Aon Investment Research and Insights

Introduction to private equity

February 2019

Aon
Empower Results®

Table of contents

About Aon Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions supports trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

To learn more and to access other research and insights from Aon's investment experts, visit **aon.com/investmentuk**

Executive summary

Private equity can play an important role in institutional portfolios. This typically makes up only a small allocation but can be one of the largest contributors to overall return.

Historically, data has shown clear outperformance of private equity relative to public equity over the long term (15 years). Investors typically invest in private equity alongside public equity.

Over the past decade, the number of companies opting to remain private has increased meaning the opportunity set for private equity managers is better than ever. This will help managers construct a fully diversified portfolio of companies, accessing firms that are off limits to public equity managers.

Unlike traditional public equity managers who buy securities which they expect to increase in value, private equity managers can take control of businesses and, through their changes, create value. As private equity managers drive value, returns are less dependent on broad equity market movements and are dependent on the skill of the manager.

Within private equity, investors often invest in buy-out and turnaround strategies which involve investing a majority stake in companies that require strategic work or restructuring. We would advise clients to select managers with proven expertise in these areas.

We encourage investors to consider an allocation to private equity to diversify their overall equity allocation. Even a small allocation to private equity can have a large contribution to overall return.

What is private equity?

Private equity is an investment that involves a purchase of part, or all, of a company that is not listed on a public stock exchange. The investment is used to enhance value and improve performance before being sold for a significant profit.

Private equity investing evolved from the requirement from early stage companies for private capital to help growth.

In recent years, there has been an increase in private equity investing due to the attractive returns, increased focus on governance and volatile public equity markets.

Performance relative to public markets

Over the long term, private equity has outperformed public equity markets. Returns are typically paid back over the life of the investment as stakes in companies are sold. Based on our Capital Market Assumptions over the next 10 years, we expect global private equity to return 8.9% p.a. with volatility of 27.5% p.a., relative to global public equity returns of 7.5% p.a. with volatility of 20.0% p.a.

Lifecycle of a private equity fund

Creating value takes time hence a private equity fund is usually an illiquid fund structure with a life of approximately 10-12 years.

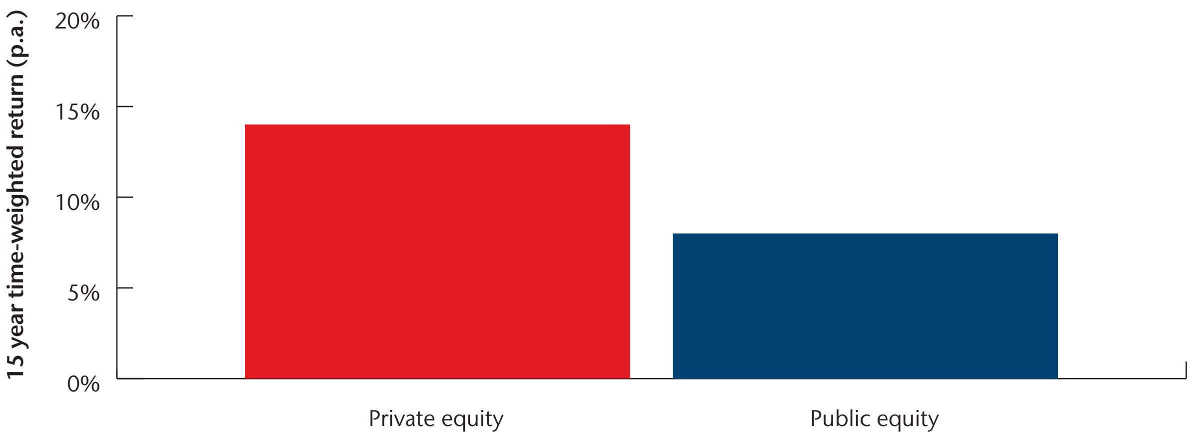
After an investor has committed to a fund, capital will be drawn down periodically as portfolio companies are purchased, this is the investment period. This period usually lasts for five years.

The manager will make enhancements to the business before selling it and the proceeds are returned to investors.

Use of managers

Investors typically employ specialist private equity managers who have experience in increasing the value of businesses. These managers typically invest their own capital alongside capital of outside investors and build a diversified portfolio of companies.

Private vs. public equity performance



Source: Burgiss and Investment Metrics as at 30 June 2018. Private Equity = Burgiss Global PE Index (USD); Public Equity = MSCI ACWI Net Dividend Return (USD).
Burgiss Global PE is a benchmark used for private equity. The specified return has been calculated by taking the quarterly pooled average returns of private equity funds in the market.
Note: Past performance is not a guide to future returns.

How returns are generated

Private equity managers have several unique return levers relative to traditional equity and bond managers. The below features apply in the context of individual businesses which are then combined into a private equity fund.

Inefficient market / private information

Although private equity managers often invest in companies through auction processes, they also can access companies through direct negotiations with their networks.

The lack of public information generally allows skilled managers to gain advantages over other investors at purchase—from sourcing opportunities to pricing.

Active management

Taking majority control positions in a company and having board representation allows private equity managers to make changes to the company's structure and strategy.

Managers can implement full or partial corporate restructuring initiatives. Restructuring can include, but is not limited to, changes to legal entities, ownership structures, operations, management teams (including the CEO) and merger and acquisition activity.

Wider opportunity set

Post the global financial crisis, the number of companies taking their businesses public has been decreasing largely due to a heightened regulatory environment. Many high growth and profitable companies, notably technology firms, are now remaining private for longer or do not plan to go public at all. Private equity managers are able to capture these opportunities to generate attractive returns.

Use of financial leverage

Private equity fund managers will often use borrowed capital (debt) to finance deals – referred to as leverage. The use of leverage can magnify potential profits as debt is cheaper than equity, however it can also magnify potential losses hence should be used with caution. The use of leverage has been cyclical, and although it has been going up recently, it is still lower than pre-financial crisis.

Top talent

Although private equity funds have relatively high management fees compared to public equity funds, the potential for large gains in terms of carried interest (profits from growing the business) allow private equity funds to offer top-tier remuneration to employees and attract high quality employees.

Aligned interest

Investment staff at most funds will commit capital alongside investors to ensure that the alignment with investors is strong. This provides a motivation for the team to add value and generate returns.

The ability to take a long-term outlook on companies and control liquidity

The life of private equity funds is typically at least 10 years. Managers make a long-term commitment on portfolio companies in comparison to public equity markets, where annual or even quarterly earnings changes are used to judge performance.

Managers also benefit from the flexibility of choosing when to sell portfolio companies, managers can hold onto companies through market downturns to limit losses.

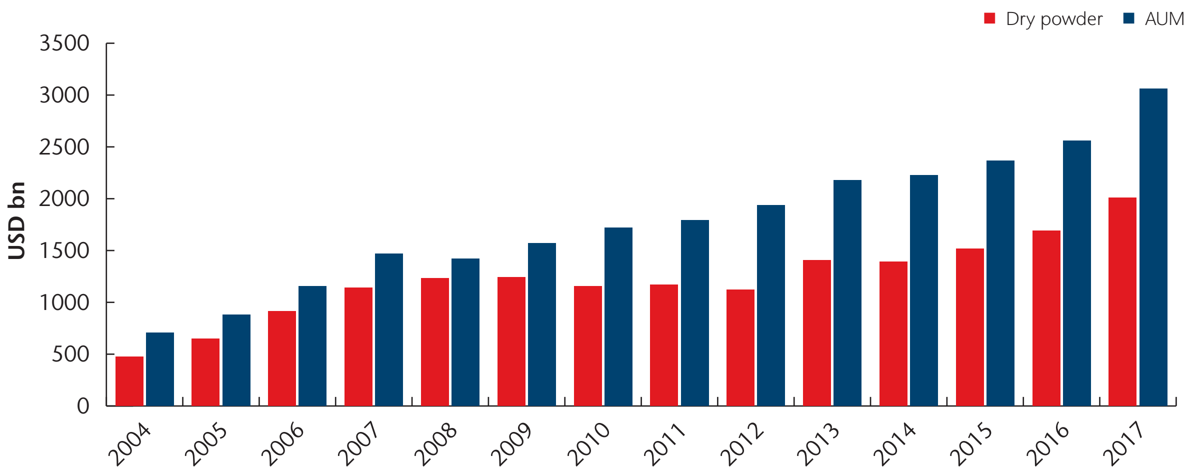
Overcoming the challenges facing the industry

Historically, strong returns have attracted more private equity investors into the market, increasing market competition, however this can be mitigated by investing in top percentile managers.

The private equity market place is fiercely competitive with assets under management continuing to increase steadily. Based on a recent survey[1], 79% of private equity investors plan to increase their allocation to private equity over the next five years. This is the largest increase compared to the other alternatives covered in the study.

Furthermore, record levels of dry powder, defined as yet-to-be-invested committed capital, mean there is a lot of capital already waiting to be put to work by managers.

AUM and dry powder



Source: Preqin

Finding value is becoming increasingly difficult

Due to high demand valuations have increased, hence a key challenge for managers will be finding value in competitive markets. Managers are having to pay more for companies, squeezing margins. Managers may look to source deals with exposure to emerging markets, which is predicted to account for 50% of global economic growth over the next 20 years.

Downward pressure of fees

The private equity industry is known for charging high fees to investors, traditionally a standard fee schedule is a 2% management fee and 20% carried interest. Carried interest is effectively a performance fee.

However, increased competition between fund managers and heightened pressure from the regulator has caused managers to be more transparent with fee schedules, offering fee discounts for first closers or offering a trade-off of a lower management fee for a premium carry. Although fees are still high, we're seeing the right direction of travel in the industry.

[1]Source: Preqin

The price of debt is rising

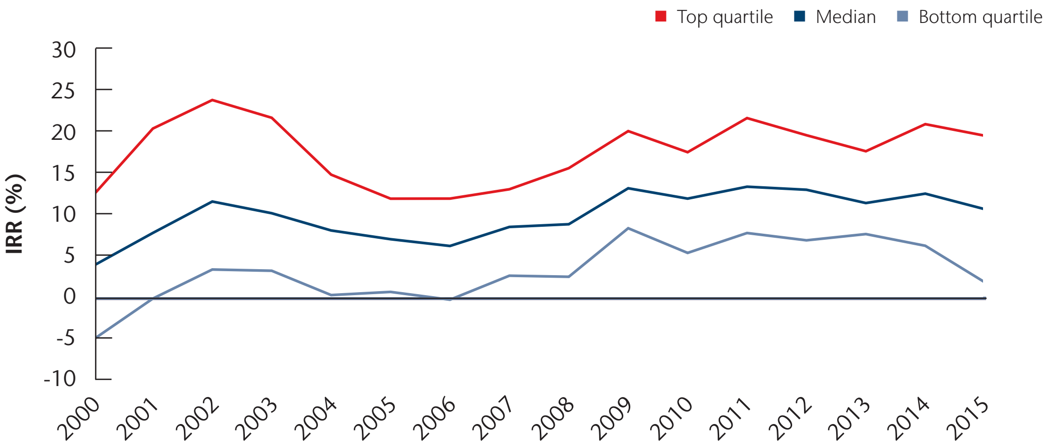
Post the financial crisis, private equity dealmakers have been able to source cheap debt financing which has bolstered investment returns. Debt financing is likely to become more expensive hence it will be ever more important to select high quality managers.

Manager selection is key

Given the increased competition, manager selection will remain paramount. Historically, there has been significant disparity between the returns of top performing managers and their peers. The internal rate of return ("IRR") is a measure of an investment's rate of return. The IRR chart shows that the top and bottom quartile funds (which launched in 2000) can vary in return by c.17% per annum (see chart below).

Market conditions make it critical for managers to source attractively priced deals. Top managers will be able to utilise their propriety networks to source deals at a good price.

IRR quartile boundaries by vintage year



Source: Burgiss.
Note: Past performance is not a guide to future returns.

Accessing private equity

Investors can gain exposure directly by taking equity positions in companies, or indirectly through a private equity manager.

Vehicle	Benefits	Drawbacks
Co-investments An investor, such as a pension scheme, invests directly into a company, alongside a private equity manager or another party	• Lower fees • Ability to hand pick deals • Accelerates time to attain targeted private equity exposure	• High concentration risk • Significant time and expense to implement • Usually available only to primary fund investors • Short time frame for investment decisions
Primary fund An investor invests in a fund of private equity investments managed by a private equity manager	• One layer of fees • Ability to make tactical allocations • Better control of timing and amounts of capital deployment • Allocations can be tailored directly to investor's overall risk appetite	• Requires large number of funds to manage concentration risk. A diversified portfolio is therefore only for larger investors • Significant time required to build and manage portfolio • Expense to find managers and review legal documents
Fund of funds Under this structure, an investor commits to a fund which invests in primary funds on the investor's behalf	• High level of diversification • Administratively efficient • May provide access to specific regions or niche strategies • Available for small commitments	• Two levels of fees reduce returns • Potentially 'index like' returns • No control of timing or amount of capital deployment • Less access to transparency to portfolio companies
Secondary funds Secondary funds invest into primary funds that are a few years into their life cycle. Secondary fund managers will often buy stakes from investors in a primary fund looking for liquidity	• High diversification • Acquired assets are known at purchase, unlike fund of funds • Faster investment and shorter time horizon to distributions • Can accelerate time to reach target private equity allocation	• Two levels of fees reduce returns • Returns highly impacted by secondary market conditions • May not provide access to high quality general partnerships • Less strategic allocation flexibility

Real life case studies

Below are examples of real life businesses that were bought by a private equity manager and exited for a profit:

Farfetch.com

Farfetch.com is a leading e-commerce marketplace and digital innovation platform for luxury fashion brands. The manager initially invested in early 2014 after seeing compelling qualities.

The manager saw strong secular growth in a large global luxury apparel online market, which was growing rapidly. Farfetch offered a unique customer proposition due to wide range and variety of products for customers through boutique stock aggregation. The business model is asset-light through the usage of boutique inventory. The manager also saw that the market had high barriers to entry through development of a global online customer base.

The manager created value and expanded Farfetch globally. Farfetch.com went public on the New York Stock Exchange in September 2018, with largely a primary offering which was reportedly 20x oversubscribed. The manager still retains some ownership, however by listing the company the manager has crystalised some added value.

Trainline

Trainline is an online and mobile-led consumer brand, selling tickets through its website on behalf of train operation companies (‘TOCs’) such as Virgin Trains.

Previously, Trainline was owned by a group of TOCs, who struggled to run the business as an independent entity. The company was run as a technical service provider rather than a consumer-focused business, which limited its investment and growth opportunities. The UK focused manager saw the strong market position of the firm and the opportunity to add value.

Once acquired, the manager repositioned the business by replacing management and transforming the business from a white-label ticketing provider into a high growth consumer brand. At exit, the manager achieved an 18.4% gross IRR and Trainline was the most downloaded travel app in the UK.

Trainline was sold to another private equity firm, who have now expanded Trainline beyond the UK. The firm now operates across Europe.

Private equity in your portfolio

Private equity is an attractive asset class that is often overlooked; by choosing the right strategy and appointing a best in class manager the impact on return can be materially positive with the inherent risks mitigated.

We believe that if clients can afford the illiquidity, adding exposure to private equity is a great way to bridge a funding gap or contribute to fund returns. For clients that can tolerate higher risk and reduced liquidity levels, opportunities within private equity offer compelling risk-adjusted opportunities.

We advise clients to allocate no more than 5% to 10% of total assets to private equity. For schemes with assets of £1bn or above, we would advise co-investment or primary investment, as described above. These investors can build a diversified private equity portfolio with a minimum allocation of c.£50m. For schemes over £100m and under £1bn, we recommend a Fund of Funds or secondaries strategy as the minimum investment threshold for entry into these funds is typically c.£10m.

Although margins are tightening and it’s becoming increasingly difficult for managers to find value, the private equity opportunity set is growing and these risks can be mitigated by careful manager selection.

We see private equity fitting into client portfolios alongside a public equity holding. With the equity cycle nearing an end, we believe superior returns are generated by active management. Private equity offers the highest form of active management with managers driving changes and creating value.

We're here to empower results

For any further discussion, please get in touch with your Aon consultant or one of our private equity specialists.

Contacts

John Belgrove
Senior Partner
john.belgrove@aon.com
+44 (0)20 7086 9021

Kate Charsley
Partner
kate.charsley@aon.com
+44 (0)117 900 4414

Tim Giles
Head of UK Investment Consulting
tim.giles@aon.com
+44 (0)20 7086 9115

With thanks to our authors

Jorge Huitron
Senior Consultant
Global Asset Engine

Olivia Kebble
Investment Analyst
Global Asset Engine

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

For further information on our capabilities and to learn how we empower results for clients, please visit http://aon.mediaroom.com.

Registered Office:
The Aon Centre
The Leadenhall Building
122 Leadenhall Street
London EC3V 4AN

aon.com

Empower Results®