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Investment Strategy Update #138

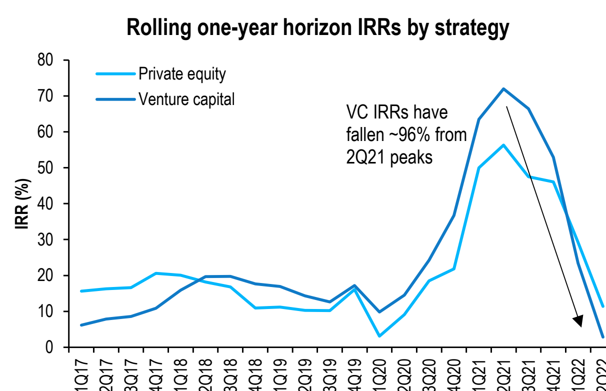
Private Markets: Short term risks but long term appeal remains

- After a 12-year bull run, a dramatic de-rating in public market valuations is now seeping into private markets.
- We expect private equity markets to face near-term headwinds including: 1) lagged valuations pressures; 2) an anaemic exit environment delaying realising returns / prolonging holding periods; and 3) tighter liquidity conditions which will weigh on capital availability and the ability to deploy into new investments.
- While investors should expect some cyclical weakness, private equity markets remain highly differentiated. Managers can still generate alpha through value-creation and transformation of underlying company operations to boost margins and revenue growth without having to rely on multiple expansion.
- Structurally, private markets remain an essential component of a diversified portfolio. For investors who are prepared to give up liquidity, private equity strategies can enhance portfolio returns and access a broader range of sectors (given more companies are staying private for longer), which provide additional diversification benefits to public markets.
- While today's environment could hurt current portfolios and vintages that are nearing exits, managers with capital to deploy can also benefit from the valuation reset. History has shown that funds invested during recessions, have outperformed growth expectations and achieved above average multiple expansion at exit.

Where are the pressure points?

2022 saw an end to the post-GFC era of free and plentiful money that had driven higher valuations for both public and private markets. As a result, private equity (PE) saw its 12-year run of outsized returns also come to an end with PE returns falling -2.4% for 2Q22, and preliminary estimates for 3Q22 suggesting a further -0.6% correction, according to Pitchbook data. Unsurprisingly, late-stage venture capital (VC) funds fared even worse, returning -8.2% over 2Q22, with 3Q22 preliminary returns down a further -4.8%.

Public deratings are flowing through to private equity and venture capital returns



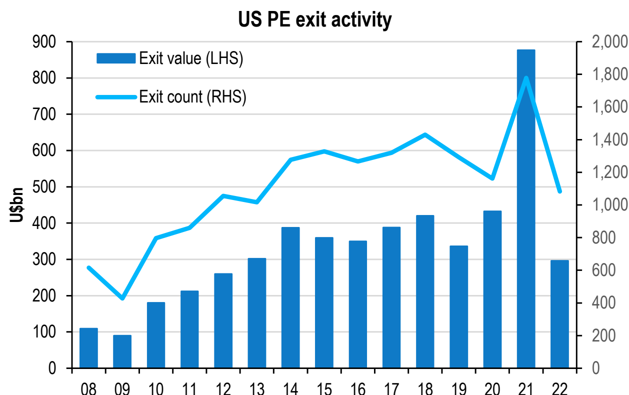
Source: PitchBook, MWM Research, March 2023

As the cost and availability of liquidity continue to tighten and the economic cycle begins to slow, we expect additional pressure points for private markets to increase including:

1. **Lagged valuation pressures:** Empirically, private equity market valuations lag public markets by 6-9 months. We expect the effects from last year's derating in public market comparables to flow through to PE (including late-stage VC) returns well into the year, particularly for later stage, larger buyouts. In contrast, we expect early-stage VC to prove more resilient, given they are more removed from movements in public markets and start from more modest entry valuations.

2. **An anaemic exit environment will delay realising returns:** Global buyout exits fell sharply year on year over 2022, with every exit channel experiencing declines, according to Bain data. Sponsor to strategic buyer exits fell 21% as macro uncertainty saw companies turned more conservative with their cash, sponsor to sponsor exits fell by 58% as lenders began to cut off financing for big transactions and, unsurprisingly, IPO exits fell by 94% as public market valuations derated sharply and sentiment dropped.

PE exits have been on hold as valuation multiples drop

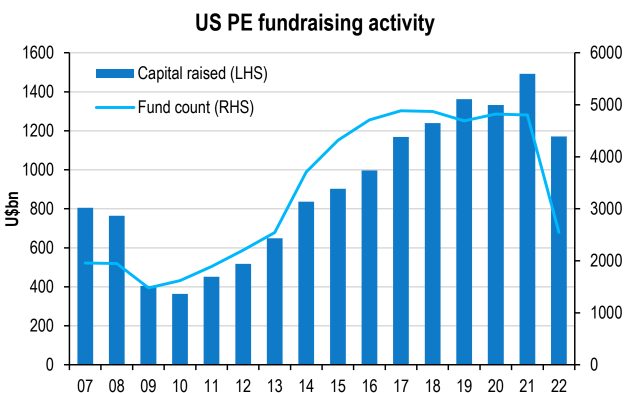


Source: Pitchbook, MWM Research, March 2023

We expect exits will remain muted over 1H23 as low valuation multiples keep growth and VC exits away from the IPO market as general partners (GPs) keep performing assets away from short term valuation pressures, and disconnect between buyer and seller prices see deal completion times extended in M&A markets, all of which are prolonging hold periods for private investments.

Should public markets begin to stabilise and interest rate policy becomes clearer, we expect exit activity to begin to thaw, with data suggesting there is an ample backlog of private companies waiting to list/exit. In addition, an abundance of dry powder (an estimated U$1.25 trillion globally, according to S&P Global) and pressure from limited partners (LPs) to return capital should all be tailwinds for fundraising and deal activity as capital begins returning to LPs for new commitments.

Rising costs of financing dampen deal making activity



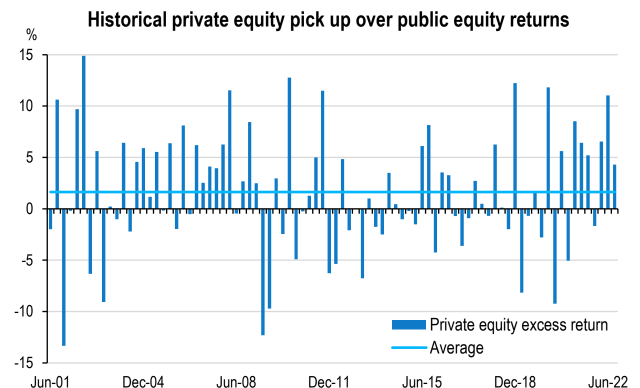
Source: PitchBook, MWM Research, March 2023

3. **Tighter liquidity conditions will see a slowdown in investment activity:** Global buyout values fall 35% in 2022 from 2021, according to Bain data. Traditional lenders such as banks are turning off the liquidity tap for large leveraged transactions. We expect this environment to continue to cap deal activity, especially for larger buyout transactions, with potentially smaller transactions (e.g. growth add-ons) that require less debt to pick up share. Furthermore, limited partners (LPs) will need time to work through allocation imbalances caused by the denominator effect and short-term cash squeeze from a slowdown in cash back from previous commitments. Although dry powder in the industry remains at near record highs following exuberant fund raises over 2021, the emphasis and competition will be for quality deals.

What does this mean for portfolios?

Looking through near term headwinds, we expect interim valuations to have a limited material impact over the life of a private equity asset. Private asset returns are ultimately delivered (or realised) at the time of exit. Although further downward pressure on multiples is expected, managers that have the expertise to generate alpha through value-creation and transformation of underlying company operations should still be able to deliver superior returns even in the absence of broad-based multiple expansion.

PE has historically offered a ~2% return pickup versus public markets



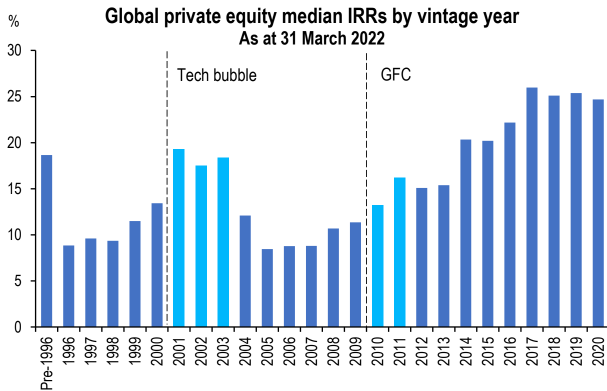
Source: Factset, Cambridge Associates, MWM Research, March 2023

Despite a changing backdrop, we believe private markets still play a critical role within an overall diversified portfolio. For investors who are prepared to give up liquidity, private equity strategies can increase the opportunities to enhance returns, with PE having historically delivered ~2% return pick-up relative to public equity markets. Further, against more persistent volatility in public markets and as companies stay private for longer, private markets strategies will continue to provide an additional degree of diversification given an ability to access a wide range of opportunities that are not available in public markets.

Where do we see areas for opportunity?

We think higher capital structure resiliency, a greater emphasis on deal quality, managers' value creation abilities and deeper sector expertise will support private equity markets in the long run.

Recession era vintages expected to show resilience



Source: Pitchbook, MWM Research, March 2023

The private equity opportunities where we think we are likely to see the highest expected returns for capital raised in 2023 are:

1. Smaller take privates and corporate carve-outs: We anticipate opportunities in the smaller, less complicated take-private and corporate carve-out transactions as companies refocus on core parts of their business in fragmented industries looking to decrease costs and increase business resiliency.

2. Secondaries and continuation funds: Recent contractions in public equities valuations have triggered the well-known denominator effect where large institutional private equity investors end up overweight private equity due to the falling value in public market exposures. This creates opportunities for GP-led secondaries and continuation funds to provide a way for investors to raise liquidity. For investors looking to deploy, this often creates an opportunity to buy a portfolio of companies at discount to Net Asset Value.

3. Structural thematics: Private equity is a long-term investment with investment horizons of 10 years or more. Companies that are providing products and infrastructure for multi-decade mega trends (climate change, decarbonisation, digitalisation and shifting demographics) will continue to provide a deep opportunity set.

Macquarie WM Investment Strategy Team

The report was finalised on 17 April 2023.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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