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Emerging Markets Queries in Finance and Business

Private Equity Market in Recovery

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Abstract

In the past three decades there has been an increasing role of Private Equity (PE) industry in the financing of enterprises especially in case of firms that have great growth potential but are in need of external financing. Via providing financing for these enterprises PE can boost economic growth. On the other hand the different subsets of PE like Venture Capital (VC) and Buyout (BO) funds appear as an important investment class and the return characteristics of these asset classes is an indicator of the performance of the whole PE industry. The authors in their earlier works focused on the history of the return characteristics of the funds in the US and in Europe found different trends and features in the two regions with regards to the different asset classes. In this paper the authors focus on the current progress of PE industry in Europe and in the US and examine the recovery of the industry from the recession of 2008. The current trends are consistent with our former findings. In average the returns of BO funds exceeded the returns of VC funds in the US as well as in Europe. Not just according to the absolute value of the returns, but also according to its risk-return tradeoff BO seemed to be a preferable investment. The gap between the performances of BO funds was not as significant as the difference of VC funds. While the recession of 2008 affected negatively the returns of PE, the 'dotcom' boom of the millennia had much higher impact on the industry, and our finding is that PE returns are on a recovery course.

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1. Introduction

There are many studies that examine the different aspects of the return characteristics of private equity. The measurement and evaluation of the performance of private equity as an asset of investment is uncertain due to the irregular disclosure of data. The quality of data raises many concerns regarding the analysis of the return

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characteristics of private equity. Although there are extensive datasets, like Preqin, Cambridge Associates and Thomson Venture Economics, the estimations vary depending on the database we use. First of all we have to overcome the methodological problems and we have to be aware of the possible biases of our estimations in the interpretations of our results.

The recent financial crisis has had a huge impact on the private equity market. Private equity is proved to be sensitive to economic cycles in the past (Becsky-Nagy and Fazekas, 2014). The downfall of returns at the dotcom bubble was followed by the recovery of the industry, but the recession at the end of the decade affected significantly the performance of funds. In our study we focus on the current trends in the performance of private equity market with regards to the different subsets of private equity, regional differences and its relative performance compared to the public market.

2. Relative performance of private equity compared to public market

There are many studies that examine the relative performance of private equity. Kaplan and Schoar (2005) examined the performance of buyout and venture capital funds in the US in the 1980-2001 period based on the data of Venture Economics and found, that the net average returns¹ of the different classes of private equity was higher than the return of the market portfolio. On the other hand, Phalippou and Gottschalg (2009) came to a different conclusion using the same datasets and found that venture capital funds underperformed the S&P500 in average, while the buyout funds slightly outperformed it. The reason of the difference is that their estimation was based on different assumptions. Kaplan and Schoar (2005) take account of net asset value² in the value of the original investment, while Phalippou and Gottschalg (2009) take them as living dead investment and they assume that their value is zero.

The studies mentioned above used the data of Venture Economics what is downwardly biased. Stucke (2011) showed that as a result of the ceasing of data update Venture Economics shows systematically lower performance especially in case of buyout funds. This realization gives a new perspective for the interpretation of the studies mentioned above and for the further research. Harris et al. (2012) shows that, the dynamics of the returns of private equity changed since 1990. In the 90's venture capital and buyout funds outperformed the market portfolio, while after the millennia venture capital returns were lower in average. In face of the result of Stucke (2011) this change in the trend of the relative performance of the private equity can be at least partially the consequence of the systematic bias of the estimation caused by the lack of data disclosure of funds after the millennia. Other datasets, like the Cambridge Associates, Preqin or Burgiss are qualitatively similar and consequently report a higher performance, than Venture Economics (Stucke, 2011). As private equity can realize profit via exiting their portfolio companies and the information of these exits are private we have to be aware the fact that in case of returns we only have estimations that may be biased. In our globalising world the role of information became more important according to the rapidly changing technical conditions, market and economic regulations (Orbán, 2013).

Figure 1. shows the Preqin Private Equity Quarterly Index from 2000 to 2013, that includes the return of buyout and venture capital funds and the S&P500 as a public market benchmark. It is a money-weighted index that uses fund-level cash flow transactions and net asset values for over 7,500 individual private equity partnerships. As our focus is mainly on the effects of the financial crisis, the 2007-2013 period is highlighted.

¹ The net return is the return that is realized by investors of the funds and does not include the fees and profit share of fund managers.

² The net asset value is the value of the unrealized investments of the fund at the end of a given time period.

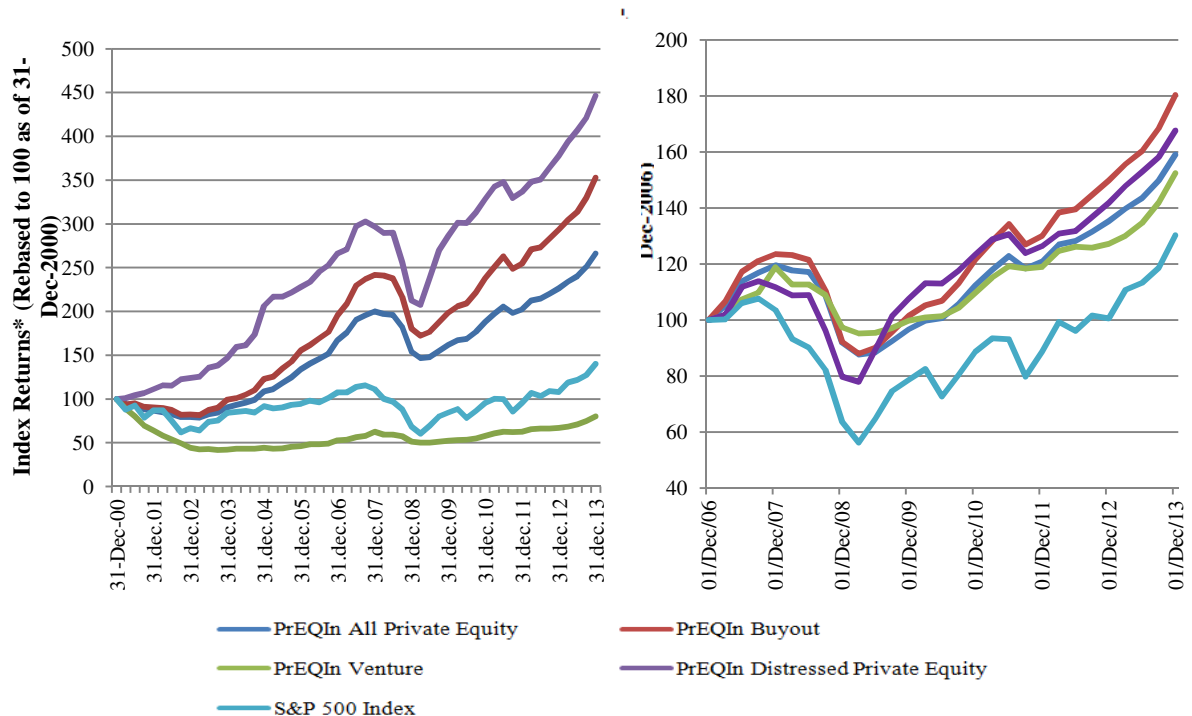


Fig. 1. Quarterly index returns of private equity, buyout, venture capital funds and S&P500 (net to LP)

Source: *Preqin (2014)* *Percentage change in quarter = $[(NAV \text{ at end of quarter} + \text{distributions during quarter}) / (NAV \text{ at start of quarter} + \text{call-ups during quarter})] - 1$

As we can see as a result of the dotcom bubble around the millennia the returns of venture capital funds decreased sharply, by the end of 2002 it was less than 50 % of its value in 2000. Also the financial crisis had negative effect on the returns of venture capital but it had far less impact on it. It is not a surprising result if we take a look at the nature of the two recessions. Technology-oriented enterprises are in the focus of venture capital investments; hence the dotcom bubble affects on the profitability of the industry were higher than in case of other type of private equity classes. On the other hand the decrease of venture capital returns during the financial crisis is not so substantial. Two defining components of risk; variability and uncertainty (Tarnóczy et al, 2011) are both high in case of venture capital investments, hence their idiosyncratic risk component is high, but as Cochrane (2005) showed, the systematic risk component does not play an important role. That is the reason why venture capital returns were less affected by the financial crisis than the returns of S&P500. Other private equity subsets on the other hand were affected much more by the financial crisis of 2007-2009 than venture capital and moved in correlation with the public market portfolio which suggests that the systematic risk component plays a crucial role in case of these types of investments. In 2008 buyout funds lost 25 % of their value.

In average buyout funds highly outperformed the public market portfolio in the previous decade but the return of distressed investing was even higher according to the Preqin dataset. Distressed private equity focus is on troubled companies and these funds can earn profit via restructuring and selling the companies they invested in (Metrick, 2007). On the other hand, despite its lesser decrease during the financial crises the venture capital return index on the long run was below S&P500 and other private equity classes. On the short run however, on

the basis of 2006 venture capital return index increased at a steady pace as well as other private equity classes and on a higher rate than the public market portfolio.

3. The performance differences within private equity

3.1. Risk and return characteristics of private equity classes

By private equity financing we mean the external equity like financing of companies by professional investors who are involved in the operation of the invested company and provide personnel assistance and value adding services for them (Becsky-Nagy, 2013). On one hand, the changes in the capital structure caused by the equity financing are favourable than loans (Herczeg, 2009), on the other hand through equity type financing the investors become interested in the increase of the firm’s value and in the maximization of the owner’s wealth (Rózsa and Tálás, 2012) so they will provide non-financial value added services to increase the value and the growth-rate of the invested companies. Despite the similarities of these type of investments their role in the life of companies in micro level and in the economy as a whole in macro level vary depending on the different stages they focus on, hence their characteristics show significant differences as well. In this section of the paper our focus is mainly on the performance of buyout and venture capital funds. Venture capital segment of private equity market focuses on the financing of young and innovative, mainly technology-oriented enterprises. On the other hand, buyout funds provide financing for more established companies.

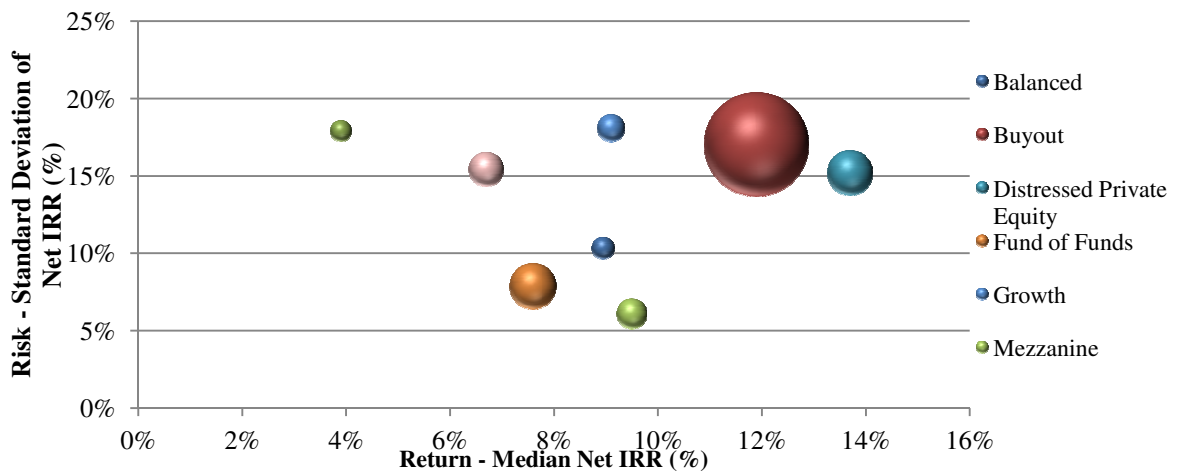


Fig. 2. Risk and return by strategy (vintage 2001-2011)
Source: Preqin (2014)

Figure 2 shows the risk and return of different subsets of private equity with regards to the focus of their investments in the 2001-2011 time periods illustrating the relative size of subsets as well. As we can see the standard deviation of buyout and venture capital funds were of the order of 15-20%. On the other hand the average value of return is very different. The earlier the focus of the private equity fund is the lower the median returns are. While the risk is slightly higher in case of venture capital investments the median returns of buyout funds are much higher. Figure 1 shows the median returns, but the mean of the returns is higher in case of private equity because the distribution of the returns of these investments is right-skewed (Cochrane, 2005).

Table 1: Net pooled IRRs since inception of private equity classes in Europe in up to 2013.12.31. (%)

Stage-focus of fund	Net pooled IRR	Top-quarter pooled IRR	Upper-quartile IRR	Top-half pooled IRR	Median IRR
Seed/early	-0,13%	12,36%	2,31%	7,06%	-2,17%
Later	2,37%	17,77%	6,95%	12,79%	-0,36%
Balanced	4,61%	17,89%	5,21%	10,48%	-0,12%
All VC	1,68%	18,51%	3,72%	11,28%	-1,30%
Buyout	11,41%	20,49%	15,70%	15,13%	6,88%
Mezzanine	6,44%	17,83%	13,14%	12,20%	3,53%
Generalist	9,29%	37,38%	4,40%	10,78%	0,18%
All PE	9,24%	20,82%	8,62%	13,42%	0,55%

Source: EVCA (2014)

Table 1 that shows the net pooled IRRs of private equity classes in Europe in 2013 confirms that in average venture capital underperforms buyout funds. While the investors of venture capital funds could realize only 1.68 % return, buyout investors could reach 11.41 % internal rate of return in Europe. This difference on the other hand is not so significant in case of the top performing funds. While the upper quartile value of venture capital funds is still much lower, the net pooled IRR in the top-quarter is slightly different. The difference is only 2 % between the two asset classes. This suggests that while most venture capital funds performs relatively poorly, the best performing funds can reach very high returns.

3.2. Regional differences of private equity classes

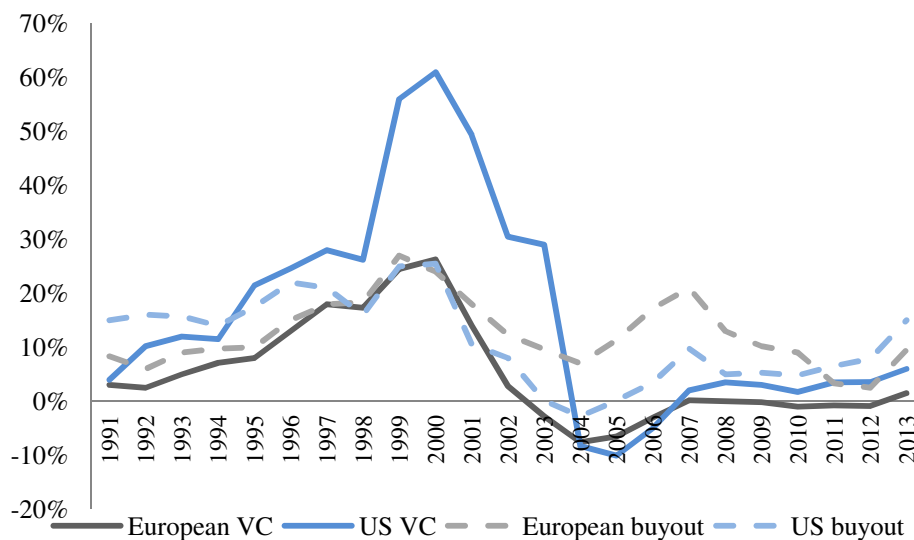


Fig. 3. The 5-year rolling horizon IRRs of BO and VC funds in Europe and in the US from 1992 to 2013
Source: EVCA (2014)

It is well documented; that the private equity market of the US is more developed than the European (Kelly 2011, Becsky-Nagy and Fazekas 2014) hence the performance differences that can be seen in figure 3 are not surprising. On the other hand there is a correlation in the movement of private equity subsets in the different regions. The dotcom bubble's boom and bust affected the venture capital investments more in Europe as well as in the US, although the decline in the US was much sharper. Also the financial crisis in 2007-2009 caused a

similar decline for both the US and European buyout funds, while the venture capital returns were stagnant.

US market started its recovery quicker than the European, though in 2013 European returns increased in a relatively high rate. While in the previous decade European buyout funds outperformed the US funds in average, after the recession US funds performance was higher. Also, venture capital funds performed better since the recession started

3.3. Changing attitude towards private equity

As we showed in the previous sections, despite the negative effect of the current recession private equity returns are on a recovery course. At the same time the changing attitude towards private equity can hold back the further recovery. The current trend in the regulation of the investment activity of institutional investors as well as the regulation aiming the operation of private equity funds is very likely to cause the decrease of the amount of capital allocated into the private equity industry (Karsai, 2013).

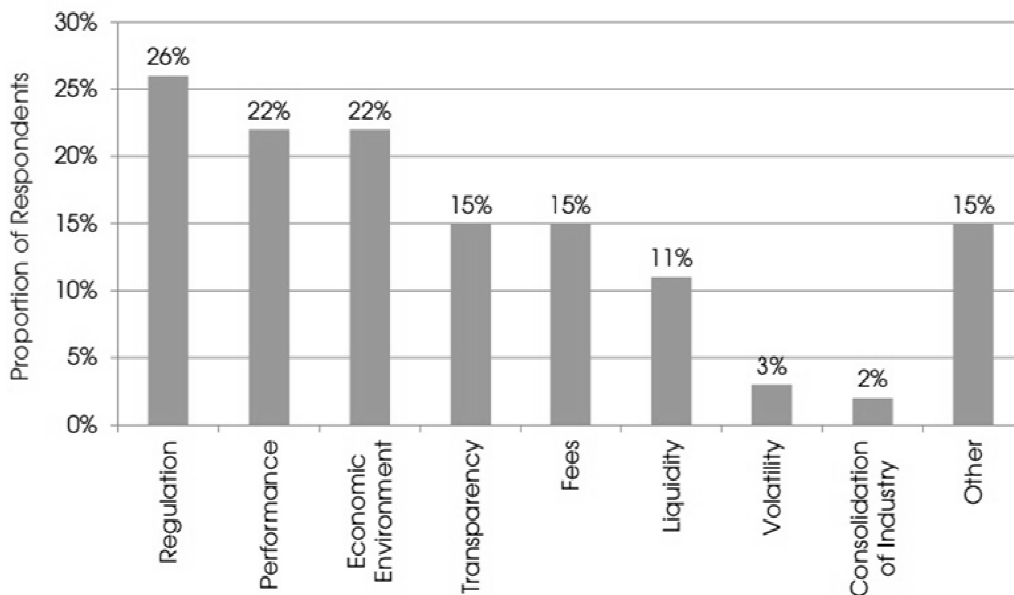


Fig. 4. Biggest challenges facing investors seeking to operate an effective private equity program according to the investors in 2014
Source: Preqin (2014)

Figure 4 shows the opinion of investors on the possible challenges the private equity industry faces. As we can see volatility is not a factor that plays an important role according to the investors. Transparency, fees and liquidity on the other hand are special in case of private equity and investors take emphasis on them. While the performance and economic environment are general factors their importance is obvious, the first role of challenges caused by the regulation reflects that the current changes in the regulation can decrease the effectiveness of the industry according to the limited partners. Cumming (2013) show, that extreme regulation reduces capital as well as returns and firm performance.

Also the mention must be made that the economic policy's attitude towards the different subsets of private equity is not the same. While regulation of buyout funds became more rigor the venture capital investment is considered as an investment class with positive externalities and it is promoted by most countries.

4. Conclusion

In our study we examined the performance and return characteristics of private equity with special emphasis on the effects of the current financial and economic crisis. We found that contrary to the end of dotcom bubble that decreased sharply the returns of the venture capital industry the buyout industry was more affected by the financial crisis as a result of different risk characteristics. While buyout funds are more exposed to systematic risk, in case of venture capital investments the idiosyncratic risk plays a more important role. This statement stands in case of the European market as well as in the US. Although the financial crisis was a break in the returns especially in case of buyout funds private equity started its recovery soon after the start of the current recession and now it can show up high returns. In the same time the changes in the regulation aiming the private equity industry may have negative effects in the future.

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