

J Curve Exposure

Managing a Portfolio of Venture Capital and Private
Equity Funds

Pierre-Yves Mathonet
Thomas Meyer



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Further praise for J Curve Exposure

“Private Equity worldwide attracts growing amounts of capital that fuels the growth of an industry which probably faces its greatest challenge so far. The buy-out industry has yet to demonstrate the sustainability of the exceptional returns it has produced over the last five years while the venture capital industry has yet to bounce back and produce the sort of premium that its risk levels should command for investors. Against this backdrop, the publication by Pierre-Yves Mathonet and Thomas Meyer provides investors in the asset class with the necessary toolbox to understand its fundamentals and to enable them to apply their own judgment on the market. This should allow both existing and prospective investors to navigate the sometimes complex intricacies of the industry and to construct a robust portfolio at this crucial point of the cycle. Congratulations for this superb new work which, as their first book Beyond the J Curve will become an industry benchmark.”

—Philippe Poggioli, Managing Partner, Access Capital Partners

“Notwithstanding the attractive returns private equity may offer, there are many potential pitfalls for investors. Mathonet and Meyer have done an excellent job (again) in helping investors avoid such pitfalls and build a robust portfolio of private equity funds. Written for practitioners, their new book, J Curve Exposure provides a theoretically sound basis for those seeking exposure to this asset class. I can strongly recommend it.”

—Peter Cornelius, Head of Strategy & Economics, AlpInvest Partners

“Brilliant. No other book provides practical tools in private equity funds investments. Together with their first book Beyond the J Curve, institutional investors are now able to sail out with a compass to navigate the turbulent sea of "private equity funds". I strongly recommend this book for all of investors and especially for Asian investors who are increasing exposures in private equity assets.”

—Kazushige Kobayashi, President & CEO, Alternative Investment Capital

“The commitment of the authors to exploring, rationalising and proposing tools and methods for understanding the Private Equity industry in their second book is proof in itself of the need to permanently monitor, understand and follow the evolution of this industry. I can only praise their hard work and their willingness to make us all benefit from their valuable, wise and professional views.”

—Javier Echarri, Secretary General, European Private Equity & Venture Capital Association (EVCA)

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This book is printed on acid-free paper responsibly manufactured from sustainable forestry in which at least two trees are planted for each one used for paper production.

P.-Y.M.

To my wife Barbara

T.M.

To my wife Mika Kaneyuki who deserves my heartfelt gratitude for her
love and for encouraging me to work on this book

Contents

List of Boxes	xvii
Foreword	xix
Acknowledgments	xxi
Abbreviations	xxiii
Disclaimer	xxv
PART I PRIVATE EQUITY LANDSCAPE	1
1 Introduction	3
1.1 Barbarians, pirates and privateers	3
1.2 A difficult world to conquer	4
1.2.1 Get rich quick?	4
1.2.2 Chartering a course	5
1.2.3 Storms and barrier-reefs	6
1.2.4 Drawing a map	6
1.2.5 Setting out ships and navigating the oceans	7
1.2.6 Staying on course and moving into calmer waters	8
2 Institutional Investing in Private Equity	11
2.1 Limited partnership	12
2.2 Funds-of-funds	20
2.2.1 Additional layer of management fees	20
2.2.2 Jumpstarting the allocation to private equity	21
2.2.3 Diversification and scaling of investments	21
2.2.4 Access to top teams	22
2.3 Private equity funds investment program	22
3 Private Equity Environment	25
3.1 The informal VC market	26
3.1.1 Business angels	27
3.1.2 Business incubators	28
3.2 Private equity as part of alternative assets	30
3.2.1 Comparison of private equity with hedge funds	30

3.2.2	Encroachment and convergence	34
3.2.3	Distressed assets	35
3.3	Mezzanine financing	37
3.4	Overlap with public market	40
3.5	Conclusion	42
4	Risk Management Lessons from a Listed Private Equity Fund-of-Funds	43
4.1	Relevance of the Private Equity Holding case	43
4.2	The Swiss private equity funds-of-funds industry	45
4.2.1	The market for publicly quoted private equity funds-of-funds	45
4.2.2	Importance for investors	46
4.2.3	Growing opportunities	47
4.3	Commitments and investments	47
4.3.1	Importance of over-commitments	48
4.3.2	Best practices	48
4.3.3	Over-commitments and risks	49
4.4	The rise and (near) fall of Private Equity Holding	50
4.4.1	Opportunities and growth	51
4.4.2	The 'new economy'	53
4.4.3	Clouds gathering	54
4.4.4	Iceberg ahead	59
4.5	Definition and analysis of ratios	61
4.5.1	Comparison of Private Equity Holding and Castle Private Equity	62
4.5.2	Other factors	66
4.6	Lessons and epilogue	68
	Appendix 4A Adjusted current ratio methodology	70
	PART II THE ECONOMICS OF PRIVATE EQUITY FUNDS	71
5	Venture Capital Fund Fair Value	73
5.1	Valuation Guidelines	73
5.2	Motivation	77
5.3	Current practices	78
5.4	Problem areas	80
5.4.1	The negative impact of the J Curve	80
5.4.2	The high workload associated with valuation reviews	81
5.4.3	Entry barriers for new investors in venture capital	82
5.4.4	Current valuation techniques do not capture risk	83
5.4.5	The J Curve creates a false sense of security	83
5.4.6	Models can be abused	84
5.5	Conceptual questions	84
5.6	Can one do without judgment?	84
5.7	Is there a pragmatic way forward?	85
5.7.1	Differentiate between young and mature VC funds	86

5.7.2	Accept different standards for reliability	86
5.7.3	Assure reliability through valuation process reviews	87
6	Model-Based Approach to VC Fund Valuation	89
6.1	Why model?	89
6.1.1	Modeling simplification	90
6.1.2	Model limitations	91
6.2	The private equity data market	91
6.2.1	Players in the private equity data market	92
6.2.2	Data providers	93
6.2.3	Data service providers	95
6.2.4	Users of data	98
6.2.5	Quality of data	99
6.2.6	The economics of the VC data market	100
6.2.7	Conclusion	103
7	Private Equity Fund Valuation Approaches	105
7.1	Determining the economic value of a private equity fund	105
7.1.1	Modified bottom-up approach	106
7.1.2	Modified comparable approach	108
7.1.3	High-level comparison of modified bottom-up approach and GEM	117
7.2	Accounting valuation of a fund's portfolio of investee companies	119
7.2.1	Surveyed portfolio of private equity funds	119
7.2.2	Assessing compliance with IPEV guidelines	120
7.2.3	Assessing the degree of compliance	121
7.2.4	The impact of the new IPEV guidelines on valuations	121
7.2.5	The implications for limited partners	125
7.2.6	Model valuation process	127
7.3	Conclusion	136
8	Distribution Waterfall	137
8.1	Introduction	137
8.1.1	Terms and conditions	139
8.1.2	General partner investment in fund	140
8.1.3	Management fees	140
8.1.4	Profit and loss	143
8.1.5	Carried interest	145
8.1.6	Vesting	146
8.1.7	Main drivers of distribution waterfall	148
8.2	Basic waterfall model	150
8.2.1	Preferred return and hurdle rate	155
8.2.2	Catch-up	161
8.3	Impact of carried interest distribution approaches	162
8.3.1	Fund-as-a-whole	162
8.3.2	Deal-by-deal	165
8.3.3	Considerations and possible solutions	166

8.4	Clawback	169
8.4.1	Controversy	172
8.4.2	Protection of investors	172
8.4.3	Escrow	174
8.4.4	Timing	175
8.4.5	Limited partner clawback	175
9	Break-even Analysis	179
9.1	Objective of break-even analysis	179
9.2	Methodology	180
9.2.1	Step 1: capital contributions	181
9.2.2	Step 2: use of the contributions	181
9.2.3	Step 3: net asset value	182
9.2.4	Step 4: distributions	183
9.2.5	Step 5: distribution waterfall	184
9.2.6	Step 6: break-even IRRs	186
9.3	Scenarios and sensitivity analysis	187
9.4	Additional analysis	188
9.4.1	Incentive scheme analysis	188
9.4.2	Analysis of the wealth transferred	188
9.4.3	IRR distributions	189
10	Track Record Analysis	191
10.1	Due diligence	191
10.1.1	Performance persistence	191
10.1.2	Gathering and evaluating the data	196
10.1.3	The perils of charisma	197
10.1.4	Improving investment decisions – luck or skills?	199
10.2	Benchmarking	200
10.2.1	Classical relative benchmark	201
10.2.2	Public market equivalent	205
10.2.3	Absolute benchmarks	206
10.2.4	Prospective performance analysis	210
10.3	Track record analysis tools	210
10.3.1	Portfolio gross performance stripping	211
10.3.2	Performance dispersion (profit and losses)	212
10.3.3	Realized track record	214
10.3.4	Winners dependence analysis	214
10.3.5	Backing the winners analysis	214
10.3.6	Value creation analysis	218
10.3.7	Deal structuring analysis	219
10.3.8	Multiple arbitrage analysis	219
10.3.9	Added-value analysis	221
10.4	Limitations	222
10.5	Conclusion	223
Appendix 10A	Performance spread between best and worst manager	224

PART III	MANAGING UNDER UNCERTAINTY	227
11	Grading and Fitness Landscapes	229
11.1	Fitness landscapes	231
11.1.1	VC market as an evolutionary system	232
11.1.2	VC firms' genetic code	232
11.1.3	Does this allegory hold?	234
11.1.4	Extinctions in VC markets	235
11.2	Grading-based evaluation of private equity funds	236
11.2.1	Can we predict success?	239
11.2.2	Why not invest only in P-A graded funds?	241
11.3	Grading as portfolio management tool	245
11.4	VC market dynamics – power laws	247
11.5	Searching landscapes	249
11.5.1	Exploitative search	249
11.5.2	Explorative search	250
11.6	Conclusion	250
12	Private Equity Funds and Real Options	253
12.1	Agency problems and contracting	256
12.1.1	Incomplete contracting	257
12.1.2	Renegotiation and real options	257
12.2	Changes in limited partnership agreements	258
12.2.1	Main findings	258
12.2.2	Changes related to promising funds	260
12.2.3	Changes related to problematic funds	260
12.2.4	Other observations	261
12.3	Braiding	262
12.4	Summary	267
13	Co-investing	271
13.1	Motivation	272
13.1.1	Relevance	272
13.1.2	Co-investment approach	273
13.2	Co-investment risk and rewards	275
13.2.1	Limited partner perspective	276
13.2.2	Fund manager perspective	277
13.2.3	Experiences with co-investment programs	277
13.3	Potential issues related to co-investments	277
13.3.1	Second-guessing fund managers	277
13.3.2	Cherry-picking	278
13.3.3	Conflicts of interest	278
13.4	Implementation issues	279
13.4.1	Speed of execution	279
13.4.2	Team set-up	280
13.5	Portfolio management	281
13.5.1	Managing portfolio composition	281
13.5.2	Link to other strategies	282

13.5.3	Leveraging international network	283
13.6	Conclusion	283
14	Side Funds	285
14.1	'Classical' side funds	285
14.1.1	'Raison d'être'	285
14.1.2	Structuring	288
14.2	Side funds – similar structures	291
14.2.1	Re-investment of proceeds	291
14.2.2	Top-up funds	293
14.3	LPs structure or how to increase flexibility	294
14.3.1	Conditional commitment	294
14.3.2	Limited partners' staged investment	295
14.4	Conclusion	298
15	Limited Partner Decision-Making Fallacies	299
15.1	Decision-making with poor data	299
15.2	Herding as a response to uncertainty	300
15.2.1	Betting on every horse	301
15.2.2	Imitate and turn to experts	301
15.2.3	Protect one's reputation	302
15.2.4	Creating reality	302
15.2.5	VC industry as 'crisis hunter'	304
15.3	Decision-making biases	305
15.3.1	Mental accounting	306
15.3.2	Anchoring	308
15.3.3	Endorsement effect	309
15.3.4	Status quo bias	309
15.3.5	Regret	310
15.3.6	Home bias	311
15.3.7	Over-optimism	311
15.4	Conclusion	312
PART IV	MANAGING PORTFOLIOS OF PRIVATE EQUITY FUNDS	315
16	Portfolio Construction Principles	317
16.1	Private equity and modern portfolio theory	317
16.1.1	Fitting private equity into the requirements for MPT	318
16.1.2	Private equity fund risk	320
16.1.3	Private equity fund exposure	321
16.1.4	How much to allocate to a private equity funds investment program?	324
16.1.5	Other issues	328
16.2	Creating a portfolio of private equity funds	328
16.3	The risk profile of private equity assets	331
16.3.1	Private equity funds	331
16.3.2	Portfolio of private equity funds	341
16.3.3	Further remarks	346

16.4	Risk dimensions	346
16.4.1	Stage focus	347
16.4.2	Vintage year	348
16.4.3	Industry sector	349
16.4.4	Geography and currencies	350
16.4.5	Agent concentration	350
16.4.6	‘Naïve’ diversification	350
17	Portfolio Construction Rules of Thumb	355
17.1	What we know	356
17.2	What we think we know or simply don’t know	360
17.3	Exploitation vs. Exploration	364
17.3.1	Structured exploring	364
17.3.2	Core/satellite portfolio	365
17.3.3	Uncertainty budget	366
17.3.4	Balancing exploitation, exploration, growth and survival	366
17.3.5	Adapting, shaping & insuring	368
17.3.6	Diversification and portfolios as networks	370
18	Guidelines, Monitoring and Corrective Actions	371
18.1	Investment guidelines as framework	372
18.1.1	Trade-offs	374
18.1.2	Investment policies	374
18.1.3	Investment strategy	375
18.2	Implementation of investment policies	375
18.2.1	Negative screens	376
18.2.2	Positive screens	376
18.2.3	Best-of-sector approach	376
18.3	Monitoring investment restrictions	377
18.3.1	Investment restriction checking	377
18.3.2	High-level process description	378
18.3.3	Conceptual questions	380
18.3.4	Statement of assurance	382
18.4	Monitoring strategy implementation	383
18.4.1	Portfolio limits	383
18.4.2	Portfolio benchmarking	383
18.5	Corrective actions	387
18.5.1	Rebalancing through secondary sells	388
18.5.2	Portfolio segmentation	388
18.5.3	Conclusion	393
19	Securitization	395
19.1	Structure of private equity CFO	395
19.1.1	Introduction to securitization techniques	395
19.1.2	The CFO market	397
19.2	Which private equity assets?	400

19.3	Parties involved and their objectives	402
19.3.1	Overview	402
19.3.2	The originator	403
19.3.3	Fund managers	404
19.3.4	Investors	404
19.4	Modeling the transaction – simulating the performance of the assets	406
19.4.1	Monte Carlo simulation	406
19.4.2	Modeling approaches	408
19.4.3	Use of historical data	409
19.5	Modeling the transaction – structural features	411
19.5.1	Investment guidelines	411
19.5.2	Cash flow management	412
19.5.3	Interest rates	415
19.5.4	Currency	417
19.5.5	Liquidity	417
19.5.6	Waterfall	417
19.6	External rating	417
19.6.1	Rating approach	417
19.6.2	The management review	418
19.6.3	Surveillance	418
20	J Curve Exposure	423
20.1	Cultural influences	423
20.2	Blurred boundaries	424
20.3	Limited scalability	425
20.4	End-game?	425
	References	427
	Index	441

List of Boxes

2.1	Basic definitions	12
2.2	(Pre-)Islamic finance and venture capital	16
3.1	Equity gap	27
3.2	Possible candidates for turnaround deals	36
4.1	Stock market view	55
4.2	Fair value	58
4.3	Earn-out	60
4.4	Adjusted current ratio	62
4.5	Outstanding commitment level	64
4.6	Investment level	65
5.1	The J Curve	74
5.2	Valuation disputes	78
7.1	Expected performance grades	109
7.2	Operational status grades	110
7.3	Internal age	113
7.4	Valuation committee	128
7.5	Valuation reviews	133
8.1	Affiliates' arms-length services	142
8.2	'Hard' hurdle rate	156
8.3	'Soft' hurdle rate	157
8.4	Hurdle rate distortion	159
8.5	Full-fund-back impact	162
8.6	Nightmare clawback scenario	172
8.7	Clawback insurance	174
10.1	'Experts' vs. 'tourists'	192
10.2	Spread	194
10.3	Questionnaires	197
10.4	Return measures	200
10.5	Other influences on track record	202
10.6	Aggregation methodology	204
10.7	Cost of capital vs. return expectations	206
10.8	Herfindahl index	213
10.9	Attribution letter	223
11.1	Uncertainty	230
11.2	'Elite' funds	237

11.3	'Special deals'	243
11.4	Peer groups	246
12.1	Limited partner real option to defer	255
12.2	Limited partner real option to abandon or to contract	259
12.3	Limited partner real option to extend or to expand	265
12.4	Public scheme option to expand	267
13.1	Specialized co-investment funds	273
14.1	UC Stand-By Facility	286
15.1	Are investors in VC funds rational?	302
15.2	Active waiting	305
15.3	Mental accounting	306
15.4	Institutional quality funds	308
15.5	Regret	310
16.1	Skewness and kurtosis	319
16.2	Return risk and capital risk	320
16.3	Return-to-risk ratio	333
16.4	Sortino ratio	333
16.5	Risk-adjusted pricing	335
16.6	Cluster analysis	351
17.1	Desirable and undesirable diversification effects	361
18.1	Investment guideline design	372
18.2	Socially responsible investing	375
18.3	Ensuring compliance with investment restrictions	379
18.4	Exclusion criteria interpretation	380
18.5	Drawdown note/disbursement compliance checklist	382
18.6	Interim performance of a portfolio of private equity funds	384
18.7	Portfolio of funds benchmarking	385
18.8	Final expected performance	386
18.9	VC fund restructuring case study	389
19.1	Securitization of VC funds	398

Foreword

Private Equity is possibly more visible now than in any other period in its history. As a consequence, many people today feel entitled to express strong and often radical opinions on the industry. Whilst the variety of opinion is impressive and to a large extent constitutes the proof that the industry has become 'on-exceptional', the lack of depth in some of the more colourful is regrettable and harmful.

In their previous book, 'Beyond the J Curve', Thomas Meyer and Pierre-Yves Mathonet provided readers with an in-depth presentation of the private equity industry. By sharing further their professional experience as investors in the asset class they positively contribute to the current debate. The Private Equity industry is complex and any comment on its operation and/or economic impact should be based on a thorough understanding. New comers in private equity will build such understanding by reading this second book while seasoned readers will be challenged by the approach presented in terms of portfolio construction and notably by the role played by venture capital.

The historical track-record evidence of the Private Equity industry used by the authors in their introduction reveals itself as cleverly entertaining and particularly clarifying in understanding the relevance of the industry business model in its different forms, its adaptation capacity and its intrinsic nature of permanent search for effective investment.

To use the analogy of some of the current opponents of the Private Equity industry, the 'wildest animal in the zoo' is actually one of those rare and old animals which from the start, like the Venetian Merchant, have been able to adapt and evolve to embrace the changing nature of the economy and as a consequence remain relevant, alive and rewarding today.

This Darwinian nature of the industry is further evidenced and very well documented by the authors at the level of individual management companies that go through the private equity cycle from the initial fundraising to the next one. While many teams fail to raise their second fund, new players enter the market on the back of their relevant experience for the foreseeable challenges and opportunities. Understanding this basic principle of permanent adaptation is a sine-qua-non start point for entering the industry.

It is important for institutional investors embracing this asset class to acknowledge that it requires not just a strategic long-term commitment but also a deep understanding, permanent monitoring as well as active building and management of the portfolio. As the authors highlight, it is about building a 'life-time program' of an asset which is core and not peripheral. This book will help investors build the tools for understanding, measuring and managing and diversifying their portfolios with that long-term perspective in mind and away from knee-jerk reactions or fashionable me-too strategies.

Regardless of the future evolution of this permanently changing asset class, the size and scope of the players in this market – from brand names to specialized boutiques – the

foreseeable higher liquidity potential and sophistication derived from the combined impact of the secondary market, portfolio management and individual deal management, the tools provided in this book, as well as the in-depth understanding that it facilitates, make it a permanent consultation work to be kept on the office desk.

A thorough reading of this work could also help some of those with extreme opinions to assess the relevance of their views and the impact of what they wish for. I would argue that the Venetian merchant families 'commendas' benefited the whole of Venetian society and not just themselves.

The commitment of the authors to exploring, rationalising and proposing tools and methods for understanding the Private Equity industry in their second book is proof in itself of the need to continually monitor, understand and follow the evolution of this industry. I can only praise their hard work allowing us all to benefit from their valuable, wise and professional views.

Javier Echarri
EVCA SECRETARY GENERAL
Brussels, 31st July 2007

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Abbreviations

ABS	Asset Backed Security
AFIC	Association Française des Investisseurs en Capital
BVCA	British Venture Capital Association
CAPM	Capital Asset Pricing Model
CDO	Collateralized Debt Obligation
CFO	Collateralized Fund Obligation
DCF	Discounted Cash Flows
EIF	European Investment Fund
EU	European Union
EVCA	European Venture Capital and Private Equity Association
FLP	First Loss Piece
FOIA	Freedom of Information Act
FoF	Fund-of-Funds
GEM	Grading-based Economic Model
GP	General Partner
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IRR	Internal Rate of Return
LBO	Leverage Buyout
LP	Limited Partner
M&A	Mergers and Acquisitions
NAV	Net Asset Value
NPI	Net Paid-In
NPV	Net Present Value
NVCA	National Venture Capital Association
PE	Private Equity
POC	Performance, Operational and Compliance grading
PPM	Private Placement Memorandum
PTPE	Publicly Traded Private Equity
SPV	Special Purpose Vehicle
VaR	Value-at-Risk
VC	Venture Capital

Disclaimer

Private equity firms whose names are mentioned explicitly in this book were taken as representative examples, but are not positively or negatively recommended. Many of the concepts presented here have been researched and developed in the course of our work with the European Investment Fund. However, for this book we have researched private equity market practices and discussed different approaches with industry practitioners. The statement made in this book represents the personal opinion of the authors and does not necessarily reflect the views of the European Investment Fund.

Part I

Private Equity Landscape

