PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

PRIVATE EQUITY FUND INVESTMENT DUE DILIGENCE

Strategies for evaluating and selecting top performing fund managers

Edited by
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Contents

Figures and tables

Figures

Tables

About the editor

Kelly DePonte is a managing director and currently the head of research for Probitas Partners. Prior to joining Probitas Partners, Kelly was chief operating officer and managing director at Pacific Corporate Group. Before joining PCG, Kelly held various positions at First Interstate Bancorp, including management of a $170 million venture capital portfolio and the Corporation's SBIC, and oversight of all financial derivative activity in the corporation and its banks. Kelly earned a BA from Stanford University and an MBA from The Anderson Graduate School of Management at UCLA. □

Introduction

When looking at the current private equity fund landscape, we often forget how new the sector is as a financial asset class and how differently it is structured from many other sectors of the financial markets. Until 1978, when the US Department of Labor introduced its 'prudent man' interpretation of the ERISA regulations, these funds were basically a cottage industry, with small amounts of money raised in blind-pool vehicles managed by small teams of general partners (see Table I). Most of these investment vehicles were limited-life partnerships, meant to be self-liquidating and not permanent.

Table I: **A brief history of private equity: Key milestones**

1946	American Research and Development Corporation (ARD) founded by George Doriot and JH Whitney & Co. founded by Jock Whitney; institutional private equity investing begins, though it starts slowly.
1968	Bull market for IPOs; ARD takes Digital Equipment Company public, generating an IRR of 101%, raising the profile of venture capital.
1972	Kleiner Perkins raises $8.5 million for its first venture capital fund.
1976	The firm that will become Adams Street opens the Institutional Venture Capital Fund, its first fund of funds, with $60 million.
1976	KKR raises its first buyout fund, with $31 million in commitments.
1978	US capital gains tax rate slashed from 49.5% to 28%, increasing interest in long-term investments; US Department of Labor clarifies that pension plans can invest in private equity, dramatically increasing the potential supply of capital.
1980	Total commitments raised for North American and European private equity: $2.5 billion.
1982	Pantheon Ventures of the UK raises its first fund of funds.
1982	Apax raises its first fund of £10 million focused on venture capital; firm later shifts to a buyout focus.
1982	JAFCO raises its first Japan-focused venture capital fund totalling ¥1,600 million.
1985	Permira of the UK raises its first fund totalling £75 million.
1987	Venture Capital Fund of America raises its first dedicated secondaries fund totalling $13 million.
1988	The team that would found Oaktree Capital Management raises its first distressed debt fund while at TCW, the TCW Special Credits Fund I, totalling $97 million.
1990	Total commitments raised for North American and European private equity: $19.5 billion.
1998	Grove Street Advisors launches California Emerging Ventures, the first in a series of three large separate accounts for CalPERS.

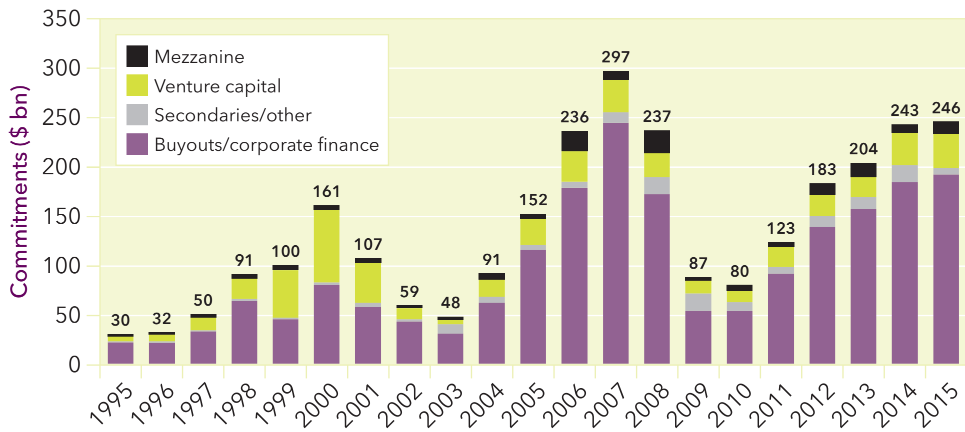
Table I: **A brief history of private equity: Key milestones** *continued*

2000	US venture capital fundraising hits $74 billion at the height of the Internet bubble, the largest amount ever raised for venture capital in the largest market; the collapse of the bubble leads to a steep decline in venture capital fundraising.
2000	Total commitments raised for North American and European private equity: $306 billion.
2006	Blackstone raises the largest private equity fund of all time, Blackstone Capital Partners V, at $20.4 billion.
2007	Fortress becomes the first private equity management company to go public, followed quickly by Blackstone.
2007	Apax Europe VII raises €11.2 billion for the largest pan-European fund ever raised.
2007	Fundraising in the US reaches an all-time peak in advance of the Global Financial Crisis (GFC); European fundraising hits its peak the following year.
2008	Oaktree Capital Management raises the largest distressed debt fund ever, OCM Opportunities Fund VIIB, with $10.9 billion in commitments.
2010	In reaction to the GFC, the Dodd-Frank Act is passed in the US – part of the Act requires private equity funds over a certain size to be regulated by the Securities and Exchange Commission.
2010	Gávea Investment Fund IV, the largest Latin American fund raised to date by a local manager at $1.8 billion, targeting Brazil.
2010	Total commitments raised for North American, European and Asian private equity: $140 billion; fundraising is dramatically impacted by the GFC.
2011	Alternative Investment Fund Managers Directive (AIFMD) is passed in the European Union; it introduces a wide swathe of new regulation for private equity fund managers in the EU.
2011	Fundraising for China-focused funds peaks at $36.7 billion, with over 60% of that total raised for funds denominated in renminbi.
2014	Largest African-focused fund, Helios Investors III, raises $1.1 billion.
2015	Largest locally headquartered Asian-focused fund raised, RRJ Master Capital Fund III, at $4.5 billion.
2015	Lexington Capital Partners VIII raises $10.1 billion, the largest specialty secondaries fund ever raised.

The adoption of the prudent man rules, and the development of leveraged buyouts in the US in the 1980s, led to a slow but steady transformation of the sector into an asset class increasingly backed by large institutional investors. Figure I provides some insight. The US private equity market is the deepest and longest lived private equity fund market and provides an excellent snapshot of the growth of the market. However, even with increased activity in the 1980s, fundraising in the US did not rise above $25 billion in annual commitments until 1995. Over the past 20 years fundraising has grown dramatically. It surged with the Internet bubble and in the run up to the Global Financial Crisis, plunged as the public markets collapsed in late 2008 and in 2009, then rebounded strongly thereafter.

Although not detailed in Figure I, private equity began to expand rapidly in Europe in the late 1990s, and in Asia and other key emerging markets since 2005. As the sector

Figure I: **Commitments to US private equity partnerships by sector, 1995–2015**



Note: Does not include funds of funds and infrastructure funds.
Source: Private Equity Analyst.

has grown in both size and geographic coverage, it has become more complex. Managers are overseeing series of funds and fund strategies developing from generalist buyout and diversified venture capital vehicles, to specialist sector strategies and new sub-sectors such as distressed, secondaries and co-investment.

Even as it has grown and developed, certain things about private equity have not changed:

- *It is an inefficient asset class.* The 'efficient market theory' developed by academics to explain returns in publicly traded securities simply does not apply for a variety of reasons to private equity. That is evident in the very wide spread between top quartile and bottom quartile fund returns within the various private equity strategies.
- *It is illiquid.* The vast majority of private equity structures are illiquid. Even with the development of the secondaries market, these structures make it much more difficult to exit an investment than it is in the public markets. Prices are negotiated, and not independently set by a mark-to-market value because no mark-to-market value exists.
- *Activist strategy.* Especially in core private equity strategies such as buyouts, growth capital and venture capital, the best managers are the ultimate activist investors. Investment success comes not simply from deciding to invest in a company and at what price, but from serving on the company's board of directors. Managers take an active role in deciding company strategy, reviewing operations to make them more efficient, and firing and hiring company management when necessary.
- *Manager selection drives returns.* The combination of these factors means that fund manager selection drives an investor's returns. An investor cannot simply allocate capital to European middle-market buyouts or life science-focused venture capital and expect success.

For these reasons, intensive fund due diligence is necessary in private equity – not only to target the highest performing funds, but also to avoid potential disasters.

This edition of *Private Equity Fund Investment Due Diligence* gathers a very experienced group of practitioners to share their views on various elements of fund targeting, due diligence and selection. They are not professional writers but professional investors and consultants with deep knowledge of the subject matter. Many of them have turned to writing 'after hours' in order to share their experience, and any success this book has is due to them. □

Kelly DePonte
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2 Track record due diligence

By Edmond Ng, Chris Loh, Alex Lee Sao Wei and Marc Lau, Axiom Asia Private Capital

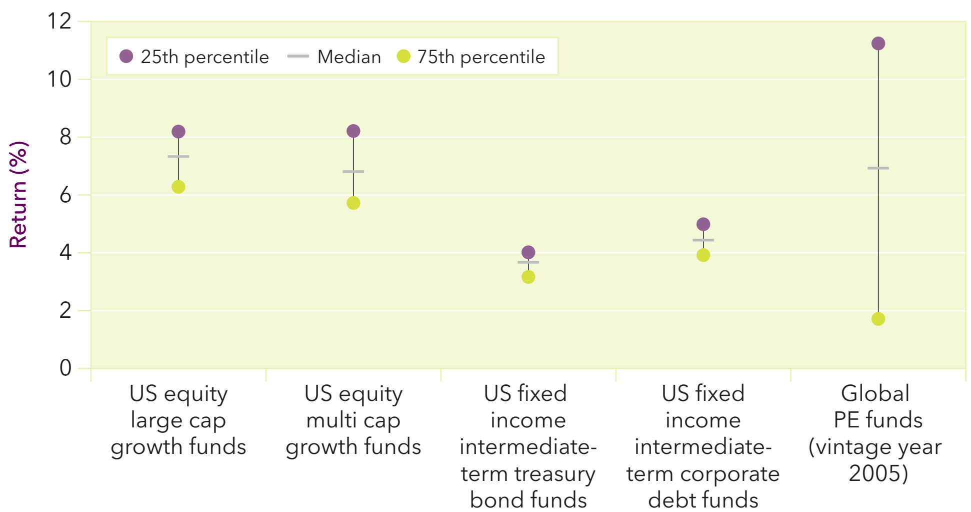
Studies indicate that the spread between the best and worst performing managers is much more prominent in private equity than in any other asset class (see Figure 2.1). As manager selection drives returns in private equity, undertaking comprehensive due diligence, in particular through bottom-up track record analysis, can mean the difference between subpar performance and top-quartile returns.

Investors must have a disciplined fund selection process. The relatively short investment track records of many Asian funds, unlike those of more mature private equity markets in the US and Europe, mean that conducting due diligence on the quantitative performance of Asian GPs' prior funds is often more challenging. It is essential to carry out qualitative track record analysis not only at the fund level and portfolio company level, but also at the individual team member level.

There are a few key considerations investors should keep in mind when selecting a GP:

- *The quality of portfolio companies of the GP's prior funds.* This may involve visiting selected portfolio companies over the course of due diligence, including a sampling of the best and worst companies in a fund's portfolio.

Figure 2.1: **Ten-year annual return dispersion by asset class and strategy**



Note: Classification of US funds are based on Lipper's Global Classification Scheme to ensure comparability of funds. Data is as of 31 December 2015, except for global private equity funds (30 September 2015 due to unavailability of return figures as of 31 December 2015).
Source: Preqin, SPIVA.

- *The strength and complementary skills of the fund management team.* Heavy focus is expected to be placed on the competitive landscape in the geographical region and sub-asset class – buyout, growth capital and venture capital – within which the fund is operating, and benchmarking the fund manager against its competitors.
- *Deal-sourcing capability,* including the ability to generate proprietary deals.
- *The ability of the fund manager to add value* post-investment and to exit investments successfully.

At the heart of track record analysis is the ability to discern whether a GP's investment returns are generated simply by being at the right place at the right time (luck) rather than by possessing true deal-sourcing capability, investment acumen, and/or adding value to portfolio companies. Through both quantitative and qualitative analysis, this chapter seeks to determine which drivers of return are repeatable.

Quantitative track record analysis

Return analysis

Absolute return measures, like internal rate of return (IRR) or total value to paid-in (TVPI), are no guarantee of future performance, but funds that have above-average alpha generally tend to continue to produce above-average alpha with the next fund in their series. There is no better proof of success than exited investments, particularly for buyouts. Analysing an investment's cash flows at exit provides more clarity on the actual drivers of return. Questions to address include: Does the manager have financial engineering capabilities as evidenced by its ability to pay down debt? Was value created through multiples expansion and was this a result of true operational improvements or simply serendipitous market timing? A manager able to show consistent performance, especially during deteriorating market conditions (for example, during the 2007–08 Global Financial Crisis), is an indicator of true value creation ability.

Comparisons can be made by benchmarking a GP's performance against other GPs in the same vintage year in similar investment categories such as geography (US, Europe, Asia and even at country level) or strategy (buyout, growth and venture capital). In such peer group indices, it is important to use a consistent benchmark for internal due diligence, as many funds can claim top-quartile performance based on using different benchmark providers or peer groups. Investors should take into account how GPs define 'vintage year', which can differ from fund to fund. Some managers consider vintage year to be the year in which capital from the fund is first invested, while others consider it to be the fund's legal inception year. If a 2006 vintage fund is compared to 2007 or even 2008 vintages, it could appear to have superior performance than its peers because its investments have had more time to harvest.

Similarly, an investor can compare a GP's performance against public market indices. In this case, the opportunity cost of tying up one's capital in an illiquid private equity fund is compared to what the potential returns could have been if the capital had been invested in the stock market. Simply looking at an investment's multiple on invested capital (MOIC) does not take into account the opportunity costs if the investor had purchased a basket of publicly traded investments (for example, an S&P500 Exchange Traded Fund (ETF)). That said, there is no benchmark that encompasses the full

10 Diligencing operating value creation capabilities

By an experienced operating partner

Introduction

There is a fundamental tension in the private equity world today regarding operational value creation. LPs seek to invest in private equity funds that can add significant operating value in an environment of intense competition for deals and record-high multiples. GPs tout their operating abilities both as a value add and as a differentiator. This chapter addresses how LPs can better diligence a GP's value creation abilities.

A 2016 survey by Probitas Partners finds that LPs' number one criteria for investing in US middle-market funds is 'funds focused on operating improvements heavily staffed with professionals with operating backgrounds'. In 2013, the Institutional Limited Partners Association (ILPA) included the following question in its due diligence questionnaire: 'Do you have a dedicated operating team?' However, it is becoming more difficult for the typical private equity fund to afford on-staff operating partners as a result of downward pressure on management fees; competing needs for deal sourcing, investor relations, LP reporting and compliance resources; and greater difficulty in charging and retaining the costs for operating partners to the portfolio companies due to increased LP and regulatory scrutiny.

So private equity firms are in a bind. They know they need to add operating capabilities to improve returns and meet LP expectations, but cannot do so without negatively impacting their near-term profitability and partner compensation. As a result, when fundraising, funds are motivated to project the most operational value creation capability with the least incremental net investment on staff resources. Examples are abundant and easily identified:

- Funds with many portfolio companies, but just a few on-staff operating partners.
- Funds with part-time resources, such as senior advisors employed directly by the portfolio companies.
- Funds that take a 'general contractor' or outsourced approach.

These approaches may create the appearance of capability, but they are hardly what LPs really need, which is a systematic, repeatable approach to move the needle on returns of an entire portfolio over its ten-year life. The resource gap may only worsen. Since the Global Financial Crisis of 2007–08, developed markets have faced a moderate economic expansion with low interest rates, plentiful debt financing and improving employment. What looks like sufficient operating capability in 2016 would be wholly insufficient at some point in the future when the economic cycle turns downward.

In this environment, LPs need a better approach to assess a private equity firm's ability to add operating value. LPs have many competing demands on their time, many investments and funds to evaluate, and many other factors to consider that any such approach must be highly efficient, effective and practical. Often, only the largest LPs and advisors have the resources, time and clout to conduct a customised, thorough due diligence process. With abundant capital flowing into private equity these days, if LPs only invested in funds with proven operating track records, staffed by many people with deep operating expertise, they would be hard pressed to meet their private equity allocation targets. Practically speaking, it comes down to, all else equal, whether a GP's ability to add operating value should be:

- A deciding factor in and of itself.
- A differentiator among many other factors.
- A non-factor in the investment decision.

The bar is high and without proof to the contrary, LPs have a right to be sceptical.

The diligence process today

Let's start with what happens in the diligence process today and why there is an opportunity to help LPs in this area. Having sat on the other side of the table as a GP and presented to many LPs in the course of two fundraisings over the last ten years, I have been asked some very insightful questions about operating capabilities, including the following:

- *Team*
  - How many people are on your team?
  - What are their backgrounds?
  - Are they functional or industry specialists or generalists?
    - How did you choose to add these functional specialties vs. others?
  - How well are the operating partners integrated with the rest of the firm?
  - How are the operating partners compensated?
    - Do they participate in deal-by-deal or firm-wide economics carry?
  - What has been the turnover of the operating resources? Why?
  - How do you allocate the individuals to the companies?
  - How many companies do they each cover?
- *Approach*
  - When are you first involved in the deal, pre-closing or post-closing?
  - What is your role in due diligence?
  - Describe your typical engagement approach?
  - On what operational areas do you focus?
  - Do you do 100-day or value creation plans?
  - Do you do monthly operating reviews and quarterly portfolio reviews?
  - Do you use external consultants?
- *Results*
  - How do you measure your impact?
  - Can you provide case studies of your impact?

16 Panel discussion: Practical advice on targeting and accessing funds

When LPs are going through a period of focusing heavily on making new investments and fundraising, being able to access a fund of interest – especially at a specific target amount – can be as much of a problem as performing due diligence. This process begins with targeting fund managers the LP finds attractive and developing a relationship to learn more about them in advance of a fund being launched.

To examine the practice of targeting and accessing funds, PEI convened an expert panel of LPs to discuss a number of issues, including how they approach targeting and developing relationships with fund managers and their approach to dealing with 'hot' funds that are likely to close quickly. There is no single template for dealing with these issues, so the panel members are providing their own experiences and perspectives.

The panel

Our panel participants are experienced investors who represent a broad cross section, by size and type, of institutions from very targeted investment programmes to broader mandates. The panel members are:

Nicole Belytschko, CM Capital Advisors
Linda Calnan, Houston Firefighters' Relief and Retirement Fund
Brian Gallagher, Twin Bridge Capital Partners
William Chu, Zurich Alternative Asset Management

PEI: *Describe how you target new managers.*

Belytschko: Our process is continuous and involves referrals from other LPs and GPs, as well as placement agents and other service providers.

We have found that one of the most fruitful sources of new fund relationships is other LPs. Our team meets with a wide range of other LPs globally, whom we have met through our participation in organisations such as the Institutional Limited Partners Association (ILPA), and through conferences and industry events. We have cultivated an active local network of like-minded family offices and other institutional investors within the San Francisco Bay Area, as well as family offices globally, and meet on a regular basis to share ideas. These interactions are complemented by input from placement agents and other service providers. We maintain an ongoing dialogue with placement agents, providing clear guidance on areas we are seeking to supplement within our portfolio. Agents have a view into the broader market, so while they are marketing a particular set of funds, they also typically know or can help to identify other interesting managers within a segment. We also monitor the news regularly for spin outs and new funds. However, given the speed of fundraising today, if we are reading it in the press, it is likely too late for a potential seat at the table.

In an ideal world, we would meet a manager between funds or well before a new launch so that we can develop the relationship over several years outside of the sales cycle. In reality, the process varies widely. Given the current market environment, we are seeing a number of emerging or spin out managers go through the market within a matter of weeks. We have had the fortune of tracking some of these managers prior to launch, and we have been prepared to come to a quick decision once fundraising commenced. In the case of hard-to-access established managers, we strive to follow groups for several years prior to a fundraise. In several instances, our relationship development work has paid off and our organisation has gained access in a subsequent fund. If this does not work, the manager goes back on our target list so that we can continue to develop the relationship for a later fund. Regardless, our goal is to stay in front of the manager so that we can continue to be considered an attractive partner.

We have touched on the speed of fundraising in today's market. Nonetheless, it is important to view both target listing and relationship development as long-term initiatives, as timing can be a challenge for either party.

For established managers, commencing a relationship shortly after a fundraise is the ideal time. This provides us with an extended time frame to convey the benefits of having our organisation as an LP. At the same time, we can pace some of our due diligence as we gain visibility into the manager's investment activities and decision-making processes.

As we mentioned previously, referrals from other LPs are typically our most productive source of new manager ideas. When we receive a referral, we perform preliminary background work to determine if the manager is a fit within our investment portfolio. There are plenty of interesting managers that do not fit within our investment programme for one reason or another, and it is important to make that determination quickly. As referrals from other LPs are invaluable, we do our legwork right away, and if it makes sense to move forward, we ask for a warm introduction. We follow up with an email highlighting our organisation and private equity programme, and we ask for an introductory call to kick things off.

LP relationships are invaluable to this process, and we cannot emphasise enough the value of maintaining active LP-LP relationships in which teams are able to share ideas and information. Also, many GPs find it challenging to network among the family office community, so we provide introductions to other family offices as a value add for prospective new and existing GP relationships.

Calnan: Culling the private equity fund manager universe to identify GPs of interest with whom we do not have an investing relationship is a difficult task. Fortunately, our