

Private Equity

Material #3

What is private equity?



Broader than buyouts

Private capital in privately held companies, usually through a professionally managed fund. The asset class includes buyouts, growth equity and other private-company strategies. Buyouts matter because they combine company-level value creation with financial structuring.

Control and involvement

Investor.gov explains that private equity funds often take controlling interests in operating companies and actively participate in their management and direction.

Private equity across the company life cycle

Greater company maturity →

1

2

3

Venture capital

Young companies in early development. Returns depend heavily on future growth and market expansion.

Growth equity

Established businesses with proven products and markets that need capital to expand.

Buyout equity

Mature businesses where investors can acquire control. Starts from an operating business: cash flow, debt capacity, valuation, improvements.

The sources of return differ by stage, so each strategy needs its own analysis.

The private equity ecosystem

Limited Partners

Provide capital but generally don't manage individual investments: pension funds, endowments, foundations, insurers, family offices, sovereign wealth funds, other institutions.

The fund

Pools capital and invests it in a portfolio of companies.

10+ years

typical investment horizon per Investor.gov. Investments are relatively illiquid.

General Partner

- Sources investments
- Performs due diligence
- Negotiates transactions
- Manages portfolio companies
- Realizes investments

The private equity investment lifecycle



Each stage carries its own risk. A strong thesis can still fail through:



Exits include a strategic sale, another financial sponsor, or a public-market transaction.

Enterprise value and equity value

$$\text{Enterprise value} = \text{Equity value} + \text{Debt} - \text{Cash}$$

Enterprise value €500M

Equity value €350M

Net debt €150M

$$\text{Equity value} = \text{€500M} - \text{€200M debt} + \text{€50M cash} = \text{€350M}$$

Enterprise value

The operating business, independent of how it is financed.

Equity value

The residual belonging to shareholders after debt and cash.

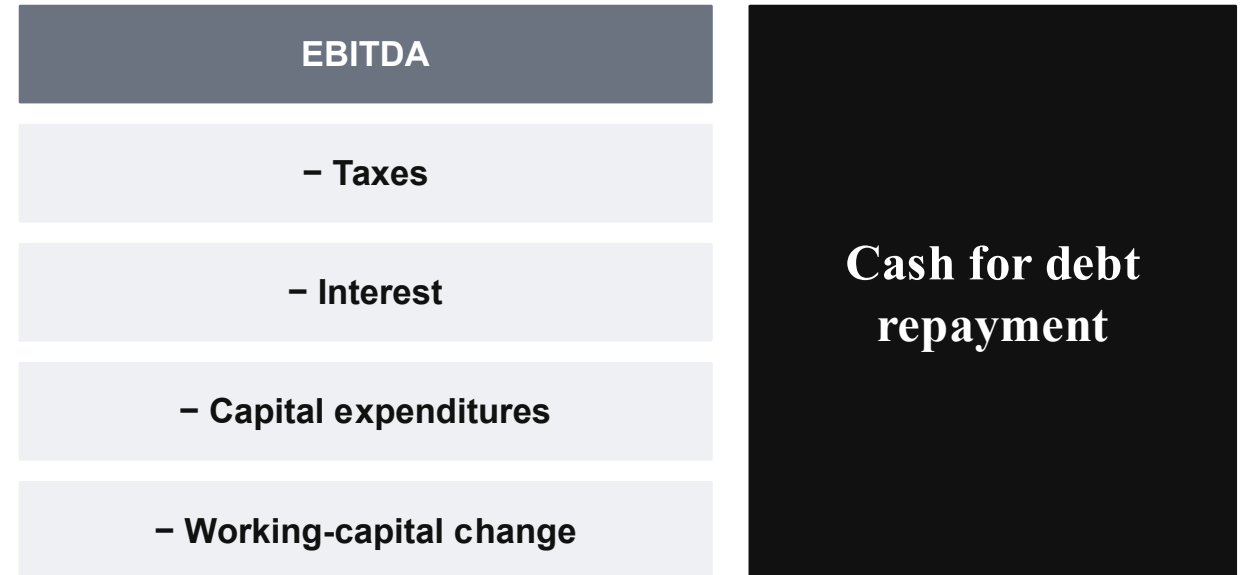
EBITDA and free cash flow

10.0x

$$\text{EV} \div \text{EBITDA} = \text{€500M} \div \text{€50M}$$

EBITDA: earnings before interest, taxes, depreciation and amortization. Used to compare operating performance and set valuation multiples.

But EBITDA is not cash flow



Strong cash conversion is what lets a leveraged company support its financing and build equity value.

The leveraged buyout

Purchase company



Finance with debt + equity



Operate company



Repay debt



Sell company

At purchase: EV €500M

Debt €300M

Equity €200M

After repaying €100M of debt: EV still €500M

Debt €200M

Equity €300M

**Debt repayment transfers
operating cash flow into equity
value.**

The CFA Institute identifies significant debt use and subsequent repayment from company cash flows as central features of LBO investing.

Sources and uses

Uses

- Purchase of target equity
- Refinancing existing debt
- Transaction expenses
- Other acquisition costs

=

Sources

- Sponsor equity
- Term loans
- Bonds or other debt
- Other financing instruments

€600M needed – €350M debt = €250M equity

Total sources = Total uses. This sets the initial capitalization and so affects the sponsor's potential return.

Debt, leverage and debt paydown



Equity €200M → €450M

Gain of €250M: €150M from enterprise-value growth, €100M from deleveraging.

The downside

If performance deteriorates, fixed debt obligations remain: less value for equity, with potential refinancing or covenant pressure. Decide how much leverage the cash flow can safely support.

The four major sources of LBO returns

1

EBITDA growth

The business is worth more because earnings increase.

2

Multiple expansion

Sold at a higher valuation multiple than the purchase multiple.

3

Debt paydown

Operating cash flow cuts debt, raising the sponsor's equity value.

4

Operational improvement

Margins, pricing, productivity or working capital improve.

Bought and sold at 10x EBITDA means no multiple expansion, yet the return can still be attractive if EBITDA grows and debt falls. This separates business improvement from valuation change.

Operational value creation

Better pricing	Cutting unnecessary costs	Sales productivity	Wider distribution
Better procurement	Technology investment	Adjacent markets	Durable, not temporary, savings

EBITDA €50M × 10 = EV €500M

€500M

EBITDA €70M × 10 = EV €700M

€700M

+€200M

from operating improvement, not multiple expansion

Value depends on durability and whether the investment needed is economically justified.

The complete LBO example

At entry

EBITDA × multiple

€50M × 10x

Enterprise value

€500M

Debt

€300M

Sponsor equity

€200M

Five years later: EBITDA €70M × 10x

Exit EV €700M

Less remaining debt

– €200M

Exit equity value

€500M

Sponsor equity invested

÷ €200M

MOIC

2.5x

€200M EBITDA-driven EV growth

€100M debt reduction

Actual IRR depends on the timing of the investment, exit and any interim distributions.

IRR, MOIC and the importance of time

$$\text{MOIC} = \text{Total investment proceeds} \div \text{Total invested capital}$$

Both investments return 2.0x on €100M → €200M



MOIC measures the multiple of capital; IRR the annualized return implied by cash-flow timing.

The SEC notes that financing techniques such as subscription lines can raise reported IRR by changing the timing of investor cash flows, without necessarily raising the fund's total economic return.

Purchase price and entry multiple

$$\text{Entry multiple} = \text{Purchase enterprise value} \div \text{EBITDA}$$

Two identical businesses, each with €50M EBITDA



Bought at 8x



Bought at 12x

The same earnings need more capital

The 12x buyer needs substantially more capital. A high multiple can still work if the company grows rapidly, but it raises the burden on future performance.

Is the price justified?

By growth, cash generation, competitive position and realistic exit assumptions.

Exit multiple and exit strategy

Strategic sale

Sold to another operating business.

Sponsor-to-sponsor

Another private equity firm acquires it.

IPO

Listed company; sponsor sells shares over time, subject to restrictions.

Recapitalization

New financing structure; may distribute capital without a full sale.

Exit EV = Exit EBITDA × Exit multiple

$$€70M \times 11x = €770M$$

The gap between entry and exit multiples can materially change returns. A robust case shouldn't depend entirely on multiple expansion.

Due diligence

Commercial	Financial	Operational	Legal, tax and regulatory	Management
Market, customers, competitors, pricing, market share, growth opportunities	Historical earnings, revenue quality, margins, working capital, capex, EBITDA sustainability	How the business actually functions and where it can improve	Liabilities and constraints that could affect the investment	Whether leaders have the capabilities and incentives to execute

The purpose isn't only to confirm the company is attractive, but to find assumptions that could make the investment case fail.

Quality of earnings and cash conversion

Reported EBITDA



Quality of earnings analysis



Sustainable earnings for valuation

Unusual revenue

One-time expenses

Customer concentration

Accounting adjustments

Acquisitions

Cost savings

Cash conversion

EBITDA can be strong while free cash flow is weak if the business needs heavy capex or working-capital investment. Debt repayment depends on cash, not accounting earnings.

How much reported operating profit can realistically become cash to reinvest or repay debt?

Risk in private equity

Leverage risk	Debt increases obligations and magnifies changes in equity value.
Operational risk	Growth, margin or cost-reduction targets are missed.
Valuation risk	Purchase price too high, or exit multiple lower than expected.
Liquidity risk	Private companies can't be sold as easily as listed securities.

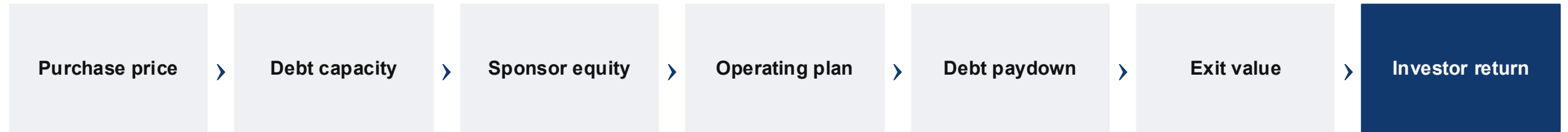
Also

Refinancing	Interest rate
Customer concentration	Regulatory
Management	Execution

Investor.gov stresses illiquidity and the need to understand fund fees, expenses and potential conflicts of interest.

Source: [1]

The investment committee decision



Downside analysis: what if...

- EBITDA growth is lower?
- Margins don't improve?
- The exit multiple contracts?
- Rates rise or refinancing costs more?

The committee tests competitive position, sustainable cash flows and realistic improvement opportunities.

A strong investment doesn't need every assumption to be optimistic. It should stay attractive under a range of reasonable scenarios.

The complete private equity framework

1

Business

Fundamentally attractive, defensible, with sustainable cash generation?

2

Market

Growing, stable or structurally deteriorating?

3

Entry valuation

Is the price justified by EBITDA, cash flow, growth, comparables?

4

Financing

How much debt without excessive financial risk?

5

Value creation

Which actions can raise EBITDA and cash flow?

6

Deleveraging

How much debt can realistically be repaid?

7

Exit

Who could buy it, at what valuation, in what conditions?

8

Return

Attractive risk-adjusted return after price, leverage, fees and timing?

The core private equity return relationship

Equity value at exit = Exit enterprise value – Net debt

Exit enterprise value = Exit EBITDA × Exit multiple

Investor return = Exit equity value ÷ Initial equity investment

Attractive returns should ideally come from improving the underlying business and generating cash, not depending entirely on leverage or a higher valuation multiple.