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Opinion **Markets Insight**

Why I am not investing in a buyout for a long time to come

The investment model of private equity has become too popular

HUNTER LEWIS

The New York Stock Exchange. Just because prices are not marked to market does not mean that those prices have not moved with the market, says Hunter Lewis © J David Ake/AP

Hunter Lewis APRIL 18 2023

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The writer is chief executive of Hunter Lewis LLC and a co-founder and former chief executive of Cambridge Associates

Since the financial crisis of 2007-08, buyouts have benefited from the gift of virtually free money. Lower and lower rates have bailed out poor investments and made good ones into home runs.

Along the way, leverage ratios of acquired companies rose. Reasonable loan covenants and restrictions were eroded and in some cases disappeared. Prices for buyout assets soared. The definition of the earnings benchmark to justify them — usually earnings before interest, tax, depreciation and amortisation — has been adjusted to a myriad of forms to flatter valuations. Will current rates cause this whole tottering edifice of debt to crash?

For most of my career, I have been a strong proponent of both venture and buyouts, not a critic. I was present at the creation of today's private equity industry. A group of us, colleagues and clients, including staff from Harvard, Yale, Princeton, Stanford and the Massachusetts Institute of Technology, began developing what became the university investment model in the mid 1970s.

I collaborated closely with David Swensen when he arrived at Yale in 1985. The university investment model that he perfected has since been a primary driver of private equity investment, although he preferred low leverage buyouts. He also deplored the high buyout fund fees that have consumed so much of the profits, and was a fierce critic of fund of funds, which further pyramid the fees.

I wrote in February of last year that dark clouds were gathering over venture capital. Within a month, both the venture capital industry and the general stock market faltered. Ironically, buyouts then became more, not less popular. Bain, Carlyle and other giant firms promoted buyouts from Davos and elsewhere.

The refrain went as follows. Want higher and more reliable returns? Tired of the public market price rollercoaster? Embrace buyouts. No public prices. Volatility solved.

Unfortunately, none of this is true. From the research I have seen over the years, buyouts, net of fees and leverage, have not outperformed public markets. One 2020 paper by Ludovic Phalippou of the Saïd Business School, for example, found that private equity funds had returned about the same as public equity indices since at least 2006.

Claims of lower volatility for private equity funds are also not what they seem. Just because prices are not marked to market does not mean that those prices have not moved with the market.

Inflated returns, denial of volatility, high prices and fees, excessive leverage, absence of covenants on buyout debt — all this together represents fantasy thinking. It is what happens when a successful investment model becomes too popular.

By now it should be very clear that current investment “alternatives” such as buyouts are no longer alternative. This should be a red flag. No investor can expect to earn above average returns by copying others.

There are reasons why this will not change soon. The Securities and Exchange Commission recommended in 2021 letting more US investors into venture capital and buyouts. In addition, venture and buyout professionals increasingly control the institutions that buy their funds.

A single institutional investor may have an investment committee chaired by a private equity partner who is also a major donor. It might also have an internal staff head from the same background and analysts devoted to studying private funds, many of whom aspire to join the same funds they are supposed to evaluate.

In addition, the investor could have external private equity advisers who would see their profits disappear without such funds, plus more donors affiliated with the funds. If so, who exactly can be expected to provide an objective appraisal or question reported fund returns?

There are also broader issues about what the rise in buyouts means for society as a whole. What are the implications as buyout funds in the US acquire more and more hospital emergency rooms, hospices and funeral parlours? What about buyouts of private homes to turn into rentals? Will the public accept this? The buyout industry poses many such questions.

In the meantime, I don’t expect to be investing in a buyout for some time, probably years. Proponents of buyouts argue that investors should not try to time their commitments. Actually, it is always the combination of when and what that determines the success of an investment.

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