CIO Office Insights

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Understanding Private Portfolio Performance

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KEY TAKEAWAYS

In private market investing, evaluating fund performance requires a multifaceted approach due to their illiquid and complex nature.

Utilizing a combination of performance metrics provides a more holistic understanding of investment performance in private markets, as each metric highlights different aspects and mitigates the limitations of relying on a single measure.

Private markets are essential for investors seeking diverse returns, but assessing their performance can be challenging due to structural complexity and lack of liquidity. Unlike public markets, private markets need more in-depth analysis.

There are various performance matrices to measure the return on invested capital and provide different results. We're going to cover five important performance metrics in Private market: **Internal Rate of Return (IRR)**, **Time-Weighted Rate of Return (TWR)**, **Total Value to Paid-In (TVPI)**, **Multiple on Invested Capital (MOIC)**, and **Net Asset Value (NAV)**. Each metric will provide unique insights into the investment performance.

NET ASSET VALUE (NAV)

At the heart of many of these metrics is the **Net Asset Value (NAV)**,which represents the total value of an investment fund or company. It's calculated by taking the fund's total assets and subtracting its total liabilities, giving a clear picture of what the fund is worth at a specific time.

NAV can also be expressed on a per-share basis, helping investors understand the price at which they can buy or sell shares in the fund.

Illustration: To understand how NAV works in practice, let's consider a hypothetical investor portfolio.

Total Commitment: **SAR 1 Million** | Management Fee & Expenses: **1.0%** | Commitment Period: **7 Years**

Year	1	2	3	4	5	6	7
Capital Calls	(500,000)	(500,000)	-	-	-	-	-
Management Fees	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)
Distributions			50,000	80,000	160,000	300,000	1,860,152
Return (Unrealized)	75,000	159,750	182,213	200,544	217,126	224,195	211,324
Net Asset Value (NAV)	**565,000**	**1,214,750**	**1,336,963**	**1,447,507**	**1,494,633**	**1,408,828**	-

The Fund and its Cashflows during a Year

Opening NAV or Initial Capital Call + Growth (Return) − Management Fee & Expenses − Distribution = Closing NAV

Cash Inflow into the Fund | **Cash Outflow from the Fund**

- Growth (Return): **Income generated**
- Management Fee & Expenses: **Cost to fund**
- Distribution: **Portion of income distributed to investors**
- Closing NAV: **Snapshot of fund's assets**

Based on the previous illustration, let's examine how the NAV changes under various scenarios

Follow-on Capital Call:
Additional capital is brought into the fund.
Effect:
The fund's NAV increases.

No Distribution:
The income generated by the assets is not distributed to investors.
Effect:
The fund's NAV increases as the income accumulates as unrealized gains.

Exit/Liquidation:
At the end of fund term, investors liquidate from the fund.
Effect:
All the net assets are distributed to investors and the fund's NAV becomes zero.

Negative Return:
The underlying investment experiences a loss.
Effect:
The fund's NAV decreases as the negative return accumulates as unrealized loss.

INSIGHT

While NAV is a key indicator of a fund's value, it doesn't show the full picture on its own. To get an insights into the fund's performance, NAV should be looked at over time along with cash flows.

Note: All the values used are for illustration purposes and do not represent any real-life fund or its performance.

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PERFORMANCE METRICS

Performance is usually evaluated using two types of metrics: **Time-adjusted metrics** and **Multiples of money (MoM)**.Time-adjusted metrics, like **IRR** and **TWR**, help measure how well an investment performs over time. On the other hand, multiples of money (MoM), such as **TVPI** and **MOIC,** show how much money has been made compared to what was invested.

INTERNAL RATE OF RETURN (IRR)

Represents the annualized rate of return, considering the timing and size of all cash flows.

Net IRR reflects the return received by investors after deducting fees and costs.

It is the discount rate at which the Net Present Value (NPV) of a fund's cash inflows equals its cash outflows.

Continuing our illustration:

Year	1	2	3	4	5	6	7
Net cash flow	(510,000)	(510,000)	40,000	70,000	150,000	290,000	1,850,152

IRR =18.46% for our illustration

$$\text{Net Present Value} = \frac{\text{Net Cash Flow}_1}{(1+\textbf{IRR})^1} + \frac{\text{Net Cash Flow}_2}{(1+\textbf{IRR})^2} + \cdots + \frac{\text{Net Cash Flow}_t}{(1+\textbf{IRR})^t}$$

IRR assumes that all cash flows generated by the investment are reinvested at the same rate as the IRR itself, which can be unrealistic. This can be avoided by using **Time-weighted Return (TWR)**.

TIME-WEIGHTED RETURN (TWR)

Evaluates the performance of an investment by calculating the returns for each period separately and then combining these returns to provide an overall rate of return.

Neutralizes the impact of cashflows in and out of the portfolio.

Preferred method for performance measurement as per the guidelines given under Global Investment Performance Standards (GIPS).

Continuing our illustration:

Year	1	2	3	4	5	6	7
Annual Return (R)	11.0%	13.1%	13.4%	13.5%	13.6%	13.7%	31.3%

TWR = 15.49% for our illustration

$$\text{TWR} = \left\{(1 + \mathbf{R_1}) \times (1 + \mathbf{R_2}) \times \cdots \times (1 + \mathbf{R_t})\right\}^{1/t}$$

INSIGHT IRR and TWR serve different purposes and are preferred in different situations:

- **IRR** is sensitive to the timing and amount of cash flows, making it ideal for evaluating a single investment or comparing a few funds where cash flow timing is largely uneven.
- **TWR** can distort performance by treating all periods equally, especially in private markets where early negative returns with low capital can skew results, giving misleading impressions of fund performance.
- However, **TWR** is useful for comparing fund managers, as it eliminates the impact of varying investor cash flows, focusing solely on the fund's ability to generate returns, offering a fair and consistent comparison of manager performance.

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PERFORMANCE METRICS

In **Multiple of Money (MoM); MOIC** and **TVPI** are common performance metrics in private equity. As they reflect the primary objective of generating value for investors by delivering returns.

TOTAL VALUE TO PAID-IN (TVPI) & MULTIPLE ON INVESTED CAPITAL (MOIC)

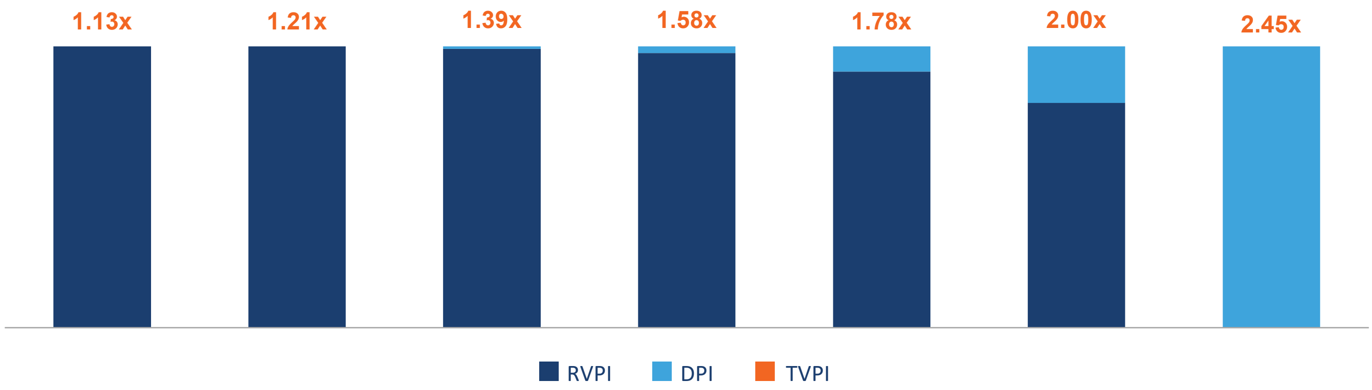
Total Value to Paid-In (TVPI) measures the total value generated by a fund for its investors, encompassing both realized profits and unrealized future gains, relative to the amount of capital contributed.

Similarly, **Multiple on Invested Capital (MOIC)** is a key metric for this, as it calculates the ratio of the total value realized to the initial investment.

TVPI comprises of two parts: **The Residual Value to Paid-In (RVPI) ratio**, which measures the value of remaining investments, and; The **Distributed to Paid-In (DPI) ratio**, which reflects the capital returned to investors.

Expressed in multiples — meaning, if the TVPI is 1.10x, the investor will receive SAR 1.10 for every SAR 1 invested in the fund.

TVPI/MOIC = 2.45x for our illustration



At the start of a fund's life, when no distributions have been made, Total Value to Paid-In (TVPI) is equal to Residual Value to Paid-In (RVPI).

By the end of the fund's term, when all assets have been distributed, TVPI becomes equal to Distributed to Paid-In (DPI).

INSIGHT

- Unlike IRR, **both MOIC and TVPI ignore the time value of money**. While a high **MOIC** may seem appealing, it doesn't account for potential value loss over time, impacting real profitability. which can lead to a misleading view of investment performance.
- **IRR and MOIC should be analyzed together**, a high **MOIC** with a low **IRR** may indicate solid returns, but over a longer period, suggesting inefficiency in timing. This highlights the balance between return size and investment speed.
- When a fund is fully funded and all capital calls have been met, then **TVPI** will equal **MOIC**.

Analyzing a mix of these metrics allows investors to gain a more comprehensive understanding of a fund's performance, addressing the limitations inherent in any single measure. By examining various aspects, investors can make more informed decisions and better evaluate the success of their investments, ensuring a holistic assessment of investment performance.

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CIO Office

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Head Office: King Fahad Road, P.O. Box: 20438, Riyadh 11455, Saudi Arabia ،Tel: 011 2256000 - Fax: 011 2256068