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Private Equity in the Economic Headwinds

The economy and markets are beset with headwinds, and private equity assets are unlikely to be impervious. Concerns are wide-ranging, from difficult financing conditions to rising interest rates, squeezed corporate margins and closed exit routes.

Given these concerns, we took a detailed look at the conditions around the four key stages of a private equity investment's life cycle: sourcing opportunities, financing the purchase, managing and adding value to the business, and selling it.

We conclude that private equity is in better shape to weather the conditions than many appear to recognize.

On the face of it, there are challenges at each of the four stages of sourcing, financing, managing and selling private investments.

The market in mergers and acquisitions (M&A), a key indicator of the abundance of deals, is quiet. Interest rates are rising and credit spreads are widening, making debt financing more expensive—and that's if you can find debt financing, as the syndicated loan market appears to be completely closed. The economic backdrop is increasingly challenging for all businesses: higher input and labor costs are squeezing margins, and debt financing is more expensive. And the market for Initial Public Offerings (IPOs), an important exit route for those wanting to sell mature companies, is closed.

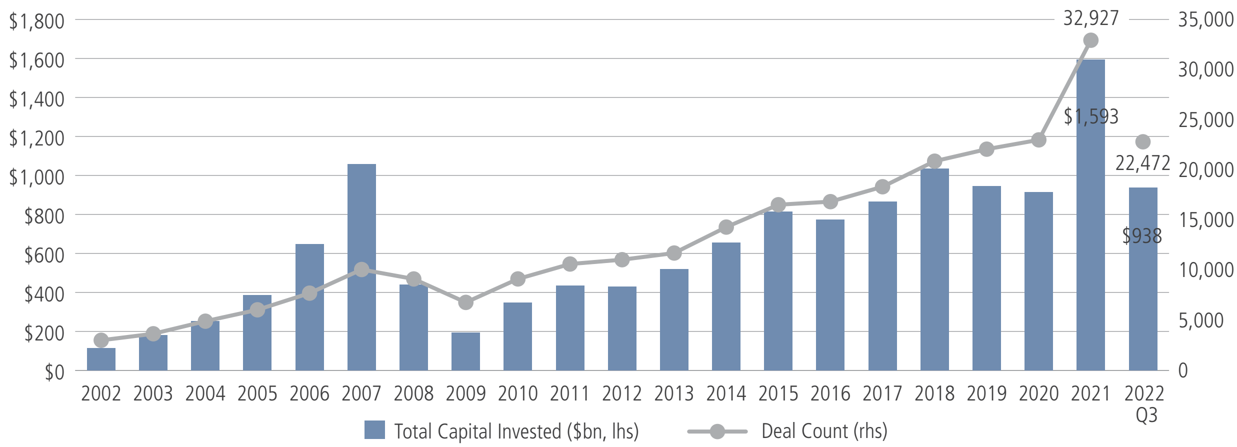
But let's take a closer look.

Sourcing Opportunities and Deals

Global private equity deal activity has slowed in 2022, and continued market volatility and any worsening of the economic outlook could curtail it further (figure 1). That said, the first three quarters saw a run rate that is 80% as high as that for the full year 2021 and, as the chart suggests, 2021 was an extraordinarily busy year as the industry got back to work following the disruption of the pandemic.

FIGURE 1. DEAL ACTIVITY HAS SLOWED IN 2022

Global private equity capital invested and deal count



Source: PitchBook. Data as of Q3 2022. Includes buyout, late-stage venture and growth equity. Includes completed deals only.

While M&A activity has dropped as the economic and market outlook has darkened, deals are still being done—arguably more than one might expect at this stage of the cycle, and some of them sizable. We would anticipate a meaningful pick-up in opportunities as companies sell off divisions in order to slim down, cut costs and focus their activities.

This year's slowdown has already brought public equity valuations down to levels that are attractive to private equity buyers that we see sitting on substantial amounts of "dry powder"—investor commitments that are yet to be invested. Further market weakness would also be likely to force more sales from distressed sellers of businesses. We also think it could accelerate a long-running trend for aging owners to sell their family businesses, as younger potential inheritors decide against the punishing grind of managing a company through tougher times.

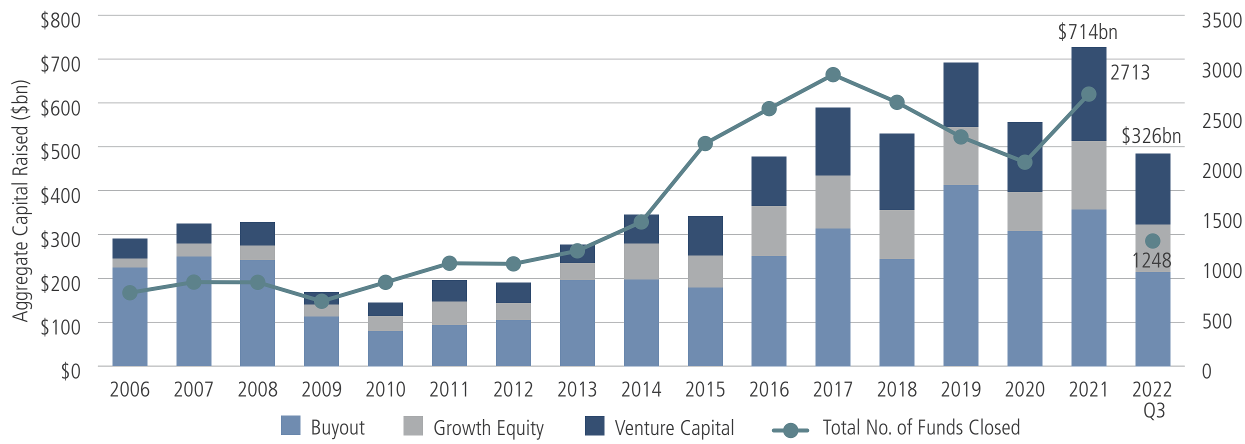
In addition to this potential pick-up in corporate and public-to-private opportunities, it's worth remembering that around a third of today's private equity transactions are sponsor-to-sponsor deals. We believe private equity firms will remain willing to buy and sell from one another as long as the price is right.

Financing

Willingness to transact is one thing. The financing to do so is another.

The main components of any transaction are equity and debt. Equity financing comes from the capital raised by private equity managers directly from investors. Fundraising has achieved a respectable run rate in the first three quarters of 2022, by historical standards, but it was down on 2021 and is likely facing headwinds into the end of the year (figure 2).

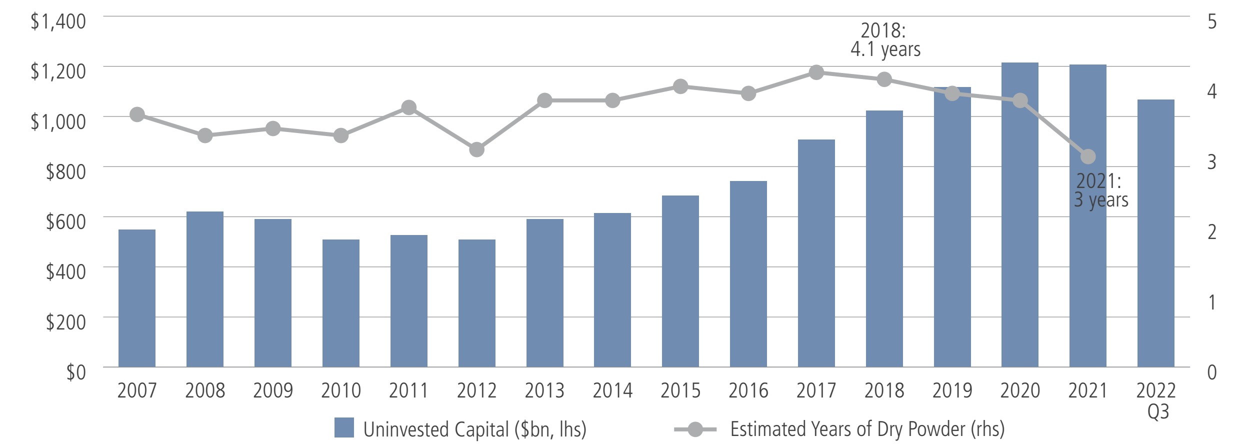
FIGURE 2. THE PRIVATE EQUITY INDUSTRY IS RAISING LESS CAPITAL
Fundraising by private equity sector



Source: Preqin. Data as of Q3 2022.

That said, the private equity industry is still sitting on more than a trillion dollars' worth of uninvested capital commitments, according to PitchBook data, close to an all-time high (figure 3). According to PitchBook's modelling, it is likely to take three years to invest this dry powder, down from more than four years in 2018. The model is based on deployment over the preceding three years, however, and is therefore skewed by the frenetic pace of investment in 2021 (figure 1). Overall, there appears to be more than enough dry powder to balance out a slowdown in fundraising.

FIGURE 3. DRY POWDER IS HIGH, BUT COULD BE DEPLOYED QUICKLY
Private equity capital raised but not yet invested



Source: PitchBook. Data as of 2022 Q3. Uninvested capital excludes energy, venture capital, real estate and co-investments. Estimated years of dry powder is for North American and European funds only, and is modelled on the preceding three years' activity.

How much equity capital will be required to complete transactions over the next few years? With potentially lower availability and higher costs for debt financing, will investors need to deploy significantly more of that equity dry powder for each transaction? We don't believe so.

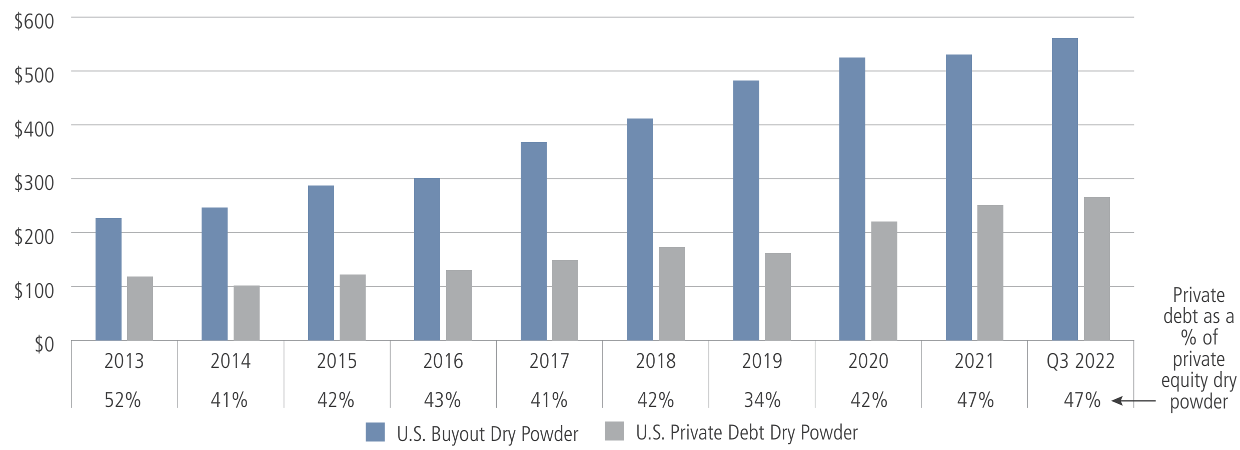
First, private equity leverage has not been excessive since the Global Financial Crisis. According to S&P Capital IQ Leveraged Commentary & Data (LCD), the average deal was geared at 5.7 times earnings in 2014, and 6.8 times in the third quarter of 2022; the average equity cushion was 37% of enterprise value in 2014 and 45% in the third quarter of 2022. We do not believe leverage multiples need to correct downward substantially.

Second, while banks have pulled away from the syndicated loan market, the impact on the broad private equity ecosystem is limited. Banks, unable to syndicate debt commitments to the market, have withdrawn after incurring severe mark-to-market losses on loans made at the recent top of the cycle, and in the pre-2008 private equity world this would have meant a big shortage of debt financing. Today, however, bank loans are mainly used to fund a small number of very large transactions.

Instead, approximately 85% of private equity lending now comes from long-term sources of capital such as private debt funds. There may be a lot of private equity dry powder ready to deploy, but private debt fundraising has more than kept pace with it over the past decade (figure 4). Private debt fundraising appears to have moderated a little in recent months, driven primarily by dwindling retail demand, but the impact has largely been at the margins; the very few direct-lending players that could write $1bn-plus checks are now tending to hold smaller amounts, which means that new deals are almost always club deals rather than being anchored by a single large lender.

FIGURE 4. NO SHORTAGE OF CAPITAL FOR DEBT FINANCING

Private debt and private equity dry power



Source: Preqin. Data as of Q3 2022.

Private debt funds are still prepared to provide long-term capital if they can get a double-digit yield from a high-quality private company. Indeed, we regard direct lending—and other, more complex "capital solutions," such as the provision of preferred stock to companies that need to bridge a financing gap between their debt and equity—as an attractive source of potential opportunity in the current environment.

In short, the cost of debt and debt-like intermediate capital is likely to rise over the coming years, but we do not think availability will be an issue.

Managing and Adding Value

Current conditions are making it difficult for many businesses to keep costs low, maintain their pricing power and sustain their margins. For the first time in a long while, management has to contend with the cost of inputs and labor going up at the same time as the cost of debt interest repayments.

The industry has changed a lot since it experienced these conditions in the 1980s and '90s, however.

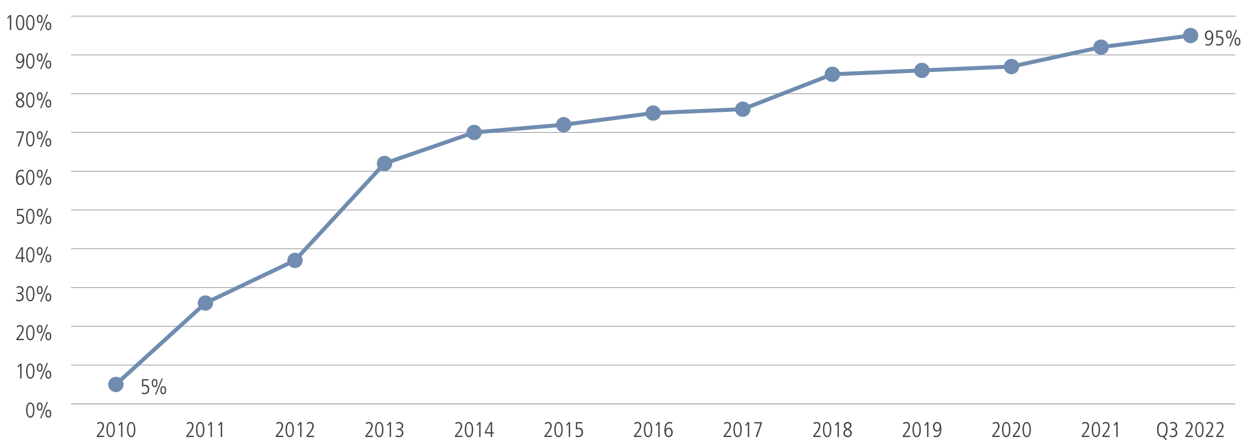
Back then, the large buyout (LBO) strategy was essentially focused on buying companies cheap, leveraging them with debt financing (with interest taxed at a favorable rate), and waiting for the valuation multiple to rise with the market. The target companies also tended to be more asset-intensive, cyclical businesses in the industrial sectors.

Today, target companies tend to be less asset-intensive and more technology- and knowledge-intensive. As the modest and stable leverage levels of the past decade suggest, there is also much less reliance on debt and a greater focus on improving business fundamentals. The private equity industry has invested heavily in building what are effectively outsourced management teams—professionals with skills and experience drawn from the industries in which they now invest, who are able to move into companies with strategic initiatives that can quickly add value to the bottom line. This hands-on approach fits well with some of the natural advantages of the private equity business model, where majority or sole ownership makes it easier to share ideas between portfolio companies and change management strategy or personnel, and where unparalleled, real-time transparency into cash flows is paired with the flexibility to ignore short-term volatility and focus on the long-term plan.

That flexibility has been enhanced over the past decade by the rise in "covenant-lite" debt financing for larger issuers. These are loans that forego some of the conditional terms that used to come with traditional lending: notably the requirement for borrowers to maintain specific financial ratios (such as leverage or interest coverage ratios). Most lenders now recognize that it's better to conduct more thorough upfront credit analysis than risk relying on debt covenants should things go wrong. Covenants can be counterproductive when business conditions become difficult, as they can make unnecessary demands on cash, time and attentions, or restrict management's ability to act.

FIGURE 5. THE RISE OF "COV-LITE" LENDING

Proportion of debt issuance categorized as "covenant-lite"



Source: PitchBook LCD. Data as of Q3 2022.

The overall impact of these developments in the private equity industry has been to make performance less cyclical and less dependent on multiple expansion—and therefore less sensitive to market sentiment.

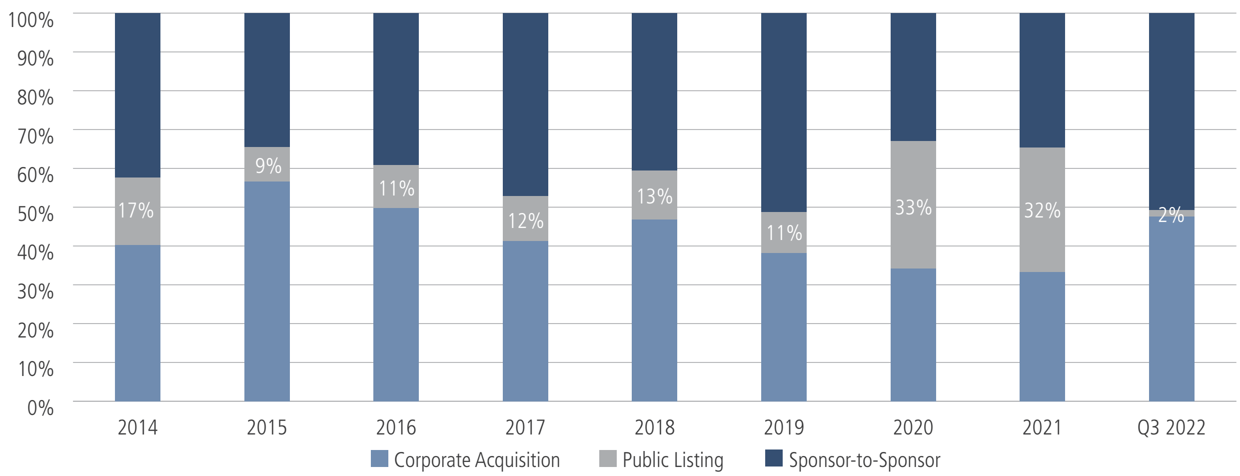
Exiting

As figure 6 suggests, there have been very few IPO exits for private equity deals so far this year. By the third quarter of 2022, that market was almost completely closed. When it re-opens after quiet periods, it typically does so only for high-quality companies offered at attractive valuations.

However, figure 6 also suggests that private equity investors worked hard to execute a number of exits last year, ahead of the downturn, when markets were still absorbing growth-oriented businesses at high valuations. Where portfolio businesses still need to be sold to return cash to investors, figure 6 indicates that corporate strategic buyers and other private equity funds remain open to new acquisitions.

FIGURE 6. WHILE THE IPO MARKET HAS CLOSED IN 2022…

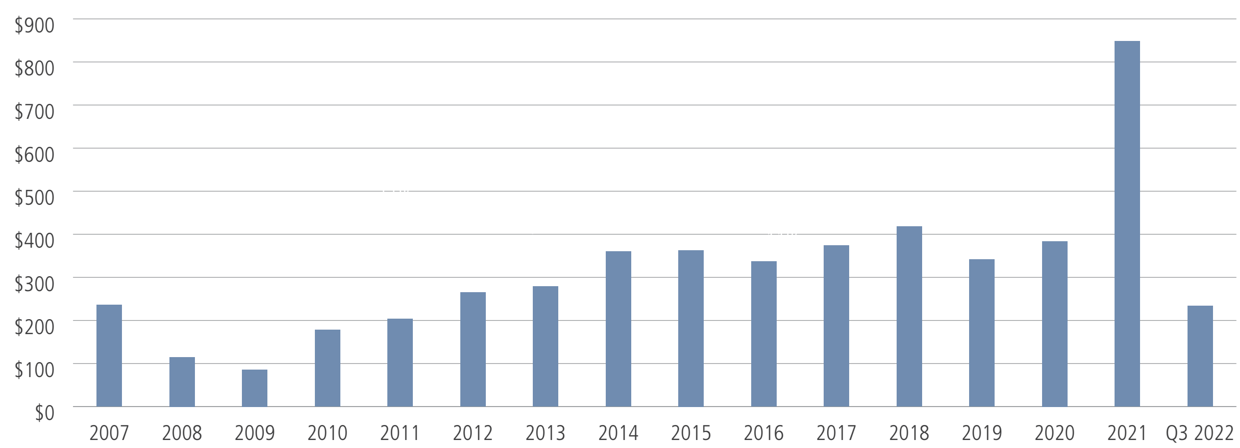
Proportion of the total dollar value of U.S. private equity exits



Source: PitchBook LCD. Data as of Q3 2022.

… MANY PRIVATE EQUITY INVESTORS GOT THEIR EXITS IN EARLY LAST YEAR

Total value of U.S. private equity exits, $bn



Source: PitchBook. Data as of Q3 2022.

Many of the remaining mature portfolio assets are high-quality companies that investors deliberately wish to hold onto through tougher times. Some are being carried over into "continuation funds," where current and new investors can maintain or gain exposure. Along with credit and capital solutions, we believe these continuation funds and other General Partner-led secondary transactions could present attractive opportunities for buyers of assets over the coming year.

In short, while we believe valuations are likely to decline from the peaks they reached at the beginning of 2022, there are willing buyers for mature assets—and, as we have seen, many will have the dry powder and access to financing required to complete those deals.

Well-Equipped to Weather the Conditions

There is a longstanding case for including private equity in a diversified portfolio throughout a cycle. Portfolio companies tend to be faster-growing than their public-listed peers and available at more attractive valuation multiples. Their governance model tends to give them flexibility and make them more responsive to the direction of skilled and engaged owners, and less subject to short-term market sentiment. Unlike many public equity portfolio managers, who must pay attention to the broad market benchmarks, private equity managers can focus on sectors where they have expertise and ignore those where they have no advantage or believe there are headwinds.

Does private equity face difficulties now, as the economic cycle turns? Yes—but the same is true for most asset classes. We would argue that these difficulties are overstated for private equity, and that the natural advantages described above become even more advantageous when the headwinds strengthen. It is notable that, in previous downturns, valuations for existing private equity investments have tended to fall only around half as much as those for public equity. In the meantime, new vintages will be putting freshly raised capital to work over the next four or five years, potentially taking advantage of lower acquisition valuations as we go through tougher economic times.

If you are already a private equity investor, we believe it is risky to turn away now and potentially miss out on future fundraising by the industry's best firms. And if you are new to the asset class, you may be investing just as the industry is deploying its skills to the fullest, in a buyers' market of declining valuations.

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