Truist Advisory Services, Inc.

Private Market Views from the Investment Advisory Group

2H 2023 – Do interest rates matter in private equity?

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Private equity returns persist in higher rate environments

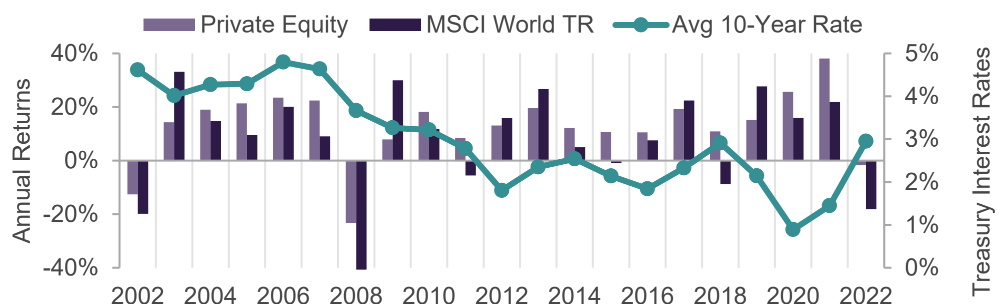
Leveraged buyout (LBO), or purchasing a company using mostly debt to improve it and sell it for a profit later, is a term and strategy most investors view as synonymous with private equity. If the sole tool for fund managers is balance sheet re-engineering, then a simple rise in rates would negatively impact performance as the cost of debt increases. However, this is not what the research on long term performance data shows.

- **Returns for private equity have a low correlation to 10-year treasury yields over time, as economic changes, market factors, industry trends and manager adaptability are also important variables.**

There are two sides to the story for managers using LBOs as a key component of their strategy in a high interest rate environment. While their lines of credit may be more expensive, their acquisition targets are often purchased at more attractive valuations from corporate sellers. Along with this favorable entry pricing dynamic, managers tend to pivot away from financial engineering during times of higher interest rates, and lean into **more heavily equity-weighted deals** which require other value creation methods to drive returns, including:

- **Business transformation** - purchasing a company with high growth potential or areas where a strategic partner (the fund manager) can add value, whether that be through operational improvements, personnel optimization, brand management and marketing, or separating business segments.
- **Business expansion** - otherwise known as “buy and build” involves purchasing a category leading company with the intent to acquire a number of smaller players in their industry (often in a specific region), ultimately maximizing market share, synergies, scale, margins, and earnings of the parent company.

A temporary shift in borrowing costs isn’t enough to sway the entire private equity industry away from leverage. Managers have been diversifying their toolkit since the 1980s to mitigate the effects of rate changes. According to Hamilton Lane, excess leverage was estimated to contribute 46% of average investment value creation for GPs prior to 2000 but has fallen to 22% in the last decade as revenue and margin growth have become more prevalent areas of focus.



Source: Preqin as of 9/30/2023

Venture decline presents an entry opportunity for investors

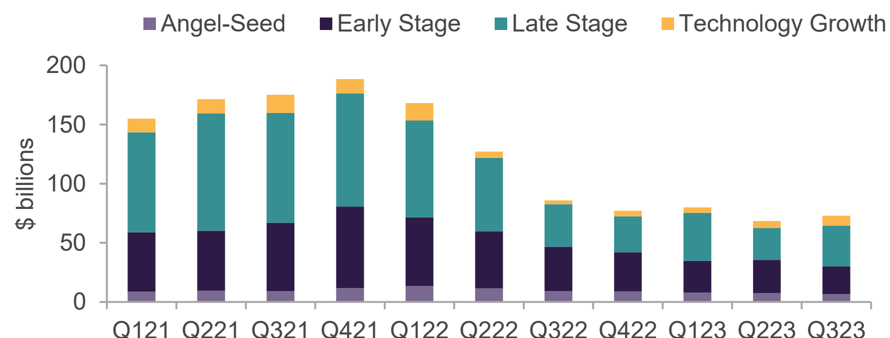
Venture capital (VC) is a prominent growth driver for technology and innovation in the 21st century that provides investors with a unique upside potential, especially if they partner with category leaders and employ thoughtful manager due diligence. Private equity performance is on track to recover from a moderate decline in 2022, but VC valuations and deal-making have remained depressed as marks over the past 18 months fell by 17%. This decline may present long-term investors with an attractive entry point, as resets in valuation tend to moderate downside risk, improving the potential for elevated IRRs for newer vintages.

- **Top Quartile US VC funds averaged net IRRs of 22% from 1996 through 2020 even while enduring three distinct recessions. The return dispersion over this period ranges from 3% to 74% depending on vintage year timing which highlights the importance of taking a strategic approach to investing in the asset class.**

Global VC funding in the third quarter of 2023 reached $73 billion, down 15% from the same quarter last year, marking the second lowest quarter since the deals environment started to slide in 2022. The negative sentiment in the space reflects investors rethinking valuations as long-term treasuries hit 15-year highs and a sustained IPO drought limits exit opportunities. **We think this is a missed opportunity to benefit from lower valuations**, especially in light of catalysts that can bring life back into the space sooner than expected, including:

According to Cambridge Associates, US Venture Capital vintages raised during the midst of the Global Financial Crisis in 2008 provided investors average TVPI's of 2.3x over the life of the fund despite overall VC valuations declining 14% for the year. 2010 vintages faired even better, deploying capital into the onset of the recovery, and delivering average multiples of 3.3x.

- **Advancements in Artificial Intelligence (AI) -** The rapidly evolving technology has attracted global interest from innovators and investors alike, with private AI focused companies raising more than $10 billion in the third quarter of 2023 alone. To put this fundraising figure into perspective, the most popular Nasdaq 100 ETF had $3.5 billion of net inflows over the same 3-month period. More use cases are being discovered daily, increasing the total addressable market for Artificial Intelligence and breadth of return potential for early private investors. As the technology matures and a smaller group of companies begin to lay foundations in their respective industries, there will likely be a "second wave" of more risk averse managers looking to deploy capital into the AI infrastructure space and mid to later stage segment leaders.
- **Healthcare -** The healthcare sector is undergoing a period of rapid change, driven by factors such as an aging population in much of the developed world and an increasing prevalence of chronic diseases. Recent R&D breakthroughs such as Ozempic, which has been shown to effectively treat both type 2 diabetes and obesity, are changing the landscape of healthcare and creating ancillary investment opportunities. The innovation and development of drugs treating diseases that have made health care immensely costly for the public may provide early-stage investors with promising returns.



Source: Crunchbase as of 9/30/2023

Co-investments offer efficient access to top companies

Companies with bright futures often need a large capital injection to fuel long term growth or overcome a bump in the road. Private capital fund managers specialize in identifying these investment opportunities, but may not always be able to meet the total capital due to concentration limits for single investments, or a shortfall of cash near the end of an investment period. In this situation, general partners can turn to their existing limited partners for an additional one-time transaction, called a co-investment, where LPs invest directly into a fund's existing or prospective portfolio company that is already a top performer or has high growth potential.

- **Co-investments allow investors, without the resources to build an entire portfolio of direct private equity holdings, to invest a portion of their capital directly into companies that their trusted fund managers have exclusive access to, and have already performed thorough due diligence on.**

While the main risk of direct co-investing is concentrating capital into a single company, investors typically participate in this space to benefit from:

- **Outsourced diligence** - leverage the expertise of the manager to underwrite deals
- **Attractive economics** - often favorable deal terms and low or no fee burden
- **Enhanced return potential** - access to companies with strong future projections
- **Asset type diversification** - spread smaller allocations across non-fund investments

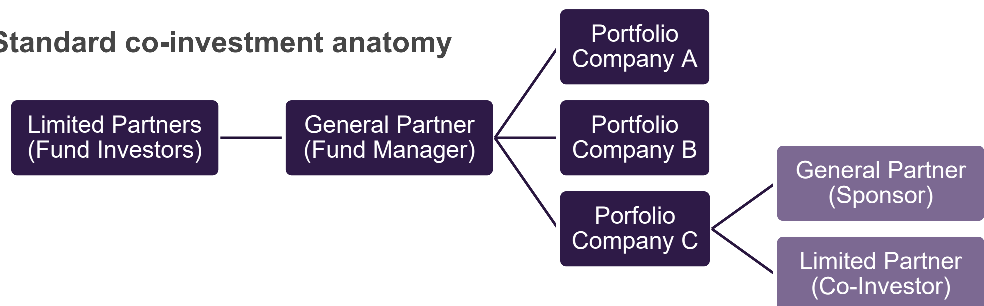
According to Preqin, of the funds launched between 1998 and 2016, 60 percent of co-investment funds delivered a higher net internal rate of return compared to peer single-sponsor vehicles.

These opportunities are usually sporadically offered to the investor base of a fund manager as they arise but can also be accessed through **dedicated co-investment funds**. Co-investment fund managers pool capital commitments so that they are in a position to deploy capital quickly and efficiently when a general partner in their network is looking for a reliable investor with the capacity to participate alongside them in an initial or follow-on funding.

Traditional co-investments are "sponsor led," or managed solely by the general partner and offered to limited partners at the previously agreed upon terms, but these transactions can take place in other forms which require earlier and more investor involvement.

- **Co-underwrite or pre-syndicated** deals commonly need a specific amount of capital at a certain time to complete, so sponsors reach out to a few dependable partners to work alongside them during diligence and structuring to ensure smooth execution.
- **Mid-life transactions** are typically offered 3-5 years after the original investment was made and can be driven by a capital need for the company or liquidity need for the fund manager that initially invested. These situational deals have unique characteristics including historical data advantages, transparent valuations, and earlier exits.

Co-investment funds that participate in traditional, co-underwrite, and mid-life transactions benefit from the incentive and structure diversification that comes with each sub-strategy. Additionally, in deals where investors are heavily engaged throughout the process, the terms they are able to negotiate for their equity and role in the decision-making process will often be more favorable.



Can private credit deliver on "golden age" expectations?

Regulatory changes after the Global Financial Crisis in 2008 started a decade-long downward trend of traditional lending, as standards and terms tightened significantly across the industry. Banks and other institutions were forced to narrow their scope of potential borrowers, leaving a significant void in the market for capital. As private credit managers slowly stepped in to address borrower demand, the public market volatility and banking instability of 2022 further pressured lenders, causing a bottom in transaction activity and expediting the transition away from leveraged and syndicated loans.

- **Of the 37 take-privates totaling $54 billion between June 2022 and February 2023 not a single deal was funded by banks and the broadly syndicated loan market.**

The widespread shift to private credit as the preferred route for direct company lending, leveraged buyout financing, and funding for special situations have some publications calling the upcoming decade a "golden age" for private credit. Alongside this expanding opportunity, recent returns have been attractive and stable across the asset class.

- **According to Pitchbook, private credit benchmarks returned 4% in 2022 while the S&P 500 fell 18% and investment grade corporate bonds lost 15% of their value.**

Despite the more popular narrative around recent performance and potential future tailwinds, more skeptical sources are referring to the sweeping shift away from more heavily regulated lenders as a "reach for yield" from "cyclical borrowers" and a move to an inherently risky "shadow banking system."

The truth is likely somewhere in the middle as increased capital flows to this strategy create both risks and opportunities. We remain constructive on private credit over the long-term as the inherent illiquidity, complexity and risk premiums of the strategy are likely to continue offering investors higher yields than public bonds. However, we caution investors against unbounded optimism around current returns, keeping in mind that:

- **The "golden age" of private credit outperforming equities may persist in the short to medium term, but should normalize over the long term.**
- **Diligent manager, strategy, and sector selection are paramount for investors to benefit from a private credit allocation.**

Private Credit Market Factor or Trend	Potential Tailwind	Potential Headwind
Widespread borrower demand and market acceptance	Ample deal flow and borrowers for managers to select from	Attract new entrants to lending and will pressure deal terms
Majority of transactions are floating rate loans with a floor	Investor returns are enhanced in a rising rate environment	Larger interest burden on borrower capital and operations
Deals have flexible terms and close-knit relationships	Manager can accommodate temporary repayment issues	Frequent refinancing reduces returns and stretches liquidity
Transaction types and borrower mix varies widely	Managers can choose various industries, stages, and structures	Fund's loan quality and structure risk can change significantly

Disclosures

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The risk profile of a private equity investment is higher than that of other asset classes and is not suitable for all investors. There are inherent risks in investing in private equity companies, which encompass financial institutions or vehicles whose principal business is to invest in and lend capital to privately held companies. These risks include a long-term investment horizon, rigid liquidity restraints, and high bankruptcy rates among portfolio companies. Generally, little public information exists for private and thinly traded companies and there is a risk that investors may not be able to make a fully informed investment decision.

Private placement limited partnerships and funds of funds, or other types of long-term investment vehicles are typically illiquid. The terms of the agreements governing these investments generally provide for significant notice periods, lock-up periods, holdbacks upon redemption, and other provisions that make prompt liquidation of these investments contractually impossible. It may often take several months, a year or even longer to process redemption in these situations.

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