Guide to Private Equity and Venture Capital for Pension Funds
If you’re considering investing in private equity and venture capital, making the first move may seem daunting, given that many characteristics are quite unlike those of more traditional types of investing.

That’s why we have put together this guide. Containing practical information on why and how to invest in the asset class, plus an overview of the benefits and risks involved and of the different ways of investing in private equity and venture capital, we’ve also gathered the experience of long-standing pension fund investors in private equity and venture capital to show how they manage their portfolios and exposure.

Over the last 15 years, the private equity and venture capital industry has grown and matured substantially to become an established part of many institutional investors’ portfolios, with pension funds among some of the most active investors in this type of fund. Invest Europe’s data shows that almost a third of the capital raised by European private equity and venture capital funds in recent years came from pension funds, the largest category of investor. As private equity continues to outperform other asset classes over the long term, existing investors are looking to increase their exposure, with a third of pension fund respondents to a Greenwich Associates report expecting to up their allocations to private equity and venture capital over the next few years.

We invest in private equity because we are looking for a premium over listed equities. To date, it has been our best-performing asset class, having achieved 17% net returns per annum since 2005 – ahead of the 300-500 basis points outperformance over the public market that we believe is an appropriate premium.

Katja Salevaara, Senior Portfolio Manager, Private Equity, Ilmarinen Mutual Pension Insurance Company
What are private equity and venture capital?

In simple terms, private equity and venture capital are long-term investments in private, unlisted companies with the potential for growth. In return for investment into the company, private equity and venture capital funds receive equity stakes in the business and partner with management teams to support growth plans and make improvements to the business with the aim of increasing its value. This value is realised through a sale (or exit) of the business, at which point the fund makes a return on its investment.

Principal types of private equity and venture capital investment

Private equity and venture capital can be split into a number of different types:

- **Venture capital** refers to equity investments in earlier-stage, younger companies that need funding and support to get an idea off the ground, develop a business model or launch into the market. Venture capital funds provide capital and hands-on support to companies often in a series of “rounds” or chunks of funding as pre-agreed milestones are met. Venture capital investors usually take minority stakes in the businesses they back.

  The high level of involvement venture capital investors have with portfolio companies means that most funds tend to target local markets, including some of the entrepreneurial hubs across Europe such as Berlin, Stockholm and London, although there are regional and global players.

- **Private equity** incorporates venture capital but the term is usually used to refer to investments in more mature – usually profitable – companies with the potential for growth. That is how we will use the term ‘private equity’ in this guide.

  Private equity funds provide funding to fuel that growth, together with expertise and support to improve company performance and to identify and pursue the correct strategy.

  Private equity funds often organise deals as buyouts – that is, partnering with the management team, taking a majority stake and providing capital to buy the business from, for example, a corporate, another private equity house, the public markets or a family owner. At the larger end of the deal spectrum are the global buyout firms, many of which now manage funds in other asset classes, such as real estate and infrastructure. Mid-market funds target equity investments up to around €150m (although the transaction size will often be larger as a result of leverage and co-investment) and their focus is usually country-specific or regional (i.e. pan-European). Further down the deal size range, there are smaller, more location-specific buyout funds that may invest in companies in local regions, for example the North of England or Northern Italy. In addition, there are specialist buyout funds that invest in particular sectors, e.g. financial services or healthcare.

**Funds of funds** are investment vehicles that pool investor capital to invest across a range of funds according to a pre-agreed strategy. While many are generalist in nature, some, for example, specialise in venture capital, others may provide access to a range of mid-market funds, and others invest in a particular geographic region, such as Asia.

**Secondaries funds** invest in private equity and venture capital funds that are part-way through their fund lives, most usually buying a position in a fund from an institutional investor that requires liquidity or is fine-tuning its private equity and venture capital exposure.
What are private equity and venture capital?

Continued

Invest Europe
Pension Fund Guide to Private Equity & Venture Capital

What are known as the limited partnership agreement. Investments on behalf of the fund and in accordance with
as limited partners (LPs) and the fund manager, or general
and organised as limited partnerships that pool together
offices as well as high net worth individuals. They raise
companies, endowments, sovereign wealth funds and family
institutional investors, such as pension funds, insurance

How private equity and venture capital manager raise funds

Private equity and venture capital firms raise capital from institutional investors, such as pension funds, insurance
companies, endowments, sovereign wealth funds and family
offices as well as high net worth individuals. They raise
this capital through funds, which are usually closed-ended
(meaning they have a fixed life—generally around 10 years)
and organised as limited partnerships that pool together
the investors’ capital. Investors in these funds are known
as limited partners (LPs) and the fund manager, or general
partner (GP), is responsible for sourcing, making and exiting
investments on behalf of the fund and in accordance with
a legal document negotiated at the point of fundraising,
known as the limited partnership agreement.

Other types of private equity

More recent times have seen the development of other sub-types of private equity. These include special situations, which are triggered by specific
circumstances within the company that mean it requires investment and support, and private
debt funds, which have grown in response to the
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Why invest in private equity and venture capital?

Over the years, private equity and venture capital have become an ever-growing feature of institutional investors’ allocation mix, pension funds included. In a 2014 Greenwich Associates report on European pension fund investment programmes and attitudes to the asset class, 62% of pension funds had built a private equity/venture capital programme, with a further 33% starting out on this process. Pension funds now account for the greatest proportion of capital raised by private equity and venture capital funds in Europe – over the last three years, they have provided a third of the total raised, Invest Europe data shows.

Performance
The most powerful rationale for pension funds to invest in private equity is its ability to provide good returns on an absolute and relative basis. Over the long term, private equity has consistently provided higher returns to investors than comparable public companies. For example, UK-based private equity funds (many of which invest on a pan-European basis) achieved annual net-of-fees returns of 14.9% over ten years to 2014, around double that of total pension fund assets and the FTSE All-Share index, according to BVCA figures.

The ten-year performance figures provide the most useful guide for potential private equity returns. This is because most funds will invest and then realise their portfolio of investments over a ten-year period. However, even over five or three years, private equity outperforms other investment types, as the chart shows.

Long-term trend in fundraising and contribution by type of LP

Summary of UK Private Equity Performance versus Principal Comparators

Note: The comparisons are for indicative purposes only. The performance of private equity funds is measured by IRR to investors, net of costs and fees. Returns from the WM Pension Fund Universe and the FTSE All-Share are gross time-weighted returns.

1. Source: Greenwich Associates
2. Source: BVCA
Our investors look at private equity as an alpha strategy – they largely invest for returns in excess of public equities. However, one of private equity’s other benefits is that it provides a different value creation model from that of public equity markets because of the alignment of interest between funds and portfolio companies. Private equity managers can promote business management and development with the long term in mind – very different from the public markets, where analysts’ quarterly expectations tend to drive many decisions.

Iain Leigh, Managing Director, Global Private Equity, APG Asset Management

These ten-year figures include performance over more challenging, post-crisis years that were characterised by low or negative economic growth. This shows how private equity firms are able to select companies with high potential and build them into stronger, more valuable businesses even in difficult times. The potential for strong absolute returns in what has been a persistently low interest rate (and therefore low yield) environment since the financial crisis has been a key attraction for many investors in the asset class.

Indeed, in the Greenwich Associates report, returns were the most commonly-cited advantage of private equity investment.

Return expectations relative to public equity

Return expectations relative to public equity

Number of institutional investors

Pension funds already investing in the asset class clearly believe it has the potential to outperform public equities in the future, the Greenwich Associates report found, with the largest proportion expecting returns of between 3% and 6% over public markets.

Long-term horizons

The long-term nature of private equity and venture capital investment also provides a good match for the long-term liability profile of a pension fund. With returns generated over a ten-year stretch (sometimes longer) exposure to private equity and venture capital can help pension funds with liability matching alongside more liquid investments, while also providing a premium for illiquidity.

Diversification

Private equity and venture capital can provide diversification benefits to pension funds. They offer investors access to private companies that are otherwise hard to gain exposure to via other asset classes. The companies are often smaller, fast-growing businesses: for example, between 2007 and 2015, private equity and venture capital firms invested almost €400bn in 31,000 companies located in Europe. Of these, 83% were small and medium-sized businesses. Through their understanding and knowledge of the markets in which they operate, private equity and venture capital firms source investments that are under the radar of other types of fund manager.
The long-term and active style of ownership characterized by private equity and venture capital investment enables firms to support companies through funding, innovation and performance improvements. In turn, this can have a positive effect on the economy through job creation and improvements to productivity.

Private equity and venture capital firms provide more than capital; they take an active role in developing portfolio companies by partnering with entrepreneurs and management teams. Executives from the fund manager will generally take board seats to help identify and execute the right strategy. Their experience of investing in businesses in similar industries and in companies of a similar scale means they can support management in its decision-making through good and bad times as well as exercise a degree of control or influence over the future direction, performance and growth path of the company.

It’s partly this characteristic of private equity and venture capital that enables fund managers to outperform the wider market: they focus on microeconomic factors as much as the broader macroeconomic picture to build stronger, more sustainable businesses.

Alignment of incentives

In addition, private equity and venture capital are a concentrated form of ownership, where management as well as fund managers have a meaningful stake in the business that can only be realised at exit. This is a model that suits rapidly growing companies as it fosters fast and efficient decision-making as well as shared responsibility and incentives for making the business successful over the long term. It is therefore very different from the highly dispersed, passive shareholder base found in public companies.

Private equity and venture capital firms provide an all-time high of €41bn in 2015, according to Invest Europe figures. However, in the following years, fund exits reduced markedly as company sales were a concentrated form of ownership, according to Invest Europe figures.

The long-term investment horizons of private equity and venture capital, which tend to span economic cycles, mean that fund managers can ride out downturns, realising the value of portfolio companies at times that will generate the best results for investors. If we take the post-crisis period as an example, private equity and venture capital fund exits reduced markedly as company sales became harder to achieve and valuations fell the value of European exits by amount at cost dropped to €32bn in 2009, from €38bn in 2006, according to Invest Europe data. However, in the following years, firms were able to continue working with portfolio companies to improve their performance and make them more valuable so that when exit conditions improved, they would be attractive assets for buyers.

By 2015, Invest Europe data shows that the value of exits at cost had reached an all-time high in Europe, of over €41bn.

Active investment style

The hands-on approach to company investing that private equity and venture capital fund managers take is unlike many other asset classes. Private equity and venture capital firms provide more than capital; they take an active role in developing portfolio companies by partnering with entrepreneurs and management teams. Executive from the fund manager will generally take board seats to help identify and execute the right strategy. Their experience of investing in businesses in similar industries and in companies of a similar scale means they can support management in its decision-making through good and bad times as well as exercise a degree of control or influence over the future direction, performance and growth path of the company.

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There is also an alignment of incentives between fund managers and their investors. Private equity and venture capital fund managers are rewarded through carried interest, that is paid out only once exits have been achieved. Added to this is the fact that individual fund managers contribute a proportion of their own capital to each fund – the GP commitment – ensuring that they also have “skin in the game”, or a very personal incentive to make investments successful.

Responsible investing

Responsible and ethical behaviour is central to ensuring trust between private equity and venture capital firms and their portfolio companies and investors. Invest Europe members are required, as a condition of membership, to follow a rigorous code of conduct and are encouraged to adhere to a comprehensive set of professional standards. These are enshrined in Invest Europe’s Handbook of Professional Standards, which is updated on a regular basis and provides clear principles of governance, transparency and accountability. The latest edition, published in 2015, includes substantially updated guidelines for reporting by private equity and venture capital firms to their investors, with an emphasis on clear and detailed disclosure on fees. The new guidelines take into account advances in accounting standards and provide a framework for non-financial disclosure in areas such as environmental, social and governance (ESG).

Indeed, ESG considerations have become an increasingly important part of investment and portfolio company management decisions in private equity and venture capital over the last few years. There are now over 150 private equity signatories to the Principles for Responsible Investment (PRI), an initiative that obliges firms to report annually on their responsible investment practices. Many private equity and venture capital firms have implemented ESG guidelines at a fund level and there is now an increasing focus on implementing them at a portfolio company level in recognition of the fact that responsible investment can help manage risk, bring financial rewards through cost reduction as well as create new opportunities in addition to environmental, social and governance benefits.

Private equity and venture capital’s diversifying characteristics are appreciated by many existing pension fund investors.

“it is a good diversifier.”

UK-based corporate pension fund manager.

“It gives diversification compared to the stock market and a good return horizon in the long term.”

A Swedish public pension fund executive.

Our main objective is to realise a long-term return needed to achieve our long-term pension ambition and private equity fits well into this strategy as it provides the level of returns we need at an acceptable risk. And, while returns are the main driver, we also see a number of other benefits. One is that it gives us access to skills that you don’t have in other asset classes – private equity’s active investment style means that you are investing in people who transform businesses to drive returns. Yet private equity also gives us exposure to different parts of the market that are otherwise hard to reach – smaller, private businesses. It has a long-term perspective, which enables management to focus on long-term objectives. This comes with a better risk-return trade-off than in listed markets, where the focus on quarterly figures leads to more volatility in our returns profile.”

Hans de Ruiter, Stichting Pensioenfonds TNO.

Invest Europe 2015 data shows that the value of exits at cost had reached an all-time high in Europe in 2015.

150 private equity signatories to the Principles for Responsible Investment (PRI).

Invest Europe 2015 data shows that the value of exits at cost had reached an all-time high in Europe in 2015.

€41bn
How to invest in private equity and venture capital

As the private equity and venture capital industry has grown and matured, so a variety of access points for investors has emerged, from investing in primary funds and funds of funds, through to secondary fund opportunities, co-investments and, in some cases, direct investments in private companies. The most appropriate route for individual investors will clearly depend on what it is seeking to achieve through the investment, but also the extent to which the investor knows and understands the markets. Investors also need to consider the resources it has to deploy on the programme: all types of private equity and venture capital investment require significant analysis, time and ongoing monitoring.

Private equity in itself is not that complicated – firms buy companies, improve them and then sell them for a return. The difficult parts for boards and trustees to understand are performance measurement, the effect of fees on returns and manager selection. It is quite unlike other asset classes and so boards and trustees need to spend a lot of time getting familiar with private equity. Typically, it needs the involvement of experienced people who can evaluate and monitor investments correctly.

Iain Leigh, Managing Director, Global Private Equity, APG Asset Management

Points of access

1.

Private equity and venture capital fund investing

One of the principal ways of accessing the market is via primary private equity and venture capital funds. These are usually structured as 10-year limited partnerships and are raised every three to four years by fund managers (known as general partners or GPs) from institutional investors, funds of funds (see below) and, in some cases, high net worth individuals. They invest directly in companies according to a strategy stated at the time of fundraising, but typically these funds target companies with high growth potential and/or with significant potential for performance improvement.

Investors will need to consider the different fund strategies when deciding how to invest their allocation. While private equity and venture capital investments are similar in the respect that they both involve equity investments into private companies, they do have distinct characteristics, largely because they involve companies at differing ends of the maturity spectrum.

Venture capital refers to investments in private companies at the earlier stages of their development that have the potential for rapid growth.

Seed capital: Venture capitalists (VCs) can provide funding and support to entrepreneurs at a very early stage of the business to get an idea off the ground or to develop a business plan, for example, and this is known as seed capital.

Early-stage capital: Once a business is ready to launch, VCs can offer early-stage capital and expertise to take the product or service to market and build momentum.

Later-stage venture capital (or expansion capital): VCs also invest in companies that have started to generate revenues but need further capital to expand and reach profitability.

Venture capitalists usually take minority stakes in a business and often provide further rounds of capital as the business develops. Investment in earlier stage companies clearly involves higher risk than that in more mature businesses, as concepts, demand and markets may not yet be proven, for example. VCs therefore seek to mitigate this risk by building large portfolios of company investments in each fund (often between 20 and 30). While some investments in the portfolio inevitably fail, the returns that can be generated from successful investments can be very high.

Private equity involves investments in more mature, usually profitable, businesses that are looking for capital and expertise to reach the next stage of their development – such as launching new products or expansion into new geographies.
How to invest in private equity and venture capital continued

Investing directly into private funds can offer LPs the opportunity to build relationships with GPs, tailor their programmes according to specific needs and keep a close eye on fund performance in a timely manner. However, this route is suitable only if investors are prepared to build out experienced in-house teams that have the requisite knowledge to identify opportunities, assess fund managers’ track records and team skills to make the right investment choices. Once the commitment is made, primary fund investment also requires dedicated resources to ensure ongoing monitoring to performance. It’s worth bearing in mind that many funds will have a minimum investment threshold. Achieving an adequately diversified portfolio via fund investing is therefore a challenge for those with only limited amounts of capital to deploy.

The fundraising process

When fundraising, private equity and venture capital funds aim to attract a target amount of capital from investors that is based on the GPs’ view of potential deal flow, valuation trends, their ability to build up an adequately diversified portfolio (by number of investments as well as type) and the resources they can deploy to follow their stated strategy. Given that raising a fund can take well over a year, firms announce a series of “closings” during the process to enable them to continue investing from the fund while it is being raised. So, for example, once the firm has attracted enough capital to make one or two investments, it may announce a first close. The fund may have one or more further interim closings until it reaches final close, after which new commitments are no longer accepted.

For their part, limited partner investors agree to invest a set amount of capital in the fund (known as a commitment) to finance the deals made by the fund manager. This is a long-term commitment that spans the fund’s life.

These funds are blind pools of capital that are invested over a period of around five years (known as the investment period), meaning that LPs do not know at the point of commitment which companies will form the portfolio. And, unlike most other forms of investment, LPs do not invest all their committed capital into a fund from the start of the fund’s life. Instead, GPs request (or draw down) capital from LPs when they make investments in portfolio companies.

A similar, staggered approach is taken to distributing returns to LPs as and when investments are realised (usually during the last five or so years of the fund’s life – the investment period). The capital invested, plus any gains from the investment, are returned to the fund and then distributed to the fund’s LPs minus agreed performance fees (see chapter 5 for more detailed information on fees).

2. Funds of funds

Funds of funds can be a useful way for investors to gain a diversified exposure to the asset class, particularly for those with limited capital to invest. This type of investment involves committing to a pool of limited partnership fund (as above) that then invests the capital across a range of private equity and/or venture capital funds.

Funds of funds are an established part of the private equity and venture capital market, with many having established track records that span well over a decade. In 2015, they were the second largest source of private equity and venture capital funding (behind pension funds) in Europe, accounting for 18% of the €47.6bn raised, according to Invest Europe data.

As the private equity and venture capital market has matured, so funds of funds have evolved over time. Some large funds of funds have global strategies, targeting funds across the world, others provide regional exposure (such as Europe, Asia, North America), while others may specialise in a particular sector or segment of private equity or venture capital (i.e., mid-market buyouts or clean tech funds). Many also offer investors the opportunity to invest in secondary opportunities or co-investments (see page 15). Some also now offer segregated, rather than pooled, accounts that enable investors to achieve a tailored private equity and venture capital programme.

There are two main types of service offered by funds of funds: discretionary and non-discretionary. In a discretionary mandate, the fund of funds has the total authority to manage the capital committed by investors in line with the agreed strategy. In non-discretionary mandates, the investor makes the investment itself, based on the advice and information received from the fund of funds.

For newer and inexperienced investors, this route can offer an opportunity to learn how private equity and venture capital funds operate and help them understand some of the processes involved in investing in the asset class. It does entail an additional layer of fees, but investors need to balance this with the fact that it requires fewer in-house resources than the direct, primary fund investing option, as funds of funds can undertake the detailed identification, due diligence and monitoring processes necessary for successful investment – this is a kind of outsourced model of investing.

3. Secondaries fund investing

Secondaries funds are a sub-type of private equity funds of funds that specialise in purchasing the interests of limited partners in funds that are part-way through their fund life. Once a niche area of the industry, this type of investment has increased in popularity among investors and there are more portfolios of fund investments and single fund interests available as LP programmes have matured. In 2014, 26 secondaries funds raised a total of US$52.7bn worldwide, according to Preqin figures, up from 22 funds raising US$9.9bn in 2011.

Secondaries investments are offered by specialist fund managers and by funds of funds that either raise vehicles specifically for secondary investing or that invest the capital of the fund raised for a fund of funds vehicle into secondary opportunities.

As the market has developed, secondary funds have evolved to offer investors access to different types of opportunity, such as early secondaries (where the funds purchased are in the earlier stage of their 10-year life and may still be making new investments), late secondaries (where the funds purchased have completed their investment stage and are in the process of exiting investments), a mixture of the two, or even secondaries based in specific regions. Sellers in the secondaries market may be doing so for a variety of reasons, including a need for liquidity, a change of strategy or, as is increasingly the case, a desire to reduce the number of GP relationships they have as their private equity and venture capital programmes become increasingly mature and complex to manage.

Some secondaries funds also buy tail-end portfolios of company investments directly from the GP – these are investments still to be exited after a fund has reached the end of its 10-year life. The general partner may decide to sell these assets to return capital to its investors in a timely manner and to concentrate on investments in newer funds.
How to invest in private equity and venture capital continued

Co-investments and direct investments

Co-investments involve LPs in a fund making an investment directly into a portfolio company alongside the GP. This type of investment has become increasingly popular over recent years – around half of investors in private equity funds pursue co-investment opportunities, according to 2015 Preqin figures. Most do so as a way of boosting returns as investors usually pay a lower fee to the fund manager for such opportunities, although this type of investment requires investors to meet tight deadlines and can be higher risk. Some funds of funds now also offer access to co-investments either through their main vehicles or through dedicated co-investment funds.

The practical aspects of investing

How a pension fund constructs its private equity and venture capital investment portfolio clearly depends on its overall rationale for investing. Investors have target allocations usually expressed as a percentage of overall allocation to the asset class for each type of private equity and venture capital investment to which they are seeking exposure, by geographic region and sub-type of investment (i.e., secondaries, funds of funds, buyouts, venture capital), and they review these targets at regular intervals according to external and internal factors.

There are certain points to bear in mind when considering how to access the market and what type of investment to make.

Diversification

Private equity and venture capital investments can provide diversification in an investor’s overall portfolio mix. However, it’s also important to ensure that the private equity/venture capital exposure itself is diversified to avoid concentration of risk. There are a number of ways in which investors can achieve diversification:

- Fund strategy. There is little correlation between different stages of private equity and so it is possible to diversify risk through investments in early and/or late-stage venture, small and mid-market buyouts and large buyouts. In addition, sub-categories of the asset class, such as secondaries funds, distressed funds or private debt funds, can provide further diversification.

- Geography. Investors can gain geographic diversification by investing in global funds, pan-regional funds (such as pan-European), regional funds (such as Southern European) or country-specific funds.

- Vintage year. Funds raised at different points in the economic cycle are able to invest in different types of opportunity and therefore the timing of funds can have an impact on performance. Given the difficulty of timing the market, experienced investors in private equity and venture capital funds usually invest consistently through all vintage years, rather than dipping in and out of the market.

- Industry. While there are some generalist funds, most private equity and venture capital investors target a range of specific sectors or sub-sectors where they have some experience of investing. There are also some funds that specialise in particular industries, such as financial services or cleantech.

- Manager. Investors need an adequate spread of investments by fund manager to reduce risk and ensure adequate diversification of the factors mentioned above.

Case study

We run a model to determine and inform decisions on our allocation to private equity – and the starting point for this is that we need to meet our return expectations. The model has many inputs, including the current shape of our portfolio in terms of assets and performance outcomes. However, this is only a guide and we frequently over-ride this model based on the current market conditions and manager availability in a given vintage year – this allows us to increase or decrease our allocation accordingly.

In terms of allocating within private equity, we look at which managers will be coming to market in which years and combine this with our top-down analysis of deal activity and volume on the different private equity segments. The bottom-up analysis (of which managers we would like to commit to) always overrides the top-down as the availability of managers is the main driver. So, if there were more attractive mid-market European managers coming out to the market, for example, this may skew our investments in one year towards Europe. Yet, despite these swings, over time, the portfolio tends to even out.

We select managers based on analysis of a number of different factors, but the top items for us are the manager’s strategy, team consistency, composition and appropriateness for the strategy, a track record of value creation, fairness of economic terms, disclosure and transparency and finally, a strong culture in areas such as ESG.*

Iain Leigh, Managing Director, Global Private Equity, APG Asset Management

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* ESG stands for Environmental, Social, and Governance.
Manager selection and due diligence

Selecting the right managers to invest with is one of the most important aspects of private equity and venture capital investing. This is because there is a very wide dispersion of returns between the top and bottom performers. It is also among the most challenging aspects of investing in the asset class, given that there are now over 7,000 private equity and venture capital funds in existence globally.

This means that the top-down approach of setting target allocations for specific geographic and investment style exposure in a portfolio should generally also be complemented by a bottom-up analysis of funds in the market that takes account of when managers are likely to be raising their next fund.

To assess the potential of fund managers, investors need to seek out and analyse information on past performance (track record), how that performance has been generated (i.e., the strategy employed), the skills and experience of the key members of the fund management team, how the firm originates (or sources) deals, how the team works with portfolio company management (i.e., how it adds value) and the source of exits it has achieved. Investors should also ensure they are satisfied with the quality of information and reporting provided as they will rely on this for ongoing monitoring of a fund investment.

While much of this information may be contained in a private placement memorandum (PPM – a document that is put together by the firm raising capital) and in supplementary information provided by the firm, investors will need to cast the net wider to make a more informed decision. Due diligence processes often include on-site visits to the firm and even some of its portfolio companies by potential investors. In the final stage of due diligence, investors also commonly make reference calls to people who regularly deal with the fund manager, such as portfolio company CEOs, intermediaries (e.g., banks and auditors), competitors or other limited partners.

Information sources

Getting up to speed with private equity and venture capital and keeping up to date with developments may seem like a challenging task. However, there are a number of different sources of information that pension funds can turn to.

Greenwich Associates’ research into pension funds’ perceptions of private equity found that consultants/advisors and colleagues/peers were some of the most commonly used sources of information. Many firms use placement agents to help them raise funds and these can provide a window on some of the funds that are currently raising capital and/or help with understanding when a firm might be looking to raise a new fund.

Investment managers themselves are also a good source, as are industry publications and industry associations, many of which provide activity and performance information as well as hold events intended to keep market participants informed of hot topics and to provide an opportunity to network.

Private equity and debt – the facts

In the majority of cases, buyouts involve the use of debt (leverage) to part-fund the deal, alongside the equity investment made by a private equity firm. The proportion of debt to equity in these deals varies according to the portfolio company’s ability to service the debt and can range considerably depending on the size and complexity of a given investment.

High levels of debt can improve financial discipline in companies, although they can also increase the risk of defaulting on loans, leading some to question whether private equity adds unsustainable amounts of debt to portfolio companies. However, a number of academic studies have suggested that private equity-backed companies have a lower default rate than other, comparable businesses. A 2009 study by Kaplan and Stromberg found, for example, that the default rate in private equity-backed portfolio companies was 25% lower than that of public companies on average.

In addition, some have questioned whether private equity’s performance is driven by the use of leverage. While it’s true that debt can enhance returns – hence a major reason for its use – private equity firms’ operational and strategic improvements to companies are the main source of outperformance. An EY analysis of European private equity exits found that, for those completed from 2005 to 2013, the use of leverage and increases in benchmark company valuations each accounted for under a third of private equity returns, while improvements delivered by private equity ownership drive well over a third of private equity returns.

Sources of returns in private equity 2005-2013

1. Source: Invest Europe
How to measure performance

The unique characteristics and cash flow volatility of private equity and venture capital can make measuring performance in the asset class something of a challenge for investors. The asset class is quite unlike others, such as public equities and bonds, in that it is a long-term investment in which full value is usually realised when a portfolio company is sold.

We measure performance using a variety of metrics, including IRR, TVPI and DPI. However, given our primary objective of outperforming public markets, we place the most emphasis on PME.

Iain Leigh, Managing Director, Global Private Equity, APG Asset Management

The true performance of a fund can only be judged at the end of its life when all investments are liquidated. However, when analysing and monitoring the performance record of a fund manager, investors also need to understand how more recent investments are faring. Private equity and venture capital fund managers produce regular (usually quarterly) reports, which include interim valuations that are often arrived at according to the International Private Equity and Venture Capital (IPEV) Valuation Guidelines on a fair value basis. However, given the fact that there is no ready market for the assets being valued, these valuations are inherently subject to an element of judgment. Some firms now use independent valuation specialists when putting together their reports and regulated funds are required to have their valuations independently verified.

A further complication is that the benchmarks used to measure private equity and venture capital performance are necessarily different from those used in more traditional asset classes to take account of illiquidity and the irregular nature of drawdowns and distributions. There is therefore no publicly available benchmark and investors must construct their own tailor-made models.
Performance metrics

Multiples. This is a straightforward measure of absolute gain that values an investment as a multiple of original cost. Multiples are calculated by dividing the value of the gain by the amount invested.

Internal rate of return (IRR). This is a more complex calculation that takes account of the time value of money invested and allows comparisons between investments of different sizes and differently timed cash flows. It uses the cash flows in the investment, together with the gain achieved through sale or from dividend income (or change in interim valuation where cash has not yet been returned) and expresses the average annual return as a percentage of investment.

The two measures combined offer the best illustration of performance for investors. For example, a high multiple generated over a long period of time can result in a lower IRR than a lower multiple generated over a shorter period. Therefore, if a fund makes significant gains early on in a fund’s life, there will be a material impact on the final IRR even if the multiple achieved is less impressive. This is why it’s worth analysing both metrics in tandem.

Benchmarking

While multiples and IRRs can provide a suitable measure of comparison between the performance of managers (provided investors are comparing like with like — funds with the same vintage year, following similar strategies, for example), other tools need to be employed when benchmarking against other asset classes.

Public market equivalent. While a number of benchmarking tools have been developed, public market equivalent (PME) is one of the most commonly used as it provides a like-for-like comparison between private equity (either individual fund or group of funds) and public market returns. This applies the cash flows of the private equity investment(s) to a hypothetical vehicle, which buys and sells shares in the chosen public market index (such as S&P 500 or FTSE All-Share).

Private equity needs to be assessed over the long term. We tend to measure private equity against public markets, plus an illiquidity premium of 3%. While in the short term, private equity doesn’t always achieve this when public markets are performing well, over the long term our private equity portfolio has delivered an outperformance compared with our benchmark.

Yolande van den Dungen, SPF Beheer

The Greenwich Associates study on pension fund attitudes to private equity found that investors tend to use a combination of benchmarking tools to arrive at their investment decisions in the asset class, including absolute returns, benchmarking against public markets and/or a private index, plus peer group benchmarking.
Fees charged to investors

Broadly speaking, there are two types of fee charged to investors by private equity and venture capital funds: those that cover the day-to-day running of the fund (known as management fees) and carried interest or carry.

Management fees

Management fees are usually charged as an annual percentage of an investor’s committed capital during the investment period (generally the first four to six years of a fund). These fees are charged to cover the cost of running the fund and their scale (most often between 1% and 2.5%) depends on the size of the fund and the resources required to implement the fund’s strategy. For example, venture capital funds usually charge in the region of 2% to 2.5% as early-stage investing usually requires significant resources, while buyout funds will typically charge between 1.5% and 2%. The fee levied by funds of funds is usually in the region of 0.5% and 1%, with the amount falling as commitment size increases. The fee levels scale back over time as funds reach maturity.

Carried interest

Carried interest (or carry) is a basic element in private equity fund structures. The detailed terms of a particular fund’s carried interest structure are agreed by the investors and fund managers and set out in the fund’s constitution document. Carry is central to the principle of alignment of interest between LPs and GPs and is the key incentive for fund managers to create long-term value in the portfolio companies they back. Carried interest is a fixed percentage of the fund’s gains (generally 20%). In Europe, it is common practice for carried interest payments to be paid out on a whole fund basis, i.e., only once LPs have received back their entire commitment and a preferred return has been reached. A preferred return is the return rate that a fund must exceed before carried interest payments are made to fund managers. This is typically set at around the 8% mark, although some venture capital funds have a lower rate or none at all. Taken together, the management fee and carried interest charges tend to be higher than those levied in many other asset classes. However, investors should bear in mind that private equity and venture capital are hands-on, active investment styles that require significant and skilled resources to execute well. It takes time to source investments in areas of the market that are often inefficient and subject to limited availability of information, to grow companies and implement performance and operational improvements and then to find suitable buyers for an investment. In addition, the resulting returns should more than make up for the fees levied.

Portfolio company fees

Private equity firms also levy transaction and monitoring fees, which are intended to cover the costs of completing transactions and ongoing portfolio management (including sitting on company boards). Practice varies according to private equity fund manager; however, these fees are increasingly being offset against management fees either wholly or in part.
What are the **risks** and how are they **managed**?

All investment types involve some element of risk and private equity and venture capital are no exception. However, the risk profile of the asset class has a number of unique characteristics that investors should consider fully and understand how to manage before establishing an investment programme.

**Illicitness and irregular cash flows**

Investing in private equity and venture capital requires investors to invest a pre-agreed amount of capital (or commitment) over the fund’s life. As noted in previous chapters, it takes time for investments to be sourced, improvements to the company made and exits to be achieved. This makes it an illiquid investment that requires capital to be tied up for a long period of time: investors need to view investments in this asset class as long-term.

However, investors do not need to provide the entire amount of capital committed up front. Instead, capital is drawn down as fund managers make investments and limited partners need to ensure they have sufficient liquidity to meet drawdown requests. They can enhance their overall return by investing the capital not yet requested (or uncalled capital) in easily accessible money market instruments.

Investors should also expect low or negative returns in the early years of a fund’s life: this is because of the time required to source and make investments and then for company improvements to be made. In addition, the fund’s establishment costs, management fees and running expenses need to be covered. Returns start to be generated and distributed in the later stages of the fund life as portfolio companies mature and exits occur.

When plotted against time to show LPs’ net cash flows, this pattern of drawdowns and distributions normally results in a J-curve effect (see chart below). As distributions usually start before the whole commitment has been drawn, it is unusual for an LP ever to have the full amount of its commitment under investment by the manager. Strategies to mitigate or accelerate the J-curve effect include investing some capital via secondaries funds, committing capital to debt-related private equity funds, or over-commitment i.e., committing more capital to a fund in the expectation that distributions will start to flow before the full committed amount is due. All three strategies introduce different risk and return characteristics.
What are the risks and how are they managed?

Manager selection

Choosing high-quality fund managers is one of the most important factors in the success of a private equity and venture capital programme. The hands-on nature of the asset class means that the extent of the skills and experience of the fund manager can make a substantial difference to the returns generated – there is a high dispersion or difference between the top and bottom quartile funds by performance.

There have been numerous studies that have suggested that there is a persistence of returns in private equity and venture capital, i.e., that the top performing managers continue to outperform their peers over the long term. Nevertheless, some more recent academic research points to a weakening of this persistence following the financial crisis as firms have had to adapt to a new investment and economic environment.

This last point underscores the importance of investors conducting thorough due diligence on fund managers before committing capital. This should examine not just past fund performance numbers, but also dig deeper into individuals’ track records and experience as well as looking at how a firm has generated its returns in the past and how it intends to do so in the future.

This is a detailed undertaking that requires the involvement of consultants or gatekeepers.

Control over investment choices

LPs delegate responsibility for deal sourcing, investing, managing portfolios and exiting investments to the private equity and venture capital fund manager; LPs have a passive role in this regard in the limited partnership arrangement. As such, they do not exercise any control over individual investments made and make a commitment to a blind pool (i.e. they do not know at the outset which specific investments will be made over the life of the fund).

However, the investment strategy to be employed by the fund manager is pre-agreed at the point of fundraising and is set out in the limited partnership agreement (LPA), which offers investors in the fund protection against off-strategy investments. In addition, the LPA should also include limits on the amount (usually as a percentage of the fund total) that can be invested in each portfolio company to avoid concentration risk.

Company risk

Fund managers undertake rigorous due diligence before investing to ensure they understand the risks each portfolio company faces and to identify areas for improvement and growth. This helps mitigate the risk of loss of capital, although it does not completely remove it and there remains a risk that a portfolio company does not perform to plan. However, the active involvement of fund managers post-investment, including taking board seats, should lower the risk of this happening. In addition, the portfolio approach taken by private equity and venture capital fund managers helps to diversify risk across a number of investments, from 10 to 15 typically in a buyout portfolio to up to 30 in venture capital fund portfolios.

There is a very high dispersion in returns between the best and worst performing managers in private equity. To be successful, investors in funds need to remain systematic and disciplined in manager selection and focused on why they are investing in the first place. They also need to invest adequate time and resources to building up the right expertise either in-house or using expert third-parties.

Katja Salovaara, Ilmarinen Mutual Pension Insurance Company

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Private equity and venture capital funds have long followed professional standards guidelines, with membership of associations such as Invest Europe dependent on following best practices in relation to conduct, reporting and valuation, fund governance and corporate governance. In addition, the industry has historically been regulated in European countries, such as the UK. However, the financial crisis set in train the introduction of new rules and regulations for the financial services industry and these have brought many funds in the asset class under a new regulatory framework.

Further regulatory developments will occur in the UK for fund managers based there as the legal framework changes following the UK’s decision to leave the European Union. The following paragraphs relate to established European Union regulation.

**AIFMD**

For private equity fund managers, the most far-reaching regulatory change has been the Alternative Investment Fund Managers Directive (AIFMD), which sets out an EU-wide standardised framework for managing and marketing alternative investment funds.

In general terms, the Directive applies to private equity and venture capital fund managers that are established in the EU and that operate closed-ended, unleveraged funds in the EU with aggregate assets worth €500 million or more. A threshold of €100m applied to managers of leveraged funds. Under the Directive, authorised firms must comply with a set of requirements, meet disclosure and valuation standards and report regularly to national regulators on their activity and exposure levels to different types of investment. The Directive also imposes new limits on the amount of leverage that can be used at a fund level. In addition, authorised firms are required to hold certain minimum amounts of capital and appoint a depositary to monitor fund cash flows, manage custody assets and verify valuations.

The AIFMD allows fund managers to market their funds to potential investors across the EU through a single passport, removing the need to gain authorisation from the regulatory authority in each member state in which the fund wishes to raise funds. This is clearly beneficial to fund managers and should help to reduce the costs and administrative burden associated with raising funds in multiple European markets, although the extent to which this is the case depends on how the directive is implemented in individual member states.

**EuVECA**

The European Venture Capital Fund Regulation (EuVECA) is a voluntary regime that provides venture capital funds with the benefits of a single EU-wide marketing passport yet with lighter-touch regulatory requirements than those mandated by the AIFMD. The regime was devised in recognition of the importance of venture capital to investment in Europe, in particular to Europe’s innovative, high-growth companies and small and medium-sized enterprises. Fund managers established in the EU managing portfolios of qualifying venture capital funds with assets that do not exceed €500m can apply for authorisation. Those not wishing to seek authorisation remain subject to existing regulations at a national and EU level.

**Investor regulation**

Institutional investors themselves are, of course, subject to their own regulatory frameworks and this needs to be taken into consideration when deciding to invest in private equity and/or venture capital. For example, new rules on capital adequacy under Solvency II require that European insurance company investors must hold more capital if they invest in illiquid asset classes such as private equity and venture capital. European pension fund investors also need to keep in mind any restrictions on illiquid or long-term investments that stem from the new IORP Directive.
Buyout (or management buyout). A type of private equity investment in which a fund provides capital to a company, typically acquiring a majority stake in the business. Private equity funds usually team with existing management to buy the business, although occasionally funds will source their own management team to acquire the company (known as a buy-in).

Carried interest. A share of the gains of the fund which accrue to the general partner/fund manager. The calculation of carried interest is set out in the fund formation documents.

Co-investment. This is a co-investment by an LP in a portfolio company alongside a fund, where the LP is an investor in such fund.

Commitment. This is an LP’s contractual commitment to provide capital to a fund up to the amount subscribed by the LP and recorded in the fund documents. This is periodically drawn down by the GP in order to make investments in portfolio companies and to cover the fees and expenses of the fund.

Distribution. Refers to all amounts returned by the fund to the limited partners. This can be in cash, or in shares or securities (known as distributions in specie).

Drawdown. Limited partner commitments to a fund are drawn down as required over the life of the fund, to make investments and to pay the fees and expenses and other liabilities of the fund. When LPs are required to pay part of their commitment into the fund, the GP issues a drawdown notice. Both the amount and the timing of the notice of any drawdown must be in accordance with the fund formation documents.

Exit. The realisation of an investment made by a fund. Common realisation routes include a sale of the business to another company (a trade sale), listing on a public stock exchange (often via an initial public offering) or a sale to another private equity investor.

Fund. This is the generic term used to refer to any designated pool of investment capital targeted at any stage of private equity investment from start-up to large buyout, including those held by corporate entities, limited partnerships and other investment vehicles, established with the intent to exit these investments within a certain timeframe.

Fund (formation) documents. These are the entire set of legal documents, including the Limited Partnership Agreement (LPA) or equivalent legally binding document and side letters agreed by the investors and the fund manager. Matters covered in the legal documentation include the establishment of the fund, management, and winding up of the fund and the economic terms agreed between the investors and the fund manager.

Fund of funds. A private equity fund that primarily takes equity positions in other funds.

General partner (GP). GP is the term typically used to refer to different entities and professionals within a private equity firm which source, analyse, negotiate and advise on potential transactions as well as invest and manage the fund. In short, this is the person or entity with the responsibilities and obligations for the management of the fund, as set out in the fund formation documents.

Holding period. The length of time an investment remains in a fund.

Investment period. This is the initial few years of a fund’s life, during which time it is intended that the fund will make its investments.

IRR. The internal rate of return, or IRR, is one of the calculations used to measure the return of a private equity fund. IRRs are used in private equity instead of time-weighted returns, which are more common in other asset classes. The IRR can be calculated on a net basis (net of fees, expenses and carried interest) or a gross basis (before fees, expenses and deduction of carried interest). The IRR is calculated as an annualised, compounded rate of return, using actual cash flows and annual valuations.

J-curve. This refers to the pattern of returns seen in a private equity/venture capital fund. The early years of a fund typically show a negative return as capital is invested but not yet generating a return. As the fund matures, the return moves into positive territory as portfolio company valuations increase and as exits (or sales) of companies occur.

Limited partner (LP). In a private equity/venture capital context, a limited partner is an investor in a fund, or put differently, a person or entity holding an investment interest (as distinct from a management interest) in a private equity fund.

Limited partnership. A legal structure commonly used by many private equity funds. The partnership is usually a fixed-life investment vehicle, and consists of a general partner (the fund manager which has unlimited liability) and limited partners (the LPs which have limited liability and are not involved with the day-to-day operations of the fund).

Management fees. This is the term used to refer to the fee/ profit share paid by the fund to the GP. For the GP to be able to employ and retain staff in order to invest and properly manage the fund until such time as profits are realised, it will typically receive, on a quarterly basis, an advance from LPs to cover the fund’s overhead costs. This management charge, generally funded out of LP commitments, is generally equal to a certain percentage of the committed capital of the fund during the investment period and thereafter a percentage of the cost of investments still held by the fund.

Portfolio company. A company in which a fund has made an investment.

Private equity. Private equity provides funding in equity form from funds to acquire a majority or minority stake in portfolio companies in different stages of development across a wide range of sectors.

Secondary fund. A secondary fund is a vehicle that pools investor capital to acquire the limited partnership interests of investors in funds. Additionally, secondary funds sometimes buy the assets of a fund that has reached the end of its life to free up capital for its investors.

Track record. The experience, history and past performance of a fund or its individual managers.

Venture capital. Funding typically provided in equity form to companies in the early stages of their lifecycles, i.e. seed, early-stage, development or expansion.

Vintage year. Vintage year is generally the year of the first closing of a fund, or later, the year in which management fees commence.