Measured returns from private equity

RECENT RESEARCH INTO PRIVATE EQUITY DEMONSTRATES 300-400 BASIS POINTS OF OUTPERFORMANCE OVER THE LONG TERM COMPARED TO PUBLIC EQUITY MARKETS. PETER MCKELLAR OF SL CAPITAL PARTNERS ARGUES THAT INVESTORS IN PRIVATE EQUITY SHOULD FOCUS ON MANAGER SELECTION TO GENERATE THIS OUTPERFORMANCE

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Since the 1980s, there has been a long line of investors, primarily pension funds, that have been attracted to the private equity asset class for the simple reason that its absolute performance was excellent. It offered a return that was not correlated to equities, and enabled them to invest in an opportunity that offered both value and growth strategies.

Investors found that private equity delivered a risk-adjusted investment that consistently achieved outperformance through the cycles. This held true until 2007. From this point through to today, private equity has suffered an identity crisis, losing its allure for investors in the midst of the financial crisis. The exposure to the ever-increasing amounts of leverage in the underlying investments, and the impact of the global recession has reduced the growth and flexibility of private equity-backed businesses. New valuation methodologies have increased correlation at a time when listed markets are performing erratically. While the US election probed the governance and validity of the private equity model, the real issue for investors lies with the volatility in performance and reduced liquidity they have been faced with during the recession. Typically there had been a steady flow of profitable exits. Today's reduced M&A activity levels mean that exits from companies and cashflows to investors have reduced. The pension funds' once-stable allocations to private equity have been unbalanced by the performance of equity markets, creating an over-allocation to private equity.

These factors have caused many investors to pause and look again at their exposure to private equity. Recent performance has been in doubt so private equity seems to have lost its edge. Given this uncertainty, advocates of the private equity model, including SL Capital, must look to re-establish confidence in the asset class as one that can produce strong long-term performance. We have to demonstrate that private equity can deliver absolute and relative outperformance.

We work with the University of Oxford Private Equity Institute at Said Business School (the Institute), sponsoring their endeavours to find the answers to a number of the issues facing the private equity industry. The objective of the Institute is to be the leading academic institution in the field of private equity. It fosters first-rate research and teaching, and encourages the exchange of views between private equity academics and professionals via discussion and independent, unbiased research. This independence is important for the Institute, allowing them to retain an authoritative perspective and achieve one of the highest standards of academic integrity.

At the crux of their research is a desire to better understand the characteristics of investing in private equity, and to give investors in the asset class a true perspective on their investments. Given its private nature, comparably complex character, and the limited availability of data, there has been a lack of comprehensive research and, hence, accurate understanding of the dynamics of private equity.

Key areas for the Institutes' research include: performance measurement and benchmarking; risk assessment; portfolio management and asset allocation; pricing and interim valuation; financial engineering and structuring; value creation in leveraged buyouts; socially responsible investing; regulatory issues; market conditions; and broad industry trends.

At SL Capital, we want to promote research that is capable of demonstrating to investors that private equity is a positive force that can provide outperformance over the long term. We also want to ensure that it does this in a constructive way, to combat criticism of the private equity model. To achieve this, we not only rely on the data, but our practitioner's perspective, having invested in private equity since the 1980s.

Recent research has delivered an important milestone. Tim Jenkinson of the Institute, Robert Harris of the University of Virginia and Steve Kaplan of University of Chicago have undertaken an analysis of the largest data set of private equity fund cash flows ever assembled to assess the true returns that can be achieved. This took a different approach to other research, by focusing on a proprietary data set of 1,400 funds from over 200 different institutional investors with a base year of 1980.

Critically, instead of analysing the net returns from these funds on an Internal Rate of Return (IRR) basis, the researchers took the approach that private equity is in fact equity and that returns should be compared to the public markets. This Public Market Equivalent (PME) methodology has been seen as a measurement tool that can enhance our understanding of performance. PME overlays the cash flows of private equity investments and distributions onto the S&P 500 or other liquid market and then assesses the value that this would create. If the PME is greater than one, then investors did better than the S&P 500.

The results from the US data have been unequivocal. Buyout PMEs are consistently above one, with the average fund delivering 1.22, the median fund 1.16 and the top quartile 1.42. Over the typical five-year investment period for a private equity fund, these results imply an excess return of 300-400 basis points, most critically as an average. While this study is based on US buyout data, the European PME returns shows that this market has outperformed the US. One industry commentator noted: "This is an unequivocal endorsement of private equity, dispelling conflicting results from prior research." Critics state that this outperformance simply comes from the leverage that is part of the private equity toolkit. In fact, leverage appears to have a limited impact on the overall returns from private equity in recent years as debt pay-down has not been a major component of the return. Returns have instead been driven by revenue growth and increasing profitability, and because of this we believe that private equity performance will continue to outperform listed markets into the future.

A key factor in private equity is considering how to select the best investments to achieve strong performance. The target has to be to get access to, and invest in, the best opportunities that deliver the highest returns beyond the average noted in the research. The debate has been whether to focus on diversifying your investments by vintage year, giving a consistent approach over time, or to be much more selective about the managers you invest with. Perhaps unsurprisingly, analysis of the Oxford data shows that the volatility of returns in a single vintage year is twice that of returns between a series of years. So, while diversification between vintage years is clearly important, the selection of the best fund managers within each vintage year is absolutely critical to enhance your return and reduce volatility. Positive selection is also important to further improve the return/risk ratio between vintage years in a portfolio of funds.

SL Capital believes that the best route to capture these returns is through a fund-of-funds structure that can provide the right resources, team and processes to select and manage high performing private equity investments. Pension fund investors can make the decision to invest directly into funds or employ consultants to make recommendations, and many do this successfully. However, this typically means some compromise on diversification, market coverage, alignment of interests and the overall management of a series of investments and related resource issues. At SL Capital, our strategy is to invest in private equity funds through primary commitments and secondary purchases, balanced with a significant co-investment capability that delivers a strong risk adjusted return in line with the results from the Institute. In terms of the additional layer of fees that is part of the fund-of-funds model, combining the investment capabilities and a full client service around monitoring, reporting and market coverage delivers compelling value for money on a net cost basis.

The message we communicate to our clients is clear. Private equity can deliver a strong return. You need to be focused on your strategy and on how you access the top managers. You should also be prepared to invest for the long term in a diversified portfolio focused on attractive markets. In this way private equity, even if it represents a small component of your investment allocation, can make a positive contribution to your portfolio in the future.