



## Too good to be true?

July 2007

Private equity is much in the news these days. Whether it's the perception of high profits, low taxation on those profits or the charge that private equity deals are bad for workers, private equity certainly has a public relations job on its hands. However, looking beyond the headlines what role, if any, should private equity play in the investment strategy of individual investors? In this article we look at the facts and draw on some of the available research to answer just that question.

Private equity is a term used to describe an industry which invests across all sectors of the economy, in all regions of the UK and at all stages in a company's development from start-up to a large management buyout (MBO). The industry is certainly maturing and in 2005 investors ploughed £27.3 billion into private equity funds, compared to just £3.3 billion in 2004. The industry invested £11.7 billion into investments in 2005 compared to £9.7 billion in 2004. Of the 1,535 companies financed worldwide, over 1,300 companies were backed in the UK. Over the past five years £33 billion has been invested by UK private equity firms. In 2005, about 20% of the amount invested was through a dozen or so mega-deals but around 80% was for deals worth £2 million or less (source: BVCA annual performance report 2005)

Gordon Brown seems to be a keen supporter of private equity:

*"The evidence is that private equity has created more jobs at a faster rate than some other institutional investments in the economy".*

Ed Balls, the Economic Secretary to the Treasury, is also a fan:

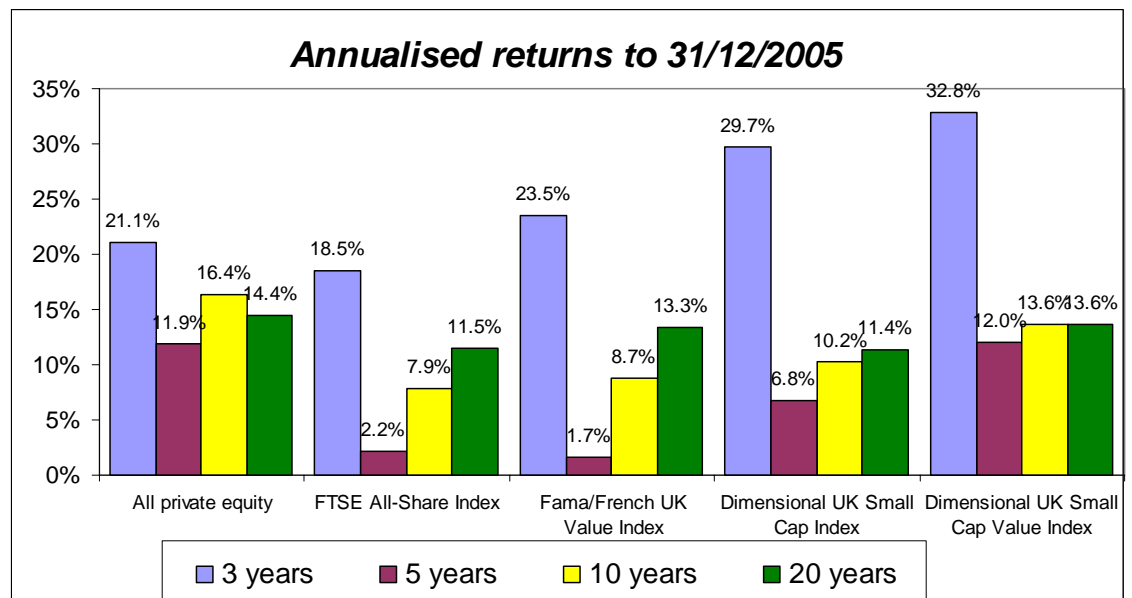
*"The conclusion I draw from the evidence, taken overall, is that private equity can play an important role in our economy, and especially in exposing companies to dynamic competitive challenge."*

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There is no doubt that the UK, particularly London, is a pre-eminent financial services centre, supporting a very large private equity industry. It is estimated that 10,000 high skill professional staff work in or support the UK private equity industry. The income generated from financial and professional services firms is estimated to be £3.3 billion in gross revenues, or about 7% of the turnover of the UK financial services sector. However, the very fact that private equity employs, directly or indirectly, lots of highly-paid people does not necessarily make it a good investment class for investors as well.



Historically the private equity sector has lacked transparency and obtaining information to carry out performance analysis has been a challenge for those seeking to evaluate the risks and returns of private equity investment funds. Based on figures supplied by the British Venture Capital Association (BVCA) we have attempted to compare the average net annualised returns of all private equity funds measured to the end of December 2005, with a number of relevant investment indices, as shown in the table.



A more meaningful comparison would be to look at the 20 year results of the 68 private equity funds started between 1985 and 1989. The long term net return to investors on these funds measured to 31 December 2005 was 13.8%pa. Source: BVCA annual performance report 2005.

Returns from the FTSE All Share index were included in the BVCA's 2005 report, but this seems an unfair comparator to us. The All Share index is heavily weighted towards large capitalisation growth stocks, which investors regard as being less risky than the sorts of businesses typically represented in private equity funds and so they have lower expected returns. We would therefore expect a higher return from private equity than from the market as a whole, because it is riskier – it would be similarly unreasonable to compare a UK gilt index with an equity index.

Two indices which seem more relevant for such a comparison with private equity are UK smaller companies and value companies (those with a low share price relative to the company's accounting value), so we have included their results as well. However, even then the comparison does not seem reasonable. This is because it would have been impossible for an investor to have bought into every private equity fund to the extent necessary to have achieved the mean return, whereas they could have bought into the broad UK market (as represented by the FTSE All Share index), UK smaller companies and UK value sectors via low cost index funds.



While some private equity funds have produced very high returns, it is impossible to clarify exactly which funds have generated which returns. It seems from the BVCA report that headline high average returns produced by the private equity industry are actually being skewed by the top quartile of companies generating high returns while the bottom three quartiles achieve much lower results. Clearly, from an investor's perspective, it would be helpful to know the returns of individual funds.

PriceWaterhouseCoopers (PWC) stated in the BVCA 2005 performance report:

*"... Large MBO funds were by far the best performing funds, achieving an 18.0%pa return. Mid MBO funds followed at 9.3%pa with small MBO funds at 1.9%pa. Venture funds achieved a -1.9% return."*

While the mean return looks attractive, this is because a very small number of highly profitable deals have a disproportionately large impact, thus dragging up the mean, while most produce at best mediocre returns. The chance of the average investor finding out about this handful of mega deals in advance and being able to take advantage of them is rather less than random chance would offer, as he or she is not a 'player' at the table.

Institutions like the Yale and Harvard endowments snap up all the best deals due to their tremendous resources and funds. So unless an investor works in the private equity sector or has billions of pounds available and a staff of people who do have the necessary skills and knowledge, the chances are that their experience is likely to be far less rewarding than the average results suggest.

***'...the return premium from private equity looks pretty meagre to say the least.'***

While the mean returns from private equity as a whole seem to have beaten those from publicly quoted equity, if we strip out the 20% or so of large MBO deals, the mean return not only falls but ends up significantly lower than that from fully liquid quoted markets. Given the lack of liquidity, higher risk and higher costs involved, not to mention the likelihood that most investors are never actually likely to be able to invest in the mega-deals which contribute so much to the mean return, the return premium from private equity looks pretty meagre to say the least. The five-year results look more impressive than do those for the quoted sector but one of the consequences of public listings is that prices for public equity are available on a minute by minute basis, unlike private equity.

Since the five year period to the end of 2005 coincides with a sharp market fall, which disproportionately impacts the results, this makes changes in the market value of quoted companies much more visible. Under such circumstances, it is doubtful whether a private investor would have actually been able to encash his or her private equity investment, given the types of fund that would have been available, let alone obtain the returns implied.



There is also some evidence that some of the returns generated by private equity are a direct consequence of the highly leveraged nature of the deals. Julie Froud and Karel Williams from the University of Manchester argue that if the debt leveraging is stripped out of the equation, the returns generated by private equity would be mediocre at best compared to the stockmarket as a whole (source: Froud J and Williams K, Private equity and the culture of extraction, CRESC, The University of Manchester, Feb 2007). A study for Citigroup also came to the same conclusion that the higher returns for private equity disappeared if the high degree of leverage were stripped out of the model. If leverage is applied to any asset which appreciates in value at a higher rate than the cost of the borrowings, the results would be a boost in net returns – however, it is unfair to compare leveraged returns with unleveraged ones when looking at comparative asset class returns.

When companies become private, the amount of information they are required to produce reduces substantially, thus reducing the scope for public scrutiny and analysis. This might be fine for a small or medium-sized company but when it happens to companies like Boots or Sainsbury's, it has greater implications.

Private equity funds incur a multitude of costs. In addition to all the usual professional fees and the cost of servicing debt interest, the private equity manager will usually charge 2% per annum of the funds invested plus 20% of the profit (usually after a predetermined amount has been repaid to the investor).

Over the past year or so we have seen a number of quoted private equity investment companies launched and, like hedge funds, an increased demand for their shares by both private and institutional investors.

Tim Bond, the respected lead author of the authoritative Barclays Capital Equity Gilt Study, had this to say about private equity in the 2007 edition: *"... diversification out of quoted equities into private equity is a popular pension fund trend. Private equity, by definition, does not have a liquid secondary market, so valuations are typically conducted on the basis of infrequent accounting updates. Unsurprisingly, historical returns appear to be much less volatile than those of quoted equities, whose prospects are subjected to minute-by-minute judgment in the stock market. Yet private equity is simply public equity with additional layers of leverage; it is therefore likely to be a good deal more risky than quoted equity markets, while several orders of magnitude more expensive in management fee structures.*

*However, pension funds that are overly focused on the reported volatility of their assets in the sponsor's accounts may find private equity attractive. From an accounting perspective, private equity might appear to be a lower-risk investment than quoted equities, while delivering historical returns that display low correlations with equities. In the real world, nothing could be further from the truth."*

***"... private equity might appear to be lower-risk... In the real world, nothing could be further from the truth."***



A similar observation was made by Michael Gordon, Chief Investment Officer of Fidelity Investments, the largest independent fund manager in the world:  
*"Private equity provides little real diversification from equities over time; comes with higher risks because of leverage; has far less transparency than a portfolio of listed stocks; and commands premium fees."*

So our conclusion is that, despite all the hype and perceived benefits, private equity does not offer any real benefit for most long term investors. The available information indicates that the apparent additional average return from private equity over that from quoted markets over 3-20 years is almost entirely down to the spectacular returns produced by a handful of mega-deals from the total of 1,500 or so. With no reliable way of identifying that handful of spectacular deals in advance, we think that most investors would be best advised to stay well clear of private equity in their portfolio (although it appears to be a great business in which to work) and instead, and to the extent that they need or want more than the market return, ensure that they are adequately exposed to those risk factors which years of academic research show provide these additional returns. Not only is it comparatively easier to capture such market returns through pure asset class funds, it is a whole lot cheaper and less risky. All but the lowest risk Bloomsbury model portfolios include exposure to these factors, including smaller and value companies.


Investors should never confuse a great business (which private equity most certainly is for a select few) with a credible and validated investment strategy, which index funds investing most certainly is for the rest of us.

Remember, there's no free lunch. If it looks too good to be true, it probably is!

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