MURRAY DEVINE PRIVATE EQUITY VALUATIONS OUTLOOK

2020

PRICED TO PERFECTION

Three factors should influence private equity activity over the next 12 months: politics, the economy, and whether sponsors can find any relief from high valuations

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In Preqin's bi-annual Investor Update, published last August, two out of every five limited partners said they would be increasing allocations to private equity over the next 12 months. This sentiment, in which PE absorbs an ever-larger share of asset owners' growing investment portfolios, reflects a shift in which those who can live with the illiquidity, view private equity as anything but an alternative asset category. In fact, some consultants are even advocating for allocations as large as 40% under the right circumstances, suggesting private capital commitments should underpin rather than merely complement a diversified portfolio.

The paradox is that even as institutional investors and family offices turn to private equity as a reliable source of alpha, many are also wary of the risk. In the same Preqin survey, nearly three quarters of respondents estimated that assets in private equity are currently overvalued and a possible correction could occur at any point over the next three years. In the parlance of GPs, it's a case of too much capital chasing too few deals.

The numbers certainly bear this out. In 2019 — as available dry powder surpassed $1.7 trillion and the number of buyout deals in the U.S. fell by nearly a quarter — LBO valuations held steady near historic highs. From a 20,000-foot view, the trends may not seem markedly different from the previous five years, a stretch in which average entry multiples ranged from 11.8x to 13.8x Ebitda. Beyond just the deceleration in the pace of activity, however, other shifts reflect an evolving GP universe, one that has grown accustomed to transacting at rich multiples, yet is also showing a sense of discipline that may not be obvious based purely on the amount they're willing to pay.

The Changing Backdrop

Even as investors remain confident in the near-term outlook, most still recognize that all cycles must end. Ten years removed from the global financial crisis, the prolonged bull market has now engendered a sense of caution, spurred as much by sponsors' internal clocks as any specific and worrisome environmental cues. Ironically, in early 2020, sponsors currently enjoy a far more accommodating backdrop than they did a year ago. Consider that last January, U.S. investors were coming off of nine consecutive quarter-point hikes from the Federal Reserve; faced a yield curve on the cusp of inverting; were confronting a decelerating GDP growth rate in Q4; and still digesting a developing trade war with China, in addition to other geopolitical risks ranging from Brexit's many iterations to the populist wave occurring throughout much of Europe.

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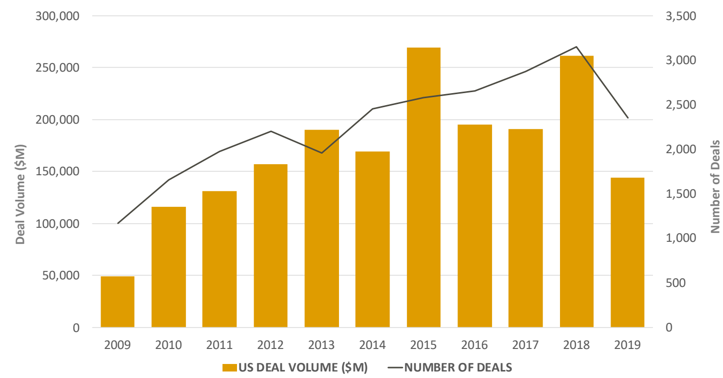
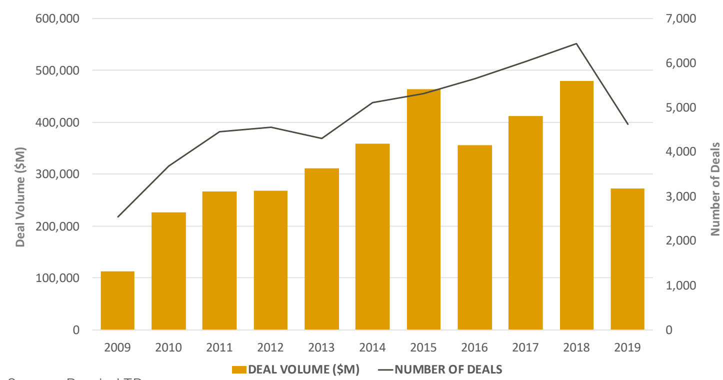
Fast forward one year, however, and three straight cuts to the Fed Funds rate in 2019 have helped to set right an inverted yield curve, while spurring economic growth and further supporting a resilient consumer. Perhaps the biggest source of comfort for investors is a renewed sense of clarity around the China trade deal (which entered its first phase in January), the USMCA trade agreement (passed by the Senate in the second week of January), and the likely outcome of Brexit negotiations (thanks to Boris Johnson's resounding win in the U.K.'s general election).

U.S.: ANNUAL LBO DEAL VOLUME & DEAL COUNT



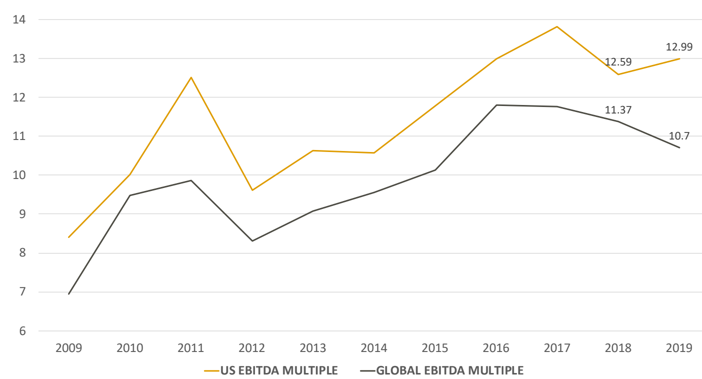
Source: Preqin LTD

GLOBAL: ANNUAL DEAL VOLUME & DEAL COUNT



Source: Preqin LTD

U.S. & GLOBAL PE ENTRY MULTIPLES (EBITDA)



Source: Preqin LTD

So what will influence GP investment activity in 2020? The answer, at a surface-level, is quite simple: the election, the economy, and the trajectory of valuations. Below the surface, it's less obvious how these variables will ultimately play out and even more uncertain how GPs will react. Certain trends, though, are already discernible in the activity from 2019 and offer some color around what the new year could bring.

Election-Year Unrest

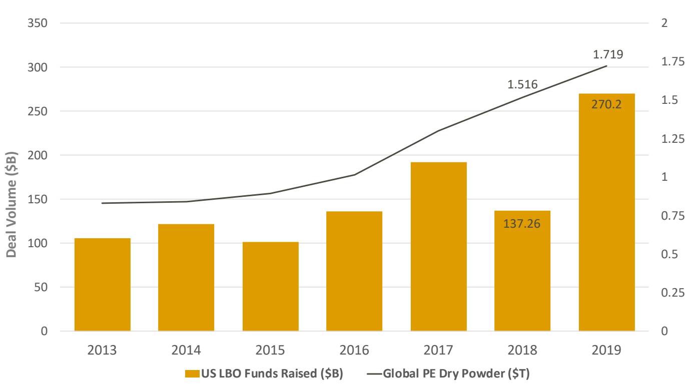
Elections have consequences. Few constituencies outside of Washington know this better than sponsors and the investors they serve. Flashback to 2012, and Mitt Romney's bid alone brought unwanted attention to the carried interest tax debate. When President Barack Obama won re-election later that year, a massive rush of deal activity followed as sponsors sought to secure realizations ahead of the New Year to avoid any potential tax hikes on dividends and capital gains. Market watchers will recall that roughly $400 billion of Bush-era tax cuts were also set to expire at the end of 2012, contributing to what Ben Bernanke termed an impending "fiscal cliff." Motivated sellers, in turn, roused awake a buyer universe armed with newfound visibility. As a result, the number of deals completed by U.S. sponsors that December nearly doubled the monthly average from the previous 11 months.

> ***The 2020 election cycle appears to be shaping the pace and nature of investment activity***

Already, the 2020 election cycle appears to be shaping the pace and nature of investment activity. It would be misleading to attribute 2019's slowdown solely to the coming election, particularly as other factors including trade uncertainty and high valuations contributed to an overriding sense of caution. But the Democratic party's tilt toward more progressive policies than past eras — ranging from Andrew Yang's "Freedom Dividend" (i.e., universal basic income) to Elizabeth Warren's proposal for an "Ultra-Millionaire Tax" — underscores divisions that seem even more stark next to the GOP's adoption of President Trump's "America First" agenda.

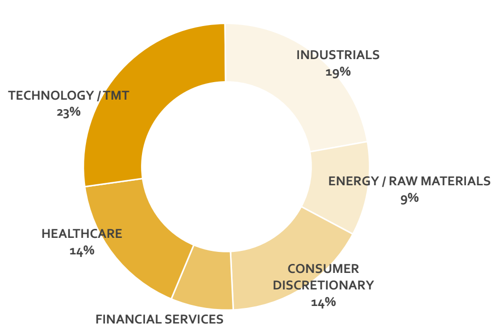
The risk to buyers, of course, is that key assumptions that inform an investment thesis can change overnight. Investors longer in tooth may recall the carnage that followed Bill Clinton's Balanced Budget Act of 1997, which altered the reimbursement rates for managed care facilities and nursing homes. This "stroke of the pen" risk, in

U.S. LBO FUNDS RAISED & GLOBAL PRIVATE EQUITY DRY POWDER



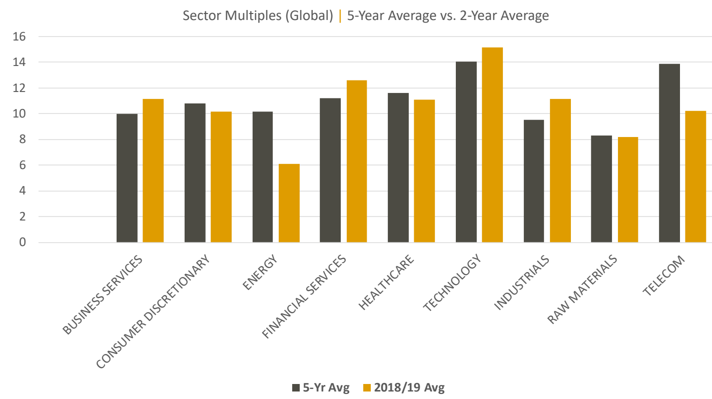
Source: Preqin LTD

2019 SECTOR MIX (US)



Source: Preqin LTD

SECTOR MULTIPLES (GLOBAL) I 5-YEAR AVERAGE VS. 2-YEAR AVERAGE



Source: Preqin LTD

which revenue projections become obsolete without any warning, led to a string of bankruptcies that were felt most acutely by highly levered PE-backed companies. Given this history, and the recurring "Medicare for All" discussion that has featured so prominently in the debates, it's no wonder both deal activity and valuations in healthcare slumped last year.

The election will certainly continue to affect activity in 2020. And some fear a potential repeat of 2012, in which a Democratic win in the general election would trigger a stampede of firms looking to exit their investments. As *Axios* pointed out in early January, the four leading candidates in the Democratic primary have proposed tax plans that would treat capital gains as ordinary income, creating an added incentive for GPs already looking to lock in returns before the cycle ends.

Tracking the Economy

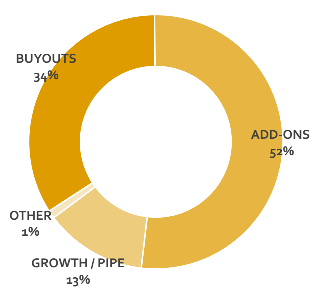
It goes without saying that the economy will be critical to deal activity and valuations. Just as earnings drives performance in public equities, in private equity it's cash flows that fuel leverage. And this keeps the PE machine churning out new investments, funding portfolio-company growth, enabling dividends and other liquidity events, and supporting valuations that contribute to multiple expansion. Exits, inturn, are more rewarding for LPs, who then recycle their distributions back into the market through new fund commitments. (Hence the $600 billion raised by U.S. buyout funds over the last three years.)

And for all the reasons cited earlier, the U.S. economy outwardly seems to be in a better place today than it was in early 2019, even if the market is now one year closer to the end of the cycle. The unemployment rate resides at a 50-year low, robust retail sales continue to reflect a strong consumer, and even manufacturing output advanced despite a strike at GM and Boeing's ongoing 737 Max struggles.

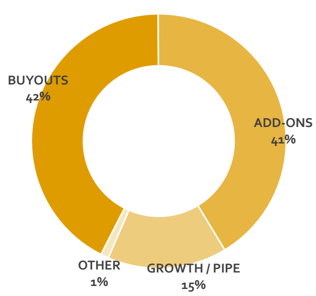
More pertinent to sponsors, ongoing economic growth has translated into a leveraged loan market that remains healthy and fluid. The endurance of the capital markets, augmented by the development and growth of the private debt ecosystem, speaks to the discipline of investors. A recent SEC "Market Outlook" panel, for instance, documented that last year the average financing arrangement carried total leverage of 5.5x Ebitda, the bulk of which (4.6x) took the form of first lien debt. The most aggressive borrowers, or the top quintile, averaged 7.75x leverage. Compared to previous eras, this is nearly a full turn below the same sample just ahead of the financial crisis. Moreover, sponsors are funding their deals with larger equity checks, representing roughly 40% of the mean purchase price. This again contrasts sharply with what the market saw in 2007, when LBO equity commitments were closer to 20% on average.[1]

This is not to say the market is free from worry. Covenant-lite loans, visibility into the underlying CLO credits, and liberal Ebitda adjustments represent three of the most cited vulnerabilities. According to some estimates, covenant-lite loans represent approximately 60% of global issuance of institutional leveraged loans, or as much as 85% when including revolving credit facilities and amortizing term loans.[2] Roughly the same percentage of LBO deals, or just below 60%, also incorporated adjustments to Ebitda. And there is also a pocket of concern as corporate debt levels balloon in size. BlackRock, for instance, recently noted that the total corporate debt as a percentage of GDP exceeded 47% last year, and the proportion of the issuance comprised of BBB credits — the lowest-rated segment of the investment-grade market — exceeded 50%. For context, in 2007, BBB bonds represented roughly a quarter of the investment-grade issuance.

2019 TRANSACTION MIX (US)

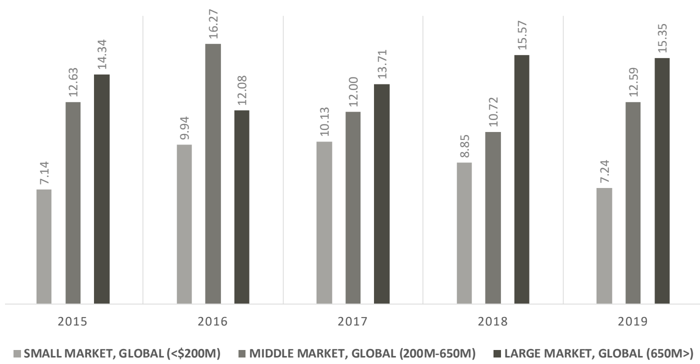


TRANSACTION MIX, FIVE YEAR AVERAGE (US)



Source: Preqin LTD

MULTIPLE EXPANSION (ENTRY MULTIPLES, GLOBAL VALUATIONS BY MARKET SIZE)



Source: Preqin LTD

Still, as long as the default rate remains in check, the capital markets should remain liquid to the benefit of sponsors. Last year, the U.S. high yield default rate hit 3.3% and is projected to tick higher in 2020, with Fitch projecting a slight bump to 3.5%. While the pace of restructuring activity is exceeding non-recessionary levels, most investors view the distress as being contained within the energy sector.

Finding a Margin of Safety

It's no secret that valuations remain quite rich by historical standards and 2019 represented the fifth straight year in which the average multiple exceeded 11.75x Ebitda. This environment has forced sponsors to either adjust or risk missing their fund's investment window waiting for the value play that never arrives. Left with no other options, GPs have recalibrated their approach and redefined what it means to "buy right."

Of note, last year, more than half of the completed deals were add-ons for previously acquired platform investments. This makes sense, given the pace of activity over the previous four years and as investors have turned to rollup strategies as a way to bolt-on accretive assets that absorb market share, grow the bottom line, and lower their effective entry multiple over time. Looking at the variance between small-, middle- and large-market deals last year, investors across all segments of the market were presented with a "multiple expansion" opportunity, assuming they were successful in growing their platforms. In recent years, such as 2016, this wasn't the case, and as valuations escalated, certain segments of the market experienced compression in the premiums between market caps.

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Not to be overlooked in contextualizing the high-valuation environmant, technology transactions continued to attract investor interest, representing one fifth of all the deal activity last year. Considering these assets fetch a premium — particularly software-as-a-service companies with recurring revenue — the propensity of tech deals has goosed the mean multiple for the broader PE industry. Ten years ago, tech investments represented about 9% of the total U.S. PE deal count.

Just as the public markets have favored growth stories over the last five years, so too has private equity. This also plays out in sponsors' value-creation efforts, as many GPs have either sought to help their portfolio companies effect digital transformations, positively impacting their valuations, or position their businesses to benefit from tech's tailwind. The prevailing investment thesis in many of the business services deals last year was to offer tech-enabled solutions in specialized areas, such as human capital management, marketing or other areas.

1. Deborah J. Enea, "SEC's Leveraged Loan Market Outlook," Pepper Hamilton LLP Client Alert, https://www.pepperlaw.com/publications/secs-leveraged-loan-market-outlook-2019-10-29/

2. The Financial Stability Board, "Vulnerabilities Associated with Leveraged Loans and Collateralised Loan Obligations," https://www.fsb.org/wp-content/uploads/P191219.pdf

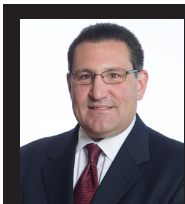
Conclusion

In a way, sponsors have been a victim of their own success. The high valuations reflect a supply-and-demand dynamic in which institutional investors can't seem to commit to the asset class fast enough or in large enough sums. After a year in which the industry in the U.S amassed another $270 billion in new commitments, PE and VC fund managers now have a record $1.72 trillion of dry powder at their disposal. And increasingly, asset managers are complementing their existing strategies with new funds to accommodate every possible LP itch — from sector- and geographic-specialist funds to long-dated and growth-oriented strategies and, more recently, distressed and special situation vehicles in the event the cycle ever does turn.

This kind of specialization, however, speaks to why valuations have been so resilient. While sponsors would certainly prefer to transact at lower multiples or find arbitrage opportunities based on price alone, they're now well versed in creating value and managing the risk that comes with higher prices. Deals may be priced to perfection, which will create vulnerabilities if the cycle turns. At the same time, sponsors have become catalysts for growth, and will be positioned to take advantage of any dislocation when the opportunity to do so again presents itself.

Methodology

All deal, fundraising and valuation data mentioned in this report, unless otherwise noted, was provided by Preqin.



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