The five forces of private equity?

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17 years of experience in private markets (USA, France, LatAm., Switz.)

- Research: Executive director in charge of private markets at UBS CIO
- Investments: venture capital fund manager, former CIO of Tiaré Investment Management AG
- Advisor to the President of CASDEN-Banque Populaire, a Swiss pension fund and MFO
- Expert for SECA, AFIC, InvestEurope and CAIA

Five books on private equity, among which:

- *Introduction to private equity*, Wiley, 2013, 2nd ed. (translated in Portuguese, Spanish and Mandarin)
- *Private equity fund investments*, Palgrave, 2015

Agenda

Five private equity forces and their consequences

- ‘Gravity’ - a continuing attractiveness
- ‘Black holes’ - the herding effect
- ‘Entropy’ - being different to succeed
- ‘Liquidity’ - the third dimension of investing
- ‘Entanglement’ - regulatory threat and opportunity

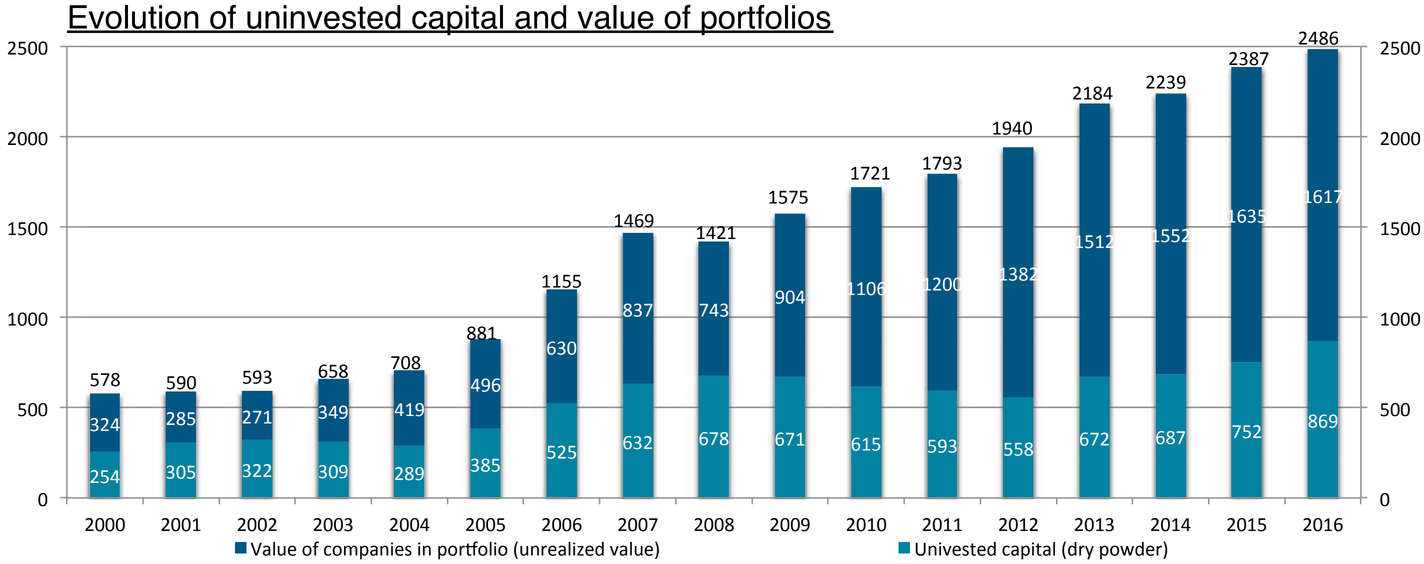
The gravitational pull of private equity

A continuing attractiveness

Growth of assets under management

Result from new entrants, increase of asset base and allocations to PE

Evolution of uninvested capital and value of portfolios



- Ratio dry powder/unr. value decreased: 90% (2000-05) to 46% (2011-16)
- Growth of AuM: 21% (dry powder: +15%, unrealized value: +25%)

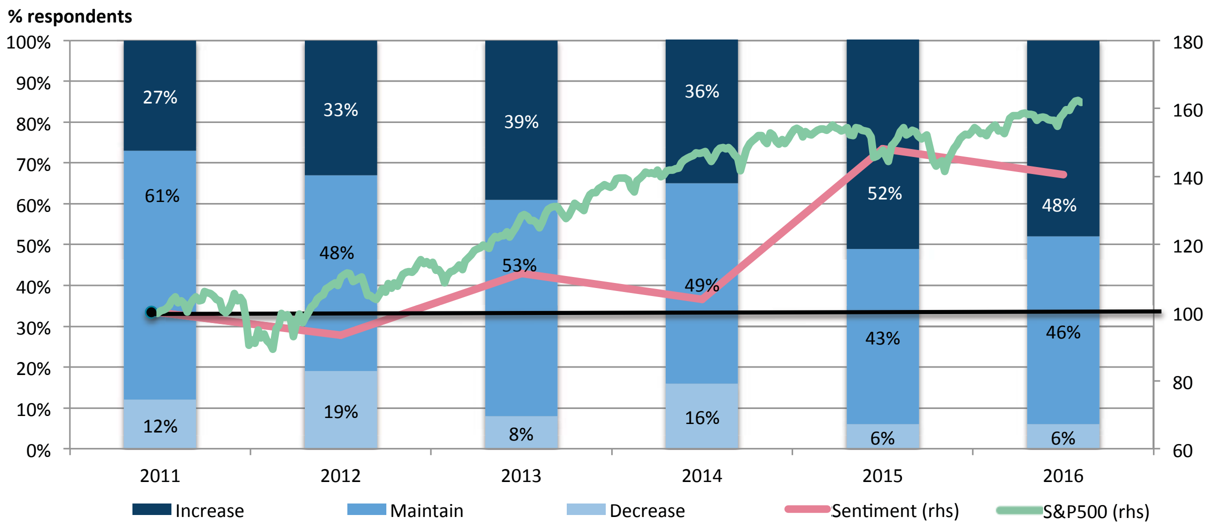
➔ At first approach, no reason to be alarmed by dry powder levels (**but funds only**)

➔ However, potential overheating of certain market segments

Figures are in USD bn. Data until June 2016. Source: Preqin, Wellershoff & Partners 2017.

Increase in allocations to private equity

Compared evolution of S&P500 and investors intentions as for private equity allocation

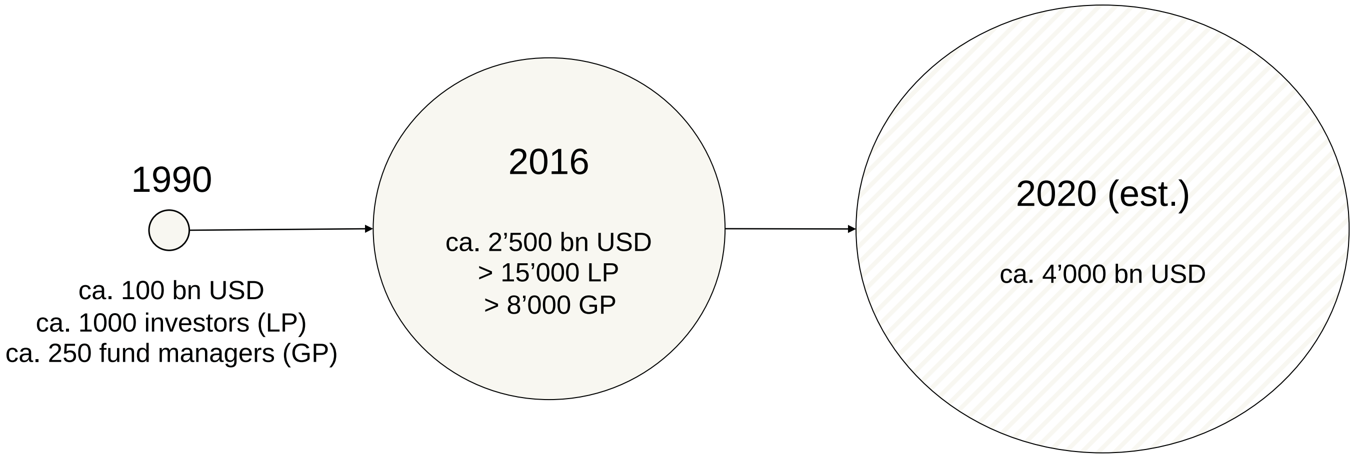


- Allocations rely on 'wealth effects':
  - Correlation of 0.79 between the progression of the S&P500 and the sentiment
  - Sensitiveness to denominator effect
- Transition from modern portfolio theory to factor-based asset allocation could lead to increased allocations to PE

Note: sentiment is the weighted average of intentions. 2011 = 100.
Source: Preqin (2017), Federal Reserve Bank of St Louis, Wellershoff & Partners.

The gravitational pull of private equity

Evolution of assets managed by private equity funds



- Estimates: funds' assets under management only (est. +25% for co-inv.)
- Increase (25x) due to:
  - **Thirst for yield**
  - **New entrants**
  - Overall **growth of assets managed** and **threshold effects**
  - **Increase in allocations** to PE and SAA **switch to factor-based investing**

Source: Preqin, EurekaHedge, Author.

Despite the pressure, LPs struggle to deploy capital

Difference between current and target allocations for median LP (in % point)

Type of limited partner	Private equity	Real estate	Infrastructure	Private debt	Natural resources
Endowment and foundation	2.0	2.5	2.8	2.0	2.1
Family office	2.0	0	1.9	3.5	–1.5
Insurance companies	1.0	4.3	1.8	2.0	4.7
Private-sector pension fund	1.0	3.5	2.1	3.0	3.1
Public pension fund	1.0	1.0	2.0	3.0	2.4
Sovereign-wealth fund	4.2	3.8	–0.8	0	–2.5
Superannuation scheme	0.9	1.6	1.0	0.5	N/A

Underweight Overweight

- Allocations should be done over 5 to 7 years to:
  - Smooth vintage effects, build a coherent and viable portfolio
  - Use allocation brackets to exploit opportunities and absorb liquid assets' volatility
- Capital committed ≠ capital deployed, structurally

➔ Adopt a long term view and aim at reducing 'friction costs'

Note: median among LPs that report current allocation.
Source: McKinsey (2017).

Private equity's black holes

The consequences of the herding effect

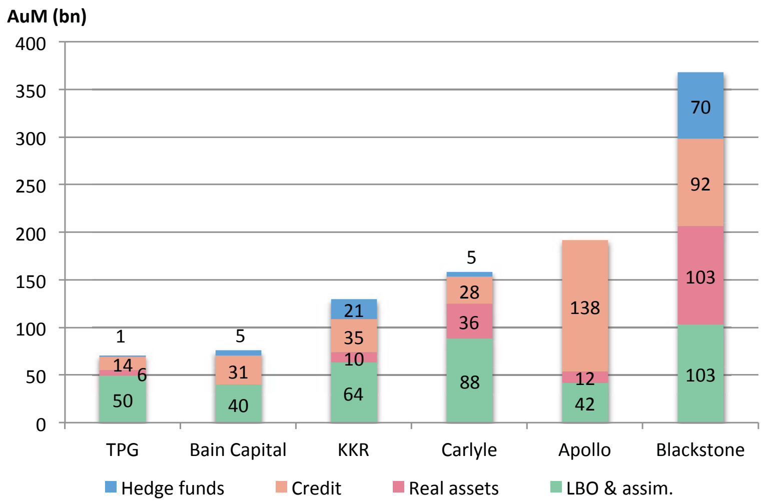
Less sophisticated investors build up risks (1/2)

A recurring lack of understanding of PE lead to herding and contagion effects

- **"Less relationships" + "save on fees":**
  - Focus on "brands", regardless expertise (failures: natural resources, hedge funds)
  - Do not push GP to optimize returns:
    - Latent risk aversion from GPs (preserve track record)
    - Impact of fees not mitigated by LPs (fear of exclusion)
    - Co-investment pretense ('lower fees'), but lack of knowledge of LPs (adverse selection, out of 'sweet spot')
  - "Investment banking approach": low value-add

  ➔ currently changing as source of differentiation (LPs need to catch up… and some do)

AuM breakdown of top private market operators

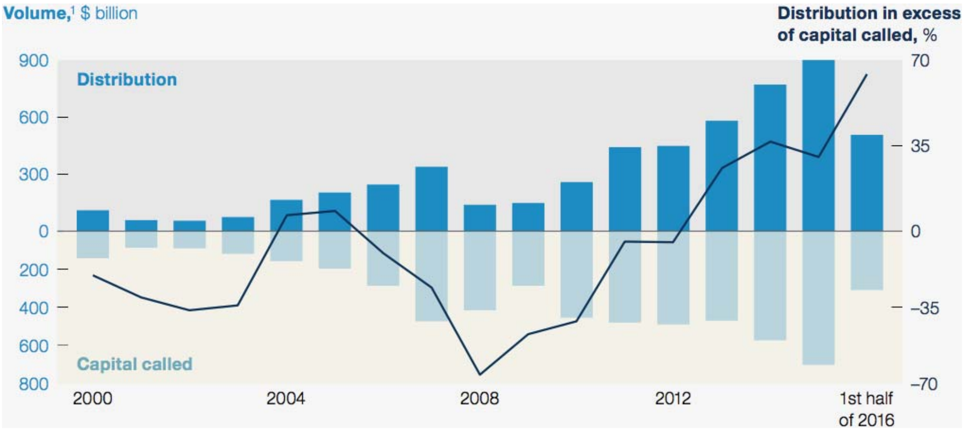


Less sophisticated investors build up risks (2/2)

A recurring lack of understanding lead to herding and contagion effects

- **“Deploy more capital faster”:**
  - Excessive focus on IRRs, possibly leading to further lack of alignment of interest (lines of credit)
  - Detrimental pro-cyclical approach of PE
  - Performance comes from the freedom attached to the mandate to GP to deploy capital wisely
  - Fighting the tide when distributions are flowing back

Contributions from and distributions to LPs



Source: Preqin, McKinsey (2017).

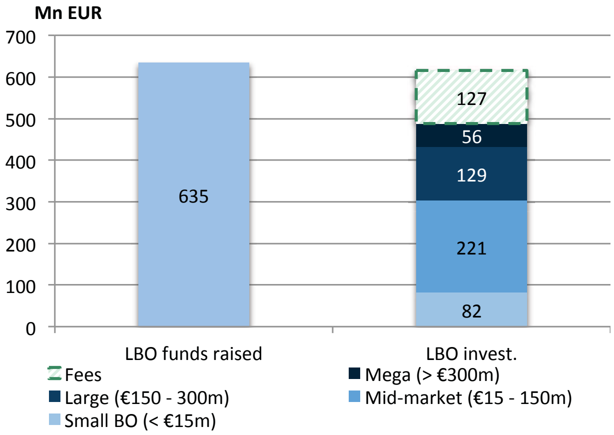
Consequences: some segments are overheating

As such, LBO is not overheating:
- Regular activity in small/mid market
- Funds raised = total invested (+ fees)

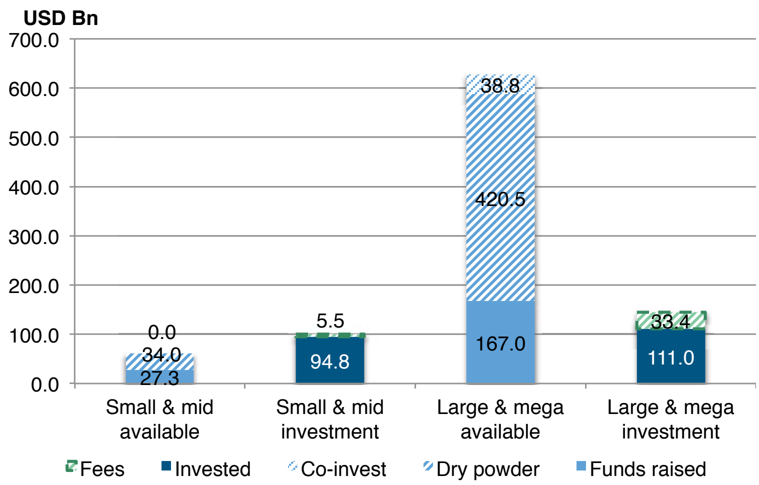
However, ‘shadow LBO’ adds up capacity:
- Correlation co-inv. / small & mid BO: 0.47
- Correlation co-inv. / large & mega BO: **0.79**

Large/mega BO exhibit an **excess** of capital:
- Dry powder = **4 years** of fund raising
- Potentially propping up valuations durably
- ➔ Possibly used for buy & build
- ➔ Possibly redirected to secondary LBO

1. Average LBO funds raised and invested (Europe, 2007-15)



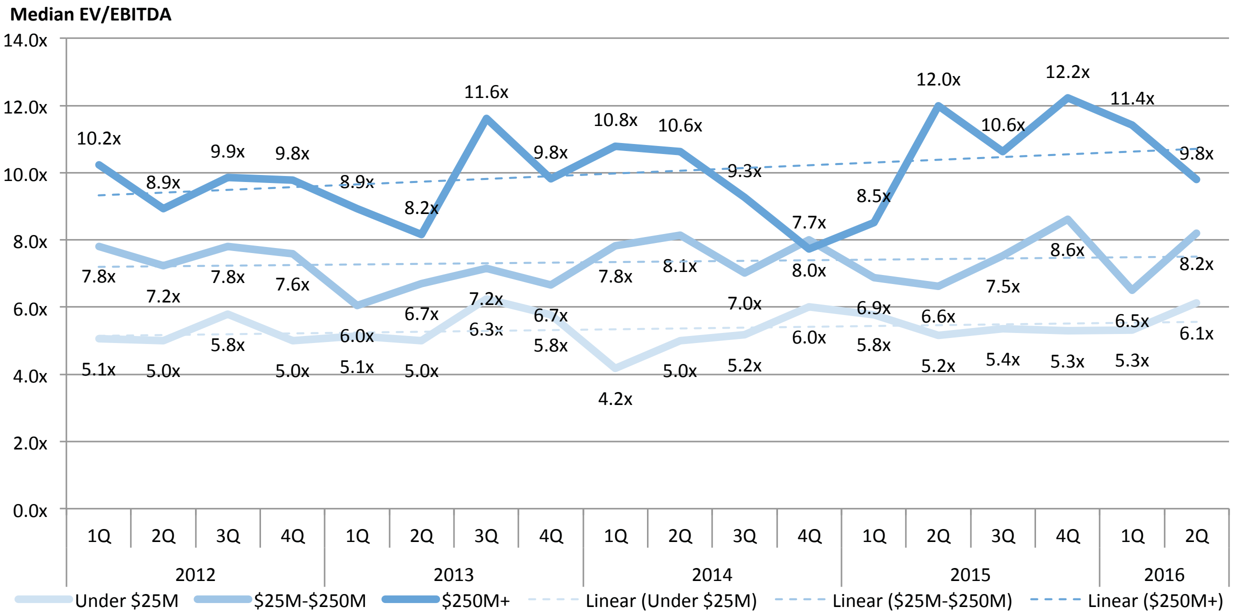
2. Average LBO funds raised and invested (US, 2012-16)



Note: calculation of fees: 2% per year over 10 years.
Source 1: InvestEurope, PEREP, 2016; Wellershoff & Partners, 2017.
Source 2: Cambridge Associates/Private Equity Analyst/Axios, Pitchbook, Wellershoff & Partners, 2017 .

Two "black holes": large LBO and secondaries (1/2)

Large & mega BO victim of its own success: the proof of valuations



- Competition from strategic investors, high valuations & limits to leverage ➔ lower future returns
- "Easy to target": LBO is the beginner's play (co-investments) ➔ expected to change

Source: Pitchbook (as of June 2016), Wellershoff & Partners, 2017.

Reduction in returns? For large/mega US LBO yes

"People used to expect 20% net IRRs or higher. Now investors are happy in the high to mid-teens, because the alternatives are so much less attractive"
D. Rubinstein (Carlyle Group), *Fortune, "The Term Sheet"*, 8/8/2012

"If you are wholly dependent on doing conventional buyouts, which today are very competitive with a lot of money around… frankly it's going to be very difficult to generate traditional private equity returns in the low- to mid-20 percent (range)"
Leon Black (Apollo Global Management), quoted by G. Roumeliotis, "Private equity investors temper return expectations", Reuters, 27/2/2013

"Blackstone considers a lower-return, longer-term approach to private equity"
W. Alden, *The New York Times*, 25/2/2015

"Private equity returns that had been an average of 15% are down to 12%, Mr. Rubenstein said: "I suspect that is where returns will stay"
A. Jacobius, "Private equity titans warn attendees to expect lower returns", *Pensions & Investments*, 3/5/2016

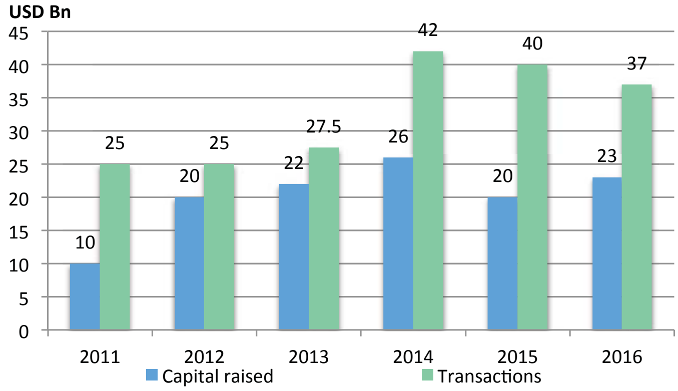
Large & Mega LBO
➔ Large allocations have reduced information asymmetries and market imperfections
➔ Leverage is commoditized in DM, and now capped informally at 6 x EBITDA (USA)
➔ Relative standardization of investments (M&A approach and cost cutting)
➔ Need to innovate and develop new sources of value creation (less industrialised)
➔ Need to diversify into different investment areas

Note: quotes refer indiscriminately to gross IRR and net IRR.

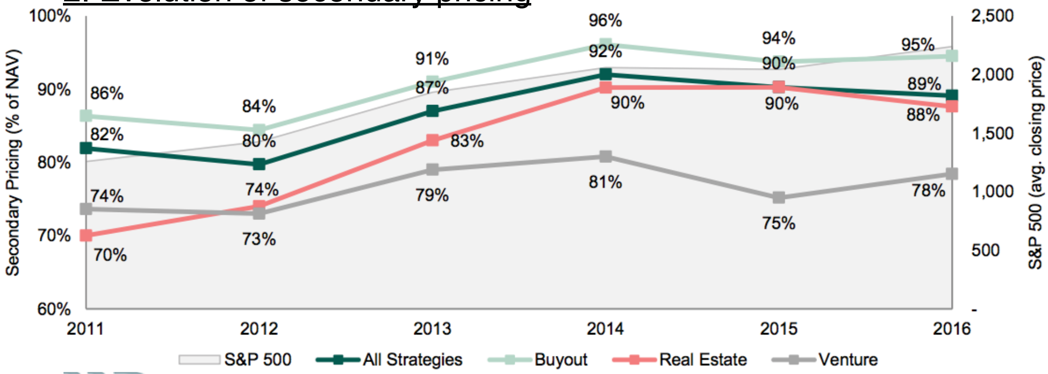
Two “black holes”: large LBO and secondaries (2/2)

- Secondary market is getting riskier:
  - This is a tactical instrument
  - Attracts significant direct investments
  - Without discount, limited upside expected
  - The real value is in primary investments

1. Secondary fund raising and transaction



2. Evolution of secondary pricing



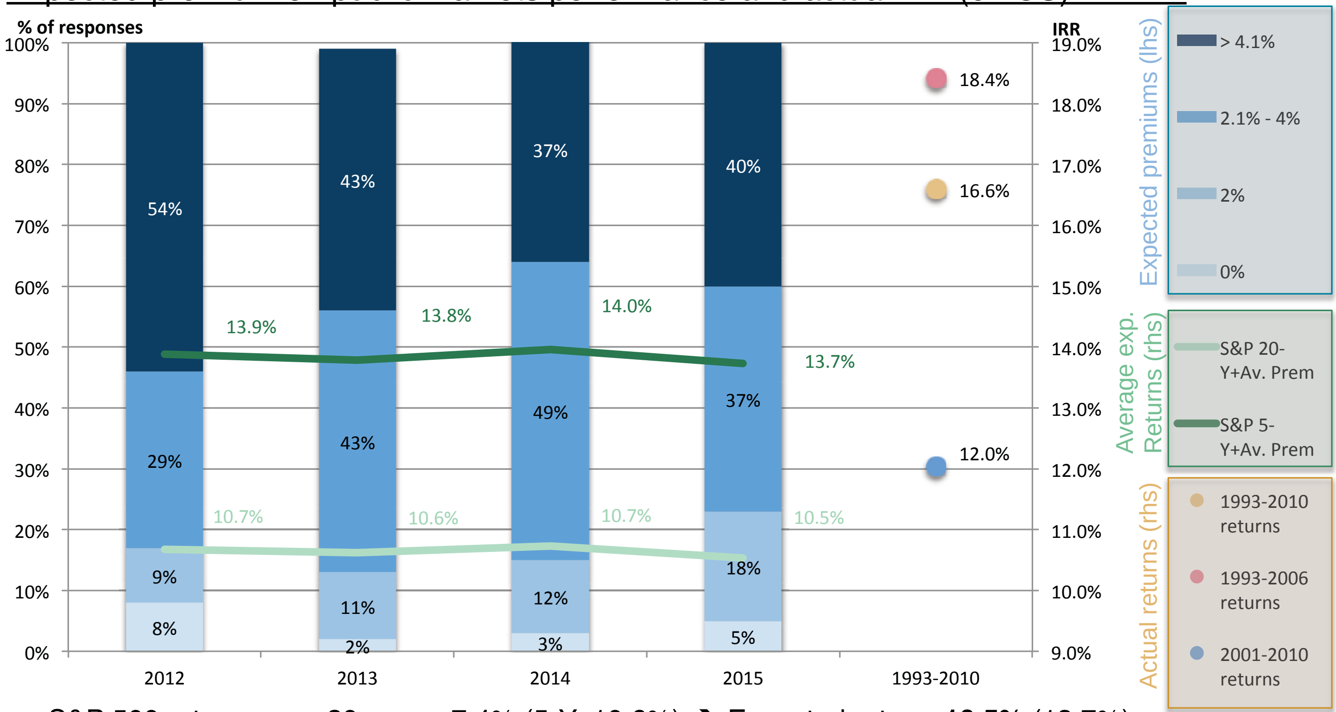
Source 1: Preqin, Greenhill, Wellershoff & Partners, 2017.
Source 2: Greenhill, 2017.

Private equity’s entropy: embrace the chaos

To succeed, dare to be different

Expected performance and actual performance of PE

Expected premium on public markets performance and actual DM (ex-US) PE IRR



S&P 500 returns over 20 years: 7.4% (5-Y: 10.6%) ➔ Expected return: **10.5%** (13.7%)
➔ Returns exceed long-term expectations, though short-term could create confusion

Note: expected performance is the weighted average of answers plus annual S&P performance over 5 and 20 years. CA returns are based on 818 developed markets PE funds ex-US (LBO, growth, venture, energy, mezzanine).
Source: Preqin (2016), Cambridge Associates (2017, data as of June 2016), Wellershoff & Partners.

Embracing the chaos to succeed

To escape risks, investors have to embrace change

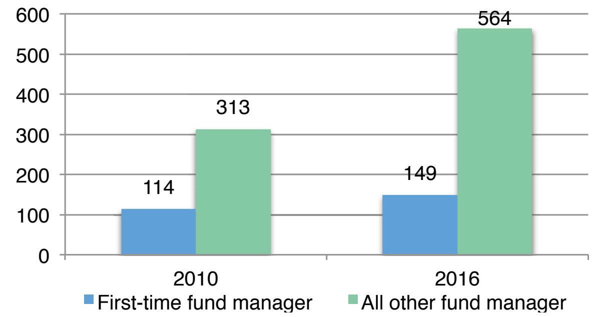
- Stasis = immobility while hidden risks abound = increased risk of losses
- “Know yourself” to define the constraints and optimize them
  - Balance portfolio between strategies, regions and vintage years
  - Leave some room for evolutions (opportunistic secondaries, denominator effect)
- To generate performance, be different:
  - Target smaller strategies and niches
  - Develop a differentiated strategy
  - Choose to be countercyclical
  - Invest in knowledge and expertise to back first-time funds
- Avoid uncompensated risks
  - Aim for mandates and segregated accounts (avoid contagion, define terms)
  - Do co-investment and direct only as co-lead with a clear expertise and value add

Invest in knowledge and expertise: first-time funds

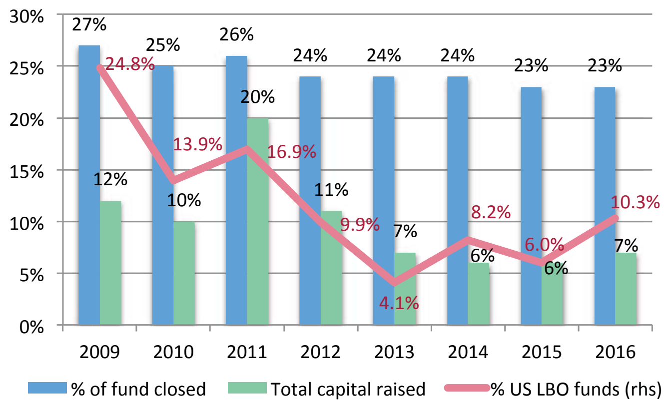
First-time funds exhibit:

- Discipline and higher alignment of interest
  - Smaller funds require capital frugality
  - Need to develop a track record to raise further funds
  - Possibly friendlier terms for LPs
- Higher performance
  - 31% are top quartile, 23% second quartile
  - Need to differentiate and develop a track record
  - Higher motivation for carried interest
- Higher risks
  - Learning curve still there (operations)
  - Deal sourcing without brand tested
- More difficult to raise funds
  - 43% of LPs "will not invest" (vs 35% in 2011)
  - 40% will invest or in spin-off (vs 50% in 2011)

Av. fund size (USD mn)



First-time funds as proportion of PE fund raising

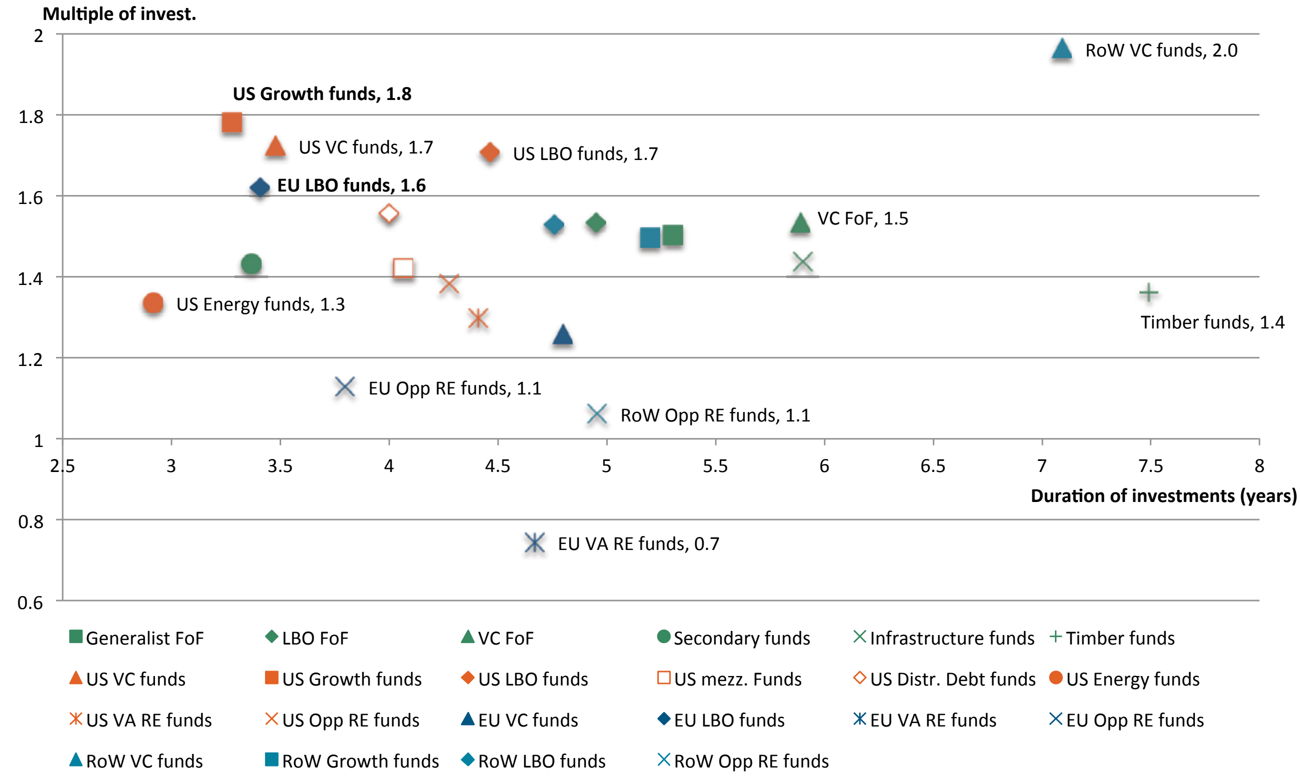


Source: Preqin, Pitchbook, Wellershoff & Partners, 2017.

Private equity's third dimension: liquidity

Optimizing the constraints: risk-return-liquidity

The third dimension of private equity: liquidity



Source: Cambridge Associates (data as of 30/6/2016, published 12/2016), Wellershoff & Partners, 2017.

Private equity's entanglement: regulations

From red tape to opportunities?

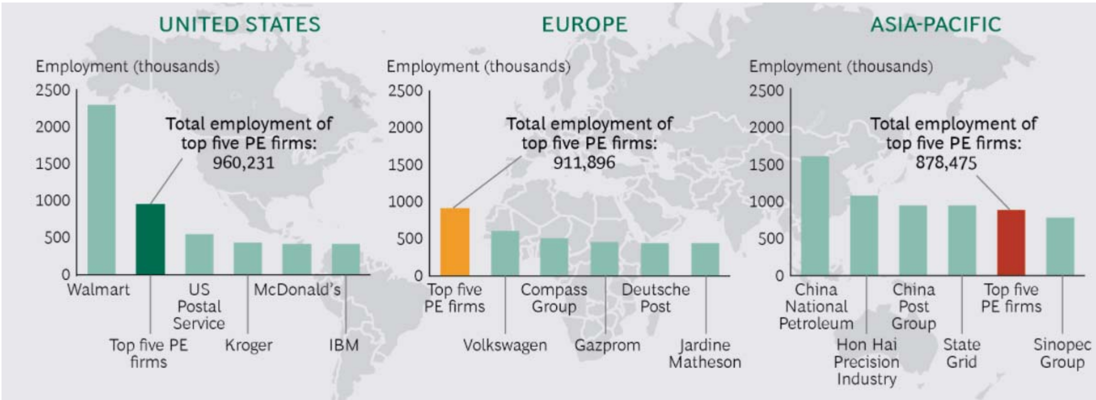
Regulations are here to stay, and to increase?

So far, regulations were aimed at investors… this could change

- Upcoming measures could add up:
  - USA: carried interest treatment, deductibility of interests, tax overhaul
  - Europe: AIFMD 2, MiFid 2, EIOPA 2
- Increasing risk of backlash:
  - Botched turn-around (Sun Capital) and Chapter 11 abuses
  - Botched dividend recap (Bain Capital)

➔ More than ESG will have to be done

Total of employees in portfolio companies of top 5 LBO operators



Source: BCG, based on Pitchbook and Fortune's Global 500, 2017.

Conclusion

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Some probable evolutions, others less obvious

PE market will continue to grow:

- LPs: focus on brand and large sizes ➔ concentration and contagion risk
- Co-investments: 'there's no free lunch' ➔ when the tide recedes, naked bathers will show
- This is a long-term gain: build conviction, avoid hype and stick to your guns

When the cycle clock will turn:

- Valuations will normalise ➔ activity increase (once 'new normal' settles)
- Some strategic buyers will sell (non strategic, overleveraged) ➔ activity increase

… but when?

Unknown:

- Treatment of debt and interest for LBO (USA/Europe)?
- Perception of future LBO failures and restructuring? Backlash?

Thank you!

Wellershoff & Partners

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