Lincoln Private Investment Office

London

Private Equity

Conventional equity investment involves purchasing shares in companies that are typically listed on a stock exchange where there is a publicly available price. By contrast, private equity is investment into companies that are not listed on any exchange, and to exit the investment those companies must ultimately be sold to other investors; either by sale to another company or private investor, or by floatation on public markets.

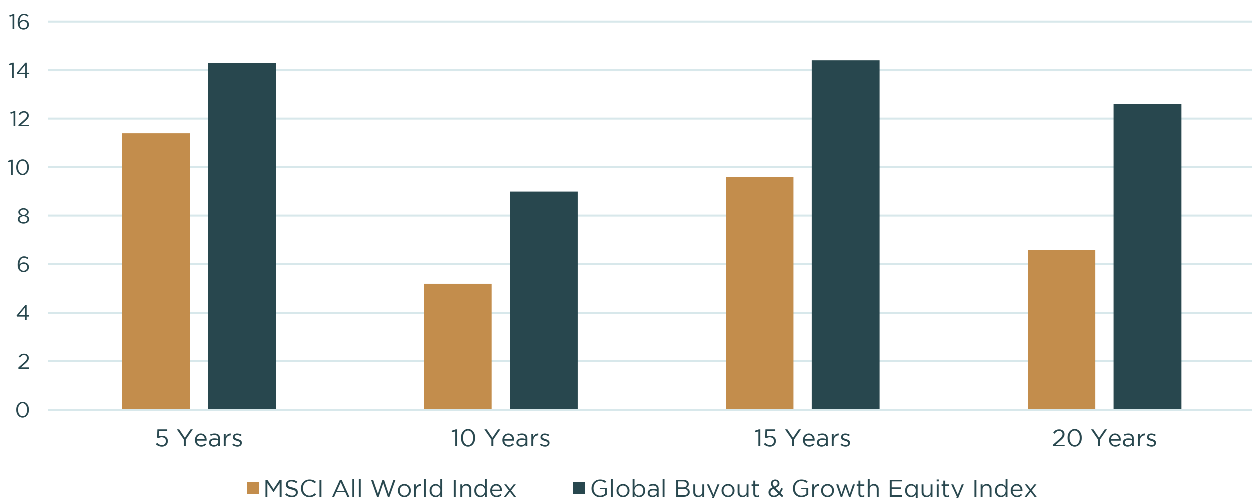
The industry traces its roots back to the late 18th century when wealthy individuals would provide capital to entrepreneurs. Private equity investment, as we know it today, developed in the late 1970s and was professionalised in the 80s and 90s, eventually becoming a large and extremely important asset class for both investors and those in need of capital.

Private equity investment is typically made over a medium to longer-term time horizon and has a number of benefits, including:

- Having a longer-term strategy avoids the need to focus on short-term targets based on arbitrary reporting cycles.
- Freedom from restrictive public company regulations which can hamper management ability to focus on business operations.
- Professional expertise and experience of the private equity investor to assist management of the company in achieving faster growth.

A key feature of the private equity asset class is the lack of liquidity. On the surface this may seem like a negative characteristic, but we believe that the benefits above mean that investors with a medium to longer-term time horizon, who are willing to accept the illiquidity of private equity, will be rewarded with higher returns.

These and other factors have led private equity to outperform public equity significantly over the longer term, as illustrated in the chart below.



Source: JP Morgan, 2018

Along with the benefits of the asset class, any investor in private equity also needs to be aware of the risks: investments are often made into smaller businesses that can have a higher chance of failing; use of leverage can increase the potential for losses; the sale price for an investment can depend on the economic environment at that point in time; and there is no guarantee a buyer for a business can be found. Because of these risks and the need to be patient when investing in this asset class, we would normally recommend clients look to allocate a modest portion of their overall investment portfolio to the asset class.

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We also believe it is important to ensure the right level of diversification across multiple companies to mitigate some of the risks. As a result, we prefer investing via a fund, which has the benefit of spreading the investment over a number of companies and allows us to access the experience and expertise of the fund manager.

Private equity investing varies widely in its style and approach – some fund managers are relatively passive investors, relying on leverage and company management to do a good job and grow profitability, whereas others are more active and support the companies they invest in. At Lincoln we tend to focus on the latter. Our preference is to search globally to seek out managers that have the following characteristics:

- Managers should demonstrate the expertise and network to be able to identify, build a relationship with, and add real value to a company.
- The private equity team should have a substantial amount of their own liquid wealth invested in their own fund to ensure full alignment with the investors in their fund.
- Recognition of capacity constraints is crucial. We only invest in funds who are disciplined in relation to their size; while some funds have the ability to raise and invest large amounts, we tend to prefer smaller specialist funds that truly understand their market and strategy, resulting in better performance over time.

There is considerable divergence between the best funds and the average funds in the sector, which highlights that the biggest challenge for individual investors is gaining access to the right managers. Based on recognised industry data, the top 25% of private equity managers delivered almost double the returns of the average manager over the same period.

Over the last 17 years, the number of private equity firms has increased three-fold and the assets under management has risen from c.$600 billion to c.$2.5 trillion. This growth has been largely driven by the reputation of private equity firms for significantly increasing the value of their investments.

At Lincoln, we are very fortunate to benefit from an exceptional network of global contacts that enable us to identify and access the most interesting private equity managers that can add long term value to investment portfolios. We employ a strong internal due diligence process together with external legal reviews to minimise investor risk. Combining these together means our investors are shown only the best opportunities, many of which are not available to private clients elsewhere.

Ultimately, we believe this asset class is an important part of most client portfolios and, over time, will deliver significant returns and diversification to more liquid investments, rewarding investors for the risk and illiquidity they have taken on.

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