

Private Equity in the Current Environment

Is the current market environment favorable for new private equity investments?

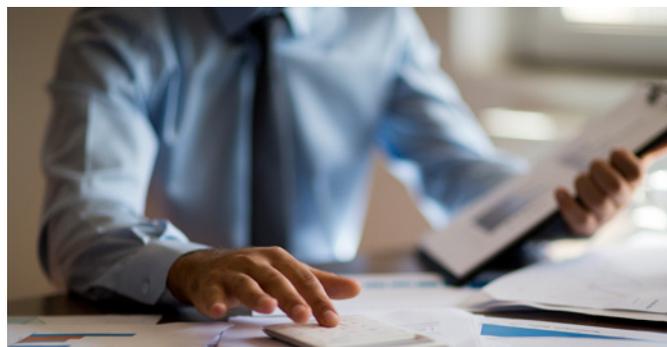


As the COVID-19 pandemic continues to spread around the world, and with economies reeling from the impact of lockdowns, we have entered a deep global recession.

Moreover, as the first two quarters of 2020 have passed and with economic forecasts for the year 2020 projecting real GDP globally to drop by 5%,¹ portfolio managers are having to rethink both tactical and strategic asset allocation. In this environment, alternative investments and private equity (PE) in particular have moved into focus and institutional investors are considering whether today's market environment, or a recessionary environment in general, is a good time to commit capital to the asset class.

To address this question, a logical first step would be to review the historical performance of private equity through previous recessions. Illustrated in *Figure 1* are the median internal rate of return (IRR) and total value to paid in (TVPI), a return multiple on invested capital, for global private equity for all vintages since 2000.² Shaded vintages in this figure represent fund vintages that started to invest during an economic crisis.

First, based on our analysis, we note that on a median basis all vintages have generated positive returns. What is more, some fund vintages that invested through an economic crisis (private equity funds typically have an investment period of five years), such as the dot-com bubble in 2001 – 02 and the global financial crisis of 2007 – 08 (GFC), outperformed the preceding vintages that invested throughout an upmarket and toward a peak. We additionally note that fund vintages of the GFC years have already returned well above investors'



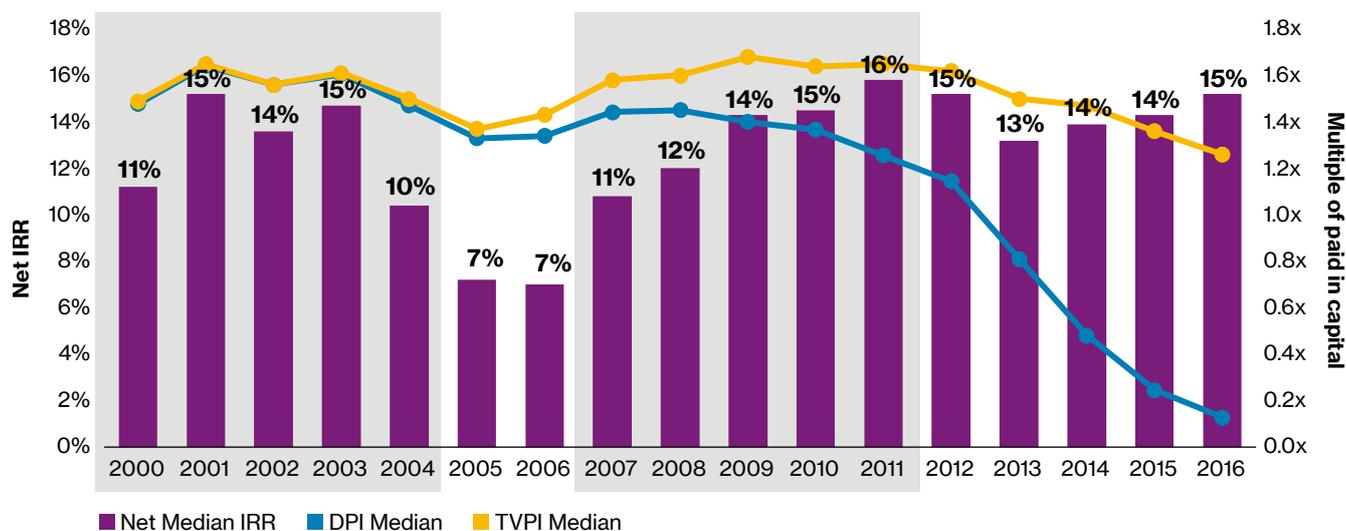
paid in capital, as measured by distributions to paid in capital (DPI) and illustrated in *Figure 1*.

In summary, based on our findings, private equity fund vintages that started to invest during the past two global economic crises have actually outperformed other vintages that started to invest two to three years before a recession or more than five years after one.



When exploring the key drivers of the performance shown, we believe there are a number of factors to take into consideration, all of which are highly important.

Figure 1: **Global private equity: Median net IRRs, TVPI and DPI by vintage year**

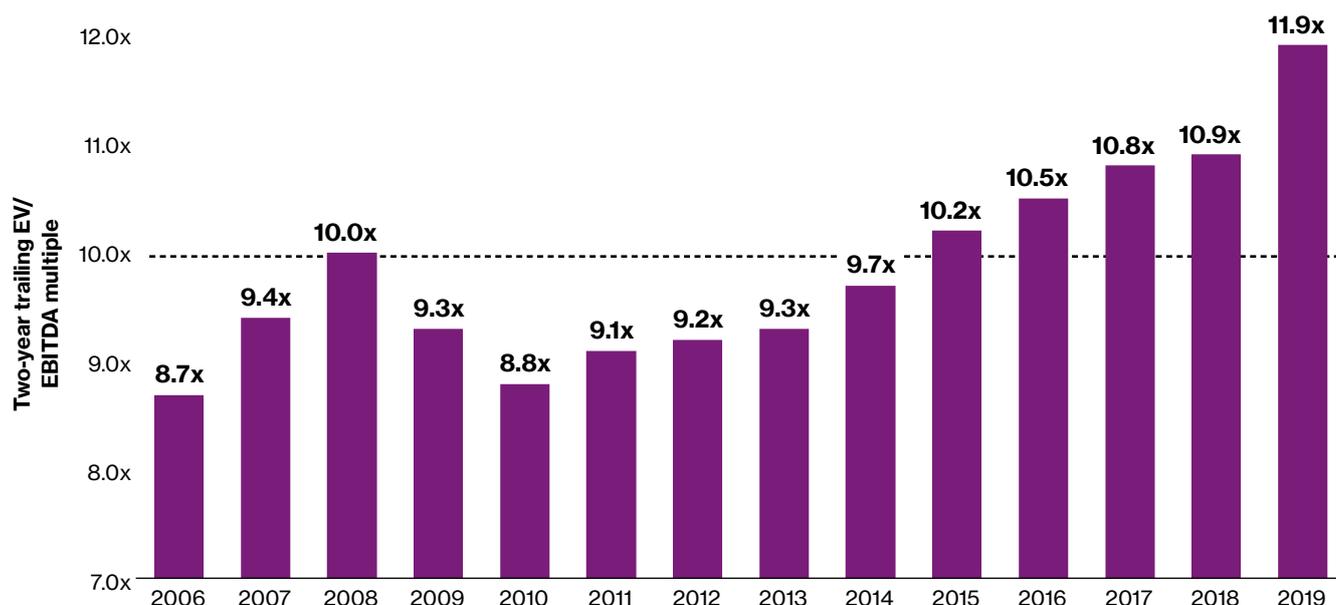


Past performance is not a reliable indicator of future returns. Source: Preqin (December 2019)

¹IMF World Economic Update, June 2020

²Vintages from 2017 to 2020 have been excluded from the analysis due to immaturity

Figure 2: U.S. buyout entry valuations by year



Source: Refinitiv LPC; S&P Capital IQ (December 2019)

Dynamics in deal valuations

Market downturns tend to result in falling equity valuations broadly, regardless of the quality of an underlying asset. During downturns, competition for deals and investor appetite decreases as projected income and other financial measures fall, and companies' abilities to service debt weaken. For private equity firms, however, this can be an excellent environment to make acquisitions at lower valuations and capture the natural upside as markets rebalance. Purchasing undervalued assets may also provide a degree of downside protection should markets fall further.



Private equity firms can also potentially benefit from the strategic acquisition of weak or failing competitors, growing market share via a "buy and build" strategy, coupled with the fact that there is less competition (especially from strategic corporate buyers) when buying a business. Following the GFC, it took over six years for U.S. buyout valuations to surpass the previous high reached in 2008, as illustrated in *Figure 2*. The dotted line represents the median pricing level in 2008 as a reference point for PE valuation levels at the peak of the market during that time.

Today private equity firms are well positioned to seize a rare buying opportunity, with an estimated \$1.5 trillion of dry powder³ in the market waiting to be deployed.

Lower use of leverage

At the top of a market cycle, debt markets are typically highly liquid, debt terms favorable and financial market regulations looser. This, coupled with high deal prices, pushes private equity investors to use leverage more aggressively to sustain returns. However, we believe excessive use of leverage is inherently risky and can prove to be disastrous when underlying assets are facing decreasing revenues and cash flows, increasing the risk of a default. While we have not seen this occur at a large scale yet in today's market, mostly due to extensive government and central bank support during the pandemic, we still believe that defaults are a likely possibility as this support cannot be infinite.

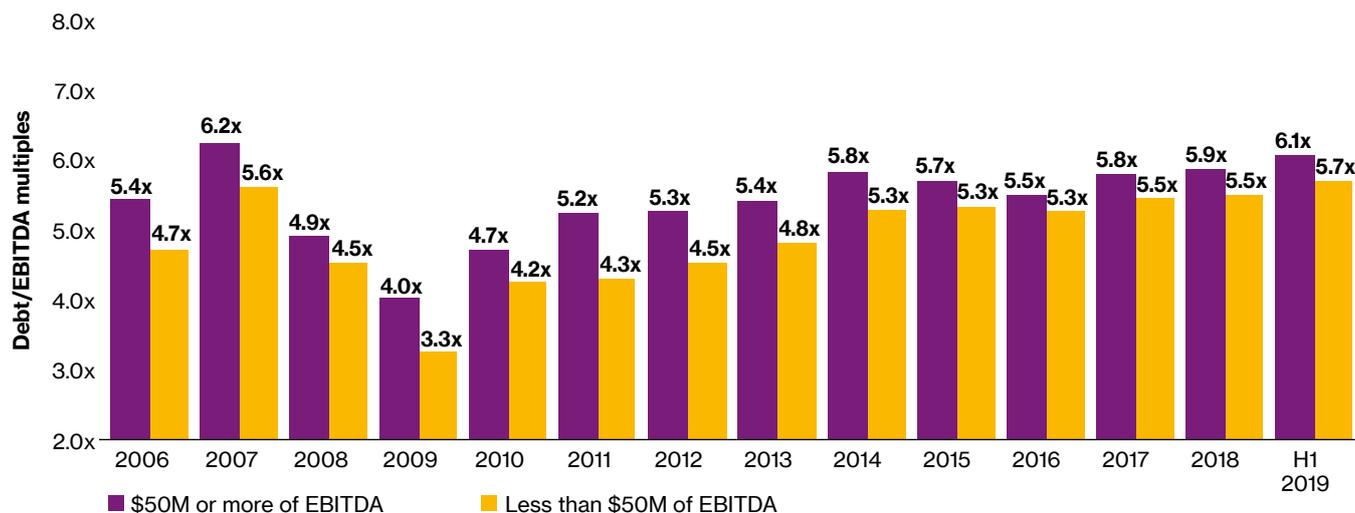


In the aftermath of a crisis, with falling pricing and with debt markets becoming far less liquid and more expensive, private equity investors apply far lower leverage to deals at acquisition, potentially allowing for stronger downside protection and more sustainable cash flow growth. Moreover, while many public companies may struggle to access additional equity funding during these times, we feel private equity firms are well placed to obtain capital with advantageous access to existing banking relationships and the availability of unfunded capital commitments from investors. This helps allow much greater flexibility to both support existing portfolio companies and deploy fresh capital in down markets. The lower use of leverage by firms during these periods drives a focus toward value creation through operational improvements. As an example, private equity-held companies during the GFC experienced far fewer defaults than their public counterparts.⁴

³Preqin Quarterly Update: Private Equity & Venture Capital Q1 2020

⁴www.institutionalinvestor.com/article/b1kq69qt38w0x6/Private-Equity-Firms-Won-t-Waste-Another-Crisis

Figure 3: U.S. buyout leverage ratios small-cap – vs. mid-cap companies



Source: S&P Leveraged Buyout Quarterly Review (Q2 2019), Reuters, GF (June 2019, latest available)

Figure 3 clearly illustrates the rapid decline in U.S. buyout leverage ratios, measured as a ratio of balance sheet total debt to operating earnings in the form of EBITDA (debt/EBITDA), following the GFC and recovering back to near pre-crisis levels in recent years. The chart also shows that small- to mid-cap companies in the PE space are typically less levered. We believe this is an important factor to consider when making PE fund commitments, and our approach at Willis Towers Watson focuses on this segment of the market with potentially lower risk to investors.

Long-term nature of the asset class

The ability of private equity firms to take a long-term view when investing, unafflicted by short-term volatility in the public markets, is incredibly advantageous for the asset class. Firms have numerous professionals working very closely with underlying companies in an agile environment, often with long-term strategic plans and incentive structures that create stronger alignment between the investors and portfolio companies. In times of economic dislocation, private equity firms can take the long-term view and invest accordingly into areas that short-term investors would shun. Furthermore, when it comes to exiting underlying companies, private equity firms can wait longer than most until market conditions have recovered and are often not in a position of being forced sellers.



We believe private equity offers institutional investors an asset class that has delivered strong returns throughout market cycles, especially for those with the courage to invest during market downturns.

Control ownership

A significant potential advantage that private equity firms have over public equity investors is the control ownership that is negotiated in a traditional buyout transaction and the informational advantage it holds from working with the management teams of portfolio companies. Additionally, majority shareholders in private equity may benefit from working together in a small group to make timely decisions, rather than having to juggle the divergent interests of large groups of shareholders of public companies. Leading private equity firms have a hands-on approach and have long-term plans for their companies, driving value creation through systematic and operational improvements. In addition, firms have access to a network of strong, talented advisors and advanced data analytics, to enhance sector and operating management expertise. We believe value creation from leading firms predominantly comes from revenue growth and improved operational performance rather than from financial engineering, a tag labeled to private equity tactics in the industry's earlier days.



Conclusion

There is great uncertainty around how the global economy and capital markets will recover from the impact of the COVID-19 pandemic. However, we believe private equity offers institutional investors an asset class that has delivered strong returns throughout market cycles, especially for those with the courage to invest during market downturns. The nature and dynamics of the asset class also give it the attributes to weather downturns and deliver strong returns as the global economy recovers. For those taking a selective and disciplined approach, allocating to long-term thematic trends, such as the shift to e-commerce or the increasing use of technology in our lives, we believe that today's market environment offers as good an opportunity as ever to make commitments to the asset class.



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