Understanding private equity's outperformance

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Many studies confirm that private equity investments have consistently outperformed public equity markets. A common prejudice is that this superior performance is attributable to the higher risk taken by private equity investors. Therefore, private equity is viewed as an unattractive asset class during difficult macroeconomic environments. This paper has investigates the hypothesis and find evidence that this view is not justified.

Private equity investments beat public equities and offer an attractive risk profile at the same time. This is proven correct especially in a challenging macroeconomic environment. Private equity's outperformance over public equities increases further while volatility still remains lower:

- Since 2000, private equity investments have outperformed the respective public equity indices by 5% in North America and 9% in Europe per annum
- In the aftermath of the burst of the internet bubble (Q2 2000 to Q1 2003), private equity investments outperformed public markets by 6% in North America and 20% in Europe on an annualized basis
- During the financial crisis from Q3 2007 to Q1 2009, private equity investments beat public market indices by 19% in both North America and Europe on an annualized basis

These results imply that private equity is a particularly attractive asset class in times of high economic uncertainty.

In order to explain these obvious discrepancies in performance and risk, one would have to look at the differences between the investment approach of a private equity investor and a public equity investor. There are three systematic advantages that are inherent to the private equity business model:

- The selection process is based on the operational performance of a company and in-depth information provided in a due diligence process ("legal insiders")
- The investors' long-term orientation enables sustainable value creation strategies beyond short-term results
- Corporate governance structures allow private equity investors to actively engage in a portfolio company's management and implement operational improvements

In particular, the ability to drive operational improvements in a company differentiate private equity investors from public equity investors as it enables them to actively engage in a company's management when the environment becomes difficult.

The required corporate governance structure is based on three major pillars:

- Controlling stakes and board representations that allow investors to be directly involved in the decision making process; every budget, every major strategic or operational decision is reviewed by the board, ensuring shareholder's full control
- Alignment of interests between owners and management by strongly incentivizing management through significant equity stakes; managers are requested to invest significant amounts into the companies they run but substantially improve their remuneration at an exit
- Regular reviews of management performance and a quick decision-making process to execute required changes; private equity investors have the resources and the capabilities to ensure continuous monitoring of operating management throughout the investment period

As the capability to execute operational improvements at a portfolio company's level differentiates successful private equity investors from their peers, investors increasingly focus on pure operational improvements in their value creation plan:

- Almost 75% of expected value creation is generated by direct operational improvements within portfolio companies.
  Revenue growth (38% of expected value creation): private equity investors focus on growth opportunities and provide financial and operational support for achieving sustainable, long-term growth.
  EBITDA margin improvement (37%): Private equity investors continuously look to improve the cost structures of their portfolio companies. Direct involvement in the operational management by the private equity investors is essential for driving these processes.
- Approximately 25% of expected value creation is to be derived from levers that are indirectly influenced by operational improvement measures:
  Multiple expansion (4%): Value creation through relative valuation differences can be driven by current market sentiments. But valuation multiples are also driven by the relative positioning of a company in its market. A clear, focused strategy driven by a long-term oriented private equity investor enables a company to achieve a superior positioning, commanding higher multiples at exit.
  Cash flow (21%): Value creation from cash flow is indirectly linked to the operating performance of a portfolio company. In private equity investments, cash flow is used to repay financial debt and decrease the leverage during the holding period of an

investment. Operational improvements can also aim at reducing working capital and capex spending without directly impacting the profit & loss statement.

INTRODUCTION

The comparison between investments in private and public equities has been a prevailing topic in many studies[1] since private equity has become a portion of most institutional asset managers' portfolios.

As the private equity business model is regarded to be heavily reliant on the state of the financial markets and the availability of credit, this topic has become even more interesting.

Do private equity investors maintain their superior performance in times of a challenging macroeconomic environment? And if so, what are the factors that enable private equity investors to weather even difficult times?

This research note will focus on the question of whether the private equity business model[2] is sustainable even in a challenging economic environment and what operational levers private equity investors use to maintain its superior performance. Key findings are as follows:

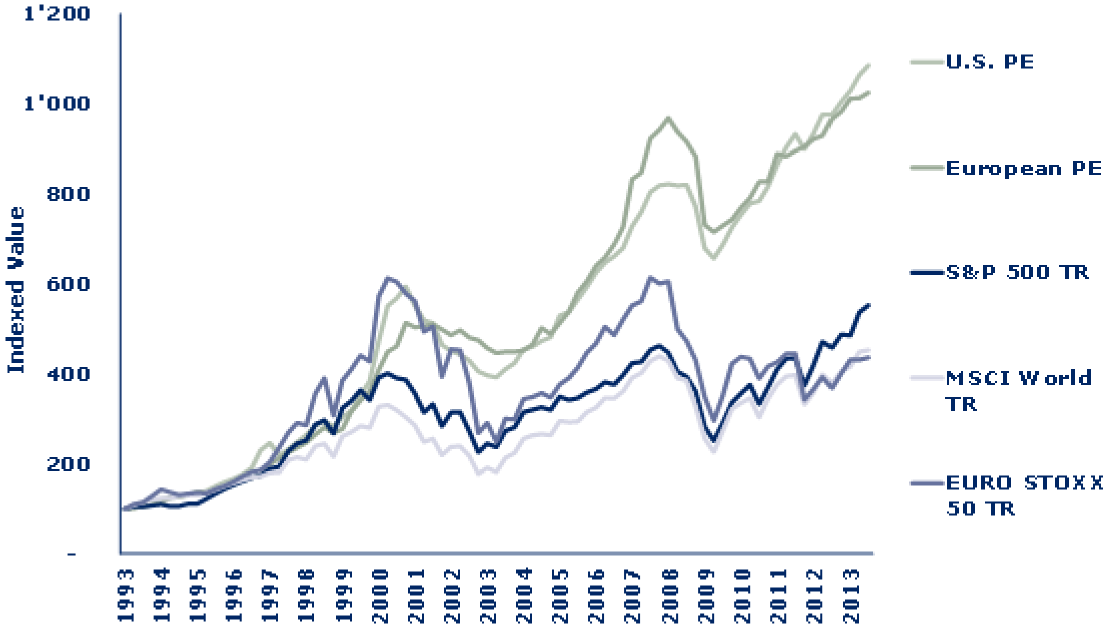
- Private equity markets beat public equity markets in terms of return and risk – especially in difficult economic times
- Systematic differences drive private equity's superior performance
- Operational improvements lead to superior value creation
- Levers for operational improvements require tight control and flexible decision-making processes

PRIVATE EQUITY BUYOUT MARKETS BEAT PUBLIC EQUITY MARKETS IN TERMS OF RETURN AND RISK

The outperformance of private equity has been looked at critically, by testing the data for different regions and time periods.

Figure 1: Performance of buyouts vs. public equities

Significant outperformance of buyout investments vs. public equity indices in Europe and North America between 1993 and 2013



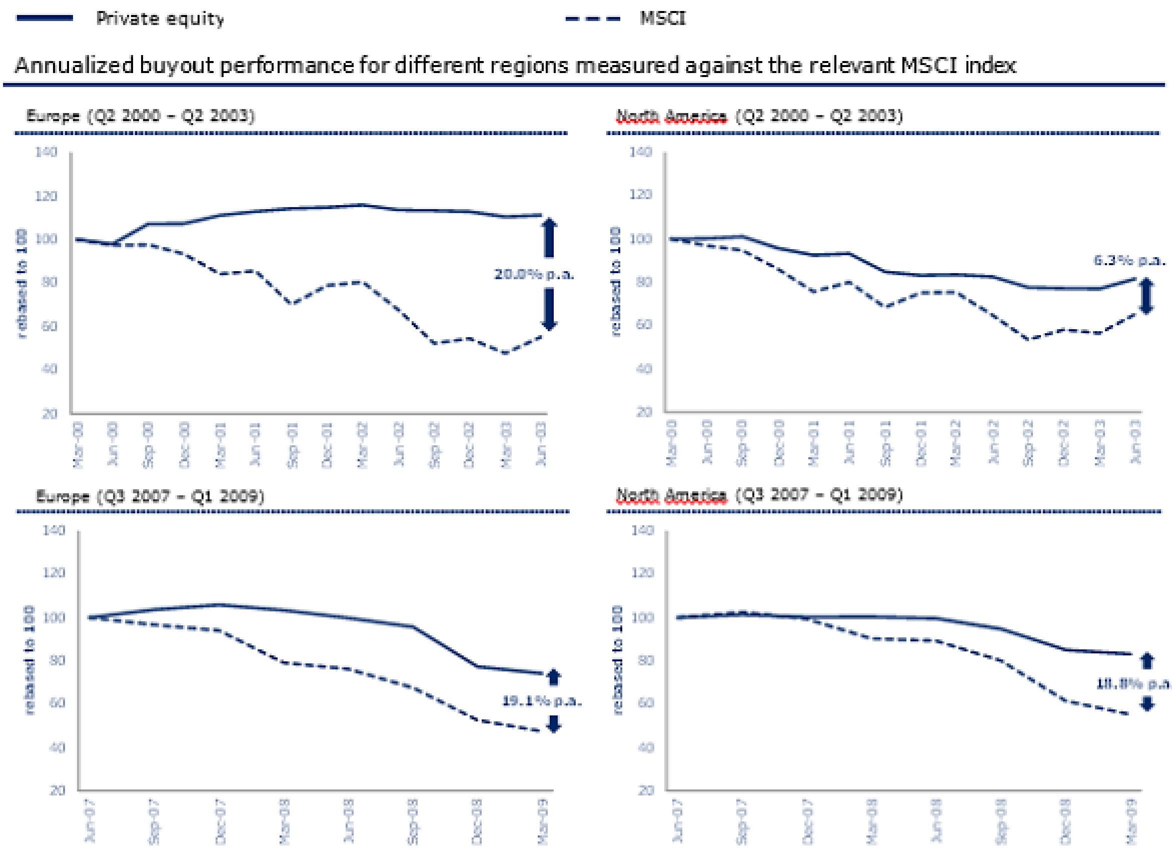
Sources: Bloomberg, Thomson Reuters (Cash flow summary report) 01.01.1993 – 30.06.2013, quarterly data in local currencies.

A common prejudice against private equity is that its superior performance comes with a significant risk exposure. Critics claim that high leverage levels, high pay-outs to shareholders and aggressive growth strategies impose an increased risk on the portfolio companies, as they would not be sufficiently flexible to cope with negative external developments that inevitably arise in difficult economic times.

The hypothesis has been tested in two ways. First, the performance of comparable markets was looked at during the past two significant downturns in the financial markets (Q2 2000 – Q2 2003 and Q3 2007 – Q1 2009).

Figure 2: Relative performance of buyouts in downturns

Outperformance of buyout investments increased during the past two downturns



Sources: Bloomberg (NDDUE15 Index in EUR, NDDUNA Index in USD), Thomson Reuters (Cash Flow Summary Report for WEU and NAM buyouts; Q2 2011)

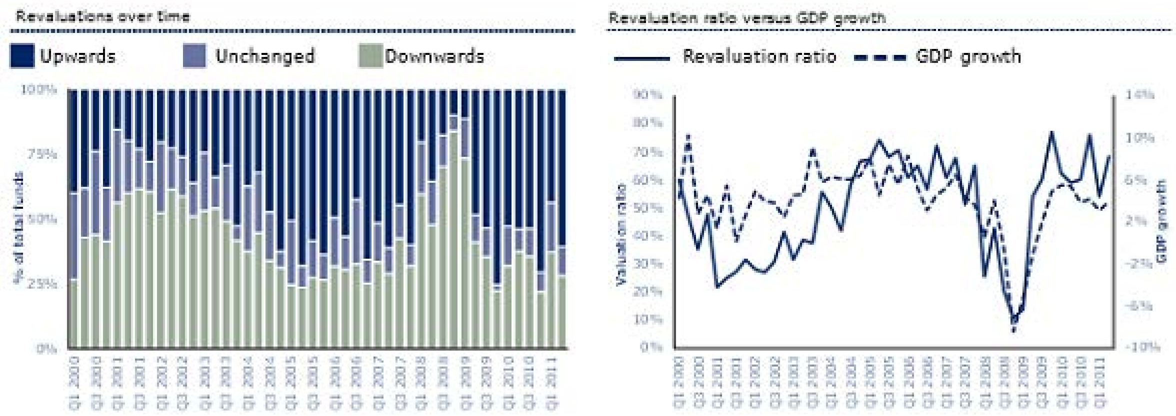
The result is contrary to common perception in that private equity investments showed an even higher outperformance during the two most recent crises. This implies that the private equity asset class has strong defensive capabilities and is a viable alternative for investors during uncertain economic environments.

Second, the volatility of both performance measures was examined by calculating their standard deviation to see whether the value of private equity investments was more volatile than a comparable investment in public equities.

Before calculating private equity volatility, one should however highlight an important characteristic of private equity returns. Quarterly returns to some extent depend on the returns of previous quarters – or as statisticians would say, they are subject to auto-correlation. Often so-called "stale pricing", i.e. reporting outdated asset prices, is used as an explanation for this effect. However, on average only 15% of funds in the sample were actually not revalued from one quarter to the next since 2000. This is illustrated on the left hand side of Exhibit 3. With the adoption of “fair value”-based accounting rules across the industry this percentage has even decreased in recent years.

Managers actually follow economic fundamentals when valuing their portfolios. The right hand side of Figure 3 shows the strong link between the fraction of positive revaluations and GDP growth. In contrast, it is a generally accepted principle in behavioral finance that public markets are often driven by market liquidity and investor sentiment and therefore actually tend to overshoot.

Figure 3: Private equity revaluations and GDP growth

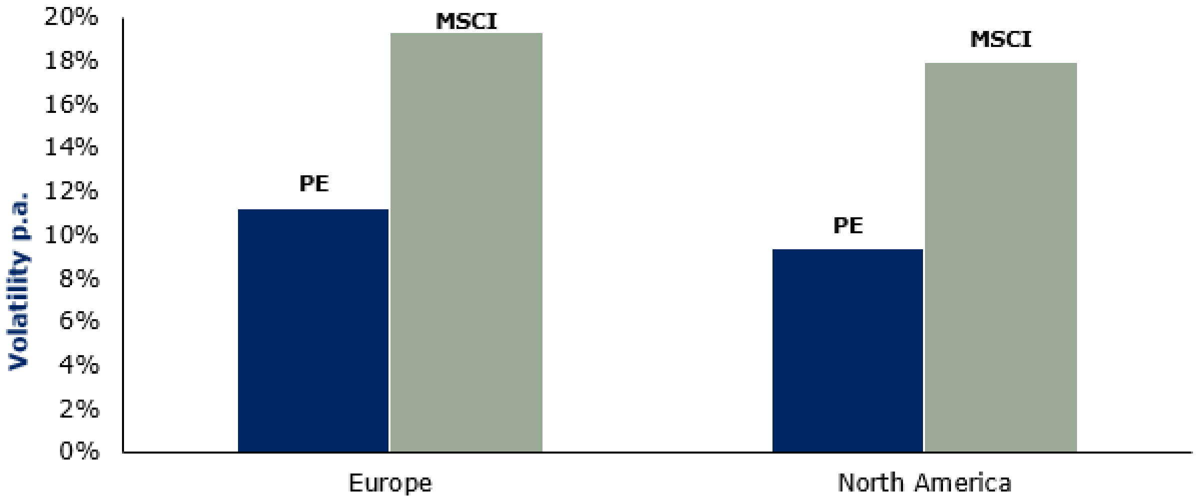


Sources: Revaluation activity: Partners Group primary buyout investments. GDP growth: Federal Reserve Bank of St. Louis

A simple calculation of the volatility using quarterly returns shows a clear advantage of private equity over public markets (see Figure 4), thus clearly showing the common notion of outdated, “stale” valuations in private markets as well as the belief of a higher risk is untrue.

Figure 4: Volatility of private equity investments vs. public equity indices

Private equity performance shows lower volatility than public equities



Sources: Bloomberg (NDDUE15 Index in EUR, NDDUNA Index in USD), Partners Group analysis based on Thomson Reuters data (Cash Flow Summary Report for Western Europe and North America buyouts; Q2 2011)

The analysis implies that superior performance by private equity investment programs is not a result of higher risk taking or irresponsible financial engineering: higher returns did not entail an increased risk of losses. These results trigger the obvious question: how are private equity investors able to generate sustainable outperformance without taking disproportional risk?

SYSTEMATIC DIFFERENCES DRIVE PRIVATE EQUITY'S SUPERIOR PERFORMANCE

Firstly, the selection of investment targets differs fundamentally. While public equity investors rely to a high degree on pre-selected equities based on the indices they are measured against, private equity investors individually select companies with compelling business models.

When assessing a business model private equity investors look for criteria such as market leadership in terms of market position and technology, high entry barriers for new competitors, above-average profitability, high cash conversion rates and top-notch management. Stability and predictability of future cash flows and revenues also rank high as criteria for qualifying a company as a suitable private equity investment. Business models that tick all or at least some of the boxes are obviously more likely to outperform their peers.

This approach requires successful private equity investors to build their franchise on a proprietary and substantial deal flow. This allows private equity investors to be extremely selective and to choose from a wide variety of different opportunities in various geographic regions.

In addition, intensive "due diligence" that is often conducted over a period of several months helps investors to examine all different aspects of a company's operating performance. In most cases, private equity investors have access to considerably more information on their targets than public equity investors as private transactions are subject to fewer confidentiality issues ("legal insiders").

In addition to a more focused selection process, private equity investors have the means and the levers to maintain or even expand a portfolio company's performance through operational improvements. Private equity investors take an active role in developing a portfolio company and are involved in a company's operating business.

LEVERS FOR OPERATIONAL IMPROVEMENTS

Controlling stake with board representation

In difficult times when the macro environment becomes challenging, operational measures to stabilize a company's performance have to be taken quickly. The corporate governance structure of a private equity portfolio company allows the prompt flow of information and subsequent responses by the owner to ensure decisive actions.

An important element is the private equity investor's board representation, allowing the investor to influence the decision-making process in a company directly. Research[3] has shown that a board of directors operates more effectively in a private equity portfolio company as opposed to the board of public company, especially in terms of strategic leadership and performance management.

Alignment of interests between owner and management

Incentive structures put in place by private equity investors for the management of their portfolio companies ensure that management teams strike the right balance between risk and reward as any negative developments will immediately impact the management's own wealth position given that in most cases they have invested significant equity into the company.

As the investment horizon for private equity investors is typically five to seven years, management teams tend to engage in long-term strategies that deliver sustainable growth and earnings improvements. Public companies that are assessed by the market each quarter find it hard to convince investors of the long-term merit of their actions and therefore often focus on short-term successes and do not necessarily make long-term investment decisions which would enhance the positioning of the company in the long run and therefore increase shareholder value.

The exit also provides a direct gauge of a management's success. Success is measured in monetary units, for the investors just as much as for management itself. There are no "golden parachutes" for management members that don't deliver on their targets. Compensation for private equity investors and their clients is only based on actual performance as they will only be rewarded should they have achieved their risk-adequate return.

Regular reviews of the management team's performance and composition

Management is one of the most important success factors if not the most important success factor for a company's performance. But different situations require different management approaches. Only a small number of managers are able to deliver successful growth strategies and are then able to implement a radical restructuring program in the same company.

Whenever a management team fails to deliver on its goals, the owner of the company has to review and assess the actions taken by management. A swift reaction to underperformance then becomes key. The private equity corporate governance model enables the owners of a company to replace or to complement a management team without going through the lengthy processes and political disagreements which can often be seen in public companies.

OPERATIONAL IMPROVEMENTS KEY

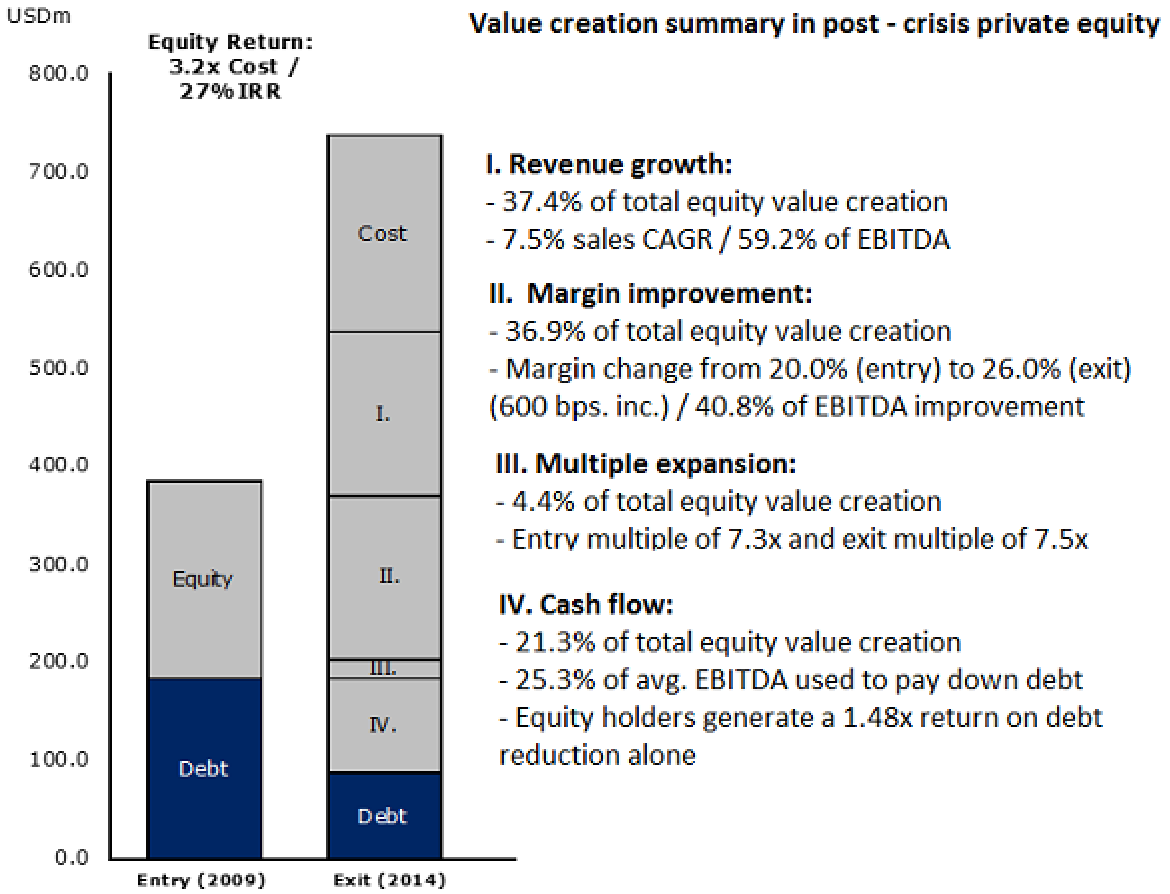
Successful private equity investors today take advantage of these structural advantages and focus on operational improvements as the main source for value creation.

Value creation in private equity investments is usually measured using four levers: revenue growth, margin improvement, multiple expansion and cash flow generation.

Figure 6: Projected value creation in private equity investments

Operational improvement measures are key for private equity value creation

Average expected value creation of investment opportunities (2009 – 2011)



Source: Partners Group data. The values represent the median value of the respective data in all direct investments reviewed by Partners Group between 2009 and 2011 YTD. The data was normalised to calculate an average investment proposal with a holding period of five years.

Revenue growth and EBITDA margin improvements represent direct operational improvements in a company and are viewed as the most important levers for creating value for investors: more than 75% of expected value creation is attributable to these purely operational drivers.

Debt repayment and multiple expansion are also indirectly influenced by operational measures and can be optimized by operational excellence, but are often regarded as levers for “financial engineering”.

Revenue growth

Private equity investors look for sustainable organic growth strategies and actively support them. Business models that have been proven successful can be rolled out to different regions or countries, brands that have been established can be expanded to related product categories. Private equity owners are willing to put up the capital, even if this means making short-term investments that are beyond a company's cash flow generation capabilities but aimed at achieving long-term benefits.

On top of organic growth, strategies to build dominant market players by using a platform company and growing it with selected add-on acquisitions are valid strategies that often require the financial backing of the owner.

Private equity investors do not only have the financial means and the willingness to deploy capital in long-term oriented strategies through long-term contracts with their clients, they also have the know-how to actively support a company in managing its growth. By replicating the success of past investments and applying the learning of previous experiences, they add tangible value to their portfolio companies.

EBITDA margin improvement

The change of ownership is often seen as the signal for change within a company. Management is given new perspectives and is empowered to "think the unthinkable" and to execute on initiatives that might have been considered long ago but lacked the backing of the board or the owners. These initiatives can lead to the introduction of new, more efficient organizational structures or other long-term oriented cost-saving measures that were not considered due to the short-term orientation of incentive structures.

Private equity investors often start their investment period in a portfolio company by launching a "100-day program" to identify all initiatives that could drive the company. These programs aim at reviewing a company's strategy and all major cost positions. In most cases, these measures had been defined beforehand by members of management, but were never acted upon as the company lacked the need and the drive to transform itself.

These changes become most apparent in cases where a company is spun off from a larger conglomerate and is owned by a private equity investor for the first time ("primary buy-out"). As larger corporations often lack the ability to impose strict cost management down to the smaller units or fail to invest in rationalization projects that pay off in the long run, these companies are promising opportunities for private equity investors.

Multiple expansion

Multiple expansion is often viewed as a pure financial lever to create value. Sometimes it is regarded as "market timing" and mostly as uncontrollable by private equity investors.

Aside from external factors that undoubtedly affect the valuation of a company in relative terms, there are ways to command premiums dependent on the positioning of the company in its market.

Companies with a compelling market position that could be expressed as either a clear leader in terms of market share, in terms of cost position or in terms of technology justify higher valuations compared to their peers. So any strategy aimed at achieving these goals will eventually drive the exit multiple for a transaction. These strategies could include the divestment of non-core subsidiaries that do not hold market leading positions, the forging of a market leader by the combination of two businesses in a market, or increased investments in innovation and technology. In any case, the strategy needs to be consistent and followed over a longer period of time as it needs time to unfold and show measurable results.

Private equity ownership ensures that due to the long-term investment horizon, management teams receive the backing to implement strategies that actually are aimed at creating sustainable shareholder value. This can be seen in contrast to boards of public companies that rather focus on short-term success as quarterly reporting cycles put strong pressure on managers to deliver rapid, but often short-lived results. In addition, strategies in public companies depend much more on actual management and are therefore subject to more frequent changes.

Cash flow

While debt repayment is often seen as a non-operational lever to create value for private equity investors, there are many ways to create value through operational improvements exclusively aimed at cash flow.

In the early days of private equity, the concept of leveraging a company and re-engineering the balance sheet was often enough aimed at creating value: the existing cash flows repaid the debt assumed in the transaction, increasing the equity value for the investor. This concept is still at the core of any private equity transaction but it has been complemented by a strong focus on increasing cash flows by actively managing cash generation.

Working capital is thereby the center of attention as this lever is often neglected by common management approaches. Especially large corporations barely include working capital in their set of key performance indicators ("KPIs") to measure performance and incentivize management. Initiatives such as the introduction of "lean management" principles or the re-design of work flows can improve relative KPIs by 20-30%. Sometimes even simple measures such as the reduction of storage space ("abolition of abundance") forces staff in companies to re-think how inventories are managed. Clearly, working capital management does not impact any profitability KPIs, but helps to accelerate a company's deleveraging.

Stringent capital expenditure ("capex") management is the second most important factor for increasing cash flows without directly affecting the profitability of a company. As capex is often linked to growth aspirations of a company, it has to be viewed in the context of the overall strategy of a company. Especially in difficult times, it becomes particularly important to quickly review any budget for capital expenditures as spending can immediately be cut without directly impacting ongoing business operations ("quick win").

CONCLUSION

Returns from private equity investments have been very significant in the past. This research indicates that these superior returns are systematic and are deeply rooted in the business model of private equity investors. Private equity investors use their influence on the corporate governance in their portfolio companies to align interests between managers and owners and to actively manage opportunities and risks. This is especially shown in difficult economic environments which force companies to act quickly and decisively to adapt to and manage challenges. In these difficult times, in particular, private equity investors have proven that they possess the skills and tools to position portfolio companies successfully.

ENDNOTES

1. Among others: Boston Consulting Group, "The Advantage of Persistence", 2008. Ernst & Young, "How do private equity investors create value?", 2007.

2. In this research, the term private equity refers to buyout investments.

3. McKinsey Quarterly, "The voice of experience: Public versus private equity", 2009.

DISCLAIMER

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