PAVILION

2008'S LONG SHADOW

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Across various global fronts, 2008 was a momentous year. Barrack Obama was elected as the first black President of the United States, Mumbai suffered a horrible terrorist attack, Russia invaded Georgia, the SpaceX Falcon 1 rocket became the first private vehicle to reach orbit, and the terms bitcoin and photobomb entered the English language. Although these events (as well as others) were prominent, the Global Financial Crisis (GFC) is regarded as the most significant event of 2008 due to its extensive effect on world financial markets and economies. Many attribute the unofficial start of the GFC to be the abrupt bankruptcy of Lehman Brothers on September 15, 2008, the largest bankruptcy in history. At this 10th anniversary of the initiation of the GFC it is worth reflecting on the divergent impact the GFC has had on the worlds of public and private equity investments.

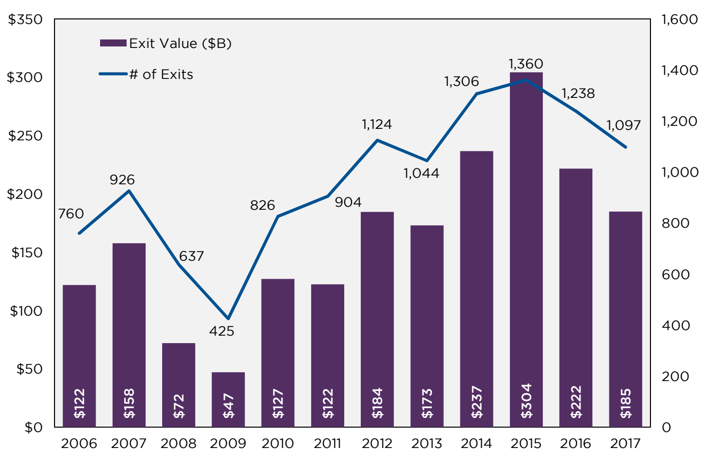
The memories of the GFC may still be painful for public market participants, however, 2008 has little relevance to their current performance metrics. The year may still factor into a 10-year look back but does not impact shorter performance horizons. In contrast, 2008 continues to have a very meaningful and lasting impact for private equity investors. That a year a decade in the past remains significant is due in part to the nature of the asset class as well as the investment vehicles generally used to access it. Most private equity investments are structured as fund vehicles in which most of the committed capital is called down during the investment period, typically the first three to five years of the fund's life. These vehicles usually have an eight to 10-year initial life with the possibility of annual extensions. The later years of a fund's life are characterized by incremental investments in platform companies and, ultimately, the generation of liquidity events in the portfolio. The typical hold period of three to five years for individual platform companies in combination with a long fund life for the overarching investment vehicle exposes private market funds to the vagaries of market conditions over an extended period of time.

A good example of how protracted market exposure can affect private equity fund performance is the precipitous decline in U.S. private equity exits in 2008 and 2009 as shown in Figure 1. Due to the characteristics discussed above the decrease in exits could have impacted funds' vintages dating as far back as 1998.

However, it is likely that the most affected vintages would have been those from 2002 to 2005. Those funds would have largely completed their primary investment programs and would have been entering the harvesting phase in which they actively generate liquidity for limited partners. Of note in Figure 1 is that the total value of private equity exits did not surpass the 2007 level until 2012, a period of five years. Consequently, even 2006 and 2007 vintage funds would have felt some reverberations from the poor exit market conditions with the degree of impact likely determined by their initial capital deployment schedule.

A market condition which directly influenced 2006 and 2007 vintage funds was the significant decline in U.S. private equity deal flow experienced in 2008 and 2009

Figure 1: US PE Exit Flow



Source: Pitchbook

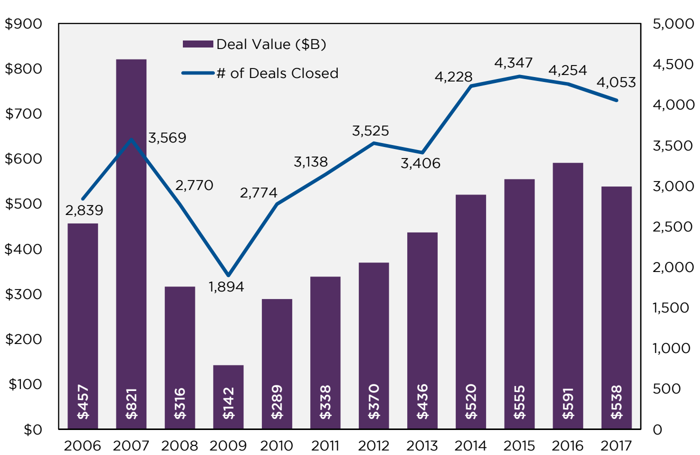
as presented in Figure 2. It is likely that several factors contributed to the pronounced deterioration of deal flow. Due to the severity of the GFC, uncertainty across the world increased markedly. This led many public and private equity investors to reassess their views on risk and its mitigation, often resulting in decreased investment pacing. Secondly, private equity valuations tend to lag public equity valuations by quarters, if not years in some cases. Thus, sellers of private equity companies may not have fully rationalized the decrease in the value of their companies at the same time that private equity buyers were experiencing a significant increase in risk aversion. This, in turn, would lead to a spread between the selling and offer price that could be large enough to be insurmountable in many cases. In those circumstances, only the more motivated sellers would have accepted the depressed valuations. A final reason for the decline in deal flow was that many limited partners had communicated to their private equity fund managers that due to the meaningful decrease in their liquid portfolios they did not have capital available to fund illiquid investments. As evidence of this, there were some prominent distressed liquidations[1] of private equity portfolios during this period. Due to these issues, as well being aware of the importance of maintaining good relationships with limited partners, many fund managers significantly curtailed their capital deployment over this period.

The considerable drop in private equity investment activity would have had a corresponding negative impact on the IRRs of 2006 and 2007 vintage funds as they were calling fees but not deploying investment capital at the expected rate. Many funds of these vintages asked for and received extensions of their investment periods to compensate for the lower deal flow they were experiencing. The extensions allowed the funds to eventually become fully invested, thereby lowering their fee drag. Although U.S. private equity deal flow has recovered, it still has not attained the high-water mark set in 2007.

As shown in Figure 3, the decrease in deal flow was accompanied by a notable drop in valuation, providing support for the observation made above that lower quality deals predominated during this period. Also of note is that valuations did not achieve their pre-GFC levels until 2014. Funds with vintages from 2009 to 2012 would have had an extended period of time to deploy considerable capital during a period of relatively attractive valuations. Thus, funds in those vintages could have generated an attractive return profile by buying during the depressed valuation period and selling when the market heated up. This phenomenon has been referred to as "multiple arbitrage." However, true arbitrage requires creating a profitable, but riskless position. In fact, uncertainty was still relatively high from 2009 to 2012 and it was far from certain that private equity valuations were destined to recover as strongly or as quickly as they did. Therefore, private markets investments made during this period did not fulfill the "riskless" arbitrage criteria and were still inherently risky.

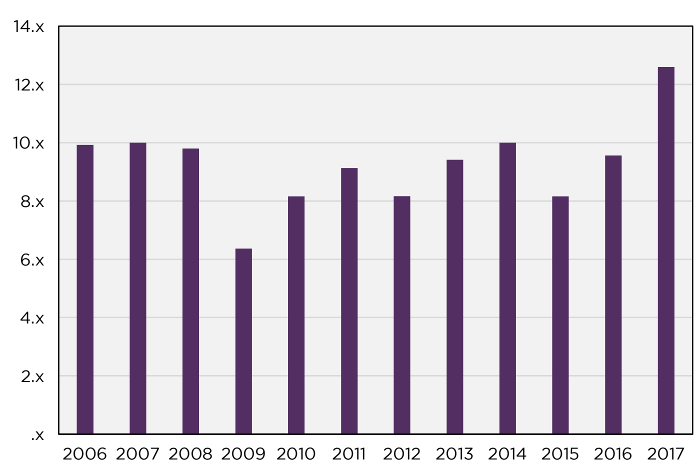
A final impact of the GFC worth examining is the significant decline in the amount of capital raised by private equity funds post-GFC. As shown in Figure 4, U.S. private equity fund raising did not recover to the 2008 level until 2013. Many market observers note that the increased fund raising in 2013 and beyond is directly correlated with the

Figure 2: US PE Deal Flow



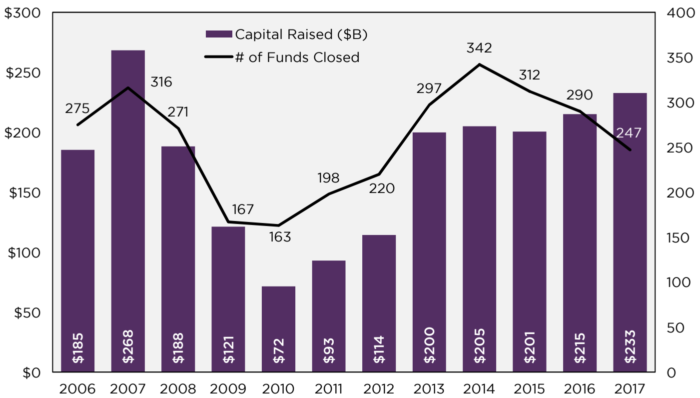
Source: Pitchbook

Figure 3: US PE Multiple



Source: Pitchbook

Figure 4: US PE Fundraising



Source: Pitchbook

rising valuation multiples discussed above. The performance numbers for funds post-2013 are still maturing so it is yet to be seen how much of an influence the higher prices will have on fund performance. Offsetting this is that many funds in those vintages have shortened their average portfolio company holding period and have been selling into a very strong exit market. This has resulted in record levels of distributions to limited partners over the last several years.

Obviously, the GFC was a major event across global financial markets and world economies. What may not be as obvious is that the GFC had significant effects across 10 vintage years of private equity funds in part due to inherent structural characteristics of the asset class. For the 2002 to 2005 vintages, the challenging exit markets limited those funds' ability to generate liquidity during the harvesting phase of the funds' lifecycles, likely depressing returns both in terms of IRR and multiple. The lower deal flow for the 2006 to 2010 vintages made it difficult to deploy capital during the investment period of those funds, potentially lowering their IRRs. Counterbalancing this for at least the 2009 to 2012 vintages was that the concurrent lower valuations allowed funds to invest capital at attractive multiples and take advantage of the subsequent valuation multiple appreciation, possibly increasing returns as measured by both IRR and multiple over "normal" market conditions.

In any market, big swings make it exceedingly difficult to discern investment skill from the impact of macro events. Due to the characteristics of private equity investments, determining the sources of the performance comes with greater uncertainty. Private equity managers typically raise funds every three to five years (four to six was more common until recently). Thus, most long-standing managers will have had two or three funds exposed to the various conditions described above. As discussed, the timing of their fund sequence can be an important determinant of their performance. However, private equity fund managers have difficulty in maintaining their deal flow and retaining investment professionals without a fund with an active investment period. As a result, they have limited control over when they raise a subsequent fund which makes it inherently difficult to "time" private equity markets.

As an investment decision maker in 2018, it is critical to appreciate the disparate private market investment environments that existed over the past decade as well as how those environments continue to impact private equity performance measurement. With that said, private equity has recently enjoyed historic levels of distributions and very attractive returns with much of the benefit accruing to limited partners. As a result, many limited partners have increased their allocations to private equity and are actively looking to deploy additional capital in the space. It is most certainly beneficial that the world's economies and markets have largely recovered from the GFC. However, it remains that this period of history will continue to have a consequential impact on how we assess performance for private equity fund managers.

1 - https://www.forbes.com/2009/10/06/stanford-endowment-private-business-finance.html#214049207633
https://venturebeat.com/2008/11/07/cash-panic-sweeping-vc-industry-the-capital-calls-problem/
https://en.wikipedia.org/wiki/Private_equity_secondary_market

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