LM03 · INVESTMENTS IN PRIVATE CAPITAL · LOS A, B, C

Investments in Private Capital: Equity & Debt

CFA Level I · 2025 Curriculum

What Is "Private Capital"?

Capital that flows to companies **outside of public securities markets** — either as equity ownership (private equity) or as loans (private debt). It's how mid-sized companies grow, how buyouts happen, and how startups fund themselves before going public.

The Private Capital Universe — Two Branches

PRIVATE EQUITY

Equity Investments in Private Companies

Ownership stakes in private companies — or public companies taken private. Investor shares in the upside (and downside) through equity.

3 categories: Leveraged Buyouts (LBO), Venture Capital (VC), Growth Capital

PRIVATE DEBT

Loans to Private Entities

Debt financing to companies that can't access traditional bank lending or choose private credit for speed and flexibility. Fixed return profile.

5 categories: Direct Lending, Mezzanine, Venture Debt, Distressed Debt, Unitranche

How Private Capital Differs From Public Markets

FEATURE	PUBLIC MARKETS	PRIVATE CAPITAL
Liquidity	Daily exchange trading	None — locked up for years
Holding period	Flexible (minutes to decades)	Long holding periods
Information	Public filings, limited depth	Full access — investor is insider
Control	Vote but rarely influence	Active involvement, often board seats
Valuation	Live market prices	Appraisal / transaction-based
Exit	Sell anytime on exchange	IPO, trade sale, secondary sale

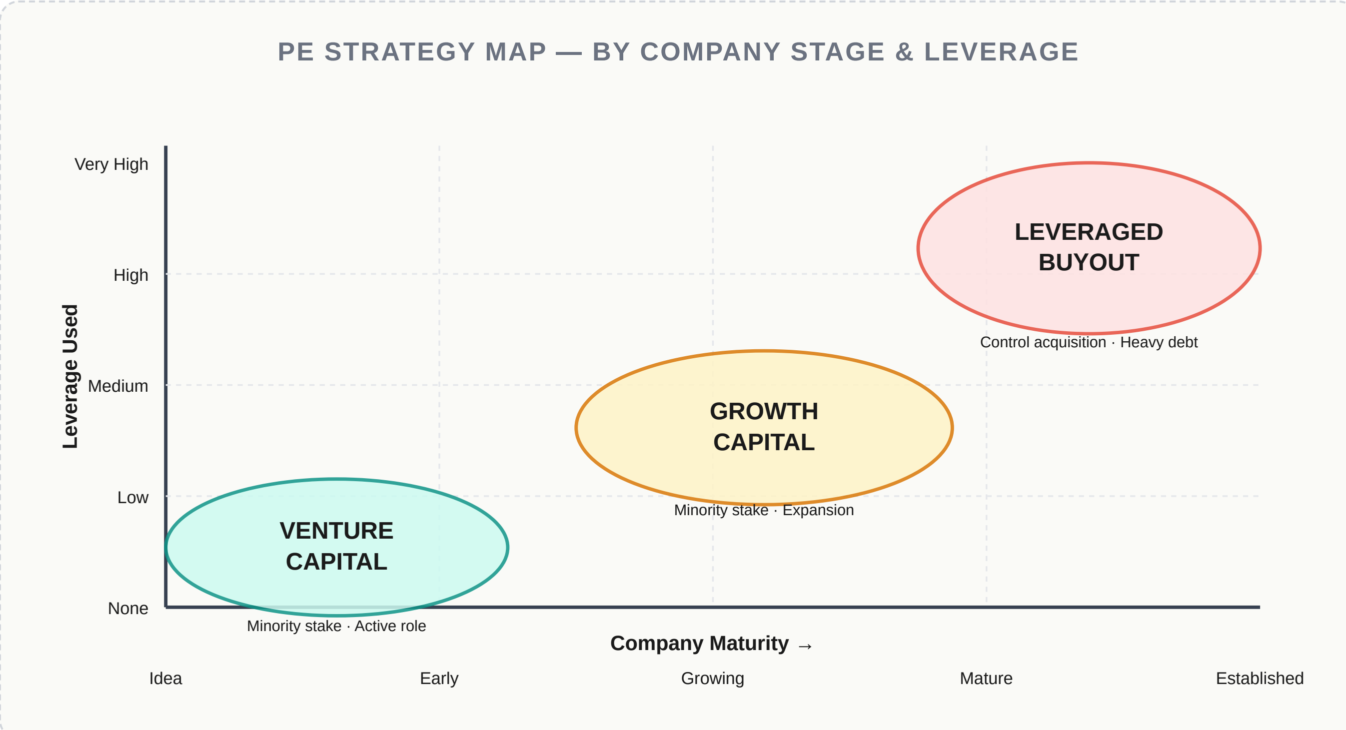
Return profile	Continuous NAV	J-curve: early loss then exits

□ **Exam Tip:** The CFA curriculum treats private capital as a **single asset category** covering both equity and debt investments in private companies. Always distinguish the subtypes: LBO, VC, Growth Capital for equity; Direct, Mezz, Venture, Distressed, Unitranche for debt.

LOS A · PRIVATE EQUITY CATEGORIES

Private Equity — The 3 Categories

Private equity funds deploy capital in one of three fundamentally different strategies. The target company's maturity and the investor's role determine which category applies.



Category Detail

VENTURE CAPITAL

VC

Investments in **early-stage companies** with high growth potential. VCs are **actively involved** (board seats, strategy). Long time horizon. Expected return depends on stage — earliest = highest risk/reward.

Example: Seed round in a biotech startup; Series A in SaaS company

GROWTH CAPITAL

Growth Capital

Minority equity investments in *mature* companies needing capital for expansion, restructuring, entering new markets, or acquisitions. Lower risk than VC; management typically stays in control.

Example: Family-owned manufacturer raising $50M to enter Asia

LEVERAGED BUYOUT

LBO

Acquires **established companies** using significant **borrowed funds**. Often involves taking public companies private.

Example: A PE firm takes a $3B retailer private using substantial debt funding

Three Things That Happen in an LBO

1. **Financial leverage increases.** Target's debt-to-equity rises significantly. Interest coverage tightens.
2. **Management or operations change.** Cost cuts, asset sales, management incentives, M&A roll-up strategy.
3. **If public, becomes private.** Delisted from exchanges, regulatory burden reduced.

MBO vs MBI — Know the Difference

MBO — Management Buyout

The **existing management team** teams up with a PE firm to acquire and run the company. Management is retained and gets equity incentives.

"The insiders buy it"

MBI — Management Buy-In

An **external management team** (plus PE firm) acquires the company and replaces the incumbent team. Existing managers are typically displaced.

"Outsiders buy in and take over"

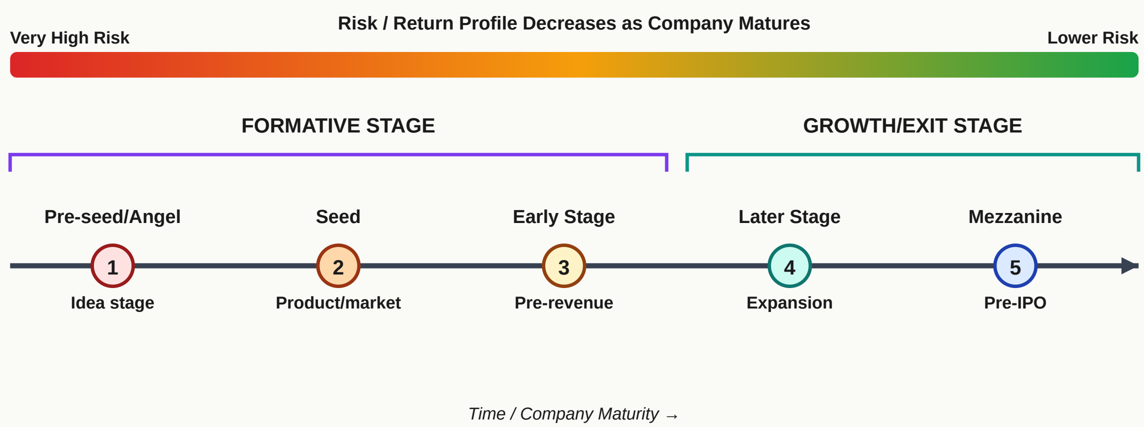
□ **Exam Tip:** The critical distinction on exams: **MBO = existing team stays**. **MBI = existing team replaced**. Remember: "B**O**" = insiders **O**wn; "B**I**" = outsiders buy **I**n.

LOS A · VENTURE CAPITAL STAGES

Venture Capital — The Investment Stages

VC funds invest in companies at very different stages of maturity. The stage determines the risk, check size, ownership dynamics, and expected returns. Earlier stage = higher risk, higher return, higher failure rate.

VC STAGE TIMELINE — RISK, COMPANY AGE & TYPICAL INVESTMENT SIZE



Stage Descriptions

STAGE	WHAT HAPPENS	COMPANY STATE
Pre-seed / Angel	Idea validation; often friends, family, angel investors	No product yet
Seed	Product development, market research, prototype	Building MVP
Early Stage	Moving toward operations, before commercial production	Pre-revenue
Later Stage	Expansion phase — after commercial production and sales	Growing revenue, may be cash-flow negative
Mezzanine	Preparing for an IPO — bridging private and public markets	Profitable or near-profitable

Terminology Warning: "Mezzanine" Has Two Meanings

Mezzanine stage (VC) = the pre-IPO stage of venture capital. **Mezzanine debt** = a tranche of debt that sits between senior debt and equity. These are unrelated concepts sharing the same word. Watch for context on exam questions.

Exam Tip: Remember the pattern: as companies mature through VC stages, **risk decreases, expected return decreases, and success rate increases**.

LOS A · VC DEAL STRUCTURES

Convertible Preferred & PIPE Transactions

Convertible Preferred Shares

The standard instrument for VC investing. Gives investors **downside protection** while preserving **equity upside**.

As "preferred": Gets priority over common stockholders if the company is wound up.

"Convertible": Can convert to common shares at the investor's option — typically at IPO or sale. Captures the upside.

Why it's used: Aligns incentives. Founders and VCs share the upside through equity; VCs have some downside protection. Mitigates information asymmetry between naive founders and sophisticated investors.

PIPE — Private Investment in Public Equity

A large institutional investor (often a PE firm or HF) purchases shares of a **publicly traded company** in a privately negotiated transaction, typically at a **discount** to the current market price.

Pros for the Company

- Faster than a secondary offering
- Lower disclosure/reg burden
- Attracts strategic institutional capital

Cons for Existing Shareholders

- **Dilution** from new shares issued
- Shares issued below market price
- Signaling issue — why private sale?

WORKED EXAMPLE

Illustration: A publicly listed biotech trading at $20/shareneedstoraise$100M for a Phase III trial. Rather than a 6-month public offering, it sells 6M new shares at $17/share (15% discount) to a PE firm in a PIPE transaction.

✓ SOLUTION

Company: Raises $102M in weeks instead of months. Discount is a "transaction cost" of speed.

Existing shareholders: Diluted — 6M new shares issued, pushing earnings per share down.

PE investor: Gets instant discount plus toehold in a public security they believe is undervalued.

□ **Exam Tip:** PIPE questions test: (1) it's for **public** companies, not private; (2) it's at a **discount** to market; (3) it causes **dilution** to existing holders; (4) reg requirements are *lower* than a public offering.

QUIZ 1 · CHECKPOINT

Test Your Understanding: PE Categories & LBO Mechanics

Q1. A PE firm acquires an established public company using significant borrowed funds and takes it private. This is *best* described as:

Q2. In a management buy-in (MBI), the existing management team is *most likely*:

Q3. A PE firm acquires a company for $1,000M(10 \times EBITDAof$100M) using 50% debt. Exits 4 years later at 10× a now-$150MEBITDA, withdebtpaiddownto$300M. The equity MOIC is closest to:

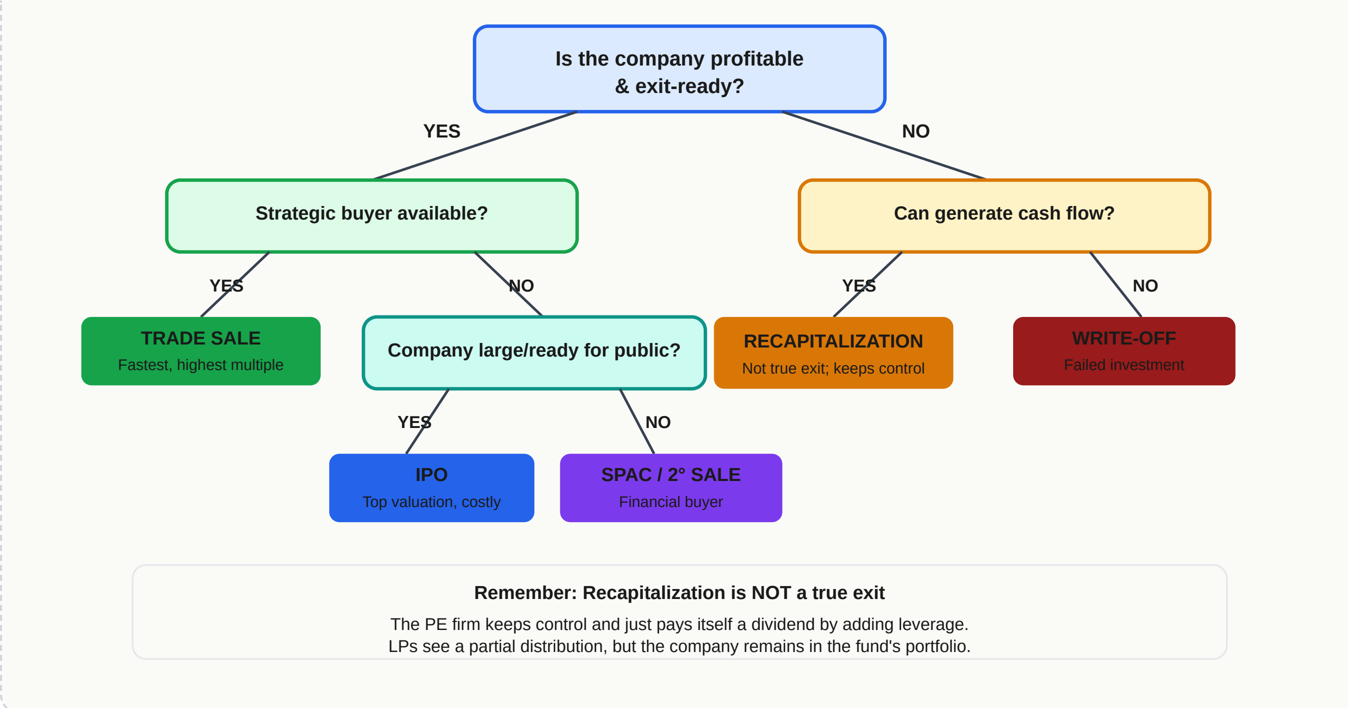
LOS A · EXIT STRATEGIES

Exit Strategies — How PE Firms Realize Returns

The exit is where the PE firm finally converts its paper investment into cash for the LPs. There are 6 main paths, each with different dynamics, transaction costs, and timing characteristics.

STRATEGY	DESCRIPTION	KEY FEATURES
Trade Sale	Sell to a strategic/competitor buyer	Most common · Fast · Strategic synergies can drive premium
IPO	Public offering — shares sold to public	Highest potential valuation · Long lead time · Best for large, mature companies
SPAC	Shell "blank check" company acquires target	Flexible · Faster than IPO
Direct Listing	Shares floated on exchange without underwriters	Low cost · No new capital raised
Recapitalization	Add debt to company, use proceeds to pay PE firm a dividend	**NOT a true exit** — PE retains control · Returns capital to LPs without selling
Secondary Sale	Sell to another PE firm or financial buyer	Used when IPO/trade sale infeasible
Write-off	Investment failed — company shut down/sold for salvage	Total or near-total loss

PE EXIT STRATEGY DECISION TREE



□ **Exam Tip:** Key exam distinctions: **Trade sale = fastest & often highest**. **IPO = highest potential valuation**. **Recapitalization = NOT an exit** (retains control). **Secondary sale = used when IPO/trade aren't feasible**.

QUIZ 2 · CHECKPOINT

Test Your Understanding: VC Stages & Exit Strategies

Q4. At which VC stage would a company *most likely* be preparing for an IPO?

Q5. Which exit strategy is *NOT* a true exit because the PE firm maintains control?

Q6. A PIPE transaction is *most likely* to result in:

Q7. Which of the following is characteristic of *growth capital* investments?

LOS B · PRIVATE DEBT TYPES

Private Debt — The 5 Types

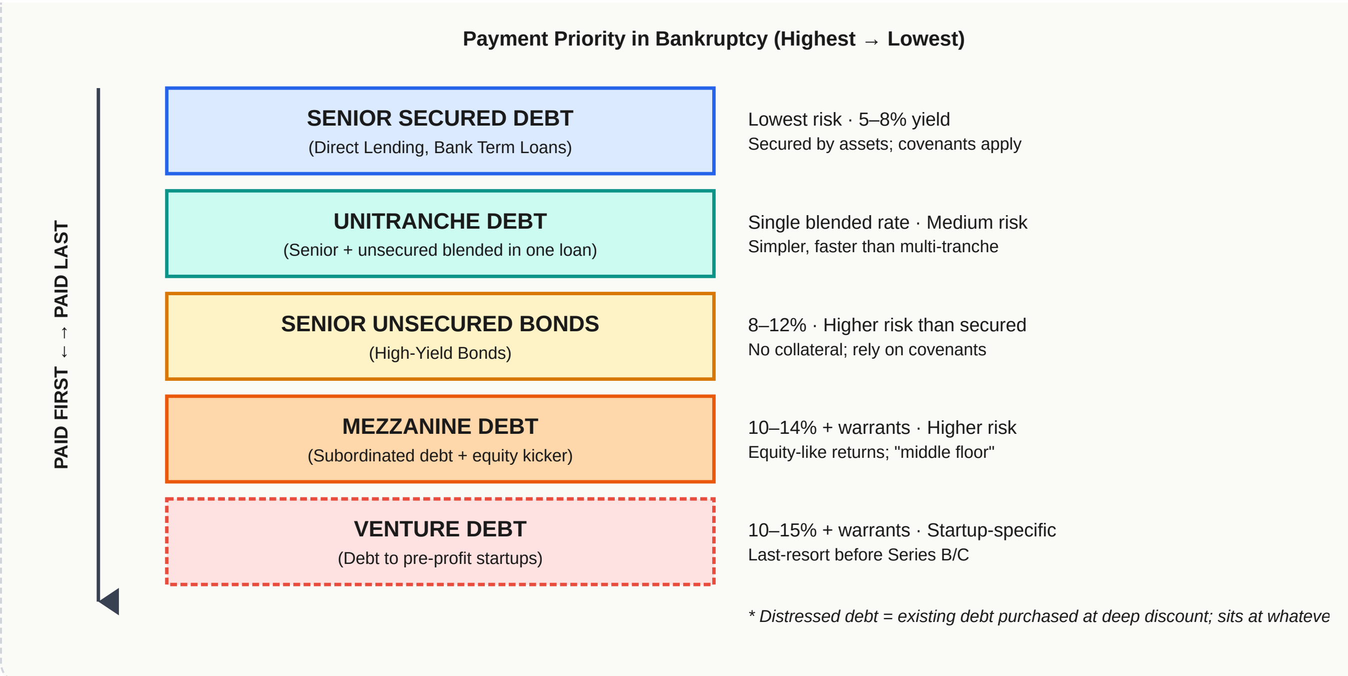
Private debt is debt financing provided by non-bank lenders directly to companies. It fills the gap when traditional banks won't lend (too small, too risky, too complex) or when the borrower needs speed. Private debt AUM has grown massively post-2008 as banks retreated from leveraged lending.

The 5 Categories

TYPE	DESCRIPTION	TARGET BORROWER
Direct Lending	Secured loans to borrowers who can't access traditional bank lending	Middle-market companies, LBO targets
Mezzanine Debt	Subordinated to senior debt, senior to equity. Often includes equity "kicker" (warrants, conversion option)	Companies needing capital without dilution
Venture Debt	Loans to start-ups with little/negative cash flow; may include warrants	VC-backed startups wanting runway without dilution
Distressed Debt	Debt of companies in financial difficulty or bankruptcy, bought at a discount	Companies in financial difficulty
Unitranche	Hybrid combining secured & unsecured tranches into *one* loan with a single blended rate	Mid-market LBOs wanting simplicity/speed

Capital Stack — Where Each Type Sits

PRIVATE DEBT IN THE CAPITAL STRUCTURE HIERARCHY



The Key Characteristics to Remember

Mezzanine Debt

Sits *between* senior debt and equity — "middle floor." Subordinated but with equity kicker (warrants, conversion rights). Lenders earn bond-like interest *plus* equity upside.

Unitranche

One loan, one blended rate. Combines what would otherwise be separate senior + subordinated tranches. Simpler documentation, faster close. Popular in middle-market LBOs.

Venture Debt

Loans to VC-backed startups. Goal: extend cash runway **without** issuing more equity. Typically includes warrants to compensate lender for risk.

Distressed Debt

Buying existing debt of companies in financial difficulty at a discount, with the aim of recovering more than the purchase price through restructuring or bankruptcy.

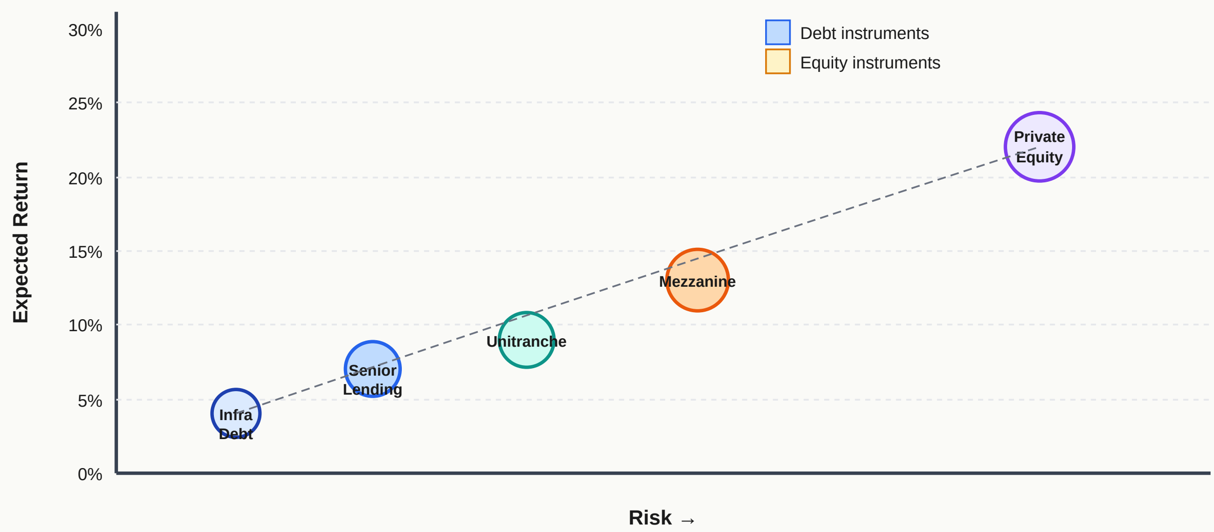
□ **Exam Tip:** The defining feature of **unitranche** is the *single blended rate*. The defining feature of **venture debt** is that it *avoids equity dilution* for startups. The defining feature of **mezzanine** is that it's *subordinated to senior, senior to equity*.

LOS C · RISK-RETURN SPECTRUM

Private Debt Risk-Return Spectrum

Understanding where each private debt type sits on the risk-return spectrum helps both for exam questions and for portfolio construction decisions.

RISK-RETURN SPECTRUM — PRIVATE DEBT & EQUITY



Risk-Return Hierarchy (Highest to Lowest)

A useful mnemonic for exams:

Private Equity (highest) → **Mezzanine Debt** → **Unitranche Debt** → **Senior Direct Lending** → **Senior Real Estate Debt** → **Infrastructure Debt** (lowest)

Vintage Year Diversification

A **vintage year** is the year a PE fund is launched and starts investing. The economic environment at inception significantly impacts realized results. Two identical strategies launched in different years can have very different realized IRRs — purely due to *when* capital was deployed.

Why it matters for performance:

- Funds launched at market **peaks** (expensive entry) often underperform
- Funds launched during or after **downturns** (cheap entry) often outperform
- Investors can't perfectly time vintages — so they **diversify across years**

Portfolio Diversification Effect

Private capital adds **moderate diversification benefit** to a portfolio of public stocks and bonds due to lower *reported* correlation with public markets.

However, the diversification benefit is partially illusory:

- **Smoothed valuations** understate the true volatility and correlations with public equities
- **Survivorship bias** in PE indexes overstates average returns
- **True economic risk** for PE is likely higher than reported, and correlation with public markets rises in crises

□ **Exam Tip:** Remember the hierarchy: **secured debt (lowest risk)** → **unsecured** → **subordinated** → **mezzanine** → **equity (highest risk)**. Vintage year diversification is the answer to "how to mitigate business cycle timing risk."

QUIZ 3 · CHECKPOINT

Test Your Understanding: Private Debt

Q8. Mezzanine debt is *best* described as debt that is:

Q9. An entrepreneur seeking to raise capital *without* further diluting existing shareholders would *most likely* use:

Q10. Unitranche debt is *best* characterized as:

Q11. Which of the following is *typically* the highest-risk private capital strategy?

FINAL COMPREHENSIVE QUIZ

Final Assessment — Integrating Concepts

Q12. A PE firm acquires a company for $500M(5 \times EBITDAof$100M) with 50% debt. Five years later, EBITDA has grown to $140M, theexitmultipleisstill5\times, anddebthasbeenpaiddownby$100M. The equity MOIC is closest to:

Q13. An investor can mitigate the timing risk of launching a private capital fund at an unfavorable point in the business cycle by:

Q14. Which of the following statements about distressed debt is *most accurate*?

MODULE COMPLETE

Your Scorecard

0 / 14

LM03 Key Takeaways — Exam-Ready Cheat Sheet

Private Capital — The Universe

1. Two main branches: **Private Equity** (equity in private companies) and **Private Debt** (loans to private companies).
2. Illiquid, long holding periods, high information access, active investor role. J-curve return profile.

Private Equity Categories

3. **LBO**: established companies acquired with significant borrowed funds, often taking public → private. Three things change: leverage, management/operations, public → private status.
4. **VC**: early-stage startups, active involvement. Stages: Pre-seed → Seed → Early → Later → Mezzanine. Risk decreases as company matures.
5. **Growth Capital**: *minority equity* in mature companies for expansion. Less leverage than LBO, more mature than VC.

LBO Math (Memorize)

6. **Exit Equity = Exit EV − Exit Debt.** Exit EV = Exit EBITDA × Exit Multiple. MOIC = Exit Equity / Entry Equity.

MBO vs MBI

7 **MBO** (Management Buyout) = existing team stays. **MBI** (Management Buy-In) = external team replaces incumbents.

Convertibles & PIPEs

8 **Convertible preferred**: VC standard. Preference over common stockholders + upside (convertible to common).

9 **PIPE**: public company sells shares to institutional buyer at *discount*. Dilutive but faster/cheaper than public offering.

Exit Strategies

10 **Trade sale** = fastest; **IPO** = highest potential valuation; **SPAC** = shell-company acquisition; **Direct listing** = no underwriter, no new capital; **Recapitalization = NOT a true exit** (PE retains control); **Secondary sale** = to another PE firm; **Write-off** = failure.

Private Debt Types

11 **Direct lending**: secured loans. **Mezzanine**: sub to senior, senior to equity (often + equity kicker). **Venture debt**: loans to startups to avoid dilution. **Distressed**: buy debt of companies in financial difficulty at a discount. **Unitranche**: single blended-rate loan.

Risk-Return Hierarchy

12 Highest to lowest: **Private equity** → **Mezzanine debt** → **Unitranche debt** → **Senior direct lending** → **Senior real estate debt** → **Infrastructure debt.**

Diversification

13 **Vintage year diversification**: spread fund launches across cycles. Primary way to manage timing risk in PE.

14 PE adds *moderate* diversification benefit (real benefit somewhat overstated due to smoothed valuations and survivorship bias).

⚡ Quick-Recall Formulas

Enterprise Value = EBITDA × EV/EBITDA Multiple

Equity Value = Enterprise Value − Net Debt

MOIC = Exit Equity / Entry Equity

IRR = $\text{MOIC}^{1/\text{years}} - 1$ (for single-entry, single-exit)

⚡ Exam-Trap Reminders

- **Recapitalization ≠ Exit** (PE keeps control)
- **MBO = stay, MBI = replace**
- **PIPE = public company, discount, dilutive**
- **Mezzanine stage (VC) ≠ Mezzanine debt** — totally different concepts
- **Venture debt avoids dilution** for startups
- **Unitranche = single blended rate**
- **Vintage year diversification** for cycle timing risk

Step 1 of 12