The lowdown on private equity

November 2021

In brief

- Private equity (PE) is where investors' capital is used to take majority or minority positions in privately held companies, that is, companies not listed on share markets.
- Many of the world's largest pension funds, Australian superannuation funds, university endowments, major investment organisations, as well as family offices, have private equity exposure.
- The private equity opportunity set is massive with the total value of unlisted companies in the world being well over US$100 trillion, larger than the total value of all listed companies.[1]
- We believe private equity can better access the growth and transformation potential of companies compared to listed markets, and by doing so potentially boost overall portfolio returns.
- There is a large return gap between the best and less capable private equity managers. This underlines the importance of investors being able to access a select group of top-tier private equity managers.
- Private equity managers are able to genuinely shape companies' strategic direction and business plans, through board appointments, management appointments, best practices sharing and providing hands-on advice.
- Share market investments and public equity risk dominates many portfolios. The addition of private equity introduces a source of potentially better risk-adjusted returns to portfolios previously made up only of shares (and bonds).

This article aims to demystify private equity, an asset class of growing interest to investors seeking meaningful returns along with different characteristics to shares and bonds.

This communication is not for circulation to retail investors.

What private equity is, and the size of the opportunity

Private equity (PE) is a form of financing where investors' capital is used to take majority and minority positions in privately held companies, that is, companies not listed on share markets.

PE firms play an important role in economies by helping businesses, especially small-medium sized businesses, grow, and, in turn, generate returns for investors.

In times of stresses, such as the COVID-19 period, they have been even more important than usual, providing companies with capital and industry expertise to help them weather the crisis better.[2]

The history of private equity can be traced back to 1901, when J.P. Morgan, one of the great bankers of his era, bought Carnegie Steel Company from Andrew Carnegie and Henry Phipps.[3]

"Phipps took his share and created, in essence, a private equity fund called the Bessemer Trust. Phipps and his children started a trend of buying ownership positions in up-and-coming companies, or buying them outright.[4]

Many of the world's largest pension funds, Australian superannuation funds, university endowments, major investment organisations, as well as family offices, have private equity exposure.

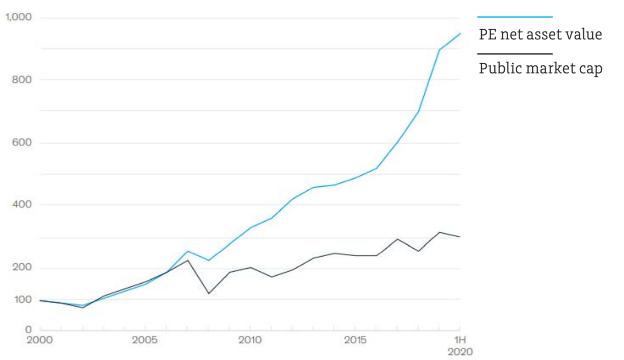
There are many reasons for investor support for private equity. Arguably, the immensity of the opportunity set is the greatest reason for investor interest in private equity.

The size of the private equity industry grew almost 10-times from the beginning of the 21st century to the first half of 2020 (**Chart 1**).[5] The private equity opportunity set is massive with the total value of unlisted companies in the world being well over US$100 trillion, larger than the total value of all listed companies.[6]

With public markets increasingly dominated by huge, maturing business that generate more cash than they can spend on future growth opportunities,[7] investors are increasingly widening their lens to the growth potential on offer in the non-listed arena.

Chart 1: Private equity market growth has exceeded listed equity market growth

Growth of global PE net asset value and public market capitalisation, 20009-1H 2020 (2000=100)



Source: A year of disruption in the private markets (Exhibit 13), McKinsey Global Private Markets Review 2021, April 2021, Exhibit 13, https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2021/mckinsey-global-private-markets-review-2021-v3.pdf, accessed 21 October 2021.

Large differences in private equity returns vs public equity returns

Another reason for investing in private equity is that it diversifies away from share market related investment risk and potentially improves portfolios' risk-adjusted returns.

"Potential" is the key word here.

Private equity investing is riskier than listed company investing, the chief risk being the illiquidity of private equity ownership.

Capital in private equity funds is tied up for the fund's life of the ownership of private companies, which can be anything from four to six years, depending on the types of companies owned.

In other words, private equity investing requires investor patience.

Owing to this illiquidity risk, private equity investors demand an "illiquidity premium"; the potential return over and above what's possible from listed shares and other forms of public market investing, on an after-fees basis.

Despite insisting on an "illiquidity premium," many private equity investments, in fact, underperform public market investments.

This fact, by itself, doesn't torpedo the case for private equity investing. What it does is emphasise the importance of having strong relationships with and access to the world's proven private equity managers.

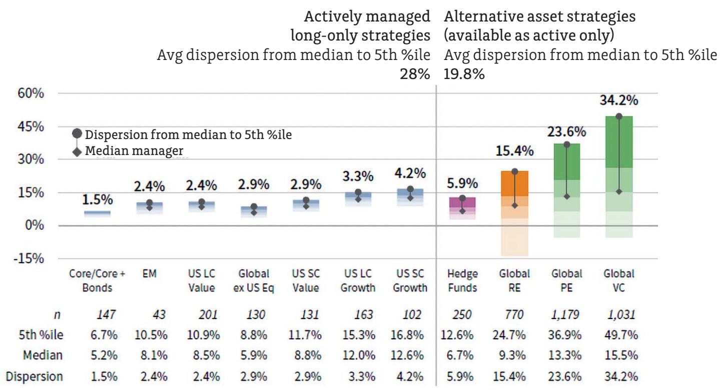
One way of unpacking this is to delve into differences in returns between managers of share market investments versus private equity managers.

There is a large return gap between the best and less capable private equity managers. By contrast, a much smaller return gap can be seen between the best and least able public equity managers (**Chart 2**).

All this underlines the importance of relationships between investors and a select group of top-tier private equity managers.

Chart 2: Large performance gap between best and less capable private equity managers vs listed equity managers

Average annual manager returns by asset class
(1 January 2006 - 31 December 2020)



Source: Building winning portfolios through private equity (Figure 6), Cambridge Associates, August 2021, https://www.cambridgeassociates.com/insight/building-winning-portfolios-through-private-investments/, accessed 21 October 2021.

In other words, just as not all companies are equally good, neither are all private equity managers equally skilled.

See *PE success drivers* for a summary of why private equity investments can potentially achieve superior returns versus public markets investing.

PE success drivers

Even the largest public company investors generally own small fractions of the shares of major listed companies.

In private equity, however, a handful of investors, usually through a private equity fund, either own companies outright, or assume large equity stakes in those companies.

This provides the ability to genuinely influence companies' strategic direction and business plans, through board appointments, and management appointments.

It's common practice for private equity owners to incentivise investee company managers with compensation regimes tied to long-term operational and financial improvement.

Increasing cashflow, widening operating margins, sharpening cost-to-income ratios are some of the key improvements management teams are expected to deliver.

Moreover, investee company managers, free from the short-termism of public companies' quarterly reporting cycle, are judged on improvements and achievements measured over the four-six year time-horizons usually associated with private equity ownership.

Finally, it's usual for experienced private equity managers to have intimate knowledge of the operational and financial details of investee companies, and their industry eco-systems, and use this knowledge to generate change and drive company performance.

Potential improvement in risk-adjusted returns

Share market investments and equity risk, dominates many portfolios. The addition of private equity introduces a source of potentially better risk-adjusted returns to portfolios previously made up only of shares and bonds.

A US study[8] delved into the issue. Using realised and publicly available forecasted data, the iCapital study evaluated scenarios resulting from the addition of private equity into a traditional 60/40 equity/fixed income portfolio.

Note that the analysis using both historical (**Chart 3**) and expected (**Chart 4**) returns, volatility, and correlation inputs, and the outcomes are illustrative, and based on modelling.[9]

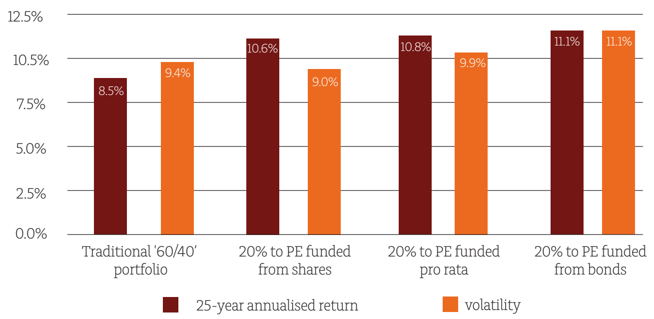
Chart 3: Private equity delivers a performance lift with varying degrees of volatility

Hypothetical historical analysis

Time period	Public equities	Fixed income	Private equity
June 1994 - June 2019	S&P 500 Index, monthly returns	Bloomberg Barclays US Aggregate Bond Index	Cambridge US PE Index, quartely

Note: For each index, the 25-year period of June 1994 through June 2019 was used, which includes multiple bull and bear market cycles with disparate performance results for each asset class.

Comparative risk and return characteristics for sample portfolio allocations (1994-2019)



For illustrative purposes only. These hypothetical portfolios are not intended to represent portfolios that an investor would necessarily have been able to construct.

Source: Evaluation the impact of private equity in a 60/40 portfolio, Joseph Burns and Nick VeronisJune 25, 2020, https://www.icapitalnetwork.com/insights/private-equity/evaluating-the-impact-of-private-equity-in-a-60-40-portfolio/, accessed 28 October 2021.

Nevertheless, they help to convey that the inclusion of private equity can plausibly increase total portfolio returns with lower volatility than equities, when the private equity allocation is funded by allocating capital from listed shares (**Chart 3**).

Of course, when the private equity allocation is funded from fixed income, overall portfolio volatility rises, but this is compensated by significant performance gain (**Chart 3**).

Moreover, forward looking analysis underscores the assertion that private equity is conceivably a source of better risk-adjusted returns, compared to shares and bonds, as private equity's markedly higher volatility of returns is compensated by a sizeable, positive return differential (**Chart 4**).

Chart 4: Private equity could conceivably be a source of better risk-adjusted returns

Model assumptions for forward-looking analysis

	Return	Volatility
Private equity	9.1%	16.1%
Public equities	6.1%	15.6%
Fixed income	3.8%	5.1%

For discussion purposes only. Future results are not guaranteed and loss of principal may occur.

Source: Evaluation the impact of private equity in a 60/40 portfolio, Joseph Burns and Nick VeronisJune 25, 2020, https://www.icapitalnetwork.com/insights/private-equity/evaluating-the-impact-of-private-equity-in-a-60-40-portfolio/, accessed 28 October 2021.

The principle of risk-adjusted return is all-important as higher risks can lead to higher returns, which most would accept as a reasonable trade-off. However, higher risks can also result in lower returns, an outcome most would want to avoid.

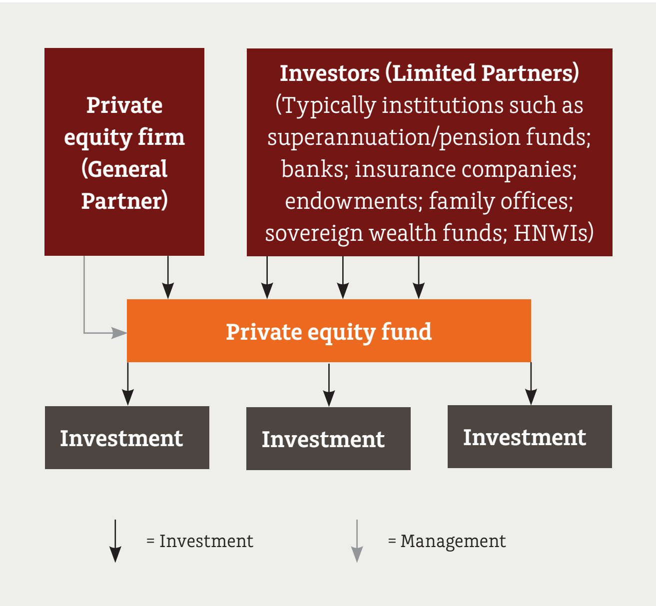
All up, we believe carefully selected private equity investments can potentially deliver extra returns with a different risk profile to shares and bonds.

Private equity fund structure

In a typical private capital structure arrangement (**Chart 5**), a private equity fund manager, (also known as a "General Partner"), will aim to raise a specific amount of capital and then close the fund when the target is reached.

The General Partner's financial contribution is generally in the 2-5% range of the total amount to be raised, with investors, (also known as "Limited Partners"), providing most funding. The General Partner's contribution ensures alignment with Limited Partner investors – the General Partner has 'skin in the game'.

Chart 5: Typical private equity fund structure



Source:MLC Asset Management

All parties agree on the time-period in which the fund will operate — usually four to six years.

Investment returns are realised when investee companies are sold to another buyer or go public, through a stock exchange listing.

How private equity creates value

Private equity investment offers access to companies that vary in their stage of maturity and size.

This access to growth and transformation potential across the company lifecycle (**Chart 6**) can boost private equity performance, when compared to listed market equities, as public markets typically only cater for larger companies that, in many cases, are already mature.

Furthermore, large listed companies are so thoroughly researched by both the buy and sell-side communities that it is difficult to unearth information advantages capable of driving long-term return outperformance.

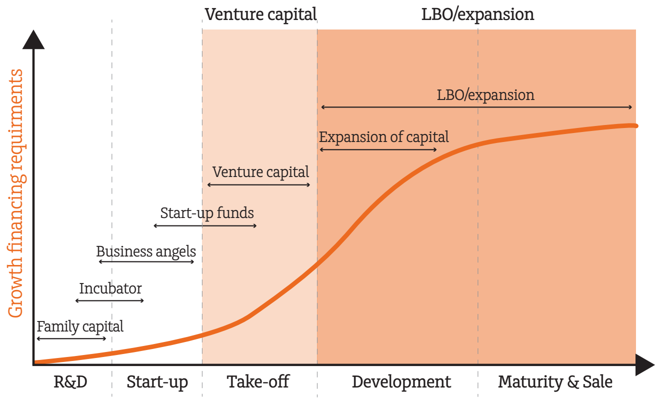
On the other hand, many small listed companies are not so well covered by research analysts. In other words, there is likely to be an abundance of smaller listed and unlisted companies of unrealised potential ready to be discovered by private equity investors' intensive due diligence and analysis.

Private equity investors are famous for running a fine-tooth comb over companies.

Intensive analysis — both before acquiring a company, as well as after the acquisition during the investment period — can uncover the most minute details that, when coupled with the right incentive regimes for management, deliver strong operational and financial performance.

Chart 6: Company lifecycle and role of private equity

Private equity stages



Source: MLC Asset Management

Comparing private equity with public equity

	Private equity	Public equity
Definition	Shares in a private company representing investors' ownership is called private equity	Shares in a public company representing investors' ownership is called public equity
Information disclosure requirements	Not required to publicly publish information about company operations, business plans and financial performance	All material financial information required to be publicly released
Time horizons to judge business performance	Investors and company can work to execute long-term plans	Short-termism stemming from quarterly disclosure cycle
Level of investor involvement and influence	Usually high as a relatively small number of investors can own sizeable positions in the company, including 100% ownership. Investors often have direct influence over the company's strategic direction and major decisions	Even the largest shareholders usually only own a relatively small part of the company and this minimises the ability to directly influence company plans and strategy
Composition of ownership	Comparatively few institutional investors, endowments and high net worth investors in each private equity fund	General public who can buy, sell, and trade shares
Regulation	Less regulated as they are not answerable to public shareholders	More regulated because shares are bought and sold by retail investors and there are public disclosure requirements
Volatility of share price	Typically lower	Daily valuations and trading can mean high volatility

Private equity strategy selection

Private equity investment strategies are usually structured around one of four strategies.

i. Venture strategies

Focus on providing funding to start-up or early stage companies. These are companies at the beginning of their life, and the funding provided helps them to commercialise their products and services.

ii. Growth strategies

Focus on investment in companies that are more advanced in the commercialisation of their products and services but that still require high levels of investment to achieve their full potential.

iii. Buy-out strategies

Involve implementing a change in the ownership of an established company, usually to facilitate a change in management, a new strategic direction, a change in capital structure or to drive improved operational performance.

iv. Turnaround strategies

Usually involves investing in companies that have run into operating difficulties, and typically aim to implement significant changes to management and the company's corporate structure to help the operation become profitable.

1 The Global Capital Stock: Finding a Proxy for the Unobservable Global Market Portfolio, Gregory Gadzinski, Markus Schuller and Andrea Vacchino, The Journal of Portfolio Management, 2018, quoted in The evolving role of public and private equity markets. Willis Towers Watson 2019. Thinking Ahead Institute. thinkingaheadinstitute.org/content/uploads/2020/11/Private-Equity.pdf, accessed 30 July 2021.

2 The growing private equity market. Deloitte Insights. Henry, Tania Lynn Taylor, Frank Fumai, Jagat Patel, 5 November 2020, https://www2.deloitte.com/us/en/insights/industry/financial-services/private-equity-industry-forecast.html, accessed 30 July 2021.

3 A Brief History of Private Equity. Derek Loosvelt, 10 March 2009, https://www.vault.com/blogs/in-the-black-vaults-finance-careers-blog/a-brief-history-of-private-equity, accessed 30 July 2021.

4 Ibid.

5 A year of disruption in the private markets. McKinsey Global Private Markets Review 2021, April 2021, https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2021/mckinsey-global-private-markets-review-2021-v3.pdf, accessed 30 July 2021.

6 The Global Capital Stock: Finding a Proxy for the Unobservable Global Market Portfolio, Gregory Gadzinski, Markus Schuller and Andrea Vacchino, The Journal of Portfolio Management, 2018, quoted in The evolving role of public and private equity markets. Willis Towers Watson 2019. Thinking Ahead Institute.file:///C:/Users/P791149/Downloads/Private-Equity%20(1).pdf, accessed 30 July 2021

7 The evolving role of public and private equity markets. Willis Towers Watson 2019. Thinking Ahead Institute. https://www.thinkingaheadinstitute.org/content/uploads/2020/11/Private-Equity.pdf, accessed 28 October 2021

8 Evaluation the impact of private equity in a 60/40 portfolio, Joseph Burns and Nick VeronisJune, iCapital Network, 25, 2020, https://www.icapitalnetwork.com/insights/private-equity/evaluating-the-impact-of-private-equity-in-a-60-40-portfolio/, accessed 28 October 2021.

9 Ibid.

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