SVG Capital

About private equity

Private equity has grown rapidly over the last ten years, with annual global commitments increasing from US$18 billion in 1990 to US$235 billion in 2005[1]. Historically, the growth in this asset class has been driven by the ability of top performing private equity firms to generate returns that significantly outperform comparative quoted markets over the medium to long term. This growth has led to private equity becoming a distinct asset class among alternative investments.

Private equity is a generic term for investments in private companies (or public companies where the investment has the character of a private equity transaction). The term private equity can broadly be broken down into the following categories: venture capital; development capital; and buy-outs/buy-ins.

Venture capital is often used to describe the private equity sector as a whole, but more accurately describes investments made at an early stage in a company's life.

Development capital is financing provided for the growth or expansion of a company that is breaking even or trading profitably.

Buy-outs/buy-ins are used to refer to different structures in private equity that are applied to established businesses with revenue and profit streams. Private equity managers provide funds to enable current operating management to acquire an existing business or to enable a manager or group of managers from outside a company to buy into a company.

In time, these investments are generally realised either through a listing on a stock exchange, or by way of a trade sale.

Recent history

The private equity industry, as we know it today, emerged in North America. Demand for investment opportunities came from investors seeking to access companies not covered by quoted markets, which offered a sufficient risk premium. Supply came from young companies seeking to stimulate their growth and established groups looking to sell-off parts of their business which were either not going to be a core focus of their operations in the future, or which were not actually profit making at that time.

The US is the most mature private equity market. The UK market opened up in the 1980's and is the next most developed private equity market. Development of private equity in Continental Europe came later, but really took off in the mid 1990's. Investment activity has increased significantly in Europe over the past five years.

Outside the US and Europe the industry is in a formative stage. In Eastern Europe, there are a limited number of private equity investors, although the pool of available capital is small compared to Western Europe. The Asia-Pacific region is relatively well served by private equity funds and Latin America is also emerging as a market in its own right.

Access to private equity

The vast majority of private equity investors are financial institutions, such as corporate pension funds, that invest through specialist managers. Investment in this area requires considerable expertise and resources.

The private equity investment products available tend to reflect this and the most common investment vehicle is the limited partnership with a ten-year life and a usual minimum investment threshold of €5 million. Given that most investors will seek to build a portfolio of fund holdings to spread their risk, this excludes many smaller institutions and most private individuals from investing through this route.

For the smaller investor - whether an institution or a private individual - the listed private equity sector on the London Stock Exchange, which includes SVG Capital, offers an effective alternative access point for investment in private equity.

The benefits of adding private equity to a portfolio

Private equity offers two primary benefits when added to a portfolio of traditional asset classes of stocks and bonds: the potential to enhance returns and increase diversification.

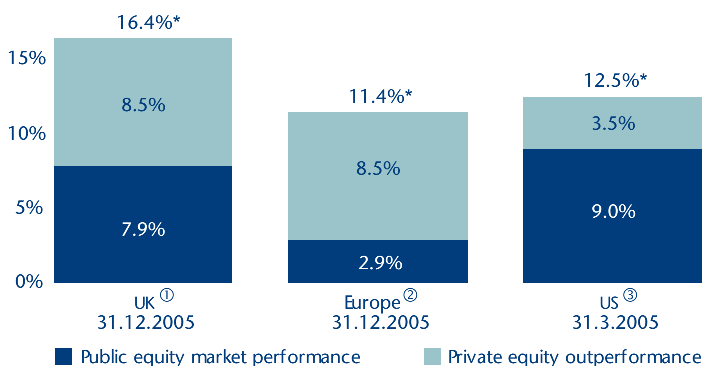
Higher returns - Private equity has demonstrated that it produces higher returns than other traditional public equity and fixed income asset classes over long periods of time, as illustrated by the chart on the left. Two of the key drivers of private equity's outperformance over public equities are:

- access to fuller information to conduct detailed due diligence;
- alignment of shareholder and management interests; and ability to create change through long-term control positions.

Diversification - Private equity has been demonstrated to provide the benefits of diversification due to the low level of correlation with other traditional asset classes.

10 year performance

Annual IRR%



Source:
① BVCA Performance Measurement Survey 2005. IRR's of all UK based private equity funds vs. FTSE All-Share Index as supplied by The WM company.
② 2006 Pan-European Survey of Performance Thomson Financial/EVCA. Investment horizon IRRs of all European private equity funds vs. Morgan Stanley Euro Index using pooled cash flows.
③ Venture Economics/NVCA. Investment horizon IRRs of all US private equity funds vs. S&P 500.
* Past performance is not a guide to future performance and the value of investments can go down as well as up.

[1] Source: Private Equity Analyst/EVCA

Issues for consideration when investing in private equity

As with other asset classes, investment in private equity has associated risks, which need to be considered and understood before any investment is made. When investing in private equity, the following are principal issues for consideration:

Access – private equity funds can be difficult for investors to access. Some smaller, country specific, funds may be relatively unknown and may have small, closed investor bases and larger funds can be oversubscribed or require substantial minimum commitments. Knowledge of local markets and personal contacts are important for gaining access to funds with the potential to outperform.

Expertise – the ability to evaluate a prospective fund's potential requires considerable expertise and knowledge. The diligence process requires extensive interviews with the members of each team and should also include significant reference calls to current and former investors, former employees, portfolio company executives and other industry insiders. The strategy, personnel and motivation of a manager may change over time.

Fund selection – the spread in returns from upper quartile to lower quartile performance, for all stages of private equity investment, is more pronounced than in other asset classes making fund selection critically important to successful investing in the asset class.

In Europe, the cumulative net IRR for top quartile private equity buyout funds formed from 1969 – 2005 was 17% as of December 2005, while the cumulative net IRR for lower quartile private equity buyout funds formed in the same period was -0.20%[2]. Spreads in the US are similarly pronounced, with the cumulative net IRR for top quartile private equity buyout funds being 18.10%, while the cumulative net IRR for lower quartile private equity buyout funds was -0.60%.

Minimum commitment – the typical minimum commitment threshold in private equity funds is €5 million, with many of the top performing managers requiring commitments in excess of this amount. Investors with limited amounts of capital to commit to the asset class may find it difficult to adequately diversify their portfolio.

Liquidity – typical investment vehicles for investment in private equity are ten-year limited partnerships, holdings in which can be illiquid.

Diversification – as with other asset classes, diversification is a key feature in reducing overall risk within a portfolio. Private equity funds often invest in a particular industry, sector or region and will generally have a limited number of underlying investments.

The benefits of a fund of funds structure

Investors can participate in the asset class by either investing directly in operating companies, in limited partnerships that invest in operating companies, or in a 'fund of funds'.

A fund of funds invests in multiple private equity funds, rather than investing directly in operating companies. By employing an experienced adviser, a fund of funds provides:

- access to desirable investment opportunities; increased diversification across multiple managers and categories of private equity; low minimum investment;
- high quality fund selection; and cost-effective access for small and medium sized institutions.

A fund of funds that has an experienced adviser should allow investors access to top performing funds including those that usually accept investment commitments only from larger institutions.

A fund of funds also provides investors with a means of achieving diversification in the private equity market. Private equity investors that invest directly in portfolio funds with less than €100 million allocated to the asset class find it difficult to achieve diversification given the relatively high minimum commitment size of most funds.

The cost of hiring in-house experienced professionals or of engaging external advisors can be prohibitively expensive. By pooling commitments in a fund of funds, investors gain access to investment opportunities across a wide spectrum of private equity investments with different strategies and geographic focuses. A low minimum investment allows investors to gain access to funds without having to meet the higher minimums of any particular underlying portfolio fund.

Finally, a fund of funds can provide investors with enhanced manager selection and monitoring capabilities. The due diligence and monitoring requirements of private equity can be disproportionately large relative to the asset allocation percentage in an investor's overall portfolio. Successful investing in private equity requires specific expertise and resources.

For further information, please contact:

Alice Todhunter

SVG Capital plc
111 Strand, London WC2R 0AG
Tel +44 (0)20 7010 8900 Fax +44 (0)20 7240 5346
Email: investorrelations@svgcapital.com
www.svgcapital.com

[2] Thomson Venture Economics 2005/NVCA/EVCA, 31 March 2006