Private Equity – A Resilient and Opportunistic Asset Class

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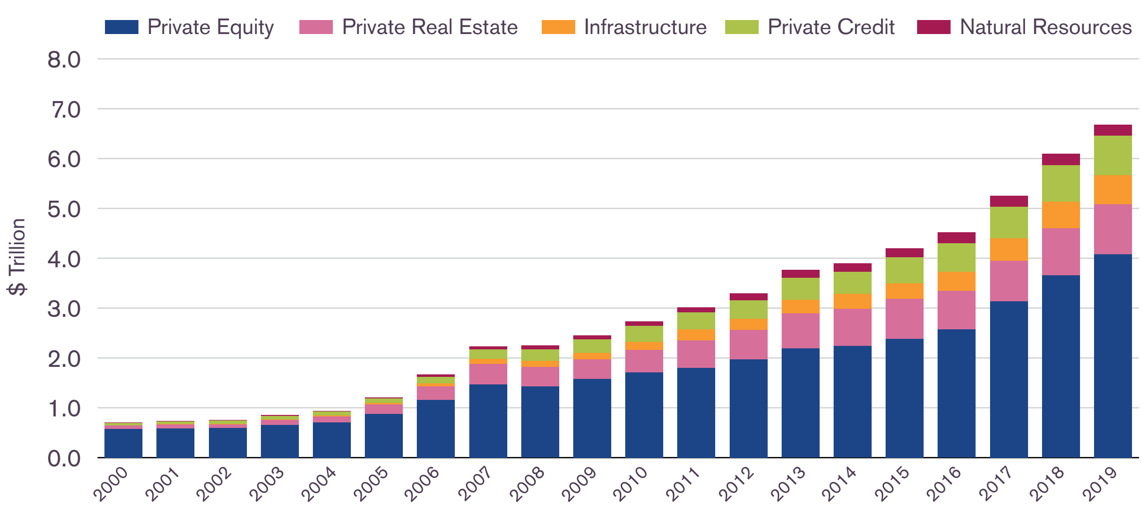
1. Introduction to Private Equity

Over the last 60+ years private equity investing has developed from the original leveraged buyout and venture capital deals, once the unproven territory of financial pioneers, into a tried and tested investment philosophy. Opportunity for investing in the asset class has grown considerably, with a multitude of strategies available across all stages, sectors and geographies.

The private equity philosophy has been successfully adapted into asset strategies such as real estate and natural resources as well as in related strategies in credit and distressed investing. Today the combined AUM amounts to $6.7tr, as shown in Figure 1, of which private equity is the largest and the focus of this article.

The fundamental concept of private equity remains the same; focused on making control orientated investments (buyouts) in companies that are not publicly listed. Today, most private equity investing is done through funds of pooled investor capital managed by a private equity firm. The private equity philosophy is to identify and acquire private companies or assets with a clear investment thesis, implement initiatives to create intrinsic value during ownership, and then exit the company or asset at a multiple of cost. This is achieved through using efficient capital structures, creating alignment between all investors and company management having the time and privacy to make the right long-term decisions.

Figure 1: Preqin Private Asset Managers AUM from 2000 to 2019



What may surprise people is that private equity has been involved in some of the most well-known companies globally including: Formula One, Hugo Boss, Intelsat, Auto Trader, and Wallgreens Boots Alliance. More interestingly, private equity was the owner of each of these companies through the 07-08 financial crisis. Private equity firms were responsible for making transformational changes and decisions which allowed these companies to weather the storm and emerge strongly into the market leaders they are today.

2. What Makes Private Equity a Resilient and Opportunistic Asset Class?

Private equity is an asset class favoured by the world's leading institutional investors. Some of the largest public and private pension funds, sovereign wealth funds and the endowments of universities such as Yale, Harvard and MIT have been long-term investors. Private equity has a number of qualities that make it attractive to this type of long-term of investor. The defining characteristics of private equity are the Three C's: **Class, Control** and **Creativity**.

Class - The private equity approach can be applied to a wide variety of companies across a range of geographies and sectors. These companies can span from the 'best in class', and typically have the following qualities:

- Market leaders: top players in their respective sectors with strong market share and high barriers to entry which allows this position to be maintained. Existing management team is typically strong but may need to be augmented.
- Essential: in companies that provide mission critical products and services in sectors like healthcare, financial services and technology. Revenue is less cyclical and switching cost for customers can be high.
- Growth and expansion potential to: capitalise further on existing markets, expand internationally, improve costs, or make accretive M&A.

Right down to companies which are inherently more complex or have specific challenges to overcome. These are often considered to have 'top class potential' with significant scope to be improved and can have the following qualities:

- Ownership or management challenges: corporate orphans, misaligned shareholders, underperforming or unsuitable management team.
- Distressed or misunderstood: can have very specific issues around their capital structure or may be in a sub-sector that is complex and difficult to understand.
- Growth and expansion potential: realign focus and shareholders, bring in A+ management teams, sort through complexity and restore performance.

Control - This is the best way to implement change. Private equity firms can choose to expand into new countries, develop new products, scale companies up or down depending on market environment, implement cost saving initiatives, buy complementary businesses or sell non-core divisions. Company management can be changed where necessary but private equity firms recognise that having an aligned team is essential to achieve transformation and value creation. This control allows for decisions to be made quickly and decisively. The scale and resources of leading private equity managers allows them to implement these broad initiatives or widescale changes effectively. This compares to a more broadly owned company which has shareholders with different agendas. Decision making can be much slower and can often lack the desired direction (in an effort to keep all parties happy).

Creativity - Private equity firms have the ability to be flexible in both where and when they invest. They can react to market cycles to pursue the best opportunities. As private equity funds are long-term investment vehicles, managers can be patient in when they invest and deploy funds over a period of 3-6 years depending on the environment. This allows managers to cut out the daily noise and instead listen clearly for growth opportunities over a longer time horizon. This creativity extends to how they source, diligence and structure deals. Companies can be sourced off market or when there is a more competitive process managers have either been tracking the company for a long time or have a specific angle to differentiate themselves. Access to private information and management during the diligence process allows for detailed and prudent underwriting of companies where both performance and people risk can be analysed. When acquiring companies private equity managers tend to structure deals with a focus on downside protection, utilising sensible leverage that is often obtained on favourable terms.

It is the combination of these Three C's that allows private equity to be both opportunistic and resilient across market cycles.

3. Resilience of Private Equity During the 07-08 Financial Crisis

To examine the resilience of private equity one can look at how the asset class performed during the 07-08 financial crisis. Figure 2 compares the performance of private and public equity through this crisis. It highlights for private equity the decline in value observed from pre-crisis peak to trough was lower, the time to recovery to that same pre-crisis peak level was shorter, and that the total return from that pre-crisis peak to today was stronger.

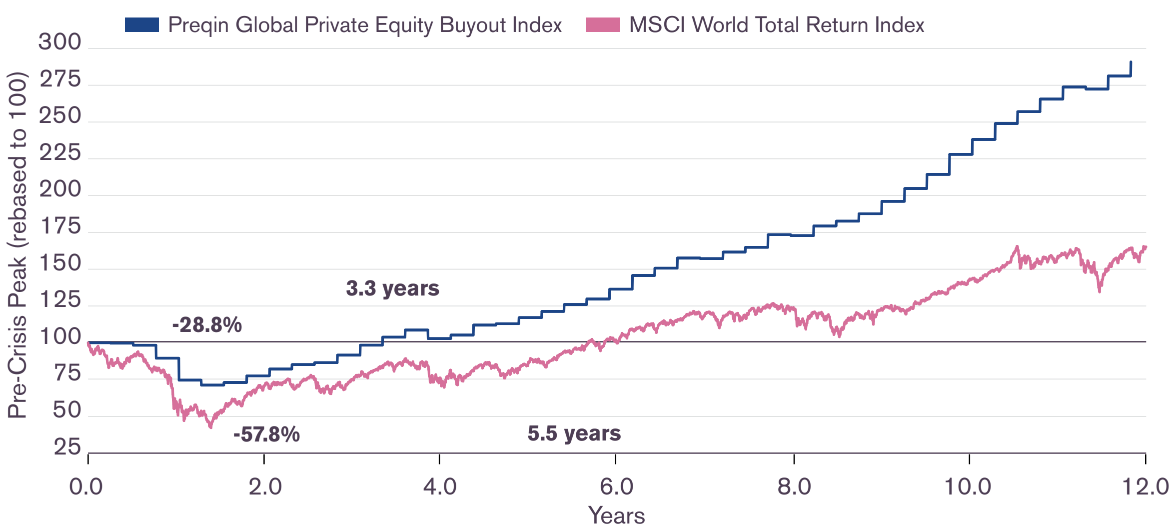
Due to their more illiquid nature, private equity funds are valued quarterly versus listed equities which are priced daily. An overbearing focus on liquidity can often be a distraction and not serve investors well. The ability for an investor to buy or sell on a daily basis can result in adverse market timing decisions or panic induced decisions. In fact, according to Vanguard founder John Bogle, the average equity mutual fund investment gained 173% from 1997 to 2011, but the average equity mutual fund investor earned only 110% because of poor market timing decisions[1]. These decisions can become particularly adverse during more turbulent markets if timing is driven more by fear than sound rationale. The private equity approach focuses on the longer-term for value creation and is less concerned with daily valuations. Only two valuation points really matter, the valuation private equity managers buy the company at and the valuation when they sell it.

To highlight the resilience and opportunistic nature of private equity it is important to examine the performance of the pooled investor funds for the years before and during the 07-08 financial crisis. Figure 3 shows the performance on a quartile basis for private equity funds before and during this period.

The 2005 and 2006 funds would have acquired many portfolio companies pre-crisis and managed them through it. Median quartile managers in 2005 and 2006 still generated returns of 1.6x net times investor's money with corresponding net IRRs of 10.0%. Top quartile managers for the same fund years returned 1.9x net times investor's money with corresponding net IRRs of 15.6% and 13.5%.

The 2007 and 2008 funds had more capital available to acquire new companies during and post the crisis. This translated into median returns of 1.7x net times investor's money with corresponding net IRRs of 12.6% and 13.1%. Top quartile managers for the same fund years returned 2.1x and 2.2x net times investor's money with corresponding net IRRs of 15.6% and 13.5%.

Figure 2: Preqin Global Private Equity Buyout Index and MSCI World Total Return Index, performance 07-08 financial crisis. Pre-crisis peak to Jun-19 (latest private equity index valuations available) Pre-crisis peaks rebased to 100.



Index	Pre-Crisis Peak to Trough	Time to Recovery to Pre-Crises Peak	Total Return Pre-Crisis Peak to Jun-19
Private Equity	-28.8%	3.3 years	191%
MSCI World	-57.8%	5.5 years	65%

Figure 3: Global Private Equity Buyout Fund Performance by Quartile for years 2005, 2006, 2007, 2008. Net Money Multiple (MM) of investors drawn capital and Net Internal Rate of Return (IRR).

Fund Year	2005		2006		2007		2008	
Fund Quartile	Net MM	Net IRR	Net MM	Net IRR	Net MM	Net IRR	Net MM	Net IRR
Top	1.9x	15.6%	1.9x	13.5%	2.1x	18.1%	2.2x	20.0%
Median	1.6x	10.0%	1.6x	10.0%	1.7x	12.6%	1.7x	13.1%
Bottom	1.2x	5.0%	1.3x	5.0%	1.3x	6.1%	1.5x	8.8%
Top vs. Bottom	+0.7x	+10.6%	+0.6x	+8.5%	+0.8x	+12.0%	+0.7x	+11.2%

One aspect that tends to be more pronounced in private equity versus more traditional asset classes is the dispersion of performance between top and bottom quartile managers. This is particularly apparent during periods of market stress as can also be seen in Figure 3. This highlights that in order to be successful in private equity over the longer term it is essential to partner with the top managers who can perform consistently across fund years. Investing in the funds of leading managers directly can be very challenging for investors due to high minimum commitments of €5m-€10m, oversubscribed fundraisings, and their preference for dealing with larger institutional investors. A private equity fund-of-funds approach for an individual qualifying investor is a solution to this.

4. Will Private Equity be Resilient and Opportunistic in 2020 and Beyond?

The private equity firms of the 07-08 financial crisis were not without their flaws and managers learned numerous lessons which they have embedded in the more robust investment philosophies we see today including:

- Longevity of investment team is invaluable. Having worked through the 07-08 financial crisis together, leading private equity teams are highly experienced. They are well positioned to manage and invest through these periods of crisis.
- Managers' proprietary networks and deal sourcing abilities are highly evolved and widespread. Companies can be better understood before acquisition.
- Managers have much better information flow from companies due to improvements in technology and transparency. This allows managers to make more informed decisions and act faster to fix issues.
- Private equity companies today tend to be less leveraged with a larger equity contribution. This leverage is also typically covenant-lite, meaning that during a downturn a company has a much longer timeline to implement change and guide the company through.
- Managers are more focused on the geographies they have performed well in historically.
- Managers focusing on more resilient sectors such as mission critical technology companies, essential healthcare business services companies, transaction and payments based financial services companies.

These learnings complement the fundamental Three C's which allows private equity to remain resilient during times of global crisis. The private equity approach is ideally suited to these present volatile markets. Leading managers are well positioned to capitalise on opportunistic investments, have the ability to be patient, and can focus on a longer-term investment horizon.

References:
1. *John Bogle, Founder of Vanguard as quoted in Lessons from the Behaviour Gap, Ben Carlson, 2013*

Figures:
2. *Preqin Private Asset Managers AUM from 2000 to 2019 as accessed April 2020.*
3. *Preqin Global Private Equity Buyout Index to 30 June 2019 (latest index valuation available) as accessed April 2020. MSCI World Total Return Index to 30 June 2019 from Bloomberg.*
4. *Preqin Private Equity Buyout Fund Performance by Quartile for years 2005, 2006, 2007, 2008. As accessed April 2020.*