Investors seek outsized returns from their private equity portfolios to compensate for the unique risks of investing in this asset class. But is re-committing capital with current top-performing private equity managers the best way to achieve that objective? Examining the evidence on this question may surprise investors. We explore the conventional rationale that many private equity investors employ during manager selection – a concentrated focus on prior fund returns as a means of predicting future top-quartile performance. Our research demonstrates that historical performance alone is not an accurate predictor of future success and that investors need to engage in a more holistic review of managers before re-committing capital.

The global financial crisis resulted in many firms within the alternative asset class feeling the strain of tight purse strings among limited partners.1 Private equity and venture capital were no exception. Since global fundraising peaked in 2008 at $666 billion,2 many firms have folded, delayed their fundraising or closed on much smaller fund sizes than was previously the case. At the same time, a handful of name-brand private equity managers have been able to open and close a fund in a matter of months. Bolstered by strong prior fund performance and brand-name recognition, these groups have been able to continue to raise larger and larger pools of capital. But is manager selection that simple – identify past winners and invest? Does past successful fund performance ensure future success?

2010 began with general partners' fundraising expectations hovering around $700 billion, approximately two-and-a-half times the amount committed by limited partners the year prior.2 As the year progressed, however, target fund sizes decreased and

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1. A private capital fund usually has one general partner (GP) and several limited partners (LP). The GP initiates the fund, whereas the LPs are mere investors receiving a return on their capital. In contrast to the GP, LPs are not liable for debts exceeding their investment.

Data as of July 2011, unless otherwise stated

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the figure reduced to $600 billion at year end. Demand for private equity continued to decline as limited partners, hampered by allocation and liquidity constraints, further reduced commitments to the asset class. In the end, 2010 totals of $228 million were 23% less than the amount raised in 2009. Half did not reach their target and approximately a quarter were only able to raise 25% of their desired fund size. In the midst of this difficult environment, however, nine percent of funds completed their fundraising in less than six months – in complete contrast to the average industry fundraise timeline of 21 months.

The strong variation in fundraising periods is partly attributable to the significant spread in returns for private equity and venture capital funds. Many limited partners base their commitment decisions on a partnership’s prior track record. Not surprisingly, funds with higher returns raise funds faster. Over the 22-year period from 1984 to 2006, the gap between top-quartile and bottom-quartile funds had an average spread of close to 2000 basis points (figure 1). Fund selection can result in returns ranging from exceeding the long-term stock market yield (top quartile) to being unable to return full capital (bottom quartile).

The definition of success

Before we discuss the replication of fund performance, it is prudent to highlight the difficulty in determining a private equity fund’s true performance, benchmarked against peers. Peracs consulting firm conducted a study which showed that 77% of the 500 private equity and venture capital firms they studied claimed top-quartile performance. An analysis by Alignment Capital provided two plausible explanations: first, that the two primary measures to determine quartile ranking are a fund’s net internal rate of return (IRR) and multiple of cost. In their study, Alignment Capital found that of the funds that declared top quartile performance, only 84% claimed it based on both metrics, whereas the remainder based their assessment on just one of the two. Consequently, more than 25% of all funds claimed to be top quartile: those being top quartile on both measures, but also the funds which were top quartile on IRR or multiple of cost grounds only. Second, a fund often moves between quartiles over the course of its life. Thus, a fund claiming “top-quartile” performance may only be referring to one point in time as opposed to a persistent ranking. This performance measurement challenge highlights the issue of timing with respect to benchmarking. The universe used for analysis showed that 64% of funds achieved top-quartile performance at some point during their lives.

In addition to Alignment Capital’s explanation, no single industry rule exists on how funds should determine their benchmark. Flexibility around vintage year, fund style and geographic region can all play into manipulation of benchmarks.

5 Theoretically, up to 50% of all funds could claim top-quartile performance – if being top on IRR and top on multiple of cost were mutually exclusive.
**Replicating performance**

In addition to questioning how performance is benchmarked, a fund’s ability to replicate its past performance after achieving top-quartile returns has been the basis of study for many industry publications. Preqin released a report last year illustrating that approximately 39% of top-quartile performing funds will go on to re-create the same top-quartile performance. An earlier study by Private Equity Intelligence pegged the number closer to 43%.

The life of a private equity fund is generally ten years with the option of one or two 12-month extensions. After completing fundraising, the investment period starts for a typical period of three-to-four years. Growth of portfolio companies can vary considerably, but typically lasts four-to-six years, ending with an exit of the investment. A manager will usually have provisions written into existing fund documents that fundraising for a new fund will commence once approximately 70–90% of the existing fund is committed or reserved. As a result, current limited partner investors need to make a determination on whether to re-invest or not within two-to-four years of an existing fund’s life.

In our view, it is important to note that a mature fund (eight years or older) benchmarked in the top quartile is most likely to remain top quartile. However, funds showing similar returns in the early stages of their life have a much lower probability of finishing in the top quartile.

Analyzing buyout and venture capital funds separately, 50% of top-quartile performing buyout funds observed in their fourth year of investment life will finish in the top quartile. For venture capital, this value is even higher with 60% of funds ending with top-quartile status. Using Bayes Theorem and coupling these statistics with the prior observation of 43% of top-quartile funds repeating their performance in their successor fund provides the following:

- 31% of top-quartile buyout funds observed during their fourth year of investment life are likely to replicate top-quartile performance in their successor fund.
- 33% of top-quartile venture capital funds observed during their fourth year of investment life are likely to replicate top-quartile performance in their successor fund.

These results demonstrate the limitation of manager assessment based solely on prior performance, given that the ex-ante probability of selecting a top-quartile manager at random is 25%!

Calculation using the fourth year of perceived performance (as opposed to year two or three) was included to coincide with the longer fundraising timelines currently seen within the industry. In cases where the fundraising period for the successor fund occurs two or three years after the top-quartile performing funds final close, the probability of maintaining top-quartile performance is reduced. Consequently, the decision to reinvest (based on performance) would therefore need to be based on funds of an even earlier generation that are more mature. As stated earlier, the historical timeline for fundraising is every two to four years. Therefore, former fund generations used for analysis will have been raised four-to-eight years ago at the earliest.

While successful “premier” funds have the ability to increase the size of their funds, generation to generation, as fund sizes increase, targeted company investment sizes – either ownership purchased or enterprise value – may also increase. This fact, coupled with changing market dynamics, refinement of areas of expertise and personnel additions/changes, to name a few, can significantly alter the strategy pursued by the manager and the environment in which the current fund will invest.

This raises an important question: if the ability to use prior fund performance is either unreliable due to the early-stage nature of the data or subject to misinterpretation given changing manager and environment dynamics, what is the best course of action to select a private equity or venture capital manager?

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Manager selection – the critical importance of due diligence

In our view, the chief determinant in successful manager selection comes from a carefully-crafted due diligence process, encompassing both a deep dive into the quantitative metrics of a fund and its underlying portfolio companies, as well as extensive qualitative analysis of each partnership and its professionals.

The usefulness of prior performance increases as the amount of additional review and analysis of contributing factors increases. A successful due diligence review includes a focus on trying to understand the common themes that influence the success and failure of portfolio companies. This objective is best addressed by talking to general partners, co-investors and portfolio company CEOs themselves. In addition, sensitivity analysis is a critical tool for providing insight as to whether performance is skewed up or down based on particular investments. This analysis enables an investor to understand how dependent the portfolio’s performance is on one exceptional success or failure. Due diligence surveys of the investment strategy and philosophy of the team add further depth, beyond what is found in the private placement memorandum (PPM) and other marketing materials. Direct meetings with General Partners and back-office personnel showcase areas of expertise, as well as limitations within the team and the overall dynamic within the firm. Lastly, reference checks should be made to current and past limited partners, prior members of the firm, CEOs of portfolio companies, lenders, consultants, etc., providing further verification of the firm’s ability or outlining additional areas of concern.

This type of in-depth process focused heavily on due diligence, rather than a performance-only approach to analyzing private equity funds and their managers, will (in our opinion) be far more apt to capture both the skill of a particular strategy and potential red flags for investors.

It is pertinent to note the importance these claims have on the inclusion of new and emerging managers within a private equity and venture capital portfolio. The most common rational provided by investors for not committing to these groups is their lack of historical track record. Given the prior discussion of historical performance functioning as an inaccurate indicator of future success, new and emerging managers should not be excluded solely on this basis. Through careful and thorough due diligence, the selection of high-quality new and emerging managers may prove effective in achieving outsized returns, while providing further portfolio diversification. Additionally, established managers that were backed previously within our funds, but have now fallen out of favor, require replacing within our portfolio of investments. Carefully selected new and emerging managers can effectively fill this void, particularly in cases where backing successful new managers results in access to later, oversubscribed fund generations.

In sum, we believe a holistic due diligence process is required in order to successfully evaluate private equity and venture capital investments. Limited partners that ignore this method, relying solely on investment performance, are prone to suffer the fate of even tighter purse strings in the future.

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