The [NAIC's Capital Markets Bureau] monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Please see the Capital Markets Bureau website at [INDEX].

Private Equity

Analyst: Jennifer Johnson

- A private equity (PE) firm is an investment management company that utilizes its own funds, as well as capital from additional investors to enhance or increase the value of a company; PE firms generate a profit for their investors, which is measured using an internal rate of return (IRR).
- PE funds are the most common type of PE investment, and they are generally formed as partnerships consisting of a general partner (GP), which is responsible for managing the fund investments and has fiduciary responsibilities, along with limited partners (LPs), which are typically institutional investors or high net worth individuals.
- PE funds are generally illiquid, as they are not traded on an exchange; they typically have a fixed term of 10 years, and they generate high relative returns.
- In 2012, PE firms became some of the most active participants in mergers and acquisitions (M&A) activity within the insurance sector, purchasing insurance companies or blocks of their businesses due, for the most part, to the predictable and steady returns, along with the opportunity to increase assets under management.
- PE-owned U.S. insurers represent a small portion (less than 5%) of total U.S. insurer cash and invested assets.

What are Private Equity Firms?

A PE firm is an investment management company "that utilizes its own funds or capital from other investors for its expansion and startup operations"[1] as it relates to private ownership interest in a company. PE funds are the most common type of PE investments, and they are usually not public; i.e., their shares are not traded in the stock market.

A GP—most often the PE firm—is responsible for managing the operations of a PE fund and selecting its investments, known as "portfolio companies." Investors in a PE fund include institutions such as insurance companies and pension funds, as well as high net worth individuals. The investors are also

[1] Corporate Finance Institute, *Equity Firm.*

known as LPs, and they are governed by a LP agreement (LPA). The LPA outlines specific terms, including: 1) a partnership timeframe (typically PE funds have a 10-year fixed life); 2) management fees (typically 2% of a fund's committed capital); 3) how capital is distributed to investors after a liquidity event; 4) restrictions on the GP; and 5) how ownership interest in the fund can be sold or transferred in a secondary market. Generally, the GP will attempt to raise a new PE fund every three to five years after a fund is fully invested. U.S. insurers typically invest a small portion of their total cash and invested assets in PE funds for diversification purposes and to achieve higher yields not offered by traditional investments.

In 1980, there were only 24 PE firms globally, and by 2015, there were more than 6,600 PE firms.[2] Along with the increase in the number of PE firms, there has been a significant increase in assets under management by PE firms to almost $5 trillion globally.[3]

Goals of a Private Equity Firm

A PE firm's primary mission is to "bring about positive change in a company that increases its value. In other words: buy, change and sell."[4] A PE firm will conduct an analysis on companies it seeks to acquire, which includes industry and market analysis, as well as reviewing the company's business model, management team, and potential risks involved. The goal of the PE firm is to generate a profit for its investors, usually within a four- to seven-year timeframe.

When a PE company exits an investment, it does so with the intention of generating a significant return, especially given that PE funds are highly illiquid. They are typically valued quarterly by the fund manager.

How are Private Equity Funds Structured?

General Partners and Limited Partners

PE funds are generally formed as partnerships between a GP and LPs. The GP is typically the sponsor of the fund, responsible for undertaking its legal organization and fundraising. The GP is also often the party responsible for managing the fund investments, so it has a fiduciary responsibility; therefore, it can be legally liable for the actions of the fund. For its services, the GP earns a management fee. In addition, the GP has a stake in the performance of the fund. For most PE funds, a performance incentive is often structured as carried interest, meaning that the GP is allocated an ownership position in the fund that it did not pay for. A PE fund structure also often requires that the LPs earn a certain minimum return, referred to as a "hurdle rate," before the GP is paid an incentive-based fee.

[2] Ibid.
[3] Prequin, 2021 Prequin Global Private Equity & Venture Capital Report, February 2021.
[4] Altegris Advisors LLC, FOCUS ON PRIVATE EQUITY | UNDERSTANDING PRIVATE EQUITY: A PRIMER, January 2019.

Capital Commitment, Lock-Up and Fees

When PE investors enter into an LPA, they become an LP and commit to providing a certain amount of capital over the fund's investment period, which is typically three to five years. In return, the LPs in PE funds receive a form of ownership or partnership interest. The money that is committed by LPs, also called "committed capital," is usually not invested immediately; i.e., it is "drawn down" (known as capital calls) by the GP in specific increments as needed and invested over time as investment opportunities are identified. An LP's ongoing obligation to fund capital calls depends on the number of unfunded commitments, also called "additional commitments." An unfunded commitment is the LP's total committed capital minus amounts contributed from prior capital calls. When U.S. insurers are LPs in PE funds, they are required to report their unfunded commitments in the appropriate investment schedules, such as Schedule BA – Other Long-Term Invested Assets.

PE funds have significant limitations in providing liquidity for their investors. During the three- to five-year commitment period, during which investments are made, no payouts or redemptions may occur. This is often referred to as a lock-up period. After that, PE funds may make distributions to LPs when investments mature or are sold.

Types of Private Equity Investments

There are several types of investments offered by PE firms, but the most common is the PE funds, or primary funds, which are pooled investment vehicles. PE firms also offer secondary market fund investments that focus on buying and selling LP interests in primary funds, or fund of funds. Fund of funds pool capital to invest in five or more PE funds and are attractive to "capital-constrained" investors. Other types of PE investments include exchange-traded funds (ETFs) and open-end mutual funds, along with other more complex types of PE investment structures.

Who are the Private Equity Fund Investors and What are Their Returns?

To invest in PE, an investor must meet the definition of an "accredited investor" or "qualified purchaser'." Accredited investors are institutions or individuals that may invest in securities not registered with the U.S. Securities and Exchange Commission (SEC), provided that they have the knowledge and expertise to participate, and they must meet certain income, asset size and net worth requirements. Qualified purchasers are institutions or individuals that own $5 million or more in investments.

The PE investors receive returns as the GP or fund manager exits the investment, also known as distributions, through a liquidity event, typically paid in cash. PE fund investors receive an IRR on their investments, which varies over the life of the fund depending on the amount and frequency of drawdowns.

What are the Different Private Equity Fund Strategies?

There are a few primary investment strategies that the PE firm can employ. These include venture capital (VC); growth capital; leveraged buyout (LBO; and to a lesser extent, mezzanine debt. VC relates to investing in small and/or start-up companies to enhance their long-term growth potential. VC funds invest in the equity of startup companies, usually in high-growth sectors such as technology, biotechnology and health care. VC investments can be classified according to the target company's stage of development. For example, early-stage VC invests in startups that invent and bring to market new ideas or technology. Late-stage VC helps startups scale ideas and operations to maximize growth. Growth capital refers to investing to expand or restructure mature or relatively mature companies. LBOs involve using capital to acquire companies (to obtain full control) with a significant amount of debt (borrowed money), to create value in cash-flow positive companies. An LBO fund typically uses debt and equity financing to acquire a company, or at least a controlling position. The debt, which is typically 85% of the total cost of the acquisition (but can be higher) is borrowed from an intermediate holding company and repaid with cash flows from the acquired company. Mezzanine funds invest in companies through notes or loans. Their position in the capital structure provides an opportunity for higher returns but not at the risk level of equity.

Other types of investment strategies that PE firms may pursue include infrastructure (focus on public works); natural resources (focus on real assets); real estate (property development); and private debt (debt structure and financing of a company).

Valuation of Private Equity Investments by U.S. Insurers

For accounting treatment, PE investments are subject to the *Statement of Statutory Accounting Principles (SSAP) No. 48—Joint Ventures, Partnerships and Limited Liability Companies*. The guidance in SSAP No. 48 requires measurement based on an equity method. Additionally, admittance is contingent on audited support. This guidance generally requires audited U.S. generally accepted accounting principles (GAAP) financial statements, but provisions exist for audited reconciliations, audited financials in accordance with International Financial Reporting Standards (IFRS), and audited U.S. tax basis equity in certain situations if audited U.S. GAAP basis financial statements do not exist.

What Are the Risks with Investing in Private Equity?

PE funds carry different forms of risk, as they may be considered alternative investments by some investors. PE funds have liquidity risk, as they are not investments readily exchangeable for cash, and they typically have lockout periods. They are not publicly traded; therefore, they lack price transparency. PE funds are also susceptible to market risk to the extent that the fund is exposed to adverse company news, industry trends, and/or negative economic impacts. As such, the value of a PE fund is subject to price volatility. There is also capital risk, or the possibility of a realized loss on original capital upon a fund's termination, due to a loss in value of the fund.

Background on Private Equity Firms Acquiring U.S. Insurers

Around 2012, PE firms became some of the most active participants in M&A activity in the insurance sector, purchasing insurance companies or blocks of their business. In particular, PE companies were interested in investing in life and annuities businesses because of predictable and steady returns, and they presented an opportunity to not only add to assets under management but also generate fee income from investment management expertise. The trend with PE firms acquiring U.S. insurers has been due in part to the low interest rate environment, whereby both sides sought benefits: PE firms taking on an additional, steady source of premium income from the insurers, and U.S. insurers' investment portfolios potentially achieving higher investment returns and improved access to capital and asset sourcing via the PE firms' capital markets networks, according to FitchRatings (Fitch) research. Being PE-owned, an insurer's asset sourcing capabilities expand; however, the investments could shift towards higher returning—i.e., higher risk—assets that are also less liquid.

In addition, according to PitchBook, a financial data company, insurance businesses have permanent capital, drive growth, and represent solid investments for PE firms.[5] Consequently, investing in insurance companies has been largely responsible for the growth in assets under management for major publicly traded PE firms.

Some state insurance regulators view the PE business model as a short-term focus on profit, while the insurance business model has more of a long-term focus.[6] Notwithstanding, whether insurers are owned by PE firms, investment activity must abide by applicable state insurance laws. According to OPTIS Partners, an investment banking and financial services firm, the number of M&A for U.S. and Canadian insurers in 2020 was 774—the highest on record and 20% higher than 2019.

[5] Institutional Investor, *Private Equity Firms Bet On Insurance,* August 2020.
[6] Institutional Investor, *Private Equity Firms Play Ball with the Insurance Industry*, August 2014.

Key Terminology

Accredited Investor

An investor that is able to invest in securities not registered with the SEC, having the knowledge and expertise to participate in the investment; must meet certain income, net worth and asset size requirements.

Additional Commitment/Unfunded Commitment

An LP's total committed capital to a PE fund minus amounts contributed from prior capital calls.

Capital Calls/Draw-Downs

Amount of capital that is drawn by the General Partner from a Limited Partner's committed capital when an investment opportunity arises.

Commitment Amount/Committed Capital

Total amount of money contributed by a Limited Partner to a private equity fund.

Commitment Period/Lock-Up Period

Period of time, usually three to five years, during which private equity fund investments are made, and no payouts or redemptions may occur; also known as 'lock-up' period.

Distributions (Returns)

Amounts returned to private equity fund investors after the commitment period has ended, when investments in the fund mature or are sold; funds that private equity investors receive when the GP or fund manager exits an investment through a liquidity event.

Exchange Traded Funds (ETFs)

SEC-registered investment companies (or basket of securities) that offer investors a way to pool their money in a fund that invests in stocks, bonds, or other assets; shares are bought on an exchange.

General Partner (GP)

Usually the sponsor of the private equity fund, it manages the fund's operations, selects the investments and earns a management fee. The GP has fiduciary responsibility and can be legally liable for the actions of the fund.

Growth Capital

Investing to expand or restructure mature or relatively mature companies.

Internal Rate of Return (IRR)

The annual rate of growth that an investment is expected to generate.

Leveraged Buyout

A transaction in which a company is acquired using debt as the main source of consideration; a PE firm typically borrows as much as they can from a variety of lenders (up to 70 or 80 percent of the purchase price) and funds the balance with its own equity.

Limited Partners

Investors in PE funds.

Mezzanine Debt

A type of financing that bridges the gap between senior debt and equity.

Private Equity Funds

The most common type of PE investment, they are generally formed as partnerships consisting of a GP and LPs; they are illiquid, not traded on an exchange and typically have a fixed term of 10 years, generating high relative returns.

Qualified Purchaser

Institutions or individuals that own $5 million or more in investments.

Venture Capital (VC)

A private equity strategy, VC funds invest in the equity of startup companies, usually in high-growth sectors such as technology, biotechnology and health care.

Useful Links

NAIC Capital Markets Bureau Special Report, "U.S. Insurer Total Exposure to Schedule BA (Other Long-Term Invested Assets) Rises 10% at Year-End 2019," September 2020.

NAIC Capital Markets Bureau Special Report, "Private Equity (PE) Owned U.S. Insurers as of Year-End 2019," August 2020.