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Understanding private equity's outperformance in difficult times

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Partners Group
Passion for Private Markets

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Understanding private equity's outperformance in difficult times

EXECUTIVE SUMMARY

Many studies confirm that private equity investments have consistently outperformed public equity markets. A common prejudice is that this superior performance is attributable to the higher risk that private equity investors take. Therefore, private equity is viewed as an unattractive asset class during difficult macroeconomic environments. We have looked at this hypothesis from various angles and found evidence that it is not justified:

Private equity investments beat public equities and offer an attractive risk profile at the same time. This is proven correct *especially* in a challenging macroeconomic environment. Private equity's outperformance over public equities increases further while volatility still remains lower:

- Since 2000, private equity investments have outperformed the respective public equity indices by 5% in North America and 9% in Europe per annum
- In the aftermath of the burst of the internet bubble (Q2 2000 to Q1 2003), private equity investments outperformed public markets by 6% in North America and 20% in Europe on an annualized basis
- During the financial crisis from Q3 2007 to Q1 2009, private equity investments beat public market indices by 19% in both North America and Europe on an annualized basis

These results imply that private equity is a particularly attractive asset class in times of high economic uncertainty.

In order to explain these obvious discrepancies in performance and risk, one would have to look at the differences between the investment approach of a private equity investor such as Partners Group and a public equity investor. We found three systematic advantages that are inherent to the private equity business model:

- The selection process is based on the operational performance of a company and in-depth information provided in a due diligence process ("legal insiders")
- The investors' long-term orientation enables sustainable value creation strategies beyond short-term results
- Corporate governance structures allow private equity investors to actively engage in a portfolio company's management and implement operational improvements

In particular, the ability to drive operational improvements in a company differentiate private equity investors from public equity investors as it enables us to actively engage into a company's management when the environment becomes difficult.

The required corporate governance structure is based on three major pillars:

- Controlling stakes and board representations that allow investors to be directly involved in the decision making process; every budget, every major strategic or operational decision is reviewed by the board, ensuring shareholder's full control
- Alignment of interests between owners and management by strongly incentivizing management through significant equity stakes; managers are requested to invest significant amounts into the companies they run but substantially improve their remuneration at an exit
- Regular reviews of management performance and a quick decision-making process to execute required changes; private equity investors have the resources and the capabilities to ensure continuous monitoring of operating management throughout the investment period

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As the capability to execute operational improvements at a portfolio company's level differentiates successful private equity investors from their peers, Partners Group and other investors increasingly focus on pure operational improvements in their value creation plan:

- Almost 75% of expected value creation is generated by direct operational improvements within portfolio companies:

Revenue growth (38% of expected value creation): private equity investors focus on growth opportunities and provide financial and operational support for achieving sustainable, long-term growth.

EBITDA margin improvement (37%): Private equity investors continuously look to improve the cost structures of their portfolio companies. Direct involvement in the operational management by the private equity investors is essential for driving these processes.

- Approximately 25% of expected value creation is to be derived from levers that are indirectly influenced by operational improvement measures:

Multiple expansion (4%): Value creation through relative valuation differences can be driven by current market sentiments. But valuation multiples are also driven by the relative positioning of a company in its market. A clear, focused strategy driven by a long-term oriented private equity investor enables a company to achieve a superior positioning, commanding higher multiples at exit.

Cash flow (21%): Value creation from cash flow is indirectly linked to the operating performance of a portfolio company. In private equity investments, cash flow is used to repay financial debt and decrease the leverage during the holding period of an investment. Operational improvements can also aim at reducing working capital and capex spending without directly impacting the profit & loss statement.

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INTRODUCTION

The comparison between investments in private and public equities has been a prevailing topic in many studies¹ since private equity has become a significant portion of most asset managers' portfolios.

The global financial crisis in 2008/2009 and most recently the European sovereign debt crisis have however created a macroeconomic environment that is unparalleled in terms of volatility. As the private equity business model is regarded to be heavily reliant on the state of the financial markets and the availability of credit, this topic has become even more interesting.

Do private equity investors maintain their superior performance in times of a challenging macroeconomic environment? And if so, what are the factors that enable private equity investors to weather even difficult times?

This research note will focus on the question of whether the private equity business model² is sustainable even in a challenging economic environment and what operational levers private equity investors use to maintain its superior performance. This will be illustrated by real-life examples in which Partners Group has been involved as an active investor in the value creation process. Our key findings are as follows:

- Private equity markets beat public equity markets in terms of return and risk – especially in difficult economic times
- Systematic differences drive private equity's superior performance
- Operational improvements lead to superior value creation
- Levers for operational improvements require tight control and flexible decision-making processes

¹ Among others: Boston Consulting Group, "The Advantage of Persistence", 2008. Ernst & Young, "How do private equity investors create value?", 2007.

² In this research, the term private equity refers to buyout investments.

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PRIVATE EQUITY BUYOUT MARKETS BEAT PUBLIC EQUITY MARKETS IN TERMS OF RETURN AND RISK – ESPECIALLY IN DIFFICULT ECONOMIC TIMES

We have looked at the thesis of the outperformance of buyouts critically, by testing the data for different regions and time periods.

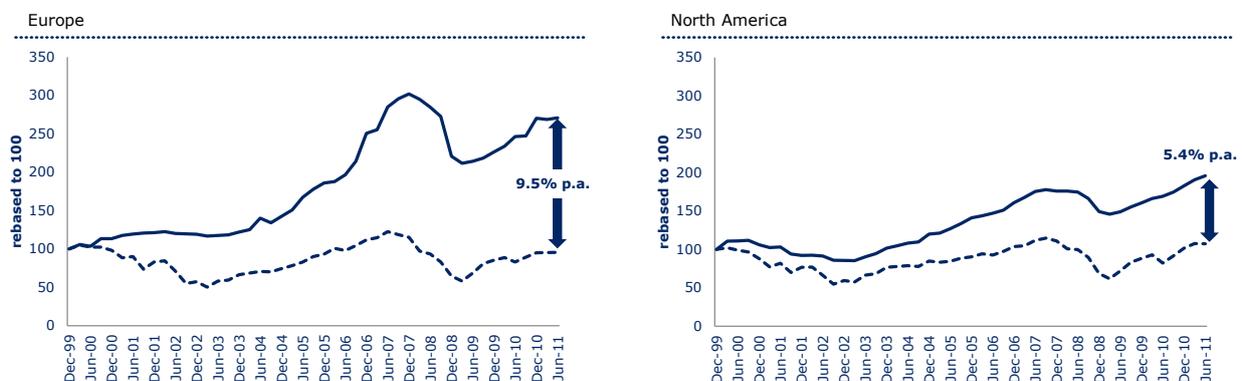
Exhibit 1: Performance of buyouts vs. public equities

Significant outperformance of buyout investments vs. public equity indices in Europe and North America between 2000 and 2011

— Buyouts

- - - MSCI

Annualized buyout performance for different regions measured against the relevant MSCI



Source: Bloomberg (NDDUE15 Index in EUR, NDDUNA Index in USD), Thomson Reuters (Cash Flow Summary Report for WEU and NAM buyouts; Q2 2011)

The chart shows a comparison of the performance achieved by the broad buyout market in different regions vs. the corresponding public equity benchmark (MSCI regional index) since the beginning of 2000. The broad buyout industry shows an outperformance of between 5% in North America and 9% in Western Europe per annum over public markets.

A common prejudice against private equity is that its undoubted superior performance comes with a significant risk exposure. Critics claim that high leverage levels, high pay-outs to shareholders and aggressive growth strategies impose an increased risk on the portfolio companies, as they would not be sufficiently flexible to cope with negative external developments that inevitably arise in difficult economic times.

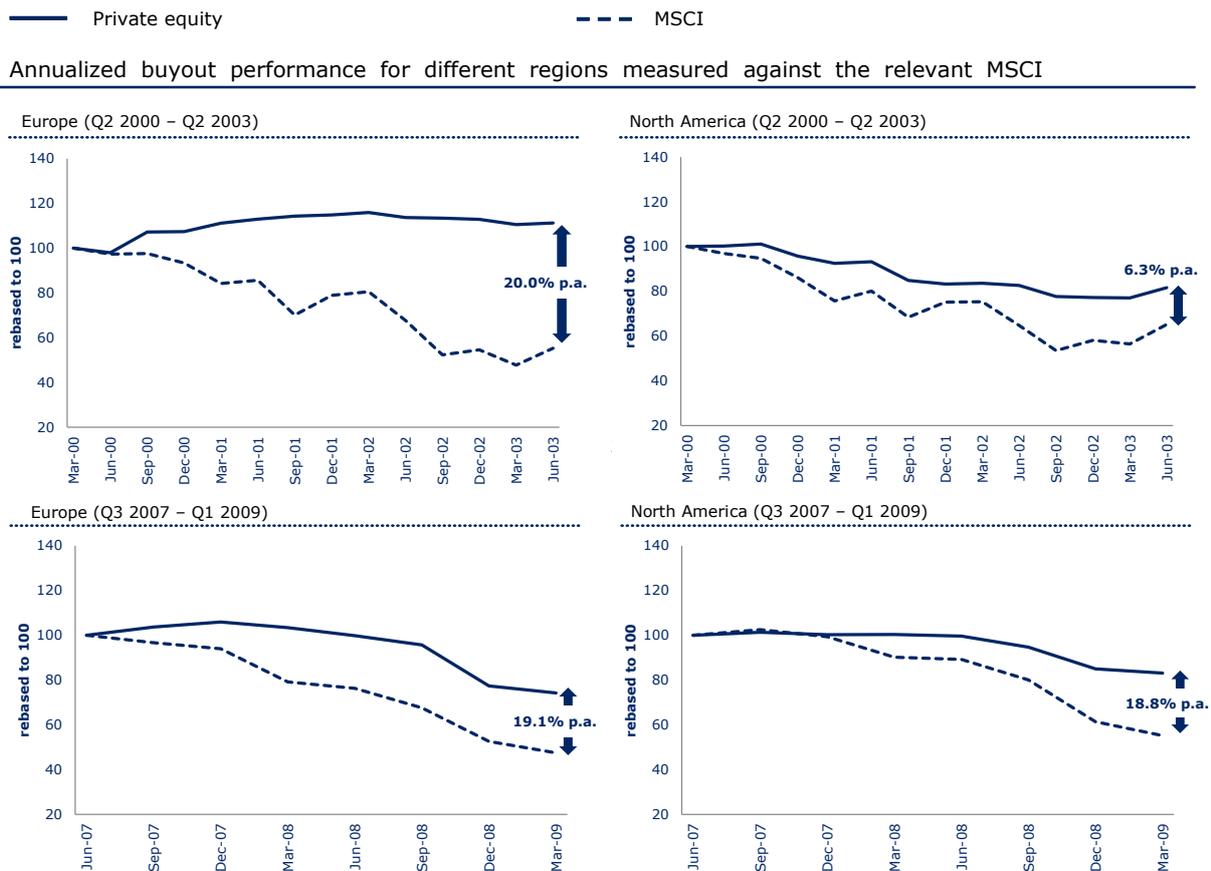
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We have tested this hypothesis in two ways:

First, we looked at the performance of comparable markets during the past two significant downturns in the financial markets (Q2 2000 – Q2 2003 and Q3 2007 – Q1 2009).

Exhibit 2: Relative performance of buyouts in downturns

Outperformance of buyout investments increased during the past two downturns



Source: Bloomberg (NDDUE15 Index in EUR, NDDUNA Index in USD), Thomson Reuters (Cash Flow Summary Report for WEU and NAM buyouts; Q2 2011)

The result is contrary to common perception in that private equity investments showed an even higher outperformance during the two most recent crises. This implies that the asset class private equity has strong defensive capabilities and is a viable alternative for investors during uncertain economic environments.

Second, we measured the volatility of both performance measures by calculating their standard deviation to see whether the value of private equity investments was more volatile than a comparable investment in public equities.

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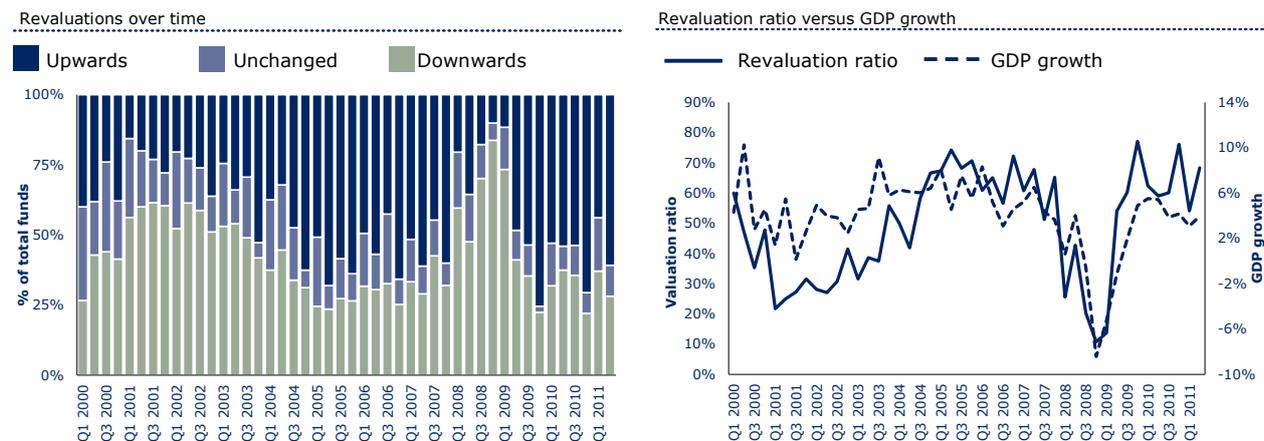
Before calculating private equity volatility, one should however highlight an important characteristic of private equity returns. Quarterly returns to some extent depend on the returns of previous quarters – or as statisticians would say, they are subject to auto-correlation. Often so-called “stale pricing”, i.e. reporting outdated asset prices, is used as an explanation for this effect. However, on average only 15% of funds in our sample were actually not revalued from one quarter to the next since 2000. This is illustrated on the left hand side of Exhibit 3. With the adoption of “fair value”-based accounting rules across the industry this percentage has even decreased in recent years.

We would argue that managers actually follow economic fundamentals when valuing their portfolios. The right hand side of Exhibit 3 shows the strong link between the fraction of positive revaluations and GDP growth. In contrast, it is a generally accepted principle in behavioral finance that public markets are often driven by market liquidity and investor sentiment and therefore actually tend to overshoot.

Exhibit 3: Private equity revaluations and GDP growth

Private equity revaluations are correlated to GDP growth

Private equity revaluation activity over time and GDP growth



While a simple calculation of the volatility using quarterly returns shows a clear advantage of private equity over public markets (see Exhibit 4, left chart), critics might argue that the standard deviation might not be a representative measure for true risks in private equity in the light of the inherent auto-correlation. In order to address this concern, we have corrected the standard deviation for auto-correlation³. Such “unsmoothed” figures still compare favorably to the volatility of public markets (see Exhibit 4, right chart). Private equity valuations are linked to the same underlying economic factors as public market investments and therefore similar inherent risk drivers apply, explaining a comparable, though still smaller level of (unsmoothed) volatility in the asset class compared to public markets. However, our research suggests and our daily experiences reconfirm that fair market value valuations might be closer in many instances to the true fundamentals of underlying companies than sentiment-driven public valuation. We thus clearly disagree with the common notion of outdated, “stale” valuations in private markets as well as the belief of a higher risk.

³ Asset Allocation Effects of Adjusting Alternative Assets for Stale Pricing, Andrew Connor, The Journal of Alternative Investments, 2003

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SYSTEMATIC DIFFERENCES DRIVE PRIVATE EQUITY'S SUPERIOR PERFORMANCE

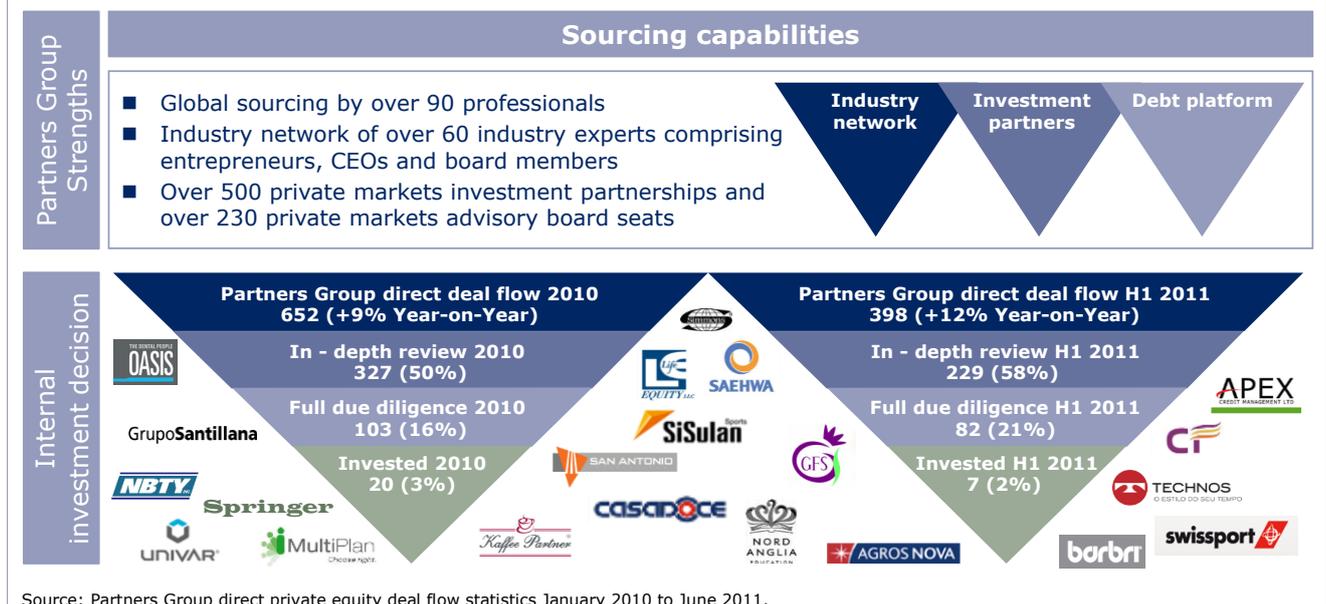
Firstly, the selection of investment targets differs fundamentally. While public equity investors rely to a high degree on pre-selected equities based on the indices they are measured against, private equity investors individually select companies with compelling business models.

When assessing a business model private equity investors look for criteria such as market leadership in terms of market position and technology, high entry barriers for new competitors, above-average profitability, high cash conversion rates and top-notch management. Stability and predictability of future cash flows and revenues also rank high as criteria for qualifying a company as a suitable private equity investment. Business models that tick all or at least some of the boxes are obviously more likely to outperform their peers.

This approach requires successful private equity investors to build their franchise on a proprietary and substantial deal flow. For example, Partners Group uses its global integrated investment approach, its industry teams and its network in the specific industries to build an unparalleled pipeline of deal opportunities. This allows the firm to be extremely selective and to choose from a wide variety of different opportunities in various geographic regions:

Exhibit 5: Deal flow of Partners Group

Strong deal flow from diverse sources



In addition, intensive "due diligence" that is often conducted over a period of several months helps investors to examine all different aspects of a company's operating performance. In most cases, private equity investors have access to considerably more information on their targets than public equity investors as private transactions are subject to fewer confidentiality issues ("legal insiders").

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In addition to a more focused selection process, private equity investors have the means and the levers to maintain or even expand a portfolio company's performance through operational improvements. Private equity investors take an active role in developing a portfolio company and are involved in a company's operating business.

LEVERS FOR OPERATIONAL IMPROVEMENTS REQUIRE TIGHT CONTROL AND FLEXIBLE DECISION-MAKING PROCESSES

Controlling stake with board representation

Especially in a crisis situation when the macro environment becomes challenging, operational measures to stabilize a company's performance have to be taken quickly. The corporate governance structure of a private equity portfolio company allows the prompt flow of information and subsequent responses by the owner to ensure decisive actions.

An important element is the private equity investor's board representation, allowing the investor to influence the decision-making process in a company directly. Research⁴ has shown that a board of directors operates more effectively in a private equity portfolio company as opposed to the board of public company, especially in terms of strategic leadership and performance management.

Partners Group is represented on various boards, taking an active role in developing its portfolio companies. Board members are selected by their industry expertise and their company fit to ensure the maximum benefit for the portfolio company as well as for Partners Group and its clients.

Alignment of interests between owner and management

Incentive structures put in place by private equity investors for the management of their portfolio companies ensure that management teams strike the right balance between risk and reward as any negative developments will immediately impact the management's own wealth position given that in most cases they have invested significant equity into the company.

As the investment horizon for private equity investors is typically five to seven years (which can be considered rather long-term these days), management teams tend to engage in long-term strategies that deliver sustainable growth and earnings improvements. Public companies that are assessed by the market each quarter find it hard to convince investors of the long-term merit of their actions and therefore often focus on short-term successes and do not necessarily make long-term investment decisions which would enhance the positioning of the company in the long run and therefore increase shareholder value.

The exit also provides a direct gauge of a management's success. Success is measured in monetary units, for the investors just as much as for management itself. There are no "golden parachutes" for management members that don't deliver on their targets. Compensation for private equity investors and their clients is only based on actual performance as they will only be rewarded should they have achieved their risk-adequate return.

These incentive structures allow private equity portfolio companies to attract the best talent in the respective industries as the financial benefit of leading a successful private equity portfolio company can be a life-changing event for each executive and his team.

⁴ McKinsey quarterly, "The voice of experience: Public versus private equity", 2009.

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Regular reviews of the management team's performance and composition

Management is one of the most important success factors if not the most important success factor for a company's performance. But different situations require different management approaches. Only a small number of managers are able to deliver successful growth strategies and are then able to implement a radical restructuring program in the same company.

Whenever a management team fails to deliver on its goals, the owner of the company has to review and assess the actions taken by management. A swift reaction to underperformance then becomes key. The private equity corporate governance model enables the owners of a company to replace or to complement a management team without going through the lengthy processes and political disagreements which can often be seen in public companies.

OPERATIONAL IMPROVEMENTS KEY FOR SUCCESSFUL PRIVATE EQUITY INVESTORS

Successful private equity investors today take advantage of these structural advantages and focus on operational improvements as the main source for value creation.

Value creation in private equity investments is usually measured using four levers: revenue growth, margin improvement, multiple expansion and cash flow generation.

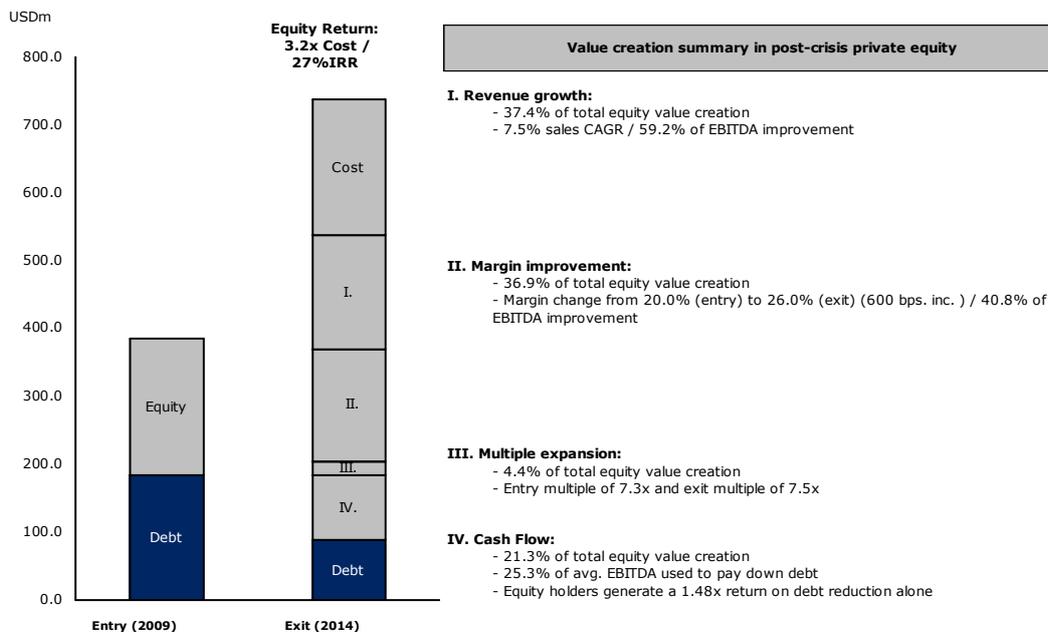
In order to be able to analyze the approach that private investors take in their value creation plan, we assessed all our deal opportunities in the past 24 months and the set of financial projections presented by the teams. We then looked at the median values of their initial investment plan to see which levers are forecast to contribute the most to value creation, i.e. which focus the investors have in their investment approach.

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Exhibit 6: Projected value creation in private equity investments

Operational improvement measures are key for private equity value creation

Average expected value creation of investment opportunities (2009 – 2011)



Note: The values represent the median value of the respective data in all direct investments reviewed by Partners Group between 2009 and 2011 YTD. The data was normalized to calculate an average investment proposal with a holding period of five years.

Source: Partners Group data

Revenue growth and EBITDA margin improvements represent direct operational improvements in a company and are viewed as the most important levers for creating value for investors: more than 75% of expected value creation is attributable to these purely operational drivers. Debt repayment and multiple expansion are also indirectly influenced by operational measures and can be optimized by operational excellence, but are often regarded as levers for “financial engineering”.

Revenue growth

Private equity investors look for sustainable organic growth strategies and actively support them. Business models that have been proven successful can be rolled out to different regions or countries, brands that have been established can be expanded to related product categories. Private equity owners are willing to put up the capital, even if this means making short-term investments that are beyond a company's cash flow generation capabilities but aimed at achieving long-term benefits.

On top of organic growth, strategies to build dominant market players by using a platform company and growing it with selected add-on acquisitions are valid strategies that often require the financial backing of the owner.

Private equity investors do not only have the financial means and the willingness to deploy capital in long-term oriented strategies through long-term contracts with their clients, they also have the know-how to actively support a company in managing its growth. By replicating

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the success of past investments and applying the learning of previous experiences, they add tangible value to their portfolio companies.

One example of investing into a company that took advantage of favorable market dynamics and experienced significant growth is Odlo International AG ("Odlo"). Odlo is a maker of sports underwear and stylish outdoor clothing and was perfectly suited to benefit from the strong trend towards an outdoor lifestyle. The company underwent a significant transformation during its private equity ownership, from a specialized manufacturer to an international consumer brand with innovative technology and several initiatives were launched to increase the reach of the brand and establish new sales channels. Together with management, a retail strategy was developed which comprised both a store concept as well as a shop-in-shop concept that was rolled out in several countries and new markets. In addition the "Odlo" brand was complemented by two new brands focused on downhill skiers ("Kjus") and cross country skiers ("Bjørn Dæhlie") allowing the company to fuel growth by using the existing and newly developed sales channels more efficiently. As a result, revenues grew by more than 8% p.a. and revenue growth represented more than 60% of total value creation.

In the case of the Spanish company Grupo Palacios ("Palacios"), a producer of sausages, ready meals and frozen food, Partners Group was able to leverage its global network. One major growth driver for the company was the expansion of both its distribution network outside Spain and the broadening of its product offerings via several introductions to distribution partners in Europe (such as supermarket chains) that were interested in including Palacios' products on their shelves.

The same strategy was pursued for an Asian portfolio company: Golden Foods Siam, a Thai vertically integrated manufacturer of raw and cooked chicken products. The company sought to explore new markets outside its home markets in Asia and was introduced to several distribution partners in Europe and the Middle East. By this, the company was able to directly tap into new markets without the onerous and time-consuming task of building meaningful local operations that would lead the push into these new markets.

In order to offer this kind of added value, Partners Group can rely on a team of over 350 investment professionals based in 15 offices across five continents. Our investment teams combine first-hand industry experience and long-term investment expertise and are organized in vertical industry groups that systematically build intelligence in all relevant industry segments on a global basis.

EBITDA margin improvement

The change of ownership is often seen as the signal for change within a company. Management is given new perspectives and is empowered to "think the unthinkable" and to execute on initiatives that might have been considered long ago but lacked the backing of the board or the owners. These initiatives can lead to the introduction of new, more efficient organizational structures or other long-term oriented cost-saving measures that were not considered due to the short-term orientation of incentive structures.

Private equity investors often start their investment period in a portfolio company by launching a "100-day program" to identify all initiatives that could drive the company. These programs aim at reviewing a company's strategy and all major cost positions. A typical result can be the revamp of a company's sales approach by reducing the number of variations offered or the phase-out of unprofitable customer relationships. In most cases, these measures had been defined beforehand by members of management, but were never acted upon as the company lacked the need and the drive to transform itself.

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These changes become most apparent in cases where a company is spun off a larger conglomerate and is owned by a private equity investor for the first time ("primary buy-out"). As larger corporations often lack the ability to impose strict cost management down to the smaller units or fail to invest in rationalization projects that pay off in the long run, these companies are promising opportunities for private equity investors.

Also the experience across numerous other past and present portfolio companies allow private equity investors to apply best practices from other companies and even industries and focus on key cost drivers to achieve rapid successes. For this purpose, Partners Group can rely on an extensive database of portfolio company performance data that help to identify weaknesses or areas for improvement.

Also, the extensive network portfolio companies can build upon helps in improving a company's cost position. Similar to the way growth initiatives are supported by looking for suitable partners in different geographies, the same approach applies to examine a portfolio company's supplier base. As sourcing becomes an increasingly global topic, an international set-up allows the identification of suitable suppliers with superior cost positions. This approach was used at AHT Cooling Systems GmbH, an Austrian maker of supermarket refrigerators, cooling boxes and bottle coolers. We used our proprietary database to help in revamping the company's sourcing approach by identifying suitable suppliers and providing local support for the newly founded Chinese subsidiary, helping the company to avoid roadblocks and obstacles, difficulties that medium sized companies in particular face due to their lack of international experience.

Multiple expansion

Multiple expansion is often viewed as a pure financial lever to create value. Sometimes it is regarded as "market timing" and mostly as uncontrollable by the private equity investors.

Aside from external factors that undoubtedly affect the valuation of a company in relative terms, there are ways to command premiums dependent on the positioning of the company in its market.

Companies with a compelling market position that could be expressed as either a clear leader in terms of market share, in terms of cost position or in terms of technology justify higher valuations compared to their peers. So any strategy aimed at achieving these goals will eventually drive the exit multiple for a transaction. These strategies could include the divestment of non-core subsidiaries that do not hold market leading positions, the forging of a market leader by the combination of two businesses in a market, or increased investments in innovation and technology. In any case, the strategy needs to be consistent and followed over a longer period of time as it needs time to unfold and show measurable results.

Private equity ownership ensures that due to the long-term investment horizon, management teams receive the backing to implement strategies that actually are aimed at creating sustainable shareholder value. This can be seen in contrast to boards of public companies that rather focus on short-term success as quarterly reporting cycles put strong pressure on managers to deliver rapid, but often short-lived results. In addition, strategies in public companies depend much more on actual management and are therefore subject to more frequent changes.

Private equity investors define and implement strategies, whereby they leave execution to the most suitable management team for the respective task. Changes in strategy will only be triggered by a changing environment and do not depend on the management team in place.

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A focused strategy is probably the single most important factor when creating value for the shareholders. A successful strategy affects all operating key numbers as they ultimately reflect a company's competitive position. Consequently, the superior positioning of a company also affects its multiple.

Through its representatives on the boards of its portfolio companies, Partners Group has positively influenced the strategy by re-focusing companies on their core strengths.

At Odlo, one of the first measures taken was the divestiture of a trading subsidiary that was importing sports equipment to Switzerland due to a lack of synergies to the core business, the manufacturing of sportswear. The retail expertise was then used to execute on the roll-out of the branded shop strategy, but the company became a "pure play", i.e. a leading player in sportswear business with a corresponding retail business.

A similar case is the investment in Palacios. At the time of investment, Palacios was set up as a local player with a limited product offering. The defined growth strategy is to build an international player that is much more diversified in terms of product range and distribution channels. This is also aimed at reducing the risk within the company by leveling out demand across all regions and thus decreasing the exposure of the company to single negative events in one market.

Cash flow

While debt repayment is often seen as a non-operational lever to create value for private equity investors, there are many ways to create value through operational improvements exclusively aimed at cash flow.

In the early days of private equity, the concept of leveraging a company and re-engineering the balance sheet was often enough aimed at creating value: the existing cash flows repaid the debt assumed in the transaction, increasing the equity value for the investor. This concept is still at the core of any private equity transaction but it has been complemented by a strong focus on increasing cash flows by actively managing cash generation.

Working capital is thereby in the center of attention as this lever is often neglected by common management approaches. Especially large corporations barely include working capital in their set of key performance indicators ("KPIs") to measure performance and incentivize management. Initiatives such as the introduction of "lean management" principles or the re-design of work flows can improve relative KPIs by 20-30%. Sometimes even simple measures such as the reduction of storage space ("abolition of abundance") forces staff in companies to re-think how inventories are managed. Clearly, working capital management does not impact any profitability KPIs, but helps to accelerate a company's deleveraging.

Stringent capital expenditure ("capex") management is the second most important factor for increasing cash flows without directly affecting the profitability of a company. As capex is often linked to growth aspirations of a company, it has to be viewed in the context of the overall strategy of a company. Especially in difficult times, it becomes particularly important to quickly review any budget for capital expenditures as spending can immediately be cut without directly impacting ongoing business operations ("quick win").

A good example for this category of operational improvements is the automotive supplier Micro-Poise, a developer and producer of equipment used by tire and tire & wheel assembly manufacturers to meet their testing requirements. In the crisis years of 2009 and 2010, the company underwent a significant restructuring of their production facilities. The measures

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included the introduction of lean production principles ("Kan Ban") and the re-design of the factory layout. In addition, capital expenditure projects were immediately put on hold and significantly reduced to an absolute minimum to reduce the cash spending of the company. The benefits of these measures could be reaped within a short amount of time: despite negative EBITDA in 2009 cash flow increased slightly compared to 2008, helping the company to weather the crisis and to deleverage further.

CONCLUSION

Returns from private equity investments have been very significant in the past. Our research indicates that these superior returns are systematic and are deeply rooted in the business model of private equity investors. Private equity investors use their influence on the corporate governance in their portfolio companies to align interests between managers and owners and to actively manage opportunities and risks.

This is especially shown in difficult economic environments which force companies to act quickly and decisively to adapt to and manage challenges. In these difficult times in particular, private equity investors have proven that they possess the skills and tools to position their portfolio companies successfully.



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