

LP (Limited Partner) assessment of a fund. V6

What is the purpose of this article?

- 1) Help individual LPs (Limited Partners) think about how to assess a fund making investments in private companies. Institutional investors, family offices, and ultra-high net worth individuals should do more than what is discussed here.
- 1) Help fund managers prepared to engage with knowledgeable LPs.
- 2) This article is for those people who view these investments as part of their overall investment portfolio and thesis.

This article does not provide legal, tax, financial, or investment advice.
You must do your own research and fact-based analysis using current and relevant information.

This article is focused on funds which control portfolio companies.

This article helps LPs start to think about the fund talent which will grow the LPs investment and return cash to the LP.

This article does not address funds which have no control over their portfolio companies.
An LPs success in this situation requires two stages of success: picking a fund which can then invest with a controlling fund; and the controlling fund then being successful.

What are the critical learnings in this article?

- 1) Assess a fund (which is asking you for money) the same way they'd assess a company asking them for money.
- 2) Understand how the fund and its managers are competitively superior i.e. managers know things that others don't and can do things others cannot.
- 3) Understand the potential for the fund managers to succeed in rapidly changing and different future.

Is your fund going to be part of an asset class in your overall investments?

Your overall investments have the core goal of growing and preserving your capital. This capital may be needed for:

- 1) Retirement;
- 2) Heirs and estate (may include a foundation); or
- 3) Major future spending; etc.

I've observed that some early-stage investors, including some angel investors, do not include these expenditures as part of their overall investments. They view these expenditure as:

- 1) Giving back; or
- 2) Supporting worthy causes and worthy individuals.

This article is focused on those people who consider their fund investment as part of an asset class in their overall investments.

The economic interests of the fund general manager and fund investor are not the same.

- 1) The fund investors' economic return is the rate of return on the capital put into the fund.
- 2) The fund managers' economic return is a combination of management fees, other fees, and a share of the increase in the value of the capital in the fund.

What is the most critical part of the LPs assessment?

How does the fund manager plan to return cash to LPs via successful exits? At this point in time many funds are having difficulty selling portfolio companies, resulting in cash returns to investors no meeting expectations.

- 1) What has been the manager's historical results? What has been the return on investment?
- 2) What is the manager's process for exit planning?
- 3) Does the manager start exist planning as part of the investment selection processes? Do they talk with potential buyers to determine the exit potential? Do they maintain ongoing dialogue with potential buyers? I've seen buyers disappear as the world changed, resulting in the inability to exit.

What is the fundamental approach for assessing a fund?

There are four stages to a fund

- 1) Assembling a group of LPs.
- 2) Selecting investments.
- 3) Growing the value of the investments.
- 4) Achieving the value by exiting/selling the investments.

Some of the critical questions you must answer regarding the fund managers include:

- 1) How are the fund managers competitively differentiated in their capabilities? This includes talent, processes, and technology.
- 2) What do they know that fund managers don't know?
- 3) Are the fund managers above average? In the top quartile? Or higher? Or in the bottom quartile
- 4) What has been their historical performance. This may be: in a previous fund, previous persona investment results, or their career.

Assess a potential fund (which is asking you for money) the same way the fund assess a company asking them for money

Why focus on understanding how the fund managers are competitively differentiated?

Unlike 10+ years ago, these days there are countless funds and unlimited capital available. Some of the implications include:

- 1) Many funds have been created by managers with limited capabilities to be successful.
- 2) The massive increase in the total number of funds means that there has been a massive increase in the number of below average funds.
- 3) Superb portfolio companies seek out funds that can provide more than just capital.

Do the fund managers have the potential to succeed in a rapidly changing and different future? ¹

The future will quickly be very different from the past. Leading companies (of all kinds) are finding new and better ways to be successful. To what degree do the fund managers have the 8 core components of talent to succeed in a very different and uncertain future?

- 1) Self-awareness: e.g. Do the fund managers understand their strengths and weaknesses?
- 2) Character: e.g. Values, morals, and ethics. Warren Buffett supposedly said "...looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if you don't have the first, the other two will kill you."
- 3) Relationship skills: e.g. Ability to create and sustain a network of personal relationships.
- 4) Crystallized intelligence: e.g. what skill, knowledge, ways of thinking, mental paradigms, and facts must the managers have.
- 5) Fluid intelligence: e.g. The ability to solve problems without past experience. This is critical for innovation, which is coming up with new and better solutions.
- 6) Cognitive skills: e.g. Able to collect and do fact-based analysis with sound logic and reasoning.
- 7) Ability to quickly learn and unlearn: paradigms, frameworks, methodologies, data, facts, knowledge.
- 8) Creativity

Some large LPs test the fund partners for the above talent components.

Your assessment of the above 8 talent components requires defining positive and negative indicators for:

- 1) observations regarding the analysis of the data room;
- 2) answers to questions for the fund managers references;
- 3) answers to questions for others who have interacted with the fund managers;
- 4) answers given by questions to the fund managers; and
- 5) outcomes of the behavioural interviews of the fund managers.

What are the four decision stages for assessing a fund?

You need a filtering process to end up with a few high potential fund candidates. Why a filtering process? You might have contact with dozens or hundreds of funds. You don't have time to do in-depth analysis of each fund.

- 1) Should you open an email from a fund or reach out to a fund?
- 2) Should you have a brief chat with a fund?
- 3) Should you conduct due diligence with the fund?
- 4) Should you make an investment?

There are three sets of assessment criteria and analysis, distributed throughout the four decision making stages.

- 1) Alignment with and support of your investment thesis.
- 2) Past accomplishments and plans to grow your investment.
- 3) The capabilities of the fund managers to succeed in an uncertain future.

Some assessment criteria result in an immediate rejection of the fund (e.g. you don't trust the fund managers) while other criteria result in a scoring.

Your assessments reflect:

- 1) The competitive differentiation of the fund and its managers.
- 2) Both the potential to increase the value of your assessment and to manage risk.

What is the purpose of the data room?

- 1) The data room provides a collection of documents which are intended to help answer some of your due diligence questions.
- 2) You'll need to analyze the data room contents and benchmark the fund relative to other funds. The benchmark may range from an informal judgement to a factual analysis.

What are the fund's 8 sets of data room contents, if this is the managers' first fund?²

- 1) Fundraising pitch deck, including: team, including managers, advisors, etc. (with biographies), the opportunity (i.e. what is the market gap and why is the team best positioned to win), investment thesis, sourcing strategy decision making process, case studies, track record spreadsheet, portfolio construction, fund structure and terms.
- 2) Investment track record detail. If this is the managers' first fund, the investment track record will include results from previous funds the managers were at and the managers personal investment results.
- 3) Investment memos and market map. The market map illustrates the segments and potential portfolio companies.³
- 4) Due diligence questionnaire. An industry standard questionnaire is provided by the ILPA (Institutional Limited Partners Association)
- 5) LPA (Limited Partnership Agreement).
- 6) Fund Model. A financial spreadsheet illustrating hypothetical future portfolio, with a number of key metrics
- 7) Reference list. You may also contact people not on the reference list. You may also require a formal background check of the fund managers. Who are the other investors, their experience and value, and why did they invest?
- 8) Fund contact list. This includes lawyers, accountants, other professionals, etc.

What are the fund's 6 additional sets of data room contents, if this is NOT the managers' first fund?²

- 1) Financial information i.e. free cash flow actuals and forecast scenarios; audited financial statements.
- 2) Examples of prior capital call and distribution notices.
- 3) Compliance manual.
- 4) ESG (environmental, social and governance) and DEI (diversity, equity and inclusion) policies.
- 5) Valuation policies.
- 6) Business continuity planning.

How are LPs engaged with the General Partner?

- 1) What information is provided to the LPs and when?
- 2) How often is there a meeting of all LPs and what is the purpose of those meetings?
- 3) What authority do LPs have? What decisions must they approve? What veto power do they have?

What is the role of the LPAB (LP Advisory Board)?

- 1) What is the purpose of the LPAB?
- 2) What is the documented mandate?
- 3) What authority does the LPAB have? What decisions does it make? What veto power does it have?
- 4) How often does it meet?
- 5) What information is provided to the LPAB and when?
- 6) Who is on the board and how are they members selected?

What fees might be charged to investors, directly or indirectly?

Fund manager fees are specific to each fund. Compensation is not always fully disclosed to LPs, especially if fees are charged to portfolio companies. Fees may include:

#1 Annual management fee: This could be based on: invested capital; or committed capital; or net asset value of the fund. The fees often range from 1.25% to 2%. Some charge less.

#2 Fund's administrative fees: These could include: legal, audit accounting. Sometimes these are capped at 0.10% to 0.15% of assets.

#3 Annual performance fees: These can range from 15% to 30% of annual net profit. Performance fees are often subject to:

- 1) hurdle rates (e.g. profit must exceed 5%-8%, compounded annually. The manager's performance fee is based on profit after the hurdle rate);

- 2) high water mark (fund value exceeds previous highest value of the fund. Thus, if a fund drops in value, and then goes backup, performance fees are only paid after exceeding the previous peak value)
- 3) The degree to which portfolio companies meet or exceed environmental, social, sustainability, climate, and governance factors. Some funds say that they are focused on these factors.

#4 The fund may receive fees from the portfolio companies. Sometimes these fees reduce the management fees charged to investors.

- 1) Breakup fees: a portfolio company buyer decided to not do the acquisition.
- 2) Directors' fees: portfolio companies may compensate board directors who are representatives of the fund.
- 3) Advisors: advisors to the fund and/or portfolio companies may charge fees
- 4) Affiliate services fees: Affiliates of the general partner may be paid for thing such as: underwriting, consulting, placement agent services
- 5) Placement agent fees: agents who are paid to sell LP partnership interest

#5 How much of the fund's management fee is going into partners pockets vs helping to grow the long-term value of the fund?

- 1) Some funds make provide support people such as HR, finance, IT, etc. These are funded from the management fee, not by investors. Thus, short-term partner income is reduced.

How has the fund manager learned and changed from their past experiences?

- 1) Is the manager doing the same things as 10 years ago or have they learned and evolved? How has their talent, processes, and technology changed? E.g. What role is data science and AI playing in both portfolio company screening and daily monitoring?

What are the fund's performance numbers and value drivers?4

- 1) 75% of LPs recalculate a fund's performance using deal-level cash flow data. This enables LPs to make consistent comparisons of performance among funds.
- 2) Determine the impact of credit facilities and financial leverage on the fund's performance.
- 3) Analyze the fund's value creation drivers using techniques such as: PME (Public Market Equivalent analysis), Sensitivity analysis (e.g. did one deal drive all results, and every other deal failed), Valuation Bridges (e.g. did value creation come from operational improvements, financial engineering, M&A, etc.)
- 4) How did the fund managers increase the capabilities of the portfolio company leadership teams? E.g. improving the talent, improving recruiting, improving exiting, improving succession planning?
- 5) How did the fund managers assess and improve the leadership coaches and advisory boards for their portfolio companies?

The above questions regarding talent improvement in portfolio companies also apply to the fund managers and other talent in the fund company.

What technology does the fund use?

- 1) What software is used to manage the pool of potential portfolio companies? This pool could include: companies applying, companies discovered by the software, or companies contacted by the fund. Software could also manage the process and information of potential companies going through the selection and deal process. What are the metrics?
- 2) What software is used to manage the data room made available for potential LP investors?
- 3) What data science tools are used in the selection and monitoring of portfolio companies? What are the metrics?
- 4) What AI tools are used in the selection and monitoring of portfolio companies? What are the metrics?
- 5) What tools are used to manage the relationship with LPs, including reporting to LPs?
- 6) What tools are used to support the LP Advisory board?

What valuation methodology does the fund manager use?

There are various methodologies, including:

- 1) International Private Equity and Venture Capital Guidelines ⁵
- 2) Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies - Accounting and Valuation Guide ⁶
- 3) Fund performance (in terms of cash distributions) relative to an ETF, such as S&P 500 or asset allocation fund.
- 4) Realizable value if sold the fund investment on the secondaries market.

What value does the fund manager assign to a portfolio company if there are no current buyers. I've seen some funds assign value of what they hope or wish to achieve in the future.

The further reading section of this article provides reports from INSEAD regarding private equity valuation.

What are your next steps?

- 1) Define the words/concepts you're using, in a glossary. I've seen major confusion when the same words mean different things to different people.
- 2) Review your overall investment thesis and thesis for the asset class your fund will reside in.
- 3) Create your template for your personal investment memo. This will capture your facts, analysis, and judgement as to why you want to make the investment in the fund. This will be helpful in the future, both as you look back and as you consider additional fund investments.
- 4) Prepare your plan. This will include specific decision-making processes and criteria, including those red flag items which result in immediate rejection of a fund candidate.
- 5) Assemble your team e.g. lawyer with experience in LP agreements (and governance and dispute resolution), tax advisor, other professionals to assist with the data collection and analysis. Your team might include psychologists.
- 6) Prepare your selection and evaluation plan and identify at what stage(s) the information will be collected and analyzed. Depending upon the number of investments you plan to make, you may decide to use LP management software.

Footnotes

¹ What are the core components of talent, Koor and Associates

<http://koorandassociates.org/creating-business-value/core-components-of-talent/>

² "Data Room Best Practices", Silicon Valley Bank

<https://www.svb.com/emerging-manager-insights/starting-a-fund/data-room-best-practices>

³ Illustration of a market map, Atlantic Canada Fintech, 2022

https://atlanticfintech.ca/wp-content/uploads/2022/11/fathom4sight_atlantic-fintech_ENG-report_2022.png.pdf

⁴ Enhancing private equity manager selection with deeper data

https://caia.org/sites/default/files/enhancing_private_equity_manager_selection_with_deeper_data.pdf

⁵ International Private Equity and Venture Capital Valuation Guidelines, 2022 DEC

<https://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202022.pdf>

⁶ The American Institute of CPAs

<https://www.aicpa-cima.com/cpe-learning/publication/valuation-of-portfolio-company-investments-of-venture-capital-and-private-equity-funds-and-other-investment-companies-accounting-and-valuation-guide-OPL>

What further reading should you do?

Valuation and return measurement in private equity. Insead 2011 May

<https://publishing.insead.edu/case/valuation-and-return-measurement-private-equity-overview>

Measuring private equity fund performance Insead 2019 Feb

https://www.insead.edu/sites/default/files/assets/dept/centres/gpei/docs/Measuring_PE_Fund-Performance-2019.pdf

Value Creation 2.0 A framework for measuring value creation in private equity investment Insead 2016 Feb

<https://www.insead.edu/sites/default/files/assets/dept/centres/emi/docs/value-creation-2-0.pdf>

"Data Room Best Practices", Silicon Valley Bank

<https://www.svb.com/emerging-manager-insights/starting-a-fund/data-room-best-practices>

"Due Diligence Questionnaire", Business Finland Venture Capital

<https://www.businessfinland.vc/4af44d/siteassets/venture-capital/sijoitusdokumentit/bfvc-due-diligence-questionnaire.docx>

Why are values, morals, and ethics important?

<http://koorandassociates.org/values-morals-and-ethics/why-are-values-morals-and-ethics-important/>

How to assess director and CEO talent – regarding values, morals, and ethics.

<http://koorandassociates.org/values-morals-and-ethics/how-to-assess-director-and-ceo-candidates-regarding-values-morals-and-ethics/>

How do asset managers assess private equity fund managers?

<http://koorandassociates.org/creating-business-value/survey-how-do-asset-managers-assess-private-equity-fund-managers/>

Institutional Limited Partners Association

<https://ilpa.org/>