The private equity proposition: it still makes sense

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The world has gone through a lot in recent years.

A once in a century pandemic stalled society. A major war erupted in Europe, and there is more suffering and strife in the Middle East.

In the economic arena, levels of inflation and a pace of interest rates increases beyond the experience of many current investors has displaced more than three decades of relatively low inflation, as well as a prolonged period of low interest rates.

By doing so, two well-worn ways of achieving investment success are now less possible. Think high leverage, made doable by low interest rates charged on debt, as well as valuation expansion, also underpinned by those same low rates.

The change to the interest rate regime over the past two years has been a game-changer. It raises the obvious question: can private equity (PE), which began to emerge as an institutional asset class in the 1980s and thrived in following decades, succeed in the new investment world?

Our answer is yes because the enduring features that make well-chosen private equity investments attractive, within well diversified portfolios, was never primarily about leverage or valuation expansion.

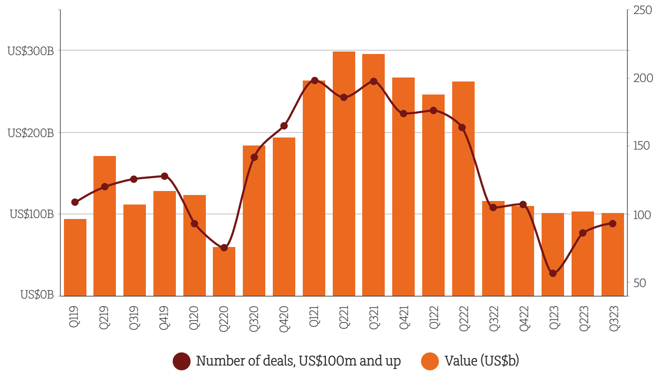
Instead, well-chosen private equity's enduring features are the potential for superior returns from genuinely active management; the capacity to provide complementary industry and sector diversification, relative to listed equities' industry and sector composition; and the capacity to improve the investment frontier by increasing return potential without increasing overall portfolio risk.

Deal volumes recovering after falling sharply

Notwithstanding our strong conviction in private equity, there is no denying that the changed investment climate has impacted the industry. It would be remarkable if it was untouched by the macroeconomic conditions of the past few years.

Global deal volumes and the value of deals fell sharply from 2021 to the first quarter of 2023, though a nascent recovery is observable in subsequent quarters of 2023 **(Chart 1)**.

Chart 1: Deal volumes fell significantly in recent years but a nascent recovery is observable



Source: *Private equity pulse: key takeaways from Q4 2023*, Peter Witte, 11 January 2024, **https://www.ey.com/en_au/private-equity/pulse**

Anchoring, which leads to extrapolation by assuming that the future is a straight-line continuation of the recent past and present, is a behavioural risk investors need to be mindful of and so it is not sensible to make definitive predictions as to what may come next.

The past is an imperfect guide to the future, but history may provide some clues on how things might progress from here.

In short, downturns may incubate strong returns down the track. This is because first-rate private equity managers (also known as General Partners) have a knack for finding companies that can benefit from private equity capital and expertise through varying business conditions.

Legendary Intel chief Andy Grove authored a book titled, *Only the Paranoid Survive: How to Exploit the Crisis Points That Challenge Every Company*, and in our experience, this is how good private equity managers operate.

They model multiple scenarios for potential investee companies, before committing clients' capital, forensically pouring over companies' business models and cash generating power to gauge their resilience in difficult market situations.

We believe successful investing is as much about picking winners as it is about minimising blow-ups. A handful of failures can take down portfolios.

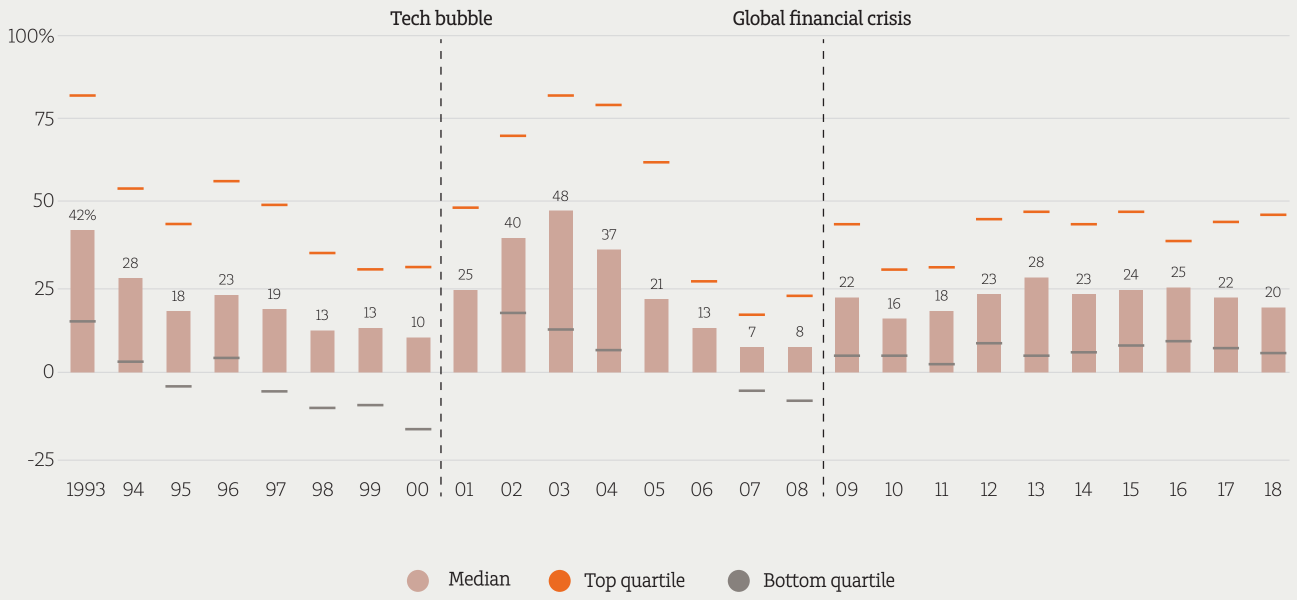
In our experience, private equity managers who have stood the test of time stay active and are not deterred by adversity. If a good target company is found at a good price, they will consider buying it perhaps by committing more equity than may have been the case when borrowing costs were lower.

Companies' balance sheets can be adjusted when borrowing conditions improve but waiting for the perfect time to buy risks missing potentially attractive opportunities.

In our view, challenging times like the bursting of the late 1990s internet bubble and the Global Financial Crisis foster strong private equity returns **(Chart 2)**, in part, because of the very uncertainty associated with such episodes.

Chart 2: Investments made coming out of downturns have generated strong returns over time

Global buyout deal internal rate of return (IRR) by year of entry



Notes: Includes fully and partially realised deals; all figures calculated in US dollars; post-2018 data not shown, as most deals entered later than 2018 are still unrealised.

Source: *Global Private Equity Report 2023*, Bain & Company

Uncertainty can make investors gun-shy, and this can lead to less competition for asset buying by those private equity managers who already have capital from investors who look beyond the stresses of the moment.

We think now could again be one of those times, which creates the conditions for private equity funds to buy investee companies at potentially more attractive valuations than on occasions of fiercer competition.

Despite current ambiguous business conditions, forward-looking investors have committed sizeable capital towards private equity, endowing select private equity managers with formidable dry-powder/capital ready to be deployed **(see Chart 3, on the next page)** as opportunities are uncovered.

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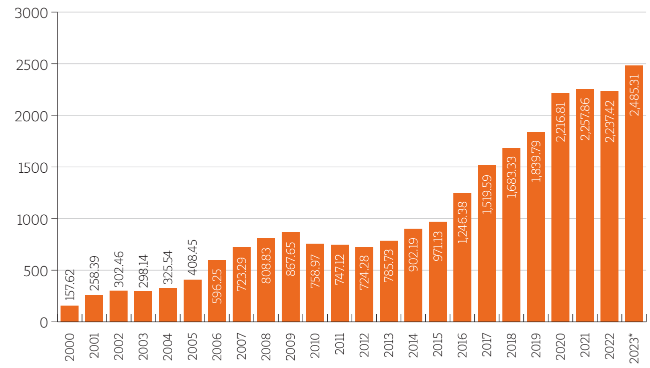
Chart 3: Sizeable global dry-powder waiting to be deployed

Global private equity dry powder trend, 2000 - 2023 (US$ billions)



*As of 3 July 2023

Analysis includes aggregate dry powder of global private equity funds with vintage years between 2000 and 2023. Dry powder data is supplemented by Preqin.

Source: S&P Global Market Intelligence

As S&P Global commented in a report: "Global private equity dry powder soared to a record $US2.49 trillion around the middle of 2023 as sluggish dealmaking limited opportunities for the deployment of uncommitted capital into buyouts and other investments. A challenging fundraising environment did not halt private equity funds' accumulation of investor capital."[1]

In our view, deal activity will likely pick up when there is greater macro-economic confidence.

That said, it is not as if it has all been smooth sailing over the past three to four decades. The private equity industry has navigated plenty of shocks and market events.

It's active management, not an illiquidity premium that delivers

The term "illiquidity premium" often crops up in relation to private equity, as if the asset class's illiquidity miraculously endows it with the capacity to earn higher returns than possible from public equity.

In our view, it is not illiquidity that drives stronger returns; the decisive factor is what private equity managers do with illiquidity.

Private equity is the epitome of an active asset class. Through their ownership of investee companies, private equity managers can nominate board members and by doing so directly influence senior management appointments, business plan creation and the setting of operational and financial objectives, measured in years, rather than listed markets' quarterly reporting cycle.

It is our belief that the long-termism of private equity (the life cycle of private equity funds can be upwards of 7-10 years)[2] enables investee company managers and employees, with support from private equity managers with deep and relevant industry experience, to work as partners to transform businesses and accelerate their growth and profitability.

Free from public markets' compressed reporting cycle and the associated demands on management time, investee companies can go about implementing operational improvements, such as cost reductions, re-engineering production processes or reconfiguring supply chains; as well as growth initiatives such as acquisitions, new product launches, or expanding into new markets.

Moreover, given the multiyear investment time horizons associated with the asset class, private equity managers can exit from investee companies at a time of their choosing to maximise value. Finally, private equity managers have multiple exit options, including taking companies public, selling to strategic industry buyers, or selling to other private equity firms.

In our view, the entry and exit points of investments are an important and often underestimated lever that private equity managers have over active public equity managers that, for the most part, tend to remain fully invested.

Private equity also offers managers and investors legitimately exploitable information advantages that are prohibited in the public equity domain.

Public disclosure requirements in the listed company world mean that everyone gets access to materially significant information at the same time. Those same kinds of information exist in the private company world, however, not everyone has equal access to such information.

This creates the potential for an information advantage and consequently greater potential for stronger financial returns because the information is not widely distributed. Instead, material insights into what may be happening inside a private company are generally confined to those with access – such as private equity managers and their investment partners.

Private equity managers 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.

1 *Private equity dry powder swells to record high amid sluggish dealmaking.* Dylan Thomas, Annie Sabater, 20 July 2023, https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/private-equity-dry-powder-swells-to-record-high-amid-sluggish-dealmaking-76609335

2 *The life cycle of private equity.* Blackstone, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://pws.blackstone.com/emea/wp-content/uploads/sites/20/blackstone-secure/Life-Cycle-of-Private-Equity-EMEA.pdf?v=1638976450

Private equity offers different sector weights to public equities

Private equity sector exposures differ meaningfully from those in major public equity markets. We think this diversity represents a significant source of return potential.

While there are common private equity sector overweights globally, such as Industrials, each region has its own features **(Chart 4)**.

In the United States, for instance, private equity sector allocations lean towards the Industrials, Technology, Healthcare and Consumer Discretionary sectors while being underweight Financials, Energy, and Consumer Staples **(Chart 4)**.

Chart 4: Private equity sector weights difference from public equity sector weights
Sector allocation differences between private and public equities in US, Europe, and Asia

	U.S.			Europe			Asia		
	PE	Public Equities	Diff +/-	PE	Public Equities	Diff +/-	PE	Public Equities	Diff +/-
Financials	5%	12%	-7%	7%	17%	-10%	6%	21%	-14%
Energy	0%	5%	-5%	0%	6%	-6%	0%	4%	-4%
IT	30%	26%	4%	23%	8%	16%	12%	14%	-2%
Cons Disc	13%	10%	3%	16%	11%	6%	18%	13%	6%
Healthcare	19%	16%	3%	15%	15%	0%	17%	7%	10%
Utilities	0%	3%	-3%	0%	4%	-4%	1%	3%	-2%
Cons Staples	4%	8%	-4%	8%	12%	-4%	8%	9%	-1%
Industrials	20%	9%	11%	19%	15%	4%	13%	13%	0%
Comm Services	5%	8%	-3%	5%	3%	2%	12%	7%	4%
Materials	4%	3%	1%	6%	9%	-3%	12%	8%	4%

Private sector weights based on NAV as of 2022Q3 of all Burgiss cumulative deals from 2020-2022. All public sector weights are re-calculated to exclude Real Estate for comparison purposes. Only deals valued at over US$100 million were included. Public equity sector weights based on S&P 500 for the US, STOXX Europe 600 for Europe and MSCI Asia for Asia. Data as of 31 December 2022.

Source: Burgiss, MSCI, Eurostoxx, S&P, Bloomberg, KKR Portfolio Construction analysis. This chart is taken from Insights: Global Macro Trends. Volume 13.1 March 2023. *Regime Change: The Role of Private Equity in the 'Traditional' Portfolio*. KKR Global Institute **https://www.kkr.com/insights/regime-change-role-private-equity-traditional-portfolio**

The story, however, goes beyond headline sector weightings and recent years' sector trends deserve attention.

For example, "the weight of Technology sector exposures in US private equity portfolios rose from around 12% in 2017 to 45% of deal volume in 2022 but the business models of these private tech companies – many younger than public tech comparisons and part of the software subsector – also evolved to one of slower but steadier growth, recurring revenues, and higher free cash flow generation."[3]

In Europe, Financials represent 17% of public markets' capitalisation, but only 7% of European Union private equity deal flow over the past three years.[4] The opposite is true for Technology as the sector represents just 8% of public European market capitalisation compared to 23% of EU private equity deal flow, "driven by the large proportion of European tech companies that are privately held."[5]

The performance impact of sector allocations in private equity does not get enough attention, but we think it deserves to as private market investors have proven to be particularly nimble in pursuing the most attractive value creation opportunities across sectors at opportune times.

3 *Regime change: the role of private equity in the 'traditional' portfolio*. KKR Global Institute: Insights: Global Macro trends. Volume 13.1 March 2023, https://www.kkr.com/insights/regime-change-role-private-equity-traditional-portfolio

4 Ibid

5 Ibid

As might be expected, sector composition differences between private equity and public equity leads to differences in factor exposures – the underlying source of equity returns. Private equity, for instance, had a strong value bias around the period of the tech bubble and burst in the early 2000s, which led to significant private equity outperformance against public equities.[6]

Today, private equity is more exposed to sectors associated with growth, such as Technology, than two decades years ago.[7] That said, the private equity industry's largest sector overweight continues to be Industrials, a sector generally associated with value and solid cash flows.[8]

As for which parts of the technology realm private equity funds are deployed to; around 88% of technology investments by buyout funds are in software, which is significantly less volatile than the technology sector overall.[9] These are mostly mature Software-as-a-Service ('SaaS') enterprise businesses with stable cash flows.[10]

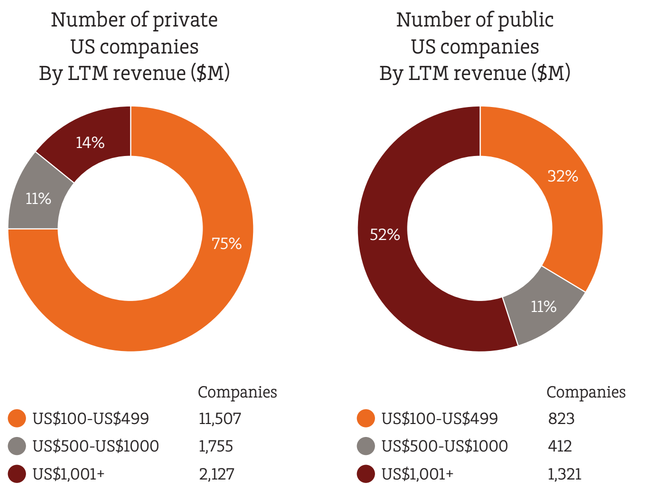
We think they tend to be more resilient in a downturn because their products are either mission-critical or deeply embedded in a company's operations. Likewise, many private equity portfolios are also balanced by investments in healthcare companies, which tend to be more cycle-resistant, from our experience.

Private equity opportunity set remains compelling

The immensity of the private equity opportunity set represents another perspective on the diversification theme. Here's just one data point, albeit from 2020. In that year, in the United States, there were an estimated 15,000 private companies with annual revenues over US$100 million versus 2,500 public companies with the same revenues **(Chart 5)**.

An inference from this is that equity investors who only invest in listed companies are accessing a fraction of the company universe and missing out on both the diversity and potential strong returns available in the private company space.

Chart 5: More private US companies with US$100 million revenues than public companies



Source: *Power tool: Why private markets are no longer niche*
https://russellinvestments.com/au/blog/power-tool-private-markets

The flip side of the immensity of the private company universe is shrinkage in the number of public companies.

A *Center for Research in Security Prices* study found that the count of publicly listed companies traded on US exchanges has fallen substantially from its peak in 1996 when the number exceeded 8,000 companies.[11] By 2020, the number had fallen by more than 50% to just 3,700.[12]

It is not that the United States has half as many companies as it did more than two decades ago – it is that companies are increasingly choosing to stay private for longer, or never list at all.

According to another US study, in 1999, new companies tended to stay private for around 4.5 years before publicly listing.[13] By 2020, the private portion of companies' life cycles had ballooned to 12 years.[14] It is reasonable to argue that it is in the private period when a great portion of these companies' valuation creation occurred.

Growing private funding markets means that companies feel less incentivised to go public to realise value or to access growth capital. Incidentally, the public listings drop-off is not a US-only phenomenon. In the UK, for example, the number of companies listed on the country's stock exchanges has fallen by 12.5% in three years.[15]

6, 7, 8 Ibid

9 *Global Private Equity Report 2023.* Bain & Company

10 Ibid

11 *America has lost half its public companies since the 1990s. Here's why.* Nicole Goodkind, 9 June, 2023, https://edition.cnn.com/2023/06/09/investing/premarket-stocks-trading/index.html

12 Ibid

13 *Power tool: Why private markets are no longer niche.* Vic Leverett, 28 September 2021, https://russellinvestments.com/au/blog/power-tool-private-markets

14 Ibid

15 *Private equity's place in the remodelled portfolio.* Moonfare, 22 August 2022, https://www.moonfare.com/blog/private-equitys-place-in-the-remodelled-portfolio

The same trend is evident in Australia too. A clutch of takeovers of ASX-listed companies coupled with a dearth of new floats means the Australian share market has shrunk for the first time since 2005.[16]

Finally, small, listed companies, usually less than $500 million in market capitalisation, often struggle to receive quality sell-side coverage (equity research), which crimps their capital raising ability and thus growth prospects. From our experience, it is not unusual for boards of such companies to approach PE managers seeking expansion capital or to be acquired altogether as their share price performance can lag.

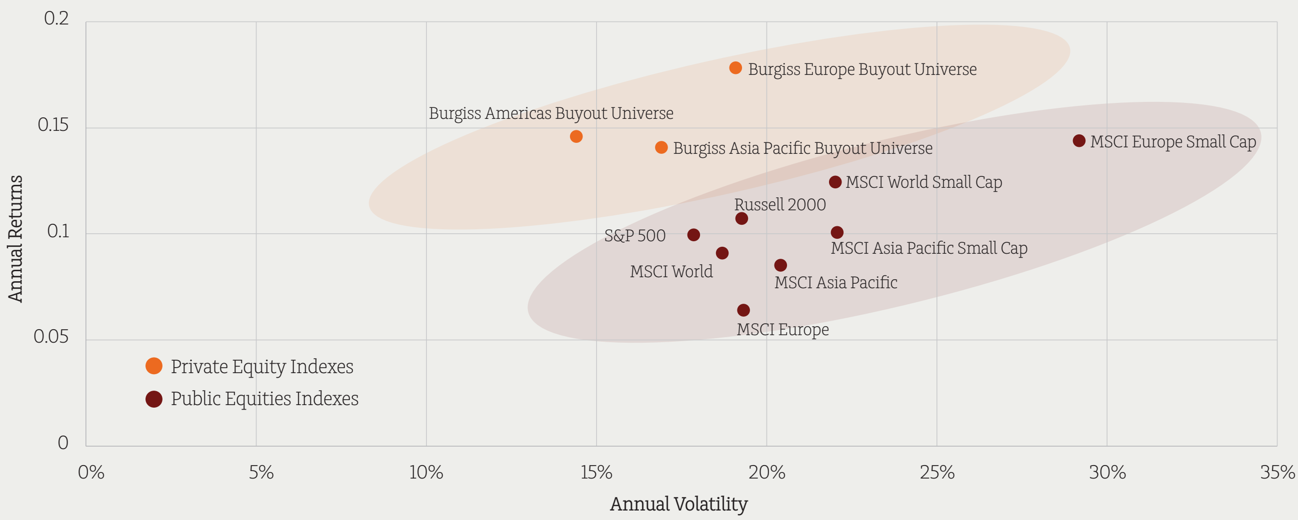
Potentially improving the efficient frontier

The final way of approaching the diversification theme is to unpack the proposition that allocating to well-chosen private equity, as part of a well-diversified portfolio, can positively shift the efficient frontier.

Using annual returns to measure volatility across both private equity and public equities, which mitigates the smoothing effect in private market portfolio returns, research by KKR found that private equity portfolios have lower volatility coupled with strong returns **(Chart 6)**, notwithstanding qualifications around comparing private and public market performance.[17]

No doubt there will be plentiful intellectual arm-wrestling about whether this is a case of comparing like-for-like, but **Chart 6** is, at the very least, a useful reference.

Chart 6: Private equity has historically delivered strong returns with lower volatility than public equities



Notes: Annual returns were used to partially correct for the well-known downward bias of volatility. Data as of 31 December 2022.

Source: Burgiss, KKR Portfolio Construction Analysis. This chart is taken from Insights: Global Macro Trends. Volume 13.1 March 2023. Regime Change: *The Role of Private Equity in the 'Traditional' Portfolio*. KKR Global Institute **https://www.kkr.com/insights/regime-change-role-private-equity-traditional-portfolio**

Sceptics could assert that strong private equity returns, alongside lower than public equity volatility, were achieved in a low-inflation, low-interest world and thus question the likelihood of continuing this in a higher interest rate world.

To answer this, let us lean on to the just cited KKR research as well as **Chart 7, on the next page** which shows that private equity has delivered around 6% above public equities, represented by the S&P 500, in high inflation environments.

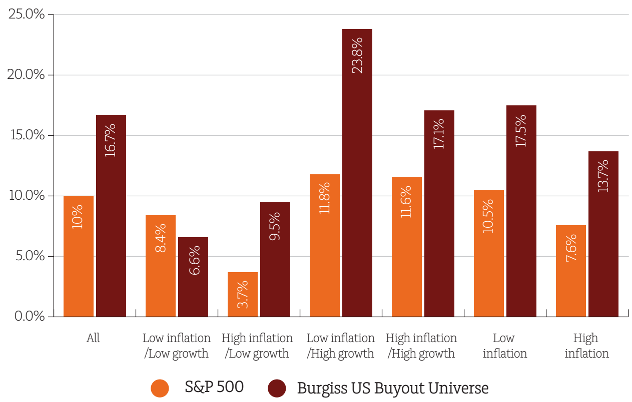
[16] *The ASX is shrinking for the first time in 19 years.* Alex Gluyas and James Thomson, June 5, 2023, https://www.afr.com/markets/equity-markets/the-asx-is-shrinking-for-the-first-time-in-18-years-20230601-p5dd33

[17] *Regime change: the role of private equity in the 'traditional' portfolio.* KKR Global Institute: Insights: Global Macro trends. Volume 13.1 March 2023

As to how or why this premium was achieved: we believe excess returns in inflationary/rising interest rate environments may be explained both by private equity managers' ability to make operational improvements to drive revenue improvements as well as bending the cost curve to protect margins – along with active capital management, a strong-suite of private equity managers.

Chart 7: Private equity has outperformed public equity, including during inflationary periods

Public versus private equity across different economic regimes in the United States



Returns modelled using annual total returns from 1981 to 2021. Real returns are calculated using nominal returns after subtracting CPI inflation rates.

Source: Burgiss, KKR Portfolio Construction analysis. This chart is taken from Insights: Global Macro Trends. Volume 13.1 March 2023. Regime Change: *The Role of Private Equity in the 'Traditional' Portfolio*. KKR Global Institute **https://www.kkr.com/insights/regime-change-role-private-equity-traditional-portfolio**

Chart 7 also reveals that private equity has historically outperformed US public equities in all environments "except the 'low inflation/low growth' environment, typically a period where multiple expansion in the public markets often can outweigh the benefits of operational improvements in private equity."[18]

A word about risks

As PE enthusiasts, we are more than happy to speak about what we regard as the good things associated with the asset class all day long. That said, PE has distinctive risks that investors should bear in mind, the foremost being illiquidity.

Private equity can lock in investors' capital for 5-10 years, and over this period investors are typically unable to access their capital. Moreover, given the absence of a vast active liquid market for the underlying investments (in contrast with public markets), it is difficult to estimate when investments may ultimately be realised and at what valuation.

Given this illiquidity and uncertainty, investors demand higher long-term returns from the asset class than those generally associated with listed shares, by way of comparison. However, not all PE investments meet higher performance expectations.

Final thoughts

There is a tendency in the investment industry to portray issues in binary ways – listed assets versus unlisted assets; active versus passive; one investment style versus another, and on it goes.

There is no perfect investment. All investing involves trade-offs.

Rather than opting for one type of investment or thematic versus another, seasoned investors take an 'all of the above' approach so that portfolios are not dependent on just one idea for success.

We think well-chosen private equity programs and managers enrich portfolios through multiple dimensions of diversification.

The asset class provides complementary industry and sector diversification relative to listed equities' industry and sector composition. It can potentially improve the investment frontier by increasing return potential without increasing overall portfolio risk, and the immensity of the private company universe means the private domain provides a far greater opportunity set than public equity investing.

Above everything else, the most striking feature of private equity is that it is the epitome of active management.

Privately owned businesses, free from public companies' quarterly reporting cycle, can implement long-term transformation and growth programs through changing, even hostile business conditions, to realise value.

16 Ibid

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