EVCA International Investors Conference

Conference Proceedings

Conference Proceedings

Geneva, 12-13 March 2003

20 years
1983 - 2003
PROMOTING EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL

evca
European Private Equity & Venture Capital Association

EVCA International Investors Conference

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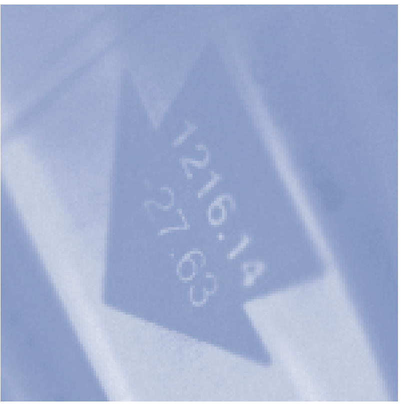

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Background

The European Private Equity and Venture Capital Association (EVCA) held its 2003 International Investors Conference in Geneva, Switzerland in mid-March. This was the fifth time that EVCA set out to organise an event specifically to bring together its members with representatives of the investor community. The Conference attracted over 650 delegates with one in three representing an institutional, or other professional, investor. The aim of this forum is to stimulate debate and to provide for an open exchange of views between existing and potential investors in the European private equity asset class and the managers of private equity funds throughout Europe.

Executive Summary

There were a number of key messages emerging from EVCA's 2003 International Investors Conference. Arguably the most important was for all those involved in private equity to remain calm during these turbulent times.

Despite the difficult climate, it emerged that the appetite for private equity by the institutional investors remains strong. The asset allocation strategies of pension funds and insurance groups might be affected by the long-term bear market in public equities - many might be considering a shift in their holdings towards bonds - but private equity continues to demonstrate a capacity to deliver a premium over the public markets in the long run.

There are grounds for cautious optimism in both fundraising and investment returns figures. Preliminary figures reveal that more than €19.4bn was raised during 2002, which compared with more than €38bn in 2001. Of the 2002 amount raised, 63% is expected to be allocated to buyouts and only 32% to venture capital. This is indicative of a trend that is to be expected after the blow out of the dot.com era as investors focus on the perceived safety of more established businesses by which to base their private equity selections.

More than €27bn was invested during the year, which was higher than the amount invested in 2001 and second only to the boom year of 2000. The major difference is that industry experts believe that 2002 will become a better vintage for investments than 2000 as a consequence of the cheaper prices that are currently being paid for assets.

Preliminary statistics indicate that IRRs since inception for European funds have fallen but at a lesser rate than might have been predicted. The headline figure: the pooled IRR for all private equity at the end of 2002 was 11.5%. Taking a long-term overview, performance is holding up well and the top quartile numbers remain very attractive when compared with public market indices.

During the course of the conference there emerged a number of key issues that are likely to set the agenda over the course of the coming year. It will be up to the industry to supply suitable arguments and debates to these issues if it is to continue building its credibility as an asset class with investors.

Key questions focused on the management of funds as businesses in their own right. Manager selection remains a fundamental question for any investor and the onus is on the funds to prove their worthiness and ability to investors over the long term. Within that, the manner in which they communicate details of their fee structures and ensure that they remain focused on building their investments as opposed to enjoying the management fees is an evergreen topic.

The topic of disclosure and transparency appears to resemble a gathering storm. Everyone can see it on the horizon and knows that it is an issue but cannot yet work through its full implications. Simply put, most investors appear satisfied with the manner in which they are provided with the information they want. But if the press and the politicians do decide to run with it as a campaigning issue, there could be ripple effects and the industry is going to have to determine the best method for dealing with external groups seeking information about the performance of certain funds.

Operational skills in terms of building and developing investee companies, but also in reference to developing the private equity businesses in their own right, is going to continue being a topic that investors do want to discuss.

Set in the context of the huge influx of capital that the industry enjoyed during 1999 and 2000, there remains a large number of funds that are going to have to try and review their structure and strategy if they are not to write off their investments. This is likely to have a negative impact on performance figures, contributing to the vagaries of this as an asset class and further re-affirming the need for strong operational managers to take the reins of the investment organisations.

For those committed to a long-term future in the industry, the conference detailed a number of governing principles by which funds should operate. For many, arguing that the industry should base all its principles in the code of law and value of a contract, to name but two points, might seem obvious but it is vital that as private equity develops as its own asset class it is seen to lead the way in how it views best practice performance.

Executive Summary

These remain difficult times for investors, whether they are focused on the public or private markets. The higher prices paid for unstructured venture businesses in recent years and the auctions that triggered large prices paid for buyouts means that there is a degree of under-performance that still has to work its way through the investment system and cycle. But for those not carrying too much baggage from the recent past and for those sitting on newly raised funds from the last two years, these are exceptionally exciting times to be investing. So long as calm heads are held, it should become a good vintage.

This spirit will separate the best and the worst businesses; the strongest performing and weak investors. This robust approach was also applied to all the events during the conference, whether they were focused on how to manage the expectations and performance demands of institutional investors or how best to manage portfolios and build up the private equity funds as businesses in their own right.

According to Javier Loizaga, Chairman of the EVCA Investor Relations Committee, “The extent to which we do learn from these times will shape our industry in the next decade, just as today’s industry was itself shaped by the difficulties of the early ‘90s and the lessons that were learned from them.” For those willing to apply the lessons of the past, the future can look bright.

Introduction

The conference was opened by Max Burger-Calderon, EVCA Chairman 2002-2003 and Executive Director of Apax Partners. The scene was then set by Javier Loizaga, Chairman of the EVCA Investor Relations Committee and an Executive Partner of Mercapital.

OPENING REMARKS

Max Burger-Calderon, *EVCA Chairman 2002-2003, Executive Director, Apax Partners.*

The world might look as if it is due for a downturn but that does not cloud the numbers at EVCA's fifth annual International Investors Conference. I would like to thank our eight sponsors: Argos Soditic, Siparex, Close Brothers Private Equity, Howden Insurance Brokers, ECI Ventures, Swiss Life Private Equity Partners, Crédit Suisse First Boston and Efront– for having sponsored this event. As you all know, this event would not be possible without them.

CHAIRMAN OF THE DAY

Javier Loizaga, *Chairman EVCA Investor Relations Committee and Executive Partner Mercapital.*

It is a privilege and an honour to chair this fifth International Investors Conference, especially in EVCA's twentieth anniversary year. To set this conference in perspective, let us briefly recall where last year's fourth EVCA International Investors Conference led the industry. The following quote from last year's conference proceedings summarizes what we were left with as a conclusion: we thought it was the worst of times, it will be the best of times, and the consensus was that the upheavals were normal, not a paradigm shift, but a normal adjustment to evolutionary growth.

This year's question is when will the best of times return or emerge? Will the industry be ready and prepared to benefit from them when they do come? How much will the industry have to change before they arrive?

One of last year's speakers, Paul Myners, put it this way as to what he saw as being the industry's key challenge going forward. He spoke of more emphasis on operational skills, and he thought the key challenge for the industry was to re-skill in order to ensure its capacity to add value through management and through control. So, it is back to building businesses, and being sure that, as an industry, we have the necessary skills to do so.

It is not just the impressive number of delegates that makes this conference such a significant event. It is more the extent to which it highlights the key challenges facing the industry, as well as providing good insights into how best to address them. This year's edition, the first as an EVCA member-only event, welcomes 656 participants from 30 countries, among which there are 219 investors from more than 20 countries, of which more than 25 investors are from outside Europe.

2002 EVCA Annual Survey Headline Figures

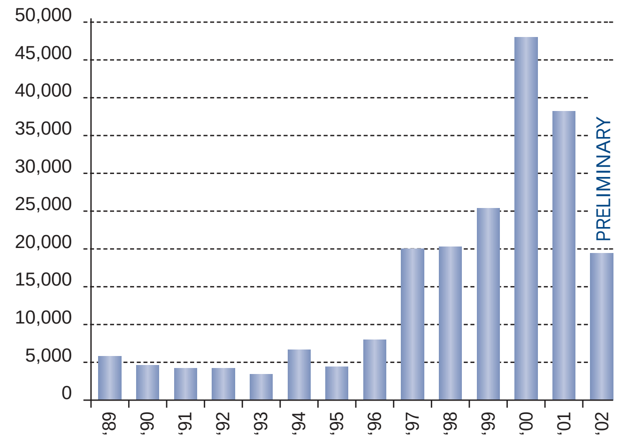
Headline Figures

Keith Arundale, *Venture Capital Leader, Pricewaterhouse-Coopers Global Technology Industry Group*

The survey covers 28 countries, 7 of which are pilot countries. It is preliminary data, so we do not have the splits by country or industry as yet. But having said it is preliminary data, we have approximately 80% of the major responses in, so we do not expect the figures to change significantly. The survey is based on 1,300 private equity firms in Europe, in total, and no estimations are made to any of the data.

In terms of funds raised in 2002, we are back to 1997 levels. 2002 has obviously been a tough year for raising funds. In fact, the funds raised are half of what were raised last year and just 40% of the all-time record in the year 2000, of €48bn.

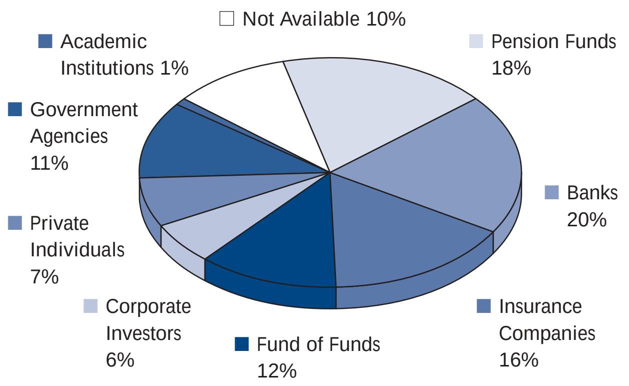
€19,416m FUNDS RAISED IN 2002*
(Preliminary Data March 2003)



The quarterly build up of these funds shows that more than a third were raised in the first quarter of 2002 and after that, the climate worsened. For the quarterly data, we do this with Thomson Venture Economics, looking at 150 of the larger private equity funds in Europe on a quarterly basis.

Where are the funds coming from? The pension funds, the banks, and the insurance companies are still the major contributors to funds raised, and they contribute in total over half of all the funds raised. But the pension funds' contribution fell from 26% last year to just 18% in 2002, banks held steady at 20%, and insurance companies actually increased their allocation from 13% up to 16% of total funds raised. Funds of funds remained steady at 12%, and government agencies increased from 6% to 11% of total funds raised. There is a major shift in terms of the expected allocation of these funds, as you might expect.

SOURCES OF NEW FUNDS IN 2002*
Key sources of capital remain the same



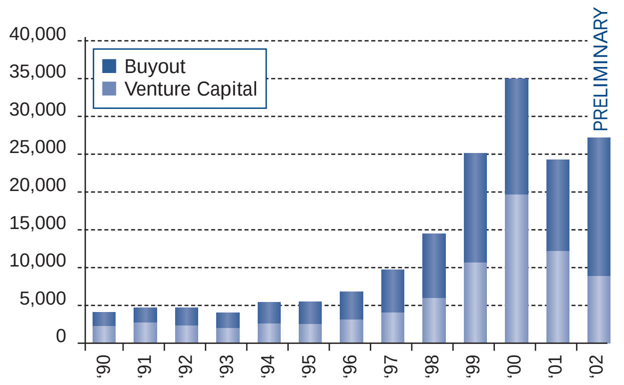
There has been a shift away from funds raised for the high-tech industry, and in fact, the high-tech expansion stage has gone down from 10% to just 4% in 2002, and the early stage has gone down from 15% to 9% in the same period. But, on the buyout side, it has been a less difficult period for fundraising and the amounts raised by buyout funds have gone up to 63%. They have much less difficulty raising funds than the venture capital stage funds.

The interesting and very positive news on the investment side is that investments have actually gone up in 2002 over 2001. 2002 is the second best year ever for investment in the private equity industry in Europe, after the year 2000. Approximately €27 billion was invested compared to €24 billion in 2001. This also is the first time ever, apart from 1993, when there was not a larger amount of funds raised, the first time ever that investments exceed funds raised in the year, so we actually have €8bn more money invested than was raised in 2002. This means that we have used up some of the overhang from previous years of private equity funds, and a rough estimate would put the overhang now at about €30bn. This is slightly more than one year's worth of investments.

**Source: EVCA Annual Survey of Pan-European Private Equity and Venture Capital Activity 2002. Conducted by PricewaterhouseCoopers. PRELIMINARY FINDINGS.*

Headline Figures

€27,196 INVESTED IN 2002*
Investment maintains momentum



The venture capital side (seed, start-up and expansion) declined by 27%: it went down to €9 billion from €12 billion in 2001. But a 27% decline is a lot better than the situation in the US, where the monetary report that we produce with Thomson Venture Economics showed venture capital investments decreasing by 50% in 2002. In fact, the actual size of the difference between the European and the US venture capital industry is not as big as it used to be. The €9bn in Europe compares to the €21bn in the US, so we are talking roughly twice the size of the US compared to Europe, as opposed to three or four times in the past.

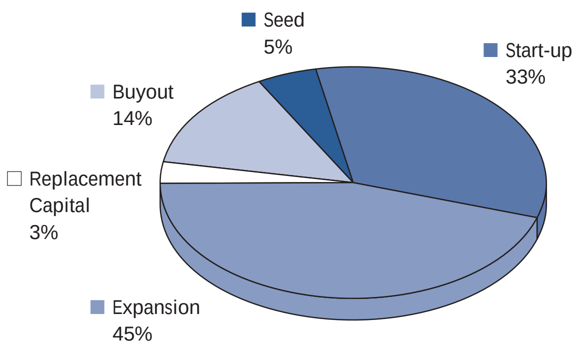
In terms of the stage distribution by number of investments, the expansion category, as usual, accounted for the largest proportion of all deals, 45%. The buyout stage was about €14m. The average deal size of the venture capital stage was €1.2m. The seed and start-up stages were down to €750,000, compared to about €1m in 2001.

It is interesting to see whether this trend is going to continue into 2003. Obviously, we have major political and economic uncertainties, and of course there is still no sign of any upturn in the equity markets.

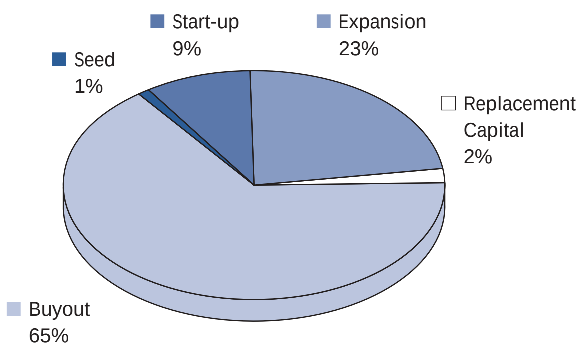
If we look at the venture capital investment side, by quarter, it has picked up a little in the third and fourth quarters. This is to be contrasted with the US, where there has been a downward trend in venture capital investments over the year. On the buyout side, buyout investments increased in the second half of the year due to some very large buyouts happening later on in the year.

Obviously, there are some very large deals resulting from the decrease in the M&A market and economic conditions which encourage corporate restructuring and the spin-off of non-core assets. So in total, about €18bn of funds were invested in buyouts, which is 65% of the total amount of investments, compared to 45% of the total amount in 2001.

STAGE DISTRIBUTION OF INVESTMENT BY NUMBER OF INVESTMENTS*
High number of expansion deals



STAGE DISTRIBUTION OF INVESTMENT BY AMOUNT*
Economic conditions provide opportunity for buyout



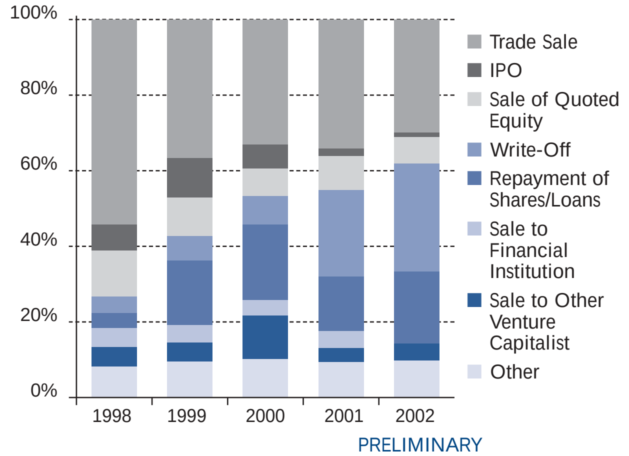
The number of companies receiving new as opposed to follow-on investments in 2002 is another key area of the report. About 64% of companies received follow-on investments compared to 54% in 2001, and the average follow-on investment size was just over €1m. The average size of the new investment for all private equity was about €6m because of the large buyouts that were happening. Of the total amount invested, the new investments have the largest share of the pie at 76%, simply because of the new investments going into the buyout area.

**Source: EVCA Annual Survey of Pan-European Private Equity and Venture Capital Activity 2002. Conducted by PricewaterhouseCoopers. PRELIMINARY FINDINGS.*

Headline Figures

Looking at divestments, the total divested at cost was just over €8bn, compared to €12bn the year before. The largest category, again, was trade sales, accounting for 30% by value (or by cost) of all divestments. There were around 830 trade sales and 1,370 write-offs in 2002. Write-offs accounted for 29% of the divestments by amount and were the second largest type of divestment. But divestments by write-off were 27% by number, compared to 17% for trade sales by number. There were somewhere around 32 private equity-backed IPOs in 2002, accounting for just 1% of total divestments. The 32 private equity-backed IPOs equate to about 175 IPOs in total in the year 2002, as shown by the PwC IPO Watch Europe Survey.

EUROPEAN DIVESTMENT AT COST 2002: €8,146 MILLION*
Exit market remains tough



It was a difficult year for fundraising, but steady investments in 2002 could mean we are seeing signs of an upturn appearing. The final figures will be available at the EVCA Symposium on 5 June, and published in the EVCA Yearbook.

Keith Arundale directs the PricewaterhouseCoopers Money for Growth European Private Equity and Venture Capital Survey of Technology Industry Investments. This information is based on EVCA's Annual Survey of Pan-European Private Equity & Venture Capital Activity, conducted by PwC through Keith and the PwC International Survey Unit.

**Source: EVCA Annual Survey of Pan-European Private Equity and Venture Capital Activity 2002. Conducted by PricewaterhouseCoopers. PRELIMINARY FINDINGS.*

Private Equity Performance Figures: What do they mean?

This session began with a presentation by Jesse Reyes, Vice President, Global Product Management and Development, of Venture Economics. He presented the background of the survey and examined the important reasons behind producing independent performance figures before presenting the latest findings. It was followed by a question and answer session, led by Ivan Vercoutere, a Partner at LGT Capital Partners.

Jesse Reyes, *Vice President, Venture Economics*

The first key question is: why benchmark? When Venture Economics started benchmarking in the mid-1980s, it was driven by a desire to produce industry standards. These would help individuals look at the market and understand what was happening in it, so as to guide the decision-making process of those who make commitments from a limited partner perspective, and for benchmarking purposes if you are a general partner.

Ultimately the aim is to provide information that ensures appropriate transparency for crucial information and due diligence, and to try to make private equity an asset class with replicable benchmarks.

Benchmarking began in the US in 1988 when the Venture Capital Journal did a large study for several clients including a module on 175 US venture funds. The following year, in 1989, Venture Economics worked with the US NVCA (National Venture Capital Association) to try to create valuation guidelines. Even though they were not formally adopted by the NVCA, they are still known as the NVCA guidelines.

Then, in 1991, we created a series called the *Investment Benchmarks Report*, and did our first report on venture capital; we did the same for buyouts in 1990. And in 1994, we worked with the US Association for Management Research, creating performance measurement standards for US private equity firms which was updated in 1997 and 2002.

In Europe, EVCA produced its first performance measurement principles document in 1993. In conjunction with Bannock Consulting, we did performance studies in 1994 for the BVCA, and then worked with the European Commission in 1996. Then, in 1997, Bannock, Venture Economics and EVCA did the first study on the performance of the European private equity industry.

Since then, Venture Economics has been working with EVCA to create private equity benchmarks on an annual basis, with more frequent reporting. There is also a Global Investment Performance Council, of which Venture Economics is a member, that is trying to create global standards for private equity performance to ensure that everyone within the industry is using the same metrics.

It should be noted that not everything obtained comes as a consequence of surveys. Thomson Venture Economics currently monitors about $350bn of assets under management for institutional investors. On a quarterly basis, we look at financial documents from general partners, both in the US and Europe, on behalf of institutional investors, and enter that data into a database for reporting. A by-product of that are the benchmarking services from the analytics group. What this does is give us credibility in being able to handle sensitive data.

On a quarterly basis, there is a team of people reviewing more than 2000 fund reports and financial documents from general partners. We are truly independent, we do not do gate-keeping, we do not make investment choices and we do not provide advice in terms of where to invest, adding further credibility as funds and people can supply their information knowing that it will be handled appropriately.

Our sources include surveys that are conducted through EVCA and through other associations, but also information coming from general financial documents. We also have databases on firms, funds, companies, limited partners themselves, commitments made, investments made, exits, and of course, performance. We have a database on performance that we have maintained since 1988. We have almost 1,600 US funds formed from 1969 to the present, 765 European funds formed from 1980 to 2002 and 175 other funds from the rest of the world, from Asia and from Australia.

All information that we collect is kept confidential. To calculate performance we need relatively little information: we need information about firms, about funds, about the company investments, transaction details, and cash-flows. We also ask for details of the commitments made by the investors in the funds and for any capital calls or takedowns, whether for investment or management fees. We need distribution, both of cash and stock, and then a net asset value at the end of each period.

Private Equity Performance

Whereas valuations are struck on a quarterly basis in the US, in Europe it is primarily annual, with some biannual updates. We make sure that all of this is net of fees and net of carried interest in order to provide investors with the most relevant benchmark. It should be stressed that in Europe, 18% of the number of funds and 35% of the capital in our sample come from institutional investors. In the US, institutional investors are the source of 61% of the number of funds and 84% of the capital that comprises our benchmark.

We assume that institutional investors invest in the good, the bad, the medium, and the ugly. As a result, we are able to look at virtually all factors and all stages, and all the best and worst performers, so we feel that what we see in the US is highly representative of the industry. In Europe, we think it is representative, but we want to see more institutional investors' involvement in our process to make sure that we have the most comprehensive information across all sectors and all performance characteristics.

The calculations used to measure performance include internal rates of return but also cash-on-cash returns. Cash-on-cash multiples (DPI, RVPI and TVPI) are basically measures of realized and unrealized investment. We break this down by vintage year, by fund size, and by stage. We also calculate other types of returns; we calculate horizon IRRs over the last year, the last 3 years, the last 5 years, and we also look at time-weighted returns.

This allows an institutional investor to be able to look at this asset class much as he would look at any other asset class, and not be handicapped because there is less information about this asset class than others.

However, one must understand that there are still some things about private equity that are very different from public equity. One of the first things is net asset value, including valuation of unrealized investments. Other key points to recognize are firstly how representative a sample is, and secondly, can one use the entire world or should one only look at mature funds?

Valuation of unrealized investments remains a controversial topic, however guidelines exist that aim at harmonizing industry practices.

** Preliminary Benchmarks 12/31/2002*
Source: Thomson Venture Economics VentureXpert database

As the sample hits all the different stages of investment, it can be considered representative of the performance of the asset class. Nevertheless, we are continuously improving the sample, in particular by collecting information from a greater number of institutional investors. Regarding the issue of mature funds, there are stakeholders that feel we should only look at mature funds, i.e. funds that are at a point where they are actually returning capital. Anything beyond that would be speculation. We do both. The problem is that, if you use only mature funds, you eliminate the J curve effect, but if you use a total sample, it mirrors what is going on with limited partners because limited partners also have young funds in their sample.

Preliminary European Private Equity Performance in 2002

In 1996 when the first report was completed the information was sourced from 278 funds, which represented about €20bn of invested capital. Today there are 765 funds that represent €129.4bn. That is a function of not only how much more data has been collected but also a symptom of how large the industry has grown during the recent years. The majority of the sample are multi-country focused funds. The United Kingdom, France and Finland follow thereafter on the basis of where the funds are domiciled.

INVESTMENT BENCHMARKS DATABASE
European Sample Growth

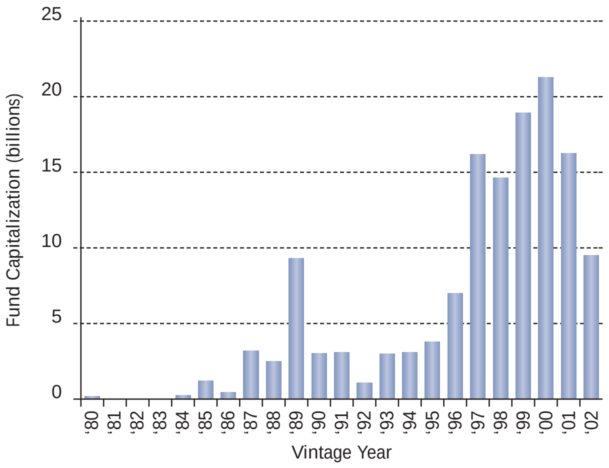
Report Year	No.	Committed Euro Bn.
1996	278	20.6
1997	384	39.8
1998	438	51.4
1999	511	68.8
2000	573	87.6
2001	665	108.8
2002	765	129.4

The preliminary figures show performance as one would expect. Venture funds that were raised in the run-up to the peak of the dot.com boom have suffered the worst performances, while the more traditional buyout funds that avoided that part of the market and focused on value investing are enjoying a better time but are still finding it very difficult to make superior returns.

Private Equity Performance

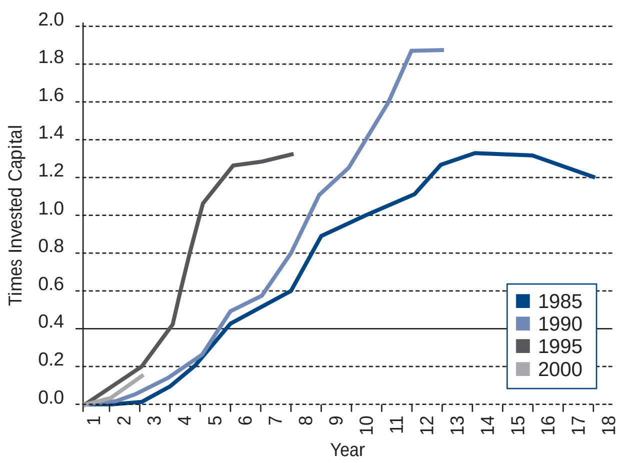
It will take time for the full implications of this to emerge. A key point to recognize is the relative youthfulness of the European market. So many new funds have been formed during the past five years in Europe, so the sample is young - this is particularly applicable to venture funds. Collectively many of these funds are still unrealized and may take many years to realize their holdings.

EUROPEAN PRIVATE EQUITY SAMPLE
TOTAL BY VINTAGE YEAR*

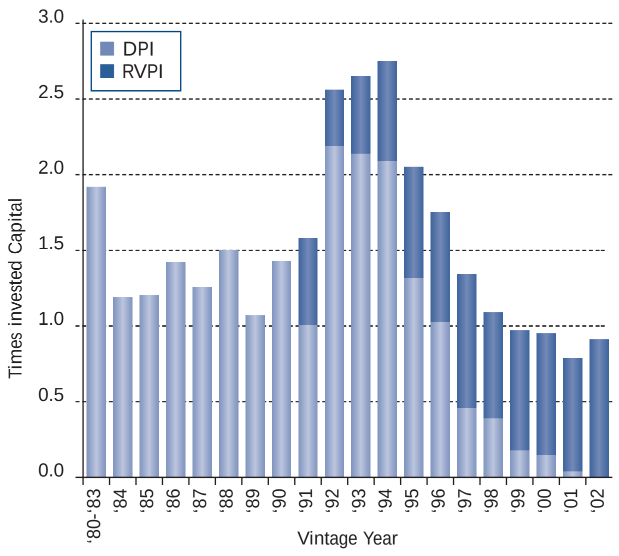


If one looks from a historical perspective, one sees that those funds raised in the mid-1990s did particularly well. These were particularly good vintages. Some of these funds returned capital after only 5 years of existence. It is too early to tell when the funds formed in the year 2000 are going to return capital, but the important point is that the funds formed in the mid-1990s did very well on a cash-on-cash basis and the funds formed in more recent times are going to find it much harder to replicate that success.

J CURVES – REALIZATION MULTIPLE (DPI)
1985, 1990, 1995, 2000 Vintage Years



REALIZATION MULTIPLES (DPI/RVPI) BY VINTAGE YEAR*



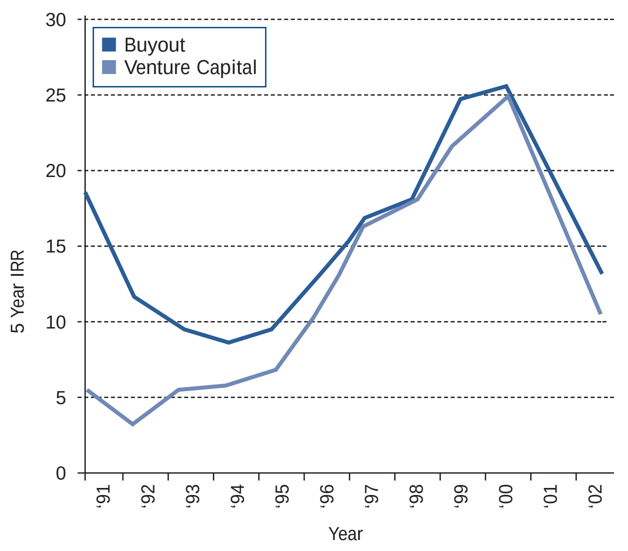
A key question is whether one can make a future prediction based on this past performance. There have been more investments made in recent years than realizations. As the investment pace lowers, the realizations are likely to improve during 2003/04.

If one takes a five-year horizon, one sees that both venture capital and buyouts tend to mirror each other in Europe. Both had a giant run-up in 2000 and we continue to see a correction from that to levels previously seen during 1997/98. Much in the same way as investment levels have returned to those of the pre-bubble days, one is now seeing the levels of performance return to those pre-bubble days as well.

** Preliminary Benchmarks 12/31/2002*
Source: Thomson Venture Economics VentureXpert database

Private Equity Performance

FIVE YEAR ROLLING IRRs
FUNDS FORMED 1980-2002*



Since inception, from 1980 to the present, the pooled average for the entire sample is 11.5%. Performance varies from 5.1% for early-stage investments to 14.2% for buyouts. All venture capital (early stage, development and balanced) had a 10.4% pooled return.

FUNDS FORMED 1980-2002
NET RETURNS TO INVESTORS*
From Inception to 31-Dec-2002

Stage	No.	Pooled	Upper Quart	Med	DPI	RVPI	TVPI
Early Stage	187	5.1	8.8	0.0	0.47	0.70	1.17
Development	137	10.6	9.5	0.8	0.87	0.78	1.65
Balanced	113	11.4	13.6	1.9	0.70	0.70	1.40
All Venture	437	10.4	10.3	0.6	0.73	0.70	1.43
Buyouts	265	14.2	17.4	6.9	0.70	0.68	1.38
Generalist	63	10.4	6.7	0.4	0.94	0.50	1.44
All Private Equity	765	11.5	12.3	2.1	0.74	0.65	1.39

The upper quartile (the mark that gives the IRR which the fund must exceed to rank in the top quarter) shows 8.8% for early stage, 10.3% for all venture and 12.3% for all private equity. The median return (the value appearing halfway in a table ranking funds by IRR in descending order) is pretty much close to 0 for most venture capital funds, with buyout funds having a slightly higher median - overall a median of 2.2%.

** Preliminary Benchmarks 12/31/2002*
Source: Thomson Venture Economics VentureXpert database

In terms of multiples, all private equity returned 1.39 times invested capital (TVPI: Total Value to Paid-in), of which 53% had been returned to investors (DPI/TVPI: Distribution to Paid-in/Total Value to Paid-in) while 47% is still unrealized (RVPI/TVPI: Residual Value to Paid-in/Total Value to Paid-in).

In 2002, the short-term return for all venture capital in Europe was -28% (one-year horizon IRR). In the US, that number was somewhere around the same place. In Europe, the short-term return for all private equity was -8.2%. On a 3-, 5- or 10-year basis, one can see that the longer-term returns are more positive.

FUNDS FORMED 1980-2002
NET IRRs TO INVESTORS*
Investment Horizon Return as of 31-Dec-2002

Stage	1 YR	3 YR	5 YR	10 YR	20 YR
Early Stage	-30.7	0.3	1.2	5.8	5.1
Development	-27.2	2.0	7.9	12.6	10.6
Balanced	-27.3	6.0	15.5	17.3	11.5
All Venture	-27.6	4.1	10.6	13.6	10.4
Buyouts	-1.6	5.2	13.4	14.8	14.2
Generalist	-15.1	4.2	8.1	16.5	10.4
All Private Equity	-8.2	4.1	10.9	14.5	11.6

Performance can be different depending on which size of funds you are investing in. Short-term performance for smaller funds is down by around 20%, with funds in the €100m range doing slightly better but still under water. The mid-market funds have performed better in the short run, while the groups that range between €250-€500m have definitely done better in the long run. Bigger is better, but only to a certain point.

FUNDS FORMED 1980-2002
NET IRRs TO INVESTORS*
Investment Horizon Return as of 31-Dec-2002

Stage	1 YR	3 YR	5 YR	10 YR	20 YR
0-25 Mill	-20.2	9.2	11.5	13.6	8.8
25-50 Mill	-21.5	13.4	14.4	12.1	9.2
50-100 Mill	-18.6	-0.9	5.3	10.1	10.0
100-250 Mill	-7.1	1.0	11.2	15.3	12.3
250-500 Mill	-20.3	5.4	24.3	21.8	21.1
500 Mill+	0.7	4.5	9.6	14.2	11.1

A full sample of statistics will emerge in late May/early June. Venture Economics is set to finalize the data and intends to publish it within its Investment Benchmarks Report.

The key point is that we will continue to contact more institutional investors in Europe and in the US. We would like both limited and general partners to get more involved in supplying information. The information is kept confidential and the more participation we have the better the sample will be.

Private Equity Performance: Questions & Answers

Ivan Vercoutere, *Partner, LGT Capital Partners, led the questioning of Jesse Reyes.*

How does currency play a role in the figures? Some funds are in euros, some in pounds and some in dollars. How do you treat the currency issue to arrive at your figures?

All performance figures are reported in euros. The information is collected in native currency, which for most is euros, but obviously exceptions exist such as British pounds, which then get converted into euros for the benefit of the research.

The statistics provided cover the last 20 years. If we look at the last 5 or 6 vintage years, 1997 to 2002, approximately 70-75% of all private equity capital has been provided during that period of time. How can one value the underlying assets that have yet to be realized?

Yes, I think it was obvious with our vintage year chart that a good portion of the performance, right now, is valuation-driven, which makes it all the more important that we all have an equal measure of valuation to make sure that everyone is using the same guidelines, the same metrics. It does not necessarily mean that you value an early-stage company the same way you do a buyout, but the same governing principles should apply. One should remember that Thomson Venture Economics does not make any independent valuation of these funds.

A significant correction in public markets has taken place. Has the venture capital and buyout industry adjusted its valuations to reflect both public and private market conditions?

In late 2000 and 2001, some of the large better performers in this industry started taking write-downs and write-offs fairly early in the process, but it has taken a good 18 to 24 months for people to realize that what we see in the public market is real; it is not just an aberration. I do not really have any good way of saying is this the end of it, have we seen the bottom of it? My feeling is that in looking at the financial documents that we have seen in the last couple of weeks, for December 2002, both in the US and Europe, we saw more significant write-downs in 2002, and I think that makes us feel that the industry is trying to get to a point where I would say, we leave this behind us, and we just want to look forward.

Could there be a 12, 18, 24 months lag in valuation, even if we see a recovery in capital markets?

Well, I am going to put my economist hat on a bit. I tend to think that these prices valuations, no matter whether in the US or in Europe tend to be sticky. They tend to be very sticky going down but adjust upwards more easily. It is just part of human nature. What is important is that limited partners and general partners have a firm understanding of how the valuations are going to be done. I think the guidelines that EVCA has put together are a good set of rules that people can follow, rules that we do not have in the US.

Companies acquired in buyouts in the late 1990s were bought on an average multiple in the US and in Europe at about 8 times cash-flow. If we look at the economic cycle, it probably also marks the peak of the cash-flow earning cycle. Have things declined since then? Are valuations reflective of that?

Valuations are reflective of what is going on in the markets, although if I talk to some buyout groups they think that valuations are still too high. But looking at the number of transactions being done in the buyout markets in the US and Europe, it tells me that there is some efficiency in this pricing.

For buyouts, does Europe offer more opportunities than the US at the moment?

Europe definitely offers more opportunities right now in the buyout area than the venture world did. Driven by a number of structural factors, the buyout market is in a healthier state in Europe than in the United States.

Terminology

- IRR Internal Rate of Return
  The IRR is the interim net return earned by investors (Limited Partners), from the fund from inception to a stated date. The IRR is calculated as an annualised effective compounded rate of return using monthly cash flows to and from investors, together with the Residual Value as a terminal cash flow to investors. The IRR is therefore net, i.e. after deduction of all fees and carried interest. In cases of captive or semi-captive investment vehicles without fees or carried interest, the IRR is adjusted to created a synthetic net return using assumed fees and carried interest.

- Pooled IRR
  The IRR obtained by taking cash flows from inception together with the Residual Value for each fund and aggregating them into a pool as if they were a single fund. This is superior to either the average, which can be skewed by large returns on relatively small investments, or the capital weighted IRR which weights each IRR by capital committed. This latter measure would be accurate only if all investments were made at once at the beginning of the funds life.

- Horizon IRR
  The Horizon IRR allows for an indication of performance trends in the industry. It uses the fund's net asset value at the beginning of the period as an initial cash outflow and the Residual Value at the end of the period as the terminal cash flow. The IRR is calculated using those values plus any cash actually received into or paid by the fund from or to investors in the defined time period (i.e. horizon).

- 5 year Rolling IRR
  The 5 year Rolling IRR shows the development of the five year Horizon IRR, measured at the end of each year.

- Median IRR
  The Value appearing halfway in a table ranking funds by IRR in descending order.

- Quartile IRR
  The IRR value which lies a quarter from the bottom (lower quartile point) or top (upper quartile point) of a table ranking individual funds in descending order.

- Top Quarter
  Comprises funds with an IRR equal to or above the upper quartile point.

- Upper Half
  Comprises funds with an IRR equal to or above the median point.

- DPI - Distribution to Paid-In
  The DPI measures the cumulative distributions returned to investors (Limited Partners) as a proportion of the cumulative paid-in capital. DPI is net of fees and carried interest. This is also often called the "cash-on-cash return". This is a relative measure of the fund's "realized" return on investment.

- RVPI - Residual Value to Paid-In
  The RVPI measures the value of the investors' (Limited Partner's) interest held within the fund, relative to the cumulative paid-in capital. RVPI is net of fees and carried interest. This is a measure of the fund's "unrealized" return on investment.

- Residual Value
  The estimated value of the assets of the fund, net of fees and carried interest.

- TVPI - Total Value to Paid-In
  TVPI is the sum of the DPI and the RVPI. TVPI is net of fees and carried interest.

- Mature funds
  Funds that have been in existence for over two years.

- Early Stage Fund
  Venture capital funds focused on investing in companies in the early part of their lives.

- Development Fund
  Venture capital funds focused on investing in later stage companies in need of expansion capital.

- Balanced Fund
  Venture capital funds focused on both early stage and development with no particular concentration on either.

- Buyout Fund
  Funds whose strategy is to acquire other businesses; this may also include mezzanine debt funds which provide (generally subordinated) debt to facilitate financing buyouts, frequently alongside a right to some of the equity upside.

- Generalist Fund
  Funds with either a stated focus of investing in all stages of private equity investment, or funds with a broad area of investment activity.

Venture Capital refers to Early-Stage (=seed and start-up) and Expansion finance. Private Equity provides equity capital to enterprises not quoted on a stock market and refers to all stages of industry, i.e. Venture Capital and Buyouts.

Using Public Market Analysis for Private Equity Market Insights

Satya Pradhuman and Bill Kan of Merrill Lynch presented a keynote address on how the information from the public markets can be applied to private equity and venture capital. They attempted to suggest what lessons could be learned from a broader overview instead of short-term analyses and presentations.

Bill Kan, *Director and Strategist in the Small Cap Research Department*

Bill Kan is an MBA graduate from Columbia University. Bill is a chartered financial analyst and a member of the New York Society of Security Analysts. A director and strategist at Merrill Lynch, Bill's focus is on small and mid cap stocks and the private equity market. Before joining Merrill Lynch, Bill worked at Kidder Peabody and at the Federal Reserve Board. He published in the Journal of Private Equity, the Handbook of Inflation Indexed Bonds, and Economic Studies Quarterly.

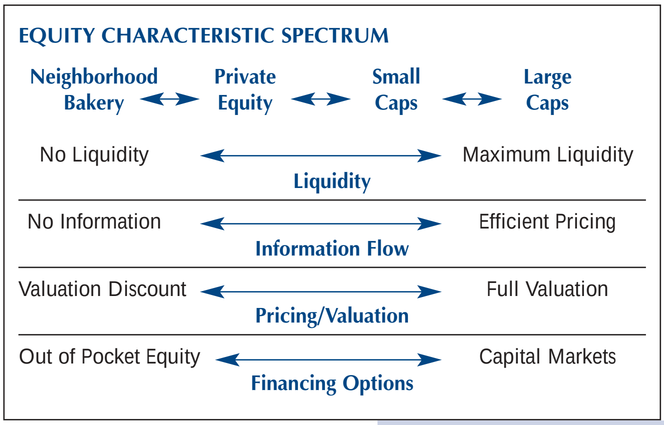
There are certain similarities in the public and private equity markets that can be leveraged. Our work on the public market is focused on lower market cap stocks – mid, small and micro cap stocks. Like the companies in the private equity arena, this segment of the public market relative to large cap public companies are less liquid and have less information flow, they tend to be priced at discounted valuation multiples, and they have more limited access to capital. In addition, our work suggests that it is also useful to think about the linkage by associating venture capital to growth investing in the public market and buyout funds to value investing.

We believe that the public markets can offer insights into how valuations might evolve; where they were, and where they're heading. In addition, relative valuation measures in the public market should help one to discern where things are changing in the different segments of the market.

This thinking has emerged as a consequence of the research of the Merrill Lynch Small Cap Research Department where much of our work is on stocks below $2bn in equity market capitalization. Our approach is more top down, macro based and, where appropriate, more quantitatively based, but the exercise here is focused on applying the lessons of the public markets to the private equity markets.

Why are there certain similarities? Initially one can look at the relationship between the different parts of the equity market. Start, for example, with a neighborhood bakery at one extreme and compare it with large cap stocks such as General Electric or Microsoft at the other extreme.

There are a number of characteristics that can be reviewed, but we will highlight the four that we noted earlier. The first one is liquidity. Large cap stocks have "maximum liquidity" as it is simple to buy and sell the stocks. One can also short those stocks.



Unfortunately, for the local baker, he does not have that flexibility as there is little to be done with the equity in a single bakery. Somewhere in between the extremes are the companies that the private equity industry have exposure to or are considering and lower market cap public stocks.

Second, large cap public companies are inundated with coverage, in other words, much better information flow. In the US, there are 25 to 30 sell-side analysts that cover large cap stocks such as Microsoft, not to mention the numerous buy-side analysts and people doing research at home in their spare time. For the local baker there is no coverage. In between there are hundreds of smaller stocks, where in the US there is an average of only about 5 sell-side analysts that cover a small cap stock. Who covers the companies under consideration by the private equity industry? That is down to the investors, largely the general partners of buyout and venture funds.

Market Insights

Third, let's say that large cap stocks sell at "full valuation" because they are in a more efficient segment of the equity market. They are liquid and information is readily available. In contrast, lower market cap public stocks and private equity belong to a less efficient segment of the market and tend to sell at discounts to the valuation of large cap companies. Both lower market cap public and private companies are less liquid and enjoy much less information flow.

Lastly, financing options are much more abundant for large caps such as GE, which can tap various parts of the capital markets such as commercial paper, securitized debt, the corporate bond market and also banks. Small, less well known companies don't have the luxury of choice such as a GE and may need to rely on a narrow set of options such as bank loans in some cases. Private equity-backed companies often have even less options.

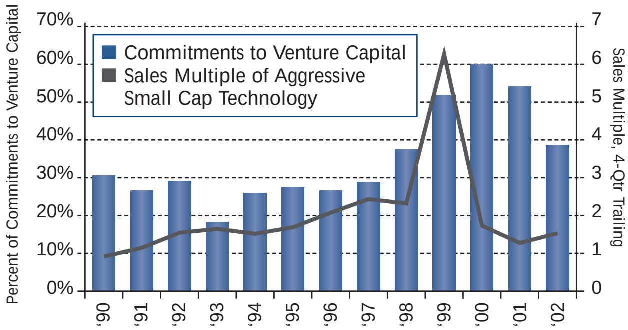
One can also talk about styles of investing to draw insights into the private market from information in the public market. In the public markets there are lots of debates about whether you are a growth investor or a value investor. In private equity the two main splits are whether you are a venture investor or whether you are a buyout investor.

This temporal allocation discussion will continue to grow. If one was to make a comparison it would be that venture capital investors are akin to growth investors and buyout and mezzanine financing equates to value investing.

Let's look at some of the linkages as it applies to venture capital and buyouts.

VC & GROWTH MULTIPLES*

Commitments to Venture Capital & Aggressive Growth Tech Multiples

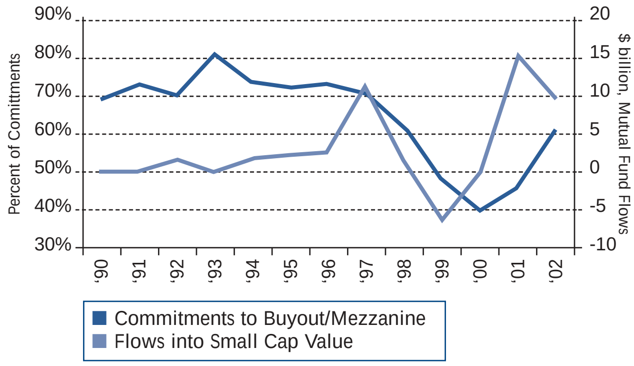


In exploring the linkage, we have also found that investors behave similarly in the private and public markets. During the late 1990s when investors were rushing to get into venture capital, they also did the same thing in the public side in terms of growth investing. There was a flood of money going to small cap growth funds. In fact, net mutual fund flows went from roughly $2bn in 1997 and 98, to about $20bn in 2000.

One common thread that ties together private and public investors is valuation. This is illustrated by the figure on commitments into venture capital and the sales multiples of small cap technology stocks. Valuations increased rapidly in 1999, from roughly 2.5 times sales in 1998 surging to 6.3 times. At that time the ability to exit investments via IPO or an industry sale was high, which helped provide investors with healthy returns. This helped trigger a rapid increase in commitments into private equity. But then when valuations collapsed and the tech bubble burst, one can also see that valuations came down more quickly than commitments into venture capital funds. Flows into small cap growth funds followed a similar pattern.

BUYOUTS-STYLE & INVESTOR INTEREST**

Commitments to Buyout/Mezzanine Funds vs. Mutual Fund Flows to Small Cap Value



Commitments into buyout funds and fund flows into small cap value funds also have a similar pattern. During the late 1990s, when growth investing was popular, venture capital took the share of committed capital away from buyouts. But then, in the last several years, as interest in value investing picked up again, buyout funds started taking share away from venture capital.

** Source: Merrill Lynch Small Cap Research, Venture Economics*
*** Source: Merrill Lynch Small Cap Research, Venture Economics, Lipper*

Market Insights

The relationship between commitments into buyout funds and the relative sales multiples between small cap value versus the small cap growth benchmarks also illustrate the linkage. When growth was running away from value investing, multiples from growth stocks ballooned and gapped away from the multiples for value stocks. At their widest, value stocks sold at 0.4x or a 60% discount to the sales multiple of small cap growth funds. Once again, we see that the money going into the asset appears to coincide with the trend in relative valuation in the public market.

Given these linkages, one can use the information from the market quoted prices on small cap stocks and their required disclosures to draw insights into the private sphere, where such information is not readily available. A look at valuation trends and other metrics may help identify the segments of the market with compelling opportunities. For example, we estimate that the portion of micro cap stocks selling below an enterprise value/EBITDA multiple of 4x is increasing. About 12% of micro cap stocks in the U.S. excluding financials are selling at that level compared with a long term average of 10%.

We also look to the conditions in the public market to help us gauge conditions in the private market. Current difficulties that are in the market place do present opportunities for certain investors, especially those focused on buyouts. Right now, it is no surprise that corporate America is increasing the amount that it is writing off each quarter, and we're seeing that basically relate to a rise in divestiture activity. Roughly 40% of the operating earnings for 2002 of the S&P 500 has been written off. The preoccupation with write-offs and other issues such as corporate governance have contributed to the slow down in trade sales, for example.

As write-offs come down, it seems management can take more time to start reconsidering strategic moves, maybe reconsider doing some M&A once again. That is going to be interesting and will relate, in part, to the capital markets. Can corporate America or can general partners out there get access to capital to help effect these deals? Financing is obviously a key issue for companies to grow and it is also a key issue for any dealmakers in deciding whether to back a deal or not. We have lots of discussions with our high yield bond strategists, for example, to assess where the markets are going. We explore if there are relationships between the small cap market and the high yield market, and can we use these relationships to obtain a preview, a clearer idea of trends in private equity.

It is noteworthy that the cost of issuing high yield bonds has been declining, partly because of the general decline in interest rates. And what is also interesting is that it is actually about the same level now as it was in the late 1980s, when the high yield market was a source of funds for M&A transactions.

Since the end of last year yields in the high yield market are even lower and are currently at about 11%. In terms of credit spreads to 10-year treasuries, the spread of high yield bonds has collapsed by another 50 basis points, but still awfully high at about 750 basis points, in terms of spreads to treasuries. More importantly, spreads are declining. So, somewhere along the way, it gives us a warm and fuzzy feeling that, maybe, things are improving, but of course all the recent events in the last couple of days, especially to do with military action, may not help things. Investors have been stepping up, putting money to work in the high yield market, because they've been generating positive returns over the last several months. And also, the forward calendar for the high yield market is not dead right now. In fact, there are signs of life, signs that companies doing LBOs are getting some funding. About $4bn in high yield debt have come to market so far this year. Meanwhile risk taking or the willingness to take some risk has improved. It may not be easy for companies to issue debt right now, but it seems that spreads have been coming in, which is a sign of optimism.

In summary, there are certain similarities that can be leveraged between the public and private markets, certainly in terms of their characteristics: private equity and lower market cap stocks are generally less liquid; there is less information flow; they sell at a valuation discount; and they have limited financing options.

There is an association between venture capital to growth investing and buyout funds to value investing. These insights can help identify where valuations are, where they were, and where they're heading, and looking at the relative valuations helps us figure out where things may be changing.

Market Insights

Satya Pradhuman, *Chief Small Cap Strategist at Merrill Lynch*

Satya Pradhuman is a MBA graduate from New York University who joined Merrill Lynch in 1989. He is now the chief small cap strategist at Merrill. He is responsible for the small and mid cap equity and related derivative strategies. A recognized researcher in his field through the publication of several reference articles and books, including the acclaimed Small Cap Dynamics in 2000, Satya is also a member of various professional organizations, including the Chicago Quantitative Alliance and the Society of Quantitative Analysts.

The reasons why you should look at some of this public market data are from an allocation standpoint; some of it is from a performance standpoint, but most importantly for investment ideas. The data is workable and attainable. The second key point is that individual sectors provide their own individual links between the public and private markets. This point is highlighted by reviewing the contrast between the basic industrials sector and the broadcast arena.

There are some huge discrepancies on valuations on the basic industrials side. It is not a glamorous sector, but if you don't have pricing power, the only way to deal with that is in terms of consolidation, which is interesting and presents lots of opportunities. If you do see quality spreads, the difference between high yield bonds and treasuries or higher grade paper narrow, as those spreads are now, it makes the story more compelling.

In contrast the broadcasting sector is not filled with firms with stable top line turnover trends that make investment decisions easy. This is especially the case as economists start to focus on double dip scenarios. Ad-spending might be returning but that is not factored in some of the extreme valuations that are currently present. This makes it an uncertain and interesting space.

For buyout funds, the business overall has been somewhat healthy and reasonable. It is also interesting that quality spreads remain wide although they're improving. A key point here is that to really see the volume of business for buyouts grow, ultimately you need leverage. Trends that are being witnessed right now in the markets and that have been evolving over the last few months suggest that we should see buyout activity grow over the next 12 to 18 months.

This part of the presentation is focuses on two cyclical industries - broadcasting and basic industrials-which are from different parts of the spectrum and we will examine how they are performing in the US public market and what lessons can be applied to the private equity market.

By basic industrials, the focus is on paper and metals related companies. If you go back to the 1980s, the group has effectively lagged the market as a whole by about 50%, which is dramatic. Driven by reasons such as capacity constraints, technology and other factors, there has been increased pressure exerted on commodity-based businesses. Today this sector is becoming of greater interest to investors. It seems as if the current economic backdrop is taking its toll on short-term expectations, but in recent years it has significantly outperformed the market as a whole.

Looking at the companies in the small, micro, and mid cap space, it is a very deep universe. There are roughly 130 that would be considered mid, small and micro cap basic industrial companies and there are only about thirteen or so large companies. The beauty of this is if you look at simple things like price to sales or price to revenues, what you're getting a sense of is the sort of discount that the smaller firms are trading at. This is important for when one compares it with the merits of a private company.

VALUATION SUMMARY
SIZE PREMIUM FOR BASIC INDUSTRIALS*
Snapshot of Basic Industrials as of 1/31/03

MLSCR Composite	Price-to Sales	Price-to Book	Dividend Yield	Expected 3-5 Year Growth	Number of Companies
Large	1.1	2.3	2.9%	10.4%	13
Mid	0.8	1.6	2.2%	10.4%	30
Small	0.5	1.4	1.8%	11.4%	70
Micro	0.2	0.7	2.1%	13.9%	50

What is curious to an analyst is that the yield spread for basic industrials is quite large. In terms of dividend yields, the smaller firms carry almost about as much yield as the larger firms. This is not to say these smaller firms are paying out more but this is ultimately a valuation statement. Curiously, the smaller firms are also expected to grow faster. I think it is known that Wall Street tends to over-estimate growth rates but here the bias is across the space, and there is still a spread.

** Source: Merrill Lynch Small Cap Research*

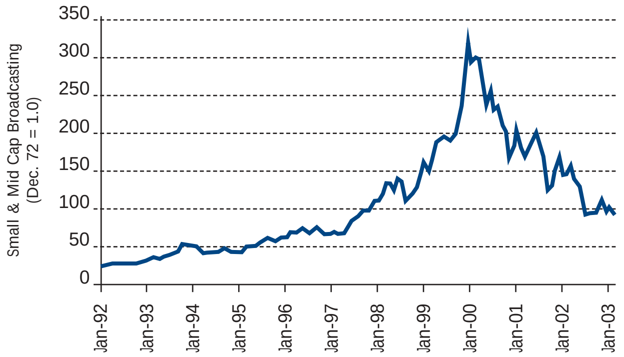
Market Insights

It is possible to look at how the smaller basic industrial firms trade against the larger cap names. What this is telling us is that it is selling at a historical low of 56% discount to the sales multiple of the larger cap basic industrial names. This is terribly important because, after all, these are not companies with pricing power. So how do you combat a lack of pricing power? The only way through this is consolidation.

This means that the limitations facing these companies in the public markets will drive them towards consolidating triggering deals for those in the private markets. If I can show you that the smaller names are selling at record discounts, I think clearly that gives us some sort of an investment motivation.

Compare this with the broadcasting sector in general and radio stations in particular. Simply put, this group has seen a collapse in its valuations. More than 2/3 worth of the capitalization has dried up in just about three years. Now this is going to scare a number of people away, but ultimately one has to put an investor's cap on here.

BROADCASTING: SECTOR PERFORMANCE*
Small & Mid Cap Market Weighted Total Return - Broadcasting

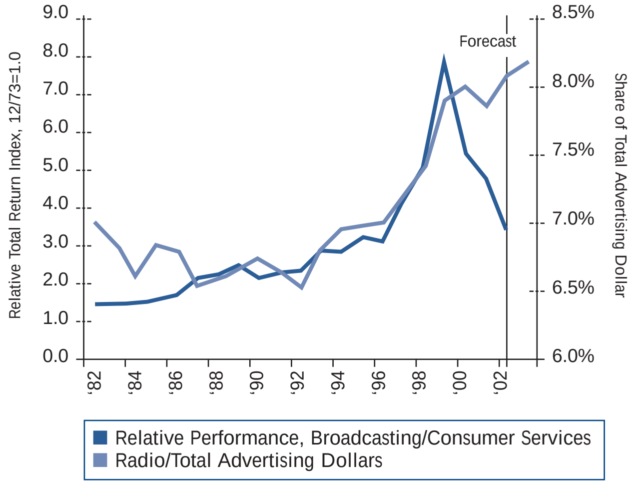


This graph explains how the valuation of the broadcasting sector has been negatively affected in recent times. It obviously enjoyed a dramatic rise from 1998-2000 before its steep decline. Let us go through the rubble and see what damage has been done.

The fundamental question is whether there is a good business model and can one get a good price for what is on the table? These questions apply to both the public and private markets.

What is terribly important here to recognize is that the group has collapsed from a performance basis. What is also very interesting is that one is starting to see signs that ad spending is starting to stabilize.

ADVERTISING FORECAST VS SECTOR PERFORMANCE*
Relative Total Return vs. Radio's Share of Advertising Dollars
MLSCR Small & Mid Cap Broadcasting Industry



This is interesting as the forecasters are predicting advertising revenue will grow but it has not followed through yet to the valuations.

But what are these companies valued at? Most importantly, is there a size premium? And what one starts to see is, when looking at revenue multiples, large cap media related firms are about 3 times sales, small and mid cap firms are about 2.4 times sales, and micro cap firms are about 1.5 times sales. Interestingly enough, not everything lines up. There is a difference in terms of book value, and I think that has to do with the difference in tangible book value.

Look at the large cap space. There are six public companies out there. Looking at S&P 500 data is not going to help when one is trying to make the decision about the valuation of a smaller cap broadcasting firm. When one is looking to the small mid cap space, there are only about 25 companies that are in this sample set, when you look to the micro, it is more like 15 companies that exist.

** Source: Merrill Lynch Small Cap Research*

If you take this data going back much further, what this tells us is that we're really at the low end of the range that the groups are trading at, so the collapse we've seen in capitalization seems to be reflected here. Most importantly, where we look at the relative numbers, this is what I think is interesting, it starts to give us a hint that we're probably at the bottom end of relative values in terms of how the smaller to mid cap size broadcasting firms valued versus the larger caps.

Fairly good, clean public data can therefore be a very powerful tool and, most importantly, you have a sense of time series, which ultimately gives us all a basis for decision making, when attempting to apply it to the private markets.

Governing Principles and Sound Practice for the Establishment and Management of Private Equity and Venture Capital Funds

This presentation by Simon Thornton, a Vice-President at Landmark Partners Europe, announced the launch of the new document by EVCA. Simon Thornton has been Chairman of the Task Force responsible for the research.

Simon Thornton, *Vice President, Landmark Partners Europe*

The "Governing Principles and Sound Practice for the Establishment and Management of Private Equity and Venture Capital Funds," is a milestone in EVCA's history. The association has been in existence for 20 years, and over those 20 years the development of professional standards and training for industry practitioners has been a key role.

A NEW MILESTONE

Since its creation, EVCA has committed itself to develop the professionalism of the industry:

1983	Code of Conduct for EVCA Members
1993	First Valuation guidelines
2000	First Reporting Guidelines
2001	Second Valuation Guidelines
2003	**Governing Principles and Sound Practice**

That role started in 1983, with the formation of the association and the establishment of a code of conduct for members. That has been in place throughout the entire two decades. In 1993, the association launched its first set of valuation guidelines. This was a response to interest from investors in having common guidelines and also to provide a tool for general partners to help them in their valuation methodology. Between 1993 and 2000, we also published performance measurement standards, again to help standardize the calculation of returns.

In 2000, EVCA launched the first set of guidelines to provide a common standard for reporting to investors, to help promote accurate and good flow of information. 2001 saw a fairly major update of the valuation guidelines in order to encompass changes in the industry over the preceding eight years. We now have the "Governing Principles" document.

GOVERNING PRINCIPLES TASK FORCE

Q1-2001	EVCA Executive Committee launches the initiative
Q3-2001	EVCA Professional Standards and Communications Committee initiates the creation of a specific Task Force
Q4-2001	The Task Force is created

The Executive Committee launched the initiative early in 2001. The Professional Standards & Communications Committee established a specific task force to produce the document at the end of 2001. It consisted of 10 people presenting a variety of views. We had: general partners; limited partners; legal experience from SJ Berwin; and great support from the EVCA secretariat. We also tried, where possible, to bring in people who had experienced more than one side of the fence - we have one person on the task force who has been a lawyer, a general partner, and a limited partner. The members of the task force also represented the Professional Standards & Communications Committee, the Investor Relations Committee, and the Tax & Legal Committee.

The document is produced in two core sections. The first consists of nine governing principles that should be observed by a private equity manager throughout the life of a private equity fund. The second section provides examples of their application. Why did we take this approach?

When we began, I think we wanted to produce a how-to manual to cover every situation every private equity fund might encounter. We quickly realized that we have a very diverse industry. One that ranges from the mega buyout funds managing billions of euros, operating across multiple jurisdictions, with teams of up to 100 people. At the other extreme, there are some very small funds focused perhaps on a region or perhaps on seed-stage investment, with two or three people managing perhaps tens of millions of euros. Secondly, we have an industry that operates in multiple jurisdictions, ranging geographically in the west from Ireland, through Western Europe to Central and Eastern Europe.

Governing Principles

We have members operating in all of those countries and raising capital across the globe. So we have a wide variety of types of firms and a wide variety of jurisdictions. Therefore, a single sound practice manual would be thousands or tens of thousands of pages long and out of date by the time it was printed.

THE NINE GOVERNING PRINCIPLES	
1.	The Law
2.	The contract
3.	Integrity
4.	Skill, care and diligence
5.	Adequacy of resources
6.	Investors' interests
7.	Transparency
8.	Conflicts of interest
9.	Investors' assets

We took the approach that we would start with governing principles which would run to one page. We've listed the nine principles here. Principle one, the law: a fund operator should make sure that legal requirements are met in the jurisdiction where the fund is established and in each jurisdiction in which it operates. That for us is a key principle. It overrides every other principle and so therefore acts as an umbrella to take into account the fact that we're operating across numerous jurisdictions.

The second umbrella principle that sits within the first – the law – is the contract. Every private equity fund has some form of contract establishing the vehicle, be it a limited partnership, an investment company, or whatever. The second priority, for a fund manager, is to ensure that the terms of the contract are followed. Again, that overrides any of the other governing principles.

Many of the remaining seven principles are self-explanatory: e.g. integrity, skill, care, and diligence. Adequacy of resources is one that we focused on because we felt it was important to stress the need to have adequate human and financial resources in a fund manager to carry out the investment strategy of the fund.

Fund managers need also to pay attention not just to operations today or this year, but to bear in mind that they are managing 10-year vehicles, typically, and therefore should be adequately resourced throughout the life of the vehicle. Transparency, principle seven, is also very important to the task force. The obvious application of transparency is in areas such as reporting. The examples recommend that the EVCA reporting guidelines are followed. It is also important to avoid prescription.

As an example, we haven't said you should invest say 75% of a fund before you start raising a new fund, because there are situations where that won't apply. What we've said instead is that you should set standards for when you raise a new fund and then be transparent with your investors about communicating those standards. So transparency is reflected throughout the document.

Conflicts of interest, investors' assets, are again very important areas. The document, in section C, provides about 50 examples of how we see the principles being applied throughout the lifecycle of a private equity fund. These take the format of a question, elucidation, and then a recommendation based on how we believe the principle should be applied.

We start by covering initial considerations in the formation of a private equity fund, followed by the fundraising process. We then go on to look at the other stages of the investment and divestment cycle, from investment through to the winding up of a fund. We also cover two non-lifecycle-specific areas: the management of multiple funds, and in particular the management of conflicts of interest between those funds. We've also spent some time looking at managers' internal organizations. So, throughout the document, we cover 49 specific areas.

For the task force, the production of the first draft of the document was only the beginning of the exercise. We – and EVCA's Executive Committee – felt that a broad and deep consultation with the private equity community was a vital part of the process. First, to ensure that we didn't miss anything critical and we didn't do anything which offended the industry; second, to give weight to the document; and third, perhaps most importantly, to ensure that as many people as possible feel a sense of ownership and support for the document.

Governing Principles

We've had continuous feedback throughout the task force life from the various EVCA committees, which represent a broad range of investors and general partners: the Executive Committee, the Professional Standards & Communications Committee, the Investor Relations Committee, and the Tax & Legal Committee.

CONSULTATION PROCEDURE

Consultation procedure involved:

1. EVCA Executive Committee
2. EVCA Professional Standards and Communication Committee
3. EVCA Tax & Legal Committee
4. EVCA Members
5. Limited Partners worldwide
6. National Venture Capital Associations across Europe

In November 2002, we started a formal consultation process, sending a draft of the document to selected general partners, limited partners, and the national venture capital associations. We had a meeting in January 2003 where we discussed feedback from that process and incorporated it into the document. What you have in front of you today is the final consultation document, which we believe will be close to the final version but which is still waiting the incorporation of feedback from the last consultation process. That last consultation process is concluding today, having started about a month ago. So we are near to the end of the task in its first stage.

We expect that the document will evolve over time. I believe that the principles will probably not change, but we may see more examples of their application added, and we may see refinements to those examples. We hope that the document will prove invaluable: for individual GPs, as an aid to covering issues in the development of their business; for LPs, looking at an investment in private equity; and for the industry as a whole, providing a testament to the high professional standards that we use.

Javier Loizaga mentioned Socrates and the need for discussion. Over 18 months of working on the task force with a small group, it is easy to become introverted. I was therefore very pleased, two weeks ago, to be at a conference in Munich where David Rubinstein, one of the founding partners of Carlyle, was speaking. He said that he felt that the European private equity industry had two key advantages in comparison with the US. The first is that we have a single association, in the shape of EVCA, the European Private Equity & Venture Capital Association, to represent the whole private equity community. That's a situation that doesn't exist in the US. The second advantage is the role that EVCA has taken in setting professional standards. He was referring to the valuation standards and the reporting standards. We, on the task force, hope that he and you will feel that these governing principles are a valuable addition to that body of work.

Questions & Answers

How far is this document from a full corporate governance document?

The document, as it exists today, is voluntary; it is purely a recommendation for EVCA members. Having said that, our experience from the consultation is that nobody has had any significant issues with any of the governing principles, and we would see that as something I think we would expect members to follow. Obviously, there is no compulsion, but we believe that a professionally managed firm will find it very easy to follow these principles. There are no plans currently to introduce a formal corporate governance program, though we also expect that we may see investors, over time, increasingly keen to see the governing principles incorporated by the funds that they're investing in.

The document excludes good practice with respect to syndication investors. Do you assume that everybody who applies the principles will work harmoniously in a syndicate?

When preparing the examples we felt we couldn't cover every situation. If you believe that that is an area that should be incorporated, we would be very pleased to consider that comment as part of the consultation process.

Would non-compliance with these principles be linked to the code of conduct or to the non-adherence to the code of conduct at some point?

That is not envisaged at this stage. The code of conduct is something we see as being very separate from the governing principles, although they all fall within the remit of promoting high professional standards within the industry.

Governing Principles

What happens when funds set out to invest in one area and then deviate from it?

To the extent that the contract incorporates the investment guidelines for the funds, it is covered by principle two. One of the areas we actually look at in some detail in the examples is the areas that we feel should be covered in the contract for the fund, whatever structure that fund takes. We believe that it's important that the investment strategy be incorporated into the fund documents. So, it's not a direct principle, but I think your question is answered by the fact that, if you follow the recommendations, you will incorporate those guidelines into the contract.

Would EVCA consider involving entrepreneurs in the task force?

If you look at the code of conduct, a lot of it is actually focused on the relationship between the general partners and the portfolio companies. It clearly is an important area for individual members and for the reputation of the industry as a whole. When we set out to work on the governing principles, the decision was taken to focus on the behavior of the fund manager vis-à-vis the investors. It's perhaps worth stressing that we focused on professional institutional investors into private equity rather than any duties that a manager might have if they're raising capital from unsophisticated investors. We took the decision not to focus on the relationship between the fund manager and the portfolio company, except in as much as it touched on the responsibilities to investors. But you're right, it is an area that could be incorporated in a future development.

Allocation Strategies - Past, Present & Future Investor Mind-Sets

This panel session examined the issues facing investors questioning whether private equity has outperformed listed equities and improved their portfolio distribution in recent years. How are allocation strategies evolving and is the market changing as a consequence of the range of new products, such as secondaries and funds of funds, that are growing. It began with a presentation by Stefan Hepp, a Founding Partner of SCM Strategic Capital Management.

Stefan Hepp led the questioning of the panel before opening up the discussion to the floor. The panelists were: Armin Braun (AB), Chief Investment Officer of the City of Zurich Pension Fund; Peter Gale (PG), a Pension Trustee of the Royal Bank of Scotland; Paula Chester (PC), the former Head of Private Equity for the New York State Common Retirement Fund; and Marinus Keijzer (MK), Chairman and Delegate of the Board of Directors for Private Equity Holding.

Stefan Hepp, *Founding Partner, SCM Strategic Capital Management*

Examining the context surrounding this debate is an important starting point. Obtaining an institutional perspective on private equity always provides valuable lessons. This panel takes place at the time when EVCA has made an incredible drive to open up what has been traditionally just an industry gathering to the limited partner group at large. We have seen the release of a new policy document on transparency and corporate governance.

The profound and common interest in the private equity market comes at a time when the oil price is reaching new highs and stock markets are in accelerated free-fall. If interest rates rise, what will be the impact on bond markets? Private equity may be a minority element to institutional investors' asset allocations but it is on their radar screen.

There are a number of key themes to consider. Performance of the funds that are being invested in remains critical. Over the long term of three, five and ten year periods, the returns from private equity at all levels have outperformed the main market indices.

PRIVATE EQUITY – PERFORMANCE UNTIL 3Q 2002*
United States (30.09.2002) in USD p.a.

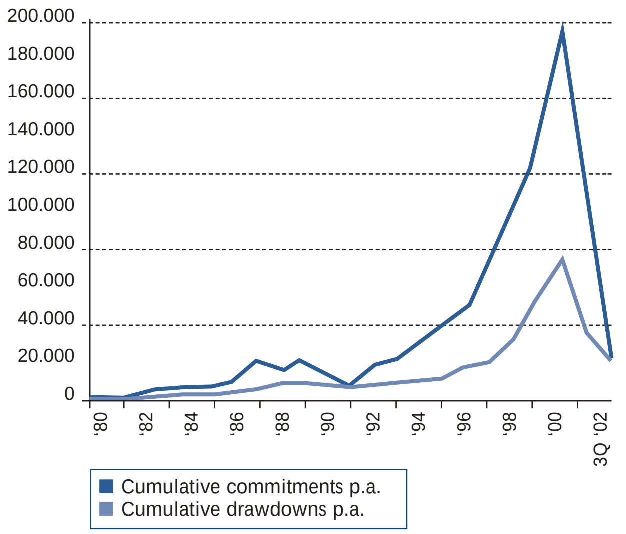
	1 YR	3 YR	5 YR	10 YR
All Venture	-22.11%	5.53%	17.97%	22.29%
All Buyouts	-7.36%	-2.05%	4.63%	12.13%
All Private Equity	-12.05%	1.98%	9.80%	15.94%
S&P 500	-21.67%	-14.02%	-2.96%	6.91%

PRIVATE EQUITY – PERFORMANCE UNTIL 3Q 2002*
Europe (30.09.2002) in USD p.a.

	1 YR	3 YR	5 YR	10 YR
All Venture	-3.88%	10.36%	14.71%	14.18%
All Buyouts	-1.30%	4.73%	12.94%	10.69%
All Private Equity	-1.72%	6.91%	12.78%	13.24%
MSCI-Europe	-19.14%	-13.42%	-3.63%	6.86%

Meanwhile, European investors are gaining in significance. Today, more money is coming out of European pockets to fund the industry than ever before. This is not the result of an overall increase in the amount of money invested in the industry, but it is a result of the fact that Europe held up better than the United States in terms of sustaining their commitment programmes.

COMMITMENTS AND INVESTMENTS OF US PRIVATE EQUITY*
(cum. amounts p.a. in USD million)

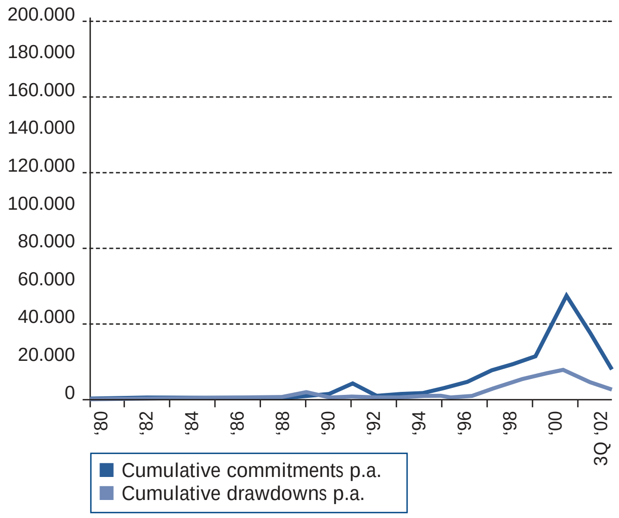


In terms of fundraising, the comparative chart shows you the US and the European fundraising picture. One could compare the US to Everest and Europe to the Matterhorn, with regards to funds raised in 1999/2000.

** Source: Thomson Venture Economics*

Allocation Strategies

COMMITMENTS AND INVESTMENTS OF EU PRIVATE EQUITY*
(cum. amounts p.a. in USD million, Drawdowns 3Q. 2002)



Things that go up steeply, fall steeply, hence the decline on both sides of the Atlantic with regard to new money flowing into the industry.

But what does this show? If we take venture capital out of the picture, we still have a strong bow wave of commitments flowing into the industry, but it looks decisively less extreme if venture capital goes out of the picture. So, do we have a capital overhang, or is the attractiveness of Europe partly a result of the fact that there have been, relative to the size of the economy, far less commitments of money in recent years than has been the case in the United States?

What has driven much of the motivation of investors to back private equity in recent times? Is it the success of the private equity industry for presenting a viable investment opportunity for investors, or the common greed on the street that attracted so much increased appetite for risk during the dot.com years?

From an investor's perspective there also needs to be a debate focused on the planning demands of investors. Most investors look to stagger their stakes in this asset allocation over a number of years as part of a well thought through plan. But in the context of declining equity markets, it is easy to see how the proportion of private equity holdings has risen rapidly as other indices have fallen. The question of contending with and resolving this is important.

** Source: SCM Strategic Capital Management AG*

Another key question that Europe has to face, and possibly learn from the US, is how to cope with a decline in performance, how to contend with a slowdown in realizations, and the overall decline in their asset base due to the fact that the stock market has clocked up significant negative performance.

How can European investors and funds apply the lessons which have been learned from the US in recent times?

PC: Most institutional investors are still actively seeking private equity investments. However, there are a lot of issues with regard to the kinds of deals that they are looking at. For instance, I think that investors will begin to demand a little bit more than they did in the hype of the fundraising environment that has been pointed out to in the year 2000. Investors in the United States are going to demand that general partners show some more performance. You will probably see investors looking for a slower investment pace and realizations before coming back to market.

With the public markets being down and no exits readily available it impacts the allocation statistics and so allocation to private equity is higher perhaps than the targets they have set. As the stock market keeps declining, this is very pronounced, especially as you have targets of between 5 and 7%. At New York State our allocation was 8%, which was set at a time when it was 5%, and suddenly as we saw the market drop, it was going to 6%, 6.5% or 7%. It had nothing to do with increased purchases, or acquisitions, or investments in private equity, but everything went to the decline of the denominator. Cash management issues within the funds are also going to become a key issue and one that has not historically been paid enough attention to.

How are UK institutional investors' attitudes towards private equity and quoted equity markets changing?

PG: When you get a big fall in quoted stock markets, where most of our assets are, and the private equity holds up, (in our case, it has actually carried on rising through the quoted stock market), you get a very large increase in invested monies in private equity. So I've breached all my own guidelines. Effectively, I should sack myself. It is a real issue, because the trustees actually don't understand this and believe that guidelines are there to be adhered to.

We're in quite a difficult position, because we're vastly over-allocated now in terms of our actual invested money.

What do you do? You try to explain to the trustees that this is a long-term asset class and it shouldn't be penalized because of the success of the strategy. But it is easier said than done, particularly when you've got actuaries involved, who tend to look at things in black and white, and then secondly lawyers, who definitely look at it in black and white. So, we're trying to persuade the trustees that this is a temporary aberration. My fear is that it isn't a temporary aberration, that there is a long-term structural bear market in quoted equities, particularly in America as a result of the over-investment boom in the 1990s. Hopefully, that fear won't come to pass, but we haven't changed our targets, so we are actually technically in breach of where we want to be.

Nevertheless, the last 3 years have been a real shock to people. Now, if anything, the mood is swinging the other way. There has been such a negative reaction that people are forgetting the power of equity, and they're swinging very much in favor of bond strategies. They're seeking protection in bonds, in my view a false protection, because the yields on bonds are very low. Because of that, they're actually a very high-risk investment, particularly if inflation takes off again.

The real concern is one of equities in general, and the bubble has been burst in a major way. My fear is that it will swing the other way. People don't take a balanced view about the power of equity in the long term. That theory is being mirrored exactly by trustees. At the end of the day, trustees are just representatives of the man in the street and they pick up the emotion of what is happening, particularly in the press. So that is the fear. As a result, I think that equity allocations in general will suffer and private equity will be caught up in that. Because, at the end of the day, private equity is only an equity, a geared form of equity.

How has the fall in the equities markets impacted the investment decisions of the City of Zurich pension fund?

AB: So far, the falls have not impacted our decisions. I think a more efficient secondary market could help the private equity industry as a whole, from this point of view. I also think that general partners who still hold on to contractual terms that give them the right to prevent limited partners from selling their stakes without any good reason are detrimental for the private equity market.

For many people private equity is a new investment class. We began to invest in 1998 and now, when people read about Enron, about Swissair, they are of course afraid that we will have the same bad experiences in private equity. We have to educate our board members that investments in private equity are investments in the real economy. We have to show them that we feel that we are able to find and select good partnerships, which are able to select and find good investments. I think the most important thing to say is that they can add value to these companies. When one takes this positive approach, even the likes of trade unionists who sit on trustee boards can be convinced of the merits of the investment schemes.

What are the benchmarks that investors have?

PC: The times of getting three, four and five times your money back are gone in the venture market for the current time. Nonetheless there remains an expectation of a reasonable return. Historically that would have been a return of two times cash-on-cash but time erodes an IRR and currently the focus is on longer-term holdings. Currently the private equity market is contracting and ridding itself of individuals who should probably not have been in the market in the first place.

AB: Our expectation today is a performance that is about 2% above listed equities. But the second point, for us, is diversification. Private equity returns were driven by the bubble on the stock market. In the future we shall rely on the ability of private equity partnerships and general partners to build up good portfolios. If this is the case, I think that we will get a diversification effect in comparison with the listed equities, where stock market fancies and doom-and-gloom will have a higher influence on valuations than on private equity.

PG: Only when you determine the objective of why you are in private equity can you rationale what the scorecard is. Private equity is a geared form of equity. It is not there as an absolute return. We look for a premium that is above the quoted markets, in the region of 4-6% per annum, in terms of return.

Allocation Strategies

Our benchmark for performance is based on time-weighted returns. We are interested in the performance of all of our assets that are out there in the marketplace, rather than the IRR basis, the cash-on-cash basis, which others look at. So, when we talk about premium, we talk about performances we measure, i.e. the performance of all the stocks all the time. The answer is a substantial premium.

Secondly, private equity is not insulated from the world economy and the stock market cycle. The drivers of private equity are still the same drivers that drive the world stock markets, such as economic growth and enterprise. So the only scorecard available is how we are doing versus our equity portfolios.

Nonetheless there is a need to be very careful in terms of where the money is directed, when it is invested and in which part of the world, fundamentally where the cycle remains critical to the performance of your investments. Our private equity values have carried on going up, and quoted stock markets have plummeted. Over the last 3 years, we have had something like a 60% differential in performance between our quoted portfolios and our private equity portfolios, which results in us being oversupplied in private equity right now.

What role does timing have on the investments made?

PC: The large pension funds are not market timers. And so, to some extent, getting in and out of the market is something they do not do. At New York State, we used to have an asset allocation study every three to five years. But generally, it was the same. Your public equities are going to range between 60% and 70% of your portfolio. There are unlikely to be major changes and this means the same for private equity. But because it is a longer-term strategy, you should always be in the market.

What regulatory changes are impacting the private equity industry?

PG: In the UK, it is not so much a question of regulation as trends in the industry.

The natural home for private equity is the large pension funds, which tend to be fund salary schemes. And within fund salary schemes, basically two assets are held: fixed interest, to match known liabilities; and equity, to match unknown liabilities, active members. We don’t know how much is going to have to be paid out for such members.

One of the major themes of the last 5 years, particularly in the UK, is that such schemes have been tending to become more mature, as large companies downsize their workforces. And secondly, it has become an increasing theme that fund salary schemes have been shut down. Almost 50% of all major companies have closed their fund salary schemes to new members. That exacerbates the issue of this aging process of schemes. The implication of that is that, for schemes such as the one I run, the natural investment asset has become bonds rather an equities. The pot available to be allocated to private equity is shrinking, not because of private equity, but because of the demographics, the parent scheme.

Regulation is just reinforcing that theme, it is not creating it. In the UK, it is largely an accounting issue. New accounting regulations are coming in that are forcing finance directors and trustees to look at surplus or deficit on an annual basis. They are being encouraged to match more closely assets to liabilities, hence reinforcing this bond issue. One scheme has taken it to the extreme: it got out of equities completely and moved completely into bonds.

AB: In Switzerland, we must reach an annual return of 4% of the funding capital for pensioners every year. At present, government bonds yield roughly 2.2%, but we need 4% so there is a need to keep focusing on other investments. Discussions now in Switzerland have begun to find out whether it would perhaps be better to be a little bit more flexible when speaking about benefits. So far, it is not possible for a pension fund to lower benefits to pensioners, even when the financial state of the pension fund is very critical. That, perhaps, is detrimental not only for the pension fund but also for the members and the pensioners when we look in the future. Would it be possible, if necessary, to decrease benefits for one, two or three years, and be a little bit more flexible about investments? You should in theory be able to get higher returns in the long run.

PC: In the United States, the key regulatory changes relate to the freedom of information laws that are triggering so much discussion about transparency and disclosure of information. That is probably the most compelling regulatory issue, and it is not one, it is fifty, because every state has different laws. So if you haven’t thought about how it affects you, you really should if you have public limited partners as part of your investor base.

Allocation Strategies

There is a growing trend, starting last year, first with UTIMCO, which is a Texas pension fund, and then in California, both with CalPERS and CalSTERS, where they were required to disclose fund information to the public. The inquiry came from the press, and there is no politician in America who will get up and say this is not a good thing.

The biggest concern to the general partners is how far down, in terms of the disclosure, the issue is going to come. Most fund managers, at least in the US, but probably here as well, assume that fund performance information is ultimately going to have to be disclosed. In New York State, we never disclosed that information, nor did we get a freedom of information act request that was contested in the courts.

Every fund must realize that freedom of information act laws state that a state pension fund does not have to disclose that information if the information contains trade secrets or is proprietary. Unfortunately, in the case of a portfolio company, it is really not up to the pension fund to actually say that it contains trade secrets, because they are your trade secrets, not ours.

Building Businesses - The essential value-added tool kit of General Partners

This panel focused on whether GPs are armed with the necessary skills to build great businesses. How do they approach the value-added challenge from their diverse investment strategies and focus? Are local and global players equally prepared for the task? The moderator of the panel was Leslie Brun, Chairman of Hamilton Lane Advisors.

The panel was conducted in front of an audience, with the moderator leading the questioning initially. The panelists were: Michael Hoffman (MH), Co-Founder and Managing Partner of Palamon Capital Partners; Paolo Colonna (PC), Chairman and Managing Director of Permira Associati in Milan; Wim Borgdorff (WB), Director of NIB Capital Private Equity; and Jonathan Clarke (JC), Director of Cinven.

Leslie Brun, *Moderator and Chairman, Hamilton Lane Advisors*

As more people ask where the returns will originate from, the emphasis on how funds are structured and run is a growing concern. Manager selection is arguably the critical element of a successful private equity experience for an investor.

The era of risk-free returns is long since gone. The enormity and magnitude of the bubble, and its consequent bursting have colored the views and opinions of many practitioners, particularly investors, who are feeling the pain, not only in their private equity portfolios, but overall in terms of total portfolio size, and the consequent depression of the public markets. How value is generated and how businesses are built, will be the key driver in how returns are generated.

What are the key issues impacting the operational management of private equity funds?

WB: At NIB Capital we manage a €15bn investment programme. The greatest asset of our programme is the network of the best of breeds, GPs, in each segment we are targeting. For that reason, understanding the investment managers is one of the key things we need to get right.

MH: Whilst we are not operators, we must accept a willingness to take a very active role in the companies we invest in. The fund's own business success depends on its ability to invest in the right companies. Therefore we must be involved in reviewing and setting their strategy, ensuring adequate internal systems, ensuring the right financial structure and financing arrangements within a company, and helping to assess and in many cases helping to make acquisitions for them.

JC: A very important part of what we do is the post-mortems we carry out after exiting investments, successful or otherwise. We invest a lot of time in examining what we did right or wrong to ensure we learn from it for the wider benefit of the business.

Are there differences between the venture orbit and the private equity buyout fund world in terms of how to build these businesses?

WB: There is a need to distinguish between venture investing and private equity funds. My view is that operational value-add is neither present nor required for many venture firms. Investing in these funds is akin to taking an option on a sort of potential breakthrough growth opportunity somewhere in the future. When the growth is not going to kick in somewhere along the line, that option will simply expire. If you look on a quarter by quarter basis, there is something like a 5-6% devaluation process going on each quarter, and those were the options which expired during that period.

Secondly, most venture funds partners do not have enough time to make a difference to their investments. They average ten board seats per individual. Recognizing that 50% of the time has to be spent on making new acquisitions, there is simply no time available for partners to micro-manage their investments. The question then is whether that is an issue in venture land. Should you be scared of that? At the end of the day, in a growth play, in a growth investment strategy, we think that 90% of the value created simply comes from selecting the right opportunities at inception, and simply sticking to it. When, in a venture setting, you have to go into value creation, i.e. doing difficult things to a company, then you are probably already in trouble.

On the buyout side, of course, the story is quite different. Our current assessment of many of the strong buyout firms is that there are quite a lot who are wrestling with the change in the marketplace. A lot of firms have invested quite a lot of time, resources, and energy during the end of the 1990s to build those sorts of growth-oriented practices. Now they are going back a little to basics, and focusing more on value vs. growth, which takes time.

Building Businesses

For those who take a value-oriented approach, there are some whose sole objective is merely to get in at a cheap price, then sit and wait until the market recovers and valuations turn back to more average kinds of numbers.

But within this value-oriented box, there is also a change towards working on more distressed, complicated, difficult kinds of transactions, which are difficult to structure, originate and get out of the hands of distressed sellers - where huge amounts of work can generate huge value.

The mid-market part of the fund scene is the most popular with investors currently. How can those funds try and build their businesses and add value?

MH: In recent times, the mid-market has seen a high level of actual investment, compared to some of the other areas. There is a wide range of exit options, allowing the next owner, which may be a financial investor, to continue to develop the business. And importantly, there has been cash distribution achieved. We are essentially, in this space, intermediate owners helping businesses undergo significant change driven by often highly-focused development strategies.

Generating value and subsequently realizing it does not necessarily involve building through acquisition, though many successes can be pointed to. Like most managers in mid-market investments, we are keen to help implement strategic and operational changes in the existing assets, rather than simply injecting capital in order to grow through acquisitions. Our approach is to find and drive scaleable growth platforms. The objective is to create a business that somebody else wants to own.

There are a number of ways by which mid-market operators can lay down the markers that will determine their ability to maximize the value of these deals. These include using the due diligence process to set your approach so allowing you to develop strategic insights as to how the business can be grown, whether it is through vertical integration or external acquisitions.

Identify possible or obvious gaps in management and their shortcomings that can be addressed. Most growth-phase businesses have incomplete management teams. I can hardly think of a growth investment, and I have been involved in some 40 investments over the last dozen years, where we have not had to make significant changes within the management team.

One hopes to find and buy into the ideal management team and is able to support that, but the practical reality is that a lot of changes need to be made. Timing is essential and the first 12 to 18 months of any investment are critical to its likely success. If you do not actually make significant strides in implementing them, you are probably going to be struggling uphill throughout your investment life. While we are not operators, we must play a highly active role.

The funds investment team needs to have strategy capability, systems knowledge, financial capability and acquisition capability. These might not all come at once but they are all needed. Most importantly, you need to get things done for your companies. Do not just attend board meetings. We all have to do those, but I must say, over the years, I view that as perhaps the least productive use of time. It is what happens between the board meetings that is important. You need to also be able to show the sorts of things that you can do for the companies, the difference that you can make.

Adding value can also come as a consequence of recognizing the role that leverage can play in adding value to the investment, enhancing the returns on equity. It is particularly true for rollouts and buildups, but it can also be very beneficial for growth buyouts, where a company simply has a superior wind to its back.

I have often seen that leverage has been underutilized, partly because things are going so well. We do not pay a lot of attention to that. We think about leverage perhaps ahead of time, and we think about figuring out where to find debt when we have problems. But when things are going well it is essential to consider how leverage can make a difference as a value-added element on its own.

Is earnings growth the key driver of success?

PC: Market globalization and sector consolidation are the key drivers that make buying other companies the easiest method of building businesses. But it is not always the best way. Companies that lack critical mass end up getting bought. We always compete against trade buyers and have become a trade buyer, but with a financial approach. But a key question is how we build value in the companies that are backed, which grow organically rather than through acquisition.

Building Businesses

The key answer lies in terms of helping them add size and by implementing our knowledge in turnaround situations. Size, not only because you trade in multiples, but because you can appeal to better management, and because you are a much more solid and less risky business. It is much easier to make a turnaround part of a successful group than do a turnaround on a stand-alone basis. A few years ago many were driven by growth decisions whereas today our decisions are based on turning around businesses that need to be built.

How important are buy and build investments to the wider strategy of a fund that wants to build businesses?

PC: A good example for us is Ferretti Yachts. With outlets in Italy and the US, the Ferretti yacht group had very strong synergies in distribution but the business had a number of management issues and needed to grow in terms of its scale and reach. We found excellent management and put it in place in four companies that were almost bankrupt. We were able to involve two very successful entrepreneurs with their own company to co-invest in the group, to bring their company in the group and co-manage the group. It became one of the few successful IPOs in Italy. This is an exceptional experience that we are trying to repeat right now, with a totally different fund. Originally it was our Italy 2 fund that struck the agreement but now it is a huge fund and we are coming to the US next to buy a few other companies in this field.

How can you review how successful you have been at building businesses?

JC: One of the things we do in particular is build a value creation bridge between the cash we put in and the cash we get back: have we generated increase in value for our clients' money?

We normally break that down into three elements: one is leverage and cash generation out of the business; the second is movement and multiple; and the third is earnings growth. By far the largest component to value creation, across our history, is earnings growth.

Earnings growth does not come about by accident; there is a considerable amount of effort expended to ensure that it happens across the portfolio. There are four contributing factors to that. The first one is people. Our directors have spent more of our working lives at Cinven or in the private equity industry than we have spent doing anything else.

Secondly, we devote a great deal of time prior to making an investment working out what is our strategy for that investment during its whole life. How are we going, hopefully, to take this small investment to a large investment? That strategy is quite often vital to the success in winning a transaction. It certainly is vital in having a systematic way of dealing with the investment after you have acquired it. And it must encompass what your exit is. There is no point building a business that nobody wants to buy at the end of the road.

The third element is, I am afraid, people again, the management. A major part of what I and my partners do is assess and, where necessary, change and build the management team who are actually implementing the strategy we have determined. This is absolutely critical in our investments.

The final point is monitoring that investment. I talk to my investments on a regular basis, sometimes daily, certainly weekly. It is not a matter of simply turning up to board meetings. You cannot do that and grow systematically businesses.

If one reviews Cinven's investment in the UK's National Car Parks, it provides an illustration. Internally there was a view that there were in fact two businesses under a single corporate structure. It was actually a property ownership and investment company, and a car park operator. Once we had come to that realization, and that was a very long iterative process rather than a blinding flash of light, our strategy for dealing with the acquisition, the business and the management flowed out of that. We structured the acquisition by way of a mixture of a sale and lease-back of the property assets of the business, leaving us, net of that transaction, the car park operating business, which we called Opco. That structuring helped us win the deal, whilst maintaining very attractive equity returns on the Opco investment. Secondly, it gave us a clear strategy for the business going forward: it was to build a car park service business.

That was a very clear mission for the management team, whereas historically it had been much more blurred, and there was much confusion whether they were there to develop property sites, or whether they were there to grow parking income.

Having got to that point, we took a look at the management, and decided we did not have the right team for that strategy. We promoted a new chief executive internally, recruited a new CFO and recruited a new chairman, a very able individual who has come out of the facilities management industry. Having got a new team and a new strategy in place, we do not leave the investment alone. I talk to the relevant members of management, regularly. I am afraid the sale and lease-back is much easier to say than it is to do, and if you are selling and leasing back 140 properties, that takes a lot of time. There has been a lot of work and discussion involved in fleshing out the detail of that strategy, and more importantly the implementation.

And then, there has been a lot of discussion with the chairman and chief executive about what management structure and what people you need below the top team to actually implement that strategy. But, throughout it all, we have got now a clear vision of where the business is going. We have got a management team that share that vision, and hopefully, with a lot more work, we will get to the right result in terms of value creation.

So should returns be at the heart of all strategic decisions?

WB: In current market circumstances, there is a clear opportunity to buy good assets at attractive prices. In order to create value based on that, you need a recovery of the marketplace to exit. I would argue in those sorts of situations that you are fairly dependent on economic development in itself. In other cases, like Jonathan, Paolo and Michael have described, of course, there are ways, even in the current environment, to increase earnings of a company.

The issue of improved valuation is not as prominent as it has been historically. Currently, times are so severely distressed that exiting is close to an undoable job. Even if growth is not returning rapidly to our marketplaces, the situation is a little bit more normalized. In many cases a number of our firms have proven that during this year, and last year they have been able to exit and create liquidity. But then, you need well-positioned assets which have strong and dominant market positions in their targeted industries.

MH: It behooves the GPs to focus very carefully on bringing capital back. That is what is required and there are various ways to do that. Where there are no IPOs and where trade sales perhaps are difficult, because the trade companies themselves do not have the value in their own currency to be able to construct an acquisition, you need to think creatively. You need to be thinking about ways, with some of your businesses that are profitable and have a fair amount of cash, to look at ways to recapitalize the business, to bring as much of the base cost as you can back to the investors as rapidly as is possible. But in these conditions, in these circumstances, the investors do want to see returns. I think it is impossible to raise new capital unless you have really shown substantial realizations. And therefore, you need to be much more open to alternatives.

JC: Undoubtedly cash-flow is a topic that most LPs come to sooner or later in every conversation. The key way to approach that is to be communicating with your LPs about what is going on in the portfolio. Equally, you have got to be open to communication and listen to their needs. Therefore as an industry, as a firm, we have to strike a balance between the desire to hold on to an investment and sell it at the absolutely optimal time, against the clear need of the client to have cash-flow. Certainly, what we have endeavored to do through the current difficult times is to keep cash flowing back to our clients.

WB: Action speaks louder than words. To some extent, of course, information is key and is vital. We are hammering a lot of our GPs from the point of view of getting real disclosure on things going on in their portfolios. Of course, you can keep a relationship going based on warm words for some time, but at the end of the day, some real proof will have to emerge. You can explain to an LP that in the current environment it is not in their best interest to push towards exit at any price. But as soon as the market has changed a bit, you should really be able to come up with very convincing proof to get the full confidence back.

How can you build a business at a time when a fund might include lots of distressed investments?

JC: Hypothetically, what we would do I suppose is two-fold. There are clearly a number of operators out there in the secondary market. We also occasionally get the situation where, at the time of our closing, there are one or two investors who maybe could not make the time scale, and hypothetically, we would have introduced them to people in that situation. We also become aware of investors coming into the market after we have closed our funds. Quite often, they like to talk to us at that time.

It is not fundraising, it is a less pressured dialogue. So we find that we have built up a list, which is not enormous, but a list of people who have expressed interest in our funds. We are very happy to put those parties together, hypothetically. What we do not do is, obviously, try and manage the process. There are an awful lot of potential conflicts of interest there, but certainly we are aware of sales of at least one of our holdings going very successfully.

WB: There is a clear mechanism in the marketplace to take care of those sorts of situations. But, especially in very venture-oriented portfolios, the whole process of recognition of what has been going on in these portfolios, and the valuations which are coming up to a limited partner in many cases are not a solution he can handle internally from the point of view of reducing his exposure to this asset class. So then, in many cases, they normally choose to simply sit and wait.

Disclosure and Transparency

This panel session examined the growing issues surrounding the demands for greater disclosure and transparency that originate from investors and the media. The moderator of the panel was Richard Rivlin, Founder of Bladonmore Training and Bladonmore Publishing.

The panel was conducted in the form of a question and answer session in front of the audience. The panelists were: Graeme White (GW), Managing Director and Head of Private Equity at Barclays Private Equity; Claus Stenbaek (CS), Executive Director and Partner of Danske Private Equity; and Raymond Maxwell (RM), Managing Director of Private Equity at Invesco.

Is the discussion symptomatic of the current difficult economic times?

RM: During the 1990s, no one believed disclosure and transparency was an issue. People were too busy focusing on their returns. But with markets declining and corporate scandals growing such as Enron and Worldcom, disclosure and transparency has become a major issue.

In certain quarters investment discipline declined but we are now in a new era. The onus is firmly on general partners to provide their LPs with better quality information. But the details of how much information and the methods in which it is best transmitted still need to be worked through. For instance I have lots of misgivings about putting information on the web unless you can actually set the context in which that information is given. The debate is not dissimilar to the UK government league tables for schools and hospitals. Ultimately they are meaningless unless you understand the dynamics that drive education and health, and for private equity as well.

It is very difficult to know what the standard should be, but if the information is purely for public consumption, then we all have to be careful, because it may, in the long term, modify and modulate the way in which venture capitalists and private equity management teams make their investments.

CS: Due to a combination of the general economic depression and the mega scandals of Enron and Tyco, drastic and hasty, quick and dirty measures, however warranted, have been introduced in corporate America. Due to further, much publicized, inquiries into private equity returns in general and through the disclosures by UTIMCO and the San Jose Mercury News and CalPERS lawsuit, a lot of attention has been drawn to disclosure and transparency, and I think our industry is also facing possible frantic overkill by regulators and government. It will probably happen first in the US and later on in Europe.

Where we are at currently in the debate is akin to the early stages of just putting a few drops of firelighter onto a barbecue. We might not want a big fire to start and we have to ensure our hand stays firm so as not to throw too much firelighter around.

Providing short-term information about a long-term asset class could be open to misinterpretation and could be meaningless as it cannot be properly digested and analyzed and put into the context of the individual policy holder, whether it be a state teacher, fireman, railroad worker, or university professor for that matter. Journalists' objectives are to sell magazines and newspapers and they need to find people to name and to blame when things go wrong, as much as they love to lift them to the sky when things go well.

But there is a price, and the private equity industry ought not to get into the same situation as the public markets, where the requirement for quarterly reporting is mainly to satisfy equity analysts and to create turnover for investment banks and stockbrokers. It is detrimental to management's ability to drive long-term businesses, because short-term decisions will basically be the ones that will drive the stock price. However, all that being said, and no matter what you think about the background of the situation, it is clear that tougher and stricter information requirements will prevail within this industry in time. Standardized reporting and accounting will be required as well. We should use this opportunity to proactively work with regulators and government to define the levels of information and disclosures required, to set acceptable standards in reporting for IRRs and multiples, and to create a standardized reporting framework of minimum reporting requirements to unify data and make data comparable. This would be good for the industry as well, because the better the data the more acceptance the asset class will have and the less volatility will be pursued by investors, with possibly better allocations as well.

GW: Private equity is clearly now an established asset category. We have a wider investor base, a deeper commitment from investors, and it seems to me that this is a normal development in the private equity industry.

Whilst there may be some acceleration of that by virtue of Enron et al, I would say that this was coming anyway. The debate and calls for greater transparency and disclosure is really a natural evolution and not something that is symptomatic of the current times.

Will you all be investing more money in your investor relations functions in the coming years? Are these individuals becoming more highly valued members of your teams?

CS: Investor relations is important, however investor relations between fundraising periods is more important, and has become so, not only with the need to disclose information about returns but also to keep investors updated about the general market and about what the fund is doing with their money.

The debate has moved on and the focus today is where within the organisation should these people sit. Today, a lot of the investor relations functions look to be a kind of extravagant Personal Assistant function, more like an information hub in the GP. I think what it should be is an integral part of the team, part of the place where information is made, where decisions are made as well, so that they can be a real value add to the GP itself. It will probably lead to having to re-examine their incentive structures as well.

The investor relations function that is today generally paid through salaries and bonuses should also probably have a place in the incentive structures on the carry side in order to become a more integrated part of the organization.

RM: The support function, particularly investment liaison with our investors and naturally with our investee companies, is very important. Investors should be very much aware of what they're investing in. The more aware they become, the less that a blame culture can be allowed to develop. A lot of people went into venture capital in the 1990s expecting it to do one thing, which was making a whole lot of money, and didn't really assess the risk. And now they're saying it is not their fault, that it has to be someone else's. Let us blame the fund of funds manager, let us blame a traditional fund, or let us blame the press. Regrettably this is not a risk-free world.

Investors must assess whether or not it is applicable for their investment activity, for their pension fund, for their insurance company. But there must be a good flow of information from the investee company to the investment manager, and from the investment manager to their investors. It is extremely important that everyone knows what is going on, and for us, and having worked in the pension industry myself, the important thing is that there are no surprises.

If there is bad news, we always like to hear it early. We're grown up and can accept it and would rather see it than wait, such as seeing a high valuation and then all of a sudden the investment written off. So I think it's becoming more important and those involved in these activities, in supporting the investment function, are becoming increasingly important and should be properly compensated.

GW: Funding is the lifeblood of the private equity business. Having recently completed a fundraising, one thing is clear and is a key point: fundraising is not something that you do every three to four years.

You need to build long-term relationships with your investor base, and that clearly means good communication. The point has already been made that there should be no surprises. There is also a need to manage expectations and, therefore, to communicate in a structured and efficient way. No investor would want us to be knocking on his door every second month of the year with more news and updates on the most recent exit discussion. And in that respect, it is quite important to manage expectations. But above all, it has got to be enlightened self-interest for private equity houses to keep their investors well-informed and to build those relationships.

Who should be setting those guidelines? Should the guidelines be coming from organizations such as EVCA? Or should there be more self-regulation?

GW: For investor relations there should be more self-regulation. It is difficult to see that EVCA should impose some sort of regular form of reporting or indeed regular form of visiting to the investor base. The formatting and the information that flows in terms of valuation should certainly be something that is consistent. The detail and the business of looking after your investor base must be left to the GPs.

RM: This industry is still a fragmented one with many different players and many different products which are getting broader all the time. Attempting to standardize reporting is extremely difficult, especially as there are so many different debt instruments, off-balance-sheet mechanisms, warrants and dividend payments. To standardize that would be extremely difficult. Nonetheless there does have to be some sort of consistency in terms of valuation. The problem, of course, is that valuation is nevertheless still more of an art than a science. And if anything, the BVCA guidelines are becoming much broader, recognizing that each individual investment is different. So it behooves the GPs to explain very clearly what the underlying assumptions are in respect of each investment. Now that may mean that, in terms of reporting, it is going to become a little bit more onerous. Nevertheless, that is going to be much fairer and I think that the investors are actually going to be able to understand what is going on a lot more clearly than actually just trying to place an arbitrary valuation forced upon them by either a regulatory body or any other body.

CS: The industry will be forced to have some new rules, or regulatory framework, for the standardization of reporting of some kind, or calculation of IRRs, and also to define the levels of disclosure. In that context, I think EVCA definitely will be, for Europe at least, the organization that should take the upper hand in working with the other local venture capital associations to try to drive that in a good way for the industry.

How should one treat the tails inside funds that are coming to the end of their life and show no real sign of achieving high returns?

CS: There's a lack of attention at the back-end of a fund's life. Normally, both the general partners and the investors are particularly worn out by then, and of course, in most instances, there are two, three or more funds that have been raised subsequently. It is an issue. In the natural way of things, it is actually starting to be addressed. That is certainly because of the increase in the levels of secondary transactions. And so, to some extent, we are seeing a lot more groups actually buying these interests, admittedly very cheaply, but there is no reason why they shouldn't, because the impact of the back-end of a portfolio in terms of IRR is going to be fairly minimal. Of course most of the carry that was likely to be available has already been allocated and distributed to general partners.

Through the rise of the secondary market, these pieces are of little interest, although, on aggregate, they do mount up. They are now actually being addressed and cleaned up. However, there are a number of funds where I was happy to send them anniversary cards because there were still investments 13 or 14 years into the life of the fund, and it was becoming a common practice to see an extra year added on. And there was a big argument about whether or not there should be any management fee attached.

GW: Portfolios can go on beyond the usual 10-year life. I guess the private equity house has got to demonstrate to its investor base that it is capable of managing that, and managing out of that, in an effective way. And once again, it seems to me to be an opportunity, it seems to be a way of encouraging your investor base to believe that you are a better GP at the end of it all. So, I think it is a question of close management and considering the business to be a long-term business. In some funds, companies just disappear. You look in the footnotes at the end and you see that the company was liquidated somewhat quietly, but you don't hear about it until the year-end report. It is those kinds of things that tend to raise questions rather than add transparency.

CS: Much still depends on the GP; some are very good at reporting on a quarterly basis or even, if they decide to do something with the company, in between reporting. I think we've already seen the first examples of funds that are coming out and trying to make deals with their LPs to wave the escrow or the claw-back for reduced or waived management fee for the rest of the life of the fund.

RM: Not only do some fund managers lose investments, some of them actually lose whole funds as well. But I think it actually raises another question, which is extremely important: is a 10-year limited partnership really applicable for all types of investment in private equity? I would contend that it may work for buyouts, where the gestation period is normally pretty short, maybe three or four years.

But for venture capital, particularly for seed and first round, if they're actually staying in that deal, given the attenuation, then it is very unlikely that 10 years actually works. I started out doing this in the mid-1980s and it was very rare that we actually saw a venture fund be in the position to realize many of its interests by year 10.

How much prescription is needed in determining the valuation methods?

RM: I suppose the problem is if you have something which is prescriptive, how can you value different deals? How does an art dealer value a Titian, compared to a Caravaggio, compared to a Kandinsky? I would agree that, to some extent, there has to be a degree of prescription, so there is a level of consistency, and that is extremely important.

Nevertheless, that consistency also then has to mirror reality, and whether or not it makes sense at the time. So, as an investment follows its journey to an exit, at least at certain points we can recognize some thought in terms of the underlying value. But it is extremely difficult. I don't think there is a right or a wrong way. From our standpoint, all that we are looking for is a degree of consistency, so we understand what is actually going on, and that there is some logic behind the way in which the valuation is formed.

How are management and transaction fees evolving? Will it be an area with scope for greater transparency?

GW: The management fee is essentially there to cover the cost of running the private equity business. Out of 24 investors in our fund, no one raised management fees as a big issue, which isn't to say it wasn't mentioned, but it certainly wasn't regarded as a big issue. Clearly that doesn't deal with poor performance, nor does it deal with a concern that the investor might have that this is money that is not being invested with a prospect of a 30+% return or whatever the target might be. My experience, through the last fundraising, was that this is not as big an issue as it has been made out to be in some quarters. I also think there is not much emphasis on transaction fees, although it is probably an area where investors would like to see more capping, which is to say the normal formula is sharing at 50-50 between the LPs and the GPs. But on top of that, I think capping is something that investors might like to see going forward.

CS: Have management fees gotten out of hand? I don't think they have actually. Should there be a justification of management fees to the investors? It depends really on the fund. It is not a clear-cut thing and it is very difficult to set standards across the industry. Are you looking at a very large buyout fund or a much smaller one? One must look at the size of the organizations behind them, and look at what they are doing, whether they are making too much money in one place to take away incentives maybe from the carried interest on the other side. So, it is a balance.

A budgeted fee approach has been used in numerous funds and I think many more are thinking about that. It makes sense for a buyout or maybe even a venture capital fund. For fund of funds, however, that case is somewhat different because a lot of institutional investors, particularly in the US, are not keen on paying very large carried interests. And, as a firm, you really have to make money. That is why we're all in business. Whether you make money one way or the other, the individual investors, at the end of the day, have to find out whether it is the right balance between the incentive to actually create performance and return to the investors.

RM: In the 1990s no one cared because net returns were exceptionally good. If the gross returns in the industry are coming down, the impact of the management fee on those returns is much more exacting. The net return falls away very sharply because the management fee is something you're paying very much up front, based on commitment, which may be questionable. For example, in the first year of a fund 2% of that fund is drawn down. Effectively, you're paying 20% of that called-down money, so it is actually extremely expensive.

Private equity covers a huge range of activities from seed funds through to LBO funds - very large funds. I was very much brought up on the idea that the management fee is there to make sure the activity runs smoothly. The real economic interest is in the carry. If you're in a business where - because the quantum of money you can raise generates a phenomenal management fee and you are able to effectively enhance that by raising funds on a periodic basis every two or three years, without necessarily increasing your overhead - then there is a huge amount of profit that may go through to the management company. The key issue is: does the model of behaviour change? For a number of funds, is it more important to generate a management fee than it is to try and generate profit and, in doing so, create a carried interest? Some may argue it is, some may argue it isn't. What is very clear to me is that, if the asset class as such, at the gross level, performs poorly, then the net returns to investors and then, if it's through a fund of funds, although we are by nature extraordinarily modest in our fees to our clients, the net return to them is actually going to be quite derisory.

It is something that we actually have to look at, but it is not just about management fee, it is about the way carried interest works and whether or not we should have performance elements in the fund. My view is that 20% carried interest is not necessarily the right figure. I would rather see incremental performance introduced, the step function: the greater the level of performance, the higher the carried interest.

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This Special Paper has been compiled and edited on behalf of EVCA by Richard Rivlin, Founder of Bladonmore Training and Bladonmore Publishing.

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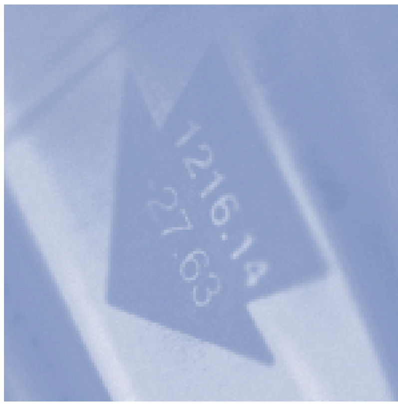

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The European Private Equity and Venture Capital Association (EVCA) exists to represent the European private equity sector. With over 950 members throughout Europe, EVCA's many roles include providing information services for members, creating networking opportunities, acting as a lobbying and campaigning organisation and working to promote the asset class both within Europe and throughout the world. EVCA's activities cover the whole range of private equity, from seed and start-up to development capital, buyouts and buyins, and the flotation of private equity-backed companies.

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