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Private Equity Market Outlook

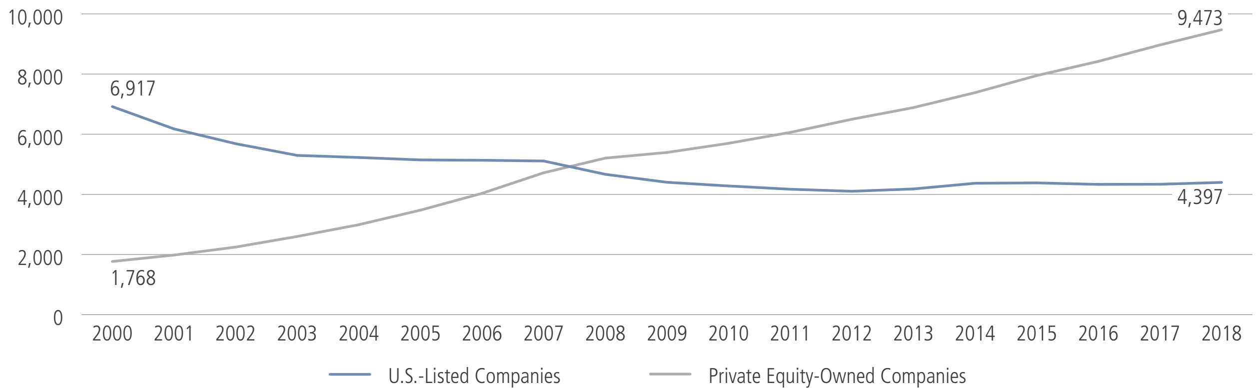
Private equity (PE) is an asset class that can potentially provide enhanced returns and greater diversification to a portfolio in the medium to long term. PE investments have historically generated attractive absolute and relative returns compared to public equity markets, largely due to structural characteristics unique to the asset class, at the time of the initial investment, during ownership and at the time of exit. At entry, PE managers generally have the ability to perform due diligence with extensive access to inside information on the companies and negotiate the transactions; during ownership, PE managers have the ability to guide the affairs of the businesses, and implement strategic and operational initiatives that drive long-term value creation; finally at exit, PE managers can choose and optimize the manner and timing of sale. In the following pages, we review current trends in the private equity market and provide insights into key themes, including the rapidly growing co-investment and secondary strategies.

A Broadening Opportunity Set

As we head into 2020, the investable opportunity set in PE markets is poised to continue its steady expansion. On the eve of the last global financial crisis, U.S. PE-owned firms and their publicly listed counterparts were roughly equal in number. A decade later, the universe of privately owned firms is twice that of the corresponding listed companies (see Figure 1), and similar trends have been observed in many other markets globally.

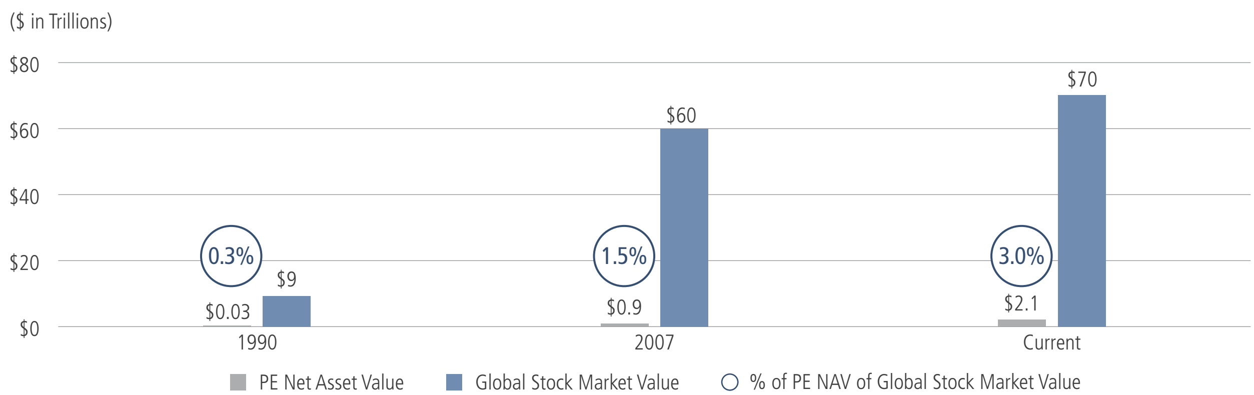
In dollar terms, PE markets still remain a fraction of the size of public stock markets, with the total net asset value of privately owned firms standing at just 3% of the value of global stock markets (see Figure 2). However, this is twice as high as levels observed a decade ago, and we expect PE markets to continue growing at a faster rate than public equity markets in the coming years, as the industry develops further and becomes accessible to a broader range of investors.

FIGURE 1: U.S.-LISTED COMPANIES VS. PRIVATE EQUITY-OWNED COMPANIES



Source: PitchBook and World Bank.

FIGURE 2: COMPARATIVE SIZE OF GLOBAL EQUITY MARKETS



Source: ThomsonOne, World Federation of Exchanges and World Bank. Public equities data as of August 31, 2019. PE data as of March 31, 2019, which is the most recent data available.

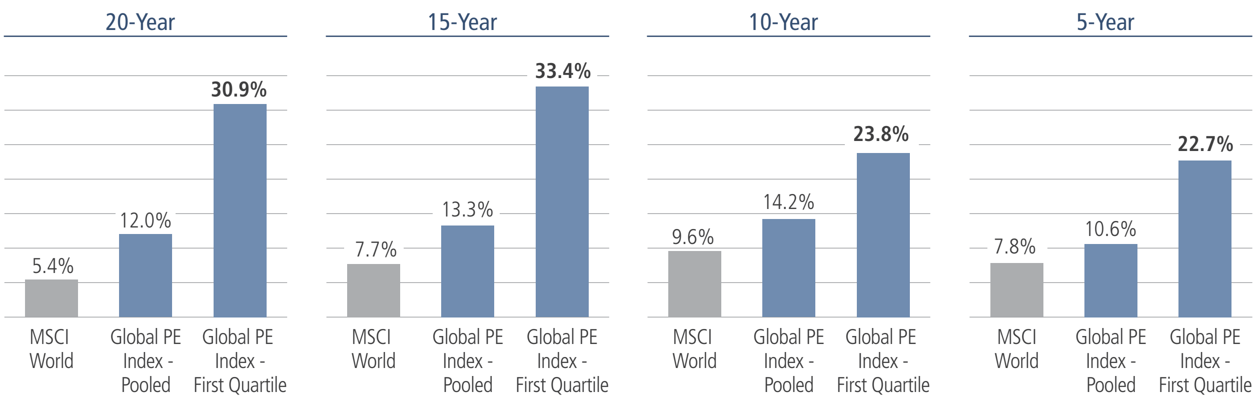
It is important to note the significantly smaller size and equity capitalization of businesses in PE markets, with the average firm size under PE ownership clocking in at just under $200 million, as opposed to the $10.5 billion median of publicly listed Russell 1000 companies. We anticipate that investors will continue to appreciate the industry's unique access to smaller businesses, many of which are still in their earlier growth and development stages, and the attractive risk/return profile that it can offer portfolios. Furthermore, private capital also seems to be a preferred source of funding for digital, asset-light businesses, and we expect it to expand as the economy transitions from industrial, asset-heavy businesses to the digital era.

The PE asset class' structural advantages relative to public stock markets—information advantages on the buy, active ownership, broader exit positioning and timing options—should also continue to make for an attractive proposition for investors in need of higher-yielding alternatives than traditional asset classes.

Attractive Asset-Class Returns, Despite New Challenges

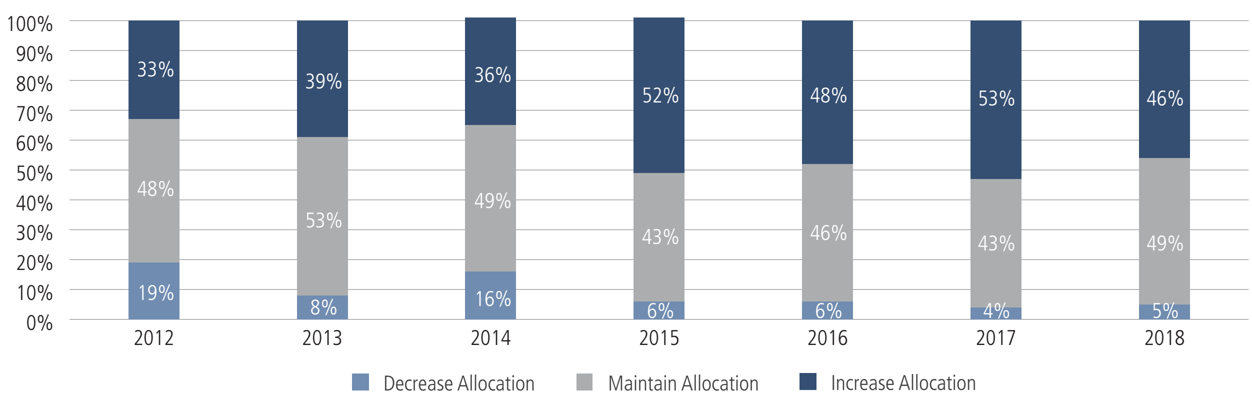
PE has been one of the best-performing asset classes across a variety of time periods and has delivered meaningfully stronger returns than public equity markets over 5-, 10-, 15- and 20-year investment time horizons (see Figure 3). While we believe that PE markets will continue to generate attractive returns and a generally robust illiquidity premium over public counterparts, a number of cyclical and structural factors—including the general macroeconomic environment, increased competition, maturation of the industry, and accelerating pace of technological change, among others—will likely result in more compressed returns in absolute terms in the future relative to historical levels. This hasn't, however, deterred investors from increasing their exposure to the PE asset class. Since the late 1990s, investor capital has flown into private markets at record rates. Furthermore, despite the general sentiment that we have entered the latter stages of the market cycle, surveys continue to show that, over the long term, an overwhelming majority of institutional investors intend to either maintain or increase their allocations to PE (see Figure 4).

FIGURE 3: PERFORMANCE OF GLOBAL PE VS. PUBLIC MARKETS



Source: Cambridge Associates (CA). Represents pooled horizon IRR and first-quartile return for the Global All PE Index from CA as of June 2019, which is the latest data available. The benchmark performance is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of the benchmarks may be different than the investment objectives and strategies of a particular private fund, and may have different risk and reward profiles. A variety of factors may cause this comparison to be an inaccurate benchmark for any particular type of fund and the benchmarks do not necessarily represent the actual investment strategy of a fund. It should not be assumed that any correlations to the benchmark based on historical returns would persist in the future. **Past performance is no guarantee of future results.** Indexes are unmanaged and are not available for direct investment.

FIGURE 4: INVESTORS' ALLOCATION INTENTIONS TOWARD PE



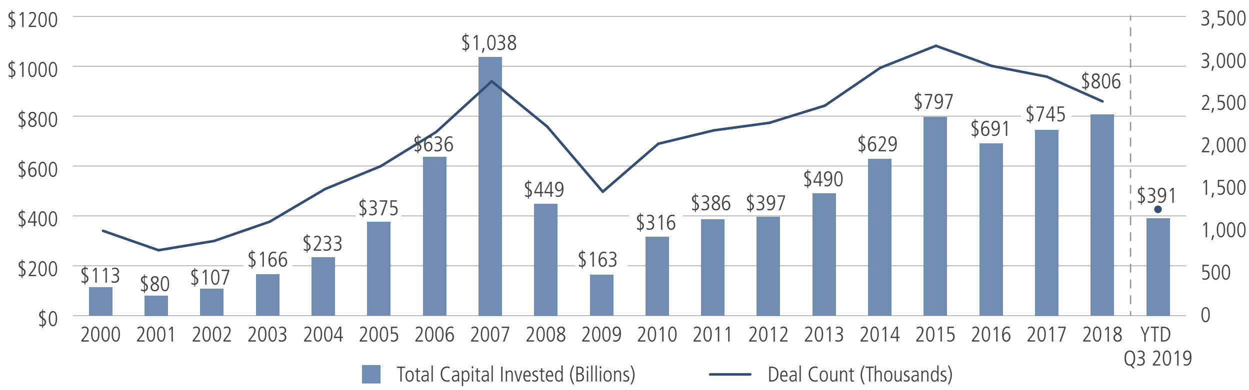
Source: Preqin surveys, November 2012 – 2018.

State of the Market

Global PE activity was strong in 2018, with the largest number of PE-backed buyout transactions and second highest buyout volume level experienced over the past decade.[1] Despite the continuously challenging macro and geopolitical backdrop, PE volumes look set to come close to those figures in 2019, due to a buoyant leveraged buyout activity sustained by a combination of low interest rates, extended economic growth, supportive credit markets and dry powder available to PE funds (see Figure 5).

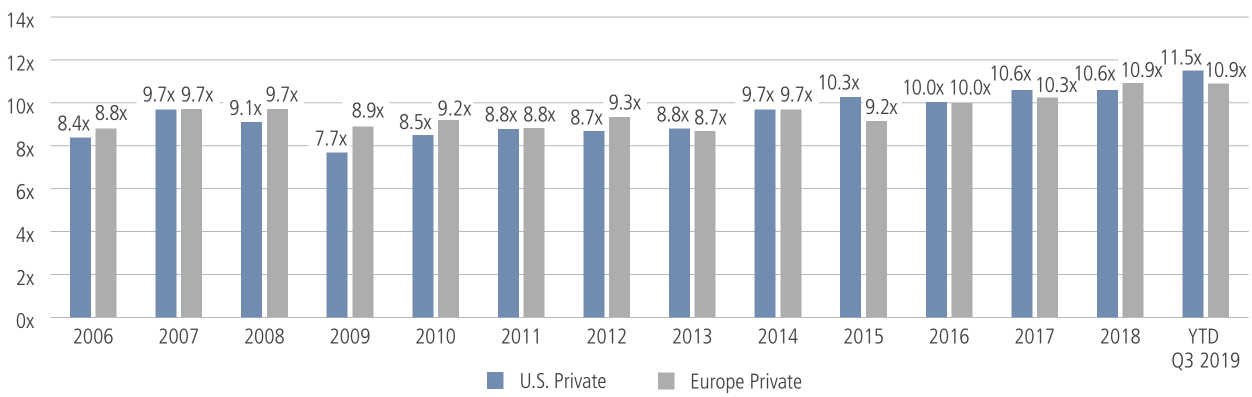
These very conditions have led to a highly competitive investment environment, resulting in a continued increase in valuation multiples. In both the U.S. and Europe, PE valuations have steadily appreciated in recent years. In both markets, current valuations are at peak levels and above those observed in 2007 (Figure 6).[2] This said, private market valuations, notably in the U.S., remain below public market valuations.

FIGURE 5: GLOBAL PE INVESTMENT ACTIVITY



Source: PitchBook. Data as of September 30, 2019; excludes venture capital.

FIGURE 6: U.S. AND EU PE VALUATIONS



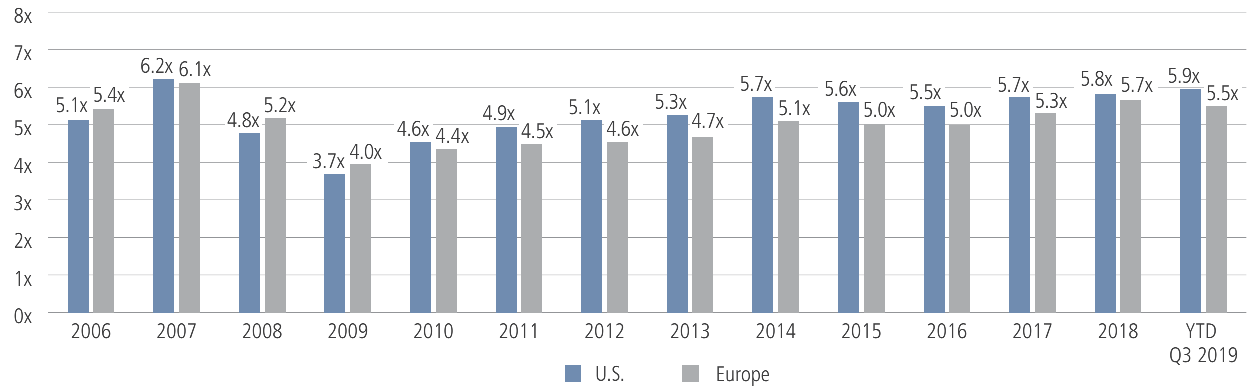
Source: *S&P Leveraged Buyout Quarterly Review,* Q3 2019. Valuations represent EV/EBITDA multiples.

Financing conditions have been relatively benign for a number of years now. In general, financing levels for leveraged buyouts were supported by an accommodating lending policy by banks and direct lenders, offering a high quantum of financing capital at attractive interest rates coupled with borrower-friendly terms (see Figure 7). Flexible structures and covenant-lite terms have become commonplace: Roughly 85% of all institutional loans underwritten in 2018 were covenant-lite loans.[3] We have also seen an emergence of alternative private lenders, who have added to the competitiveness of the financing markets. Although leverage levels

[1] Source: PitchBook.
[2] Source: *S&P Leverage Buyout Review.*
[3] Source: S&P Leveraged Commentary Data, Q3 2019.

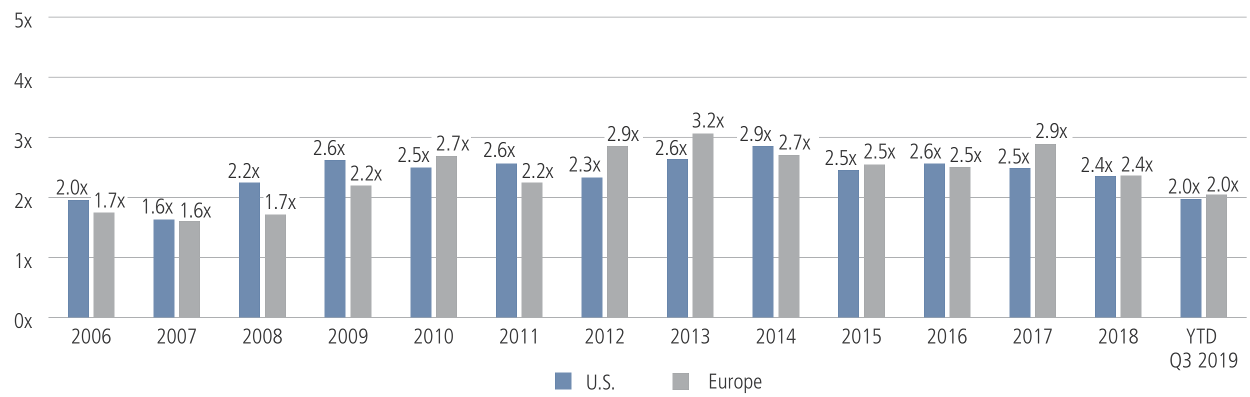
have steadily increased, they remain below the last peak of the market in 2006–07, and debt affordability, measured by fixed charge coverage ratios, is well above the levels seen pre-crisis (see Figure 8). In addition, a key feature of post-global financial crisis buyouts is the relatively higher equity contributions in the total sources of funds—about 40–45% versus about 33% in 2005–2007—providing a higher level of cushion to lenders, and also resulting in a larger need for co-investment capital.

FIGURE 7: LEVERAGE LEVELS IN PE BUYOUTS



Source: *S&P Leveraged Buyout Quarterly Review,* Q3 2019. Leverage levels represent debt/EBITDA ratios.

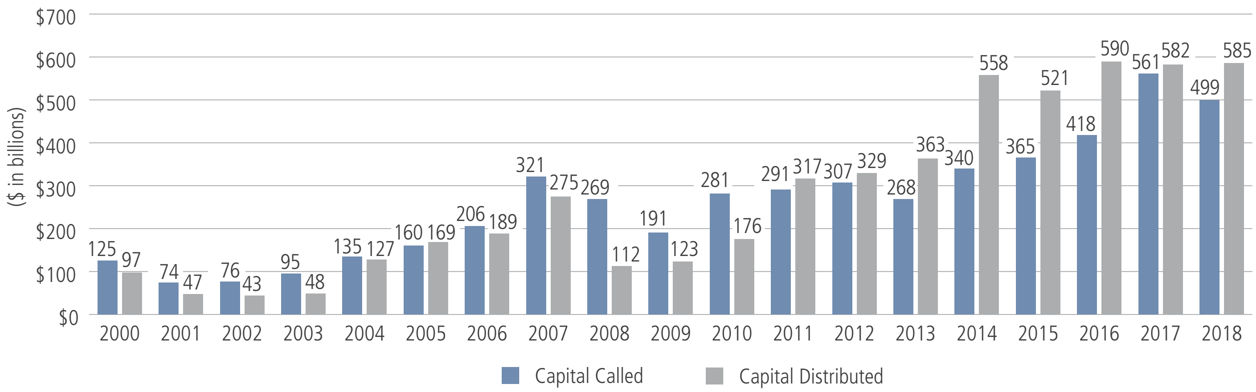
FIGURE 8: INTEREST COVERAGE RATIOS



Source: *S&P Leveraged Buyout Quarterly Review,* Q3 2019. Interest Coverage levels represent EBITDA – capex/interest ratios.

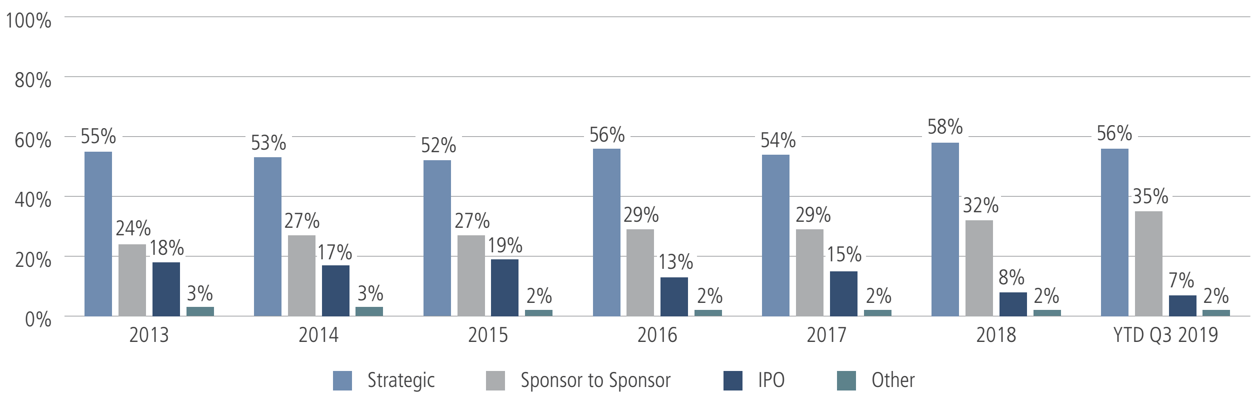
Realizations of PE investments have been attractive as well. The industry achieved outsized exit realizations from 2014 to 2018—by far the largest five-year total on record at $2 trillion—and PE firms seem on track to produce similarly high exit levels in 2019. For the past eight years, distributions of cash realizations back to investors have consistently exceeded contributions to fund new investments (see Figure 9). The median holding period of investments by PE managers stands at roughly 4.5 years, down from a peak of around six years in 2014. Healthy corporate balance sheets continued to drive strong interest from strategic investors for M&A. Sales to these strategic buyers continue to account for the greatest proportion of exits. Meanwhile, sponsor-to-sponsor exits turned in their third strongest year for the industry in 2018 at $1.2 billion (only behind 2007 and 2017), while the value of IPOs has dropped since the second half of 2018 amid continued market uncertainty and higher volatility (see Figure 10).

FIGURE 9: PE CASH CONTRIBUTIONS AND DISTRIBUTIONS ACTIVITY



Source: Preqin.

FIGURE 10: PE EXITS BREAKDOWN



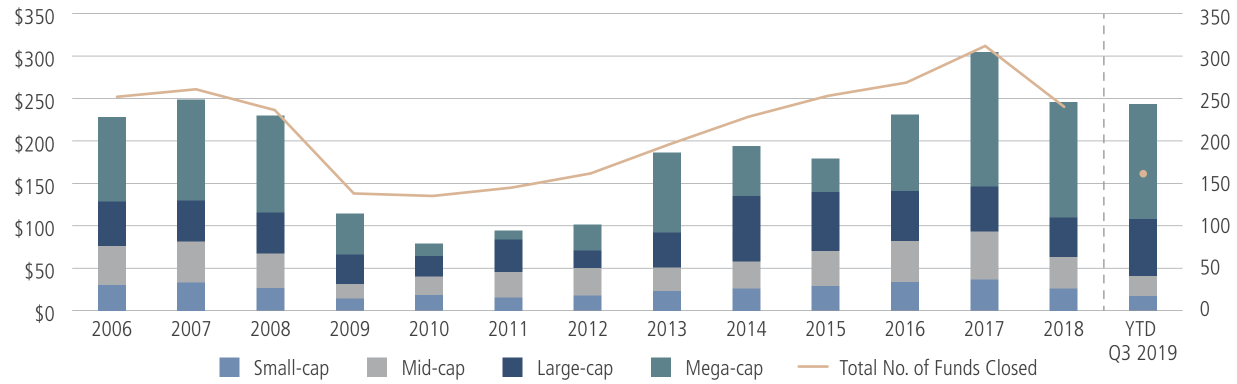
Source: Preqin Buyout Deals Analyst.

On the fundraising front, PE markets have remained upbeat after 2017's recordbreaking activity levels. 2018 was the second strongest year for fundraising in a decade, and as of November 2019, U.S. fundraising efforts had already bested their 2017 all-time-high levels (see Figure 11). The strength of the fundraising market was conducive to recordbreaking fund sizes, attained by many well-established high-quality PE firms. In addition, we have seen a number of new fund offerings enter the market, notably through team spinouts, strategy adjacencies and emerging managers. Several factors have worked in tandem to sustain these high fundraising levels. Long-term PE returns have been positive for all "mature" vintages and have continued to materially outperform public markets, reinforcing investor confidence. PE distributions generally exceeding contributions over the last decade have exacerbated investors' need to redeploy capital in the asset class. Finally, many investors with scheduled liabilities have continued to shift their strategic allocation toward the PE asset class as a means to overcome and compensate for lower yields in their traditional fixed income portfolios.

All this interest in PE has resulted in an accumulation of so-called "dry powder" available for new investments. While such dry powder—or uninvested capital available for new investments—has increased steadily, investment activity has also accelerated, as there have been plenty of opportunities requiring capital. When measured relative to the historical investment pace over the past five years, "dry powder on hand" has actually stayed range-bound at three to four years' worth of investments, and well within the typical four- to six-year investment period of a PE fund (see Figure 12).

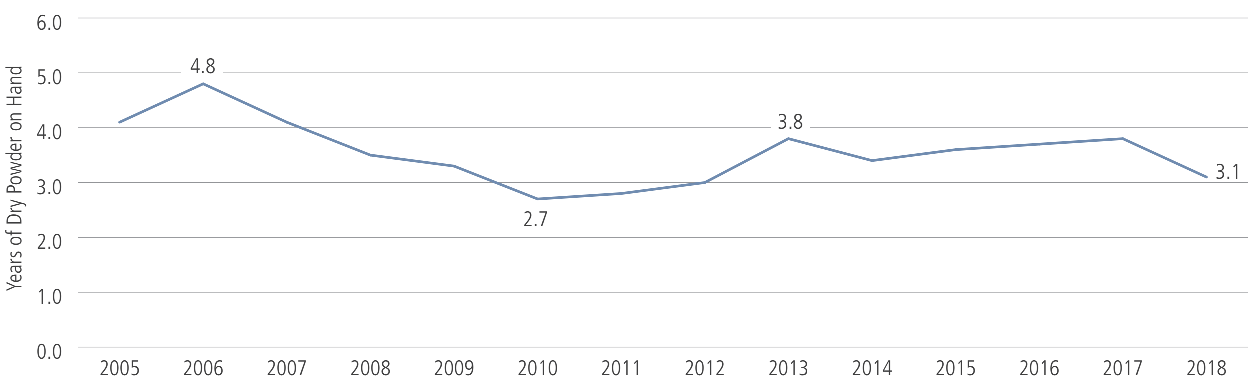
As for the leading investors in the asset class, they continue to be pension funds, insurance companies, sovereign wealth funds, asset managers, family offices and other institutional investors; however, in the future, we believe PE to become more mainstream and open to non-institutional investors, subject to regulatory hurdles being alleviated.

FIGURE 11: FUNDRAISING ACTIVITY



Source: Preqin. Data as of September 30, 2019. Represents global buyout funds raised. Small-cap <$500 million. Mid-cap $501 million – $1,500 million. Large-cap $1,501 million – $4.5 billion. Mega > $4.5 billion.

FIGURE 12: DRY POWDER ON HAND



Source: PitchBook. Data as of December 31, 2018.

Co-investments: A Capital-Efficient Way to Invest in Private Equity

In just a few years, co-invest deals have evolved from a fringe activity of PE investing to a widespread one, making up an increasingly large share of overall PE volumes. For investors, co-investments often possess the advantage of no associated management fees or carried interest and are normally fully funded soon after commitment, thereby providing a more efficient way to deploy capital. Meanwhile, PE firms leverage co-investors' capital to complete larger transactions without resorting to "clubbing" with a competitor, and to extend and enhance relationships with limited partners (LPs).

The competitive landscape has changed significantly for co-investments since the global financial crisis of 2008. We believe that several categories of co-investors such as banks and hedge funds are no longer significantly active, and we have noticed an increase in the popularity of co-investments among LPs. Co-investment participation tends to be concentrated among LPs of a particular PE firm.

However, there is a wide divergence of resources, processes, relationships and experience observed among them. Many LPs are often only willing to participate in syndication rounds after the closing of a transaction or are only able to invest relatively small amounts of capital in relation to the overall co-investment equity needed to complete the deal. "GP club deals" have become less prevalent in the market and PE firms are instead offering more co-investments in response to LPs' stated desire for co-investments. Continued robust global buyout volumes and the aforementioned higher equity capitalization in LBOs also bode well for the continued generation of co-investment opportunities.

Overall, we believe that co-investments can meaningfully improve fee and capital efficiency in a portfolio, offering direct exposure at the portfolio company level alongside the lead PE sponsor. With shorter deployment periods, co-investments can be used by investors to express their views of the market cycle in a more immediate way and to allocate capital more tactically across sectors, geographies, strategies and PE sponsors. For that same reason, co-investments require extensive due diligence and deep industry expertise to properly evaluate the opportunities they represent.

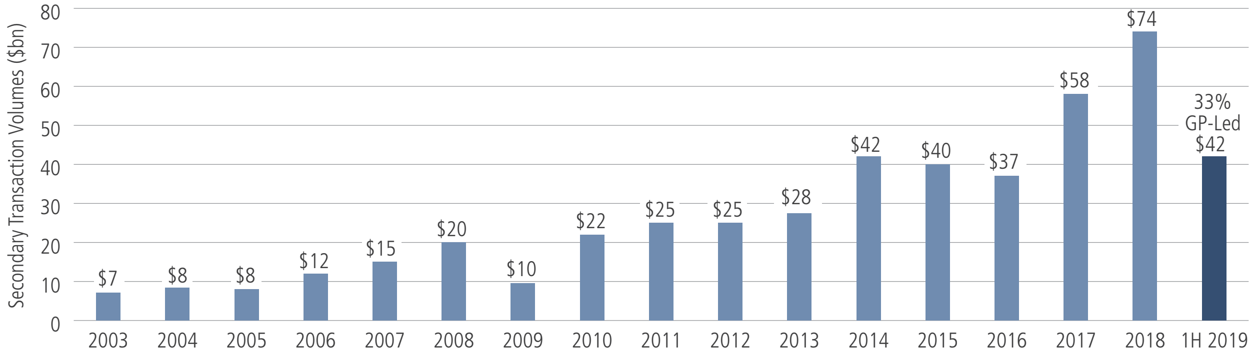
Secondaries: An Expanding Market, Propelled by the Rise of GP-Led Transactions

Another segment of the PE universe that has become more sophisticated in recent years is the LP secondary market, which has evolved from a source of liquidity for distressed LPs into a widely accepted LP portfolio management tool, as evidenced by secondary market volume growth from $20 billion in 2008 to $74 billion in 2018 (see Figure 13).

The advantages for investors are compelling. Since the majority of secondary assets are already substantially invested, their addition to a portfolio can increase the rate at which capital is deployed and materially reduce "blind pool risk," as there is visibility on a substantial portion of the assets in the fund. An added diversification benefit exists because, unlike primaries and co-investments, secondaries can add exposure to PE funds that began investing in portfolio companies years earlier. Since most of the assets acquired in secondary transactions have been owned by the PE fund for a number of years, this results in a shorter holding period than if investors had obtained exposure to the same companies at the original investment date. This faster payback increases the receipt of proceeds from the sponsors early on and may enhance the internal rate of return (IRR) early in the fund's life.

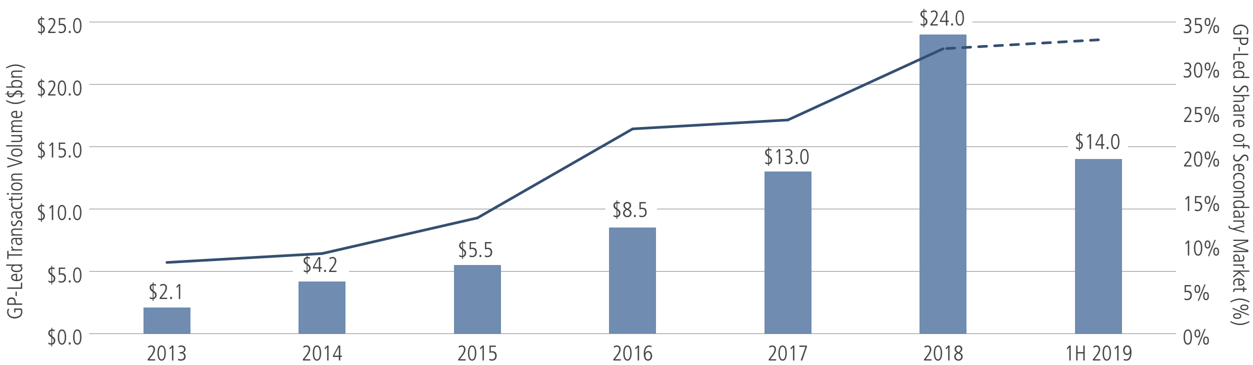
While portfolio management, regulatory pressure and liquidity needs have historically been the largest catalysts for LPs to sell their PE interests, the GP-led secondary market has been increasingly taking market share. GP-led transactions such as fund restructurings, LP tenders or team lift-outs generally seek to offer liquidity to existing LPs, create new investable capital for the PE firm, reset sponsor incentives, and provide time and capital to maximize value in the remaining assets for remaining LPs, new secondary investors and the PE sponsors. These transactions have grown from 7% of the market in 2013 to approximately 32% of the secondary volume in 2018 (see Figure 14). Growth has stemmed from lengthened fund duration and the overhang of illiquid unrealized value, which has led to investor fatigue. Responding to mounting pressure from LPs, PE firms are partnering with experienced secondary investors to provide a comprehensive, structured liquidity option to all LPs in order to manage complex duration and liquidity issues. These transactions are often highly structured and can afford better alignment of interests between the PE firm and secondary buyers. Secondary buyers can also benefit from more targeted asset selection and less competition for these types of transactions due to their complexity. Finally, valuations across the secondary industry remain full, at 95% of Net Asset Value (NAV) for buyout funds as of mid-2019, and expectations for GP-led transactions are higher due to the factors mentioned above. We believe the strong fundraising market for PE over the last decade should continue to fuel both LP- and GP-led secondary deal flow for many years to come.

FIGURE 13: SECONDARY MARKET ACTIVITY



Source: Greenhill Cogent. Data as of August 2019.

FIGURE 14: GP-LED SECONDARY MARKET VOLUME



Source: Greenhill Cogent. Data as of August 2019.

Conclusion

We maintain a positive outlook on PE investing given its unique structural advantages vis-à-vis other asset classes. PE's long-term-oriented nature encourages an investment and value creation approach that looks through and withstands the cycle. However, current market conditions require an "extra cautious" discipline in portfolio construction and careful selection of investments. PE is an asset class renowned for being difficult to time, given fund structures and the capital deployment deferral over a multiyear period. A measured commitment pace and partnership with the industry's most experienced groups, with distinct sourcing networks, skilled professionals and deep resources, will remain paramount to successful investing in the asset class in the years ahead.

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