Private equity transactions are privately negotiated and highly structured investments, primarily in privately-held companies. Most private equity deals involve controlling stakes in target companies and, critically, include an active operational role in setting policy and strategy in partnership with portfolio managers. This hands-on approach to investing requires a long-term commitment to deploy capital in an attempt to enhance the value of the enterprise.

Importantly, private equity may offer investors some advantages over publicly-traded securities, such as diversification, exclusivity, strong alignment of interest and historically higher returns. However, an investor must consider unique challenges in private equity investing, including low liquidity, long time horizons and non-standard valuation timeframes.

In our view, the current environment may offer a prime opportunity for qualified investors to explore private equity as an alternative asset class. As typical in most markets, macro trends play a role in the private equity investment cycle. Our analysis indicates that investors seeking to maximize potential returns would do well to consider private equity in the early stage of a global economic recovery. What follows is an introduction to what private equity investing entails, how it differs from other asset classes and why now may be an opportune time to invest.

Private Equity Fundamentals

While private equity can take many forms, broadly speaking, these investments fall into two main categories: corporate finance and venture capital. Corporate finance includes funding for business activities such as add-ons (buying a piece of another business in the same industry), buyouts, consolidation, expansion and/or restructuring. Venture capital usually involves providing funds for seed capital, early stage expansion or a rapid growth stage. While a corporate finance investment usually focuses on established companies in a broad range of sectors, venture capital targets start-ups in sectors with aggressive growth potential such as information technology and life sciences.
Why Invest in Private Equity?

Private equity offers the potential for an expanded opportunity set by virtue of its ability to access investments outside of the limited confines of the public equity markets. Moreover, we believe private equity may trump public equity in a number of areas, including the potential in privately negotiated transactions for extensive due diligence, greater operational control/influence, a hands-on approach by managers and a better alignment of interests. Indeed, our analysis indicates that private equity may generate higher rates of return than many other investment vehicles over the long term. Exhibit 1 illustrates this point by showing the time-weighted annualized returns for U.S. private equity indices versus the S&P 500 over different time horizons. Most private equity strategies aim to achieve an aggregate realized return 4-5% above the returns generated by a comparable, well diversified public equity portfolio.

Importantly, implementation through investment selection is the most crucial element in achieving return enhancement. The dispersion of internal rates of return (top through bottom quartile) among private equity investments has been significant in both absolute terms, as demonstrated in Exhibit 2, and also substantial relative to other segments of the investment universe.

Due to this historical dispersion, we contend that portfolio implementation is as important (or more important) than the strategic decision of whether or not to allocate to alternative investments. It is our view that the requisite return enhancement objective will not be achieved consistently by matching average or median industry-relative performance. Instead, we believe that a private equity investment strategy should be formulated with the goal of consistently delivering industry leading (e.g., top-quartile) relative performance.

Although the dispersion of internal rates of return can be large, research from the Boston Consulting Group has shown that persistence in private equity performance does exist; i.e., top private equity firms consistently “beat the fade.” Therefore, a top performing general partner is more likely to continue to outperform markets over time. Historically, top performing private equity investors have been able to differentiate themselves from their lower performing peers through their development of highly specialized capabilities. As a result, they have been able to avoid a “reversion to the mean,” which is often seen with investments in the public markets.

Private Equity Life Cycle

Most private equity investments are structured as a partnership managed by a General Partner, or “GP,” an Advisor, or a limited liability company with a specified lifetime within which investments must be made, sold and the proceeds...
returned to investors. As part of that process, an Offering Memorandum (OM) is prepared for potential investors that describes the terms of the partnership and the types of investments the GP intends to make. Actual investments are typically not made until the fund closes, however.

An investor becomes a Limited Partner or Member upon execution of a subscription agreement to invest a specified amount of capital into the partnership. The fund is closed to new investors following a deadline (often 270 days after the activation of the fund) or whenever a certain amount of capital (the “cap”) has been raised. After closing, the GP begins to make investments in companies consistent with the strategy as outlined in the OM by making “calls,” or “draw downs,” that commit capital from investors on an as-needed basis. The year in which a private equity partnership commences its investment activity is known as its “vintage year.”

As illustrated in Exhibit 3, committed capital is drawn down over a period of time, ranging from one to over five years as investment opportunities are identified. As an investment matures, proceeds are returned to investors instead of being reinvested (as would be the case for most public equity funds). Oftentimes, the partnership will provide distributions back to investors before their committed capital is fully drawn down. Further into the life cycle of the partnership, capital calls begin to wind down. Distributions become larger as liquidity events occur, which creates a cash flow positive scenario for investors over the later years of the partnership’s life. Companies are typically held as investments in the partnership for an average of three to five years. Exit strategies for portfolio companies include IPOs, sales to strategic buyers or financial buyers (i.e., M&A) and recapitalizations.

In private equity, the “J-curve effect” represents a pattern realized by plotting the returns generated by a private equity fund against time (from inception to termination). Payment of fees and start-up costs in the early years of a partnership, prior to any returns to the investor, should cause capital contributed to be higher than the book value of the portfolio investments. As a result, a private equity fund will typically show a negative return in its earliest years. Another negative impact on early returns is the writing down of portfolio investments that are considered to be “behind plan” (according to the terms outlined in a sponsor’s investment program). These early days form the bottom hook of the “J.” Investment gains usually come in the out years as portfolio companies mature and increase in value. When the first realizations are made, the fund returns may rise quite steeply and can offset remaining capital calls for investments and expenses. This period forms the stem of the “J”—and represents the reward to investors for putting up capital.

Given that capital is both drawn down and distributed over time, capital committed to private equity investments is typically greater than the actively invested capital at any given time. Therefore, to reach a target percentage allocation for private equity relative to a plan’s total assets, many investors earmark additional capital to approximate invested capital at the target level. Investors generally re-assess their committed and invested capital relative to their asset allocation targets every 12 months.

**Why ‘Now’ for Private Equity?**

When considering an allocation to private equity, a level and consistent approach to private equity investing over time and life cycles reduces the effect of the J-curve and allows for vintage year diversification across an investor’s total private equity portfolio. Historically, purchasing high quality companies at cyclical lows has provided above average internal rates of return for disciplined investors. Exhibit 4 highlights average vintage year returns for U.S. pooled private equity over time. We would recommend that an investor not take an overly “top-down” approach to allocating commitments, but rather let market opportunities dictate how much should be invested in any particular year or sector.
Considerations for the Private Equity Investor

As noted above, private equity aims to produce risk adjusted returns above those of public markets to investors with a long-term investment focus. Unlike many other alternative investments, private equity generally does not have investor-driven reinvestment or redemption features. Therefore, investors in private equity must carefully consider both liquidity requirements and the time horizon for investment, as well as equity risk. Furthermore, because the dispersion of private equity returns can be large, we believe an investor should aim to invest with top-tier private equity managers since they have traditionally outperformed lower-tier firms.

Conclusion

In sum, private equity can be considered an extension of the equity spectrum beyond the confines of public stock exchanges in that it involves privately negotiated, highly structured and hands-on investments in start-ups, growth companies and/or mature firms. Unlike a passive public equity investment, the objective in private equity is to unlock latent value by injecting capital in tandem with managerial expertise. Moreover, most private equity investments play out over an extended time horizon to maximize returns, often at least six years in duration. Due to the non-public nature of the transaction, private equity aims to offer an investor attractive entry multiples relative to potential exit multiples.

While private equity allocations can be more complex than other investments because capital is drawn down and distributed over time, the asset class offers qualified investors a way to diversify their portfolios. In fact, it is our view that the current investment climate offers an attractive opportunity for those seeking to capitalize on the macroeconomic recovery.