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Private Equity 2.0: Uncovering Value in a Shifting Landscape

CONVERSATIONS

Mina Pacheco Nazemi discusses the key trends driving today's private equity market, the biggest challenges facing limited partners today, and where the Barings team is seeing the most compelling opportunities.

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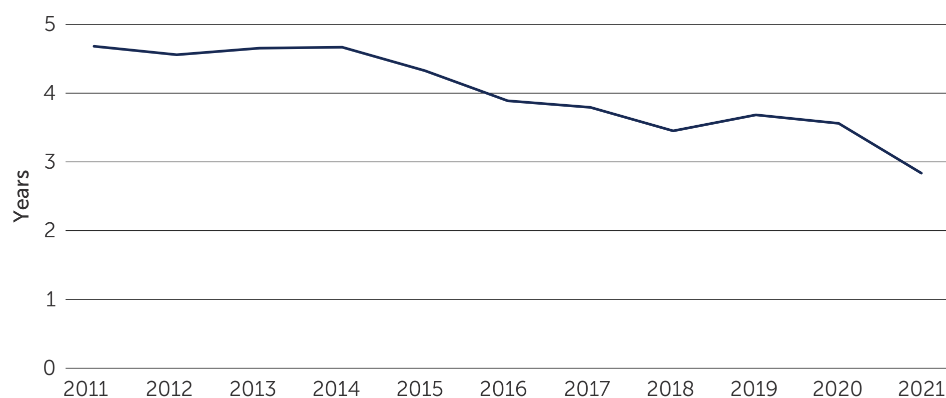
What are the noteworthy and emerging themes within private equity that investors should be aware of?

There are a number of notable trends impacting the private equity landscape today. For one, managers are coming back to market with increasing frequency and larger funds, meaning there are more funds in the market in general. **Figure 1** illustrates the drop in fundraising cycles from ~4.7 years in 2011 to merely ~2.8 years in 2021. Alongside new opportunities, this inundation of re-ups has created challenges for investors already coping with existing exposures at or above target allocations. The volatility in the public markets has further exacerbated the constraints that LPs face (denominator effect), making it more difficult for them to put money to work.

Figure 1: Average Time Between Funds



Source: Pitchbook 2021 Annual U.S. PE Breakdown. As of December 31, 2021.

Coinciding with the trend toward larger funds, we have a seen a trend toward managers expanding the investible universe that they have traditionally operated within. This could mean expanding into new sectors, participating in larger deals or, in some cases, investing in strategies where they have not yet demonstrated expertise or track record. While this growth and evolution isn't inherently problematic, LPs do need to ensure they are comfortable that managers—when expanding into these new areas—have the right amount of expertise to generate the expected returns as advertised.

Similarly, alignment between the LP and manager are of critical importance. In recent years, we've witnessed some degradation of this, specifically when it comes to the capital that managers, or general partners (GPs), have invested in their own funds. In some cases, even as managers have had successful exits, crystalized carry dollars, and raised subsequent funds—generating higher fees for the management team—the level of alignment has remained at the market standard of roughly 2%, instead of increasing commensurate with the manager's generated wealth. In our view, this can represent a red flag for LPs, and is something to monitor.

The headwinds that have driven current market sentiment, namely rising rates, high inflation and recession concerns, are likely to persist for the foreseeable future. How has this impacted the opportunities in private equity?

For one, the macro environment has shifted the types of companies coming to market, and COVID-related challenges are impacting the opportunity set. For instance, we are seeing a theme of founder-owned businesses coming to market as the fatigue from the last few years has pushed owners to seek an opportunity to exit. Companies from industries that have held up well during the pandemic, such as health care and technology, are also coming to market. In contrast, the impact of the environment has exposed less sophisticated management teams who have historically benefited from up markets. These less attractive companies may be waiting longer to come to market than they would in a more favorable macro environment. Additionally, the pandemic and the current economic environment have weighed on managers with large legacy portfolios. The time and attention managers need to devote to struggling legacy assets can detract from the focus required for growth and value creation.

For these reasons, **the value of emerging managers becomes more apparent in this environment.** The current volatility highlights the importance of managers who know their sector and industry well, can evaluate new opportunities within their specialization, and have a demonstrated track record of creating value. Emerging managers often fit this bill. It is also worth noting that emerging managers are not the same as inexperienced managers. Often, emerging managers are teams who have spent years or decades investing together in one segment of the market, or in one industry. Emerging managers may be raising first, second, or third-time funds—and are often doubling down on their experience over 20 or 30 years.

Emerging managers typically employ appropriately sized teams and can focus on a given sector without the burden of managing multiple funds with a large number of portfolio companies. These teams tend to have the time and attention to help their businesses weather economic storms while simultaneously attending to future growth. That level of specialization and attention may represent an advantage during a recession, as managers with massive legacy portfolios must oversee and help each of their many portfolio companies navigate through a downturn. Finally, the level of alignment that emerging managers commit to is often higher on a relative basis than their larger peers—even at the industry standard of 2%.

What are some common traits and differentiators associated with managers that typically perform well?

As mentioned, the alignment of a GP with its investors is critical, as the amount of "skin in the game" is one of the more reliable indicators of a manager's performance. Sector specialization has also been historically important, and again, may be even more valuable amid continued economic uncertainty.

Other key factors in evaluating a manager are the experience of the team, how they have operated over time, and how they have performed through different market cycles. The management team is often locked into a commitment for 10 to 15 years, so a cohesive, tight relationship among partners, junior partners, and staff can be indicative of long-term success. For emerging managers, evaluating the team's performance in pre-fund structures or as independent sponsors is often necessary to observe the working relationships and understand the team's ability to source differentiated opportunities and to demonstrate their effectiveness in creating value.

Investment teams with women and diverse talent also represent a rising differentiator. Women and diverse managers have historically been overlooked despite the data demonstrating their outperformance compared to their peers.[1] This dynamic presents opportunities to build out networks of underrepresented talent—both women and diverse led managers as well as companies with diversity in the C-level

1. Source: McKinsey Diversity Matters data set. As of December 2019.

ranks. We view a manager's ability to evaluate different opportunities through different lenses as an advantage. Constructing a team of diverse viewpoints, backgrounds and experience leads to a greater diversity of thought and ensures that "herd mentality" or "group think" which typically leads to less than favorable outcomes is circumvented.

Given the challenges in the current environment, are there particular investment vehicles or structures that present more opportunity, or less opportunity, in today's market?

Private equity 1.0 represents the traditional private equity opportunity set including funds, co-investments, and secondaries. **Private equity 2.0 represents a landscape where value is created and identified in a variety of structures.**

As an example, a relatively recent trend toward **continuation vehicles** has presented interesting opportunities for LPs. In a continuation vehicle, a manager has an asset in their portfolio that they have typically created economic value with, and would traditionally be at a point where a sale is forthcoming to return capital to investors. But rather selling the asset and moving on, in the case of a continuation vehicle, the manager sees further upside and prefers to hold the asset for a longer time period. In this case, the manager would structure the single asset in a new vehicle—the continuation vehicle—and offer their investors (limited partners) the opportunity to either exit and liquidate the position or continue to hold the asset.

While most LPs typically choose to exit, others participate in the new vehicle and continue their investment in the asset. In our experience, more LPs could benefit by taking the time to evaluate the opportunity presented by the continuation vehicle from managers within their portfolio as well as those outside their portfolio. While the liquidity provided from exiting is beneficial in some instances, LPs may be missing upside potential by declining to participate in an asset that has performed well and is run by a management team that has demonstrated success in growing that asset. This is particularly true given that many continuation vehicles feature a portfolio's best-performing assets.

Regardless of the vehicle or structure, there are a number of potentially attractive opportunities in private equity today, especially in the lower-middle market. Given the more volatile and challenging economic backdrop, it is critical for LPs to ensure that they have a comprehensive view of the market and invest with managers with strong alignment and a demonstrated ability to generate repeatable returns.

At Barings, and specifically within our Diversified Alternative Equity team, we aim to act as an extension of our clients' investment teams—enabling them to cover more ground and evaluate opportunities in areas like emerging managers, continuation vehicles and more. In a quickly evolving private equity market, we aim to leverage our knowledge and relationships to help our clients navigate the constantly changing tides.

This piece is adapted from an episode of Streaming Income. Listen to the full conversation here.*

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