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The private equity value-add premium

Quick-read summary

Private equity has generated attractive returns over the past several decades, in absolute terms and relative to public equities (see Figure 1). However, there are several misconceptions regarding how private equity general partners (GPs) primarily generate returns.

These misconceptions include the "illiquidity premium," leverage, "asset stripping" and/or reducing headcount, "buy low, sell high" rotation strategies, and the GPs providing "just money" and not expertise. None of these are as relevant as commonly presented.

Figure 1. Private equity horizon IRRs and public market indices returns

Strategy	1-year	3-year	5-year	10-year	15-year	20-year
Private equity	17.7%	14.4%	15.2%	14.0%	12.2%	12.3%
Venture capital	30.4%	21.3%	14.2%	14.1%	11.0%	6.8%
S&P 500	18.4%	14.2%	15.2%	13.9%	9.9%	7.5%
MSCI All Country World Index	16.8%	10.6%	12.9%	9.7%	7.8%	6.7%
MSCI World Small Cap Growth Index	29.2%	14.2%	15.6%	11.9%	10.0%	9.4%

Source: *PitchBook Benchmarks (as of Q4 2020)*, released June 30, 2021.

GPs primarily generate returns by buying portfolio companies and transforming them into forms with higher valuations ahead of eventual sale, termed an exit. A successful transformation earns a "value-add" premium for the GP and its investors (limited partners or LPs) that supply the capital for the GP's fund. GPs utilize their prior experience of transformations to identify the changes most likely to generate an increase in the value of their portfolio companies.

GPs apply well-developed skill sets and operational resources to guide companies through change. Deep and direct involvement is a key attribute differentiating experienced GPs from their public market equivalents. The GP is incentivized by being able to retain a considerable proportion of the value it creates. And because GPs induce transformations independent of market conditions, they can likely continue to generate above-market returns.

Introduction

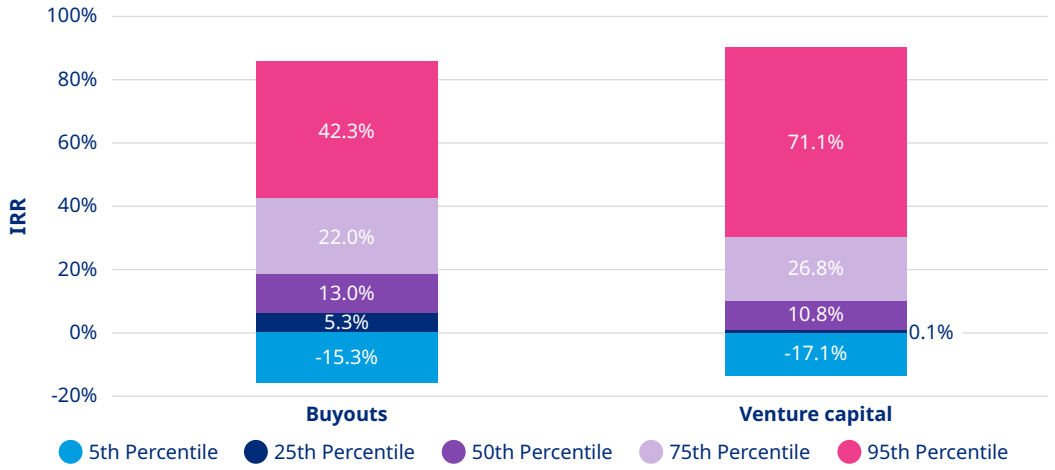
The February 28, 2021, *New York Times* article "The Private Equity Party Might Be Ending. It's About Time" reiterates a common critique. Sycamore Partners purchased public clothing retailer Jones Group in 2013, renaming it Nine West Holdings, and added considerable debt before it filed for bankruptcy in 2018. The article argues that, for decades, GPs have been "loading up companies with huge amounts of debt they will surely have difficulty repaying." Although, in this case, the debt did ultimately lead to bankruptcy, this argument does not reflect how GPs create value.

While private and public equity fund managers share many traits, there are critical distinctions. GPs hold substantially more equity and have a direct impact on strategy and operations; they are actively involved in success or failure and work directly with management. Although public fund managers also engage with management, they often do not have significant influence. Therefore, the roles are fundamentally different.

The roles of public and private fund managers in portfolio companies are fundamentally different.

This paper discusses five separate misconceptions about private equity — but each shares the premise that public and private equity are not materially different. It does not offer an unequivocal endorsement of GPs, since performance is highly variable (see Figure 2), but an insight into how good GPs generate above-market returns.

Figure 2. The dispersion of private market returns



Source: Burgiss Private i as of March 31, 2021.

Misconception 1: Illiquidity premium

Private markets are often considered analogous to public markets, only with an added illiquidity premium deriving from long holding periods, the lack of active trading in securities and the complexity of transactions.

A premium should only persist if there is a limited number of potential investors; otherwise, it should be eroded by competition. But beyond limited capital, a current major concern is the high level of uninvested dry powder.

A premium should only persist if there is a limited number of investors and/or investors have a restricted amount of capital that can be applied to the opportunity.

A recent Mercer paper[1] argues that the increase in dry powder is consistent with expanding or fresh allocations, new investor types — such as sovereign wealth funds — and LPs adding or expanding co-investment programs. Thus, the actual total could be considerably higher. It is therefore likely that the illiquidity premium is negligible.

[1] Mercer. *Dry Powder Meets Low Interest Rates — Time for a Private Market Boom or Bust?*, 2021, available at https://www.mercer.com/content/dam/mercer/attachments/global/investments/gl-2021-dry-powder-in-private-markets.pdf.

Misconception 2: Leverage

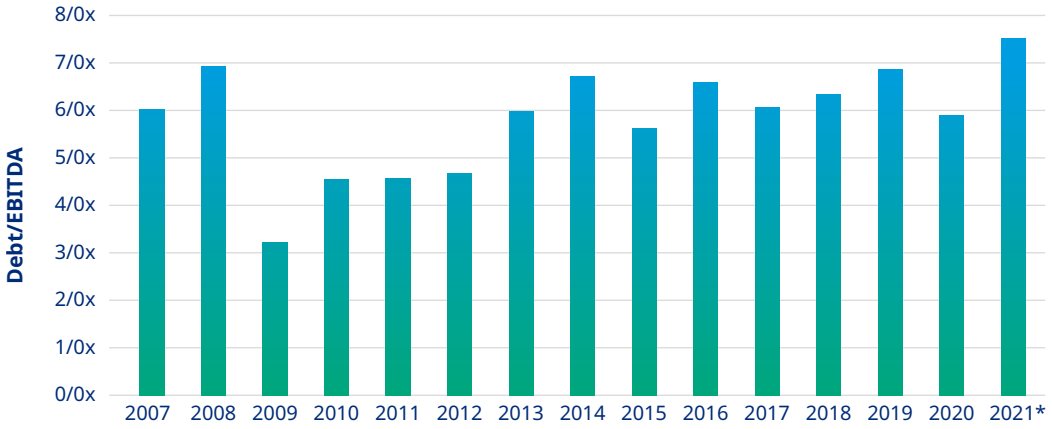
Many commentators suggest that GPs use large amounts of debt to drive returns. But although some do use considerable leverage, and this has increased in recent years (see Figure 3)[2] due to low interest rates, it is not a primary driver.

Taking on debt amplifies returns both positively and negatively. If the company's value decreases, it could have a profoundly negative effect and even eliminate the fund's equity stake. Given the typically small number of portfolio companies (10–30), losing just a single company can have a large negative impact on a manager's returns. Writing down or writing off a company is viewed very negatively and may limit the GP's ability to raise subsequent funds.[3]

Companies could opt to take on the equvalent debt load without engaging with a private equity GP.

Companies could take on comparable debt without engaging a GP, which usually comes with the potentially undesirable requirements of revealing proprietary information and surrendering considerable equity and control. Either corporate owners and managers are irrational or incompetent for not taking on more debt themselves, or there are other reasons for them to accept a GP's offer. Also, as GPs typically fully invest to optimize fund performance metrics, debt is additive rather than a replacement.

Figure 3. US private equity leverage ratios



Source: PitchBook's Q1 2021 *US PE Breakdown.*

* Through March 31, 2021.

[2] It could be argued that the recent increase in debt levels represents a return to a more "normal" market after the recovery from the period of very high risk aversion that followed in the wake of the global financial crisis.

[3] These comments primarily apply to private equity funds (that is, buyout and growth funds). Venture capital funds often have significantly higher loss ratios. However, they can offset the losses by generating much larger returns on their successful companies relative to private equity funds, so the loss ratio is less material.

Misconception 3: Asset stripping

Some commentators expect GPs either to break up portfolio companies and sell the pieces or to aggressively cut costs. Asset-stripping worked in the early days of leveraged buyouts (LBOs) but is unlikely to work as effectively today. Back then, there was a trend toward building conglomerates of unrelated businesses that smoothed quarterly earnings but did not generate synergies. GPs could buy conglomerates and sell segments that were more valuable as distinct entities, freed from servicing a corporate overhead or being constrained by a suboptimal strategy.[4] Conglomerates have since fallen out of favor, and analysts routinely scrutinize acquisitions for synergies.

Although a GP may reduce headcount, the drivers are likely organizational efficiency and refocusing corporate strategy. There may be an imperfect match between the new strategy and employee skill sets; for example, if the strategy shifts from seeking one-off sales to multiyear contracts.

Misconception 4: Buy low, sell high

Some suggest GPs merely make sectoral bets — identifying an undervalued sector (or one in an early growth stage), purchasing a company in it and flipping the company when the sector returns to favor — but sector rotation strategies are difficult to manage.

Most GPs will assume that either the market price of the target company remains the same or it decreases over the planned holding period.

Instead, a GP typically focuses on sectors in which its experience is concentrated — which further hones its expertise and networks — and where its ability to make transactions and manage operations is greatest.

LPs are skeptical of sector rotation and therefore less willing to fund it. That said, a GP may rotate out of a sector that becomes less attractive, perhaps due to pricing, increased competition or unfavorable regulation. This was seen when the US Department of Education (DOE) changed its attitude toward for-profit, post-secondary-education establishments.

Sector rotation is also limited by the long holding periods; it is exceedingly difficult to forecast market conditions three to five years ahead.

Misconception 5: Just money

The GP does not offer only capital, as many assume, but also capabilities. As mentioned above, there are many less intrusive sources of capital, so it would not be rational for a company to engage with a GP if all it offered were capital. A company may well accept a lower bid from a GP that has a skill set more suited to helping it create value.

[4] The 1989 RJR Nabisco buyout deal is one of the most famous private leveraged buyouts of such a conglomerate and subsequent breakup. The investment classic *Barbarians at the Gate* (1990) by Bryan Burrough and John Helyar discusses the transaction in great detail.

How value creation works

The common theme of the above misconceptions is that they all minimize the potential for the GP to add value — but GPs can generate substantial value-add premiums by fundamentally transforming acquisitions. Indeed, GPs often specialize in areas where they have a strategic advantage (see sidebar).

VCPs outline the change plans, timelines, key performance indicators (KPIs), resource requirements, risks and risk mitigators.

While it is easy to acknowledge the need for change, it is much more difficult to make it happen. GPs typically have extensive experience in implementing change and can therefore guide management to add value. They commonly develop extensive value creation plans (VCPs) prior to purchases and use these during negotiations to prove their depth of knowledge and commitment. VCPs outline proposed changes, timelines, key performance indicators (KPIs), resource requirements, risks and risk mitigators.

GPs often have deep sectoral experience, which can be utilized through providing consultation or placing professionals in the portfolio company. Industry professionals may be drawn from previous investments; GPs frequently recycle CEOs multiple times, and access to high-quality personnel is a major selling point in negotiations.

Real-world examples

Company founders can be guarded in disseminating information, even internally. A GP specializing in manufacturing experienced this when it bought into a physical product company with a high defect rate in its finished products.

The GP identified several KPIs throughout the company's manufacturing process. The KPIs (including measurements and thresholds) were derived from its extensive experience with similar companies. The VCP utilized the effective technique of posting KPI metrics on the production-area wall every day so that line workers could see each other's performance. The nearly instantaneous feedback led to a precipitous fall in the defect rate. The founder could have done this years earlier — but, importantly, had not.

When a portfolio company struggles, it can absorb a disproportionate amount of limited resources.

Not all changes will work this well, and VCPs usually incorporate many transformations. In the above-mentioned *New York Times* article, the VCP clearly failed — perhaps due to poor conception, insufficient oversight, inadequate execution or market conditions.

Failures are very costly beyond lost capital. GPs are often small organizations. So when a company struggles, it disproportionately absorbs resources and may constrain the execution of the VCPs of other portfolio companies. Failures also do immeasurable damage to credibility.

Transformational examples

- Redefining corporate strategy
- Upgrading professional skill sets
- Product development
- Supply chain improvements
- Acquisitions
- Optimizing distribution
- Enhancing marketing strategy
- Production enhancements
- Technical expertise
- Operational efficiency

Private equity structures

The long holding periods, high equity ownership and leverage of private equity transactions are necessary due to the scale of transformation. Financial performance may initially deteriorate as the GP invests and prunes unprofitable elements; the benefits may take years to materialize.

It is common for the benefits from the changes to take years to materialize.

Significant equity ownership provides GPs with the authority to drive change. Adding sizeable debt provides the company with the discipline needed to enact the VCP. Failure to enact may result in bankruptcy, as was the case in the *New York Times* article, and cause the fund's equity to evaporate.

GPs versus public company management

If corporate change drives value creation, a key question is whether public or private company management is better at managing change.

Public company managers often complain about how severely stock markets punish their companies for missing quarterly earnings targets. But pursuing short-term targets may limit managers' capacity for long-term transformation, especially of larger public companies. And change that does not immediately generate earnings is often perceived negatively.

The high level of equity ownership and the deep information flow available to GPs allow them to implement significant changes to portfolio companies.

By contrast, portfolio companies provide deep information flows to GPs that allow them to implement significant changes without justifying them to third parties. And direct observation of operational changes means GPs can make adjustments before they filter into financial results.

Limited incentives

A public company manager's incentives are often tied to the company stock price to align with shareholder interests but do not allow them to capture a substantial proportion of the uplift. Programs are usually complex and not designed to encourage large valuation hikes, as this may encourage undue risk-taking.[5]

The fund-and-carry structure common in private markets creates a different set of incentives for GPs.

The structure of most private market funds offers GPs the ability to capture a significant proportion of the value they helped create. Funds typically have a 10-year lifespan, with possible extensions. GPs deploy capital during the investment period, starting the clock to generate value. The GP usually retains 20% of the fund's profit (the carry), and private corporate managers are also often highly compensated for value creation.

Experience

Public company managers usually reach their positions after years of demonstrated success, usually at a small number of companies, so they rarely have experience with dozens of companies or managing substantial organizational change.

By its third fund, a GP will have experience with approximately 40 corporate transformations.

By contrast, by its third fund, a GP may have experience with 40 corporate transformations, not including any earlier experience that enabled the launch of its first fund. The lessons learned from previous transformations are crucial to the expertise GPs bring to portfolio companies.

[5] For example, Apple's market capitalization increased from US$1.2 trillion to US$2.2 trillion over 2020, a spectacular increase of US$1 trillion (Source: Yahoo! Finance as of 12/31/20), some of which could be attributed to the pandemic. Tim Cook, Apple's CEO and consistently one of the highest-paid public CEOs, received US$3 million in salary, US$10.7 million in non-equity incentives and US$1 million in other compensation in 2020 (Source: Investopedia as of 1/5/21). He held 1,001,961 in Apple shares (Source: CNBC as of 9/29/20), which were worth US$132.5 million at the end of the year. Interestingly, the total of his 2020 compensation and stock ownership represents just 0.015% of the increase in Apple's market capitalization over 2020. Further, Cook is often cited by business critics as a prime example of an overpaid CEO.

Is the party over?

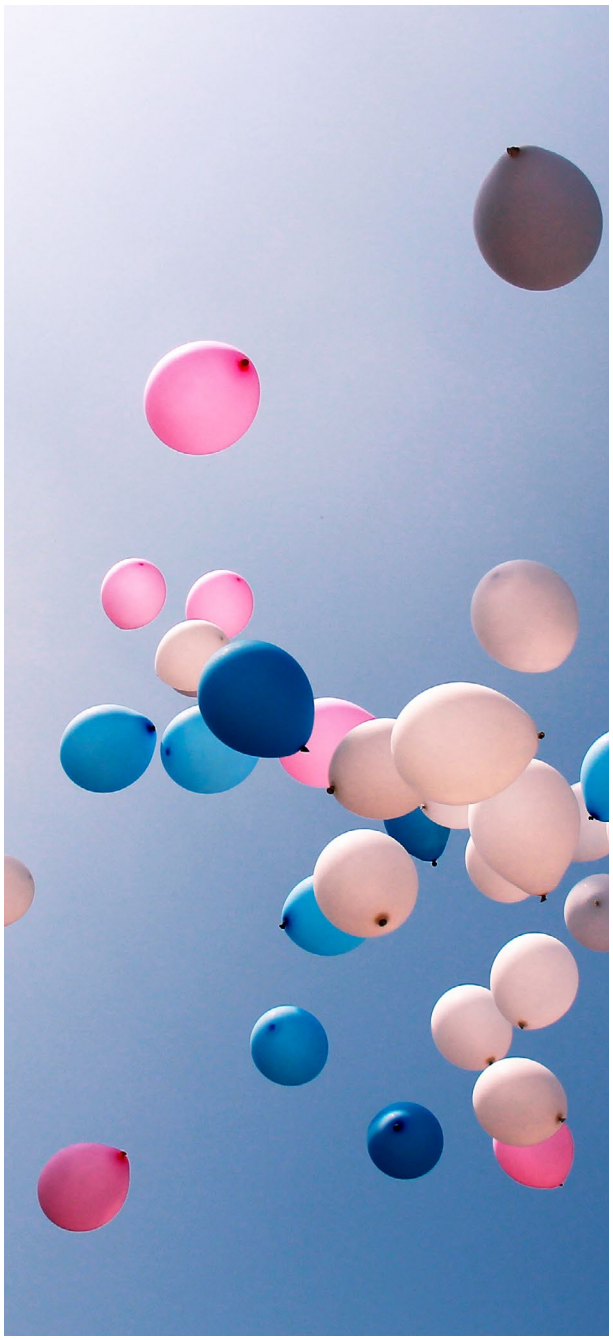
GPs have historically produced attractive returns and are generating increasing investor interest. But is it reasonable to believe GPs can continue to outperform public markets?

Value creation is driven by making strategic and operational changes, and the ability to implement those improvements is largely independent of market conditions.

Certainly, market conditions impact private companies, but as value creation is driven by strategic and operational change, pursuing success is largely independent of the investment environment. Close involvement means GPs are often quick to adapt to changing conditions. For example, after the global financial crisis, GPs lengthened holding periods and developed value while waiting for markets to recover. Whereas IRRs declined, exit multiples remained within historical levels. The ability to manage exit timing is a major benefit.

There are several scenarios in which GPs may not be able to maintain outperformance. For example, if a GP overpays and there is a structural downward shift in public valuations, returns would likely suffer.

A substantial decline in the availability of debt financing would also lower returns; although there is little sign of this happening, this would be especially true for those funds relying heavily on leverage. Likewise, there could be a decline in the number of companies that would benefit from GPs' transformational skills, but there is little indication that this is occurring.



Summary

GPs can generate substantial value by transforming portfolio companies, providing a "value-add" premium over public markets. These transformations usually involve major strategic and operational improvements over several years.

A GP's outcome depends on its skills, knowledge and ability to navigate challenges, so strong ones are likely to continue generating attractive returns even in a poor economic environment.

However, transforming companies entails risk. GPs might overpay, misjudge a market, adopt a poor VCP, hire the wrong people, make poor acquisitions or choose unfruitful corporate relationships. The wide dispersion of performance among GPs across vintages, geographies and sectors (see Figure 2 above) reveals such risks.

Being committed to a poorly performing fund for a decade is problematic from a return perspective — but also because it would require the LP to expend meaningful resources monitoring the GP. It is therefore critical for investors considering private equity to articulate an appropriate investment philosophy, understand the target sectors, perform due diligence, implement an effective investment decision process and build strong relationships with good fund managers.

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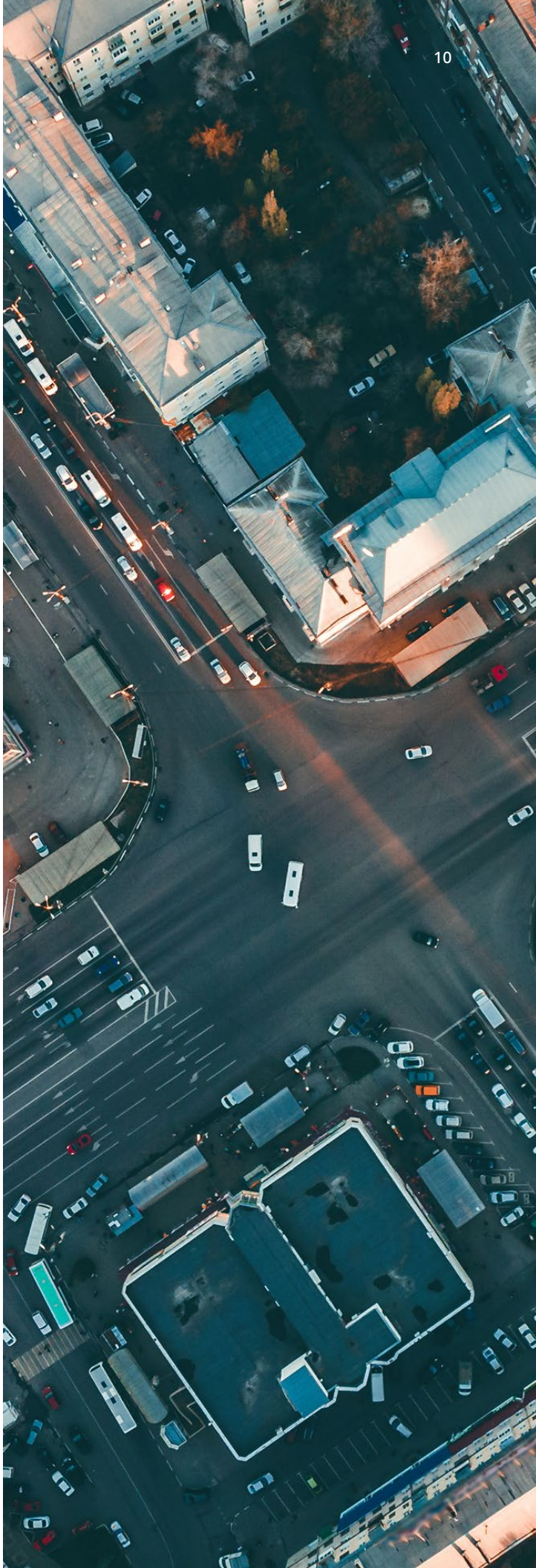

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