THE TRIAGO REVIEW & OUTLOOK

Dear Reader,

Private equity and the wider global society in which it operates have confronted a broadening range of potential dangers over the past year. But PE and many of the sectors and economies in which it invests are proving reassuringly resilient, adapting to headwinds even as we cycle through uncertainty; what we called the new normal in these pages a year ago.

Private equity's health and sheer inventiveness in tough times are demonstrated here (and contrasted with other less dynamic, more passive ownership models) from our roundtable on how general partners are financing growth using GP currency, to our item on limited partners zeroing in on recession-resistant assets through targeted direct investment. Indeed, in an anxious world, PE's ability to produce strong returns may be better than many imagine.

As always, we hope the information found here helps you make the right business and investment decisions. To all, we wish health and happiness over the holidays and a joyful 2023!

Sincerely, The Triago Team

ANALYSIS: PE CHUGS ALONG
Despite LP liquidity draught

ROUNDTABLE: GP CURRENCY SPURS FIRM GROWTH
GPs of all types turn firm stakes into cash

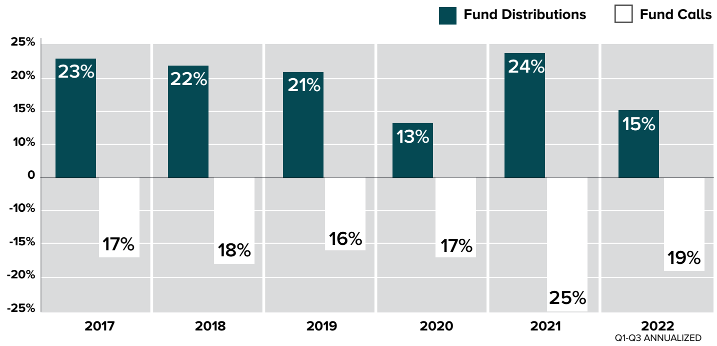
PRIVATE EQUITY BLOG
Explaining the PE/stock value gap, LPs gravitate to primary market single-asset directs, New PE model for M&A, When blind pools aren't blind pools, Proliferating forms of secondary leverage

PE CONTINUES TO OUTPERFORM STOCKS
Just as investors' need for liquidity sharpens.

Stock volatility means PE is more appealing…
Private Equity Net Asset Value Change Versus the S&P 500[1]

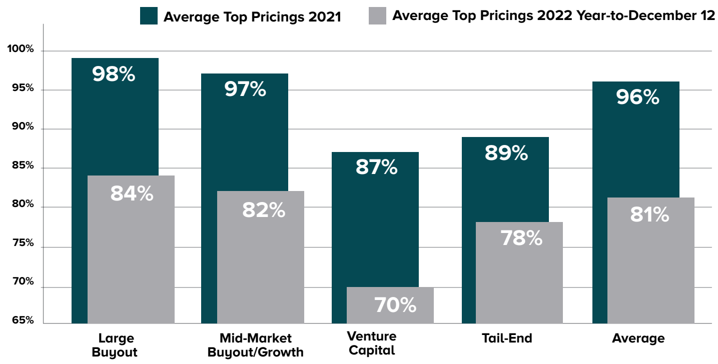
INDEX	FY 2021	Q1 2022	Q2 2022	Q3 2022	Q1-Q3 2022
Triago NAV Index	+42.7%	+2.2%	-0.5%	+0.5%	**+2.2%**
S&P 500 Index	+28.7%	-4.6%	-16.1%	-4.9%	**-23.9%**

…but leads to falling exits & investor distributions…

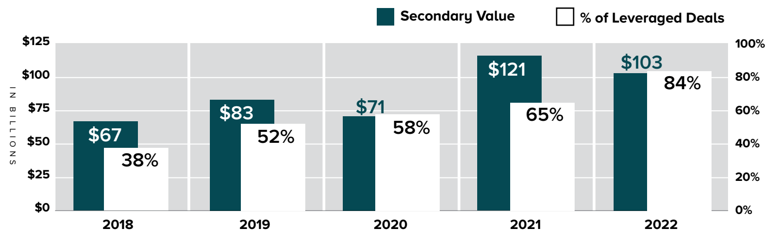


Percentage of limited partners' committed capital – annual average

…and considerably lower secondary prices for funds…
Fund Types Sold on the Secondary Market
Pricing Relative to Net Asset Value (excludes GP-Led)



…as secondary leverage aids volume & liquidity.
Secondary Volume & Deals with Leverage[2]



1 The Triago NAV Index is capital weighted, global and includes value changes for buyout, venture capital, growth, real assets, distressed, turnaround and secondaries.

2 Percentages show proportion of secondary transactions incorporating some form of leverage. Leverage includes deferred payments, debt and preferred equity. Secondary value and leverage for 2022 are preliminary estimates.

PE Keeps Chugging Along

Private equity finds the liquidity it needs, as acquisitions and fundraising remain at near-record levels.

To paraphrase Mark Twain, reports of private equity's travails are greatly exaggerated. In a year when public stock markets have lost considerable value, PE is registering a slim gain (chart 1, p. 1), while Triago's (conservative) preliminary estimates for fundraising and PE-backed purchases indicate a banner year.

With less than eight days left in 2022, our estimate for annual global buyouts is $825 billion, the second-best year ever for purchases, although down 25 percent from 2021. Capital unspent in the initial phase of the Covid-19 pandemic flooded the market in 2021, leading to annual global buyout value of $1.1 trillion – more than double the previous five-year average of $543 billion. PE-backed purchases in 2021 more than match healthy, pre-pandemic levels, with volume crucially helped by the emergence of private credit providers willing to make leveraged loans at a time when banks can't or won't. Private credit fund assets of $1.2 trillion are four-and-a-half fold what they were during the global financial crisis of 2009 when PE-backed deals fell off a cliff (declining 70 percent).

Meanwhile, across the globe, PE broadly defined - encompassing strategies in buyout, venture capital, growth, real assets, turnaround, secondaries, structured credit and funds-of-funds - chalked up some $885 billion in commitments, the second-best tally ever (albeit in a crowded market). While that's 14 percent below last year's apex of $1.03 trillion, 2022 will clearly edge-out previous silver medalist 2017, when $829 billion was raised.

Solid fundraising numbers continue to be supported by the strong fundamental performance of PE-backed firms. From the thousands of conversations we've had in 2022 with managers and investors, it's evident that private equity-backed firms are seeing stronger earnings growth than publicly quoted counterparts (explained by PE's activist ownership model, where owners shore up and expand businesses faster than under the passive, public company ownership model).

Given a sharp drop in realized PE investments and a consequent fall in distributions to investors, continued fundraising strength is even more impressive. Distributions from realized investments are 27 percent below the previous five-year average and 38 percent below 2021's spike (chart 2, p. 1). Despite the distribution draught, and PE accounting for a relatively greater portion of overall investment portfolios due to plunging stocks, most investors are robustly committing to PE, frequently raising allocations (officially or defacto). They're also selling near-record amounts of non-core funds on the secondary market. But reduced distributions are leading to proportionally greater commitments to existing relationships - raising the bar for new managers and making the last mile tough for record-sized funds.

Triago's $103 billion estimate for 2022 secondary volume is 14 percent below last year's all-time annual peak of $121 billion, but towers above erstwhile second-place 2019 by 24 percent (chart 4, p. 1). Secondary volume - like PE-backed purchases - is being aided by the rise of new leverage tools, i.e. deferred payments, preferred equity and debt, ideal for bridging pricing expectations between buyers and sellers amidst uncertainty. Some 84 percent of secondaries - both GP-led and LP-stake deals - involved some form of leverage in 2022 versus just 38 percent in 2018 (chart 4, p. 1).

Relative bargains for LP-stakes, where the average price fell to 81 percent of net asset value in 2022 versus 96 percent in 2021, are, to some degree, acting like chum for buyers. LP-stake sales accounted for a majority of secondary volume - 53 percent in 2022 versus 36 percent in 2021 - reversing a two-year trend of GP-leds, typically priced closer to NAV, taking the lion's share of value. Multi-asset portfolios (as opposed to single-assets) accounted for 59 percent of GP-led deal value in 2022, up from 47 percent in 2021, again due to a widening pricing gap and bargain hunting.

In sum, despite considerable hand-wringing, rapidly developing liquidity options are keeping PE on track in a discombobulated world. With assistance from these newly viable liquidity options, and an unprecedented store of committed but unspent capital ($3.7 trillion in dry powder in Q3 2022), managers in 2023 should be able to take full advantage of the exceptional valuations that are the silver lining of volatility and crisis.

The Growth of GP Currency

Big, small, old and new groups can now convert "GP currency" – or fungible PE firm stakes – into cash for development.

In both public and private markets over the last three years, private equity firms - referred to as general partner firms or just GPs - have come to be valued more highly than classic asset managers for the first time ever. Indeed, an unprecedented range of capital providers are looking to tap into the growing relative value of GPs by offering firms everything from straight equity to non-dilutive financing (the latter typically as debt or preferred equity). GP currency is now routinely used to finance mergers and acquisitions, diversification, staff recruitment, talent retention, skin-in-the-game fund investment and even the launch of newly independent PE groups. As one of our roundtable participants notes, all GPs today can develop their franchise well beyond what's "possible with just the capital contributions of partners." But the strategic and tactical choices of when and how to use GP currency are growing ever more complex.

BRAD COLEMAN
Managing Director and Head of GP Coverage, Hunter Point Capital

AUGUSTIN DUHAMEL,
Managing Partner and Founder, 17 Capital

ANTHONY MANISCALCO
Managing Partner and Head of Strategic Capital Group, Investcorp

TOM GLOVER
Operating Advisor, BC Partners Credit

What accounts for the climbing value of private equity firms relative to other asset managers?

TOM GLOVER: It's largely explained by the rapidly rising value of assets under management. But the other key is the growing recognition by investors of the superior profit margins of private equity. PE is more profitable than traditional asset management for both investors and managers. That said, valuations of PE firms are not immune to the negatives that impact all equity, including rising interest rates and increased risk. We're in the midst of the first major interest rate tightening cycle in more than a decade, with elevated inflation, major war in Europe and heightened political and economic uncertainty. Valuations for listed PE firms have slid on the order of some 20 percent this year, and that's likely to spill over into the private PE firm sector. But the long-term re-rating and the outperformance we've seen against both traditional managers and the broad market will continue.

BRAD COLEMAN: I would add that the conversion of quoted PE firms - starting some four years ago - to C-corporations from publicly traded partnerships helped values materially. Institutional investors, banned from investing in publicly traded partnerships, were finally able to invest. They understood the advantages of PE's locked up money and the value of higher management fees and performance fees. It was pretty much a perfect scenario for PE, with low interest rates driving record fundraising, cheap leverage, and the prospect of exceptional returns. Given today's rising interest rates, previous grow-to-the-sky expectations are coming back to reality. But the sector's relative prospects and the desire to own these firms - whether the companies are listed or private - hasn't diminished, nor has the steadily growing capital need of GPs.

AUGUSTIN DUHAMEL: I'd add that the profitability of PE firms has risen dramatically as firms have grown larger and achieved increasingly important economies of scale. That drive for size has led to a much greater need for financing, spurring equity investment in PE firms, something that was largely nonexistent a few years ago. Now, it's sparking the rapid rise of debt and preferred equity as a means of financing PE firms. We expect the use of such non-dilutive capital to accelerate as interest rates increase and possibly push down the equity valuations of PE firms.

ANTHONY MANISCALCO: This is a sector with exceptionally stable management fees and great long-term growth prospects - especially when we consider the likelihood of increasing fund sizes. The rise in the risk-free interest rate [essentially the average return on government bonds], which all of us use to discount cash flow models for PE firms inevitably means that the average valuation has to come down. The good news is that valuations on the private market side have come down considerably less than the roughly 20 percent decline Tom mentioned for publicly listed PE firms. Private firms are trading in a fairly tight range compared to where they were when rates were low. That's because the private markets never paid the sky-high multiples we saw in the public markets.

TG: I'll just note that public market investors on average have a 12- to 18-month horizon for realizing investments, whereas everyone here today is looking at discounted cash flow over a much longer period. That means market volatility on either the up or downside has a much lower impact on our valuations.

AD: To sum it up, we all make valuation calculations on a case-by-case basis determined largely by how much bigger we believe a particular PE firm's successive fund vehicles can grow in the future, while paying relatively less attention to valuations or average cash flow multiples paid in the public markets.

How can monetizing the value of GP ownership help firms?

BC: At a time of rapid expansion, the big challenge for firms is managing capital, whether equity or debt. That capital is important for accelerating the growth of firm resources and personnel, for covering rising general partner commitment to funds, for providing incentive pools for the next generation of partners, and for protecting firms' flanks through mergers, acquisitions and joint ventures. The latter is of growing importance given increasing consolidation between alternative managers, broad asset managers and even insurers. And monetizing firm value can come with strategic perks - we give our partners access to a 13-person fundraising and marketing team, streamlined procurement networks, talent management through an affiliation with Council Advisors, and internal ESG counseling. We're a catalyst for improvement of all kinds.

AM: Brad and I focus on a similar part of the market and it's not the mega-firms. Our partners are typically at an inflection point and the permanent capital, strategic resources and counsel that comes with our investment - in everything from human resources to engineering continuation vehicles – provides a lot more bang for the buck than it would at the industry's giants. The latter, of course, have frequently raised equity capital through stock market listings.

AD: The decision to sell equity, or to take the flexible non-dilutive preferred financing we offer, or accept straight debt from the likes of a bank or credit fund boils down to determining the best way to seize a growth opportunity. Interestingly on the non-dilutive capital side, we increasingly work with very large managers - several of our own clients are in the top ten globally. In some ways, we're discussing a tale of two markets, one with smaller firms geared for exceptionally rapid growth relative to size - they're a bit more likely to look for a general equity partner - and one where the players are already big and where the priority is financing less exponential, more focused growth - they're more likely to go for a non-dilutive solution. That said, there are no hard and fast rules.

> "Market volatility has a relatively low impact on GP firm valuations."
>
> *Tom Glover, BC Partners Credit*

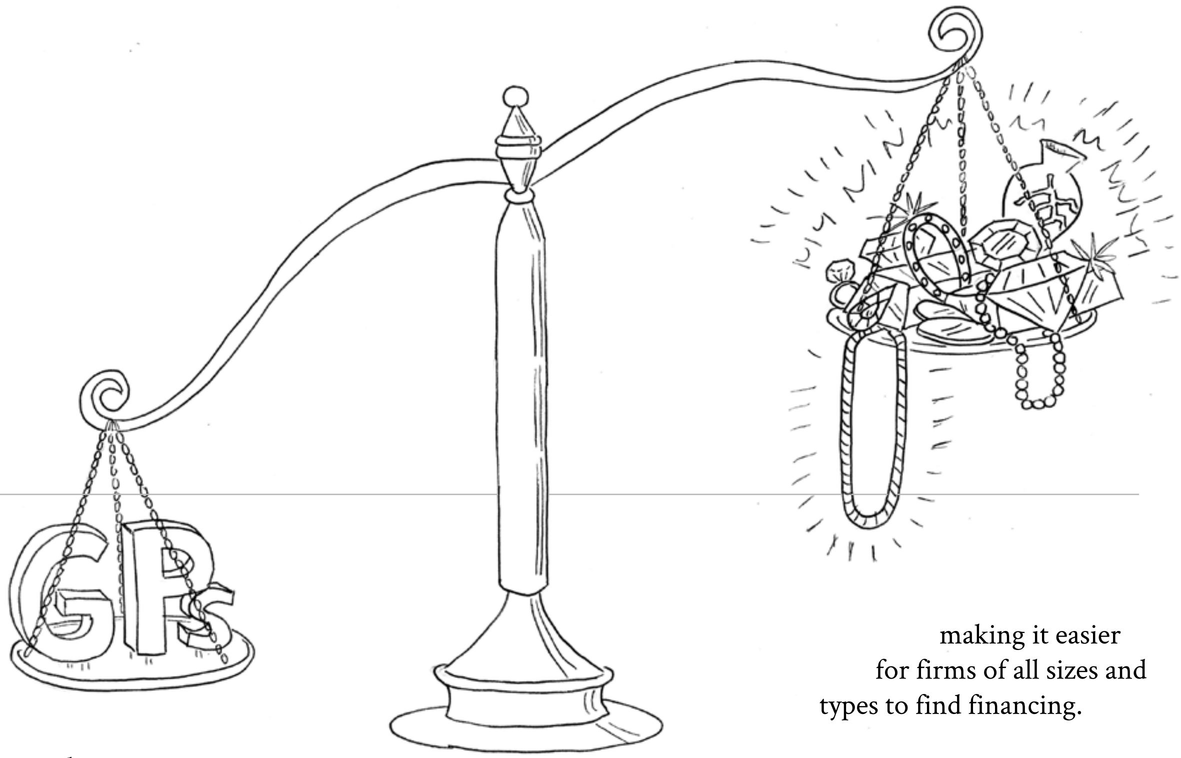
TG: We clearly see the powerful value of equity, in fact Blackstone owns a minority stake in BC Partners. But sometimes the financing tool that is the absolute right choice is the non-dilutive capital that firms like ours and Augustin's offer. Regardless of size, non-dilutive capital is often used to take out equity investors, like cornerstone limited partners, or managing partners when there's generational succession.

Let's dig into that a bit more with a few further examples of when a GP should use equity financing or non-dilutive capital.

AD: A scenario where it typically makes more sense for a GP to use non-dilutive financing is when the next fund the GP expects to raise will be substantially larger than their current fund. The value of that larger fund is most likely not going to be fully reflected by equity financing.

AM: We should keep in mind that there's nothing black and white here and that seeking some combination of non-dilutive capital and equity at the same time for either one goal or several at the same time is increasingly common. Exactly what the ratios should be has a lot to do with the GP's current balance sheet and their growth prospects.

AD: Anthony's right – we're starting to see GPs use a combination of both debt and equity, though doing both at once, rather than successively, can be quite complicated, especially in terms of setting valuations.



TG: To elaborate on my earlier point, there really are some straight-forward cases where non-dilutive financing is clearly the best option. When you're buying out an equity investor - either a cornerstone investor or a retiring managing partner – the goal is almost always the consolidation of the shareholder base within the firm. Accomplishing that through a third-party equity sale is self-defeating. For financing new, untested strategies - say a GP commitment to a fund in a new area or financing the warehousing of assets for a new strategy's demonstration portfolio - non-dilutive capital can also be the best way to avoid pricing GP potential too cheaply.

BC: It's been years since large GPs woke up to the fact that they are not just great investors, but that over time they've created brands and real enterprise value. Now that outside capital providers of all stripes cater specifically to GPs of all sizes - really only a phenomenon of the last three years or so – everyone in this business is realizing that they have the potential to develop their franchise well beyond what would be possible with just the simple capital contributions of partners. Figuring out an ideal mix of equity financing and non-dilutive capital is subjective and based on a wide range of possible variables. But the third-party capital now being offered allows GPs a means to efficiently maximize their own balance sheets and plan for their future growth.

Is it harder for small GPs to monetize value than it is for large ones?

BC: Growing numbers of firms offer seed capital, so financing is increasingly available for even first-time managers. But there's still a risk spectrum and emerging managers are by their very nature higher risk. The more established a franchise is, the easier it is to monetize – this would be the case in any industry. In the early days of the GP stakes business, say six or seven years ago, it was pretty much just the big GPs that had access to equity investment. As the market has become more competitive and as capital providers have become more experienced, players have come to recognize that there's very solid potential at smaller firms. At Hunter Point, we're comfortable investing in a wide range of successful mid-market GPs with demonstrated cash flow and franchise value.

AD: A successful GP, whatever their size, will always find capital and will always be able to finance their growth. What we see developing today is capital providers specializing in different market segments. That's making it easier for firms of all sizes and types to find financing.

TG: Augustin is right - there's clearly a lot of segmentation going on, both in the GP stakes arena and in non-dilutive capital. Our deal focus is on the non-dilutive small and middle market space, with financings as small as $10 million and as large as several hundred million. And financing managers with less of a track record is honestly what makes this field so exciting. We now have the ability to craft tailored financing packages, analyzing and then slicing and dicing in different ways all the possible pools of value that might exist within a GP, including management fees, eventual income from GP commitments and potential carry. To emphasize Augustin's point, a good manager will always find a way to source capital for the right opportunity. Mapping exactly how to do that is the major challenge.

AM: We're very risk averse in terms of potential loss of capital. We care a lot about the firms we partner with being on at least their third fund and being of a certain size. We want to be able to vet a substantial track record of performance and growth. But we're creative. Although it's not strictly in our sweet spot, with promising emerging managers we will occasionally do deals that include both an equity component and, for downside protection, a non-dilutive component.

Illustration: Marc Tyler Nobleman

PRIVATE EQUITY

BLOG

A round-up of current trends and issues for general partners and limited partners

Single-asset investment gives funds a run for their money

The purchase of recycled single assets is falling in the secondary market as investors are drawn to relative bargains among diversified, second-hand LP stakes (more detail on p. 2). But targeted investment continues to take market share in the primary market. Commitments from LPs investing directly (on their own or via fundless sponsors) and co-investing (alongside the LP's existing PE fund managers) in specific companies amounted to respectively $190 billion and $145 billion in 2022, a combined value equal to nearly 38 percent of annual fundraising for classic vehicles ($885 billion). This compares to 31 percent in 2021 and the previous five-year average of 25 percent. Unlike blind-pool fund investment, both direct investment and co-investment can be easily stress-tested, helping to keep deals flowing in uncertain times.

> Direct & co-investment is 38% of classic fundraising.

More blind-pool funds close with assets on their books

The average time it took to raise capital for PE vehicles notching final fundraising closes in 2022 was 16 months versus 14 months in 2021, according to Triago's preliminary 12-month estimate. But more noteworthy than that 14 percent year-on-year increase, is the proportion of classic blind-pool funds that actually were no longer entirely blind pools at final close. In 2022, funds with a quarter or more of their total fundraising target already invested stood at 27 percent of all final closes, up from 21 percent in 2021. Against a backdrop of reduced distributions (more detail on p. 2), rising interest rates, inflation, and war in Europe, investors are increasingly more likely to part with their money if they can kick the tires on at least some investments. Dovetailing with rising single-asset investments in the primary market, this is evidence of investor desire to get closer to identifiable, stress-testable assets.

Listed holdings shed some light on pricing discrepancies

During 2021, when stocks were considerably more volatile than PE, it's hardly a surprise that funds with material holdings of publicly listed companies were priced much lower on the secondary market than funds holding few-to-zero listed firms. Two funds of similar size, vintage and composition with the same net asset value, could easily price 10 percentage points apart, with one dragged down because of a legacy holding in a publicly-quoted company viewed as particularly vulnerable to market swings. Yet that pricing discrepancy also serves to highlight an important reason why PE values have been insulated from the declining values of listed comparables (PE portfolio companies' stronger earnings – discussed on p. 2 – are another reason). Holding listed comparables typically doesn't come with the control premium priced into the value of PE holdings.

A new way to finance deals

Just a little bit more on the impact of direct investing: A new financing model for mergers and acquisitions that bypasses traditional investment bankers is emerging, as limited partners increasingly leaven classic fund investment with potentially high-alpha direct investments, more often than not after a pitch from a fundless sponsor. In their search for financing, rather than turning to investment bankers with their access to strategic buyers, PE fund managers, bond investors and stock investors, fundless sponsors are turning to classic fundraising advisors (like us!), cementing relationships via exclusive, long-term contracts. Fund raising advisors' capital raising connections are directly with limited partners of every stripe, from state pension funds to family offices. We humbly posit that seeking financing for individual deals directly from PE investors will open up a major new financing mechanism for mergers and acquisitions of all types. Time will tell.

More on the amount of leverage in secondary deals

As the number of secondary transactions incorporating some form of leverage reached a record level of 84 percent in 2022 (more detail in chart 4, p. 1), the average amount of leverage used in each levered deal rose too, hitting an all-time high of 61 percent across LP-stake and GP-led trading. This exceeds the former apex of 54 percent achieved in 2021. For LP-stake transactions, leverage in 2022 is overwhelmingly in the form of deferred payments, typically funded by new investment realizations post-transfer. For GP-stake funds leverage is typically in the form of debt. Preferred equity accounted for some 8 percent of overall secondary market value in 2022.

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TRIAGO

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