Private Equity in a Low-Return World

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In light of modest equity return expectations for the public markets, many institutional investors are turning to private equity to try to boost portfolio returns. But investors must realize that although private equity returns come from a variety of sources that are not market driven, the potential for diversification in this asset class is not as high as they may think. Additionally, other factors, such as choice of manager, can have a drastic impact on performance. Consequently, investors should choose a manager carefully by evaluating several factors, including firm stability as well as the discipline and strategy for buying, managing, and exiting private equity deals.

The outlook for long-term, forward-looking equity returns is not rosy. That is, after accounting for dividend yields, P/E expectations, interest rates, and normalized growth expectations, many people believe that in the next few years, stocks are unlikely to return what investors have become accustomed to over the past 10 years.

Given these modest expectations, institutional investors have begun looking in earnest for alternatives, and private equity is certainly one of the possibilities they are considering. In this presentation, I will discuss some of the core issues that investors must grapple with when they try to evaluate the potential role for private equity in their portfolios. I will address the subject primarily within a portfolio context and from an asset allocation perspective, touching on such topics as the kinds of returns one might expect from private equity and where those returns come from. Ultimately, I hope to provide an intuitive understanding of what drives this field and to describe the factors that investors working to develop a program in this area should incorporate into their analysis.

Private Equity Characteristics

In the public equity market, earnings growth, dividends, and trends in P/Es drive expected stock returns. And the role that most financial analysts play is to try to understand the various trends in prices, earnings, cash flows, and so on. Earnings growth is clearly an issue for individual stocks, but it is also an issue for the broader market, and the broader market is the tide that raises or lowers all boats.

In the private markets, returns are driven by considerations other than the underlying market exposure. These factors are aspects of returns that are not found in the public markets. They help form the basis for the broader palette of value-adding propositions that general partners or managers can take advantage of when they are working with private, as opposed to public, companies.

Sources of Return. Table 1 shows a pro forma analysis that we have done at General Motors Investment Management Corporation for some of the possible sources of return in a private market investment—in this instance, a buyout deal. This example begins with a very modest base case, in which one buys a company at eight times cash flow and the company grows at roughly 5 percent yearly and has average margins. The base case return expectation is about 11 percent. While holding this private company, a general partner can do many things to enhance its value beyond the base case and ultimately to achieve higher returns.

One immediate possibility is to double the leverage, adding roughly 7 percent to the internal rate of return (IRR). Furthermore, if the general partner negotiates well and buys the company not for eight times cash flow, as in the base case, but for 10 percent less than that figure, the general partner could expect to add 5 percent to the IRR. Cutting costs also

Table 1. Sources of Private Market Returns

Component	Value Added
Base case	11%
Double leverage	7
Buy 10% cheaper	5
2-Point cost cut	6
Double growth rate	7
Multiple expansion	8
Sell 10% higher	3
Total	47%

increases returns. Taking two margin points from the costs would add an additional 6 percent to the IRR over time. Moreover, doubling the company's growth rate by increasing the top line of the company through product acquisitions or other approaches would further enhance return by roughly 7 percent.

Another possibility is multiple expansion, which is essentially getting other people to pay more for the company than the general partner did. Multiple expansion is an element of private equity that everyone shoots for, but it is tough to achieve in a competitive market. The common way to go about it is to determine what factors drive the market's assignment of a particular P/E to a company. Then, the challenge is to enhance those factors to earn the higher P/E, whether through faster growth, increased size, or any number of other possibilities. This multiple expansion might further enhance the IRR by 8 percent. Finally, the general partner could try to negotiate a 10 percent higher sale price for the company, which would add about 3 percent to the IRR.

If the general partner did all those things, he or she could obviously add a lot of value, turning the IRR expectation from something pretty modest, such as 11 percent, into something considerably higher, such as the 47 percent in this example. Of course, adding value is not always easy. And doing all these things concurrently is probably not possible in any particular company. But these are the kinds of things that a general partner can do to bolster his or her return. And as one can see, a substantial number of these factors are not dependent on the underlying market exposures per se.

Historical Returns. So, what kinds of returns have investors actually seen in the private equity market? The numbers can vary, of course, depending on the type of analysis. For this presentation, I have developed the returns using what is called point-to-point IRRs. The reason for using this method rather than time-weighted returns is that investors cannot actually put money to work in an equally distributed method implied by time-weighted returns. Investments have to be based on availability of funds and the allocation an investor may be able to make to a particular fund given the restrictions that the fund may apply. This behavior is better captured by point-to-point IRRs.

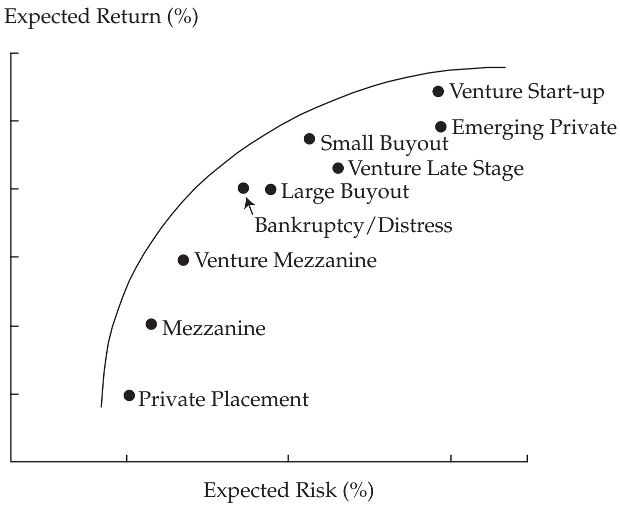
Venture Economics tracks a universe of partnerships. That universe has existed for the better part of 20 years and is generally representative of the universe of available private market investments, usually funds. That portfolio of opportunities has been growing over time, so Venture Economics values the entire portfolio of opportunities at one point in time, rolls forward to the next period, and values the portfolio again while looking at all the cash flows that occurred between those two points. Based on those metrics, Venture Economics determines an IRR.

If one looks at these returns in relation to the public market index over 5-, 10-, and 20-year periods, a pattern emerges in which private equity tends to outperform by a considerable margin. For example, the five-year average return for private equity as of 30 September 2004 is 5.8 percent versus a loss of more than 2 percent for the S&P 500 Index over the same period. The 10-year and 20-year average returns for private equity are 12.9 percent and 13.7 percent, respectively, compared with returns of 12 percent and 11.3 percent in each case for the S&P 500. This outperformance is what has given rise to the expectation that private equity can enhance returns in an institutional public market portfolio.

Return and Risk by Investment Type. Rather than simply looking at returns for all private equity, returns can be broken into various subcomponents. Some of the subcomponents of private equity, in particular venture capital and leveraged buyouts, show substantially different historical returns depending on vintage year and the period under observation. The point-to-point IRR for venture capital over the five years ending 30 September 2004 is 14.5 percent versus 3.1 percent for buyouts—a spread of 11.4 percentage points. This spread between venture and buyouts has existed for some time. Over the past 10 years, venture returned 26.7 percent versus 8.5 percent for buyouts, for a spread of 18.2 percentage points. Over the past 20 years, venture brought in 15.8 percent versus 12.8 percent for buyouts—a 3.0 percentage point difference.

Along with differences in expected return come differences in risk. Risk and return expectations can vary quite a bit from one type of private equity investment to another. **Figure 1** shows risk and return schematically for several types of private equity investments. This figure does not, of course, show the entire market efficient frontier. All of private equity would fall into the upper segment of an entire market efficient frontier. Figure 1 focuses just on the private

Figure 1. Private Equity Risk–Return Profile



equity portion of the entire market efficient frontier. Also, note that this type of analysis cannot be pushed too far because of the paucity of data in private equity. Nonetheless, it illustrates what investors might find within private equity.

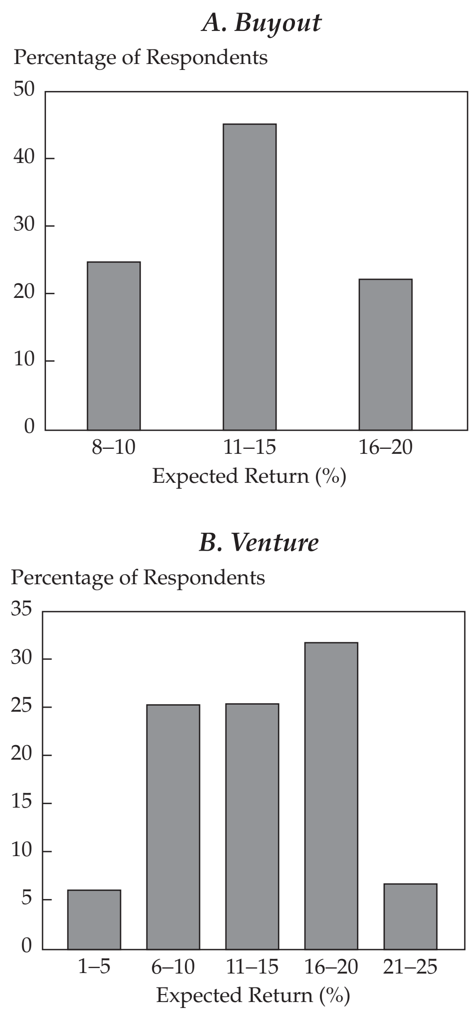
Future Return Expectations. Thus far, I have looked at historical returns, offering a generalized view of where risk and return expectations fall for various private equity investments. What about future expectations? In late 2003, KPMG conducted a survey of roughly 500 institutional investors to gauge their return expectations for private equity over the next 10 years. The results are shown in **Figure 2**. It turns out that in contrast to the historical record, investors have more modest expectations for private equity over the next several years. Of course, these lower expectations are probably partly a function of reduced expectations for the broader public market. In trying to estimate a single expected return from the data, one could view expected returns for both venture and buyouts as falling somewhere in the mid-teens.

Diversification. When trying to understand the role of private equity in a portfolio, institutional investors must consider diversification. A lot of people believe that private equity is a good diversifier. Unfortunately, the data do not always support that belief. Panel A of **Figure 3** shows the correlation of five-year rolling quarterly returns for the 10 years ending 31 March 2004 for private equity versus the S&P 500. The correlation is about 91 percent, which is pretty high. In the same analysis against the NASDAQ, shown in Panel B, the correlation is lower but still significant at about 84 percent. When examined at this time horizon, the benefits of diversification are slight. Thus, the primary reason for entering this asset class should probably be return expectations.

Expected Allocations. Aside from a bottom-up analysis of asset allocation, private equity allocation targets can be viewed by looking at what investors do in terms of voting with their feet. By looking at what typical investors have allocated to private equity funds, one can determine what various groups of investors implicitly believe about expected returns and the contribution to their portfolios.

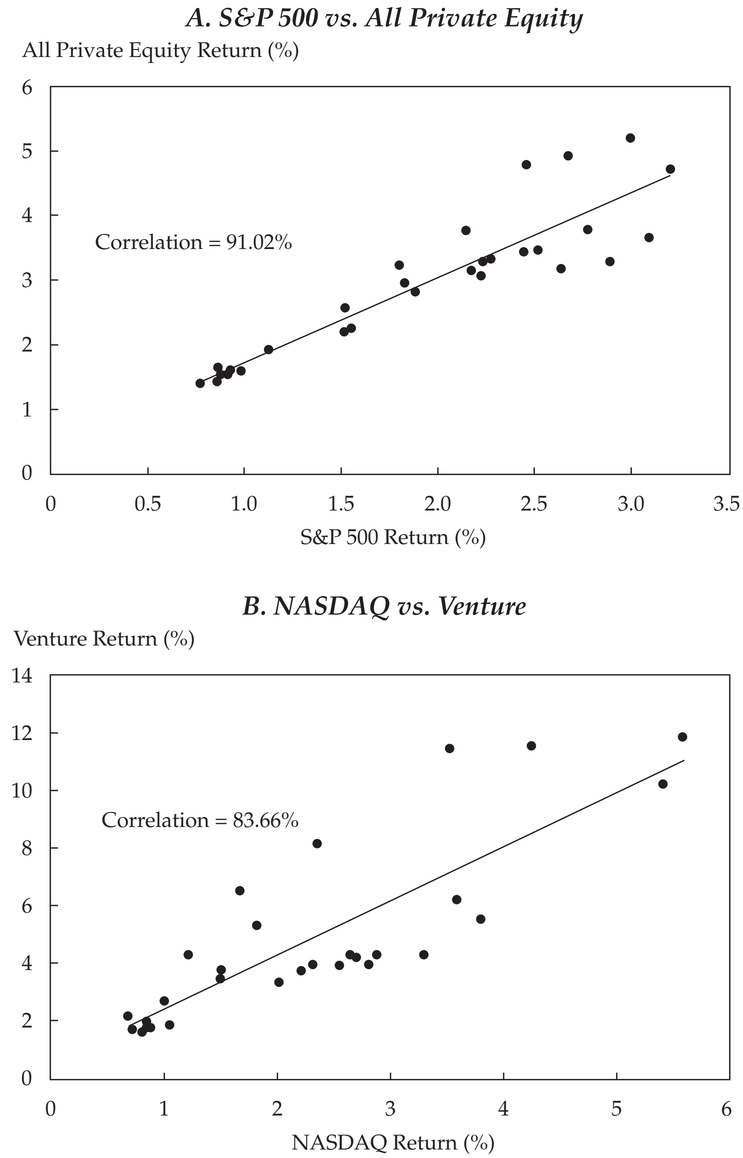
Different types of institutional investors have consistently different allocations to private equity. Endowments and foundations have invested in private equity (particularly venture) the longest. They also tend to be the most aggressive: The typical size of their allocations to private equity is generally on the order of 10–15 percent, with even higher allocations for some of the larger, well-known endowments. Conversely, corporate pension plans have typically not been as aggressive, although they have been involved in private equity for a long time. Their

Figure 2. Expected Returns in the Next 10 Years



Source: Based on data from a survey conducted by KPMG.

Figure 3. Five-Year Rolling Quarterly Returns for the 10 Years Ending 31 March 2004



Source: Based on data from Venture Economics.

allocations tend to hover around 5 percent. For example, General Motors' allocation to private equity is about 5–7 percent.

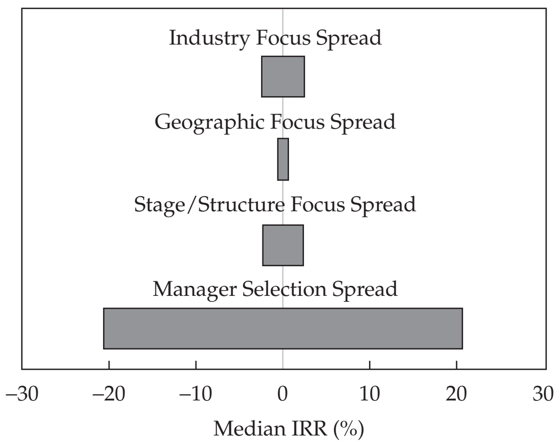
Public pension plans have been late to join the game. They have entered the private equity arena only in the past 10 years, and in some cases, only in the past 5 years. Consequently, the allocations to private equity made by public pensions are relatively modest (about 2–3 percent), although these investors appear to be fairly aggressive about increasing their exposure, with many public pensions planning to double their percentage allocation to this asset class.

Seeking Alpha

I have discussed both historical and expected returns for private equity, but investors should consider another critical aspect of private equity as they evaluate the asset's potential role in a portfolio. I would argue that investors should not think about the expected returns for private equity from a market-driven perspective. Rather, I believe they should focus on trying to develop a strategy that targets manager alpha because this factor will define the success of a program more than underlying market returns.

The reason for my assertion is that manager selection swamps what is going on in private equity market cycles. **Figure 4** shows the key dimensions investors might take into consideration when looking at private equity. As can be seen, manager selection dominates the other factors in generating total performance.

Figure 4. Comparative Spreads between Returns across Strategies
(20-year period ending December 2003)



Source: Based on data from Venture Economics.

Moreover, as **Table 2** shows, the spread between top-quartile and median returns can be quite high within private equity compared with the same spread for other asset classes. So, investors might get the market cycles right, but if they select the wrong manager, they could still fall far short of their expected return.

Table 2. Illustrative Spread between Top-Quartile and Median Returns
(10-year period ending December 2002)

Asset	Return Spread
U.S. private equity	15.60%
International (non-U.S.) stocks	2.00
U.S. stocks	1.25
U.S. bonds	0.45

Sources: Based on data from PSN/Effron and Venture Economics.

This wide spread attributed to manager selection exists across time. The spread may expand in bull markets, but it is still wide during bear markets. Additionally, the spread exists among subcomponents of private equity, such as venture capital and buyouts. The spread is consistently present and consistently meaningful.

This manager alpha spread is a unique characteristic of private equity that needs to be built into an investor's strategic expectations. Normally, asset allocators do not see alpha as a factor in their asset allocation. They think of alpha as something that will be done after the strategic picture has been worked out. But I would argue that in the case of private equity, investors need to take manager selection into consideration early in the process.

Vintage Sensitivity. Another unique and important characteristic of private equity is vintage sensitivity. Very often, when investors examine vintage expectations, they look at such factors as median manager performance through time. But this type of analysis is complicated by the fact that the distribution of returns from one vintage to another can vary considerably. **Figure 5** shows the IRR distribution within different vintages for buyouts in 1992 and 1998 and for venture in 1992 and 1998.

Clearly, the distribution is vastly different for different vintages. For example, for buyouts in 1992, there was a substantial tail, with the dispersion in IRRs ranging from –23 percent to 60 percent. But the return distribution showed a strong central tendency, with more than one-third of the universe producing a 20 percent return. Overall, 1992 turned out to be a good vintage year for the average buyout investor.

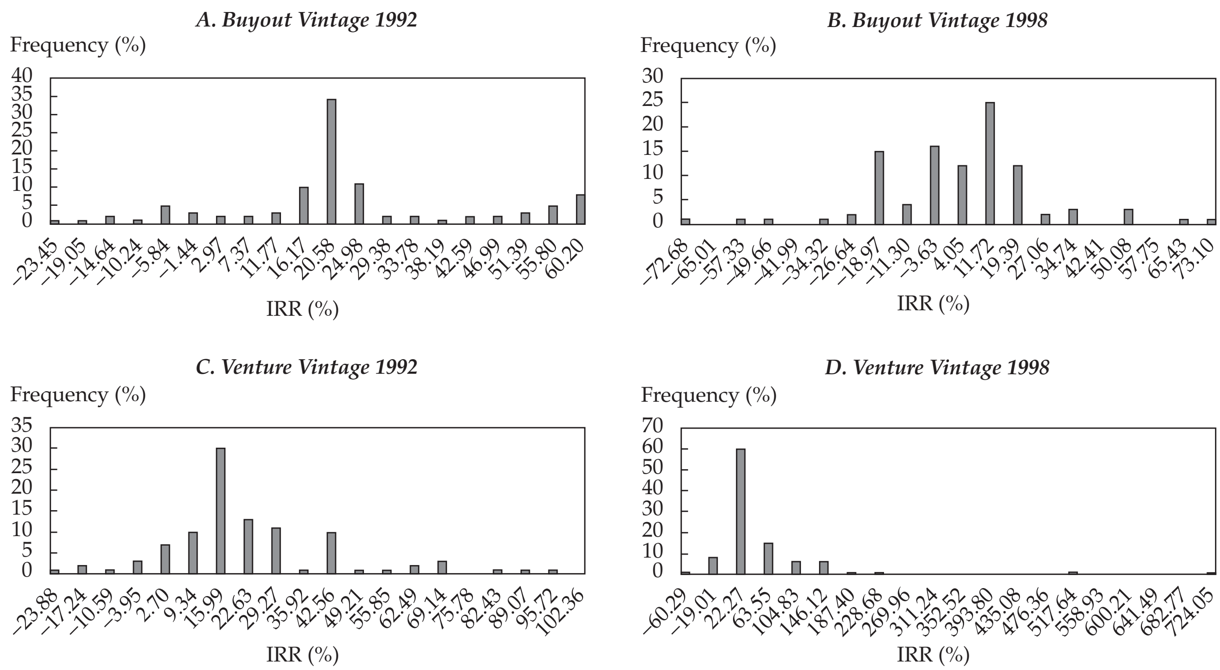
In contrast, the 1998 vintage year (shown in Panel B) was less desirable for the average buyout investor. The tails were not as substantial, but the average return was lower and the tails were skewed much more to the left—into negative territory.

Venture for the same vintages also shows substantial differences in terms of dispersion and skew around the mean. I mentioned that performance can vary between buyout and venture; Figure 5 also reinforces this point. In vintage 1992, almost three out of five venture funds produced less than a 22 percent IRR, as shown in Panel C. In comparison, more than 7 out of 10 of the buyout funds produced an IRR of 20 percent or better. And note that these returns are now fully realized. Thus, buyouts did much better than venture in that vintage year.

In contrast, in vintage 1998, shown in Panel D, roughly 90 percent of the venture funds produced a return of 22 percent or better while fewer than 90 percent of the buyout funds produced a return of 20 percent or better. This 1998 return will not be fully realized for another couple of years. Still, the venture return is substantial and even has some extreme outliers in excess of a 300 percent IRR.

In all, Figure 5 does a good job of illustrating how much return distributions can vary, not only by type of private equity investment but also by vintage year.

Figure 5. Private Market Return Distributions



These disparities can throw a curveball to the average institutional investor, who may not have equal access to private equity opportunities over time. Public markets are much more flexible in this respect.

Finding Consistent Performance. In private equity funds, the difference between the median and the top-performing funds is based on a small number of deals that performed exceptionally well. That is, exceptional performance is driven by something on the order of 5–10 percent of the deals inside a fund. The fact that top performance tends to result from a small proportion of the deals raises the question of talent versus luck: Is top performance a function of manager talent and organizational franchise, or is it simply a matter of luck?

One way to answer that question is to look at persistence. And one way to get a sense for persistence is to look at managers with multiple funds and evaluate the relationship between the performance of one fund and that of subsequent funds. For this type of analysis for both venture and buyout funds, the research suggests that venture has a slight persistence. Among venture funds, our studies at General Motors Investment Management have found about a 60 percent chance of repeating first-quartile performance. Among buyout funds, we see a little less persistence, with about a 50 percent chance of repeating first-quartile performance.

So, what contributes to this consistency? This is a complex question that lacks the research needed to be definitive. Yet, a simple conceptual approach can point in some useful directions. Simply put, there are four main drivers of success: firm stability, timely and prudent buying, effective company management, and successful exiting of companies.

- *Firm stability*. Investors need to find a firm that stays the course. If they are going to enter into a 10-year private equity partnership, it is imperative that the firm have stability of people and process. If it does, then investors can evaluate how the organization takes advantage of market opportunities through time.
- *Buying*. The buying side is more complicated for the general partner than it is for the average stock picker. Clearly, sourcing becomes a big issue. A universe of deals is not available all the time, so the general partner has to go looking for them, and the strategy that the general manager has for looking for deals makes a big difference. Due diligence also takes on increased importance because not much public information is available. At the same time, the firm must have a discipline for constructing portfolios. I have explained the importance of vintage sensitivity. If the firm cannot manage the portfolio through time and balance the vintage sensitivity, it could wind up with a concentration that completely dominates the outcome. And of course, pricing discipline is important. But in this case, pricing discipline is not about a

bid–ask spread; rather, it is about negotiation. I would argue that a firm's check-writing discipline (i.e., selecting a company and setting the purchase price) determines more than half of the returns.

- *Managing*. Managing companies is really about having a strategic plan, working through the governance of the company, and focusing on the operating side. It is about understanding where enhanced value might be derived and having an integrated strategy for realizing that additional value.
- *Exiting*. Just because a general partner created a nice company does not mean somebody will come along to buy it. It is important that the manager be proactive. He or she must manage and market the sale in order to create multiple expansion. Think about some of the stronger general partners, specifically in the venture area: There always seems to be a buzz about any company that they are taking public. That buzz is created through a well-executed exit strategy.

Summary

Private equity is an asset class that offers many opportunities, but investors must pick the right managers. And although the returns come from a variety of sources that are not market driven, private equity does not offer as much diversification potential as many people believe. Furthermore, I do not think diversification is a good reason for getting into private equity. Rather, investors in private equity should be seeking enhanced return.

Manager alpha drives returns more than other factors in private equity and thus must form the basis of investor expectations. An investor's ability to select good managers is the key to realizing enhanced returns, a task further complicated by the fact that a lot of other investors are also looking for these good managers. At the end of the day, the returns are available, but they are not always easy to extract.

Question and Answer Session

Charles G. Froland, CFA

Question: How do you assess a manager when the markets are different from what they were for the manager's previous fund?

Froland: That is a tough question and an issue that comes up often in private equity. Not only do markets change, but people also change. Most general partners are opportunistic. They go after those parts of the market that they think are the most attractive, which often means they will be doing something different from what they've done before.

I think the best place to start is with the manager's discipline and strategy. How well does the manager understand the companies? What is the manager looking for, and what is the bet? A bet is not about deciding to buy a consumer company versus an airline or something else. A bet in private equity is about what will be done with the company, how it will be repositioned, and how value will be added in the operating structure.

Next, you should evaluate the consistency of the manager's discipline in conjunction with the manager's judgment and risk management. Even though the bet may be changing as companies change and types of technology change, you will see good managers that are consistent in their underlying investment logic.

Question: What is your view on international private equity markets? Do you expect the return characteristics of those markets to be similar to those in the United States?

Froland: It depends on what part of the globe you're talking about. At General Motors, we have put most of our money into westernized economies. We have a long history of investing in emerging markets on a more opportunistic basis with mixed results.

That experience has led us to believe that private equity really depends on an underlying infrastructure. That infrastructure has to do with the kinds of professional services that are available (such as the services of accountants and consultants), the country's rule of law (typically with respect to bankruptcy), and the kind of managerial talent that is available within a country.

Managerial talent can be a bigger factor than you might think because a lot of private equity deals involve uprooting managers from normal home lives. In some countries, you just won't find many managers who'll sign up for those jobs. Also, in many countries, it is difficult to find people who like that entrepreneurial kind of environment; they tend to prefer large organizations and the stability that they provide.

So, those factors keep us from getting heavily involved in nonwesternized markets. When we did get involved and ended up experiencing some difficulty, the problems often had to do with macroeconomic conditions, such as monetary policy changes, currency devaluations, or problems in the banking system. Some of those macro factors can completely swamp an otherwise promising venture.

Western Europe is another matter. That is a pretty well-developed market, and a substantial number of U.S. general partners work in that environment. The wild cards in Western Europe have to do with the regulatory environment with respect to labor and with respect to some of the market restrictions you find in the European Union. When you are operating in the United States, there is not a big difference between working with someone in one part of the country and another. But in Europe, where you are talking about Italy versus Germany versus Spain, there are much bigger differences to overcome. Integrating across cultures is not easy and requires different talents. This often also means that certain kinds of bets are not going to work there, at least not the way you would expect them to work in the United States.

But ultimately, the opportunity in Europe is growing. You can make the same kinds of returns in Europe as you can here. If you're a U.S. investor, you still have the problem of what to do with the euro. The currency fluctuations can pose a bigger risk than many people estimate, so I would encourage you to think about that aspect. But in general, I think you can be bullish on Europe.

Question: Are you currently allocating any funds to managers in China? What criteria do you use to evaluate managers in new markets?

Froland: We've looked at China in the past, and we continue to watch it now. We have not made many bets in China over the past half-dozen years, except through more global funds, a few of which are much more opportunistic and cover many different markets.

There is a big debate within the private equity industry as to whether managers should be solely and uniquely committed to the country where they are working or whether they should be more global. They obviously have to work with local managers, but do they need to be from the country to be effective? I think you can find success with both approaches, so I'm reasonably neutral on the matter. Ultimately, I think it is more important to have a good discipline, a good strategy for finding deals, and a solid approach to managing those deals.

Question: There seems to be increased competition in fully priced transactions with little discount versus the public markets. Can you explain this phenomenon?

Froland: I think it depends on the sector where you are working. It is certainly true in certain aspects of buyouts. It is certainly true among the megadeals that are shared among three or four major funds. It is part of private equity in terms of the fund-raising cycle and the cycle in which people put money to work. It is one of the reasons why vintages are so important, and it is part of the risk of private equity.

Such cycles are why it is so important to pick good managers. The good managers generally know how to maneuver in a number of different environments. Being a deal maker as opposed to a deal taker can make a big difference. But that is more a function of vision, discipline, and strategy than of having a big checkbook.

You will find that there is a herd in private equity, just as there is in the public markets. And just as in the public markets, you want to stay away from that herd. Some managers are better at that than others.

