PRIVATE EQUITY OFFERS RESILIENCE IN A DOWNTURN

A long-term focus and hands-on management approach help explain private equity's increased outperformance during recessions.

Private equity (PE) has seen an influx of investors in recent years, many of whom are new to the asset class. In fact, 2018 marked the first year that more capital was raised through the private markets than the public markets, prompting some noteworthy consultants to conjecture that we're in the middle of one of the most profound shifts in the capital markets since the 19th century. The reason for this heightened investor interest is simple: Private equity acts as a portfolio diversifier and has generated strong historical returns at a time when growth has become increasingly hard to find. Private equity's consistent long-term outperformance against major indices is well-documented, with the asset class generating 597 basis points of outperformance over a 20-year period and 489 basis points over a 15-year period versus the S&P 500.[1]

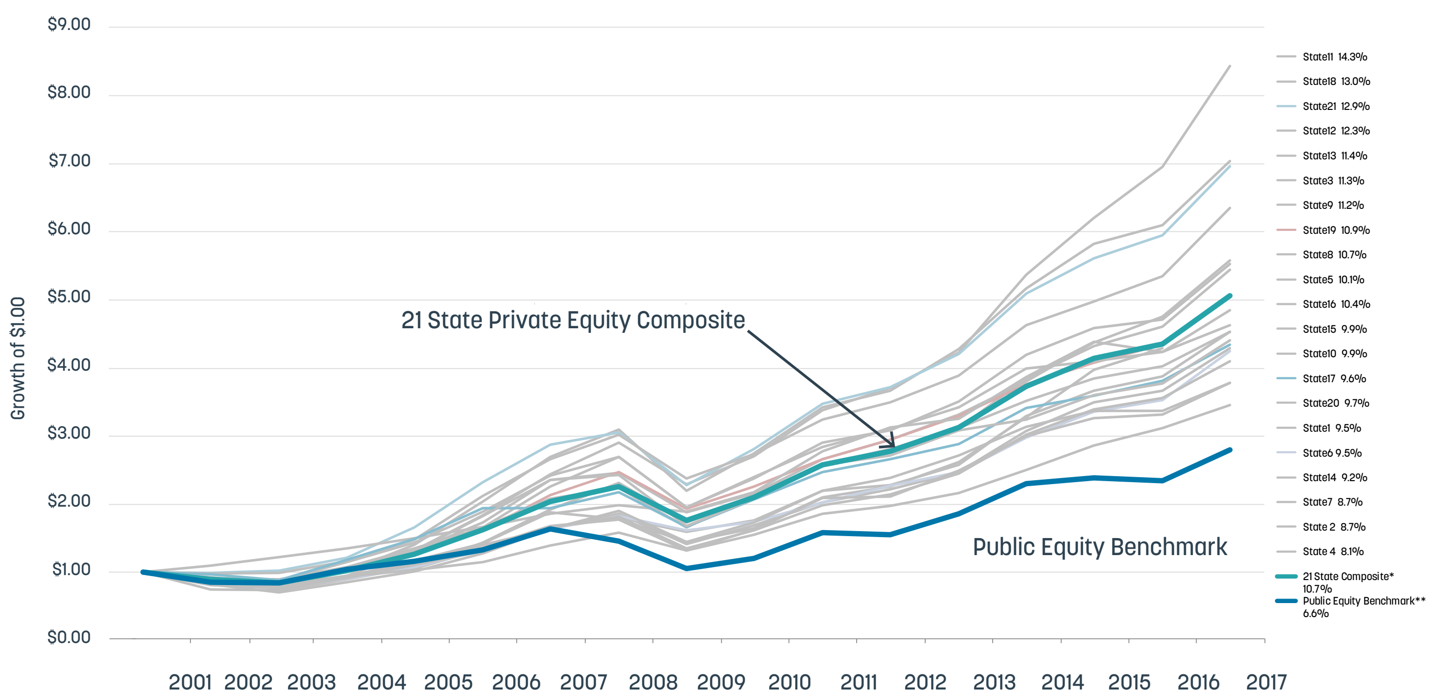
We are, however, in the eleventh year of the longest bull run in history and, as concerns rise over an eventual downturn, it's natural for investors to ask how private equity will perform in a recession. Significant historical data shows that private equity's outperformance actually increases during distressed periods, a logical outcome given the long-term nature of the asset class. For PE firms, a downturn represents opportunity. They can deploy capital at more attractive terms and make bold, calculated moves without being hamstrung by the short-termism that afflicts so many public companies.

PRIVATE EQUITY HAS OUTPERFORMED PUBLIC MARKETS IN RECESSIONS, WITH LESS VOLATILITY

One of the more interesting reports on this subject was generated by Cliffwater,[2] which examined PE investment programs at U.S. state pension plans over the 16-year period ending June 30, 2016 (encompassing two bear markets and two bull markets). During this period, PE outperformed public equities by 440 basis points annually on average across the 21 pension plans studied (Exhibit 1). These strong relative returns were even more pronounced during bear markets than in years of economic growth.[3] When the broader economy was stronger, private equity outperformed by an average of 290 basis points; however, during weaker economic times, this increased to 660 basis points.

An analysis of median net IRRs of U.S. buyout funds across vintages confirms private equity's outperformance during economic downturns (Exhibit 2). In fact, we found that the asset class generated some of its strongest returns in recession-year vintages, including 2001, 2002, and 2009.

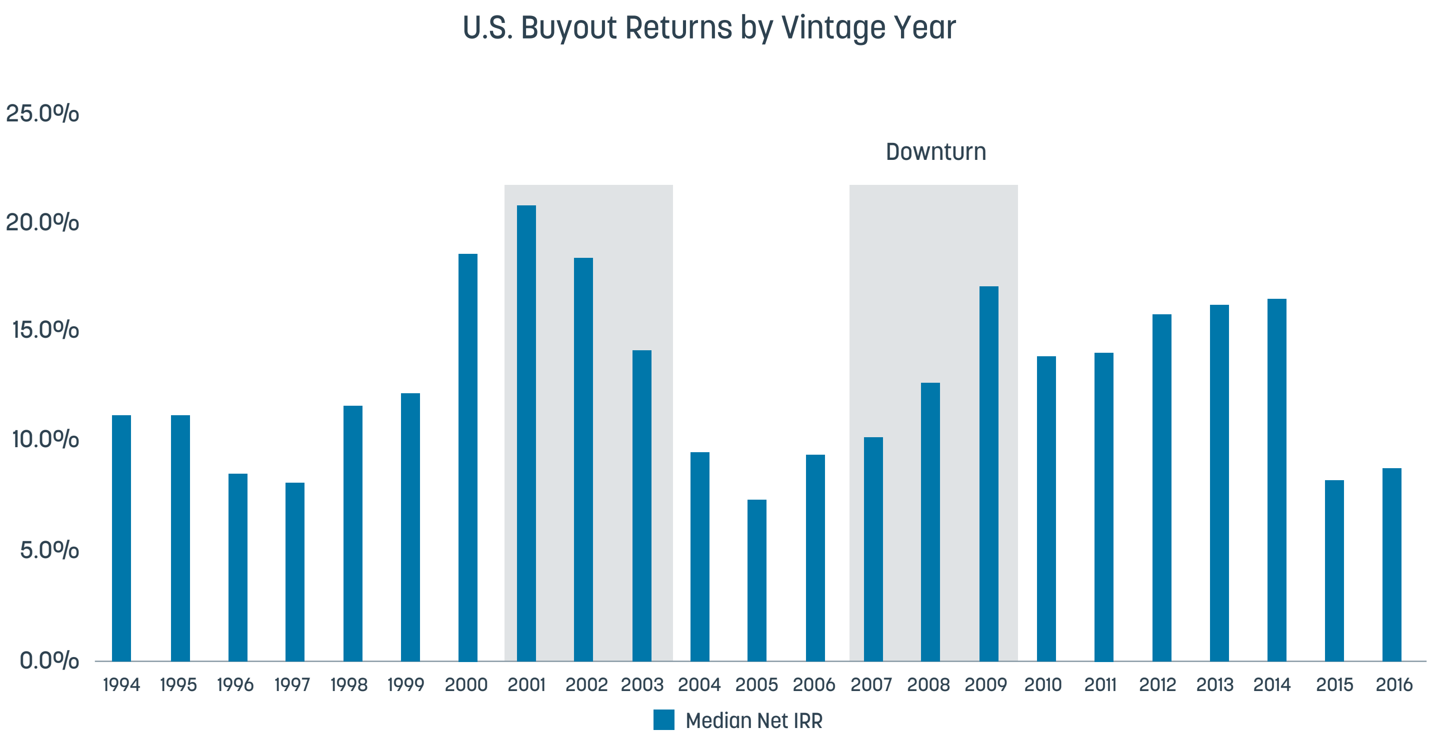
Exhibit 1:
Private versus public equity performance in U.S. state pensions



Fiscal Years ending June 30
*An equal-weighted average of all 21 state funds who reported private equity returns in annual CAFRs for June 30 fiscal years 2002-2017.
** A public equity benchmark weighted 70% to the Russell 3000 Index (6.8% annualized return) and 30% to the MSCI ACWI ex US Index (5.9% annualized return), with assigned weights reflecting Cliffwater's judgment of the US and non-US content of a diversified private equity portfolio.

Source: Cliffwater, "An Examination of Private Equity Performance among State Pensions, 2002-2017," updated May 2018. 2017 is the most recent data available. For illustrative purposes only.

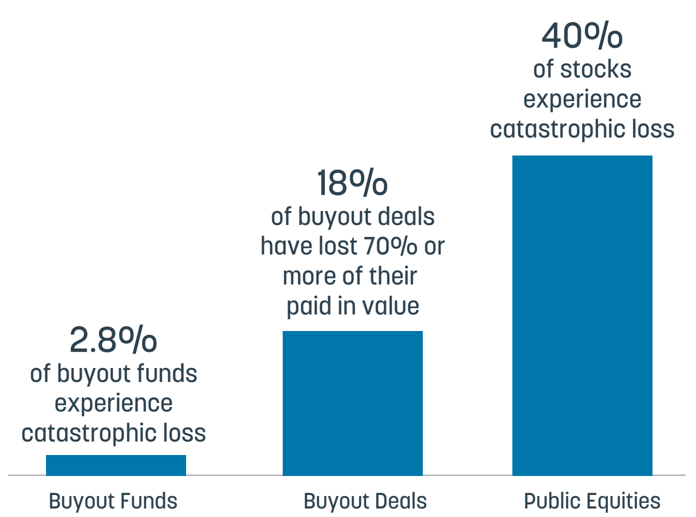
Exhibit 2:
Some of PE's strongest vintages began investing during downturns



Source: Cambridge Associates U.S. Buyout Index, as of March 2019. 2016 is the latest vintage available. For illustrative purposes only.

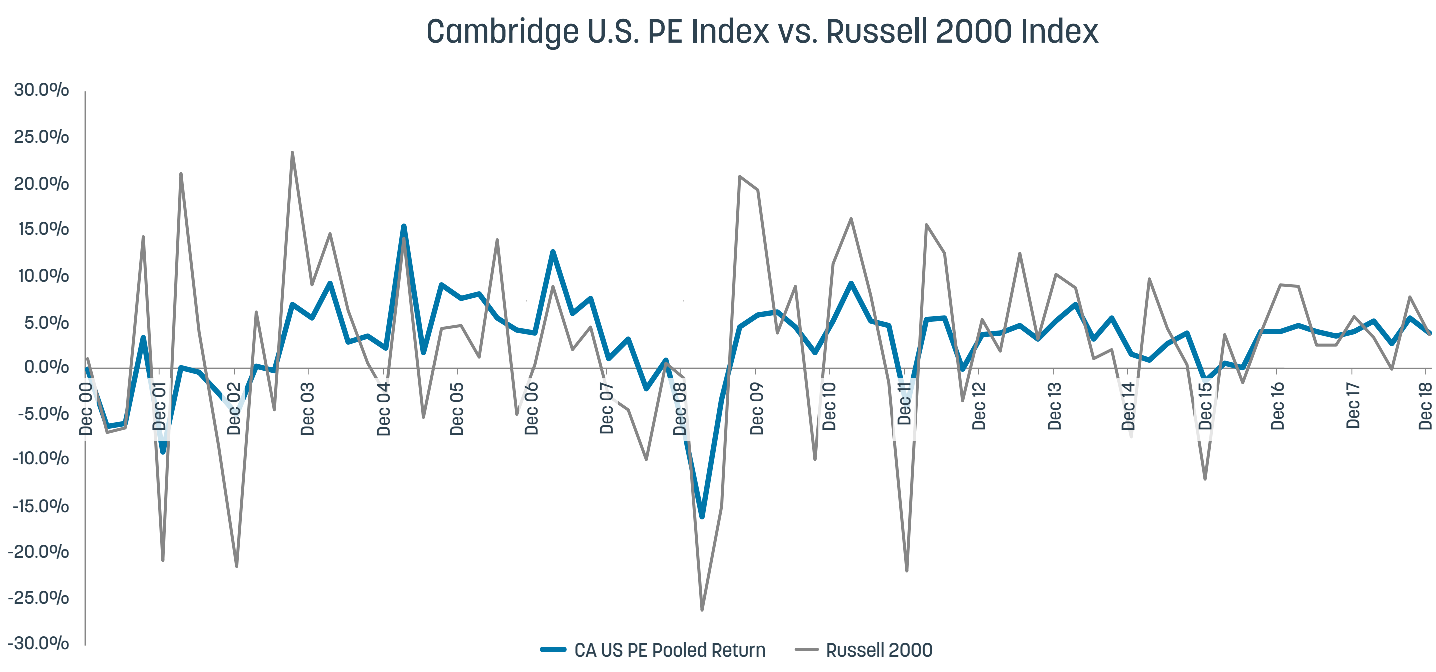
Data from Hamilton Lane and J.P. Morgan further supports private equity's ability to weather downturns.[4] J.P. Morgan analyzed the Russell 3000 Index (which represents approximately 98% of the investable U.S. equity market) between 1980 and 2014. They found that during recessions, two-fifths of publicly listed equities have experienced "catastrophic loss," defined as a 70% or greater drop from their peak values. Yet less than 3 out of 100 private equity funds have suffered a similar loss (Exhibit 3). When examined from this perspective, stocks are 13 times riskier than private equity funds. PE's lower volatility relative to public markets is also apparent when comparing index performance over time (Exhibit 4).

Exhibit 3:
Private equity has demonstrated a lower risk of catastrophic loss



Sources: Hamilton Lane, as of October 2017; FactSet; J.P. Morgan Asset Management, "The Agony & The Ecstasy," 2014. For illustrative purposes only.

Exhibit 4:
Private equity has delivered a smoother ride than public equities



Source: Cambridge Associates, US Private Equity Index and Selected Benchmark Statistics, as of March 2019. For illustrative purpose only.

THE LONG-TERM NATURE OF PRIVATE EQUITY OFFERS ADVANTAGES DURING BEAR MARKETS

The ability of private equity firms to plan and invest over the long-term, particularly relative to public companies, confers several advantages that are at the root of its outperformance.

Hands-on approach to managing portfolio companies.

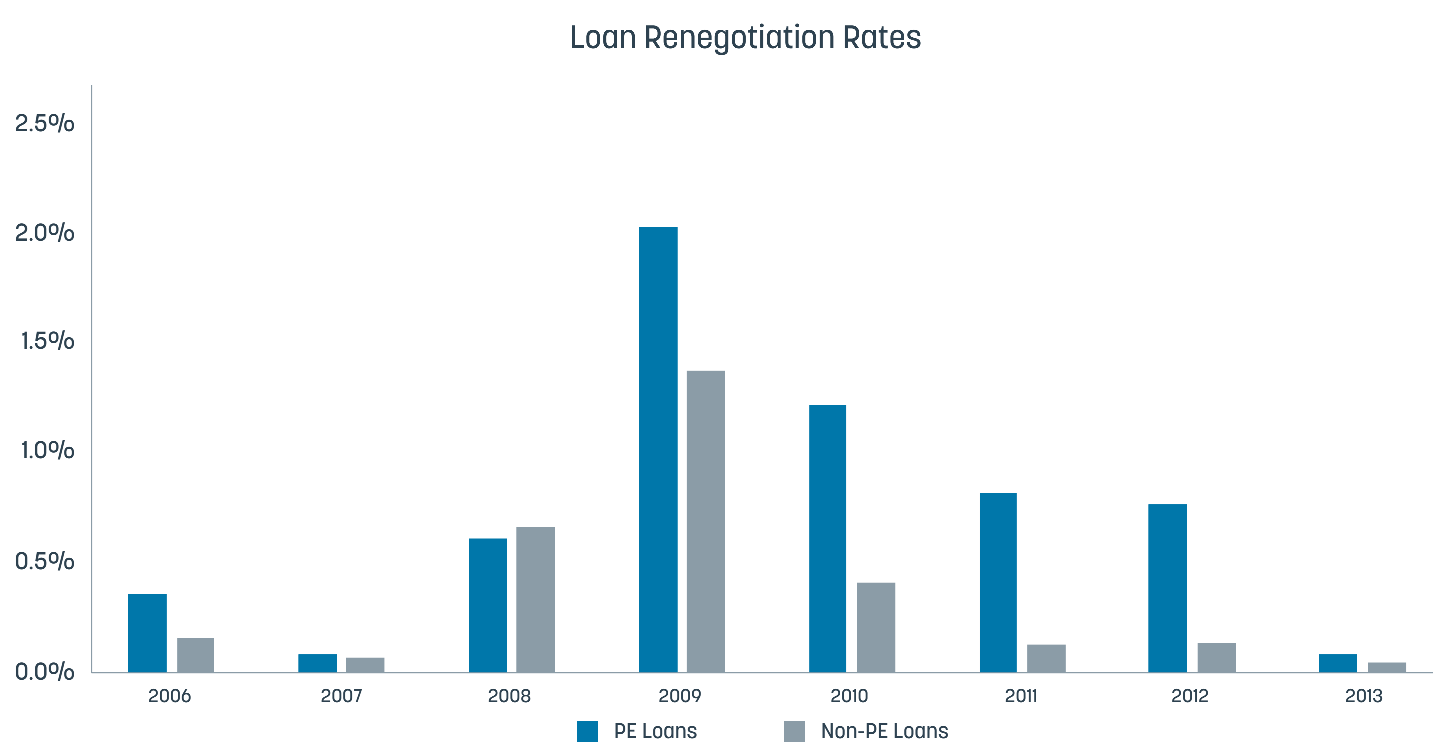
PE managers have an asymmetric information advantage over public market investors and, often, access to a deep bench of talent that enables them to pivot their approach during downturns to help their companies successfully weather the storm. In particular, they can use available dry powder to alleviate a company's financing concerns, as well as help them renegotiate loan terms and debt obligations. Similarly, PE firms can take a buy-and-build approach to consolidate a sector, using the same dry powder to make add-on acquisitions at a time when purchase price multiples are low. This can be particularly effective in down markets because public companies tend to retrench and avoid making investments during these periods, creating opportunities for private companies to gain the upper hand. PE managers are also often sector specialists, owning companies within a specific industry over multiple economic cycles. They are therefore well-equipped to identify difficulties early on as well as the best path forward.

A recent Harvard-backed study that focuses on the period around the Global Financial Crisis (GFC) confirmed that PE-backed companies are generally more resilient to downturns and can act as an economic stabilizer during a recession.[5] In the study, PE-backed companies were found to be less likely to face financial constraints during the GFC, allowing them to grow and increase market share versus their peers. PE firms were also found to have been significantly more likely to assist portfolio companies with their operating problems and provide strategic guidance during the crisis. In fact, PE-backed companies invested 6% more and gained 8% market share versus their non-PE-backed peers during the GFC. As a result, PE-backed companies were 30% more likely to be acquired in the period post-crisis, with a greater potential for a profitable exit.

The same study also showed that in the years immediately following the GFC, loans to PE-backed companies were about 50% more likely to be renegotiated than those to non-PE backed companies. This points to PE firms being able to leverage their existing banking relationships to access credit for their portfolio even when market liquidity is limited. It also demonstrates PE managers' active approach to assisting their companies to raise debt financing, interacting with intermediaries on financial structure and, in some cases, even buying back the debt obligations of their portfolio companies.

PE-backed companies were 30% more likely to be acquired in the period post-crisis, with a greater potential for a profitable exit.

Exhibit 5:
PE firms can help portfolio companies renegotiate loans when liquidity is limited



Source: Bernstein, Lerner, Mezzanotti, "Private Equity and Financial Fragility during the Crisis," January 2018. This figure reports year-by-year probability of renegotiation of leveraged loans issued between 2003 and 2007 with a size of at least $30 million. The figure reports separately renegotiation probability of loans granted to PE-backed companies and non-PE backed companies. The sample considered is the one of U.S., non-financial corporations. Data on renegotiation comes from S&P and the background loan information comes from DealScan. For illustrative purposes only.

Ability to exploit the benefits of illiquidity.

While it may seem paradoxical, private equity's illiquid nature is an advantage in a recession, as it insulates investors from panic selling during the depths of a downturn. Panic selling almost always comes at a high cost, as investors often liquidate their holdings for below-market value (in fear of values declining even further). Meanwhile, PE managers have the benefit of a multi-year holding period, with the ability to patiently wait for more welcoming market conditions to exit their underlying portfolio companies. PE's illiquid structure also renders PE's correlation with the broader public markets of less importance, as the decision to exit an investment is put in the hands of professional managers who are closest to the underlying asset.

Private equity's illiquid nature insulates investors from panic selling during the depths of a downturn.

Given PE's inherent attributes – a long-term investment philosophy, highly active involvement with portfolio companies, and fund structures that prevent fire sales – there is much for its investors to embrace across all market environments, but particularly in the face of market stress. Investors turning their thoughts to portfolio construction ahead of the next downturn should consider adding a private equity allocation, not only for its outperformance potential, but also to help provide a smoother ride.

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END NOTES

[1] Cambridge Associates, US Private Equity Index and Selected Benchmark Statistics, Q1 2019.
[2] "An Examination of Private Equity Performance among State Pensions, 2002-2017," Cliffwater. Updated May 2018.
[3] The study notes 2002-03 and 2008-09 as the bear market years.
[4] Hamilton Lane Market Overview 2017/2018.
[5] Bernstein, Lerner, Mezzanotti, "Private Equity and Financial Fragility during the Crisis," January 2018. Study focuses on the UK market (largest PE market as share of GDP pre-crisis). Similar financial data is not publicly available in the U.S.

IMPORTANT INFORMATION / DISCLAIMER

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