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EVCA published a Joint Study of CEFS and CDC IXIS on the Role of Private Equity in Strategic Asset Allocation

The research was conducted on behalf of European Private Equity and Venture Capital Association EVCA and carried out by Patrick Artus and Jérôme Teïletche, CDC Ixis Capital Markets Research Department, France, and by Christoph Kaserer and Christian Diller, Center for Entrepreneurial and Financial Studies (CEFS), Technische Universität München, Germany. Return and cash flow data on European private equity funds has been provided by Thomson Venture Economics. The authors of this paper make a case for the introduction of private equity into the framework of modern portfolio theory. The most challenging issue in this context is the absence of a market providing pricing guidance for the assets in the portfolios of private equity funds on a continuous basis. As a consequence the value of assets in portfolios is the result of an appraisal, leading to a potential bias in net asset values (NAV) disclosed by private equity funds. In order to deal with this problem two completely different approaches have been chosen.

In a first stage, Patrick Artus and Jérôme Teïletche from CDC IXIS concentrated on correcting aggregated quarterly returns of venture capital funds generated by the smoothing process. By applying an appropriate measurement technique they found an average annualized return of 9.8% for European venture capital funds over the period 1994-2003. The smoothing corrected annualized standard deviation of venture capital returns was 27.5%, while the correlation with the MSCI Europe equity index was 0.7. Over the same period the return on the index was 8%, the standard deviation 21.1%. Using these results it turned out that a well diversified portfolio may allocate about 3% of the wealth into venture capital funds. As far as buy-out funds are concerned it turned out that they have a slightly lower return but, simultaneously, also a consistently lower standard deviation. Their correlation with public stock markets as well as with venture capital funds seems to be rather low.

In the second stage, Christoph Kaserer and Christian Diller from CEFS conducted an analysis based on the cash flows of a total of 780 European private equity funds in 1972-2003. As cash flows are unaffected by strategic valuation decisions this approach may be a good check of the robustness of the above presented results. Moreover, the

authors were able to give some insight into the time pattern of cash flows. It turned out that the average European private equity fund draws down 25% of the total commitment when starting its business and 63% within the first three years. On the other hand, 53% of total disbursements are paid out to the limited partners within the first six years. Taking both figures together the authors argue that limited partners on average get back the money invested slightly more than 7 years, which is in the range of results obtained for US private equity funds. Next, Christoph Kaserer and Christian Diller calculated various performance measures. They found that the internal rate of return (IRR) based on cash flows for 201 funds, which were either liquidated or had a small residual net asset value, is around 12%. The results also indicate an average IRR of buyout funds of 13.4% and of venture capital funds of 10.6%. The average difference between the IRR and the contemporaneous MSCI Europe equity index return is 4.4%.

Because of the shortcomings of the IRR calculation method, the authors developed a benchmark for returns based on the assumption that the limited partners will reinvested the distributions from the funds either in a public equity or bond index. This benchmark is called the public market equivalent (PME). It is defined in a way that a result of 1.1 would tell us that one has to invest 10% more money into a public market index than into the private equity fund in order to have the same wealth on the liquidation date of the fund. The authors found an average PME of 0.93 and a value-weighted average of 1.04. Again, buy-out funds seem to perform better than venture capital funds as far as the PME-measure is concerned. Moreover, it could be shown that funds with later vintage years have a consistently higher PME. Finally, the authors used the PME-approach in order to assess the riskiness of a private equity investment. In this context, basically, the riskiness is associated with the statistical distribution of the PME. On this basis, it turned out that a well diversified portfolio should allocate about 5% of wealth to private equity investments.

The results of the study have been presented on the EVCA international investors conference on March, 10-11, 2004, in Geneva, Switzerland.

For additional information please check our web-site www.cefs.de or call Christian Diller.