Why Invest In Privates

What Are Privates?

What are ”privates” and how do they compare to “publics”?

- “Privates” refers to companies that are not listed on public equity exchanges (the NYSE and NASDAQ, for example), so *do not* offer the general public access to ownership. Private companies tend to be younger, smaller, and growing faster than public companies.
- Private strategies include **venture capital** (investment in companies that are implementing new technologies and are yet to generate meaningful revenue or be profitable), **growth equity** (often into tech, healthcare, or business services companies, but those that are already generating some revenue and are close to being profitable), **private equity** (investment in more mature, profitable, and often family-owned, companies across all sectors, but especially in the industrial, consumer, healthcare, and business service sectors), and **real estate** (developing or enhancing properties and their operations). Additional strategies include energy, infrastructure, timber & agriculture, and distressed.
- In the United States there are hundreds of thousands of private companies versus a couple thousand public companies (S&P *500* and Russell *3000*). However, the value of public companies still dwarfs private (the Russell 3000 market cap is ~$30 trillion versus just several trillion for private companies—Google, for example, is ~$1 trillion versus ~$100 billion for the largest venture-backed private companies such as Stripe).

Have investors in private companies outperformed investors in public companies via the S&P 500, for example?

- Over the last ~25 years, yes. However, less so more recently as increasing valuations have boosted US stock market returns.
- Investors can invest in ex-US private companies as well. These companies have also outperformed their public equity counterparts. Valuations for ex-US public companies are lower, so investors in private companies have outperformed significantly.

	5-Year	10-Year	15-Year	20-Year	25-Year
Private Equity ("PE")	10.3	13.8	12.0	10.5	12.8
Venture Capital ("VC")	10.7	15.2	11.2	5.1	36.2
Real Estate ("RE")	7.2	10.5	6.0	6.8	7.1
S&P 500	*10.7*	*14.0*	*8.8*	*5.9*	*9.3*

	5-Year	10-Year	15-Year	20-Year	25-Year
ex-US PE and VC	13.9	13.8	12.3	12.8	13.7
MSCI World ex US	*2.0*	*5.4*	*4.1*	*3.0*	*4.7*

Note: annualized compound return data sourced from Cambridge Associates’ website and is as of June 30, 2020.

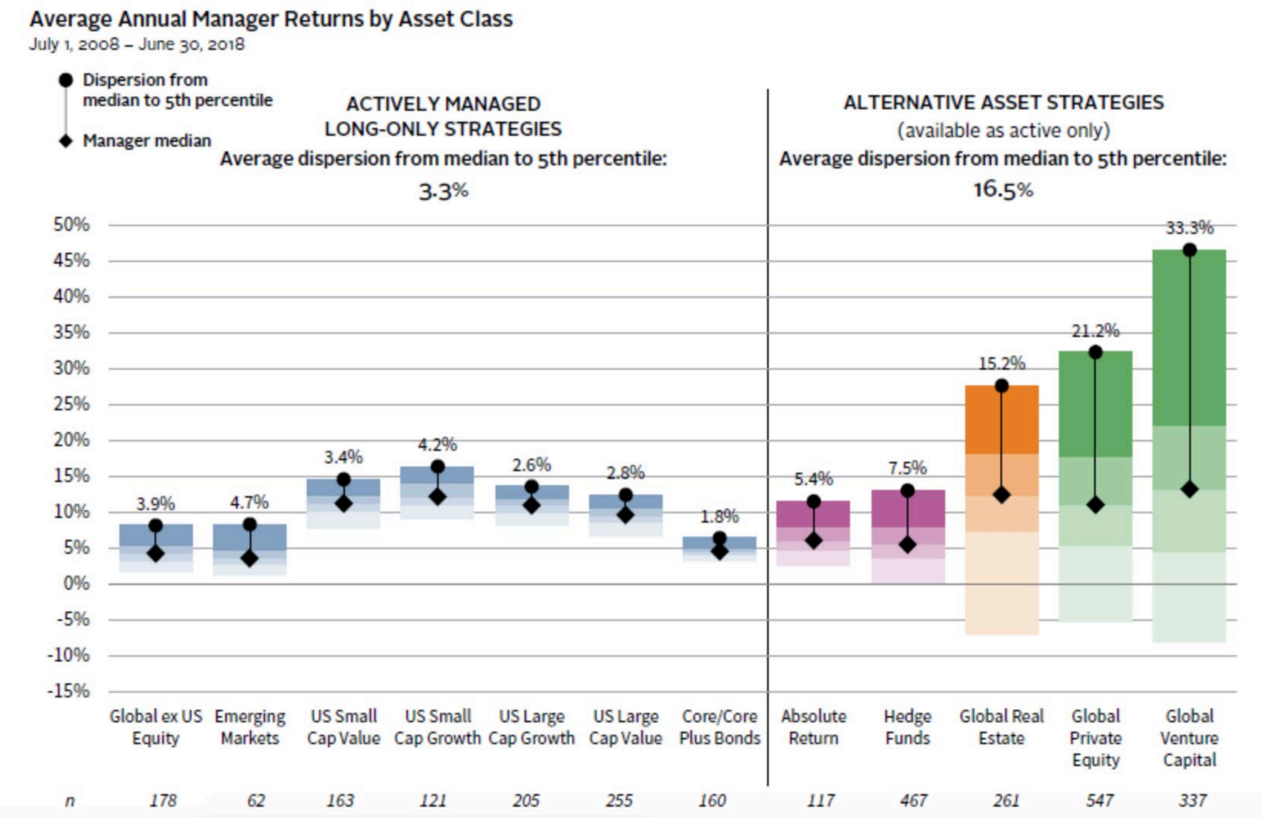
Why Have Privates Outperformed?

- **Exposure to innovation**: Many entrepreneurial people—who are often former employees at larger, more bureaucratic public companies—are founders or early employees at smaller private companies. They are willing to forego salary and job security in return for equity in companies that are trying to disrupt larger companies. This equity can become valuable if a company is successful. While private companies fail at a much higher rate than public companies, American culture doesn't stigmatize those who worked for "failed" companies.
- **Better incentives and active management**: Management at public companies often own a very small % of the outstanding shares and are incentivized "not to mess up." Consequently, public companies are less likely to innovate, which is an inherently risky and inefficient activity. In contrast, private companies must innovate if they hope to disrupt larger companies and grow. In addition, because private investment managers ("GPs") can diversify the risk present in any one small private company across a portfolios of companies, they push private companies to grow both organically and through acquisitions and re-invest into their business (instead of hoarding cash, for example). Many managers are also actively involved in helping grow these companies—in the case of private equity, they are majority owners; growth equity and venture investors, which invest via minority positions, help companies recruit employees, develop business plans, and acquire competitors, for example.
- **Less competitive ("efficient") market:** Many private companies target markets that are highly profitable, but too small to attract competition from larger public companies.
- **Ability to sell or IPO successful private companies at valuations that are higher than entry valuations:** In the United States, successful private companies can generate cash profit for private investors by selling to larger companies, both public and private (especially those owned by large GPs) as well as through an IPO. In doing so, they typically sell their shares at a premium to what the private investment managers paid. Many larger companies don't mind paying a premium since acquisitions, from their perspective, are small; many also view acquisitions as "outsourced R&D."
- Other potential, but less significant drivers include:
  - Falling interest rates for the last ~40 years: because managers can diversify company-specific risk, they tend to add debt to the companies they own (instead of just using cash equity);
  - Many good private companies staying private for longer: existing owners prefer avoiding the hurdles that public companies face; they also prefer a smaller group of active investors managing the company instead of broad, often passive, public ownership;
  - Perhaps compensation for "illiquidity risk": those who prescribe to the academic "CAPM" theory, which assumes that rational investors would not invest in private companies unless they were compensated with higher returns, often point to this.

Why Invest in Privates?

In addition to the median returns for privates being higher than for publics, some private investment managers outperform other managers substantially; so investors who can pick good private investment managers will substantially outperform public equities.

- Part of this dispersion is due to the sample (global venture capital, for example) being comprised of individual strategies that are taking more specific bets (US *biotech* venture capital, for example) than Emerging Markets equities (companies across sectors and geos); and a mix of different bets will naturally lead to dispersion.
- However, many private managers develop a reputation for helping companies in a sector, which enables them to invest in additional private companies at attractive valuations because the existing owners/entrepreneurs in these companies want the managers' investment. This flywheel effect can perpetuate good performance.*
- But, as shown to the right, the downside is also high for private investments. This is largely due to private assets needing good, active ownership—if an asset is performing poorly, the investment manager may stop managing the asset (or the manager itself may dissolve).



However, investors can reduce the downside risk by diversifying:

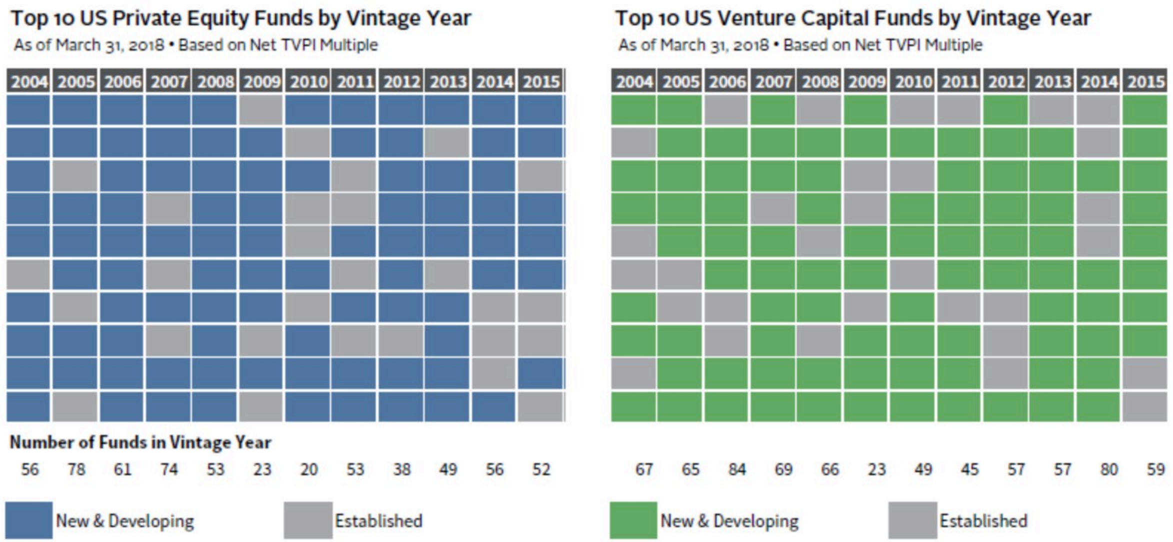
- By private asset class (private equity, growth equity, venture capital, real estate) and across geographies, managers, and vintage years (consistently investing in private funds over multiple years).
- In addition, when underwriting private investment managers, investors should focus on minimizing "organization risk" by backing managers who have already worked together, are meaningfully invested into their own funds, and are good people.

**Venture managers with "above median" funds are more likely than PE managers to raise future funds that also produce above median returns. "Outperformance persistence" is stronger for VC than PE.*

Investing in a Competitive Market

- More investors—endowments, foundations, pensions, families, and sovereigns—are allocating capital to private investment managers (“GPs”). In the early 2000’s, GPs managed, collectively, a couple hundred billion. Today they manage over $3 trillion.
- While this growth has led to increased competition between GPs, GPs can’t invest vast sums of capital into many private investment strategies. In venture capital, for example, GPs invest just a couple million into each early-stage company (though they invest more as these companies grow). Consequently, they often raise funds that are a couple hundred million (so that each partner at the GP isn’t managing so many companies the partner isn’t able to help any *single* company, thereby damaging the GP’s brand). Well-known venture firms such as Sequoia and Benchmark cap their early-stage funds at <$750 million even though many investors enthusiastically ask to invest in their funds. GPs focused on growth equity, private equity, and real estate do this as well (to a lesser extent), despite the companies they invest in being more mature and larger (GPs also use debt to acquire these companies, which reduces the need to write a large equity check).
- Consequently, it’s hard for investors to allocate capital to managers that have generated good returns, developed a reputation in a market which enhances their sourcing (and likelihood of continued outperformance), and attracted additional interest from investors, especially pensions.
- Nonetheless, many newer “emerging” managers have generated impressive performance and offer investors:
  - Strong alignment: emerging managers are often younger and know they must generate good returns if the hope to raise future funds;
  - Lower fees and potential for investors to invest in the GPs’ funds over many years as well as co-investment opportunities;
  - Ownership of smaller companies, which are in less competitive markets.
- When underwriting an emerging manager, it’s important for investors to minimize the “organization risk” that can lead to poor performance and to diversify across a portfolio of managers. In addition, investors should try to invest in mature managers who have a good chance of continued outperformance (because of their brand and successful retention of younger investment professionals at the GP).

FIGURE 8 NEW AND DEVELOPING FUNDS ARE CONSISTENTLY TOP PERFORMERS



Risks When Investing in Privates

Illiquidity

- Because investors typically make 10+ year commitments to individual private investment funds, an investor building a portfolio of funds must have sufficient liquidity in the non-privates portion of the portfolio—public equities, hedge funds, and fixed income.

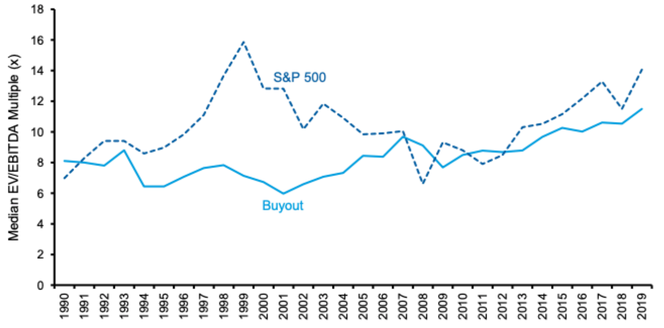
Building a private investments portfolio requires patience

- It takes time to underwrite emerging managers and develop relationships with mature managers that can pick their own investors.
- Managers also mark their portfolios conservatively, especially in early years, so new privates programs often "lag" public equities during this time.

High valuations

- Valuations have increased meaningfully in recent years—private equity and growth equity valuations are similar to public equities'; valuations for later-stage venture capital companies (less so for early-stage) have also increased:

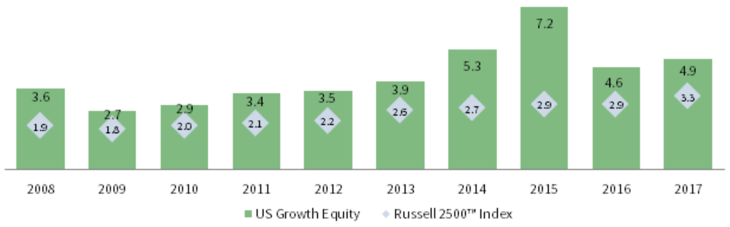
Exhibit 28: Median EV/EBITDA for U.S. Buyout Deals and S&P 500, 1990-2019



Source: FactSet; S&P Global Market Intelligence; and Ulf Axelson, Tim Jenkinson, Per Strömberg, and Michael S. Weisbach, "Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts." Journal of Finance, Vol. 68, No. 6, December 2013, 2223-2267.

FIGURE 6 AVERAGE LTM REVENUE PURCHASE PRICE MULTIPLES

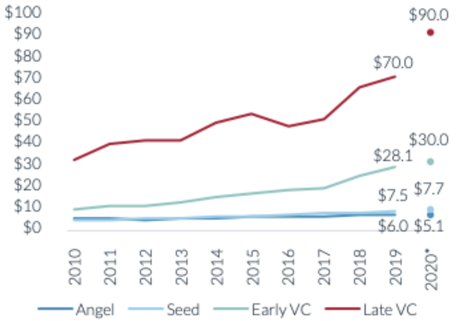
As of December 31, 2017 • Enterprise Value/Revenue



Sources: Cambridge Associates LLC Private Investments Database (as reported by investment managers), FactSet Research Systems, and Frank Russell Company.

Median valuations continue growth

US VC median pre-money valuation ($M) by stage



PitchBook-NVCA Venture Monitor
*As of September 30, 2020

Tax efficiency

- Not as tax efficient as passive public equities (especially tax loss harvesting strategies), but still quite efficient; most gains are taxed as long-term.
- Preference for strategies that generate returns via capital appreciation instead of yield, which is the case for venture capital, growth equity, private equity (to a slightly lesser extent), and real estate strategies that generate returns via development or re-development.

Downside risk

- The average bottom quartile buyout fund has returned 90 - 110% of investors' capital, which is 60 - 70% of what investors could have returned if they had instead invested in public equities. Bottom quartile venture is worse: ~70% of investors' capital (and over a longer hold), which is ~40% of public equities' performance.

Appendix

Overview of Private Investments Market

- JPM Overview of Investing in Private Equity
- Michael Mauboussin on the Growth of Private Markets
- Old (from 2002), but still relevant guide to Investing in Privates
- Allen Latta's blog post on private equity and how to invest in it
- Bain 2020 Private Equity Report (returns; industry, market, and company metrics)
- Pitchbook's most recent US PE, US "middle market" PE, and US VC Reports
- Cambridge Associates on Families Investing >40% of Portfolios in Privates
- Cambridge Associates Overview of Growth Equity
- JPM on Dynamism of US Markets
- Cambridge Associates on Benchmarking Private Investments
- Should investors instead invest in levered deep-value stocks instead of private equity?

Overview of Emerging Managers

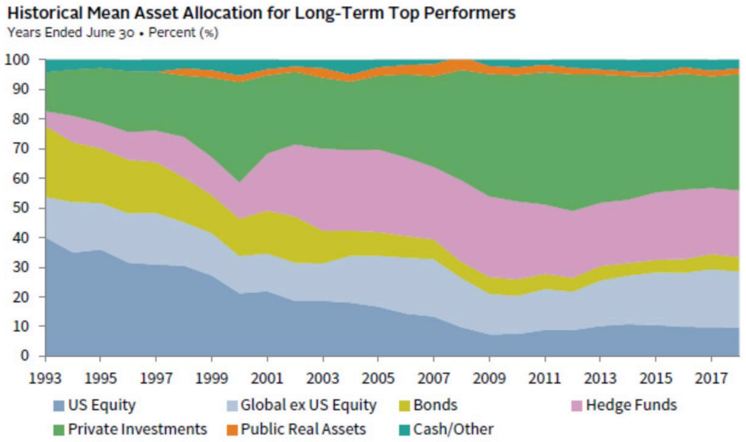
- TIFF's Case for Emerging Managers
- Cambridge Associates' Performance of Emerging VC Managers

Performance Persistence (short answer is not really, but perhaps a bit for venture capital)?

- Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds
- How Persistent is Outperformance in Venture Capital?

Appendix

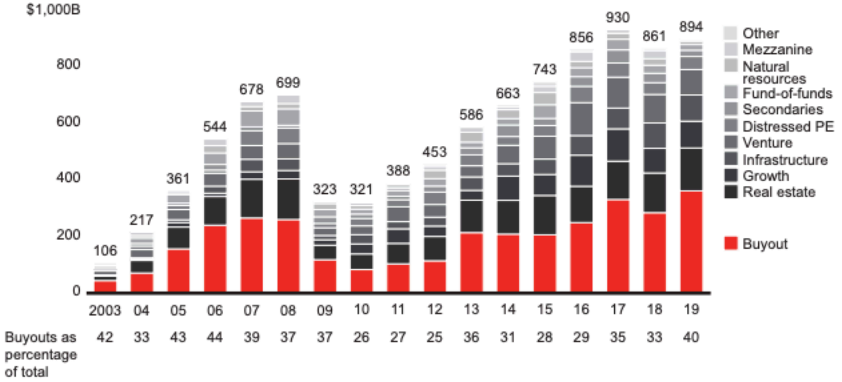
FIGURE 2 TOP PERFORMERS STEADILY INCREASED PI ALLOCATIONS OVER TIME



Source: Endowment and foundation data as reported to Cambridge Associates LLC.
Note: Long-term top performers represent the institutions that were in the top decile for the 25-year AACR as of June 30, 2018.

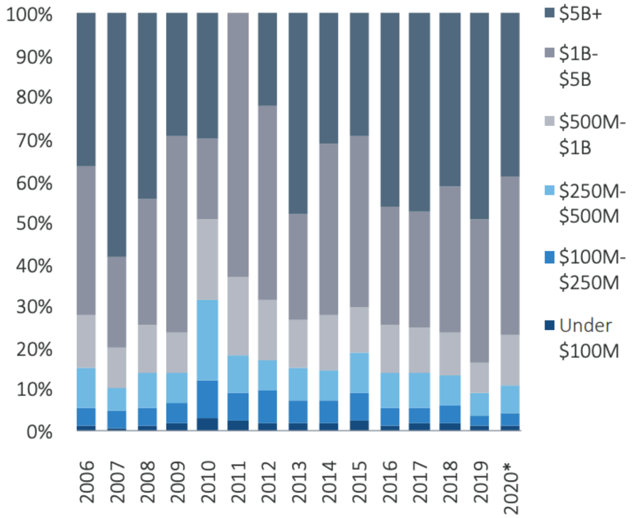
Figure 1.20: Investors continued to pump capital into alternative asset classes, with buyouts gaining share

Global private capital raised, by fund type



Notes: Includes funds with final close and represents the year in which funds held their final close; buyout includes buyout and balanced funds; distressed PE includes distressed debt, special situation and turnaround funds; other includes private investment in public equity and hybrid funds; excludes SoftBank Vision Fund
Source: Preqin

PE funds ($) by size



Source: PitchBook | **Geography:** US
*As of September 30, 2020

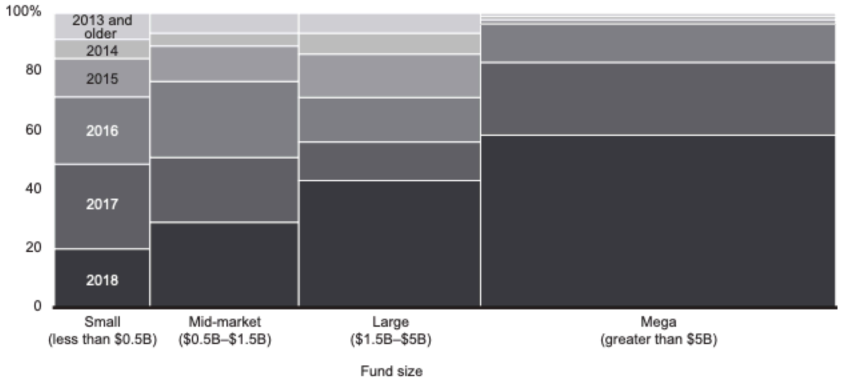
Figure 3.5: In a maturing market, average private equity returns have been trending downward, while top-tier returns remain steady

10-year annualized IRR for global buyouts

Source: State Street Private Equity Index

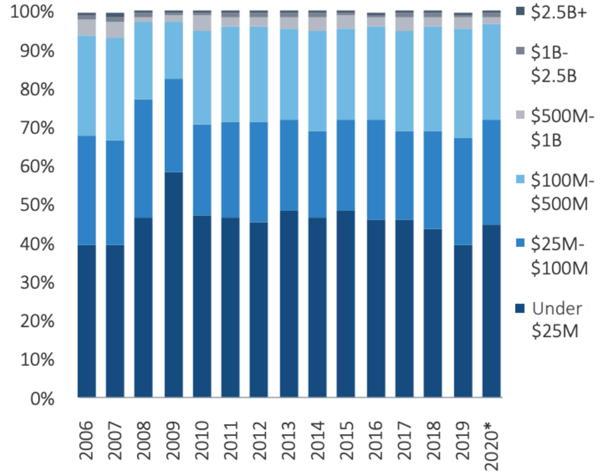
Figure 2.6: Megafunds hold by far the largest share of dry powder, dialing up the pressure to do more multibillion-dollar deals

Distribution of global buyout dry powder, by fund vintage year



Notes: Vintage year represents the year of initial investment/drawdown from the fund; excludes vintages older than 2008
Source: Preqin

PE deals (#) by size



Source: PitchBook | **Geography:** US
*As of September 30, 2020

Note: sourced from Cambridge Associates, Bain, and Pitchbook websites.