

Examining Private Equity's Place in Investors' Portfolios





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Acknowledgements

We would like to thank those investors and fund managers that we spoke to when putting this document together, all of whom gave up their time to offer their unique perspective on private equity and the place that it has in investors' portfolios.

In addition, we would like to thank Mark Drugan of Capital Dynamics and Alex Koriath of Cambridge Associates, as well as the BVCA Limited Partner and Investor Relations Advisory Committees for their comments and support for this paper. All errors, of course, remain our own.

Disclaimer

No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this paper. Specific advice should always be taken in each situation.

I Introduction

What have Boots and the AA got in common? How about Pret a Manger and Poundland? Or Skyscanner, Odeon Cinemas or Transferwise?

The answer is that they are, or have recently been, backed by private equity.

In fact, there are thousands of these companies across the UK and tens of thousands globally – BVCA members alone have invested in close to 4,000 companies over the last five years, from household names to innovative technology companies.

Creating value in a business is key to the private equity model. At its most basic level, it means improving the business over the lifetime of the investment, so that by the time it comes to sell, the company is in better shape and is worth more than when the investment was first made. This is achieved through an active ownership model, where the private equity investor works alongside the management team to drive operational improvements and determine the path to growth.

It is an approach which clearly works. As of the end of 2014, BVCA members had delivered annual returns to their investors of 13.8%, on a net since-inception internal rate of return (IRR) basis, almost double the amount that the FTSE All-Share (7.6%) and UK pension fund assets (7.8%) have returned over the last decade. As a result, it is not surprising that institutional investors are increasingly putting money into private equity – it is an asset class that has continuously delivered strong, consistent returns.

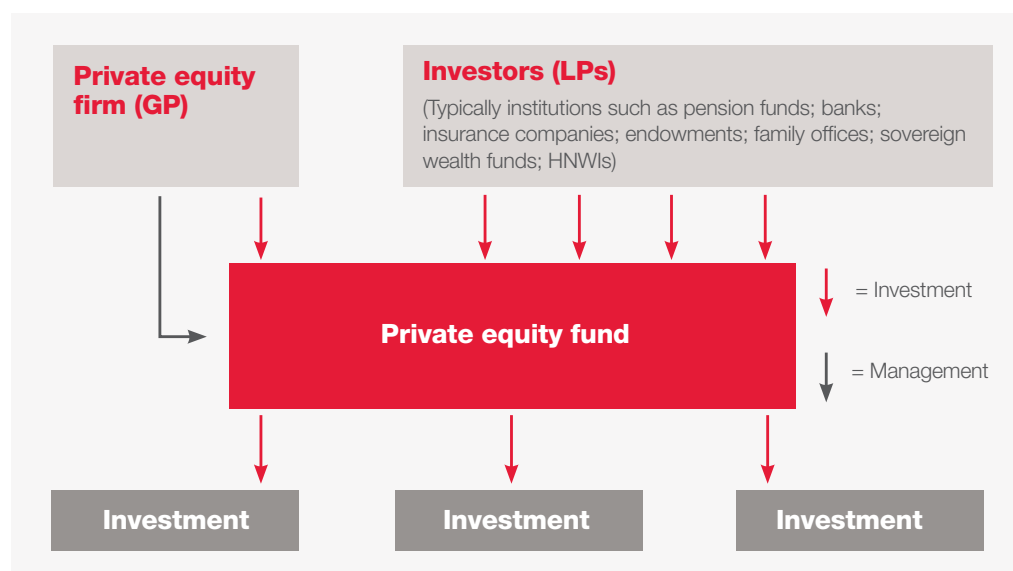
This paper considers private equity and its place in investors' portfolios. It examines how the industry adds value to the companies it invests in, and what this means for investors. Along the way, it will explore what a private equity fund does, provide an overview of the academic evidence on the impact of the asset class on the businesses it invests in, and give a fund manager's view on the day-to-day activities they undertake to create value for their investors. It will also talk to investors about their reasons for investing in private equity, providing a unique perspective on what the asset class can do to enhance returns. Finally, the paper will highlight the responsible investment agenda within the private equity community and discuss ways in which investors can better evaluate the environmental, social and governance (ESG) implications of their decision-making.

II What is Private Equity?

Private equity is a form of finance provided in return for an equity stake in potentially high growth companies and infrastructure businesses. Growth in the businesses is delivered by working with the company's management team to improve performance and strategic direction, making complementary investments and driving operational improvements.

Private Equity Fund Structure

Rather than selling shares in the stock market, private equity firms raise their funds from private sources, such as pension funds, insurance companies, endowments and high net worth individuals. Investors band together with a fund manager in an investment partnership, with investors taking the role of Limited Partner (LP), and the manager taking the role of General Partner (GP). This fund then invests in often-majority stakes in companies with high-growth potential, with the aim of improving the performance and value of the business and selling it for a profit at a later date.



This sale will tend to take place somewhere between five and seven years after the original investment, reflecting long-term ownership over which significant operational changes and other improvements can be enacted. This process is called an exit and is achieved through selling an investor's stake in a company, usually through listing on the public markets in an initial public offering (IPO), selling to a strategic buyer (a trade sale or secondary buyout) or selling the company to the management (buy-back).

Unlike other asset classes where money is drawn down all at once, private equity commitments are drawn down as investments into different companies are made over time. Because these funds are structured as long-term investment vehicles, LPs are often required to commit their capital for the entirety of the fund's life – typically 10 years. A fund's lifetime is typically broken down by an initial five year investment period followed by a five year divestment period. Because of the long-term nature of its investment strategy, private equity is illiquid.

What is the difference between private equity funds and hedge funds?

Generally private equity seeks to create value over the long-term, whereas hedge funds have a shorter horizon more in line with movements in the stock markets. Private equity investors usually buy and own a majority stake in a company and thus have alignment of interests with the managers of the company – this ensures the investors can help the company achieve its growth potential over time and realise their investment.

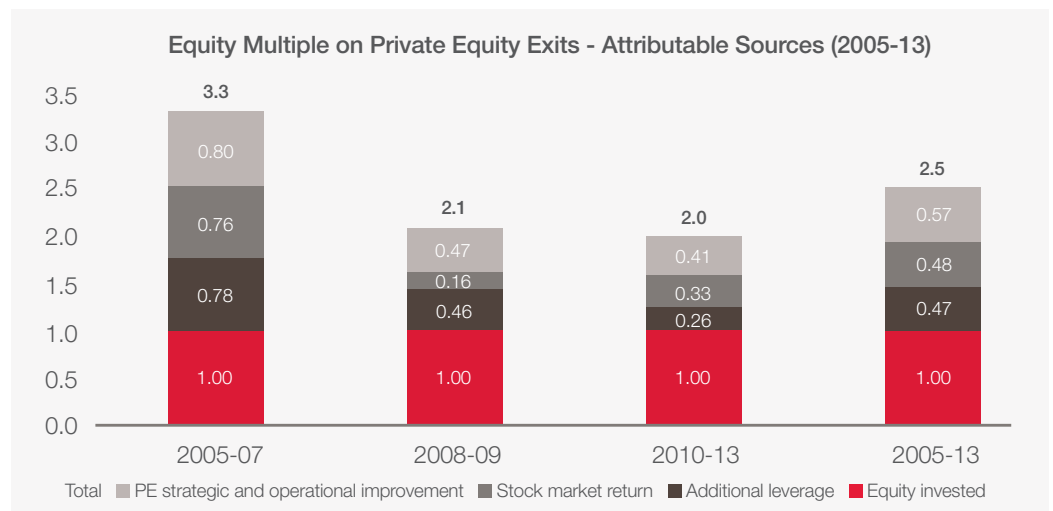
Hedge funds are pools of capital that tend to invest in stocks, bonds or commodities and do not usually purchase a controlling interest in a company. Hedge funds try to capitalise on short-term market movements, using complex trading strategies involving options, derivatives and other financial instruments. In some cases, hedge funds bet against the shares of the companies they do not own (i.e. short selling), hoping to profit from falling prices.

	PRIVATE EQUITY	HEDGE FUNDS
Long-term outlook	✓	
Operational improvement	✓	
Active management	✓	
Alignment of interests	✓	
Liquidity		✓


How does Private Equity add Value?

Growth in investee companies is delivered by a private equity investor working with the company's management team to improve performance and strategic direction, making intelligent investments and driving operational improvements. Most private equity executives are industry veterans and have had the specialist experience of funding and assisting companies at a time of rapid development and growth. To enhance long-term performance, a firm's focus goes beyond bottom-line improvements, such as making reductions in both cost and waste and improving IT infrastructure, to include operational and strategic planning, such as opening up the business to enter new markets, improving competitiveness, and executing a strong business strategy.

With nearly a decade of data at their disposal, EY has been examining how European private equity investors create value in their portfolio companies, measuring the industry's track record and performance from 2005-2013. These annual studies consistently find that exits from private equity-backed companies outperform comparable publicly-listed companies by a multiple of over three times (EY, 2014). While financial leverage played a part in their results, the strategic and operational improvements made by industry professionals accounted for a greater – and growing – share of outperformance. As the graph below demonstrates, for portfolio companies exited between 2005-13, investors achieved a gross return of 2.5 times equity invested, with strategic and operational improvements producing the greatest single source of gain, before, during and after the financial crisis.



Source: EY (2014) *Taking Stock: How do private equity investors create value? A study of 2013 European exits.*



Certainly, for a partnership to be successful, investors and management must establish a structure in which both parties share an active ownership vision and are motivated to generate long-term, sustainable value, rather than fulfil short-term demands. Placing an executive from the private equity firm on the board of an acquired company can also promote effective organisational change, providing keen oversight, defined goals and timing, disciplined decision-making and abundant resources. By ensuring that the management team in a company has an ownership stake, there is a fundamental alignment of interests between the company and the firm – both are focused on long-term value creation – one of the principal reasons why companies owned by private equity outperform similar publicly-owned companies.

Fees and Transparency

As one of the most actively managed asset classes, private equity involves a fee structure, both to meet the day-to-day operational expenses of a fund manager, and to incentivise the fund manager to achieve the best possible return for an investor. Management fees allow the fund manager to meet their own operating costs, including salaries for the team and regulatory compliance. These fees are expressed as a percentage of the funds raised and tend to vary in a band between 1.5% and 2.5%, with larger funds tending to have lower fees.

Carried interest relates to the fund manager's performance-related share of realised profits from fund investments – usually 20% – only if the investors have achieved a certain level (hurdle rate) of returns. In some cases, carried interest is paid throughout the life of a fund when individual investments are realised, while in others, it is paid only after the whole fund has achieved the hurdle rate. In either case, investors have a clawback provision put in place to ensure that the overall split at the end of the fund's life reflects the agreed profit-sharing ratio and that any excess carried interest distributions are returned to them. If the fund's final return is lower than its interim returns, the clawback will ensure that the fund manager repays any carried interest paid out over and above what should have been paid out.

As carried interest is only allocated after investments are realised, it incentivises private equity firms to focus on operational improvements and the long-term realisation prospects for an investment, rather than short-term or interim valuations. This in turn aligns the interests of the fund manager with those of investors and is a distinctive feature of the asset class.

How to Measure Returns

The ability to benchmark the performance of different asset classes is of paramount importance to institutional investors when considering where to put their money. In the case of private equity, the comparison is not always an easy one. For publicly quoted equities which have clearly defined and often liquid markets, the returns are easily accessible, frequently in real-time and easily understood. Private equity, however, is somewhat different, reflecting the irregularity in the timing and discretionary nature of the cash flows between the fund and its investors. Once an investor has made a commitment to a fund, it may not be invested for a period of month or even years, and when it is invested, this may be at irregular intervals and sizes. In light of these distinctions, measuring private equity returns requires a different approach to measuring the performance of more traditional asset classes.

The two most commonly used methods to measure private equity are money multiples and the internal rate of return (IRR). Money multiples are calculated by dividing the value of the returns by the amount of money invested and are often used in the industry as they offer a simple way to show the scale of returns an investment has given. IRR calculates the average annual return of the investment by looking at all of the cash flows from the investment over a given period, taking into account possible capital gains and income through dividends. By expressing returns as an annual percentage of investment rather than as an absolute return, IRR allows investments with differently timed and sized cash flows to be easily compared.

Valuations and Reporting

Due to the long-term nature of private equity investments, it can take time for investors to see the final realised return on their commitments. Valuing unquoted investments is inherently a judgement call and firms often reference the International Private Equity and Venture Capital Board's (IPEV) valuation guidelines. These provide practical guidance and ensure that firms adopt consistent and appropriate valuation

methodologies. They outline the main valuation techniques that have helped increase the transparency of the industry, as well as confidence in the interim fund net asset values that the firms report.

High-quality reporting is a vital instrument in helping to keep the private equity industry one that is both transparent and meets investors' needs. Reporting requirements, including frequency, accounting standards and audit requirements are agreed upfront with investors, usually in the Limited Partner Agreement. While there are a number of sources of guidance, in practice fund reporting varies as it is tailored to the specificities of the fund and investor requirements. Reporting to investors is usually comprised of a letter or report from the firm detailing the fund's activities and performance, financial information including a calculation of net assets, and other performance metrics and supplementary information.

Fees and carried interest and reporting

The fees and carried interest earned by fund managers and the reporting thereof is increasingly being sought by investors. The industry has over recent years taken, and continues to take, steps to determine best practice in reporting to investors as mentioned above generally and in particular on the matter of fees and carried interest earned by fund managers and fees earned by other third party service providers.

Invest Europe, the pan-European private equity trade body, has recently undertaken an exercise to update its investor reporting guidelines between fund managers and investors. The exercise included representatives from both the fund manager and investor community and its proposals were widely circulated to its members for consultation. The new investor reporting guidelines which have been finalised include recommendations on fee reporting, including the required detail of breakdown between the types of fees that fund managers earn and also indicates to what extent fees paid by investors are to be reduced by amounts earned directly by managers through fee offset arrangements. It also covers the carried interest earned by fund managers and whether the fund has a hurdle rate that will apply before carry is paid. The guidance also requires the fund to provide an analysis of how much carry has been paid in cash, whether it is subject to clawback or whether there are escrow arrangements. In addition, the investor reporting guidelines also provide guidance on best practice of disclosure of third party fees (such as administrators, consultants and auditors). Rather than prescribe a standard template, the Invest Europe guidelines sets out best practice of required disclosures and possible additional disclosures and the guidelines are accompanied by examples of disclosure to illustrate possible layouts of disclosure.

The Institutional Limited Partners Association (ILPA) also has a Fee Transparency Initiative, offering guidance on reporting and transparency in the private equity industry. The Initiative is considering a standardised reporting template that details fees, incentives or expenses from limited partners to private equity managers and their affiliates. It is due to consult with its members on this subject more widely and the intention is that the fee and expense reporting and compliance disclosures to be appended to its Private Equity Principles.

The Private Equity Reporting Group (PERG)

The Private Equity Reporting Group was formed in 2008 by the BVCA to increase transparency, disclosure and introduce Guidelines on self-regulation for the UK private equity industry. Since then, the industry has embraced and adopted the Guidelines with over seventy portfolio companies currently providing additional disclosure voluntarily. The PERG meets several times a year to adapt the Guidelines and ensure they remain relevant and fit for purpose. The Guidelines look at three groups: private equity portfolio companies, private equity firms, and the BVCA.

Portfolio companies must publish annual reports which: identify the private equity funds that own the company, their senior managers or advisers, and the members of the board; include a business review that meets the requirements of the Companies Act 2006; and contain a financial review, relating to risk management, that considers the risks facing the company (including leverage).

The Guidelines and the work of the PERG remain essential for the industry as they demonstrate the industry's commitment to transparency to all stakeholders including employees, suppliers, customers and the public more widely. By publishing financial statements and further disclosure on private equity firms' websites, the industry is able to demonstrate its aim of building businesses and quash concerns regarding secrecy and asset stripping.

III Why Private Equity? Perspectives from Institutional Investors

In putting together this report, the BVCA reached out to several leading institutional investors to get their perspectives on private equity and what makes it an attractive asset for investors. Participants included pension funds, sovereign wealth funds, banks, insurance companies, investment managers, endowments and family offices from around the world. These institutional investors collectively represent global private equity assets under management of over £1.1tn.

Outperformance

Any investment decision, irrespective of its size, always begins with the same question: What gains do we stand to make? For institutional investors interviewed in this report, private equity was, across the board, perceived as being consistent in delivering superior long-term returns. Investors overwhelmingly listed the significant outperformance of the asset class as the primary driver behind why they began investing in private equity, many of whom noted it was the highest returning asset class within their portfolios. To achieve this alpha, investors highlighted the importance of an active private equity management team and the analysis, negotiation and oversight that they regularly provide. Investors noted that their ultimate goal was to maximise returns without taking undue risk and explained that they viewed private equity as an asset class that would be able to do that, adding that it comprised an important part of a broader means to actively manage their portfolio. Secondary considerations included the benefits of increased diversification across a number of investments and access to opportunities not available through public markets, such as leveraged buyouts and venture capital opportunities. Other respondents highlighted how well private equity accommodates illiquidity by being a provider of longer-term capital and the exposure to innovation that the asset class provides.

Absolute return expectations across investors stood, on average, at an internal rate of return (IRR) of between 15% and 20% , and on a relative basis at 3%-5% above public markets. To benchmark these returns between funds and against other asset classes, almost all investors surveyed said that they used third party professionals to provide a relevant benchmark, with most using Cambridge Associates and a smaller number measuring against the State Street Private Equity Index. When reviewing new fund opportunities, some investors stated that they compared the past performance of GPs against relevant funds in their portfolio, alongside private equity benchmarks. Peer groups were also used as a measure to assess relative value between funds, with Public Market Equivalent and Public Market Equivalent+ (PME and PME+) measures used to compare between asset classes.

“We target private equity to be the highest returning asset class within our portfolio. Historically we would only look at it relative to the public markets: basis points over the public markets for funds and 1000 basis points for directs. Now we think about it more in absolute terms, so now we wouldn’t target a fund unless we thought it could return 20% IRR.”

North American Pension Fund

Building a Portfolio

The length of total experience in private equity varied across investors, ranging from seven years for the newest entrants, to over 40 for the most established. The majority of the investors surveyed have been active in private equity for over 20 years. That they have been return buyers for so long is a testament to the fact that the asset class has, and continues to perform strongly for them. Almost all investors surveyed, irrespective of their size or when they made their first commitments, initially built their portfolio

“The primary driver has always been the source of returns. This remains the case today. Secondary considerations are better diversification risk, access to opportunities not available through public markets and being able to capitalise on the illiquidity premium through longer-term capital.”

Global Investment
Consultancy

“The ability for private equity to deliver a higher return relative to other asset classes was absolutely a driver behind why we had a programme here.”

North American
Pension Fund

“We believed that the governance structure for private equity was superior to traditional assets. We therefore expected that long-term private equity returns would be sustainably higher than those for public equities.”

North American
Pension Fund

“We are seeking to increase allocations to private equity as we believe investors seeking high returns are looking for new sources of income and growth as well as investments that can demonstrate protection from the volatility of capital markets. The diversity of options (strategy, stage, sector, geography) and the access we have to high quality firms results in our belief that relative value can be captured against other asset classes.”

**Global Investment
Consultancy**

through the use of fund of funds and secondaries to provide reach until portfolio maturity – a process that took, on average, 10 years to reach. Once maturity was reached and more experience in the asset class was gained, investors made the move away from fund of funds to making individual fund commitments directly, as well as co-investments.

“The strategic decision was made to build a private equity portfolio with an in-house team with an investment strategy to build a globally diversified portfolio made up of a concentrated number of primary fund relationships, to be an active co-investor, and to make secondaries investments opportunistically.”

North American Pension Fund

Allocations of private equity varied across investors, ranging from as little as 1.5% to as much as 25% of total assets. When asked whether they were looking to increase, decrease or maintain their private equity portfolio over the next five years, 50% of investors stated they were looking to increase their allocation while the other half stated they were looking to maintain current levels. Importantly, none of the investors interviewed stated that they were looking to decrease their private equity exposure. The most common reasoning behind this was private equity's ability to align high returns with long-term growth while avoiding the volatility of the public markets.

“Private equity is our highest returning asset class. We have consistently achieved over 15% IRRs annually for over 30 years and continue to expect roughly the same amount.”

European Investment Adviser

In terms of portfolio diversification, all investors surveyed stated that their private equity portfolio was well diversified, from investment stage and type to geography. The unanimity of this finding across investors is significant, as it demonstrates that all types of investors can get what they want from private equity and that it is a flexible asset class.

Investment Constraints

Private equity portfolios are not built overnight, nor are they all created equally. In order for an investor to maximise their returns, it is necessary to have an alignment of interests between investor and private equity manager. We asked our survey respondents to tell us what they considered to be constraints to allocating as much of their portfolio to private equity as they would like. Constraints to investing were largely external to private equity's performance, and were mainly centred on the asset class' illiquidity, fee structure and limitations arising from regulatory changes.

“Our focus on fees is mainly with respect to alignment of interest and motivation of our partners, rather than the absolute amount of fees.”

North American Pension Fund

On the topic of fees, investors generally felt that a fund's net of fee levels should be appropriate for both the strategy and the scale of organisation of each fund, and that they are fundamentally set up in such a way for an alignment of interests between both parties. On the whole, respondents felt that industry fees were largely reasonable to investors but that on a manager basis, individual funds were, at times, too high. They explained that the responsibility to manage fees ultimately rested on the investor to assess individual funds on the terms and fees that they offered. While an important issue, none of the respondents stated that they would dogmatically pursue low-cost funds as an investment strategy.

IV Value Added: A General Partner's Perspective

From due diligence and deal origination, to setting a strategic direction for businesses and cultivating growth, a GP's work is multifaceted and unending. To present a comprehensive view of the industry for this report, the BVCA reached out to a senior partner at a UK mid-market private equity firm to talk through the role of the private equity manager and the day to day activities that follow in ensuring they add value to investors and portfolio companies alike.

Deal Origination


“ We've got a large team of people in the origination department whose sole job is to make sure that we are seeing the most interesting businesses that we can back and help them grow. To do this, we capture the entire scope of the UK company population and take the time to go through and see which of these companies are doing innovative things that are the future for their industries. Due diligence potentially starts several years before you actually invest, which enables us to spend time thinking about a particular business, where it is positioned and where it could go. Ideally, I would go and meet the chief executive of a company that is not looking to do something today, but may be looking to do something in the next year or even five years from now, whether they want to make an acquisition for the business, bring a new management team or to simply diversify. Doing so enables me to meet them in an environment where they are not for sale, but rather to have an understanding of their business model, what they want to achieve and whether they have any problem points where we could provide our expertise and support. We'd then check in on them every six months to get an update on how they're doing.

This phase involves quite a light touch approach, as opposed to the sharper end, where we're actually doing a deal. At that point, we would spend anywhere from two to six months just thinking about that specific company and are engaged in conversations with the executives about their business. It's not a case of, "How much do you want for your business", but rather, "How can we help you to achieve your strategic aims"? Part of that will obviously be capital, but an even larger part of it is about our experience. Whether it's about expanding to North America, acquiring other companies, or transitioning from founder to CEO, the expertise and resources that we provide is of great value to our portfolio companies.”

Post-Acquisition

“ Strong origination is only part of our work, because we are very involved once we have acquired a company. For instance, say we need to help one of our companies recruit a MD for one of their divisions. How do we help? First, it's about our network: who is the right head-hunter to find the best candidate for this role, or do we know a candidate from a previous portfolio investment? Second, what does "good" look like? For a majority of the CEOs of our portfolio companies, this is the largest business that they've ever run and they haven't had the time to go out there and see what "good" looks like. On the other hand, through our origination and portfolio, we have met hundreds of these people and our benchmark of what their expectation should be is much higher, minimising the risk of hiring the wrong person.

We also often take our newer CEOs to go and spend time with a chief executive from another company in our portfolio that is further along in its journey. Having that newer CEO sit in through their weekly meeting allows them to see how someone else runs their business. How do they interact with their team? How do they get the process to be as efficient as possible? Having this experience not only helps them to develop their own skill set, but also pushes them to better support their own team. We also organise events for our portfolio companies. They're all of a similar size and they're all facing similar obstacles, so creating an afternoon where we get some of the more experienced



people to talk through their experiences provides newer businesses with a network of people that can help them get the most out of their business and see the bigger picture. On the strategy side, we have a team made up of former strategy consultants who have a strong understanding of the market and are able to look at the competition and say, “Here’s what they’re doing wrong and here’s how we can do it in a more structured way to help you succeed”. This team will get involved at every level of the portfolio company to help support growth initiatives.

At the end of each month, we have a board meeting with our businesses which provides us with the opportunity to take a step back, to look at what the performance was like last month and what strategic things we want to be doing next month, in terms of resource allocation. It’s about figuring out how we prioritise when we are investing time, delivering the most value and growth for that company. Most of our portfolio companies are very well resourced and have lots of great people in the business. As a firm, we have a 3:5 ratio of companies in our portfolio to investment professionals, so we are always able to help companies when they need it.”

The Market Today

“The market has changed phenomenally in the last 20 years. Everyone has heard of private equity and the market has become more efficient, and therefore more competitive, than ever. An entrepreneur now has a lot of choice in terms of which firm they want to work with and the amount of time that we spend thinking about investments has increased exponentially over the last two decades. Higher competition means higher prices, so it’s vital that we are putting in all of our collective time and resources to make sure we’re going after the right deals and that we are comfortable with what we are doing. Today, management teams are both buyers and sellers, so you can’t simply rely on financial commitment, they will need to be absolutely certain about their financial plan. That means that we, as part of our origination team, want to know who the most interesting, high-growth businesses are, so that we can go and approach them to find out what is the best way that we can add value to their business and help it grow.”

V Creating Value: The Academic Perspective

Due to high leverage, the risk of private equity-backed firms defaulting on their loans is a source of concern and has raised questions regarding its impact on the stability and survival of these companies. The financial crisis and resulting recession have further incited this debate, as private equity firms began to experience greater difficulty both in raising new funds and refinancing debt for their existing portfolio companies, prompting academics to re-examine whether the industry is still creating value in this new age. More than ever, substantial attention is being paid on understanding the long-term impact of private equity, both in terms of value creation for investors and for the portfolio companies themselves.

Outperformance

The Performance of Private Equity from Higson and Stücker (2012) of the London Business School and the University of Oxford, analysed how private equity has performed relative to public equity benchmarks using a dataset of fund cashflows that covered 85% of capital raised by US buyout funds from 1980 to 2008. The study found that private equity outperformed the S&P 500 by 544 basis points per annum and that when young vintage years (2006 to 2008) were excluded, outperformance rose to 809 bps per annum. Over the entire sample period, the equally-weighted IRR average was 468 bps higher than the S&P 500 and the median buyout fund had a positive spread of 390 bps. *Private Equity Performance: What Do We Know?* from Harris, Jenkinson, and Kaplan, (2014) of the University of Virginia, University of Oxford and the University of Chicago, examined the performance of nearly 1,400 US buyout and venture capital funds and found that buyouts consistently outperformed public markets, particularly the S&P 500, net of fees and carried interest, in the 1980s, 1990s, and 2000s. Their research found that each dollar invested in an average buyout fund returned 20% to 27% more than a dollar invested in the S&P 500 over a fund's life, equating to an outperformance of 3% per year.

By contrast, *Private Equity Performance: Returns, Persistence and Capital Flows* from Kaplan and Schoar (2005) of the University of Chicago and MIT, found lacklustre performance in private equity, suggesting that average funds returned, on a net basis, the same as the S&P 500. Another study, *The Performance of Private Equity Funds*, from Phalippou and Gottschalg (2009) of the University of Oxford and HEC Paris, used an updated version of the dataset and found that average net returns were 3% below the S&P500. However, *Updating History*, a paper by Stücker (2011) from the University of Oxford, identified a significant problem with the dataset in question for both papers, presenting evidence that many funds stopped being updated from 2001 and were retained in the database, nonetheless. As a result, fund-level IRRs in the sample fell over time and multiples of invested capital remained constant, rather than increasing, suggesting that the results in both papers understated fund returns.

The Active Ownership Model

Private equity's active ownership and governance model is one of the most distinguishing features of the asset class. *Do Private Equity Owned Firms Have Better Management Practices?*, a study by Bloom, Sadun and Van Reenen (2009) from the London School of Economics, used data from over 4,000 firms across Asia, Europe and the US and found that private equity-backed firms were significantly better managed than government, family and privately-owned firms. When looking at management practices in greater detail, the authors found that private equity-backed firms had strong people management practices and even stronger operations management practices than the other groups in the sample, additionally finding that private equity-backed firms improved their management practices at a faster rate than other ownership types. Because of this, the study concluded that private equity ownership was associated with wide-ranging operational improvements in management rather than simply just stronger performance incentives.

Corporate Governance and Value Creation: Evidence from Private Equity, a study by Acharya, Hahn and Kehoe (2009) from the Centre for Economic Policy Research, also stressed the importance of value creation through operational improvements. The paper examined deal-level data from 395 private equity transactions in Western Europe initiated by large private equity firms between 1991 and 2007. The authors found that deals with higher alpha (outperformance) and higher margin growth were associated with greater engagement of private equity firms during the early phase of the deal, employment of value-creation initiatives for productivity, and complementing top management with external support. Overall, the study found a positive impact of ownership by large, mature private equity firms on the operating performance of portfolio companies, relative to that sector, with EBITDA/sales increasing by 0.4% per annum above the sector median.

In addition to lending companies operational expertise, private equity firms can also lend their financial reputations, particularly when it comes to their ability to broker cheap debt and provide their portfolio companies with a valuable borrowing advantage. In *Private Equity Firms as Gatekeepers*, de Fontenay (2013) discusses precisely this. As leading players in the debt markets, private equity firms can use their reputations with creditors to circumvent problems of borrower adverse selection in the companies that they manage. By doing so, they reduce creditors' costs of lending to these companies. Because of this, companies that are backed by private equity have the ability to borrow money on better terms than those that are not. de Fontenay concludes that by acting as gatekeepers, private equity firms can make debt markets more efficient and provide their portfolio companies with borrowing advantages.


Better Boards?

Effective corporate governance is one of private equity's key tools in value creation. *Private Equity vs. PLC Boards: A Comparison of Practices and Effectiveness* from Cornelli and Karakas (2012) from the London Business School and MWM Consulting, interviewed 20 chief executives with experience of operating on both public and private equity boards in the UK. The study found that 75% believed private equity boards were "clearly superior" in the value they added and scored better on overall effectiveness when compared with their public counterparts. The authors attributed this added value as being driven by the boards' aligned focus on value creation, better clarity on strategic and performance priorities and the greater engagement and commitment of their board members. While average FTSE 100 boards had an average size of 11.4 members and saw their non-execs spend three to five days in informal discussions with management, private equity boards had seven to eight members and saw their non-exec counterparts spend 35 to 40 days in such meetings.

In *Private Equity and Corporate Governance: Do LBOs have more effective boards?*, Cornelli and Karakas (2008) follow the board composition of all public to private transactions that took place in the UK between 1998 and 2003. Looking at the boards after the companies had been taken private, the study found that those undertaking a LBO became 15% smaller. The study also found that LBOs with a larger presence of private equity executives on the board had a lower CEO turnover but higher operating performance, a finding consistent with the view that CEOs in change of the restructuring process face a longer term horizon, allowing them to focus on the restructuring process.

Do Buyouts Respond Better to Financial Distress?

Private Equity and Insolvency, an academic study commissioned by the BVCA from the Centre for Management Buyout Research (CMBOR) and the Entrepreneurship and Innovation Centre, Wilson, Wright and Cressy (2010) set out to determine whether the likelihood of insolvency was higher for private-equity backed buyouts than non-buyout firms. To study the causes of failure, the authors developed a dataset comprising 1.97m individual private companies and over 10m company-year observations in the UK over the period 1995-2009. While the level of leverage was higher for buyouts compared with other companies, those backed by private equity had a significantly better coverage ratio (the ability to pay interest on debt from profit and cash-flow) and were less likely to fail in the wake of the crisis. Importantly, the study found that poor management and failure to generate cash were distinguishing factors between buyouts that failed and those that survived – and not leverage levels. One of the main factors behind the asset class' resilience was determined to be its active ownership model. Due to this



unique structure, buyouts that were backed by private equity delivered more than twice the recovery rate of debt than those backed by public ownership (62-63% compared to 26-30%).

Findings from *Private Equity Portfolio Company Performance through the Recession* from Wilson, Wright and Scholes (2011), academics from CMBOR and the Credit Management Research Centre, provide an insight as to the robustness of private equity backed investee companies. Here, the financial performance of a sample of private equity-backed buyouts was tracked from 1995 to the start of 2010, and compared to a matched sample of private companies, non-private equity-backed buyouts and listed companies. One of the key findings was that private equity-backed buyouts demonstrated stronger economic performance in the period before and during the recession than a matched sample of private and listed companies. In addition to robust interest coverage on debt and higher gross margin, private equity-backed buyouts had a 5% higher return on assets and 14% higher productivity in the recession period than before it.

VI Risks Involved in Investing in Private Equity

When evaluating investment options investors always have to consider and manage the risks inherent in those investments. A commonly held belief is that private equity investments generate higher returns but are also riskier than other asset classes, with liquidity and volatility risk often being cited as drawbacks of the asset class. There is, however, little evidence in the existing literature that this is the case.

In order to explore this area further, the BVCA recently published a piece of research by Montana Capital Partners (2015) Risk in Private Equity, which investigated the different types of risk that are present in a private equity investment, and looked into the strategies that can be used to manage them. The paper identified five key areas of risk: funding, liquidity, market, realisation and capital risk; and found that, contrary to conventional wisdom, funding and capital risk (that is, the risk of an investor being able to meet their capital calls, and the risk of them losing money, respectively) are far more important in the context of private equity than volatility or liquidity risk.

The paper analysed the prevalence of these risks in private equity, using three different data sets to check that the results were robust. It found that diversification could be used to greatly reduce the risk that investors face. In terms of capital risk, an investor who had invested into one fund had a 28% chance of having a total value multiple (TVPI) of less than 1 after eight years of the fund's life. This dropped to 1.4% if they had a simulated portfolio of twenty funds and just 0.26% when fifty funds were in the portfolio. Similarly, greater diversification was found to make the capital calls for investors far more predictable, enabling them to better plan to ensure that they meet their commitments.

The report also found that the private equity market is less volatile than the public market. Whilst there are a number of common external factors that influence both markets private equity investments are better at protecting themselves, and consequently have a stabilising influence on the balance sheets of their investors.

The strong development in recent years of the secondary market has also helped to reduce the risk to investors. The market has grown significantly over the past 15 years, enabling investors more flexibility if they wish to exit an investment early. The health of the market has been reflected in the prices at which the secondary market has been trading. In 2009 after the financial crisis investments were trading at 59% of their NAV on average, this has since increased back to 91% in the second half of 2014.

These findings, taken together, help demonstrate that private equity is not as risky as is sometimes supposed, and that the risks in the asset class that investors should be concerned with are not necessarily directly aligned with other assets. With proper evaluation and management, private equity can be an attractive and rewarding asset class for investors.

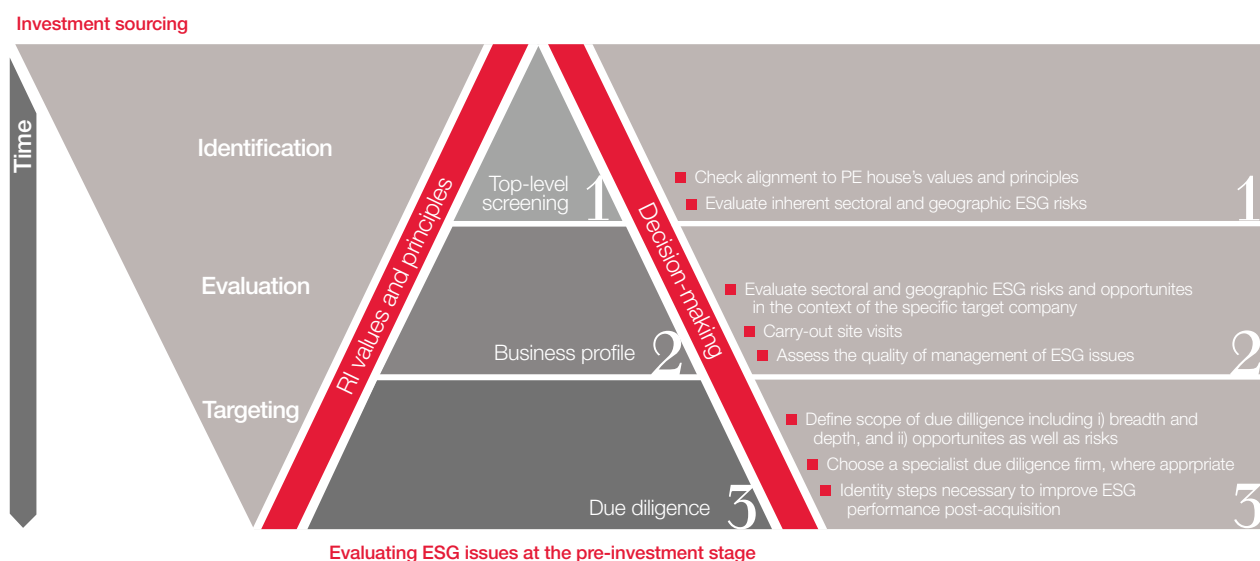
VII Value Creation and Responsible Investment


Private equity adds value to a company in a variety of ways. Thorough due diligence sheds light on a company's strengths and weaknesses alike, and with it comes a sound initial investment rationale. By targeting growth sectors and new markets, private equity investors can focus on creating better revenue generation and implementing programmes that yield operational efficiencies and help to achieve environmental and social change.

Recent years have seen significantly more emphasis placed on the responsible investment agenda within the private equity community. This agenda encourages investors to better evaluate the environmental, social and governance (ESG) implications of their decision-making, both in areas they directly control and also in areas over which they can exert a strong influence.

In the marketplace, ESG issues can have a real impact on business value and investment risk, and a well-founded approach to these issues can be a means by which private equity firms and portfolio companies can balance risks, create opportunities and, ultimately, differentiate themselves from their competitors. Many private equity firms have already recognised the value of ESG initiatives not only in achieving environmental and social change, but also in reducing costs and minimising risks. Many firms already consider certain ESG issues during pre-acquisition due diligence, particularly focusing on compliance and potential ESG-related liabilities, while others are working towards a more structured and strategic approach under an over-arching sustainability strategy, linked to the firm's business strategy.

It has been widely recognised within the industry as a whole that implementing and maintaining ESG strategies during the investment and ownership periods can have a positive impact upon exit. Although the market is still young and firm quantified data on the financial impact of strong ESG performance is not widely available, it is believed that a positive GP and portfolio company attitude towards ESG issues, translated into improved ESG performance, can result in higher exit prices. The most significant contributing factor to this enhanced exit value from ESG issues is without a doubt good market reputation, both for the portfolio company and for the GP. This is a "win-win" situation for GPs, who will see both an improved return on their investment and also additional opportunity at fundraising, as LPs are increasingly looking for evidence of sound ESG issue management in fundraising documentation.





Finally, there is the potential for long term value creation, which is often more difficult to generate within the ownership period for a GP. In the majority of cases, sustainability improvements may require longer periods of time to come to fruition than the expected ownership period, and therefore significant investment in this area may be difficult to justify in terms of short-term return. However, appropriate management of the longer-term sustainable business strategy may be critical to the ultimate performance of the business in a changing social, economic and physical environment. Often, it will be a case of the GP “doing the right thing” without the ability to justify their actions in short-term economic terms. However, there is also an increasing trend to scrutinise long term ESG initiatives set up, or proactively supported, by exiting GPs, even if these have yet to produce positive results at the time of divestment. Long term ESG strategies and the existence of a workable plan may be seen as offering the potential for value creation by interested parties.

It is therefore essential that the GP makes sure that an ESG ethos is entrenched not only within their own investment managers, but also the portfolio company. This will ensure continuity of the projects beyond subsequent owners. Where social and environmental programmes are implemented as part of the ESG policy, liaison with stakeholders may also be necessary, and this should be driven by the GP with due regard to the risks and opportunities that this sort of engagement can create.

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