

The Importance of Diversification

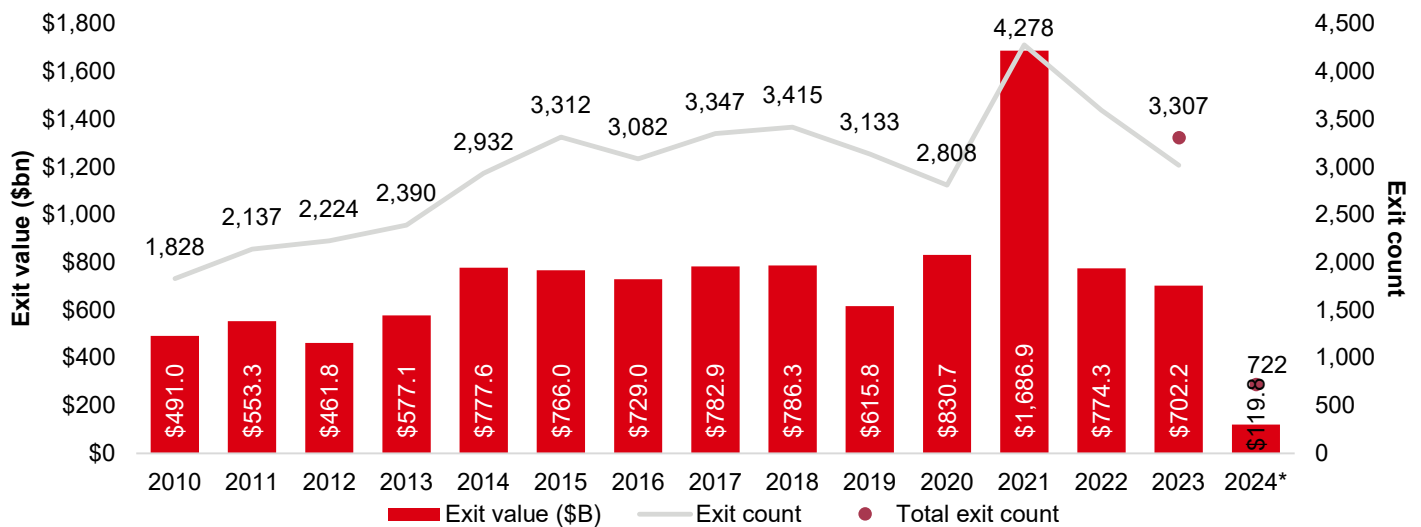
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Marketing Communication. For Professional Clients.

Private equity investors will be acutely aware of the slowdown in exit markets. This is impacting many parts of the private equity market, not least leading to a reduction in distributions back towards investors. In turn, capital calls are causing many investors to experience negative cash flows. While there are always ups and downs to the investment cycle, the current market is causing uncertainty among investors, which have been used in recent years to some relative visibility in their private market portfolio returns and commitments. If anything, the current market highlights the need for diversification across vintages, so investors can benefit from investments across the cycle, with funds exposed to differing phases of investment and divestment. What's more, investors should also look to achieve broad exposure across industries within their private market commitments, so no single part of their portfolio is overexposed to potential weakness or market stresses.

We have stated many times that 2021 was the recent peak of activity in global private equity markets. Yet, it is worth stating again. During 2021, private equity managers were incredibly active, calling capital from investors and quickly deploying it. In the space of a year, private equity deal volumes increased from \$1.1tn in 2020 (across around 13,000 deals) to \$2.2tn in 2021, according to Pitchbook data. Over the same period, private equity exit values ballooned, rising from \$830.7bn in 2020 to \$1.7tn in 2021, equal to an annual increase of almost 105%.

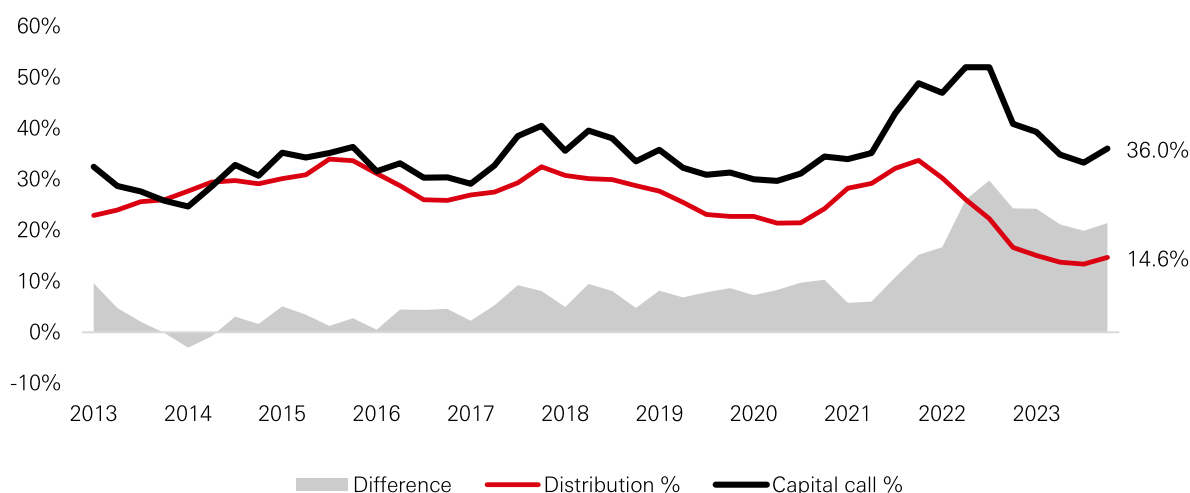
Global private equity exit activity



Source: Pitchbook, data as of April 2024

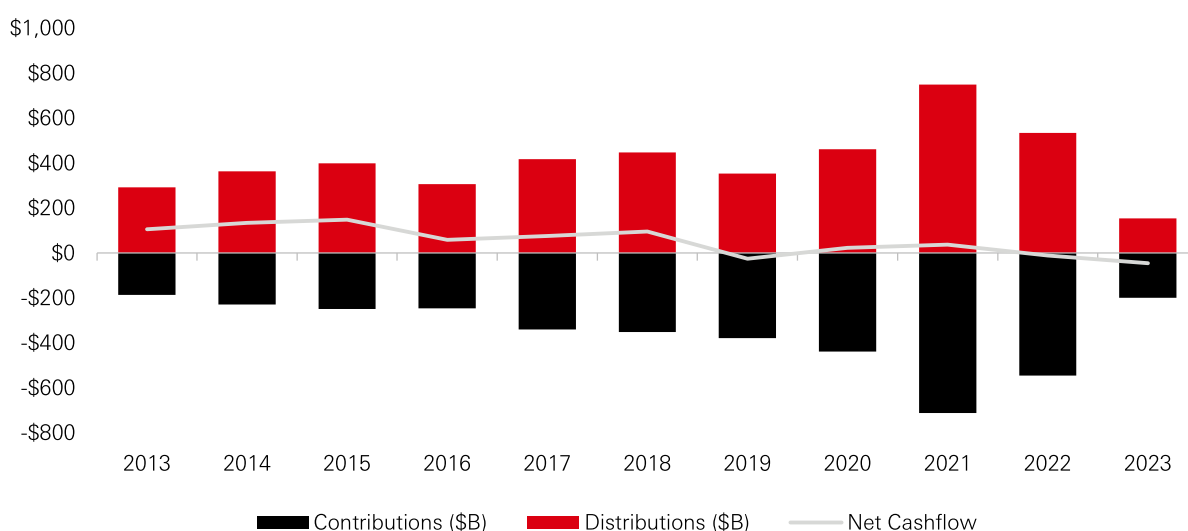
The huge increase in deal activity resulted in a surge in distributions back to investors during 2021. During this single year, distributions reached almost \$750bn – up from \$462bn in 2020. Expressed in a different way, twelve-month distributions as a proportion of NAV (the unrealised value of investments held by managers) for private equity funds reached 33.7% in 2021. In comparison, the historic average was just 24.4%. On the flipside, managers gave with one hand and took with the other, as capital calls also increased significantly – rising to a much higher level than was normal. During 2021, twelve-month capital calls as a percentage of dry powder (committed but undrawn capital) increased to 48.8%, a margin 14.1 percentage points higher than historic averages. As the market was buoyant at this point, net cash flows remained positive during 2021. However, with the market experiencing a much slower pace of activity since interest rates began to increase in 2022, cash flows have now turned negative.

Aggregated PE distribution vs. capital call rates



Source: Pitchbook, December 2023 data as of April 2024

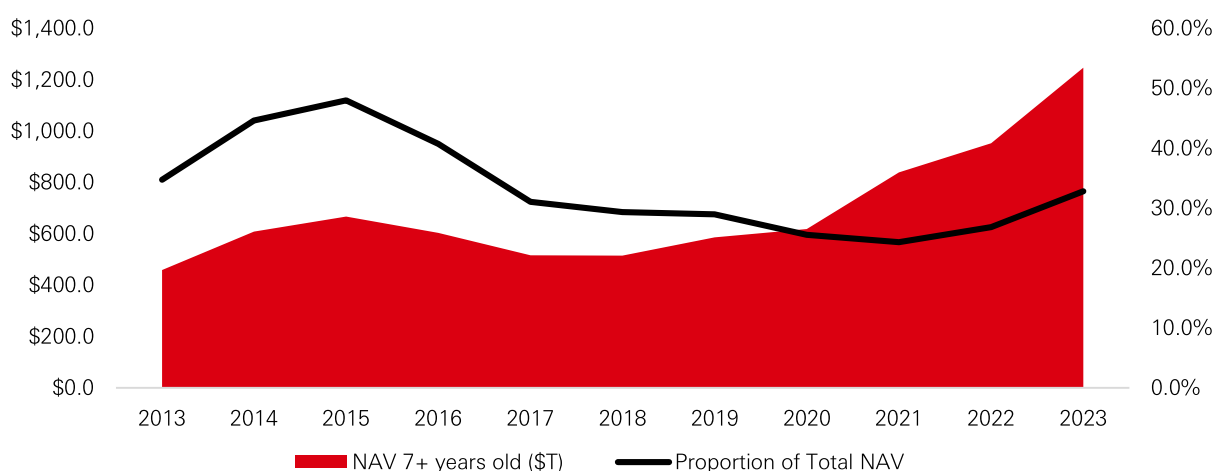
Private equity cash flows by year (\$bn)



Source: Pitchbook, data as of April 2024

One further impact of the current market malaise is that a large proportion of assets are being held by private equity managers for longer. To put this into context, the weaker exit environment means that around one-third of NAV (around \$1.2tn) is held within private equity funds for an extended period of time – in this case, more than seven years (as of Q2 2023). Compared to 2021, when the equivalent figure was \$838.3bn, this is an increase of more than 43%. Holding onto assets is not necessarily a bad thing in itself. However, it is reflective of the fact that deal markets are weaker, and managers are unwilling to offload assets at potentially weaker values to fund distributions. This is resulting in some creative solutions, with NAV financing increasingly an option for managers and investors as a route to return capital without offloading assets simply to fund distributions. Similarly, many investors are turning to the secondary market to offload fund interests. This is not necessarily to reduce overall exposure to the private equity asset class. In some instances, investors are selling interests in more mature funds, to generate returns they can invest in current vintages. In such cases, they are recycling capital to maintain exposure across a broad range of funds.

NAV seven years old or more, held in private equity funds.



Source: Pitchbook, December 2023 data as of April 2024

In addition to the reversal in the dynamics between calls and distributions, they are now also less predictable than they have been in the past. Investors, who have been accustomed to some relative visibility in the capital flows across their private market investments, are now coming to terms with a period where cash flows are far less predictable. This is putting stress on some investors, which are finding that with calls continuing and distributions slowing, they may be over-allocated to some asset classes or strategies.

While larger institutional investors are likely experienced and have invested in private markets across cycles in the past, those new to private markets may find these market dynamics relatively difficult to adjust to. In particular, given the increased representation of non-institutional investors to the investor mix, managers will need to focus on education of these investors and are likely to spend a disproportionate amount of time making them comfortable with the current environment.

Diversification and creativity can ease pressure on portfolios.

Following the surge in activity in private equity markets during 2021, it was perhaps to be expected that there would be a period of relative quiet. But with the sharpest increase in interest rates in decades, the market has seen activity slow significantly. This has clearly impacted the deal market in general and the exit market in particular. Distributions back to investors have slowed, while calls have continued – a sign that there are still attractive opportunities to deploy capital. Managing this environment has not been particularly easy for either managers or investors.

But investors can actively seek to reduce these impacts through diversification across fund vintages and through varied sector exposure. Such an approach should mean that investors are not overexposed to a particular point in the cycle through a single fund. This approach will not mean investors escape market impacts fully, but it should mean that there is more of a balance than a single targeted approach to private equity investment.

And over time the market will recover – as it generally does. Managers will not sit on their hands and wait for this to happen, using the tools at their disposal to manage their exposure and do what they can to the benefit of their investors. Tools such as continuation funds and NAV loans are some examples of the toolkit at their disposal. Increased activity in the secondary market is another. While the timing is still uncertain, interest rates should begin to fall too, potentially bolstering the market and improving the exit environment. It may be a tough market at present, but we believe it is unlikely to remain that way in the long-term.

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- ◆ **Model Risk:** Model risk occurs when a financial model used in the portfolio management or valuation processes does not perform the tasks or capture the risks it was designed to. It is considered a subset of operational risk, as model risk mostly affects the portfolio that uses the model.
- ◆ **Investor's capital at risk:** Investors may lose the entirety of invested capital.
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