

Benchmarking Performance: Challenges and Approaches for Emerging Markets

Although venture capital and private equity fund managers might like to think so, try as they might, not all funds are above average. In fact, the differential in performance between the best and the so-so can be enormous, and this dispersion creates a pressing need for GPs and LPs to compare, or benchmark, individual funds against peers and against alternative uses of capital. As this article will explore, making those comparisons is particularly challenging in emerging markets.

Gauging Relative Performance: Sources for Comparison to US Private Equity

For funds in the US, a good supply of information exists, for free or subscription, that GPs and LPs can use to evaluate relative performance. Thomson Financial publishes fund performance data for 2,300 funds through the online VentureXpert database, some of which is reproduced in free reports produced by the National Venture Capital Association and the PricewaterhouseCoopers MoneyTree Survey. The consulting firm Cambridge Associates tracks over 3,300 funds globally and publishes a free quarterly report of US private equity and venture capital data that includes a range of comparison tools. According to Cambridge, the U.S. Private Equity Index[®] represents returns data for funds representing approximately two-thirds of the capital raised by private equity (buyout, subordinated debt and special situations) partnerships since 1986. Exhibit 1 highlights data from one of the core tools, the vintage year analysis, from the Cambridge Associates US Private Equity Index and Benchmark Statistics Report of September 2007.

A table like this allows GPs and LPs to place a given US fund's performance by quartile (top quartile are those above "upper quartile net") or compare the fund's return multiples to the average for the vintage year.

Thomson Financial's Venture Economics Investor Services Group (VEIS) calculates internal rates of return on over 2,300 funds globally using data compiled through client relationships with institutional investors, supplemented with use of FOIA (public) sources such as cashflow schedules and financial reports and surveys conducted jointly with venture capital associations.

The sophistication and best efforts of Thomson and Cambridge notwithstanding, these data sets inevitably face methodological challenges given the inherent disclosure issues related to private equity and by the asset class' long time horizon. Cambridge and Thomson depend for the datasets on relationships with GPs and LPs who provide the quarterly data on the cashflows of funds, typically in exchange for the ability to use proprietary reports. Both firms have the ability to acquire a lot of information, but both are inevitably working with samples rather than the entire universe of private equity activity, and this introduces the challenge of sample bias.

"In private equity, benchmarking is about ensuring we have a representative sample of funds, meaning across size, region, industry focus, etc. Importantly, it also has to have both good funds and bad funds—or poor performing funds. Advisors, fund of funds, etc., who have strong performing portfolios are going to have higher IRRs but they are not representative without a healthy dose of reality," says Thomson's Jim Beecher, Publisher.

Despite challenges of sample bias, Eric Johnson, Managing Director for Cambridge Associates, stresses that a peer-group derived measure of performance is the right model for private equity. "There is no comprehensive and inclusive standard like exists for public equities such as the Wilshire 5000 Index. An ideal benchmark would represent the full opportunity set available to an

Exhibit 1: Cambridge Associates LLC—U.S. Private Equity Vintage Year Analysis *As of September 30, 2007*

Vintage Year	Pooled Mean Net to LPs (%)	Median Net to LPs (%)	Equal-Weighted Pooled Mean Net to LPs (%)	Upper Quartile Net to LPs (%)	Lower Quartile Net to LPs (%)	Standard Deviation Net to LPs	Distribution/ Paid In Net to LPs	Residual Value Paid In Net to LPs	Total Value/ Paid in Net to LPs	Number of Funds
2000	19.21	16.74	17.72	24.04	7.99	14.57	1.01	0.71	1.72	69
2001	33.06	22	26.42	35.81	11.99	24.04	1.01	0.94	1.95	20
2002	29.46	22.8	25.78	36.85	13.68	19.43	0.84	0.88	1.72	33
2003	31.2	19.49	24.07	33.28	5.55	20.18	0.44	1.18	1.62	24
2004	22.77	13.18	19.52	24.1	5.64	19.8	0.21	1.09	1.3	58
2005	13.2	-0.62	8.48	17.38	-9.53	22.82	0.07	1.04	1.11	68
2006	0.06	-5.64	-7.09	3.32	-14.99	25.21	0.02	0.98	1	45

Notes: Based on data compiled from 671 U.S. private equity funds, including fully liquidated partnerships, formed between 1986 and 2006. Returns are net of fees, expenses and carried interest. Vintage year funds formed since 2003 are too young to have produced meaningful returns. Analysis and comparison of partnership returns to benchmark statistics may be irrelevant.

Continued on page 14

Continued from page 13

investor, and would be investable—neither is true for private equity,” notes Johnson. “LPs focus on benchmarks derived from manager performance because they invest via funds and because of the difficulties inherent in collecting representative samples of the wide range of private transactions that occur in each market.”

Johnson claims, however, that the inherent stickiness to a benchmark helps to offset some self-selection bias. “Survivorship and add-in bias affect all types of peer-group benchmarks, but at least in private equity, if a single manager does poorly, they can’t just withdraw and cease reporting—that fund remains in the institution’s reporting portfolio until the fund is liquidated.”

The need to protect the confidentiality of individual funds in publicly available benchmarks poses yet another challenge—large group aggregation, e.g., US venture capital, or Asian private equity, rather than more finely sliced peer groups. Other challenges include reconciling cashflow reporting formats and assessing the valuation of the not-yet-exited investments.

Kathy Jeramaz-Larson, Executive Director of the Institutional Limited Partners Association (ILPA), notes that these challenges make the publicly available benchmarks a reference that LPs use among others, but “not a definitive standard you can hang your hat on.” “LPs say benchmarking is very important,” she notes. “What we see is that LPs will consider the published benchmarks as one part of an analysis, but also calculate their own measurements when making fund comparisons.”

Jesus Arguelles, who manages emerging markets private equity for California Public Employees Retirement System (CalPERS), explains that his team will often construct as many as three benchmarks to evaluate the performance of a manager they are considering: one to peer funds, one to public markets over the same time period, and one to the currency markets, to understand the impact of exchange rate changes on the performance. Vintage year comparisons are used not just in terms of comparing performance, he adds, “but also for comparing investment pace relative to peers, pace of exit, and time period until carry payments.”

The typical source for LPs of this peer performance information is marketing meetings with those peer managers, but some information can also be obtained from databases like Preqin Performance Analyst. See Exhibit 2 for a sampling of research-driven sources of

fund-level returns. Those data providers typically do not have the quarterly cashflows required for accurate benchmarking, but instead rely on disclosures from public sector LPs, which can be difficult to interpret because they typically do not include the net asset value of the undivested portfolio of their funds.

Benchmarks that Cover Emerging Markets

Some might hypothesize that, given the relative youth of the asset class and the rapid pace of change, there is less need for intensive comparisons of previous performance in emerging markets. One of the leading analysts of performance persistence in private equity—i.e., the idea that past performance is a predictor of future relative performance—dismisses the notion. Josh Lerner, Jacob H. Schiff Professor of Investment Banking at Harvard Business School, says, “So far, we have seen a pattern of persistence of returns in every segment of the private equity industry that has been examined: venture capital, buyouts, European private equity, and even real estate private equity. This seems to be a universal feature. I have no reason to think that emerging markets private equity will be any different.”

As readers of EMPEA’s *Emerging Markets Private Equity Quarterly Review* are aware, Cambridge Associates does produce time horizon return indices for Asian private equity, Latin American private equity, Central/Eastern Europe and Russia private equity, in addition to an aggregate index for emerging markets private equity, which includes all of the regional data of the other indices aside from Japan, as well as Africa funds.

The Cambridge emerging markets index has been a useful tool to illustrate the change in fortunes of emerging markets private equity as the drag of disappointing funds from the 1990s passed and was replaced by a significant upturn in recent years. Ten year returns for EM PE funds climbed from -4% in June 2003 to 8% in June 2007, while five year returns increased from -5% to 18% over the same period. The Cambridge emerging markets benchmark was started in 2003 in conjunction with development finance institutions, who were seeking to compare performance of their fund investments and to establish baseline data on aggregate performance of private equity funds investing in these markets. One of the agenda items for the group of GPs and DFIs that first formed EMPEA was to strengthen and disseminate benchmarking

Exhibit 2: Research-Driven Sources of Non-Benchmark Performance Data

Source		Coverage	Data Available
Eurekahedge Private Equity Fund Database	Global	4,676 funds, 600 funds of funds	Net IRR, size, capacity, assets, sectors, geographic focus, management information
Preqin Performance Analyst	Global	3,700 funds	Size, vintage, type, % called, % distributed, unrealised value, value multiple, IRR
Asia Private Equity Review	Asia	Asia only, 175 realizations in 2006, 169 in 2007	Quartile analysis of median IRRs and cash multiples for exits on annual basis

² Source: Ernst and Young Press Release, October 23, 2007

Continued on page 16

Continued from page 14

information. "One reason Cambridge worked so closely with the IFIs was to increase the representation among fund managers not in our clients' portfolios or otherwise already reporting to us," said Johnson. "Since we began, the number of emerging markets funds in our index has grown roughly threefold, a good number of these in more recent years. These funds raised since 2004 are creating the track records that LPs will be reviewing over the next decade, so it is particularly important that they participate in a benchmark."

At the same time, the horizon indices have a limited utility for evaluating how an individual fund's performance ranks in a region. For example, an index value for Asian private equity of 22.4% for the three-year time period ending September 2007 doesn't necessarily imply that the average performance for funds of the last three vintage years was 22.4%. The index value 22.4% is the IRR of the cashflows that occurred over the three years to and from all Asian

"Ultimately demonstrated ability at deal sourcing, creating value and exiting will always be the most important elements of private equity. A great deal of emerging markets returns have come through IPOs recently, but the best managers know how to generate exits in all markets and by different routes, not just IPOs."

– Jesus Arguelles, CalPERS

private equity funds in the database (including older vintage funds) plus the NAV of the remaining assets of the funds in the database at the end of the time period. For any given time period, therefore, the index value may be affected by exogenous factors, such as a concentrated amount of fund raising and investing during the period, (which can mean a larger set of negative

cashflows) or by a dramatic improvement of exit opportunities immediately relative to the years preceding the time period, which could increase positive cashflows.

"In an ideal world, each market would be deep and broad enough to look at vintage year comparisons for similar strategies in individual markets, but with few exceptions, that's not reasonable. For now, benchmarking broadly across the emerging markets remains helpful for investors considering whether to allocate capital outside of the US and Western Europe. Many LPs continue to view these markets as lacking the same levels of stability and protections taken for granted in the US and Europe," said Johnson.

In addition to these indices, Cambridge also generates vintage year comparison statistics (analogous to Exhibit 1) for Asia and for emerging markets, which are available to consulting clients of Cambridge, and also to GPs that commit to sending financial state-

ments to the firm. EMPEA members receive updates for the pan-EM, Asian, Central/Eastern Europe, and Latin American indices on a quarterly basis, and have access to time series trend analysis as well as sector and quartile analysis where available.

Beyond the Cambridge emerging markets index and vintage year analysis, one information product that is potentially useful is the aggregate exit data published semiannually by Asia Private Equity Review (APER). APER's focus is on logging as many deals as possible, gaining reliable information about the entry and exit price of the deals, and from there calculating and comparing deal level IRRs. This methodology is not an attempt to calculate the returns of actual funds, so in that sense it is less robust than Cambridge's. APER is also susceptible to survivor bias, given that it is the firms with the highest returns that are most likely to want their exit multiples to be known. That being said, there is an interesting argument behind the APER approach: that a cohort of similarly timed exits might be as useful to compare as a cohort of similarly-timed fund closes (i.e., vintage year analysis).

"I hold the view that a very different benchmarking methodology applies in Asia," says APER's Kathleen Ng. Ng notes that "In Asia, we have a kaleidoscope of funds investing in companies, e.g. global funds, principal investments, entities that are essentially ever-green and this range of players makes it difficult to make apples-to-apples comparisons at the fund level." APER reported in its year end review of 2007 an increase in the overall median IRR for Asian funds including Japan from 49% in 2006 to 67% in 2007.

While recent news of strong exits is very encouraging, and precisely the sort of tangible success stories that LPs need to take the plunge in some markets, Johnson asserts that benchmarks help investors go behind the headlines, "which naturally skew to the really good or really bad stories." "The importance of a rigorous approach is that it gets at what people aren't talking about," said Johnson.

Deconstructing Performance: The GP-LP Dialogue

A common challenge for GPs as they prepare to market a new fund is that they often will have little idea how their performance compares to peers. Firms providing data to a benchmarking program like Cambridge have access to quarterly benchmark reports that allow for evaluating their performance against peers at least on a regional basis. For firms lacking that data, putting their performance in perspective requires triangulation. For example, a performance triangulation could include comparisons between the fund's exits to similar year exits in APER, the fund's IRR to the vintage year among US PE investors, and the fund's IRR to the return that would have resulted from making the same investments in local public markets for the same time period. GPs can anticipate that LPs will be deconstructing their performance in much the same way.

Continued on page 17

Continued from page 16

Ernest Lambers, who for many years managed emerging markets private equity investing at Alpinvest before founding the fund-of-funds EMAlternatives, explains: "Whenever we consider making a commitment we get data from funds with the same strategy and vintage year." Lambers notes that EMAlternatives will also benchmark the fund performance against public markets in the same geography by taking the cashflows of the target fund's investments and calculating the return that would have been achieved from investing them in a local index fund. "Outperforming publics isn't necessarily a firm requirement," says Lambers, "just another tool for discussion."

Another form of performance comparison is an analysis of the share of return due to multiple expansion at exit, growth in earnings, de-leveraging effects, and changes in exchange rate for a target fund and its peers. Maninder Saluja and Carlos Heneine co-head emerging market investing for the family office Quilvest. Saluja says that some GPs will provide this kind of breakdown as one element of how they present their track record.

Saluja and others believe that this kind of detailed disclosure is always preferable to a performance presentation that glosses over rough edges. "LPs are generally aware of how you can affect the presentation of an IRR," he says. Since the LP "is inevitably going to ask the question," Saluja advises that it is better for the GP to be forthright in the presentation of the many angles of their performance: IRR and cash multiples; realized, unrealized and aggregate returns; gross IRR and net to LPs, and an analysis of the source of the returns (e.g., multiple expansion, exchange rates).

Should GPs expect they will be judged more by their IRR or their cash multiples? LPs differ on this issue. Ernest Lambers of EMAlternatives claims there is no hard and fast rule. Jesus Arguelles of CALPERS and Maninder Saluja of Quilvest by contrast believe that cash multiples are very important in putting some of the IRRs that have recently been achieved into perspective, and may be a better guide in emerging markets. Arguelles explains that "pockets of liquidity have come and gone, but the best managers have always done well on a multiples basis, though not necessarily on an IRR basis relative to established private equity markets." Arguelles also points out that IRR calculations can be manipulated on the basis of the time period selected, and cites the example of a fund for which the IRR calculated on a quarterly cashflow basis was 400bp higher than when calculated on a daily basis.

LPs emphasize that for emerging markets the qualitative evaluation is particularly important. "If funds are not that old, say 3-4 years, the IRR doesn't mean a lot," says Lambers. "What you have to do is dig deep into the whole portfolio and focus on what has been achieved with the portfolio companies since the fund invested."

"Because emerging markets are new, dynamic and performance information is difficult to collect, the quartile of an emerging markets manager is less relevant to our decision making than it would be in the US, because the track records typically are shorter," says Arguelles. "Performing within the top quartile is still important, but how the team managed through different cycles, and if it's a newer team, how they can adapt to changing environments is very important." •



OVERSEAS PRIVATE INVESTMENT CORPORATION

An Agency of the United States Government

will issue

A GLOBAL CALL FOR PROPOSALS FOR OPIC FINANCING OF INVESTMENT FUNDS FOCUSED ON THE RENEWABLE ENERGY SECTOR



OPIC is preparing to launch a global call for proposals to support one or more funds investing at least 50% of its capital in companies or projects in the **Renewable Energy Sector**. OPIC will consider proposals from funds focused globally, or regionally in Asia, Eurasia, Central Asia, the Middle East or Latin America, in OPIC-eligible countries. In addition, these funds can also invest in other related sectors in the field of energy and environmental sustainability, which could include energy efficiency systems and equipment, and water, waste and emissions control and treatment. Please note that OPIC's evaluation criteria will be weighted towards those funds with strategies emphasizing investments in renewable energy projects and/or companies.

OPIC will consider providing up to \$100 million in capital to one or more selected managers, which financing will represent generally no more than 33% of a fund's total capitalization. Funds that OPIC deems to be highly developmental could receive up to 50% of a fund's total capitalization. The balance of each selected fund's capital is to be raised from private sector and other investors.

Please consult the announcement of the call for proposals appearing on OPIC's Web Site (www.opic.gov) on or about **March 4, 2008**.