The Challenging Role of a "Gatekeeper" in the Rapidly Changing World of Private Equity

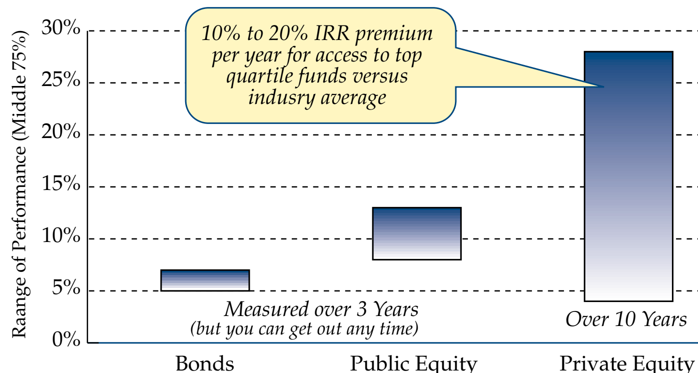
Recent changes in the private equity industry have made the identification of future top performing equity funds a demanding and complex task. Clint Harris, founder and Managing Partner of Grove Street Advisors, with more than $3 billion under management, discusses the responsibilities of gatekeepers in this fast shifting environment.

In spite of the recent collapse of the "IT/Internet Bubble" and roller coaster financial performance, the prospects for attractive returns in private equity (which include both venture capital and buyouts) appear quite sound, and the vast majority of the major US and European financial institutions are sustaining and/or increasing their allocations to the asset class. The role of the investment adviser (or "gatekeeper") in this new environment has, however, become much more difficult, and requires qualifications not typically found with most advisory firms.

Private equity has been the best performing financial asset class in the US since the 1960s and in Europe since the early 1990s. Returns have been both high and surprisingly low risk. Over the last 40 years, individual funds have rarely lost substantial capital because, while the individual investments may be very high risk, the shared (or system) risk in a fund's portfolio is much lower than other types of investment. For example, while the risk that one firm will be successful in developing a new drug is quite high, this risk has almost no correlation with another firm's ability to develop a new computer chip. Conversely, in a bond portfolio, a small change in interest rates can have a big impact on the total portfolio. As a result, sophisticated financial institutions in the US typically allocate between 5 percent and 20 percent of their total capital to private equity, but usually use outside advisers to help make those investments.

The primary challenges for the private equity investor are that investments in funds are illiquid over the life of the fund, and that performance from one fund to the next varies much more widely than in other asset classes. In the public equity market, variations in a manager's performance are typically a few percentage points, and if a mistake has been made, it is relatively easy to shift assets to a new manager within a few days. In private equity, the difference between "median" and "top quartile" performance has historically averaged between 20 to 25 percent per year, compounded over 10-year fund life, and it is quite costly to liquidate a position prematurely even if the performance of a fund is unattractive. As a result, the manager selection process – namely the ability to invest with the "top quartile" funds – is by far the most important success factor in private equity investing.

Key to performance in private equity is fund manager selection



Source: Grove Street Advisors

← The Range of Gatekeeper Approaches →

Consultants	Account Managers	Funds of Funds
Provide support to the process, typically not responsible for investments	Manage allocations for large investors either with or without discretion	Manage pools of capital for investment from multiple investors
Cambridge Associates	Abbott, Hamilton Lane, Pacific Corporate Group Pathway Capital Management	HarbourVest, Horsley Bridge

"Gatekeepers" exist because most institutional investors find it difficult to build and/or retain the in-house expertise to participate successfully in the asset class. The skills are different. Market compensation for successful practitioners is often well above what an institution is able to pay its employees, and there is a very real need for the private equity team to have a long-term dedicated focus on the asset class. The industry operates on 10-year cycles and experience, relationships, and reputations take many years to build. A gatekeeper essentially supports the in-house team, assisting institutional investors, such as pension funds and insurance companies, to identify, evaluate and gain access to top performing private equity funds. Gatekeepers range in style from consultants, which provide data and due diligence support, but leave the final investment decisions to their clients, to fund-of-funds, in which the institutional investor joins a pool of other investors and turns over the complete responsibility for building and monitoring the private equity investments to the outside firm.

In the current environment, the "gatekeeper's

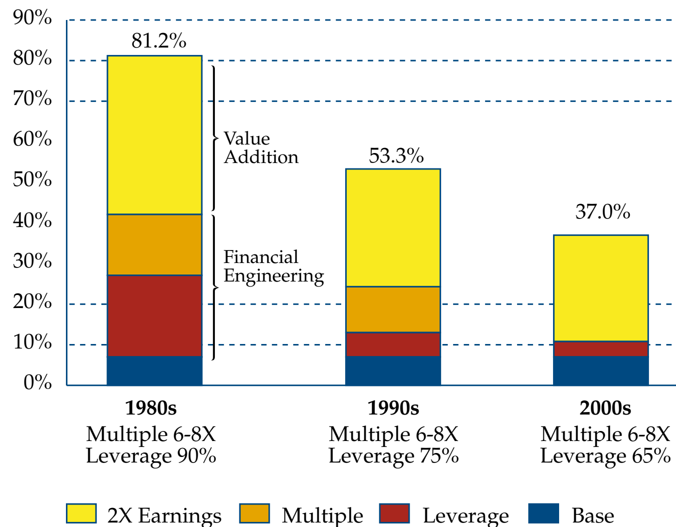
role" has become even more important. Historically, private equity has been an asset class where past performance has been a much better predictor of future performance than in most other types of investment. While there is a significant delay in the feedback loop – it usually takes four to six years before one can realistically predict how a fund will do – teams that have delivered top quartile performance in the past have been proven to have about a 75 percent probability to continue that performance. However, we believe that correlation will be much lower for the next fund raising cycle of the industry.

Since the late 1990s, venture capital has undergone an unprecedented boom and bust. The keys to success have changed radically, and now, more recently, have changed back. Prior to the "Internet Bubble," the top funds had to be patient builders of great companies, typically over several years. In the late 1990s, the key to success was an ablility to predict the next "New New Thing." The venture capitalist essentially became a "Guru," able to anticipate what the white hot IPO market wanted next. The firms that were successful generated huge returns, both for the investor and for the senior partners in those firms. Today, however, we are clearly back to building companies, even more slowly and efficiently (from a capital perspective) than in the early 1990s. Venture firms have had to go through a painful triage with the portfolio companies they funded during the "Bubble", as well as identify sound investments for the new environment. The premium skills today are back to those of the successful line operator who knows how to build companies and provide support as companies expand internationally.

For the prospective investor in venture capital funds, track records from the late 1990s are largely irrelevant, and, in most cases, the people who built the track records in the early 1990s have left the industry, or are near retirement. The most relevant investments are those made since the "Bubble" collapsed. Unfortunately, these investments are still largely unrealized. Good due diligence requires the contacts, manpower and expertise to research each private company in depth, to independently evaluate a company's prospects for success and the roles/contributions of the individual venture capitalists. It is also clear that many of the best firms are going through substantial changes in their internal leadership. Venture firms are typically small and dependent on a few key individuals. When one or two senior partners choose to step back, it can radically change the internal culture of a firm and the firm's future performance. The prospective investor must have the ability to evaluate the long-term team dynamics, identifying which firms have established stable organizations with sound succession plans and the right skills for this new environment.

In the buyout world, changes have come more gradually, but are, in essence, much more fundamental. In the 1980s, top quartile performance could be achieved solely through financial engineering. Today, leverage and transaction skills can at best contribute five percent to ten percent rates of returns. In order to generate attractive private equity rates of return, the buyout firms must find ways to materially improve the performance of their portfolio companies after they invest. Historically, the industry was dominated by investment banking skills and culture. Today, firms need a much broader range of operating and business analysis skills to impact the operations of their companies.

Changes in the Fundamental Profitability of Buyout Transactions



Source: The Audax Group

Related is the trend of smaller buyout funds (targeting investments in smaller companies) to outperform the larger funds. That difference in performance will probably continue to increase in the current environment. It is simply much easier to improve performance with smaller companies, than with multibillion dollar companies targeted by today's mega-funds. In addition, the smaller the targeted deals, the better the chances of finding market inefficiencies and proprietary opportunities that also can contribute to attractive returns.

In summary, despite the recent "roller coaster," there is no question that the overall prospects for attractive (and relatively attractive) rates of return in private equity are positive. Money is scarce from the entrepreneur's perspective,. the economy is somewhere near the bottom, and both the venture capital and the buyout firms do best when they can buy low and sell into a rising tide. In addition, it is clear that the rules for success have changed substantially in both sectors. As a result, there will be substantial changes in terms of which firms deliver the best results over the next fund raising cycle, creating important opportunities for investors to gain access to the new generation of top quartile funds.

This is not the time to simply invest with the established brand name firms. While many of the top tier firms have transformed themselves to be successful in the new environment, many have not. The gatekeepers that can effectively sort out the trends and identify those teams that have the best prospects for success will be able to add most value to their clients, positioning them for attractive returns well into the future.