Private equity has been in a sweet spot in recent years - should that give investors pause for thought?

By Merrick McKay, Fund Manager, Standard Life Private Equity Trust plc

- The private equity sector has drawn considerable interest thanks to robust returns and some high profile companies.
- There is 'dry powder' in the sector, but there are still reasons to believe the sector can thrive from here.
- Standard Life Private Equity Trust (SLPET) primarily focuses on more nimble, mid-tier private equity managers with a European focus.

Private equity has drawn considerable interest in recent years. Some of the world's most exciting and high profile companies have chosen to remain private, while returns from private equity funds have been strong. Investors have, understandably, looked at the asset class more closely.

This has seen a lot of capital flow into the sector, with private equity managers sitting on significant 'dry powder'- money that is waiting to be invested. At the margins, investors have started to ask whether this reflects greater competition for deals and higher pricing, potentially leading to poor returns in the future. Are private equity's glory days behind it?

To our mind, many of the reasons for its success to date are still in place. The private equity sector underwent a reinvention in the wake of the global financial crisis. Many of those managers who had relied on simply using leverage and a rising market to generate returns are no longer in business, while those that remained made sure they got better at what they did. Improvements included building in-house operational expertise to directly assist portfolio companies, implementing intense buy-and-build strategies and putting more robust capital structures in place. We have also seen private equity managers become more specialised, going deeper into a narrower range of sub-sectors so they can acquire companies more like a trade buyer. Today, we believe private equity managers are in far better shape to weather a shift in the economic climate.

Equally, private equity has provided a fertile environment for companies to thrive. There are high profile names such as Uber, Airbnb or WeWork, that have spent far longer in the private market than would have been the case a few years ago. They have been able to raise funding and grow without some of the short-term constraints that may have been placed on them by a public listing. This is also true for smaller, less high-profile companies – they are generally staying private for longer. There are less publicly-listed companies today than 10 or 20 years ago. This trend doesn't look like stopping any time soon, creating opportunities for those prepared to invest in private equity.

These factors have helped private equity returns outstrip those from listed equities over the medium and long-term. At Standard Life Private Equity Trust, we believe returns from listed equities could remain low for some time, with private equity continuing to thrive. The current levels of 'dry powder' do not reflect a lack of opportunity, but simply that private equity groups have taken advantage of high levels of demand to raise capital.

That said, the level of uninvested capital, coupled with more competition for deals, may mean that future returns are lower than we have seen in the years immediately after the global financial crisis. Expecting returns to remain consistently at such a high level is unrealistic. However, investors need to bear in mind that returns would be falling from a high level and should still compare favourably to other asset classes.

Certain sub-sectors, such as medical technology or software, have been very popular and current valuations look high. Investors have been quick to pick up on areas of secular growth and businesses demonstrating high levels of recurring revenue. These are areas with significant economic resilience and, in many cases, deserve a higher valuation multiple. In general, we believe that the private equity market is efficient at pricing deals. Private equity investors have to decide how much they are willing to pay in this context and how they can create value over and above the target company's existing business plan. This is where the aforementioned increase in sector specialism, operational value creation and buy-and-build capabilities come into play.

There is no doubt that private equity has evolved following the global financial crisis and will continue to do so moving forward. It remains only a fraction of the size of the global listed market, but it continues to attract significant companies. There is now a broader range of funding options outside the public market, which is helping support these companies. The latest industry developments, particularly in sectors like technology and healthcare, continue to be driven by what is happening in private markets.

Our approach is to look for the best-in-class private equity managers, a majority of which will have a European focus. Our portfolio holds a concentrated portfolio of around 15-20 core private equity managers and we build and monitor these relationships carefully. We have known all our underlying managers for a long time. Our longevity, experience and large team allow us to access hard-to-reach opportunities.

We believe that the managers to whom we commit have built their portfolios to perform well in any economic environment and that they are addressing the sweet spots of the European and North American markets. Private equity investing requires committing capital for the long-term. This means we must have absolute conviction in our managers and the way they are positioned for rapidly evolving market dynamics.

At the Standard Life Private Equity Trust we are primarily focused on the mid-tier (investing in companies between €100m-€1bn in size), whereas a lot of the money that has come into private equity markets has gone towards the mega-cap managers. We believe there are more opportunities in the middle part of the market where managers have greater flexibility and can pivot their portfolios more readily if the economic environment changes.

Standard Life Private Equity Trust will always hold a carefully selected blend of managers pursuing different strategies, but at the same time, we re-underwrite each existing manager relationship during every fundraise and are always on the lookout for new and interesting opportunities. However, they must fit the SLPET criteria - last year, we reviewed 36 funds and made five commitments.

The recent interest in private equity should not deter investors. The sector has seen considerable change and exciting, fast-growing companies are remaining private for longer than ever before. We believe private equity still holds a wealth of opportunities for investors.

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