GOLDING

Study on the Alpha of Private Equity Investments

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Introduction

In this fifth edition of their Alpha Study, Golding Capital Partners and Professor Oliver Gottschalg from HEC School of Management Paris have examined the relative investment performance of historical private equity transactions. As in the past four studies, the metric used is the excess return (alpha) generated by such transactions in relation to comparable deals on public stock markets. The study calculates alpha for different market phases, holding periods, deal volumes, regions and sectors.

The authors also look at the persistence of alpha, i.e. the question of whether a high alpha in the past is an indicator that the corresponding fund manager will continue to generate a high alpha in the future. It is the first time that this investigation was carried out not only at the fund management level, but also in relation to the individuals directly involved in the transactions. The results of the survey have far-reaching strategic implications for private equity investors.

Key findings

- Across all market phases, private equity transactions generate a significant excess return, or alpha, of 9.9 per cent compared with similar stock market transactions.
- Alpha is significantly positive in every single market phase and at its highest by far in periods of crisis, reaching 35.4 per cent.
- Looking at individual deal makers reveals a strong correlation between the performance of previous and future deals. This is not true to the same extent for fund management companies.

Study design

The dataset used for the analysis is the Golding Capital Partners database, which contains some 4,300 private equity transactions completed between 2000 and 2021 in the US and Europe. This means the universe of analysed deals is large enough to draw valid conclusions, and the timeframe covered includes periods of relative market calm as well as boom times and severe crises such as that of 2008.

In line with the proven methodology of earlier studies, the authors made various adjustments when calculating the excess returns from private equity compared with the stock market, to ensure that the two asset classes can be properly compared with one another. This entails structuring a comparable stock market investment for each private equity transaction, which reflects the following factors:

(1) the timing of cash inflows and outflows,

(2) the sector effect, i.e. the performance of the industry in which the company operates, and

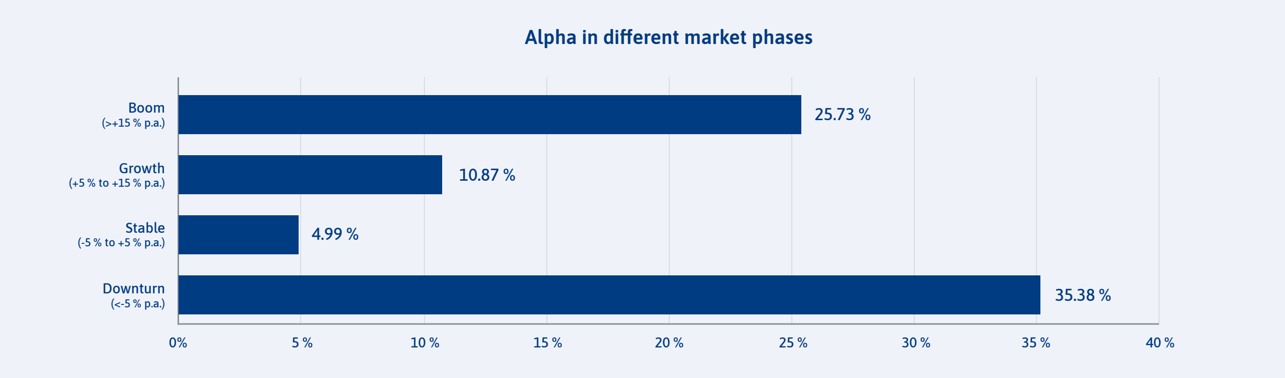
(3) leverage, i.e. the amount of debt used to finance the private equity investment compared with a publicly listed investment.

At the same time the return of the private equity transaction is adjusted to reflect realistic reinvestment opportunities using the modified IRR function (M-IRR). The portion of the adjusted private equity return that cannot be obtained from a comparable investment on the stock market is the alpha for private equity.

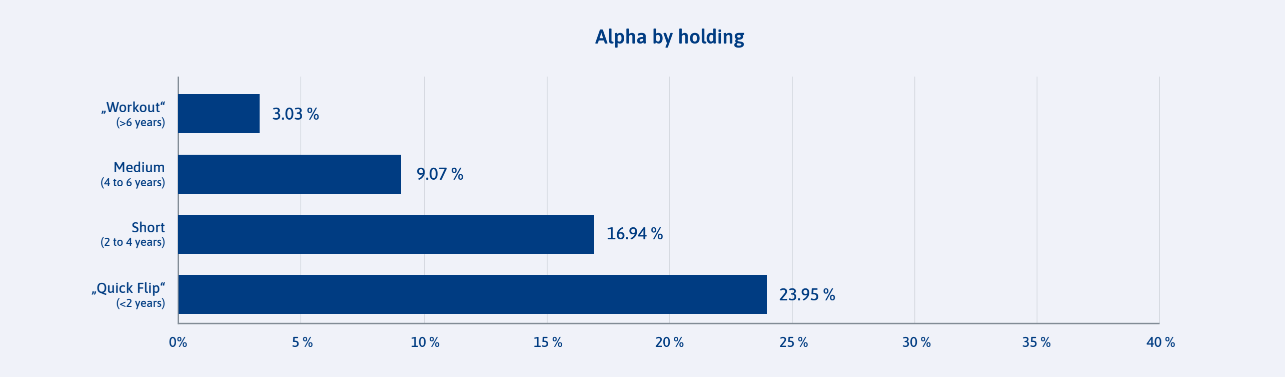
To determine the persistence of alpha the study measures the correlation between the tested variable in the prior period with the same variable in the following period. Persistence was measured both at the level of the fund manager and of the individual deal makers. This required sufficient data on individuals who completed deals at more than one fund manager. A total of 2,200 data points were used to calculate the persistence.

Results

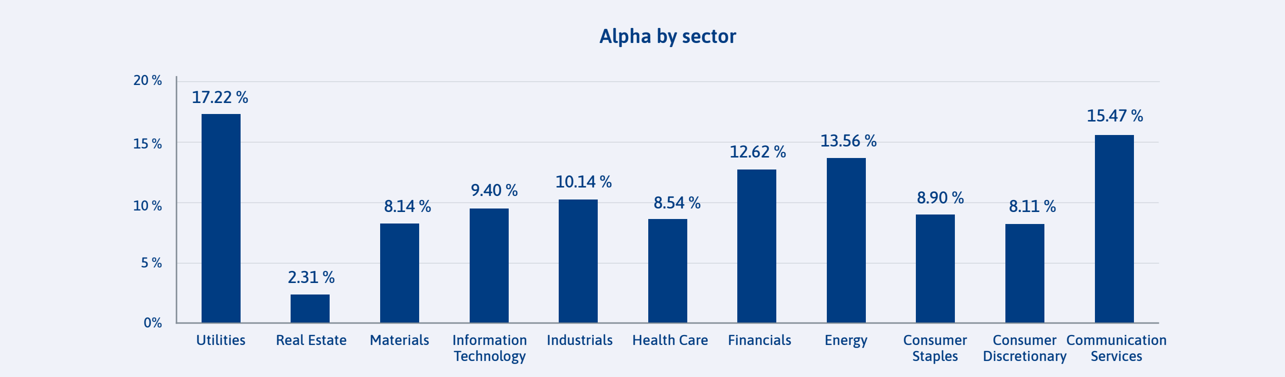
The analysis confirms the results of the previous studies: private equity transactions generate significant excess returns over the long term compared with similar stock market transactions. In the period from 2000 to 2021, the average alpha came to 9.9 per cent – after making all the necessary adjustments for timing, sector mix and leverage.



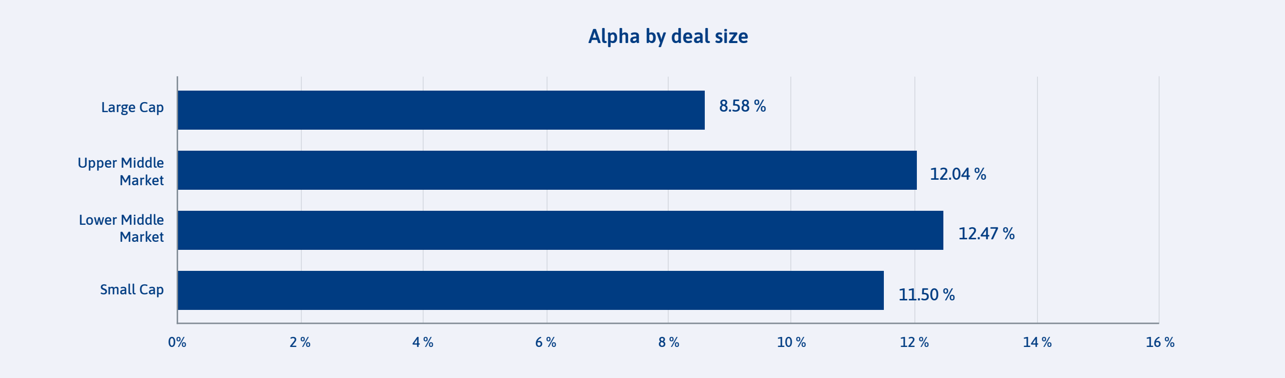
Differentiating between market phases with different growth rates shows that alpha is particularly high during times of crisis, at 35.4 per cent. Private equity also generates a significant excess return of 25.7 per cent when markets are booming. The difference is slightest during periods when the market is flat. Private equity has a positive alpha in all market phases, however.



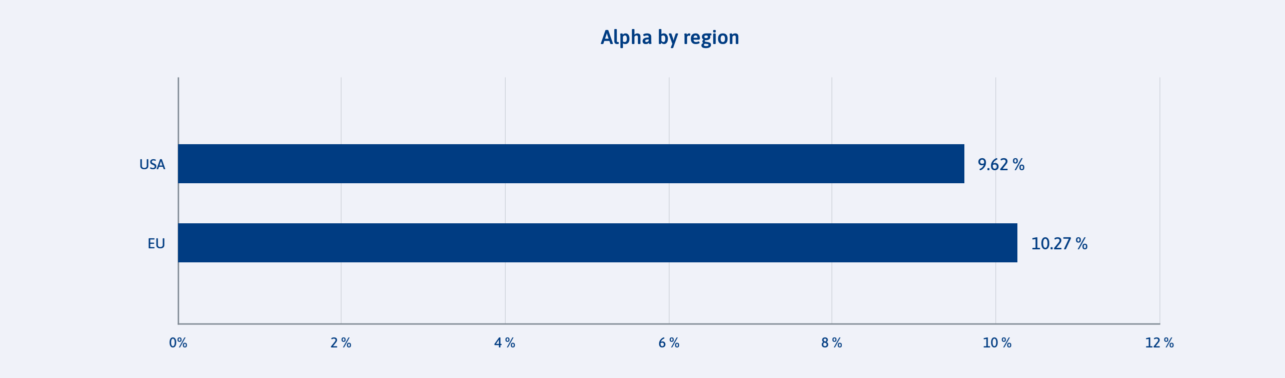
There are also significant differences when the dataset is analysed by reference to the holding period of the private equity investments. Alpha is highest at 24.0 per cent for what are sometimes known as quick flip transactions, with a short holding period of two years or less. As the holding period increases, alpha declines, but remains positive even for what are known as workout deals with a holding period of more than six years.



There are also significant differences in the breakdown by sector. Alpha is highest for the utilities sector at 17.2 per cent and the communication services sector at 15.5 per cent. Private equity transactions in the real estate sector had by far the lowest alpha.



The breakdown by deal size shows that mid-market transactions have a slight advantage over the larger and smaller ends of the market.



The breakdown by region reveals practically no difference in alpha between transactions in the European Union and those in the US.

Persistence of alpha demonstrated

When deciding whether or not to make a commitment to a private equity fund manager, investors generally focus on the absolute performance of past returns. Their assumption is that a positive track record is indicative of a fund manager's ability to continue taking the right decisions, which will generate positive returns in the future.

However, recent empirical analysis suggests that there is little statistical evidence for this assumption. Indeed, it shows that future performance in the private equity market is not correlated with past returns – similarly to the stock market, where this finding has caused investors to abandon active management strategies and concentrate increasingly on passive funds that track stock market indices.

But whereas the track record as measured by absolute performance indicators such as IRR or multiple of money does not act as a predictive indicator, this is not true of relative outperformance indicators such as alpha The current study highlights a positive correlation between past and future alpha. Funds that have generated above-average alpha in the past are therefore more likely than other funds to do so again in the future.

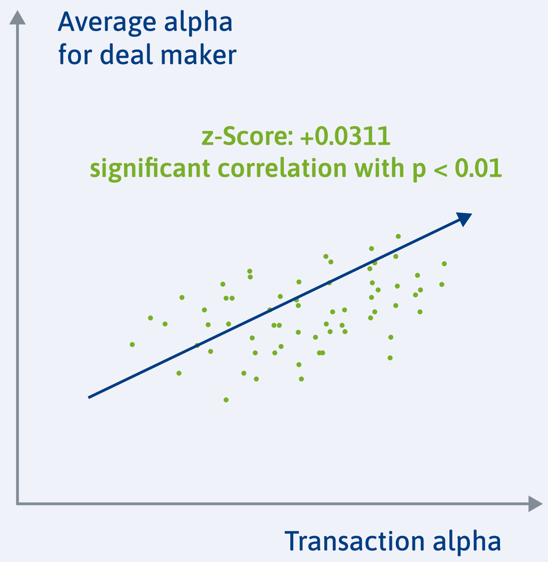
Man beats machine

For the first time this analysis was also carried out at the level of the individual deal makers responsible for the transaction. Here the correlation is even stronger than at the level of the fund management company. This means that the alpha of private equity transactions is largely driven by the person actually responsible for doing the deal.

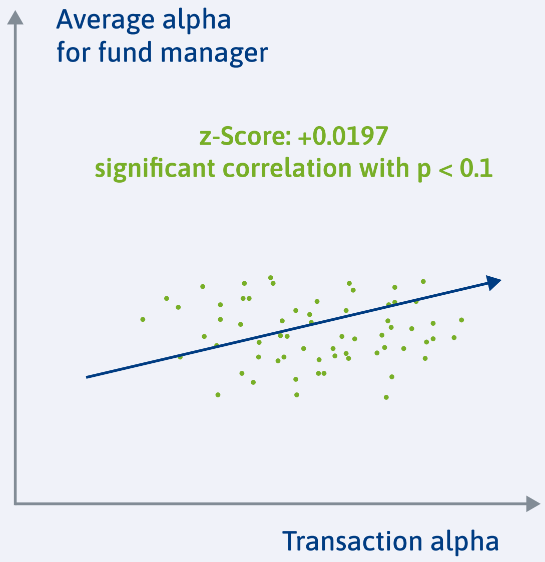
For the investment strategy of private equity LPs, this implies that it is not enough simply to go with fund managers that have been successful in the past. In fact, it is vital to look very closely at the people on the team and the personal track record of the individual investment professionals. If there has been a change of key personnel, there is a real risk that a previously successful fund manager will not be able to reproduce its historical track record. This risk also applies particularly to fast growing fund management companies.

Correlation

Persistence at deal maker level – “Man”



Persistence at fund manager level – “Machine”



- The average alpha of a deal maker is predictive of the alpha for their current transactions – deal makers who have generated alpha in the past are highly likely to generate alpha in the future.
- For the fund managers there is also a positive connection between the average alpha and the alpha for current transactions – but the correlation is much weaker (lower z score) and the significance level is lower (higher p value).
- In a direct comparison it is the persistence at the level of the deal maker that dominates; persistence at the fund management level is mainly driven by the persistence of the underlying deal makers.

Significant implications for fund managers and investors

The findings of the study are highly relevant in practical terms, both for fund management companies and investors. From the perspective of the fund managers they reduce the importance of the brand name to the benefit of the people directly involved. Particularly with successful, fast-growing fund management companies there is a risk that performance will suffer because new employees cannot replicate past successes. To a greater extent than the senior managers may realise, the findings show how important it is to ensure the top performers stay with the company. Bonuses based on the success of individual deals can be a suitable way of achieving this.

The findings of the study also have important implications for investors and their processes for determining how they make their fund commitments. Track records remain an important tool for assessing whether a fund manager will be able to repeat its past successes, but the usual focus on absolute returns and the fund management company itself does not go far enough.

Investors should commit to individuals rather than to brand names. A renowned brand name may turn out to be nothing but an empty shell if there has been a lot of churn in the team, because the fund’s performance depends to a great extent on talented individuals. This also makes it important to differentiate between different kinds of leavers. It is generally considered to be a bad thing when team members leave a management company. But in reality this is only the case if top performers leave; if a manager with a poor track record moves on, it may improve the performance of the remaining team. Taking a view on this requires continuous observation of how the teams within the fund management company are developing, however, and knowledge of individuals’ performance.

The results of the study also imply a reassessment of new funds and fund management companies entering the market. Such first-time funds are typically considered to be high-risk and hard to judge. But if the fund managers is made up of individuals with a strong track record, their fund may have better prospects than the latest offering from an established brand name that has seen a lot of fluctuation in the team. Here too, the study shows that it is not the brand that counts, but rather the individuals that represent it.

All the above conclusions apply not only to commitments to private equity funds, but also to co-investments. Due diligence by the potential co-investor should not be limited to the transaction itself and the company, but also extend to individuals directly responsible for executing the deal. Here too, the investor should examine the track record of the deal team very closely. And in contrast to fund commitments, with co-investments it is possible to concentrate on certain deal teams and so improve the investment's risk-return profile.

Oliver Gottschalg

Professor Oliver Gottschalg is Head of Research at MJHudson Performance Analytics, formerly PERACS, a specialist advisory firm that offers advanced due diligence and benchmarking services for private equity funds. He is currently Co-Head of the Strategy department at HEC School of Management, Paris. He is the academic dean of the TRIUM Global Executive MBA programme, leads the HEC Private Equity Observatory and lectures on strategy, entrepreneurship, venture capital financing and management buyouts. He holds a degree in business and engineering from Karlsruhe University, an MBO from Georgia State University, and an M.Sc. and doctorate from INSEAD. His current research is focused on strategic logic and the key factors behind the performance of private equity investments.

Jakob Schramm

Jakob Schramm, Partner, Head of Credit and Head of US Office, has been with Golding since 2004. He is responsible for the identification, due diligence and selection of fund, secondary and co-investments and for subsequent portfolio management.

Jakob Schramm completed his studies of economics at Ludwig-Maximilian University in Munich with a Diplom-Volkswirt degree and is a member of the CFA Institute. During his studies he worked as a research and analytics assistant at the Ifo Institute for Economic Research.

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