Embrace the information age

Cyril Demaria argues that private equity has everything to win from a more systematic and transparent approach to reporting information

Private Equity Reporting

Whether private equity practitioners like it or not, fund managers will have to disclose more information about their activity and performance in the future. This information will have to be:
- Consistent in the method applied;
- Built on qualitative and quantitative data;
- A reflection a fair view of the private equity business;
- Coherent over time;
- Systematic, impartial and based on facts;
- Accessible easily to third parties;
- Comprehensive.

The information should also balance the interests involved in the process: it should be disclosed in sufficient detail to fulfil most of the needs of third parties while protecting the interests of the underlying portfolio companies.

This information need was reflected by landmark decisions in 2002 of UTIMCO, CalPERS and MassPRIM, followed by other American pension funds, to publish information about their private equity holdings – decisions triggered by the Freedom of Information Act (FOIA) but really the result of the increased share of their assets allocated to private equity. Private equity allocations are no longer marginal, and the asset class itself has developed beyond a niche.

Over the course of 30 years, private equity has grown from a few hundred million to a major asset class. According to Preqin, worldwide private equity now manages $1,500bn (after leverage). This trend is expected to continue due to a triple influence.

Firstly, pension funds in Latin America are now able and willing to allocate part of their assets to private equity, following the thirst for absolute returns to pay the pensions of an ageing population. CalPERS's alternative investment management programme generated a 21.5% return in 2010. CalSTRS had registered a 12.7% return for its private equity programme (versus 16.9% in 2009), while endowment and foundations declared a return of 11.3%. Moreover, there is a threshold effect: above the investment fund level of $100m the share of private equity in portfolios (defined as venture, buyout and distressed debt) increases rapidly. In 2010, the median size of endowments in the US was $73.5m – up 7.4% compared with 2009 – which suggests that a wave of newcomers is to be expected. At the current pace, the median should cross the $100m threshold in 2016.

Secondly, Current investors are increasing their allocation target. The Yale and Harvard endowments are showing the way with allocations topping 15%, but public pensions are following suit. It is expected that European institutional investors, which currently allocate 3.6% to private equity, according to Russell Research, will grow it close to the US level at 6.8%. According to Preqin, in 2010, European pension funds were allocating 3.7% of their assets under management to private equity.

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And finally, the assets under management themselves are growing, which means that private equity will not only increase as a proportion, but also mechanically in absolute value.

Silence is no longer golden

History has shown that the more an asset class gets public exposure through its economic role and weight, the more it has to comply with increased regulation. Without any exception, the recent AIFM Directive, Dodd-Frank Act, Basel III Agreements and Solvency II Directive, as well as the MiFID, are indeed increasing the pressure. Oddly, private equity fund managers have been fighting these initiatives and are still in denial of the fact that these disclosure and transparency requests can only increase. Henceforth, they must take the initiative to organise the disclosure and accommodate their interests with the public need of disclosure.

Beyond the regulatory stance, silence is actually prejudicial to private equity. Uninformed decisions hurt the private equity value chain in many respects. Silence creates the much decried herd mentality among limited partners if they have to struggle to find the relevant information for due diligence; and can lead to funding gaps (for example in IT, biotech and cleantech venture capital) and asset valuation bubbles (for example in social media). Long term, the effects of lack of information will be reflected in booms and busts of fund raising which affect adversely an asset class normally investing over the course of five to seven years in non-listed businesses.

Private equity fund managers themselves have a strong incentive to communicate information. Indeed, private equity has seen an increased volatility of its unrealised portfolio valuation due to the generalisation of the 'fair market value' and mark-to-market rules. These rules have actually imported the volatility of listed stock prices into the valuation process of private equity portfolios. Under these circumstances, the implied risk that this volatility is supposed to express is making private equity investments more expensive for insurance companies and banks under the new solvency rules. For pension funds, it creates a discrepancy between the target allocation and the actual allocation which is difficult to manage. By providing more quantitative and qualitative data, private equity fund managers will actually encourage the treatment of private equity as a specific asset class – ultimately helping private equity to organise its own valuation framework, which could be half-way between real estate and stock valuation methods.

Detailed asset allocation of US university and college endowments

Size of fund	Domestic equities %	Fixed income %	Internat. equities %	Private equity %	Marketable alternatives %	Venture capital %	Private equity Real estate %	Commodities, energy, and Natural resources %	Distressed Debt %	Short-term securities/ Cash/other %
Over $1bn	11	10	15	15	23	4	7	8	3	4
$501m to $1bn	18	14	17	9	21	3	4	5	3	6
$101m to $500m	25	17	17	6	19	1	2	5	2	6
$51m to $100m	31	21	18	3	14	1	2	3	1	6
$25m to $50m	35	24	16	1	10	1	2	2	1	8
Under $25m	40	27	13	1	7	1	1	1	1	8
Dollar-weighted Av.	15	12	16	12	21	3	5	7	3	5
Equal-weighted Av.	30	21	16	4	14	1	2	3	2	7

All data are dollar-weighted average, otherwise specified. Due to rounding, details may not sum to 100%.
Source: National Association of College and University Business Officers and Commonfund Institute (2011). 2010 NACUBO-Commonfund Study of Endowments

Valuing private equity per se

Information does exist for private equity, as it is structuring itself through an increased number of secondary operations and greater popularity of private markets (hence creating more dots on the 'asset pricing radar'). AIFMD will also mandate third-party valuation, which will establish a common ground to evaluate the portfolio. This will probably not eliminate valuation discrepancies, but it should reduce them.

Commercial databases were an interesting first attempt to produce a set of information, but they suffer from the fact that they gather data on a declarative and non-systematic basis. There is survivor bias and data is often aggregated too broadly – and the process can also prove to be expensive.

An alternative would be to gather information from fund administrators, funds of funds and gatekeepers. These data providers are a potential source of reliable, consistent and systematic information. They have a responsibility in shaping information in private equity. As third parties, they can structure a pool of information which addresses needs according to the criteria described at the start of this article.

Initiatives have been launched by academics to structure this effort. This guarantees a reliable, scientific and unbiased approach to build a complete data repository. It can also create an accessible pool of data which is necessary for authorities and authorised third parties who need to assess, on an aggregated basis, the specifics of private equity. This does not equate to disclosing individual performance for example, but, for example, to cash-flow based analyses of private equity investments.

The consequences of this new information flow are significant. On the positive side, it means that the asset class will be better understood, and its specificities will be recognised by third parties. It will encourage the emergence of benchmarks which are unbiased and reliable, and probably reduce significantly the perception of risks associated with private equity. Information will hence change the overall appreciation of the risk/return profile of the asset class – while the perception of returns has changed over time thanks to various studies, the risk borne by private equity investors remains largely uncovered due to the lack of systematic and reliable data.

By slowing down the movement towards more information, private equity fund managers have actually reduced their fund raising potential by lowering the attractiveness of the actual risk/return profile they provide.

By drastically reviewing the risk borne by private equity investors, private equity investments will be seen to be far less expensive with regard to the solvency requirements of institutions. The worst case scenario would be a lack of action. The clear example is the case of private equity funds of funds which have seen their attractiveness decrease after their failure to act and be recognised under the Basel II and Solvency II agreements as a major source of risk reduction. The costs represented by their fees were not compensated by a more attractive treatment under solvency ratios and so they are being progressively marginalised.

The net losers will be the bad performers, whose failure will appear more clearly, and private databases will, of course, have to reinvent their business models – but the vast majority of the actors will win from this new information flow.

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