



Preqin Private Equity Performance Report

Early Warning System for LPs: Using Year Four/Six Performance
Metrics to Predict Final Outcomes

March 2011

Early Warning System for LPs

Using data from Performance Analyst, Preqin has examined the relationship between the quartile ranking of funds at both their sixth and fourth investment year compared to their final ranking at maturity. Preqin currently holds transparent net-to-LP performance data for over 5,300 private equity funds of all types and geographic focus. In terms of aggregate value, this represents around 70% of all capital ever raised by the industry.

For more information on Performance Analyst, the private equity industry's leading source of fund performance data, please visit: www.preqin.com/pa.

The Importance of Past Performance

Making a commitment to a private equity fund is an important decision based on multiple considerations. With over 1,600 funds currently on the road worldwide seeking institutional backing, competition amongst fund managers remains fierce as investors carefully consider the strengths and potential downsides of potential opportunities. In addition to new relationships, investors are also faced with the decision of whether or not to re-up with their existing managers. Central to all these considerations is past performance, and whether the fund manager in question has been successful in achieving top quartile returns for past vehicles. Of course, the full story regarding past performance is not complete until a fund reaches liquidation. However, the long-term nature of the asset class means that such data will not be available until at least 10 to 12 years (and often more) after the fund was initially launched.

Past Performance: The Shortcomings

Is the performance of a 1998 vintage fund really going to be relevant in the context of today's market? Certainly it will be of interest to a prospective LP, but of far more interest is the performance of more

recent vehicles actively participating in an environment more similar to that of today. Potential investors are especially keen to assess how 2006-2007 vintage funds have performed relative to peers. However, is it fair to examine the performance of a fund less than half way through its life-cycle? Are the results really reliable? Using over 12 years' worth of historic returns, we tracked the quartile performance of vehicles over time in order to assess the reliability of relative fund returns at various points in the fund life cycle.

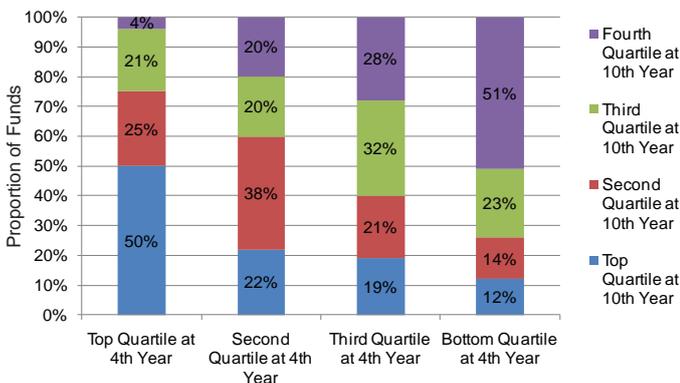
Early Performance as an Indication of Likely Future Performance

Preqin's Performance Benchmarks product (available free to industry professionals) shows the benchmark performance for all different metrics across all different fund types and geographies. As part of this service, we show median returns alongside the values for upper and lower quartile boundaries. We use these quartile rankings to show relative performance for the individual funds we hold performance data on, assigning quartiles from the third year of the fund's life onwards. How good an indicator is relative performance early on in a fund's life?

To investigate early fund performance indications, Fig. 1 shows the proportion of buyout funds that remain in the same quartile at maturity as they were in as at their fourth year of investment, alongside the proportion that move to each of the other quartiles. Fig. 2 shows the same split, but for venture funds.

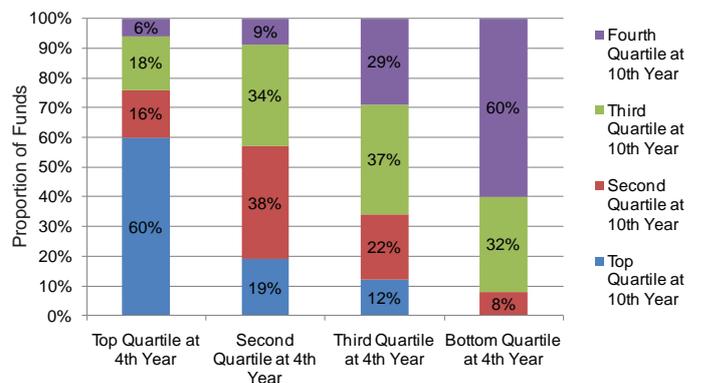
As Fig. 1 shows, although still relatively early in the fund life, relative performance in year four does represent a strong indicator of future performance for buyout funds. In 50% of cases, funds in the top quartile remained in this quartile at maturity, 75% of such vehicles beat the median, and only 4% saw a drop to the bottom quartile.

Fig. 1: Buyout Funds - Relationship between Quartile Ranking at Fourth Investment Year and at Maturity



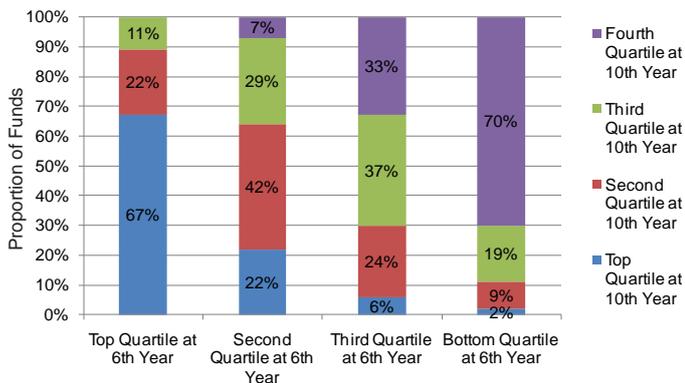
Source: Preqin

Fig. 2: Venture Funds - Relationship between Quartile Ranking at Fourth Investment Year and at Maturity



Source: Preqin

Fig. 3: Buyout Funds - Relationship between Quartile Ranking at Sixth Investment Year and at Maturity



Source: Preqin

At the other end of the scale, bottom quartile funds are also unlikely to turn around their fortunes, with over half remaining in the bottom quartile. There is a small but significant minority that are able to turn poor performance around however, with 12% of funds rising from the bottom to top quartiles.

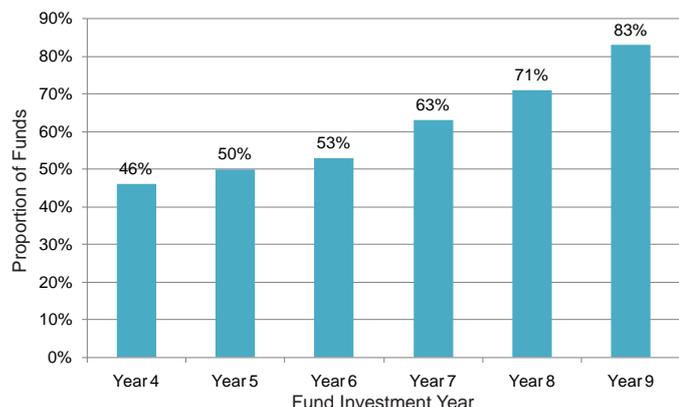
As Fig. 2 shows, quartile rankings for venture funds are especially relevant, perhaps counter-intuitively more so than buyout vehicles. In 60% of cases top quartile funds remain in this grouping at maturity, while none of the bottom quartile venture funds in our sample were able to turn their performance around and reach the top quartile, with only 8% managing to beat the median.

Clearly at this stage of a fund's development much can change, and does for a large proportion of funds. However, the data clearly shows that for the top and bottom performing vehicles, quartile rankings at this stage do represent a meaningful predictor for future relative performance.

Reaching Maturity? Examination of Funds in Year Six

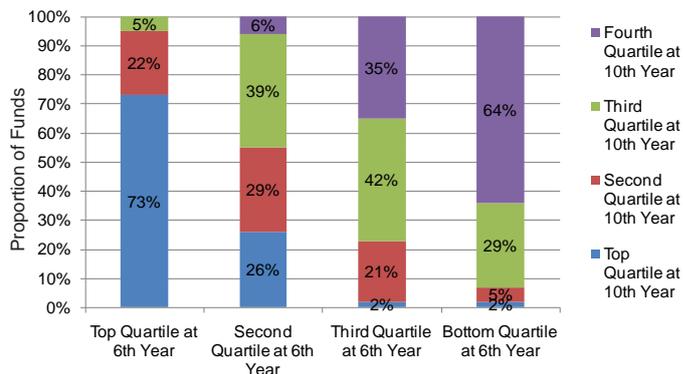
Once a fund enters its sixth year, it will have made the bulk, if not all, of its investments. Following this point, the fund manager will be looking

Fig. 5: Proportion of Funds with Same Quartile Ranking as at Maturity



Source: Preqin

Fig. 4: Venture Funds - Relationship between Quartile Ranking at Sixth Investment Year and at Maturity



Source: Preqin

to mature investments before exiting and returning capital back to investors. The performance at this point therefore represents an assessment of the final portfolio relative to that of other final portfolios held by other firms.

Such analysis is thus also a good indication of how important investment decisions are relative to management skill, and whether it is possible through to initiate significant change in performance relative to peers once the final portfolio has been assembled. Fig. 3 shows year six performance of buyout funds vs. mature performance, while Fig. 4 shows the same information but for venture funds.

Clearly at this point in the fund's life, relative performance is a very strong indication for future performance of both buyout and venture funds – especially once again in the case of the best and worst performing vehicles. Top quartile buyout funds in year six maintain their top position at maturity in 67% of cases, with venture maintaining in 73%. Top quartile funds are beating the median at maturity in 89% of cases for buyout funds and 95% of cases for venture funds in our sample.

At the bottom end it is now extremely unlikely that fund managers are able to turn performance that is poor relative to peers around, with only 11% and 7% of buyout and venture funds respectively in the bottom quartile in year six going on to beat the median at maturity. For funds in the second and third quartiles, the outlook is less certain, mostly due to the existence of other quartiles at two rather than just one end. The evidence does show that buyout funds have been substantially more likely to beat the median if they are in the upper quartiles at the end of year six, while the outlook for venture funds remains rather more uncertain. It could be the case that the very best and very worst venture funds are already set in place at this point in many cases, but for second quartile vehicles with more mixed portfolios there remains significant uncertainty.

Approaching the End: Mature Performance

As a fund nears the end of its life-cycle, fewer investments are held in the portfolio, much of the overall fund returns have already been set, and changes in valuation have far less impact on overall IRRs.

Fig. 5 shows the proportion of all private equity funds that maintain the same fund quartile between the year in question and the final mature quartile rating. Although there is a clear trend of funds being ever more likely to maintain their position as they get closer to maturity, even for funds in year eight and nine, there is a small but significant proportion which are changing quartiles – although at this stage it is likely to be a movement up or down of one quartile.

Conclusions: Keep an Open Mind?

The overriding message coming from the analysis is that quartile performance is important, even at an early stage of a fund's life. Such performance is especially important for funds that feature in the top and bottom quartiles, and those interested in purchasing interests on the secondaries market should pay special attention to relative performance of vehicles, and show caution when considering bottom quartile funds. With the possibility of a 'home-run' investment, it is somewhat surprising that bottom quartile venture funds are less likely to turn around their performance than buyout funds, but the data does show that early relative performance for the top and bottom quartile venture vehicles is a very strong indication of final fund performance.

As ever, it is important to keep an open mind. The data does show that in some cases fund managers are able to turn around initially disappointing returns and achieve top quartile performance. With 17% of vehicles even moving quartiles between their ninth investment year and maturity, there is always the possibility of relative improvement, and each fund should also be judged on both the current strength and the future prospects of its underlying portfolio.

However, the central message is that interim performance measures from as early as the fourth year of a fund's life give a strong indication of the fund's likely fund performance - and should therefore form a core part of LPs' due diligence when considering both commitments to new funds and investment in secondary interests.

Data Source:

Performance Analyst

Performance Analyst is the most comprehensive, detailed source of private equity performance data available today. Preqin's team of analysts collect and monitor data from a number of different sources, including from GPs themselves, in order to provide the most comprehensive private equity performance data available today.

All of our performance data conforms to the same standardized metrics, with all data representing net-to-LP returns. We currently hold transparent net-to-LP performance data for over 5,300 private equity funds of all types and geographic focus. In terms of aggregate value, this represents around 70% of all capital ever raised.

This high level of coverage enables us to produce the most meaningful benchmarking and comparative tools available in the industry.

Key features of this powerful database include:

View performance data online: for private equity funds worldwide. Compare individual funds against each other and the appropriate benchmarks.

Compare funds of all types: venture, buyout, mezzanine, distressed, special situations, real estate, natural resources, fund of funds, secondary.

Assess key performance data for each fund: size, vintage, type, called-up, distributed, unrealized value, multiple, IRR.

View historic performance: for over 15,000 data points to assess how performance data has changed over time (Premium access required).

Keep current with developments: with monthly updates you always have access to the latest data.

View cash flow graphs for over 1,700 funds: assess how quickly funds have called and distributed capital and what their net cash flow position is.

Select, compare and analyze: funds according to your criteria: by type, size, vintage year etc.

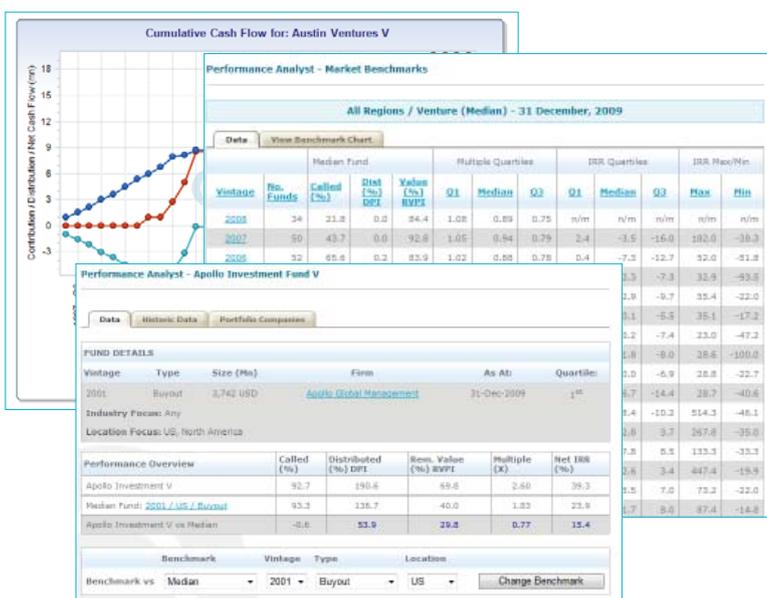
Assess each firm's long-term track record: quartile performance over several fund generations.

Median, pooled, weighted and average benchmarks: view fully transparent market benchmarks by fund type and region focus. Benchmark data for called-up, distributed, unrealized value, and top, median and bottom quartile IRRs and multiples.

Top performing GPs: view a list of firms that have consistently had funds ranked in the 1st and 2nd quartiles.

Download: data to spreadsheet for further analysis (Premium access required).

Create a tailored peer group: of funds for comparative purposes.



Performance Analyst (Standard) \$1,950 / €1,375 / £1,150

Performance Analyst (Premium) \$3,950 / €2,825 / £2,350

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Preqin private equity provides information products and services to private equity and venture capital firms, fund of funds, investors, placement agents, law firms, investment banks and advisors across the following main areas:

- Fund Performance
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Our information is drawn from as many sources as possible, with our large teams of dedicated analysts working to ensure that our research is far reaching, detailed and up to date.

Preqin regularly releases research and information on fundraising and all other aspects of the private equity industry as both research reports, and as part of our monthly Spotlight newsletter. To register to receive more research and analysis, please visit www.preqin.com/spotlight

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