Private Equity

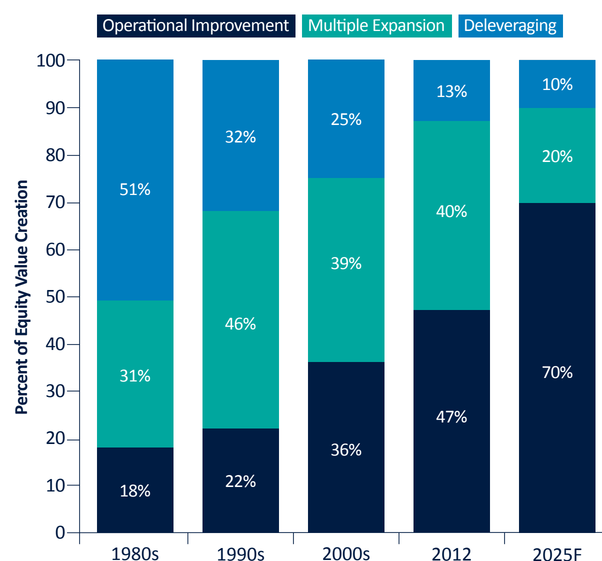
Major Trends

The end of low inflation and of falling interest rates creates a paradigm shift for the private equity world going forward. The average cost of debt for leveraged loans used to finance buyouts nearly doubled from +7.1% at the start of 2022 to +12.4% at year end.[1] We believe the impact this increasing cost of capital will have on the private equity (PE) market cannot be overstated for two reasons. First, the falling-rates-driven multiple expansion, which comprised +56% of total enterprise value creation over the past decade, is no longer a given, and many companies' valuations are more likely to experience multiple compression in the future.[2] Second, most PE-owned businesses will experience a reduction in operating cash flow due to increased interest expenses. As a result, we believe there are challenges in two of the three key value creation drivers for leveraged buyouts (the three levers being earnings growth, multiple expansion and leverage). In a rising interest rate environment, we believe earnings growth achieved via the private equity owner's post-acquisition operational value add (PAOVA) will emerge as the core source of PE equity value creation, as shown in Exhibit 1.

The pandemic bump in deal and exit activity is dissipating: Despite the challenging macroeconomic backdrop, deal activity remained relatively strong, representing a decline of −27% from 2021 but still c. +42% over 2019.[3] We view 2022 as a transition year or a 'reversion to normalcy' on deal deployment, where Q1 and Q2 represented two of the five largest deal quarters in buyout history, whereas Q3 and Q4 deal activity declined to the 2019 run-rate of $110B per quarter ($440B total) due to expanded bid-ask spreads and an inability to access syndicated debt capital.[4] Challenges in equity markets derailed almost all IPO and SPAC activity, driving exits down by −67%.[5] The full-year data do not tell the full story of the slowdown, with H2 2022 deal and exit activity declining by −45% and −70%, respectively, versus H2 2021, as shown in Exhibit 2.[6]

Exhibit 1

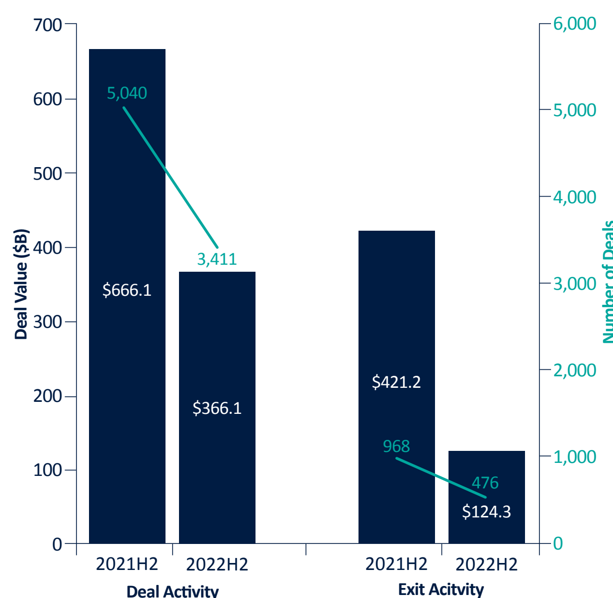
In the current macreconomic environment, earnings growth will emerge as the most important PE return driver



***Source:** BCG*

Exhibit 2

PE activity fell precipituously in H2 2022



***Source:** Pitchbook Annual PE Breakdown*

1 Proprietary data from Partners Capital private debt manager
2 Bain DealEdge
3 Preqin Private Equity Online
4 Ibid
5 Ibid
6 Pitchbook 2022 Annual US PE Breakdown

Private Equity
continued

Expect further markdowns on the back of the -16% public equity market correction in 2022.[7] While we have only seen a modest −6.8% correction in buyout book valuations through Q3 2022, we are expecting earnings headwinds to flow into further markdowns during 2023.[8] As the dust settles, the market should start to clear, and we expect deals will get done at lower prices making for a more attractive market opportunity.

Persistent levels of dry powder result in continued elevations of purchase price multiples on completed transactions: In 2022, buyout sponsors sought to deploy a record backlog of dry powder of over $1 trillion, ensuring intense competition for the fewer companies entering the market and helping to inflate purchase price multiples to a new record of 11.4x for assets that transacted.[9] We believe the key reason purchase prices remained elevated is a ‘flight to quality’ within each sector, where the only deals getting done were those companies operating in resilient end-markets with best-in-class operating metrics. For example, consumer teams flocked to consumer services deals which today command higher multiples due to higher margins and recession resilience, causing the average consumer EV/EBITDA multiple to increase from 10x to 14x.[10]

Strong fundraising activity driven primarily by the mega funds: Over $695 billion was raised across more than 1,800 funds, driven primarily by mega-funds, with LPs concentrating capital in their largest existing relationships.[11] The average fund size of $421 million represents a +57% increase from 2021 and the highest average since the GFC.[12] The record fundraising activity is also driven by funds coming back to market at a record pace, with average years between PE fundraising dropping to 2.8 in 2022 from 4.5 years in 2014.[13] Given the volatile macroeconomic climate and crowded fundraising market, LPs were reluctant to commit to new relationships, as indicated by the fact that in 2022 first-time fund activity (by number of funds) was the weakest in the past decade and the percentage of capital raised by funds with less than $1 billion declined from 23% to 16%.[14] We expect a substantial slowdown in fundraising in 2023. This is a result of the 'denominator effect' whereby the strong performance of private equity managers and recent correction in public equities has left many LPs over-allocated to the asset class relative to their long-term targets, combined with lower exit activity.

Golden Rules

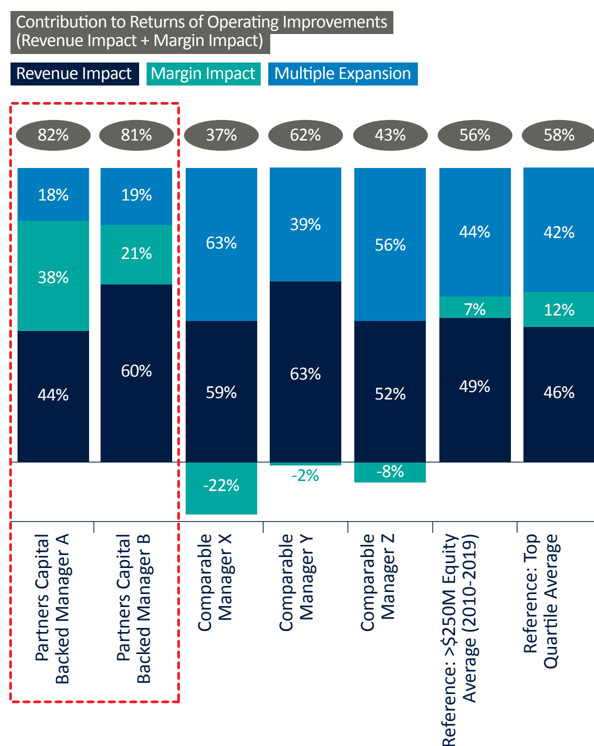
Our golden rules for investing in buyouts have not changed from prior years:

- Invest with managers who have demonstrated post-acquisition operational value add capabilities.
- Invest with young, hungry teams trained by top-tier private equity firms or who are former business owner-operators.
- Invest in lower middle market strategies where the greatest market inefficiency resides and where there is greater potential for asymmetric returns.
- Invest with sector specialists who have competitive advantages in sourcing and value creation due to deep industry insights.
- Co-invest with those whom we believe to be the best-in-class managers to increase returns through avoiding fee and carry, mitigate the ‘J-curve’, and concentrate exposure in what we view as exceptional investments.

7 MSCI ACWI Index (USD), Bloomberg
8 Cambridge Associates Buyout Index as of 30 September 2022
9 Preqin Private Equity Online
10 Ibid
11 Ibid
12 Ibid
13 Pitchbook, 2022 Q3 US PE Breakdown
14 Ibid

Exhibit 3

We focus on contributions of PAOVA to returns as a key criteria for manager selection



Source: *Pitchbook Annual PE Breakdown*

Sub-Strategy Attractiveness

Lower middle market (LMM) buyout: Positive view. Earnings can be purchased at lower multiples usually reflecting the higher business risks of smaller companies vs. larger ones. Skilled LMM buyout investors have greater opportunity to grow and stabilise the earnings of smaller companies that generally have not benefitted from professionalising management, investments in institutionalising processes (IT, sales and marketing, automation, etc.) and strategic M&A. There is also a multiple arbitrage opportunity created from growing LMM companies into middle market companies, often by selling them to larger buyout firms. The average LMM / MM deal from 2000 to 2020 has been realised at a 2.8x gross cash multiple, with 13% of deals generating returns of >5x gross cash multiple, versus large market, which produced an average 2.4x gross cash multiple and 5% of deals were realised at >5x gross cash multiple.[15]

Complex situations buyout (LMM / MM): Positive view. Within the lower middle market / middle market, we have particularly high conviction in managers that possess an ability to 'buy complexity,' which we define as acquiring businesses where poor operating performance, capital intensity, or transaction dynamics enable PE sponsors to acquire companies at discounted valuations. We believe skill in mitigating complexity will be critical in the current environment. In a deal sample of >1,500 investments, 43% of the 'cheap' companies (in the bottom quartile of EV / EBITDA multiple) generated a >3x realised gross cash multiple , versus 33% of 'expensive' companies (top quartile multiples), despite nearly identical loss ratios.[16]

Sector specialists: Positive view. Specialist capabilities in sourcing, underwriting, and post-acquisition value creation can help to offset the impact of the highly competitive deal environment. Our specialist allocations target five sectors: software, healthcare, industrials, consumer, and energy transition. In the Preqin data set, specialist buyout funds have outperformed by c. +1.4% per annum since the GFC, although top quartile specialists have outperformed by +3.8%, per annum, indicating an increased opportunity for alpha through manager selection.[17]

15 Ibid

16 Cambridge Associates. US Private Equity Looking Back, Looking Forward: Ten Years of CA Operating Metrics, November 2022. We define LMM / MM as Cambridge's "small cap", <$250M of platform entry TEV

17 Preqin Private Equity Online

Private Equity
continued

Secondaries: Neutral view. Average discounts in private equity secondary transactions increased from –8% in 2021 to –19% in 2022, reflecting buyers' expectations that future NAV growth will be lower than in recent years.[18] A small number of secondaries managers raised $10B+ funds in 2022, but the overall industry dry powder relative to annual deal volume remains low at 1.2x vs. an average of 1.5x since 2016.[19] We expect secondary deal volume to continue increasing due to the growth of assets in mature private equity funds: total AUM in primary funds 10+ years old is at a record high of $895 billion.[20] As a result, we believe traditional LP secondaries are becoming more attractive, with supply/demand dynamics favouring buyers and resulting in larger-than-average discounts.

Larger market buyout: Neutral view. Increased competition, higher prices and higher leverage levels make the space challenging. We believe managers that focus on complex situations and / or have outsized operational capabilities will continue to outperform. We also believe sponsors with an ability to pursue take-privates or carve-outs may be well positioned, given there are nearly 650 new listings from the last two years that now trade below $1 billion in market cap and an average discount of –76.5% below their IPO price.[21]

Distressed/Turnaround: Neutral view. We prefer to allocate to complex situations generalist buyout managers through market cycles to obtain comparable exposure, but we will opportunistically commit to distressed managers during what we believe are prolonged periods of market dislocation.

European buyout: Neutral view. While we have selectively allocated to European sponsors, we have preferred North American PE given what we view as more favourable supply-demand dynamics around innovative technology and healthcare deals. We note that the Preqin North American Private Capital benchmark has outperformed the European Private Capital Benchmark over each of the last 1,3,5, and 10 years.[22]

Growth equity: Neutral view. We define growth equity as minority or control investments in high-growth companies that are breakeven or approaching profitability (i.e., companies that sit between late-stage venture capital and buyouts). The correction in high-growth company valuations is a headwind for growth equity investments. Existing investments may require additional time to grow into their valuations and near-term new deal flow is a concern, as many companies in this market are "bootstrapped" and do not require institutional capital. However, these companies should also be in a better position to weather the current environment, as they do not have the capital requirements of higher growth venture-backed companies or the debt burden of software buyouts. Skilled investors will find opportunities to create transactions with founders seeking a partial realisations, through corporate carveouts, and by acquiring companies that have fallen out of favour with VCs.

Asia/Emerging markets buyout: Negative view. We believe we can generate comparable or better returns in North American buyouts with lower degrees of currency, regulatory, and/or geopolitical risk.

18 Jefferies Global Secondary Market Review - January 2023
19 Ibid
20 Preqin Private Equity Online
21 Pitchbook 2022 Annual US PE Breakdown
22 Preqin Private Equity Online

2023 Strategic Priorities

- **Double down on buyout firms with extraordinary operating (PAOVA) capabilities.** We will need to defend our strong relationships and capital allocations with those rare managers who demonstrate the greatest ability to generate PAOVA. Other LPs will become increasingly interested in this universe of managers and we must ensure that Partners Capital is viewed as among the most value-added partners to these GPs through our pro-active efforts to help them constantly improve. The sub-segments where we most commonly identify managers with what we view to be significantly differentiated operating capabilities are lower middle market managers focused on complex deals and sector specialists in technology, healthcare, and industrials. Given the criticality of PAOVA in the current environment, we are also developing a number of proprietary tools to measure how funds drive PAOVA to improve manager selection, and identify managers we believe can consistently outperform, an example of which is shown in Exhibit 3.
- **Exploit the current opportunity to gain access or increase allocations to managers with rare capacity.** We believe 2023 will be a challenging year for fundraising. We are actively working to source new relationships with either (i) who we view as high performing existing managers that were previously capacity constrained or (ii) high potential emerging managers. We believe most of these managers will either be sector specialists in our five core verticals (software, healthcare, industrials, consumer and energy transition) or value oriented LMM buyout managers who focus on complex situations.
- **Co-Invest alongside our managers in the sub-sectors in which they excel.** We aim to deepen existing relationships with those whom we believe to be our best managers to increase returns through reduced fees for our clients and enhance co-investment access. As our managers seek to take advantage of the current market environment to complete take-privates, corporate carve-outs or pursue sponsor-to-sponsor transactions, we are doubling our efforts to increase our deal flow and position Partners Capital as the partner of choice when co-investment opportunities arise.

Long-Term Expected Return

Exhibit 3

Based on our 10 year forecasts, we target the following long-term expected returns for Private Equity

	Private Equity
Risk-free Rate	3.5%
Risk Premium	4.5%
Illiquidity Premium	3.0%
Manager Alpha	1.5%
Total Return	**12.5%**

Private equity expected returns reflect +8.0% p.a. beta returns from Long Equities, 3.0% p.a. private asset class outperformance reflecting the "illiquidity premium" and 1.5% p.a. alpha from our strategy and manager selection

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Your capital is at risk and you may not get back the full amount invested.

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