



**PRIVATE EQUITY
INTERNATIONAL**

PRIVATE EQUITY FUND INVESTMENT DUE DILIGENCE

**Strategies for evaluating and selecting
top performing fund managers**

Edited by
Kelly DePonte, Probitas Partners

**Published in November 2016 by
PEI
6th Floor
140 London Wall
London EC2Y 5DN
United Kingdom**

**Telephone: +44 (0)20 7566 5444
www.privateequityinternational.com/bookstore**

© 2016 PEI

ISBN 978-1-911316-05-3

This publication is not included in the CLA Licence so you must not copy any portion of it without the permission of the publisher.

All rights reserved. No parts of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means including electronic, mechanical, photocopy, recording or otherwise, without written permission of the publisher.

Disclaimer: This publication contains general information only and the contributors are not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Neither the contributors, their firms, its affiliates, nor related entities shall be responsible for any loss sustained by any person who relies on this publication.

The views and opinions expressed in the book are solely those of the authors and need not reflect those of their employing institutions.

Although every reasonable effort has been made to ensure the accuracy of this publication, the publisher accepts no responsibility for any errors or omissions within this publication or for any expense or other loss alleged to have arisen in any way in connection with a reader's use of this publication.

*PEI editor: Wanching Leong
Production editor: Julie Foster*

Printed in the UK by: Hobbs the Printers (www.hobbs.uk.com)

Contents

Figures and tables	ix
About the editor	xiii
Foreword <i>By Peter Freire, The Institutional Limited Partners Association (ILPA)</i>	xv
Introduction	xvii
SECTION I: FUNDAMENTAL ISSUES	1
1 Private equity fund manager due diligence and selection <i>By Anna Dayn, Dayn Advisors</i>	3
Overview	3
Key considerations	3
Manager due diligence	5
Emerging managers	8
Due diligencing the next fund	8
Human capital	9
Operational due diligence	10
Conclusion	10
2 Track record due diligence <i>By Edmond Ng, Chris Loh, Alex Lee Sao Wei and Marc Lau, Axiom Asia Private Capital</i>	11
Quantitative track record analysis	12
Qualitative track record analysis	14
Conclusion	16
3 Emerging managers: How to analyse a first-time fund <i>By Kelly DePonte, Probitas Partners</i>	19
Emerging managers: A definition	20
Key points in the analysis of emerging managers	20
Sponsored funds: A special case	25
Conclusion	26
4 Private equity benchmarking: Public market equivalent methods and analysis <i>By Jesse Reyes, J-Curve Advisors and Austin Long, Alignment Capital</i>	27
Introduction	27

Contents

	PME models	27
	Inputs and terminology	29
	Inputs for measurement	29
	An important note on formulation	29
	Analysis of PME methods	30
	How do we fix the mathematical problem of the negative NAV	33
	Understanding geometric differences	44
	Summary of PME methods	48
	Conclusion	52
	Appendix: Calculation formulas	53
5	Legal due diligence panel discussion	57
	The panel	57
6	Doing due diligence on the next fund: The importance of portfolio monitoring	77
	<i>By Kelly Chaplin, British Columbia Investment Management Corporation</i>	
	Annual meetings	78
	Other meetings	79
	Advisory board participation	80
	Co-investments	81
	Conclusion	82
7	Staffing for success: The human capital factor	83
	<i>By Michael Koenig, Natalie Fitch and Tarang Katira, Hamilton Lane</i>	
	Introduction	83
	Sourcing	85
	Due diligence	85
	Co-investments and secondaries	88
	Legal and structuring	88
	Monitoring	89
	Back office/reporting	89
	Publicly traded stock distributions	91
	Buy or build?	91
	Hub-and-spoke model	94
	Conclusion	95
8	Team building, succession planning and private equity fund management	97
	<i>By Kelly DePonte, Probitas Partners</i>	
	Fund management structures	97
	Team building and succession	100
	Succession planning: Concerns from the past	104
	Conclusion	105

9	Operational due diligence	107
	<i>By Jason Scharfman, Corgentum Consulting</i>	
	LP approaches to operational due diligence	107
	Analysis areas	108
	Focus on investigative due diligence	110
	Conclusion	112
10	Diligencing operating value creation capabilities	115
	<i>By an experienced operating partner</i>	
	Introduction	115
	The diligence process today	116
	How to improve diligence	119
	What to ask GPs	121
	The importance of results/track record	121
	Approach: What a GP actually does to produce results	122
	Capabilities	124
	Sustainability	125
	Conclusion	126
11	ESG due diligence	127
	<i>By Natasha Buckley, Principles for Responsible Investment</i>	
	Role of ESG due diligence	127
	Are LPs conducting ESG due diligence?	128
	A call to action	129
	How LPs conduct private equity due diligence	130
	Putting due diligence into context	130
	An industry-consistent approach to ESG due diligence	131
	Working with intermediaries	132
	SECTION II: PRIVATE EQUITY SECTORS	135
12	Venture capital due diligence	137
	<i>By David York and Lisa Edgar, Top Tier Capital Partners</i>	
	Introduction	137
	Differences between venture capital and private equity manager evaluation	139
	Selection criteria and evaluation processes	139
	Investment performance	140
	Team	141
	Investment strategy	143
	Investment process	144
	Portfolio management	145
	Governance	146
	Conclusion	147

13	Private debt funds: A fast growing sector	149
	<i>By Matthias Unser, YIELCO Investments</i>	
	Overview of the private debt market	149
	Private debt fund strategies	152
	Due diligence	153
	Outlook	160
14	Due diligence in emerging private equity markets	161
	<i>By Ernest JF Lambers, Liberty Global Partners</i>	
	The rise of emerging markets	161
	Key elements in manager selection	163
	Conclusion	170
15	Performing due diligence in Latin America	171
	<i>By Elvire Perrin, Pavilion Alternatives Group</i>	
	Key considerations	171
	The development of private equity in Latin America	174
	Due diligence areas	175
	Conclusion	179
	SECTION III: SPECIAL ISSUES OF CONCERN	181
16	Panel discussion: Practical advice on targeting and accessing funds	183
	The panel	183
17	Building a co-investment programme	195
	<i>By Brett Fisher, Fisher Lynch Capital</i>	
	Pros and cons of co-investing	195
	Designing an effective co-investment programme	196
	Evaluating co-investment opportunities	199
	Legal documentation	201
	Portfolio monitoring	201
	Communicating with GPs	202
	Conclusion	202
18	Secondaries private equity fund pricing	203
	<i>By Charles Tingué, Kathryn Regan and John Stott, Landmark Partners</i>	
	Introduction	203
	Benefits of buying secondaries	206
	Secondaries underwriting introduction and information needs	207
	Secondaries DCF model set-up	208
	Public company projections	208
	Private company projections	211
	Operating performance and balance sheet evolution projections	212

Contents

Exit timing projections	212
Exit valuation multiple projections	212
Future capital calls and unfunded capital return	214
Converting gross cash flows to a purchase price	215
Sensitivity analysis	215
Conclusion	215
SECTION IV: APPENDICES	217
Appendix I: Private Equity Principles	219
<i>Institutional Limited Partners Association</i>	
Alignment of interest	220
Governance	222
Transparency	225
Appendix A: Limited partner advisory committee	227
Appendix B: Carry clawback best practice considerations	230
Appendix C: Financial reporting	231
Appendix II: Due Diligence Questionnaire	233
<i>Institutional Limited Partners Association</i>	
Overview	233
Frequently asked questions	235
Cover Sheet	237
Basic Questions	238
Detailed Questions	243
Appendix A - Requested Documents	252
Appendix B - Templates: Team Members	253
Appendix C - Templates: References	254
Appendix D - Templates: Fund	255
Appendix E - Templates: Portfolio Investments	256
Appendix III: Limited Partners' Responsible Investment Due Diligence Questionnaire	259
<i>Principles for Responsible Investment</i>	
About this due diligence questionnaire	259
LP Responsible Investment DDQ	260
About PEI	264

Figures and tables

Figures

Figure I:	Commitments to US private equity partnerships by sector, 1995–2015	xix
Figure 1.1:	Example of a private equity J-curve	4
Figure 1.2:	North American buyout net IRRs by vintage year, 1992–2012	4
Figure 2.1:	Ten-year annual return dispersion by asset class and strategy	11
Figure 7.1:	Dispersion of returns by strategy, 1979–2011 vintages	86
Figure 7.2:	Life cycle of investment sourcing and decision-making	90
Figure 7.3:	Hypothetical hub-and-spoke model	95
Figure 8.1:	Simplistic fund management governance structure	98
Figure 11.1:	Growth of PRI private equity signatory base, 2006–14	128
Figure 12.1:	Venture capital sectors of investment in the US, by \$ invested	138
Figure 12.2:	Venture capital fund selection process	140
Figure 13.1:	Global fundraising for private debt funds, 2016–16	150
Figure 13.2:	Participants in the US and European leveraged loan markets	150
Figure 13.3:	Forms of private debt	151
Figure 14.1:	Private equity fundraising in emerging markets, 2001–15	162
Figure 14.2:	Private equity investments in emerging markets, 2001–15	162
Figure 15.1:	GDP by country in Latin America, 2015	173
Figure 15.2:	Private capital penetration in Latin America	175
Figure 18.1:	Example of a private equity J-curve	204

Tables

Table I:	A brief history of private equity: Key milestones	xv
Table 4.1:	Example of an original ICM PME calculation with base case cash flows	31
Table 4.2:	Example of an original ICM PME calculation with private equity outperformance	32
Table 4.3:	Example of an original ICM PME calculation with private equity underperformance	32
Table 4.4:	Example of a PME+ calculation with base case cash flows	34
Table 4.5:	Example of a PME+ calculation with private equity outperformance	35
Table 4.6:	Example of a K&S PME calculation with base case cash flows	37
Table 4.7:	Example of a K&S PME calculation with private equity outperformance	37
Table 4.8:	Example of an mPME calculation with base case cash flows	38
Table 4.9:	Example of an mPME calculation with private equity outperformance	39
Table 4.10:	Example of a Bison PME calculation with base case cash flows	42
Table 4.11:	Example of a Bison PME calculation with private equity outperformance	43
Table 4.12:	Example of a Direct Alpha PME calculation with base case cash flows	46
Table 4.13:	Example of a Direct Alpha PME calculation with private equity outperformance	47
Table 4.14:	Example of a GEM IPP PME calculation with base case cash flows	48
Table 4.15:	Example of a GEM IPP PME calculation with private equity outperformance	49
Table 4.16:	Summary of PME results for base case cash flows	50
Table 4.17:	Summary of PME results with private equity outperformance	50
Table 4.18:	Summary of PME results with private equity underperformance	50

Figures and tables

Table 4.19:	Summary of PME methods and their advantages/disadvantages	51
Table 7.1:	Building a holistic sourcing model	84
Table 7.2:	Human and technology resources required for effective due diligence	87
Table 7.3:	Legal costs for private equity commitments	89
Table 7.4:	Scale of 'buying' to 'building' a private equity programme	91
Table 10.1:	Comparison of what an LP might hear in diligence vs. what could really be happening at the GP	117
Table 10.2:	Checklist comparing GP operating approaches	123
Table 10.3:	Operating resource allocation	124
Table 18.1:	Information required for secondaries fund due diligence	207
Table 18.2:	Common terms and attributes in secondaries fund transactions	209
Table 18.3:	Public company classification example	210
Table 18.4:	Forward-looking operation projections	213

About the editor

Kelly DePonte is a managing director and currently the head of research for Probitas Partners. Prior to joining Probitas Partners, Kelly was chief operating officer and managing director at Pacific Corporate Group. Before joining PCG, Kelly held various positions at First Interstate Bancorp, including management of a \$170 million venture capital portfolio and the Corporation's SBIC, and oversight of all financial derivative activity in the corporation and its banks. Kelly earned a BA from Stanford University and an MBA from The Anderson Graduate School of Management at UCLA. □

Foreword

By Peter Freire, The Institutional Limited Partners Association (ILPA)

LP due diligence – leveraging institutionalised best practices, thoughtful enquiry and specialised resources – has evolved to become more science than art. As detailed in this guide, LPs have expanded and sharpened the toolkits they use to evaluate managers’ fit with their investment objectives. Using sophisticated track record analysis, and a more in-depth qualitative review of a GP’s investment style and deal-sourcing capabilities, LPs can more accurately project return persistence. Also, a deeper investigation of a GP’s policies and protocols around compliance, governance and investor disclosures will indicate whether the LP-GP relationship is sustainable.

LPs’ quantitative analysis of GP track records is aimed to answer a single question: Can this manager consistently manage risk and outperform over long time horizons? These efforts are supported by advanced cash flow modelling and other technical advances, while also still relying on old-fashioned Excel wizardry. LPs also rely on the accuracy and hygiene of GP data rooms, as well as public and private benchmark data at both the fund and portfolio company levels. More recent advances in track record analysis software give LPs an edge in identifying managers that outperform their peers and create sustainable value within their investment portfolio.

LPs seek out managers that align with, and contribute to, their organisation’s overall portfolio construction strategy and investment objectives. The due diligence phase presents the opportunity to test the manager’s ability to fulfil that expected role in the overall portfolio, by reinforcing an LP’s understanding of a GP’s investment focus, sourcing network, operational expertise and market outlook. Further, due diligence provides LPs with the blueprint for post-commitment monitoring, including ways to assess whether a GP’s focus is maintained on the same objectives that were communicated, pre-commitment.

LPs have learned that a manager’s culture is a key predictor of future success. Interviews with key personnel, including representatives from a range of responsibilities and seniority levels within an organisation (for example, partners, operating partners, back office and junior investment staff), are critical to assess organisational culture. These interviews can confirm that policies regarding compensation, human resources and investment approval are structured to properly incentivise staff, and that investment opportunities are fairly sourced and evaluated. LPs are also sensitive to the GP’s external culture, defined by its relationship with its LP base. Therefore, key economic terms, including management fees and the waterfall, must strike the right balance between the viability of the manager and keeping the GP focused on maximising value for LPs. LPs must leverage their due diligence efforts to understand the nuances of a GP’s organisational structure to determine if this balance is optimised.

Foreword

To establish the trust needed to warrant multimillion-dollar commitments from individual LPs, GPs must demonstrate that their fund will remain the LPs' primary obligation, that investments will be fairly valued and allocated, and that they have the necessary safeguards to ensure that their employees will behave in a responsible manner. The GP must also show a commitment toward establishing similar best practices within its portfolio companies. To gain comfort with all of the above, LPs will vet several limited partnership agreement terms and organisational policies, including key person, valuation, expenses, disclosures, co-investing, personal trading, sustainable investing and anti-money laundering.

As investment objectives and oversight of private equity plans have become more sophisticated, LPs have increased the number and depth of their due diligence questions. The unintended consequence of this increase was the proliferation of unique, yet similar, due diligence questionnaires (DDQs) developed and used by individual LPs. Despite similarities within these custom questionnaires, there was enough variation in the questions to prevent GPs from responding in a single format. This created a significant administrative burden, which distracts GPs from their core priorities. To alleviate this bottleneck, the ILPA issued guidance in 2013 that streamlined DDQ processing. The ILPA DDQ provides a format, question bank and data points for GPs to proactively address the majority of LPs' diligence needs. It was built in consultation with the broader industry and reflects questions from a cross-section of pre-existing DDQs. The results of this initiative have been promising. The ILPA's preliminary, internal research suggests that approximately 30 percent of ILPA members' GPs have adopted the ILPA DDQ so far.

In September 2016, the ILPA DDQ was refreshed to reflect the ILPA's recent guidance on the disclosure of fees, expenses and carried interest, as well as the guidelines issued by the Principles for Responsible Investment (PRI) related to incorporating ESG-related questions into due diligence.

This book is a welcome addition to the canon on due diligence. The expert contributors featured, individually and collectively, have done much to move the science, and art, of due diligence forward. □

Peter Freire was appointed chief executive officer of the Institutional Limited Partners Association (ILPA) in June 2015, with the mandate to grow and diversify the ILPA's membership and to enhance the value of the organisation's research and educational offerings to its members. Prior to joining the ILPA, Peter had a successful 18-year career at the Corporate Executive Board (CEB), where he was responsible for CEB's global portfolio of HR businesses, principally the Corporate Leadership Council. He was also responsible for CEB's businesses in a number of regions outside of North America, including Asia Pacific. More recently, Peter was a managing director and member of the Executive Committee at the World Economic Forum. He has also served as an advisor and consultant to several start-ups and private companies operating subscription-based business models, primarily in the human capital/talent management fields. A Fulbright Scholar, Peter earned his BS in Economics from the London School of Economics and his MBA from Harvard Business School.

Introduction

When looking at the current private equity fund landscape, we often forget how new the sector is as a financial asset class and how differently it is structured from many other sectors of the financial markets. Until 1978, when the US Department of Labor introduced its 'prudent man' interpretation of the ERISA regulations, these funds were basically a cottage industry, with small amounts of money raised in blind-pool vehicles managed by small teams of general partners (see Table I). Most of these investment vehicles were limited-life partnerships, meant to be self-liquidating and not permanent.

Table I: **A brief history of private equity: Key milestones**

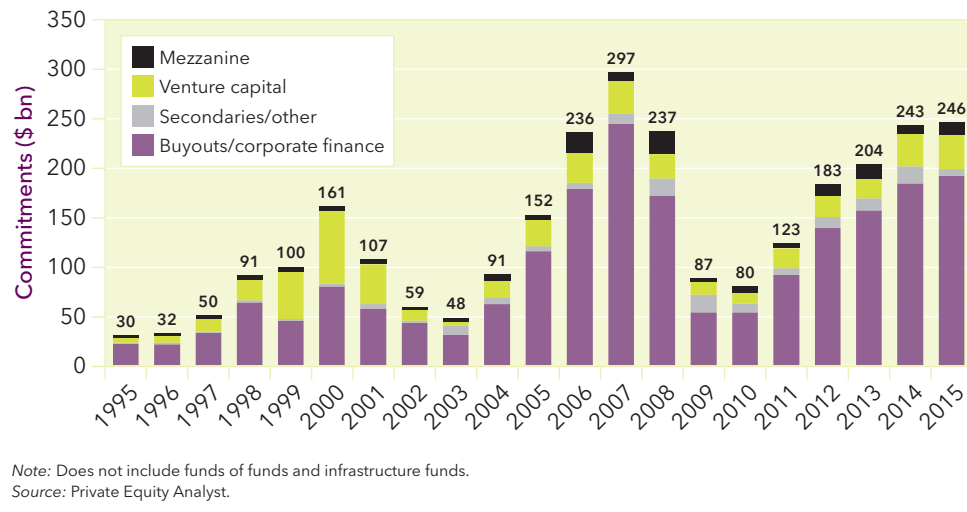
1946	American Research and Development Corporation (ARD) founded by George Doriot and JH Whitney & Co. founded by Jock Whitney; institutional private equity investing begins, though it starts slowly.
1968	Bull market for IPOs; ARD takes Digital Equipment Company public, generating an IRR of 101%, raising the profile of venture capital.
1972	Kleiner Perkins raises \$8.5 million for its first venture capital fund.
1976	The firm that will become Adams Street opens the Institutional Venture Capital Fund, its first fund of funds, with \$60 million.
1976	KKR raises its first buyout fund, with \$31 million in commitments.
1978	US capital gains tax rate slashed from 49.5% to 28%, increasing interest in long-term investments; US Department of Labor clarifies that pension plans can invest in private equity, dramatically increasing the potential supply of capital.
1980	Total commitments raised for North American and European private equity: \$2.5 billion.
1982	Pantheon Ventures of the UK raises its first fund of funds.
1982	Apax raises its first fund of £10 million focused on venture capital; firm later shifts to a buyout focus.
1982	JAFSCO raises its first Japan-focused venture capital fund totalling ¥1,600 million.
1985	Permira of the UK raises its first fund totalling £75 million.
1987	Venture Capital Fund of America raises its first dedicated secondaries fund totalling \$13 million.
1988	The team that would found Oaktree Capital Management raises its first distressed debt fund while at TCW, the TCW Special Credits Fund I, totalling \$97 million.
1990	Total commitments raised for North American and European private equity: \$19.5 billion.
1998	Grove Street Advisors launches California Emerging Ventures, the first in a series of three large separate accounts for CalPERS.

Table I: **A brief history of private equity: Key milestones** *continued*

2000	US venture capital fundraising hits \$74 billion at the height of the Internet bubble, the largest amount ever raised for venture capital in the largest market; the collapse of the bubble leads to a steep decline in venture capital fundraising.
2000	Total commitments raised for North American and European private equity: \$306 billion.
2006	Blackstone raises the largest private equity fund of all time, Blackstone Capital Partners V, at \$20.4 billion.
2007	Fortress becomes the first private equity management company to go public, followed quickly by Blackstone.
2007	Apax Europe VII raises €11.2 billion for the largest pan-European fund ever raised.
2007	Fundraising in the US reaches an all-time peak in advance of the Global Financial Crisis (GFC); European fundraising hits its peak the following year.
2008	Oaktree Capital Management raises the largest distressed debt fund ever, OCM Opportunities Fund VIIB, with \$10.9 billion in commitments.
2010	In reaction to the GFC, the Dodd-Frank Act is passed in the US - part of the Act requires private equity funds over a certain size to be regulated by the Securities and Exchange Commission.
2010	Gávea Investment Fund IV, the largest Latin American fund raised to date by a local manager at \$1.8 billion, targeting Brazil.
2010	Total commitments raised for North American, European and Asian private equity: \$140 billion; fundraising is dramatically impacted by the GFC.
2011	Alternative Investment Fund Managers Directive (AIFMD) is passed in the European Union; it introduces a wide swathe of new regulation for private equity fund managers in the EU.
2011	Fundraising for China-focused funds peaks at \$36.7 billion, with over 60% of that total raised for funds denominated in renminbi.
2014	Largest African-focused fund, Helios Investors III, raises \$1.1 billion.
2015	Largest locally headquartered Asian-focused fund raised, RRJ Master Capital Fund III, at \$4.5 billion.
2015	Lexington Capital Partners VIII raises \$10.1 billion, the largest specialty secondaries fund ever raised.

The adoption of the prudent man rules, and the development of leveraged buyouts in the US in the 1980s, led to a slow but steady transformation of the sector into an asset class increasingly backed by large institutional investors. Figure I provides some insight. The US private equity market is the deepest and longest lived private equity fund market and provides an excellent snapshot of the growth of the market. However, even with increased activity in the 1980s, fundraising in the US did not rise above \$25 billion in annual commitments until 1995. Over the past 20 years fundraising has grown dramatically. It surged with the Internet bubble and in the run up to the Global Financial Crisis, plunged as the public markets collapsed in late 2008 and in 2009, then rebounded strongly thereafter.

Although not detailed in Figure I, private equity began to expand rapidly in Europe in the late 1990s, and in Asia and other key emerging markets since 2005. As the sector

Figure I: **Commitments to US private equity partnerships by sector, 1995-2015**

has grown in both size and geographic coverage, it has become more complex. Managers are overseeing series of funds and fund strategies developing from generalist buyout and diversified venture capital vehicles, to specialist sector strategies and new sub-sectors such as distressed, secondaries and co-investment.

Even as it has grown and developed, certain things about private equity have not changed:

- ***It is an inefficient asset class.*** The 'efficient market theory' developed by academics to explain returns in publicly traded securities simply does not apply for a variety of reasons to private equity. That is evident in the very wide spread between top quartile and bottom quartile fund returns within the various private equity strategies.
- ***It is illiquid.*** The vast majority of private equity structures are illiquid. Even with the development of the secondaries market, these structures make it much more difficult to exit an investment than it is in the public markets. Prices are negotiated, and not independently set by a mark-to-market value because no mark-to-market value exists.
- ***Activist strategy.*** Especially in core private equity strategies such as buyouts, growth capital and venture capital, the best managers are the ultimate activist investors. Investment success comes not simply from deciding to invest in a company and at what price, but from serving on the company's board of directors. Managers take an active role in deciding company strategy, reviewing operations to make them more efficient, and firing and hiring company management when necessary.
- ***Manager selection drives returns.*** The combination of these factors means that fund manager selection drives an investor's returns. An investor cannot simply allocate capital to European middle-market buyouts or life science-focused venture capital and expect success.

Introduction

For these reasons, intensive fund due diligence is necessary in private equity - not only to target the highest performing funds, but also to avoid potential disasters.

This edition of *Private Equity Fund Investment Due Diligence* gathers a very experienced group of practitioners to share their views on various elements of fund targeting, due diligence and selection. They are not professional writers but professional investors and consultants with deep knowledge of the subject matter. Many of them have turned to writing 'after hours' in order to share their experience, and any success this book has is due to them. □

Kelly DePonte

August 2016