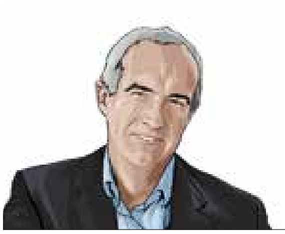

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Tim Jenkinson is a professor of finance and head of the Finance Faculty at Saïd Business School, University of Oxford. He is also the director of the Oxford Private Equity Institute. His areas of expertise include PE, IPOs, institutional asset management and the cost of capital. He has been published in journals including *The Journal of Finance*, the *Journal of Applied Finance* and *The Review of Financial Studies.*

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LIPSTICK ON A PIG?

New research suggests that younger or smaller firms or those on the lower end of the performance spectrum manipulate their interim performance numbers in order to raise their next funds. We asked three academics and three practitioners whether limited partners can see through this sleight of hand, and how it impacts these funds over the long term. **Chaired by Bailey McCann.**

Private equity's interim valuations have come under increased scrutiny over recent times as the US Securities and Exchange Commission (SEC) has shone a spotlight on this area. The SEC is particularly focused on whether firms manipulate performance data at the time of fundraising in a bid to attract commitments to follow-on funds. But do PE firms really do this? Three recent academic papers have looked into the issue: one finds that all general partners engage in some form of performance number inflation during fundraising (although younger firms that have not yet built up a positive reputation do so more than established firms) and that the higher the interim valuations, the bigger the subsequent fund; another paper finds that only the poorer performers tend to manipulate performance, and that they are punished by a lack of new commitments by limited partners; and the third piece of research finds that, while GPs generally value their investments conservatively over the life of the fund, this conservatism disappears at the time of fundraising.

Starting first with our academic panellists. Your combined research suggests that there is at least some element of performance inflation happening during the fundraising process, doesn't it?

Yasuda: "Yes. Performance can hamper a GP's ability to raise the next fund, and thus affects its business. The SEC recently raised concerns about possible performance inflation, so we wanted to look at this and how these inflationary practices might be used by GPs. We looked at established and emerging GPs in traditional PE and venture capital. Our data showed that among high-reputation GPs – firms with more than one fund, a long track record and strong assets under management – performance was less important around fundraising. But for low-reputation GPs – for example, newer GPs – we did see interim performance peak around the time of fundraising."

Gredil: "From our data, it looks like there is less for a GP to lose by inflating valuations if they are near the bottom of performance and have been without a successor fund so far. Investors may already think the numbers are inflated among such funds, so it can be harder to prove that you have a conservative valuation anyway. The incentives change if you are a top-performing fund and a high-reputation firm; then, you risk

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Antoine Dréan
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Antoine Dréan is founder and chairman of Triago. He is in charge of the group's business development and manages Triago's strategic advisory missions for clients. He has also founded Palico, an online marketplace for PE, and Mantra, an investment company focused on listed PE and non-traditional PE funds.

Paul RT Johnson, Jr
Illinois State Universities Retirement System

Paul RT Johnson, Jr is a trustee for Illinois State Universities Retirement System (SURS) and is involved in the approval process for investments made by the pension fund. He is also the owner of LSU Trading in Chicago. Prior to founding LSU Trading, he was the CEO of Boston Cabot, a broker/dealer.

tarnishing the relationship. In the middle tier of GPs, the incentives are thoroughly mixed, but ultimately these mid-level GPs aren't likely to want to risk tarnishing their relationship with LPs by inflating the numbers. According to our tests, aggressive valuations reduce the odds of a successful fundraising for an average fund."

Jenkinson: "We've seen some evidence in our data of abnormal performance – on a relative basis – around times of fundraising, but interim performance is also pretty noisy as an overall metric, and I think investors are getting more savvy about that as well."

So what does the research tell us about how investors work around the issue of asymmetry of information?

Jenkinson: "Investors generally accept that there is some embedded uncertainty about how a current fund is going to play out. Typically, LPs are going to look at an even older fund – where there is one – to see how those exits have gone in order to get a better picture of what they can expect. They are also going to look at relative performance within a cohort, or check for independent valuations. Smart GPs tend to value their investments conservatively, in order to avoid too much multiple contraction from fund to fund, investment to investment."

Gredil: "We find no evidence of naive investors, at least in our sample: they scrutinise everything they are told by their GPs and they negatively mark inflated performance. Healthy market forces do not seem to be failing here."

What do the practitioners think? Do PE firms manipulate valuations to raise funds? And how can LPs work around the possibility of this happening?

Zenni: "I don't know about manipulation, but GPs do have a wide latitude on how to value things. So human nature may lead to different valuations at different times.

"But I also think that there's a timing element here. While I don't think GPs are trying to time the market *per se*, they have to act tactically when it comes to fundraising. If the numbers aren't good, the window isn't open. If the numbers are good you might have a shot at fundraising. We have a different approach from some others around valuations. We use [valuation specialist] Duff & Phelps to value all of our portfolio companies, so everything we own is independently valued on a quarterly basis, which takes out the guesswork. We've been doing that for years, and we've done that voluntarily because it gives the LPs comfort and acts as a validator for how we value things. I don't know how many other GPs do that, but we want to be very transparent from an LP standpoint. It keeps everyone honest."

Dréan: "It's not surprising to hear of some GPs inflating performance, but I think it is very difficult to fool LPs. PE was a tiny industry a while ago, but now it is a big, competitive business. I think one of the reasons certain GPs are successful in their fundraising is because they have gained the trust of LPs. It's about making sure that you are being transparent. You also cannot underestimate what LPs are

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>
> *James J Zenni, Jr,*
> *Z Capital Partners*

doing when it comes to due diligence. PE is a long-term game, so fooling around doesn't make you a winner. I think another answer is what is happening on the secondary market. The secondary market can show who is really optimistic and who is really negative about a fund. GPs would rather see their funds sold at a premium. So discount to NAV [net asset value] *vis-à-vis* peers is a good metric when reporting on values."

Reputation seems to make a big difference in this. Can investors trust the numbers of less well-known and experienced GPs?

Yasuda: "Reputation is a big factor. I think this is what differentiates our paper: we tried to differentiate GPs' behaviours and outcomes by class of reputation. We measure reputation by looking at the size: how much capital they manage, how many funds they manage and whether they have had a top-performing fund

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> *Tim Jenkinson, Saïd Business School*

before. We combine these three benchmarks to sort these funds into high reputation and low reputation. All of our high-reputation funds are large and have had at least one top-quartile fund before. If a manager has a long track record and it's a good track record or a blockbuster fund, some poor performance matters less.

"Whereas if you have only one other fund and it's not top-performing yet, investors will focus more on each portfolio company and exit. So they are pressured by investors to show good performance and are also pressured to show good liquidations. A well-known name like TPG, for example, could decide to fundraise regardless of current performance, whereas the no-name guy really has to fundraise when their fund is doing well."

Gredil: "Our results also suggest that reputation is a really important factor when raising a fund. But it's quite a complex picture. If a GP has been able to make a significant exit or distribution from previous funds, that could outweigh the generally lacklustre performance of the current fund."

Johnson: "From the investor perspective, you see some LPs that are willing to overlook anything. We aren't. We're going to look into everything that happens. If someone is really consistent, and can explain what happens, then we will probably stay. You want to dig deep if someone is getting hired or fired, regardless of their experience levels."

So how reliable is interim performance for investors?

Jenkinson: "Unless LPs only want to base their decisions on fully realised funds, they're going to have to look at the interim data. But investors generally accept that there is some embedded uncertainty about how a current fund is going to play out."

Zenni: "LPs are very intelligent, and so our approach is to be transparent. If performance dips, it is my experience – although we haven't had much in the way of any losses – that they just want to know that your approach was sound and your thesis was sound at the time. We are only as good as the decisions we make and these need to be based on a whole variety of factors.

"As long as our decisions are thoughtful and logical based on extensive due diligence, that's as good as we can do at the time. I mean, right now we're having a rough time in oil, energy, metals and mining. I know GPs who are going to get decimated and it's not because they didn't have skill. But when oil prices were $114 a year ago and now they're at $30, you can't outsmart your way out of that."

Is the integrity of data in PE strong enough to avoid GPs cherry-picking relative performance metrics?

Dréan: "I remember an LP at a conference a few years ago saying, 'We're so glad to be invested in an industry where 70% of the members are top-quartile.' I think you can always be top-quartile of something. Finding comparables can be difficult, so you have to take a thoughtful approach to finding a peer group."

Zenni: "I think a lot of the data can be noise. It's hard to find pure apples-to-apples comparisons. But you do have to take what you can find. I think in the PE world it's not as complicated because IRR is IRR, cash flow is cash flow."

If some funds are engaging in interim inflation, how much comfort can LPs gain from performance relative to peers?

Gredil: "In our paper we compared funds against their cohorts, so that any macro factors would be muted out. If you're looking at 2006, I think it is reasonable to assume that LPs knew they were giving money when the market was hot. So if you're looking at a group of funds that all lived through a challenging period, that's going to help everyone on a relative basis. We do, however, see in some of our studies that performance inflation is most pronounced when it is challenging for everyone to raise a fund."

Zenni: "Relative performance helps a lot. I think the biggest problem LPs have today is finding managers that truly do deliver equity-like returns. So LPs are looking for relative performance and if you can demonstrate solid equity-like returns over a period of time – in our case it's 14 years – you get a following and you get solid institutional support. That's a little different from knocking on doors and looking for capital. It's a very different proposition if you already have strong relative performance."

Johnson: "We always keep an eye on this across our portfolio – is everyone falling apart or just one GP? Who is doing well? Did someone get too far away from core style? You have to look at all the factors. At SURS we are in the process of changing our asset allocations, so this is front of mind for us. If someone does make a bad bet, you have to take that on a case-by-case basis. Was it just a one-time thing, or is it the whole business? But you also have to look beyond the numbers sometimes. If you get so far you're down to the last two funds in the same

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> *Ayako Yasuda, UC Davis Graduate School of Management*

"THE FUNDRAISING MARKET TODAY IS QUITE COMPETITIVE. IF YOU WANT TO STICK AROUND, YOU HAD BETTER STICK TO TRANSPARENCY AND TO TRUTH"

Antoine Dréan, Triago

strategy, where do you go? Sometimes it is a beauty contest. If everything else is equal, where do you go? Reputation will be a factor but only a factor. If they've made it to being in front of me, they're pretty good. They've made the cut. So you have to go with the human factors."

For GPs that don't yet have the reputation behind them or that aren't raising mega-funds, is it fair to say that they have an incentive to be as good at being salespeople as they are at picking companies in order to build up fund size?

Yasuda: "I think that goes to the crux of what we are seeing here. I think the hardest place to be is the middle guy, because investors can't easily tell if you are middle because you choose to be or because you failed at being big. So there is always a nagging doubt among investors about your growth trajectory. And that's fascinating because investors have a point, and managers have a tougher time showing that they are there by choice. If you can buy a billion-dollar company and turn it around, there are fewer reasons to believe that you can't turn a $10bn company around.

"Whereas for VCs, the contrast is very interesting. With the VC you can convincingly argue that you're best at being at the accelerator level, and being good at spotting the early-stage company. If you are best at picking those companies, you can't really quadruple the size of your investments and convincingly call it a start-up. But with a buyout fund, if some of the middle guys are staying there by choice because they are best at the middle, they are still more pressured to show differentiation there. That's a hard place to be."

Gredil: "Based on our paper specifically, it pays to be transparent and not send mixed signals to LPs. It's possible that you can be a good firm and just be unlucky at certain points, which is also why reputations count. Whether GPs think it's important or not, they have to communicate clearly with investors."

Zenni: "For us, it's less about salesmanship and more of a mapping-out of what we do versus other players. LPs aren't going to get sold on anything. They are intelligent: they know the inner workings of firms like ours. It's a matter of explaining how our firm is different from others. We focus on turnarounds, so we are very transparent about how we have fixed a company and what was the value creation along the way; it's not as much about selling something."

Dréan: "As a placement agent, if you want to be around for a long time, the only word that counts is 'transparency'. We ask our GP clients to tell us about the worst story so it doesn't come up during fundraising. LPs will look under every rock, so not being transparent from the beginning will create problems. Every GP has a few skeletons, but you have to be transparent about what they are because LPs will ask. The fundraising market today is quite competitive. If you want to stick around, you had better stick to transparency and to truth."

The research

In their paper *Interim Fund Performance and Fundraising in Private Equity*, Brad Barber and Ayako Yasuda, both of UC Davis Graduate School of Management, study the interim performance of PE funds around the time of fundraising, using fund-level cash-flow and valuation data for more than 800 VC and buyout funds raised between 1993 and 2009.

First, they find that the interim performance of a fund has a significant effect on a GP's probability of raising a successor fund, and this is especially true of smaller, younger firms that have not yet built up a reputation. Second, they find that a 10% improvement in a fund's percentile rank, such as from the 30th to the 40th percentile, increases the size of their follow-on fund by 20%. The authors also find a link between the timing of fundraising and an increase in interim performance figures. The performance of funds peaks either at, or shortly before, the time of fundraising, with GPs in the low-reputation sample seeing the greatest increase in performance at this time. In addition, the research finds that mark-downs are larger and more frequent after the fundraising period. Overall, the research suggests that GPs inflate NAVs during fundraising.

Do Private Equity Funds Game Returns? by Gregory Brown (University of North Carolina), Oleg Gredil (Tulane University) and Steven Kaplan (University of Chicago Booth School of Business) looks at a similar issue, but finds, overall, that managers that boost reported NAVs during fundraising periods are less likely to raise their next fund. Their research shows that the fund-timing increase in NAVs is limited to a subset of underperforming funds that are most concerned about survival and that GPs with reputations to maintain are much more likely to report conservative NAVs during fundraising efforts. The authors also find that LPs appear to punish GPs for what they may consider aggressive interim reporting at the time of fundraising by not committing to their next fund.

How Fair are the Valuations of Private Equity Funds?, the paper by Tim Jenkinson, Rüdiger Stucke (both of the University of Oxford's Saïd Business School) and Miguel Sousa (University of Porto), uses the quarterly valuations and cash flows for all the 761 fund investments made by CalPERs. It finds that, over the life of a fund, valuations tend to be conservative and to understate subsequent distributions by 35% on average. However, it finds evidence that valuations are inflated during fundraising, with a gradual reversal after the follow-on fund has been closed. In addition, the authors find that performance figures reported during fundraising have little power to predict ultimate returns, particularly when IRR is used as a measure.