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Inside Look: Private Equity

- Private Equity has a history of improving portfolio risk/reward profiles for those who can invest with a longer-term view.
- Initiatives to improve access to this asset class will serve institutional and high net worth investors.

Liquidity constraints, fee complexity and investment blind pools, among other factors, have contributed to the asset class being accessible only to the largest and most resourced investors, namely public pension plans, sovereign wealth funds, endowments and large family offices. However, as the democratization of finance progresses, there are structural changes on the horizon that could help bring this $2.8 trillion asset class[1] into the into the hands of small-sized institutional investors and high net worth individuals. Given its attractive risk/reward profile and portfolio diversification benefits, putting Private Equity (PE) into the hands of these investors could be a major boon to their portfolios.

The What and Why of PE

Like direct infrastructure, real estate, natural resources and hedge funds, PE is categorized as an alternative asset class. Relative to more traditional investments such as public equities and bonds, PE's risk/return profile, liquidity characteristics and investment horizon are considerably different, thereby providing significant portfolio diversification. Even within PE, there are important differences in risk and reward, depending on where the investee company is in its corporate lifecycle.

	Early Stage	Growth Equity	Buyout
Company Revenue/ Profitability	From pre-revenue to pre-profit	Likely profitable & cash flow-positive, still expanding	Profitable; cash flow-positive but maturing in its growth cycle
Use of Funds	R&D; product development; product and market launch	Market expansion; M&A	Recapitalization to rejuvenate growth and increase profitability
Risk/Reward and Target Returns for Portfolio Companies	High probability of loss; potential for very high gains; return target in excess of 5x	Low risk of total loss; high probability of large gains; return target ~3-4x	Very low risk of total loss; high probability of above-market gains; return target ~2-3x

Investee company age →

Source: Fiera Capital

1 "The rise and rise of private markets; McKinsey Global Private Markets Review 2018"; McKinsey & Company. February 2018.

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In industry parlance, the term PE generally refers to buyouts and growth equity, whereas venture capital refers to earlier stage investments. For the purposes of this paper, we will refer to PE in reference to growth equity and buyouts, as they provide an adequate balance between risk relative to public equities and the potential for enhanced levels of returns.

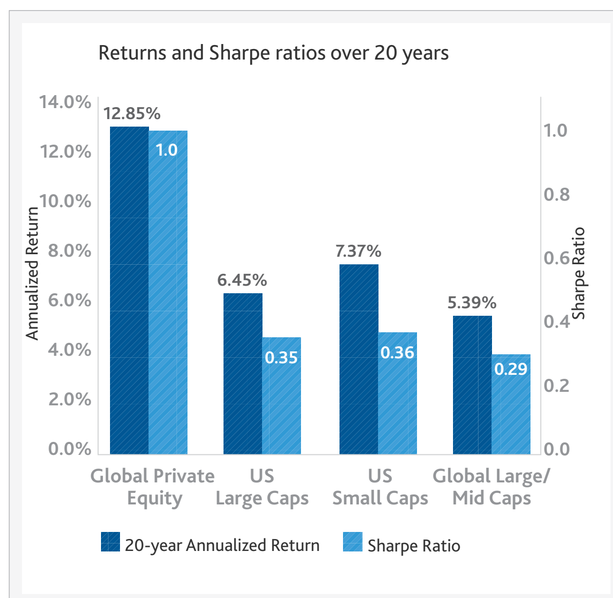
The primary benefit of PE comes down to this: long-term returns have outperformed public equities across the board with less risk. Over the 20 years to Q1 2018, global PE has returned 12.85% annually (in Canadian Dollar terms) with a Sharpe ratio of 1.00. Compare that to, say, the S&P 500's return of 6.45% with a Sharpe ratio of 0.35, and it's clear that there are significant outperformance and risk mitigation benefits to owning this asset class. The same is true when compared to US Small Caps and Global Large/Mid Caps.

What explains these outsized returns? First, the opportunity set for PE is much broader than the public equity market, given the larger number of private companies. Often, mid-market and lower mid-market companies are not well-suited for public markets, as they haven't reached the scale necessary to overcome many regulatory and legal costs. Investing privately thus allows access to a part of the corporate market that has not been efficiently tapped by the public market.

Second, unlike public market investors, PE investors have access to private information prior to making an investment, as they perform months of due diligence inside a company. Such access to management and private corporate information helps uncover more differentiated insights, enabling for deeper understanding of businesses and better investment decision making.

Third and most importantly, a key driver of company outperformance is the operational value creation that PE investment firms, or the "General Partners", bring to the table. Portfolio companies often have grown beyond the capabilities of their resources and management teams; the General Partners can help identify and solve specific issues, while accelerating growth. Often, solving the issues involves bringing in experienced management or directors from the GPs network; revamping the company's capital structure; helping the company expand to new markets; or supporting the acquisition of competing firms. As a result, after experienced PE investors take a position in a company, that company is usually in a stronger financial and operational position than before.

PE has shown better risk/reward over time



Source: Fiera Capital, Multi Asset Class Solutions. Indices: US Large Cap, S&P 500 (USD); US Small Cap, Russell 2000 (USD); Global Large/Mid Cap, MSCI World (Local currency); Private Equity, Cambridge Global Buyout (USD). Total return data, quarterly from Q3 1998 to Q1 2018.

General Partner vs. Limited Partner in a PE fund

General Partner (GP)

Invests the capital committed by the LPs and manages the portfolio of investments, taking a management fee for doing so.

Limited Partner (LP)

The external investor which provides capital. They are primarily pension plans, insurance companies, endowments, Sovereign Wealth Funds, family offices and high net worth investors.

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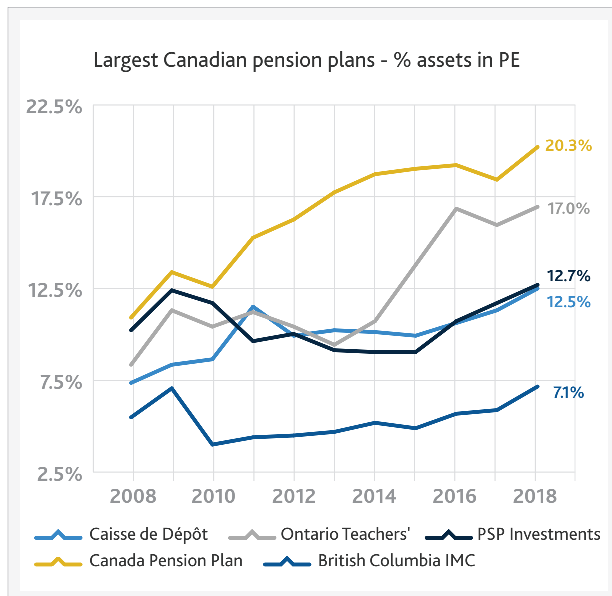
Institutional Presence and Growing Interest

PE is by no means a new asset class and is widely held by large institutions in the US, Canada and abroad. In fact, its return characteristics have resulted in it occupying a more significant place in the portfolios of large investors such as pension plans and sovereign wealth funds. University endowments in the US were early adopters of Private Equity, scaling up their allocations significantly from the 1990s on. Large state pension funds have also been invested since the early days of the asset class.

Over the last decade, Canadian pension plans in particular have been successful at integrating PE and other alternative assets and have increased their allocations to PE significantly.

These pension plans were some of the first institutions to integrate alternative investments into their portfolios, recognizing the benefits that they provide, particularly to investors with a long time horizon such as them. They were also early adopters of private equity, and developed a diversified investment model that includes secondaries and funds, co-investments and direct investments. The "Canadian Model," as it's become known, has proven successful, and is being replicated by major funds around the world.

Canada's pension plans growing allocation to Private Equity



Source: Fiera Capital; individual pension plans' annual reports. CDPQ & OTPP moved forward one year due to different financial year end dates.

PE investment vehicles

Direct Investments
Control or minority investments directly into a company.

Co-investments
Direct investments in a company alongside one or more private equity firms.

Funds (Primary)
Commitments to a new private equity fund that will invest in a portfolio of companies

Secondaries
Sale of a mature or maturing fund commitment or aging portfolio of private equity assets or funds.

Fund of funds
Fund vehicle that invests in multiple private equity funds.

Approaches to PE Investing

Historically, PE General Partners have adopted the closed-end fund structure, whereby a manager raises capital over approximately one year before closing the fund to new money and investing the capital over several years. Though not perfect, these structures have been an acceptable approach for large investors. With their size and scale, the largest institutional players are able to overcome many of the challenges inherent in this structure, namely the strict investment timeframes (since the fund has a "lifespan"), long lock-up periods, and existence of a "blind pool" structure in which investors don't have details about what investments will be in their PE portfolio. As demand for the asset class has continued to grow, the closed-end fund structure has continued to survive. Effectively, large institutions have continued to commit significant capital to Private Equity funds, and dry powder (cash in funds' hands waiting to be deployed) in North America and Europe alone stood at around $677 billion at the end of 2017.[2]

There are three traditional avenues of PE investment: Direct investment, in which an investor negotiates and invests directly into a private company; investment in a single PE Fund, which raises capital from multiple investors, deploying the combined capital into multiple portfolio companies; and a Fund of Funds, which chooses and deploys capital to multiple PE Funds.

Of course, with the beneficial returns that come from PE investments come significant challenges, no matter the avenue chosen. For example, while Direct investment may reduce fees paid to GPs, it necessitates in-sourcing an investment team at the investor level. This may in fact prove to be more expensive since economies of scale don't exist for investors with less capital to allocate. Single Fund and Fund of funds investment usually requires a significant lock up period – often ten years or more – while fees (and, in the case of Fund of funds, fees on top of fees) tend to eat into investor returns. Additionally, there is usually a significant time lag between when capital is allocated to the Fund and when that capital gets deployed. Often, the investor does not achieve its target exposure to the asset class until it is time for realizations. Given that management fees are paid on committed capital, this contributes to a drag on investor returns commonly known as the J-curve effect.

Private Equity – Investment Avenues & Challenges

Direct Investment	Single Fund	Fund of Funds
• Highly complex – tens of thousands of actionable private companies globally • Expensive to in-source due to low economies of scale in small institutions or private investors • Little to no diversification	• GP, vintage, sector and region concentration • Blind pool – investors may not know what they are investing in • Time lag between capital commitment and deployment • J-curve effect – investors often suffer negative returns early on due to fees on committed rather than deployed capital • Long (~10 year) lock up periods → little to no liquidity • Fees eat into performance	• Indexing • Blind pool – investors may not know what they are investing in • Time lag between capital commitment and deployment • More pronounced J-curve effect • Long (~15 year) lock up periods → little to no liquidity • Second layer of fees eat into performance even further

Source: Fiera Capital

2 "PE & VC Fundraising Mid-Year Update." PitchBook Data. 2018.

Structural Evolution: Open-end Funds

In order to broaden the level of access to PE for all investors, industry players have taken action to ease access and effectively democratize PE by creating open-ended PE vehicles. Open-ended PE Funds present features which mitigate many of the aforementioned challenges to investing in the asset class.

For example, because they would be living, dynamic and perpetual, open-end vehicles could offer increased liquidity in the form of redemption windows. Moreover, fees on Net Asset Value (as opposed to on committed capital) along with the fact that new investors may be investing in a portfolio of already-performing assets mitigates the J-curve effect. Finally, open-ended vehicles could be more transparent, showing their investors exactly what investments lie in their portfolios, thereby eliminating the concerns surrounding a Blind Pool. Taken together, these changes make for a much more attractive vehicle for PE investment for investors of all sizes.

Portfolio Benefits

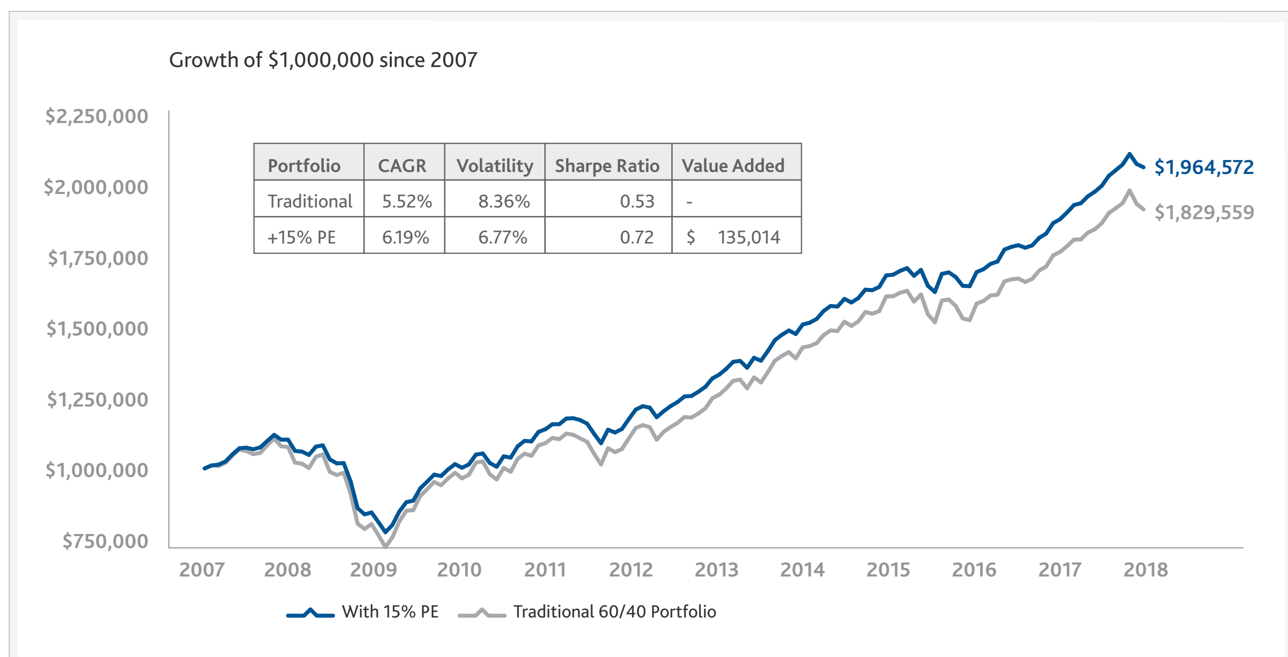
We've shown that over long periods, PE as a standalone asset class has consistently demonstrated better risk and return characteristics than public equities. But how does adding PE to a classic portfolio improve said portfolio, and is it worth the associated reduction in liquidity?

First, it's important to understand that a PE is as a long-term investment. It may take several years for operational and strategic changes to materialize at a portfolio company. As mentioned earlier, the norm for PE is a decade long lock-up period for clients' capital. Therefore, investors shouldn't be looking to allocate capital towards PE with a short-term view.

That said, for longer-term investors, there is a significant benefit to adding PE to a traditional portfolio due to its risk and return characteristics along with its relatively low correlation to public equity markets. For example, using data from the beginning of 2007 to the first quarter of 2018, we compare the performance of a $1 million traditional 60% public equity / 40% fixed income portfolio to that of one with a 15% PE allocation, replacing some of the traditional public equity allocation. The new portfolio generates an additional $135,000 of returns with one fifth less volatility, leading to an improved Sharpe Ratio.

The benefits become especially valuable if one holds PE through economic cycles; as we'll see below, PE weathers economic downturns.

Portfolios with PE have better risk and reward over last economic cycle



Portfolio	CAGR	Volatility	Sharpe Ratio	Value Added
Traditional	5.52%	8.36%	0.53	-
+15% PE	6.19%	6.77%	0.72	$ 135,014

Source: Fiera Capital, Multi Asset Class Solutions. Indices: Global Equities, MSCI ACWI (local currency); Global Bonds, Barclays Global Aggregate Hedged in USD; Private Equity, Cambridge Global Buyout (USD). Quarterly data for PE, monthly for Equities & Bonds, from Q1 2007 to Q1 2018.

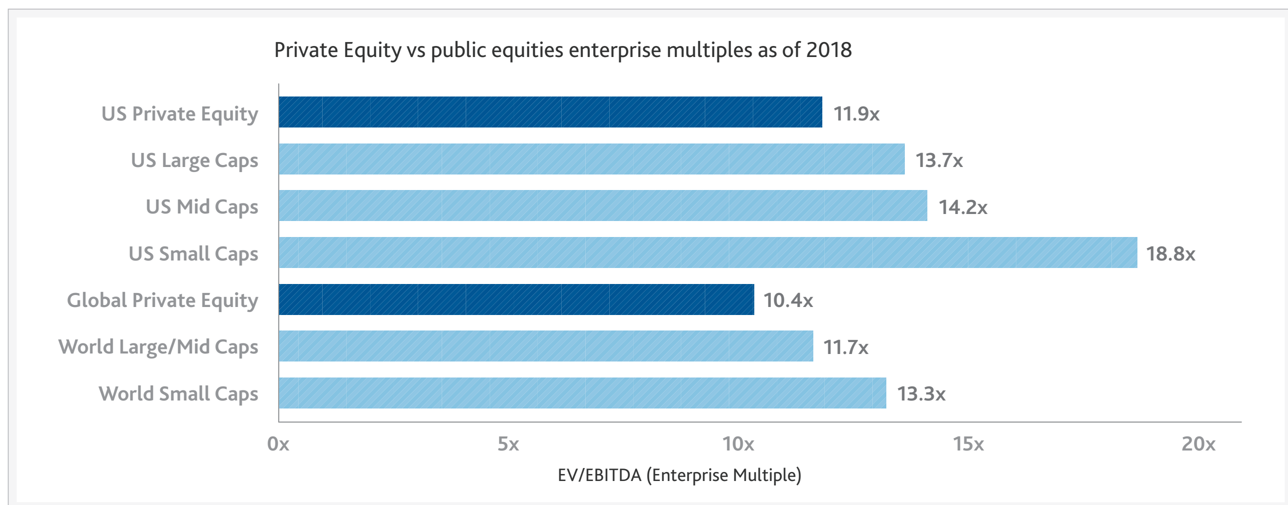
PE and the Cycle

One of the key concerns for investors considering an allocation to PE is timing. Private equity valuation multiples have expanded significantly since the global financial crisis, making acquisitions more expensive. Given where we likely are in the market cycle, some are beginning to doubt PE's ability to generate above-market returns through a recession. Given this, is now really the time to begin investing in PE?

It's undeniable that PE transaction multiples have increased, as a combination of a strong economy, excess dry powder and low interest rates have spurred buyout activity. However, it is equally true for PE as it is for public equities, which have seen Price to Earnings (P/E) and Enterprise Multiples (EV/EBITDA) expand significantly since the global financial crisis.

But if one is seeking value, PE would seem to be the better choice, since US and global enterprise multiples in PE are cheaper than for comparable public equities. This has historically been true, at least in part due to the liquidity premium public equities command. However, if managed correctly – say, by investing with a long-term horizon and by choosing vehicles with opportunities for liquidity – investors can take advantage of the PE discount while reducing liquidity risk. On the whole, this means that though buying into PE isn't necessarily cheap by historical standards, it's still significantly cheaper than it would be to buy large positions in the public equity market.

Private Equity multiples are lower than those of similar public equity indices



Source: Indices for public equities retrieved from Bloomberg, end of Q3 data retrieved on Nov. 13 2018: US Large Caps, Russell 1000 Index; US Mid Caps, Russell Midcap Index; US Small Caps, Russell 2000 Index; World Large/Mid Caps, MSCI World Index; World Small Caps, MSCI World Small Cap Index. For Private Equity: Pitchbook data, Q3 2018 for US, Nov. 2018 for Global.

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Finally, for investors who believe that we are in the tail end of a cycle and potentially heading into tougher economic times, PE has proven itself more capable of withstanding downturns than similar public companies. Several academic studies have demonstrated that PE-backed firms actually outperformed non PE-backed firms and listed public companies through the Global Financial Crisis.

Specifically, it's been shown that PE-backed buyouts had a 5% higher return on assets and nearly 14% higher productivity than listed public companies throughout the recession[3]. PE-backed private firms also had higher asset growth rates and exited recessions with larger market shares than before[4]. Much of this is likely due to the fact that while credit was frozen and public companies were unable to invest in profitable projects, PE-backed firms actually increased investment, using the financial resources and network of their PE fund owners.

So is now the right time to invest in PE? Taken together, PE's ability to withstand market cycles and their cheap valuation relative to public equities make a strong case for investing in PE in the current environment.

Bottom Line: Long-term Investors Can Benefit from Easing Access to PE

The benefits of Private Equity are compelling; portfolios with PE have produced outsized returns with less risk than traditional portfolios. Though traditionally the asset class has been reserved only for the largest and most resourced investors, the industry is beginning to adapt so that more investors can benefit from PE's risk/reward profile and ability to diversify a portfolio. Given performance through recessions and cheaper valuations relative to the public market, PE may be poised to be an important asset class for a broader group of investors going forward.

3 Wilson, Nick; Wright, Mike; Scholes, Louise. "Private Equity Portfolio Company Performance Through the Recession". March 17, 2011.

4 Bernstein, Shai; Lerner, Josh; Mezzanotti, Filippo. "Private Equity and Financial Fragility During the Crisis". Harvard Business School. 2017.

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