THOUGHT FOR THE WEEK

WHAT IS PRIVATE EQUITY?

Global Financial
Private Capital

SYNOPSIS

- The average annual return of private equity has more than doubled world equity markets over the last two decades.
- Investors often ask how private equity works and if they can invest in this asset class.
- Direct investment into private equity funds tends to be restricted to institutions and ultra-high net worth investors.

PRIVATE EQUITY FUND

Investments that do not fall into either the equity or fixed income buckets are often referred to as “alternative investments.” One that has gained a lot of attention over the last several years is private equity.

Investors often ask how private equity works and if they can invest in this asset class. Before we discuss the historical performance and what is required to invest, let’s first explain how a private equity investment works and the key players involved.

Imagine that a team of five seasoned executives skilled at building manufacturing companies decided to partner and seek out small firms that exhibit the potential for success but are struggling through the challenges of growing their business.

They form an investment fund that targets private companies, or those whose stock is not listed on a public stock exchange, and are considered “general partners,” or GPs for short because they are going to be responsible for managing all aspects of the fund. Their next step is to find companies to put in their portfolio, so they conduct a search across the country for manufacturing companies that meet their criteria for investment.

These executives carry decades of manufacturing experience and are very confident that they can help companies grow. They also know that they cannot simply tell existing management what needs to be done. Instead, they need control over the day-to-day activities such as operations, financials, personnel, etc.

Few companies will just hand over the reins to outsiders, so the team is going to have to buy enough of each target company’s stock to where they have control. These purchases can take hundreds of millions of dollars, so they raise money from two primary sources.

> *“The goal of this approach… is to better position investors using a more sophisticated playbook that, until recently, was reserved for only the largest institutional investors.*

The first is from traditional bank loans, where the GPs will secure funds from multiple banks and pay interest on these loans over time. Second, the GPs will embark on fund raising activities to find investors who are willing to share in the risk for a piece of the return. They are called “limited partners,” or LPs for short because they have limited involvement in the fund.

The LPs tend to be large institutions or ultra-high net worth investors because minimum investments in private equity funds tend to be in the $1 - $10 million range. They also have a long-term investment horizon and are comfortable locking up their capital for 7-10 years.

Typically, investors will not hand over the full committed capital up front. Instead, the GPs will do a “capital call” periodically over the coming years as they encounter investments along the way.

For example, if a pension fund committed $10 million to a private equity fund on Year 1, they would not deposit any capital up front. If the GPs found an investment in Year 2 and called 20% of the capital from all the LPs in the fund to buy the target business, the pension fund would then send a check for $2 million ($10 million x 20% = $2 million) representing their share of the investment.

Once the GPs secure the capital, they need to hire personnel, rent office space, and do everything else a company needs to do to stay in business. In order to pay for it all and to compensate the GPs for doing the heavy lifting, they charge the LPs a management fee.

This fee ranges between 1% to 2% annually, so if the fund called $50 million from its LPs and charges a 2% management fee, then the GPs would use $1 million of the funds called ($50 million x 2% = $1 million) to pay its expenses in the first year.

The GPs do not work as hard as they do just to earn a management fee. Instead, their goal is to profit from the sale of the fund's investments. For example, if this fund invested $20 million of the capital raised into a small manufacturing company that was sold three years later for $200 million, then both the GPs and LPs will realize a big return on their investment.

The profit split between the two partners varies, but the industry average is 20% to the GPs and 80% to the LPs. The percentage that GPs keep is called the "carried interest," which can add up to huge amounts of money.

For example, if the profits from the sale of the investment above were $100 million after the debt was paid back, that means the GPs take home $20 million, which in this case gets split amongst five people.

This is just one illustration of how a private equity fund operates, and while the terms and investment strategies vary greatly within the industry, the one commonality is that the GPs and LPs involved in these funds are sophisticated investors.

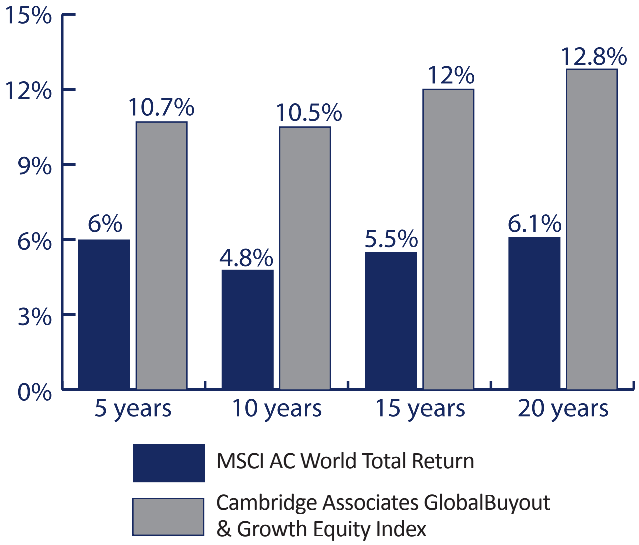
Regulators also usually require that a private equity investor be an "Accredited Investor." This condition states that either an investor's net worth exceeds $1 million (excluding a primary residence) or annual income exceeds $200,000 for individuals or $300,000 joint with spouse in each of the last two years.

Therefore, despite private equity gaining a lot of attention these days, getting access to these investment opportunities is challenging for most individuals.

PUBLIC EQUITY VS. PRIVATE EQUITY

The chart below indicates that the average annual return of the Cambridge Associates Global Buyout & Growth Equity Index, which is a measure of private equity industry performance, has more than doubled the MSCI World Total Return index, which is an index of world equity market performance, over the last two decades.

PUBLIC EQUITY VS. PRIVATE EQUITY (AVERAGE ANNUAL RETURN)



Source: Cambridge Associates, Deutsche Bank, FactSet, MSCI, National Venture Capital Association, J.P. Morgan Asset Management. Data as of 2Q2016. It is not possible to invest directly in an index. Past investment performance is no guarantee of future results.

These astronomical returns are possible due to a number of factors, but by far the most important is control. The GPs roll up their sleeves and get their hands dirty, and since they usually have control of their investments, they have the ability to replace management, change the strategic direction of a company, sell off unprofitable business units, etc.

Furthermore, private equity can be incredibly sophisticated and requires a team of seasoned executives who spent years cutting their teeth in an industry. The number of professionals who carry the experience necessary to unlock value in an investment is small, so the barriers to entry into private equity are relatively high when compared to public equity markets.

However, this control comes at a price. When an investor buys a publicly-traded stock, that transaction is conducted in seconds on a highly-regulated stock exchange. Private equity deals take months, sometimes years to complete between two parties that both hire teams of lawyers and experts in everything from valuation and earnings quality to human resources.

Another challenge with private equity is the time horizon. Most investments require capital to be locked up for at least 5-7 years, and investors are often required to invest additional capital along the way.

Simply put, even though the returns look attractive, it can take a long time to realize them.

IMPLICATIONS FOR INVESTORS

Direct investment into private equity funds has historically been restricted to institutions and ultra-high net worth investors. The “accredited investor” requirement, high investment minimums and lack of liquidity are real hurdles, and managing the risks associated with private equity investments requires extensive training and experience. However, there is still a way for individuals to gain exposure to this asset class.

Any real estate agent will say that the three most important rules of real estate are location, location, and location, because the neighborhood determines most of the value of a home. Buy a bad house in a great neighborhood, and you should still do ok.

Similarly, the three most important rules in investment management are asset allocation, asset allocation, and asset allocation. Picking the right allocation explains 93% of long-term returns[1], and Yale has done a phenomenal job finding the best neighborhoods.

Sectors of the global economy act a lot like neighborhoods in real estate, where one area can quickly become hot and attract a lot of attention due to the opportunity for higher expected returns.

For example, consider a run-down neighborhood right outside a major metropolitan area that developers begin to revitalize thanks to tax incentives enacted by local government officials. Builders erect apartment towers, chefs open up trendy restaurants because rents are cheaper, etc. These efforts slowly attract people to live, work, and play.

Early successes get noticed by competing builders and chefs, which bring even more capital to the neighborhood. More housing is created, newer restaurants open, and retail stores selling overpriced candles start popping up. In short, the early profits generated by a few brave souls in this neighborhood breeds more success because it attracts more capital and entrepreneurship.

There are two ways an individual could profit from the revitalization of this neighborhood. First, she could learn how to cook, take out a huge loan from a bank, and then roll the dice as a restauranteur.

The second is to simply own land in this neighborhood or buy rental property and profit indirectly from the successes of others in the area. This option does not require significant expertise in any given trade, nor does it require understanding the intricacies of running a business.

Admittedly, a seasoned builder will likely profit more than a land owner, but since most of the long-term return on any investment in this neighborhood can be explained by its location, the individual could still capture a large portion of the returns the builder will realize without having to build.

The same applies to investing into various sectors in the global economy. For example, a scientific breakthrough in oncology (a catalyst similar to the tax break above) will most likely attract investment capital and the attention from competitors. This would then incentivize other scientists to innovate in the pursuit of similar success, and even more capital would then follow.

The barriers to entry into biotech are as high as they get for a sector. The science is incredibly complicated, the regulatory environment is cumbersome, and the technology is extremely expensive. Most investors are unable to comprehend these intricacies to know which companies will succeed and which will fail.

However, opportunities do exist to invest in the biotech sector without having to pick individual stocks. Investment solutions are readily available to allow an investor to participate in biotech returns by investing an exchange-traded fund (analogous to owning land).

This same strategy can be applied to private equity. Similar to watching where the best builders are developing new apartments, determine where private equity capital is being invested, and an individual could potentially capture a large portion of private equity returns by investing in these sectors.

Such a solution does exist and is one of several others that are designed to provide investors with increased diversification and an alternative source of returns. The goal of this approach to asset allocation is to better position investors using a more sophisticated playbook that, until recently, was reserved for only the largest institutional investors.

The bottom line is that private equity has historically delivered strong returns, and while there are barriers to direct investment for most individuals, investment strategies do exist that can offer exposure to this asset class for investors with appropriate return objectives and risk tolerance.

Sincerely,

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[1] Brinson, Hood and Beebower, "Determinants of Portfolio Performance" (1986, 1991)

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