MV CAPITAL MANAGEMENT

Weekly Market Flash

Private Equity Not Immune from the Troubles

July 15, 2022

It has been a tough year so far for the traditional asset classes of stocks and bonds. Rising interest rates, inflation and concerns about economic growth have all taken a toll on performance. Not surprisingly, we have seen a lot of marketing effort extolling the benefits of alternative assets – things that are supposed to act as hedges against the prevailing trends besetting stocks and bonds.

To be sure, when it comes to alternative asset classes the performance often does not back up the marketing hype. Cryptocurrencies, to name one egregious example, were (according to many of their promoters) supposed to provide a gold-like hedge against equities. Scarcity value, right?! That theory hasn't worked out too well in the real world. Another asset class hailed by many as a port in a storm is private equity, a $4.6 trillion market that ran hot in 2021 with $850 billion in new deals done by private equity funds. Because the companies that make up private equity portfolios don't trade on public securities exchanges, they do not bear the visible scars of the companies whose valuations, marked to market every day, have suffered during the 2022 downturn. Is the confidence expressed by many in this sector of the market justified, or are there likely to be tough times ahead?

It's Still Equity

Despite generally being classified as an "alternative" asset class, it's important to remember that at the end of the day it's still basically equity. A private equity fund (or partnership – we'll use the terms interchangeably although there are legal distinctions) is a pool of interests in the equity (mostly common equity) of companies in much the same way that regular mutual funds are. The key difference is that the shares of the private companies do not mark to market every day, which matters considerably when it comes to valuations and returns – we will come back to this issue below.

Another notable difference between private equity funds and their mutual fund counterparts is that the general partners (i.e. the fund's operational managers) own a much larger stake in the companies and thus take a more active role in the management of the underlying businesses. One of the common themes among private equity managers is their claim that their business management skills are superior to those of the businesses they are taking over. Whether that is true or not is a matter of opinion, at best, and not necessarily validated by the evidence to date.

Again, though, when all is said and done, what you have in the portfolio of your typical private equity fund is a pool of equities (sometimes enhanced with preferred stock or other instruments). Since they are not valued by the day-to-day movements of prices on publicly traded stock exchanges, there have to be other ways to determine what these shares are worth. Here is where the travails of 2022 in the year to date may be about to catch up with private equity.

Comparable to What?

The method of choice for valuing an illiquid private company is to impute a value based on what comparable companies are being bought and sold for. Private equity funds achieve exits for the assets in their portfolios via stock exchange listings (IPOs) or private sales to other companies (M&A). The

conditions for both the IPO market and M&A are very much affected by the changing conditions in global capital markets.

Take IPOs. In 2021 the IPO market was hot as the stock market surged. As we noted above, the benign conditions last year facilitated $850 billion in private equity transactions. But in 2022, not surprisingly, the IPO market has tanked. As the universe of “comparables” starts to reflect the reality of the 2022 stock market you can expect to see those valuations drop accordingly. Likewise, private sales via M&A are also starting to reflect a more conservative mindset among companies on the hunt for strategic acquisitions as they face the challenges of persistent inflation and the potential for a recession at some point in the near to mid-term future – not the conditions likely to make one want to pay top dollar for a company. This has led to the somewhat curious trend recently of private equity firms buying and selling their assets to each other rather than to external buyers – something that may goose numbers in the short term but is unlikely to be sustainable.

Losing Leverage

The other challenge for private equity will be in financing new deals. There is currently some $1.3 trillion of so-called “dry powder” – money invested in private equity funds that has not yet been deployed into new investments and is thus idly sitting in cash for the time being. The biggest tailwind to financing new deals in the past couple years – to say nothing of the previous decade – was the easy money that flowed from the Fed’s zero interest rate policy. About 50 percent of all private equity transactions are funded by debt – mostly from riskier sectors of the $3 trillion private debt market like leveraged loans. This market has been hit hard by the rise in interest rates. High yield (speculative) debt with a C credit rating currently trades around a 14 percent yield. As the cost of capital goes up, the valuation of assets funded by that capital goes down.

The last twelve years have been very good to private equity. The good times are unlikely to last much longer. Investors thinking they are getting a comfortable hedge from the troubles in public equity and debt markets may be in for a rude awakening and some tricky currents to navigate ahead.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by MV Capital Management, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from MV Capital Management, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. MV Capital Management, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the MV Capital Management, Inc.’s current written disclosure statement discussing our advisory services and fees is available for review upon request.