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Anna Rathbun, CFA, Director, Research

# The Unique Sounds of Private Equity Investing

BY ANNA J. RATHBUN, CFA, DIRECTOR, RESEARCH

In the spring of 1913, a young Russian composer named Igor Stravinsky premiered a ballet and orchestral work called "The Rite of Spring." This avant-garde music (and the choreography by Vaslav Nijinsky) was so shockingly new and out of convention that a riot broke out among the audience members, as the story goes. Stravinsky's intention was not to stoke violence in the Parisian art scene. Like many composers of the twentieth century, he was pushing the limits of the musical forms and sounds that he inherited. The expressions in the "old" sound had been exhausted, and Stravinsky was searching for new opportunities in the musical palette.

I cannot imagine audience members throwing punches at Carnegie Hall or Severance Hall in 2017, but as an investment professional, I do see investors reaching for new opportunities when they feel that the most readily available options are not meeting their needs. When the Federal Reserve lowered rates to near zero in 2008, no one had expected that the rates would remain at historic lows for the next 7 years. During that time, U.S. bond yields remained depressed, and although the lower rate environment raised asset prices and fueled the U.S. equity markets, lukewarm growth prospects continued to put downward pressure on expected returns of U.S. equity investments. As investors sought out sources for higher returns, many of them turned to private investments. Chart 1 on the following page shows the growth of the private equity industry in terms of total capital invested as well as the number of deals completed from 2008 through 3Q 2017.

## Hartland 2nd Annual Women's Luncheon Hosted by HEELS

Hartland's 2nd annual women's luncheon was held on October 20th at the Country Club in Pepper Pike. The luncheon was hosted by the women of HEELS (Hartland Empowers Exceptional Ladies). 130 women joined together to enjoy lunch and the musical selections of Anna Rathbun and Donna Lee. Anna Rathbun is a Director in Hartland's research department. She is also an accomplished soprano with a Doctor of Musical Arts from the Cleveland Institute of Music. Donna Lee accompanied Anna on the piano. The featured speaker was Jackie Acho, Ph.D., President of the Acho Group. Jackie shared her thoughts on the role of empathy in leadership. A few lucky women went home with beautiful gifts from local women-owned businesses. It was a wonderful afternoon of learning, networking, and fun.

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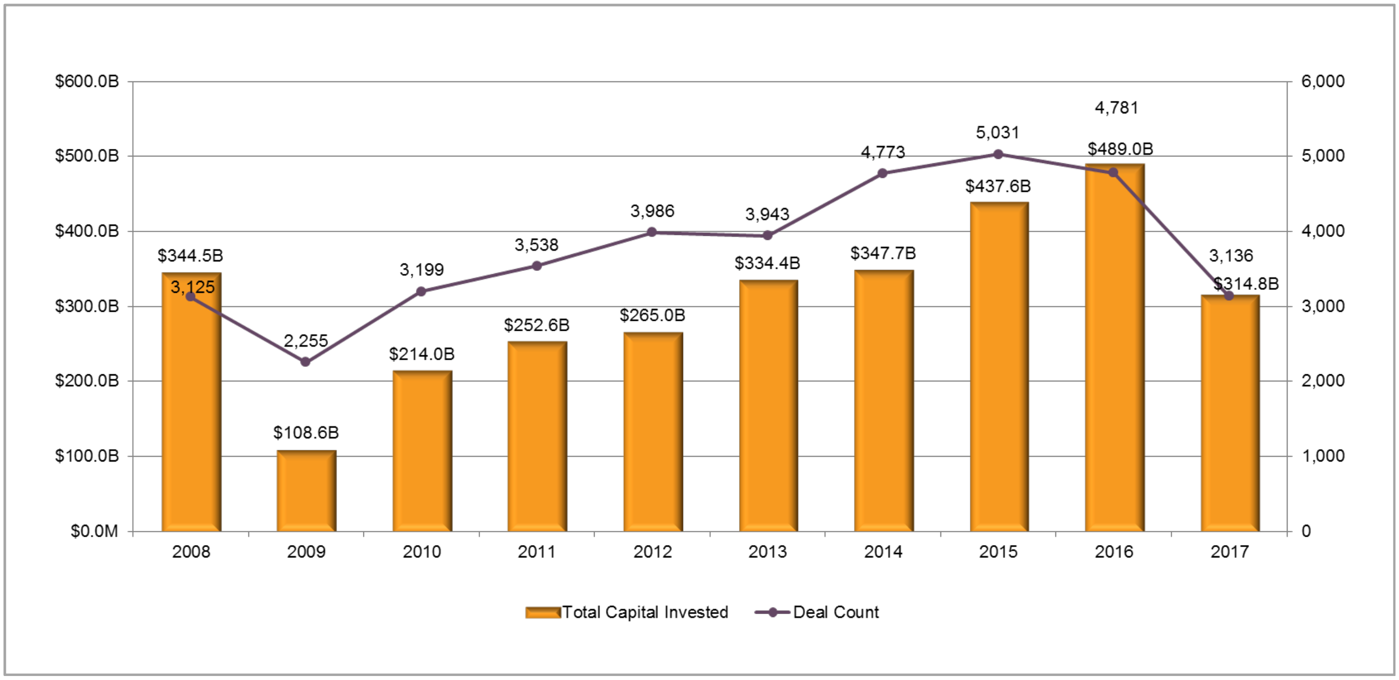
**CHART 1:**




Source: PitchBook. Data as of 9/30/2017.

So, what are investors finding in the private space that they cannot obtain in the public markets? They are discovering unique market exposure, tapping into manager value-add, and harvesting an illiquidity premium.

## New Opportunities

The U.S. public exchanges make available a great number of companies for investing, but by no means do they cover all businesses in the United States. The U.S. Census Bureau estimates that there were 5.8 million firms in the United States in 2014, with about 90% of them being small with less than 20 employees.[1] Of that number, only 4,369 companies were publicly traded during the same year, according to The World Bank.[2] These statistics indicate that there are significant investment opportunities outside the public exchanges, including start-ups and small businesses that need private sourcing. Private equity managers play a significant role in the economy by helping unlisted businesses find financing, and by expanding the opportunity set beyond the public markets for investors.

## The Value-Add

The benefits of private investing extend beyond merely accessing investments outside the market exchange. Private companies have not been vetted as thoroughly by investors as those on the public exchanges, making them an "inefficient" investment. What makes private markets inefficient? Efficiency of the market generally refers to information availability and liquidity. First, information regarding private companies is not readily transparent and is asymmetrical, meaning that the investors know significantly less about the company than the management. Secondly, transactions of these businesses do not take place frequently, and therefore, any timely and accurate information is not reflected in the price or worth of the private company. Such inefficiencies present an opportunity for an investment manager to add value, by engaging with the private companies at a more intimate level, obtaining the information that is necessary to add value to the firm, and improving operations to increase the value of the business.

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Successful enhancement of investment portfolio companies often requires a hands-on partnership from the private equity manager. To achieve this, the private equity fund can become a controlling stakeholder in the firm, where the investors can have a significant influence on the direction of the private company. With active ownership, there is room for strategic and operational guidance, and ultimately what McKinsey calls "governance arbitrage:"[3] an improvement of corporate leadership that will directly influence the effectiveness and efficiency of the private company. Ideally, the result is better management comprised of talented industry leaders and properly-aligned incentive for longevity of success beyond the ultimate sale of the private company. In the private debt world, investors may also be able to demand favorable terms in the debt covenants. Certain private investments may also span the capital structure, as with distressed debt investing containing an equity upside upon success of the investment. These are some tangible ways in which private equity managers can effectively add value to the companies they acquire. Ironically, the inefficiencies of the private markets ultimately render the companies in them an opportunity to be more efficiently run. This is the source of the expectation of a higher return potential compared to the public markets – the direct effort of active managers to turn companies around at the core and/or build them to augment their value.

## Illiquidity

All of this work takes good time, certainly longer than the quarterly reporting cycle by which public companies are measured. Private equity managers normally employ a lock up period that can last around ten years and sometimes be extended a few more. The locking up of capital means that one cannot make redemptions, and this may seem daunting to some investors. The liquidity restriction, however, allows the manager to embrace the long-term view. Making meaningful changes to organizations costs both time and money, and these often take time to realize their potential. Table 1 shows the negative IRR (internal rate of return) during the initial phase of private equity funds followed by the dramatic recovery in the later years, commonly referred to as the "J-curve" based on its shape. The lock-up period allows the private equity manager to shape and influence business decisions without facing short-term investor redemptions with the goal to ultimately realize the potential of their value-add down the line.

**TABLE 1:**

PE J-curve: IRRs over time by vintage

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|
| 0 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| 1 | -21.5% | -20.6% | -30.7% | -28.1% | -22.4% | -21.7% | -20.5% | -10.2% | -15.6% |
| 2 | -1.1% | -18.9% | -12.4% | 4.8% | -7.0% | -3.0% | 2.5% | -1.8% | -0.6% |
| 3 | -11.7% | -4.0% | 0.0% | 8.0% | 2.9% | 5.3% | 12.0% | 6.0% | 8.4% |
| 4 | -7.5% | 4.5% | 3.6% | 10.6% | 8.9% | 10.8% | 11.6% | 11.7% | |
| 5 | 1.7% | 6.3% | 7.9% | 13.0% | 11.4% | 11.4% | 13.4% | | |
| 6 | 4.5% | 8.7% | 11.3% | 14.5% | 9.6% | 13.5% | | | |
| 7 | 5.0% | 8.6% | 10.8% | 12.7% | 10.2% | | | | |
| 8 | 6.4% | 9.6% | 10.6% | 14.6% | | | | | |
| 9 | 6.2% | 9.5% | 9.9% | | | | | | |
| 10 | 7.0% | 9.2% | | | | | | | |

Source: PitchBook, 2017 PE & VC Fund Performance Report. Data as of 12/31/2016. Past performance is no guarantee of future results.

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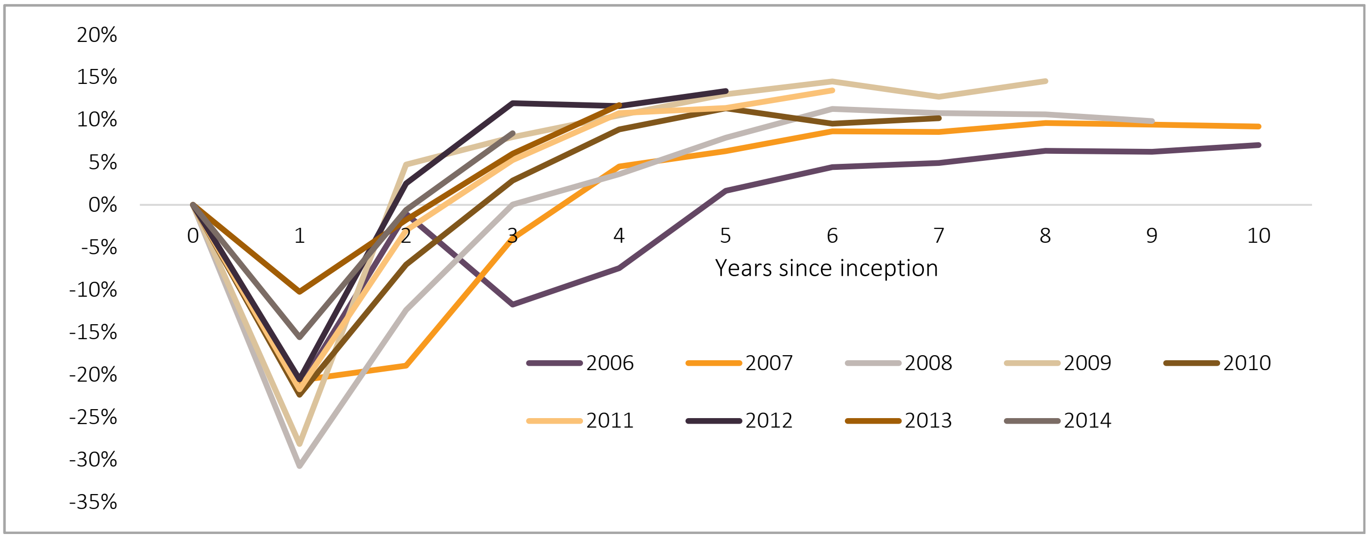
Chart 2 below is a graphic representation of Table 1 on the previous page, and it helps one to see why this pattern of returns is called the "J-curve."

**CHART 2:**

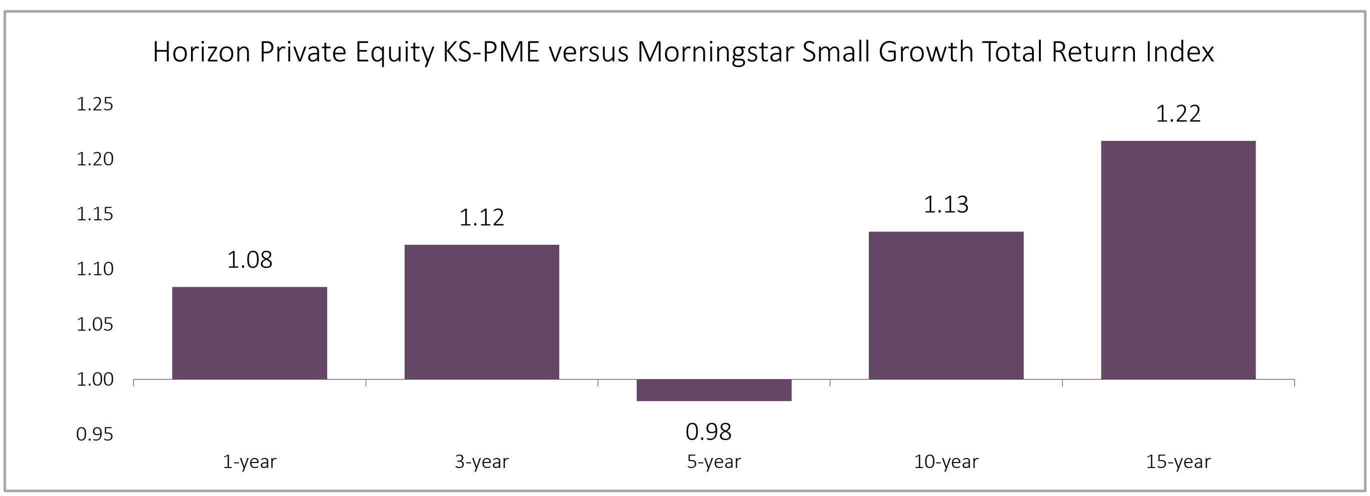



Source: PitchBook. Data as of 12/31/2016. Past performance is no guarantee of future results.

At the end of the investment period, investors should be rewarded with an illiquidity premium, which is essentially compensation for their patience. This premium is above the returns that one would expect from a highly liquid market, such as publicly traded stocks. In addition, lack of liquidity means that private investments are not subject to daily market-to-market practice. When the public markets experience short-term volatility, privately held companies do not ride those waves.

Chart 3 summarizes the premium a private investor would have experienced over the public markets over specific time horizons. For every dollar return from the Morningstar Small Growth Total Return Index, private investments returned $1.22 for the fifteen-year period (for the Kaplan Schoar (KS) PME Index, value greater than 1 means that private investments outperformed the public index). In summary, this premium includes access to the private markets, the active manager value-add, and, finally, compensation for illiquidity.

**CHART 3:**

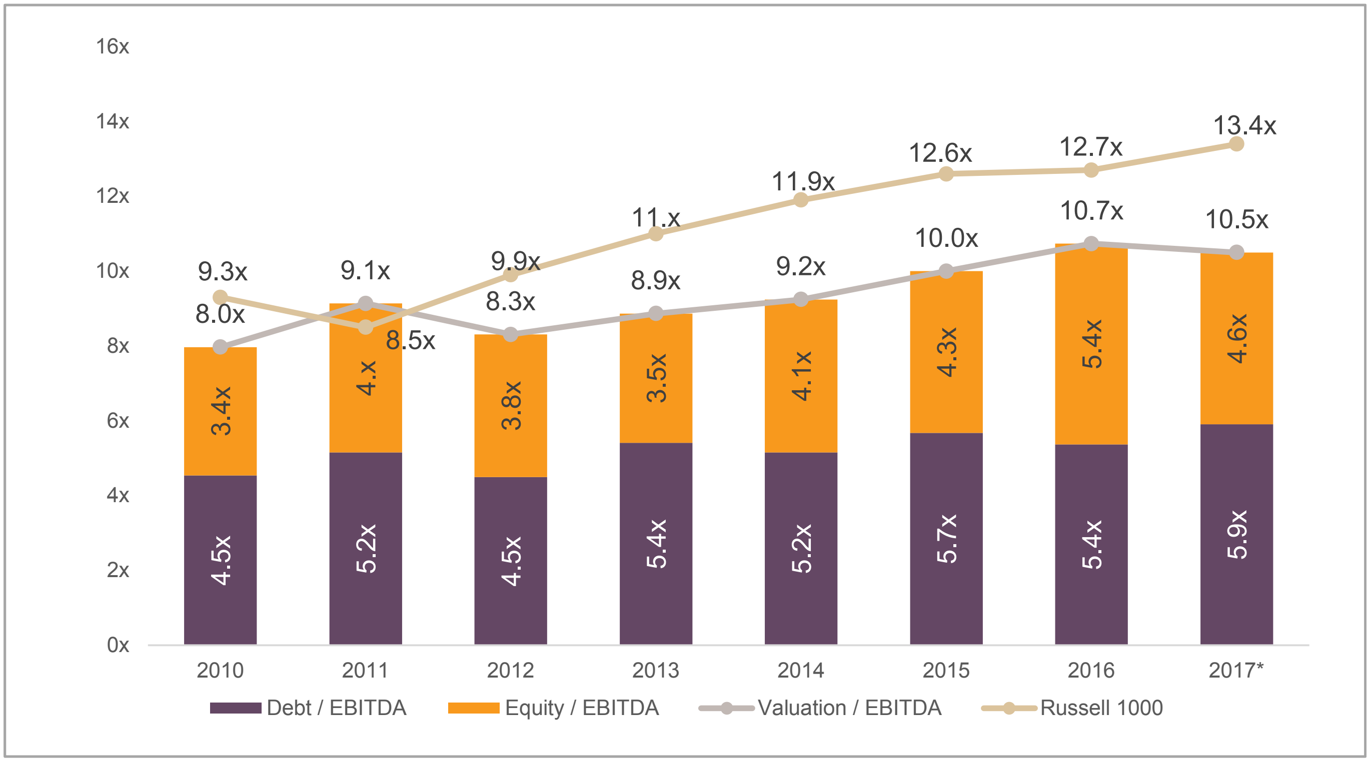



Source: PitchBook. Data as of 12/31/2016. Past performance is no guarantee of future results.

## Valuation

The increasing capital chasing private equity means that fund managers face a more competitive environment for deals. Private equity is certainly not cheap by historical standards, and concerns around higher prices are noteworthy. While valuations are elevated for private equity, it is important to consider it in the context of other investments, many of which are also highly valued. U.S. equity indices have hit multiple highs so far in 2017, and, as Chart 4 shows, public market multiples have risen faster than private equity valuations. In an environment when valuations seem high all around us, private investments still offer an attractive premium above what is available in the public markets.

**CHART 4:**

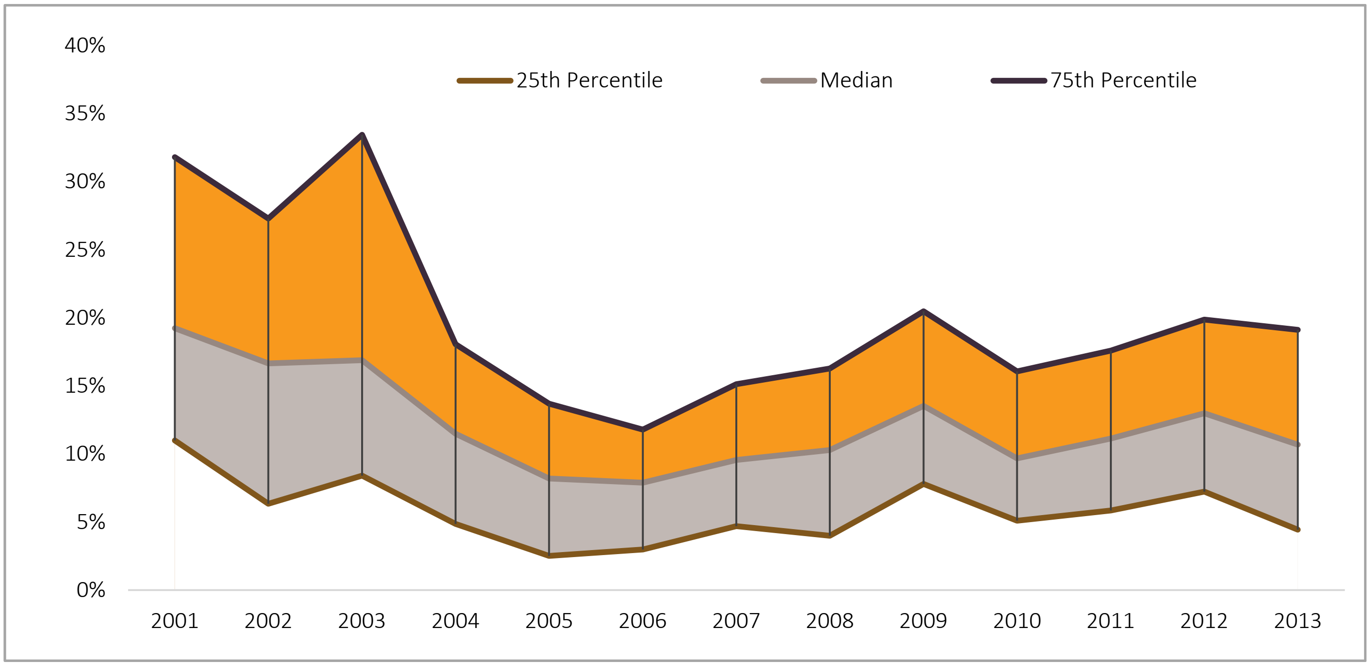



Source: Bloomberg, PitchBook. Data as of 6/30/2017.

Behind the increase of capital infusion into private markets, there is also a substantial amount of dollars on the sidelines to be invested. According to Preqin, that number stands at $963 billion as of July 2017.[4] The investor effort in putting cash to work also explains the "increased appetite" for private equity witnessed by fund managers.[5] Once you remove the silo around a single asset class and consider the whole investable universe, private equity remains an attractive investment opportunity.

High valuations, nevertheless, mean that manager skill in sourcing deals at a good price and adding value to the investment companies is paramount. Dispersion in private equity manager performance by vintage year, as measured by IRR (Internal Rate of Return), is fairly wide as shown on the next page.

**CHART 5:**




Source: PitchBook. Data as of 12/31/2016. Past performance is no guarantee of future results.

**TABLE 2: Global PE IRR Quartiles by Vintage Year**

| Vintage Year | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Top | 31.8% | 27.3% | 33.5% | 18.1% | 13.7% | 11.8% | 15.1% | 16.3% | 20.5% | 16.1% | 17.6% | 19.9% | 19.1% |
| Median | 19.2% | 16.7% | 16.9% | 11.5% | 8.2% | 7.9% | 9.6% | 10.3% | 13.5% | 9.7% | 11.2% | 13.0% | 10.7% |
| Bottom | 11.0% | 6.4% | 8.4% | 4.9% | 2.5% | 3.0% | 4.7% | 4.0% | 7.8% | 5.1% | 5.9% | 7.2% | 4.4% |

Source: PitchBook. Data as of 12/31/2016. Past performance is no guarantee of future results.

The dispersion of manager performance through time highlights the importance of manager due diligence. When most asset class valuations seem stretched, whether or not managers have influence in pricing and significant control in the improvement of the private company, they can make a difference in the investor outcome.

## Conclusion

Stravinsky is certainly one of the pioneers of “new” music, along with Karlheinz Stockhausen, John Cage, Erik Satie, and many others. It is not the case, however, that all the composers who experimented with new sounds during the twentieth century made an impact on history’s musical landscape. The influence of all the 20th-century composers may be graphed in a performance dispersion chart similar to Chart 5, and my suspicion is that the resulting graph will look much more volatile. There is not a procedure to understand what musical pieces may spark riots and grace the headlines of major newspapers, but, fortunately for our investors, we have a disciplined due diligence process in private equity manager selection. For those wishing to expand the boundaries of investing, Hartland's dedicated independent research team is ready to help clients extend beyond the public market arena and into private market investments.

**Sources:**

(1) U.S. Census Bureau, Statistics of U.S. Businesses (SUSB) 2014 Annual Data Tables by Establishment Industry. https://www.census.gov/data/tables/2014/econ/susb/2014-susb-annual.html.

(2) The World Bank, World Federation of Exchanges database. https://data.worldbank.org/indicator/CM.MKT.LDOM.NO. For 2016, The World Bank estimates 4,331 publicly traded companies in the United States.

(3) McKinsey & Company, The Private-Market Investing Revolution. Fall 2016.

(4) Preqin Special Report: Private Equity Fund Manager Outlook 2017.

(5) Ibid.



## MARKET BENCHMARK RETURNS

| October 31, 2017 | | 1M | 3M | 12M | YTD |
|---|---|---|---|---|---|
| US Large Cap | S&P 500 | 2.3% | 4.8% | 23.6% | 16.9% |
| US Small Cap | Russell 2000 | 0.9% | 5.8% | 27.8% | 11.9% |
| Developed Intl | MSCI EAFE | 1.5% | 4.0% | 23.4% | 21.8% |
| Emerging Intl | MSCI Em Mkt | 3.5% | 5.4% | 26.5% | 32.3% |
| Real Estate | NAREIT | -0.1% | -0.1% | 8.8% | 6.6% |
| Core Fixed | BarCap Agg | 0.1% | 0.5% | 0.9% | 3.2% |
| Short Fixed | BarCap 1-3Yr | 0.0% | 0.1% | 0.7% | 1.0% |
| Long Fixed | BarCap LT G/C | 0.4% | 1.7% | 2.5% | 8.1% |
| Corp Debt | BarCap Corp | 0.3% | 1.0% | 3.2% | 5.4% |

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.