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PRIVATE EQUITY MARKET

DIFFERENCES BETWEEN 2019 AND 2006-07

The current record level of "dry powder"[1] that has been accumulated by private equity (PE) managers has been capturing headlines in the financial press and drawing worrying comparisons to 2006-2007, when the industry deployed large amounts of capital at high asset valuations, underperforming historical returns. However, as a recent Harvard report confirms[2], PE-backed firms outperformed their non-PE-backed peers during that turbulent period, and a deeper look into what occurred then versus what is happening now reveals substantial differences that leave even less reason to be alarmed.

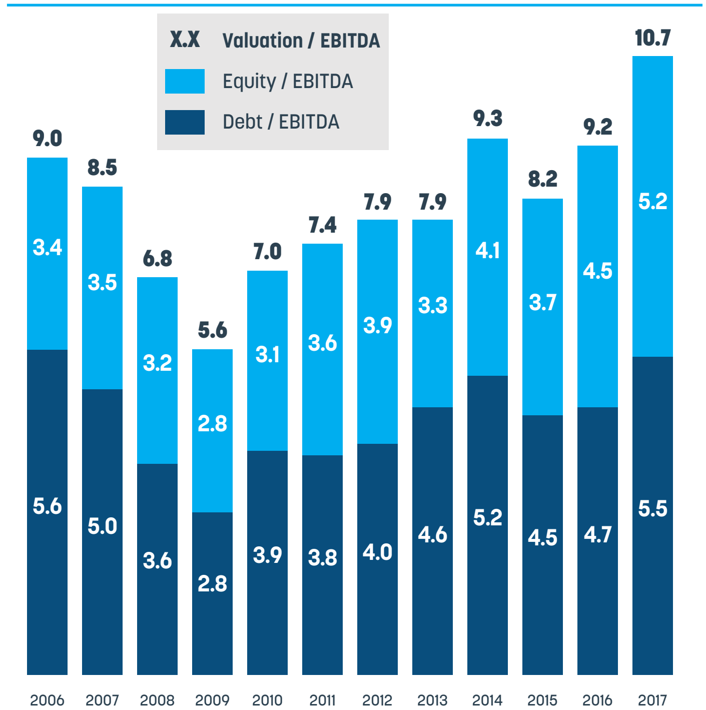
The financial media often points to the same two statistics when comparing today to the period preceding the great financial crisis (GFC). The first of these is the unprecedented amount of PE dry powder, which stood at $707 billion for buyouts and at $1.2 trillion overall (including growth equity, venture capital, and other PE) as of Q2 2018.[3] This represents an 18% increase from the end of 2017, which is in line with the annual growth trend seen in PE dry powder since 2012.[4] The steady increase in available capital has been driven by several record years of fundraising, a function of new investors being drawn to PE in today's low-yield, low-growth environment, as well as existing investors reinvesting their distribution income.

In fact, PE distributions have remained at historically high levels since 2013 while capital calls have fallen steadily to their lowest level on record.[5] This distribution pace has been driven by a highly attractive exit environment that has seen GPs shorten their portfolio company hold periods as they look to crystallize returns while the current "sellers' market" holds. Despite this, when viewed as a percentage of total global PE assets under management ("AUM"), dry powder has actually been running at a relatively low level of overall AUM (representing 34% in 2017) compared to the early-mid 2000s (when it ranged from 53% to 42%).[6]

Competition for the best deals remains high, with the potential risk that less-disciplined general partners (GPs) could be tempted to lower investment standards in response to limited partner (LP) pressure to keep up their investment pace. Unlike public market investors, GPs can't sit out for extended periods of time because they aren't paid to time the market and are expected to deploy capital throughout market cycles. The relatively easy availability of capital also could drive some GPs to raise ever-larger funds, at levels above their core competencies, potentially leading to style drift and dilution of returns.

The second oft-cited data point is the continued rise of PE deal multiples. Figure 1 shows that the median private equity earnings before interest, taxes, depreciation, and amortization (EBITDA) multiple reached a 10-year high of 10.7x in 2017.[7]

FIGURE 1:
GLOBAL MEDIAN PRIVATE EQUITY EBITDA MULTIPLES, 2006-17

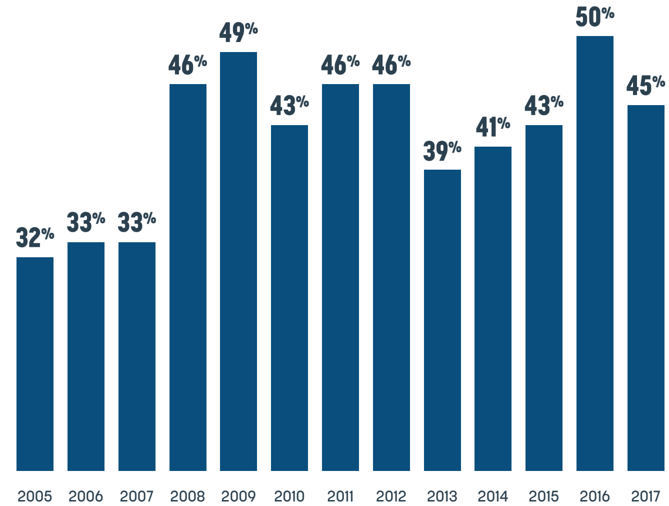


Source: PitchBook; The Rise and Rise of Private Markets; McKinsey Global Private Markets Review 2018.

One driver of this trend has been the elevated multiples in the public markets themselves, which PE managers look to for comparable valuations when valuing private companies. Another factor has been the record amount of fundraising referenced above. Growing competition for deals has been edging up the prices that GPs are willing to pay, particularly in competitive auctions to source deals. Another contributing factor has been the continued availability of low-cost debt, which has brought up leverage levels within deals in recent years. Access to cheap financing has also encouraged strategic investors to pursue acquisitions more aggressively, which has driven up multiples and increased competition with private equity.

However, even though leverage multiples have crept up, they do remain below prior levels. In 2007, more than 60% of all U.S. leveraged buyouts were levered at 6.0x or higher with an average 6.8x debt/EBITDA,[8] significantly above the 6.0x level specified by federal agencies in 2013 as meriting special concern.[9] In 2018, the average leverage multiple had come down to 6.2x.[10] Moreover, the ratio of debt to equity in PE-backed deals is far more conservative today than it was during 2006–2007 (as seen in Figure 2). Back then, the average percentage of equity that managers were committing to their deals reached a low point of 32%–33% — meaning they had less skin in the game and were using almost 70% debt or leverage to finance their deals.[11] This frothy period led many bankers at the time to parrot the ominous phrase "loan to own." Today, PE firms are putting up, on average, 45%–50% of equity into their deals, which is quite different from 2006–2007.

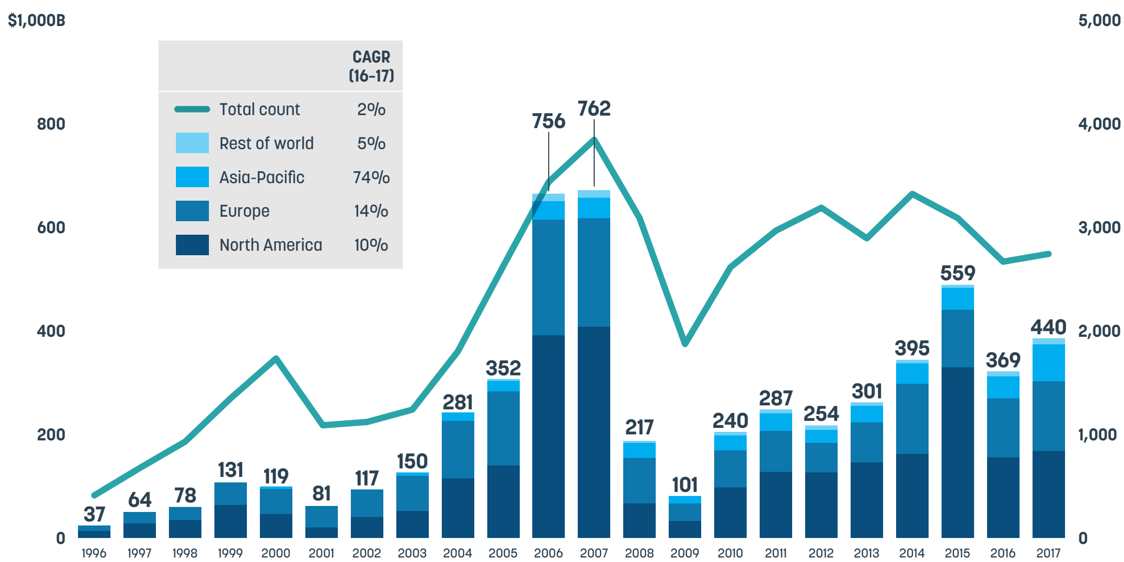
FIGURE 2:
AVERAGE EQUITY CONTRIBUTIONS TO BUYOUT DEALS



Source: PitchBook; The Rise and Rise of Private Markets; McKinsey Global Private Markets Review 2018.

There are several other key metrics that distinguish today from the 2006–2007 boom. The first is that overall private equity investment activity, in terms of both deal number and value, has been running at significantly lower levels than we saw in 2006 and 2007, as shown in figure 3. Private equity deal volume remains 42% lower in 2017 than at its peak in 2007, and discrete deal count has fallen by approximately 33% over the same time frame.[12]

FIGURE 3: **GLOBAL BUYOUT DEAL VALUE (INCLUDES ADD-ON DEALS) DEAL COUNT**



Source: Dealogic, Bain Private Equity Report 2018

Excluding add-ons, the value of PE deals has remained rather steady since 2014 while the number of deals has been trending lower, albeit with a slight uptick in 2017.[13] This indicates that volume has been supported by mega funds and their larger deal sizes while the broader private equity industry has been exercising caution in a high-multiple environment and moderating its investment pace.

Another way in which GPs have been exercising caution is often by underwriting their deals assuming longer hold periods, with some even factoring in the possibility of lower exit multiples in their models. Moreover, living through the GFC has made prudent GPs more thoughtful about their use of leverage. It also has renewed their focus on stress testing the performance of cyclical businesses during due diligence to better understand the potential effects of an economic recession. Many GPs have decided to either avoid such investments or to use less leverage on companies susceptible to cyclical pressures. Many experienced GPs are instead focusing their sourcing efforts on cash flowing companies with a high rate of recurring revenues as well as resilient business models.

Another key lesson is the importance of avoiding club deals in which several fund managers partner together to finance large PE transactions; club deals accounted for more than 50% of all buyouts greater than $1 billion in 2006.[14] Club deals allowed firms to invest into larger companies without breaching concentration limits in their funds. During the GFC, GPs were faced with the difficulties of joint control, which often impeded quick decision-making — a hallmark of strong PE governance — and led to board-meeting paralysis. The sheer size of these deals led to a lack of viable exit options and several high-profile club deals — such as Caesars Entertainment and TXU Energy — led to bankruptcies that wiped out the initial equity. Club deals are still done today (albeit typically rebranded as "consortiums"), but they have decreased in popularity and represented only about $50 billion of aggregate deal value in 2016 versus more than $300 billion in 2007.[15] Instead, GPs are more likely to partner with their institutional LPs, who often are eager to co-invest in such deals, or with corporations that can provide a specific strategic edge. Today, when GPs do team up with each other, they typically take a more cautious approach by partnering with only one other financial sponsor and in situations where they both bring relevant expertise to the table.

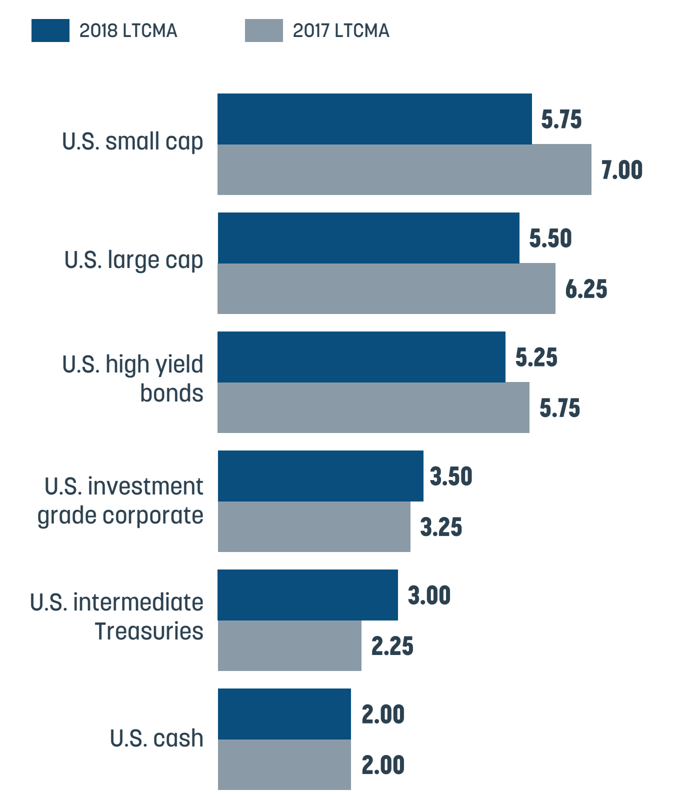
Despite some of the challenging situations detailed above, PE (as opposed to strategic or public) ownership during the financial crisis was generally a positive experience for many companies. During that period, as shown by a recent Harvard study[16], PE-backed companies were less likely to face financial constraints, allowing them to grow and increase market share versus their peers. PE firms were also found to have been significantly more likely to assist portfolio companies with their operating problems and provide strategic guidance during the crisis.

Today's buoyant PE environment will not be without consequences for future PE returns. Record levels of uninvested PE capital may dampen return expectations due to increased competition for a finite number of deals encouraging higher acquisition prices. Elevated deal multiples also require PE sponsors to commit more equity overall (because deals levered above 6.0x tend to attract increased regulatory attention), which likely will decrease a deal's internal rate of return (IRR) due to the higher percentage of equity employed — which we view as generally a good thing. Many GPs are acknowledging these trends and are resetting the performance expectations of their LPs. Whereas previously a GP might underwrite a typical buyout fund to a net IRR of 20% or more, many GPs now are advising that a net IRR in the mid to high teens is a more realistic target. This is in line with the 18.6% pooled net IRR that U.S. buyout funds posted for the 12 months ending June 2018.[17]

These lower IRRs represent lower returns — on an absolute basis — than the industry generated in prior decades, but we believe PE should significantly outperform public equities on a relative basis over the next decade. If we consider today's long-term capital market assumptions (we reference J. P. Morgan's in figure 4 below) which are used to project return assumptions to help determine optimal asset allocations for portfolios, 2019 projections are as follows.[18]

- 6.00% return on U.S. small-cap equities
- 5.25% return on U.S. large-cap equities
- 5.50% return for a U.S. dollar-based traditional 60/40 portfolio

FIGURE 4:
J.P. MORGAN LONG-TERM CAPITAL MARKET ASSUMPTIONS ("LT CMAS")



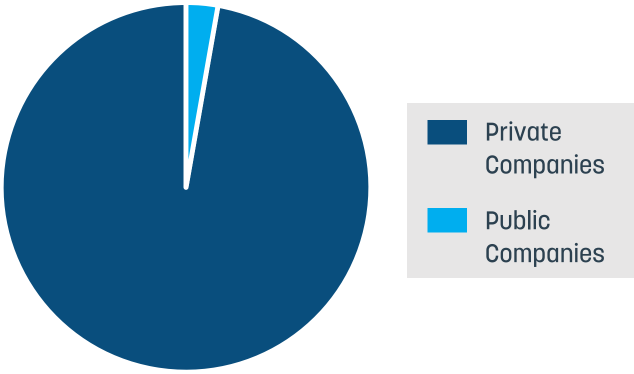
Source: J.P. Morgan Asset Management, estimates as of September 30, 2016, and September 30, 2017. Project return assumptions are for illustrative purposes only.

If there is a market correction, which we believe is inevitable within the next PE fund lifecycle of 10 years, it isn't difficult to imagine public equity annualized returns trending lower than 5%. Some LT CMAs have more bearish return projections, with GMO's latest seven-year asset class forecast anticipating a recession and consequently negative returns for the public markets: a -5.2% return for U.S. large caps, a -2.1% return for U.S. small caps, and a 0% return for U.S. bonds.[19]

When compared to the above public market assumptions, PE remains highly attractive on a relative basis. Many existing institutional investors stand by this view of PE's continued relative outperformance. A 2H 2018 survey by Preqin found that 86% of institutional investors (pension funds, endowments, foundations, insurance companies) planned to devote the same amount of capital or more to PE in the coming 12 months.[20]

This confidence in the asset class is logical and supported by historical data. If we look to historical returns, PE has generated an average of 230 basis points of outperformance against the S&P 500 over the past 10 years and an average of 370 basis points over the past 15 years.[21] One driver of these returns has been the sheer size of the private company universe, which is immense compared to the continuously shrinking pool of public companies: over the past 20 years, the number of publicly listed U.S. companies has nearly halved, from 7,322 in 1996 to around 4,000 today.[22] By contrast, there are almost 200,000 middle market companies in the United States,[23] of which about 98% are private (see figure 5 on next page).

FIGURE 5:
LARGEST 185,000 COMPANIES IN THE UNITED STATES



Source: NAICS Association, Firmographic Breakdown of Business Establishments by Company Size.

Other key drivers of outperformance include the fact that skilled PE managers benefit from an asymmetric information advantage compared to public market investors and they're able to focus on executing long-term value creation plans (as opposed to being constrained by pressures to meet short-term earnings targets).

With that in mind, it is important to note that the spread between the top-quartile and bottom-quartile managers in PE is massive compared to other asset classes. Manager selection is therefore essential — it is almost impossible to invest broadly across managers without first conducting extensive due diligence.

The managers who outperform are typically those who remain steadfast in the face of today's PE market challenges and execute their chosen investment strategy with the necessary discipline. These are also often the GPs who have embedded lessons learned from the financial crisis into their PE best practices and have a sharp focus on risk management. While we believe it is likely that private equity returns will decline from their 1990s and 2000s heyday, we expect that experienced top-tier PE managers will continue to generate a significant premium over public market returns, irrespective of the phase of the economic cycle. This should encourage investors to continue allocating to private markets, with manager selection remaining the critical driver of returns when choosing a fund.

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END NOTES

[1] The amount of cash or other liquid assets available for a fund to deploy, based on capital committed to the fund by investors. In other words, dry powder is the difference remaining between a fund's total committed capital and invested capital to date.

[2] Private Equity and Financial Fragility During the Crisis, Stanford Graduate School of Business. Shai Bernstein, Josh Lerner and Filippo Mezzanotti, January 2018.

[3] Preqin: Private Capital Dy Powder Reaches $2TN, January 2019. http://docs.preqin.com/reports/Private-Capital-Dry-Powder-January-2019.pdf Other PE includes balanced, co-investment, co-investment multi-manager, direct secondaries, and turnaround funds.

[4] Preqin: Private Capital Dy Powder Reaches $2TN, January 2019 http://docs.preqin.com/reports/Private-Capital-Dry-Powder-January-2019.pdf

[5] When measured as a proportion of committed capital. Source: Private Equity Capital Calls Shrink to Lowest Level on Record, August 2018. EFront, Private Equity Wire U.K. https://www.privateequitywire.co.uk/2018/08/14/267395/private-equity-capital-calls-shrink-lowest-level-record.

[6] Source: Preqin data, as of December 31, 2017.

[7] PitchBook, The Rise and Rise of Private Markets; McKinsey Global Private Markets Review 2018. https://www.mckinsey.com/~/media/mckinsey/industries/private equity and principal investors/our insights/the rise and rise of private equity/the-rise-and-rise-of-private-markets-mckinsey-global-private-markets-review-2018.ashx

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[9] Federal Register, Vol. 78, No. 56. Friday, March 22, 2013. https://www.govinfo.gov/content/pkg/FR-2013-03-22/pdf/2013-06567.pdf

[10] As of September 30, 2018. PitchBook Q3 2018 U.S. P.E. Breakdown. https://files.pitchbook.com/website/files/pdf/PitchBook_3Q_2018_US_PE_Breakdown.pdf

[11] S&P Capital IQ and Pitchbook 3Q 2017 U.S. PE Breakdown.

[12] By total deal volume (including add-on deals). Source: Bain Private Equity Report 2018. https://go.bain.com/global-private-equity-report-2018.html

[13] Bain Private Equity Report 2017. https://www.bain.com/insights/global-private-equity-report-2017/

[14] Pitchbook; represents deal by count.

[15] Preqin; Financial Times November 2017. https://www.middlemarketcenter.org/Media/Documents/MiddleMarketIndicators/2017-Q4/FullReport/NCMM_MMI_Q4_2017_FINAL_web.pdf

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[18] J.P. Morgan Asset Management, 2019 Long-Term Capital Market Assumptions. https://am.jpmorgan.com/us/institutional/library/ltcma-2019-overview

[19] GMO, as of September 30, 2018. https://www.advisorperspectives.com/commentaries/2018/10/23/gmos-7-year-asset-class-forecasts-still-favor-emerging-markets-over-u-s-stocks

[20] "Preqin Investor Update: Alternative Assets H2 2018" http://docs.preqin.com/reports/Preqin-Investor-Update-Alternative-Assets-H2-2018.pdf

[21] Source: Cambridge Associates, LLC. US Private Equity Index Summary, as of September 30, 2017. Past performance does not guarantee future results. Performance data is for illustrative purposes only.

[22] Mauboussin, Michael, Dan Callahan, and Darius Majd. 2017. The Incredible Shrinking Universe of Stocks: The Causes and Consequences of Fewer U.S. Equities. Credit Suisse (March 22 2017)

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