Introductory Notes: Private Equity
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"Where you stand depends on where you sit."
Miles's Law

Before we begin
These notes are a living document, updated on an ongoing basis and represents an introduction to the world of M&A, valuations, restructurings, and private investments, with a focus on practical application. The following pages are written from my perspective of a professional investor. Surely, a consultant's, a regulator's, an advisor's, or an academic's perspective would differ in substantive ways.

In terms of sources, I have drawn on my doctoral studies as well as my experience in private equity (Mutares, CUDOS Capital, Castle Harlan), management consulting (BCG), and investment banking (Bank of America). My perspective is also particularly impacted by classes I took at Yale University from Michael Schmertzler and the late David Cromwell, both of whom I am grateful, and intellectually indebted, to.

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Road map
Before we meet in the (virtual) classroom, I would like you to have a certain level of familiarity with the subject matter, so that we can hit the ground running. These notes will give you a grasp on the vocabulary of the field and will give you a taste of the basics. Since your familiarity with finance varies given your backgrounds, these notes are mostly aimed at those of you who are new to finance. The time you spend with the coming pages should therefore be inversely proportional to your familiarity with the subject. Then in class, we will build on this basis, take on a case, and have an in-depth discussion.

The framework we'll take in class is the iteration of valuation-restructuring-valuation. On the front end of a private investment, one conducts a valuation from a buyer's perspective. Then, the hard work of the turnaround or restructuring phase begins and lasts throughout the holding period, until the eventual exit. In order to have a successful exit, a seller has to be even more finely attuned to the valuation of the business that is being sold than that one being acquired. The usual rule of thumb applies—you want to buy low and sell high, but that's much easier said than done.

[1] Apart from substantive improvements, which are always welcome, a wise man once told me that typos in any document are an infinite set contained in a finite one. **Hall of fame** of people who have provided valuable feedback improving earlier versions this document: Andreas Meier, Ernest Tseytler, Johannes Metzger and (placeholder for **YOU**).

Jargon

Every field of knowledge erects barriers to entry to keep "the uninitiated" out. Therefore, we should first make sure we use the same language consistently. To that effect, see below a list of important terms of art that we will use to communicate in this class. Hopefully, (almost) all are already familiar to you from prior classes.

Acceleration

The condition whereby, upon an event of default debts become due and payable immediately. This condition is written in the debt contract.

Accounting

The language of finance and valuation. While it may sometimes deviate from the true economic picture of a business (e.g., some young businesses with negative earnings but fast growth may indeed be good investments). Still, it is a starting point for quantitative modeling and a measuring stick for financial success. The accounting is usually confirmed in the annual report by a quasi-independent third party, the auditor.

Active investors

Generally, anyone who does not just "buy the market" by, e.g., buying an index ETF. In private equity someone who has at least some control over a portfolio company, appoints director(s) to the board, and gives advice and assistance to the company.

Adverse selection

The phenomenon whereby, the differential information of the buyer and the seller results in the former getting a bad deal. For more information, google "the market for lemons."

Advisor, investment banker

A professional intermediary paid to write the book and run a process. Big companies are represented by investment banks, smaller companies usually go with boutique firms or the advisory arms of, e.g., the Big 4 accounting firms.

Appraiser

An external party paid to provide a usually quantitative valuation of an asset. Usually hired out of reporting necessity. Active investors like doing their own valuations.

Arm's length

An agreement as would be customarily negotiated by two self-interested parties. The opposite would be collusion or self-dealing.

Articles of association, bylaws

Foundational corporate documents that set out the rules and procedures of a corporation. These can make a corporation more valuable in the hands of one investor than another. Devil's in the details.

Asset

In addition to what's found on the active side of the balance sheet, this may refer to a company as a whole.

Backward induction
A game theoretic concept which unravels the strategic interaction (or a "game") starting at the last stage and moving in the reverse order of actions. A useful in determining what others may do in a business situation. E.g., "if we cut prices, the competition will too, and we both will lose money, so we should not cut prices."

Beta
A coefficient of covariance between a publicly traded company and the total public equity market, as represented by a proxy. A vital input when determining the WACC.

Bid, binding bid, indicative bid
An offer from a buyer, binding or not, indicating their willingness to pay a certain amount of money for a given company. Can be phrased both in terms of EV or equity value.

Board (of directors)
The governing body of a company, responsible for the hiring and firing of the CEO and, potentially, other top management. The directors have fiduciary duties to the company. Note: in Europe there is often the dual structure of a management board and a supervisory board, the latter being the final arbiter within the company.

Board minutes
A protocol of what is said during board meetings. Well-kept minutes are a basic step in good corporate governance.

Boiler plate
Standard language in a legal contract. See: documentation, legalese.

Bond
A widely held debt security much more common for big companies in the US. In Europe most institutional lending is done by commercial banks.

Book, (Confidential) Information Memorandum, CIM, Info Memo
A marketing document for a company that is being sold (see: process).

BP (pronounced "bips"), basis points
A basis point is one hundredth of one percent. Most interest rates are quoted in basis points over a reference interest rate, such as EURIBOR.

Breakup fees
Money payable in case a deal falls through. Sellers love contracts that include breakup fees, buyers don't.

Breach
A violation of a contractual term. Most commonly a breach of a debt covenant, resulting in technical default.

Bridge loan
A debt facility used as interim financing during and shortly after closing to finance the transaction in the short term until long-term financing is being finalized.

Business ethics
A sometimes-overlooked aspect of being in private equity. You often interact with people more than once, so it is smart business to treat others with the dignity, respect, and fairness you'd like to be extended to you.

Buyout, Leveraged buyout, LBO
A transaction in which a company, usually a financial sponsor, acquires another, the target, using a significant portion of debt (bonds or loans) to finance the acquisition. The assets of the target are often used as collateral.

Capital structure
On the passive side of the balance sheet, this refers to the long-term financing of the company with debt and equity. The choice of funding sources and instruments can impact the value of the company significantly.

CAPM
The capital asset pricing model. The theory behind the systematic pricing of publicly traded securities, and, by extension, all securities (esp. in an efficient market). While the empirical results for the CAPM are iffy, practitioners use it for lack of a better tool. For some academics the CAPM borders on religion.

Carried interest, carry
The portion of the investment profit payable to the general partner once an investment or a fund is harvested.

Cash flow
Money coming into or coming out of the business. Hopefully the inflows far surpass the outflows.

Cashout, Sale, Exit
Other than an IPO, one of the two main ways that sponsors liquidate their investments.

Change in / of control
A significant ownership change that triggers (usually unpleasant) legal consequences, such as losing tax carryforwards and giving banks the right to accelerate loans they have provided in the past.

Clawback
The ability to recoup disbursements already made. For example, if a fund with a clawback option makes a profit on one deal but a loss on another, the GP may have to return some of the carry received on the first deal.

Claim, senior claim, junior claim
A claim on a company or an asset is the right, under specific circumstances, to receive money from that company. Within debt securities, senior claims get satisfied in full first, before junior claims are. Equity is the residual claim of a company, meaning that once all debt (a.k.a., fixed claims) are satisfied, equity retains all remaining proceeds. There may be different tiers on the equity side, too.

Closing
The event which signifies the end of a process. Some documents are signed, money and ownership change hands. Usually followed by a closing dinner at a fancy restaurant, where recently adversarial negotiating parties have a good time together.

Closing mechanism
The final steps of a deal closing are prescribed very carefully and painstakingly in the SPA. The main types are "closing accounts" and "locked box." Devil's in the details.

Collateral, lien thereon
Security taken for the extension of debt financing. For example, my bank has my flat as collateral for the mortgage loan that it has extended to me. Pro tip: never take collateral that eats, e.g., a racehorse.

Comp, Comparable company / transaction
Used in determining "relative value." A similar company that is traded on the public markets or one that has was recently acquired.

Control
Corporate control is usually exercised by a party that owns 50% plus one share of the company's common equity (or an equivalent thereof, such as registered capital). That said, more limited control can be exercised in a company by shareholders that may not have the majority but may have enough ownership to veto decisions or appoint a single board member.

Convertible debt
A debt contract that, under certain predetermined conditions, may be converted into (common) equity.

Corporate structure
The legal entity form, and ownership relationships.

Covenant, negative or affirmative
Statements in a legal document that set out what the parties may not or must do over the life of the contract.

Data room, virtual data room, VDR
A repository of information about a company that is being sold. During the due diligence process, a seller sets up a VDR for select finalists to get to know the company in full detail.

DCF, Discounted cash flow
A mathematical method used to calculate what the future stream of returns a company is projected to generate are worth today. Used in determining “absolute value.”

Deal
A transaction. Either the purchase or the sale of a company. Sometimes subsets, such as the sale of a business unit or a major debt raise may be referred to as deals. See: process.

Deal flow
The stream of potential investment opportunities for a fund.

Debt-free cash-free (basis)
When companies are acquired, the payment that changes hands is usually the EV plus the cash on the balance sheet minus the financial debt. See equity bridge.

Debt service
Like a Lannister, paying your debts. On time, and don’t forget the interest.

Deal structure
The key terms and conditions of a private equity deal, as set out in a term sheet. At a minimum this includes the price, all the financial instruments, and the parties who are investing in these instruments.

Debt, debenture, loans, notes
Capital provided to a company at a fixed or quasi-fixed (e.g., EURIBOR-based) rate for a fixed period of time. The most common form of debt is a bank loan.

Default, cash default, technical default
Any breach of a debt contract. A cash default is a missed payment. A technical default is a breach of a covenant. Such an event alerts a lender to focus on the company in trouble before the problems spiral out of control.

Devil’s in the details
Very small changes in the wording of a deal can have a very big impact on the economic outcome for the parties. Therefore, it is important to read through documents carefully and consider the impact even seemingly unimportant details.

Dilution
If an investor, who has previously invested in a company does not participate in a subsequent financing round (or does so in less than their pro-rata share), then their percentage ownership of the company diminishes, an outcome known as dilution.

Discount rate, discount factor
Mathematical parameters used in determining the DCF value of a company.

Documentation
Every deal is, legally speaking, a set of contracts that set out the terms in excruciating detail. The more specific the detail, the better. See: Legalese, Devil's in the details.

Downside, loss
Refers to the liability a party can have in an adverse situation. Limited liability allows companies to cap out the downside to the capital that is in the company. Unlimited liability allows creditors to go after the personal assets of the owners/managers.

Drag along right
The right to force other pari passu investors to sell when you sell (usually subject to terms and conditions).

Due diligence
The process through which a buyer familiarizes itself with the company that is being sold. This involves studying the VDR, talking to management and doing their own independent research, often with the support of external advisors (lawyers, management consultants, tax advisors, auditors, etc.). It is an understatement to say you drown in information during a DD – in addition to the financial, legal, commercial, HR, etc. information available on the VDR, you get to ask lots of clarifying or explorative questions. The value of the ability to parse through this ocean of information cannot be overstated.

Dumb money
Derogatory terms for investors who are not knowledgeable about their actions.

Duty of care
The fiduciary duty mandating that a director exercise reasonable effort to make informed decisions on behalf of the company.

Duty of loyalty
The fiduciary duty mandating that a director act in the interest of the company, even when that interest is in conflict with, e.g., the director's personal interests.

Early/Late stage
Mostly used in a startup context. The maturity of a business (which, at least in theory, inversely correlates with the riskiness of investing in the business).

Earnout
A means for aligning incentives. If a buyer is concerned about overpaying for a company, they can offer part of the consideration paid for it at a later time under the condition that the purchased business performs as expected. The seller "earns out" that extra payment, fully or partially, if the business indeed performs as agreed.

EBITDA, EBIT, Earnings before interest, taxes, (depreciation, and amortization)
EBITDA stands for "earnings before interest, taxes, depreciation, and amortization." EBIT, all but the last two. These are measures of the income of a company, that are both easily obtainable from a company's financials and thought a truer reflection cash flow than net

income is. Companies' enterprise values are often quoted as a multiple of forward or trailing EBITDA. Please note, even these metrics can be manipulated.

EPS, Earnings per share
Net income divided by the number of shares outstanding.

Escrow
A function usually performed by a lawyer or another intermediary that the parties trust. The escrow agent is tasked with receiving the consideration being exchanged (most commonly money and company shares) and then forwarding these to the respective parties. This alleviates the risk of one party reneging in the middle of a deal and pocketing the money of the other side.

Equity, shares, (common) stock, common, registered capital
A residual claim on the assets of the company after all fixed claims are satisfied. In a philosophical sense, these are the true owners of a company. In a practical sense, as long as the company is not in default, the equity holders are the ones controlling the company.

Equity bridge
A calculation that reconciles the enterprise value offered for a company and the equity value which is paid to the seller. Sounds simple in theory, but the devil's in the details.

EV, enterprise value
The main measure of the value of a company, abstracting from capital structure decisions. Usually comprised of the equity value (or market cap) plus the financial debt (but not trade debt) of a company. If you're feeling lazy, Bloomberg calculates these on a consistent basis for public companies.

Exclusive
An exclusive deal is one where the two parties have agreed to only work with each other. Sellers dislike exclusives (because of the price effect of the competitive dynamics) and often require breakup fee arrangements to enter into an exclusivity arrangement, and even then, it is usually for a limited period (known as the exclusivity period).

Fair value
The theoretical worth of an asset that someone should be willing to pay. Different valuation methods are devised to approximate fair value in the real world (e.g., DCF, comps, etc.).

Faith, good faith, bad faith
In this context not a religious concept. A party negotiating in good faith truly wants to come to an agreement. A party negotiating in bad faith only pretends to do so.

Fraud, dishonesty
Something to be avoided in both counterparties and the management you hire. It is dangerous and costly to do business with people who do not subscribe to sound business ethics. The ability to tell con men apart is acquired through (painful) experience.

Fiduciary
A relationship involving trust, whereby one party relies on another to act properly on its behalf.

Financial ratios
Calculations of relative size and relationships of income statements and balance sheet items, in financial analysis.

Financial reporting standards
Rules passed by accounting industry bodies which constrain companies in how they can report their operations in a consistent transparent manner.

Financials
Refers to the income statement (a.k.a. P&L), balance sheet, and cash flow statement of a company and the attendant notes and clarifications. It is the quantitative measure of the past of a company's business and is usually projected into the future to determine the value of the business.

(Right of) first offer
The right to make an offer to buy stock from a seller before anyone else does.

(Right of) first refusal
The right to buy stock from a seller before the seller can dispose of the shares elsewhere. Usually, a party holding a right of first refusal can wait to see what terms others are willing to offer before sweeping in to buy. This can discourage other potential buyers. See: poison pill.

Follow-on, round, tranche
Companies don't usually receive all of their equity financing at one point in time. As they grow, they may need further equity financing, either from existing or from new investors.

Fund, Sponsor, General Partner, GP
These terms all refer to a firm, which manages (a family of) funds. A sponsor raises capital from private investors (also known as limited partners or LPs) and invests that in portfolio companies. For its efforts, a GP is remunerated with annual management fees (usually 2% of the capital committed) and carried interest (a percentage, usually 20%, of the profit generated over the lifetime of the deal). Note the carry is not calculated on the profit of the target, but on the cash return to the fund. The usual compensation scheme for a GP is hence referred to as 2/20.

Good management
The critical element in most private companies. For investors, good managers are people, who among other things, are honest and always keep their promises. The ability to judge the difference between good management and otherwise is the single most important skill of successful private equity investors.

Governance, ESG, Environmental, social, governance
Investors place an increasing focus on procedural matters such as a business's environmental sustainability, social responsibility and commitments and good governance. This includes but is not limited to striving for a gender balance on the board and a transparency of corporate actions.

Gremlins
Every deal features unexpected problems. They hide, usually in plain sight, make themselves known at the worst possible moments, and often lead to long nights at the office. David Cromwell used to call these gremlins.

Haircut
In this context, not something done by a coiffeur. A haircut is the difference between the value of collateral and the amount lent against it, a type of a security buffer not unlike the margin being posted on certain leveraged trading accounts.

Home run
A very successful deal. The term is borrowed from baseball.

Hostile takeover
A takeover against the wishes of current management. Most investors do these rarely as they take special planning, nimbleness, and skill, invariably result in the quick ouster of management and an immediate reset and restructuring.

Impact investing
Investing that has goals other than a cash-on-cash return. Promoting ESG goals can be a common non-pecuniary investment focus.

Insider information
A.k.a., material non-public information. Knowing something important about a company that others don't, because of your position of trust, e.g., as a board member of the company. Acting on insider information for your financial benefit is a blatant violation of business ethics (and fiduciary duties if such have been assumed) and are likely to result in a prolonged stay in public housing, a.k.a. prison. Google Martha Stewart. Some insider information may be OK in purely private deals.

Investment committee
Most financial sponsors have a governing body that makes the final decision on new investments. Those are comprised of senior partners and may include trusted advisers.

Investment grade
Refers to a debt instrument (vernacularly applied to companies as well). Signifies a credit rating of BBB-/Baa3, considered the lowest non-speculative credit risks.

IPO, initial public offering, going public
A process that results in a preciously privately held company starting to trade on a public market, such as the NYSE or Euronext. While privately held companies' equity value is

observable only at rare valuation events (sales), publicly traded companies in liquid markets see their values updated in real time.

IRR, internal rate of return
A popular return measure that ignores the size of an investments but focuses on the timing of cash flows and the relationship of the positive to the negative ones.

Junk (bonds), high-yield bonds
Bonds rated below BBB-/Baa3. High risk but high return.

Legal jargon, legal language, "Legalese"
To reiterate, every private equity deal is a set of legal contracts. Thus, an understanding of the language in which these contracts are written, together with its business implications and a certain facility to craft such contracts, is very important for the job.

Leverage
Debt. The more debt a company has, as a share of total capital, the more leveraged it is. Debt usually attracts a lower rate of return, called interest, which is tax deductible. To its advantage, debt ranks higher in the waterfall of claims.

Long position
A financial position such that the one holding it profits from increasing prices.

M&A, Mergers and acquisitions
The act of purchasing another company, usually aided by advisors and/or investment bankers. For a classic movie, see *American Psycho*.

MBO, Management buyout
A rare form of buyout, where management pays the other equity holders out and continues both running and owning the business.

Money multiple
A popular return measure that ignores timing and focuses on total amounts instead. If I put in €100 in an investment that paid off €350, my money multiple is 3.5x.

Moral hazard
The closer you are to a business, the more you know about it and this may skew your incentives. Owners know more about a business than outsiders and the mere act of wanting to sell a business should make you ask why. This is related to, though separate from both insider information and the winner's curse. A good due diligence is aimed at decreasing the informational asymmetry and resulting moral hazard, as are contractual mechanisms, such as earnouts. Note – moral hazard describes *individually rational* pathological behavior.

NDA, non-disclosure agreement
The parties to this agreement exchange sensitive information necessary for them to engage in a potential deal but promise to do so only for the purposes of the matter at hand. NDAs

are customary, but hard to enforce in a court of law. Execute them as a precaution, but mostly try to do business with people with whom you wouldn't need them.

NOLs, net operating losses
Past losses can be a valuable asset inasmuch as they can shield future profits from taxes, increasing the cash flows of a company.

NPV, net present value
A popular return measure that takes into account both the return characteristics and the volume characteristics of an investment. This is the correct theoretical measure of return but requires a stance on some modeling inputs (e.g., the correct discount rate).

NI, Net income
Or net loss in bad times. The "bottom line" of a business. An accounting measure of the amount of money a company has generated over a given period of time.

OCF, Operating cash flows
Cash generated in the normal course of business.

Option
The right but not the obligation to buy or sell an object (usually company stock) to another market participant or a contractual party. Option theory is a rich field that can warrant a full class in its own right. Important parts of this theory are the Black-Scholes option pricing model as well as the binomial options pricing model.

Paper, securities
Generic terms for debt or equity.

Paper profit
A profit that is the result of the value of a security, rather than a realized cash outcome. The last is called a realized profit. People with large paper profits are known to sleep less soundly at night.

Pari passu
In the same position ("in the same boat") as another investor, with respect to both rights and liabilities deriving from a company.

Passive investors
The opposite of active investors. More often than not, dumb money.

Payback period
A popular return metric. The answer to: How quickly do I recoup the value of my investment and start generating profit? Measures that pay back under a year are "quick wins."

P/E, price to earnings ratio
An important financial ratio. It divides the equity price (or market cap) by net income.

Poison pill
A corporate measure meant to preclude a hostile takeover.

Portfolio, portfolio company
Sponsors raise funds, or pots of cash, that are then invested to buy a number of companies, together referred to as a portfolio, and individually as portfolio companies.

Privilege
Communication with your lawyers is confidential because of this right.

Pre-money (valuation)
The valuation of a business immediately before a capital increase.

Post-money (valuation)
The valuation of a business immediately after a capital increase. The difference between the pre-money and the post-money is the investment (the “money,” Lebowski).

Pricing
Setting an agreed value for all the equity of a company, usually in connection with new equity to private investors or to the public in an IPO.

Pro rata
A proportional share of an obligation or an investment.

Process
A live deal. Any uncompleted transaction that is actively being worked on.

Reps & warranties
Facts about the company and its circumstances that management or sellers say are true in the legal documentation of a private equity deal.

Retainer
A cash fee paid to advisors to secure their engagement to help a company complete a deal. The company pays this fee at the beginning of a professional engagement. Compare and contrast with: Success fee.

Road show
The ritual of visiting institutional investors to offer them debt or equity securities that will be newly issued. A stressful time for investment bankers and top management.

Share classes, e.g., preferred stock
A company may issue different types of equity that differ in economic claim or voting rights. Many companies, including Google and Berkshire Hathaway have different classes of equity.

Short position
A financial position such that the one holding it profits from decreasing prices.

Signing
The culmination of a transaction. Once signed, the transaction is final subject to regulatory approval, if necessary. Once that's granted, the closing takes place.

Sources and uses of capital
A structured representation of the funds that are necessary for a transaction and the purpose for which they are earmarked. E.g., Sources: €50 bank debt, €50 equity; Uses: €80 payment to the sellers for 100% of the shares, €20 growth capital (new manufacturing equipment).

SPV, special fund vehicle, box, entity
Funds and individual investments are usually segregated in dedicated legal entities for the purposes of corporate and tax structuring. Each of these entities is a special purpose vehicle. The optics of the great financial crisis were even worse given the unfortunate names that bankers had picked for SPVs. If you ever need to name one, go with a boring choice.

Strategic investor
A company, engaging in M&A activity, which has an existing operational business.

Strategy
A concept on which entire courses can be taught and hundreds of books have been written. In general, any long-term plan of action, complete with "what if" scenarios for unlikely actions of the competition or surprising events, is a strategy.

Strike price
For an option, the threshold price at which the option becomes valuable, or "in the money."

Success fee
A payment charged only if the service performed is successful. Investment banks, for example, typically only charge fees out of the proceeds of successfully executed deals.

Syndication
If an investor does not take on a deal by itself, usually for risk diversification reasons, and instead forms a group of investors, that jointly take on the investment group, this group in known as a syndicate. Often large bank loans are syndicated across multiple banks.

Synergies
Situations in which the whole is more than the sum of the parts. For example, after a merger, the combined entity may eliminate unnecessary costs (e.g., by eliminating duplicate roles) and get a boost to revenues (e.g., by cross-selling the products of the acquired business to existing customers). Synergies are often overestimated by outside consultants and over-zealous buyers.

Tag along right
The right to force the sale of your share to a buyer at the same terms he has bought from a fellow pari passu investor.

Takeover
The act of changing corporate ownership. Takeovers are usually negotiated between an interested buyer and a motivated seller in a setting where management is also informed and properly motivated. In rare occasions these are done against the wishes of management—these are known as hostile takeovers.

Term sheet
Before a due diligence is conducted and legal documentation is drafted, the businesspeople on both sides summarize the terms of the business agreement they are aiming at. Term sheets are meant to commit the understanding in writing so as to minimize miscommunication and avoid unnecessary rounds with the lawyers. These are not only applicable in sales processes, but also may appear as a precursor to any legal document. They are usually not binding.

Trade sale
A sale of a company to a strategic buyer (a large corporation, usually in the same or an adjacent industry). Strategic buyers, unlike financial sponsors, have other operations. The business combination of the acquired and existing businesses can lead to synergies, and hence strategic buyers are often willing to pay more than financial sponsors.

Turnaround
Taking a company that is not doing well and, through a series of improvement measures, putting it back on track to be a profitable business. This is not unlike buying a flat in a bad condition, refurbishing it, and selling at a profit. Some private equity funds specialize on such opportunities, but they are not as abundant, as it may seem at a first glance.

Vesting period
A period of time that must pass before something happens, e.g., before management becomes entitled to their stock options. Vesting may also depend on (legal) milestones.

Volatility
A measure of statistical variability (or “noise”) around a trend.

WACC, Weighted average cost of capital
A vital input in a DCF calculation, this is the appropriate discount rate for a given capital structure.

Warrant
The right, but not the obligation, to acquire company shares directly from the company (as opposed to ones from another market participant—these are called options).

Winner’s curse
The situation, in which the party that submits the highest (and therefore winning) bid overpays for the asset.

Working capital
Inventory, accounts payable, and accounts receivable. Working capital is necessary for the running of the business, “tied up” in it. Inventory and accounts receivable cost cash, while accounts payable free cash up (by borrowing from suppliers).

Yield, yield curve
An interest rate, usually a quoted one. Graphing the yields for different time horizons traces the yield curve.

Zero
A type of a bond (a.k.a. zero-coupon bond). Also, the return one receives if they are unwilling to take risk.

Basics 1: Industry

What is private equity?
Private equity is the practice of buying and selling companies that are not available on public markets. While the biggest companies are usually public (like Apple or amazon), and thus anyone with a brokerage account can buy a share of the future profits of the company, sizeable companies have chosen to remain private. These are often owned by families (e.g., Swarovski or Böhringer-Ingelheim) or by financial sponsors, who specialize in buying, operating for some time, and then selling companies. These funds are driven by a profit motive—while they usually manage other people's money the business is only interesting for them if they generate significant value appreciation for their LPs. In short, private equity is primarily about cash-on-cash return.

The three sources of return are operational improvement / growth, multiple expansion (buy low / sell high), and financial engineering (loading a company with debt, which is low-return and deductible for tax purposes). As the know-how to do the third one has become a commodity and the sophistication of the players have put pressure on the second, more and more funds are looking to operational improvement to deliver a high return.

Thus, in order to generate a high return, a PE professional must be good at valuation and restructuring. Valuation to be able to understand and measure the value of an asset, so as not to overpay when buying or be undercompensated when selling. Restructuring (or strategic turnaround management), so as to be able to create value with the business during the holding period.

Industry characteristics
Private equity is populated by professionals who have done a variety of different jobs prior to PE. These include legal professionals, investment bankers, and management consultants. It is also not uncommon for managers of portfolio companies to make the jump into a PE fund, e.g., as operational partner.

PE funds vary in size from the tens of billions (e.g., KKR, TPG, Apollo, Bain Capital) to smaller, local players, one of which is CUDOS. Funds may focus on particular industries or geographies and over time have built up the know-how to add value to their portfolio companies in a variety of ways. A reliable base of investors and proprietary deal flows are two other keys to success.

On the most general level, private equity is a sub-class of illiquid alternative investments.

Risk / reward
Whether through operational leverage (risky industry or business model) or financial leverage (a high leverage ratio), private equity funds enter into high-risk investments and work hard at mitigating the inherent risks, so as to generate superior risk-adjusted returns. Their success is rewarded with a management fee, which especially for small funds, is sufficient to run operations, but not to get rich, and a carried interest, typically 20% of the profit of the limited partners. This "carry" can be in the millions of Euros and is the proverbial pot of gold at the end of the private equity rainbow.

Basics 2: Facets

As part of the PE process, an investment professional has to focus on different facets of the job at different times. It is hard to combine all of the skills below.

Fundraising
Without the ability to attract LPs, a PE fund cannot get off the ground and begin the cycle of buying and selling companies. Because of this, PE funds are usually started by people who have a far-reaching network of trusting investors, who are willing to trust the manager with their money. These senior individuals usually have a track record of successful investments in the past that demonstrate that they know what they are doing (and will hence not be the blind leading the blind, a.k.a., dumb money).

Often times anchor investors in funds are large organizations that are institutional investors in their own right. Examples of such investors are university endowments, insurance companies, and funds of funds. To alleviate the moral hazard with respect to the skill of the PE manager, it is helpful if he or she co-invests in their own fund (i.e., “has skin in the game” and “eats his own cooking”). Even a limited investment in the fund may give investors comfort as long as it is a substantial portion of the personal assets of the PE manager.

Negotiations
Key for everything, a strong negotiations background allows a fund to buy cheaper, sell more dearly and create more value for the business. An often-overlooked side of negotiations, however, is the ability to listen to the other side and make strategic concessions, in a way that optimizes value. Creative solutions, which include earnout provisions, are more of an art than a science.

Legal
In keeping with the theme that every deal is just a set of legal documents, the ability to read through and pick out key information from documents is essential. Knowing which provisions matter and which don’t for economic value goes a long way to being able to negotiate effectively by conceding some issues but insisting on others. Most practitioners acquire their legal acumen “by osmosis.” The key message here is that a trusted competent lawyer is indispensable for anyone engaged in PE. A stitch in time saves nine.

Modeling / Valuation / Determining business economics / Accounting
This is the “hard numbers financial analysis” aspect of the job. It is an indispensable as supporting analysis for negotiations. It involves mastering the various techniques of business valuation—comps, DCF, etc. and applying them in a way that forces the practitioner to “put their money where their mouths are.” It is also vital for understanding the business and playing a “game of follow the dollar”—investigating how a dollar of revenue flows through the income statement and how much results in profit.

Turnaround / Restructuring
Some funds (*cough cough*) have made their names on buying thrash and turning it into gold. This transformation process is akin to running an in-house management consulting team, sometimes supported in key spots by actual consultants. The goal is to take a business that

may have struggled in the past due to mismanagement and institute good management practices. This may take many forms—including, but not limited to hiring and firing staff, renegotiating contracts, acquiring additional companies, and changing the focus of the business. Having a clear business strategy is vital. Failing to plan is planning to fail.

Project management / Due diligence

Every process is a project, which involves multiple parties (the different employees of the fund itself, auditors, lawyers, etc.) that have to work toward a common goal under a customarily compressed timeline. The ability to retain a big-picture view and coordinate all of these parties is a prized skill that few have mastered.

Communication

Last but not least, there is the art of communicating within the team and to the outside world in ways that promote the right image. Efficient internal communication, both written and verbal, allows the team to work seamlessly and effectively.

Outside communication supports the fund's efforts, e.g., in hiring the right type of employees. Networking can also be seen as part of external communication and is an important means of fundraising and generating a proprietary deal flow, which in turn helps a fund buy assets more cheaply than it would in competitive processes.