Don't overlook the hidden costs

Commentary

Cyril Demaria looks at factors that can generate substantial costs for large institutional investors apart from the usual direct and indirect costs associated with investing in private equity funds

Large institutional investors are often described as 'universal owners' – their asset pool is so large that excluding certain assets from their portfolio increases risk without any corresponding return potential. Private equity adds another dimension to the usual risk/return arbitrage of asset selection – time/liquidity. This third dimension has a specific impact on universal owners and puts in perspective the value creation of private equity fund managers.

A key feature of private equity is its illiquid nature and the time horizon associated with investing in non-listed assets. Private equity fund managers' performance is usually based on two indicators – the multiple of investment and the internal rate of return (IRR). The first is deemed to provide an absolute-return indication (to support asset class arbitrage), whereas the second one takes into account the impact of time on the investment (and support benchmarking). These indicators supposedly provide investors with the information needed to select funds.

In the case of a universal owner, these two financial indicators are a minor component of the overall calculation to decide whether or not to invest with a given fund. From among the multiple other elements of information, two categories can be drawn: the hidden costs associated with private equity investments; and the hidden costs associated with being a universal investor.

Hidden costs associated with private equity investing

De facto, private equity has the possibility to finance a company throughout its life, from inception to turnaround and even beyond (see figure). Private equity funds bear a lot of direct and indirect costs, which can be categorised as set-up costs, management costs (management, custodian, and audit fees), due diligence costs (including aborted deals) and performance fees (carried interest). Usually, private equity fund managers communicate on returns net of these fees, which are already substantial. Unfortunately, the list does not end here (it could notably include funds of funds or consultants fees).

For limited partners (LPs), additional costs have to be factored in. The first is the cost of uncalled capital (cash management). Once committed to a fund, the capital can be called at any time by the general partner of a private equity fund. The amount committed can be technically deployed somewhere else than on the money market meanwhile, but the lack of visibility on capital calls makes it difficult to properly time the rebalancing (and the corresponding sales on the public equity market for example). Investors who have ventured to put the uncalled capital at work in hedge funds instead of money markets have suffered from dramatic liquidity issues during the 2007-09 crisis.

Then come the opportunity costs: the fact that the LP cannot plan the distribution from private equity funds means that some cash will stay idle (or on the money market) until finding a new place. The fact that the amounts distributed in private equity are usually substantial magnifies the opportunity costs. This should notably be factored in when private equity funds show a high IRR and low multiple of investments. The rotation of assets is hence accelerated but not necessarily optimal for the limited partner which will see the benefit of this high IRR depleted by the lack of opportunities to reinvest it at the same level of return.

Hidden costs associated with being a 'universal owner'

Above these costs, a universal investor has to factor in friction costs. Assuming that a universal investor is investing on the stock exchange and in private equity, the friction costs appear every time the business changes hands and the universal owner has to bear these costs. These costs notably include placement, M&A, IPO and any other intermediary costs.

The worst case is probably when the costs related to the asymmetry of information kick in and result in a bad M&A operation. An example is the acquisition of Skype by eBay, with a write-off from the latter of $1.7bn. A universal owner which would own eBay stocks and have been investing in a venture capital fund which financed Skype would not only have supported all the costs associated with venture capital investing, the cost of uncalled capital and the opportunity costs, but also the friction costs (investment banking fees) and the ultimate loss associated with the eBay excesses in the Skype acquisition.

Another example is the Vonage IPO, where a universal owner invested in Vonage through a fund dedicated to primary-emission investments, and previously through a venture capital fund, would have seen a 90% write-off on the stock price. Here, above all the costs listed before, the universal owner would have supported the IPO costs and possibly the mutual fund costs.

Beyond fees, value creation

A few conclusions come to mind. The first is that analysing private equity funds in terms of simple multiples and IRRs is pretty much irrelevant; the value creation is what matters. This can be assessed by the analysis of the performance of the asset after divestment and the analysis of the situation of the companies before and after each private equity investment.

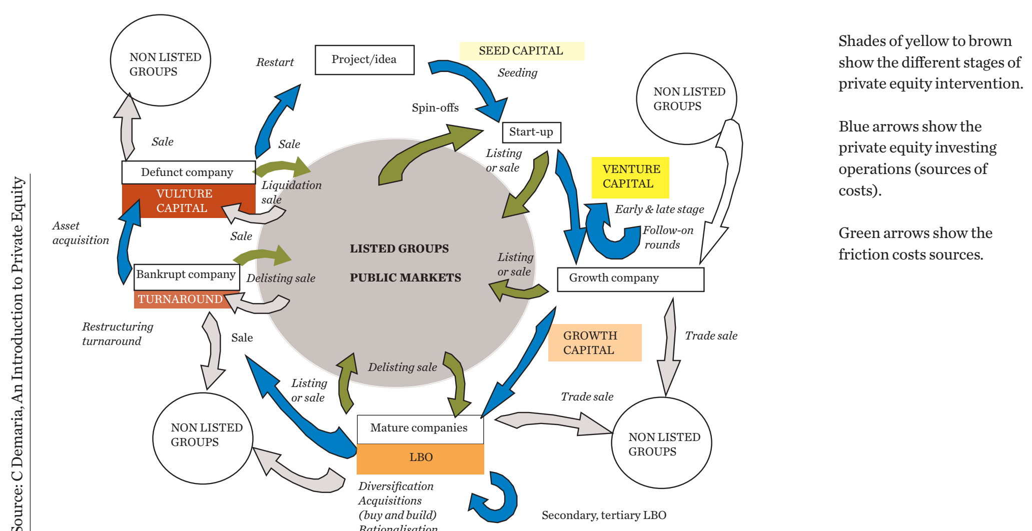
The second conclusion, is that institutional investors should set a return target for their investments in private equity and sanction not only the under-performance but also the over-performance (notably IRR-wise). A high rate of rotation of assets can actually harm the overall returns of an institutional investor: it increases the cost of uncalled capital, the opportunity and friction costs. The return target should be calculated as a trade-off between the overall costs supported all along the investment chain by the universal investor and the extra return generated by each intervention.

The third conclusion, which is counter-intuitive, is that private equity funds should be designed to actually last longer. In Europe prior to the crisis, it took at least seven years for a company to go from inception to the stock market (and recently, on average, 12 years). This means that a universal owner willing to decrease the cash management, opportunity, friction and asymmetry of information costs should encourage venture capitalists to build longer-term funds and increase their holding periods.

That also means that the incentive structure of the fund manager should be drastically reviewed. Beyond the current debate on the level of fees paid to fund managers, the real challenge is to design an incentive system which aligns better the interests of the fund manager and the interests of the institutional investor. An accrued carried interest for every increment of multiple of investment generated, combined with a cap on management fees (or budget) would be a first step in the right direction.

Cyril Demaria is the author of An Introduction to Private Equity, to be published by John Wiley & Sons in May 2010

Lifecycle of a company and interventions in private equity



Shades of yellow to brown show the different stages of private equity intervention.

Blue arrows show the private equity investing operations (sources of costs).

Green arrows show the friction costs sources.

Source: C Demaria, An Introduction to Private Equity

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