

# FOUNDATIONS OF PRIVATE EQUITY

## B7457

Summer 2020

**DRAFT**

**Marc Kitten** (London) will teach the Friday-Saturday program and 8 modules of the Saturday program.

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**Donna M. Hitscherich** will teach 4 modules of the Saturday Program (if in class).

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**Office Hours:** Mondays by appointment Teaching Assistant contact information on Canvas

**Teaching assistant:** TBD

### Course Information and Required Materials:

Private equity is primarily the investment of capital in the equity of private companies to fund growth or in public companies to take them private. This elective examines the role of private equity from both aspects: as a financing tool and as an investment opportunity. It reviews the critical issues that the parties involved in a transaction (investors, lending banks, managers, entrepreneurs/shareholders and advisors) will face during the investment process and their negotiations. Topics covered include industry organization, fundamental analysis of investment situations and drivers of value creation, use of applications and models by industry professionals.

Private Equity is not a “pure” finance course. While the section discussing valuation contains quantitative work, the focus will be on analytics, including numerous qualitative factors.

This course is offered over the Summer 2020 semester (12 sessions of 3 hours each). **The class is for 3 credits.**

Students must have the following materials for this course:

1. Private Equity Case Materials (Marc Kitten & Donna M. Hitscherich © 2020) (the “PE Case Materials”). The PE Case Materials will be provided electronically and contain the lecture notes for the associated Modules set forth below
2. Articles posted to CANVAS or distributed by the professor prior to the class sessions (collectively, the “Articles”)
3. Potential materials and assignments distributed by in-class speakers throughout the semester (“Practitioner Materials”). Note that guest speakers may decide not to share their material.

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Please note the following:

1. **Class sessions will be recorded and kept available for a few weeks on CANVAS**
2. Active class participation is an important component of the course and will count for one-third (1/3) of the course grade
3. Prior preparation of materials for each and every class session is essential. In addition to the assigned readings, there will be a written assignment, generally a case study, required for each of the class sessions. Some of the written assignments will be graded and account for one-third (1/3) of the course grade and will involve both individual and group work.
4. The course will require: (a) a group presentation (the “Group Presentation”) presented during class time and (b) successful completion of an individual take-home closed book objective short answer 20-question “quiz” (the “Objective Questions” and together with the Group Presentation, collectively, referred to as the “Class Final”). The Class Final will account for one-third (1/3) of the course grade. The purpose of the “quiz” is to ensure the individual student has mastered the key foundational concepts of the class. *Each part of the Class Final is equally weighted; however, the student must achieve a grade of 65% or higher on the Objective Questions to receive a grade of P or higher for the course.*
5. This course will apply the core course standard regarding unexcused absences. *Thus, unexcused absences equal to or greater than 33% of the number of class sessions (4 classes) will result in a grade of no higher than P and unexcused absences equal to or greater than 50% of the number of class sessions (6 classes) will result in a grade of F for the course. Excused absences will follow the guidelines established by the Office of Student Affairs, including religious observance, personal, medical and family emergencies, military service, or court appearances*

The PE Case Materials along with the associated Articles and potential Practitioner Materials are designed to be self-contained and to serve as lecture materials for the designated classes. The remainder of the course materials and information—case questions, teaching notes, announcements, case and current event specific web links, and additional handouts will be found on the course web page on CANVAS. Students should plan to check the site regularly, as hard copies of materials published on CANVAS will not be made available.

Additional materials are available (and on Reserve) on the CBS Watson library website:

<http://library.columbia.edu/locations/business>

### Required Prerequisites and Connection to the Core

This course builds upon the introductory courses in finance and connects with many aspects of the Columbia Business School core curriculum. **Materials covered in this class and the pace of the class presume student familiarity with the topics covered in the core curriculum, including those set forth below.**

Core Course  
Corporate Finance

Decision Models

Financial Accounting  
Global Economic Environment  
Leadership Development

Connection to the Class  
Firm Valuation Models  
Capital Structure  
Fundamental Concepts of Decision Making  
Sensitivity Analysis  
Business Combinations  
Drivers of Business Cycles  
Negotiations

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### Course Objectives, Class Work and Module Topics

The purpose of this module is to provide a strong theoretical framework as well as practical applications and tools to business school students interested in private equity finance & investments. It covers the main topics of Raising Equity and Debt Finance, Growth Capital, LBO, and Distress. It doesn't cover the early stages of Venture Capital, in many ways a distinct topic. Through this course the students will learn about the PE markets and their latest developments, the finance instruments and structures, the valuation process, the applications of these tools in companies' acquisitions, and the role of the parties involved.

The primary objectives of the course are:

To develop knowledge of,

- The origins and organization of the private equity industry
- The various segments of PE, and how they create value
- The investment process and the importance of due diligence
- How PE funds structure deals, monitor and add value to their portfolio companies
- How they manage the exit
- The latest developments in the PE industry
- The roles and careers in the PE industry

To enhance and develop skills in,

- The evaluation of PE investment opportunities
- Private equity negotiations and deal structuring
- Valuation of LBOs

The course is intended to benefit,

- Entrepreneurs and corporate managers whose companies may seek private equity financing
- Those who wish to join private equity funds, in the areas of fund raising, deal sourcing or fund management
- Those who wish to further their careers in advisory or support services to private equity, in particular in investment banking, leverage finance, transactions services and management consulting.

Class topics will be imparted through lectures, assigned reading materials, required individual assignments, required written group case studies, and optional presentations by private equity professionals. **Students will be expected to complete each of the assigned readings prior to class and consequently, be in a position to participate meaningfully in class discussions.** Class lectures and discussions will mix the “nuts and bolts” of the private equity practice, and the practical and real world issues associated with decision making in the context of private equity.

At the conclusion of this course students will have an understanding of the topic areas set forth below gained through class presentations and the opportunity to practice many of the quantitative and non-quantitative skills necessary for success in the private equity industry.

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### COURSE OUTLINE

1. FINANCIAL SPONSORS VS. PRIVATE EQUITY – WHAT’S IN A NAME?
2. WHAT ARE THE TYPES OF PRIVATE EQUITY?
3. WHAT ARE THE BUSINESS MODELS OF PRIVATE EQUITY?
4. HOW DO YOU START A FUND?
5. WHAT VALUATION TECHNOLOGIES ARE EMPLOYED IN PRIVATE EQUITY?
6. WHAT ARE THE FINANCING STRUCTURES AND HOW DO YOU MODEL AN LBO?
7. HOW ARE TRANSACTIONS SOURCED AND ASSESSED?
8. WHAT ARE THE STEPS FROM “THE HANDSHAKE” TO DEAL CLOSING?
9. HOW IS THE PORTFOLIO COMPANY MANAGED?
10. WHAT ARE EXIT STRATEGIES?
11. HOW DOES PE DIFFER IN EMERGING MARKETS?
12. HOW IS PE EVOLVING?

### MODULE 1 - FINANCIAL SPONSORS VS. PRIVATE EQUITY – WHAT’S IN A NAME?

Questions Considered: How do we define Private Equity? What was the genesis of today’s private equity industry? What are the key differences between private equity of the 1980s and today? Who are they key players on today’s private equity landscape? What fuels competition among private equity firms today

#### Reading Assignments:

- *Case study: Middlesex in the Middle East (Imperial College working paper)*
- Review of The Barbarians at the Gate, The Wall Street Journal (January 4, 1990)
- The Barbarian Establishment, The Economist (October 22, 2016)
- The Rise and Rise of Private Markets, McKinsey Global Private Markets Review (2018)
- W. Deutsch, Equity crowdfunding is inflating a bubble, Chicago Booth Review (Nov 2018)

**Video assignment:** Blackstone Investor Day

**Reflection:** Identify and provide support for the three (3) biggest differences between the private equity industry in the 1980s and private equity industry of today.

### MODULE 2 - WHAT ARE THE TYPES OF PRIVATE EQUITY?

Questions Considered: What are the segments and their economics? What are the drivers of value creation and how do they vary? What are the relations with debt? With public capital? What are the risks to the private equity business model? Are family offices and co-investing changing the economics of private equity?

#### Reading Assignments:

- *Case study: Yale University Investments Office: August 2006 (HBS 9-807-073)*
- J. Kelly, The New Tycoons: Inside the Trillion Dollar Private Equity Industry that Owns Everything (2012) (Excerpts as assigned) - TBC

**Reflection:** Identify and provide support for each of the three (3) biggest challenges and three (3) biggest opportunities facing the private equity business model. Based on your analysis state and provide support for three (3) predictions for the future of private equity.

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### MODULE 3 - WHAT ARE THE BUSINESS MODELS OF PRIVATE EQUITY?

**Questions Considered:** what are the opportunities and the risks for investors? What is the J-curve? How do you assess the performance? Why is it different from other asset classes? Does PE provide diversification?

#### Reading Assignments:

- [L. Phalippou, The hazards of using IRR to measure performance, SSRN-id1111796, pages 1-8](#)
- [Barber and Goold, The strategic secret of PE, HBR \(Sept. 2007\)](#)
- [S. Kaplan and A. Schoar, Private Equity Performance, Chicago and MIT – Pages 1-4](#)

**Reflection:** Why is performance more difficult to assess in Private Equity than in other asset classes?

### MODULE 4 - HOW DO YOU START A FUND?

**Questions Considered:** How are private equity funds structured? Why is careful structuring in establishment of a private equity fund important? What are the key structural considerations in starting a fund? What are the legal liability differences between a “general” and a “limited” partner? What happens to the fund if a portfolio company faces legal liability from a third party? What is a private placement? What is a “fund of funds”?

#### Reading Assignments:

- [Case study: Realza Capital \(A\)](#)
- [Private Equity Funds Adopting Higher Hurdle Rates, FINalternatives \(Jul 7, 2016\)](#)
- [CVC to cut hurdle rate, Financial News \(Nov 4, 2016\)](#)

**Reflection:** What are key considerations of each of the General Partners, Limited Partners and private equity fund principals in the fund formation process?

### MODULE 5 - WHAT VALUATION TECHNOLOGIES ARE EMPLOYED IN PRIVATE EQUITY?

**Questions Considered:** What are the typical valuation techniques and what are the peculiarities? How does participation of management change the economics of the transaction? What is the holding period trade off? How does a private equity buyer stack up with a strategic buyer?

#### Reading Assignments:

- [Case study: Bain Capital's 'Take Private' of China Fire \(HEC # 116-0020-1\)](#)
- [Cannella, Technical Note on LBO Valuation and Modeling \(Columbia Caseworks 2015\)](#)

**Reflection:** How does the methodology employed by private equity buyers differ from the valuation methodology typically employed by a strategic buyer and as such, what are the most important valuation concerns for the private equity buyer relative to a strategic buyer?

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### MODULE 6 - WHAT ARE THE FINANCING STRUCTURES AND HOW DO YOU MODEL AN LBO?

**Questions Considered:** What is a “typical cap table” for a private equity transaction? How is an LBO typically financed? What are the major terms of the debt financing? What determines the “optimal” capital structure for the LBO? How are “buyouts” analyzed? What are the steps of LBO modelling? What are the legal implications?

**Reading Assignments:**

- *Case study: Midas, Asclepius and Oizys – The Tale of CVC and the Greek Hospitals (Imperial College working paper)*
- Skadden, Arps, Slate, Meagher & Flom LLP, *Impact of US Tax Reform on Mergers and Acquisitions: New Opportunities and Pitfalls (January 2018)*

**Reflection:** How have recent market conditions and legislation impacted the attractiveness of mega-buyouts?

### MODULE 7 - HOW ARE TRANSACTIONS SOURCED AND ASSESSED?

**Questions Considered:** What is an “auction”? Is it necessary to run a “process” when selling a public company? What is a “busted IPO”? What is a parallel path? What is a “no-shop”? What is a go-shop? Do go-shops add economic value for the target shareholders? What do investors first consider when assessing an investment opportunity? What is a good LBO candidate?

**Reading Assignments:**

- *Case study: Berkshire Partners: Bidding for Carter’s (HBS 9-205-058)*
- *Case study: Cannella, Dynacast: Solid Middle Market LBO (Columbia CaseWorks 2016)*
- Antoniadis, C. Calomiris and D. Hitscherich, *No Free Shop: Why Target Companies in MBOs and Private Equity Transactions Sometimes Choose Not to Buy ‘Go Shop Options’*, 88 *Journal of Economics and Business* 36 (November – December 2016)

**Reflection:** What is the role of an investment bank in the private equity deal sourcing process and how are deal sourcing and the provision of financing connected?

### MODULE 8 - WHAT ARE THE STEPS FROM “THE HANDSHAKE” TO DEAL CLOSING?

**Questions Considered:** What is the investment process? How do investors assess a Business Plan? What is due diligence? What is Commercial Due Diligence? What are the key provisions of a confidentiality agreement? What is a letter of intent and is it enforceable? What are the key provisions of a merger agreement? What are “social” issues? What is the difference between a one-step deal and a two-step deal?

**Reading Assignments:**

- *Deal making - Using strategic due diligence to beat the odds, Bain & Co. (2010)*
- D. Hitscherich, *Challengers to the Deal-Mastering Transactions Series in The Financial Times (October 19, 2006)*

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You can also consult relevant excerpts of:

- Wachtell, Lipton, Rosen & Katz, 2018 Takeover Law and Practice

**Reflection:** What are the principal differences between the acquisition of a private company target and a public company target?

### MODULE 9 - HOW IS THE PORTFOLIO COMPANY MANAGED?

**Questions Considered:** What is a “100 day” plan? How important is the “talent” component in a private equity transaction? What are the key metrics to determine portfolio company performance? What are some of the key considerations in providing appropriate incentives for the management of the portfolio company? How do you manage all stakeholders, including other investors?

#### Reading Assignments:

- *Case study: Dietswell's changing fortunes: private equity and IPO. What next? (EDHEC # 117-0047-1)*
- Transformational Ownership - CD&R - PEI Alternative Insight
- M. Fitzpatrick, K. Kellner and R. Williams, What Private Equity Strategy Planners Can Teach Public Companies (McKinsey Corporate Finance October 2016)
- H. Kazimi and T. Tan, How Private Equity Owners Lean Into Turnarounds, McKinsey Quarterly (January 2016)

**Reflection:** What are the three (3) most significant challenges facing the sponsor in the management of the portfolio company?

### MODULE 10 - WHAT ARE THE EXIT STRATEGIES?

**Questions Considered:** What is the difference between a “private” market exit and a “public” market exit? What is a secondary buy-out? What is a leveraged recap? How does the holding period of the asset impact the exit decision? How do market conditions impact the exit decision? What are the attributes of a portfolio company that make it an attractive IPO candidate? When is a parallel path strategy appropriate?

#### Reading Assignments:

- M. Ewens and J. Farre-Mensa, The Deregulation of the Private Equity Markets and the Decline in IPOs (March 8, 2018) Pages 1-6
- Gresham closing down, Financial News 09 June 2015

**Reflection:** What are the three (3) most important attributes of each of a portfolio company that is a candidate for a public market exit and one that is a candidate for a private market exit?

### MODULE 11 – HOW DOES PE DIFFER IN EMERGING MARKETS?

**Questions Considered:** What are the drivers and risks of investing in EM? Who are the main investors? What are the particularities of each of the four BRIC markets?



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### Reading Assignments:

- *Case study: Southern Cross (IESE E-115-E-0-608-015)*
- *Inside the fall of Abraaj – Financial Times (2018)*
- *J.Li, M&A Report on China, Euromoney IFLR (2019)*

### MODULE 12 – HOW IS PE EVOLVING?

**Questions Considered:** What are the lessons from the credit crisis? What are the ethical questions raised by PE ownership? What makes a company an attractive target for an activist as compared to a PE firm and do they together create a corporate governance dream? What are the recent developments in terms of fundraising, investments and performance? What are the developments to watch (regulation, retaining investors, raising new money, finding new investment opportunities)? What is the impact of Covid-10? What future for you in PE?

### Reading Assignments:

- *Banks forcing profitable firms into liquidation (extract), The Economist (2009)*
- *The Dark Side of PE (extract), CEPR (2012)*
- *Elliott Management\_ shape shifting, Financial Times (2016)*
- *How Might the Changing Face of Shareholder Activism Affect Your Company? PwC Governance Insights Center (January 2018)*

### Optional reading:

- *L. Bebchuk, A. Brav and W. Jiang, The Long-term Effects of Hedge Fund Activism, Columbia Law Review (June 2015)*

**Reflection:** Do you believe activists and/or private equity firms contribute to “good corporate governance”? If so why and if not, why not.

### Assignments, Class Final and Evaluation of Performance:

This course will require (all as more fully described on the Course Schedule and Assignment Due Dates posted on CANVAS):

- (1) Case studies prepared in groups (“Group Case Studies”) of Type A or individual assignments of Type B1 (one-third);
- (2) Class participation of Type C (“Class Participation”) (one-third); and
- (3) Class Final (one-third) composed of two parts: (a) individually prepared Objective Questions (comprehensive take home final objective short-answer questions) of Type C and (b) Group Final written presentation of Type A which will require the student group to prepare an investment proposal ready to pitch to potential investors.

*Each part of the Class Final is equally weighted; however, the student must achieve a grade of 65% or higher on the Objective Questions to receive a grade of P or higher for the course.*



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The grading rubric for each assignment is on the course website with the assignment. Due dates for the class work will be posted to the course website in the Class Schedule. *All assignments are due on the date indicated. Late assignments will not be accepted for full credit.*

### Module assignments:

Reading and other assignments must be completed prior to class. They are designed to support the course notes and case materials, which will form the basis of the class discussions. Class discussions constitute an integral part of the course and prior preparation of the assignments is essential. *Class participation accounts for one-third of the grade in this course and will be evaluated through (1) quality of contribution to class discussion and posting on weekly Discussion Boards on CANVAS and (2) class surveys and in class questions that will be answered individually by the student using interactive response ware.*

### Review Materials:

Students are encouraged to contact the professor with any questions or problems that may arise during the course. Students may set up an appointment at a mutually convenient time. Contact information is provided at the top of the syllabus.

### Course Schedule and Assignment Due Dates:

The Course Schedule and Assignment Due Dates are posted to CANVAS. Please note that while the material covered in each class session is subject to change (due to the scheduling of presentations by outside private equity professionals), the assignment due dates are not

### Integrity Code:

Students are expected to abide by the Honor Code of Columbia Business School. Accordingly, when preparing solutions to Individual Assignments, Case Studies and the Class Final students are expected to present only original work. Thus, you must not rely on the work of students who have taken the course previously, students in other sections of the course, solutions posted on the internet, etc.

For the avoidance of doubt, reproduced below are the Individual and Group Work Guidelines as set forth in the Honor Code of Columbia Business available at:

<https://www8.gsb.columbia.edu/honor/definitions>

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### Individual and Group Work Guidelines

TYPE	DESIGNATION	GRADE	PREPARATION OF SUBMISSION	DISCUSSION OF SUBMISSION*	DISCUSSION OF CONCEPTS**
A	Group Work	Same grade for all group members	By the group	Permitted to discuss (within group)	Permitted
B1	Individual w/ Discussions of Concepts and Submission	Individual grade	Individual preparation	Permitted to discuss; sharing solutions or submission files is not allowed	Permitted
B2	Individual w/ Discussions of Concepts Only	Individual grade	Individual preparation	Not permitted to share/discuss solutions or submission	Permitted
C	Individual	Individual grade	Individual preparation	Not permitted to share/discuss solutions or submission	Not permitted***

\* Submission means any work and/or output pertaining to the specific assignment. If an assignment submission contains a calculation or decision related to a specific set of data and setting, discussing the details how to make this calculation or decision with regard the data/setting is to discuss the submission. Providing another student with a draft of the calculation or decision is sharing the submission.

\*\* Concepts mean any ideas, examples, readings, or other related materials from the class/course. Conceptual discussion should not be based on a specific set of data or setting related to a calculation or decision required in the assignment, but could be based on other related examples, preferably those from class/course materials.

\*\*\* As no conceptual discussion is permitted, Type C is akin to a take-home exam.

### Other Administrative Issues:

Class Attendance/Lateness: It is expected that you will come to class on time and stay for the full period. **In addition, please note that this course will apply the core course standard regarding unexcused absences. Thus, unexcused absences equal to or greater than 33% of the number of class sessions (4 classes) will result in a grade of no higher than P and unexcused absences equal to or greater than 50% of the number of class sessions (6 classes) will result in a grade of F for the course.** Excused absences will follow the guidelines established by the Office of Student Affairs, including religious observance, personal, medical and family emergencies, military service, or court appearances.

Laptops and Other Electronic Devices: Laptops and other electronic devices are permitted during in-class sessions but must be used exclusively for the class work. Emailing, streaming, social networking or other non-relevant activities are not allowed.

Zoom: for online class, please turn your video on. Leave your microphone muted when not talking to the class.

Name Cards: In physical classes, please bring your name cards to all sessions. For online classes, ensure that your name appears with your video.

Resumes: Your professional experiences before business school will greatly enhance the learning experience. Accordingly, please share relevant experiences with the class on CANVAS.