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This is the next installment of our private equity commentary. We recently have met with many top tier VC and LBO firms about their upcoming funds. We also have seen a few interesting emerging managers recently. This month, we will discuss key elements to look for when evaluating both types of managers.

Challenges in Selecting Private Equity Fund Managers

"Top quartile returns" is a phrase often used in the private equity industry – claimed by GPs and sought by investors – and its significance is displayed in historical data. For funds formed between 1980 and 2000, the average top quartile cutoff was 24.7% for VC funds and 20.0% for LBO funds, respectively. However, during the same time period the median cutoff was significantly lower at 9.9% for VC funds and 12.2% for LBO funds, underscoring the importance of investing with the best managers.¹

Evaluating Established Managers Through Quantitative and Qualitative Measures

When evaluating a firm, the investment team's abilities are paramount. Private equity is a people-oriented business because the industry experience, financial expertise and relationships of private equity firms are so critical to the success of their portfolio companies. The best firms add significant value to their portfolio companies by rolling up their sleeves and helping their businesses grow. A strong track record *can be* a key indicator of future success, but it is no panacea. In April 2004, Steve Kaplan of the University of Chicago and Antoinette Schoar of MIT published a study on the correlation between the past performance of private equity firms and the likelihood that their future funds will generate similar returns. They conclude, "General partners whose funds outperform the industry in one fund are likely to outperform the industry in the next and vice versa."² This is no surprise because brand name private equity firms tend to be lightning rods for high-quality deal flow. Entrepreneurs want access to fund managers' operating, financing and technical expertise and networks and naturally gravitate to managers who have "been there and done that," giving such managers a significant deal flow advantage over their fledgling peers. But what happens when the teams who built great track records start to retire or break apart like we are seeing at many firms today? Just as with emerging managers, qualitative factors take on extra importance.

Evaluating Emerging Managers Through Mostly Qualitative Measures

Evaluating emerging fund managers poses serious challenges to the casual investor. Few emerging managers have a meaningful track record as a team. Instead, most only offer a track record cobbled together from their tenure at other firms. Such track records are obviously of limited predictive value. Given this, investors instead must focus on qualitative factors such as industry specialization, the extent of the firm's proprietary deal flow (quality, quantity and sources) and ability to add value to portfolio companies through unique industry insights, a proprietary financing strategy and expansive industry networks. Investors must also endeavor to determine how motivated the team is, how well they work together and whether they possess the investment discipline and patience of a more seasoned firm. In our years of providing both transaction and private equity expertise, we have learned that one can never do too much due diligence when selecting a fund manager. Yet by asking the right questions and with hard work, a disciplined investment process and the right industry contacts, investors can parse through these qualitative factors to select outstanding VC and LBO managers.

¹ Source: Venture Economics. Net IRR data thru 6/30/04 as of 1/7/05.

² "Private Equity Performance: Returns, Persistence and Capital Flows," Steve Kaplan and Antoinette Schoar, April 11, 2004.

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