PRIVATE EQUITY PERFORMANCE

Is private equity a good investment? Depends on what data you look at.

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Private equity and venture capital have matured into an asset class of great interest to institutional investors and pension plan sponsors. In the first three quarters of 2005 alone, 122 buyout and 130 venture funds were raised in the U.S. at a value of more than $61 billion between them, according to figures from Thomson Venture Economics and the National Venture Capital Association. The question is, however, what do we know about the return characteristics of private equity funds and what distinguishes successful fund managers?

Measuring private equity performance is subject to three challenges. The first is the so-called "J-curve." In the early years of a fund's life, cash flows and, therefore, returns are negative as fund managers draw down cash from their investors to fund promising ventures. Only once fund managers begin to exit portfolio companies do cash flows and returns turn positive. Thus, it makes little sense to measure a fund's performance in the early years. In fact, its true performance will not be known until all portfolio companies have been exited or written off and the fund has come to the end of its life, which can take 10 years or more. Evaluating an emerging fund manager's track record is, therefore, an inaccurate science. Moreover, the J-curve makes it exceedingly hard to measure cyclicality, liquidity premia, diversification benefits, etc.

Data vendors such as Venture Economics and others do report performance statistics for ongoing funds. They base these in part on unrealized capital gains. However, the second challenge lies in the absence of agreed valuation guidelines for private equity portfolio holdings. In fact, it is not uncommon for different funds to report different valuations for the very same portfolio company.

The third challenge is due to the limited range of data sources. The private equity industry has traditionally resisted disclosing fund-level performance data to anyone other than their own fund investors. Venture Economics get much of their data from co-operative fund investors, but it is unlikely that the 1,000 or so funds for which Venture Economics has data are an unbiased sample of the universe of U.S. funds. Over the last 25 years, these have numbered in the thousands.

In light of these challenges, it is perhaps not surprising that there is enormous disagreement about the returns to private equity. Using Venture Economics data, a recent academic article by Steven Kaplan of the University of Chicago and Antoinette Schoar of MIT argues that private equity funds raised between 1980 and 1999 have performed roughly in line with the public markets, with IRRs averaging 17% for venture funds and 18% for buyout funds. Using the same data but trying to adjust for the fact that the Venture Economics data represent a biased sample, two European researchers, Ludovic Phalippou and Maurizio Zollo, have come up with very different estimates: 11.3% for venture funds and 14.5% for buyout funds. The latter set of numbers imply that private equity has underperformed the public markets, which likely means negative alphas. Using different data from a proprietary source, Matthew Richardson and I have estimated that venture and buyout funds have returned 14.1% and 21.8% on average, respectively.

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In the absence of better data, agreement on the average level of private equity returns will remain elusive. But what do we know about the cross-section of private equity returns? First, fund returns are highly persistent: good managers tend to continue to outperform on their next fund. Second, first-time funds, on average, have negative expected returns. Third, returns are sensitive to changes in investment opportunities and macro variables (such as bond yields), and show a tendency for "money to chase deals." ■