

PERFORMANCE: The enigma of private equity

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By Josh Lerner, Harvard Business School

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Few aspects of the private equity industry generate more confusion than the measurement of returns. This claim can be illustrated with examples from many corners of the industry.

A private equity group raises a fifth fund, claiming in its placement memorandum that its fourth fund (from which only one investment has been realised) has an internal rate of return (IRR) of more than 50 per cent. Within a year of the closing, there is a series of write-downs that brings the return of the fourth fund down to the single-digit level. An institutional investor, having signed a partnership agreement which calls for the share of profits going to the private equity investor to vary with the internal rate of return of the fund, discovers that the fund actually has two different IRRs, one positive and one negative. Many millions of dollars depend on which rate of return is selected.

* A successful investment adviser begins presentations to prospective clients with the assertion that private equity is negatively correlated with the market as a whole, and thus provides a valuable source of diversification.

As these anecdotes reveal, private equity remains a young industry and the practices and understanding regarding returns reflect that immaturity. But in the past few years, there has been a flurry of research and writing about the nature of private equity returns, providing a better understanding of how this sector works. In this piece, I will review the new evidence regarding private equity returns, and highlight four important lessons.

First, private equity is not a business that lends itself to an index fund approach. Many limited partners beginning private equity programmes have extravagant expectations, seeking to equal the returns of, for instance, the Yale Endowment (which has enjoyed annualised returns of 31 per cent since its first private equity investment in 1973). The reality is very different. The work of Steve Kaplan and Antoinette Schoar * suggests that, taken as a whole over the past several decades, the returns from venture capital funds have only slightly exceeded public market benchmarks, while those of buy-out funds have slightly underperformed comparable public market indices.

Moreover, given the risks of private equity investments - for instance, the high degree of leverage associated with many buy-outs - the "fair" rate of return that we would expect from these investments may actually be higher than the general public market indices. A series of papers by Ludovic Phalippou, Oliver Gottschalg, and co-authors ** among others, suggests that once these and other adjustments are made, private equity investments actually substantially underperform the market on average.

While the exact degree of underperformance can be debated, the basic lesson seems clear: the average return from private equity is quite unspectacular.

Second, there are much better ways of assessing performance than are being used. The IRRs typically used are prone to a wide variety of methodological and interpretive problems. For instance, these calculations are frequently sensitive to assumptions about the draw-downs of capital and do not lend themselves readily to being aggregated: the return of two funds taken together may be very different to the average of the individual IRRs.

A variety of approaches used to assess private equity returns in the academic literature - ranging from "public market equivalents" to "alphas" in performance regressions - give a far more reasonable sense of the performance of private equity funds.

Third, the extreme disparities between groups create attractive investment opportunities. The

previous point might lead one to suspect that this was an unlikely area for positive investment returns.

But despite the modest average returns for private equity funds (particularly when risk adjusted), there are many groups that have delivered truly excellent returns.

The reason is that, when compared with public equity and bond fund managers, there is an extreme dispersion in returns across private equity funds: the differences between the top performers and the underperformers are huge indeed.

Moreover, unlike among mutual and even hedge fund managers, where there is a tremendous amount of turnover among the leading fund managers, here persistence is the rule. Kaplan and Schoar show that groups that outperform their peers are likely to do so again when they raise their next fund and the fund after that.

It might be thought then that a willing investment strategy would be simply to invest with groups which have had good returns in the past.

Many successful groups have taken such an approach. There is just one important limitation: groups that have been successful in the past tend to rapidly expand the capital they have under management. And this growth in fund size seems to translate into a deterioration of investment returns.

Fourth, the private equity investing "playing field" is very uneven. While the disparity between private equity groups is great, so too is that in the performance of different limited partners. In a recent study, Antoinette Schoar, Wan Wongsunwai, and I show that there is a huge disparity in the returns realised from private equity by different classes of limited partners. In particular, university endowments on average enjoyed annualised returns almost 20 per cent greater than other investors. While the returns from investments made between 1991 and 1998 were at least in the double digits for all classes of limited partners, if we extend the analysis through 2001 (the turn of the century saw mediocre returns from many funds), the differences are even starker.

What explains these dramatic differences in returns? In part, these reflect "good luck": endowments were more active in the early 1990s, when the returns from private equity were better. In part, these reflect access: many endowments, being early to private equity investing, gained "grandfather rights" to invest in subsequent funds of premier organisations that were essentially closed to new investors.

But a large portion of the differences seems due to simply superior decisions about funds to invest in, and which relationships to terminate.

* Steven N.Kaplan and Antoinette Schoar, Private equity performance: Returns, persistence and capital flows, *Journal of Finance*, August 2005.

** Ludovic Phalippou, Oliver Gottschalg, and Maurizio Zollo, Performance of private equity funds: Another puzzle?, Working paper, 2007.

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