MULTIPLICITY REVIEW

ISSUE NO. 2

2 WHEN HAPPINESS BREEDS ADVENTURE

Three-quarters of respondents were happy with their private equity performance, according to a recent limited partners survey. Private equity is definitely en vogue. So much so that many investors feel confident enough to dabble with co-investments and direct investments. We believe that complacency in adventure can lead to risky behaviour.

4 PERFORMANCE AND RISK: WHY DURATION MATTERS

There appears to be predictive power in duration analysis. While the average IRR for funds with a cash flow duration of 4.5 years is 13.7%, performance after duration year nine turns negative. We argue that, particularly in this market environment, investors should pay close attention to the duration of their private equity investments.

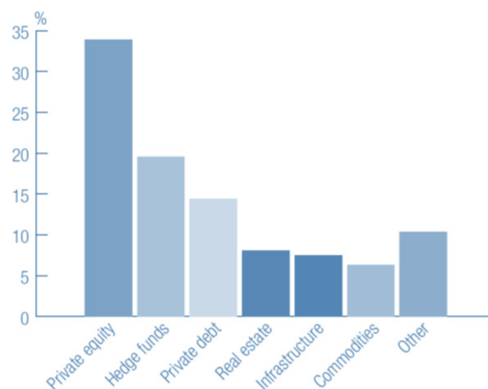
PRIVATE MARKETS

WHEN HAPPINESS BREEDS ADVENTURE

According to Intralinks' LP Survey 2018, three-quarters of respondents were happy, or very happy, with their private equity performance, while only 7% indicated that their allocation had performed below their expected return objectives. Two-thirds of respondents plan to increase their allocation to private equity during 2018/2019.

Private equity allocations to trump all other alternative asset classes

Allocation preferences for 2018/2019



Source: Intralinks' LP Survey 2018

Limited partners profess to prefer private equity in 2018/2019 by a long shot. In fact, the next two runners-up (hedge funds and private debt) only match investor preferences when combined.

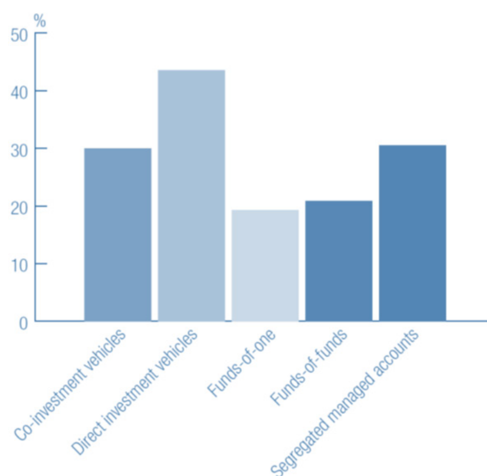
The most extended equity bull market in recent history, and the fact that, overall, hedge funds tend to have lower market betas than private equity may have been a contributing factor.

Optimism: when everyone thinks they can identify and access top quartile investments

This run towards private equity is particularly remarkable since Pitchbook's recent 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 public market equivalent multiple scratching 2.00x. Since the 2005 vintage, even the best managers were unable to beat public markets by more than 1.50x.

Cutting out the middle-man

Preferred investment methods 2018/2019



Source: Intralinks' LP Survey 2018

According to the Intralinks LP Survey 2018, 58% of limited partners planned to complete direct private equity investments in the next 12 months. These figures confirm our market observations that investors for years have been flocking towards more transactional investments such as co-investments and direct investments.

With private equity becoming mainstream, and even average performance having been satisfactory for years, internal allocators at big institutions and family offices are feeling increasingly confident to become more transactional in their investment approach. Reasons often cited are the freedom over the timing of contributions, and removing at least one layer of fees compared to a more traditional LP approach.

We do not hide our caution when it comes to what we believe is an overheating private equity market

Our experience shows that the skill profiles of fund level allocators and portfolio company level risk-takers can differ significantly. Investment professionals straying from their wheelhouse and becoming more adventurous, to us, is just another indication that prudent investors might want to consider revisiting their private equity allocations.

Sources, links & further reading

https://www.intralinks.com/resources/whitepapers/2018-lp-survey

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

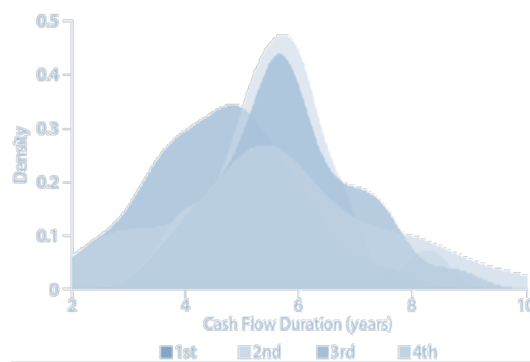
PRIVATE MARKETS

PERFORMANCE AND RISK: WHY DURATION MATTERS

Since one commits up to a 15-year relationship with a general partner and their private equity fund, being able to assess the liquidity risk of a PE investment is essential. Duration (please see inset on next page) can be use in this regard.

Distribution of cash flow duration across fund performance quartiles

Higher cash-flow duration means lower private equity performance



Source: Stepstone ¦ Cracking the Illiquidity Code: Long-Term Partnerships, Short-Term Cash Flows

Since the internal rate of return is time-sensitive, returning the same capital quicker results in a higher IRR. There is a clear pattern indicating that, on average, top-quartile funds are returning money quicker than their lower-performing peers.

In private equity, both success and failure become evident more quickly

A notable exception: bottom-quartile funds that show a less pronounced distribution curve and shorter cash flow durations than their second and third quartile peers. It appears that, in private equity, both success and failure become evident more quickly.

Funds with a cash-flow duration of seven years only average 5.2%

According to Stepstone's research, there may be some predictive power in these figures: a simple linear model predicts an average IRR of 13.7% for funds with a cash flow duration of 4.5 years. The slope of the performed regression is negative, indicating that performance is only 5.2% with a seven-year duration, and flipping into negative IRR territory somewhere around duration year nine.

Setting oneself up for very long fund durations..

Today, we find an eerily similar private equity market constellation when compared to prior downturns, which resulted in longer durations: a mature 9-year equity bull market, record amounts of dry powder, all the while buyout funds continue to raise record figures to satisfy investor appetite for private equity. The return of leverage witnessed recently only adds to this picture.

As the saying goes: sometimes, what looks like a duck and talks like a duck may be one. We believe that these days, private equity investors should pay extra close attention before committing to new investments.

Should one hold private equity fund investments to maturity in today's environment?

Finally, while each investment must be assessed individually, we believe that Stepstone's findings regarding longer durations should also provide food for thought to those investors who hold on to mature or non-performing fund investments, hoping to squeeze an extra return out of them.

More about cash-flow and performance duration

Stepstone's recent piece on duration in private equity (Stepstone: Cracking the Illiquidity Code: Long-Term Partnerships, Short-Term Cash Flows) contrasts cash flow duration (the difference between average distribution time and average contribution time) against performance duration (the time it would take for an investment, compounded at the internal rate of return (IRR) to achieve the realized total value multiple (TVM)).

While the former requires actual cash flows to be known, the latter can be used when only the TVM and the IRR are known. Using a subset of 332 USD denominated buyout funds, Stepstone finds that the average difference between the two methods to assess duration is only 0.22 years.

Sources, links & further reading

https://www.stepstoneglobal.com/news-press/cracking-the-illiquidity-code/

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