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Private equity: Changing perceptions and new realities

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Industry performance is better than previously thought, but success is getting harder to repeat. Investors and firms will need to adapt to changing conditions.

Private-equity performance has been misunderstood in some essential ways. It now seems that the private-equity industry decisively outperforms public equities with respect to risk-adjusted returns, which may prompt return-starved institutional investors to allocate even more capital to the asset class. But this good news comes with an asterisk: top private-equity firms now seem less able to produce consistently successful funds. That's because success has become more democratic as the general level of investing skill has increased.

The new priority for success is differentiated capabilities. Limited partners (those who invest in the funds raised and managed by general partners) expect funds that exploit a general partner's distinctive strengths will do well, while more generalist approaches may be falling from favor. Institutional investors will need to get better at identifying and assessing these skills, and private-equity firms will need to look inward to better understand and capitalize on the factors that truly drive their performance.

A new understanding of an elusive industry

Private equity has grown from the equivalent of 1.5 percent of global stock-market capitalization in 2000 to about 3.9 percent in 2012. Along the way it has boomed and busted alongside public markets, while inexorably taking additional share. At the same time, many have observed that private equity—though ostensibly an "alternative" asset class—has in two ways drifted toward the mainstream. Several researchers concluded in the mid-2000s that, on average, buyout funds underperformed the S&P 500 on a risk-adjusted basis; only about a quarter of firms consistently beat the index. Other research has found that private-equity returns have become highly correlated with public markets.

As the perception of private equity's differentiation has waned, the fees that the industry charges investors, already under pressure, have come to seem especially exorbitant to some. And as firms have come under fire for some of their practices, they have not always done a good job of explaining their role to the public.

These are serious challenges but, if returns are only average, none of the rest matters very much. Private-equity returns are, however, notoriously difficult to calculate. By and large, the industry does not publish its results; the data that are available can be inconsistent and hard to reconcile, as both private-equity firms and their limited partners use diverse approaches for their calculations. Making things more difficult, a database on which researchers have relied turns out to have had serious methodological issues.

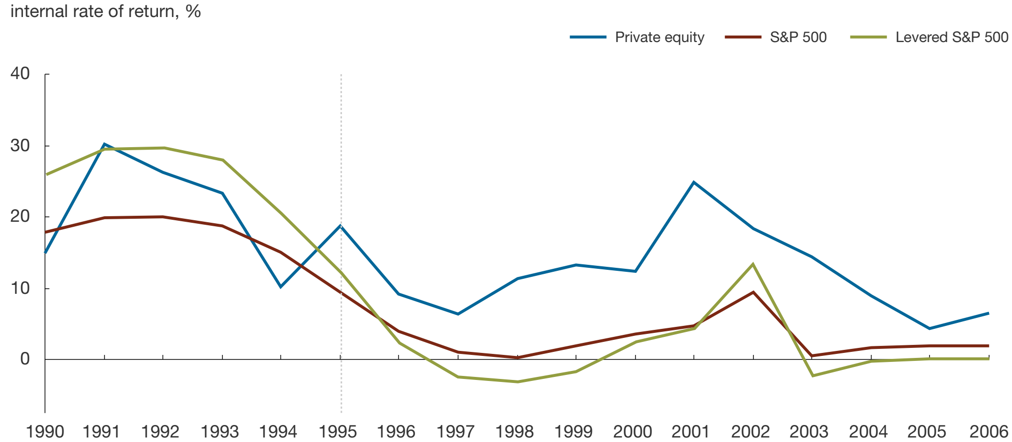
Encouragingly, new research based on more recent and more stable data suggests that private-equity returns have been much better than previously supposed, though top firms' performance is now somewhat less consistent. The conventional wisdom on returns stems from analyses of funds raised in 1995 and earlier. In January 2011, McKinsey developed an analysis for the World Economic Forum in which we found that funds created since 1995 appear to have meaningfully outperformed the S&P 500 index, even on a leverage-adjusted basis (Exhibit 1). Two academic teams have since reached similar conclusions.[1] Both find that over the long term, private-equity returns have outstripped the public market index by at least 300 basis points.

Other McKinsey analysis finds that the persistence of returns—in particular the tendency of top firms to replicate their performance across funds—is not nearly as strong as it once was. Until 2000 or so, private-equity firms that had delivered top-quartile returns in one fund were highly likely to do so again in subsequent funds. Knowing that yesterday's winners were likely to excel again today enabled limited partners to focus their due diligence on identifying top-quartile funds.

[1] Robert S. Harris, Tim Jenkinson, and Steven N. Kaplan, "Private equity performance: What do we know?," National Bureau of Economic Research working paper, Number w17874, February 2012, nber.org; Chris Higson and Rüdiger Stucke, "The performance of private equity," Social Science Research Network, March 2012, ssrn.com.

Exhibit 1 Private-equity returns have historically outperformed.

Investment returns for private equity and S&P 500 (levered and unlevered),[1]
internal rate of return, %



[1] Analysis based on a cash-flow-matching approach; assumes that investment into and out of public equities matched the average of cash called and returned by private-equity companies, after initial fund-raising in vintages 1999–2009, except for vintages 2004–06, where 5.5-year returns of S&P were used.

Source: Bloomberg; Cambridge Associates; Preqin; McKinsey analysis

Since the 2000 fund vintage, however, this persistence has fallen considerably (Exhibit 2). At the same time, the focus of value creation in the industry has shifted from financial engineering toward improvements in the operating performance of portfolio companies. These shifts are forcing limited partners to develop new means of predicting tomorrow's winners. Meanwhile, returns remain widely dispersed: the best funds in any vintage generate returns of about 50 percent, while bottom funds lose up to 30 percent of their investment. With persistence waning and dispersion still significant, selection risk remains as high as it was in the 1990s, but it has become tougher to predict which firms will deliver top-performing funds.

Poised for growth, with new complications

These insights on persistence and dispersion are important nuances to the larger story: private equity is a more attractive investment class than was previously understood. A 300-basis-point

Exhibit 2 Top firms no longer outperform consistently.

Firms that produce consistent performance from fund to fund,[1]
%

[1]For some early vintages, a small sample size may increase volatility in fund performance.
Source: Preqin; McKinsey analysis

gap in returns makes a world of difference: a 9 percent annual return from private equities is a big improvement on the 6 percent or so that institutional investors tend to expect from listed equities. Confirmation of this persistent performance superiority means that return-seeking limited partners, especially those like pension funds that also crave stability, will likely increase allocations to private equities. The industry can also look forward to a new wave of commitments from high-net-worth individuals as private-equity firms roll out new retail offerings and distribution mechanisms.

As a result, we believe the industry is on the verge of a new phase of growth in capital under management—though with the history of troubled data, the potential for other possibilities must be acknowledged. But where will this additional capital be deployed? There are several possibilities. One is that fund size will rise as general partners seek larger deals. A recent McKinsey analysis found no meaningful correlation between performance and either deal size or fund size. If the boom era's megadeals prove successful and borrowing costs remain low, then more such large transactions are likely as the demand among institutional investors to deploy large amounts of capital continues to increase. Another possibility is that private-equity firms will look to more nascent markets and to adjacent asset classes. Finally, firms could expand the universe of potential targets simply by lowering their return expectations.

But before the industry can accelerate to its full potential, some questions must be answered. Limited partners are increasingly concerned about management fees; some also wonder if they can get the scale they need, or if private equity will remain a small slice of their portfolio. While fund-raising in 2013 was the highest in five years, many general partners are struggling to raise new funds on the heels of disappointing recession-era vintages, let alone to convince limited partners to commit larger sums. Both sides will need to take stock and design strategies to capitalize on the new realities in private equity.

An agenda for limited partners

The shifts in the industry are pushing limited partners to rethink their general-partner-selection capabilities. Despite the drop-off in persistence, the reward for selecting the best general partners is still great—but making that choice is now much more difficult. Track record is no longer a reliable indicator. General-partner selection is becoming more focused on understanding the capabilities that have driven past returns and assessing whether those capabilities are still present, relevant, and sufficiently differentiated to continue to drive outperformance into the future.

To make these assessments, limited partners will need to generate deeper insights into the drivers of private-equity performance, follow these insights to identify high-potential geographies and sectors, and have the conviction to use these insights to select external managers.

The challenge of acting on conviction is particularly acute in the emerging markets, where shorter track records and even spottier data create further challenges in general-partner selection.

Achieving such insight will require real investment in research and in due diligence of managers. These capabilities should be built by enhancing the talent base within institutional investors and exploiting data through advanced analytics. In addition, investors will need to improve the general knowledge and understanding of private equity among their board members, as these directors are often entrusted with asset allocation and manager selection.

Some limited partners have begun to "insource," effectively to doing private-equity investments on their own. Recent academic research has found this approach preferable for institutional investors in certain circumstances; direct private investment saves fees and can generate better results than an external manager. The research considered a small sample of seven Canadian pension funds that have enjoyed higher returns from their own deals than from their investments in private-equity funds or even from their coinvestments in the funds' deals.

While the returns may be enticing, this kind of forward integration is not for everyone. Many institutions may face daunting structural obstacles, notably in their ability to hire, govern, and retain top talent. And the effort put forth by the Canadian investors was substantial: first, they had to establish professionalism in their management and governance, including the board. To build and sustain internal teams of investment professionals with the right skills, the funds had to be able and willing to provide an attractive level of compensation that was frequently much higher than that of professionals in other asset classes. The funds had to learn to trust these professionals with investment decisions. And they needed to build strong research teams to understand the cyclical and structural trends of private markets to determine the optimal time to invest.

How general partners might respond

General partners have several options they might consider. To raise capital in a newly competitive era, private-equity firms must be able not only to point to a track record of success, as in the past, but also to say how that track record was achieved and, even more critically, how it will be maintained. As such, private-equity firms may need to develop a more detailed understanding of their past performance and be able to describe its fundamental underpinnings—in particular, the skills, brand, focus, and other capabilities that the firm brings to its deals. They may also need to explain how these capabilities are evolving to allow them to keep ahead in a competitive market. Limited partners are looking for clear, differentiated strategies, with relevant and proven capabilities; general partners will need ready answers.

As a simple example of the kind of distinctive skill and insight that limited partners may now seek, McKinsey research has shown that deal partners with strong transaction backgrounds add considerable value to transactions in roll-ups (deals made to expand market share in a given industry)—but not as much when companies develop organically. The converse is true for those with managerial or consulting backgrounds.[2]

Knowing how a differentiated value proposition and strategy for the future generates performance can help a general partner articulate one that sets it apart from both its private-equity competitors and from limited partners that aspire to invest directly. It may want to review the possibilities for increasing its specialization, by sector, geography, or deal type. It should consider cataloguing its skills, identifying both the relevant abilities it has and those it needs to deepen or build from scratch. It can then raise funds for investments that can only succeed with those skills. Imagine a firm with exceptional skills in chemical deal making and operations. It might raise a fund with a 15-year lifetime, rather than the usual 10 years, to ensure that it was active through at least two of the industry's cycles. And it might swear off any investment that is not directly tied to the subsectors in which it specializes.

As limited partners concentrate their investment with fewer firms, general partners should consider ways to integrate investors further into their business system. General partners already regularly invite their limited partners to coinvest in some deals, where a decade ago they might have formed a consortium with other buyout funds. But more is possible. For example, general partners may provide investment advice to limited partners on some portions of their portfolio that are not invested in private equity. A general partner with expertise in China, for example, may counsel a limited partner on how to invest there. And general partners might look to limited partners as an exit route for certain types of businesses that limited partners may want to own for the long term. All these closer relationships can benefit both parties.

General partners can also consider some bold changes to their incentive structures. In an era of smaller fund sizes, the 2 percent management fee was designed to "keep the lights on"—that is, to cover basic operating costs. It was a way to simplify the annual process in which the investment firm submitted its budget to investors for approval. Today, even though most firms have lowered the fee, it is often a major source of income. Some institutional investors worry that it distracts managers from their main task of generating returns. Firms have an opportunity to distinguish themselves by shifting incentives away from the management fee and toward carried interest. This is not a zero-sum move; rather, it should increase the size of the profit pool that general partners and their investors share.

Along these same lines, firms can also offer options to their investors. Some leading firms, for example, now allow investors in some funds to choose either "1 and 20" (a 1 percent management fee and 20 percent of carried interest) or "2 and 15." Firms may also consider changes in the calculation of carry. Measuring carry by its true rate of return rather than returns in excess of an absolute threshold (typically 8 percent), as is the common practice, can better align the interests of general partners and their investors.

[2] Viral V. Acharya and Conor Kehoe, "Board directors and experience: A lesson from private equity," *McKinsey on Finance*, March 2010, mckinsey.com.

It remains to be seen if the next phase of private-equity growth can match the last boom. What does seem clear, though, is that limited partners will have to work harder and smarter to find top funds, and general partners will need to become better marketers of their unique abilities. □

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