Institutional allocation to private equity

A maturing industry calls for a differentiated approach

Structural tailwinds continue to support the case for private equity allocation

The quid pro quo of becoming a public company has changed considerably over the past decades, in favour of staying private[1].

Becoming a public company is less desirable than before. In the meantime, when businesses can raise sufficient capital outside the public market (see **Exhibit 1**) – thanks to a thriving private equity industry – going public stops being a need. It becomes a choice, and more and more companies now exercise that choice to stay private for longer.

This brings challenges for investors. Public market investors are now accessing companies at a later stage of their development than in the past, if they can access them at all. The delay could lead public market investors to miss out on a significant period of growth.

The need for private equity allocation becomes obvious as a result. Private equity, as a portfolio construction building block, will continue to grow its significance in institutional portfolios.

Exhibit 1: vast amounts can now be raised privately

- **Uber** issued $8.1 billion worth of new shares in 2019, having already raised more than $22 billion in the private space (a ratio of 0.37 to 1).
- **Google** raised over $1.9 billion in new capital in its 2004 IPO. Prior to that, it had raised $25 million of private capital (a public-to-private fund-raising ratio of 76 to 1)
- **Facebook** raised over $16 billion in new capital in its 2012 IPO. Prior to that, it had raised $2.4 billion of private capital (a ratio of 6.7 to 1)

Source: Thinking Ahead Institute

Private vs public equity returns: a lost decade of excess returns

Despite structural tailwinds, private equity performance has been coming under some pressure over recent years. A Bain[2] study shows that for the last 10 years U.S. public equity returns have essentially matched returns from U.S. buyouts, at around 15%. A 2020 research paper by Professor Ludovic Phalippou[3] came to a similar conclusion: from 2006-2015, private equity funds have returned about the same as public equity indices.

The pressure on average returns is likely to persist. Dry powder levels, an industry term referring to money committed to private equity funds but not yet invested, have been steadily increasing since 2012 from just over $700 billion to a record high of $1.8 trillion in late 2020[4]. High dry powder levels likely lead to a higher level of competition which then feeds into higher pricing multiples paid on deals. This is simply a natural evolution of the market maturing. As private equity's relative outperformance draws increasing amounts of capital from investors, competition for a limited number of high-quality assets increases.

[1] "The evolving role of public and private equity markets", Thinking Ahead Institute, 2019
[2] "Public vs. private equity returns: Is PE losing its advantage?", Bain, 2020
[3] "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory", Ludovic Phalippou, University of Oxford, 2020
[4] Per Preqin data.

Selectivity becomes ever more important in a maturing industry

Nonetheless, it has been possible to buck this trend through the types of managers selected and approach to building a private equity programme. While average returns have declined over time, top-quartile returns have essentially held steady, according to the Bain' study mentioned earlier. Consistent with this finding, we believe that the key to successful private equity investing is the ability to identify high performing managers. And, by definition, a differentiated approach is required to deliver above average returns.

To start with, we prefer a diverse line-up of a small number of high-conviction bets to a large number of underlying funds. The logic here is very simple. In an environment where the average is increasingly not good enough, we need to take active risks to be better than the average.

Big is not necessarily good – more truffles can be found in the mid-market segment

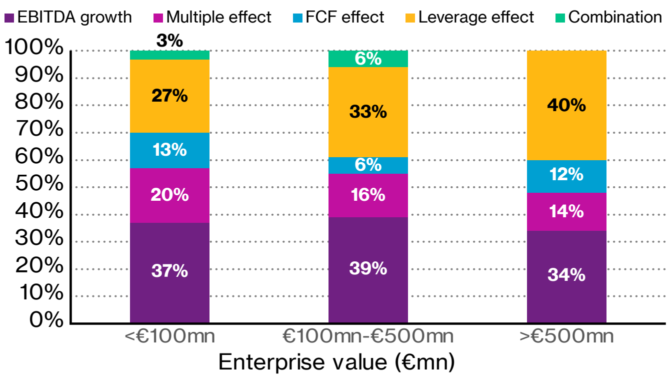
Small- and mid-cap buyout funds are one of our key focuses in searching for high-performing private equity funds. We believe that smaller funds have a higher potential for outperforming their larger counterparts. An analysis on Preqin data for 1,870 buyout funds globally with vintages between 1985 and 2015 suggests that buyout funds with fund sizes of €1bn and below generated an average net internal rate of return (IRR) of 17.4% whilst the average net IRR of buyouts funds with fund sizes above €1bn amounted to 14.1%. There are three main reasons why we believe there might be more gems in the small- and mid-cap market segment:

1. Larger opportunity set - data provided by PitchBook (**Exhibit 2**) indicates that sub-$500 million private equity deals account for almost 90% of all private equity deal volume (by deal count).
2. A better chance that a focus on operational value creation can generate good financial returns. According to a study by Capital Dynamics and the Technische

Universität München, more than half of the value creation in private equity investments is driven by operational improvements. What is interesting to note is that value creation drivers differ across transaction sizes with small-to mid-cap deals relying more on EBITDA growth and multiple expansion whilst large-cap deals are more reliant on leverage, as shown by **Exhibit 3**.

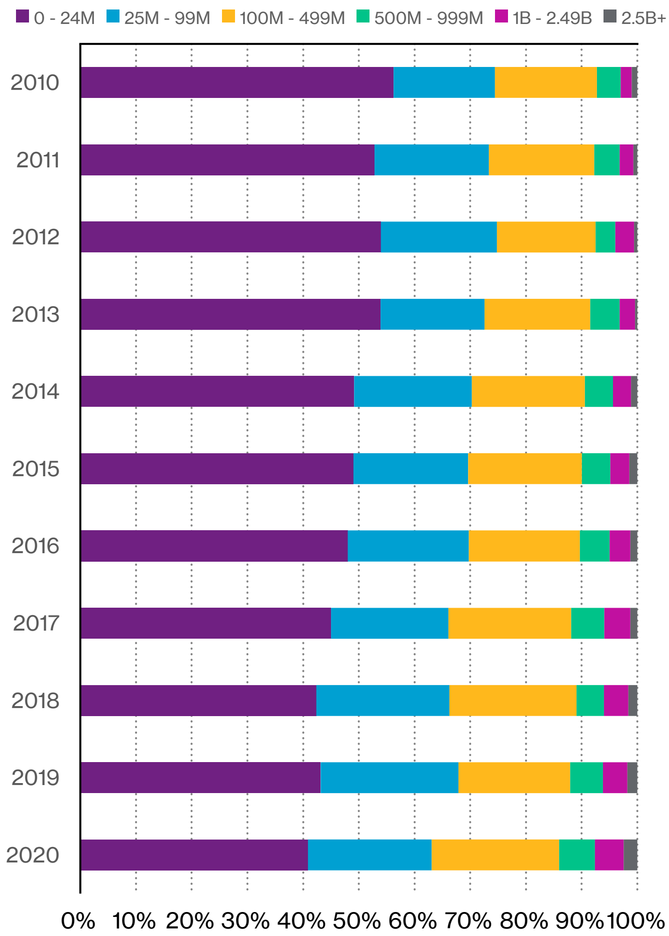
3. Less intermediation and competition. Data from Dealogic suggests (**Exhibit 4**) that valuations for small- and mid-cap deals have consistently been lower, giving managers more room for multiple expansion. In the large-cap space, a combination of large amounts of dry powder and a smaller opportunity set means there is often considerable competition for deals. In addition, large-cap managers tend to make up for these higher multiples by acquiring companies with more leverage.

Exhibit 3: Value creation drivers



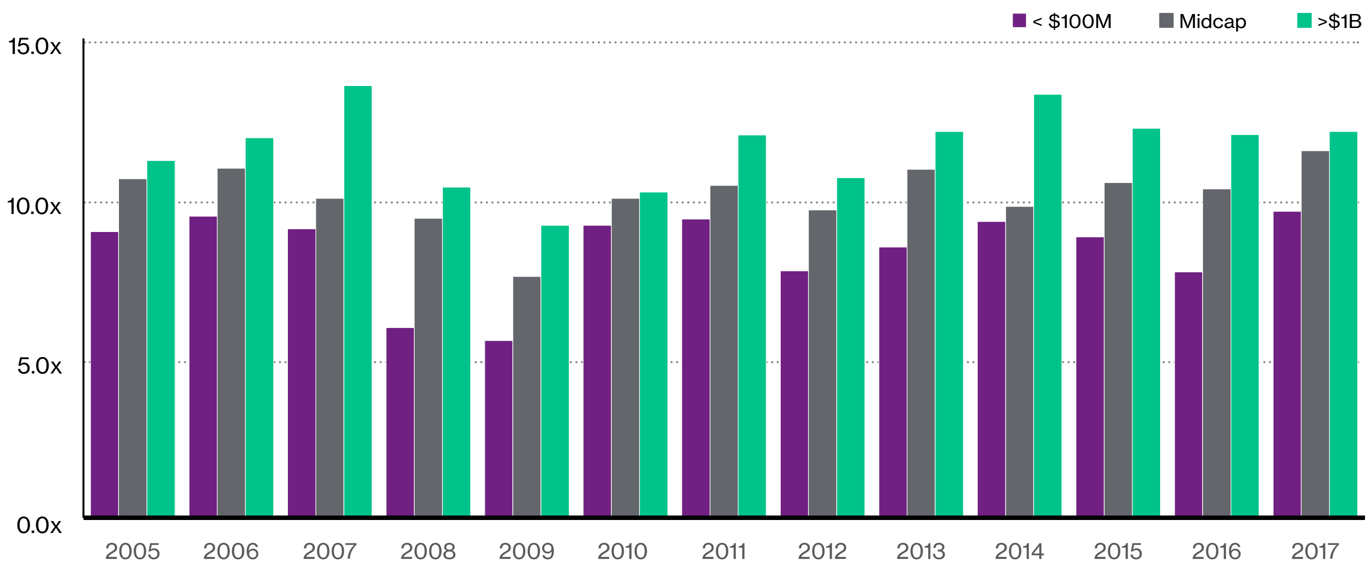
Source: Capital Dynamics and the Technische Universität München

Exhibit 2: Private equity deal count by deal size ($ million)



Source: PitchBook

Exhibit 4: EV/EBITDA by deal size (U.S.)



Source: William Blair/Dealogic

Sectoral exposure shaped by a deep understanding of megatrends

We believe that megatrend dynamics will result in multi-dimensional transformations across society, technology, economics, environment and politics[5]. An in-depth understanding of these megatrends allows us to apply a thematic lens to assess and in turn better construct our sectoral exposures within private equity. Due to the nature of this asset class, many of the business models that private equity – including venture capital (VC) – funds invest in are at the forefront of various key megatrends.

As an example, one of these megatrends is evolving demographics. A combination of an aging population and a global rise in per capita healthcare spending leads to attractive opportunities in various segments of the healthcare industry, including healthcare equipment / services, pharmaceuticals and biotechnology.

Sustainable investment considerations are deeply embedded

Sustainable investment[6], we believe, is central to successful long-term investment outcomes and a key part of our investment approach. While there has been growing awareness of environmental, social and governance (ESG) issues, sustainable investment continues to face scepticism in the private equity industry, especially in the U.S[7]. The way the industry is wired is that until there is consistent data establishing a positive and decisive link between ESG considerations and financial returns, there will likely always be cynicism among some private equity investors.

Albeit mostly outside the private equity industry, growing evidence of the financial impact of ESG factors and stewardship has started to emerge[8]. We are a strong advocate that it is time for private equity managers to stop viewing ESG issues as a sideshow and consider ESG practice a core part of what differentiates them from competition. This is against a backdrop of a rapid sustainable investment evolution in terms of how the market prices ESG risks and opportunities as well as how end savers and policy makers demand a stronger integration of real-world impact into investment outcomes. The investment industry has never experienced this before. It therefore does not make sense to look for guidance in the past.

We have a formal process for integrating sustainability considerations into our manager research decisions[9]. Our assessment of an asset manager's sustainable investment practices and implementation feeds into our overall view of their ability to sustain a competitive advantage and the suitability of those products for our client's portfolios.

Best-in-class private equity managers not only make managing ESG-related risks an integral part of their processes but also become very active in identifying and exploiting ESG-driven opportunities. For example, investment opportunities are emerging in a number of strategies in the climate change solution area that seek alignment with de-carbonisation goals. These include (but are not limited to) development of renewable energy, transport electrification, greening industrials, and developing plant-based food. Pursing ESG-driven opportunities also allows investors to help create positive impact on the world that savers live in and will retire into. **Exhibit 5** presents a case study where one of our preferred private equity managers leverages its technology know-how to explore an attractive investment opportunity while creating positive impact in the area of combatting climate change.

[5] "Responding to megatrends", PRI and Willis Towers Watson, 2017
[6] Our "Sustainable Investment Policy" describes how Willis Towers Watson Delegated Investment Services team currently embeds the best of our sustainable investment research, risk management and idea generation.
[7] "Global Private Equity Report 2021", Bain & Company, 2021
[8] "Sustainable investment, show me the evidence", Willis Towers Watson, 2018
[9] Further information is available upon request.

Exhibit 5: Case study: a private equity investment in a leading electric vehicle (EV) charging service provider in China

This is an investment made by a VC / growth fund that makes minority investments in the healthcare, consumer, supply chain and technology sectors in China. The investee company is currently China's largest EV charging service provider with a market share of around 35%. Given the rapid growth in China's EV industry that is underpinned by accommodating government policies, the manager identified a looming gap in charging infrastructure. The company pioneered a world-leading automatic charging system that is capable of intelligently scheduling the charging process to achieve safe charging during a period of low residential power consumption. This innovation, along with a versatile operational model, allowed the company to quickly expand network with improved utilisation ratio, which augmented its market-leading position. As a trusted partner, the private equity manager has been working closely with the company to organise and monetarise its data pool collected from EVs and also better manage its mobile app.

And we continue to innovate

As the market evolves and new ways of investing in private equity emerge, we commit ourselves to embracing innovation.

For example, we are seeing more and more public equity managers extending their reach to the private space. Many of their existing skills are transferable, though not all. Some have adopted a standard private equity closed-end fund structure, while others have explored alternative structures, such as listed funds. The latter allows them to pursue a strategy that the current structure is unable to accommodate - that is, to invest in fundamentally sound businesses, whether public or private, and hold them without a pre-set period to exit. We could potentially see the rise of a new breed of investment managers executing investment strategies across the entire equity spectrum. In early 2021, we launched a dedicated working group that brings together expertise from both public and private equity teams to actively search for and evaluate opportunities in this space.

After decades of market developments, private equity market has inevitably matured with fewer opportunities to grasp low hanging fruit. However top tier funds are expected to continue to deliver strong returns and we believe a differentiated selection process is ever so more valued by investors who would like to allocate to this increasingly important asset class.

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