MOONFARE

Now is the time to invest in Private Equity

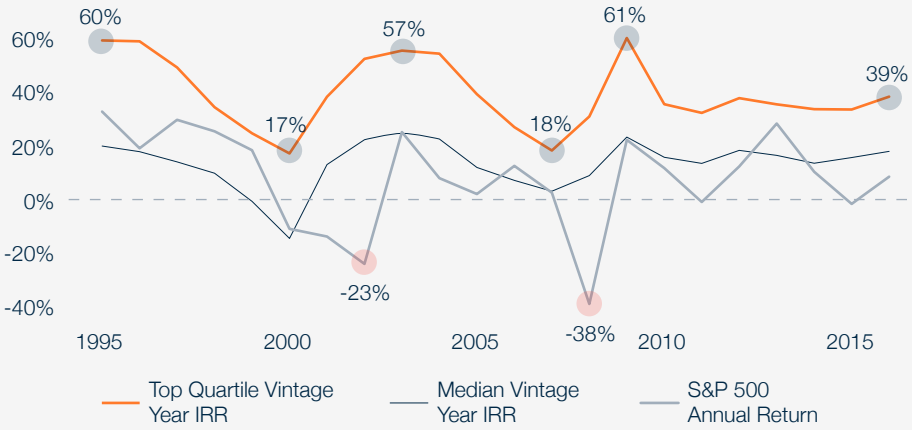
Insights from past recessions

Private Equity's best returns tend to follow recessionary periods

With Covid-19 turning the global economy into recession and causing turmoil in public financial markets, investors are reviewing their investment strategies and deciding when the best time is to invest.

Data from various providers and academics analysing private equity returns show, that PE outperforms public markets throughout the business cycle, and Internal Rates of Return (IRR) pick up following recessions, as most recently observed following the 2000-1 Dot-com Bust and the 2007-8 Global Financial Crisis ("GFC").[1]

Figure 1: Deal Vintage IRRs and S&P 500 Annual Return, 1995 - 2015



Sources: Hamilton Lane Deal Database, accessed via Cobalt LP (April 2020). S&P 500 data from Yahoo Finance.

To assess if this will apply also to the current market situation, it is important to understand what causes PE outperformance. We find the data shows three significant drivers:

1. Funds can invest in companies at lower valuations, leaving more room to expand multiples after recovery.
2. PE has better access to capital and deploys it more flexibly, allowing portfolio companies to seize growth opportunities in a crisis, while competitors may be mired in austerity measures.
3. Large funds' active management approach and operational support gives PE-backed businesses a competitive advantage as they respond to a crisis more quickly. One successful European buyout funds calls it, "future-proofing companies".[2]

Let us take a deeper look into what each point entails.

1 EY: Why Private Equity Can Endure the Next Downturn https://www.ey.com/en_gl/private-equity/how-private-equity-will-respond-to-the-next-economic-downturn

2 About EQT https://www.eqtgroup.com/About-EQT/

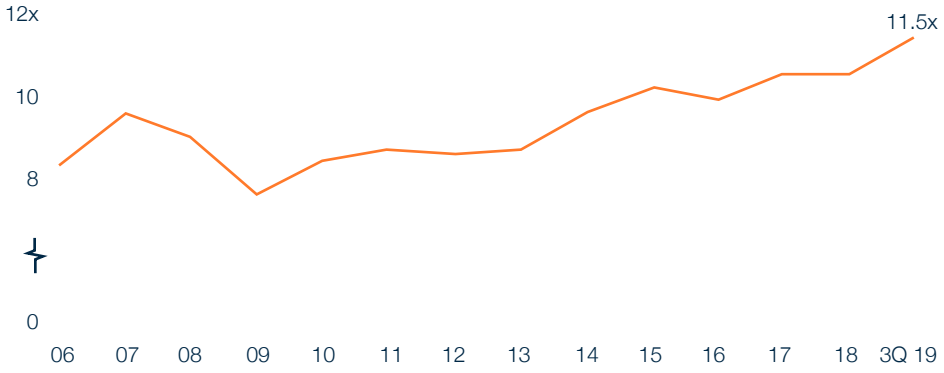
1

Funds can invest at lower valuations

Data from past crises[3] has shown that EV/EBITDA multiples tend to go up in years before a crisis, and then drop for one to three years from the start of a downturn.

In fact, increased acquisition multiples has been one of the major concerns for investors looking to deploy capital in pre-crisis years. While there are valid arguments in favour of paying high multiples for strong businesses with good growth prospects, being able to acquire the same businesses at lower valuations further increases the potential and thus drives returns.

Figure 2: Average EBITDA purchase price multiple for US LBO transactions



Sources: S&P Capital iQ, cited in Bain & Company Global Private Equity Report 2020

Acquisition cost is impacted as the crisis develops - one year into a crisis the base EBITDA for the last twelve months would also be depressed by the business downturn. This generally leads to an undervaluation of companies and provides opportunities for buyers with liquidity.

Funds and their portfolio companies benefit from the opportunity to acquire smaller competitors or businesses that complement existing platform investments at lower, sometimes distressed valuations. Expect funds that raised capital in 2018-19 to make more and smaller investments to take advantage of these so called “add-on” opportunities.

3 Bain: Global Private Equity Report 2020 https://www.bain.com/insights/topics/global-private-equity-report/

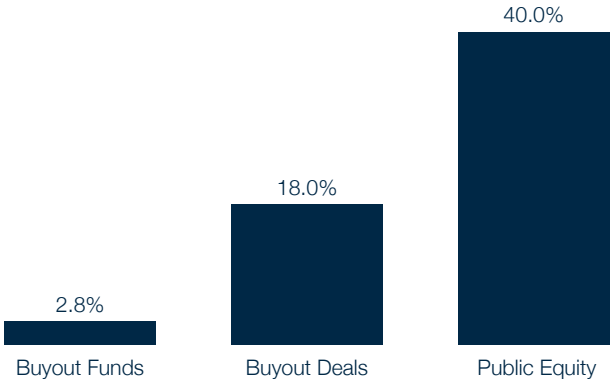
2

PE has the ability to deploy capital more flexibly

As has been widely reported,[4] PE 'sits' on unprecedented amounts of so-called 'dry powder' – raised capital yet to be invested. According to Preqin, the industry's dry powder grew to nearly $ 1.5 trillion 2019.[5] In addition to the existing dry powder, funds also have the flexibility to use credit lines.

First, flexible access to capital in a downturn can be essential to prevent bankruptcies. While defaults of individual businesses do go up during recessions, studies by Hamilton Lane and JP Morgan[6] show that the risk of 'catastrophic loss' (defined as a 70% or greater decline in peak value with minimal recovery) is less than half for buyout companies compared to public companies. At a portfolio level, JP Morgan finds, "stocks are a stunning 13 times riskier than private equity funds."[7]

Figure 3: Risk of 'Catastrophic Loss' (more than 70% decline from peak value with minimal recovery)



Sources: Hamilton Lane Data (October 2017), FactSet, J.P.Morgan Asset Management

Second, PE companies have shown to deploy capital more flexibly in a crisis than traditional businesses. One study[8] of almost 500 PE-backed companies in the UK during the GFC found that these companies recovered faster from the crisis and captured more market share relative to their comparable non-PE competitors.

Lastly, Hamilton Lane's analysis of IRR data pre and post GFC by vintage finds that not only did PE returns increase but also the spread between 2nd and 3rd quartiles contracted significantly.[9] As publisher Institutional Investor concludes, PE firms have learned from the GFC and are prepared for an economic shock – "PE won't miss another crisis".[10]

4 e.g. Bain, PitchBook, Preqin, McKinsey - please see footnotes 4, 6

5 Preqin 2020 Preqin Global Private Equity & Venture Capital Report

6 Hamilton Lane Annual Market Overview 2017-18
https://www.hamiltonlane.com/Customer-Content/WWW/CMS/files/Annual_Market_Overview_-_2017-2018.pdf

7 Forbes Private Equity os Safer than Stock in Downturn, But Finding the Best PE Fund Is Hard
https://www.forbes.com/sites/antoinedrean/2018/10/02/private-equity-is-safer-than-stock-in-downturns-but-finding-the-best-pe-fund-is-hard/#5989a63f4c3e

8 Bernstein, Lerner, Mezzanotti Private Equity and Financial Fragility during the Crisis
https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/PE_UK_new_paper.20170304.pdf

9 Hamilton Lane Data (July 2019), Hamilton Lane Market Overview 'The Beast in the Jungle'
https://www.hamiltonlane.com/what-were-thinking/MarketOverview/

10 Institutional Investor: Private Equity Firms Won't Waste Another Crisis
https://www.institutionalinvestor.com/article/b1kq69qt38w0x6/Private-Equity-Firms-Won-t-Waste-Another-Crisis

3

Positive impact of active management

One of the key – and sometimes underestimated – drivers of value[11] by buyout funds is their active approach to governance. While CEOs of public companies generally report to their board of directors only once per quarter and, owner-managers have to rely on their own resources, global top tier funds have three ways to actively support the management of their portfolio businesses:

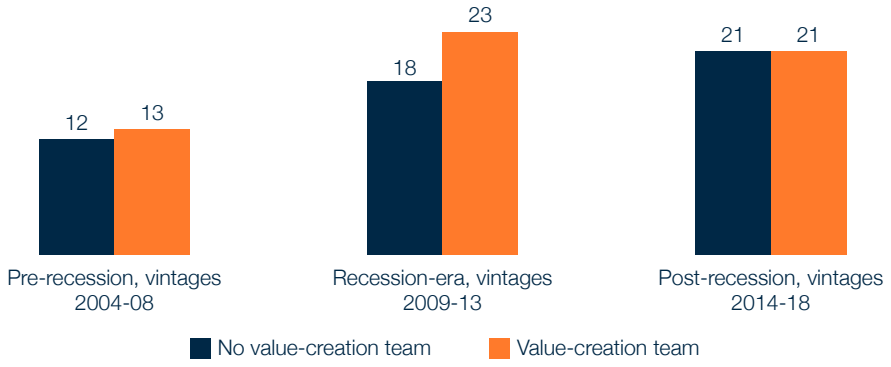
1. Close contact between company management and the fund manager and advisors: Some PE funds hold board meetings or management workshops monthly, and typically the CEO and GP would have a weekly call to discuss affairs. In times of crises, this frequency could even increase.

2. Outside expertise: Most top tier funds retain senior advisors who join the boards of various portfolio companies. Typically, these advisors are experienced former CEOs with expansive industry and leadership experience. Senior advisors support the CEOs and make their time, knowledge, and network available to the portfolio company.

3. Operational support: Most global platform funds have operational teams to support their portfolio companies, helping businesses develop new capabilities and manage transformation programmes. Hard to access expertise, in areas such as information technology, data and analytics, digitalisation and new market entry, are where funds' operational teams provide particular value. Some funds also operate their own buying platforms, offering their portfolio companies significant cost advantage in their supply chain.

A recent study by McKinsey[12] found that operational teams have a significant impact on funds' performance, particularly in post-recession era vintages.

Figure 4: PE firm performance (IRR), 2004–18, %



Note: Average of firms' net internal rate of return from all funds during the analysis period. n = 120 large GPs worldwide.
Sources: Preqin, cited in McKinsey's Global Private Markets Review 2020

11 For additional information about value creation by PE funds we recommend our whitepaper with Private Equity Insights 'Navigating Private Equity, Value Creation Primer' which you can access at https://www.moonfare.com/docs/Navigating-PE.pdf

12 McKinsey's Global Private Markets Review 2020
https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review

Yes, but ...

Investors ask us three common questions about investing in PE in a downturn:

The risks of leverage are manageable. At fund level, large cap PE is signficantly less risky than public equities.

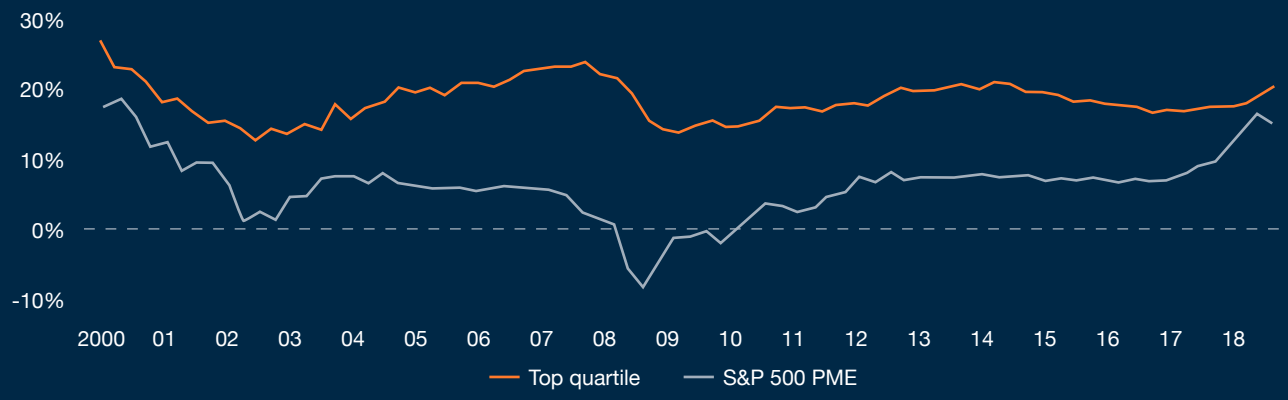
Question: With many PE-backed firms being leveraged with debt, aren't the risks increasing disproportionately in a downturn?
As we have discussed above (in section 2 on page 4), defaults do increase in a downturn, but PE-backed companies tend to default at significantly lower rates than their public counterparts. In addition, the risk would largely apply to investments that have been made already. As all investors, GPs now pay extra attention to a target's financial position before making an investment.

Top quartile PE funds outperform public market equivalents across all market cycles

Question: With public markets down, shouldn't I invest all my capital in attractively priced stocks now?
We don't claim to be public equity experts. Two observations are largely accepted by those who are:

- Identifying a market bottom is difficult[14]. The decline of bear markets from peak to trough (duration before bottom), and the years it takes for recovery have fluctuated widely in past recessions. Bear market rallies have given investors a false sense of the cycle. With this high uncertainty, valuations may seem attractive now but the public market is fragile and investments can take years to achieve positive returns.
- PE, especially the top quartile funds, has outperformed public markets across most timelines and metrics. The onset of a recession, the data shows, serves to boost the opportunity of those private returns. An analysis by French University HEC finds a significant negative correlation between average buyout vintage performance and stock market performance in the same year, which leads the author to the conclusion that "the best times to allocate to PE are during tough stock market years.[13]

Figure 5: 10-year annualized IRR



Note: PME is a public market equivalent based on the Long-Nickels methodology
Sources: State Street Private Equity Index, cited in Bain 2020 Global Private Equity Report

Now is the time to invest in PE

Question: Isn't timing less relevant and less significant for PE?
You got us there. In fact, we published a whitepaper arguing[15] that investments with longer holding periods, across different funds and vintages, deliver higher and more consistent returns. For investors who hold a significant portfolio of PE funds, staying the course and spreading new commitments across various vintages is backed by the numbers. This is also sensible strategy to create steady income from PE investing.

→ **For investors new to private assets or planning to allocate a higher proportion into this category, the data discussed above shows now is an opportune time to do so. Commitments made this year will be invested in 2021-23 when the economy will likely be in recovery mode. Fund managers are preparing to use the crisis to their advantage, investors can do the same.**

13 HEC Paris Prof. Oliver Gottschalg: PE Returns and Business Cycles (2020)

14 Robert J. Shiller, Standard & Poor's, and Thomson Reuters Datastream. Cited from Cambridge Associates 'The Bear Awakens, Market implications of Covid-19' Recording from March 19, 2020

15 Moonfare Marketing Timing or Time in the Market? Why staying invested makes a difference https://www.moonfare.com/docs/Stay-Invested-Whitepaper.pdf

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