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University of Western Ontario DC Pension

Private Equity: An Update & Review

March 12, 2012

Agenda

- Current market environment
- Implementation considerations
  - Type, cost & diversification
- Implementation considerations
  - Secondary market options
- Conclusions

- Appendix A
  - Introduction to private equity
- Appendix B
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- Appendix C
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Current market environment

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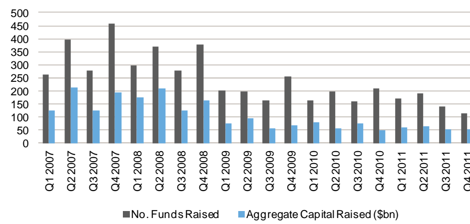
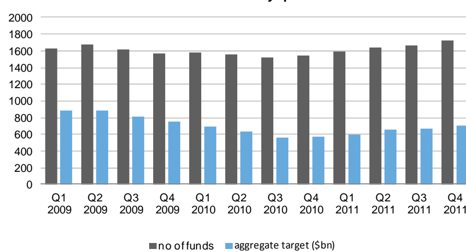
Fundraising





Source: Preqin

- Fundraising is still significantly below pre-crisis levels
- There has been a slight increase in 2011 versus 2010 and 2009
- With the number of funds 'on the road' and the aggregate level of capital sought increasing, this could be seen as an increased level of optimism, but is more likely a reflection of funds experiencing difficulty raising the targeted level of funds

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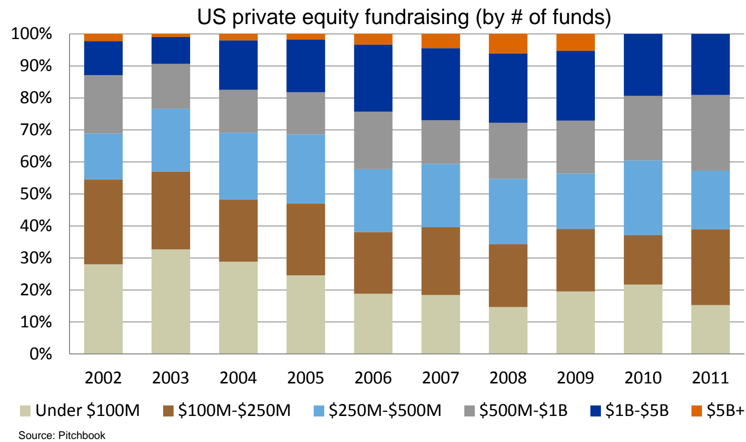
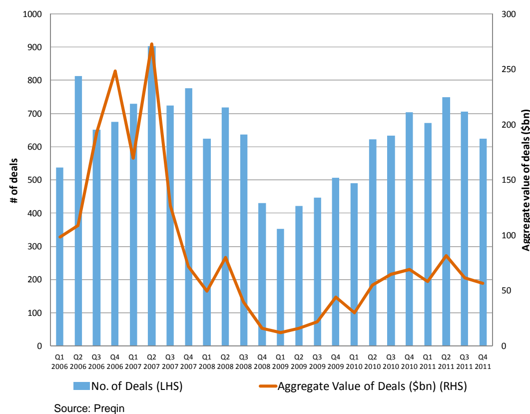
Fundraising



Source: Pitchbook

Middle market funds continue to dominate the fundraising

Deal volumes globally

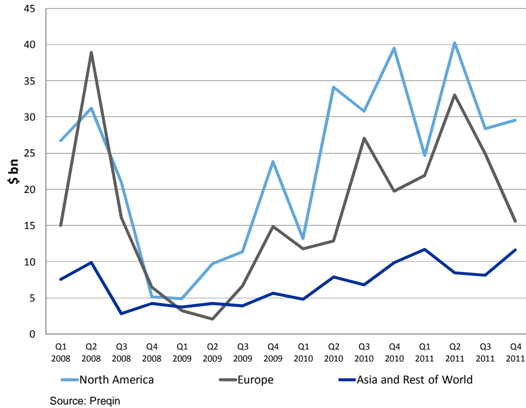


Source: Preqin

- **Similar to fundraising, deal volume is significantly below pre crisis levels**
- **Deal volumes have slowed in response to tightened credit markets and an unwillingness to sell at low valuations**
- **After increasing deals through the end of 2010 and beginning of 2011, the deal volume fell through the second half of 2011**
- **Russell is concerned about the potential for a significant and prolonged reduction in both new deals and exits in the coming quarters**

Deal volumes by region

Quarterly aggregate value of PE-backed buyouts by region



Source: Preqin

- **As the market turmoil of the second half of 2011 was particularly felt in Europe, the European deal volume fell most significantly**
- **Russell is concerned about the potential for a significant and prolonged reduction in both new deals and exits in the coming quarters**

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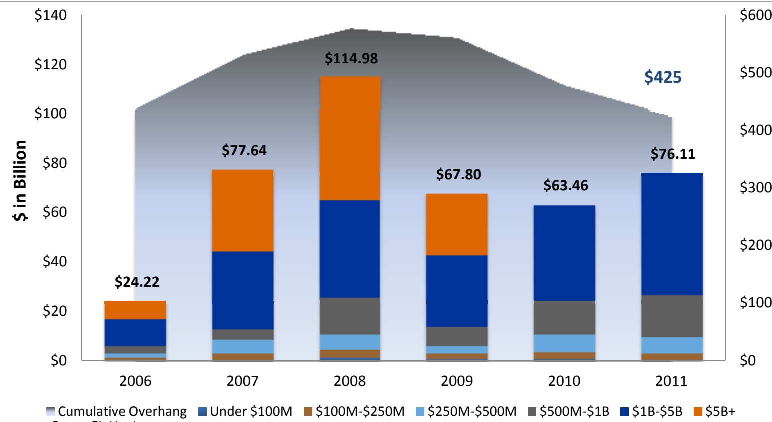
Dry powder



Source: Pitchbook

- **Dry powder is still significant, but it has continued to fall each year since 2008, and the cumulative dry powder overhang is now below 2007 levels**
- **Of the $425m dry powder overhang, $100m is nearing the end of its investment horizon**

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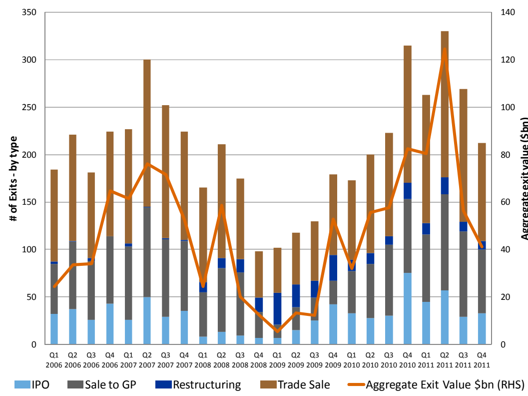
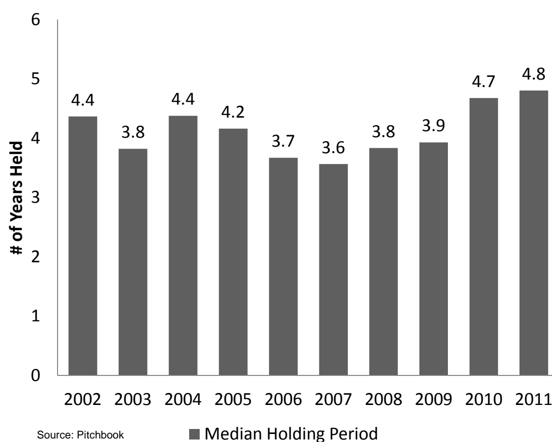
Exits



Source: Preqin

- The second quarter of 2011 led to the highest aggregate annual exit value on record of $302.5bn for 2011
- However, after the high exits in the second quarter, exits fells sharply through the third and fourth quarter of 2011
- The exits in Q4 2011 were a third of the value of the exits in Q2 2011 and half of the value of the exits in Q4 2010

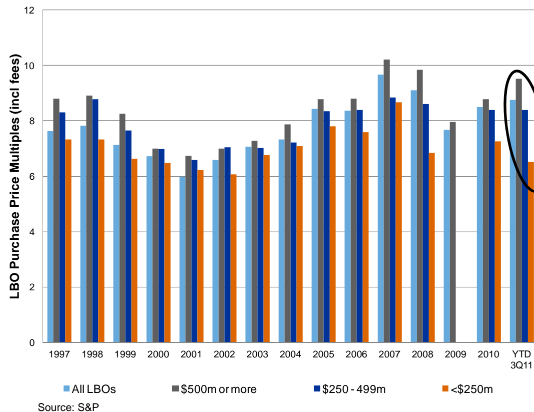
Holding period



Source: Pitchbook

- With the collapse in exits during the financial crisis, the average holding period of portfolio companies has increased
- A strengthening market for exits will allow funds to sell those companies that have been held for a prolonged period of time

Valuation by market size



Source: S&P

- Although the price multiples have increased in the LBO market, there are significant differentials based on deal size
- The dispersion of multiples based on size has increased over time, with more attractive valuations now seen at the smaller end of the market
- Potential returns in the small to mid buy out space are particularly attractive as
  - Companies can be purchased at lower multiples
  - Greater value creation and exit opportunities exist
  - However, manager selection is even more important in the small end of the market

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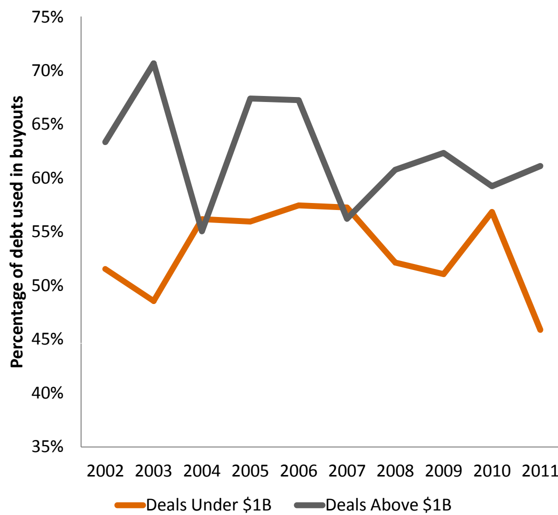
Bifurcation in credit markets

Another reason the small end of the market is more attractive



- Credit conditions have improved for large transactions, but it is still harder and more expensive for smaller businesses to borrow
- This makes smaller deals harder, but also creates attractive opportunities to buy small companies at attractive prices (due to the lack of available debt in this market)
- Once the GP turns around these smaller companies and professionalizes them and they grow into the larger fund space, they can be financed at attractive prices and sold at higher multiples
- As well, for small debt issuers with less options for extending their debt, attractive opportunities will arise for lower middle market distressed and turnaround managers

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The private equity market is still expected to grow

- Despite concerns about the global economy and decreasing liquidity premia, the private equity market is still expected to grow
- The main driver of this growth is expected to come from sovereign wealth funds increasing their investments in private equity, along with some increased investments from pensions, endowments and foundations

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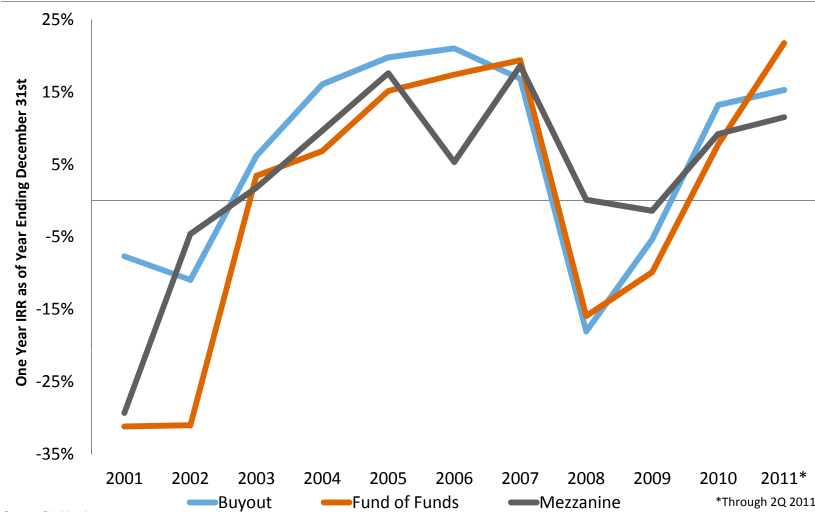
…that will be especially true if returns continue to increase



Source: Pitchbook

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Implementation considerations

Type, Costs & Diversification

Fund-of-Funds

- Fund-of-Funds ("FoFs") commit to a range of funds in different industries and regions over a period of about 3 years
  - A FoF will often have an interest in as many as 50 underlying funds
  - A FoF will be able to provide portfolio construction to MACF
- FoF managers do the research on the underlying managers and manage the ongoing relationship
  - A FoF will provide the ongoing manager due diligence
  - A FoF may provide access to single manager funds that MACF would otherwise not have access to
  - A FoF will be able to create diversification for small investment sizes that could otherwise not be accommodated
- FoFs provide an opportunity to get targeted, yet diversified, exposures
- FoFs charge a fee on top of the underlying manager fees
- Because of the diversified nature of their holdings, a FoF is an ideal product for a core Private Equity exposure

Cost

- Single Manager Fees
  - Base Fee
    - Usually in the order of 2% of the total commitment for the duration of investment period, with venture capital funds (range of 2 - 3%) usually charging higher fees than buyout funds (range of 1.5 – 2%)
    - After the investment period the fee usually reverts to a percentage of NAV (i.e. invested not committed)
  - Performance Fee
    - Typically 20%-30% of the profit from the fund
    - Profit is defined as the amount returned to the investor over and above the amount contributed
    - Buyout funds generally have an 8% hurdle, while venture capital funds often have no hurdle
- Additional costs for FoF investments include:
  - 0.5% - 1.25% of committed capital
  - Up to 10% carry depending upon annual management fees
  - Due diligence and monitoring

Managing risks through diversification

- Manager Risk
  - Investors should team up with more than one fund manager
- Geographic Risk
  - Innovation is now global
  - Political/Regulatory risk
- Vintage Year Risk
  - Vintage years represent differing opportunity sets
  - Secondaries allow diversification of vintage years from inception of the private equity mandate
- Sector Risk
  - Economic cycles influence the relative opportunities between VC, LBO and Mezzanine sectors

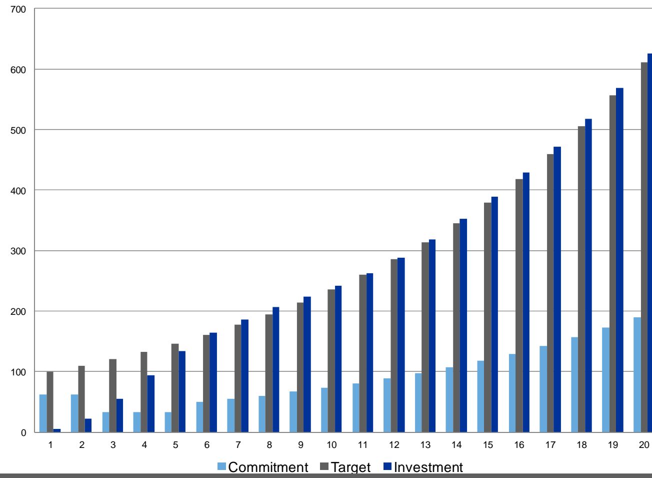
Vintage year diversification

- The vintage year is the year that a fund is raised
- Vintage year diversification is vital
  - Closed ended nature means that the underlying assets across funds of the same vintage are usually bought and sold at the similar times.
    - Eg: Valuations are high at time of purchase and low at time of exit
      - Vintage year is likely to be poor
- Very difficult to identify, in advance, a good vintage year from a bad one
  - Making regular commitments over a long period helps to mitigate this risk

Reaching target exposure

- Ongoing commitments are required in order to maintain a desired exposure
- The size of ongoing commitments must take into account:
  - The target exposure (percentage of the total portfolio)
  - The expected growth of the remainder of the portfolio
  - Expected cash flows within the fund
  - Desire for vintage year diversification
- Russell has built a projection tool which facilitates projections as to the extent of over commitment necessary to reach the target allocation based on fund dynamics
- Other questions remain as to how to manage other asset classes exposures while the private equity exposure is building.

Accelerated build up of commitments to an increasing target



Over committing will help reach target size earlier – but hurts vintage year diversification

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Implementation considerations

Secondary market options

Secondary market

The advantages of the secondary market in building the allocation

- Investors looking to begin allocating to private equity can use secondaries to speed up the process of attaining their target allocation
- Secondary investments generally have shorter durations than primary investments
- They can also be used to truncate the J-curve

Secondary market

Potential excess return drivers

- The secondary market can provide excess returns through market inefficiencies
  - Many sellers lack resources and quality information to request a fair price
  - Many sellers are forced sellers
  - Quality information is difficult to access

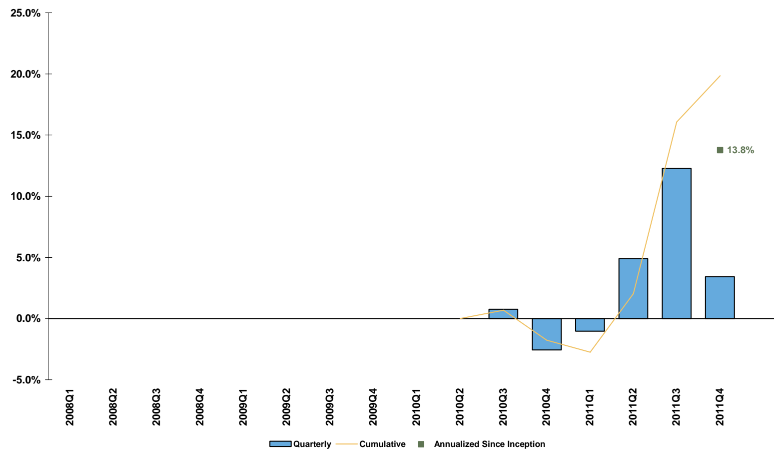
Market environment through 2009 and 2010

- The secondary market slowed through 2009 as bid-ask spreads widened due to high seller expectations based on the rebound in the public markets, whereas buyers had difficulty making offers due to limited visibility on portfolio companies
- Secondary volumes then reached record highs in 2010, and there are several reasons for the resurgence in deals:
  - Regulatory changes and illiquidity issues causing forced selling
  - A recovery in pricing
  - Entry of non-traditional buyers
  - Improved visibility into corporate performance
  - Increased pricing and information transparency
  - Recovery of debt capital markets activity

Market environment going forward

- Through 2011 pricing rose, which could be a concern for investors who would like to purchase secondaries – and achieve excess returns
- However many market participants believe that there are signs of increasing supply in the secondary market which will cause prices to fall
  - Increased supply is expected as losses are experienced in other parts of investor's portfolios and there is a desire for liquidity and rebalancing
  - Financial institutions will also be sellers due to new regulations such as the Volcker rule, Basel III and Solvency II
- Purchasing in the secondary market always requires skill in order to purchase the right investments at attractive prices
  - If this skill does not exist "in house" it can be accessed through the careful selection of a Secondaries fund
  - Adam Street Partners has already been vetted and engaged by the UWO Endowment

Adams Street
Value Added Over MSCI All Country World Index



- Q4 return was +3.4% above benchmark
- Value added of +21.0% for one year

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Conclusions

Conclusions

- Fiduciaries are facing many demands in trying to reach their investment target
- Private equity can deliver higher returns and increase diversification
- Private equity is a non standard investment
- Issues can generally be practically managed
- A balanced portfolio takes time to build
- There are many areas of interest
- Fund of funds help gain efficient diversification and provide targeted exposures
- Fund of funds reduce work load
- Secondaries can reduce the J curve effect

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Appendix A

Introduction to private equity

Nature of private equity

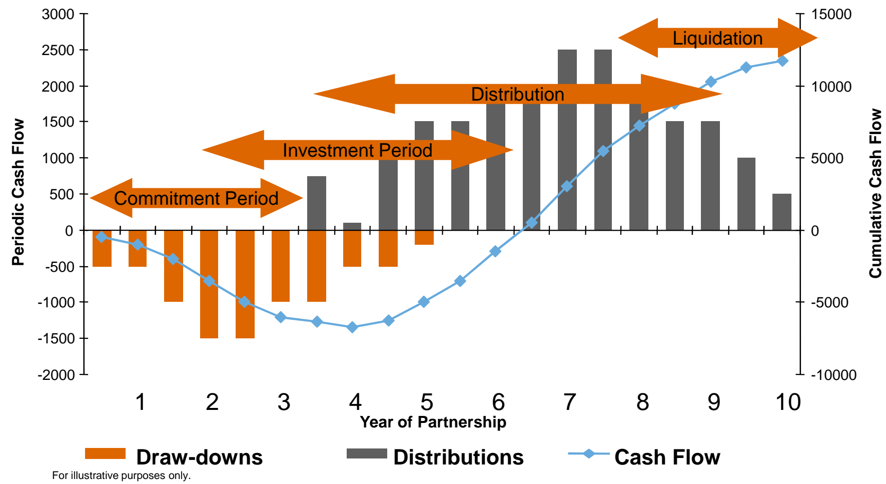
- Inefficient market
- Limited information on private deals
- Investment opportunity not widely known
- Vendors consider non-price related factors
- Manager provides expertise to company
- Buying investments with capital provided by investors
- New business plan leads to new structure
- Market position and track record built up
- Investment sold and proceeds distributed
- Not investable in a passive environment

Broad characteristics of private equity

- Commitments made to "blind pools" of capital
  - Investors make a financial commitment to a fund before any investments are actually made
- Investments are made via a closed-ended fund
  - Funds are typically open for 10 – 12 years
- The manager makes calls on the investor to contribute capital up to the committed amount
  - Capital to invest
  - Manager fees
- Distributions are made as the underlying investments are sold
  - Unlike listed managers, these distributions are quite irregular and not controlled by UWO

Performance results

Life Cycle of Private Equity Partnerships



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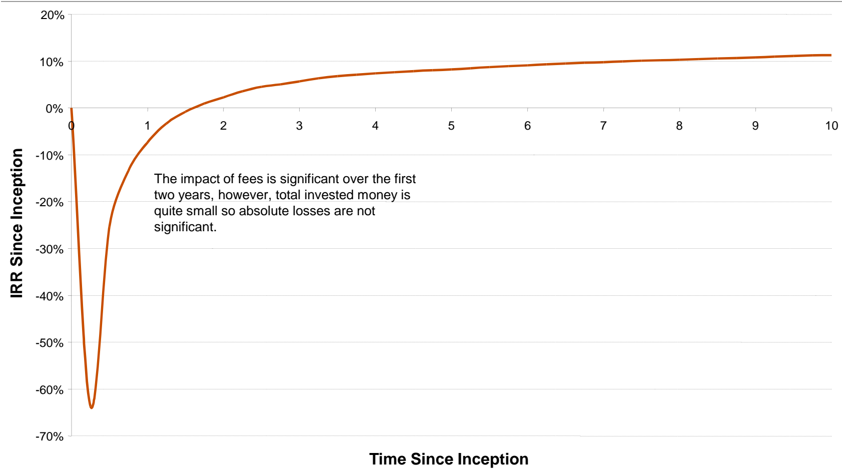
IRR and the J-Curve



Returns on private equity investments are typically reported as an Internal Rate of Return (IRR)

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The J-Curve

And how to mitigate it

- The J-curve is a function of fees and exit activity
- Certain strategies could allow one to partially mitigate the J-Curve
  - Invest in secondaries – mature private equity portfolios
  - Invest in mezzanine debt that has current yield
  - Arrange to pay fees on called capital rather than committed capital

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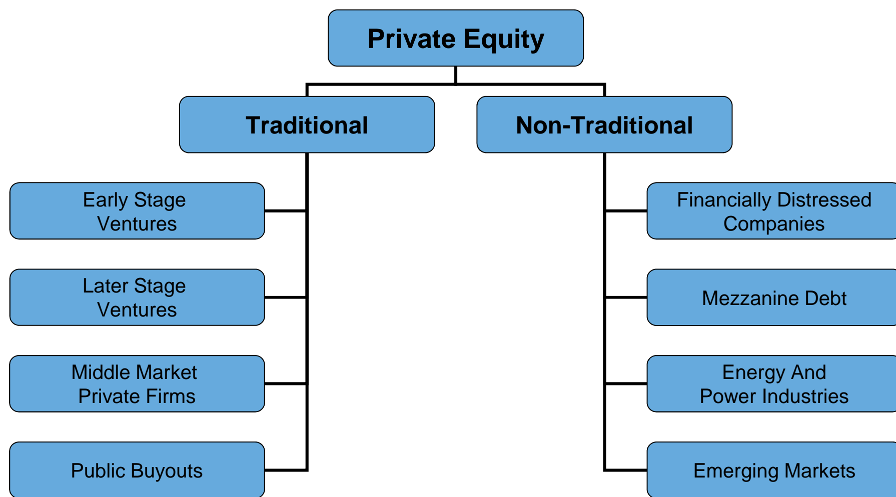
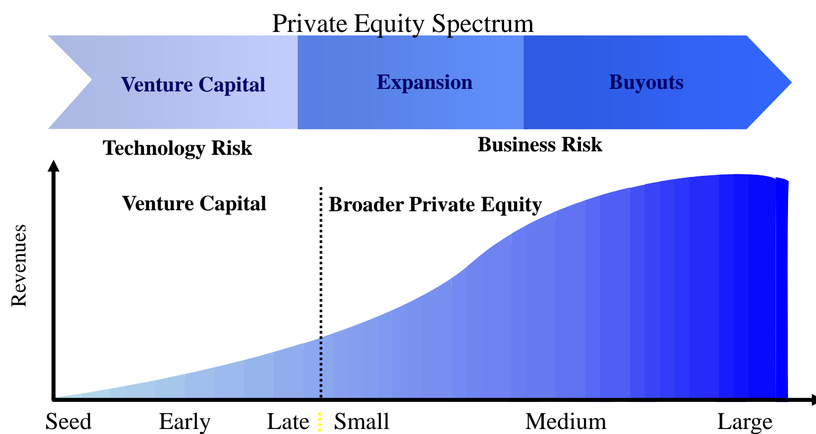
Appendix B

Types of private equity

Types of Private Equity



Nature of private equity market



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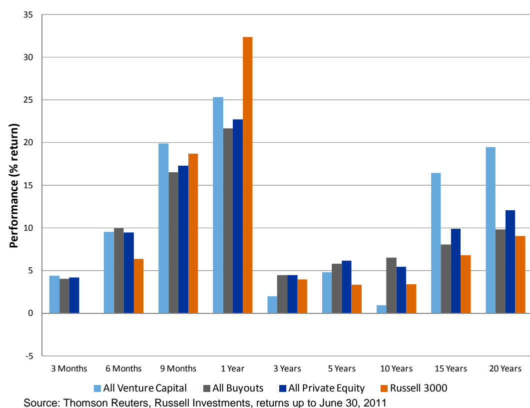
Appendix C

Considerations when investing in private equity

Return and diversification benefits

- Greater return potential
  - Less efficient market
    - Good returns available to those who can access quality information but this is very difficult for most.
  - Illiquidity Premium
- Diversification benefits
  - Access a larger opportunity set
- Valuations less volatile
  - Appraisal based valuations
  - Less impacted by market sentiment that listed markets
- Overcome listed managers' capacity constraints
  - Quality managers are still very difficult to access

Higher return potential



Source: Thomson Reuters, Russell Investments, returns up to June 30, 2011

Potentially higher returns from private equity

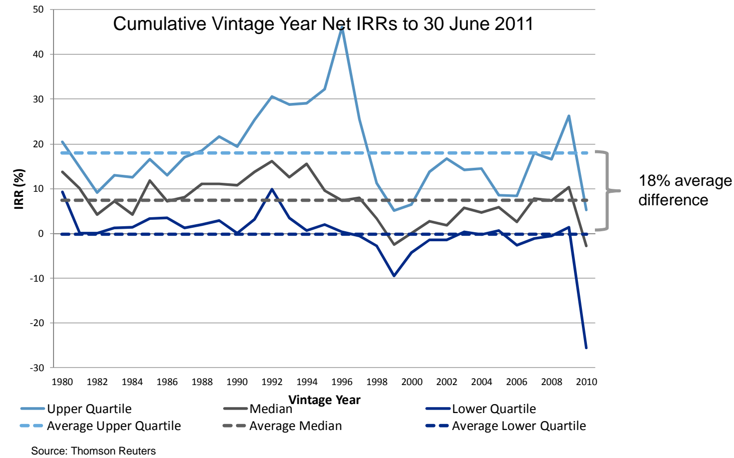
- **Compensation for illiquidity**
- **Information advantages**
- **Shareholder activism**
- **Meeting long-term objectives vs satisfying shareholder pressures**
- **Access to top quality management**

In the long-term private equity has generated excess returns versus the public markets

Large differential between best and worst managers

- **Very large range between the top performing and the bottom performing manager**
  - **This is especially true for venture capital**
    - **Often invest in unproven technologies**
    - **If technology can be commercialised then large returns are achieved**
    - **If not, then very large losses are made**
- **Diversification by manager is very important**
- **Comprehensive due diligence is a must to identify the top quartile managers**

Manager selection is critical to success



Investing in top quartile managers can make the difference in achieving high returns

Persistence of performance…

- **Unlike e.g. mutual funds, PE demonstrates persistence of performance**
  - **Underpins the "virtuous circle" that drives the creation of successful PE franchises**
  - **BUT still only 1 in 2 chance of successive top tercile performance**
  - **Critical to identify the DRIVERS of returns**

	Bottom	Medium	Top
Bottom Tercile	49%	31%	20%
Medium Tercile	30%	38%	32%
Top Tercile	21%	31%	48%

Source: Private Equity Performance: Returns, Persistence and Capital Flows, Kaplan and Schoar [2004]

Lack of Benchmark

- No widely accepted benchmark
  - Difficult to construct a suitable benchmark with available information
    - Private equity funds hold information very closely. Little information is publicly available
    - Survivorship bias
- Some possible "benchmarks"
  - Venture Economics Survey
  - Public Market Comparison
  - Cash + x

  However, each of these have significant flaws
- Implications
  - Active management is a must
  - Difficult to measure performance of manager.

Illiquidity

- Private equity funds are closed ended
- Funds usually terminate 10 to 12 years after inception
- Capital cannot easily be withdrawn
- Investor will not begin receiving positive annual cash flows until after year five
- Funds with high liquidity requirements should limit their exposure to private equity

Illiquidity

- Options for withdrawing capital early are limited
  - Secondary transactions
    - Sell your interest to another investor (either existing or new)
    - Managers often have to approve the sale
    - Matching buyers and sellers is very difficult
    - Historically, sales have been at a significant discount to NAV
    - Discounts if between 10% and 30% are readily observed
      - This is especially true where the seller is a forced seller.
- Research on funds before making a commitment is absolutely vital
    - Manager track record, people, processes, deal flow
    - Provisions for termination of the fund if things do go wrong