MACKENZIE Investments | Northleaf

Your guide to investing in private equity

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Why private equity?

Private equity (PE) is a broad, well-established and rapidly growing asset class that involves the purchase of equity in companies that are not publicly traded. Private equity sponsors (also known as general partners or GPs) typically control these companies and combine them in portfolios alongside other private companies in private equity funds. They also provide hands-on management to improve business operations with the aim of eventually selling these companies for a gain.

Private equity returns typically come in the form of capital gains upon the sale of portfolio companies, either into the public market or to another strategic or private owner.

Generally, investors seek out private equity for its substantial total return potential, as well as its lower volatility and lower correlation compared to publicly traded equity investments.

In this guide, we'll explore:

1. What is private equity and why is it growing so fast?
2. How does private equity work?
3. What are the different kinds of private equity?
4. How do managers access private equity?
5. What does it take to be a successful private equity manager?
6. How does the valuation of private equity funds work?
7. What are the key risks associated with private equity investing?
8. What is Mackenzie's view on the future of private equity?

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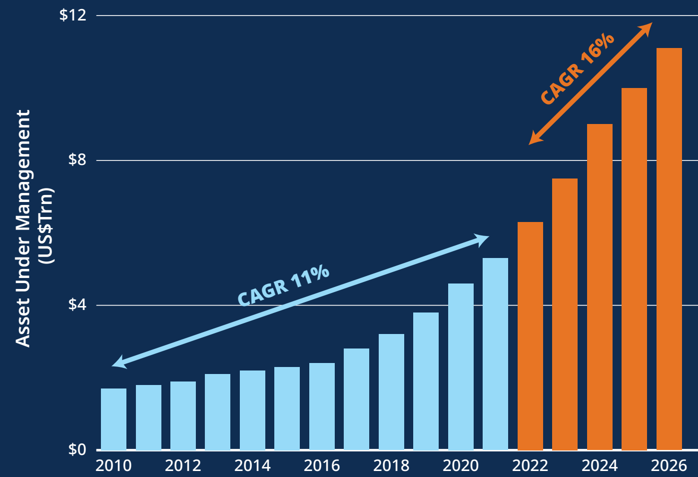
A well-established asset class on the rise

Private equity investing has been around since at least the 1960s. Over the past 10 years, growth has accelerated as private equity has gained widespread acceptance as a mainstream asset class. According to data from private markets data firm Preqin, private equity's growth rate is poised to accelerate further in the years ahead, driven by a broadening investor base, improvements in access to the asset class and increased allocations among investors in response to strong returns and on-going volatility in public equity markets, among other factors.

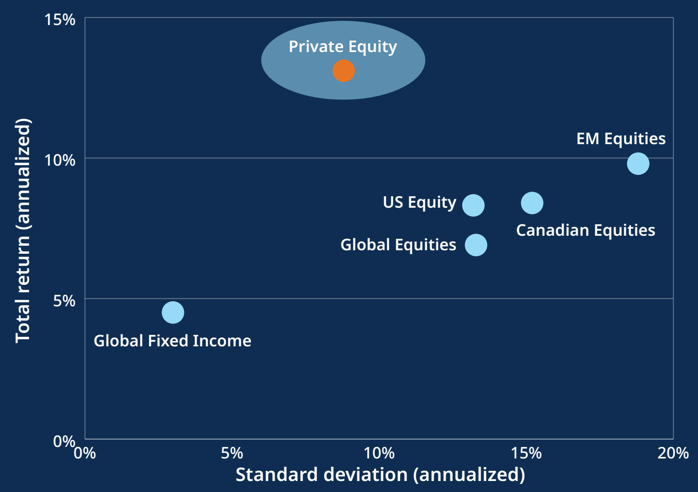
Private equity is sought out by investors for its enhanced total return potential and relatively low volatility compared to publicly traded equity investments. Over the past quarter-century, private equity has delivered mid-teen annual returns — several percentage points ahead of public equity markets. At the same time, volatility, or risk, has been between that of public global fixed income and equity markets.

Growth of private equity AUM (US$Trn)[1]



Private equity vs. public markets[2]

Total return vs risk



1 Source: (1) 2021 figure is annualized based on data to March. 2022-2026 are Preqin's forecasted figures.
2 Sources: Private equity data provided by Cambridge Associates. Public market indices provided by Morningstar Direct. Private Equity: Cambridge U.S. Private Equity Index (Legacy), Canadian Equities: S&P/TSX Composite TR, US Equities: S&P 500 TR, Emerging Markets: MSCI EM IMI NR, Global Fixed Income: ICE BofA Global Broad Market TR HCAD, Global Equities: MSCI World NR. Time period, 10/01/2001 – 09/30/2021. Private equity returns are shown net of fees, expenses and carried interest. Data denominated in CAD.
Standard deviation is a measure of how much an asset's return varies from its average return over a set period of time and is commonly used to assess volatility in investment funds.

A well-established asset class on the rise *(cont'd)*

Although the world's financial media focuses almost exclusively on publicly traded companies and markets, the world of private companies is considerably larger in terms of investment opportunities. Private markets offer significantly greater depth than public markets, as there are many more companies in the world that are privately held than are publicly listed. This is true for businesses at the large end of the spectrum and even more so for medium and smaller sized companies. Investment in private equity offers investors the opportunity to participate in the significant amount of global business activity and value-creation that occurs outside of the public markets.

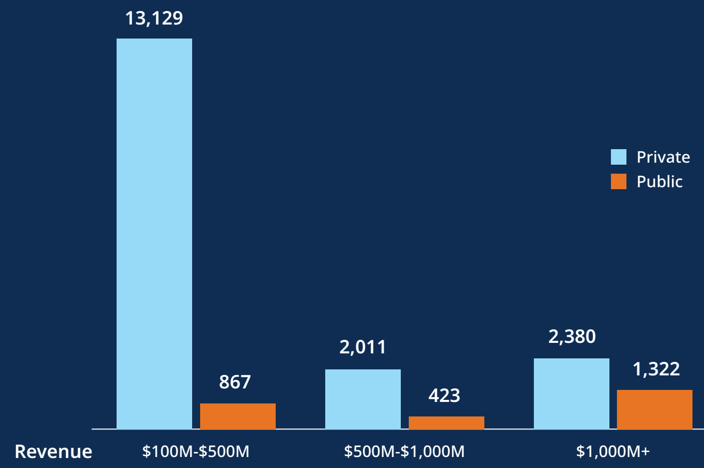
Private equity can also bring significant diversification benefits to portfolios, given its limited historical correlation to traditional asset classes.

	Correlation to private equity[1]
Private Equity	1.00
Canadian Equities	0.23
US Equities	0.57
EM Equities	0.27
Global Fixed Income	-0.28
Global Equities	0.55

Canadian pension plans and other large institutional investors have recognized the enhanced risk/return potential available from private equity investment, including the opportunity to capture an illiquidity premium. These characteristics help explain why institutional investors have increased allocations to private equity over the past decade and why it currently occupies a significant portion of their overall portfolios.

Expanded opportunity set[2]

(based on US companies)



Private equity allocations at Canadian pension plans[3]

	2010	Current
CPPIB	12%	27%[4]
Ontario teachers	11%	23%[5]
CDPQ	11%	18%[6]
PSP	12%	16%[7]
OMERS	12%	16%[8]

1 Sources: Private equity data provided by Cambridge Associates. Public market indices provided by Morningstar Direct. Private Equity: Cambridge U.S. Private Equity Index (Legacy), Canadian Equities: S&P/TSX Composite TR, US Equities: S&P 500 TR, Emerging Markets: MSCI EM IMI NR, Global Fixed Income: ICE BofA Global Broad Market TR HCAD, Global Equities: MSCI World NR. Time period, 10/01/2001 – 09/30/2021. Data denominated in CAD.
2 Source: Northleaf, Capital IQ, as of February 2021
3 Data from annual reports, 4 As of March 2021, 5 As of December 2021,
6 As of December 2020, 7 As of March 2021, 8 As of December 2021

The private equity process

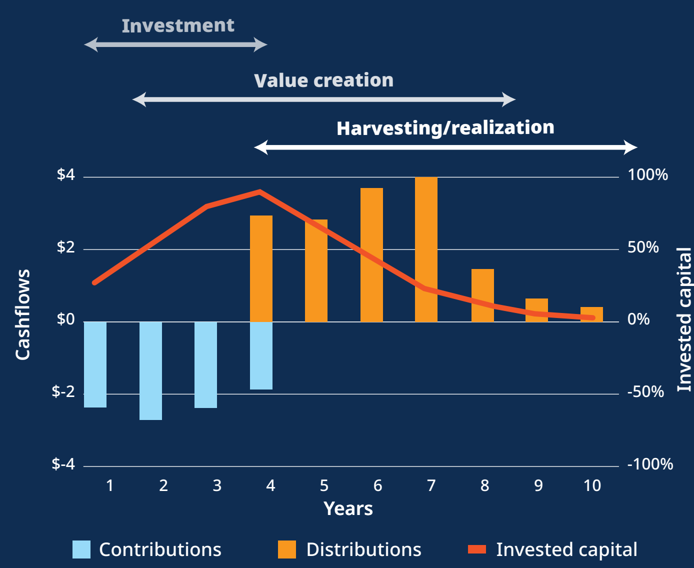
A private equity fund is typically created by a general partner (GP) who is responsible for sourcing and executing the investments. The most successful GPs often have specific sector expertise, operational and other capabilities that allow them to create value through active management of their underlying portfolio companies. The GP will raise money from limited partners (LPs) — private equity investors who provide most of the capital to finance acquisitions.

After an initial fundraising period, the life cycle of a traditional private equity fund can be broken down into three stages:

- **Investment phase:**
  Transactions are sourced and privately negotiated. Capital is gradually called into the fund to finance acquisitions from investors who made capital commitments during the fundraising period.
- **Value creation phase:**
  Net asset value growth is driven by organic growth strategies, mergers and acquisitions, operational/profitability improvements, management team additions and in selective instances restructuring. These initiatives are focused on improving the business' growth, financial performance and outlook.
- **Harvesting/realization phase:**
  The transformed companies are sold, gains are realized, and cash is distributed to investors. The typical lifespan of individual private equity investments is 4-7 years.

Illustrative investment lifecycle and cash flow profile[1]

Representative $10 million commitment to a fund. Figures in US$ millions



1 Source : Northleaf Capital Partners

The private equity process *(cont'd)*

Structure

Traditional private equity funds are structured as **closed-end funds**. Investment capital is raised during an initial fundraising period and called from investors as opportunities are identified. Investors achieve liquidity over time as companies are sold following value-creation. Capital and any gains are returned to investors over a typical 10-year fund life.

Private equity funds can also be structured as **open-ended funds**, and this is becoming more available in the retail investor market. These funds differ from closed-end funds, in that they:

- Accept new capital on an ongoing basis with limited or no capital call requirement.
- Have a seeded pool of private assets to which new investors immediately gain exposure.
- Can have a perpetual lifespan.
- Offer regular but limited liquidity to investors.

These funds generally seek to maintain a mix of investments at each stage of the traditional private equity fund life cycle, which allows for a measure of liquidity. They may also utilize some public market investments to provide additional liquidity.

The importance of manager selection

The scale and diversity of the opportunity set in private equity, combined with the inefficient and asymmetric flow of information in the market, have resulted in a meaningful dispersion of returns between the most skilled and successful managers and those that are lower performing. This dispersion of returns is particularly pronounced in the small/middle market where additional returns have historically been achieved by top quartile managers.

The most successful managers can add value across all stages of the private equity process:

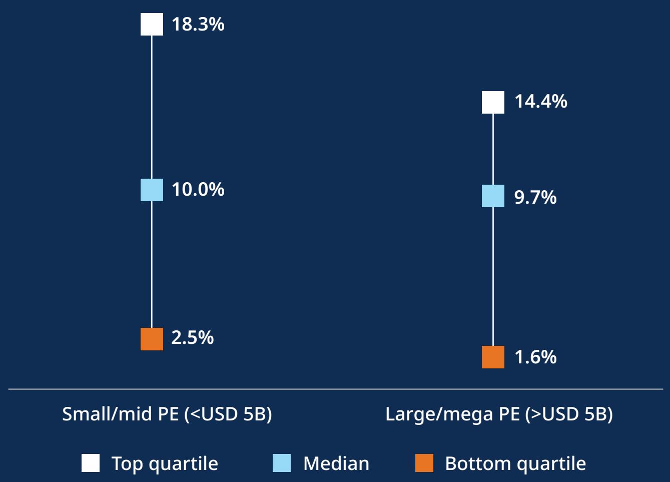
- **Investment phase:** sourcing the most attractive transactions and negotiating/structuring the best deals.
- **Value creation phase:** driving superior company performance through strategic mergers and acquisitions, product development and marketing initiatives, and operational and financial improvements.
- **Harvesting phase**: preparing companies for exit and timing exits appropriately.

Given the significant excess returns generated by top quartile managers, manager selection and diversification are particularly important in the private equity asset class.

1 Source: Burgiss Private IQ, JP Morgan Asset Management; data as of June 20, 2020. Includes buyout and expansion capital funds for vintages 2006 to 2019

Returns of private equity funds by size

Mid-market private equity has historically outperformed larger transactions



Private equity strategies

Private equity can be split into four broad categories, each with their own unique risk and return characteristics, which tend to focus on companies at different stages of their life cycles. Private equity sponsors (GPs) will typically have expertise in and focus on one of these areas.

Private equity - Investment strategies

Venture capital

- Early-stage companies looking to convert a new solution into a commercial result
- Zero/Lower use of leverage
- Target return: 25%+
- Relatively high risk

Growth equity

- More developed companies looking to scale a viable product and increase revenues
- Lower use of leverage
- Target return: 15-20%+
- Medium-high risk

Buyouts

- Mature companies looking to optimize operations in an established industry
- Higher use of leverage
- Target return: 13-20%+
- Medium risk

Special situation

- Later stage companies that are struggling operationally or financially
- Higher use of leverage
- Target return: 15-20%+
- Medium-high risk

Company stage

For illustrative purposes only. Target return information is provided for general guidance and should not be relied upon when making investment decisions.

How investors can access private equity

Private equity can be accessed in three different ways as detailed below. Investors will often invest across this spectrum to build diversified exposure to underlying private equity.

Direct investments	Primary investments	Secondary investments
• Directly purchasing the equity in a private company. • Requires manager expertise and active ownership. • Highly concentrated exposure to a single asset.	• Capital commitments are made to GPs during the initial fundraising period. • Investors do not have visibility into the ultimate private assets (blind-pool risk) and capital is deployed over time as opportunities are identified. • Typically have the longest duration. • Investors select GPs based on specific geographic, sector or other expertise. • A typical primary buyout fund will give investors exposure to 10-15+ companies over the course of the full fund cycle.	• Accessing companies that are already under private equity ownership at a later stage of their value-creation cycle. • Often achieved through purchasing units in mature private equity funds. • Full visibility on the underlying companies being acquired. • May also buy equity directly or indirectly in companies already under private equity ownership in partnership with the existing sponsor. • Typically have a shorter lifespan than primary funds, and a quicker path to liquidity.

Valuation

Private equity investments are relatively illiquid because there is no public market for the underlying securities. The asset class is suitable for investors who have a longer time horizon, as their ability to redeem their funds will be limited. This limited liquidity is generally compensated for by a higher expected return — also known as an "illiquidity premium".

Private equity investments are usually valued at regular intervals, such as quarterly, semi-annually or annually, with a lag of between 30 and 90 days. This infrequency of valuation and prioritization of longer-term financial projections contribute to the lower volatility of private versus public market investments, which are priced continuously through a trading day and may fluctuate in response to investor sentiment and other factors that may have relatively little impact on individual company performance.

The process to determine fair value for these investments can vary depending on the fund, but they all tend to follow generally accepted accounting principles (GAAP).

The following approaches to valuation are common:

- **Discounted cash flow**
  Involves forecasting the expected cash flows from a business into the future, applying a discount rate based on company risk factors and adding them up to arrive at a net present value.
- **Transaction comparables**
  Determines appropriate valuation multiples (price to earnings, price to cashflow, price to sales, etc.) based on observable transactions involving similar companies in the private markets.
- **Public company comparables**
  Determines appropriate valuation multiples based on comparable publicly traded companies.

Fees

Private equity funds typically charge a management fee. These fees typically support the resources that private markets managers need to source, structure and manage transactions.

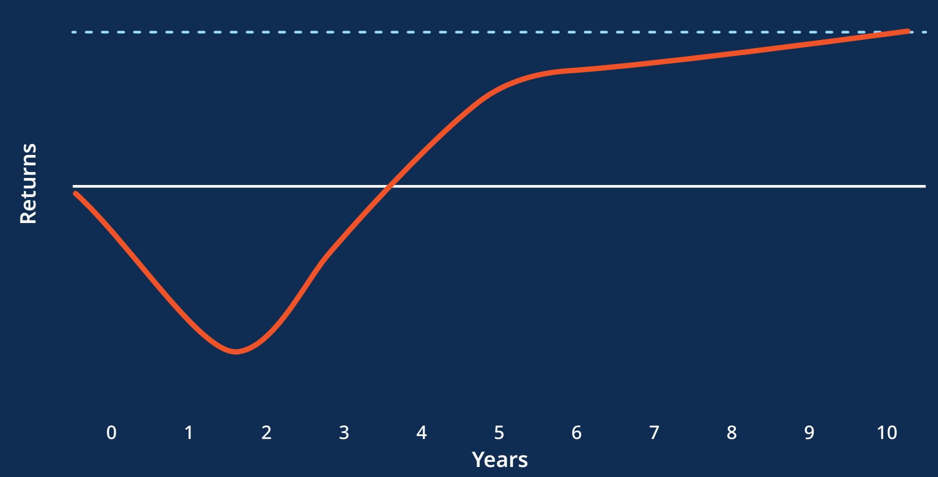
Additionally, private equity managers typically charge a variable performance fee that increases with fund performance. This type of fee structure provides an incentive for a GP to deliver strong returns and aligns the interest of fund managers with fund investors. The variable performance fee often is subject to a hurdle rate – this is a minimum return that must be achieved prior to the performance fee being earned.

Understanding the J-curve

The performance life cycle of a traditional closed-end private equity fund often forms a "J-curve" as management fees are charged on the amount of committed capital (rather than the net asset value) and accrue during the investing phase while the GP searches for transactions. Additionally, the early value creation phase on an investment will involve investment into the business (such as capital outlays, technology investments, etc.) to allow for accelerated growth over time.

The steeper increase in value occurs as company growth accelerates and can often be concentrated as mature portfolio companies are sold. The J-curve effect can be mitigated by investing in a broadly diversified pool of private equity investments with diversification across vintage years.

J curve



For illustrative purposes only

What are the key risks of investing in private equity?

Equity risk

Equity investments are inherently risky. If a company held in a private equity portfolio underperforms, it should have its valuation reduced, which will affect investor returns. This risk can be mitigated in a fund through diversification across different sectors.

Broader economic factors, such as growth and inflation, can also affect underlying company performance and company valuations. The private market valuation process described above generally helps insulate investments from the kind of volatility seen in public equities, but it does not eliminate the general risk that comes with the ownership of businesses in an uncertain economy.

Liquidity risk

Liquidity refers to the ease and speed with which an investment can be bought or sold. Investments in private companies typically take time to mature, as the GP implements operational improvements to raise the profitability of the businesses in the portfolio. It is essential to understand that investing in private equity requires the ability to commit capital that the investor does not require for several years.

With no active secondary market, it can be difficult and/or expensive for a private equity manager to sell a position to another party to raise cash to fund redemptions. The average expected holding period of businesses inside a private equity fund will also affect the amount of liquidity which may be available for investors. It is in the best interest of investors for private equity funds to offer limited and structured redemption terms aligned with the liquidity of the underlying portfolio. It is crucial for investors to understand the liquidity characteristics of a private equity strategy before investing, as this will affect their ability to redeem units should the need arise.

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The democratization of private equity investing

The demand for private equity has never been higher and it is now generally seen as an essential building block of a well-diversified portfolio.

Private market investments still generally remain out of reach for retail investors, but there is reason to be optimistic about the democratization of this asset class.

Innovations in product design are making private equity investing more accessible and more liquid, with reduced investment minimums. Private equity offers a range of strategies investors can use to complement public market investments to produce better absolute and risk-adjusted returns.

As the capital markets continue to evolve, and investor demand for alternative investments continues to grow, we are confident that more and more retail investors will be able to benefit from the substantial value creation and attractive returns generated by private equity.

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