Opinion

Chris Bryant, Columnist

Private Equity's Bubble Vintage May Fizzle

It matters not just what you buy but when you buy it, and 2021 wasn't a great moment to deploy capital.

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By **Chris Bryant**

Chris Bryant is a Bloomberg Opinion columnist covering industrial companies in Europe. Previously, he was a reporter for the Financial Times.

Private equity firms that spent hundreds of billions of dollars on acquisitions at the top of the market risk a nasty hangover.

A combination of higher interest rates and lower valuations could lead to disappointing returns for deals struck in the frothy mid-2020 to early 2022 period, after which borrowing costs rose sharply. In industry parlance, it's shaping up to be a disappointing "vintage."

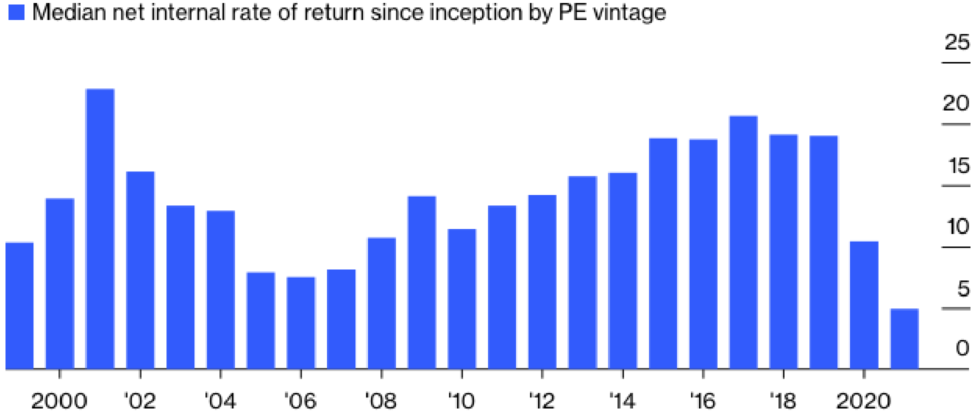
While another bull market or interest-rate cuts could spare PE firms' blushes, the onus is on them to deliver operational improvements rather than relying on rising valuations to generate profit for their investors. They won't all pass the test.

Investors need to pay attention not just to *what* sponsors buy but *when* they put money to work. Some of the industry's best returns came during or following recessions, as starting valuations were lower and there was less competition to acquire assets.

By contrast, returns from deals immediately preceding the 2008 economic crisis were relatively poor because purchase prices were economic crisis were relatively poor because purchase prices were stretched and holding periods increased. (This variation is why private equity investors are well advised to diversify across vintages.)

Varying Vintages

2005-2006 wasn't a great time for private equity firms to deploy capital; 2021 might turn out much the same



Source: Bloomberg PEBM function
Note: IRRs from very recent vintages aren't considered that meaningful

PE funds often generate low or negative returns early in their roughly 10-year lifespan, so one shouldn't read too much into the 2021 vintage's current lackluster performance – the internal rate of return is just 4.9%, according to data compiled by Bloomberg.

Nevertheless, Bloomberg Intelligence analysts Paul Gulberg and Ethan Kaye predict PE returns will diverge by vintage with those that deployed capital just prior to 2022 potentially most challenged.

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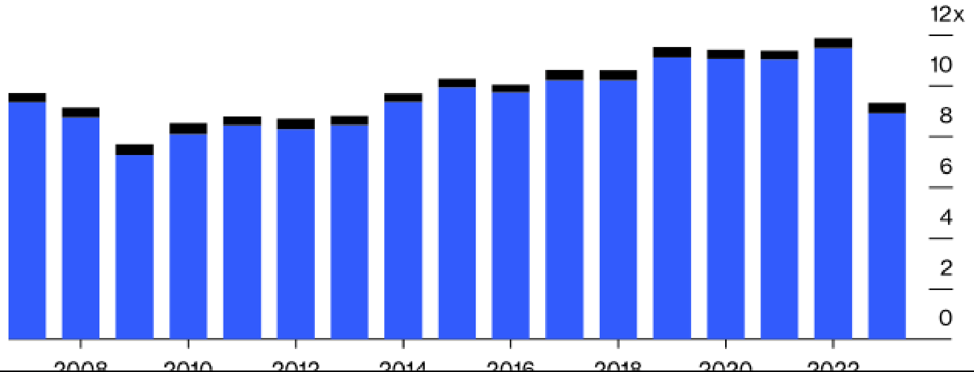
“This environment is a trickier one for some of the embedded equity that got put in the ground, particularly in private equity from call it 2019 to 2022, where prices were much higher, rates were much lower, and expectations for growth were there,” Kipp deVeer, Ares Capital Corp. chief executive officer, told analysts last month. “A lot of those things have changed, right?”

Right. Consider valuations: Average purchase prices – expressed as a multiple of earnings before interest, tax, depreciation and amortization – were about 40% higher in 2022 compared with 2010.

Stretched Buyouts

US LBO valuations jumped more than 40% between 2010 and 2022

Purchase price multiple Fees/Expenses



Source: Pitchbook
Note: multiple is total sources divided by pro forma trailing ebitda. Data are full year totals, except 2023 which shows the third-quarter and therefore includes a comparatively small number of deals.

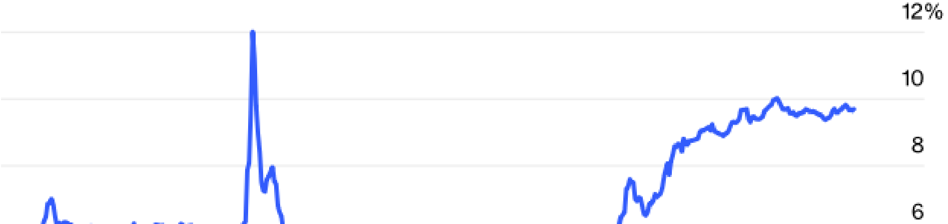
This was great for older PE vintages that exited investments at high prices but bodes ill for for new funds that were required to write larger equity checks. Around half of the value creation by PE firms since 2010 has come from higher earnings multiples, according to consultancy Bain & Co., so the recent contraction in valuations isn't a good start. [1]

Plunging borrowing costs in 2021 triggered a surge in deal making, with sponsors increasingly turning to private credit to fund large transactions and using projections of recurring revenue rather than earnings (because targets had little or none of the latter). The cost of servicing floating-rate borrowing has since more than doubled, and most sponsors didn't hedge this exposure.

Buyout Loan Blues

Borrowing costs for private equity firms looking to do deals plunged in 2021. The respite didn't last

Morningstar LSTA US Leveraged Loan 100 Index weighted average yield



Buyout Loan Blues

Borrowing costs for private equity firms looking to do deals plunged in 2021. The respite didn't last

Source: Bloomberg

It's not the only way PE firms may have overestimated the ability of portfolio companies to support high debts: Flattering adjustments to earnings – so-called add-backs – also became much more prevalent in this period. [2]

Private credit loans originated in 2021 will likely perform worst, rating company Moody's Corp. warned in June, noting these were underwritten "when there was rising optimism around operating performance and higher tolerance for weaker creditor protections, including covenants."

LBO Leverage

PE firms piled on more debt as deal costs ballooned but leverage has declined now that interest costs have risen

Total debt/ebitda

LBO Leverage

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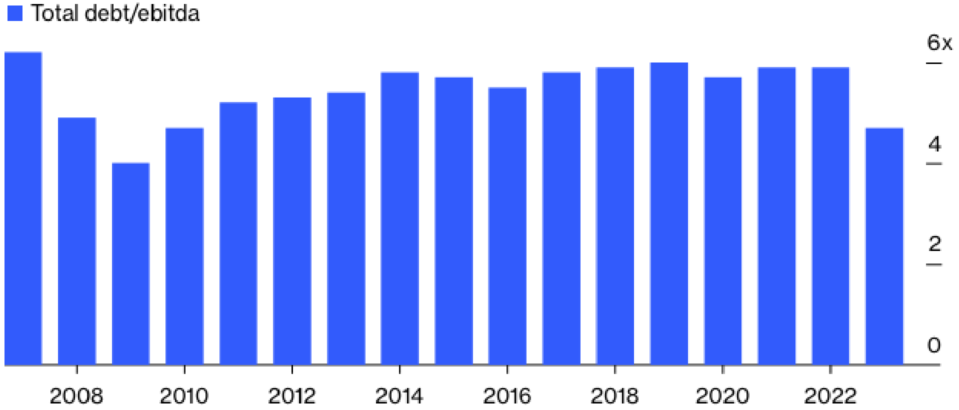

Source: Pitchbook
Note: shows issuers with more than $50 million of ebitda, which is adjusted for prospective cost savings or synergies. Full year except 2023, which shows Q3.

Borrowings from this PE vintage generally don't require refinancing yet, providing some breathing space. But if interest rates remain higher for longer and valuations stay compressed, PE owners may have to inject more equity, lowering their returns.

Typically, private equity funds spread their investments over four or five years, reducing the risk of buying only when prices are high. But some of that conservatism was jettisoned in 2021; for example, when software-focused PE firm Thoma Bravo LLC spent almost all the $23 billion it had raised from investors in just 14 months. The firm declined to comment, but its co-founder, Orlando Bravo, said at a Financial Times conference last month that "the time to buy the right company that fits your strategy is when you can."

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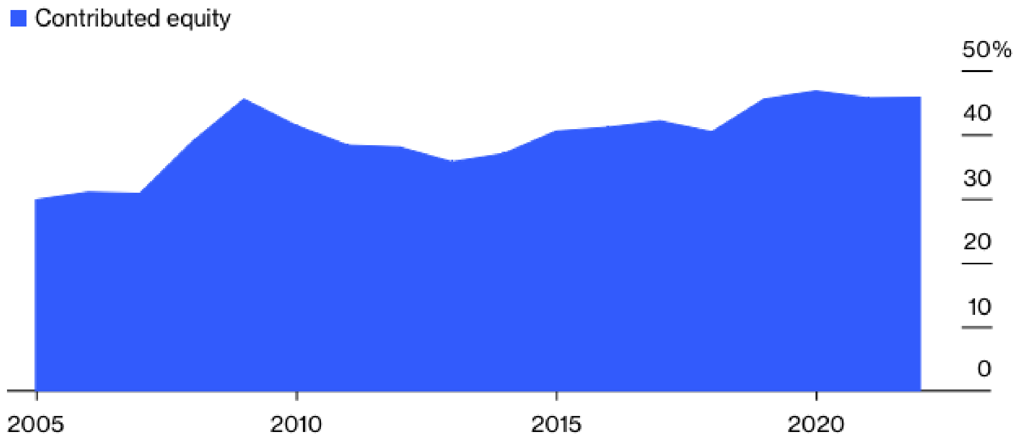
“When things are very frothy, when the markets are ripping, people tend to be pro cyclical and over-invest capital at the top of the market,” Joseph Bae, co-chief executive officer of KKR & Co., told investors last year, adding his firm was more measured in its approach.

More Equity in Leveraged Buyouts

Equity checks for LBOs have increased to more than 45% of total financing with the rise of software LBOs contributing to this trend



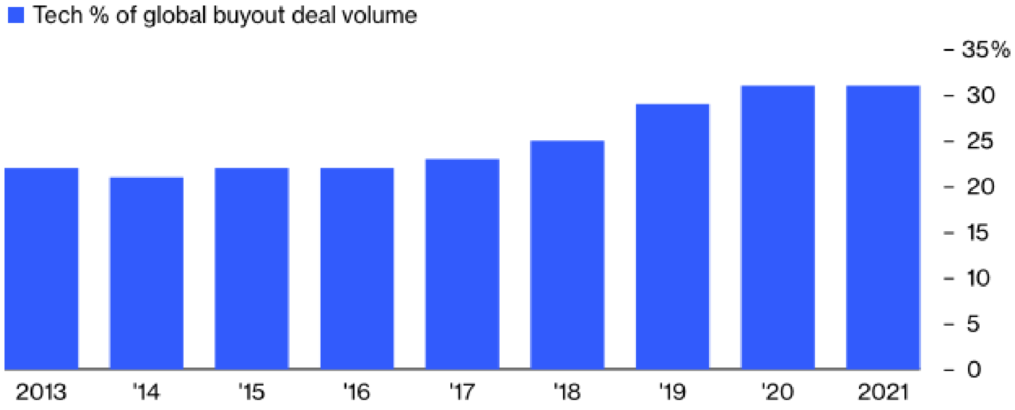
Source: American Investment Council
Note: contributed equity is equity provided by LBO sponsors. Does not include rollover equity.

Buyout volume in this period was dominated by a couple of sectors – technology and health care – whose revenue and pricing power were expected to remain “sticky” even if the economy slowed. (Companies are reluctant to switch software providers due to the costs and inconvenience, for instance).

However, cracks have started to emerge. US health care has been hit by a combination of wage inflation and insurer reimbursement difficulties, and several PE-owned companies have filed for bankruptcy this year, including KKR's Envision Healthcare Corp. PE-backed software firms may be vulnerable if revenue doesn't grow or they don't control costs sufficiently. Fintech Finastra Group Holdings Ltd.'s $5.3 billion debt refinancing this summer was complicated by its stalling sales, forcing owner Vista Equity Partners LLC to inject an extra $1 billion.

PE Is All About Tech Now

Almost one third of buyout deals in 2021 were in technology



Source: Bain
Note: includes add-ons

Of course, it's too soon to give up on PE's bubble vintage. The stock market's recent blistering rally and high valuations awarded to profitable tech companies are encouraging. In June, Thoma Bravo profitable tech companies are encouraging. In June, Thoma Bravo agreed to sell a financial software investment, Adenza Group Inc., to Nasdaq Inc. for $10.5 billion, roughly doubling its money in fewer than three years. (Nasdaq's shares fell after the deal was announced due to concerns that the exchange overpaid.)

Plus, as Dan Aylott, head of European private investments at Cambridge Associates, told me, funds that still have dry powder "should be able to spend it now in a more favorable valuation environment."

The current drought in PE exit sales shows sponsors aren't yet ready to lower their price expectations or accept that rates will remain higher for longer. However, following a decade of stellar PE returns, investors should be prepared for a poor vintage.