

Earnings Era: Future Performance in Private Equity

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With the world of finance at another major turning point, asset owners are increasingly allocating to alternatives such as private equity (PE) to meet their long-term investment objectives. The trend may become more pronounced, as recent volatility in public markets adds to the appeal of private assets. At this critical juncture for markets, however, allocation decisions are not straightforward and asset owners must confront a host of questions as they evaluate prospective managers. For instance, what investment style is best suited for generating returns in today's changed investment landscape and how will cyclical drivers affect performance? Should limited partners (LPs) increase PE exposure now or wait until volatility dissipates?

Key Takeaways

- **INVESTMENT STYLE:** As earnings growth is likely to be the principal driver of PE returns ahead, manager selection will remain key, with experts in profitability-enhancing operational improvements and strategies that capture synergies best placed to generate alpha.
- **CYCLICAL DRIVERS:** As we enter a new phase of the cycle, rising interest rates may lead to reduced leverage and lower multiple expansion, limiting the contribution to performance from these

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key return levers. Accordingly, allocators may want to limit exposure to managers who have predominantly relied on these performance drivers to generate returns.

- **TIMING:** While LPs may experience pressure to stray from long-term investing planning in times of financial turbulence, data shows that, historically, private equity vintages following a market crisis have performed strongly, notably in comparison to public market equivalents.
- **DRY POWDER:** Fundraising may slow, but dry powder remains at record levels of \$3.6 trillion, which should sustain high transaction volumes. Given the ongoing competition for quality assets, deal origination at attractive value-at-entry levels is not a given and GPs have to remain selective and disciplined to create value.

Understanding Performance Drivers

Monetary tightening, fiscal retrenchment and supply-side disruptions are together reducing global demand. The slowdown in economic activity, together with higher inflation and rising interest rates, has

shaken global equity markets, pushing them into bear market territory. Pre-Covid, investors were already looking to increase their allocations to alternatives to meet their long-term investment objectives (e.g., private equity AUM is forecast to double by 2025 from \$4.42 trillion in 2020).¹ Given the current volatile investment climate, this trend can only be expected to accelerate, as the value add from stable private equity returns in an investment portfolio has become increasingly clear.

To put the health of private equity markets and long-term return trends into context, we need to understand:

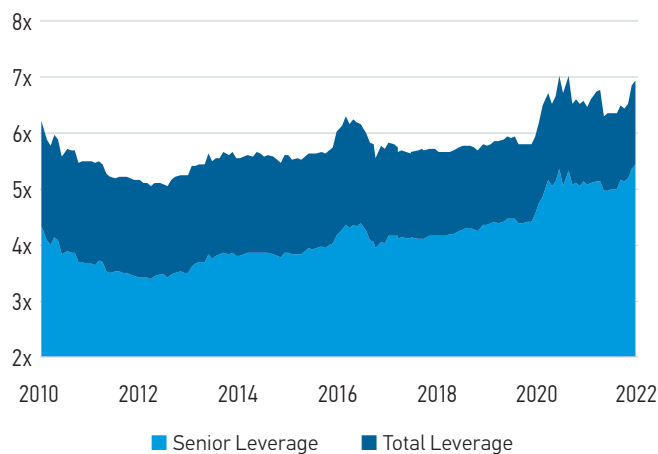
- First, the main performance drivers for the asset class, and
- second, the critical importance that market timing has for PE vintages during downturns.

Below, we analyze 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 Post-GFC, leverage edged up to reach roughly seven times EBITDA by the early 2020s from just over five times a decade ago (*Display 1*). Falling global interest rates and low financing costs made higher leverage possible. Accordingly, as rates have begun to rise, the impact of higher financing costs may become a headwind, particularly for businesses with high gearing. As a result, capital structure health will become key for general partners (GPs) evaluating prospective investments. In the leveraged loan market, an important financing source for PE transactions, technicals and fundamentals have become slightly less supportive but remain healthy compared to historical levels. Default and distress ratios are low at 0.28% and 2.81% respectively but are slowly trending upward. Interest coverage has slipped in line with higher rates but remains adequate at over four and a half times earnings before interest and taxes. Against this backdrop, the market is arguably well placed to weather an outlook for higher rates. That said,

DISPLAY 1 Credit Fundamentals

Weighted Average Leverage



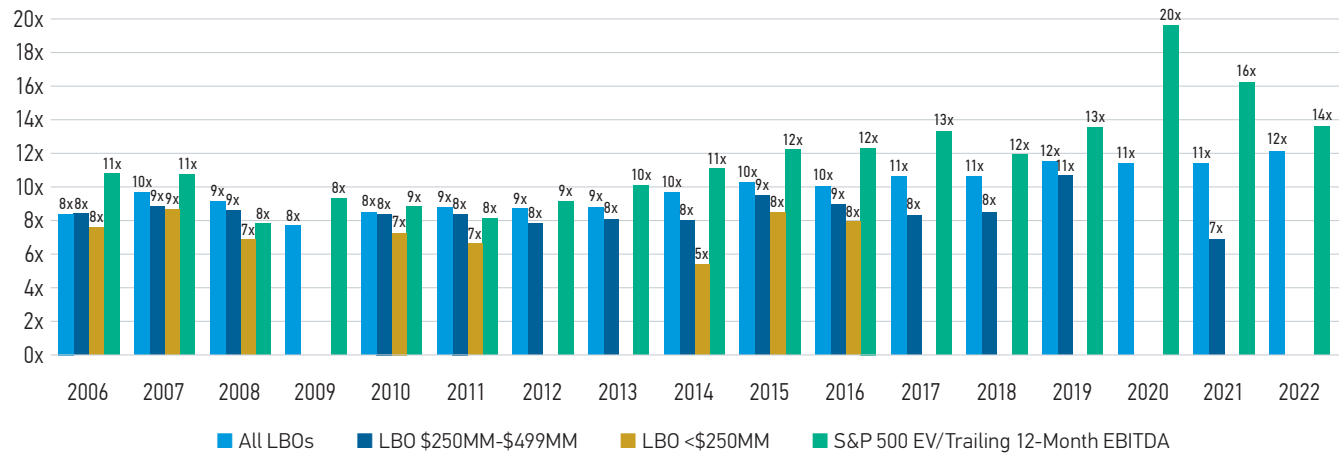
Interest Coverage



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

¹ "The Future of Alternatives 2025," Preqin. As of August 2020.

² "Performance Analysis and Attribution with Alternative Investments." Institute for Private Capital. 12 February 2022.

DISPLAY 2**Historical PE Entry Valuations**

Sources: S&P LCD Comps LBO Review Q2 22 and Capital IQ. The S&P 500 is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE and the NASDAQ. Data as of 30 June 2022.

financing conditions are becoming more restrictive, signalling 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. Of course, lower entry multiples may present a buying opportunity for flush GPs (*Display 2*), though, PE sellers may also face exit headwinds, admittedly. 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 private equity, 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 (*Display 3*). As indicated above, multiple compression and rising debt costs will likely see earnings increase its importance as a source of value creation

DISPLAY 3**Private Equity Performance Attribution, 1984-2018**

	REVENUE GROWTH	EBITDA MARGIN EXPANSION	TOTAL EARNINGS	MARKET EBITDA MULTX	GP EBITDA MULTX	TOTAL VALUATION	MARKET LEVERAGE	GP EXCESS LEVERAGE	DELEVERAGING	TOTAL LEVERAGE	MOIC
ALL YEARS	36%	6%	42%	12%	7%	19%	16%	30%	-7%	39%	2.65
PRE-2000	36%	6%	42%	-6%	-6%	-12%	15%	46%	9%	70%	2.87
2000-2007	35%	2%	37%	0%	12%	12%	15%	37%	-2%	50%	2.78
2008-2018	37%	10%	47%	25%	3%	28%	17%	22%	-14%	25%	2.52

Source: "Performance Analysis and Attribution with Alternative Investments." Institute for Private Capital. 12 February 2022.

Note: MOIC = Multiple on Invested Capital.

³ Ibid.

even further. Accordingly, GPs will need a credible growth strategy in order to create value for LPs. In our view, buy-and-build strategies will be key to unlocking stronger revenue growth and maximizing operational efficiencies, as they help to grow scale and capture synergies. Such an investment 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 (particularly, those seeking support from financial investors for the first time) and reducing operational vulnerabilities to make businesses less sensitive to economic headwinds.

The Importance of Market Timing STAYING THE COURSE

Private market investments tend to be long-term by design. However, during periods of market stress, short-term pressures can cause investors to veer away from long-term investment 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 sharp falls in public markets result in higher portfolio exposures to less liquid asset classes.

As Morgan Stanley Investment Management’s Portfolio Solutions Group (PSG) noted in “Post-Crisis Private Markets Investing,” 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 4*), private equity also outperformed its public market equivalent (PME) consistently and regardless of market conditions. In fact, the magnitude of outperformance suggests investors would have garnered higher returns by upping PE allocations

IN BRIEF

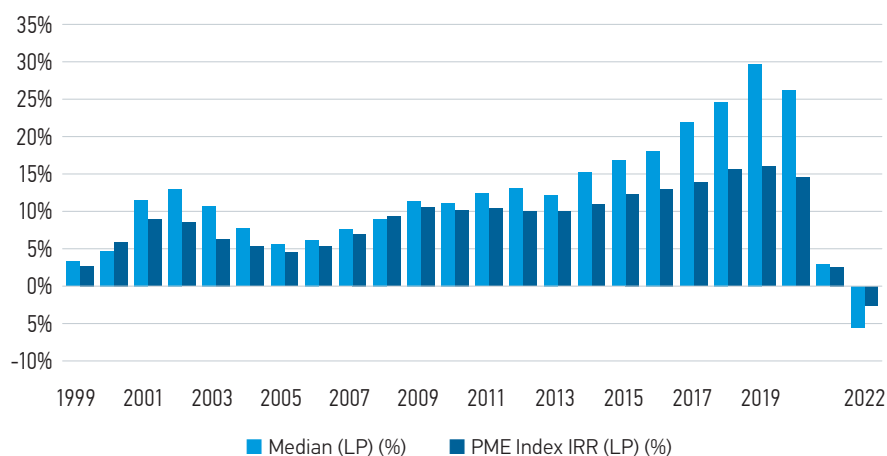
PAST: Pre-2000, PE buyouts were fuelled by the advent of the leveraged credit market, which allowed leverage to drive as much as 70% of PE returns. Although debt-to-equity ratios in LBOs gradually trended downward, financial gearing still contributed 50% to PE returns over 2000 to 2007.

PRESENT: Earnings is the engine of growth in private equity, accounting for nearly half of value creation, according to the most recent data available (*Display 3*).⁴ Leverage’s contribution comprised roughly one-quarter of total MOIC, only slightly behind multiple expansion.

FUTURE: GP skilfulness in operations will matter more. Implementing best-in-class operations and capturing synergies and scale through strategies such as buy-and-build will be key to manager success. Concurrently, higher borrowing costs and less buoyant IPO and strategic buyer demand will do little to lift multiples.

DISPLAY 4 Market Timing Critical to Performance

Private vs. Public Equity Performance



Source: Cambridge Associates. As of 31 March 2022.

and decreasing their public equities exposure in times of crisis.

The PSG paper also highlighted the wide dispersion in returns between private equity managers, which historically has widened in post-crisis markets: In 2003, the spread between top and bottom quartile fund performance was 18% wider year-on-year and peaked at 72% in 2009 compared to the previous year.⁶

Turning to fundraising, history shows that commitments to private equity 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.

All of that being said, dry powder remains at record levels of \$3.6 trillion and GPs will be eager to draw down this capital to put to work in deals.⁷ This should sustain

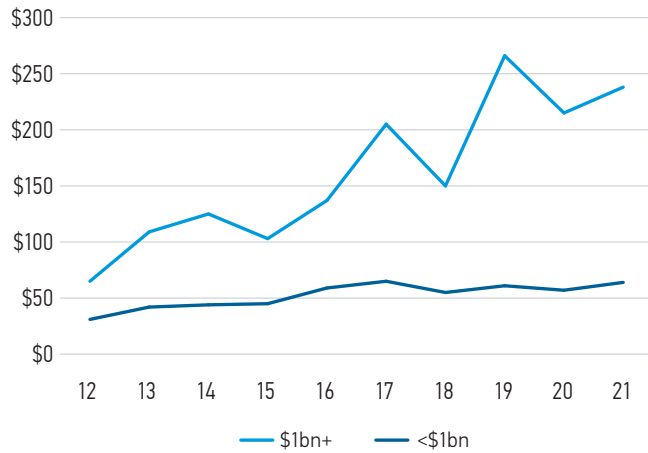
⁴ Ibid.

⁵ “Post-Crisis Private Markets Investing,” Portfolio Solutions Group, Morgan Stanley Investment Management. 2020.

⁶ Ibid.

DISPLAY 5**Fundraising Dips in Down Markets**

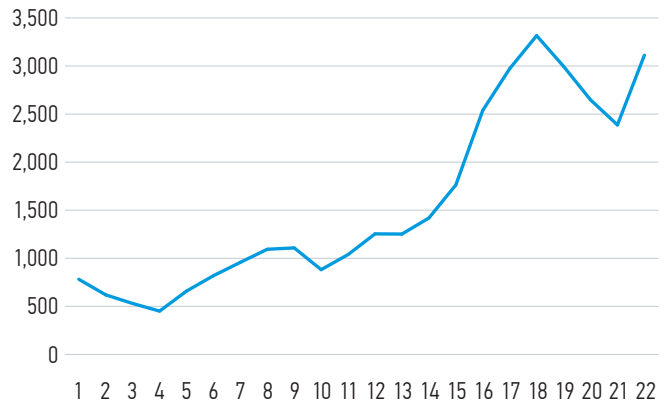
U.S. PE Capital Raised By Fund Size



Source: Cambridge Associates. As of 31 March 2022.

DISPLAY 6**Buyout Funds Proliferate**

Number of North American Buyout Funds



Source: Cambridge Associates. As of 31 March 2022.

competition for assets, particularly in the large-cap space (*Display 5*), which makes deal origination and value at entry key to PE value creation. As the large-cap LBO market often attracts the greatest amount of capital, specialists in mid-market deals may be better placed to source investments with greater potential for upside.

Conclusion

In summary, we believe that investors should prepare for an environment where neither multiple expansion nor leverage contribute significantly to performance, which means GP skilfulness in operations will matter more. We expect GP performance dispersion to increase, as the changing composition to returns benefits some managers and challenges others.

While current market conditions remain challenging, we believe that private equity is well placed for future growth and will reward investors allocating to the asset class. In our view, the historical evidence supports staying the course, as PE has managed to absorb market dislocations and capitalize on interesting entry points. PE is showing the most growth potential among private assets and will very likely account for nearly 70% of alternatives AUM by 2025, according to Preqin.⁸ As it is, PE fundraising has been strong thanks to the asset class's exceptionally robust performance over the past decade.

While the denominator effect may slow fresh commitments from LPs, longer-term allocations will likely rise as this

constraint eases and new investors come into the market. Tactically, after the initial shock of the Covid pandemic, investor sentiment turned towards opportunities in an environment of capital scarcity. Ahead, we would expect investors with capacity for new investments to remain active and seek to benefit from dislocation vintages.

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 investors and GPs who can create value through operational improvements.

⁷ "Shifting Gears: Private Equity Report Midyear 2022," Bain & Company. 18 July 2022.

⁸ "The Future of Alternatives 2025," Preqin. As of August 2020.

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