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Private equity – a guide for pension fund trustees

This report was written by the Pensions Investment Research Consultants (PIRC) for the Trades Union Congress

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Section one

Introduction

In recent years, pension funds have been encouraged to increase their allocation to private equity. In 1999 the Prime Minister gave a speech urging pension funds to invest more in the asset class, principally as a way to support British entrepreneurship. This call was endorsed by the major actuarial consulting firms, who agreed that pension funds should consider an allocation.

The following year Gordon Brown announced in the Budget that he had asked Paul Myners to review why pension funds had not been active investors in private equity. The Myners Review subsequently made recommendations both to trustees and the private equity industry on how to move forward.

The result of this pressure has been a slow but steady increase in the amount of money UK pension funds contribute to private equity, although it still lags behind the amount allocated by US pension funds. Views on the potential returns available to investors such as pension funds vary. The industry argues that for the best-performing funds the returns frequently outstrip those available in the public equity markets. Pension funds themselves often consider investing in private equity both in order to generate superior returns and as a way to achieve diversification.

However, more recently there has been increasing concern about the impact that private equity can have on investee businesses. The increased amount of pension fund money allocated to private equity is credited with encouraging the industry to attempt ever-larger buyout activity. Deals in the UK have resulted in some household name public companies being taken private.

Trades unions have raised concerns both about the impact on employees, in terms of wage and job cuts, and the potential damage done to businesses by loading them with debt. Environmentalists and other NGOs have argued that private equity involvement can result in a major loss of transparency, specifically where public companies are taken private.

More broadly, a number of investment experts, including Paul Myners, have queried the role private equity is playing in the economy. Some argue that the levels of debt being incurred in many buyouts could create future financial instability.

Although the private equity industry denies many of the charges that are aimed at it, moves have been made to address the criticism that it lacks transparency. In addition in some recent buyout activity private equity firms have given commitments to maintain existing employment levels.

Trade unionists who are member-nominated trustees are in the middle of these arguments. On the one hand private equity offers the potential to generate significant returns which help fund their pension schemes. On the other, many trustees will want to invest in a way that does not create social or economic damage.

This briefing provides an overview of private equity as an asset class and explores some of the criticisms that are made of it. It concludes with a list of suggested questions that trustees can ask if their fund is considering making an allocation to private equity.

Section two

What it is and how it works

Very broadly, private equity refers to equity investment in an asset that is not tradable on public markets, such as the London Stock Exchange. Like public equity (shares in publicly-listed companies) this capital is invested in all types of businesses. The term ‘private equity’ actually covers a range of types of company financing ranging from venture capital, where money is invested in typically small businesses which are starting up or expanding, through to the large-scale public-to-private buyouts of the type which currently attract much attention. The two core elements of the private equity market are ‘venture capital’ and ‘buyout’.

The table below summarises the range of different strategies involved in private equity activity.

Venture capital:

- **Start-up:** Financing provided to companies for use in product development and initial marketing. Companies have not yet sold their product commercially.
- **Other early stage:** Financing provided to companies that have completed product development stage and require further funds to start commercial sales. They may not yet be generating profits.
- **Expansion:** Capital provided for the growth and expansion of an established company. Capital provided for rescue/turnaround situations is also included in this category.
- **Refinancing bank debt:** By replacing existing liabilities with a mixture of debt and equity, the company obtains a more flexible financing package.
- **Secondary purchase:** Purchase of existing shares in a company from another venture capital firm or from other shareholders.

Non-venture private equity:

- **Management buy-out (MBO):** Funds provided to enable current operating management to acquire an existing product line or business. Institutional buy-outs (IBOs), Public to Privates and similar financings are included under MBOs for BVCA reporting purposes.
- **Management buy-in (MBI):** Funds provided to enable an external manager or group of managers to buy into an established company.

- **Public to Private:** Purchase of equity of publicly listed companies, which are then delisted to become private companies again. Private equity capital is provided to finance development of the private company, with a view to subsequent listing or trade sale.

Source: Institutional Investment in the United Kingdom: A Review, HM Treasury, 2001

Where private equity invests

Much of the policy interest in private equity in the late 1990s focused on venture capital, with the emphasis on encouraging pension funds to back British entrepreneurs. However it is notable that the funds allocated to private equity are increasingly skewed towards buyout activity, as opposed to early stage or expansion investments. According to the most recent publicly available statistics from the BVCA, early stage investment accounted for just 2% of the total in 2005, with expansion accounting for 22%, and MBOs and MBIs representing the remaining 76%.¹

Of the total funds raised in 2005, the vast majority, 91% (£24.966bn) was expected to be invested into the MBO/MBI stages. A 3% allocation was expected for expansion (£853m) and 3% for early stage (£752m). Within the MBO/MBI category, 78% (£21.351bn) was intended for the largest investments (i.e. those with over £100m total deal value); 8% for those between £50m and £100m; 5% for £10m to £50m transactions; and less than 1% for the smallest deals of up to £10m.²

This represents a significant shift from the earlier history of the industry when venture capital accounted for a much bigger proportion of funds raised. Although there has been an increase in real terms in the levels of money raised to finance both venture capital and buyouts, it is clear that in recent years the significant growth has been in buyout activity. It is also worth noting that venture capital actually continues to play a very minor role generally in the financing of small and medium-sized businesses. According to the Bank of England it accounted for just 3% of the external finance to SMEs in 2000-2002.³

As the Myners Review highlighted, “Private equity is a powerful but specialised form of financing, relevant to only a small minority of companies with the potential and ambition to grow rapidly. Any increase in the supply of private equity and, within that, venture capital, will not automatically find a

¹ BVCA Report on Investment Activity 2005

² BVCA Report on Investment Activity 2005

³ Finance for Small Firms – An Eleventh Report, The Bank of England, 2004

corresponding increase in demand from enterprises able to meet the private equity investors' ex ante expectations of returns.”⁴

Finally, there is also a regional dimension to private equity investments in the UK. Measured by both number of companies in which investments are made, and the amount of capital invested, London and the South East attract the lion's share. This was 40% of the total by number of companies and 44% of the total by money invested in 2005. This skew towards London and the South East is reflected across both the venture capital and buyout ends of the private equity investment spectrum.⁵

The UK and European market in context

Private equity is an increasingly important form of finance around the world. The UK accounts for over a fifth (22%) of the global private equity market as measured by investment value, second only to the US (40%). The investment value of the UK market was equivalent to 1.3% of GDP in 2005.⁶ While pension funds' investment in private equity typically represents only a relatively small portion of their assets, they are the second largest source of funds raised by European Private Equity funds, representing 26% of the total, only surpassed by banks (31%).⁷

The table below gives an indication of some of the leading private equity firms in Europe in terms of deals undertaken.

Private equity M&A deals (Year to Dec 20 2006)

Europe	Value \$bn	Number
Kohlberg Kravis Roberts	27.5	5
3i	25.9	25
AlpInvest Partners	20.8	3
Apax Partners	19.7	11
Goldman Sachs International	17.3	3

⁴ Institutional Investment in the United Kingdom: A Review, HM Treasury, 2001

⁵ BVCA Report on Investment Activity 2005

⁶ Private Equity, City Business Series, October 2006

⁷ Tim Jenkinson, The development and performance of European private equity, Said Business School, 2006

Carlyle	14.9	8
Cinven	12.4	6
Hellman & Friedman	12.2	3
Contracted Services	11.3	1
Thomas H Lee Partners	11.3	1
Industry total	272.6	1,564

Source: Financial Times December 27 2006.

Section three

Pension fund investment in private equity

Pension funds are increasingly shifting away from portfolios built largely around equities, bonds and property, to include so-called ‘alternative assets’ such as private equity and hedge funds. UK pension funds are increasing their allocations to private equity but it is worth noting that they account for a relatively small proportion of the total amount of money raised by private equity funds in the UK. In 2005 UK pension funds accounted for only 5% of funds raised, or just £1.5bn in cash terms. In contrast overseas pension funds accounted for 26% or £7.1bn. UK pension fund allocations may also account for a proportion of the 4% (£1.13bn) invested via fund-of-funds.⁸ Overall pension fund investment is 31% of the total in the UK, slightly higher than average for European private equity funds.

The UK’s total pension assets are estimated to be approximately £1,200bn.⁹ This suggests that the typical UK pension fund’s weighting in private equity is very low. Research from the National Association of Pension Funds (NAPF) shows that in practice it is typically larger funds that have money invested in private equity and many smaller funds have no allocation at all. In its latest annual survey it identified only one fund under £100m in assets that had an allocation. The NAPF estimates that amongst those schemes that have allocated money to private equity the typical weighting is just over 3%.¹⁰

Types of investment

There are three ways in which pension funds might typically invest in private equity – through a limited partnership, through a fund-of-funds or through an investment trust. The three options are explored in more detail below.

Limited partnership

A limited partnership is the most common way that pension funds invest in private equity. Research suggests almost 80% of investment by UK institutional investors takes this form.¹¹ The limited partnership retains ownership and management in the company and is managed by an

⁸ BVCA Report on Investment Activity 2005

⁹ 2007 Global Pension Assets Study, Watson Wyatt

¹⁰ NAPF Annual Survey 2006

¹¹ Understanding UK institutional investors, AltAssets Research/BVCA, March 2003

independent management company, the general partner (GP). Broadly speaking therefore the GP can be seen as a 'fund manager'. The GP retains liability for the actions of the partnership. In turn, investors within these funds are known as limited partners (LPs). A limited partnership has a limited life-span of perhaps 10 or 12 years. Investors might be expected to commit capital to the fund over period of 3 to 5 years, with revenues from sales distributed throughout the life of the fund.

Such funds will usually start to return cash to investors after three to five years. If one of the companies in which the fund is invested is floated, investors are sometimes offered the shares in the company. However, typically the shares are held within the fund until finally sold by the private equity manager.

The advantages of the Limited Partnership approach are that it is 'tax transparent', meaning that income and capital gains flow through the partnership untaxed. In addition capital gains are shared between the limited partner investors and the general partner private equity manager. This gives the latter strong incentives to invest for absolute capital growth over a defined period, to the benefit of the former. However, limited partnerships may be regarded as illiquid as participation is not publicly tradable.

Fund of funds

A fund of funds is a structure for sharing investment across several private equity funds. The fund of funds is managed by a team of professionals, offering investors a diversified portfolio of companies. These professionals manage the relationships with the various underlying funds, organize the review of valuations, provide information and back office services for the funds.

One of the key advantages of investing via a fund-of-funds is that it offers a diversified way to gain exposure to private equity. On the other hand the extra level of management also results in extra fees which will eat into returns. The industry trade body, the British Venture Capital Association (BVCA) considers that investing via a fund-of-funds represents a longer-term commitment.¹²

Investment trust

The key advantages of investing via an investment trust are that the fees are relatively low, and the investment is more liquid than other forms of exposure to private equity. However it may also be the case that returns are more closely correlated with the public market. Although trusts are an investment vehicle, they are structured as public companies, whose shares are traded on the stock market and are thus available for members of the public to purchase. In addition, shares in a particular trust might trade at discount to the value of the

¹² How To Invest In Private Equity, BVCA, September 2003

assets held within it. The major player in the private equity investment trust sector is 3i¹³.

Direct investments

Trustees might also consider direct investments. However it should be noted that this is a far more complex, and committed, way to invest in unquoted companies. It is probably only suitable for the largest pension funds which have sufficient in-house expertise to undertake the commitment and exercise effective oversight.

Fees

Looking at the limited partnership structure, the funds will usually charge an annual management fee based on the amount of capital committed to the fund. The annual management fee is typically 2% of committed capital. In addition, the general partner is usually entitled to a share of the profits known as “carried interest” or “carry”, effectively a performance fee, based on the returns generated by the fund. The carried interest is only payable after a “hurdle rate” of return has been achieved.¹⁴

The fees levied by private equity managers are significantly higher than for other standard publicly-traded asset classes (equities, bonds etc), and more comparable to those charged by hedge funds. The industry argues that these higher fees are balanced by higher expected returns, and are justified by the labour-intensive nature of private equity investment compared to public equity.

Trustees may also wish to note that there are criticisms of the high “carried interest” fees, focusing on the incentives they provide. The Myners Review made the point that they might encourage general partners to embark on bigger deals.

“The ‘carried interest’ mechanism gives private equity managers personal incentives to invest larger funds which would give a higher absolute return (for a given rate of return on the underlying investments).”¹⁵

At this point trustees might question whether there is any scope to negotiate more reasonable fees with private equity funds on an individual basis. Unfortunately the clear consensus from within the private equity industry is that this is very unlikely. Put simply, because there is currently a surge of money from pension funds and other investors pouring into private equity, the general partners in limited partnerships are in a position where they do not have to respond to demands for fee negotiations from individual investors.

¹³ <http://www.3i.com/>

¹⁴ See How To Invest In Private Equity, BVCA, September 2003

¹⁵ Institutional Investment in the United Kingdom: A Review, HM Treasury, 2001

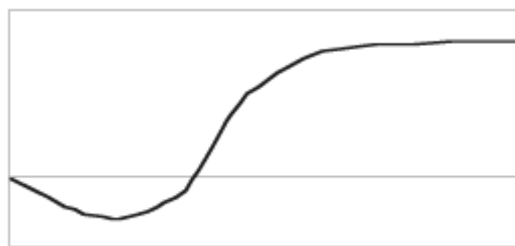
The strong position held by GPs has been explained in a recent book by industry veteran Guy Fraser-Sampson.

“[T]he LP’s only sanction when faced with what may be deemed an unacceptable situation is not to invest, but invest elsewhere. The fund, if it is a quality fund, will be potentially oversubscribed almost immediately. It therefore matters not one jot to the GP whether the LP invests or not; if that particular LP does not proceed, there are others who will... [A]s long as there are new investors waiting to crowd into a fund if existing ones fail to take up their offered entitlement, then GPs will be able to call the shots... [N]ot only is the situation not going to improve, but if anything it is going to get even worse given the large amounts of extra capital which will be seeking a home in the asset class in future.”¹⁶

Returns

The potential that private equity has for superior returns is the principal reason that most institutional investors give for investing.¹⁷ The returns trustees can expect from private equity funds are rather more complicated than those from say publicly-traded equities. Overall returns to private equity funds are based on the ‘vintage year’ of a fund’s inception. Because of the nature of private equity investments, where capital is drawn down early on and returned later in the life of the fund, returns are normally negative in the early years, before becoming positive as cash-flow is generated. This pattern of returns is known as the “J-curve”, by nature of the shape generated when returns over the life of a fund are displayed graphically. A simple illustration of this is provided below.

Y



X

X axis – lifetime of the fund

Y axis – investment return

Because of the J-curve effect, funds of the most recent vintage years may report negative returns, since this represents the stage at which investors’ capital is

¹⁶ Private Equity As An Asset Class, Guy Fraser-Sampson, 2007

¹⁷ Understanding UK institutional investors, AltAssets Research/BVCA, March 2003

being drawn down. While some funds may begin to generate positive returns early, it may take three to five years before investors experience positive returns and net cash-flows.

Performance statistics

Some in the industry argue that simple average performance figures tell investors very little, since they put funds of very different sizes, and investing in different stages, together.¹⁸ Performance figures are therefore often split into various subcategories – such as venture, small MBO, medium MBO, large MBO. In addition, average returns can also be reported in a way that takes account of fund size, this is known as the Capital-Weighted Average (CWA). It should also be noted that private equity performance figures are reported net of fees.

The standard industry performance figures are produced by the BVCA each year, and report an average Internal Rate of Return (IRR). The BVCA's medium to long-term IRR figures are provided below, broken down by vintage year and by type of fund.

Medium to Long-Term Return – IRR (% pa) by vintage year

Vintage Year	Number of funds	3 years	5 years	10 years
1980-84	13	n/a	-64.6	38.5
1985-89	68	10.7	6.0	34.2
1990	14	-39.7	-22.7	9.3
1991	14	83.3	-8.2	26.7
1992	7	39.9	17.9	27.9
1993	10	17.9	4.6	17.4
1994	20	42.3	24.1	41.4
1995	10	-1.0	-14.3	23.4
1996	15	11.4	2.9	n/a
1997	25	19.2	5.7	n/a
1998	16	20.0	12.0	n/a
1999	27	17.0	7.3	n/a
2000	28	14.2	9.2	n/a
2001	30	29.9	n/a	n/a
2002	19	31.2	n/a	n/a
2003	19	n/a	n/a	n/a
2004	7	n/a	n/a	n/a
2005	20	n/a	n/a	n/a
Total	362	21.1	11.9 1	6.4

¹⁸ Private Equity As An Asset Class, Guy Fraser-Sampson, 2007

Medium to Long-Term Return – IRR (% pa) by investment stage

Pre-1996 vintage funds	Number of funds	3 years	5 years	10 years
Early Stage	22	-0.9 -	5.8	17.6
Development	37	3.2	-3.6	22.0
Mid MBO	33	15.8	10.3	20.2
Large MBO	26	14.0	5.6	28.1
Generalist	38	18.8	-1.8	35.4
Subtotal pre-1996	156	14.6	3.3	27.8
1996 vintage funds onwards				
Venture	77	-2.4	-11.5	-2.5
Small MBO	19	11.3	2.2	4.6
Mid MBO	85	18.8	9.8	9.6
Large MBO	25	26.2	18.7	18.5
Subtotal 1996 onwards	206	21.2	12.3	13.5
Total all funds	362	21.1	11.9	16.4

Source: BVCA Private Equity and Venture Capital Performance Measurement Survey 2005

Unfortunately, trade secrecy limits the public availability of data on individual funds. While the BVCA’s annual performance survey provides information on an aggregate basis, the underlying data on individual funds is typically not publicly available, since private equity firms will regard it as commercially sensitive. Trustees may only be able to obtain data once they begin looking for potential investments.

As the Financial Standards Authority (FSA) has warned, the limited transparency may “deter investment by various professional investors who may not be comfortable interpreting the information. It could also lead to ill-informed investment decisions by such investors.”¹⁹ While the FSA does not intend to impose a transparency requirement on private equity, it is currently considering its position in light of an enhanced retail access to private equity.

How private equity returns compare to those available from other assets classes, principally public equity, is a subject of much debate. By comparing the data provided above with the average returns to pension funds calculated by The WM Company, it has been claimed that the ten-year returns on private equity outperformed the other major asset classes.²⁰ A London Business School report in 2000 estimated that, based on a simulation where the cash-flows invested in private equity were invested in benchmark tracking funds, private equity returns outperformed UK equity returns by a narrow margin.²¹

¹⁹ FSA, Private equity: a discussion of risk and regulatory engagement, 2006

²⁰ Private Equity, City Business Series, October 2006

²¹ UK Venture Capital and Private Equity as an Asset Class for Institutional Investors, Foundation

Fees should be taken into account when considering the potential returns available. A major US study by Steve Kaplan and Antoinette Schoar, University of Chicago Graduate School of Business, found that average buyout returns over the period 1980-2001 were broadly equal to from the S&P500 public market in the US, once fees had been stripped out.²² This suggests that before fees private equity has the potential to deliver significantly higher returns.

If trustees are considering a private equity allocation it is clearly important that they take a view on how they believe it will perform as an asset class compared to say public equities. When considering this, trustees should ensure they understand the performance statistics they use to inform their decision.

Spread of returns

Trustees should also take note of the wide variation in returns from private equity funds. The Kaplan and Schoar study found a wide spread of returns, both across funds and time. In addition, the study identified substantial persistence in buyout and venture capital fund performance. Put simply, general partners whose funds outperform the industry in one fund are likely to outperform the industry in the next one they raise and vice versa. This highlights the need for trustees to ensure that they are sufficiently informed to identify the funds most likely to perform well and/or the need to diversify in order to avoid the risks of poor choices, a point also made by the London Business School.

“Due to the considerable spread of returns, diversification is of utmost importance for investors. Investors should make appropriate asset allocation decisions to allow for an effective diversification rather than invest in just one or two funds. Alternatively, they should consider an indirect investment via a fund of funds.”²³

Potentially ‘indifferent’ investment returns, if trustees do not pick the best funds, have also been flagged as a risk by one the UK’s leading investment consultancies Watson Wyatt.²⁴ There is much focus therefore on picking ‘top quartile’ funds with the best performance, and the performance for such funds will often be quoted alongside average returns in industry statistics. Figures from Thomson Venture Economics show that top quartile buyout funds achieved an average internal rate of return of 27.5% from 1985 to 2006 against a return of 12.8% from the public market over the same period. However, buyout funds on average underperformed, with a return of 11.1%.²⁵

for Entrepreneurial Management, London Business School, January 2000

²² Private Equity Performance: Returns, Persistence and Capital Flows, Steve Kaplan and Antoinette Schoar, University of Chicago Graduate School of Business, 2004

²³ UK Venture Capital and Private Equity as an Asset Class for Institutional Investors, Foundation for Entrepreneurial Management, London Business School, January 2000

²⁴ Pensions alert over private equity, Daily Telegraph, 9 May 2007

²⁵ Statistics quoted by Edgar Millar, visiting lecturer – private equity, Cass Business School

Industry experts suggest that professional investors should be able to pick consistently from the upper quartile, and that fund-of-funds can also achieve this.²⁶ However the fund-of-funds approach will typically involve higher fees. In addition the continuing lack of publicly-available performance data also complicates the investment process. The clear message is that trustees should consider how they will identify the best funds, and how they might achieve a diversified exposure to private equity. A diversified approach should both help mitigate the impact of initial negative returns as outlined above and address the spread of returns. The BVCA argues that a mature and diversified portfolio can be highly cash generative.²⁷

The use of leverage

Trustees might also bear in mind the significant role that leverage (debt) plays in generating the returns from buyout activity. Although it might seem counter-intuitive, it can be easier to generate investment returns by buying a company using a significant amount of debt, or leverage. Thus private equity activity using debt is often characterized by the term 'leveraged buyout' (LBO). When debt is cheap, using it to finance takeovers can have a significant 'gearing' effect on returns. This is demonstrated in the simple example displayed below.

Investment A

Buy a £100 company with £100 cash
Sell the company for £120 cash after one year
 $£120 - £100 = £20 = 20\%$ Return on Investment (ROI)

Investment B

Buy a £100 company with £50 cash and £50 debt @ 10% interest
Make one £5 interest payment
Sell company for £120 cash after one year
Repay £50 loan
 $£120 - £5 - £50 - £50 = £15 = 30\%$ ROI

Investment C

Buy a £100 company with £25 cash and £75 debt @ 10% interest
Make one £7.50 interest payment
Sell company for £120 cash after one year
Repay £75 loan
 $£120 - £7.50 - £75 - £25 = £12.50 = 50\%$ ROI

Example adapted from Behind The Buyouts – Inside The World Of Private Equity, SEIU, April 2007

There are questions about how sustainable the returns from leveraged buyout activity are. Industry experts themselves have pointed out that regulators are increasingly interested in whether financial engineering of this type is in an

²⁶ Private Equity As An Asset Class, Guy Fraser-Sampson, John Wiley & Sons, 2007

²⁷ How To Invest In Private Equity, BVCA, September 2003

economy's best interests.²⁸ In addition, another impact of the growth in leveraged buyouts has been to encourage listed companies to take on more debt. This limits the ability of LBOs to extract more value through gearing.

The central role that leverage plays in much buyout activity can be inferred from the relatively modest average level of investment per deal reported by the BVCA. The average level of investment was slightly higher for MBIs at £15.2m, with MBOs recording an average of £14.4m.²⁹

Future returns

Finally, trustees should note that there are predictions about a potential fall in returns from buyout activity in the future. There are two principal reasons cited for this. First, many commentators have noted that at present debt is relatively cheap. This means that the gearing effect of leverage in buyouts makes such activity very profitable. However, it is not unlikely that in the future the situation will reverse, and as such the potential returns available will decrease. Secondly the sheer amounts of money might have an impact on returns. There may not be sufficient worthwhile investments to be made to meet investor expectations.

The potential for lower returns in the future has been acknowledged by those within the industry.

“What is being suggested is that the general trend of buyout returns has undoubtedly been downwards, that this downward trend has a direct inverse link to the growth both in individual fund sizes and the amount of capital being deployed by the industry as a whole, and that all three of these trends are likely to continue into the future.”³⁰

Defined contribution schemes

For completeness, it is necessary to briefly consider how private equity investments might fit, if at all, with a pension scheme providing benefits on a defined contribution basis. It is estimated that approximately a third of the UK's pension fund assets are now accounted for by defined contribution schemes.³¹ This is likely to accelerate further following the introduction of the national Personal Accounts scheme which will also work on a DC basis.

Historically DC schemes have invested in a more limited range of assets than DB schemes. This raises the question of how such schemes and their members will view private equity. The Bank of England warned several years ago that the money allocated to private equity from UK pension funds could reduce.

²⁸ Private Equity As An Asset Class, Guy Fraser-Sampson, 2007

²⁹ BVCA Report on Investment Activity 2005

³⁰ Private Equity As An Asset Class, Guy Fraser-Sampson, 2007

³¹ 2007 Global Pension Assets Study, Watson Wyatt

“Another factor which could have a significant impact on the flow of pension fund money into private equity is the gradual move from defined benefit pensions to defined contribution pensions... [DC scheme] members are unlikely to be fully aware of venture capital or how to measure its associated risks. This lack of knowledge, together with the difficulties involved in investing very small amounts of money, will not be conducive to investment in venture capital.”³²

Similar concerns were raised by actuarial consultancy Lane Clark & Peacock.³³ These comments preceded the accelerating trend from DB to DC provision.

In a recent report from the Pensions Institute on DC investment there was some analysis of how alternative asset classes including private equity could be factored into DC fund choices.³⁴ Although it was noted that the level of expertise and fees involved make including such an exposure within funds more complicated, it was suggested that they might be included in a ‘diversified growth fund’ option, and that this could even provide the default fund in DC schemes. The Pensions Institute also identified one fund with a 10% allocation to private equity.³⁵

In practice, however, it seems that to date DC schemes are generally not investing in private equity. The NAPF’s annual survey does not provide any evidence of any DC schemes investing in private equity.³⁶ Although investment strategies in occupational DC schemes will without doubt develop over time, it remains an open question as to how, if at all, they will bring private equity into their asset allocation.

³² Finance for Small Firms – A Seventh Report, The Bank of England, 2000

³³ http://www.lcp.uk.com/information/press_release.asp?ID=46

³⁴ Dealing with the reluctant investor: Innovation and governance in DC pension investment, The Pensions Institute, April 2007

³⁵ JP Morgan Diversified Growth Fund

³⁶ NAPF Annual Survey 2006

Section four

Criticisms of private equity

This section is intended to provide trustees with a brief overview of some of the recent criticisms of the private equity industry.

Private equity as an asset class

It is useful to start by considering the views of investment management professionals on the benefits of private equity allocations. As can be seen in the table below, based on UBS Global Asset Management’s assessment of consensus views, many believe returns from private equity can be very good, although they also consider it to be an illiquid asset class which offers moderate diversification benefits.³⁷ It is notable that investment professionals rank the liquidity of private equity as low. Illiquidity is one of the major obstacles to investment cited by many institutions.³⁸ Investment risk can also be high, although this is widely accepted and may be regarded as reasonable given the potential returns available.

	Potential returns	Liquidity	Diversification benefit	Risk	Holding / management costs
Venture	Very High	Low	Moderate	Very high	High
Buyout	High	Low	Moderate	High	High

Source: Pension Fund Indicators 2006

The relative lack of public information on private equity also causes some concerns on the part of investors. In a 2005 survey of big UK investors, they ranked transparency risk on a par with illiquidity as one of the major reasons given for why many pension funds steer clear of the asset class.³⁹

A broader question for trustees to consider is that of diversification, since this is the second most common reason institutional investors give for investing in the asset class.⁴⁰ A key factor here is the correlation, if any, between private equity returns, and those from other asset classes in which pension funds invest. Put simply, if there is a strong correlation in returns then clearly the diversification benefit to be gained from investing is weaker.

³⁷ Pension Fund Indicators 2006, UBS Global Asset Management

³⁸ Understanding UK institutional investors, AltAssets Research/BVCA, March 2003

³⁹ FT, Private equity opacity is 'a top risk', 26 October 2005

⁴⁰ Understanding UK institutional investors, AltAssets Research/BVCA, March 2003

A major London Business School report on private equity found evidence of a correlation between returns from public and private equity. It stated that the correlation between returns from smallcap public companies and those from private equity over the eight-year period from 1987 to 1995 was “striking”. However the report found that in subsequent years the public and private markets moved in opposite directions.

Recognising the limited data on which the analysis was based, the report concluded that it was impossible to come to a more definitive assessment of the extent to which private equity returns are influenced by the movement of public markets.⁴¹

As the Myners Review suggested, it should not be surprising if private equity returns do closely correlate with those from the public markets. Returns from buy-out funds depend on company valuations at entry and exit, both largely based on public equity markets. However this highlights the need for trustees to understand how returns from private equity will fit within their portfolio.

The sustainability of leverage

As we noted in the previous section, the use of leverage is central to private equity buyout activity. There are questions however about how sustainable such an approach will be. It might be less attractive going forward, as the industry acknowledges.

“Thin’ financing structures (i.e. having very little equity compared with the amount of debt involved) are the dream of buyout firms... but the opportunities to employ them are becoming less, partly because most businesses today will already have quite high levels of operating debt (if only to make a takeover or buyout a less attractive prospect!) and partly because some countries are pursuing tougher and tougher ‘thin equity’ tax rules under which it can be difficult to make loan interest fully deductible.”⁴²

Arguably changes in the capital structures of listed companies may be one of the greatest impacts of the current wave of buyout activity. As the IMF has pointed out, the current wave of buyout activity could be seen as a form of capital structure arbitrage, focused on companies that are not making the most of the opportunity offered by cheap debt.⁴³

The question has been asked recently why public companies do not employ the tactics of private equity funds.⁴⁴ Increasingly, it appears, that is precisely what is happening, as listed companies do take advantage of cheaper debt. Although

⁴¹ UK Venture Capital and Private Equity as an Asset Class for Institutional Investors, Foundation for Entrepreneurial Management, London Business School, January 2000

⁴² Private Equity As An Asset Class, Guy Fraser-Sampson, 2007

⁴³ Global Financial Stability Report, International Monetary Fund, April 2007

⁴⁴ See for example Learning from Private-Equity Boards, Harvard Business School Working Knowledge, January 2007

this might be seen as bringing greater efficiency to companies' balance sheets, it may also be storing up potential problems for the future. Businesses may be at greater risk from economic shocks, and the banks involved in providing debt could potentially suffer large losses if there are adverse market developments.

The IMF concludes: "Current takeover activity is taking place against a benign backdrop of continued global growth, low real interest rates, high corporate profitability, and low volatility. If one of these factors changes, deals that looked promising in a benign environment could suddenly appear much less attractive. It is therefore likely that some private equity deals will fail to live up to expectations."⁴⁵

Private equity's wider impact on the public equity market

There has been much speculation about the impact that buyout activity has had on the public market. The FT reported recently that a delisting wave hit the global stock exchanges in 2006, with global de-equitisation amounting to £77bn. While the FSA, in its 2006 discussion paper on private equity, reported that private equity fund raising had outstripped public market capital raising in the UK in the first half of 2006 (£10.4bn that were raised via LSE public equity IPOs are contrasted with £11.2bn of capital raised by private equity fund managers)⁴⁶, over 2006 as a whole annual IPO activity at the London stock Exchange outstripped de-equitisation (also due to Chinese and Russian IPOs).⁴⁷ On the other hand, IPOs of US companies were less than half of public-to-private transactions (\$41bn compared to \$97bn). Citygroup estimates that the UK equities market shrank by 3% in 2006.⁴⁸

The FSA has some concerns about this development, because "the quality, size and depth of the public markets may be damaged by the expansion of the private equity market", as fewer companies go public, and the growth potential of those that do go public may already have been exploited. On the other hand, the FSA argues that private equity practices bring a number of enhancements, e.g. the increased accuracy of company valuations which factor in growth potential, and the enhanced efficiency of corporate capital structures.⁴⁹

Another view is that the shrinking equity markets may offset declining demand for mainstream equities by institutional investors, hence helping to boost the FTSE share indices going forward. As private equity expansion is funded by cheap debt, a significant rise in the cost of borrowing could mean that the

⁴⁵ Global Financial Stability Report, International Monetary Fund, April 2007

⁴⁶ Private equity: a discussion of risk and regulatory engagement, FSA, November 2006

⁴⁷ Delisting wave hits London, Financial Times, 2 January 2007

⁴⁸ Financial Times, op. cit. (this number takes share buybacks into account)

⁴⁹ Private equity: a discussion of risk and regulatory engagement, FSA, November 2006

M&A boom, 25% of which is accounted for by PE, could come to an end if interest rates rise.⁵⁰

Short-termism

In tandem with concerns about the future of public equity there have been accusations that buyouts are simply a short-termist form of financial engineering. Here arguments can be made both for and against private equity. Proponents of private equity often argue that taking companies private can allow management to focus on running the business, as opposed to feeling pressured to meet quarterly earnings targets. It is sometimes argued that the typical life of a private equity investment compares well to the rapid turnover in public equity holdings.

In addition, the industry has argued that private equity provides a much better alignment of interests between investors and the management of companies in which they invest.⁵¹ Indeed some argue that this provides a superior form of corporate governance to that in the public market.⁵²

There is logic to these arguments, but there are important counter-points. Many funds managers trade only at the margins of their holding in a company, rather than, for example, selling out of it altogether. They frequently retain a core holding in large companies for a very long time. This of course raises other questions about why fund managers hold shares in companies they expect to underperform, but it does partly address the question of their long-term commitment to companies.

It is certainly true that directors of listed companies do complain about the short-term pressure they are put under by institutional shareholders. However arguably this is the same sort of 'discipline' (i.e. a strong focus on immediate financial results) that private equity aims to bring to the companies in which it invests. In fact, even private equity's proponents suggest that part of the discipline such financing brings stems from the desire for an early 'exit'.

"[I]t provides a 'new and improved' model for running companies. Ownership and control are concentrated in the hands of a few active investors. The focus is on exit and achieving results within a relatively short-term horizon."⁵³

Trustees might also note that the Myners Review found evidence of concerns from smaller businesses about the impact that private equity would have on

⁵⁰ Still some mileage in M&A, Financial Times, 2 January 2007

⁵¹ Learning from Private-Equity Boards, Harvard Business School Working Knowledge, January 2007

⁵² See introduction to BVCA Private Equity and Venture Capital Performance Measurement Survey 2005

⁵³ See introduction to BVCA Private Equity and Venture Capital Performance Measurement Survey 2005

them. These included a loss of control, and strong pressure to deliver financial results.⁵⁴

Finally there is an argument that private equity investors take a short-termist approach, in saddling companies with debt and returning them to the public market, which does not sit well with the needs of long-term investors. As pension funds are universal owners – that are investing in a wide range of companies, assets and, increasingly, countries – arguably this represents robbing Peter to pay Paul. The return they make from private equity may come at the expense of public companies they will also own. The short-term return from one asset class may create long-term problems that pension funds experience elsewhere in their investment portfolio.

For example, the retail group Debenhams was taken off the stockmarket in 2003 by private equity consortium Baroness Retail, which paid £1.9bn for the company. After financial restructuring it was re-listed in 2006 valued at £3.6bn and with a share price of 195p. Since then the company has lost around a third of its value and its share price currently stands at around 130p.⁵⁵ Debenhams has also significantly underperformed both the FTSE250 index, of which it is a constituent, and other retailers.⁵⁶ Pension funds which passively hold index weightings may therefore have sold Debenhams shares in 2003, only to buy them back at a higher price in 2006, and subsequently see them fall in value.

Conflicts of interest

Trustees should also keep in mind that there is an inherent conflict in management buy-outs: board directors who are part of the MBO deal owe the target and its shareholders the duty to achieve the best price possible, but at the same time they would want to achieve the lowest price possible, because they are the purchasers and future owners of the business. Conflicts also arise in respect of time commitment and confidentiality.

As one legal firm has pointed out:

“A director is obliged to keep the company's secrets. However, potential investors in an MBO are unlikely to commit to invest in the buy-out on the basis solely of published information (e.g. the company's last annual accounts). They will want the management team to disclose significant amounts of 'inside information' before they are willing to commit to invest in the buy-out.”⁵⁷

⁵⁴ Institutional Investment in the United Kingdom: A Review, HM Treasury, 2001

⁵⁵ Share price as at July 24 2007

⁵⁶ Based on information report on Debenham's investor relations website:
<http://www.debenhamsplc.com/deb/price/>

⁵⁷ Manches LLP, Briefing: Management Buyouts, 2005.

<http://www.manches.com/downloads/briefings/MBO - Directors Duties.pdf>

Most recently the potential for problems has been highlighted in the case of KKR's purchase of Alliance Boots. The role of Alliance Boots deputy chairman Stefano Pessina, who was part of the KKR bid, was closely followed. Pessina's ability to contribute to the operation of the company's board whilst simultaneously planning to buy the company was one concern. Although the company stressed that Pessina did not attend meetings where such conflicts would be material, this raised further questions about time commitments.⁵⁸ Some commentators also asked why he could not introduce the strategy outlined by KKR under Alliance Boots' existing ownership.

Because of such issues, shareholders' position is weakened, as much of the bidding process happens prior to the official announcement of the bid, with investment banks as intermediaries making it even more opaque. The management of the company is also likely to be offered very significant rewards as part of the process. The levels of remuneration offered to directors can be much higher than those available in the public market, providing a major incentive for directors to take companies private.

Corporate restructuring

Private equity is often characterised as 'asset-stripping' businesses it takes over, often resulting in job cuts. There are high-profile examples of this type of activity such as the AA buyout, which has resulted in significant job cuts. But how does the argument stand up across the private equity industry as a whole?

The evidence here is both mixed and the subject of dispute. A study by the Nottingham Centre for Management Buyout Research found that there was a significant difference between management buy-outs and management buy-ins. MBOs were found to be more likely to increase employment over the longer term. MBIs in contrast were likely to result in significant job cuts.⁵⁹ Private equity professionals argue that this is understandable since an MBI replaces existing management typically where a business is underperforming and management has underperformed. An MBO in contrast will back existing management to essentially do more of the same. Therefore drastic restructuring is less likely to be required, and jobs are more secure in the short term.

Within buyout activity the split of investment between MBOs and MBIs in 2005 was 83% to 17% respectively by reference to the value of investments made, and 84% to 16% in terms of numbers of firms invested in.⁶⁰ Given the predominance of MBOs in buyout activity, this suggests that overall the sector would create employment in the long term, if the industry's assertions about job growth are reliable.

⁵⁸ 'AWOL' Boots boss blasted, The Scotsman, 17 April 2007

⁵⁹ The Impact of Private Equity: Setting the Record Straight, Wright, Jensen, Cumming and Siegel, Nottingham Centre for Management Buyout Research, 2007

⁶⁰ BVCA Report on Investment Activity 2005

However, as the TUC has noted previously, aggregate figures on jobs created may obscure important trends.⁶¹ Going further, analysis by David Hall of the Business School at the University of Greenwich has raised significant criticisms of the methodology used in many studies of the impact of private equity on employment.

It states: “The major surveys conducted for the UK, EU, and USA private equity associations suffer from a number of flaws, both in sampling and in data quality, rendering their estimates of employment impact effectively worthless.”⁶²

The Hall report goes on to argue that private equity appears to have no clear overall effect on employment compared with other forms of ownership.

More broadly, research carried out by the Nottingham Centre for Management Buyout Research reported by the Work Foundation found that private equity can put pressure on employee wages, with MBIs again showing the bigger effects.⁶³ It estimated that wages in private equity-backed companies grow more slowly than in the private sector as a whole. For MBI companies, workers are £231.35 a year worse off, while for MBOs, the figure is £83.70. The Work Foundation also found greater hostility to unions in private equity firms and argues that some employers may use private equity involvement as a way to de-recognise unions.⁶⁴

Corporate social responsibility

There have also been concerns about the impact that buyout activity may have on the commitment of businesses to corporate social responsibility. A recent paper by Business for Social Responsibility asked the question how “private equity funds [can – and should] be held accountable while preserving the aspects of these funds that enable mid-term, strategic investments, which bring new vitality to stagnant companies?” The paper argues that transparency is a key pillar of Corporate Social Responsibility. On the other hand, it has been argued that the attraction of private equity lies precisely in the absence of regulated disclosure.

The lack of public scrutiny potentially puts a private equity investor such as a pension fund at risk: Yale University, for example, discovered in 2002 that it invested in a firm accused of a questionable water development project in an environmentally sensitive area.⁶⁵

⁶¹ Private equity – a trade union perspective, TUC, 2007

⁶² Methodological issues in estimating the impact of private equity buyouts on employment, David Hall, Business School, University of Greenwich

⁶³ *Inside the dark box: shedding light on private equity*, The Work Foundation, 2007

⁶⁴ *Inside the dark box: shedding light on private equity*, The Work Foundation, 2007

⁶⁵ A. White, Invest, Turnaround, Harvest: Private Equity Meets CSR, Business for Social Responsibility, 2006

Following purchase by the Apax group and subsequent de-listing from the stock exchange, Somerfield decided to withdraw from the Ethical Trading Initiative (a multi-stakeholder alliance including retailers, NGOs and trade unions), in order to reconsider “short- and medium-term business priorities”.⁶⁶

Concerns were also raised about the potential impact of a leveraged buyout on clothes store Gap at the point when it was considered to be going through a process of ‘social turnaround’, as Ethical Corporation magazine highlighted:

“Leveraged buyouts are associated with cost cutting and disbursement of assets by the targeted company to pay off the acquisition loans. Not only the workers in its supply chain, but the company's direct employees, would suffer the consequences. On the other hand, LBOs are not associated with gains in transparency. So even if a privately held Gap somehow managed to maintain its promising work on supply chain labour standards, a Gap LBO would be likely to reverse the progress the company has made on reporting in this area.”⁶⁷

Some have also argued that buyout activity may result in weaker corporate governance where public companies are taken private. Indeed in some cases there seems to have been an explicit desire to avoid the regulatory ‘burden’ associated with listing on the public markets.

“For instance, in the United States, managers of some publicly traded companies subject to more stringent regulation following implementation of the Sarbanes-Oxley Act have reportedly opted to pursue management buyouts as a means to reduce the regulatory burden.”⁶⁸

It is certainly true that at present there can be a substantial loss of transparency, and by association accountability, when large publicly-listed companies such as Alliance Boots are taken private. As a result of widespread concerns over such issues, at the beginning of March the BVCA announced that it was forming a working group to deal with the question of transparency.⁶⁹ The working group is expected to report back in November 2007, and its activity will focus on the following areas:

- Appropriate levels of narrative and financial reporting.
- Whether and to what extent the case is made for increasing the level of reporting for PE-backed companies.
- Timing of any increased reporting for PE-backed companies.
- Clarity and consistency of practice with regard to valuation methodology, its verification and disclosure to investors of returns and fees.

⁶⁶ Trading down corporate responsibility, Ethical Corporation, 14 November 2006

⁶⁷ Leveraged buyouts: undermining corporate responsibility?, Ethical Corporation, 7 August 2006

⁶⁸ Global Financial Stability Report, International Monetary Fund, April 2007

⁶⁹ http://www.bvca.co.uk/publications/publications/working_grp_press_release.doc

- The working party will recognise the very different types of investment undertaken by the industry from small start up financing to large buyouts.

Whether this initiative proves sufficient to address public policy concerns about the lack of transparency of major businesses which are taken private remains to be seen.

Section five

Key issues for trustees to consider

There are a number of key areas that trustees should review when considering whether and/or how to invest in private equity. The London Business School report on private equity as an asset class made a number of sensible recommendations for trustees that are useful to consider.⁷⁰ These included:

- **Take a long-term perspective**
The decision to invest should be taken with a long-term perspective in mind since it normally takes three to five years before investors experience positive returns and net cash flows.
- **Appoint a dedicated private equity fund manager**
Managers of private equity portfolios should be subjected to different organisational procedures from the managers of marketable security portfolios. The assessment of track records and selection of private equity firms - skills that have a large impact on the returns of a private equity portfolio - require an expertise which is quite different from analysing public equity markets. London Business School suggests that pension funds appoint exclusive private equity managers and subject them to different incentive and monitoring procedures.
- **A well-structured portfolio**
A well-structured private equity portfolio has attractive cash flow implications. Initially it will require net contributions over several years. After this period, such a portfolio should generate positive net cash flows for a longer period.
- **Diversify between funds and managers**
Diversification between funds and managers smooths cash flows and can reduce the spread of returns.

It is important for trustees to have a clear idea of both how private equity fits with the investment objectives of their scheme, and how it operates as an asset class in practice. This should involve a proper discussion within the trustee board of the issues concerned. This could include both investment issues, such as the nature of returns from private equity, and broader concerns including the durability of an investment approach based on leveraged buyouts.

⁷⁰ UK Venture Capital and Private Equity as an Asset Class for Institutional Investors, Foundation for Entrepreneurial Management, London Business School, January 2000

If the trustees decide that the pension fund will allocate assets to private equity, the next focus will be on selecting a suitable manager or managers. As we have seen earlier, given the wide variation in returns from private equity funds, selecting the right investments can have a major impact.

The industry itself has produced a useful list of issues that should be taken into consideration when selecting a private equity manager, which is reproduced below.

What key points should I consider when selecting a private equity manager?

Managers of private equity limited partnership funds

- Performance record
- Ability to add value to portfolio companies (past, present and future)
- Deal sourcing ability (past, present and future)
- Process established
- Exit ability/experience
- Experience/commitment/motivation of key executives
- Investment strategy fits with your requirements
- Evidence of ability to move with changing market conditions to ensure future returns
- Flexibility - is the minimum/maximum investment permitted in line with your needs?
- Distribution policies - are distributions managed so that investors can obtain cash, thus eliminating the need for them to take on the task of managing distributions?
- Fees and terms
- Reporting methods

Gatekeeper/fund of funds manager

- Performance record
- Proven ability to access the best private equity managers. The better private equity funds are often oversubscribed and access can be by invitation only
- Appropriate diversity across stage, style and geography
- Flexibility - is the minimum/maximum investment permitted in line with your needs?
- Distribution policies - are distributions managed so that investors can obtain cash, thus eliminating the need for them to take on the task of managing distributions?
- Fees and terms
- Reporting methods

Source: How To Invest In Private Equity, BVCA, September 2003

If trustees are, as is likely, investing in funds that focus particularly on the buyout market, then there are further questions that industry experts suggest. These include:

- Can the firm consistently increase earnings in real terms?
- Is the firm using more debt than competitors?
- Is the firm paying higher multiples for companies?
- How many of the executives share in the carry and the management fee profits, and in what percentages?
- Who takes the investment decisions and how are decisions arrived at?⁷¹

Social responsibility

Looking more broadly trustees' discussion of the issues around private equity could legitimately include the social and economic impact of the asset class. Pension funds are increasingly encouraged to consider such 'extra-financial' factors in their investment strategies.⁷² One significant legal opinion has made clear that consideration of such factors is compatible with trustees' fiduciary duty.⁷³ In addition more recently pension funds have begun to explore ways in which genuinely long-term investment strategies could be developed, which take account of social and environmental issues.⁷⁴

Although historically interest in responsible investment strategies has focused on public equity investments, there is an increasing interest in how such thinking might be applied to alternative assets, even private equity (although at the venture end of the spectrum).⁷⁵

It may well be possible to ascertain a private equity firm's approach to and track record in corporate governance and CSR prior to signing up to a partnership, for example by asking for case evidence. The Environment Agency, for example, asks all its private equity managers to sign up to its "Responsible Entrepreneurial Guidelines"⁷⁶. The European Private Equity and Venture Capital Association (EVCA) has issued Corporate Governance and Professional Standards that contain 'principles of good governance' and 'principles of conduct' as shareholder, board member and for management.⁷⁷

⁷¹ Examples drawn from *Private Equity As An Asset Class*, Guy Fraser-Sampson, 2007

⁷² For example the United Nations has developed a set of Principles of Responsible Investment <http://www.unpri.org/>

⁷³ A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment, Freshfields Bruckhaus Deringer report for UNEP Finance Initiative

⁷⁴ <http://www.marathonclub.co.uk/>

⁷⁵ A halo for angel investors, McKinsey Quarterly, Number 1, 2004

⁷⁶ <http://www.environment-agency.gov.uk/news/1433261?lang=e>

⁷⁷ http://www.evca.com/pdf/evca_corporate_governance_guidelines.pdf

Whilst these are fairly generic principles, funds may want to ask whether their prospective general partner has subscribed to them as a minimum standard.

Although this is a rare approach to take, this should not prevent trustees from undertaking it. Investment providers dealing with trustees frequently state that they detect little pension fund interest in social, environmental or ethical issues, yet when surveyed trustees say these issues are important and may affect company valuations.⁷⁸ This suggests that trustees do not effectively communicate their beliefs and/or concerns when developing investment strategies. If the private equity industry is to be encouraged to develop in a socially responsible direction it is necessary for trustees, as clients, to make clear that such factors are important to them.

Performance disclosure

As highlighted earlier, the returns from private equity as an asset class are spread over a wide range, and picking the right funds ('top quartile' funds) can have a major impact on the returns trustees can expect. However information on individual private equity fund performance can be difficult to obtain, and both the industry and many of its clients are reluctant to disclose such data. This may make the selection of the better funds a more difficult and expensive (if the fund-of-funds approach is taken) process for pension funds.

Therefore trustees may consider whether there is merit in lobbying for broader public disclosure of standardised individual fund performance figures. These could be broken down by the individual funds run by a particular private equity house. Although private equity firms seem resistant to publicising such data, it is notable that CVC Capital Partners does disclose limited data, broken down by individual funds, on its website.⁷⁹ A standardised form of disclosure could therefore involve the production of IRR figures for each firm's principals funds based on vintage year.

It should be remembered that private equity fund performance is very different from that of say normal equity fund managers. A typical public equity fund run by one asset manager will hold shares in many of the same companies as a comparable fund run by a rival house. In contrast individual private equity funds, even those run by the same firm, invest in different companies. Private equity funds are therefore not directly comparable in the same way as funds holding publicly-traded equities.

However, as highlighted earlier, there appears to be persistence in performance amongst private equity firms that is not typically achieved by fund managers investing in publicly-traded equities. Given the importance of picking good

⁷⁸ Will UK Pension Funds Become More Responsible? A Survey of Trustees - 2006 Edition, Just Pensions

⁷⁹ <http://www.cvc.com/Content/En/OurPerformance/OurPerformance.aspx>

funds, disclosure of individual fund data could greatly aid trustees in the selection process.

Trustee collaboration

Looking more broadly, trustees might consider exploring whether there is any scope to work with other investors to push for better terms from general partners of private equity funds. As discussed previously, individual pension fund investors have little power to negotiate with GPs, but funds could work together to develop standard terms. Industry commentators have suggested that it is surprising that investors have to date not sought to mitigate the bargaining power of GPs by working in tandem.

“Perhaps surprisingly, there is little attempt made by LPs to get together and negotiate terms collectively, nor to agree ‘industry standard’ terms amongst themselves and say they will only invest on this basis, although common sense would appear to commend both these courses of action.”⁸⁰

Whilst the quote above envisages LPs working together to agree certain terms, there is no reason in principle why this could not be extended to disclosure of individual fund returns as outlined above, to include commitments to maintain high standards of corporate social responsibility, or even employment levels. Already there are some attempts to encourage private equity funds along this route by suggesting principles that the industry might adopt.⁸¹

Although the private equity industry can appear to be all-powerful it is notable that in some countries the labour movement has been able to have some influence in its development.⁸² If trustees in the UK were to seek to work together more effectively they may be able to achieve concessions from the industry. Although general partners have held dominance in recent years, the current barrage of criticism facing the private equity industry may provide trustees with a window of opportunity.

⁸⁰ Private Equity As An Asset Class, Guy Fraser-Sampson, 2007

⁸¹ Behind The Buyouts – Inside The World Of Private Equity, SEIU, April 2007

⁸² For example in Canada labour-sponsored investment funds have sought to aid in the development of new businesses whilst also promoting decent working conditions. These have focused on the venture end of the private equity spectrum.

Appendix

Glossary of terms⁸³

Alternative asset class — a class of investments that includes private equity, real estate, and oil and gas, but excludes publicly traded securities. Pension plans, college endowments, and other relatively large institutional investors typically allocate a certain percentage of their investments to alternative assets with an objective to diversify their portfolios.

Buyout — a sector of the private equity industry. Also, the purchase of a controlling interest of a company by an outside investor (in a leveraged buyout) or a management team (in a management buyout).

Carried interest — a share in the profits of a private equity fund. Typically, a fund must return the capital given to it by limited partners plus any preferential rate of return before the general partner can share in the profits of the fund. The general partner will then receive a 20% carried interest, although some successful firms receive 25%-30%. Also known as “carry” or “promote”.

Deal flow — a measure of the number of potential investments that a fund reviews in any given period.

Distribution — the transfer of cash or securities to a limited partner resulting from the sale, liquidation or IPO of one or more portfolio companies in which a general partner chose to invest.

Due diligence — the investigatory process performed by investors to assess the viability of a potential investment and the accuracy of the information provided by the target company.

Early stage — the state of a company after the seed (formation) stage but before middle stage (generating revenues). Typically, a company in early stage will have a core management team and a proven concept or product, but no positive cash flow.

Expansion stage — the stage of a company characterized by a complete management team and a substantial increase in revenues.

Fund-of-funds — a fund created to invest in private equity funds. Typically, individual investors and relatively small institutional investors participate in a fund-of-funds to minimize their portfolio management efforts.

⁸³ These definitions are taken from the more comprehensive Private Equity Glossary provided by the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth College. <http://mba.tuck.dartmouth.edu/pecenter/resources/glossary.html#alternative>

General partner (GP) — a class of partner in a partnership. The general partner retains liability for the actions of the partnership. In the private equity world, the GP is the fund manager while the limited partners (LPs) are the institutional and high net worth investors in the partnership. The GP earns a management fee and a percentage of profits (see Carried Interest).

Going-private transaction — when a public company chooses to pay off all public investors, delist from all stock exchanges, and become owned by management, employees, and select private investors.

Initial public offering (IPO) — the first offering of stock by a company to the public. An IPO is one of the methods that a startup that has achieved significant success can use to raise additional capital for further growth.

Internal rate of return (IRR) — the interest rate at which a certain amount of capital today would have to be invested in order to grow to a specific value at a specific time in the future.

Leverage — the use of debt to acquire assets, build operations and increase revenues. By using debt, a company is attempting to achieve results faster than if it only used its cash available from pre-leverage operations. The risk is that the increase in assets and revenues does not generate sufficient net income and cash flow to pay the interest costs of the debt.

Leveraged buyout (LBO) — the purchase of a company or a business unit of a company by an outside investor using mostly borrowed capital.

Limited partnership — a legal entity composed of a general partner and various limited partners. The general partner manages the investments and is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The general partner receives a management fee and a percentage of profits (see Carried Interest) the limited partners receive income, capital gains and tax benefits.

Limited partner (LP) — an investor in a limited partnership. The general partner is liable for the actions of the partnership while the limited partners are generally protected from legal actions and any losses beyond their original investment. The limited partner receives income, capital gains and tax benefits.

Management buyout (MBO) — a leveraged buyout controlled by the members of the management team of a company or a division.

Management fee — a fee charged to the limited partners in a fund by the general partner. Management fees in a private equity fund typically range from 0.75% to 3% of capital under management, depending on the type and size of fund.

Quartile — one fourth of the data points in a data set. Often, private equity investors are measured by the results of their investments during a particular

period of time. Institutional investors often prefer to invest in private equity funds that demonstrate consistent results over time, placing in the upper quartile of the investment results for all funds.

Return on investment (ROI) — the proceeds from an investment, during a specific time period, calculated as a percentage of the original investment. Also, net profit after taxes divided by average total assets.

Secondary market — a market for the sale of partnership interests in private equity funds. Sometimes limited partners chose to sell their interest in a partnership, typically to raise cash or because they cannot meet their obligation to invest more capital according to the takedown schedule. Certain investment companies specialize in buying these partnership interests at a discount.

Seed stage — the state of a company when it has just been incorporated and its founders are developing their product or service.

Venture capital — a segment of the private equity industry which focuses on investing in new companies with high growth rates.



Trades Union Congress
Congress House
Great Russell Street
London WC1B 3LS

www.tuc.org.uk

contact:
Janet Williamson
jwilliamson@tuc.org.uk

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