Private Equity: Too Much Money?

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New investment in private equity is projected to reach $250 billion worldwide in 2006, nearing its prior peak of $262 billion set in 2000. Much of this growth comes from the U.S. buyout sector where investors have been increasing their allocations in recent years in response to strong past performance.[1] Recently, investors have raised concerns that perhaps there is too much money chasing buyout opportunities. In particular, investors point to a significant and growing portion of buyout commitments going to a few "mega" buyout funds.[2] Even so, many experienced investors argue that first quartile fund managers will continue to do well despite frothy market conditions. Other investors are more cautious, concluding that capital abundance might undermine performance for even the best private equity managers. The purpose of this report is to look to history to understand whether fundraising levels have impacted subsequent (vintage year) performance and, if so, whether top tier managers can be counted upon to mitigate otherwise lower returns.

U.S. Buyout Fundraising

Exhibit 1: U.S. Buyout Fundraising by Year

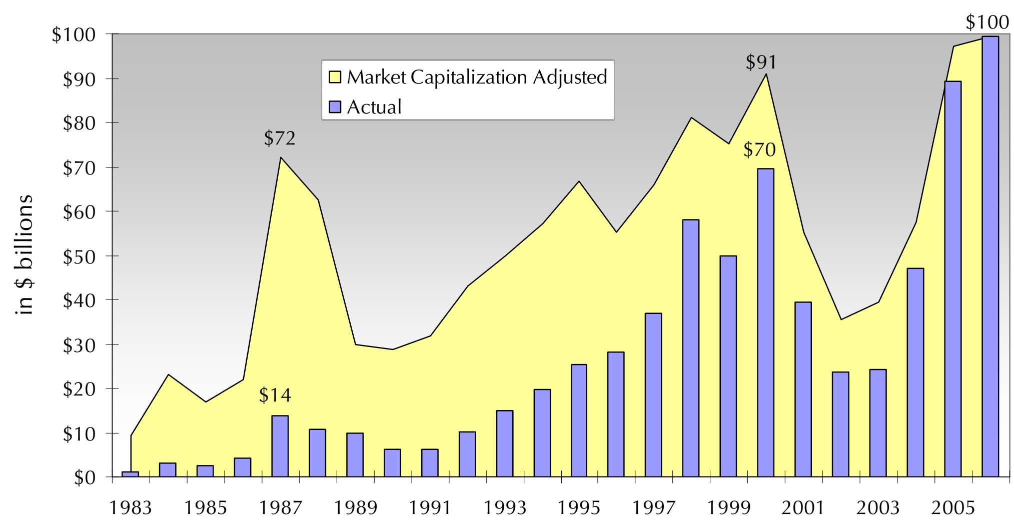


Exhibit 1 records annual fundraising by U.S. buyout firms from 1983 through 2006.[3] We focus on U.S. buyouts because it is the sector that has attracted the most recent attention. The bars represent actual dollars raised by U.S. buyout firms. The shaded region shows annual fundraising adjusted for changes in the capitalization of the U.S. equity market. For example, a total of $14 billion was raised by U.S. buyout funds in 1987, a record at the time. But, companies which could have been purchased in 1987 with the $14 billion raised by buyout funds would require $72 billion if purchased in 2006.[4]

Fundraising peaks in 1987, 2000 and 2006 are apparent from the adjusted fundraising numbers (shaded region) rather than actual fundraising dollars (bars) which partially obscure fundraising cycles. The $100 billion expected to be raised in 2006 by U.S. buyout funds is just 10% higher than the $91 billion adjusted level of 2000 and 39% higher than the 1987 adjusted level of $72 billion. While 2006 represents a fundraising peak by either measure, an optimistic view is that the $100 billion will be deployed by a buyout industry that is broader and deeper than ever before. A pessimistic view is that 2006 is a peak year which will cause returns to suffer.

U.S. Buyout Returns

What happened to the performance of buyout funds raised at or near the earlier fundraising peaks of 1987 and 2000? Exhibit 2 provides some perspective.

Exhibit 2: U.S. Buyout Vintage Year Returns through June 2006

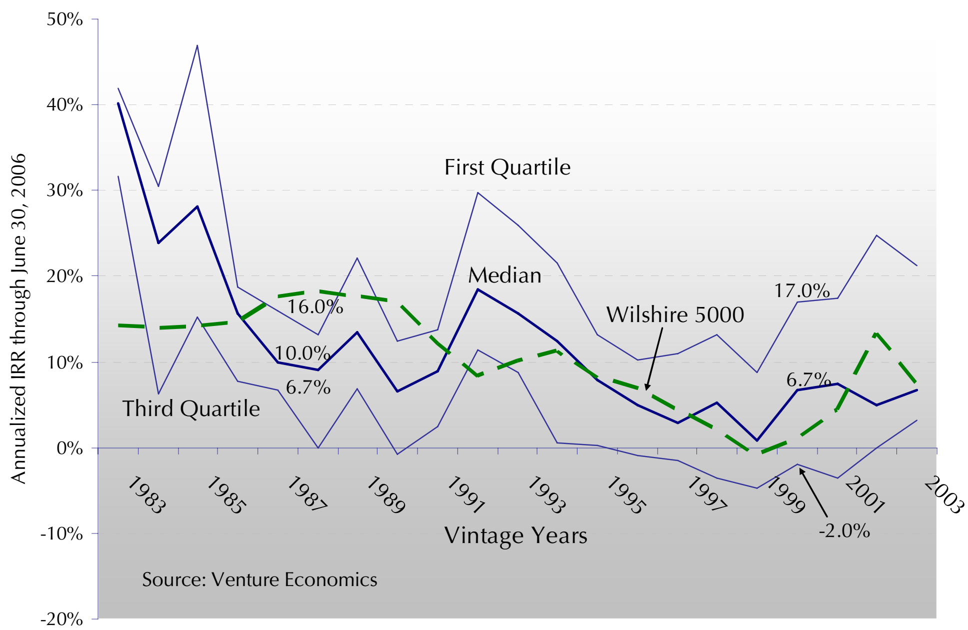


Exhibit 2 plots U.S. buyout first quartile, median and third quartile returns through June 30, 2006, the most recent date for which buyout returns are available. For each year shown on the horizontal axis there is a unique set of buyout funds that were formed in that "vintage year" and each year's quartile returns are plotted on the vertical axis. The quartile returns represent cumulative annualized net of fee returns from that date through June 2006. For example, vintage year 1987 buyout funds earned a 16.0% first quartile return, a 10.0% median return, and a 6.7% third quartile return for the cumulative period 1987 through June 2006, though almost all of these 1987 funds are now liquidated.[5] We do not report returns for vintage years after 2003, following industry practice that returns for buyout funds less than three years old are not meaningful.

We also show in Exhibit 2 the performance for the Wilshire 5000 Index, a common long term private equity performance benchmark, as the dashed green line.[6] The Wilshire 5000 return for each date is the annualized return through June 30, 2006, unless the time period is longer than 10 years in which case the Wilshire 5000 Index return is calculated for the subsequent 10 years. We select a maximum 10 year benchmark period for the Wilshire 5000 Index because roughly 90% of all buyout distributions occur within a 10 year time frame. As expected, the Wilshire 5000 Index returns are somewhat more stable than private equity vintage year returns because the Wilshire 5000 Index represents a broadly diversified portfolio while the buyout percentiles represent individual fund returns.

The following observations might be drawn from Exhibit 2:

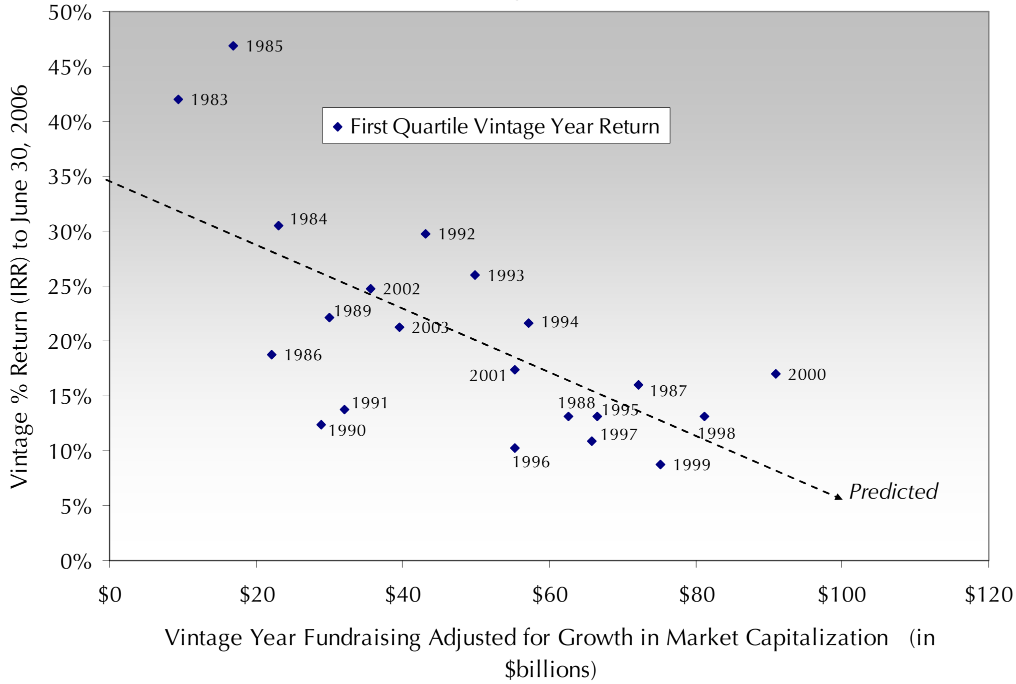
1. A common perception is that the average buyout fund performs no better than public equities and therefore investors need to select first quartile managers to meet their objective of outperforming public equities. Exhibit 2 generally supports that view. Differences between median buyout returns and Wilshire 5000 index returns average only 0.4% over the last 20 vintage years and 0.2% over the last 10 vintage years.[7]
2. The opportunity for large excess returns above public equities has been significant. The average spread between first quartile and median buyout returns is 8.9% during the last 20 vintage years and 9.8% during the last 10 vintage years.
3. There appears to be only one subperiod that was unfavorable to buyout returns, vintage years 1987-1991, where first quartile buyout returns were similar to Wilshire 5000 Index returns. Vintage 1987 saw a dramatic jump in fundraising to a record level that stayed high through vintage 1988. Since buyout firms generally take a few years to invest commitments, record 1987-1988 fundraising may have affected pricing in subsequent years, explaining depressed 1989-1991 vintage year results.
4. There are three subperiods that are unusually favorable to buyout returns: vintages 1983-1985, 1992-1993, and 2000-2001. Fundraising was low to average during all those years except 2000 when fundraising reached a record high level. A 40% decline in public stock prices starting early in 2000 probably gave buyout firms a unique opportunity to invest the funds raised.
5. There appears to be a somewhat downward trend in all returns, similar to what is found in the public markets. However, unique to private equity, we might expect more recent vintage year funds to have lower returns due to the “J-curve” effect.[8]

Fundraising and Vintage Year Returns

Exhibit 3 plots adjusted vintage fundraising levels (from Exhibit 1) on the horizontal axis and first quartile vintage year returns (from Exhibit 2) on the vertical axis. First quartile vintage returns are used rather than median returns on the expectation that first quartile funds will be selected, because achieving less would probably lead to not investing in private equity. Vintages 2004 and 2005 are omitted as before.

First quartile buyout returns appear to have an inverse relationship with fundraising levels in Exhibit 3. Returns do not fall much below 10% in any vintage year.

Exhibit 3: US Buyout Capital Raised and Subsequent First Quartile Performance through June 30, 2006



We test for the statistical relationship between fundraising levels and vintage returns through a simple regression model.[9]

Our regression equation is:

$$V_{return} = a + b_{\$}(V_{\$}) + e$$

Where:

V_{return} is the vintage year return through June 30, 2006

$V_{\$}$ is the total dollar value of funds raised in the vintage year

We perform a regression on the 21 vintage year data points with the following results:

a = 34.7%

$b_{\$}$ = -0.30% (t-stat = -3.85)

The regression R squared equals 0.44.

The dashed line in Exhibit 3 plots the regression equation. The regression line depicts a statistically significant (t-stat equal to -3.15) negative relationship between fundraising and vintage return. The beta coefficient, equal to -0.30%, implies that for every additional $10 billion of funds raised in a vintage year, first quartile buyout vintage year returns will decline by 3%. A fundraising year that approaches $100 billion, as we expect 2006 to achieve, would by our regression results imply a 10-year annualized return of 4.7% (equal to 34.7% minus $100 billion times 0.3%). If accurate, it would result in the lowest vintage buyout returns on record.

Of course, other factors may cause returns to differ from the model's prediction. For example, vintage year 2000 returns have been well above returns that would have been expected given the level of fundraising (See Exhibit 3). We have already suggested that the bear stock market created above average opportunities for buyout funds raised in the 2000 vintage year.

Factors may cause 2006 vintage year returns to exceed expectations. For example, buyout firms are acquiring ever larger companies which necessitate greater equity capital. Assuming that buyout firms can identify pricing and/or operating inefficiencies comparable to those found in more traditional small and middle market companies, the 2006 vintage year returns may not be impaired by higher fundraising levels. Secondly, many buyout firms are expanding staffs and resources, and looking at deals globally. If this trend is successful, greater levels of equity capital can be successfully deployed across an expanded group of buyout opportunities rather than more capital chasing an unchanged opportunity set. Nonetheless, without such mitigating circumstances, our model predicts lower returns ahead for current U.S. buyout investments.

Conclusion

Vintage year diversification is a mainstay among private equity investors. Our finding that high fundraising years are generally associated with weaker vintage year returns should not cause investors to second guess that best practice. Given the current "sellers' market" environment, it would be very difficult and costly to turn the private equity investment switch on and off. However, the data does suggest caution in the current environment. For example, investors should not be tempted to over allocate in a vintage year like 2006 in an effort to "catch up" to peers. Investors should also be careful about funding less experienced efforts. Investing with experienced teams with proven track records across market cycles is good advice in today's fundraising climate.

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[1] A Cliffwater survey of large institutional investors shows that their private equity portfolios have outperformed publicly traded stock portfolios by over five percentage points per year over the past 10 years.

[2] The definition of "mega" changes, but most likely will include funds raising over $10 billion.

[3] Source: *Venture Economics*. 2006 fundraising values are estimates.

[4] We adjust annual fundraising values for the growth in the market capitalization of the largest company in the Russell 2000 Index, which is also the 1000th largest U.S. public company. This benchmark was selected because we believe it is a good representation of the size company targeted by buyout firms for investment. We adjust historical fundraising levels for the growth in capitalization by multiplying each year's actual fundraising level by the ratio of 1000th company market capitalization at 2006 ($1.96 billion), the base year, divided by capitalization for the

1000th company at the earlier year. For example, the adjusted fundraising amount for 1987 is $72 billion, equal to the actual $14 billion in fundraising for that year, multiplied by the ratio of market capitalization for the 1000th ranked company in 2006 ($1.96 billion), divided by market capitalization for the 1000th ranked company in 1987 ($256 million).

[5] Buyout fund returns use the internal rate-of-return ("IRR") calculation method, which is the discount rate that equates investor cash outflows (drawdowns) to a buyout fund with subsequent cash inflows (distributions) to the investor. Since most buyout funds have a partnership term of 10 to 15 years, IRR calculations for buyout funds in older vintages are unlikely to change with time.

[6] Institutional investors often set as their long term objective for private equity a return equal to the return on public equities (i.e. the Wilshire 5000 index return) plus a premium of 3% to 5% per year.

[7] The average difference between the median buyout return and the Wilshire 5000 index return is 1.65% if all 21 vintage years, including 1983, are included.

[8] The J-curve effect should be less so for buyouts compared to venture capital.

[9] Other variables such as the age of the vintage year to capture possible J-curve effects and the level of interest rates to capture the availability of cheap financing were tested as independent variables but were found have little or no explanatory value.