The Private Equity of Yesterday, Today and Tomorrow

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Anu Rajakumar: Traditionally, private equity has offered important return potential and diversification benefits that have generally boosted overall portfolio results. Over the past two decades, we've seen more and more companies staying private for longer, and today there are more than twice as many private companies as there are public, but does the private for longer trend have broader implications for investors? And importantly, what does the selloff in public markets, the end of cheap leverage, the rising rate environment, and potential recession risk mean for private equity investors? My name is Anu Rajakumar and joining me today is my colleague Maura Reilly Kennedy, a managing director in private equity here at Neuberger Berman, who's going to share more about the evolution of private equity, its unique characteristics, and how private equity investors are adapting to today's new normal. Maura, thanks for coming on the show.

Maura Reilly Kennedy: I'm thrilled to be here. Thank you for having me.

Anu: So let's start off with a bit of context, Maura, private equity investing has evolved dramatically over the past few decades. Talk us through that evolution of this important segment of the investment opportunity set.

Maura: So yes, we have seen many investors allocating to private equity but to set the stage, private equity is a different industry today than it was in years past. The private equity market has grown dramatically over the last 30 years, and during that same period, as you mentioned, the number of publicly traded companies has declined. And to put it in context, in 1990, the private equity industry was 21 billion or 0.2% of public equity market capitalization of 9 trillion.

But last year, the private equity industry represented 2.3 trillion while the public market cap was up around 100 trillion. Private equity still represents a modest 2% of public market capitalization. So it's still a pretty small industry in comparison. We think the growth was attributable to evolving investor behavior, disruptive innovations, financial disintermediation, and regulatory changes. And we believe this growth will continue in the future as investors are in pursuit of those higher returns. Our colleague Erik Knutzen, the head of Neuberger Berman's multi-asset investment team just published a paper in the June edition of the *Journal of Investing* about the evolution of private equity over the last 30 years, and I encourage listeners to have a read.

Maybe let's address an important question, and that's why. Why has private equity increased in popularity? Why have investors allocated and why will investors continue to allocate to the asset class? The two biggest reasons to include private equity in a portfolio are return potential and diversification benefits. So let's focus on the diversification argument. First is the opportunity set for private equity firms. Private equity firms are playing in a different pond than public investors, and that pond is big and stocked with some great market-leading companies. As I just said, the investible universe on the public side is shrinking while the investible universe on the private side has continued to grow. Many companies today are staying private for longer periods of time before deciding to go public, if they do so at all. And this private for longer trend has some significant implications for the market and for investors. If we put some numbers around it, private equity makes up about two-thirds of US companies today by number.

What this tells me is that for clients to really get exposure to the US economy, for example, one actually needs to have exposure to private equity because public markets only give them exposure to a part of the US economy. And applying another lens, the median company market capitalization for an S&P 500 company is about 30 billion, for PE it's 400 million. What this further tells me is that the public markets are only giving clients exposure to large cap, and the smallest companies in the public markets are actually some of the largest in the country.

Anu: Terrific. That is an excellent primer. Thank you, Maura. Uh, you know, you spoke a lot about the differences, uh, between public and private markets in terms of size and, you know, market cap exposure. You know, some will argue that in public market investing, just being invested is "good enough". You know, as an active manager here at Neuberger Berman and we tend to disagree with that. Is the just being invested approach something that works in private equity as well?

Maura: So, no is this short answer. Um, and I'm sure many of our listeners have seen the public versus private market return data before, but I'll just summarize. So based on data from Burgiss over any reasonable period of time, the private equity pooled index has outperformed the public markets by 450 to 850 basis points depending on the time period. So the past 5 years, 10 years, 15 years or 20 years. Important to know that even with increased competition and capital flowing into private equity as we just discussed, the returns have been stable and even increasing over the last 15 years.

And to note, the first quartile of funds in the Burgiss index has significantly outperformed the public markets by 1,500 to over 20,000 basis points over that same historical time period. Of course, we know that past performance is not indicative of future return, but in private equity relative to other asset classes, the dispersion of returns between the top and bottom performers in private equity is huge. The top managers can outperform even the median by a wide margin, so picking the right partner in Private Equity is really important.

Anu: Absolutely. You know, you've spoken a little bit about performance for Private Equity relative to public markets, so maybe turning to the current environment, 2022 has of course been extremely challenging for public equity and public fixed income markets. Talk about how that turmoil translates to Private Equity returns. What tends to happen to Private Equity when we see these massive selloffs in public markets and how should investors be thinking about their Private Equity allocations, if they're concerned about looming recession or, you know, the worst is yet to come?

Maura: So, it's a really interesting and incredibly timely topic, especially because Private Equity marks are on a lag and public market marks are instant. So, my colleagues in Neuberger Berman's institutional solutions team recently published a paper on the historical impact of economic downturns on Private Equity. They analyzed historical Private Equity market performance during three recent periods of market distress to gain perspectives on current conditions. And I'll say that both this paper and Erik Knutzen's paper are available on our website, nb.com.

So we of course recognize that the dynamics behind today's and recent volatility may be quite different from the past. It is important to note that Private Equity is not impervious to market downturns, of course not, but in each of the downturns of the 2000s, the 2007 to 2009 global financial crisis, and the 2020 COVID-related market events, this analysis found that Private Equity historically experienced a less significant drawdown, about 50% of the public market's drawdown, and a quicker recovery than public equities in all three cases.

We also noted a lag in the slowing of capital calls and a more immediate drop in distributions, both of which resumed as the economy and public markets regained their footing. One other thing to add, if you look at the historical vintage year by vintage year analysis of Private Equity returns, the best time to commit to Private Equity is during a downturn so that the Private Equity manager is actually investing out of the downturn. It's almost impossible to time the market in Private Equity, however, so most seasoned Private Equity investors apply a consistent approach to committing to Private Equity annually with the understanding that certain vintage years will perform better than others.

Anu: Great. Thank you very much, Maura. So now, just to focus on how rising rates have been a big concern around valuations, could you speak to current multiple levels in Private Equity?

Maura: So one of our biggest concerns now and-and has been for years really is elevated valuations, entry valuation levels in private equity have risen pretty steadily over the last eight or nine years. And while anecdotally, we're seeing a slight reduction in entry valuations now versus where we were in the beginning of the year, we think that valuation risk still is one of the biggest risks that private equity investors face in today's market.

The private equity index data only goes through Q1 of this year because as I said, private equity valuations are on a lag. And I know the world is different now. Q2 metrics are-are only now being estimated, but to better understand how investors should think about valuation risk and importantly, the future prospects of private equity, we do need to dig a little deeper to understand what's behind the valuation metrics. So private equity firms have been shifting their focus towards higher quality/ higher growth companies.

Firms are investing in faster-growing industries and in companies that tend to warrant higher valuations. In our co-investment business, we are investing about $4 billion per year directly into companies and over the last 18 months or so, we've looked at close to 500 opportunities around the world with hundreds of private equity firms. Five years ago, about 50% of the deals that we did, we underwrote to future top-line growth of 5%.

Now 100% of the businesses we're investing in, we're underwriting growth of over 5%. We are focused on these faster-growing industries that will capitalize on attractive tailwinds. And I would say that while private equity firms are able to hand select quality, the returns that private equity firms and public market investors have enjoyed over the last 10 years may just not be repeatable in the upcoming 10 years.

Anu: Yeah, I'm sure. I think even more of a reason to pick the right partner for your private equity portfolio.

Maura: Yes!

Anu: And maybe just to take that a step further, Maura, how is the current rate environment broadly impacting private equity?

Maura: So as we know, all risk assets have benefited from a decade of easy monetary policy, low-interest rates in moderate inflation and private equity's no exception. At a high level, rising inflation and interest rates impact private equity returns through the same avenues as public equities, reduce valuations as interest rates and therefore discount rates used to value companies rise; and potential margin compression from rising input and debt service costs.

Private equity GPs—because they control private equity companies—have greater flexibility in addressing these challenges through strategic and operational improvements that are less dependent on valuation expansion to drive returns. But maybe, I can share a few takeaways from our research around this topic. First is that, while current interest rates are high, they're low relative to long-term history. Second, while there appears to be a negative correlation between returns and interest rates—think rates up returns down and vice versa—there are many factors that impact historical returns aside from rates, including the 2000 tech bubble, the 2008 global financial crisis, et cetera.

Notably, no vintage year median resulted in capital destruction during those times. In fact, pre-recession time periods think 1996 to 1998 and 2005 to 2007 were the only vintage years that produced single-digit annualized return in the median case. All others produced double-digit in the median case. Third is that vintage year diversification is important. Money put to work in the past few years, amid peak valuations may be challenged in the future. However, history shows that capital raised during recessions produced attractive returns due to the ability to deploy capital into weakness.

Now may be an attractive time to commit and deploy capital and private equity investments. Lastly, private equity has evolved resulting in lower potential sensitivity to interest rates. As I said earlier, today's private equity firms are less dependent on high debt levels and financial engineering and more focus on driving value creation within secular growth companies through strategic and operational improvements that increase that top-line revenue. So though not immune from rates and inflation, this should mitigate the impact of rising rates on balance sheets.

Anu: All right. Thanks very much. So more from your comments so far, um, you've delivered a fairly strong case for private equity, particularly in, uh, challenging markets as these, you know, you've mentioned valuation risks. What are some other main risks that you see within the asset class, and can you also touch on potential barriers to entry?

Maura: So sure. The biggest risk of this asset class is illiquidity. A typical private equity fund investment is held for 10 or more years. And in traditional private equity structures, an investor commits to a private equity fund and their commitment is called over four to five years. And then as the fund sells its portfolio companies, an investor typically receives cash back in the form of distributions starting around year four or five, but those cash flow patterns are pretty unpredictable. But, if an investor can withstand an element of illiquidity and unpredictability, we believe private equity is an attractive addition to a diversified portfolio. But you mentioned barriers to entry and-and maybe I'll speak to the barriers that individual investors have had or reasons they have not typically invested in the asset class. And those barriers include high investment minimums, think $5 million per fund, for example, or high eligibility requirements. One must be a qualified purchaser to invest in private equity. Long lockup periods as I just mentioned of 10, 12 plus years, uncertainty around future cash flows, and K1s that individual investors tend to dislike.

We at Neuberger Berman are focused on the democratization of the private equity asset class and hypersensitive to doing so in a way that offers truly institutional quality, private equity to a broader audience, importantly, not in a way that's watered down. And this means developing structures that are tailored to the individual investor, but with that institutional investment content.

Anu: All right, thanks very much, Maura. Now, as we wrap up with this conversation, share some of your key takeaways that you really want our listeners to walk away with today.

Maura: So it is a hard time to be an investor. I think almost all of us feel that sentiment in one way or another. Specific to private equity, I want it to be clear. There's no such thing as a free lunch in private equity anymore, a manager can no longer bank on financial engineering or multiple expansion from entry to exit to achieve attractive returns. And private equity is not impervious to a market downturn. A potential recession will affect both public and private companies, but the fundamental point that I want to make is that a private equity's ability to add value to the companies they invest in sets private equity apart from other asset classes. This is why we continue to believe in private equity as an asset class. This value creation truly differentiates private equity. Private equity firms have invested heavily in strategic and operating experts and resources to drive revenue growth in their portfolio companies, earnings, and return.

The best firms develop aggressive, strategic and operating plans with their portfolio company management team and provide them guidance and resources to successfully implement on these plans. Think add-on acquisitions, margin improvements, geographic and product expansions, and strategic repositioning. These plans allow private equity firms to create value, not correlated to the market while significantly mitigating valuation risk. And we believe this to be a huge advantage private equity investors have over public market investors. Simply put, if a firm can double the earnings in a company over a four to five-year period, even if exit multiples can contract during that firm's ownership, the investor is still likely to make good returns because of this ability to create value during ownership. As-as you alluded to earlier a new, we have a squeeze in labor markets, tight supply chains, rising inflation, geopolitical tensions, and an ongoing pandemic. And despite the recent volatility in public markets, although we're seeing some cracks, we still see relatively high valuation levels as well.

Maybe I'll just cover a few strategies that we're pursuing at Neuberger Berman. We're focused on our core investment strategy, we're leveraging the strength of Neuberger's private equity platform, and the relationships and deal flows that we have. We're trying cast to a broad net looking for the best opportunities and then being highly selective and investing only in what we believe are the best opportunities. And I'll mention three core themes. First is long-term secular growth trends, investing in companies that we expect to benefit from higher growth rates due to long-term trends in our economy.

The next is to focus on businesses that we expect to have lower cyclicality. These are companies that are more defensive in nature, either from the sectors that they're in or their end markets. And we're also looking to capitalize on complexity or market dislocation. Over the last number of years, we've seen opportunities that were complex and have taken advantage of that complexity. But there have been fewer opportunities for market dislocation. Given what's going on in the public markets, we believe there may be more opportunities for market dislocation opportunities coming up in the near term. And if so, we'll look to invest in those.

Anu: All right. Terrific. Those were very powerful closing comments. I'm going to end our conversation today with our staple bonus question. So, Maura, private equity funds invest in companies that are often founded by entrepreneurs passionate about their business. So outside of your professional life at Neuberger Berman, what is something that you are particularly passionate about?

Maura: I'll tell you that I am passionate for women's rights, and I will share that I recently was a gestational carrier for my sister and her husband. That's something I was passionate enough to do.

Anu: That's lovely. Thank you very much for sharing that. Maura, this has been an enlightening and important conversation about private markets. I'm sure our listeners have very much appreciated your views on private equity as an asset class and hearing about the historical resilience of private equity during challenging environments such as these, as well as hearing about the evolution and democratization of private equity. So Maura, thank you again for joining me today.

Maura: Thank you.

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