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Private equity may be trapped by the rigidity that made it successful

Sir, Sujeet Indap ("Private equity chiefs feel misunderstood — and undervalued", Inside Business, March 22) omits three critical facts. First, in terms of historical performance, there is every reason to feel misunderstood. According to a 2014 Journal of Finance study, top quartile buyout fund outperformance relative to the S&P 500 has consistently averaged at least 20—27 per cent over a fund's life and more than 3 per cent annually. In the words of legendary investor Carl Thoma: "Private equity is about superiorly managed and performing companies, not being an investor. It is about being proactive." In that regard, public market investors should carefully study operational and governance engineering measures routinely practised by leading PE firms.

However, there are two structural challenges that may suggest that public markets are right in discounting PE firms' expected future performance. On the one hand, according to Bain's 2015 Global Private Equity Report, there is an excess of more than $1tn in dry-powder waiting to be invested. "Money chasing deals" is likely to erode investment returns. There are diseconomies. More important, however, the question arises as to whether the formula for success of the past is likely to work in today's disruptive market environments where operational and governance engineering may not be enough but business models will be disrupted. Private equity might be trapped in the very rigidity of its execution model that laid the foundation for past success.

For PE to be valued "fairly" and continue generating outsized returns, it must transform industries rather than just focus on monetising efficiency gains or untapped growth. The PE industry is challenged to first reinvent itself: become more flexible and explorative, create unique deals as opposed to simply outbidding on high profile assets, and recruit a more diverse employee base to foster creativity and "out-of-the-box" thinking.

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