PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

PRIVATE EQUITY FUND INVESTMENT DUE DILIGENCE

Strategies for evaluating and selecting top performing fund managers

Edited by
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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 aims 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.

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	JAFCO 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.

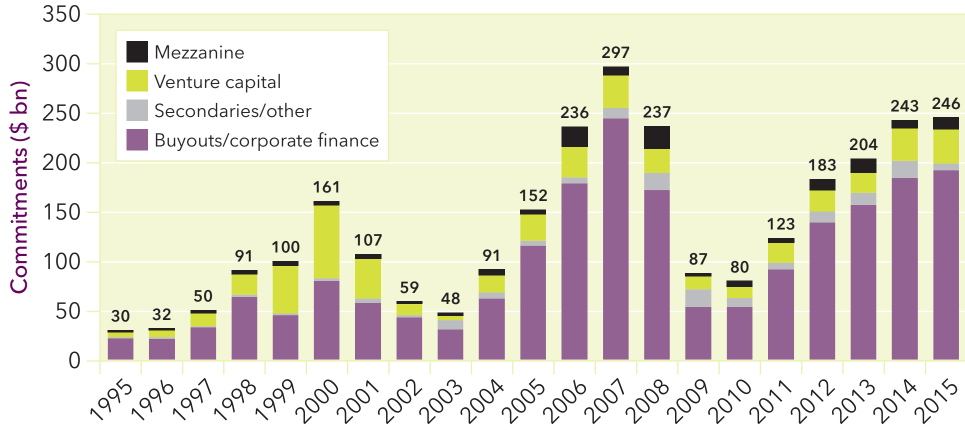
Table I: **A brief history of private equity: Key milestones** *continued*

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**



Note: Does not include funds of funds and infrastructure funds.
Source: Private Equity Analyst.

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.

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. □

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