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THE MODERNIZATION OF PRIVATE EQUITY

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Understanding and Implementing Private Equity Today

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KEY POINTS

- A diversified private equity portfolio has been a staple of institutional investing for decades.
- Greater investor access to preeminent private equity managers should help diversify and enhance portfolio returns for a broader array of investors.
- We expect lower returns from public equity for the next five to ten years. The illiquidity premium is likely to persist for private equity, potentially providing a meaningful return enhancer to one's public equity allocation.
- Liquidity considerations and one's investment time horizon are key when determining allocations to private equity.
- The performance difference between upper quartile and lower quartile private equity managers is significant. Investing with a skilled private equity manager that has demonstrated success over time is critical.

With $2.6 trillion in assets under management, private equity has long been a core investment strategy for institutional investors across the globe.[1] In fact, endowments alone have allocated ~21% of their portfolio to private equity investments.[2] For many individual investors, however, private equity has historically been difficult to access and even more difficult to build a well diversified portfolio. Our belief is that one's net worth should not dictate the availability or quality of investment options.

[1] *Preqin Global Private Equity and Venture Capital Report as of year-end 2014.*

[2] *Source: 2014 NACUBO-Commonfund Study of Endowments. Includes private equity (LBOs, mezzanine, M&A funds and international private equity), venture capital, and private equity and real estate (non-campus). Everyone cannot invest like an institution. Institutions are professional money managers who have unique access and the ability to perform extensive due diligence on managers. Many investors' experience, financial means, objectives, risk tolerance, and time frame will differ from that of institutions, and they may not be able to access the same investment opportunities as institutions. These factors should be taken into consideration when creating an allocation to alternatives. The above should not be construed as investment advice. Diversification does not ensure profit nor protect against loss.*

More investors deserve access to preeminent private equity managers in order to diversify and try to enhance their portfolios. As a result, our firm and others have helped to modernize investor access to private equity, making it available to a broader set of investors than ever before. First-time investors may have some questions. In this paper, we aim to address several topics about investing in private equity—from the basics to how to invest given the market environment ahead.

KEY QUESTIONS FOR NEW INVESTORS:

- What are the key differences between private equity and public equity from an investment perspective?
- What are the different sectors of private equity—just as there are small-cap stocks, international stocks, or sector-specific stocks?
- How does one allocate to private equity?
- Should an allocation to private equity be considered an alternative investment in a client's portfolio or be grouped with public equity?
- How should a portfolio with private equity be evaluated on a look-forward basis? More specifically, what's the opportunity set in private equity versus public equity in the future?

Private versus Public Equity

Few terms in the investment industry are as literal to their definition as private and public equity. Public equity is public capital (defined as shares or stock of a public company) that are publicly listed and traded on exchanges. For example, Target (TGT) is a publicly listed retail company whose shares trade on the New York Stock Exchange; an investor can become a shareholder of TGT by buying shares at its currently traded market value. Target is managed by an executive management team, which ultimately reports to a board of directors that represents all shareholders.

Conversely, private equity is private capital that is not traded on an exchange—there is no public quote for a private equity investment. Private equity refers to investing in privately-owned companies or public companies that intend to become privately held. [3] Private equity managers aim to capitalize on the **illiquidity premium** as they are willing to give up liquidity to achieve higher returns over a longer-term holding period. Private equity managers raise capital from investors and establish funds that acquire equity ownership in companies or assets that are not publicly listed or traded. They typically evaluate thousands of companies each year, ultimately selecting a very small number that have the potential for value creation. Once they assume ownership, private equity owners work closely with their companies and utilize their industry and operational experience with the goal of enhancing performance and ultimately improving profitability and company value.

A specific private equity fund typically consists of a small number of companies in a portfolio, although all companies fit within the stated geographical and strategic mandate of the fund, e.g., North America, Asia, or Energy. The fund structure is typically a limited partnership (LP) that remains in existence for many years—on average ten[3]—and is not liquid except if there is a return of capital from the sale of companies in the portfolio. Private equity managers typically hold underlying portfolio companies for five to seven years, and look for an exit strategy (via IPO, sale to another company, or sale to another private equity firm) to monetize any value they created during the ownership period.

One of the most prominent methods for value creation is through buyout opportunities. Buyout private equity funds aim to acquire attractive businesses and work closely with their management over the long term to design and implement value creating strategies. Firms that focus on buyout opportunities have their "skin in the game." They typically work directly with their portfolio companies to use their respective operational expertise with the goal of enhancing and improving the value and performance of the company's assets to positively impact the return on investment. If the buyout fund is successful in this effort, fund's investors are the ultimate benefactors as value is accrued and realized.

Illiquidity premium: Forgoing frequent liquidity can be rewarded with enhanced returns. This is a primary reason why investors should consider private equity.

[3] *CFA Institute.*

Types of Private Equity

Private equity opportunities generally focus on certain value creation methods. Some private equity managers raise capital for funds focused on a specific geography such as Asia or North America. Others may focus on different types of strategies, including buyout opportunities, infrastructure, special situations, venture capital, mezzanine, distressed, growth equity or real estate. Most primary private equity funds specialize in one of these private equity strategies at a time. Basic definitions of each type of strategy are shown in Figure 1.

FIGURE 1.

STRATEGY DEFINITIONS

Buyout	Focus on value creation in cash flow positive companies, business units or assets
Infrastructure	Focus on public works opportunities such as bridges, tunnels, toll roads, airport and public transportation
Special Situations	Focus on event-driven or complex situations, where a fund manager may be able to exploit pricing inefficiencies due to an unexpected or actual significant event
Venture Capital	Focus on new and rapidly growing companies
Mezzanine	Focus on the private debt of a company with a senior ranking to equity but subordinate to other claims
Distressed	Focus on the equity or debt of an underperforming company
Growth Equity	Focus on operating companies requiring capital infusions for growth
Real Estate	Focus on equity and debt investments in property development and re-redevelopment

Accessing Private Equity

Newly formed private equity portfolios structured in a limited partnership format are called **primary funds**, which can be strategy and/or geographically focused—for example, a primary fund focused on special situation opportunities in Asia. Private equity managers typically raise capital for these new funds over a several year period, and use **capital calls** to draw on the committed capital from investors as opportunities for investment arise. The year in which a newly formed fund starts investing is referred to as the **vintage year**. These funds are closed-end investments with an average lifespan of ten years. Primary funds are generally accessible by qualified purchasers only, which require a high level of suitability and high investment minimum to access. Investors may also want to diversify their private equity investments beyond one geography, vintage, or strategy type. With minimums averaging around $5 million per primary investment, it takes considerable capital to invest in a diversified array of primary fund opportunities, and may take many years for investors to be fully allocated.

The secondary market or **secondaries** are another method of accessing private equity investments. Secondary investments are more mature funds that were once primaries. These funds include both funded and unfunded portfolio companies (capital has already been called to invest in funded companies, and uncalled capital will be invested in future opportunities) and are available for purchase when a limited partner no longer wants to continue holding the investment. This typically occurs if the holder has determined a different investment strategy for its assets, developed a near-term cash need, or the size of the investment remaining after having received earlier distributions is too small to warrant continued monitoring. These sellers are typically institutions that are responsible for very large portfolios. Since the value of the remaining holdings consists of mostly private companies, there is no fixed public value of the secondary portfolio. Buyers of secondaries are generally firms that specialize in analyzing these portfolios. These firms likely have developed a greater knowledge of the existing portfolio companies within these limited partnership assets. There are a handful of specialty firms that focus on sourcing and evaluating secondary market opportunities. These firms aim to use their analytical capabilities to help determine the long-term return potential of secondary portfolios. Most of these firms focus on acquiring secondary interests a few years after their initial formation, ideally at a discount to their net asset value (NAV). Typically, these firms have a goal of building a portfolio of secondary opportunities and making them available for investment. Some firms also advise direct investors on the value of a particular opportunity.

One final access point to private equity investments is through **co-investment** opportunities. Co-investments allow investors to invest directly alongside the private equity firm in specific portfolio companies or transactions. These investments require specific analysis of the individual company and its future prospects to determine the risk/return characteristics one can expect over the life of the investment.

Private Equity in a Portfolio

AN ENHANCEMENT TO PUBLIC EQUITY ALLOCATIONS

For investors considering an investment in private equity—whether it be in primary, secondary, co-investments or a combination thereof—we believe that capital to fund the allocation should come from one's equity allocation. Private equity has historically been a significant return enhancer to public equities, but with lower drawdowns and lower volatility [Figure 2].

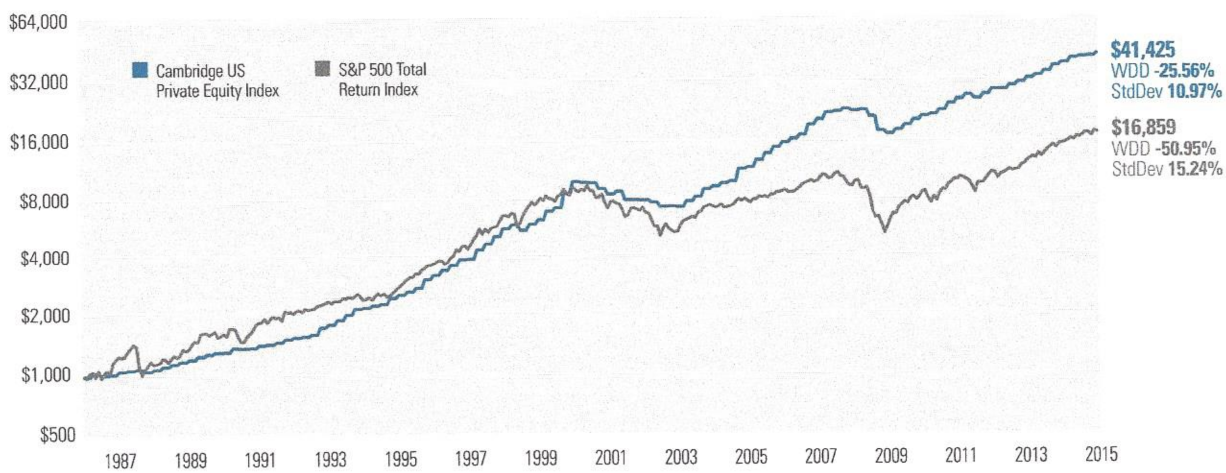
Unlike alternative strategies such as global macro or managed futures, private equity is a strategy that should not be viewed as a diversifier with very low or zero correlation to the rest of a traditional 60/40 stock/bond portfolio. Private equity does have diversifying properties; however our belief is that the primary objective of private equity within an individual investor's portfolio is to enhance returns over a long-term horizon—as it has done for decades [Figure 2].

It is important to note that an investment in private equity is subject to substantial fees and carrying costs. In some cases, fees may be charged on invested capital, while others may charge fees only

FIGURE 2.

HISTORICAL OUTPERFORMANCE OF PRIVATE EQUITY—VALUE OF AN INITIAL $1,000 INVESTMENT

Logarithmic Scale | April 1986–March 2015



Past performance is no guarantee of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. There are significant differences between public and private equities, which include but are not limited to, the fact that public equities have a lower barrier to entry then private equities. There is also greater access to information about public companies. Private equities typically have a longer time horizon than public equities before profits, if any, or realized. Additionally, public equities provide greater liquidity whereas private equities are considered highly illiquid. Private equity investments are subject to substantial management fees and carrying costs. These fees will reduce return and may even result in negative returns, particularly in the early years of an investment.

Cambridge U.S. Private Equity Index data based on quarterly returns. S&P 500 Total Return Index data based on monthly returns. Date range based on common period of data availability. Worst drawdown (WDD) measures the peak to valley loss relative to the peak for a stated time period. Standard deviation (StdDev) is a statistical measure of how consistent returns are over time; a lower standard deviation indicates historically less volatility. The reference indices are shown for general market comparison and are not meant to represent any particular investment. An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented. Source: Cambridge Associates, Pertrac based on data from S&P.

on committed capital. Fund of private equity funds may be subject to an additional layer of fees charged by the underlying private equity funds in which they invest. Over the typical 3- to 7-year window that an underlying private equity portfolio may be held, the fees can range from organizational costs, servicing fees, carried interest, transaction fees, and management fees. The potential for substantial fees and costs often result in capital outflows and negative returns in the early years of a private equity fund's existence.

The fee structure for private equity can be complex. Nevertheless, the potential for higher performance is still attractive to investors. Figure 2 shows that private equity has outperformed public equity by approximately 4% annually, based on data from the Cambridge U.S. Private Equity Index. We expect this level of outperformance to continue as the illiquidity premium is likely to hold or even expand. The relative performance of private equity versus US stocks could be even more significant depending on the private equity firm and ultimately the funds selected for one's private equity investment portfolio. This is because private equity investing is a skills-based business, and generating returns is dependent on how much value a private equity manager can realize from its underlying portfolio companies; in short, this is where experience matters.

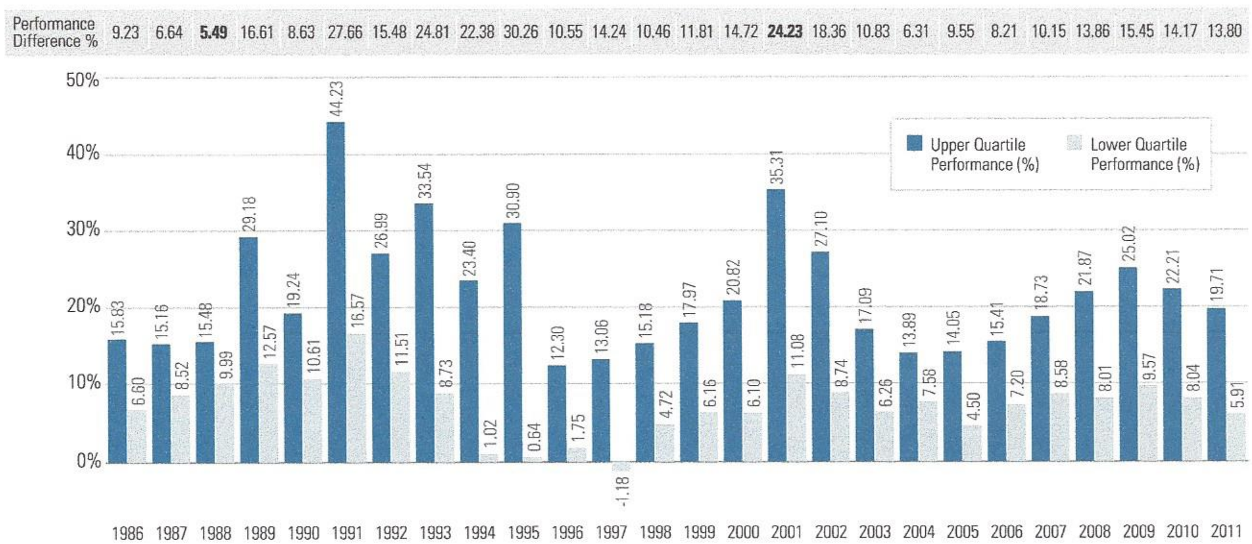
Indeed, there is a wide disparity of performance among private equity managers, with the top quartile significantly outperforming the average.

In Figure 3 below, we have detailed the percentage difference between the best and worst performing private equity funds as defined by Cambridge Associates.[4] These numbers are based on data

FIGURE 3.

US PRIVATE EQUITY UPPER QUARTILE VERSUS LOWER QUARTILE: IRR BY FUND VINTAGE YEAR

1986–2011



Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. Figure 3 is based on data compiled from 1,181 US private equity funds, including fully liquidated partnerships, formed between 1986 and 2013. The upper quartile and lower quartile are based on the fund internal rate of return (IRR) included in a vintage year. IRR is net of fees, expenses and carried interest. Vintage year is the year of fund formation and the first drawdown of capital. Source: Cambridge Associates.

[4] *Cambridge Associates, US Private Equity Index® and Benchmark Statistics, March 31, 2015.*

compiled from 1,181 institutional private equity funds formed from 1986 to 2013. Looking at simple averages, one can see that the upper quartile of funds significantly outperformed the lower quartile by an **average** of 14.38% on an annual basis. In 1988, this difference was as low as 5.49% while in 2001, this difference was a stark 24.23%—over the long term, this difference is even more magnified. *Please note that we have excluded vintage years 2012 and 2013 given the short life of these funds.*

ALLOCATION ASSUMPTIONS

Because private equity is less liquid than public equity, investors must utilize a long-term investment horizon to fully realize the potential benefits of the strategy. Therefore, the optimal percentage allocated to private equity depends on an individual's long-term investment goals and, importantly, one's liquidity needs. An analysis of liquidity needs may be the most important factor to consider when making a decision to take advantage of the illiquidity premia that exist in certain strategies.

It should be noted that private equity may not be suitable for everyone. As with any investment, there are numerous risks to investing in private equity including the possible loss of principal. Nevertheless, for those investors who understand the risks, and have available risk capital, private equity can provide an opportunity to enhance their portfolio returns.

A conservative investor, perhaps nearing or at retirement age, should not allocate a significant portion of his or her portfolio to private equity if substantial liquidity could be needed. This investor is more focused on capital preservation than capital generation, and may need to have a larger percentage of his or her assets in investments that can be easily liquidated. If this individual is primarily building a portfolio for one's heirs and has determined what portion is needed for one's own cash needs, it could be a different story. Likewise, an investor with a more opportunistic investment profile and ability to take on greater liquidity risk may consider a larger allocation. This investor has more time to benefit from the illiquidity premium—they can be patient with their capital, allowing private equity fund managers to use their expertise to try to enhance portfolio returns.

Their investments will also be less influenced by various public market factors including investor sentiment, volatility, quarterly reporting and seasonality. Rather, the performance of the underlying portfolio companies and ultimately the private equity funds (whether it be primary, secondary, co-investment or a combination thereof) will be dependent on idiosyncratic factors related to the private equity manager's ability to deliver on a specific company's potential value.

While we cannot predict exactly how public equity or private equity will perform over the next decade, we believe that the next ten years are unlikely to repeat the past four decades of double-digit public equity returns. More likely, we expect to see a lower global growth environment from an economic standpoint with low- to mid- single digit annual returns from public equities. We do, however, expect volatility levels to fall within historical norms. Thus, investors should expect lower returns but similar volatility ahead for US stocks. Our assumptions used in determining recommended allocations [Figure 5] for private equity within a client's equity portfolio are predicated on these assumptions about the markets ahead.

FINAL RECOMMENDATIONS

We've utilized Black-Litterman—which incorporates a forward-looking approach—to formulate recommended equity allocations inclusive of private equity [Figure 4]. Using this methodology, adding private equity to one's portfolio of US stocks may lower the volatility profile, but more importantly may increase annualized returns.