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Five key findings from Bain’s 2017 Private Equity Report

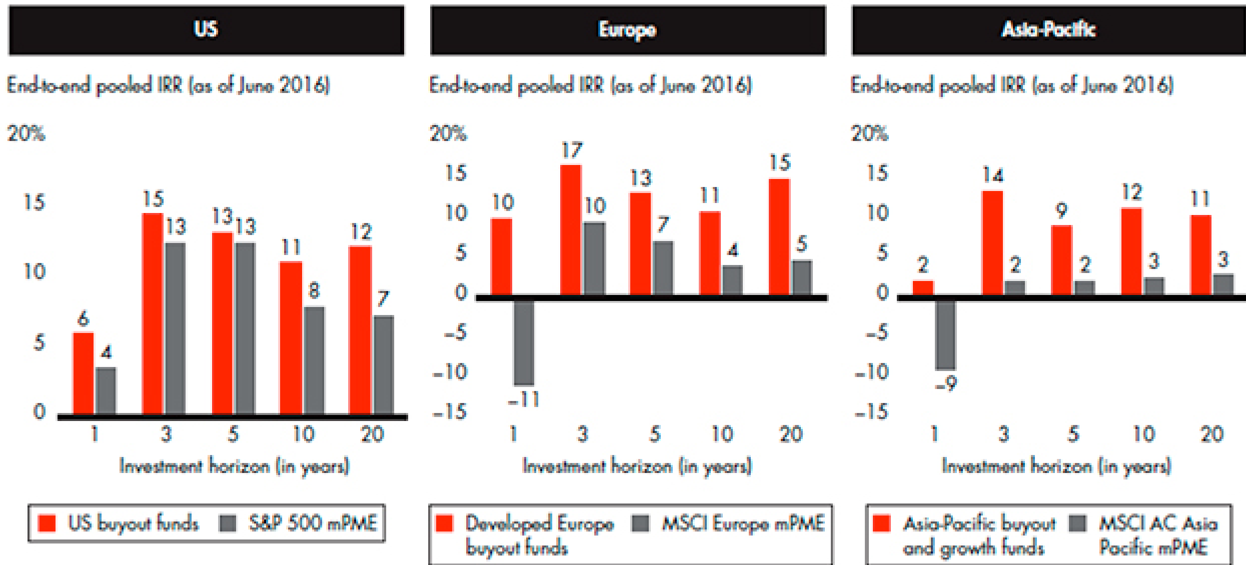
Posted on Apr 06 By Caroline Rasmussen

Each year global consultancy Bain issues a comprehensive, state-of-the-industry report on private equity, which has become required reading for most investors in the asset class. Below, we’ve highlighted five key findings from the report, which speak to the continuing appeal of the asset class, the importance of selecting the right managers and the emergence of tech as arguably the strongest sector for private equity.

1. Private equity returns had another strong showing, continuing to outperform public markets by a meaningful gap over both short-term and long-term time horizons.[1]

Using the modified public market equivalent (mPME) metric, which replicates the timing and size of PE cash flows as if they had been invested in public equities in order to directly compare private and public equity returns over defined time periods, every region saw outperformance by buyout funds for the 12 months ending June 2016. As we’ve noted before however, short term measurements do not capture the effect of private equity value creation, which due to its intensive operational nature requires several years to fully manifest in valuations. Private equity showed sustained outperformance over longer time periods, returning 11% compared to 8% for the S&P over the past 10 years and providing investors with a 5% illiquidity premium vs the S&P over the last 20 years. Outperformance was even stronger in Europe and Asia.

Figure 1.21: Buyout funds have outperformed public markets in all major regions over short and long time horizons



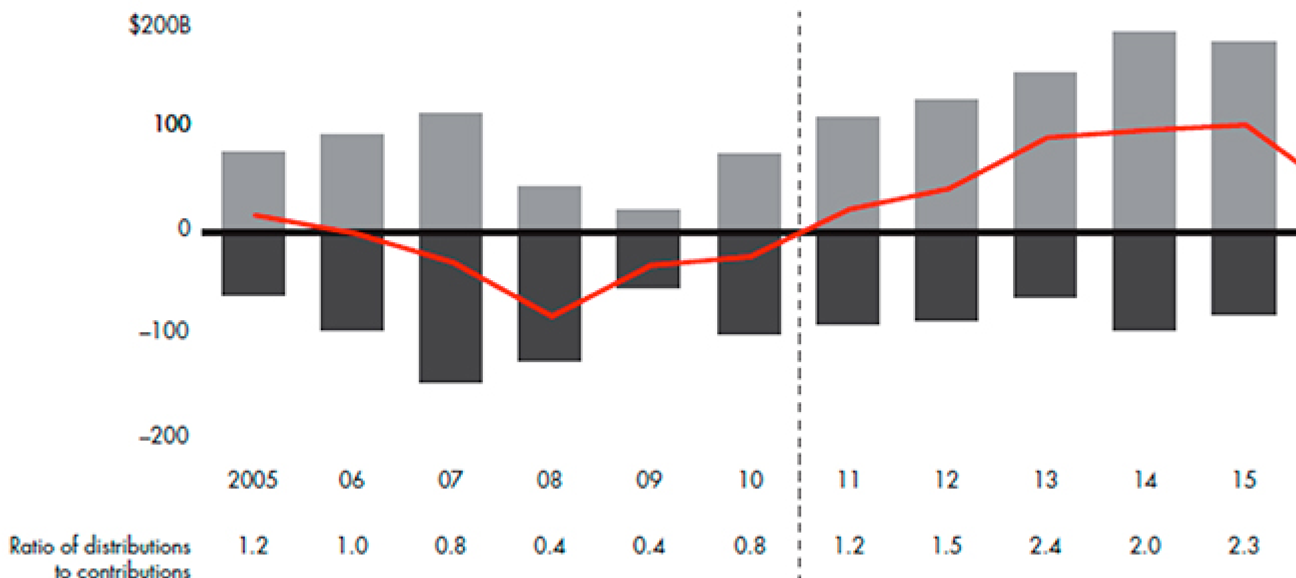
Notes: Data for US and Asia-Pacific calculated in US dollars; data for Europe calculated in euros; Europe includes developed economies only; Cambridge Associates' mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in private equity been invested in public markets instead; the public index's shares are purchased and sold according to the PE fund cash flow schedule; discrepancies in bar heights displaying the same values are due to rounding
Source: Cambridge Associates

2. Investors' private equity programs have been cash flow positive for six years running.

Globally, PE fund distributions (the return of investors' original capital plus any gains) have exceeded contributions each year since 2011. In other words, exit conditions have been so robust over the past several years that proceeds from the sale of private equity-owned companies have surpassed the combined capital put to work in new investments plus the increase in valuations of existing portfolio assets. The ratio of distributions to contributions stood at 1.9 for the first half of 2016, meaning that for every $1 investors put to work nearly $2 came back, allowing their PE allocations to become self-funding by a significant margin.

Figure 1.10: LPs' private equity programs have been cash flow positive for six years running

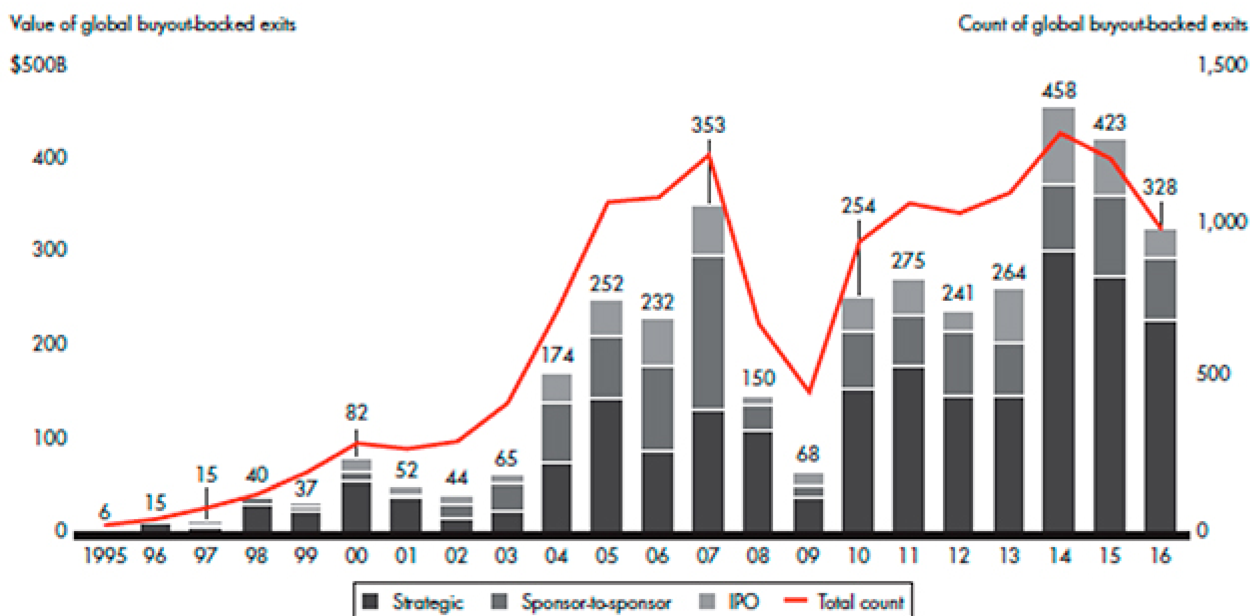
Capital contributions and distributions (global buyout funds)



3. Companies have increasingly been able to fuel their growth with private capital, rather than tapping the public markets.

Raising capital from private investors has been possible at about the same, or arguably better, valuations than the public markets have been offering in recent years. [2] As a result, dual-track processes have become more common, with many private equity managers preparing IPOs for portfolio companies while simultaneously exploring a private sale of the asset. To provide an example, cybersecurity company Blue Coat dual tracked IPO and private sale processes last year, ultimately electing to be acquired by private company Symantec for $4.65 billion just two weeks after filing for an IPO[3]. The certainty and speed of a sale to a strategic buyer or to another financial sponsor often are more attractive than a public offering for PE fund sponsors seeking an exit, especially in times of volatility. Given the sizeable swings in public markets over 2016, it is unsurprising that the count and value of IPOs sank relative to 2015, dropping by 40% and 48% respectively.

Figure 1.6: Sales to strategic buyers remained the dominant channel, and IPO value halved from 2015



Notes: Bankruptcies excluded; IPO value represents offer amount and not market value of company; discrepancies in bar heights displaying the same value are due to rounding
Source: Dealogic

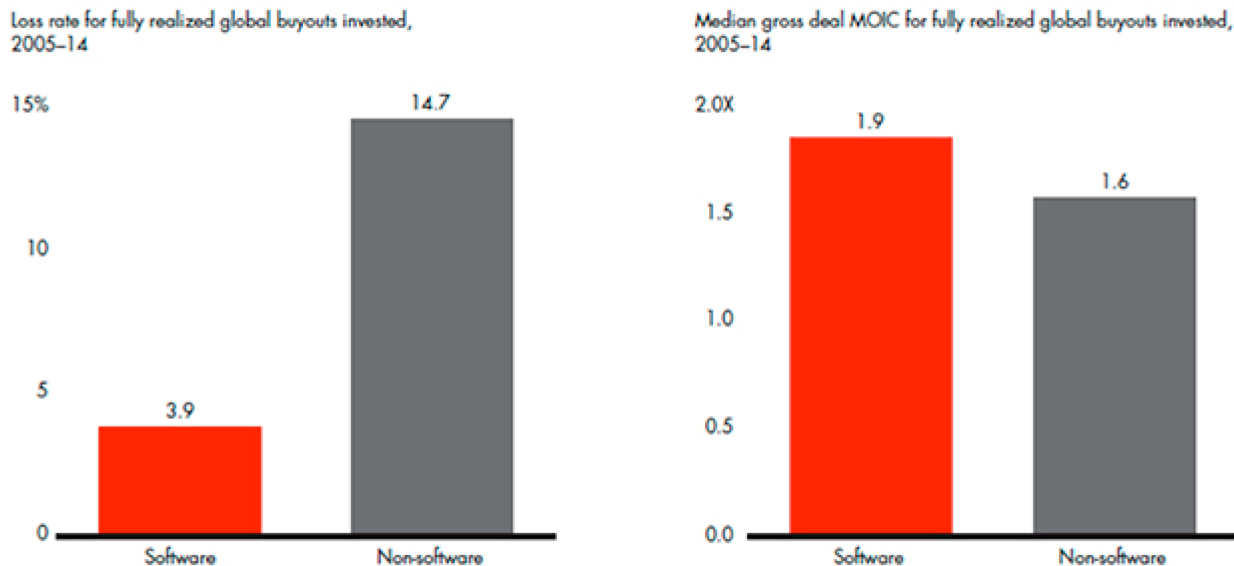
4. Tech deals continue to stand out with strong fundamentals, despite high valuations.

Bain compared the five largest software public-to-private deals closed during 2015 and 2016 with the five largest non-tech deals, and found that the average price-to-EBITDA multiple for the software deals was 18.1 vs. 10.2 for the non-tech deals. Despite these high valuations, there are good reasons why tech deals have traded at a premium:

- Tech-focused companies tend to generate stronger revenue growth. Over the five years preceding acquisition, the five largest software public-to-private deals in 2015 and 2016 had average annual revenue growth of 22.6% vs. just 5.7% for the nontech deals. Looking ahead, more and more corporate spending is slated for IT and digital projects. In addition, many software providers benefit from strong customer loyalty, creating an opportunity to raise prices over time. Finally, many enterprise applications are still penetrating their markets, so there is room for new customer growth.
- Tech assets typically deliver high free cash flow conversion, particularly in software and tech-enabled services, which account for roughly 80% of technology deals by count and value.
- Providers in these industries enjoy relatively recession-resistant recurring revenue streams, as customers often view their products as critical systems that are used daily in their core businesses. The premium on technology's valuations has risen in recent years as the economic cycle has grown longer in the tooth.

• Recent tech deals have outperformed those in many other industries. Return multiples for software deals have been higher, and fewer deals have suffered from capital impairment, as shown in the chart below.

Figure 1.26: Software buyouts have lower rates of capital loss and higher median deal returns than buyouts in other industries



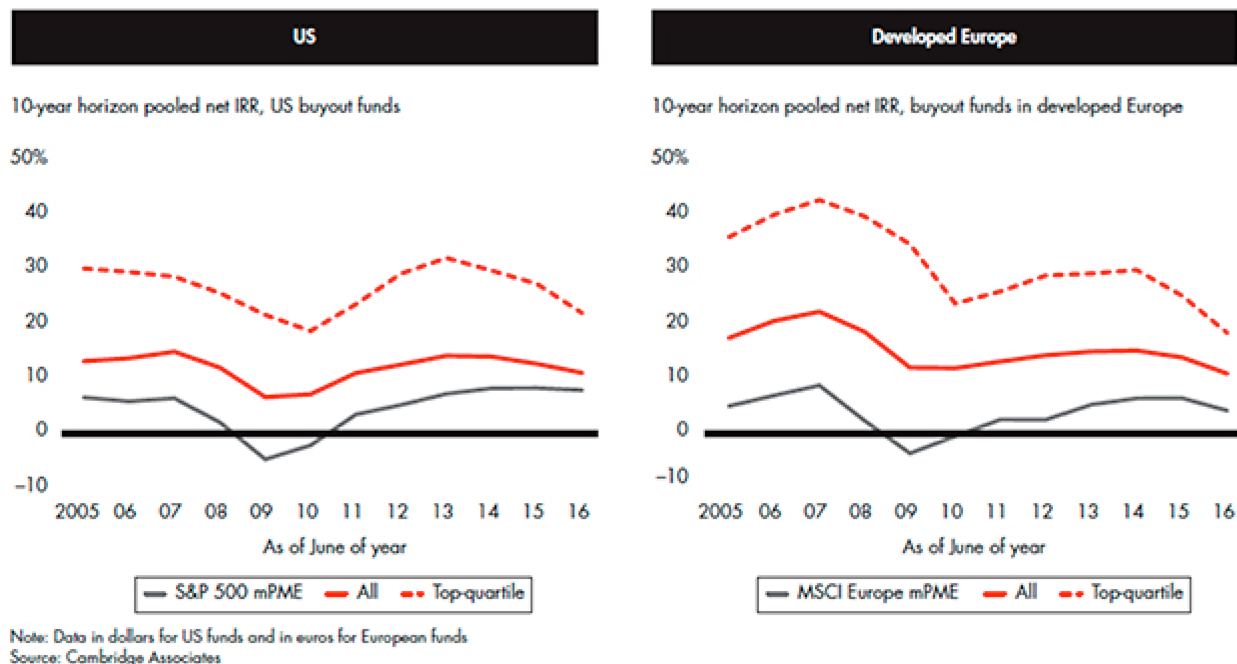
Notes: Loss rate is the equity capital invested in deals realized below cost, net of any recovered capital, divided by the total invested capital and expressed as a percentage; MOIC=multiple of invested capital
Source: CEPRES

5. While the interquartile spread in private equity has begun to narrow, the best funds continue to outperform both the public markets and their peers by a wide margin.

The spread between top and bottom quartile private equity funds has narrowed slightly in recent years but remains at about 10%, demonstrating the critical importance of picking the right managers[4] . Looking over the past three decades, top-quartile funds exhibited two consistent characteristics, achieved by employing higher quality due diligence and post-acquisition value creation processes:

• Lower rates of capital impairment. Top-quartile funds had 20% of their deals experience capital impairment and an additional 6% of deals fully written off, about half the levels of bottom-quartile funds.
• More homeruns. Top-quartile funds reaped more than 5x capital invested on 13% of their deals, compared with just 2% of deals for bottom-quartile funds.

Figure 1.22: Top funds outperform by a wide margin



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1 Past performance does not guarantee future results. While investments in private equity funds provide potential for attractive returns, they also present significant risks not typically present in public equity markets, including, but not limited to, illiquidity, long term horizons, loss of capital and significant execution and operating risks.
2 http://www.wsj.com/video/silver-lakes-kenneth-hao-addresses-sluggish-ipo-market/A26E44A4-D691-490E-91BA-82549017E5F7.html
3 http://fortune.com/2016/06/12/blue-coat-abandons-ipo-plans-sells-to-symantec-for-4-65-billion/
4 Cambridge Associates, US Private Equity: Since Inception IRR & Multiples by Fund Vintage Year, 9/30/2016.

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