Level III of the CFA® Exam

Item-Set Questions with Answers - Private Markets Pathway – Volume 1

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Table of Contents

14	-	Estragon SA	3
15	-	Evergreen Capital Partners	7
16	-	The Stratton Venture Fund	12
17	-	Polaris Capital	19
18	-	Atlas Real Assets	26
19	-	Arcadia Pension Fund	33
20	-	Cobalt University Endowment	40
21	-	Zamora Sovereign Investment Authority (ZSIA)	47
22	-	Tectra Capital	54
23	-	Oakridge Capital Advisors	61
24	-	Altura Capital Partners	68

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Case 14: Estragon SA

Estragon SA is a French venture capital (VC) fund focused on funding innovative startup companies across Europe. The fund, established in 2010, has seen varying degrees of success in its investments, adhering to the industry-standard 100/10/1 rule of thumb. Estragon's historical data indicates a 75% failure rate among their investments, aligning closely with general VC expectations. Estragon's latest funding round aims to nurture four successful startups from its current batch.

The fund operates primarily through a closed-end limited partnership. When assessing potential investments, Estragon uses the VC method of valuation.

Q.1 Based on Estragon SA's funding structure, the general partner funds startup companies *most likely* by:

A. Allowing investors to freely withdraw their capital at any time.

B. Requiring investors to commit capital for a specified term.

C. Providing liquidity through a secondary market for shares.

The correct answer is **B.**

Estragon SA operates primarily through a closed-end limited partnership. In this structure, the general partner solicits capital commitments from investors for a specified term, during which the capital is gradually deployed across multiple startups. This method requires investors to commit their capital upfront and typically locks in the investment for a period, often around ten years, aligning the interests of the general and limited partners by focusing on long-term growth and development.

A is incorrect. A closed-end limited partnership does not allow for the free withdrawal of capital. Investors are required to commit their capital for a specified term without the option of early withdrawal, providing stability and certainty in the capital available for investments.

C is incorrect. A closed-end limited partnership typically lacks a secondary market for shares, meaning that investors cannot easily sell their interests before the term ends. The focus is on long-term capital commitments rather than liquidity.

CFA Level III, Private Markets Pathway Volume 1, Learning Module 1: Private Investments and Structures LOS 1(b): Discuss private investment methods and structures and their uses

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Q.2 How many startup pitches must Estragon *most likely* review to achieve four successful startups?

A. 400

B. 1,600

C. 2,000

The correct answer is **B.**

With a 75% failure rate, Estragon must select around 16 startups to ensure that 4 are successful. Following the 100/10/1 rule of thumb, Estragon needs to review approximately 1,600 startup pitches. This rule implies that for every 100 pitches reviewed, 10 might receive funding, and only 1 will likely be a success.

Therefore, to achieve 4 successful startups, Estragon must review 1,600 pitches (16 startups × 100 pitches/startup).

CFA Level III, Private Markets Pathway Volume 1, Learning Module 3: Private Equity LOS 3(d): Estimate and interpret key inputs and calculate the value of a private equity investment for venture capital, growth equity, and buyout situations.

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Q.3 Which type of investor is *most likely* to provide the pre-seed funding that Estragon SA relies on before reaching the seed stage?

A. Founder, family members, or friends.

B. Angel investors.

C. Venture capital funds.

The correct answer is **A.**

Pre-seed funding is typically provided by the founders, their families, or friends. At this early stage, startups have not yet established a feasible business concept, and this initial funding is crucial for developing their ideas before attracting more significant investors. Founders and those close to them are often the primary source of capital because they are willing to take the highest risk before the startup has proven its potential.

B is incorrect because angel investors usually come into play at the seed stage or slightly later when the startup has achieved some initial milestones and demonstrated basic feasibility.

C is incorrect because VC funds, like Estragon SA, typically invest at later stages when the startup has passed the pre-seed stage and shown potential for growth and scalability.

CFA Level III, Private Markets Pathway Volume 1, Learning Module 1: Private Investments and Structures LOS 1(b): Discuss private investment methods and structures and their uses.

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Q.4 Which of the following statements most correctly describes how Estragon SA estimates the exit value of its investments using the VC method of valuation?

A. Using a single estimate of revenue potential and a single estimate of price-to-sales.

B. In the context of a range of revenue potential and price-to-sales.

C. Using a single estimate of forecasted earnings and a single estimate of price-to-earnings.

The correct answer is **B.**

Estragon SA estimates exit value using a range of revenue potentials and price-to-sales ratios due to the high degree of uncertainty in the future performance of startups. This approach reflects the variable nature of early-stage companies and provides a more realistic and flexible valuation method. Using ranges rather than single estimates allows for better handling of the inherent uncertainties in predicting the success and profitability of startups.

A is incorrect because using single estimates does not adequately account for the high uncertainty and variability in the revenue potential and valuation multiples of startups.

C is incorrect because startups are less likely to have stable and positive earnings necessary for applying a price-to-earnings multiple, making this method unsuitable for early-stage venture capital valuation.

CFA Level III, Private Markets Pathway Volume 1, Learning Module 2: General Partner and Investor Perspectives and the Investment Process; LOS 2(e): Discuss alternative exit routes in private investments and their impact on value.

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Case 15: Evergreen Capital Partners

Evergreen Capital Partners, a private equity firm, is establishing a new fund, Evergreen Fund IV, to invest in buyouts, venture capital, and growth equity. The fund is in the pre-commitment phase.

During a recent meeting, Sarah mentioned, "Private market returns are typically less reliant on price appreciation over the investment life cycle versus public market returns." Mark countered, "Once a fund’s investment returns reach the amount of capital contributed, the fund reaches an IRR of zero." Linda added, "Fund returns are typically positive during a fund’s capital deployment phase."

The GPs are considering an investment in TechNova, a startup requiring substantial capital for development and expansion. They believe the initial year of capital deployment will mark TechNova’s vintage year. In a discussion about vintage years, Sarah stated, "A GP deploying capital over multiple years for a single fund has multiple vintage years for the fund." Mark disagreed, saying, "A GP deploying capital over multiple years for a single fund has one vintage year, defined as the final year in which capital is deployed." Linda clarified, "A GP deploying capital over multiple years for a single fund has one vintage year, defined as the first year in which capital is deployed."

The GPs also discussed the importance of aligning their interests with those of the LPs. They agreed that incorporating performance metrics and favorable terms, such as a clawback provision, would ensure fair distribution of returns and protect the LPs from paying performance fees on volatile returns that are not sustained over the full investment life cycle.

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Q.1 Based on the discussion among the GPs at Evergreen Capital Partners, who made the ***most accurate*** statement about returns over a private market investment life cycle?

A. Sarah Johnson

B. Mark Thompson

C. Linda Martinez

The correct answer is **B.**

Mathematically, when the cash inflows from investments equal the capital that was initially contributed, the Internal Rate of Return (IRR) is zero. Any returns beyond this point will result in a positive IRR, reflecting actual gains on the invested capital.

A is incorrect because private market returns are actually more reliant on asset price appreciation compared to public market returns. Private market investments typically aim to create value through operational improvements and strategic acquisitions, which enhance asset prices significantly.

C is incorrect because during the capital deployment phase, funds typically experience negative cash flows due to the initial investments and costs. Returns generally become positive during the later stages of the investment lifecycle, after value has been created and realized.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 1: Private Investments and Structures: LOS 1(b): Discuss private investment methods and structures and their uses.

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Q.2 Which activity is **most likely** being conducted by Evergreen Capital Partners during the current pre-commitment phase of the private market fund investment life cycle?

A. Implementing a strategic financing plan

B. Identifying target investments

C. Deployment of capital

The correct answer is **B.**

During the pre-commitment phase of a private market fund, the general partners (GPs) are primarily engaged in establishing the fund's investment strategy and identifying potential target investments. This phase involves conducting preliminary due diligence and selecting investments that align with the fund's strategy before soliciting capital commitments from limited partners (LPs).

A is incorrect. While formulating a strategic financing plan may begin in the pre-commitment phase, its actual implementation typically occurs during the commitment or deployment phases, after the capital commitments have been secured and the fund is operational.

C is incorrect. Capital deployment is not a pre-commitment activity. This phase occurs after the capital has been raised and involves investing the committed capital into the selected investments, executing the strategies laid out during the pre-commitment phase.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 2: General Partner and Investor Perspectives and the Investment Process: LOS 2(a): Discuss a general partner's roles and responsibilities in managing private investment funds.

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Q.3 Based on the GPs' discussion about vintage years, who made the **most accurate** statement?

A. Sarah Johnson

B. Mark Thompson

C. Linda Martinez

The correct answer is **C.**

The vintage year of a fund is defined as the initial year in which the fund's capital is first deployed. It marks the beginning of the fund's investment period and is a critical point for performance measurement and benchmarking.

A is incorrect because a fund can only have one vintage year, which is the year it starts deploying capital. Having multiple vintage years would imply multiple starting points for the same fund, which is not possible.

B is incorrect because the vintage year is defined by the initial capital deployment, not the final year. The final year may be relevant for other performance metrics but not for defining the vintage year.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 2: General Partner and Investor Perspectives and the Investment Process: LOS 2(b): Discuss how private investment firms align their interests with those of their investors, and calculate, interpret, and discuss private market fund performance from an investor perspective, including management fees and carried interest

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Q.4 Given the high expected volatility of exit values of TechNova, which one of the following elements in the agreement with Evergreen Fund IV's GP would LPs most likely seek?

A. Soft hurdle rate

B. Clawback provision

C. High-water mark

The correct answer is **B.**

LPs are most likely to seek a clawback provision in agreements with GPs when there is high expected volatility in exit values. This provision ensures that if the GP has received performance fees on returns that are not sustained over the full investment life cycle, those fees will be returned to the LPs. It protects LPs from overpaying for performance that ultimately does not materialize as expected.

A is incorrect. A soft hurdle rate is a threshold that must be met before the GP can earn performance fees, but it allows for catch-up payments if the fund performance exceeds this rate. This benefits the GP and does not specifically address the risk of volatile returns.

C is incorrect. A high-water mark ensures that performance fees are only paid on new profits, not on the recovery of past losses. While this is a useful provision, it is more common in hedge funds and does not directly address the issue of volatile exit values in private equity as effectively as a clawback provision.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 2: General Partner and Investor Perspectives and the Investment Process: LOS 2(d): Discuss the role of conducting due diligence and establishing a business plan in the private investment process.

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Case 16: The Stratton Venture Fund

The Stratton Venture Fund, a private equity firm based in Boston, has been operating for over a decade, specializing in growth equity and buyout investments. Recently, the firm is considering an investment in a mid-sized technology company, Innovatech Solutions, which has shown significant growth potential in the artificial intelligence sector.

Innovatech Solutions was founded five years ago and has rapidly expanded its market presence with innovative AI solutions for healthcare. The company has secured several key patents and has a robust pipeline of new products. However, it requires additional capital to scale its operations and market its products globally. The founders are open to selling a significant minority share to secure the needed investment.

Stratton Venture Fund plans to invest $50 million into Innovatech Solutions, aiming to hold the investment for a period of five to seven years before exiting. They intend to provide both equity and debt financing, structuring the deal with 70% equity and 30% mezzanine debt.

Stratton Venture Fund has conducted extensive due diligence, including a thorough review of Innovatech's financials, market position, and growth projections. They have also evaluated the company's management team, which includes several industry veterans with a strong track record. To align interests, the fund proposes to implement an incentive structure for the management team, including performance-based equity options.

Stratton's investment committee is also exploring various exit strategies, such as a strategic sale, an initial public offering (IPO), or a recapitalization. The fund is particularly focused on the potential impact of these exit strategies on their internal rate of return (IRR) and multiple on invested capital (MOIC).

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Q.1 What type of private equity strategy is Stratton Venture Fund *most likely* employing with its planned investment in Innovatech Solutions?

A. Venture Capital.

B. Growth Equity.

C. Buyout Equity.

The correct answer is **B.**

Stratton Venture Fund's planned investment in Innovatech Solutions is best classified as a growth equity strategy. Growth equity investments typically involve providing capital to mature companies that have already demonstrated significant growth potential but require additional funding to expand their operations, enter new markets, or accelerate their growth trajectory. In this scenario, Innovatech Solutions, a mid-sized technology company in the AI sector, has shown significant growth and needs further capital to scale its operations and market its products globally. The investment does not involve taking control of the company (as in buyout equity) nor investing in an early-stage startup (as in venture capital), which aligns with the characteristics of a growth equity strategy.

A is incorrect. Venture Capital involves early-stage companies or startups that are in the initial stages of their development and need capital to further develop their products or services and grow their business. Innovatech Solutions is already a mid-sized company with a proven market presence and several key patents, which does not fit the profile of a venture capital investment.

C is incorrect. Buyout Equity involves acquiring a controlling interest in a company, often leading to significant changes in management and operations. Stratton Venture Fund is planning to make a significant minority investment rather than taking control of Innovatech Solutions, making buyout equity an inappropriate classification for this investment.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 3: Private Equity: LOS 3(a): Discuss private equity strategies over the company life cycle.

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Q.2 Which performance metric should Stratton Venture Fund *most likely* prioritize to evaluate the realized returns of its potential investment in Innovatech Solutions?

A. Price-to-Earnings (P/E) Ratio.

B. Distributed to Paid-In (DPI).

C. Dividend Yield.

The correct answer is **B.**

Stratton Venture Fund should prioritize the Distributed to Paid-In (DPI) metric to evaluate the realized returns of its potential investment in Innovatech Solutions. DPI measures the amount of capital that has been returned to investors relative to the amount of capital paid in. It is a key performance metric in private equity because it reflects the actual cash returns that have been distributed to investors, thus providing a clear indication of the realized performance of the investment.

A is incorrect. The P/E ratio is commonly used in public equity markets to value companies by comparing their current share price to their earnings per share. However, it is less relevant for private equity investments, where the focus is on total returns and cash flow distributions over the investment period rather than short-term earnings.

C is incorrect. Dividend yield measures the annual dividends paid by a company relative to its share price, which is more applicable to public market investments with regular dividend payments. Private equity investments, particularly in growth equity and buyouts, typically focus on capital appreciation and total returns rather than income from dividends.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 1: Private Investments and Structures: LOS 1(c): Discuss the difference between public and private market performance, and calculate, interpret, and discuss the use of performance metrics including distributed to paid-in, residual value to paid-in, and total value to paid-in.

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Q.3 What is Stratton Venture Fund's primary risk management concern when structuring the mezzanine debt component of its investment in Innovatech Solutions?

A. Interest rate risk.

B. Credit risk.

C. Liquidity risk.

The correct answer is **B.**

The primary risk management concern for Stratton Venture Fund when structuring the mezzanine debt component of its investment in Innovatech Solutions is credit risk. Mezzanine debt is subordinated to senior debt, meaning it is repaid only after senior debt obligations are met. This makes it riskier and more vulnerable to default if Innovatech Solutions faces financial difficulties. Ensuring the company's creditworthiness and ability to service this debt is crucial for managing this risk.

A is incorrect. While interest rate fluctuations can affect the cost of borrowing and the returns on debt investments, mezzanine debt typically carries a fixed interest rate, making interest rate risk less of a concern compared to credit risk.

C is incorrect. Liquidity risk pertains to the ability to sell an investment quickly without significantly affecting its price. Although private equity investments, including mezzanine debt, are generally illiquid, the primary concern here is the risk of default (credit risk) rather than the ability to quickly liquidate the investment.

CFA Level III, Private Markets Pathway Volume 1: Learning Module 4: Private Debt: LOS 4(a): Discuss the use of debt financing in private market strategies over the investment life cycle.

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