

Mystery solved



Alice Murray reviews how John Gilligan and the late Professor Mike Wright have comprehensively explained the asset class in the fourth edition of *Private Equity Demystified*

The fourth edition of *Private Equity Demystified* encompasses a vast array of the complexities of private equity (PE), from the technical intricacies of deal-doing to the role of debt, and the industry's impact on the wider economy. Like the previous three editions, this is a practical and informative guide. It has just been published by Oxford University Press and is on the academic reading lists of business schools across the world.

Those who will benefit most from this book are undoubtedly existing investors, advisers and those who

are considering allocating capital to the asset class for the first time. As alternative assets become a larger component of investors' portfolios, the nuances and intricacies of PE investing have required a deeper contextual understanding.

Written largely by the start of 2020, in the belief we were at the top of a cycle, which may well prove to be true, this edition has a greater emphasis on debt than previous ones. Interestingly, it's not portfolio company leverage in focus this time. Instead, the authors John Gilligan, director of the Finance

Lab at Said Business School, and the late Mike Wright, who was a professor at Imperial College Business School, take a long, hard look at fund finance.

Fund finance, which is essentially a loan at fund level that's secured against limited partner (LP) commitments, is described as an important innovation because it changes one of the central features of the private equity model. Subscription lines, used to finance deals without having to call down capital from investors, have become "almost ubiquitous since we first wrote this guide"; the authors say. "Introduced to



'Few books about private equity span such an array of its facets with such academic rigour'

manage working capital for LPs, they have subsequently become tools to massage returns," they add.

The book notes that when the asset class was first established, "funds were not traditionally structured using third-party debt and therefore didn't generally carry significant bankruptcy risk". The 2014 edition predicted that increased fund borrowing would lead to increased systemic risk, and in the latest book the authors "stand by the implications of that analysis".

Fees and performance

Private Equity Demystified also analyses fund fees and returns. However, when it comes to PE, the private nature of the asset class means evidence "remains patchy". The authors find PE does outperform, but, "the evidence, such as it is, suggests that much (but not all) of the outperformance has, on average, been captured by the fund managers".

PE performance hit the headlines in 2020. *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory*, Professor Ludovic Phalippou's working paper, gained much media attention when it was published in summer 2020 because it questioned the industry's performance calculations and argued that fee structures overly benefited general partners (GPs) at the expense of LPs. Gilligan and Wright have seemingly preempted the renewed focus by noting the distinction between gross returns and net returns. The net return "is the one that should concern investors, since this is the return they would have actually earned if they had invested".

As the authors track the shifting fundamentals of PE (fund-level debt; altered fund economics), there is a new 'deeper dive' section on the asset class's most fundamental contract – the Limited Partnership Agreement (LPA). This once again highlights the necessity and relevance of this book to investors. The authors nod to the publication of the standard LPA, aware that the industry body Institutional Limited Partners Association was working on this at the

time of writing (it was published in July 2020). Again, for any investor currently involved in or considering a move into PE, this updated and detailed book on such an intrinsic contract is not only essential reading but a vital companion throughout the selection, negotiation and commitment periods.

When it comes to standardising the LPA, the authors put forward two compelling arguments. First, there will always be negotiated terms, but a standard template will reduce costs and allow for greater focus on the substance of the relationship. And second, greater standardisation supports an easier and larger secondary market.

ESG and private equity

The authors skim over PE's growing environmental, social and governance (ESG) obligations. In the final section, which draws out areas for further research, there's no mention of ESG. In the closing remarks of the addendum about COVID-19, it says: "Each crisis has tested the PE model and each one to date has ended with the industry stronger and larger than it was before the storm broke." This is highly likely. We can see the asset class weathering the storm valiantly, but it's clear that ESG will be a major transformative force emerging from this crisis.

The pressure on GPs to integrate fuller ESG practices grew in importance over 2020. But, given the recent turbulence affecting all corners of the business and investment landscapes, it remains to be seen if other matters such as PE's use of leverage become more pressing matters in the short term.

Despite this omission, few books written about PE span such a vast array of its facets and features. Perhaps none does so with such academic rigour. The majority of books written about PE to date either focus on the specifics of deal-doing, and therefore have limited reach, or could be accused of attacking or holding an opinion on PE, which isn't surprising given the divisive and controversial nature of the investment model. But this is exactly where Gilligan and Wright truly shine – in their deep understanding of why that is, and their desire to share their insights with a broad audience.



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What's new?

Debt

The most remarkable development in recent years for private equity has been the mainstream acceptance of fund-level debt. This edition tackles fund finance from various angles, including the forms these loans can take, why they have become so common, their impact on returns and the risks they create.

Fees and performance

Private equity is known for outperformance, and it is this that continues to attract a growing number of investors. However, the industry's private nature has made it difficult to truly get to grips with performance. This edition takes an academic approach to the issue and neatly cuts through the noise.

Fund management agreements

The lynchpin of the private equity model is the contract that sits between general partners and limited partners. As private equity matures, this edition rightly pays attention to how this central agreement is developing.

Private Equity Demystified, Fourth Edition, by John Gilligan and Mike Wright

is published by Oxford University Press. The book will be made freely available online to Corporate Finance Faculty members as part of their annual fee. Further copies can be purchased online for £26.99. John Gilligan's royalties for the book will be donated to *The Big Issue*.

