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# Private Markets in Volatile Times

## Recent market turbulence provides yet another example of how private equity managers have improved their ability to weather volatile conditions.

After a series of scares and hurried rescues in the banking system, the effects of the Silicon Valley Bank (SVB) collapse and related events continue to reverberate throughout the financial system. Although financial markets have seemingly calmed down, sticky inflation and other macro headwinds are driving uncertainty. Meanwhile, central banks' task of fighting inflation without undue damage to the economy and jobs has become more complex as they seek to maintain stability in the banking system.

For private equity and venture capital, banking worries were immediate. Many of these firms were clients of regional banks, which, at the firm and portfolio company levels, held their deposits, lines of credit and capital call facilities. Amid fears of a "run on the bank" at certain institutions, private equity and venture capital firms were instrumental in helping to swiftly identify exposures, provide liquidity and contingency plans, if needed, and expand access to banking relationships.

Although it's tempting to draw parallels to the financial crisis of 2008, we think there are important distinctions. Fifteen years ago, problems revolved around system-wide exposure to bad assets and a lack of capital reserves to withstand a liquidity crunch. In this case, banks are much better capitalized due to regulatory reforms. Moreover, the coordinated actions of policymakers and regulators have been effective—which we believe has made it easier to restore confidence in the financial system. However, whether we are out of the woods yet is unclear.

In light of ongoing uncertainty, it makes sense to consider the characteristics of private market investments, in terms of their ability to weather market storms and to add value when public counterparts may be challenged. In this *Insights,* we talk about some of these attributes, how private investments have changed, and how broader economic and market trends have affected opportunities in the asset class.

## KEY OBSERVATIONS[1]

- The impact of volatility is generally more muted for private markets than for public counterparts.
- Managers are highly adaptable and able to provide liquidity to companies in difficult times, and have a long-term orientation that helps them ride out the storm.
- Return generation is now largely oriented to a sponsor's ability to transform and grow a company rather than to financial engineering.
- Private credit is a key part of private markets' evolution, as direct lenders provide additional access to capital.
- General partners are increasingly using the GP-led secondary market to provide liquidity options to limited partners, who welcome distributions when exits have slowed and some are overexposed to the asset class.
- We view private equity as an all-weather, strategic asset class; however, periods of volatility have traditionally produced better-performing vintages for investors.

## Private Markets: Resilient in Volatility

Although private markets are not impervious to market challenges, the impact of volatility can be more muted, as they tend to reflect longer-term views. Capital is locked up, fire sales are rare, and in turbulent times, sellers can simply hold onto assets for longer.

The current climate is instructive. Determining private equity valuations requires multiple inputs, including comparisons to public companies and discounted cash flow models, but there has recently been a greater emphasis on comparable private market transactions as well as operating performance. In our experience, many existing private equity investments have not been marked down despite a slowing economy and higher interest rates. This is because deal flow has been slower with only the highest-quality assets being sold, most of which buyers believe still warrant a full price. In addition, operating performance of many private equity-backed companies has held up surprisingly well, with many still growing.

Importantly, private equity managers are capable of being highly adaptable. Many can be quicker than public counterparts to manage costs, conserve cash, change management or inject equity into portfolio companies. Private firms also tend to have ready access to capital in turbulent times, so they can inject more equity into businesses that may be temporarily affected by economic or market volatility.

This resilience is evident in historical performance data. In a white paper published in December 2022, we compared peak-to-trough valuations of public and private markets in the 2007 – 2009 Global Financial Crisis (GFC) and 2020 COVID-related market events. Overall, we found that private equity valuation declines generally happened on a lag and were less severe with shorter recovery times. Last year's results reinforce this view: While public markets fell about 20%, private equity buyout valuations, based on our estimates, were flat.[2] The impact of any slight multiple correction in sponsor valuation models was essentially offset by underlying company growth.

## Evolution of an Asset Class

Private equity firms have learned many lessons from the events of 2008, which have driven meaningful transformation for the asset class. Sponsors have invested heavily in resources to navigate turbulent markets and economies, the results of which were evident during the COVID-19 pandemic. At that time, when public markets were falling and liquidity was seizing up, private equity firms often took decisive action around their businesses and portfolio companies, helping to insulate them from uncertainty and the potential unknown duration of the pandemic.

[1] Based on NB Private Markets analysis and observations as of May 1, 2023.

[2] Data as of April 3, 2023, based on NB Private Markets analysis. Due to the illiquid nature of many fund investments, any approximation of their value will be based on good-faith determination as to the fair value of those investments. There can be no assurance that these values will equal or approximate the price at which such investments may be sold or otherwise liquidated or disposed of. In particular, the impact of the recent COVID-19 pandemic is likely to lead to adverse impacts on valuations and other financial analyses for current or future periods. **Past performance is no guarantee of future results.**

Private equity managers have also invested heavily in improving operational and non-investment functions, such as investor relations. The value of these improvements was particularly apparent during the recent banking crisis, as we saw sponsors react efficiently to help their firms proactively communicate with investors in real time.

Although standard for public equities, this vast improvement and willingness to provide LPs with transparency is a major shift for private equity, and an example of the evolution of the growth and sophistication of the asset class.

## Evolving Role of Private Credit

A discussion of private-market evolution would not be complete without noting the role of private credit. Essentially non-existent before the GFC, demand for private credit has expanded over the past decade, with an estimated $1.8 trillion now under management across an array of subsectors.[3] We believe this asset class can continue to grow as it presents potentially attractive risk/return for investors moving forward.

Roughly 85% of private equity lending last year came from long-term sources of capital such as private debt funds.[4] This was largely due to a significant pullback in the syndicated loan and high yield markets amid tighter credit conditions. Private players have been able to step in given their ability provide flexible, constructive capital across different-sized companies. However, the volume of private debt activity will likely fall for the largest transactions as the syndicated loan markets recover.

Private equity firms have directly benefited from the rise of this young asset class. As we have seen over the last year, private credit now has the scale to support deals of all sizes and stable funding from long-term investors. We believe it could remain the preferred path of financing for small to midsize businesses, which make up the majority of private equity transactions. These lenders can be more timely, flexible and creative in their financing solutions. In addition, the mindset of most private credit providers is more relationship-oriented than for their bank counterparts, which means they can be more constructive with companies in both good times and bad.

## Current Dynamics: Leverage in Focus

Today, a key challenge for both GPs and LPs is high interest rates, especially when coupled with fears of a potential recession. However, we believe the magnitude of its impact is less than most would expect, as return generation in private equity today is coming more from sponsor-driven improvements in portfolio companies than financial engineering.

In the past, private equity firms often looked to buy low, sell high and lever up company balance sheets to as much as 70% debt.[5] However, today, sponsors often make investments with plans for strategic operational improvements, and have invested heavily in functional tools to achieve them—something that is reflected in the way they underwrite investments. We now often see the following:

- Sponsors underwrite entry/exit at the same (or a lower) multiple.
- Less debt is used as a percentage of the capital structure, often 40 – 50%.[5]
- Add-on mergers and acquisitions are part of the underwriting strategy, and can be highly accretive through lower buy-in purchase price multiples with opportunities for synergies.
- Return potential is largely driven by strategic growth plans and sponsor playbooks focusing on accelerating organic growth and unlocking cash flow.
- An increased focus on companies with more variable cost structures that are often asset-light and with less cyclical businesses.

Our primary focus in environments like this is to make sure that the capital structures are appropriate and that the interest burden is not too heavy for the underlying businesses; the latter should have resilient cash flows so that they can manage the amount of debt that is put on the balance sheet.

[3] Source: Preqin, data through June 2022.
[4] Source: Preqin, data as of Q3 2022
[5] Source: Pitchbook LCD, as of 4Q 2022.

## Strategic and Growing Opportunity

Even with such an emphasis on strategic, long-term return generation, investors may wonder, given recent economic challenges, if now is a good time for private markets. On an absolute basis, funds that have invested most of their dry powder (capital raised by private equity groups that has not yet been deployed) after a market correction have outperformed other vintages.[6] However, we would argue that timing is beside the point. Pinpointing market turns is hard in almost any asset class, but almost impossible in private equity given its long investment timeframes, which sometimes cover multiple economic and market cycles. Importantly, private equity funds have a natural hedge against any specific year, as funds are normally invested over three to five years, insulating investors from annual peaks and troughs.

We would argue that private equity is a strategic asset class, to which investors should maintain exposure in all market environments—although it has the potential to be very opportunistic when circumstances arise.

As mentioned, private equity managers are focused on transforming companies, or rather, what to do with the business after it is purchased. The goal is to accelerate earnings growth, so that even if multiples contract, the investor still has the potential to generate attractive returns.

Private equity firms are also playing offense within their portfolio companies by pursuing accretive M&A. Managers know that, right now, because of more challenging times and volatility, smaller companies are much more open to selling, and may need the resources of a bigger firm. This can create the opportunity for multiple expansion even if a company is sold at the same price as when it was purchased, because the manager's blended buy-in price becomes lower because of the accretive acquisitions.

We are starting to see valuations come down slightly, with potential to decrease further, but we believe this likely will not occur until broader dealmaking activity further rebounds. That said, we do not expect a significant correction in private valuations for new transactions given that there is over $1 trillion[7] in dry powder. Given the contrasting reset in public equity valuations, we believe there are still compelling opportunities for larger-scale private equity managers in "take-private" transactions. The acquired companies can benefit from the sponsor transformation plans, which take time to implement and are hard to execute given quarterly disclosure demands in the public market context.

## Demand for Liquidity Is Driving Opportunity

The recent market volatility, bank scare and other macro events have contributed to public market weakness over the past 15 months, causing some investors to experience the so-called denominator effect. This phenomenon occurs when there is overexposure to private equity because marks in the asset class have not come down while public marks have, causing some LPs to be over their targeted private equity allocations. Moreover, deal flow has slowed from record 2021 levels, which has resulted in slower distributions in the asset class, albeit still in line with historical pre-COVID levels.

These dynamics have helped continue the growth of the GP-led secondary market, which has grown from $2 billion to $52 billion over the last decade.[8] Given the challenging exit environment, GPs are hesitant to sell a company today if they believe the market will not support a full valuation for an asset, while simultaneously facing demand to provide capital back to LPs. By selling a secondary partner a minority stake of the portfolio company, GPs can maintain control and continue to create value by executing on their operational plans. In other words, the GP-led secondary market has helped private equity firms not only provide liquidity to their investors, but also gives them the ability to extend holds on assets that may take longer to mature or maximize their value than a fund's set term.

[6] Source: NB Private Markets analysis, Burgiss and PitchBook data as of December 2022.
[7] Source: PitchBook. Data as of 3Q 2022, which is the latest available. Excludes energy, venture capital, real estate and co-investments.
[8] Source: Jefferies. Data as of January 2023.

## Conclusion

To close, we believe that private equity is an all-weather asset class: Strategies derive their returns from buying high-quality businesses, putting in great management, and implementing strategic and operating plans to create value. That said, given recent market volatility, prices are generally somewhat lower than recent market peaks, while capital structures tend to be more conservative, and competition for assets from non-private equity players has been reduced. In terms of tactical opportunities, public-to-private transactions and the GP-led secondary markets stand out to us. In addition, the growth in private debt has emerged as a growing asset class, which in our view is a positive for private equity as another reliable source of financing.

Over the years and across market environments, we have found that volatile environments often provide a favorable backdrop for private investments and can provide the best vintages in private equity. In our view, the industry is well-suited to the task of finding opportunities, and more so than in the past, given lessons learned through past cycles and the reforms and structural improvements that many firms have made to their operations and teams. Although it will be important to be cognizant of ongoing volatility and uncertainty, we think it remains a good time to commit to private markets.

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