Performance Measurement
Agenda

• Introduction and welcome – Angela Crawford-Ingle
• Performance measurement, GIPS & Private Equity – David Gould
• An investors perspective – Rod Selkirk
• Private equity performance and valuations – Patrick Cook
• The private equity performance revolution – Marie-Fleur Bonte
Performance Measurement, GIPS and Private Equity
David Gould

17th May 2004
Agenda

- Why measure performance?
- How?
- What are the issues?
- Performance standards
Why measure performance?

“If it isn’t measured, it isn’t managed”

- Process creates control
- To understand risks
- To see if Managers are achieving objectives
- To see if Fund’s achieving objectives
A key ingredient of performance measurement is based on prices

Prices available

- **Equities**: ✓ Except for illiquid companies
- **Bonds**: ✓ Except for illiquid bonds
- **Property**: × No perfect price without a sale
- **Private Equity**: × No perfect prices without a sale
What are the PE issues?

- No liquid market
- Performance based upon appraisals/estimates
  Leads to ⇒
  - Longer time frame needed to assess performance
  - Comparisons more difficult
  - Treat performance figures with care
Performance Standards

- Calculations of performance can vary
- Different price sources
- Different ways of dealing with cash flows

Presentation of performance can vary
- House average or individual account
- Quarterly, yearly or rolling 3 year returns

Performance standards desirable
- Global Investment Performance Standards (GIPS)
- NAPF – UK Investment Performance Standard (UKIPS)
Who measures performance?

<table>
<thead>
<tr>
<th>Independent</th>
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<td>Russell Mellon</td>
<td>Fund Managers</td>
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<td>Bank of New York</td>
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<td>J.P. Morgan</td>
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<td>Northern Trust</td>
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<td>State Street</td>
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<td>Others</td>
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What’s the history?


“independent measurement of performance is welcomed by all concerned with pension fund investments…”
1992 – 1st UK voluntary standard for performance track records of balanced UK pension fund accounts.
1996 – Revised to include segregated accounts
1997 – UKIPC begin work with AIMR on new global standard
1999 – GIPS released
2000 – UKIPS released
2001 – UKIPS endorsed as a Country Version of GIPS (CVG)
Identical to GIPS BUT

“with the requirement for independent verification”
“Critical” differences between PE and “quoted” asset classes

• Measurement hugely dependent on interim valuations

• Interim valuations based on relatively subjective methodologies

• PE industry has evolved differently across the world
Addition of VC & PE Provisions and Guidance to GIPS

NAPF response April 2003

- www.napf.co.uk/policy/investment

Joint response with Private Equity Investors Association (PEIA)
Main features of response

- Consultation proposals welcomed by UKIPC
- Intention should be a single international standard
- Need an agreed valuation methodology
- Use of independent experts to verify recommended
How will GIPS provisions help?

- Encourage convergence of practices at a global level
- Flexibility of methodology based on more extensive disclosure and explanation
- Recognises how difficult the objective valuation of PE investments can be
Why are investors interested?

- Consistent treatment with other asset categories
- Global valuations standard including the concept of verification
- Removal of barriers to market entry
- Supports good internal controls
- Reduces risk of restrictive regulation
Where now?

- Gold GIPS out for comment to 1st August 2004
- Includes PE/VC (and property)
- UKIPC working party currently drafting response
- Effective 1 January 2006
Private Equity Performance Measurement
Rod Selkirk

17th May 2004
Hermes Private Equity Activity

- £900 million capital under management
- Invest as LP in buy-out and venture funds
- Invest directly in European middle-market buy-outs using dedicated £200 million fund
Private equity performance measurement – an art or a science?

- Realised investment performance is relatively simple
  - cash on cash IRR
  - cash multiple
  - does not necessarily map exactly with an equivalent investment in public equities
- Unrealised investment performance measurement dependent on investment valuations
Listed equity valuation

- Is a market valuation for a stock
- Is a function of publicly available information (or analyst’s views!) not necessarily underlying corporate performance.
- Sharp share price movements as a result of bad news or good news (announced bid) can make sharp apparent valuation fluctuations.
- It’s not as perfect as you think!
Example of a Private Company Valuation at 31 December 2003

- FTSE Sector P/E : 14
- Net indebtedness of £40 million
- Exit within 12-24 months

Year end 31 March 2003

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Valuation of equity?

- 20% discount at P/E multiple £38.4 million
- 40% discount at P/E multiple £18.8 million
- Public equivalent £68.6 million
Example of a Private Company Valuation at 31 December 2003

- FTSE Sector P/E : 14
- Net indebtedness of £40 million
- Exit within 12-24 months

Year end 31 March 2003 2004
EBITA 10,000 12,000
Interest 3,000 3,000
PBT 7,000 9,000
Tax at 30% (2,100) (2,700)
PAT 4,900 6,300

Valuation of equity
- 20% discount to forward earnings multiple £54.1 million
- 40% discount to forward earnings multiple £30.6 million
Example of a Private Company Valuation at 31 December 2004

- FTSE Sector P/E : 14
- Net indebtedness of £40 million
- Exit within 12-24 months

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<tr>
<th>Year end 31 March</th>
<th>2003</th>
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Valuation of equity
- 20% discount to forward earnings multiple £30.6 million
- 40% discount to forward earnings multiple £12.9 million
Conclusion

- Valuation is not just a mathematical exercise
- Relies on knowledge of business and its underlying prospects
- There is no substitute for GP evaluation and judgement
How do we evaluate GPs

- Historic track record is only a small part of our evaluation
- Cohesiveness of strategy
- Background, experience and motivation of team
- How we perceive the relationship will look
  - Openness
  - Honesty
  - Integrity
- These are **subjective** assessments
Private Equity performance – the last frontier

- **AIMR (GIPS) – ILPA, EVCA, BVCA, NVCA, IASB…….**
  - the sheriff has arrived
- **AIMR / IASB / ILPA / Hi level – VCAs do detail**
- **IRR v TWA**
- **Disclosures (from 2005 – see AIMR website)**
  - SI (net net net) IRR and Gross
  - Vintage, strategy, size
  - Methodology, procedures and dates
  - TVPI, DPI, PIC, RVPI
  - Open ended / Fund of Funds modifications
- **All good stuff – but there is an elephant on the table**
Some valuation issues

- The Fair Value Movement
  - mark to market
- Accuracy, uncertainty and Schrodinger’s cat
  - mark to model
- Transparency and complexity
  - mark to myth
  - Rules to protect the dishonest?
- The players; their motives and mindsets
  - priests, rocket scientists, spin doctors and the Tao
- Fingers and toes
  - the economists’ notion of second best approach
  - hierarchy of principles
The Private Equity Performance Revolution
Marie-Fleur Bonte

17th May 2004
“There are three kind of lies: Lies, damn lies and statistics”

Mark Twain
PwC survey on Performance Measurement

- Last survey 3 years ago
- New survey to be released next week
- Reflects substantial progress and development in standards and investors expectations
- 94 key personnel surveyed from global asset management firms
- Amongst those surveyed
  - 72% compliant with performance standards
  - 18% more intending to comply in the next 3 years
Focus on Private Equity

- On 1 December 2003, the IPC (Investment Performance Council) adopted the Private Equity Provisions for the Global Investment Performance Standards (GIPS)
- Amongst those surveyed:
  - 32% hold private equity investments
  - Within UK the number rises to 50%
- Of the Private Equity holders
  - 75% hold Private Equity via funds
  - 50% invest directly
GIPS has published proposals, recently approved, which include specific guidelines for venture capital and private equity valuations and performance reporting. How likely is it that you will seek to comply with these private equity guidelines?
Impact of the new guidelines

• Survey results
• 57% of asset managers surveyed indicated their willingness to comply
• Out of those
  – 71% invest directly
  – 55% invest via funds
• Only 11% unlikely to comply

• Industry background
• Investors pressure for transparency
• FOIA
• To date little demonstration of awareness of the guidelines by independent GPs
Asset Managers’ view of performance measurement in Private Equity

![Diagram showing the importance of following as forms of performance measurement](chart.png)
Asset Managers’ view of performance measurement in Private Equity

- 44% believe Gross IRR is the most important indicator
- 59% recognise Gross IRR some level of importance
- 54% of asset managers surveyed think that consistent calculation and appropriate disclosure are equally important
- 31% favour consistent calculation
- 12% favour appropriate disclosure

- This confirms that the guidelines are relevant to the industry
Challenges to implementation

- Valuation of unrealised portfolio and consistency
  - Valuation guidelines in Europe
  - Valuation guidelines in US
  - Fair Value as per IAS 39
- Performance belongs to the firm not to the individuals
  - Historic performance data for spin off individuals unlikely to be in a position to claim GIPS compliance
Advantages of the new guidelines

- Guidance for consistent calculation basis and disclosure
- Global scale
- Applicable for new and existing clients
- Guidelines are well recognised in AM industry
- May become competitive advantage when fund raising
- David Gamble:
  “Not a matter of if but when”