Uncertain Times for Private Equity Investors

Pension Bridge speakers expound on issues in marketplace

BY ARLEEN JACOBIUS, P&I JULY 28, 2017

Steven Kaplan says private equity is closing in on the high side of the cycle.

It's a scary time to be a private equity investor, with the market near its peak, high prices and expected lower returns, said speakers at this year's Pension Bridge Private Equity Exclusive conference.

Private equity might not be at its cyclical peak, "but it's at a pretty high point," Steven Kaplan told the crowd attending the conference in Chicago, July 24-25. Mr. Kaplan is the Neubauer Family Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business.

The closer the private market is to the high side of the cycle, the less likely private equity funds will beat the stock market, he said; and private equity is closing in on the high side of its cycle. "I would be staying awake at night," he said.

And there's a lot of money invested in private equity, Mr. Kaplan noted. Between 1997 and 2005, private equity mostly outperformed the S&P 500, with the exception of the 2006-'08 period when performance was similar, according to the Kaplan-Schoar private market equivalent, which measures private equity performance compared to the S&P 500. Since 2009, private equity has earned better returns than the S&P 500.

It's a different story when it comes to whether general partners are able to repeat their performance. Managers of top-quartile funds can have sustainable returns some of the time, Mr. Kaplan said, but not a lot of the time. Bottom-quartile managers are most likely to persistently have bottom-quartile returning funds.

What's more, except for the bottom quartile, there is not much difference in the performance of managers' current funds, when they go out to raise new funds, Mr. Kaplan said.

The new funds of firms with top-quartile prior funds will not necessarily also be top performers, Mr. Kaplan said.

Venture capital outperformance

Meanwhile, the amount of money being raised for venture capital funds is about average. Before 2006, private equity "crushed venture capital" in terms of the ability to beat stock market returns, Mr. Kaplan said. However, since 2007 venture capital has outperformed private equity in this regard.

What's more, venture capital returns are persistent.

"Venture capital is one asset class where there is the most persistence on the planet," Mr. Kaplan. New funds of venture capital firms with prior top-quartile funds tend to also be top quartile close to half of the time.

"It's not so easy to see who will win based on past performance, but even if you can't get into the top quartile private equity funds, there is hope," he said.

Venture capital manager returns are more predictable, he said.

Competition for dollars

Investors are paying attention to whether private equity will be outperforming the public markets.

"If we can get the same level of return in public equities, money will come out of private equity," said Alex Done, deputy chief investment officer-private markets with the $170.6 billion New York City Retirement Systems, speaking on a panel on pension plan perspective.

It's very hard to earn an illiquidity premium in private equity today, Mr. Done said.

At the same time, investors are uneasy about some managers' use of leverage, especially lines of credit stretching out as far as three years, said Karen Rode, partner and global head of private equity and infrastructure, Aon Hewitt Investment Consulting, who moderated a panel on the current state of the private equity market.

In the past, managers used subscription lines of credit only as a bridge and to delay capital calls, said David Fann, president and CEO of private equity consulting firm TorreyCove Capital Partners LLC.

The use of lines of credit artificially inflate the internal rates of return of managers that use them.

It is also more difficult to compare managers' returns because investors don't know which funds are using subscription lines of credit, said Travis L. Haney, senior investment manager, State of Michigan Department of Treasury, speaking on the same panel with Mr. Fann and Ms. Rode.

"The benchmark could be incredibly inflated depending on how many funds are using leverage," Ms. Rode said.

TorreyCove executives are digging into the data these days to figure out if leverage is the primary or secondary driver of private equity funds' returns, Mr. Fann said.