FrontLine Research Paper

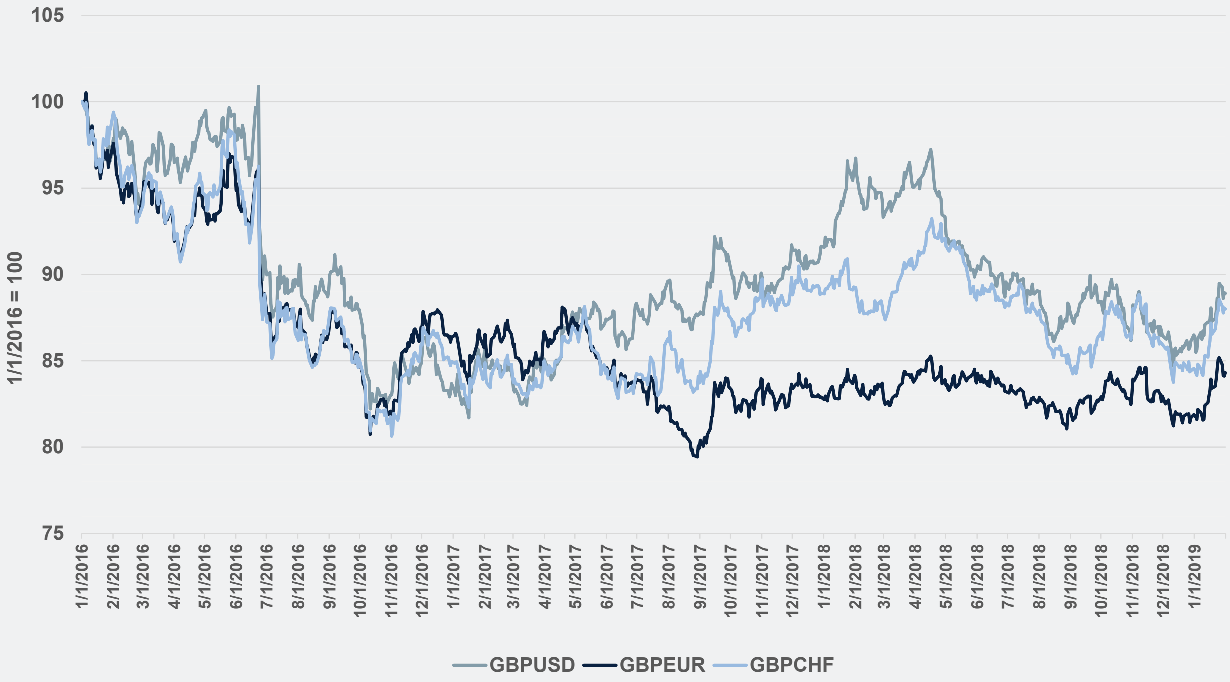
Has the prospect of Brexit already affected British LBO funds?

Private equity is an industry that thrives on so-called disruption. Venture capital benefits from innovations that overhaul entire value chains and industries. Growth capital capitalizes on market shifts through business concentration, diversification, and internationalization. LBO grows out of operational, financial, and industrial imbalances, which can be unveiled by major macro-economic events. One of these events, unfolding somehow in slow motion, is the exit of the United Kingdom from the European Union – the so-called "Brexit".

Private equity is an industry that thrives on disruptions, of which one unfolds somehow in slow motion: the "Brexit".

Although the details are still unknown at the time of publication, the prospect of Brexit has already had some consequences on the local British economy. One of them is the significant decrease of the pound against major currencies such as the US dollar, the Euro and the Swiss Franc (Fig. 1). Since the decisive vote of June 24, 2016 to leave the EU, sterling has lost between 10% and 15% of its value against its major peers. The first question for fund investors with a different currency of reference is if the vote has affected their portfolio of British funds in the same proportion that it has affected the British pound.

Figure 1 – Evolution of the British pound against the US dollar, Euro and Swiss franc



Source: Bloomberg, Wellershoff & Partners.

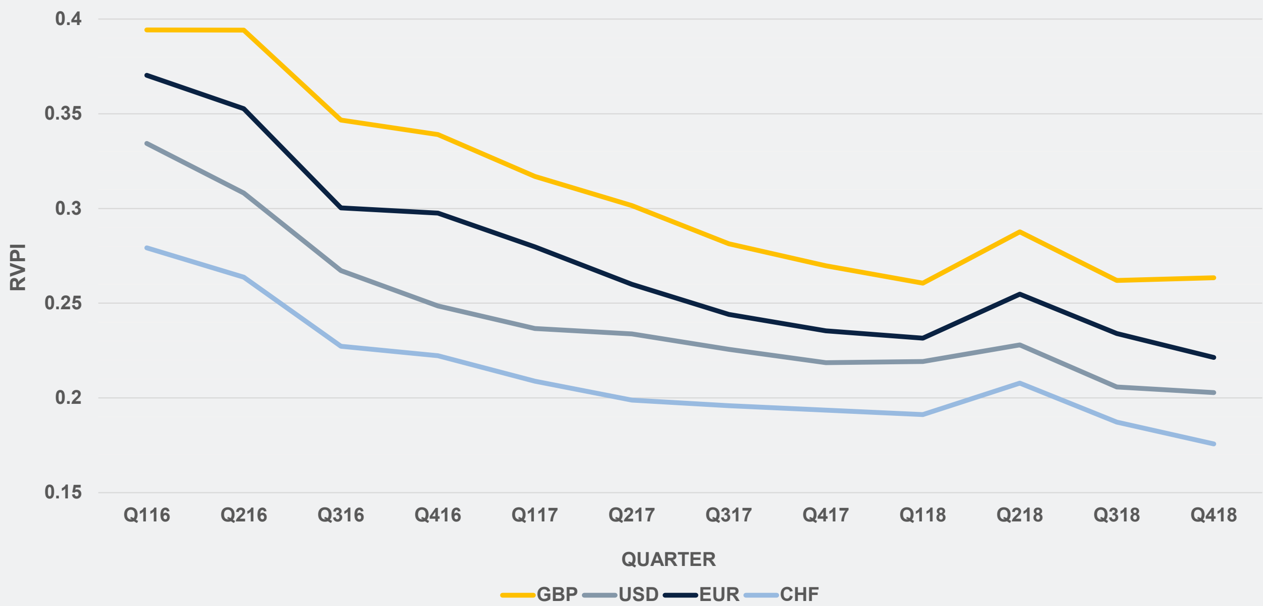
The second question is if the prospect of Brexit, and the lack of information surrounding it, has affected the performance of British private equity funds. This is a more challenging assessment.

Thanks to the high-quality data provided by eFront Insight, it is possible to gather elements of answer to this question.

The impact of post-referendum foreign exchange fluctuations

At first glance (Fig. 2), foreign exchange did not seem to affect significantly the evolution of the net asset values of British LBO funds. Regardless of the currency used, the RVPI follows one single downward trend. However, the drop in the value of RVPI in foreign currencies looks sharper than in pounds. There might be more than meet the eye.

Figure 2 – Evolution of the RVPI of British LBO funds in four currencies of reference



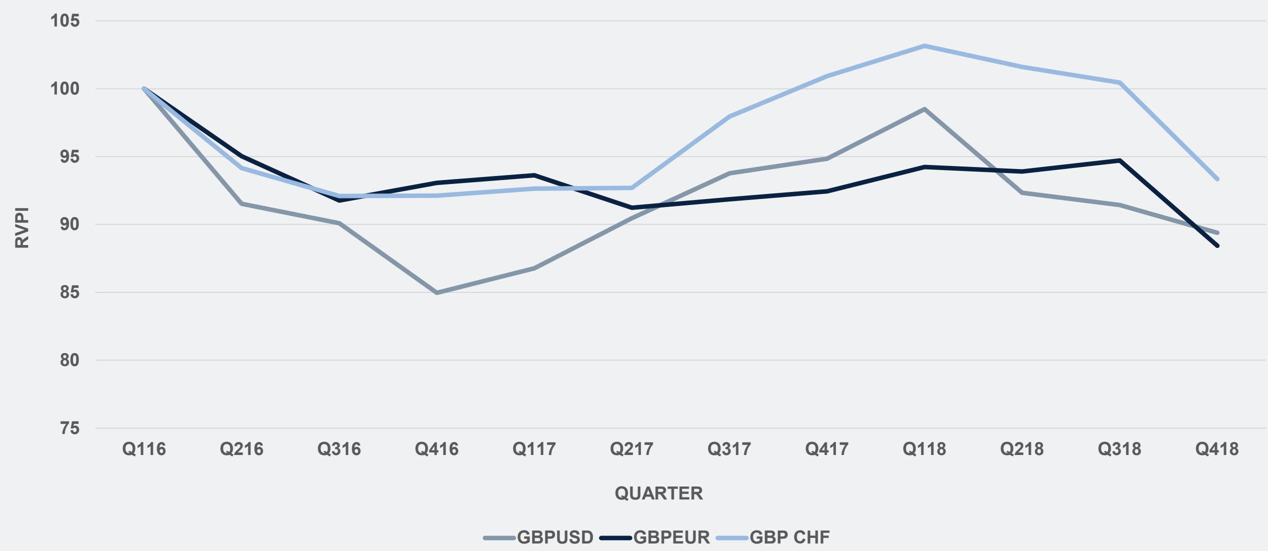
Source: eFront Insight, as of Q4, 2018.

Indeed (Fig. 3), applying currency parities to RVPIs shows a different perspective. The drop in value of the British pound against the US dollar is clearly visible in its impact on RVPIs. The correction of RVPIs in dollars is commensurate in its magnitude with the drop of the currency itself against the dollar. In Euros, the correction is less important for RVPIs than the actual correction of the currency. In Swiss francs, the relationship is less clear, and in fact, the variations are higher than the parity GBPCHF would indicate.

This is probably due to the fact that, as shown by Fig. 2, British RVPIs reported in CHF were substantially lower at the onset. Variations are, therefore, much more visible afterward.

British funds have deployed capital unabatedly since the vote, recycling distributions on a net basis since Q4 2017.

Figure 3 – Evolution of RVPIs of British LBO funds, rebased, by currency pairs



Source: eFront Insight, as of Q4, 2018.

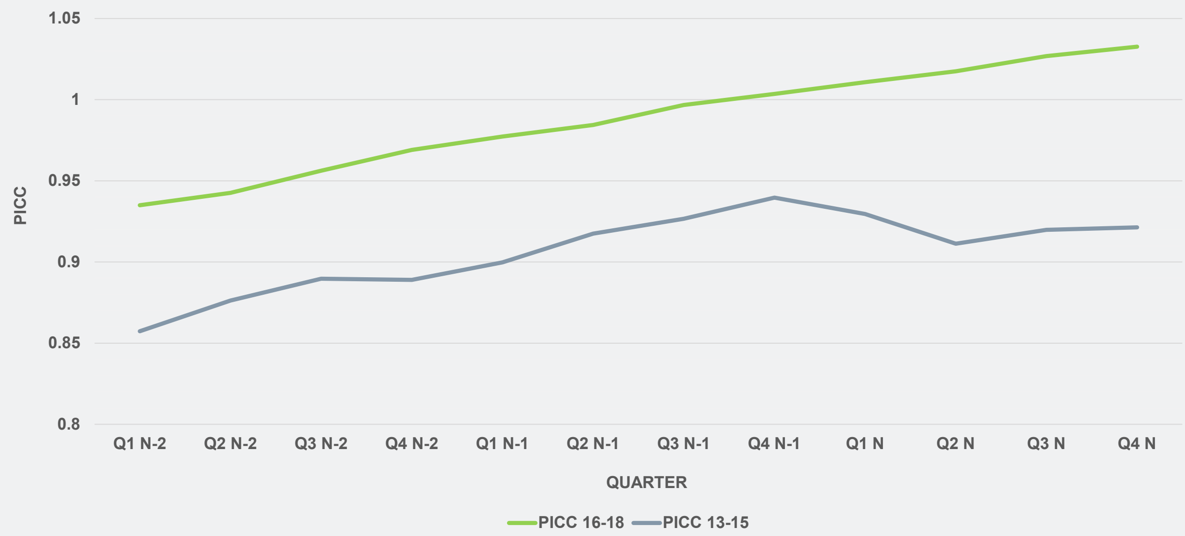
Adverse impact on the performance of funds

Assessing the early impact of a Brexit prospect on the performance of funds is more difficult. Capital deployment as measured by the Paid-In to Committed Capital (PICC, Fig. 4) shows that British funds have deployed capital unabatedly since the vote. This is striking for two reasons. First, the deployment over the course of the previous three years was not as steady. Indeed, the quarterly growth of capital deployment from Q1 2016 to Q4 2018 was 0.98%. As a matter of comparison, it was 0.68% from Q1 2013 to Q4 2015.

Second, this pace of deployment does not appear as the result of pressure to deploy an excessive amount of capital, but appears to be driven by investment opportunities. To exploit them, funds have been recycling distributions on a net basis since Q4 2017, as the PICC exceeds 1.0x. These distributions have been particularly vigorous during the period 2013-2015 (Fig. 5) but appeared to have slowed down in 2016-2018. A slowdown has been recorded for European (excluding UK) and North American buyout funds, as well.

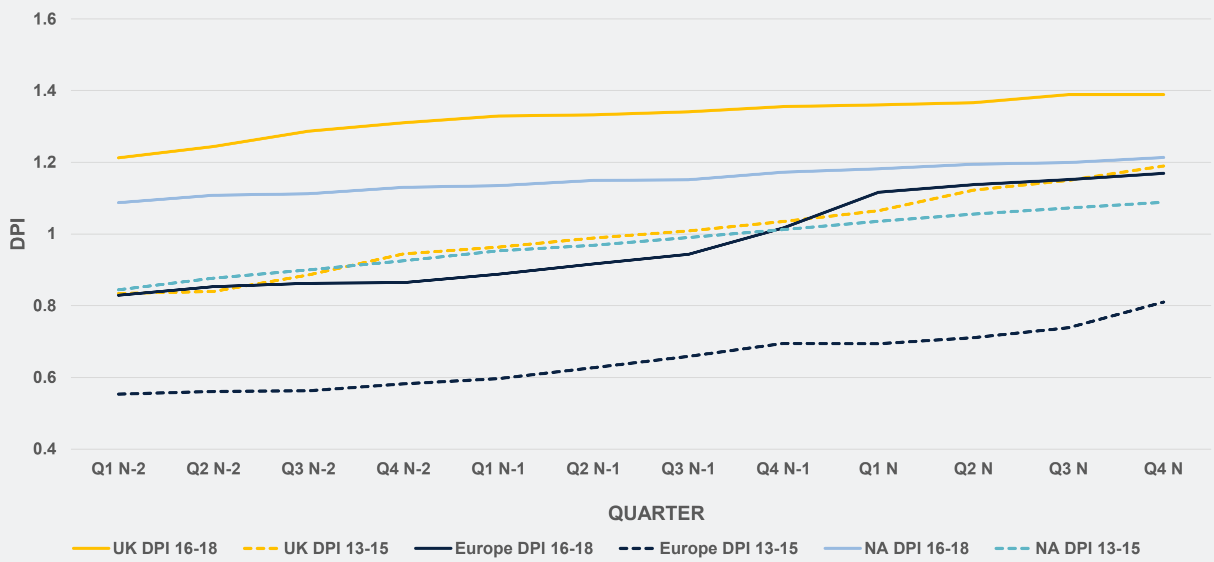
However, the drop in average quarterly growth rate in distributions was the most pronounced in the UK market. It fell from 3.9% to 1.3%, while European and North American DPI growth rate experienced the reduction from 4.2% to 3.7% and from 2.6% to 1.1% per quarter, respectively.

Figure 4 – Evolution PICC of British LBO funds in 2013-2015 and 2016-2018



Source: eFront Insight, as of Q4, 2018.

Figure 5 – Evolution DPI of British, European (excl. UK) and North American LBO funds in 2013-2015 and 2016-2018

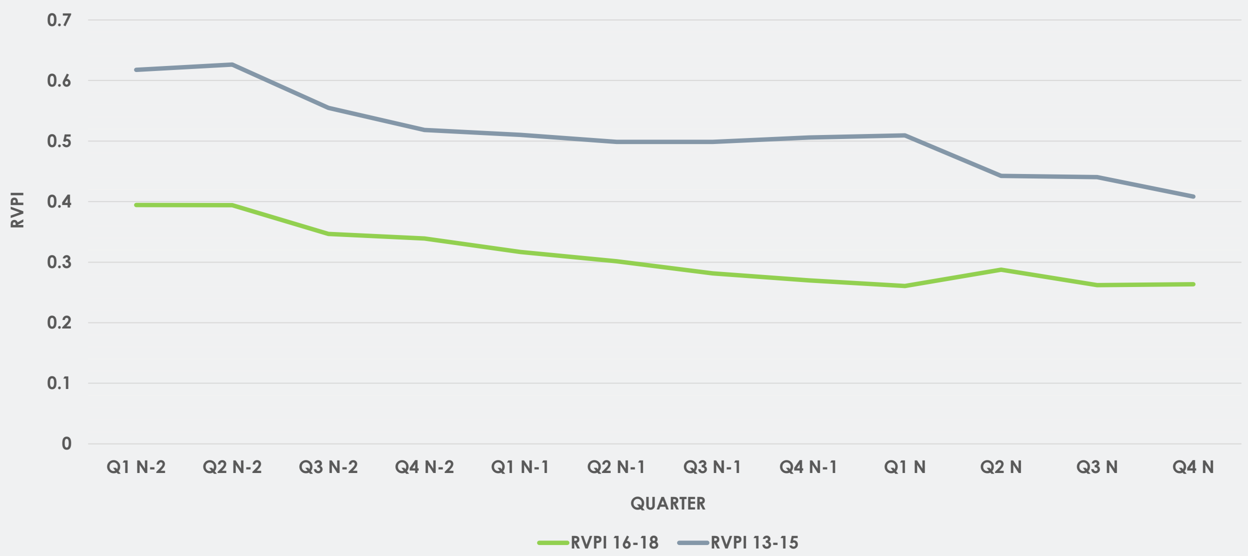


Source: eFront Insight, as of Q4, 2018.

Should fund investors worry about the decrease of RVPIs described in the first half of this report? Comparing the evolution during 2016-2018 with the evolution during 2013-2015, it seems that this trend is continuous and was kick-started a long time ago (Fig. 6). Indeed, the RVPI declined by 3.08% in 2013-2015 and by 3.02% in 2016-2018. Funds appear to be mostly focused on divesting, and some of the divestment proceeds are then partially used to reinvest, as seen above.

Capital deployment appears to be driven by investment opportunities, not under pressure to deploy dry powder.

Figure 6 – Evolution RVPI of British LBO funds in 2013-2015 and 2016-2018



Source: eFront Insight, as of Q4, 2018.

This could hint at a "wait and see" approach of British LBO fund managers, delaying the fundraising of new funds as the Brexit scenario finally unfolds. While the average time-to-liquidity was 2.56 years as of Q1 13, it regularly increased to finally stabilise at 3.40 years in Q2 2018.

Conclusion

Funds appear to be mostly focused on divesting, hinting at a "wait and see" approach of managers as the Brexit scenario finally unfolds.

British LBO funds have already recorded some of the consequences of Brexit. First, the drop of the British pound against major currencies had a direct impact for fund investors whose currency of reference is different. Second, the behaviour of fund managers appears to have changed in multiple ways. A focus on fast divestments (or dividend recapitalizations) has provided them with extra capital to recycle, leading to a high PICC. A "wait and see" approach has then led to a significant decrease in RVPIs over the last three years.

The actual Brexit will lead to further disruptions. Will this trigger a wave of new investments? Once the outcome of the negotiations is known, it seems likely that British fund managers will capitalize on this expected major economic disruption.

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

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