An Outlook for the Private Equity Industry

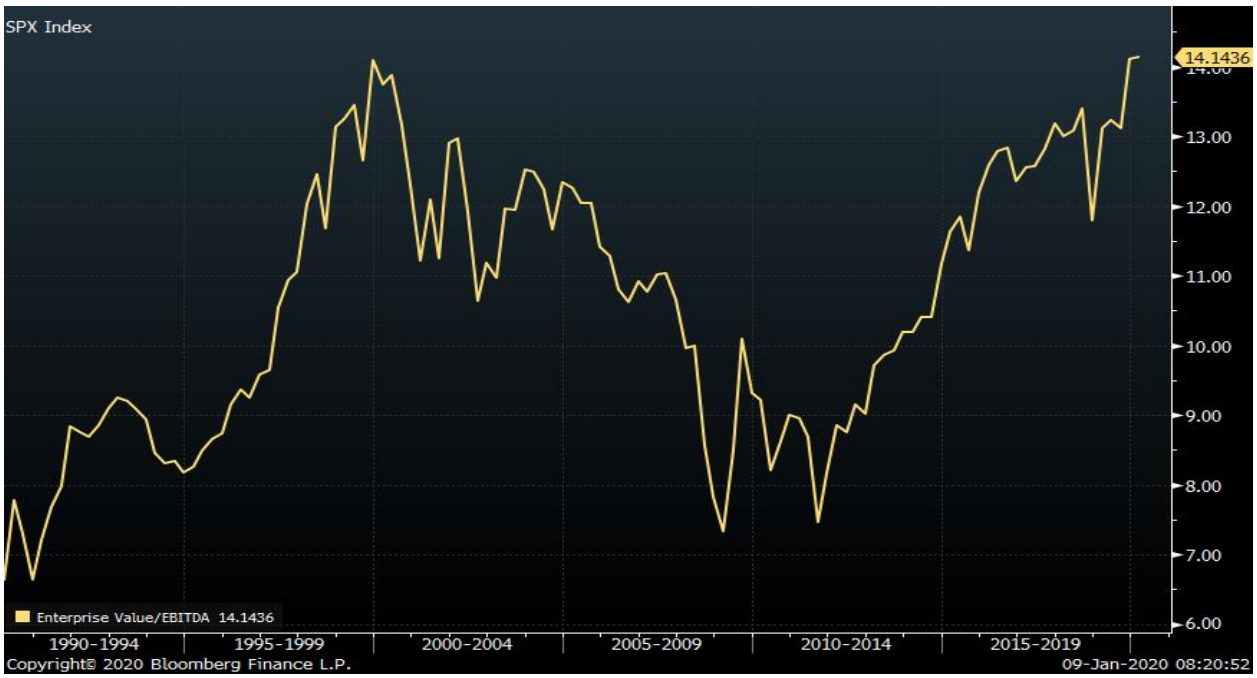
Introduction

Today, private equity funds are facing a major challenge. General partners can no longer rely on multiple expansion and leverage to boost fund returns. As interest rates are being hiked to combat surging inflation, debt is harder to assume, and valuations are coming down across the board. Previously, investors benefited from a low interest rate environment leading to higher multiples, which considerably enhanced returns on leveraged buyouts. Such performance brought higher capital allocations by institutional clients, fund of funds, and high net worth individuals. However, given the present conditions, will private equity be able to provide attractive returns and draw in further investor capital in the future?

Why did Private Equity perform well in the past?

In the past two decades, private equity funds outperformed compared to public markets. According to a 2022 World Economic Forum study, over the last 10-year period, private equity funds generated an annualized return of 14.8%, outperforming the S&P 500 by 0.6%. Over the past 20 years, private equity resulted in 11.2% annualized return, whereas the S&P 500 only returned 6.8%. Although this outperformance suggests that private markets are resilient and that they can mitigate cyclical risk in crisis times, their leverage makes them vulnerable to high losses in a downturn. There are multiple examples for deals going bad during the financial crisis. Despite these losses in the financial crisis, total assets in private markets rose to $10tn in 2021 according to Preqin, five times larger than in 2007. This boom underlines the growing will in the past decade of institutional investors such as pension funds or insurance companies, fund of funds, and high net worth individuals to invest in private equity. As yields on conventional investments such as bonds were decreasing with low interest rates, investors were attracted by private equity's strong performance through less volatile, long-term investments with higher return potentials. In a buyout transaction, the objective of private equity funds is to take a majority ownership of a company and drive change together with management to create value over a 3-5 year-period. The three main drivers of value creation are multiple expansion, operational change, and leverage.

To value companies, private equity funds attribute multiples to their targets. The most popular multiples are EV/EBITDA and EV/EBIT, depending on whether the company is in a capital-intensive or capital-light industry, as it determines the overall significance of depreciation and amortization. The P/E ratio is the most relevant when evaluating financial institutions. Over the past decade, there has been a substantial expansion of such multiples in public markets. Subsequently, private markets saw a similar increase as they are valued based on public company comparables and past transactions. The graph below reflects the EV /EBITDA multiple evolution of the S&P 500, where a significant increase can be observed starting in 2010. According to Statista, certain industries, such as information technology and industrials, saw their EV/EBITDA multiple double from 2014 to 2021. Amongst the reasons for this are that growth stocks were valued highly in a low interest rate environment, and that industries with a lot of deal activity saw their multiples bid up in competitive acquisitions.



(Source: BNN Bloomberg)

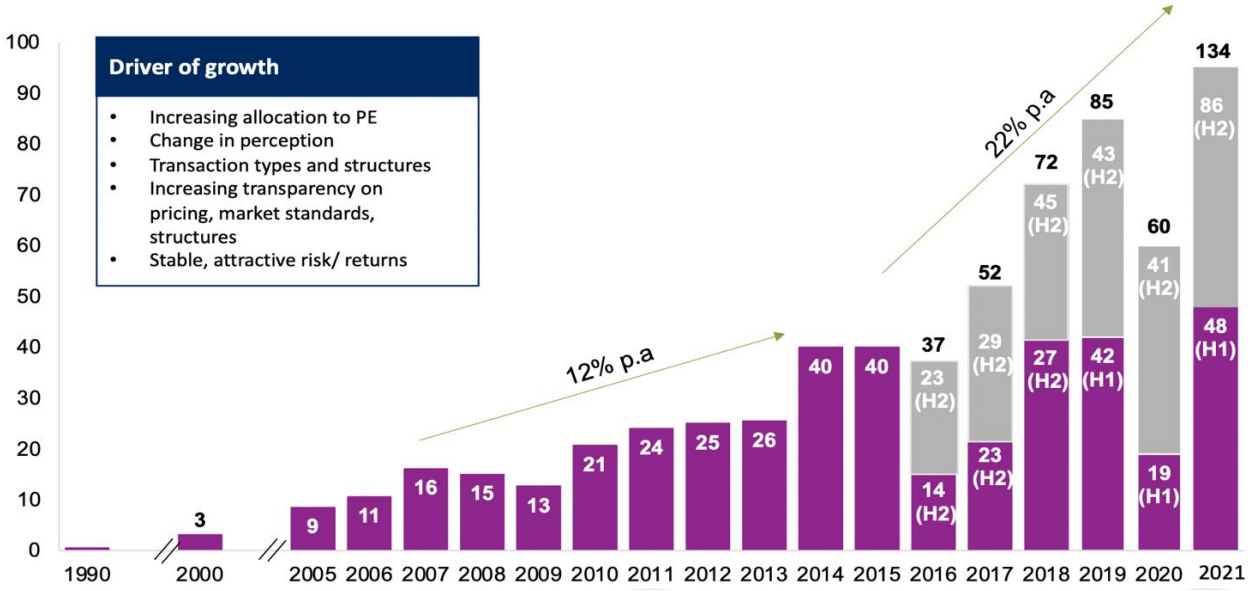
The multiple expansion was highly beneficial for investors as they could exit their portfolio companies at higher multiples than acquired 3-5 years prior, ensuring stronger returns. Moreover, this 10-year increase tempted buyers to believe this trend will prevail and persuaded them to enter deals at higher multiples, especially in industries with fierce competition. Hence, since 2010 the multiple expansion led to an aggregate increase in valuations, activity, and potential which contributes to the strong performance of private equity funds in the recent past.

An important distinction to make is the multiple expansion resulting from a general trend in public markets and from operational improvements. Alongside managers, private equity funds work to increase profitability and financial strength of their portfolio companies. By providing strategic and restructuring advisory, funds can boost revenues and improve EBITDA margins resulting in greater valuations. In addition, effective repositioning, and size expansion, organically or through M&A transactions, commands greater multiples. For example, a company that differentiates its services and widens its geographical presence will tend to have considerably higher multiples than a smaller local competitor. Furthermore, certain strategies like buy and build deals imply strong premiums for buyers. This practice relies on acquiring a platform company to benefit from strategic synergies and scale into a larger group with higher multiples. As this acquisition will lead to a greater valuation of the merged company, investors are willing to pay higher prices for the platform companies and thus, contribute to the rising dynamic of multiple expansion. Therefore, when analyzing the past private equity performance, the behavior of public markets can't be the only factor to consider in the multiple expansion phenomenon, but also the funds' strategies and increasing expertise to guide managers in creating value for portfolio companies.

Leverage is a key component in the success of a private equity fund. Leveraged buyouts rely on debt to increase returns. A larger the debt-to-equity ratio accentuates any outcome for the firm: it can generate greater returns on equity at exit, but also emphasize losses. In addition, a high debt-to-equity ratio allows private equity funds to take over larger companies for the same amount of equity invested. It also contributes to funds' wider diversification as capital tickets can be deployed on more deals. However, debt is risky and implies interest payments. Therefore, general partners must be selective on their targets and ensure a strong cash flow generation to cover interest payments. Across the 2008-2021 period, interest rates were historically low which made borrowing cheaper, less

risky and encouraged funds to adopt a more aggressive strategy. As a result, deal flow and competition significantly rose. Companies could assume higher levels of debt, and LBO targets' growth opportunities became increasingly important compared to their cash flow generation. Furthermore, low interest rates' stimulating economic environment increased investors' desires for returns which added pressure to general partners, contributing to greater bids and emphasized the expansion of multiples. Thus, one can argue that low interest rates and cheap leverage in the past decade have the most significant contribution in private equity funds' strong performance. Funds took on more debt, directly boosting their returns and changing their strategy, but the higher deal flow and the confident economic outlook further contributed to the expansion of multiples.

The secondary market offers liquidity solutions to limited partners wishing to exit early from their commitment in a private equity fund to rebalance their portfolios. Private equity funds also transfer assets that they don't wish to part ways with to a secondaries fund. Key participants in the market are sellers motivated to divest and buyers such as pension funds, insurance companies and foundations attracted by risk-weighted returns and diversification. Prices in the secondary market are mostly affected by the underlying asset quality, vintage of funds, as returns are typically higher in later years, and the M&A and IPO environment. Therefore, as activity in private markets rose in the past decade, the secondary market also expanded. From 2005 to 2015, the secondary market grew by 12% p.a., and 22% p.a. from 2015 to 2021. The drivers of this strong expansion include higher capital allocations to private equity, attractive risk/return rates, increasing transparency on pricing and market standards.



(Source: Terzi & Partners)

In 2021, the secondary market reached its peak with a $134bn transaction volume, resulting in a 120% increase with respect to 2000 and 50% to 2019. Secondary transactions accounted for the largest source of exits in 2021 and strongly highlights their upward trend across the past decade. Thus, the secondary market adds onto the higher prices private equity funds could charge when selling assets and contributed to their strong performance in the recent past.

Will These Drivers of Success Exist in the Future?

Over the last ten years, we witnessed significant multiple expansion. This considerable growth has benefited private equity firms, as high exit multiples led to high returns on their investments. However, due to the rising inflation,

central banks are raising interest rates, in an effort to cool it down. If inflation, however, persists, we will witness multiples contraction rather than expansion. In fact, interest rates negatively affect a company's enterprise and equity values. High interest rates result in a higher risk-free rate and a higher cost of debt. These are directly linked to the weighted average cost of capital used to discount a company's unlevered cash flows and terminal value to get a company's enterprise value. Therefore, the higher the WACC, the lower the enterprise value.

High interest rates will also negatively affect leverage, which is essential to private equity acquisitions. The classical leveraged buyout is primarily financed by debt and only partially by equity. The cost of equity is usually higher than the cost of debt and therefore, through leverage, private equity firms can achieve higher returns. As mentioned above, the higher the interest rates, the higher the cost of debt. As a result, deal financing becomes more expensive and difficult as companies need larger cash flows to pay the interest on the debt. If private equity firms decide to finance a larger part of the acquisition through equity, they are likely to achieve lower returns due to equity being more expensive than debt.

Another essential element that contributed to the success of private equity firms over the past ten years is secondary transactions, which refer to transactions involving the sale of a portfolio company to another private equity firm or to another vehicle of the same PE firm. Traditional PE funds can only hold their best assets for a short time period, usually five years. By selling the portfolio company to themselves they can keep receiving the value generated by the investment. Often these secondary funds do not have a time restriction meaning that they can hold the investment as long as they want. Although secondary buyouts look appealing from the PE firm perspective, investors are starting to express their concerns. Mikkel Svenstrup, chief investment officer at ATP, Denmark's largest pension fund, compared the private equity industry to a pyramid scheme. He stated that last year "more than 80 per cent of the sales of portfolio companies by the private equity funds that ATP has invested in were either to another buyout group or were 'continuation fund' deals". Investors are worried that this scheme might lead to potentially lower returns and higher costs and are starting to cut down the number of secondary buyouts they commit to. If people reduce their investments in secondary funds, an important source of exits for PE firms will disappear. Reduced exit opportunities might eventually result in less attractive returns.

The current macroeconomic environment is harming the asset management industry, and private equity is no exception. Besides the effects of high interest rates mentioned above, another factor threatening deal financing is the uncertainty of the market. Over the last years, banks have financed highly levered and aggressive deals because of the optimistic view on the global economy. However, they are now finding it difficult to syndicate this debt due to rising interest rates and the risk of a recession. Banks are, therefore, experiencing large losses on their levered loan books and are not inclined to lend additional money. As a result, financial institutions will carry out more rigid due diligence before entering a contract, and PE firms will experience higher competition to obtain a loan. The large amounts of dry powder private equity firms are sitting on will increase competition for deals, which is likely to drive down returns even more.

Will People Invest in Private Equity in the Future?

Pension funds are amongst private equity firms' primary investors. However, these institutions are unique as they have allocation limits for the different asset classes and can only invest a specific percentage of their total assets into private equity. As already mentioned, the macroeconomic environment has resulted in lower public market valuations. Because private markets have not been marked down as much as public ones, the percentage of pension funds' total assets in private equity has increased, making some funds exceed their private equity allocation limits. Such pension funds are not allowed invest additional capital in private equity. Another characteristic of pension funds is that their investments must reflect a good balance between risk and returns, and they also face several restrictions regarding how much risk they can undertake. The public market experiencing high bond yields might

result in pension funds investing less in PE for two main reasons. Firstly, when bond yields are high, private equity is less attractive because its excess returns relative to bonds go down. Furthermore, many pension funds undertake liability driven investing (LDI), meaning that they invest their assets in order to cover their pension obligations. In the past, when yields were low and returns on bonds were not high enough to cover the liabilities, they invested in private equity. However, with the current high yields the bond market, LDI pension funds may no longer need PE to fulfil their obligations. As a result, in the following months, there will be a greater opportunity cost of investing in private equity as the high risk-free rate of the market will lead to less attractive relative returns in PE. The pressure on asset allocation limits and the high risk-free rate should result in pension funds investing less in private equity in future. This might slow down PE firms' growth that have always heavily relied on the large amounts of capital these institutions supplied.

While pension funds are expected to lose some of their interest in private equity, a new class of investors is affirming itself: private individuals. Until recently, only ultra-high-net-worth (UHNW) individuals were able to invest in private equity, as the minimum investment was in the millions of dollars. Today, the minimum requirement is going down to hundreds of thousands of dollars and therefore also high-net-worth (HNW) individuals can participate in private equity investments. To incentivise these individuals, private equity firms are setting up funds directly targeting them, such as Blackstone's Private Wealth Solutions. Furthermore, several platforms have gained considerable attention over the last years syndicating investment in private equity funds. For example, the startup Moonfare has collected over €2bn from individual investors, and its minimum investment requirement is only €50,000.

Conclusion

In conclusion, over the last ten years, the low-interest rate environment favoured private equity and its growth. Deal financing was relatively cheap, and therefore funds were able to lever investments more, leading to higher returns. Returns were also spurred by the growth of valuation multiples that were positively affected by low interest rates and investors' confidence in the market. Investors were attracted by the high returns private equity delivered compared to other investments, such as bonds.

However, these trends are likely to reverse due to the current macroeconomic environment, making private equity investments less attractive. Although financial institutions, like pension funds, might reduce their investments in private equity, capital will still be available as private individuals are finally getting access to private equity funds. Several platforms targeting HNW investors are gaining a lot of attention and will supply PE firms with the capital needed to carry out new acquisitions. It is interesting to notice that only now that PE funds returns are expected to go down average people are given the possibility to invest in them.