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Can leveraged public markets match PE returns?

Private Equity (PE) firms seek to provide investors with the chance to generate financial returns that exceed those available in public markets. But, given PE's use of leverage, it may be that public investors could generate the same returns simply by borrowing money from their bank and investing in publicly traded equities. Building on a previous Research Note that discussed the appropriate way to compare private equity and public market returns, this note examines this claim using BVCA data on fund performance. We find that, because the risk profiles are very different, leverage can actually reduce returns that investors get from public markets.

The role of leverage

Benchmarking private equity returns against public market investments is an important way of gauging whether private equity (PE) can genuinely deliver significant outperformance or not. A previous Research Team note, *Benchmarking private equity against public markets*, set out an appropriate way of comparing these returns, known as the Public Market Equivalent method, or PME. This showed significant outperformance by private equity funds, based on the data that that the BVCA collects. However, those calculations ignored the role of leverage.

Leverage plays an important role in the private equity investment model. It allows PE firms to take control of a business with a smaller equity stake, or buy larger businesses, thereby giving them the opportunity to boost the overall return on equity that they can deliver. That said, a large body of research has shown that leverage contributes only part of private equity returns. In fact, leverage does not directly generate any return on its own – it merely amplifies returns from other activities. Fundamentally, the primary driver of returns is the improvement in the performance of portfolio companies.

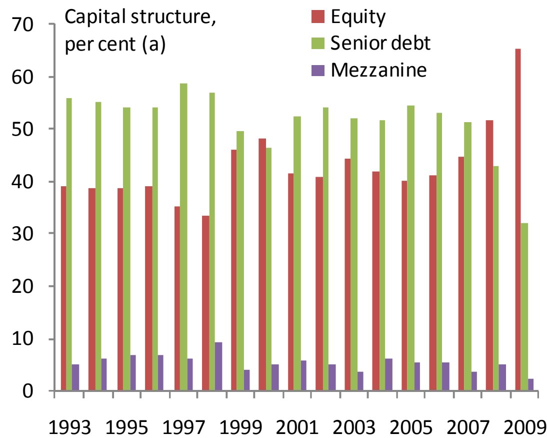
Risk profiles of public markets and private equity

One criticism sometimes levelled against private equity is that investors could generate the same returns simply by borrowing money from their banks and investing in publicly traded securities. By investing, say, £50,000 of their own funds, and borrowing a further £50,000 from their bank, private investors could boost their returns from public markets, in a similar fashion to the way PE investors stand to boost their returns using leverage. However, there is one critical caveat: private equity has a very different risk profile compared with private investors borrowing money to invest in public markets.

When a PE firm invests in a company, and borrows money to fund a buy-out, those loans are secured against the assets and value of the company, not the assets of the investors who provide PE houses with funds with which to invest. This means that, if a PE firm invests £5mn, and bank financing provides a further £5mn to fund the transaction, investors are liable for £5mn – that is the most they stand to lose. In contrast, when individuals borrow money to invest in the FTSE All Share, they could potentially lose their entire investment, and would still be liable for the funds that they have borrowed from the bank. The risk profiles of these investments are fundamentally different.

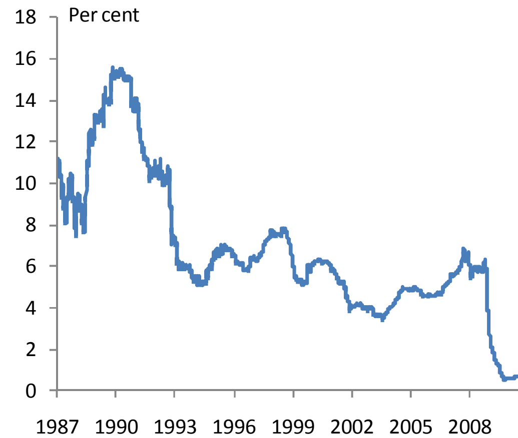
It is also important to recognise the role that leverage plays in reducing returns, which is not always spelt out. While bank borrowing allows PE houses to buy businesses with less equity than they would otherwise need, it also brings with it significant funding costs, in the form of interest payments. These obviously reduce returns to investors. Data from the Centre for Management Buy-Out Research (CMBOR) show that the precise structure of debt funding often varies within and between deals, and over time (Chart 1). Senior debt typically carries a lower interest rate than more junior debt such as mezzanine finance. These interest charges must also be taken into account when calculating leveraged PME returns.

Chart 1: Capital structure in buy-out deals



(a) Share of equity, senior debt and mezzanine finance. Source: CMBOR

Chart 2: Three-month Libor



Source: Bloomberg

Leveraged public market returns

So what returns can leveraged public markets generate? To conduct our analysis, we assumed that our hypothetical 'leveraged public investor' borrowed money on the average basis observed in CMBOR's data (Chart 1), invested the funds in the FTSE All Share, and paid down debt when cash was returned from investments. In terms of the interest cost for our investor's borrowings, hard data on interest charges for PE financing is difficult to find, but banks typically charge spreads over Libor, the benchmark London interbank interest rate (Chart 2). Based on practitioner feedback, we assumed that the cost of senior debt is 300bps above three-month Libor, and mezzanine debt 1000bps above the same benchmark. However, the broad results reported below are robust to other likely assumptions.

Table A: Internal rates of return (IRRs)

	PE IRR (%)	PME IRR (%)	Leveraged PME IRR (%)
Returns to end-2009	14.3	7.3	2.5
Returns to end-2007	17.5	9.0	7.2

Sample: 1986-2009. Source: BVCA.

It turns out that, due to the very different risk profiles and high interest payments, as well as the significant variation in the stock market, a public investor who borrowed money on the same basis as PE houses would actually have received lower returns than if they had not borrowed money at all (Table A). This clearly illustrates private equity's different risk profile, as well as its ability to use leverage appropriately and add value to portfolio companies. Borrowing money and investing those funds in public markets does not offer even a close comparison.

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