
CASE STUDIES

“Case Studies” presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

TRADEOFFS IN GOOSING THE IRR

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The internal rate of return (IRR) has long been a favored performance metric in private equity (PE), with most fund managers considering the IRR to be the most important metric in conveying a given PE fund’s return performance to limited partners (LPs—i.e., investors in the fund).¹ Indeed, the IRR has many attractive characteristics including uniformity with other competing investments making benchmarking possible, and importantly, accounts for the timing of cash flows going in and out of a fund. However, Jane and Jon, the managing partners of TPEF, a major PE firm, are increasingly at odds as to the propriety of and potential drawbacks to the use of this performance metric.

Notwithstanding the IRR’s obvious curbside appeal, Jane is worried about negative externalities arising from TPEF’s reliance on the IRR as the predominant metric by which TPEF’s funds are assessed. Jane has already been fielding more frequent requests from LPs and hesitant would-be investors for increased transparency around the timing of distributions, fund operations, fees and performance, no doubt related to the 2023 market downturn. As a major PE firm that primarily deploys growth strategies, TPEF’s funds largely focus on investing in non-controlling stakes in small- and mid-cap companies poised for expansion without the need for significant operational changes.

Like many other PE firms, TPEF’s funds have been increasingly reliant on *subscription lines of credit* (SLCs).² SLCs are used to smooth out the timing of *capital calls*, also known as *draw-downs*, made to investors. That is, when LPs commit capital to a fund, they hold onto the capital until the fund identifies an investment opportunity and issues a capital call to collect the promised

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contributions from investors. This committed but not-yet-allocated capital is known as the fund's *dry powder*, and an SLC, which is extended to a fund by a bank, is a revolving credit facility backed by the fund's dry powder.

When used judiciously, an SLC allows funds to react quickly to investment opportunities as they arise while relieving both managers and investors of the administrative burdens inherent in numerous and irregular capital calls. The value of quick access to capital, by way of SLCs, is particularly prominent for certain types of investment opportunities, such as in cross-border deals, where a fund manager wishes to additionally enter derivative positions to hedge against currency risk during the sign-and-close period. However, Jane has noticed an uptick in the use of subscription lines to manage the cadence of capital calls in a way that artificially boosts a fund's IRR but at a cost to the fund's LPs. That is, a fund's IRR to its LPs is calculated based on the timing of cashflows collected from and distributed to the LPs. By strategically drawing capital from a subscription line and later issuing capital calls to pay off the outstanding loan,³ Jane argues that fund managers can manufacture higher IRRs for the same (or worse) actual performance.

As shown in Table 1, the differing cashflow sequence for the same investments made results in different IRRs when relying only on capital calls to LPs versus first borrowing from subscriptions lines then issuing capital calls to repay the loans. Furthermore, Jane is concerned that relying so heavily on the IRR further skews fund managers' incentives due to the implicit assumption hidden in the IRR: namely, that interim cashflows can be re-invested at the IRR—an assumption that is less plausible the higher the IRR. Thus, Jane advocates for (i) using a *modified* IRR as well as more prominently highlighting other performance metrics in investor decks including distributed to

paid-in ratio (DPI) and total value to paid-in ratio (TVPI) which incorporate how much cash as been returned to LPs,⁴ and (ii) imposing tighter rules on the use of subscription lines by TPEF's fund managers.

Jon counters, though, that since IRR is the prevailing metric in private equity, restricting fund managers' use of subscription lines, even in a way that is beneficial for their LPs, would impact the firm's ability to raise capital for subsequent funds. He also argues that this move could have real consequences for actual performance, since he anticipates that TPEF may also lose its best fund managers who wish to maintain more control over their use of SLCs. Jon reiterates the important benefits provided by SLCs, which, in his opinion, overshadow the drawbacks arising from opportunistic use of SLCs. He also reminds Jane that even in the recent downturn, SLC utilization rates of growth funds (like those of TPEF) have remained higher than in other sectors, such as those following buyout strategies, which typically involve controlled takeovers of troubled larger companies requiring major restructuring.

Moreover, Jon is worried that their fund managers may prickle at being portrayed unfavorably relative to other fund managers based on restrictions and metrics that are not yet mainstream in assessing PE-fund performance and may lead to misunderstandings as to their abilities as fund managers. He agrees that lower private equity valuations across the board are placing greater pressure on private equity funds to return capital back to LPs and that the IRR does not necessarily demonstrate how successful TPEF is at doing so. However, there are nuanced behavioral complexities and bounded rationality that must also be considered.

With the tired realization that they both agree in theory though not in practice, Jane concedes not to tighten controls on SLC utilization while Jon

Table 1 Cash inflows and outflows, Net profits, and IRR from a PE fund's investment activity.

Month	No SLC	Using SLC		
		No Interest	3% Interest	6% Interest
<i>Panel A. Timeline of Cashflows</i>				
0	(50,000)	—	—	—
1	—	—	—	—
2	(60,000)	—	—	—
3	—	—	—	—
4	—	(110,000)	(110,802)	(111,609)
5	(50,000)	—	—	—
6	(45,000)	—	—	—
7	—	—	—	—
8	—	(95,000)	(95,601)	(96,205)
9	(55,000)	—	—	—
10	(15,000)	—	—	—
11	(25,000)	—	—	—
12	—	(95,000)	(95,551)	(96,105)
13	(35,000)	—	—	—
14	(35,000)	—	—	—
15	—	—	—	—
16	—	(70,000)	(70,438)	(70,879)
17	(75,000)	—	—	—
18	—	—	—	—
19	—	—	—	—
20	—	(75,000)	(75,564)	(76,131)
21	(55,000)	—	—	—
22	—	—	—	—
23	—	—	—	—
24	—	(55,000)	(55,414)	(55,829)
25	—	—	—	—
26	—	—	—	—
27	—	—	—	—
28	—	—	—	—
29	—	—	—	—
30	—	—	—	—
31	—	—	—	—
32	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
<i>Panel B. Net Profit and IRR</i>				
Total Capital Invested in Portfolio Companies	500,000	500,000	500,000	500,000
Total Capital Called from LPs	500,000	500,000	503,370	506,757
Net Profit	\$500,000	\$500,000	\$496,630	\$493,243
IRR (Monthly)	3.22%	3.58%	3.46%	3.43%
IRR (Annualized)	38.60%	42.97%	41.53%	41.13%

concedes to explore how to organize the numerous performance metrics to paint a more effective yet balanced picture.

Questions

- What are the pros and cons of relying on the IRR as a key metric to assess fund performance?
- What other metrics can be used to assess fund performance, and what are their pros and cons relative to the IRR?
- In calculating a modified IRR, how can one arrive at an appropriate return assumption for the reinvestment rate?
- This case broached how and why SLRs are used for entering investments. As an extension, how might a credit line or term loan be used to fund exits?

Endnotes

¹ In fact, in a recent survey of over 100 funds with over \$130 billion of AUM (assets under management), Silicon Valley Bank reported that 38% of private equity

funds cited IRR as the most important return metric. *See* Silicon Valley Bank (2023). Q3 2023 Global Fund Banking Outlook Report. <https://www.svb.com/globalassets/trendsandinsights/reports/gfb-outlook-report-q3-2023.pdf>.

² According to Preqin, purveyor of data for the alternative investment industry, 88% of the capital raised in 2022 was by funds with access to an SLC, up from 35% in 2012. *See* Preqin (2023). Trending Data: How subscription credit went mainstream. <https://www.preqin.com/insights/research/blogs/trending-data-how-subscription-credit-went-mainstream>.

³ SLCs for larger PE firms are normally pegged to the Secured Overnight Financing Rate (SOFR), with typical spreads around 200 to 300 basis points (bps).

⁴ The modified IRR recalculates an investment's compound annual growth rate based on a given assumption for the rate at which interim cash flows are reinvested. DPI is a measure of the total distributions paid to the investors in a private equity fund relative to the money invested. DPI is expressed as a multiple of investors' paid-in investment capital. TVPI is the sum of DPI plus RVPI (residual value to paid-in capital), accounting for both realized returns (distributions) and unrealized returns (residual value).