

## MORE FANFARE FOR THE COMMON INVESTOR, PLEASE INVESTING IN TAX-ADVANTAGED PRIVATE EQUITY

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 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 million to \$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, health-care 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 percent of these companies are backed by private equity firms<sup>1</sup>.

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 merger and acquisition 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 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-plus billion industry that encompasses over 50 percent of restaurant sales nationwide<sup>2</sup>. Typically, when these QSRs are sold by a small owner/operator to 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 that a private equity firm can perform in a QSR portfolio is 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 and the company's stage of growth. Liquidity, market, operational and funding risks are just some of the 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 1980s, 1990s and 2000s, private equity funds exceeded S&P 500 returns by roughly 3 percent per year<sup>3</sup>. Once those differentials start compounding, the total return over a 20- to 25-year period can be two to three times greater. 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. Private equity may offer low market correlation, with higher return potential 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. 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. However, most qualified account holders cannot benefit from deducting losses if their qualified account loses value.

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.

#### Sources

1. <https://www.ft.com/content/e089cd78-d223-11e9-a0bd-ab8ec6435630>
2. <https://www.qsrmagazine.com/reports/qsr-50-9>
3. <https://cepr.net/images/stories/reports/private-equity-performance-2016-06.pdf>

\*This information is not intended to be, nor should it be construed or used as, financial, legal, tax or investment advice or an offer to sell, or a solicitation of any offer to buy or sell an interest in any private placement. No offer or solicitation may be made prior to the delivery of appropriate private placement offering documents to qualified prospective investors. This information does not take into account the particular investment objectives or financial circumstances of any specific person who may receive it. More complete disclosures and the terms and conditions relating to an investment in a particular private placement is contained in the proper set of offering documents. Before making any investment, prospective investors should thoroughly and carefully review offering documents with their financial, legal and tax advisor to determine whether an investment is suitable for them. An investment in any particular private placement is not suitable for all investors.