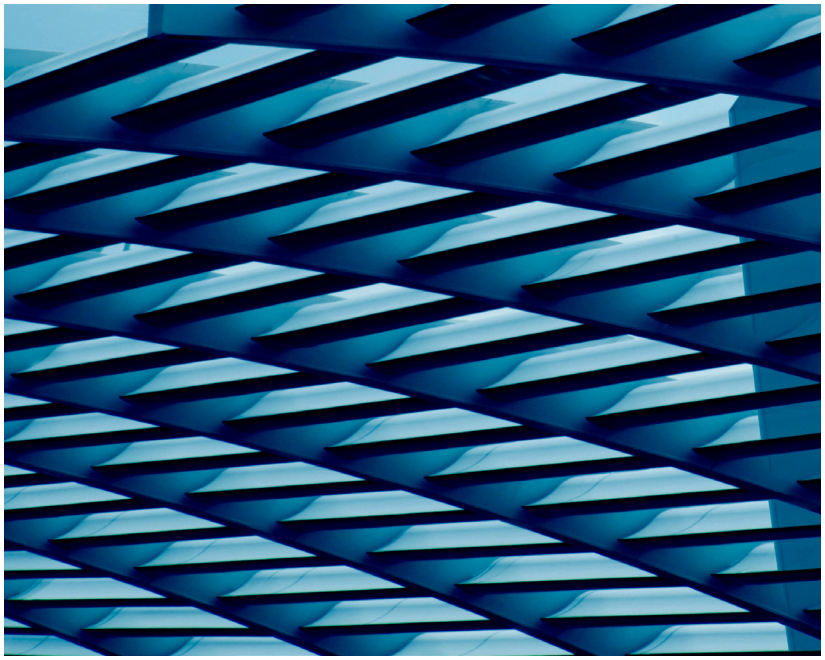








GLOBAL OUTLOOK
2023

PRIVATE EQUITY WIRE



Welcome to Private Equity Wire's 2023 Global Outlook.

Following one of the most volatile years for the asset class in living memory, we asked a group of well-known industry leaders to provide their view on the market that awaits in 2023.

Their views have been organised across four chapters – the macro environment, dealmaking, fund performance, and fundraising – and I am sure you will agree they each make for interesting reading.

Unlike in previous years, this year's contributors have had to take account of continued and growing headwinds in the form of weak economic activity, difficult political environments, and tight credit markets.

As John Stake at Hamilton Lane points out on page 13, downward pressure on performance can't continue indefinitely. 2022 is likely to be a mediocre year performance-wise – a rare occurrence for the asset class – but he believes it is unlikely that 2023's performance will continue this downward trend, and instead, with the benefit of new deals at compelling valuations, he expects to see high single-digit to low double-digit returns for the asset class. Outperformance over public equity indices will also be driven by higher capital structure resiliency, a more comprehensive value creation toolkit, and the deeper sector expertise inherent to private equity managers.

From a dealmaking perspective, volatility brings opportunity, and few are better positioned to capitalise on that opportunity than private equity investors. The new market reality of 2022 has led buyers to adjust how they calculate risk and structure transactions, and more GPs are building buffers into the capital stack. Yet, in an uncertain exit environment, deployment pace will remain slow. A.J. Rohde at Thoma Bravo believes mission-critical software – one of his company's sweet spots – will continue to drive deal activity in 2023. He predicts that companies will increasingly adopt workplace automation tools as they realize they can use technology in tough macroeconomic environments to streamline their businesses.

The outlook for fundraising in 2023 is less clear. As Steve Standbridge at Capstone explains on page 20, 2022 has seen some of the most challenging fundraising conditions in private equity history. The denominator effect will persist into 2023 and has impacted LPs' appetite for different private equity strategies. As a result, portfolio management, for both GPs and LPs, will be the top priority in the months to come.

We would like to thank all the contributors to this year's Global Outlook for their thoughts and insight on the year ahead and wish all our readers a happy and healthy 2023.

- Colin Leopold
Head of Research & Insight

CONTENTS

CHAPTER 1: MACRO OUTLOOK

5 Blackrock Alternatives

6 JP Morgan Asset Management

7 Schroders Capital

CHAPTER 2: DEALMAKING

9 Thoma Bravo

10 Providence Equity Partners

11 BC Partners

CHAPTER 3: PERFORMANCE

13 Hamilton Lane

14 Manulife Investment Management

15 EY

16 Cambridge Associates

CHAPTER 4: FUNDRAISING

18 Rede Partners

19 MVision Private Equity Advisers

20 Capstone Partners – a Mizuho Company



MACRO OUTLOOK



GLOBAL OUTLOOK 2023



LYNN BARANSKI
CIO OF PRIVATE EQUITY PARTNERS
BLACKROCK ALTERNATIVES

2022 has brought market upheavals, geopolitical instability and economic conditions that few could have foreseen. Yet, in volatility there is opportunity, and few are better positioned to capitalise on that opportunity than private equity investors.

Our focus is on building recession-resilient portfolios, which means focusing on leading companies that deliver must-have services and products with built-in sales pipelines and predictable cash flow. This could include mission-critical enterprise software businesses or firms in more defensive sectors like essential healthcare and consumer staples. We also believe sectors with strong tailwinds, such as space, defence and cybersecurity, are well positioned to benefit in the long term.

From a dealmaking perspective, the new environment has led PE buyers to adjust how they calculate risk and structure transactions. More GPs are building buffers into the capital stack, as negotiating leverage increasingly shifts away from companies toward investors. We anticipate more take-private and corporate carve-out deals in the next 12 months as companies refocus on core parts of their business in fragmented industries.

While the increased cost of debt could slow deal activity in the short term, the demand for strategic capital to help GPs execute on transactions will grow. This dynamic opens the way for a proactive and opportunistic direct co-investment strategy for managers with ready capital and experienced teams.

We also anticipate that increased levels of activity in the secondaries market will present attractive investment opportunities for investors. Recent contractions in public equities valuations have triggered the well-known denominator effect, leaving many LPs looking for liquidity and a way to rebalance portfolios to maintain their illiquid alternatives allocation targets. This will be compounded by a slowing exit environment. As LPs increasingly pressure their GPs for realization events, secondary transactions provide increased optionality and an innovative way to manage assets.

Although 2023 may also bring some turbulence, we remain confident that private equity as an asset class will continue to deliver strong returns, as well as outperformance over public equity indices. This will be driven by higher capital structure resiliency, a more comprehensive value creation toolkit, and the deeper sector expertise inherent to private equity managers, amongst other factors.

Research has shown that private equity-backed companies experience resiliency during times of crisis as they have greater access to external funding, as well as their fund managers who can provide deep sector expertise and informational advantages as a value-add. Indeed, we already are seeing more acquisitions by our portfolio companies to take advantage of lower average purchase price multiples to drive top-line growth and economies of scale.

We think that highly selective investors with patient capital and broad market sourcing capabilities stand to be rewarded over the next 12 to 18 months as opportunities inevitably arise as a result of changing market dynamics.



DANA HAIMOFF
PRIVATE EQUITY PORTFOLIO MANAGER
JP MORGAN ASSET MANAGEMENT

What a difference a year makes. Following record investment and exit activity in 2021, this year we saw how all types of private equity deal activity retrenched significantly. We saw exit activity slow relative to 2021 and expect a similar trajectory for the first half of 2023. And it's been a similar story on the deal-doing front. We expect this slower deployment pace to continue, especially at the larger end of the market, as market volatility and uncertainty remain. At the same time, we expect to see more funds compete for reduced investor capital, creating investment opportunities. This should drive three key outcomes for the year ahead.

First, we expect the current denominator effect on LPs' PE allocation will continue into 2023, even as equity markets may recover some lost ground. In addition, a re-evaluation and reduced allocation to illiquid exposure will likely contribute to reduced demand for new and existing relationships and size of those commitments. Simply put, re-ups into existing relationships are not a given, and most certainly at reduced commitment amounts. While valuations, as of September 2022, are yet to take meaningful write downs or adjustments to 2022 public market comps, this is not unexpected – we have historically seen a meaningful lag from public to private market correction, often taking at least three quarters, if not more. This indicates PE valuations will likely be adjusted downward, as full year 2022 LTM earnings are captured among other factors, reflecting a softness well into 2023. Nevertheless, a combination of capital raise delays combined with reduced allocations and valuation adjustments should lead to investment opportunities, mainly in the secondary market and high-quality co-investment/ staple deals.

Second, any pick-up in meaningful investment transactions and exits will depend upon stability in the expected rates market allowing for debt, especially at the larger end of the market, to unfreeze. In the small/mid-market, where the debt is primarily floating, interest rates are still manageable for many of these sized existing holdings. The question is what this environment could do for exit multiples. Whilst we haven't seen multiples contract on recent new deals and exits generally, this could happen in 2023. On the other hand, many GPs have been aggressively buying down their entry multiples through growth and M&A. This year, add-on acquisitions have been at the largest percentage (>60%) of US Private Equity deals since 2007. We expect this strategy to continue in order to manage down multiples, gain market share and grow underlying earnings.

Third, despite the current macro uncertainty, over-allocation and locked debt market, GP capital supply remains large, currently estimated to be $1.4 trillion. Moving from 2021 to 2022, fundraising was larger and faster with funds being quickly deployed. But as the 2022 market environment changed, fundraising slowed. Funds should trickle into 2023, given the large number of funds that are currently in the market and the limited LP demand due to overallocation. Coupled with slower exits, we expect fund deployment to slow to pre-2021 levels as GPs become more conservative in the market. On the other hand, we have seen continued momentum for access to top VC names. Also, in lieu of traditional exits, we have seen and expect to continue seeing a rise in continuation vehicles driving liquidity for investors.

Aside from the macro-economic environment impact on PE markets, we also expect to see further integration and monitoring of environmental, social and governance factors. Especially in Europe, where we see increasing integration and alignment with regulations such as EU Sustainable Finance Disclosure Regulation (SFDR) within Private Markets which we anticipate will grow further in 2023 and beyond.



NILS RODE
CHIEF INVESTMENT OFFICER
SCHRODERS CAPITAL

> "Getting dry powder back to normal levels can take quarters, or even years"

In 2023, private asset investors face a complex mix of challenges and risks. Nevertheless, private assets are long-term in nature. It's more appropriate that investors assess the medium- to long-term outlook before making any decisions. Over this longer timeframe, numerous durable, long-term trends mean we remain optimistic.

In particular, five long-term mega trends should provide tailwinds: climate change and decarbonisation; technological revolution; sustainable lifestyles; aging populations; and the growth of emerging and frontier markets.

Even so, the near-term is undoubtedly going to be difficult. Here are three key things investors can focus on to ensure they are as resilient as possible to short-term market challenges.

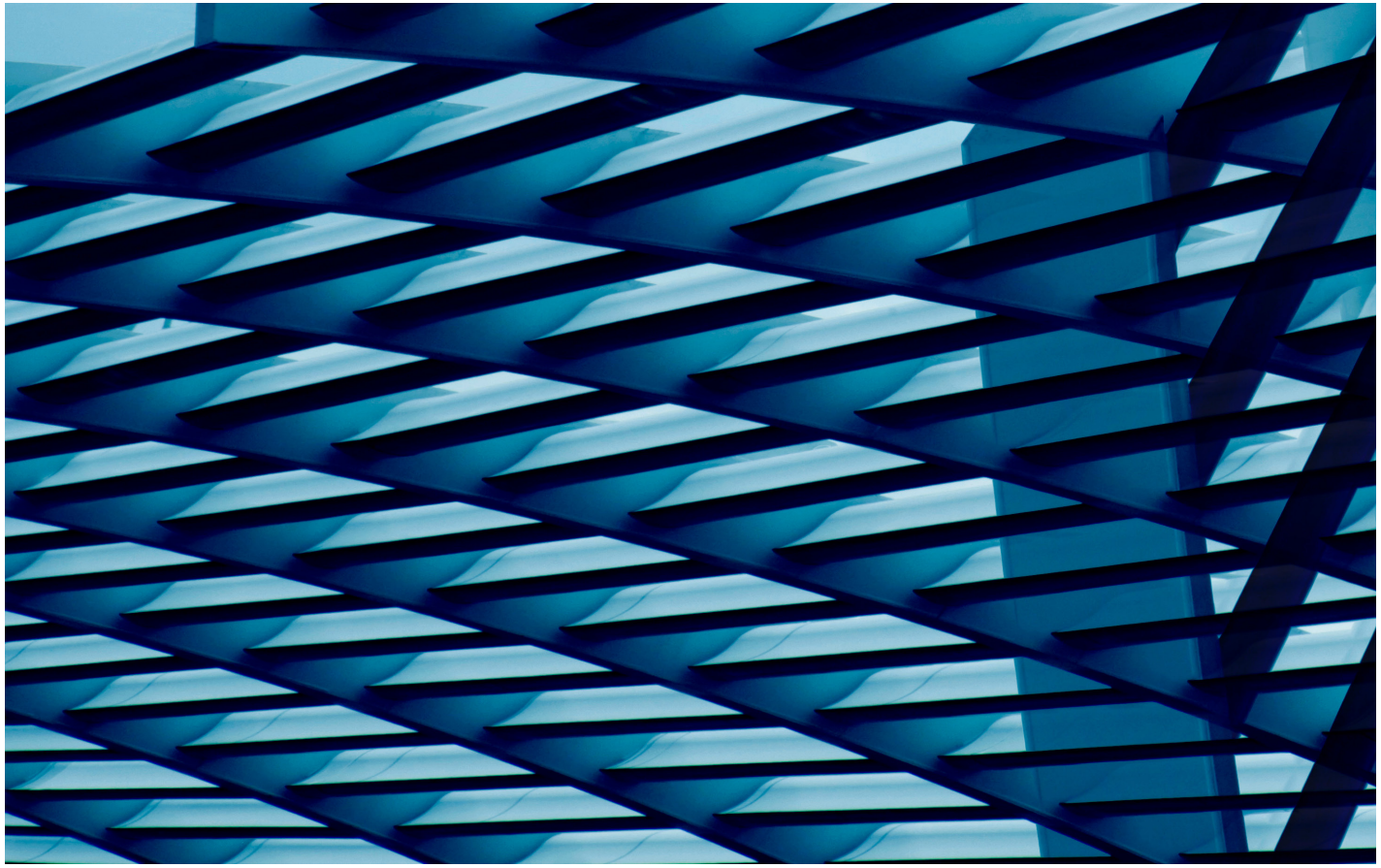
Firstly, keeping a steady investment pace. This may be difficult. Nevertheless, investors who can make new fund investments in 2023 are well advised to do so. Recession years tend to be particularly attractive vintage years, according to our analysis. Structurally, funds can benefit from 'time-diversification', where capital is deployed over several years. This allows funds raised in recession years to pick up assets at depressed values as the recession plays out. The assets can then pursue an exit later on, in the recovery phase, when valuations are rising.

Second is less correlated strategies. Even though private assets' valuations tend to correct less than listed markets, they are not immune to an increase in nominal and real interest rates. However, the private asset market has grown hugely and become very diverse. There are specialised strategies in each asset class that should be resilient to even a prolonged and deep recession. Most of these investments can be found along the long tail of private assets. This is the 95% of transactions - smaller and mid-sized - that typically present 50% of the investment volume in each asset class. Additionally, we believe that investments with strong sustainability and impact characteristics provide better upside potential and more downside protection.

Third is avoiding major dry powder overhangs. In our outlook last year, we highlighted that exuberant fund-raising posed a risk to vintage year performance. During the Covid-induced boom-bust cycle, fundraising for private assets has boomed. However, the build-up of dry powder has been very unequal. Some strategies have seen fundraising skyrocket, while for others it has remained more stable. For many years, we've studied the deviation of fundraising from its long-term trend as an early indicator for vintage year performance. There is a negative correlation between the two. When fundraising has been above trend, vintage year performance has been negatively affected, as dry powder can inflate entry valuations. For late stage/pre-IPO venture and growth capital, fundraising has been significantly above trend in recent years, which has contributed to the strong correction which started at the end of 2021. Large buyouts have exhibited similar behaviour, just not to the same extent. Fundraising dynamics in small buyouts, conversely, have been much more stable. This has led to a valuation gap between large and small buyouts that has led to increased absolute debt levels for large buyouts.

We would advise investors to avoid strategies with these dry powder overhangs, until they fall to more normal levels. However, getting dry powder back to more normal levels can take quarters, or even a few years.

DEALMAKING



GLOBAL OUTLOOK 2023



> The big theme for 2023 is the continued resilience of software

A.J. ROHDE
SENIOR PARTNER
THOMA BRAVO

In the current economic and geopolitical environment, many LPs are prioritizing backing GPs with strong track records in compelling sectors. The most compelling sectors, in our view, are the ones that can thrive no matter the macroeconomic conditions, and there's perhaps no better example than software.

The big theme we are expecting for 2023 is the continued resilience of software – both as a business model and in terms of corporate spending and priorities.

In the year ahead, we predict that companies will increasingly adopt workplace automation tools as they realize they can use technology in tough macroeconomic environments to streamline their businesses. Historically, when we've seen big shocks to the market, corporate buyers refocus their priorities to digital adoption. We are already seeing this occur in our portfolio and expect to see an acceleration of digital adoption across the broader market. When we are seeing retention rates of over 100% at these software companies, it really speaks to the strength of the business model during inflationary periods. Software is mission critical, which is why these companies have pricing power even in periods of uncertainty and volatility.

We expect this theme to continue to drive deal activity, particularly in the public markets. As public companies transition their focus from 'growth at all costs' to profitable growth, there is a significant opportunity for private equity buyers. Technology stocks took a large hit in 2022 and the public markets are not valuing these companies the same way that we do. Even during times of deceleration and drops in share price, we can see the immense value these innovative companies have to offer and the accompanying growth potential. As private companies work alongside a private equity firm, they can make operational improvements and focus on becoming even better companies – without having to myopically focus on quarterly earnings. The challenge of finding willing sellers at a reasonable premium remains, however, but we predict more companies and boards will be willing to engage in the year ahead.

We see incredible opportunities in 2023 and remain bullish on enterprise software. We have seen first-hand how software can not only survive in challenging times but thrive, and we look forward to seeing continued investment in this dynamic sector.



DAVIS NOELL
SENIOR MANAGING DIRECTOR
PROVIDENCE EQUITY PARTNERS

> "We see another big move down in the stock market as unlikely"

2022 was a year of great change for private equity. The correction and volatility in the public markets spilled into private equity with deal activity slowing down significantly, as buyers and sellers struggled to find pricing equilibrium. The heated auctions with constantly increasing valuations in 2021 gave way to a dearth of new deal opportunities and a reset on price expectations in 2022. This also drove some multiple contraction in the private markets, albeit not to the same extent as the public markets. Another factor was that many private equity firms were feeling overexposed from investing too much capital last year, and were hesitant to invest this year. We were fortunate that we purposefully slowed down our investment pace in 2021. In 2022, we've been able to find attractive new investment opportunities using our sector-focused approach to leverage longstanding relationships, and as a result have invested a similar amount to last year.

Ultimately, there is still substantial dry powder across private equity and a desire to invest more in 2023. As long as there is relative stability in the economy and markets, we would expect that deal activity should pick up significantly. One area of potentially increased deal making in particular would be take-private transactions. With equity valuations depressed, and a number of recent IPOs well below offering price and orphaned in the public markets, look for private equity firms to be more aggressive in pursuing take-privates. Public company boards will be in a better place to accept those offers next year as the 52-week highs will no longer include the 2021 stock prices, and more closely reflect current conditions.

As we look into next year, we see many attractive potential investment opportunities in our core markets of media, communications, education and technology. Some themes we like are the growing demand for live events and premium content, the need for ubiquitous high-speed broadband, and the digitization of education. All of these are themes which can create long term secular growth and where there are really good companies with strong financial models and profitability. We are sector focused, but we are more business model agnostic. We believe this has helped us find strong, growing businesses at more reasonable multiples, away from the SaaS business model. If B2B software was the hottest part of the market prior to 2022, we believe that more private equity firms will be seeking opportunities outside of that area, and driving deal activity in services, data and consumer-facing companies.

Certainly we are closely monitoring the overall economic conditions and watching for signs of a recession, and that is the looming risk for 2023. Sitting here today, we would expect the uncertainty to continue, but we see a massive recession or another big move down in the stock market as unlikely. More likely, we believe that next year will bring bouts of volatility but a market that is stable enough to enable a more active private equity dealmaking environment. In addition, private equity activity levels should continue to benefit from increased capital allocations to private equity and a long-term shift from public to private markets.



ALEXIS MASKELL
PARTNER
BC PARTNERS

2022 has felt like a year of transition. It also signalled the start of a new era: shorter business cycles, higher interest rates and higher inflation. This points to a new valuation paradigm, where the desire to pursue top line growth at any cost is replaced with a focus on resilience and profitability.

Market consensus points to inflation peaking in Q1, before a significant drop during 2023 – although remaining at elevated levels. This should enable central banks to pause their hiking cycle, but the consequence of aggressive tightening will be a recession in 2023 and gradual recovery in 2024. As such, we expect 2023 to be a year of tougher economic adjustment but stronger deal activity as the market gains much-needed clarity.

The rapid rise in interest rates unsurprisingly created a dislocation in the financing markets. Despite the softer economic environment, we anticipate a rebound in deal activity, albeit under a different valuation framework. If central banks do stop raising rates in Q1, this could provide the catalyst for financing markets to return to form. As a GP, we view this as time to be an investor, not a deployer. This new cycle will provide an attractive opportunity for investments, but the focus should be on asset quality, and prices need to reflect the new valuation environment.

The rebound in deal activity should also provide a helpful backdrop for exits. The hiatus of 2022 undoubtedly has created pent-up demand from GPs looking to keep up their pace of deployment. However, we don't expect the path next year to be smooth: this new business cycle will bring heightened volatility, with market windows opening and closing at relatively short notice.

Private market valuations have typically trailed public peers by 6-9 months, and it remains to be seen to what extent adjustments in private valuations will have on relieving this overallocation pressure for LPs. Alongside wider trends, there is no doubt it is a very challenging environment for investors to manage and calibrate their allocations.

However, the bigger challenge facing LPs is selecting GPs and investment strategies that are well positioned in this new environment. Over the last decade, multiple expansion has provided a significant tailwind for returns, especially for high growth sectors. In this new cycle, we have seen a significant rotation in public markets away from growth and into defensive sectors in pursuit of diversification and resilience.

In this short cycle environment, we believe a sector-diversified portfolio will best deliver lower volatility, resilience and consistent returns. We're also anticipating a multiple contraction, with returns generated from building a better, more profitable businesses. A track record of operational improvement is therefore key for GPs.

Across our portfolio in the last ten years, over 70% of value creation has come from EBITDA growth, rather than multiple expansion and we're especially confident in our approach as we move into the new business cycle of 2023 and beyond.

PERFORMANCE



GLOBAL OUTLOOK 2023



JOHN STAKE
CO-HEAD OF FUND INVESTMENT
HAMILTON LANE

Starting on an upbeat note, we think fundamentals going into 2023 look solid, setting us up for performance in line with or likely surpassing 2022. Perhaps we are setting the bar too low with that statement: 2022 is likely to be a mediocre year performance-wise and may even be negative, a rare occurrence for the asset class. While Q3 data is still filtering in, we have a good sense that PE will likely be flat to slightly down for the quarter. This implies that we have seen a contraction of about 7% through the first three quarters of 2022.

Since 1995, the asset class has only had three years of negative performance, two driven by the dot com bubble and one because of the GFC. With that historical context, we think it's unlikely that we see 2023 performance continue this downward trend, and instead, with the benefit of new deals at compelling valuations, we expect to see high single-digit to low double-digit returns for the asset class. To be clear, we do not expect 2023 to return to the golden touch days of 2021, where we saw nearly 40% annual returns. Instead, we are anticipating being slightly below long-term historical performance. Our data suggests that average is about 16%. We will remind the readers that performance is net of GP fees and compares quite favorably to other asset classes.

At Hamilton Lane, we are tactically increasing allocation to a handful of strategies including secondaries, value-oriented managers, as well as infrastructure managers with a focus on energy transition. That is not to say we are pulling back significantly on growth-style managers, but here we do expect a thinning of the herd as we see which GPs were buying high-quality companies that can grow without market tailwinds. While each manager needs to be assessed individually, we like managers who: stick to their knitting, rather than shifting or expanding into new strategies; have strong deal team oversight and governance; have significant investment and operating team capacity; have proactively managed leverage profiles; and can prioritize portfolio construction and net returns. We call these five topics the 'Fantastic Five Focus Factors'. However, with the benefit of what has happened in the last three years we would also add: managers with robust vintage diversification; and managers that have not shifted to premium terms. Overall, we have a positive outlook for the asset class, particularly when comparing to long term averages and not the recent outperformance seen in 2021. That said, portfolio construction and manager selection continue to differentiate investors and the seven factors listed above are just some of the places we are digging in further at Hamilton Lane.



JEFF HAMMER
GLOBAL CO-HEAD OF SECONDARIES
MANULIFE INVESTMENT MANAGEMENT

As a derivative of the private equity market, secondary market values have mimicked trends in the primary market. Secondary funds have produced solid returns in 2022 while offering to purchase the very same LP interests they hold at meaningful discounts.

How does one reconcile this seeming contradiction of secondary funds producing solid returns while pricing LP assets at significant discounts? In one word: opportunism. The secondary market has been able to achieve superior performance across the decades by investing wisely during calm markets and by buying well during market dislocations.

With that said, LPs have learned from prior dislocations and have become better at managing a wide bid-ask spread for their assets. Sellers balk at parting with valuable LP interests subject to discounts that did not exist only months before – the result is lower secondary transaction volumes. This is the stalemate that currently exists in the traditional LP secondaries segment of the market. However, history demonstrates that this is a transient logjam that will break over time. A pent-up desire for liquidity along with less volatile public markets and NAV stability should tighten the bid-ask spread. A buoyant market for traditional LP interests should follow in 2023 and beyond.

The newer but increasingly important GP-led segment of the secondary market has shown resilience in the face of headwinds. When results are tallied for 2022, GP-led secondaries volume is likely to be lower than the robust $65bn in 2021 volume. However, the number of GP-led transactions brought to market in 2022 may be higher than in 2021.

Secular changes and cyclical trends have created this result. One secular shift is the growing use by sponsors of GP-led secondaries as an active portfolio management tool, especially in the mid- and lower-mid-markets. It is worth noting that this interim liquidity has proved valuable to LPs seeking distributions during the market downturn. A second secular change is the growing number of advisors that have entered the market - Goldman Sachs, Morgan Stanley, Jeffries, Raymond James, William Blair, Lincoln International, and Baird, to name a few. A cyclical element has secondary investors taking a more conservative posture, slowing investment pace into GP-led secondaries to accommodate for increased risks caused by inflation, rising interest rates, supply chain disruptions, and labor shortages.

In summary, 2022 will prove to be a transition year, not unlike others following highly disruptive periods. Volume will be down with fewer completed investments in both traditional LP secondaries and newer GP-led secondaries. But the private equity secondary market has proven itself over four decades to be an all-weather market. This suggests 2023 and beyond will be a buoyant time for secondaries as all market participants play catch up and structural factors propel secondary market volumes to new heights as the world emerges from the current economic dislocations.



> “A firm’s abilities to add operational value will define success this year”

BRIDGET WALSH
GLOBAL PRIVATE EQUITY LEADER
EY

There are a lot of reasons that PE is better suited today to manage volatility than ever before. The industry has more capital at its disposal to deploy into interesting opportunities – nearly US1.2trn in dry powder is currently available. PE has diversified in ways that increase its resilience and flexibility, such as adding new asset classes; and most importantly, it has expanded its operating toolkit by building deep sector and functional expertise.

Whilst we expect that financing will become more widely available during 2023 and that costs will recede from current levels, rates are likely to remain elevated relative to much of the last decade. At the same time, opportunities for margin expansion remain less certain, especially for portfolio companies acquired during the post-pandemic boom.

It becomes a firm’s abilities to add operational value that will define success in the coming year - sponsors will need to continue to double down on their efforts to maximize both the levers they pull and the enablers behind them.

For example, periods of increased volatility always elevate the importance of cash discipline, and the specifics of today’s challenges make it especially critical. Firms will place greater emphasis on cash flow forecasting in order to improve visibility and maintain line-of-sight into the health of the business. They will optimize working capital in order to free up locked-in cash that can be used for acquisitions, repayment of debt, investment in talent, or to fund business transformation and investments in technology.

The macroeconomic environment means that maintaining margins will be a top priority this year. Top-line initiatives focused on developing and executing an optimal product, pricing, and customer strategy amid a potential pullback in spending will help firms build resilience into their portfolios and lean into new growth opportunities. Firms are already intensely focused on managing costs, a dynamic we expect to remain in place, and which will increase efficiencies, help keep input expenditures in check, and ultimately drive strong Ebitda performance.

At the same time, firms and their portcos will focus on the overarching enablers of value creation such as: digital transformation, including harnessing the full power of data analytics; an effective talent management program that recruits, and most importantly, retains the best talent through structured engagement and proper alignment of incentives; and shifting how they think about ESG, from a risk management exercise to a robust value driver. Executed properly, they’ll help PE firms not only thrive through 2023’s highly dynamic environment, but position firms for long-term success that’s independent of cycle.



> "The 2023 vintage could benefit from the valuation reset"

KEIRSTEN LAWTON
CO-HEAD US PRIVATE EQUITY RESEARCH
CAMBRIDGE ASSOCIATES

We expect continued headwinds for private equity. Weak economic activity, difficult political environments, and tight credit markets will pressure current valuations and slow investment and realization activity. While public equities quickly reflected these concerns in 2022, private markets reacted more slowly. Multiples are trending lower but strong earnings growth has mitigated the mark-to-market impact thus far.

In 2022, we saw a drop in activity. Heading into 2023, transaction activity should continue to be slower as valuations settle and lending costs increase, and this lull should favor buyers. General partners (GPs) with mature assets to sell may delay exits given volatile markets pressured by uncertainty. Investors should expect longer holds, and perhaps more GP-sponsored continuation vehicles. Fewer realizations will result in fewer limited partner (LP) distributions, which since the beginning of 2011 have averaged $1.49 for every PE dollar drawn, enabling new PE commitments. However, in 2023 we do expect capital calls to pick up given GPs have near-record dry powder. We believe new investment activity, while slower than recent years, will precede a return to robust realizations. The potential of fewer distributions raises the spectre of liquidity concerns for LPs as they might need to fund their PE commitments from other sources for the first time in years.

In the current market, GPs are focusing on company-specific actions, risks, and opportunities. From a value creation perspective, revenue growth and EBITDA margins are primary levers of returns, but amid a tight labor market, GPs are also seeking to pull the talent management lever. On the risk side, GPs are revisiting recession scenarios, managing expenses, and monitoring sales. They have raised prices to compensate for higher inflation, which might not be a sustainable strategy. COVID-era PE returns were strong but largely unrealized and not likely to be sustained in the current market. History has shown that funds deployed at high valuations based on high growth expectations (such as the pre-GFC vintages) posted below-average net internal rates of return, and it is likely that recent vintages will suffer the same fate. Conversely, recession-era vintages, invested at more moderate valuations, have historically outperformed growth expectations and achieved multiple expansion at exit. So, while today's environment could hurt current portfolios, the 2023 vintage could benefit from the valuation reset.

FUNDRAISING



GLOBAL OUTLOOK 2023



> GPs will need to focus on mitigating the 'DPI gap' to ensure LP capital flows

GABRIELLE JOSEPH
HEAD OF DUE DILIGENCE AND CLIENT DEVELOPMENT
REDE PARTNERS

Distributions will be a key factor in LPs' ability to commit capital to new funds in 2023. Our most recent Rede Liquidity Index report found that 50% of LPs surveyed cited the slow pace of exits/DPI as a key concern for 2023, rising from 13% 12 months earlier in 2H 2021. While investors anticipated a slowdown in distributions in 2021, this did not materialise and instead we saw a bounce back in the market. Now, however, with an RLI that is significantly lower than what we saw in 2020, macro conditions have caught up with the asset class.

Our survey indicates that the slowdown in exits will be a significant factor for LPs as they plan their deployment programmes for 2023. We know that distribution velocity has a direct effect on fundraising liquidity: typically, the more capital that is returned to LPs via distributions from exits, the more they can commit to new funds. Thus, with exits continuing to be subdued in the latter half of 2022 and into 2023, LPs may encounter a liquidity bottleneck, with insufficient capital flowing back to their programmes.

Over the coming months, GPs will need to focus on mitigating the 'DPI gap' to ensure the flow of capital back to LPs is not too severely interrupted. As a result, we expect to see an increase in creative approaches to boosting liquidity, such as partial exits, GP-led transactions and NAV financings. In particular, we believe that GP-led transactions will be an important weapon to counter the slowdown in exit momentum and help to close the 'DPI gap'.

More broadly, against a volatile macroeconomic and geopolitical backdrop, our research highlights a challenging picture for private markets fundraising. After several years of growth, the PE fundraising market is now entering a period of reduced liquidity, with LP capital constraints contributing to a slowdown in fundraising momentum.

Despite this, the RLI report identifies several bright spots for the asset class. Many investors are planning to increase exposure to lower mid-market and mid-market buyout strategies, while sector strategies focused on healthcare, sustainability/impact and technology remain favoured by LPs. Meanwhile, there will likely be continued growth in LP deployment to funds focused on North America and to their co-investment programmes.



> “Special situation strategies may have their moment in the sun again”

MOUNIR GUEN
CEO
MVISION PRIVATE EQUITY ADVISERS

After the last few years of hectic activity the private equity markets now seem to have returned to a more normal pattern of deployment, with investors having more time to process and funds slowing down their fundraising cycles (for now at least). We now see a stable pattern of activity with investors working thoughtfully through processes, portfolio construction and how to generate alpha in a markedly different environment.

A key focus is how to gain exposure to strategies with the potential to generate strong returns, that are uncorrelated to both the public markets and to their existing portfolios. ‘More of the same’ is clearly not going to cut it. Novel strategies do have a long timeline for institutional adoption, but investors do get there eventually as evidenced by the surge in content royalty where interest first began a while back.

A greater number of investors are also increasing their co-investment programmes and this will have an impact on primary commitments by focusing on larger commitments to fewer GPs. A recurrent theme is decreasing the number of relationships to a set of core partners of choice for different strategies and geographies.

Certain sectors like consumer, healthcare and innovation are continuing to do well and attract interest but performance and popularity are nuanced. In the consumer sector for example, there seems to be a barbell with non-discretionary staples and high-end luxury goods seemingly more insulated from recession. Special situation strategies also look to finally have their moment in the sun again with investor interest attracted by a strong pipeline of actionable deals after a slow several years.

The US has strong and steady activity, but Europe is more selective with the Ukraine war casting a pall among investors who are increasingly cautious, although what happens during a potentially cold winter will be a litmus test. Asia Pacific has its own dynamic with China slowing down after a record year of activity in 2021 and buyouts shrinking to less than 6% of overall activity, but the region is active.

At the end of the day however, private equity as an asset class has been the biggest contributor to returns for most investors, be they pension fund, sovereign wealth funds, endowments or family offices. So, while relative success has been the main factor for the denominator effect, funds will get raised, and will continue to grow, although it may take longer and require a lot more work.



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There is no doubt that 2022 has seen some of the most challenging fundraising conditions in private equity history. It hasn't stopped some GPs successfully raising large funds but the numbers speak for themselves: in 2021 over $1.2tn was raised by private equity funds, the highest level on record, while in 2022 there was an 11% drop in fundraising totals, the sharpest decline since 2009.

Much of this can be explained by the uncertain economic conditions and their impact on LPs. We explored this in a recent survey of more than 140 institutional investors from across the world, most of whom are anticipating a global economic recession, with an impact greater than Covid. A sizeable proportion expect it to be more significant than the Global Financial Crisis.

Most LPs are expecting a long-term impact. More than two thirds of those we surveyed anticipate volatility in valuations for more than 12 months, while nearly 20% envisage 18 months or more of disruption. While the GFC was largely liquidity-driven and the recovery occurred relatively quickly, the current economic situation is being driven by inflation, higher interest rates and tightening liquidity. This hasn't yet been fully reflected in corporate earnings and so the full effect is likely to be felt well into 2023.

The recent market volatility has resulted in many LPs being currently overallocated to private markets. Nearly a quarter of the LPs surveyed are now overallocated, with a further 60% more than 75% committed. Just 7% of LPs surveyed are less than 50% committed.

Overallocation seems to most prominent among North American investors. It is less prevalent in Europe and Asia, but nevertheless both regions see a very high proportion of investors with more than 75% of their target allocated to private markets.

While 57% of the LPs we surveyed said they have no plans to change their allocations in 2023, with reups and embedded relationships in the best position and little scope for new relationships, the most impacted are LPs invested in public markets. Nearly half of those investors report that the denominator effect will affect their 2023 allocation to private markets. This will be a key factor for fundraising in the year ahead, with some LPs needing to reduce their allocations or curtail new investments completely. At the very least, we expect it to take longer for GPs to raise their funds.

Furthermore, we see that the economic environment has impacted LPs' appetite for different private equity strategies. Secondaries are currently an appealing choice for the majority of LPs across the global market. Distressed debt is also popular in North America and Asia and direct lending appealing to European investors. Similarly, impact funds stand out as being safer homes for capital in turbulent times, particularly in Europe. There will inevitably be winners and losers.

Aside from allocations, the recession brings with it a range of operational pressures which will be on LPs' minds as we head into 2023. Higher interest rates and inflation figure high on the agenda. These issues will hit portfolios at company level hardest and indicate that LPs expect them to first feel the impact of tough economic conditions. The quality of a private equity fund is put to the test when times are tough and so for GPs and LPs alike, portfolio management will be at the top of the priority list in the months ahead.

PRIVATE EQUITY WIRE

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