

ALTERNATIVES RESEARCH

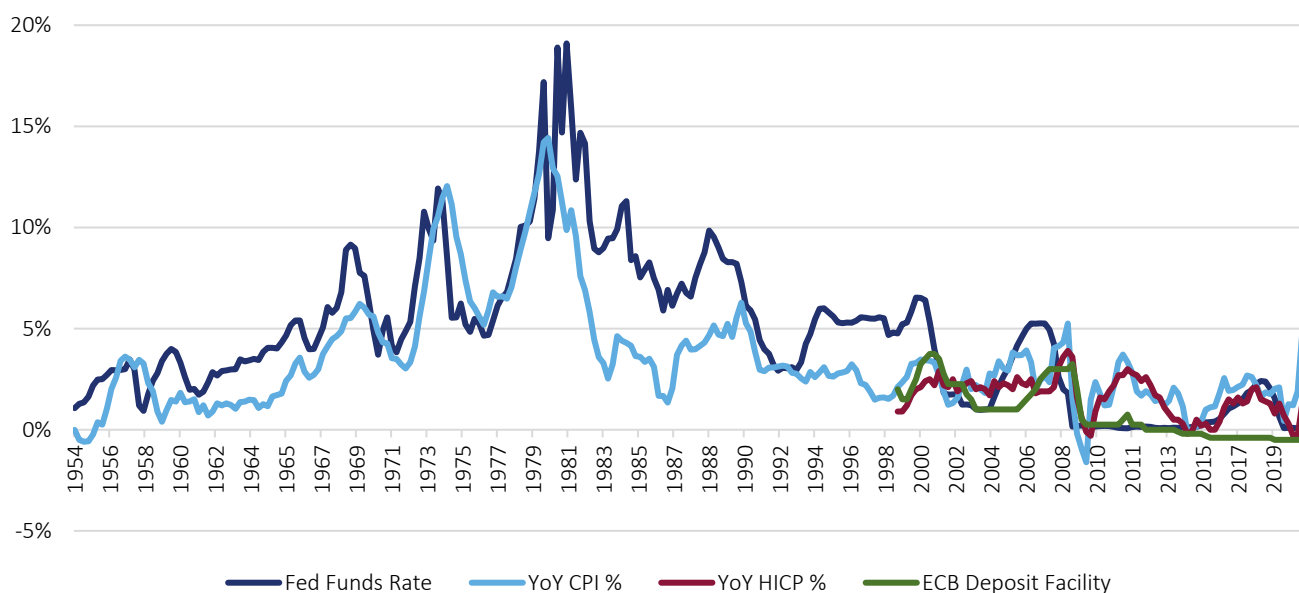
Private Equity in a Higher Inflation, Rising Interest Rate Environment

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In February, the U.S. Labor Department announced that the Consumer-Price Index (“CPI”) increased 7.5% year-over-year in January 2022, the highest level in nearly 40 years. This increase (which topped 6% year-over-year for the fourth straight month) is representative of a global trend of higher inflation driven by ultra-expansionary monetary policies implemented to counter the COVID-19 pandemic, supply chain disruption, and geopolitical issues driving higher energy prices. The U.S. Federal Reserve has indicated that several interest rate hikes are expected in both 2022 and 2023 with the aim of combatting rising consumer prices. The European Central Bank (“ECB”) is likely not far behind, expecting rate hikes to start in 2023, which poses the following question: how should we expect higher inflation and rising rates to impact private equity?

Inflation & Benchmark Rate



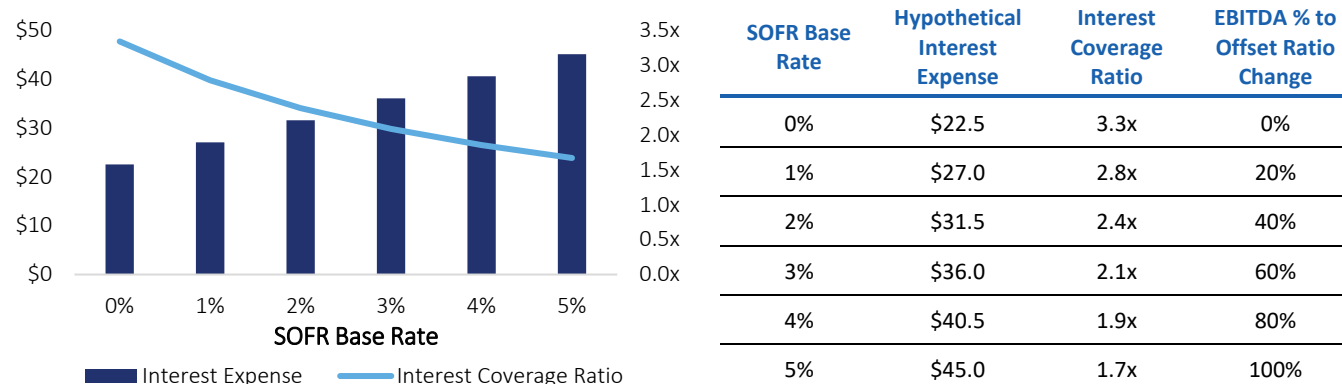
Source: St. Louis Federal Reserve Bank; ECB as of January 2022.

Private Equity

Broad conclusions on the impact of higher inflation and rising rates are challenging to draw on the private equity asset class given the number of variables at play, including but not limited to differences in strategies and approaches, regulatory changes, macroeconomic events, and the evolution of the asset class itself over the last 30 years. With that said, one can assess the impact that inflation and rates have on various critical components of private equity transactions such as financing, valuations, and operations. Importantly, the below assessments apply primarily to leveraged buyouts and special situation-oriented investments given that venture capital and growth equity transactions are generally completed with less or minimal leverage, often non-control in nature, and can exhibit a wider skew of return outcomes. A more granular assessment of impacts on the aforementioned key components of LBOs is as follows:

Financing – Considering inflationary pressures in isolation – absent interest rate increases – higher inflation should provide a boost to the leveraged buyout model making existing debt less expensive in real terms on the back of higher margins for companies with the pricing power to pass through higher input costs. Managers that have borrowed at fixed rates or secured covenant-lite loans in particular should reap these benefits. However, when higher inflation does eventually catalyze higher interest rates, over levered capital structures will face increasing difficulty in making interest and principal payments. As seen in a hypothetical example below, interest coverage ratios for simple businesses with floating rate debt could deteriorate a full turn with an increase of only 200 bps in the base rate (all other variables held constant), requiring significant EBITDA improvements to maintain appropriate debt service levels. Companies that lack pricing power – without the ability to compensate for these higher expenses elsewhere in their income statements – are at the highest risk.

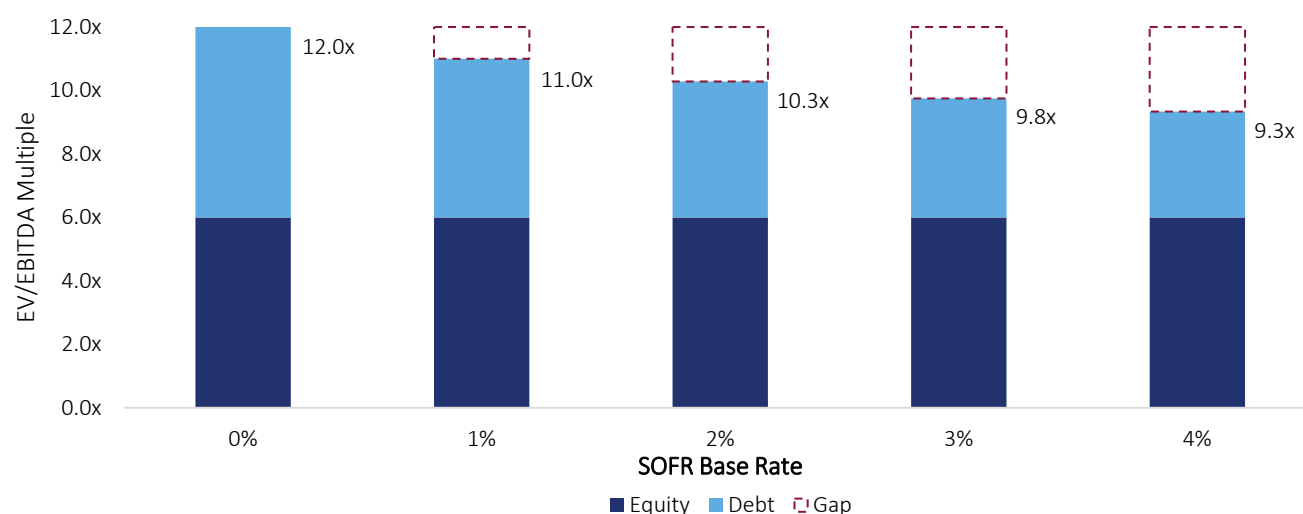
Impact of Rising Rates on Debt Service for Company with Floating Rate Loan (SOFR+500)*



*Key assumptions include the following: \$75 million in EBITDA; 25% EBITDA margin; \$900 million EV business with 50% debt / 50% equity capital structure; floating rate debt priced at SOFR+500 with no amortization requirements; and no depreciation or amortization.

Valuations – It is difficult to imagine that valuation multiples will continue to rise from their current historically high levels in an increasing rate environment. The first driver behind this is the expected impact on leverage multiples. For new investments, increasingly expensive debt could put a ceiling on the debt levels that companies can accommodate, potentially requiring proportionately higher equity tickets or absent this, lower purchase prices. The latter may also impact existing investments made at peak valuations, with declining exit valuations that are not sufficiently offset by earnings growth resulting in lackluster returns. The figure below continues from the hypothetical company presented above, demonstrating that the leverage load able to be taken on while maintaining a constant debt expense declines as rates go up. To continue making new investments, GPs will need to fill this gap through (i) maintaining debt and increasing interest expenses, resulting in increased financial strain on the company and/or lower profitability, (ii) increasing the entry equity investment (lowering potential return on equity), or (iii) simply lowering offer prices for assets. Financial engineering as a means to value creation is at risk. Nevertheless, it is likely that most GPs will be capable of putting forward additional equity given available dry powder. On the other hand, managers that have historically taken a conservative approach to leverage should see limited impact and stronger relative returns.

Impact of Rising Rates on Entry Valuation for Company with Floating Rate Loan (SOFR+500)*



*Key assumptions include the following: \$75 million in EBITDA; 25% EBITDA margin; \$900 million EV business with 50% debt / 50% equity capital structure; floating rate debt priced at SOFR+500 with no amortization requirements; and no depreciation or amortization.

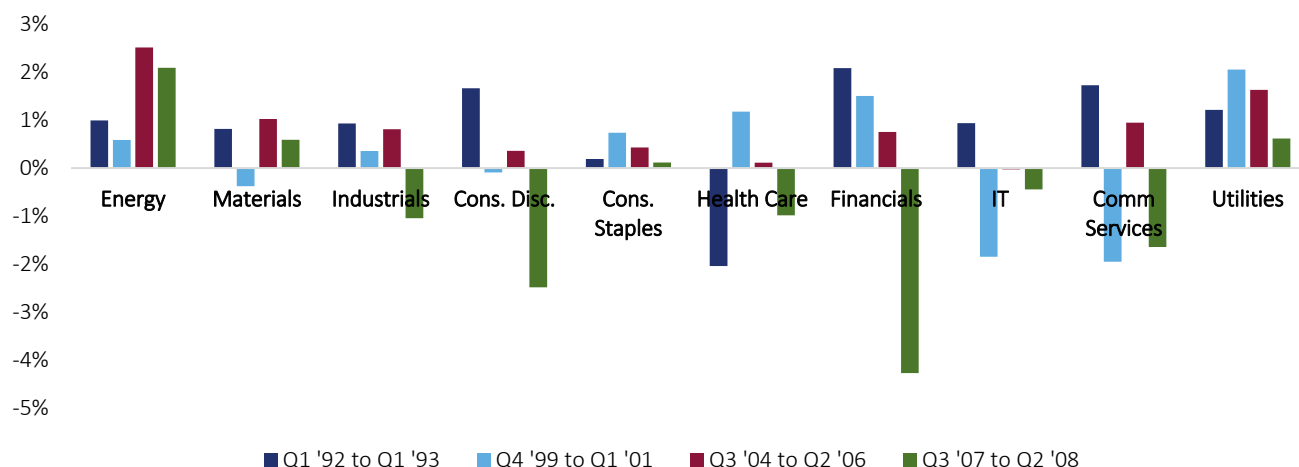
More broadly, increasing interest rates will drive higher discount rates and lower present values of future cashflows, which is expected on both the private and public front. Again, this will impact businesses in different ways – e.g., high-growth businesses that burn significant cash will be the most at risk. Especially for venture capital and growth investors, investments may see valuations fall at exit. Further, companies that struggle operationally and see profits and margins decline will likely also see their valuations impacted as a result. Nevertheless, there should be a few natural limits to how far valuations can fall. Leverage levels today are still arguably moderate compared to those in the pre-GFC era, and there will likely continue to be buyers for assets given the current level of dry powder and strong demand by LPs for private equity exposure as part of their asset mix.

Asset Selection – While inflation and rising interest rates may affect sectors differently, managers with strong bottom-up underwriting and asset selection capabilities have the potential to generate outperformance during periods of volatility. The highest quality assets during this time should maintain the pricing power to offset inflationary pressures with consistent margins. Companies with differentiated products, IP, and a diverse customer base should be well-positioned to pass along higher input costs and ensure that margins are protected. On the contrary, less differentiated businesses will be forced to compete on price, which may see their margins put under pressure. While the degree to which companies are impacted will vary by sector, customer type, and where they sit in the value chain, the most well-positioned companies, both in current and future portfolios, should hope to see the most competitive sales processes and highest exit valuations.

Operations and Sector Divergence - As leverage and financial engineering become less-effective tools to drive returns, managers who bring real operational value-add capabilities to their portfolio companies should benefit from relative outperformance. Owning businesses in an inflationary environment will require emphasis be placed on managing these businesses to perfection to ensure they remain competitive. It will become increasingly clear which GPs emphasize the basics, such as working capital and inventory management, as well as engage with, enable, and properly incentivize portfolio company management to drive growth.

Sectors will also respond differently to inflationary pressures, as different revenue models will allow some businesses to pass on price increases to consumers. While the public markets are not a perfect proxy, the performance of public indices during the latest periods of higher relative inflation provide some insights. Among them, the Energy, Materials, Industrials, and Utilities sectors have been some of the most consistent positive performers during those windows and likely benefit from the ability to easily pass through or adjust costs due to inflation. One might expect similar trends to be exhibited in the private markets as well.

S&P Sector Index Performance During Higher Inflationary Periods*



Source: S&P as of January 2022; *higher inflationary periods denoted as at least four consecutive quarters with YoY CPI above 3%.

Conclusion

What remains evident over the last 30 years is the importance of vintage year diversification to combat macroeconomic cycles. Overall private market performance reactions to increasing rates tend to lag those of the public markets, which can occur instantly as new monetary policies are enacted, though the impact may be directionally similar. Funds with vintage years immediately preceding or coinciding with periods of rising rates tend to have the potential to be adversely impacted by the higher cost of leverage and valuation decreases; however, funds with significant dry powder at the height of these cycles have the opportunity to benefit from attractive entry valuations. The ability to balance private market investments across vintage years helps to mitigate these risks and eliminate the element of market timing as it related to impacts stemming from inflation and rising rates.

While inflation and rising interest rates will undoubtedly represent a headwind to parts of the private equity market, other segments should be positioned well to capitalize on the complexity of this market environment. Strong managers (i.e., those with strong asset selection capabilities and the ability to present true operational and strategic value-add initiatives) will likely continue to see outsized returns and oversubscribed funds. Ultimately, the role of the LP will remain what it always has been: identifying and supporting these best-in-class managers.

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