Chapter 1

The private equity fund as the intermediary in an expert market

The private equity fund as the intermediary

Private equity arises from the need of a privately held company to raise capital for an ambitious business plan. Private equity financing of companies supports many different business strategies, for example: to develop new products and technologies, to expand working capital, to make acquisitions, to strengthen a company's balance sheet, and to resolve ownership and management issues in a family succession, or a management buy in or buyout. However, this book is not about private equity financing per se, but only about how the institutional investor can gain exposure to private equity financing. Institutional investors investing in private equity through private equity funds is the overriding theme of this book.

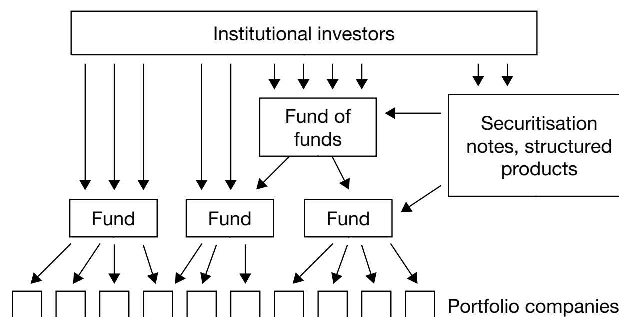
Private equity is an expert market, where the right skills, experience and resources are vital to succeed. The private equity fund is the intermediary that provides institutional investors with a safe access to the asset class. The fund management team has the right skills and experience to undertake direct private equity investments in companies, called the portfolio companies, on behalf of the fund investors, who have equipped the fund with the necessary capital resources. The objective is to sell the portfolio companies after a few years of value development for a higher price, and to generate profit for the fund's investors.

Investing in private equity funds

Exhibit 1.1 shows how institutional investors gain exposure to private equity financing on a company level. By far the most important access channel is to directly invest in funds which

Exhibit 1.1

Different ways to invest in private equity funds



Source: Authors' own.

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themselves invest in companies. Depending on their needs and constraints, some investors choose to invest in a private equity fund of funds, which then in turn invests in private equity funds. About 20 per cent of the capital provided to funds come from funds of funds.[1]

Other ways of accessing private equity are gaining popularity but are still niche investments. The institutional investor can go via other alternative investment vehicles such as securitisation or structured products, but again the capital ends up in the hands of fund managers. Finally, the investor can gain exposure to private equity by buying fund or fund of funds investments second-hand or investing in a secondary fund of funds. The different types of investments are not only different ways to access private equity funds but they also have very different risk profiles.

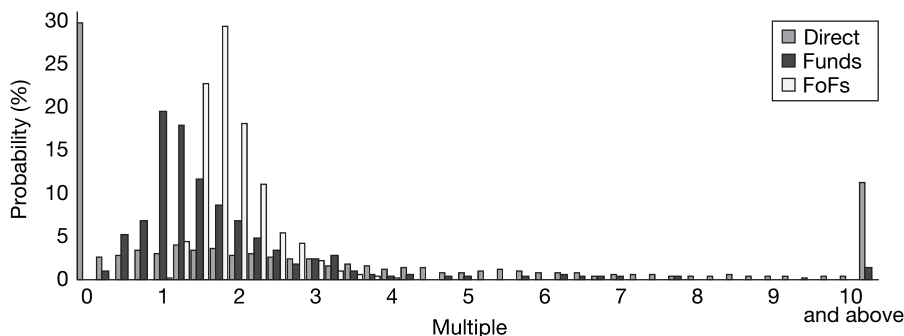
Risk levels of private equity investments

Investors often perceive private equity as a risky asset class. This is certainly true for direct investments in companies. Especially in the venture capital segment, the total loss rate of private equity direct investments is very high. On the other hand, successful venture capital investments return many times the invested amount. However, investments in private equity funds are far less risky than one direct investment. Institutional investors always invest in several private equity funds to gain exposure to a range of portfolio companies where the gains on a few would more than compensate the losses on others. Other investors do not have the skills or resources to directly invest in a sufficient number of funds, and choose funds of funds or other alternative vehicles.

Exhibit 1.2 illustrates just how different the risk profiles of investments in a company, in a fund and in a fund of funds are. It shows the return distribution of US venture capital direct, fund and fund of funds investments. The horizontal axis indicates the return expressed as a multiple of capital invested, and the vertical axis gives the frequency of investments with a given multiple. For example, about 30 per cent of all direct investments have a multiple of zero, which is effectively a complete loss of the capital invested, but no total loss for a fund or fund of funds investment. And around 10 per cent of all fund investments have a multiple of less than one, that is, they return less than the capital invested. However, a fund of funds

Exhibit 1.2

The return distribution of US venture capital direct, fund and funds of funds investments



Source: Weidig and Mathonet (2004).

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investment nearly always returns the capital invested. To conclude, private equity might be a risky asset, but a private equity investment is not necessarily so.

Direct investments

Private equity funds undertake risky direct investments. The rewards on a single direct investment can be high, and so can the pitfalls. Exhibit 1.2 shows that the return distribution of a direct venture capital investment is highly skewed and very spread out. Around 30 per cent of all direct investments result in a total loss, but more than 10 per cent generate high profits and return more than 10 times the capital invested. Of course, these extreme high multiples vary between different segments of private equity, and are lower for buyout investments, for example. Nevertheless, investors should only commit all their capital in one direct investment if they want to gamble. If investors believe in the superiority of their selection skills and their ability to add value they should invest in several direct investments to achieve a much better risk–return ratio than for a single investment. Their potentially superior skills would generate a higher average return and the diversification effects reduce the risk of extreme losses but also reduce the upside potential of their portfolio return. If investors are not sure whether they have the appropriate skills, resources or risk appetite for direct investments, they would be better to seek exposure to private equity through indirect investment instruments such as funds, funds of funds or structured products. This is the case for the vast majority of institutional investors.

Private equity funds

A fund is a collective investment scheme that invests in between 10 and 30 portfolio companies. It is far less risky than a direct investment, because it is very unlikely that all direct investments in a fund's portfolio perform badly or result in a total loss. Exhibit 1.2 shows that unlike for direct investments the returns of fund investments are centred around a peak, with still a significant tail of high returns but very few extreme losses. The fund portfolio induces significant diversification effects compared with a direct investment. A fund investment is not as risky as a direct investment, but the risks are not negligible. If investors have good selection skills and monitoring resources, as related to funds, and sufficient capital to build a diversified portfolio, they should invest in funds. The skills necessary for successful fund investments are described in Parts II and III. However, if investors do not possess the necessary skills to manage the risks associated with fund investments or do not have enough capital to build a diversified portfolio of funds, they should invest in a fund of funds, or structured products.

Private equity funds of funds

Funds of funds typically invest in more than 20 funds, which then have several hundred direct investments in portfolio companies. Funds of funds offer a far better diversification of risks, are much safer, and their managers typically have a wide market view and access to well-established funds. Exhibit 1.2 shows that the return distribution of a fund of funds looks similar to an index of an efficient public market; it has a symmetric distribution, not too pronounced fat tails and no total losses. The hundreds of portfolio companies do not go bankrupt together, but the high returns and total losses from these direct investments

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balance out. Even the probability to lose any capital seems small. (For a discussion of funds of funds see Part IV.)

Securitisation and structured products

Collateralised fund obligations (CFOs) are one example for the securitisation of a portfolio of private equity funds. The securitisation effectively transforms the risk of a private equity fund of funds into various layers of different degrees of risk. These different risk layers are then sold as bonds to investors who choose the appropriate one according to their risk appetite. The individual tranches are typically rated by rating agencies, often starting with an AAA for the most senior debt layer. Often the capital of the bond benefits from a guarantee by a monoline insurer. CFOs may serve multiple purposes and not only be used to invest in private equity but also to decrease exposure to private equity by selling assets into a CFO deal.

Another example of structured products in private equity are funds or funds of funds raising capital for their investment activity by issuing a bond that pays interest and may provide a limited participation in the fund's or fund of funds' profits. (Securitisation and structured products are discussed in Part IV.)

Publicly traded private equity

Another interesting alternative vehicle is publicly traded private equity (PTPE), for example: listed companies whose core business is private equity, quoted investment funds and specially structured investment vehicles. These entities are often evergreen funds that have raised capital from the public market, and reinvest proceeds from exits. They cater for investors that cannot hold unlisted products or need more liquidity. Thus in terms of liquidity and transparency, they are less risky but at a cost, as they typically trade below their net asset value. The market price reflects the market's judgement on their fair value, minus an illiquidity discount. Still, it is difficult to judge the risk profile of publicly traded private equity instruments on the basis of their market price evolution, because most products are infrequently traded. (These products are discussed further in Part IV.)

1 According to the European Venture Capital Association (EVCA) statistics provided to the authors.

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