PRIVATE EQUITY WIRE

INSIGHT REPORT

H1 Update:

Private equity faces bear market

AUGUST 2022

EXECUTIVE SUMMARY

Welcome to the first-ever Private Equity Wire Performance Insight Report, looking back on the first half of 2022.

Our research relies on benchmark average IRR performance across the asset class for Q3 and Q4 2021 from Pitchbook and Preqin, dealmaking and M&A data for H1 2022 and interviews and qualitative research with leading fund managers, consultants and investors.

Private equity benchmark returns have begun a descent from their post-pandemic high.

Average global returns for Q3 2021 fell to 6.8% from almost 15% in Q1, the strategy's lowest quarterly IRR since the pandemic rocked public markets in Q1 2020, according to Pitchbook, which shows a further decline to 3.42% in Q4 based on preliminary data.

According to a survey by Private Equity Wire, almost half of respondents expect a decrease in returns for their buy-out strategies in the second half of the year.

Global dealmaking has plummeted this year compared to 2021 as banks have pulled back financing in a risk-off environment but activity still appears resilient when compared to previous economic cycles.

In recessionary times, the IT sector tends to suffer most in public markets, followed by communication services and industrials. However, technology still remains the most active sector for M&A and is expected to offer the strongest returns for buyout investors going forward, according to research by Private Equity Wire.

The IPO market has ground to the slowest pace in years, limiting exit opportunities for large-cap GPs that missed the party in 2021.

As a result, GPs are looking for other exit routes in the second half of the year, with private M&A channels taking the lead. Those with assets for sale are being advised to take advantage of the still active M&A market and the GP-led secondary market to accelerate processes in the event of a near-term reversal of fortunes.

Most active LPs are not sensitive to quarterly bumps in average IRRs as the long-term outlook for the asset class remains positive. However, the portfolios of many have been hit by the denominator effect, as the relative drop in value of their equities has left some overexposed to private equity. With fundraising processes being pushed into 2023, manager selection will prove key in the upcoming months if macro and geopolitical risk continue to increase.

COLIN LEOPOLD
HEAD OF RESEARCH & INSIGHT

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METHODOLOGY

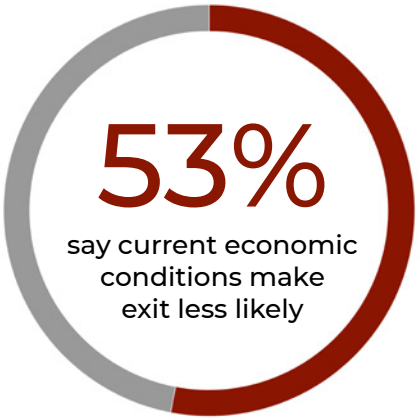
Private Equity Wire surveyed over 50 private equity industry stakeholders during July 2022 on the subject of financial performance in the asset class. Of that group, all were private market fund managers or GPs active in private equity.

KEY FINDINGS

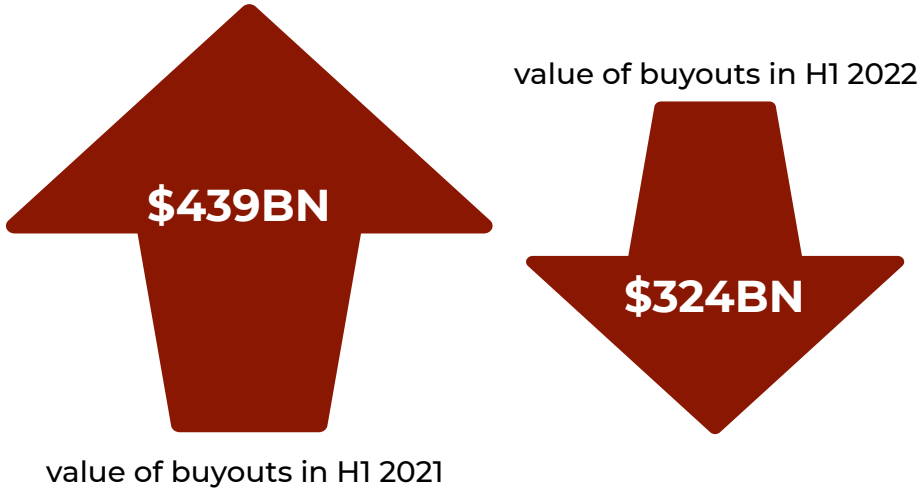
PRIVATE EQUITY RETURNS ARE EXPECTED TO DROP IN 2022

In response to the question: 'As we enter H2, do you expect returns to decrease, increase or stay the same in your most active buyout strategies?

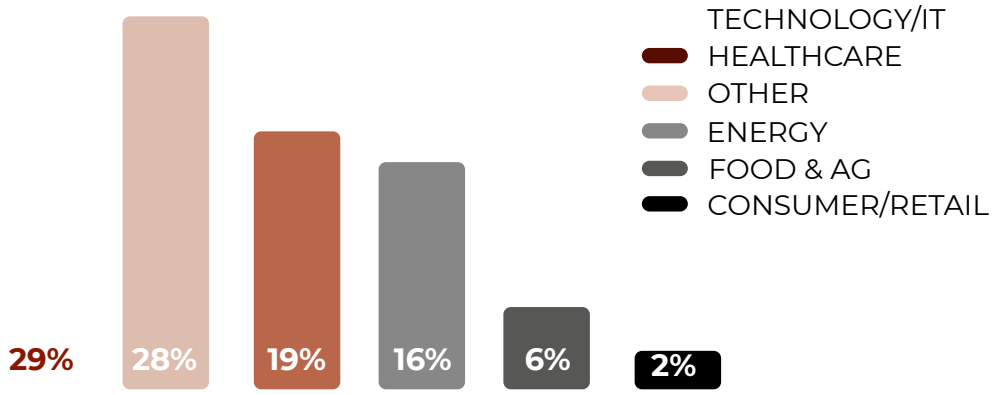
AFTER AN IPO BOOM LAST YEAR, MOST PRIVATE EQUITY FUND MANAGERS EXPECT TO DELAY EXITS IN 2022



BUYOUT DEAL VOLUME IS BACK TO PRE-PANDEMIC LEVELS, AND MAY FALL FURTHER DURING THE REST OF 2022



PRIVATE EQUITY MANAGERS STILL EXPECT TECHNOLOGY TO YIELD STRONGEST RETURNS IN 2022



Private equity managers were asked which sector will see the strongest returns for buy-out funds going forward

SECTION 1

PRIVATE EQUITY REPOSITIONS AMID MACRO VOLATILITY

Average returns across private equity have come off their 2021 peak. Fund managers say portfolios remain resilient and, in a recession, the asset class can still outperform

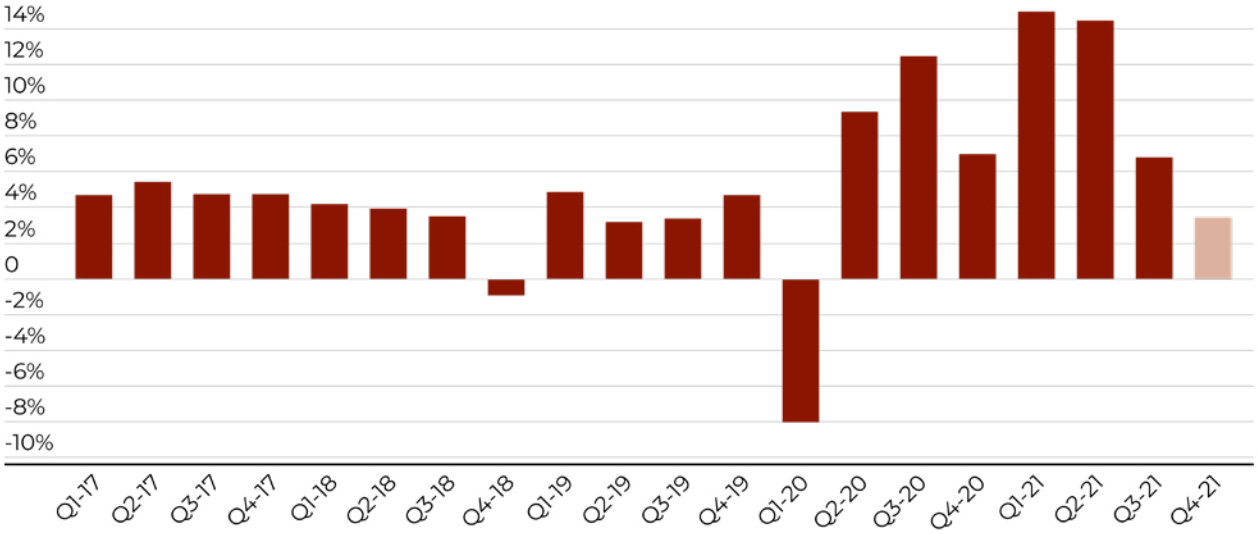
Private equity benchmark returns have begun a descent from their post-pandemic high.

Average global returns for Q3 2021 fell to 6.8% from almost 15% in Q1, the strategy's lowest quarterly IRR since the pandemic rocked public markets in Q1 2020, according to Pitchbook, which shows a further decline to 3.42% in Q4 based on preliminary data.

"A tighter policy environment is putting downward pressure on risk assets and causing returns to normalise after several standout quarters driven by ultra-loose fiscal and monetary policies," it said.

According to qualitative research by Private Equity Wire during June, the decline has continued into the first half of 2022.

Figure 1.1: Private equity funds' quarterly internal rate of return (IRR), 2017–2021



Analyst note: Q4 2021 figures are preliminary

Source: Pitchbook

Asked whether they are seeing an increase, decrease or the same performance in returns across their most active buy-out strategies, only 20% of respondents to a survey of more than 50 industry stakeholders reported an increase during H1 – with the majority seeing flat or downward numbers.

Almost half of respondents expect a decrease in returns for their buy-out strategies in the second half of 2022.

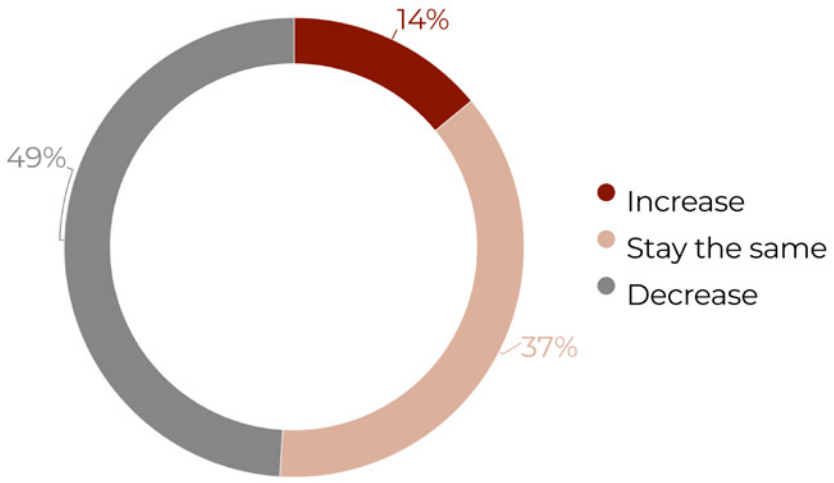
"There's absolutely no doubt that asset classes are being impacted [by a slower dealmaking environment and an adjustment in valuations] and it's going to continue like this," says Jean-Baptiste Wautier, partner and chief investment officer at BC Partners. "There will be a bit of a mourning period, risk will reprice and then things will start back up again but this is exactly where we are right now."

The Private Equity Wire survey found that the majority of respondents (51%) believe data from North America will show the strongest fund performance by year-end 2022, with Europe (26%) only slightly above Asia (23%).

Europe has its own unique set of challenges and has been more

> I think there's likely to be a real reckoning of private equity firms. Not everybody is created equal.

Figure 1.2: PE fund manager expectations for returns across buy-out strategies in H2 2022



Source: Private Equity Wire survey, July 2022

exposed to issues relating to the war in Ukraine, says Simon Finn, managing partner at Intriva Capital. "But I'd like to just hold breath on the impact until we get to Q4 2022 because I think by then you will start to see everything wash through. At the moment there's more downside than upside, but we see opportunities and remain acquisitive."

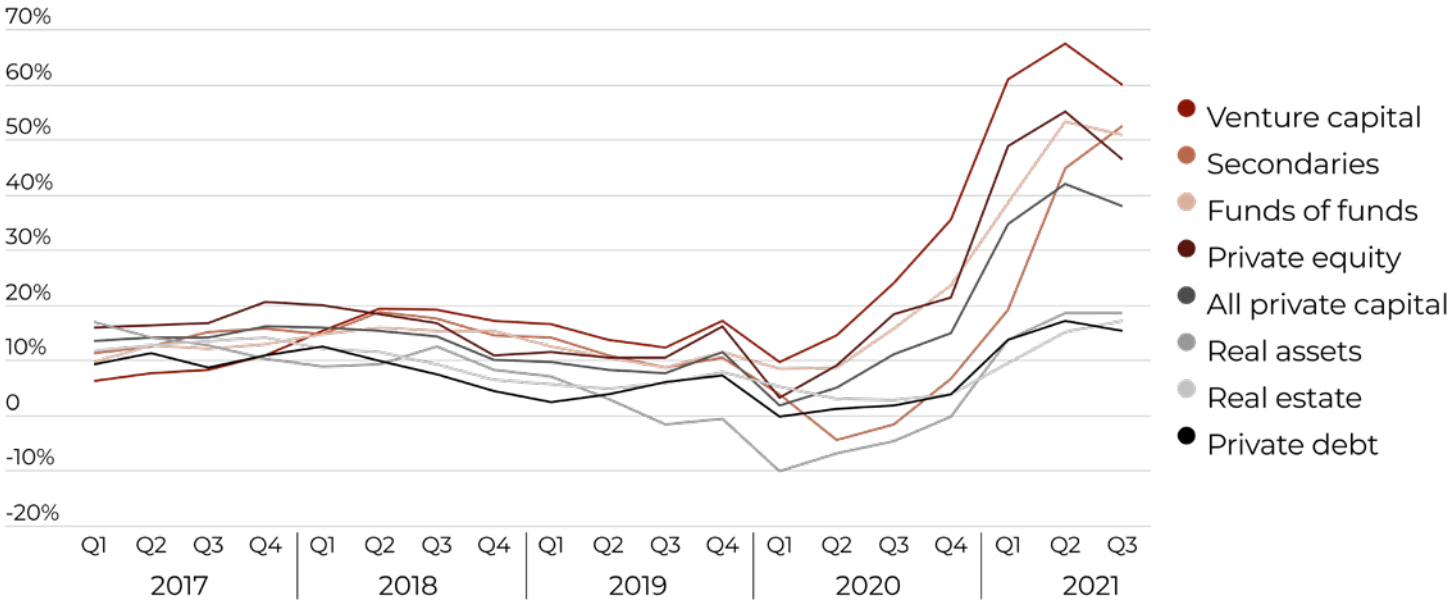
Even for managers seeing no impact on their 2022 Q1 or Q2 numbers, there is a growing sense of caution around several pronounced macroeconomic risks: from inflation and interest rate hikes to war in Europe and public market volatility.

"Private equity has been an enduring and growth asset class and continues to outpace over time, by and large, the public markets," says Hythem El-Nazer, managing director at US-based private equity firm TA Associates. "However, I think there's likely to be a real reckoning of private equity firms. Not everybody is created equal, and with a more challenging market backdrop, firms will need to generate differentiated value in order to sustain top quartile returns."

Following a risk assessment earlier this year, France-based fund manager Ardian found inflation to have a net zero effect on its portfolio but considers a potential European energy crisis after the summer to be a "big unknown", says Oliver Personnaz, head of Ardian Buyout UK and managing director at Ardian.

Others are more sanguine. "We think that the overall benchmark coming down could be a good thing, because we feel really good about the portfolio we have and the potential performance of that portfolio of assets. And so, the sort of eye-popping IRRs generated in 2021 by many of the tech focus funds will

Figure 1.3a: Private capital rolling one-year horizon internal rate of return (IRR) by strategy, 2017–2021



Analyst note: 2021 figures as of 30 September 2021

Source: Pitchbook

come down to a more normalised level, and I think that will be a good thing for us as a firm," says Davis Noell, senior managing director and co-head of North America, Providence Equity Partners.

Fund managers also agree that private equity investments with a three- to seven-year horizon are typically stress-tested under a recession scenario and although a public market correction does influence private market valuations, it is not a direct correlation.

"There's really no tactical change we have made because a recession shouldn't be a surprise to anyone," says Nils Rode, chief investment officer at Schroders Capital. "Private equity should be more resilient than the public markets [and] I believe we will benefit from the strategy bias and the sector bias that we have in our global diversification. We are sleeping well."

Multiples flatten

Recent increases in sponsor returns have come from the expansion in valuation multiples, but a rising interest rate environment is likely causing multiples to flatten and returns to reduce.

In the latest benchmark figures, returns have dropped across all fund size buckets and regions, but with greater resilience coming out of Europe and for funds sized under $500 million. Mega-funds ($5.0 billion or larger) continued to drive returns in the year through Q3 2021, buoyed by a healthy exit market for larger assets

from cash-rich corporates, according to Pitchbook. But the exit environment in 2022 has shifted drastically (see Chapter 3).

"We expect to see in the benchmarks that small should be doing better than large and early-stage growth should be doing better than late," says Rode, adding that larger fund managers can be more exposed to corrections than smaller managers, due to the amount of leverage in their portfolios and their entry valuations which can be elevated.

While the dispersal of returns within the asset class has widened over time, the growth of specialist managers may make recent high performers, for example in the technology sector, more vulnerable to concentration risk when valuations shift downward. Venture capital – which is heavily weighted towards growth-orientated tech start-ups – is facing a cyclical reset in 2022, following years of rising and largely unrealised valuation growth.

However, to put things in context, Q3 returns for private equity still outpaced the quarterly returns of the S&P 500 and STOXX Europe 600 and were still above private equity's five-year quarterly average.

According to research by Private Equity Wire, the asset class is also positioned to perform well in a recessionary environment (see box below).

Figure 1.3b: Private equity rolling one-year horizon internal rate of return (IRR) by fund size, 2017–2021

Analyst note: 2021 figures as of 30 September 2021

Source: Pitchbook

> I think you will see funds with different mechanisms for capital deployment emerge in different macro environments

JEAN-BAPTISTE WAUTIER,
CIO, BC PARTNERS

"You haven't really seen any markdown in portfolios in Q1 2022. You should have seen some in the tech space. It's something you're going to see in Q2. It's going to be very hard to say, 'My portfolio hasn't moved in value' when the NASDAQ has lost 35% since the start of the year. So the biggest drop will be in technology but it remains to be seen whether market participants will decide to do this gradually or take a massive markdown at the end of Q2. Younger managers tend to forget that it's quite unusual to be in a bull market for so long So we were always going to have a pretty sharp correction, but I'm absolutely convinced, as the market adjusts, it might be a painful adjustment but it's going to be a fantastic buying opportunity. The private equity model hasn't changed: we can take decisions quicker, we care about the long run, and we care about value creation. There's no quarterly dictatorship with the share price."

New paradigm

Speaking in June, the CEO of IK Partners Christopher Masek was reported saying: "We believe there will be attractive investment opportunities at more reasonable multiples using more rational baseline metrics (cash EBITDA rather than multiples of ARR) with conservative financing. Investors will be taking their time to consider which strategies are the winning ones in this new environment where we see a move towards quality and tangible performance as the key differentiator. We believe our firm has long been prepared for this and will thrive in this new paradigm".

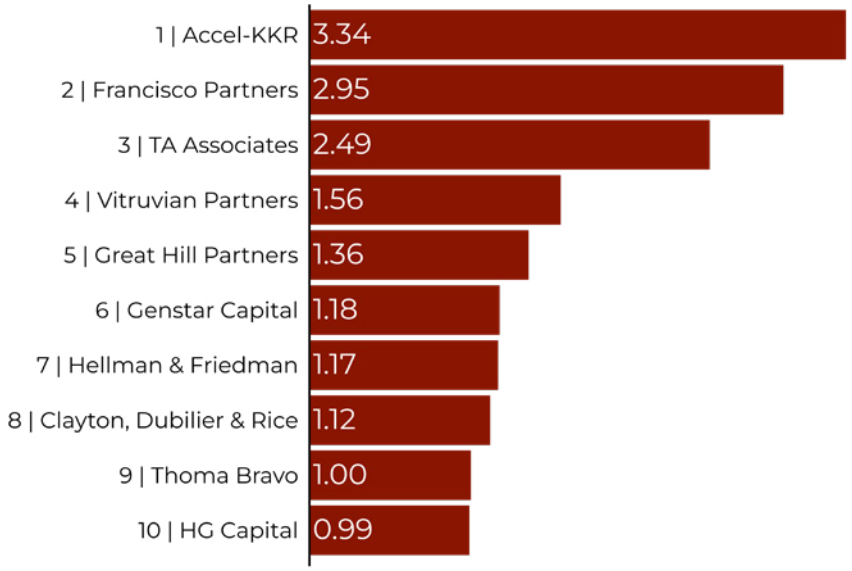
Other established managers have been raising special-situations funds, which deploy capital into troubled industries and credit-constrained companies.

In June, JP Morgan's asset management unit closed its Lynstone Special Situations Fund II, raising $2.4 billion beyond $2 billion target. Oaktree is currently marketing its third special-situations fund, seeking to raise $2.5 billion to $3 billion, and MidOcean Partners, is marketing Tactical Credit Fund III, to invest in stressed and distressed assets.

Indeed, when asked 'Which private equity strategy do you expect to see the strongest returns going forward?' in Private Equity Wire's June survey, special situations/turnaround was the third most popular strategy for respondents, after buy-out and growth equity.

"We believe private equity has the unique ability to deliver flexible

Figure 1.4: 2021 HEC Paris-Dow Jones Private Equity Performance Ranking



Analyst note: Based on data from buyout funds raised between 2008 and 2017

Source: 2021 HEC Paris-Dow Jones Private Equity Performance Ranking

capital solutions in the private markets, so we're spending a lot of time thinking through our areas of expertise, focus, capabilities, and the companies where traditional M&A financing may not be available, but where there's an opportunity to invest," says Daniel Penn, managing director, consumer at MidOcean Partners, in reference to where the firm's finding opportunities in private equity specifically. "I think you will see funds with different mechanisms for capital deployment emerge in different macro environments." ■

Key Takeaway

For LPs: A rising interest rate environment is likely to cause valuation multiples to flatten. Fund managers will need to generate differentiated value to sustain top quartile returns and should target depressed value assets during a recession. Special situations funds are also lining up.

HYTHEM EL-NAZER,
MANAGING DIRECTOR,
TA ASSOCIATES

"We are not seeing any major cracks in the portfolio. Operating performance has continued to be solid, demand within our portfolio companies was strong: Q1 was really good, Q2 was fine, and even Q3, at this juncture, looks to be shaping up similarly. The uncertainty begins to increase in Q4 and into Q1 2023. The overwhelming majority of our portfolio companies have recurring business models, with a high degree of visibility in the business, often times six to 12 months out. But I think many people are asking themselves questions around 2023 and taking a cautious approach. On the other hand, we're actively tracking opportunities, visiting companies, and interacting with founders and entrepreneurs. The bar remains high to put capital to work and our return expectations have not changed, with a chance to do better. Companies and management teams want to know that you're active and supportive, not just in good times, but also in more challenging times. We don't have any deployment pressures so we plan to stay disciplined and focus on our knitting."

SECTION 2

M&A PLUMMETS IN THE WAKE OF ECONOMIC UNCERTAINTY

A marked slowdown in private equity dealmaking so far this year is expected to impact the second half. A buying opportunity may await, but sellers must adjust their valuations expectations first

Global dealmaking by private equity funds has plummeted in 2022 as banks have pulled back financing in a risk-off environment.

Across the M&A market globally, activity fell by 23% in value to USD 2.2 trillion in H1 2022, compared with the same period last year, according to Dealogic. By volume, the drop was 20% to 15,764 deals over the same period.

Sponsor-led activity, which typically involves private equity firms, showed a relatively smaller 13.1% decrease in value compared to H1 last year, buoyed by several large and high-profile buyouts in Q2 such as Blackstone's $46.4 billion majority acquisition of Atlantia, the $21 billion takeover of Ramsay Health Care by KKR and the $10.3 billion take private of Zendesk by Hellman & Friedman and Permira consortia.

In Europe, Blackstone and Edizione's $46.6 billion public offer for Italian transport firm Atlantia was the largest European leveraged buyout on record.

"M&A is just plummeting," says a partner at a

major UK-based private equity fund. "We're not yet seeing proper adjustments [to valuation] in seller expectations and volume is quite small, but there's more pain to come."

There are two views here: year-on-year slowdown or cyclical resilience.

According to EY, global M&A activity has remained remarkably resilient and CEOs continue to have a healthy appetite to pursue transactions. Compared to the average of the last deal cycle prior to the pandemic (2015-2019), H1 2022 activity is up 35% by value and 13% by volume.

Other trends are also evident in H1 dealmaking data.

In private equity, there has been a multiyear trend toward bigger funds doing bigger deals. The trend accelerated in 2021, but the real shift came in the market's broad middle, where the number of $1 billion–plus deals roughly doubled last year – increasing average deal size by 57% and pushing it past the $1 billion threshold for the first time, according to consultant Bain.

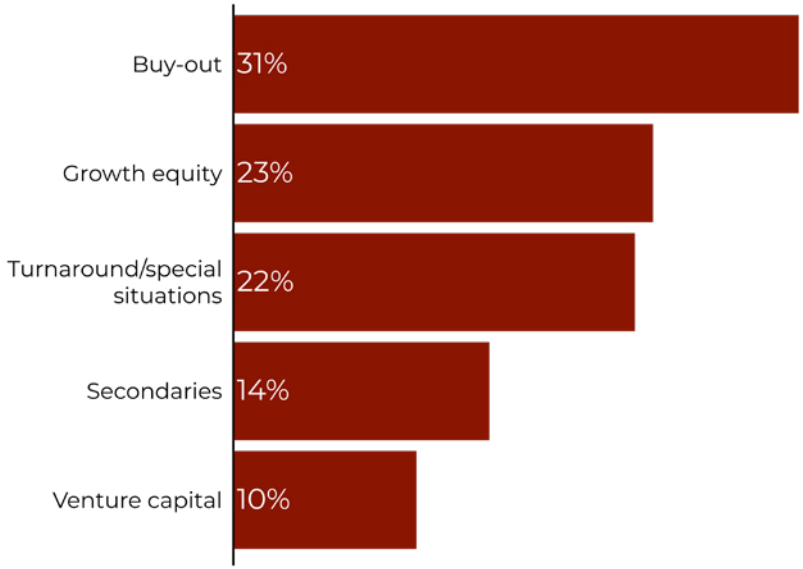
This mega-deal phenomenon seems unlikely to continue to grow through 2022.
In the US, there were only 17 private equity transactions valued at $1 billion or more in the first three months of 2022, accounting for nearly $80 billion in total value, according to Pitchbook. Over the course of 2021, the total was 124 mega-deals, totaling $377 billion.

Past the peak

Speaking to Bloomberg in June, managing director at Carlyle Group Marco De Benedetti, pointed to a "definite slowdown" in private equity deal-making, adding: "I think the peak is behind us."

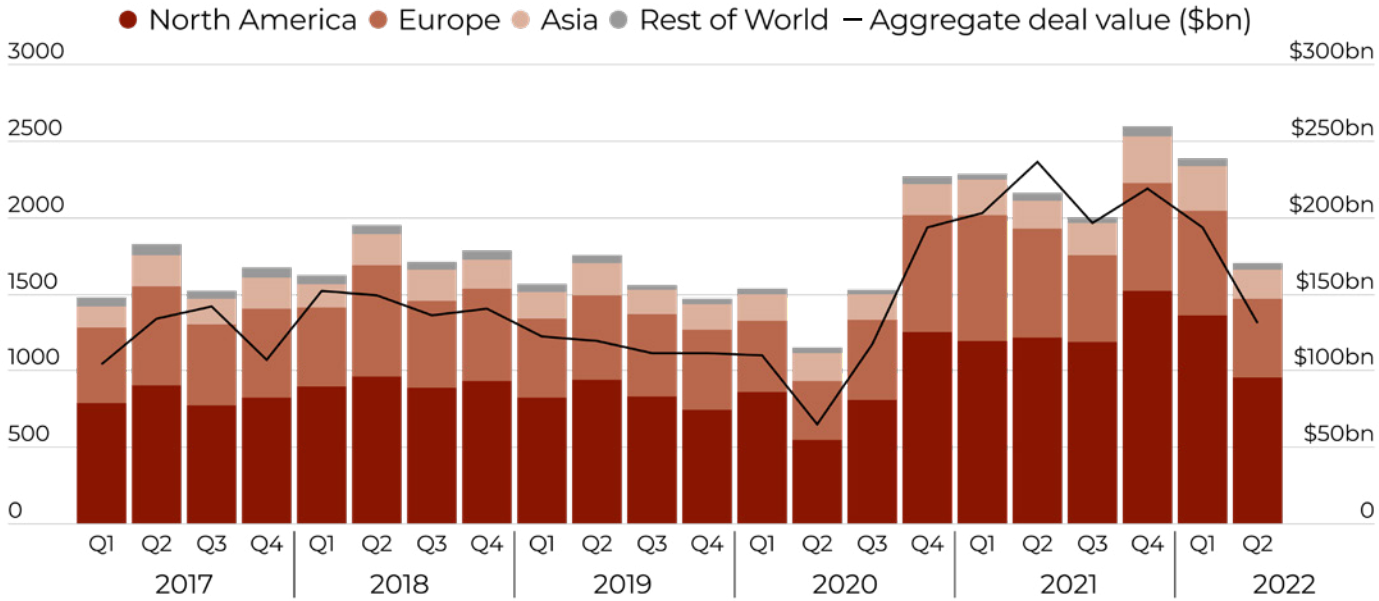
Given that many of the deals recorded in Q1 2022 would have been initiated at the end of 2021, before the Ukraine war, H2 2022 deal volumes may be even more vulnerable to the inflation, recession fears and rising cost of capital of H1.

Figure 2.1: PE strategy fund managers expect to yield the strongest returns going forward



Source: Private Equity Wire survey, July 2022

Figure 2.2: Quarterly private equity-backed buyout deal volume by region, 2017–Q2 2022



Source: Preqin

The average time to close a deal has also increased in 2022, with 60% of transactions during the first six months taking over 70 days (the long-term average time between announcement and closing), compared to 54% in the first half of 2021, according to WTW's Quarterly Deal Performance Monitor (QDPM).

"With the uncertainty that we have, it is our view that we will continue to see [this slowdown] evolve to an even greater velocity into the second half of the year," says Finn at Intriva Capital. "So far, we are not seeing sellers wanting to realise a lower multiple and exit, we're just seeing the slowdown in activity caused by deals not being done."

For the buyout activity that is continuing, capital structures were more conservative in H1 than at any point in the last 10 years, according to data from the Centre for Private Equity and MBO Research (CMBOR) in July, showing that sponsors and lenders alike clearly cautious against a backdrop of rising interest rates and squeezed earnings.

UK on top

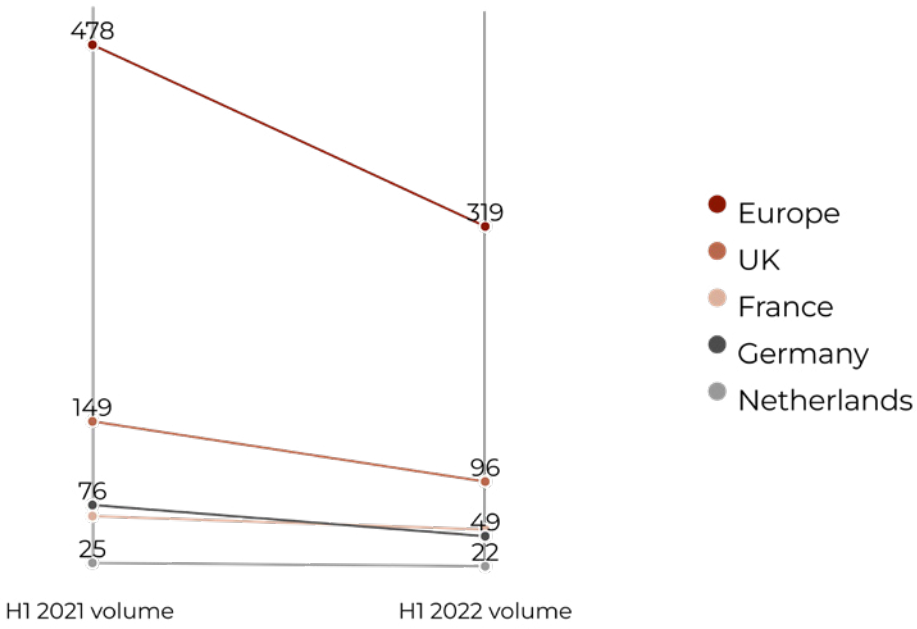
For deal structures above £100 million, the average equity portion has risen from 37.3% in 2021 to more than 50% so far this year – meaning larger buyouts have been majority-funded by equity for the first time since 2012. The average debt portion has fallen to 47%, down from 62.7% last year.

The UK remained Europe's largest private equity market by both volume and value in H1, according to the CMBOR, with the Netherlands jumping to second in value after 3G Capital's €6.3 billion buyout of Hunter Douglas and Apax Partners and Warbug Pincus' €5.1 billion acquisition of T-Mobile Netherlands.

Elsewhere in Europe, other factors impacted activity in the first half, says Christian Marriott, head of investor relations at CMBOR's sponsor Equistone.

"The French presidential and parliamentary elections seem to have prompted a temporary slowdown in larger-cap deal activity. Meanwhile the DACH market is more proximate to the conflict in Ukraine and some

Figure 2.3: European buyout activity, H1 2021 vs. H1 2022



Source: The Centre for Private Equity and MBO Research, based at Nottingham University Business School and sponsored by Equistone Partners Europe

sectors are heavily exposed to potential disruption in energy supply, causing both sponsors and businesses to exert more focus on navigating these challenges."

For some private equity funds, this may present investment opportunities in H2.

"Most of our activity is focused on North America but we are also seeing the opportunity set expand in Europe in the face of massive disruptions from the Ukraine conflict," says Reuben Munger, founder and managing partner of Vision Ridge Partners, which invests across real assets and private equity.

"We have been focused on how niche opportunities within agriculture can create an enduring market position given the various disruptions and changes taking place in the marketplace. This also translates into core other parts of power infrastructure – as market volatility and cost concerns are causing disruptions, they are also creating significant opportunity."

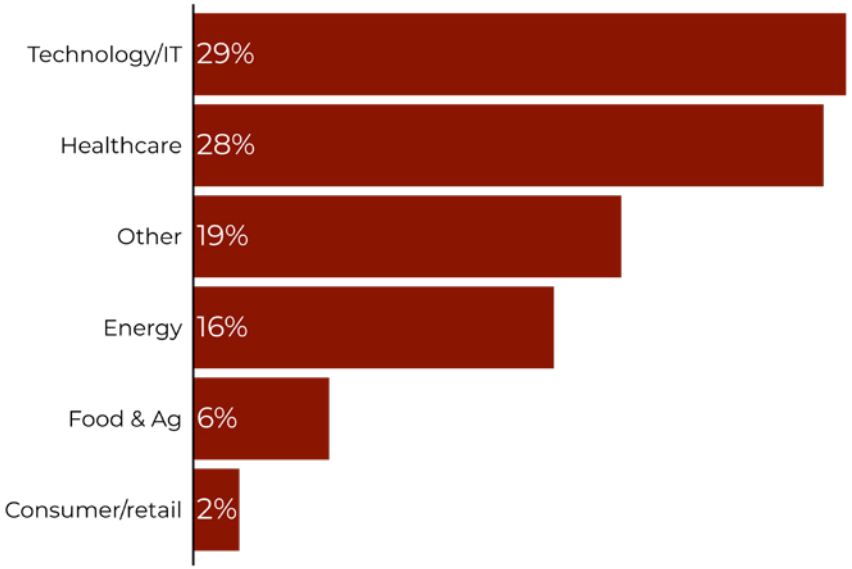
Indeed, in a forecast survey published in July by research firm Third Bridge, almost two-thirds (61%) of respondents representing firms with funds worth more than €500 million plan to prioritise diversification into new geographic markets in the next year, with 52% saying they will focus on entering new industries. "Private equity is extremely well-adapted at turning periods of volatility and market dislocation to its advantage," said co-founder of Third Bridge Joshua Maxey of the findings.

"If you roll into the back half of the year, and you can at least get some stabilisation," says Noell at Providence. "I think that'll lead to much greater levels of activity. And we're seeing it pick up some in terms of new opportunities kind of coming to market." ■

Key Takeaway

For GPs: 2021 looks like the peak of private equity dealmaking in the current economic cycle. M&A activity is falling in H1 but is still strong compared to previous cycles. The correction in public market valuations is slowly trickling through to private markets as GPs wait for buying opportunities.

Figure 2.4: Sector that private equity fund managers expect to yield the strongest returns going forward



Source: Private Equity Wire survey, July 2022

Buying opportunity?

Despite – or maybe because of – the correction in the public markets, technology remains the most active sector for M&A and is expected to offer the strongest returns for buyout investors going forward, according to research by Private Equity Wire.

When asked 'Which sector do you expect to see the strongest returns for private equity buy-out funds going forward?', around one in three respondents pointed to technology/IT, with healthcare a close second.

According to EY, deals focused on technology targets are now at double the level of the previous cycle, up 95% against the 2015-19 average.

In recessionary times, the IT sector tends to suffer most in public markets, followed by communication services and industrials, according to Schroders in June. In a

PRIVATE EQUITY IN A RECESSION

Current macroeconomic conditions impact the private equity sector in a number of ways.

"In the event of a recession or a prolonged period of stagflation, company earnings will decrease, valuations will fall, and deal flow activity will slow down," wrote industry veteran Vincent Gombault in in a July investor note sent to Private Equity Wire.

Adding in an increase in the cost of debt (due to rising interest rates) there could be an equity squeeze in the capital structure, he added.

Yet, looking at vintage year performance, recessions have been better for private equity funds than might be expected.

GPs with high past downturn success ratios are also more likely to deal better with downturns in their next fund, says Professor Oliver Gottschalg of HEC Paris.

The average IRR of private equity funds raised in a recession year at over 14% has been higher than that of funds raised in the run-up to a recession, according to research by Schroders based on data since 1980.

The private equity model has inherent advantages for riding out volatility: funds can also deploy capital over several years, rather than one; and the illiquid nature of the asset class typically insulates investors from panic selling in a downturn (see Chapter 4).

"This allows funds raised in recession years to pick up assets at depressed values as the recession plays out. And then to exit later on in the recovery phase when valuations are rising," says Rode.

Indeed, that is exactly what happened during the global financial crisis, when – according to an academic study in 2018 ("Private Equity and Financial Fragility during the Crisis" by Shai Bernstein, Josh Lerner, Filippo Mezzanotti) – private equity-backed companies invested 6% more and gained 8% market share versus their non-PE-backed peers.

fundraising round in July by private equity-backed fintech Klarna, its valuation was reduced to the lowest level since August 2019.

"We need to be careful around the correction in multiples in some sectors where multiples were not really correlated with cash flows," says Personnaz at Ardian.

In contrast, downturns tend to be a good time to invest in more defensive plays such as consumer staples and healthcare companies, as well as in bolt-on M&A for existing portfolio companies.

"I don't think valuations are going to go shooting back up, but at least right now, I don't see another big leg down in terms of valuations," says Noell at Providence.

"When you hit volatile waters," notes Finn, "the ones that start screaming for help at the beginning, were perhaps not so sound going into difficult times. And the more time goes on, you see that opportunity set starts to evolve."

Whether 2022 represents a buying opportunity for private equity also depends on the amount of dry powder within a fund strategy.

In July, it was reported by the Wall Street Journal that technology-focused Francisco Partners accelerated the fundraising of almost $17 billion in advance of a possible market correction. Founding partner and chief executive DJ Deb said he expects plenty of attractive investment opportunities to emerge in the coming years, although they could materialise in the public markets a bit sooner than in the private markets.

CHRISTOPHER MASEK, CEO, IK PARTNERS

While one could reasonably perceive that in a downturn, new deals can come at discounted valuations (generally with a delay) and generate a new cycle of opportunity not to be missed, the first concern of GPs must be on the existing investments. In this respect, the funds which steered unconsciously towards tech businesses, accepted ARR based valuations and blindly adopted all-things-Saas will be confronted with the immediate problem of overall valuation. This exercise will rightly point to the flaws of simply paper valuation at astronomical multiples and should not only turn to necessary corrections but equally to the merits of measuring performance on actual return of money to investors. Hence, for the existing investments, rather than TVPI, the rule of the era will be DPI and funds which have maintained the discipline of returning money to their investors early on with further liquidity achieved in this market will be rewarded.

Therefore, for existing investments, it's all about liquidity. For the moment there are two obstacles to achieving this: a disconnect between what investors believe their assets are worth (generally leading them to wait things out and hope for an improvement in market conditions) and the absence of private equity buyers who are in many cases at the end of their funds and afraid to return too quickly to the market combined with a real tightening of the screws on financing particularly on the higher end of the market.

The noteworthy buyers remaining are strategic who are looking for opportunities which fit their own logic of complementary growth and synergies. PE was in large part established to precisely cater to such demand but the model became somewhat locked into its own eco-system for exits also due in fairness to the slower pace of strategic buyers compared to their more nimble PE competitors. The present market is therefore one which will reward companies which have followed a strategic logic and attract their industrial or sector peers.

SECTION 3

EXIT ROUTES WIND PAST A DORMANT IPO MARKET

The first half of 2022 has been one of the worst in recent memory for IPO exits. With large amounts of liquidity still in the M&A market, an acceleration of exits to private strategic buyers may follow

With the IPO market grinding to a veritable halt in 2022, GPs are looking for other exit routes in the second half of the year, with private M&A channels taking the lead.

Those with assets for sale are being advised to take advantage of the current environment and accelerate these processes in the event of a near-term reversal of fortunes.

"If I had a portfolio with a select number of companies which needed to be exited, I would definitely try to accelerate the process," says Marco Belletti, CEO of Italian buyout firm Azimut Libera Impresa. "We're not sure how the next few months will evolve and if this window of opportunity closes suddenly, then you may have to wait one or even two years to reopen the cycle."

The market is currently in a "perfect curve", he says, having come through the recovery from 2020, achieving extraordinary results in 2021; and it still has legs in 2022.

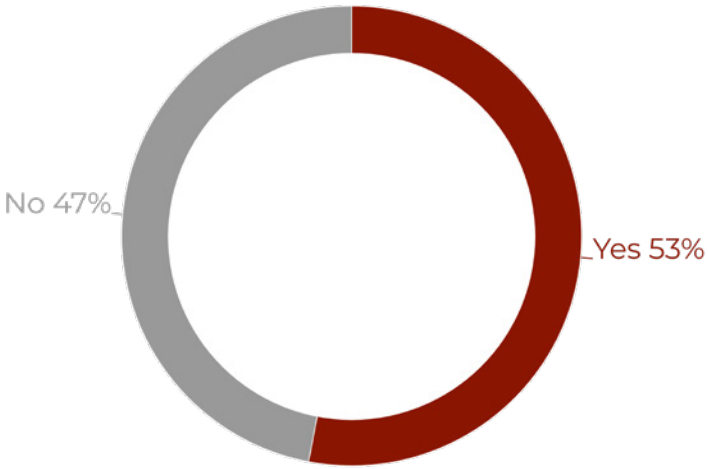
"We have seen companies in almost all sectors continue to grow. A few may have lost one or two points of profitability because of rising costs of raw materials and energy but it's still a solid market."

Exit slowdown

Such an acceleration would follow a slowdown in exit activity since the beginning of the year. Data from PitchBook finds US PE exit value dropped to an estimated $90.1 billion in the first three months of 2022, which is a 57.5% decrease over the previous quarter.

Discussing the various options available to GPs looking to sell assets, Georges Gedeon, managing partner, at alternative strategies firm Antler Capital Partners, says: "If you want to take the traditional exit

Figure 3.1: Proportion of fund managers expecting to delay or consider delaying an exit due to the recent economic climate



Analyst note: Respondents were asked, 'During H1, have you delayed or are you considering delaying the exit of an investment due to current economic conditions/ market volatility?'

Source: Private Equity Wire survey, July 2022

route through a dividend recap, it is very difficult to finance in this current environment. Access to public markets is also hard and I haven't seen a major IPO in a few months at least. The other alternative is to sell to another financial sponsor or to a corporate, knowing that both are facing an unattractive financing environment."

Coming off a stellar 2021 for exits, IPO activity this year has been lacklustre, to say the least. Schroders Capital wrote earlier this year that "2022 is shaping up to be the worst year for IPO volumes for a long time".

Prolonged inflationary headwinds, projected interest rate hikes, geopolitical conflicts, and the subsequent volatility of capital markets are all contributing to this but there are still a few sectors that may work well for an IPO exit route, says Belletti.

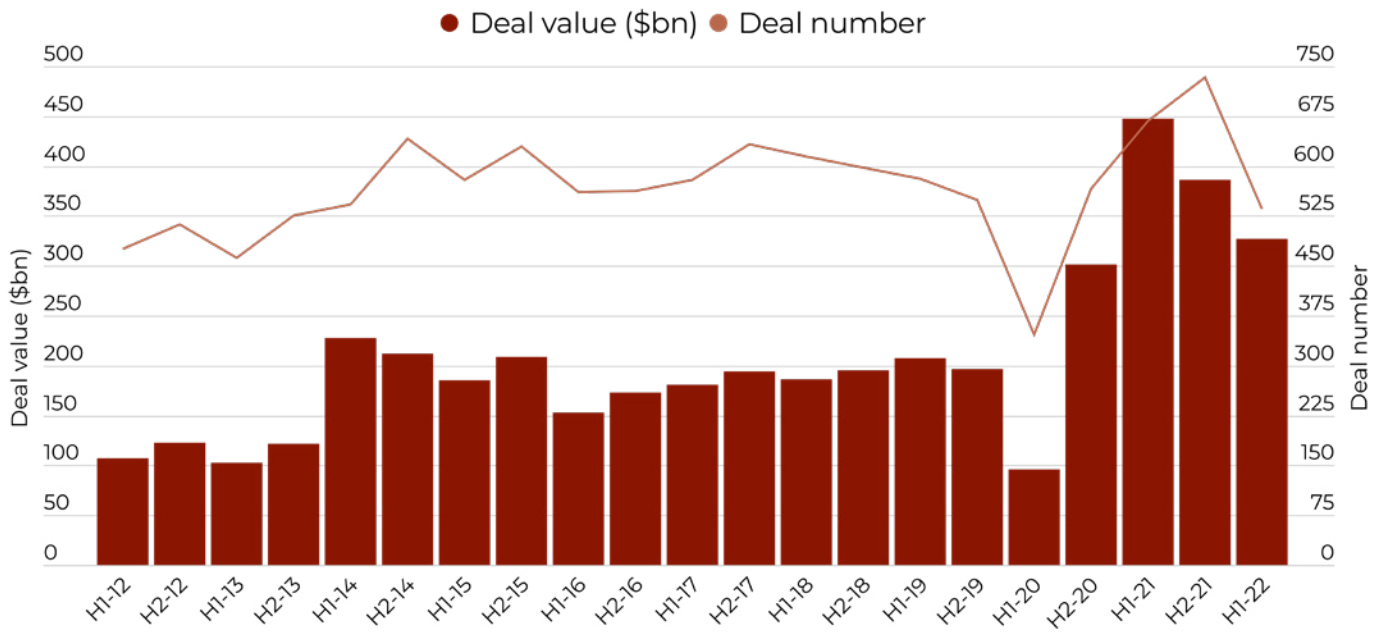
"As a private equity house, in today's markets we are only considering IPOs when we are dealing with a sector which has proven to be somehow less linked to volatility with resilient business models and profitable growth, while incorporating ESG (environmental, social and governance) issues as part of their core corporate values - One which has been found to be watertight; bulletproof.

"Technology and energy, especially energy transition, are two examples. If I were to IPO a company in such sectors, I can still consider a stock exchange listing as valuable, given the appetite we still observe in these sectors. A listing in such sectors wouldn't see the devaluation of my assets."

However, a partner ina major UK private equity firm believes some tech companies in haste to float might struggle in 2022: "It [the stalling of the IPO market] is going to be a bigger issue in the tech space, for companies that just have to IPO because they need the money and might be still burning cash."

In using the M&A market, an exit may be constrained by the amount of debt financing available to prospective buyers. This situation may favour strategic buyers – large companies with deep pockets that can still raise money at attractive spreads.

Figure 3.2: Global private equity exits



Source: Dealogic

Good buyers

For Justin DeAngelis, co-head of sustainable infrastructure at investment firm Denham Capital, financial or strategic exit routes have always been more suitable.

"Large - $10, $15 billion - infrastructure funds have to deploy a significant amount of capital which is what makes them good buyers for the businesses we build. There are also many strategic players who are looking to deploy capital and grow their sustainable infrastructure footprint. We have interest from both types of buyers all over the world."

Commenting on the firm's exit plans in general terms, DeAngelis says Denham has some mature portfolio companies which are ripe for sale: "We are a buyer and a seller. We continue to build up the value of our infrastructure businesses block by block. We have an exit plan for each one of those portfolio companies and I am always open to selling as well as buying and putting more capital to work."

He believes there is definitely an exit opportunity in the market right now but envisages the most attractive routes to be through private transactions.

"A high percentage of our business sales are done through private deals – corporate, strategic or financial investors. We don't have explicit preferences in terms of the type of buyer as that largely depends on where they are and when they need to put capital to work."

Belletti underscores the current appeal of private transactions: "The private market exit is the one I would consider most compelling for my strategy, given the large amount of liquidity available. Notwithstanding

HOW TO OUTPERFORM...

While private equity still outperforms public markets, the level of median outperformance compared to the public markets may be narrowing.

In a research paper last year, Michael Cembalest, chairman of market and investment strategy at J.P. Morgan Asset Management, claimed that since 2009 the median annual outperformance of private equity buyout funds has been "bouncing around on a median and average basis from 1 to 5 percent."

This range is down from around 15% in outperformance 20 years ago, he found, which shows that private equity returns peaked in the early 1990s.

Also, since 2009, he found that a second indicator of financial performance – median multiples of invested capital (MOIC) – have been declining as IRRs keep rising. The primary reason, he said, was the increased use of subscription credit lines, which allow managers to finance investments with bank loans and delay capital calls to LPs until later in the investment period.

Of course, an overall median performance only shows the midpoint of returns, which means that some funds still outperform, just as some public equities do better than the indexes.

In 2020, consultant Bain put these outperforming private funds in four distinct categories: sector specialists; firms with a focused hunting ground; differentiated playbook funds; and scale managers with broad expertise exploiting the complexity premium.

Looking at the top 10 firms in the 2021 HEC Paris-Dow Jones Private Equity Performance Ranking, more than half have a focus on technology and software. According Professor Oliver Gottschalg of HEC Paris, the share of software, IT and healthcare funds in the top quartile was 4% between 2002-2016, growing to 50% by 2016 but the most important factor in predicting their outperformance was not the sector, but the GP itself.

Noell at Providence expects to see a wider dispersal of returns as well as more sector diversification among fund managers.

"The next five years will be much more about who's making really smart investments with good management teams and helping those businesses grow and bringing their operational expertise to bear, as opposed to a class of private equity firms having the top returns by virtue solely of the sector in which they're investing."

inflation or the increase of raw materials, private markets are still a worthy exit route for all sectors."

With M&A deal volume down in H1, a report by PWC claims: "The near-term investing climate is likely to be a test for this generation of private equity firms, most of which saw their fortunes increase in the last decade. Performance could start to diverge as the cost of debt rises and exits are more difficult."

In the view of DeAngelis, the tipping point could be a realisation that within some recent market "seller-friendly deals, valuations were too high and getting the expected returns might be a stretch."

However, he, and other industry experts, expect activity to pick up given the high levels of dry powder.

"There is still tremendous amount of capital pouring into the space, chasing sustainable infrastructure. So, I still see some frothy transactions getting done. It will be interesting to see how an increase in rates and inflation will affect the overall market though."

Belletti concludes: "Private equity has been proven to be one of the most resilient industries through decades. Operating in the private markets means we set the value so there is no concern about the exit strategy for our portfolio companies. There will always be appetite for good companies in strong sectors." ■

Key Takeaway

For GPs: 2022 is shaping up to be one of the worst years in recent memory for IPO exits, following record levels last year. Some sectors and assets may still work well for IPO in H2 but GPs may opt to accelerate private sales to strategic buyers with deep pockets that can still raise money in a down market.

SECTION 4

LPS THINK LONG-TERM ON PERFORMANCE

Though benchmark returns may be slowing after two years of record returns, limited partners still favour the asset class over public markets

While nearly 50% of firms surveyed in the latest Private Equity Wire survey believe that returns in PE will decrease, LPs haven't been put off the asset class and still believe that private equity will deliver good returns.

"I think that this is just a burgeoning asset class that will continue to grow. When you're invested in your [fund] vehicle, you're probably not sweating quarterly marks as much but if you've got more of a liquid portfolio, which may be far more driven by public markets, then you're concerned," says Simon Finn at Intriva Capital.

According to MidOcean managing director, Daniel Penn, LPs generally expect returns to be moderate in 2022 versus 2021 but are bullish on the private equity asset class long-term.

Investment manager Neuberger Berman believes institutional investors overwhelmingly want to maintain or increase their exposure to private markets. However, investors are being impacted by slower exits and rapid declines in public markets, which can cause big shifts in their asset allocation mix. Investors aren't lacking conviction in private markets but may be lacking capacity.

UK pension pool, Border to Coast, remains confident in its PE exposures and expects to continue deploying in the asset class.

"We continue to believe high quality private equity managers have levers they can pull up from an operational improvement perspective to continue to drive value. We remain confident in the long-term outlook," says portfolio manager, Christian Dobson.

Sophisticated enough

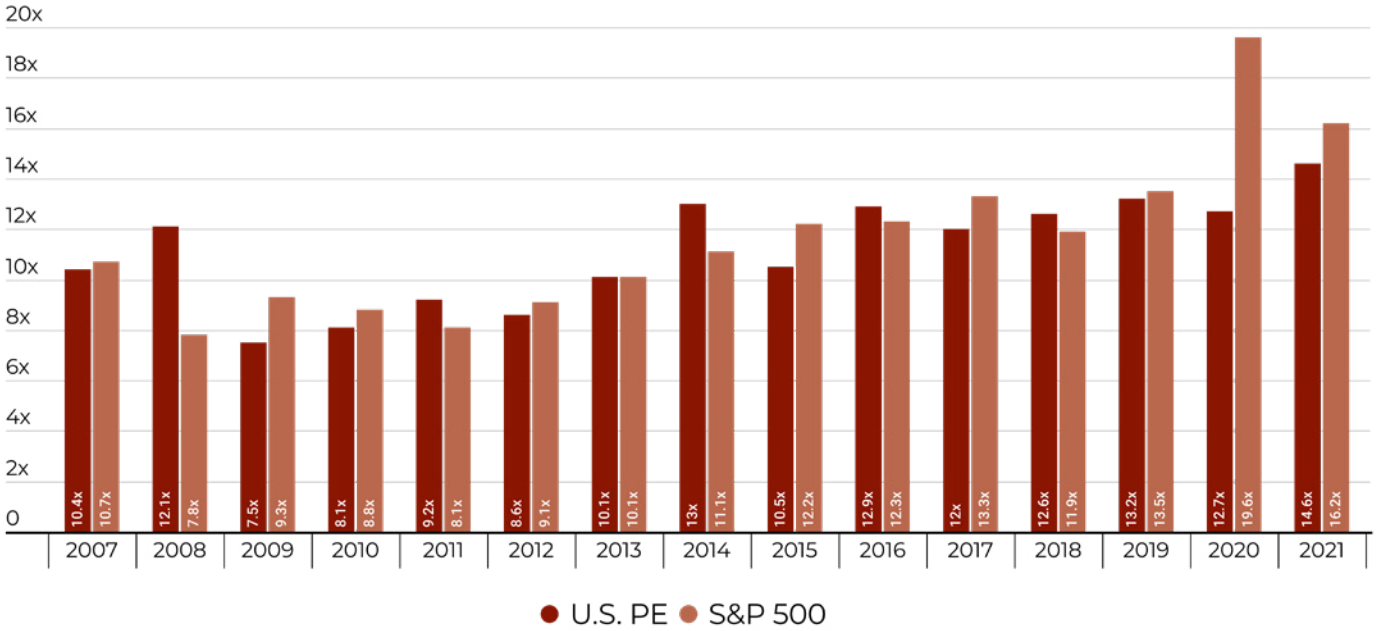
While some fund returns may have dropped, LPs continue to see the value of a long-term approach to private equity investing.

"I suspect that private equity returns won't be as strong over the next few years, particularly compared to performance last year. Last year, 2021, was a banner year for most firms, particularly from an exit perspective, so it would be hard for returns to continue at that level. But we do still expect private equity returns to be favourable versus public market equivalents, mostly driven by the illiquidity premium," Dobson says.

The majority of LPs are sophisticated enough to look through economic cycles but investment consultants have been educating their clients to view the asset class as part of a long-term approach, especially after the panic engendered by the last financial crisis in 2008.

According to such consultants, seasoned

Figure 4.1: US private equity valuations versus S&P 500 valuations, 2007–2021



Analyst note: Charts covers year-end EV-to-EBITDA multiples

Source: Bloomberg, Pitchbook, as of 9 May 2022

investors won't be panicking about a potential slow-down, but more recent entrants to the asset class may worry.

Some LPs are becoming increasingly concerned about the denominator effect after two strong years of allocations and returns which will leave certain LPs overweight in private equity until public markets recover.

"LPs typically have a range of allocation per asset class. Due to the denominator effect, they're not so keen on PE now, even if on paper, it performs better than other assets. They tend to reduce when things go well, and vice versa," says one GP.

Some of the more astute LPs also recognise that recession year fund vintages – if 2022 or 2023 prove to be recessionary – have historically offered outsized returns.

"I believe most investors have understood by now that vintage diversification is really important," says Nils Rode at Schroders Capital. "You see in our analysis that recession years tend to be very good vintages. Most investors know that. The question is, can they convince everybody around them? And might they run into some hard limits and a denominator effect that makes it more difficult for them to continue. Performance is not the main concern from investors from what I observe currently, it's more about the denominator effect."

Secondary solution

One solution to the denominator could involve selling assets or fund stakes on the secondary market.

"LPs have gotten much better at using the secondary sale as a portfolio management tool. That's one reason why the secondary market has grown so much," says Brad Young, global CIO, private markets, Mercer.

It's clear that LPs are being more careful and retaining an element of caution as we enter Q3 and Q4.

"I think the uncertainty of how valuations are going to shake out on the private side has led a lot of LPs to slow down and reassess where they want to be. Many of them have gone heavily into

technology private equity investing; they want to reallocate that to some other parts of private equity," says a partner at a large US-based private equity fund.

"We've seen a number of LPs hit the pause button in terms of additional allocations. They want to see how things will play out throughout the remainder of the year," adds a partner at a mid-market private equity fund.

Manager selection will also prove key in the upcoming months, with LPs looking to reallocate to the best GPs they have relationships with.

"One of the biggest challenges LPs are going to go through is how to choose the best managers. There are a lot of good managers who performed well and they will probably run into some challenges since they're not going to make the roster with every LP," notes Young.

"When it comes to manager selection, it's important to set the bar high – we know that there are managers that can find the best businesses regardless of the market cycle," observes Joshua Beers, principal, head of private equity investments at NEPC.

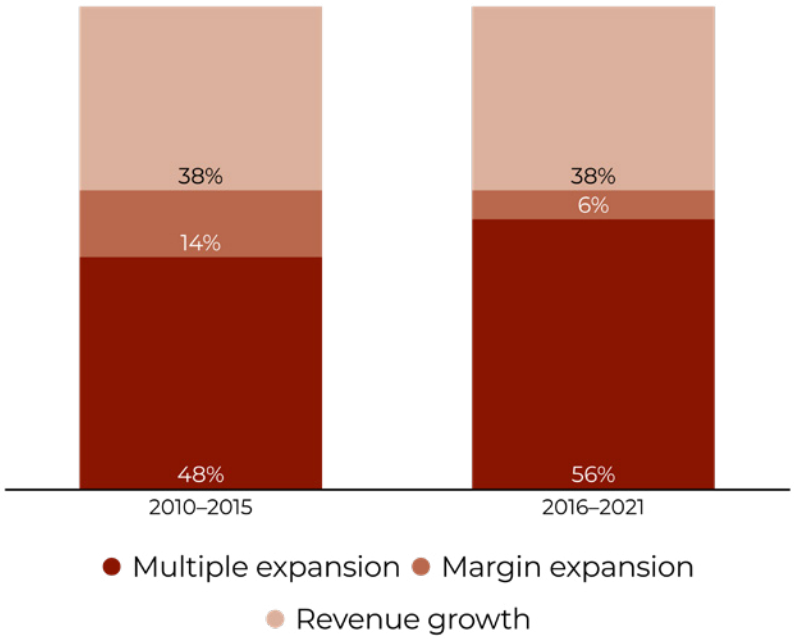
"There will be parts of this market that will suffer, resulting in poor returns. We've lived through these market cycles before, and we understand the importance of backing the very best, those with experience and resilience, as those managers are often the ones that produce stronger risk-adjusted returns," he says.

Commitment issues

LPs are also seeking more commitment and stability from their GPs so they can plan ahead and make more informed decisions with their allocations.

"A more recent trend I've seen is investors asking fund managers who are currently fundraising what their plans are for future fundraising for the next one to three years. Some fund managers have found it helpful to give their investors a sense of their investment plans and pace and when they should expect to see them back in the market again. That's been helpful, both for investors

Figure 4.2: Private equity returns – value bridge



Source: CEPRES Market Intelligence

Figure 4.3: Common words used to describe the biggest threat to returns currently

Analyst note: Respondents were asked, 'What is the biggest threat/challenge to the performance of your private equity portfolio currently?'

Source: Private Equity Wire survey, July 2022

who are trying to manage allocations of capital during this flurry of fundraising, and also helpful from the fund manager's perspective and getting investors to focus on the current fundraising they're doing," notes Kerry Shriver, partner at law firm Proskauer.

The latest Coller Capital Global Private Equity Barometer reported that private equity portfolios outperformed public equity portfolios since the financial crisis according to limited partners. The majority, 70%, of LPs stated as such, confirming that PE will continue to be a sought-after asset class for among them.

The strategies expected to perform particularly well in the coming months include distressed strategies, credit and infrastructure.

"In a more volatile and challenging market, we look to special situation strategies, such as distressed for control and operational turnaround focused strategies – they should have opportunities to do well," notes Dobson.

The Private Equity Wire survey supports this, with over 20% of respondents stating that they expect to see strong returns from special and turnaround strategies. Other strategies which are proving favourable include growth equity (23.1%) and buy-out strategies (30.8%).

"I see an interesting opportunity in private credit as banks have retrenched. Private credit strategies are typically linked to the base rates. As they have a margin on a base rate, their total rate of return increases as rates are ticking up," observes Joana Rocha Scaff, head of Europe private equity at Neuberger Berman.

"Infrastructure is also quite interesting because generally you're investing in essential, long-duration assets. They often have barriers to entry which make their cash flow relatively predictable and stable, and generally also have an element of inflation protection, which is quite important in this environment," she adds. ■

Key Takeaway

For GPs: Sophisticated investors in the asset class are unlikely to be deterred by quarter-to-quarter drops in benchmark returns. Rather, the issue facing many in the current market is the denominator effect, with some now overweight to private equity. This could trigger LP secondary sales and push large fundraising processes further into 2023.

CONTRIBUTORS:

Colin Leopold
Head of Research & Insight
colin.leopold@globalfundmedia.com

Fiona McNally
Reporter
fiona.mcnally@globalfundmedia.com

Angele Paris
Head of Partner Projects
angele.paris@globalfundmedia.com

Scott Newman
Art Director
scott.newman@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Jack Hassall
Senior Commercial Director
jack.hassall@globalfundmedia.com

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