Mercer

The private equity value add premium

Private market insights

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	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

An article in the *New York Times* entitled "The Private Equity Party Might Be Ending. It's About Time." on February 28, 2021 encapsulates a common critique of the industry. The article focuses on the December 2013 purchase by Sycamore Partners, a private equity GP, of the Jones Group, a public retail clothing and shoe company. In financing the transaction, Sycamore Partners added considerable debt to the company and renamed it Nine West Holdings.

Without discussing the underlying business reasons for the outcome, the article reports that Nine West Holdings filed for bankruptcy in 2018. It states that private equity firms have for decades been "loading up companies with huge amounts of debt they will surely have difficulty repaying". While this may be a fair assessment in a specific case, the arguments presented are a good illustration of the lack of appreciation of the dynamics that characterize private equity investments.

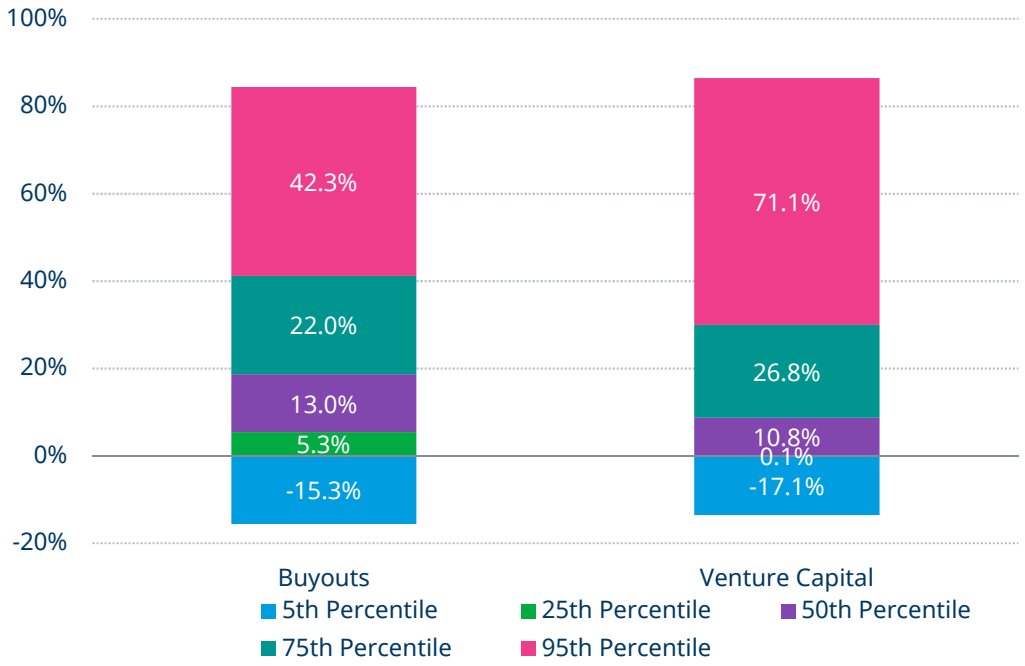
While private and public equity fund managers certainly share many common traits, there are essential distinctions between the two asset classes. Relative to GPs, public market fund managers typically hold substantially less equity in their portfolio companies. Due in part to this, they often have limited direct impact on the operations of their invested companies. While they can engage with corporate managers and express their opinions, public market fund managers often do not have significant influence over corporate behavior.

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

By contrast, private equity GPs are actively involved in the success or failure of portfolio companies, at times working directly with management on a daily basis. This does not imply that public market fund managers are not adding value for their clients; determining which public companies are better positioned to perform, with regular reviews, can surely be very value-additive. Rather, the roles of public and private fund managers in their portfolio companies are fundamentally different.

This paper will discuss some misconceptions about private equity as well as ways in which GPs directly contribute to the value creation process. Note that this paper is not meant to be an unequivocal endorsement of all private equity GPs, especially as the dispersion of performance is very high (see Figure 2) and there are more than enough examples of them behaving poorly. Instead, this paper is intended to address some of the misunderstandings of private equity investment dynamics and offer insights into how quality GPs have historically generated returns above public markets.

Figure 2: The dispersion of private market returns



Source: Burgiss Private i as of 3/31/2021.

Misconceptions

There are several misconceptions of how GPs generate the attractive returns that the asset class has produced over recent decades. In some cases, these misconceptions are applied singularly, as in the article cited above, while in other cases they are cited in various combinations. However, one aspect these misconceptions have in common is the view that public and private equity investments are not materially different.

Misconceptions

- Illiquidity premium
- Leverage
- Asset stripping
- Buy low, sell high
- Just money

Misconception 1: Illiquidity Premium

A widely expressed view is that private market investments are analogous to public market investments but with an added premium to compensate for illiquidity. This illiquidity derives from the longer holding periods for most private market investments, the lack of an active trading market in private market securities and the complexity of private market transactions.

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.

Theoretically, a premium should only persist if there are a limited number of investors or investors have a restricted amount of capital that can be applied to the opportunities. However, if capital is not limited or some substantial investors do not have liquidity concerns, any premium should be eroded by competition between market participants.

Currently, a major concern in private markets is the high level of reported uninvested capital, so-called dry powder. A recent Mercer paper[1] argues that the increase in dry powder is consistent with existing investors expanding private markets programs, other investors establishing new allocations, and the entrance of large new investor types such as sovereign wealth funds. Further, many LPs have added or expanded co-investment programs and, in a few cases, implemented direct private company investment capabilities. Consequently, the widely reported level of dry powder may represent an underestimate and the true available capital could be considerably higher.

As there has been a significant increase in capital seeking private market investments over recent decades, and investors continue to allocate additional capital despite full knowledge of the increase in dry powder, we believe it is likely that any illiquidity premium is diminishing.

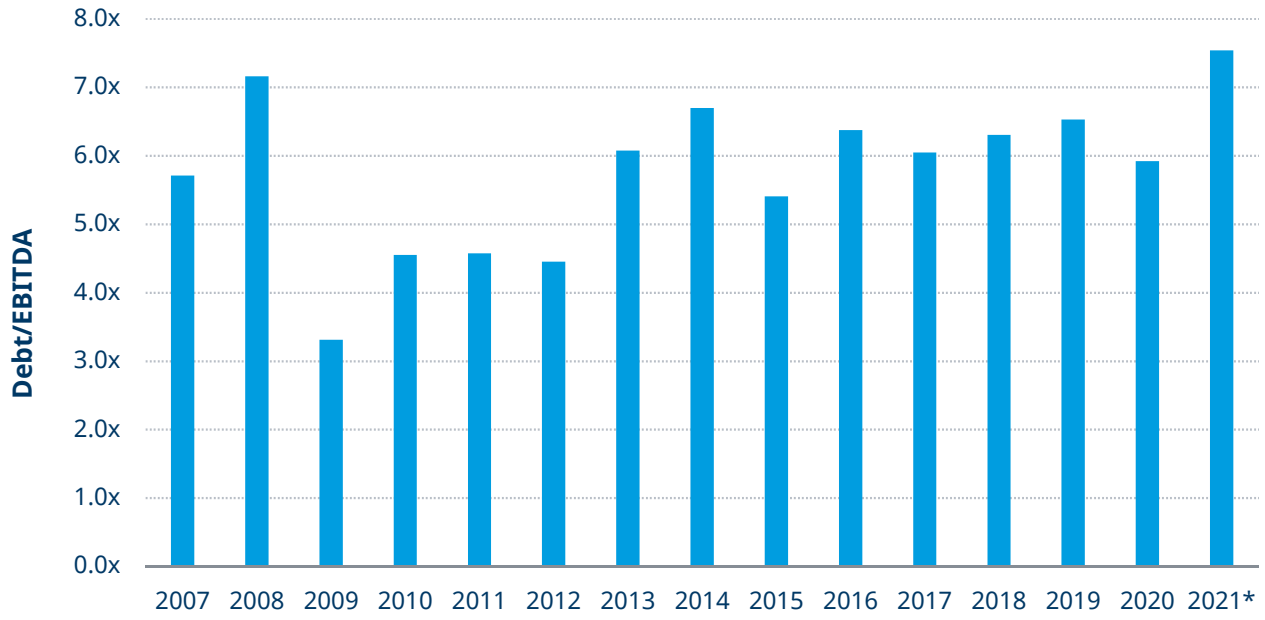
Misconception 2: Leverage

Another common misconception is that private market GPs generate returns by buying companies with a small amount of equity and large amounts of debt (as cited in the *New York Times* article) so when they subsequently sell companies the returns are amplified. It is true that some private market strategies, such as buyout funds, often use considerable leverage in transactions. Further, as interest rates have decreased over recent years, due to competition between an increasing number of lenders, the use of leverage has increased (see Figure 3).[2]

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

[2] It could be argued that the recent increase in debt levels represent 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.

Figure 3: US private equity leverage ratios



Source: PitchBook's Q1 2021 US PE Breakdown.

** Through March 31, 2021*

It is a basic business economics principle that debt can amplify equity returns. However, the amplification applies both positively and negatively. If the value of the underlying company decreases, the use of debt can have a profoundly negative impact and, in severe cases, eliminate all of a fund's equity. Due to the relatively small number of portfolio companies in most private market funds (typically 10-30), losing all the capital invested in just a single company can have a large negative impact on the fund's overall return. A GP that regularly writes-off or even writes-down companies is generally viewed as especially risky by the LP community and, as a result, the GP may find it challenging to raise subsequent funds.[3]

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

An additional rebuttal of the argument that leverage is solely the key to returns is the simple observation that companies could opt to take on a comparable debt load without engaging a private equity GP. A company raising its own debt would not have to reveal potentially proprietary information to external investors and would not, perhaps more importantly, have to surrender the considerable amounts of equity and control that are characteristic of buyout transactions. Therefore, corporate owners, boards, and managers are either irrational and/or incompetent for considering a private equity investment or there are other factors at work that explain a company's willingness to participate in a private equity transaction.

[3] These comments primarily apply to private equity funds (i.e., buyout and growth funds). Venture capital funds often have significantly higher loss ratios. However, good venture capital funds 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.

While many private market funds use debt to finance their purchase transactions, it is very common for their portfolio companies to reduce debt levels over the holding period in preparation for exit. Also, due to how fees and returns are calculated in private markets, almost all GPs fully invest the capital raised in their funds so they can optimize fund return metrics. Therefore, debt is additive to the GPs' investment capital, not a replacement for it. While debt can amplify private equity returns, it cannot be the sole component generating them.

Misconception 3: Asset Stripping

An additional misconception is that GPs buy companies and either seek to break them up and sell the pieces or meaningfully cut costs, often by reducing employee headcount.

In the early days of leveraged buyouts (LBOs), this asset-stripping strategy did generate attractive returns. However, the success of that strategy was largely due to the previous long-term trend of companies making acquisitions in unrelated business sectors to form conglomerate organizations. A primary motivation for forming these large organizations was to smooth reported quarterly earnings rather than to generate synergies. In some of the most egregious cases, profitable segments of a conglomerate were used to subsidize failing ones. Essentially, corporate managers built a diversified portfolio of uncorrelated or weakly correlated businesses to smooth earnings which had the desirable benefit (at least to the managers) of also securing their professional positions. Private fund managers could therefore generate attractive returns by separating unrelated segments; companies were more valuable as distinct entities as they did not have to service the conglomerate overhead or be constrained by a suboptimal corporate strategy.[4] The conglomerate organizational form has largely fallen out of favor and it is now common for public company acquisitions to be heavily scrutinized on the basis of the potential synergies they offer.

Private fund managers could therefore generate attractive returns by separating unrelated segments; companies were more valuable as distinct.

While it is not unusual for a portfolio company to reduce headcount after being purchased by a private equity GP, the driving factor is increasing organizational efficiency or refocusing corporate strategy rather than the simplistic goal of minimizing payroll expenditure. Further, employee departures may be driven by a less than ideal match between a new corporate strategy and the existing employees' skillsets. For example, the sales strategy may shift from selling one-off projects to developing multi-year contract relationships. If employees cannot be retrained to execute this new strategy, they could lose their positions. In any case, the goal of GPs is not to minimize employment but to increase the value of portfolio companies and thereby generate returns for investors and themselves.

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

Misconception 4: Buy low, sell high

A further misconception is that GPs are merely making market or sector bets. That is, they identify a sector that they believe is undervalued, purchase a company in it, and flip that company when the sector returns to favor.[5] Alternatively, they look for sectors that are in the early stages of a growth phase and buy into them before the general market fully appreciates them.

To generate attractive returns, by definition, any fund manager, public or private, has to sell assets at prices higher than they purchased them.

To generate attractive returns, by definition any fund manager, public or private, has to sell assets at prices higher than they purchased them. Therefore, buying low and selling high is foundational for all fund managers and not unique to private markets.

GPs typically focus on a limited number of sectors, usually based on the professional experience of the fund managers and their available operational resources. This allows GPs to further hone their expertise and considerably improve their networks in their chosen sectors, which can benefit both the purchase and sales transactions as well as the operations of portfolio companies. Due to the importance of deep sector experience, many sophisticated LPs are very critical of GPs that attempt to pursue a sector-rotation strategy and this makes it more difficult for the GP to raise additional capital.

That said, sector selection issues come into play in private equity when a GP determines that a target sector has become less attractive, either due to pricing or other market dynamics such as increased competition or unfavorable regulation. If the sector becomes less attractive, the GP may well abstain from making new investments. A good example of this was when the US Department of Education (DOE) unexpectedly changed its attitude towards the for-profit, post-secondary education sector. Several GPs had generated good returns from vocational training companies and had active investment programs in the sector. But after the DOE's change in attitude, many GPs struggled with their existing vocational training companies and refrained from additional investments.

It is relatively unusual for a GP to make sizeable investments in a sector in which it has not had previous experience.[6] A GP that wants to expand its sector coverage usually does so by making small initial investments, which are often accompanied by bringing in partners and/or operating resources that have deep sector experience. If the small initial investments develop as expected and the resources integrate well into the organization, the GP can expand its focus on the sector in its next fund in the series. This provides LPs with the ability to assess the opportunity and GPs the time to develop the necessary knowledge, skillsets, and resources.

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[5] In this context "sector" refers to the major industrial classifications: finance and insurance, health and social care, durable manufacturing, information, etc.

[6] GPs may shift focus within a sector based on market conditions. For example, a GP with a consumer retail specialization may shift from bridal stores to pet supplies but they are not likely to move to healthcare services.

Another factor that limits the application of sector rotation strategies in private markets is the extended holding period of most portfolio companies. Although there are cases of private companies being sold within a year of being purchased, the typical holding period for private companies is between three and five years. It is exceedingly difficult to forecast which sector will be in favor even one year ahead, let alone in three to five years. As uncertainty increases rapidly with the length of the holding period, GPs tend to remain focused on their target sectors unless they believe a dynamic is developing that fundamentally changes their attractiveness.

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

GPs can certainly benefit if one or more of their target sectors becomes of greater interest to the general market, but that is not usually the primary driver of returns. In building the investment base-case for purchasing a company, most GPs now assume that the market multiple of the target company either remains the same or decreases over their planned holding period.[7] Due to the complexity of private market transactions and long holding periods, sector rotation strategies are rarely successful and many investors purposely avoid GPs that attempt to employ them.

Misconception 5: Just money

The final main misconception is that the core benefit GPs offer portfolio companies is providing capital. In this conceptualization, GPs do not add meaningful capabilities other than providing capital the company needs to transform itself. But, as discussed in the leverage commentary above, there are ample alternative sources of financing available, including private debt, so companies could easily finance a transformation without the complications and cost of a private equity transaction.

Moreover, it would not seem to be sensible for the owner of a private company to give up majority ownership and control if all the GP provided was capital. For good companies that put themselves up for sale, GPs vigorously compete not only on price but also on what ideas and resources they can offer. It is not unusual for a company to accept a lower bid from a GP if it believes that GP has a superior skillset relative to the higher bidders and will use it to create a more valuable company.

[7] In buyout transactions, the value of the company is often calculated as a market earnings multiple (that is, what the market it willing to pay for a dollar of earnings) times current earnings. The highest returns are often earned when a GP substantially increases company earnings over a period in which the market multiple also increases.

How value creation in private markets works

The common characteristic that the proponents of the misconceptions described above either ignore or minimize can be summed up in a single phrase: “value add." GPs generate returns from their ability to fundamentally transform the condition of a portfolio company at the time of acquisition to something discernibly better when it is sold. In doing so, GPs earn a value-add premium for their investors and themselves. Examples of transformations are shown nearby (see table for examples). Some GPs specialize in specific transformational areas, while others are more generalized. A GP’s sector specialization can provide a strategic advantage as some sectors benefit more from certain types of transformations. For example, an industrial manufacturing company can often benefit from a combination of supply chain improvements, increased operational efficiency, production line optimization, and defect management whereas changes to marketing or sales strategy might not generate as much value.

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

It’s all about transformation

Although it is exceedingly easy to acknowledge the need for change, it is much more difficult to successfully make it happen. GPs can use their experience and knowledge to implement effective change with the aim of adding considerable value to portfolio companies. Innumerable changes could be made to almost any company but the options are practically limited by the resources available to implement those changes. As GPs often have extensive experience transforming companies, they can guide management to enact changes likely to generate the greatest increase in company value. Further, GPs can determine priorities and help manage the change processes. It is common for GPs to develop extensive value creation plans (VCPs) prior to closing a purchase transaction. Moreover, GPs often uses the VCPs in the purchase negotiation process to prove to the target company their depth of knowledge and commitment to the investment.

The VCPs outline the priorities, proposed changes, timelines, key performance indicators (KPIs), resource requirements, risks, and risk mitigators. In addition to developing these plans, GPs often have designated teams with deep operational experience in the sector. Some GPs use these experienced personnel in a consulting model, while others place them directly in the portfolio company; the specific approach is usually dependent on both the company’s needs and the resources’ desired level of involvement. Often, the industry professionals are drawn from the GP’s previously successful investments, which is another reason why sector specialization is

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

beneficial. There are abundant examples of GPs recycling the same CEO through two or three portfolio companies. Having access to high-quality personnel is another major selling point when negotiating the transaction.

An example of change

It is not uncommon for founders that lead companies to be relatively guarded in releasing information, even internally, which can lead to less-than-optimal organizational results. A good example of this occurred when a GP that specializes in retail manufacturing bought a consumer product company. The company was struggling with a high defect rate in its finished consumer products, which led to an elevated product return rate and dissatisfied customers. The high return rate was hurting both the company's growth and profitability. As part of the VCP, the GP identified several KPIs that measured the performance of the manufacturing process from the beginning point, through various stages, to the finished product. Knowing what those KPIs should be, how they should be measured, and what were reasonable thresholds, were all derived from the GP's extensive experience in working with similar manufacturing companies.

Once the KPIs were established, the GP employed a very effective technique: it had the KPI metrics posted on the production area wall every day. Employees could now observe not only their own performance but also everyone else's on the production line. As a result of this detailed and near instantaneous feedback, the defect rate fell precipitously. Obviously, the founder could have done exactly the same thing years earlier – but had not done so. Whether this was due to a lack of knowledge or a difference in management style is immaterial as it created an opportunity for a knowledgeable and experienced GP to significantly improve the organization's operations, thereby increasing the value of the portfolio company and generating a good return for itself and its investors.

It doesn't always work

Not all changes that GPs attempt to implement will work as well as the example above. Usually, the VCP does not rely on a single change but rather incorporates a series of transformations, both large and small. In the aforementioned *New York Times* article, we do not know the specifics of the changes Sycamore Partners planned for the Nine West Holdings transaction, but clearly many, if not all, of them failed to generate the expected value creation. Also, we cannot establish whether the failure was primarily due to a poorly conceived VCP, insufficient GP oversight, inadequate execution, or unexpected changes in market conditions.

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

It is worth noting that these types of failures are also very costly to a GP beyond the obvious loss of their investors' capital and its impact on fund performance. Many GPs are relatively small organizations so, when a portfolio company struggles, remediation can absorb a disproportionate amount of a GP's limited resources. This, in turn, can constrain the GP's ability to execute on its VCPs for other companies in its portfolio.

An additional issue is the uncertain cost to the GP of a decrease in its credibility. GPs usually keep their investors informed of the planned changes to their portfolio companies and update them regularly on progress. A GP that consistently fails to execute planned changes can lead investors to reevaluate their original investment thesis and may make them very reticent to commit to subsequent funds.

Why private equity is structured the way it is

Some of the distinct characteristics of private equity investing – such as the long holding periods, the high level of equity ownership by the GP, and the use of leverage – are necessary due to the depth and duration of the planned transformation. Due to a myriad of factors, it is not uncommon for a portfolio company's financial performance to deteriorate in the first year or two of the holding period. Revenue may decrease as the GP implements its new strategy and prunes non-profitable revenue streams. Further, profits could drop or even become negative as additional investments are made to accomplish the changes outlined in the VCP. And, it is common for the benefits from the VCP changes to take years to materialize.

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The high level of equity ownership provides the GP with the authority necessary to drive the changes identified in its VCP. Further, the target company's willingness to assume sizeable debt as part of the purchase transaction provides a disciplinary function, in that effective implementation of the planned changes is often necessary to service the additional leverage. If the changes are not implemented well or if the changes did not generate the expected results, the debt may create a difficult financial situation and, when severe enough, such as in the case in the *New York Times* article, result in bankruptcy. In that case, the fund's equity stake could become worthless. As most funds have a small number of portfolio companies, the complete loss of an investment can have a large negative impact on overall fund performance metrics and would likely make future fundraising for the GP more difficult.

GPs vs. public company management

Private equity companies do not have a monopoly on instituting corporate change. Moreover, if corporate change drives value creation, a very relevant question to ask is whether public company management is better or worse at managing change than GPs.

Quarterly earnings calls

A common complaint from both many public company managers and some business commentators is how severely stock markets punish public companies for missing expected quarterly earnings. Managing to quarterly targets may limit the degree to which a public company manager can implement aggressive transformational programs, especially as the typically larger size of public companies would require markedly greater corporate change to meaningfully impact earnings.

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

Additionally, corporate investments that do not immediately generate earnings are often perceived negatively by analysts. By contrast, private market investments involve high levels of equity ownership and deep information flows to GPs, allowing them to implement significant changes in portfolio companies without having to defend decisions to external parties. Further, a GP's direct involvement provides it the opportunity to observe operational changes before those results filter through into financial metrics. If the changes are not meeting expectations, a GP can make adjustments without enduring public criticism.

Incentivized, but with limited upside

Public company managers are often incentivized with financial rewards tied to their company's public stock price. The purpose of this structure is to align managers' incentives with the interests of shareholders. Although public company managers personally benefit from an increased stock price, they do not usually capture a substantial proportion of the total increase in corporate value. Additionally, these incentive programs can become quite complex, with a mixture of short- and long-term benchmarks, but are not usually designed to encourage large, short-term increases in the value of the company as doing so might also meaningfully increase risk. Therefore, while public company managers may certainly be incentivized to increase corporate value but concerns about risk and their limited ability to capture the value creation may constrain their behavior.[8]

[8] For example Apple's market capitalization increased from $1.2 trillion to $2.2 trillion over 2020, a spectacular increase of $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 $3 million in salary, $10.7 million in non-equity incentives, and $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 $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

The fund and its carry structure (i.e. profit sharing) common in private markets creates a different set of incentives for GPs. Most private markets funds have a limited lifespan, typically ten years with possible extensions. As GPs deploy their capital during the fund's investment period, usually the first three to five years, they are well aware that the clock is ticking and any changes should generate value-creating events sooner rather than later. Further, if the GP increases the value of its portfolio companies and is able to generate successful exits, the GP usually retains approximately 20% (the carry) of the profit over the total fund investment cost. While private company managers do not receive carry, they are often also highly compensated based on achieving the VCP objectives and directly share in the increased corporate value. Therefore, GPs and private company managers have direct incentives to substantially transform companies. If they are successful, they are rewarded by retaining a considerable proportion of the value they created.

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

Experience

Top public company managers usually reach their positions because they have demonstrated years of successful business management. In some cases, that experience is derived from a single company while in other cases it is a result of their work across several organizations. However, rarely do public company managers have management experience with dozens of companies. Public company managers may have had extensive experience in managing substantial organizational change – or they may have had limited involvement with it. By contrast, by their third fund, GPs will typically have experience with approximately forty corporate transformations either completed or in process (assuming an average of twenty portfolio companies per fund). Moreover, this does not include the transformations that likely provided them the credibility to raise their first fund, seldom an easy task. The lessons and pattern recognition from all those successful, and unsuccessful, transformations are crucial to the knowledge base and skillsets GPs bring to portfolio companies.

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

Apple's market capitalization over 2020. Further, he is often cited by business critics as a prime example of an overpaid CEO.

Is the party over?

As noted at the beginning of this paper, private equity has produced attractive returns across recent decades and those returns have generated increasing investor interest. A very important question for investors considering a private equity allocation or expanding an existing one is: is it reasonable to believe private equity can continue to outperform public markets? As discussed above, much of the value creation is driven by making strategic and operational changes and the ability to implement those improvements is largely independent of market conditions.

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

Also, as GPs closely monitor the performance of portfolio companies, they are often able to quickly adapt to changing market conditions. This was seen during the years following the Global Financial Crisis; GPs adjusted by lengthening the holding periods of their portfolio companies and implementing additional value generating initiatives. This allowed GPs to wait until exit markets had recovered from the crisis. To accomplish this, many GPs requested fund extensions from their LPs and delayed their subsequent fundraising plans, both of which LPs generally supported. As a result, IRRs declined but fund return multiples remained near historical levels. The ability for GPs to actively manage the timing of exits is a major benefit of the long, but notionally fixed, life of most private equity investment vehicles.

There are circumstances in which private equity may not be able to maintain outperformance relative to public markets. Public and private equity valuations are certainly linked, although determining precisely the timing and strength of the linkage is challenging and represents a major unresolved research issue. Nonetheless, if GPs overpay in the short-term and there is a subsequent long-term structural downward shift in public market valuations, private equity returns could suffer.

Also, a substantial and permanent decline in the availability of debt financing could lower private equity returns for funds heavily relying on leverage. However, the growth of private debt funds in recent years indicates that investors seem to be maintaining an appetite for the asset class.

An additional situation that could suppress private equity returns is if the number of companies that could benefit from the strategic and operational improvements offered by GPs becomes limited. But this implies most companies are already performing optimally, an unlikely prospect.

Undoubtedly, this list of scenarios is not comprehensive and there may be several other conditions in which private equity could underperform.

Summary

Good GPs transform portfolio companies and, through these transformations, GPs can generate substantial value creation and thereby earn a “value add” premium over public markets. The transformations usually involve major strategic and/or operational improvements and take several years to accomplish. Success depends on the GP’s skills, knowledge, and ability to navigate the various challenges that inevitably arise over the course of the long investment holding period. As it is improbable that existing companies are fully optimized, it is likely that GPs will be able to continue to generate value and attractive returns even in a challenging economic environment.

When they exit portfolio companies, GPs share a substantial proportion of the profits with their investors, and successful GPs can become wealthy from their share of the profits. However, transforming companies is not without risk. GPs can make any number of mistakes including overpaying for a company, misjudging the market, adopting a poor VCP, retaining or hiring the wrong people, making poor acquisitions, and choosing the incorrect corporate relationships, among others.

The risk of private market investments can be seen in the wide dispersion of performance among GPs across every vintage, geography, and sector (as shown previously in Figure 2 above). Below median GPs do not produce returns that are commensurate with their risk. Further, being committed to a poorly performing fund manager for a decade or more can be problematic not only from a return perspective but also as monitoring the GP and reporting on the fund performance will continue to require the LP to expend meaningful resources. Therefore, it is critical for investors that allocate to private markets to articulate an appropriate investment philosophy, develop a thorough understanding of their target private market sectors and geographies, perform arduous due diligence, implement an effective investment decision process, and build strong relationships with good fund managers.

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