Private Equity Fundamentals and Fund Economics

Interview preparation summary · PE track

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INT.PF.1.a · Fund structure and economics

Explain how a private equity fund is structured, including the GP, LPs, fund term, commitments and drawdowns.

A private equity fund is usually a closed-end limited partnership. Limited partners, such as pension funds and endowments, commit capital and stay passive, so their liability is capped at what they commit. The general partner manages the fund, usually puts in one to a few percent of commitments itself and earns a management fee and carried interest. Commitments are drawn down through capital calls for deals, fees and expenses, so the LP pays in over the investment period, commonly around five years, rather than on day one. The fund then holds and exits companies over a term of about ten years, often with one or two extensions that need LP consent. Distributions go back to LPs as exits happen, and some agreements let the GP recall them. A limited partner advisory committee reviews conflicts. Interview point: be clear that a commitment is a promise to fund on request, and that unfunded commitment is what is left to call.

WORKED EXAMPLE: A PENSION FUND TRACKS ITS COMMITMENT

A pension fund commits 10 million to a 100 million buyout fund. The GP calls 25%, 20% and 20% of commitments in years one to three. In year four the fund distributes 12 million in total, and the agreement lets the GP recall distributions. The GP itself committed 2% of the fund. How much has the pension fund paid in, how much is left to call, and what does it risk at most?

Answer: The pension fund has paid in 6.5 million, has 3.5 million unfunded (rising to 4.7 million after the recallable distribution), and can lose no more than its 10 million commitment.

> **Interview tip:** Say that a commitment is a promise to fund on request and that unfunded commitment is what is left to call. The interviewer listens for whether you keep commitment, paid-in and unfunded distinct.

INT.PF.1.b · Fund structure and economics

Calculate management fees for a fund on committed and invested capital and apply fee offsets.

The management fee pays the GP for running the fund and is usually quoted as a percentage a year, commonly 1.5% to 2% for buyout funds, though practice varies by strategy and fund size. The base matters as much as the rate. During the investment period the fee is normally charged on committed capital, so it is paid even if the money is not yet invested. After that it commonly steps down to a lower rate on invested capital, often measured at cost of unrealised investments, so it falls as companies are sold. Fees are drawn from LP commitments, which means they reduce the amount available to invest. Transaction, monitoring and directors fees earned from portfolio companies are often partly or wholly offset against the management fee, with the percentage set in the agreement. Interview point: always state the base, the rate and the offset before giving a fee figure.

WORKED EXAMPLE: FEES IN THE INVESTMENT PERIOD AND AFTER

A 100 million buyout fund charges 2% a year on committed capital for a five-year investment period, then 1.5% a year on invested capital at cost of unrealised investments. In year three the GP earns 0.5 million of transaction fees from portfolio companies, and 80% of these offset the management fee. In year six cost of unrealised investments is 60 million. What are the net fees in years three and six, and what do fees cost over the life if cost then falls by 10 million a year?

Answer: Net fees are 1.6 million in year three and 0.9 million in year six, and fees take about 13.0 million (13%) of the 100 million commitment over the life.

> **Interview tip:** Quote the base, the rate and the offset in that order, then the figure. The interviewer listens for the point that fees come out of commitments and so reduce what can be invested.

INT.PF.1.c · Fund structure and economics

Work through the distribution waterfall, including hurdle, catch-up and carried interest, and compare European and American structures.

Carried interest is the GP's share of fund profits, conventionally 20%. A typical whole-fund (European) waterfall has four steps: first LPs receive their contributed capital, then the preferred return or hurdle, usually around 8% compounded; then a catch-up in which the GP receives most or all of the next distributions until it holds 20% of cumulative profit; then the remainder is split 80/20. Without a catch-up the hurdle is hard and the GP shares only in profit above it; with a catch-up the hurdle is soft. A deal-by-deal (American) waterfall pays carry as each deal is realised, so the GP is paid sooner, and a clawback and escrow protect LPs if later losses leave the GP overpaid. Terms vary by fund, region and strategy. Interview point: with a full catch-up and enough profit, carry equals 20% of total profit, not 20% of the profit above the hurdle.

WORKED EXAMPLE: A WHOLE-FUND WATERFALL WITH FULL CATCH-UP

LPs contribute 100 million at the start of a fund with a whole-fund (European) waterfall. The terms are an 8% annual compound hurdle, a 100% GP catch-up and 20% carry. The fund makes one distribution of 220 million at the end of year five. Ignore fees, tax and the GP's own commitment. How much carry does the GP receive, and how much would it receive with no catch-up?

Answer: The GP receives 24.0 million of carry, 20% of total profit, against 14.61 million with no catch-up.

> **Interview tip:** Walk the four steps in order and finish with the check that, with a full catch-up and enough profit, carry is 20% of total profit. The interviewer listens for whether you know the catch-up is what turns a hard hurdle into a soft one.

INT.PF.2.a · Returns and the J-curve

Explain the J-curve and why a young fund's net returns look poor.

The J-curve describes how a fund's cumulative net return typically dips below zero in its early years before rising. The drivers are mechanical. Management fees and set-up costs are charged from the start, while investments are usually held at cost until there is evidence to revalue them, so net asset value sits below capital paid in. Early write-downs of weak holdings show up quickly, while gains are recognised slowly and are realised late through exits. The effect is deeper when fees are charged on commitments and shallower with slower fee ramps, fee offsets, quicker deployment and conservative-but-timely marks. Investors reduce the dip by spreading commitments over several vintages or buying mature positions on the secondary market. Interview point: a negative early IRR is common and a poor basis for judging a fund; check the pace of deployment, the valuation approach and company performance instead.

WORKED EXAMPLE: WHY A THREE-YEAR-OLD FUND SHOWS BELOW ONE

A trustee asks why a 100 million fund is reporting a net multiple of under one after year three. Paid-in capital is 66 million: 60 million invested in companies and 6 million of management fees. Investments are held at cost except one holding written down by 3 million, and nothing has been sold. By year seven paid-in is 100 million, distributions are 20 million and remaining value is 120 million. Explain the pattern with numbers.

Answer: The net multiple is 0.86 at year three because of fees and conservative marks, and recovers to 1.40 by year seven, a J-shape.

> **Interview tip:** Give the mechanical causes first (fees from day one, holdings at cost, early write-downs, late gains), then say what you would check instead. The interviewer listens for whether you refuse to judge a young fund on early IRR alone.

INT.PF.2.b · Returns and the J-curve

Measure fund performance with gross and net returns, DPI, RVPI, TVPI and IRR, and answer the follow-up probes an interviewer asks.

Fund performance is read through several lenses. Gross returns describe the investments before fees, carry and fund expenses; net returns describe what LPs keep after them. DPI is distributions divided by paid-in capital, RVPI is remaining reported value divided by paid-in capital, and TVPI is their sum. DPI is realised cash, so it is the hardest to argue with; RVPI relies on the GP's valuations. IRR is time-weighted by the timing of cash flows, so it rewards speed and can be raised by delaying capital calls with a subscription credit line, while the multiple does not change. A short, high-return deal can have a high IRR but a small multiple. Net multiples and IRRs also depend on the fund's age: early figures are noisy. Interview point: quote IRR and multiple together and say whether each is gross or net.

WORKED EXAMPLE: READING A FUND AND TWO DEALS

A fund has paid in 100 million, distributed 60 million and reports remaining value of 80 million. Separately, deal A turns 100 into 150 in two years and deal B turns 100 into 250 in six years. Use year-end flows and ignore fees. Give the fund's DPI, RVPI and TVPI. Which deal is better? Then an interviewer asks: what if the fund funds deal A on a credit line for one year at 6% before calling the LPs?

Answer: The fund shows DPI 0.60, RVPI 0.80 and TVPI 1.40; deal A has the higher IRR (22.5% against 16.5%) and deal B the higher multiple, and a credit line lifts A's LP IRR to 41.5% while lowering its multiple to 1.42x.

Interview tip: Always give IRR and multiple together and say whether each is gross or net. The interviewer listens for the point that a credit line raises IRR by shortening the time capital is invested without adding any value.

INT.PF.3.a · Strategies, value creation and deal flow

Break down how a private equity firm creates value using operational improvement, multiple expansion, deleveraging and growth.

Buyout returns are usually explained by three levers. EBITDA growth comes from revenue growth, pricing, margin expansion, procurement, working capital discipline and add-on acquisitions. Multiple expansion is a higher exit multiple than entry, helped by a stronger, larger or better-quality business, but mostly driven by markets. Deleveraging is the fall in net debt from free cash flow, which transfers value from lenders to equity. A common attribution values EBITDA growth at the entry multiple, applies the multiple change to exit EBITDA, and takes debt reduction as the change in net debt; conventions differ on where the cross term between growth and multiple change sits. Leverage magnifies all three effects on equity. Interview point: build the base case on growth and cash generation, show multiple expansion as upside only, and say which levers you control.

WORKED EXAMPLE: SPLITTING THE EQUITY GAIN INTO LEVERS

A sponsor buys a company at 8x EBITDA of 50 million, financed with 240 million of net debt. After five years EBITDA is 70 million, the exit multiple is 9x and net debt has fallen to 160 million. Ignore fees and tax. Split the equity gain between EBITDA growth, multiple expansion and deleveraging, using the convention that growth is valued at the entry multiple, and give the money multiple and IRR.

Answer: EBITDA growth adds 160 million, multiple expansion 70 million and deleveraging 80 million, for 2.94x and a 24.0% IRR, falling to 2.50x and 20.1% at a flat multiple.

Interview tip: Say which convention you used for the cross term, then rerun at a flat multiple. The interviewer listens for whether you treat multiple expansion as upside rather than the base case.

INT.PF.3.b · Strategies, value creation and deal flow

Distinguish buyout, growth equity and venture capital by target, control, leverage, risk and return pattern.

Buyout funds usually acquire control of mature, cash-generative companies and use significant debt, so returns come from operational improvement, deleveraging and a good entry price. Growth equity funds typically take minority stakes in profitable, expanding companies, often with structured protections and little debt, and returns come from growth and a sensible exit. Venture capital funds back young companies, mostly without debt or profit, and returns come from a small number of very large winners alongside many losses, so the distribution of outcomes is highly skewed. Risk, expected loss rates, fund size and holding periods differ, and the boundaries between strategies are not rigid. Interview point: describe the target company's cash flow, who has control and where the return comes from, and match the strategy to the case you are given.

WORKED EXAMPLE: TWO FUNDS, SIMILAR MULTIPLES, DIFFERENT SHAPES

A venture fund and a buyout fund each invest 1 million in ten companies. The venture fund gets 0x on five, 1x on three, 3x on one and 12x on one. The buyout fund gets 0.5x on one, 1x on two, 2x on five and 3x on two. Compare the fund multiples and the shape of the outcomes, and say what each pattern implies for how the investor works.

Answer: Both funds return about 1.8x, but one venture company supplies 66.7% of proceeds against 16.2% for the best buyout, so venture is a skewed return pattern and buyout a diversified one.

Interview tip: Describe the company's cash flow, who has control and where the return comes from. The interviewer listens for the skew of venture outcomes, not just a list of definitions.

INT.PF.3.c · Strategies, value creation and deal flow

Describe how private equity firms source, screen and exit deals, including the main exit routes.

Private equity firms find deals through intermediary-led auctions, proprietary relationships with owners and management teams, sector specialisation and add-on opportunities for existing platforms. Screening is a fast, structured filter: does the opportunity fit the fund's strategy and size, is the business high quality with resilient cash flow, can a realistic price deliver the target return, and what are the main risks and diligence questions? Deals that pass move to deeper work, an investment committee and negotiation. Exits are planned from the start. The main routes are a sale to a strategic buyer, a secondary buyout to another sponsor and an IPO with staged sell-downs, and a dividend recapitalisation returns cash without selling. A dual-track process prepares two routes at once. Interview point: link the exit route to the buyer universe and the return, and note that the exit view should be part of the entry case.

WORKED EXAMPLE: CHOOSING AN EXIT ROUTE

A sponsor holds a company with EBITDA of 70 million and net debt of 160 million, bought for 160 million of equity five years ago. A trade buyer offers 9.5x EBITDA, a secondary buyout bidder 9.0x, and an IPO would price at a 10% discount to a fair 9.0x valuation with the sponsor selling half. Ignore fees and tax. Compare cash proceeds at exit and say how you would run the process.

Answer: The trade sale gives the highest cash at 505 million (3.16x), against 470 million for a secondary buyout and 211.5 million upfront from the IPO, so I would run a dual track.

> **Interview tip:** Tie each route to its buyer universe and its proceeds, and say the exit view should be in the entry case. The interviewer listens for why a credible second route improves the price.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.