Private equity - overview

Addressee

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The paper examines aspects of private equity, including the role that private equity plays in an investment structure, the investment premise, fees and charging structures and the current environment.

Private equity – broad principles

Private equity relates to investment in equity in unlisted companies. In essence, private equity is one part of global equity markets. It probably accounts for nearly half of equity, although that will vary from small private enterprises (e.g. a corner shop) up to very large scale businesses (Alliance Boots). Other things being equal, equities, whether listed or private, are equities in an asset allocation sense. From this perspective, private equity is not a diversifying asset, so **any investment decision would need to be grounded in a belief that private equity is capable of delivering better risk adjusted returns than listed equities**.

Most institutional investment in private equity targets the buyout market, although there is modest allocation to earlier stage ventures and also mezzanine debt for business expansion. Institutional investments in private equity are normally made through the medium of closed ended funds (typical life of 10-12 years). Investors commit a specific sum of money which is drawn down over an investment period, usually the first 3-5 years, as opportunities become available. When the investment opportunity is sold on or brought to the market, the proceeds arising are returned immediately to the investor. This might mean that a commitment (of say £10 million) is invested gradually and each individual investment is participating in returns for (say) 4-5 years only. The process of repayments of proceeds also means that it is necessary to keep re-committing to new funds regularly to maintain exposure to private equity.

The broad explanation of the buyout process is to identify assets that are undercapitalised or under-utilised. This might be a subsidiary of a larger company that is no longer a strategic fit for that company. Or it might be a part of the business that has proved to be a challenge to manage. Or, it might be possible to consolidate small scale businesses into a single entity with sufficient critical mass to generate economies of scale. Typically, the private equity fund will acquire and re-structure the business, including potential re-capitalisation of the balance sheet, replacement of management and driving the objectives to deliver strong cash flow, with a view to selling on the business to a trade buyer or to list in the stockmarket. At an economic level, this is a value additive proposition since it will typically take under-utilised assets and run them more effectively, extracting a higher price. The issue for investors, however, relates to the distribution of risk and reward between the provider of capital and the private equity manager. The remuneration model of the industry is such that there are serious question marks over whether all of the risk and very little of the return goes to the capital provider whereas the manager may take most of the reward and bear very little risk.

Financial mathematics

The “model” for private equity is to acquire and re-structure a business over a four year period and then sell it on for twice the amount of money invested. It is easy to establish that doubling the amount invested in 4 years delivers a gross return (internal rate of return) of 19% p.a. The costs and fees involved in managing this will typically amount to (say) 7% p.a. so the net return to investors, after taking account of fees and costs, will be 11% p.a. To the extent that a long term expected return on equity markets is approximately 7% p.a., the above numbers would mean that **the extra return from private equity would be 4% p.a. ahead of listed market returns.**

There are various caveats to the simple exposition above. For example:

1. If it takes longer than four years to double the investment amount, the annualised return reduces. One reason for a longer holding period might be equity market weakness, resulting in a poor pricing environment for exits. Of course, the prevailing equity market return in that environment might be lower, so private equity might still deliver a 4% p.a. excess return.

2. Private equity tends to operate in mid-cap and small cap space. It may be the case that the comparator that should be used is not the broad listed market index but a mid or small cap index instead. Since mid and small cap stocks have outperformed the broader market by 3% p.a. or more for extended periods, the excess return from private equity would look less impressive. Further, private equity managers have made extensive use of leverage, particularly in the past. Once leverage (and the increased risk that accompanies leverage) is taken into account, it may well be the case that private equity does not produce higher risk-adjusted returns to investors.

Part of the problem is the high level of fees and costs involved in the process. The figure of 7% p.a. results from:

- Basing core fees on commitments (rather than money actually invested). Since the money is "in the ground" for only half of the life of the fund, a typical fee of 2% p.a. becomes 4% p.a.

- If a fund of funds basis is used, there is an additional layer of fees (at a lower level) paid to that manager. This again is subject to doubling, so a fee of 0.75% p.a. will double to 1.5% p.a.

- There are performance fees payable to both layers of managers; the performance element is based on returns in excess of a hurdle (usually around 8% p.a.)

- There are undoubtedly other costs extracted and fees paid to other providers in the process, although those fees tend to be paid out of assets, so have already been taken into account before arriving at the estimated "gross" return of 19% p.a.

If a layer of fees can be removed, e.g. by use of co-investments, fees paid to managers will be reduced so that the net return to capital providers can be improved. In a secondary fund, the period of time spent until commitments are drawn will be reduced significantly and entry prices should be lower. This should improve the internal rate of return significantly.

Nevertheless, there are still basic issues remaining with the accepted fee model that applies in the industry; thus far, the managers have not addressed this issue and investors have not applied sufficient pressure for change in sufficient quantity, e.g. by withholding new commitments, to force change.

Market environment

The private equity market has developed in phases. In the late 1980s and early 1990s, it was something of a cottage industry. It grew in scale over the 1990s and, in the US in particular, became strongly focussed on ventures at the time when activity around the internet and, to a lesser extent, biotechnology was particularly prominent. Private equity then suffered a setback in the collapse of the technology bubble but this made for a relatively attractive investment period for new commitments. Over the period from 2004 to 2007, increasing amounts of debt were being applied; this resulted in criticism that private equity was no more than financial engineering. In the credit turmoil of 2008-09, there was considerable value destruction for over-leveraged investors. The industry has been labouring since 2009. Part of the reason is that there is a very substantial amount of existing commitments which has yet to be deployed. For much of this latter period, it has been hard for private equity managers to exit from participations, which has resulted in longer holding periods, depressing internal rates of return. More recently, managers have found exits easier, with greater trade buying activity.

Fund raising

A further issue to consider is whether there is too much capital chasing too few deals. There is a substantial overhang of uninvested capital inside funds raised in the recent past, which managers have been unable to deploy. Large listed companies which may struggle to grow organically may see an advantage in buying companies that would fit strategically. To the extent that the large companies have substantial uninvested cash piles and can acquire debt cheaply, they can be competitive in the bidding process against private equity managers.

In European buyout markets, the amount of leverage being applied in deals is close to the level of c. 6 times EBITDA (earnings before interest, taxes, depreciation and amortisation – an approximate measure of operating cash flow) that occurred in the first quarter of 2008, just before the credit turmoil commenced.

In the secondary market, there is also an overhang of uninvested cash, believed to be in excess of $60 billion. One of the major US secondary specialists, Lexington Capital Partners, is close to completing its current secondary fund raising at a record level (for Lexington) of US$8 billion, adding further to demand.

Industry practices

There had been earlier concerns that private equity funds struggling to exit and other funds struggling to invest commitments would solve each other's difficulties by transferring participations. This led to questions about the transfer prices used and whether the process was equitable to end investors. In an environment where there is considerable supply of new capital and what had until recently been a weak market for exits, there may be greater use made of inter fund transfers in the near future.

Use of financial engineering might also be an issue. The talent in private equity funds may have been financial or may have been operational. Those managers who were "financial engineers" may have produced strong performance in an environment when higher debt levels were acceptable but may be poorly positioned to participate in a market which requires longer holding periods and operation and managerial ability. The fund of fund providers need to be able to reassess manager credentials against this different, more recent, environment.

Conclusions

The Committee has already decided not to commit to Wilshire's fund raising. In the absence of further commitments, the exposure to private equity will erode as existing participations are exited.

Taking all of the foregoing into account, it may be the case that the Committee is unconvinced by the attraction of making new commitments to its private equity programme. This might be based on the views that other potential investments would provide better diversification within the asset structure and that the risk-adjusted return prospects for private equity are not clearly better than listed equities (especially assessed against mid and small cap). Further, the level of transparency in private equity and the long-term commitment might be considered unattractive relative to the potential in other categories of illiquid investment where fees are lower and transparency might be greater.

Assessing private equity performance

As a general view, in order to obtain the excess returns that investors might expect from private equity relative to listed equity, it is necessary to be in the top quartile of private equity returns (as measured by the private equity benchmarking provider, Venture Economics). One difficulty with assessing private equity performance is that it can only be determined accurately looking back, after a period of at least 8 years and preferably longer. Further, the comparison can only be made satisfactorily by looking at each fund raising individually and by using a consistent cash-flow based internal rate of return approach for both listed and private equity markets.

One of the factors that is important in the delivered performance is timing, both in terms of the price environment when deploying commitments and the environment when selling out of participations. In other words, both entry and exit price are important. It takes a few years to deploy commitments and a longer period before redemptions occur, and it is impossible to predict future environments. Consequently, most investors adopt a process of time diversification, committing to each new fund raising vintage. There is a view that a consistent environment will apply in listed markets so that, in a vintage with weak private equity returns, the listed equity returns are also likely to be weak, and vice versa. Accordingly, investors should be satisfied as long as private equity has managed to deliver the 4% p.a. excess return.

The fact that performance depends on vintage also makes it difficult to compare private equity funds, unless we compare funds with the same vintage. If we assume a two year cycle of fund raising in primary private equity and a potentially longer (3 year) cycle in secondary launches, two funds that you want to compare may not overlap in vintage.

The area of investment activity, e.g. geographical location, size (mega, large or mid-size buyout) and industry type may also be a factor of differentiation between secondary managers that can affect return comparison, even over the same vintage period.

The Fund currently uses two private equity managers, Pantheon and Wilshire. These managers were appointed as part of an OJEU procurement process, and part of the reason for their appointment was their ability to deliver consistent top quartile performance over past vintages. It would be possible for the Committee to take an "investment decision" to commit to the pooled fund of another private equity manager, subject to conducting an appropriate level of investigation or receiving satisfactory investment advice to support the decision. But this would add further to the governance load of the Committee. Further, Pantheon engages in primary, secondary and co-investment vehicles. We believe it is desirable to maintain a relationship with existing managers, subject to being satisfied with process and return, rather than seeking to add another manager.

Secondary funds

The benefit of secondary funds is a shorter investment period, the potential to acquire participations at better prices and a potentially reduced level of fees. The general partners offering funds may have a say in the type of investor they wish to participate in their funds, so may choose to alert selected secondary fund providers looking to buy to the selling interest from investors seeking early exit. This may result in speedier deals because the fund of fund provider is likely to be an existing investor which has already conducted due diligence on the investee fund. Major secondary fund specialists, for whom this is their sole business, are also likely to maintain close relationships with underlying private equity managers. What is clear is that networking forms a vital part of the skillset in secondary investing; not every auction of primary interests will be conducted in an open-market environment.

Co-investment funds

The benefit of co-investment funds is the removal of a layer of underlying manager fees. At the same time, there is less diversification, so the level of commitment should be modest to avoid excessive risk. Co-investments will be made in participations in which the manager is already investing, but where additional funding is required. This should give comfort that appropriate due diligence will have been conducted.

Conclusions

We believe the Committee has to make two high level decisions.

1) Does it believe that investment in private equity continues to be an appropriate element of their structure? If this is not the case, they will not commit to further funds and the existing investment allocation will gradually erode as existing participations are realised. This might take five years or longer.

2) If the Committee is happy to continue to make new commitments, are they prepared to make a commitment to Pantheon's co-investment fund or other fund raising activity at present? A commitment of £10 million (as originally considered for Pantheon's current co-investment fund) is unlikely to be sufficient to maintain the Fund's target allocation. Further commitments over the next two years are likely to be necessary.

   Given the general level of unpredictability about future returns from any fund raising, we do not believe there is benefit in trying to identify an alternative "co-investment fund" manager, instead of using Pantheon. Essentially, we would expect the environment over the investment period to be the more important driver of returns, rather than the manager, subject to having a manager with satisfactory credentials and record in this space. We believe Pantheon fulfils these credentials.

We will be pleased to answer any questions you may have about this at the forthcoming Committee meeting.

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September 2013

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.