PERSPECTIVES

PRIVATE EQUITY

Performance Through Recessions

JUNE 2020

CBRE CALEDON

INTRODUCTION

Private equity investments have historically generated attractive returns over short and long-term time horizons. The current economic dislocation has created an opportunity for private equity investors to take advantage of lower valuations and potentially generate excess returns. To determine how attractive it is for investors to deploy capital to private equity strategies during these periods, CBRE Caledon analyzed private equity performance through the last two major recessions to provide insight into what the coming quarters may look like for the asset class.

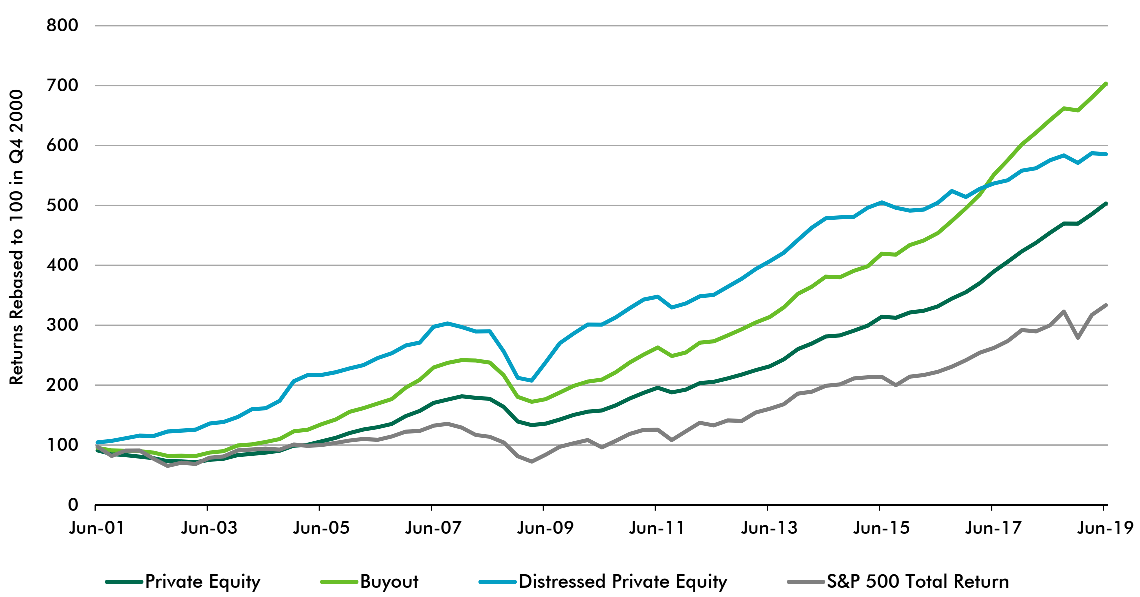
CBRE Caledon found that in periods of economic dislocation, top-performing private equity managers have been able to invest in attractive businesses at discounted valuations and generate outsized returns. Firms most successful during these periods are those focused on buyout investments and distressed for control transactions. Importantly, not all managers can achieve superior performance, so selecting the right managers is critical for a private equity investor to obtain long-term outperformance.

In addition, CBRE Caledon found that investors who have built strong relationships with top-performing GPs are best positioned to outperform through these periods and can capture additional upside by co-investing with these managers in their more attractive investments.

PRIVATE EQUITY PERFORMANCE – LAST 20 YEARS

Private equity has traditionally outperformed public markets during both the medium and long-term. The ability to invest with a long-term mindset and drive operational and strategic change by supporting management teams has enabled private equity managers to outperform their public market peers. Within private equity, buyout and distressed private equity managers have consistently shown an ability to produce outsized returns over longer periods, as **Figure 1** indicates.

FIGURE 1: Private Equity Returns - Compared to S&P 500



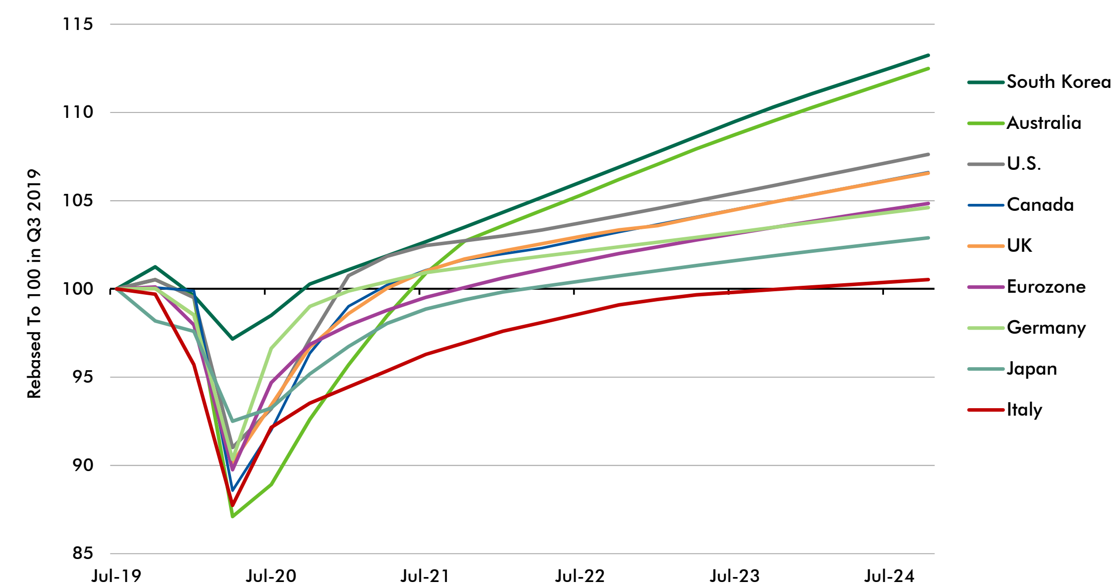
Note: Past performance is not indicative of future results.
Source: Preqin

Notably, distressed private equity's performance has flattened over the last five years due to a robust economy, and the increasing scarcity of attractive distressed opportunities. However, given the challenge of timing markets, exposure to distressed managers through cycles positions investors to benefit from their expertise when economic uncertainty inevitably occurs.

PRIVATE EQUITY PERFORMANCE COMING OUT OF THE LAST TWO RECESSIONS

The unexpected economic shock of the COVID-19 pandemic had a significant impact on global markets. Working in conjunction with the CBRE Global Investors macroeconomic team, our analysts are currently modeling a sharp economic contraction and a slow recovery that brings the global economy back to 2019 footing by 2022, as described in **Figure 2**.

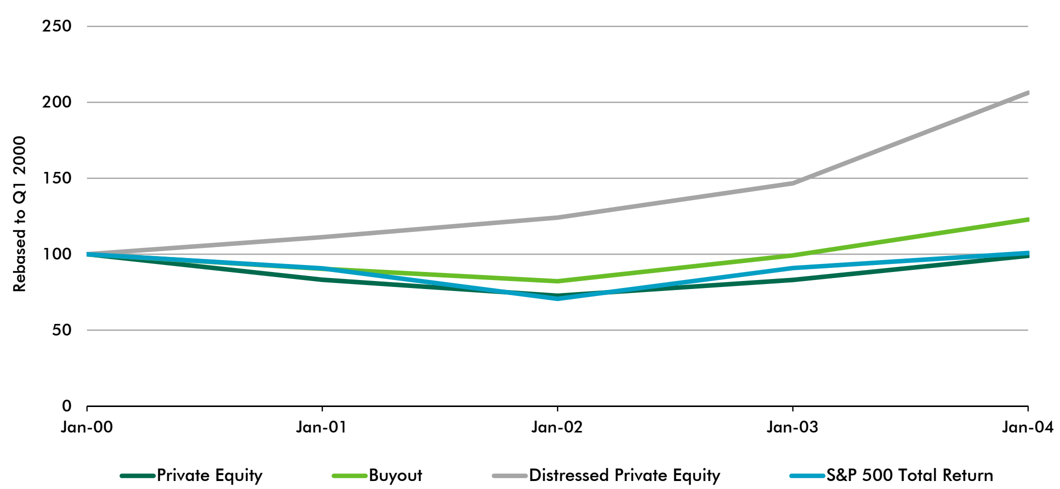
FIGURE 2: CBRE Global Investors GDP Projections



Sources: Oxford Economic Forecasting, CBRE Global Investors

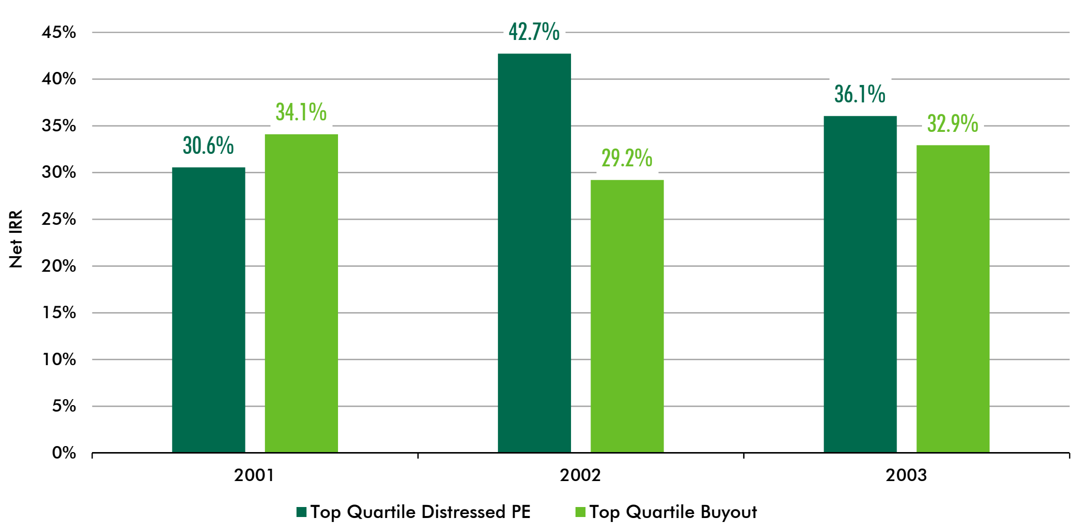
The unprecedented global shutdown is expected to create opportunities for distressed private equity managers who can support undercapitalized and operationally distressed companies. In addition, the current environment presents an opportunity for buyout firms to acquire companies at attractive multiples when compared to late in the economic cycle. To assess the potential performance of buyout and distressed private equity strategies through economic cycles, CBRE Caledon reviewed how these types of strategies performed during the last two recessions. The charts below (**Figures 3-6**) track the performance of private equity strategies through both the 2000 and 2008 recessions and provide a snapshot of performance by buyout and distressed private equity managers relative to the public and private equity markets generally.

FIGURE 3: Private Equity Returns Coming Out of 2000 Market Correction



Note: Past performance is not indicative of future results
Source: Preqin

FIGURE 4: Buyout and Distressed Private Equity Performance By Vintage Year

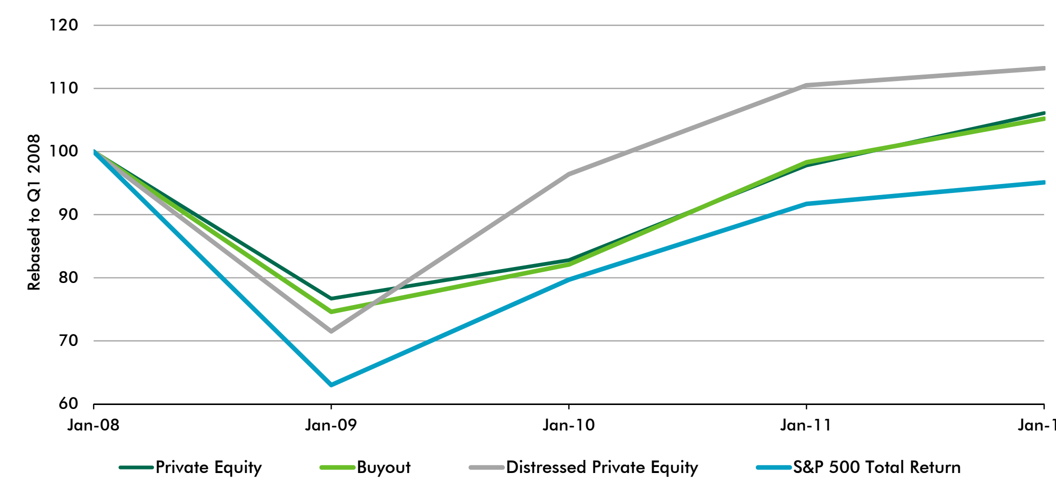


Note: Past performance is not indicative of future results
Source: Preqin

As the charts indicate, periods of market dislocation and increased volatility tend to favor distressed private equity firms as the number of potential distressed investment opportunities dramatically increases.

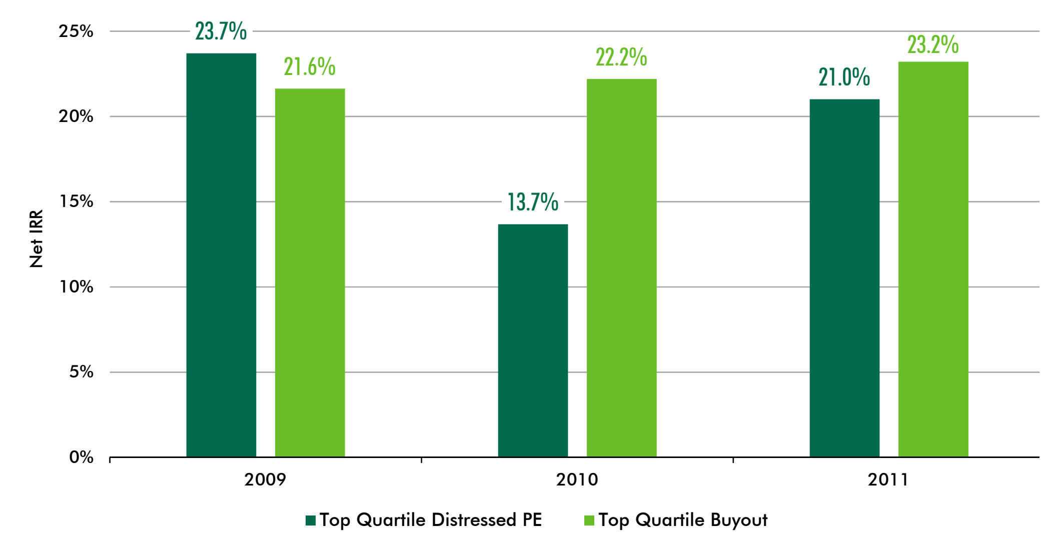
Tellingly, buyout managers also perform well in periods of increased volatility, as they are often able to invest in companies at discounted valuations. Overall, the last two recessionary periods have demonstrated that investing in private equity through these vintage years, particularly with top-quartile managers, has led to returns that are greater than the long-term average returns of both strategies. These findings highlight the need to build relationships with managers that can invest in distressed transactions consistently. Having ongoing relationships with these managers enables LPs to take advantage of market uncertainty as it occurs.

FIGURE 5: Private Equity Returns Coming Out of 2008 Market Correction



Note: Past performance is not indicative of future results
Source: Preqin

FIGURE 6: Buyout and Distressed Private Equity Performance By Vintage Year



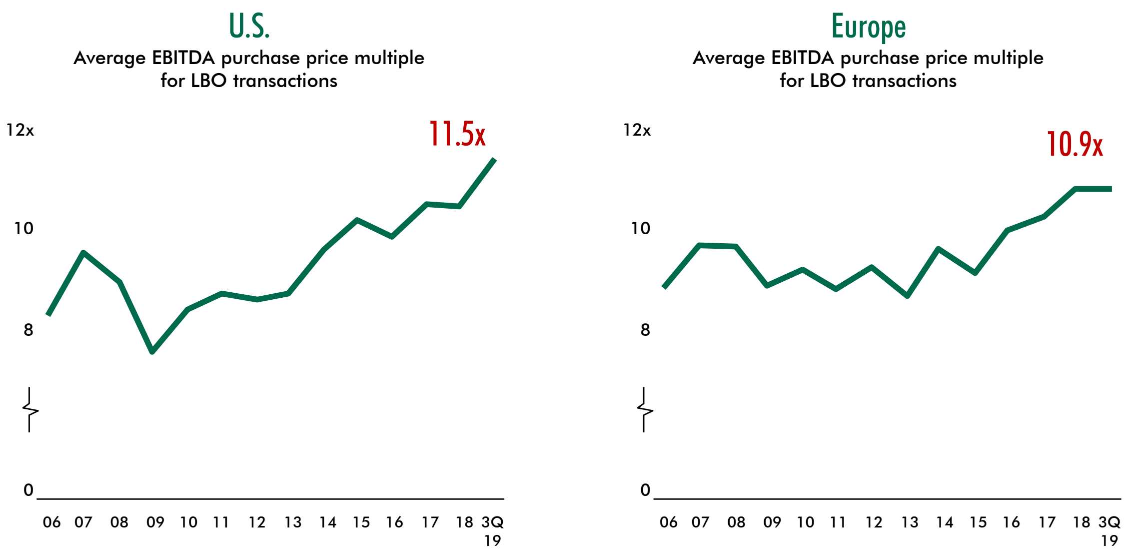
Note: Past performance is not indicative of future results
Source: Preqin

THE CURRENT OPPORTUNITY

Since 2009, the average entry multiple in a buyout transaction has been steadily growing and surpassed 2008 levels. In Q3 of 2019, the average EV/EBITDA multiple for leveraged buyout transactions reached 11.5x in the U.S. and 10.9x in Europe. In 2019, over 50% of U.S. buyouts had an EV/EBITDA purchase price multiple above 11x.

A strong driver of these purchase multiples has been an inexpensive and plentiful supply of covenant-lite debt from both traditional lenders and a swell of fundraising in the private debt space.

FIGURE 7: Multiples For Leveraged Buyouts Reached Another High In The U.S. But Moderated Slightly In Europe

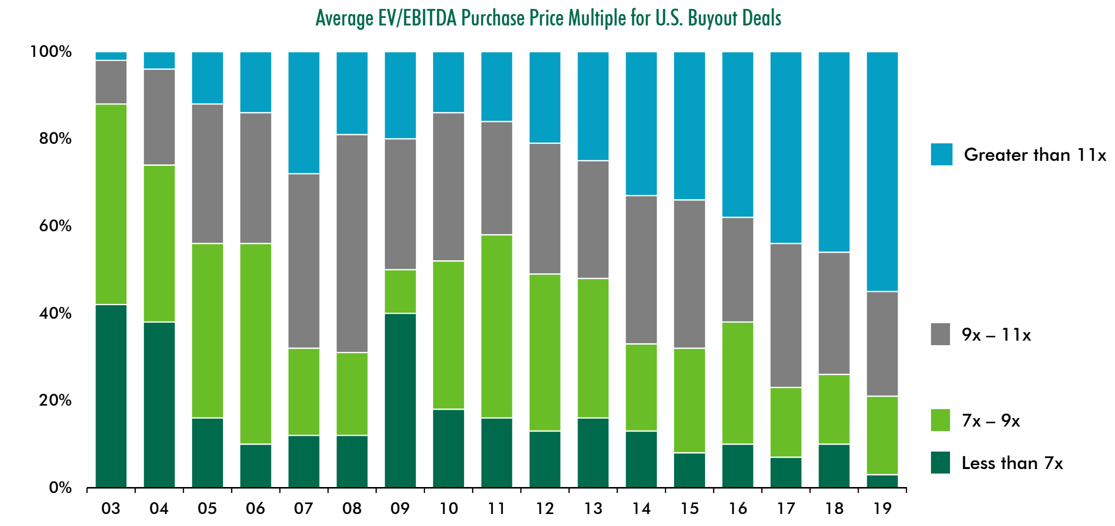


Sources: S&P Capital IQ, Global Private Equity Report 2020 – Bain & Company

In the U.S., private equity firms have been negotiating larger debt packages to complete investments. Transactions with debt multiples higher than six times EBITDA rose to more than 75% of total transaction volume over the last five years. In addition, the real leverage of many deals is likely higher than noted, as banks have increasingly calculated EBITDA with a number of adjustments on future earnings rather than actual results.[1]

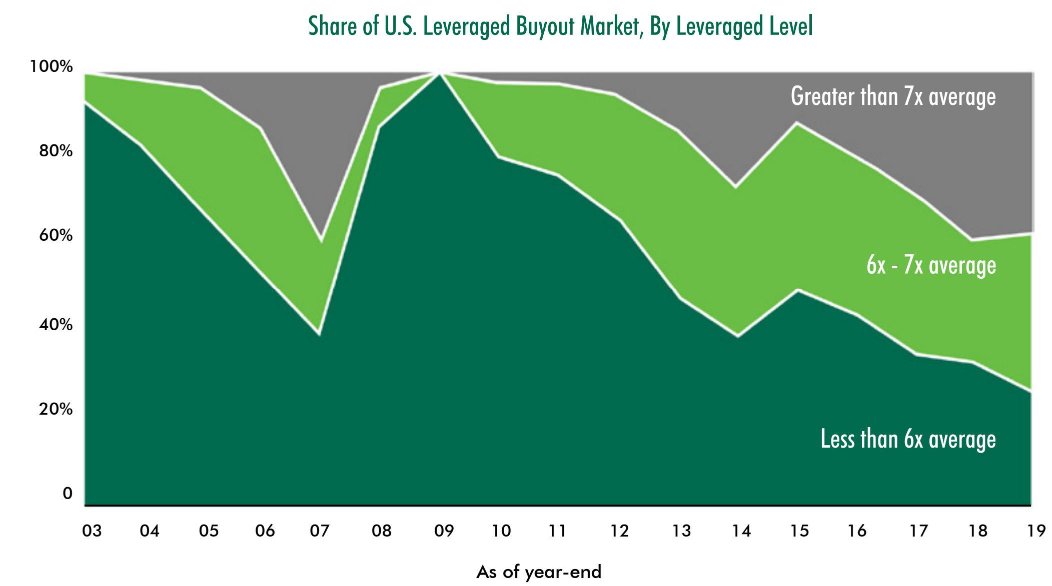
[1] Global Private Equity Report 2020 – Bain & Company

FIGURE 8: More Than 55% of U.S. Buyout Deals Had a Multiple Above 11x



Note: Includes deals which disclosed purchase price and leverage levels only.
Sources: Thomson LPC, Global Private Equity Report 2020 – Bain & Company

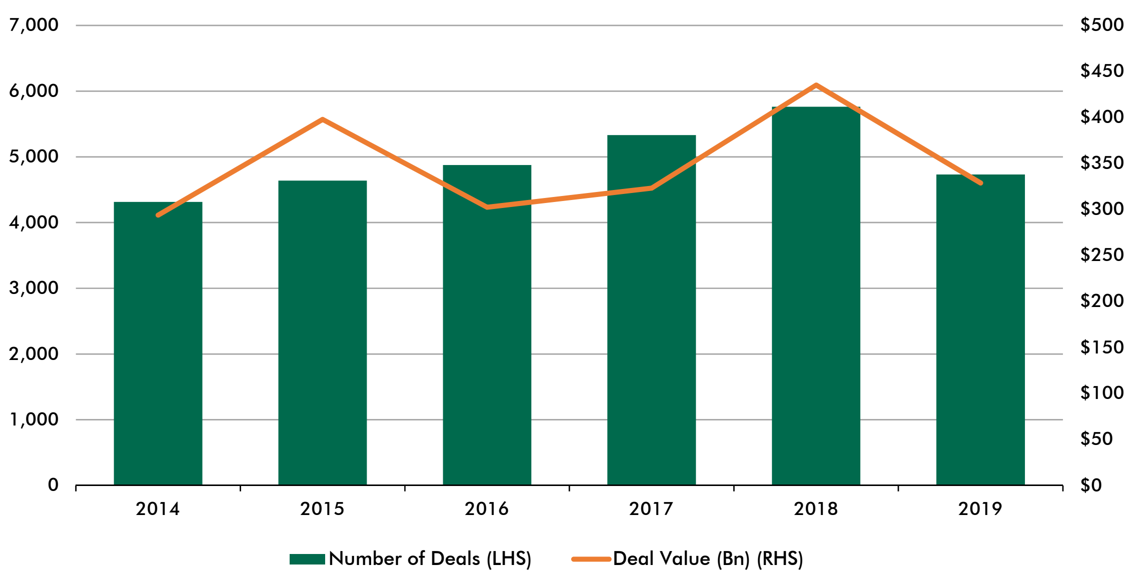
FIGURE 9: A Growing Share of Buyout Deals Have Been Highly Leveraged With Debt



Sources: Thomson LPC, Global Private Equity Report 2020 – Bain & Company

Preqin data suggests that in North America and Europe, over $2 trillion in transactions were completed in the private equity landscape over the past five years. If over 75% of these transactions used excessively large debt packages, then ~$1.5 trillion worth of transactions are highly levered and may require financial support in the event of a protracted economic downturn. Managers with the appropriate capabilities and experience, dry powder, and strong LP support are best positioned to review this deal flow and allocate capital to the most attractive opportunities.[2]

FIGURE 10: Private Equity - Transaction Volume (North America and Europe)



Source: Preqin

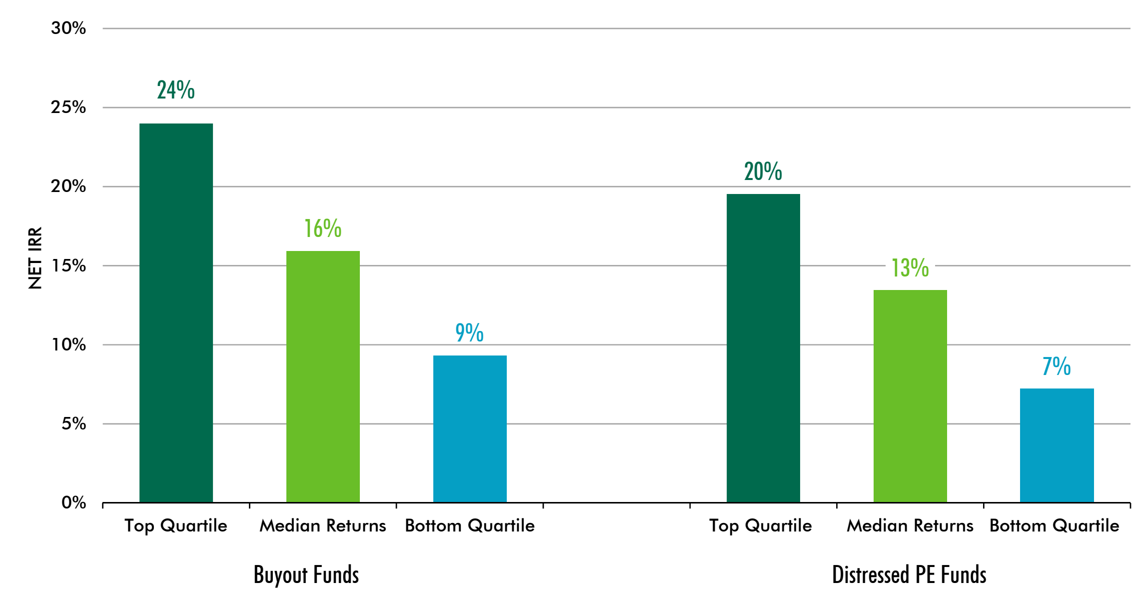
[2] Preqin

NOT ALL MANAGERS ARE CREATED EQUAL

Working with the right partners is critical when investing in private equity. Having strong relationships with high quality, alpha-generating managers during periods of economic contraction is especially vital. It is in these periods that a manager's ability to preserve capital and outperform is demonstrated. When reviewing historical performance between 2000 and 2012, on average, the best performing buyout managers generated an IRR that was 15% higher than the bottom-quartile. In the distressed for control space, top-quartile managers returned an IRR that was 13% higher than their bottom-quartile counterparts, as **Figure 11** indicates.

The difference in performance tends to increase even further after market dislocations. In the three years following the 2001 and 2008 economic recessions, the difference between the top-quartile buyout and distressed private equity managers and their bottom-quartile counterparts grew to a 16-17% IRR on average[3], as **Figure 12** indicates.

FIGURE 11: 2000-2012 Average Performance Difference

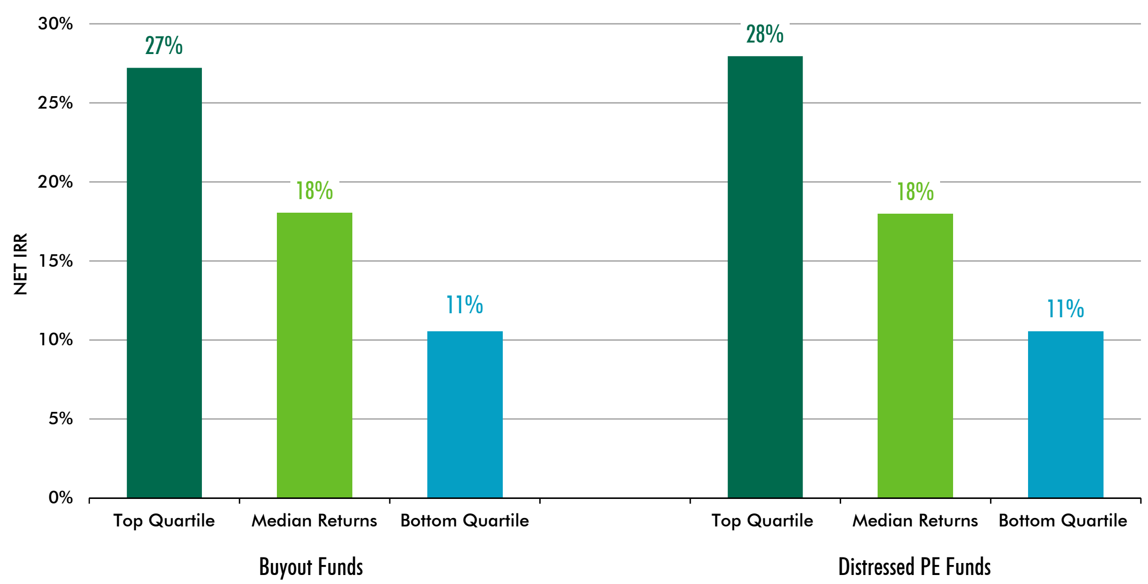


Source: Preqin

[3] Preqin

While investing with top-quartile managers generates significantly higher returns, accessing proven managers is incredibly challenging. Over the past five years, there have been over 550 institutional-grade funds[4] raised by managers in the buyout space in North America and Europe. Of these, **76%** were oversubscribed. In this environment, sponsors with a lengthy track record of generating meaningful outperformance are often oversubscribed by a factor of 2x or 3x relative to the fund's target size.

FIGURE 12: Difference In Performance - Subsequent To Market Correction



Note: Average net IRR for the 3 years following 2000 and 2008 recession
Source: Preqin

As a result of these conditions, investors seeking to gain access to top-performing managers will usually need to develop deep relationships with them over time and prove to be a meaningful, value-add, long-term partner.

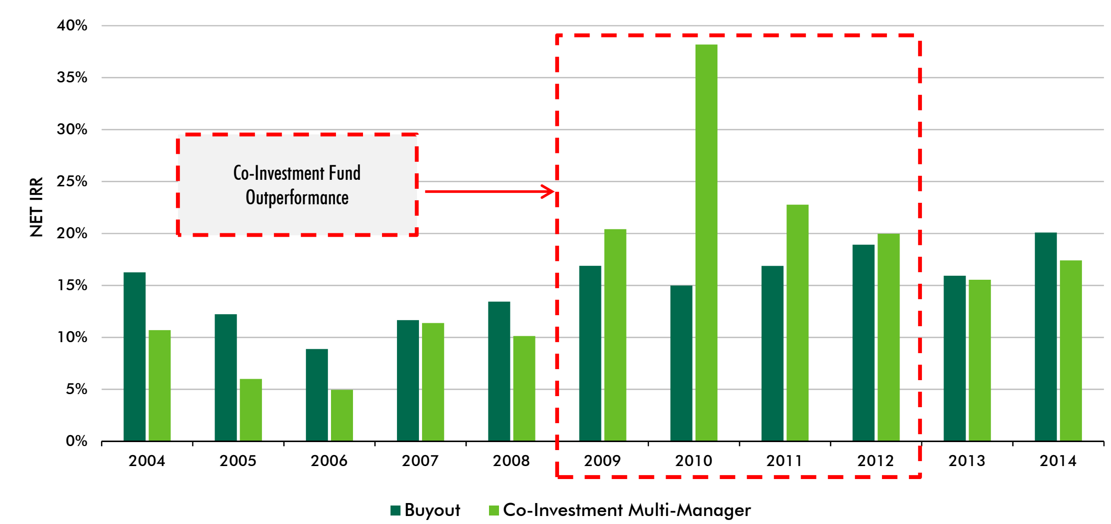
[4] Preqin - Institutional grade consists of managers with fund targets greater than $400 million

DESIRE FOR CO-INVESTMENT

In most market environments, GPs offer their LPs co-investment opportunities to sell down oversized investments for portfolio construction purposes and to build stronger relationships with their LP base. This type of co-investment is typically done through post-close syndications after the investment is completed. In an environment where the supply and the complexity of opportunities rise, GPs are less likely to invest in larger transactions in the hope of syndicating a portion of the investment to their LP base. As a result, as more attractive opportunities present themselves, GPs will increasingly be looking for partners to complete transactions on a co-underwritten and co-sponsorship basis. For this reason, many of the world's largest and most sophisticated institutional investors (CPPIB, GIC, etc.) have become active in the co-sponsorship and co-underwriting space.[5] Engaging with their sponsors earlier ensures that they receive a more significant proportion of deal flow relative to the limited set of LPs that regularly act on syndicated transactions.

Co-investment returns are especially pronounced during periods of market dislocation since GPs are far more likely to offer co-investment, given the volume of opportunities, capital constraints, and a sharper focus on their "sweet spot". As **Figure 13** indicates, periods of economic uncertainty have resulted in meaningful investment returns for LPs capable of investing directly into companies. In some instances, by reducing fee drag through co-investments, LPs have been able to outperform the funds in which the investments are held.

FIGURE 13: Vintage Year Returns By Strategy



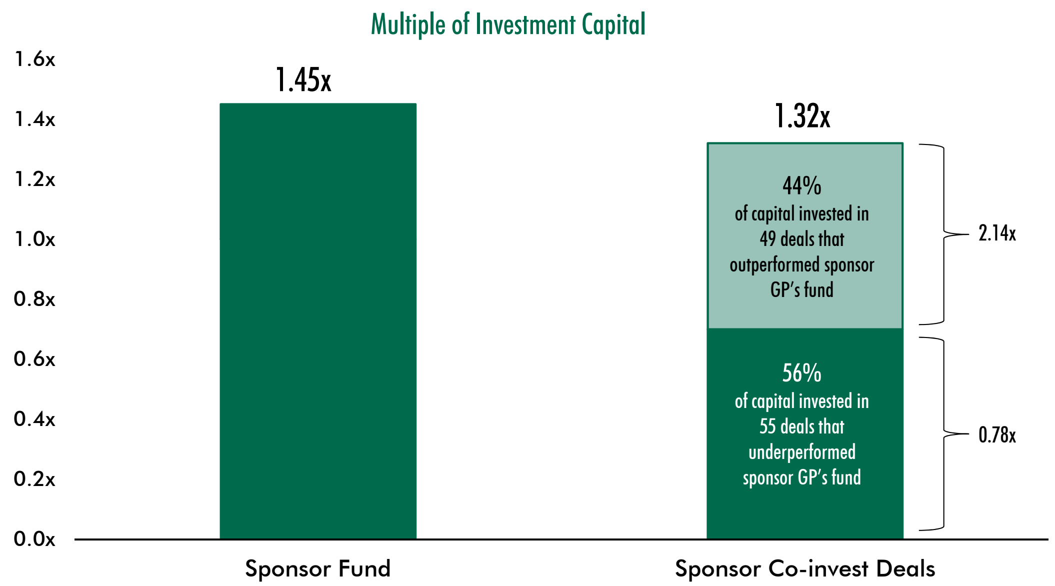
Source: Preqin - Funds larger then $100 million in committed capital

[5] Global Private Equity Report 2020 – Bain & Company

INDEXING CO-INVESTMENT PORTFOLIOS?

While co-investment through economic downturns has demonstrated outperformance, LPs should be wary of "indexing" co-investments and accepting every investment their GPs show them as a means of reducing fee drag. When reviewing co-investment performance relative to sponsor performance through the last two recessions and subsequent recoveries, **Figure 14** shows that only 44% of co-investments outperformed their sponsor funds.[6] As a result, LPs looking to co-invest must do so prudently and adopt a highly selective approach to determine which transactions they choose to participate in.

FIGURE 14: Co-Investment Performance vs. Sponsor GP's Fund Performance



Source: Cambridge Associates - Funds larger then $100 million in committed capital

CONCLUSION

Deploying capital to buyout and distressed private equity strategies through periods of economic uncertainty has proven to generate meaningful returns to forward-thinking investors. Private equity performance after economic disruptions is often enhanced through asset repricing and manager skill. As a result, buyout and distressed private equity strategies have generated some of their best performance through these periods.

The leadup to this market environment was a record amount of transaction activity, asset pricing, and leverage. CBRE Global Investor's macro-economic team has forecast that the global economy is going to experience a sharp economic contraction and slow recovery. Such an environment is expected to generate meaningful deal flow and enable skilled investors to source unique investment opportunities, as seen in prior recessions.

Given the size of the private equity manager universe, the challenge for most LPs is identifying and building relationships with the appropriate managers. Manager selection is critical as top-performing managers significantly outperform their respective peers and produce objectively higher returns on an absolute basis. Importantly, given their strong performance, most top-performing GPs have loyal LP bases making it difficult for new LPs to build relationships with managers.

In addition to selecting the right GPs, co-investing alongside them can further enhance an investor's return and deepen relationships. An investor's ability to be flexible and co-sponsor, co-underwrite, or complete post-close syndications provides strategic value that relatively few LPs can offer today and enhances their relative importance to GPs. In addition to being a value-add partner, this flexibility increases an investor's opportunity set and provides a greater selection when deploying capital, thus improving the likelihood of generating attractive returns. Overall, being more selective, rather than indexing co-investments, can lead to alpha generation.

History has shown that while the current economic situation is unprecedented, sophisticated investors who deploy capital prudently through this period are more likely to generate significant outperformance over the long-term.

[6] Source: Cambridge Associates

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