LONDON BUSINESS SCHOOL'S COLLER INSTITUTE OF PRIVATE EQUITY UNVEILS NEW GROUND BREAKING RESEARCH ON PRIVATE EQUITY PERFORMANCE

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London Business School's Coller Institute of Private Equity unveils new ground breaking research on private equity performance

- Outperformance of 8% against S&P 500
- Underlying problems with previous research studies

In a Coller Institute of Private Equity event on 13 February Chris Higson, a professor in the accounting group at London Business School, presented a ground breaking piece of academic research on private equity performance.

This research paper, co-authored with Dr Ruediger Stucke of Oxford University, sheds new light on private equity's performance. Some influential existing academic studies have concluded that returns from private equity, net of fees, have been no better than public market measures such as the S&P 500. The authors show that these papers have significantly understated private equity returns as a result of problems with the underlying data.

Professor Higson and Dr Stucke's study uses a unique, high quality data set of fund cash flows. The paper includes a complete account of the performance of US buyout funds since 1980 using Cambridge Associates' private equity fund database and a hand-collected sample from various LPs. The authors calculate IRRs and money multiples for sample funds by vintage year, and benchmark against the S&P 500 using a public market equivalent approach.

The authors show that the IRRs of US buyout funds with vintages 1980 to 2005 display significant outperformance of around 8% against the S&P 500. Inclusion of the years 2006 to 2008 significantly reduces overall outperformance to around 5%. The results also show a marked variation in performance of funds with only 60% of funds displaying a positive IRR spread against the stock market comparator.

This is an important study as it reports new findings about the performance of private equity, an asset class whose performance has been problematic to measure and benchmark due to opaque information and no active market.

Professor Higson commented: "For many years there has been ambiguity in the evidence about private equity performance, that has been troublesome both for the industry itself and for commentators trying to understand the economics of buyouts. This paper finally resolves that issue and can be taken as definitive. "

A presentation from the event is available on www.collerinstitute.com.

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THE PERFORMANCE PUZZLE

How does private equity perform against the S&P 500? Academics have long been debating this question. But the authors of a new study claim they now have the answer. What's different about this paper? And what do the results mean for limited partners?

By Vicky Meek.

Chris Higson

Higson is a professor in accounting at London Business School (LBS), where he has stood as chair of the Accounting Group and director of the School's Financial Seminar for Senior Managers. He has degrees in philosophy and economics from University College London, and a doctorate in finance from LBS. He is a chartered accountant and worked for Deloitte & Touche.

Private equity performance has been a contentious issue among academics, with various studies showing contradictory results (see *Private Equity Findings*, issue 2, pp 12-15). Of the three most prominent studies (see box-out), two found equal or underperformance on a net basis relative to the S&P and one found outperformance.

But the authors of a new study, Chris Higson of the London Business School and Rüdiger Stucke of the University of Oxford, have revealed new evidence. Their research, which was first presented at a Coller Institute event, points to outperformance of 500 basis points per annum over the S&P 500 by US buyout funds between 1980 and 2008. Omitting the younger funds with 2006-2008 vintages, they find excess returns of 800 basis points per annum.

Higson says: "We wanted to understand why the results of the two most influential studies [Kaplan, Schoar and Phalippou, Gottschalg] were so at odds with the stories from papers based on LP results, which were more positive. This was an issue that had to be resolved."

The new research, *The Performance of Private Equity*, covers 85% of the US buyout fund universe by capital raised across nearly three decades – a more comprehensive dataset than other studies have used and spanning a longer period. It is drawn from Cambridge Associates' data, made available for the first time to researchers, which has the integrity of a broad set of LP data. But even this only covers 60% of the universe by value, so the academics hand-collected further data from LPs to reach the 85% mark. "This is as good a sample as you are ever going to get," says Higson. "It's close to a complete dataset and removes the problem of selection bias."

The authors were not surprised by the results. "Given the growing flow of capital towards PE over the years, it would have been a surprise if we had found that PE didn't deliver to LPs," says Higson.

The other key difference between the Higson et al. research and the Kaplan et al. and Phalippou et al. papers was treatment of net asset values. While Kaplan et al. chose fair market values and Phalippou et al. opted to write off investments whose valuations had not moved for several months as a means of assessing unrealised returns, Higson and Stucke discounted these investments using the rates being paid in the secondary market in mid-2010.

However, the research did chime with past literature in some respects: it found a wide variation in performance between funds. Only 63% of the funds in the sample generated returns in excess of the S&P 500, and it found that the average fund did much better than the median, suggesting that outperformance is driven by positive outliers. This adds to the weight of evidence that suggests manager selection in PE is of paramount importance to LP returns. It also found evidence of high cyclicality in returns, with fund vintages in the early years of each decade – times of downturn – performing much better than those raised towards the end of the decade – the boom years, when capital flowed freely to funds.

The results, says Higson, should serve to reinforce much of what LPs know already. "They should draw reassurance that PE performance was, objectively, as good as they thought overall," he says. "The research confirms what LPs know about the importance of manager selection and highlights that they should be aware of the cyclical nature of PE – herd investing is disastrous for the asset class."

Next on Higson's agenda is the benchmarks issue. "We used the S&P 500 as our benchmark because the other studies did," he explains. "That was because we wanted to document the bias in other studies. But the S&P 500 is an imperfect benchmark. PE investments are highly illiquid, highly leveraged and relatively small in size – unlike the S&P 500. So we can't say conclusively that buyout funds create a certain amount of value."

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