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MULTIPLICITY REVIEW

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PRIVATE MARKETS

ARE THE GOOD DAYS OVER?

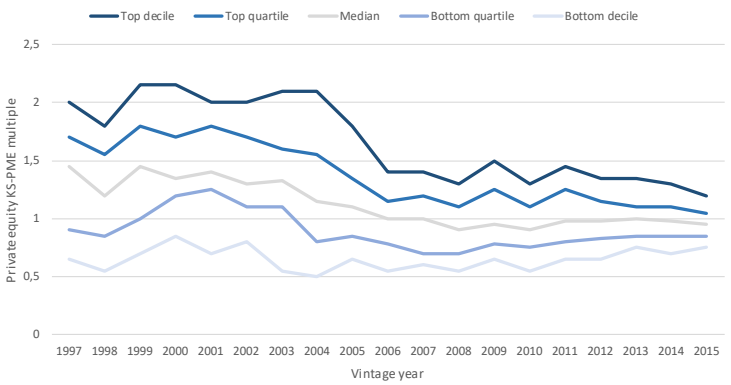
In addition to using the common practice of pinning similar private market funds against each other and grouping them into performance quartiles, PitchBook's most recent Benchmarks publication employed public market equivalents (PME) to benchmark the performance of private market funds to public equities.

Since commonly used pooled PME's tend not to account for the full degree of dispersion among managers, Pitchbook calculated individual PMEs for each fund to provide a comprehensive picture that accounts for performance differences due to manager selection.

This is important because, unlike the most renown institutional investors, the smaller investor may neither have access nor the resources to invest with top decile or top quartile funds. Picking a manager without much analysis will not result in a probability above 75% of beating the public markets anymore, contrary to two decades ago!

Using such an approach on fund vintages since 2006 has been even worse than flipping a coin.

From the 2006 vintage year until today, the median private equity manager has underperformed the S&P 500 index



Source: Pitchbook, data as at 31 December 2017

One plausible explanation for lower private equity returns is the recent equity bull market which is in its ninth year.

There must be other factors at work, however. Pitchbook's study found that private equity performance overall has been in decline. Those few investors who were fortunate enough to have secured allocations to top-decile managers before the 2004 vintage may have enjoyed a PME multiple scratching 2.00x. Since the 2005 vintage, even the best managers were unable to beat public markets by more than 1.50x.

This overall decline of returns across the board may be attributed to crowding of the private equity sector, where substantial capital inflows over the last few years have resulted in record dry powder and consequently pushed up the cost of acquisition in competitive bidding situations. This observation is supported by our recent analysis of the pricing and volume in the private equity market (see links below).

It is a good time to consider adjusting the commitment to private equity

Big institutional investors might still find plausible reasons to allocate to private equity in their overall multi-asset portfolio context. We believe, however, that it is a good time for the average private equity investor to consider adjusting their strategic commitment to the asset class.

With declining return prospects amid a crowded deal universe, the increased probability of an overall public market reversal, firm pricing levels, and eager buyers even for small fund interests, it might be a good time to sell.

Sources, links & further reading

https://reports.pitchbook.com/2018-pitchbook-benchmarks-platform-data-as-of-4q-2017/
(paid access)

http://www.mpag.com/news/private-equity-secondary-market-update-pricing-and-volume/

http://www.mpag.com/news/interview-pe-secondary-market-pricing-and-volume/

DISTRESSED ASSETS

A CLOSER LOOK AT THE EUROPEAN MARKET FOR NON-PERFORMING LOANS AND NON-CORE ASSETS

As at the end of 2017, the gross value of non-performing loans (NPLs) and non-core bank portfolios in the Euro area were estimated at around 8.8% of GDP.

While the overall volume of European NPLs has decreased by almost one third over three years from EUR 1,100 billion to EUR 780 billion, small non-performing loans are still disproportionately represented.

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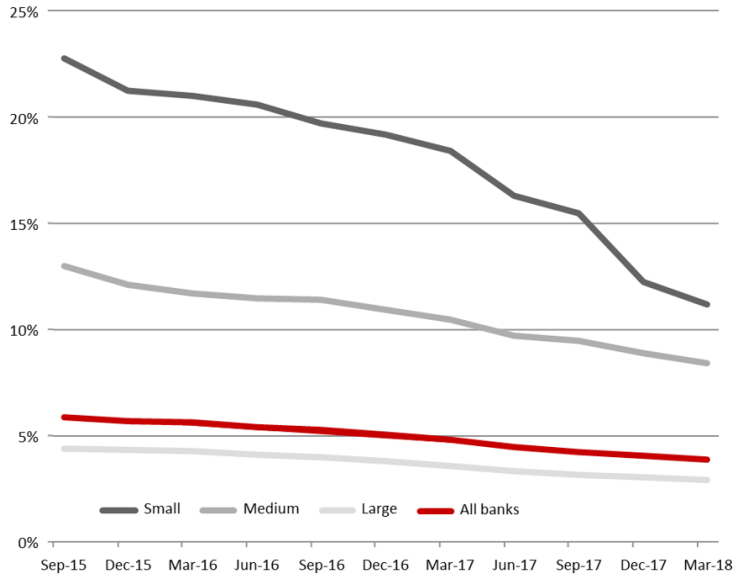

Source: European Banking Authority - 3rd Edition DISTRESSED INVESTMENTS FORUM – Berlin, 13 September 2018

There has been little demand for unsecured assets, particularly among SMEs and other corporate borrowers, loans held by smaller banks, or exposures to larger enterprises that could benefit from comprehensive debt restructuring and additional finance (Bruegel Policy Contribution, Issue N 02, January 2018).

Moreover, there is a high level of NPLs still concentrated in a few member countries.

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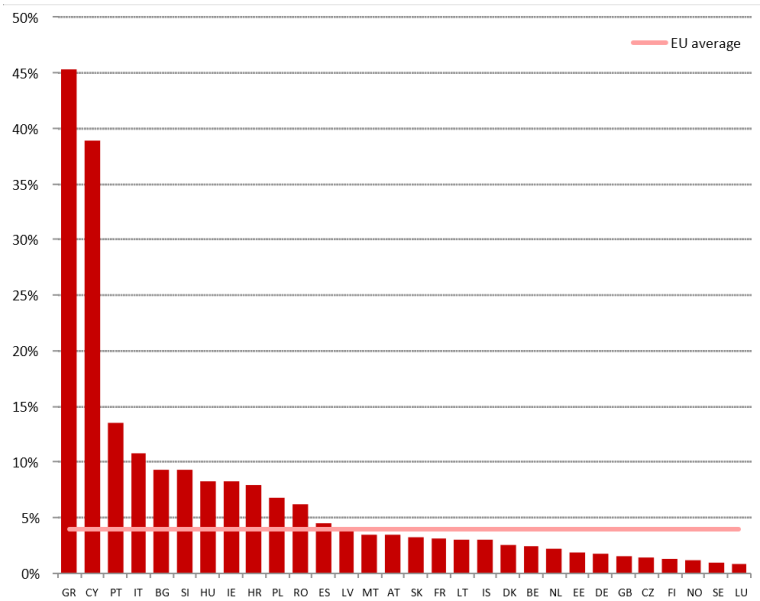

Source: European Banking Authority - 3rd Edition DISTRESSED INVESTMENTS FORUM – Berlin, 13 September 2018

Inflows of NPLs and non-core assets in 2018 in the wake of the implementation of IFRS 9 are expected to temporarily make the situation worse before it gets better. IFRS 9 is an international financial reporting standard set to replace IAS 39, the current reporting standard. The European Union has recognised that developing a well-functioning secondary market for loans would be instrumental to the recovery of Europe's banking sector. In its European Council July 2017 action plan it has mandated several measures:

- Standardised data templates and enhanced disclosure and reporting requirements to reduce information asymmetry in the market
- Guidelines for a sustainable reduction of non-performing loans on the balance sheets of credit institutions
- Guidelines on loan origination and monitoring

Additionally, there are plans for the creation of NPL transaction platforms and the establishment of public and centralised asset management companies which were deemed instrumental in unwinding similar scenarios, such as the Japanese and Korean banking crises in the 1990s (Bruegel Policy Contribution, Issue N 02, January 2018).

Sources, links & further reading

http://bruegel.org/2018/01/risk-reduction-through-europes-distressed-debt-market/

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

http://www.mpag.com/news/distressed-assets-market-update/

http://www.mpag.com/news/interview-distressed-assets-in-2018/

RESEARCH

WHAT MAKES A BUSINESS INTERESTING TO PRIVATE EQUITY BUYOUT FUNDS?

In this section, we chose to highlight a research paper by Kaul, Nary and Singh published earlier this year that examines what kind of businesses are acquired and held by buyout funds, and how strategic criteria of buyout managers differ from those of corporate buyers ("Who does private equity buy? Evidence on the role of private equity from buyouts of divested businesses", https://doi.org/10.1002/smj.2759).

The paper forms a fresh contrast to traditional literature which tends to deal with the performance consequences of buyout investments.

This paper forms a fresh contrast by looking at the motivations of buyout investments

In a nutshell, private equity buyout firms tend to prefer

- non-core businesses;
- businesses that are underinvested in R&D compared to their peers; and
- businesses that have weaker incentives for their executives compared to the competition.

The study's authors posit that buyout funds target businesses with the following characteristics:

Non-core businesses within a traditional publicly traded conglomerate

Those businesses suffer from coordination costs since they receive less attention from the top management, which tends to be focused on the core business which they naturally consider closer to their core industry competence.

Due to their specific markets and activities, non-core businesses are also harder to correctly value by traditional analysts.

Finally, a non-core business by definition has a somewhat marginal contribution to overall results, which may distract from its true strategic potential.

Businesses that suffer from the short-term, speculative nature of their public market parents

Compared to privately held businesses, long-term strategic investments in public companies are difficult to keep secret and are therefore seldom pursued.

Also, unique, innovative approaches that depart from conventional thinking are not often understood by less sophisticated investors.

Finally, the short-term, speculative nature of public equities investors (who tend to disregard the need to endure short-term losses in return for long-term performance) form a stark contrast to buyout funds. Their investment horizon of five to ten years affords them the necessary patience to systematically pursue strategic and operational performance improvements.

Businesses that suffer from weak and misaligned incentives of their executive team

The study highlights the buyout space's aspirations to contribute to innovation, coporate governance and the pursuit of long-term value generation

Despite recent adjustments, the incentives for central and business unit management tend to favor short-termism, which results in less being invested in maintenance, and in excessive use of existing assets. Additionally, high-powered incentives for management linked to stock market performance may lead to behaviour that exploits the cognitive biases of its public market investors.

The study highlights the negative consequences of equity market pressures, especially for novel or technologically advanced business models. It also shows the aspirations of the PE buyout space to contribute to innovation, corporate governance and the pursuit of long-term value generation.

It may be particularly interesting to contrast this understanding of how buyout firms target and operate their investments to the Pitchbook study we outlined earlier in this publication. It appears that, as noble the aspirations of the private equity buyout space may be, the results achieved have been continually declining, both in absolute and in relative terms when compared to public markets.

Sources, links & further reading

https://onlinelibrary.wiley.com/doi/abs/10.1002/smj.2759

The full paper can be rented for reading for a modest amount.

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