

Questions to the EBA regarding Article 155 of the Capital Requirements Regulation (No. 575/2013)

Pursuant to paragraph 2 of Article 155 Risk weighted exposure amounts for equity exposures, a risk weight of 190% may be applied for private equity exposures in sufficiently diversified portfolio under the simple risk weight approach.

To our knowledge, there are no technical standards defining “sufficiently diversified portfolios”.

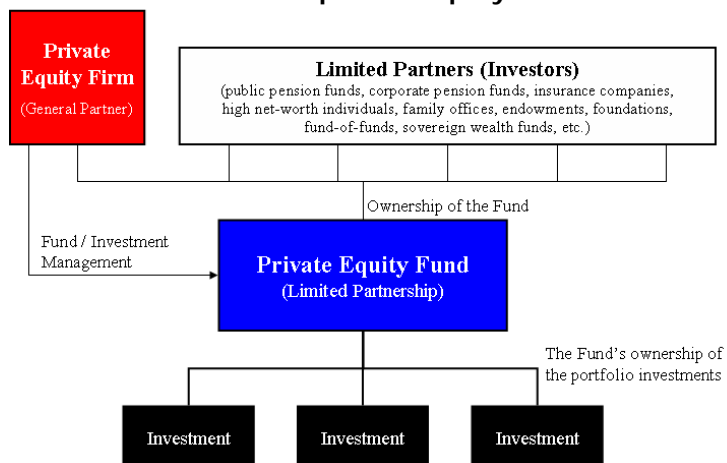
- What rules should be applied in assessing whether a private equity exposure is in a sufficiently diversified portfolio of portfolio companies?
- In case of exposure to several private equity funds, may the portfolio companies of these private equity funds be considered as one portfolio before assessing whether the portfolio is sufficiently diversified?

Background

Most private equity funds are set up as a limited partnership and are governed by the terms set forth in the limited partnership agreement (LPA). The fund has a general partner (GP), which raises capital from investors, which invest as limited partners (LPs) in the fund. The private equity fund typically makes investments in companies known as portfolio companies (see chart 1).

Private equity funds typically make control and co-control equity investments in companies with strong market positions, significant potential for revenue and earnings growth, strong cash flows and a solid platform that can retain and/or attract high quality management.

Chart 1. Structure of a private equity fund



Some private equity funds may have a special sector focus, but in general they are diversified across sectors. They can have a specific focus by region, e.g. Europe or the US, or they can be global. Some also have a special focus regarding the size of the companies they acquire, e.g. small or large cap. The private equity fund itself typically invests in 10-15 portfolio companies.

As an investor you typically invest in several private equity funds in order to diversify the exposure in the underlying portfolio of portfolio companies.

Appendix

In this appendix we try to explain how private equity funds are set up and how liquidity and cash flows are determined through the life of the fund.

Private equity investments are characterised by the so-called J-curve effect, and it is important to underline this fact. In the graph below we have illustrated this by the mechanics of the following six observations regarding liquidity and cash flows (see chart 2):

- **Committed capital:** The credit institution commits a certain amount: Index capital amount 100. As this constitutes a cash outflow for the credit institution, we have entered the amount in the graph at -100. The committed capital stays at the same level over the life of the investment. Committed capital is not equivalent to Invested capital. This is a common misunderstanding in Private Equity, but these two concepts are not the same.
- **Paid-in:** The credit institution pays a certain amount of its total commitment, as and when called by the private equity fund. The time horizon of the gross capital investment is typically 6-8 years.
- **Distribution:** As a direct consequence of a realisation in the underlying private equity fund, the returns will be redistributed on a pro rata basis to the credit institution. Distributions will occur until the last investment is sold, thereby closing the fund.
- **Cumulative Paid-in:** Typically, the committed capital will be drawn down over a 6-8-year period, the cumulative paid-in thereby approaching -100 over that time, by accumulating the net paid-in every year.
- **Cumulative net cash flow:** Similar to the IRR curve, the cumulative net cash outflows deepen in the first years by the accumulated paid-in amounts and are smoothed out in year 3 when the first distributions are returned. Typically, the net cash flow position reaches the lowest negative level in the year in which the IRR curve turns positive. As from this year, the cash flow increases every year by the net amount redistributed to the credit institution. As illustrated, the maximum net outstanding cash flow is rarely more than 70% of total committed capital.
- **IRR:** Representing the J-curve, the IRR is negative over the first couple of years. Initially the curve is steeply falling as the management fee weighs on the modest actually invested capital with no cash returns as of yet. Please note that the actual invested capital is quite insignificant during this time, and that the undrawn capital can be invested alternatively until the cash is drawn down. Typically, the credit institution will get its first cash return in year 3; the J-curve has bottomed out in year 2 and is now trending toward positive, which usually happens in year 4-5. Nykredit Realkredit would then experience a continuously rising IRR until the fund is closed.

Chart 2. Cash flow profile of a private equity fund

