

>spotlight

"IT'S THE ALPHA, STUPID"

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Many years ago, when I began my career in private equity, one of the key features that all of us - consultants, managers and intermediaries - touted as a key benefit of this new "alternative asset" was its low correlation to other asset classes, particularly public equities. As a result, private equity made its way into many institutional asset allocations in the 1990s and early 2000s because of its presumed diversifying effect within portfolios. To some extent, that was correct; valuations of private equity investments were at that point generally held at cost until an actual realization event. Specifically, they were not adjusted up or down even in rising or falling equity markets. The theory was that illiquidity made private equity not only "alternative" but also uncorrelated.

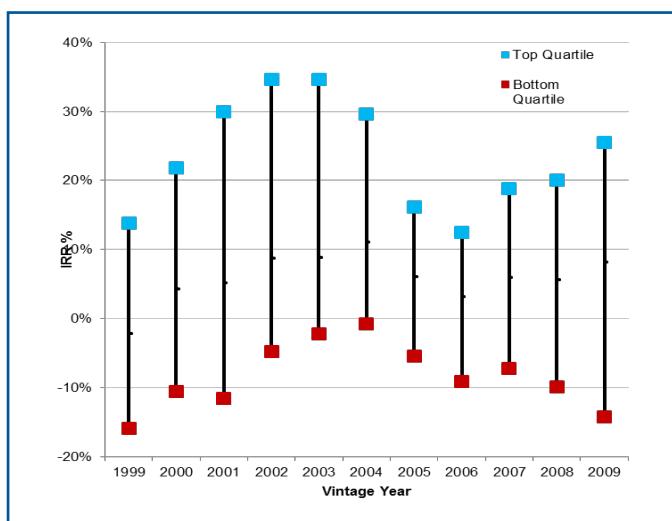
Enter the dragon: fair market value accounting standards and a whopping global financial crisis. Starting in 2007 as managers were forced by new accounting standards to mark-to-market their investments - using public comparables, recent M&A events and other methodologies - it soon became apparent that private and public equity were indeed correlated - highly correlated in fact! Stir in a tumbling global equity market, and falling private equity valuations ensued. Thus, the "ah-ha" moment occurred - public equity and private equity are the same corporate assets subject to the same company-specific issues and macroeconomic trends. They are simply subject to a different ownership model! The historic lack of private equity valuation adjustments had created the false perception of uncorrelated returns, and with this new insight, private equity's ability to diversify was quickly discredited. As widely respected investor and Yale University endowment [CIO] David Swensen noted in 2009, "because of the strong fundamental links between private equity investments and marketable equities, private equity provides limited diversification to investors...illiquidity masks the relationship between fundamental drivers of company value and changes

in market price, causing private equity's diversification power to appear artificially high."¹

One might then ask: if private equity offers few diversification benefits, why should investors bother to include this illiquid asset class in their portfolios? To paraphrase a famous US presidential campaign theme, "It's the Alpha, Stupid!". High quality private equity managers have proven for over 30 years that they can generate excess returns on a risk adjusted basis. They do this by improving the operations and management of their portfolio companies. They optimise the alignment of management incentives. They introduce initiatives to grow revenues and optimize margins. They expand overseas and combine with competitors. They re-invest cash flow at the expense of short-term earnings. It's an activist ownership model on steroids that public ownership typically can't deliver. Private equity's alpha is the component of performance that cannot be replicated by simply leveraging a portfolio of publicly traded securities; it is the increment of returns that captures the value adding activities that high quality managers are able to implement.

This concept of alpha is often misunderstood with respect to private equity, so let me try to provide a simple illustration. Top quartile funds - that is, funds managed by high-quality private equity managers - are expected to have higher risk adjusted returns than bottom quartile funds, generally those managed by low quality managers. Given my description of the skills involved in being a great private equity manager, one would expect a significant dispersion in the amount of alpha generated by top quartile and bottom quartile funds, and historically this is exactly what has happened. Chart 1 below illustrates the dispersion of returns between top quartile funds and bottom quartile funds from 1999 through 2009. In addition, chart 2 measures the amount of alpha generated by the top quartile firms.

Chart 1



The figure plots the median cumulative IRR for upper quartile funds (blue squares), lower quartile funds (red squares), and all funds (black dashes). Labels report the corresponding alphas, constructed as the median difference between the cumulative IRR and the S&P500 PME. Funds data is taken from Preqin. Data is between 1999 - 2009.

Chart 2

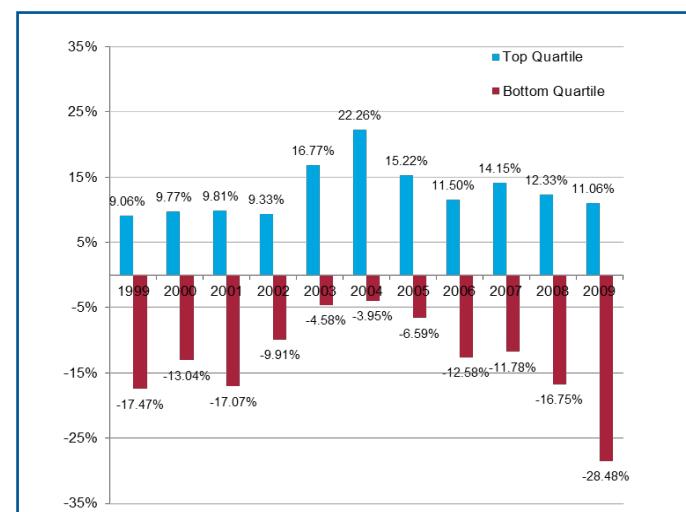
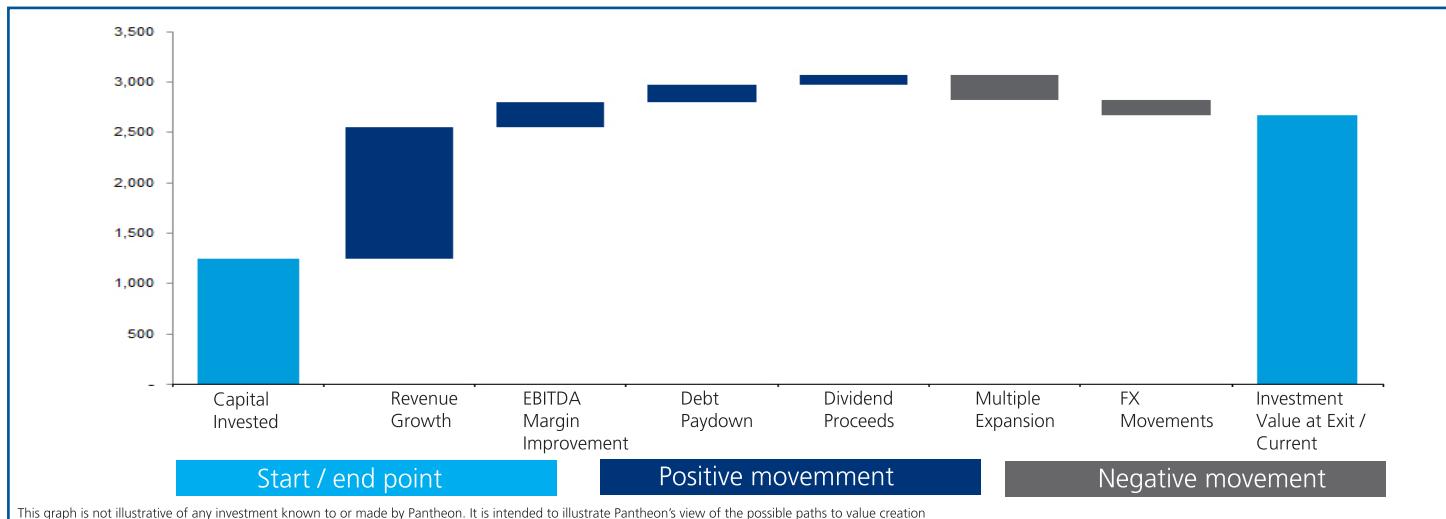


Chart 3



This graph is not illustrative of any investment known to or made by Pantheon. It is intended to illustrate Pantheon's view of the possible paths to value creation.

The conclusion is that while private equity may have much more limited diversification benefits than initially thought, a portfolio of top quartile funds adds significantly to the return profile of a portfolio if investors are able to consistently pick the best managers.

Of course, that gives rise to the question of how investors can determine in advance that a fund will be top quartile? Fortunately, the techniques that specialised private equity fund investors such as Pantheon employ are able to get directly to the heart of the matter by isolating and analysing the manager skills responsible for their good prior performance as well as the likelihood of a firm's ability to replicate them going forward. Then, absent a significant unexpected change in the firm's talent pool, their out-performance tends to be persistent (Kaplan and Schoar, 2005)². As a result, without some exogenous factor, with private equity investing past performance is generally quite a good predictor of future results.

While there are many different dimensions that professionals use to evaluate manager capability, some of which are fairly objective - such as alignment of interest, team compensation matters and turnover - others are much more subjective, these include investment team talent and size, investment strategy and organizational dynamics. Fortunately, the analysis of the track record, which is one of the most important components of the evaluation process, is quite objective. The key tool used to evaluate private equity manager skill is the construction and analysis of a "value bridge" for historical investments. A simple example and description of this tool is provided in the chart 3.

In essence, the value bridge breaks down the various components of how a manager created value in an investment from the point of entry to the point of exit. As you can see in the chart, the value bridge highlights six drivers of value creation:

- > Revenue growth
- > Margin improvement (expense reduction)
- > Debt paydown (similar to paying down a mortgage to accrue equity)
- > Dividends
- > Multiple expansion (accounts for the market environment at entry and exit)
- > FX movement (important to consider when investing US\$ into another currency)

The most replicable elements of value creation are those that the manager can control, so the impact of revenue growth and margin improvement are usually the most important. However, a manager can also impact other elements, such as multiple expansion, where executing a buy-and-build or other strategy could allow for a re-rating of a company in terms of its valuation multiple.

If you expend the time and effort to analyse each of the transactions in a managers' track record in this way, you will have developed a good idea of whether they will be able to give you the alpha that private equity is capable of providing.

¹ Quote taken from: "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment" by David F Swensen. ² The journal of finance, Volume LX No. 4. August 2005. "Private Equity Performance: Returns, Persistence and Capital Flows" by Steven N Kaplan and Antoinette Schoar.
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