January 31, 2023

RPM Ep 25 transcript

MY: [00:00:03] Welcome to RPM, the podcast that explores the world of private markets. I'm your host, Maribel Yoo. Joining me to discuss the private equity market outlook for 2023 are two members of our private equity team based in our New York office, Aditya Raina and Laura White. Aditya joined Stepstone in 2014 and Laura has been with the firm since 2018. Thank you both for joining me and welcome to RPM.

AR: [00:00:24] Hey, Maribel. A pleasure to be on with you.

LW: [00:00:34] Thanks for having us, Maribel.

MY: [00:00:35] Absolutely. Again, it's so great to have you both. Now, let's get started. There are a few macroeconomic themes that continue to remain in the backdrop as we head into 2023, like inflation, tightened monetary policy, and geopolitical risks. It'd be great to highlight a few key market observations and what that means for private equity. With that said, how about we kick off with the fundraising environment?

LW: [00:00:55] I'm happy to discuss this one. Overall, we've seen fundraising activity trend upward over the last ten years. We saw a dip between 2019 and 2020 due to the impact of COVID. However, fundraising activity rebounded strongly to record levels in 2021. Since then, however, we've begun to see this trend abate as fundraising activity began to slow in the second half of 2022. And there were a couple of interesting insights we found when we looked further into the data here. So while the number of funds and the total capital raised declined in the second half of 2022, we saw that the average fund size has continued to increase. This implied to us that dry capital is being concentrated with larger, more established managers, and we saw the number of first-time funds and the share of all private equity funds continue to decline.

LW: [00:01:42] It's now at 14% versus an average of 23% over the last 15 years. And while larger, more established managers have continued to raise larger funds and have continued to come back to market at shorter intervals of time, we've begun to see the fundraising timelines for these GPs begin to extend. LPs have begun to push back on GPs' aggressive fundraising timelines, and we've seen many GPs extend their final closes from 2022 to 2023 to accommodate limited partners. And for the first time in a while, we've really begun to see LPs have more sway in the fundraising process as it relates to timing and fees and this environment has enabled LPs to access previously oversubscribed GPs. So while fundraising activity has begun to slow, dry powder remains at record highs and is concentrated with large and global buyout managers, as I mentioned. And this high level of dry powder creates an increasingly competitive environment for private equity managers, which really highlights the importance of manager selection for LPs, particularly in this environment.

MY: [00:02:42] These are all important trends to note. So given this fundraising activity, the abundance of dry powder and a less favorable exit environment. Can you talk about how these elements are affecting private equity transaction activity?

AR: [00:02:54] Sure, Maribel, I can take this one. It's safe to say that the private equity market activity started in 2022, like a bit of a lion and went out like a lamb. Valuations, activity, and fundraising pace were all up as we enter 2022. But that dynamic has meaningfully changed by the end of the year. Maybe I can first speak to what we're seeing in the market and then maybe speak a bit more to the outlook going forward. Starting with where we left off on fundraising, despite a relative slowdown in fundraising, as Laura mentioned, 2022 was still buoyed by large and mega-cap established managers. So dry powder continues to grow at that larger end of the market, which we believe will continue to facilitate an exit environment for smaller cap managers that may help sustain transaction activity going forward. But while dry powder increased in 2022, it's important to note that dry powder as a percentage of net asset value has remained relatively depressed. This metric has remained at historic lows despite dry powder being at historical highs, which could imply that despite the growth in dry powder, transaction activity in recent years has actually kept pace or outpaced fundraising, leading to relatively larger growth in overall private equity net asset value. But when we double-click into the recent transaction activity, we have seen a drop off in the back half of 2022.

AR: [00:04:22] This has been a result of a combination of factors that we've touched on previously, but it fundamentally all comes back to uncertainty. This is uncertainty around the macro and geopolitical climate, recession risk, or the rising interest rate environments. And while public equities were quick to reflect these areas of concern last year, private markets reacted a bit more slowly. Multiples are slowly starting to trend lower as it has become difficult for investors to execute on deals when underwriting assumptions are not really on firm grounding. This has also pushed investors to hit pause, causing a bit of a stall in deal activity. Heading into 2023, transaction activity should continue to be slower as valuations settle and lending costs increase. But this lull may ultimately favour buyers. Taking a step back, we've seen rising rates create difficult or even inaccessible debt capital markets with declines in debt issuances and significant spread widening. And with monetary policy having been tightened to prevent inflation expectations from becoming unanchored, recession risk has also proliferated. The uncertainty from this, as discussed, has contributed to a pullback in transaction activity. But the impact of the troubled debt markets and uncertain buyer underwriting hasn't fully flowed through to seller expectations, leading to bid-ask-spreads that have also stalled processes. And I would note based on central bank rhetoric, recent macro indicators, CPI, inflation, data rates are likely to continue to rise in the near term.

AR: [00:05:54] Honestly, if you look at the last period of runaway inflation in the late seventies and early eighties, the Fed funds rate was in the double digits to battle similar levels of inflation compared to the mid to high single-digit Fed funds rate that we see today. Obviously not an apples-to-apples comparison with our situation today, but I think it puts our situation into some context. And while US inflation has begun to slow, I think history suggests it could take a couple of years for it to come down to more normalized levels. So until seller valuation expectations moderate and we see a tightening in that bid-ask-spread transaction activity will likely remain muted. And that's why in the beginning of 2023, we are likely to see a similar trend to the last few months, given there are so many variables that are still up in the air, including financing conditions and market uncertainty impacting that bid-ask-spread. And with historically cheap debt, I think sellers are pretty content holding onto assets for longer and waiting for more favorable exit environments and investors should expect longer holds and perhaps more GP-sponsored continuation vehicles, which I'm sure we'll touch on in a little bit.

AR: [00:07:02] One other point I'd like to add to this discussion on transaction activity is a profile trend we're seeing, which is this flight to quality. This has been both in terms of sectors and business models. Despite inflation rates and recession risks, there are pockets of activity and opportunity, with buyers seeking more defensible assets, with pricing power and recession resilience often tied to more secular demand drivers. So while there is a noticeable pullback in transaction activity, it's been less pronounced in sectors like technology and software. This is also the case at the lower end of the market, especially in these first institutional capital type deals where typically less leverage is used and there's less reliant on the debt markets. If you look at StepStone buyout co-invest deal flow, which I think is a pretty decent proxy for the broader market movements, nearly two-thirds of our deal flow has been in the small and mid-cap businesses in the last six months as compared to around one-third for the same period about a year ago. And maybe to kind of close this out as we look forward, many of our clients and limited partners are asking us where we see the opportunity for activity. And I think in the current market, GPs will look to focus on company-specific risks and actions, including revenue growth, margin management to drive returns, and even look to inorganic growth evaluations, facilitate a buying opportunity.

AR: [00:08:23] And perhaps we can touch on this later, but on new investment activity, I think the headline is, is that some of these uncertain or recession recessionary time periods are often the best-performing vintages given the opportunity to benefit from a subsequent recovery, as well as just the value buying opportunity. History has shown recessionary vintages have historically outperformed growth expectations and achieved multiple expansions at exit. So while today's environment may hamper existing portfolios, the 2023 vintage could benefit from a valuation reset. But in the meantime, there continue to be opportunities in the current market driving activity. There has and will likely continue to be an acute secondary buying opportunity driven by a relatively larger fall in public valuations compared to privates creating that denominator effect. Also related to secondaries, there's a viable exit opportunity for sellers where we've continued to see a proliferation of GP-led secondaries such as continuation vehicles. And lastly, if we do ultimately miss the quote-unquote soft landing and find ourselves in a recessionary period, there has been a significant amount of distress capital raised in recent years that could take advantage of the buying opportunity there as well.

MY: [00:09:40] Let's talk more about the rapid growth of the secondary market. Can you elaborate on the opportunity this market presents for the private equity asset class?

LW: [00:09:46] Absolutely. We've seen the secondary market evolve significantly over the last decade. In 2010, for instance, the market was primarily limited partner stake sales and the total market size was around 22 billion. However, in recent years, the market's expanded dramatically due to the growth of GP-led solutions, which as Aditya mentioned, encompass single and multi-asset continuation vehicles, GP spin outs, strip sales, and LP tenders. And today actually the GP-led market is larger than the size of the entire secondary market in 2010. When we look at the market today, we see that LP commitment pace has continued to accelerate as GPs return to market at a faster pace. And this increased private equity allocation, combined with the decline in the public markets, has created a denominator effect for many LPs, which Aditya alluded to. Many investors have set targets for their private equity exposure and as the public portion of their portfolio declines, the percent concentrated in private equity often rises, as private equity has not historically captured as much of the downturn as public markets.

LW: [00:10:52] And we expect this to create a large wave of secondary volume as investors seek liquidity and look to bring their private equity exposure back in line with the target. And while we expect this denominator effect will drive increased LP stake sales, we note that the GP-led market remains robust as well. And thinking back to the history of it, while the GP-led market was primarily a solution for GPs looking to restructure underperforming funds pre-2018, this is meaningfully shifted in the last five years as we've seen many first and second quartile GPs increasingly leverage the secondary market to accrue further value from their trophy assets. And as IPO markets remain largely shut, we expect that continuation vehicles will offer GPs another exit route from their highest-quality assets. So overall, I think the secondary market presents a highly attractive investment opportunity, particularly at this point in the cycle. We note that the supply demand imbalance creates an attractive buying opportunity for secondary investors.

AR: [00:11:49] And the only thing I would add to what Laura has laid out is maybe just underscoring the attractive buying opportunity we're seeing, and I think this is even more pronounced in the venture capital market where our secondaries team has been seeing discounts to net asset value of nearly 40% for some top quartile managers funds. As venture portfolios with resilient assets have seen an outsized capture of the public market volatility, despite having what are quite resilient portfolio companies that have growth prospects going forward. So again, this is just one example of the buying opportunity that we see in the secondary space.

MY: [00:12:29] Absolutely. Now, as a firm that advocates for the promotion and adoption of responsible investment standards, we're seeing this becoming more mainstream in private equity. What are you guys seeing when it comes to ESG considerations and impact funds?

LW: [00:12:40] With regard to ESG in the venture capital space, I'd begin by saying that ESG programs within the broader private equity space are now ubiquitous and are now considered table stakes for many buyout GPs. However, there's much more to be done in the venture capital space. While VC is playing catch up, the good news is we're seeing signs that venture is starting to make headway. I think that the benefits of developing effective ESG programs in venture capital are clear. Given the role of VC in the investment lifecycle, effective ESG programs at VC firms can help early-stage companies to, one, form strong governance practices, which is an important foundation for any ESG program, two, help them attract and retain the best talent. And three, navigate regulatory and reputational risks. And really minimize risks as the businesses mature and grow. So we're seeing VCs develop ESG programs and move towards more ESG integration. And internally, our data shows that the number of VC GPs who have ESG policies and who are signatories to bodies such as the Principles for Responsible investment has been increasing year over year. We've also begun to see the launch of initiatives such as Venture ESG, which is the PRI VC network and provides valuable ESG resources dedicated to venture capital. And these initiatives are really geared to help VC firms grow ESG programs and also offer initiatives such as policy templates and DDQs. And VC GPs have expressed to us how helpful these industry initiatives and resources are, particularly for managers that don't have dedicated ESG staff.

LW: [00:14:16] Just especially given that staffing and resource constraints have previously been a roadblock for many smaller groups to develop ESG programs. So taking all these elements together, we anticipate a ramp up in ESG adoption and ESG programs at VCs in the coming years. And maybe switching gears to impact funds specifically, we note that the impact opportunity set is vast and rapidly growing in 2022. We learned about a significant development in the Impact investing space via the peak body, the Global Impact Investing Network, which noted that the size of the impact investing market actually grew to over 1 trillion in 2022, and our internal data at StepStone supports these trends as well. And across the impact and thematic space, the number of investments we're tracking continues to increase year over year. StepStone is tracking over 1000 private impact funds aligned with impact investment themes, including over 400 funds currently in market, seeking over 200 billion in capital commitments. And the continued growth and maturity of the impact investing space is characterized both by mainstream and specialist managers launching impact strategies. Mainstream and leading private equity firms are launching and raising dedicated impact investing funds. And we've seen multibillion-dollar impact funds raised over the past couple of years, and we expect this trend to continue. Beyond mainstream firms, we also see the proliferation of dedicated and specialist managers. The manager universe is weighted toward smaller-sized funds that are often more difficult to identify, access, and or diligence. And this is where StepStone can really be a valuable partner.

LW: [00:15:54] And relatedly, within impact, given that this is a relatively new space, there's great dispersion of returns and the risks of greenwashing are real. At StepStone, we parse through the universe and seek to mitigate these risks through our rigorous investment and impact due diligence processes. And maybe lastly, with regard to what we're seeing in the market today, we're seeing an increase in focus in two areas, specifically. One, climate tech and solutions, and two, diversity. And these two focus areas are driven by both current events and compelling investment opportunities. StepStone believes the decarbonization of the global economy is one of the largest investment opportunities of our time. And research shows and data corroborates that diverse managers outperform those who are not diverse. And so I think we view there to be significant tailwinds to investing in both climate tech and solutions, including increased proliferation of corporate, government, and investor net zero commitments, which is driving favorable demand dynamics for climate solutions. And there's also increasing maturity and cost competitiveness of climate technologies, which is rapidly moved climate tech companies to commercialization. So in short, the large volume of capital required to transition to a low carbon economy has translated to expanded opportunities for climate investing. And we're seeing increasingly sophisticated managers and management teams execute climate tech strategies, providing opportunities for investors to achieve impact and competitive financial returns. And we anticipate the demand for climate solutions and diverse managers to continue to grow in 2023 and beyond.

MY: [00:17:29] Now, private equity has historically outperformed public markets across market cycles. Can you touch on why you guys believe this continues to be the case?

AR: [00:17:39] Absolutely. I'm happy to take a crack at this one and maybe spend some time on specific areas of opportunities we see going forward. When looking at private equity versus public market performance, I think it's important to stress some of the asymmetric risk capture of private equity. Based on StepStone data across multiple market cycles, including the Dot Com bubble, the global financial crisis, and the COVID-19 pandemic, private markets have on average captured about 60% of the downside seen in the public markets during those same time periods. Conversely, private equity performance captured more than 115% of the upside on average seen in the rebounds from those same market down cycles. The inherent question here is why is this the case? One reason is the buying opportunity that downturns or market dislocations can create for private equity investors. Looking again to StepStone's database, the data illustrates that there was more than two turns of valuation multiple contraction on average between 2007 and 2009 when looking at private equity transactions, with those investments ultimately selling into rebound and valuation markets. While you could argue that the same depression and valuations may exist or have existed in the public markets, we think private markets have been more conducive to identifying A-quality assets that are undervalued by the broader market during a down cycle, and conversely, avoiding buying lower quality assets for cheap in a market downturn that may not ultimately survive that downturn. I think this is where manager selection becomes even more important.

AR: [00:19:17] Across market cycles, we've seen a large dispersion in private equity returns between top-quartile and bottom-quartile funds. This is especially the case in venture and in the smaller end of the buyout market, and is even more true during market downturns. In the data, there is a consistent number of outperforming investments in a down cycle, but there is also typically an elevated number of underperforming deals. This is why it's imperative to have exposure to the top quartile managers that can identify the assets and opportunities that will be accretive to overall programs even in market downturns. Although there are opportunities to generate alpha even in recessionary periods, it's important to note that at StepStone we don't recommend trying to time markets. Instead, we see the benefit in taking a more structured and most importantly, consistent approach to capital deployment and capital pacing. By achieving a smoother pacing of capital deployment across high-quality managers, a portfolio can achieve exposure targets, self-funding status and vintage year diversification, as capital committed today is deployed over multiple years, allowing for portfolios to take advantage of macro-level market opportunities. And data shows that this consistent capital pacing and private equity can actually produce relatively attractive risk-adjusted returns as the cost of missing good vintage years outweighs the cost of being invested in worst performing vintages. Despite this difficulty in timing markets, we should still take some time to reflect on some particular areas of potential opportunity that we're currently seeing. Laura touched on the big wave of secondary deal flow we're seeing at what are quite attractive discounts.

AR: [00:20:50] And as I mentioned, I think this is especially the case in the venture market where we are seeing some very large discounts on what are high-quality portfolios with relatively operationally sound underlying companies. And at the end of the day, venture more broadly can be described as a market that is cyclical, as in an innovation can occur in any market environment. And we do see a digital transformation supercycle that has continued to accelerate more recently. So while some things have changed recently, whether that's public market sell-off and the trickling down of these valuations to private markets or a shut IPO market, and one may have considered the venture market in recent years to be overvalued, broadly speaking, there is certainly a buying opportunity to take advantage of in the current market. The hypothesis is also supported by data, with top-quartile venture managers outperforming the public markets in the years following recessions. This is the case for the nineties as well as 2008-2009 and this outperformance is almost by two times. A couple of other areas I did not want to fail to mention were around the public to private market as well as the opportunities we see in Europe. Quickly on the public to private opportunity, it goes without saying that in this uncertainty and evaluation gap between public and slower moving private company valuations could imply a healthy uptick in taking publicly traded companies private. Public to privates in 2022 already outpaced 2021. And this is a trend that we could continue to see.

AR: [00:22:20] On the European market, I think the key here is that there are varying pockets of opportunities across strategies and regions. Examples of this include impact investing, where Europe has been a front-runner and we continue to think that this will be an opportunity driven by global secular demand for ESG friendly and sustainable investments. Geographically, our team in Europe has noted relatively stronger macro trends in the Benelux and Nordics region, while Southern Europe presents an investment opportunity around digitization trends as well as around smaller cap first-institutional type transactions. And while energy shortages have been dissipating more recently helping to moderate inflation and recession concerns, our team is beginning to see a distressed opportunity arise in the DACH region, with some restructuring opportunities starting to pop up. And maybe we can end the overall distressed opportunity discussion on a few points. In recent years, there's been a considerable amount of capital raised around a looming distressed opportunity that hasn't necessarily played out. With at least 100 billion of dedicated dry powder for this opportunity sitting on the sidelines today, compared to about half as much four or five years ago. Depending on where you fall on the recession or no recession debate, we could see the dry powder being put to use in the not so distant future. I think most of the big financial institutions' publications aren't predicting the global economy to be in an imminent risk of sliding into recession, and there is still hope for a potential soft landing.

AR: [00:23:44] But most baseline views from analysts assume at least a mild recession before the end of 2023, both in the US and Europe. But it's all a balancing act between monetary policy and multiple macro factors. So while there is a probability of a recession, the average consumer remains fairly resilient. Despite some softening, recent data, supply chain disruption, and inflation are easing. The overall U.S. labor market remains relatively stable, despite some of those recent high-profile tech layoffs and energy prices in Europe have been moderating. And while the global economy is slowing, it's worth pointing out that no constituency has been able to accurately forecast the macro climate over the last 18 months. And one of the main reasons for that disconnect really seems to be the number of exogenous factors and shocks to the economy, whether it's the pandemic, the war in Ukraine, or unprecedented monetary stimulus. These are generally uncertain times. And with the uncertainty and risk of economic slowdown across the globe, there's a reason to be cautious as well as opportunistic. There are certainly pockets of opportunity, and data would suggest that there is room for outperformance in these types of recessionary periods. However, at StepStone, we believe the best way to achieve a successful private equity portfolio is to target a steady investment pace, prioritize strong manager selection, and focus on long-term trends.

MY: [00:25:04] All very helpful insights across private equity as we dive into 2023. Thanks again for joining me. I'm looking forward to catching up with you both soon.

AR: [00:25:11] Thank you so much, Maribel. Was a pleasure to be on with you.

LW: [00:25:14] Thanks for having us.

MY: [00:25:15]That does it for this episode of RPM. Thanks for listening. For more research and information on private equity at StepStone, visit us at StepStoneGroup.com. RPM is available on Apple Podcasts, Spotify, Stitcher, and other podcast platforms.