The five forces of private equity

Private equity has grown from the status of a cottage industry in the 1990s to a full fledge asset class. This shift is so radical that it calls for an analogy with astrophysics. First, private equity exhibits a gravitational effect for investors. This leads to the equivalent of black holes, as the industry is subject to herding effects. To succeed, investors have to dare to be different (entropy) and actively manage the third dimension of investing (liquidity). The ransom of success for the industry is to anticipate the effects of regulatory entanglement.

Gravity

Assets managed by private equity fund managers have grown from an estimated total of USD 578bn in 2000 to more than 2.5tn at the end of 2017. This growth is fuelled by new commitments by institutional investors, which translate into roughly USD 900bn of capital ready to be invested ('dry powder'). This amount is an all-time high, outstripping the USD 678bn to be deployed in 2018. Some observers see a cause for alarm in this figure, but a quick ratio between amounts to be invested and amounts invested show that the average over 2000-2005 was 90% while it fell to 46% over 2011-2016. As some of the dry powder is used to recycle some assets in portfolio (through so-called subsequent LBOs, for example), it appears as growing in line with the sector itself.

However, four causes for concern emerge. First, fund investors tend to concentrate their investments in a small number of funds dedicated to large and mega LBO in the US, fuelling price inflation and therefore leading to lower mid-term performance[1]. Second, an increased number of fund investors also reserve some of their private equity allocation to co-invest with funds. This fuels further the inflation of valuations of large companies targeted by US LBO fund managers. It is estimated that dry powder reserved for co-investments represents 25% of the total committed every by investors in private equity funds.

Third, current fundraising relies a lot on wealth effects. Many investors allocate their assets according to a simple breakdown in percentage. The continuous increase of stock prices over the course of the last eight years has led to a de facto overweight of listed stocks. This triggered significant increases in allocations to private equity, in order to stick to asset allocations.

Fourth, the 1.6tn worth of assets in portfolio themselves are subject to an inflationary phenomenon. Valuation methods of portfolio companies have shifted from prudent/historical methods to a 'fair market' method relying on mark-to-market. As listed stocks have witnessed a continuous and significant increase in their price, the value of private companies marked to market correlatively increased. This could pave the way to bad surprises, in the case of a significant and durable correction of valuations of listed assets.

[1] This is further developed in Demaria C., 'Is there too much capital in leveraged buyouts?', Critical Perspectives, n° 60, August 2017, Wellershoff & Partners

Black holes

Private equity fund investors have over time tried to import some of their practices developed for other asset classes. First, large institutional investors have tried to reduce the number of their relationships with fund managers. This approach supposedly supports them in getting a better deal and reduces their monitoring costs. Second, investors have tried to save on fees, that they judge as comparatively high as regard to the rest of the financial services providers.

This has proven to be wishful thinking. Private equity is not scalable. Only very large funds can accommodate proportionally higher commitments. And deal size is directly correlated to fund sizes. In effect, large investors reducing the number of their relationships have shifted to a concentrated asset allocation and therefore increased their risk. Moreover, they have focused on brands that are not necessarily providing the best of breed in every single strategy. The one-stop-shop of private markets (or of investing, in certain cases) often translates in suboptimal choices under the cover of the marginal reduction of costs (the 'save a penny, lose a pound' phenomenon). Saving on fees, notably through co-investments, can lead to adverse selection and invest in deals that are out of the sweet spot of fund managers (here again increasing risks).

Another black hole is the pressure to deploy capital. Investors have suffered for many years from low interest income. They have entered a race to find alternative sources of revenues compensating the shortfall associated with sizeable allocations to fixed income investments. As private equity funds deploy capital over five years, and a sound allocation requires investing over five to seven years, capital is deployed relatively slowly. Investors also do not get to deploy 100% of their capital as funds call capital while other distribute. Not surprisingly, secondary investments, which promise fast capital deployment and rather short time-to-liquidity, have witnessed a strong capital inflow. The consequences are that investors misled by artificially high internal rates of returns effectively leave profits on the table.

Entropy

Academic literature has proven that solid investors in private equity funds have the capacity to generate additional performance through their asset allocation (20% of the outperformance against their peers) and their fund manager selection (80% of their outperformance). This is not only true in selecting established but also emerging fund managers. The proportion of first-time funds has decreased to 7% of total capital raised by private equity funds. These funds exhibit a higher performance (31% are top quartile and 23% second quartile) but require more expertise and resource to evaluate the fund manager.

The third dimension of investing: liquidity

Private markets are wrongly seen as 'illiquid', leading many investors to completely shun them. In fact, the average investor exposure is three to five years, depending on the region and the strategy considered. The aggregate pooled average net performance ranges from 1.1x for some opportunistic real estate funds to 1.8x for American growth capital. As investors usually set an investment time-horizon of five years, avoiding private markets implies to sacrifice attractive returns associated with low risk. This is a high premium paid for liquidity. Most investors could be better served by setting cash reserves.

Entanglement

Regulatory entanglement, already high since the implementation of the ill-conceived European AIFM Directive, could worsen if the profession does not engage constructively and pragmatically with political and regulatory bodies at national and international levels. Fund managers cannot act anymore as if being under the radar and tending for a small business: they command power on large swaths of developed economies and will suffer the backlash following failed operations as in the recent past. We need to collectively act responsibly for the benefit of the profession and the public and pre-empt the most contentious debates by offering innovative, concrete and attractive solutions to political, regulatory and social representative bodies. This is the price for a thriving private equity sector.

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