

Where should you invest in private equity today?

September 2018

High levels of private equity fund raising often foreshadow lower returns and vice-versa. Our proprietary Schroder Adveq Fund Raising Indicator quantifies this relationship and highlights a divided market at present. It suggests that investors would be wise to prioritise exits in the large buyout, late stage venture/growth and Chinese renminbi-denominated strategies. For new investments, more favourable conditions exist in small/mid buyouts, early stage venture and in certain emerging markets.

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Investors have flocked to private equity in recent years, attracted by a combination of impressive returns, low volatility and diversification potential. This culminated in 2017 being an exceptional year for fund raising, with the headline amount raised increasing by over 40% year on year, breaking the previous record. New records were also set across many individual categories (Figure 1).

Figure 1: Record-breaking private equity fund raising

Record	Fund	Size	Year
Largest aggregate industry amount*	n/a	\$753bn	2017
Largest fund	SoftBank Vision	\$100bn	2017
Largest first-time fund	SoftBank Vision	\$100bn	2017
Largest buyout fund	Apollo IX	\$24.7bn	2017
Largest European buyout fund	CVC VII	€17.9bn	2017
Largest Asian buyout fund	KKR Asia III	\$9.3bn	2017
Largest venture/growth capital fund	NEA 16	\$3.3bn	2017
Largest US growth capital fund	TPG Growth IV	\$3.7bn	2017

* Combines Preqin and Zero2IPO fund raising data. Includes Chinese renminbi (RMB) funds and 50% of SoftBank Vision Fund (50% assumed to be invested in public markets)
Source: Preqin, Pitchbook, Zero2IPO, Schroder Adveq, 2018

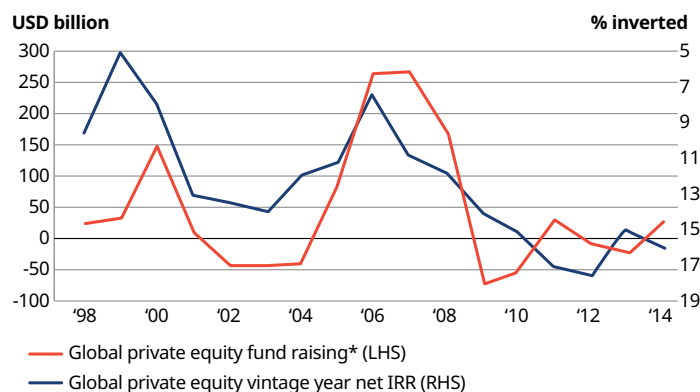
With public company valuations already at very high levels, especially in the US, this flood of private capital has left acquisition multiples stretched, at least in certain segments. EV/EBITDA multiples reached new all-time

highs in both the US and European large buyout markets last year, stoking fears that the market was overheating. Investors are increasingly asking what this means for their existing private equity strategy and new investments.

A leading indicator for performance

Intuitively, it is easy to see that fund raising volumes and future performance may be related. Increased fund raising leads to increased dry powder, tougher competition for deals, higher prices being paid and lower subsequent returns. The reverse is also true with slack periods for fund raising foreshadowing an environment more conducive to performance. Clearly other factors matter too, not least the broader economic and financial market environment but, as Figure 2 shows, the relationship has been reasonably consistent over time.

Figure 2: Increased fund raising has led to lower returns



Past performance is not a guide to future performance and may not be repeated.

* Fund raising amount has been de-trended and inflation-adjusted.

Source: Preqin, Schroder Adveq, 2018

The last two big booms in fund raising occurred in the early 2000s and in 2006-07, both preceding downturns in returns. It is unlikely to be a coincidence that these also coincided with market tops, as enthusiasm for private equity and broader risk appetite are obviously related.

In order to formalise and quantify this relationship in a manner which aids investment decision making, we have developed a proprietary tool, the Schroder Adveq Fund Raising Indicator (Schroder Adveq FRI). It has had a negative correlation with vintage year performance (correlation coefficient of -0.4) and has been a leading indicator for long-term (5-10 year) performance. A high figure has been associated with poor future returns and a low figure with stronger returns. It is calculated by relating cyclical fund raising to the longer-term inflation-adjusted trend, estimated using robust regression techniques under the assumption of constant annual growth. It normalises the magnitude of cyclical over- or under-fund raising in a way that permits comparison across regions and strategies. In this way, it can be used to identify areas of the market that are better placed to deliver returns and those where caution is required.

It should not, however, be relied on in isolation. Although robust regression techniques are used to estimate the long-term trend, data limitations mean that relatively few data points underpin the analysis and the parameters of the regression analysis may change as new data are received. Furthermore, the assumption of constant annual growth may prove unrealistic, especially in maturing or very immature markets. Return data can also be incomplete and subject to biases (e.g. survivorship bias). The indicator might also be less reliable on sub-strategies with fewer funds than for the overall market.

Outside factors must also be taken into account.

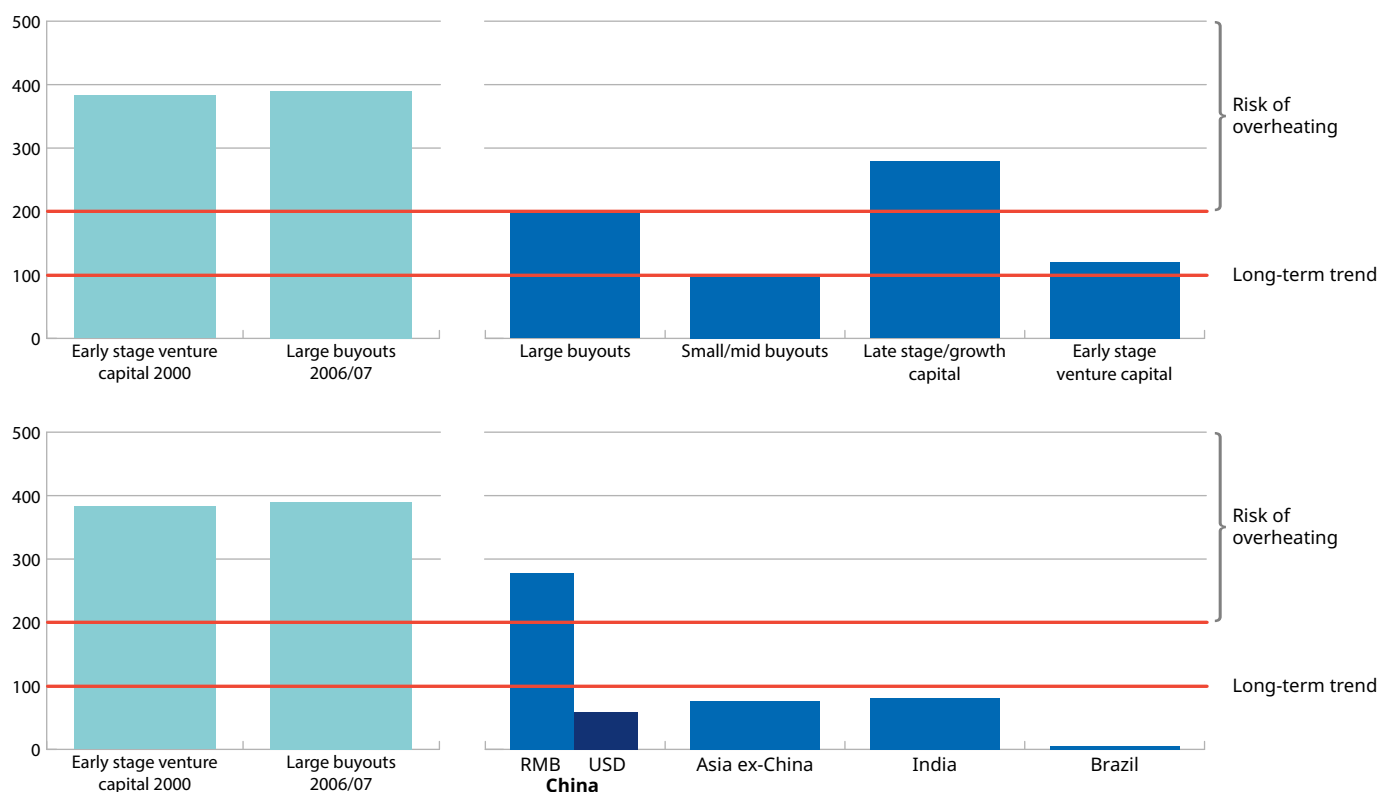
Notwithstanding these reservations, the intuitive underlying rationale for the relationship between fund raising and future returns provides a degree of confidence about the predictive power of the Schroder Adveq FRI.

Where to invest and where to tread carefully

Figure 3, below, shows the current level of the Schroder Adveq FRI across a number of markets (dark blue columns). The peaks of 2000 and 2006-07 are shown for comparison purposes (light blue columns). The underlying fund raising trend analysis for a selection of these markets is also shown in Figure 4, overleaf. At a very high level, the Schroder Adveq FRI highlights that the private equity industry is currently characterised by a bifurcation between segments which are at risk of overheating, and where exits should be prioritised, and related, but less crowded segments that appear a more promising destination for new commitments.

Within the buyout market, the current level of the Schroder Adveq FRI confirms that fears of overheating in the large buyout market are justified, although things are not as stretched as they were before the financial crisis. In contrast, fund raising in the small/mid market has been relatively stable over time. This stability has a structural underpinning. More established small/mid buyout managers tend to migrate towards larger funds and, in consequence, larger buyouts over time. Their departures and replacement by newer managers (who tend to run smaller funds) acts as a natural stabiliser of fund raising volumes in the small/mid sector.

Figure 3: Schroder Adveq FRI



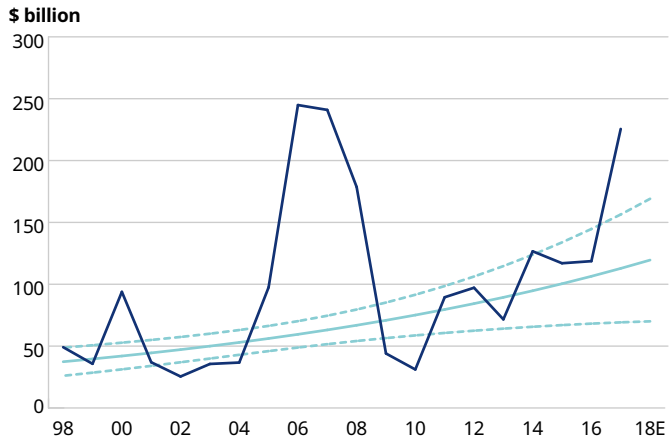
Late stage/growth capital includes 50% of SoftBank Vision Fund and includes investment activity from non-traditional sources of capital (e.g. corporate investors).

Source: Preqin, Pitchbook, Zero2IPO, Schroder Adveq 2018

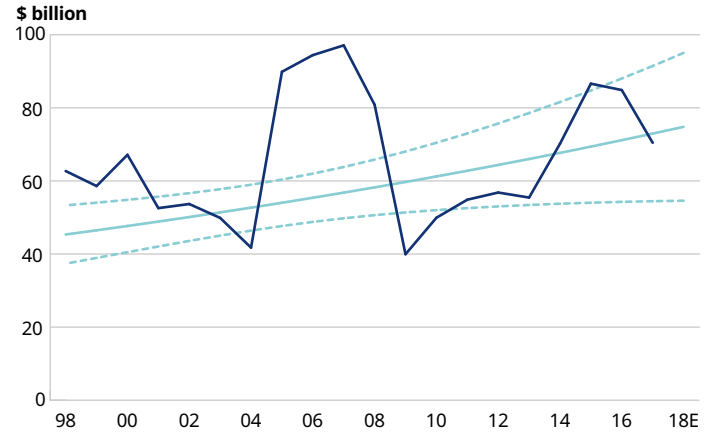
Figure 4: Current fund raising versus trend

— Fund raising (inflation-adjusted) — Long-term trend - - - 80% confidence interval for long-term trend

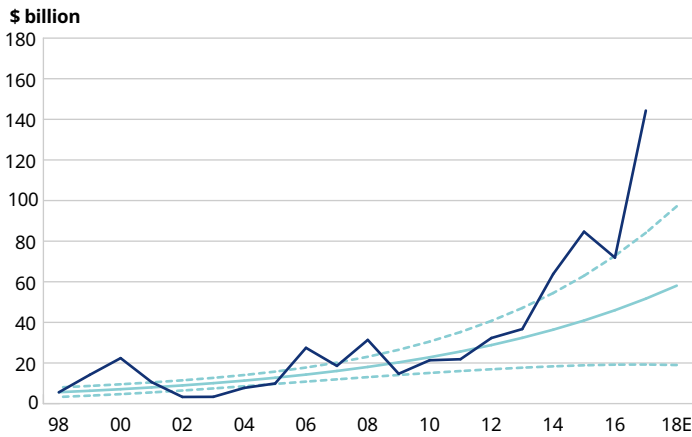
Large buyout fund raising (US/Europe) is heating up, but less dramatically than in 2006-2007...



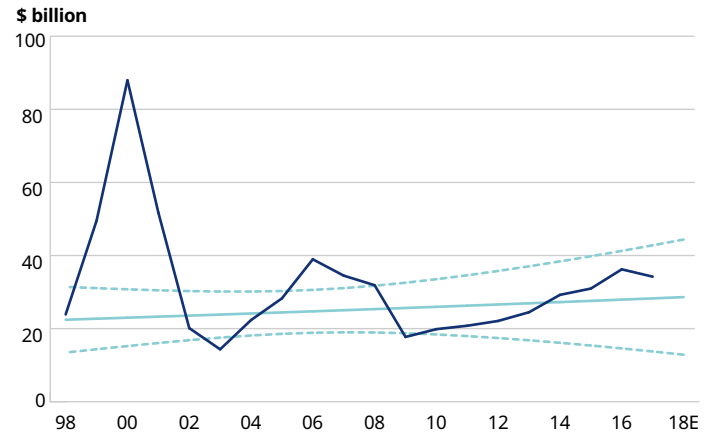
...but small/mid buyout fund raising (US/Europe) is marked by stability



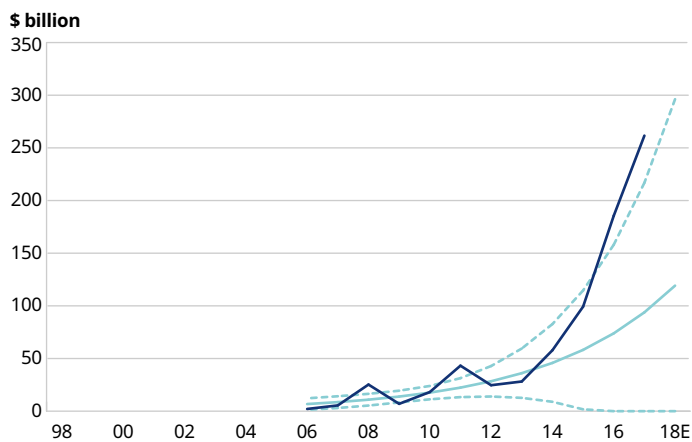
An overabundance of late stage/growth capital (US/Europe including strategic investors)...



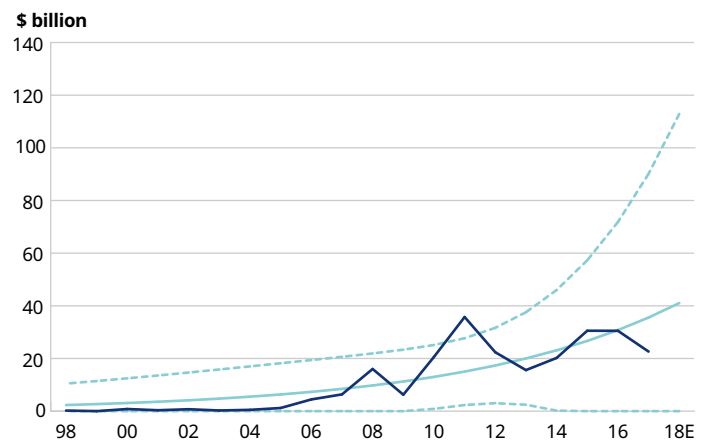
...but early stage venture capital fund raising (US/Europe) is in a healthy state



In China, RMB fund raising has increased...



...but market dynamics look healthy for USD investments in China



Large buyouts are funds at or above EUR/USD 2 billion. Late stage/growth capital includes 50% of SoftBank Vision Fund and includes investment activity from non-traditional sources of capital (e.g. corporate investors). A floor of 0 has been set for the lower bound of the confidence intervals as a negative fund raising amount is meaningless.

Source: Preqin, Pitchbook, Zero2IPO, Schroder Adveq 2018

Similarly, fund raising for late stage venture/growth capital is at an extreme, but earlier stage investments are more favourably positioned. Pricing is already being pushed to very high levels in the late stage venture/growth market – in the US, the median late stage company is worth six times more than it was five years ago. However, investors focused on earlier stage venture have less to be concerned about. Fund raising volumes here have been well contained and healthy new company creation rates are driving a steady increase in deal prospects.

In Asia, and in China specifically, there is further bifurcation. The Chinese USD market looks in good shape, as do India and the rest of Asia ex-China, but the Chinese RMB market has experienced rapid expansion. The track record is

short so it is difficult to be conclusive but, even against a trend growth rate of over 25% a year, recent fund raising volumes have been large. Chinese RMB investors need to be especially discriminating when making new investments. Helpfully for overseas investors, who can access the USD market but generally not the RMB market, there is little overlap between the two. They may therefore be better served by focusing on those parts of the market where there is low or no competition with the RMB universe.

For the brave, Brazil presents an intriguing contrarian opportunity. Fund raising has collapsed close to zero but any investment is high risk given the economic backdrop, so especially careful due diligence and fund selection are imperative.

Conclusion

The Schroder Adveq FRI is a useful quantitative addition to the private equity investor's toolkit, complementing other top-down considerations such as valuations and exit prospects. We plan to update and publish it on an annual basis to aid in investment decision making.

Across the private equity industry, many investors have historically allocated a large portion of their portfolio to large buyouts and late stage/growth capital funds. However, based on signals from the Schroder Adveq FRI, it is time to rethink those allocations for new commitments. A focus on segments with healthier dynamics such as small/mid buyouts, earlier stage venture and certain parts of emerging markets could drive improved long-term results.

However, irrespective of any top-down factors, major performance differences will always exist across private equity funds, even within a single vintage year. Bottom-up considerations are paramount, as always.

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