How to Avoid the Private Equity Liquidity Trap

June 22, 2018

by Avi Lavi, Tawhid Ali

of AllianceBernstein

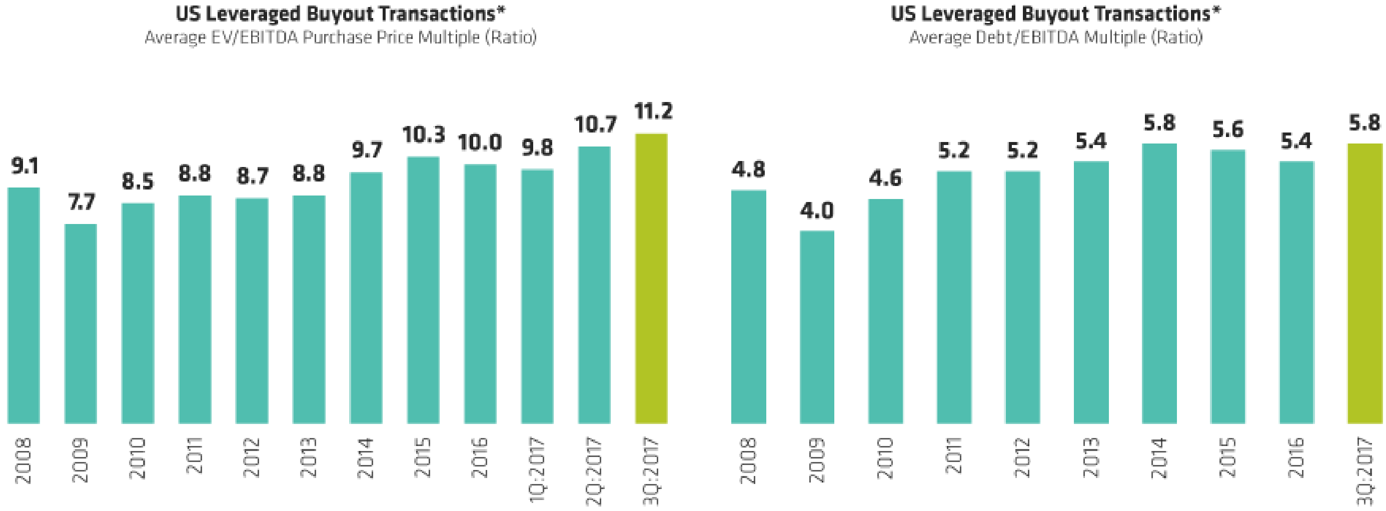
Private equity funds continue to attract interest, despite rising deal valuations and high levels of leverage. We think there's a way to get many of the benefits of private equity in public markets—without forfeiting liquidity.

It seems like nothing can stop the private equity boom. Yet after a record year of fundraising in 2017, big challenges loom. Private equity funds are sitting on more than $1 trillion of dry powder, or funds that have yet to be deployed, according to Preqin, a research group. Mounting competition for deals is having a profound impact on the market.

Leveraged Buyouts: At Any Price?

Deal prices and leverage reached very high levels last year. In the US, the multiple paid for leveraged buyouts, using enterprise value to EBITDA, reached a record 11.2x in the third quarter of 2017, according to S&P Capital IQ. Debt taken to fund these transactions reached 5.8 times EBITDA—about 1.4 times higher than in 2009 (*Display 1*). Deal multiples may rise further this year amid rising competition, in our view.

Private Equity: Paying Higher Prices and Taking on Greater Leverage



As of September 30, 2017

Past performance does not guarantee future results.

*Includes large transactions where issuer's EBITDA is greater than US$50 million

Source: S&P Capital IQ

That spells trouble for private equity funds. It's going to become much harder to source deals that can yield expected profits over the long term. And if exits become more challenging too, returns could take a hit. Investors who park their money in a private equity fund could end up stuck in a liquidity trap if tougher markets make it harder to cash out over time.

Avoiding the Headaches of Private Equity

Liquidity is clearly a growing risk, in our view. Bain & Co., a management-consulting firm, asked in a recent report whether it's possible to replicate private equity returns in more liquid public equity markets to help investors "avoid the headaches of PE investing—including high fees, illiquidity and the challenge of securing allocations in funds of top-performing managers." Probably not, the report said, because private equity investors have three investing tools that public equity investors lack: they can use debt to magnify equity returns; they can provoke corporate change to foster improvements in company performance; and they can select sectors that will outperform the broad market.

We beg to differ. In our view, private equity investors have no inherent advantage in sector selection over public equity investors. Active managers with a strong industry knowledge base and research culture can allocate capital to sectors and companies that have outperformance potential with the same proficiency as a private equity investor. What's more, active equity managers can apply several components of private equity investing to public markets (Display 2), including:

- **A business owner mindset.** Public equity investors should evaluate companies based on their business fundamentals—not market metrics like a stock's beta. That means developing long-term forecasts as if you were buying a strategic stake in the company.
- **Returns from cash flows.** These are a better indicator of corporate health than reported earnings figures. Cash flows are insightful because they show just how much cash may be flowing into or out of companies in the form of working capital and capex spending—which don't show up in reported earnings. By shifting away from earnings toward cash flows as a key indicator, public equity investors can identify high-return-potential stocks.
- **Internal rate of return.** Private equity investors use IRR to show the return potential from investing in a company based on cash-flow forecasts—without the benefit of an expansion of the company's stock market multiple, or a market rerating of the stock. By applying the same IRR concept to stock candidates in the market, we believe public equity investors can identify companies that can deliver returns, even in a challenging market environment.

Private Equity vs. Public Equity

	Private Equity	Public Equity
Business-Owner Mindset	✓	✓
Returns from Cash-Flow Generation, Not Multiple Expansion	✓	✓
Focus on Internal Rate of Return	✓	✓
Good/Improving Balance Sheets	✓	✓
Attractive Fees	✗	✓
Unlevered Returns	✗	✓
Liquid	✗	✓
Change/Reincentivize Management Teams	✓	✗

Source: AllianceBernstein (AB)

Beware of High Leverage as Rates Rise

Bain's assessment isn't all wrong. It's true that public equity investors don't use leverage to supercharge their investments. But we think that's a good thing. If interest rates rise, excessive leverage could prove to be very costly as higher financing costs erode return potential.

It's also true that public equity investors can't change management or reincentivize executive teams, strategic moves that help create private equity alpha. That said, active equity investors can play an important role by engaging with management teams to promote positive change in many areas, from corporate strategy to environmental, social and governance issues. This type of engagement ultimately supports shareholder returns.

With the right attitude, we think public equity investors can take advantage of many of the benefits of private equity investing, minus the liquidity risk. In a world of intense competition for deals and new market challenges that could raise the bar for private equity success, investors should carefully consider whether locking up funds for several years could be counterproductive to their long-term goals.

The views expressed herein do not constitute research, investment advice or trade recommendations and do not necessarily represent the views of all AB portfolio-management teams. AllianceBernstein Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.