

International Investments In Private Equity

Asset Allocation, Markets, and Industry Structure

Peter Cornelius

Foreword by Josh Lerner



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International Investments in Private Equity

For Heike and Paul

Foreword

After the recent dramatic events in the private equity industry—such as the boom of the mid-2000s and the collapse in the wake of the financial crisis and the attendant recession—its future remains uncertain along many dimensions. Nonetheless, two predictions about the industry’s evolution can be made with confidence.

First, much of the future growth in venture capital and private equity activity is going to take place outside its traditional hubs of the United States and continental Europe (especially Great Britain). In particular, it is likely that the industry’s focus will be increasingly on the emerging markets. The trend toward increased globalization of the private equity industry was evident from the first days of the 21st century. The industry downturn has only accelerated this trend, and although there will be growing pains in many markets, there are many reasons to conclude that private equity investing will increasingly be a global enterprise.

A related change will be a shift in the ranks of who is raising private equity. According to the Emerging Market Private Equity Association, 26 percent of the total amount invested by private equity funds in 2009 went to companies based in emerging markets, but only 9 percent of funds was raised by groups based in these markets. Going forward, it is likely that emerging market-based groups will gain a much larger share of the global private equity pool.

Second, the model of “loose governance” by limited partners, who have traditionally relied on incentive compensation to ensure that the general partners “do the right thing,” may have reached its limits. The disappointments brought about by the bursting bubbles of the late 1990s and mid-2000s have opened the door to tough questions about the behavior of general partners, and whether carried interest still serves as a sufficient spur to good behavior. As a result, we are likely to see increased attention—and perhaps a fundamental rethinking—of the way in which private equity groups are governed and rewarded. In particular, there is likely to be a much greater emphasis on performance measurement and evaluation.

This book is a very timely one along both these dimensions. First, unlike so many texts that implicitly take a national view of the industry, *International Investments in Private Equity* assumes a global perspective throughout. Second, the volume emphasizes an analytic view throughout, highlighting cutting-edge research and quantitative methodologies that can address many of the concerns raised by current and potential investors in the asset class.

It is also worth noting that it is hard to think of a more perfect author for a text like this than Peter Cornelius. Peter combines many years of experience grappling with

thorny global macroeconomic questions, a substantial understanding of the practicalities of the private equity industry, and a deep interest in the sometimes fascinating, sometimes befuddling realm of academic research into this arena. (Peter is one of the few practitioners I know who is interested and engaged after 2 days of presentations of academic papers, a task I often struggle with!) As such, this book can build a bridge between perspectives that are not often seen in conjunction with each other.

Josh Lerner

Harvard Business School, Boston, Massachusetts

June 10, 2010

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Written predominantly for practitioners, this book takes into account the growing academic literature on private equity investing. Many in academia have been extremely generous with their time and ideas, greatly helping me make the book more rigorous. First of all, I am extremely grateful to Josh Lerner, Harvard Business School, for writing the foreword to this book. In fact, many ideas developed in this study go back to Josh's extensive contributions to the literature on private equity. The same applies to Steven Kaplan, Booth School of Business at the University of Chicago, with whom I had several conversations on many key subjects in this book. His comments on an earlier paper on cross-border private equity capital flows (coauthored with Karlijn Juttman and Broes Langelaar) proved extremely helpful in drafting parts of this book. Furthermore, my former coeditor of *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press, 2003), Bruce Kogut, Columbia Business School, deserves special thanks for his availability and feedback over the years. As always, his observations and suggestions have provided extremely useful guidance in undertaking this project. Other academics I am highly grateful to are Francesca Cornelli, London Business School; Heinrich Liechtenstein, IESE; Roger Leeds, Johns Hopkins University; Ludovic Phalippou, University of Amsterdam; and Peter Roosenboom, Rotterdam School of Management, for their comments on the manuscript. I am also thankful to Ulf Axelson, London School of Economics and Political Science, and Per Strömberg, Swedish Institute for Financial Research, with whom I have discussed various aspects of performance measurement and portfolio and risk management in private equity.

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About the author



Peter Cornelius

Peter Cornelius is heading economic and strategic research at AlpInvest Partners, one of the world's largest investors in private equity. Prior to his current position, he was the group chief economist of Royal Dutch Shell, chief economist and director of the World Economic Forum's Global Competitiveness Program, head of International Economic Research of Deutsche Bank, and a senior economist with the International Monetary Fund. Dr. Cornelius is the chairman of the European Venture Capital & Private Equity Association's working group on private equity risk management. A visiting professor at the Vlerick Leuven Gent Management School, he has been a visiting scholar at Harvard University and an adjunct professor at Brandeis University.

List of abbreviations

ADB	Asian Development Bank
ADIA	Abu Dhabi Investment Authority
AfDB	African Development Bank
AIF	Alternative investment fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Manager Directive
ALM	Asset-liability management
AMF	Autorité des Marchés Financiers
APG	Algemene Pensioen Groep
ARD	American Research and Development
ASEAN	Association of Southeast Asian Nations
AUD	Australian dollar
AUM	Assets under management
BRIC	Brazil, Russia, India, and China
BRL	Brazilian real
BV	Besloten vennootschap met beperkte aansprakelijkheid
CA	Cambridge Associates
CAD	Capital Adequacy Directive
CanD	Canadian dollar
CAPM	Capital asset pricing model
CAGR	Compound annual growth rate
CalPERS	California Public Employees' Retirement System
CDC	Commonwealth Development Corporation
CDO	Collateralized debt obligation
CEE	Central and Eastern Europe
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CIC	China Investment Corporation
CIS	Commonwealth of Independent States
CLO	Collateralized loan obligation
CPIS	Coordinated Portfolio Investment Survey
CPPIB	Canadian Pension Plan Investment Board
CSR	Corporate social responsibility

(Continued)

CV	Commanditaire vennootschap
DCF	Discounted cash flows
DEG	Deutsche Entwicklungsgesellschaft
DPI	Distributed to Paid-In
EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EIF	European Investment Fund
EMPEA	Emerging Markets Private Equity Association
EMS	European Monetary System
EMU	European Monetary Union
ESG	Environmental, social, and corporate governance
EU	European Union
EUR	Euro
EVCA	European Private Equity and Venture Capital Association
EWS	Early warning system
FASB	Financial Accounting Standards Board
FDI	Foreign direct investment
FCPI	Fonds Commun de Placement dans l'Innovation
FCPR	Fonds Commun de Placement à Risques
FCR	Fundos de Capital de Risco (Portugal); Fondos de Capital de Riesgo (Spain)
FIP	Fundos de Investimento em Participações
FMIEE	Fundos Mútuos de Investimentos em Empresas Emergentes
GBP	British Pound
GCR	Global Competitiveness Report
GDP	Gross Domestic Product
GIC	Government Investment Council (of Singapore)
GmbH	Gesellschaft mit beschränkter Haftung
GmbH & Co KG	GmbH & Co Kommanditgesellschaft
GP	General Partner
HH	Hirschman-Herfindahl (index)
HNWI	High net worth individual
IASB	International Accounting Standards Board
ICR	Investidores em Capital de Risco
ICAPM	International capital asset pricing model
IFC	International Finance Corporation
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
ILPA	Institutional Limited Partners' Association
IMF	International Monetary Fund

INR	Indian Rupee
IOSCO	International Organization of Securities Commissions
IPO	Initial public offering
IT	Information technology
IRR	Internal rate of return
JPY	Japanese Yen
KG	Kommanditgesellschaft
KKR	Kohlberg Kravis Roberts & Co
KPCB	Kleiner Perkins Caufield & Byers
LBO	Leveraged buyout
LIBOR	London Interbank Offered Rate
LP	Limited partner
LPA	Limited partnership agreement
LQ	Lower quartile
LTCB	Long-Term Credit Bank (of Japan)
LVCA	Latin American Venture Capital and Private Equity Association
M&A	Mergers and acquisitions
MM	Money multiple
NAV	Net asset value
NIAC	Newly industrialized Asian country
NOK	Norwegian Krona
NPV	Net present value
NV	Naamloze vennootschap
NVCA	National Venture Capital Association
OECD	Organization for Economic Co-operation and Development
OMERS	Ontario Municipal Employees Retirement System
OPIC	Overseas Private Investment Corporation
OTC	Over-the-counter
PAYG	Pay-as-you-go
PE	Private equity
PIPE	Private Investment in Public Equity
PME	Public market equivalent
PPP	Purchasing power parity
PREQIN	Private Equity Intelligence
RMB	Renminbi (Chinese)
RPPP	Relative purchasing power parity
RVPI	Residual Value to Paid In
SA	Société par actions (France); Sociedades Anónimas (Spain)
SAS	Société par actions simplifiée
SCA	Société en Commandite par Actions
SCR	Société de Capital Risque (France); Sociedades de Capital de Risco (Portugal); Sociedades de Capital Riesgo (Spain)

(Continued)

SEC	Securities and Exchange Commission (USA)
SEK	Swedish krona
SHE	Sand Hill Econometrics
SWF	Sovereign Wealth Fund
TVE	Thomson VentureXpert
TVPI	Total Value to Paid In
UQ	Upper quartile
USD	US Dollar
VaR	Value at risk
VC	Venture capital
VY	Vintage year
WCY	World Competitiveness Yearbook
ZAR	South African Rand

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