PANTHEON

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WHAT DO INVESTORS NEED TO KNOW ABOUT **PRIVATE EQUITY INVESTING?**

Research Team

Key takeaways

1 Private equity has historically outperformed public equities, with the Cambridge Associates Private Equity benchmark producing an excess return of +5.6%[1] per annum compared to the MSCI World Index since 2008.

2 Private equity's long-term investment horizon, coupled with direct control through which managers can bring operational skill to bear, mean that investment managers can be afforded the time to effectively execute value-add theses without being burdened by daily mark-to-market volatility.

3 Diversification of investments across strategy, vintage year, sector, stage and geography is key to building a successful private equity program.

4 Manager selection is also important for investors to consider, due to the wide dispersion in private equity manager performance.

Why Private Equity?

The private equity (PE) industry has come a long way since the 1980s, which is considered by many as the decade when PE as we know it today evolved into being. Back in 1980, there were only 28 PE firms across buyouts, growth equity and venture capital[2]. Fast forward to 2021, there were more than 9,200 firms and 1,600[2] PE funds in the US alone. Globally, PE assets under management (AUM) have risen from $581 billion as recently as 2000 to $4.2 trillion[3] by the end of 2021, representing 2.3% of all investable assets[4]. Preqin's latest forecast indicates that AUM could rise to $7.6 trillion by 2027.

At their core, PE investments involve the purchase of private companies (or the taking private of public companies) by professional investment managers, who are known as General Partners (GP).

These investments are typically funded by institutional investors – and, increasingly, qualified individuals – who commit capital to GPs' funds and are known as Limited Partners (LP). Acquired companies are typically held for around five years before the GP executes an exit strategy, which could be in the form of selling to another GP or strategic buyer, or a public listing.

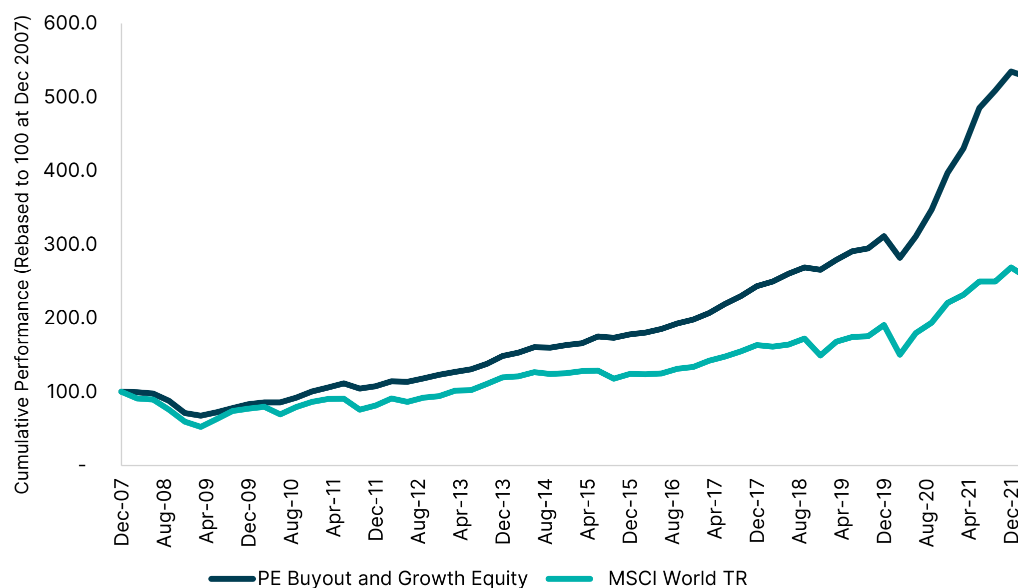
Investors are attracted to PE primarily because of the return potential. PE-backed businesses often benefit from having access to operational expertise, ranging from management consultants to ex-CEOs acting as advisors. The long-term investment horizon, coupled with direct control through which managers can bring operational skill to bear, mean that GPs can be afforded the time to effectively execute their value-add theses without being

burdened by mark-to-market volatility, or the pressure to hit short-term profitability targets. PE becomes even more compelling when considering the exceptionally large pool of potential candidates: there are over 7.4 million[5] private companies in the US compared to around 4,266[6] that are publicly listed.

Historical return figures showcase the outperformance potential of PE. The Cambridge Associates Private Equity benchmark generated annualised annual returns of +12.4% per annum (p.a.) between Q1 2008 and Q1 2022, beating the MSCI World index by +5.6% p.a., as shown in Figure 1. In addition to the performance advantage of private equity, investors may have benefited from the potential reduction in volatility by adding private equity alongside traditional public equity and fixed income allocations[7].

Figure 1:

Performance of Cambridge AssociatesPE benchmark and MSCI World Index



Source: Cambridge Associates and Bloomberg as at 31 March 2022. Private equity benchmark returns are net of fees. Past performance is no guarantee of future performance.

Performance and risk benefits aside, PE is also integral to the US economy :

It is a major employer – PE-backed businesses directly employed 11.7 million workers, out of 165.7 million, in 2020[8].

Beyond directly employees, suppliers to PE-backed businesses employed an additional 7.5 million workers[8].

Diversification is key to building a sound investment strategy

When it comes to building a PE portfolio, there are a number of considerations. Chief among them is diversification, which has been called the only "free lunch" in investing by the Nobel Prize laureate Harry Markowitz[9]. This refers to the idea that different financial assets exhibit different traits and, therefore, behave differently over time. Understanding this, one could invest in a combination of assets and, through diversification, achieve the same return as holding a single asset with less fluctuation in the value of the assets over time. In other words, Markowitz argues that investors can potentially achieve the same return with less risk through diversification.

In the context of building a PE portfolio and as we will show below, LPs should consider diversification across a variety of PE investment attributes, such as strategies, vintages, stages, geography, and managers.

Diversification by strategy

The three main PE strategies for LPs are: (1) primaries, (2) secondaries and (3) co-investments. Each has its own unique characteristics, and the three strategies can complement each other to provide a more balanced portfolio.

Primaries

This is the strategy most investors associate with private equity, as it accounts for more than 90%[10] of all PE AUM. It refers to LPs committing capital to a GP's fund, which in turn invests in a portfolio of companies over time. The typical deployment period is two to five years, with the overall lifespan of a fund running to around 10 years, so capital is invested over a long-term time horizon.

In the early years of the investment, as capital is put to work, investors experience a negative cash flow as commitments are being called, or invested, into the companies and the GP takes their management fee. Over time, as the GP in theory successfully executes its value-add strategies across the fund's portfolio assets, investors should receive returns in the form of cash distributions. As the distributions increase and capital calls recede, investors should expect to see an overall positive cash flow.

Secondaries

A growing part of PE is the secondaries market, where GPs can buy and sell pre-existing investor commitments in a portfolio of assets, or even a single company. There is often the potential to purchase stakes at a discount, if, for example, the transaction is driven by a seller's desire for liquidity.

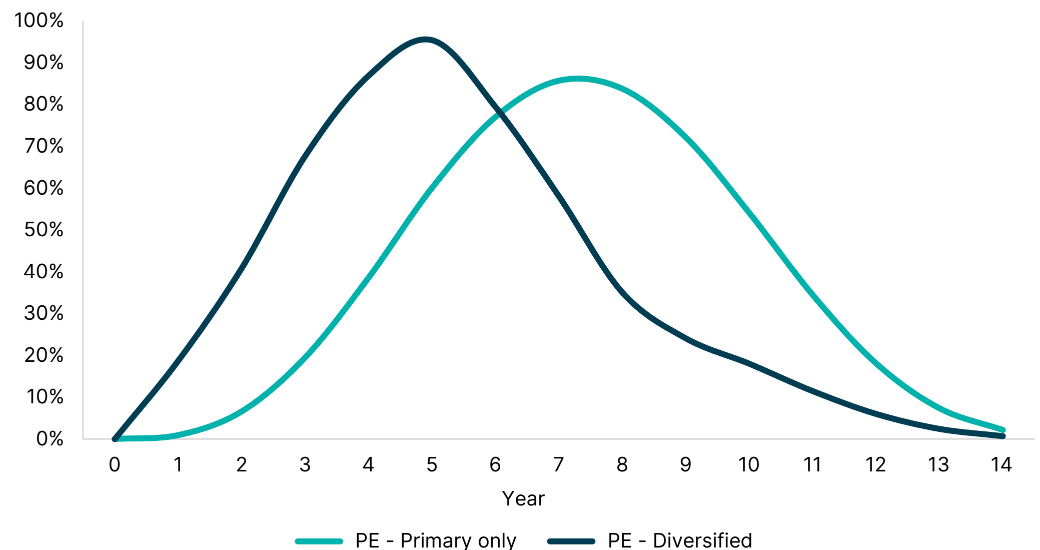
Secondaries plays an important role in diversifying a PE portfolio. Traditional secondary transactions involve purchasing stakes in mature funds that are typically four to six years into their lives. Because most of the capital has already been put to work, investors usually have good visibility on the underlying assets and performance track record. Crucially, investors can expect net cash flow to turn positive much sooner than the case of primaries or co-investments.

Co-investments

As the name suggests, this strategy involves investing directly in a company alongside a GP. These investments have the potential to enhance returns in a portfolio due to the defining feature of a typical co-investment deal: low, and often, no management fee or performance-related fees, which over time can be accretive from a net return perspective.

Figure 2 is a hypothetical portfolio that illustrates the net asset value (NAV) impact of a diversified PE portfolio with commitment split equally across primaries, secondaries and co-investments, compared to a primary-only portfolio. The diversified portfolio has the potential to harness the benefit of early positive cash flow from secondaries and the lower fees from co-investments, to allow distributions to be re-invested more quickly and potentially therefore to enhance overall return.

Figure 2:
NAV profile of two hypothetical PE portfolios with different strategies



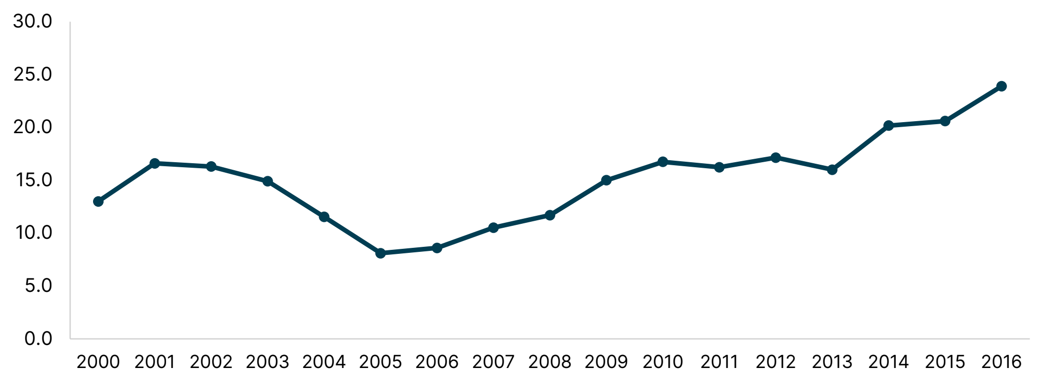
Source: Pantheon. PE Diversified strategy assumes an equal allocation to primaries, secondaries, and co-investment. This is for illustration purposes only and is not representative of all Pantheon client portfolios.

Diversification across vintage

Within each strategy, it is also important to diversify across vintage year, which refers to the year in which an investment is made, or when a fund began investing. Given the longer-term time horizons it can be almost impossible to time PE investments with optimal market conditions. For instance, few GPs would have foreseen the Global Financial Crisis of 2007-2009, and, if they had deployed all capital in the years prior to the crisis when markets and valuations were reaching a peak, it is likely that performance would be subpar due to exits taking place in the years that followed the significant market correction.

This is illustrated in Figure 3, which shows the internal rate of returns (IRRs) from vintages between 2000 and 2016 and highlights that the vintage years with the lowest median IRRs were 2005 and 2006, while those for the years after climbed steadily. GPs tend to deploy capital consistently across all vintage years in their investment phase to mitigate the risk of adverse macro conditions.

Figure 3:
Median net IRR by vintage year



Source: Preqin

Diversification across sector, stages and geography

The same arguments can be extended to support diversifying across sectors, stages and geographies. Stage refers to the type of private companies being considered. Broadly speaking, the main types are: (1) buyout, (2) growth equity, and (3) venture. Similar to strategy, each stage has its own unique characteristics and together they should complement each other to achieve a more balanced risk-return profile.

Buyouts

In the life cycle of a company, buyouts generally involve purchasing mature businesses with well-established revenue, operating costs and profitability. The value-add comes in the form of operational efficiency improvements and/or merger and acquisition opportunities.

Growth Equity

Growth equity companies sit in between buyout and venture capital from a risk-return perspective. These are fast-growing businesses with established business models, but that have yet to reach their full potential, or sometimes to have returned a profit. Here, GPs can work with management to build a roadmap to achieve and maintain profitability.

Venture Capital

Venture sits at the highest end of the risk/return spectrum. These businesses tend to be start-ups with limited operational track record, let alone any profits. GPs often back an idea, an individual or a team. Risk of business failure is high, but when investments do succeed, the return potential can be outsized compared to other stages.

With respect to geography, although there might be a strong tendency to only invest in LPs' home country (in economic terms, this is known as "home-bias"), doing so could result in sub-optimal portfolio construction and performance. This is because economies experience fluctuating fortunes in the same way as sectors and markets do, so LPs could be missing out on potentially superior investment opportunities in other parts of the world at any given time. As an example, a well-balanced portfolio could have its core exposure in North America, Europe and Asia, while supplementing the portfolio with opportunities from the rest of the world (ROW).

Combing stage and geography, Figure 4 provides a good illustration of the risk of not diversifying across both attributes, as no single combination of these diversifying characteristics has consistently topped the performance ranks over nearly two decades. Being invested in only one set of characteristics could have performed well in one year, but could not have performed consistently over the whole reference period and so returns would be likely to be either sub-optimal, or at least volatile.

Figure 4:
Median net IRR by stage/geography for each vintage year

Ranked in order of median net IRR from higest to lowest

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Europe-Buyout	Europe-Buyout	Europe-Growth Equity	Europe-Buyout	Asia & ROW-Growth Equity	Asia & ROW-Growth Equity	Asia & ROW-Growth Equity	North America-Buyout	Asia & ROW-Buyout	Asia & ROW-Venture Capital
Asia & ROW-Buyout	Asia & ROW-Buyout	Europe-Buyout	North America-Growth Equity	Asia & ROW-Buyout	North America-Growth Equity	North America-Growth Equity	North America-Growth Equity	North America-Buyout	Europe-Growth Equity
North America-Buyout	North America-Buyout	Asia & ROW-Growth Equity	Asia & ROW-Buyout	Europe-Buyout	Asia & ROW-Buyout	Europe-Buyout	Asia & ROW-Buyout	Europe-Buyout	North America-Buyout
Asia & ROW-Growth Equity	Asia & ROW-Growth Equity	North America-Buyout	Asia & ROW-Venture Capital	North America-Growth Equity	Europe-Buyout	Europe-Growth Equity	Europe-Buyout	Europe-Venture Capital	Europe-Buyout
Europe-Growth Equity	North America-Growth Equity	Asia & ROW-Venture Capital	North America-Buyout	North America-Buyout	North America-Buyout	North America-Buyout	Asia & ROW-Growth Equity	Asia & ROW-Venture Capital	Asia & ROW-Growth Equity
North America-Growth Equity	Europe-Growth Equity	Europe-Venture Capital	Europe-Growth Equity	Asia & ROW-Venture Capital	North America-Venture Capital	Asia & ROW-Buyout	North America-Venture Capital	North America-Growth Equity	North America-Venture Capital
North America-Venture Capital	Asia & ROW-Venture Capital	Asia & ROW-Buyout	Europe-Venture Capital	North America-Venture Capital	Asia & ROW-Venture Capital	North America-Venture Capital	Europe-Growth Equity	North America-Venture Capital	Europe-Venture Capital
Asia & ROW-Venture Capital	Europe-Venture Capital	North America-Growth Equity	North America-Venture Capital	Europe-Venture Capital	Europe-Venture Capital	Europe-Venture Capital	Asia & ROW-Venture Capital	Asia & ROW-Growth Equity	North America-Growth Equity
Europe-Venture Capital	North America-Venture Capital	North America-Venture Capital				Asia & ROW-Venture Capital	Europe-Venture Capital	Europe-Growth Equity	Asia & ROW-Buyout

2010	2011	2012	2013	2014	2015	2016	2017	2018
North America-Growth Equity	Asia & ROW-Venture Capital	Europe-Venture Capital	North America-Venture Capital	Asia & ROW-Venture Capital	Europe-Venture Capital	North America-Venture Capital	North America-Venture Capital	Asia & ROW-Venture Capital
Europe-Venture Capital	Asia & ROW-Buyout	North America-Venture Capital	North America-Growth Equity	Asia & ROW-Buyout	North America-Growth Equity	North America-Growth Equity	Asia & ROW-Growth Equity	North America-Venture Capital
Asia & ROW-Growth Equity	Europe-Growth Equity	North America-Buyout	North America-Buyout	North America-Growth Equity	North America-Venture Capital	Europe-Growth Equity	North America-Growth Equity	Europe-Venture Capital
North America-Buyout	Europe-Buyout	Europe-Buyout	Europe-Buyout	North America-Venture Capital	Asia & ROW-Buyout	North America-Buyout	Asia & ROW-Venture Capital	Europe-Buyout
Asia & ROW-Venture Capital	North America-Growth Equity	Asia & ROW-Growth Equity	Asia & ROW-Venture Capital	Asia & ROW-Growth Equity	North America-Buyout	Asia & ROW-Venture Capital	Europe-Growth Equity	Asia & ROW-Growth Equity
Asia & ROW-Buyout	North America-Buyout	North America-Growth Equity	Europe-Venture Capital	Europe-Growth Equity	Europe-Buyout	Asia & ROW-Growth Equity	North America-Buyout	North America-Buyout
Europe-Buyout	North America-Venture Capital	Asia & ROW-Venture Capital	Asia & ROW-Buyout	Europe-Buyout	Europe-Growth Equity	Europe-Buyout	Europe-Venture Capital	Asia & ROW-Buyout
Europe-Growth Equity	Asia & ROW-Growth Equity	Asia & ROW-Buyout	Asia & ROW-Growth Equity	Europe-Venture Capital	Asia & ROW-Venture Capital	Europe-Venture Capital	Europe-Buyout	North America-Growth Equity
North America-Venture Capital	Europe-Venture Capital	Europe-Growth Equity	Europe-Growth Equity	North America-Buyout	Asia & ROW-Growth Equity	Asia & ROW-Buyout	Asia & ROW-Buyout	Europe-Growth Equity

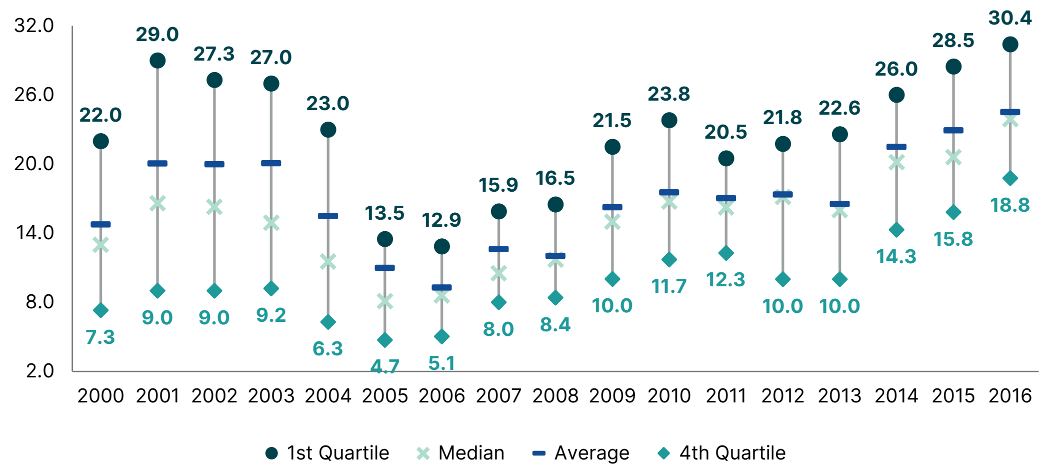
Source: Preqin as of 31 December 2021

Manager selection is key

In addition to the different aspects of diversification explained above, manager selection is key due to large variations in GP performance. As Figure 5 shows, there has historically been a wide gap between the top and bottom-quartile performing GPs in any given vintage year, making it especially important to choose the right manager or managers.

Figure 5:
Dispersion of performance by vintage year

Private Equity Net IRR (%) by Vintage Year



Source: Preqin

Conclusion

Private equity focuses on investing in businesses over the long-term. Through this, GPs can in theory work more effectively with experts and management to improve operational efficiency of investee companies and generate value-creation for underlying investors. This is reflected in the long-term outperformance of private equity over public equities.

To build a strong private equity program, LPs should place emphasis on diversification, specifically across strategy, vintage year, sector, stage and geography. This could not only reduce risk and volatility, but in some cases also improve performance.

Finally, manager selection is also critical. This is as, if not, more important to building a successful private equity program due to the wide dispersion in private equity manager performance.

Endnotes

1. Source: Cambridge Associates and Bloomberg as of 31 March 2022
2. Source: Preqin
3. Source: Preqin, The Future of Alternatives in 2027, October 2022.
4. Source: State Street which calculated $179 trillion in market value of all investable assets as of 2021.
5. Source: Agency for Healthcare Research and Quality: Number of private-sector establishments by firm size and State: United States, 2020
6. Source: World Bank 2019
7. Source: JP Morgan Asset Management, Guide to Alternatives 3Q 2022
8. Source: Employment statistics come from the American Investment Council, 2020 Economic Impact.
9. How to diversify your investment portfolio when all prices are in freefall | Money | The Times https://www.thetimes.co.uk/article/how-to-diversify-your-investment-portfolio-when-all-prices-are-in-freefall-j77j02vx0
10. Source: Pantheon calculation based on Preqin data as of December 2021.

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