All you need to know

About private equity

01	Private equity as an asset	
01	Private equity investment characteristics	
02	2017 private equity industry review	

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Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock exchange. Private equity investments are generally less interchangeable than publicly traded shares and are usually considered a long-term investment. The private equity market is an important source of capital for startup and young companies, for firms in financial distress and those seeking growth or buyout financing.

Private equity as an asset class

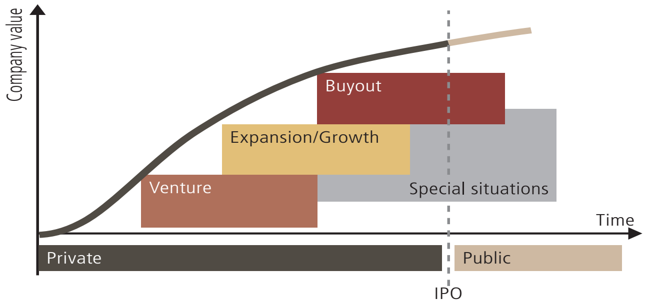
Private equity investing usually refers to an activity of investing in privately owned companies, which are typically acquired, in whole or in part, through privately negotiated transactions. Private equity funds pool capital from investors into strategy specific funds. These are often organised as limited partnerships, which are the most common legal structures for making private equity investments.

Investors in such funds usually commit a certain amount of capital upfront to the private equity fund and, when requested by the fund's manager or general partner (GP), pay in the amount (or percentage of the amount) over a period of time, usually over the first three to five years of the fund's life. The general partner, i.e. the fund, then makes private equity investments on the basis of a pre-defined investment strategy and in accordance with the terms of the offering memorandum.

A fund's investments are usually realised, or 'exited' after a five-to-seven-year holding period through a private sale, an initial public offering (IPO) or a recapitalisation, and the proceeds are distributed to the fund and the fund's investors. The funds themselves are typically wound up after a period of 10 to 12 years.

Private equity investments are usually categorised according to financing stage, which refers to the stage of development of a company at the time the fund makes its investment. Each investment strategy (i.e. financing stage) carries distinct risk and return characteristics. Accordingly, each financing stage (as shown in *Figure 1*) potentially has a different value proposition within a diversified private equity portfolio.

Figure 1 Private equity investment activity



Source: UBS Asset Management.

Depending on the point of the company's life cycle, the following are the principal financing stages:

Venture capital (VC)
Venture capital investing generally refers to investments in new and emerging companies. Companies financed by venture capital are generally not cash flow positive at the time of investment and may require several rounds of financing before the company can be sold privately or floated. Venture capital investments can be made into companies at the pre-product and/or pre-revenues stage, or it can be made into companies which have just started to generate revenues. Venture capital investors typically acquire a minority ownership position in the company.

Expansion/growth
Expansion or growth financing are investments which often follow the venture capitalists and comprise investments whereby the company needs capital to grow and expand the business, usually as quickly as possible. Depending on the nature of the business, companies receiving expansion or growth financing are already generating sustainable revenues but might still not yet be profitable.

Buyout
Buyout generally refers to investments seeking to acquire significant or often controlling interests in established, typically cash flow positive, or profitable companies. The use of debt financing, or leverage, is often prevalent in buyout transactions and debt components of an acquisition financing structure can reach up to 75% of the purchase price. Within the buyout strategy, there are mega, large, medium, small and micro-sized buyouts.

Special situations
Special situations refer to a broad range of private equity investment strategies outside the scope of venture capital, expansion and growth, and buyout investments. Typically, special situations include investment strategies such as turnaround investments, distressed investments, mezzanine capital and lately, a growing segment called 'secondaries'.

Private equity investment characteristics

– Attractive performance over the long term. Typically, private equity investors expect a minimum net return between 3% to 5% above publicly quoted indices. Top-quartile private equity fund managers have historically considerably outperformed public equity markets, even amid global economic uncertainty.

- Private equity investments earn money for investors primarily from capital gains and to a much lesser degree from dividends. In general, returns to investors are driven by growth in cash flows, multiple expansion and repayment of debt, whereby these elements do vary across private equity strategies.

- Sophisticated private equity investors have proven processes and tools to proactively increase business value and thereby investors' return. Within the ongoing sophistication of the industry, many private equity investors have accumulated significant sector and operational expertise.

- Private businesses have a considerably lower volatility than public equities and show lower correlation. Private equity investors generally invest in less efficient markets where informational advantages can occur as a result of preferential status or extensive due diligence.

- Private equity investments usually align the interests of the investor and the company, because management of the target company is motivated by ownership in the business.

- Long duration private equity investments provide a good match for long-dated liabilities. The global demographic trend of aging populations has resulted in the need for longer-term capital returns to fund retirement incomes.

- A considerable amount of risk lies in the inherently illiquid nature of private equity investing. Once the fund commits to a private company, the investment is usually not liquid.

2017 private equity industry review[1]

2017 turned out to be another strong year for private equity, but with fewer political or macroeconomic surprises than what we saw in 2016.

Against a backdrop of improving global macroeconomic conditions, not least in Europe, and a strongly performing public equities market, private equity continued to attract strong inflows globally and across various investment strategies. As in prior years, this was driven by investors' appetite for strong risk-adjusted returns and portfolio performance drivers as well as portfolio diversification. Some investors are, at the expense of public equities, further increasing their overall allocation to alternative asset classes such as Private Equity.

An already benign environment further buoyed by favourable financing conditions created a challenging environment for the general partners (GPs). GPs faced increasing valuations and intense competition from both their peers and cash-rich corporates, making it difficult to put money to work. This led the best GPs to focus on their competitive strengths and to stay disciplined, while taking advantage of the high valuations to exit investments and generate liquidity at attractive prices but also to lever on the strong demand in the asset to raise larger follow-on fund generations.

[1] Source: UBS Asset Management, Real Estate & Private Markets; PitchBook, 2017 (final figures for 2017 are subject to change).

North America
Buyout activities for 2017 amounted to USD 421 billion, representing an increase of 12% on 2016. The deal volume remained flat at 3,377 transactions compared to the previous financial year. The average deal size, however, increased by USD 12.7 million to USD 124.7 million in 2017, reflecting an 11.3% increase year on year (YoY). Valuations measured by EV/EBITDA remained elevated at 10.5x – relatively flat compared to the previous year, though still near the all-time high of 10.9x in 2016.

The elevated valuations also contributed to an attractive exit environment. GPs were quick to take advantage of this, exiting 1,775 investments for a total value of USD 791 billion. Compared to 2016, exit volume was down by 6.3%, but up in value by 31.2%. Due to several mega-funds closing, not least the closing of Apollo IX at USD 25.7 billion, fundraising hit a new high at USD 214 billion, almost 25% YoY. However, one reason for concern is the debt/EBITDA multiple which reached a new all-time high at 5.7x. This value is well above the levels of 5.0x and 4.9x seen in 2007 and 2008, respectively. Despite the new high, it is reassuring that GPs are contributing significantly more equity at 4.8x compared to 3.9x and 3.4x in 2007 and 2008, respectively.

Venture capital activity slightly declined in terms of value (USD 120 billion) and volume (9,201 deals), indicating a 2.6% decline YoY. Exits also declined slightly by both value and volume. Value dropped from USD 109 billion to USD 106 billion (-3% YoY) and volume fell from 1,258 to 1,184 transactions (-6% YoY). Fundraising slowed down significantly in 2017. Value declined from USD 40.5 billion to USD 33.3 billion and volume declined from 289 to 221 deals – down by 17.8% and 21.3%, respectively.

Europe
2017 was another strong year for European buyouts. Though volume fell slightly by 8.5% (YoY), value soared by 23% to almost USD 300 billion – one of the highest years on record. As was seen in 2016, this was partially driven by cross-border deals completed by non-European investors, which accounted for almost half the total value and one-third of the volume. Add-on deals remained prevalent and accounted for almost 50% of all deal activity. That said, on a QoQ basis, both cross-border deals and add-on deals declined in volume and value. This slowdown might, to some extent, be explained by the continued high valuations at 7.6x, vs 7.4x in 2016.

Exits in Europe followed the same trend as seen in North America, with 2017 volume declining slightly from 1,570 deals in 2016 to 1,544. However, value surged by 41% (YoY) from USD 355 billion to USD 499 billion. Fundraising, on the other hand, experienced a slight dip – 88 funds closed at an aggregate value of USD 69 billion (-1.6% YoY). The debt/EBITDA multiple, which is well below the levels observed in North America, increased to 4.0x compared to 3.6x in 2016, representing the highest on record. Both valuations and debt multiples are significantly lower than compared to North America. However, the equity cover in Europe is also significantly less than in North America, declining from 3.9x (2016) to 3.5x. While not necessarily a cause for concern, it does invite closer scrutiny on how managers structure their individual deals and how they account for this risk.

Venture capital activity fell by both volume (-19% YoY) to 4,165 deals and by value (-17% YoY) to USD 46bn. VC fundraising followed the overall downward trend, dropping from USD 10 billion to USD 8.1 billion for the 53 funds that closed. It is important to note that despite the downward trends compared to 2016, European VC performance is still strong when compared to the long-term average.

Asia
Following the broader global trend, buyouts in Asia also increased in 2017. Value increased from USD 111bn to USD 133bn (20% YoY) while volume fell from 521 to 485 transactions (-7% YoY). Exits were buoyant, increasing in value to USD 197bn (27% YoY) and by volume to 288 (8.3% YoY). Fundraising volume remained flat at 26 deals. Meanwhile, fundraising value fell by 15% YoY to USD 20 billion. Of this, at nearly USD 10 billion, KKR's Asia III fund accounted for around 50%.

2017 venture capital activity in Asia, though down by volume to 2,132 deals (-19% YoY), remained robust with a larger total value of USD 82 billion, up 3% YoY. Even as exit volume remained stable at 316 exits for the year, value declined significantly by 32% YoY to USD 36 billion. Fundraising also slowed significantly with only 35 funds closed (-35% YoY) at USD 6.6 billion (-48% YoY).

Performance
Figure 2 shows the latest available returns for the US and European private equity industry. The data confirms the attractive performance characteristics of private equity in the long-run, which seems to compensate for the illiquidity aspect as well as the differing cycles for the individual sub-segments. In the US, private equity provided comparable returns to the S&P 500 on 10 and 20-year investment horizons. While the S&P 500 ended 2017 strongly, its struggle in early 2018 serve as a reminder to the market's volatility in the current economic climate. In Europe, with the exception of venture on a one-year return, both venture and buyout investment strategies consistently outperformed the MSCI Europe for the second year in a row.

Figure 2 Private equity returns in the US and Europe

European private equity returns to 30 September 2017 (% p.a.)					
	1 year	**3 years**	**5 years**	**10 years**	**20 years**
All Venture	14.44	11.20	13.65	6.05	7.24
All Buyout	26.55	13.57	13.30	6.35	15.22
All Private Equity	25.47	13.24	13.17	6.43	14.49
MSCI Europe	14.52	5.19	9.24	0.19	3.16

US private equity returns to 30 September 2017 (% p.a.)					
	1 year	**3 years**	**5 years**	**10 years**	**20 years**
All Venture	7.93	10.78	14.76	9.11	22.26
All Buyout	17.42	12.91	15.69	10.02	12.08
All Private Equity	14.90	11.79	14.91	9.94	13.44
S&P 500	18.61	12.02	18.89	10.49	14.36

Source: Cambridge Associates (via ThompsonOne); data as 30 September 2017 generated on 28 March 2018, S&P 500 and MSCI Europe Total return data from Bloomberg as of 28 March 2018. Please note that past performance is not a guide to future performance.

Overall, buyout deals generally outperformed the venture category. This is in line with the results discussed in the regional breakdown. As added emphasis, 2017 saw the largest buyout funds ever raised in the US, Europe and Asia. However, on the 20-year outlook, US venture investments provided a particularly advantageous return compared to the S&P 500 and buyouts.

Trend to watch – PE and Healthcare[2]
As one of the world's largest industries, healthcare has attracted increased interest from PE investors. In an environment which is generally impacted by political and macroeconomic uncertainties, powerful secular and demographic trends provide the ground for a surge in healthcare activities as investors take advantage of the long-term growth dynamics, which are mostly resilient through economic cycles. In addition, the nature of this sector is a good fit for the full universe of private equity strategies, as it comprises venture-backed start-ups, growth-oriented rollouts of disruptive business models, and consolidation strategies for high-margin and stable cash-flow companies operating in fragmented market niches which are attractive for dedicated buyout funds. Furthermore, healthcare fits nicely into most impact investing strategies.

[2] Source: UBS Asset Management, Real Estate & Private Markets; Bain & Company, 2017; IQVIA (formerly Quintiles IMS), 2017; Evaluate, 2017.

Though the background for the anticipated long-term growth trend is different from developed markets compared to emerging markets, it is interestingly very much a global trend. The annual healthcare expenditure in the US is currently north of USD 3 trillion and growing by 4% to 6% p.a., representing about 17% of GDP in 2016, and so remains by far the largest market globally. Growth expectations are driven by the well-known demographic effects of an aging population alongside dramatic scientific breakthroughs. The latter is based on a better understanding of biology, which has created new opportunities in treating and preventing diseases in many therapeutic areas including cancer and hepatitis. From the perspective of investors, this provides additional opportunities for new business models, which aim to better control costs and increase efficiency in the healthcare system. Digital health, value-based-payment models and personalised medicine are amongst investment themes that will benefit from this for at least the next 10 years.

Outlook for 2018

Overall, expectations for 2017 were mostly in sync with results. Private equity did well despite a weakened USD against other major currencies. The political fallout from 2016 – an upsurge in both protectionism and populism – turned out to be less onerous than feared.

Going into 2018, the global environment of high public market valuations will be a cause for concern as PE players fret over the availability of upside and the pressure it puts on private market valuations. Undoubtedly, the equity bull market that started 2018 has been partly fuelled by the quantitative easing undertaken across much of the world, not least in China. As this tapers, as is expected, global growth may slow to the point of a downturn, instead of the so-called global synchronised upturn we've been witnessing. In addition, uncertainty around global trade, brought on by the pending US tariffs, have already soured the bull market.

Where does this leave private equity? While increased prudence and additional caution is advised, we do not think private equity will drop off significantly. We maintain our conviction that growth activity, including small and medium-sized buyouts, is better positioned to reap the upside of a continued growth scenario. In the case of a downturn, if PE firms are properly structured and well managed, they should continue to grow without the greater risk that high leverage and lower GDP growth causes for larger companies. Finally, a focus will remain on selecting fund managers that can add real value, such as operational and transformation to their portfolio companies and that apply leverage sensibly, avoiding using leverage as the dominant value driver.

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