Private Equity

DESPITE THE RISKS, INVESTING IN PRIVATE COMPANIES OFFERS POTENTIAL BENEFITS

EXECUTIVE SUMMARY

■ T. Rowe Price’s private investments approach is intended to identify innovators that can compound wealth as they scale and transition from early-stage to durable growth companies.

■ Returns vary significantly among early-stage growth companies, requiring strong fundamental research to uncover innovative companies that are more likely to outperform.

■ Investing in private-equity growth companies provides our investment teams the broader benefit of insights into potential industry disrupters, fresh perspectives on business innovation, and the occasional opportunity to assess companies before they go public.

■ A surge of venture capital investing has created valuation distortions in the private-equity market and made adherence to a disciplined evaluation approach critical.

Investing in private companies that have moved beyond the venture capital stage but may still be years from going public has always been challenging. Such securities are more illiquid and usually far more risky than investments in more established public companies with longer track records.

Moreover, a surge of venture capital investment in recent years has undercut the overall quality of the field and led to sharply higher valuations among the more promising firms.

Nevertheless, an allocation to early-stage growth companies offers the potential to earn above-average returns and other benefits to public company investors.

T. Rowe Price has participated in private-equity investments on a limited basis for 30 years but has gradually been increasing and broadening its stake over the past decade to take advantage of a wider array of opportunities. The firm has committed more capital than virtually all other mutual fund managers, according to Morningstar, Inc.¹

Altogether, various T. Rowe Price funds had about $2.5 billion invested in 41 private companies as of March 31, 2017, including such innovative firms as Uber Technologies and Airbnb.

The firm’s investments in early-stage growers encompass a variety of sectors and industries, including technology, biotechnology, media, communications,

¹Unicorn Hunting: Mutual Fund Ownership of Private Companies is a Relevant, but Minor, Concern for Most Investors, Morningstar, December 2016.
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In recent years, private companies have tended to delay going public for various reasons, including a surge in venture capital investment driven by the prospect of higher returns in the sluggish growth environment. This has enabled start-ups to expand and attain access to capital, as well as avoid the scrutiny and transparency of the public market. An increased regulatory burden and additional costs stemming from the Sarbanes-Oxley Act of 2002 have also dampened the desire to go public.

Reflecting these developments, the median age of companies executing an initial public offering (IPO) increased from 7.8 years during the 1976–1996 period to 10.7 years in the 1997–2016 period, a 37% increase, according to Credit Suisse. And companies are going public with much larger market capitalizations than in the past. As of January 2017, there were 112 U.S.-based so-called unicorns—venture-backed start-ups valued at more than $1 billion, according to PitchBook, a company that tracks global venture capital, private-equity, and merger and acquisition activity.

Because of this trend, some early-stage companies have merited consideration in larger-cap funds. Indeed, 14 T. Rowe Price mutual funds that focus on large-cap stocks had invested in Snap Inc., the parent of Snapchat, before it went public in March 2017.

**T. ROWE PRICE APPROACH**

T. Rowe Price funds adhere strictly to the firm’s private investments oversight process, which requires that all such investments be approved by either a director of equity research or the appropriate regional head of equity (see sidebar above). In addition, the funds typically invest less than 5% of their assets in these higher-risk, less liquid securities—well below the 15% limitation imposed by the Securities and Exchange Commission. In fact, only five T. Rowe Price funds had more than 1% invested in nonpublic companies as of March 31, 2017.

Managers also take a long-term view when investing in private companies. They are not usually looking to reap a big gain when a highly touted company goes public. More likely, they will add to their position over time as the company develops a successful track record.

“We want to be fair to both buyers and sellers of our funds that own private equity while making an independent analysis that considers both the currently available information and the long-term potential of these investments,” Mr. Casserly says. Dedicated and independent private company valuation analysts in the Enterprise Risk Department focus on the valuation of these investments.

The Private Company Valuation Advisory Group was formed in 2016 to provide an additional investor perspective. The group is composed of professionals who work in or with the Investment Division but who do not currently manage or cover private company investments, which helps reduce potential conflicts of interest.

For further oversight, members of the firm’s Equity Steering Committee receive a monthly update of any notable activity or valuation changes, and each T. Rowe Price fund Board must annually review and approve the firm’s formal valuation policies and procedures.

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**VALUING PRIVATE COMPANIES**

Among the many challenges posed by investing in private companies, one of the more significant is determining their appropriate valuations—a task complicated by a lack of readily available market prices, confidentiality obligations that limit disclosures, and occasional irregular information flows from private companies, often due to their resource constraints.

At T. Rowe Price, a rigorous process is based on the guiding principles of fairness and independence, says Christopher Casserly, a member of the firm’s Valuation Committee, which is composed of senior members of the Enterprise Risk, Pricing, Legal and Compliance, Investment Treasury, Equity, Fixed Income, and Global Trading Departments.

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growth New Horizons Fund, who has led the firm’s private-equity effort since 2007. “You have to source new ideas and buy them. And then you just have to not sell them. With the failure rates and the number of rocks you have to turn over before you find that special company, you have to let the power of compounding work for you.

“So we do not invest in private companies merely to guide them to an initial public offering or benefit from private-public arbitrage,” he adds. “We tell their chief executives that we want to deploy capital in companies that can become long-term holdings. Our goal is to compound wealth in these companies as they scale and transition from early-stage to durable growth companies.”

While T. Rowe Price’s research and investment in private equity has deepened, managers remain extremely selective in their execution. Because of the higher risk and illiquidity, managers seek a higher expected return than they would of public investments.

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early a stage in the company’s growth, and we keep our investments in any single private company relatively small to manage the liquidity risk.”

The managers’ research process mirrors that in the public markets. “We do the same level of due diligence, build models and projections, do valuation analysis, and routinely meet with management,” Mr. Greene says. “We also seek the same level of information and access that we get in public investments at a minimum.”

Mr. Ellenbogen says that from the start, the New Horizons Fund has always placed a premium on the chief executive and management team of private enterprises. “In early-stage companies, leadership has an exponential impact on business success,” he says.

RESULTS

Over time, even small investments in businesses that can sustain their success after going public can make a meaningful contribution to a fund’s performance.

For example, cloud software company Workday and social media firm Facebook are among many successful, public holdings in the funds that originated as smaller private-equity investments and have become much larger since going public. As of March 31, 2017, T. Rowe Price funds collectively owned 31 public companies with a total market capitalization of more than $14.7 billion that were private companies when the funds initially invested in them.

A recent study by the New Horizons Fund illustrates the potential benefits and risks of participating in private equity.

The fund owns 15 public companies that it invested in when the firms were private and owns another 28 private holdings. One successful investment is restaurant referral service GrubHub, in which the fund invested in 2013. At the

FIGURE 1: U.S.-Listed IPOs

As of April 2017

Source: Dealogic. Deal value represents the total value raised in the initial public offering.
time, GrubHub generated $54 million in revenue, was largely dependent on a couple of markets, and did not offer deliveries. That was before it acquired Seamless, which helped the company consolidate its target markets and achieve early market leadership.

GrubHub, which went public in 2014, has now grown from 5,000 to more than 50,000 restaurant partners, expanded nationwide, and offers delivery for its restaurant partners. It is still considered an early-stage growth company and faces stiff competition, but it is a market share leader and “has shown an ability to continuously improve its offering, optimize its operations and management team, and generate solid financial returns at a reasonable scale,” Mr. Ellenbogen says.

Similarly, when the New Horizons Fund invested in Atlassian in 2014, the software company had less than half the 60,000 customers it services today. Atlassian went public the following year and is now the market leader in solutions that support the software development process for some of the largest businesses in the world. Since 2007, the fund overall has invested $1.2 billion of initial capital in 63 private companies. Of those, 33 have had a “liquidity event”—an IPO, an acquisition by another company, or liquidation. In each of these cases, capital has been returned to the fund in the form of a fully liquid asset—either cash or a freely traded public stock.

Overall, including private companies still held in the portfolio, the fund has earned a total weighted annual return (before fees and expenses) of 34.8% on these investments compared with a return of 7.7% for the Russell 2000 Growth Index of public small-cap companies.

Moreover, 12 of the 30 IPOs from the fund’s private portfolio—40%—have achieved at least $500 million in revenue, and several more are expected to hit that mark in 2017. Of this group, seven have earned $1 billion in revenue—a hurdle that only a small percentage of companies going public over the past 20 years has achieved. By comparison, a T. Rowe Price study shows that less than 25% of venture capital-backed IPOs achieve $500 million in annualized revenue.

At the same time, Mr. Ellenbogen says the fund has made its share of mistakes, reflecting the high-risk nature of private-equity investing. Three of its private investments—Reed Krakoff, Peixe Urbano, and Living Social—have been marked to zero. The fund had initially invested almost $59 million in these three holdings.

Why do early-stage companies fail? Sometimes the business model just doesn’t play out. At other times, a business may face increasing competition or the company’s market shows less potential growth than expected.

That was the case with Castlight Health, an innovative software company in which the New Horizons Fund invested in 2012. The company built a transparency tool allowing employees to compare the cost of procedures at a wide array of health care providers.

“While Castlight had a strong management team and the potential to become an established player in its target market,” Mr. Ellenbogen says, “we
underestimated the difficulty in getting end customers to use its products, as well as the ability of competitors to replicate certain product features and eventually erode the economics of its industry." The fund sold the stock shortly after Castlight’s IPO—a move it usually tries to avoid.

A LENS ON DISRUPTION

In addition to the potential for earning above-average returns, private-equity investing affords other indirect but tangible benefits. These include providing a window on potential disruption that new companies could pose for certain industries or existing holdings, gaining insights on business innovation and industry trends, and the opportunity to assess a company’s prospects and management well before it enters the public arena.

Mr. Ellenbogen, for example, says that researching private companies “has given us valuable insights into business innovation within several industries. We believe innovation to be a valuable lens for evaluating all of our companies.”

Brian Berghuis, manager of the Mid-Cap Growth Fund, says investing in private companies “enables us to analyze markets from a different perspective. We’re able to more deeply understand the insurgents entering an industry and have a better idea of how they might threaten public companies—or not threaten them.

“The insights we glean are very important in terms of how we view industry structures and the futures of various industry participants,” he adds. “Even if the returns in the private market were only comparable to those in the public market, I would argue that insights we gain warrant our involvement. They inform our public investing.”

For example, several T. Rowe Price funds invested in software company Workday before it went public in 2012. “We saw this enormous addressable market and a company with a disruptive technology and an extremely strong team, solving problems that conventional wisdom would have had us believe were unsolvable,” Science & Technology Fund Portfolio Manager Ken Allen says.

“We were bullish on the cloud software trend before, but Workday gave us valuable additional insight into its merits and how rapidly companies were adopting cloud-based software,” he adds. “Workday was solving a harder problem than some of the cloud companies that were public at the time because they were building a broader suite of software that was suitable for larger companies. The fact that Workday was successfully winning and serving many of the most demanding customers highlighted how revolutionary the cloud trend is.”

This insight also influenced the firm’s view on other public software companies it held—both positively and negatively. “It made us more bullish on Salesforce.com because of the strength of the overall cloud trend and their ability to unlock market opportunity they had only just started to address,” Mr. Allen says. “What we learned from Workday were very strong proof points that Salesforce would be able to sell a broader set of applications to larger companies.”

At the same time, the team’s experience with Workday heightened

FIGURE 3: While U.S. Venture Capital Deal Activity Drops, Amount Invested Remains Strong

As of December 2016

![Graph showing venture capital deal activity and investment amounts over time.]

Source: PitchBook. Investment includes new start-ups and existing private companies raising additional financing.
their longer-term concerns about incumbent software leaders such as Oracle and SAP. “A lot of their business is traditional software applications running at each customer’s premises and they have been slow to develop cloud offerings,” Mr. Allen says. “Both are very strong companies, but they’re being challenged by the cloud software trend, and, in many cases, relatively smaller players like Workday and Salesforce have the upper hand.”

Among smaller companies, Mr. Ellenbogen says “disruption and the pace of change is really occurring across multiple market sectors.” Warby Parker, which sells branded eyeglasses online and in retail stores at a discounted rate, is taking share from Luxottica, a public company that owns Sunglass Hut, LensCrafters, Pearle Vision, and others. In the real estate industry, Redfin, an innovative private technology-enabled online broker that has cut commissions and made it easier to sell residential real estate, is giving traditional brokers such as Coldwell Banker a run for their money.

And, of course, Uber, the car-driving service, has had a significant impact on the transportation industry while Airbnb has disrupted the traditional hotel business.

Since taking over as manager of the large-cap Media & Telecommunications Fund in 2013, Mr. Greene has increased its private-equity holdings from just 0.30% of assets to almost 2.3% by December 2016.

“Mr. Greene says... ‘Just as in public markets, investors can become overzealous and push valuations to excessive levels. As more investors enter the private funding market, it makes it tougher to find attractive opportunities.’”

“In order to understand the dynamics in a particular industry or market,” he explains, “we believe it is important to examine and meet with all participants—public and private alike.

“The primary goal of this research is to support and make better investment decisions regarding our large public stock holdings. The other key advantage is that getting to know a company and its management team gives us the opportunity to assess its prospects well in advance of the company’s IPO. Most investors only get to spend a short time learning about a company and meeting with its management (if they do at all) before having to make a decision whether to participate in the offering.”

CHALLENGES

The private-equity investment boom in recent years has created opportunities but also challenges—such as lowering the overall quality of the field and boosting valuations among the most promising firms. “There are legitimate reasons for the higher levels of funding into private companies,” Mr. Greene says, “but this does not mean there are not excesses. Just as in public markets, investors can become overzealous and push valuations to excessive levels. As more investors enter the private funding market, it makes it tougher to find attractive opportunities.”

As a result, some managers have sharply curtailed their private-equity investments over the past couple of years. “Valuations are generally still elevated,” Mr. Berghuis says. “I’m still leery. That doesn’t mean I’m not open to good opportunities, but I’ve been much more selective.”

Although it may be more difficult to find compelling opportunities now compared with a few years ago, Mr. Berghuis says the firm’s commitment to private-equity investing “remains very strong. Like any other investment, when capital is readily available and valuations get frothy, we need to tread even more carefully. We have to be mindful of valuations. But there’s no question that we will be part of the private company ecosystem for many years to come. The benefits definitely outweigh the risks.”
In the image, there is a section labeled "Important Information" that contains details about the fund's performance and holdings. Additionally, there is a section titled "Invest with Confidence" which highlights T. Rowe Price's commitment to delivering investment management excellence. The page also contains a call-to-action to visit troweprice.com for more information. There are disclosures about the material being informational and not intended to be investment advice. It also mentions specific holdings and performance metrics of various funds as of particular dates and addresses the volatility of investing in small companies compared to larger ones. The document is structured to provide comprehensive information to potential investors, ensuring they have all the necessary data to make informed decisions.