The PODfolio Podcast Episode 22: Asset Class Mini-Series: Private Equity

SPEAKER 1: There's an increasing perception of public markets becoming more and more short term. And so having businesses that are looking to grow for the long term don't necessarily see the stock exchanges as being as attractive, perhaps as they once were.

SPEAKER 2: Welcome to The PODfolio, Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolios.

LOK MA: Hello, and welcome to The PODfolio Investment Podcast and our mini series looking at the different asset classes. Now, we're going to wrap up the series with a discussion of how to pull all these different elements together within your overall portfolio. But I do just want to look at least one more asset class. So today, we're talking about private equity, and I'm delighted to give a warm welcome to two special guests who are both specialists in private markets. So we've got Joseph Bassey-Duke. So welcome to the show, Joe.

JOSEPH BASSEY-DUKE: Hello.

LOK MA: And we've also got Ben Leach. Hey, Ben.

BEN LEACH: Hey, Lok. Thanks for having me on.

LOK MA: So let's kick off with the obvious question then. What is private equity? And let's start with you, Ben. I think we all know what equity is, so what's the significance of the private bit?

BEN LEACH: Sure. Well, I think, quite simply, as you said, equity is investing in companies stocks. And in private equity, you're just investing in companies who aren't listed on a stock exchange. So it's really the business of investing into and making returns, as I say, from private companies, not from public ones.

LOK MA: And why do companies prefer to go down this private route instead of being on the stock exchange because I thought the whole point if you're setting up a company, you're trying to grow it to a certain size, and then you float it on the stock market with an IPO, and then you make yourself rich? I mean, why not just do that?

BEN LEACH: Well, yes. That is still a path to making yourself rich, Lok, if you'd like to give it a try. I guess, increasingly, we've observed companies wanting to stay private for longer. And I think two major reasons for that, firstly, the abundance of private capital. So fundraising by private equity managers has continued to reach record highs, and the amount of dry capital, that's the amount of money that's been raised, but not been deployed into the market, is somewhere just short of $2 trillion. So there's a lot of capital chasing private investments, first and foremost, which means the owners of businesses can find partners and capital to help them grow those businesses without needing to go into the stock market. And I think a couple of other reasons is that going public is fairly costly. So it's a substantial cost to going public on a stock exchange and substantial costs and regulatory requirements of maintaining a public company versus a private one, which means it's less attractive than it has been for some time. And I think some of the statistics that support that. In the US equity market, for example, had around 8,000 companies in the late 1990s but just around 4,000 today, so halving of the number of companies listed on US stock market.

So as I say, a few reasons for remaining private versus public, I think the last one I would just say is that there's an increasing perception of public markets becoming more and more short term. And so having businesses that are looking to grow for the long term don't necessarily see the stock exchanges as being as attractive, perhaps as they once were.

LOK MA: And obviously, we will shortly come on to talk about specific examples. So some of these companies may be that longer term vision, but before we do that, I just want to touch on the overall investment case for private equity. And I normally think if you're motivated to invest in anything other than the simple stuff of mainstream equities and bonds, you're typically looking for one of three things. So you're looking for better returns, or you're looking for lower risk, or you're just after something that behaves differently to the mainstream markets for that diversification benefit. So which of these would you say is your main motivation for investing in private equity?

BEN LEACH: So I think that one's fairly simple in that, predominantly, clients are looking for increased returns by investing in private equity. We typically find that clients make an allocation to private equity from their public equity part of the portfolio, not always, but typically, they do that. And the enhance returns that can be on offer and private equity really come as a result of what we call an illiquidity premium, so locking up your capital for a period of time, and then a skill premium, which is the ability of the private equity fund managers that look after capital to go and buy businesses, improve those businesses, grow their earnings, develop the strategy, potentially look at other transactions and the like. That mean their skill set and being active within that business within those companies that they're buying leads them to having the ability to enhance those returns over time.

LOK MA: And can I just ask maybe a silly question at this point, just to be kind of 100% sure? I mean, private obviously means no the stock is not traded on a public exchange. And so how do you actually-- and maybe I'll throw this at you, Joe-- how do you actually get hold of it if you want to make an investment? Is it always through a fund of some sort?

JOSEPH BASSEY-DUKE: Sure, Lok. So I think it's best if you look at this I guess from basic principles and by thinking about why would the founder want to sell the company. Why would they want to sell their baby that they spent years building up? And these founders tend to sell, I guess, for multiple reasons. They could have a life event. They could be looking to retire. Or maybe they want to start a new business. Or maybe they believe that they've taken their company as far as they can really, and they want to hand over to someone else that can continue to grow the company after they have moved on.

But buyers, on the other hand, who actually wants to buy these companies could be either other businesses, so big strategic players that want to build this business onto what they already own and take on their assets, take on the customers. Or maybe their services join these companies together to gain value, or they could be active financial players that want to hold the companies for a finite amount of time, make some changes to the company, and then sell it. On and that's typically what you find within that private equity.

So how do these financial players source the companies that they want? This is one of the hardest things you can do within private equity because for every deal that a company invests in, they would typically look at dozens of other companies before they actually find one that they like. So the PE firms would typically have an in-house sourcing team that uses their own professional network or their investment banking relationships. Or like in recent times, actually, they use like some data platforms where from the companies up for sale that end up getting listed to find the companies that they could be interested in buying.

But actually, what I say is that these deals, by the time you see a company already up for sale, you have significant competition from other buyers that may be interested in the company. So the pricing tends to be a lot richer, and at valuations that are paid to those firms tends to be a lot higher. So in our view, the best deals are often sourced when you actually get access to a company that's not up for sale. Maybe the founder hadn't even thought about selling the company to begin with. It's not in the market. And this is where private equity firms have to use almost a business development function to try and convince the manager that they should consider potentially an exit.

And given the fact that there is just much as competition for these deals by their very nature, pricing tends to be better, and this is where we see the best opportunities. So if we want to think about how an investor can actually get hold of these companies, you would often typically invest through a fund structure. But I'd mentioned this earlier. It's a fund. It's a closed end fund, typically a 10-year life. And the private equity manager manages these funds with investors, given the capital for the managers to use, to find these companies that they want to invest in. And that's the typical structure that the market operates in.

LOK MA: OK. So that's how you buy it. And if you want to sell private equity, presumably, the same manager would now have to find like a private buyer to take it off your hands. And that's obviously a more roundabout way than using a public exchange. So I just want to ask you, Joe, whether there're any potential issues around liquidity, so in other words, you can't find a buyer easily, but you really need to get your money back. So you have to lower your price or something and so on.

JOSEPH BASSEY-DUKE: Yes. Sure, Lok. So there are two ways that, I guess, you can think about selling. You can think about selling from the perspective of the company that you own that the PE manager owns that they're looking to sell. But also, you can think about selling from the perspective of the investor in a private equity fund who is looking to exit the holding, and I'll touch on both of those separately.

So I'd mentioned that the people who would be potential buyers of a private company before could be strategic buyers but also other financial buyers as well. And what a private equity manager is looking to exit the company that they already own, those could potentially be the same buyers that they can look to sell to. So you can look to sell to another company that could bolt on this PE-owned company as part of their existing firm and take on the assets and drive value through synergies that way. Or they could sell it potentially to another private equity firm that can look to implement a new strategy to drive value that way.

But Ben has mentioned IPOs, and IPOs ultimately remains one route as well that managers could choose to exit a company and put it some public market. But of course, you are then dependent on what pricing is in the public market, so you don't tend to be less dependent if you're looking to do an IPO on the pricing in the public markets much more broadly. But also, this is a rule that only tends to be available, I'd say, to the largest firm. So small and medium-sized companies actually don't tend to find IPOs as a route that they actually proceed.

And then the other aspect that you can look at, which I mentioned, is how you as an investor who owns a private equity stake in a fund can actually exit. And we think that the kind of liquidity of these funds tends to be underestimated. Yes, we're close ended. Yes, it tend to have 10-year fund lives. But each private equity fund will have a number of companies that over that fund, managers are going to exit and every time that the exit, the manager's actually return capital to investors, hopefully at a significant profit. So there are some natural liquidity generated that way.

But for those investors that actually want to exit the position entirely before the 10 years has ran past, there is a very large, and there's a very vibrant secondary market that actually has around $50 billion worth of transactions in the market every single year. And these are where different participants in the private equity marketplace that sell fund stakes but also buy fund stakes.

And we, as a firm, have lots of experience actually helping clients sell and buy stakes in funds on that secondary market. So to summarize that, there is a great natural liquidity within the funds themselves when the managers exits when they exit the holdings. And also, the fund stakes themselves can be sold on the secondary market.

LOK MA: Right. So that's the mechanics of how you buy and sell these things. Let's do move on then to the types of companies that you can invest in with private equity. So first of all, I mean, are there typical characteristics or typical differences that you see between the private and the public companies?

JOSEPH BASSEY-DUKE: Yes. Yes, there are. I'd say, the most obvious ones are age and size with public companies tend to be older, larger, and much better established. But this has some implications, I'd say, for public equity investors that don't consider private companies because these public companies tend to be just older if we're thinking about the company stages of life, so growth-- growth, et cetera. So if you only consider large public companies, you're still missing out on significant portions of growth that you could get if you're investing in younger companies that tend to be private for longer, as Ben had mentioned earlier.

Another key difference is that there tends to be much greater resources actually available to the public companies because they tend to be bigger. So whether we're talking about financial capital, physical capital, or also human capital, public companies just tend to have much more resources to bring to bear if they face any challenges. And this is one area where private equity managers can actually have significant input into the private companies they own because they can give them financial capital. Yes. But one thing that they can also bring together is lots of sector expertise. And in some cases, they can even bring in new management that could help turn around the private companies that they own.

LOK MA: So lots more control over the investments, not just actually holding a piece of it, but possibly influencing what they do as well.

JOSEPH BASSEY-DUKE: Exactly.

LOK MA: So I think we're coming to favorite examples time. Say, can you just give us some examples of companies that have chosen to stay private, as opposed to going down the traditional IPO route.

JOSEPH BASSEY-DUKE: Yeah. Sure. So there are some large companies that you might be familiar with. There's IKEA out of Sweden that makes a flat-back furniture. There's Bosch out of Germany that we know for their DIY tools, but they also have a very, very big industrial business as well that uses other firms. And there are firms like Mars that makes chocolates, which I love very much.

Three things-- the one thing that these three companies actually had in common is that they're large. They're private, but they're family owned, and they have been for generations really because you don't just want it to sell up. But there's another example that, I think, actually illustrates a lot of the challenges that Ben has mentioned better, and that's Dell.

Dell are a US company that makes personal computers, and they were founded in the 80s by their founder, Michael Dell. They were a public company for a number of decades. They were very successful in the 80s and 90s and the early 2000s, but they started to suffer under lots of competition from other players in the market.

So that's your Apple and your Lenovos, et cetera. And the company was under lots of pressure from the shareholders who were seeing pool at returns. The founder, Michael Dell, actually had a fairly ambitious turnaround plan that he wanted to implement in another company, but he thought that he couldn't do that under the glare of the public marketplace.

So in 2013, he decided to take the company back private, and there was a management buyout, which is worth at $25 billion at the time. And he took the company private. He implemented that plan out of the glare of the public markets. And in 2018, the company went public again. And actually, today, it's now worth over $80 billion, so that was an incredibly successful transaction. And that conflict, I guess, between management, shareholders, and the other stakeholders of a public company is something that's very, very common, as anyone who sees like Elon Musk's Twitter feed and will be able to tell you.

LOK MA: Yeah. Thanks for that, Joe. And now, let's move on to implementation, so the practicalities of finding your manager who will go out and look for the good opportunities in the private market. So first of all, by the nature of these things, there's not going to be an index of private equity investments that you can just track passively. So presumably, Ben, everything's going to be on an actively managed basis?

BEN LEACH: Yes. It would be. I mean, just to take a little step back, we talked about the private equity managers going into these companies and transactions. Typical private equity fund, we'll probably invests on average into maybe 10 deals, And if you think about your portfolio of private equity investments, you wouldn't want to just have one manager with 10 deals. There's potentially risk in that.

So as we think about clients investing in the asset class, we want them to have a portfolio of funds built up over a period of time that allows them to get a diverse portfolio of private equity investments. And so yes. You would do that on an active basis, trying to find the best managers in certain markets or sectors, areas that you see as attractive and try to build a portfolio of those funds out, as I say, over a period of time.

LOK MA: And so what's the sweet spot in the number of managers. And I think looking at the other asset classes, in this miniseries, Ben, I think I'm getting the feel that 10 to 12 or upwards of that as the typical number. Is that the right ballpark for you?

BEN LEACH: So we think about it a little bit differently in private equity. As Joe's referenced earlier, private equity funds tend to be closed end funds, which have a 10 year-life, typically five years of an investment period and had five years to harvest the capital thereafter. So you're constantly having to put new funds into the portfolio as those funds mature and distribute capital back to investors.

So we don't think about it so much as the aggregate number of funds in the portfolio, but think about it more so in the number of investments you need to make per year as you need to continually deploy more capital into the asset class. So we think you probably invest in somewhere around the four or five funds per year. We like a selective higher conviction approach.

If you think about a five-year investment period, that probably leads you to having a portfolio of funds around 20 to 25, I suspect, over time. So thinking about it a little bit differently than you would in a public equity portfolio, but that tends to be how we think our clients should access the asset class and having that high conviction selective approach to funds is one we prefer. Others have different philosophies for their clients in that space, but we do want each fund to obviously make an impact on outcomes at the portfolio level.

LOK MA: Right. And in terms of all these different advantages and thinking about their strategies for choosing the investments themselves, so what are the sorts of things that the managers themselves are looking for when they're deciding on which companies to invest in?

BEN LEACH: So it depends on the managers. So depending on what the managers strategy is, they might be looking at a particular sector, for example. Maybe they're a health care specialist, and so they're playing in a particular narrow niche that they're experts in. Joe's reference deals sizes and the area of the market, the size of companies that can be attractive. And so managers will have maybe different skill sets in a particular size band of companies.

Perhaps they are specialists in companies under $100 million in size or between $100 and $500, or you get the mega cap funds that are looking at companies, $1 billion, $2 billion, and more. So each manager is going to have their own sort of discipline, their own level of expertise, and they will sort of look for companies that fit within their particular skill sets as they look to as we talked about earlier in illiquidity premium and a skill premium driving returns, where they feel they can have the most value.

LOK MA: And any kind of common themes across opportunities that the managers are finding as good value within the private equity space?

BEN LEACH: So we think in private equity, you need to really take a long-term approach to finding value. If you think about owning a company for five years or more, you need to have some sort of a process, whereby you identify managers and sectors that you want to play in. And so when we work with clients in private equity, we tend to use what we call a long-term thematic approach, and I suspect you talked about this with others in the other mini series around asset classes.

We want sustainable returns generated from themes that we think are going to play out over a very long time frame, be that around global connectivity and the use of technology driving, digitization around the world, or the need for cybersecurity, spending by corporates and individuals to protect all of that stuff that we're doing online.

So whatever the themes might be and so we'll tend to try and work with clients to find managers and ideas that deliver along those themes, such that when you buy a company in three years time, and you sell it, and five years after that, in eight years time, you think you've got a good handle on what's going to drive value for that company operating in a sector or in an industry. That is going to continue frankly to exist and hopefully flourish and thrive, and that tends to be that long-term, as I said, thematic tailwind. This tends to be the starting point for how we go about identifying managers and thinking about the companies that they're going to buy.

LOK MA: And of course, one of the biggest of the long-term themes for investing, in general, not just private equity in 2021, is obviously around sustainability and ESG. And turning to you, Joe, maybe, I mean, how is the private equity industry handling that sustainability question?

JOSEPH BASSEY-DUKE: This scenario, that is very important for the whole investment market. But one of the things that I would say is that the industry is perhaps a bit behind their public equity counterparts. And there are a couple of reasons for this. A key challenge that the industry has is getting data for the companies that they own because these companies tends to be-- they tend to be smaller. They have much less resources than the much bigger public companies that we were talking about earlier. But it's an area where we see the actually managers are very willing to then engage, not just with us, but with the companies that they own to actually develop ways that they can measure a whole bunch of these metrics that we care about within ESG and then manage those over time.

And I see some managers in the PE space tend to be better at this than others. But what's most important to us as a firm is not just where the managers stand today, but actually where they tend to be over the next 5, 10, 20, 30 years. And they need to show a very strong commitment that take ESG very seriously. And also, they need to show a pathway to actually measure a whole host of those metrics over time.

But then beyond that, we actually see PE as an area where you can invest directly in a whole host of assets that can actually help you implement some of these things that we're very focused on today. So a very good example is climate solution space. We're seeking to give capital to companies that will innovate and launch new products that will help us try and mitigate against climate change. And to give some examples of some of the things we've been doing recently is we recently backed a manager that's focused really on companies that serve the EV market.

So these companies actually make different components that will ultimately go into the Teslas or the Audis, the EVs that we all drive. And then looking at what we're going to do in the future, we're actually currently just looking at the large private equity manager right now. That's also focused, especially on that climate solutions space so lots of stuff to watch out for in this area.

LOK MA: Right. So just to let you know, we're going to have to have a separate conversation outside this podcast about electric vehicles because I'm about to go down that particular path myself. And you sound like what you're talking about. So expect to call me outside of this.

But I think we're coming towards the tail end of this episode. So you've been taking us on, I guess, a tour of the world of private equity. But before we wrap up, obviously, private equity, it's one important part of the universe of private investments. Ben, are you able to just paint a quick picture for the other types of private investments, just in terms of the broad categories that exist maybe?

BEN LEACH: Yeah. Sure. So I think the two things that really sit alongside private equity under that private markets banner you referenced Lok it's real assets first and foremost, I think you covered certainly a lower risk strategy into real assets and secure income assets in one of your other podcasts here. So hopefully, familiar to listeners, but real assets, encompassing all things related to real estate, infrastructure, and natural resources. And you can find higher return and higher risk ways of getting into the asset class that potentially can provide private equity like returns.

And then the second category really is around private debt, which I think a lot of clients will be familiar with. It tends to be the first strategy you think of when private debt would be direct lending to companies that are quite oftentimes backs by private equity firms themselves so looking to extract returns from lending capital to some of those companies and stepping into the place of where banks may have done a decade or so ago. So those would be the two broad categories that we think can be attractive at certain times. And to clients, looking to build a more holistic private markets portfolio, we think, could be a part of that thank you for that.

LOK MA: And let's do wrap up at this point. So really appreciate you coming on to the, Joe.

JOSEPH BASSEY-DUKE: Awesome, Lok. Thank you.

LOK MA: And also a big thank you to you as well, Ben.

BEN LEACH: Thank you for having me, Lok. Appreciate it.

LOK MA: So I think we are going to wrap up this mini series in the next episode by looking at how all of this can come together in a well-designed portfolio. So please do tune back in then. But for now, do take care, and thanks for listening.

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