Investing in Tax-Advantaged Private Equity

By Brian Buehler
Triton Pacific Securities

Understanding the complexities of private equity and how value is created in such investments are the first steps in investing in an asset class that is gradually becoming more accessible to individual investors. Private equity is often ruled out of a portfolio, but it shouldn't be. As long as investors understand the risks and have no short-term liquidity needs, there are several ways to participate in a private equity investment.

Equity investments from various sources provide capital for businesses during the growth stages of a company. The earliest stage, often referred to as the seed stage, typically relies on investments from friends and family, or angel investors. The seed stage is often the riskiest time for any new business, as their brand and/or product are not yet widely known by consumers. This is followed by the early stage, when venture capital firms may infuse capital to help an organization grow and establish its brand identity. Later, when a company reaches $10-$50 million in revenue, private equity firms are the likely candidates to take a company through its expansion stage to help provide additional growth and position the company for an ultimate sale or listing. In this position, private equity firms often hold a controlling interest and typically will have meaningful influence over the future direction of the company.

Private equity firms invest in a wide variety of industries, including: consumer, financial, energy, healthcare and business services—and the investment opportunities seem endless. There are more than 200,000 companies across the United States that have at least $10 million in annualized revenue; however, less than 7% of these companies are backed by private equity firms.[1]

Creating value is often the main objective in any business venture, and private equity firms are no different. They strive to drive the business and create value through two areas—deal origination/transaction execution and portfolio oversight.

- *Deal origination/transaction execution* involves creating, maintaining and developing relationships with mergers and acquisitions intermediaries, investment banks, and others to secure both high-quality and high-quantity deal flow. This is followed by comprehensive due diligence and assessment of management, the industry, historical financials and forecasts, and a valuation analysis.
- *Portfolio oversight* occurs upon the acquisition or investment in a company. It involves oversight and support of the firm's various portfolio companies and their management teams. In this role, a private equity firm may walk a young company's executive staff through best practices in strategic planning and financial management. Additionally, it can help institutionalize new accounting, procurement and IT systems to increase the value of its investment, preparing the company for a future sale or public listing.

For example, the quick serve restaurant ("QSR") industry is a $500+ billion-dollar industry that encompasses over 50% of restaurant sales nationwide.[2] Typically, when these QSR's are sold by a small owner/operator to a large private equity firm, the locations are consolidated into a large operating platform. When this occurs, economies of scale and efficiencies are created across the portfolio of QSR locations which, in turn, can lead to increased revenue and profitability. The critical functions a private equity firm can perform in a QSR portfolio are the strategic alignment of a franchisor, and improving capital and operating efficiencies.

Private equity firms typically gather the funds necessary to invest in a company from a group of investors, either on an individualized basis or through a private investment fund that is created. Many sophisticated investors have become accustomed to allocating a portion of their equity investments into private equity and other alternative investment classes as a means of diversification; however, it's important to note that these investments may carry with them additional risks that are inherent to their business nature

Triton Pacific partners with companies in high growth or rapidly changing industries. They focus on solid management, operational excellence, efficient capital structure and a sound business model. They provide their portfolio companies with a commitment of time, valuable insight, access to resources and capital. They are flexible in their investment structure and responsive to the needs of their portfolio companies.

and the stage of growth a company is in. Liquidity, market, operational and funding risks are all areas that need to be considered before making an investment into any private equity venture.

As an asset class, private equity has consistently outperformed the public markets. Looking at data from the 1980's, 1990's and 2000's, private equity funds exceeded S&P 500 returns by roughly 3% per year.* Once those differentials start compounding, the total return over a 20- to 25-year period can be two to three times greater.[3] Since 2000, public pension funds and other investors have made allocations into private equity funds because they have generated strong returns in their investment portfolios.[3] Private equity may offer low market correlation with higher return potentials; an active-management investment style; and portfolio diversification.

From a tax perspective, private equity is appealing because its normally structured as a limited partnership, which provides favorable tax treatment for long-term, capital gains and allows investors to bypass standard income tax brackets.[4] Furthermore, many private equity funds allow investments from an investor's IRA or other qualified account, which will defer the capital gains taxes due until an investor begins pulling money from these accounts for retirement.[5]

As with all investments, there are risks and liquidity characteristics that need to be carefully considered when evaluating any private equity investment. However, due to the size and scale of the 'untapped' private equity market, there seem to be endless opportunities for investors to consider. Low market correlation, investment return potential, portfolio diversification and favorable tax treatment of private equity investments provide a compelling reason for investors to consider this as a potential asset class.

*The Cambridge Associates Index is not transparent and cannot be independently verified because Cambridge Associates does not identify the funds in the index. Because Cambridge Associates recalculates the index each time a new fund is added, the historical performance of the Cambridge Associates Index is not fixed and will differ over time from the data presented in the chart. Funds included in the Cambridge Associates U.S. Private Equity Index report their performance voluntarily and are unidentified and unaudited, and therefore the index may reflect a bias toward funds with track records of success.

This material has been prepared for informational purposes only, and it is not intended to provide, and should not be relied on for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction. This whitepaper does not constitute an offer to sell or solicitation of an offer to buy any security. Offers are only made through an offering memorandum or prospectus to qualified investors and only in jurisdictions where permitted by law. Investments referenced herein may involve a high degree of risk and may not be suitable for all investors. Any potential investor should carefully consider the "Risk Factors" described in the applicable investment's offering memorandum or prospectus before investing. Past performance does not guarantee future returns. No representation, guarantee or warranty is provided as to the correctness, completeness or timeliness of information provided in this message, which information has not been prepared to meet the reporting standards of any regulatory, association or trade organization, has not been independently verified, may be based upon assumptions, may change without notice and should not be relied upon in making an investment decision.

Securities offered through Triton Pacific Securities, LLC/Dealer Manager/Member FINRA/SIPC. ▲

References

1. National Center for the Middle Market. Number of U.S. companies with at least $10 million in revenue.
2. The NPD Group/Fall 2015 ReCount and GE Franchise Finance.
3. http://alphaacademyedu.com/key-topics-wht-is-private-equity
4. https://www.investopedia.com/articles/investing/072215/how-private-equity-and-hedge-funds-are-taxed.asp
5. https://www.pensco.com/blog/tax-advantages-of-investing-in-private-equity-with-your-ira#.XchpFVdKiM8