Current Private Equity Markets and the Internal Rate of Return Fallacy

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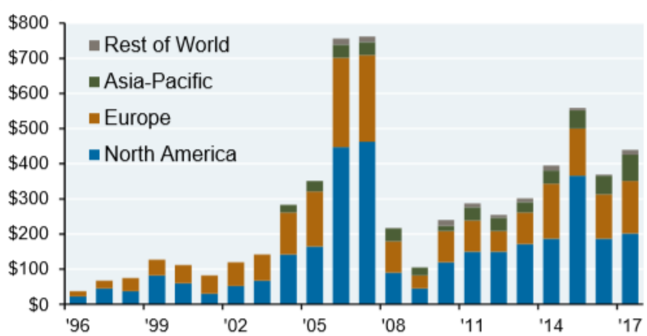
So first, after reading this you might think I am hesitant or opposed to private equity. Please do not misunderstand my cautionary assessment. Private equity is an important component in long-term portfolios. As a former endowment CIO, I have invested in many private equity funds across many strategies. Today, we still work with some of the most talented PE managers, but what I see today concerns me a lot.

THE CURRENT ENVIRONMENT

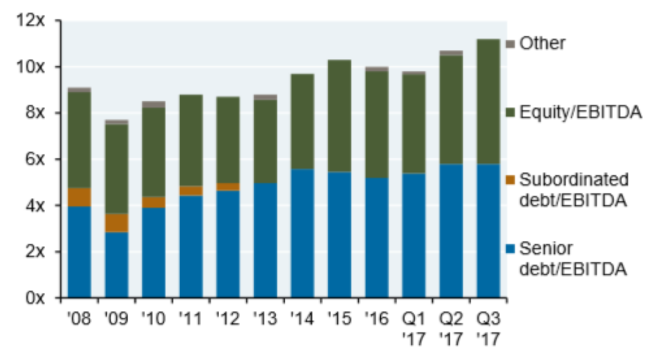
The number of PE funds reached an all-time high in 2018. Dry powder, or money ready to be called and deployed by PE funds, is estimated to be between $1 - $1.5 trillion. I am not surprised to see this activity at this stage of the cycle. With lower expected returns in public equity and fixed income markets and the promise that long-term PE funds produce higher returns than public markets, institutional and individual investors are increasing their allocation to PE funds.

Global buyout deal value
US$, billions



Source: Bain Global Private Equity Report. 2018.

Buyout purchase price multiples
Average EBITDA purchase price multiple for US LBO transactions

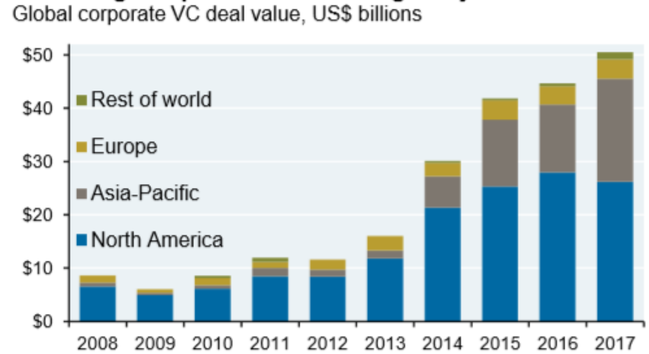


Source: Bain Global Private Equity Report. 2018.

LBO leverage
Average debt/EBITDA multiple for large US LBO deals

Source: Bain Global Private Equity Report. 2018.

Increasing competition from strategic buyers
Global corporate VC deal value, US$ billions



Source: Bain Global Private Equity Report. 2018.

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This environment has also created the most misleading and sometimes overstated past and future performance presentations I have ever seen. We now see more often managers presenting high IRRs and top-quartile rankings. I also think this is one of the reasons investors are looking to allocate so much capital to this asset class.

THE FALLACY OF IRR

The IRR (internal rate of return) method has its advantages, but the way it is being used and reported by many funds makes it a horrible measure for the success of PE funds. It is so misunderstood that I recommend that investors who do not understand how IRR is calculated and its pitfalls to not look at it at all when examining a fund's returns. If you inquire, you will be amazed to see how many investors think that a 25% IRR means the fund made 25% annually through the time of the investment.

Every investor is familiar with the past performance disclaimer found in any investment fund presentation: "Past performance is no guarantee of future results." But guess what the IRR is doing? The main problem with the IRR calculation is the assumption that cash proceeds are reinvested at the same IRR for the entire investment period. For example, if a fund returned capital at an early stage and reported an IRR of 40%, the IRR calculation then assumes the money that was distributed is put to work at the same IRR of 40%, **but in reality, no investor will really receive the equivalent cash returns.**

The IRR calculation puts a lot of weight on the earliest cash flow, how quickly a fund deployed capital and how quickly they returned capital will have significant effect on the IRR. This effect will sometimes overstate IRR by two times or more.

START WITH CASH ON CASH MULTIPLE

The simplest way to approach this is by first calculating the cash-on-cash return. Divide the amount distributed back by the fund by the amount invested in the fund. This is not a perfect calculation for performance, **but if the IRR is overstated, it will be apparent in the cash-on cash-multiple.**

THE RIGHT WAY TO INVEST IN PRIVATE EQUITY FUNDS

For us to be comfortable locking a family's money for 10 and sometimes 15 years, we have to be as confident as possible that the returns vs. the risks offered by the fund are superior. The due diligence and selection of a PE fund is a long and complex process and should be done by professionals with significant experience. A mistake in fund selection could be very costly.

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