PALLAS
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PCA Market Commentary

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Private Equity Opportunity

The search for alternative investment opportunities has become increasingly mainstream throughout the past decade. Once seen as the domain of institutional investors, alternatives that employ private capital has become a more common conversation in retail households. The interest is a natural outcome of investors seeking greater opportunities for returns that provide diversification to buffer against downturns. Thus, the unicorn search begins.

As with the analysis for any investment vehicle, the questions are often simple:

- *What are the inefficiencies that are exploitable within the investment decision process?*
- *Is the investment thesis sustainable over the long term?*
- *Can those insights be translated into an appropriate investment vehicle for a given audience?*
- *What are key aspects of risk diversification offered through this type of asset/strategy?*

...but the answers are not.

Thus far, a consequence of institutionalizing private investments, translates into two-fold benefit for individual investors. First, there is a shift towards greater transparency as an outcome of greater regulatory oversight in combination with structured analytics demanded by institutions and investment consultants. Second, there has been a structuring of large-scale investors in the primary and secondary markets to provide pools of liquidity for themselves, and consequently, liquidity for smaller investors.

The growth of private investment opportunities has been steady over the last 15 years. Estimates on the opportunity set varies depending upon which research publication is considered. More recent studies infer an opportunity set between 3%-9% of total market portfolio, depending upon how assets are classified. Compiling data from a recent study by Doskeland and Stromberg (2018), the combination of real estate, private equity, infrastructure, natural resources, and private debt, equates to $4.9 trillion of global private assets in 2015.

	Total Estimated Value (billion)	% of Total
Public debt	70,000	61.0%
Public equity	39,800	34.7%
Real Estate	810	0.7%
Private Equity	3,131	2.7%
Infrastructure	417	0.4%
Natural resources	229	0.2%
Private Debt	335	0.3%
Global market portfolio	114,722	100.0%
Total public	109,800	95.7%
Total private	4,922	4.3%

Source: Pallas Capital Advisors, Doskeland and Stromberg (2018)

Regardless of the precise size of today's private capital market opportunity, the positive trend shows little signs of abating. Generally, private market performance has outpaced public market performance, pushing up private market valuations through both asset inflows and multiples expansion, and at a greater pace than comparable public market metrics. The following charts compare the return rates of buyout funds as tracked by Prequin (alternative assets data), against that of the market public equivalent index created by Cambridge Associates (investment consultant).

Source: Bain, Prequin, Cambridge Associates

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The Challenge

While private investment opportunities have expanded substantially, and transparency is improving through data/analytics, it's not entirely clear how performance is generated by the private capital investment managers, nor is it clear how such managers gain an information advantage. The body of research, while growing, remains inconclusive about what proportion of traditional risk, if any, is being exploited by this segment of investors.

Essentially, we don't really know how or if, alpha is generated beyond common risk factors such as illiquidity, style, size, and sector, that explain public equity behavior. One possible conclusion is that it's not easy to use public market proxies to represent the performance of private markets. Apparently, traditional analytic frameworks (drawn from public markets) are hampered at the outset.

We intuitively acknowledge that at least some proportion of the 'value-add' from private market investors stems from participating within an inefficient space where improvements to the holding (asset) comes from investor impact, such that managers act upon information that's not publicly known. This scenario represents inherent opacity where data is neither deep, nor broad, nor of reasonable historic length.

Hence, we don't have any great answers to the first two questions that we postulated at the start of the conversation. Although we try, we can't quite put our finger on what inefficiencies are being exploited by private market investors. The possible answers might be more idiosyncratic and less generalizable. Of course, if we can't be sure of what might comprise the exploitable inefficiencies, we'll also have trouble determining how long that information advantage might persist or be actionable.

Further, there is the potential for distortions in performance, caused by NAV gaming or strategic selection of benchmarks. By compounding a lack of depth and breadth of data with the inherent pitfalls of manager self-reporting, investors face a trifecta of potholes when contemplating an allocation within private capital markets.

Thinking Ahead

With the consistency of recent out-performance strengthening demand within private markets, the challenge comes from increasing amounts of uncalle capital fishing within a slower growing pool of qualified opportunities. Recognizing the mounting pressu for private capital managers to find more deals, we observe the following…

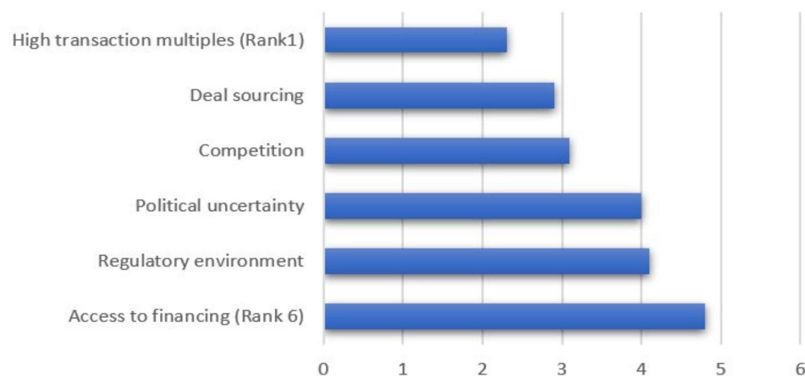
- Leverage is increasingly employed by private ca ital managers to improve performance and relative standing within peers. This tends to amplify risk tendencies taken by these managers.

- Returns as measured by multiple of invested capital (MOIC), while high, is trending downwards. Buyout returns reflect a lower level today, when compared to the period preceding the global financial crisis.

- Uncalled capital as a percentage of total commitments, continues to grow, suggesting a supply/ demand imbalance that tilts towards a declining universe of good opportunities.

This sentiment is consistent with data from Pitchbook's PE Crystal Report from 2018, where top-ranked issues were generated through their survey of private capital managers. The key challenges, according to respondents, have remained consistent through the years, with the top challenge being valuation and deal set. It seems that the selectable pool of opportunities available to investment managers is now smaller and more expensive.

Reflecting upon the third question that we asked at the outset, we realize that the answer remains inconclusive. Thinking about whether the manager's information advantage can be translated effectively to the individual investor, we suspect that the answer remains 'yes.' However, it's safe to say that doing so is getting harder, and the top managers will distance themselves even further as the private market continues to mature.



Source: PE Crystal Ball Report, Pitchbook Data Inc.

However, this does not mean that private investments are less accretive today, within a diversified portfolio, than they were in years past. We observe that endowments of various size (most exemplified by Yale), continue to produce better (and more stable) returns through exposure to private pooled and/or direct investments.

This is partly explained through the following:

- *Top performing private investment managers substantially outperform their peers and the breadth of returns (good vs poor performance) is greater within with private market investors than their counterparts within public markets. In other words, top performing private market investors vastly outpace their median peers, when comparing the same metric as applied within public markets.*

- *Positive performance is autocorrelated within private markets, which is to say that outperforming managers, tend to produce a continuation of out performance into the future.*

- *Private investments tend to buffer downturns. This was observed empirically in "Private Equity in a Deleveraged Economy: Lessons from the Financial Crisis" (2010), where the author found that the illiquidity of private investments shielded (at least in part) those portfolios from the volatility that occurred within public markets. (Editorial sidebar: one data point does not make a trend.)*

- *Private capital investing is opportunistic by nature, which further supports its role as a buffer to volatility. In this case, investments are injected into long-term sustainable organizations that are caught within crosscurrents of short-term dislocations.*
- *There's positive contribution that is generated through buy and build strategies within inefficient spaces, where investment managers create value by strategically improving the operational effectiveness of the individual assets. (Editorial sidebar: This information advantage is being applied by the search fund investment model, born at Stanford and Harvard, and increasingly adopted in pockets outside of these endowments.)*

Such observations have not escaped notice from non-endowment investors, where in general, participation by institutions within private markets, has expanded dramatically. This is increasingly seen in direct investments within pooled or non-pooled vehicles.

What does an investor do in a situation where an asset class can't be ignored, but remains somewhat opaque? How reliable is the data that we see? Fortunately, the task of separating the good from the bad, is not as impossible as it might appear at first glance.

For example, there's evidence that NAV inflation (by investment managers) is not as pervasive as one may suspect. Research by Barber and Yasuda (2017), Brown et al (2016), and Jenkinson et al (2016), suggest that such calculations may be somewhat conservative, as investments are often exited at or above the last reported NAV. Fortunately, this conservatism is reinforced by 'Fair Value Measurement' of illiquid assets by regulatory bodies. (FASB rule 157)

Distortions in performance can cloud our analysis, which may occur through different standards of measurement. However, the private capital industry generally reports using one of a handful standards: internal rate of return (IRR) of cashflows, or distribution of paid in capital (DPI). Both methods can be augmented using Public Market Equivalents as benchmarks.

The net translation of our brief conversation is the following: private capital markets remain a compelling opportunity for investors, having become more accessible to individuals who might view the asset class as a diversifying component of his or her portfolio. The evolution in private capital reporting and investment vehicles has improved transparency and facilitates the due diligence process. We believe there is an increasing opportunity-set for individual investors as this investment class evolves into more 'digestible' vehicles beyond the institutional domain.

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