CapitalDynamics

Private equity benchmarking with Capital Dynamics PME+

Overview

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Public market returns are not directly comparable to private equity Internal Rates of Return ("IRRs") due to several values, including the timing of the investments. One method to compare the two types of returns is to apply the cash flows of a private to a comparable public equity fund. This fund purchases and sells shares at the same time as the private equity vehicle calls and distributes cash. The Net Asset Value ("NAV") of the model fund, called the public NAV, depends on the number of shares and the share price (i.e. the index value). This methodology is called the Public Market Equivalent ("PME") and the computed public market equivalent return is the Internal Rate of Return (IRR) of so defined hypothetical fund. The basic premise of this approach is to allow a like-for-like comparison by translating time-weighted returns to money-weighted returns. We note, however, that the public equivalent NAV (depending on the number of public shares bought and sold) might be negative if the private equity fund outperforms the public index.

About our benchmarking method

Unlike the approach above, Capital Dynamics has developed a different methodology, which is believed to better approximate comparisons of the performance of public and private equity products. Capital Dynamics PME+ scales the distributions by a factor lambda such that the final private and public NAV are equivalent. This ensures that the final equivalent NAV is positive that the public equivalent is not short. This method allows a consistent and meaningful comparison between a private equity portfolio and the public market.

One of the most attractive features of both PME and PME+ is their conceptual simplicity. They can also be adjusted for factors, such as leverage, to reflect the additional risks associated with higher levels of debt versus a passive public market investment. As with any benchmark, the choice of comparable elements (here, public indices) becomes the most important factor in creating a fair comparison.

Additional sources of information

A publication from the British Private Equity and Venture Capital Association reviews the strengths and weaknesses of different PME methods (https://www.bvca.co.uk/Portals/0/library/documents/BVCA%20Perspective%20Series/Private%20Equity%20Performance%20Measurement.pdf?ver=2015-04-09-105554-523).

About the indices used

Commonly used benchmarks in today's investment environment are: MSCI World, S&P 500, Russell 3000 and FTSE All Shares. These indices are generally well-known and have sufficiently long histories to overlap most of the existing private equity funds. We recommend using the total return indices to take into account the effects of the dividends. While these indices are also well-diversified, their diversification might be larger than the diversification present in the private equity portfolio or fund to benchmark; at least in terms of number of companies captured. They are, however, still helpful indicators to evaluate private equity portfolios.

However, these indices generally do not make adjustments for advisory fees, brokerage or other commissions, and any other applicable expenses a private equity investor would have to pay or has actually paid. Tax is another complicated factor in comparing returns and is not generally included in the benchmarks. Not all investors are subject to the same taxes and some may not be taxed at all, meaning that this is another basis on which rates of returns may vary among investors.

Conclusion

PME+ does not attempt to specifically adjust to any risk differential that might exist between the private equity cash flows and the public index, as the impact of tax on returns or as a potentially higher leverage ratio on private equity companies. Our goal is to provide you with the most accurate and relevant performance information possible. Capital Dynamics is always working to enhance our private investment performance database and ensure that our benchmarks are representative of a sample investor opportunity set.

As we often receive requests to give guidance on how Capital Dynamics PME+ should be implemented, we have prepared an example that can be downloaded on our website.

Endnotes and additional risk factors

All information in this explanation of private equity benchmarking with Capital Dynamics PME+ is attributed to Capital Dynamics, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of Capital Dynamics or its affiliates (collectively, "Capital Dynamics").

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When considering alternative investments, such as private equity funds, the Recipient should consider various risks including the fact that some funds may use leverage and engage in a substantial degree of speculation that may increase the risk of investment loss, can be illiquid, are not required by law to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. Any such investment involves significant risks, including the risk that an investor will lose its entire investment.