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Discount to Net Asset Value: A Key Factor to Producing High Returns?

By Charles Soulignac of Fondinvest Capital

Over the past two years, secondary pricing for private equity funds has trended upward, reflecting improving market conditions and more competitive deal processes, particularly for larger transactions. Although buyout funds received an average price of 84% of their net asset value in 2012, deals are being done at an average price of 92% of NAV, according to Cogent Partners' *Secondary Market Trends & Outlook, January 2014*.

For investors, the opportunity to purchase assets at a discount to NAV constitutes one of the main benefits of buying fund interests on the secondary market as it mathematically offers additional value creation. But now that discounts have narrowed, can investors still expect high returns from their secondary investments?

Deeper discounts to NAV do not necessarily offer higher returns

To assess whether performance is related to the amount of discount to NAV, we have conducted an extensive analysis of about 90 secondary investments completed by Fondinvest Capital since 1994 (i.e., later-stage fund interests that are realized/almost realized). Although this sample only includes data from Fondinvest, we believe it provides a good indication of secondary player activity across different market cycles.

Global Discount vs. IRR

(Correlation coefficient: 0.23)

Sample size: 91 later-stage fund interests acquired between 1994 and 2007 by Fondinvest II, Fondinvest IV and Fondinvest VI. Data as of 9/30/13. Source: Fondinvest Capital.

Through the application of statistical regression techniques, we can see that a positive correlation exists between discounts to NAV and fund performance (i.e., the two variables move in the same direction). This correlation, however, is considered a weak one and not certain enough to be useful for making predictions. This weakness of this correlation is reflected by the dispersion of performance obtained for the same level of discount.

A minimum discount level is required to outperform the market

Even if a strong correlation between the two variables cannot be demonstrated, there's no doubt a minimum level of discount to NAV is necessary if investors want to obtain strong returns. In the table below, we illustrate how performance can vary depending on the average level of discount applied to our sample of funds.

How Discounts to NAV Affect Performance

Avg. Disc. to NAV	-10%	-5%	0%	5%	10%	15%	20%	25%	30%
Avg. Total Value Paid In	1.30x	1.36x	1.41x	1.48x	1.55x	1.62x	1.70x	1.80x	1.90x
Avg. IRR	8.9%	10.7%	12.6%	14.8%	17.2%	20.1%	23.4%	27.3%	31.8%

Note: A negative discount corresponds to a premium to NAV. Source: Fondinvest Capital

Discounts are attractive, but in-depth analysis is required for successful secondary investments

The pricing and discounting of a transaction result from a careful analysis of the underlying assets in terms of exit timing and expected investment gains, taking into account the performance expected by investors in the secondary funds. But we at Fondinvest Capital believe that, in addition to the discount, other issues need to be assessed, including:

- the quality of the general partner, its ability to consistently deliver top-quartile returns and its determination to generate liquidity for investors
- the quality of the underlying portfolio companies and their upside potential for sustaining the expected level of performance
- the valuation policy of the general partner (either aggressive or conservative)
- the actual reasons motivating the disposal

Investors should also keep in mind that a discount to NAV is an instantaneous indicator (i.e., calculated at the time of the acquisition), and adjusted according to the maturity of the fund and the amount of risk taken. Therefore, funds with low levels of funded commitments or with riskier investment strategies (like venture capital) should generally be traded at larger discounts.

All these elements indicate that determining secondary performance is not just a matter of discounts but also require long-term expertise in the private equity sector.

Charles Soulignac is the founder and managing partner of Fondinvest Capital. He started the firm's secondaries business in 1994. Prior to this, he spent five years managing investments in private equity funds and direct equity investments for CDC Participations. He also has previous experience in industry (Potain), consulting (Maynard) and finance (Bred). Reach him at c.soulignac@fondinvest.com.