Investing in Europe: The Case for Private Equity Funds of Funds

By Emmanuel Roubinowitz and Charles Soulignac of Fondinvest Capital

As the economic recovery consolidates, many investors in the US will start increasing their allocation to private equity. Based on historical data, private equity has the potential to achieve higher returns than most other asset classes. Private equity investing also provides access to a wider, more varied universe of companies than public equity, providing a layer of diversification that reduces overall risk. And as globalization continues to shrink the economic sphere, investors who are already familiar with the US market for private equity will increasingly begin to look overseas in an effort to build geographical diversification into their portfolios.

Fund of funds, the right vehicle to invest in foreign markets

Yet investing in private equity in foreign markets isn't easy. That's why investors who don't have the capital, the access or the experience to build a well-diversified private equity portfolio in unfamiliar environments will consider using a fund of funds. Private equity funds of funds pool the assets of multiple participants and invest in diversified portfolios of private equity funds. Each private equity fund, in turn, invests in privately held companies typically dispersed by geography, industry, and stage of development, hence providing investors with appropriate diversification. Funds of funds also offer an administrative support service for capital calls, distributions, reporting and follow-ups.

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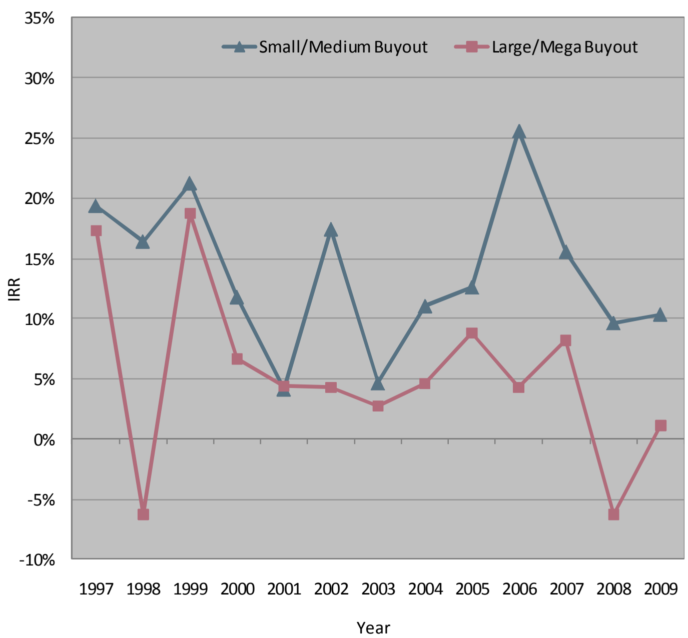
Nonetheless, as the credit crisis created a difficult environment for private equity, the fund of funds industry has come under attack. Critics say that with their double layers of fees and focus on the same pool of well-known buyout firms, funds of funds fail to add enough value for their clients. They maintain that investors would be better advised to build in-house private equity capacities to manage investment programs. Is the fund of funds model still relevant in the post-crisis investment climate?

Small funds provide performance but are difficult to access

The first fund of funds dates back to the early 1990s, but the industry really began to take off 10 years ago; between 2002 and 2009 the number of fund-of-funds managers worldwide doubled to 240. Many of the fund-of-funds teams, however, lacked direct experience in private equity and placed more effort on marketing than on investment. In Europe, a number of them focused on deploying the funds rapidly and did not work out a well-defined strategy in terms of business sector, segment and country. They tended to invest exclusively in the most visible brand-name larger LBO funds. They were asset gatherers rather than performance seekers.

By ignoring the small and mid-market funds, they lost a significant opportunity to add value for their clients, as this segment of the European private equity market has consistently outperformed the large buyouts (see Chart 1). From 1997 to 2009, the cumulative returns since inception of small and mid-market buyout funds ($50 million- $500 million size) in terms of capital weighted average IRR, were higher than those of larger buyout funds in every year except 2001. In some years, such as 2006, this difference was a striking 20%.

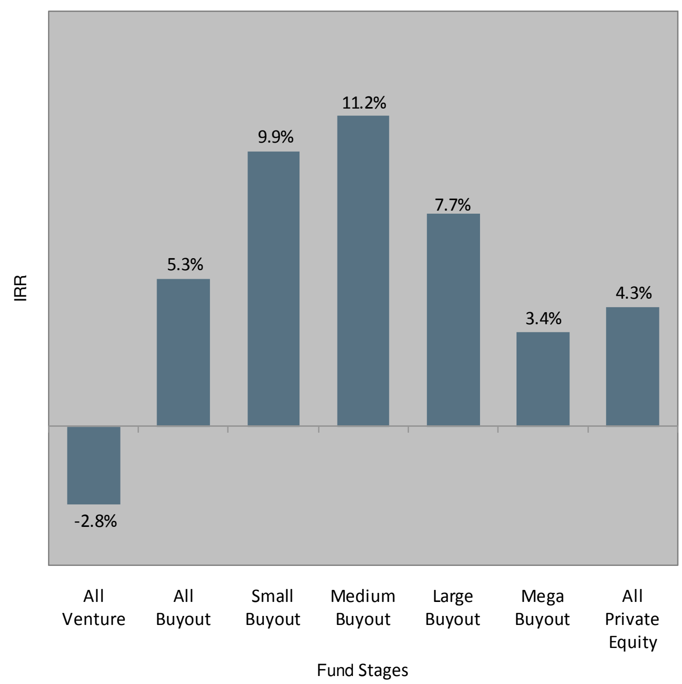
Chart 1. Consistent Outperformance of Small and Mid-Sized Funds in Europe



Source: Thomson Reuters.
Cumulative Returns since inception, Capital Weighted Average IRR, funds formed 1980-2009. Buyout fund sizes are defined as follows: Small: $0-250 million, Medium: $250-500 million, Large: $500-1 billion, Mega: $1 billion+.

With its 30-year track-record, the European lower mid-market private equity sector has definitely shown that it can deliver high performance, with returns of 9.9% and 11.2% as of June 30, 2010 (see Chart 2). This performance is partially due to the fragmented nature of the European market at its smaller end, with legal, economic and cultural barriers limiting competition among private equity funds and creating economic inefficiencies. It is also due to the relentless efforts of the teams of GPs and managers in portfolio companies, where the focus is to create value through operational improvement and growth rather than through pure financial engineering. During the financial crisis, while the large funds suffered from excessive leverage, smaller funds' portfolio companies continued to operate with a reasonable level of debt, thus offering downside protection to their investors.

Chart 2. Private Equity Performance in Europe Driven by Small and Mid-Market Buyout Funds



Source: Thomson Reuters.
Cumulative Returns since inception, Capital Weighted Average IRR as of 06/30/2010, funds formed 1980-2009. Buyout fund sizes are defined as follows: Small: $0-250 million, Medium: $250-500 million, Large: $500-1 billion, Mega: $1 billion+.

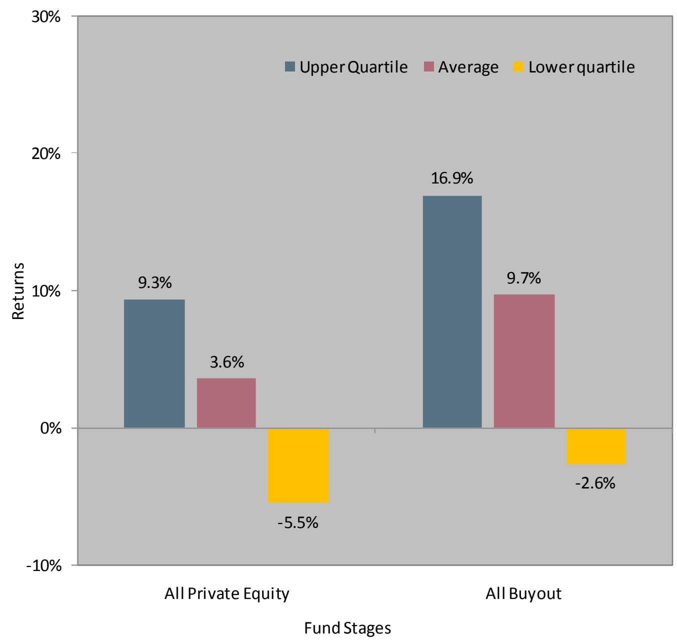
It is important to note that this performance has been generated against a background of slow to moderate growth in Europe. As of today, however, most countries in the region are on the road to recovery and offer many "bottom-of-the-cycle" investment opportunities - at a time when bubbles are clearly looming in emerging markets. As an example, recent economic data released by the German government show the economy growing at 3.6%, a faster clip than any other time since reunification. And, despite all the headlines, the Euro basically trades at its 2005 level to the dollar.

Importance of selecting the best fund-of-funds managers

The European small and mid-market segment, however, is not easily accessible to US investors. While the large private equity funds can afford to send marketing teams on the road, small and mid-sized GPs cannot. So the first hurdle for the US-based Limited Partner is discover the names of these smaller national funds. Even if detected by overseas investors, these funds often remain off-limits because they want to maintain a small, manageable investor base and are often over-subscribed. Many are available “by invitation only.” The due diligence process is long and expensive, involving a strict analysis of the quality, experience and profile of each member of the management team, the fund’s track record, and the past and forecasted performance of the general partners. LPs need regular, on-the-ground information on all the teams. They also need to follow the economic and industrial developments that affect the underlying portfolio companies. Over the next three years an estimated 160 European buyout funds will return to the market to raise money. The problem is to identify the best performers and avoid the pitfalls.

This is where the best specialized funds of funds play their role. Only their teams of pro-active, seasoned professionals have the market knowledge and the contacts to identify and invest in the top funds (see Chart 3). By delegating to a fund-of-funds team the selection of the most promising GPs, investors benefit from an optimum risk to diversification ratio. Most LPs can reasonably invest in three to ten funds maximum over a ten-year period, while a fund of funds typically invests in 40 to 50.

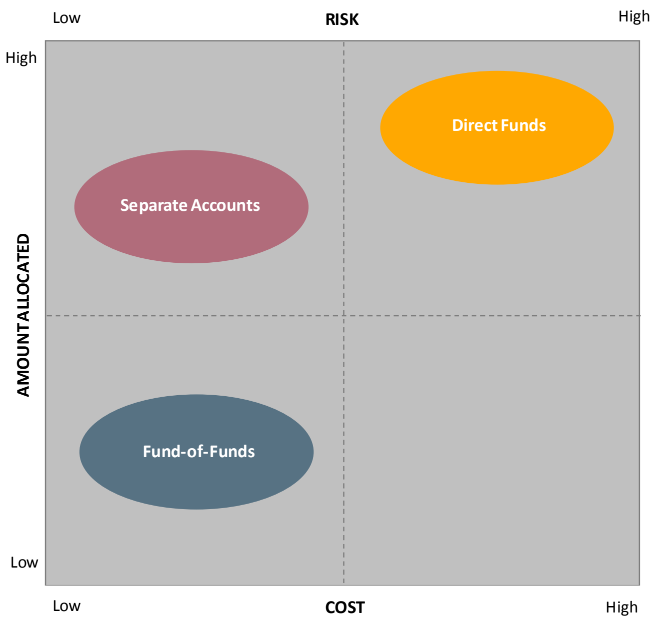
Chart 3. Careful Manager Selection is Critical in Private Equity Portfolio Construction



Source: Thomson Reuters. Capital Weighted Average IRR as of 06/30/2010.

Some LPs continue to question the so-called “double fees”. First, the costs of running a solid private equity program in a complex area such as the European mid-market buyout are significant and often initially underestimated by investors. Second, if funds of funds enable their investors to access the best performing segments, their fees will be largely absorbed by the additional returns. Many LPs who choose to go into unfamiliar niche segments with an understaffed in-house team eventually limit their program to a handful of funds, often the more actively marketed ones. They then lose the benefit of diversification (see Chart 4). They also run the risk of an investment program biased towards private equity managers with aggressive marketing teams, who are content to visit them but do not necessarily offer the best performance.

Chart 4. Building an in-house team or outsourcing?



Source: Fondinvest Capital.

The European lower mid-market has historically offered a very good risk reward profile and the upcoming vintages should generate interesting returns for focused, performance driven teams with knowledge of this segment. Many US investors who wish to profit from the attractiveness of the European market should carefully select teams offering dedicated products and showing long term track-record in funds investment.

Investors ready to commit a significant amount to private equity may wish to consider entrusting their funds to a primary separate account run by a fund of funds team. This approach allows for a more direct dialogue between LP and GP, an investment program specifically tailored to meet their needs and, in some cases, more attractive fees and conditions.

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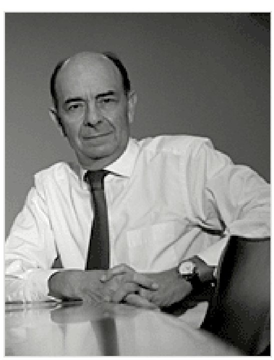

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About Fondinvest Capital

Founded in 1994, Fondinvest Capital is a leading independent management company specialized in investments in private equity funds, with a particular focus on the European small and middle market.
With €2 billion under management and offices in Paris, San Francisco and Tokyo, Fondinvest Capital today provides investors with privileged access to Europe's best performing small and mid-market investment opportunities.

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