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MEMORANDUM

TO: All Clients
FROM: Meketa Investment Group
DATE: March 17, 2020
RE: COVID-19 Update: Effects on Private Equity

Over the past few weeks, you have received several updates from Meketa related to the COVID-19 pandemic and its impact on the markets. Here, we focus on some of the implications specific to private equity investments. In general, we believe that the current stock market correction reflects a dramatic change in the global business climate that will have a meaningful impact on private equity portfolios. However, it will take months before company valuations reported to private market investors reflect this impact.

Private Equity Exposures & Risks

Private equity companies are exposed to similar risks as publicly-traded companies. As such, it is reasonable to expect that the current setback in global economic growth will create challenges for many businesses held in private equity portfolios. Structurally, there are some differences between public and private portfolios, however. The latter tend to have lower exposure to financials (banks and insurance companies); greater exposure to information technology via venture and growth equity strategies; and greater exposure to smaller companies. Industry sectors that may show relative strength in this downturn may be technology, life sciences, and healthcare; conversely, sectors that may underperform are financials, consumer, retail, and energy (discussed later). Smaller companies, based on some early manager reports, may be somewhat less affected by global supply chain disruptions and drops in non-US demand for products and services. However, smaller companies may also be less resilient and more vulnerable to a general economic downturn.

Exposures to geographies affected first by the pandemic, such as China, South Korea, and Italy tend to be small for most private equity portfolios, in the range of 5% to 10% combined. However, the situation in North America – where 60% to 70% of most private equity portfolios is invested – is still evolving and the potential impact on investments here remains difficult to assess at this point.

As with any market dislocation, there will both winners and losers at the individual asset level. Conversations with private equity managers in recent weeks have revealed some companies benefitting from recent events (e.g., those enabling remote conferencing and transacting), some with immediate negative impacts (e.g., travel–related), and many with no immediate impact – but an expectation for negative impacts in the near term. With respect to timing, managers expect second quarter 2020 results to be meaningfully impacted across most of their portfolio companies and a resumption of normal business activity to take another one-to-two quarters after that.

Individual companies that might be more vulnerable in the current environment include those with greater financial leverage, significant consumer-facing exposure, and those with greater exposure to supply chain and logistics challenges – as is also the case with publicly-traded companies.

Just before the global financial crisis ("GFC"), in 2007, the average leverage ratio (net debt/EBITDA) for the private equity markets was near 6x and the average equity contribution was near 30%;. By 2019, purchase multiples on deals rose from roughly 10.0x to 11.5x, but with a similar leverage ratios (~6x), larger equity contributions (~40%), and stronger growth rates.

With the increased likelihood of a recession to occur in 2020 comes an increased likelihood of breached debt covenants. However, we have just been through another easy lending period, with roughly three-fourths of all new loans in recent years being covenant-lite. As the current crisis unfolds, a number of buyout managers have looked to secure liquidity and – as a matter of policy – drawn down credit facilities where possible at each of their portfolio companies. The same managers have begun contingency planning for a potentially rough second quarter and beyond. With the exception of those companies facing a near term debt maturity, there is likely to be sufficient flexibility in most capital structures to avoid near term technical defaults and allow for a sufficient runway to recovery – if there is a return more normalized economic activity in the next few quarters.

Energy Sector

As Meketa has previously discussed, a crisis developed in the oil markets recently when Russia surprisingly decided not to participate in production cuts proposed by Saudi Arabia and OPEC. This ultimately led to a decline in global oil prices as Saudi Arabia launched an all-out price war.

Saudi Arabian oil officials proposed production cuts to help stem the decline in oil prices amidst the expected negative demand shock due to weakness resulting from COVID-19. With prices already lower by roughly 30%, the decision by Russia to not participate in the cuts prompted Saudi Arabia to increase production while simultaneously reducing prices to key customers in an effort to take market share away from Russia. In the wake of the announcements, the price of West Texas Intermediate (WTI) crude oil declined by over 30% to trade near $30 per barrel, where it has generally held since.

Concerns about US producers' abilities to maintain profitability or just remain solvent at such low price levels is being heavily assessed by financial markets. A broad review of public market performance for oil and gas exploration and production ("E&P") companies reveals price declines for companies in excess of 60% year-to-date. Additionally, as a number of oil producers over the last few years have been issuing debt, including US shale producers, market participants expect an increase in defaults and even bankruptcies.

A significant re-pricing of assets has occurred across the entire value chain in the energy sector. While E&P companies will take a direct hit from lower oil prices, midstream and service companies will also suffer from lower volumes and drilling activity.

Denominator Effect & Transaction Volume

The private equity asset valuation process works with a multi-month lag – relative to stock market movements – in reflecting both increases and decreases in value. Until the first quarter 2020 valuations are reported beginning in mid-May, private equity allocations will certainly appear to increase in proportion relative to those of other asset classes, and – in some cases – take them above target ranges. This is the so-called "Denominator Effect" that institutions have experienced during similar stock market corrections in the past.

A related issue is an expected slowdown in private equity deal activity. As with any period of uncertainty, deal makers are reluctant to act until they have more visibility about future prospects. This slowdown is compounded somewhat by managers not being able to meet with company management teams and recent bumps in financing costs. It is reasonable to expect that a slowdown in capital calls and distributions will potentially mirror a slowdown in deal activity.

As we look at our own client private equity contribution and distribution data from the GFC, we see that all cash flows were down meaningfully during the period, with activity beginning to decline in 2008 (the Lehman Brothers bankruptcy was in September) and significantly slowing in the first quarter of 2009. Activity slowly recovered over the following two years. Distributions were more meaningfully impacted than contributions, which remained more stable, leading to significantly higher than average net outflows over the period, as managers sought to put money to work at more attractive valuations.

During past periods of market dislocation we have observed a meaningful "expectations gap" between buyers and sellers on price. Sellers are mentally anchored to the most recent valuation of their asset and buyers are reluctant to give up valuable liquidity in a period when it hard to price risk and additional deterioration is unknown. This is starting to happen today; a number of managers have reported that transactions are slowing down and it may take months before buyer and seller expectations again converge.

We have yet to observe a meaningful amount of forced selling. Many private equity programs include strategies that will buy opportunistically (distressed debt, deep value buyout, and turnaround strategies), but at the core of most programs are buyout strategies that depend on having reasonable earnings visibility in order to transact. As discussed earlier, the private equity markets have enjoyed "covenant-lite" financing for the past few years, which may help to delay distress for a number of private equity-owned businesses.

In just the past two weeks, however, the financing market for private equity has changed meaningfully. According to some buyout managers, the markets are only "selectively open," meaning that some deals will still get done, but most that were slated for late March will be delayed. Rates for new deals are expected to be higher and the amount of leverage supported will be lower. While banks will be more conservative in their lending, they are better-capitalized today than they were in the GFC.

2020 Program Strategy & Pacing

Private equity allocations are made to benefit from – among other things – sacrificing liquidity and enabling long-term value creation plans of the managers. Each fund commitment contemplates a ten-year horizon. As ever, we feel that consistent deployment of capital is critical to reaping all of the benefits of a private equity allocation. Historically, the performance of private equity vintage years following stock market corrections has been strong. The 2008, 2009, and 2010 vintage year net IRR returns for private equity are 15%, 20%, and 17%, respectively, as of September 2019.

In spite of this strong observed performance, we don't recommend any attempt to increase capital deployment in 2020 beyond previously decided plans. Established private equity programs with commitments made to the past few vintage years will likely have significant capital available for 2020 and 2021 opportunities. In fact, recent vintage funds were categorized by fairly aggressive fundraising with respect to timing and fund size, such that many of them should have ample capital for a few years to come.

In addition to this dry powder, private equity programs that employ managers with strong resources and a long operating history have an additional line of defense. Managers today report being in close communication with the management teams of portfolio companies, focusing on supply chain management, as well as the potential need to secure additional liquidity with lenders and control costs.

Meketa Investment Group will continue to monitor economic activity and the capital markets, and their specific effects on private equity investments. An immediate focus for us will be a review of pacing study assumptions for the upcoming year and the consideration of potential revisions, based on declines in the public markets and an expected drop in transaction volume. We recommend clients not make significant near-term asset allocation changes based solely on perceived over allocation to private equity due to the valuation timing difference between public and private asset classes.

Our core approach to private equity deployment should not change in 2020. As ever, we will seek consistent exposure across vintage years, commitments to strategies that can be opportunistic, and managers with experience in market cycles, and teams that have exhibited discipline with pricing and leverage, as well as with skill with company operations.

Lastly, please know that we remain available to our clients. Meketa will provide periodic updates to you as the impacts of COVID-19 ripple through the world economy. In the meantime, please feel free to reach out to us at any time.

Stay safe and stay healthy!

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