Why and How to Invest in Private Equity

Special Paper

Special Paper

An EVCA Investor Relations Committee Paper

Written by Alex Bance

EVCA Investor Relations Committee

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European Private Equity & Venture Capital Association

About EVCA...

The European Private Equity and Venture Capital Association (EVCA) exists to represent the European private equity sector. With over 950 members throughout Europe, EVCA's many roles include providing information services for members, creating networking opportunities, representing the industry in public affairs and working to promote the asset class both within Europe and throughout the world. EVCA's activities cover the whole range of private equity, from seed and start-up to development capital, buyouts and buyins, and the flotation of private equity-backed companies.

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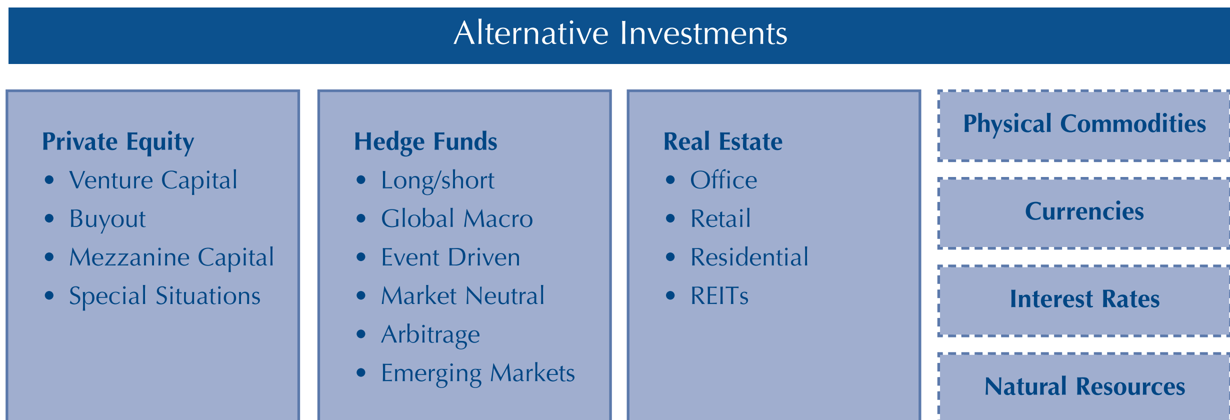
Part One Introduction and Background to the Asset Class

1. Introduction

Private equity has arrived as a major component of the alternative investment universe and is now broadly accepted as an established asset class within many institutional portfolios. In Europe, sums committed to private equity funds have increased dramatically over the last ten years. Consequently, many investors still with little or no existing allocation to private equity are now considering establishing or significantly expanding their private equity programmes.

This document is designed to help such investors consider the characteristics of private equity investment and how best to approach the construction and implementation of a private equity portfolio. Information on private equity, by its nature, is harder to come by than information on the public markets. This can make it challenging to understand the dynamics of the asset class and to determine how best to construct an investment strategy.

It is useful to begin with an overview of the industry. Private equity is often categorised under the umbrella of "alternative investments", comprising a variety of investment techniques, strategies and asset classes that are complimentary to the stock and bond portfolios traditionally used by investors. The chart below shows the main components of the alternative investment space at a broad level.



2. Definition of private equity

Private equity investing may broadly be defined as "investing in securities through a negotiated process".

The majority of private equity investments are in unquoted companies. Private equity investment is typically a transformational, value-added, active investment strategy. It calls for a specialised skill set which is considered in more detail in Part 5 and which is a key due diligence area for investors' assessment of a manager. The processes of buyout and venture investing call for different application of these skills as they focus on different stages of the life cycle of a company.

Private equity investing is often divided into the broad categories described below. Each has its own subcategories and dynamics and whilst this is simplistic, it provides a useful basis for portfolio construction, which is discussed in Part 3. In this paper, private equity is the universe of all venture and buyout investing, whether such investments are made through funds, funds of funds or secondary investments.

Introduction

Venture Capital

Described as the "business of building businesses", venture capital is investing in companies that have undeveloped or developing products or revenue. Venture capital has a particular emphasis on entrepreneurial undertakings and less mature businesses.

Seed stage	Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.
Start-up stage	Financing for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially and will not yet be generating a profit.
Expansion stage	Financing for growth and expansion of a company which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital. This stage includes bridge financing and rescue or turnaround investments.
Replacement Capital	Purchase of shares from another investor or to reduce gearing via the refinancing of debt.

Buyout

A buyout fund typically targets the acquisition of a significant portion or majority control of businesses which normally entails a change of ownership. Buyout funds ordinarily invest in more mature companies with established business plans to finance expansions, consolidations, turnarounds and sales, or spinouts of divisions or subsidiaries. Financing expansion through multiple acquisitions is often referred to as a "buy and build" strategy.

Investment styles can vary widely, ranging from growth to value and early to late stage. Furthermore, buyout funds may take either an active or a passive management role.

Special Situation

Special situation investing ranges more broadly, including distressed debt, equity-linked debt, project finance, one-time opportunities resulting from changing industry trends or government regulations, and leasing. This category includes investment in subordinated debt, sometimes referred to as mezzanine debt financing, where the debt-holder seeks equity appreciation via such conversion features as rights, warrants or options.

3. Historical development of the industry

The phrase "private equity" only became widespread in the late 1980s following public interest in leveraged buyout ("LBO") fund activity, particularly in the US. In reality, the private equity market dates back to the formation of groups in Europe such as Charterhouse Development Capital in 1934 and 3i in 1945 and, in the US, American Research and Development Corporation ("ARD") in 1946.

3i (originally named the Industrial and Commercial Finance Corporation) was founded by UK clearing banks and the Bank of England to meet the needs of smaller companies and address the shortage of long-term capital available to them for development. In contrast, ARD set out to commercialise some of the new technologies that had been developed in the war by raising institutional capital using a publicly traded, closed-end investment company. Both new investors brought industrial expertise to their assessment of companies, a shift from the traditional focus on security.

However, the broader private equity market remained fragmented for some time, consisting largely of venture investment into early stage companies by private individuals (known as "business angels") and, to a lesser extent,

foundations and university and government investment programmes. Some of the better-known, early venture-backed companies include Digital Equipment (which went public in 1968 valued at US$37 million after Digital's original funding of US$70,000 in 1959), Federal Express and Apple Computer.

The main catalysts in the development of the private equity industry in both Europe and the US occurred in the 1970s. In the UK, the move towards the Competition and Credit Control policy in 1971 gave banks greater investment flexibility. In the US, clarification of the "prudent man" rule issued by the US Labor Department in 1978 relaxed many of the limitations placed on institutional pension funds allowing them to invest in private equity and other alternative strategies.

Subsequent structural and legal changes throughout Europe, for example to pension fund and insurance company regulation, have allowed for the liberalisation of investment choices available to institutions. In addition, tax reforms around Europe, which made investments that return capital gains more attractive, have also been a catalyst.

The movement of assets from fixed income investments into equities and other products was accelerated in the late 1990s by a low inflation environment. This environment has created a particular need for growth stocks and highlighted a core skill of successful private equity managers, namely creating conditions for growth in portfolio companies.

In the early 1990s the industry began a period of rapid international growth, culminating in over €200 billion being raised globally in 2000 by private equity funds.

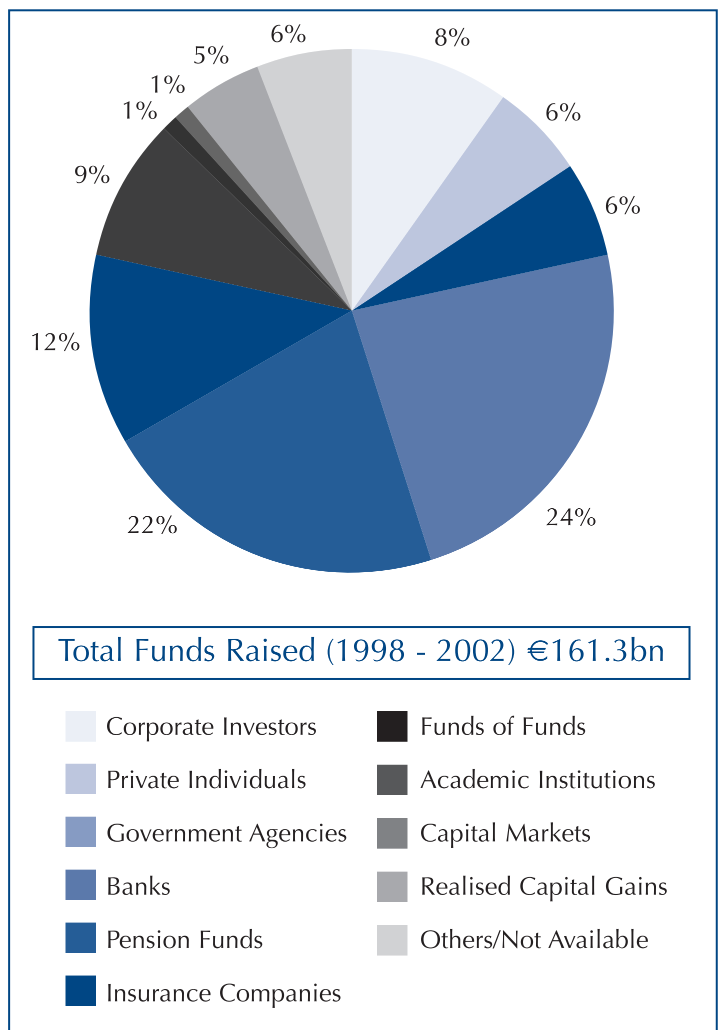
4. What are the main sources of private equity finance?

The spectrum of investors in private equity has expanded rapidly to include numerous different types of investors with significant long-term commitments to the asset class. In general, the majority of commitments to private equity funds based in respective geographical regions have come from institutions within the same region. This is evolving as investors seek a higher level of geographical diversification in their private equity portfolios.

The number and calibre of institutions that have invested in European private equity funds and allocated significant pools of capital to building their portfolios demonstrates, in conjunction with the rapid growth of the market, the maturity and stature of private equity as an asset class in Europe.

The charts below illustrate the evolving sources of investment in European private equity funds, analysed by investor type. Geographically, over 70% of this funding still originates from European investors.

Sources of European Private Equity



Source: EVCA

Part Two **Why Invest in Private Equity?**

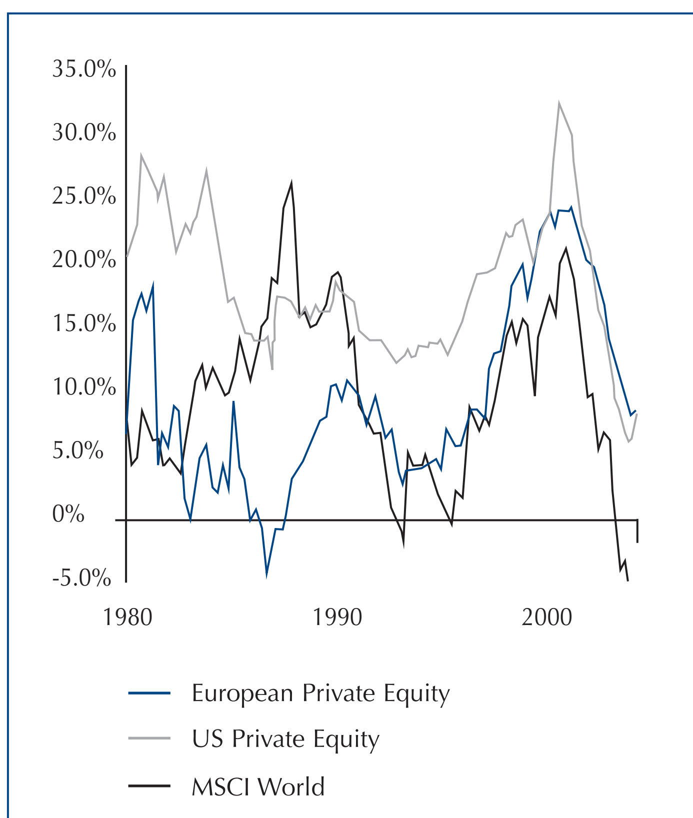
The fundamental rationale for investing in private equity is to improve the risk and reward characteristics of an investment portfolio.

Investing in private equity offers the investor the opportunity to generate higher absolute returns whilst improving portfolio diversification.

1. **Long-term historical out-performance**

   The long-term returns of private equity represent a premium to the performance of public equities. This has been the case in the US for over 20 years and also in Europe, following an increase in the number of private equity funds, for over 10 years.

5 Year Return Figures: Private Equity Vs MSCI World



Source: Venture Economics / Datastream

For many institutions, such a premium over more conventional asset classes justifies the different risk profile of the asset class. Growth in the European private equity fund market has been assisted by growing awareness amongst investors of the excess returns from private equity investment that have been generated in the US over the longer term and more recently in Europe too.

2. **True stock picking in a low inflation, low growth environment**

   A low inflation environment creates a focus on growth stocks as a means of out-performance. One of the core skills of successful private equity managers is to pick companies with growth potential and actively to create the conditions for growth in those companies. Since private equity funds own large, often controlling, stakes in companies, few, if any, other private equity managers will have access to the same companies. Private equity managers are therefore true "stock pickers". This contrasts markedly to mutual funds, which will often hold largely the same underlying investments as their peer group, with variations in weightings being fine-tuned to a few basis points.

3. **Absolute returns**

   Excessive volatility and poor investment performance experienced by quoted equity portfolios, many of which have index-tracking strategies or are benchmarked to an index ("closet trackers"), have led to a swing in favour of strategies that seek absolute returns.

   Demographic trends have compounded the desirability of such a change. The pressing need to provide for an ageing population has obliged many institutions to adopt a more absolute return oriented investment approach in order to meet future liabilities.

   Private equity managers do seek absolute returns and their traditional incentivisation structure, the "carried interest", is highly geared towards achieving net cash returns to investors.

4. **Portfolio diversification improves risk and volatility characteristics**

   Within a balanced portfolio, the introduction of private equity can further improve diversification. Although correlation of returns between private equity and public market classes is widely debated and needs further investigation, the numbers presented on the following page, based partly on unrealised gains, do indicate a lower correlation.

Why Invest

Correlation of Private Equity with Other Asset Classes				
	Equity Markets (%)		**Bonds (%)**	
	Long Term	Short Term	Long Term	Short Term
Annual[1]	0.57 to 0.59	0.49 to 0.58	-0.18 to 0.12	-0.37 to -0.07
Quarterly[2]	0.58 to 0.59	0.58 to 0.61	0.00 to -0.11	-0.22 to 0.03

1 Long term horizon 30 years, short term horizon 19 years. Correlation ranges for large and small cap stocks; Treasury bills and bonds and corporate bonds.

2 Long term horizon 24 years, short term horizon 16 years. Correlation ranges for large and small cap stocks; Treasury bills and bonds and corporate bonds.

Sources: Venture Economics, Investment Benchmarks Report: Venture Capital (2002 Edition)

As a result, adding private equity to a balanced portfolio can reduce volatility and contribute to an overall improvement in risk profile. This would allow higher targeted returns for the same level of calculated risk, or a reduction to the level of risk in the portfolio whilst preserving the target rate of return.

5. **Whilst the majority of European GDP is generated by private companies, the private equity market has much fewer funds under management than the public markets**

There is still plenty of scope for growth in the asset class and a much greater universe of assets from which to select. This is particularly true in Europe where private equity fund investment remains a much smaller proportion of GDP than in the US.

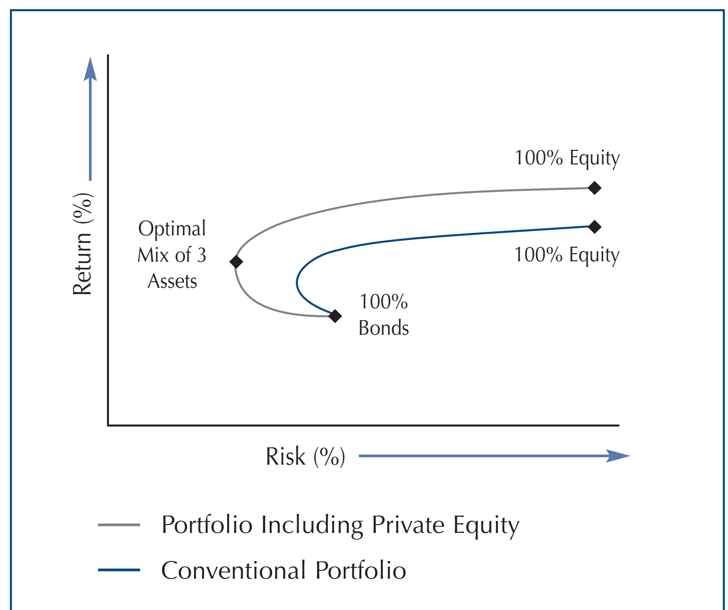
6. **Exposure to the smaller companies market**

The private equity industry has brought corporate governance to smaller companies and provides an attractive manner of gaining exposure to a growth sector that went out of favour with quoted market investors in the mid 1990s for reasons of liquidity.

7. **Access to legitimate inside information**

A much greater depth of information on proposed company investments is available to private equity managers. This helps managers more accurately assess the viability of a company's proposed business plan and to project the post-investment strategy to be pursued and expected future performance. This greater level of disclosure contributes significantly to reducing risk in private equity investment. Equivalent information in the public markets would be considered "inside information". By definition, investors in public markets will know less about the companies in which they invest.

Improving the Risk-Return Trade-off



8. Ability to back entrepreneurs

The wider emergence in Europe of entrepreneurs as an important cog in the economy has been facilitated by a period of larger company rationalisation. This has reflected similar developments in the US that, for example, fostered rapid growth in technological innovation and substantial knock-on benefits for the whole economy through the 1990s. Entrepreneurs have also been at the heart of developments in Europe, creating value in both traditional and hi-tech industries. The private equity asset class offers the ability to gain investment exposure to the most entrepreneurial sectors of the economy.

9. Influence over management and flexibility of implementation

Private equity managers generally seek active participation in a company's strategic direction, from the development of a business plan to selection of senior executives, introduction of potential customers, M&A strategy and identification of eventual acquirers of the business. Furthermore, implementation of the desired strategy can normally be effected much more efficiently in the absence of public market scrutiny and regulation. This flexibility represents another feature whereby risk can be reduced in private equity investment.

10. Leveraging off balance sheet

Buyout managers in particular are able to make efficient use of leverage. They aim to organise each portfolio company's funding in the most efficient way, making full use of different borrowing options from senior secured debt to mezzanine capital and high yield debt. By organising the company's funding requirements efficiently, the equity returns are potentially enhanced. In addition, because the leverage is organised at the company level and not the fund level, there is a ring-fencing benefit: if one portfolio company fails to repay its borrowing, the rest of the portfolio is not contaminated as a result. Thus the investor has the effective benefit of a leveraged portfolio with less downside risk.

However, there are features that investors might not find attractive and which must be understood.

I) Long-term investment

In general, holding periods between investment and realisation can be expected to average three or more years (although this may be shorter when IPO markets are especially healthy). Because the underlying portfolio assets are less liquid, the structure of private equity funds is normally a closed-end structure, meaning that the investor has very limited or no ability to withdraw its investment during the fund's life. Although the investor may receive cash distributions during the fund's life, the timing of these is normally uncertain. "Liquidity risk" is one of the principal risk characteristics of the asset class. Private equity should therefore be viewed as a longer-term investment strategy.

II) Increased resource requirement

As a result of the active investment style typical of the industry and the confidentiality of much of the investment information involved, the task of assessing the relative merits of different private equity fund managers is correspondingly more complex than that of benchmarking quoted fund managers. This makes investment in private equity funds a much more resource-intensive activity than quoted market investment. Likewise, post-investment monitoring of funds' performance is also more resource-intensive. Resource is a key issue in the development of a private equity programme that is suitable for the investor.

III) "Blind pool" investing

When committing to a private equity fund, the commitment is typically to provide cash to the fund on notice from the general partner. Whilst launch documentation will outline the investment strategy and restrictions, investors give a very wide degree of discretion to the manager to select the companies that the investors will have a share in. Unlike some real estate partnerships, there is usually no ability at the launch of a private equity fund to preview portfolio assets before committing, because they have not yet been identified. Likewise, there is generally no ability to be excused from a particular portfolio investment after the fund is established.

Part Three **Approaches to Portfolio Construction**

Portfolio construction will reflect the principal objectives of investing in private equity discussed in Part 1, including targeting higher long-term returns and portfolio diversification through reduced correlation to public equity markets. Issues of correlation will apply not only in connection with other assets, but also amongst the assets in the private equity portfolio itself.

Decision 1 - The size of the private equity allocation

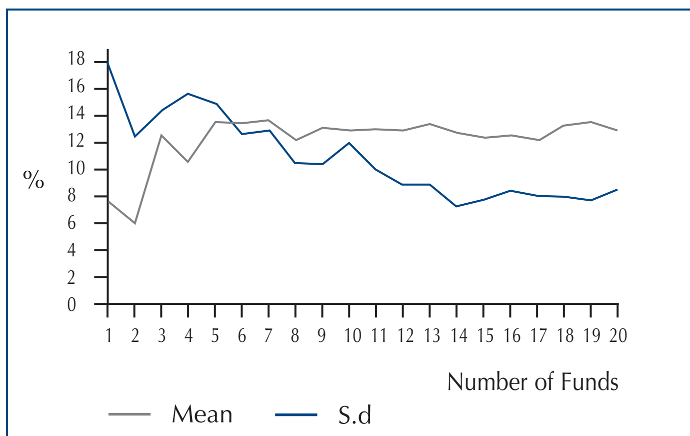
Investors in private equity should be able to accept the illiquid character of their investment, hence the extent to which liquidity may be required is often a factor in the size of allocation. For this reason, it is often the case in the US that the investors who make the largest proportional allocations to private equity from their overall portfolios are those who are able to invest for the long term with no specific liabilities anticipated. These would include endowments, charities and foundations. Pension funds also are often large investors in the asset class. A reputable 2003 survey found that the average allocation to private equity amongst US institutions invested in the asset class was 7.5%. The comparable figure for European institutions was 4.0%.

Based on the requirement to increase targeted returns and/or reduce volatility, the investor will determine the proportion of its overall portfolio that it believes is appropriate to allocate to private equity.

Decision 2 - Number of private equity funds to commit to

It is a challenge for investors to avoid concentration of risk within their private equity portfolio and to control portfolio volatility. It is appropriate to aim for some diversification. The chart below indicates that a level of diversification can be achieved by holding at least 6 different funds.

Example of volatility of returns versus number of funds held



Source: Venture Economics / UBS

Decision 3 - Ways of achieving diversification

i) Stage

There is limited correlation between returns from different stages of private equity. Diversification can therefore reduce risk within a private equity portfolio and this should be an important consideration.

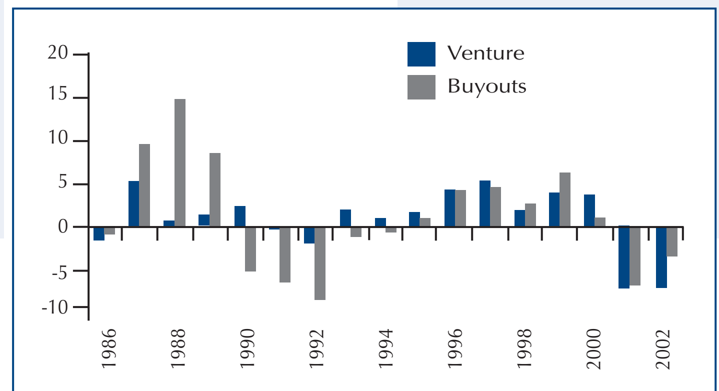
Correlation between Sectors of Private Equity

	Buyouts
Venture Capital[1]	
Annual	0.36
Quarterly	0.47

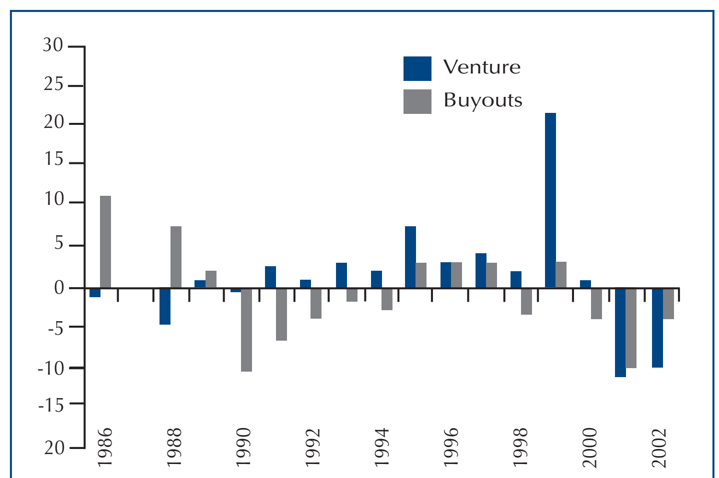
Source: Venture Economics Investment Benchmarks Report: Venture Capital (2002 Edition)

[1]Annual correlation based on period of 19 years; quarterly correlation based on period of 16 years.

Europe - 5 Year IRR Evolution (in Percentage Points)



US - 5 Year IRR Evolution (in Percentage Points)



Source: Venture Economics / EVCA

As mentioned in Part 1, venture capital can be further sub-divided into categories ranging from seed stage to late stage investment. In respect of buyout funds, a distinction can be made between larger, mid-market and growth buyouts.

ii) Geography

Geographical diversification can be secured in Europe through the use of country-specific, regional and pan-European funds. Non-European exposure is also widely available, in particular through US funds, but also for example through Global, Israeli, Latin American and Asian funds.

A simple diversification model (whose weightings to each segment are not necessarily equal) might look as follows:

	Larger Buyouts	Mid-Market/ Special Situation	Venture Capital
US			
Europe			
ROW			

iii) Manager

Selecting a variety of managers will reduce manager-specific risk.

iv) Vintage year

Timing has an impact on the performance of funds, as opportunities for investment and exit will be impacted by external economic circumstances. For this reason it has become normal practice to compare the performance of funds against others of the same vintage. There may be marked differences in performance from one vintage year to another. In order to ensure participation in the better years, it is generally perceived to be wiser to invest consistently through vintage years, as opposed to "timing the market" by trying to predict which vintage years will produce better performance.

v) Industry

In venture investing, most of the focus tends to be on technology based industries. These can be sub-divided, for example into healthcare / life sciences, information technology and communications. Buyout funds tend to focus on technology to a lesser extent, providing exposure to such sectors as financial institutions, retail and consumer, transport, engineering and chemicals. Some have a specific sector focus.

Decision 4 - How to implement the strategy

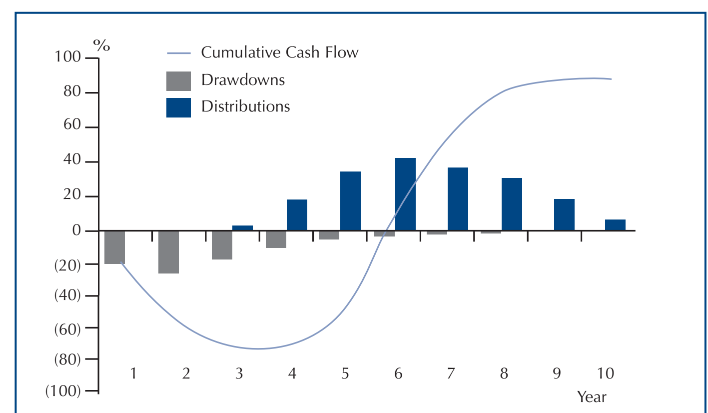
Given the typical minimum investment size of private equity funds, establishing a diversified portfolio will require certain minimum levels of capital commitment. It will also take time to put into effect, bearing in mind vintage year diversification and the over-riding objective to identify the best managers in a given area. Part 4 covers these and other practical aspects of investment.

Decision 5 - How to plan for the volatility of cash flows - the J-curve

An investor is typically required to fund only a small percentage of its total capital commitment at the outset. This initial funding may be followed by subsequent drawdowns (the timing and size of which are generally made known to the investor two or three weeks in advance) as needed to make new investments. Just-in-time drawdowns are used to minimise the amount of time that a fund holds uninvested cash, which is a drag on fund performance when measured as an internal rate of return ("IRR"). Investors need to maintain sufficient liquid assets to meet drawdown obligations whenever called. Penalty charges can be incurred for late payment or, in extreme cases, forfeiture of an investor's interest in the fund. In most funds' early years, investors can expect low or negative returns, partly due to the small amount of capital actually invested at the outset combined with the customary establishment costs, management fees and running expenses.

As portfolio companies mature and exits occur, the fund will begin to distribute proceeds. This will generally take a few years from the date of first investment and, as with drawdowns, the timing and amounts will be volatile. When drawdowns and distributions are combined to show the net cash flows to investors, this normally results in a "J-curve", illustrated in the chart below. As distributions normally commence before the whole commitment has been drawn, it is unusual for an investor ever to have the full amount of its commitment actually managed by the manager. In the illustration below, net drawn commitments peak at around 80%.

Typical fund annual cash flows to investors



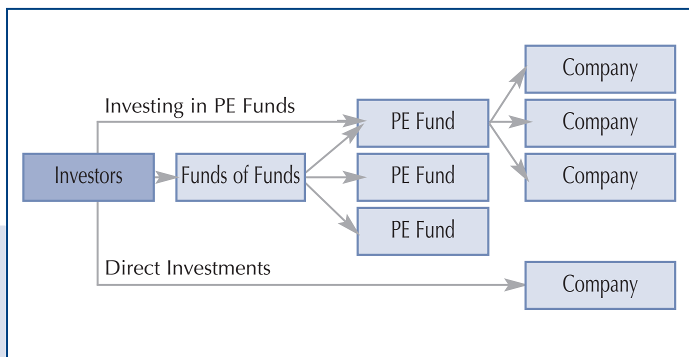
1. The principal means of private equity investment

The principal means of private equity investment are:

a) Investing in private equity funds

b) Outsourcing selection of private equity funds, for example through a fund of funds

c) Direct investment in private companies.



While it is sometimes the ultimate objective of investors to be able to make direct investments into companies, compared with investing through funds it requires more capital (to achieve similar diversification and exposure), a different skill set, more resource and different evaluation techniques. Whilst this can be mitigated by co-investing with a fund and the rewards can be high, there is higher risk and the potential for complete loss of invested capital. This strategy is recommended only to experienced private equity investors. For most investors the use of private equity funds would be preferred, selected in-house or through outsourced selection.

In-house private equity fund investment programme

Investors in a fund generally expect to gain broader exposure through a portfolio built during the commitment period by investment professionals who specialise in discovering, analysing, investing, managing and exiting from private company investments. Being diversified amongst a number of different investments helps ensure that the risk of total loss of capital in the fund is relatively low compared to investing directly in unquoted companies. Compared to quoted equity funds, private equity funds often invest in relatively concentrated portfolios, for example there might be 10–15 companies in a typical buyout portfolio or 20–40 companies in a venture capital portfolio. Some factors that investors should consider when selecting funds are discussed in Part 5.

Outsourcing

(i) Fund of Funds

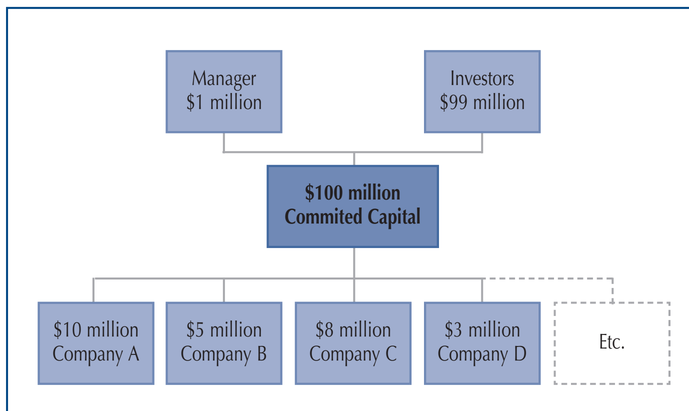
A fund of funds is a pooled fund vehicle whose manager evaluates, selects and allocates capital amongst a number of private equity funds. Because many funds of funds have existing relationships with leading fund managers, and because commitments are made on behalf of a pool of underlying investors, this can be an effective way for some investors to gain access to funds with a higher minimum commitment or to heavily subscribed funds. Many funds of funds are "blind" pools, meaning that exposure to particular underlying funds is not guaranteed. Rather the investor is relying on the record of the manager to identify and secure access to suitable funds. Some funds of funds by contrast do disclose a pre-selected list of investments. Investors in funds of funds need to balance the extra layer of management fees and expenses involved against the cost of the extra resource that the investor would need itself to select and manage a portfolio. Fund of funds investors should be able to achieve efficiently the diversified exposure referred to in Part 3 through a smaller deployment of capital with managers selected on rigorous criteria. It also decreases the burden of ongoing monitoring, reporting and administration.

(ii) Consultants

Consultants will offer similar expertise to fund of fund managers, but may offer a choice of discretionary or advisory services. The latter will facilitate construction of a tailor-made portfolio, as opposed to committing to a blind pool alongside other investors. Consultants may also offer segregated rather than pooled accounts. Consultancy services are also offered by some fund of funds managers.

2. Private equity fund structures

Example of a simplified fund structure



a) Legal and taxation aspects

The many legal jurisdictions in Europe make it difficult to create a fund structure that can be marketed effectively to investors in different regulatory and taxation environments. Often it is necessary to create two or more vehicles, with different structures or domiciles, to permit investors in different countries to co-invest in a common portfolio. Two of the principal considerations in any fund structure are:

- the structure should not prejudice the investor's tax position; and
- investors should have the benefit of limited liability.

In relation to tax, it is important that there should be no additional layer of tax at the level of the fund, nor should investors be rendered liable to tax in another country as a result of the fund's activities. As a result, fund structures are often based on the principle of "transparency". In other words, investors are treated as investing directly in the underlying portfolio companies.

A common structure used internationally is the US or English limited partnership. However, although based on the principal of transparency, they may not always be recognised as transparent in other jurisdictions. Some of the more common fund structures that satisfy the criteria of transparency and limited liability in different jurisdictions are:

Finland	Limited partnership
France	FCPR and FCPI
Germany	GmbH & Co KG
Netherlands	CV (partnership)
Sweden	Limited partnership
UK	Limited partnership

There are, in addition, numerous incorporated and other structures available that may better suit different investors on a country by country basis.

b) Liquidity

Private equity investing is a long-term investment activity and for this reason private equity managers generally impose rigid restrictions on the transferability of interests in their funds. Issues of liquidity can therefore put some investors off. There are however ways these can be circumvented.

i) Quoted private equity funds

There are a number of high-quality private equity funds in Europe that are quoted on major European stock exchanges. Whilst many of these were established to take advantage of tax benefits (for example freedom from tax on capital gains for quoted investment trusts in the UK), they remain less common than privately held vehicles.

Some of the reasons for this include:

- the tendency of quoted investment companies to trade at a discount to asset value, which may fluctuate, eroding the return on investment or making it more volatile.
- the limited ability to return cash to investors - this means that when portfolio investments are realised, the cash received remains inside the fund and dilutes its performance until such time as it can be re-invested.

Nevertheless, some investors can for regulatory reasons only invest in quoted securities and for these investors quoted private equity funds remain a good option.

ii) Development of the secondary market

There is a rapidly developing market in interests in existing private equity funds, referred to as "secondaries". A secondary offering may comprise a single manager's entire fund of direct investments or, more commonly, a portfolio of interests in a number of different funds.

There is a growing number of well-financed investors that specialise in purchasing interests in existing funds from their original investors. Generally, however, investors should not assume that secondary purchasers will offer a liquid or attractive exit path.

For the larger secondary portfolios, it is common for a buyer to be secured through an auction process. For the smaller transactions, these are often effected in a confidential manner, sometimes with buyer and seller matched by the fund's manager or by an intermediary.

One of the keys to a secondary transaction is securing the goodwill of the underlying manager. The manager often has the ability to refuse or restrict transfer of the interest. In addition, valuation of the underlying assets is facilitated by the co-operation of the manager.

As institutional private equity programmes increase and start to reach maturity, the ability for investors to realise some existing commitments in order to raise cash for future commitments will become more attractive. This will be one of the factors that accelerates the development of the secondaries market going forward.

c) Breaking new ground

i) Structured products

Specialist techniques of structuring funds have more recently allowed private equity fund products to be offered with features that are attractive to particular types of investor. Through securitisation, incorporated fund vehicles have been able to offer interests to investors in the form of notes or bonds with credit ratings, including convertible securities. Such interests may also benefit from partial or complete guarantees of the principal sum invested. To date, such products have usually been funds of funds structured as "evergreen" funds, meaning that realised investment returns are not distributed to investors but reinvested within the fund. Likewise, commitments have generally been drawn down at the outset rather than on a just-in-time basis for investment. These funds are normally quoted.

ii) High Net Worth Investors

High net worth investors are becoming a significant and active section of the market. Since it is not practical for many to secure diversified exposure to a variety of funds, bearing in mind the usual minimum commitment size, there are a variety of pooled vehicle types that may be offered. For example, dedicated feeder structures may provide specific single-fund exposure to private investors on a pooled basis. A variation of this model is a pooled vehicle that provides exposure to several (for example between four and six) pre-selected funds. Alternatively, investors can outsource their investment decision-making (as discussed above) by investing in one of the fund of fund products available to high net worth investors, for example through private banks.

d) Typical private equity fund terms

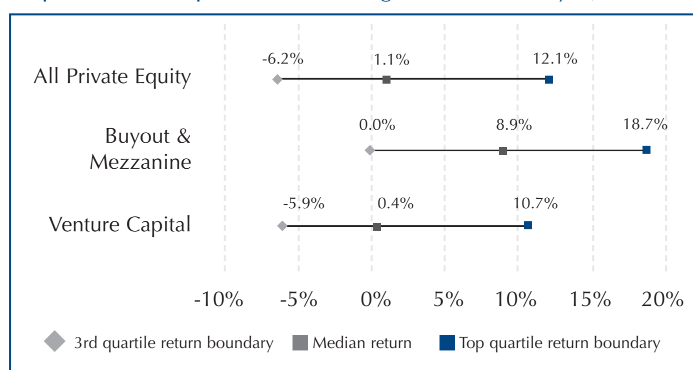
Minimum Commitment	Often between €5 million and €10 million
Manager's Commitment	Fund managers typically invest their personal capital alongside their investors' capital, which often creates a higher level of confidence in the fund. Investors look for a "meaningful" manager investment of at least 1% of the fund.
Partnership Term	The investment term for most private equity funds is 7 to 10 years, with the possibility of extensions. The investment remains usually illiquid during this period of time but distributions may be made as investments are sold.
Investment / Commitment Period	On average, private equity funds invest committed capital over a three to six year period.
Management Fees	Fund fees traditionally include an annual management fee of around 1.5% to 2.5% of committed capital, which should approximate the actual costs of operating.
Incentive / Performance Fees	A share, typically 20%, of total gains that is payable to the manager. This is known as "carried interest".
Preferred Return	The carried interest may be subject to the fund exceeding a certain level of returns on the drawn down money. This preferred return is a margin on the risk free return per annum over the life of the fund.

Part Five Due Diligence

1. The importance of manager selection

The principal criteria for private equity fund selection usually relate to the credentials of management teams. The variation in performance between upper and lower quartile managers in the private equity market is substantially more diverse than in listed equity and bond markets. The chart below illustrates the importance in private equity of selecting upper quartile management teams.

Dispersion of European Active Management Returns by Quartile



Source: Venture Economics

2. What to look for in a potential fund investment

Investors should evaluate each manager's credentials by investigating closely its track record and reputation. Previous research has shown that a manager's track record can be an indicator (though not a guarantee) of future success as the percentage of new funds that become top quartile performers has historically been highest amongst managers of previous top quartile funds. The following are some key considerations:

a) Investment strategy and market opportunity

A proposed fund's investment strategy should be clear and very similar to that on which the manager's track record is founded. The track record should demonstrate a disciplined approach and the ability to adhere to the articulated strategy. The amount of money being raised should be clearly justified by the magnitude of the perceived investment opportunity and the extent of the manager's resources. The investment strategy should be attractive in the context of the wider economic landscape, which will impact the market opportunity.

b) Track record

Publicly available statistics showing upper quartile rates of investment performance are becoming more accurate as a benchmark for funds by sector and vintage year. Prospective investors need to examine internal rates of return on investments in conjunction with multiples of original cost realised. Consistent upper quartile returns over an extended period of time and a good number of realised investments are preferred. Returns are often quoted on a "gross" and "net" basis. The gross return represents the fund's return on its investments and does not take into account the fees and expenses of the fund or the dilutive effect of holding uninvested cash. The net return represents the investor's return and is also referred to as the "cash on cash" return. Returns on realised investments are often also distinguished from returns on unrealised investments. Investors should look for a large proportion of realised investments in the portfolio. In respect of unrealised investments, investors will want to examine valuation policy. An analysis of the dispersion of returns on an investment by investment basis illustrates the volatility of returns and risk associated with the investment strategy. Investors should look for a level of volatility that is consistent with the strategy. For example, buyout returns ought to be less volatile than venture capital returns. Another way to analyse a track record is by method of value creation. For instance, portfolio returns can be attributed to different elements of the strategy, including growth in sales, reduction in costs, improvement in price / earnings multiple and cash generation / deleveraging. A record that demonstrates a large proportion of returns being generated through earnings growth is often popular.

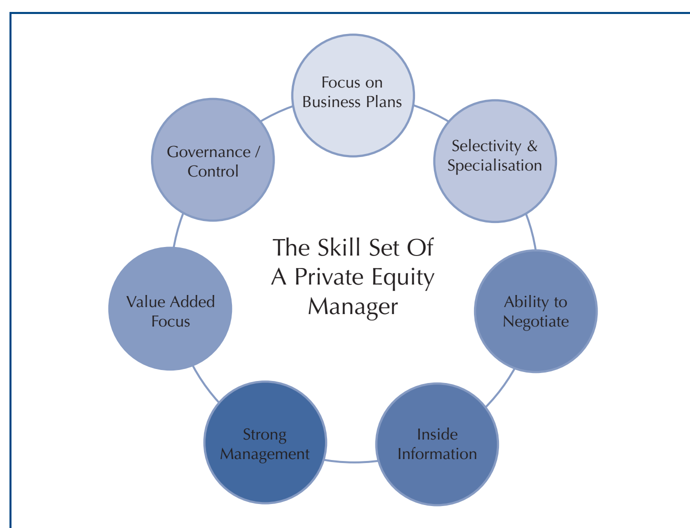
c) Investment team

An assessment of the ability of a manger to reproduce previous upper quartile performance will focus on the individuals comprising the management team, their incentivisation and the past and future continuity within the team. The most important aspect of each individual's background should be solid experience as a private equity manager. Additional attributes, such as relevant operational, sector or scientific experience, are helpful. It is important that the core members of the management team have already been working as a team for a significant period and departures from this core team over time have been minimal. This will provide clearer attribution of the investment track record to these individuals and give some comfort as to the future continuity of the team. It is normally very helpful to speak to business counterparts (for example portfolio company

executives or peer group fund managers) in respect of the individuals, as they may provide some insight into the dynamics of the team. Further comfort with respect to the future can be derived from the incentivisation structure. Broadly, all the key executives should receive a fair proportion of the carried interest and ideally it would be spread widely throughout the team. This will give comfort as to the strength and depth of the team. It will also evidence planning for the future succession of senior management responsibility within the management team. Personal commitments to the fund by the management team that are meaningful in the context of their net worth are also a good indicator of commitment.

d) Summary of key skills

Successful private equity managers will be able to demonstrate a number of key skills. Some of these are described below.



Focus on Business Plans	Business plans will be carefully built and analysed prior to any investment. Scrutinising a business plan and helping to create the conditions for its effective execution is one of the major areas where private equity managers can add value to their portfolio companies.
Selectivity and Specialisation	Good private equity managers will see a large number of potential transactions each year, which permits them to be extremely selective, pursuing only those where they have the knowledge and capability to "add value." A full technological and operating knowledge of these opportunities has become increasingly important as the industry matures.
Ability to Negotiate	Unlike the purchase of a public security, a private equity manager does not have to buy exclusively on the basis of price. The manager can negotiate a variety of protections including exclusion of liabilities, indemnities and retroactive price adjustments.
Inside Information	Unlike the purchase of a public security, the private equity manager can legally employ inside information such as management projections in its investment process.
Strong Management	Strong management, both within the private equity manager and the company itself, is crucial to the success of an investment. The private equity manager will depend heavily on the company’s management in the day to day operations of the business.
Value Added Focus	Ownership and management become aligned, which almost always occurs to a greater degree than is usual in public equity. In addition the private equity manager will become involved in the strategic direction of the company and the risk management of the business. The imposition of debt, common in a buyout investment, forces aggressive business plans.
Governance / Control	Unlike the governance structure of a public company, the private equity manager often has a degree of control or influence, allowing strategic and even operational intervention when necessary.

e) Deal origination and investment process, monitoring and exit

Investors will generally look for a co-ordinated origination strategy and a disciplined procedure for evaluating investments. This should include evaluation of the business plan, the likely exit route and expected investment returns. There needs to be proven discipline amongst the principals of the fund as to application of decision-making criteria. This will include pricing discipline and it is an advantage for managers to demonstrate transactions declined on pricing grounds. In venture capital, investors may look for evidence of preparedness to cut losses in under-performing investments rather than following on in subsequent rounds. In buyout funds, the ability to tap the debt markets efficiently is an advantage. With regard to monitoring, how the manager uses valuation metrics or milestones in the business plan will be of interest. Having alternative exit strategies is a strength in all private equity and the way a manager plans for an exit is a key factor.

f) Number and variety of underlying investments

The greater the number of underlying investments, the greater the diversification of risk. If the investments are very concentrated in number, or focused in one particular geography or field of operation, then the risk becomes more concentrated. However, private equity managers tend to be heavily committed to investments and therefore the number of deals that a team can source, evaluate, operate and realise is strictly limited. So there is also risk if a team spreads itself too thinly or operates in fields or geographies where it has limited prior experience.

g) Portfolio fit

Given the importance of building a diversified portfolio an investor should ensure that the type of fund and its strategy fits into their broader private equity portfolio strategy without unnecessary duplication.

h) Quality of client servicing, reporting and administration

Transparency and regularity of reporting are a key area to enable investors to monitor the progress of their fund portfolios. Manager attention to this responsibility does vary.

Part Six Monitoring the Portfolio and Measuring Performance

1. Monitoring

If an investor is to take an active approach to monitoring the activities of a fund holding, this can be a resource consuming exercise. Larger investors may be offered a place on the fund's Advisory Board, which generally focuses on investor and conflict issues.

Some investors will review in detail the investment case for each of the fund's investments. In some instances the opportunity to co-invest may be made available.

Achieving a close working relationship with the fund manager is a long-term objective, which will promote a deeper understanding of the strengths and weaknesses of the manager and its investment strategy.

Investors that want to build a close relationship with their managers should ensure that they are able to dedicate an appropriate level of resource. For this reason, many investors will limit the number of private equity fund manager relationships that they maintain and to whom they commit funds.

As mentioned earlier, regular and comprehensive investor reporting by the manager is essential to effective portfolio monitoring. This should include detailed financial statements for the fund, a statement of the investor's account and detailed company by company reviews including prospects for realisation.

Investors should expect that the IRRs reported by their portfolio funds will show a J-curve profile, as discussed above in Part 3.

2. Measuring performance

a) IRR and multiple

Performance over time is typically measured as internal rate of return and absolute gains are measured as a multiple of original cost. By using both measures simultaneously it is possible to illustrate the nature of returns. For example, a higher multiple combined with a lower IRR would indicate that the returns had been achieved over a longer period. Conversely, a higher IRR over a shorter period may be based on a small absolute gain. It is important for investors to be aware that it is common for anomalous and unsustainable IRRs to be produced by uplifts in valuation that occur early in a fund's life. In addition, significant realisations achieved early in a fund's life will have a material impact on a fund's final IRR performance even though its aggregate multiple may not be equally impressive. Thus it is always preferable to look at both measures in tandem.

The IRR is defined as the discount rate used to equate the cash outflows associated with an investment and each of the cash inflows from realisations, partial realisations or its mark-to-market (the expected value of an investment at the end of a measurement period). The IRR calculation covers only the time when the capital is actually invested and is weighted by the amount invested at each moment.

b) Peer group benchmarking

When comparing a fund's performance with that of other private equity funds, it is important to compare like with like. First, one should compare funds in the same sector. For example, to compare a buyout fund with a venture capital fund would be meaningless. Comparing two mid-market pan-European buyout funds against each other would be appropriate.

To compare sub-sector funds established during the same vintage year is also appropriate. As funds generally invest committed capital over a three-to-six year period and generally harvest investments in years three to ten, no meaning can be derived for example from comparing a fund in its first year to a fund in its sixth year. Also, funds with different vintage years may have experienced substantially different economic and investment environments, which makes such comparisons inadvisable.

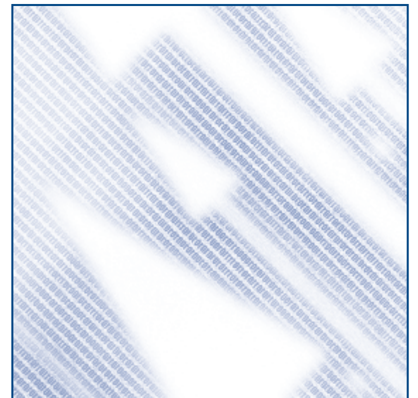
Whilst private equity funds do not usually publish their return data, funds of funds and consultants will have built up their own databases of return information and should be in a position to make comparisons. In addition, statistics of increasing accuracy are publicly available showing aggregate quartile performance by vintage year, geography and sector.

c) Benchmarking against different classes of assets

The IRR computation is similar to that used to compute the yield-to-maturity on a fixed income investment. It is however different from the time-weighted rate of return calculation that is standard

for mutual funds and hedge funds as the variability of the timing and amounts of private equity fund cash inflows and outflows make it unsuitable.

As a result, benchmarking against other assets is not a straightforward process. One method is to pick a benchmark index and to apply to a notional holding of that index the same cash flows that are experienced as a holder of an interest in the private equity fund. For example, when the fund draws down cash, it is treated as a purchase of the benchmark index of the same amount. When cash is returned, again it is treated as a realisation of the same amount from the notional holding. If the fund out-performs the index, then the notional holding will have been reduced to nil before the fund finishes distributing. Benchmarking a portfolio in aggregate is also an option.



Appendix Glossary of Terms

Acquisition
The obtaining of control, possession or ownership of a company.

Angel
A wealthy individual who invests in entrepreneurial firms. Although angels perform many of the same functions as venture capitalists, they invest their own capital rather than that of institutional and other individual investors.

Asset Stripping
Dismantling an acquired business by selling off operational and/or financial assets.

Average IRR
The arithmetic mean of the internal rates of return.

Balanced
A venture fund investment strategy that includes investment in portfolio companies at a variety of stages.

Bridge Financing
Mezzanine financing for a company expecting to go public within six months to a year or prior to raising a new funding round.

Buffer
Unused credit facility or cash reserves.

Burn Rate
Timeframe for a company to use up a capital injection.

Buyout
The purchase of what is normally a majority stake in an established mature company.

Capital Gains
Short or long-term profits from the sale of assets.

Capital under Management
The amount of capital available to a management team for private equity investments.

Capital Weighted Average IRR
The average IRR weighted by fund size with funds contributing to the average in proportion to their size.

Captive Fund
Investment fund partly owned by a larger financial institution.

Carried Interest
Also known as "carry". The share of profits from investments made by the fund (generally 20-25%) that the managers receive. Typically, carried interest is only paid after investors receive their original investment back plus a preferred return.

Commitment
An investor’s obligation to provide a certain amount of capital to a fund.

Corporate Venturing
Venture capital provided by large corporations to further their own strategic interests.

Dilution
A reduction in the fraction of a firm's equity owned by the founders and existing shareholders associated with a new financing round.

Distribution
Cash or the value of stock payments to investors after the realisation of investments in the partnership.

Distributions to Paid-in Capital
The amount a partnership has distributed to its investors relative to the total capital contribution to the fund.

Due Diligence
The investigation and evaluation of a management team's characteristics, investment philosophy, track record and terms and conditions prior to committing capital to the fund.

Early Stage
A fund investment strategy involving investment in companies carrying out product development and initial marketing, manufacturing and sales activities.

Equity Kicker
Option for private equity investors to purchase shares at a discount.

Exiting Strategy
A fund's intended method for liquidating its holdings while achieving the maximum return possible.

First Stage/Round
The first round of financing following a company's startup phase that involves an institutional venture capital fund.

Fund
The investment vehicle, often a limited partnership, to which the investors commit capital.

Fund Capitalisation
The total amount of capital committed to a fund by investors.

Fund Focus
The indicated area of specialisation of a private equity fund.

Fund of Funds
A fund which takes minority equity positions in other funds. If the focus is primarily investing in new funds this is a Primary fund of funds and if focusing on investing in mature, existing funds this is referred to as a Secondary fund of funds.

Gatekeepers
Specialist advisers who assist institutional investors in their private equity allocation decisions. Most manage funds of funds.

General Partner
A partner in a limited partnership responsible for the day-to-day operations of the fund.

Holding Period
The amount of time an investment remains in a portfolio.

Horizon Return
An IRR calculation between points in time where the beginning point is variable and the end point is fixed. An example would be the 3, 5, and 10 year returns ending 12/31/99.

Inception
The starting point at which IRR calculations for a fund would be calculated; generally, the vintage year or date of first capital takedown.

Investment Philosophy
The stated investment approach or focus of a management team.

IRR (Internal Rate of Return)
The discount rate that equates the net present value (NPV) of an investment's cash inflows with its cash outflows.

IPO (Initial Public Offering)
The sale or distribution of a stock of a portfolio company to the public for the first time.

LBO (Leveraged Buyout)
A fund investment strategy involving the acquisition of a product or business, from either a public or private company, utilising a significant amount of debt.

Lead Investor
Member of a syndicate of private equity investors usually holding the largest stake, in charge of arranging the financing and most actively involved in the overall project.

Limited Partners
The investors in a limited partnership.

Limited Partnerships
The legal structure used by most private equity funds. Usually fixed life investment vehicles. The general partner or management firm manages the partnership using policy laid down in a Partnership Agreement. The Agreement also covers terms, fees, structures and other items agreed between the limited partners and the general partner.

Liquidation
The sale of the assets of a portfolio company to one or more acquirors where venture capital investors receive some of the proceeds of the sale.

Lower Quartile
The point at which 75% of all returns in a group are greater and 25% are lower.

Later Stage
A fund investment strategy involving financing for the expansion of a company which is producing, supplying and increasing its sales volume.

Management Buyin (MBI)
Take over of a company by external management.

Management Buyout (MBO)
Take over of a company by existing management.

Management Fee
Compensation for the management of a fund's activities, generally paid quarterly from the fund to the general partner or management company.

Mature Funds
Funds which have been investing for at least five years.

Median
The mid-point of a distribution where half of the sample are less than or equal to the median and half of the sample greater than or equal to the median.

Mezzanine
A fund investment strategy involving subordinated debt (the level of financing senior to equity and below senior debt).

Paid-in Capital
The amount of committed capital an investor has actually transferred to a fund. Also known as the cumulative takedown amount.

Pooled IRR
A method of calculating an aggregate IRR by summing cash flows together to create a portfolio cashflow and calculate IRR on portfolio cashflow.

Portfolio Company
The company or entity into which a fund invests directly.

Placement Agent
A financial intermediary hired by private equity organisations to facilitate the raising of new funds.

Preferred Return
Either (i) the set rate of return that the investors must receive before the general partners can begin sharing in any distributions, or (ii) the level that the fund's net asset value must reach before the general partners can begin sharing in any distributions.

Quartile
Segment of a sample representing a sequential quarter (25%) of the group. (First 10 out of 40 funds - first quartile, etc.)

Ratchet
Arrangement whereby the eventual value of a targeted business depends on its future performance.

Realisation Ratio
The ratio of cumulative distributions to paid-in capital.

Realised Multiple
The ratio of total gain/(loss) to cost of realised investments.

Residual Value
The remaining equity which an investor has in a fund.

Restricted Securities
Public securities which are not freely tradable due to securities regulations.

Second Stage/Round
Funds provided for the early expansion of a company.

Glossary

Secondary Buyout/Sale
Exit mechanism whereby one investment firm sells its position in a company on to another investment firm.

Seed Stage
An investment strategy involving portfolio companies which have not yet fully established commercial operations, and may also involve continued research and product development.

Standard Deviation
A measure of the dispersion of the frequency distribution.

Takedown Schedule
The plan providing for the actual transfer of funds from the investors.

Terms and Conditions
The financial and management conditions under which funds are structured.

Third Stage/Round
Funds provided for the major expansion of a company whose sales volume is increasing and which is breaking even or profitable.

Trade Sale
Sale of a portfolio company to another company, typically operating in the same industry.

Turnaround
Financing provided to a company at a time of operational or financial difficulty with the intention of improving the company's performance.

Upper Quartile
The point at which 25% of all returns in a group are greater and 75% are lower.

Valuation Method
The policy guidelines a management team uses to value the holdings in the fund's portfolio.

Venture Capital
Describes the universe of venture investing (see Private Equity). It does not include buyout investing, mezzanine investing, fund of fund investing or secondaries.

Vintage
The year of fund formation and first takedown of capital.

Warranty
Statement made by vendor regarding the terms of a proposed transaction.

Write-down
A reduction in the value of an investment.

Write-off
The exit from an investment at a valuation of zero.

Write-up
An increase in the value of an investment.

building the industry
representing the industry
promoting the industry

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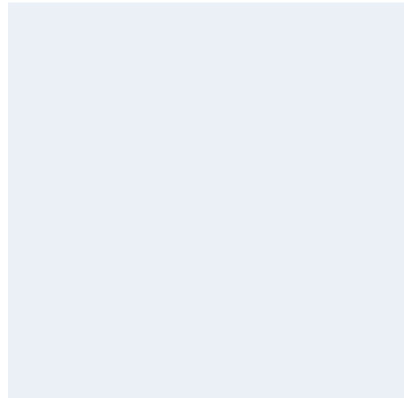

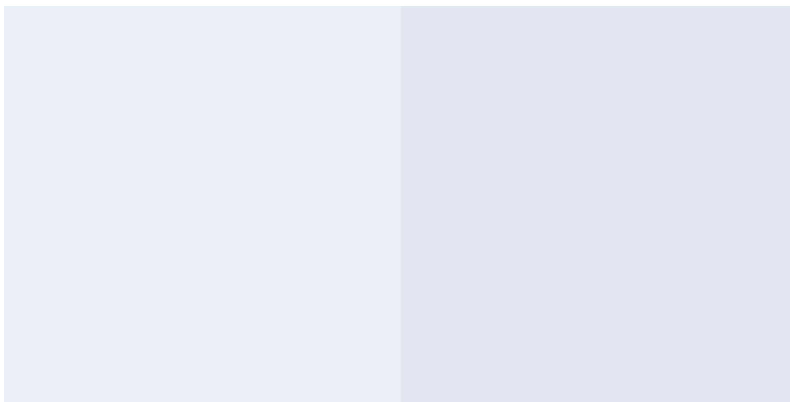

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