Private Market Views from the Investment Advisory Group

Q1 2023 – Is the “private market correction” coming?

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Ravi Ugale
Managing Director
Private Capital Strategies

Will Repath
Director
Private Capital Strategies

Dylan Thompson
Analyst
Private Capital Strategies

Private equity versus public equity valuation and performance spreads are unlikely to narrow

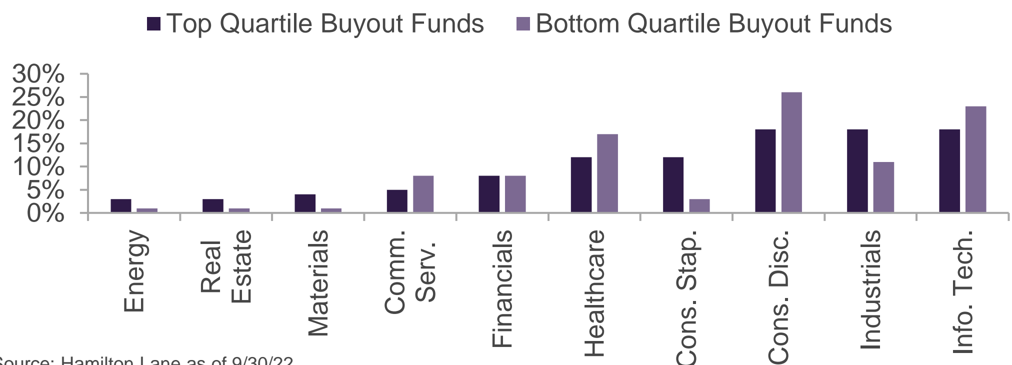
In 2022 some investors questioned private equity (PE) portfolio valuations as they held reasonably steady, especially in larger buyout vehicles, while public equity indices saw double-digit declines.

However, it’s important to recognize the wide variation in types of private funds and their underlying assets. For example, according to some preliminary year-end data from Neuberger Berman during Preqin’s “Valuations and Performance Trends” webinar:

- Buyout fund net asset values were up 3.5% on average in Q4 and flat for 2022
- While Venture fund net asset values fell every quarter and were down 16% on average for the year.

How individual companies fared had a lot to do with their respective operating sector and the quality of their business.

- Public markets saw wide performance dispersion under the surface. The S&P 500 declined 19.4% in 2022, while more than 30% of the stocks in the index had positive returns.
- Similarly, top quartile private market managers benefitted from defensively weighting their portfolios towards companies with external and internal tailwinds.



Source: Hamilton Lane as of 9/30/22

Explore further:

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

- Private equity value spreads unlikely to narrow
- Venture secondaries GPs capitalizing on “risk off”
- Private credit growth spurred secondaries market
- Performance and fundraising update
- Innovation continues to democratize private capital

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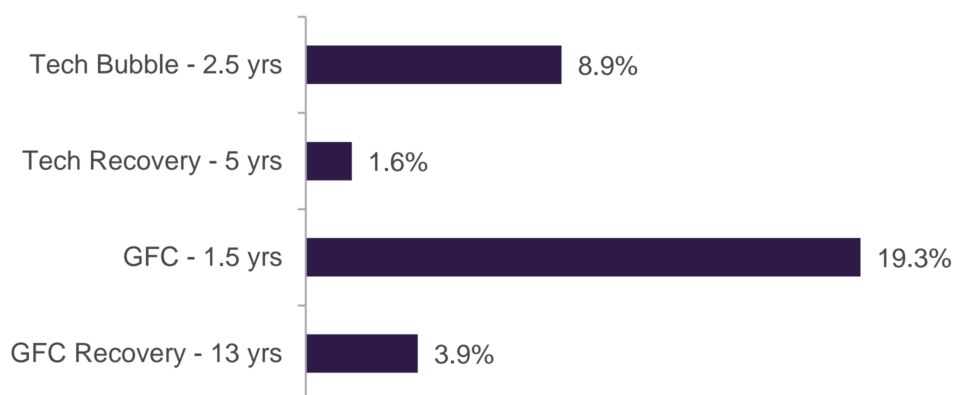
When the stock market recovers, private equity historically follows suit

Private market valuations have an implicit spread against comparable public market companies and their fluctuations are positively correlated to movements in the global stock market. However, private equity performance swings, up or down, tend to be more muted.

Accordingly, final year-end valuations of private investments won't necessarily reflect as deep of a decline as public markets.

- **Recent research by Hamilton Lane found that since 1990 only one quarter showed negative buyout fund returns when the MSCI World was positive.**
- For various reasons including disciplined investment selection, stable entry prices, majority ownership and hands-on value creation methods, private equity funds may perform better than public indices.

Private equity outperformance by market cycle



Source: Hamilton Lane as of 1/31/2023; Comparison to the MSCI World Index; Tech Bubble = 4/1/2000-9/30/2002, Tech Recovery = 10/1/2002-9/30/2007, GFC = Global Financial Crisis 10/1/2007-3/31/2009, GFC Recovery = 4/1/2009-12/31/2021

The surge in interest rates will significantly impact larger, leveraged deals

As the 10-year Treasury yield spiked from less than 1% in 2020 to over 4% in 2022 the private deal landscape shifted, creating a much more challenging environment for fund managers, and weakening exits while strengthening entries. When interest rates were low, fund managers were able to flourish in a market buoyed by rising multiples and by relying on cheap leverage, especially for larger transactions in which a significant portion of the capital came from debt.

- General partners must now focus on increasing value through revenue growth and margin improvement to deliver positive returns.

Returns have been stronger in low or declining rate environments and weaker in high or rising rate environments, but global private equity has outperformed the public markets across multiple rate cycles as managers seize pricing advantages in a downturn. Investors who have remained committed to the private markets should diminish the impact of negatively affected vintages with those vehicles positioned to take advantage of lower valuations.

Venture Secondaries managers capitalizing on recent banking developments and broad “risk off” environment

Silicon Valley Bank, a key banking and credit partner for venture capital firms (VC) and start-up companies, collapsed in early March. Due to this event as well as other pressures, the venture capital market was stagnant in the first quarter of 2023, as confirmed by Pitchbook’s latest data.

- In Q1 ’23, approximately $5.8 billion in exit value was generated – the lowest quarterly total since the Global Financial Crisis. Deal value fell more than 60% from its quarterly peak, in Q4 ’21 and only $11.7 billion of VC partnerships were raised, trending toward the lowest annual total since 2017.

As the capital market remains relatively frozen for start-up firms, many venture investors in need of liquidity are being forced to explore options for offloading their positions.

- This has created an opportunity for Venture Secondaries managers and Limited Partners (LP) willing to look past the current stale transaction environment and absorb the holding period risk.

Various types of sellers taking discounts to turn their VC shares into cash

The broader private equity secondaries market has become increasingly popular with over $160 billion in assets under management (AUM) and over 50% of investors surveyed by Preqin noting the asset class as “presenting the best opportunities in PE.”

- A lesser-known strategy with fewer participants is venture secondaries where the objective remains the same with a different market niche.
- VC Secondaries managers seek to access top-performing funds and companies at a discount, with the nuance being a focus on well-positioned venture funds and later-stage direct venture investments.

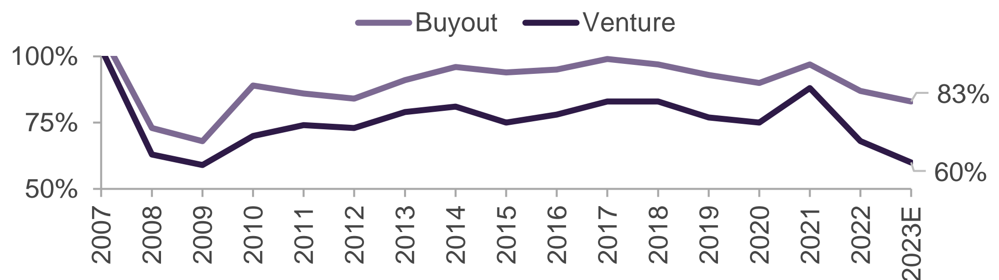
Silicon Valley Bank’s collapse and other banking issues could create a cash crunch in the VC industry at a time when limited partners are already cash constrained and unenthusiastic about funding capital calls.

A select group of managers have established track records in this area, and they have historically been successful in capitalizing on market volatility and accessing sought-after companies towards the end of their exit windows at favorable prices.

The sellers offer their interests in exchange for timely capital and creative transaction structures. The distinct categories of sellers include:

- Limited partners looking to rebalance a portfolio or that have a liquidity need
- Hedge funds or other non-traditional investors in need of capital to meet redemption demands or similar cash requirements
- And start-up founders and early employees preparing for life events

LP interest secondary pricing as a % of Net Asset Value (NAV)



Source: Industry Ventures as of 3/31/23

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Private credit outperformance and asset growth spurred an underserved secondaries market ripe for new entrants

Floating-rate debt as well as the leveraged loan market held up well in one of the worst years on record for fixed income in 2022.

- The Morningstar LSTA US Leveraged Loan Index returned -0.67% for the year compared to -15.1% for the S&P 500 Investment Grade Corporate Bond Index and -19.4% for the S&P 500. This is just the third time loans have outperformed stocks and bonds in the 25-year life of the index.

Limited Partners' (LP) allocations to private debt managers have accelerated over the past five years with fundraising increasing at a rate of 10% annually and ending 2022 with $208 billion in commitments.

- Even with the spreads of interest income over risk free assets decreasing, Preqin's most recent investor survey shows that 63% of those polled intend on increasing their long-term private debt allocations. For context, that's more than private equity at 47% and infrastructure at 58%.

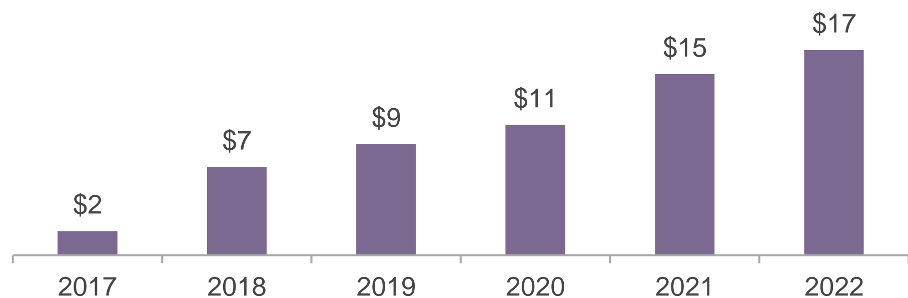
A quickly growing investor base and an uncertain future created a demand for liquidity from investors that fund managers filled with Private Credit Secondaries vehicles.

- Several well-known managers such as Coller Capital, Portfolio Advisors, Pantheon, and others are amassing commitments to dedicate capital to this emerging secondaries market.
- The current dry powder is only about half of annual deal volume. Many larger deals are going untraded due to the supply-demand mismatch.

The private credit secondary market has grown 30x since 2012 which has led to the current undercapitalization.

Experienced buyers can be extremely selective in this market, but new entrants need to focus on the quality and terms of their purchases especially as risk tolerance and rates fluctuate.

Private credit secondary deal activity (billions)



Source: Pitchbook as of 1/31/23

The influx of capital into the private credit space has shifted the competitive landscape with the introduction of new managers with varying levels of expertise and risk management.

- Capital has become concentrated among top quartile funds, with more than a third of capital raised going to the 10 largest lenders.
- Additionally, the heavy inflow of capital into the space has led to increased interest in distressed debt of companies that would not have had access to capital otherwise.

Rate hikes and covenant-lite loans raise risks to private credit

With uncertain economic conditions moving forward, defaults are likely to increase. Historically private credit vehicles have weathered downturns with creative terms and direct involvement.

Investors are aware of uncertainty in this growing asset class as the Federal Reserve's tightening agenda over the past year has impacted both public and private credit.

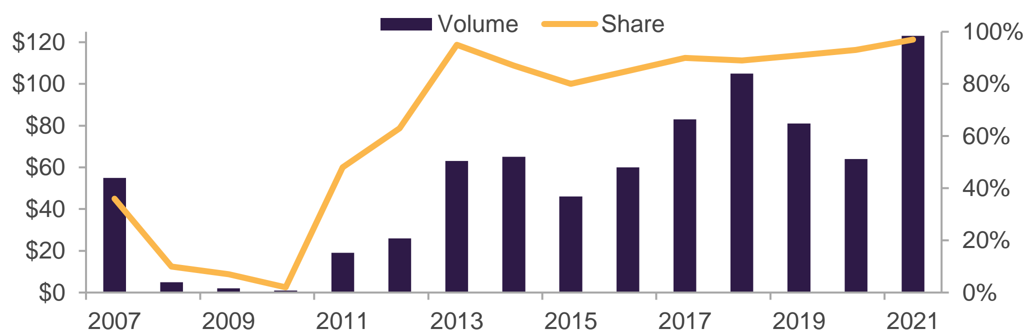
- While most private loans are issued as floating rate, thereby minimizing interest rate risk to lenders, continued tightening in the context of a recession could lead to cash management issues of the underlying holdings and increase defaults.
- Ever more stringent lending standards in the marketplace and earnings pressures that naturally arise during an economic slowdown could lead to fund managers consulting with restructuring experts to mitigate risk.

Covenant-lite loans, loans designed with more favorable collateral requirements and clauses for borrowers, have taken an overwhelming share of the private credit marketplace, potentially increasing risk from weaker due diligence standards. In a recessionary environment the dealmaking pendulum will likely swing back to favor stricter protections, but lenders are also relying on more creative provisions such as restructuring agreements, equity ownership and note convertibility.

In 2021, 90% of private equity-backed loans were covenant-lite, compared to 1% in 2010.

The relative ease of access to capital for borrowers has ushered in a style of covenant-lite loans giving fewer traditional protections for lenders and greater flexibility to borrowers.

Covenant-lite new-issue volume ($billion) & share % for Leveraged Buyouts



Source: S&P Global Intelligence as of 10/4/21

During the Great Financial Crisis (GFC), which was arguably the worst default period in the last few decades, private credit performance was propped up by pre-recession rate hikes which increased payments on floating rate notes, as well as deal structure, borrower selection, and repayment flexibility.

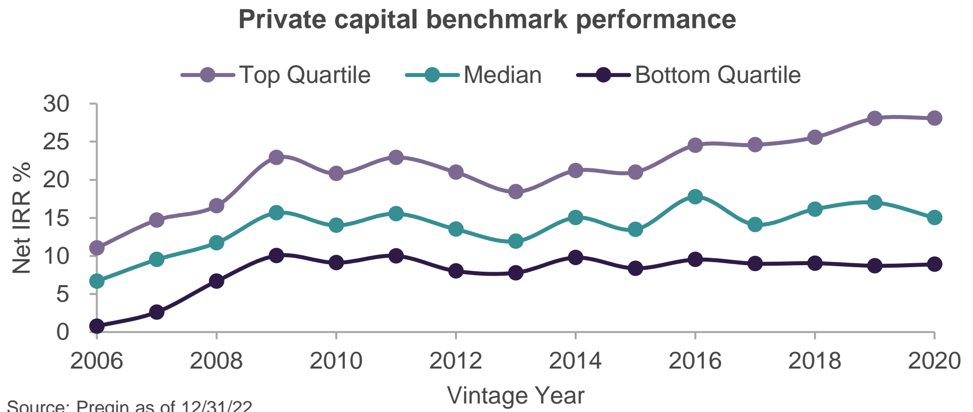
Nonetheless, though default rates have remained near long-term averages, a recession could open the door for more underwater investments and issues related to debt servicing as seen during the GFC.

- A "perfect storm" of abrupt rate cuts reducing interest income and a significant earnings collapse increasing defaults would likely pressure deal returns. The more junior lenders would take the brunt of a downturn, but top tier managers with a more senior lending position would rely on their defensive terms and high-quality borrower cashflows to support their lending operations.
- Conversely, should the Fed continue to hike interest rates to combat persistent inflation, it could continue to squeeze corporate earnings and companies' ability to service borrowing cost, opening the possibility for increased defaults across the asset class.

Private capital performance and fundraising update

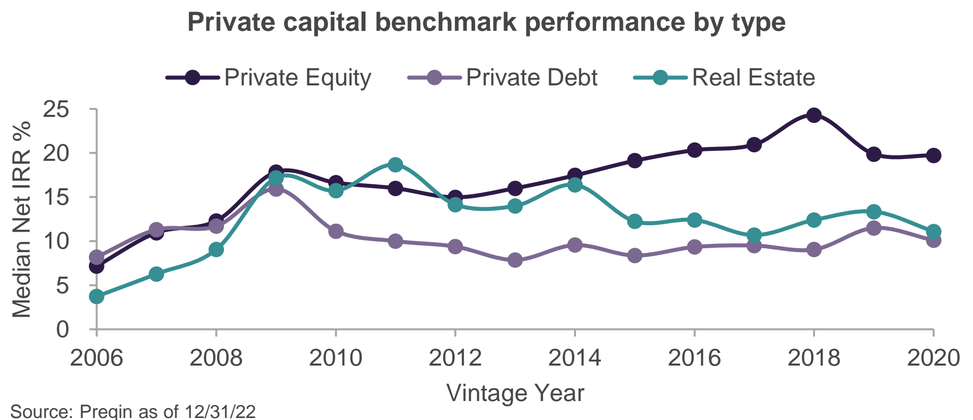
Quartile dispersion has widened for later vintages as managers rely on scale and experience to produce returns in a challenging environment

Bottom quartile managers will likely struggle in a recessionary environment and the return dispersion will continue to widen as they lack the resources and network that top funds lean on in unfavorable markets.



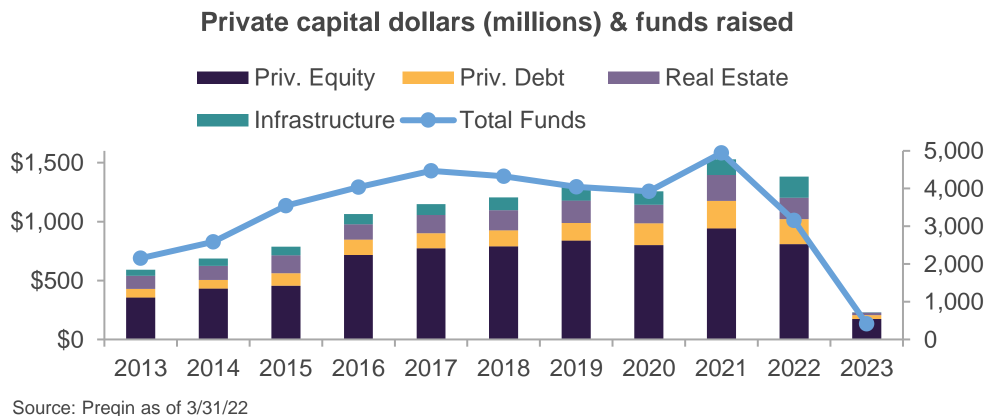
Returns for private equity vintages since 2016 remain stable as other asset types show mild volatility and trend downward after 2019

As more December return data is reported with the completion of annual audits, there may be stronger IRR declines in valuation reliant asset classes such as real estate and private equity particularly for 2020 vintages.



Fundraising slowed substantially in 2022, after a record-breaking 2021; 2023 is on pace for a considerable annual decline

As institutions and wealth advisors consolidate commitments into familiar managers, the broader mid-sized and newer fund universe is delaying closings.



Innovation continues to democratize private capital access as managers seek growth and investors seek flexibility

Wealthy individual investors are increasingly drawn to private capital investments as they may offer differentiated returns and enhanced portfolio diversification. The Truist Wealth Investment Advisory Group's research shows that including private assets in portfolio mixes indeed may enhance risk and return expectations.

When comparing the expected performance and volatility of various Public Equity/Private Equity/Bonds portfolio constructions to a traditional 60/40 allocation, we generally expect a positive return and risk adjusted statistic (Sharpe ratio).

The forward-looking analysis shows enhancements to risk-adjusted returns in exchange for illiquidity when adding private investments to a traditional 60/40 portfolio.

	60/40 Stocks/Bonds	**50/25/25** Stocks/Bonds/ Private Equity	**50/30/20** Stocks/Bonds/ Private Equity
Forward Return Expectation	6.0%	7.1%	6.8%
Forward Sharpe Expectation	0.28	0.31	0.31
Liquidity Estimate	100%	70%	55%

Source: Truist IAG; Risk & return expectations based on 10-year forward-looking Capital Market Assumptions.

Managers, with the goal of AUM growth and LP diversification, are now catering to the private wealth space. They've dedicated significant resources to building and servicing high-quality products with low minimums, monthly or quarterly liquidity options, and market terms that may offer better risk-adjusted returns than their public peers. As the landscape has developed, these innovative, accessible, and investor-friendly vehicles have evolved from "fringe" adoption to more mainstream acceptance.

Decade-long commitments and administrative burdens are main hurdles

Bain & Company projects that institutional capital allocated to alternative investments will grow 8% annually over the next ten years while private wealth investors will grow their alternatives exposure 12% annually from $4 trillion to $13 trillion by 2032. This growing group of high-net-worth investors expect that the process of investing in private funds will be similar to the process of investing in stocks or bonds, i.e., relatively straightforward. However, this has not historically been the case as commitments are often for 10 or more years, typically taking weeks to initiate and months to get funds to work, involving multiple legal document submissions.

- The use of open-ended funds has risen considerably since 2020, as more managers try to address these issues and investors are taking advantage of relaxed qualifications, growing from 4.1% of private market AUM to 7.6% in 2022.

The technology available today has allowed fund managers to absorb or ease a lot of the "headaches" investors traditionally endured, such as subscription timing, commitment modeling, capital management, and tax reporting.

As the offerings have continued to expand, the Net Asset Value of the open-ended product universe is still dominated by a small number of larger players, but comparisons have been made to private equity forty years ago when a similar dynamic existed. As more managers entered, the market concentration was reduced, unique products were launched, and best practices were adopted, a strikingly similar progression to today's semi-liquid landscape.

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