



## PRIVATE EQUITY INVESTING

### THE FUNDAMENTALS OF THE ASSET CLASS

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We were asked many times over the last year what the recessionary environment, and ultimate recovery, might mean for private equity returns. The short answer is that private equity returns will likely be negatively impacted in the current challenging environment – private companies must sell products to customers just like public companies.

On the other hand, we feel that private equity firms have greater flexibility to manage through this period due to several structural advantages of the asset class. In fact, it has become a favorable environment in which to make new investments, albeit at a slower pace than in recent years (this period looks similar to the 2001 to 2003 period, which historically proved to be an excellent entry point into the private equity market). Overall, we continue to believe that a well-diversified portfolio with access to top-tier funds should continue to do well on a relative basis and make a valuable addition to an investment portfolio.

The events of the last few months have led to some reflection on our part as to the structure of the public and private markets, and what the possible implications are for investors. We keep coming back to the fact that private equity possesses many basic structural advantages over other asset classes that may make it attractive as a long-term investment. These advantages become even more apparent when markets become volatile and irrational.

#### STABLE, LONG-TERM INVESTOR BASE

Private equity funds tend to enjoy a stable, long-term-focused investor base. This can provide numerous benefits to private equity firms, foremost of which is the time required to grow the equity value of their businesses. It takes time to change the culture of a company, design an effective strategy, and execute on a business plan. Many times, it takes even longer for the results to show up for investors.

The capital that is invested in private equity funds has a time horizon that can be consistent with this business-building timeline. Private equity fund investors are locked into their investment for ten years or more. As such, private equity firms enjoy the freedom to build their businesses without the “noise” of redemptions and a shifting investor base.

Unfortunately, as recent events have shown, a mismatch between what investors think they have invested in (especially in terms of risk and liquidity) and what they have actually invested in, can lead to unfavorable outcomes for everybody. Due to the structure of private equity funds and the long-term investment horizon of the investor base, private equity tends not to suffer from this mismatch.

#### EVERYONE IS AN OWNER

Private equity enjoys a strong alignment of interest among all the parties necessary to build equity value – everyone is an owner. Agency costs that exist in the public markets may be significantly reduced in the private markets. Business owners (the private equity funds) have the ability to directly control their outcomes because they generally own the majority of the voting stock in the company.

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**Private equity firms enjoy a private setting in which to build business leaders.**

While the funds do not manage the businesses day-to-day, they can align the incentives (generally through outright ownership or options) of top-tier management teams to execute on business plans. In theory, management makes money on their equity ownership if they execute well; limited partners make money if the company is sold at a higher value; and the private equity firms make money if their investors make money by taking a percentage of the profits.

In this scenario, as long as the capital structure has downside flexibility, there usually is no incentive for any of the interested parties to sell into a down market. The control position of the private equity firm allows them to hold if they desire and exit only when warranted; a patient capital base allows this flexibility; and management alignment motivates them to focus on continuing to build the equity value of the business.

### **A PRIVATE SETTING IN WHICH TO BUILD**

Private equity firms enjoy a private setting in which to build business leaders. It costs a lot to build a business into a market leader. You have to invest heavily in research and development to design a product the market wants. You have to hire sales talent to expand the distribution for your products and grow revenue. You have to expand, build or buy manufacturing capacity to keep up with growing sales. A public company has to do all of this while managing earnings to quarterly estimates in order to appease many shareholders who are focused on short-term returns.

In a private equity setting, this is not the case. Private equity firms can come in and take a fresh look at the business and analyze everything from its market position and competitive landscape to its growth forecasts and ability to generate cash. Business plans are normally designed around a five- to seven-year outlook, not quarter to quarter. High upfront costs of executing the plan may be justified by the potential for long-term returns, and investors will not penalize the business over the short term for executing such a strategy.

### **AN INEFFICIENT MARKET**

Private equity funds participate in a more inefficient deal market. When you buy and sell stocks in a public company, the transaction is conducted on an anonymous basis. When you are selling a stock, you do not know who the buyer is, and generally do not care as long as the buyer meets your offer price. This is not the case with a private company.

The sale of a private company can be a lengthy, inefficient process in which personal relationships, face-to-face negotiation, and chemistry can weigh heavily in deciding who the ultimate buyer will be. Information access, deal structures, and long-range business plans can differ widely among potential buyers, and often the entity with the greatest insights and strongest relationships can “win” the business at what may not be the highest offer price. Many times, a seller may want to sell to the buyer who will be the best steward for its business, employees and customers, not necessarily the highest bidder. These inefficiencies may allow private equity funds to buy companies for below-market prices, and hopefully generate above-market returns.

## FOCUS, PURPOSE, URGENCY

Private equity firms tend to bring focus and purpose to improving portfolio companies, and instill a sense of urgency. Due to their control position, private equity firms have the freedom to implement business plans to grow their portfolio companies. This representation means that fund managers have direct influence over decisions that affect investment value, including management team selection, strategic direction, and ultimately the company exit.

In almost all cases, private equity firms believe in simplifying, not complicating, business models. It is hard to value something that you do not understand, and while many people often consider private equity complex and mysterious, the top-tier firms actually make it quite simple. They do this by buying companies they understand, and simplifying business models so that value may be extracted and later recognized by future buyers. Private equity is really fundamental investing at its best, in contrast to the exotic financial engineering and complexity of today's financial world.

## DISCIPLINE AND DIVERSIFICATION

All of these structural advantages make private equity an attractive asset class. That said, investors still need to make sure they execute an appropriate strategy within this framework. Discipline in investment selection remains paramount, as does appropriate diversification.

The bottom line is that we believe private equity should continue to be solid in this environment, and in fact may be even more attractive as a long-term investment. Purchase prices should be lower and debt will be used more prudently. In addition, management teams, private equity firms and investors are economically aligned, and the firms enjoy a patient capital base on which to execute. In our opinion, the current environment has only re-emphasized the fundamental advantages of the asset class.

## FOR MORE INFORMATION

Please contact your Northern Trust relationship manager to discuss your portfolio needs. If you have questions regarding private equity investing, please contact Northern Trust's private equity team.

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