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By Nick Veronis and Tatiana Esipovich

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Private equity (PE) has seen an influx of investors in recent years, many of whom are new to the asset class. In fact, 2018 marked the first year that more capital was raised through the private markets than the public markets, prompting some noteworthy consultants to conjecture that we're in the middle of one of the most profound shifts in the capital markets since the 19th century. This interest in private equity extends beyond the institutions that have constituted the majority of PE limited partners historically. Allocations are rising among high-net-worth investors, with wealth managers reporting current allocations to private equity of 7.5 percent and target allocations of 8 percent.[1]

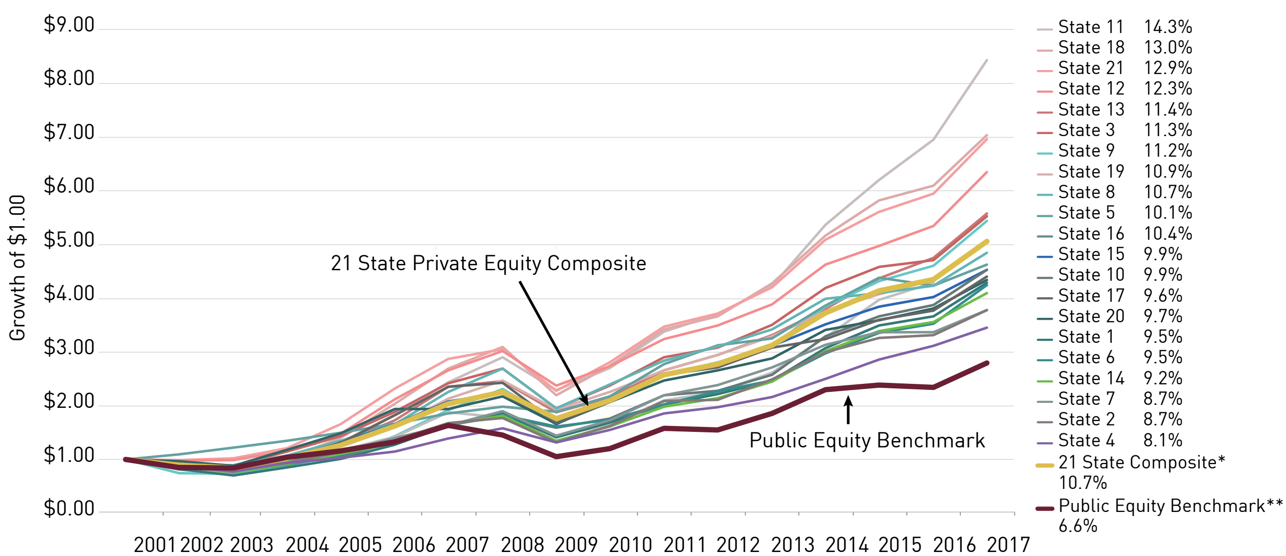
The reason for this heightened investor interest is simple: Private equity acts as a portfolio diversifier and has generated strong historical returns at a time when growth has become increasingly hard to find. Private equity's consistent long-term outperformance against major indexes is well-documented, with the asset class generating 597 basis points of outperformance over a 20-year period and 489 basis points over a 15-year period versus the S&P 500.[2]

The 11-year bull market, the longest in U.S. history, has just ended and concerns are rising over the sudden and steep economic downturn driven by COVID-19. As such, it's natural for investors to ask how PE will perform in a recession. Significant historical data show that private equity's outperformance actually increases during distressed periods, a logical outcome given the long-term nature of the asset class. For PE firms, a downturn represents opportunity. PE firms can deploy capital at more attractive terms and make bold, calculated moves without being hamstrung by the short-termism that afflicts so many public companies.

This resiliency in a downturn also has been a key driver—along with its broader outperformance relative to the public markets—of investors' continued support of private equity. In June 2019, Preqin ran its long-standing survey of investors, and 87 percent of institutional limited

Figure 1

PRIVATE VS. PUBLIC EQUITY PERFORMANCE IN U.S. STATE PENSIONS



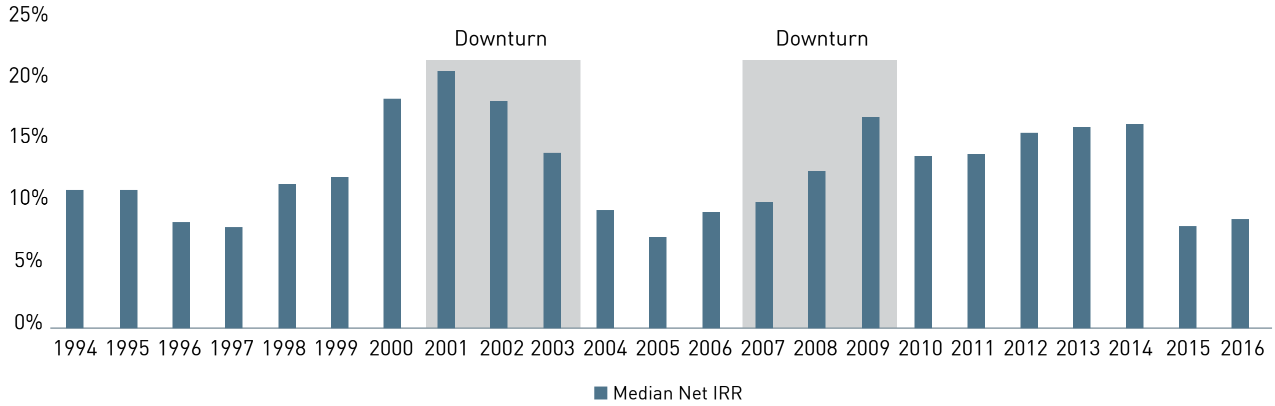
Source: Cliffwater, "An Examiniation of Private Equity Performance among State Pensions, 2002–2017," updated May 2018. 2017 is the most recent data available. For illustrative purposes only; for fiscal years ending June 30.

**An equal-weighted average of all 21 state funds that reported PE returns in annual Comprehensive Annual Financial Reports (CAFRs) for June 30 fiscal years 2002–2017.*

***A public equity benchmark weighted 70 percent to the Russell Index (6.8 percent annualized return) and 30 percent to the MSCI ACWI ex US Index (5.9 percent annualized return), with assigned weights reflecting Clffwater's judgment of the U.S. and non-U.S. content of a diversified PE portfolio.*

Figure 2

SOME OF PE'S STRONGEST VINTAGES BEGAN INVESTING DURING DOWNTURNS

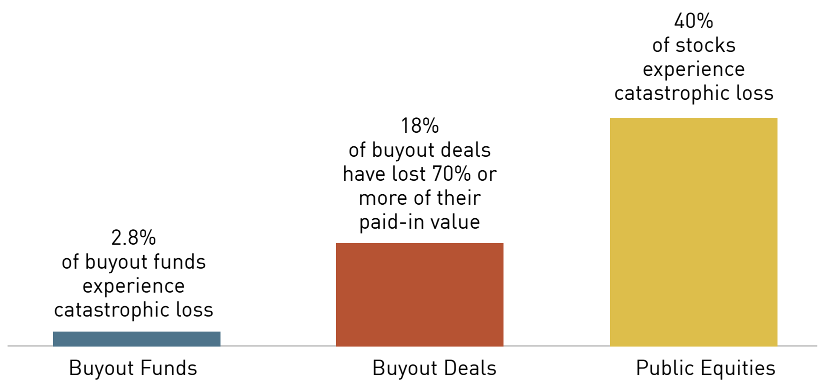


Source: Cambridge Associates U.S. Buyout Index, as of March 2019. 2016 is the latest vintage available. For illustrative purposes only.

partners (LPs) were expected to either increase or keep current allocations to private equity. When Preqin ran a similar survey in April 2020, once the economic effects and market volatility driven by COVID-19 were widespread, the percentage of investors committed to either keeping or increasing long-term PE allocations had risen to 91 percent.

Figure 3

PE HAS DEMONSTRATED A LOWER RISK OF CATASTROPHIC LOSS



Sources: Hamilton Lane as of October 2017; FactSet; J.P. Morgan Asset Management, "The Agony and the Ecstasy" (2014). For illustrative purposes only.

PRIVATE EQUITY HAS OUTPERFORMED PUBLIC MARKETS IN RECESSIONS, WITH LESS VOLATILITY

One of the more interesting reports on this subject was generated by the investment-research firm Cliffwater, which examined PE investment programs at U.S. state pension plans over the 16-year period ending June 30, 2016 (encompassing two bear markets and two bull markets).[3] During this period, PE outperformed public equities by 440 basis points annually on average across the 21 pension plans studied (see figure 1). These strong relative returns were even more pronounced during the bear markets of 2002–2003 and 2008–2009 than in years of economic growth. When the broader economy was stronger, private equity outperformed by an average of 290 basis points; however, during weaker economic times, this increased to an average of 660 basis points.

An analysis of median net internal rate of return (IRR) of U.S. buyout funds across vintages confirms private equity's outperformance during economic downturns (see figure 2). In fact, we found that the asset class generated some of its strongest returns in recession-year vintages, including 2001, 2002, and 2009.

Data from Hamilton Lane and J.P. Morgan further supports private equity's ability to weather downturns.[4] J.P. Morgan analyzed the Russell 3000 Index (which represents approximately 98 percent of the investable U.S. equity market) during 1980–2014. It found that during recessions, two-fifths of publicly listed equities have experienced "catastrophic loss," defined as a 70-percent or greater drop from peak values. Yet less than three out of 100 PE funds have suffered a similar loss (see figure 3). When examined from this perspective, stocks are 13 times riskier than private equity funds. PE's lower volatility relative to public markets is also apparent when comparing index performance over time (see figure 4).

PE'S LONG-TERM NATURE OFFERS ADVANTAGES DURING BEAR MARKETS

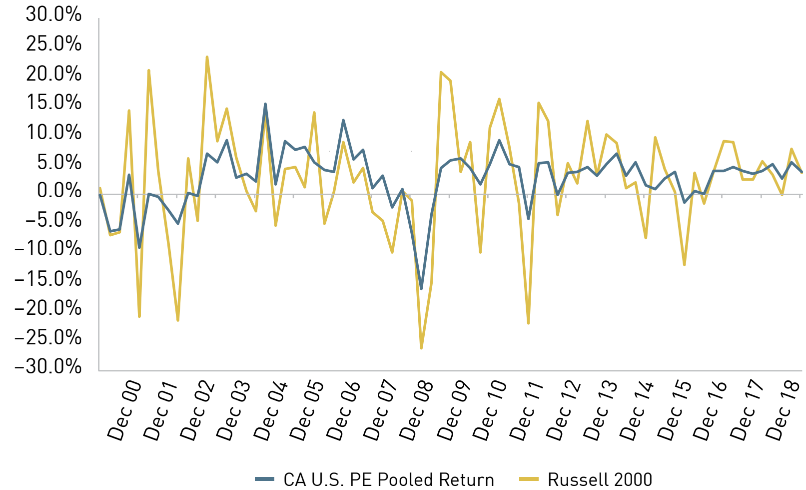
The ability of PE firms to plan and invest over the long term, particularly relative to public companies, confers several advantages that are at the root of its outperformance.

HANDS-ON APPROACH TO MANAGING PORTFOLIO COMPANIES

PE managers have an asymmetric information advantage over public market investors. Often they have access to a

Figure 4

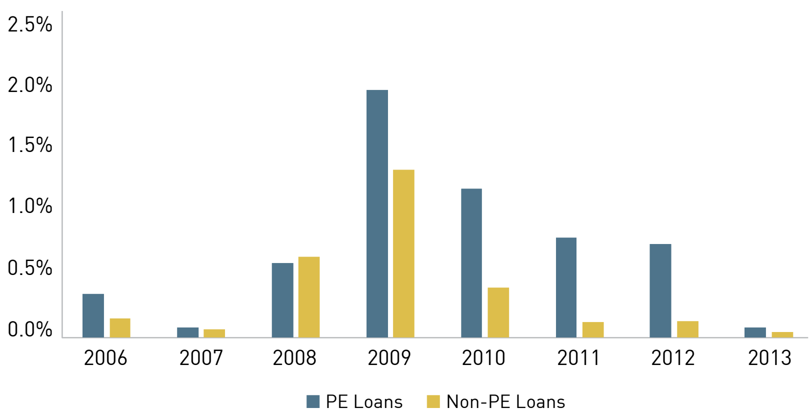
PE HAS DELIVERED A SMOOTHER RIDE THAN PUBLIC EQUITIES



Source: Cambridge Associates, U.S. Private Equity Index and Selected Benchmark Statistics as of March 2019. For illustrative purposes only.

Figure 5

PE FIRMS CAN HELP PORTFOLIO COMPANIES RENEGOTIATE LOANS WHEN LIQUIDITY IS LIMITED



Source: Bernstein, Lerner, Mezzanotti, "Private Equity and Financial Fragility during the Crisis" (July 2017). This figure reports year-by-year probability of renegotiation of leveraged loans issued between 2003 and 2007 with a size of at least $30 million. The figure reports separately renegotiation probability of loans granted to PE-backed companies and non-PE backed companies. The sample considered is the one of U.S., non-financial corporations. Data on renegotiation comes from S&P and the background loan information comes from DealScan. For illustrative purposes only.

deep bench of talent that enables them to successfully pivot their approach during downturns. In particular, they can use available dry powder to alleviate a company's financing concerns as well as help them renegotiate loan terms and debt obligations. Similarly, PE firms can take a buy-and-build approach to consolidate a sector, using the same dry powder to make add-on acquisitions when purchase price multiples are low. This can be particularly effective in down markets because public companies tend to retrench and avoid investing during these periods, creating opportunities for private companies. PE managers are also often sector specialists, owning companies within a specific industry over multiple economic cycles. Therefore, they are well-equipped to identify difficulties early on as well as the best path forward.

A recent working paper that focuses on the period around the Global Financial Crisis (GFC) confirmed that PE-backed companies are generally more resilient to downturns and can act as an economic stabilizer during a recession.[5] In the working paper, PE-backed companies were found to be less likely to face financial constraints during the GFC, and thus were allowed to grow and increase market share versus peers. PE firms also were found to have been significantly more likely to assist portfolio companies with operating problems and provide strategic guidance during the crisis. In addition, PE-backed companies invested 6-percent more and gained 8-percent market share versus non-PE-backed peers during the GFC. As a result, PE-backed companies were 30-percent more likely to be acquired in the period post-crisis, with a greater potential for a profitable exit.

The same working paper also showed that in the years immediately following the GFC, loans to PE-backed companies were about 50-percent more likely to be renegotiated than those to non-PE backed companies. This points to PE firms being able to leverage existing banking relationships to access credit for portfolios even when market liquidity is limited. It also demonstrates PE managers' active approach to assisting their companies to raise debt financing, interacting with intermediaries on financial structure, and, in some cases, even buying back the debt obligations of their portfolio companies.

ABILITY TO EXPLOIT THE BENEFITS OF ILLIQUIDITY

Although it may seem paradoxical, private equity's illiquid nature is an advantage in a recession because it insulates investors from panic selling during the depths of a downturn. Panic selling almost always comes at a high cost; investors often liquidate holdings for below-market values because they fear values declining even further. Meanwhile, PE managers have the benefit of a multi-year holding period, with the ability to patiently wait for better

Continued on page 42 →

PRIVATE EQUITY OFFERS RESILIENCE . . .

Continued from page 34

market conditions to exit underlying portfolio companies. PE's illiquid structure also renders PE's correlation with the broader public markets of less importance, because the decision to exit an investment is put in the hands of professional managers who are closest to the underlying asset.

PE's inherent attributes include a long-term investment philosophy, highly active involvement with portfolio companies, and fund structures that prevent fire sales. These characteristics provide value for PE investors across all market environments—but particularly in the face of market stress. Today's investors should consider adding a private equity allocation for its outperformance potential and to help provide a smoother ride in this volatile market environment.

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ENDNOTES

1. Preqin, "2020 Global Private Equity & Venture Capital Report" (February 2020), https://www.preqin.com/insights/global-reports/2020-preqin-global-private-equity-venture-capital-report.
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4. Hamilton Lane Market Overview 2017/2018, https://www.hamiltonlane.com/Customer-Content/WWW/CMS/files/Annual_Market_Overview_-_2017-2018.pdf, page 17.
5. See Shai Bernstein, Josh Lerner, and Filippo Mezzanotti, "Private Equity and Financial Fragility during the Crisis" (July 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3011104. The study focuses on the U.K. market (largest PE market as share of gross domestic product pre-crisis). Similar financial data not publicly available in the United States.

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