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THREE INVESTOR CONSIDERATIONS FOR THE PRIVATE EQUITY INDUSTRY

Q4 2022

Following several years of rapidly growing capital inflows and strong investment performance, the global private equity industry is adjusting to a tougher economic and fundraising environment. In this paper we reflect on three questions being posed by investors. Whilst we don't anticipate a radical change in the industry, we do foresee a period of adjustment as investors re-assess their private equity exposures following falls in their listed equity portfolios and private equity managers evaluate deal pricing in a higher interest rate and inflation environment.

The issues we discuss below have been present, to varying degrees, over the last decade and have their origins in the rapid expansion of the industry since the mid-1980s, a topic we addressed in some detail in a paper we authored earlier this year.[1] Whilst private equity managers (or General Partners ('GPs'), as we refer to them) have navigated the investment waters well since the 2007/8 Global Financial Crisis ('GFC'), a significant part of this success can be attributed to the vast amounts of monetary stimulus the world's central banks supplied to the global economies.

As we move towards the end of 2022, with listed markets' technology valuations having fallen sharply, interest rates rising quickly, global inflation set to hit 8.8% in 2022[2], continuing geo-political tensions and supply chain disruption, we felt it would be timely to examine these key issues for private equity.

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IS THERE TOO MUCH CAPITAL OR 'DRY POWDER' CHASING THE AVAILABLE DEAL FLOW?

'Dry powder' is the aggregated amount of 'committed, but not yet invested' capital that private equity firms across the industry have at their ultimate disposal. The industry has always operated with large amounts of dry powder, reflecting the model of GPs raising their funds before investing the capital over a five-year investment period. With the largest GPs raising ever larger funds, and where >$20bn fund sizes have become increasingly commonplace, coupled with buoyant fundraising conditions over the last five years, it is no surprise that levels of dry powder have reached record levels.

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It is estimated that at the end of 2021[3], after ten years of steady growth, there is approximately $1 trillion of dry powder sitting in global buyout funds alone (accounting for around a third of total private markets dry powder). This has undoubtedly put pressure on GPs to put money to work over the last two to three years and has helped fuel the high levels of investment into technology and tech enabled industries where deal valuations became elevated. It also drove the sharp increase in public to private transactions in 2021, particularly in the US and Asia-Pacific regions, where GPs took advantage of the opportunity to buy large and established companies that were unloved by public investors. These take-private transactions accounted for $469 billion globally in 2021[4](a 57% year on year increase) and included the £7bn takeover of Morrisons, the fourth largest supermarket chain in the UK, by the US private equity group Clayton Dubilier & Rice.

Whilst this $1 trillion of current dry powder is of course extremely large, it should be viewed in light of **four distinct contextual factors,** which we believe makes it much less of a cause for alarm than it might immediately appear.

1

The first is **the volume of annual buyout investment.** In the first half of 2022, there were $518 billion worth of buyouts completed[5] which, when added to the deal value of 2021 buyouts, means that over the last 18 months there have been $1.7 trillion worth of buy-outs concluded globally. Assuming the average debt to equity ratio in buyout transactions is in the range of 50:50 to 60:40, and a future annual buyout deal volume of $1 trillion, the current dry powder equates to approximately 2 to 2.5 years' worth of buyout equity funding. McKinsey actually estimate a lower figure of 1.5 years[6], though they usefully report that the trend, which is arguably more informative, shows a relatively constant range of c1.2 to c1.8 years over the last decade or so (having dropped off from a 2009 figure closer to $4trn).

Seen through this lens, the quantum of dry powder looks more manageable. Indeed given the significant slowdown we are already seeing in the fundraising environment and the increasing difficulty of transacting deals in current M&A markets, having this amount of deal firepower puts many GPs in a strong position to weather the downturn and be well placed to invest in attractively priced opportunities as they emerge. Having an inventory of cash can lead to the ability to negotiate more LP friendly terms from businesses that have stretched capital structures (as was seen following the GFC in the period after 2009 – cash is king in recessionary times).

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2

The second factor is that **all of this money is not contractually available for immediate deployment.** Whilst the terms of any one fund's Limited Partnership Agreement ('LPA') vary, they place limits on the amount that can be 'called' from LPs in the first and subsequent years of a fund's investment period. Sarasin Bread Street estimate[7] that of that $1trn of dry powder around one third of that is available for deployment over the next 12 months, which is a significantly lower figure than reported. To this one has to add the impact of recallable distributions[8] and co-investment capital, and of course leverage, but the figure (and article headline) is specifically in respect of fund level dry powder.

3

The third factor to consider is the phenomena of **stale unfunded commitments ('stale UFCs').** An unfunded commitment ('UFC') is money that has yet to be drawn by the GP from the investor. UFCs become stale once a fund is past its investment period and in theory cannot be spent without LPs' consent. There are a host of reasons why stale commitments occur, and range from prudence (i.e. the GP reserving capital to support portfolio companies that might need later unplanned funding), to opportunism (keeping cash back for the perfect deal or better valuation timing), to efficient portfolio management (i.e. in low interest rate environments, using a debt facility to delay capital calls, which can knock all future capital calls forward). Regardless of the reason, our experience suggests that most growth and buyout funds ultimately deploy only around 90% of potentially deployable LP capital, and we factor that unused 10% into our calculations for available dry powder.

It's worth dwelling on this latter point a little further: a GP's track record on capital deployment discipline is a key due diligence factor for Sarasin Bread Street, and becomes much harder to judge, and therefore a higher risk factor, when looking at first time funds, and especially first-time teams. Our experience suggests that with many good capital raising years behind us, there is currently a greater risk in the market of smaller newer funds (particularly in the venture space) spending up to the ceiling of their total fund raise, and creating liquidity issues later in these funds' lives. It's poor practice we've seen in previous cycles and therefore with the exception of specialist/opportunistic funds with shorter investment periods, we like to see a relatively steady rate of deployment, good portfolio management and deal sizing, and prudent reserving of capacity for follow on calls for unforeseen capital injections should they be needed.

4

The final point to consider here is that **significant capital commitments are made by the GPs** to their own funds which creates alignment with their investors and acts as a safeguard against underwriting standards being lowered as a way to deploy capital too rapidly. In our experience, the managers we work with have built strong sourcing skills and deep industry networks, enabling them to successfully invest the larger amounts of capital being raised.

GIVEN IT IS NO LONGER POSSIBLE TO RELY ON FINANCIAL ENGINEERING, CAN PRIVATE EQUITY CONTINUE TO GENERATE EXCESS RETURNS?

The use of leverage was of central importance to returns in the 1980s when leveraged buyouts, using up to 85% debt in their capital structures, represented the lion's share of private equity activity. As the industry grew and developed during the 1990s and 2000s, encompassing growth and development capital investing, the degree of leverage used by GPs reduced significantly as managers increasingly focussed on earnings growth and multiple expansion as a way of generating returns.

Over the last ten years, the level of debt used in buyouts has been fairly steady at around 50% debt and 50% equity[9]. The rapid expansion in growth capital and late stage venture capital investing, particularly in the technology and tech enabled sectors, has typically employed less leverage than buyouts as high growth companies are less able to sustain the levels of debt that larger more mature businesses can.

The large amounts of capital flowing to private equity over the last ten years, and the resulting increase in competition and asset prices, has meant that the earnings multiples being paid by GPs for new US buyout transactions now averages 12.3x EBITDA, steadily rising from below 10x in 2012[10]. This has led managers to focus on specific industry sectors and build deep domain knowledge and develop specialist teams of experts in order to move quickly and decisively and add real operational and strategic value to their portfolio companies.

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There is evidence that the use of debt is not the most important tool for generating private equity returns and other levers are now the principal drivers. By way of illustration, a Pan European GP with over €15bn of AUM (and with whom we have a long investing relationship) and who focus on Healthcare, Tech, Industrials and Business Services have produced analysis of the sources of value creation in their portfolio companies. This shows that in aggregate they have delivered a net 2.6x money multiple on their realised investments and the sources of this value creation breaks down as follows: 48% from EBITDA growth, 31% from price earnings multiple expansion at exit versus acquisition and 21% from financial deleveraging.

These sources of value creation and their relative weightings are not untypical across the range of strategies that the Sarasin Bread Street team has invested in previously and demonstrates that whilst the use of leverage continues to be an important contributor to overall returns, both the degree of leverage employed and its relative importance as a value driver have both declined significantly. With debt financing costs materially rising this year, this trend is not about to suddenly reverse.

DOES THE GROWING INVENTORY OF UNREALISED INVESTMENTS RAISE QUESTIONS ABOUT THE PERFORMANCE OF THE ASSET CLASS?

As the private equity industry has grown in size and importance, the inventory of unrealised investments has also grown significantly.

A consistent criticism of the industry, given its rapid growth, has been that, rather like a tropical python consuming a domestic cat and the resulting bulge slowly moving along the snake's body, until the large inventory of private equity owned companies has moved through the system and been successfully exited, it is hard to really assess the performance of the asset class.

Given the increasing maturity of the industry and accompanying data on the annual levels of investment and exits over many years, there is a growing body of evidence to suggest, returning to the analogy, that the cat has been fully digested and the snake remains hungry!

Taking 2021 as an example, whilst global buyout deal value doubled to approximately $1.1 trillion[11], the exit markets were just as strong with approximately $950 bn of assets being sold by buyout funds[12]. All exit channels were fully open including IPOs, sales to strategic trade buyers, sales to other private equity managers and sales to SPACs. Buyout managers took full advantage of the buoyant and receptive markets with the level of exits almost doubling from their previous high of approximately $521 bn in 2014.

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The British Venture Capital Association 2021 performance measurement survey, produced in conjunction with PWC, tracks the amount of capital paid in by investors and the amount of capital distributed to investors on an annual basis going back to the 1980s. The data is based on the response of 114-member firms out of 164 eligible members and covers a significant proportion of private equity activity in the UK and Europe across buyout, growth and venture capital. This shows that in aggregate across all funds raised each year, for all vintages up to 2014, investors have received more capital back in distributions than they have paid in. The levels of distributions versus paid in capital for the more mature vintages (pre-2010) are in predominately in a range of 160% to 200%. For the 2014 vintage, investors have received back 105% of their paid in capital and this reduces steadily over more recent vintages to 39% for vintage year 2017.

There are two other points that are relevant here:

1. Firstly, whilst the absolute number of privately held companies now exceeds publicly listed companies, the combined enterprise value of private companies remains a fraction of the capitalisation of public markets. In June 2020 according to analysis by the Wall Street Journal as quoted in market medium.com, the market capitalisation of the Big Five tech stocks (Alphabet, Apple, Amazon, Microsoft and Meta) was $7.4 trillion which compares closely to the assets under management in private markets of $7.5 trillion (source: McKinsey Global Private Markets Review Report 2022).

2. Secondly over the last decade the so-called secondary market, where specialist firms raise capital to purchase seasoned interests in existing private equity funds, has expanded even more quickly than the overall private equity market. According to the leading European private equity firm Ardian, one of the largest investors in secondaries, in 2021 there were $130bn of secondary transactions globally, a 5x increase over the level in 2011. Private equity GPs have taken advantage of this growing source of capital to sell selected underlying portfolio companies to acquisition vehicles principally funded by secondary investors. These so-called 'GP led restructurings' accounted for around 46% of the secondary market in 2021 and were a way for GPs to provide liquidity to those investors who desired it, whilst allowing those investors who wanted to remain invested to do so.

In conclusion, change in this industry continues to be evolutionary rather than revolutionary and in part this can be explained by the benign economic backdrop created by Central Bankers following the GFC. As we enter a much tougher global economic environment, we continue to monitor these issues closely, as well as considering new trends that will play out over the coming decade. These include the effect of the private equity asset class becoming more accessible to the global defined contribution pension funds' market and of course regulatory pressures on an industry that continues to generate large rewards for those investors at the capital deployment coal face, namely the private equity GP.

1. Sarasin Bread Street Q3 Thoughtpiece : How might Private Equity perform in a prolonged public equity market downturn
2. Source: IMF.org, World Economic Outlook, October 2022
3. Prequin & Bain & Co. Global Private Equity Report 'The Private Equity Market in 2021: The Allure of Growth', 7 March 2022
4. *Ibid*
5. Source: Dealogic, Bain & Co. 'Shifting Gears; Private Equity Report Mid Year 2022 ', 18 July 2022
6. Source: McKinsey, Private Markets 2022 Annual Review: 'Private markets 2022: Private markets rally to new highs
7. Assumptions available on request
8. We will discuss recallable distributions ('recallables') in a future research paper, but these are distributions made by a GP and subject to a clawback for reinvestment purposes. The quantum of recallables is almost impossible to estimate and they are not always recalled, however this an industry pool of recyclable capital that, in theory, that is potentially available in addition to the dry powder pool
9. Sarasin Bread Street estimate, November 2022
10. S&P Capital IQ, S&P LCD & Bain & Co. Global Private Equity Report 'Private Equity's inflation Challenge' 7 March 2022
11. *Ibid*
12. *Ibid*

REPORT AUTHORS

ALEX BARR
Partner

CV:

- Janus Henderson Investors
- Aberdeen Standard Investments
- Deutsche Asset Management
- Henderson Global Investors
- Franklin Templeton

JAMES WITTER
Partner

CV:

- Aberdeen Standard Investments
- SVG Advisers
- Nomura
- Merrill Lynch
- Dresdner Kleinwort

NOTES

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CONTACT US

T +44 (0)20 7038 7000
sarasinbreadstreet.com

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