

Still life in the FoFs model

Commentary **Private Equity**

While relationships with funds of funds are evolving, **Katharina Lichtner** outlines the costs and dangers of going it alone in private equity

Recently, voices have been heard in the market claiming that private equity funds of funds are dead. Those voices generally argue that an expected decline in returns will put more pressure on limited partners (LPs) to save costs by investing in funds themselves; and they assume that the decline in overall fundraising levels alleviates access problems, which was one of the reasons why LPs have worked with funds of funds in the past.

However, this line of argument appears unlikely to withstand detailed analysis. In the following paragraphs these and other arguments will be discussed, and the conclusion is that funds of funds – granted, with a modified approach – are very much alive.

Many investors who are questioning what they perceive as the extra costs associated with funds of funds have forgotten that a fair comparison must also factor in the full costs of running an in-house private equity programme.

Even today, private equity remains a complicated asset class and considerable time and knowledge are required to find and evaluate high-class teams. Once those teams are identified and an investment selection has been made, complex legal, tax and compliance aspects need to be worked out. While this may be less challenging for well-established large cap managers in Europe and the US, it can be quite difficult in emerging markets, where legal costs alone can reach up to €10,000 for a single complex legal due diligence that includes structuring of the side letters often required in these jurisdictions.

Furthermore, private equity follows complex cash requirements, and its administration and monitoring are not straightforward. It is necessary to retain highly skilled professionals to manage the portfolio adequately, post investment. The most recent financial crisis has made it painfully obvious that cash management is particularly important. Lastly, private equity remains an industry where investment access to funds is granted on the basis of long-standing personal relationships. This creates a dilemma for many LPs. The private equity industry typically pays attractive salaries, even for fund of funds professionals. If an LP wants to build a high-quality, stable team, it needs to pay market rates.

It is generally accepted that a single individual cannot cover a market so diverse that it spans emerging markets mid cap growth investments all the way to US venture and to mainstream EU mid-cap buyout. Consequently, to make a global footprint across all strategies – desirable for diversification – a team of three or more relatively senior professionals is required. Add a professional specialised in private equity accounting, costs for travel and for legal and tax due diligence, one ends up with substantial expenses.

A further problem is that the average private equity allocation is unlikely to exceed 10% of the overall portfolio and is likely to be around 3-5%. This drives the relative costs sharply out of proportion

to what is typically spent on the management of the rest of the portfolio. Figure 1 illustrates that it takes about €75-100m before it becomes more cost-effective to rely solely on an in-house team rather than funds of funds, at least for parts of the allocation.

Another consideration is diversification. Diversification across geography, strategy, vintage year and industry is crucial for reducing risk and enhancing returns. Today the industry continues to require a minimum commitment size of €10m or more. This means that a reasonably diversified portfolio, be it local, regional or global, across 20-30 funds, would require a total allocation that would likely exceed many smaller investors' allocation to private equity. Even with a €5m commitment per fund, the total amount would be too much for many smaller investors. For them, the only route to reasonable diversification would be through a fund of funds.

As well as poor diversification, poor investment decisions are also detrimental to good returns, and poor investment decisions in private equity do not become visible for many years. They are also difficult to correct and can be very costly. Historically, there is a large performance spread between managers in the top half and those in the bottom half, and the median performance would fall short of most investors' expectations.

Top-half performance averages an IRR (US/EU) of 21%/17% and a multiple of 1.8x/1.6x, while for the bottom half it is -2.2%/-5.7% and 0.9x/0.8x respectively (see figure 2).

This simple example illustrates the point: an investment of €100m in well-diversified top-half performers might be expected to generate approximately 2x cash-on-cash over the life of the assets. Average investment decisions or indexing can easily reduce this to 1.4x over the same period. This would make a difference of about €60m in total gains – dwarfing the costs any fund of funds would generate over the life of the investment. Considering that in-house costs are incurred as well, the net-cost burden of investing with a fund of funds would be considerably lower.

The counter argument would be that LPs have learned from funds of funds, built relationships themselves and in the absence of access problems can now re-up with the good managers without the help and costs of a fund of funds manager. However, there might be two obstacles lurking around the corner.

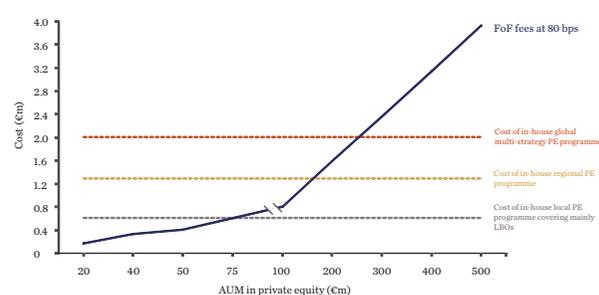
Post-crisis, the focus of creating value is shifting back to operational improvements, while the use of leverage is being de-emphasised. This shift requires fast adaptation from some management teams. It also renders recent track records less meaningful, particularly with respect to investments that were made shortly before or during the debt bubble. Selection of future winners has become much more complex – it entails a good understanding of how a manager has been creating value in the past, as well as whether the team has adapted the appropriate skills to generate attractive returns in the future.

In an industry that is still consolidating post-crisis, where only top-performing managers are likely to emerge unscathed and where it is natural to take flight to the well-known and proven names, access to top-tier funds is also likely to become further constrained. Funds of funds that have been solidifying their relationships with these top managers for decades will be best placed to continue investing with them. The combination of some institutional investors increasing their allocations to private equity and the shrinking and shifting pool of top-performing managers has already prompted a number of pension funds to turn to funds of funds to manage their specialised investing.

While it is short-sighted to sound the death knell for funds of funds, we do expect the industry to continue evolving. While historically funds of funds have offered global one-allocation-fits-all products, more customised techniques are becoming the norm. Investors are increasingly employing a mixed approach to private equity investing. The trend is to keep lean in-house teams concentrating on investing the core portfolio, and to rely on funds of funds for specific additions to portfolios. A similarly evolving trend is to use a fund of funds as a benchmark for the core portfolio where, through a commitment, investors can gain access to the fund of funds' extensive research and resources. These customised approaches provide an efficient means to better portfolio expansion and diversification, as the funds of funds are used to cover remote areas such as Asia, or complex niche strategies like venture, secondaries, distressed, co-investments or clean energy-related strategies.

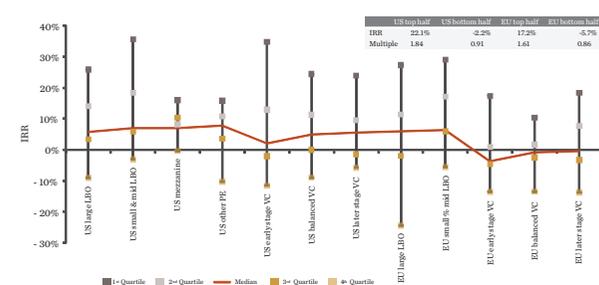
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1. Comparison of funds of funds fees with costs of running an internal team



Source: Capital Dynamics analysis on average fund of fund professionals wages; including costs for legal, tax, travel, software and research material

2. Performance spread of various private equity strategies in EU and US



Source: Thomson One, as of 4 June 2010. IRR data is as of 31 December 2009