



Market Commentary
June 28th, 2024

English Version

Insigneo Weekly Dispatch

Private Equity: Forces at Play

Exploring the changing dynamics in private equity markets

Guidance on investments and the major structural factors behind your clients' portfolios.

insigneo

**By Alejandro Lara**

Product Manager – Private Assets
Insigneo

Private Equity: Forces at Play

Private Equity is a resilient industry. This is how Hugh MacArthur, Chairman of Bain & Co's private equity practice, described the industry when he alluded to its performance over the past two years, after taking into account the meaningful impact of rising interest rates. In 2023, aggregate returns for this industry registered in the low double digits, undoing the negative markdowns seen the previous year. At the same time, many of the biggest funds in the history of the asset class closed in 2023, some raising over \$26 billion. The industry's size and relevance has led many key financiers to express renewed concerns about its possible adverse effects on public markets, as it allows large companies to remain private for longer, if not permanently.

However, under the surface, the private equity industry has been shaken by a powerful storm. As the Fed began its tightening cycle in 2022, deal activity relented significantly. In 2023, as well as the first quarter of 2024, fund exits were down substantially, relative to the highs of 2021. This led to a cash distribution shortage, which impacted Limited Partners and their plans to commit more capital to the space. At the same time, this dynamic pushed investors towards other avenues in search of liquidity, such as asset sales at undesirable discounts in the secondary market. The slowdown in deal activity continues as we approach the third quarter of 2024 and third year of high interest rates. However, there may be signs on the horizon that the deal floodgates could open sooner rather than

later, and that some of the industry's tensions could ease.

In parallel to the distribution shortage, the prospect of high future return generation, arguably the most appealing characteristic of private equity, also finds itself in question. The currently elevated risk-free rate is casting doubt on the financial impact this could have on current private equity-owned companies. This dynamic is being exacerbated by the currently limited supply of leverage available for new transactions. Making matters worse, the industry has for years been in the spotlight of critics and academics alike, who have alerted to the possibility of decaying returns, the use of financial engineering to the detriment of portfolio companies, and the alpha erosion caused by the colossal compensation numbers set aside for General Partners, or "GP's". So far though, detractors have not been able to thwart the strong growth of the private equity industry, or the large amount of capital committed by investors.

Back to basics

Buyout PE funds have historically relied on a model that consists of purchasing companies of all sizes and industries with a combination of equity and debt, the latter also referred to as leverage. Debt is a relatively cheaper source of capital, allowing the free cash flow distributable to shareholders to be larger than the flows available if a company were to be purchased strictly with equity. Once a fund is in control of the target company, it will typically carry out a series of plans to aggressively grow revenues and improve financial margins, with the principal

objective of expanding its free cash flow or EBITDA (Earnings Before Interest, Depreciation and Amortization) and selling it within a time frame that will maximize the returns of the transaction. Average holding periods typically range between four and seven years, although some PE funds can sometimes sell specific companies before year four or hold them for much longer periods.

As previously mentioned, leverage is an important part of the private equity business model, and there is widespread consensus that it can be an important driver of returns. Pitchbook, an aggregator of PE data, published a study that indicated that leverage contributed over 30% of the value created in some vintages between 2010 & 2016. As a refresher, the "vintage" is the year in which a private equity fund starts investing or when a specific portfolio company is purchased. Understandably, due to the relatively high use of debt in the PE model, some investors question whether the industry can continue to outperform public markets given the current environment of high interest rates.

What is in store for the future of Private Equity?

Those seeking positive news regarding the prospects of outperformance of the industry, within the context of a prolonged environment of expensive capital, can find solace in a [report from Goldman Sachs](#). In this, the company concluded that, based on academic studies, the following points ring true:

1) Private equity is poised to continue generating value and having an advantage relative to public

markets at carrying out “large-scale company transformation”.

2) Although the drivers of return vary over time, the most important historical contributor to returns is revenue growth, not leverage.

3) The impact of leverage on overall performance has decreased over time. Surprisingly, between 2008 and 2021, leverage had a lower impact on returns than from the period of 2000-2007.

4) Private equity funds have an array of tools at their disposal to generate value. More importantly, not all these tools are implemented at the same time. Given the current dynamics at play, funds have the flexibility to implement different tool kits for different scenarios.

Goldman Sachs’ report coincides with a 2024 study by Hamilton Lane, which showed that there is no clear correlation between deal returns, measured by gross Investment Rates of Return, and leverage, measured by Debt to EBITDA. Deals that employed a leverage ratio of 3x EBITDA were able to generate equivalent returns to those with leverage ratios north of 5x. The study also showed that the median Debt to Enterprise Value ratio has declined over the last 15 years, while the median Debt to EBITDA ratio has oscillated between 4x and 5.5x. What this means is that although private companies have become more expensive, this incremental value has not been financed by additional debt, but rather, other sources of capital.

However, Hamilton Lane’s study does indicate that environments of high interest rates do impact both

public and private equity returns, where private equity funds that are seven or more years into their lives are affected the most. This makes sense, as older funds tend to be fully invested and most likely have deployed a substantial portion of their portfolios during low interest rate environments. Vintage year clearly matters. Deals that closed before 2021 had better access to lower-priced debt and were subject to valuation corrections, whereas deals closed after the second quarter of 2022 were consummated at the current cost-of-capital, and associated pricing consistent with such levels.

Higher debt costs lead to less activity

The impact of the increase in the cost of capital has been twofold: interest expense has increased, while less debt is available to finance buyout deals, resulting in a lower capital stock available within the private equity ecosystem. These two forces, in unison, are the main culprits of an impacted deal flow. Understandably, valuations on the buy-side have been adjusted downwards, as the Weighted Average Cost of Capital, or WACC, has increased while there is less debt-derived capital available for new acquisitions. On the sell-side; however, PE funds have held up firmly to their target valuations, unwilling to sell mature portfolio companies at undesirable discounts. This dynamic has led to average holding periods that are hitting historic peaks. As much as the private equity industry may affirm that valuations are precise, there is a degree of dissonance between what Bain Consulting calls the “Bid-Ask Spread” and current valuations. This is particularly true after a year like 2023, in which aggregate fund marks resulted in positive returns

close to 10%. This argues in favor of the idea that private equity funds are protective of valuations regardless of market conditions.

However, there are forces at play in the industry that could cause this situation to abate sooner rather than later. For starters, cash needs to be returned to investors, so that these may consider new commitments into the same capital-hungry partnerships. At the same time General Partners need to deploy the vast supply of callable capital, or “dry powder”, before investment periods expire, which typically have a life span of five years. Additionally, the debt facility landscape appears to be changing. Even though the risk-free rate has stubbornly remained above 5%, the reappearance of banks as M&A lenders, after two years of almost complete absence, coupled with intense competition within the direct lending sector, has compressed spreads in the core and upper middle market between 100 bps and 150 bps, or 1 to 1.50%. This dynamic has allowed less cash to be directed towards debt servicing, creating tailwinds for equity valuations and deal generation.

It is important that investors looking to commit to the private equity space keep in mind that not all private equity is created equal. As a result, funds that focus on smaller companies, such as those that operate in the lower middle market segments of the industry, are not as reliant on debt and therefore not impacted as much by high interest

rates. Additionally, potential sellers in these segments are not as sensitive to valuations. Growth equity transactions, where minority stakes of cash flow-positive businesses are acquired in exchange for some degree of control, are typically not as reliant on debt, and have proven capable of generating top quartile returns. Also, the opportunity to participate in private equity secondaries remains attractive, as large institutional investors continue selling tranches of their private equity portfolios at deep discounts. This allows investors the opportunity to buy into mature private equity interests at attractive valuations.

Considering the changing currents present in the private equity industry, proper manager selection matters now more than ever. If constrained access to capital is a concern, investors could focus on sectors or segments that have been able to deliver Alpha without depending on leverage. After all, it turns out that the impact of leverage on returns might not be as determinant as expected.



Click or scan this code to access more insights at insigneo.com/insights

Important Legal Disclaimer

Insigneo Financial Group, LLC comprises a number of operating businesses engaged in the offering of brokerage and advisory products and services in various jurisdictions, principally in Latin America. Brokerage products and services are offered through Insigneo International Financial Services, LLC, headquartered in Puerto Rico, and through Insigneo Securities, LLC, headquartered in Miami. Both are members of the Financial Industry Regulatory Authority (FINRA) and Securities Investors Protection Corporation (SIPC) <https://www.sipc.org/>. Investment advisory products and services are offered through Insigneo Advisory Services, LLC, an investment adviser registered with the Securities and Exchange Commission. In Uruguay, advisory services are offered through Insigneo International Asesores de Inversion Uruguay, SA, Insigneo Asesores de Inversion Latam, SRL, and Insigneo Asesores de Inversion de Uruguay, SRL, in Argentina through Insigneo Argentina, SAU, and in Chile through Insigneo Asesorías Financieras, SPA. Collectively, these eight operating businesses make up the Insigneo Financial Group. To learn more about the Broker Dealers including their conflicts of interest and compensation practices, please go to <https://insigneo.com/disclosures/> or via www.finra.org. To learn about Insigneo Advisory Services, LLC and any conflicts related to its advisory services, please see its Form ADV and brochure which can be found at Investment Advisor Public Disclosure website <https://adviserinfo.sec.gov/>.

FOR AFFILIATES LOCATED IN CHILE

Insigneo Asesorías Financieras SPA se encuentra inscrito en Chile, en el Registro de Prestadores de Servicios Financieros de la Comisión para el Mercado Financiero. Este informe fue efectuado por área de Research & Strategy de Insigneo Securities LLC, o sus proveedores, en base a la información disponible a la fecha de emisión de este. Para evitar cualquier conflicto de interés, Insigneo Securities LLC dispone que ningún integrante del equipo de Research & Strategy tenga su remuneración asociada directa o indirectamente con una recomendación o reporte específico o con el resultado de una cartera.

Aunque los antecedentes sobre los cuales ha sido elaborado este informe fueron obtenidos de fuentes consideradas confiables, no podemos garantizar la completa exactitud e integridad de estos, no asumiendo responsabilidad alguna al respecto Insigneo Securities LLC, Insigneo Asesorías Financieras SPA ni ninguna de sus empresas relacionadas.

Este material está destinado únicamente a facilitar el debate general y no pretende ser fuente de ninguna recomendación específica para una persona concreta. Por favor, consulte con su ejecutivo de cuentas o con su asesor financiero si alguna de las recomendaciones específicas que se hacen en este documento es adecuada para usted. Este documento no constituye una oferta o solicitud de compra o venta de ningún valor en ninguna jurisdicción en la que dicha oferta o solicitud no esté autorizada o a ninguna persona a la que sea ilegal hacer dicha oferta o solicitud. Las inversiones en cuentas de corretaje y de asesoramiento de inversiones están sujetas al riesgo de mercado, incluida la pérdida de capital.

La información base del presente informe puede sufrir cambios, no teniendo Insigneo Securities LLC ni Insigneo Asesorías Financieras SPA la obligación de actualizar el presente informe ni de comunicar a sus destinatarios sobre la ocurrencia de tales cambios. Cualquier opinión, expresión, estimación y/o recomendación contenida en este informe constituyen el juicio o visión de área de Research & Strategy de Insigneo Securities LLC, o sus proveedores, a la fecha de su publicación y pueden ser modificadas sin previo aviso.

FOR AFFILIATES LOCATED IN URUGUAY

En Uruguay, los valores están siendo ofrecidos en forma privada de acuerdo al artículo 2 de la ley 18.627 y sus modificaciones. Los valores no han sido ni serán registrados ante el Banco Central del Uruguay para oferta pública.

FOR AFFILIATES LOCATED IN ARGENTINA

Insigneo Argentina S.A.U. Agente Asesor Global de Inversión se encuentra registrado bajo el N° 1053 de la Comisión Nacional de Valores (CNV) e inscripto ante la Inspección General de Justicia (IGJ) bajo el N° 12.278 del Libro 90, Tomo -, de Sociedades por Acciones. Este informe fue efectuado por área de Research & Strategy de Insigneo Securities LLC, o sus proveedores, en base a la información disponible a la fecha de su emisión. Para evitar cualquier conflicto de interés, Insigneo Securities LLC dispone que ningún integrante del equipo de Research & Strategy tenga su remuneración asociada directa o indirectamente con una recomendación o reporte específico o con el resultado de una cartera. Aunque los antecedentes sobre los cuales ha sido elaborado este informe fueron obtenidos de fuentes consideradas confiables, no podemos garantizar la completa exactitud e integridad de estos, no asumiendo responsabilidad alguna al respecto Insigneo Securities LLC, Insigneo Argentina S.A.U. ni ninguna de sus empresas relacionadas. La información base del presente informe puede sufrir cambios, no teniendo Insigneo Argentina S.A.U. la obligación de actualizar el presente informe ni de comunicar a sus destinatarios sobre la ocurrencia de tales cambios.

Este material está destinado únicamente a facilitar el debate general y no pretende ser fuente de ninguna recomendación específica para una persona concreta. Por favor, consulte con su ejecutivo de cuentas o con su asesor financiero si alguna de las recomendaciones específicas que se hacen en este documento es adecuada para usted. Este documento no constituye una oferta, recomendación o solicitud de compra o venta de ningún valor negociable en ninguna jurisdicción en la que dicha oferta o solicitud no esté autorizada o a ninguna persona a la que sea ilegal hacer dicha oferta o solicitud. Las inversiones en valores negociables están sujetas al riesgo de mercado, incluida la pérdida parcial o total del capital invertido. Cualquier opinión, expresión, estimación y/o recomendación contenida en este informe constituyen el juicio o visión de área de Research & Strategy de Insigneo Securities LLC, o sus proveedores, a la fecha de su publicación y pueden ser modificadas sin previo aviso.