KEYNOTE INTERVIEW

PE demonstrates resiliency in the face of change

Private equity fundraising and investment remain defiantly active in the wake of the pandemic, say Neuberger Berman's Susan Kasser, Joana Rocha Scaff and Patricia Miller Zollar

Some 18 months have passed since the World Health Organization declared covid-19 a global health emergency. As economies tentatively begin to re-open, three Neuberger Berman managing directors – Susan Kasser, co-head of private credit, Joana Rocha Scaff, head of Europe private equity, and Patricia Miller Zollar, head of NorthBound Equity Partners, the firm's emerging managers platform – explain how the pandemic has impacted their respective corners of the market and consider whether any resulting changes could be here to stay.

Q What changes have you seen in your respective roles over the past year? What has not changed?

Patricia Miller Zollar: What has not changed is deal volume or fundraising. Yes, there was a brief pause early last year, but all those records are now being broken. We had one of our most active years in terms of both the number of commitments made and the amount of money raised.

Joana Rocha Scaff: From a co-investment perspective, after a brief hiatus in the second quarter, things resumed very quickly in terms of fundraising, dealmaking and realisations.

The change that has taken place has been this big human experiment we have all been a part of, and I believe that some of those changes in work and communication practices will become permanent. I expect virtual communications between GPs and LPs to persist to some degree, and that we will have a hybrid model going forward. In fact, LP-GP communications have been one of the real positives to come out of this crisis. GPs have been far more forthcoming than during the global financial crisis. That has been enabled by tech adoption.

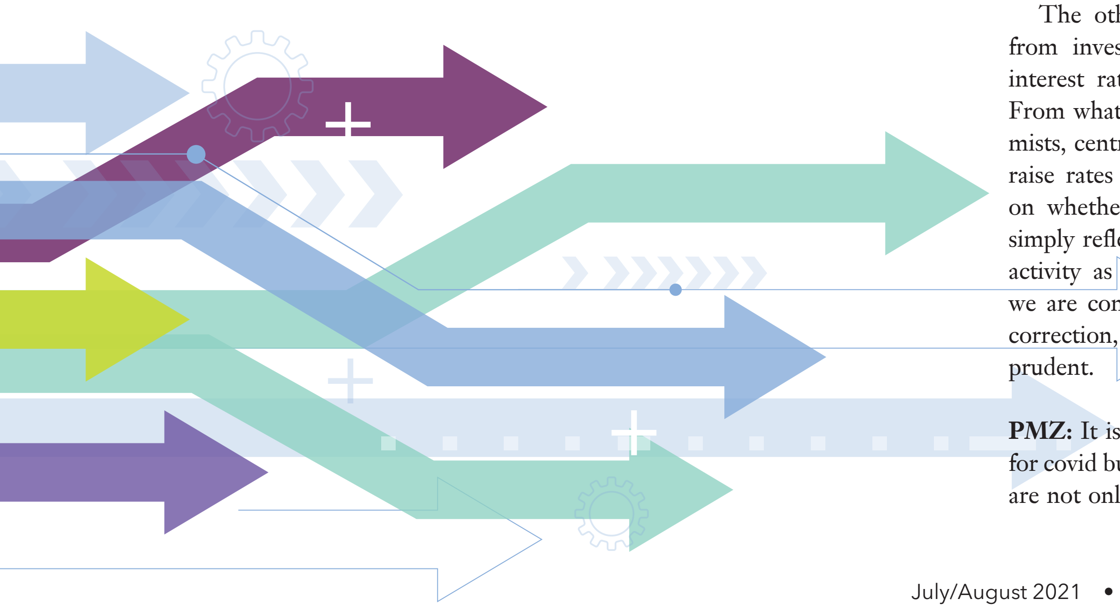
Susan Kasser: From a direct lending point of view, a great deal has happened but, at the end of it all, little has actually changed. In the first quarter of 2020, there was a significant amount of activity driven by a buoyant private equity market. Then the pandemic struck, and it seemed that everyone spent a couple of months looking through their portfolios, working out how to keep employees and customers safe, managing costs and preserving liquidity. By around August, private equity appeared sufficiently confident to embark on new buyouts. But, as a lender, competition was still muted in this period and pricing, leverage and documents were all more lender friendly than in 2019. Then private equity started to focus on add-on acquisitions, giving us, as lenders, the opportunity to finance accretive M&A for companies many of us already knew. Because we had so few defaults in our portfolio, we did not have difficult conversations with sponsors, and we were able to pick up market share there.

Q What do you think the future holds for private equity?

PMZ: Private equity has shown that it can be resilient and perform well in a difficult environment and so I see investor appetite and allocations continuing to grow. Also, the general low level of yields globally will make the private markets an area to achieve attractive risk-adjusted returns.

JRS: The asset class has generated a demonstrable illiquidity premium over the public markets, and it is extremely hands-on in its ownership style, which is critical in a high valuation environment. That is where private equity generates its alpha.

The other trend I see continuing is a concentration of capital with fewer managers, and those managers will be the ones that are investing in their own ability to create value by hiring operating partners and functional specialists. I believe these managers will increasingly look to launch complementary offerings by raising small-cap funds, debt funds or funds focused on particular sectors or regions where they have excess dealflow, leading to further manager concentration.



By the end of 2020, many lenders were eager to start deploying again and so pricing, leverage and terms today all look a lot like they did pre-pandemic.

Q Are there any concerns about equity valuations, interest rates and inflation?

JRS: Prices have been high because most investors have focused, almost exclusively, on those assets that have proved to be 'covid-resilient'. Average valuations reflect only a sub-section of the economy that has been transacting. As economies gradually open and conditions stabilise, we would expect investor interest for broader sectors of the economy to improve. Valuations are one of our main concerns when investing. We have been living in a high-valuation environment for some years and have felt for some time that we must be reaching the top of the market. We have therefore prudently been factoring in multiple compression at exit in our underwriting process.

The ability to discern quality and growth profile is also crucial. There are market leaders in industries with high barriers to entry, with true revenue resilience and the opportunity to grow their product base or expand into new geographies. I think those businesses are fetching high multiples commensurate with their quality, but others, in my view, simply do not deserve the valuations they are receiving.

The other concerns that we hear from investors are around inflation, interest rate and corporate tax rises. From what I hear from macro economists, central banks will be hesitant to raise rates until there is more clarity on whether inflation is persistent or simply reflects a temporary pick-up in activity as lockdowns ease. However, we are conscious that we could see a correction, which only makes us more prudent.

PMZ: It is also important to look out for covid bumps – those businesses that are not only resilient but have actually benefited from the pandemic. I think there are firms overpaying for businesses based on this spike rather than looking at normalised earnings.

Q How have you evolved your respective sourcing, diligence and portfolio management strategies to reflect this environment?

PMZ: We have been heavily focused on ensuring we are investing with managers that have experience through different cycles and have a team structure and strategy that we think will prove resilient. Having said that, we also invest with emerging managers, particularly those with real domain expertise, that we believe can drive value creation in a particular industry. Of course, we diligence the team's track records at their previous establishments and make sure we only work with managers that are going to be investing alongside us to ensure our interests are aligned.

JRS: One area that has been further bolstered by the pandemic has been environmental, social and governance analysis, including carbon footprint and climate change risk analysis. That is becoming ever more important as investors increasingly make zero-carbon commitments. The ESG element of the due diligence process was already in private equity, but it has gained even more prominence over the past 18 months.

SK: Quite frankly, I would have to say that we have not changed a thing. Our default rates are at 0.6 percent across our entire strategy, compared with overall default rates of 3.3 percent for direct lending in the 12 months to 31 March 2021, according to Proskauer, so why would we?

Q Where are you seeing the most attractive opportunities?

SK: As a creditor, we do not believe in attractive opportunities. We start from a position of suspicion, looking for reasons why not to invest. The burden of proof is incredibly high. First, we do not invest in industries that are cyclical or that we cannot forecast. In reality, that means no energy, automotive, travel, retail or restaurants.

Second, we believe a 'follower' company in an excellent industry is vulnerable. If the unexpected happens, the follower company might not make it, but the market leader likely will. Take healthcare as an example. That sector is meant to be resilient in a recession, grow faster than GDP and offer the potential benefit of pricing power. However, healthcare was hit hard by the recession because no one was getting their hips replaced or going to the dermatologist.

We did not see a single default or material issue with coupons in that segment of our portfolio, but there was significant underperformance in that market sector in Q2 2020. That reaffirms that even if you get the industry right, if you get the company wrong, you could have a problem.

Third, we look at the quantum of leverage a company can service and whether our investors will be fairly compensated for that risk. We look to see whether the credit documents are sufficiently protective.

Fourth, we look at the private equity sponsor. Have they previously treated creditors with respect or have they sought to take from creditors for the benefit of the equity? Each one of those hurdles must be cleared. We decline 95 percent of the opportunities we see.

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SUSAN KASSER

Q How is investor appetite for private debt evolving?

SK: Investors appreciate that private credit, especially the senior debt component, is at the top of the capital stack. Further, it typically does not have the pricing volatility you see in the liquid debt markets. While returns in the liquid market are driven, at least in part, by price appreciation, in private debt returns are driven primarily by the coupon, which is contractual and in cash.

The one concern that investors sometimes have about private debt is a perception that it only began after the GFC and that it has not been tested sufficiently in a downturn. That is not actually the case – the asset class is a lot older than that. Regardless, with market default rates at 3.3 percent (LTM 31 March 2021) through the pandemic and economic shutdowns, private debt has proven to be just as defensive an asset class as advertised, so we believe that concern can be laid to rest. ■