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Private equity and COVID-19

Lessons from the Global Financial Crisis

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Countries across the developed and emerging world are trying to manage the severe economic short-term impacts of the COVID-19 crisis. Given the immense uncertainty, it will take much longer to even begin to assess the permanent implications for the world's populations, companies, and economies. The ultimate effects will, in large part, be dependent on the duration of the crisis, the length and depth of which is currently generating speculations and requires substantial analysis.

Due to the inherent lag in private market reporting, even the initial impact on private markets will take considerable time to fully evaluate. However, the behavior of private markets during the Global Financial Crisis (GFC) may provide some insight into the potential short-term and long-term expectations of private markets in the current crisis. The historical results presented in the paper show that while some funds were negatively impacted by the GFC, others may have benefited based on their respective vintage. Below we examine how private market fund managers reacted to a similarly unexpected and profound crisis which began in 2008.

Some of the takeaways from the GFC were that it led to:

- A decline in exits.
- A decline in deal flow.
- Lower internal rates of return.
- Attractive returns for post-GFC vintages.
- Ripple effects across vintages for years after the crisis.

Across various fronts, 2008 was a momentous year for the global economy and financial markets. Many attribute the start of the GFC to the abrupt bankruptcy of Lehman Brothers on September 15, 2008, which was the largest corporate failure up to that time. However, initial warning signs were already noted with Bear Stearns being bailed out and sold earlier in the year. The exact initiation date of the COVID-19 crisis is still open to debate, but it is thought to have occurred over a relatively limited timeframe around the beginning of 2020 and there was no parallel precursor.

Private equity fund structures

The memories of the GFC may still be unpleasant for public market investors. Nevertheless, 2008 has little relevance to current performance metrics for publicly traded assets. For private markets, however, 2008 continues to have a very meaningful and lasting impact. This has to do with the nature of the asset class as well as the investment vehicles generally used to access it.

Private equity partnerships usually have a seven to 10-year initial life with possible annual extensions. The majority of committed capital is called down during the investment period — typically the first three to five years of the fund's life — and subsequently invested in portfolio companies.[1] The later years of a fund's life are characterized by incremental investments in these portfolio companies. Ultimately, liquidity events are generated as investments are realized and capital as well as profits are returned to the Limited Partners (LPs).[2]

The typical holding period of three to five years for individual portfolio companies in combination with the incremental investment program, as well as the long fund life for the overarching investment vehicle, expose private market funds to the vagaries of market conditions over an extended period of time.

Impact on exits

A good example of how protracted exposure to market conditions can affect private equity fund behavior is the precipitous decline in U.S. private equity exits[3] in 2008 and 2009, as shown in figure 1. Due to the characteristics discussed above, the decrease in exits could have impacted funds' vintages dating as far back as 1998. However, it is likely that the most affected vintages would have been those from 2002 to 2005. These funds would have largely completed their primary investment programs and would have been entering the harvesting phase in which they actively generate liquidity for limited partners by realizing investments and returning cash.

As shown in figure 1, the total value of private equity exits did not surpass the 2007 level until 2012, a period of five years. Therefore, even funds of the 2006 and 2007 vintage years would have felt some impact of the poor market conditions when funds realized their investments, with the degree of this impact partly determined by their initial capital deployment schedule.

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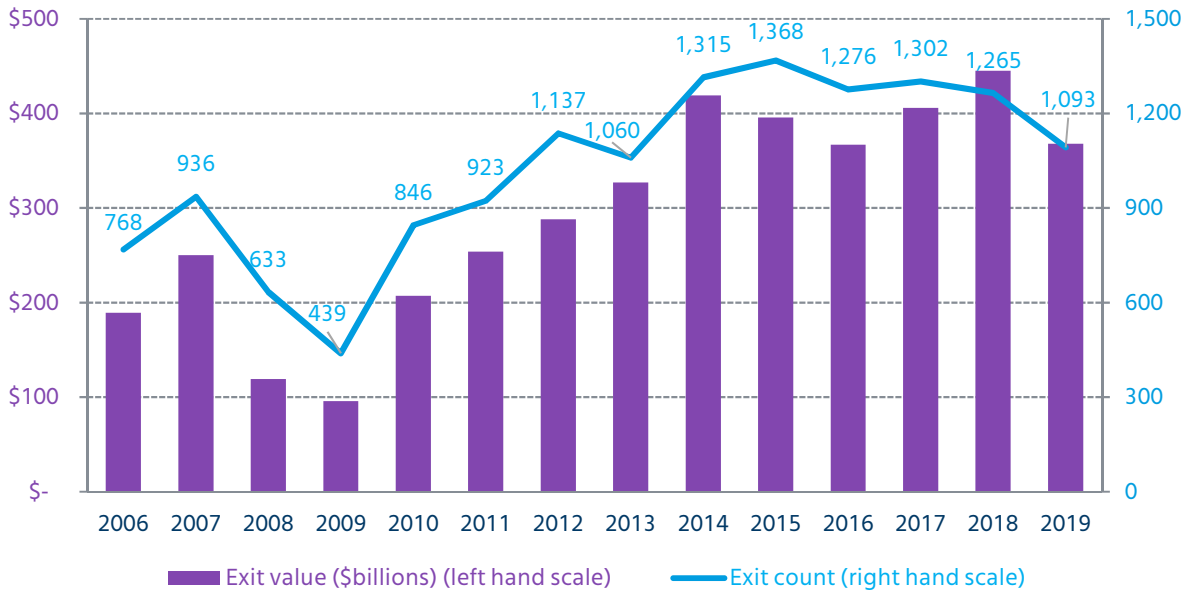
[1] Portfolio companies are private companies in which private equity partnerships invest.

[2] Private equity funds are set up as partnerships where the investors are the limited partners and the general partner manages the fund and makes all investment decisions.

[3] In this context, private equity refers to buyout funds.

Figure 1: U.S. private equity exit flow

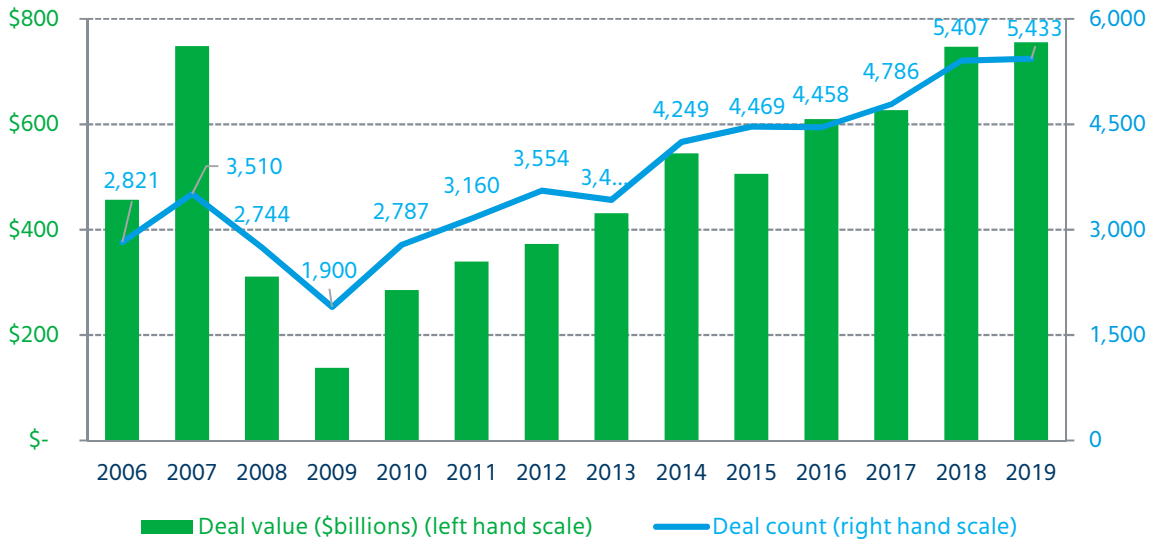


Source: Pitchbook as of March 31, 2020

Impact on deal flow

One factor that influenced 2006 and 2007 vintage funds more directly was the significant decline in U.S. private equity deal flow experienced in 2008 and 2009, as presented in figure 2. Several factors contributed to the pronounced deterioration of deal flow. Amid the GFC-induced uncertainty, many public and private equity investors reassessed their views on risk and its mitigation, often resulting in a decrease in investment pacing. Additionally, fund managers devoted substantial resources to understand how existing portfolio companies were affected by the financial crisis. This decreased the availability of resources that could have otherwise been devoted to new deal development and investment.

Figure 2: U.S. private equity deal flow



Source: Pitchbook as of March 31, 2020

Another potential reason for the decline in deal flow was that many LPs had communicated to their private equity fund managers that, due to the significant decrease in their liquid portfolios, LPs did not have capital available to fund illiquid investments. As evidence of this, there were documented cases of LPs actually paying secondary buyers to relieve them of their 2008 vintage fund commitments, presumbably to avoid subsequent capital calls.[4] Due to these issues, as well being aware of the importance of maintaining good relationships with LPs, many fund managers significantly curtailed their capital deployment over the years following the GFC.

Impact on valuations

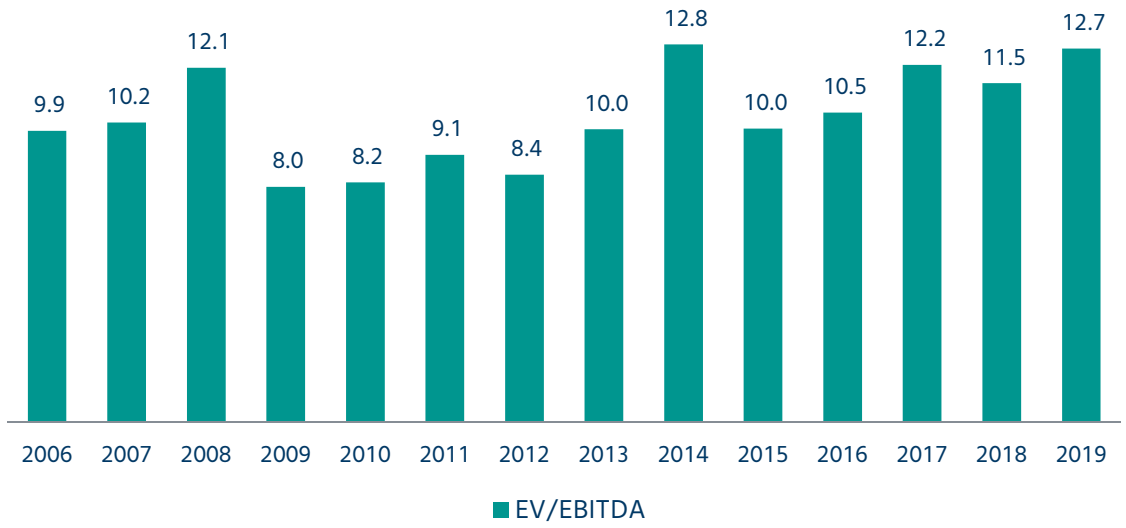
Private equity valuations tend to lag public equity valuations by quarters, if not years, in some cases. This contributed to the deal flow decline as shown in figure 1 as sellers of private equity companies may not have fully rationalized the decrease in the value of their companies at the same time that private equity buyers were experiencing a significant increase in their risk aversion. This, in turn, would lead to a spread between the selling and offering price that could be large enough to be insurmountable in many cases. In those

[4] Source: "The Private Equity Secondaries Market During the Financial Crisis and the 'Valuation Gap," *The Journal of Private Equity*, April 2011

circumstances, it is likely that only the more motivated sellers would have accepted deals offered on the basis of the depressed valuations.

As shown in figure 3, the decrease in deal flow was accompanied by a notable drop in valuations, providing support for the observation made above that motivated sales predominated during this period. Also worth noting is that valuations did not achieve their pre-GFC levels until 2014. Funds with vintages from 2009 to 2012 would have had an extended period of time to deploy considerable capital during a period of relatively attractive valuations. As a result, many funds in those vintages could potentially have generated an attractive return profile through "multiple arbitrage," which is buying while valuations are depressed and selling as the market recovers. Uncertainty was very high during this time as well as following the GFC, and it was not obvious how long it would take for private equity valuations to recover — or even if they ever would.

Figure 3: U.S. private equity purchase multiples



Source: Pitchbook as of March 31, 2020

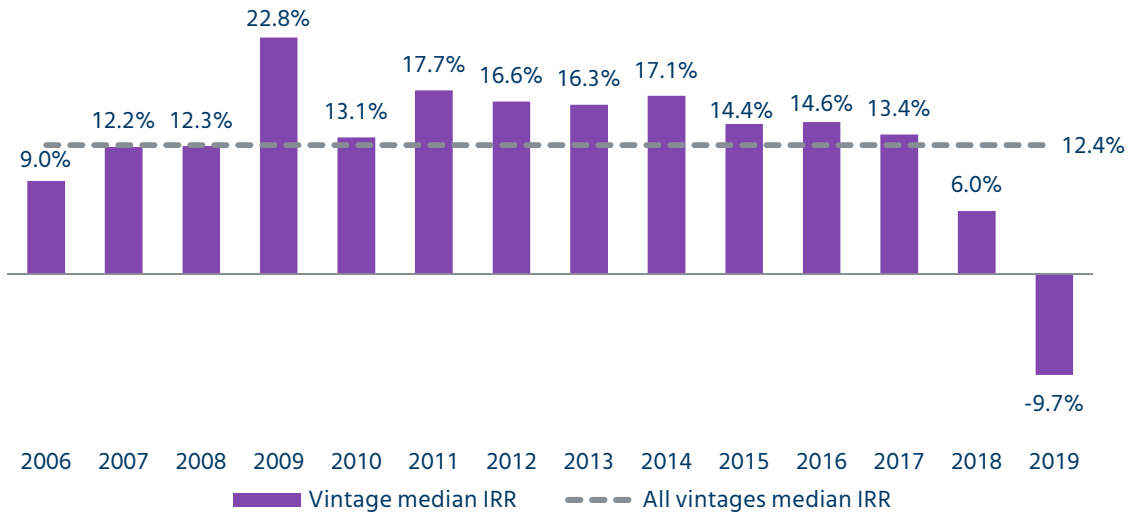
Impact on returns

The considerable drop in private equity investment activity would have had a corresponding negative impact on the IRRs[5] of 2006 and 2007 vintage funds as they were calling fees but not deploying investment

[5] The iinternal rate of return (IRR) is a commonly used performance measure in private equity. It is the implied discount rate that makes the net present value of all cash flows equal to zero.

capital at the expected rate, therefore excerbating the usual J-curve effect[6] as shown in figure 4. Many funds of these vintages asked for (and received extensions) to their investment periods to compensate for the lower deal flow that they were experiencing. The extensions allowed the funds to eventually become fully invested, thereby ultimately lowering their fee drag. Although U.S. private equity deal flow has recovered, it only recently exceeded the high-water mark set in 2007.

Figure 4: U.S. private equity IRRs



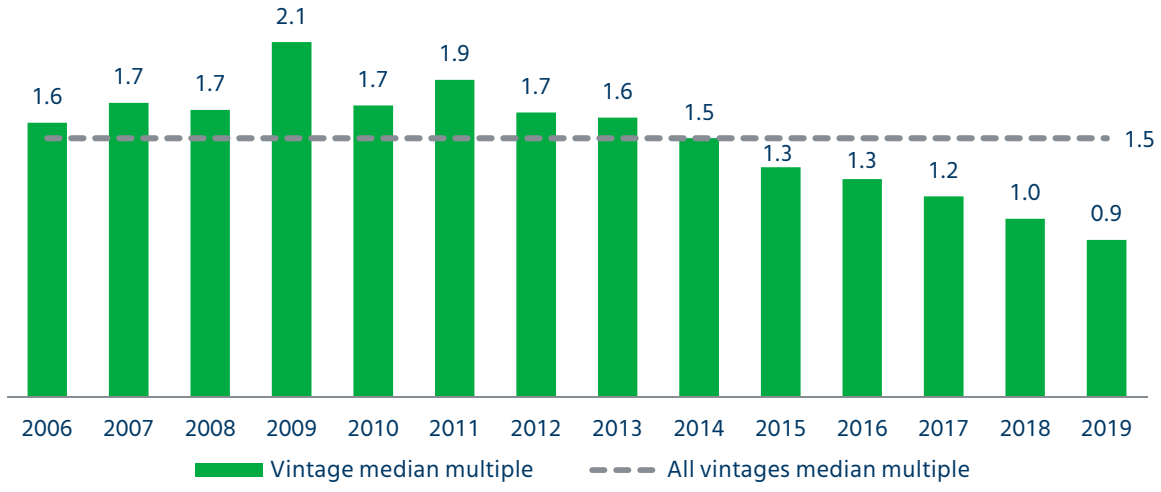
Source: Burgiss Private i as of December 31, 2019

The 2006 IRR was significantly below the historical median, but 2007 and 2008 showed improvement. Of particular note, however, is that for the following nine vintages the median IRRs were consistently — and often substantially — above the historical trend.[7] This consistent performance has led many existing private equity investors to increase their allocations to the asset classes, and investors who did not have an allocation to consider creating one.

[6] A J-curve plots private equity returns against time; early in the investment period it is negative as fees are charged while many investments have not been realized yet. In addition, existing investments are usually not revalued upward until later in the investment period.

[7] The lower IRRs for both the 2018 and 2019 vintages are likely due to the previously referenced J-curve effect as those funds are still early in their initial investment cycle and have probably have not generated any exits.

Figure 5: U.S. private equity multiples



Source: Burgiss Private i as of December 31, 2019

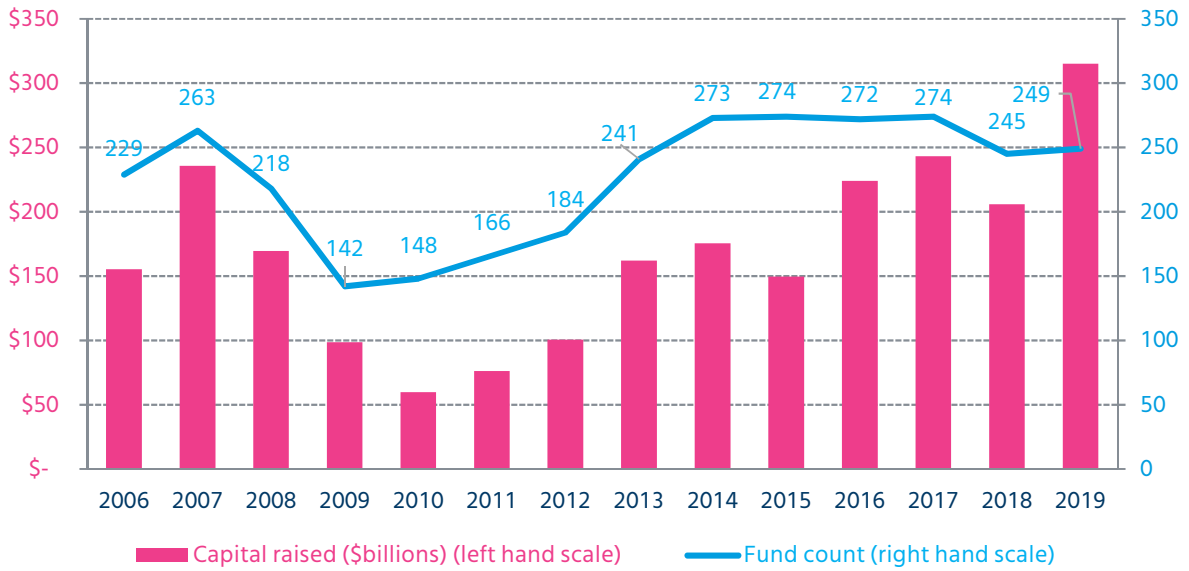
Figure 5 presents the fund return multiples for the same sample as the IRR graphic. As opposed to the IRR results, even the 2006 vintage exceeds the historical median. This, we believe, provides evidence that the IRR underperformance was due to the extended exit timing rather than the absolute level of returns from exits. As before, the vintages following the GFC crisis generated consistently attractive returns. The difference in performance between the IRR and multiple performance in the later vintage years can probably be ascribed to the quirks of IRR when calculated over shorter periods of time.

Impact on fund raising

One final impact of the GFC worth examining is the significant decline in the amount of capital raised by private equity funds post-GFC. As shown in figure 6, U.S. private equity fund raising did not recover to the 2008 level until 2013.

Many market observers note that the increased fund raising in 2013 and beyond is directly correlated with the rising valuation multiples discussed above, which raises concerns about the impact on IRRs. An offsetting impact on IRRs is that many funds in those post-2013 vintages have shortened their average portfolio company holding period and have sold into a very strong exit market. This resulted in record levels of distributions to LPs over the last several years.

Figure 6: U.S. private equity fundraising



Source: Pitchbook as of March 31, 2020

Impact over time

Obviously, the GFC was a major event across the world's financial markets and almost every national economy. What may not be as obvious is that the GFC had significant effects across almost ten vintage years of private equity funds in part due to the inherent structural characteristics of the asset class. For the 2002 to 2005 vintages, the challenging exit markets limited those funds' ability to generate liquidity during the harvesting phase of the funds' lifecycles, depressing returns both in terms of IRR and multiple. The lower deal flow for the 2006 to 2010 vintages made it difficult to deploy capital during the investment period of those funds, thereby lowering their IRRs. Counterbalancing this for at least the 2009 to 2012 vintages was that the concurrent lower valuations allowed funds to invest capital at attractive multiples and take advantage of the subsequent valuation multiple appreciation, increasing returns as measured by both IRR and multiple over "normal" market conditions.

Figure 7 presents a summary of the primary positive and negative impacts associated with the various vintage year ranges as well as potential performance impacts relative to "normal" market conditions.

Figure 7: Primary positive and negative impacts

Vintages	Negative GFC impacts	Positive GFC impacts	Potential IRR impacts	Potential multiple impacts
2002-2005	**Portfolio triage** **Exit conditions**	--	**Lower** (holding period, valuations fell)	**Lower** (valuations fell)
2006-2009	**Portfolio triage** **Some exit conditions** **Capital deployment**	**Some lower valuations**	**Lower** (capital deployment)	**Mixed** (dependent on deployment)
2010-2012	**Some capital deployment**	**Lower valuations**	**Higher** (lower valuations, deal flow)	**Higher** (valuations increased)

Source: Mercer (for illustration purposes only).

In most cases, big market swings make it exceedingly difficult to discern investment skill from the impact of macro events. Due to the characteristics of private equity investments, determining the nature of the performance has even greater uncertainty. Private equity managers typically raise funds every three to five years. Thus, most established managers will have only had two or three funds exposed to the various conditions described above. Strong performance across all market conditions is likely attributed to a manager's skill, but usually at least one of their funds would have been significantly impacted by macro events, and this makes it even more challenging to accurately gauge their skill versus the macro impacts.

As discussed, the timing of their fund sequence can be an important determinant of their performance. However, private equity fund managers have difficulty in maintaining their deal flow and retaining investment professionals without a fund with an active investment period. As a result, they have limited control over when they raise a subsequent fund, and this makes it inherently difficult to "time" private equity markets.

Impact of COVID-19

As we have outlined, the GFC had a profound impact on the behavior of private equity fund managers and influenced the performace of funds across almost a decade of vintages. The post-GFC behaviors of portfolio company triage, longer holding periods, slower capital deployment and investing in a lower valuation regime can provide guidance as to what to expect in a post-COVID-19 world. The GFC started as a financial crisis that then spread to Main Street, whereas the COVID-19 crisis is more akin to a global natural disaster with a very direct and immediate impact on business activity across the board. Based on our experience from

the GFC and observations to-date on COVID's impact, we believe LPs should keep several key considerations in mind for their private markets portfolios:

- Stay committed to private markets — investors who maintained their exposure to private markets post-GFC have, in most cases, achieved consistently attractive returns since the crisis.
- Maintain a steady investment pace — the long-term nature of private market fund vehicles makes it very difficult to execute market timing strategies; investors who sustained their investments pacing post-GFC benefited from subsequently strong exit markets.
- Be opportunistic — it may be possible to establish or gain additional exposure to highly-rated fund managers if other LPs pull back from private markets. Also, there may be attractive opportunities with secondary or distressed funds.
- Incorporate lessons learned from the GFC — LPs should expect slower capital calls, longer holding periods for portfolio companies and a decrease in fund raising. These dynamics should be factored into LPs' portfolio-planning processes.
- Use your leverage — if fund raising becomes more difficult for GPs, it may be possible to negotiate terms that are more beneficial to LPs.

As severe as the GFC was, it is now part of history, while we are very much in the midst of the COVID-19 crisis with all of the associated uncertainty as to its depth and length. However, the post-GFC private market returns offer some hope that once past the current crisis, it still may be possible to generate attactive returns for those investors who are both capable and willing to continue executing an active private markets investment program.

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