# Feeling the pulse of private equity

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Passion for Private Markets

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# Feeling the pulse of private equity

Against the background of raising complexity and uncertainty, private markets investments, conducted by a leading global integrated investment manager, can provide significant long term benefits across economic cycles.

Realizing private markets investments across the cycle requires an in-depth assessment of the different segments from a top-down and bottom-up perspective. Investment managers have to be able to attract the most compelling investment opportunities along all phases of the economic cycle to the benefit of their clients.

Key findings of our research study comprise:

- Considering the link between the economic environment and private equity realizations, a significant pick-up in distributions is strongly linked to a recovery of economic growth
- Although this period of low realization activity did and will further cause issues for some investors ("liquidity perspective"), other investors appreciate investment managers to realize their investments in a less risk-averse post-crisis exit environment at a higher multiple ("return perspective")
- Many investment managers have only limited reserves for further investments (especially the ones who invested at an aggressive pace in 2006-2007) and will need to invest remaining dry powder in existing portfolio companies instead of allocating it to new investment opportunities
- We expect a consolidating business environment where investors are looking for quality managers with solid track records and a global integrated approach. Some players in the industry may have to go out of business

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## INTRODUCTION

Private equity investments are characterized by two types of cash flows: once the investment manager of a fund has identified an investment opportunity, capital will be called from investors. Typically, after three to six years investors are rewarded with a distribution after the company has successfully been exited. An obvious question is the dependence of these cash flows on the prevailing economic climate.

Data suggest a strong dependence of distribution activity and GDP growth. This is also a natural reflection of the incentive schemes that govern private equity. With investment managers participating in the value created for investors, exits are mainly executed in times where attractive valuations are achieved. The transaction activity of investment managers on the other hand is observed to be largely independent of the economic climate except for severe economic crises, where financing is scarce and managers are heavily involved in their existing portfolio companies.

The year 2009 has been characterized by a historically low cash flow activity. Distribution activity was less than one fifth of a normal year, similarly investment activity only stood at around 50% of a normal year. With GDP growth rates estimated at slightly over 3% in 2010 and 2011 in the U.S. and at 1.2% in 2010 and further increasing to 1.8% in 2011 in the Eurozone, investors can be confident that the distributions will continue to increase from the historically low levels observed in 2009. At the same time, GDP growth in developed economies is anticipated to remain below potential growth for an extended period of time and loose monetary policy may lead to an increase in inflation in the mid-term. In such a stagflationary environment, investment activity is anticipated to outpace exit activity. For investors that pursued an aggressive commitment strategy, liquidity may remain tight in the years to come. As many investors are still ramping up their private equity portfolio, demand from new entrants for the asset class will remain strong – existing investors will need to see realizations before capacity for new investments is freed up. This is expected to further the consolidation process in the industry.

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## MEASURING THE PULSE

In contrast to public market investments, where the investor is in full control of the timing of investment and exit, private equity investments, or more specifically investors in private equity fund investments, delegate this timing decision to investment managers. These specialists decide after a thorough due diligence process on when a company warrants an investment and after a period of typically three to six years, during which the investment manager aims to maximize the value of the company, when the investment is to be realized. The cash flows arising from this delegation are an important characteristic of private equity investments and naturally provide a measure on the industry's investment- and exit-activity as measured by the so-called realization and investment ratio.

The *realization ratio* is defined as the sum of all distributions during the respective period divided by the net asset value at the beginning of the period. In other words, the realization ratio measures what percentage of the prevailing value is distributed to investors (on an annualized basis). For example, a fund which during a quarter realizes USD 5m from total assets worth USD 100m at the beginning of the quarter has a quarterly realization ratio of 5% or 20% if annualized. Given the typical holding period of private equity companies of three to six years a typical realization ratio of a mature program is expected to stand at around 20-25% on average.

The *investment ratio* is defined as the sum of capital called during the respective period, divided by the aggregate amount of uncalled capital at the beginning of the period (on an annualized basis). In other words, the investment ratio measures what percentage of money available to investment partners ("shooting power") has actually been invested. For example, let's take a fund with uncalled commitments of USD 400m. Within the quarter, the investment manager calls USD 16m representing 4% of the amount available for investment or 16% if annualized. As for the realization ratio, the typical investment ratio depends on the maturity of the portfolio. While in the first year, an investment manager will typically call around 20% of commitments (and thus 20% of undrawn) the investment ratio increases in years 2 to 5 with a similar (absolute) investment activity but less undrawn capital. A blended investment ratio of a portfolio that is diversified across vintage years is expected to range between 30-35%.
The focus of the analysis is the relation between cash flow activity[1] and economic activity as measured by GDP growth.[2]

## REALIZATIONS ARE STRONGLY LINKED TO GDP

There is no doubt that realization activity is strongly linked to GDP growth, both for the U.S. and Europe. The correlation of the buyout realization ratio stands at 0.71 for the U.S. and 0.77 for Europe. Investment managers achieve the most significant part of their realizations in a strong economic environment; typically representing an environment when investments can be sold at attractive valuations. We observe that investment managers are less willing to sell their companies in an economically challenging environment. Swings in the realization activity have been significant with the maximum realization activity being 3-4x the activity in challenging periods even after smoothing.

[1] Private equity cash flow data is taken from Thomson Reuters which covers a significant portion of the fund universe in North America and Europe and from Partners Group for more recent private equity activity (2010). To reduce the noise of activity ratios, data has been smoothed by taking the 3-year rolling averages.
[2] GDP growth rates are taken from data of the International Monetary Fund.

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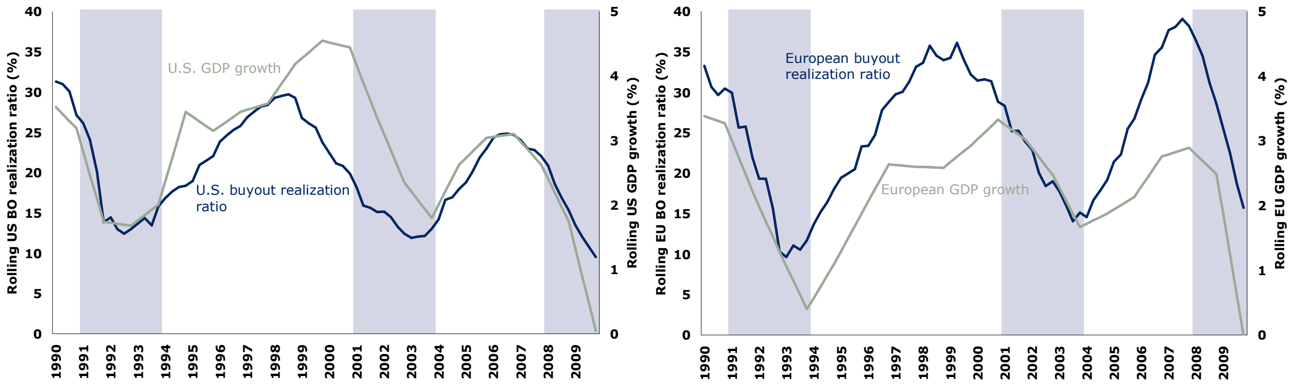
This control over the timing of realizations is in our opinion a significant benefit of private equity over other asset classes. Investors delegate the decision on selling assets to investment managers, which are appropriately incentivized through carry schemes to aim at maximizing the profits on underlying investments. This benefit comes at the cost of illiquidity, but we are convinced that the benefits outweigh. In the case of hedge funds, investors that had to redeem their stakes in the most recent crisis have also impacted the results for all other investors by forcing the respective vehicles to generate liquidity at depressed valuations.

**Exhibit 1: U.S. and European buyout realization ratio (blue) vs. GDP growth (grey)**

***Economically challenging periods (early nineties, TMT bubble, sub-prime crisis) are highlighted with a light blue background colour.***




The strong link between the realization ratio and GDP growth has again become manifest in the 2009 realization activity of less than 20% (!) of a normal year. Such a slow pace is not observed over the last 20 years and is indicative for the severity of the crisis. Beginning in Q4 2009 and continuing in 2010, investors have observed a clear pick-up in distribution activity. Investment managers successfully sold companies such as Unity Media or Tommy Hilfiger to strategic buyers and achieved flotations across the globe (e.g. Sensata, Amadeus, Kabel Deutschland). By far not all exits that had been targeted were finally achieved: investment managers had to delay many of the announced listings as the appetite is not able to capture all the planned exits. Based on historical observations, investors might well need to wait until 2012 before distributions will be back to normal.

## INVESTMENT MANAGERS INVEST ACROSS THE CYCLE

Historical data indicates that there is no clear link between the investment ratio and GDP growth. Except for a severe economic slow-down, such as observed at the beginning of this decade or during the most recent crisis, where the investment ratio decreased sharply, the investment ratio has been relatively unaffected by economic cycles. Moreover, investment activity has historically been significantly less volatile than the realization activity. For example, the volatility of the European investment ratio is half the volatility of the respective realization ratio.

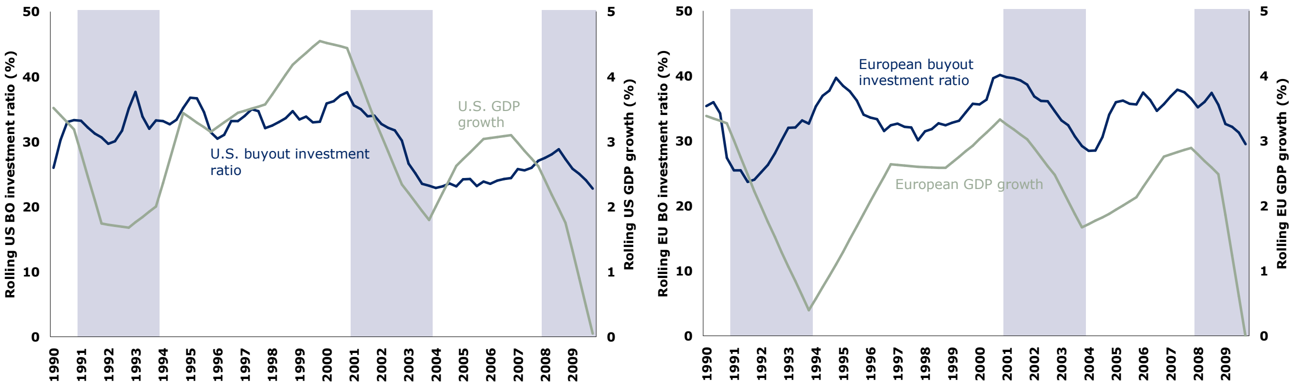
This relative stability can be explained by various factors: i) the investment period is contractually limited to (typically) five years, ii) investment managers have limited resources to work on transactions (which provides for a limit on transactions that can be executed in any given time period and thus also an upper cap on investment activity) and iii) investment managers adapt quickly to a changing environment by investing into different industries or by adapting to prices and/or capital structures to the prevailing environment and by taking advantage of their ability to generate deal flow largely independent of the cycle.

Similarly, the decrease of investment activity in economically very challenging times is explainable by i) a general increase in risk aversion – assessing a business case in late 2008 or early 2009 has been a challenge. A significant bid-ask spread is observed with sellers, unless distressed, not being willing to adjust price expectations as quickly as buyers adapt their offers to their conservative scenarios, ii) low availability of financing, and iii) investment managers are spending a considerable amount of time on their existing portfolio companies, which is what investors expect them to do!

All these factors were again strongly prevalent in 2008 and especially 2009 and have led, similar as in the case of distributions, to a low activity without historic precedent. At the same time, investors have observed a pick-up of the investment activity in H1 2010.

**Exhibit 2: U.S. and European buyout investment ratio (blue) vs. GDP growth (grey)**

***Economically challenging periods (early nineties, TMT bubble, sub-prime crisis) are highlighted with a light blue background colour.***




## CASH FLOW ACTIVITY IN A LOW GROWTH ENVIRONMENT

Considering the (quantitative) link between the economic environment and private equity realizations, a significant pick-up in distributions is only expected to happen once we observe a recovery of economic growth. On the back of an expected global real GDP growth of 4.6% in 2010, a recovery in the realization pace from the heavily depressed levels in 2009 has already taken place in H1 2010 and is expected to continue. With the looming sovereign debt and the long-term impact of the most recent crisis especially in the developed countries on economic growth, we however expect distributions to remain significantly below normal levels in 2010 and most likely also in 2011. For the realization activity to return to normal levels, investors might well need to wait until 2012. Beyond the more quantitative arguments, realization ratios are expected to lag as exit channels are still not strong enough to absorb the volume that is tagged for realization. Although this period of low realization activity did and will further cause issues for some investors ("liquidity perspective"), other investors appreciate investment managers to realize their investments in a less risk-averse exit environment at a higher multiple ("return perspective").

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Nevertheless, investors looking back to the aftermath of the challenging economic environment in 2000-2002, still recall the sharp increase in realization activity in H2 2003 and even more so in 2004. While we have seen a sharp decline in distributions starting in summer 2008, investors have started to observe a similar phenomenon as in H2 2003 in the first half of 2010.

Historically, investment activity showed a more stable development across cycles. We believe however that investment managers will remain reluctant to send out too many capital call notices for various reasons:

- i) Investment managers are expected to be mindful of (some of) their investors' continued liquidity/allocation constraints
- ii) Many investment managers have only limited reserves for further investments (especially the ones who invested at an aggressive pace in 2006-2007). Investment managers will need to carefully consider how to split their reserves into the necessary funds to bring their portfolio through the cycle and allocate capital to new investments. A part of the remaining dry powder will need to be invested in existing portfolio companies
- iii) The current environment remains to be very challenging for fundraising. Fundraising in 2009 was at around 30% of 2008 across the globe and has not picked up significantly in 2010. Capital constrained limited partners will carefully select how to spend their money

We expect a consolidating business environment where investors are looking for quality managers with a solid track record and a global integrated investment approach, whereas some other players in the industry may have to go out of business.

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