The Risks, the Returns and the Fundraising Successes of Private Equity Funds

Jessica Duong looks at Preqin's historical performance data in order to investigate which fund types have provided the best risk-return profile for investors, plus the fundraising success of different fund types.

Preqin's latest Investor Outlook: Alternative Assets, H1 2014 report revealed that 22% of LPs believe that fund performance is the key issue for the private equity industry in 2014, the second most commonly cited challenge. Additional results give a clear indication of the importance investors place on performance track records when considering commitments to the private equity asset class and forming relationships with fund managers; our survey of over 100 LPs across the world shows that 40% of investors rank past performance as the most important factor when looking for a private equity fund manager, and a significant 80% of investors surveyed stated that assessment of past performance is a key factor when conducting due diligence on private equity fund managers.

In this month's feature article we delve into performance data in order to investigate which fund types have provided the best risk-return profile for investors, plus overall returns over recent years. Specifically, we aim to test the relationship between performance and fundraising success, considering the effect that performance of different fund types has had on investor sentiment, through examining which funds have reached their target and how long they spent fundraising.

Any investor in the private equity space is fundamentally seeking to obtain high returns from their private equity portfolios. But with over 2,000 funds in market, the LP community is spoilt for choice, and faces a complicated decision making process when selecting which vehicles to commit to. Typically, the trend is higher risk generates higher return, but is this truly the case in private equity? Are there any fund types that buck this trend, and are those sectors having an easier time when it comes to attracting fresh capital?

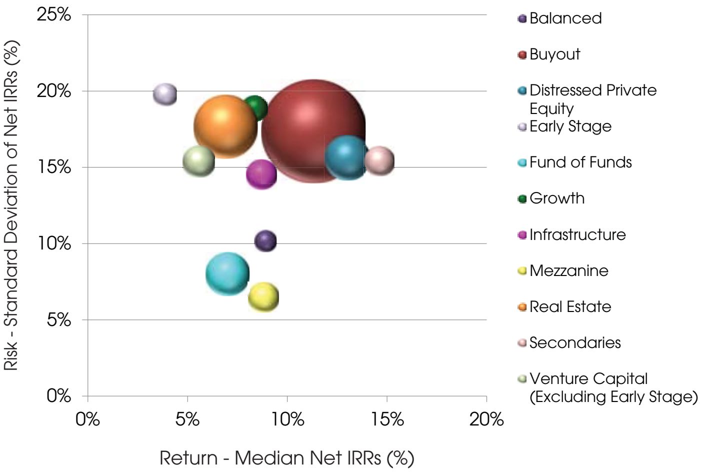
Risk-Return

Examining the risk-return relationship of different private equity strategies through the median and standard deviation of net IRRs can help investors select fund types to match their own risk-return requirements. Preqin's Performance Analyst tracks the performance of more than 7,000 funds; using this data, Preqin has been able to provide insight into the risk-return profiles of the main private equity fund types. Fig. 1 shows the performance of different fund strategies, plotting risk against return and taking into account the size of each market by capital raised. An interesting picture is painted, with a significant range displayed across both axes; though there are risks inherent in any illiquid market such as private equity, the level of risk between different fund strategies varies by some margin.

The fund type with the lowest standard deviation of net IRR, and therefore lowest risk, is mezzanine, with 6.5%, compared to early stage venture capital funds, which has the highest risk and standard deviation of 19.8%. Furthermore, the chart shows that early stage posts the lowest returns of all fund types displayed, with a median net IRR of 3.9%. In contrast, distressed private equity generated returns of 13.0%, which encompasses distressed debt, turnaround and special situation funds. However, investors remember that there have been numerous instances of 'homerun' early stage funds in the past, vehicles that have had high double, triple and even quadruple figure returns as they place investments in hit portfolio companies.

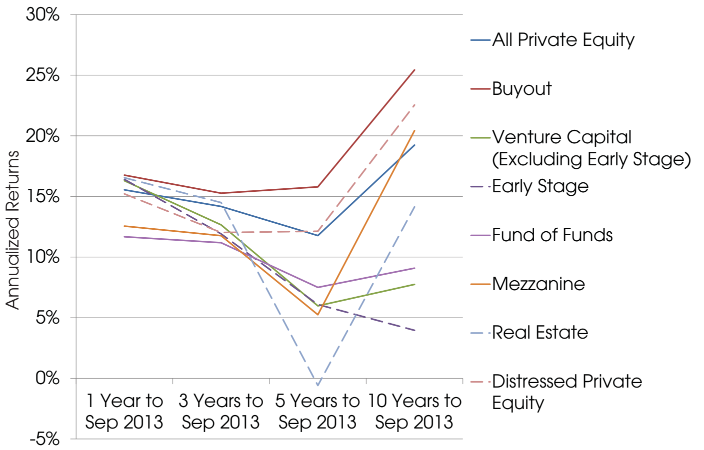
AMWIN Innovation Fund is a stellar example of such a vehicle, a 1998-vintage early stage fund that had a net IRR of 1015.71% according to Preqin's Performance Analyst. AMWIN invested in a number of early stage companies across the information technology, biotechnology and mining technology sectors. The outstanding rate of return was mainly due to the success of online company LookSmart, which listed on NASDAQ and the ASX. Notably, AMWIN Innovation Fund is a pre-2000 technology-focused venture capital fund, making its first investment from its AUD 42mn pool in 1998. The dot-com crash that was to follow in subsequent years and the struggle of the venture capital industry to recover back to the heights of the 90s has meant that to date, no other venture capital fund, early stage or otherwise, has come close to reaching such astronomical

Fig. 1: Risk and Return by Fund Strategy (Vintage 2001-2011)



Source: Preqin Performance Analyst

Fig. 2: Private Equity Horizon IRRs as at 30 September 2013 by Fund Type



Source: Preqin Performance Analyst

figures since. Performance Analyst shows a further 87 venture funds that have an IRR above 50%. Some of these are the big household names such as Apax Partners, Menlo Ventures and Kleiner Perkins Caulfield & Byers, but there are also a number of less established fund managers that feature in this list. Fund sizes range from $616mn to less than $1mn.

The Benefit of Diversification

Funds of funds sit low in the bottom left quadrant of the graph in Fig. 1, displaying a lower level of risk, with a standard deviation of 8.0%. This is largely due to the effect of diversification; fund of funds vehicles typically invest in a range of fund types and vintage years which spreads and reduces the level of risk. The median net IRR of this fund type also falls on the lower end of the spectrum, at 7.0%. A key factor behind this is the double layer of fees intrinsic to funds of funds, which of course negatively impacts on returns, as investors pay an extra fee for the expertise of fund of funds managers.

Diversification can also achieved by investment in the secondary market. Eleven percent of respondents to Preqin's recent private equity secondary market survey indicated that they buy fund stakes on the secondary market for the purpose of vintage year diversification. Secondary investments provide a good way of providing portfolio diversification, particularly via exposure to older vintages. Such investments often deliver strong risk-adjusted returns, with early cash returns mitigating the J-curve. With the evident growth of the private equity secondary industry over recent years, it is clear that investors are increasingly recognizing the appeal of secondary market purchases and though the size of the market is relatively small, the momentum that has been demonstrated over recent years indicates that this market will continue to grow in size.

Horizon IRRs by Fund Type

Preqin holds quarterly cash flow information for almost 2,600 individual private equity funds, and using this data, we are able to calculate horizon IRRs for a range of timeframes. Private equity horizon IRRs, as shown in Fig. 2, provide a useful snapshot of the performance of the industry over a set period of time. The calculation uses the net asset value (NAV) at both the beginning and the end of the period. The horizon returns are all annualized, dollar-weighted and net of management and carried interest fees.

Fig. 2 shows the horizon returns over the one-, three-, five- and 10-year periods for private equity as a whole, and also for a range of fund types within the asset class. Given the illiquidity and the long-term nature of investments into the private equity asset class, the most relevant data points to analyze and compare are the horizon returns of five and 10 years. These longer term horizon returns provide a better indication of the returns an investor could expect over the entirety of a fund's life.

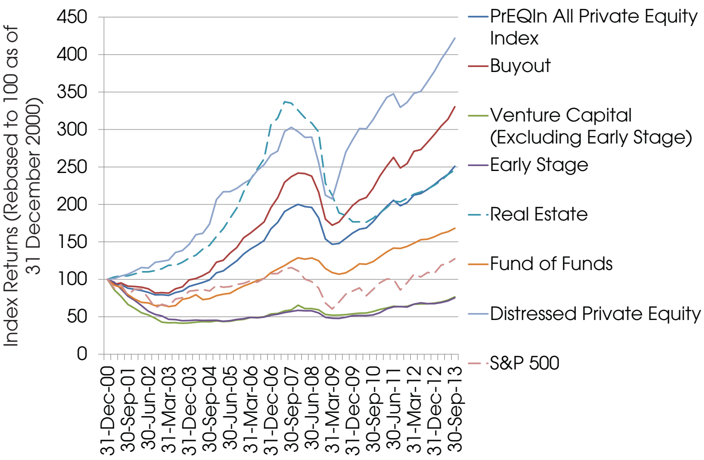
The dip in the IRRs at the five years to September 2013 mark is seen in almost all fund strategies, and reflects the detrimental effect of the financial crisis in 2008, with some fund types suffering more than others. The most significant decline is seen in real estate, the only fund type to post negative returns in this time frame.

Over the longest timeframe of 10 years, buyout outperforms all other private equity strategies with a 10-year return of 25.4% compared to 22.5% for distressed private equity, 14.1% for real estate, and 9.1% for funds of funds. Early stage funds have the lowest returns over the longer term horizon of 10-years (4.0%), with funds investing in other venture capital stages performing slightly better (7.7%). Buyout funds have similar returns to all private equity strategies across each time period shown, due to a large proportion of overall industry capital being accounted for by buyout funds. However, returns generated by buyout funds exceed the industry average by 6.2 percentage points over the 10-year timeframe.

The PrEQIn Index, the first quarterly global private equity index, captures the returns earned by investors on average in their private equity portfolios, based on the actual amount of money invested in private equity partnerships. Fig. 3 shows all fund types with the exception of early stage and other venture capital funds outperforming the S&P 500 over this time period. The PrEQIn Distressed Private Equity Index has consistently outperformed the private equity asset class as a whole, currently standing as the best performer at 421.9. Although this index also experienced sharp quarterly decreases between Q2 2008 and Q1 2009 due to the financial crisis, the subsequent recovery was achieved at a faster rate compared to other fund types, as managers sought to take advantage of the relative abundance of distressed investment opportunities following the economic crisis.

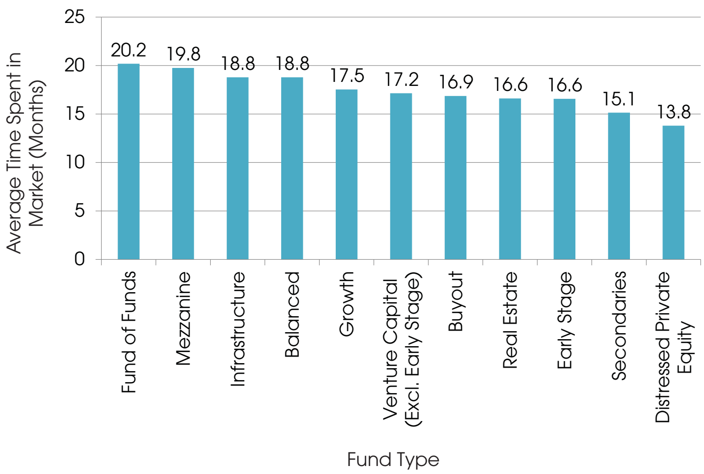
The PrEQIn Real Estate Index outperformed all other strategies prior to the economic downturn; however, as illustrated in Fig. 2, the

Fig. 3: PrEQIn - Private Equity Quarterly Index by Fund Type



Source: Preqin Performance Analyst

Fig. 4: Average Time Spent in Market to Reach Final Close, Funds Closed 2008 - Q2 2014



Source: Preqin Funds in Market

strategy was among the most severely affected by the market turmoil as a result of the subprime mortgage crisis, and took longer to reach its lowest post-crisis point.

Time on the Road

How does this all relate to the fundraising process? The figures presented so far show clear distinctions between the different strategies in terms of the average returns generated and risk profiles, but will similar patterns be evident in fundraising data? Fig. 4 depicts the average number of months each private equity fund type on average takes to complete fundraising, from launch to final close. Unsurprisingly, fund of funds vehicles spend the greatest amount of time on the road, with an average of 20.2 months for such vehicles closed in 2008-2014 YTD. The struggles of the fund of funds industry have been widely reported, with many examples of consolidation as firms put their private equity divisions up for sale in response to regulation and the challenging economic environment they have been facing in recent years.

Of all fund types displayed in Fig. 4, distressed private equity shows the lowest average length of time spent fundraising; distressed private equity funds closed in 2008 to 2014 YTD spent an average of 13.8 months on the road before reaching final close. In Fig. 1, we saw that distressed private equity funds (vintage 2001 – 2011) have generated one of the highest median net IRRs of all fund strategies investigated, at 13.0%, which will no doubt motivate investors to direct capital commitments to this fund strategy.

The highest returns of all fund types in Fig. 1 came from secondaries funds (15.4%), which also took the next shortest time on average to complete fundraising (Fig. 4). This suggests a strong correlation between the returns posted and the fundraising success of a fund strategy in terms of length of time taken to reach a final close. An example reinforcing this trend is the recent accomplishment of Ardian Secondary Fund VI, which is not only is the largest dedicated secondaries fund ever to be raised, but also was raised in a short amount of time. It launched in Q4 2013 and held its final close in April 2014. The fund originally targeted $7bn, but secured $9bn in total.

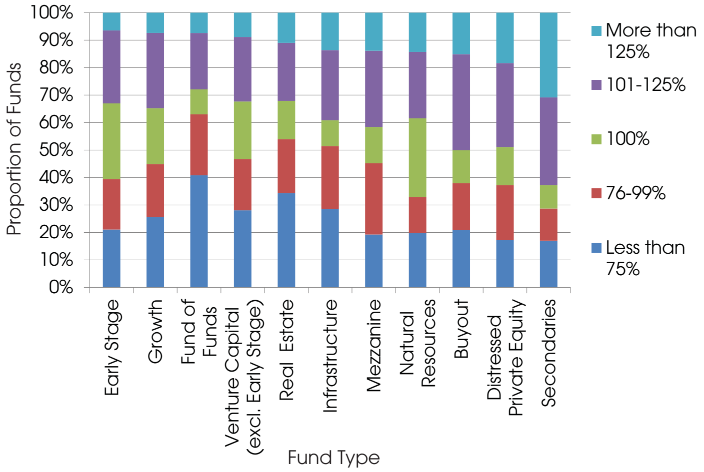
Hitting Targets

The ability to meet, or surpass, target amounts is another indicator of fundraising success. It reflects a variety of important factors such as investor appetite for a fund strategy, market conditions and effectiveness of fund managers. Fig. 5 compares fundraising of different fund types raised, by the proportion of target the vehicles within each strategy achieve. These statistics serve as a good gauge of the success of each fund type's fundraising efforts over recent years, focusing on the extent to which they have been able to meet or exceed target sizes, which in turn illustrates the investor appetite for that strategy.

A greater proportion of funds of funds failed to raise 75% or more of their target than any other strategy. This is further evidence of the challenges that the fund of funds market has faced in recent years in attracting LP capital. The industry has shrunk and as the private equity investor community has become progressively more sophisticated, LPs are increasingly looking to invest directly, therefore saving on the cost of the double layer of fees that impact the returns investors actually see.

Secondaries funds again stand out as a successful fund type; the strategy has the highest proportion of vehicles that have achieved

Fig. 5: Fundraising Success of Private Equity Funds by Proportion of Target Reached, Funds Closed 2008-Q2 2014



Source: Preqin Funds in Market

over 100% of fund's target size of any fund type. When we consider the risk-return profile presented for secondaries again, it is clear that it ranks as the strategy that offers the highest median returns and carries a lower level of risk compared to other prominent private equity fund types such as buyout and growth. A link between its performance and investor sentiment is well demonstrated by Preqin's statistics on fundraising. A substantial 63% of secondaries funds closed in 2008 to 2014 YTD exceeded their targets, with almost a third attaining a final close size of more than 125% of the original intended target amount (Fig. 5).

Conclusion

This study has shown there is indeed a correlation between the fundraising success of certain fund types and their risk-return profiles. As best exemplified by secondaries funds and funds of funds, which occupy opposite ends of the spectrum, the level of fundraising success achieved by vehicles (here measured by time taken to reach final close and ability to reach fundraising target) is linked to the risk-return profiles of the fund types.

Investors' consideration of risk-return profiles of different fund strategies is an important component of their decision to make a commitment. With private equity becoming a more prominent asset class, with growing investor allocations, further boosted by an increasingly sophisticated LP community trying to yield the highest returns in an uncertain economic climate, risk-return profiles will remain vital. As they inform investor appetite, it is therefore likely that such performance metrics will continue to be reflected in fundraising statistics, with certain fund strategies experiencing more success than others.

Data Source

Preqin's **Performance Analyst** is the industry's most extensive source of net-to-LP private equity fund performance, with full metrics for over 7,000 named vehicles.

Preqin's **Funds in Market** contains detailed profiles for over 17,800 funds in market or closed historically.

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