

Investment and Finance in New Mexico

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Investment

- > For an individual, it is helpful to understand investment as deferred consumption... “saving”
 - Rather than consume now, I contribute to my retirement (401(k) account so that I have funds that I can use to support my standard of living in retirement
 - I should expect to earn a rate of return on my investments to compensate me for the investment risk I am taking
- > Individuals can invest directly or through an “institution” like a mutual or pension fund
 - I buy and sell stocks through my brokerage account, or I contribute to my mutual/pension plan who invests on my behalf
- > Investors supply capital for companies to grow
 - Investment is fundamental to the health of an economy

Finance

> Finance is the study of value

- Investments are one branch of finance...suppliers of \$\$\$
- Business/corporate finance is another branch...users of \$\$\$
- Financial markets and institutions are a third branch. Think of them as the “intermediaries” between the suppliers and users of capital (\$\$\$)
- Capital markets are both debt (bonds) or equity (stocks)

> Value can be created or destroyed based on the decisions made by managers of a company

- Governance over decision making matters
- Major decisions include where to invest (capital budgeting), what type of capital to use (capital structure), and how to structure operations.

Publicly-Traded Companies

- > These are companies whose stock is traded on one of the US exchanges
 - Example: New York Stock Exchange – started in 1792
 - Public companies have evolved - number of stocks trading today on US exchanges is about half what it was 30 years ago
 - Over time, large tech stocks (the “Mag 7”) have increased the value concentration of US publicly-traded equity markets
- > Individuals often invest in publicly traded stocks through retirement plans
 - This is most often done through mutual funds, which pool our investments across many companies to diversify away from company-specific risks.

Private Equity (PE) History

- > Historically, investing in private companies was the domain of very wealthy families using their own capital
 - By private, I mean NOT traded on a stock exchange
- > Modern (institutional) PE begin just after World War II
 - The rise of funds facilitated growth in PE just as the rise of funds facilitated investment by individuals in publicly traded stocks
- > PE is a broad term that encompasses different areas
 - Angel Investing (e.g., Pioneer Venture Capital Club at DU)
 - Venture Capital (early stage)
 - Growth Equity
 - Buyout

How Does Private Equity Work?

- > PE funds pool capital from institutional investors like pension funds, wealthy individuals, and more recently the mass affluent, to engage in value creating activities
- > Buyout Example: Companies can be managed poorly
 - Actions like conglomerate acquisitions/operating disparate divisions make a company bigger...but not better (e.g., 1960s)
- > Angel Investing/Venture Capital/Growth: Capital may not be available (or be extremely costly) to smaller firms.
- > PE typically makes changes in operations, capital structure, and governance...to create value

PE Landscape and Growth

- > Publicly traded companies attract a lot of attention, but about 87% of US companies with revenues over \$100M are *privately* owned
- > PE facilitates the growth and restructuring of both private and public companies
 - The compound annual growth rate of PE assets under management since 1997 has been about 13%
 - Wide range of PE strategies that span generalist, industry specialists, middle market focus, and lower middle market focus, along with large buyout funds
 - PE is critical to the economy (7% of GDP) and PE-financed firms can perform better during a crisis (e.g., 2008)

PE Impact: US and New Mexico

> PE National Data:

- 13.3M jobs in PE, approximately 8% of US nonfarm workforce.
- Average PE employee earned \$85K in wages and benefits.
- The median PE backed business employed 72 employees
- 85% of PE investment went to small businesses (fewer than 500 employees)

> New Mexico Specific:

- There are 67,000 jobs in the PE sector in New Mexico
- \$6 billion and wages and benefits were paid to workers in the New Mexico PE sector – average wage/benefits over \$89K
- The PE sector contributes approximately \$10B in GDP to the New Mexico economy (about 7%).

How is PE Structured?

- > PE funds have been traditionally organized as finite life (drawdown) limited partnerships (LPs)
 - General partner manages the funds and limited partners contribute capital
 - PE manager costs are typically a % of assets under management and carried interest in the profits (e.g, “2 and 20”)
 - Profit payoff can be above a “hurdle rate” (e.g., 8%)
 - Highly competitive industry, e.g., student having six rounds of interviews for an entry-level job
- > Perpetual PE limited partnerships growing rapidly
- > Explosive growth in “evergreen” structures that hold both public and private assets (e.g., interval funds) has fueled the movement to “democratize” access to private assets

PE – Investors' Capital Markets Perspective

- > Institutional investors use PE with the goal of improving portfolio *risk adjusted* performance to allow them to meet income goals for beneficiaries
 - California Public Employees Retirement System (CalPERS) was one of the early movers into PE (1990) and has a current allocation of about 13-17% of assets.
 - New Mexico PERA 10-year annualized performance of 15.07% is well above the median (13.2%) for public-sector pension plans
 - PE is moving into retirement plans. Adding PE can improve 401-k participant retirement readiness so that is similar to that of households with defined benefit plans

Private Equity – Current Issues and Opportunities

- > Traditionally, PE Funds had finite lives (e.g., 10 years)
 - Finite-life PE funds typically seek “exits” from its portfolio within the life of the fund
 - Rising interest rates and business (e.g., AI disruption) issues in the last decade can impact exits in PE
 - In 2021, the ten-year Treasury yield was under 1%; today it is over 5%. Cost of capital is rising...
- > But a perpetual (“open end”) PE fund can deploy patient capital for long-term goals – e.g., energy transition
- > The growth of perpetual PE funds and “evergreen” vehicles is evidence of a maturing capital market.

PE Examples

- > Dunkin' Donuts acquisition by PE in 2005 led to successful initial public offering in 2011
 - Operations: Shift to franchising model, menu modernization, geographic expansion west of Mississippi, operational improvements, enhanced supply chains, and aligned franchisee incentives
 - Marketing: Launched the “America Runs on Dunkin’” campaign to boost brand visibility
- > Growth Equity transformed Shopify by scaling its operations from a promising e-commerce platform into a global market leader - initial public offering in 2015
- > Themes of Good Outcomes: Enhanced scale, greater financial efficiency, operational improvements, better products and services, happy customers

PE Examples

> PE is not immune to bad outcomes

- Research shows that PE firms can generally support higher levels of debt and do well during downturns, but...

> When there are unanticipated/adverse macroeconomic, business, or legal issues, PE buyouts can end up in financial distress, and bankruptcy

- Red Lobster – consumer discretionary sector (2014 buyout, 2024 bankruptcy) issues tied to use of sale-leasebacks, and “endless shrimp”
- Envision – healthcare sector (2018 buyout; 2023 bankruptcy) due to high interest payments and the Federal law ending “surprise medical billing”
- TXU – utility sector (2007 buyout; 2014 bankruptcy) issues tied to high interest payments, the Great Recession, and natural gas price declines

Considerations: Public and Private Companies

- > Criticality of capital access
 - Especially now with debt costs rising due to high levels of private and government borrowing...cost of capital is increasing
- > PE buyout or growth equity can lead to financial and operational efficiencies, increased employment, and better customer outcomes, but it doesn't always work
- > Balancing test of benefits and risks to consumers, workers, and the environment exists regardless of ownership structure
- > Sector matters for both public and private companies
 - As industries become more monopolistic, essential, and environmentally sensitive, the PE company-government interface grows and becomes more complex

Conclusions

- > Investment is critical to the growth of a market economy
- > PE provides capital for funding growth and facilitating the restructuring of companies
- > The intersection between private and public capital markets is growing... “democratized finance”
- > PE funds are shifting to longer duration and attracting capital from institutions with similar investment horizons
- > Previous PE buyout examples provide helpful context, but the particulars of the transaction are critical