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What is the Cost of Private Equity?

Given the changes in today's economic environment, what return should a private equity investment generate?

by Mark D. Working

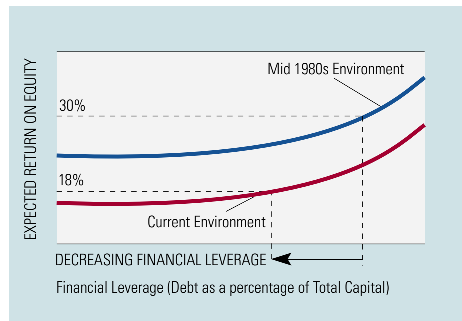
For many years, we have heard the comment, "A private equity investment should generate a 30% return". This comment has come from investment fund managers, investment bankers, and owners of privately or closely held businesses. But, is this single equity return benchmark still relevant in today's business climate? It doesn't make sense to us that this investment hurdle continues to be valid, given the changes in the economic environment. Two readily observable economic factors lead us to conclude that a fundamental shift in equity-return expectations must have occurred: lower interest rates and the reduced leverage (and risk) of target investments.

As a result of these experiences, and because of the perceived risk associated with these investments, the industry became comfortable with the notion that a return in the 30% range was proper compensation.

CORPORATE FINANCE MATH

Private equity funds dramatically expanded in the mid-1980s, at the onset of the leveraged-buyout era. During that time, private equity investors were investing relatively small amounts of equity capital (around 10%-20%), coupled with large amounts of debt (80%-90%), to complete transactions. As these transactions matured and the portfolio companies were sold, private equity funds realized large returns. As a result of these experiences, and because of the perceived risk associated with these investments, the industry became comfortable with the notion that a return in the 30% range was proper compensation.

It is a much different environment today. Interest rates are significantly lower. This factor alone should cause all return expectations to decrease, because the benchmark against which all investments are ultimately measured, the risk-free rate, has declined. In comparison, a 10-year treasury bond in the mid-1980s yielded around 10.5%. Bonds with the same maturity in today's market yield approximately 3.3%. The reality is that a 3.3% return today and a 10.5% return in the 1980s are equivalent in terms of the risk-reward payoff.



Additionally, the ability and willingness to use leverage to finance a transaction today is significantly reduced from the early days of LBOs. Current private equity transactions only support debt in the range of 50% of enterprise value. The result is a greater equity investment and a significantly reduced level of financial leverage and risk.

The cost of equity is a significant factor in the determination of the WACC. Equally important components are the cost of debt and the amount of financial risk, measured as the relative amount of debt and equity in the capital structure.

The above graph illustrates the corporate finance theory of return and risk as measured by financial leverage. The downward shift of the curve represents the effect of lower interest rates and the leftward movement along the curve shows the impact of less risk on the return requirement.

After adjusting for these factors, our calculations lead us to believe that the required return-on-equity for similar businesses should be much lower. A 15%-20% return on equity sounds much more reasonable than 30% in today's market.

WHAT DOES THE MARKET THINK?

Discussing this issue with private equity managers yields agreement on the intellectual concept of less risk requiring less return. Yet, many private equity fund managers say that the private equity industry experience with private-company investments has proven that the business risk is far greater than was previously thought and that fact justifies continuing high return hurdles. Some equity managers indicate that their investors have started to adjust to the lower-return environment. Investments in the low-yielding corporate bond market (5%-6%), the low return stock market (7%-9% expectations), and less-than-promised venture capital and private equity returns have lowered institutional investors' expectations.

A more sophisticated assessment of risk seems to be evolving, with very good private companies being valued at higher levels and less mature or riskier market position businesses being more harshly assessed.

Investment advisors to institutional investors in private-fund investments provide additional evidence for the thesis that equity returns have dropped. Our sense from these discussions is that a fund manager that could generate returns to investors in the range of 15% would have little trouble generating an institutional following. Grossing up this return for management costs implies a cost-of-equity in the range of 18% for a private

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equity investment.

THE RELATIONSHIP BETWEEN THE COST OF EQUITY AND VALUE

Value is a function of the projected operating cash flow stream discounted by the weighted-average cost of capital ("WACC"). The cost of equity is a significant factor in the determination of the WACC. Equally important components are the cost of debt and the amount of financial risk, measured as the relative amount of debt and equity in the capital structure. The table in the next column illustrates the change in values of the different components between the mid-1980s and today, and the effect on the WACC and business value.

	MID-1980s	CURRENT
Cost of Debt	13%	6%
Cost of Equity	30%	18%
Financial Leverage*	80%	50%
WACC*	12.8%	11.0%
Implied Value/EBIT Ratio*	5.09	5.94

* *Defined as Debt/Total Capital Invested*
** *Tax rate is held constant for both periods*
*** *Assume no growth cash flow stream*

If the underlying fundamentals of the business remain equal, changes in the WACC should imply higher values. This may help to explain the relatively high transaction values being assigned to very good companies showing long-term market stability and growth. The high degree of competition for these opportunities has shown that investors are willing to accept a lower rate of return for a high quality, low risk business.

But, not all transactions are generating these values. Institutional investors have learned more about the risk of private equity investing and are showing greater selectivity. In the last few years, we have observed a much narrower focus on acquisition candidates by potential acquirers. In short, they are sticking close to what they know. A more sophisticated assessment of risk seems to be evolving, with very good private companies being valued at higher levels and less mature or riskier market position businesses being more harshly assessed. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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