WILSONS

# The Case for Private Equity

Our weekly view on asset allocation.

23 August 2021

# Private Equity: What's the deal?

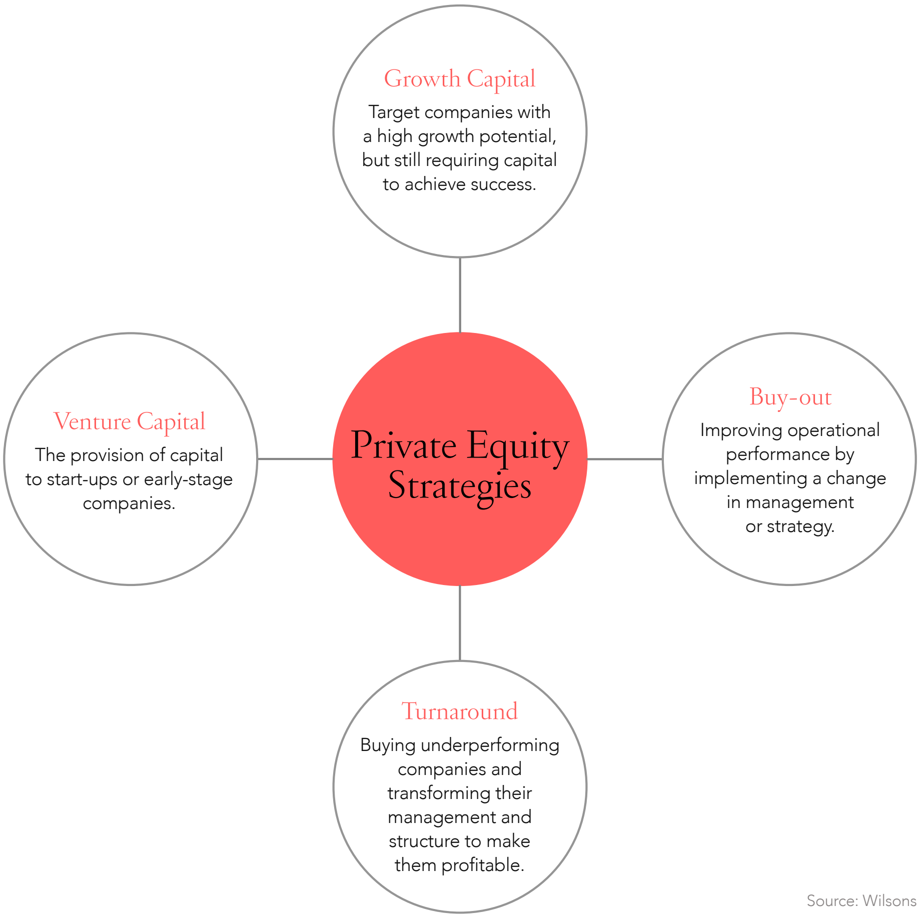
A private equity (PE) fund invests in a variety of unlisted companies with the aim of maximising their return on investment.

Private equity fund managers typically take a majority stake in their investments, which they generally hold for 3-7 years. A long-term, active approach is generally utilised in order to increase the value of the investment.

Private equity funds will then find the right opportunity to exit their investment through resale to another firm (via a secondary PE sale or trade sale) or via an IPO.

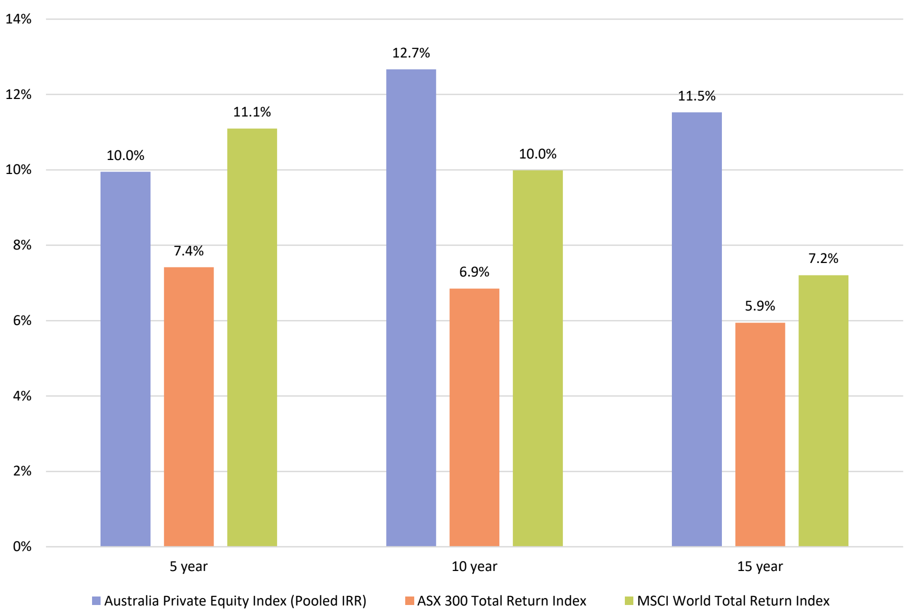
To create value, private equity managers use a number of different strategies:

**Exhibit 1: Private equity strategies**




Source: Wilsons

**Exhibit 2: Over the past decade, Australian private equity has outperformed listed equities**




Source: Cambridge Associates, Refinitiv, Wilsons (Returns as of 30 September 2020)

## Why Invest in Private Equity?

### Superior returns

Private equity funds (both domestic and global) have historically yielded better long-term returns than public equities (on average). As a result, many of the world's most sophisticated institutional and high net worth investors have included private equity in their asset allocation mix in recent decades.

# What Makes Private Equity so Succesful?

### Active management

Taking advantage of the expertise provided by private equity firms can create substantial value for private companies that may lack the depth of resources to reach their full potential. Efficiencies can be improved and growth accelerated by attracting talent, expanding customer bases, acquiring companies, optimising debt levels and reducing costs.

The fact that private equity can provide access to industry experts can be valuable to these businesses. These experts can provide expertise that is harder to access otherwise.

### A larger pool of opportunities

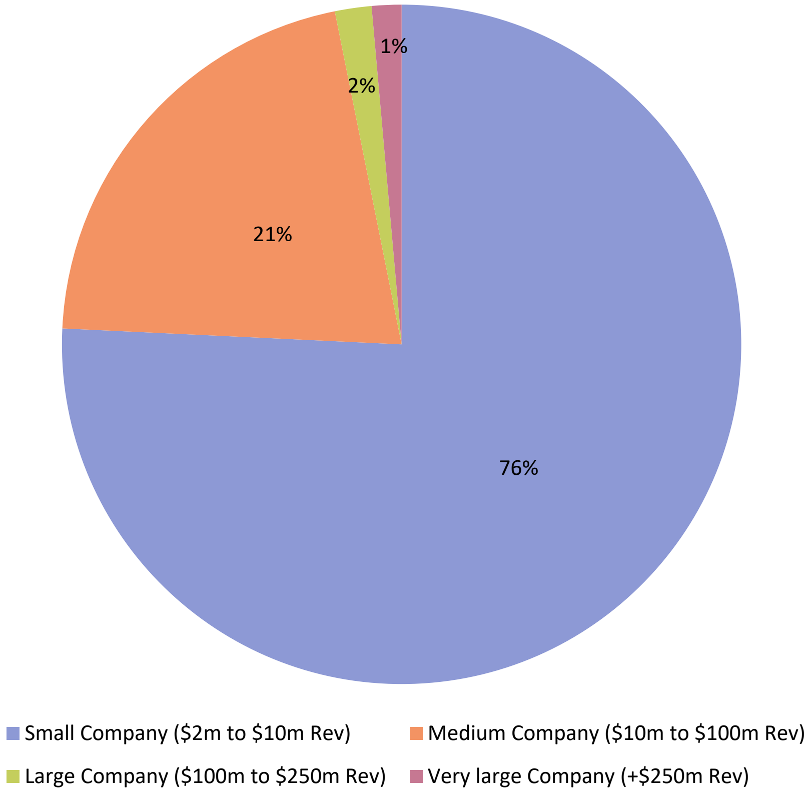
There is a larger investable universe in private companies than listed companies. There are more than 1 million companies with annual revenues greater than $2m or 23,000 companies with annual revenues greater than $10m, according to ATO data. In comparison, only ~2000 companies are listed on the ASX. A large cap public equity manager is typically unable to invest in more than 200 stocks due to their mandate or liquidity constraints, so their pool of investable assets is much smaller.

In a less competitive market, where there are fewer buyers competing for a larger number of companies, private equity acquisitions can generally be made at a discount to listed market valuations.

### Private equity entry multiples are cheaper

Private businesses generally have lower entry multiples than public ones.

**Exhibit 3: There are many more small companies than large companies in Australia**




Source: ATO, Wilsons

This phenomenon is due to more open information markets about public companies, a smaller pool of listed equities, as well as lower prices buyers are willing to pay for (illiquid) private assets.

As a result, multiples paid for small to medium private businesses are on average lower than those paid for larger businesses owing to the perceived risk of smaller enterprises. Small to midsized private companies in Australia tend to have multiples between 6-8x EBITDA, whereas larger enterprises tend to have multiples between 10-12x – this trend is also observable in Europe and the United States.

### Balancing governance and growth

It is common for boards of listed companies to spend quite a bit of time discussing matters concerning controls and reporting as opposed to business expansion. Private equity managers can generally strike a better balance between governance and growth to increase the value of their portfolio companies.

Company management also has the scope to focus on longer-term value creation when freed from the distraction of quarterly or half yearly profit reporting which receives considerable focus in the public equity market.

**Exhibit 4: It is usually cheaper to buy smaller companies than larger ones**

| Revenue Range | 2020 | 2018 | 2017 | 2016 | 2014 | 2012 | 2011 | Average |
|---|---|---|---|---|---|---|---|---|
| **Australia EV/EBITDA transaction multiples** | | | | | | | | |
| Less than $20m | 6.3 | 5.1 | 7.2 | 5.5 | 5.5 | 4.9 | 6.1 | 5.8 |
| $20m to $50m | 6.2 | 6.6 | 5.9 | 8.8 | 6.7 | 6.1 | 6.5 | 6.7 |
| $50m to $100m | 11.5 | 8.2 | 8.9 | 6.1 | 8 | 7 | 7.9 | 8.2 |
| $100m to $200m | 8.9 | 12.6 | 7.6 | 10.8 | 7.8 | 8.7 | 7.5 | 9.1 |
| $200m to $500m | 8.2 | 13.2 | 10.2 | 8.5 | 8.8 | 7 | 8.7 | 9.2 |
| Over $500m | 10.8 | 11.4 | 11.9 | 10.9 | 7.1 | 8.9 | 9.8 | 10.1 |

Source: Grant Thornton, Wilsons

### Higher returns, but also lower volatility

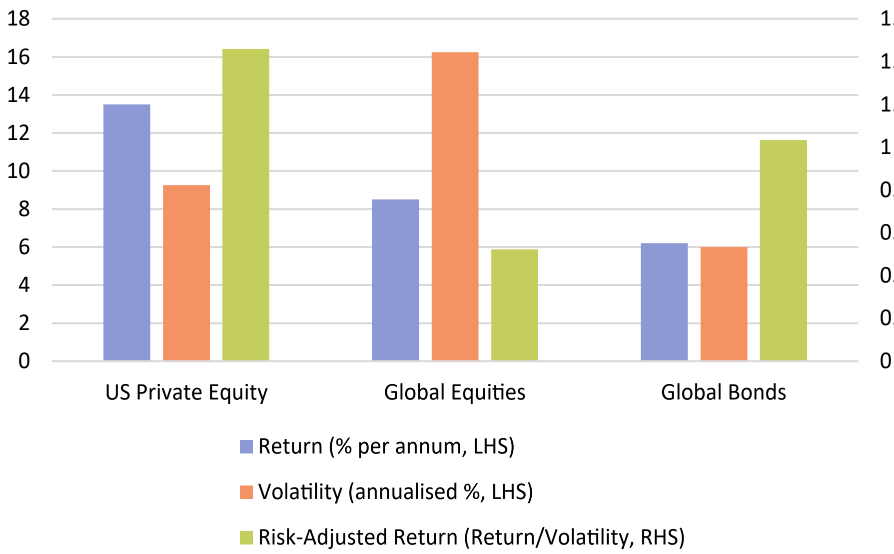
The addition of private equity to a portfolio has the potential to increase returns while reducing volatility. Private equity fund valuations tend to reflect companies' actual earnings performance and thus are less susceptible to short-term investor sentiment swings, which may impact public market share prices.

Private equity assets are usually valued only every quarter as opposed to listed equities, which are quoted on a daily basis. Valuations are generally derived from assessments of long-term value rather than volatile traded market values that are a fact of life in public equity markets.

As a result, private equity fund performance is generally less volatile than listed equity funds.

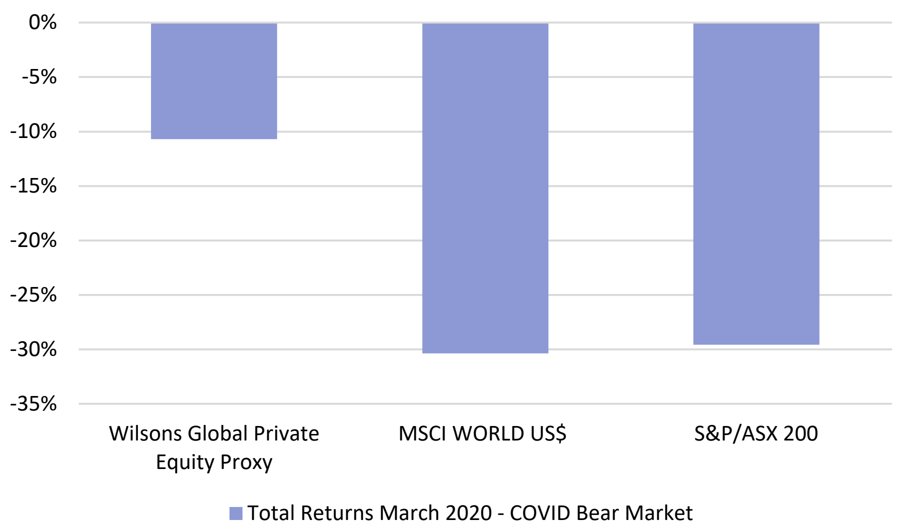
Private equity fund managers have shown a tendency to outperform listed equities during bear markets, when investors' sentiment is low. Market/economic downturns also provide private equity managers with opportunities to acquire assets cheaply. Private equity funds have shown a tendency to perform in the immediate years coming out of downturns.

**Exhibit 5: PE has historically provided higher risk-adjusted returns than listed equities or bonds**




Source: BCA Research, Wilsons

**Exhibit 6: Private equity outperformed listed equities in the face of COVID uncertainty**




Source: Partners Group, Refinitiv, Wilsons

## Challenges Facing Private Equity Investors

Private equity funds do have some risks or challenges:

- **Illiquidity** -PE investments usually require lengthy minimum commitments (3-7 years).
- **Transparency** - Investors receive infrequent valuations and there can be a lack of clarity on the future strategy of a fund (acquisition targets etc).
- **Deal-making** - Transaction pricing in private markets depends significantly on negotiation. Hence, managers must be skilled in deal-making to succeed.
- **Time and expertise** - As active managers, a larger investment of expertise and time is required by private equity managers to deliver returns. Increasing the importance of a highly skilled and well-resourced manager.

However, as discussed above, investors are normally well compensated for taking on these risks with the returns private equity fund managers generate, particularly the best in class managers.

## Why Invest in Private Equity Today?

In our view, exposure to private equity continues to appeal due to low funding rates and improving economic conditions, alongside a continued wide dispersion of listed market valuations, which provides scope for astute buying and selling of assets.

While private equity has seen strong investment flows over the past few years, and this has gradually increased the price paid for the average private company, valuations in private markets remain materially lower than those in public markets.

Following COVID-19, valuations in some sectors are currently lower than in recent years, making the longer-term opportunistic nature of private equity an attractive proposition at present. During times of uncertainty, private equity managers can negotiate favourable terms for acquisitions. We have seen this in the Australian listed market, with proposals for Sydney Airport, Tabcorp and Crown, all from private equity funds.

We believe an allocation to private equity makes sound strategic sense within the broader alternative investments portion of diversified portfolios.

## How to Position Private Equity in a Portfolio

In our view, the case for private equity investment rests on three key pillars: a strong performance track record for the asset class, a deep and differentiated opportunity set, and significant diversification benefits.

Private equity forms a key part of our alternatives asset allocation, providing investors with an actively and expertly managed diverse exposure to private businesses that would otherwise be inaccessible to non-institutional investors.

When used in a portfolio with other assets, private equity can reduce overall portfolio volatility because it offers a unique investment universe, unique (longer-term focused) valuation methodologies, and a low correlation to more volatile listed markets

As an alternative manager, we classify private equity funds as Satellite holdings given the less liquid nature of the investment. In a balanced portfolio, the expected weighting in this investment would be 20-35% of the alternatives asset allocation.

# Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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