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To:	**ECM Clients**
From:	**Austin J. Wagner**
Date:	**22 January 2020**
Re:	**Private Equity**

Howard Marks of Oaktree Capital wrote in one of his highly distributed memos, "No asset class or investment has the birthright of a high return. It's only attractive if it's priced right." One area in the markets today where we're seeing this birthright endowed is private equity (PE). PE typically spans microcap businesses but recently has reached unicorn status (over $1bn in valuation) in businesses such as Uber, Airbnb, and WeWork. The birthright of high returns placed upon PE has caused a flood of capital from institutional investors like endowments and pensions. It is estimated PE groups have over $2 trillion of unspent cash waiting to be deployed. We think the thesis around PE of higher returns, lower volatility/risk, and diversification has become stretched.

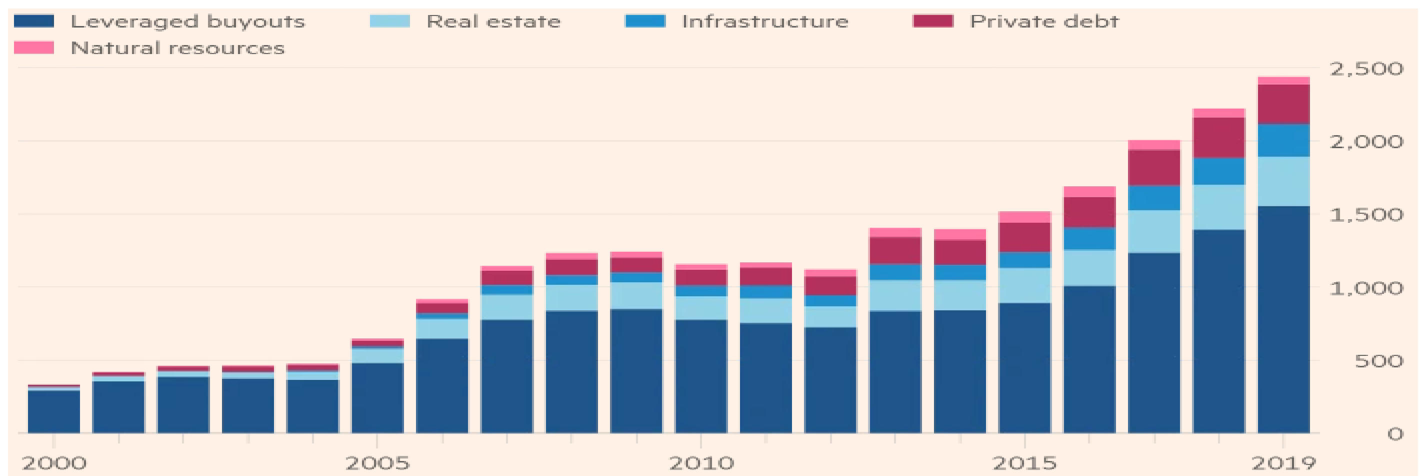

Figure 1. Private equity dry powder $bn (Source: Preqin)

Advocates of private equity point to the historical outperformance of PE versus marketable equity. And the point is valid. According to Cambridge Associates, PE outperformed the S&P 500 by 6% per year (net of fees) from 1980 to 2006. During this period, however, the average EBITDA to enterprise value multiple paid for PE assets was 7x. These assets also carried less leverage than private assets today so firms were able to buy these assets at a low multiple and lever them up. Today the average multiple paid is 11-12x EBITDA for firms with more leverage than historical comparisons. Figure 2 shows the change in valuation gap of PE versus the S&P 500 over time.

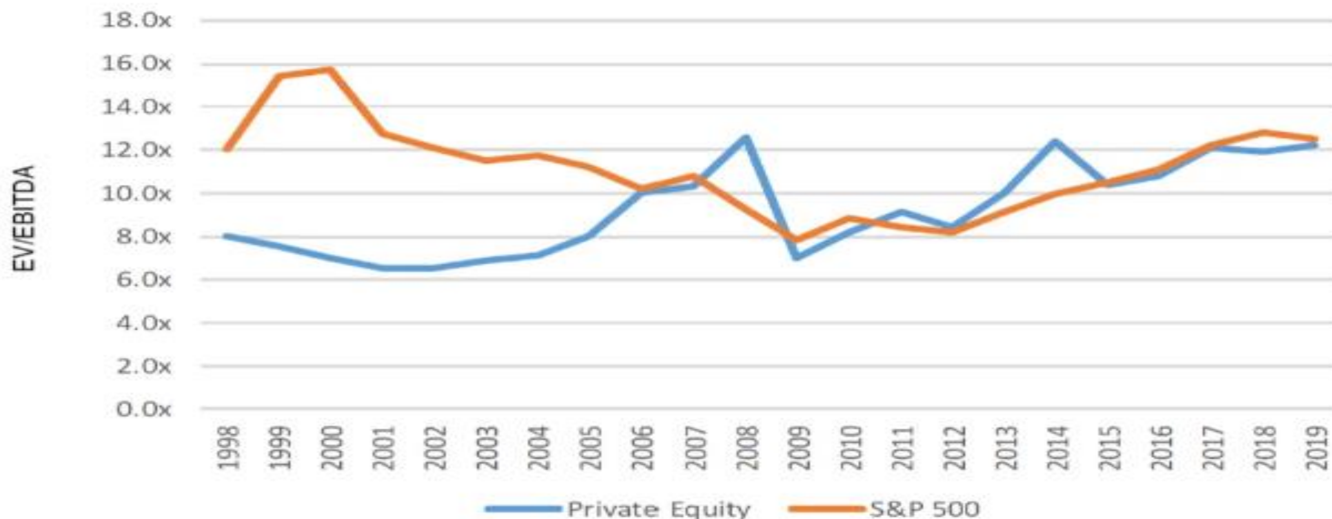

Figure 2. PE valuations (Source: S&P Capital IQ)

The valuations (above) paid for these assets are based on adjusted EBITDA. Much like a fisherman over exaggerating the size of his fish, PE and public companies add back numerous adjustments and expenses in order to make the price look lower. For example, one company added back adjustments of "shutting offices, cutting workers, and renegotiating contracts" to EBITDA. They call them adjustments. We call them expenses nearly every business in the world encounters. An S&P study found when comparing the actual EBITDA of PE companies in 2016 and 2017 against the firms' own projections in 2015, the REAL EBITDA was 29% lower in 2016 and 34% in 2017. Next time you get a business loan from a bank try to convince them some of your expenses aren't real and should be added back. This tactic seems to work for these companies.

As PE firms are now paying a higher price for these assets on an adjusted EBITDA basis, they are also greatly overestimating the quality of the assets they are buying. A recent survey by Verdad Advisors of institutional investors found 76% of these investors believe their PE portfolios command a credit rating of "BB" or better. The credit rating agency Moody's found, however, just 2% of PE portfolios possess a rating of "BB" or better (Figure 2). Remember, a credit rating below "BBB-" is considered junk or high-yield. "BB-" rated bonds have experienced an average cumulative default rate over ten years of over 25% since 1981.

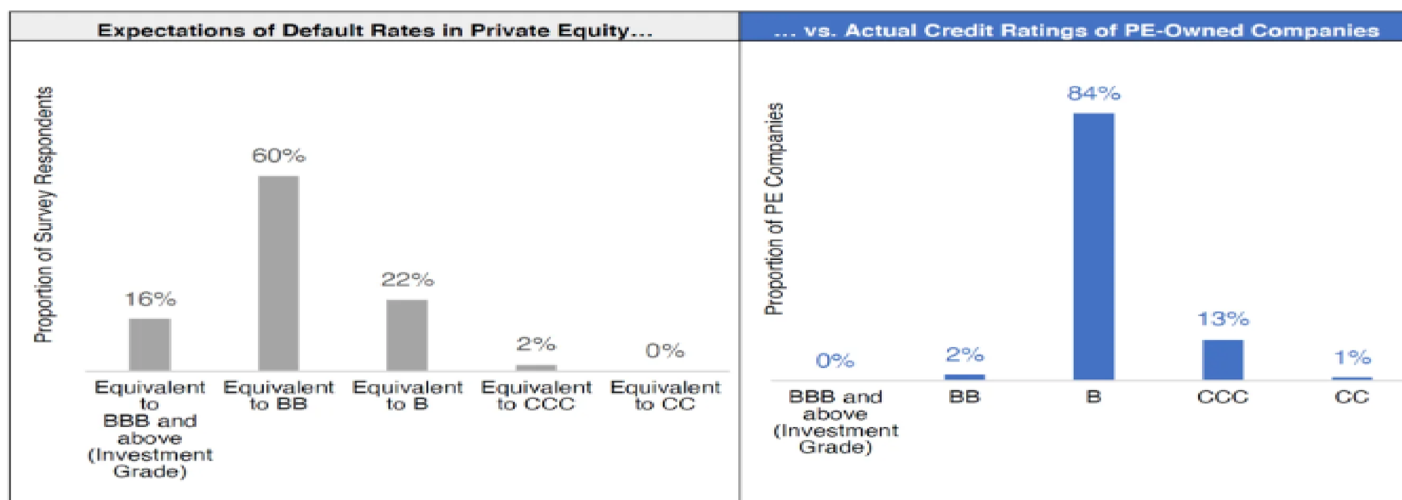

Figure 3. PE credit rating expectations vs. actual (Source: Moody's, Verdad Advisors)

As these PE firms overestimate their earnings (adjusted EBITDA) and credit quality (Figure 3) they then do the most logical next step, take on more leverage (Figure 4). After the financial crisis the Federal Reserve, OCC, & FDIC issued guidance (https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf) to banks around lending, which stated most companies with leverage in excess of 6x EBITDA raises concerns. Banks now tend to stop at 6x EBITDA, but PE firms utilize the adjustments to EBITDA discussed above to work around this. These levels of leverage leave companies with little to no margin of safety. Most companies' cash flows are too volatile and unpredictable to maintain these debt levels.

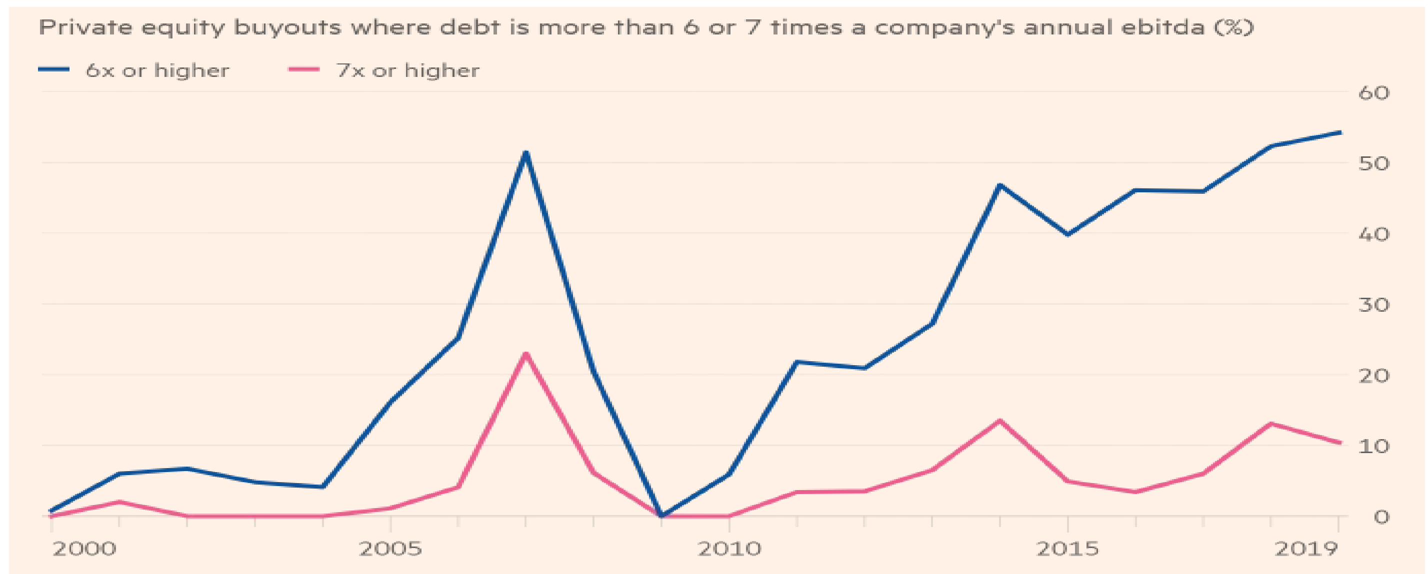

Figure 4. PE Leverage (Source: Bain & Company, Loan Pricing Corp.)

What about the diversification benefits of private equity? JPMorgan found from 2009-2019 the correlation of private equity with global equities to be 80%. Part of the "diversification" component of PE comes from the characteristic of being self-marked. Unlike public equities where you can get a daily price, PE is marked quarterly, semi-annually, or even on an annual basis. PE outperformed the S&P 500 by 1% per annum from 2013-2018, however, all of this outperformance came during Q4 2018. This is the same quarter the S&P 500 was down 13.5% but PE was self-marked down only 1%-2%. How can the largest stock market in the world be down double digits but private equity is almost unaffected?

So as the multiples of these assets on an "adjusted EBITDA" basis has risen, credit quality is drastically overvalued, leverage has increased, and volatility of these assets is being underestimated due to the ability to self-mark, surely institutional investors are factoring this into their return assumptions and allocations. Not exactly. In the same survey by Verdad cited above, 94% of institutional investors thought private equity would outperform public markets by at least 2% and 24% of the investors thought it would outperform by more than 4%. To quote Marks again, "The riskiest thing in the world is the belief that there's no risk."