



Image: Michael Kurtz

SEEKING OUTPERFORMANCE IN THE COVID-19 STORM

**ANALYSING WHY CRISIS-ERA FUNDS DELIVER ENHANCED
RETURNS AND WHERE TO DEPLOY TODAY**

By Reji Vettasseri

ANALYSING PERFORMANCE OVER THE CYCLE – pg. 2

- Strong performance across the cycle, with best returns for funds closed in downturns
- Peak returns for immediate post-crisis funds in credit and a year or two later for PE

WHY DOWNTURN VINTAGES OUTPERFORM – pg. 3

- Dislocation: private markets stay active when other forms of financing pull back
- Innovation: private markets provide sophisticated solutions for new challenges
- Market timing: crisis-era funds invest in downturns and harvest in improved conditions

OPTIMISING POSITIONING AFTER COVID-19 – pg. 3

- Lockdown has created a liquidity crisis and above all a need for new credit solutions
- PE deal flow could take a while to recover, but opportunities already exist in credit

Outperformance in the Storm

Analysing Why Crisis-Era Funds Deliver Enhanced Returns

The Need For Long-Term Mindsets In Private Markets Investing

During confinement in an era of instant information, it is easy to get sucked into watching the incessant flow of tragic news and minute-by-minute progression of horrifying statistics, and fixating on trying to predict exactly when we turn the corner.

For many investments that issue is key. However, private markets are long-term asset classes that require a long-term mindset. Investors in the space are often at their best when navigating dislocated conditions to find unusually attractive deals from early in a downturn. For them, “calling the bottom” exactly may be as unnecessary as it is impracticable. Knowing that we are in a dislocation with potential for opportunistic deals matters more.

This article will explore data from previous cycles to highlight that crisis-era funds tend to outperform – even and especially many that close before macro conditions reach their nadir. It will also set out a framework for optimising positioning in a downturn. Applying it reinforces our view that specialised credit is especially relevant at this point in this particular cycle. It remains actionable even straight after a stress event, and it tackles head-on the key challenge for the post-pandemic economy – an unprecedented liquidity squeeze.

Analysing Performance over the Cycle

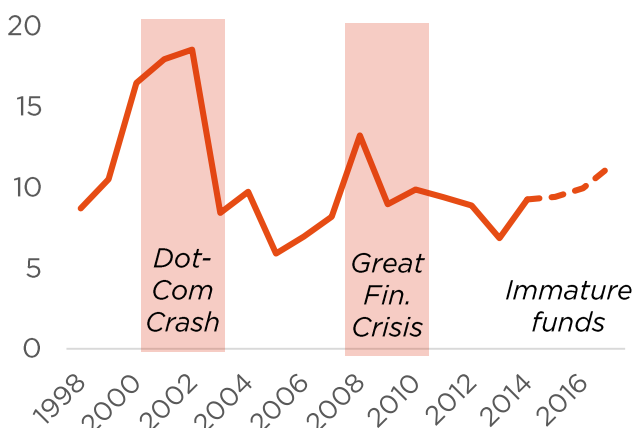
The graphs below show average returns for private credit and private equity funds closed in each year since the late 1990s, based on a data set from Preqin – one of the most comprehensive sources of information on fund performance.

It is first worth noting that overall returns have been consistently good. Perceptions of private markets as risky linger in some quarters, but the reality is that, over two full cycles, even the weakest vintages delivered high single-digit net returns.

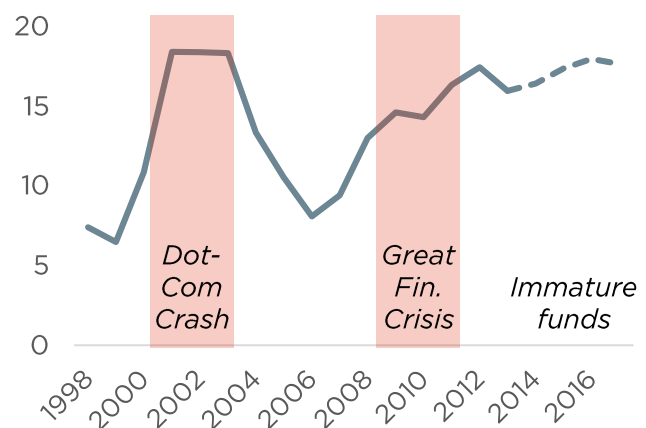
However, the most striking feature of the charts is that the funds that performed best were those closed around the two periods of greatest market turbulence – clearly suggesting that unusually attractive opportunities are available when deploying at the bottom of the cycle (NB: The pattern is even clearer when bearing in mind that recent vintages could see markdowns in upcoming quarters, whereas crisis-era funds are mostly fully realised.)

It is also notable how the best credit returns come immediately after the stress event, but PE peaks a year or two later. This is largely because, in the midst of a crisis, refinancing needs can become acute but PE deal making often takes a pause.

Private Credit Net IRR (%) by Year of Fund Closing



Private Equity Net IRR (%) by Year of Fund Closing



Source: Preqin, weighted average net IRRs based on latest available marks for all funds in the global database as of Apr-2020
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Outperformance in the Storm

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Why Downturn-Era Vintages Outperform

Three core themes underpin the outperformance of downturn vintages:

- **Dislocation:** After crises, IPOs and bond issuance grind to halt. Meanwhile, banks also scale back, nursing hits to their regulatory capital positions. When these sources of financing return, it can take years to wean them off their initial, cautious taste for plain vanilla assets. In contrast, private markets always remain open for those who need them. And, facing less competition, private investors benefit from better terms and valuation.
- **Innovation:** In a period of macro uncertainty, rigorous underwriting and innovative structuring is critical to investor protection. Private markets investors are expert at this. They are also typically early movers in adapting to the long term changes prompted by stress events - the growth of private credit to replace bank lending after the 2008 financial crisis is a case in point.
- **Market timing:** Funds take a few years to fully deploy and assets are held for a few further years. Hence, funds closed soon after the initial crash invest over the downturn and sometimes the early recovery period; and even in protracted recessions they harvest in mid or peak cycle conditions.

Optimising Positioning After Covid-19

LPs can apply several rules to maximize exposure to these themes, which see as supportive of credit allocations today:

1) Focus on the most disrupted segments

Every crisis creates unmet financing needs, but the locus of greatest disruption varies.

The 2008 crisis was primarily a “balance sheet crisis”. It was caused by overvaluation combined with overleverage, and when this created a systemic crisis at banks it resulted in a key source of funding for the economy seizing up. Private credit and equity both played a big role in response. Private credit replaced banks. PE picked up assets at a discount and drove necessary operational change.

In contrast, economically, the 2020 crisis is primarily a “cash flow crisis”. A sudden collapse in activity has created a huge liquidity squeeze for the companies and individuals whose earnings vanished. In this type of crisis, we believe that the key unmet need is in credit. This is highlighted by the extraordinary assistance that governments have had to provide to the private sector, which unusually has mostly been in the form of liquidity measures - bridge loans and tax deferrals. However, state support has its limits and most current measures are temporary. When

A Framework for Optimising Private Markets Positioning in a Downturn

Tackle Dislocation

- 1 Focus on the most disrupted segments
- 2 Avoid dry powder overhangs

Embrace Innovation

- 3 Tackle emerging opportunities
- 4 Provide sophisticated solutions

Take Advantage of Market Timing

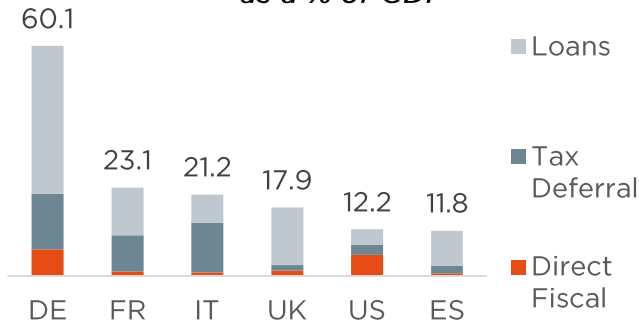
- 5 Invest early
- 6 Tread carefully, but keep upside exposure

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they expire, private sector balance sheets will have to take over in some way.

Gov't Support in Response to Covid-19 as a % of GDP



Source: Bruegel, April 2020

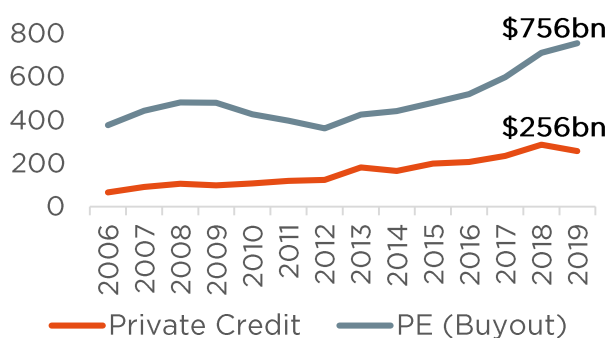
2) Avoid dry powder overhangs

Even though traditional financing pulls back during a crisis, some private markets segments could still be overcapitalised due to “dry powder” accumulated in the boom.

Yet-to-be-invested fund commitments hit a record \$756bn in buyout and \$256bn in credit at the end of 2019. As large as these sums are, they represent just 1.8 years of deal flow in PE and 1.6 years of deal flow in private credit based on 2015-19 rates of activity (*Preqin*). However, a challenge comes if dry powder is combined with lower deal volumes. This can happen in strategies dependent on M&A after a crash. After the Lehman collapse, buyout volumes fell by three-quarters (*Dealogic*), and, anecdotally, buyout investors already call 2020 a “lost year” for deployment.

The best buyout deals in PE and acquisition finance deals in credit tend to

Global Dry Powder (\$Bn)



Source: Preqin

come a year or two after a crisis, once dry powder has burned off and deal making resumes. In contrast, most other credit strategies (i.e. excluding those focussed on financing new PE deals) started with less dry powder, and many are likely to see deal flow rise in a liquidity crisis.

3) Tackle emerging opportunities

Some dislocations will be in areas where private market are mature. Others will allow investors to earn a premium for innovation amidst a dearth of competitors.

For instance, private credit has historically focussed on solutions for the leveraged loan market, but in coming years, we expect a greater need for many specialised credit strategies. For instance:

- o Given economy-wide issues there will be more demand for credit outside PE-backed situations, including for SMEs;
- o Given unpredictable cash flows, there will be a need for more structured deals including asset-backed lending;
- o Given some asset owners will need to raise cash, there could be rapid growth in secondary markets for private credit.

None of this requires truly ground-breaking change. Just as the tech trends of 2020 (e.g. remote working) involve adoption of well-established systems, “innovation” in private markets will mostly be about proven but underpenetrated strategies.

4) Provide sophisticated solutions

In challenged macro conditions, specialised investors providing bespoke solutions are best placed both to engineer upside and to protect downside.

When the environment is changing rapidly, there is no substitute for *rigorous due diligence*. With elevated risks and unusual financing needs, more complex structuring

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Analysing Why Crisis-Era Funds Deliver Enhanced Returns

will need to replace standard term sheets. Furthermore, *operational engagement* will be more important to add (or preserve) value, in credit as well as equity.

5) *Invest early*

Dislocations are, by their nature, temporary. Some expect the current downturn to be short, with a V-shaped recovery. But, even if this proves optimistic, the Great Financial Crisis sets a benchmark for a protracted double-dip recession, where recovery was clearly underway within five years. As fund investment periods (typically 2-5 years) are about as long as periods of dislocation (also typically 2-5 years), there is a clear logic to investing early to maximise the overlap.

But it is also important to consider when individual strategies become actionable. In PE, it takes six months for attractive deals to emerge even in distressed and the sweet spot for buyout and growth often starts after a year. Credit opportunities emerge earlier in a series of waves. At the very start of a crisis, asset sales and bridge financing can be needed to shore up cash positions. A few months later the first new quarterly reports can trigger restructurings due to covenant breaches and disposals by banks of marked-down assets. M&A and growth financing normally emerges at the same time as PE deals, but in this crisis there may

be an new type of growth deal - “restart capital” for firms coming out of lockdown.

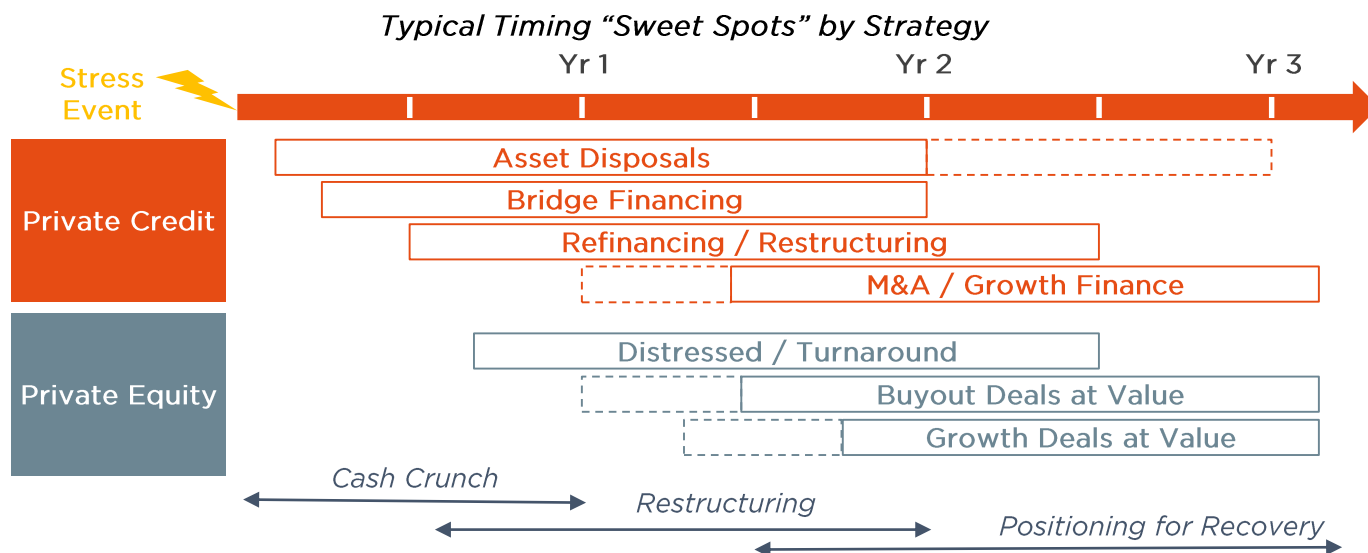
6) *Tread carefully but keep upside exposure*

The key risk of investing early is “catching falling knives” – picking up assets where performance is just starting on a longer than expected downward path. Credit structuring offers a solution; in dislocated markets it is usually possible to underwrite to draconian downside cases. However, traditional credit returns are capped and investors may miss out on the value unlocked in a recovery.

Fortunately, there are credit strategies that offer upside as well as downside protection. One is to include an equity-like interest (e.g. a warrant or profit share) as part of the compensation for a loan. Another is buying credit assets at discount, offering strong yields if held to maturity and outsized returns if sold at a premium beforehand.

Conclusion

Downturn vintages in private markets tend to outperform, but not all strategies benefit equally. The best are those that offer new solutions for the most severe dislocations and that are actionable early. In today’s liquidity crisis, specialised credit might be a fertile hunting ground for them.



Note: Illustrative chart representing the views of the Decalia Private Markets team

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External sources include:

- Preqin
- Dealogic
- Breugel, “The Fiscal Response to the Economic Fallout From Coronavirus”

All analysis based on latest available data as of April 2020

Front page images from Michael Kurtz