Why and how to invest in private equity

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This document provides a summary only of the subject matter covered.
The summary is not intended to provide any advice and should not be relied on as a substitute for professional advice.

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Introduction and background

Introduction

The private equity industry in Australia has grown dramatically over the past decade. Private equity is now a major asset class of the alternative investment portfolio of many institutional investors.

This paper considers the characteristics of private equity investment and the methodologies for constructing a private equity portfolio and implementing a private equity investment strategy.

Definition of private equity

Private equity investing may broadly be defined as investing predominantly in unlisted companies through a negotiated process.

Private equity investment is typically a transformational, value added, active investment strategy. Private equity managers need to have a specialised skill set. These skills differ between buy out and venture investing, as they focus on different stages of the life cycle of a business.

Private equity investing covers the broad categories described below, whether made through funds, funds of funds or (although still uncommon in Australia) secondary investments.

Venture capital

Described as the business of building businesses, venture capital covers investment in companies that have less mature businesses with undeveloped or developing products or revenue. It encompasses the following stages of venture investing.

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 establishment 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, or to provide additional working capital. This stage includes bridge financing for floats.

Replacement capital
A purchase of shares from another investor or to reduce gearing by way of debt refinancing.

Buy out

A buy out fund typically targets the acquisition of a significant portion or majority control of businesses, normally through a change of ownership. Buy out funds ordinarily invest in more mature companies with established business plans to finance expansions, consolidations, turnarounds and sales, or spin outs of divisions or subsidiaries. Financing expansion through multiple acquisitions is often referred to as a buy and build strategy. Buy outs include the purchase and taking private of listed companies.

Special situation

Special situation investing ranges more broadly, including distressed or equity linked debt, including subordinated and mezzanine debt financing.

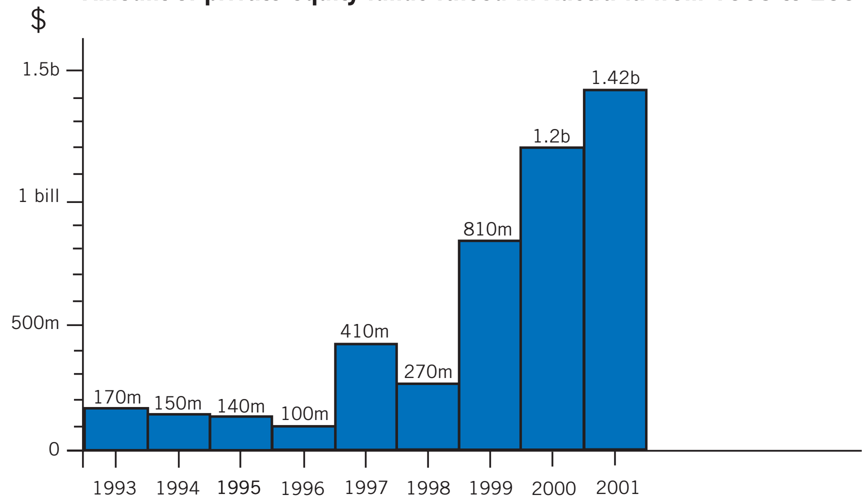
Historical development of the industry

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

The private equity market remained fragmented for some time, consisting largely of venture investment in early stage companies by private individuals (known as business angels) and, to a lesser extent, foundations and university and government investment programs. Some of the better known, early venture backed companies in the US include Digital Equipment, Federal Express and Apple Computer.

By the early 1990s, the industry began a period of rapid international growth, culminating in over A$350 billion being raised globally in 2000 by private equity funds. During this period, funds raised in Australia grew from less than $50 million in 1990 to $1.4 billion in 2000.

Amount of private equity funds raised in Australia from 1993 to 2001



Source: Venture Economics

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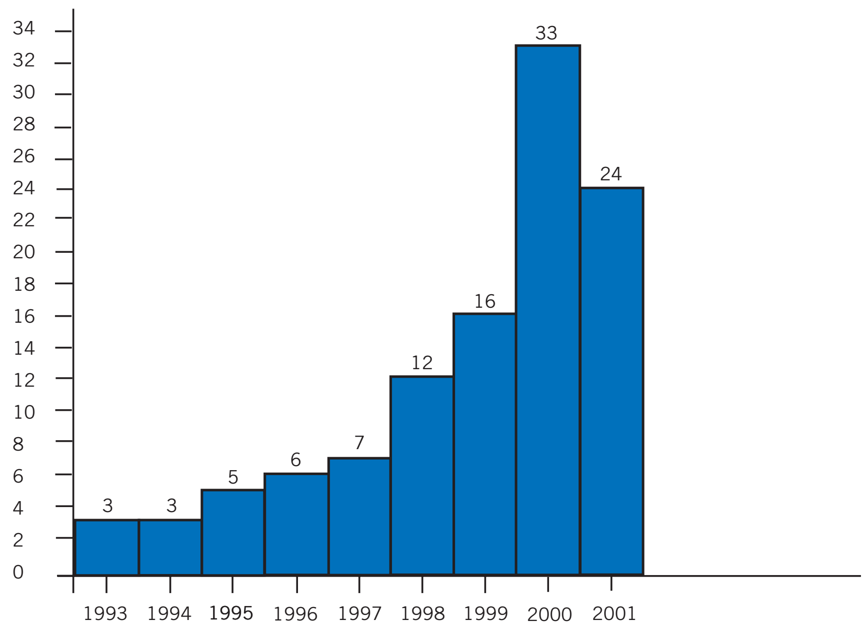


Source: Venture Economics

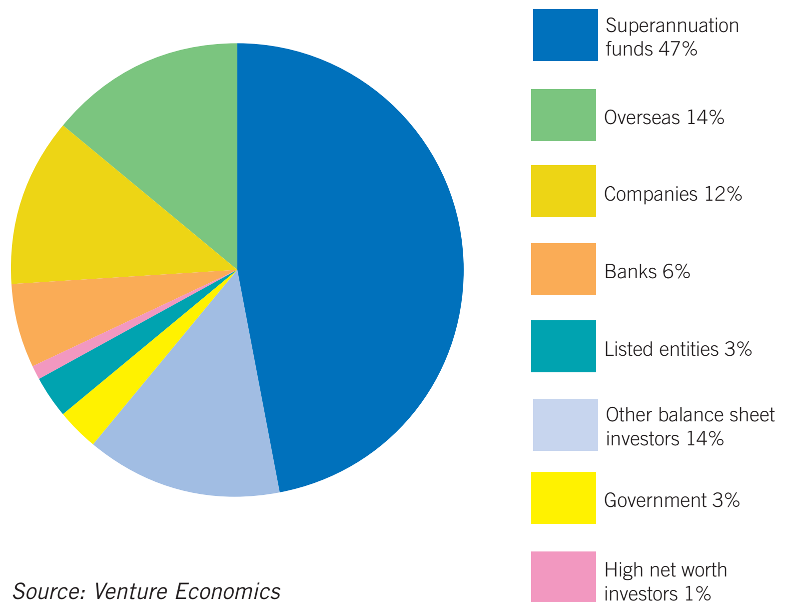
Main sources of private equity finance

The spectrum of private equity in Australia has been expanded to include different types of investors with significant long term commitments to the asset class. In general, the majority of commitments to private equity funds in Australia have come from institutions within Australia. This is evolving as major domestic and foreign private equity investors seek a higher level of geographical diversification in their private equity portfolios.

The number and calibre of institutions that have invested in private equity funds in Australia and allocated significant pools of capital to building their portfolios demonstrates the rapid growth of the market in Australia.

The chart below illustrates the sources of investment in private equity funds in Australia, analysed by investor type.

Sources of investment in private equity funds



Source: Venture Economics

Why invest in private equity?

Rationale

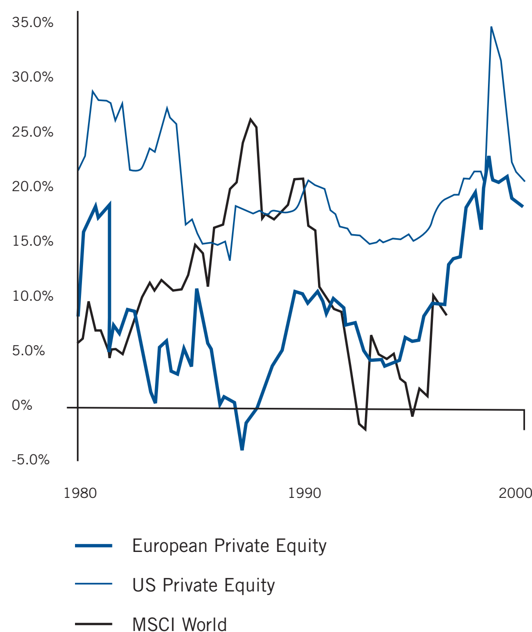
The fundamental rationale for investing in private equity is to improve the risk and reward characteristics of an investment portfolio.

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

Long term historical outperformance

The long term returns of private equity can outperform quoted equities. This has been the case in the US for over 20 years and also in Europe for over 10 years. In Australia, the upper quartile return of private equity funds over 15 years ending on 30 June 2001 was 17% per annum compared to an accumulation return on the ASX200 index over the corresponding period of 11.9% per annum

5 Year Return Figures: Private Equity V MSCI World



Source: Venture Economics/Datastream

For many institutions, the potential to outperform more conventional asset classes justifies the different risk profile of the asset class. Growth in the private equity fund market in Australia has been assisted by growing awareness among 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.

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True stock picking in a low inflation, low growth environment

A low inflation environment creates a focus on growth stocks as a means of outperformance. 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 quoted equity portfolios, 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.

Absolute returns

Excessive volatility and poor investment performance experienced by quoted equity portfolios, some of which have index tracking strategies or are benchmarked to an index, 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 some 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.

Portfolio diversification improves risk and volatility characteristics

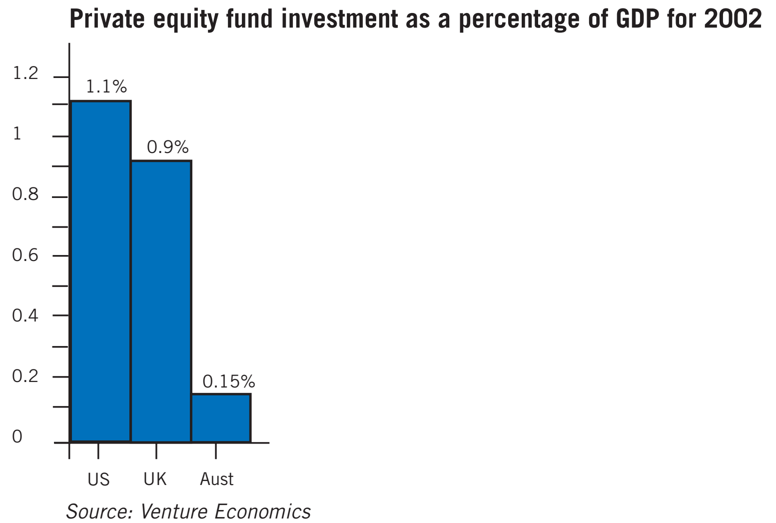
Within a balanced portfolio, the introduction of private equity can further improve diversification.

Adding private equity to a balanced portfolio can reduce volatility and contribute to an overall improvement in risk profile. This is because of a lower correlation between private equity and quoted securities markets. This would allow higher targeted returns for the same level of calculated risk, or a reduction in the level of risk in the portfolio while preserving the target rate of return.

Imbalance between public and private markets

While the majority of our GDP is generated by private companies, the private equity market has much fewer funds under management than the quoted 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 Australia where private equity fund investment remains a much smaller proportion of GDP than in the US or UK.



Source: Venture Economics

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.

Access to legitimate inside information

A much greater depth of information on proposed company investments is available to private equity managers. This helps managers assess more accurately the viability of a 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 quoted markets would be considered inside information. Investors in quoted markets will know less about the companies in which they invest.

Ability to back entrepreneurs

The wider emergence globally of entrepreneurs as an important cog in the world economy has been facilitated by a period of larger company rationalisation. This has fostered rapid growth in technological innovation and substantial benefits for the economy through the 1990s. The private equity asset class offers the ability to gain investment exposure to the most entrepreneurial sectors of the economy.

Influence over management and flexibility of implementation

Private equity managers generally seek active participation in the strategic direction of a company, from the development of a business plan to selection of senior executives, introduction of potential customers, acquisition 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 quoted market scrutiny and regulation. This flexibility represents another feature whereby risk can be reduced in private equity investment.

Leveraging off balance sheet

Buy out managers in particular are able to make efficient use of leverage. They aim to organise funding of each portfolio company in the most efficient way, making full use of different borrowing options from senior debt to mezzanine debt. By organising the 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.

Other features

There are other features of private equity investment that also need to be understood.

Long term investment

In general, holding periods between investment and realisation can be expected to average 3 or more years (although this may be shorter when quoted equity markets are especially healthy). Because the underlying portfolio assets are less liquid, private equity funds are normally closed end in nature, meaning that the investor has limited or no ability to withdraw or sell its investment during the life of the fund. Although the investor may receive cash distributions during the life of the fund, 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.

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 managers of quoted equity portfolios. This makes investment in private equity funds a much more resource intensive activity than quoted equity investment. Likewise, monitoring of ongoing performance of a private equity fund is also more resource intensive. Resource is a key issue in the development of a private equity program that is suitable for the investor.

Blind pool investing

When committing to a private equity fund, the commitment is typically to provide cash to the fund on notice from the private equity manager. While the information memorandum and fund documentation will outline the investment strategy and restrictions, investors give a very wide degree of discretion to the manager to select the companies in which the investors will have a share. 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.

Approaches to portfolio construction

Objectives

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

The size of the private equity allocation

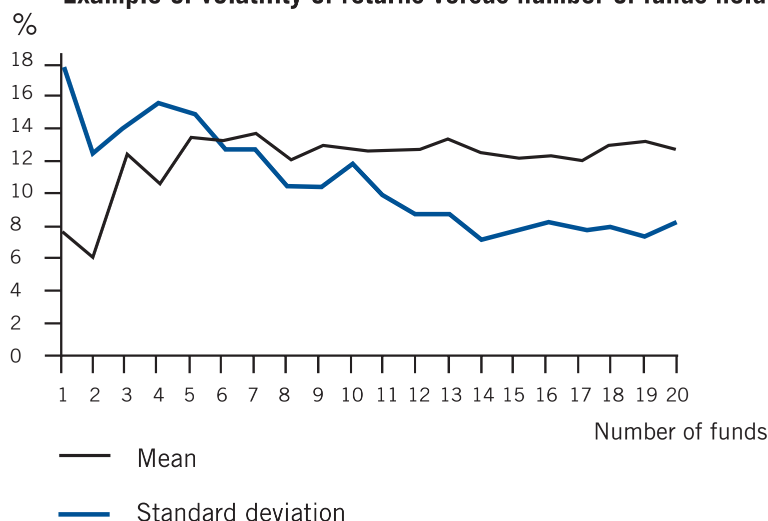
Investors in private equity need to be able to accept the illiquid character of their investment. The extent to which liquidity may be required is often a factor in the size of allocation. For this reason, it is often the case that the investors who make the largest proportional allocations to private equity from their overall portfolios are those who are able to invest for the long term with no specific liabilities anticipated. Accordingly, superannuation funds are the largest investors in the asset class. A reputable survey in 2001 found that the average allocation to private equity among US institutions invested in the asset class was 7.5%. The comparable figure for institutions in Australia was 3.9%. An investor may need to commit up to twice as much as its target allocation to private equity funds to achieve its target. This is because private equity funds do not normally re-invest proceeds of realised investments, meaning that investors would typically receive returns of realised capital before the amount they have committed to investment in the fund is fully drawn.

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

Allocation across private equity funds

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, which is based on global experience with private equity funds, 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 Warburg

Ways of achieving diversification

Stage

The different stages and types of private equity allow diversification for investors. Diversification can reduce risk within a private equity portfolio and this should be an important consideration.

Venture capital can be further subdivided into categories ranging from seed stage to late stage investment. In respect of buy out funds, a distinction can be made between larger, and smaller buy outs.

Geography

Geographical diversification can be obtained through investment in foreign funds and funds of funds.

Manager

Selecting a variety of managers will reduce manager specific risk.

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.

Industry

In venture investing, most of the focus tends to be on technology based industries. These can be subdivided, for example into healthcare or life sciences, information technology and communications. Buy out funds tend to focus on technology to a lesser extent, providing exposure to such sectors as manufacturing, financial institutions, retail and consumer, and chemicals.

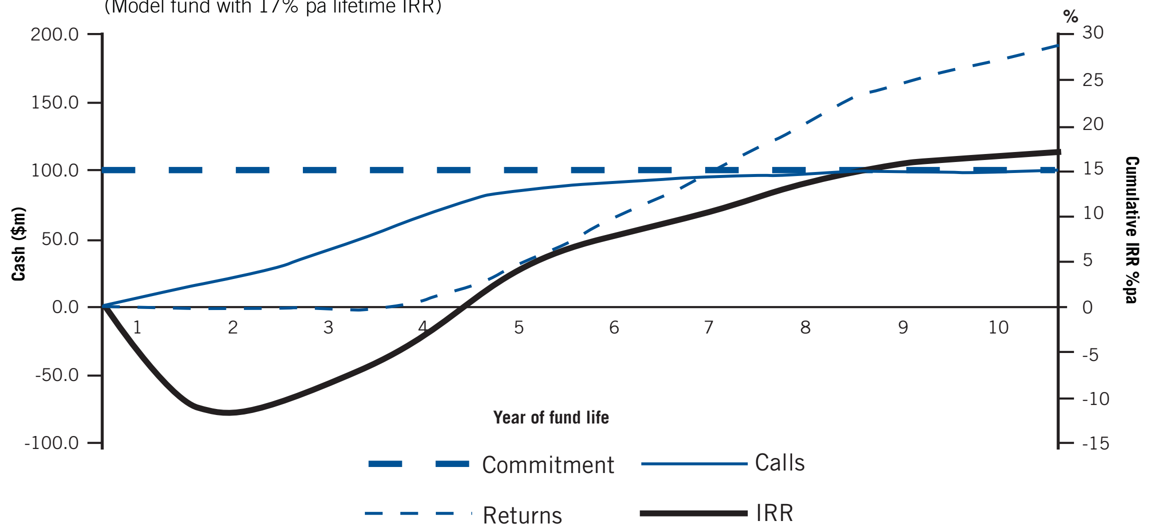
How to implement the strategy

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 overriding objective to identify the best managers in a given area.

How to plan for the volatility of cash flows

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 draw downs as needed to make new investments. Just in time draw downs 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. Investors need to maintain sufficient liquid assets to meet draw down obligations whenever called. Penalty charges can be incurred for late payment or, in extreme cases, the investment in the fund may be sold or forfeited. In the early years of most funds, 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 draw downs, the timing and amounts will be volatile. When draw downs and distributions are combined to show the net cash flow 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%.



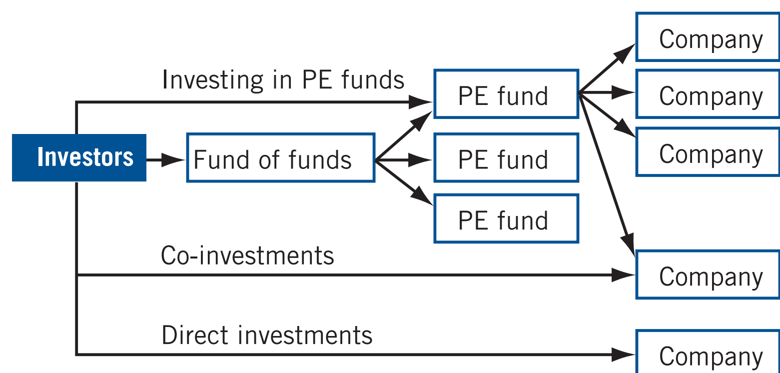
Source: Quay Partners

Practical aspects of investment

The principal means of private equity investment

The principal means of private equity investment are:

- investment in private equity funds;
- outsourcing selection of private equity funds, for example through a fund of funds; and
- co-investment and direct investment in unlisted companies.



While it is sometimes the ultimate objective of investors to be able to make co-investments and direct investments in companies, compared with investing through funds, it requires more capital (to achieve similar diversification and exposure), a different skill set, more resources and different evaluation techniques. While 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 among 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 would normally invest in a much smaller number of companies.

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Outsourcing

Fund of funds

A fund of funds is a pooled fund vehicle whose manager evaluates, selects and allocates capital among 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. Funds of funds in Australia are normally blind pools, meaning that exposure to particular underlying funds is not ensured. Rather, the investor is relying on the record of the fund of fund manager to identify and secure access to suitable funds. 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 a diversified exposure through a smaller deployment of capital with managers selected on rigorous criteria. It also decreases the burden of ongoing monitoring, reporting and administration.

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 fund managers.

Private equity fund structures

Pending the proposed tax reform of limited liability partnerships discussed below, the closed end unit trust remains the preferred private equity fund structure in Australia. Fund structures are becoming increasingly uniform, particularly in light of the terms commonly sought by investors.

Typical features

Some typical features of private equity funds are set out below.

Investors

Investment in most private equity funds is limited to wholesale investors, including professional investors such as superannuation funds, insurance funds, listed companies and their subsidiaries, government bodies and persons controlling at least $10 million.

Closing

The closed end nature of most private equity funds means that the fund cannot raise further capital after an initial period of around 6 months.

Term

The term for most private equity funds is around 10 years, with the possibility of extensions. The investment in the fund remains usually illiquid during this period but distributions are usually made as investments by the fund are realised.

Draw down

Capital committed to private equity funds is usually drawn down from investors on a just in time basis as and when funds are required.

Commitment period

On average, private equity funds invest committed capital over a 3 to 6 year period. Undrawn committed capital after this period is usually cancelled except for the purposes of follow-on investments or meeting fees, expenses and other liabilities of the fund.

Management fees

Fund fees traditionally include an annual management fee of around 1.5 to 2.5% of committed capital after adjustment for the investment cost of realised or written off investments.

Carried interest

The manager and its executives are typically entitled collectively to a carried interest of 20% of total returns to investors, subject to a hurdle or preferred rate of return before tax of around 8% per annum to investors. With a hurdle rate of return the carried interest applies only to returns in excess of the hurdle. With a preferred rate of return the carried interest can apply to all returns provided that the preferred rate is attained for investors.

Taxation aspects

Private equity funds are structured with the aim of providing tax transparency for investors. Income and capital gains would therefore be taxed in the hands of the investors and not the fund. Tax transparency may be lost if a fund is taxed as a public trading trust. This may occur if the fund controls a business, whether by owning a majority stake in a company or having control through extensive veto powers over business decisions. Tax transparency is particularly key for superannuation fund investors who rely on the effective one third tax discount available to them on long term capital gains.

Parallel fund structures, whereby investment is made across two co-investing unit trusts managed by the same manager, can reduce the risk of the fund being subject to tax. This is because it is less likely that either trust would, on its own, control a business.

Following submissions by the Australian Venture Capital Association to stimulate the inflow of foreign private equity investment, the Federal Government is proposing to reform the tax treatment of limited liability partnerships as private equity investment vehicles. The initiative aims to create an environment

where the limited liability partnership becomes the preferred vehicle for private equity investment, as is the case in the US and the UK.

The proposal seeks to reform the tax treatment of limited liability partnerships by:

- ceasing to tax qualifying LLPs as companies, thereby allowing flow through tax treatment for investors; and
- exempting a broad range of foreign investors from capital gains tax on investments through qualifying LLPs.

Investments by an LLP in companies with total assets exceeding $250 million or which carry on a property development, retail or finance related business will not qualify for capital gains tax exemption under the proposed tax reforms.

The reform proposals apply to funds of funds as well as other private equity funds.

Liquidity through a secondary market

There are signs of a developing market in interests in existing private equity funds, referred to as secondaries. A secondary offering may comprise all or part of a private equity fund.

A secondary market allows investors to achieve a higher level of liquidity within a private equity investment portfolio, either by acquiring investments in private equity funds which have reached a later stage of their lives, or by realising investments in private equity funds by selling them to interested buyers.

The secondary market has recently come of age in Europe and the US as some institutions look to reduce exposure to private equity, availing buyers of the asset class the opportunity to purchase existing portfolios at discounted prices. Managers of secondary portfolios have been among the most successful fundraisers recently in Europe and the US.

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 an interest in its fund. 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 may become more attractive.

These factors could lead to a developing secondaries market in Australia, bringing an added degree of liquidity to some private equity funds.

Due diligence

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 among managers in the private equity market is more diverse than in quoted securities markets.

What to look for in a potential fund investment

Investors should evaluate the credentials of each manager by investigating closely its track record and reputation. A track record of a manager can be an indicator of future success. The following are some key considerations.

Investment strategy and market opportunity

A fund investment strategy should be clear and very similar to that on which the track record of the manager 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 resources of the manager. The investment strategy should be attractive in the context of the wider economic landscape, which will impact the market opportunity.

Track record

As the private equity industry continues to mature, so does the level of publicly available statistics of investment performance. The public availability and transparency of such data is essential for accurate benchmarking of 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 investment return to the fund 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 investment return to investors 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, buy out returns out can be less volatile than venture capital returns. Another way to analyse a track record is by method of value creation.

The performance among private equity managers can vary more widely than that of quoted securities managers. Upper and lower quartile performance of quoted securities managers tends to be a lot closer to the mean performance than it does for private equity managers. It is generally the private equity funds that achieve upper quartile performance which enables a portfolio of investments in private equity funds to outperform quoted equities by the targeted level.

As mentioned earlier, the upper quartile return of private equity funds over 15 years ending on 30 June 2001 was 17% per annum. Realisation ratios for this period are shown below.

Upper quartile private equity fund realisation ratios for 1986 to 2001

DPI	0.49
RVPI	1.00
TVPI	1.53

Source: Venture Economics

DPI is the ratio of distributions to amounts paid by investors. It measures the ratio of distributions to investors compared to the amount of capital contributed by them.

RVPI is the ratio of residual value to amounts paid by investors. It measures the net asset value of the undistributed funds compared to the amount of capital contributed by investors.

TVPI is the ratio of total value to amounts paid by investors. It measures the ratio of the aggregate of distributions to investors and the net asset value of undistributed funds compared to the amount of capital contributed by investors. It is the aggregate of the DPI and the RVPI.

More information on overall private equity fund performance is provided in the 2001 yearbook of the Australian Venture Capital Association.

Investment team

An assessment of the ability of a manager to reproduce previous superior performance will focus on the individuals comprising the management team, their incentivisation and the past and future continuity within the team. The management team should have solid experience as a private equity manager. Additional attributes, such as relevant operational, sector or scientific experience, are helpful. An important consideration is whether the core members

of the core management team have already been working as a team for a significant period and whether there have been any departures from the core team over time. This will help to assess the potential correlation between past and future performance of the team and give some indication as to future continuity. It is normally helpful to speak to business counterparts (for example portfolio company executives or peer group fund managers) regarding the individuals, as they may provide insight of the dynamics of the team. Further comfort as to the future can be derived from the incentivisation structure. Broadly, all of the key executives should receive a fair proportion of the carried interest. Ideally the carried interest 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 team. Personal investment in the fund by the management team is also a strengthened sign of commitment.

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 an 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 quoted securities, a private equity manager can legally access inside information such as management projections in its investment process. This assists private equity managers in negotiating better investment terms for their fund.

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 managers of the company in the day to day operations of the business.

Value added focus

Ownership and management become aligned in private equity, which occurs to a greater degree than is usual with investments in quoted securities. In addition, the private equity manager will become involved in the strategic direction of the company and the risk management of the business. Leveraging through debt, common in a buy out investment, forces more aggressive business plans.

Governance and control

Unlike the governance structure of a listed company, the private equity manager often has a degree of control or influence, allowing strategic and even operational intervention when necessary.

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 by the private equity manager as to application of decision making criteria. This will include pricing discipline. It is an advantage for managers to demonstrate transactions declined on pricing grounds. In venture capital, investors may look for evidence of preparedeness to cut losses in underperforming investments rather than following-on in subsequent rounds. In buy out funds, the ability to access senior and mezzanine debt effectively is key. 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. The way a manager plans for an exit is a key factor.

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 a particular geographic region or field of operation, the risk becomes more concentrated.
However, private equity managers tend to be heavily committed to investments. Therefore the number of deals that a team can source, evaluate, make and operate is strictly limited. This means that there is greater risk if a team spreads itself too thinly or operates in fields or geographies where it has limited prior experience.

Portfolio fit

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

Quality of client servicing, reporting and administration

Transparency and regularity of reporting are key for enabling investors to monitor the progress of their fund portfolios.

Monitoring the portfolio and measuring performance

Monitoring

If an investor is to take an active approach to monitoring the activities of a fund, this can be a resource consuming exercise. Larger investors may be offered a position on the investment advisory committee of the fund, which generally focuses on investor and conflict issues. The opportunity to co-invest may be made available, particularly to larger investors.

Achieving a close working relationship with the 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 resources. 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 account for the investor and company by company reviews including prospects for realisation.

Investors should expect that the internal rates of return reported by their portfolio funds will show a J-curve profile.

Measuring performance

IRR and multiple

Performance over time is typically measured as an internal rate of return. 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 the life of a fund. In addition, significant realisations achieved early will have a material impact on final IRR performance even though its aggregate multiple may not be equally impressive. 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 market value of an investment). The IRR calculation covers only the time when the capital is actually invested and is weighted by the amount invested at each moment.

Peer group benchmarking

When comparing performance among 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 buy out fund with a venture capital fund would be meaningless.

To compare sector funds established during the same vintage year is also appropriate. As funds generally invest committed capital in years 1 to 5 and generally harvest most investments in years 4 to 9, no meaning can be derived from comparing funds which have been raised years apart. Also, funds with different vintage years may have experienced substantially different economic and investment environments, which makes such comparisons inadvisable.

While 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, growing levels of statistics are becoming publicly available, showing aggregate performance by vintage year and sector.

Benchmarking against different classes of assets

The IRR computation for private equity funds is similar to that used to compute the yield to maturity of 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, because 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 an investor 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 outperforms the index, the notional holding will have been reduced to nil before the fund finished distributing. Benchmarking a portfolio in aggregate is also an option.

For more information please contact the Australian Venture Capital Association or visit the website.

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