Private equity - the new asset class

Highlights of the London Business School report

"UK Venture Capital and Private Equity as an Asset Class for Institutional Investors"

BVCA

Representing British Venture Capital and Private Equity

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A copy of the full London Business School report is available from:

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Foreword

London Business School's report "UK Venture Capital and Private Equity as an Asset Class for Institutional Investors" is one of the most important elements supporting our efforts to obtain recognition of UK private equity as a mainstream asset class. UK pension funds have invested a decreasing amount of funds in our industry over the past few years and we are increasingly dependent on overseas funds, particularly those from the USA. The US market is highly experienced in private equity investment and appears to be using the experience of UK private equity managers as an access point for attractive returns and wider pan-European private equity investment.

The UK private equity industry accounts for nearly half of all European investment and is second largest in the world after the US. Its private equity firms have some of the most experienced managers in the world with outstanding investment records. Over the period between 1987 and 1998, cumulative private equity returns have outperformed all principal UK comparators.

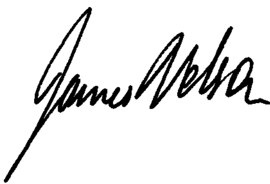
This summary report aims to highlight why the BVCA believes pension funds should invest in UK managed private equity funds, supported by the strong evidence provided by the full London Business School report, which is available from the BVCA.

The BVCA would like to thank the National Association of Pension Funds (NAPF) for their encouragement and support which led to the publication of the full London Business School report and this BVCA summary.

The work undertaken by London Business School's Oliver Burgel has been outstanding in its thoroughness and strict adherence to its independent stance. Oliver spoke to a wide range of investors, gatekeepers, advisers and venture capitalists in the course of his research. We would also particularly like to thank the time given by the members of the BVCA's Investor Relations Committee, chaired by Edmund Truell.

There are a number of other people I would like to thank who are listed at the back of this summary report whose input and dedication have been much appreciated.

We do hope you find this summary of interest. I and my colleagues would be delighted to speak to you if you have any further questions.



BVCA Chairman, James Nelson

January 2000

Private equity - the new asset class

The terms venture capital and private equity describe equity investments in unquoted companies. In the UK and much of continental Europe, the term venture capital is used synonymously with that of private equity. In the US, however, venture capital usually refers to the provision of funds for younger, early stage and developing businesses whereas private equity is mainly associated with the financing of leveraged management buy-outs and buy-ins (MBOs and MBIs). However, for this summary report we will be using the term private equity throughout.

Many people are concerned about the decline of funds in the UK private equity industry provided by UK pension funds. The BVCA, encouraged by the NAPF, commissioned a full report from London Business School to provide an independent analysis of:

- The concept of private equity finance and the fund raising and investment process of private equity firms
- The characteristics of private equity, its returns, risk and cash flow implications in order to assess the suitability of this asset class for institutional investors.

The report is focused principally on analysing UK managed private equity "limited partnership" funds, those with a fixed "life" of around 10 or more years. Details on quoted private equity investments trusts are more widely accessible and understood.

The full London Business School report runs to over 90 pages, is highly detailed and thoroughly researched. It also discusses the methodological foundations of performance measurement, risk and cash flow analysis. This summary report highlights its key findings[1].

- Attractive returns have been produced by the private equity asset class over the last 18 years. Since 1987 cumulative private equity returns have outperformed all principal UK comparator asset classes.
- The risks of investing in private equity funds are far lower than many investors may perceive as long as they build up a diversified portfolio, from which a loss of capital is extremely unlikely.
- The outlook for strong returns continues to be good, particularly among the UK-managed private equity funds, which are at the forefront of the growing pan-European market.
- The Minimum Funding Requirement presents more of a psychological barrier to trustees considering investment in private equity funds than an actual significant depletion in a fund's liquidity. A diversified private equity portfolio can be used as a long-term cash generator, suitable even for mature pension funds.
- The cash flow profile is more attractive than many investors perceive, offering strong positive cash flows from as early as two years after the first draw down. Liquidity has also been markedly improved by the increasingly active secondary market.

[1] For a more detailed substantiation of any of the statements made in this summary report, readers are encouraged to refer to the full report which is available from the BVCA - please see contact details on page 1.

Private equity - the new asset class

Full report section and other references

Private equity explained

Executive summary

Private equity is a mechanism of financing companies that represents an alternative to raising funds on public equity or debt markets. It is applicable to cases in which the perceived level of risk and uncertainty or simply the long time horizon associated with the investment is too great for debt providers and the public markets. These conditions apply to companies at an early stage of their development and especially in high-technology environments, where the commercial potential of innovations may be difficult for non-specialists to estimate. Private equity is applicable to technology-based firms and growth-oriented start-up businesses. It has also become a common mechanism to finance the separation of non-core assets from a parent company, to facilitate management succession in family-owned firms and to de-list undervalued firms from a stock exchange ("public to private transactions").

Private equity providers become co-owners of these companies and share risk and returns to the extent in which they participate in them. Their returns directly depend on the growth and profitability of the investee firm. Private equity managers realise their returns through selling their stakes in investee companies. Successful investments are usually exited through trade sales or offerings on a recognised stock exchange.

In the UK, the main providers of formal private equity are private equity firms. The majority of these firms are independent private equity firms, which raise their funds for investment from external sources, mainly institutional investors such as banks, insurance companies and pension funds. Captive private equity firms obtain their funds from parent organisations which are usually financial institutions. Increasingly, some of these captives also raise funds from institutional investors. They are known as semi-captives. For institutional investors, fixed life funds managed through independent and semi-captive limited partnerships are the primary vehicles to invest in private equity.

In limited partnerships, institutional investors constitute the limited partners and private equity firms act as general partners. The minimum investment considered by most private equity firms usually amounts to 1% of the total funds being raised. The maximum investment usually accepted from a single investor corresponds to about 10% of the total fund size. The majority of private equity funds include between 10 and 30 limited partners. A limited partnership usually has a fixed 10 year life during which the general partners select investments, structure deals, monitor investments and design the appropriate exit strategies on behalf of the limited partners. In exchange, they receive a management fee and a share of the overall returns of the fund. The latter is referred to as carried interest. The partnership's funds will usually be invested by the general partners within three to five years. Despite being set up with an initial life of 10 years, many funds continue to exist beyond that period because some investments will not be fully exited within the intended life of the fund. When all investments are fully divested, a limited partnership can be terminated or "wound up".

Adapted from full report executive summary.

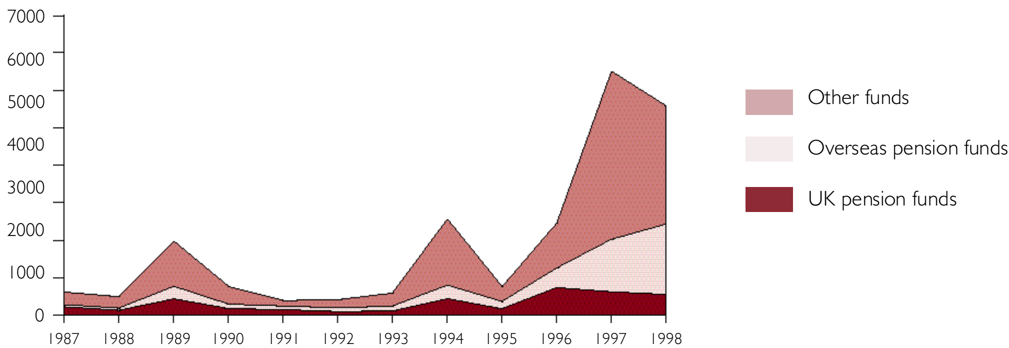
Returns

Full report section and other references

The returns generated by UK managed private equity funds have been sufficiently attractive to warrant great interest in this asset class, particularly from experienced US institutional private equity investors and increasingly from continental European investors.

BVCA Report on Investment Activity 1998

Pension fund and other private equity commitments



The BVCA/WM performance survey is "one of the most complete country specific datasets on the performance of venture capital funds in the world."

1

The London Business School report carries out a four-fold performance analysis. First, it calculates industry level returns over different time horizons. Second, it compares the returns both annually and on a cumulative basis to the main comparators. Third, it examines the absolute returns (multiples). Fourth, it compares the returns to the European and US private equity industries.

5.2

The long-term performance of the UK private equity industry since 1980 stands at over 14% per annum net of all costs and fees.

"A short-term IRR should be discussed in conjunction with the levels of investment activity since it is not a sufficient indicator to assess the industry-level performance of this asset class."

5.2.1

Over the period between 1987 and 1998, cumulative private equity returns have outperformed all principal UK comparators.

From 1987 (the first year for which individual fund valuations are available) to 1998, the cumulative annualised private equity returns were slightly higher than quoted equity returns (14.8% and 14.6% respectively). All other major UK asset classes were outperformed by a substantial margin of 240 to 460 basis points.

Since 1992 cumulative private equity returns have outperformed UK equities by a substantial margin of 910 basis points and other UK asset classes by a margin of 1270 and 1520 basis points.

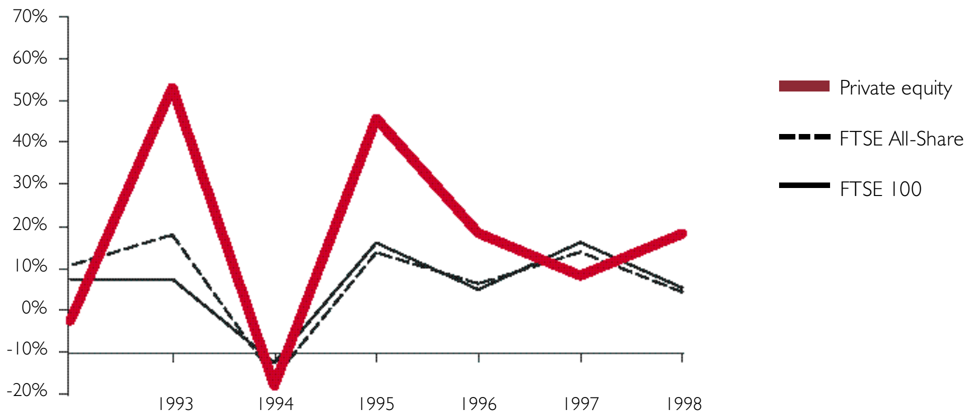
Returns

These figures are based on a comparison between historical private equity cash flows and identical cash flows invested in and divested from index-tracking derivatives for other asset classes (for annual and cumulative returns, see Figures 8 and 9 below).

5.2.1

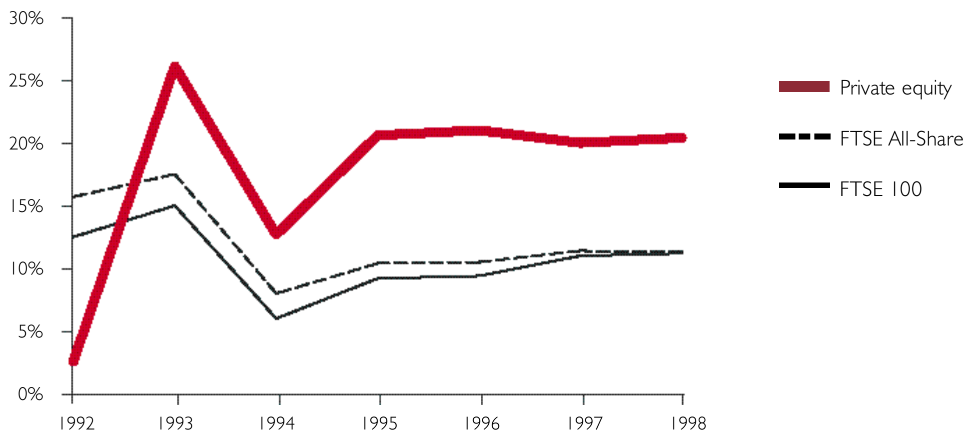
Annual IRR of UK private equity compared to equity total return indices (base year 1992)

5.2.3.1
Figure 8



Cumulative annualised IRR of UK private equity compared to equity total return indices (base year 1992)

Figure 9



Several young funds that have not yet reached maturity (those funds raised within the last four years) have already produced returns in excess of 15% per annum. The returns of these funds are likely to increase as they reach maturity and exit their investments.

5.2.1

Returns

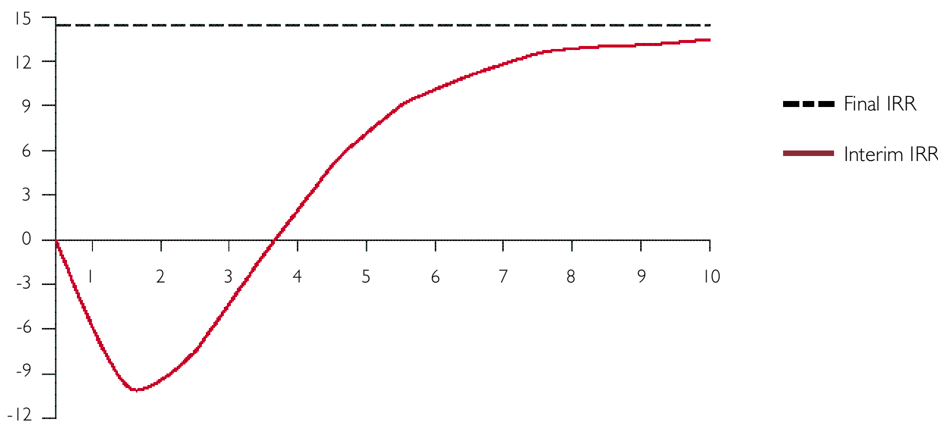
5.1.3-5.1.8

The full London Business School report analyses the returns of UK managed limited partnership private equity funds in great detail. It concludes that the methodology adopted by The WM Company and the BVCA to measure performance and the use of the Internal Rate of Return (IRR) is the most appropriate for the asset class. Private equity returns are analysed net of all costs and fees.

"An IRR of 15% does not signify that a compound return of 15% over a 10 year period is achieved for the totality of committed capital. As a result, the returns of the partnership reported only refer to the amounts of drawn funds and the time during which they have been working for the fund's portfolio."

Figure 1

The evolution of private equity returns over time: the J-curve pattern



Note: The graph shows an illustrative example

Interim fund IRRs follow the so called J-curve pattern. The J-curve (shown above) is caused by the management fee and start-up costs of the private equity limited partnership usually being financed out of the first draw downs in the first year, followed by the general partners starting to invest. BVCA valuation guidelines recommend investments should be valued at cost during the early years. Upwards adjustments of the values are made only when an investee firm has demonstrated a substantial increase in value, usually following receipt of audited financial statements. In comparison, poor performing investments are written down as soon as problems are identified, generally impacting earlier rather than later. When the first successful realisations are made, the return curve rises steeply. For MBO funds, the time period required to reach positive IRRs can be shorter than for early stage and development funds depending on the state of public equity markets.

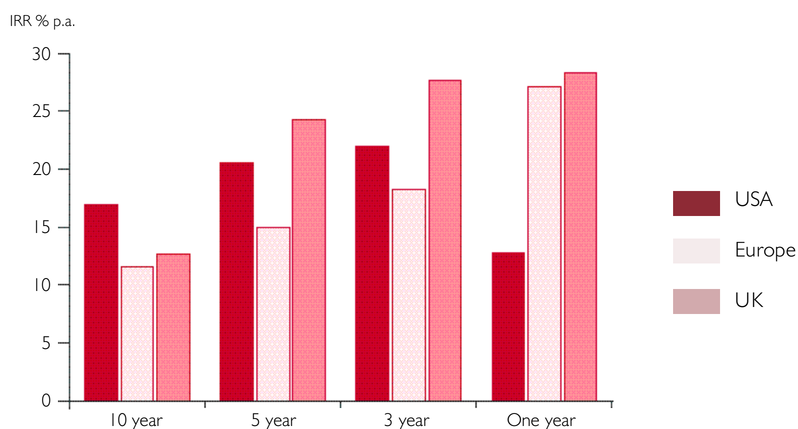
Returns

During the 1990s, the UK buy-out and generalist funds have outperformed their US and European peers. Compared with the USA, the UK funds have recently had even stronger performance. UK returns have also been consistently higher than the aggregated returns produced by European private equity funds[2].

5.2.2

Comparative private equity returns

BVCA



Data from the London Business School report, graph drawn by the BVCA. NB. Data from USA and UK are measured to 31 December 1998. USA data includes mezzanine funds; European data includes UK funds (accounting for 66% of the total amount of funds analysed) and is measured to 31 December 1997 (the latest figures available).

Mature UK funds (those raised more than four years ago) have already returned 131% to their investors while still retaining a conservatively valued 44% of the original drawn down capital within their portfolios.

5.2.4

UK private equity capital realisations by investment stage (mature funds only)

Table 21

Investment stage	No. of funds	Capital raised	Paid-in capital (draws)	Distributions (1)	Residual value (2)	Total value (3)	(1) as % of paid-in capital	(2) as % of paid-in capital	(3) as % of paid-in capital
Early stage	17	193	190	220	82	301	115	43	158
Development	34	515	486	629	155	784	130	32	162
Mid MBO	27	868	844	1164	284	1448	138	34	171
Large MBO	26	3095	3221	4249	1319	5569	132	41	173
Generalist	30	1032	1001	1262	663	1924	126	66	192
Total	134	5703	5742	7523	2503	10026	131	44	175
Technology funds only	26	383	359	566	108	674	158	30	188

Source: London Business School calculations

[2] As surveyed by the EVCA (European Venture Capital and Private Equity Association) in 1997.

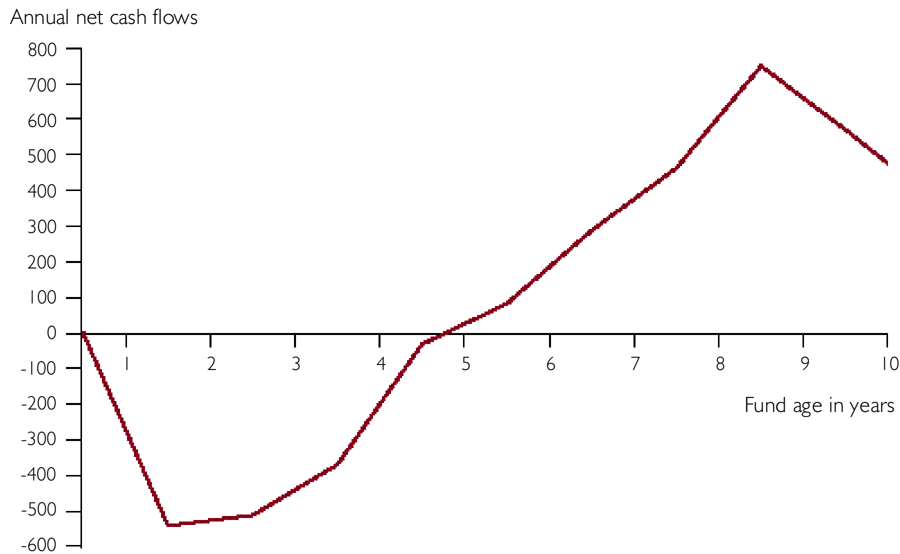
Cash flow profile

An investor is rarely required to invest its maximum commitment to a private equity fund, with funds typically drawing down from 80-95% of a commitment. Funds are usually drawn down on an investment by investment basis. Positive cash flows are generated as and when investments are realised.

2.4.2

Pooled annual industry net cash flows by fund age (all funds older than 10 years)

Figure 21



Source: London Business School calculations

Funds usually generate positive net cash flows after three to five years (some have managed to achieve positive net cash flows after periods as short as two years). This period tends to be shorter for MBO funds than for early stage and development funds. Diversification among several private equity funds would assist in smoothing the variations of monthly cash flows.

5.4.1

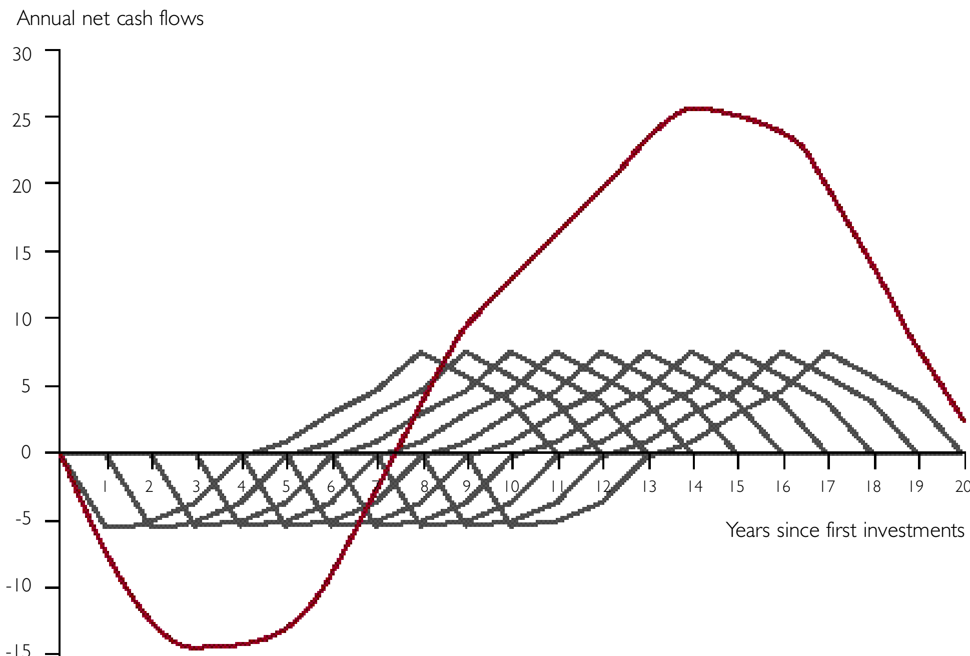
Cash flow profile

While private equity involvement will be illiquid during the initial investment period, an ongoing investment in this asset class will have a positive long-term net cash flow and thus improve the funding of a pension plan. London Business School therefore concludes that even mature pension funds should consider private equity investments since they can be used as long-term cash generators.

5.4.2

Simulation of long-term net cash flow per annum implications of private equity investments

Figure 22



Source: London Business School calculations

The growth in a secondary market in private equity partnership stakes (prior to the funds being wound up) has markedly improved liquidity in the private equity arena.

5.4.3

London Business School concludes that:

5.4.2

"An ongoing investment in this asset class will have positive long-term net cash flows and thus improve the funding of a pension plan. Even relatively mature pension funds should consider private equity investments since they can be used as long-term cash generators."

Risk

According to conventional wisdom, private equity is perceived as highly risky and the majority of textbooks usually refer to private equity as a high risk asset class. However the nature of risk involved is rarely discussed since industry risk analysis is still in its infancy. Risk analysis (using indicators such as "betas") used for quoted portfolios, where individual stocks can be valued on a daily basis, cannot be applied to private equity portfolios. The definitive return of a fund can only be calculated when a fund is wound up. However, the overall returns for the industry (including both mature and immature funds) indicate that within "a diversified portfolio" the potential for a capital loss is extremely unlikely. "A diversified portfolio" would be a well managed portfolio of regular commitments, over a number of years, across a range of managers of different types of private equity funds.

5.3

Risk can be best assessed by looking at the spread of returns and by the chance of losing money through investing in private equity limited partnerships. While individual investments may have a higher risk profile, the limited partnership fund structure automatically spreads the risk to investors.

5.3

The spread of returns show considerable variation at the fund level. To date the aggregate risk-return profile of mature funds has been more favourable for later stage investments and larger funds. Attractive returns have been generated by individual funds irrespective of vintage year, investment focus and size class. Furthermore, technology-focused private equity funds, the group of funds conventionally associated with the highest risk, have in the past actually been the least risky when considering risk in terms of IRR fluctuations and the possibility of not recovering invested funds. London Business School suggests that fund performance is driven in large part by the experience and skills of the general partners rather than structural characteristics of the fund.

5.3.1

Range of returns of mature UK private equity funds by investment stage in %

Table 23

Investment stage	No. of funds	Pooled IRR	Mean IRR	Median IRR	Min.	Max.	Range	Standard deviation
Early stage	17	8.2	6.9	8.1	-9.6	18.9	28.5	8.7
Development	34	9.1	4.6	4.8	-17.7	32.9	50.6	11.6
Mid MBO	27	16.4	15.7	14.9	-6.6	40.6	47.2	9.8
Large MBO	26	17.8	22.3	20.5	-3.0	67.3	70.3	15.3
Generalist	30	12.0	8.1	7.9	-9.9	32.0	41.9	9.8
All funds	134	14.3	11.3	10.8	-17.7	67.3	85.0	13.1
Technology funds only	26	9.8	10.2	9.1	-0.2	20.2	20.4	6.2

Source: London Business School calculations   Note: The table shows IRRs since 1980 for mature funds started before 1995.

Diversification of investment among a range of different private equity funds, or through a gatekeeper's fund of funds, is of utmost importance to reduce risk due to the spread of return from individual funds.

Executive summary
5.3.1

The fact that current mature funds have already returned 131% of funds to their investors, while still retaining a conservatively valued 44% of the original drawn down capital, must surely further weaken the arguments for private equity funds being a high risk investment.

5.2.4

The outlook for returns

Concerns that there may be "too much money chasing too few deals" has led to fears about the outlook for private equity returns. Most of the money raised by UK private equity managers comes from overseas. In fact, 73% of the total raised in 1998 came from overseas sources, the majority of which was from the USA. Even though US investors are heavily committed to their own domestic private equity arena, it has not quashed their enthusiasm for investing with UK managers, nor has it discouraged US private equity firms from setting up offices in the UK.

6

The main competition in the market place appears to be in the larger international buy-out market. Well-structured funds with a good manager, with a strong pricing discipline that prevents over paying for acquisitions, should ensure continued good performance. Other segments of the market are unlikely to be so affected.

Why you should invest in venture capital - BVCA

The strength of the UK and European economies and the availability of investment opportunities is important to the continued success of the UK private equity industry as the majority of its investments are in companies head quartered in the UK. London Business School reports that it believes the trends of continued growth in the buy-out and buy-in environment and stability in start-up rates for companies bodes well for the UK private equity industry.

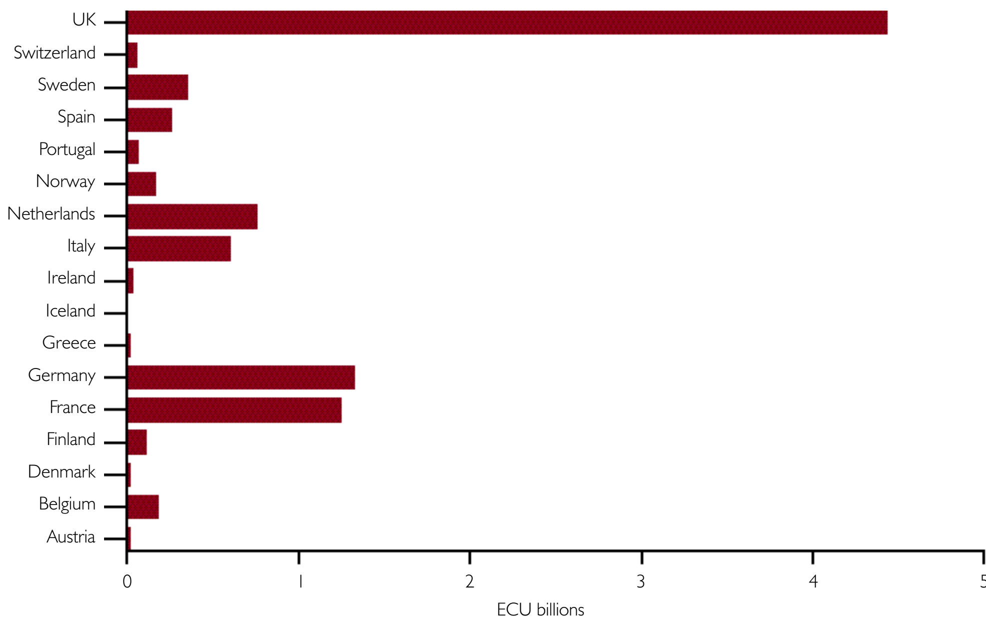
6.1

The UK market is the largest and most experienced in Europe. The UK-based managers are using their expertise to expand into Europe and elsewhere. UK based internationally focused private equity funds offer investors a way of accessing these growing markets. UK managers have also shown themselves to be capable of being more profitable than their US and European counterparts in certain areas.

5.2.2

Investment by private equity firms based in each country

EVCA 1998 Yearbook



UK-headquartered private equity firms accounted for nearly half (49%) of private equity investment in Europe in 1998.

The outlook for returns

Private equity managers are also continually growing their own market by developing new "products", such as public to private and secondary transactions.

6.1
2.4.3 & 5.4.3

The development of the second tier stock markets in most Western European countries has substantially improved the exit opportunities for the private equity industry, particularly in recent years for technology related companies, benefiting valuations, shortening the holding period for investments, thereby enhancing returns.

BVCA Report on Investment Activity 1998

Impact of Minimum Funding Requirement (MFR)

The MFR should not prevent interested funds from allocating money to private equity.

5.5.2

While a private equity investment will lead to a very small deterioration of a pension fund's MFR position, this is only experienced by first time investors. The actual effect should not prevent interested funds from allocating money to this asset class. The indirect impact, however, is not to be underestimated, since it has biased trustees' asset allocation decisions against private equity. The MFR has therefore provided a barrier to meeting the Government objective of encouraging institutional investment in private equity funds. London Business School recommends that the Government and regulators review the MFR and its potentially harmful effect on allocation decisions and pension fund performance.

Private equity firms' fees

Private equity returns are shown net of all costs, fees and carried interest

2.4.4

The remuneration of the private equity fund managers (the "general partners" of a limited partnership fund) is governed by sophisticated contractual arrangements. In return for their investment services, general partners receive a management fee and a share of the profits of the fund - known as the "carry" or "carried interest".

Fees on committed capital

2.4.4

Many private equity firms charge a management fee of between 1.5% and 2.5% of committed capital, usually paid up to the sixth year. These fees are gradually phased out to take account of realised investments.

Carried interest and hurdle rate

2.4.4
5.5.1

Profits of a limited partnership fund are usually shared on an 80/20 basis with 80% going to the limited partners and 20% to the general partners. In addition, many partnership contracts include a so-called "hurdle rate", which gives limited partners a preferential access to the profits of the partnership if the total returns are insufficient - thus eliminating part of the downside risk for institutional investors.

London Business School's point of view

5.5.1

"From an investor's point of view, the decision whether or not to invest in this asset class should not depend on the level of rewards for the venture capitalists, but on careful analysis of whether the expected net returns justify the level of risk and the necessary investment in management-picking skills."

London Business School's key recommendations to pension fund investors

Recommendation	Detail	Section
Private equity returns are attractive	Since 1987, cumulative private equity returns have outperformed all principal UK comparator asset classes.	7.1
Take a long-term perspective	The decision to invest should be taken with a long-term perspective in mind since it takes three to five years before investors experience positive returns and net cash flows.	7.1 5.1.3-5.1.8
Diversify between funds and managers	Diversification between funds and managers is of the **utmost** importance to smooth cash flows and to substantially reduce the spread of returns. (Details of private equity firms can be found on the BVCA's website and in the BVCA "Directory" of members.)	7.1 5.3
Make appropriate commitments	Investors should be prepared to make appropriate commitments to this asset class. For smaller investment funds, London Business School would not recommend the direct investment in this asset class unless a sufficient share of funds is allocated to build up a diversified portfolio or unless investment is through a fund of funds managed by a gatekeeper, or invested in a selection of quoted investment trusts. The median size for a pension fund in the UK is £54 million and the median sized private equity fund set up in the last two years raised £84 million. Generally the minimum share from an individual investor considered by a private equity firm would amount to 1% of committed capital. In this example, this would amount to £840,000. London Business School considers that a participation in 10 to 12 limited partnership funds should eliminate the largest part of the diversifiable risk. In this case, this would require between £8.4 and £10.8 million from an investor, representing 15.5-18.7% of their assets.	7.1 5.3.3
Be prepared to make higher nominal fund allocations	Usually a maximum of 80-95% of an investor's "committed capital" is drawn down. Investors should be prepared to make higher nominal fund allocations to this asset class in order to achieve their target exposure.	7.1 2.4.2

London Business School's key recommendations to pension fund investors

First time and smaller funds may consider investing in funds of funds

London Business School therefore recommends that smaller pension funds that do not wish to invest more than, say, 5% of their assets in private equity, may wish to consider investing through gatekeepers' funds of funds. Gatekeepers' funds of funds usually accept lower contributions from smaller pension funds than private equity funds.

7.1
5.3.3

Ideally appoint a dedicated private equity fund manager, subjected to different incentive and monitoring procedures

Managers of private equity portfolios should be subjected to different organisational procedures than the managers of public equity portfolios. For example, a measurement of private equity on a monthly basis only makes sense if the managed portfolio comprised a large number of individual private equity participations. Furthermore, 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 recommends that pension funds appoint dedicated private equity managers and subject them to different incentive and monitoring procedures.

7.1

A well structured portfolio can be attractive to all types of pension funds, irrespective of maturity

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 will generate positive net cash flows for a longer period. Despite the common belief that pension funds approaching maturity should not invest in private equity for reasons of illiquidity, London Business School believes that an appropriately structured private equity portfolio can be attractive for all funds irrespective of their maturity since it generates substantial positive net cash flows after an initial investment period.

7.1
5.4.1

Market liquidity has improved with the growth in the secondary market.

More recently, the growing secondary market has led to a substantial improvement of the liquidity of the private equity industry. Therefore, it is now perfectly possible to sell stakes in limited partnerships before the partnership is wound up.

7.1
5.4.3

The BVCA recommends that those considering investment into private equity always seek professional advice.

How to invest in private equity

The following represent five of the principal ways of investing in private equity.

Private equity funds

Pros	Cons
Over 200 private equity funds enabling a wide selection of investment opportunities	Need for staff to achieve and maintain a good knowledge of private equity fund managers, fund raisings, portfolio content, performance, etc
Wide range and number of private equity managers seeking to raise new funds in which to invest over the next few years	Each fund's performance is generally reported quarterly or half yearly. More regular valuations are not usually available
High level of control	Minimum level of investment may apply.
The amount or commitment to a fund is agreed at the outset and the fund has a predetermined investment life	
Self liquidating fund structure	
Private equity funds are directly accountable to you	
Many private equity fund managers take a position on the board of the company in which they invest to keep in close contact with the companies' development	
Private equity funds managed by most BVCA members have a high level of expertise and quality deal flow.	

Dedicated funds managed by a private equity fund manager

Pros	Cons
High level of control	Requires substantial funds to be commercially viable and to spread risk.
Good accountability and direct contact	
Flexible.	

How to invest in private equity

Listed venture and development capital investment trusts

Pros	Cons
Performance measurable on a daily basis	Spread of investments across different managers limited - there are only about 20 UK venture and development capital investment trusts managed by BVCA members
Liquidity	Shares may trade at a discount to net asset value.
Many investment trust managers take a position on the board of the company in which they invest to keep in close contact with the companies' development	
Investment trusts managed by BVCA members have a high level of expertise and quality deal flow.	

Funds of private equity funds

Pros	Cons
Access to a diversified private equity portfolio and therefore eliminating the risk of under-diversification	Double layer of fees (from the gatekeeper and the private equity fund manager)
Expertise in investing in private equity funds, knowledge of private equity managers' performance, methods, portfolios, fund raising timings, etc	Potential barrier between private equity manager and fund manager, reducing accountability
Delegated control, therefore saving in management time	Potential conflict of interests between gatekeepers' objective advice if they are raising a fund of funds when other private equity managers are raising funds
Offers an insight into private equity fund investment for those who do not yet wish to be involved in in-house or direct fund investment	Limited number of fund of fund managers in the UK
Offers a wider spread of investments for smaller investments by pension funds	Longer term commitment.
The amount or commitment to a fund is agreed at the outset and the fund has a predetermined investment life	
Self liquidating fund structure	
May offer current direct private equity fund investors a different and wider view of the market.	

How to invest in private equity

Direct investment into unquoted companies

Pros	Cons
Full control	Full responsibility
Direct access to portfolio companies.	Requires substantial funds to achieve an adequate spread of investments
	Cost and commitment: need for substantial permanent staff
	Staff need expertise in negotiating and structuring the initial investment, monitoring the companies and exits
	Requires access to potential investment opportunities, as success depends on quality and quantity of deal flow. The private equity industry estimates that it invests in only one in 100 proposals.

Source: BVCA

Glossary of terms

Carried interest ("carry"): Carried interest or simply "carry" represents the share of a private equity fund's profit (usually 20%) that will accrue to the general partners.

Committed funds (or "raised funds" or "committed capital"): Capital committed by investors. This will be requested or "drawn down" by private equity managers on a deal-by-deal basis. This amount is different from invested funds for two reasons. Firstly, most partnerships will invest only between 80% and 95% of committed funds. Second, one has to deduct the annual management fee which is supposed to cover the cost of operation of a fund.

Distributions: Payments to investors after the realisation of investments of the partnership.

Divestments (or realisations or exits): Exits of investments, usually via a trade sale or an IPO (Initial Public Offering) on a stock market.

Draw downs: Payments to the partnership by investors in order to finance investments. Funds are drawn down from investors on a deal-by-deal basis.

Fund of funds: Private equity funds whose principal activity consists of investing in other private equity funds. Investors in funds of funds can thereby increase their level of diversification.

Gatekeepers: Specialist advisers that assist institutional investors in their allocation decisions to private equity. Most manage funds of funds.

Hurdle rate: Arrangement that caps the downside risk for investors. It allows investors to get preferential access to the profits of the partnership. In the absence of reaching the hurdle return, general partners will not receive a share of the profit (carried interest). A hurdle rate of 10% means that the private equity fund needs to achieve a return of at least 10% before the profits are shared according to the carried interest arrangement.

Interim return: The definitive rate of return of a private equity investment can, by definition, only be calculated when the fund is wound up. Most return calculations therefore produce interim IRRs which approach the definitive rate of return after approximately three to six years. This period is usually shorter for buy-out funds than for early stage and development funds.

Internal rate of return (IRR): The IRR method is the most appropriate method for calculating the returns of a private equity fund. In essence, the IRR represents the rate at which positive and negative cash flows are discounted so that the net present value of the fund amounts to zero.

Investment stage: In this report, the term investment stage refers to the fund's investment preferences. In accordance with the "cut-offs" used for The WM Company's annual BVCA performance survey, funds were divided into:

- "Early stage" funds - investing in companies in the seed (concept), start-up (within three years of a company's establishment) and early stage of development
- "Development" funds - investing in expansion stage companies, ie. established companies which raise private equity to make acquisitions, fund working capital, buy new plant, etc and small management buy-outs (MBO) and buy-ins (MBI) with less than £2 million of equity invested
- "Mid-MBO" funds - investing in MBOs and MBIs with £2-10 million of equity invested
- "Large MBO" funds - investing in MBOs and MBIs with more than £10 million of equity invested
- "Generalist" funds - investing in companies at a variety of stages of development.

Glossary of terms

J-curve: The J-curve illustrates the IRR pattern of a fund over time. During its first one or two years, a private equity fund will show a negative return. This is due to the impact of the start-up costs and the annual management fee which do not result in the creation of book-value. The fund's returns will start to rise as soon as the first realisations are made. After approximately three to six years, the fund's interim IRR will approach its final IRR.

Limited partnership: Most private equity firms structure their funds as limited partnerships. Investors represent the limited partners and private equity managers the general partners.

Secondary market: The secondary market enables institutional investors to sell their stakes in a private equity partnership before it is wound up.

Trade sale: Sale of the equity share of an investee company to another company.

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BVCA

Representing British Venture Capital and Private Equity

"The BVCA represents virtually every major source of venture capital and private equity in the UK and is dedicated to promoting the industry for the benefit of entrepreneurs, its investors, practitioners and the economy as a whole." BVCA mission statement.

Founded in 1983, the BVCA represents virtually every major source of private equity in the UK. It currently has 128 private equity firms as full members, who are actively involved in making long-term equity investments, primarily in unquoted companies. Private equity firms are funded by institutions (such as pension funds and insurance companies), or their parent organisations (such as banks), or both.

The BVCA also has 127 associate members, which include financial organisations with funds available to support private equity investment (but for whom this activity is not their principal business); professional firms, such as accountants and lawyers experienced in advising entrepreneurs seeking private equity backing; 'gatekeepers', which manage private equity funds of funds and provide advice on international private equity investment; and academic organisations which have an active involvement with the private equity industry.

Since the emergence of the formal private equity industry in the UK in the late 1970s, private equity investment in new and developing businesses has grown dramatically. Nearly £28 billion has been invested by private equity firms in up to 18,000 businesses since 1983. A record £4.9 billion was invested in over 1,300 companies in 1998 alone, 26 times the amount invested in 1984 (£190 million). Annual investment by BVCA members accounts for nearly 50% of total private equity investment in Europe and the UK industry is second only to the USA in world importance. BVCA members are currently involved in the management of around £60 billion.

The BVCA seeks to fulfil its mission statement by:

- Providing information to those seeking private equity and carrying out relevant research
- Acting as a common point for handling industry issues and technical matters on behalf of members and communicating these matters to members
- Educating and training the employees of member firms and holding meetings and events for members
- Developing and maintaining the highest standards of professional practice
- Facilitating an adequate supply of capital into the industry by increasing awareness and general perception of private equity with fund providers.

All members are listed in the BVCA's free annual "Directory" of members. Other free publications include; "A Guide to Venture Capital" which describes the private equity process and outlines what to include in a business plan and "Sources of Business Angel Capital", which lists services that introduce business angels and entrepreneurs seeking smaller amounts of private equity to each other. The BVCA also carries out an extensive research programme, publishing reports such as the annual "Report on Investment Activity", "Performance Measurement Survey" and "Survey of Business Angel Investment Activity". Around 50,000 of these BVCA publications and research are sent out each year.

Notes