A $3tn Juggernaut: Can Private Equity Offer Outperformance?

Industry assets under management have now hit record levels. Alex Jones takes a look at the latest performance figures and assesses whether private equity can still offer outperformance.

In spite of sustained periods of economic upheaval, the private equity industry has grown significantly over recent years. As of December 2011 the total assets under management (AUM) of the private equity industry stood at $3tn for the first time, an increase of around 9% from 2010, with private equity funds holding just over $1tn in dry powder and over $2tn in unrealized portfolio value. While the amount of capital raised by private equity funds of all types has declined since 2008, the industry has seen growth. How is this explained and what does this mean?

The high level of unrealized portfolio value held by the industry is as a result of the prevalence of large deals made during the buyout 'boom period', coupled with the negative impact of the financial crisis. During 2004-2007 the rise of mega-sized funds and a propensity for large deals caused AUM to grow at its fastest rate, with assets expanding by 136%. Following the onset of the financial crisis in 2008, however, many of the assets purchased during this period remained unsold, with funds retaining investments for longer than originally intended due to unfavourable exit conditions.

Consequently, industry assets under management are likely to decline in the short term as these companies are sold, but as distributions filter back to investors capital will be fed back into private equity funds through new commitments, as LPs look to maintain their overall allocation levels.

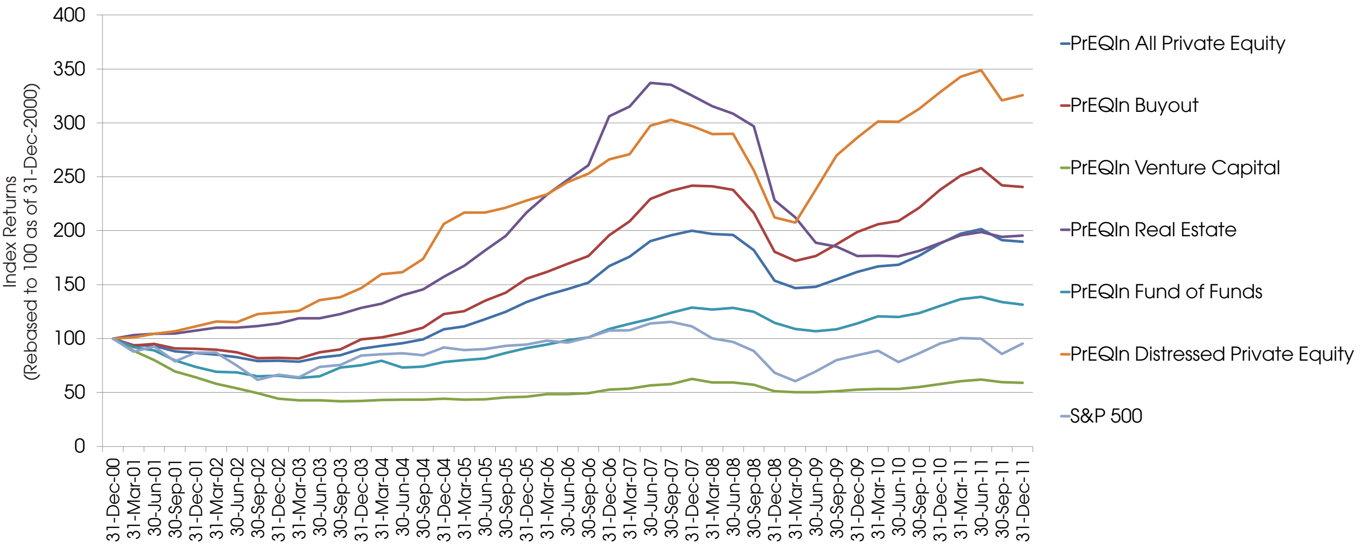
In general, investors remain committed to private equity (see page 9 of this month's Private Equity Spotlight for further details), but a primary concern for LPs is whether the asset class can still offer strong returns. This has led to two important questions – how have private equity funds fared, and can such investments provide returns to investors in times of economic uncertainty?

Private Equity Performance during Crisis Periods

Despite the challenges faced by private equity fund managers since 2008, industry performance has proved resilient. The onset of the financial downturn and the introduction of mark-to-market valuations in 2008 saw a steep fall in value in the short term; however, since that time the asset class as a whole has been in a state of recovery. The PrEQIn Quarterly Private Equity Index, shown in Fig. 1, tracks the quarterly movements in the performance of the private equity industry since December 2000, illustrating the downturn as well as the subsequent rebound of private equity fund returns.

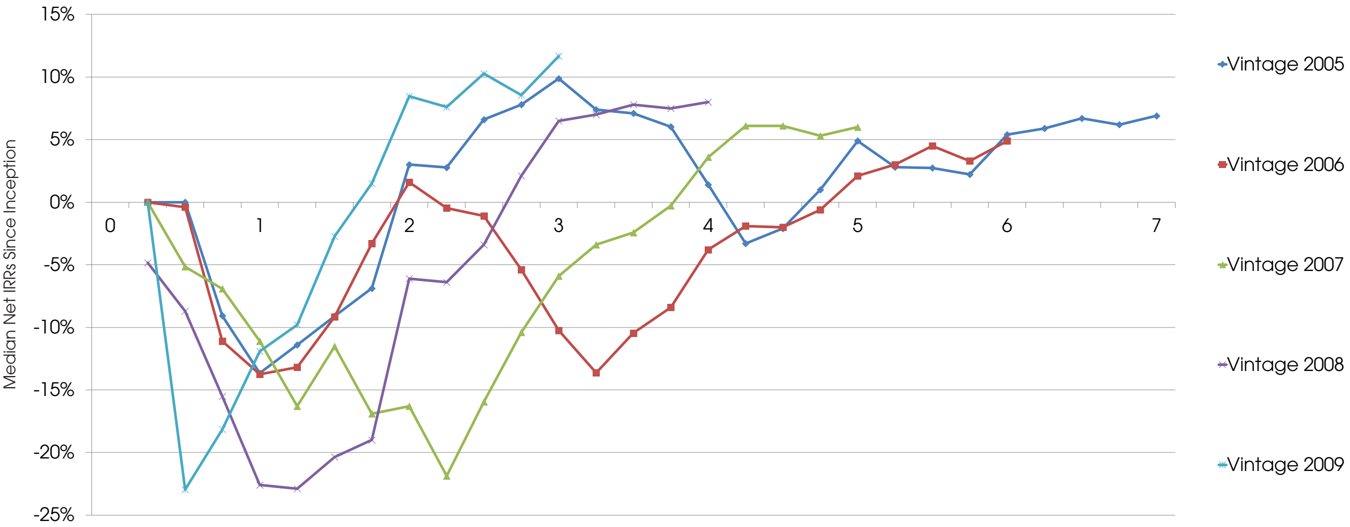
The immediate impact of the financial crisis can be seen in the "J-curves" of funds of vintages 2005-2006, shown in Fig. 2. Traditionally these curves are shaped as a "J", demonstrating how net IRR declines then subsequently improves as a fund advances through its life-cycle and value is added to investments. For these vintage years, however, the trajectories were effectively

Fig. 1: PrEQIn Index: All Strategies vs. S&P 500



Source: 2012 Preqin Private Equity Performance Monitor

Fig. 2: All Private Equity - J-Curve: Annual Median Net IRRs by Vintage Year



Source: 2012 Preqin Private Equity Performance Monitor

reversed and the IRR paths took on more of a "W" shape due to the widespread portfolio devaluations experienced at the end of 2008.

Since Q2 2009 the recovery of the industry is apparent, with the median net IRRs of private equity funds of all vintage years showing consistent improvement. Significantly, preliminary data reveals that vintage 2009 funds moved into positive IRR territory a full year earlier than most of the other vintage years. At the height of the global financial crisis there was an element of optimism in the private equity industry, with the knowledge that investments made during a recession often go on to generate strong returns for investors. It is early days for vintage 2009 funds, as these vehicles are early in their fund lives and still have many years to go before they liquidate. However, our preliminary data suggests that investors can be cautiously optimistic about the returns made for this vintage year.

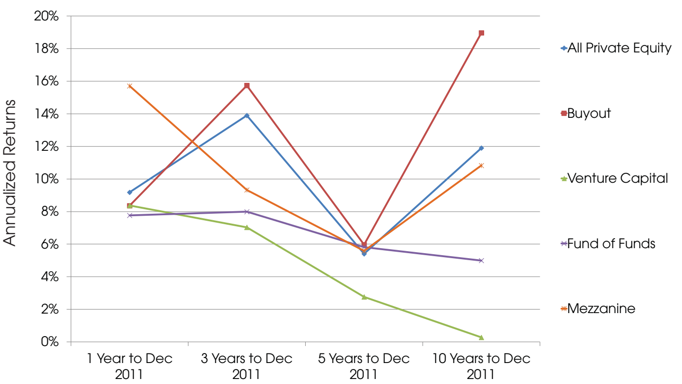
How Has Private Equity Performed over the Long Term?

Private equity is a long horizon investment type, with investors locked into funds for 10 years or longer. Consequently, while it can be interesting to look at short- and medium- term performance, it is most important to assess the returns of funds over a longer period of time.

Across all private equity fund types for the 10 years through 31st December 2011, the annualized returns stand at 11.9%, but the returns generated by the different private equity strategies vary significantly. For example, buyout funds report an annualized IRR of 19.0%, mezzanine 10.8%, fund of funds 5.0%, and venture capital 0.3%.

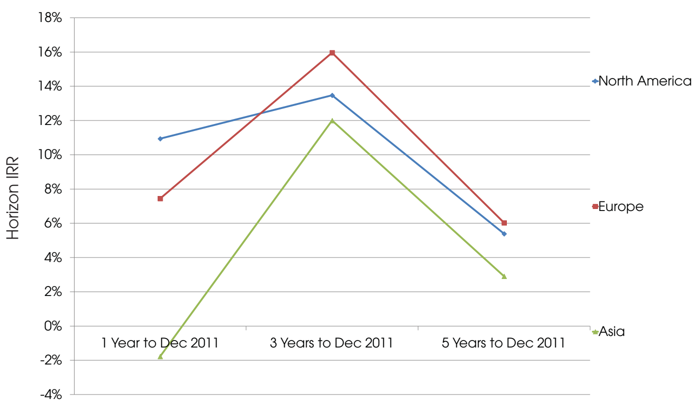
In addition, performance also varies significantly across different geographies. Fig. 3 looks at the returns earned by funds primarily investing in North America, Europe and Asia. While China and other Asian countries began to experience a slowdown in their economies in H2 2011, private equity returns across the region

Fig. 3: Private Equity Horizon IRRs by Fund Type as of 31 Dec 2011



Source: 2012 Preqin Private Equity Performance Monitor

Fig. 4: Horizon IRRs by Fund Primary Regional Focus as of 31 Dec 2011



Source: 2012 Preqin Private Equity Performance Monitor

Fig. 5: Top Five Consistent Performing Buyout Fund Managers

Firm	Location	No. of Funds with Ranking	No. of Funds in Top Quartile	No. of Funds in Second Quartile	Average Rank
Altor	Sweden	3	3	0	1.00
Lovell Minnick Partners	US	3	3	0	1.00
Southern Cross Group	Argentina	3	3	0	1.00
FIMI	Israel	4	3	1	1.25
Waterland	Netherlands	4	3	1	1.25

Source: 2012 Preqin Private Equity Performance Monitor

over the one-year period to December 2011 stood at -1.8%. The return for funds with a primary focus on investment in Europe stood at 7.4% over the same period, while North America-focused funds generated a return of 10.9%. The returns are higher over the three-year period across all three regions and lower over the five-year time frame.

What Is the Best Performing Private Equity Strategy?

The PrEQIn Distressed Private Equity Index demonstrates that this fund type is the top performing private equity strategy. The Index shows a steady quarterly increase from Q4 2000 until Q3 2007 and increased sharply from Q3 2009 after falls as a result of the financial crisis. In recent years managers have sought to take advantage of the relative abundance of distressed investment opportunities caused by the economic downturn.

The PrEQIn Buyout Index shows that buyout funds are the second top performers in the industry, standing at 240.7 as of 31st December 2011. Private real estate funds stand at 195.6. In contrast, the PrEQIn Venture Capital Index shows a steady decline from Q4 2000 until Q4 2003 caused by the technology crash in 2000, which resulted in large write-downs of portfolio valuations. Since this time, the Index has remained relatively flat, reaching a peak of 61.9 in Q2 2011.

Private Equity vs. Public Indices

A key component of private equity investment is the opportunity for strong capital growth. All private equity strategies, with the exception of venture capital, have outperformed Standard and Poor's free-float capitalization-weighted index of 500 US-based large cap stocks (S&P 500) since 31st December 2000, as shown in Fig. 1. Indeed, the PrEQIn All Private Equity Index has remained above the S&P 500 for all of the quarters following the rebasing, with the exception of Q2 2001 and Q1 2002. As of the latest data available (31st December 2011), the PrEQIn All Private Equity Index stood at 189.9 and the S&P 500 at 95.3.

Annualized horizon returns also show a similar pattern. Across the one-year period to 31st December 2011, private equity has a return of 9.2%, while the returns are 13.9% over three years and 5.4% across five years. Over the 10-year period, private equity returns stand at 11.9%. Returns for the public indices show that over the one-year horizon the S&P 500 is in the black, posting a return of 2.1%, but the MSCI Europe and Emerging Markets indices are both in the red. The three-year returns for the public indices are all in the black, whereas over five-years the MSCI Emerging Markets is in the black and the S&P 500 and MSCI Europe are returning -0.3% and -5.2% respectively. Across the 10-year horizon, the MSCI Emerging Markets generated 13.9%, with the S&P 500 returning 2.9%, and MSCI Europe 4.4%.

It should be noted, however, that any comparisons made between private equity and public markets should be viewed with caution. As the private equity asset class is illiquid and investors' capital is locked up over a long period of time, the horizon returns are not as relevant for private equity as they are for listed equity.

Identifying Top Performing Funds

While private equity investment can offer long-term rewards to investors, there is a significant spread between the performance of individual funds, with a particularly large gulf between the returns generated by the best and worst performing funds. As institutional investors look to construct their private equity portfolios and commit to funds that meet their requirements, the ability to identify, select and evaluate top performing funds is of paramount concern.

Despite the fact that past performance is not a guarantee of future success, there is clear evidence to suggest that managers of top-tier funds have continued to produce top-quartile returns with subsequent funds more often than other managers. While 15% of managers of bottom quartile funds subsequently improve and manage top quartile successor funds, many more do not and therefore despite trends there are no guarantees. Therefore, it is important to recognize that despite the importance of a fund manager's track record, each new opportunity should be judged on its own individual merits. Thirty-six percent of fund managers with a top quartile fund go on to manage a top quartile successor fund, and 66% outperform the median benchmark. In addition, 36% of bottom quartile managers remain in that quartile with their next offering, while 65% underperform the benchmark.

Consistent Performers

Identifying consistent performing managers is no easy task, particularly in an industry known for its lack of transparency. Despite improvements made in the level of disclosure across the private equity space, it remains a challenge for LPs and GPs to access the reliable, accurate and fully transparent data necessary to effectively benchmark funds. To help with this, all funds that Preqin holds performance data for are assigned a quartile ranking, with the exception of more recent vintages that do not yet show meaningful performance. These rankings are based upon the peer group of each vehicle, taking into account vintage, strategy and region focus. Both the multiple and IRR are used as key indicators and equal emphasis is placed on both metrics.

Fig. 5 lists the top five consistent performing buyout fund managers. A fund manager's average score is determined by awarding each top quartile fund a score of one, each second quartile fund a score of two, and so on. The list shows that the top three managers - Altor, Lovell Minnick Partners and Southern Cross Group - have all of their funds ranked in the top quartile and therefore have achieved the best possible score of 1.00. Israeli-based FIMI and Netherlands-based Waterland follow next, each with a score of 1.25.

Outlook

As private equity assets under management have increased over recent years, it is clear that the industry has weathered the negative impact of sustained economic uncertainty well. The 10-year median performance of private equity shows the potential for strong returns, while the PrEQIn Index demonstrates the returns generated by the asset class consistently beating the S&P 500. Despite this, our analysis also highlights the wide gulf between the performance of top and bottom quartile funds. Investors hoping to tap into the potential for outperformance are faced with the challenge of fund selection, and a result it is important for LPs constructing a portfolio to conduct in-depth research and assess track records in order to ensure that they commit to the best possible fund managers.

Data Source:

This article draws on data from the latest Preqin publication, the 2012 Preqin Private Equity Performance Monitor.

Now in its ninth edition, the latest Monitor provides in-depth analysis of private equity returns, tables of top performing funds and firms by strategy/type, net-to-LP returns for over 6,000 separate vehicles of all types and geographies, and more.

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