Private Equity – Is It Worth the Illiquidity?

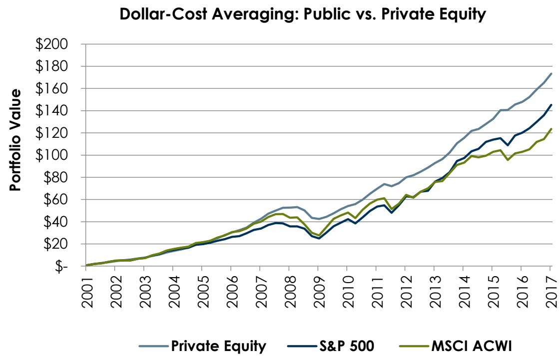
December 2017

BACKGROUND

- **Private equity has underperformed public equities over the trailing 8-years**
- **Purchase price multiples and private equity fundraising are near record highs**
- **Investors wonder…Is it worth the hassle?**

Private Equity as an Asset Class - Private equity is different than most assets classes for a number of reasons. Most private equity funds are illiquid and investors receive distributions from investments at the manager's discretion. Private equity managers typically call capital to fund new investments over several years, compared to more liquid asset classes in which investors are fully invested at inception. As a result, private equity strategies typically experience the "j-curve" effect in which it takes a long period of time to overcome organizational expenses and management fees to show positive performance figures. Private equity investors typically receive multiple capital calls each year and are subject to more complicated tax filings. For all of these reasons investors expect to receive a premium for investing in private equity compared to public equity.

Do Investors Receive an Illiquidity Premium? – According to private markets data provider, Preqin, the median private equity manager generated a 13.6% annualized return over the trailing eight years (as of March 31, 2017, the most recent performance information available). The S&P 500 has been in a bull market over the same period, generating a 17.0% annualized return. Over the shorter time frame, investors have not received an "illiquidity premium" for investing in private equity.

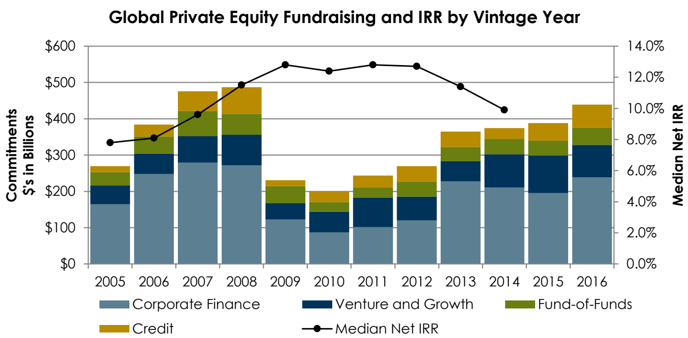


Source: ACG Research, Preqin

A Longer Term Performance Perspective – Given the illiquid nature of the asset class, it is more constructive to compare the performance of private equity to public equity over longer periods of time. Using Preqin median quarterly returns back to 1Q 2001 (first quarterly return provided) the chart above compares the portfolio value of investing $1 per quarter in Private Equity, the S&P 500, and the MSCI ACWI (global stocks). Over 16 years, the terminal value for the private equity portfolio was $173, compared to $145 for the S&P 500 and $124 for the MSCI ACWI. From an internal rate of return (IRR) perspective, this simplified analysis results in an 11.0% net IRR for private equity, a 9.1% IRR for the S&P 500, and a 7.4% IRR for the MSCI ACWI.

Private Equity Purchase Price Multiples and Fundraising – The median acquisition price for a private equity-backed company purchased in the first half of 2017 was 10.8x EBITDA (Source: S&P Capital IQ). This is up from 10.0x EBITDA in 2016, and higher than the transaction multiples of 2007, the end of the last cycle. At the same time, private equity fundraising continues its torrid pace and 2017 could exceed the global fundraising high water mark of $487 billion set in 2008. It seems reasonable to assume that a record level of capital available to invest will push purchase price multiples higher and potential returns lower.

However, after a fund is raised, private equity managers control the pace at which the fund is invested. For example, a buyout fund that held a final close in 2008 likely invested in 2008, 2009, and 2010. This provides time diversification even within a single private equity fund. The chart below illustrates that although 2007 and 2008 were record fundraising years with more than $475 billion of capital raised globally, the median private equity managers during those vintage years generated a 9.6% and an 11.5% net IRR since inception, respectively. These funds, while raised during a very frothy fundraising environment (similar to today), still generated competitive returns.



Source: ACG Research, Preqin

ACG'S POSITION

Private equity investments exhibit unique challenges when compared to traditional asset classes. Investors allocating to private equity need to be aware of the illiquidity and additional administrative burden inherent in the asset class. Private equity may underperform public equity over short timeframes. However, private equity managers have shown the ability to generate attractive absolute and relative returns over long periods of time, even during robust fundraising environments. Private equity should be considered a strong complement to, not a replacement for, public equities in well diversified investment portfolios.

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