Private Equity Fund of Funds & Secondaries – Certification Quiz Questions

Module GP-01 – GP Stakes Valuation and Investment Recommendation (4-Hour Case Study)

26. One of your co-workers has argued that GP Stakes deals provide "the best of three worlds": Fixed income, equities, and LP-led secondaries.

    He has provided an excerpt from a GP Stakes model he is working on, including the returns analysis and the cash flows from each income stream of a middle-market PE firm: Fee-Related Earnings (FRE), Performance-Related Earnings (PRE), and the GP Commitment.

    His analysis also includes the "Fee Yield" as a key metric at the bottom, which is based on the FRE in the period divided by the upfront price paid for the stake in this PE firm. You can see the relevant metrics in the image below this question.

    He claims that this "Fee Yield" metric provides the best evidence that GP Stakes deals are a mix of fixed income, equities, and LP-led secondaries.

    Which of the following statements **CORRECTLY** describe whether this claim is correct or incorrect?

    This question has **4 correct answers** and 2 incorrect answers. You must select **ALL 4 correct answers** and no incorrect answers to earn a point for this question.

Returns Analysis:	Units:	Total:	2032E	2033E	2034E	2035E	2036E
Total Fund Cash Flows During Holding Period (Entire Firm):							
Fee-Related Earnings (FRE) from Existing Funds:	$ M	$ 178.7	$ 5.4	$ (2.8)	$ -	$ -	$ -
Fee-Related Earnings (FRE) from Future Funds:	$ M	655.2	88.4	83.0	105.9	124.7	113.9
Performance-Related Earnings (PRE) from Existing Funds:	$ M	780.9	161.5	148.6	37.2	-	-
Performance-Related Earnings (PRE) from Future Funds:	$ M	305.2	-	-	-	30.8	274.4
GP Commitment Cash Flows from Existing Funds:	$ M	225.0	30.4	30.4	7.6	-	-
GP Commitment Cash Flows from Future Funds:	$ M	(68.4)	(26.3)	(0.7)	5.2	(7.2)	11.8
Total Exit Values (Entire Firm):							
Fee-Related Earnings (FRE) from Existing Funds:	$ M	-	-	-	-	-	-
Fee-Related Earnings (FRE) from Future Funds:	$ M	1,418.6	-	-	-	-	1,418.6
Performance-Related Earnings (PRE) from Existing Funds:	$ M	-	-	-	-	-	-
Performance-Related Earnings (PRE) from Future Funds:	$ M	462.2	-	-	-	-	462.2
GP Commitment Cash Flows from Existing Funds:	$ M	-	-	-	-	-	-
GP Commitment Cash Flows from Future Funds:	$ M	103.2	-	-	-	-	103.2
Net Cash Flows:							
(+) Fund Cash Flows During Holding Period:	$ M	2,076.6	259.4	258.5	155.9	148.3	400.2
(+) Exit Values:	$ M	1,984.0	-	-	-	-	1,984.0
(-) Upfront Purchase Price:	$ M	(1,250.0)	-	-	-	-	-
Total Net Cash Flows:	$ M	**$ 2,810.6**	**$ 259.4**	**$ 258.5**	**$ 155.9**	**$ 148.3**	**$ 2,384.1**
"Fee Yield" on Upfront Purchase Price:	x		**7.5%**	**6.4%**	**8.5%**	**10.0%**	**9.1%**
Multiple of Invested Capital (MOIC):	x	**3.25 x**					
Internal Rate of Return (IRR):	%	**17.4%**					

a. The Management Fees provide predictable, recurring income, similar to interest income in credit deals; the "Fee Yield" quantifies this similarity.

b. The Fee-Related Earnings provide some downside protection, but it's significantly less than in credit deals because there's no "maturity" or fixed "principal repayment."

c. The "Fee Yield" represents potential equity upside from individual investments made by specific PE funds because the Management Fees are higher when the funds retain companies for more time.

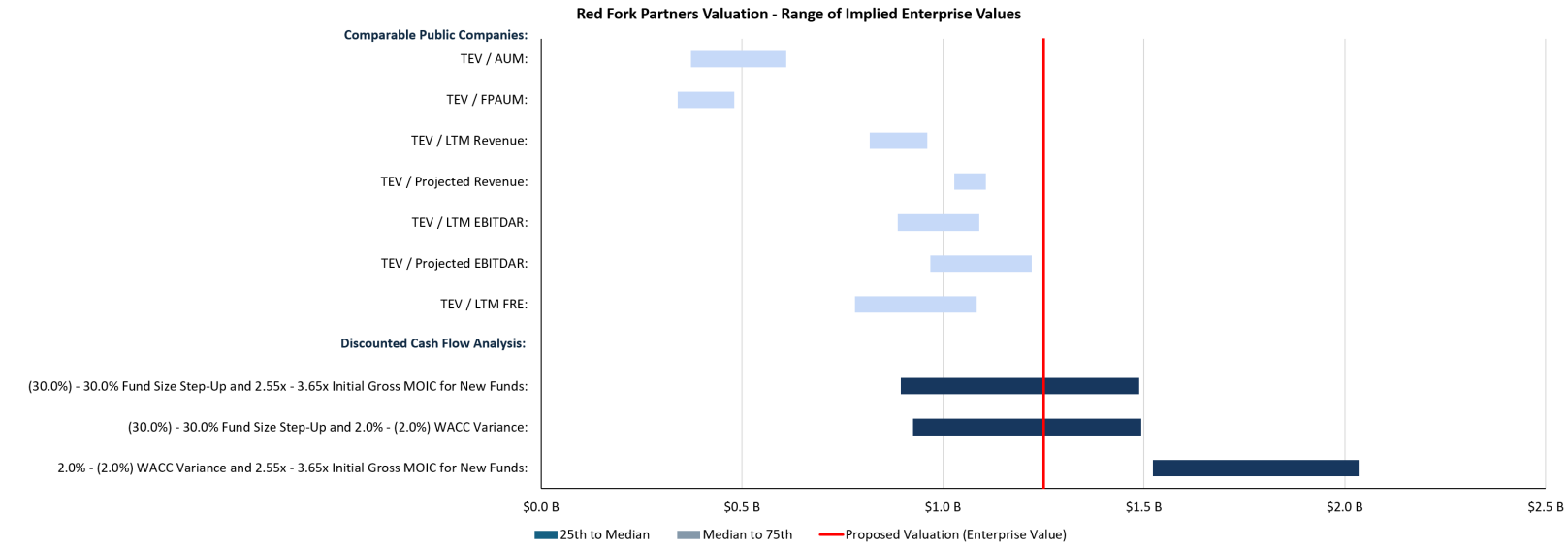
d. The "Fee Yield" shows that there is an indirect relationship between the equity returns of individual funds and the Management Fees.

e. Since the "Fee Yield" maintains itself in a similar range over time, it provides some of the benefits of continually investing in new PE funds.

f. The “Fee Yield” removes the “blind pool risk” in traditional primary investments in new PE funds, similar to the benefits of LP-led secondaries.

27. You are reviewing the output of your co-worker’s valuation for the PE firm in this GP Stakes deal. As shown in the image below this question, the DCF and Public Comps tell very different stories about the proper implied Enterprise Value.

    Based on the numerical ranges, metrics, and multiples in this graph, which of the following is **NOT** a reasonable inference or observation?



a. This might not be the correct set of Public Comps (e.g., they are in a much different size range or market than the subject company).

b. Most likely, the subject company is smaller than the Public Comps and has very different long-term growth potential, even if its near-term financial metrics are in similar percentage ranges.

c. The DCF may be too generous in terms of the Discount Rate range, the Fund Size Step-Ups, or other assumptions.

d. If this analysis used Equity Value-based metrics, such as Distributable Earnings or Net Income, that might change the valuation because the subject company might have major capital structure differences vs. the Public Comps.

e. The "Fund Size Step-Up" percentage, i.e., the percentage growth rate in the size of each new PE fund, appears to be the most important DCF driver.

28. You are now reviewing your co-worker's DCF setup for this private equity firm. As shown in the image below this question, he has assumed a Discount Rate for each income stream (e.g., FRE from Existing Funds vs. Future Funds) and applied it to all the cash flows from these funds over the holding period.

    The PE firm has 4 current funds and plans to raise 6 new funds over the next 10 – 20 years, but it does not necessarily plan to operate "indefinitely" since it's run by a small group of Partners. As a result, your co-worker has decided **AGAINST** using Terminal Value in the DCF and has instead projected each fund until its cash flows reach $0.

    Suppose, however, that you want to change this approach and take the Present Value of each cash flow stream over ~10 years and then calculate a Terminal Value based on all the cash flows after this 10-year forecast period.

    Which of the following statements **CORRECTLY** describe the consequences of this change?

    This question has **2 correct answers** and 3 incorrect answers. You must select **BOTH correct answers** and no incorrect answers to earn a point for this question.

				Implied Values:			WACC			Weighted Average WACC:	
	Fee-Related Earnings (FRE):			FRE:			Baseline:	Sensitized:		Cash Flows:	Discount Rate:
	Existing Funds:	$ M	$	179.5			6.0%	6.0%	$	202.4	6.0%
	Future Funds:	$ M		1,045.2			8.0%	8.0%		3,036.8	8.0%
				Implied Values:			WACC				
	Performance-Related Earnings (PRE) and GP Commitment:			PRE:	GP Commit:		Baseline:	Sensitized:			
	Existing Funds:	$ M		365.1	99.0		20.0%	20.0%		1,026.3	20.0%
	Future Funds:	$ M		84.8	(18.1)		25.0%	25.0%		2,746.4	25.0%
	Firm Total Implied Value:	$ M	$	1,755.6					$	7,011.9	16.4%

a. This approach with the Terminal Value makes sense only if the firm plans to operate indefinitely, or on a much longer time frame, such as 50+ years rather than 10 – 20 years.

b. If you used this approach, you would apply much lower Terminal Multiples to the PRE than to the FRE, such as 12 – 15x for the FRE and 5 – 7x for the PRE.

c. If you calculate the Terminal Values using the Perpetuity Growth Rate Method, you would use the same Discount Rate for each income stream in the explicit forecast period and the Terminal Period.

d. If you calculate the Terminal Values with the Multiples Method, applying a single Terminal Multiple to the given income stream in the final year of the explicit forecast period should present no issues (i.e., no adjustments are required).

e. Even with this altered approach for Terminal Value, the "Weighted Average WACC" shown on the right-hand side of this image should stay about the same.