Private equity

In times of monetary normalisation

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The announcement of Fed tapering has boosted financial market volatility and high-yield spreads. This is an important development for private equity because debt markets are a major driver.

Over the medium term, monetary normalisation should be associated with stronger risk assets and better prospects for private equity. This is not because private equiteers would cheer a cut in liquidity supply. Instead they would cheer the underlying economic improvement that would allow cutting liquidity in the first place. However, we acknowledge that Fed tapering is somewhat uncharted territory, meaning that past experiences can only be a rough guide.

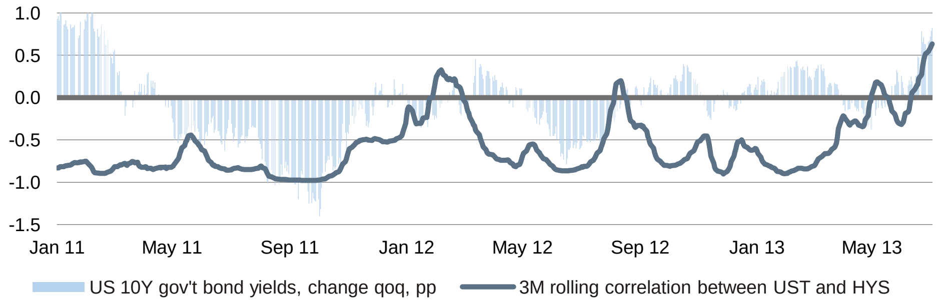
Current returns to private equity should benefit from ongoing recovery. By contrast, vintage returns are likely to decrease somewhat because the best buying opportunities may have existed when markets were most downbeat during the peak of the crisis. Moreover, tight high-yield spreads and a large pile of uncalled capital commitments will likely exert moderate upward pressure on purchase multiples in the future.

Private equity is an important catalyst for structural improvements. The relative shortage of private equity activity in Europe's periphery is thus a missed opportunity because there are plenty of firms that need the type of structural overhaul private equiteers provide.

Key risks include too aggressive monetary tightening or that market reactions overshoot and trigger a downward spiral. This seems an odd statement given that the Fed does not plan to sell assets and that rate hikes are not expected before 2015. But in times when central bank rates are close to the lower bound, communication about the future path of monetary policy becomes the most powerful policy tool.

A monetary lapse of reason

Past experience suggests that the latest concurrent increase in US gov't bond yields and high-yield spreads will likely be a temporary phenomenon

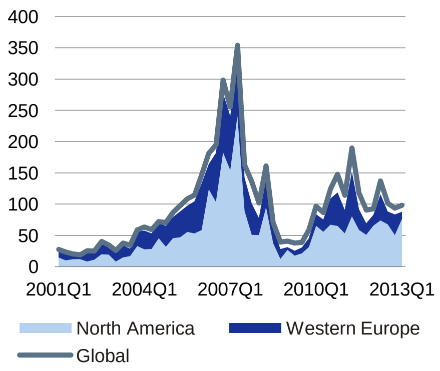


Data edge: 5 July 2013

Sources: DB Research, DBIQ, IHS Global Insight

Slow start to 2013 1

Private equity investments, per quarter, USD bn

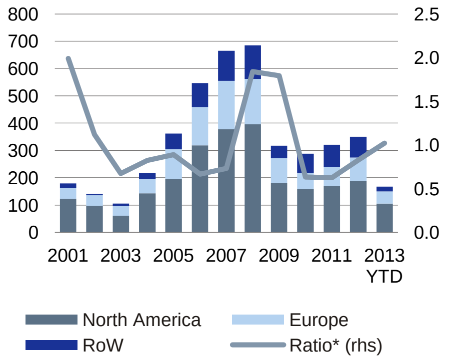


Deal value (debt and equity) of pending and completed deals with private equity participation
Data edge: 25 June 2013; recent quarters may be subject to upward revisions.

Source: Bloomberg

Better access to capital 2

Private equity fundraising, USD bn (lhs)

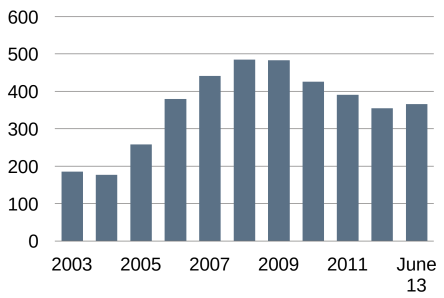


*Global fundraising to global investments (debt & equity)
2013 YTD as of June 14

Sources: Bloomberg, Preqin, DB Research

Pile of money 3

Buyout funds, dry powder, USD bn



Source: Preqin

This paper examines the main macroeconomic and financial market drivers of private equity (PE) to see what lies ahead for this asset class given an improving macroeconomic outlook and gradually tighter monetary policy. We also review some structural issues – in particular the overhang of uncalled capital commitments (so-called dry powder) and the potential role private equity can play in restoring competitiveness in Europe's periphery.

The credit cycle is a key driver of PE investments and performance. Hence, we will take a closer look at debt markets with our focus on sub-investment grade bonds and loans. The recent past has been characterised by an unusual combination of historically low interest rates and moderate spreads on high-yield products leading to extraordinarily lush financing opportunities. This would have been a boon for private equity were it not for countervailing forces including the still fragile state of the economy and weak monetary transmission.

Besides debt, capital committed by limited partners (LPs) is the second pillar of funding. Fundraising from LPs has recovered from the post-crisis slump. Investors in private equity committed USD 350 bn to PE funds globally last year – up from USD 290 bn in 2010. Surveys among LPs also suggest that target allocations are likely to increase further, albeit some LPs have voiced mixed feelings towards covenant-lite debt (discussed below) and the overhang of committed capital.[1] Moreover, the fresh inflow of money adds to the already considerable amount of dry powder. For the first time since the crisis, the amount of dry powder with buyout funds actually increased to USD 366 bn in June.

Overall, private equity had a restrained start into 2013. Global investments reached USD 98 bn in Q1 according to data by Bloomberg, which collects information on completed and pending deals with private equity participation. This is only a slight increase over the same period last year. Investments in North America saw a stronger boost (+16% yoy) whereas investments in Europe collapsed (-35% yoy).

Of course, quarterly figures are volatile and subject to later revisions. Moreover, the strong figures in North America were helped by the announcement of two large buyouts with PE involvement concerning a ketchup-maker and a computer-maker, respectively.

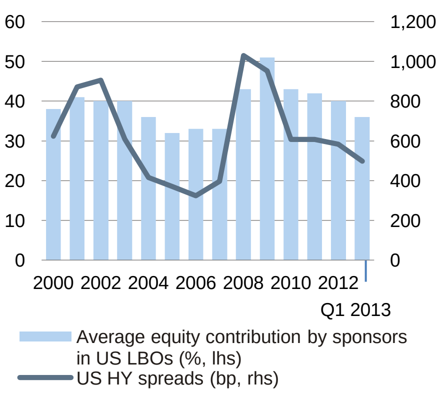
Driven by credit cycle

For an asset class that still has a whiff of mystery, it is remarkable how well it corresponds to macroeconomic trends. The credit cycle is one of the key drivers. This is because PE transactions are typically financed by a large share of debt capital. The average equity contribution by sponsors in US leveraged buyouts (LBOs) amounted to 36% in Q1 2013, according to S&P LCD, meaning that credit is a large part of any deal. Strong debt markets are therefore a major boost for PE investments.

To investigate the link between debt markets and PE investments in more detail, we have created a few simple empirical models. In particular, we look at the impact of debt market conditions and monetary policy on PE investments. In addition, we take current returns to PE as well as currency movements into account. We split our sample into PE investment in North America and Western Europe because the markets are at different levels of sophistication. Moreover, the 2007 financial crisis hit harder in US credit markets whereas the euro debt crisis, obviously, has affected Europe more. Both arguments may lead to different characteristics.

[1] See for instance: Coller Capital (2013). Global Private Equity Barometer. Summer 2013.

Cheap credit boosts leverage 4



Sources: DB Research, S&P LCD

Specifically, we use high-yield spreads (HYS) and 10 year government bond yields as representations of the credit cycle. The main central bank rates (federal funds rate and ECB main refi rate) indicate the monetary stance. Additionally, we use central banks' balance sheets to take unconventional measures such as asset purchases and quantitative easing into account.

GDP growth, interest rates and FX are used in the models with a lag of one quarter to allow some latency in the translation of economic and financial trends into deals. Unsurprisingly, we find that global PE investments are positively related to credit conditions, meaning that tight high-yield spreads tend to boost investment volumes. Tests for Granger causality suggest that, indeed, causality appears to run from high-yield spreads to PE investment volumes but not the other way round.

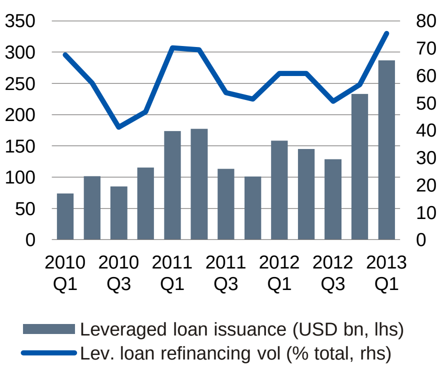
High-yield spreads are the most powerful explanatory factor for PE investments. This is partly due to the high share of debt financing involved in a typical PE deal, but also because high-yield spreads capture a number of additional underlying trends. Firstly, high-yield spreads determine the affordability of debt and hence have a direct impact on the affordability of PE transactions. Secondly, spreads have a strong influence on leverage. When spreads are tight, debt is cheap and private equiteers tend to use more of it for acquisitions. Historically, a decrease in HYS by 100 bp is associated empirically with an equity share that is around 1.8 pp lower. Thirdly, cheap debt and high leverages tend to push up takeover prices as private equiteers compete with each other and strategic buyers for the best targets. Higher prices then translate into larger aggregate investment volumes.

Government bond yields are positively correlated with US PE investments, illustrating that higher yields typically go together with lower risk aversion. Also, there is multi-collinearity caused by the traditionally inverse relationship between bond yields and HYS. This means that including government bond yields in the estimation typically tends to decrease the impact of HYS.

Weak monetary transmission bears on PE

Refinancing wave 5

US



Sources: Fitch, Thomson Reuters, DB Research

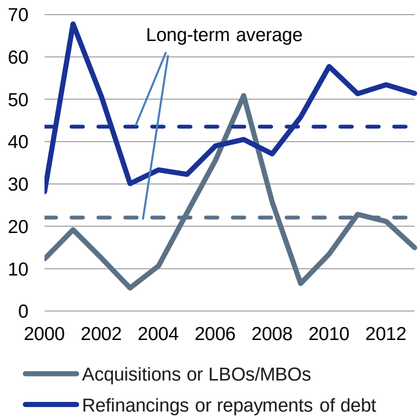
The approach also illustrates the impact of unconventional monetary policy, such as quantitative easing (QE), on PE investment volumes. The models suggest an inverse relation between the size of central bank balance sheets and investment volumes. This means that asset purchases by the central banks tend to have a negative impact on PE investments. This seems odd. After all, the point of QE is to facilitate access to finance and to boost investments.

But context is important. QE is an instrument used when conventional monetary policy has reached its limits, i.e. rates are close to the lower bound, or monetary transmission, i.e. the translation of liquidity supply in actual economic activity, is failing. Hence, it is these underlying problems that bear on investments, not QE itself.

The impact can be seen for instance in high-yield debt markets. Yes, spreads declined and issuance boomed (more on this below) – also thanks to expansionary monetary policy. However, much of the freshly raised money was used to refinance, re-price or repay old debt or pay dividends. Indeed, refinancings accounted for 75% of US leveraged loans issued in Q1. By the same token, more than 51% of the proceeds from US high-yield bond issuance 2013 YTD were used to refinance or repay debt. By contrast, the share of proceeds dedicated to LBOs/MBOs or other acquisitions declined to 15%.

Less economic traction 6

US HY corporate bond issuance, by use of proceeds, % total



2013 YTD as of June 7

Sources: Dealogic, DB Research

This is an important caveat because it means that despite lush debt markets, only little money was actually used to expand businesses or to execute new deals. This illustrates that the transmission of money supply into real economic activity was arguably weaker than normally.

No fear of monetary normalisation

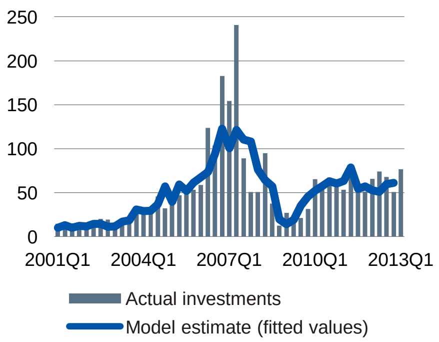
The flipside is that monetary normalisation – tapering of asset purchases and eventually higher central bank rates – would be associated with higher PE investments. Again, this is not because private equiteers would cheer a cut in liquidity supply. Instead they would cheer the underlying economic improvement that would allow monetary normalisation in the first place. However, we acknowledge that Fed tapering is somewhat uncharted territory, meaning that past experiences can only be a rough guide.

Overall the empirical models explain up to 84% of the quarterly variation in PE investments. As the charts illustrate, the overall fit of the models is fairly good and the results are robust to a number of different specifications and sub-samples.

There is one notable occasion where actual investments deviate substantially from the fitted values: during the peak of the pre-crisis boom investments in Europe and the US far exceeded levels explained by economic and financial fundamentals. This is arguably no flaw of the models but rather highlights the exuberance in the market shortly before it began to collapse in summer 2007.

Driven by credit cycle 7

Private equity investments, USD bn
North America



Deal value (debt and equity) of pending and completed deals with private equity participation.

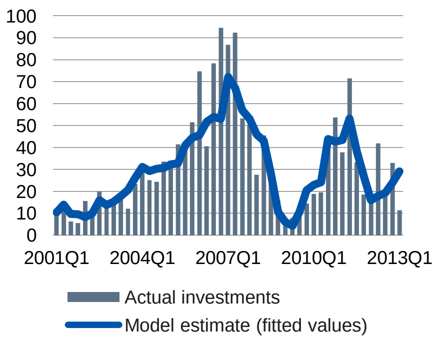
Model:
Log(PE) = 2.2 - 0.08*HYS(-1) - 0.95*Log(Fed b/s) + 0.32*UST10(-1) + 0.037*PE_returns + 0.086*Trend

Sample: 2001Q1-2012Q4; R^2=84%; DW=1.89

Sources: DB Research, Bloomberg

Boom crash boom (slump) 8

Private equity investments, USD bn
Western Europe



Deal value (debt and equity) of pending and completed deals with private equity participation.

Model:
Log(PE) = 40.4 - 0.08*HYS(-1) + 0.09*GDP(-1) - 2.7*Log(ECB b/s) + 0.12*ECB_main_refi(-1) - 1.26*USDEUR(-1) + 0.11*Trend

Sample: 2001Q1-2013Q2; R^2=79%; DW=1.85

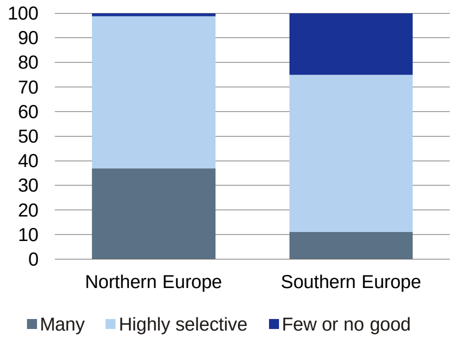
Sources: DB Research, Bloomberg

Missed opportunities in Europe

There are notable differences between North American and Western European PE figures. Most obviously, the overall volume of PE investments is much bigger in North America – last year they were more than twice as large as in Europe – owing to the longer history of private equity and overall greater depth of capital markets in the US. Indeed, the models suggest that Europe is still in a catch-up

Periphery is not attractive 9

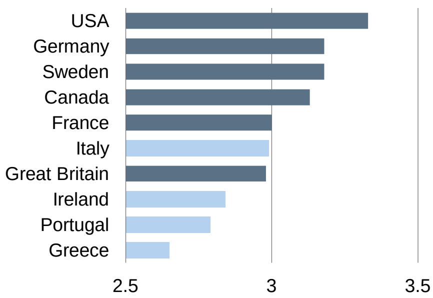
Share of LPs expecting many / selective / few attractive investment opportunities in Europe, %



Source: Coller Capital

Southern Europe needs better management 10

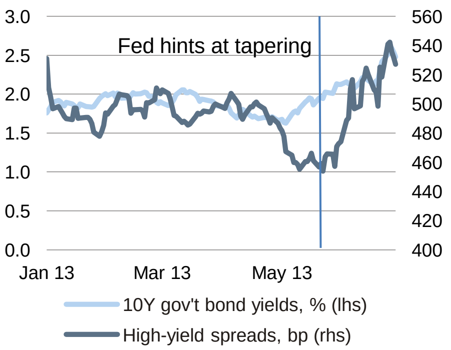
Management practice score, scale from 1 (bad) to 5 (good)



Source: Bloom and Van Reenen (2010)

What goes down, must come up 11

US



Sources: DBIQ, IHS Global Insight

stage which is also illustrated by the fact that the time trend estimated in the models is stronger in Europe than in North America. Moreover, PE in Europe had already recovered somewhat in relation to pre-crisis levels whereas PE across the Atlantic has stabilised well below the peaks.

The euro debt crisis interrupted further convergence because of the squeeze in financing options, persistent uncertainty over corporate profits and at times elevated transfer risk caused by the non-zero chance of euro exit.

Surveys of LPs show that particularly Southern Europe is seen to offer few attractive investment opportunities. This is unfortunate because firms in the European periphery clearly are in need of the type of management overhaul PE investors often provide. Research suggests that the average management quality of firms in Italy, Portugal, Ireland or Greece ranks low in Europe and that one effective way to improve management is to be taken over and restructured by a PE fund.[2] Stronger PE activity could be an important catalyst to gain competitiveness and implement needed structural reforms at the firm level. Indeed, our previous studies suggest that buyout investments have a positive and statistically significant impact on growth.[3] The lack of PE is thus a missed opportunity for Europe but also for LPs as the most underperforming firms are often the most attractive investment targets.

Debt markets: The honeymoon may be over

Until May, when the Federal Reserve started hinting at tapering asset purchases, debt markets were in jubilant mood. Economies in the US and Europe were fragile and underperforming, allowing central banks to provide ample liquidity and set interest rates at exceptionally low levels.

At the same time, recovery was making progress with the US economy having passed pre-crisis levels of GDP and growth in Europe hopefully having bottomed out around the turn of the year. This supported a more optimistic outlook by investors and growing risk appetite. Moreover, central banks in key markets made it very clear that they would go to great length to prevent a relapse into crisis using unconventional measures if necessary.

Lush credit markets

The result was low benchmark rates, moderate spreads as well as strong issuance activity. The global volume of high-yield bond issuance reached almost USD 280 bn in H1 2013 surpassing pre-crisis peaks by significant margins – particularly driven by buoyant activity in the US. By the same token, leveraged loan issuance recovered from post-crisis lows, reaching USD 470 bn last year in the US alone.

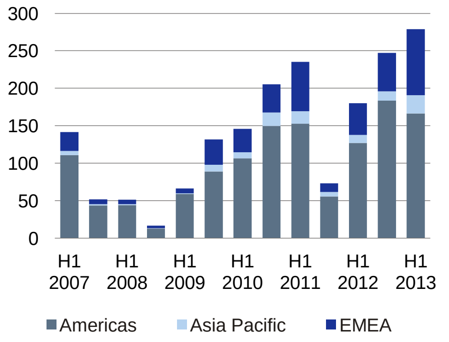
This boom was helped by some new activity in the market for collaterised debt obligations (CDOs), which fell into disgrace during the crisis. New CDO issuance is still a far cry from peak levels of the past but can be seen as successfully testing the waters. The rise of the CDO market in combination with the originate-to-distribute model was one of the strongest corollaries of the

[2] Bloom, Nicholas, John Van Reenen and Raffaella Sadin (2009). Do private equity owned firms have better management practices? In: The Global Economic Impact of Private Equity Report 2009. World Economic Forum. pp. 3-23; and Bloom, Nicholas and John Van Reenen (2010). Why do management practices differ across firms and countries? Journal of Economic Perspectives. Volume 24. Number 10. Pages 203-224.

[3] Meyer, Thomas (2008). Venture capital: Bridge between idea and innovation. E-conomics 65. Deutsche Bank Research. Frankfurt am Main.

Boom in high-yield issuance 12

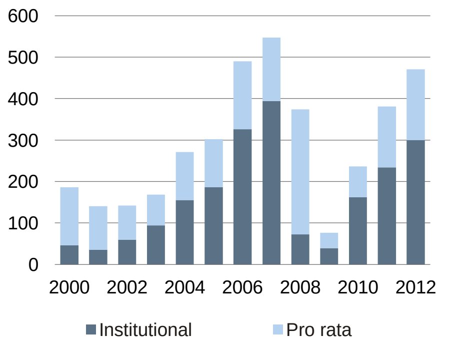
High-yield bond issuance, per half year, USD bn



Source: Dealogic

Historical peaks in sight 13

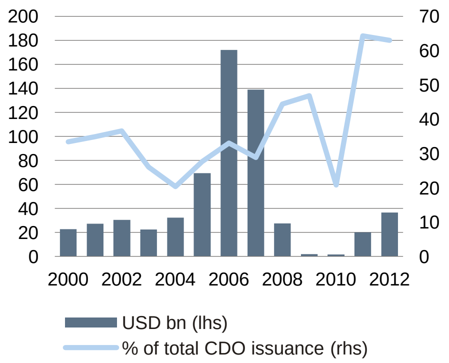
US leveraged loan issuance, USD bn



Source: S&P LCD

Rise from the dead 14

Global issuance of CDOs backed by HY loans



Sources: DB Research, SIFMA

previous PE boom.[4] A CDO renaissance might thus give new impulses. It might also offer more robust access to high-yield credit for issuers once the current debt honeymoon is over.

Banks and CLO managers have also been more accepting of covenant-lite loans. According to Fitch, a rating agency, issuance of covenant-lite loans in the US increased to USD 78.3 bn in Q1 (27% of total issuance volume) – the highest quarterly figure since 2007. The average limit for covenant-lite loans with US CLOs was close to 50% in Q1 2013 – up from 44% in the previous quarter.[5]

Some observers have taken the surge in covenant-lite loans as a sign of overheating in the credit market because the last crisis was also preceded by a boom in covenant-lite loans. The key concern is that a lack of covenants simply delays the day of reckoning when a firm runs into trouble because creditors have fewer rights to intervene at an early stage. The result may be a number of zombie firms, i.e. firms that are not yet technically insolvent but whose business model has become obsolete.

This very feature makes covenant-lite loans interesting for business owners and managers who, in testing times, may disagree with creditors about whether the business model is indeed obsolete. With weaker covenants, firms have more financial flexibility to ride out a temporary decline in business. This flexibility is particularly interesting for PE funds because they often target underperforming firms and use more aggressive financing. This increases the chances of breaching traditional covenants.

Moreover, the idea behind covenants is that lenders can force restructurings as soon as certain conditions are violated. However, many PE funds are fairly sophisticated in doing restructurings themselves and may be in a better position to judge whether it is necessary and what needs to be done. Indeed, one study found that PE-backed firms use the best management practices.[6] Little wonder that according to Moody's, another rating agency, 72% of covenant-lite loans in Q1 2013 had PE sponsors (up from 65% in Q4 2012).[7]

For obvious reasons, default rates on covenant-lite loans have been lower than on traditional loans (by definition, there are fewer default triggers). More surprisingly: recovery rates have also been higher. This is because covenant-lite loans are usually protected by subordinated debt – i.e. there are layers of subordinated loans that need to be wiped out in case of default before covenant-lite loans take a hit. In other words: lenders replace the protection from covenants with protection through subordination quite effectively.

Honeymoon would not last forever

We argued before that this honeymoon would not last forever.[8] Indeed, since the Fed announced tapering in late May, US bond yields have jumped 70 bp and US high-yield spreads have widened by up to 88 bp. Global yields followed a similar pattern. Equities, commodities and other risk assets sold off.

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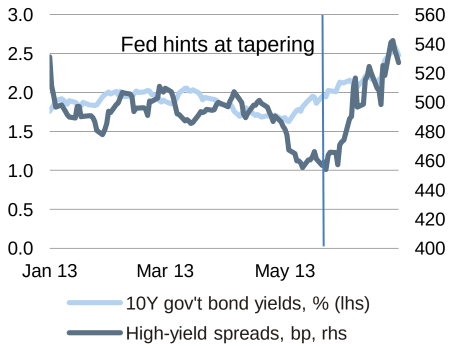
[4] Meyer, Thomas (2011). Private Equity: Opportunities in turbulent times. E-conomics 87. DB Research.
[5] Fitch (2013). U.S. Leveraged Market Quarterly. April 22, 2013.
[6] Bloom, Nicholas, John Van Reenen und Raffaella Sadin (2009). Do private equity owned firms have better management practices? In: The Global Economic Impact of Private Equity Report 2009. World Economic Forum. pp. 3-23.
[7] Moody's (2013). Covenants: Signs of a "Covenant Bubble" Suggest Future Risks for Investors. Moody's Investors Service. Special Comment, May 20, 2013.
[8] Kaya, Orcun and Thomas Meyer (2013). Corporate bond issuance in Europe. Where do we stand and where are we heading? EU Monitor. Global financial markets.

What goes down, must come up 15

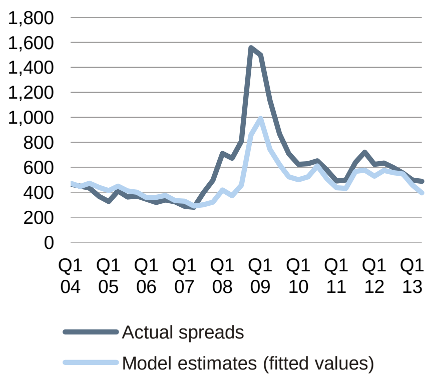
US



Sources: DBIQ, IHS Global Insight

Panic after Lehman 16

US high-yield spreads, bp



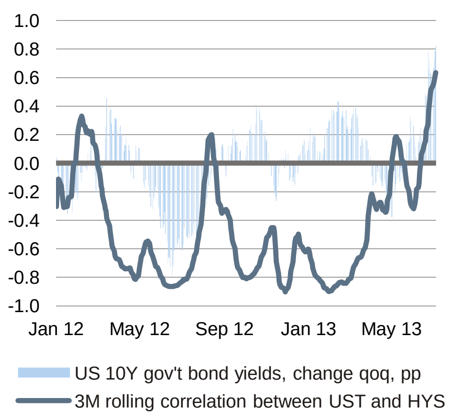
Model:

Dlog(HYS) = -0.49*Dlog(UST10) - 1.4*Dlog(S&P 500) - 0.014 D(GDP)

Sample: 2004Q1 - 2013Q1; R^2 = 76%; DW= 1.59

Sources: DBIQ, DB Research

Normally negative 17



Sources: DB Research, DBIQ, IHS Global Insight

Additional volatility has also slowed bond issuance after a strong start into 2013. Up to May, global corporate bond issuance was up 25% compared to the same period last year. In June, however, issuance was 12% lower on the year.

An empirical model of high-yield spreads

Given that the credit cycle in general and high-yield spreads in particular are key drivers of PE investments it may be instructive to take a closer look. High-yield spreads are basically the result of the opportunity cost of capital, liquidity supply, credit risk and the risk appetite of investors. In practice, these drivers overlap, of course. For instance, in times of ample liquidity default rates may be artificially low because even many badly performing firms manage to secure funding. Hence, credit risk may be underestimated.

To capture these different factors, we calculated a simple model based on 10Y US treasury yields (UST10) as an indicator of the opportunity costs of capital and the monetary stance. US GDP growth and the S&P 500 stock market index capture the current and expected state of the economy (as a proxy for credit risk). The S&P 500 market volatility index (VIX) indicates additionally investors' risk appetite.

Such a simple model performs reasonably well – explaining 75% of the variation in high-yield spreads. The statistical time series properties are a bit complicated; hence, the model uses quarterly changes rather than levels. The model fails to capture the full extent of the crisis when spreads skyrocketed and the bond market ground to a halt in Q4 2008. This just illustrates the degree of panic that took hold of investors following the collapse of Lehman Brothers.

Overall, the models suggest that high-yield spreads are negatively correlated with treasury yields, equities and GDP growth. They are positively associated with equity volatility because both variables are a measure of risk aversion by investors. The results paint a fairly conventional picture and basically say that investors demand a smaller risk premium when the economy is on a stronger footing.

Making sense of bond price movements

The latest experiences defy this conventional picture. While there is an overwhelmingly negative correlation between government bond yields and risk assets, this correlation is not entirely stable over time. As shown by recent events, there are episodes when bond yields and high-yield spreads go up at the same time, i.e. have a positive correlation.

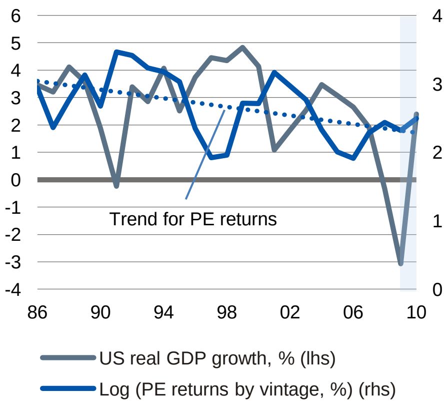
Historically, such bouts of positive correlation have (a) proved rather short-lived and (b) often been associated with important changes in monetary policy. The previous spike in late summer 2012, for instance, can arguably be attributed to the introduction of OMT (Outright Monetary Transactions programme) by the European Central Bank.

Such historical patterns suggest that monetary normalisation, commensurate with economic recovery, and rising benchmark bond yields should be associated with tighter high-yield spreads over the medium term. Monetary decisions themselves are often accompanied by higher financial market volatility and exceptional price movements. However, it would be very unusual if such a situation persisted.

The key risk is that monetary tightening proceeds too fast or that markets think it does. While the Fed has stressed that tapering is contingent on better economic data – lower unemployment in particular – even the announcement of tapering in the future is already a form of monetary tightening right away. This is because communicating the future path of monetary policy is one of the most powerful tools remaining when central bank rates are close to the lower bound. Hence, changing the future path is a big deal because it changes market expectations even if nothing happens immediately.

Moreover, the Fed might care less about the impact in Europe where recovery and de-leveraging have made less progress, or emerging markets which saw some reversal of recent capital inflows.

Bad growth, good vintages 18

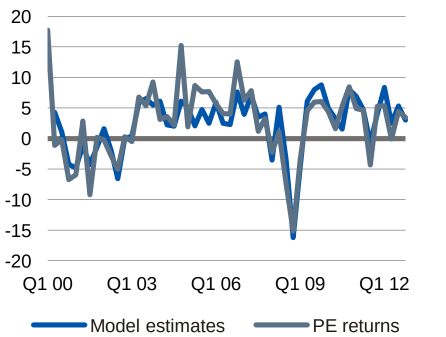


Recent vintages have not yet produced reliable performance figures. PE returns are pooled returns (IRRs) since inception net to limited partners.

Sources: DB Research, Cambridge Associates

Current PE returns are pro-cyclical 19

US PE one quarter end-to-end pooled returns net to limited partners, %



Model:
Returns = -5.8 + 0.41*GDP + 0.04*D(S&P 500) + 6.03*USDEUR

Sample: 2000Q2 to 2012Q4; R^2 = 72%; DW = 2.03

Sources: Cambridge Associates,: DB Research

Recovery in vintage returns so far weaker than in previous cycles

Ultimately, the (expected) returns to investors determine the attractiveness of private equity as an asset class. When discussing returns of PE funds it is important to distinguish between current returns and vintage returns because both follow opposite macroeconomic patterns. Current returns are pro-cyclical, whereas returns by fund vintage years show a clear anti-cyclical streak. This basically means that PE funds benefit from improving economic and financial conditions (current returns) but also that it is usually best to have started investing when markets were down (vintage returns).

The anti-cyclical pattern of vintage returns is not entirely unique to private equity, of course. It is usually best to buy assets when the price is lowest. However, vintage PE fund returns maintain an anti-cyclical pattern even if benchmarked against already cyclical stock market returns. This means that boom-bust cycles are even more pronounced for vintage PE returns than for, say, equities.[9]

The sharp economic contraction during the financial crisis thus offered buying opportunities for PE funds – entry valuations were depressed and weak fundraising translated into less money chasing deals.[10] It takes a few years until PE funds produce reliable performance statistics, so it was not immediately clear whether such a strategy would prove successful during this cycle as well. By now, quite a few funds do provide performance figures and allow a first review of this period.

The overall picture corroborates the conventional wisdom: vintage returns slumped during the pre-crisis boom, suggesting some over-investment. Vintage returns recovered with the beginning of the crisis, supporting the anti-cyclical pattern. However, the recovery seems weaker than in previous cycles, giving rise to a negative trend in vintage PE returns over the last 25 years.

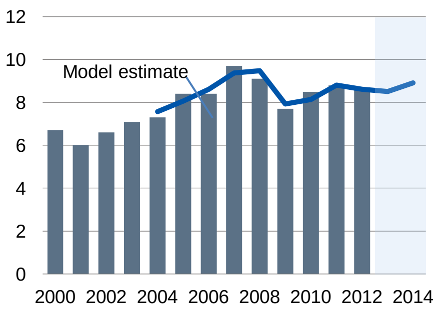
The recent crisis has been exceptional – financial crises tend to have weaker recoveries and this crisis in particular originated in the bond market, so a somewhat restrained bounce-back was to be expected. Moreover, bear in mind that young PE funds have not yet exited many investments, hence the returns are calculated not only from actual cash flows but also include estimated changes in the portfolio companies' net asset value (NAV). Should successful exits fetch prices that exceed these NAVs, performance figures might be revised up in the future. Indeed, a glance at current returns does not show a declining trend.

9 Meyer, Thomas (2012). Tight credit, low growth. How will private equity fare in Europe? Research Briefing. February 27, 2012. DB Research.

10 Meyer, Thomas (2011). Private Equity: Opportunities in turbulent times. E-conomics 87. DB Research.

More competition 20

US LBOs, purchase price multiple



Model:
Multiple = 8.3 - 0.28*HYS(-1) + 0.005*Dry_powder(-1)

Sample: 2004 to 2012; R^2 = 83%; DW = 2.94

Sources: S&P LCD, DB Research

Current PE returns benefit from recovery

Current returns to PE have a clear pro-cyclical pattern. Empirically, they benefit from higher GDP growth and stronger equities because such improvements tend to be associated with stronger NAV of portfolio firms and allow better exit prices. There is no statistically significant trend over time putting the negative trend of vintage returns in perspective. Progress in economic recovery should thus be a positive for current returns.

Upward pressure on purchase multiples

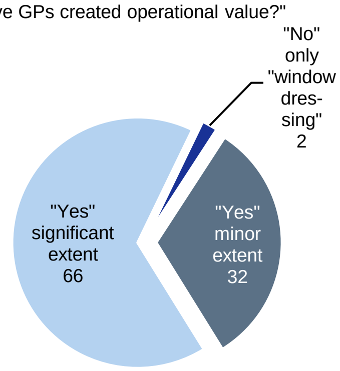
Easy access to debt and equity also boosts competition between private equiteers. Large amounts of dry powder increase the pressure to invest in a timely manner, putting upward pressure on prices. Low-cost debt also makes higher prices more affordable for PE funds.

The pile of dry powder with buyout funds has only just started to increase again after a multi-year decline. This downward trend will likely dominate multiples in the near term. Indeed, purchase multiples declined to 8.4x in the first quarter of 2013, down from 8.7x in 2012. However, tight HYS and a bigger pile of dry powder will likely exert moderate upward pressure on multiples in the future.

Outlook

Operational improvements are key 21

Q: "Have GPs created operational value?"



Source: Coller Capital

The fundamental business model of private equity – buying underperforming firms, executing operational improvements, selling at a premium – seems intact. This view of the basic mechanism is supported by research showing that PE-backed firms, indeed, employ the best management practices (see Bloom et al, 2009). Institutional investors widely agree with this notion, saying overwhelmingly that PE funds create operational value. The bottom line appears to add up, too. Private equity delivers consistent outperformance compared to public equity.[11] Studies suggest that PE even held up reasonably well during the recent financial crisis.[12]

The relative shortage of PE activity in Europe's periphery is a missed opportunity because there are plenty of firms that need the type of structural overhaul PE provides.

The honeymoon for debt, i.e. the combination of ultra-low benchmark yields and moderate high-yield spreads, has seen first cracks. While government bond yields will likely continue to go up in the future in the course of monetary normalisation (first in the US; later in core Europe), risk assets might benefit from recovery. The net effect will likely result in somewhat more expensive credit for borrowers, though.

Offsetting factors include a stronger economy and better company data. The S&P 500 index, for instance, is seen by DB strategists at 2000 points by end-2015 – an increase of 24% versus end of June 2013.[13] This will help profits of portfolio companies and allow higher exit valuations. Moreover, monetary transmission is likely to improve, meaning that the impulse from credit markets will translate better into actual investments than previously.

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11 See for instance: Harris, Robert; Tim Jenkinson and Steven N. Kaplan (2011). Private Equity Performance: What Do We Know? Working Paper No. 11-44. Fama-Miller Paper Series. Chicago Booth. P 36.

12 See for instance: A.T. Kearney (2011). Rating Operative Performance of PE Portfolio Companies. PE fund companies in Europe stage a post-recession comeback; Gottschalg, Oliver and Jakob Schramm (2013). Im Auge des Sturms. Die Bank 5/2013.

13 Deutsche Bank (2013). Multi-year path to PE expansion. US Equity Insight. June 14.

Current returns to private equity should therefore benefit from the ongoing recovery. By contrast, vintage returns are likely to decrease somewhat because the best buying opportunities may have existed when markets were most downbeat during the peak of the crisis. The negative trend in vintage returns over time may be evidence of growing maturity of private equity and, hence, lower outperformance vis-à-vis other asset classes. But we caution that this may also be a statistical artefact owing to the fact that the last cycle has not yet produced fully reliable data. Indeed, we find no trend with current returns.

The wildcard is monetary policy. The announcement of Fed tapering has boosted financial market volatility and high-yield spreads. This may be a temporary phenomenon during which markets are weaned off the liquidity glut. Over the medium term, monetary normalisation should be associated with stronger risk assets which should benefit PE. This is not because private equiteers would cheer a cut in liquidity supply. Instead they would cheer the underlying economic improvement that would allow cutting liquidity in the first place.

The key risk is that monetary tightening is too aggressive or that market reactions overshoot and trigger a downward spiral. This seems an odd statement given that the Fed does not plan to sell assets and that rate hikes are not expected before 2015. But in times when central bank rates are close to the lower bound, communication about the future path of monetary policy becomes the key policy tool because it shifts market expectations. Hence, charting a course for monetary policy, commensurate with economic recovery, will be a delicate task.

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