



PRIVATE MARKETS FOCUS

Quarterly edition Q3 20



THIS TIME IS DIFFERENT

**WHY THIS CYCLE WILL BE UNUSUAL
AND WHAT TO DO ABOUT IT**

By Reji Vettasseri

THE CAUSE: A LIQUIDITY SQUEEZE- pg. 2

- The crisis has seen a collapse in corporate cash flow but not a valuation crash
- Opportunistic credit may have more potential than trying to find undervalued equity

THE RESPONSE: UNPRECEDENTED STIMULUS - pg. 3

- QE has hammered yields and long-term return expectations for many asset classes
- The potential for private markets to deliver "alpha" has never been more valuable

THE EFFECT: ASYMMETRIC IMPACT - pg. 4

- Varied effects by industry: long term threat, short-term stress or new opportunity?
- Diversification has become more important, but so has specialist expertise

This Time is Different

Why This Cycle Will Be Unusual And What To Do About It

Adapting to an Unusual Cycle

At the start of 2020, many believed the long bull run would continue to propel markets to new heights. Others warned that a recession could be just around the corner. Almost no one predicted the remarkable reality of what actually happened – both at the same time. The words “this time is different” can be dangerous. They are sometimes used to justify indiscriminate risk taking at the peak of the market. However, today, the real risk of hubris may be from the opposite direction - a failure to adapt to the unique features of a clearly unusual cycle.

In our last article (*Seeking Outperformance in the Covid-19 Storm*), we looked at how and why private markets funds have a strong tendency to outperform in crisis-era vintages. In this note, we will focus on how investors looking to take advantage of that time-worn pattern should also be aware of several ways in which this crisis is different:

- o its unusual **cause**, a collapse in earnings rather than a market crash, means there is more potential in opportunistic financing than seeking cheap valuations;
- o an unprecedented central bank **response** has pushed down yields and long-term return expectations, creating more need for “alpha-generating” strategies; and
- o the asymmetric **impact** on the economy calls for more thoughtful diversification.

The Cause: A Liquidity Squeeze

A typical cyclical downturn starts within financial markets (with an asset price bubble that pops or a spate of defaults) and then goes on to infect the real economy. Overvaluation is the root cause, and as prices reset, private equity normally finds opportunities to acquire attractive assets cheaply amidst the turmoil.

In contrast, coronavirus provided a shock to the real economy and effects on markets are second order. The key feature has been a sudden fall in earnings putting companies and individuals through a liquidity squeeze. Here the biggest opportunity should be providing financing solutions, especially credit, to strong counterparties with unexpected needs.

We have highlighted this point in previous notes, but as the pandemic has progressed, its importance has become increasingly clear. Normally even in a crisis defined by a liquidity squeeze, valuations are hit as a knock-on effect. This time, the correction lasted a matter of weeks – too short for PE deal-making. However, the jump in demand for many types of credit looks very real.

PE: Valuations High, Activity Down

There has been little sign of “fear” replacing “greed” in investor psychology in public or private markets. As stock indices

Unusual Features of the Covid-19 Crisis and Their Implications for Investors

The Cause	The Response	The Impact
A liquidity squeeze after a collapse in income/output (not a valuation crash)	Unprecedented monetary stimulus	Asymmetric economic impact sector by sector
Interesting opportunistic credit deals ; few cheap equity deals	Need for differentiated strategies to avoid yield/return compression	Importance of intelligent diversification without losing specialisation

Please see appendix at the end of this document for information on sources, important disclosures and disclaimers

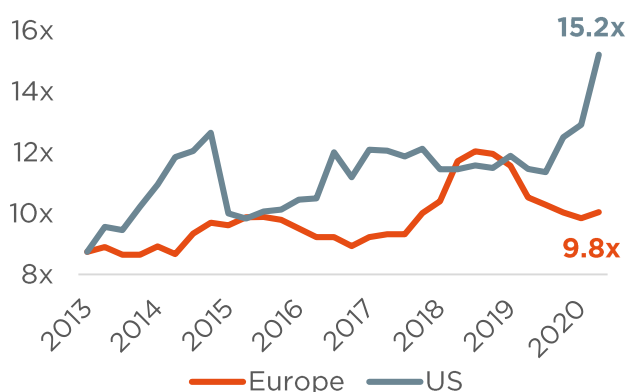
This Time is Different

Why This Cycle Will Be Unusual And What To Do About It

shot up to peak levels, PE deals continued to see buoyant valuations. The median EV multiple for buyouts in Europe ticked up from 9.8x to 10.0x EBITDA between Q1 and Q2. In the US it leapt two turns to a multi-year high of 15.2x (*Pitchbook*).

These statistics should not be over-interpreted. Volume was down 18% y-o-y in Europe and 58% y-o-y in the US by value in Q2. In a selective environment, average multiples were affected by a flight to quality and a mix shift towards tech and healthcare deals. Market-level data also hides individual deals with opportunistic valuations, especially smaller transactions. PE firms focussed in the right areas have been doing exciting things; but volume is thin and its hard to argue that there are bargains across the board.

Median Rolling Four Quarter EV/EBITDA Buyout Multiples (Q1 13 – Q2 20)

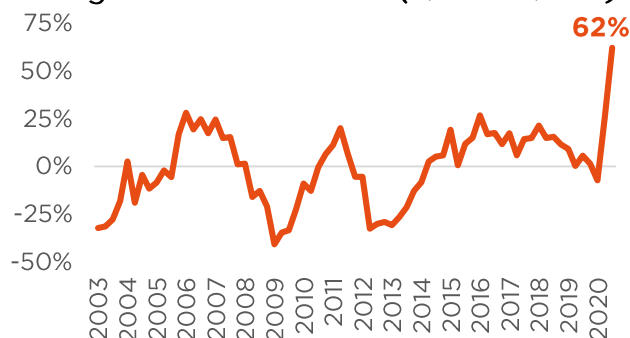


Source: Pitchbook

Private Credit: Surging Demand

Well-positioned private lenders are seeing different dynamics. The ECB's Q2 Bank Lending Survey pointed to a record-breaking increase in credit demand from firms - far above anything seen in the aftermath of Lehman (see chart). Not all credit funds benefitted. Many specialise in acquisition finance with a focus on PE deals, and have seen activity plunge in line with buyout volumes. However, those that provide a broader set of solutions are seeing strong deal flow and this trend may be set to accelerate.

Net Percentage of EZ Banks Seeing Rising Demand for Credit (Q1 13 – Q2 20)



Source: ECB

At the start of the pandemic, governments provided extraordinary liquidity support to businesses in the form of loan guarantees and direct grants estimated to total \$5.4Tr globally (*IMF*). However, the huge cost means many flagship measures will be scaled back in coming months. The fiscal deficit in the Eurozone is forecast by the IMF to be an unsustainable 11.7% in 2020, but shrinking to 5.3% in 2021. Borrowers will soon need to look elsewhere for help.

Without state support, banks may not be able to fill the gap. The ECB Bank Lending Survey showed that banks' risk aversion jumped in H1 but lending standards barely changed due to loan guarantee schemes. As these end, a net 23% of banks now plan to tighten standards in Q3, suggesting a major pullback in credit availability. Rising needs for alternative lending seem clear.

The Response: Unprecedented Stimulus

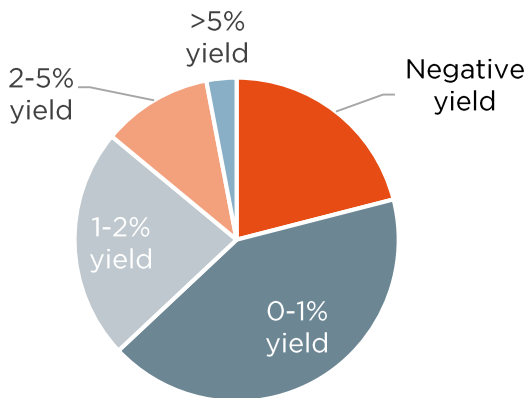
Beyond fiscal steps, unprecedented monetary stimulus has of course been the other key policy response.

Such action has triggered a jump in asset prices. Yet once the rally completes, it may turn out to be a case of "jam today" and no "jam tomorrow", as gains seem to be a direct consequence of a fall in long-term return expectations. This is most visible in fixed income, where 86% of bonds were trading with yields below 2% at the end of June (*ICE*). The point also applies to equity where prices have jumped before earnings.

This Time is Different

Why This Cycle Will Be Unusual And What To Do About It

Share of Global Bond Market by Yield Category (30-06-20)



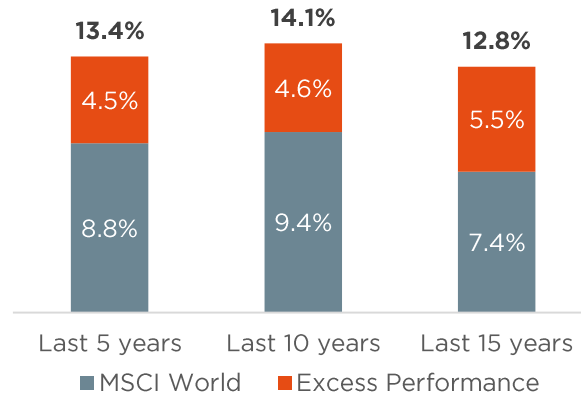
Source: ICE Data Services

Overall, low central bank rates and QE may have reduced long-term returns in liquid markets by a percentage point or two - a significant portion of total return expectations. This makes private markets' potential to outperform conventional asset classes all the more important. Data suggests that PE as a whole has consistently beaten the MSCI World by around 5p.p. over long-term time horizons (see chart below). The excess performance of the best funds has been even higher.

Much of this can be attributed to "alpha" driven by one of two factors: (a) finding off-market deals with limited competition from other sources of capital, or (b) adding value to justify a premium. Private markets will not be immune to the drag from monetary policy. However, in at least some strategies, this could be offset by greater opportunities for "alpha generation".

Increased capital needs and demand for swift solutions in areas like credit and or PE turnaround create increased potential for off-market deals. This is especially the case for smaller cap strategies, serving SMEs with no access to accommodative public market financing. Meanwhile, in a more complex macro-economic environment, it should also be easier to find ways to add value, whether through operational engagement or bespoke deal structuring.

Global Private Equity Net IRR (Excess Performance vs. Public Market Equivalent)



Source: Cambridge Associates

Anecdotally, our conversations with a wide range of private markets investors indicate that a meaningful proportion in areas such as specialised credit plan to increase their return targets for upcoming funds. The confidence of these market participants is supported by promising near-term deal pipelines and stands in marked contrast to the way public bond yields are trending.

The Impact: Asymmetric Effects

A third unique feature of the Covid-19 crisis is the unequal impact sector by sector.

Firms in sectors like bricks and mortar retail and aviation have seen their business models challenged by long-term behavioural shift. Private markets investors can help with operational repositioning and financial restructuring in deep value deals.

Other businesses, for example much of the consumer goods and manufacturing sectors, have seen short term stress but are expecting to bounce back. Here private capital is particularly needed for refinancing to navigate the short term.

There are also some industries, for example healthcare and technology, that serve new needs created by the pandemic. To these, private markets funds offer growth capital and help with operational execution.

This Time is Different

Why This Cycle Will Be Unusual And What To Do About It

This creates what might appear to be a paradox for investors. On the one hand, current events highlight the value of diversification. Going into the crisis, even a seemingly balanced multi-sector portfolio could have been devastated through high exposure to industries impacted by lockdowns. The only way to avoid hidden correlations is even broader diversification.

On the other hand, coming out of the crisis, there is also a greater need for specialisation. Given the varied impact of the crisis on individual sectors, a range of strategies (growth, deep value etc.) as well as deep sector knowledge are needed to successfully build a well-balanced portfolio.

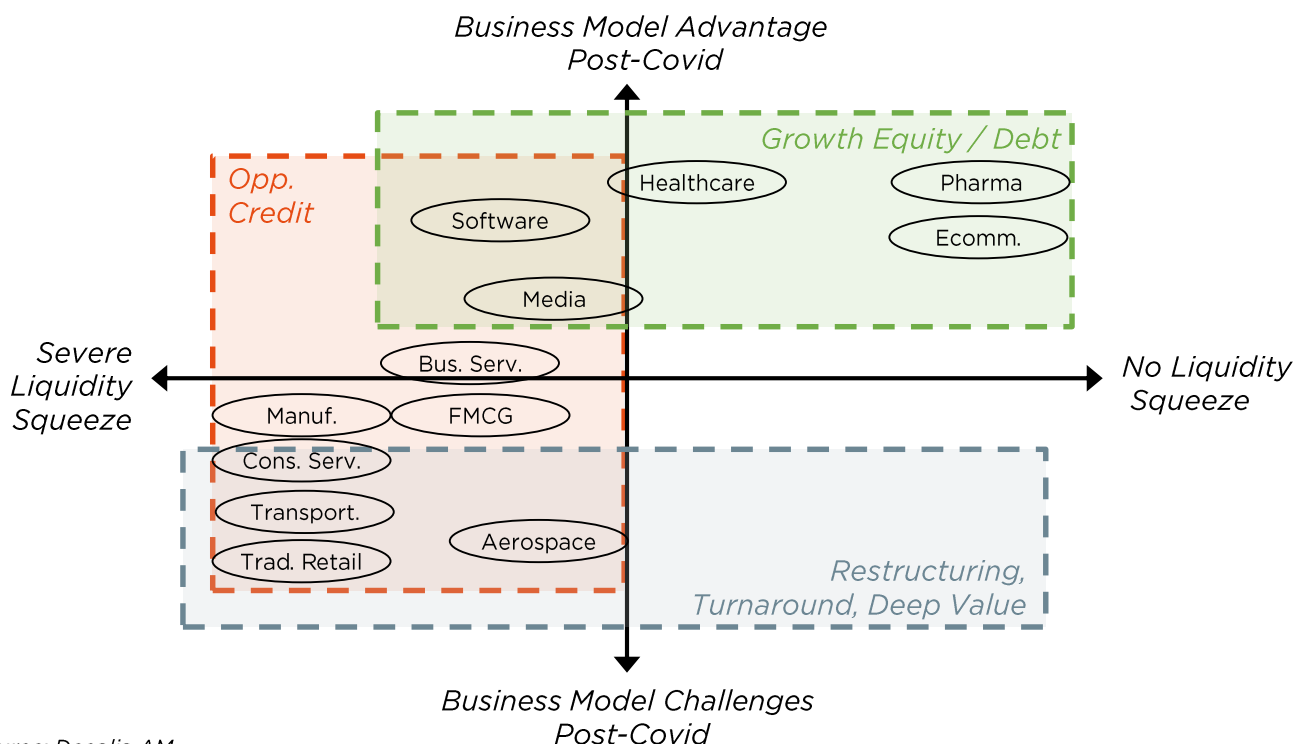
We believe that these considerations support the approach of working with a broad range of specialist investors, each focussed on an attractive market niche, rather than backing generalist approaches.

Conclusion

The phrase “This Time is Different” was made famous by a book with that title by US economists Reinhart and Rogoff. It argued most financial crises were caused by complacent investors who thought that the laws of financial gravity had ceased to apply. Although we have argued that this time really might be “different”, our underlying message is actually the same: to warn of complacency.

Post-Covid dislocations are throwing up many interesting private deals but selection really matters. We think investors need to focus on: (a) opportunities that truly respond to the unique features of this crisis, (b) strategies that have the greatest chance of delivering “alpha” in a world where long-term market returns are subdued, and (c) achieving diversification without losing specialised expertise.

Covid-19 Impact and Advantaged Private Market Strategies by Industry



Source: Decalia AM

Reji Vettasseri is Lead Portfolio Manager for alternative funds and mandates invested in private markets. Reji was previously a portfolio manager at Morgan Stanley Alternative Investment Partners, an executive director at Goldman Sachs Investment Banking and a consultant at Bain & Company. Reji received a B.A. (Hons) in Law and a Master of Laws from the University of Cambridge, and an M.B.A. with Distinction from Harvard Business School.

Copyright © 2020 by Decalia Asset Management SA. All rights reserved. This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Decalia Asset management SA.

This material is intended for informational purposes only and should not be construed as an offer or solicitation for the purchase or sale of any financial instrument, or as a contractual document. The information provided herein is not intended to constitute legal, tax, or accounting advice and may not be suitable for all investors. The market valuations, terms, and calculations contained herein are estimates only and are subject to change without notice. The information provided is believed to be reliable; however Decalia Asset Management SA does not guarantee its completeness or accuracy. Past performance is not an indicator of future results.

External sources include:

- Pitchbook, “Q2 2020 European PE Breakdown” and “Q2 2020 US PE Breakdown”
- ECB, “The Euro Area Bank Lending Survey”
- IMF, “World Economic Outlook Update, June 2020”
- ICE Data Services
- Cambridge Associates, “2020 Q1, Private Equity – Index and Selected Benchmark Statistics”
- Reinhard and Rogoff. “This Time is Different: Eight Centuries of Financial Folly”

All analysis based on latest available data as of August 2020

Front page images from Shutterstock