2013 Preqin Investor Network Global Alternatives Report

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Due Diligence: What Do Investors Need to Know When Assessing Potential Private Equity Investment Opportunities?

- Stephen Cravens, Head of Fund Analytics, Cogent Partners

Investors are taking a fresh approach to underwriting private equity commitments to both new and legacy relationships. Driven by the collective learning in the aftermath of the financial crisis, as well as the natural progression away from funds of funds and discretionary mandates, more LPs are deciding to do the work themselves.

Investors are taking on this directive in order to avoid mistakes and achieve higher returns with the belief that only top managers can materially outperform a more liquid investment program over time.

Discerning LPs set out to gain confidence in a manager's investment process, understand its team dynamics and business practices, verify its operational procedures, and check references. Focusing on these issues is especially critical since you are locking up your money for many years. One must do the homework to cross-examine the selling points represented in the marketing materials and understand what differentiates managers from their peer group.

While past performance is an indicator of quality, understanding how managers achieved their results is more relevant to answering the main question: is it likely that they will repeat past success? And further, will the investor's take be meaningful enough to justify bearing the intrinsic risks?

Potential investors need to understand the track record in detail, not just the headline IRR numbers. What types of companies have been bought and sold, and at what multiples? Which investments have not been realized and why? What happened to the underlying companies' fundamentals (revenue, EBITDA, and net debt)? Is performance built on a home run that might be luck, or rather a consistent track of meaningful realizations? Was there a process for generating the ideas that led to their investments or was it more reactionary? Be bold in asking what the market inefficiencies are that produced prior success and further, to be convinced that those inefficiencies will remain.

LPs must also understand whether the manager generated returns by actively improving the companies or through fortuitous timing. If a previous fund's returns were dominated by a single sector or geography, potential investors need to be able to identify that in short order. LPs are wise to ground in truth a manager's claim of proprietary deal flow. The longer (and more realized) the track record, the more predictive value there is in historical results. With so many funds in the market vying for your attention, it's crucial to identify these key points of differentiation early on in the process.

Once you have assimilated the information in the data room and conducted a first meeting, it's perfectly reasonable to ask for additional materials. Ask for investment memos. Ask which firms they believe to be their closest competitors. Ask how many of their existing LPs they expect to re-up. Are there any side-letters that put other investors on more attractive footing? LPs should include in the course of due diligence interviews with portfolio company executives, intermediaries of past transactions, as well as current or former LPs (ideally those on the advisory board).

While this is often difficult to verify, the general partners' capital commitment should represent a meaningful portion of their personal net worth. Team cohesion is also hugely important, and you should ask yourself if this is a team that you can see staying intact for a decade or more. Due diligence should uncover whether there has been any irregular turnover or whether the partners responsible for past success are still with the firm. Is succession being managed with steps in place to transfer ownership of the firm from senior partners to the next generation? Seeing carry pushed down far into the organization gives comfort that the broader team is properly incentivized. If the new fund is much larger, is it reasonable to think that this team can be successful either hiring rapidly or competing for significantly larger transactions?

Thanks in large part to initiatives pushed by the ILPA, terms are moving in the investor's direction, characterized by better alignment of interests. The balance between management and performance fees should provide ample motivation to generate strong returns. Preferred hurdles and back-end weighted carry protect economics for limited partners, and a strong key man clause provides a layer of protection against an unstable organization.

The difference in performance between top and average players is enormous in private equity and therefore manager selection is crucial. Building an efficient system to work through and decode the provided materials will allow for important synthesis to take place, resulting in productive in-person meetings and stronger GP relationships. These relationships are key because top managers are generally less accessible, requiring more effort on the part of new relationships.

The legal structure and lock-up timeline of private equity partnerships provide limited partners very little control over the outcome (apart from a secondary transaction). Rigorous due diligence is the primary line of defense and will best position your portfolio to outperform.

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