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Private equity cha-cha

Evan Lorenz writes:

"One of the questions that we always get asked is, 'When is the party going to end?'" Orlando Bravo, co-founder, managing partner and one-half of the nameplate of Thoma Bravo, told the *Financial Times* in December. The problem with that analogy, the private equity titan continued, is that a party has a "finite end."

Now in progress is a reappraisal of Partners Group Holding, A.G. in the context of today's scalding-hot private equity market. In preview, we're bearish—still—on Partners (PGHN in Switzerland; *Grant's*, July 10, 2020). As to private equity, we say that its cyclical moment is past.

The facts on the ground, and the perception of those facts by the well-satisfied onlookers, remind us of another *FT* interview. "When the music stops in terms of liquidity, things will be complicated," former Citigroup, Inc. CEO Charles Prince was famously quoted as saying in July 2007. "But as long as the music is playing, you've got to get up and dance. We're still dancing." Prince's former employer received the biggest bailout of the bust, $476.2 billion, including asset guarantees.

To be sure, private equity isn't going away any more than value investing did after its long bout of underperformance. But parties do end, and those of the Wall Street variety stop when you least expect them to. For ourselves, noting flyaway valuations and the resurgent cost of leverage, we sense a hangover in the making.

For private equity, last year was a rager on almost every count. "The $1.1 trillion in buyouts doubled 2020's total of $577 billion and shattered the old record of $804 billion set back in 2006 during the exuberant run-up to the global financial crisis," notes Bain & Co.'s 2022 Global Private Equity Report. "North America led the surge with $537 billion in deals transacted and, on its own, matched the global total of a year ago."

Private equity last year set records on the sell side as well as the buy side. It exited, or listed, $957 billion's worth of investments, almost double the $460 billion haul in 2020 and besting the prior record of $521 billion set in 2014.

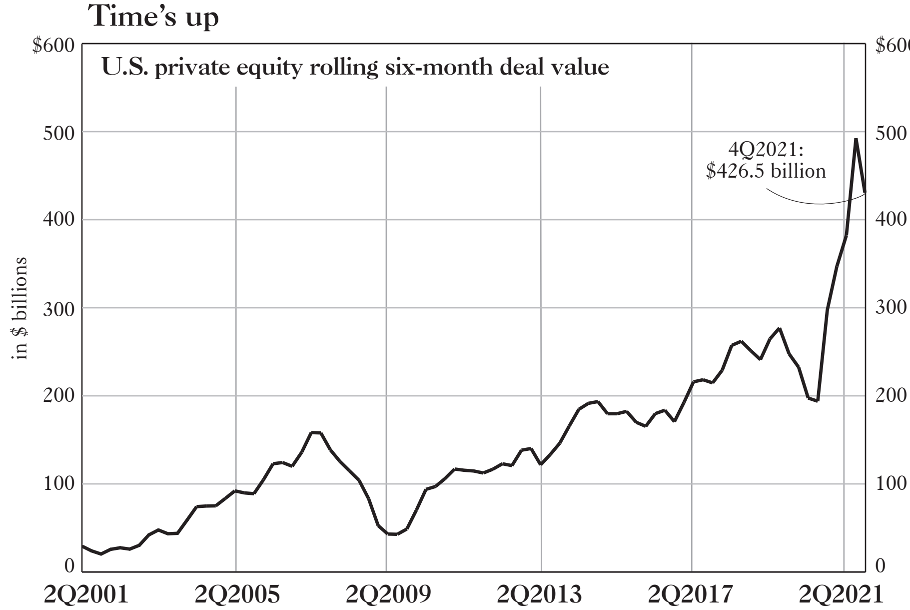
There's more than one way to skin an LBO, of course, and American managers in 2021 extracted $34.9 billion in dividends from LBOs funded by leveraged loans. The prior record, of $29.9 billion, dates from 2013.

Fundraising last year fell a little short of record-breaking, a mere $455.7 billion according to PitchBook, but so-called dry powder, i.e., committed but undrawn funds, summed to $1.38 trillion, little changed from the 2020 peak.

Across the broad realm of private debt, infrastructure, venture capital and p.e., investors could hardly believe their eyes. Polled by data-compiler Preqin Ltd., some 90% of respondents said that performance in 2021 had met or exceeded their expectations, compared with a 72% customer satisfaction rating in the hedge fund world.

The most coveted source of income

Time's up



source: PitchBook

in publicly traded p.e. shops are recurrent management fees on AUM. Performance fees generated by exits, though not unwelcome, are a choppier, and therefore less desirable, revenue source.

And so, to maximize their share price, some p.e. managers are promising to pay out more fee-derived income and retain more performance income. KKR & Co., Inc. and Apollo Global Management, Inc. are in the vanguard of this movement.

Then, again, many a high-flying tech company paid employees in stock (while adding back share-based compensation to adjusted earnings) while share prices sizzled. The subsequent cooling has forced a reconsideration, and firms like Zoom Video Communications, Inc. and DocuSign, Inc. are boosting cash bonuses or modifying the value of restricted stock units to appease shell-shocked employees. Time will tell if the new private-equity payout distribution model can survive a bear market.

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Partners Group may be the biggest private equity manager that you've never heard of. Founded in 1996 by a trio of Goldman Sachs Group, Inc. alumni in Baar, Switzerland, it initially invested in other p.e. funds rather than buying businesses for its own account. That approach has changed over the intervening 26 years, and direct investments accounted for 57% of AUM as of Dec. 31, 2021.

Last year, assets under Partners' management expanded by 16.5% to $127 billion. Compared with U.S. private-manager whales like Blackstone, Inc. ($880.9 billion in AUM) and Carlyle Group, Inc. ($301 billion), Partners is a mere sardine, but it's bigger than most of its continental peers, including, barely, Ardian ($125 billion; formerly AXA Private Equity). While buyouts remain the investment manager's focus at 49% of AUM, Partners also dabbles in private debt (22% of assets), private infrastructure (15%) and private real estate (14%).

Spreading its bets, Partners raises lots of small funds rather than a few big ones. It homes in on small and medium-sized companies rather than on mega-buyouts. "From an investment perspective, we are diversified across more than 90 sectors," CEO David Layton told his audience on a March 22 call. "This means we're less likely to run into material issues with supply-chain disruption or sector-specific volatility."

Partners laid out the bull case for both itself and the p.e. industry on its fourth-quarter earnings call. Thus, private markets are becoming "the new 'traditional' asset class" while public markets are "dominated by 'hype' assets," e.g., speculative growth stories and profitless technology firms.

Total private market assets have tripled every decade since the turn of the century, said Partners: to $3 trillion in 2010 from $1 trillion in 2000, and again to $10 trillion in 2020. The firm reckons that the trend will continue and that total private investments will sum to $30 trillion by 2030.

Partners Group Holding, A.G. at a glance
all figures in CHF millions except per share and AUM data

	2021	2020	2019	2018	2017
revenue	CHF2,589.9	CHF1,382.1	CHF1,546.9	CHF1,280.2	CHF1,214.0
operating income	1,650.4	913.8	1,007.6	881.6	811.4
net income	1,463.6	804.8	899.9	769.3	752.3
earnings per share	55.12	30.36	33.66	28.65	28.09
shares	26.0	26.3	26.7	26.8	26.5
assets under mgmt.($ bns)	127	109	94	83	74
cash	910.7	1,227.6	933.0	412.2	852.3
debt	799.1	798.9	798.6	299.4	299.2
total assets	4,832.8	4,032.0	3,949.7	2,949.1	2,932.7

source: company reports

In fact, Partners reckons, the private markets have provided more capital than public equity issuance in every year since 2016 (excluding preferred shares, closed-end funds, business-development companies and SPACs).

Not to be outdone, Preqin predicts that the p.e. component of private investments will grow at a compound annual rate of 15.9% over the next five years, well above the 10.2% rate posted between 2010 and 2020.

You wonder what Partners can do for an encore. Last year, its revenue bounded by 87.4% on the back of a 24.9% rise in management fees and a 349.2% explosion in performance fees; earnings per share leapt by 81.6%. As a percentage of overall revenue, performance fees rose to 46% from 19% in 2020. Longer-term, management expects performance revenue to make up between 20% and 30% of the top line; it calls that income source "quasi-recurring."

Notably for this purveyor of leverage, Partners, at year end, showed more cash and equivalents of CHF 910.7 million ($982.5 million) than debt of CHF 799.1 million.

Of the 16 analysts who follow the company, 10 say buy and none says sell. The stock trades at 26.4 times estimated 2022 earnings, a premium to the 17.2 times average forward multiple assigned to Blackstone, KKR and Apollo. Since we had our bearish say in the summer of 2020, the Partners share price has appreciated by 33.6% in dollar terms versus a 49.1% rise in the S&P 500 (both including reinvested dividends).

Over the past 12 months, insiders have sold 31,747 shares for proceeds of CHF 45.3 million while not one insider has bought.

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That the private investment markets have supplanted the public ones is a contention on which the jury is still out (Mr. Market, the foreman, won't be rushed). Easy money and a voracious hunger for yield are the not-so-silent partners in p.e.'s brilliant run over the past decade, and they may have also stymied the public markets while they were at it. After all, why go through the hassle of quarterly reporting when the Partners of the world are willing to pay a higher price than the IPO market will?

With that said, p.e. is no less susceptible to the urge to chase the asset du jour than public investment managers are. Last year, tech deals accounted for 25% of buyout value.

The 2021 deal bonanza itself presents problems for the p.e. fan base. In the three years prior to Covid, Partners sold or listed 17% of the assets with which it began the year. In the plague year of 2020, that figure fell to 13%—and in the recovery year of 2021, it zoomed to 27%.

A repeat of last year's cornucopia seems unlikely this year, and it's a fair guess that it borrowed heavily from the future. Even successful buyouts need time to earn themselves a prime valuation.

Indeed, Hans Ploos van Amstel, the chief financial officer of Partners, sounded a cautious note on the March 22 earnings call: "First, we had the benefit of catch-up activity following the Covid year 2020. Second, we had the benefit of some select portfolio realizations which were originally planned in 2022, which we brought forward to 2021 as we were already delivering on our value-creation targets."

Partners earns performance fees of 5% to 10% on debt funds. It earns 10% on secondary transactions (buying limited partners' stakes in other p.e. funds) and between 15% and 20% on direct equity investments.

Management recognizes performance fees in the profit-and-loss statement but fails to distinguish between realized and unrealized gains. Peruse the footnotes, however, and you'll notice that accrued-fee revenue jumped by CHF 304.3 million last year, a sum equal to 18.4% of operating income. Unrealized gains are, of course, noncash, and therefore contingent; you need an accommodating market to turn a mark into money. Just as worrying, long-term accrued revenues, i.e., sums that management does not expect to collect in the next 12 months, accounted for CHF 176.5 million of that CHF 304.3 million surge.

And while Partners sports a 2.9% dividend yield, internally generated cash funds don't fund it all. Last year, cash from operations weighed in at CHF 701.8 million, dividend payments at CHF 724.6 million.

Whether multiple expansions will continue to fill the sails of the private equity promoters depends on the fates. According to CEPRES Market Intelligence, rising valuations accounted for 48% of industry-wide p.e. returns between 2010 and 2015 and for 56% of such returns between 2016 and 2021.

From their respective peaks, the S&P 500 has declined by 3.4% and the Renaissance IPO Index, which tracks recent listings, by 39.1%. Since the start of the year, the yield on sub-investment-grade bonds has shot higher by 165 basis points, to 6%, while the price of an average leveraged loan, as measured by the S&P/LSTA Index, has dropped to 97.35 from 98.64 (with a pit stop at 95.88 on March 15). Oxford Lane Capital Corp. and Eagle Point Credit Co., Inc., a pair of publicly traded closed-end funds that invest in collateralized loan obligations, have fallen by 16.7% and 15.3%, respectively, from their highs late last year.

Such facts do not enhance the standard private equity story line. Nor does it prettify the bull-market slide decks that the industry is sitting on investments made at record-high valuations. Bain Capital finds that multiples in "take private" deals in 2021 averaged 19.3 times enterprise value, or 1.6 times the market average, versus 12.6 times, or 1.3 times the market average, in 2007.

If those valuations look high, it's because they pertain only to public-company buyouts rather than to the composite-buyout universe—not just to public companies but also to private ones and to companies purchased from other p.e. managers. The source of the disparity, private versus public, is accounting style. Regulated, investor-owned businesses take fewer liberties with "adjusted" and "pro forma" numbers than their private counterparts do. The upshot is that public-market data look considerably bubblier than private-market data. You pays your money and takes your choice, as the man said.

Accounting conventions serve, too, to understate financial leverage. According to PitchBook data, the median American buyout carried debt equal to 5.8 times Ebitda last year. But this figure, which encompasses all sectors of the buyout world, includes "add-backs," the often fanciful assumptions concerning post-deal efficiencies, the effect of which is to inflate projected Ebitda and therefore suppress projected leverage. The next recession will provide a truer picture of LBO financial strength.

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From Washington, D.C. comes yet another source of pressure on highly leveraged companies. As it is, the Tax Cuts and Jobs Act of 2017 restricts the deduction of interest expense to 30% of Ebitda. Multiply that leverage ratio of 5.8 times by a 6% junk bond yield, and you see that interest expense consumes 35% of Ebitda.

It started to take a bigger bite on Jan. 1, 2022, with the law capping the deduction at 30% of Ebit, rather than Ebitda. (The loss of the "d" and the "a" means that depreciation and amortization expense have vanished from the Ebitda tax shield.) Swiss-headquartered Partners buys enough American assets—about half of its annual purchases since 2019—to share the incremental pain.

Highly leveraged companies do best with low economic volatility. As it goes without saying, high economic volatility is rather the state of things today, what with two years of supply-chain bottlenecks, a decade of underinvestment in energy resources, growing trade embargoes and percolating inflation.

With the p.e. industry sitting on $1.38 trillion's worth of dry powder, one might suppose that a bear market would be just what the company buyers are rooting for. But buying at the bottom with carefully husbanded cash is rarely how things play out. It's unusual enough to find an investor with the cash and courage to pull the trigger. It's no easier to find a would-be owner who's eager to sell.

To pay for the odd company that does come up for sale at a bargain-basement price, a p.e. firm issues a capital call. However, knowing that its limited partners are nursing losses on their existing investments, the firm may choose to remain silent. Or it may issue a call, only to discover that the limiteds are having the dickens of a time locating their check-writing pens. Besides, firms that can borrow easily during bull markets may struggle to find lenders during selloffs. Access to debt is procyclical.

So it is that deal activity falls apart just when it ought to be heating up.

According to PitchBook, U.S. buyout activity peaked at $158.3 billion in the first half of 2007. On Nov. 25, 2008, the Federal Reserve announced its first quantitative-easing program. Early the next year, on Feb. 17, former President Barack Obama signed a $787 billion stimulus act and, shortly thereafter, on March 9, the S&P 500 bottomed. Yet American buyouts collapsed to $48.8 billion in the second half of 2009 and didn't beat the 2007 record until the six months ended March 31, 2014.

There's a time for everything. Maybe, for this cycle, the time for Partners has passed.

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