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# The Fortunes of Private Equity: What Drives Success?

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Both market and management factors drive returns in private equity. Most firms can attribute about half of their returns to the market, but the returns of top performing managers are less sensitive to public markets than are those of average managers. The key to management success in private equity is skill in manager selection.

**M**any institutional investors question the degree to which private equity adds value to a portfolio. They want to know what they can realistically expect from the asset class. In this presentation, therefore, I will attempt to help institutional investors better understand the drivers of success in private equity, both market drivers and management drivers. I will treat buyouts and venture capital discretely, even though as a group of alternative assets, they tend to cluster together in institutional portfolios.

## The Promise of Private Equity

Most investors expect three things from private equity—higher returns, diversification, and alpha. In return for these benefits, most investors assume they must incur higher risk, although, interestingly, few investors are specific in identifying the actual nature of this increased level of risk. I hope, therefore, that my remarks will clarify the actual sources of return and risk in private equity. Unfortunately, the data in private equity can be somewhat opaque, and we lack the systematic databases available on the public side. But some sources, such as Venture Economics and Cambridge Associates, are available to provide data that can be used (at the risk of oversimplification) to compare long-term results in private equity with long-term results in the public markets.

Looking back over 20 years, most observers agree that private equity firms have had mixed success. Reasons for such outcomes include the effects

of good and bad periods for investments in general as well as the validity of various strategies and the actual execution of strategies. Therefore, institutional investors want to know how private equity is likely to perform in normal market cycles—in good times and bad. They also want to know which strategies are most effective. Unfortunately, the data needed to provide sharpened insights into strategies are only just beginning to emerge.

Of all asset classes, private equity probably has the greatest variation in returns as a function of management. Such variation implies great difficulty in understanding the market, but it also implies great opportunity because where large variations occur, security selection can provide significant returns. Therefore, I intend to frame my discussion around two possible sources of return in private equity: the market itself and the management of assets.

The private equity market is not so segregated that it is unaffected by public market company prices. Therefore, developments in the capital markets and the macro economy drive developments in the private equity market. The question is: To what degree do capital markets affect private equity at any given time? Many of my comments will be directed at this question.

As for the variation in results based on private equity management, I will concentrate on trends and data that will help differentiate the various management factors that affect private equity returns. Finally, I will describe how market and management factors combine to provide institutional investors with insights into the most likely sources of value in private equity.

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## Return Drivers

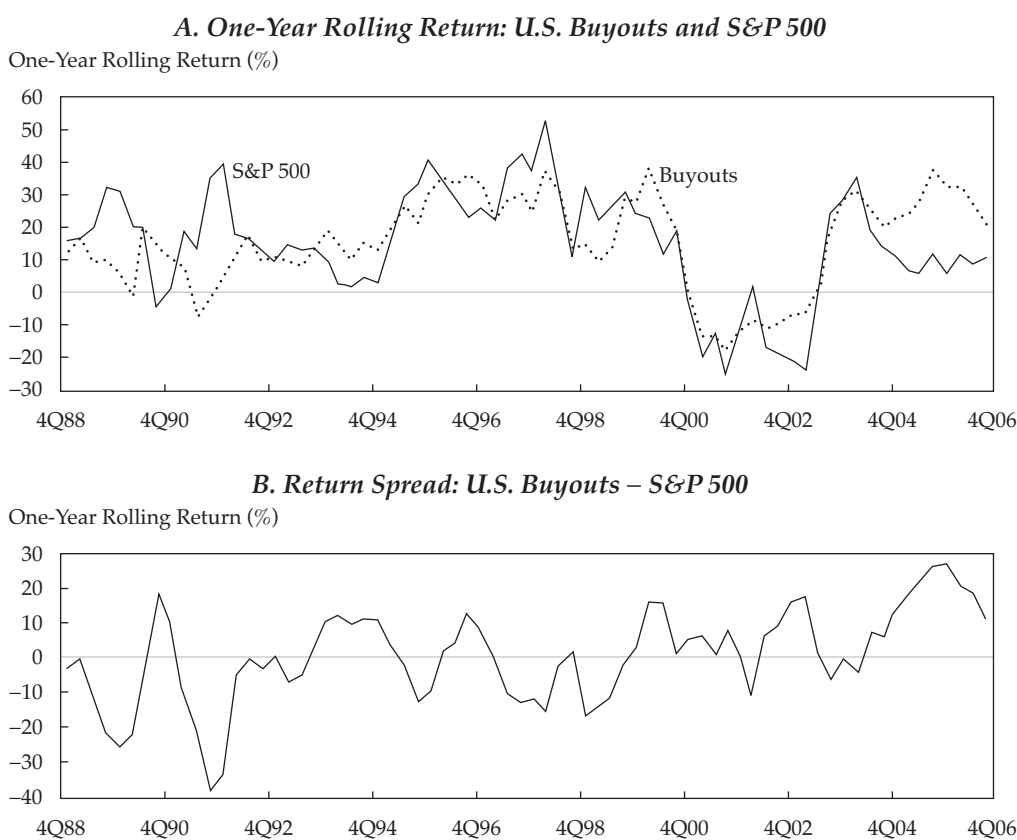
In private equity, the main drivers of returns are markets and management.

**Markets.** I will start by comparing the returns of the U.S. buyout market with the returns of the S&P 500 Index from 1988 through 2006. I calculated time-weighted quarterly internal rates of return (IRRs) for a large index, the Venture Economics Private Equity Index, and compared these returns with those of the S&P 500, thus providing a comparison aligned with the way investors typically look at public market indices. To obtain the time-weighted returns, I took the entire portfolio of private equity funds at any given point in time and calculated a quarterly return based on beginning and ending valuations and adjusted for intermediate cash flows. Each quarter's IRR was linked to successive quarterly returns to form an annual return. To compute rolling one-year returns, four-quarter returns were time weighted and rolled forward by deleting the oldest quarter and acquiring the newest one.

Panel A of **Figure 1** compares the annual rolling return for each index, and Panel B shows the return spread between the two indices. Notice in Panel A that the two indices appear to be strongly correlated, demonstrating that the broad outlines of the returns of the two are quite similar, even though individual point-to-point comparisons differ considerably. The mean one-year rolling return for the U.S. buyout market was 13.0 percent, whereas the S&P 500 produced a mean one-year rolling return of 14.4 percent. With a standard deviation of 20.4 percent compared with the S&P 500's 17.0 percent, the buyout data demonstrate higher volatility. But with an  $R^2$  of only 40.3 percent, they do achieve some diversification benefits. As Panel B indicates, for this period, buyout market returns underperformed the S&P 500 by 1.3 percent annually.

These data corroborate the anecdotal comments I have heard from institutional investors—that the median private markets manager is actually underperforming relative to public market indices. Therefore, if an institution makes a median bet, it is unlikely to satisfy its objectives.

**Figure 1. Returns of U.S. Buyouts and the S&P 500, 4Q 1988–4Q 2006**



Note: S&P data include dividends invested.

Sources: S&P data are provided by Datastream. U.S. buyout data are provided by Venture Economics.

**Figure 2** shows a similar comparison of U.S. venture capital and the NASDAQ Composite. I used the NASDAQ because venture capital is a sector-concentrated bet that correlates more accurately with the NASDAQ than with other public market benchmarks. Note the phenomenal peak in returns associated with the NASDAQ bubble of 1999–2000 and the subsequent retrenchment in returns in the postbubble period.

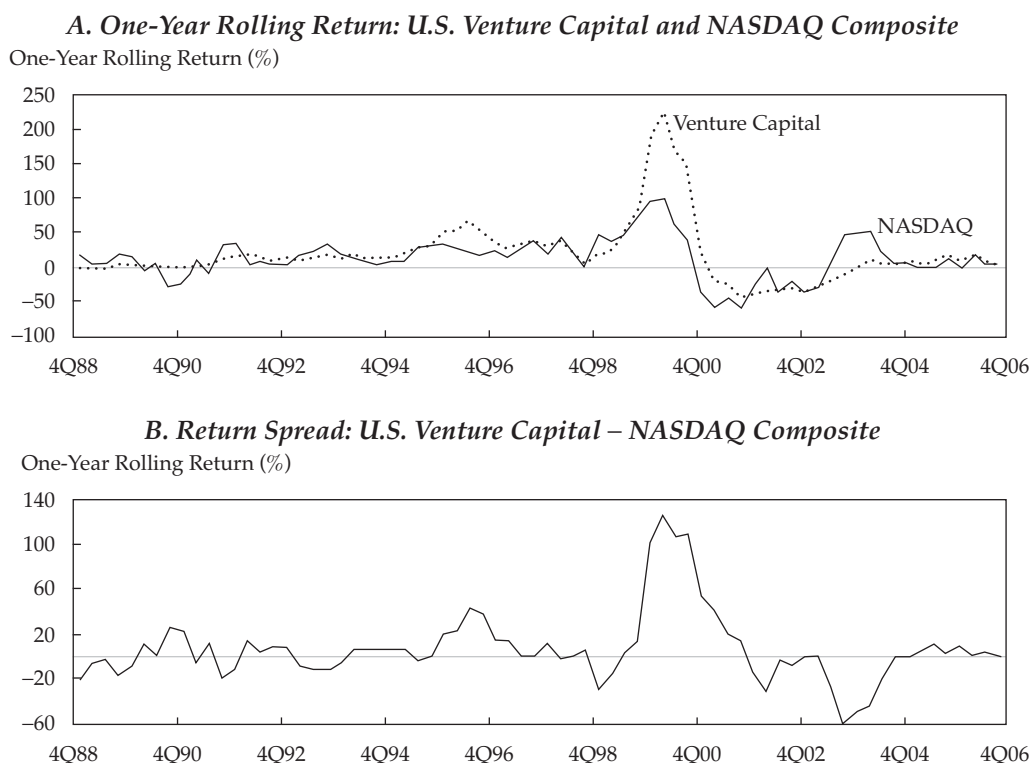
These data indicate that venture capital market returns outperformed the NASDAQ's time-weighted returns by 5.1 percent annually, although if the bubble were removed, the variance would change considerably. The difference in volatility is higher than in Figure 1, with U.S. venture capital having a standard deviation of 43.9 percent and the NASDAQ having a standard deviation of 28.3 percent. The diversification provided by venture capital is moderate with a 51.6 percent  $R^2$ .

Most institutions prefer to compute performance from one point in time to another because they want to capture the notion that the weight of

capital flows influences returns. Private equity is not about buying into an index on a constant-dollar basis, holding for a period, and then getting out. It is about investing in a staggered fashion and withdrawing in similarly staggered steps. Therefore, the timing of cash flows is important to the returns investors receive, and point-to-point analysis can weight that information and thus reflect the timing element of returns.

A point-to-point analysis for 20 years that compares, once again, U.S. buyouts with the S&P 500 and U.S. venture capital with the NASDAQ Composite shows that venture capital's IRR improves some (alpha of 6 percent versus 5 percent for time weighted) but that the IRR of buyouts outperforms that of the S&P 500 by almost 4 percent, on average, versus a negative alpha on a time-weighted basis, on average. This apparent contradiction of the underperformance shown in Figure 1 probably indicates that the flow of capital is making this difference and implies that managers have timing skills that provide value to their investors.

**Figure 2. Returns of U.S. Venture Capital and the NASDAQ Composite, 4Q 1988–4Q 2006**



Note: NASDAQ data include dividends invested.

Sources: NASDAQ data are provided by Datastream. U.S. venture capital data are provided by Venture Economics.

Some academic studies disagree with this conclusion.<sup>1</sup> These studies assume that as the market improves, investors invest more money. With more money chasing fewer deals, prices are bid up and returns go down. My analysis of the data at least casts doubt on that hypothesis. Perhaps managers do have some skill—not because they are timing market trends but because they are disciplined in buying companies, which means they are willing to reject deals that do not meet their prerequisites. This bottom-up timing benefit may not generally be seen at a macro level but, rather, at the sector level or in the timing of deals within sectors.

**Management.** The data show that the market obviously influences the returns of private equity, but the data also indicate that the market does not account for all such influences. The variation in manager performance may also be a critical factor underlying portfolio outcomes in private equity. To a large extent, measuring performance by the year a fund was started, or vintage year, helps to control for market influences because by holding the fund vintage constant, no one is rewarded or penalized for putting money to work during different market environments. Furthermore, it helps in understanding relative performance because everyone starts from the same point.

For vintage years 1986 to 2002 (the most recent mature vintage), the spread between top and bottom quartiles for U.S. buyouts averaged 37 percent with a standard deviation of 19 percent; the data for venture capital are even more impressive—61 percent average spread and a 33 percent standard deviation. The spread suggests an alpha because it does not correlate with the median or general trends in the market. This potential alpha can be seen for buyouts, where the spread between the top quartile and the median has an  $R^2$  of 3 percent. The comparable  $R^2$  for venture capital is 25 percent.

The data raise questions about the source of private market returns. Do such returns reflect a certain degree of skill, or are they a misrepresentation of some sort? Certainly, investors are pursuing the sort of skill implied in these data.

**Summary.** At this level of analysis, both market and management factors appear to drive overall returns in private equity. Institutional managers, therefore, need to structure strategies that gain the greatest benefit from both sources of return. Total volatility in private equity is higher than in public market indices, but market volatility is about 60–80

percent of the volatility for the median manager. Although this suggestion is controversial, capital flows may indicate some timing effect, which implies a certain degree of skill among managers.

Alpha contributions to total returns are often substantial, and the industry needs to find ways to measure such alpha more discretely. Investors need to know how to determine which parts of the private equity return depend on the market and which on manager alpha, and they need to establish ways to manage these two sources of return independently.

## Factors Affecting Market Returns

In this section, I will deconstruct the factors that drive market returns, first in buyouts and then in venture capital. I will indicate how these factors relate to an institution's portfolio in public markets and also identify some of the drivers of manager success to provide institutions with some guidance in manager selection.

**Buyouts.** When examining leveraged buyouts (LBOs), most analysts start with a cash flow, LBO model. The basic elements in such a model are the following:

- valuation,
- growth,
- leverage,
- ROE (return on equity),
- ROE versus WACC (weighted average cost of capital), and
- returns.

To examine these elements, I have developed a bridge analysis (a standard often used in the buyout industry), depicted in **Table 1**. The first row shows the IRR of an average LBO. The last row shows the IRR of a top performing LBO. Between the two are five components that make the difference between being an average performer and a top performer. Each of these factors is embedded in base returns, but when each factor is taken to a superior level, returns are substantially improved. For example, in this case, extra sales growth adds 1 percent to IRR, expanding margins (through cost cutting and product-mix realignment) add 4 percent, paying down more debt adds 3 percent, expanding multiples adds 5 percent, and a quicker exit (in this case, the difference between exiting at 5.0 years and 4.5 years) adds a final 3 percent. The result is an extra 16 percent return to the base case.

This analysis is a simplified version of what every buyout shop does when investigating companies with LBO potential. They conduct due diligence on these drivers to determine the extent to which each is likely to influence returns.

<sup>1</sup>See, for example, Steven N. Kaplan and Antoinette Schoar, "Private Equity Performance: Returns, Persistence and Capital Flows," MIT Sloan Working Paper 4446-03 (November 2003).

**Table 1. Bridge Analysis of Average vs. Top Performing LBOs**

Item	Amount
Average LBO IRR	12%
Topline sales growth	1
Margin expansion	4
Debt paydown	3
Multiple change (exit–entry)	5
Quicker exit	3
Top performing LBO IRR	28

Notes: Average LBO assumes a 5-year holding period with a 1.75× exit. Top performing LBO assumes a 4.5-year holding period with a 3× exit. Top performing LBO also assumes that topline sales growth contributes 10 percent, margin expansion contributes 30 percent, debt paydown contributes 20 percent, and multiple expansion contributes 40 percent to ending value.

The price paid for a deal is important to the success of private equity and is reflected in the purchase multiple paid. Unfortunately, investors tend to look at private equity in isolation from the broader financial world and often think that higher multiples in buyouts mean lower returns without reference to multiples in the broader market. **Table 2** compares the average purchase multiples of buyouts with those of the S&P 500 and the Russell 2000 Index. The pricing multiples are expressed as enterprise value relative to EBITDA (earnings before interest, taxes, depreciation, and amortization), a standard cash flow metric for most buyouts. The most obvious insight from these data is that buyout purchase multiples are generally below market averages. I cannot say that the prices paid for buyouts are cheap, but I would argue that buyouts tend to be skewed toward the value part of the spectrum. The reason can be found in the model for LBO cash flow metrics, which drives investors toward companies with cash flow, and that cash flow provides stability. Obviously, the more investors pay for a buyout, the more stress is placed on a capital structure, so buyout shops are clearly looking for lower rather than higher multiples. Because such purchases have to be levered, a good cash flow allows for coverage of debt.

One reason buyout investors focus on value is that they are cash buyers. They cannot pay with stock. In contrast, most of the higher multiples in mergers and acquisitions are paid by stock transactions. That situation has been modified somewhat with the accounting changes required by the IRS, but strategic buyers still tend to use stock to buy more growth, and they do so because these are maturing companies and need to add growth to keep their multiples high. Strategic buyers, therefore, are prepared to pay up because they can pay with stock. Buyout specialists cannot compete in

such cases. They can only compete when dealing with a value proposition that allows them to get good financing, as they have been able to do for the last five years. Thus, buyout specialists put a premium on cash flow behavior.

Leverage relative to purchase multiples is a key issue in analyzing buyouts, and this concept is well illustrated by a comparison of total debt to EBITDA. (This ratio can be thought of as the total debt burden being placed on the acquired company's cash flow.) Most observers are surprised to learn that buyouts have a substantially lower total-debt-to-EBITDA ratio (ranging from roughly 4 to 6 in the 1997–2007 period) than the average S&P 500 company (ranging from roughly 11 to 16 in the 1997–2007 period). The result seems counterintuitive because so many investors assume that buyout specialists put more leverage in their deals than do investors in the S&P 500. Buyout firms can get away with this because of their bias toward value-oriented purchase multiples. In effect, this permits the presence of more debt (as a percentage of the capital structure) for acquired companies than for companies in the public markets.

But ultimately, buyout specialists must worry about optimizing their cash flow coverage because that is what determines their ability to pay the debt. The optimal coverage ratios depend on developments in the larger credit market, including the cost and availability of debt. Certainly, the years 2005–2007 were a high-water mark for the availability of credit for levered transactions.

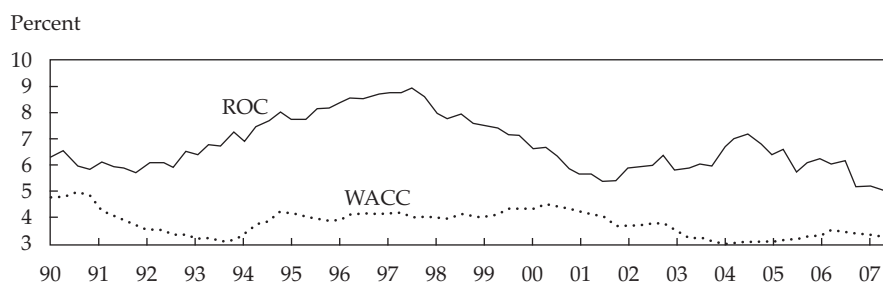
The relationship between WACC (weighted average cost of capital) and ROC (return on capital) brings together many of the components essential to creating superior performance in leveraged buyouts. **Figure 3** shows the return gap between ROC and WACC, which tends to drive buyouts. This

**Table 2. Enterprise Value to EBITDA for Buyouts vs. the S&P 500 and Russell 2000**

Year	Buyouts	S&P 500	Russell 2000
1998	8.1	10.3	10.7
1999	8.0	15.6	11.2
2000	6.8	16.9	14.4
2001	6.7	11.2	18.8
2002	7.0	10.5	8.8
2003	7.3	8.4	8.5
2004	7.7	10.2	12.5
2005	8.5	11.7	7.1
2006	8.8	12.1	9.6
12 months to November 2007	10.2	11.8	10.5

Note: Buyout data exclude media, telecom, energy, and utility deals.

Sources: Buyout data from S&P M&A stats as of 30 November 2007. S&P and Russell data are provided by Ned Davis Research.

**Figure 3. Gap between ROC and WACC, 1 January 1990 through 30 September 2007**

Notes: WACC cost of debt is based on weighted average of corporate bond yields and commercial paper. Cost of equity is earnings yield. WACC is deflated by a corporate price deflator.

Source: BCA Research as of 30 September 2007.

comparison allows a buyout shop to see how much it is making in relation to the cost of buying a company, depending on the amount of debt taken on. The result is a simple difference, but it is a powerful discriminator for what defines success in buyouts. Furthermore, the spread pattern shown in Figure 3 reflects a lag of roughly 3–4 years to subsequent buyout returns, which is the amount of time needed for company realizations to be reflected in the market. Return on equity and pricing multiples define the basic profit spread before debt costs and thus explain much of the success of buyouts.

**Venture Capital.** Quite different from the buyout world, venture capital is focused on start-ups, so cash flow is not an issue going in. Furthermore, venture capital tends to focus on discrete sectors—primarily information technology and the life sciences, although interest is obviously broadening to include activity in other sectors and geographical areas, such as venture growth deals in China. Nevertheless, venture capital in the Chinese market is still nascent, and other sectors remain a smaller part of the activities that define this market.

The metrics affecting venture capital are similar to those affecting buyouts, but with certain differences:

- valuation: Venture capitalists want to be certain that the premoney multiples (revenues to company value prefinancing) are fair.
- growth: Revenue growth of more than 50 percent is key in venture capital deals.
- ROE: Expected margins are more significant in venture capital than in buyouts.
- market breadth: Venture capitalists want to determine whether growth is based on a broad market trend or a more narrow trend in demand and whether such trends are cyclical or longer term.

- exit environment: Venture capitalists require a clear exit strategy; they need to know that the exit windows will open over a realistic time frame for the investment.
- returns: Returns are dependent on how fast the money is realized, which is, in turn, influenced by revenue growth, pricing multiples, and exit environment.

As with leveraged buyouts, venture capital can be studied with a bridge analysis, comparing the factors that differentiate an average venture capital deal from a top performing deal, as shown in Table 3. In this case, an average performer has a holding period of seven years with a return of 1.9 times on invested capital, but a top performer has a holding period of six years and a return of 9.5 times invested capital. This tremendous disparity relies largely on three factors: (1) Faster revenue growth brings an additional 17 percent to the IRR percentage, (2) the quicker exit adds another 6 percent, and (3) improved price-to-sales exit multiples bring 13 percent, thus raising the IRR from an average 10 percent

**Table 3. Bridge Analysis of Average vs. Top Performing Venture Capital Deals**

Item	Amount
Average venture capital IRR	10%
Revenue growth	17
Quicker exit	6
Price/sales multiple change	13
Top performing venture capital IRR	46

Notes: Average venture capital deal assumes a seven-year holding period with a 1.9× exit. Top performing venture capital deal assumes a six-year holding period with a 9.5× exit. Top performing venture capital deal also assumes that revenue growth contributes 47 percent, quicker exit contributes 17 percent, and price/sales multiple expansion contributes 36 percent to ending value.

performance to a far more impressive 46 percent. These differences are illustrative of how high-impact deals can drive top-quartile fund returns.

In the early stage of a venture capital deal, the entrepreneurs are being paid for their time and effort, and during that time, cost cutting and profitability are not issues. It is all about proof of concept and moving toward revenue possibilities for early adopters. Speed of exit, however, is a critical factor. The quicker a start-up takes off, the more likely venture capitalists are to get a large return on their money. Similar expectations occur with growth. Venture capitalists are not looking for 15 percent growth on revenues; they are looking for hyper growth—that is, 100–200 percent growth on an annual basis. In effect, they are seeking very different behavior from that found among public companies or buyout candidates for LBOs.

Venture capital valuations are defined by pre-money multiples, which depend on the stage of the venture, and the public exit multiples. Typically, multiples are weighted averages at different stages. Early-stage multiples—including seed stage and first and second financing rounds—are reasonably stable because they are distant from the public market, which today means six to seven years before the venture exits into the market. However, late-stage pre-money multiples are more sensitive to the market.

Many venture-backed companies go public on the NASDAQ. But the entry prices for venture capital deals are not particularly sensitive to public markets, and public market multiples only indirectly influence venture capital prices. Pre-money multiples start with public price-to-sales ratios but are discounted for time, and the dispersion of the multiples is tremendous, depending on expected growth. Nevertheless, price-to-sales ratios define venture-backed companies in terms of their valuation.

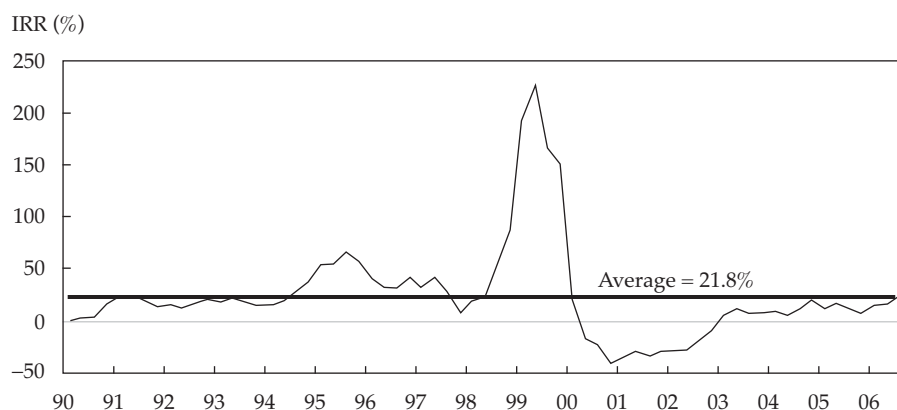
Growth expectations are a major driver, but profitability varies in importance, and revenue expectations are based on the demand cycle. Most information technology ventures are so discrete, their footprint so specific, that the broader market does not matter to them. Aside from life science deals, most venture investors want to know whether a venture's products and services will sell to enterprises or consumers; corporate profits will drive the demand cycle for enterprises, and consumer spending will drive the demand cycle for individuals.

Venture-backed companies are less sensitive to the ROE of the public markets than are buyouts. The reason is that ROE is thought of as a broad economic cycle indicator of profitability and is thus not a key factor for start-up growth expectations until a year or so before a start-up goes public. Throughout their early stages, start-ups focus primarily on revenue growth.

The exit environment is a key determinant of venture capital returns. **Figure 4** shows that from 1990 to 2007, U.S. venture capital earned a 17-year rolling average IRR of 21.8 percent. But these returns are based more on sector-specific price-to-sales multiples than marketwide multiples. The figure is also indicative of significant cyclicality, which is determined by conditions in the market at the time of exit.

For venture capital, one can see how broad market trends influence returns through the components of growth and pricing. Venture has much more specific risks than buyouts, so market influences have a smaller impact. The exit environment is more important in venture than in buyouts, although for many companies, such may not be the case. The broader point is that conditions in the public markets drive median private market returns.

**Figure 4. U.S. Venture Capital Performance as One-Year Rolling IRRs: 1990–2007**



Source: Data are from Thomson Reuters.

## Management Drivers of Success

Anyone who has managed a public portfolio knows how important it is to fully understand the factors that govern returns in your portfolio. These factors, such as sector bets, if not properly controlled for in the risk management process, can increase risk and tracking error and reduce alpha. It is natural, therefore, to search for similar factors on the private side. I will begin by examining the importance of several factors, such as strategic tilts, for both venture capital and buyouts.

**Portfolio Factor Tilts.** For this analysis, I took data from 1993 to 2004, which allows for both mature and more recent vintages but is also somewhat reflective of the scale of development of private equity over the period. For various categories, I compared the IRR spread between the top and the bottom performing quartiles on a vintage-year basis. The categories included strategy tilts, such as sector, stage, and size of company. General partner (GP) variation in results was also examined. For both venture capital portfolio selection and buyout portfolio selection, it is not strategic tilts but GP selection that dominates. Balancing exposure through strategic tilts can add value for venture capital but apparently very little for leveraged buyouts.

More specifically, GP selection shows an IRR spread of almost 40 percent between the top and bottom quartiles in venture capital and almost a 20 percent spread between buyout quartiles. Among venture capital outcomes, industry, geography, and stage tilts show meaningful spreads between top and bottom quartiles, but the buyout spreads in the parallel categories—industry, geography, and fund size—are much smaller. Such data can shed useful light on a variety of issues, one of which is the recent debate about whether large buyouts can produce value. Some critics have suggested that large buyouts do not produce adequate returns, so institutions should gravitate toward the middle market buyer. These data indicate that the selection of fund size is unlikely to lead to much difference in IRR spread. Comparably, for venture capital, the data show that stage of development makes little difference as well.

Clearly, quality of management is the factor that makes the majority of the difference. GP selection—in essence, manager selection—swamps the other decisions because quality managers can find success in a variety of situations. For example, if I were perfect at making the right stage bet, that decision would be worth less than a 10 percent spread in IRR, whereas choosing the right manager would be worth almost 40 percent.

**Persistence.** When institutions choose private equity managers, they want to know not only the causes of success but also the likelihood that managers who have been successful in the past will continue to be so in the future. In other words, they want to know the likelihood of persistent performance. To explore the issue of persistence, we commissioned a study of all funds with multiple funds. The general methodology was to identify the first instance in which a family of funds had a top-quartile private equity fund and then identify the likelihood that its next fund would be in the top quartile. The study, for the period 1981–2000, followed venture capital and buyouts separately. We found the persistence of success to be about 30–40 percent in venture capital and just over 40 percent in buyouts. That is, once a fund group had a top-quartile fund, it had a 30–40 percent chance of getting its next fund into the top quartile. Conversely, it had a 60–70 percent chance of having a fund below the first quartile. Broadening the criteria for persistence, we found that the data indicated that once a venture capital group produced a top-quartile fund, it had just over a 60 percent chance of its next fund being above the median. A buyout group had just over a 50 percent chance of its next fund being above the median. Past performance, therefore, is not a thoroughly reliable predictor of persistence because underperformance is still quite likely to follow initial success. But past success does tend to skew the data toward better performance in the future.

### Good Multiples vs. Timing of Returns.

Another question we have investigated is whether a bias exists in top-quartile results, which are usually defined on the basis of IRR. In other words, rather than getting good multiples, are top-quartile performers simply returning money so quickly that they are achieving outstanding IRRs? For this study, we used the Private Equity Intelligence database, which includes about 500 buyout funds and about 400 venture funds worldwide. Most are from the United States; a few are from the United Kingdom. The data we studied encompassed 1987–2000; our goal was to capture fully realized funds and identify whether top-quartile funds convert multiples into IRR differently from how other quartiles do. What we found runs somewhat counter to expectations: Top-quartile funds tend to return money a little bit slower than do the second, third, and fourth quartiles. Top-quartile funds earn a significantly higher multiple, but they take marginally longer to do so. The pattern is similar for venture capital and buyouts, although speed seems to be even less of a driver for venture deals.

**Loss Management.** Another issue institutions tend to raise is whether downside management can make a difference in overall performance. That is, can success be at least partially defined by how much money a manager does not lose? The data indicate that the answer varies according to strategy, although downside management is certainly important across strategies. For example, according to data from Cambridge Associates for 1981 to 1998, approximately 30 percent of buyout deals returned less than 1.0 times capital (i.e., provided negative returns). By comparison, about 40 percent of late-stage venture deals and 50 percent of early-stage venture deals also returned less than 1.0 times capital. Obviously, a meaningful percentage of deals can benefit from strong management of their loss rate.

Using the same data and considering venture capital firms more specifically, I find that about 45 percent of early-stage venture deals had an IRR of less than 0 percent, but only about 35 percent of late-stage deals had IRRs below 0 percent, thus indicating that late-stage funds are better at loss management than are early-stage funds. Furthermore, top-quartile funds were better than average funds at selecting impact deals—those deals with more than 50 percent IRR. More than 40 percent of top-quartile, late-stage venture firms achieve IRRs of more than 50 percent. Most would almost certainly assert that success arises from impact deals, not loss management. After all, they are hired to achieve those highly lucrative deals, not to be defensive players.

**Firm Characteristics.** If impact deals are indeed the real drivers of success, then institutional investors want to find managers with a high probability of finding/managing such deals. One way to help identify such managers is to examine the holding period return to separate the appreciation of the broader market and the subsector from the performance of the individual firm. Unfortunately, most information available for venture capital firms tends to be anecdotal in this area, so all of my data for this analysis apply only to buyouts.

The data in **Table 4** indicate that 56 percent of returns on above-average buyout deals come from firm-specific factors (in this case, either earnings performance or multiples performance), and 79 percent of returns from the top buyout deals are firm specific.

Of the two firm-specific performance measures, multiples performance dominates over earnings, especially in the top deals. Such dominance indicates that perhaps top deal makers create a perception in the public market that they deserve—because of their expected growth, strategic platform, or competitive position—a much higher than average multiple.

**Table 4. Firm Return Attribution**

Factor	Above-Average	
	Deals	Top Deals
Market appreciation	27%	15%
Subsector appreciation	15	6
Firm outperformance	56	79
Earnings outperformance	23	14
Multiple outperformance	33	65
Total value created	100%	100%

*Source:* Conor Kehoe, "Private Equity Returns," McKinsey Private Equity, EVCA Conference, 2001.

## Conclusion

As far as sustainable success in private equity, average managers appear to be more affected by the market impact on returns than are top managers. Average firms can attribute about two-thirds of their returns to the market or their sector. The returns of top managers, however, are less sensitive to public markets than are those of average managers, with the alpha they are able to generate in many cases doubling that of the market. Therefore, institutions should think twice about investing in private equity if they cannot select anything better than the average manager.

Firm-specific factors dominate top performance. Company building is important, but operational progress is outweighed by fundamental changes in perception that lead to the market multiples of impact deals.

Finally, sustainable GP performance is not guaranteed. Investment success requires management success, but acquiring and maintaining the necessary skill sets as opportunities change will continue to be a challenge for investment firms.

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# Question and Answer Session

Charles G. Froland, CFA

**Question:** How do you determine the stability of the managers in the top quartile? Do they change over vintages?

**Froland:** Year to year, the same people will not always show up in the top quartile, but they show up often enough over time to provide the risk-adjusted returns an institution is seeking relative to its objectives. I believe the data support the idea that there are managers who demonstrate persistence.

The key to successful portfolio management is to find managers who will consistently produce the required returns, and that key is not based on statistics alone.

There is no equation you can apply to a manager's track record to determine the potential for persistence. You have to examine the members of the team and their roles in past deals. You have to identify their skills, their judgment, and the strategic or operational management ability that

they brought to each deal and determine whether those factors are still in place to offer a promise of performance sustainability. This is what most institutional investors today are focusing their attention on. They know there are limitations to the statistics, so they are examining the skills and talents that lead to and sustain outperformance.