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Private equity – closer to the real economy

Introduction

Investors should remember that the economy is far broader than only the listed markets and that numerous opportunities can often only be accessed in private markets through private equity investments. Even though we face unprecedented headwinds, especially in South Africa, we expect private equity to outperform in the long term, with generally lower volatility than public markets.

What is private equity?

Private equity is equity investments or ownership of private companies that are typically not listed and not bought or sold regularly. In most cases, the investment is long-term orientated and therefore considered 'patient' capital.

The private equity investment manager, together with a management team, acquires control of a business to execute an agreed-upon investment strategy to grow and transform a business over a long-term horizon.
The private equity investment managers also bring skillsets that may include the enhancing of corporate governance of these private companies, skills and resources to enhance the operational efficiencies, and access to new markets or other geographies.

Private equity and JSE listed companies

The Johannesburg Stock Exchange (JSE) has a combined market capitalisation of approximately R14 trillion and comprises 342 listed companies.

According to the Southern African Venture Capital and Private Equity Association (Savca), which is the industry body for private equity in South Africa, the local private equity industry had R184 billion in assets under management in 2019.

Private equity firms made 588 new investments in 2019 worth about R25 billion, according to Savca.

While private equity firms are making new investments, the JSE has had 71 delistings in the past decade. The JSE is not replacing these delisted companies with new listings, and consequently advance the growth in private markets.

Figure 1: The private equity market

Source: Smallcaps.co.za, JSE

Leading private-equity-backed companies

Some of the leading private-equity-backed companies we were directly or indirectly involved in include many household names, while others fly under the radar but still provide goods and services that we all use.

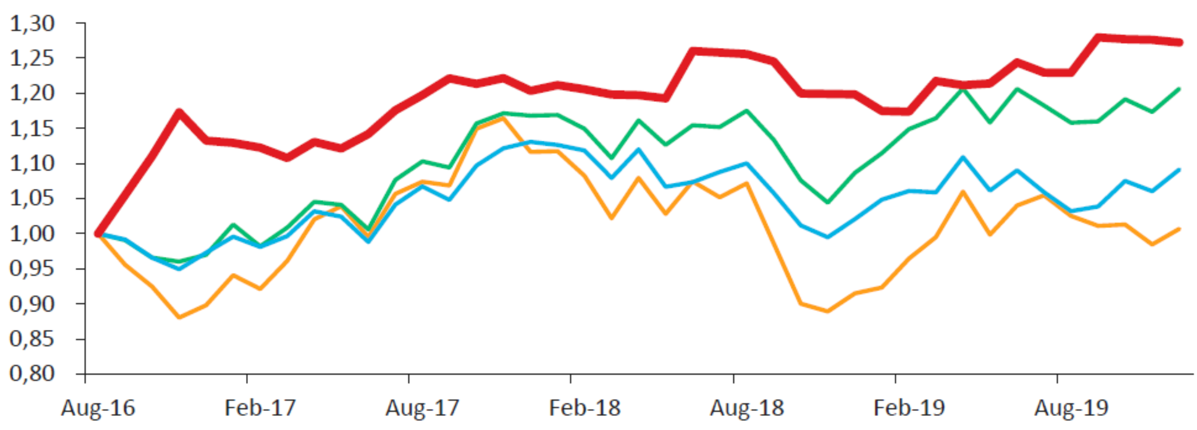
Examples include Vox, the internet service provider and fibre business, Primedia, the leading broadcasting and advertising group with well-known brands such as 947, 702, Cape Talk and KFM as well as Twinsaver, the leading brand in tissue and toilet paper.

Advantages of private equity

So why invest in private equity? Private equity provides opportunities that are not available in the listed markets, and with lower volatility and possible outperformance. The annualised volatility of the Momentum Private Equity Portfolio is about two thirds of that of the FTSE/JSE All-Share Index (Alsi).

The lower volatility is because there is no frequent buying or selling of shares – the companies are held for a five- to eight-year investment period compared to short-term trading on the JSE.

Figure 2: Lower volatility and outperformance



Source: Iress, Momentum Investments

Valuations of these private companies are typically performed quarterly and are mainly driven by the actual earnings of these companies, rather than by sentiment of fear or greed of listed markets.

The valuations of private equity companies essentially reflect what is happening in the economy on the ground and as such it cannot escape the macro-economic realities.

The COVID-19-related lockdown brought new realities, with a drop-off in demand from consumers and business, and the revenue and earnings of most companies contracted, and a downward revaluation of many companies in private equity portfolios followed. Other companies, many of which supply essential goods and services, were less severely affected and some even managed to grow their earnings.

Public markets have rallied off March lows

In March, there was a global selloff in public equity markets, fueled by fear and panic over the COVID-19 pandemic. Central banks were quick to inject liquidity and, since then, the S&P500 had the greatest equity rallies of all time, both in terms of speed and magnitude, reaching its previous high in less than four months.

The rally was, however, concentrated in a few technology stocks, most notably Facebook, Amazon, Apple, Netflix, Google and Microsoft.

South African public indices also rallied strongly off the March lows but have not yet reached its previous highs.

Many economists, investors and analysts have raised concerns about the sustainability of the rebound in listed markets, especially if further rounds of lockdowns are implemented, with very little room for disappointment in growth or earnings.

Public markets more expensive

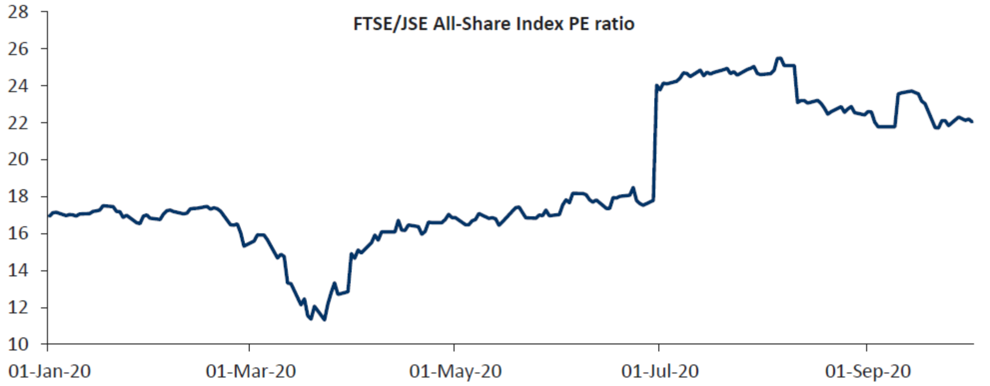
As the public markets have rallied off their lows, they have become more expensive.

Global gross domestic product is expected to contract by around 3% in 2020 and a rebound of around 3% is forecasted for 2021. The local economy is expected to contract by more than 7% in 2020, with a rebound of only 2% in 2021. The so-called 'SA Inc.' shares – those companies that earn most of their profits in the local market – have massively underperformed SA 'global' shares, including Naspers and Prosus.

Even though markets have rallied strongly, the rallies are not necessarily underpinned by earnings.

In South Africa, equity earnings per share are expected to contract by around 20%. The effect of this is reflected in the price/earnings (PE) ratio of the Alsi, which has increased dramatically. It highlights the disconnect between the listed markets and what is happening on the ground in the economy.

Figure 3: Public markets rallied off market lows but became more expensive



Source: Iress, Momentum Investments

Private equity expected to outperform

Even though we face unprecedented headwinds, especially in South Africa, we expect private equity to outperform in the long term.

This is driven by the vast opportunity set, as compared to listed markets in South Africa.

These opportunities are fairly priced and, using the private equity investment managers' proven skillsets, can enhance value.

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