Private Capital Unveiled: Critical Considerations For Investors

December 2023

Introduction & Executive Summary

- **Private Capital Unveiled: Critical Considerations For Investors**

  - Private capital annual fundraising has grown exponentially since 2010, growing from US$360 billion to US$1,373 billion in 2022 – a remarkable 280% increase.[(1)]
  - Now in 2023, the tides have turned, and YTD fundraising has fallen to US$502 billion in 2023 - a 63% decrease from 2022.[(1)]
  - Private capital grew in popularity as investors sought for a high returning and low volatility asset class. However, one of the fastest rate hikes in history and plummeting liquidity has brought a wave of skepticism across the entire private capital industry.
  - Private capital investors are increasingly concerned by the growing spread between Total Value to Paid-In Capital (TVPI) and Distribution to Paid-In Capital (DPI) – or put simply, the value of the underlying assets on paper versus what has been returned in actual cash to investors.
    - The Leonard Green private equity fund family highlights the disparity between reported and actual returns. Green Equity VI fund, raised $6.3 billion with a 2012 vintage, and has yet to sell 47% of its stated investment value 11 years after inception. If these remaining assets are so valuable, why does no one want to buy them? Furthermore, despite a 20% stock market downturn in 2022, the fund's reported 14% Internal Rate of Return (IRR) remained unchanged from 2021 to 2022 - defying economic logic.[(2)]
  - Moreover, private equity funds have returned about the same as public equity indices since at least 2006.[(3)] Given an opaque fee structure, no liquidity, amplified leverage, and flexible reporting; private equity returns comparable to those of public equities does not seem reasonable.
  - We would like to highlight eight concerning and timely facts regarding private capital:

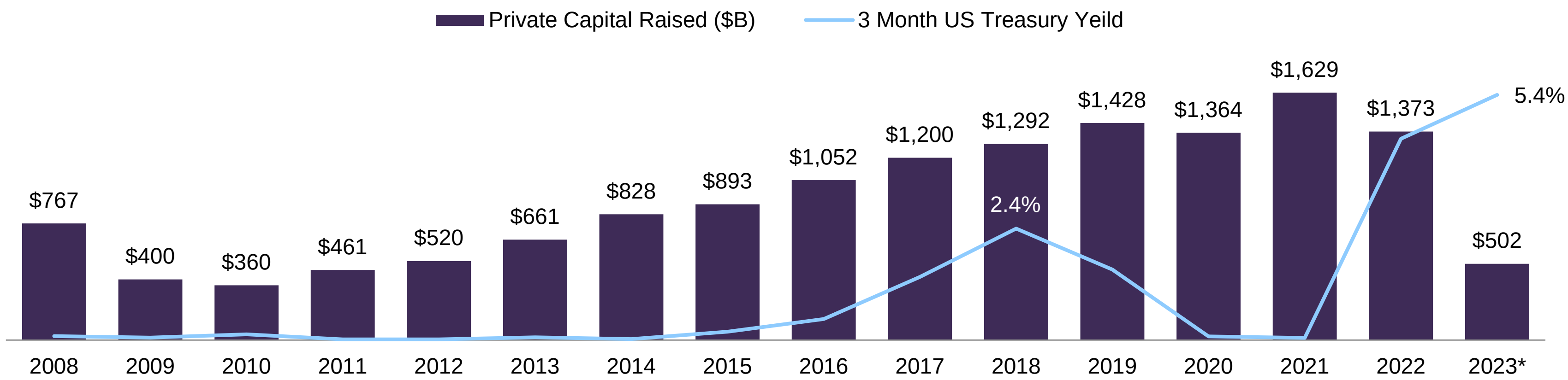
    1. As interest rates have risen, private equity deal volume has decreased on average 57% this year with illiquidity intensified.[(4)]
    2. In the International Monetary Fund's (IMF) latest Global Financial Stability Report, the IMF comments that privately traded assets may not have fully adjusted to higher interest rates. The IMF provides data regarding return discrepancies between publicly and privately traded real estate investment trusts.[(5)]
    3. Private equity (12.9x) is currently more expensive than public markets (12.0x) on an EV / EBITDA basis.[(6)]
    4. Industry buyout leverage remains at a historic high of ~7x EBITDA with interest rates at elevated levels.[(6)]
    5. Traditional banks have cut back significantly from lending buyout debt for large deals (down 50% from 2021) and almost entirely from small ones. Alternative lenders with lower risk tolerances have taken substantial market share from traditional lenders.[(7)]
    6. As private equity has benefited from increasing capital flows, private equity returns have relied heavily on multiple expansion.[(7)]
    7. With the average buyout deal size of US$964 mm, and the average IPO market value of US$993 mm (at first close), private equity will conceivably have to gain future liquidity from public markets.[(7,8)]
    8. Private companies recently gaining liquidity from public markets have been disastrous, with the average North American IPO down 47%, signaling a severe disconnect between public and private market valuations.[(9)]

  - Lastly, we provide a list of key investor questions for individuals seeking to increase allocations to private capital. Key topic areas include investing in new vintages versus existing ones, understanding TVPI versus DPI spreads, sources of liquidity, timing of liquidity, current valuation levels versus public equivalents and more.

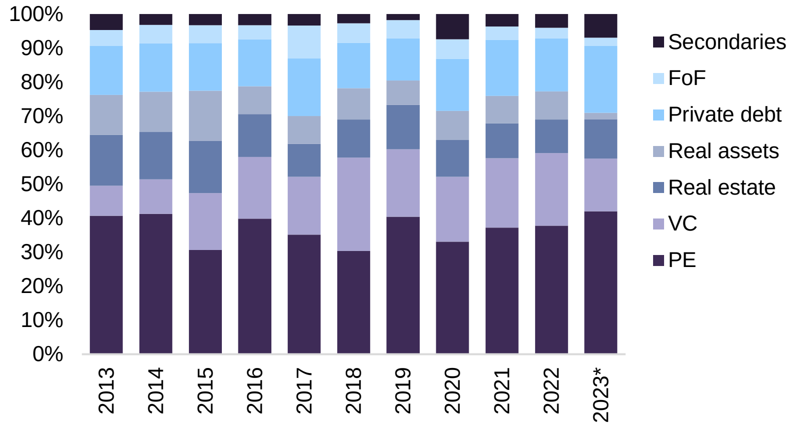
1. Pitchbook Q2, 2023
2. John Hopkins University
3. University of Oxford
4. Bloomberg
5. International Monetary Fund
6. McKinsey
7. Bain & Company
8. University of Florida
9. Letko Brosseau, Factset

The Rise and Recent Fall of Private Alternatives[1]

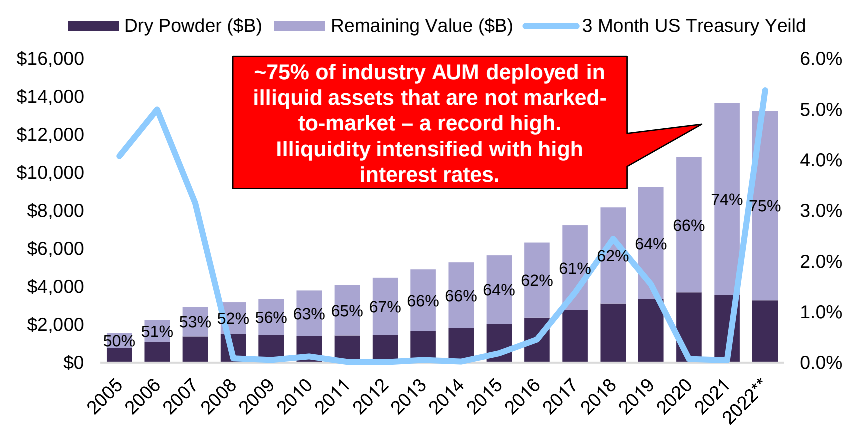
Recent Rate Hikes Have Led to Plummeting Private Capital Fund Raising After Decades of Rapid Growth[1]



PE Continues To Dominate Private Fund Raising[1]



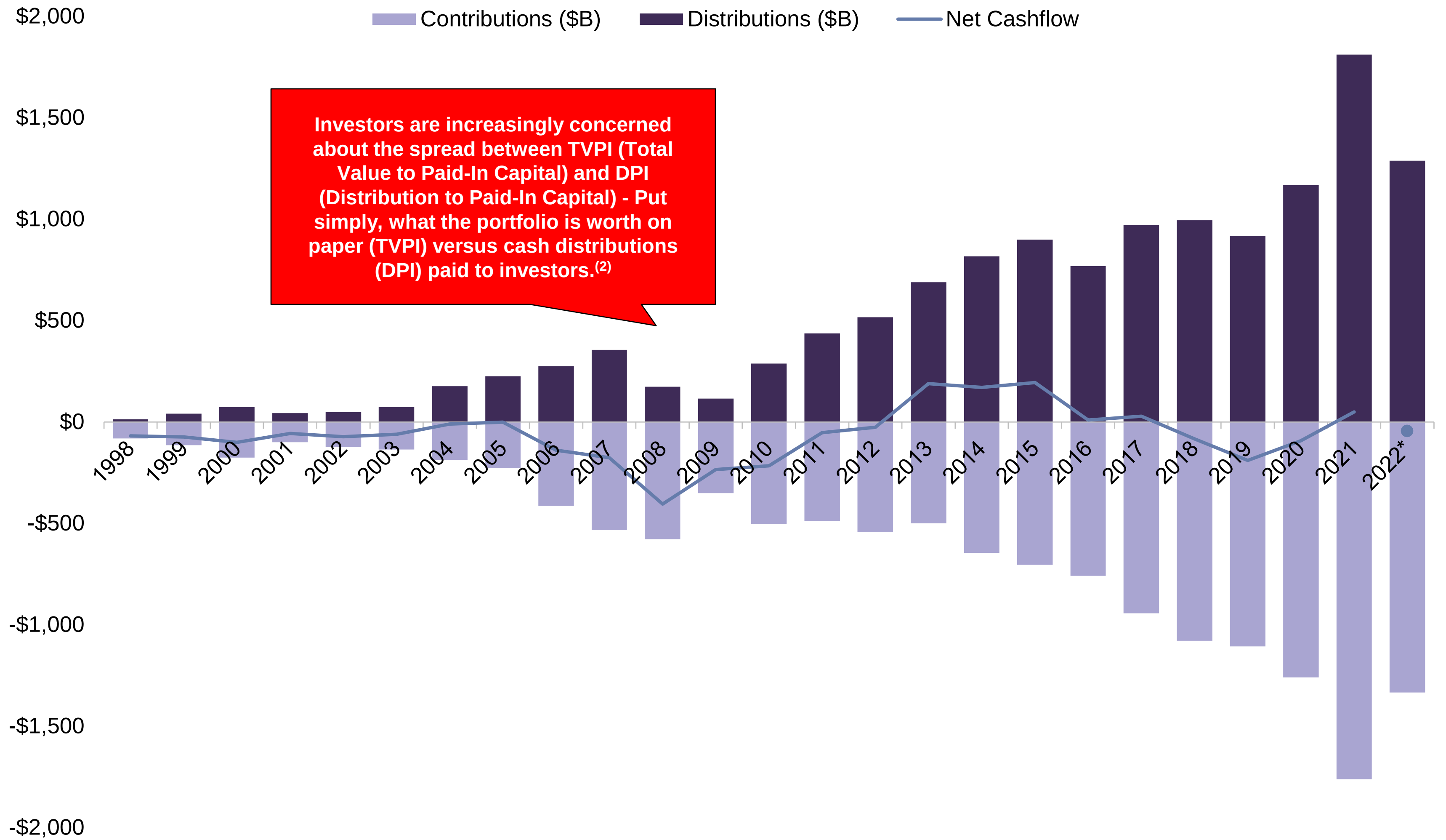
Industry AUM & Dry Powder Has Declined[1]



After decades of rapid growth, private capital fundraising and AUM have begun to decline. This presentation serves to help explain why and highlight key investor considerations.

1. * As of June 30, 2023, ** As of December 31st, 2022, US$, Pitchbook Q2, 2023, Factset

More Cash Has Entered The Industry Than Has Come Out[1]



Since 1998, cumulative contributions into private capital consist of US$14.64T, with distributions of US$13.18T - creating a cash outflow of (US$1.45T) for investors.[1]

1. Private Capital cash flows, As of December 31st, 2022, US$, Pitchbook
2. Cambridge Associates

Recent News & Calls For Liquidity Have Raised Concerns(1)

Private equity portfolio companies on track for most bankruptcies since 2020

Private equity portfolio companies in the US are on track in 2023 to see the highest annual number of bankruptcies since 2020, as rising interest rates and an uncertain economic outlook force tough decisions.

Private equity: higher rates start to pummel dealmakers

The firms that used the era of cheap money to become the new financial titans are wrestling with rising interest costs

Potential Risks in the Growth of Private Debt Funds

An Inconvenient Fact: Private Equity Returns & The Billionaire Factory

University of Oxford, Said Business School, Working Paper

Private Equity Is Killing Your Pets

Private equity firms have gobbled veterinary companies around the country—and the results have been disastrous.

Party City's founder blames bankruptcy on private equity firms that jacked up prices

By Josh Kosman

Private equity's new financial engineering brings risks

NAV loans can buy time but cannot stop the inevitable if businesses have not improved

Why some investors may have rose-tinted glasses

By Andrew Woodman

November 18, 2022

US Colleges Face Credit Risk Due to Their Private Equity Exposure

- Investments in private equity are growing in endowments
- Smaller endowments are among most vulnerable: Moody's report

Going Bankrupt in the Name of Efficiency

Two new books offer harsh assessments of private equity firms that specialize in buying up companies only to saddle them with debt and squeeze them for profits.

Why I am not investing in a buyout for a long time to come

The investment model of private equity has become too popular

FT Alphaville Investing in funds

The volatility laundering, return manipulation and 'phoney happiness' of private equity

Are investors the mark, or in on it?

Blackstone limits withdrawals from its US$69-billion REIT

CHIBUIKE OGUH

Warren Buffett won't go near it, so why has CPP Investments placed a third of our pension assets with 'private equity?'

High interest rates, bankruptcies, growing TVPI / DPI spreads, and a lack of liquidity have created concerns. There is a lot of noise about alternatives - but let's cut to the facts.

1. Photos hyperlinked

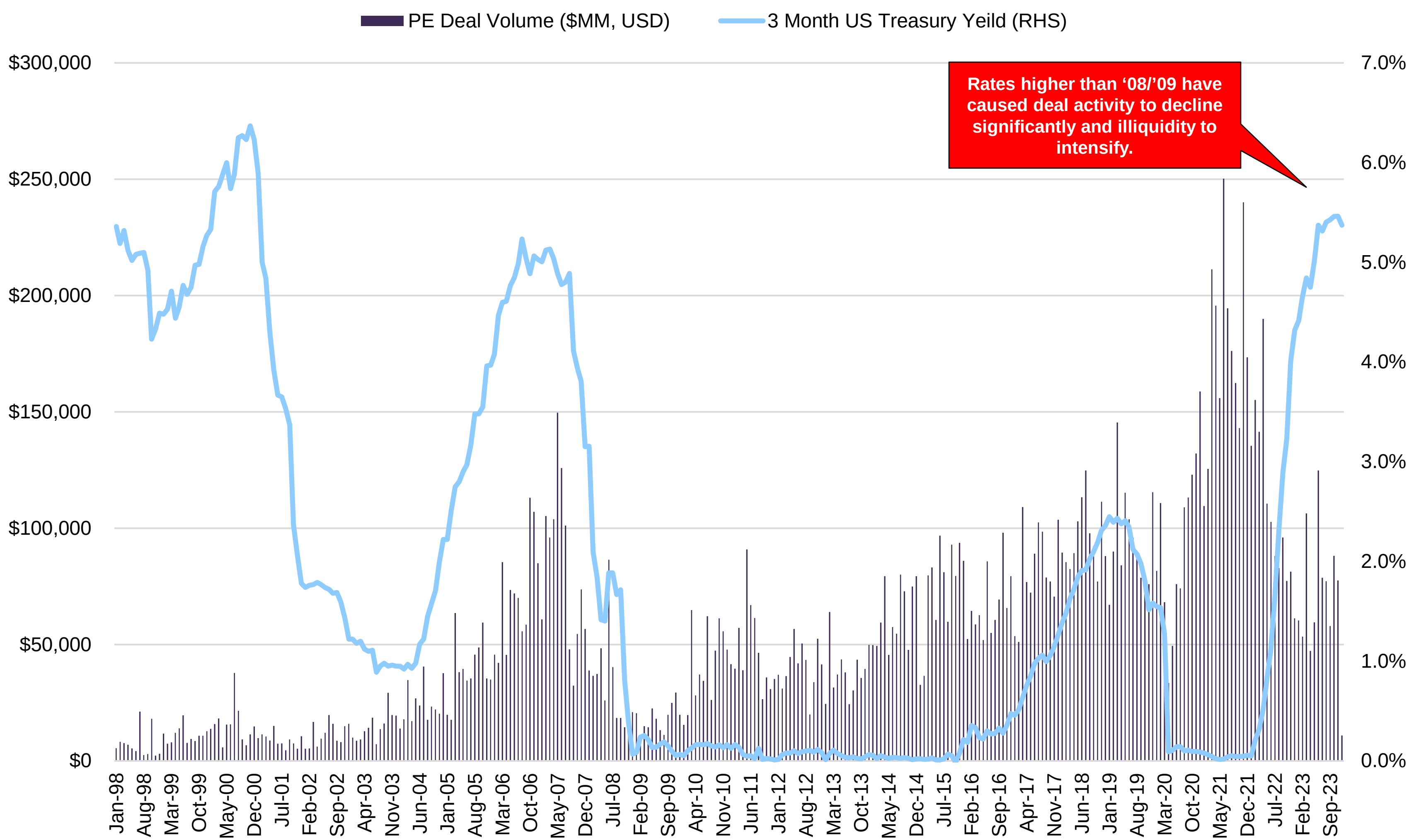
Is Private Investing Better Than Public Investing?[1]

The Facts	The Answer
Greater liquidity	**No**
Lower fees	**No**
More transparent market	**No**
Higher returns[2]	**No**
Lower leverage	**No**
More mature companies	**No**
More diversified companies	**No**
More capacity	**No**
Better reporting	**No**
Greater confidence in valuations	**No**
More time to research opportunities	**No**
More eyes on	**No**
Easier fiduciary oversight	**No**
Return reporting flexibility[3]	**Yes**

Flexible accounting rules can smooth returns and reduce volatility, influencing the choice to allocate more to private capital, but investors should assess the facts.

1. Letko Brosseau
2. An Inconvenient Fact: Private Equity Returns & The Billionaire Factory, University of Oxford
3. University of Florida, Catering and Return Manipulation in Private Equity

Fact 1: Liquidity & Deal Volume Have Plummeted Due To Higher Rates[1]



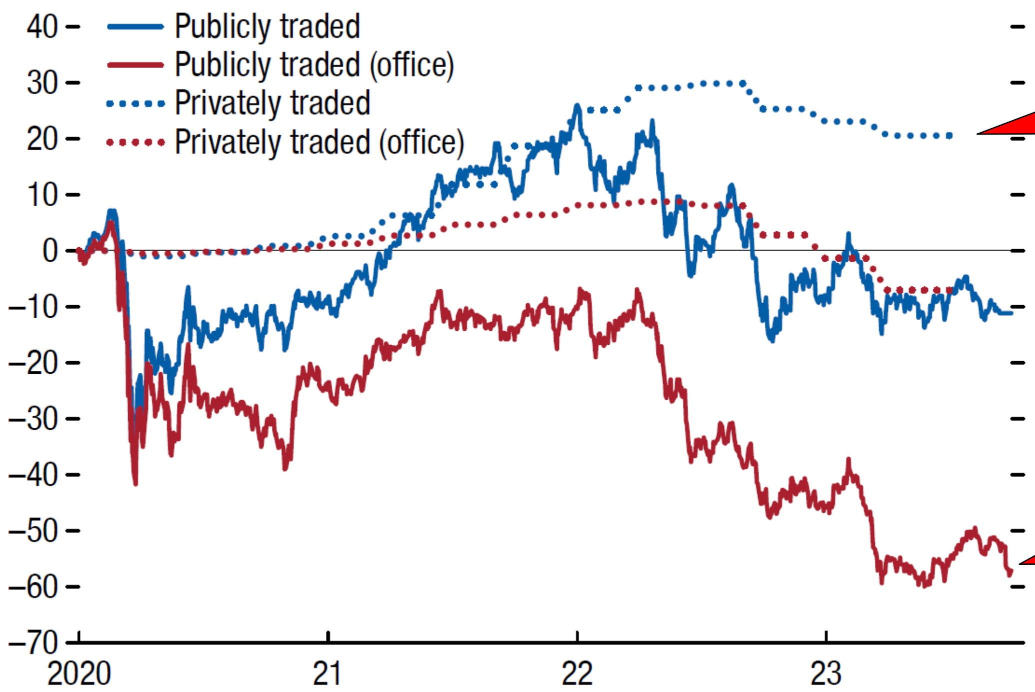
As interest rates have risen, private equity deal volume has decreased on average 57% this year. Illiquidity intensified across private capital industry.

LetkoBrosseau

1. Bloomberg, Private Equity Deal Volume. $US MM.

Fact 2: Private Assets May Not Have Adjusted To Higher Interest Rates

Return of Privately and Publicly Traded Real Estate (Percent, price return since January 2020)[1,2]



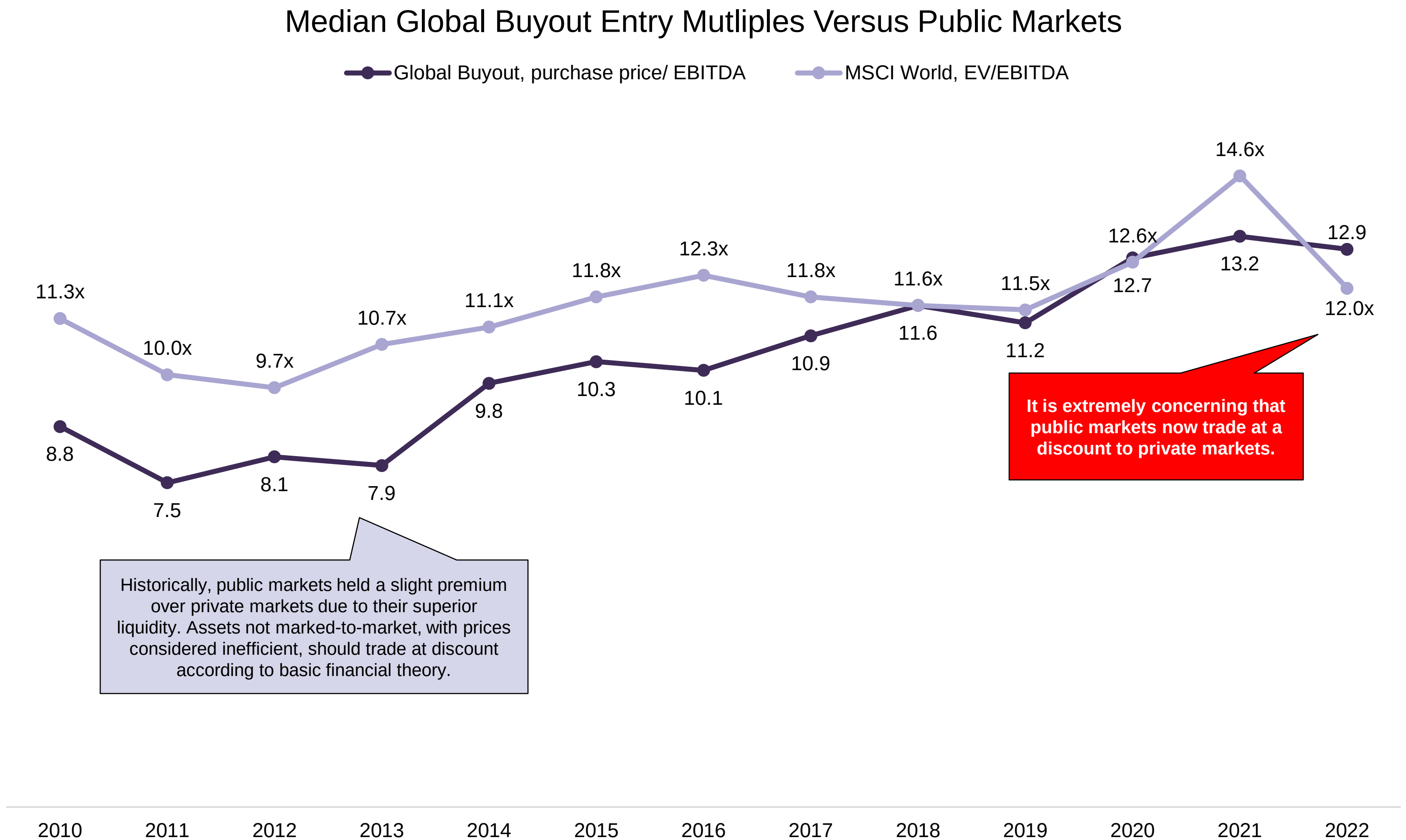
It is concerning that given the substantial rate hike cycle, *privately traded* real estate investments have increased in value, while *publicly traded* real estate investments have declined.

In the office segment, grappling with challenges from both rate hikes and evolving consumer trends like remote work, *publicly traded* office investments have undergone more significant adjustments compared to their *privately traded* counterparts.

The International Monetary Fund's latest global financial stability report warns that privately traded assets may not have fully adjusted to higher interest rates.

1. International Monetary Fund, Global Financial Stability Report, October 2023
2. Analysis based on a sample of 219 exchanged-traded real estate investment trusts.

Fact 3: Private Equity Is More Expensive Than Public Markets[1]

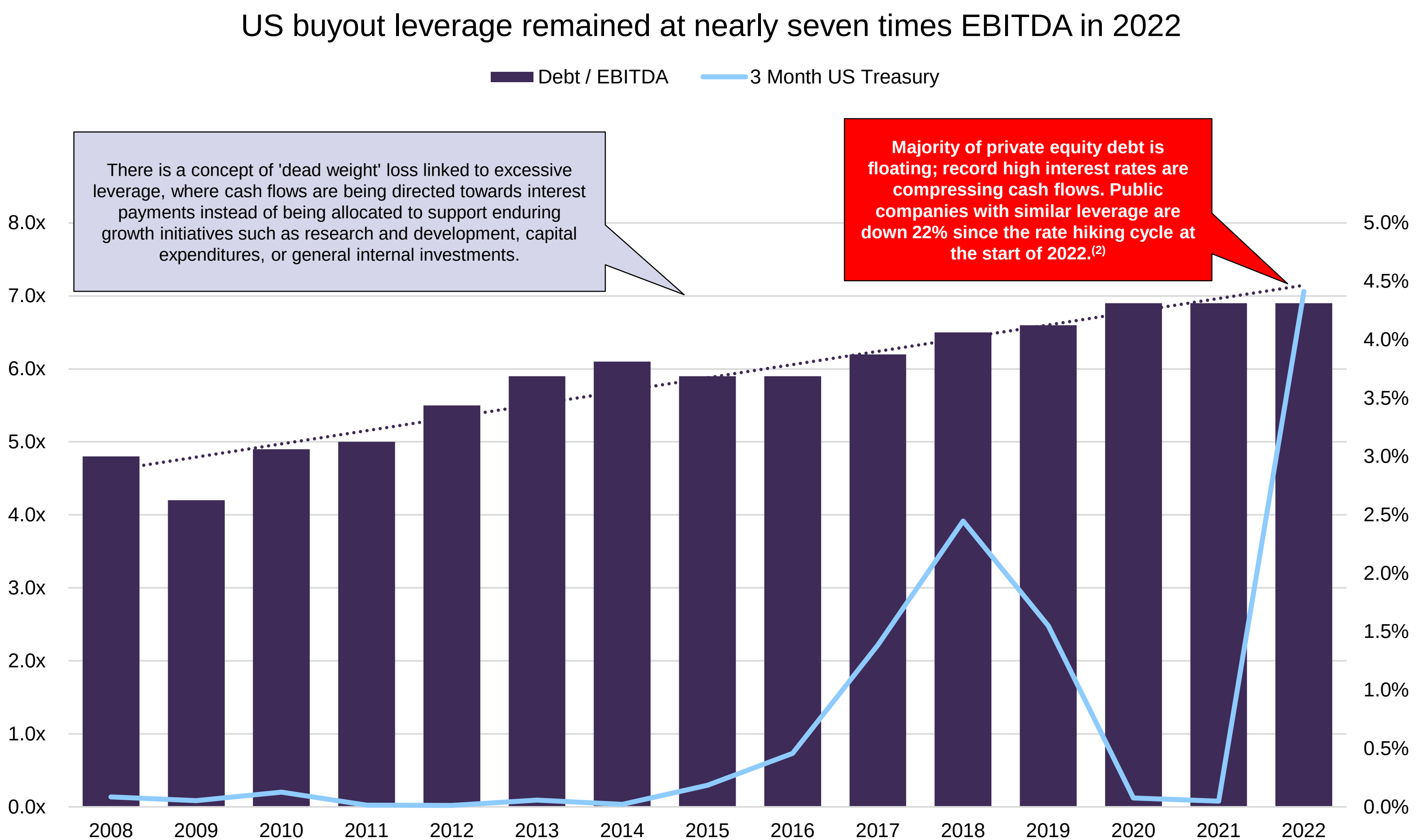


Private equity is currently at a premium to public markets – a nonsensical occurrence.

LetkoBrosseau

1. McKinsey

Fact 4: Buyout Leverage & Interest Rates Remain At Concerning Levels(1)



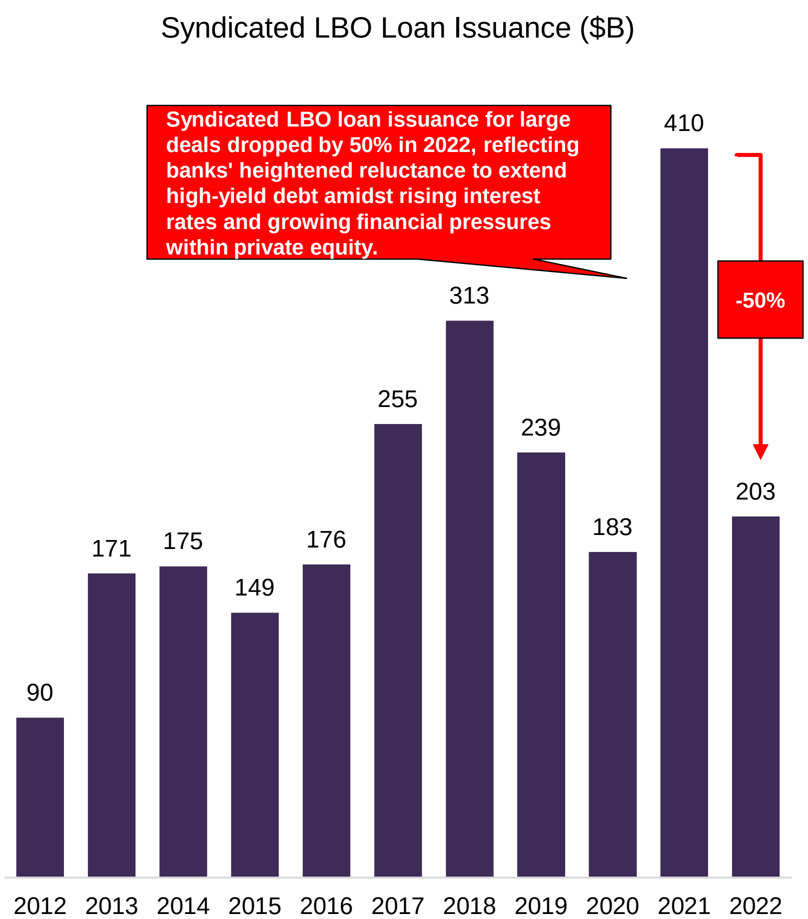
US buyout firms continue to utilize debt, and do so excessively, with approximately 55 percent of a deal's purchase price financed with debt despite recently high interest rates.

LetkoBrosseau

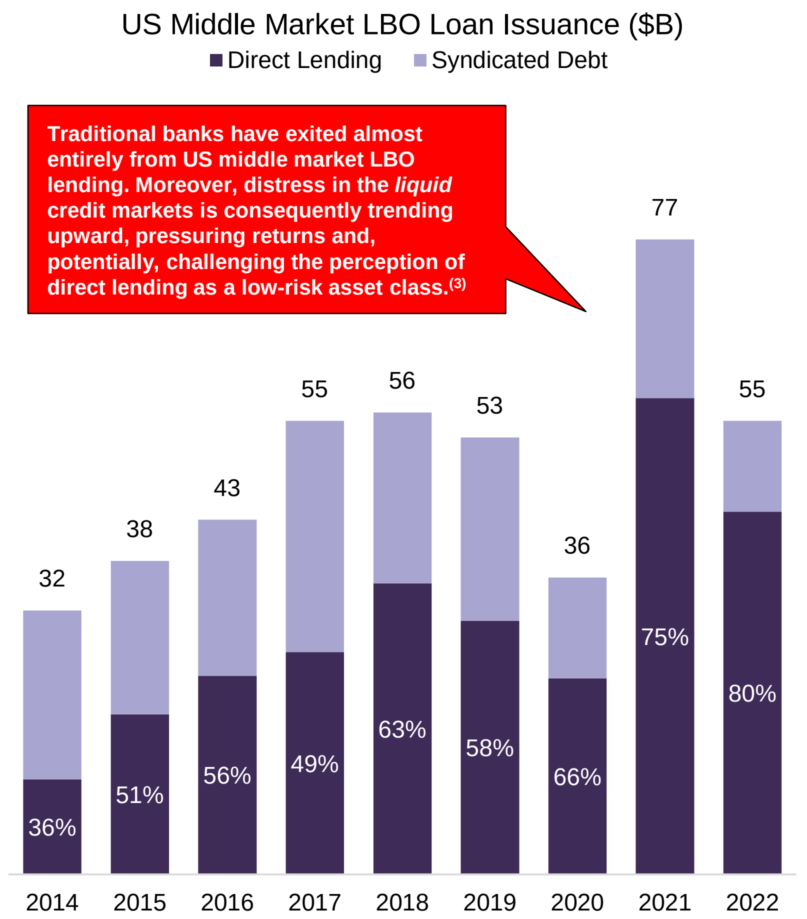
1. McKinsey, ingoing leverage.
2. Factset data includes global developed market companies with a minimum market size of $500 million USD and net debt to EBITDA of at least 6x. The price returns are measured from the beginning of the rate hike cycle, starting on January 1, 2022, and extending to November 22, 2023.

Fact 5: Traditional Banks Have Reduced Their LBO Exposure

Banks Retracted Substantially From Large LBOs(1)



Banks Exited Almost Entirely From Mid-Size LBOs(2)



Traditional banks have substantially pulled back on lending from both large LBOs and almost entirely from small LBOs – direct lending no longer being perceived as "low-risk."

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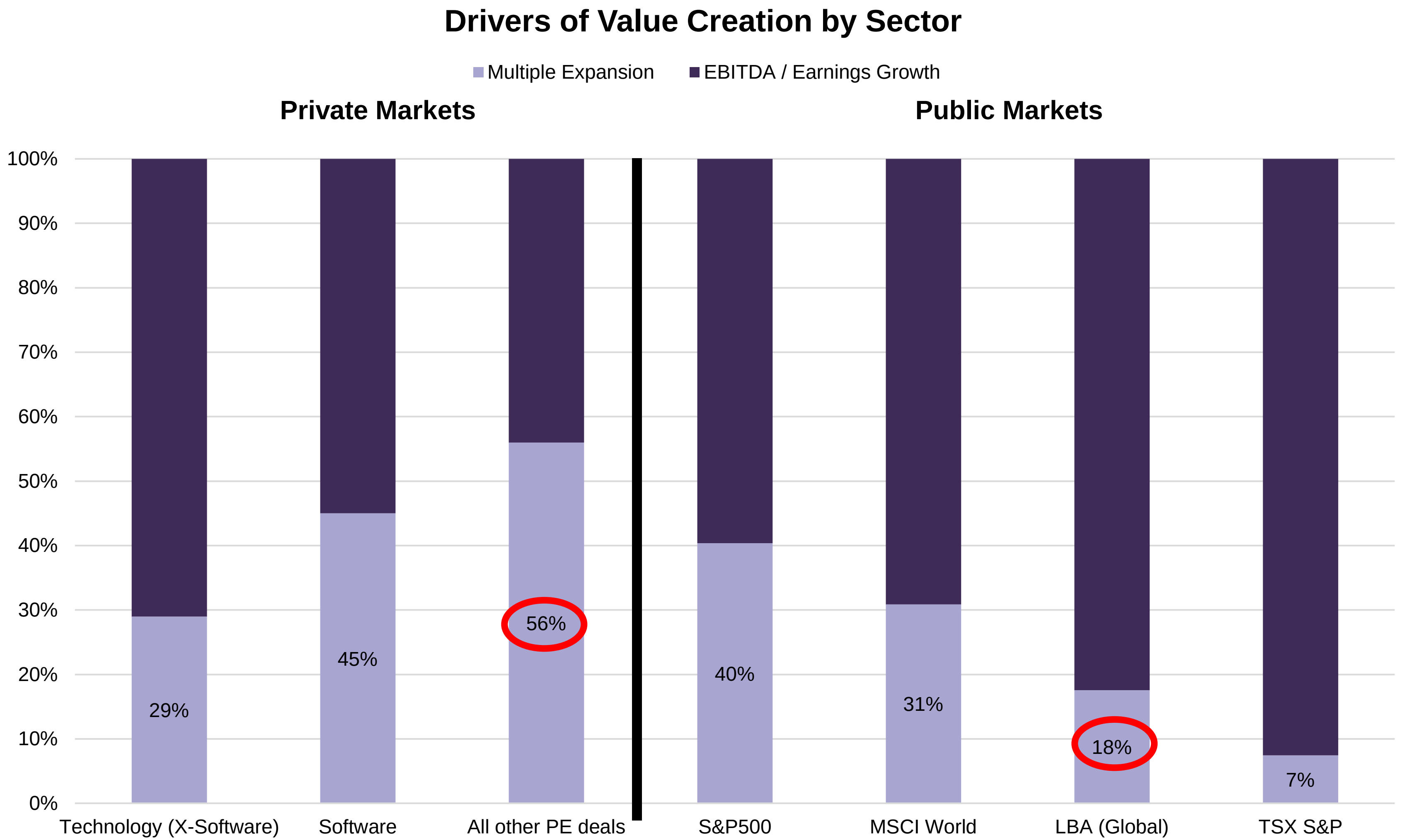
1. Bain & Company, consists of all European LBOs regardless of size and US LBOs with more than $50 mm in EBITDA.
2. Bain & Company, middle market includes issuers with revenue less than $500 mm and total loan packages less than $500 mm; direct lending includes non-syndicated facilities, including club lending. Direct lending primarily from Sixth Street Partners and Ares Credit Group.

Fact 6: Private Equity Has Relied Heavily On Multiple Expansion[1,2]

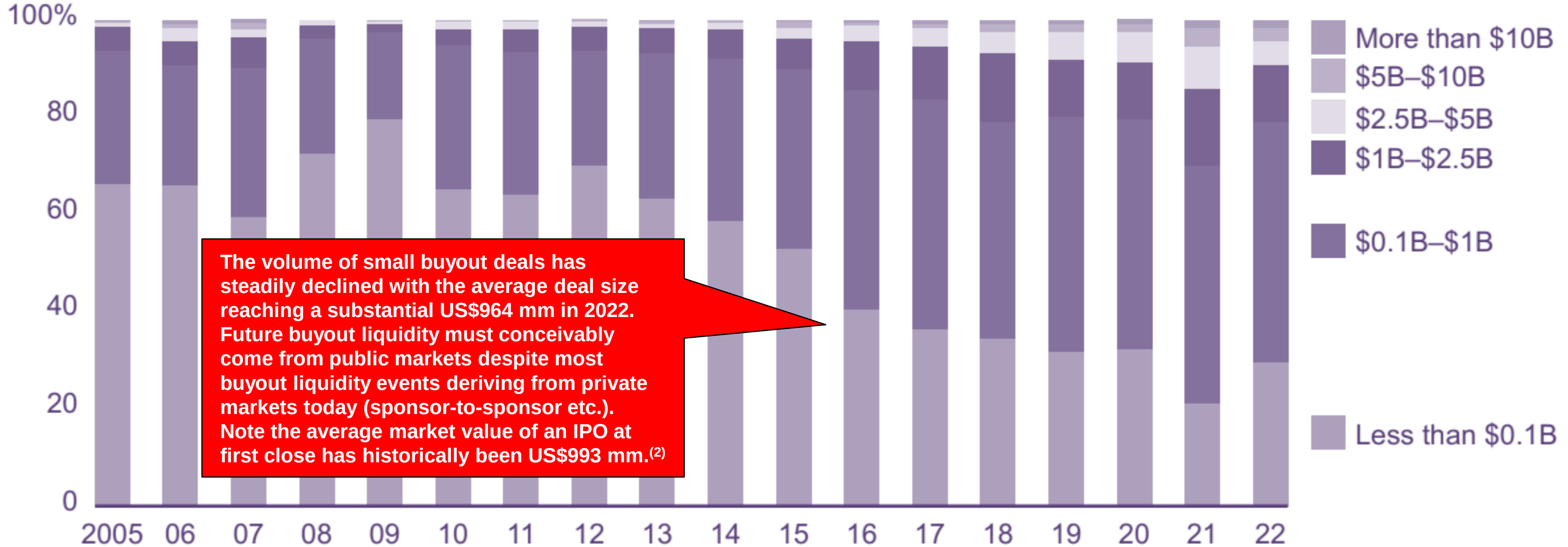


Compared to private markets, public markets offer superior returns driven predominately by earnings and EBITDA growth versus precarious multiple expansion.

1. Bain & Company, Deal Edge: Includes multiples for global software buyouts with more than $50 million in invested capital entered or exited between 2010 and 2021; 2021 data as of December 14, 2021.
2. Letko Brosseau Global Portfolio average returns of a 2010 portfolio to 2021 assuming weights remain in similar proportions in Canadian dollars. Data provided by Factset and limited to data availability.

Fact 7: Larger Deals Imply Future Liquidity Derives From Public Markets(1,2)

Share of global buyout deal count, by deal size (1)

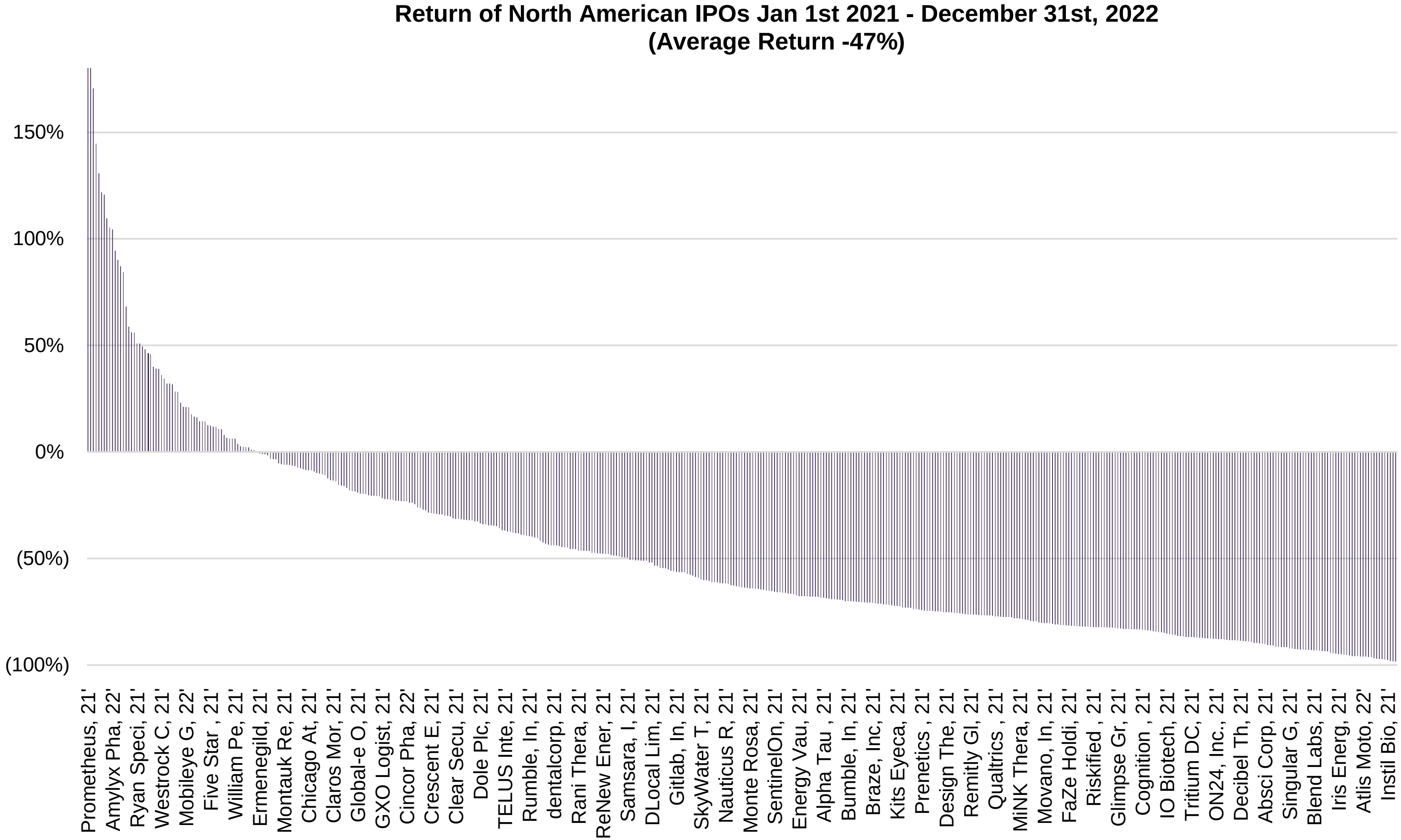


	2005	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20	21	22
Avg. deal size ($M)	256	494	476	165	119	229	254	216	310	303	445	520	645	732	761	819	1,245	964

With the average buyout deal size of $964 mm, and the average IPO market value of $993 mm, private equity will conceivably have to gain future liquidity from public markets.

1. Bain & Company, Includes deals with disclosed value only; excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change.
2. University of Florida, Table 4f, average IPO market value at first close from 1980-2022 adjusted for inflation, data set includes 9,127 IPOs.

Fact 8: Gaining Liquidity From Public Markets Have Been Disastrous[1,2]



Exiting from private markets, recent IPOs have been disastrous. Private market valuations have not been accepted by public markets.

1. Letko Brosseau, Factset. Data set restricted to IPOs on the NYSE, NASDAQ, and TSX exchanges since January 1st, 2021 to December 31st, 2022. Companies must have had a minimum market capitalization of $50M USD and be actively traded. Returns in US dollars.
2. 481 companies within data set, only a portion of these companies are illustrated within the bottom axis.

Key Investor Questions For Private Capital

- **Investing In New Vintages:**
  - What is the fee structure and how does it compare to public market products?
  - Are fees charged on committed capital or called-capital?
  - How is carried interest computed and how does this affect total returns?
  - When is the LP responsible for providing capital, how much notice will be provided?
  - When are liquidity or future distributions anticipated? Typically, what will be the mechanism of liquidity (IPO, strategic, financial buyer etc.)?
  - Historically, how has the private manager performed across funds after fees (TVPI, DPI, MoM, time period etc.) and how have the returns compared relative to common public market benchmarks across the same period?
  - Decompose the key driver of past funds returns on a portfolio company level one-by-one (revenue growth, margin expansion, earnings growth, multiple expansion, deleveraging etc.) – what is the main source of returns?
  - Are fund returns concentrated in one investment or are they relatively diversified across investments?
  - What level of debt financing is typically employed and what percentage of portfolio companies have entered bankruptcy within all previous funds?
  - What strategy has the manager typically employed (consolidation, operational, financial engineering, etc.) and what are the main risks with this strategy?
  - When the GP acquires ownership of a new company, what typically happens to employees, R&D, G&A, and S&M levels?
  - How will existing restrictive debt financing affect future returns?
- **Investing In Existing Vintages:**
  - What is the stated purchase NAVPS and how is this computed? How does the NAVPs diverge from the TVPI per share?
  - Are contributions providing liquidity to exiting investors or providing capital to existing portfolio companies?
  - How do current portfolio multiples compare to public market equivalents? Is there divergence and, if so, why?
  - How levered are existing portfolio companies and what percentage of EBITDA is contributing to current interest expense?
  - What percentage of the vintage has been liquidated and when will all liquidity be provided? What are the mechanisms for liquidity?
  - Why invest in an existing vintage versus waiting for a new one?

Given the regime change in interest rates, we encourage investors to ask critical questions when assessing private capital allocations.

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