The public side of private equity

A basket of stocks or ETFs allow investors to play in the big leagues

›BY ARTHUR SALZER

A COUPLE OF YEARS AGO, I was presenting on an investment panel called Opportunistic Investing in Private Equity that was made up of other professional investors such as pension and sovereign wealth funds. All of us came to the conclusion that there was significant capital being raised by the large private-equity firms, but the leveraged buyout (LBO) firms caused us the most concern. We believed the large amounts of capital that had to be put to work would create an environment where these firms would overpay for acquisitions. In essence, we did not see the same opportunity we did after the Great Financial Crisis.

An idea then came to me to examine how the public stocks of private-equity firms such as Apollo Global Management LLC, Blackstone Group LP, Carlyle Group LP, etc., were performing. We quickly discovered that most of these stocks were trading 40% or more below their highs. They were also trading at discounts to their prospects — the large management fees that these firms would generate from the mega-funds of $5 billion or more that were raised. The carry or performance fees, while potentially even larger, are not typically paid until towards the end of a private-equity fund's life, which is typically 10 years.

The way private equity works is that there is a general partner (GP) and many limited partners (LPs). Depending on the fund, the GP will commit its own capital (typically money from employees, senior partners and shareholders) within a range of 1-10% of the overall fund raised. This is called skin in the game, another phrase coined by former trader and now author, Nassim Taleb, who wrote the books *Black Swan* and, most recently, *Skin in the Game*). Skin in the game is important because it aligns the rewards and, especially, the risks of investing and operating complex investments such as private equity. In the case of publicly traded private-equity stocks, the shareholders also share in the risk and return of the GPs. Two years ago, many of the public private-equity stocks were down due to increased regulation and the potential for increased taxation on the GPs' fees.

My argument to the audience and fellow panelists was that despite the mega-funds that were being raised, if you still wanted to invest in one of the funds from one of these large and publicly listed private-equity firms, but either didn't have the capital to write the US$10-million cheque or wanted to put capital aside to meet the capital calls that would occur, an investor should consider buying one, or better yet a basket of these listed companies (of course, after completing due diligence).

An easier and more efficient method than buying than a basket of stocks would be to buy an exchange-traded fund, which have exposure to a group of publicly traded private-equity companies. At this time, there are only two listed ETFs of significant size and trading volume: the iShares Listed Private Equity UCITs (short for Undertakings for Collective Investment in Transferable Securities) ETF, which trades on the London Stock Exchange, and the PowerShares Global Listed Private Equity Portfolio ETF, which trades on the NYSE.

These ETFs hold familiar Canadian private-equity firms such as Brookfield Asset Management Inc. and Onex Corp., which may be included alongside U.S. counterparts such as KKR & Co. LP and Blackstone, among others. There are pros and cons to using ETFs. One of the latter is the underlying management fee, but this is typically offset by the reduced commissions and increased efficiency of not having to execute on multiple trades.

Whether an investor uses a basket of stocks or an ETF, it's best to look at these public proxies as a trade or short-term replacement for the underlying private-equity funds, but not a likely long-term investment. This, in essence, follows the private-equity model as well, since the key to success for a top quartile private-equity investor is the ability to time the deployment of capital from LPs into private companies and subsequently when to sell. The ability to manage and grow portfolio companies is extremely important, but the managing of cash flow should not be underestimated.

Back to my panel discussion, had an investor bought the beaten-down publicly traded private-equity firms at the time in 2016, they would have seen some of the stocks rise 50%, some even 100%, over the following 18 months. Indeed, there was an opportunity to invest in private equity, but it was found in the public markets.

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