INSIGHTS
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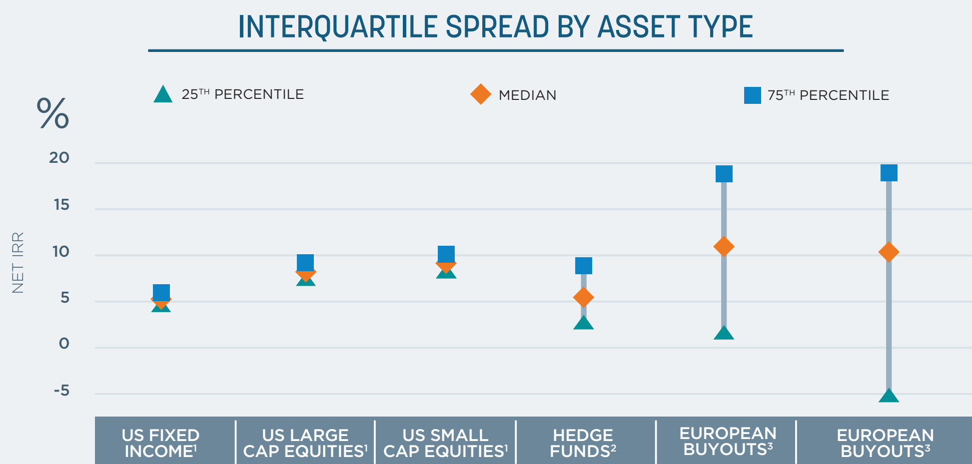
iCapital NETWORK

7 CRITICAL CONSIDERATIONS

SELECTING A PRIVATE EQUITY MANAGER

Choosing the right private equity manager to invest with is crucial to achieving top-tier performance in an industry where the return dispersion is massive. In today's low return environment, a growing number of individual investors have been taking a closer look at private equity, which has outperformed the S&P 500 Index by over 500 basis points over the last 20 years.[1] While this premium is substantial, it may understate the outperformance of private equity when you consider that there are over 9,000 private equity firms globally[2] and the difference between top-quartile and bottom-quartile has been nearly 1,700 basis points over the last decade.[3]



[1] Source: Investment Metrics. Represents 10-year time-weighted return as of September 30, 2017.
[2] Source: Eurekahedge and Bloomberg. Returns from December 31, 2009 through December 31, 2016.
[3] Source Cambridge Associates, 10-year pooled investment horizon IRRs. Data as of June 30, 2016. Net annual rate of return after deduction of management fees, expenses, and carried interest.
Past performance is not indicative of future results. There can be no assurance that any fund will achieve top quartile returns or that any fund in the top quartile will match the historical returns of top quartile funds, or any funds, demonstrated in charts provided.

This dispersion then begs the question of "How can an investor increase the likelihood of choosing the best managers in an industry that is thought to be less than transparent?" While there is no single factor to determine future returns, iCapital believes if investors can get a true understanding of the following 7 considerations during their diligence process, it can put them on a solid pathway during manager selection:

1. VALUE CREATION METHODS

There are three primary value creation drivers, and managers usually employ all three. Investors should examine these attributes to look for consistent patterns and assign the highest value to growth in revenue and/or EBITDA.

- **Financial engineering** typically refers to increasing a company's leverage ratio or adjusting the capital structure to boost equity returns. While leverage can be a useful tool to increase returns, it isn't without risk, as leverage magnifies both gains and losses. While applying debt in an acquisition model is an important method to create value (as debt is cheaper than equity), we generally view it as a commodity.
- **Multiple expansion** occurs when a manager sells a portfolio company at a higher entry valuation multiple than the multiple at which the manager acquired it (i.e., buying at 8x EBITDA and selling at 10x EBITDA). This can be evidence of a disciplined buying strategy and/or an experienced seller who knows how to optimize value by choosing the right time to sell.
- **Revenue/EBITDA growth** is mainly driven through a combination of operational improvements, streamlining costs, add-on acquisitions, and organic growth. Essentially, from entry to exit, if a private equity firm implements improvements in a company's

financial performance, it should realize a gain on the investment even if it applied zero leverage and sold the portfolio company at the same multiple at which it was acquired. This is the most important driver and the hardest to consistently generate.

2. INVESTMENT TEAM

It is critical to evaluate the capabilities of the team that will be sourcing, negotiating, monitoring and exiting the manager's investments. Prospective investors should investigate the backgrounds and experience of the investment professionals, as well as the team's continuity and experience in working effectively together. Investors should also understand the key person provisions in the legal documents to ensure that the appropriate investment professionals will be devoting a specific amount of time to the fund.

It is also important for investors to consider whether the terms of the fund properly align the economic interests of the investment team with those of their investors. If management fees represent a disproportionate amount of the manager's total compensation, it may reduce the incentive for the team to generate outsized returns. Further, investors should ensure that the most effective members of the investment team (who may not always be the most senior members) receive an appropriate portion of the fund's carried interest (the private equity firm's share of profits).

3. DEAL SOURCING AND INVESTMENT PROCESS

A manager's ability to source a sufficient volume of high-quality investment opportunities is key, and an ability to identify and connect with target companies before competitors is a major differentiator. To generate proprietary opportunities, most private equity managers utilize a combination of their networks, cold calling programs, and the formation of specific investment themes within their core sectors. It is also critical that a manager has a structured process in place to prioritize and evaluate these opportunities efficiently.

4. TRACK RECORD

Investors should use both quantitative and qualitative analyses when examining historical performance. Focus on attributes such as:

- Sector
- Equity check size
- Source of investment
- Geography
- Lead investment professionals

5. UNREALIZED PORTFOLIO

Typically, a meaningful proportion of the manager's past investments remain unrealized when the manager begins raising its next fund – which can mask a potential deterioration in the overall track record. It is important to analyze these unrealized companies to try to determine if they are on track to generate returns that will support, or even improve, the current valuation of the fund, or if they are underperforming, which will likely detract from the fund's overall value. In either case, it is important that the manager has the proper resources to oversee these companies through exit while deploying the new capital raised in the successor fund, in particular, any underperforming companies may absorb additional bandwidth as the team works to get them back on track.

6. BENCHMARKING

While a manager's track record may be attractive on an absolute basis, certain vintage years have outperformed others due to favorable market conditions. It is crucial to compare the manager's historical performance to other funds in the same vintage year that pursued a similar investment strategy to determine relative performance.

Investors should also compare past performance to a relevant public market benchmark to measure the illiquidity premium that one should expect for investing in a private markets structure without daily liquidity.

7. INVESTMENT STRATEGY & MARKET OPPORTUNITY

Be sure to assess the private equity manager's strategy to see how it fits with the market environment that is expected over the investment period of the fund. Try to confirm that the "go forward" strategy is consistent with the manager's past practices. It could be the case that a secular trend from which a fund manager benefited may have run its course, forcing the manager to find opportunities in different sectors or strategies in which the manager has less experience.

CONCLUSION

In today's market, private equity funds are raising money at the fastest pace since 2006, and there is a record amount of dry powder (uninvested capital) with increased competition for deal flow. We believe that this further heightens the need for a careful, rigorous selection process.

This article was previously published in Financial Poise.

END NOTES

[1] Cambridge Associates, "US Private Equity Index and Selected Benchmark Statistics", as of March 31, 2018.
[2] Neuberger Berman, "Asset Matters: The How's and Why's of Private Equity", May 5, 2017
[3] Cambridge Associates, 10-year pooled investment horizon IRRs, as of June 30, 2016
[4] Financial Times, "PE firms raise money at the fastest pace since 2006", August 27, 2018

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