CLEARPOINT

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JOSEPH D. BOUSHELLE, CFA, CAIA, SENIOR MANAGING DIRECTOR, ALTERNATIVES, CLEARSTEAD

THE CHANGING PRIVATE EQUITY LANDSCAPE: GENERAL PARTNER-LED SECONDARIES & NET ASSET VALUE (NAV) LENDING. HOW WILL THEY WEATHER AN IMPENDING STORM?

BY JOSEPH D. BOUSHELLE, CFA, CAIA, SENIOR MANAGING DIRECTOR, ALTERNATIVES, CLEARSTEAD

The last 10 years have been a boom time for private equity. Granted, declining interest rates, which have only recently reversed, and increasing valuations have lifted risk assets across the board. However, according to preliminary data from the 2Q23 Pitchbook as of 3/31/2023, private equity has been the one of the strongest performers over the past ten years, even compared to the S&P 500 or venture capital.[1]

This performance has not gone unnoticed, as investors have increased their allocations to private equity during this time. According to Pitchbook,[2] annual private equity fundraising from U.S. funds has grown from $92.5 billion in 2012 to $381 billion in 2022. From 2013 through the end of 2022, U.S. private equity fundraising reached almost $2.5 trillion. While fundraising as slowed in 2023, over $242 billion has been raised by U.S. private equity managers during the first nine months of the year.

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client and Administration teams with James Jackson, Liz Piper, and Kelsey Alletto respectively.

James Jackson has joined Clearstead as a Client Planning Associate. James is a graduate of Malone University, with a BA in Accounting, Finance and Business Administration and a Master of Arts in Organizational Leadership. Prior to joining Clearstead, he was employed at CTBK as an Accounting Analyst.

Liz Piper has joined Clearstead as a Client Planning Associate. Liz is a graduate of Baldwin Wallace University, with a BA in Accounting and is currently pursuing her Master of Accountancy at Baldwin Wallace. Liz was previously employed at Oatey Co. as an Accounting and Tax Analyst.

Kelsey Alletto has joined Clearstead as a Senior FP&A Analyst. Kelsey has a BS from Ohio University, majoring in Finance and Entrepreneurship. She brings experience with several Cleveland companies where she has held roles of increasing responsibility in finance including financial planning and analysis, billing, and systems/data.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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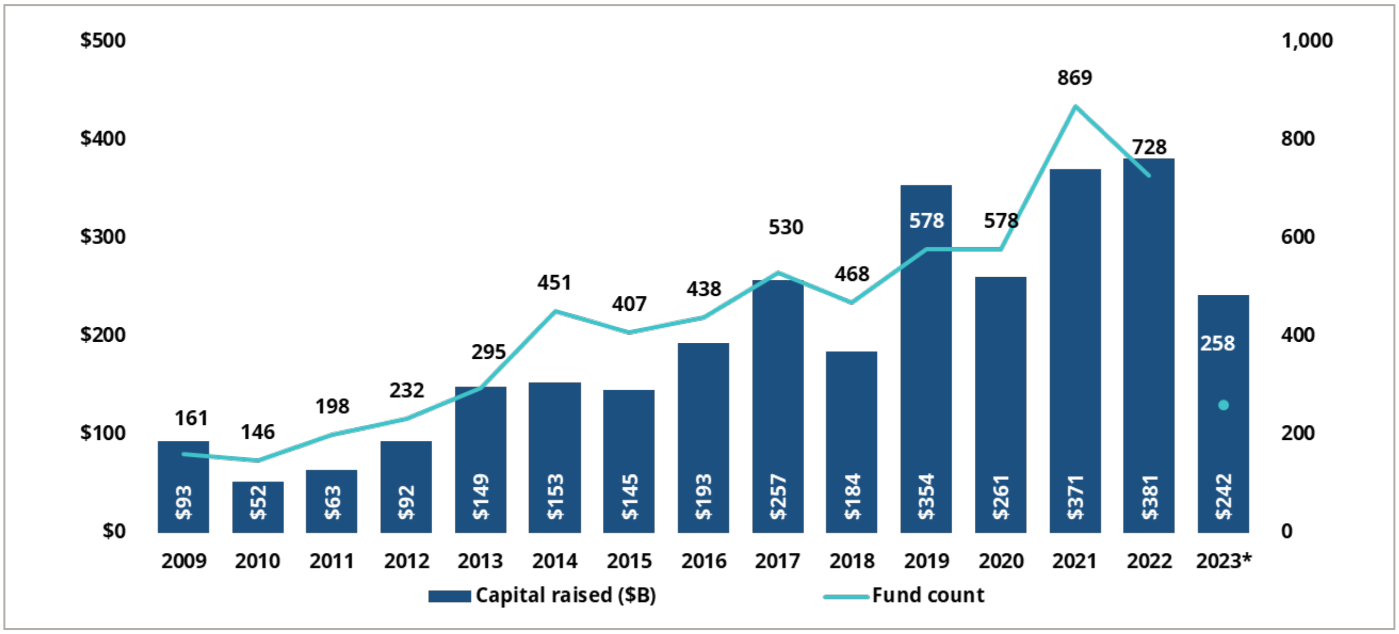
U.S. PRIVATE EQUITY FUNDRAISING



Source: Pitchbook. Data as of 9/30/2023.

Meanwhile, exit activity has slowed as debt has become more expensive and private equity sponsors ("GPs") have become more focused on quality and price. Despite this focus, we are still seeing sponsors pay robust prices for premium assets. Assets that are viewed to have stable cash flows, such as financial services, residential services (HVAC, roofing, landscaping, etc.) and premium pet food brands, continue to trade at multiples of EBITDA of 20 or even higher. In fact, according to Pitchbook data,[3] median private equity buyout multiples in the U.S. and Europe are 13.2x through the first 9 months of 2023, reversing a trend downward that we had seen in late 2022. Debt multiples have come down but remain robust. In North America, multiples in 2023 are 16.2x up from 14.9x in 2022 and 8.3x in 2012.

	MEDIAN NORTH AMERICA AND EUROPE PE BUYOUT EV/EBITDA MULTIPLES											TTM	YTD
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023*	2023*
Median EV/EBITDA	9.0x	10.2x	10.1x	10.4x	10.2x	11.8x	11.5x	12.0x	12.3x	12.2x	12.7x	12.0x	13.2x
Debt/EBITDA (LCD)	5.1x	5.3x	5.7x	5.6x	5.4x	5.7x	5.8x	5.8x	5.7x	5.8x	5.9x	5.1x	5.1x
Debt Percent (LCD)	59.6%	61.5%	60.3%	56.2%	55.1%	55.6%	57.6%	51.3%	49.9%	51.4%	50.8%	43.9%	43.9%

* As of 9/30/2023

Source: Pitchbook.

Fewer deals are being done today and almost every fund is chasing the same deals. We have seen a proliferation of sponsors leaning into buy-and-build strategies since they view add-ons as a way to pay down the multiples. This is happening at a time when private equity dry powder continues to grow, despite a more challenging fund-raising environment that has seen sponsors extend their fundraising periods past 12 months[4] or raise smaller funds than their initial targets.[5]

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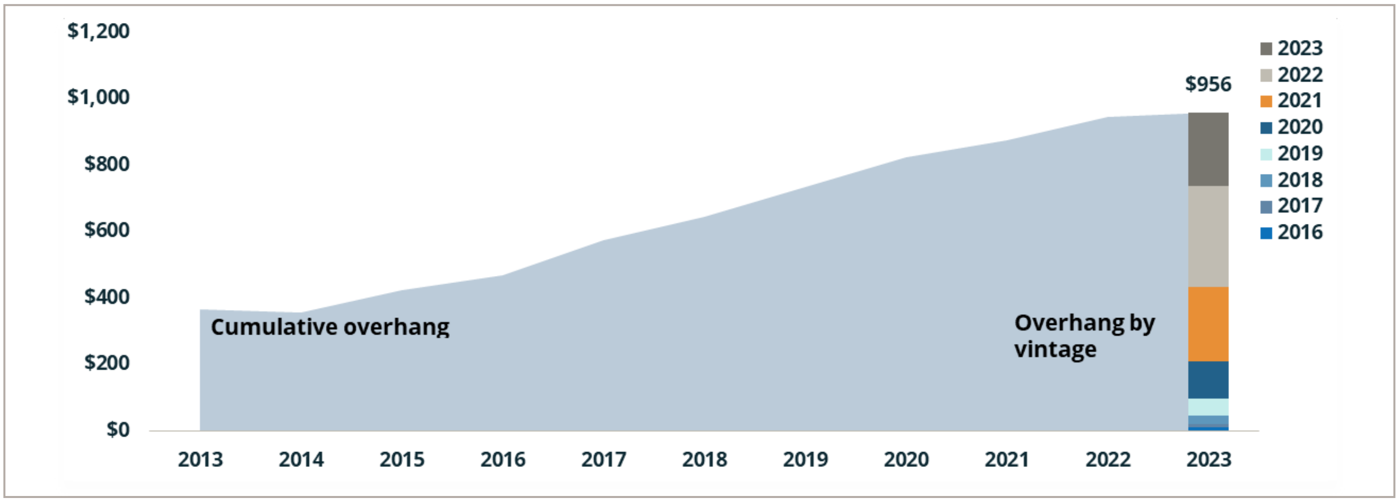
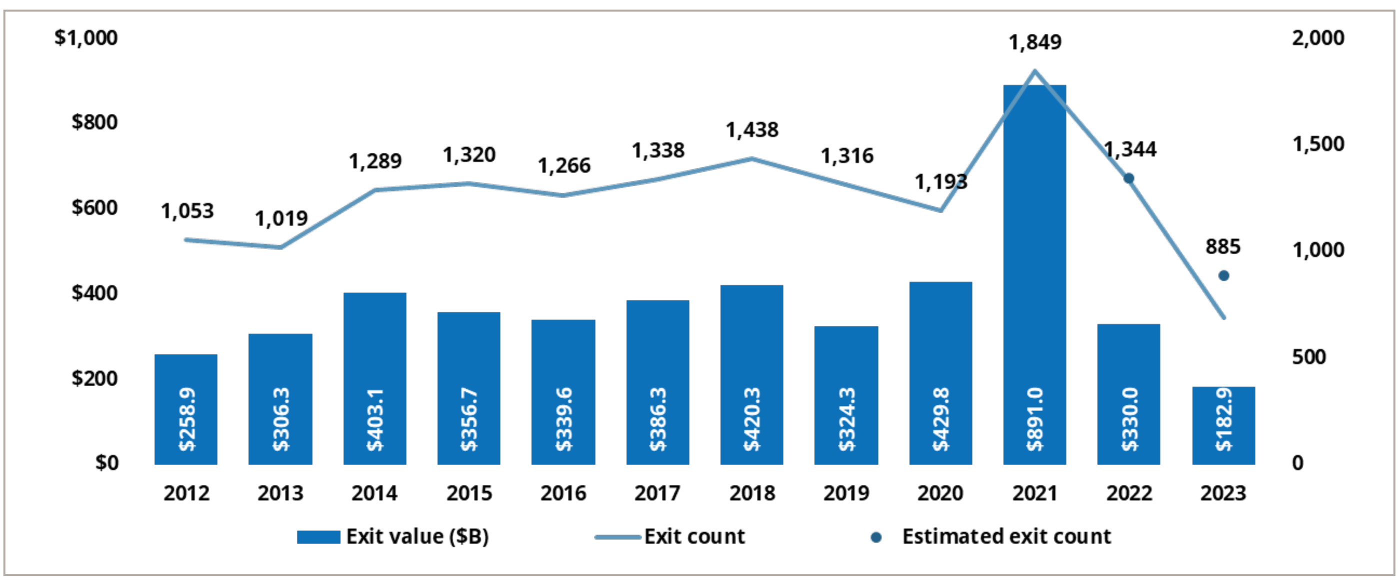
U.S. PRIVATE EQUITY DRY POWDER



Source: Pitchbook. Data as of 9/30/2023.

In addition, there is a divergence in valuations between where GPs are marking their portfolios and what the market is willing to pay. This has led to a dramatic slowdown in exit activity, especially from the peak in 2021. Private equity firms not only have more capital that they need to deploy, but they are also hanging onto assets longer than they have had to in recent years.

U.S. PRIVATE EQUITY EXIT ACTIVITY



Source: Pitchbook. Data as of 9/30/2023.

GPs continue to look to raise more capital while investors ("LPs") have more of their capital tied up in earlier funds, whether in actual investments or committed capital still looking for deals. From a Limited Partner (LP) perspective, their allocation to private equity is also affected by the denominator effect, as the private equity portfolio continues to grow but public market valuations fluctuate.[6] This means LPs are either investing less in private equity or increasing their allocations. GPs are looking to return capital to investors sooner, so those who do not want to increase their allocations to private equity have more capital to deploy.

Exits have been the traditional method to return capital to investors. However, as a result of the slowdown in exit activity, GPs have started to look at other alternatives to return capital to LPs and free up capital for LPs to commit to future funds. Traditionally, a dividend recap was a popular route when interest rates were low. However, today's interest rate environment has made that more expensive. Given the amount of dry powder, a sponsor-to-sponsor transaction might also be an option, but activity has been limited to only the best deals. Additionally, selling GPs might be giving up future upside or control when they rollover some equity. That has led GPs to look at GP-led secondaries or continuation funds.

GP-LED SECONDARIES/CONTINUATION FUNDS

GP-led secondaries really came to fruition after the global financial crisis in 2008. Private equity funds were coming to the end of their fund lives and needed to sell the remaining assets in their portfolios. GPs did not want to sell assets in a distressed market and some assets had issues that came about from the GFC that still needed to be worked out. Some of these assets were of good quality while others were not.

A GP-led secondary is where a third-party buyer, typically a private equity secondaries fund, sets the valuation for the asset or pool of assets that the manager is looking to sell. If the buyer is a secondary fund, the transaction usually takes place at a discount on the current carrying value of the assets, which is often supported by a third-party valuation. Current LPs usually get the option to either sell the assets at the negotiated price or roll their portion of the investment into the continuation fund. Investors that roll over their commitment will be subject to new financial terms and investment timelines. Today, we are also seeing more managers commit new capital from their current fund to the investment. This is because most managers today say that they are using continuation funds so they can continue to grow their best assets. Their story is that LPs in their new fund can also participate in that growth opportunity while often providing capital for additional growth initiatives.

GP-led transactions have created a new opportunity for secondary funds. According to Pitchbook, the first GP-led secondary transactions did not take place until 2012. That year, they were a small part of the secondary market, making up only 7.1% of secondary transactions. By 2020, that number has grown to 58% and has remained over 50% over the past two years, despite a growing overall secondaries market. While some secondary funds invest in LP secondary transactions, we are seeing funds that do both GP-led and LP secondary transactions target roughly a 50/50 split between the two strategies. We are also seeing more funds focused solely on GP-led transactions. As a result, we expect the number of GP-led transactions to grow over the next couple of years. As with any investment strategy that sees an influx of capital, there is the potential that this drives down future returns as lower quality funds get capital or competition pushes prices higher than they should be (this is also an issue given secondary players' propensity to anchor valuations to the manager's most recent carrying value).

Over the past ten years we have seen sponsors roll equity from the new fund into transactions with other sponsors. This solves the issue of returning capital to existing investors and gives the sponsor the ability to maintain exposure to the investment. The downside is that existing LPs do not get the option to roll their investment (they only stay invested if they are committed to the new fund) and the original sponsor will likely have to cede some or all control to the new manager. It is interesting that we seem to be seeing fewer of these transactions and more continuation funds, despite the growth in dry powder from traditional managers. Our initial assumption is that the GP-led transactions are likely the highest bid for a number of these deals, or managers are choosing them because they do not need to give up control of the investment, since most secondary investors are passive.

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Both exit options have the benefit of returning capital to current investors and helping the GP lock in carry. Although, in the case of GP-led secondary transactions, GPs are often being asked to roll over their carry into the new investment. According to a survey from Buyouts Insider, over 60% of LPs said that reinvestment of GP carry[8] was an important consideration when evaluating a continuation fund. We also have a positive view on rollover carry; however, we believe the strongest alignment comes when a manager decides to roll additional capital into the transaction.

We are seeing more GPs roll capital in their new funds into these deals. This is great for new investors if the investment has strong growth opportunities in front of it. However, we do look at sourcing when evaluating potential fund investments. We generally prefer managers who can find assets at reasonable valuations. This usually provides a margin of safety if things do not go as planned. In these transactions, GPs have a conflict around valuation. The GP typically has the greatest incentive to lock in the best price for the existing investor, as this helps to lock in carry and prop up their investment track record. It also leads us to question the current opportunity set. Is the fund really investing in the best opportunities out there? Given the growth of the GP's funds and competitors in the sector, have all the best deals already been acquired?

We are also starting to see an increase in fund-to-fund transactions from the same sponsor. While those transactions often have a third-party appraisal and receive LP Advisory Committee approval, we place a higher value on a price set by the market. At the end of the day, an asset is only as valuable as someone else is willing to pay for it. Another way GPs are looking to raise capital without relinquishing control of assets is the use of NAV loans.

NAV LOANS

NAV loans have traditionally been used by LPs to raise capital, using their private equity portfolio as collateral to fund capital needs, including capital calls. These loans are priced off SOFR (plus an additional 400-500 bps). The growing cost of these loans—as SOFR has risen—means these loans are less attractive to LPs today.

Regardless, we are starting to see GPs use NAV loans, using assets in the fund as collateral, to fund growth initiatives in portfolios companies or to return capital to LPs without diluting their equity stake. In addition to reducing dilution, these loans also tend to come at a discount to a direct loan to one portfolio company. They also reduce the need to mark down assets that have been impaired. From a lender's perspective, these loans are usually less risky than direct loans, as a diversified portfolio of assets is supporting the loan and loan-to-values tend to be relatively low, 25-40% of net as value vs. 40-60% for direct loans. Meanwhile, the lender is still able to generate returns and yields in the low to mid- double-digit range.

For current LPs, this adds potential risk to the portfolio. If a couple investments start to materially underperform or become impaired, they risk impairing the value of the entire portfolio. While the risk is low today, we believe there are storm clouds on the horizon which should make investors more cautious.

WHAT'S ON THE HORIZON?

In today's environment, we believe that due diligence is even more important than ever. The last ten years have been a relatively easy time to invest in private equity, as borrowing costs were extremely low and deal multiples continued to rise, reaching over 16x today. We do not expect the next ten years to be the same. Our base case assumes that interest rates will stay higher, and multiples will likely start to come down as a result, even for those assets deemed to be of the highest quality. However, we do not expect this to happen overnight. Too much liquidity remains in the system and covenant light loans, combined with PIK toggles, has allowed companies to kick their cash flow problems down the road. However, with 39% of companies today generating negative cash flows, we expect more companies and funds to have problems over time.

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We believe that a big part of the market is set up for a quick selloff and bounce back, like scenarios that we saw during the GFC and COVID-19. A slow, but protracted drawdown will make it harder for overleveraged companies and funds to recover, as their debt burden overwhelms their business.

How long can businesses with negative cash flows pay double digit interest rates? There are three things that a company can do to get out of this predicament:

(1) They can wait for interest rates to fall and their debt payments to reset at a lower rate or they are able to refinance at a lower rate. Historically, the Fed has only dropped rates 200 bps or more when there is a recession. A recession, even a mild one, will make it more difficult for companies to service their debt or find cheaper financing as spreads tend to widen and revenues are pressured.

(2) They can grow out of their debt burdens. The economy is still growing today, as advanced estimate of third quarter 2023 GDP growth was 4.9%.[9] However, many companies continued to see their debt loads increase and failed to generate positive cash flow in what has been a pretty robust period of growth over the past couple of years. Now they need to offset interest payments that are in the double digits. In addition, inflation remains relatively high and labor costs could continue to eat into profit margins.

(3) They can raise equity to pay down debt. However, this will dilute the current equity. Right now, that additional equity, in the form of GP-led transactions, is coming at valuations close to current carrying values. But how long can companies trade at 20x EBITDA (essentially a 5% cash yield before capital investments and debt costs) when the risk-free rate is 5%?

We still believe private equity will continue to earn desirable relative returns, as public equity markets have the same issues. However, manager selection will be more important and those that can add value in ways other than financial engineering are more important today than ever. We also expect opportunities to open for credit and distressed funds. Although, investors should also tread cautiously in this space as we would not be surprised to see losses in some areas, like direct lending, exceed historical norms.

Sources:

(1) Pitchbook Global Benchmarks as of Q1 2023 with preliminary Q2 2023 data
(2) Pitchbook Q3 2023 US PE Breakdown Summary
(3) Pitchbook Q3 2023 US PE Breakdown Summary
(4) https://www.bloomberg.com/news/articles/2023-04-20/apollo-pitches-investors-on-deal-to-ease-fundraising-slump
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(6) https://clearstead.com/wp-content/uploads/2023/02/February-2023-ClearPoint.pdf
(7) Q2 2023 Pitchbook Analyst Note The Evolution of Private Market Secondaries
(8) Buyouts Secondaries, June 2023
(9) https://www.bea.gov/news/2023/gross-domestic-product-third-quarter-2023-advance-estimate

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MARKET BENCHMARK RETURNS

October 31, 2023		1M	3M	12M	YTD
US Large Cap	S&P 500	-2.1%	-8.3%	10.1%	10.7%
US Small Cap	Russell 2000	-6.8%	-16.7%	-8.6%	-4.5%
Developed Intl	MSCI EAFE	-4.1%	-10.9%	14.4%	2.7%
Emerging Intl	MSCI Em Mkt	-3.9%	-12.2%	10.8%	-2.1%
Real Estate	NAREIT	-3.5%	-13.1%	-7.9%	-8.5%
Core Fixed	BarCap Agg	-1.6%	-4.7%	0.4%	-2.8%
Short Fixed	BarCap 1-3Yr	0.3%	0.6%	3.2%	2.2%
Long Fixed	BarCap LT G/C	-4.5%	-12.5%	-3.7%	-9.7%
Corp Debt	BarCap Corp	-1.8%	-5.0%	2.7%	-1.7%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.