## In Defense of Private Equity

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Private equity gets a bad rap.

It's often portrayed as some relatively new form of financial engineering, constructed by Wall Street fat cats in order to fleece the common man.

The first misconception herein is that private equity is new or exotic. There is evidence that as early as 1,100 BC, sea-faring merchants in the Middle East secured funding from wealthy benefactors to conduct trade in textiles, dyes, and spices in exchange for a percentage of their profits. As a result of this successful business model and alignment of interests, Phoenicians came to dominate global commerce during this period. Further, at some point during an average day, many of us will patronize a business owned by private equity, be it a gas station in the morning on our way to work, a local sandwich shop at lunch, or perhaps downloading the newest addictive game (for our kids, of course) on our iPad.

Private equity is nothing more than directly owning a business. With roughly $3.5 trillion in assets today, the private equity fund industry has undeniably developed more recently as a means for large, institutional investors to access the return possibilities of this asset class.

The second misperception is that this industry is rife with ethically-impaired Gordon Gekko acolytes, seeking the next big deal at nearly any cost. Good private equity firms, while certainly capable of tough negotiations and making difficult decisions, actually provide a valuable service. For various reasons, including resource constraints, legal restrictions, or staffing limitations, institutional investors are often precluded from investing directly in private equity stakes in individual companies. While no industry is free from the taint of a few bad actors, in my experience, they are no more prevalent in private equity than in mutual funds, automotive repair, or healthcare.

It also is important to draw a fundamental distinction between the typical private equity firm and slash-and-burn groups that primarily engage in extracting value from businesses through fire-sale asset divestitures or dividend recapitalizations before effectively pawning off the decaying vestiges of the prior business onto an unsuspecting buyer. This story always makes good copy.

Fortunately, such entities do not last long as the market as a whole quickly learns their tricks and refuses to partake in their financial shell game. Few market participants willingly negotiate with counterparties that continually operate in bad faith; the desire to prevent future losses is a strong motivator. No,

private equity companies usually cannot long sustain such a parasitic business model. Although they may be highly profitable for a period, they will invariably be short lived.

The private equity investment firms that have built long standing and successful track records are in the business of providing capital to fundamentally strong companies, supported by talented and visionary executives, in order to facilitate either growth or a turnaround.

According to information provided by the US Small Business Administration (SBA, 2014), there were 28 million small businesses at the end of 2011 compared to 17,700 large companies (defined as those with more than 500 employees). These same small companies employ 48.5% of the private sector payroll yet account for 63% of all new jobs added between 1993 and 2013. Smaller firms are also often more productive and innovative than their larger peers as well. In fact, small IT or biotech firms generate 16 times more patents per employee than large firms do! It is these firms which are the engine of growth in the US, and many of them were made possible by professional private equity investors.

From 1999 to 2011, the SBA estimates that on average 425,000 small businesses were started annually. Comparing this to information compiled by the National Venture Capital Association (NVCA, 2014), roughly 4,000 start-ups each year received funding from venture capital or growth funds. Moreover, although the venture backed firms were only 1% of all start-ups, these companies actually accounted for nearly a quarter of the new jobs created by the small business sector. These include such well known brands as Google, Facebook, and Tesla Motors, among many others, all of which received venture or acceleration funding during this period and have grown well beyond the small business category which they originally occupied.

That's not to say all businesses founded by private equity are successful. Approximately 50% of all new companies fail within 5 years. Still, the SBA estimates that a whopping 40% of all new jobs added to the US economy come from the net of new start-ups minus closures whereas only 60% result from all other existing companies combined. While many private companies do fail, it is often the ability of private equity managers to quickly stem losses from money-losing ventures which preserves capital for other entrepreneurs to restart the growth cycle.

Sometimes, the removal of underperforming executives may be necessary, or failing businesses may need to be restructured or reorganized. Buy-out or distressed for control funds are often the vehicle that allows for a successful turnaround or restructuring to be implemented in public companies. There are numerous examples of companies that have gone on to have their greatest successes after a private equity buy-out, including Harley-Davidson, Safeway, and Viacom.

And other times private equity sponsored deals do indeed go south simply due to unforeseen circumstances, or yes, even mistakes, including the use of excessive leverage. However, there is little evidence that private equity sponsored firms fail any more frequently than other firms. (On the contrary, some research indicates the opposite). Again, profit-oriented owners have an incentive to maximize returns, or conversely minimize losses, for all shareholders, and hence private equity is often

better positioned to manage such restructurings than family owners or other conflicted parties. Successful private equity firms effectively limit those mistakes and minimize the impact of them when they do occur. More broadly, an economy that removes capital quickly from unsuccessful or unprofitable businesses that are ultimately unsalvageable and redirects that investment towards more promising ventures is in the end a healthy and vibrant one, one which creates more opportunities for all.

It is important to note that a failing company, or bankruptcy, is thus the real risk in private equity, although this is no different than public equity. While there is a possibility of failure for any single privately owned firm, this merely implies that holding one private equity position is highly risky, in much the same way that buying shares in only one publicly listed company as the entirety of a stock portfolio would be wildly imprudent. Diversification in both cases removes much of the idiosyncratic risks.

If a single private equity position is risky, a private equity fund, portfolio of roughly ten private equity stakes, is far less so. Even better, a portfolio of private equity funds diversified by vintage year, size, style, sector and geography has very little risk of significant permanent loss of capital. In fact, academic research suggests (Weidig & Mathonet, 2004; Weidig et al, 2005) that risk as defined as probability and severity of loss goes down significantly as a private equity portfolio becomes more diversified.

**Table 1 – Private Equity Risks**

| | **Individual Position** | **Individual Fund** | **Portfolio of Funds** |
|---|---:|---:|---:|
| Probability of Loss | 42% | 30% | 1% |
| Average loss | -85% | -29% | -4% |
| Probability of Total Loss | 30% | 1% | 0% |

*Source: Weidig & Mathonet (2004)*

The true risks inherent in private equity can therefore be reduced through the prudent construction of a truly diversified portfolio of private equity funds to basically equivalent to that of a portfolio of public stocks. So, if the riskiness of the investment can be mitigated and this argument rebutted, are the returns still worth the fees that the "fat cats" in our earlier narrative charge?

Again, academic research does indeed support an allocation to the asset class based upon the higher net returns it can provide. There is evidence that suggests private equity does outperform public equity over longer periods of time (Lungqvist and Richardson, 2003). More importantly, research strongly indicates that top private equity managers generate significant excess returns to the public markets, and this outperformance of top managers is repeatable and consistent across time (Kaplan & Schoar, 2005; Gompers et al, 2010).

There are many theories presented as to why such outperformance may exist, including earning a premium for illiquidity or reducing problems of agency that may exist in owner/manager structures.

However, the mere evidence of past performance or such hypothetical arguments are irrelevant if an individual allocator is not capable of selecting managers and building a prudent, diversified portfolio. It is perfectly reasonable to require evidence of such skill, and fortunately, Kentucky Retirement Systems can provide this to its constituents.

Comparing the net returns of the public equity portfolio and private equity portfolio since inception yields the results in Table 2 below. Of course, private equity has not "beaten the market" every single year, but such a short term evaluation of success is entirely inappropriate given the long term nature of both private equity and pension liabilities. Over nearly eleven-and-a-half years, the private equity portion of the pension portfolio has compounded at 11.7% per annum versus 8.2% for the public equity portfolio after accounting for all fees. This is an excess return of 3.5% per year – again, it's worth reiterating *after* all fees – over a period decade-plus period generated by private equity.

**Table 2 – KRS Public Equity vs. Private Equity Returns**

| Year | KRS Public Equity Returns (Net of Fees) | KRS Private Equity Returns (Net of Fees) | Excess Return |
|---:|---:|---:|---:|
| 2003 | 32.4% | 32.8% | 0.4% |
| 2004 | 12.7% | 30.1% | 17.4% |
| 2005 | 7.7% | 15.0% | 7.4% |
| 2006 | 19.2% | 25.2% | 6.0% |
| 2007 | 5.8% | 2.4% | -3.4% |
| 2008 | -37.4% | -13.4% | 24.0% |
| 2009 | 31.1% | -6.6% | -37.7% |
| 2010 | 14.7% | 16.8% | 2.1% |
| 2011 | -8.1% | 11.0% | 19.2% |
| 2012 | 17.1% | 13.8% | -3.3% |
| 2013 | 24.0% | 15.3% | -8.7% |
| Apr-14 | 1.4% | 7.6% | 6.2% |
| **Compound Rate of Return** | 8.2% | 11.7% | 3.5% |

*Source: Kentucky Retirement Systems*

In real dollar terms, using actual allocations each year times the excess return earned, private equity has contributed an additional $238 million in returns after all fees to the balance of the pension system *above* what would have been earned if those dollars had been invested in the KRS public equity portfolio. In fact, performance over this period has been strong enough for KRS to be noted as a Top Ten public plan investor in private equity by the Private Equity Growth Capital Council (Pension & Investments Online, 2013).

Oversight and transparency are critical components of a successful public pension system. Healthy scrutiny from regulators, legislators and the public in general on behalf of the constituents of KRS as well

as the taxpayers of the Commonwealth is also important in ensuring the system is working as intended. However, misinformed albeit well-intentioned accusations have the potential to erode goodwill, alter investment regulations (not always for the better) and change the process, undoing the positive improvements which have occurred in the past few years, all of which could ultimately reduce KRS' ability to generate the benefits it is tasked with providing.

Private equity has not been the problem. Quite the contrary, it has been one of the most successful investments KRS has ever made.

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