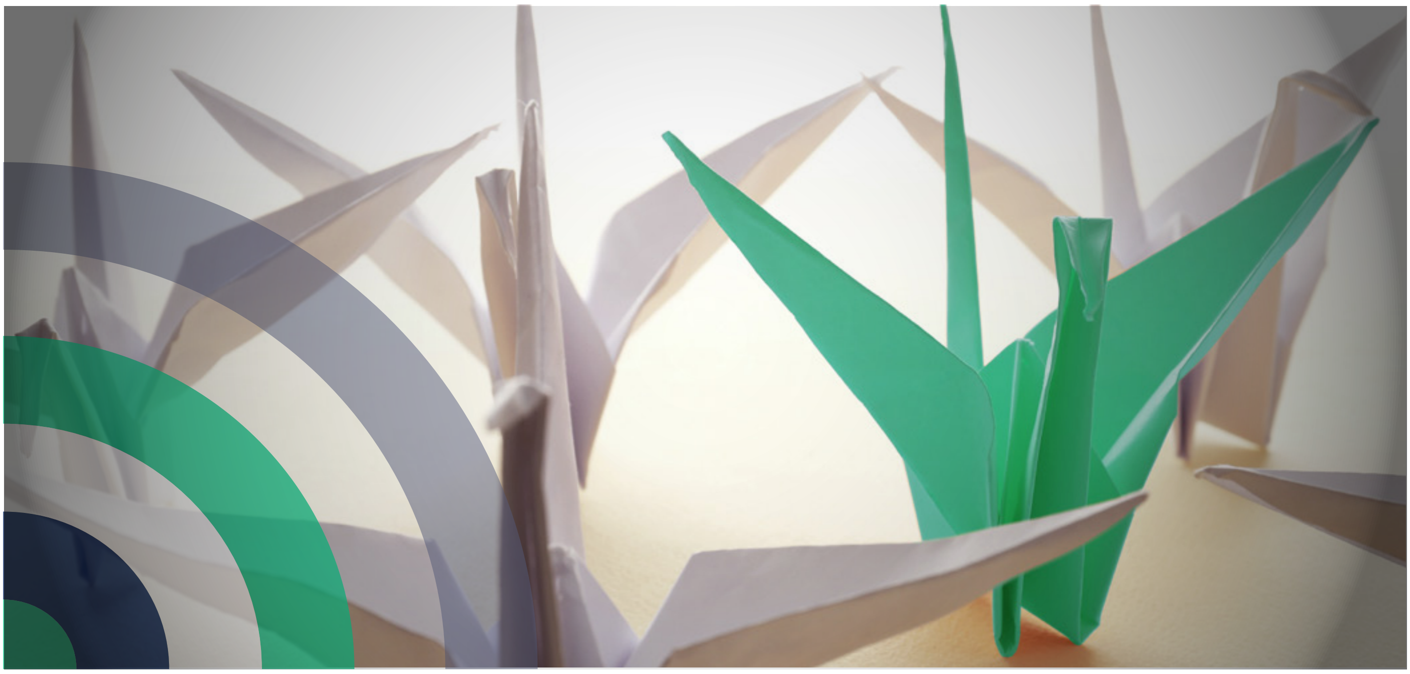
SuperReturn US

SuperReview:

FINDING ALPHA
US PRIVATE CAPITAL IN 2016



WHAT IS PRIVATE EQUITY'S UNIQUE CONTRIBUTION TO COMPANIES COMPARED TO OTHER ASSET CLASSES?

As a private equity investor, the single most important thing is to demand risk-adjusted net returns that exceed what is available from public equities. Fortunately for the industry, academic research concluded that the asset class has a track record of delivering these returns, which are known as "alpha".

This might not be surprising. These days, business school graduates are well drilled in the theory of the leveraged buyout (LBO), which, conventionally, describes the benefits of the alignment of incentives between managers and shareholders, the discipline of debt, the benefits of tax shields and, finally, the opportunity to apply operational leverage. All of which can combine to enhance the company in a way that creditors and minority shareholders can be less well equipped to achieve, potentially resulting in financial outperformance .

Now here's what might be surprising. In a recent study, we found evidence that private equity backing has historically generated enhanced company growth, as measured by excess sales growth versus publicly-listed comparables. Furthermore, not only did the deals in our historical sample grow sales significantly more than their publicly-listed peers, but this was the key driver of alpha .

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Textbooks on corporate finance do not make such a strong prediction. On the contrary, the LBO model has been criticized by some for potentially encouraging restructuring and downsizing, and this criticism suggests a limit to the extent that private equity can contribute to companies while servicing shareholders. Our study, however, suggests that those fears are potentially unfounded, and that private equity as an asset class has a significant historical track record in stimulating growth in companies. In fact, this observation is not without precedent, and there is academic research that private equity backing has led to an increase in long-term entrepreneurial investments, as measured by patent activity .

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The very fact that portfolio companies are unquoted means that they are not at risk of takeover, freeing managers to focus on longer-term objectives, rather than prioritizing short-term profits in order to defend the stock price[7].

All of which confirms what some industry experts have maintained all along: lock-up encourages general partners to circumvent the short-termism of capital markets. The very fact that portfolio companies are unquoted means that they are not at risk of takeover, freeing managers to focus on longer-term objectives, rather than prioritizing short-term profits in order to defend the stock price . In this way, the asset class may overcome “managerial myopia” by virtue of being private, while the alignment of incentives from the fund partnership structure supports the discipline of management, creating the optimal conditions for long-term firm growth. If this is true, as the academic research suggests, this would be a unique contribution not only to companies, but to society overall.

But private equity is not a silver bullet. For example, we have found evidence that mature funds which meet their carry threshold can offer greater incremental performance (net of fees), when compared to funds that have not entered carry . On the one hand, this demonstrates how carry can incentivize value creation, but it also highlights the risks facing limited partners if the fund vehicle fails to cross the carry hurdle. This demonstrates, once again, the importance of manager selection, a process which ensures that capital is deployed with general partners that truly contribute to their portfolio companies, and in doing so generate alpha for their limited partners.

[1] Harris, R.S. et al. (2014), “Private Equity Performance What Do We Know?”, Journal of Finance 69.

[2]Jensen, M.C. (1989), “Eclipse of the Public Corporation”, Harvard Business Review.

[3] Acharya, V. et al. (2007) “Corporate Governance and Value Creation: Evidence from Private Equity”, Review of Financial Studies 26.

[4] Pantheon InFocus publication, “Value Creation and the Business Cycle”. This is available at www.pantheon.com, and includes a full description of the sample, method and results of the study.

[5] In unreported results we found that the sales growth observed in our private equity sample was not driven by deals that experienced inorganic growth, and when we removed all deals associated with an M&A event during the holding period, the results looked similar.

[6] Amess, K. et al. (2015), “The Impact of Private Equity on Firms’ Innovation Activity”, Dusseldorf Institute for Competition Economics, Discussion Paper no. 184.

[7] Stein, J.C. (1988), “Takeover Threats and Managerial Myopia”, Journal of Political Economy 96. Note that a hostile takeover can destroy shareholder value if the raiders undervalue the firm due to asymmetric information.

[8] Pantheon InFocus publication, “Private Equity Performance: Carried Interest and the Persistence of Quartile Rankings”. This is available at www.pantheon.com, and includes a full description of the sample, method and results of the study.

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