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Quantifying expertise in private equity

Singapore Management University

QUANTIFYING EXPERTISE IN PRIVATE EQUITY

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Just how much is expert knowledge worth in running a private equity fund?

It seems intuitive: private equity funds run by companies with more financial, technical, and management expertise will outperform those run by companies with less. But what kinds of funds – buyout, real estate, venture etc. – are more sensitive to differences in expertise? And what is the difference in performance between high-expertise and low-expertise funds?

These are some of the questions which the Asia Private Equity Institute (APEI) at the Singapore Management University sought to explain with the Q2 2013 issue of the *APEI Private Equity Insights*, titled "*The Value of Human Capital in Private Equity*".

THE VALUE OF HUMAN CAPITAL

Using data from investment intelligence firm, Preqin, APEI analysed the performance of 4,111 funds based on their Internal Rate of Return (IRR), Public Market Equivalent (PME) and investment multiple. Preqin's data also include self-reported information on whether the general partners of the funds – those who raise the money and do the investing – have the following expertise:

- Financial
- Technical
- Industry
- Operational
- Management
- Strategic
- Marketing
- Recruiting
- Networking

As a baseline for comparison, APEI compared funds which had expertise in any of the nine areas mentioned above versus those which did not. To illustrate, funds which have financial expertise (presumably ex-investment bankers and/or financial consultants) had an IRR of 13.90 per year versus 10.23 for those which did not – a 3.67 percent difference. These funds also deliver on average 26 cents more for every dollar invested.

To further differentiate between funds with expertise and those that do not, the 4,111 funds are split into five groups of equal numbers or quintiles, based on the total number of expertise reported by each fund. Funds in the top quintile (those with the highest expertise level) deliver IRRs that were 5.40 percent per year higher than those in the lowest quintile (14.35 v 8.95), which works out to 50 cents for every dollar invested.

GEOGRAPHY, FUND TYPES, AND SIZE

APEI's research also found these findings to be true across investment regions. Across seven geographical areas – U.S., Europe, Asia, Latin America, Africa, Middle East & Israel, and Australiasia – there was a difference between the top quintile and the bottom quintile except in Africa. The difference in the Middles East & Israel was the greatest, where the difference was 20.49 percent (28.71 v 8.23), while the difference in Asia was just 1.87 percent (11.43 v 9.56).

These numbers took a different turn when they were sorted into different fund types: Buyout; Growth; Real estate; Infrastructure; and Venture. Here, the difference in performance between the top quintile and the bottom quintile were noticeable in Buyout (5.25 percent), Infrastructure (10.77 percent), and Venture capital funds (8.01 percent). APEI suggests that the spread "may reflect the financial and management skills needed in buyout to understand debt convenants and effect corporate restructurings as well as the networking and marketing skills needed in venture capital to connect startup firms to suppliers and clients."

What about fund size? Does it affect how funds with skilled investment partners perform? Here, APEI split the funds into quintiles again by Assets under management (AUM), and within each of those five groups separate the funds into another five quintiles based on expertise levels. The results were uniform: there was at least a 4 percent IRR difference between the highest-expertise and lowest-expertise funds across funds of all sizes.

HANDS-ON AND FOCUSED

However, APEI writes that "it is more important for private equity general partners to possess strategic vision and savvy management skills than for them to be technical gurus and industry experts." APEI came to the conclusion via regression analysis, which singled out management skills as the most important factor in delivering superior fund performance.

The main takeaway in all of this is private equity firms that are hands-on in their investment approach, and who are focused on a few industries tend to benefit more from partner expertise. Funds with experts on board and that require board representation are better able to advise their portfolio companies. Meanwhile, funds that focus on a few industries "are able to devote more partner time to each portfolio company, [and] are also better able to parlay expertise into better performance."

In conclusion, It is interesting that firms with skilled partners outperform firms without skilled partners *net of fees*. Why do skilled general partners not extract the rents fully from the capital providers or limited partners by raising management and performance fees? The answer must lie in the practice of general partners allocating significant personal capital in their own funds alongside the capital from limited partners. Still expert general partners by raising significant capital are able to partially internalise some of the rents and monetise their valuable skills.

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