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INVESTORS

PRIVATE EQUITY YET TO ADJUST TO THE NEW REALITY ALREADY DIGESTED BY PUBLIC MARKETS

Higher interest rates represent considerable headwinds for the private equity business model

By Brian Demain, Portfolio Manager

Portfolio Manager Brian Demain explains why investors should consider reassessing their allocations to public and private equity in the wake of higher interest rates.

Over the past two decades, a confluence of forces created the impetus for institutional investors to increase their allocations to private markets. For private equity, one driver was low interest rates. In addition to the reach for yield that compelled investors to increase allocations toward riskier asset classes, low rates incentivized the shift toward private equity by reducing the financing cost of the highly leveraged transactions that underpinned these vehicles. Furthermore, a lower discount rate raised the value of future cash flows expected from these long-duration assets, boosting valuations and making the asset class all the more appealing.

This model proved lucrative as long as interest rates remained low and a plodding economy elevated the appeal of investments that offered hard-to-come-by earnings growth. The resetting of interest rates, however, has the potential to upend the private equity returns machine. With the cost of financing having increased, the possibility of a stalling economy calls into question the ability of debt-laden businesses to cover their obligations. Similarly, higher discount rates will likely result in valuations compressing further, following the trajectory of what occurred in public markets in 2022. That possibility is compounded by private equity having become more growth – and technology – focused in recent years.

The evolution of private equity has altered its historical relationship with publicly traded equities. Valuations attached to corporate buyouts used to trade at a discount compared to public companies. But for well over 10 years, private valuations have commanded a premium. Especially puzzling has been investors' willingness to forego a liquidity premium despite their funds being locked up for as long as a decade. Our view is that current private equity valuations are not sustainable in a higher interest rate regime, leaving the asset class vulnerable to a meaningful correction.

Key takeaways

- While publicly traded stocks felt the brunt of higher interest rates in 2022, private equity valuations have yet to fully reflect the headwinds brought on by a higher interest rate regime.
- Private equity appears acutely vulnerable to a correction given portfolio companies' substantial debt loads and investors likely again demanding a premium for holding illiquid assets.
- We believe the risk/return profiles of publicly traded small- and mid-sized growth companies that already reflect higher interest rates match up favorably against private equity at this time.

As the low rates from the post Global Financial Crisis (GFC) and COVID-19 pandemic era fade, we believe institutional investors should reassess the tenets underpinning private equity allocations. Entry multiples, leverage levels, and liquidity premiums are likely to merit a greater degree of scrutiny. As private equity valuations adjust to higher rates and economic uncertainty, their relationship with public equities will likely find a new equilibrium – one that better reflects the fundamentals of each asset class.

A timely business model

Since its ascendence in the 1980s, private equity – namely corporate buyouts – has earned a spot in many institutional allocations. Private equity funds typically sought out companies that were primed for a catalyst to unlock earnings growth. Given this focus on boosting earnings and commanding higher valuation once the new strategy had been proven, private equity could be seen as a form of value investing. U.S. buyouts have typically been valued at a discount relative to public equities on an enterprise value (EV) to EBITDA basis.[1] Indeed, the cheap valuations attached to turnaround stories were central to the private equity business model. Also pushing down entry multiples were the discounts investors required for locking up their funds for an extended period. The payoff was that, by optimizing assets, privately owned companies could improve cash flow and, thus, command a higher exit multiple.

Another argument for putatively better outcomes was private equity's reputation for placing a greater emphasis on corporate governance relative to public shareholders. While that may have been in the case in the past, we believe the recent push toward better governance by public investors has narrowed this gap.

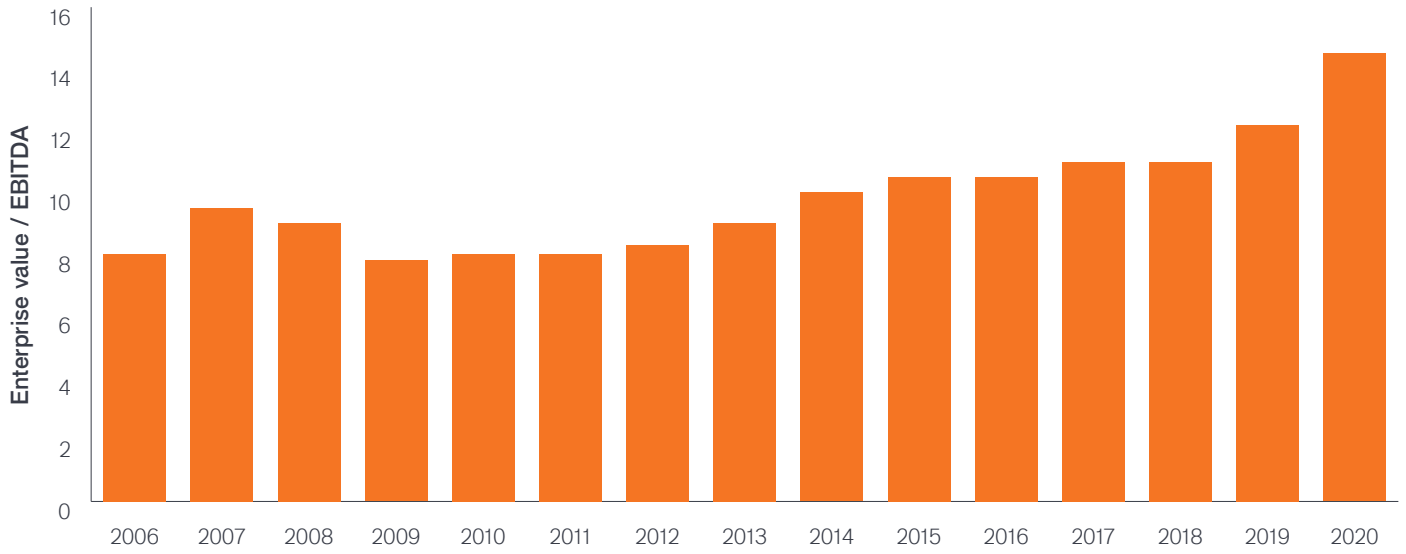
Private equity thrived in the era of low rates, fueled by the tailwinds of valuation math, the reach for yield, and a shift toward growth-oriented companies. Its growing viability as an alternative to public markets also resulted in demand for deals exceeding the supply of buyout candidates. This imbalance tended to not only raise entry multiples, but also led to situations where the private equity firms exited companies by selling them to other private investors at higher valuations.

The long shadow of higher rates

We believe higher rates are undermining the forces that propelled private equity during the post-GFC era. Purchase price multiples as measured by EV/EBITDA increased from 8x in 2006 to as high as 15x in 2020.[2] And while purchase multiples are modestly off their peaks, they have not fallen nearly as much as EV/EBITDA valuations of publicly traded small- and mid-cap companies – a trend also reflected in public companies now paying considerably less for acquisitions relative to their recent peaks versus private buyers.

Exhibit 1: Private equity purchase price multiple

The price private equity firms have been willing to pay for buyout and growth equity opportunities has climbed since the economy emerged from the GFC as low rates pushed up valuations and acquirers were more open to forgoing a liquidity premium.

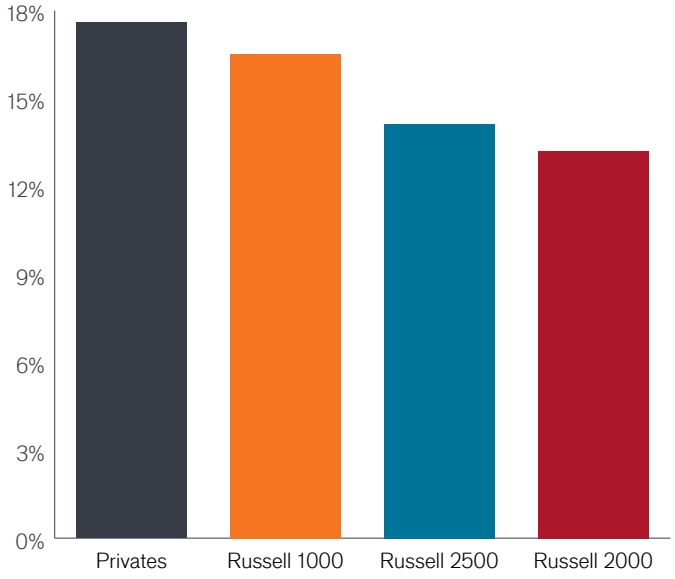


Source: Cambridge Associates, as of November 2022.

One would have expected higher entry multiples to have led to lower returns. That, however, has not been the case as buyout funds shifted their focus toward fast-growing tech and biotech companies, leaving them more akin to small- and mid-sized growth strategies than value stories. Returns data reflect this transition: Private equity's 10-year internal rate of return (IRR) as of December 2021 was 17.6%, but for 5- and 3-year periods it climbed to 22.5% and 27.4%, respectively.[3]

Exhibit 2: Total annualized private equity returns relative to public markets

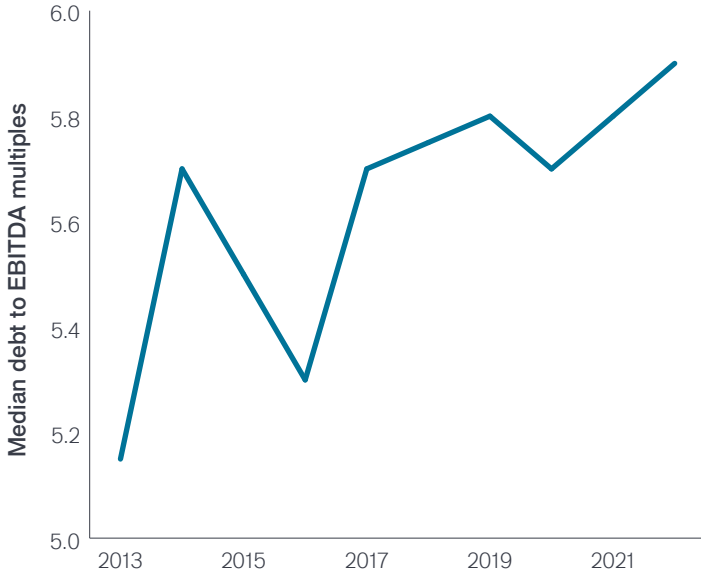
In the decade preceding 2022's rate increases, both public and private equities benefited from low rates and an increasing concentration in growth-oriented tech themes, but these parallel trajectories have since ended as liquid public markets already reflect the higher rate environment.



Source: Bloomberg, Pitchbook, as of 31 December 2021.

Exhibit 3: Debt-to-EBITDA multiples of private equity portfolio companies

Typically leveraged, debt loads of private equity portfolio companies increased materially in the era of low rates – a tactic that does not translate well to a higher rate regime.



Source: Pitchbook, as of March 2023.

The shift toward growth, however, makes private companies acutely vulnerable to higher discount rates as the value of cash flows expected far in the future gets slashed. Another area of concern is the increased level of leverage on portfolio company balance sheets. Deploying debt has always been central to buyouts, but total debt-to-EBITDA multiples increased from just above 5x in 2013 to nearly 6x by 2022.[4]

The 2022 public equities bear market was led by tech as the valuations attached to their secular-growth profiles collapsed under the weight of higher discount rates. Private valuations proved more resilient as marking to market tends to lag shifts in public valuations. This "volatility laundering" represents an additional threat to private valuations as it potentially glosses over the risks posed by the massive levels of leverage on private companies' balance sheets. If public growth companies, valuations collapsed under the weight of a higher discount rate despite their generally sensible use of leverage, we can presume that highly leveraged private companies would have proven even more volatile in the 2022 selloff had their prices been marked daily.

Higher rates are also likely to put an end to the reach-for-yield era. Between 2008 and 2021, the yield on the 10-year U.S. Treasury averaged 2.4%, roughly half its 2000 to 2007 average.[5] As yields have reset across the risk spectrum, we believe the need for investors to increase allocations toward riskier asset classes to generate sufficient returns should diminish. A likely first step will be investors demanding a liquidity premium for holding private equity when the potential for attractive risk-adjusted returns is once again present elsewhere in the market.

A reckoning

The slowing economy that is expected to be the consequence of higher rates only magnifies the risks posed by the debt loaded onto private companies' balance sheets. Intermittent marking to market may obscure stressed coverage ratios for a while, but there is precious little margin of error with debt/EBITDA ratios of 6 and borrowing costs having doubled within the past two years.

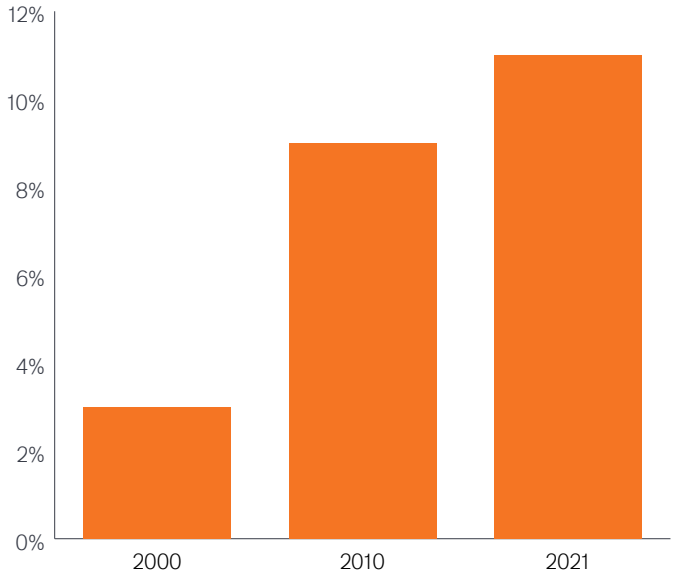
As with all markets, prices are set at the margin, and we believe a reckoning may occur with private equity valuations when the marginal demand for the asset class subsides. There are signs that this scenario is beginning to unfold, especially as institutional allocations to private markets, including private equity, have swelled over the past 20 years. Between 2000 and 2021, endowments' and foundations' allocations to private equity rose from 3% to 11%.[6] By early 2022, global private equity assets under management reached $3.3 trillion for buyouts and another $1.2 trillion for growth equity.[7]

An open question is how much higher institutions are willing to take their private equity allocations. In 2022, global fundraising for private equity declined by 15% from the previous year's record haul.[8] With other private equity firms increasingly becoming exit options for earlier vintages, reduced demand from peers could pressure exit multiples. This risk could be exacerbated by a soft initial public offering market, which is another common exit channel.

The nature of private vehicles means that general partners can keep funds locked up for longer periods. But absent an incremental increase in annualized returns, this tactic would likely weigh on a portfolio's IRRs. Extending holding periods also runs the risk of having to refinance the debt of older vintages at considerably higher borrowing costs. The culmination of these forces could lead to a vicious spiral should consistently lower IRRs compel institutions to further reduce their allocations to privates, reversing the past decade's prevailing dynamic of demand exceeding supply.

Exhibit 4: Institutional allocations to private equity

The average allocation to private equity by endowments and foundations has increased more than threefold in the past two decades.



Source: Cambridge Associates, as of November 2022.

Seeking balance

In recent years, private ownership has become a popular path for companies undergoing transition and investors seeking enhanced returns. Concurrently, publicly traded equities have continued to play a key role in funding corporations and driving economic expansion. This is especially true for small- to mid-sized businesses focused on compounding earnings growth. And while both of these asset classes have a place in institutional allocations, they need to sufficiently reflect the risk and return profiles of their component companies as well as the macro environment in which they operate.

The reach for yield resulted in private equity becoming unmoored from its historical valuation range. For the asset class to reflect its current risk/return profile more accurately, it will need to account for a higher cost of capital, increased levels of debt, and the likelihood that investors will again demand to be compensated for illiquidity. Many segments of public markets have already been forced to adjust to a higher-rate – and possibly lower-growth – era. The Russell 2500 Index, for example, remains 18% off its peak.

We believe investors cannot ignore the alignment of forces that could send private equity valuations lower. If economic growth only slows – rather than collapses – in the wake of higher rates, maturing private equity vintages may be able to maintain the acceptable IRRs upon which the industry is measured. If, however, there is an absence of strategic buyers, other acquisitive private vehicles, or a weak IPO environment, exit multiples and returns could suffer.

In either case, we believe it's time for institutional investors to revisit their allocations to both public and private equity. With a higher rate regime, elevated debt loads cannot be ignored, and investors will likely no longer tolerate forgoing a liquidity premium. For public equities, we believe their large universe, liquidity, earnings profiles of smaller growth-oriented companies, and valuations more tethered to corporate and economic fundamentals mean they will become more appreciated by investors seeking attractive risk-adjusted long-term growth opportunities.

[1] Cambridge Associates, Pitchbook, November 2022, based on the S&P 500® Index; EBITDA, or earnings before interest, taxes, depreciation, and amortization, is a measure of a company's operating cash flow.

[2] Cambridge Associates, November 2022. Private equity includes both U.S. buyouts and U.S. growth categories covering companies acquired between 2006 and 2020.

[3] PitchBook, December 2021.

[4] PitchBook, March 2023.

[5] Bloomberg, August 2023.

[6] Cambridge Associates, November 2022.

[7] McKinsey Global Private Markets Review, June 2023.

[8] McKinsey Global Private Markets Review, June 2023.

Russell 1000® Index reflects the performance of U.S. large-cap equities.

Russell 2000® Index reflects the performance of U.S. small-cap equities.

Russell 2500® Index reflects the performance of U.S. small- to mid-cap equities.

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