Private Equity Key Terms and Performance Metrics

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This publication is Part 3 of a Private Equity series prepared by BMO Family Office with the aim to raise awareness and understanding on a variety of private equity topics, and how they can be utilized to potentially enhance client portfolios. This article will discuss the common terms used in the private equity sector and how performance is evaluated.

Private Equity Common Terms

Prior to discussing how performance is measured in private equity, it is important to understand the terms that are most commonly used in the private equity sector.

Common Terms
General Partner or GP is the manager of the fund and is the firm responsible for managing the investments on behalf of the LPs.
Limited Partner or LP are the investors in the fund. LPs can range from individual investors to large institutions.
Performance Fee is the fee that is collected by the manager or GP on the performance achieved from their investments. This is the GP's main form of compensation and is designed to align the interests of the manager and investors.
Committed Capital is how much an investor committed to invest in a private equity strategy. It is important to remember that the bulk of the amount an investor commits to a strategy is not immediately invested, unlike traditional investments where the funds are entirely taken up front.
Capital Call is when the GP requests an LP to send a portion of their committed capital to the manager to fund an investment. Note that the majority of capital is called within the first three to four years of a fund's life.
Reinvestment Risk represents the risk that an investor will be unable to reinvest capital received into a similar investment. This is a key risk for private equity as it typically produces larger and irregular cash flows. However, there is often a lag between when an investor receives distributions and their ability to reinvest.

Measuring Performance

Evaluating private equity performance is more challenging than traditional equity securities, as investments and distributions are made in different amounts over several years. Therefore, investors should not only consider the amount they are earning on their investments, but also the timing of the cash flows. Below are several of the most common performance metrics with explanations for each.

Relationship between RVPI, DPI &TVPI/MOIC

Residual Value to Paid In (RVPI)	+	Distributions to Paid In (DPI)	=	Total Value to Paid In (TVPI)/Multiple on Invested Capital (MOIC)
What is it? The total value of the current investments divided by the total amount contributed. **Its weakness?** It can inflate performance as there is no guarantee that returns will be realized. **When does it matter most?** Typically in the earlier years of a fund's life when the manager is focused on value creation rather than returning capital.		**What is it?** The total value of the distributions divided by the amount contributed. **Its weakness?** Early in the life of the fund, this amount will be low and does not indicate future performance. **When does it matter most?** In later years as lower DPIs in mature funds may indicate that they are unable to sell current investments at attractive prices.		**What is it?** The total value of combined distributions and share price divided by the amount contributed. **Its weakness?** Does not reflect timing of cash flows or reinvestment risk. **When does it matter most?** Overall, it is generally helpful, but is more meaningful as the fund matures and usually a greater proportion of distributions have been made.

Public Market Equivalent (PME)

What is it? Compares the return that would have been generated had the capital been deployed in a specific public market index instead of the private equity fund. A PME above 1 represents that the fund outperformed the public market index.

It's weakness? It assumes the investor is reinvesting into the applicable market index which is generally not the case.

When does it matter most? In situations where the investor is investing in private equity strategies without a plan for reinvestment into other private equity funds.

Internal Rate of Return (IRR)

What is it? The rate of return an investor would achieve by investing in the fund, while having the ability to reinvest the distributions received into the same fund.

It's weakness? An investor cannot directly reinvest into the same fund; as a result, it can drastically over-or-underestimate performance in earlier years.

When does it matter most? Typically after the first three years of the fund's life and for a diversified portfolio of investments. This is the closest metric to traditional return metrics commonly used with other assets.

Understanding the Tradeoff between TVPI & IRR

	Low IRR	High IRR
High TVPI/MOIC	**High TVPI/MOIC & Low IRR** The fund has likely distributed quite a bit of capital back to the investor, but it has taken a longer period of time. This results in less time being available to compound returns; however, these strategies generally have lower reinvestment risk. This is most common in Venture Capital strategies given the long investment horizon and high upside potential in the portfolio companies.	**High TVPI/MOIC & IRR** The fund is outperforming and has returned capital in a timely fashion and distributions have been relatively large. It is important to not overreact to early strong performance, as the underlying investments may still face challenges as they mature.
Low TVPI/MOIC	**Low TVPI/MOIC & IRR** The fund is likely underperforming. In earlier years, this is not as concerning as the fund still has time to build value. As a fund approaches maturity, we recommend benchmarking the fund to understand if this was simply a bad vintage or the fund itself underperformed.	**Low TVPI/MOIC & High IRR** The fund has returned capital to investors quickly, but the total size of the distributions are relatively small. This creates an income stream for investors, but also requires the need to reinvest effectively. This is most common in Secondaries given they are usually investing in more mature investments, allowing for faster return of capital, but at a lower absolute magnitude.

Evaluating Performance

Many investors review these metrics and are unsure as to how best to evaluate private equity given no single metric is a perfect measure of performance. When examining performance at a high level, investors should start by examining both IRR and TVPI/MOIC to better understand the performance they achieved. Generally, a fund with a higher IRR and TVPI/MOIC has achieved better performance than one that scores lower on both metrics, assuming a similar risk profile. It can be a challenge if these two metrics differ and understanding your priorities and preferences is a key to evaluating the investment. Consequently, there is no single measure to evaluate performance. Your BMO Private Wealth professional can assist you in this analysis and has access to additional metrics to help you gain insight into the quality of a private equity fund and the manager's ability to replicate past performance.

Performance Example

Let's look at an example, Fund A has an TVPI/MOIC of 3x and an IRR of 15%, whereas Fund B has an TVPI/MOIC of 2x and an IRR of 20%. Which one should you choose? The answer depends on the investor. If they prefer earlier cash flow and are willing to take on some additional reinvestment risk, Fund B may be a more suitable option; however, if the investor would prefer not to deal with the challenges of reinvestment and wants to maximize the multiple on each investment, might be better suited to Fund A. Ideally, an investor might choose to have a blend of both types of strategies in their portfolio to allow them to receive regular cash flows from their investments while also mitigating reinvestment risk.

Conclusion

In conclusion, private markets performance terminology differs from metrics more commonly known to investors and certain investment attributes will have greater importance based on an individual's investment objectives and preferences. Given the unique nature of private equity investing, understanding how performance is evaluated can assist with more meaningful private equity portfolio discussions and allocations. Working with your BMO Private Wealth professional will help you navigate the private equity landscape and determine which investment products are most suitable based on their overall objectives.

If you have an interest in discussing private equity solutions as a potential opportunity for your portfolio, please reach out to your BMO Private Wealth professional.

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