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HOW MIGHT PRIVATE EQUITY PERFORM IN A PROLONGED PUBLIC EQUITY MARKET DOWNTURN?

Q3 2022



Private Equity has had a remarkably strong run over the past 40 years. 2021 was a record year for the industry, both in terms of new capital raised and the public offerings of PE backed companies. There is - as yet - no hard evidence that ongoing performance is about to reverse but clearly headwinds are building. In this article the Sarasin Bread Street team consider these headwinds in the context of the development of the asset class since the 1980s.

A TOUGHER ENVIRONMENT TO GENERATE EQUITY RETURNS

The strength in Private equity returns in recent years has been helped by the technology sector. Once the graveyard of many investments, and which many of us learned the hard way in 1999/2000, since 2010 it has been the sector that has delivered the best returns, both in public and private markets. The outlook for the sector seems to be changing though as the world rapidly adjusts to its post lockdown reality of rising interest rates and absorbs the implications of a likely long drawn out Russo-Ukrainian war. The listed markets have reflected this tech malaise and 2022 year to date has seen a 21.8% decline in the NASDAQ and steeper decline of -40.2% in the NYSE FANG+ vs. -13.7% in the S&P 500)¹.

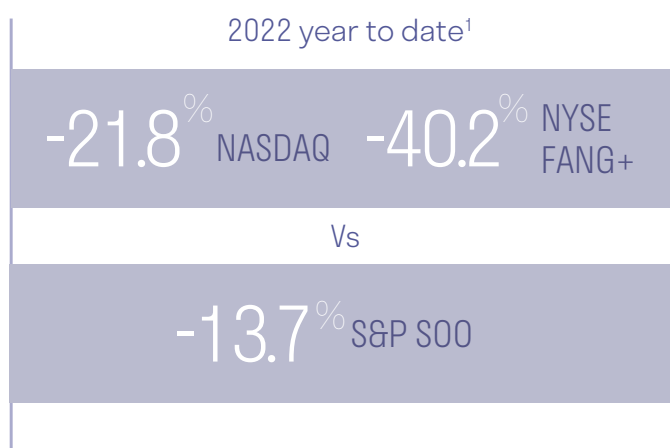
In periods of economic uncertainty and market volatility, private equity, with its long term committed capital funding model, is ideally placed to take advantage of investment opportunities



More broadly, global economies are now facing supply shortages of everything from fertiliser to automotive chipsets, rising energy and food prices and inflationary increases across all sectors. This points to a much tougher environment in which to generate equity returns: whether a company is in private hands does not make it immune to economic forces.

To understand how PE might perform in the future, it is helpful to review the past: looking back to its modern beginnings in 1977 (when KKR effectively pioneered the industry in North America and began its leveraged buy-out programmes), shows that since this time the industry has been through **three significant cycles of private equity underperformance**.

DETERIORATING OUTLOOK FOR TECHNOLOGY SECTOR



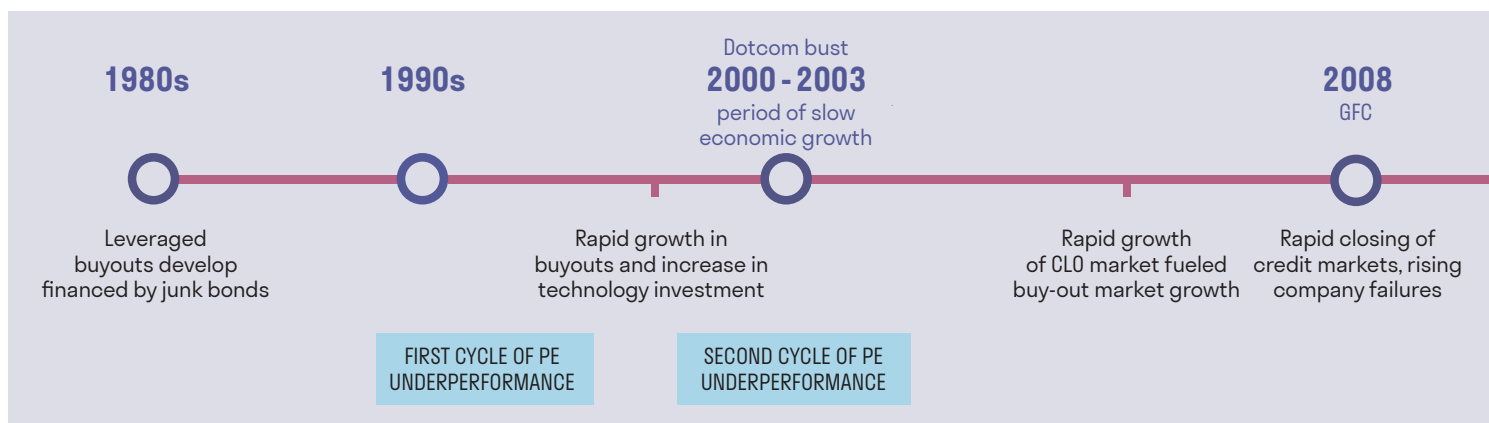
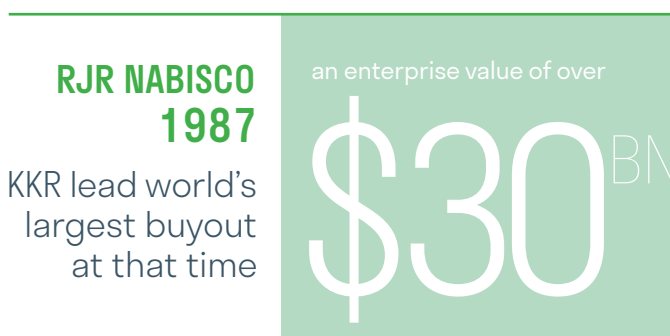
THE FIRST CYCLE OF PRIVATE EQUITY UNDERPERFORMANCE

KKR case study

KKR is as good a case study as any to consider this historical context. Since its founding by three entrepreneurial former investment bankers who left Bear Stearns to pioneer a new firm, KKR expanded rapidly, cumulating in leading the world's largest buyout at that time in 1987, RJR Nabisco. This had an enterprise value of over \$30bn, with much of that EV funded by debt sourced from the savings and loan industry and junk bonds promoted by Michael Milken, who ran the corporate debt desk at Drexel Burnham Lambert. Subsequent securities violations, the Drexel bankruptcy and a downturn in the economy at the end of the 1980's led to the end of this bonanza in leveraged loan funding and caused a recessionary period for the buyout industry between 1991 and 1995, **the first significant cycle of underperformance**.

KKR returned to prominence in 1996 with a new \$6bn buy-out fund. In the interim the firm had taken a hard look at its systems and procedures and developed a focus on systematic thorough analysis of the businesses it was targeting, leading to a formula for operational improvement

in the companies that they acquired, rather than relying on leverage alone for returns. This new approach was successful and was adopted by rival firms, and is now ubiquitous across the buyout sector. It is these operational levers, implemented by highly capable practitioners who repeatedly perform hands-on operational roles in underlying portfolio companies, together with rapid implementation, that gives experienced private equity investors their confidence in the asset class.



THE SECOND AND THIRD CYCLES OF PRIVATE EQUITY UNDERPERFORMANCE

Dotcom bust and the GFC

Following the slowdown of the early 1990s, the buyout industry subsequently went on to expand beyond its previous peaks. By the late 1990s buyouts had grown alongside the rapid increase in technology investment, based on the new area of internet-led e-commerce and dotcom mania. The euphoria developed too fast and led to a significant correction in the valuation of TMT companies that ended that cycle of private equity growth. The three years which followed were **the second significant cycle of underperformance**.

Following this 2000 to 2003 period of slower economic growth, a gradual recovery in PE activity was led by attractive asset pricing and availability of cheaper debt. However, the old thorns of excess leverage and inflated asset prices began to emerge again in 2005-2008 which immediately preceded the global financial and banking crisis ('GFC'). The GFC marked the end of another cycle of private equity growth and brought with it a rapid closing of credit markets and rising company failures and led to a 'PE winter' during 2009 and 2010 with a dramatic slowdown in PE deal activity (and hence capital calls and distributions) and fund raising. This was **the third and most recent significant cycle of underperformance**.

To try and create some form of stability, central banks stepped in with comprehensive stimulus policies, led by quantitative easing and flooding the markets with liquidity. A gradual thawing of the world economies began in 2011 and the limited supply of risk capital began a renewed period of transaction flow helped by the return of the high yield bond market and re-emergence of new collateralised loan offerings (the CLO markets) providing the debt to the growing deal flow. Deal prices crept up again and the old chestnut of excess capital chasing deal flow was back. By 2014/15 the environment was becoming more attractive to sell existing investments than to make new ones. The continuation of central bank policies to ease credit markets and create liquidity continued all the way to the beginnings of the global health pandemic in the winter of 2019.

Interest rates remained at levels that had not been seen in living memory and the supply of low-cost debt proliferated. Central banks responded to the pandemic as they had after 2008 by continuing the policy of flooding the markets with cheap liquidity and interest rates fell to record lows. By 2021 the global M&A market had boomed to over \$5 trillion² fuelled by cheap debt in an era of rock bottom interest rates. Whilst this policy steered the economy through the pandemic, measures of global self-isolation enacted by governments around the world between 2020-2021, sowed the seeds of the current headwinds which have now become prominent and are growing stronger.

This leads to the recurring question: how will the PE industry cope with what could be the end of a decade long growth cycle for PE?

Declining stock market values led by reducing price earnings multiples will translate to a reduction in the valuation of many private equity backed companies. Private equity firms generally use a 'valuation football field' to establishing a corporate valuation i.e. essentially a spread of techniques that create a valuation consensus. Different weight is applied to different techniques, dependent on the nature of the underlying business, but for most companies a 'market comp P/E ratio' is a key valuation driver. If listed companies' P/E ratios decline during a period of listed market compression this will lead to many lower private company valuations albeit, based on the evidence of past market downturns, these tend to lag and be slightly dampened compared to public markets.

Based on the evidence of past market downturns, Private Equity valuations tend to lag and be slightly dampened compared to public markets.

2009-2010



'PE winter', a dramatic slowdown in PE deal activity

2011



Return of the high yield bond market and growth of CLOs

2014/15-2019



Low global interest rates, rapid expansion of growth funds as companies stay private for longer

2020-2022

rising inflation and interests rates



Economic downturn post-pandemic

THIRD CYCLE OF PE UNDERPERFORMANCE

LONGER HOLD PERIODS AND AMEND AND EXTENSION OF LOANS

But this in itself is unlikely to lead to an increase in company failures. Businesses generally only fail when they run out of liquidity, which is effectively cash and credit to meet their liabilities when they fall due. Declining revenues and profits might be a symptom of failure, but are not the cause. Valuations will decline, but a valuation is only a measure of what a company is worth at a point in time and is most likely not what it will be realised for, unless the owner is a forced seller. Private equity managers will not sell (and indeed don't have to sell) until the price is right to generate the targeted required return, and unless the company faces a liquidity crisis that they cannot refinance, they will continue to hold. This will lower the potential for an acceptable IRR when the exit does eventually come but likely doesn't lead to a lost investment. The banking system supported this strategy following the 2008 financial crisis and regularly consented to amend and extend the terms of debt packages rather than force a default and risk the return of the loan principal.

Approximately half the capital structure of a typical buyout investment comprises debt but the majority of current debt packages do not contain covenants which stipulate protective rules that must be followed and should the borrower be in breach, the loan falls into default which gives the lender a potential right to control the business. Such loans are known as "cov-lite" to use the jargon and this system operates for a reason. It is not in the interests of the employment markets and economic stability as a whole for the banking community to place a company into default because it has failed a covenant test. It is also not healthy for a bank to have a balance sheet of loans that are in interest default. Central banks have been very aware of these problems and have therefore supported a light touch on the corporate loan market.

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COV-LITE

ADVANTAGES OF PRIVATE EQUITY MODEL IN CHALLENGING TIMES

This has all worked well in a period of low inflation, but now inflation is coming back strongly for the first time in 35 years and the waters are beginning to become increasingly uncharted. Central banks have begun to apply a policy of rapidly rising interest rates in an attempt to slow the rate of inflation. This is pointing to the present risk of a low growth but high inflation economy, leading to poor investment returns on all asset classes and economic hardship for those with low savings and wages that are not able to keep up with inflation. This may be the period we have now entered.

Against such a backdrop private equity backed companies are unlikely to fail en-masse (though some undoubtedly will) but neither will they be exited at valuations needed to generate the required mid-teens IRR and two times cost money multiple that investors have become accustomed to. Valuations will come down but provided the business can cover its cost base, the company will likely survive. And this is where the advantages of the PE model can come into play. The ability of company management, with the support of the PE owner, to take rapid operational and strategic action, unencumbered by the constraints and time pressures of public governance and investor reporting, and the cash drain of equity buybacks and dividends, greatly assists businesses to thrive (or frankly, just survive in very difficult times).

In 2013 when Michael Dell took his eponymously named computer business private he was quoted as saying "I couldn't be more thrilled to have control over my own destiny in a way that is not possible as a public company". At that time Dell was expecting its annual PC shipments to drop 9%, it wasn't in the smart phone market and recent acquisitions were not developing as expected. Dell took on c\$18bn of debt to take itself private and fund an ambitious plan to get itself out of the mire – but the debt service cost was considerably lower than the outflow of cash had been from dividends and buybacks in the public realm. Forbes magazine³ subsequently noted "As a private company, unshackled by Wall Street's 90-day attention span, Dell has boiled the priorities down to just two metrics: cash flow and growth". Dell himself told Forbes that this had been "incredibly clarifying".

Prior to joining Sarasin, we directly invested in the Dell 'take private' transaction⁴ and saw at first-hand how a relentless focus on cash flow and execution of a clear growth plan turned a business around in a way that had it still been public would have been much harder to achieve. Not all take

private and buyout scenarios will map out this way, but past experience gives us confidence that privately-owned entities can still thrive in challenging times, and with the right financing, strong deal sponsors and smart incentivisation they can remain attractive investments. Indeed in periods of economic uncertainty and market volatility, private equity, with its long term committed capital funding model, is ideally placed to take advantage of investment opportunities.

Of course, exits will take longer to achieve, and a period of declining performance from private equity will result in new fund raisings becoming much more difficult and less capital flowing into the asset class, though this will eventually result in more attractive entry pricing for new investments. Over time this will lead to the desired returns on investment once again being reached when the next crop of acquired businesses are exited.

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This cycle will take time to run its course because the present stock of uninvested capital, or 'dry powder' available to be invested into the market, is still significant. For investors looking to invest into PE for the first time, this points to being highly selective and only investing with proven quality PE managers and being relatively cautious about the speed of committing fresh capital to new funds. Notably, history shows that some of the best returns are made from funds raised in recessionary vintage years when entry pricing is under pressure and competition for new deals less fierce, creating the environment for these investments to be sold when capital markets become more buoyant again.

Sarasin Bread Street
August 2022

Editors' notes: This discussion piece focuses on buyout, the largest of the three principle PE strategies. The other two - growth and venture capital - have their own outlook profiles though share much of the current market sentiment with buyout.

1. www.marketwatch.com. as at 23.08.22, price only, in USD
2. 'Reuters 31.12.21, "Global M&A volumes hit record high in 2021" quoting Dealogic data
3. 'Forbes, 30.10.2013
4. Co-investment for Aberdeen Private Equity Fund Ltd, an LSE listed investment company

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