THE RECENT PERFORMANCE OF PRIVATE EQUITY – AND THE INVESTMENT CASE FOR THE SME ROLL-UP STRATEGY

ABSTRACT:

This paper provides recent empirical research, to assess the historical performance of private equity, versus other notable alternative asset classes and also, versus public equities. The paper next delves into the broad asset class of private equity, and provides topical evidence to support the integrated SME roll-up strategy, as an effective substitute for the higher multiple, large-cap leveraged buyout strategy.

KEYWORDS:

Private equity, debt, EBITDA, IRR, performance, operations, SME, beta, standard deviation, valuations, large-cap, small-cap, multiples, transactions

INTRODUCTION PART 1 – CONTEXTUALIZING THE PERFORMANCE OF PRIVATE EQUITY

Over the past two decades, private equity on an absolute basis, has outperformed all other private market asset classes.

For 2007-2017 vintage PE funds, the median IRR is 13.3% - which outpaces other private market investments.[1]
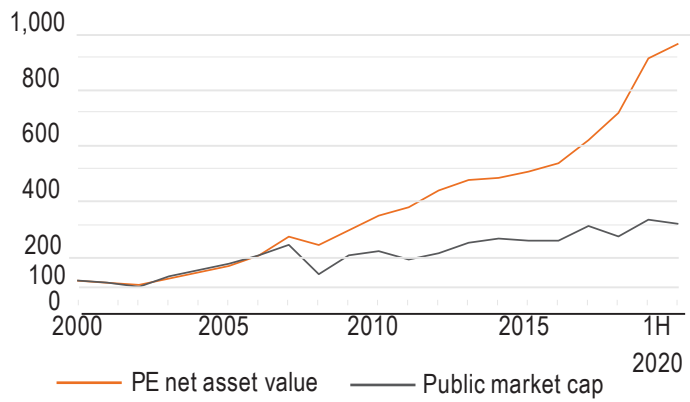
Global fund median IRR and percentile spreads by asset type, net IRR to date through Sept 30, 2020, for vintage 2007-17 funds, %
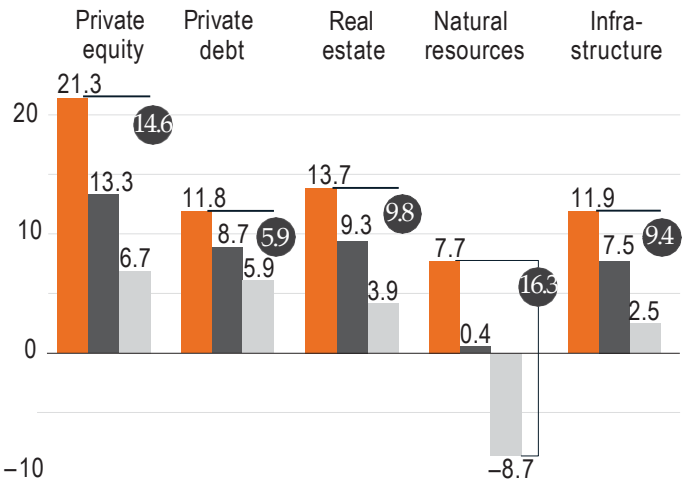
Source: Burgiss

Since 2000, private equity has also outperformed the public stock market.[2]

**Growth of global PE net asset value and public market capitalization, 2000–1H 2020, (2000 = 100)**

Source: World Federation of Exchanges, Preqin

The weighted average net present value of private equity has materially outgained the total market cap of listed companies.

PART 2 – THE INVESTMENT CASE FOR THE SME ROLL-UP STRATEGY

The average EBITDA multiple of a company valued at under $100 million, has been materially lower than the average EBITDA multiple of a company that is valued at over $500 million.[3]
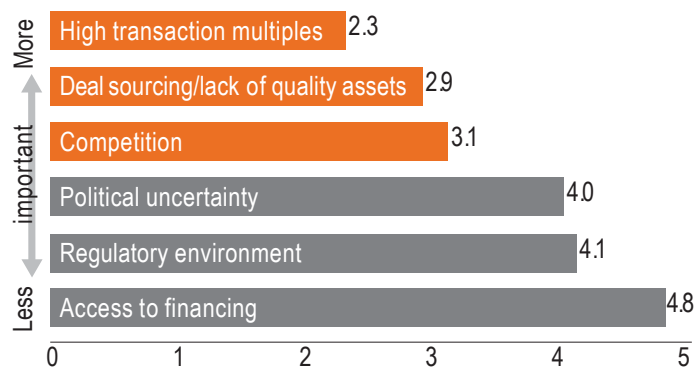
Median EBITDA purchase price multiple for global buyout transactions, by deal size
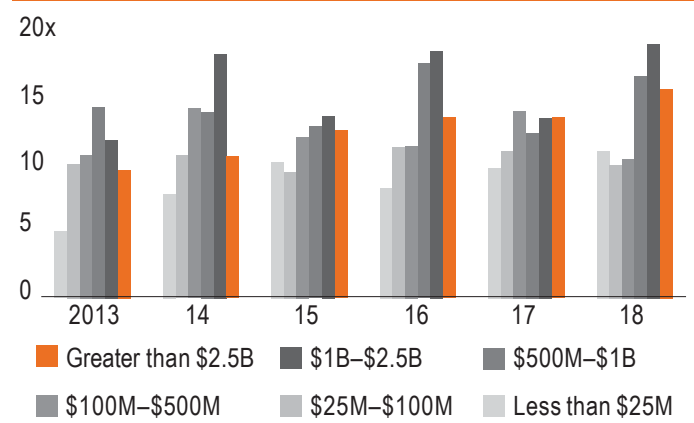
Source: PitchBook Data, Inc.

Interestingly, 'higher transaction multiple' is currently identified as the biggest challenge facing PE firms.[4]

What do you anticipate to be the biggest challenges for PE dealmakers in 2018?


Mean of responses by category (1 as most important and 7 as least)

Source: Crystal Ball Report 2018, PitchBook Data, Inc.

Following the aftermath of the 2008 financial crisis, the U.S. private equity market has shown a year-over-year uptick in the leverage factor that is used for acquisitions.

This trend can be reconciled by the upward drift in transaction multiples during this time, coupled with the persistence in historically low nominal interest rates.[5]

### US buyout debt multiples and debt share, 2007–20
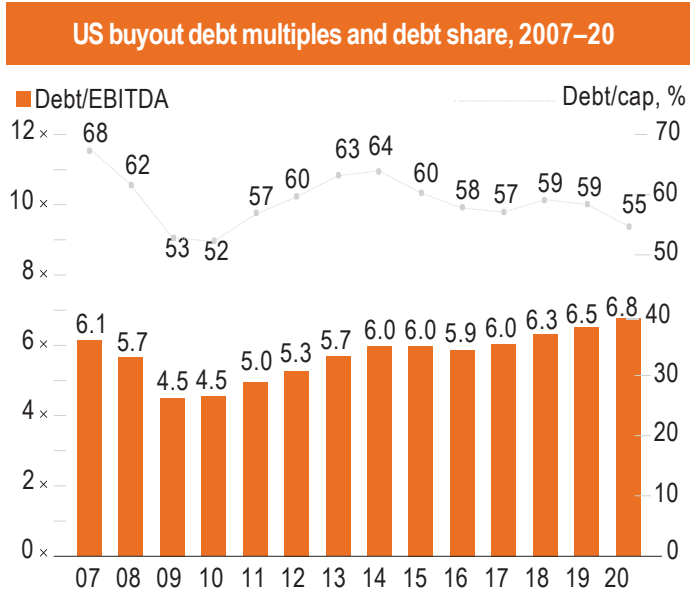
Source: Renitiv LPC

Attractive transaction multiples offer the private equity private manager, opportunities for scale arbitrage and for competitive overall returns – at the expense of potentially increasing the portfolio's beta.

Within the realm of buyout strategies, small-cap buyouts showed the largest variance in performance, versus strategies dedicated to medium cap and large cap buyouts.[6]

Global buyout fund percentile performance over 2000–20 for buyout funds raised in 2000–17, IRR for 2000–17 vintage funds, %

X Difference between top and bottom 5%, percentage points
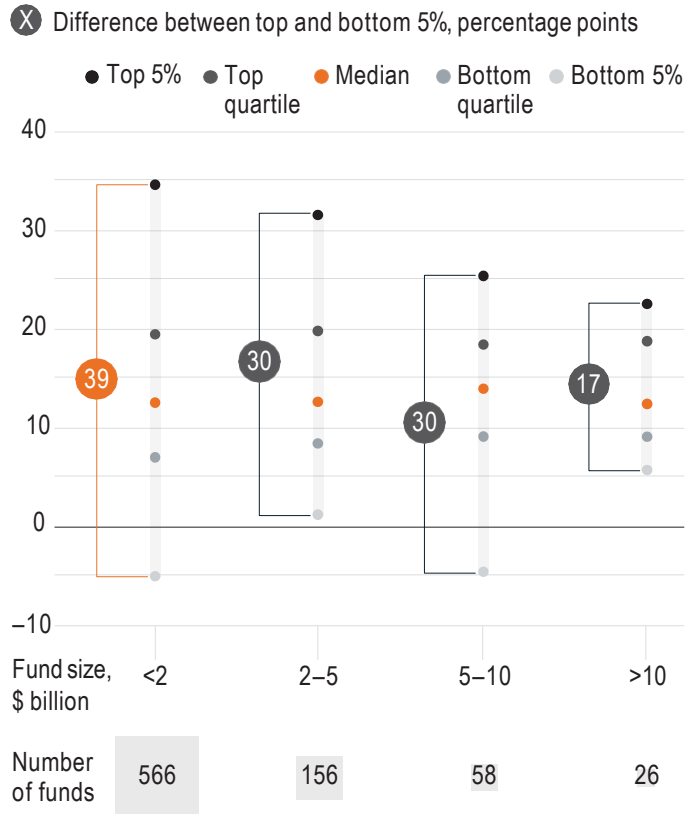
Source: Burgiss

This larger beta affect within the small cap buyout space, re-enforces the need for proper diversification and for systems integration, within a small cap buyout strategy.

PART 3 – GLOBAL PRIVATE EQUITY VS THE CANADIAN SME ROLL-UP: REPLACING LEVERAGE WITH LOWER TRANSACTION MULTIPLES

KKR, one of the 3 largest private equity firms in the world, has built a reputation that is synonymous with large scale leveraged buyouts. Equicapita is Canadian SME roll-up fund that currently operates across 5 distinct industry verticals.

In 2015, ICapital launched a KKR global fund of private equity funds ("FOF"); the study below incorporates the monthly returns that have been generated by KKR's FOFs and the quarterly returns that have been generated by Equicapita.

Equicapita Performance Metrics (as of June 30th, 2021)		KKR's Global Portfolio Performance Metrics (as of June 30th, 2021) [7,8,9,10]	
5.5 Year IRR (annual compounding)	11.07%	5.5 Year IRR (annual compounding)	11.07%
8 Year IRR (annual compounding)	10.75%	Historical Standard Deviation (monthly returns)	7.95%
Historical Standard Deviation (quarterly returns)	8.66%	Skewness (monthly returns)	0.91
Skewness (quarterly returns)	1.08	Kurtosis (monthly returns)	5.9
Kurtosis (quarterly returns)	8.48		

The performance metrics table below suggest strong similarities in the absolute and risk adjusted performance metrics between Equicapita and KKR's FOFs portfolio.

The line graph below plots the year end debt-to-EBITDA ratios of Equicapita, versus the broad U.S. buyout market.[11]

Debt-to Ebitda
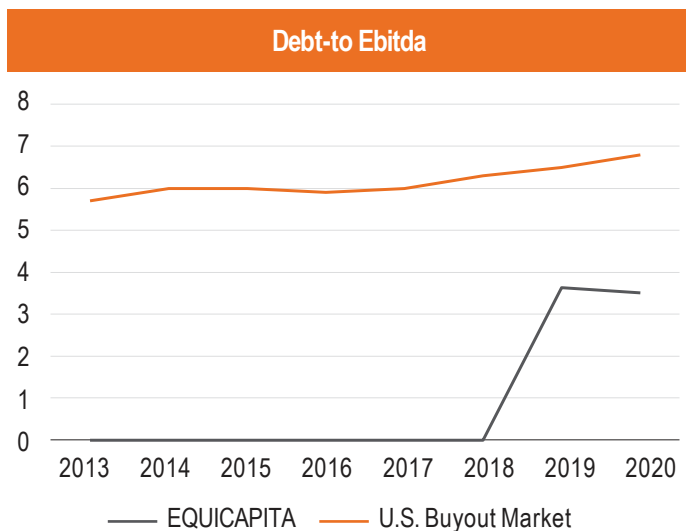
From 2016 to 2018, Equicapita outperformed KKR global portfolio, while using no balance sheet leverage.[12]

Annual Returns
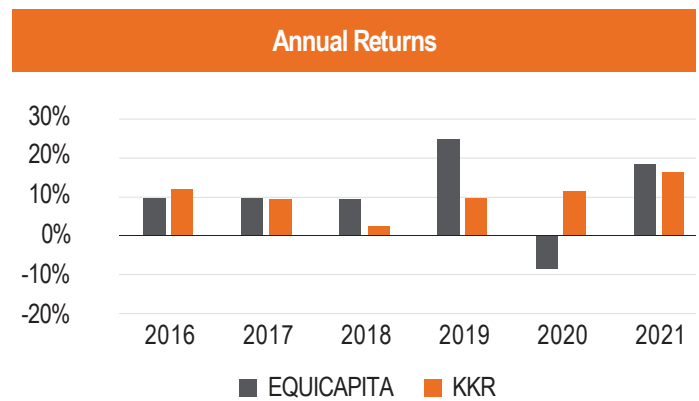
PART 4 – CONCLUDING REMARKS

If recent history is any indication, one could reason that private equity strategies predicated on maximizing leverage to acquire larger cap/higher multiple companies, can be replaced with a lower leverage strategy, that is focused on using operations/monitoring systems and integration techniques, to buy a series of smaller companies at lower multiples.

SOURCE DATA, ANALYSIS AND NOTES:

1. A year of disruption in the private markets: McKinsey Global Private Markets Review 2021

2. A year of disruption in the private markets: McKinsey Global Private Markets Review 2021

3. https://www.bain.com/contentassets/ 875a49e26e9c4775942ec5b86084df0a/ bain_report_private_equity_report_2019.pdf

4. https://www.bain.com/contentassets/ 875a49e26e9c4775942ec5b86084df0a/ bain_report_private_equity_report_2019.pdf

5. A year of disruption in the private markets: McKinsey Global Private Markets Review 2021

6. A year of disruption in the private markets: McKinsey Global Private Markets Review 2021

7. Performance & Distributions – iCapital KKR PM Fund

8. For Equicapita – a quarterly standard deviation was estimated using the raw data from the time series.
   • That estimate was annualized using the time weighted square root factor. The time weighted square root factor is derived by taking the square root of the approximate number of quarters in a 252 day trading year (there are approximately 60 trading days in a quarter which yields approximately 4.2 trading quarters in a year).

9. For KKR – a monthly standard deviation was estimated using the raw data from the time series.
   • That estimate was annualized using the time weighted square root factor. The time weighted square root factor is derived by taking the square root of the approximate number of months in a 252 day trading year (there are approximately 20 trading days in a month, which yields approximately 12.6 trading quarters in a year).

10. Skewness measures the degree and the direction by which the mean return diverges from the median return; it is an indicator on how larger unexpected returns will impact investor performance.

11. A year of disruption in the private markets: McKinsey Global Private Markets Review 2021

12. Performance & Distributions – iCapital KKR PM Fund

13. Portfolio Holdings – iCapital KKR PM Fund

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