THE NORTHERN TRUST INSTITUTE

PRIVATE EQUITY'S ROLE IN LONG-TERM CAPITAL PLANNING

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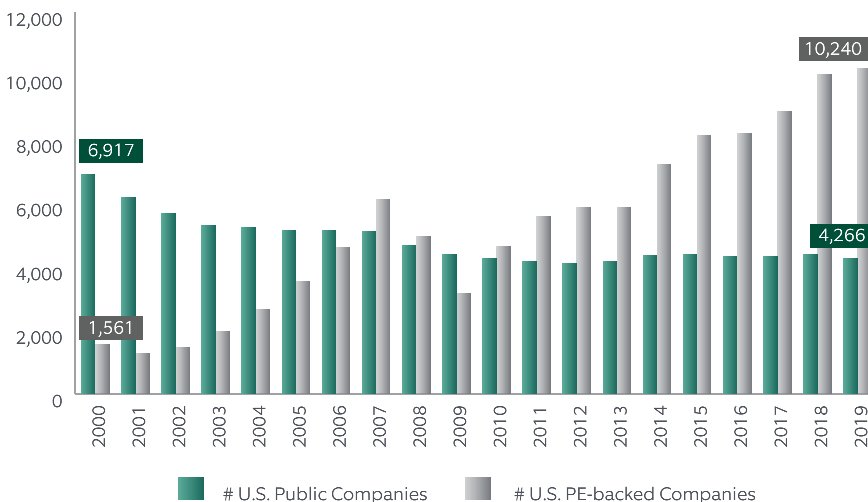
WHAT IS PRIVATE EQUITY?

Private equity is an alternative investment asset class that invests in or acquires companies at various stages of their lifecycle. Private equity investments are not listed on a public exchange and typically have a duration of three to ten years, while the shares of publicly traded companies can be bought or sold daily. This longer timeframe enables multiyear strategic planning and value creation by private companies, compared to the regulatory oversight and market pressures commonly navigated by public companies. Private equity investments provide access to an inefficient segment of the market, offering the opportunity to increase the returns of traditional stock-bond portfolios.

THE PRIVATE EQUITY OPPORTUNITY

The number of privately owned companies, inclusive of smaller start-ups to more established private businesses, has grown significantly over the last two decades and now surpasses the number of publicly listed U.S. companies.[1] Private investments include a wide variety of strategy types that enhance the risk/return profile of a traditional portfolio, and private equity is notably one of the largest considerations for foundation, endowment and other long-term capital pools.[2]

CHANGES IN CORPORATE OWNERSHIP



Source: *World Bank, Pitchbook*

1 World Bank and Pitchbook.
2 As described in Northern Trust Wealth Management Research paper "Increase Portfolio Returns with Private Investments," July 2021.

The net asset value of the private equity market has multiplied almost three times as fast as public market capitalization since 2000, growing to $3.5 trillion in assets under management (AUM) from $324 billion in AUM, relative to U.S. public market cap growth to $40.7 trillion from $15.1 trillion over the same time period.[3] While private equity AUM remains small relative to public markets, these growth trends are expected to continue, as global private equity is projected to reach $9 trillion by 2025.[4]

PRIVATE EQUITY STRATEGIES EXPLAINED

There are several different types of private equity investments. Each offers a specific type of ownership interest, as well as access to companies at different stages of their development. key strategies include:

Buyout	Venture Capital	Secondaries
The largest portion of the private equity market, buyouts focus on controlling a business and typically have a majority ownership in cash flow positive companies.	The second largest portion of the private equity market, venture capital focuses on investments in the form of minority equity ownership in early-stage businesses with high growth potential.	Secondaries represent acquisitions of an existing interest or asset in private equity funds, which can be both buyout and venture funds. The secondary market provides liquidity optionality of portfolios and funds to investors and fund managers outside of the fund life (typically 10 – 12 years).

WHY SHOULD LONG-TERM CAPITAL POOLS INVEST IN PRIVATE EQUITY?

Private equity has historically outperformed the public markets over longer periods of time and may enhance investor returns. Private equity is a multiyear investment, and investors with long-term capital pools can benefit from private equity's historical competitive return over public equity. This advantage can be attributed to the illiquidity premium and the following key factors:

- **Market inefficiencies:** Private equity transaction processes are competitive and not always efficient and solely based on price. This can create opportunities for outperformance by applying a high level of due diligence, access to proprietary information and strong talent.
- **Business control:** Private equity managers generally have majority or controlling interests in a company. This allows for a high level of influence over company management, overall business direction and timing of their exit strategy.
- **Alignment of interest:** Private equity managers maintain sizeable stakes in company investments and share in company performance alongside company management, which aligns their economic incentives with those of their investors.
- **Value creation:** The length of the typical private equity holding period enables companies to focus on value creation over the long term without fixating on shorter-term public market expectations.

3 World Bank and Prequin. Net asset value is defined as AUM not inclusive of dry-powder.
4 Prequin.

POTENTIAL RISKS OF PRIVATE EQUITY INVESTING

There are considerations to investing in private equity that are different from those associated with traditional equity investing, including:

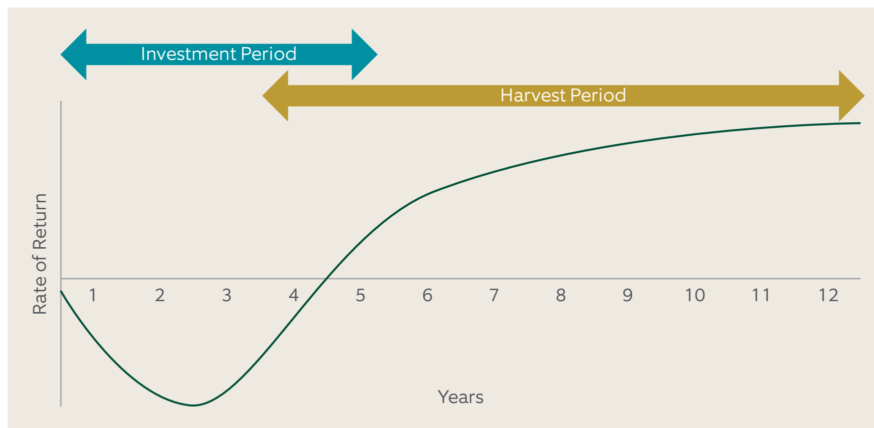
- **Illiquidity:** Investor capital in private equity funds is committed for a period of 10 years or more, which means that once invested, the money cannot be withdrawn on demand. Capital is returned as investment deals are harvested, typically not until the fifth or sixth year.
- **Manager selection:** There is a large dispersion between top and bottom quartile private equity fund managers, which makes manager sourcing, due diligence and selection critical for strong performance.
- **Concentration:** Ideally, a private equity program is a long-term plan involving multiyear commitments, rather than a one-time investment. A "one and done" private equity investment can result in an exposure to an overly concentrated fund in a particular vintage, strategy, sector or geography, leading to outsize risks to the portfolio.
- **Higher costs:** In addition to a management fee charged on upfront committed capital, private equity funds charge performance fees on profits over a return hurdle. However, it is worth noting that private equity returns are reported net of all fees.
- **Leverage:** Investments can be levered, magnifying the potential for losses.
- **Performance reporting:** Because private companies do not have the same robust reporting requirements of public companies, portfolio valuations are typically conducted in-house, and performance is calculated on a quarter lag.

Funds raised within each calendar year are referred to as a vintage. The vintage year — the year in which an investment begins — can have an impact on ultimate returns, as underlying investments can be influenced by various macro and economic factors throughout a cycle.

UNDERSTANDING THE PRIVATE EQUITY LIFE CYCLE

Investing in a private equity opportunity requires investors to make up-front dollar commitments in increments, as capital is requested from investors (also known as being "called") and deployed over a number of years. As a result investors often experience negative returns during the early years from capital calls and fees, and higher returns in later years as investments mature and are realized. This is known as the "J-curve" effect, representative of the shape of returns as illustrated below.

HYPOTHETICAL PRIVATE EQUITY FUND LIFE CYCLE



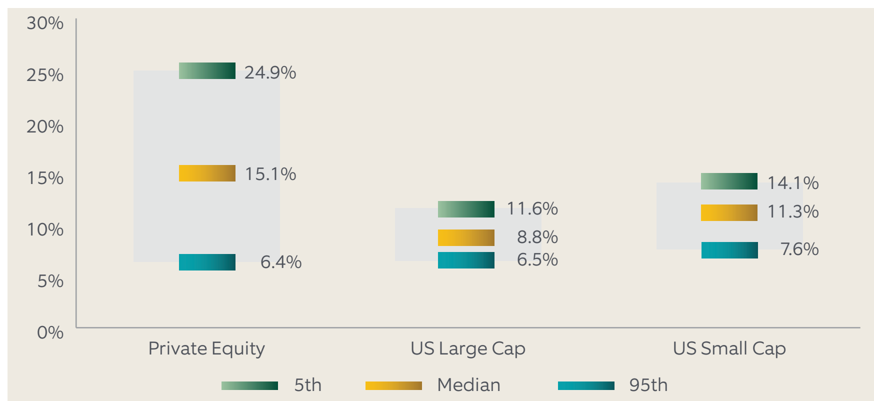
For illustrative purposes only.

Private equity investing should not be accomplished with a single commitment. Identifying a target allocation and methodically designing a program with ongoing commitments is necessary to offset distributions from maturing funds. Adding capital over several years has the benefit of delivering diversification across managers, vintage years, strategies, sectors and geographies.

THE IMPORTANCE OF MANAGER SELECTION

While manager selection is important among traditional public investment managers, it is paramount in private equity as there is a wider performance dispersion between top and bottom quartile managers due to the lack of efficiency in private markets.

ASSET CLASS RETURNS BY PERFORMANCE PERCENTILE



Source: Cambridge, eVestment. Asset class returns over 20-year period ending 12/2020.

The difference in performance between the top 5% of private equity managers and the bottom 5% amounted to nearly 19 percentage points over the 20 years through 2020. This dispersion of returns is a critical distinction between private and public markets. Alpha generation opportunities exist for top managers, as these differences can be even more extreme within specific years or sectors.

HOW TO BUILD A PRIVATE EQUITY PROGRAM

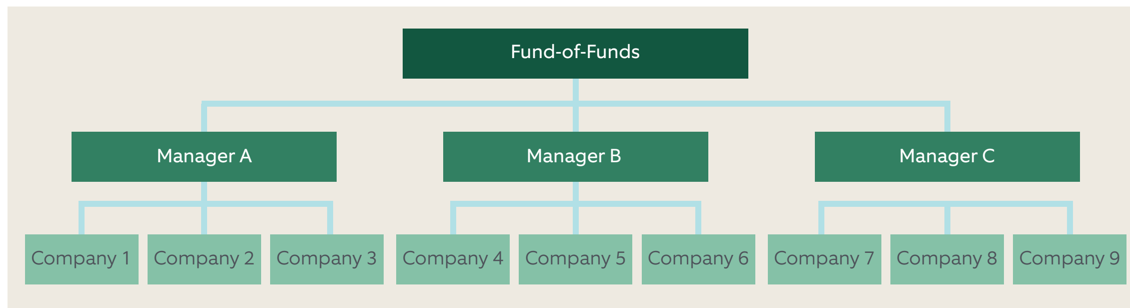
The aforementioned characteristics of private equity make the asset class difficult to navigate without professional advice and guidance. In addition, it can take a number of years to build out a self-funding private equity program, whereby capital distributions support or exceed capital contributions. This requires investors to take a disciplined, long-term approach.

Investors should consider multiple variables as they implement a program, including their spending rates, operational needs, capital reserves, overall liquidity budget, and staffing and reporting capabilities.

HOW TO ACCESS PRIVATE EQUITY

There are multiple ways for foundations, endowments and other long-term capital pools to invest in private equity, with two common approaches being through a fund of funds (FOF) manager and through a feeder fund with an individual fund manager. Each has a different level of ownership characteristics, fees and administrative responsibility. A private equity program is often a combination of these approaches and should be designed to reflect the needs unique to an investor's size and comfort level with the asset class.

For many building their private equity allocation, a FOF approach provides core exposure while mitigating many risks of the asset class. A FOF is a diversified portfolio of multiple funds and companies and allows investors to come in at a lower minimum investment while still accessing a broad range of strategies, sectors and geographies. The network and capital of a FOF can provide a connection to hard-to-access managers. In addition, the portfolio is professionally managed and offers the convenience of streamlined administration, management of capital calls and distributions, and reporting.



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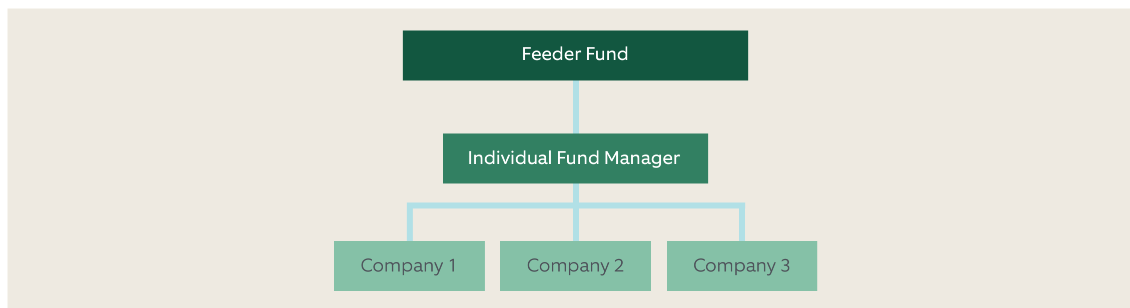
Investing through a feeder fund approach provides direct access to fund managers and unique opportunities that build upon a private equity program's overall investment strategy. For example, a co-investment vehicle leans into a fund manager's best ideas, and additional exposure to a dedicated secondaries fund can help mitigate the J-curve effect on the total portfolio. A private equity program can also be complemented with private investments in credit, real estate and infrastructure to enhance diversification benefits. A feeder fund structure similarly pools investor capital and utilizes third-party management to help streamline administration and reporting.



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SUMMARY

The private equity asset class has grown over the past number of years and is projected to continue this growth trajectory. While this can be a complex asset class to navigate given its unique differences compared to traditional equity investing, a thoughtfully designed private equity program can help long-term capital pools access the benefits of this important asset class.

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