KPMG
Insight into investor attitudes to PE 2003
PRIVATE EQUITY
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Forward thinking

Key insights

Expectations of growth in private equity

How do institutional investors view the private equity (PE) industry? KPMG LLP (UK) interviewed 15 leading investors and investment advisers. Assets managed by these investors totalled over UK£700bn, with advisers influencing a further UK£700bn. Those investing in PE currently allocate a combined total of over UK£8bn to this asset class.

Our research reveals that there appear to be significant impediments to further investment in the asset class: these include concerns about the fee structure, a perception that there is a lack of performance transparency, a belief that governance costs are high compared to other asset classes and a view that contractual arrangements are biased in favour of the general partner. Investors are also concerned about the industry's capacity to absorb funds, as the rate at which committed funds are drawn down has slowed.

In spite of these reservations, respondents expect investment in PE to continue to grow. Moreover, the lack of transparency and the other barriers to investment are believed to confer an advantage to experienced and well established investors, who are able to leverage their inside knowledge to select the best PE managers – considered by all our respondents to be the most critical factor in successful investment. This reflects the wide disparity of returns achieved by different managers.

While there appears to be insufficient momentum in current market conditions to dismantle the barriers to investment, pressure for change may arise from other sources. For example, major investors in the US have published PE fund performance figures, and a recent court ruling may oblige them to do so in the future. This is likely to lead to greater demand for performance information in general, which in turn will facilitate benchmarking. Greater transparency will play a part in intensifying competition between PE houses, which is likely to lead to market concentration.

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Summary of findings

Attitudes to the PE sector

- Of those that responded, 66 percent believe that the number of funds currently allocated to PE will increase gradually over the next few years, and 80 percent expect the total amount allocated by each fund to increase.
- All those currently investing in PE report a reduction in the rate at which committed funds are being drawn down by PE managers.
- Opinion is equally divided on whether PE can be said to compete with other alternative asset classes such as hedge funds, property, or other distressed debt. For those who believe that these classes compete, liquidity and diversity are among the factors favouring other forms of alternative assets.
- All respondents believe that PE carries inherent additional risks over investment in public equities, and expect a risk premium of 400 to 500 basis points to reflect this.

Barriers to investment

- The overall quantum of management fees causes some resentment – particularly over the last two years, as returns have been poorer and the scale of undrawn funds has increased substantially.
- Respondents frequently referred to the lack of transparency and many claim this to be a concern.
- High governance costs are an issue. Investors are likely to have to spend disproportionate resources on monitoring and managing their involvement in the sector.
- The limited partnership structure involves high legal costs and many respondents feel that the present contractual framework is biased in favour of the general partner.
- Respondents believe that the inability to close out funds on time is one of the negative aspects of PE investment.

Manager selection

Key criteria include:

- Track record and experience: track record is considered vital in view of the wide disparity in returns achieved by different managers.
- A hands-on approach: this is increasingly important as investors expect a greater proportion of returns to derive from performance improvement within the portfolio companies.
- Continuity and succession planning: investors seek evidence of stability before selecting PE houses.
- Personal presentation: PE houses need to make a convincing case for why they should be selected in preference to other managers and be able to demonstrate a chemistry in their relationships with investors.

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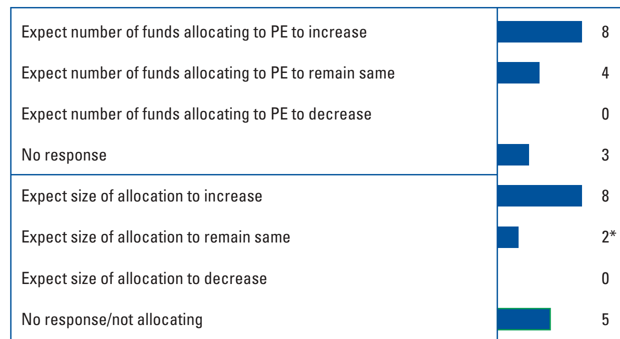
Allocation to the PE growth trends



KPMG Investor Attitudes Survey
KPMG LLP (UK)

Attitudes to the PE sector

Growth trends

Institutional investors expect the PE sector to achieve steady growth in the short to medium term. A clear majority of respondents believe that the number of funds allocating to PE will increase gradually over the next few years, and more expect that the proportion allocated will also increase slowly. No respondents considered that there will be fewer funds allocating to PE, or that allocations will decrease.

Investment capacity

The PE industry in Europe in recent years has not absorbed the commitment levels made available to the industry:

Moreover, these figures do not for the most part take account of the ever-increasing amount of commitments available to US funds operating in Europe.

The level of draw-down was clearly a cause of concern to our respondents:

'There are still significant outstanding commitments.Very little has been drawn down from recent funds.'

'PE is incapable of absorbing significantly more capital.'

'If drawdowns continue to be slow, funds will ask for their money back.'

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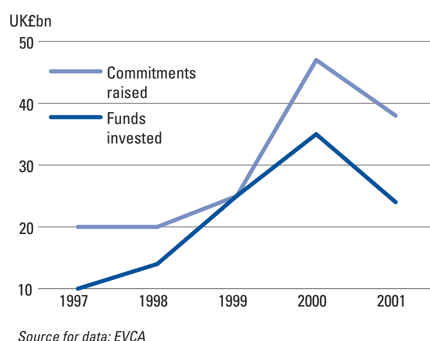
Investor capacity – funds raised against funds invested



Source for data: EVCA

KPMG Investor Attitudes Survey
KPMG LLP (UK)

'Atlas Venture is cutting its US$850m (826.6m euro) Fund VI to US$600m…It is the second time the company has trimmed the fund, which raised US$967m during early 2001.' (Grimes, A. The Wall Street Journal Europe, 19 December 2002).

With investment levels in 2002 running at approximately half those of 2001, this trend is unlikely to reverse in the short term. Slow draw-down cannot be solely attributed to the collapse in high tech related venture capital, as the buy-out capital overhang has also increased significantly in 2000 and 2001, by 9.6bn euro and 10.5bn euro respectively (source: EVCA).

Nearly three-quarters of our respondents believe the position is unlikely to change over the next few years; the remainder expect a slow improvement in the rate at which committed funds are invested. This may reflect the lack of deals available to absorb capital, but is also likely to be the product of PE houses remaining cautious of making too many investments in anticipation of prices falling further.

Asset class comparisons

Attitudes differ on PE's status as an asset class. Half the respondents see PE as a distinct class in its own right, while the remainder regard it as a sub-division of equities in general.

Opinion is equally divided on whether it can be said to compete with other alternative asset classes such as hedge funds, property, or distressed debt. For those who believe that these classes compete, liquidity and diversity are among the factors favouring other forms of alternative assets. Respondents who believe that PE competes predominantly with public equities expect the outlook for public markets to remain poor, and an increasing emphasis on absolute returns – both of which tend to favour PE:

'The popularity of PE will increase as absolute returns become more highly valued.'

'We expect poor returns from listed equities, and PE is likely to increase as a result.'

Many investors expect the public equity markets to produce modest returns in the short to medium term and hence consider PE attractive. However, it shouldn't be forgotten that asset transaction prices paid and received by PE buyers are to a large extent based on public market valuations.

One reason that PE remains attractive to investors is the lower volatility associated with conservative portfolio valuation policies often employed by PE houses, and their ability to arbitrage the financial cycle after a large fall in public market equities. These factors help to explain the continued inflow of funds to the PE market, despite concerns over its ability to absorb commitments.

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Inherent risks

All respondents believe that PE carries inherent additional risks over investment in public equities, and expect a premium of 400 to 500 basis points to compensate for this perception. In addition to lack of liquidity and the size and relative immaturity of some investee businesses, several respondents highlighted PE houses' management capabilities as a key risk factor.

Readers may recall our previous research, *Insight into Portfolio Management 2003,* which addressed the enhanced expectation of PE houses to make a difference at an operating level, not only to take advantage of investment conditions:

'PE carries additional risk because active management is expected.'

'There is a skill risk associated with the PE house. PE managers' skill sets are fairly wide.'

Managerial risk arises from uncertainty both in respect of the PE manager's ability to select the correct investments and to extract value from the portfolio companies in conjunction with their executive teams.

With regard to investment selection, the additional risk arises from the illiquid nature of PE investment and the concentration of risk in relatively few exclusive assets. Public equity fund managers have the ability to structure their portfolios to prevent divergence from the relevant benchmark index by more than a pre-determined amount – PE managers, on the other hand, do not have this luxury.

Value created in a portfolio business will to some extent reflect the PE manager's effectiveness in assisting the company to procure the right resources and any further capital necessary to achieve its full potential. Under performance in this area by the PE manager is likely to affect the PE house's portfolio as a whole.

These risks lead to an enormous disparity of returns between managers, underlining the importance of manager selection and of diversification. In a flat market, a higher proportion of PE managers' returns are likely to come from performance improvement in portfolio companies (rather than equity multiple arbitrage). This highlights the importance of selecting managers with the appropriate skills for the current economic environment. The management of these risks is also difficult for the PE investor due to the lack of transparency and comparability of PE managers reporting and hence the lack of ability to measure returns with certainty until relatively late in a fund's life.

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Barriers to investment

A majority of respondents (60 percent) see a clear distinction between the inherent risks associated with PE investment, and a range of factors which they believe act as a barrier to further investment but over which PE managers have some control.

Investors cited a number of issues which PE managers, to a greater or lesser extent, are in a position to address if they choose to do so. The most important are as follows:

PE managers' fee structures
PE is seen by the respondents as a very expensive asset class to invest in. The overall quantum of charging carried interest and management fees causes some resentment, particularly as over the last two years as returns have been poorer and the scale of undrawn funds has increased substantially.

In addition, many PE managers have substantially increased the size of their funds – particularly in the large LBO market – without proportionately increasing headcount or resources. This has created a perception, at this level at least, that management charges are providing a higher level of profit to the PE houses at a time when investors have suffered. Many investors would prefer to see a return to the "eat sandwiches on the management charges, eat caviar on the carry" days. General partners' arrangement fees in connection with deals are also considered a case of double charging depending on how these are treated.

'Investors could bring pressure to bear to reduce fees and carried interest, particularly at a time when private equity no longer produces the very high levels of returns that have been seen in the past. We expect to see changes [in the fee structure] as it is no longer acceptable.'

Generally, investors consider PE managers' basis of charging to be opaque: some institutions favour certain managers because they believe their fee structure is fair and open:

'We liked them because their fee structure is fair and straightforward.'

Regrettably, as far as the investors were concerned, there appears to be little difference between charging structures across the industry.

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Lack of transparency on performance

At present, it is almost impossible to track individual fund performance against reliable indices. The organisations which attempt to benchmark performance data are dependent on the funds themselves for the relevant information – with the result that coverage is not comprehensive, particularly in Europe.

Respondents frequently referred to the lack of transparency and many consider this to be a concern:

'You don't know the real returns until you cash out.'

'The one certainty is that valuations are never right.'

'There is a performance vacuum for five to six years and a lack of benchmarks: trustees find that hard to love.'

The valuation of the underlying unquoted investments inevitably involves a degree of subjectivity and this can make fund performance difficult to compare, especially during the first few years. However, respondents clearly believe that managers could do more to improve transparency, thus enabling investors to benchmark more readily the performance of their allocations.

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High governance costs
PE is perceived to be more complex than other asset classes and accounts for a relatively small proportion of total investment. The combination of these factors means that investors are likely to have to spend disproportionate resources on making and monitoring their allocations.

The larger institutions tend to develop an in-house capability – often regarded as resource-hungry – while smaller funds are more likely to invest through funds-of-funds. Both routes will, of course, create an extra layer of cost, in addition to the expense involved in trustee training and general governance:

‘PE is the most time and knowledge-intensive asset class. There’s a need to judge the percentage of the governance budget compared to the allocation.’

‘Myners has increased interest in PE – but the trustees can’t be cavalier any more.’

This highlights the need for trustee education as trustee responsibilities were given considerable prominence in the Myners report. This element of Myners can be seen very much as a double edged sword for private equity.

Overall, the impact of Myners on PE has been broadly neutral: 50 percent of the respondents believe that it will not affect investors’ propensity to invest in the asset class, while the remainder believe there may be a small increase in PE allocations as a result of the review.

Legal and contractual issues
The setting up of the limited partnership structure, which forms the legal basis of the relationship between the institution and PE manager, involves high legal costs. More fundamentally, many respondents feel that the present contractual framework is biased in favour of the general partner (GP) and doesn’t provide investors with sufficient flexibility, particularly in circumstances where a manager begins to under-perform:

‘The structure of the LP/GP contract makes it difficult to get rid of a GP that is not performing. This can be an appalling problem.’

This provides a further illustration of the risks inherent in manager selection.

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Fund closure

There is a natural tendency for PE houses to focus their energies on the star performers in their portfolio, while under performers get left to one side. Everyone wants to be associated with a successful investment; there is often less incentive for managers to deal with less illustrious businesses where a profitable exit may be difficult to achieve. The result is that often the life of the fund is extended beyond its normal 10-year span.

Respondents believe that the inability to close out funds on time is one of the negative aspects of PE investment, and could create an obstacle to increasing allocations to the asset class:

'We like funds to do what they say in terms of the lifetime of the fund. If it's a ten year fund we expect to see it close in ten years.'

'There is an unwillingness to wind up old funds. Managing cashflows is a problem.'

The emergence of secondary funds could provide liquidity either for limited partners to exit funds that have run beyond their lifetime or alternatively allow PE managers to exit stub portfolios. However, to date, secondary funds have been used principally by banks, corporate venturers or LPs wishing to exit their investments or commitments rather than by PE managers themselves. Could an alternative approach be to increase the weighting of IRR, in the carry calculation, providing a greater incentive for general partners to dispose of stub portfolios earlier than at the end of a fund's life?

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Manager selection: key factors

One of the points which emerges very clearly from the survey is that choosing the right manager is seen as critical to the success of the investment. This reflects the huge disparity in returns achieved by PE managers. Although there have been no major changes to the due diligence process, 90 percent of respondents said that they strive to improve their selection process.

Respondents cited similar criteria for selecting their managers:

Track record and experience
Not surprisingly, investors look for evidence of past performance and relevant experience:

'We don't like a short track record or a small number of deals. We do like to know how they achieved their returns and whether their skill set matches their focus.'

'Investment policy, track record – IRR, money multiple, a good spread of successful investments and not too big a proportion of losses – consistency of the team, spread of carry, an ability to add value, success at sorting out problem investments, deal flow, knowledge of the sectors in which they invest. These are all important and we will not invest if we are not satisfied with each area.'

There is evidence to suggest that investors are right to put their faith in track record: a recent study by a leading strategy consultancy indicates a close correlation between past and subsequent performance by the same PE manager.

A hands-on approach
Although respondents tended to be non-committal about the extent to which PE managers add value to their investee businesses, a clear majority believe a hands on approach is essential:

'We would not back a PE manager who does not intend to take a hands-on approach. That is what justifies the high management fees and the carried interest.'

'We look at whether they allocate enough resources to managing their portfolio, as opposed to deal-making.'

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This factor is increasingly seen as important, as investors expect a greater proportion of gains to derive from performance improvement in portfolio companies – as opposed to equity multiple arbitrage, which provided considerable profits in the late 1990s. The issue is highlighted in our previous research, *Insight into Portfolio Management 2003.*

However, respondents do not expect PE managers to run their investee businesses, excepting those focusing on turn-around situations, but rather to have the ability to provide or source assistance to enable management teams to realise the full potential of the business.

Continuity and succession

Many of the respondents specifically mentioned succession as a key issue. Institutions are looking for assurance that the managers they appoint will be involved over the long term, or at least if there are personnel changes within the PE house that this won't adversely affect their investment:

'We need to see their succession plans - longevity is important, age groups, skill sets, experience of exits and closing funds.'

'PE houses can change. We've had problems with a venture capital company where major changes in the team led to problems with underlying investments.'

Personal presentation

Respondents referred to the importance of the personal impression created by the managers; 'chemistry' and 'integrity' were frequently mentioned as essential qualities in addition to their ability to articulate a differentiation strategy:

'I don't think it's different from the attributes we look for in any investment manager. It's all about making a judgement on the manager's edge - their ability to articulate the reasons why we should employ them rather than somebody else.'

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Issues for PE houses

Inherent obstacles to investing in PE
Lack of liquidity relative to public equities, a performance vacuum for perhaps five years or so post-investment, subjective valuations of unrealised investments (and hence uncertainty about true IRR until fund closes), uneven cash flows, and unquantified risks are intrinsic to the asset class. Although investors expect a return premium to compensate for these factors, they will deter some institutions from making or increasing allocations.

However, investors may have an exaggerated perception of the scale and significance of these obstacles: for large funds, the liquidity of any asset class may be illusory, and while short-term returns may be calculated for marketable securities with certainty, these are dominated by capital market volatility.

Moreover, not all institutions feel that liquidity is an issue with PE investment:

'We don't see liquidity as a problem because we have been in it long enough to have money coming back in as fast as we're putting it out again. Until we increased our allocation last year, we had positive cashflow from our investments.'

Increased competition in the secondaries market could lead to a substantial improvement in the liquidity position. With relatively few funds currently in the secondaries market and many potential investors seeking liquity (such as the insurance sector because of capital adequacy and solvency considerations), liquidity comes at a high cost. The development of the market should see a weakening in the bargaining power enjoyed by the secondary funds and consequently a reduction in the cost of liquidity.

This suggests that the intrinsic barriers to further investment are of only limited significance and that persuasive arguments can be put forward to support the merits of PE as an asset class.

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'Variable' barriers
To what extent do PE houses need to address the perceived barriers to investment over which they have some control? Despite complaints about costs, transparency and contractual arrangements, the reality is that there seems to be no shortage of funds for PE: if anything, rather the reverse.

Interestingly, we found virtually no correlation between the perceived barriers to investment and the criteria investors use to select their PE managers. Only one respondent cited fee structure as a factor in selecting a particular manager, and even then track record and other factors probably outweighed fees in arriving at the investment decision.

With respect to transparency, the current situation favours the seasoned investor, who can leverage his or her experience and insider knowledge to achieve superior manager selection – the factor which really is considered to be crucial in determining the success of the investment. This is likely to be one of the reasons for the substantial growth in funds-of-funds, as they provide the novice PE investor not only with diversification at relatively low levels of investment but also in-built experience.

Furthermore, it is arguable that established investors have an interest in keeping the market to themselves: if the perceived barriers to investment were lowered and allocations increased as a result, the industry would struggle to absorb the extra capital. Experienced investors could be crowded out of established successful funds through oversubscription. Greater capital within the industry might also lead to additional pressure to do deals and bid up prices, potentially increasing risks and reducing returns.

Transparency
The PE industry's willingness to introduce greater transparency may depend to some extent on its appetite for attracting new investors into the market. In current market conditions, where the proportion of draw-down to committed funds has been falling, there is on the face of it no great incentive for PE houses to change.

On the other hand, it is possible that external demands may force the industry's hand. For example, CalPERS (California Public Employees Retirement System), the world's largest private equity investor, and UTIMCO (University of Texas) took the unprecedented step of publishing valuations of their PE portfolio. (Financial Times – Private Equity Report, 12 December 2002).

The CalPERS figures were published some while ago, and then withdrawn. This was the result of PE general partner pressure and the realisation at CalPERS that some of the disclosures were being misinterpreted or taken out of context, because of the lack of any benchmark data against which to judge the disclosures.

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However, a recent ruling in a lawsuit brought against CalPERS under the US Freedom of Information Act suggests that it will be forced to reveal performance data unless it can prove that such data is a 'trade secret'. Any forced disclosure will surely heighten the need for improved benchmark data and allow new investors easy access to historical returns.

If some form of benchmarking becomes more readily available and transparent in America it is likely to be only a matter of time before a similar approach is adopted in Europe – a significant proportion of European private equity commitments originate from the US, particularly in the buyout sector.

In addition, demands for better reporting to limited partners have been taken on board by the European Venture Capital Association (EVCA) and the British Venture Capital Association (BVCA) in connection with portfolio valuation and disclosure guidelines (at the exposure draft stage in the case of the BVCA). Surprisingly, no guidelines exist in the US, the largest and most developed PE market. The EVCA and BVCA guidelines appear to differ in their philosophy, and these differences will need to be resolved if a truly global standard is to be reached. Development of valuation and disclosure guidelines is also being championed in North America via the International Limited Partners Association.

In sum, there would now appear to be a gathering momentum for change which is likely to result in greater transparency in the medium term.

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Competitive pressures
It is likely that competitiveness within the industry will intensify, for a variety or reasons.

From our research, we noted little difference in charging structures and rates across the industry. One possible explanation for this is that in the period when PE returns were healthy, the advantage in the partnership agreement negotiation remained firmly with the general partners. Now that returns are falling, at least in absolute terms, the PE houses' advantage may be eroded, leading to greater variation in charges.

At present the PE market is highly fragmented, comprising as it does a large number of operators which have been able to attract funding. At the same time, one of the industry's most notable characteristics is the wide disparity in returns being achieved by PE managers. Over the longer term – as investors' experience of PE managers accumulates, and as performance transparency increases – PE houses with relatively poor performance may fail to raise capital in the market, and investment could become concentrated in fewer funds able to demonstrate a quality track record.

A more discriminating approach from investors may lead PE houses to pay greater attention to the issues of continuity and succession planning in the future. An avaricious approach to carry at the top levels of a partnership is likely to create unacceptably high turnover at director and executive level, which could seriously damage the house's ability to demonstrate to its potential investors the continuity of investment philosophy beyond its principals. Being able to demonstrate long term stability and continuity will become increasingly important.

Semi-captive houses with outside investors are likely to come under a degree of pressure, as some have been seen to be unstable in the recent past. Outside investors are likely to require assurance over stability, and will wish to be comfortable that their positions are not perceived to be compromised by the sponsoring institution.

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Industry-wide initiatives

In view of the increasing emphasis on the trustees' responsibilities as highlighted by the Myner's review – and the climate of governance in general – it may be beneficial for the industry to take the lead in providing guidance and support in this critical area. For example, trustee training could be tackled in a more structured way by the industry as a whole.

It is likely that the demand for an improved approach to contracts will intensify, among all types of investors. One possibility is for a body such as the National Association of Pension Funds (NAPF) or the Association of British Insurers (ABI), in conjunction with the BVCA, to draw up a model contract and an illustrative fee structure as a benchmark for the industry.

Opening up new markets

PE houses may also want to consider ways in which the market for PE can be expanded, possibly through re-engineering their products to appeal to a wider base of potential investors.

Competitive pressures have driven PE managers towards focusing on particular sectors which together with regulatory change has had an impact on the nature of investment tools used. PE managers have nevertheless tended to take a uniform approach to the method of providing returns. The absence of an income or yield element in the returns is a deterrent for some investors such as insurance companies where the discount rate used for liabilities in regulatory solvency calculations is linked to the income stream.

By slightly de-gearing their investments, PE houses may still be able to out-perform public equity income funds in terms of yield while at the same time providing potentially attractive capital gains. This may also prove an appealing proposition for those cash generative but low growth companies for which the public markets are often a harsh environment. This would clearly create new challenges in terms of PE structures and PE manager remuneration models, but we can be certain that the industry will strive to find appropriate strategies if the potential rewards are sufficient.

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