FrontLine Research Paper

Private Equity Valuations during Downturns

Analyzing private markets is an exercise in patience. Performance data is available with a time lag, even though eFront Insight has reduced this lag to a bare minimum of around three months. Moreover, performance is generally a mix of distributed profits and estimated net asset values (NAVs). The latter is the aggregated result of a myriad of fund manager perspectives. They are often described as 'smoothened' and even at times as 'stale'. Managers have some latitude to appraise the value of fund holdings with the help of the guidelines issued by the International Private Equity and Venture Capital Valuation Guidelines (IPEV). Valuation professionals would often refer to the assessment of the fair value of private assets more as an art than a science.

In a benign environment, that debate would remain within the confine of academia or become a series of intellectual jousts between expert professionals. In stressed times, this debate attracts a much wider audience. The consequences are significant, ranging from adjustments in asset allocations to the planning of cash-flows. Usually, when observers are confronted with a crisis case, they would look back to identify other similar cases and compare.

However, the current situation is fairly unique and one needs to be careful in extrapolating the correlations, as well as the magnitudes of the economic developments from the past. There are circumstances specific for this crisis that need to be factored in, such as the

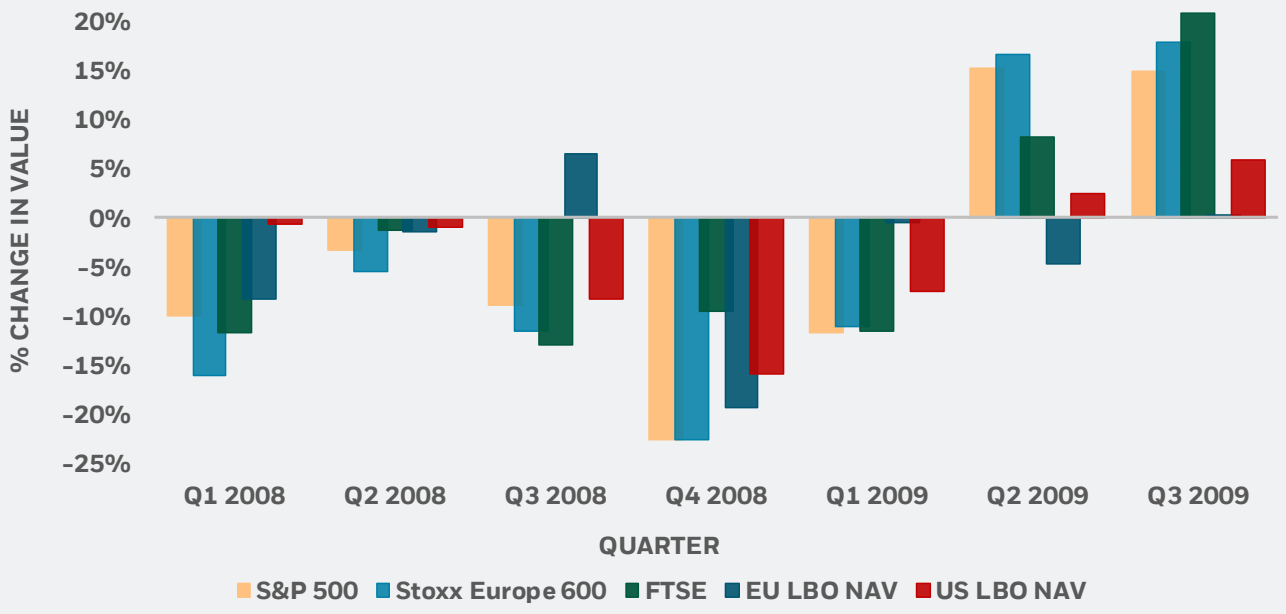
usage of subscription lines by GP companies, as well as the immediate response by portfolio companies to a drop in demand by drawing heavily on revolving credit facilities, thus deepening the debt burden. Another important component to be considered is the scope of national economic stimulus policies. For example, Federal Reserves economic relief package disqualifies many at risk portfolio companies due to their GP legal structures.

The concept of 'fair value' has been largely implemented since the last significant global crisis of 2007-2009. It is still possible to evaluate its impact on the NAVs of American and European LBO funds (Fig. 1), thanks to the high quality of data of eFront Insight. The NAVs under-react to the evolution of listed indexes. A few explanations come to mind.

NAVs under-react to the evolution of listed indexes

First, the composition of the indexes and the portfolio of funds differs significantly. For example, indexes tend to include banks, which are not part of the usual investment universe of LBO funds. Second, fund managers tend to react faster, thanks to advanced and early key performance indicators (KPI), but also strong governance frameworks. Academic literature has also demonstrated that they tend to better support their portfolio companies in a downturn, including with reinvestments. Third, listed markets tend to over-react to events and downturns, before reverting to the average.

Figure 1 – Quarterly evolution of major indexes of listed stocks and the NAVs of LBO funds



Source: eFront Insight, as of Q4, 2019.

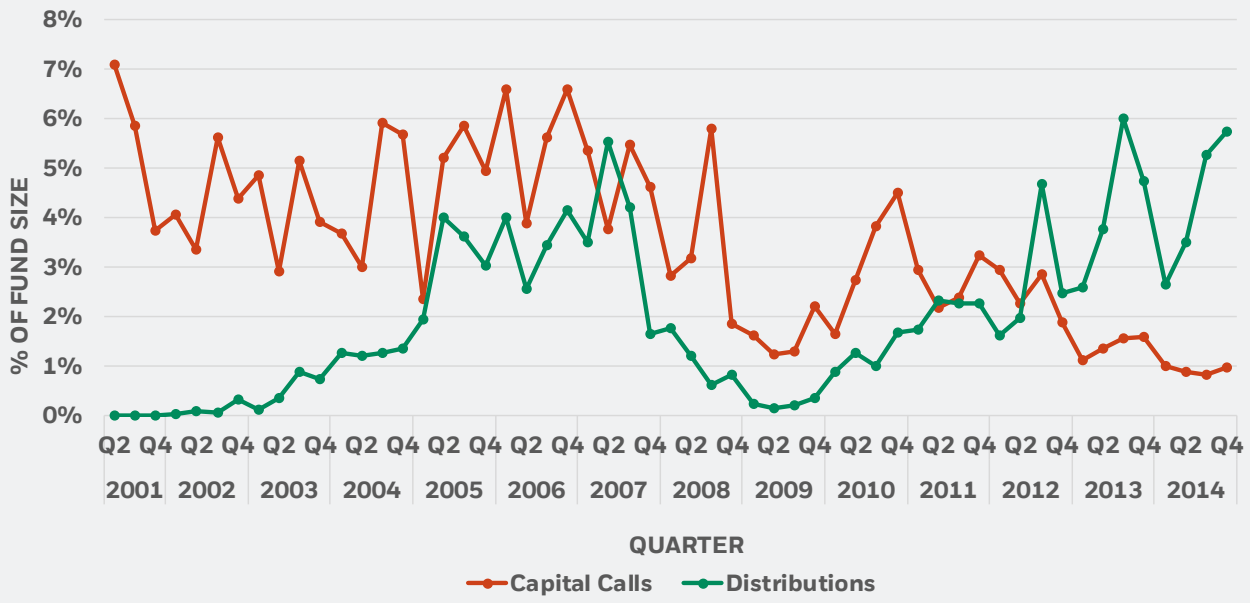
Digging deeper

A few additional factors have to be taken into account. First, NAVs are pictures of portfolios in constant evolution. Fund managers can snap up good investment opportunities in difficult times, at attractive valuations. As a consequence, this can prop up NAVs during that quarter and the following quarters. Essentially, indexes are buy-and-hold products, while private market funds are, by design, interim owners, constantly buying and selling companies.

This is visible in two instances in Figure 2: the 2001-2002 and the 2008-2009 downturns. Distributions were negligible between Q2 2001 and Q3 2003, as well as between Q1 2009 and Q1 2010. As for capital calls, the picture is different. Calls above 0.5 to 0.75% per quarter, which account for the payment of costs and quarterly management fees, represent investments. As we can see, there was no meaningful slowdown in 2001-2002, and even during the 2008-2009 period, some funds still invested.

NAVs are pictures of portfolios in constant evolution

Figure 2 – Calls and distributions of European LBO funds



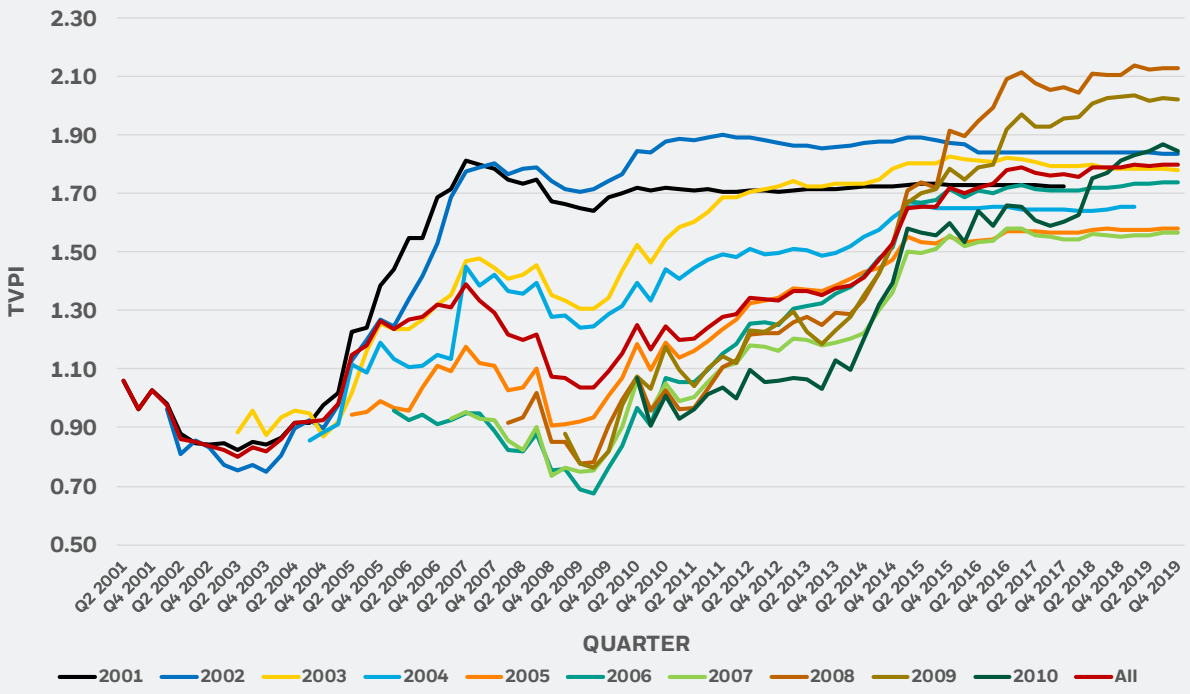
Source: eFront Insight, as of Q4, 2019.

The spike in capital calls of European LBO funds in Q3 2008 (Figure 2) explains the odd spike in NAVs (Figure 1), against the odds of the decrease of listed indexes. When the activity is moderate or slow, as in Q1, Q2 and Q4 2008, the NAVs evolve in the same direction as the indexes. How to interpret the significant decrease of NAVs of Q4 2008? As these figures are audited, fund managers may have had to comply with specific requirements from auditors about NAV adjustments. Additionally, fund managers might, in fact, look at average stock prices over six or even nine months to compute the fair value of their stakes. This could explain why the NAV recoveries of Q2 and Q3 2009 are much more limited than in the case of stock prices.

Short- and long-term consequences

How deep and durable are the decreases of NAVs? Depending on the maturity of funds, the answer varies. The vintage year 2001 was affected in its divestment period and only partially recovered from its peak multiple of invested capital of 2007. The contrast with the vintage year 2002 is visible, as the latter also suffered from a drop, but much more limited and it was fully recovered by 2010. The vintage year 2003 experienced the crisis right after the end of its investment period. The value of its assets was visibly affected but recovered well and did not seem to have had any meaningful impact on its overall performance.

Figure 3 – Evolution of the multiple of invested capital of European LBO funds



Source: eFront Insight, as of Q4, 2019.

As for vintage years which experienced the crisis during their investment period, the picture is more contrasted. The vintage year 2004 followed the same trajectory as 2003, although with a spike of activity in 2007, at the peak. The recovery of the value of assets took a bit longer than with 2003 and the overall performance is below the levels of older vintage years.

Depending on the maturity of funds, the decrease of NAVs varies in depth and duration

The vintage years which suffered the most are 2005 and 2007. Their overall performance is the lowest of the sample. 2005 was probably the hardest hit, as it made investments which rapidly gained value, then lost all of these gains, and then more. The recovery took time and the increase in performance was rather progressive. The vintage year 2007 suffered a lot at the beginning of its investment period but recovered strongly in 2010. Surprisingly, the performance plateaued afterwards, possibly due to the prolonged eurozone crisis in 2010-2014.

However, this does not explain why the vintage year 2006 seems to have escaped the fate of its predecessor and successor. That vintage invested in the same conditions than 2007 but did not experience the same plateau of multiple increase. A possible explanation is that the pool of funds captured in 2006 is particularly good, compared to 2005 and 2007. Meanwhile, the 2008 and 2009 vintages were exceptional, having invested during the depth of the crisis at very low prices and also having avoided the eurozone crisis in 2004, allowing them to outperform the rest of the sample.

Conclusion

Each crisis is unique in its own right. It is difficult to compare a financial crisis with a pandemic crisis. However, what is clear is that the NAVs of funds will to some extent mirror the gyration of stock prices, but not the full swings. Given this, funds will probably snap up attractive deals even during the worst of the crisis. Those will probably generate very attractive returns. Assuming that the worst of the pandemic crisis will be in 2020, and if history is of any help, the vintage years which will suffer the most would be 2016, 2017 and 2018.

However, the experience of the vintage year 2006 shows that this is far from being written in stone. The quality of fund managers within these vintage years will make a substantial difference. The depth and the extent of the recession, as well as the action of fund managers, will largely condition the effective performance.

Every vintage year affected by the past crisis has recovered from its dip in NAV and recorded at least a multiple of 1.5x

In any event, what is also clear is that each and every vintage year affected by the past crisis has recovered from its dip in NAV in stressed times. Moreover, each also recorded on aggregate a positive multiple, above 1.5x net. The worst-case scenario would then be that fund investors panic and sell their primary fund stakes on the secondary market at a significant discount on a depressed NAV marked to market. The universal lesson, which also holds true for investors on the listed markets, is, therefore: do not panic.

Note

The aim of this newsletter is to provide readers with elements of analysis and understanding of the private finance universe, based only on cash-flow data collected by eFront Insight. It does not intend to draw any definitive conclusion, nor judge the performance of fund managers. By providing a guided reasoning, FrontLine hopes to contribute to the overall progress of understanding of the asset class in a short monthly format, with all the limits that this entails.

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