ATLAS
CAPITAL ADVISORS INC

ALTERNATIVE INVESTMENTS REALITY CHECK PART 3

PRIVATE EQUITY INVESTING

ATLAS CAPITAL ADVISORS

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What's Discussed

This paper on private equity investing is the third of a series on alternative investments.[1] The alternatives industry is making a concerted effort to gather more assets from individuals due to declining appetite from institutional investors. The purpose of the series is to help individual investors recognize the drawbacks of alternative investments before investing in them. If you are considering private equity for your portfolio, you should be aware of the following issues:

1. Returns as reported by private equity firms can be misleading.
2. Even as reported, private equity returns have not been better than the outcomes of similar public equity portfolios in the past decade.
3. The high fee burden, particularly for funds of funds, detracts from private equity outcomes.
4. There are severe liquidity strains in the private equity ecosystem – a rapidly growing number of private equity-backed companies are facing a shrinking exit window.
5. Success in private equity investing requires organizational capabilities and access that, for the most part, are not available to individuals or their advisors.

[1] See our recent commentaries about alternative investments: https://atlasca.com/7-reasons-why-individual-investors-should-avoid-hedge-funds/ and https://atlasca.com/alternative-investments-reality-check-part-2-venture-capital-investing-good-ideas-disappointing-returns/

Why Private Equity?

The lasting appeal of private equity investing is understandable.
The apparent advantages include:

1. *A much greater opportunity set.* Of the more than 20,000 US companies with over $100 million in revenue, only 2700 (13%) are listed on the stock market.
2. *Greater influence.* A private equity investor in a company typically has the means to improve operations and optimize capital structures to boost performance.
3. *High historical returns.* In the earlier years of private equity, the average investment returns were meaningfully above public equity returns, and allocators skilled at selecting managers did even better. High private equity returns helped generate exemplary investment outcomes for the early adopters of alternative investing.

Returns as Reported Can Be Misleading

Private equity performance can be challenging to decipher. Reported investment results are based on the Internal Rate of Return (IRR), a deeply flawed metric. IRRs are often misleading and typically exaggerate true performance.

One key source of distortion has been the increased use of subscription lines of credit (SLCs) to manipulate IRRs. These lines permit the fund manager to make investments with borrowed money, thus delaying capital calls. By reducing the time between the capital call and the exit, the manager increases the IRR. A 2019 paper[2] estimated that the use of SLCs improved reported IRRs by 6% per year (though most other estimates are smaller). Twenty years ago, a private equity fund which achieved a multiple of invested capital (MOIC) of 1.6 (the long-term average) would typically report an IRR of around 10%. The same achievement today, a 1.6x MOIC outcome, will lead to a reported IRR of 15% or more.

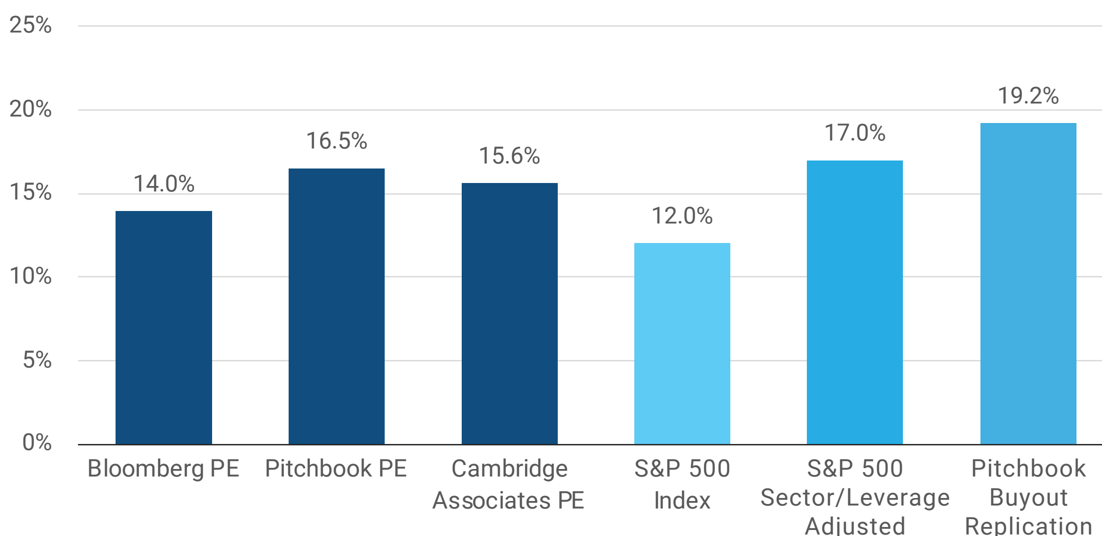
Company valuations, as set by the private equity firms, often overstate performance as well. Since at present **private equity firms are largely unable to sell their mature holdings at the valuations being reported**, reported performance is higher than what it would be at fair market value.

Even as Reported, Returns Do Not Look Better Than Public Equity

On the surface, it appears that private equity returns have exceeded public stock market indices. However, private equity holdings have different sector allocations, leverage, risk, and market capitalization than public equity indices. Most studies of private equity performance which make appropriate adjustments for these differences have found that private equity firms, on average, have generated net of fee performance lower than public market equivalents.

[2] https://www.kenaninstitute.unc.edu/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance_07192019.pdf

The chart below shows the ten-year annualized return through December 2023 for three private equity indices and three public market benchmarks.[3] The three private equity indices show annual returns in the range of 14.0% to 16.5%. An investment in S&P 500 sector indices with the same sector weights and leverage as private equity would have returned 17%. PitchBook recently released a fascinating and valuable study[4] with a methodology to replicate private equity outcomes in public equity. If one chose stocks systematically based on the factors which are typical of take-private transactions (small, underperforming companies with reasonable valuations and cash flow) and adjust the leverage to match private equity, the ten-year performance would have been 19.2% per year.



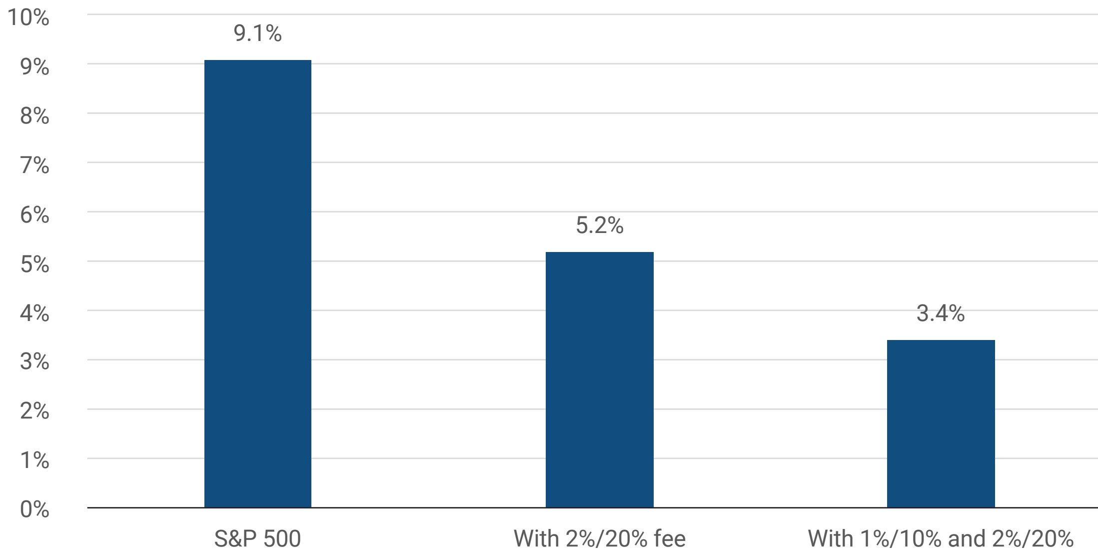
Manager Fees Impact Performance

The fees paid to private equity managers are a significant obstacle to achieving attractive returns. Private equity firms typically charge a 2% management fee plus a carried interest of 20% of investment returns.

Often an individual investor in private equity will invest via a “fund of funds” vehicle. Relative to selecting managers one at a time, a fund of funds can provide better diversification across managers and vintage years. The drawback is that the manager of the fund of funds will charge their own fees on top of the fees already being collected by the underlying private equity managers. These fees can be as high as 1%/10%. The chart illustrates how the return of the S&P 500 since 1997 would have been impacted if 2%/20% fees were applied, and if both 1%/10% and 2%/20% were applied. **An investor in the S&P 500 who paid both layers of fees would have paid away over 60% of their investment return in fees.**

[3] Sources: Pitchbook, Cambridge Associates, Bloomberg.

[4] PitchBook: “Taking the Private Out of Private Equity,” Andrew Akers, April 18, 2024.



Private equity funds raised between 2000 and 2019 who report their performance to Preqin invested $8 trillion of capital commitments. To date, the carried interest paid on the invested funds exceeds $1 trillion.[5] In contrast, the fees earned by Vanguard on its $8 trillion under management are just $7 billion per year. One would not begrudge the lucrative compensation of private equity managers if their clients were also thriving. But are they? The long-term history of investment outcomes of college and university endowments shows, on average, no benefit (and most likely a cost) from the increased use of alternative assets.[6]

Private Equity Exits Scarce

There is an escalating mismatch between the money which has gone into private equity and the money coming back out, which has become a source of strain for both private equity firms and their investors.

The chart below shows the growth of US private equity assets.[7] Growth has been significant – the $3.1 trillion invested in private equity at the end of 2023 is more than four times the amount which was invested in 2006. The $3.1 trillion includes $2.1 trillion invested in companies and another $960 million of "dry powder" – capital committed to private equity which has not yet been deployed. The amount in private equity is meaningful relative to public equity – the combined value of the companies in the Russell 2000 small cap index is $2.95 trillion, a bit less than the $3.1 trillion in private equity.

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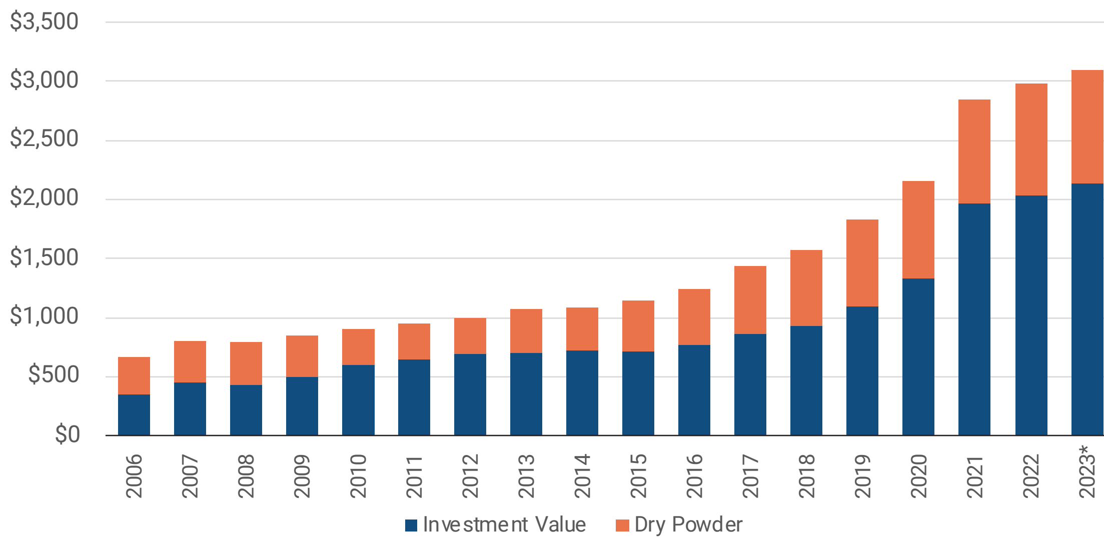
5 Source: "The Trillion Dollar Bonus of Private Capital Fund Managers," Ludovic Phalippou, University of Oxford, June 2024.

6 See https://atlasca.com/have-alternative-investments-helped-investment-outcomes/

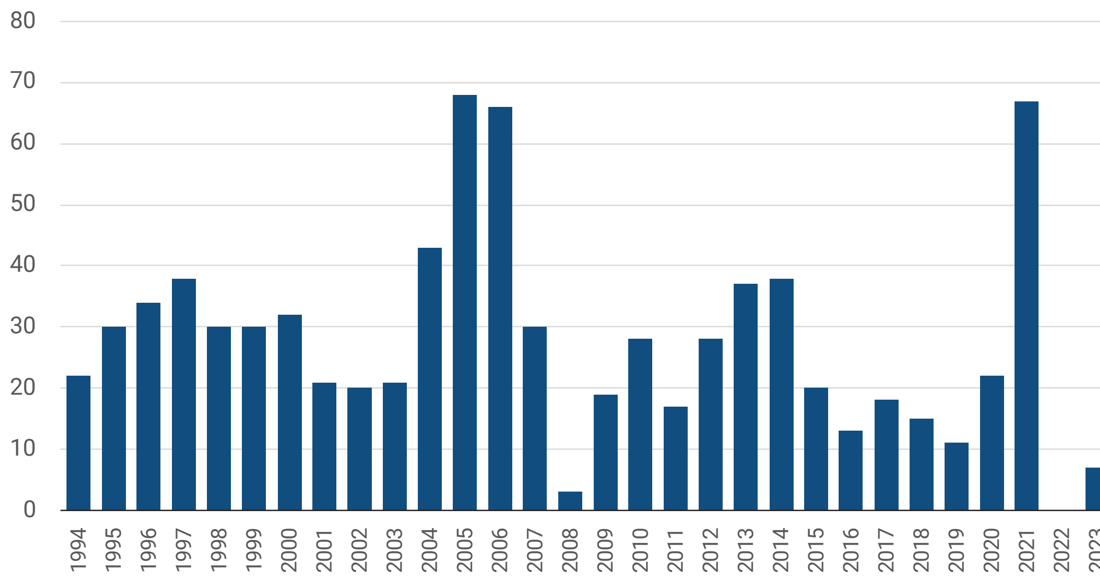
7 Source: Pitchbook.



For each private equity portfolio company, the goal is to reach a successful "exit," when the value built by the company is realized through an initial public offering (IPO) or a sale to a strategic or financial buyer, allowing capital to be distributed back to investors. The number of successful exits and value of distributions has shrunk meaningfully in the past two years.

As the chart below indicates,[8] IPO activity tends to be aligned with the stock market, with surges in stock market prices coinciding with surges in the number of IPOs. But the nice rebound in stock prices since late 2022 has not yet led to a corresponding rebound in IPOs of companies backed by private equity. The years 2022 – 2023 had the lowest number of buyout-backed IPOs in a two-year period since 1981 – 1982.

[8] Source: Initial Public Offerings: VC-backed IPO Statistics Through 2023, Jay R. Ritter, University of Florida.



It is much more common for companies backed by private equity to be sold to a strategic or financial buyer than to go public. But this type of exit has also been impaired, in part because the rise in interest rates has impacted financing costs. There are about 20,000 US companies backed by private equity, with 500 – 1000 added every quarter, yet there were only about 1000 exits of any kind in 2023.

In 2023, the proportion of private equity investments which was distributed back to investors fell below 9%, the lowest "distribution yield" since the Global Financial Crisis in 2009.[9] The long-term average yield has been around 30%. If exits are hard to obtain now, when the economy is strong and the valuations of public stocks are surging, what will become of the exit environment if conditions worsen? Sluggish distributions are leaving private equity investors with less capital available for new commitments and are forcing some investors to sell off their private equity holdings at a discount in the secondary market.

Who Should Invest in Private Equity?

There is significant dispersion in outcomes from private equity investing. According to JP Morgan, the performance of the top quartile of global private equity funds over the past decade exceeded the performance of the bottom quartile by more than 20% per year.[10] Investors with the best chance to benefit from private equity funds are institutions that have experienced specialists to identify the best funds and are perceived as being a desirable limited partner.

[9] Source: Pitchbook-NVCA Venture Monitor Summary. Average distribution yield has been 18%.

[10] Source: JP Morgan Guide to Alternatives: https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-alternatives/

Large, sophisticated institutional investors such as the large university endowment funds have had the means to participate successfully as private equity investors. Such an investor will have direct access to the manager, visit the manager's premises frequently, and spend many months undertaking an in-depth analysis of the people, investment strategy, prior performance, and business operations of a private equity manager before making a choice to invest. If your private equity manager selection process is done with this exceptional level of resources, access, and diligence, you might have reason to participate. Otherwise, there is a good chance of ending up with an average private equity fund portfolio or worse, with the drawbacks discussed here.

Summary

David Swenson, the masterful Chief Investment Officer of the Yale University endowment once said: "in the absence of truly superior fund-selection skills (or extraordinary luck), investors should stay far, far away from private equity investments."[11] Individual investors have nothing like Yale's experience, access or resources for screening private equity managers, and should not attempt to do so. Instead, Mr. Swenson argued that for individual investors the emphasis should be on well-constructed portfolios of liquid asset classes at the lowest possible implementation cost. We support this approach wholeheartedly. As discussed in this paper, the average outcomes obtained by private equity investors are disappointing, and individuals are more likely to succeed as investors if they avoid the category altogether.

[11] The Economist, "Bain or Blessing", Jan 28, 2012.

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