THE CHANGING LANDSCAPE AND GROWING IMPORTANCE OF PRIVATE EQUITY IN CLIENT PORTFOLIOS

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Angeles

SUMMARY

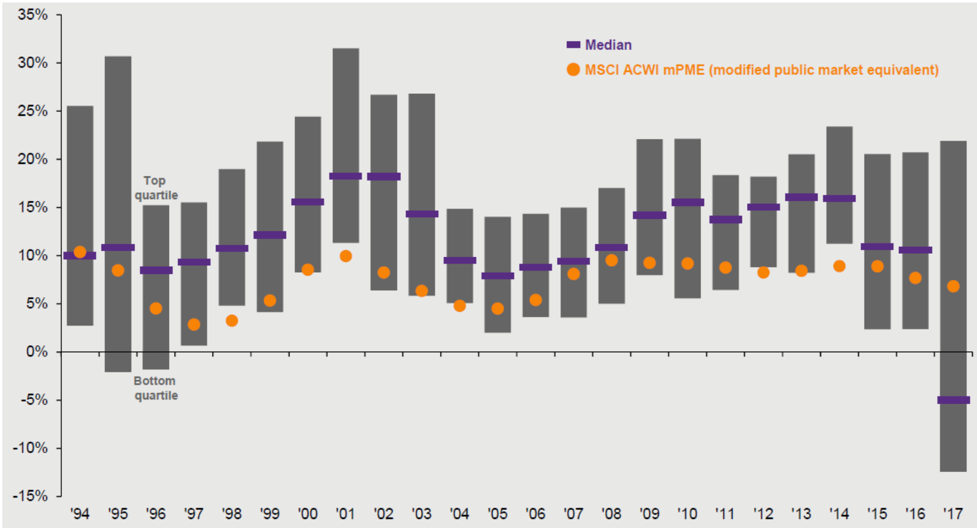
- The private equity industry has grown significantly over the last few decades while the number of publicly traded companies has declined
- While dispersion among private equity manager performance is wider than any asset class, investors have been richly rewarded for selecting superior funds
- Besides performance, we see the appeal of private equity as far more structural in nature as the industry has changed and grown in size and importance
- With the investment landscape changing and prospective returns on the decline, we see robust demand for private equity as likely to persist, creating both opportunities and risks

Today truly is the golden age of private equity. Institutional investors, facing high required returns in a low prospective return environment, have been steadily allocating more to the asset class over the last few decades, increasing the demand for talented managers capable of delivering outsized returns. As a result, fund sizes are increasing to lofty levels, more funds are oversubscribed as competition for access increases, and the best managers are securing premium fees and terms for the privilege of investing in their funds.

While it is well publicized that private equity has historically been the highest returning asset class over the last few decades, there has been a wide dispersion in returns between the top and bottom performing funds, greater than any other asset class. Investors lucky enough to be in the top performing funds have reaped returns hundreds of basis points above that of public equities, but investors in bottom quartile funds have not been compensated for taking on illiquidity risk. Both the return disparity and subpar bottom quartile fund returns can be seen in Chart 1, which shows the median global private equity return by vintage year over the last 24 years vs. a global public market equivalent (PME). On balance, though, one can see the appeal of the asset class vs. public equity, as the median returning fund in virtually all vintage years since 1994 surpassed that of a global public market equivalent[1].

[1] Private equity relies extensively on the internal rate of return (IRR) as a reporting metric, whereas public equity uses time-weighted rate of return (TWR). Since the IRR considers the timing of cash flows and private equity managers have control of investor capital calls and distributions, the IRR is a better measure of manager performance. In contrast, public equity managers do not control the timing of investor cash flows, therefore, the TWR, which neutralizes the timing of cash flows, is a better measure of manager performance. Because IRR and TWR metrics are vastly different, comparing the two proves immensely challenging and frequently yields limited useful results. While there are a number of methodologies for deriving a public market equivalent (PME), the goal of PME is to measure how an investment in a private fund would have performed in a public market index.

Chart 1: Global Private Equity IRR by Vintage Year



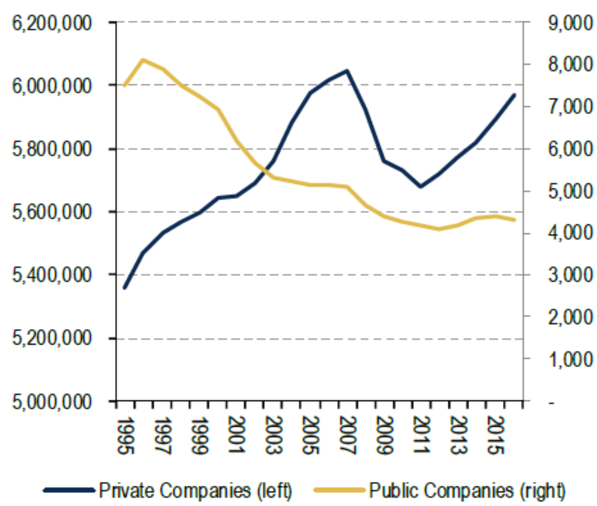
Source: Cambridge Associates, J.P. Morgan Asset Management.
The Cambridge Associates Modified Public Market Equivalent (mPME) methodology determines how much the private equity funds' cash flows would have earned had they been invested in the MSCI All-Country World Index (ACWI) instead.
Data is based on availability as of August 31, 2019.

While higher returns are the most obvious and widely publicized appeal of private equity for most investors, we believe the asset class' higher return potential in and of itself is insufficient to take on the additional risk (notably illiquidity), especially in today's environment of abundant capital and demand, fierce competition for deals, and fair to high valuations across all asset classes. Instead, we see the appeal as far more structural in nature. In fact, we have seen a tremendous structural change in the asset class over the last two decades, a shift so dramatic that it has completely transformed the investment landscape and will likely continue on its current trajectory for the foreseeable future. However, we also believe these changes have occurred at a slow enough pace that they have gone unnoticed by the average investor. They include the following:

- **Increasing opportunity set.** Historically, when entrepreneurs wanted to raise capital, they would go to the public markets via an initial public offering (IPO). Now, they have the option to raise capital through private equity and venture funds, with more than $1 trillion of global private capital dry powder[2]. As a result, the number of private companies continues to expand, while the number of public companies in the US has decreased ~40% over the last two decades[3] (Chart 2). Private equity investments in early-stage companies are approximately $100 billion per year, and acquisitions at $75 billion per year, up from $20 billion a year for both in the mid-2000s[4]. At the same time, IPOs have steadily declined and are now approximately $50 billion a year, down from more than twice that in the last 15 years[5]. Thus, private capital new offerings are now substantially higher than the public IPO market. Investors without exposure to private equity are thus missing out on an attractive and fast-growing opportunity set, while their opportunity set within public equities is declining. However, private equity and venture capital are still small relative to public markets, representing 5% of global equity market capitalization and 2%, respectively[6].

[2] J.P. Morgan Asset Management. Dry powder is the amount of capital that has been committed to the private equity fund (and thus the amount contractually obligated to be contributed over the course of the fund's life), but has yet to be called.
[3] Ibid
[4] Bridgewater Associates
[5] Ibid
[6] Ibid

Chart 2: Shrinking # of US Public Companies, Growing Number of Privates



Note: Number of public and private companies in the U.S.
Source: U.S. Census Bureau, World Federation of Exchanges

- **Private companies staying private longer.** Private companies are staying private much longer than before, slowing the pace at which companies enter the public markets. This has been due to a multitude of factors including higher costs of regulation on public companies, broader sources of available financing as a private entity, and a lack of desire to provide the transparency required of public companies. This trend is likely to continue in the foreseeable future, with more than $600 billion in dry powder in early stage private equity funds, up from around $250 billion a few years ago[7].

- **Larger IPOs.** A related outcome of staying private for longer is companies are coming to market at ever increasing market caps. Whereas a $1B+ IPO was originally dubbed a "unicorn" for its uniqueness, there are now dozens of companies debuting on the market with over $1B in market cap, 98 in 2018 alone[8]. This trend has particularly affected the US small cap segment of the equity market, as companies get acquired or graduate out of the small cap space yet are not replaced with a healthy supply of small cap IPOs.

- **Rising demand from investors.** Over the last 20 years, assets under management for private equity has exploded, to over $3 trillion from $500 billion 20 years ago (Chart 3). Institutional allocations to private equity and other alternatives in the public fund space have more than quadrupled, from 5% in 1995 to 26% in 2018 (Chart 4). Meanwhile, allocations to alternatives within Endowments remained steady between 51-54% of portfolios over the last decade[9], while Endowment assets continued to increase, further fueling demand for private equity. As a result of this increased demand, there are now more than 6,600 private equity firms, an increase of 71% over the last decade[10]. Thus, the asset class' available investment universe, and managers operating within it, has never been larger.

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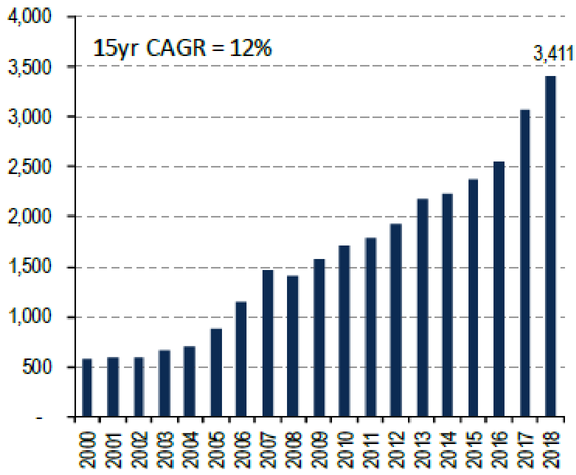
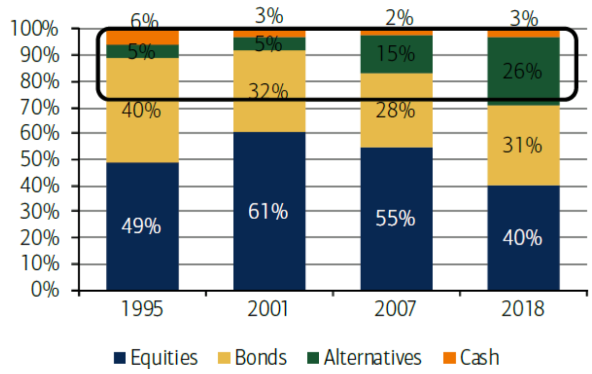
[7] Ibid
[8] Pitchbook
[9] 2018 NACUBO-TIAA Study of Endowments
[10] Bank of America Merrill Lynch

Chart 3: Private Equity AUM Growth ($B)



Source: Preqin

Chart 4: Public Fund Asset Allocation



Source: Towers Watson Global Pension Assets Study and BofA Merrill Lynch Global Research

We see all of these structural trends as likely to persist, leading to an asset class that will continue to grow in size and importance in client portfolios, while traditional equity and fixed income asset classes face headwinds including record high equity prices, fair to higher than average valuations, negligible real bond yields, and a shrinking opportunity set (for equities). If total return is segmented between its components "beta" (defined as the return of the broad asset class) and "alpha" (defined as value added by the manager above the benchmark), and betas across major asset classes are low, then investors will need to turn to alpha to meet their total return hurdles, or move up the risk spectrum to achieve higher returns. Here, too, private equity has an advantage, as alpha opportunities within the asset class are available not only because of the illiquid and inefficient nature of private small and medium sized companies, but also because private equity managers have the ability to exert more control over and meaningfully improve the prospects of their acquired businesses, resulting in higher valuations upon exit.

However, we would caution that we believe future returns of private equity, in aggregate, are unlikely to deliver the market beating returns of the past. While the opportunity set in private equity is compelling and increasing in size, fierce competition among a growing number of managers, an abundance of capital, rising valuations, and high stock and bond prices will make it difficult to achieve the lofty returns investors earned historically. Careful manager selection, more than ever, will be of the utmost importance. Investors allocating to the asset class without private equity expertise should only do so with the help of an experienced, trusted advisor that has invested in the asset class through multiple cycles with a proven track record of accessing top performing funds.

CONCLUSION

The growth of private equity over the last few decades has been truly remarkable, a result of its higher returns, investor demand and growing opportunity set, among other attributes. Investors capable of identifying and accessing top performing funds have been richly rewarded with high absolute and relative returns. While we do not expect forward returns to be as strong as they have been in the past, we believe private equity remains attractive for its increasing opportunity set, alpha opportunities, and growing structural importance in the investment universe.

CONTACT US

www.angelesinvestments.com

Santa Monica
429 Santa Monica Blvd., Suite 650
Santa Monica, CA 90401
310-393-6300

New York
375 Park Avenue, Suite 2607
New York, NY 10152
212-451-9290

Angeles