

Private equity study: It is all about the alpha!

The success of private equity is repeatable: Study by Golding Capital Partners and the HEC School of Management confirms the persistence of private equity funds' performance

Munich, 27th May 2014 – The present study by Golding Capital Partners (Munich) and the HEC School of Management (Paris) substantiates that above-average performance of private equity funds is repeatable. The excess return (alpha) that a fund manager achieves compared to investments on the stock market is a reliable indicator for its future investment success. However, this persistence (repeatability) does not apply to absolute return performance indicators. The present study by Golding Capital Partners and the HEC School of Management now confirms for the fourth year in a row the long-term positive excess return from private equity with an average alpha of 8.6 percent. The research project is based on the scientific methodology of earlier studies and on a data set of more than 5,600 realised private equity transactions from the years 1977 to 2014.

The repeatability (persistence) of the successful performance of investments in private equity is one of the key issues for investors. The results of predecessor funds are analysed very carefully before investing in a private equity fund for this very reason. It has been shown over the last few years that a sustainable excess return compared to benchmark indices is only possible to a limited extent through active portfolio management for many investment classes. Many scientific studies have demonstrated low persistence particularly for stock market investments. On the financial markets, massive movements of capital from active fund managers to passive ETF investments have been observed accordingly.

"When selecting investment companies investors in private equity follow the wide-spread rule within the sector of mainly investing in funds where their predecessors have already achieved good results in terms of IRR and investment multiple. This simplified approach can be misleading as the alpha from private equity is the crucial factor for future success", says Jeremy Golding, Founder and Managing Director of Golding Capital Partners.

Defining performance indicators for funds

Golding Capital Partners and the HEC School of Management have now analysed whether the historical performance of a private equity fund manager actually provides an indication of future performance. The repeatability of the success of private equity was examined using various parameters on the basis of an extensive data set at transaction level. "When assessing a fund manager's performance record

investors frequently focus on absolute return performance indicators such as the standard IRR or investment multiple and often just at fund level. In our research project we expanded this focus to analyse additional success indicators such as the alpha, holding period, loss ratio and return dispersion for persistence at transaction level", explains Daniel Boege, Head of Buyout at Golding Capital Partners.

Alpha as a significant indicator for the future performance of funds

The study comes to the conclusion that predictions can be made about the future performance of private equity funds. Important parameters are not return performance indicators such as the standard IRR or investment multiple but relative return performance indicators such as the alpha. Looking at the alpha from private equity shows that there is a statistically significant correlation between an excess return compared to stock market investments in the past and in the future. Investment companies that have generated an above-average alpha in the past with their funds are highly likely to also achieve an above-average alpha in future. "As an investor in private equity I have to understand which value added a private equity manager has contributed at transaction level before making my investment as this value added is persistent", adds Daniel Boege.

Higher absolute return by concentrating on alpha performance

The results of the study have also clearly revealed that the alpha also allows for predictions about the future absolute return. "Our study results suggest that investors can significantly increase the returns of their private equity portfolios by concentrating on the best performers in terms of the alpha. This means that the return could be increased by roughly 600 basis points compared with the market average simply by investing in funds that were in the top quartile in the past with regard to the alpha", explains Oliver Gottschalg, Professor at the HEC School of Management in Paris and one of the study's authors. The study by Golding Capital Partners also provides evidence regarding the persistence of specific risk performance indicators and the holding period of portfolio companies. This reveals a significant correlation between the previous and subsequent period with the holding period, portfolio loss ratio and return dispersion of individual fund managers.

"The results of our study substantiate that there is a remarkable excess return from investments in private equity compared to investments on the stock market with an alpha of 8.6 percent. Once more we have been able to prove how important the selection of the right fund manager is for investors in private equity. A simplistic glance at the absolute return performance indicators of predecessor funds is only helpful to a limited extent. Because: It is all about the alpha! Private equity investors would be well advised to select fund managers whose performance has an above-average alpha and therefore allows for conclusions to be drawn about the persistence of their investment success", summarises Jeremy Golding.

About the study

The "Success in private equity is repeatable" study was carried out jointly by Golding Capital Partners and the HEC School of Management. The study analyses the excess return from investments in private equity compared with investments on the stock market as well as the persistence of different performance parameters, for example the internal rate of return (IRR), multiple (investment multiple), alpha (excess return from private equity compared to investments on the stock market), holding period, loss ratio and return dispersion. Over 5,600 transactions realised between the years 1977 and 2014 were analysed. The data set used is the transaction database from Golding Capital Partners.

Adjustments were made to the respective returns in order to make the returns from public shares and private equity directly comparable, as in earlier studies from 2010, 2011 and 2013. Three effects were considered with public shares: timing, i.e. the specific times for each cash flow, the influence of sector development on the respective company as well as the leverage effect, which means the debt equity ratio of an investment in private equity compared with listed companies. The return of private equity transactions is also adjusted. The discount rate for reinvesting cash flow is a stock market index and not the internal rate of return, as with the standard IRR. The difference between the two return values is the alpha from private equity.

About Golding Capital Partners

Golding Capital Partners is the leading independent investment partner for private equity, private debt and infrastructure in Germany. With a team of some 60 professionals Golding Capital Partners helps institutional investors to develop their investment strategy and manages about €3 billion in assets. Its more than 100 institutional investors include insurance companies, pension funds, foundations and banks, especially savings banks and cooperative banks.

About HEC School of Management

HEC (Ecole des Hautes Etudes Commerciales) is considered to be one of the leading elite European teaching and research universities in the field of company management. HEC offers the top managers of tomorrow a spectrum of degree courses that is as broad as it is remarkable; i.e. various Masters courses (MSc programmes and Specialized Masters), an MBA programme (full time or after-work), a PhD programme and the TRIUM Global Executive MBA.

Further information:

IRA WÜLFING KOMMUNIKATION GmbH
Dr. Reinhard Saller
T +49 (0)89 2000 30 38
F +49 (0)89 2000 30 40
reinhard.saller@wuelfing-kommunikation.de