

Introduction

David Rubenstein, co-founder of the Carlyle Group, has been said to compare private equity with sex. According to him, if one tries out either one with reasonable expectations, one should be pleased with the results. To quote the Yale endowment 2002 annual report, private equity *“offers extremely attractive long-term risk-adjusted return characteristics, stemming from the University’s strong stable of value-added managers that exploit market inefficiencies”*. Certainly many potential investors will find annualised private equity returns of 29% to the Yale University’s endowment, since the inception of their programme in 1973 until 2003 as a “sexy” opportunity.

Unfortunately, such return expectations may often be juvenile and slightly exaggerated. One will be definitely disappointed if quick results are expected. As Raschle & Ender (2004) observed, the *“overall private equity market has historically not delivered the often mentioned ‘guaranteed’ top return. Since the early 1980s the market size has developed approximately in line with the required return for private equity, which is basically the public market return plus an illiquidity premium”*. Private equity is largely illiquid. Either you decide to make a long-term commitment and follow a systematic approach or you had better stay out entirely. Industry practitioners believe that investing consistently and continuously probably works best, while trying to time the market and getting in and out will lead to frustration. Indeed, it is only through a methodical approach and with a disciplined implementation over a significant time period, that the results can become highly rewarding.

1.1 ROUTES INTO PRIVATE EQUITY

There are different routes for investing in private equity. We believe that few institutions have the experience and especially the incentive structures that would allow them to invest directly in unquoted companies, and therefore most of them seek intermediation through the limited partnership structure that, according to Bosut (2003), *“is the most ideal financial fund management structure avoiding possible conflicts of interest between the fund managers and limited partners, and aligning the incentives of the parties with each other”*. For institutions the most relevant approaches to investing in private equity are, for example, through fund-of-funds specialists as intermediaries or through similarly structured dedicated in-house private equity investment programmes. Other routes are via the publicly quoted private equity vehicles, or to open a dedicated account managed by a private equity specialist, which is similar to the fund-of-funds route but without the pooling of interests.

1.2 THE LIMITED PARTNER'S VIEWPOINT

While start-ups and entrepreneurs and occasionally their financiers catch the limelight, the “financers of the financers”, i.e. the limited partners, are generally overlooked. Most institutions themselves believe that this kind of investing is “just like any other asset” and do not pay too much attention to this—typically immaterial—part of their activities. Our book is about the portfolio management of investments in private equity funds and focuses on the limited partner’s investment process, as so far few publications address their needs. We use the expression “private equity funds investment programme” and for simplification will not differentiate between institutions’ in-house investment programmes and accounts managed by specialists on behalf of such institutions. Generally, intermediation in this asset class is continuously evolving and even an in-depth discussion of the current industry landscape goes far beyond the scope of this book.¹

It is unclear at the moment whether some disillusioned LPs might conclude that this is a game that is just too hard to play.

Josh Lerner (quoted in Borel, 2004.)

1.3 THE CHALLENGE OF VENTURE CAPITAL FUND VALUATION

Venture capital is a subclass of private equity that poses specific challenges, mainly because of the difficulty of valuing such investments. This book was partly motivated by our involvement in internal and external discussions on how to address the requirements of “fair value” accounting under the new International Financial Reporting Standards (IFRS) and the treatments of risks under the new Basel Accord (Basel II) or the new Capital Adequacy Directive (CAD II). Not only banks but also other institutional investors under regulatory supervision, such as insurance companies, become more and more concerned about the quantification of risks.

Before talking about risks, however, one needs to tackle the question of valuations, and already at this point the problems become apparent. Established techniques can only be applied with restrictions, under heroic assumptions or not at all for venture capital funds. Because of the difficulties inherent in valuing investments in innovative technologies, early stage investments have so far caused significant problems for many institutions and have led to a strong reluctance to become exposed to such assets. It is not only impractical but also conceptually questionable—at least during its early years—to value a fund “bottom-up” by assessing individual portfolio companies. We will argue that looking at the so-called net asset value (NAV) alone is an oversimplified way of assessing the value of an investor’s stake in a private equity fund, ignoring material factors such as the undrawn commitments that are still to be paid into the fund and, notably, one of the most important factors stressed by all industry players, the quality of the fund manager.

¹ For example, publicly quoted private equity funds, publicly quoted private equity funds-of-funds, or collateralised fund obligations. In 2001 in the landmark “Prime Edge” transaction Capital Dynamics raised \$175 m by a collateralised private equity fund obligation. With such a securitisation, investors who do not normally buy private equity were also given access to the asset class.

1.4 HARD FIGURES OR GUT INSTINCT?

In the investment industry the majority of managers have a strong quantitative orientation and feel comfortable with the disciplined application of a decision science-based tool set. Precise projections of returns, risks and correlations have become an indispensable part of the modern investment management process. Specifically in the hedge fund industry, where occasionally even part of the investment decision is “delegated” to computer-based “black boxes”, this may be driven to the extreme. There is a heavy dependence on “proven” models and high quality data that give reliable forecasts.

At the other extreme, according to Swensen (2000), *“judgemental investors rely on ‘gut instinct’, managing portfolios by the seat of their pants. Sensible investment operations avoid both extremes, melding reasonably rigorous quantitative disciplines with a substantial dose of informed judgement. Combining hard quantitative inputs with soft qualitative inputs satisfies the notion that successful investment operations incorporate both hard and soft factors”*.

1.5 MANAGING WITH FUZZY FIGURES

In private equity the poor quality, limited availability and even the non-existence of data restrict the application of a quantitative tool set significantly. Some think that ever-increasing transparency and standardisation one day will have created a basis that makes a quantitatively driven management of these assets feasible. We do not believe that this is possible, as the industry is private and transparency therefore has its limits. Moreover, for venture capital, which is by definition mostly innovation, the environment is continuously evolving. Consequently, precise quantification is, in our eyes, out of reach in principle.

The focus on “risk” in venture capital may even be off the mark. In fact, because of the long time horizons and due to the nature of investing in innovative technologies, the traditional risk measures fail at capturing the “unknowns” of an uncertain environment that characterises this alternative asset class. Therefore, an investment process has to take this into account. In this context, Courtney, Kirkland & Viguerie (1997) remarked that danger lies *“at the other extreme: if managers can’t find a strategy that works under traditional analysis, they may abandon the analytical rigour of their planning process altogether and base their decisions on gut instinct”*. Unfortunately, this phenomenon appears to be all too common in venture capital investing.

1.6 MAKING THE GRADES

Building on the established credits rating principles, we developed a system for grading private equity funds. This so-called “grading” is a structured approach that takes quantitative and qualitative criteria into consideration.² With this technique we have developed a new way of tackling the questions associated with valuations, portfolio and risk management of private equity funds investment programme. As Raschle & Jaeggi (2004) pointed out, *“other*

² We use the term “grading” as the formal definition of a “rating”, according to Krahnen & Weber (2000), is based on the concept of defaults and therefore is not applicable to private equity funds.

rating models, or models based on a systematic approach, have to date rarely been published in the literature or practised in the private equity industry . . . only those fund-of-funds providers can be successful who have a clear basis for making their investment decisions and who are able to state the reasons for their decisions”.

Box 1.1: Private equity as winemaking

Private equity funds are blind pool investments, they are very long-term oriented and are exposed to economic cycles. As cycles are difficult to predict and as funds run over many years, most investors just try to identify the best funds available in the market, the so-called “first quartile fund managers”. To illustrate this approach, think about wine-making—it is not without reason that expressions like “vintage years” are used in the private equity industry. By convention, the vintage year typically is the calendar year in which a fund is established and the first drawdown of capital is made. The analogy to wine is not far-fetched and in fact is referred to occasionally.

It is easier to pick a good wine if one starts with a list of the vintage years. As in wine-making, venture capital has its good years and of course its bad years. Sometimes the quality of the year is not apparent until some maturation has taken place, but in many cases the indicators are apparent from the environment and maturation merely serves to confirm what everybody feared in the first place . . . it will take a fair amount of tasting and time to see what the quality is and which hardy stocks modestly reward the palate. Quality brands will always stand out.

Smart (2002)

The difference between “traditional” asset classes and private equity funds can be compared to the difference between “ordinary” agriculture and wine-making. While it is quite common to grow at one time, say, wheat and at another time corn on the same piece of land—or even leave it idle from time to time—one cannot switch in and out from and to wine-making. A vineyard has to be cultivated consistently and over many years. For example, the average age of the vines at Smith Haut Lafitte is 30 years. Like a wine-grower, limited partners need to take a long-term perspective and need to be patient. Either this market attracts you and you decide to enter and stay in, or you forget about this market entirely. The entry barriers and switching costs are prohibitively high.

We know—or at least assume—that the market is profitable but we have to manage it in the best way. We need to build a portfolio of good fund managers and prune the bad ones. As in private equity, there are good vintage years for wine and bad ones. The wine-grower will not know in advance which ones will be spectacular and which ones will only be good for vinegar. Nevertheless, to make good use of his resources, he needs to participate in all vintage years regardless, because the good years will—according to historical observation—compensate for the bad years. Every wine-grower follows this basic approach to cultivate the vineyard. This approach leads to a certain average yield that can only be measured and improved over the long term, as the influence of weather etc. varies over time and as any improvement will only become visible after several years.

If the wine-grower aims for improvements and deviates from this approach, the yield may change; as the techniques in wine-making have been developed and tested over centuries, the assessment of the change’s impact is only possible through long-term observation.

1.7 OUTLINE

In this book we take the practitioner's view and aim to give an integrated picture of a well-structured private equity investment programme. While we cannot present a magic formula that can give you immediately the sustainable high double-digit returns everybody is dreaming of,³ we discuss the components of such a programme and how they are intertwined. In this discussion we focus on the principles rather than describing a specific environment. The set-up of a private equity investment programme is a complex task and is associated with a series of technical and organisational challenges. The process to starting a programme can take several years. To have any effect on the overall portfolio return, a significant percentage of the total assets under management has to be allocated to private equity. One could argue that this is best outsourced to a fund-of-funds, but for many medium-sized institutions there may be a case to set up their own in-house programme. Our book is organised in five parts as follows:

- We give a broad outline of the private equity environment with its structures and its dynamics.
- We define an investment process for a private equity fund investment programme.
- We describe the main tools for designing a portfolio of funds: portfolio construction, liquidity management and fund grading.
- To manage such a portfolio, a series of tools exist: we discuss monitoring, secondary transactions and restructuring in more detail.
- We demonstrate the application of our techniques in the context of managing in an uncertain environment.

The techniques we propose here for venture capital can also be used for private equity in general, although for later stage investments other tools could be more meaningful. For the purposes of this book we use the term “private equity” whenever data, observations or concepts are applicable in general, while we use the term “venture capital” when we discuss the specific challenges.

Many of the concepts presented here have been researched and developed in the course of our work with the European Investment Fund. However, for this book we have researched private equity market practices and discussed different approaches with industry practitioners. We target commercially-oriented institutions that are either already managing or considering setting up a private equity funds investment programme. Rather than proposing an “ideal” programme, we discuss various methods and trade-offs. Therefore, the statement made in this book represents the personal opinion of the authors and does not necessarily reflect the views of the European Investment Fund.

³ If we could, we would be spending our time differently . . . sigh!

