It's a Case of 'BuyIRR Beware' for Private Equity Investors as Headwinds Compress Multiples

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KEY TAKEAWAYS

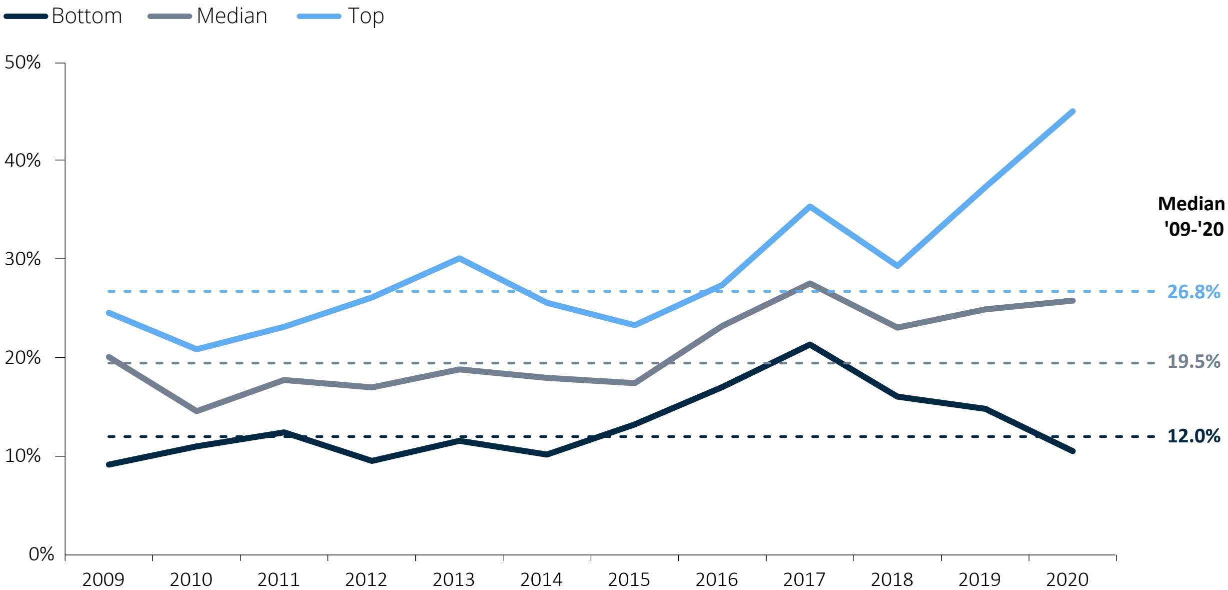
- Private equity managers can no longer rely on favorable monetary policy to boost deal multiples and the Internal Rate of Return (IRR)
- As economic headwinds increase, the ability to separate repeatable alpha from unsustainable beta is increasingly important
- Sponsors who apply resources to help portfolio companies to achieve their maximum growth and profit margin potential relative to their peers build resilience through the ability to withstand some market valuation multiple compression and higher debt costs
- Investors seeking to allocate to managers with the ability to meaningfully exceed median buyout returns should conduct rigorous IRR diligence while tracking private equity firms' teams, strategies, and execution to identify those that are well positioned to outperform

With the recent banking crisis beginning to recede, hopefully permanently, investors can once again focus on one of their core tasks — allocating to investments, including private equity.

Adams Street is regularly asked by investors if we think private equity returns can continue to outperform liquid options across cycles. Our firm has invested for over 50 years and across many market cycles globally. After the 2008 global financial crisis, private equity enjoyed an uninterrupted run of superior returns thanks to macroeconomic tailwinds — most notably rock bottom interest rates and an accompanying rise in valuation multiples.

The benign climate allowed investors to often hit their internal rate of return (IRR) bullseye without the need to carefully aim their allocation arrows, as evidenced by median US buyout returns (see Figure 1). In our view, a decent chunk of these returns have been derived from unsustainable beta, which can artificially inflate a private equity manager's performance. Now that the macro backdrop has turned into a headwind, our advice to investors is to adhere to our internal mantra — BuyIRR Beware — by parsing repeatable alpha and unsustainable beta in private equity manager IRRs.

Figure 1: US Buyout Vintage Year Returns[1]



Private Equity Alpha vs. Beta

Unsustainable beta is typically marked by revenue growth at or below the market or portfolio company's competition. This leads to pre-tax cash flow margin expansion that lags both revenue growth and peers. Other "beta" performance factors include rising market valuation multiples, deal leverage, dividend debt recaps, and fund lines of credit.

By contrast, a fundamental factor that we consider to be characteristic of repeatable alpha is revenue growth that exceeds the portfolio company's market and/or competition. This often leads to pre-tax cash flow margin expansion that matches or exceeds revenue growth and peers. If these two factors are present, companies can graduate to a higher valuation multiple category due to increased scale.

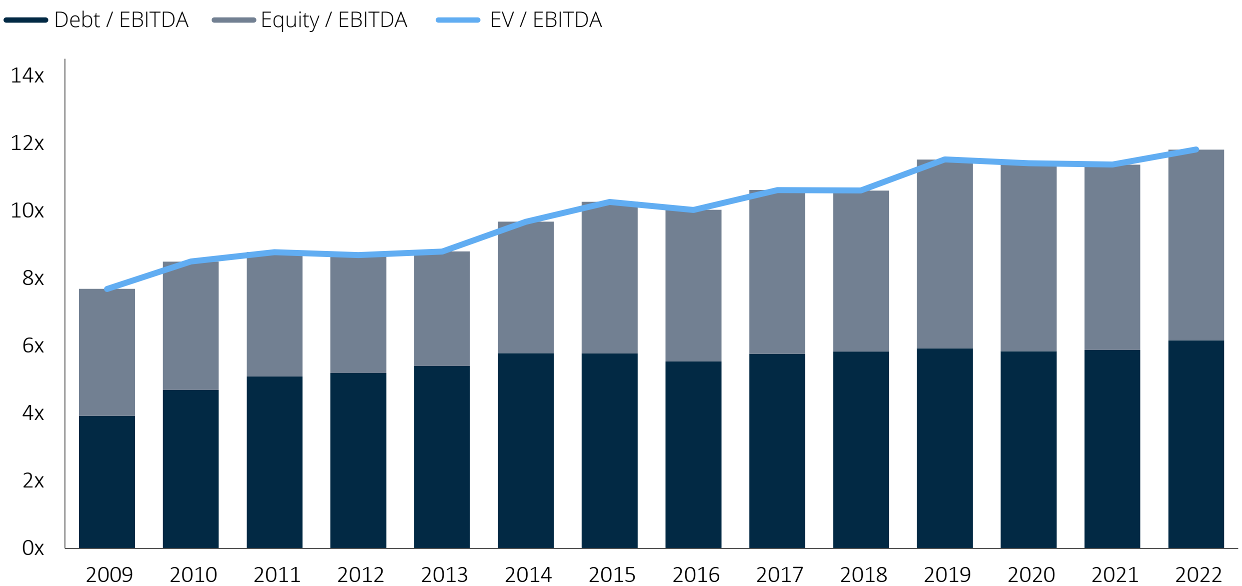
Two key challenges for most private equity investors are gathering enough data to distinguish between alpha and beta in fund net IRRs, and determining if the alpha portion is repeatable and sustainable. In our mind, the former is necessary, but not sufficient, to invest. The ultimate secret sauce to selecting managers with a high probability of producing top quartile results is the latter, which requires longitudinal observation and judgment. Investor decision making can be complicated by expanding fund sizes and product extensions — common features of today's private equity ecosystem – which can introduce strategy drift and basis risk when assessing potential return persistence.

Beta in a Rising Tide

To understand how a rising tide lifted all boats on private equity returns, let's review a hypothetical buyout deal named Lucky,[2] completed in 2017 and exited in 2022.

The entry valuation multiple for Lucky was 10.6 times earnings before interest, taxes, depreciation, and amortization (EBITDA), the median for US private equity transactions in 2017. That purchase price was financed with 4.85 turns of equity and 5.75 turns of debt. Five years later, the exit valuation was roughly 12 times EBITDA, the median for a US private equity transaction in 2022 (see Figure 2 for market valuation multiples).

Figure 2: Beneficial Macro Conditions Help to Expand US Private Equity Transaction Multiples (EV/EBITDA)[3]



Assuming 5% annual debt principal amortization and no change to Lucky's business over the five-year hold, the deal multiple is 1.6x and the gross IRR is 9.6%. The deal multiple rises to 2x and the gross IRR reaches 17.1% if the sponsor uses a fund line of credit at a 3% rate to finance 50% of the equity check while executing annual deal dividend recaps to take the debt back up to its starting level.

Because this return was produced without making **any** improvements in Lucky's business, it is quite likely that Lucky materially underperformed its peer set on revenue and profit growth during the holding period. This is 100% beta. Not repeatable and, in fact, easily reversible because the macro-economic tailwinds that existed during this hypothetical deal have vanished.

Today, deal leverage has declined between 10 and 20 percentage points, while equity contributions have climbed 20 percentage points or more to compensate. And because the cost of debt at both the deal and fund level has at least doubled, it is now more likely that over the next five years entry to exit valuation multiples will be flat to down instead of up.

Given these factors, if Lucky were completed in 2023, the sponsor would likely lose the positive IRR tailwinds from beta that managers enjoyed over the past 15 years. In fact, the deal IRR turns negative with a compression of just 10% in Lucky's entry to exit valuation multiple while current interest rates stay flat.

Faced with levered beta headwinds, we believe median private equity returns, and those of many private equity managers, are likely to disappoint. Generating repeatable alpha requires skillful identification and selection of companies by the private equity investor. Those that can apply resources repeatedly across market cycles to help companies to achieve their maximum growth and profit margin potential relative to their peers can withstand some market valuation multiple compression and higher debt costs. They often do it in sectors going through significant dislocation and change, where being private is an advantage.

To select managers who remain well positioned to outperform median returns by a healthy margin, investors must conduct rigorous IRR diligence while applying judgment based on longitudinal tracking and referencing of private equity firms' teams, strategies, and execution.

Now that private equity investors can no longer rely on "beta" from macro tailwinds to lift all boats, they will be well served to heed the mantra - BuyIRR Beware. ■

1. Source: Burgiss.
2. For illustrative purposes only. Deal statistics are based on observed deal terms seen at relevant periods and are not intended to represent deal characteristics of any Adams Street investment.
3. Source: S&P LCD (Pitchbook) as of January 2023.

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