Private Equity

Beware the leverage, my son!

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> While the scepticism surrounding private equity is probably overdone, investors need to be aware that many of the negative headlines have been focused on leveraged buyouts, for which the outlook really is subdued. But that should not scare investors away from more attractive opportunities in early stage ventures and growth financing.

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Some investors get concerned about private equity

Private equity has served its investors well over the past decade. While it continues to do so and retains many adherents, others are raising warning flags.

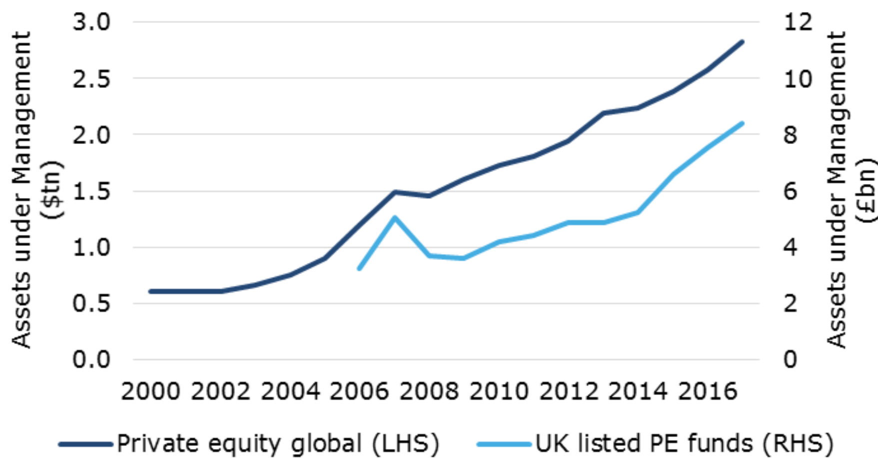
Arguing the case for the prosecution is hedge fund manager Daniel Rasmussen, who writes: "The great private equity gold rush of the post-crisis era, like the subprime bubble before it, is led by managers and consultants, whose spreadsheets are well formatted and precisely wrong".[1] For the defence, David Swenson, legendary CIO of the Yale endowment fund, has described private equity as a "superior form of capitalism", given its longer-term investment horizon.[2]

We think decent returns can still be made in the asset class, though risks are certainly growing – in some sectors more than others.

What's more, fund selection is not the no-brainer some commentators, relying on a belief in strong persistence, might have you believe.

Time was when one could let one's designated PE manager hunt the illiquidity premium in much the same way as Lewis Caroll's unnamed protagonist hunted the Jabberwock: no-one was quite sure what the beast was, so best just let them get on with it. Now, one must tread with greater care, as rich valuations bring even the strongest proponents of the asset class to warn that a slapdash approach to due diligence may mean these premia – much like the Jabberwock – prove to be quite nonsensical or – unlike the Jabberwock – simply leverage.

Fig 1: Growth of private equity funds



Source: Preqin, Bloomberg, Fidante Partners.

[1] https://americanaffairsjournal.org/2018/02/private-equity-overvalued-overrated/

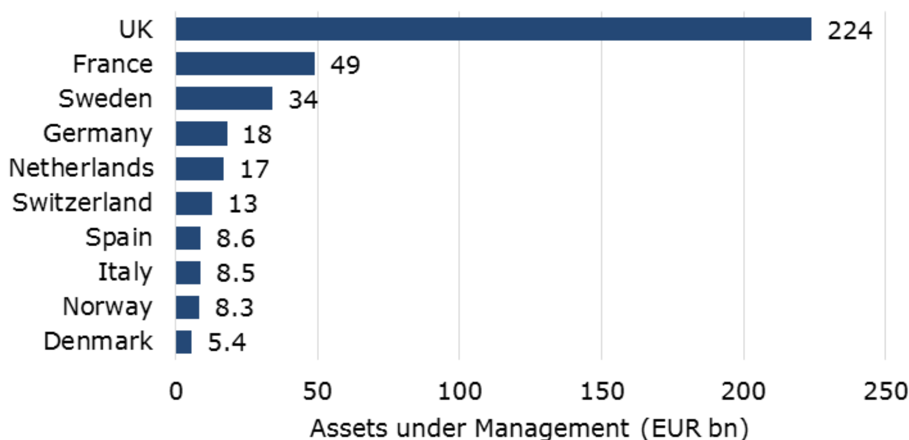
[2] https://www.cfr.org/event/conversation-david-swensen

Growth of the market

Private equity assets have increased substantially in the past five years, with global assets under management (AUM) at an all-time high of $2.83tn by June 2017.[3] UK-listed companies specialising in the asset class have been particular beneficiaries of the trend, growing their assets under management by an average of 15% per year, compared to an average growth of 8% globally (Fig. 1).

Overall, more than four times as many assets are managed out of London and Edinburgh than second-placed France. A significant number of assets are run from Scandinavia, where institutional investors tend to have higher allocations and are more experienced with the asset class (Fig. 2).

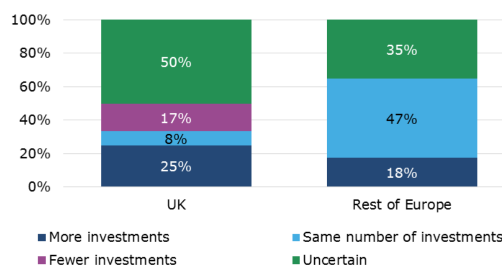
Fig 2: Private equity funds in Europe



Source: Preqin, Fidante Partners.

But with a growing list of businesses, from Airbus to car manufacturers, threatening to up-sticks from the UK if a workable Brexit deal isn't agreed, could the same thing happen to its private equity firms? It seems unlikely. While UK managers express a greater degree of uncertainty over the number of post-Brexit deals, a higher percentage than their peers in the rest of Europe see this increasing (Fig. 3). Corporate restructuring resulting from Brexit might produce a slew of carve-outs, and some firms may wish to escape the volatility of public markets by going private, meaning the UK's private equity sector could well be a beneficiary of Brexit.

Fig 3: Fund manager expectations of impact of Brexit on private equity investments



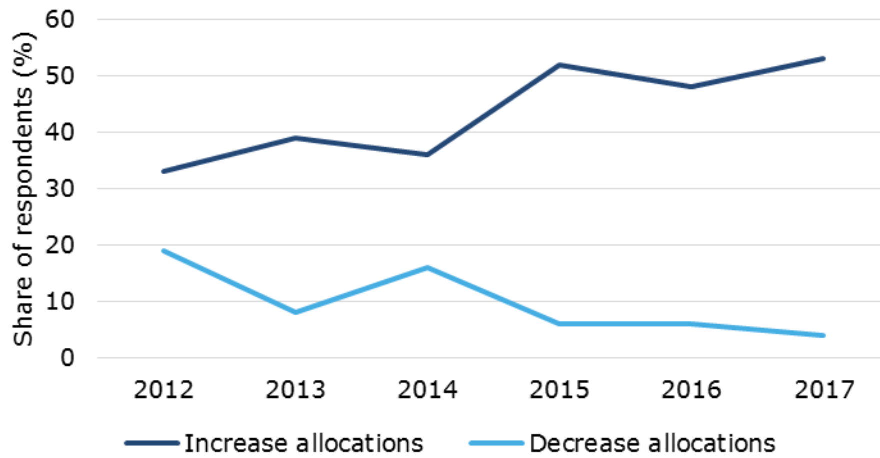
Source: Preqin, Fidante Partners.

[3] 2018 Preqin Global Private Equity & Venture Capital Report.

Still wanting more

Private equity optimists such as Swenson still typify the market mood, with a majority of institutional investors wanting to increase their allocation to the asset class – a fairly constant trend since the post-crisis market bounce (Fig. 4). If anything, the share of investors that want to increase their allocation to private equity continues to rise slightly, while the share of investors that want to decrease allocations is declining.

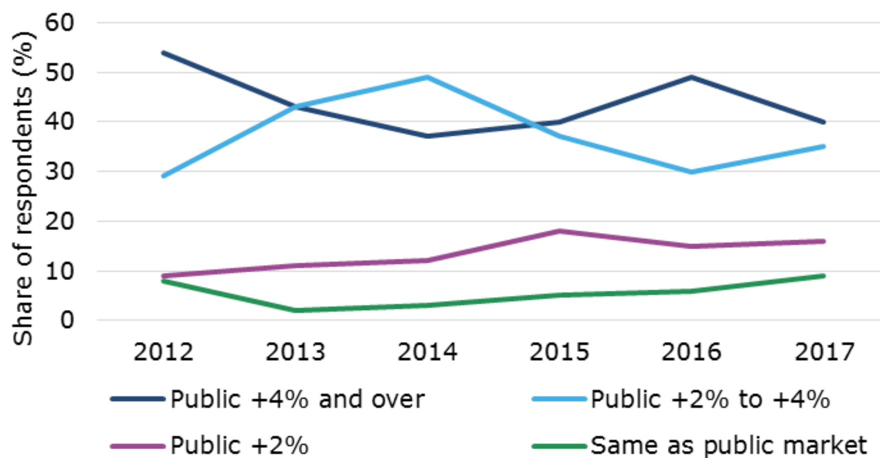
Fig 4: Institutional investor intentions for private equity allocations



Source: Preqin, Fidante Partners.

Those same investors, in the vast majority of cases, expect to see private equity continuing to outperform public markets, though it's worth noting that the percentage that believe they will receive four percentage points and more above public markets has been in decline since last year, and those expecting the same as public markets has returned to 2012 levels, at 9% (Fig. 5). So caution is growing, but there's certainly no rush for the exit – far from it, as asset and dry powder growth indicate that people are still queuing at the turnstiles.

Fig 5: Institutional investor return expectations



Source: Preqin, Fidante Partners.

Growth projections

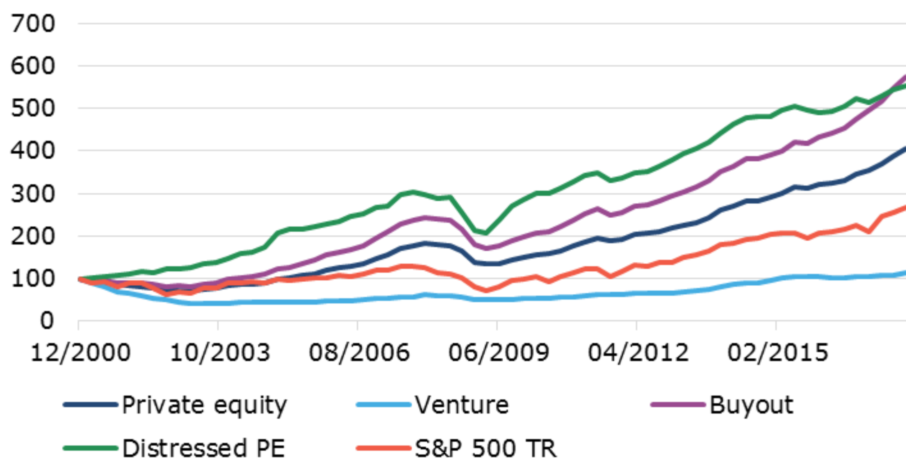
In line with other research that we are going to publish soon, we estimate global private equity assets will grow by $700bn to $1,300bn over the next three years, quite a bit more than the $587bn of asset growth over the past three years.

The reason for our optimism in this asset class is the fact that growth globally and in the US is expected to remain solid, while public equity market valuations and returns should decline somewhat from current levels. This will give investors an incentive to allocate to private markets in order to harvest potential private equity illiquidity premiums.

Valuations and performance

On the basis of past performance, those investors should expect to be well rewarded for this. Private equity has significantly outperformed its public equity counterpart across all sectors bar one. Since 2000, the average annual performance of private equity has been 8.8% compared to 7.3% for the S&P 500 Total Return index. The performance of buyout and distressed private equity funds has been even better, at 11.0% and 10.8% per year, respectively. Only venture capital has underperformed, at an annual rate of return of 1.3% (Fig. 6). However, past performance, as those regulatory disclaimers everyone knows by heart tell us, is no guide to the future. We'll come back to that shortly.

Fig 6: Performance of private equity vs. US stock market



Source: Preqin, Fidante Partners.

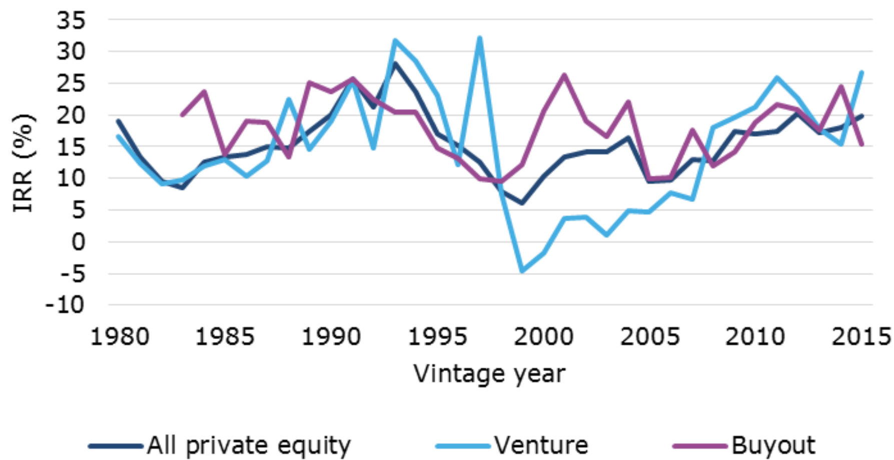
Private equity is only suitable for long-term investors. Looking back to 2000, private equity has underperformed the US stock market in about one third of all cases when looking at holding periods of five years, but we could not find a single ten-year holding period where private equity underperformed listed stock markets. Thus, in order to fully benefit from the superior returns private equity investments offer, investors need to commit capital for an entire business cycle or longer. This, no doubt, is a factor driving the launch of an increasing number of funds with longer maturities.

However, as indicated above, some investors are likely to be disappointed. In the long run, excess returns of 2% to 4% over listed equities is reasonable and has been achieved in the past. Investors who expect to earn 4% or more above listed equity markets, however, are likely to be disappointed. Only rarely have private equity investments managed to systematically outperform listed equity markets by such margins over prolonged periods of time.

Buyouts show the strain

These trends are also being played out in private equity internal rates of return (IRR). IRRs have been steady in recent years, at around 20% (Fig.7). While top quartile IRRs have remained relatively stable for most private equity sectors, they have started to come down for buyout funds, from above 25% to the range of 15% to 20%. The top quartile buyout funds (not shown in Fig. 7) have seen IRRs drop from above 30% to 20%. The 2015 vintage currently has IRRs last seen for the 2007 vintage. While private equity investments overall continue to perform well, buyout funds seem to have a performance issue.

Fig 7: Buyouts start to struggle – median IRR of private equity funds



Source: Preqin, Fidante Partners.

This could well be due to the way such funds operate. While there "has been a shift in the way private equity generates returns — from financial engineering and leverage to creating durable value through the period of ownership", according to recent commentary from EY, those who fail to do this face disappointing returns, "as exit multiples won't be higher than those available in public markets."[4]

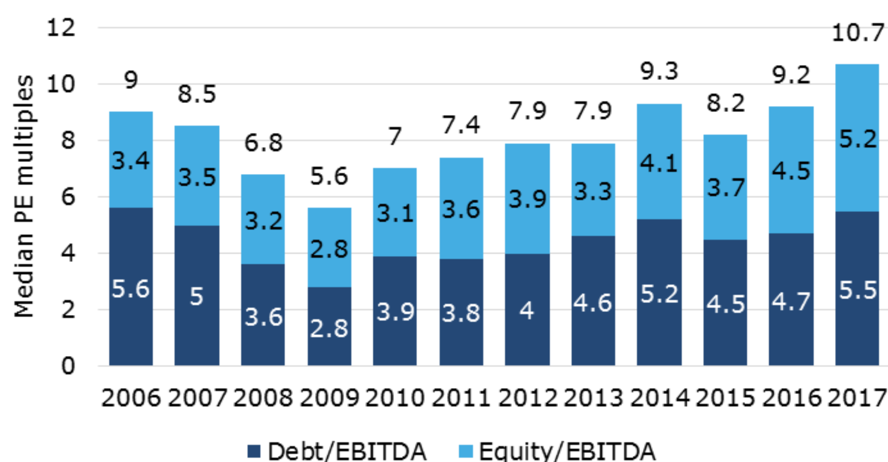
Buyout funds look to be guiltier of this 'lever and launch' approach than most. One academic study of pre-crisis private equity found that "the primary effect of LBOs is to produce a sustained increase in financial leverage".[5] This seems to be an on-going issue: "private equity firms typically double the amount of debt on the balance sheet, from 2.5x Ebitda to 5x Ebitda—the biggest financial change apparent from our study", warns Rasmussen.[6] What's more, in some cases, stated multiples may be overly optimistic, as he outlines:

> Lenders now tend to stop at 6x Ebitda in keeping with that rule, but they allow private equity firms to play with the definition of Ebitda. Lenders allow private equity firms to use 'pro forma' Ebitda.[7]

[4] https://www.ey.com/gl/en/industries/private-equity/ey-optimizing-across-the-business
[5] https://papers.ssrn.com: The evolution of capital structure and operating performance after leveraged buyouts: Evidence from U.S. corporate tax returns, Jonathan B. Cohna, Lillian F. Millsa, Erin M. Towerya.
[6] https://americanaffairsjournal.org/2018/02/
[7] Ibid.

The valuation multiples of new deals are now at the highest levels in more than a decade (Fig. 8), driven by cheap debt, rising valuations in listed equity markets that push investors into private markets, and more money chasing a limited number of good deals. Again, our research points to leverage buyouts as the area with the highest valuation multiples that raises the overall multiples shown in Fig. 8. In addition, private equity companies find themselves in greater competition with corporate buyers, equipped with strong understanding of the assets within the marketplace.

Fig 8: Median multiples paid for private equity acquisitions



Source: Pitchbook.

Investors need to allocate carefully – broad-brush private equity investments are unlikely to deliver the returns they have come to expect. The large role played by buyout funds renders this even more the case, as McKinsey outlines with regard to the way private equity is growing: "one trend stands out: the surge of megafunds (of more than $5 billion), especially in the US, and particularly in buyouts. Remarkably, the industry's record-setting 2017 growth is attributable to a single sub-asset class in one region".[8]

Those managers who don't have good origination capabilities are therefore left trying to achieve the level of return their investors anticipate by deploying capital in businesses with less development potential and making good the return shortfall with leverage. Either that, or the dry powder stays dry, and you're running a cash fund, not a private equity business. But with rates rising, so does the cost of leverage, a factor which could well have an increasingly negative impact on returns.

Performance persistence

Because returns may trend lower, it will become even more important for investors to select top quartile funds. However, it is not easy to identify top quartile fund managers ex ante, despite the assets class' reputation for 'stickier' performance from its managers.

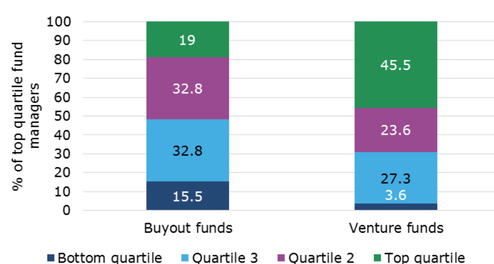
While one study determined that pre-2000 private equity fund performance showed persistence, "post-2000, we find little evidence of persistence for buyout funds, except at the lower end of the performance distribution…" For such funds, "there has been regression to the mean for individual GPs since 2000. In other words, since 2000, GPs who perform particularly well in one fund perform less well in the next fund".

Only 19% of top quartile buyout fund managers remain in the top quartile with their subsequent fund (Fig. 9) and about five times as many top quartile fund managers end up in the bottom quartile with their next fund than is the case for venture funds.

[8] The rise and rise of private markets, McKinsey Global Private Markets Review 2018

Luckily, venture capital fund performance is more persistent: "Post-2000, we find that performance in venture capital funds remains as persistent as pre-2000". The study showed that, when using IRR as a performance measure, 45.5% of venture capital fund managers in the first quartile of their peer group remain in the first quartile with their subsequent venture fund. Similarly, 32.4% of bottom quartile fund managers remain there with their subsequent fund.

Fig 9: How do top quartile managers perform with their next fund?



Source: Harris et al. (2014), Fidante Partners.

Outlook: finding opportunities

Leveraged buyouts will most likely be the worst performing sector within private equity because of the double whammy of rising valuations and rising rates. Venture capital should do reasonably well, because it is the sector with the highest contribution from actual improvements in the operating performance of underlying companies.

Since we do not expect a recession in the next two years, small, innovative companies should be able to grow their businesses well. The big challenge, however, for this segment is going to be the exit scenarios: if exits need to be financed by debt instead of an IPO, then higher interest rates are likely to depress exit valuations. The 'exit supercycle' that may have peaked in 2014 is likely to continue falling, and both IPOs and debt-financed sales might be impossible in any significant downturn or heightened market volatility.

Growth financing seems to have a reasonably attractive outlook, due to the limited capital committed by investors in this area at the moment, while the opportunity set remains relatively large, counteracting higher valuations and financing costs.

While the scepticism surrounding private equity is probably overdone, investors need to be aware that many of the negative headlines have been focused on leveraged buyouts, for which the outlook really is subdued. But that should not scare investors away from more attractive opportunities in early stage ventures and growth financing.

To paraphrase Lewis Caroll's contemporary, Mark Twain, reports of private equity's death are somewhat premature. But the sickly bits are best avoided.

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