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PRIVATE EQUITY:

The Increasing Appeal of Customization

by | **Helen Lais**

Pension funds looking to expand investment opportunities may want to consider private equity. This article describes the building blocks to constructing a private equity portfolio.

A Growing and Maturing Asset Class

Global private equity fundraising exceeded $450 billion in more than 1,300 funds in 2018. An almost identical amount was invested in more than 5,300 companies by private equity investors.[1]

Private equity has become a more attractive investment opportunity as returns in the public market are increasingly volatile and more companies are going private. The asset class offers unique structural characteristics, including an illiquidity premium to public assets, greater portfolio diversification benefits and some downside protection over multiple market cycles.

This article will introduce private equity and offer considerations for why customizing a private equity portfolio is the best way to meet plan objectives and obligations.

Private Equity Primer

Private equity is considered an alternative investment class and consists of debt and equity investments in privately held companies and assets that are not listed on a public exchange. Investors generally include professionally managed pooled funds and investors that invest directly into private companies, typically to pursue long-term growth strategies. These direct investors serve as highly active board members, often bringing additional management and resources into the companies to actively drive increases in revenue and earnings.

Private equity has substantially matured as an industry since its earliest days following World War II. Institutional investors in private equity include sovereign wealth funds, pension funds, insurance companies, endowments, foundations and family offices. Securities and Exchange Commission qualifications for such investors include having a securities portfolio of not less than $25 million to participate in the asset class. Institutional allocations range in size from as small as $1-$5 million to more than $100 billion for larger programs.

Private equity offers several attractive characteristics, such as an illiquidity premium to public assets over the long term. An *illiquidity premium* is a higher return relative to investing in public company shares because the private securities are not as liquid or tradeable on a daily basis.[2] Private equity also offers diversification because of its lower correlation to public asset classes[3] (Figures 1 and 2).

Private equity *net vintage year returns* (the returns to investors in the funds by each year in which the private equity funds made their first investment) have also demonstrated resilience to cyclical downturns. Over the 30-year period beginning in 1985, the lowest net vintage year internal rate of return (IRR) was 6%, and in only three of these 30 years was the net vintage year return below 10%.[4]

With the number of public companies shrinking over time, particularly in the U.S., investors without exposure to private equity do not benefit from the upside of a much larger invest-

able universe. Furthermore, private equity– and venture capital–backed companies stay private longer, supported by private capital and value creation by investment firms. When such companies do become public, much of the upside has already been captured by private investors. Allocations to private equity for private and public pension plans typically range from 5-6% but can go as high as 30% in well-funded plans relative to pension liabilities (Figure 3).

There is broad recognition today that the fundamental nature of private equity investing affords sustainable advantages, including:

- The ability to enter at reasonable or lower-than-market valuations due to private market inefficiencies and the very large investable private company universe
- The opportunity to reap the benefits of very active and aligned investors working together with management to grow the companies
- Opportunistic or negotiated and well-planned exit processes when these business are sold, which can further optimize investment returns.

Commensurately, allocations to private equity continue to grow, and there is an increasing shift among U.S. institutional investors away from public equity to private equity (Figures 4 and 5).

Customization: A Powerful Tool for Achieving Investment Objectives

After deciding to allocate to private equity, customization can be a powerful tool in helping investors meet plan obligations, improve solvency and generate investment success relative to performance objectives.

Private equity is not a one-size-fits-all model. Similar to customizing public markets or hedge fund portfolios, investors have many options to construct diversified private equity portfolios that meet the specific needs of their respective investment programs. This is a key tenet utilized to offset certain risks, such as illiquidity, J-curve reduction or loss of principal risk.

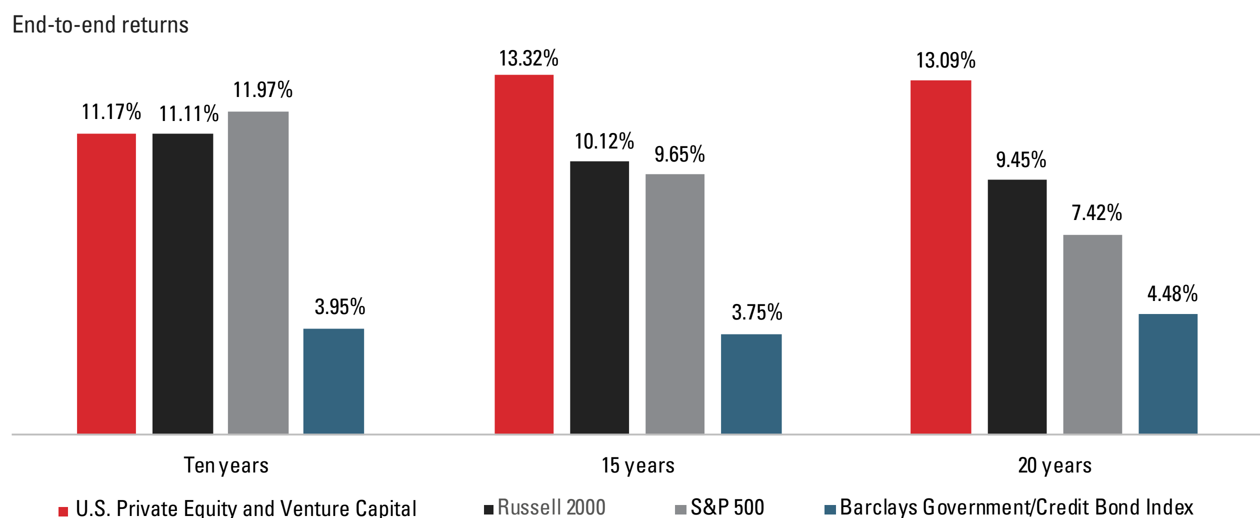
Several core building blocks in portfolio construction to consider include the following.

Geography

Private equity investment is very well-established in the U.S., Europe and

FIGURE 1

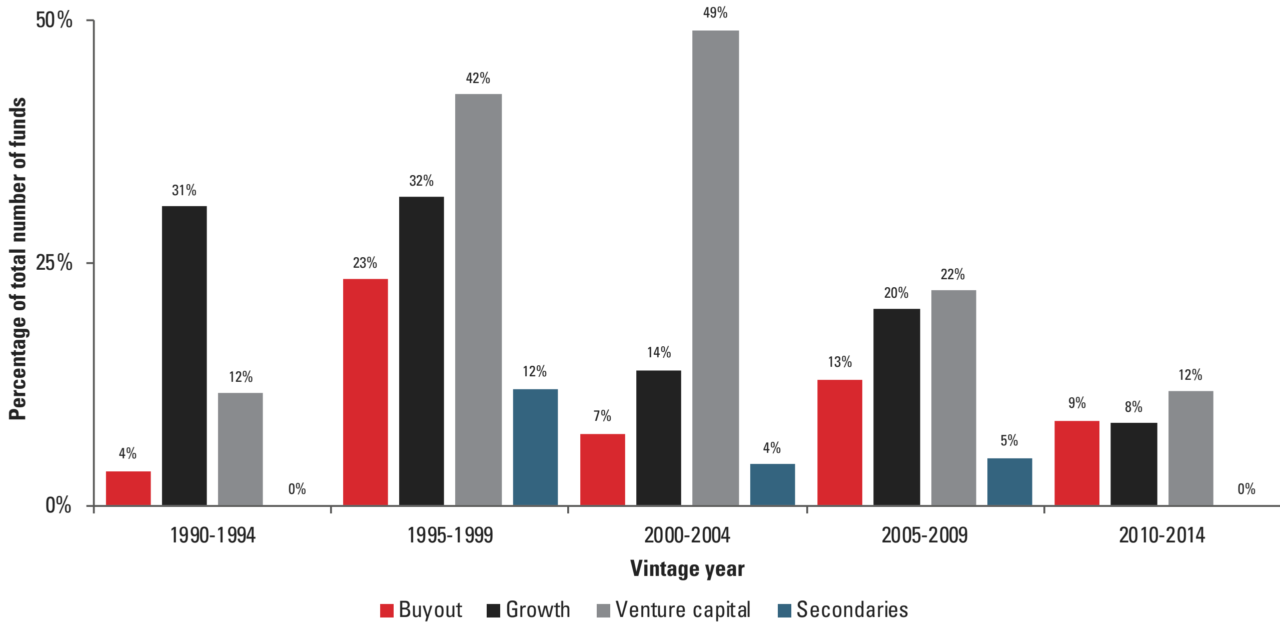
Private Equity Outperformance Over Public Markets



Source: Cambridge Associates Private Equity & Venture Capital Index Statistics and Benchmarks, third quarter 2018. The end-to-end performance calculation is measuring the return between two points in time. The calculation takes into account the beginning net asset value (NAV) as the initial investment. The subsequent quarterly cash flows and the ending NAV for the specified time period (i.e. one quarter, one year, etc.) are utilized in the same fashion as the internal rate of return (IRR) calculation. All returns greater than one year are annualized.

FIGURE 2

Percentage of Funds Returning Net Internal Rate of Return (IRR) Less Than 0%



Source: Capital Dynamics analysis based on Thomson One Cambridge Associates data, as of June 30, 2018.

Asia. It is more risky to consider investments in Latin America and other emerging markets, but more sophisticated and larger investors are more willing to broadly diversify. Most often, investors consider allocation by geography in markets they are comfortable investing in relative to the size of the respective markets. Programs that may have a U.S.-only investment restriction can still achieve very substantial portfolio diversification. The U.S. private equity market makes up roughly two-thirds of the global private market by fund capitalization. Allocations outside of the U.S. may be warranted for diversification, since European buyouts or Asia-Pacific buyouts have outperformed U.S.-based strategies in some past years.

Strategy

By including select strategies from across the entire business cycle in portfolio construction, investors can influence their risk/return profile; decrease certain key risks, such as illiquidity; and get downside protection. The table on page 55 identifies several major strategies to consider across the business cycle.

These strategies can be accessed by investors directly or through professionally managed funds or separate accounts via:

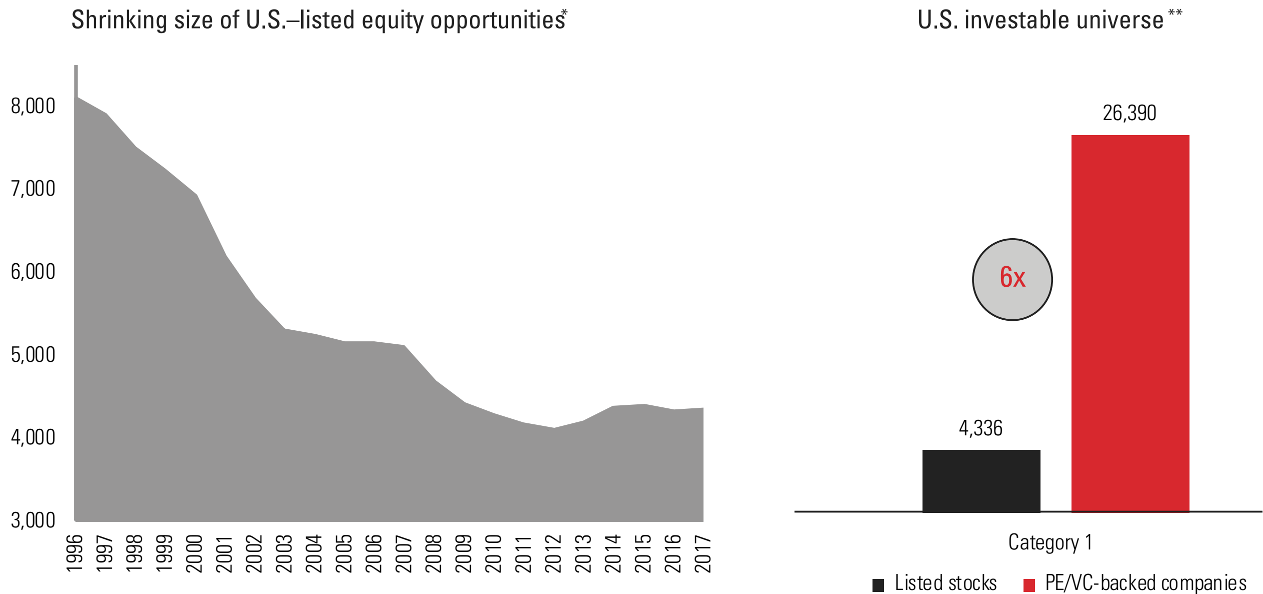
- **Primaries:** Diversified new fund investments
- **Secondaries:** Diversified mature portfolios of existing fund assets and individual direct company stakes
- **Coinvestment:** Individual direct company interests alongside managers with demonstrated professional investment expertise
- **Industry sector funds:** Investors can choose to invest in specific sector funds, for example, industrials, health care or technology. It is also very easy for investors to exclude sectors they may not like, due to cyclicality or other factors.

Values

More principles-based factors, such as environmental, social and governance factors (ESG), are gaining increasing importance in many investors' programs. Some also are being mandated. The more rapid uptake of ESG implementation, which some firms and programs began to adopt formally in

FIGURE 3

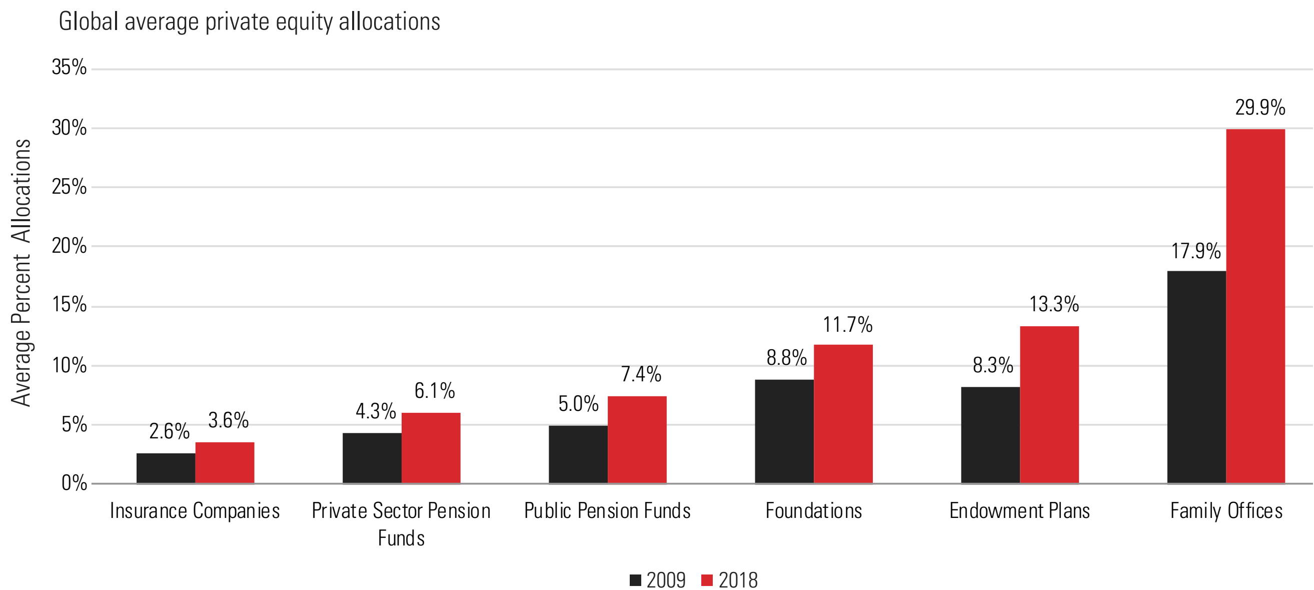
U.S.-Listed Equity Relative to Private Equity (PE)–/Venture Capital (VC)–Backed Opportunity



*World Bank, data as of December 31, 2017. **Pitchbook inventory report for PE-backed companies, third quarter, 2018, and NVCA/ Pitchbook *Venture Monitor* for 2017 for VC-backed companies.

FIGURE 4

Global Trend of Increasing Allocations



Source: 2018 *Preqin Global Private Equity & Venture Capital Report*.

TABLE

Risk and Return of Private Equity Strategies

Strategy	Brief Description	Top Quartile Returns (Greater than or equal to)*	Bottom Quartile Returns (Less than or equal to)*	Yield	Loss Ratio**
Venture Capital	Investments in preprofitable to profitable, innovative companies in need of equity capital for initial creation, research and expansion	23.6%	5.3%	None	11%
Growth Equity	Typically profitable companies with enterprise values below $1 billion in need of equity capital for expansion and expertise to bolster growth	19.3%	5.4%	None	9%
Leveraged Buyouts	Mature companies seeking equity capital and expertise to bolster growth and/or restructure	21.4%	9.6%	Low	11%
Private Credit	Private equity–backed companies and assets seeking credit, but which cannot access public credit markets	13.0%	7.3%	Moderate to high	4%
Infrastructure	Investments in physical facilities providing essential services, such as utilities, communications infrastructure, (renewable) power generation, bridges, toll roads	12.0%	3.5%	Moderate	13%
Real Estate	Investments in the acquisition, financing, management and ownership of properties	16.3%	6.2%	Moderate	11%

*Thomson One Cambridge Associates, data for vintage years 2008-2016 as of September 30, 2018. **Thomson One Cambridge Associates, data for vintage years 2008-2016 as of September 30, 2018. Loss ratio is percentage of funds returning less than 0% net internal rate of return.

Note: The data in the above table beginning in 2008 reflects the time period inclusive of Lehman Brothers' Chapter 11 bankruptcy protection filing on September 15, 2008, the largest bank failure in U.S. history. The data set for private credit and infrastructure prior to 2008 is insufficiently robust.

the late 1990s to the early 2000s, stems from a growing view that these principles have strong benefit for all constituents and will generate long-term, sustainable investment outperformance.

Values-based investment strategies include:

- **ESG:** Investment managers can implement formal policies regarding elements such as energy efficiency, recycling, pollution, diversity, labor standards, safety and social impact.
- **Socially responsible investing (SRI):** For example, investors may specify outright prohibitions in their portfolio related to investments in companies dealing in categories such as tobacco, weaponry or gambling.
- **Labor-friendly:** For example, growth-oriented managers may choose investments that demonstrate job creation. Infrastructure investors may choose projects that encourage responsible contracting and/or industrial and manufacturing managers with strong safety values and records.

Fee, Carry Structure and Reporting

Investors will pay a management fee and a *carry,* or share of the profit, to the asset manager or underlying manager. Investors going directly into funds typically pay a 2% manage-

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Stephan R. Leimberg, Thomas R. Robinson and Robert R. Johnson. National Underwriter. 2017.

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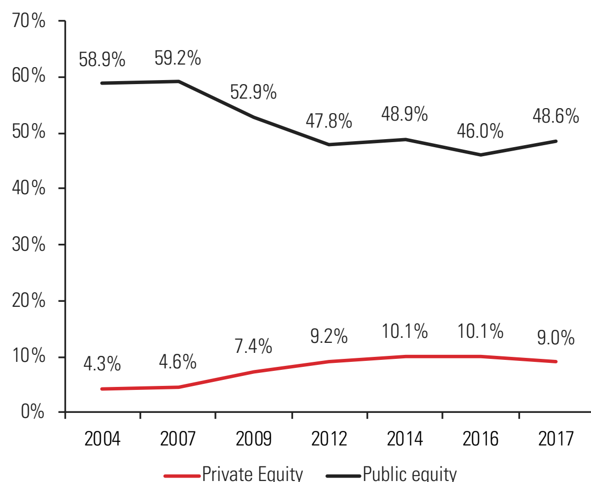
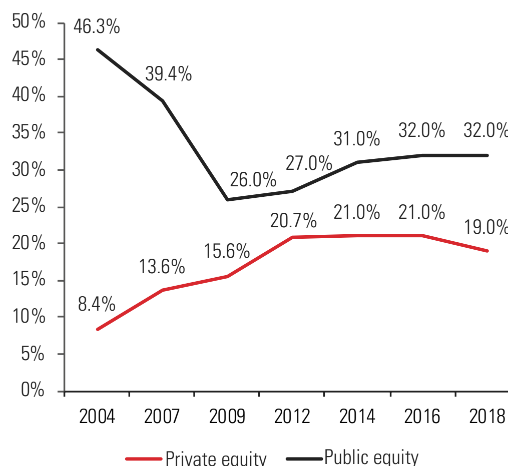
FIGURE 5

U.S. Average Asset Allocations





Sources: Wilshire Consulting *2018 Report on State Retirement Systems: Funding Levels and Allocations.* The NACUBO endowment studies 2004-2019. Private equity includes buyout, venture and mezzanine funds.

ment fee and 20% carry. Investors participating in pooled investor vehicles and separately managed accounts can negotiate fee and carry structures with asset managers. These can be fee or carry only or a combination of both. Fees typically range from 0.1% to 1.0% and carry ranges from 0-10% of the profits, typically after a 6-10% return to investors has been achieved.

Investment programs can be further structured to include any of the features highlighted above and to be in alignment with an investor's fiscal reporting year and regulatory and fiduciary requirements. Customized statistics that the investor deems of importance can be added to standard financial reporting.

Key Risk Considerations

Investors and their boards must be well-informed of the inherent risks of private equity and should be well-versed in elements of complexity, characteristics of risk/return profiles and the importance of diversification.

Key risk considerations include the following:

- **J-curve:** An IRR of a private equity fund will initially be negative due to investments into companies, start-up costs and management fees but will rise in successful funds as time passes and portfolio companies build value and can be exited. The term *J-curve* refers to the shape of the curve of the fund's IRR when plotted over time.
- **Fluctuating fund net asset values:** Values calculated under Financial Accounting Standards Board (FASB) accounting guidelines can differ from the final return. Furthermore, realized and unrealized fair market values are reported on a one-quarter lag, relative to daily pricing from public equities.
- **Illiquidity:** While the secondary market for private equity is very robust today, exceeding $74 billion in transaction value in 2018,[5] investors need to be prepared to accept less liquidity than is typical with public equity investing. Pricing obtained for secondary sales can be at a deep discount to, at par with or at a premium to carrying value depending on the quality of the assets.
- **Opacity and blind-pool investment:** Private equity managers treat company information and performance as confidential, and access to reliable industry data can be difficult to obtain. Investors are also subject to strict confidentiality provisions. Investors

who invest in pooled funds don't know what the fund's ultimate holdings will be at the time of commitment because the fund manager has completed few, if any, investments when the manager is raising capital.

- **Dispersion of returns:** The performance differential from the best to worst private equity managers is far more significant than in public equity investing. Experienced due diligence and rigorous investment processes, diversified portfolio construction, access to first-quartile managers, and ongoing management and monitoring are strong requirements of success, including from a cash and risk management perspective. Some of the strongest performing U.S. managers historically raised capital over a full year before beginning the investment period or drawing down of capital, creating increased complexity in forecasting cash flows. These collective dynamics can result in a greater return dispersion and complexity, which requires resources and expense in internal investment staff or the utilization of outside asset managers to access and manage investments prudently.

Endnotes

1. Preqin database, as of March 25, 2019.
2. Capital Dynamics research, as of 2018.
3. J.P. Morgan 2018 long-term capital markets assumptions.
4. Capital Dynamics analysis based on Thomson One Cambridge Associates database, performance data as of September 30, 2018.
5. Greenhill & Co., *Global Secondary Market Trends and Outlook*, January 2019.

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takeaways

- The private equity asset class may offer institutional investors attractive characteristics, such as an illiquidity premium to public assets and portfolio diversification benefits.
- Investors that choose to participate in private equity, particularly in the U.S., gain exposure to a larger investable universe than the public equity markets alone provide.
- Investing in private equity requires experienced due diligence, rigorous investment processes, diversified portfolio construction, and strong cash and risk management.
- A tailored investment approach can help investors achieve objectives in accordance with their specific needs related to important considerations, such as desired risk profile, yield, illiquidity and values.
- Disadvantages of private investments include a wide dispersion in performance among private equity investment managers, lack of transparency of investments, fluctuating values and illiquidity.

When considering alternative investments, such as private equity funds, the Recipient should consider various risks including the fact that some funds may use leverage and engage in a substantial degree of speculation that may increase the risk of investment loss, can be illiquid, are not required by law to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. Any such investment involves significant risks, including the risk that an investor will lose its entire investment.

bio

Helen Lais is a managing director and head of U.S. primaries at Capital Dynamics. She has more than 25 years of private equity and management consulting experience. Prior to joining Capital Dynamics, Lais was managing partner of Arborist Capital and a partner and co-head of U.S. fund investments at AlpInvest Partners. Earlier in her career, she worked for Goldman, Sachs & Co.; Massachusetts Institute of Technology; Mitchell Madison Group; and McKinsey & Company. She holds a bachelor's degree in finance and philosophy from Boston College and a master's of business administration degree in finance and product and venture development from the MIT Sloan School of Management.

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