**Press Release** **Nice, June 21, 2010**

# New EDHEC study calls into question the suitability of the calibration of private equity in the Solvency II standard formula

In the study, entitled "**On the Suitability of the Calibration of Private Equity Risk in the Solvency II Standard Formula**," EDHEC calls into question the method and the data used by the European regulator to measure the risk of private equity investments, in particular the correlation coefficient of performance of private equity and that of listed equities. The drawing-up of Solvency II prudential rules has become a matter of major concern for the private equity sector since the current measure for private equity risk, used by the European regulator, is likely to dissuade insurers from investing in this asset class. As an example, in the French market, in 2007, the total investments in private equity represented €22bn in the balance sheet of insurance companies (FFSA 2008). They finance 21% of the funds raised (AFIC); thus becoming the leading national investors in unlisted stocks.

In addition to casting doubt over the use of VaR (Value at Risk), which requires the implementation of correlation matrices that have been very controversial to date, the EDHEC Financial Analysis and Accounting Research Centre study questions the representativeness of the LPX50 index selected by the regulator to measure the capital required for private equity investment risk. This index, which is defined on the basis of the stock prices of the fifty largest listed private equity firms in the world (i) is not representative of investments of European insurance companies, either on a geographical level or as a representation of the weight of investments in venture and buy-out, (ii) does not reflect the non-liquid contractual nature of investments in private equity, and (iii) as a result of the underlying investments, the LPX50 poses an idiosyncratic risk that is added to the risk of investment in private equity.

To correct the identified drawbacks of the CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) approach, EDHEC's proposal involves replacing the LPX50 index with a benchmark that is more representative of insurance portfolios invested in private equity. The analysis is based on the performance of private equity funds for various investment classes and geographical zones, taken from the Thomson One database. In accordance with the practices of the private equity industry and academic approaches, the EDHEC Financial Analysis and Accounting Research Centre calculated the internal rates of return (IRR) of private equity funds by vintage year, and then measured the return of an equivalent investment in the MSCI indices, with the same portfolio structure as the private equity benchmark (vintage year, incoming and outgoing cash flows, geographic zone). This index is known as the Public Market Equivalent Plus (PME +).

The correlation between private equity and listed market performance is measured using four families of private equity investments (two geographical zones combined with two types of investment: buy-out and venture). In order to provide an optimal reflection of European insurance companies' investments, these four families were then aggregated into a single portfolio. The results (both by family and for the aggregated portfolio) show that private equity performance is significantly less correlated to that of listed equity markets than assumed in the 0.75 correlation coefficient selected by the CEIOPS.

Finally, the study shows through simulations the impact of the level of the correlation coefficient (representing diversification in investments) not only on the capital requirement for equity risk but also on the marginal cost of the capital requirement as a consequence of asset reallocation between listed equities and private equity.

**This study was sponsored by the Association Française des Investisseurs en Capital (AFIC).**

This study can be downloaded by pressing [Ctrl] and clicking on the following link:
http://docs.edhec-risk.com/mrk/000000/Press/EDHEC_Publication_Calibration_PE_SII_UK.pdf

EDHEC BUSINESS SCHOOL For further information or to receive a copy of the study, please contact
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## About the EDHEC Financial Analysis and Accounting Research Centre

The EDHEC Financial Analysis and Accounting Research Centre was created in 2006 around the theme of company valuation. Cultural and technological changes now make it possible to use multiple dynamic analyses, the cornerstone of which is the discount rate. There is an abundance of academic research into the determination of the discount rate, but the gap between academe and business seems to be growing wider by the day. In practice, those who do the valuations often oversimplify, invalidating their reasoning; they may even ignore theory and transform the discount rate into a black box to hide the absence of objective and academic foundations in the determination of the risk premium and of beta.

The objective of the EDHEC Financial Analysis and Accounting Research Centre is to call into question certain financial paradigms, in particular that which consists of separating idiosyncratic risk—because it is diversifiable—from the risk premium and to provide the financial markets (financial analysts, investors, companies, rating agencies, auditors) with new light on the discount rate and to recommend new ways to determine it.

The great diversity of backgrounds is one of the advantages of the Centre (specialists in financial analysis, in accounting, in law, researchers from academe or from business), and it allows the Centre to take a multi-disciplinary approach to financial analysis: company evaluation, the impact of IFRS and Solvency II on insurance companies, the impact of IFRS on the valuation and pricing of risk, the growing use of fairness opinions, the status of the outside expert, and the measurement of intangible assets.

## About AFIC

The Association Française des Investisseurs en Capital (AFIC) includes all the private equity structures (venture capital, expansion capital, buyout, turnaround capital) operating in France. The association has 270 active members - corporate shareholders – who accompany and finance the growth of nearly 5,000 companies in France. AFIC also has 200 associate members from a wide range of related professions which support and advice investors and entrepreneurs in the structuring and management of their partnerships.

AFIC is the only French professional association dedicated entirely to the private equity business. It is a member of the Association Française des Etablissements de Crédit et des Entreprises d'Investissement (AFECEI). AFIC membership is one of the conditions required by the Financial Markets Authority (AMF) in approving the practice of the profession by management companies.

Beyond, its mission of control and development of generally best practices, AFIC federates, represents and assures the promotion of private equity business among institutional investors, entrepreneurs, opinion leaders, and public policy makers. It thus contributes to the financing of the economy, more precisely the financing of SMEs and SMIs, to promote economic growth and entrepreneurial spirit.

The French private equity business is ranked number 1 in continental Europe, and represents more than 20% of the European market today.

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