THE PRIVATE EQUITY MARKET IN 2018

THE DIFFERENCES BETWEEN 2018 AND 2006-07
The current record level of “dry powder” that has been accumulated by private equity managers has been capturing headlines in the financial press and drawing worrying comparisons to 2006-07, when the industry deployed enormous amounts of capital at high asset valuations, underperforming historical returns. However, as a recent Harvard report confirms, private-equity backed firms outperformed their non-PE backed peers during that turbulent period, and a deeper look into what occurred then versus what is happening now reveals substantial differences that leave even less reason to be alarmed.

This growing chorus within the financial media typically points to the same two statistics when comparing today to the period preceding the Great Financial Crisis (GFC). The first of these is the unprecedented amount of private equity (PE) dry powder, which stood at $650 billion for buyouts, and at $1.1 trillion overall (including growth equity, venture capital, and other PE) as of Q2 2018. This represents a 7% increase from the end of 2017, in line with the annual growth seen in dry powder since 2012. The steep and steady increase in available capital has been driven by several record years of fundraising, which itself is a factor of new investors being drawn to PE in today’s low-yield, low-growth environment, as well as existing investors re-investing their distribution income. Indeed, PE distributions have remained at historically high levels since 2013, while cap calls have fallen steadily to their lowest level on record.

This excess of dry powder has translated into an increasingly crowded private equity marketplace. Competition for the best deals has intensified, with the potential risk that less disciplined General Partners (GPs) could be tempted into lowering investment standards in response to limited partner (LP) pressure to keep up their investment pace. Unlike public market investors, GPs can’t sit out for extended periods of time, as they aren’t “paid to time the market” and are expected to deploy capital throughout market cycles. The relatively easy availability of capital could also drive some GPs to raise ever-larger funds, above where their core competencies lie, potentially leading to style drift and dilution of returns.

The second oft-cited data point is the continued rise of private equity deal multiples, with the median private equity EBITDA multiple reaching a ten-year high of 10.7x in 2017. One driver of this trend has been the elevated multiples in the public markets themselves, which PE managers look to for comparable valuations when valuing their investments in line with U.S. GAAP. Another factor has been the record amount of fundraising referenced above — high competition for deals has been edging up the prices that GPs are willing to pay, particularly those bidding in competitive auctions to source deals. Perhaps equally responsible has been the continued availability of low-cost debt, which has driven up leverage levels within deals — approximately 52% of all U.S. leveraged buyouts (LBOs) were levered at 6.0x or higher in 2018. Access to cheap financing has also encouraged strategic investors to pursue acquisitions more aggressively, which has also driven up multiples and increased competition with private equity.
However, despite the private equity skeptics, if one digs below the surface, several key metrics distinguish today from the 2006-2007 boom. The first is that overall private equity investment activity, in terms of both deal number and deal value, has been running at significantly lower levels than we saw in 2006 and 2007. Private equity deal volume remains 42% lower in 2017 than at its peak in 2007, while discrete deal count has fallen by approximately 33% over the same time frame.8

Excluding add-ons, the value of PE deals has remained about steady since 2014, while the number of deals has been trending lower, albeit with a slight uptick in 2017.9 This indicates that volume has been supported by mega funds and their larger deal sizes, while the broader private equity industry has been exercising caution in a high-multiple environment and moderating its investment pace.

The second factor that distinguishes today from 2006-07 is that, even though leverage multiples have crept up, they remain below prior levels. In 2007 over 60% of all U.S. leveraged buyouts were levered at 6.0x or higher with an average 6.8x debt/EBITDA,10 significantly above the 6.0x level specified by Federal agencies in 2013 as meriting “special concern”.11 Moreover, the ratio of debt-to-equity in PE-backed deals is also far more conservative today than it was in the 2006-07 period. Back then, the average percentage of equity that managers were committing to their deals reached a low point of 32%-33%—meaning they had less skin in the game and were using almost 70% debt or leverage to finance their deals.12 This frothy period led many bankers at the time to parrot the ominous phrase “loan to own.” In the current environment, private equity firms are putting up, on average, 45%-50% of equity into their deals — so, again, very different from the 2006-07 period.
Because many GPs are cognizant of today’s market environment, they are often underwriting their deals assuming longer hold periods and some are even factoring in the possibility of lower exit multiples in their downside models. Moreover, living through the GFC has made prudent GPs even more cautious on their use of leverage and has renewed their focus on investing in companies where they can truly implement operational improvements and enhance value during their ownership, rather than focusing on multiple expansions to generate returns. This should serve GPs well in avoiding mistakes made in past recessions.

One key lesson learned is the importance of better understanding and stress testing the performance of cyclical businesses during due diligence, to comprehend the potential effects of an economic recession. Many GPs have decided to either avoid such investments or to use less leverage on companies susceptible to cyclical pressures. Another lesson learned is the avoidance of club deals—where several fund managers partner together to finance large private equity transactions, which accounted for over 50% of all buyouts above $1 billion in 2006.13 Club deals allowed firms to invest into larger companies without breaching concentration limits in their funds. However, GPs found that during the GFC, they were faced with the difficulties of joint control, which often impeded quick decision making, which is a hallmark of strong PE governance, and led to board meeting paralysis. The sheer size of these deals led to a lack of viable exit options and several of these high-profile club deals—such as Caesars Entertainment and TXU Energy—led to bankruptcies where the initial equity was wiped out. While club deals are still done today (albeit typically rebranded as “consortiums”), they have lessened in popularity and represented only -$50 billion of aggregate deal value in 2016 versus $300 billion+ in 2007.14 Instead, GPs are more likely to partner with their institutional LPs, who are often eager to co-invest in such deals, or with corporations that can provide a specific strategic edge. Today, when GPs do team up with each other, they typically take a more cautious approach by partnering with only one other financial sponsor and in situations where they both bring relevant expertise to the table.

Despite some of the challenging situations detailed above, private equity (as opposed to strategic or public) ownership during the financial crisis was generally a positive experience for many companies. During that period, as shown by a recent Harvard study15, PE-backed companies were less likely to face financial constraints, 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.

Moving from the 2006-07 environment to today, although there are several distinctions, it is important to note that today’s buoyant private equity environment will not be without consequences for future PE returns. Record levels of uninvested PE capital may dampen return expectations, due to increased competition for a finite amount of deals encouraging higher acquisition prices. Elevated deal multiples also require PE sponsors to commit more overall equity (as deals levered above 6.0x tend to attract increased regulatory attention), which will likely decrease a deal’s internal rate of return (“IRR”) due to the higher percentage of equity employed—which we view as generally a good thing. Many GPs are acknowledging these trends and are re-setting the performance expectations of their LPs. Whereas previously a GP might underwrite a typical buyout fund to a 20%+ net IRR, many GPs are now advising a mid-to-high teens net return as a more re-
alistic target. This is in line with the 17.3% pooled net IRR that U.S. buyout funds posted for the 12 months ending June 2017.\textsuperscript{16}

While this represents lower returns—on an absolute basis—than what the industry generated in prior decades, \textit{iCapital} believes that PE will significantly outperform public equities on a relative basis over the next decade. If you look to today’s long-term capital market assumptions (“LT CMAs”)—here we reference J. P. Morgan’s—which are used to project return assumptions to help determine optimal asset allocations for portfolios, 2018 projections are as follows:\textsuperscript{17}

- 5.75% return on U.S. small-cap equities
- 5.50% return on U.S. large-cap equities
- 5.25% return for a U.S. dollar-based traditional 60/40 portfolio

\textbf{J.P. MORGAN LONG-TERM CAPITAL MARKET ASSUMPTIONS}

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\item 5.50% return on U.S. large-cap equities
\item 5.25% return for a U.S. dollar-based traditional 60/40 portfolio
\end{itemize}

Particularly if there is a market correction, which we believe is inevitable within the next PE fund lifecycle of ten years, it isn’t difficult to imagine public equity returns trending even lower than 5%. Moreover, other LT CMAs have even more extreme return projections—GMO’s latest 7-year asset class forecast anticipates a recession and consequently negative returns for the public markets: a negative -4.7% return for U.S. large caps, a negative -3% return for U.S. small caps and a negative -1% return for U.S. bonds.\textsuperscript{18}

When compared to the above public market assumptions, private equity remains highly attractive on a relative basis. Many existing institutional investors also stand by this view of PE’s continued relative outperformance. A December 2017 survey by Preqin found that 92% of institutional investors (pension funds, endowments, foundations, insurance companies) plan to devote the same amount of capital or more to private equity in the coming 12 months, with 96% saying that they plan to maintain or increase their PE allocations over the longer term.\textsuperscript{19}

\textbf{LARGEST 185,000 COMPANIES IN THE US}

<table>
<thead>
<tr>
<th>Category</th>
<th>2018 LTCMA</th>
<th>2017 LTCMA</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. small cap</td>
<td>5.75</td>
<td>7.00</td>
</tr>
<tr>
<td>U.S. large cap</td>
<td>5.50</td>
<td>6.25</td>
</tr>
<tr>
<td>U.S. high yield bonds</td>
<td>5.25</td>
<td>5.75</td>
</tr>
<tr>
<td>U.S. investment grade corporate</td>
<td>3.50</td>
<td>3.25</td>
</tr>
<tr>
<td>U.S. intermediate Treasuries</td>
<td>3.00</td>
<td>2.25</td>
</tr>
<tr>
<td>U.S. cash</td>
<td>2.00</td>
<td>2.00</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management, estimates as of September 30, 2016, and September 30, 2017. Project return assumptions are for illustrative purposes only.
This confidence in the asset class is both logical and supported by historical data. If we look to historical returns, over the past 10 years, private equity has generated 230 basis points of outperformance against the S&P 500 and 370 basis points over the past 15 years.\textsuperscript{20} And that’s the average private equity return. One driver of these returns has been the sheer size of the private company universe, which is massive compared to the continuously shrinking pool of public companies:\textsuperscript{21} over the past 20 years, the number of publicly listed U.S. companies has nearly halved, from 7,322 in 1996 to around 4,000 today.\textsuperscript{22} By contrast, there are almost 200,000 middle market companies in the U.S., of which, about 98% are private.

Other key drivers of outperformance include the fact that skilled private equity managers benefit from an asymmetric information advantage compared to public market investors and they’re able to focus on executing long-term value creation plans (as opposed to being constrained by pressures to meet short-term earnings targets). On a final note, it is prudent to remember that even though today isn’t a repeat of 2006-2007, the U.S. remains nine years into the longest bull market on record—having surpassed the prior record of 3,452 days on August 22nd, 2018.

As we always remind investors, the spread between the top quartile managers and bottom quartile in private equity is huge compared to other asset classes, hence manager selection is essential—you cannot “buy the private equity market” and invest broadly across managers without conducting extensive due diligence.

The managers who outperform are typically those who remain steadfast in the face of today’s PE market challenges and execute their chosen investment strategy with the necessary discipline. These are also often the GPs who have embedded lessons learned from the financial crisis into their PE best practices and have a sharp focus on risk management. iCapital expects that prudent, top-tier private equity managers will continue

### BULL RUNS ON WALL STREET

**DURATION AND CHANGE OF S&P 500 DURING BULL RUNS SINCE 1957**

<table>
<thead>
<tr>
<th>START</th>
<th>END</th>
<th>DAYS</th>
<th>CHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 9, 2009</td>
<td>Current</td>
<td>3,452</td>
<td>+323%</td>
</tr>
<tr>
<td>October 9, 2002</td>
<td>October 9, 2007</td>
<td>1,826</td>
<td>+101%</td>
</tr>
<tr>
<td>October 11, 1990</td>
<td>March 24, 2000</td>
<td>3,452</td>
<td>+417%</td>
</tr>
<tr>
<td>December 4, 1987</td>
<td>July 16, 1990</td>
<td>955</td>
<td>+65%</td>
</tr>
<tr>
<td>August 12, 1982</td>
<td>August 25, 1987</td>
<td>1,839</td>
<td>+229%</td>
</tr>
<tr>
<td>October 3, 1974</td>
<td>November 28, 1980</td>
<td>2,248</td>
<td>+126%</td>
</tr>
<tr>
<td>May 26, 1970</td>
<td>January 11, 1973</td>
<td>961</td>
<td>+74%</td>
</tr>
<tr>
<td>October 7, 1966</td>
<td>November 29, 1968</td>
<td>784</td>
<td>+48%</td>
</tr>
<tr>
<td>June 27, 1962</td>
<td>February 9, 1966</td>
<td>1,323</td>
<td>+80%</td>
</tr>
<tr>
<td>October 22, 1957</td>
<td>December 12, 1961</td>
<td>1,512</td>
<td>+86%</td>
</tr>
</tbody>
</table>

Chart: as of August 22nd, 2018. Data Source: Yahoo Finance and S&P Dow Jones Indices; Chart Source: Harry Stevens/Axios
to generate a significant premium over public market returns, irrespective of the phase of the economic cycle. This should encourage investors to continue allocating to private markets, with manager selection remaining the critical driver of returns when choosing a fund.

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Co-founder and Managing Partner

Tatiana Esipovich
Director, Due Diligence

END NOTES
1 Private Equity and Financial Fragility During the Crisis, Stanford Graduate School of Business. Shai Bernstein, Josh Lerner and Filippo Mezzanotti, January 2018.
2 Other PE includes balanced, co-investment, co-investment multi-manager, direct secondaries and turnaround funds.
3 Source: Preqin Quarterly Update: PE and VC, Q2 2018.
4 When measured as a proportion of committed capital. Source: Private equity capital calls shrink to lowest level on record, August 2018. EFront, Private Equity Wire U.K.
5 Earnings before interest, taxes, depreciation and amortization.
8 By total deal volume (including add-on deals). Source: Bain Private Equity Report 2018.
10 Source: Reuters, LPC: Private equity firms put more capital, less debt into LBOs, August 2016.
11 Source: LCD, S&P Global Market Intelligence.
12 Source: S&P Capital IQ and Pitchbook 3Q 2017 U.S.
13 Source: Pitchbook; represents deal by count.
15 Private Equity and Financial Fragility During the Crisis, Stanford Graduate School of Business. Shai Bernstein, Josh Lerner and Filippo Mezzanotti, January 2018.
18 Source: GMO, as of December 31, 2017.
20 Source: Cambridge Associates, LLC. US Private Equity Index Summary, as of September 30, 2017. Past performance does not guarantee future results. Performance data is for illustrative purposes only.
21 Please reference the iCapital paper on The Importance of the Private Markets, March 2018, for a deeper dive on this topic.
23 Source: The National Center for the Middle Market: Q4 2017 Middle Market Indicator.
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