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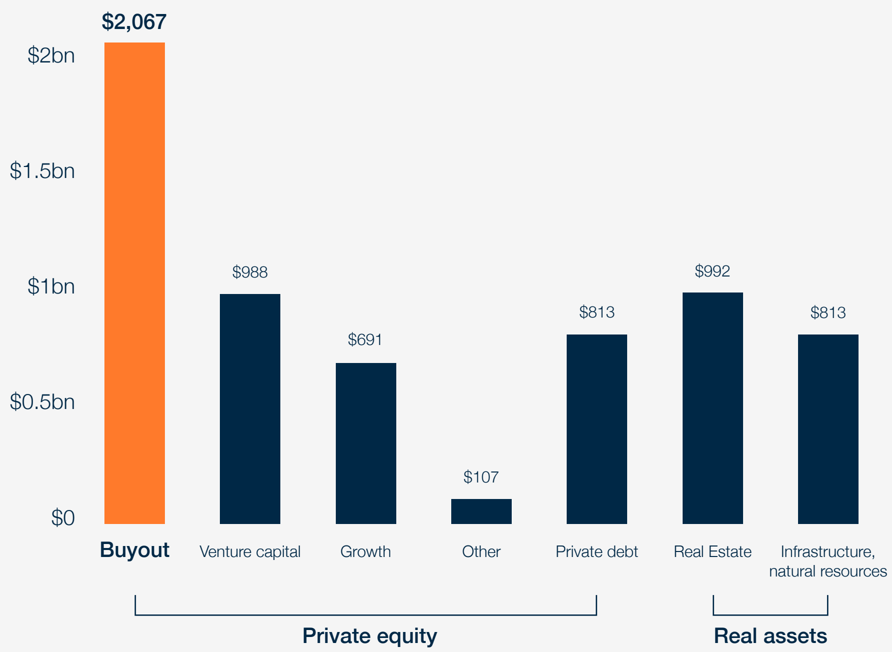
How buyout funds create value:

a 20-year story of outperformance

Of all global private capital in 2019, 32% was invested into buyout funds.[1]

Buyout funds represent the most mature, developed segment in private equity, an asset class that has frequently outperformed the public markets in recent decades, and one that is now becoming increasingly accessible to the individual investor. Any investor considering alternative asset classes needs to understand buyout funds, how they have created value so effectively over the last two decades, and the different ways of incorporating them into their investment strategy.

Figure 1: Buyout funds leading private market assets under management, H1 2019



Sources: Preqin, cited from McKinsey & Company, McKinsey Global Private Markets Review 2020
Note: Figures are rounded to nearest million

In this report, we explore buyout funds and their significance to private investors, looking at three key areas:

1. How and why investing in private markets has boomed over the last 20 years
2. How buyout funds work and the ways in which they create value for investors
3. How individual investors can access these funds, and what investor profiles they may suit

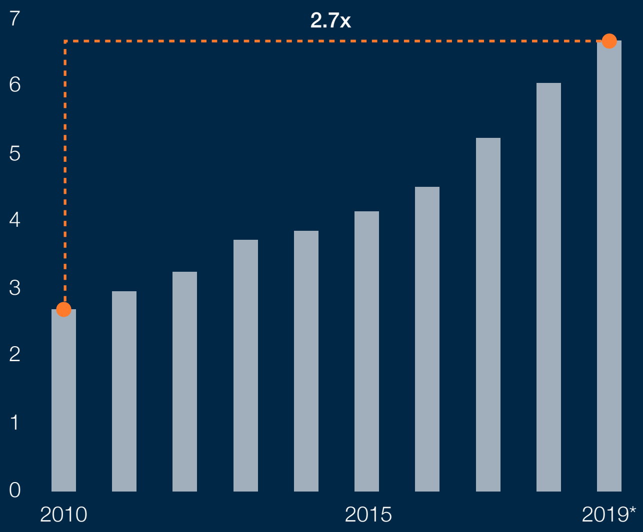
1 Bain & Company, Global Private Equity Report 2020: Buyout funds include Private Equity, Real Estate, Infrastructure and Natural Resources

Private Capital grew from niche to a well established asset class

The last two decades have seen a marked shift in the investment landscape as assets and returns have increasingly shifted into private markets.

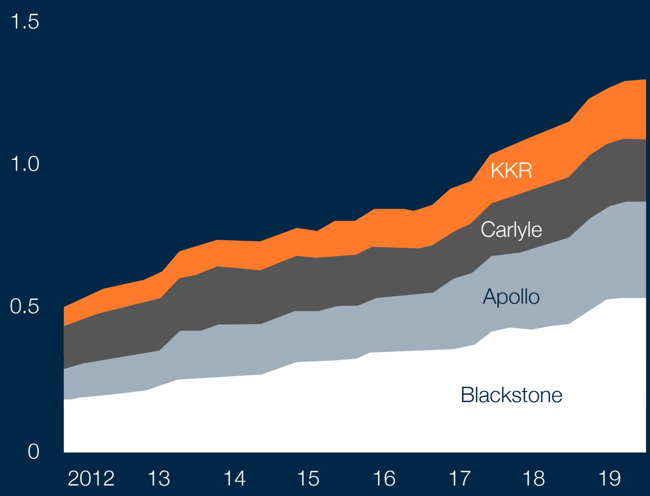
Most recently, since 2010, assets under management (AUM) in private markets have grown 2.7x, totalling $6.5 trillion in the first half of 2019. This has been driven by institutional investors, who have steadily grown their allocations since 2012.

Global private capital, AuM 2010-2019, in US $trn



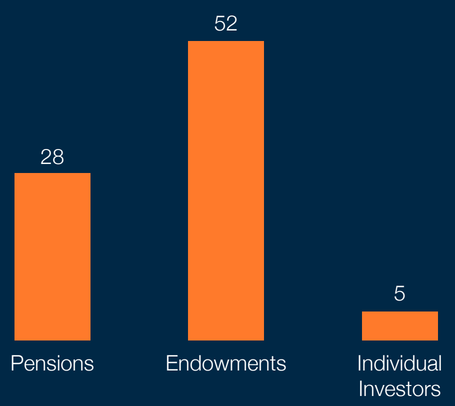
*At June 2019
Source: Preqin

Top four private-equity companies' AUM, in US $trn



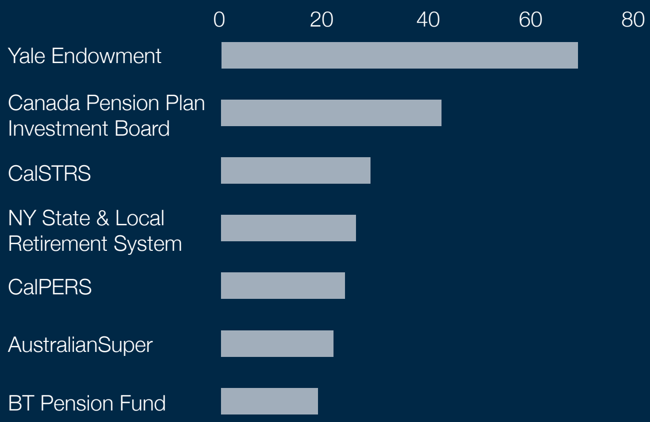
Source: Bloomberg

Exposure to Private Markets investments of different investor classes, % of total



Sources: Willis Towers Watson, "Global Pension Assets Study", 2019; National Association of College and University Business Officers, "TIAA Study of Endowments", 2018; Money Management Institute, "Retail Distribution of Alternative Investments", 2017. Averages provided are dollar-weighted. Cited from Blackstone Group Seeking an Alternative: Understanding and Allocating to Alternative Investments

Endowment selected funds, estimated assets in private markets, 2009 or latest, % of total



Sources: Company reports; The Economist

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Three factors explain the steady and sustained movement of capital into the private markets, and the emergence of private equity into the mainstream:

1. Addressable market: The opportunity set is much greater - private companies represent 10x more market cap than publicly listed ones.[2] Additionally, the number of publicly listed companies in the US has declined by 50% since 1996.[3]

2. Outperformance: Private equity has maintained a consistent record of outperformance: according to a study by JPMorgan Asset Management, private equity generated 14.4% net annual returns between 2003-17, compared to 8.8% from the MSCI World equity index. Since 2000, the net asset value of private equity companies has grown more than 8x, compared to 2.8x for publicly quoted companies.[4]

3. Institutions: Institutional investors have been increasing their allocations to private equity, with 52% of endowments and 28% of pension funds now invested in the asset class. In turn, the number of private equity managers has increased, with private equity firms growing in number by 143% between 2000-2014.[5]

Within private markets as a whole, the most established segment is buyout funds, which collectively raised $361bn last year. Buyout funds are the most common form of private equity. They typically invest by taking a controlling stake in privately-held companies, working to improve the operational efficiency and profitability of these businesses, so as to enhance the return on investment when the stake is sold. These funds will sometimes also take public companies private, and use leverage (borrowing) to acquire larger assets and target excess returns.

Buyout funds are distinct from venture capital funds, which typically take a minority stake in early-stage companies and exercise less control; and growth funds, which do the same with more mature companies.

If private markets as a whole have been a source of rapid asset growth in recent decades, that has largely been driven by private equity, which grew by 12.2% between 2018 and 2019. And within private equity, the biggest engine is the growth and performance of buyout funds, which now account for their highest share of private capital since 2006.

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2 World Economic Forum (April 12, 2018), Fueling the US economy's middle market growth engine

3 Bloomberg (April 9, 2018), Where Have All the Public Companies Gone?

4 McKinsey Global Private Markets Review 2020

5 Pitchbook (June 10, 2015), Number of Active private equity firms up 143% since 2000: A global breakdown

6 Bain & Company, Global Private Equity Report 2020

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Value creation in buyout funds

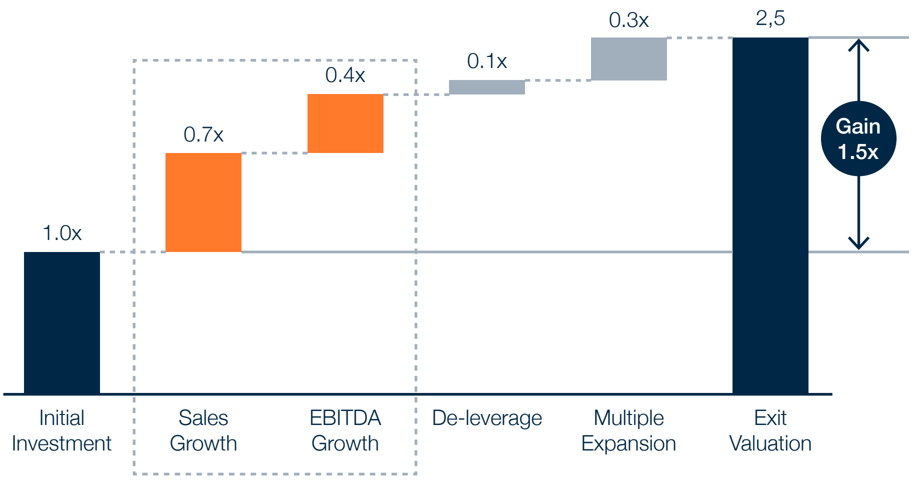
The historic outperformance of buyout funds is no accident. It derives directly from the ability of fund managers to add value to the companies they invest in, generating returns through an active approach to investment and management.

Unlike investors in public equities, who must trust in a target company's ability to create value without intervention, most buyout funds actively manage their investments. A fund's general partner (GP) and team will work closely with each portfolio company's management to improve its efficiency, performance and valuation multiple.

The evidence bears out the value created by this active approach. An analysis by the Moonfare investment team of five completed funds selected for their success found that 72% of the incremental value created from investment to exit could be attributed to operational changes that resulted in revenue and EBITDA growth.[7]

In this section we look at four main drivers of this value creation: management effectiveness, operational support, access to finance and multiple expansion (Figure 2).

Figure 2: Active Manager Interventions and Financial Value Impact
The leading buyout funds have developed platforms and playbooks to consistently create value for their investments
Illustrative Financial Value Impact (sample of five leading buyout funds assessed by Moonfare due diligence)



Source: Performance attribution of all exits for 5 complete funds of recent Moonfare GP due diligence

Value creation in global buyout platforms
Active Manager Intervention

1. Step-change the effectiveness of a firm's management

- Superior governance model
- Equity incentive to turn managers into owners
- Talent upgrade

2. Increase top-line growth and margins through operational support

- Process and systems improvements
- Expand sales & marketing effectiveness
- Global network produces synergies

3. Support strategic changes by providing direction and capital market access

- M&A to consolidate fragmented markets
- Anti-cyclical investments using funds' capital access
- Increase capital efficiency

4. Non-Operational Factors

- Deleverage
- Multiple Expansion

7 EBITDA stands for Earnings Before Interest, Tax, Depreciation and Amortisation and is a commonly used metric for profit

i) Improve Management Effectiveness

The ability of a leadership team is usually one of the most important factors that determines a firm's performance. Buyout funds work with management teams to increase their effectiveness in a number of ways.

- Superior governance: Fund partners will take board seats and often appoint independent senior advisors (frequently ex-CEOs from the industry) to bolster governance and lend expertise. This enhanced board will typically meet on a monthly basis to review financial updates, progress against operational milestones, and strategic planning in detail. That compares to the less intensive, quarterly board meetings of most public companies. By taking this approach, buyout funds can be hands-on, keep management teams accountable, and provide advice on strategic issues as they occur.
- Equity incentivisation: Funds will instigate or optimise long-term incentive plans for management teams, and sometimes the wider employee group. By disproportionately rewarding outperformance (measured against the target exit valuation), these incentives encourage an ownership culture among management teams – aligning them to the same ultimate goals as investors.
- Talent upgrade: A major area of focus for buyout funds is performance management and talent development. Fund managers will review skill levels and performance at all levels of a business, and identify where changes should be made to ensure the company can maximise execution and innovation. In certain cases this will include replacing the CEO, to bring in someone who has experience working with private equity investors to create value.

ii) Enhance Operational Support

Not many mid-market private companies can claim to operate to the same standard as the global leaders in their industry. The role of buyout fund partners is to bridge this gap, leveraging their experience to help portfolio companies develop best-practice processes and systems. This operational support comes in many forms, but focuses especially on three areas:

- Business operations: Many funds have a central operations team that can help portfolio companies improve systems from the supply chain to management reporting. Using the knowledge gained from supporting digital transformation across multiple companies and industries, funds are ideally placed to help their companies implement standardised processes and best practice – helping them meet changing customer needs and retain competitive advantage.
- Revenue growth: With revenue growth being the single largest driver of value creation, funds and their operations teams will focus on supporting portfolio companies to achieve this – whether through entering new markets, leveraging additional distribution channels, or improving sales and marketing. Funds also bring deep industry experience that help them advise portfolio companies on how to grow revenue and build market share.
- Platform synergies: Buyout funds have access to a global network of resources that portfolio companies can use to their advantage. For example, private equity companies including KKR and Blackstone use a shared buying platform (CoreTrust) that provides a significant benefit in procurement costs. Via their global office network they can assist with internationalisation and connect portfolio companies with partners and customers in their network. We have observed that large buyout funds focused on leveraging their operational platforms not only deliver above average returns, but also do so more consistently.

iii) Access to Finance and Capital Markets

Buyout funds also support portfolio companies through financial expertise: helping them to access credit, invest in inorganic growth (M&A), and make anti-cyclical investments. private equity's access to capital and ability to structure complex capital transactions give portfolio companies a financial advantage over their peer group, something that can be especially important during downturns.

An analysis of how private equity-backed companies in the UK fared during the 2008 recession, compared to those without private equity support, showed that the former group both saw a smaller decline in investment during the crisis, and was able to recover and gain market share more quickly in the aftermath.8 This was attributed to their superior access to capital and fewer financial constraints.

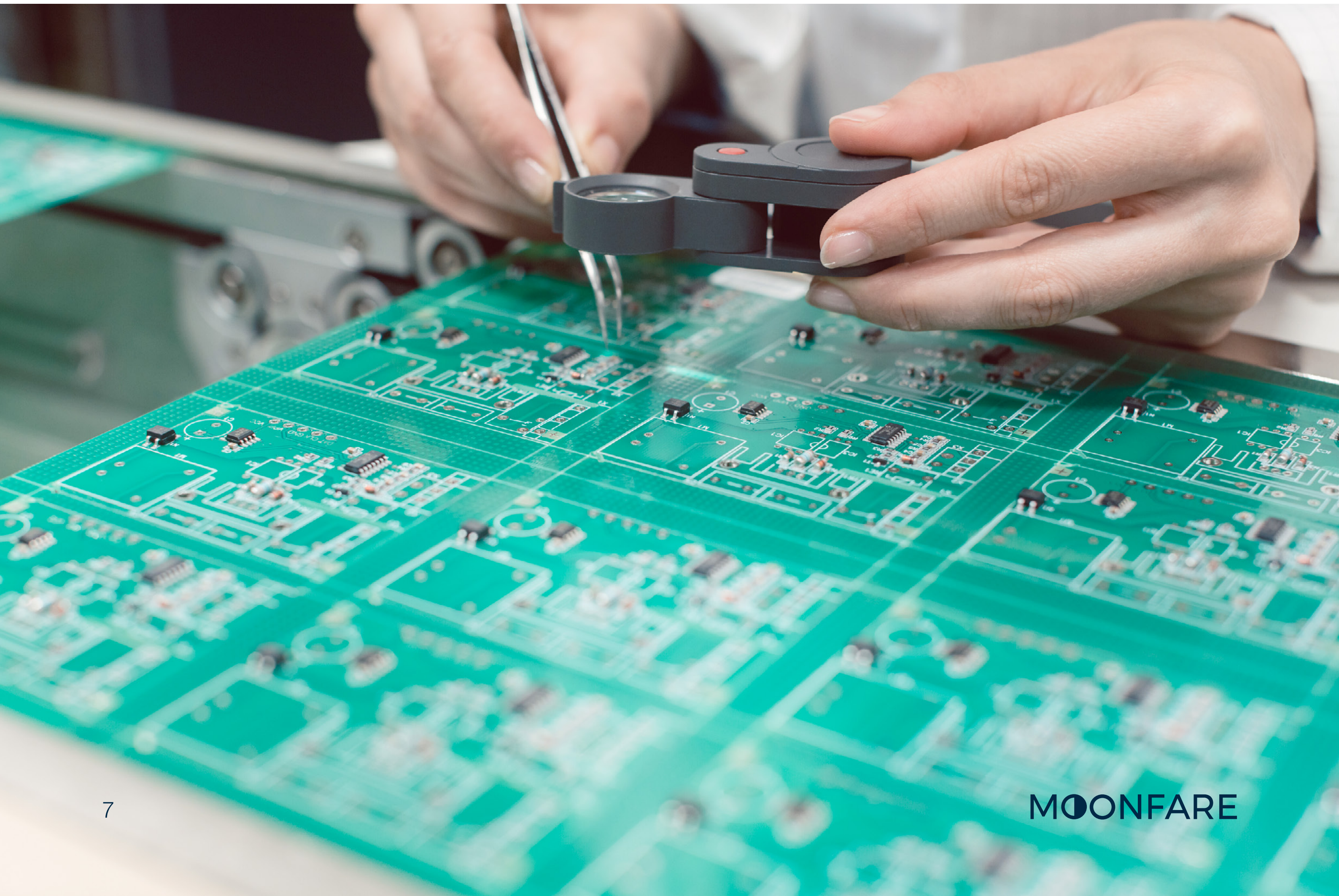
Far from the myth that private equity creates value primarily through financial engineering, this underlines that private equity-backed companies frequently benefit from greater financial flexibility and firepower. Additionally, as our analysis has shown, changes in portfolio companies' debt structure have played by far the smallest role of all private equity interventions in value creation.

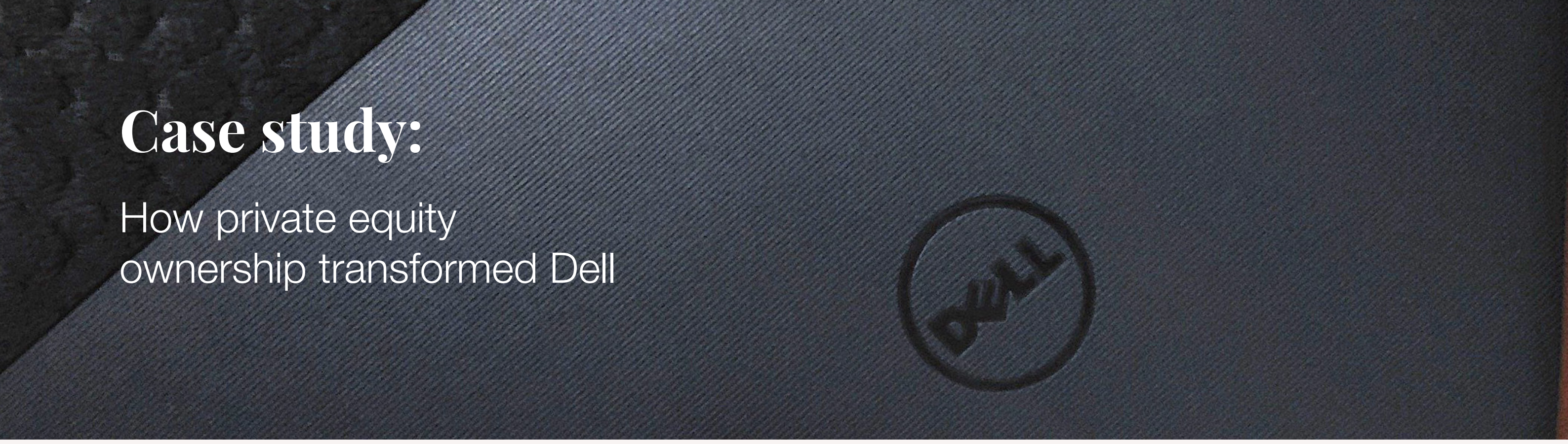
iv) Multiple Expansion

Finally, funds will work to achieve multiple expansion: selling portfolio companies at a higher valuation (expressed as a multiple of enterprise value over EBITDA) than they were acquired. The ability to do this partly depends on the initial choice of investments, with some funds focusing on companies which are undervalued or have significant room for operational improvements. In other situations, timing, competitive advantage or information access can play an important role in driving multiple growth.

Equally, many flagship buyout funds seek to acquire market leading businesses where the multiple is already high, but can be expanded further through operational improvements, or acquisitions made using leverage. Ultimately, the ability of buyout funds to achieve multiple expansion through improving the health of an underlying business, and achieving a timely exit to either the public markets or a strategic investors (both of which tend to embrace higher valuation multiples) is one of their most important means of creating value.

8 S.Bernstein, J. Lerner and F.Mezzanotti, "Private Equity and Financial Fragility during the Crisis": https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/PE_UK_new_paper.20170304.pdf





Case study:

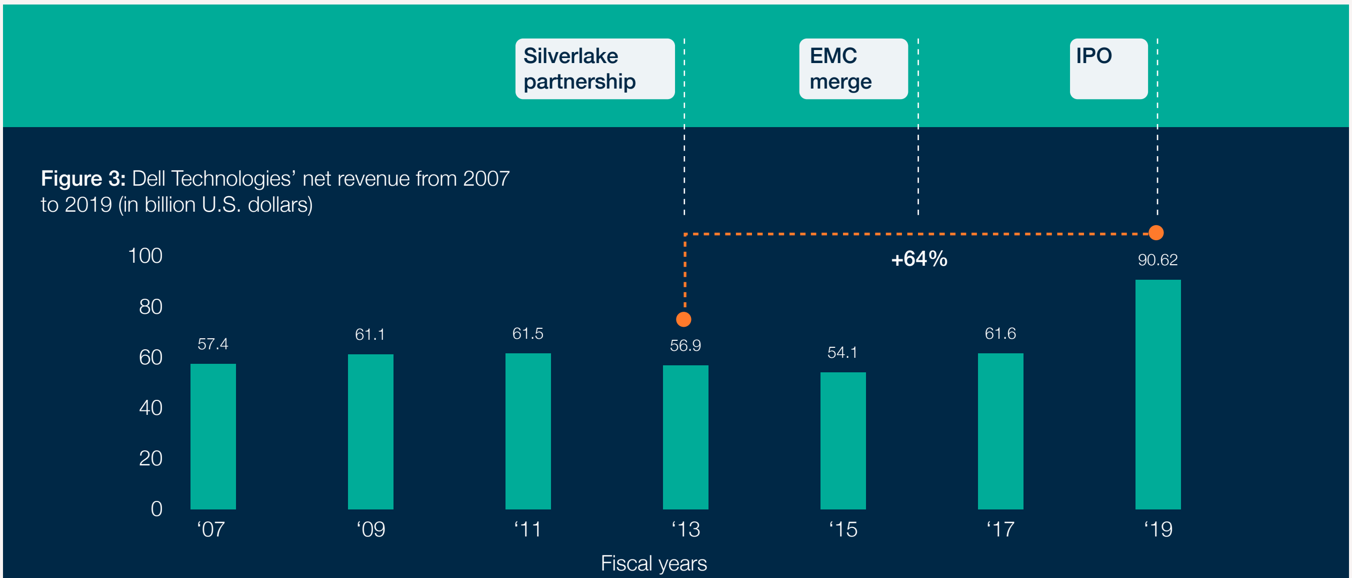
How private equity ownership transformed Dell

A legendary name in the computing industry, Dell was a pioneer of custom configurated PCs, and a recognised brand the world over. But, by the end of 2012, it was struggling: its PC market share had dwindled to little over 10 percent, and shipments were down by a fifth as customers turned to mobile and tablet devices.

It was at this point that the founder, Michael Dell, partnered with private equity firm, Silver Lake Partners, to take Dell private through a leveraged buyout: halting the firm's 24-year run as a public company. As a private equity-backed company, Dell pursued an ambitious turnaround strategy: reducing its reliance on the challenging hardware market to focus on enterprise software, services and IT solutions. The centrepiece was Dell's 2016 merger with data storage and security company, EMC, at $67bn the largest technology deal in history. As a private company, it also more than quadrupled its investment in R&D.

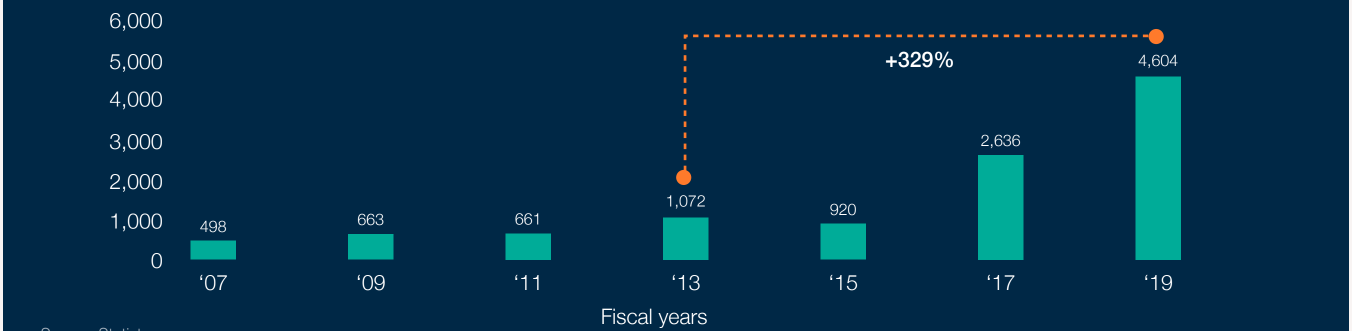
Having used the time as a private company to overhaul the business, Dell went public again in December 2018. Silver Lake, which had invested an estimated $2.4bn, held a stake that was worth over $6bn in January 2019. With private equity backing and management, Dell was transformed as a business and delivered a substantial return to investors: underlining the value that buyout funds can create.

Figure 3: Dell Technologies' net revenue from 2007 to 2019 (in billion U.S. dollars)



Source: Statista
Note: The fiscal year ends either at the end of January or start of February of the respective financial year (Fiscal year 2020 ended January 31 2020 for example)

Figure 4: Dell Technologies' expenditure on research and development from 2007 to 2019 (in million U.S. dollars)



Source: Statista
Note: The fiscal year ends either at the end of January or start of February of the respective financial year (Fiscal year 2020 ended January 31 2020 for example)

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Investing in buyout funds

A recent Bloomberg Law analysis shows that despite the financial difficulties generated by the Covid-19 crisis, private equity M&A market share and buyout volumes remain solid. In the US alone, there is $101.3bn in proposed, pending, and completed private equity buyouts in 2020, a 15% rise from 2019.

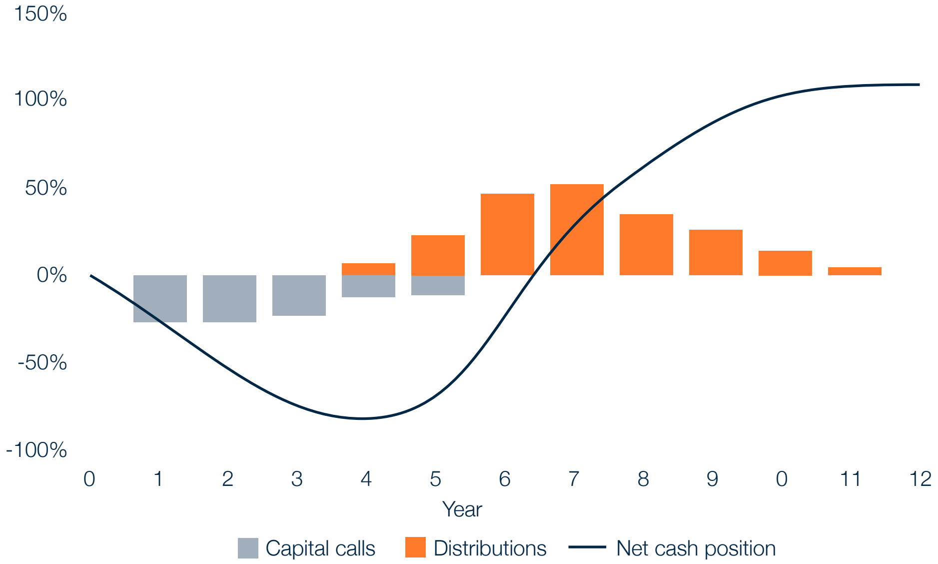
For those who have not previously invested in private equity, there are some important considerations to bear in mind:

1. Cashflow

- Illiquidity - unlike in public markets, there is no regular trading of shares, this illiquidity premium is the foundation of private equity.
- Capital commitments - investors typically commit their capital to a fund over its decade-long lifetime, with capital calls spread out over the first few years.
- Distributions: Funds make distributions progressively as assets are sold, the typical holding period for an asset being 3-5 years.

This leads to a ‘J’ curve of cash flow, as Figure 5 illustrates.

Figure 5: The expected cash life-cycle of a private equity fund



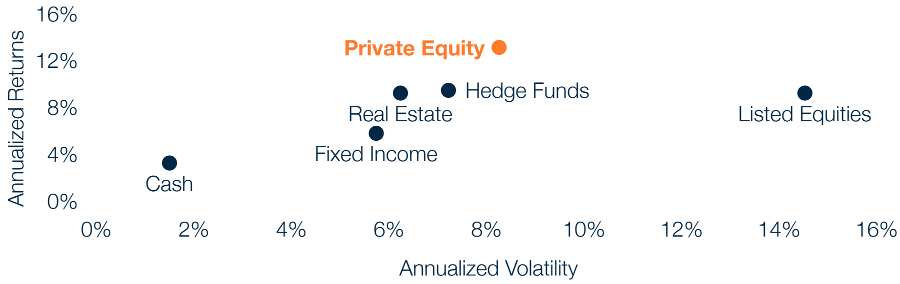
Source: Moonfare
Note: For demonstration purposes only. Private equity investments are inherently risky

Essentially, investors are engaging in a trade-off: lower liquidity in return for the potential of higher returns, creating the time needed for managers to make the strategic and operational changes that generate value.

2. Role in portfolio

Data from at least the last three decades shows that private equity has provided investors with the highest risk-adjusted returns as an asset class. private equity offered the highest annualized returns among the major asset classes while exhibiting less volatility than listed equities, even when desmoothing private equity returns (Figure 6).

Figure 6: Asset Classes Risk Return Chart



Source: McVey, H., H. (2018). Rethinking Asset Allocation (Rep.). New York: KKR Global Institute
Data as at 1Q86 or earliest available to 4Q17, and de-emphasizing 2008 and 2009 returns at one third the weight, due to the extreme volatility and wide range of performance which skewed results

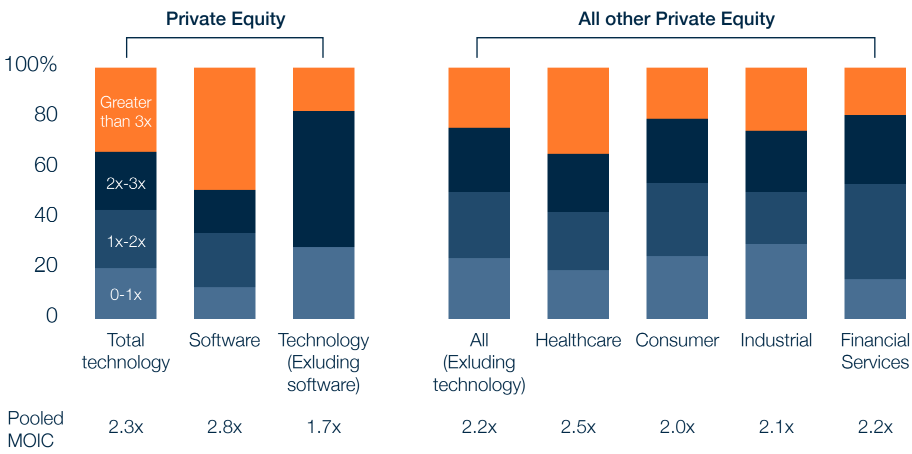
Yet, Sharpe ratios[9] are not prescriptive and asset classes are not assessed by investors in isolation. What is also relevant is an asset class' diversification potential, since, as Markowitz, the father of Modern Portfolio Theory, put it, diversification is "the only free lunch in finance". The very basis of investment portfolios is to construct them with imperfectly correlated assets in order to take advantage of the principle of diversification.

3. Buyout as a private equity investment strategy

Large cap buyout funds offer new private market investors a vehicle to access the benefit of strong underlying assets stewarded by effective, experienced managers. The investment strategy targets the technology sector, which has generated the strongest returns for investors between 2010 and 2018.

Figure 7: Technology deals, especially software buyouts, have produced stronger returns than the private equity market overall

Pooled MOIC[10] for fully realized buyout deals, 2010–18



Note: Includes leveraged buyouts only
Sources: CEPRES Platform; Bain analysis

Existing investors in the asset-class may want to consider if they are sufficiently diversified, both across the different fund types (from buyout to private debt and real assets), and in terms of the underlying assets. Accessing the full range of opportunities afforded by private equity requires diversification even within the asset class.

9 In finance, the Sharpe ratio measures the performance of an investment compared to a risk-free asset, after adjusting for its risk. It is defined as the difference between the returns of the investment and the risk-free return, divided by the standard deviation of the investment. Source: Investopedia

10 The realization multiple is a private equity measurement that shows how much has been paid out to investors. The realization multiple measures the return that is realized from the investment. Source: Investopedia

About Us

Moonfare is a private equity and alternatives investment platform focused on providing qualified professional investors access to top-tier funds. Whilst these asset classes have traditionally only been within reach of institutional investors, Moonfare's deep private equity experience and due diligence process, coupled with platform driven onboarding and subscription, enables qualified professional investors to access funds with the potential for significant returns. Headquartered in Berlin, it currently accepts investors in the UK, Germany, Luxembourg, Switzerland, and Hong Kong.

Disclaimer

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