IQEQ & Cebr

Macroeconomic Trends and the Private Equity Sector

A Cebr whitepaper for IQ-EQ

July 2023

Preface

Any successful investment requires patience and discipline and perhaps even a bit of luck along the way.

Successful investing also needs an understanding of the macroeconomic trends that are likely to inform investor decision-making.

Even as private equity funds proliferate, the outlook for the private equity sector in 2023 and beyond is mixed. Interest and inflation are both proving tough beasts to tame, with interest rates likely to remain elevated for some time as broad-based inflation threatens to persist more strongly than present estimates by central banks suggest. The shake-up of the banking world with the SVB and Credit Suisse turmoil looming large over the financial services sector has wider implications for companies seeking finance for large, leveraged transactions.

The private equity market is likely to see improved growth prospects as it can realistically look ahead to the likelihood of interest rates peaking and potentially tapering off in H2 2023. Deal-making is already showing signs of recovery, and fund managers are advised to take advantage of the fact that the private equity market has historically had a faster recovery rate than public equities. Private equity managers would certainly serve investor interests best by assessing the macroeconomic environment carefully and timing their investments well, as deals made when emerging from a downturn are more likely to generate greater returns over time.
Against the backdrop of a challenging macroeconomic landscape and mixed market sentiments on the way forward, we have commissioned London-based Centre for Economics and Business Research Ltd (Cebr) to produce a whitepaper that aims to provide fund managers with the outlook for the private equity sector for 2023 and beyond. In this report, we seek to provide insights into how private equity is likely to fare in the US, UK, Eurozone and APAC regions within the context of current trends, including inflation, GDP growth and labour markets, alongside fiscal and monetary policy stances.

We would like to thank Cebr for all their support in this endeavour, and we hope that private equity managers and LPs will find our Macroeconomic Trends and the Private Equity Sector report useful as they dig deeper into the broader trends that will inform their funds' future.

Justin Partington

GROUP HEAD OF FUND AND ASSET MANAGERS

Executive Summary

- An unprecedented mix of macroeconomic forces alongside a lack of clarity regarding current conditions have resulted in considerable uncertainty in the private equity sector
- The outlook for the private equity sector for the rest of 2023 and beyond is mixed. Interest rates are likely to be close to their peaks but are expected to remain elevated due to sticky, broad-based inflation
- This is likely to weigh on activity in the sector and reduce equity valuations. Recent banking sector turmoil has further dampened risk appetite and made banks unwilling to finance large leveraged transactions
- Positive signs for the private equity sector have emerged, including glimpses of pockets of strength in deal-making. Moreover, growth prospects have improved compared to the gloomy forecasts made last winter. However, the risk of recession remains present, and the latest figures show that the Eurozone entered a technical recession in Q1 2023
- Improved growth prospects, along with the potential uplift provided by the reopening of the Chinese economy on the APAC economy, will provide some upward pressure on equity valuations, after tighter financing conditions and high inflation led to a drawdown in valuations
- Nonetheless, the private equity sector will likely remain subdued for the rest of 2023 until interest rate cuts are implemented. Such cuts are expected to take place in 2024, and the access to cheaper debt, alongside the possibility of favourable macroeconomic conditions as markets recover from ongoing developments, will likely herald in a pick-up in private sector activity
- Meanwhile, in the current environment, general partners (GPs) need to explore alternatives to leveraged transactions, such as add-ons, which align well with mounting inflation and subdued growth prospects
- To maximise returns, GPs should take appropriate steps, including:
    1. Conducting proper due diligence and engaging in scenario planning to ensure they are well-positioned to capitalise on current conditions
    2. Leveraging the historically faster recovery rate of the private equity market compared to public equities, focusing on deals made when emerging from a downturn, which have higher potential for long-term returns
    3. Implementing improved tracking of financial metrics such as interest coverage, cash forecasting and debt serviceability to prepare portfolio companies for higher interest rates and potential financial headwinds, ultimately leading to better returns over the long term
    4. Exploring opportunities in emerging markets and sectors with resilient growth potential to find attractive investment targets

1. Introduction

The private equity sector operates in an ever-changing macroeconomic environment that can have a significant impact on its outlook and performance. As the world emerges from the pandemic and economies are faced with multi-decade highs of inflation and a synchronised tightening of monetary policy, it is crucial to understand the mechanisms through which current macroeconomic conditions have and will continue to affect the private equity sector.

The aim of this whitepaper report is to determine the outlook for the private equity sector for 2023 and beyond within the context of current macroeconomic trends. This report will provide an overview of the economic conditions in the US, UK, Eurozone, and APAC regions, including inflation, GDP growth, and labour markets, alongside fiscal and monetary policy stances. It will also evaluate the impact of macroeconomic developments on private equity activity, including supply chain disruptions, the impacts of the Russian war in Ukraine, tighter financial conditions, lower growth outlook, and banking system turmoil.

Furthermore, this report will examine the potential opportunities for private equity firms, such as alternative financing and exploiting downturns, and analyse the outlook for equity valuations in light of growth prospects in the UK, Eurozone, and US. It will also consider the usefulness of public equity indices as proxies for private equity market performance and relevant for exits.

Overall, this report aims to provide valuable insights into the current macroeconomic conditions and their impact on the private equity sector, enabling stakeholders and investors to navigate the current market turmoil and make informed investment decisions for the future.

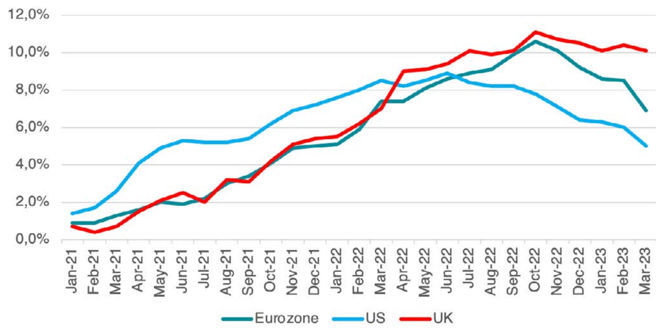
2. Macroeconomic overview – US, UK, Eurozone & APAC

2.1. General overview of macroeconomic conditions

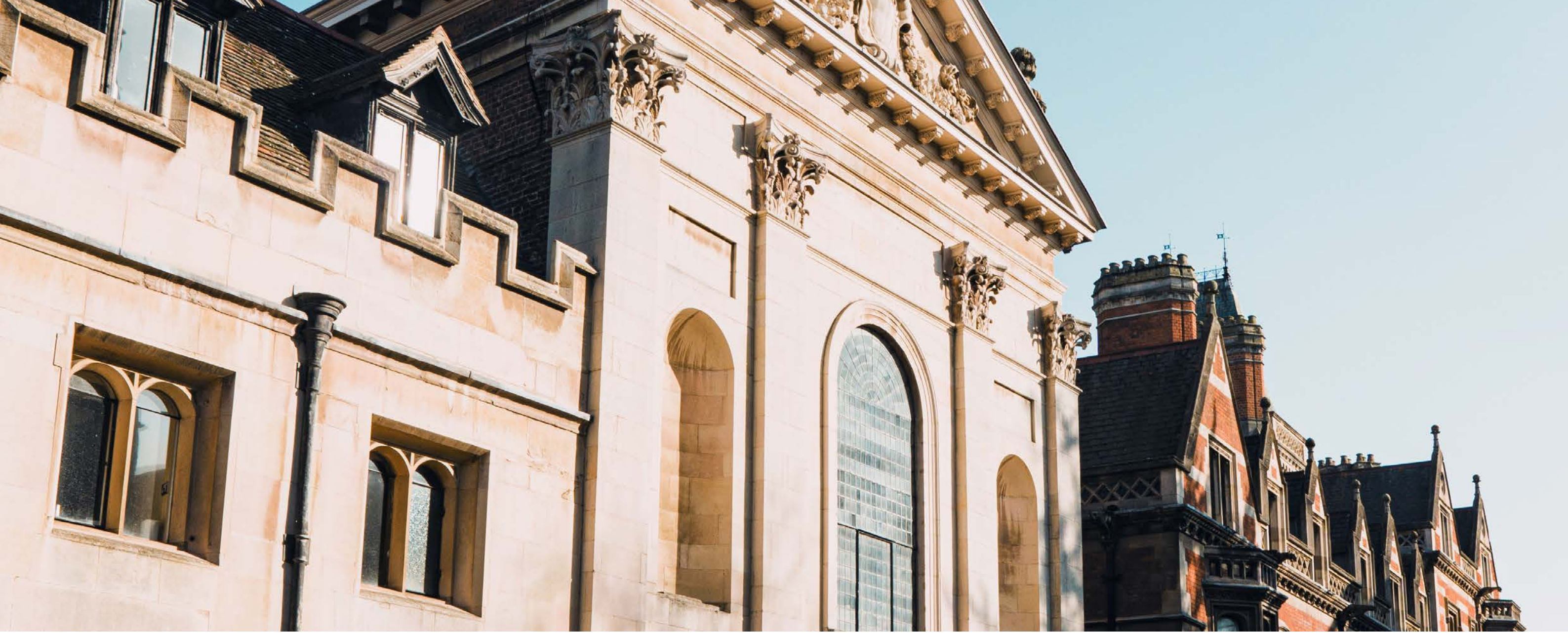
Inflationary pressures started to accelerate noticeably in the second half of 2021 as a result of the post-pandemic uptick in demand. As economic activity and consumer spending began to recover from the pandemic-induced lows of 2020, firms struggled to keep up. Moreover, with firms having made supply chains leaner as a means to cut costs over the past years, supply chain bottlenecks became a major theme for the second half of 2021.

Such inflationary pressures exceeded expectations while becoming more broad-based in nature over the course of 2022. A key factor to this was the Russian invasion of Ukraine in February 2022, which represented a major supply-side shock to developed and developing economies alike, due to the impact on energy prices. Given Europe's dependence on Russian natural gas at the time, the continent was particularly vulnerable to an energy price driven spike in inflation. Yet, conflict in Eastern Europe was not the only contributor to excessive inflationary pressure, with erratic weather and continued supply chain disruptions also contributing to an increase in the price of consumer goods, subsequently placing upward pressure on the headline rate of inflation globally. Resultantly, annual inflation peaked at four-decade highs in the United States (US) at 9.1% and the United Kingdom (UK) at 11.1%. For the Eurozone, peak inflation reached. 11.1% in October 2022, the highest on record since comparable records began in 1997.

Figure 1: Trend in annual inflation (Jan 2021 – April 2023), by market economy



Source: Macrobond



Subsequently, surging inflation has prompted central banks to adopt an aggressive approach towards tightening monetary policy to bring price growth back to target.

Headline inflation has started to ease since the end of last year, which is most pronounced in the US where the effects of pandemic stimulus spending and supply chain disruptions subsided. Lower energy prices have also helped to reduce price growth in the Eurozone.

Yet, significant price pressures continue to linger as inflation has become more entrenched across most economies. Indeed, core inflation rates, which strip out volatile prices for food and energy, continue to trend upwards in the UK, Eurozone and US, highlighting the risk of inflation becoming embedded in economies through higher inflation expectations and persistent wage pressures. While the disinflationary impact of lower energy prices is projected to strengthen from summer onwards as lower prices are passed on to households, inflation is still expected to remain elevated above the 2.0% inflation target by the end of 2023.

This is shown in the macroeconomic projections of the Federal Reserve (the Fed), the Bank of England (BoE) and the European Central Bank (ECB). Looking further ahead, the ECB and Fed predict a relatively smooth transition towards their inflation target while the BoE even predicts a substantial inflation undershoot beyond the second half of 2024. However, as was the case in 2021/22, it is possible that central banks again underestimate inflationary dynamics and the degree to which higher price pressures will prevail even as commodity price shocks subside. Against this backdrop, the recent signs of a nascent but developing banking crisis could have the potential to further complicate the mandate of central banks. If policy makers face a trade-off between providing liquidity to support the financial system while also attempting to stave off inflation, monetary tightening might be paused or even reversed. This would however run the risk of precipitating a renewed uptick in inflation further down the line. Early evidence of the recent banking turmoil on central banks' decision making is apparent. The Fed raised its base interest rate by 25 basis points in its Federal Open Market Committee (FOMC) meeting in March, even though its chair, Jerome Powell, had initially stated that the Fed would likely pursue a larger incremental hike in light of stronger-than-expected economic data.

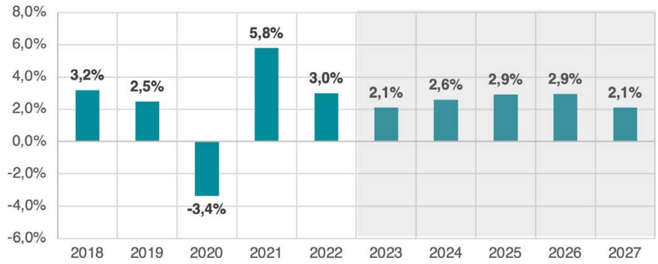
The latter statement came before the collapse of Silicon Valley Bank, however, in a clear sign that the banking crisis had prompted the Fed to reconsider its monetary policy tightening campaign. Outside of preventing central banks from fulfilling their mandate of reining in inflation, the recent turmoil in the banking sector could also make banks less willing to lend. Tighter credit conditions could therefore become a threat for businesses who rely on new financing for investment or to manage their cashflow. This compounds the effect monetary tightening has had on lending, with high interest rates disincentivising businesses taking up loans. Indeed, the US M2 monetary aggregate fell by the largest amount on record in annual terms in February, reflecting the impact of tighter financial conditions even before the current banking crisis.

The implications of a high inflationary environment can be felt acutely across global economies. High inflation depresses consumer demand by eroding purchasing power and leads to increased uncertainty among economic decision makers. Moreover, the distributional impacts of inflation tend to affect lower-income households the hardest as a larger share of their budgets goes towards essential spending. Resultantly, economies have employed fiscal policy in a bid to protect vulnerable groups from the harshest impacts, with increased government spending and stimulus measures being implemented to support economic recovery and help households deal with rising prices. This has been especially prominent among European countries where governments intended to shield their populations from record-high energy prices throughout 2022 and the recent winter. These measures, alongside the support measures employed as part of pandemic support packages, have put further strain on public finances across many major economies.

As such, while the post-pandemic recovery buoyed global growth in 2021, surging inflation has offset some of this in 2022, and will continue to do so over the course of 2023. Indeed, while global GDP growth accelerated to 5.8% in 2021, 2022 saw a marked slowdown to around 3.0%. A further downtick is expected for 2023, with Cebr's latest forecasts pegging GDP growth to amount to 2.1% this year. Despite the slowdown, there are some positive points to highlight in early 2023, including an uptick in business activity indicators amidst stronger-than-expected data and the reopening of China.

Nonetheless, near-term headwinds to global GDP growth still persist, as major economies continue to grapple with the fallout of elevated inflation and high interest rates. Moreover, any further developments in the banking system have the potential to aggravate recessionary risks further.

Figure 2: Global GDP growth, by calendar year



Source: Cebr forecasts

Outside of near-term issues of high inflation and tighter monetary conditions, longer term challenges include the broader geopolitical realignment in the face of the Russia-Ukraine war and potential conflict over Taiwan with China. In addition, global industrial strategy is making a comeback with the US providing $500 billion in new spending and subsidies as part of its Inflation Reduction Act, challenging other regions to re-think their rules on state-aid, subsidies and industrial policy.

2.2. Regional economic outlook

This subsection provides a broad macroeconomic outlook for the US, UK and Eurozone economies respectively, as well as a broader review of Asia as a whole, with a focus on China, Singapore and Hong Kong.

US outlook

Annual inflation in the US, as measured by the Consumer Price Index (CPI), peaked at 9.1% in June 2022 after which it gradually decelerated, with the latest data showing inflation standing at 5.0% in March 2023. Inflationary pressure in the US has differed to other developed markets, including the Eurozone and the UK. While the latter two saw inflationary pressure mostly due to an

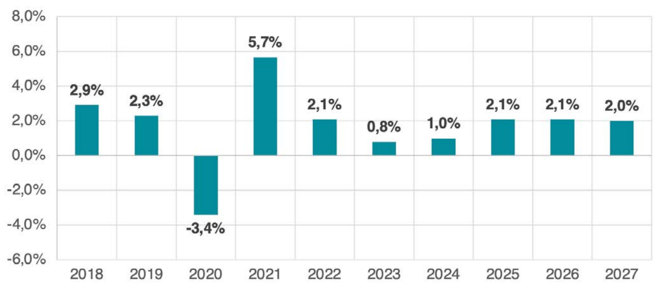
uptick in energy prices, the inflationary pressure in the US was disproportionately caused by a strong recovery in consumer demand following the pandemic.

The Fed has reacted by embarking on an aggressive monetary tightening campaign, with base interest rates rising nine times, bringing them to a target range of 4.75% to 5.00% as of April 2023. Given the differing nature of inflation in the US, along with a relatively steeper climb in interest rates over 2022, the Fed has been more successful in bringing inflation down from its peak, compared to other central banks. The US labour market still remains historically tight however, with the latest unemployment rate for March hovering close to its half-century low of 3.4%, while average net additions to non-farm payrolls for the first three months of 2023 remained robust at 345,000. Consequently, the Fed, as recently as the end of February, had reiterated the need to raise interest rates by more, in a bid to dispel second-round inflationary effects. The economic and monetary policy outlook has been clouded due to the recent banking turmoil.

Indeed, the collapse of Silicon Valley Bank, amongst others, has forced the Fed to reconsider the future path for the federal funds rate. This is evident in the FOMC's latest macroeconomic projections, which suggest a single, additional, quarter point rise for the rest of this year, before rate cuts from 2024 onwards. Tighter credit conditions could therefore contribute to the Fed's target of bringing inflation down, however, this would happen at the cost of a reduction in business activity and a potential uptick in insolvencies and unemployment.

Cebr expects interest rates in the US to stay elevated for the rest of 2023, with higher borrowing costs predicted to weigh on activity in the private equity sector and the wider economy. In terms of GDP growth, a considerable slowdown in growth for 2023 is expected, compared to 2022. Overall, our latest forecasts expect US growth to amount to 0.8% in 2023, compared to 2.1% in 2022.

Figure 3: US GDP growth, by calendar year



Source: Cebr forecasts

Eurozone outlook

The ECB was slower relative to other central banks in tightening monetary policy.

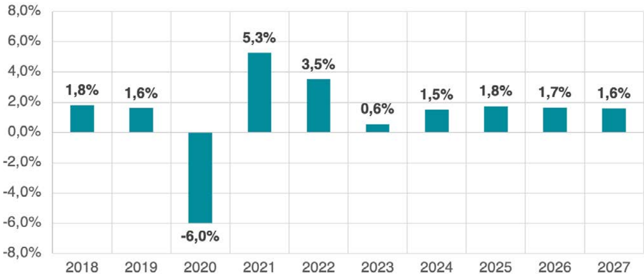
A key reason includes the Eurozone's relatively larger exposure to the fallout from the war in Ukraine, and the need to assess macroeconomic conditions before tightening monetary policy.

Nonetheless, the ECB has raised rates aggressively in the past nine months, with key interest rates increasing by 350 basis points in that period. In March, ECB President Christine Lagarde reiterated that the ECB would not 'entertain trade-offs' around their primary objective of bringing inflation down, hinting at further rate rises in upcoming Governing Council meetings. Indeed, annual CPI inflation in the Eurozone peaked at 10.6% in October 2022, with the latest data showing inflation standing at 6.9% in March 2023. In addition, the Eurozone labour market continues to remain tight, with latest data for February showing the unemployment rate holding steady at its record low of 6.6%. Given the relative tightness in the labour market and considering that core inflation has continued to accelerate, rising to a record 5.7% in March, policy makers remain nervous regarding potential second-round inflationary impacts. Another key reason why the ECB continues on its current path is interest rate parity, with the substantial hikes by both the Fed and the BoE necessitating the need for the ECB to follow suit to avoid a weakening of exchange rates, which could contribute to import cost-push inflation.

Indeed, the ECB raised its benchmark rates by 50 basis points in its latest Governing Council meeting in March. This came in spite of the recent banking turmoil, which saw a forced takeover of Swiss lender Credit Suisse by its domestic competitor UBS and caused substantial volatility in the share prices of other European lenders. Higher interest rates are also likely to place pressure on sovereign bond yield spreads within the Eurozone, with debt-laden countries, such as Italy, at risk of being unable to refinance their debt if yield spreads become too large.

Nonetheless, there has been increased optimism since the turn of the year that the Eurozone will avoid a sharp recession in 2023, amidst reduced fears over energy supplies and recent upticks in business activity. Growth in 2023 is expected to amount to 0.6%. This, however, does represent a marked slowdown from the estimated 3.5% growth seen in 2022.

Figure 4: Eurozone GDP growth, by calendar year



Source: Cebr forecasts

UK outlook

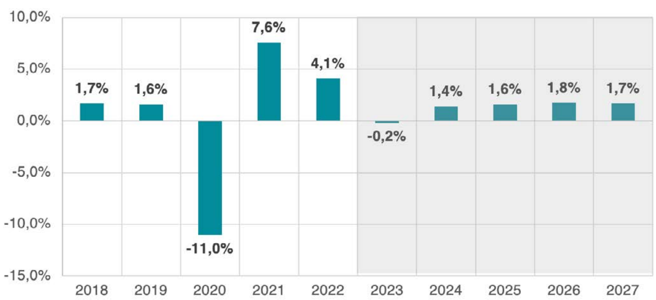
The UK economic outlook remains challenging, as evidenced by its relatively poorer growth outlook and higher CPI inflation rate. On the former, fears for a deep recession in 2023 have now largely subsided due to more resilient consumer spending and falling energy prices. Nevertheless, GDP growth will likely hover around 0.0% in 2023.

In terms of price pressure, annual CPI inflation in the UK remains elevated compared to the Eurozone and the US, though it has fallen from the 11.1% peak seen in October 2022. The latest data, published by the Office for National Statistics, saw annual inflation in the UK amounting to 10.1% in March. There are signs that price pressures are broadening, with February's reading breaking a three-month streak of disinflation in the headline reading and a surprise uptick in core inflation. Cebr forecasts see annual inflation easing considerably, to 4.4% in December, as households start to benefit from lower energy prices in the second half of the year.

Similar to other major central banks, the Bank of England

has raised its main policy rate significantly since late 2021, from its near-term low of 0.1% to 4.25% in March 2023. The UK financial system has also had to deal with the fallout of the US banking failures. Nonetheless, the banking sector in the UK seems to have held off any further contagion for now, with coordinated, timely action by the BoE, the UK Treasury and HSBC. This enabled HSBC UK Bank to acquire the UK arm of Silicon Valley Bank, thereby providing insurance to depositors.

Figure 5: UK GDP growth, by calendar year



Source: Cebr forecasts

Asia outlook (focus on China, HK, SG)

The outlook for Asian economies for 2023 is slightly rosier, compared to their Western counterparts. Key reasons include lower exposure to the fallout from the Russian war in Ukraine, and the expected recovery in the Chinese economy.

On the latter, we expect growth in China to amount to 5.0% in 2023 with risks skewed to the upside, after the ruling party abruptly ended its zero-Covid controls late last year. This is expected to herald in a release of pent-up demand as well as an easing of supply-chain disruptions that have been a constant theme since the post-pandemic period, buoying global growth in a period of poor growth prospects for the rest of the world. While there remains a degree of uncertainty, the latest data seems to suggest that a steady post-Covid recovery is underway. First quarter GDP data showed the Chinese economy rebounding 4.5% year-on-year, marking the fastest pace of expansion since Q1 2022. The retail sales sector grew 10.6% year-on-year, the highest growth in retail sales volumes in almost two years, though this has to consider the low base effect of last year's lockdown of Shanghai. Meanwhile, exports saw a much larger annual increase in March, at 14.8%.

Nonetheless, investment in real estate fell by 5.8% year-on-year in the first quarter of 2023. A key contributor to this is the depressed property sector, which has seen a downturn since late last year, after a tightening of borrowing rules. Any recovery in the Chinese property market will be drawn out after the property downturn last year. Yet, there is some positivity in the property sector, with average new home prices contracting by its lowest amount, at 0.8% in March, and marking the second straight slowdown in price contractions. The ruling party is expected to introduce reforms to help the ailing property sector, including easing restrictions on debt growth, easing borrowing caps and pushing back the grace period for meeting debt targets.

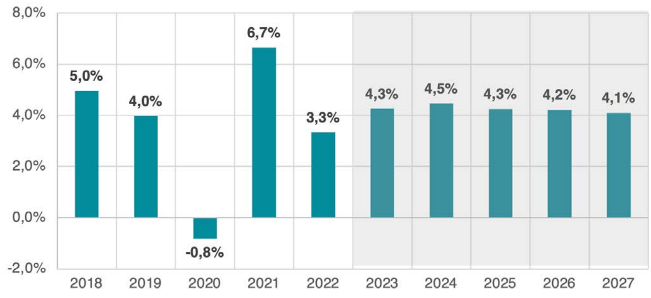
Meanwhile, Hong Kong has largely followed the mainland's lead in efforts to tackle Covid-19, implementing a 'zero-Covid' strategy of their own. Consequently, strict enforcement measures meant that the Hong Kong economy contracted by 3.5% in 2022, as strict Covid controls and weakening global demand weighed on spending and exports. Yet, there is an expectation that the economy will rebound this year, after measures to relax Covid controls were announced. This, alongside an expected resurgence in China's economic outlook and fiscal measures to help boost domestic spending, will help alleviate some pressure from the economy. Hong Kong has seen output contractions in three of the last four years, as it grappled with the pandemic, rising geopolitical tensions, and an increasing shift of financial services companies to its regional rival, Singapore.

Singapore's current performance is more reminiscent of Western economies, with the country exhibiting high inflation and a tight labour market.

On the former, the latest reading showed annual inflation standing at 5.5% in March, down from its near-term peak of 7.5% in August and September. Singapore's lack of natural energy resources has exposed it to global energy price shocks, which in turn has resulted in substantial imported cost-push inflation for the country.

Unlike other markets however, the country's monetary policy is centred around exchange rates rather than interest rates, with this choice predicated on the economy's small size and its historic openness to trade and capital flows. Given the mounting inflationary environment however, monetary policymakers have adjusted its policy band in recent months to ensure price stability.

Figure 6: APAC GDP growth, by calendar year



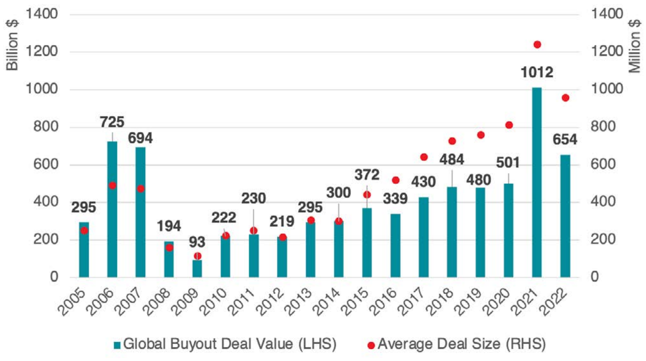
Source: Cebr forecasts

3. Impact on private equity sector

3.1. Current state of play of private equity sector

Activity in the private equity sector hit new records in 2021, with the Covid-19 pandemic, barring the early months of the pandemic where dealmaking was essentially suspended, doing little to slow the momentum in the sector. Nonetheless, private equity's performance in 2021 can be considered as an outlier by historic standards. A release in pent-up demand fuelled by post-pandemic trends, along with the presence of cheap debt in light of depressed interest rates, and the prevalence of record-high dry powder, brought about an unprecedented mix of favourable conditions that led to the industry reaching remarkable heights. Indeed, buyout values hit $1.0 trillion in 2021, breaking the previous record of $725 billion seen in 2006. The exits market exhibited similarly strong activity in 2021, with total global buyout-backed exit values amounting to $969 billion in the year, more than double the reading seen in 2020.

Figure 7: Global buyout deal value (with labels) and average deal size, by year



Source: Dealogic

2022 started brightly for the private equity sector.

The first half of the year saw large volumes of deal flows and exits, along with a considerable amount of funds being committed, thereby extending the rally seen over the course of 2021. This came in spite of growing geopolitical tensions, not least the Russian invasion of Ukraine, and stubborn inflationary pressures.

While a prolonged period of near-zero interest rates ushered in large amounts of borrowing and was a key contributor to the robust performance seen in the first half of 2022, this outlook changed dramatically once central banks around the world started hiking interest rates in a bid to rein in inflation. Indeed, central banks' shift from accommodation to tightening had a more pronounced impact in the second half of 2022, making banks less willing to provide leveraged loans, thereby cutting off access to cheap debt. Higher interest rates also affect valuations by increasing the discount rate applied to future cash flows, which in turn places significant downward pressure on the net present value (NPV) of an acquiree company, hence depressing private equity valuations.

Subsequently, overall dealmaking saw a marked slowdown in 2022, while exits and fund-raising totals also fell. Global buyout values (excluding add-ons) totalled $654 billion for the year, marking a drop of 35% from the corresponding 2021 figure. However, despite this decline, the industry's performance in 2022 remained robust, with global buyout values 31% higher than 2020 values. This momentum was partially due to the exceptional performance of the sector in 2021. Exits followed a similar trend, with values dropping 42% compared to 2021 but remaining 21% above 2020 values. These figures suggest that the private equity sector has demonstrated resilience in the current macroeconomic climate and continued to generate strong returns, even without the outlier performance of 2021. The tighter monetary conditions in 2022 also presented challenges in raising new capital, with the total value of buyout capital raised decreasing compared to 2020.

However, the drop was only 3%, which is significantly less than the 56% drop seen during the global financial crisis of 2008/09. This further highlights the sector's resilience in the face of high interest rates. One factor contributing to this resilience is the shift in limited partners' (LP) preferences towards established mega-funds in uncertain markets. As a result, there was an influx of capital towards these well-established funds, causing their share of total buyout capital raised to increase from 44% in 2020 to 57% in 2022, and placing upward pressure on the total value of buyout capital raised. Yet, higher interest rates and tighter financial conditions are not the only reason why private equity markets have been subdued following a robust first half of 2022. A range of developments have afflicted the

private equity market, not least persistent supply chain disruptions since the reopening of economies in the wake of the Covid-19 pandemic, the war in Ukraine, multi-decade highs in inflation, recession risks for developed economies and recent banking sector turmoil.

The latter is pertinent, aggravating private equity firms' financing challenges as more traditional lenders withdraw from the market. While measures implemented on both sides of the Atlantic have eased concerns in the financial sector for the time being, there is a strong likelihood that the current macroeconomic environment, alongside developments in the banking sector, has affected markets' risk appetite considerably.

All these forces, though they may not directly affect buyers, lenders and/or sellers alike, add uncertainty in terms of future projections for valuations and cashflows.

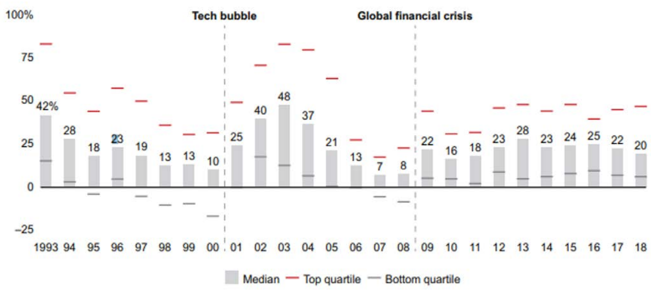
As long as these forces are not resolved, private equity activity will remain in a subdued state, especially for those transactions that require a considerable amount of leverage. This uncertainty due to the unprecedented mix of various macroeconomic forces currently afflicting the global economy is compounded by the fact that there is lack of clarity regarding current conditions, with no definitive event having triggered this marked shift. As such, the near-term is expected see buyout and exits activity remain somewhat depressed.

3.2. Opportunities for 2023 and beyond

The outlook for the private equity sector has become rosier since the turn of the year however, in line with the release of some more upbeat macroeconomic data. Interest rates are likely at or close to their peak in the UK, the US and the Eurozone, providing some much needed relief to the sector after the general theme of monetary tightening over the course of 2022. Meanwhile, anticipated recessions expected for the aforementioned economies have so far failed to materialise amidst improvements in growth outlooks, further alleviating uncertainty in the sector.

Nonetheless, it is likely that interest rates will stay high for some time as central banks stick to their mandate of squeezing out inflation. Cebr's latest forecasts for the interest rate path suggest that in the absence of further banking sector turmoil the BoE will only cut rates in December 2023, while the Fed and the ECB are only expected to cut rates early next year. Consequently, with debt-financed transactions likely to remain expensive for some time, private equity firms will have to look to alternate means to navigate through the current climate and manage near-term headwinds, especially that of uncertainty.

Figure 8: Global buyout deal internal rate of return by year of entry



Source: DealEdge, Bain analysis

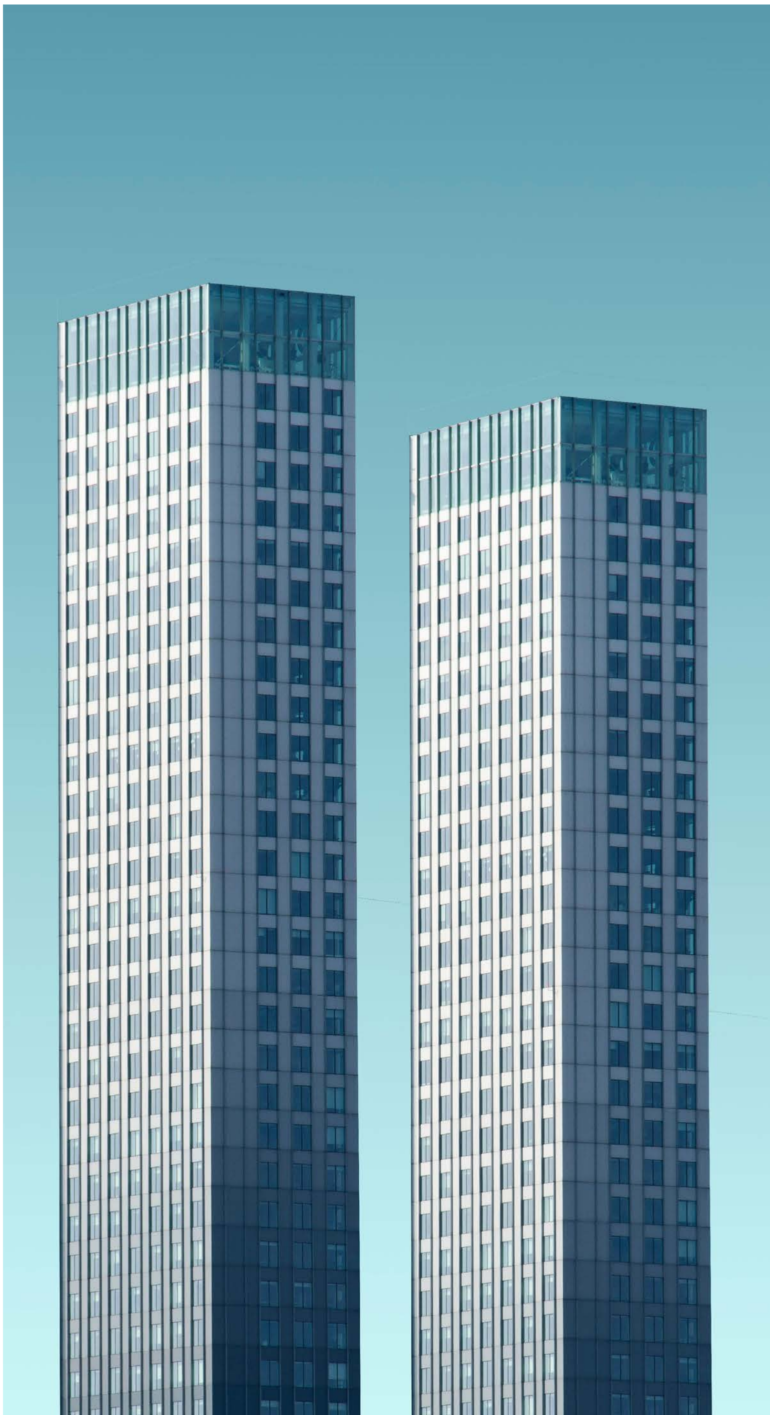
A key challenge for firms will be the ability to conduct appropriate and insightful due diligence in order to properly investigate how shifts in macroeconomic conditions affect companies and the relevant industry.

Firms that are able to identify the specific subset of macro factors that matter for their deal, and are subsequently able to produce clear scenario and mitigation plans that account for a set of different outcomes, tend to emerge as winners out of a downturn. The data supports this; deals made during a downturn tend to generate greater returns over time.

In light of recent banking turmoil and uncertain markets, it is also imperative for GPs to be able to safeguard themselves from extreme volatility, and there are several steps GPs can take to enhance the financial resilience of portfolio companies, while generating long-term value for investors. One such measure is to implement improved tracking of financial metrics, such as interest coverage, cash forecasting, and debt serviceability. By keeping a close eye on these key indicators, GPs can better monitor the financial health of their portfolio companies and take timely corrective actions if needed. In addition, to weather potential financial storms and create long-term value, portfolio companies should be equipped with a sound financial and operational foundation. By implementing these measures, GPs can mitigate risks and ensure that portfolio companies have the necessary resources and capabilities to navigate challenging economic conditions. Ultimately, this can lead to better investment outcomes and higher returns for investors.

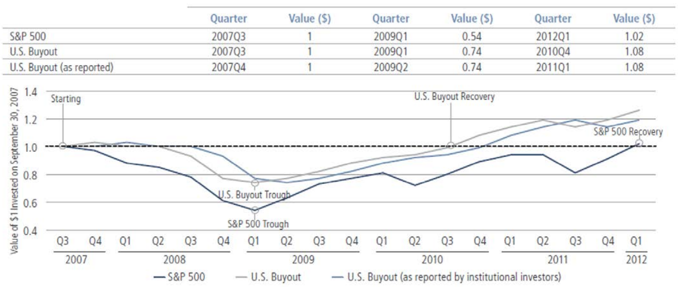
In the meantime, while larger leveraged transactions may not be ideal given the current conditions, private equity firms can explore alternatives, including add-ons, which are well-suited in today's market, where mounting inflation and relatively subdued growth prospects have contributed to a drop in company valuations. Add-ons tend to serve buy-and-build strategies, and if executed well, such transactions can average down the purchase price multiple, create large, high-multiple platforms from smaller acquisitions, and reduce costs through economies of scale, all while generating growth and protecting value. With dry powder hitting a new record of $3.7 trillion in 2022, GPs do have some ammunition to pursue such a strategy, and the data suggests this has in fact been the case, with add-ons contributing to 72% of all North American buyout transactions in 2022, a seven percentage point increase on the corresponding average share across the five-year period from 2017 to 2021.

Other alternatives do exist, including that of hedge funds. In 2022, hedge funds also faced significant challenges, recording a loss of 4.25% for the year, according to the HFRI 500 Fund Weighted Index. However, this was substantially better than the S&P500, which experienced a 19.4% decline. Hedge funds' diversifying characteristics, which exhibit low correlations with traditional equity and fixed income strategies, have enabled them to be well-positioned to face the near-term headwinds currently afflicting the private equity sector.



Neuberger Berman investigated the private equity market performance during three recent periods of market stress: the early 2000s downturn, the 2007 to 2009 global financial crisis, and the 2020 Covid-related depression. The results showed that private equity investments experienced a less significant drawdown and a quicker recovery than public equities in all three cases. These findings suggest that the private equity sector is likely to rebound faster than public equity markets, highlighting the significance of private equity as a valuable investment option for maximising returns in the current downturn.

Figure 9: Return analysis – Global Financial Crisis & Recovery (Q3 2007 to Q1 2012)



	Quarter	Value ($)	Quarter	Value ($)	Quarter	Value ($)
S&P 500	2007Q3	1	2009Q1	0.54	2012Q1	1.02
U.S. Buyout	2007Q3	1	2009Q1	0.74	2010Q4	1.08
U.S. Buyout (as reported)	2007Q4	1	2009Q2	0.74	2011Q1	1.08

Source: Cambridge Associates, FactSet, Neuberger Berman Analysis

Given these past observations, it is crucial for GPs to leverage the current market conditions to maximise returns in the current downturn. Private equity firms should consider a range of factors, including the specific characteristics of their portfolio companies, market conditions, and potential exit opportunities. While public equity indices can serve as useful proxies for private equity market performance and can provide benchmarks for potential exit opportunities, limitations exist, such as time lags and differences in risk profiles. Private equity investments typically have a higher risk profile than publicly traded companies, which implies that public equity indices may not fully reflect the risk and return characteristics of private equity investments. Given the fact that dealmaking activity seems to be showing signs of recovery and may have moved past its trough, it is imperative that private equity firms conduct thorough analyses to evaluate the performance of their investments and make informed decisions about how best to navigate the current market conditions, in order to maximise their returns coming out of the current downturn.

Looking beyond the near-term, a boost in the growth prospects for the UK, Eurozone, and the US, along with the uplift provided by the reopening of the Chinese economy on the APAC economy, will provide some upward pressure on equity valuations, after tighter financing conditions and high inflation led to a drawdown in valuations over the course of 2022. With interest rates likely to be cut from 2024 onwards,

access to cheaper debt will help buoy the private equity sector further.

A recovery in the dealmaking already seems underway, following Pfizer's acquisition of Seagen for a total enterprise value of $43 billion, and more recently, Merck's purchase of Prometheus Biosciences for approximately $11 billion.

4. Conclusion

The private equity sector saw record-breaking activity in 2021, but it should be considered an outlier due to post-pandemic trends and favourable conditions. In 2022, the sector started strongly with high deal flows and exits, but central banks' shift to tightening monetary policies and other factors led to a significant slowdown in the second half of the year. Despite this, the private equity industry remained robust in 2022 and showed resilience in the current macroeconomic climate, generating strong returns even without the outlier performance of 2021. However, challenges in raising new capital and a range of developments such as supply chain disruptions, inflation, and banking sector turmoil have affected private equity markets. These factors have added uncertainty in future projections for valuations and cash flows, leading to subdued private equity activity in the near term.

Despite the challenges, opportunities exist outside of using debt to finance deals. The data suggests that GPs have shifted their preferences towards add-on executions as part of buy-and-build strategies. Moreover, the private equity sector can still capitalise on the current downturn to maximise returns. Firms need to conduct proper due diligence and engage in scenario planning to ensure all possible outcomes are covered in today's volatile climate. Past data suggests that deals made during a downturn are more likely to generate greater returns over time.

Looking forward, the outlook for the private equity sector has improved since the turn of the year, with stronger growth prospects and a low likelihood of further interest rate rises beyond the summer of 2023 feeding into this improved outlook. Deal-making is showing signs of recovery, and past literature suggests that the private equity market has a faster recovery rate than public equities. Thus, it is crucial for GPs to reassess their strategies to capitalise on the current conditions and maximise returns.

To achieve this, GPs should consider implementing improved tracking of financial metrics such as interest coverage, cash forecasting, and debt serviceability, and focus on building a strong operational infrastructure within portfolio companies. This includes robust financial reporting systems and effective cost management strategies. By doing so, portfolio companies will be better equipped to weather potential financial storms and ultimately create long-term value for investors.
In addition, GPs should prioritise developing a talent management strategy that focuses on recruiting and retaining top talent within portfolio companies. This may include investing in employee training and development, implementing competitive compensation packages, and providing opportunities for career growth. By doing so, GPs can help ensure that portfolio companies have the talent needed to execute on growth strategies and ultimately create value for investors over the long term.

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Key contact

Justin Partington

GROUP HEAD OF FUND AND ASSET MANAGERS

T +352 466111 3852

E Justin.Partington@iqeq.com

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