

Unhappy returns to investors in private equity

By

David Hall

Principal Lecturer and Director of PSIRU, Business School, University of Greenwich,
d.j.hall@gre.ac.uk

June 2007

This paper was commissioned by Unite – the Union.
Contact: Jane Barker jbarker@tgwu.org.uk

1. RETURNS TO INVESTORS IN PE FUNDS	2
1.1. PERFORMING BELOW THE STOCK MARKET	2
Table 1. Poor returns for investors in PE funds compared with stock market	2
1.2. INVESTORS UNCLEAR ON RETURNS	3
1.2.1. <i>Manipulated accounts</i>	4
1.2.2. <i>IRRs</i>	4
1.2.3. <i>Borrowing from banks to pay dividends</i>	4
2. INFORMATION.....	5
2.1. BVCA ON INFORMATION TO INVESTORS ON PORTFOLIO COMPANIES	5
2.2. CREATING INFORMATION MONOPOLY	6
3. CONCLUSIONS	6
4. BIBLIOGRAPHY	7
5. NOTES.....	8

1. Returns to investors in PE funds

The general impression given by coverage of the private equity industry is that it obtains much better returns for investors than could be obtained by more conventional investments in shares traded on the stock market, and that this explains the great increase in the amounts of money being invested in PE funds.

However, the empirical evidence from a number of studies suggests that investors in PE funds do worse than if they invested the stock market.¹ The increase in investment is then a paradox, which is explained by poor information and understanding on the part of investors.

1.1. Performing below the stock market

Research by American academics showed that, once the partners' fees were excluded, the returns actually achieved by PE funds was about the same as the average return on investment in shares on the USA stock exchange: "Over the sample period, average fund returns net of fees approximately equal the S&P 500". This research covered both venture capital and buyout funds: for buyouts alone, it found that the returns net of fees were **lower** than those of the stock exchange. They also found that there was a wide range of different performance across funds, with some achieving much better returns than others. An experienced investor offered a similar summary: 'The large majority of buy-out funds fail to add sufficient value to overcome a grossly unreasonable fee structure.' (Kaplan and Schoar 2005; Swenson 2005).

A series of empirical studies by Dutch and French academics has reached similar conclusions. Actual returns to PE funds have been similar to the yields from the stock market investments, and changes in returns on PE investments closely reflect general trends in stock market prices and GDP. Once adjustments are made for bias in samples, bias in valuing and risk of investments, and after deducting the fees of the PE group partners, the returns to investors in PE funds is actually 2.6% per year *below* the returns delivered by investing in shares trading on the stock exchange. The authors conclude that:

"...Performance estimates found in previous research and used as industry benchmarks are overstated....We conclude that the stunning growth in the amount allocated to this asset class cannot be attributed to genuinely high past net performance." (Phalippou and Gottschalg 2007).

The real performance of funds looks even worse than simply mirroring the stock exchange, because adjustments have to be made, especially for two factors. Firstly, the value of funds have to be reduced in respect of investments in companies which have not yet been exited. It should not be assumed that these will yield the same returns as those actually exited, as many of them may not have any prospect of ever delivering a return. The value of such funds is normally assumed to be substantial whereas the researchers found "evidence that they mostly represent living dead investments". Secondly, PE investments are significantly more risky than investments on the stock exchange, and adjusting for the extra risk involved further big reduction in the performance of the firms. After adjusting for these factors, the research concludes that investing in PE creates a massive loss compared with other forms of investment: "According to this result, investors [in PE funds] have lost about 25% of the capital invested".

Table 1. Poor returns for investors in PE funds compared with stock market

			Profitability index
Stock exchange			100

¹ "While the exact degree of underperformance can be debated, the basic lesson seems clear: the average return from private equity is quite unspectacular." (Lerner: The enigma of private equity. Financial Times 24/04/07)

PE funds	Before adjustments		101
	After adjustments for bias and risk	Buyouts	75
		Venture capital	77

Source: calculated from text of Phalippou and Gottschalg 2007

Both the USA and the more recent European studies found that the performance of funds was closely linked to past performance of funds. Empirical evidence from these and other studies also shows a wide range of performances between different funds: the OECD report refers to a recent study which showed the average (mean) return was 22.2%, but the median was negative (-5.3%). In effect, this is an indicator of the risk – most PE funds deliver losses, but the successful minority are making big profits. (Wright et al 2007A).

1.2. Investors unclear on returns

The rush of investors into PE funds is thus a paradox: the partners in the PE groups are taking handsome returns, but, overall, the pension funds and others investing in them are receiving worse returns than they would by simply investing in the stock market.

This may be partly explained by information asymmetries – investors find it difficult to understand what is really happening to the PE funds in which they invest, but do not want to miss out on an investment opportunity which is so widely publicised as successful. Investors are impressed by a few selected successful investments, or by misleading indicators of returns, or because returns are reported before the PE firms deduct their fees, or because of simple ‘headline’ publicity: “The increased investment is partly due to well-publicized returns of some private equity funds, especially at the end of the 1990s.”

It may seem surprising that institutional investors with vast resources could be so easily misled, but a number of research studies suggest that many have failed to understand the true value of investments in PE funds.

Researchers Phalippou and Gottschalg give two striking examples of this. Firstly, they observed that some investors did not seem to understand the difference between the gross returns of the PE funds – before the partners extracted their fees – and the net returns actually received by investors, after these fees had been deducted: “It is surprising that sophisticated investors would not realize the full impact of fees, but our conversations with LPs indicate that it may be true for at least some of them”.

Secondly, they noted that investors often claimed to like PE funds because they had “doubled” their money – when in fact they had not. The actual performance of PE funds over the relevant period was to deliver 1.77 times the amount invested – worse than the 2.1 multiple which the stock market would have delivered over the same period (Phalippou and Gottschalg 2007).

Another study found that big university endowments and public pension funds got much better results from their investments in private equity than those whose investments were selected by investment advisors and banks, and suggested that some institutions were better at understanding private equity (Lerner et al 2005).

But other researchers found that even large institutions seem confused about the actual performance of PE. They tried to collect data about the performance of PE funds from major USA institutions which had invested in them – including CALPERS, University of Michigan, and University of Texas. But there was an unexpected problem: different investors reported different performance figures by the same PE fund. There was no way of telling which institution was reporting the correct figure for each fund, so their data had to be set aside as useless. (Kaplan and Schoar 2005).

1.2.1. Manipulated accounts

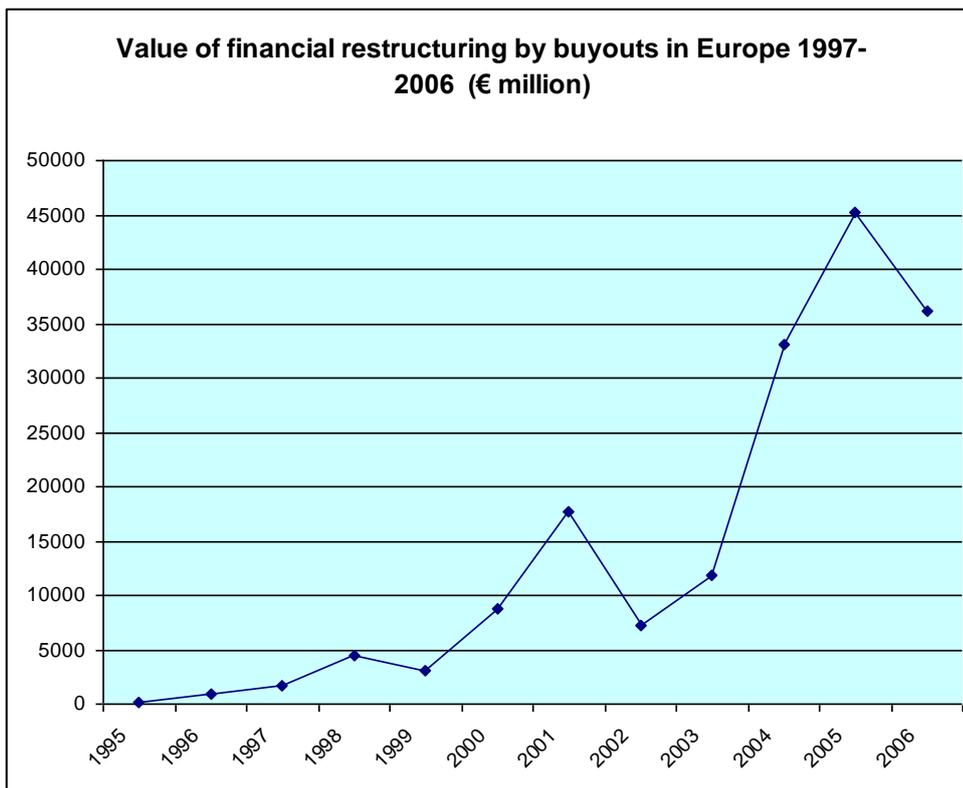
Company accounts may be manipulated by PE funds in order to give a misleadingly good picture. The OECD report notes that “Earnings manipulation... appears to have been evident in a number of transactions (*e.g.* United Airlines)”, and a recent academic overview stated more bluntly that: “Financial performance of buyouts is difficult to measure, particularly in the case of accounting measures which have been shown to be plagued by earnings manipulation.” (Wright et al 2007A; Cumming et al 2007)

1.2.2. IRRs

Internal rates of return (IRRs) are frequently used as performance measures for private equity funds. They can however be misleading, for example by including funds of longer duration (which are usually less profitable): if the bias is eliminated the average IRR falls from 14.64% to 12.22%. (Phalippou and Gottschalg 2007)

1.2.3. Borrowing from banks to pay dividends

One way in which PE groups may generate a misleading impression of high returns is through ‘dividend recapitalisation’. This involves borrowing more money and using it to pay dividends to the partners and investors – often within months of the original takeover. For example, a consortium of PE groups bought Hertz Corp. from Ford in December 2005 and six months later paid themselves a dividend of \$1 billion—nearly half their original investment—funded by new bank loans to the company. Similar transactions have taken place in the UK: “Former private-equity-backed companies such as Debenhams are struggling on the stock market after aggressive refinancings that allowed investors to take out big dividends, while others still in private equity hands such as Focus DIY are flirting with collapse after the owners loaded them up with debt when they took out profits” (Power 2007). Ratings agencies have been concerned that such recapitalisations increase the debt burden on companies still further and so increase the risk of default. The report to the OECD gives figures showing the sharp rise in the amount of debt used to refinance buyouts in Europe, and comments that this increase indicates that PE funds are using borrowings to replace equity and pay dividends to investors. (Hall 2006; Standard and Poor 2006; Wright et al 2007A)



Source: from data in Wright et al 2007 Table 12

2. Information

The information on real returns to investors highlights the importance of information for investors.

2.1. BVCA on information to investors on portfolio companies

One of the statements in the BVCA evidence to the select committee is that “Levels of disclosure about the performance of companies in which the private equity firm has invested are much higher than in public companies. Private equity and venture capital firms report to their investors regularly, typically quarterly. The reporting about the companies in which they have invested goes far beyond, is far more detailed and far more up-to-date than how a public company reports to its shareholders.” (BVCA 2007b, p.7)

This is a surprising claim, which is not supported by the BVCA’s own ‘Guidelines for reports to investors’, of which the BVCA says: “These Guidelines set out recommendations, intended to represent best practice, on the contents of reports to investors in private equity funds structured as limited partnership fixed-life funds.” (BVCA 2007)

The section of these guidelines relating to portfolio companies starts by restricting the guidelines themselves to companies which represent more than 5% of a fund’s investment or are among the 10 biggest companies in the portfolio: for all others, the BVCA makes no information recommendations at all. For these largest companies, the guidelines recommend the disclosure of the name and address and “a brief description” of the company, and information about the amount invested by the fund, its relations with other investors, percentage ownership, value of investment, stage of investment, a “brief analysis of significant events during the reporting period and anticipated events”, and “disclosure of any significant extraordinary items.”

The BVCA guidelines thus recommend no information at all about the operations and performance of the company. This is far less than is required of companies’ for basic registration at Companies

House – and the BVCA does not even recommend that the Companies House accounts should be disclosed to investors - let alone what is expected of stock exchange quoted companies.

2.2. Creating information monopoly

Small firms and start-up companies suffer from information opacity – they do not have detailed published accounts so potential investors find it difficult to decide whether to invest. Private equity companies investing venture capital were a new kind of intermediary solution to this problem, by providing active monitoring and support to small start-up firms on behalf of investors (Berger and Udell 1998; Gompers and Lerner 2000). Companies which are large, long-established, and publicly traded do not suffer from this informational opacity, and information is typically publicly available through published accounts, media scrutiny and published research. The effect of buyouts by PE firms is the reverse: they are taking information about the firms out of the public domain, and the PE firms themselves gain a monopoly on information about these companies. This information monopoly creates asymmetries which are problematic not only for employees and unions but also for investors and policy makers.

3. Conclusions

Investors in PE funds are receiving a poor risk-adjusted return compared with the stock market. This fact, and the growth in funds invested in PE despite these poor real returns, indicates that investors are disadvantaged by information asymmetries, including poor information about the actual rate of return being achieved by funds, inflated by unrealistic assumptions about the ‘living dead’ zombie investments. In this respect investors face the same disadvantages as employees. The public supply of information has been dominated by the promotion literature of the private equity companies. The financial media have failed to provide any correction to this bias, and have arguably amplified it by uncritical reproduction of industry claims on returns (as on employment).

Investors need greater rights to information, both about the actual performance of private equity funds, and about the performance of companies in which funds have invested, similar to those for stock exchange companies. As with stock exchange companies, this information should be published, to ensure that all stakeholders have access to it. Regulatory bodies including the FSA should subject the private equity groups to a constant monitoring of results (including employment effects), including the development of accurate indicators of funds actual performance. Meanwhile trustees of pension funds, in particular, should require comprehensive analysis of risk-adjusted returns before committing further investments to private equity funds.

4. Bibliography

Amess K. and Wright M. 2007 The Wage And Employment Effects Of Leveraged Buyouts In The UK. Forthcoming: International Journal of Economics and Business 2007

AT Kearney 2007. Creating New Jobs and Value with Private Equity <http://www.atkearney.com/>

Berger A. & Udell G. 1998. "The economics of small business finance: the roles of private equity and debt markets in the financial growth cycle," Finance and Economics Discussion Series 1998-15, Board of Governors of the Federal Reserve System (U.S.)

BVCA 2007 Reporting Guidelines <http://www.bvca.co.uk/>

BVCA/IE 2007 The Economic Impact of Private Equity in the UK. <http://www.bvca.co.uk/>

Cumming D., Siegel D., and Wright M. 2007 Private Equity, Leveraged Buyouts and Governance. <http://ssrn.com/abstract=983802>

EBRD 2006. Annual Report 2006 <http://www.ebrd.org/pubs/general/ar06.pdf>

EIB 2007. www.eib.org

EVCA/CEFS 2005 Employment Contribution of Private Equity and Venture Capital in Europe. EVCA. December 2005. http://www.evca.com/images/attachments/tmpl_9_art_129_att_953.pdf

Froud and Williams 2007. Private equity and the culture of value extraction. Version 2 - February 2007 CRESC Working Paper Series Working Paper No. 31CRESC The University of Manchester

FT 2007 Private equity deals that cement business growth; by Chris Bryant and Andrew Taylor Financial Times April 2, 2007

Gompers P. and Lerner J. 2000 Money chasing deals? The impact of fund inflows on private equity valuations. Journal of Financial Economics 55 (2000) 281-325

Gottschalg O., Phalippou L., and Zollo M. 2003 Performance of Private Equity Funds: Another Puzzle? INSEAD October 2003

Hall D. 2006 Private equity and infrastructure funds in public services and utilities <http://www.psiru.org/reports/2006-11-PE.doc>

IE/BVCA 2007 The Economic Impact of Private Equity in the UK (full report) Available from BVCA.

Steven N. Kaplan & Antoinette Schoar, 2005. "Private Equity Performance: Returns, Persistence, and Capital Flows," Journal of Finance, American Finance Association, vol. 60(4), pages 1791-1823, 08.

Josh Lerner, Antoinette Schoar, and Wan Wong 2005. Smart Institutions, Foolish Choices?: The Limited Partner Performance Puzzle. MIT Sloan School of Management Working Paper 4523-05 January 2005

NVCA/Global Insights 2007. The Economic Importance of Venture Capital Backed Companies to the U.S. Economy Third Edition 2007 http://www.nvca.org/pdf/NVCA_VentureCapital07.pdf

Phalippou L. and Gottschalg O. 2007 The Performance of Private Equity Funds

Power H. 2007 Permira lifts the lid on private equity The Sunday Telegraph 11 February 2007

Shleifer, A. and Summers, L.H. (1988). 'Breach of Trust In Hostile Takeovers' in Auerbach A. (ed) *Corporate Takeovers: Causes and Consequences*. Chicago: University of Chicago Press.

Standard and Poor 2006. The Dividend Recap Game: Credit Risk Vs. The Allure Of Quick Money. Aug.2006. <http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,0,1145848227253.html>

Swenson D. 2005. Unconventional Success: A Fundamental Approach to Personal Investment. Free Press.

Thornton P. 2007 Inside the dark box: shedding light on private equity. The Work Foundation March 2007 <http://www.theworkfoundation.com/products/publications/azpublications/privateequity.aspx>

Wright M., Burrows A., Ball R., Scholes L., Meuleman M., and Amess K. 2007a The Implications of Alternative Investment Vehicles for Corporate Governance: An Empirical Study by Consultants 13th Meeting of the OECD Steering Group on Corporate Governance DAF/CA/CG(2007)1/ANN1 16th March 2007

Wright M., Jensen M., Cumming D. and Siegel D. 2007b. The Impact of Private Equity: Setting the Record Straight.. Working paper.

Zollo, M. and Phalippou, L. 2005 What drives private equity fund performance? INSEAD 2005 <http://faculty.insead.edu/strategy/buyouts/documents/WhatdrivePEfundsreturnsatMS.pdf>

5. Notes