PRIVATE EQUITY

Six Current Challenges Facing Private Equity LPs

INSIGHTS

In the uncertain economic climate of 2023, limited partners may benefit from revisiting several important considerations when managing existing private equity portfolios and allocating capital.

With economic dislocation and a possible recession on the horizon, limited partners (LPs) investing in private markets will face a field of hurdles in coming months when making decisions about existing and new commitments. In particular, there are six specific challenges of which private market investors should be aware.

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1. Deconstructing the 'Denominator Effect'

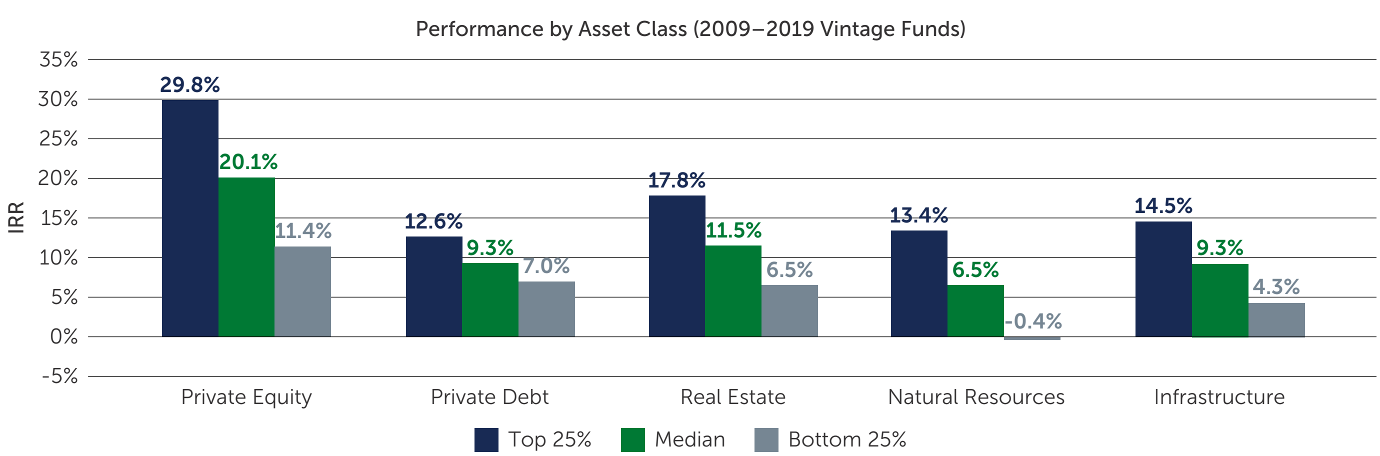
LPs' private market exposures have increased materially (as a percentage of total plan assets) over the past year due to a combination of:

1. Public market valuation declines coupled with relatively flat private market valuations
2. Declining distribution rates
3. Accelerated commitment pacing due to the increased velocity of general partner (GP) fundraising timelines

As some LPs consider re-balancing their portfolios in response to these recent market changes, we believe it is imperative that LPs employ a more nuanced, thoughtful approach in deconstructing and analyzing all of the complex private market sub-strategy components embedded within the numerator and denominator calculations of the so-called 'denominator effect', which occurs when the value of one portion of a portfolio (e.g., public markets) decreases dramatically and diminishes the value of the total portfolio, causing any portfolio segment that did not decrease in value (e.g., private markets) to constitute a larger percentage of the total.

Risk-return and liquidity profiles for all private markets sub-strategies are certainly not created equal and will likely be impacted differently across economic environments. Thus, these complicated nuances need to be carefully considered when re-weighting long-term exposures to private markets. For example, private equity sub-strategies such as buyouts, growth equity and venture capital generally carry a significantly higher target return expectation relative to infrastructure or private credit strategies, even though these strategies may all receive identical risk-based capital treatment. In contrast, infrastructure or private credit strategies typically are characterized by smoother, recurring distributions due to those strategies' current yield components, which may help compensate for these strategies' generally lower return expectations. Even with the private equity asset class, buyout strategies investing in mature, profitable companies have a vastly different risk and cash flow profile relative to venture capital or early stage growth strategies investing in unprofitable, high cash burn businesses, which is further exacerbated during periods of economic stress as more intense scrutiny is placed on profitability and cash generation, valuations come under pressure and exit timelines via traditional IPO or corporate M&A windows are extended. Similar risk-reward and distribution nuances also must be taken into account for other sub-strategies, such as real estate or natural resources, along with a myriad of other portfolio characteristics, such as underlying vintage, geography, capitalization and sector exposures.

Figure 1: Private Markets Asset Class Performance in Recent Years



Source: McKinsey & Company sourced via Burgiss. As of September 30, 2022. Note: IRR spreads calculated for funds for separate vintage years for 2009–2019, and then averaged out. Median IRR was calculated by taking the average of the median IRR for funds within each vintage year.

While portfolio rebalancing can be achieved through secondary sales and by reducing and/or halting new commitments, LPs should also carefully consider whether crystallizing portfolio losses, foregoing vintage diversification and possibly missing out on opportune investments outweigh the risk of a temporary overexposure to private markets.

2. Assessing Inflation & Interest Rate Pressures

Sustained inflation and a continuation of tighter monetary policy are expected to exert ongoing pressure on private market portfolios. LPs must carefully monitor the effects of these macro forces on their portfolios, particularly in the areas of margin degradation, free cash flow generation and debt covenants. Companies with market-leading positions, strong customer/supplier relationships, contractual pricing pass-through mechanisms and lower exposure to input price volatility are likely to be more insulated from inflationary pressures. Similarly, companies with high cash conversion ratios, conservative capital structures and flexible covenant terms should be better positioned to withstand the pressures of rising rates. Companies that do not exhibit such characteristics should be monitored more carefully. It may be prudent, therefore, for LPs to revise their original underwriting expectations for existing investments to account for more conservative exit multiples and longer holding periods. In fact, during the underwriting process, we believe that LPs should memorialize financial projection and return targets along with operational key performance indicators (KPIs) and key milestones for their investments, which should then be tracked on a quarterly basis if not more frequently during periods of market stress. On a quarterly basis as well, LPs should be engaging with their sponsors to better understand the performance of their investments and ask more pointed questions, particularly in instances where those investments may be underperforming against previously targeted metrics.

3. Employing an Independent Risk Framework

Recent banking problems and reputational issues involving portfolio companies owned by prominent private equity firms raise concerns about the degree to which those GPs may be outsourcing too much of their diligence and risk assessment to third parties, including attorneys, accountants, consultants, buyside brokers and others. Also concerning is how well these GPs understand and can address potential risk areas among their investments. This, in turn, raises further questions about how value creation takes place at portfolio companies and the extent to which private equity firms are really driving value. For these reasons, we believe it is more important than ever for LPs to employ their own independent risk frameworks to identify potential areas of investment and operational risk within their GPs and in their underlying portfolio investments.

4. Avoiding the Blind Re-Up Trap

In making new allocation decisions, LPs now face re-up decisions with much higher frequency due to the accelerated fundraising cycles of many GPs. While investors often favor continuing existing GP relationships rather that re-evaluating and exploring new relationships, LPs must take a very discerning approach to re-upping with current managers, particularly in the context of increasingly skewed internal rates of return (IRRs). In many cases, return figures are distorted due to the more aggressive use of capital call lines in recent years. When assessing a GP's relative performance as part of a re-underwriting process, LPs should decipher the unlevered return performance of their prior funds (excluding the impact of capital call lines) and consider how that performance benchmarks relative to unlevered returns for funds in similar vintages.

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Several red flags often signal an impending decline in manager performance over time. These include:

- Accelerated fundraising and deployment cycles, which can consume a manager's time and attention as portfolios expand without a commensurate increase in team resources
- "Strategy drift" into new sectors as well as larger, more competitive transactions with higher purchase multiples and more aggressive leverage profiles
- Asset aggregation into new fund products outside of the firm's flagship strategy, which shifts the firm's focus from investing to business-building
- Senior and mid-level team turnover due to poor economic alignment beyond the original firm founders
- Degradation in economic alignment between GPs and LPs
- Greater track record volatility in subsequent portfolios

5. Scrutinizing Valuation

Amid ongoing macro headwinds, including a rising inflationary and rate environment, private market valuations are expected to face further pressure. Whether underwriting a new transaction or evaluating portfolio company valuations across a GP's existing portfolio, LPs should apply a rigorous lens around the GP's valuation methodology, such as their assumed valuation multiple, discount rate and basis of revenue or earnings. These valuations should be fair and reasonable in the context of the current market. Investors must consider several factors when assessing current valuations including changes in public and M&A transaction multiples, the relevancy of a valuation based on the last financing round and the increasing cost of capital. It is also important that LPs understand the quality of earnings used as the basis for portfolio company valuations, as many pro forma, adjusted or forward-looking measures can overstate current cash generation, distorting efforts to assess how the business can service its debt and fund other ongoing liquidity needs. One suggestion: Look at levered free cash flow as an alternative to EBITDA when assessing valuations.

6. Identifying Key Manager Success Attributes

In the face of market uncertainty and an expanding competitive universe of GPs, manager selection becomes increasingly critical for LPs. In challenging environments, certain key manager attributes appear to be correlated with persistence of returns. These attributes include the presence of:

- Sector specialists with experience investing through multiple cycles
- Ample and dedicated operational resources and capabilities
- Flexible mandates allowing structural flexibility and sufficient downside protection
- Strong sponsor alignment
- Diverse teams with varied backgrounds and viewpoints

Where to Find Opportunities in a Challenging Market

While a cautious approach to investing is prudent in this current macro climate, LPs should remain disciplined and consistent in their deployment of capital and mindful of their longer-term fundamentals and investment horizons. That said, potentially attractive opportunities exist in any market environment, and the following areas are likely to present compelling opportunities throughout the course of 2023:

LOWER MIDDLE MARKET

Current market cycle dynamics are expected to result in heightened volatility and more muted growth prospects across the private equity asset class in the near term. Nevertheless, we expect the lower middle market to demonstrate greater resiliency and outperform relative to the upper middle market and large/mega cap segment of companies. In recent years, as LP capital has increasingly gravitated toward larger, more established managers—and as those GPs have moved further up-market into larger transactions—a competitive void has been created in the lower middle market. That segment represents the vast majority of businesses and constitutes the largest opportunity set. It also has the benefit of being a less competitive battleground for investments and generally offers more attractive valuations and capital structures. In addition, lower middle market opportunities typically provide a wider set of value creation levers to private equity sponsors. The businesses are often founder/family-owned and have not had the benefit of sophisticated institutional management and capital to help professionalize their operations and invest in growth opportunities. Furthermore, the up-market movement of many sponsors provides a more favorable exit environment as well as valuation multiple arbitrage opportunities for these lower middle market businesses.

GP-LED CONTINUATION VEHICLES

With an anticipated weakening environment for traditional exits via mergers and acquisitions or initial public offerings, we expect the GP-led secondary market to remain active as an attractive alternative means of providing liquidity to LPs, while also enabling GPs to hold onto and extract further value from their trophy assets. Continuation vehicles, which allow GPs to roll an asset (or assets) from an existing fund (or multiple funds) into a new investment vehicle, are a way for GPs to maintain exposure while providing additional capital for growth initiatives. Continuation vehicles are a relatively new area of the GP-led secondary market that has emerged as an attractive investment option for general and limited partners alike. We believe these transactions can serve as a particularly attractive complement or substitute to traditional LP secondaries as they enable LPs to target highly specific vintage years, manager types and asset types. This allows for the construction of a more tactical portfolio than would be possible through traditional LP secondary opportunities, which often consist of more highly diversified portfolios where the ability to cull the most desired assets may be more limited.

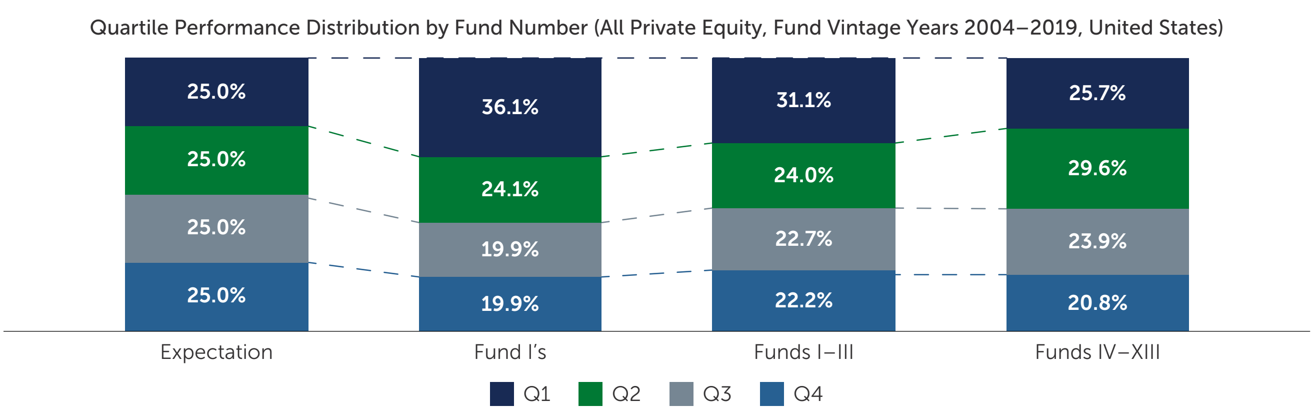
In pursuing these transactions, GPs can continue to manage a high-performing asset, which provides the benefit of a larger fee base and the resetting of the deal carry pool, which can re-incentivize the team for continued value creation. For LPs, assuming that the asset has been fairly priced and that the GP's motivations are properly aligned, these vehicles can provide an attractive opportunity to maintain exposure to a successful company at a lower fee/carry basis. In addition, some LPs have the ability to invest secondary capital into what may be perceived as a less risky opportunity when compared to buying a new unknown asset. This especially can be the case if the asset (or assets) were held and performed well during the challenges posed by the pandemic, labor and supply chain issues, and inflation in recent years. Over time, continuation vehicles offer the potential for LPs to realize strong risk-adjusted returns, particularly with GPs and management teams that have worked together successfully in the past. When making sell versus roll determinations on these opportunities, it is imperative that LPs understand the GP's rationale for the transaction, their detailed value creation plan, and their economic alignment, most notably including the amount of carried interest generated via the platform exit that the GP is rolling into the new vehicle. In those situations, where there is strong GP alignment in a top-performing, high-conviction asset with strong continued growth prospects and a clear value creation plan, we believe continuation vehicles can offer particularly compelling opportunities for investors.

EMERGING MANAGERS

As managers mature and raise subsequently larger funds, relative fund performance often tends to trend downward in a gradual reversion to the mean. This movement is due to various factors that may push the manager away from the hallmarks that contributed to its original success. These factors include:

1. "Strategy drift," which can result from a broadening of strategy focus, movement up-market into a larger, more competitive deal segment, or the development of an asset-gathering approach resulting in overly diversified and beta-like portfolios.
2. Team turnover, which may be driven by the desire of team members primarily responsible for the success of prior investments to spin out and launch their own firms in response to changes in strategy focus, economic incentives or cultural dynamics.
3. Increasing capacity constraints and distractions among key team members. The latter may arise from the demands of managing expanding portfolios and the addition of other firm responsibilities, such as fundraising. Due to the demands imposed by greater inflationary and interest rate pressures as well as the looming risk of recession, many well-known managers with large legacy portfolios may face increasing time and resource constraints. Their greater focus on existing assets may detract from a focus on new growth opportunities and initiatives to create value.

Figure 2: Funds' Actual vs. Projected Quartile Performance Distributions



Source: Pitchbook. As of March 1, 2023. Data set includes primary funds (i) employing buyout, growth, diversified private equity and turnaround / distressed strategies; (ii) with vintages between 2004 and 2019; and (iii) domiciled in the United States. Funds must have performance data and fund size to be considered. Sample set includes 1,047 funds.

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In contrast to larger managers, emerging managers often are better positioned for success due to their focus on the less competitive end of the market where, among smaller companies, their value creation strategies can be executed by more nimble and dynamic teams to drive operational improvements. Emerging managers also have the benefit of not being over-burdened by large legacy portfolios that hamper their ability to provide the necessary attention to existing portfolio companies and new investment opportunities. The bandwidth to provide heightened attention along with their typically more specialized sector focus provide emerging managers with an advantage in adapting to market shifts. In our view, experienced emerging managers, often with decades of tenure at their prior firms, also tend to be more entrepreneurial and hungrier for success than their more established counterparts. This motivation to create something new and innovative drives the potential to generate outsized returns for investors.

Key Takeaway

Looking ahead, there are a number of challenges facing LPs investing in private markets—especially given the uncertainties around the path of inflation, central bank policy and a possible recession. Against this backdrop, we believe LPs should remain disciplined and consistent when it comes to managing existing private equity portfolios and deploying capital. At the same time, we believe there can be potentially attractive opportunities in any market environment. In the coming months, in particular, we see compelling value in the lower middle market, GP-led continuation vehicles, and emerging manager segments.

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