Earnings era: future performance in private equity

Slowing economic activity together with higher inflation and rising interest rates has shaken global equity markets. As with prior market inflection points, asset owners are taking a close look at current portfolio allocations. Pre-Covid, investors were already increasingly looking to alternative investments to meet their long-term investment objectives. Private equity (PE) AUM in particular is forecasted to double by 2025 from $4.42 trillion in 2020, a trend that may become more pronounced, as public market volatility adds to the appeal of private assets.[1]

At this critical juncture for markets, however, allocation decisions are not always straightforward. To put the health of private equity markets and long-term return trends into context it is critical to understand (1) the main performance drivers within the asset class, and (2) the critical importance that market timing has for PE vintages during downturns. Here we analyse the three performance contributors driving long-term return trends—leverage, multiple expansion and earnings—and investigate how current conditions for each factor may shape returns into the future.

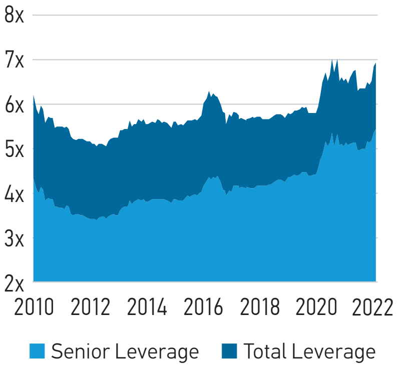
Leverage. Prior to the global financial crisis (GFC), leverage contributed 50% to 70% of PE returns, before gradually declining to 25% in the decade following the crisis.[2] Despite dissipating as a performance driver, leverage on balance sheets edged up post-GFC to roughly 7x EBITDA by the early 2020s (Display 1), aided by the fall in borrowing costs. Clearly, rates are now rising and, while still healthy, technicals and fundamentals for leveraged loans have become slightly less supportive. Default and distress ratios are trending upward, but remain low at 0.28% and 2.81%, respectively, while interest coverage has slipped but remains adequate at over 4.5x EBIT. Against this backdrop, the market is arguably well placed to weather higher rates, but tighter financing conditions signal that leverage and its contribution to PE returns is likely to be lower than we have seen in the past 20 years.

Multiple expansion. Just as low interest rates facilitated rising leverage, the willingness of lenders to back deals also sustained buoyant valuations, helping multiple expansion contribute 28% to PE returns in the decade following the financial crisis.[3] As rates continue to rise and credit conditions become potentially less supportive, simply relying on multiple expansion will not be enough to drive returns. As we have seen in past downturns, GPs may opt to delay divestments until better conditions prevail, which may also cause structures such as secondaries or continuation funds to see stronger growth as GPs seek to avoid forced exits. Importantly, we do not expect multiple expansion to drive returns as much as it has over the past 20 years in an environment of rising interest rates, which places an added emphasis on capturing value at entry in transactions.

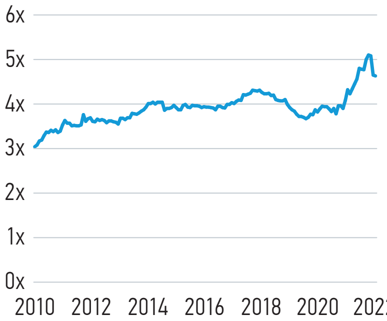
EBITDA growth. Earnings has become the most important value driver for PE, particularly in the post-2008 crisis period. In the decade following the GFC, revenue growth and margin expansion accounted for 37% and 10% for a total 47% contribution from EBITDA growth.[4] Multiple compression and rising debt costs will likely further this trend. Accordingly, GPs will need a credible growth strategy to create value for LPs. In our view, buy-and-build strategies will be key to unlocking stronger revenue growth and maximising operational efficiencies. This approach is repeatable and often allows for add-on acquisitions at below headline valuation multiples. Other avenues of value creation may include partnering with founders in the mid-market and reducing operational vulnerabilities.

DISPLAY 1: Credit fundamentals

Weighted average leverage

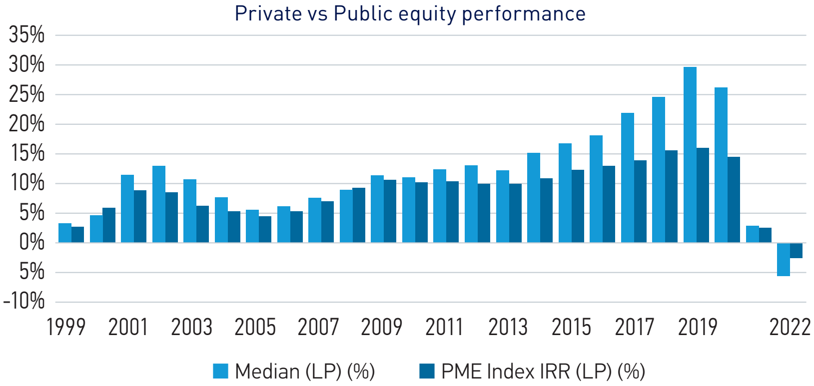


Interest coverage



Source: Floating Rate Loan team, at Morgan Stanley Investment Management. As at June 30th, 2022.

DISPLAY 2: Market timing critical to performance



Source: Cambridge Associates. As of March 31, 2022.

Staying the course

Private market investments tend to be long-term by design. However, periods of market stress can cause investors to veer away from long-term planning. At the same time, market corrections tend to slow future commitments, as investors focus on more volatile liquid investments or face constraints related to the so-called "denominator effect," which typically occurs when drops in public markets result in higher portfolio exposures to less liquid asset classes.

PE vintages following the immediate onset of a crisis (2001-2004, 2009-2012) outperformed late-cycle vintages (1998-2000, 2005-2007) by an average of 64% on a median net IRR basis.[5] As can be seen in the below chart (Display 2), PE also outperformed its public market equivalent (PME) consistently across market conditions. In fact, the magnitude of outperformance suggests investors would have garnered higher returns by upping PE allocations and decreasing their public equities exposure in times of crisis.

Turning to fundraising, history shows that commitments to PE have traditionally fallen in downcycles. Accordingly, we may see a short-term dip in fundraising while market conditions remain challenging. Furthermore, it is also probable that some institutional investors now find themselves slightly over-allocated to PE due to the sharp swings in public market valuations, which may cause the denominator effect to temporarily impede future commitments.

We believe investors should prepare for an environment where neither multiple expansion nor leverage contribute significantly to performance, which means GP skilfulness in operations is paramount. We expect this changing composition of returns to cause GP performance dispersion to increase.

While current market conditions remain challenging, we believe that PE is well placed for future growth. For investors looking to deploy capital and select GPs, the private equity universe is not a panacea and sector and manager selection will likely become much more important. There will be elements of stress and fewer tailwinds, but it should favour long-term

FOOTNOTES

1 "The Future of Alternatives 2025," Preqin. As of August 2020.
2 "Performance Analysis and Attribution with Alternative Investments." Institute for Private Capital. February 12, 2022.
3 Ibid.
4 "Performance Analysis and Attribution with Alternative Investments." Institute for Private Capital. February 12, 2022.
6 "Post-Crisis Private Markets Investing," Portfolio Solutions Group, Morgan Stanley Investment Management. 2020.