Private Market Views from the Investment Advisory Group

Q4 2022 – Public markets rout hatches private equity opportunities

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Window of opportunity

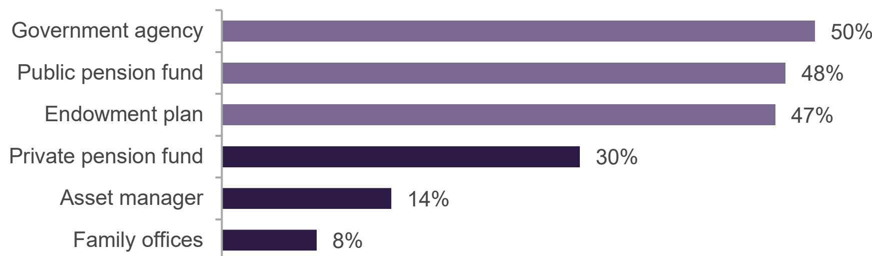
The 2022 bear market in stocks and bonds had many large institutional investors pulling back on adding to private equity (PE) allocations.

Context: As investors' stock and bond values have fallen, for many their percentage of private holdings – whose values have generally been more stable – has swelled beyond investment policy ranges. To bring portfolio allocations back to targets, these affected pensions, foundations, and insurance companies reassessed their new PE commitment volumes in 2022.

- This is a forced short-term pause by some institutional investors that typically have access to the most attractive deals.

More opportunities in the private markets are becoming available to high-net-worth individuals and smaller institutions as private funds' general partners (GPs) have been forced to accommodate a broader range of investors (limited partners – or LPs).

Percentage of investors surveyed who consider themselves "over-allocated" to private equity in 2022



Source: Preqin

We expect favorable returns from recently closed, and soon to close, secondaries vintages. The stage is set for them to deploy capital quickly into an accommodating market in 2023 and reap the rewards when regular deal flow resumes.

- GPs have amassed $140 billion of dry powder and considerable amounts of discounted fund stakes are coming to market in the near term.

Go deeper:

We outline opportunities we're seeing in select private market strategies and highlight top-of-mind market developments in the following pages.

- Spotlight: Secondary market opportunities
- Deal structure key to private debt success
- PE performance following market shifts
- How Private REITs are protecting investors

TRUIST

Past performance does not guarantee future results.

Investment and insurance products:
• Are not FDIC or any other government agency insured
• Are not bank guaranteed
• May lose value

Wealth

Secondary market opportunities in the spotlight

The secondaries strategy within private equity will play a pivotal role against the backdrop of a dry IPO and rigid acquisition environment. Attention in this area has significantly increased as the public equity and bond market sell-off begins to take a toll on allocation targets and cash reserves.

- 52% of investors surveyed saw secondaries as an attractive investment opportunity, compared to only 21% last year.

Potential repeat of ’20 deal flow for private investment buyers and sellers

A key secondary market driver is limited partners looking to rebalance their portfolios because their private equity allocation percentage has increased. One of the main market detractors is large GPs trading among themselves during this weak exit environment.

- Tactical rebalancing is also underway as some investors offload LP interests in preparation for a forecasted recession and coinciding private market correction.
- Forfeited interests from cash-strapped limited partners is another avenue for secondaries managers to purchase stakes at a significant markdown.

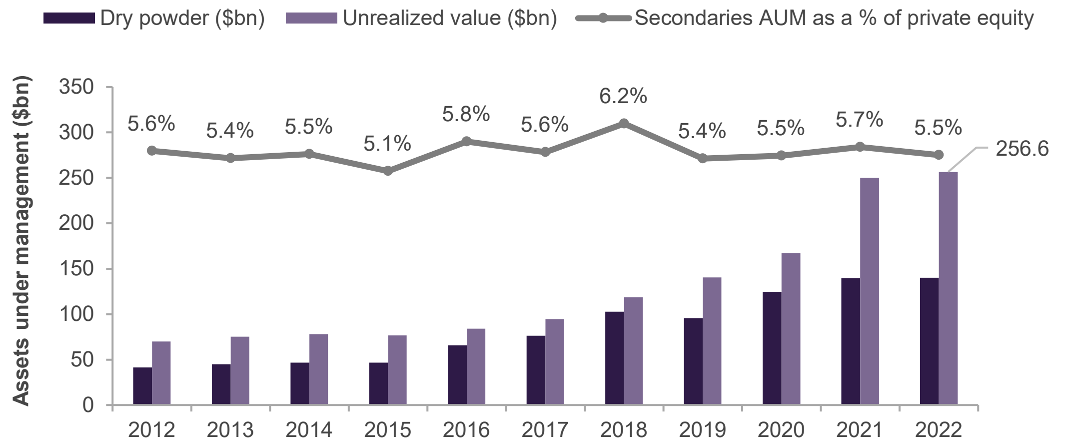
As noted, the stage is set for timely secondaries vintages to deploy capital quickly and deliver favorable returns when regular deal flow resumes. The current conditions have several parallels to the 2020 COVID disruption.

However, many skeptics are concerned about a backlog of private portfolio holdings being widely mispriced which would negatively impact long-term returns.

- The counter to this observation is the thorough diligence and modelling during pre-transaction deal valuation which is often linked to public market peer multiples and includes liquidity discounts of 20-30% or more.
- Asset acquirers in the secondary market lean on superior negotiation skills and deal terms to differentiate their strategies from competitors and deliver return on investment (ROI).

Unrealized value jumped by 33% from 2020 to 2021 while Assets Under Management (AUM), in dollars and as a percentage of the total private equity landscape, has remained largely unchanged since 2012.

Secondaries dry powder, unrealized value and AUM



Source: Preqin. As of 9/30/2022

Managers eyeing deal structure as key to private debt success

Despite market headwinds, managers are set to use their focus on deal structures to the best advantage. High-grade private debt in established businesses is well suited for today's investing landscape as banks tighten their lending standards.

A very constructive deal environment for private credit managers is evidenced by:

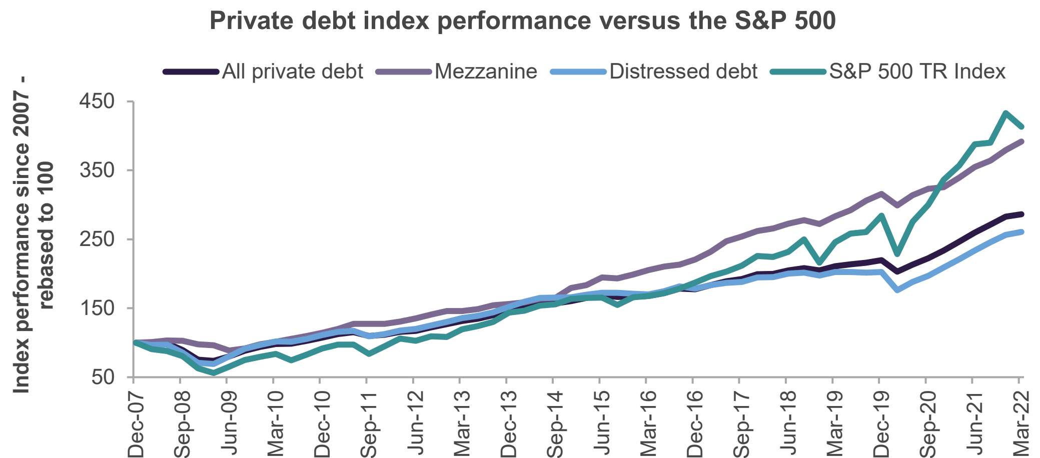
- Quality businesses
- Floating rate coupons (which are defensive relative to a rising-rate environment)
- Excellent loan-to-value ratios
- Strong financial covenants
- Material equity kickers
- And top-tier private equity sponsorship

The asset class also has a low correlation to headline risks and offers a diversified source of income with total return potential.

Floating rate component turns investor focus to spreads

While yields have started to increase, they're still below pre-Global Financial Crisis levels, reflecting the extraordinary amount of liquidity injected into the financial system. Investors who tolerate private debt's illiquidity have concentrated capital into top quartile GPs, where debtor firms have sufficient cash flow to meet rising interest obligations. Since 2008 those investors have been rewarded with a spread over government and corporate rates.

Mezzanine funds, which often have significant equity exposure to their portfolio companies through a subordinated convertible structure, have more closely tracked the S&P 500 than other debt strategies.



Source: Preqin. As of 9/30/2022

Private REITs protecting investors with redemption limits

Non-traded Real Estate Investment Trusts' (REIT) terms include limits designed to protect existing investors as well as the long-term health of the funds by mitigating any liquidity mismatch.

- For example, two of the largest non-traded REITs, the Starwood Real Estate Income Trust (SREIT) and the Blackstone Real Estate Income Trust (BREIT), allow for repurchases of up to 2% of net asset value (NAV) in any month and 5% of NAV in a calendar quarter.

In December 2022, SREIT and BREIT limited redemptions given their monthly and quarterly redemptions caps.

- Key factors cited as driving the elevated redemption activity included year-end tax related transactions, institutional capital rebalancing and foreign investor redemptions.

Public REIT investors cope with volatility and NAV discounts

As private non-traded REITs use the contractual tools at their disposal to diminish externally driven volatility, public REIT investors are enduring market-driven fluctuations.

- In January 2022 public REITs were trading at a 14% *premium* to the value of their underlying real estate. When interest rates rapidly increased, NAVs fell sharply and in July public REITS were trading at a 19% *discount* to NAV.
- There have been eight instances since 1997 when public REITs traded at a discount to NAV of more than 15% and the average total returns following these periods were 33% after one year and 62% after 3 years.

It's difficult to determine if the pricing methods of public or private real estate funds are more accurate relative to changing market conditions and underlying holdings, but non-traded asset investors have been the beneficiaries of more stable estimates historically.

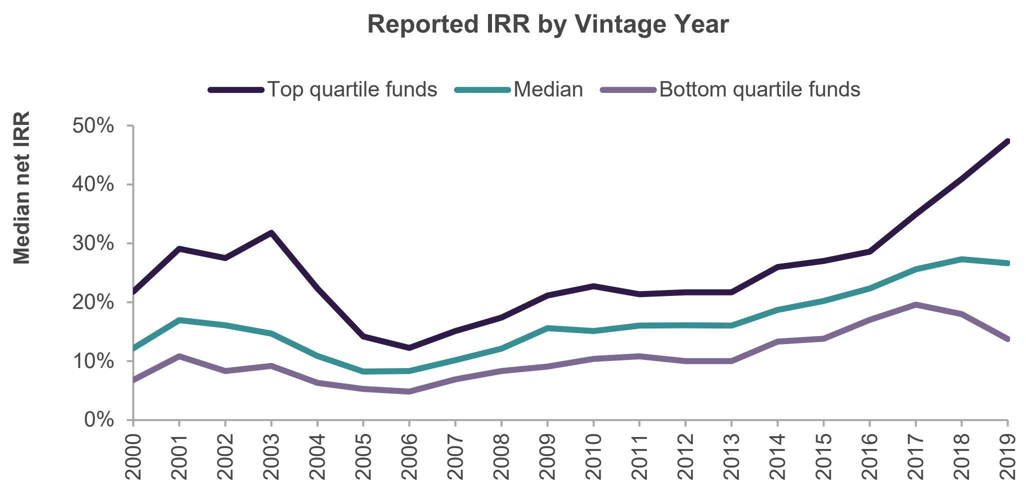
Private equity and private capital performance update

Private equity returns for vintages 2019 and prior years have held steady amidst the valuation pressures from rising interest rates and public market price corrections.

- 2020, 2021 and 2022 vintages have not yet reported meaningful Internal Rate of Return (IRR) figures but are showing resiliency in net multiples as top quartile managers have produced a 1.5x,1.3x and 1.1x TVPI, respectively.

  However, most of these markups are unrealized and subject to market fluctuations.

Top quartile funds are taking advantage of the recent dislocation with favorable entry points and exclusive exit options, while bottom quartile strategies are wavering as deal flow has stalled on both ends of the transaction lifecycle.



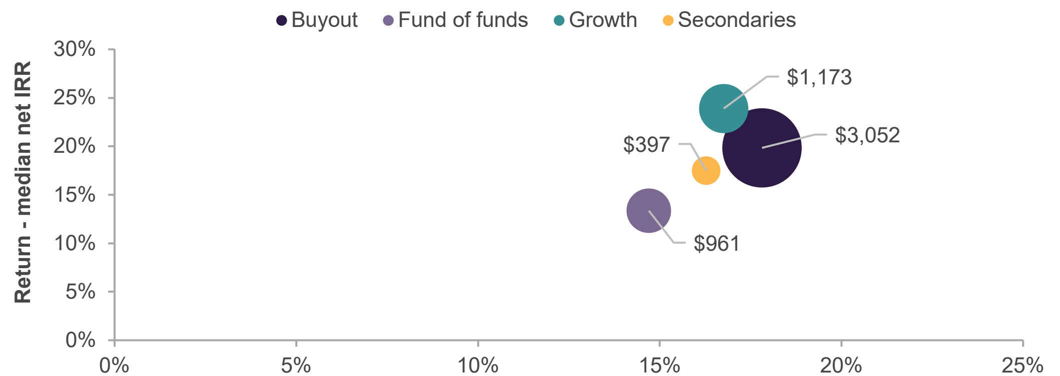
Source: Preqin. As of 9/30/2022

Growth outperforming buyout as the cost of leverage rises

When separating private equity returns by strategy, growth managers have outperformed with a 24% median net IRR from 2009-2019, whereas buyout funds have only returned 20% even with a slightly higher risk component as measured by standard deviation. The moderation of buyout performance can likely be attributed to an overcrowded mega-deal market and inflated financing costs.

- Fund of funds have the lowest aggregate IRR at 13%, due in part to an extra layer of management fees. However, this cost of oversight may have earned its keep, as reflected in the lowest risk measure of the PE strategies.
- Secondaries have delivered a strong risk-return ratio to date, as the market has become more liquid and transaction volumes have surged with the recent turmoil.

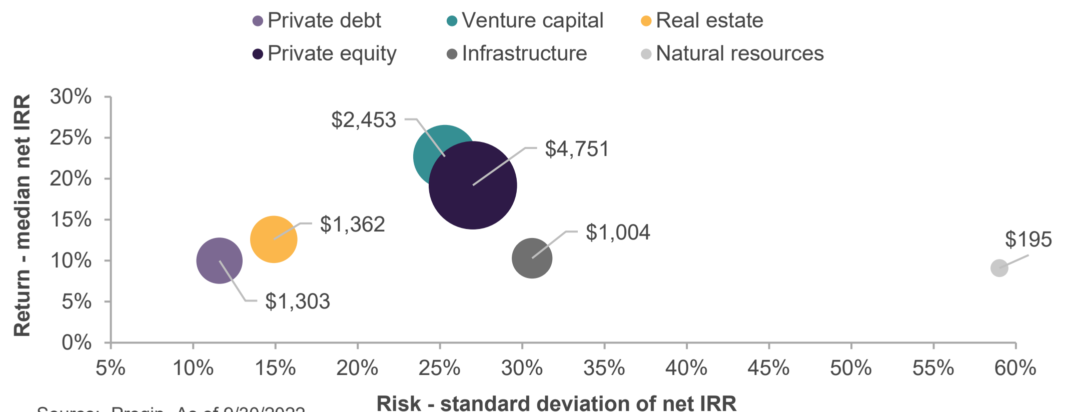
Buyout AUM is approximately double Growth at $3.1 trillion as shown by the size of each plot.



Private capital returns widely dispersed across asset types

Venture capital and private equity have offered the most favorable risk-adjusted return profile especially in larger North American focused vehicles. Private debt, which holds predominately senior secured floating rate loans, and real estate have provided a haven from other areas markedly impacted by inflation and rate hikes.

Private equity AUM is approximately double Venture Capital at $4.7 trillion as shown by the size of each plot.



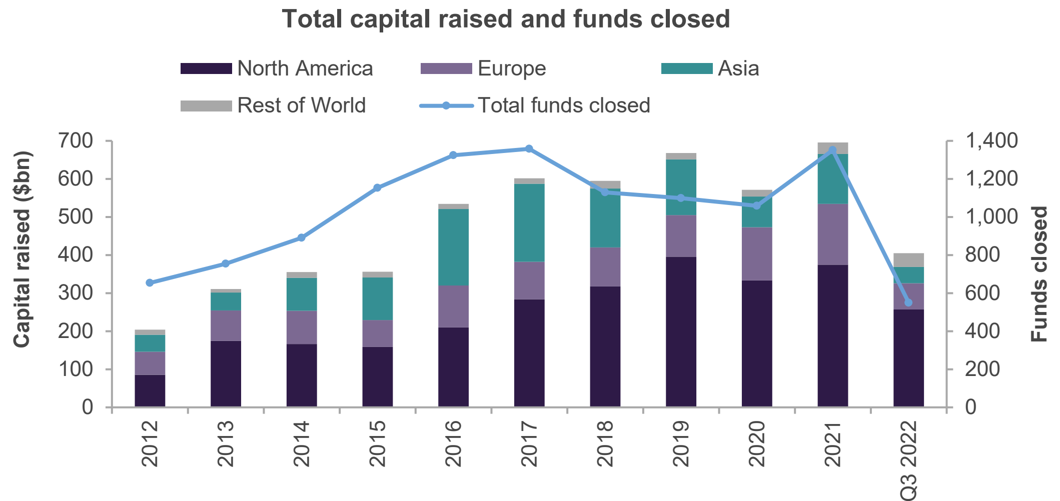
Fundraising struggling to catch historic 2021 highs

Private equity funds have raised $405 billion through Q3 2022 (42% below last year's record total) in 550 closings compared to 1,352 for the full year in 2021.

- While North America-focused funds held up relatively well at 31% below the prior year's level, APAC (Asia Pacific Countries) recorded the steepest drop as measured by both dollar amount and percentage at -67%.
- This APAC decline was driven by a notable risk aversion towards China-focused funds where a structural slowdown in the residential property market and ongoing lockdown measures weighed on activity.

There were more than 3,185 funds in market as of September 2022, with an aggregate target of $1.2tn.

Both metrics are pushing record highs as it seems that supply is set to outpace demand in 2023.



Source: Preqin. As of 9/30/2022.

Open-ended fund structures gaining popularity

Fully deployed private equity and debt funds with an open-ended or "evergreen" structure are entering the mainstream as an acceptable option for investors looking to mitigate the administrative and liquidity burdens of traditional drawdown vehicles.

A straightforward core holding with liquidity options has been sought by high-net-worth clients, as well as some institutions. Prominent managers have been rolling out new strategies over the last two to three years to meet the demand.

- Partners group, headquartered in Switzerland, has been known as the pioneer of this structure since 2009. But other large firms such as Hamilton Lane, Blackstone, Blackrock, Apollo, Neuberger Berman, and others have recently launched differentiated vehicles. They all share the goal of offering diversified private markets exposure in one fully funded allocation.

Key differences - drawdown versus evergreen

There are some general distinctions between the two structures which can be seen as compelling advantages for either, depending on the type of investor and their situation. (see table on next page)

	Traditional drawdown	Open-ended evergreen
Cash management	Calls and distributions	At investor discretion
Capital deployment	Over multiple years	Upon funding
Subscription timing	Offered every 2-3 years	Offered monthly
Liquidity	Not available	Quarterly
Diversification method	Limited or fund of funds	Primary, secondary, & direct
Asset allocation	Static targets	Dynamic
Tax reporting	K-1	1099
Performance	No liquidity constraint	Material liquidity sleeve
History	Long and tested	Limited for most offerings

Conclusion

As private capital fundraising during 2022 substantially slowed from an unprecedented 2021, and the limited partner composition is changing, general partners are surveying the market and adjusting their business models accordingly.

Returns have not yet buckled through September 2022, but highly anticipated year-end valuation reports, which managers will be distributing throughout the Spring, should tell the full story of the last twelve months.

Wide performance dispersion across strategies, vintages, and quartiles have left investors with the burden of weighting their private capital portfolios appropriately. A key for 2023 will be taking advantage of potential opportunities as they arise in areas such as secondaries, private debt, evergreen structures, and REITs, to offset the broader private market challenges forecasted in the upcoming year.

With negative public market performance and elevated volatility, many investors might be tempted to take a tactical pause in their allocation to private equity. The performance of the asset class over more than two decades reinforces the idea that completely pausing allocations in adverse public markets or economic downturns typically is not the most prudent decision.

Consistently committing to a diversified private equity portfolio of high-quality managers has been essential for long-term outperformance. Investing in private capital strategies typically entails at least a 10-year commitment with a long investment horizon.

- Having a commitment and liquidity management strategy at the outset is key. Reducing versus halting commitments in times of distress could be appropriate depending on an investors' overall portfolio and liquidity constraints.
- A steady allocation pace across vintages helps to mitigate risk in a similar fashion to dollar-cost averaging and allows an investor to build out a systematic private capital program that eventually should become self-funding by producing distributions that can be reinvested. Skipping a vintage can make maintaining allocation targets difficult by disrupting the virtuous circle of distribution and reinvestment associated with private equity fund structures.

Private equity is a unique asset class that may offer higher returns relative to the public markets, in exchange for taking on higher levels and different types of risk. Against a challenging macroeconomic backdrop, private capital strategies can provide investors diversification benefits resulting in an improved risk-reward profile across their portfolios.

Disclosures

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