AltAssets Research

BVCA investing in enterprise

Understanding UK Institutional Investors

March 2003

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1. EXECUTIVE SUMMARY

Private equity has tested the extremes in recent years. It rode on the crest of the late 1990s technology wave and was turned inside out as the market crashed. Institutional investors, however, remain convinced of its essential rationale. Good private equity firms are capable of generating superior risk-adjusted returns even in the most testing of conditions. The theme of the last couple of years and the likely theme of the next few will be a return to more traditional patterns of investment, with the buy-out sector restoring its ascendancy over venture capital and early-stage investing. Expectations are drifting back down to more sustainable levels and discipline is being rigorously reinforced. Hyperbole from the boom times lingers as an embarrassment; professionalism has become the new mantra. Institutional investors still like private equity but there is a new atmosphere around the asset class.

Nearly 40 per cent of respondents said they expected to increase their allocation to the asset class over the next two years, pushing the average allocation from just above three per cent to about four per cent over that time.

Their expectations amount to a strong endorsement of the asset class in the context of the tough market environment over the last few years. They acknowledged the difficult operating conditions that were likely to prevail over the period but said they were attracted by private equity's capacity to generate absolute returns, even against the backdrop of weakening public markets.

The overwhelming reason for investing in private equity is considered to be its capacity to deliver superior risk-adjusted returns although it is also judged to be an important way to diversify a portfolio.

Institutions also think there are good non-financial reasons for investing in the asset class, such as boosting entrepreneurship and supporting regional development ambitions. However, these are widely considered to be an added bonus rather than a primary motive for investing.

The survey's respondents have a historical average annual net return on their private equity investments of nearly 20 per cent.

Over half of them described their returns experience as good or very good and the rest said they had been adequate. None of them said they had been poor. Those institutions that had been investing since before 1990 were even more positive about their experience. Overall, investors expect returns over the next five years to average closer to 13 per cent but they still regard that as good in the context of the likely performance of other asset classes.

The defining trends over the next five years are expected to be consolidation among private equity firms, weaker returns and greater comparability of data.

Investors think the effect of the ongoing purgative experience will be to unwind the imbalances created during the late 1990s and to lay a more solid set of foundations for the asset class generally. However they expect profoundly different conditions in different parts of the industry: buy-out firms look much better positioned to weather the forthcoming period than venture capital firms.

Investors' main frustrations with the asset class are the lack of transparency, the lack of liquidity and the expense of investing in funds.

However, none of these is considered insuperable. Investors said they were fully apprised of all these issues before first investing and none of them came as a surprise. In fact, most of them are defining features of the asset class and sometimes even part of the reason private equity is capable of generating atypical returns.

For investors, the transparency issue relates to their ability to interpret or compare fund data and not, as the term is widely employed in the media, to the question of disclosure.

Although more than two-thirds of investors said they would like the private equity industry to do more about transparency, they were almost unanimous in saying that it was not as profound a problem as recent media coverage has suggested. In essence, it boiled down to a desire to have more comparable performance data. Among other improvements, they said they would like to see a stronger investment consultancy industry, lower fees, and a greater level of expertise among trustees.

More than half of investors complained about the resource demands of private equity investing.

They said that many private equity firms were not sufficiently sensitive to these demands and did not fully understand why it sometimes took them as long as it did to reach investment decisions. Many of those that complained, particularly the relative newcomers to the asset class, said the resource demands had persuaded them to use funds of funds as a means of outsourcing some of the workload.

2. INTRODUCING UK INSTITUTIONAL INVESTORS

UK institutional investors in private equity come in different shapes and sizes. There are large institutions that have sophisticated investment strategies managed entirely in-house. There are small public pension funds that outsource almost all the investment decision-making. There are firms that have been investing for years and firms that are complete novices. Consistent patterns of behaviour, however, belie all these differences and there is a certain predictability about their private equity programmes. Identifying those patterns is the key to understanding how best to approach the different categories of investor.

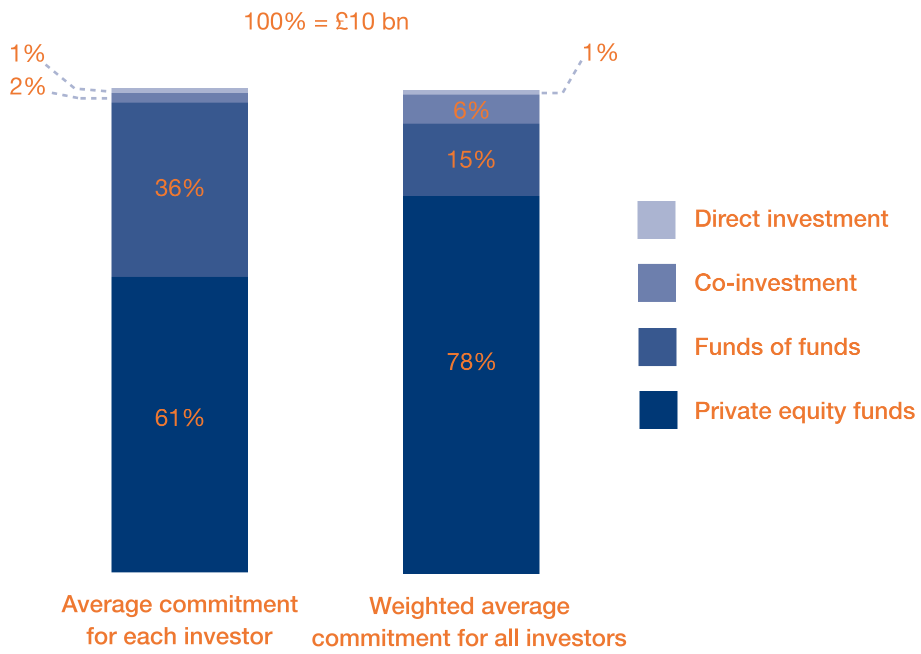
The average UK institutional investor

▲ The average UK investor allocates about three per cent of total assets to private equity

The average UK institutional investor has a strategic allocation to private equity of just over three per cent of total assets under management and commitments worth about £330 million. They have been investing in the asset class for more than ten years and are satisfied, often pleased with their returns over that time. That is even allowing for the brutal downturn that followed the collapse of the technology bubble in 2000 and the general weakness that has seeped across from public equities. Most of them, after all, are fully alert to the long-term nature of the asset class.

Their pedigree depends to a large extent on the type of institution. Asset management firms and insurance companies, for example, are generally the most experienced of investors, often dating their interest in private equity back to the early 1980s. Some of the corporate and public pension funds also stretch their involvement back into the dark ages of the asset class but most started investing over the last decade. Banks are also relative newcomers, mainly because their motivation is often strategic and there has not been enough activity in the market until recently to make it worth their while.

Figure 1. SHARE OF COMMITMENTS TO DIFFERENT TYPES OF INVESTMENT



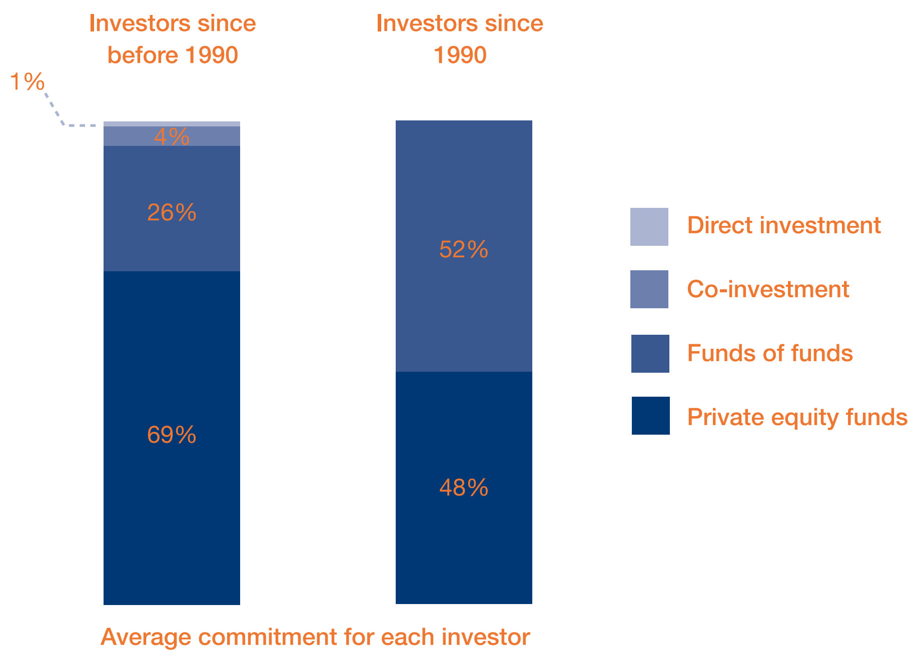
Source: AltAssets Research

The two main constituents of any investor's private equity portfolio are primary funds and funds of funds. Figure 1 shows that the average portfolio is made up of about 61 per cent primary funds and 36 per cent funds of funds. There is a negligible amount allocated to co-investments and direct investments. Most investors do not get involved in direct or co-investments but some of the more experienced investors make small allocations to supplement the bulk of their programme.

▲ The largest part of most portfolios is made up of primary funds...

There is, however, a significant difference between this average allocation and a weighted average commitment for all investors - in other words the breakdown of the aggregated commitments of all respondents. The value of analysing the weighted commitments is to see how the entire UK private equity programme is allocated and to get a better sense of how large investors construct their portfolios. The second column of Figure 1 shows a much bigger proportion of capital is allocated to primary funds than is the case in the average portfolio. This is entirely at the expense of funds of funds. There is also a bigger commitment to co-investments, reflecting the strategy of some of the larger investors.

Figure 2. SHARE OF COMMITMENTS TO DIFFERENT TYPES OF INVESTMENT, BY AGE



Source: AltAssets Research

Figure 2 shows a similar phenomenon. Experienced investors, many of whom are also among the largest, are much less likely to invest in funds of funds than newcomers to the asset class. This is simply because the main function of funds of funds is to service investors that might not have the resources, the expertise, or the inclination to make their own fund selections. These might be small investors who want a diversified portfolio but do not have the capital to make enough individual commitments. Or they might be inexperienced investors making their first forays into the asset class and eager to buy in some market knowledge.

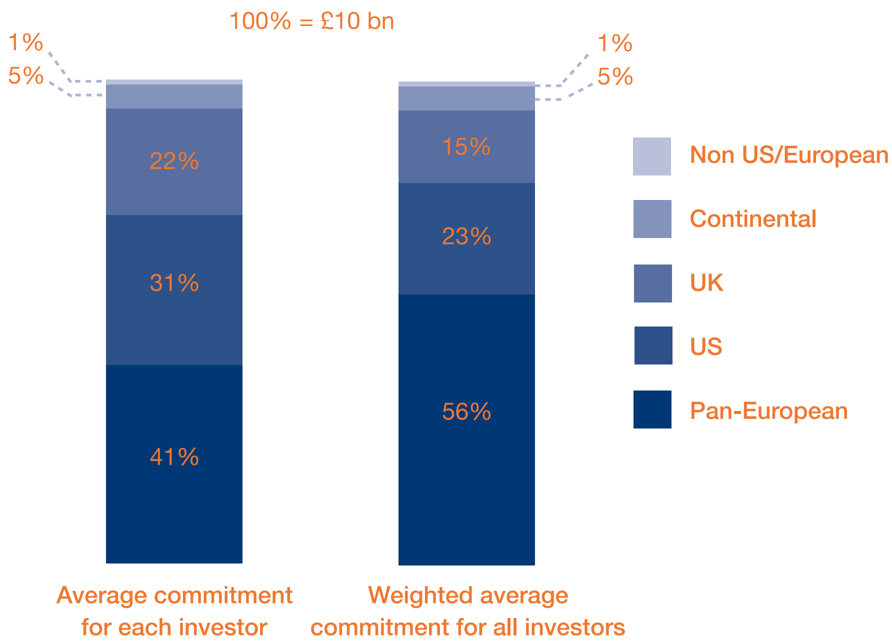
▲ ...but less experienced investors generally have a significant commitment to funds of funds

The absence of a developed intermediary sector of advisors and gatekeepers is a conspicuous difference between the US and Europe. Instead of employing a gatekeeper to advise on fund selection, UK and continental European investors are often driven to invest with a fund of funds instead to achieve the same result. One local authority pension fund said it had tendered for either a gatekeeper or a fund of funds and was left with little choice but to settle for the latter:

"We put out tenders for gatekeepers, advisors and funds of funds but the market only really presented funds of funds. The first search in 2000 was at the peak of the boom and people seemed to have bigger fish to fry... Then we tendered again in late 2001 or early 2002 and got 22 submissions. Only three were from gatekeepers. Only one was short-listed.

"I think there was an issue that our business wasn't big enough. But it was also our first foray into private equity so we wanted to be sure that we were being advised by someone experienced and with a good track record. We short-listed a gatekeeper but they didn't convince us they could add much."

Figure 3. SHARE OF COMMITMENTS TO DIFFERENT REGIONS



Source: AltAssets Research

▲ Pan-European funds account for the largest share of geographical allocations

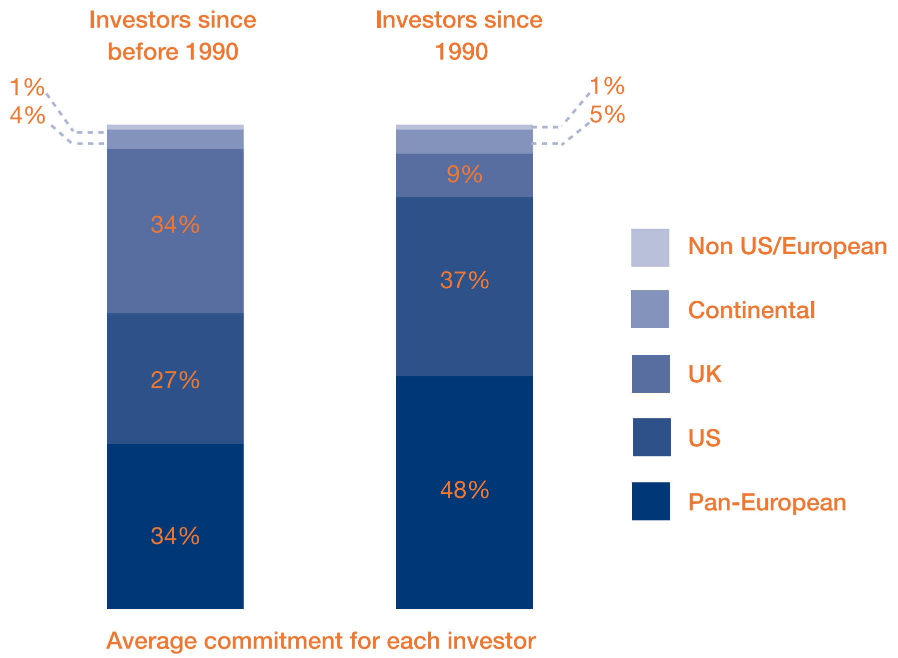
The average UK investor allocates roughly 40 per cent of commitments to pan-European funds, 30 per cent to the US and 20 per cent to the UK. (See Figure 3.) Continental European country-specific funds account for only about five per cent of the portfolio, reflecting their relative novelty. Investors have traditionally been comfortable getting their exposure to the Continent through pan-European funds, many of which originate in the UK. That is gradually changing as the local continental markets mature and country-focused funds grow in number and experience.

The importance of the US in the average portfolio reflects the size of its market and its far greater maturity than other parts of the globe. It is particularly important for venture capital and early-stage investing. Despite the violent downturn in the US venture market since 2000, its wealth of investment opportunities is still considered a long way ahead of Europe. The UK, the largest European market by a long stretch, also forms a very significant proportion of the average portfolio.

The second column of Figure 3 shows how the breakdown changes when it is weighted by the size of commitments. Pan-European funds become much more important at the expense of both the US and the UK. Again, this is mainly because the large and experienced investors have traditionally made substantial commitments to the large pan-European buy-out funds. It also reflects the fact that many of these firms started life as more modest UK operations. The fall in the US total may also result from the fact that a lot of newcomers to the asset class, most of whom were small investors, had a disproportionate interest in the booming venture sector.

It is significant that in both instances, whether in terms of the average portfolio or the breakdown of aggregated commitments, non-European and non-US funds are negligible. Most UK investors do not acknowledge the existence of a private equity industry outside Europe and the US. There is some activity in Asia and slightly less in Latin America, but they are generally regarded as unproven markets and far too risky.

Figure 4. SHARE OF COMMITMENTS TO DIFFERENT REGIONS, BY AGE

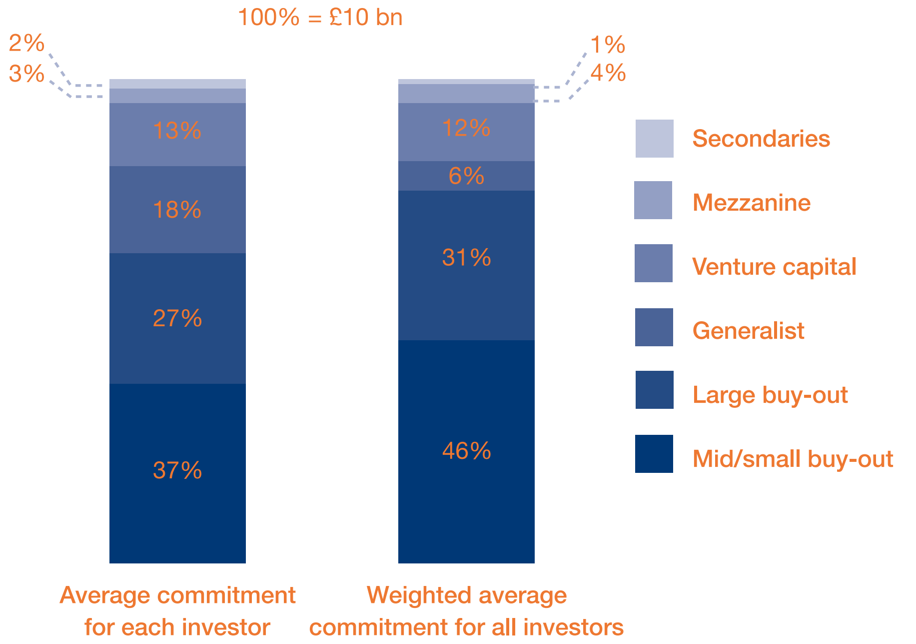


Source: AltAssets Research

Investors who have been investing since before 1990 generally have larger allocations to the UK than more recent investors. (See Figure 4.) Some 34 per cent of their portfolio is committed to UK funds, another 34 per cent to pan-European, and 27 per cent to US. The size of UK commitments presumably reflects the fact that many of these investors would have started their private equity programme with UK funds. More recent investors have much larger US allocations, again because many of them moved into private equity in the second half of the 1990s to take advantage of the booming US technology markets.

Pan-European funds are often considered as low risk because they offer immediate regional diversification. Some investors also feel the UK market is more crowded and therefore less attractive than continental Europe. Neither group makes meaningful commitments to non-US or non-European funds.

Figure 5. SHARE OF COMMITMENTS TO DIFFERENT STAGES



Source: AltAssets Research

▲ Small and mid-market buy-out funds are the most popular stages

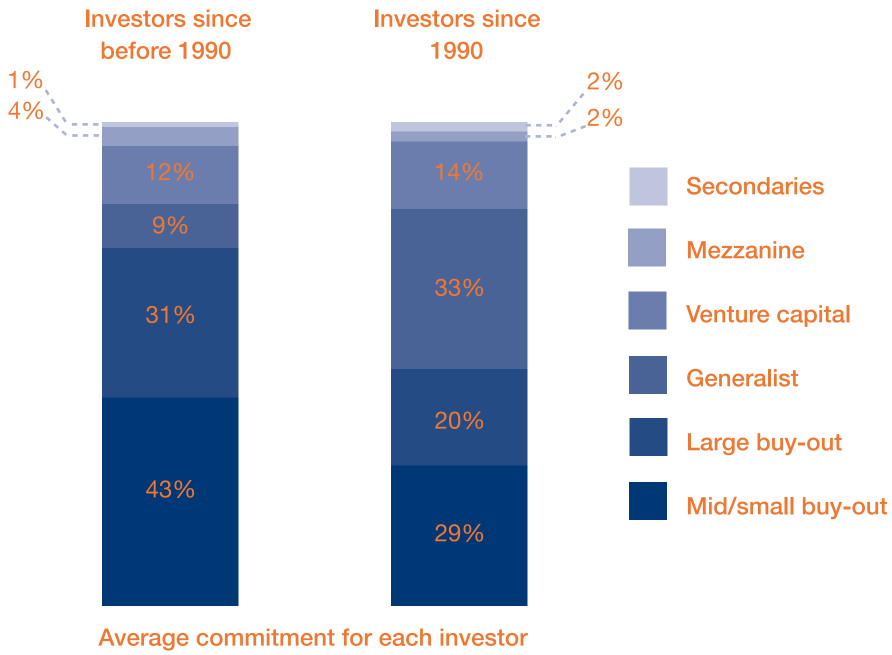
Small and mid-market buy-out funds are the most popular stage of investment among UK investors, accounting for about 37 per cent of the average portfolio. (See Figure 5.) The small and mid-market sector of the buy-out market is judged to include all deals with an enterprise value of less than £500 million. Anything above that is classed as a large buy-out.

Investors think the mid-market is attractive at present because it is not subject to the same competitive pressures as the large end of the market, where most of the deals are auctioned and fought over by well capitalised US and European funds. There is also thought to be a rich supply of investment opportunities across Europe, ranging from family-owned businesses looking for new financing to spin-offs from major corporations.

Despite mounting concerns about competition, particularly since the arrival of big US players such as KKR or Clayton, Dubilier & Rice, the large buy-out funds still form the second largest part of the average portfolio. This is followed by generalist funds, which allocate across the buy-out and venture sectors. Dedicated venture capital funds represent about 13 per cent of the average portfolio, although this is likely to have slipped over recent years.

The composition changes when it is weighted by the value of commitments. Mid-market fund investments assume even greater importance, accounting for 45 per cent of total commitments. Large buy-out investments are also slightly more popular. Both these changes are mainly at the expense of generalist funds. Venture capital accounts for about 12 per cent of total UK commitments.

Figure 6. SHARE OF COMMITMENTS TO DIFFERENT STAGES, BY AGE



Source: AltAssets Research

Experienced investors commit an average of 43 per cent of their capital to mid-market buy-out funds and 31 per cent to large buy-out funds. Venture capital accounts for some 12 per cent on average, and generalist funds only nine per cent. By contrast, less experienced investors commit about a third of their capital to generalist funds. They are considered an effective way of diversifying a smaller portfolio, promising investments in buy-outs and some venture. Small and mid-market buy-out funds are the most popular dedicated buy-out vehicles, followed by large buy-out funds.

3. REASONS FOR AND AGAINST INVESTING IN PRIVATE EQUITY

The pre-eminent reason for investing in private equity is its capacity to deliver superior risk-adjusted returns. The survey respondents were unanimous in endorsing the financial attractions, albeit emphasising the need for a genuinely long-term strategy and sensitivity to some of the idiosyncrasies and frustrations of the asset class. Indeed, investors are never short of grumbles about private equity; whether it is the lack of transparency, the cost of management fees, or the resource demands of investing. None of them are grievous enough to outweigh the substantial upside but the industry has some reputational issues that need to be addressed.

Reasons for investing

Figure 7. REASONS FOR INVESTING IN PRIVATE EQUITY

Source: AltAssets Research

▲ Historical performance is the chief attraction of private equity

The historical performance of private equity fund investments is by far the most attractive feature of the asset class. (See Figure 7.) For all the attention on the precipitous slide in returns since the implosion of the technology bubble in the US, a long-term perspective still more than validates the attractiveness of its risk-adjusted returns. Investors say the experience of the late 1990s has distorted the popular perception of private equity and the sort of time horizon over which it is reasonable to expect returns. It also underlies the disillusionment felt by investors that rushed into the market in the second half of the decade to join what they thought would be an interminable gravy train.

Investors also consider private equity to be an effective way to diversify their portfolio. The extent to which the asset class is closely correlated with public equities remains the source of intense debate. The impact on returns of the present paucity of exit opportunities, itself a function of the downturn in public markets, strongly suggests there is a clear correlation, albeit with a time lag. Diversification, however, is still considered a significant attraction of the asset class.

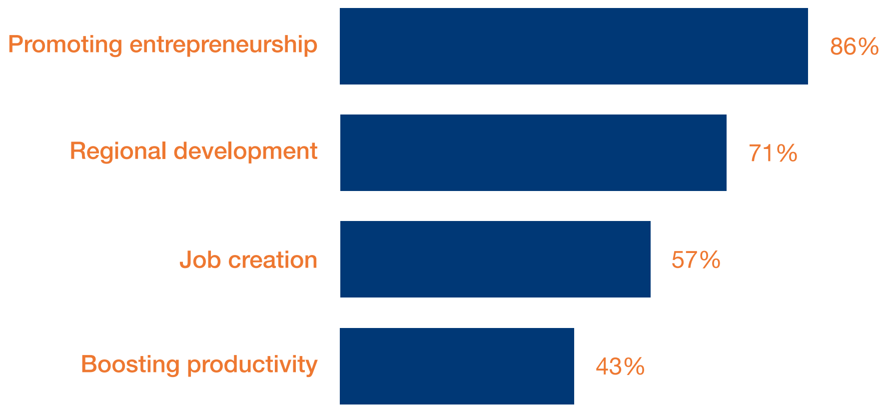
One local authority pension fund said diversification was one of the main reasons it moved into the asset class. "We got into it because we felt that shares were reaching a point where bubble or no bubble we thought we should diversify out of them and spread our eggs." Another investor described diversification as more of a secondary benefit but one that compounded the allure of its returns profile. "Private equity provides a useful diversification of investment risk: if you have a sufficient spread of private equity exposure, through funds of funds or investments in primary funds, then the risk is not excessive and the potential returns are significant," said this corporate pension fund.

▲ It is also appealing as a means of diversifying portfolios

Strategic reasons for investing mainly relate to banks. They often invest in buy-out funds in the hope that the private equity fund managers reciprocate by giving them debt mandates when they finance transactions. All of them ally that strategic motive with a financial motive. It could otherwise be an extremely expensive way of generating deal flow.

Among the other reasons provided by investors for investing in private equity was its ability to provide exposure to the financial benefits of technological progress. "We invest in private equity over the long term mainly to get the benefits of technological innovation. We expect venture to outperform buy-out over the long-term," said one insurance company. Other investors listed simpler attractions among their secondary reasons for investing. "You can have a bit of fun with a small part of the portfolio," said a local authority pension fund. "It's what real investing used to be. It's a terrific asset class," said another.

Figure 8. NON-FINANCIAL ATTRACTIONS OF INVESTING IN PRIVATE EQUITY



Source: AltAssets Research

Non-financial reasons for investing are generally considered an added bonus of private equity rather than a primary motive. Most institutions have liabilities that need to be covered by their returns and cannot afford the luxury of indulging in economic altruism. "At the end of the day we are managing client money and we can't really get involved in softer issues," said an asset management firm. There is, however a widespread conviction that these non-financial reasons are genuine. "The non-financial reasons are basically incidental to our investment decision-making but they are definitely a useful spin-off," said one corporate pension fund.

▲ Investors say private equity benefits the wider economy...

The most significant of these spin-offs is the role private equity plays in promoting entrepreneurship. (See Figure 8.) Encouraging and facilitating the formation of small businesses, which have become the motor of job creation in developed economies in recent years, has long been one of the government's primary economic ambitions. It was also at the heart of the European Union's Lisbon agenda, its collective policy initiative to make the Continent the most competitive knowledge-based economy in the world by 2010. Private equity is widely considered to play a central role in financing and rewarding precisely this sort of entrepreneurial activity.

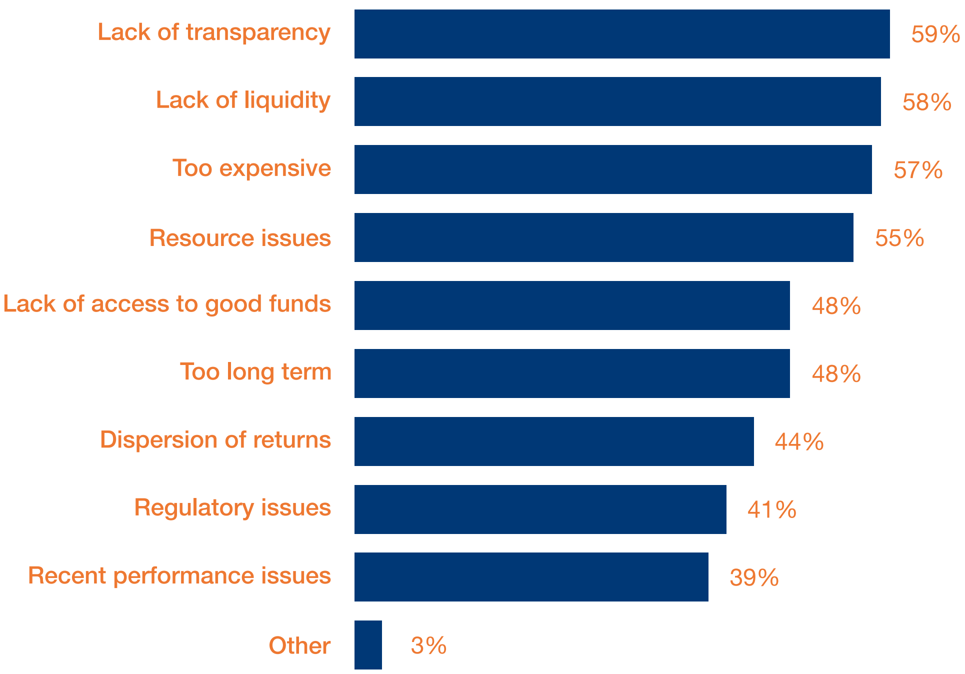
Investors also thought that private equity could have a positive effect on regional development. Locally-focused funds are a relatively new initiative but some established investors have a history of backing funds that, while not regionally-specific, do have a strong presence in particular areas. "Returns are the key feature of our investment strategy but if we can get money into the local economy then we see that as an important element," said one local authority pension fund.

▲ ...but non-financial reasons for investing are secondary

This pattern of investing, however, remains a relative rarity. Another local authority pension fund said it had looked at the possibility of backing regional funds but had not been able to convince the decision-makers that it was possible to marry its financial requirements with its local development ambitions. "There have been proposals made to the investment committee but they have been turned down each time. There is even a local regional fund but it has been turned down three times. There is a feeling that whatever was put into regional funds would just go into urban areas anyway and the premium is not enough given the risks," the pension fund said.

Obstacles to investing in private equity

Figure 9. OBSTACLES TO INVESTING IN PRIVATE EQUITY



Source: AltAssets Research

Investors usually have some form of complaint about investing in private equity but none of the issues are considered insuperable. In many instances they are probably better described as irritants rather than obstacles. In fact, only a handful of the front-runners managed to qualify as 'important' or 'very important' with more than half of the respondents. (See Figure 9.)

Some 59 per cent of respondents said that lack of transparency was an important obstacle, making it the biggest grievance among investors. Transparency is a complex issue in the private equity industry and has been the source of much debate in recent months. In essence, the problem for investors relates to the difficulties they have comparing the performance of one fund with another because of the innumerable ways private equity firms calculate their valuations and the complex timing of capital draw downs. (See Chapter 8 for a more detailed discussion of the issue.)

▲ Lack of transparency is a frustration...

> *"The measurement of how successful or otherwise a fund manager has been is a major problem. It's hard to measure them against one another on the same basis, there is very little data for comparing them, and their figures are never prepared in the same way."*
>
> Asset management firm

"The measurement of how successful or otherwise a fund manager has been is a major problem. It's hard to measure them against one another on the same basis, there is very little data for comparing them, and their figures are never prepared in the same way," said an asset management firm. "Comparability and ranking are extremely difficult compared with any other asset class. You have to look at it very closely but you can never really compare like with like."

The response of investors to lack of transparency is generally to undertake exhaustive due diligence to ensure the information they get from funds makes sense or is in some way comparable with other firms. Where an investor does not feel they can make adequate sense of this information, either because of its complexity or the lack of a meaningful benchmark, they generally outsource the job to funds of funds or gatekeepers. The main function of these intermediaries is, after all, to excel in the business of fund selection.

The lack of liquidity was also considered a significant obstacle. It has assumed even greater importance since the downturn in the market that followed the bursting of the technology bubble in 2000. Suddenly, a lot of investors found themselves holding venture portfolios that were worth much less than they had hoped and were extremely difficult to offload. There is an expanding secondaries market servicing the private equity industry but it remains complex and weighted in favour of the buyer. Other liquidity options, such as securitisation, are still in their infancy and have yet to provide an efficient way for investors to divest under-performing fund holdings.

The cost of investing in private equity funds is a favourite on the conference circuit. The prevailing view is that management fees are too high, particularly now that a lot of private equity fund managers are handling much larger funds than in the past without having adjusted down their fees. This is compounded by the generous share of profits that is usually claimed by managers - the carried interest. Most investors say they are happy to remunerate the firm from the profits but they do not like to see management fees used for anything besides operational expenses.

▲ ...as is the level of management fees

Much of the irritation expressed by investors about fees stems from comparing them with the fees charged in other asset classes. "The expense of investing is a significant inhibiting factor and has deterred us from increasing our allocation. It is fundamentally wrong and a major problem. Fees are much too high," said one corporate pension fund.

> *"Something strange happened in the 1990s. As more players came into the market, so the fee levels increased. You had to wonder why competition wasn't driving fees down."*
>
> Corporate pension fund

Some of the annoyance also comes from the view that fees have not been affected by the greater degree of competition in the market. "Something strange happened in the 1990s. As more players came into the market, so the fee levels increased. You had to wonder why competition wasn't driving fees down," said a corporate pension fund. Other investors were blunter in their judgement of the fee structure. "I have never seen a skint venture capital manager," said a local authority pension fund manager. "It is outrageously expensive," said a corporate pension fund.

Resource issues are also problematic. It is a demanding asset class that rewards expertise and experience and is inescapably time-consuming. This explains the attraction of funds of funds and advisors. (The subject of resources is dealt with in more detail in Chapter 6.)

Most of the other issues are recognised to be intrinsic parts of the asset class. There is, for example, no way around the fact that private equity is a long-term investment. That consideration is elemental to the decision to invest but it is also one of the reasons the asset class is capable of generating such attractive returns. "The holding period is about as long as it gets for any investment. It can easily be seven or eight years. If you invest in two funds with one manager it could cover half your career. In public markets you are lucky to hold onto something for 18 months without seeing a concrete return or otherwise," said one asset management firm.

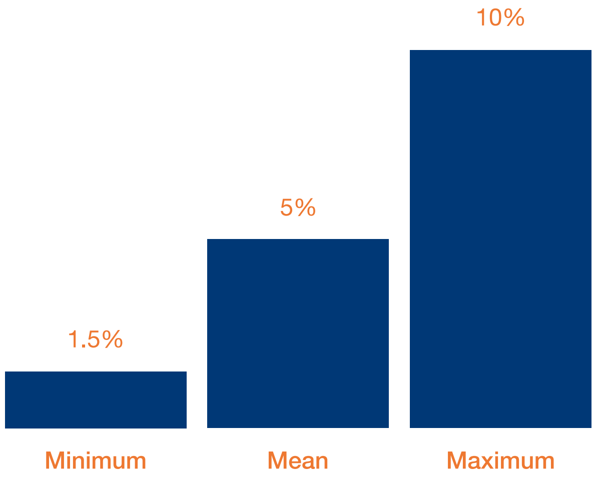
It is precisely this profound, almost cultural difference between private equity and other asset classes that belies the frustrations felt by some of its investors. It takes a long time. It requires a different skill set from other asset classes. It is more difficult to see through the investment vehicle into its underlying components. However these are the same dynamics that enable good managers to generate superior risk-adjusted returns.

4. RETURNS

The survey's respondents have a mean historical return on their private equity investments of nearly 20 per cent, demonstrating the attraction of the asset class to those who are prepared to adopt the right sort of time horizon. Indeed, the breakdown of their returns experience on the basis of the length of time they have been in the asset class only serves to highlight the need for a long-term perspective. However, even those that are relatively new to the asset class were not displeased with their returns. The effect of the late 1990s venture hump will undoubtedly sour returns, but it need not have irreparably damaged a well diversified portfolio.

Target premiums

Figure 10. DISPERSION OF TARGET PREMIUM OVER QUOTED EQUITIES



Source: AltAssets Research

Most investors have in mind a target premium when they make their private equity investments to reflect the additional risk. The mean premium over a broad equities benchmark such as the FTSE-All Share is 500 basis points, but there is a relatively wide dispersion. (See Figure 10.) Some investors, for example, say that the risks of a well-diversified private equity programme are not that much greater than investing in public equities and can be represented by a premium of as little as 150 basis points.

▲ Most investors look for a premium of 500 basis points over public equities...

Other investors take the opposite view. "A risk premium of 500 basis points is not enough to allow for the risks. The money is tied up for ages and you can lose it very quickly. Five per cent is only a bit more than a reasonably good active manager would get in public markets," said an asset management firm.

Whilst an investor's target premium is enlightening about their perception of the risks of investing in private equity, its significance has changed over the last couple of years. The dismally poor performance of public markets has thrown the emphasis onto absolute returns rather than relative performance. Many investors still retain some sort of relative benchmark but its usefulness has been suspended in present market conditions.

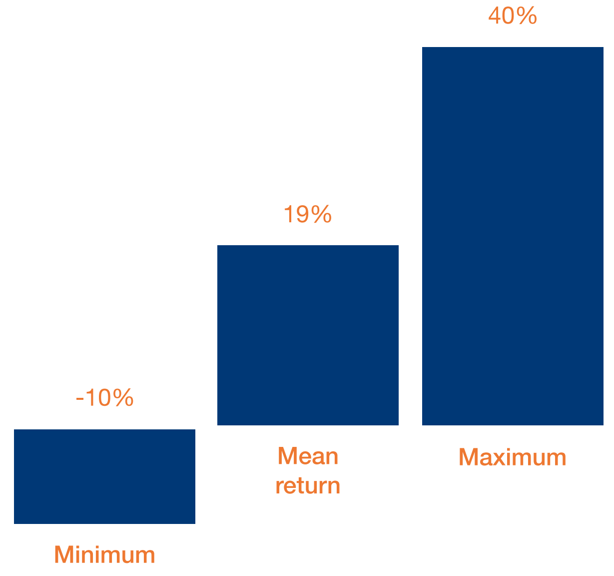
"We target a premium of about four per cent but we expect that to be absolute," said a bank. "We tell the optimiser that we are looking for three per cent over quoted equities but we tell the managers we are looking for five per cent. And we are looking for absolute returns," said a corporate pension fund.

▲ ...but they also target absolute returns

In fact, the capacity for private equity to produce absolute returns even in extreme market conditions has only served to heighten its attraction for some investors. "The performance of public markets in the last couple of years would argue for a more significant allocation to private equity. If you are backing the right people then you should make a positive return regardless of public markets. You can get positive returns even if the markets are flat," said one asset management firm. "Most of the end users, such as pension funds, need growth and not just to outperform the public markets or certain benchmarks."

Historical performance

Figure 11. DISPERSION OF HISTORICAL NET RETURNS



Source: AltAssets Research

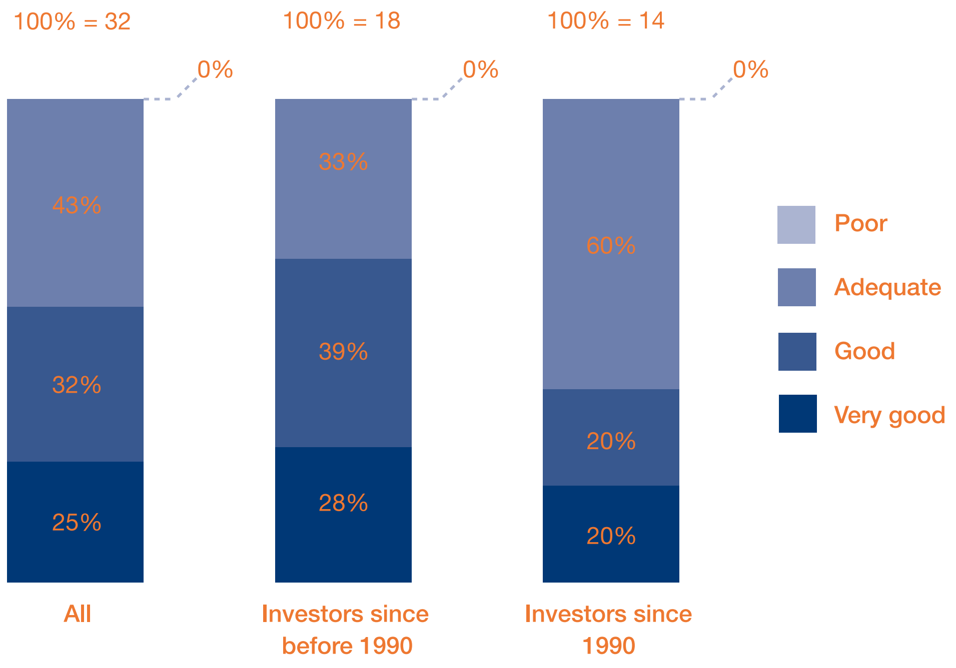
▲ Investors on average have enjoyed a historical net return of almost 20 per cent

The average return among the survey respondents was a net annual 19 per cent. (See Figure 11.) This is very much in line with the 15 to 20 per cent target that most long-term investors think appropriate. However there was a wide dispersion, with respondents reporting returns ranging from negative ten per cent per annum to 40 per cent. The lower returns were reported by investors that had entered the market in the late 1990s. They are suffering from making initial investments at the top of the market, since when valuations have fallen substantially.

The worst hit of all were those with a large exposure to early-stage venture capital. "Recent performance issues have tended to have a disproportionate effect on people relatively new to the asset class and people that rushed into venture," said one asset management firm.

The J-curve effect is an established feature of private equity investing. The early years of a fund's life generally produce nominal negative returns because investments are made some time before any returns are generated. It can be at least three or four years in some cases before funds begin making distributions.

Figure 12. FEELINGS ABOUT RETURNS, BY AGE



Source: AltAssets Research

The newcomers, despite their underwhelming returns, were not unduly disillusioned by their experience with the asset class. They appear to have been fully aware of the risks of judging their investments over such a short timeframe and are hopeful that the troughs of the last couple of years will be significantly outperformed by their commitments to funds investing at presently depressed prices. Figure 12 shows investors' response to their returns experience. Over half described them as good or very good and the rest said they had been adequate. None of them took the opportunity to say they had been poor.

▲ Newcomers to private equity have experienced weaker returns...

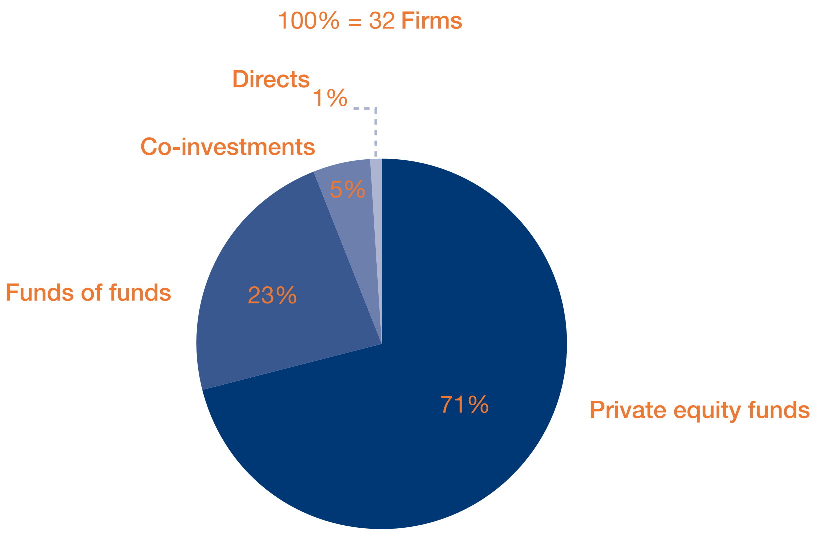
The breakdown between investors that began investing before 1990 and those that began in 1990 or after is also highly instructive. Some 67 per cent of longstanding investors said their returns had been good or very good - with over a quarter saying they were very good. Only 40 per cent of more recent investors were as enthusiastic about their returns. The contrast between the two different groups highlights the necessity of having a genuinely long-term approach to the asset class.

▲ ...but none of them described their returns as poor

By far the most upbeat group of investors was the asset management firms, all of whom were more than satisfied by their returns. There may be an element of sample bias reflected in the result - the success of their business depends on the quality of the returns they generate for their clients so they have a strong vested interest in promoting their fund selection skills. They are, however, generally well-resourced and professional, with plenty of experience and historical performance information about the industry.

The least upbeat investors are public pension funds. Less than half of them said their returns had been good or very good. Much of this is explained by their relatively late arrival into the asset class. Many of them only began investing in the last few years and have therefore suffered the venture hump. They also tend to invest in small quantities, which means they are much more likely to invest with a fund of funds. This adds another tier of fees to the expense and makes it highly unlikely they would also be able to benefit from the positive effects of co-investing.

Figure 13. COMMITMENTS TO DIFFERENT TYPES OF INVESTMENT BY INVESTORS WHO VIEW THEIR RETURNS AS GOOD OR VERY GOOD



Source: AltAssets Research

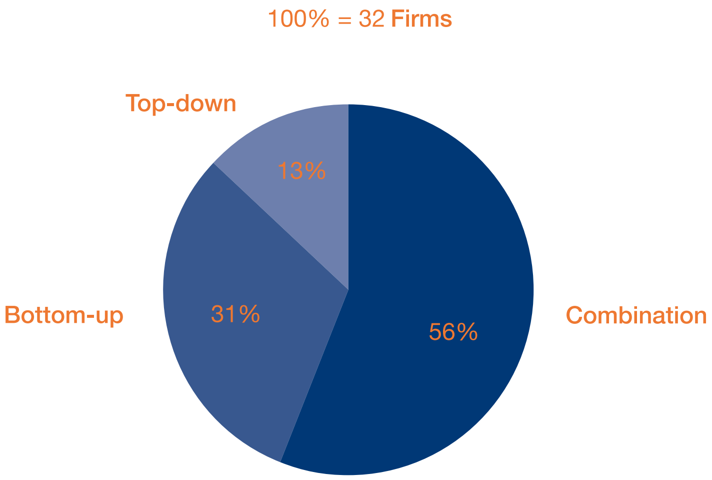
It is clearly not possible to retro-engineer the ultimate private equity portfolio. Much of a firm's future success depends on its preparedness for unexpected future developments. In other words, the right portfolio over the last 20 years would not be the right portfolio for the next 20 years. However it is illustrative to see the rough outlines of the sort of portfolio built by contented investors. Figure 13 shows the breakdown. The most conspicuous element is the high proportion of the commitment to primary funds and the lower than average commitment to funds of funds. The commitment to co-investments is also significant. Some of the strongest performing investors attribute their above average returns to co-investments.

5. THE INVESTMENT PROCESS

Every institution's investment process differs in its detail but there are significant similarities in their generality. The broad structure, for example, follows a similar pattern: sourcing, initial review, due diligence and final review. Investment strategy is less formulaic. Some institutions take a top-down approach to their fund selection - choosing regions or sectors first and fund managers second. Others take a bottom-up approach - purely focusing on the best fund managers irrespective of their investment focus. Most of them, however, are less prescriptive and use a combination of the two.

Investment strategy

Figure 14. PREFERRED INVESTMENT STRATEGY



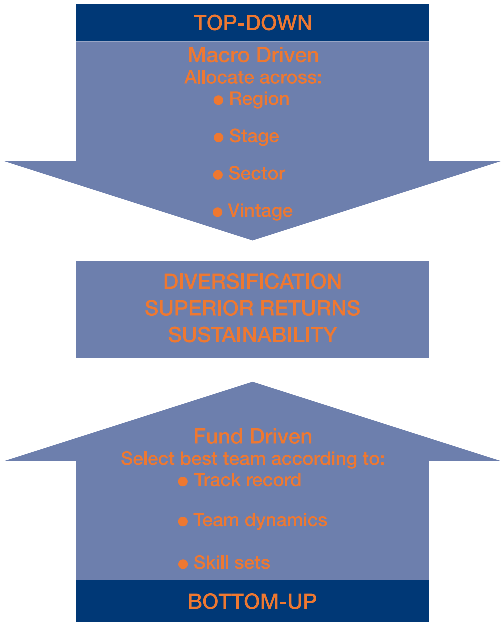
Source: AltAssets Research

Some institutional investors start their fund selection process by reaching a judgment about the different stages, sectors or regional markets. They pick the areas that promise to present the strongest investment opportunities and then look for the most compelling funds within those categories. This is called a top-down investment strategy and is the preferred approach of 13 per cent of UK private equity investors. (See Figure 14.) They are generally experienced and well-resourced investors; probably asset management groups with a deep pool of proprietary research to dip into as part of the decision-making process.

▲ Some investors have a top-down strategy

One such investor described their strategy saying: "It's top-down. We look across all the markets on a five to ten-year timeframe and pick the target markets that we like. Then we do some research on each market, identifying the managers that will be coming to market within the timeframe. Then we do preliminary due diligence and research on the top teams in each market and produce a short-list."

Figure 15. INVESTMENT STRATEGY



Source: AltAssets Research

▲ Others are bottom up ...

Other investors take a different approach, focusing almost exclusively on the quality of the management teams currently available in the market. (See Figure 15.) This is based on the judgment that the best teams can produce returns almost regardless of their operating environment. (There are, however, usually some basic prerequisites about markets and sectors.) This sort of strategy is articulated here by a corporate pension fund: "In the end you have got to believe in the people, in the stability and culture of the firm. Private equity is like any other investment; they are all run by people and there will be some losers and some winners."

▲ ...but most use a combination

Most investors, however, use a combination of approaches, attaching roughly equal significance to the sectors, stages and regions as they do to the quality of the teams. In practice that means ignoring good teams focusing on questionable markets, or missing out on promising markets if they are not served by strong teams. The boundaries between these three approaches are invariably blurred but the distinction remains valid as a means of isolating the different emphases.

Strategic investors are also considered to employ a combination of approaches. They want funds that will both deliver strong returns and channel the relevant business their way. "We choose funds on the basis of the sort of returns we think they will be able to deliver and on the sort of debt deal flow we think they will be able to generate," said a bank.

Investment process

Figure 16. PRIVATE EQUITY INVESTMENT PROCESS

Origination	Screening	Initial review	Due diligence	Negotiate terms	Investment committee review	Final decision
• Screening proactively	• Compile documentation	• Review intial proposal	• Clarify team issues	• Negotiate tax and legals	• Examine in detail	• Approval by board and investment committee
• Remain passive	• Distribute questionnaires	• Co-ordinate peer review	• Review track record	• Agree on terms and conditions	• Prepare final proposal	• Finalise legal issues
	• Meet teams	• Identify issues	• Examine tax and legals	• Discuss special issues	• Perform further due diligence	

Source: AltAssets Research

The investment process varies from institution to institution. It depends on overall strategy, size of the institution, their experience, and any number of other internal dynamics. For example, investors who use a rigorous top-down strategy are much more likely to be proactive about sourcing prospective funds than bottom-up investors. Institutions with large teams are much more likely to do several layers of due diligence, while smaller investors often outsource most of the process to funds of funds or gatekeepers. The volume of deal flow also varies significantly from one investor to another and is a factor in how institutions decide on their investments.

▲ There is a great deal of variety in the investment process

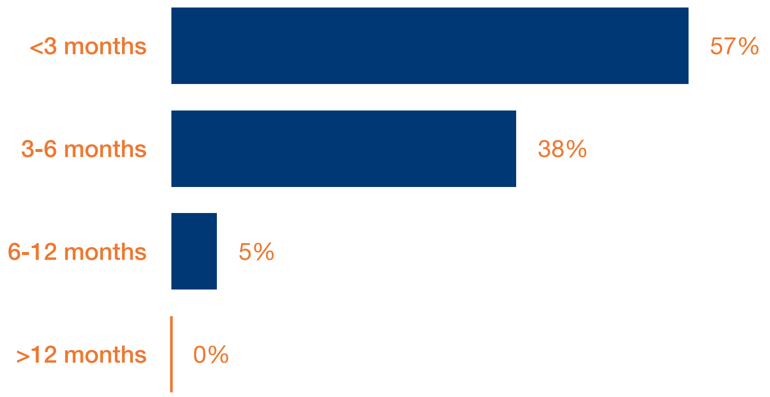
A large asset management firm described its investment process: "First we generate the deal flow, about 120 funds a year. We do an initial screening to weed out the ones that clearly don't meet our criteria and then do some desk research using the PPM (private placement memorandum) and make some preliminary reference calls. From this we produce an initial paper for the investment committee for review. Second phase, we do some detailed due diligence using lawyers, amongst others, and then produce a final recommendation paper for the investment committee. They determine approval."

Another asset management firm emphasised the sort of issues that it tests as part of its investigations. "We look at the type of things that will drive our investment decisions. That means not every little part but the key things that will influence our decisions, such as the investment management abilities, their ability to replicate the sort of returns they have achieved historically. Then we talk about it with the investment committee."

A lot of investors said they had refined their investment process over the last couple of years to take account of the lessons of the late 1990s venture bubble. They also wanted to make allowances for the expectation that the operating environment over the next five years will be very different from the one that characterised the last ten years. The emphasis, for example, is much more on the operational capabilities of buy-out firms than their financial engineering skills.

Time taken to invest

Figure 17. TIME TAKEN TO MAKE INVESTMENT DECISIONS



Source: AltAssets Research

▲ Most investors take longer than in the past

Some investors say they can expedite an investment proposal in a matter of weeks, while others say that it can take them months. Figure 17 shows that most investors claim to reach their final decision in less than three months, but a significant proportion can take up to six months. In general, private equity fundraising now takes a great deal longer than it did during the late 1990s. On average, European buy-out firms now expect to spend at least 12 months fundraising and venture firms expect it to take even longer. Much of that reflects the fact that investors are more demanding.

A more protracted fundraising process can be circular in effect. Some institutions say they take longer to reach a decision point now than in the past, not because they are more diligent but because the private equity firms themselves have adopted a more casual pace. "We usually take about two or three months to make a final decision. We could move more quickly but funds are generally not in a hurry these days as they often have nothing to do with the money," said a corporate pension fund.

6. RESOURCE ISSUES

The resource demands of private equity can be a profound problem for institutional investors. It is a complicated business that punishes short cuts and requires exhaustive attention to detail. More than half of the survey's respondents said that their available resources impacted the decisions they made. Sometimes this meant they could not spend as long exploring potentially attractive investment opportunities. Often it meant they were forced to outsource a lot of the heavy work to funds of funds. Only about one-third of them had chosen to use gatekeepers or advisers to help with their private equity strategy.

Shortage of resources

Most institutions said they did not have enough manpower to do full justice to their private equity investments. Fund selection, due diligence, the investment decision-making process and monitoring existing investments are serious undertakings. The absence of any underlying assets to evaluate, the so-called 'blind pool' problem, makes investigating private equity firms an almost unique exercise for most institutional investors. It can be a heroically demanding asset class, as befits the atypical returns that it can generate.

▲ Investors say their private equity resources are often stretched

Most investors are quick to complain about the disproportionate amount of their time that is taken up by private equity. "We allocated three per cent to the asset class in what we thought was the least time-consuming way and it still took 97 per cent of my time. It can be laborious and difficult," said one corporate pension fund. Most respondents, however, admitted they had not adjusted their views about private equity's demands in line with their returns.

> *"People look at what you can do with listed equities and think you can somehow manage a certain amount of capital with a given number of people. They often don't have an understanding of how resource intensive private equity is as an asset class."*
>
> Asset management firm

The problem generally stems from the fact that institutions' fund investments have historically been a very small proportion of the overall portfolio. Even the largest investors might only have about five per cent of their assets in private equity. So the teams were generally resourced with reference to the sort of size considered adequate for other asset classes. "People look at what you can do with listed equities and think you can somehow manage a certain amount of capital with a given number of people. They often don't have an understanding of how resource intensive private equity is as an asset class," said one asset management firm.

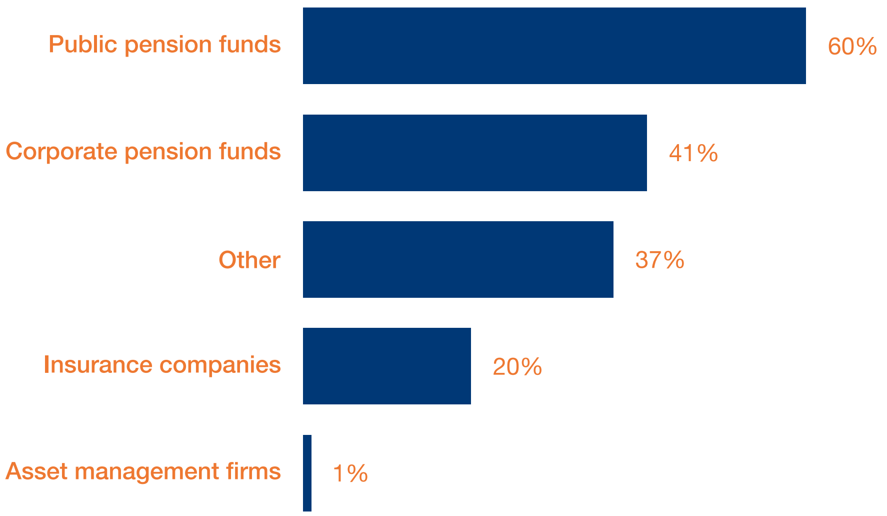
Others had additional problems to contend with. "Resource issues are very big for us. We have had our allocation doubled, taken on more money, and expanded our scope recently. Then there is the issue of there being a lot more funds around than there were ten years ago...Resource issues are also perhaps less obvious in other asset classes. We have about 120 existing positions and look at around 160 new opportunities every year. In addition, two of us are on 14 or 15 advisory boards, each of which take up at least one or two days a year," said one investor.

▲ The main impact of resource issues is the exploration of funds of funds

Of the 55 per cent of respondents that said their resources affected decision-making, most of them said it had forced them into investing through funds of funds. They provide the simplest way into the asset class without having to build a sizeable team, investors said. Using funds of funds enabled them to buy resource, expertise, and an element of diversification. Although the decision was invariably affected by a number of factors, resource was often the most compelling motive.

"Resource issues are the reason for selecting a fund of funds. With a fund of funds you can get money in quickly and achieve diversification without commensurate time commitment," said a corporate pension fund. Another LP stressed the attraction of getting access to the best funds without having to develop that sort of market knowledge himself. "Local authorities don't have the money or expertise to gain access to the top tier of funds. That's why we use funds of funds. We need to develop expertise and then we may start picking specific funds," he said.

Figure 18. SHARE OF COMMITMENTS TO FUNDS OF FUNDS, BY TYPE OF INVESTOR



Source: AltAssets Research

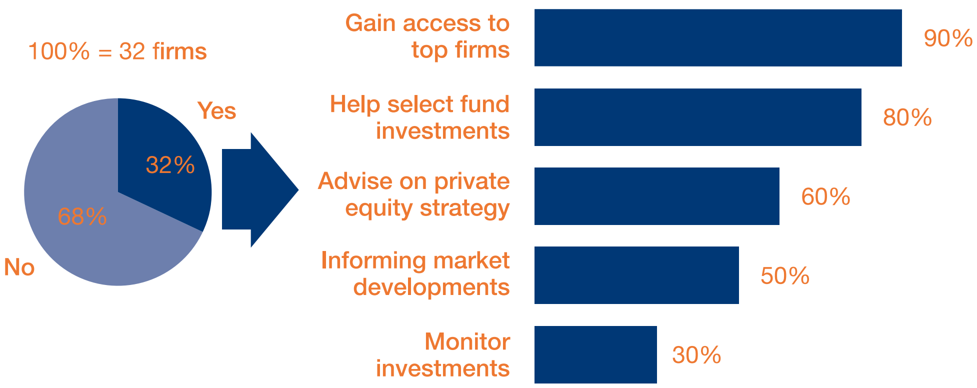
Pension funds are by far the most likely type of investor to use a fund of funds. (See Figure 18.) They are much more familiar with outsourcing their investment mandates than the other institutions and generally have small teams. Most of the different investor groups, however, have some sort of exposure to funds of funds. Many small institutions, for example, do not invest in big enough chunks to qualify for the best private equity firms. Pooling their commitments with other investors in the form of a fund of funds overcomes the problem of size.

Banks and asset management firms were the exception, in that they do not usually invest in funds of funds. Banks often invest in private equity for strategic reasons and investing in a fund of funds would not bring them the benefits of backing primary funds. Asset management firms are in effect already acting as funds of funds for their clients.

Some investors prefer to address the resource demands of private equity by employing a gatekeeper or advisor to help them with their investment strategy. However the role of intermediaries is not as highly developed as in the US, where they are a much more familiar part of the landscape. Over 30 per cent of respondents said they used a gatekeeper. (See Figure 19.) Respondents said the most important function of advisers was to help them gain access to the top funds.

▲ A third of investors use gatekeepers or advisors

Figure 19. FIRMS USING INTERMEDIARIES, AND THEIR PURPOSE



Source: AltAssets Research

Some of the larger investors said there was no simple solution to their resource issues. They managed all their investments in-house and could not simply contract out any of their functions. The only recourse was to limit the geographical or sector scope of their investment or accept that there were funds they would not be able to reach. "We don't spend a lot of time on the US. If we added extra resources we would be free to look more closely at the different regions," said one asset management group.

Another explained that resource demands sometimes meant passing up on attractive opportunities. "Sometimes it prevents us from investing in something in the first place because of the time of closing. We might not have had the chance to do the necessary work before it's too late," the asset management firm said.

▲ There is a scarcity of proven private equity investment specialists

Most investors said they saw little hope of the situation improving over the medium-term, with both internal and external drivers likely to worsen demands on their time. “Looking ahead, resourcing the asset class is going to be important. It is a relatively new investment area for a lot of people and there is a big question about whether there are enough people out there to provide the sort of coverage they need. If investors are not properly resourced then ultimately they will go into the wrong funds and see their returns dragged down,” one institution said.

Another investor complained about a dispiriting recent experience trying to recruit seasoned private equity investment professionals. “There is a relatively shallow pool of expertise. There are a few people out there with about 18 months experience but finding anyone with significantly more than that is difficult,” the investor said.

The imperative for private equity fund managers, in the meantime, is to show a greater sensitivity to these sorts of resource issues than many of them have displayed in the past. “Fund managers sometimes seem to wonder why we do all the work behind our investments and I think they often lack an understanding of what we do,” said one institution.

7. THE COMPETITION FOR CAPITAL

UK-based private equity firms compare pretty favourably with their US and continental European counterparts. There are some subtle differences across a range of criteria but they generally belie the respective maturities of their local industries. UK firms, for example, are considered to be slightly more professional than continental European firms but less so than US firms. In the context of an increasingly global marketplace, at least in regards to fundraising, some homogenisation is to be expected over the years ahead. For the meantime, however, UK-based firms are judged to be well placed to emerge strongly from the competition for capital.

Figure 20. HOW UK PRIVATE EQUITY FIRMS COMPARE WITH THOSE IN US AND EUROPE

	US	Europe
Professionalism	✗	✓
Buy-out returns	✓	–
Venture returns	✗	✓
Reporting standards	–	–
Quality of marketing	✗	✓

✓ Better – Same ✗ Worse

Source: AltAssets Research

The private equity industry is unusually personality-driven. Most firms are small and their culture determined by their handful of founders. That makes it difficult for investors to make comparisons about entire markets. "I wouldn't like to make too much of a distinction because it is so much down to the individual partners," said a corporate pension fund. Experienced investors, however, have been exposed to a large enough sample of firms in each area to express a meaningful view.

▲ UK private equity managers compare well with their international competitors

Figure 20 shows where UK firms were considered to perform better or worse than their counterparts in the US or Europe. By and large, they were judged to fall a little short of the more mature businesses in the US, but slightly outdo their younger competitors in continental Europe. In most instances, the differences were only subtle and in some cases the survey's respondents did not think they were measurable.

Professionalism

Professionalism is a broad term that aims to capture the overall impression that private equity firms make on investors. It encapsulates the resources available to firms, their experience in the market, and the way they present themselves to investors. It does not, however, have a direct relationship with performance. UK firms were judged to be a little less professional than their US counterparts and a little more than their European. This is largely attributable to their age and experience.

"Americans generally have bigger resources and they tend to be bigger and better established. Most of the British firms are reasonably professional but continental Europe is less well developed. It is not so much in the firms themselves, more the markets they are operating in are less well developed for this type of finance. There is less depth of skills. You find some very good guys in there, who compare well with anyone anywhere but then there are also some jokers in the background," said one asset management firm.

▲ There is a wide spectrum of quality

The delicacy of most investors' judgment, even when they came down in favour of UK over continental European firms, was clear in the comment of another asset management firm. "There's quite a broad spectrum in terms of the professionalism of firms. There are good and bad in both. There is a higher proportion of younger firms in (Continental) Europe and the older established firms are often better to deal with in that respect but that's not to say that younger firms are not moving in the right direction."

> *"Americans generally have bigger resources and they tend to be bigger and better established. Most of the British firms are reasonably professional but continental Europe is less well developed. It is not so much in the firms themselves, more the markets they are operating in are less well developed for this type of finance."*
>
> Asset management firm

Venture and buy-out returns

▲ US venture firms are considered stronger...

The general rule is that US private equity firms have historically produced much stronger venture returns than UK firms but UK firms, in turn, have generally done better than the continental Europeans. There are a handful of reasons for that. The US venture industry is more experienced than the UK and even more so than the continental European. US technology sectors are often more advanced and, crucially, more familiar with venture financing. Many continental European high-tech industries are more comfortable with state-backed financing. There are also strong cultural reasons for the far greater fertility of the US venture sector.

Some investors were fairly blunt about the differences. "Venture returns are far better in the US than in the UK and (Continental) Europe. There are probably only a small number of credible venture managers in Europe. In fact, there are probably more credible venture managers on one street in California than in all of Europe," said an asset management firm. The immediate future, however, for the US venture sector may not look quite so bright. "Europe invested a lot less than the US at the top of the market in technologies," said a corporate pension fund.

▲ ...but European buy-out returns have been good historically

Buy-out returns were a different story. The survey respondents said continental Europe and the UK had generally performed better than the US, largely because competition had been less intense and the structure of the local economies still presented a volume of attractive investment opportunities. The outlook, however, was less clear. "Buy-outs have done better in Europe than in the US but we would expect that excess to return to normal over time as the European markets become more efficient," said an insurance company.

Reporting standards

Investors said there were often substantial qualitative differences in reporting standards from one firm to another but failed to identify any regional patterns. Industry guidelines in the US, UK and continental Europe were all considered to be perfectly adequate but their implementation was erratic. “The quality of reporting standards varies hugely. It is very difficult to generalise. There are a lot more new firms in continental Europe and they have often come in at a higher standard,” said one asset management firm. “There are big differences. Some firms go for complete overkill while others seem content with a one-sheeter,” said another.

Marketing material

US firms are generally considered to be slicker marketeers than their UK or continental European counterparts. “US firms are much better. Europe lacks the polish the US has,” said a corporate pension fund. The gap between the US and Europe, however, is closing, providing a telling metaphor for the evolution of the two regional industries. “The quality of marketing material in Europe has improved dramatically over the last ten years. The industry is quickly becoming more sophisticated,” said an asset management firm.

> *“The quality of marketing material in Europe has improved dramatically over the last ten years. The industry is quickly becoming more sophisticated.”*
>
> Asset management firm

Also telling, some investors complained that US firms were often too aggressive in the way they tried to raise their funds. “US firms are more aggressive than UK firms when it comes to marketing. They also seem more inclined to use a placement agent but that can be counter-productive if they are too pushy,” said a local authority pension fund.

Other regional considerations

The increasingly global nature of the private equity fundraising experience is having a profound impact on the industry. Private equity firms are no longer restricted to targeting 'local' investors and can now sell their investment proposition very effectively to overseas investors. That has long been the case for US venture, which has been a destination for European capital in volume since the 1980s, but the capital flows have until recently been less conspicuous in the other direction.

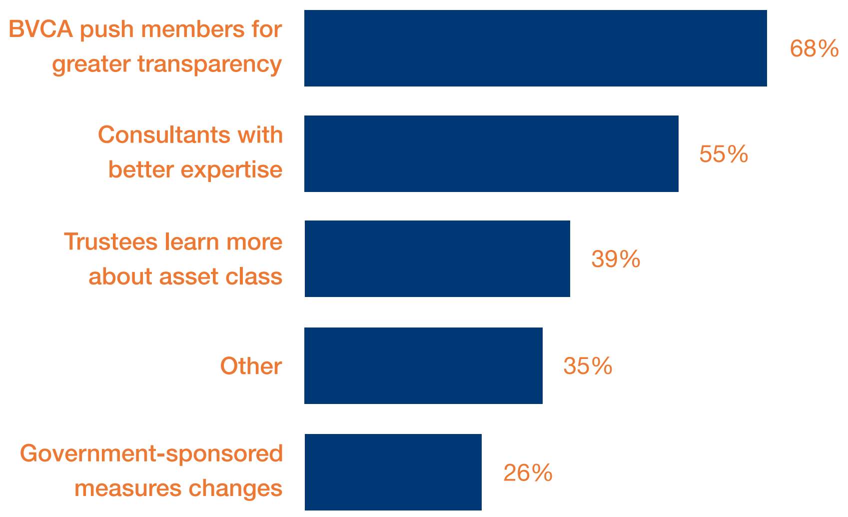
There are still some respects in which geography is relevant to the fundraising process; in the funds of funds business, for example. Some respondents complained that global firms were not always as sensitive to their requirements as they would have liked and the reality of their operations sometimes fell short of their promise.

"We short-listed a couple of big US firms but we felt the UK firms were better balanced in terms of resources. A lot of US firms were based in Chicago or San Francisco and they might have had two or three people in an office in London or Singapore but it seemed very much as if everything was driven out of the US. With the UK firms, we felt we were meeting the people who made the decisions. We were not wholly convinced that the US firms were resourcing the non-US side of the business all that well," said a local authority pension fund.

8. IMPROVING THE ENVIRONMENT FOR INSTITUTIONAL INVESTORS

At the top of the wish list for investors would be a big push by the private equity industry to address their concerns about transparency, by which they mean the ability to understand fund data and not the tangential issue of disclosure. This is followed by an improvement in the quality of information provided by investment consultants, and more expertise on the part of trustees. Less than a third of respondents said they thought there was more the UK government could do, satisfied by the rigour of the Myners report and broadly happy with the regulatory environment. Most investors also acknowledged the importance of the role they had to play collectively in addressing their grievances.

Figure 21. BEST WAYS TO IMPROVE THE ENVIRONMENT FOR INVESTORS



Source: AltAssets Research

The private equity industry

It is only to be expected that the private equity fund managers would be laden with the bulk of the clean-up exercise. More than two-thirds of respondents felt the private equity industry itself had the largest role to play in improving the environment for their investors. (See Figure 21.) (However it is significant that nearly a third of investors did not think there were major issues for the industry to sort out.) The most important aspect was, of course, the need for greater transparency and comparability of performance, but there was also a significant amount of criticism levelled at the more reputational issues. The level of management fees, for example, and a general perception that firms were not always entirely sensitive to their investors were often listed.

▲ Investors want to see the private equity industry act on their concerns

Clearly, the private equity industry would benefit from addressing the background concern that most of its practitioners are remunerated beyond their worth. As already discussed, investors are convinced of the value of the asset class and are attracted to the associated benefits that it brings to the wider economy. However there is one cheap criticism that surfaces time and time again. "There is a suspicion that being a fund manager is a comfortable place to be," said one corporate pension fund. "Private equity firms could be a bit more humble," said another.

At the heart of this recurring theme lies the issue of fees, which substantiate this caricature of the industry. They are high when compared, albeit often inappropriately, with other asset classes. "The industry has got to be sensitive to the issue of fees. They are anomalously high and generally not performance sensitive," said one asset management firm. Another put the issue into a more historical context and said the problem had only really emerged when private equity firms began raising really large funds.

"In days gone by we didn't worry too much about that sort of thing. Markets were rising and IRRs were high and one of the main incentives for the fund managers was obviously the carry. But going forward it's going to take longer to realise investments and the IRRs are going to go down. I wonder whether carry is going to be as important as a part of the remuneration as it has been and whether the annual fees are going to assume more importance. We are starting to ask for much more detail about how people are paid. We are being much noisier now than in the past," the firm said.

"There are often a lot of negative reports about the asset class in the papers that go without being redressed. The press often presents a biased view, that somehow it isn't a good asset class. Maybe there is something for the industry to do in providing some more information about what really happens."

Asset management firm

Regardless of the appropriateness of the present level of fees, many investors agreed that the industry had not always been the best guardian of its own interests. These reputational issues had historically proved to be a blind spot. "There are often a lot of negative reports about the asset class in the papers that go without being redressed. The press often presents a biased view, that somehow it isn't a good asset class. Maybe there is something for the industry to do in providing some more information about what really happens," said an asset management firm.

The real transparency issue

▲ Transparency relates to the difficulty in comparing fund performance

Transparency in the private equity industry is a complicated issue, not least because it has become semantically embroiled in the broader concerns of the investment community since the explosion of the Enron debacle. Investors are supposed to have become increasingly worried that something untoward may be going on beneath the surface of their investment portfolios simply because they often have trouble seeing the underlying assets. That, at least, is the version of the transparency problem that has captured the media imagination; more appropriately termed disclosure.

The reality, however, is very different. None of the survey respondents expressed this sort of concern. The main substance of their frustrations related to something much simpler: the intrinsic difficulty of comparing and interpreting the performance of one private equity firm with another. It is important to decouple the two, disclosure and interpretability, to establish what investors feel needs to be done and to establish what can be realistically achieved. After all, public equity and bond investors were not spared a litany of horrors when Enron, Worldcom et al unfolded, for all the transparency they were provided by closer regulation and accountability.

> *"You have to be careful saying that greater transparency will improve the industry. It is important but if you look at the public markets it is clear that all that information still wasn't enough to stop the recent bubble. A lot of people are blaming lack of transparency for the mistakes they made in private equity."*
>
> Insurance company

"You have to be careful saying that greater transparency will improve the industry. It is important but if you look at the public markets it is clear that all that information still wasn't enough to stop the recent bubble. A lot of people are blaming lack of transparency for the mistakes they made in private equity," said an insurance company.

The simplest manifestation of the problem is the lack of a single reliable source of performance information. "The best thing for the industry would be the availability of accurate and consistent benchmarking material," said a bank. There are figures available but many investors find them hard to decipher. "It would be good if there was a specific performance measurement source that you could rely on. Proper information on what's actually happening. The stuff that's available tends to be patchy and its quality depends entirely on who provides the information," said a local authority pension fund.

An asset management firm went further, suggesting that some firms took advantage of the intrinsic complexity of the problem to cloud their performance figures. "There is quite a lot of obfuscation of returns and a certain lack of candour. There's plenty of publicity if the returns are good but reticence to the point of being secretive if things have not gone well. It all leads to a level of suspicion about returns figures."

While there may be some consensus about the need to address the issue, there is far greater variability about the most effective solution. Standardised reporting material would go some way to improve the situation but it would still leave plenty of unanswered questions. Similarly, investors said the present lobbying to release as much information as possible about funds might well do more harm than good to the cause. "I wouldn't want to see people publishing all their returns on the internet for the rest of the world to pick up and examine without really understanding what they are looking at. There should be increased transparency but not in a way that the information can be misinterpreted... Providing this sort of information to investors and the general public are two entirely different things," said an asset management firm.

An insurance company reiterated the need to disentangle the issue of understanding the information and its disclosure. "There is a need for better interpretation of information more than new information itself... Investors need a better understanding of returns. The issue is interpretative rather than purely informational."

"There is a need for better interpretation of information more than new information itself... Investors need a better understanding of returns. The issue is interpretative rather than purely informational."

Insurance company

It seems investors are largely accepting that the transparency problem will not be easily resolved. The very fact of investing in unlisted assets makes that an inescapable condition. There will always be an element of art as well as science in valuing private businesses, particularly in thin markets. "Information is never going to be as easily distributed as it is in quoted markets. There is no reason for it to be so. Shares in these companies are not freely transferable," said an asset management firm.

Some of the more experienced investors even argued that this lack of transparency was one of the main reasons for the attractiveness of the asset class. "We must be careful not to kill the golden goose. The lack of transparency makes private equity as successful as it is, as long as it is managed by professional and experienced people," said one investor. "If it is easier to invest in private equity then the returns will decrease. What makes it attractive is the fact that it is difficult to invest in," said a corporate pension fund.

▲ Some investors say the transparency issue has been overblown

Investors also suggested, more fundamentally, that the scale of the problem had been overblown. It is significant that more of the demands for information have in fact come from outside the asset class than within. Several investors complained about the source of pressure for more disclosure from state or public pension funds in the US over the past 12 months. In some instances, the momentum has come from journalists hoping to find suspicious relationships between public investment decisions and local politicians. In other cases, opportunist businesses have been employing the Freedom of Information Act to force disclosure of fund data so that they can package it for resale to the industry.

"To the outside world it is pretty intransparent but I must say that whenever we speak to our fund managers they are always forthcoming. In fact, I have some problems with it being more transparent. The whole premise of it being private is that it's private. You lose some of the edge if it's all open," said an asset management firm. It is the different perceptions of investors and people looking from outside the asset class about transparency that has bred the prevailing confusion. Decoupling the two produces a less disconcerting picture.

> *"To the outside world it is pretty intransparent but I must say that whenever we speak to our fund managers they are alway forthcoming. In fact, I have some problems with it being more transparent. The whole premise of it being private is that it's private. You lose some of the edge if it's all open."*
>
> Asset management firm

Investment consultants

There is a wide range of opinion among investors about the levels of private equity expertise among investment consultants. Some respondents said consultants did not know enough about the industry, while others said they had improved significantly over the last few years. The implication is that while consultants may not have been entirely supportive of the asset class in the past, they were at least no longer putting investors off.

> *"Investment consultants were quite slow to push private equity but they've changed and they've done a lot. They are now willing to recommend an allocation. I wouldn't say they were raging enthusiasts but they are not putting people off."*
>
> Local authority pension fund

"Small institutions often rely on the consultants for their advice and a lot of consultants don't know a lot about it. Generally, I don't think they are that good," said one asset management firm. Others, however, were less critical. "Investment consultants were quite slow to push private equity but they've changed and they've done a lot. They are now willing to recommend an allocation. I wouldn't say they were raging enthusiasts but they are not putting people off," said a local authority pension fund.

Trustees

Less than half of respondents thought the private equity industry would benefit from trustees learning more about the industry, suggesting their understanding of the asset class was not a major issue. There was, however, plenty of anecdotal comment to support the diagnosis of the government-sponsored Myners report that trustees' lack of expertise in the asset class had sometimes bred a reluctance to invest. "Trustees generally don't seem to know a lot about it," said an asset management firm.

Corporate pension funds, however, were generally more circumspect in their criticism. "If you were a pension fund trustee with no prior exposure to the asset class why would you take money out of something you understood and put it into something you understand less about?" said one. "A lot of private equity players aren't familiar names and trustees need to reach a certain level of comfort. This takes time and time is something that trustees don't have much of," said another.

Institutional investors

▲ Investors accept there is more they could do themselves to improve the industry

The private equity industry has plenty to work on but its investors also recognise the role they have to play in shaping the future environment. Some of them felt that the impetus to change the fee structure, for example, would more effectively come from them than from the industry itself. Others explicitly bemoaned the passivity of their colleagues in letting private equity firms operate the way they did. As a rule, the most sophisticated and experienced investors said that only pressure from the investor community would professionalise the asset class. The lesson from other asset classes was that the forces of competition were generally the most effective way of promoting reform, they said.

"There could be more coordinated action by investors, particularly with regard to fees and structures. Private equity fund managers do get away with a lot because there is a lack of coordination on the part of institutional investors. A lot of people spend a huge amount of time getting specific agreements out of managers for their own benefit but if they clubbed together they could do it more easily," said one asset management firm.

Another blamed the inexperience of many investors and the legacy of nervousness from the late 1990s boom for the general reticence. "Investors need to do more. There are so many people who don't want to stick their head above the parapet. It is very very hard to get investor consensus on difficult issues; where they might need to change a manager for example. There is a very long way to go. I'm not sure why that is. We're all for it. Partly it's resources. These things can be pretty time consuming. Some people are also scared of doing it as well. They don't want to get a reputation as a difficult investor and they don't want to upset people for relationship reasons."

The more proactive investors said the solution lay in the formation of an investors' association. The idea has been floating around for some time and, indeed, there has been a quasi-investor forum in the past. The urgency, however, is mounting as the industry undergoes a period of profound change, they said. "Some sort of institutional investor association is the way forward. It would enable people to get together and take a more coordinated approach," said a bank.

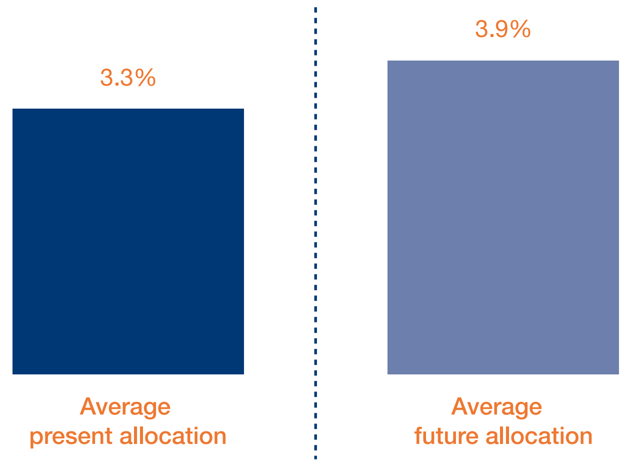
> *"Some sort of institutional investor association is the way forward. It would enable people to get together and take a more coordinated approach."*
>
> Bank

9. FUTURE EXPECTATIONS

UK institutional investors expect a gentle increase in their allocation to private equity over the next two years despite predicting that returns will be weaker than their historical experience. The apparent contradiction is explained by the feeling that other asset classes will also under perform, thereby preserving private equity's premium. As for the defining trends within the asset class over the next five years, investors were unable to produce much of a consensus. Among the wide range of issues they said they expected some consolidation among private equity firms, a gradual improvement in transparency, more investor activism, and the emergence of more specialist funds. Together these factors will represent an important maturing process as the industry edges towards a more convincing adulthood.

Allocations

Figure 22. PRESENT AND FUTURE PRIVATE EQUITY ALLOCATIONS



Source: AltAssets Research

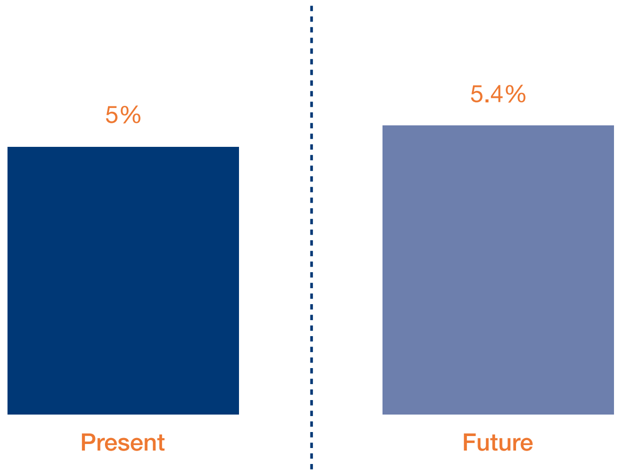
▲ Nearly 40 per cent of investors plan to increase their private equity allocation

The survey respondents have an average strategic allocation to private equity of just over three per cent and expect that to creep higher over the next two years to almost four per cent. (See Figure 22.) Some 38 per cent of respondents said they expected to increase their allocation over the period. This is still some way short of the sort of allocation that is typical among US investors but is significant nonetheless. It represents an endorsement of the asset class despite the difficult experiences of the last few years. Recent performance issues, particularly in the venture sector, have cast a cloud over some corners of the private equity industry. Most investors, however, said these needed to be seen within the context of long-term performance. They also said there should be allowances made for the fact that the late 1990s were historically aberrational.

The respondents that said they were planning to increase their allocation were spread evenly between pre-1990 investors and those that had entered the asset class from 1990 onwards. Although more recent entrants to the asset class have generally suffered more from the downturn, they appear to understand the need for a long-term investment horizon. A lot of investors were also basing their judgement on expectations for other asset classes, which they said could make private equity look even more attractive than in the past. Its capacity to generate absolute returns regardless of the broader macro-economic conditions suddenly assumes a new importance in the present context. In aggregate, the respondents' increase over the next two years will represent more than £1 billion of new capital.

Returns

Figure 23. DESIRED PREMIUM OVER PUBLIC EQUITIES

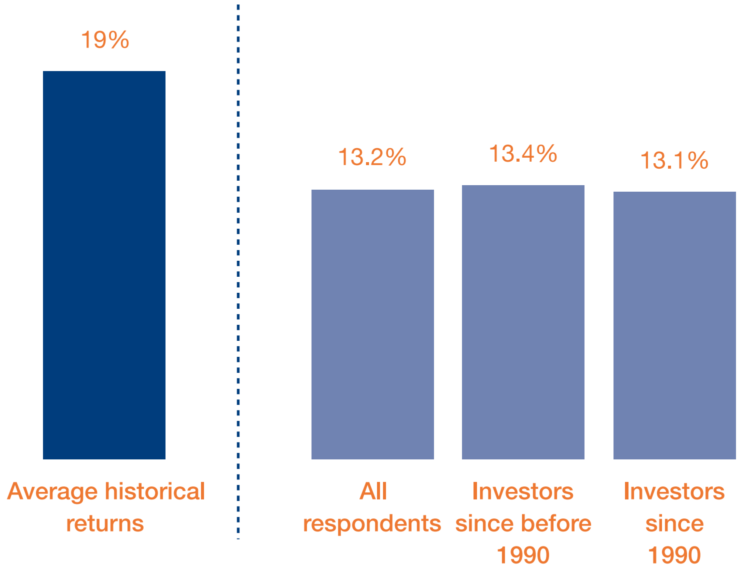


Source: AltAssets Research

The issue of absolute returns is highlighted by the survey's revelation that investors will be targeting a higher premium over public equities from their private equity commitments over the next few years. The average premium at present is around five per cent over public equities to allow for the additional risks of the asset class. The average, however, creeps up to 5.4 per cent for the next five years. (See Figure 23.)

This is more reflective, in fact, of their expectations for public equities than it is about any escalation in the risks associated with private equity. All investors say they also target absolute returns. In the context of public market performance over the last few years, that reduces the premium to being of little more than illustrative value as an indicator for the foreseeable future. Public equities, after all, have often fallen substantially more than the premium, suggesting inaccurately that investors would be happy with negative returns from their private equity investments.

Figure 24. EXPECTATIONS FOR AVERAGE NET ANNUAL RETURNS OVER THE NEXT FIVE YEARS



Source: AltAssets Research

▲ Returns are expected to soften

The survey's respondents predicted that average net annual returns from private equity investments would slip to around 13 per cent over the next five years, compared with their historical experience of about 19 per cent. (See Figure 24.) That initially appears to be a major deterioration but looks far less unsettling when measured against expectations for returns from other asset classes. In some quarters, a flat performance by the major public equities indices is considered almost optimistic at present.

The more experienced investors were a little more upbeat, forecasting an average return of just above 13 per cent. The less experienced investors, presumably more heavily affected by the recent downturn, forecast returns a little below more experienced investors. The proximity of their forecasts, however, suggests a broad consensus about the health of the market, which should provide some reassurance to the industry.

Defining Trends

Figure 25. DEFINING TRENDS IN PRIVATE EQUITY OVER THE NEXT FIVE YEARS

Rank	
1	Consolidation
2	Weaker returns
3	Greater transparency
4	More investor activism
5	Less money in the asset class

Source: AltAssets Research

The defining trends in the private equity industry over the next five years promise to bring cheer and disappointment in almost equal measure to the asset class. Investors, however, look set to be the major beneficiaries at the end of that period as the asset class assumes new levels of professionalism. The next few years will unwind some of the imbalances, flush out the pretenders, increase transparency and instil a new discipline in the way private equity fund managers behave. If nothing else, the competition for capital will have the effect of raising standards.

▲ Some consolidation is expected

Figure 25 lists the main trends suggested by respondents. They are ranked to represent the frequency with which they occurred among investors but not necessarily the individual likelihood they attached to each. More than anything, investors said they expected some consolidation across the industry. “There are too many private equity firms. There needs to be some sort of consolidation of firms as they are effectively bidding against one another,” said a local authority pension fund.

The key driver of that consolidation is almost certain to be the fundraising process. Private equity firms with decent supplies of uninvested capital can stay alive for a very long time simply by slowing their pace of investment. “There are a lot of firms out there that are not going to raise another fund,” said an asset management firm.

▲ Venture firms are considered especially vulnerable...

This is expected to affect all areas of the market but will be much more pronounced in the venture sector. The operating environment for venture firms since the collapse of the technology bubble is much more hostile than for any other private equity practitioners and the prospects for a meaningful recovery in the medium term still appear slim, investors said.

"Some who jumped onto the venture bandwagon in the early 1990s with little or poor advice were badly burned. This is no bad thing. If they do continue to invest they may realise that they don't have the requisite skill set and therefore turn to funds of funds. In effect, they will outsource their management. I certainly don't see the same levels of venture investing emerging again for quite some time," said an asset management firm.

> *"Some who jumped onto the venture bandwagon in the early 1990s with little or poor advice were badly burned. This is no bad thing."*
>
> Asset management firm

▲ ...as are funds of funds

Despite that endorsement of the value of funds of funds, the sector is also judged to be vulnerable to a major downturn. Investors said it had become overcrowded in the last couple of years and there was simply not enough institutional capital to sustain all the new entrants.

"I expect to see a lot of consolidation among the number of managers, especially on the fund of funds side. I don't see how they can be economic. They won't be able to raise further funds given the stretching out of realisations. It will be more difficult for them to produce a decent track record," said an asset management firm. "There are a lot more funds of funds in the market than there were. You do worry. Some look like they have been put together by people that have lost their job elsewhere and thought they could patch something together," said a local authority pension fund.

Greater transparency is also expected to be one of the defining trends of the asset class. Investors said they were taking their lead from developments in the US in recent months, which has seen pressure build on some of the major public institutional investors to reveal the performance of their private equity investments. UTIMCO and CalPERS, for example, have posted information about their portfolio on the internet. The exact form of this greater transparency is more difficult to envisage in Europe, where public sector investors are both much smaller and more resistant to the sort of pressure felt by their US counterparts.

▲ Investors expect it will become easier to compare fund performance

The hope is that the march towards greater transparency will be led by industry participants themselves. Its progress, however, may be accelerated by an increase in investor activism, which is expected to be another of the key trends over the next few years. The balance of power between private equity fund managers and investors has swung in favour of the institutions since the heady days of the technology boom, when venture funds were in such demand they could afford to turn away investors. Investors, for their part, were often reluctant to object about terms and conditions in case they compromised their chances of getting into a new fund. Times have changed. Few funds have enjoyed the luxury in recent years of turning away investors.

Performance issues are also certain to dominate conversation over the next five years, albeit in a variety of different forms. Some investors expect them to worsen, others to improve. Some think buy-out returns will look good while venture returns have yet to hit their lows. On balance, investors think returns will weaken but that there should be signs of an upturn within the forecast horizon. “Returns on private equity will come back as returns on public equities come back,” said a corporate pension fund. “We expect to see an improvement in investment returns as exit conditions improve,” said a bank.

> *“The distinction between the good and the not so good funds will increase because the general market conditions will be so much more unforgiving than in the past.”*
>
> Corporate pension fund

Investors also expect the more challenging environment to expose the weaker firms. “The distinction between the good and the not so good funds will increase because the general market conditions will be so much more unforgiving than in the past,” said one corporate pension fund. “There will be an end to the state of denial and the surprise about poor returns,” said another.

▲ Some investors may leave the asset class...

One of the most pressing issues for many private equity firms is the likely inflow or outflow of capital into the sector over the next few years. “I guess the big question is whether new people really do move into alternatives or not,” said an asset management firm. The survey respondents in aggregate predicted a modest increase in their allocation to private equity but some were less convinced. Once again, they tended to be bleakest about the prospects for the venture sector and for the US.

“The big issue has been that there are excessive expectations and an oversupply of capital that will drive down returns. I think that a lot of the investors that have moved into the asset class in recent years will tend to leave the industry. The new influx of the late 1990s will be hardest hit because of when they entered the market. That problem is most acute in the US,” said an insurance company.

> *“More pension funds will recognise the diversity of venture capital. They will increasingly need to look beyond the public markets and will therefore turn to private equity. But there will have to be a huge education process.”*
>
> Corporate pension fund

▲ ...but there will be new entrants

The more optimistic, however, said that institutional investors had been encouraged to look beyond their comfort zone by the disappointing performance of other asset classes and would increasingly want to explore private equity as part of their portfolio mix. “More pension funds will recognise the diversity of venture capital. They will increasingly need to look beyond the public markets and will therefore turn to private equity. But there will have to be a huge education process,” said a corporate pension fund. The lesson seems to be that there will be new money interested in private equity but it will be making greater demands than ever from prospective private equity fund managers. The rebalancing of expectations comes at a price.

Another of the defining trends will be the emergence of more country-specific funds in continental Europe. The UK market is much more mature and has long proved fertile for small and sector focused funds. Continental Europe, by contrast, has generally been the preserve of pan-European funds. They were not sufficiently convinced about the volume of deal flow in any single market to focus themselves exclusively and targeted a handful of markets instead. The growing familiarity of business around the Continent with private equity, the creeping process of economic liberalisation and a gradual shift in culture is beginning to show in the appearance of more specialists.

> *“I think we’ll start seeing people going into new areas, like some of the country-specific funds. We will also see parts of Eastern and Central Europe opening up.”*
>
> Asset management firm

“Deregulation of the European markets will continue to drive forward and this is what will ultimately lead to the increase in private equity investment,” said a corporate pension fund. The trend will also see new regions attracting capital from private equity investors. “I think we’ll start seeing people going into new areas, like some of the country-specific funds. We will also see parts of Eastern and Central Europe opening up,” said an asset management firm.

There could, however, be a gentle downside to this development. It might, for example, divert some capital away from more mature markets such as the UK. “I think in the UK it will get more difficult as the private equity firms are being so cautious. We are likely to start looking abroad for future funds,” said one investor. It might also result in a greater dispersion of returns, in line with the wider variety of markets. “There will be an increase in the choice of individual markets, particularly in Europe, which brings with it the potential for an increased variability of returns,” said a bank.

APPENDIX. SURVEY SAMPLE

- The survey received responses from 32 institutions. Together they have private equity commitments worth around £10.5 billion.
- They were questioned between 1st December, 2002 and 10th January, 2003.
- The respondents were made up of: two banks, two foundations, two insurance companies, four asset management firms, eight public pension funds, and 14 corporate pension funds. This broadly matches the breakdown of the UK institutional investor universe and is therefore a representative sample.
- All but two of the surveys were completed over the telephone.
- Respondents participated on condition of anonymity.

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