

How profitable is private equity? V2

What is the purpose of this article?

This article enables a discussion regarding the profitability of PE (Private Equity) buyout funds. The focus is on traditional PE funds with a fixed liquidation date.

The audience for this article includes: LPs (Limited Partners) and GPs (General Partners of PE buyout funds).

This article does not provide tax, legal or financial advice.

You must do your own research and fact-based analysis using current and relevant information.

What are the critical learnings in this article?

- 1) Close to 50% of PE buyout funds had the same returns (or worse) returns than public market indices.
- 2) Past PE buyout GP performance is not a predictor of future Direct Alpha performance.
- 3) There are ways to identify what impacts the future Direct Alpha PE of GPs but I have not found fact-based analysis that these ways will results in positive Direct Alpha.
- 4) There won't be fact-based analysis of AI on GP Direct Alpha performance for several years.
- 5) Scenario planning is important to identify the GP talent which can drive long-term Direct Alpha.

How do you read this article?

This article uses Direct Alpha as the measure of GP performance. See Appendix A for a definition of Direct Alpha.

How profitable have PE buyout GPs been for their LPs? ¹

Close to 50% of PE buyout funds had the same returns (or worse) returns than public market indices.

- 1) 25% of PE buyout funds had annual returns 8% (or more) higher than public market indices.
- 2) 25% of PE buyout funds had annual returns at least 5% lower than public market indices.

Picking the right PE buyout GPs is critical to better performance than a public market index.

Does past PE buyout GP performance help you predict future performance? ²

Past PE buyout GP performance is not a predictor of future Direct Alpha performance.

- 1) "Interim performance offers no evidence of persistence"
- 2) "Investors gain little by knowing which quartile the GPs current fund is in when they are deciding whether to invest in the next buyout fund".
- 3) But what if you took the second previous fund, which is largely realized, to predict performance? "We find no evidence of persistence using this approach".

How can you predict future performance of PE buyout GPs?

There are ways to identify what impacts the future Direct Alpha PE of GPs but I have not found fact-based analysis that these ways will results in positive Direct Alpha.

- 1) Has the GP been growing revenue and EBITDA in portfolio companies? There are reports which indicate that simply cutting costs is of limited value.
- 2) Does the GP's team do the investment due diligence or is it done only by external consultants, advisors, and lawyers? There are reports which indicate that internal due diligence, length of the due diligence process and due diligence process improve GP performance.
- 3) The use of value creating operating partners has big impact on EBITDA. One study found that deals with operating partners generated average EBITDA growth of 23.2% Deals without operating partners generated average EBITDA growth of 11.9%. ³
- 4) There are a number of talent characteristics which impact GP performance. These include: The operational and financial background of the deal partners, the ongoing replacement of poor performing deal team members, the fund having a dedicated human capital partner to managing talent acquisition and exiting at portfolio companies. The portfolio company CEO execution skills CCC (high empathy and listening skills are not correlated with EBITDA growth).⁴

Have the private equity and public markets changed?

There have been massive changes in the private equity and public markets in this century. ⁶

- 1) Over the past 10 years private equity has spent \$900 billion taking public companies private.
- 2) From 2000 to 2024 the number of US public companies declined from about 7,000 to 4,500. The number of PE backed companies grew from about 2,000 to 11,600.
- 3) 61% of the stock value creation occurs prior to the IPO, leaving less value creation potential for the average investor. 85% of US unicorns that went public were unprofitable in 2023.

- 4) 44% of the Russell 2000 companies are unprofitable.
- 5) The conventional thinking that smaller companies outperform larger companies is not supported by facts. The Russell 2000 has been underperforming the S&P 500 and Nasdaq composite by increasing amounts over the past 20 years. E.g. over 20 years: -5.6% per year, over 10 years: -9.2% per year, over 5 years: -10.7% per year.

What are the current challenges PE fund managers face in providing cash returns to LPs?

- 1) The traditional PE equity value creation model appears broken. For 40 years the approach has been financial leverage and increasing the price to EBITDA multiple. ⁶ This approach now often appears to fail.
- 2) The total PE assets appear to be greater than the capacity and demand from IPOs and operating companies.
- 3) There is a backlog of portfolio companies waiting for exits. The assets under management have tripled since 2014 while the value of exits has remained flat, resulting in a build up of unsold assets. ⁷ Late 2024, global buyout funds were holding about \$3.6 trillion of unrealized value in about 29,000 unsold companies. ⁸
- 4) To provide capital returns, GPs are borrowing money to give to LPs or selling some assets to the GP 's continuation fund. ⁹ (the cash from LPs investing in the continuation fund can be given to LPs in the original fund.) Most existing investors in a PE fund decline the option to roll over their investment in a continuation fund run by the same GP. ¹⁰
- 5) There are different points of view regarding portfolio companies sold to a continuation fund. Some believe these portfolio companies have major profit growth potential and they should be retained. Others believe these portfolio companies have few or no buyers and thus are being sold to avoid a write-down.
- 6) LPs are getting return on capital by selling their interest in a fund to a third party. This is a secondary investment. Online marketplaces are emerging to enable LPs to sell their PE fund investments.

What will be the impact of AI on GP performance?

There won't be fact-based analysis of AI on GP Direct Alpha performance for several years.

Is scenario planning important to predicting the future Direct Alpha of GPs?

Scenario planning is important to identify the GP talent which can drive long-term Direct Alpha.

- 1) The future cannot be forecast.
- 2) Public markets may change.
- 3) Interest rates and the economy may change.
- 4) The business models GP need to create positive Direct Alpha may change.

What are your next steps – as an LP?

- 1) Define the words/concepts you're using, in a glossary. I've seen major confusion when the same words mean different things to different people. Different data sources will have different definitions. Very subtle differences in definitions can have a major impact on your returns.
- 2) You should create future scenarios.
- 3) Then you create detailed evaluation criteria regarding GPs. As discussed above, assessing the talent of the GP firms is critical. They need to be able to learn and unlearn more quickly and better than the competition.

Footnotes

¹ "A optimistic but measured outlook for private equity", Vanguard

<https://corporate.vanguard.com/content/corporatesite/us/en/corp/articles/optimistic-but-measured-outlook-private-equity.html>

² "Has persistence persisted in private equity? Evidence from buyout and venture capital funds" Journal of corporate finance, Page 15.

<https://www.sciencedirect.com/science/article/pii/S092911992300010X>

³ "The Impact of Operating Partners on Private Equity-backed companies in France: an exclusive study", Page 6

<https://www.franceinvest.eu/wp-content/uploads/2023/10/The-impact-of-Operating-Partners-on-PE-1.pdf>

⁴ "Which CEO Characteristics and Abilities Matter?" – National Bureau of Economic Research

<https://www.nber.org/digest/feb09/which-ceo-characteristics-and-abilities-matter>

⁵ "Private Equity Can Add Diversification to Your Public Index Holdings", page 5-6, iCapital, 2025 July 16

<https://icapital.com/category/insights/private-equity/>

⁶ “Bridging Private Equity’s Value Creation Gap”, page 2, McKinsey, 2024 April 12
<https://www.mckinsey.com/industries/private-capital/our-insights/bridging-private-equitys-value-creation-gap>

⁷ 2025 Global Private Equity Report – Bain, Page 4,6
<https://www.bain.com/insights/topics/global-private-equity-report/>

⁸ *ibid.*, Page 17

⁹ What is a continuation fund? A GP creates a new fund, managed by the GP. Some assets are sold to the new fund. LPs have the option to receive cash or roll over their investments into the new fund.

¹⁰ Kobi Kastiel, Yaron Nili “The rise of private equity continuation funds”, Chicago Booth Stigler Center January 2024 page 1
<https://www.chicagobooth.edu/research/stigler/research/-/media/5d46328c68e0466b9787f42d98275f3b.ashx>

What further reading should you do?

Your company will fail. Koor and Associates

<https://koorandassociates.org/avoiding-business-failure/your-company-will-fail-v1/>

What are the core components of talent? Koor and Associates

<https://koorandassociates.org/creating-business-value/core-components-of-talent/>

LP (Limited Partner) assessment of a fund. Koor and Associates

<https://koorandassociates.org/selling-a-company-or-raising-capital/lp-limited-partner-assessment-of-a-fund/>

Appendix A – What is Direct Alpha?

Direct Alpha is the annualized return of a fund over a public market index (e.g. S&P 500).

1) Direct Alpha is calculated using the specific cash flows of an LP in and out of a fund. These dates and dollars amounts are used to determine hypothetical purchases and sales of a public market index

2) Direct Alpha also includes the Net Asset Value of the fund, which is the value of unsold assets.

Direct Alpha measures the annual percentage return above or below the benchmark the LP would achieve. A Direct Alpha of 0% means the investor received the same return as if they had bought and sold the public market index. A direct Alpha of 5% means the investor received an annual return 5% higher than the public market index.

Why not use the IRR reported by funds?

1) The IRR reported by funds does not represent the annual % cash returns the LP would achieve over the lifetime of the fund.

2) The IRR can also be manipulated by funds to generate high values.