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Securing the future of pensions

Private equity

October 2014

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British Private Equity & Venture Capital Association

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1 Introduction

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Private equity can trace its roots back to 1945 and the establishment of the Industrial and Commercial Financial Corporation (ICFC) but its modern form began in the early 1980s. In its early years it was a small, niche segment of the investment market but over the course of the last three decades has grown to become a billion-pound industry backing businesses across the globe.

The term private equity spans a wide range of activity, from seed and venture capital investments for start-ups and early-stage businesses, through to mid-market buyouts and large leveraged buyouts of multinational companies.

One thing that all of these activities have in common, however, is that they all involve institutional investors coming together to make equity investments into businesses, with the aim of providing the capital and operational improvements needed to allow those companies to grow and increase in value, thereby producing capital gains for their investors when they are sold.

This guide has been designed to be used as a general reference for pension funds interested in investing in private equity and venture capital. It provides a simple, easy to follow guide to an asset class that is at times complicated. Contents include:

- Explaining what private equity and venture capital are;
- Providing a practical guide on how to invest into private equity and venture capital;
- Explaining the structure of private equity and venture capital funds and the Limited Partnership model prevalent within the industry;
- Providing a guide to measuring returns in private equity and venture capital investments and benchmarking them against other asset classes;
- An overview of the evolution of the private equity market in the UK and an examination of the current market and trends.

2
What is private equity?

Private equity is a form of finance provided in return for an equity stake in a private (ie unlisted) company.

Private equity firms raise capital from private sources, such as pension funds, insurance companies, endowments and high net worth individuals. These investors band together in a limited partnership as Limited Partners (LPs) with a fund manager – who takes the role of General Partner (GP) in the partnership – to invest in often majority stakes in companies with high-growth potential, with the aim of improving the operational performance of the business and selling it for a profit at a later date.

Unlike other asset classes where money is drawn down all at once, private equity commitments are drawn down as investments into the underlying companies are made. Because these funds are structured as long-term investment vehicles, LPs are often required to commit their capital for the fund's total life – typically 10 years. A fund's life cycle is usually broken down by an initial five-year investment period followed by a five-year divestment period. As it is a long-term investment strategy, private equity does involve a degree of illiquidity.

As private equity and venture capital often overlap in practice, the distinction between the two terms differs by varying degrees around the world. In Europe, the term private equity generally encompasses both venture capital and buyouts. In the United States, private equity and venture capital are treated as separate types of investment and are regarded as mainstream sources of capital for businesses.

2.1 Types of private equity funds

Buyout: Buyouts are the most common form of private equity investment in the UK. In this type of transaction, funds are provided to allow current managers and investors to buy an existing business. Funds may also be provided for buy-ins, where outside management acquires a stake in the company. Buyouts and buy-ins can range in scale from small buyouts, through to mid-market, and all the way up to large buyouts. A common feature of buyouts is the use of debt as a financing technique.

Venture capital: While venture capital and private equity are often used interchangeably, the two terms represent different things. In general, venture capital funds invest in companies at an early stage in their development when they often have little track record of profitability and are cash-hungry. In contrast, private equity funds invest in more mature companies with the aim of reducing inefficiencies and driving business growth.

The terms that most venture capital firms use to define the stage of a company's development are determined by the purpose for which the financing is required:

- *Seed investment:* Allows a business concept to be developed, often involving the production of a business plan, prototypes and additional research, prior to bringing a product to market and commencing large-scale manufacturing.
- *Start-up investment:* A stage when funds are used to develop a company's products and finance their initial marketing. Companies may be in the process of being set up or may have been trading for a short time, but have not sold their product commercially and are generally pre-revenue.

- *Early stage investments:* Initiates commercial manufacturing and sales in companies that have completed the product development stage, but may not yet be generating profits.
- *Expansion:* When funds are used to grow and expand an established company to finance increased production capacity, product development, marketing and/or to provide additional working capital. This stage is also called development or growth capital.

2.2 The types of businesses private equity funds invest in

Private equity funds typically look to invest in majority stakes in companies that have the potential for high growth. Growth in the businesses is delivered by working with the company's management team to improve performance and strategic direction, making intelligent investments and driving operational improvements.

Venture capital firms, in contrast, invest in companies in the seed, start-up and early stages of development, investing their capital and expertise to develop new products and technologies.

2.3 How private equity funds generate returns (exit routes)

Private equity and venture capital funds generate returns by selling their stake in a business for a higher price than that which it was initially acquired for, thereby creating a capital gain. This process is called an exit and is achieved through selling an investor's stake in a company, usually through an initial public offering (IPO), selling to a strategic buyer (a trade sale), selling to another private equity firm (a secondary buyout), or selling the company to the management (buy-back). Generally this sale takes place somewhere between three and seven years after the original transaction took place, signifying long-term ownership over which significant operational and other changes can be enacted.

As with all investments, private equity is not without its risks. It is possible that some or all of an investment may have to be written off. In order to minimise such a risk, experienced fund managers invest in a wide range of companies and are able to recognise possible red flags so they are better placed to cope with any potential involuntary exits.

3

Understanding the myths and facts around private equity

Private equity occasionally faces accusations from the media of job destruction, asset stripping and over-leveraging its companies with debt. The reality, however, is that these criticisms are largely myths borne out of a widespread misunderstanding of the industry.

3.1 Does private equity cut jobs?

One of the key myths relating to the effects of private equity has been its negative impact on employment. In reality, private equity's impact on employment is broadly neutral over the longer-term and potentially positive. The findings of a 2013 report of portfolio companies conducted by EY for the British Private Equity and Venture Capital Association (BVCA)[1] found that private equity ownership did not lead to adverse effects on large UK businesses and that portfolio companies saw growth in employment, revenue, investment, profits and productivity. These findings help dispel the common misperception that productivity comes at the expense of employment numbers. In truth, the results indicate that private equity's capacity to improve productivity creates more dynamic companies with higher revenues that are best placed to grow and recruit new talent.

3.2 Are private equity firms asset strippers?

Private equity firms have been accused of taking companies, stripping them of assets to pay down debt and leaving the businesses with greatly diminished prospects for the future. However, the very model of private equity is inconsistent with this claim. Because the model is based on long-term value creation and is dependent on having strong and sustainable companies for firms to sell on to strategic buyers or the public market, private equity firms have every incentive to ensure that the businesses they sell are as valuable as possible. As such, it is not at all in a firm's interest to strip assets. Evidence from EY's annual study into how private equity investors create value[2] reaffirms these views. In the study, 80% of the realised investments generated positive returns for investors and half the businesses made add-on acquisitions to build scale, while only 10% in the portfolio made disposals. The report further examines land disposals, Research and Development figures and employee pensions, finding no evidence of valuable assets being stripped off.

3.3 Do private equity firms over-leverage businesses?

Due to high leverage, the risk of private equity-backed firms defaulting on their loans is a source of concern and has raised questions regarding its impact on the stability and survival of these companies. The financial crisis and resulting recession have further incited this debate, as private equity firms began to experience greater difficulty both in raising new funds and refinancing debt for their existing portfolio companies.

However, a 2010 academic study that examined insolvency during the crisis found that private equity-backed buyouts had a significantly better coverage ratio (the ability to pay interest on debt from profit and cash-flow) than other companies and were less likely to fail in the wake of the crisis[3]. Importantly, the study found that poor management and failure to generate cash were distinguishing factors between buyouts that failed and those that survived – and not leverage levels. One of the main factors behind the asset class' resilience was determined to be its active ownership model. Due to this unique structure, buyouts that were backed by private equity delivered more than twice the recovery rate of debt than that of those backed by public ownership (62-63% compared with 26-30%).

[1] *BVCA Annual Report on the Performance of Portfolio Companies, VI.* ***http://bit.ly/1uzAelV***
[2] *Private Equity and Value Creation in Europe, VIII ed. EY, 2013.* ***http://bit.ly/1oOvQJQ***

[3] *Nick Wilson, Mike Wright and Robert Cressy, Private Equity and Insolvency. Report commissioned by the BVCA (2010).* ***http://bit.ly/1s379jO***

4

Pension fund investment in private equity

4.1 Global investment

In the wake of the global financial crisis, pension funds are re-evaluating their asset allocation strategies to avoid declines in the value of their investment portfolios.

Central to this effort has been the need to acquire financial asset diversity through increasing allocation to alternative asset classes. Owing to its long-term, sustainable, high returns and relative outperformance compared with public markets, pension fund managers are increasingly viewing private equity as a profitable investment vehicle in which to allocate capital and to diversify their portfolio.

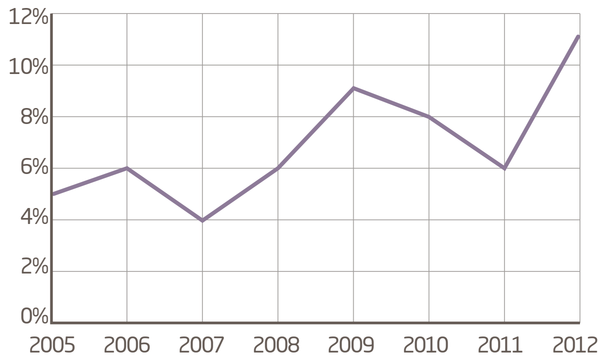
A 2014 study by the London Business School found that the private equity allocations of pension funds have been growing since 2005, leading to a significant increase in the amount of private equity fund investments being managed[4]. In the case of more experienced public pension funds, the report found that capital allocations to the industry almost doubled between 2005 and 2012[5]. The study also established a "strong negative relationship between quoted equity and private equity allocations" – a finding consistent with the results of the Organisation for Economic Co-operation and Development's (OECD) 2013 annual survey of large and public pension reserve funds, which pointed to "an increase in alternative investments at the expense of traditional asset classes"[6].

[4] *Eli Talmor and Florin Vasvari, The Extent and Evolution of Pension Funds' Private Equity Allocations. The Adveq Applied Research Series, London Business School Coller Institute of Private Equity, January 2014: 2.* ***http://bit.ly/1APSuaG***

4.2 UK investment

This global trend towards greater private equity allocation is also reflected in the UK, as demonstrated by the graph below. Data from the BVCA shows the percentage of total private equity funds raised that came from pension funds in the UK more than doubled for the period 2005-12, growing from 5% to 11%. The graph also shows that for 2011-12 the proportion of funds from pension funds grew at its fastest rate since 1997, showing the increasing demand for private equity from pension funds.

Percentage of Total Private Equity Funds Raised by Pension Funds in the UK



Source: (BVCA Report on Investment Activity, 2012)

4.3 Corporate and Local Authority Pension Funds

Based on data from Greenwich Associates, it is estimated that UK corporate pension funds had £10.6bn invested into private equity and venture capital as of 2014, with local authority pension funds investing £4.7bn.

The average allocations can be broken down as follows:

Corporate Pension Funds

- **Average: 3.6%**
- **Q1 break: 5%**
- **Median: 3%**
- **Q3 break: 2%**

Local Authority pension funds

- **Average: 4.7%**
- **Q1 break: 6%**
- **Median: 5%**
- **Q3 break: 3%**

[5] *Capital allocations to the sector nearly doubled from 4.6% in 2005 to 8% by 2012. Eli Talmor and Florin Vasvari, The Extent and Evolution of Pension Funds' Private Equity Allocations. The Adveq Applied Research Series, London Business School Coller Institute of Private Equity, January 2014: 4.* ***http://bit.ly/1APSuaG***
[6] *Ibid: 5.*

5

Value creation and responsible investment

Private equity adds value to a company in a variety of ways. Thorough due diligence sheds light on a company's strengths and weaknesses alike, and with it comes a sound initial investment rationale.

By targeting growth sectors and new markets, private equity investors can focus on creating better revenue generation and implementing programmes that yield operational efficiencies and help to achieve environmental and social change.

5.1 Governance model

Private equity executives have a wide range of experience. Most have worked in the industry for many years and have had the specialist experience of funding and assisting companies at a time of rapid development and growth. For a partnership to be successful, it is critical for both investors and business managers to establish a structure in which all parties share a common active ownership vision and are motivated to generate long-term value, rather than short-term demands in the way that most shareholders normally do.

By putting a member from the private equity firm on the board of an acquired company, the governance model can promote effective organisational change that includes constant and keen oversight, defined goals and timing, disciplined decision-making and abundant resources. Further, by ensuring that the management team in a company has an ownership stake, this active approach leads to an integral alignment of interests which results in companies owned by private equity outperforming similar publicly-owned companies with relative benchmarks.

5.2 Operational improvement

As a result of the tightening of the credit markets due to the financial crisis, private equity's ability to generate value has become less about making gains through financial engineering and has placed more emphasis back onto undertaking substantial operational improvements and strategic planning.

To enhance long-term performance, a firm's focus goes beyond bottom-line improvements, such as making reductions in both cost and waste and improving IT infrastructure, to include operational and strategic planning, such as opening up the business to enter new markets, improving competitiveness, and executing a strong business strategy. Each of EY's eight annual studies of European exits[7], have, for instance, shown that strategic and operational improvements consistently make up the largest proportion of returns generated by private equity – ahead of gains made from leverage and stock market returns.

5.3 Responsible investment

Recent years have seen significantly more emphasis placed on the responsible investment agenda within the private equity community. This agenda encourages investors to better evaluate the environmental, social and governance (ESG) implications of their decision-making, both in areas they directly control and also in areas over which they can exert a strong influence.

In the marketplace, ESG issues can have a real impact on business value and investment risk, and a well-founded approach to these issues can be a means by which private equity firms and portfolio companies can balance risks, create opportunities and, ultimately, differentiate themselves from their competitors. Many private equity firms have already recognised the value of ESG initiatives not only in achieving environmental and social change, but also in reducing costs and minimising risks. Many firms already consider certain ESG issues during pre-acquisition due diligence, particularly focusing on compliance and potential ESG-related liabilities, while others are working towards a more structured and strategic approach under an over-arching sustainability strategy, linked to the firm's business strategy.

[7] *Private Equity and Value Creation in Europe, VIII ed. EY, 2013* ***http://bit.ly/1oOvQJQ***

6

How are fees paid in private equity?

Private equity, as with many other actively managed asset classes, involves a fee structure, both to meet the day-to-day operational expenses of a fund manager, and to incentivise them to achieve the best possible return for an investor. These fees broadly fall under two different categories:

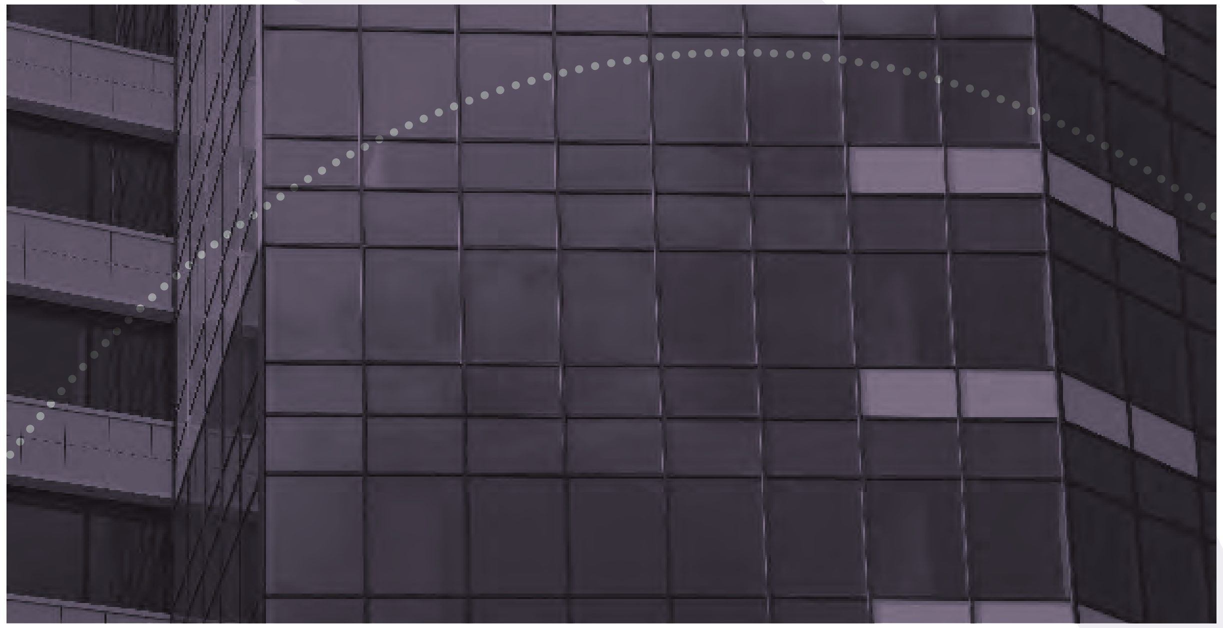
6.1 Fund level

Management fees

Management fees allow the fund manager to meet their own operating costs, including salaries for the team and regulatory compliance. These fees are expressed as a percentage of the funds raised and tend to vary in a band between 1.5% and 2.5%. In the initial five years of a fund's life, these fees are based on capital committed by investors (the amount they have agreed to invest); and later in the life of the fund are based on invested capital. Fees are paid as a priority share of the fund's profits and returned to investors once the fund starts realising its investments and reaches an agreed hurdle on returns (see below). If the hurdle is not reached, there is no requirement for the manager to repay the fees already received on the previous payment basis.

Carried interest

Carried interest is the term used to describe the fund manager's performance-related share of realised profits from fund investments – usually 20% – after the investors have achieved a certain level of returns. This level is often referred to as the *preferred return* or *hurdle rate* and is an agreed-upon rate of return that fund managers must achieve, after management fees have been taken into account, before they can receive a share of the profit. For instance, a hurdle rate of 8% means that the fund needs to have achieved a return of at least 8% before a fund manager receives any share of future profits. As carried interest is only allocated after investments are realised, it incentivises private equity firms to focus on operational improvements and the long-term realisation prospects for an investment rather than short-term or interim valuations. This in turn aligns the interests of the fund manager to those of investors and is a feature unique to this asset class.

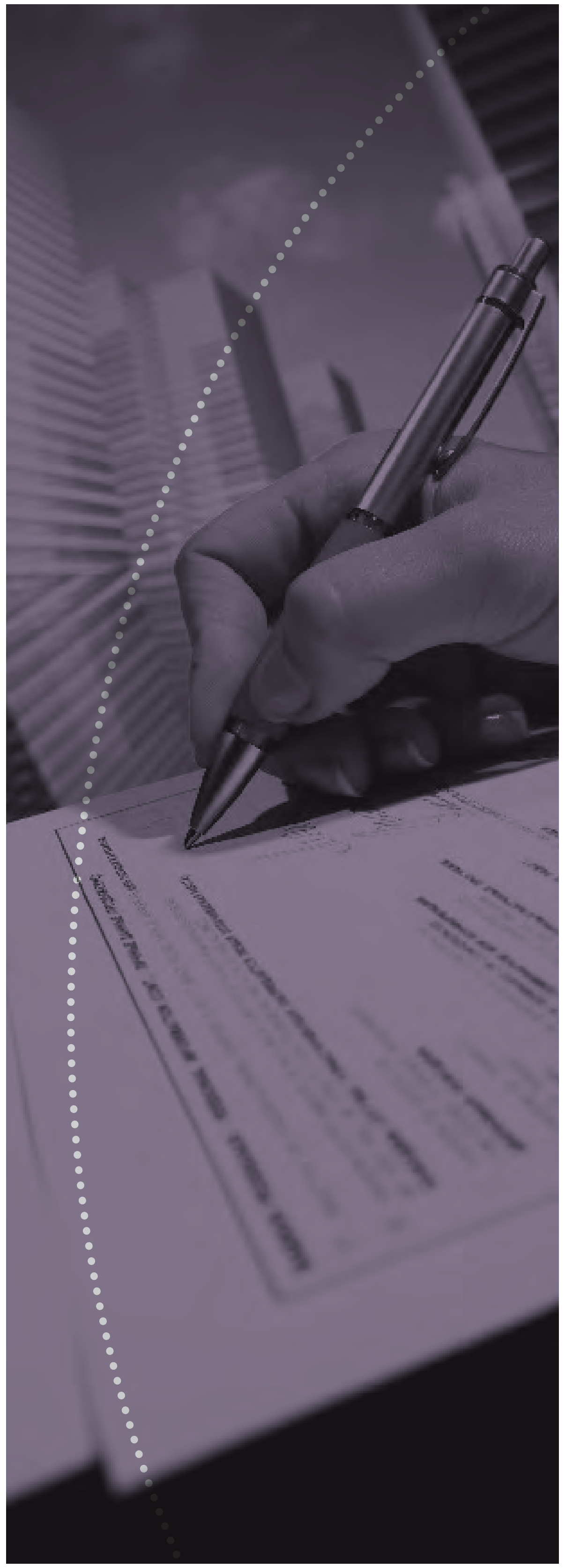


In some cases, carried interest is paid throughout the life of a fund when individual investments are realised; and in others, it is paid only after the whole fund has achieved the hurdle rate. In both cases, investors have a *clawback* provision put in place to ensure that the overall split at the end of the fund's life reflects the agreed profit-sharing ratio and that any excess carried interest distributions are returned to them. If the fund's final return is lower than its interim returns, the clawback will ensure that the fund manager repays any carried interest paid out over and above what should have been paid out. For instance, if a fund manager invests in 10 different transactions, with the first five investments making a net profit of £100m, and the second five investments making a net loss of £100m, they would initially have received £20m (or 20% of £100m)[8], even though the final profit for the fund was zero. The clawback would therefore ensure that the manager would be required to repay the carried interest.

6.2 Portfolio company-level

Transaction, monitoring and other fees

Transaction fees relate to arrangement fees levied by the manager in connection with completed investments. These fees are typically offset against the management fee paid by investors and in recent times this has increasingly led to the offsetting of the whole amount. Monitoring fees earned by the manager relate to the ongoing portfolio management of the target company as executives from the manager will often sit on its board. Other fees such as exit fees may also be charged.



[8] *This example assumes that the hurdle rate has been met.*

7 Measuring returns and benchmarking

7.1 How to measure returns

The ability to benchmark the performance of different asset classes is of paramount importance to institutional investors when considering where to put their money. In the case of private equity, the comparison is not always an easy one. For publicly quoted equities and bonds which have clearly defined and often liquid markets, the returns are easily accessible, frequently in real-time, and easily understood.

Private equity, however, is somewhat different, reflecting the irregularity in the timing and discretionary nature of the cash flows between the fund and its investors and the time lag in marking valuations to market. Once an investor has made a commitment to a fund, it may not be invested for a period of months or even years, and when it is invested, this may be at irregular intervals and sizes. In light of these distinctions, measuring PE returns requires a different approach to measuring the performance of more traditional asset classes.

7.2 Benchmarking models

The two most commonly used methods to measure private equity returns are *money multiples* and the *internal rate of return (IRR).*

- **Money multiples** are a quick and easy way to see how much the capital has grown over the life of the investment. They are calculated by dividing the value of the returns by the amount of money invested and are often used in the industry as they offer a simple way to show the scale of the returns an investment has given.
- **IRR** calculates the average annual return of the investment. It does this by looking at all of the cash flows from the investment over a given period, taking into account possible capital gains and income through dividends. By expressing returns as an annual percentage of investment rather than as an absolute return, IRR allows investments with differently timed and sized cash flows to be easily compared.

7.3 Benchmarking against the public markets and other asset classes

The irregular and discretionary nature of the timing of the cash flows of private equity investments mean that its performance is not directly comparable with the public market, and cannot be measured using standard approaches such as multiples or IRR. There have been a number of solutions developed to solve this problem, most prominent of which is the *Public Market Equivalent (PME)* approach, which effectively replicates private equity's irregular cash flows in the public market.

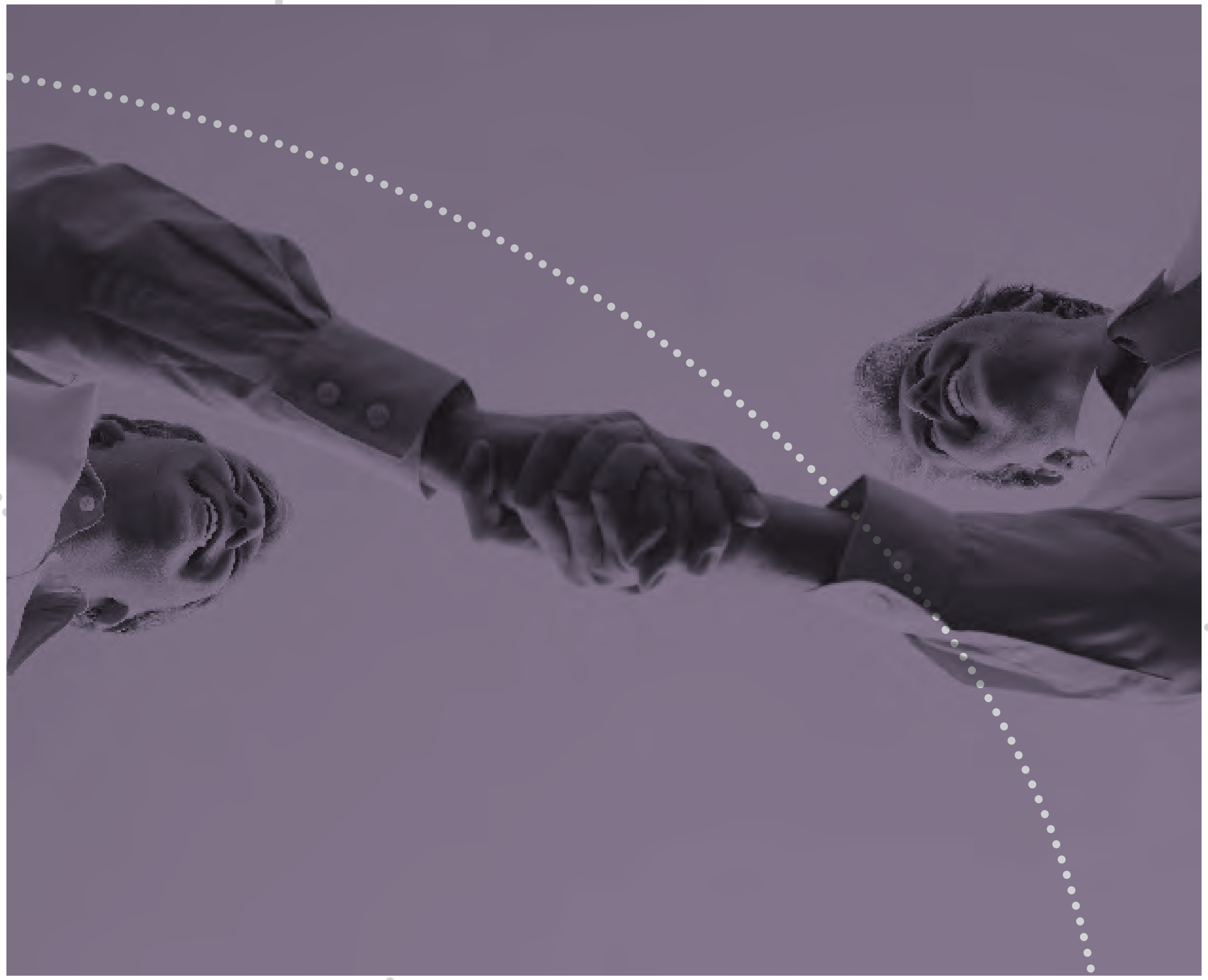
- **PME** is a returns measure which provides investors with a like-for-like comparison between private equity and the public market, offering insight into how competitive private equity returns are. The PME is generated by creating a hypothetical investment vehicle which purchases and sells shares in the public market index in a way that mimics a PE fund's irregular cash flows.

7.4 The effect of leverage on returns

Leverage can be used to significantly boost the returns gained from an investment. By leveraging a deal, a private equity firm can hold an even greater equity share of the portfolio company, which can allow them to capture far higher total returns. It is worth noting that, whilst this use of leverage can have an impact on the level of risk in an individual company investment, the structure of private equity investment means that there is no risk of debt in one company impacting another company owned by the same fund. As such, the failure of an individual investment does not have a knock-on effect on the other investments within a private equity portfolio.

7.5 What type of outperformance are investors looking for?

Different investors look for different types of outperformance, depending on their individual needs. Some investors are looking for spread above the public markets. Other investors may be looking to maximise their absolute returns. Private equity is a diverse asset class that is able to meet the needs of different investors. Smaller investments can be made into venture capital and small buyouts which offer the potential for higher rates of return, or larger investments can be made in large buyouts, enabling greater total returns. By investing in private equity, investors can help to diversify their portfolio, reducing their risk whilst still outperforming the market.



8

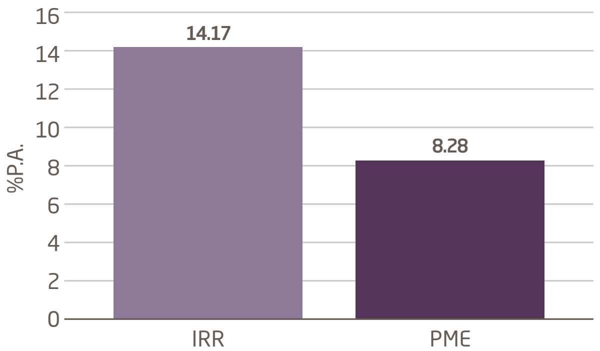
Why invest in private equity?

8.1 Return seeking and liability matching

The most significant incentive for investing in private equity is the potential for long-term, sustainable, high absolute returns. Data from the BVCA's 2013 Performance Measurement Survey showed that UK private equity funds have delivered robust returns for their investors, outperforming the public market. On a net of fees and carried interest basis, the since-inception pooled IRR covering all of the 448 PE/VC funds in the analysis was 14.2% p.a. as of December 2013. This compares strongly with the Public Market Equivalent (PME) generated return which achieved slightly more than half that rate, at 8.3%.

Private equity can be a return-seeking asset, selecting businesses which offer high growth potential. By lending their expertise to these businesses, private equity firms can create value which then translates into returns for their investments. By doing this successfully, firms are able to outperform the market. Likewise, private equity can be a liability-matching asset and has consistently demonstrated its ability to offer high returns on investments. By investing in a number of portfolio companies, the risk can be spread and reduced to the levels desired by the investor.

Private equity returns vs. the public market 2013

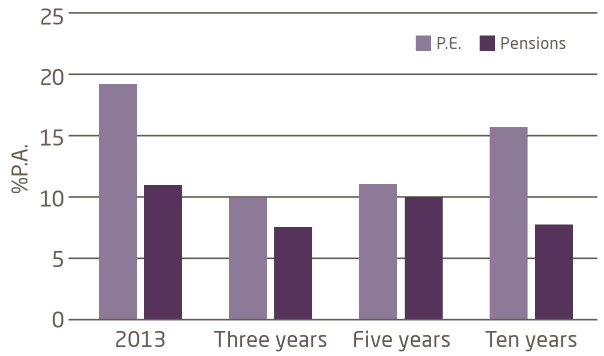


Source: (BVCA Performance Measurement Survey 2013)

Even as the domestic macro-economy stagnated over the past few years, the graph below demonstrates that UK private equity delivered positive and productive returns for its investors. On a net-of-fees and carried interest basis, the since-inception return of private equity is 14.2%. This level of return has shown itself to be highly sustainable, with returns for the past ten years standing at 15.7%, far exceeding pension fund assets which have returned 7.8% over the same period net-of-fees.

Ten year returns are the most relevant time period return for private equity, as they enable many of the deals to be fully realised. However, even when looking at shorter time frames – such as five, three and one year – private equity has always managed to outperform pension fund asset returns.

UK private equity performance vs. pension fund assets*



** The return quoted for private equity funds is the IRR to investors, net of costs and fees, while returns for total pension fund assets are measured as gross time-weighted returns, making the two measures not directly comparable.*

Source: (BVCA Performance Measurement Survey 2013)

8.2 Diversification

The pool of potential company investments available for private equity firms to choose from is exceptionally wide, allowing investors to add greater diversity to their portfolio. They can invest in companies that are not publicly listed, underfunded divisions of larger corporations, or can take listed companies private in order to improve operational performance and higher earnings growth.

8.3 Specialisation

Besides the injection of capital, companies also benefit from the experience and insight that fund managers bring to the boardroom. Having the right investors provides businesses with contacts, networking opportunities and commercial and strategic expertise that they would have otherwise not been exposed to. These investors have a vested interest in seeing the business succeed as they can only realise their investment upon exit. The acquired business then profits from having shared financial responsibility without having to increase its own debt risk[9]. This combination of accountability and desire for investment realisation for both investors and portfolio companies fosters the sense of ownership that is central to the concept of private equity.

[9] Private Equity and Venture Capital. Grant Thornton, 2014. **http://bit.ly/1uOqgv2**

9

What are the risks and how are they approached?

As with all asset classes, there are risks involved in investing in private equity. They can, as with all risks, be mitigated to a greater or lesser extent, but investors should be aware of them before embarking on a programme of private equity investment.

9.1 At the asset allocation level

Illiquidity
One of the main risks associated with investing in private equity is the illiquid nature of the asset class. Unlike other types of investment where investors are free to release capital without restraint, money invested in private equity is tied up for longer periods of time and with less flexibility.

However, as the asset class has evolved over the years, a sophisticated secondary market has emerged, increasing the liquidity of private equity investments by enabling investors to sell their stake in a private equity fund to other investors. Listed private equity funds also present investors with an opportunity to invest in the sector through the stock market.

Drawdowns
Private equity investments typically take place over a longer period of time than other investment methods. Rather than being invested immediately into a company, private equity funds are used selectively and are invested at intervals during which they can have maximum impact for the portfolio company. When investing in private equity, it is worth noting that sufficient funds will need to be kept available in liquid or semi-liquid form to meet drawdown requests as they occur.

Control over individual investments
When a private equity fund is being set up, it will draw up an investment strategy (built into any Limited Partnership Agreement), which may focus on areas such as the geographical location of potential investee companies, the sector that they work in, or the size of company, among others. The fund will then find individual investment opportunities along these lines, and once they have done so, will (with the agreement of the fund's investment committee) make an investment into that company. Because of this, investors (to the extent that they do not sit on the investment committee) do not have control over individual investments that the fund makes. They are, however, protected by the fact that the fund can only invest in those companies that meet its investment strategy, and that the investment committee has to agree to any investment being made.

9.2 At the manager selection level

Selecting a top-quality fund manager is a key component of ensuring profitable returns from a private equity investment. Top managers are highly sought after, as they make the key decisions that minimise the risks of investing while consistently achieving greater returns than competing managers. There are a number of studies that have looked at this persistence[10], finding that private equity funds which performed strongly in one fund were far more likely to perform strongly with their next fund. This highlights the importance of having a skilled manager as they will consistently deliver better-than-average returns.

9.3 At the portfolio company level

While General Partners will try and identify businesses which have both high growth potential and relatively low risk, no investment can ever be completely risk-free. However, by investing in areas in which they are familiar, General Partners are able to use their expertise to add greater value to the enterprise and have a better understanding of the possible risks and the best ways to avoid them. Furthermore, by investing in a number of different companies in various sectors, investors can diversify their portfolio and help mitigate any risk.

9.4 Currency risk

Since private equity is an investment that is held over the longer term, there is the potential for it to be susceptible to currency fluctuations and volatility over the longer term. If an investment is made in a different currency, the final return of the investment may be affected. As with any investment, it is possible to put in place hedging strategies to mitigate the risk of any investment, either at the portfolio or at the fund level.

[10] See Kaplan, S. N. and Schoar, A. (2005), Private Equity Performance: Returns, Persistence and Capital Flows. The Journal of Finance, 60: 1791-1823.

10

Listed private equity as an option for pension funds

For pension funds where administrative or minimum size requirements may be a deterrent, listed private equity (LPE) can offer access to the same underlying portfolio companies as limited partnership funds, but in the form of a publicly traded share.

There are some 250 LPE companies globally with combined market capitalisation of over £70bn, and a number have track records of over 25 years. There are three principal types of listed private equity:

- LPE direct investment companies: investing directly in a portfolio of private equity company investments – usually alongside limited partnership funds managed by the GP.
- LPE funds-of-funds companies: again alongside institutional Limited Partners, investing in a selection of other managers' private equity funds and hence in numerous portfolio companies, potentially giving exposure to different types of private equity including buyouts, venture capital or developing markets.
- LPE asset management companies: these derive a proportion of their income and value from fees for managing pools of private equity assets and may also provide exposure to a selection of their investee companies.

10.1 Access

An investor in LPE can gain immediate exposure simply by purchasing shares in a listed vehicle. This is a much easier decision than having to commit a minimum of, say, £10m to a traditional Limited Partnership vehicle for a lengthy period. Through the listed vehicle, the investor is usually buying immediate exposure to an existing portfolio of investments in unlisted companies rather than having to wait, as an LP would, for the money to be invested. Listed vehicles offer the investor regular, easy-to-digest information, which is supplemented by ongoing research from an increasing number of brokers.

10.2 Liquidity and daily mark-to-market pricing

Listed vehicles offer investors liquidity: the ability to buy and sell at short notice with low transaction costs. As shares are listed, they are priced daily.

However, liquidity in the shares of LPE companies differs greatly across companies. LPE stocks are often tightly held by long-term shareholders (particularly those with larger blocks of shares). This may require a more patient dealing strategy than would be the case in other equities.

As with the market for listed investment companies in general, share prices may not necessarily track growth in reported net asset values. Share prices are subject to supply and demand influences and may be affected by movements or trends in broader equity markets. As a result, listed private equity share prices can sometimes trade at large discounts to net asset value, which can present a buying opportunity.

10.3 Ease of administration and corporate governance

Limited partnership investing involves substantial administrative and fiduciary input, and time-consuming management of cash flows. With LPE, the investment company undertakes all this work, allowing the investor simply to determine whether to hold the shares. LPE investment decisions can of course be delegated to a multi-asset manager or fiduciary management service. Importantly, LPE shareholders' interests are also the responsibility of the LPE Company's Board of Directors, which in the UK consists of an independent chairman and non-executive majority.

11

Valuations and reporting

11.1 Valuations

Due to the long-term nature of private equity investments, it can take time for investors to see the final realised return on their commitments. Firms therefore calculate interim valuations for their portfolio companies to give investors an indication of how the fund is performing, as part of their quarterly and annual reporting to investors.

Investors and international accounting standards require investments in portfolio companies to be measured on a fair value basis. Valuing unquoted investments is inherently a judgemental call and firms often reference the International Private Equity and Venture Capital Board's (IPEV) valuation guidelines. These provide practical guidance and ensure that firms adopt consistent and appropriate valuation methodologies. They outline the main valuation techniques that have helped increase the transparency of the industry, as well as confidence in the interim fund net asset values that the firms report. It is worth noting that there have been reports that look into whether private equity firms tend to overstate the value of their assets, and these have found that there is no evidence that there is systemic overvaluation of assets in the industry. [11] Interestingly, the opposite is sometimes claimed too: are firms too cautious when valuing assets as there is often an uplift before an investment is sold? Both sides of the debate underscore the subjectivity of the valuation process, which is one that has continued to evolve over the last decade.

11.2 Reporting

High-quality reporting is a vital instrument in helping to keep the private equity industry one that is both transparent and meets investors' needs. Reporting requirements, including frequency, accounting standards and audit requirements are agreed upfront with investors (usually in the Limited Partnership Agreement). While there are a number of sources of guidance, in practice fund reporting varies as it is tailored to the specificities of the fund and investor requirements.

Both IPEV and the Institutional Limited Partners Association (ILPA) have drawn up guidelines[12] for private equity firms to follow when reporting. ILPA's guidelines have drawn much attention and aim to increase transparency between GPs and LPs and also efficiencies by creating uniformity of information across the industry. There are currently guidelines for two areas, 'The Capital Call and Distribution Notice' and 'Quarterly Reporting Standards', and both seek to standardise documentation to assist LPs in understanding how their capital is being utilised and reduce time spent answering typical questions. Reporting to investors is usually comprised of a letter or report from the firm detailing the fund's activities and performance, financial information including a calculation of net assets, and other performance metrics and supplementary information.

[11] *See e.g. Ellis, C and Steer, J, Are UK Venture Capital and Private Equity Valuations Over-Optimistic?, BVCA Research Report, April 2011*
[12] *See ILPA's Quarterly Portfolio Company Reporting Checklist.* ***http://bit.ly/1AQOEzQ***

12

How is the private equity industry regulated?

The financial crisis and its aftermath mandated the introduction of new rules and regulations governing conduct in all areas of the financial services industry, irrespective of whether they posed a systemic risk or not.

The result in the private equity context has been the introduction of the Alternative Investment Fund Managers Directive (AIFMD); the first time the industry has been regulated at EU-level. In addition, the UK private equity industry has sought to increase the level of transparency within the industry, adopting the Walker Guidelines, a set of rules that establish oversight and disclosure comparable to quoted companies.

12.1 The Alternative Investment Fund Managers Directive (AIFMD)

The Alternative Investment Fund Managers Directive (AIFMD) entered into force at an EU level on 22 July 2013 with the aim of creating a standardised regulatory framework for private equity, venture capital and other alternative investment funds in the European Economic Area (EEA). Although the UK private equity and venture capital industry was regulated in the UK, this was not consistently the case across Europe. The AIFMD aims to introduce a harmonised regulatory framework covering a wide range of areas including regulatory capital requirements, disclosure and marketing to investors, ongoing compliance, remuneration provisions and the use of depositaries or custodians. The application of these requirements is complex depending on how managers and funds are structured (as well as other

factors). There are reduced requirements for firms managing unleveraged and closed-ended funds (which are likely to include private equity funds) and the AIFMD scopes out smaller managers.

The AIFMD enables fund managers to manage and market their funds through a single market passport – a first for the industry and a key benefit of the Directive. In theory, the passport should make fundraising more straightforward for EU Alternative Investment Funds (AIF) as they will no longer have to gain authorisation from the competent authority (usually the financial services regulator) of each Member State in which they wish to market. This objective, however, is dependent on consistent implementation of the Directive across the Union.

The passport is only available to those funds that meet the requirements of the directive. These include the mandatory use of a depository, reporting obligations as well as new limits on the use of leverage at fund level. While this represents far-reaching reforms for much of the AIF industry, the general consensus of the industry appears to be that the final cut of the Directive is far more proportionate than its original incarnation in 2009. Full scope fund managers[13] in the UK had to become fully compliant and apply for authorisation from the Financial Conduct Authority (FCA) by July 22 2014 .

[13] *Full-scope fund managers are AIFMs, authorised by the FCA, managing AIFs with Assets under Management above the thresholds set out in Article 3 of the Directive. These are: €500m, provided the AIF are not leveraged and investors have no redemption rights for the first five years; and €100m (including assets acquired through leverage). Sub-threshold firms may also opt-in to the full scope of the Directive and become a full-scope UK AIFM too.*

12.2 European Venture Capital Fund Regulation

The European Venture Capital Regulation was implemented on 22 July 2013 and is available to those managers below the threshold that captures firms under the AIFMD. This was in recognition of the role venture capital and smaller investment managers play when contributing to economic growth and the intention was to provide them with an "AIFMD-lite" regime that included the benefit of the marketing passport. It has direct effect in Member States due to its status as a regulation, and will establish a new pan-European designation: a "European Venture Capital Fund" (EuVECA). Qualifying funds will be allowed to market throughout the EU via the use of a new marketing passport.

The EuVECA passport will not only be available to funds marketing to institutional and sophisticated investors that meet very specific criteria. Ongoing compliance obligations are significantly lighter and more proportionate compared to the AIFMD and do not include the need for a depositary or custodian. It should be stressed that the regulation is not compulsory. If a fund manager does not want to become a EuVECA then existing national laws and EU regulations will continue to apply.

13

What are the trustees' responsibilities?

The trustees' main responsibility is to act in the best interests of scheme members and to ensure that enough assets are built up to meet the scheme's liabilities as they fall due.

13.1 What to consider before investing in private equity

Before deciding to invest in private equity, a pension scheme will assess the advantages and disadvantages in relation to the scheme's particular circumstances. This will include looking at the scheme's liabilities, cash flows and the size and maturity of the scheme, together with an assessment of the risks. When doing this, the pension scheme will work with its investment advisers. If it decides to invest in private equity, the trustees should:

- Decide what percentages to invest in private equity and its various subcategories;
- Choose investment managers who have a proven track record in private equity investment;
- Diversify across funds with different aims and managers with different styles of investing; and
- Carry out due diligence which should include managing the risks to the pension scheme's reputation.

13.2 The due diligence process

Before agreeing to invest in a partnership, investors should carry out thorough due diligence on the fund manager (which may be carried out by the investment consultant), and legal due diligence. 'Due diligence' means researching all the people and organisations involved, their investment approach and track record, as well as legal matters (including reviewing the pension fund's trust deed and rules).

The PEIA (Private Equity Investors Association) has produced detailed guidance to help with the due diligence process, summarised below.

Investors should gather information on:

- The fund (such as the full name and address of the manager, the full legal name of the fund, and so on);
- Any agent acting for the fund, and all legal agreements;
- Fundraising and corporate governance (this would include information on the target for the size of the fund, total commitments to the fund, the General Partner's and executive's investment in the fund, policies on distributing and re-investing cash, borrowing limits, and so on);
- The investment strategy (including how this strategy compares to that of the fund's competitors and other funds in the past, the risks associated with the strategy, an explanation of the fund's involvement in portfolio companies, disclosure of the fund's valuation policy, disclosure of diversification details, predicted rates of returns, disclosure of typical leverage levels, an explanation of the role of outside consultants, and so on);
- The General Partner (full information on how the fund is managed, including advisers, custodians and administrators, how any conflicts of interest between the General Partner and the Limited Partner will be addressed, summaries of investments in previous funds, details of advisory committees used, and so on); and
- Terms (fees and costs).

13.3 Legal due diligence

The legal due diligence process would involve gathering information on:

- The legal form and structure of the investment vehicle;
- The expected life of the fund, including arrangements for extending it and methods of divestment;
- The commercial terms of the agreement;
- The investment policy and restrictions;
- The ways in which the General Partner will report to and communicate with the Limited Partner;
- Other information, including:
  - Arrangements for the General Partner to withdraw or be removed from the fund and the terms of the General Partner's indemnity and other protection;
  - Arrangements for dealing with conflicts of interest between the fund and the General Partner; and
  - Tax, regulation and related matters.

Finally, when you are looking for legal advice, it is important to choose a law firm with direct experience of private equity investment.

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The National Association of Pension Funds Limited ©
Cheapside House
138 Cheapside
London EC2V 6AE

T: 020 7601 1700
F: 020 7601 1799
E: napf@napf.co.uk

www.napf.co.uk

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