Reversal of the cycle: are the large buyout funds more resistant than the smaller ones?

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Jean-Yves Lagache
Managing Director – Fund Investments
jyl@essling.com

We analysed the behavior of buyout funds during the last market cycle reversal at the end of 2008. The study of the Preqin database data sheds light on a growing investor concern.

Key Points :

- **The performance of European buyout funds raised before the 2008 financial crisis was generally solid;**
- **Smaller funds did not prove to be more risky than larger funds**, with a comparable loss ratio for the worst performing quartile;
- On the other hand, the **first half of small and medium-sized funds significantly outperformed** that of large funds in IRRs and multiples.

Did European buyout funds weather the last crisis well?

Over the last decade, the 2005 and 2006 vintages were the most affected by the major financial crisis at the end of 2008, as these funds deployed a significant portion of their capital at the top of the cycle. Nevertheless **the performance of the European buyout on these two vintages was solid** across all fund sizes combined.

This performance to date should not be jeopardized by the risks associated with the last holdings in the portfolio, as most of the funds' holdings have been sold and the capital returned to investors.

Performance of the 2005 and 2006 vintages

European Universe of Buyout Funds		
Median IRR	Median TVPI	Median DPI
9.18%	1.57x	1.43x

Source: Preqin, data available as at 09/30/2018

IRR: *Annualized rate of return.*

TVPI: *The sum of the assets redistributed to investors and the unrealised value of the fund, in relation to the capital called, i.e. the total value to paid-in multiple of actual and potential return.*

DPI: *Redistribution of assets to investors in relation to called capital, i.e. the distribution to paid-in multiple.*

Is there a link between performance and the size of buyout funds at the bottom of the cycle?

Funds with a size between €100m and €500m (which invest equity tickets between €5m and €100m in Small Cap and Lower Mid Cap transactions) generated median performances comparable to those of funds with a size above €500m ("Upper Mid Market" and "Large Cap" transactions).

Comparison of 2005 and 2006 vintage performance by fund size

	Buyout funds between 100 and €500m	Buyout funds over €500m
Median IRR	9.7%	9.16%
Median TVPI	1.57x	1.57x
Median DPI	1.42x	1.43x

Source: Preqin, data available as at 09/30/2018

In contrast, **the first and second quartiles of small funds outperformed substantially** the first and second quartiles of larger funds.

Comparison of the high part of the performance of the 2005 and 2006 vintages by fund size

	Buyout funds between 100 and €500m	Buyout funds over €500m
Lower limit IRR 1st decile	32.00%	14.00%
Lower limit IRR 1st quartile	20.50%	11.20%
Average TVPI 1st quartile	2.94x	2.03x
Average TVPI 2nd quartile	1.70x	1.63x

Source: Preqin, data available as at 09/30/2018

It should be noted that only one large fund among a sample of 29 reached a net IRR of 20% for these 2 vintages.

On the other hand, many small and medium-sized funds performed well, with nine of them among a sample of 35 whose net IRR exceeded 20%.

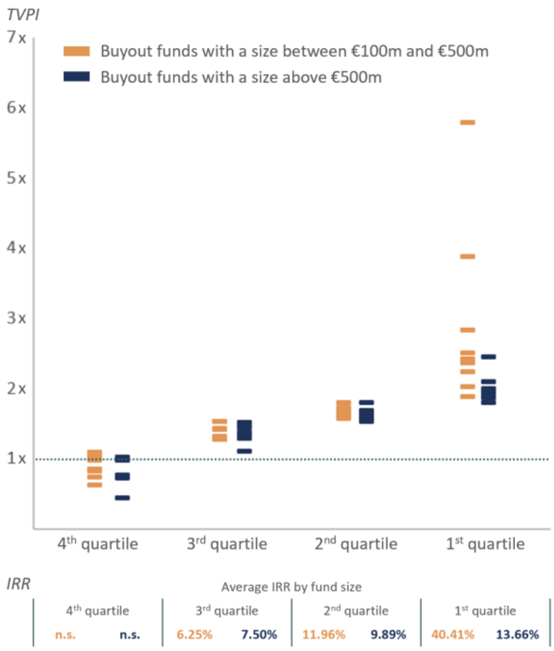
Is there a link between underperformance and the size of buyout funds at the bottom of the cycle?

The last quartile of funds with a size between €100m and €500m and the last quartile of funds with a size above €500m have a comparable negative average performance. The average TVPI are 0.87x and 0.88x respectively, representing a capital loss of 13% and 12%.

As an anecdote, the fund with the highest capital loss is a fund with a size of more than €500 million (TVPI 0.46x).

The widespread idea that small funds and transactions are more risky than large ones is not demonstrated in practice in the European buyout universe.

Breakdown of the performance of the 2005 and 2006 vintages by TVPI and TRI



Source: Preqin, data available as at 09/30/2018

Conclusion:

These factual observations of the last cycle reversal in Private Equity allow us to draw 3 main lessons:

- The dispersion of fund performance is higher among small and medium-sized funds than among large ones, but it is a "good" dispersion because it **potentially generates outperformance**, provided that you have access to these funds;
- In terms of risk, the reversal of the cycle affects both large and small buyout funds, with **a comparable loss ratio for funds in the last quartile;**
- Our interpretation of these results is that the size of the underlying companies is not sufficient protection in the event of a market downturn in private equity transactions. Indeed, **some large transactions were concluded on the basis of excessive entry prices and debt leverage between 2005 and 2007**, which penalized the funds that held these companies during the cycle reversal in 2008-2009.

Biography

Jean-Yves Lagache
Managing Director – Fund Investments
jyl@essling.com

Jean-Yves, 56, joined Essling Capital in 2017 after 22 years at Amundi, including as head of the Private Equity fund selection team since 2007.

He began his career with the Sodexo Group, then the Suez Group.

A graduate of ESSEC, Jean-Yves holds a DESCF and a Master's degree in law and is a financial analyst.

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For further information, please contact us at the following address: ir@essling.com

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