Good times or bad times ahead for Private Equity?

By Adela BAHO, Head of Risk Management AIFM, Intertrust Fund Management (Luxembourg) S.à r.l.

Since 2015 the amount of bonds trading with negative yields has increased from $2tn in 2014 to ca. $16tn in Q2 2019, according to IMF and Bloomberg data. This translates into governments being paid to borrow money. At the same time, the whole yield curve is covered by issuances such as in the German market, be it Bund or covered bonds at the extreme right end of the curve. The yield curve has inverted for the first time since the Global Financial Crises (GFC), raising the odds of a recession in western economies.

Record highs are reached for buyout deals, private debt backed deals, infrastructure deals and the dry powder (i.e. the amount of committed for investments) has reached its highest level since 2000. What is more striking is not only the high record level reached, but more importantly the pace at which this is happening, indicating a buoyant fundraising activity.

According to Preqin data on European Private Equity and Venture Capital for the European Market, it took 9 years from 2006 to 2015 for the dry powder level to double, with highest acceleration during the GFC period from 2008 to 2012. However, it took half that time for the dry powder to double again from 2015 and reach a pile of ca. EUR 600bn today.

What is the corollary for PE funds?

The current status of economic cycle coupled with the procyclicality feature of the investments in private equity increases the asset class' challenge to continue to provide a high level of returns. According to Preqin data, the median returns (measured by the internal rate of return (IRR)) has decreased following a drop in positive cashflows back to investors or LPs.

This holds true as well in terms of fundraising or so-called "PE activity" due to the existence of a strong relationship between fundraising and economic growth. These findings are supported not only by academia showing that investment activity and leverage levels are inversely related to credit spreads, but also by market activity. In that regard, investors were surprised by the latest decisions by two big asset managers to increase their exposure to PE investments by launching a "perpetual fund" and a multibillion open-ended fund, according to Financial Times, with the aim of reducing the level of leverage of highly indebted companies and de-risk the investments, and still be in a high-margin business. Another market observation is what is called in macroeconomics the "crowding-out effect" which describes the phenomenon of public equity market shrinking in the last 20 years in favour of debt and PE. Yet the academic findings covering the period from 2000 to 2018 show that 1- buyout and venture capital exceed S&P returns gross of fees 2- PE as an asset class has outperformed its benchmark, the public equity markets, over the same period.

Even though the benchmark bias is well known in the relative performance calculation exercise, by both academia and practitioners, it has been demonstrated (via various statistical methods and control variables transformations) that, in general, a strong equity market translates into a healthy PE market via, amongst others, favourable conditions for public equity offerings and M&A activity. However, attention shall be paid to, and distinctions should be made for the performance calculated during up and down equity markets and the associated PE activity sensitivity to those states of nature.

What about the sensitivity of the PE activity to the current level of interest rates and to the yield curve inversion known as "conundrum"?

Though subject to economic debate about the forecasting power of the slope of the curve of economic conditions, we have seen the latest move and commitment from the central bankers to accommodate the monetary policy via rate cuts and balance sheet expansion, and thus already positioning themselves "ahead of the curve" against a downturn on GDP growth or lower realised inflation. Referring to stylised facts, the high acceleration of dry powder amounts since 2015 coincides exactly with the highest pace of acceleration for the negative yield debt issuance to reach ca. $16tn coupled with gradual inversion of the yield curve. What's more, the latest issuances in the German covered bond market and other negative bearing interest debt issuances in western countries are indicating that investors could absorb even more debt and the negative yield environment to persist. It is also worth noting that, according to IMF, the borrowing costs are the lowest since 1975.

Is this a benign environment for PE activity to continue to thrive?

Our sensitivity analysis shows that this is good news for the PE activity in general, though more statistically significant for buyout than for venture capital funds. The performance of the former is significantly correlated to the yield level and that of the latter to the business cycles (with a 1-year lag).

Certainly, we are heading towards untested territory for alternative illiquid assets under the rationale of chasing yields with lower safety nets in terms scarcity of "heaven assets" in a subdued global economy. Under the assumption that central bankers are correct about their move and expectations, we would then expect a continuity of the buoyant activity for buyout funds and a slow-down of activity for venture funds.