PRIVATE EQUITY

Private Equity: Alive and Kicking!

Despite the collapse of mega deals and slowing activity, private equity fund raising is in a healthy state and the asset class can provide premium returns over the longer term, writes Marwan Naja

In light of the credit crunch and ongoing financial crisis I have often been asked if private equity is still a core holding for investors as deals dry up and performance reverts to the mean. My answer is that I do not agree with the premise of the question. While "mega" deal volumes have plummeted and overall deal activity has slowed, these levels continue to be high in historical terms and private equity fund raising is on track to set new records. Let us look at these elements in more details and build a thesis for the sustainability of growth in the private equity sector.

A RECORD 2008 FOR PRIVATE EQUITY FUNDRAISING

Newly released figures are pointing to a significant increase in global private equity fundraising for 2008. Venture Economics data show H1 2008 levels of $276bn (€188bn). Annualized ($552bn), this represents a 17 per cent increase over the 2007 levels, a record year, and a 59 per cent increase over the average of the past 11 years of $221bn per year.

Figure 1: Global private equity funds raised ($bns)

Source: Venture Economics

Other evidence corroborates these figures. Private Equity Intelligence and Probitas show fund raising for distressed and turnaround private equity funds through April of 2008 already equal to all funds raised for 2007. Furthermore, the Emerging Markets Private Equity Associations estimates that the $35bn raised in the first half of 2008 for emerging markets private equity represents a 68 per cent increase over the levels from the same period in 2007.

The data shows a slowdown in the growth of fundraising for mega funds and other private equity sub-classes in favor of distressed, turnaround, growth, mid-market and emerging markets funds, areas that investors perceive as having a better chance of deploying capital and achieving target returns in the current environment. The shift in allocation among the various private equity subclasses is logical and continuous calibration will persist as the norm in the long run based on prevailing market conditions. However, the key take-away from the record fundraising levels is that we are in the midst of a structural shift towards increased allocations to private equity by both institutional investors as well as high net worth individuals.

GOOD RETURN, DOWNSIDE RESILIENCE AND LIMITED VOLATILITY

The promise of private equity has been to deliver premium returns over the public equity markets - a compensation for the lack of liquidity of the asset class as well as the potential higher risk of some of the underlying assets depending on the focus of the fund (leverage for LBO funds, technology for VC funds, emerging markets risks for Asia funds, etc.). The reality has been even more attractive for some investors. Top quartile buyout managers have been able to achieve remarkable returns over the past decade. This fact is often trumpeted in conferences and pitches. Less discussed, but highly attractive are some additional factors that are propelling the witnessed growth in the asset class.

Private equity reported valuations tend to have low volatility, an attractive feature for many investors. The trend in accounting rules is for more frequent and more accurate marking-to-market of portfolio assets in private equity funds. While this may increase the volatility of reported valuations, it is likely to remain well below other asset classes. Part of the reason is that the compensation structure for private equity firms, which generates carried interest for the manager only upon cash

realisations of the underlying investments, has resulted in an industry with limited incentive to write up valuations of portfolio assets.

David Rubenstein, co-founder of The Carlyle Group, often asserts that his firm has never sold a portfolio company at a price lower than the last reported quarterly net asset value. This is consistent with what we see in our business.

Furthermore, but less documented, there is a general belief by seasoned investors that diversified portfolios of buyout funds have shown resilience to "blow ups" and capital loss (this is not the case for venture capital, a segment that has performed poorly over the past decade).

STRUCTURAL CHARACTERISTICS

From a structural perspective, private equity is very different from other institutional asset classes. These structural differences often hinder the growth of private equity as investors who do not understand them often shy away from the asset class. On the other hand, as more investors begin to understand these characteristics they often increase their allocation to private equity.

For most investors, private equity investments are typically made through closed-end funds that call capital when it is needed (to buy a company) and distribute profits as they are realized (once a company is sold). This characteristic has dramatic implications for levels of commitments by investors.

First, commitments to private equity funds do not equal exposure to private equity. For example, on the day an institution or individual commits 5 per cent of their portfolio to a private equity fund, their exposure to private equity from that fund is zero. Private equity managers typically deploy their funds over a period of four to six years.

Second, the sale and divestiture of investments made by private equity funds reduce an investor's exposure to the asset class. The proceeds from the sale of a portfolio company by a private equity fund will be paid out to the fund investors. Hopefully the investors have realized a handsome profit, but they have also a decrease in their private equity exposure. To contrast this point, a hedge fund that exits a successful trade automatically redeploys the proceeds of that trade in the fund for making other investments. In the process, the exposure of the investor has increased as the assets of that hedge fund have grown. In private equity the profits and the underlying cost are distributed and paid out to the investor reducing their exposure. The impact is that investors have to continuously add to their private equity commitments as those are structurally depleted over time.

> **"COMMITMENTS TO PRIVATE EQUITY FUNDS DO NOT EQUAL EXPOSURE TO PRIVATE EQUITY"**

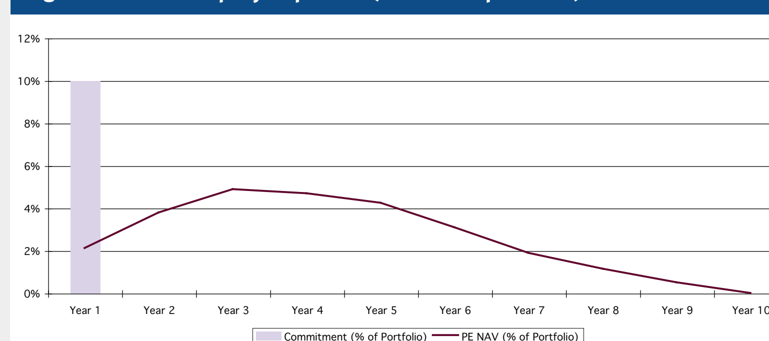
Finally, in private equity funds there is an overlap between the period when the funds are deployed (companies are bought) and when the funds begin realising some of their investments (companies are sold). For example, a company purchased in the first year of a private equity fund's life may be sold in the third year of the fund's life, only half way through the typical six year deployment cycle. The sale will result in a cash disbursement to the investor which will decrease the net cash requirements associated with this investment. Specifically, an investor who commits $1m to a private equity fund will typically never get to the point where he or she witnesses a net $1m cash outflow associated with this investment.

In fact, analysis of our data shows that diversified portfolios of buyout funds bottom out at 60 per cent to 70 per cent net cash outflow of the committed levels. Commitments of $1m will result in a net cash outflow of $600,000 to $700,000; while the entire $1m will be called, proceeds during the life of the fund will limit the net cash outflow to the levels indicated. The implication of this structural characteristics is that experienced private equity investors (can or should) "over-commit" above their target goals.

As more investors gain experience with private equity, we notice that more of them increase their commitments to the asset class as a percentage of their portfolio. They recognize that exposure levels to private equity, the percentage of an investor's assets actually deployed in private equity, is typically well bellow the commitment levels.

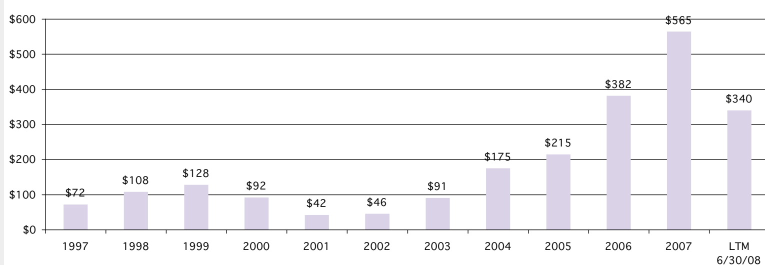
Figure 2 shows a theoretical scenario based on our models

Figure 2: Private equity exposure (% of total portfolio)



Source: Source: Pictet & Cie (Assumes: no prior private equity investments; 7% annual return on non-private equity assets; private equity investments held at cost by funds)

Figure 3: Total US sponsored volume ($bn)



which incorporates historical cash flows of over 800 private equity funds. A one-time commitment in private equity equaling 10 per cent of a portfolio will result in a peak private equity exposure of approximately 5 per cent three years after the commitment is made and gradually declining to zero as the fund is liquidated. Again, the implication is that continuous commitments in private equity are required to maintain exposure and "over-commitment" is required to reach the desired exposure level.

The combination of attractive returns, downside resilience and limited volatility experienced by buyout investors over the past decade as well as some of the structural characteristics of private equity discussed above are the key factors driving new entrants to the asset class and causing existing investors to increase their allocation.

HEALTHY DEAL ACTIVITY

A significant increase in private equity fundraising does not automatically translate into observable investments in the market as private equity funds need time to deploy the capital. Given the current market turbulence and the dramatic decline in the availability of credit, the consensus has predicted a collapse in deal activity. This has not materialized….yet.

It is true mega buyouts have all but disappeared and that leveraged loan volumes have declined to $12.2bn in Q2 2008 from a record of $68bn in Q2 2007. However, the anomaly is the outrageously high 2007 level. Deal activity is lower but in fact healthy …. and with less leverage. At $340bn for the 12 month period ending June 2008 (and encompassing the credit crisis), US sponsored volumes are comparable to 2006 levels, a record at the time, and significantly higher than historical levels.

Furthermore, senior debt continues to represent 49 per cent of the source of the proceeds, down from record breaking deal levels but very much in line with healthy historical levels.

BUT WILL PRIVATE EQUITY CONTINUE TO DELIVER PREMIUM RETURNS?

In light of market data showing strong resilience in private equity fund raising and deployment levels I have tried to provide an overview of the return characteristics and the structural characteristics of this asset class that may be behind these trends.

Private equity asset class characteristics do not address the more fundamental question of why and how can private equity generate attractive premium returns over the stock market in the long term. In broad brush strokes, what is clear to me is that the markets require a source of long term equity capital for certain companies and opportunities. Private equity is a good source of this capital and the public markets are a poor source of long term equity capital.

The pressures of daily stock price movement, analyst estimates, shareholder lawsuits, regulatory compliance (Sarbanes-Oxley, for example) and other factors have made public companies overly focused on the short term. Private equity capital can allow companies to take a longer term view in terms of executing on strategy and reorganisations.

It may be this reprieve from excessive focus on quarterly results and other public market pressures that is needed for a subset of the market that will allow private equity firms to continue to deliver on their promise of premium returns into the future.

Marwan Naja, Head of Private Equity at Pictet Alternative Investments

Contact:
• + 41 58 323 3553

email:
private-equity@pictet.com

or visit our website at
www.pictet.com

Pictet Alternative Investments (PAI) encompasses the private equity and hedge fund businesses of the Pictet Group, a leading European independent asset management bank with over $400 billion in assets based in Switzerland. Pictet has been an active investor in private equity for two decades and currently has over $12 billion in private equity commitments under management and administration. PAI's Private Equity Group provides portfolio management services through discretionary mandates and its Monte Rosa private equity fund of funds products