

YOUR PENSION FUND STRATEGY: A ROLE FOR IRISH VENTURE CAPITAL?



Current market valuations of bonds, equities and property imply relatively low returns from the mainstream investment assets for the long-term future. Despite the better conditions of the past few years, pension fund trustees should not expect that the ravages of the perfect storm of 2000, 2003 - weak equity markets, falling bond yields and increased longevity – will be corrected by returns generated in the future by the mainstream assets.

In fact for many funds, the probability is that investment returns will make only a partial contribution to the resolution of current difficulties. Contributions from members and from the corporate sponsor may also have a role. Meanwhile, in developing investment strategy trustees will be required to dig deeper and search wider to find added value in a low returns world.

For many trustees, this search will embrace alternative assets which may have the potential to increase returns and / or reduce risk (or volatility). In particular, the search will be for alternative assets which score highly on the following three key attributes

- high expected returns,
- acceptable risk (or volatility),
- low correlation with equity returns.

In Table 1 the characteristics of the various alternative assets are compared with quoted equities. Private equity, and venture capital in particular, are familiar assets to many Irish pension funds. In this article I discuss the characteristics of venture capital with particular reference to the funds raised in Ireland in 1994 and consider issues arising.

PRIVATE EQUITY DEFINED

Private Equity refers to a commitment of monies to unquoted companies across the full spectrum of company maturity from start-up to mature established businesses.

Buy-Outs focus on mature, cash generative businesses applying financial leverage to gear up returns. This has been the high growth / high returns segment in recent years, attracting huge volumes of new money.

Venture Capital exploits the superior growth rates of smaller, immature and developing companies. In Ireland the focus of the private equity industry has been largely on venture capital and particularly in recent years on high-tech, early stage companies in the information and computer technology and life sciences sectors. A buoyant economy, a friendly fiscal regime and strong government support for research and development spending provide a favourable background for new businesses driven by entrepreneurs, many with extensive multi-national experience. Importantly, entry prices to these businesses are still realistic.

ISSUES ADDRESSED

Risk

Clearly, risk at underlying investee company level is high. However, this may be managed by applying the pension fund's normal approach to diversification:

- The pension fund will blend its private equity exposure into its overall portfolio,
- Private equity exposure may be spread over type (buy-out or venture capital), region and manager;
- The private equity manager will apply sectoral and stock diversification at the portfolio construction level.

Private equity volatility appears to be on a par with quoted equity volatility, though the comparison is clouded by measurement issues and by the relatively wide dispersion of private equity fund returns.

	Private Equity	Commodities	Hedge Funds – Absolute return strategies	Hedge Funds – High return strategies	Property
Expected long-term returns	Higher	Similar	Lower	Higher	Lower
Volatility/Risk	Higher	Higher	Lower	Higher	Lower
Correlation with quoted equities	Medium	Low	Low	Medium to high	Low
Liquidity	Much lower	Similar	Lower	Lower	Much Lower
Transactions costs and management fees	Much higher	Similar	Much higher	Much higher	Much higher
Cash flows	Less predictable	No cash flows	More predictable	Less predictable	More predictable

Table 1 Alternative Assets Compared to Quoted Equities

THE IRELAND 1994 FUND : A CASE STUDY

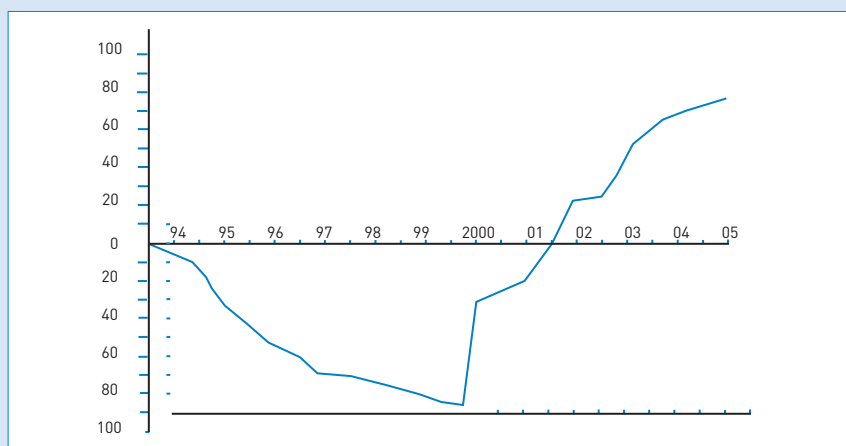


Table 2

The J-Curve

Combining the cash flow data of the three main Irish venture capital funds launched in 1994 – The ACT 1994 Development Capital Limited Partnership, The Delta Equity Fund Limited Partnership and the ICC Venture Capital Fund, which is now managed by Bank of Scotland (Ireland) – it is possible to generate a real life illustration of the Irish experience in venture capital investment over the period 1994 to 2005. The patterns of drawdowns and repayments are amalgamated to produce the J-Curve shown in Table 2.

1. Drawdown of funds committed began in the second half of 1994.
2. The total originally committed by investors was €118m. Total drawdown was €110m, but because repayments commenced before final drawdown net drawdown peaked at €85m at end 2000.
3. Just 18 months later, by mid 2002, net repayments had exceeded net drawdowns i.e. investors had received back more than their payments.
4. By end December 2005 net repayments had amounted to €67m. Residual value at that date was €53m.

Total values generated, therefore, amounted to €120m after repayment of all monies drawn down.

5. Experience since end 2005 is positive with planned realisations expected to comfortably exceed residual values.
6. The sharp upward leg of the J-Curve during 2000 demonstrates the success of the fund managers in exploiting the high market valuations which prevailed for much of that period.

Fund Investment Strategy

The evolution of the Fund's investment strategy reflected

- ▶ the different focuses of the three fund managers, ACT, Delta and ICC,
- ▶ the incipient recovery, at the time of the "Fund's" launch, and subsequent high growth phase of the domestic economy and
- ▶ the emergence of a dynamic indigenous technology sector as software, ICT and biopharmaceutical companies sought start-up and development capital.

The managers exploited the strong domestic economic background with significant investments in building and construction – McInerney, Geith International, Senator

Windows, in consumer businesses – O'Leary's Pharmacy, Lifestyle Sports, Lets Talk Phones and in media – TV3, County Media and Today FM. In the latter years focus switched to an intensive involvement in the development of the domestic technology sector. Significant investments were made, and in some cases already successfully exited, in software, ICT and biopharmaceuticals. In particular, highly remunerative investments have been realised in Aldiscon, BCO Technologies, Massana, Rogers Group and Datalex. Others continue to perform well. In summary, the fund managers followed a diversified strategy, balancing the cyclical sectoral opportunities created by the booming domestic economy with the emerging high growth and technologically driven business models which are central to Ireland's long term development.

Returns

The annual Internal Rate of Return (net of all fees) on the Fund for the period December 1994 – December 2005 was 15.7%. This outcome compares favourably with

- ▶ inflation in the period of 3.1% p.a.,
- ▶ unusually high returns of 9.1% p.a., 6.0% p.a. real, on 10 year government bonds,
- ▶ returns on European venture capital of 9.4% p.a., though this lagged well behind Buy-out returns in the period.
- ▶ returns on quoted European equities of about 10% p.a.,
- ▶ and compared reasonably favourably with the extraordinarily high returns of 16.4% p.a. generated by Irish equities in the period. These Irish equity returns of 13.4% p.a. real compare to historic real long term returns on Irish equities of 4.8% p.a.

These results confirm the international experience that venture capital adds value to overall returns.

Liquidity

Investor attitudes to liquidity are changing as the underlying volatility of the global economy and inflation rates subside. Investors are increasingly willing to attach specific roles to individual assets – match index/generate added value/reduce risk/provide liquidity. Meanwhile, perceptions

over private equity liquidity appear to be overstated. The J-Curve effect (described above), trade sales, IPOs and an improving but yet underdeveloped secondary market combine to allay these concerns.

Fees

Management fees arising on a private equity

fund typically include

- i) an annual management fee of 1.5% to 2.5% of committed capital, and
- ii) a "carried interest" or participation of 20% of total gains, which may be subject to a hurdle rate.

Private equity fees are significantly higher

than those arising for management of quoted equity portfolios and reflect the hands-on and intensely active nature of the private equity process. Fees are aligned with those arising on the alternative assets generally.

Irish VC Funds launched in 2000

These funds were launched at the height of the equity bubble and on the cusp of a devastating recession in the technology sector. Not surprisingly, the funds have struggled so far. The Irish managers slowed their investment rate, conserving capital and elongating the J-Curve effect. The J-Curve is now on its upswing and the managers have both capital and time to generate returns. In the circumstances, the eventual outcomes will be generally reasonable and

will compare relatively well with international funds of similar vintage.

CONCLUSION

The search for risk-efficient, added value will inevitably lead pension funds to private equity investment. Irish pension funds should particularly weigh the attractions of Irish venture capital:

- ▶ supportive domestic economic and fiscal environment,
- ▶ sharp focus on the high growth technology sector,
- ▶ a generation of self-confident entrepreneurs to run the investee companies, and
- ▶ an experienced and seasoned venture capital industry.



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