PRIVATE EQUITY PERFORMANCE IN 2022

ARE RISING YIELDS JEOPARDISING PRIVATE EQUITY?

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SUMMARY

- Private-equity returns were broadly flat in the first quarter of 2022 (latest data available), dragged down somewhat by venture capital (VC).
- The current innovation wave is fading and funding conditions are deteriorating, putting downward pressure on VC returns similar to that on the Nasdaq.
- During market crises, private equity tends to decline less than listed equities.
- Given generally rising bond yields, we expect the average interest rate paid to fund buyouts to converge toward the long-term average of 6.3%, slightly above the current 6%. In other words, we do not see the current rise in interest rates as a game changer for buyouts' performance.
- At end-June 2022, the valuation of buyout deals measured by EV/EBITDA (Enterprise Value / Earnings before Interest Taxes Depreciation and Amortization) for global private equity stood at 12.7x. The potential valuation derating ranges between 5% and 10%.
- Based on historical drawdown analysis, we expect VC to have recorded returns in the region of -12% to -15% in Q2 2022 and buyouts in the region of -10%.
- Our 10-year expected return for global private equity stands at an annual average of 9.2% (in USD), i.e. a 3% return premium over the MSCI AC World index.

So far so good for Private Equity, but cracks are starting to appear in VC

In mid-July, Burgiss released its time-weighted returns (TWR) for Private Equity (both Buyout and Venture Capital) in Q1 22. While performance figures for private equity lag data for public equities by three or four months, we can use the latest TWR to help gauge the performance of private assets in Q2. (We also use TWR in our annual forecasts for long-term returns, with our latest forecast contained in Horizon 2022).

Private-equity returns were broadly flat in Q1, dragged down somewhat by global venture capital's (VC) -2.7%. This relative disappointment came after two outstanding years, with VC providing returns of 56% in 2020 (in USD) and 47% in 2021.

The Pitchbook database provides information on deal flows up to the end of June 2022. Interestingly, VC activity in value remained active in H1 at 290 USD bn to be compared with 332 USD bn in H1 2021, thus still close to twice the value prevailing in H1 2018 and H1 2019. It highlights that investors did keep investing in VC at a decent pace despite curbing in Q2-22

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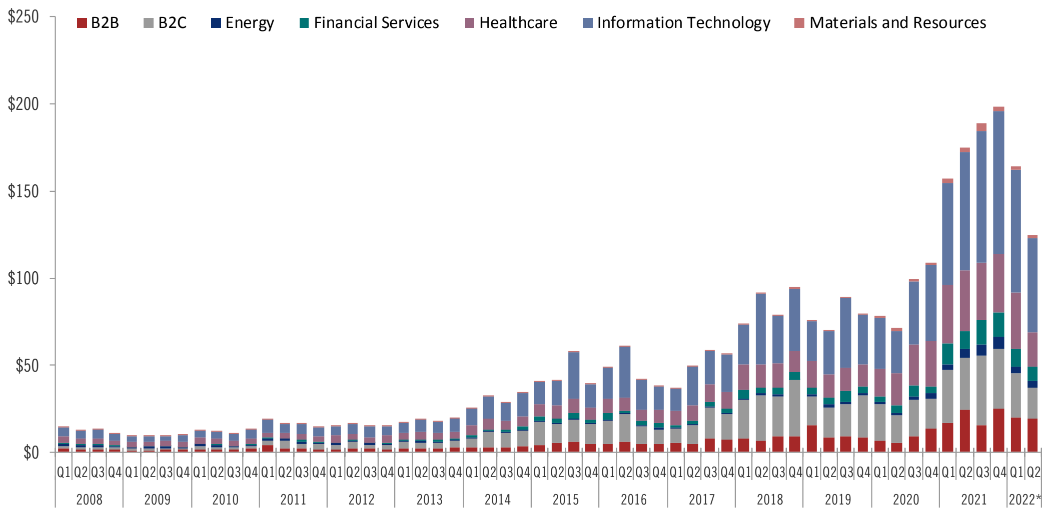
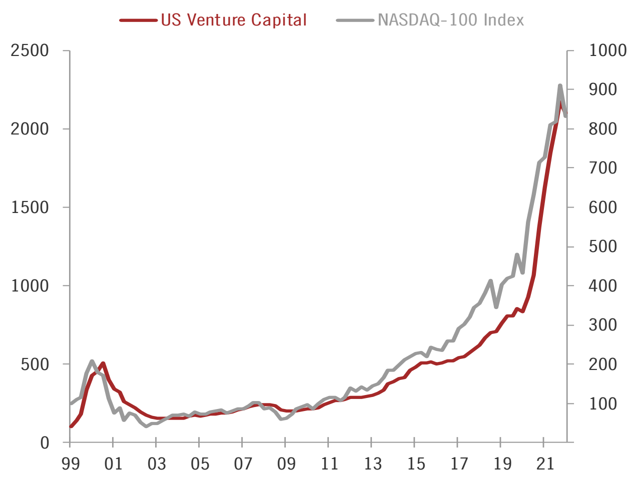
CHART 1: GLOBAL VC DEAL ACTIVITY (USD BN) BY SECTOR



Source: PWM-CIO Office & Macro Research, Pitchbook, 30.06.2022

VC's main interest is its link to innovation. As we outline in *Horizon 2022*, the current innovation wave is fading, putting pressure on VC returns. The Nasdaq 100 (which, like VC, is heavily tilted towards innovation), declined almost 30% in H1 22 when yield started to increase, suggesting further downside for VC when Q2 numbers become available.

CHART 2: HIGH CORRELATION BETWEEN US VENTURE CAPITAL AND THE NASDAQ 100 INDEX



Source: PWM-CIO Office & Macro Research, FactSet, Burgiss, 30.06.2022

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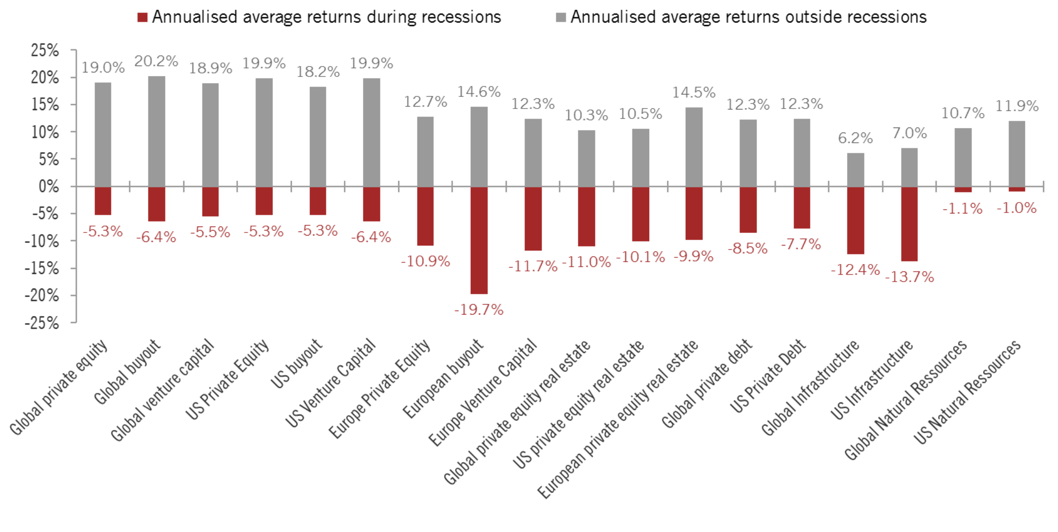
Private and listed assets alike are sensitive to the economic cycle

Just like listed assets, private assets tend to perform best during economic booms and perform poorly during economic busts. Indeed, all private assets we track over the long term have posted negative returns during recessions and positive returns outside recessions, although with some notable differences. In the case of global private equity, the annualised average quarterly return during recessions stands at -5.3% and a stellar 19% outside recessions.

CHART 3: ANNUALISED AVERAGE RETURNS FOR PRIVATE ASSETS DURING AND OUTSIDE RECESSIONS, 1980-2022



Source: PWM-CIO Office & Macro Research, Burgiss, 31.03.2022

How does private equity behave during public-equity drawdowns?

Analysing the quarterly performance of the S&P 500 against US and global buyouts suggests that private equities tend to post smaller drawdowns than blue-chip indices during times of market stress.

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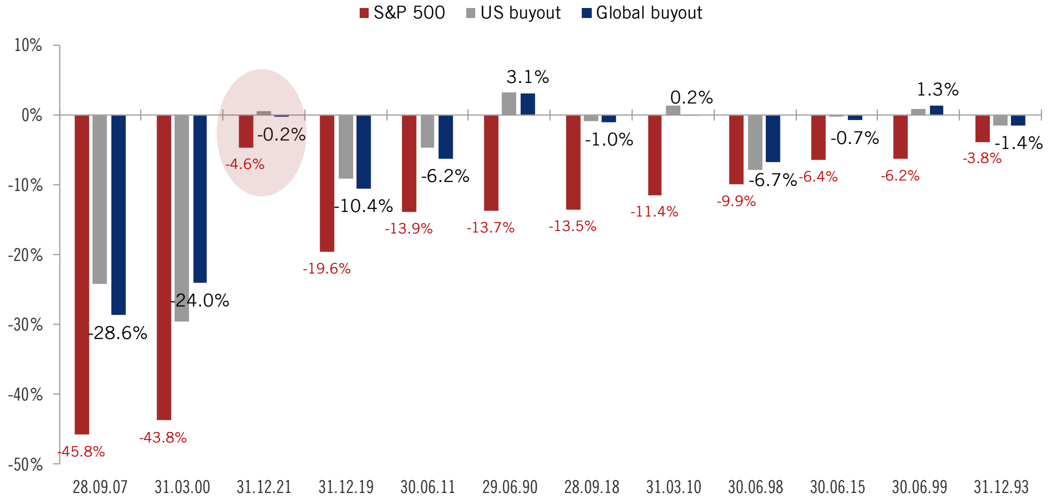
CHART 4: QUARTERLY DRAWDOWNS FOR THE S&P 500 VS. US AND GLOBAL BUYOUTS



Source: PWM-CIO Office & Macro Research, Pitchbook, 31.03.2022

Our analysis, based on beta and drawdown ratios during the dotcom bust of 2001 and the global financial crisis of 2008-2009, suggests that over the first six months of 2022, US buyouts may have returned between -10% and -14%, compared to -20% for the S&P 500. Global buyouts may have returned between -9.5% and -12% against -20.3% for the MSCI AC World over the same period. US and global venture capital may have fallen between -12% and -20% in H1 22 against -29% for the Nasdaq 100 index.

What is the link between yields and buyouts?

Buyouts, which account for over half of private-equity assets, use leverage to fund company takeovers. Financial leverage is the most important factor explaining private equity's superior returns over listed markets. The share of debt in financing buyouts has ranged between 44% and 60% over the past 20 years, with a median at 52%. In 2021, debt accounted for a historically quite low 44% of global private-equity financing, increasing to 50% this year (but still far from the peak reached in 2006).

Buyout debt tends to be fully priced at floating rates that are reset periodically. According to Pitchbook figures, the average yield paid on this debt has been relatively stable since 2010, at around 6%. There is a positive but low correlation between the rate paid on buyout debt and US high yield, but the yield on buyout debt tends to be more stable *(see chart 6)*. The recent increase in yields in the US could push the funding rate for US buyouts back to their long-term average of around 6.3%, slightly above the current 6% rate. Thus, while not as favourable as before, we are not convinced that rising market interest rates will fundamentally change the landscape for buyouts.

In large part, this is because debt maturity schedules show that debt expected to mature by end-2023 is mainly driven by 2016-2018 vintages (the year in which private-equity funds make their initial investments).

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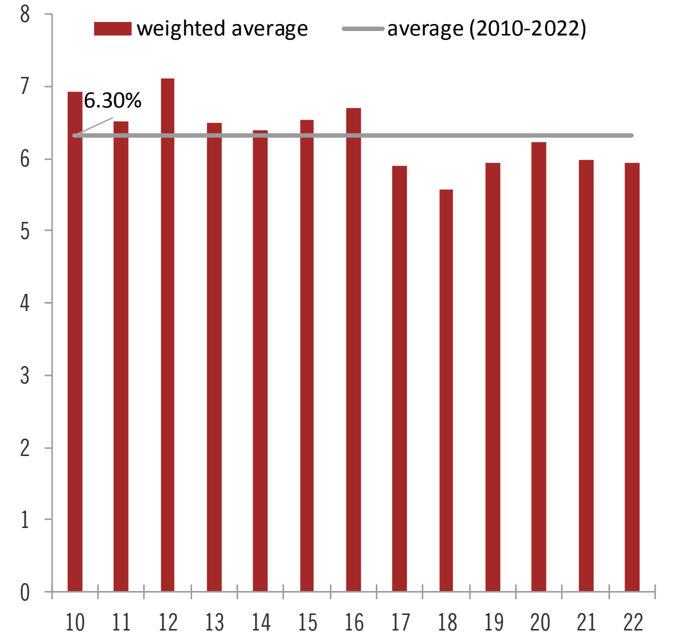
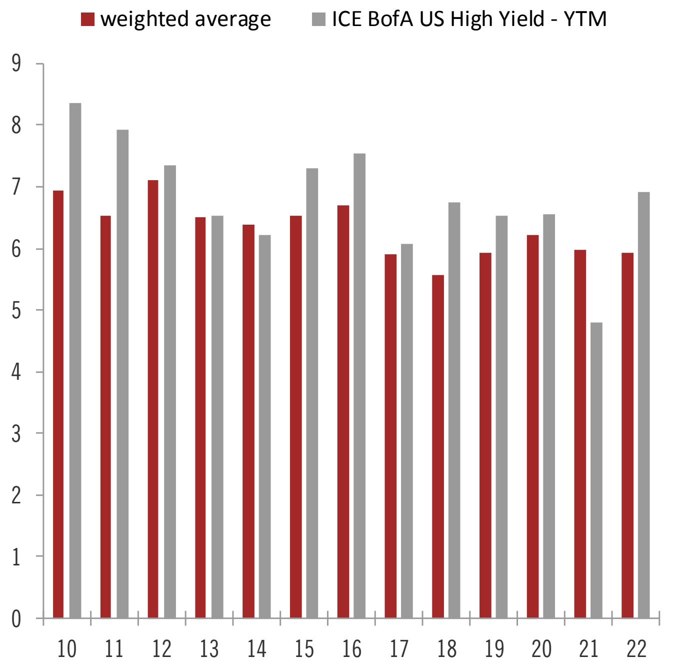
CHART 5A: BUYOUT FINANCING COST—WEIGHTED AVERAGE FLOATING RATES (US), 2010-2022



Source: PWM-CIO Office & Macro Research, Pitchbook, 30.06.2022

CHART 6: BUYOUT FINANCING COST—WEIGHTED AVERAGE FLOATING RATES VS. US HIGH YIELD YTM, 2010-2022



Source: PWM-CIO Office & Macro Research, Pitchbook, 30.06.2022

Valuations: listed and private markets compared

Since 2005, valuations for private equity have been higher than for listed equities. But whereas valuations for public equities skyrocketed during and after the pandemic, they have held broadly steady for private equity. At end- June 2022, the enterprise value (EV)/EBITDA (earnings before interest, taxes, depreciation & amortisation), a common valuation multiple, stood at 12.7x for global private equity. Assuming the valuation premium for private equity reverts back to its long-term median would lead to a multiple compression of around 5%. A tougher scenario where valuation should converge back to levels on listed markets should lead to a 12% derating. Overall, in the most realistic scenario and taking into account the slide in financial markets in the first half of this year, private-equity valuations could sink by 5-10%. The large increase in private-equity valuations in the US in Q2 means that market has to be watched especially closely (although the small number of new deals coming on streams limits concerns for the moment).

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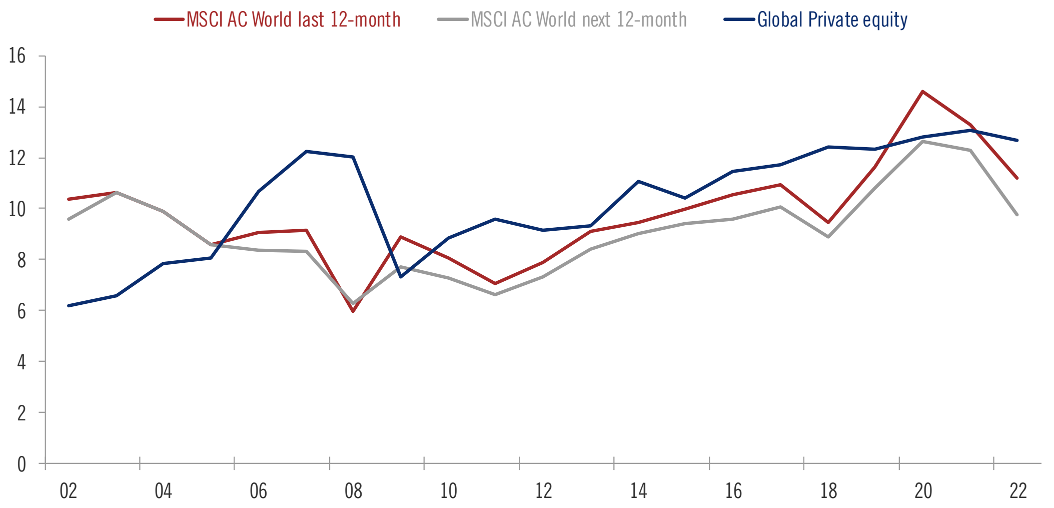
CHART 7: EV/EBITDA PUBLIC VS PRIVATE EQUITIES



Source: PWM - CIO&MR, Pitchbook, 30.06.2022

Conclusion

Buyouts by nature use debt to fund company takeovers. While the yield on long-term sovereign bonds has often been suppressed, the yield paid on buyout debt has always been fairly high. Therefore, while the recent increase in funding costs is not positive for buyouts' performance, it is not a game changer either.

After the sell-off in public equities, we expect Q2 returns for private equity (due to be released at the end of September) will be weak. VC may suffer the most, returning -12% to -15% according to our estimates, whereas buyouts could return -10%. These estimates are based on combining historical data from previous equity drawdowns with simulations of possible valuation deratings.

Investing in private equity requires a long-term investment horizon. The returns from private equity have been outstanding in the past, and while they are expected to decline somewhat, they should continue to outpace returns from public equities, particularly over the long term. In *Horizon 2022*, we calculate that private equity and venture capital will each offer an average annual return of 9.2% (in USD) over the next 10 years—down from the 15% annual return that could have been expected a decade ago, but still a nice 3% return premium over the MSCI AC World index.

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