

At the peak

Frothy valuations and a crowded fundraising market mean global returns from private equity may fall in 2017, though it is still expected to outperform more traditional asset classes, according to Siguler Guff's Ralph Jaeger.



Ralph Jaeger,
managing director and portfolio manager
of emerging markets private equity,
Siguler Guff

For yield-hungry investors, private equity has been one of the more attractive asset classes in recent years and it is unlikely to lose its appeal given the increasingly lower returns expected from more traditional investments over the coming year.

However, 2017 may be more challenging in this area of the market. There are signs private equity may be near the top of the cycle: with valuations some consider stretched, deteriorating credit conditions and private equity firms struggling to put un-invested cash to work.

Following several years of strong growth, investors will need to be more discerning in the future, says Ralph Jaeger, managing director of the multi-strategy private equity investment firm Siguler Guff. Although Jaeger expects private equity to continue to outperform public equity markets on a relative basis, investors could find their expectations put to the test as firms fail to generate returns as high as they were in the past.

“A lot of capital is being risked in private equity vehicles in developed markets,” he says. “That makes me question whether they will produce returns commensurate with what investors expect them to achieve.”

Strong recovery

For some private equity players, the trauma of the financial crisis has been long lasting – the casualty rate has been even higher than that following the bursting of the tech bubble in 2000. Of the 4,019 buyout firms that had raised a new fund between 2002 and 2008, 26% have failed to raise another since 2009.¹

However, since then it has been a time of renewed growth, aided by a supportive macroeconomic backdrop and favourable financing conditions. Debts were paid down as firms found themselves able to refinance on better terms, helped by central banks reducing interest rates to near zero levels.

Reduced regulatory and reporting requirements for private companies

have also been supportive in developed markets, with more businesses deciding to remain private. A growing number of public companies have also been choosing to go private in order to benefit from this lighter regulation, providing greater investment opportunities for private equity fund managers.

Over the past several years the good times for private equity fundraisers have continued as money has flowed in from pension funds, family offices and wealthy private investors struggling to find adequate returns elsewhere.²

Under stress

However, cracks in this positive façade are beginning to show as the cycle that began in the depths of the financial crisis appears to be reaching its peak.

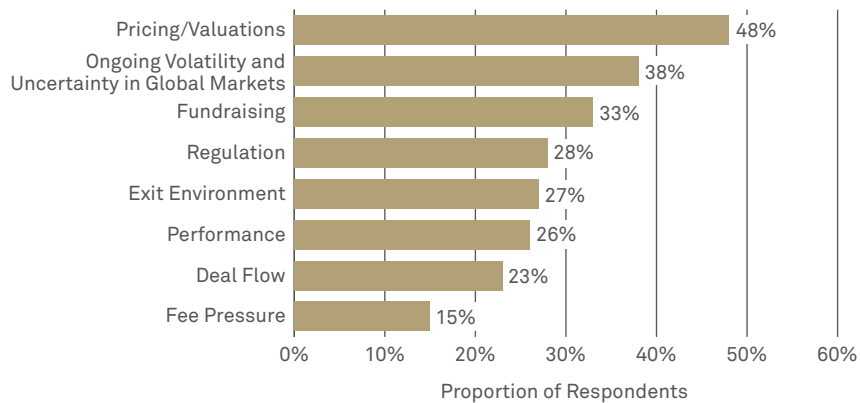
The huge inflows to private equity funds have resulted in a build-up of unprecedented amounts of unused capital: un-invested dry powder stood at a record of US\$526.6bn in H1 2016, up 11% up from H1 2015.³

¹ *Forbes*: 'The Private Equity Shakeout That Didn't Happen', 23 March 2016.

² *Preqin*: 'The Q2 2016 Preqin Quarterly Update Private Equity', 19 July 2016.

³ *The Business Times*: 'Private equity deals in S-E Asia fall in H1, notably in tech sector', 29 September 2016.

FUND MANAGER VIEWS ON THE BIGGEST CHALLENGES FACING THE PRIVATE EQUITY INDUSTRY IN THE NEXT 12 MONTHS



Source: Preqin Fund Manager survey, June 2016.

There is no shortage of potential investment targets but fierce competition between established private equity houses, new players and corporates, all flush with cash, has forced up valuations.⁴ In 2015 buyout funds were on average paying more than 10 times earnings before interest, taxes, depreciation and amortisation, surpassing the elevated multiples of 2007.⁵

Valuation pressure comes at a time when tumult in the high yield debt markets has made lenders more reluctant to provide leverage to bankroll private equity deals.⁶ Banks have been backing out of deals or shunning them altogether, making it even more difficult for private equity fundraisers to put money to work.⁷

However, as times get tougher, the long-term perspective of private equity firms can be an advantage. Even though debt financing has become more difficult to obtain, private equity firms have time to wait for credit conditions to improve. Their average investment period is 5.5 years.⁸

Nor have firms been idle even as higher valuations have made it more difficult to get deals done on the buy-side. There has been an increase in sell-side activity as private equity firms see this as an opportune time to exit portfolio companies to the benefit of some investors.⁹

As valuations rise and buyers become reluctant to pay the high prices being

asked for assets by sellers, something has to give. Jaeger says: “We are pretty much at the peak of the cycle in terms of valuations, especially in developed markets. However, we think private equity will continue to outperform public markets in the year ahead although we wouldn’t be surprised if returns become more compressed.”

Despite these tougher conditions, private equity retains many attractive features for investors in need of yield.

Jaeger says: “The increased popularity of private equity investing is as much a factor of investors, particularly pension funds, not finding other areas to invest that provide the yields they need. That is unlikely to change.

“In the past, private equity has tended to outperform the S&P 500 by 500 to 800 basis points. If interest rates remain broadly where they are now in the next 10 years we would expect outperformance by 300 to 500 basis points.”

The macro view

The macroeconomic background for the asset class also looks accommodating for the year ahead, although ongoing volatility and uncertainty in financial markets remain a concern. For UK and European private equity players, the Brexit vote has been one of the more de-stabilising factors over the past year.

However, Jaeger says: “I don’t believe Brexit will have a significant on-going impact. Demand flows in the UK and EU have continued as usual and it has had no impact in emerging markets and the US.”

Allocation choices

Jaeger believes investors looking to private equity will need to be more discriminating going forward. He says: “That means looking at more contrarian strategies: sector focused strategies, special situations, more illiquid strategies, those that are geographically diverse. It will be important to not get caught up following the herd.”

For investors who have so far focused on developed markets, the emerging markets could be a potential hunting ground. Private equity opportunities in emerging markets look more attractive than those in the US and Europe, says Jaeger. They tend to be much less leveraged, operate in higher growth environments and valuations tend to be lower than in the public markets, meaning they do not look as stretched as those in the US and Europe. Many businesses have also evolved over the past decade to be formidable competitors on the global stage.

“I expect US private equity to continue to outperform European private equity but I also believe that a discerning emerging markets strategy has the potential to outperform both.”

However, the risks in emerging markets are higher so the need to be selective in this area is even more important. Jaeger says: “The divergence between the good and bad performing private equity funds is significantly higher in emerging markets by a factor of two compared to what we see in developed markets.”

WHAT TO WATCH IN 2017

Rising buyout multiples.

Divergent return opportunities.

An increase in value-driven deals in emerging markets.

⁴ Bloomberg: ‘Blackstone’s Top Dealmaker Says Now Is The Most Difficult Period He’s Ever Experienced’, 27 September 2016.

⁵ Bain & Company: ‘Global Private Equity Report 2016’, 22 February 2016.

⁶ Reuters: ‘Private equity deals hit as banks curb lending for leveraged buyouts’, 15 January 2016.

⁷ Ibid.

⁸ The Wall Street Journal: ‘Average Private Equity Hold Times Drop to 5.5 Years’, 10 June 2015.

⁹ Bain & Company: ‘Global Private Equity Report 2016: Exits: a great year to be a seller’, 22 February 2016.