Private Equity as an Asset Class

Guy Fraser-Sampson

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Introduction

There are a number of books already in print on the subject of private equity, and (I believe) a couple more in the course of preparation, so it may be felt that a book such as this requires some justification. If so, it can very simply be provided. I have always felt the lack of a single comprehensive guide to private equity; something that does not seek to examine the relationship between GPs and LPs, or to indulge in esoteric analysis of private equity returns, but which sets out simply to answer the key questions, such as "what is private equity?" and "how does it work?".

Surprisingly for an asset class whose roots go back to before the second world war, there is no such book available and it is precisely this gap that this work is designed to fill. There is, for example, no one standard text book which can be used for the private equity elective in business schools, and I have designed the overall structure of the book in consultation with academics who teach such courses in an attempt to achieve as close a fit as possible with the course outline (not as easy as it sounds since there seems to be no one universally accepted list of course content!). Nor is there one that can be recommended to entry level professionals in private equity firms, nor for institutional investors who may be looking to enter the asset class for the first time, nor for pension consultants and their trustee clients.

However, please do not assume that just because you might have many years of private equity experience you will come across nothing new in this book. Concepts such as Total Return investing, and treasury and portfolio secondaries, have been in my thinking for several years but have been articulated for the first time in this book. These are novel ideas and may seem controversial to some, but I trust you will at least find them thought-provoking. Similarly, my analysis of historic private equity returns, both buyout and venture, has been performed specifically for this book, using the most up-to-date figures available at the time of writing (Autumn 2006), and my conclusions and suggestions in this regard are original and newly formed.

My previous book *Multi Asset Class Investment Strategy*, also published by John Wiley & Sons, answered the questions "why should I invest in private equity?", "how much should I allocate to it?", "how should private equity returns be compared and analysed against those of other asset classes?" and "how does private equity fit within an overall portfolio?". These two books are designed to be read in conjunction and therefore I do not propose to repeat any of that content here. In any event, it would seem to fit much more naturally within a book on overall asset allocation than within a specialist work of this nature. I would, therefore, strongly recommend that you read the other book first if you have not already done so.

Before we get into the main body of the book, there are a number of points which I would like to make by way of general introduction in the hope that it will enhance your understanding of what is to follow. I must also confess that this hope is somewhat self-serving, since there were a number of general issues running as a thread through every chapter but which were difficult to classify sufficiently to identify exactly where they might properly be discussed in detail.

NUMBERS, THEIR USES AND LIMITATIONS

The first is that while numbers are all we have to work with, we should constantly remind ourselves that they do not paint a perfect picture. This is true of all investment, but probably more so with private equity than with any other asset class. Private equity is different in so many ways, but most importantly it is the only asset class where (1) annual returns are meaningless, invalid and irrelevant and (2) true returns can only be measured many years in arrears. Thus, while we should make full use of the available data we should always be ready to temper the results with perceived trends and personal experience, particularly where we may be in the midst of structural change.

Similarly, we should always think about what lies behind the figures. As an industry we seem prone to looking at figures, particularly performance figures, and drawing quick and seemingly obvious conclusions from them. Yet in many cases, if we stopped and asked ourselves some intelligent questions as to how the figures have been prepared and presented, or as to what they actually represent, or as to what factors might have influenced them, we would almost certainly arrive at a totally different, and certainly a more insightful, result. We will see that the figures purporting to represent European venture performance are a particularly clear example of this, but there is hardly a single aspect of private equity data where the same point does not hold true to some lesser degree. Understanding what lies behind the figures is infinitely more valuable than a simple presentation of their surface values. Indeed, one of my main objectives in agreeing to write this book was the hope that this one important truth could be conveyed and understood.

THE NEED FOR TRANSPARENCY AND FULL DISCLOSURE

This leads us on to the second point, which is a plea for full transparency within the industry. Time and again in the book we find ourselves wishing to analyse a particular point only to find that the data we need is not available, and thus having to make some hopefully intelligent deductions and assumptions instead. The private equity industry is now large, mature and well developed. Surely we have reached a stage where full details of every individual transaction can happily and safely be released, classified according to a commonly agreed analytical model, and the data made publicly available, if necessary for a fee? It is quite ridiculous that an industry which raises hundreds of billions of dollars every year should be unable to tell, for example, whether leverage ratios have risen or fallen in European buyout within a particular period, or to what extent certain investors are being diluted or otherwise by the terms of US venture funding rounds.

I would argue that transparency and full disclosure would actually help rather than harm the industry. We are subjected to an enormous amount of ill-informed criticism, ranging from blogs in the United States that may have got hold of a small part of the portfolio data of a public pension plan, or even an individual fund, and publish it without understanding that something like the J-curve could completely alter its apparent meaning, to (regrettably) articles in the European national press which fail to understand even fundamental concepts such as the difference between venture and buyout funds, or between allocated, committed and invested capital. Were the information publicly available to rebut these stories then surely life would be made easier, not more difficult? Just what is it that GPs are afraid of, that they feel the need to shelter behind such massive ramparts of confidentiality?

ALLOCATED, COMMITTED AND INVESTED CAPITAL

As signalled in the previous section, the third point I wish to make is that time and again over the years I have been struck by how few people really understand the difference between allocated, committed and invested capital (very few LPs, for example, actually over-commit as they should). As you will see, I argue that once the distinction is fully appreciated, then it calls for a radical new approach, which I have chosen to call Total Return investing, to how we should look at a private equity fund programme as a whole, and that this in turn has serious implications as to, for example, how we look at the secondaries space.

It is difficult to exaggerate the importance of this key distinction, which does not just impact the question of programme management but in fact runs through discussion of every aspect of private equity. Is it better, for example, to earn a 60% IRR for 6 months or a 25% IRR for 6 years? The answer is, of course, that it all depends. It depends on whether you are going to be able to reinvest that money straight away at a private equity rate of return. In only about one case out of a million is the answer to this question going to be “yes”, so the answer to the original query would clearly be the latter rather than the former. Yet in that case why do we use IRR as a measure of fund performance (rather than, say, money multiples), which might incentivise the GP in the above case to give you the former course of action rather than the latter? And why do we base the GP’s management fee on committed rather than invested capital, but the carried interest (in many cases) on invested rather than committed capital? Illogical, captain.

CAN THE INDUSTRY ABSORB MORE CAPITAL?

There is also the question of the amount of capital being raised by the industry, and the resulting rise in average fund sizes. This is a topic of particular relevance since my earlier book argues that most investors worldwide should be making an allocation of 25% to the asset class. Were anything like this to occur it would of course result in massive influx of new capital and fears have been raised of the capacity of the industry to handle this much money.

The first point to make is that this new capital would not of course be coming into the industry all at once but rather over about an 8-year period in the case of each new investor, and some of these may take some years even to make the decision in the first place, which means that we could be looking at anything between 10 and 15 years. Thus, we would be looking at a steady and fairly slow (though admittedly sizeable) expansion rather than a sudden explosion.

The second point is that the capacity of, say, the buyout industry to absorb new money appears to be almost infinite. I have written many articles in recent years about this phenomenon so I think my views are well known, but let me say again that there seems to me no logical reason why the size of mega buyout funds could not rise very considerably beyond their present levels. Clearly if any one fund has the ability by itself to absorb, say, an extra $10 billion of new capital in any one vintage year then this should considerably lower people's anxiety levels.

This clearly has implications for patterns of equity ownership, and we can expect many more companies to be transferred, at least temporarily, from the quoted markets into the hands of private equity players. It also suggests that even very large companies may no longer be beyond their grasp, particularly if the current trend for hunting in packs and laying off equity to potential competitors continues. It has implications, too, for returns. You will have to read the relevant chapters to see what I have to say about this, but one general point bears making at the outset. There is a clear common sense relationship, which is in general borne out by the available data, between the amount of money poured into any particular class of private equity investment and the return which that class is likely to produce. Perhaps fortunately for those few of us who *do* understand this, it is a truth which the vast majority of LPs and their advisers have apparently failed to grasp.

ACCESS, AND WHAT THIS MEANS FOR INVESTMENT MODELS

Another point which is not at all understood by most LPs is access, and this problem is of course particularly acute in the case of US venture and what little is left of the European mid-market. How many LPs realise, for example, that US venture returns are driven by a small number of no more than about 20 firms, and that there is effectively no chance of committing new capital to any fund which they manage, since this is likely to be over-subscribed at least one hundred and possibly one thousand times? Clearly virtually none, but this is perhaps both understandable and excusable. Without wishing to ascribe any cynical motive to them, the situation is hardly helped by investment managers and advisers who claim to be able to deploy large amounts of capital here when clearly on any view they cannot.

The truth is stark: if you seek to commit anything other than a miniscule amount of money to US venture then the best possible outcome is that you will end up in the upper quartile but outside that all-important top decile. A more likely outcome (given the amount of money seeking a home and the number of available funds) is that you will find yourself with second, third or even bottom quartile performance. I am not by any means suggesting that investors should not attempt to do so, since I am a big supporter of US venture, but they should go into it with their eyes open and realistic expectations, and this will not happen so long as some people within the fund of funds and advisory communities continue to make self-serving extravagant claims that cannot be reconciled with the facts.

THE GP/LP RELATIONSHIP

This is a topic which I do not propose to discuss within the body of the book. This may cause some surprise, since it is a subject to which whole chapters have been devoted in books both actual and planned by other writers, and I therefore owe the reader an explanation of why this is.

Rather like access, this is an area where whole battle fleets of theory and discussion founder upon one massive rock of reality. Except perhaps for the case of LPs who invest on a truly massive scale (some of the US public pension plans, for example), and even then only where they are investing with GPs who are determined to raise as much money as possible in order to maximise their management fee income, this is simply no longer an issue. The GP has almost supreme bargaining power, and any individual LP effectively has no bargaining power at all. Consider the situation: the LP's only sanction when faced with what may be deemed an unacceptable situation is not to invest, but to invest elsewhere. The fund, if it is a quality fund, will be potentially over-subscribed almost immediately. It therefore matters not one jot to the

GP whether the LP invests or not; if that particular LP does not proceed, there are others who will. Conversely, if the LP goes elsewhere and finds that her views are now listened to, this should raise questions about the level of investor interest in this new fund generally, and thus of its quality (there are obvious exceptions here, where an asset class falls out of favour for reasons which may have little to do with investment logic, such as European venture, but for the most part it will be true).

Let me qualify this statement of general truth, however. There are obviously some things which even with such supreme power a GP simply could not get away with, but I am not sure that we have really tested the limits yet of what that might be, particularly in the case of golden circle US venture firms. There was initially resistance to the idea of a 30% carry, for example, but this went on to become almost commonplace (I know of one LP, a US endowment, who as a matter of principle stopped investing with a golden circle firm on this issue, and has presumably lived to rue the lost investment returns ever since). Similarly, there was resistance to the dramatic fund size increases which occurred just before the collapse of the bubble, but these still went ahead. Indeed, one or two firms successfully resisted all investor attempts to reduce them again, even when the need for this had become starkly obvious, and many of their peers had already done so. This general principle must logically hold true: as long as there are new investors waiting to crowd into a fund if existing ones fail to take up their offered entitlement, then GPs will be able to call the shots.

Please understand that I am not condoning the position. Personally, I find it extremely regrettable that the economic interests of GPs and LPs are for the most part so badly misaligned, and that friendly and constructive professional discussion of fund terms now seems to belong to a vanished golden age. I am simply recording and recognising reality. This book is designed to be a practical guide to private equity, and I have therefore decided that there is no place in it for sterile academic discussion of what should ideally be the case if only things were different. It is rather like a lot of finance theory, which is fine in theory when you learn it at business school but collapses as soon as you try to put it into practice in the real world. For those who may disagree, let me say this: not only is the situation not going to improve, but if anything it is going to get even worse given the large amounts of extra capital which will be seeking a home in the asset class in future. So, as an American might say (but I, being a courteous and well-brought-up European, couldn't possibly): "get real!". For the foreseeable future, fund terms will be more or less whatever GPs want them to be.

An obvious question, one which I am often asked but to which I do not have an answer, is why LPs do not band together to combine their bargaining power, perhaps even drawing up standard approved sets of legal terms, such as has happened in other industries, for example shipping, international sale of goods, etc. I do know that some attempts have been made to do this, particularly in the USA, and you do occasionally find it happening on an ad hoc basis within the investor base of a particular fund, e.g. on the fund size reduction issue, but I have certainly never come across any really effective large and long-term grouping. Perhaps there is a pointer here for the future. Many LPs come across each other on a regular basis anyway, and there really is no logical reason why they should not formalise these encounters into some sort of industry standards board. Perhaps one day we will come across funds being raised "on International LP committee standard terms (2100)", but somehow I doubt it.

One final point before I leave this rather controversial subject. There are many LPs who say that they view terms and fund economics as the most important single factor in deciding whether to commit to a fund or not. With great respect, I find this view completely illogical. A glance at some of the figures presented later in this book will show that the potential for out-performance by the very best funds in almost any private equity discipline, and most obviously in venture capital, is huge. Even in the case of buyout, it is huge compared with some other asset classes, such as quoted equities. I have not run the calculations, but it seems inconceivable that the impact of any fund term (for example, the difference between a 20% carry and a 30% carry) could make such a difference to the overall performance that it would invalidate the investment decision. That fund is still going to be a dramatically out-performing fund. Do you really care that it will only return 9× to you rather than 10×? And can you really be so sure of your own judgement that if you turn it down you will choose another one that will achieve 10× (the odds against which are immense) rather than, say, 2×? If you are the sort of person who is going to turn down a chance to invest with the likes of Kleiner Perkins or Sequoia on the basis of any disagreeable fund term (unless it is something which makes it legally impossible for you to invest because of your own regulatory or constitutional situation) then I would respectfully suggest that you have not grasped the way private equity returns work, and would be better employed in a different area of investment.

It is for much the same reasons that, after much reflection, I have decided not to comment specifically on fund terms. First, this discussion more properly belongs in a book aimed at an audience of lawyers, and would involve a lot of detailed issues which a non-legally-qualified reader may find very challenging. Second, it would be very difficult to do within the confines of a single chapter, and, if done properly, would probably require a whole book to itself. Third, there are specialist lawyers who will guide you through the process should you encounter it in practice, so this is knowledge which you as an investor do not really necessarily need. Fourth, it would unbalance the book, since I wanted to discuss direct investment (i.e., in companies) as well as indirect investment (i.e., in funds). Finally, and most importantly, even if you *do* understand everything there is to know about fund terms, this knowledge will for the most part be largely irrelevant since the terms will be more or less what the GPs decide they will be, and the scope for any meaningful negotiation will be strictly limited.[1]

So, just to recapitulate, this book is intended as a practical guide to how to go about the business of making private equity investments, whether at the company or (probably more usually) at the fund level. It attempts to describe reality as I, as a practitioner, have experienced it over the years, and to stick to the highways of the possible, not to explore the back lanes of intellectual perfection. Private equity investing is quite difficult enough already without getting distracted by largely irrelevant issues.

[1] Since about 1998 I can only remember one instance where a major change was made to the fund terms during the legal documentation review, and this was where something was inconsistent with an assurance which had been given verbally during the fundraising process. In all other cases, the changes that occurred were simply to correct drafting errors which were clearly nonsensical, though in the case of one well-known buyout firm, the lawyers once said to me "to be honest, we don't understand what it means either, but we're not going to change it".

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Once again Thomson Financial have kindly made available their VentureXpert database to me, and so once again I must express my sincere gratitude and appreciation, particularly to Bob Keiser who again patiently and uncomplainingly dealt with all the minutiae of copyright releases and so forth. Without access to their figures this book could not have been written.

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1

What is Private Equity?

It used to be quite easy to define what was and was not a private equity investment: “any equity investment in a company which is not quoted on a stock exchange”. In truth, however, this rather simplistic description has been in trouble for a long time. What about investments that are structured as convertible debt? What about companies which are publicly listed but are taken private? Or where the company remains listed but the particular instrument into which the new investment occurs is not?

What about a situation where an interest in a company is acquired not for itself but with the intention of gaining ownership of underlying assets, particularly property (real estate) related assets? Even a few years ago many would have drawn back from classifying this as a pukkah private equity transaction, yet today funds are being raised specifically to target such opportunities.

There again, there is the whole secondaries scene, where existing interests in private equity are traded between investors. Just to complicate matters still further, secondary players are today equally happy to buy directly the underlying investments of the fund, and frequently to make primary investments in new funds as well.

Clearly the question “what is private equity?” is no longer capable of a quick and simple answer, even if it ever was. Without wishing to confuse you still further, there is an increasing convergence between the activities of private equity funds, hedge funds and property funds, and by the time this book is published we may well have seen the first recorded example of all three co-operating together on the same transaction; it can only be a matter of time. However, there was a well-known law case in England many years ago when a judge famously said that although you cannot define an elephant you still recognise one when you see it (though some believe he may have pinched this idea from Doctor Johnson without acknowledgement). I think all of us will have an instinct for what a private equity transaction is or is not, but it is growing increasingly difficult to be certain about this as the parameters of the asset class are being stretched all the time.

In this chapter I am going to set out some basic concepts of how private equity functions as an asset class, many of which will then be developed in more detail in the following chapters. This opening chapter will thus be of most use to those with no prior experience of private equity, but I would urge the rest of you to stay with us rather than turning straight to the next chapter, as I will be referring later in the book to these concepts intending them to have precisely the meaning and context to which I am just about to ascribe them.

FUND INVESTING VERSUS DIRECT INVESTING

The first and most fundamental distinction in the private equity world is between those who invest in funds and those who then manage the capital invested in those funds by making investments into companies. This distinction is sometimes defined by the terms "fund investing" and "direct investing", and confusingly some investors do both.

We also have to deal with what Oscar Wilde described as "a single people divided by a common language", although to be fair US private equity terminology has become increasingly common in Europe and I shall usually be adopting it as industry standard, except where it is absolutely essential to draw some particular distinction of meaning.

In America, those who invest in funds are called "LPs", since the most common form of private equity fund is a limited partnership, the passive investors in which are called Limited Partners. In Europe, such folk have historically been called simply "investors". There are various different types of LP and it is worth spending some time examining these here since they will all have different investment criteria and, most importantly of all, different levels of knowledge of the asset class (typically referred to rather arrogantly as "sophistication").

At the top end of the scale are the Fund of Funds managers. These will typically do nothing except invest in private equity, and the best of them will have staff with perhaps 20 years' specialist experience. Some (Horsley Bridge would be a good example) might specialise in one particular area (traditionally early stage US venture in their case) whereas others (Harborvest, to give an example of similar vintage) are generalist both as to the type of investments which they make and the geographical areas which they cover. As we will see, however, the bulk of private equity activity occurs in the USA and in Europe, and it is these two areas into which the private equity world has traditionally been subdivided.