PitchBook

Buyout Funds in Times of Crisis

Examining how buyout funds act and perform during periods of economic duress

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Contents

Key takeaways

- As the spread of COVID-19 slows the global economy, we expect GPs will issue smaller and fewer capital calls. However, we believe this pandemic-related crisis will differ from past crises in the shorter term. GPs are already issuing capital calls to inject equity and rescue some portfolio companies. Furthermore, many GPs have been or will be issuing capital calls to repay their exiting capital call subscription loans.

- In the coming quarters, we will likely see a precipitous decline in the frequency and magnitude of buyout fund distributions. Many GPs are unwilling to sell a portfolio company when its marks have dipped by 20% or more compared to Q4 2019 reported values. Further, dividend recaps will also become rarer as the credit markets grind to a halt. With this in mind, we expect the annualized rate of distributions as a percent of commitment size to diminish by approximately two-thirds during the coming quarters.

- In times of crisis, a portfolio of buyout funds will typically swing from being net cash flow positive to negative as the decline in distributions outpaces the fall in capital calls. We expect the same will happen in the coming quarters—though the severity may be greater than in past crises—and that LPs should focus on where to source capital call funding from in their portfolio.

- Buyout fund valuations are expected to fall just as public equity indices have in recent weeks, though to a lesser extent. LPs must be aware that they are likely to face the denominator effect in their portfolios, which may prevent them from upping their allocations. However, times of crisis tend to be the best times to invest in private (or public) equities and LPs should take advantage of this pricing environment if possible.

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Introduction

As the spread of COVID-19 grips the global economy, governments are contending with the dual responsibility to save lives and keep the economy afloat, plunging countries around the world into a recession. While we don't yet know how bad this crisis will get, we do know we are headed for trying times. Further, a nationwide lockdown is already causing an unprecedented spike in joblessness, with 9.9 million Americans filing for unemployment benefits in the final two weeks of March alone.[1] Goldman Sachs believes we could see Q2 2020 GDP contract by 34%[2] while James Bullard of the St. Louis Fed stated that we may see unemployment peak around 30% and GDP drop by 50%.[3] As a comparison, the global financial crisis (GFC) caused US real GDP to decline 4.2% and 8.7 million Americans to lose their jobs.[4] These are truly uncharted waters.

With so much in flux, institutional investors are trying to predict the impact this crisis will have on their portfolios. We looked at our historical data to examine how buyout funds specifically reacted during previous crises, including the recession that followed the tech bubble and 9/11 as well as the GFC. This note examines how buyout fund capital calls, distributions and performance have been affected in previous recessions and provides our predictions for how and why this pandemic-related crisis may differ.

Capital calls

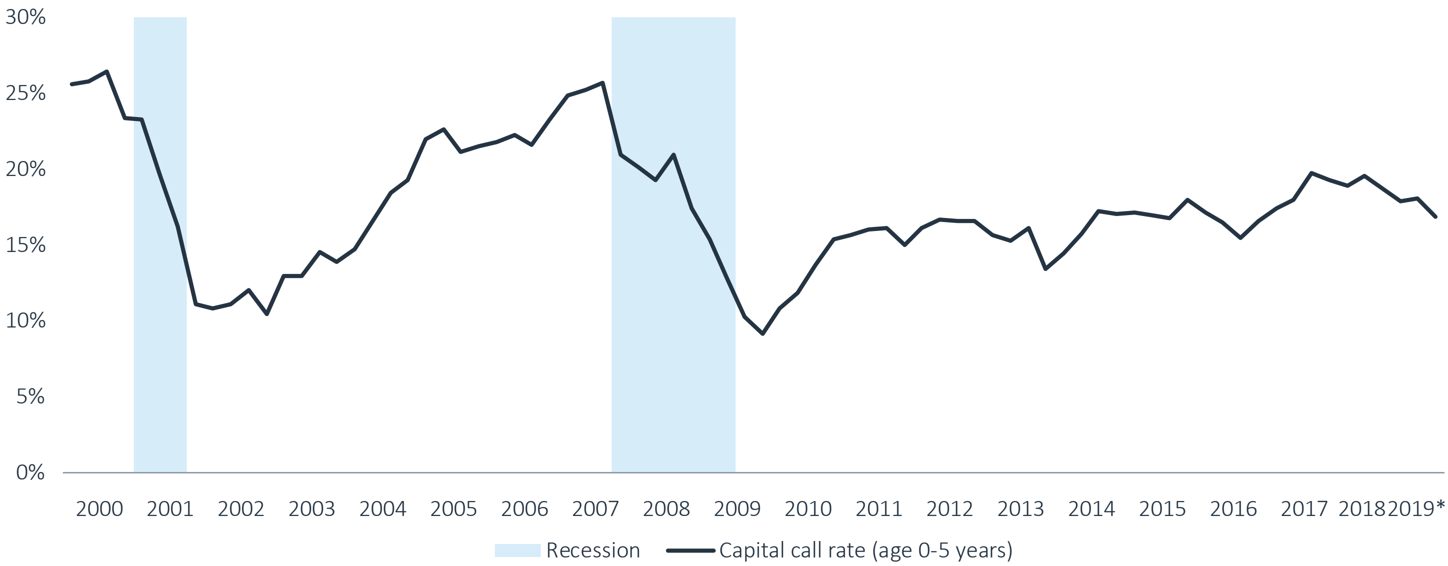
Buyout funds tend to exhibit high levels of cyclicality, calling down more capital in the years leading up to a crisis and calling down relatively less in crisis-era vintages. Although we appear to be headed into a crisis, we believe LPs should expect less of a slowdown in capital calls than in past crises, and perhaps even a brief increase in calls. A recent survey from Campbell Lutyens suggests that many PE firms are calling capital now to pay off their subscription lines and that some LPs are seeing YoY increases in capital calls in their portfolio.[5] PE firms may also preemptively call down capital to support portfolios already under stress because most PE-backed firms will need "massive infusions of capital" just to survive.[6] PE firms also invest heavily in portfolio companies in a downturn, which led to PE-backed companies gaining market share during the GFC.[7] Beyond portfolio investments, GPs are actively trying to deploy capital through private investment in public equities (PIPEs), minority deals or add-ons. These deals call for smaller check sizes than platform buyouts but are easier to get done now because wide bid-ask spreads are preventing buyers and sellers from agreeing on price on larger businesses. With all that said, we still expect a mild slowdown in contribution rates, but we believe capital calls may spike in the interim—something capital call data in March supports.[8] Some GPs are already increasing their capital call rates, surprising many LPs that weren't

1: "'No Words For This': 10 Million Workers File Jobless Claims in just Two Weeks," Politico, Rebecca Rainey and Nolan D. McCaskill, April 2, 2020.
2: "Goldman Sees Unprecedented Stop in Economic Activity, with 2nd Quarter GDP Contracting 24%," CNBC, Patti Domm, March 20, 2020.
3: "U.S. Jobless Rate May Soar to 30%, Fed's Bullard Says," Bloomberg, Steve Matthews, March 22, 2020.
4: "2008 GDP, Growth, and Updates by Quarter," The Balance, Kimberly Amadeo, June 25, 2019.
5: "Investor Liquidity: Reading the Runes," Private Equity International, Toby Mitchenall, April 2, 2020.
6: "What Drives Private Equity's Outperformance in a Downturn," iCapital Network, Nick Veronis and Tatiana Esipovich, December 4, 2019.
7: "Update on Small Business and Private Equity," Invest Like the Best, Brent Beshore, March 20, 2020.
8: "Investor Liquidity: Reading the Runes," Private Equity International, Toby Mitchenall, April 2, 2020.

expecting capital calls on their funds until summer 2020.[9] For funds still in the investment phase (funds zero to five years old) LPs should expect annualized contribution rates at 10% to 15% of the total commitment size in the coming quarters instead of the 15% to 20% range we have seen since 2010.[10]

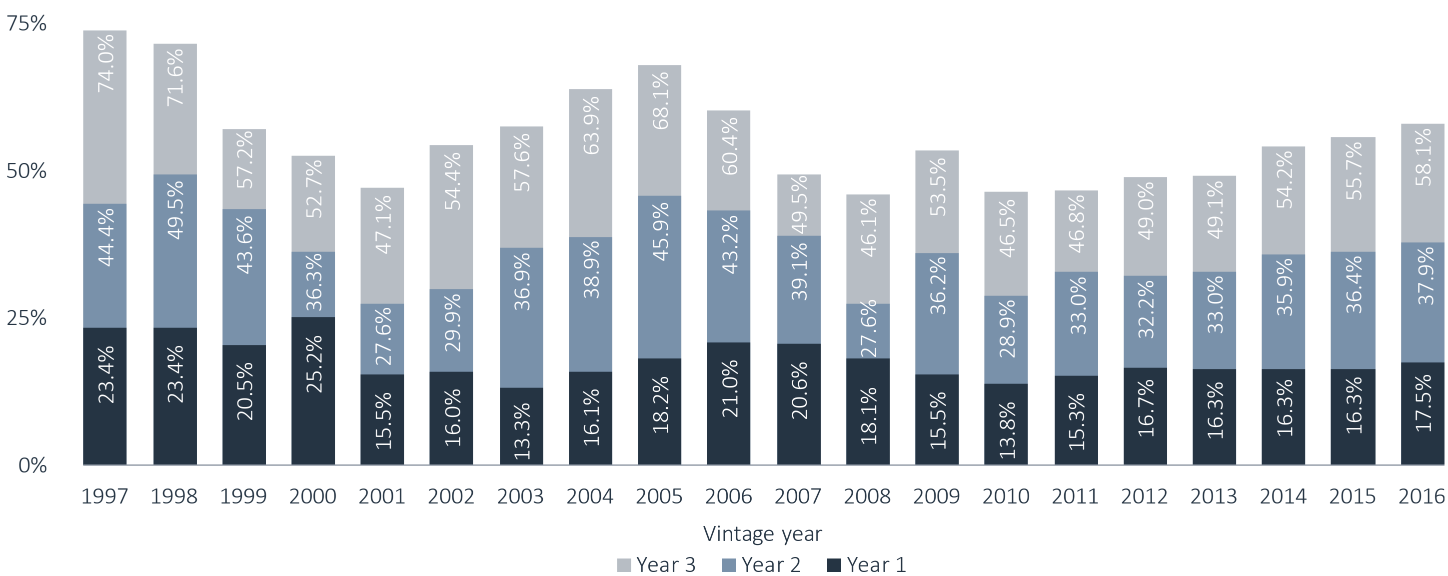
The recent proliferation of capital call facilities—which had come under heavy fire by LPs—may further change how capital calls look in this crisis compared to previous crises. While many GPs are calling down capital to clean up their subscription lines, these credit lines may allow some GPs to complete deals and capital infusions now and put off capital calls for the next three to six

Average rolling one-year capital call rates for funds 0-5 years old by quarter



Source: PitchBook | **Geography:** Global
*As of June 30, 2019

Average cumulative capital called as a proportion of fund size by vintage year



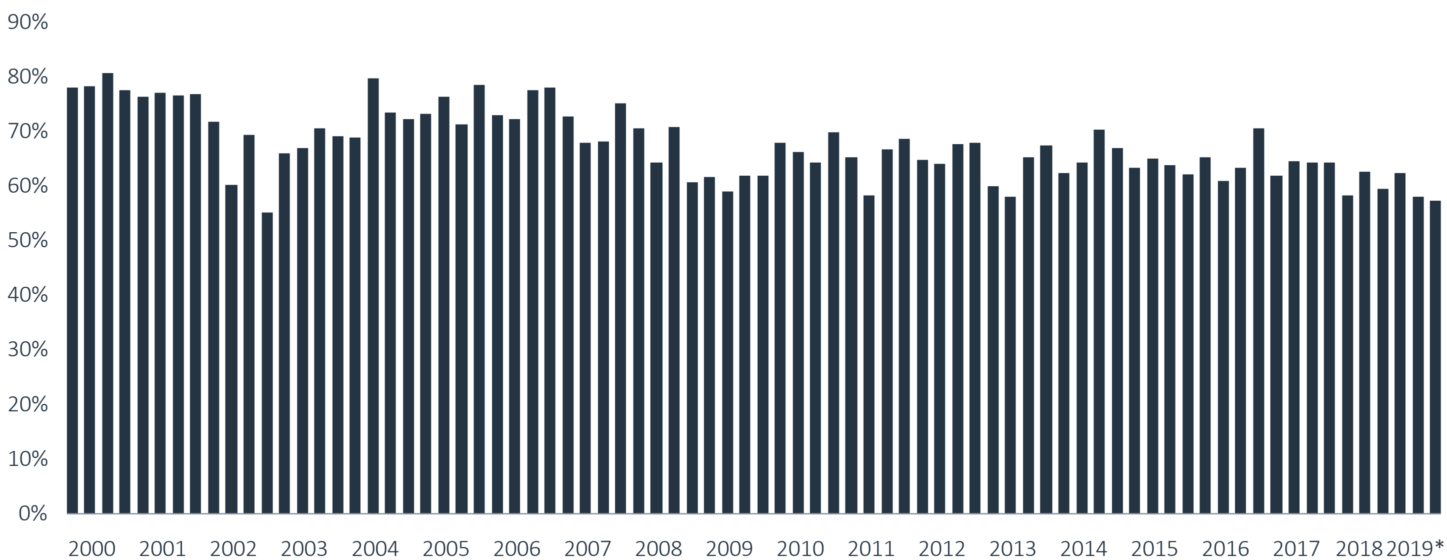
Source: PitchBook | **Geography:** Global

9: "LP Defaults 'Already Happening.' Here's Why, and What GPs' Options Are," Private Funds CFO, Graham Bippart, March 27, 2020.
10: "Update on Small Business and Private Equity," Invest Like the Best, Brent Beshore, March 20, 2020.

months, giving LPs some breathing room and allowing them more time to prepare for these liquidity needs. LPs have varied magnitudes of exposure to credit lines; it is therefore imperative that LPs and GPs communicate around this issue so each LP knows their cumulative exposure and their GPs' capital call plans.

For LPs looking at their current buyout portfolio, we expect the number of buyout funds in the investment period (zero to five years old) issuing capital calls in any given quarter to remain steady at around 60%. There may even be a brief spike as GPs seek to quickly inject capital into struggling portfolio companies and invest in new ventures at lower valuations. Even during the GFC and after the dotcom boom, the proportion of funds issuing capital calls remained relatively steady. Coming into this crisis, GPs had been stockpiling dry powder to use when prices dipped, and they seem intent on using it. More broadly, the proportion of funds calling down capital has gradually dropped over time; just under 80% of buyout funds in the investment period issued capital calls in any quarter in 2000 falling to just under 60% in 2019. We believe much of this is due to the increased usage of capital call facilities, allowing GPs to issue fewer but larger capital calls.

Proportion of funds with calls in each quarter for funds 0-5 years old by quarter



Source: PitchBook | **Geography:** Global
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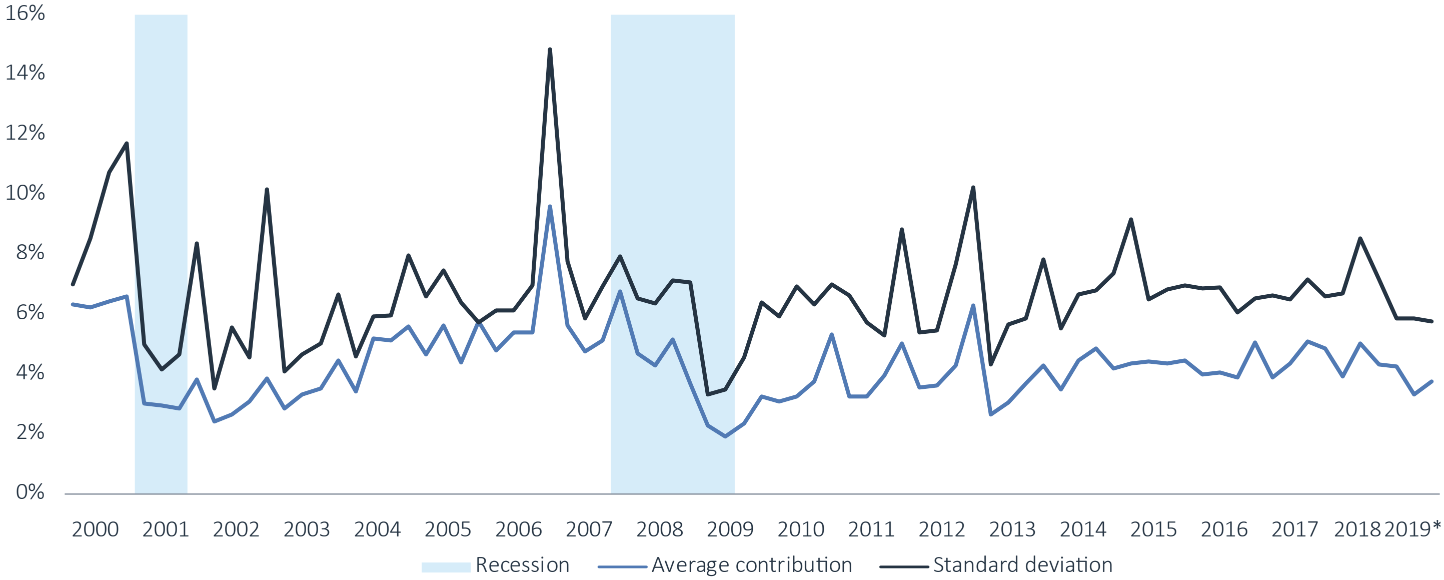
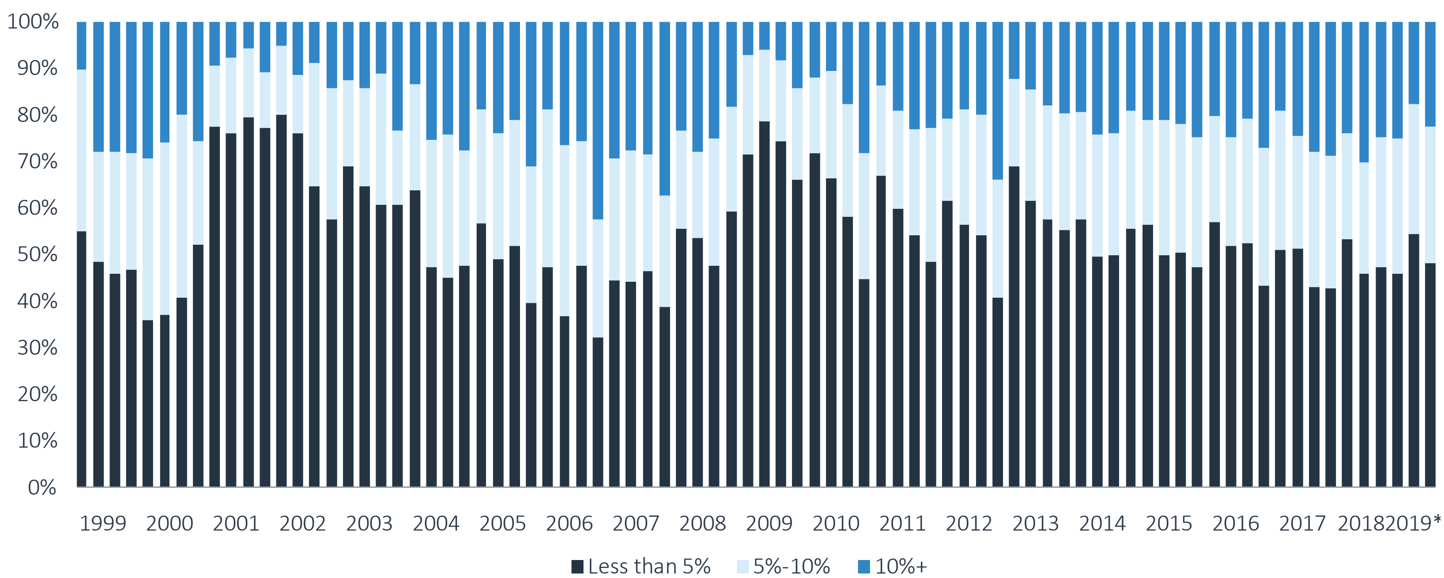
Based on previous crises, LPs should expect capital call sizes to fall in the coming quarters as deal activity slows. However, in the interim, call sizes may rise as GPs preemptively call down capital and some repay existing capital call facilities. The average capital call size tends to drop precipitously in recessions because the deals being done—PIPEs, capital infusions, minority deals, add-ons, etc.—necessitate smaller check sizes. The average capital call was approximately 5.5% of the commitment size per quarter in 2007 and fell to around 2.5% per quarter in 2009, though we expect this crisis to see less of a decline because of the need for capital infusions into portfolio companies and GPs are being more proactive about investing at discounted prices. For funds that are still calling capital in recessions, we notice the composition changes as well. In 2006 and 2007, leading up to the GFC, just under 60% of capital calls were more than 5% of the total commitment size. During 2009, that figure fell by about half and just under 30% of capital calls were more than 5% of the total commitment size.

Average and standard deviation of capital calls for funds 0-5 years old by quarter



Source: PitchBook | **Geography:** Global
*As of June 30, 2019

Capital calls (#) by size for funds 0-5 years old by quarter



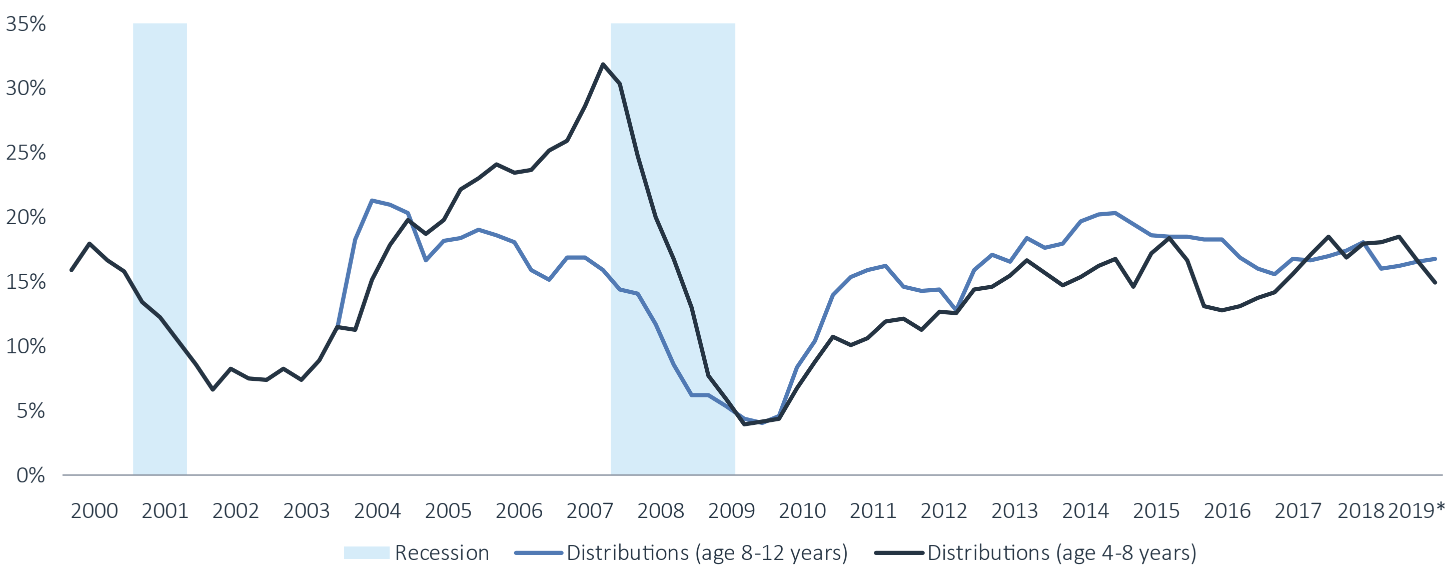
Source: PitchBook | **Geography:** Global
*As of June 30, 2019

Distributions

LPs should expect a steep drop in the frequency and magnitude of distributions in the coming quarters. We expect the cumulative cut to distributions to exceed 50% during this crisis. Not only are GPs unlikely to sell when prices of portfolio companies are down 20%-30%, or more, from their 2019 year-end marks, but with credit markets freezing up, dividend recaps will also become less frequent. Data from Colmore saw distributions to LPs in March 2020 fall YoY by 56% for European funds and 72% for US funds.[11] Since many LPs recycle cash distributions into capital calls for other funds, they should expect to have to tap their portfolio for liquidity or capital calls. While we expect the cumulative rate of capital calls to ease in the coming quarters, distributions are likely to drop even more substantially because GPs will be unwilling to exit portfolio companies at deeply discounted prices. Based on the past, proportional distributions went from approximately 15% to 20% for buyout funds down to the 5% to 10% range. As we see, much of the fall in distributions comes from the declining number of funds distributing, which affects middle-aged funds (four to eight years old) as well as older funds (eight to 12 years old), rather than just a reduction in distribution sizes. In normal times, we expect 50% to 60% of four years old and older buyout funds to have distributions in a given quarter. In a recessionary timeframe, however, that drops to around 40%.

For the buyout funds that do distribute capital back to LPs in a given quarter during recessions, the distribution sizes fall sharply. Leading up to the GFC, more than 60% of distributions were more than 5% of the fund size in funds four to eight years old and around 50% were greater than 5% for funds eight years and older. That portion dropped to around 10%- 5% for both age cohorts in the depths of the GFC. Interestingly, the proportion of distributions by size

Average rolling one-year distributions for select buyout age groups by quarter

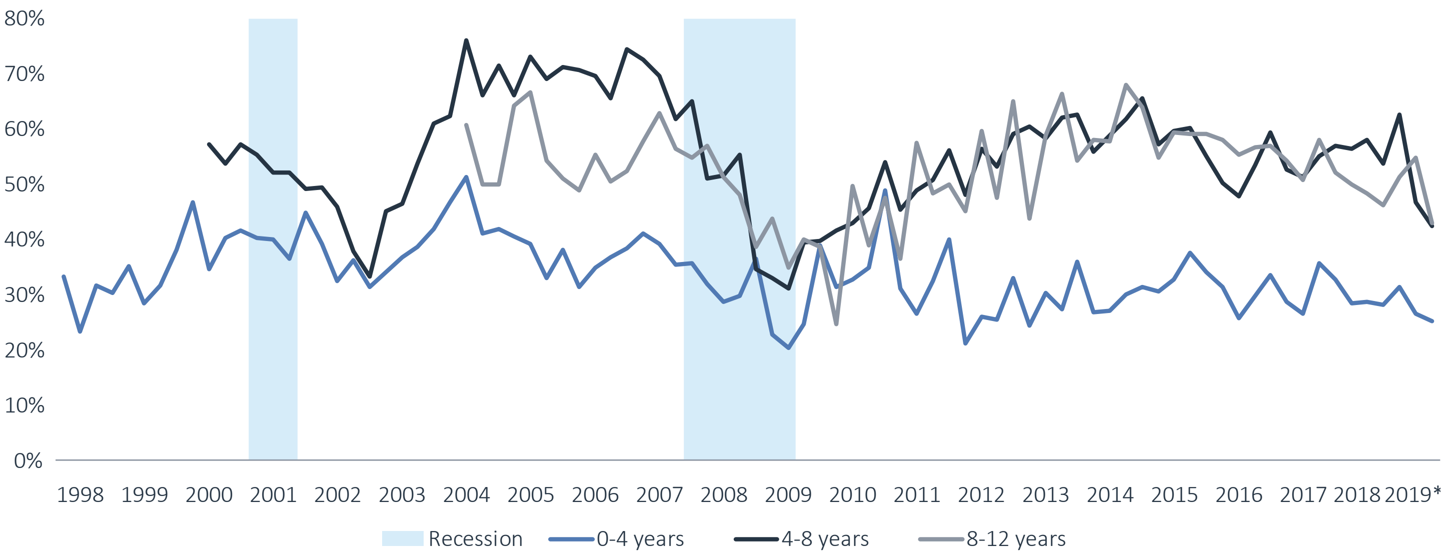


Source: PitchBook | **Geography:** Global
*As of June 30, 2019

11: "Investor Liquidity: Reading the Runes," Private Equity International, Toby Mitchenhall, April 2, 2020.

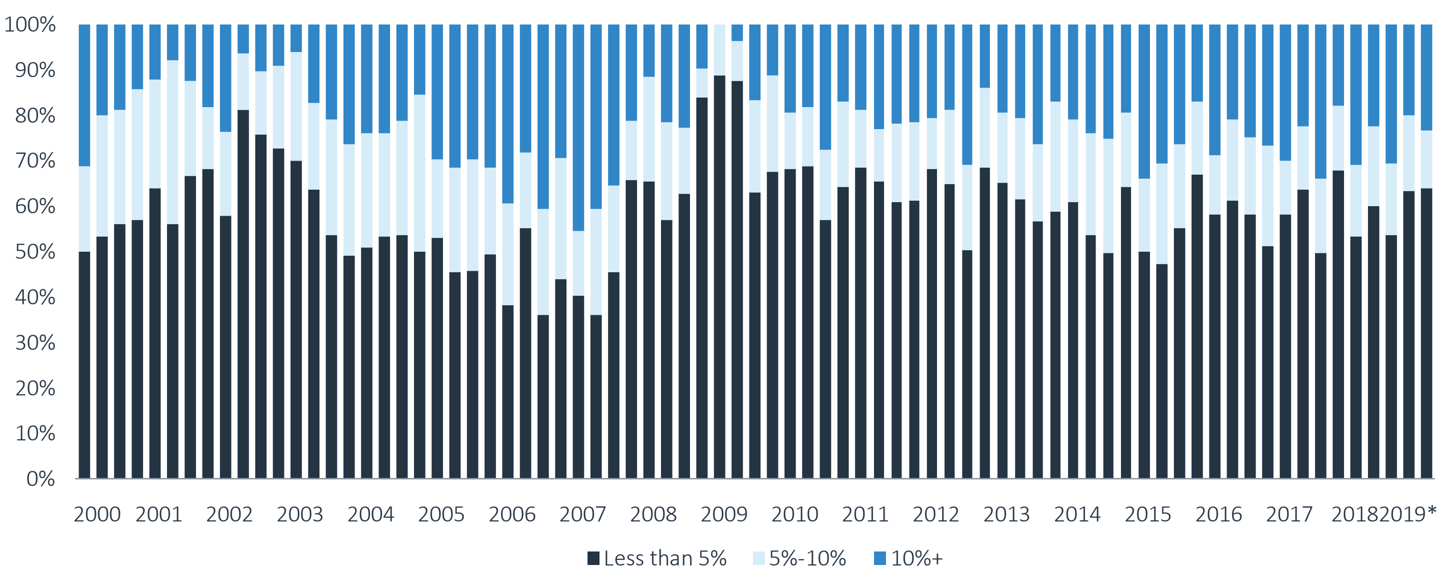
has been relatively constant since 2010 with around 40% of distributions for all funds four years old and older surpassing 5% of fund size. We think the past financial crisis should serve as a reference point for LPs projecting distributions from buyout funds. Not only should LPs project an approximately 50% cut in the number of funds issuing distributions in a given quarter, LPs must also plan for the distributions they do receive to be a fraction of the anticipated amount. We believe the worst quarters will see 80% of the distributions that do occur drop to 5% or less of the commitment size, with distributions above 10% virtually disappearing.

Proportion of funds with a distribution by age range by quarter



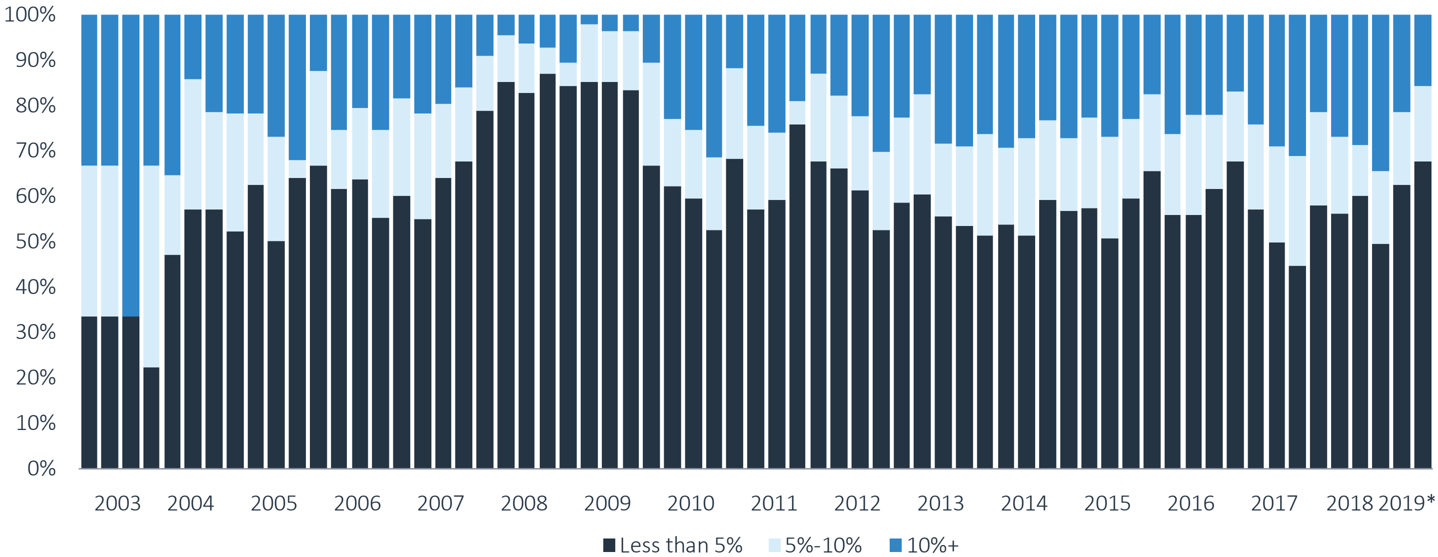
Source: PitchBook | **Geography:** Global
*As of June 30, 2019

Distributions as a percentage of fund size (#) for funds 4-8 years old by quarter



Source: PitchBook | **Geography:** Global
*As of June 30, 2019
Note: Less than 5% only includes positive values. Non distributions are excluded from this chart.

Distributions as a percentage of fund size (#) for funds 8-12 years old by quarter



Source: PitchBook | **Geography:** Global
*As of June 30, 2019
Note: Less than 5% only includes positive values. Non distributions are excluded from this chart.

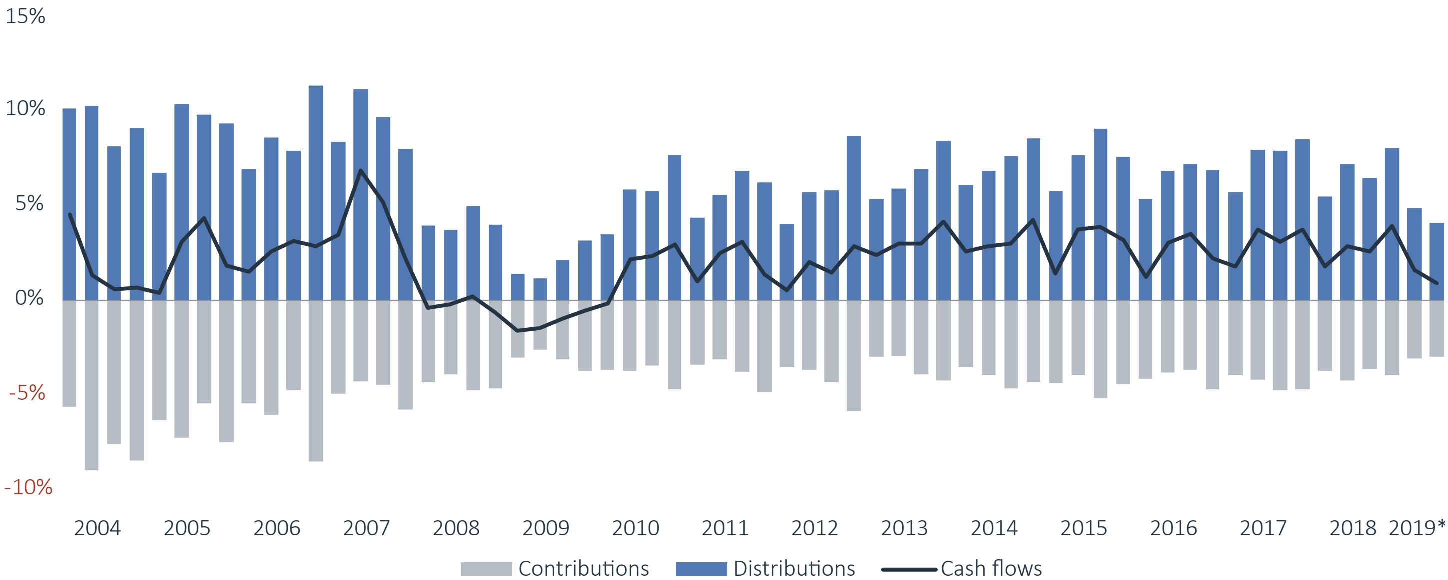
Portfolio perspective

Whereas we expect a decline in both capital calls and distributions from buyout funds, we believe the decline in distributions will be more severe, likely leading to negative net cash flows for the coming quarters. This is already playing out according to a recent Campbell Lutyens report that states, "there are real concerns about how subscription lines are increasing the amount of capital being called in a market where distributions are drying up."[12] Exit and recap activity are likely to grind to a halt while GPs are spending cash keeping portfolio companies afloat and deploying fresh capital in new opportunities. We believe LPs should be ready for capital calls to far outstrip distributions and have a plan for how to fund regular levels of calls during the coming quarters without much assistance from distributions. Numerous GPs are already issuing capital calls to pay down credit lines and most LPs will still need to fund capital calls from their portfolio when cash flows from buyout funds trend negative. However, in some cases, GPs' tendency to utilize capital call facilities may delay capital calls for a quarter or two and prevent LPs' buyout allocation from being as much of a cash drag on the portfolio.

We modeled a theoretical portfolio, assuming a constant commitment to buyout vintages throughout each year, to illustrate how net cash flows from buyout funds differ in a recession. In most years, we see the portfolio of buyout funds is net cash flow positive, with distributions outpacing capital calls. However, during times of crisis, such as the GFC, we see distributions falling dramatically and buyout funds swing from a net cash flow contributor to a detractor.

12: "Private Equity Firms Are Wasting No Time in Calling Capital," Institutional Investor, Julie Segal, April 2, 2020.

Cash flows for LP investing in "average" buyout fund each year by quarter



Source: PitchBook | **Geography:** Global
*As of June 30, 2019

Performance

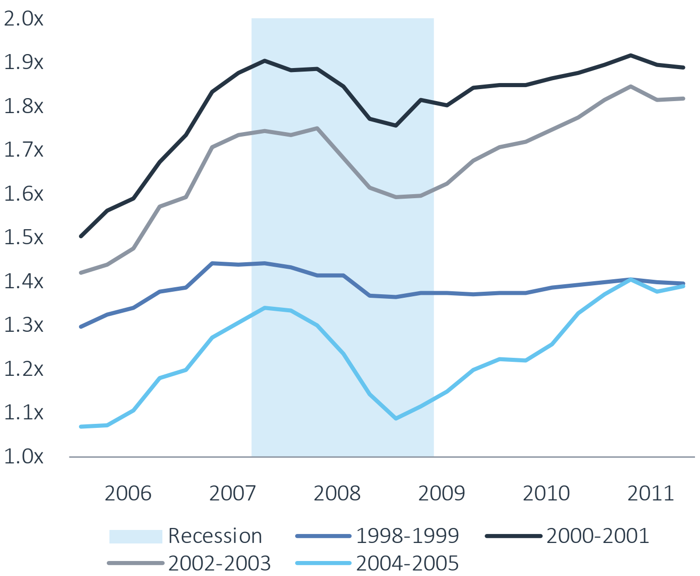
Our research has found that buyout funds demonstrate cyclical behavior in terms of IRRs and cash multiples, though the magnitude of these pricing swings are less severe with buyout funds than in public markets. We focus our analysis on cash multiples because although IRRs may be important, the metric does not affect portfolio weightings—cash multiples do. During each of the past two recessions, TVPI fell just as public equity indices did, though to a lesser extent. In the GFC, we saw pooled TVPI dip by 10% or less for funds four years and older. Younger funds were more affected, with pooled TVPI declining nearly 20%. Funds eight to nine years old when the crisis struck were nearly flat. During the GFC, the S&P 500 fell by more than 50%. LPs should expect younger funds—which are highly sensitive to economic downturns—to drop proportionally more in the coming quarters than older funds, which tend to be more resilient.

With public markets falling through Q1 2020, we expect buyout funds to mark down portfolio companies in the coming quarters, though to a lesser extent on average. This means that some LPs will run into denominator effect issues in the upcoming quarters when they reweight holdings. In fact, two European LPs have already defaulted on capital calls in recent weeks because of the denominator effect rather than from liquidity issues.[13] However, as many LPs were below their target allocations to private markets heading into the pandemic, we believe defaults will not be widespread and the results from the denominator effect[14] could be muted. Furthermore, following the GFC, many LPs instituted a flexible range for portfolio allocations and built in the ability to forego portfolio rebalancing by a

13: "LP Defaults 'Already Happening.' Here's Why, and What GPs' Options Are," Private Funds CFO, Graham Bippart, March 27, 2020.
14: The denominator effect may occur because public equities, which are usually the largest allocation in many institutional portfolios, dropped substantially. This causes portfolio weightings to shift as private market valuations can lag by several quarters. In many cases, PE allocations may go from underweight or at target weight to overweight, causing LPs to pull back allocating to new funds or to liquidate some current PE funds on the secondaries market.

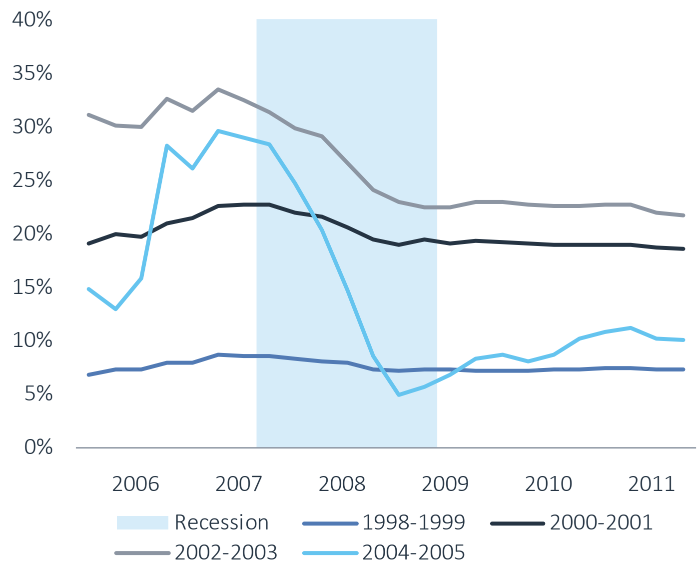
quarter or two. This gives LPs more control over immediate and longer-term portfolio weightings. For example, the Los Angeles City Employees' Retirement System has temporarily allowed rebalancing to be deferred.[15] While this may prevent LPs from selling at fire sale prices, many institutional investors are going to be focused on triage in their current portfolio rather than on new fund commitments. However, we believe this is a mistake. As our prior data illustrates, crisis-era vintages typically offer the best time to invest in buyout funds. Rather than holding steady or cutting exposure to equites—public or private—LPs should be allocating to the space.

Pooled TVPI by vintage cohort over time



Source: PitchBook | **Geography:** Global

Rolling pooled IRR by vintage cohort over time



Source: PitchBook | **Geography:** Global

Looking ahead

We believe LPs should be planning for another period in which buyout funds become net cash flow negative in their portfolios. This swing to net cash flow negative territory will probably be more severe than past crises because of subscription credit lines, and it may not be isolated to PE. It is likely that other private market strategies, including real assets, VC and others will exhibit a similar trend. Because of this, LPs ought to find sources of cash in portfolios to meet capital calls. For institutional investors with predefined liabilities, such as an endowment or pension plan, the need to fund capital calls from investments at depressed prices may wreak further havoc on their portfolios.

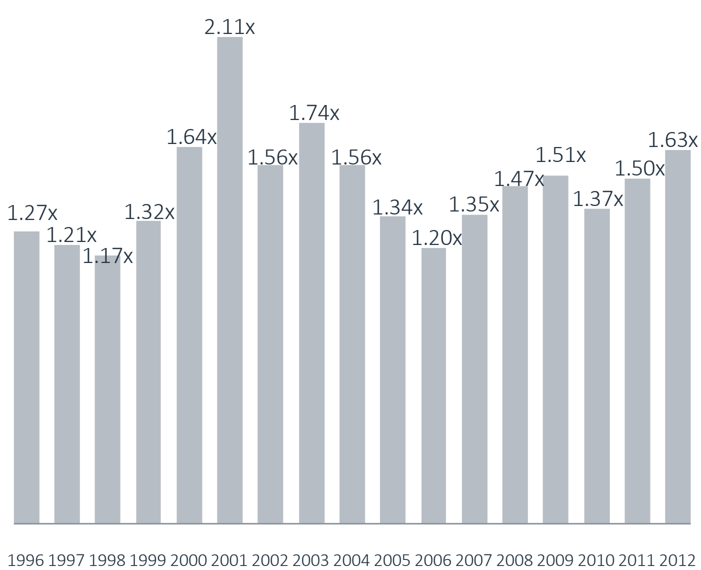
Alternatively, this crisis may present opportunities to LPs that can act quickly and take advantage of the situation. CalSTRS has already confirmed they have cash to invest and will move quickly to take advantage of any opportunities.[16] We know funds that did the bulk of their investing at lower prices in past downturns were able to record higher IRRs. Although the recession did not bottom out until 2009, funds from 2008 also recorded

15: "Los Angeles City Employees Temporarily Allows Rebalancing to be Deferred,"Pensions & Investments, Arleen Jacobius, Marc 27, 2020.
16: "CalSTRS Has the Cash to Pounce on Opportunities in Coronavirus-Fueled Dislocation: CIO," Buyouts Insider, Justin Mitchell, April 2, 2020.

similarly high IRRs, both far exceeding 2005–2007 vintage funds. As we can see, 2001 vintage funds were the best performers in the past 20+ years and 2008-2009 vintage buyout funds were outperforming pre-crisis era vintages (2005-2007) seven years in. For this reason, we believe LPs should be heavily allocating to buyout funds at this time, even though they may be overweight the strategy because of drops in public equities. This is likely one of the better times in recent history to allocate to PE because GPs are investing at depressed prices; however, many LPs will be unable to move quickly enough to take advantage of it.

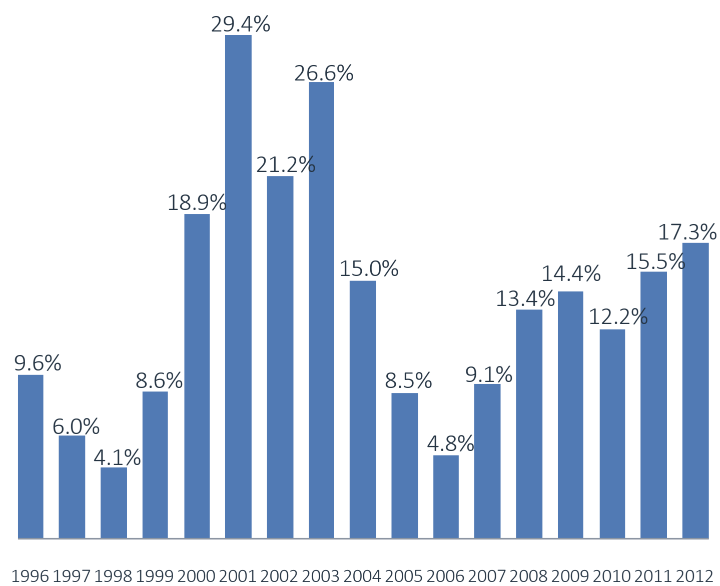
This time of duress may also give GPs an opportunity to establish themselves as a preferred partner for LPs by relying on capital call facilities for a quarter or two to meet immediate needs. This would give LPs time to react to the situation and potentially allow other assets in the portfolio to rebound, meaning LPs would be less likely to realize steep losses in other areas of their portfolios. Now, more than ever, it is vital for LPs and GPs to be in constant communication.

Pooled TVPI seven years since inception by vintage year*



Source: PitchBook | **Geography:** Global
*As of June 30, 2019

Pooled IRRs seven years since inception by vintage year*



Source: PitchBook | **Geography:** Global
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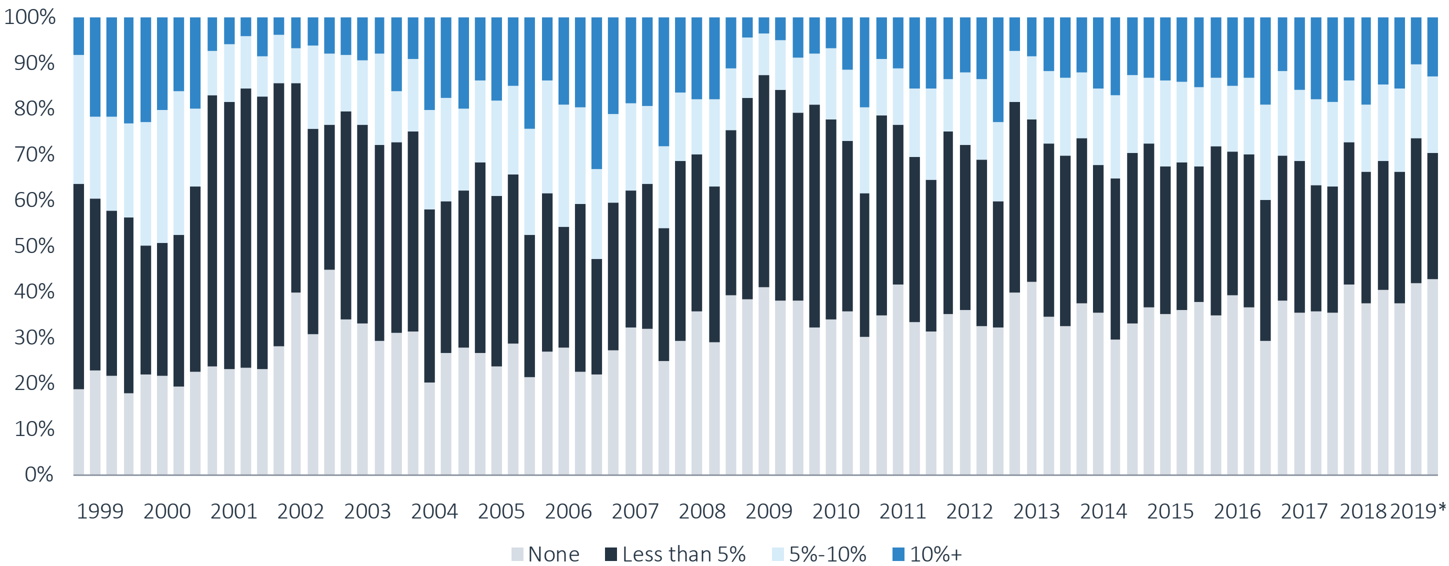
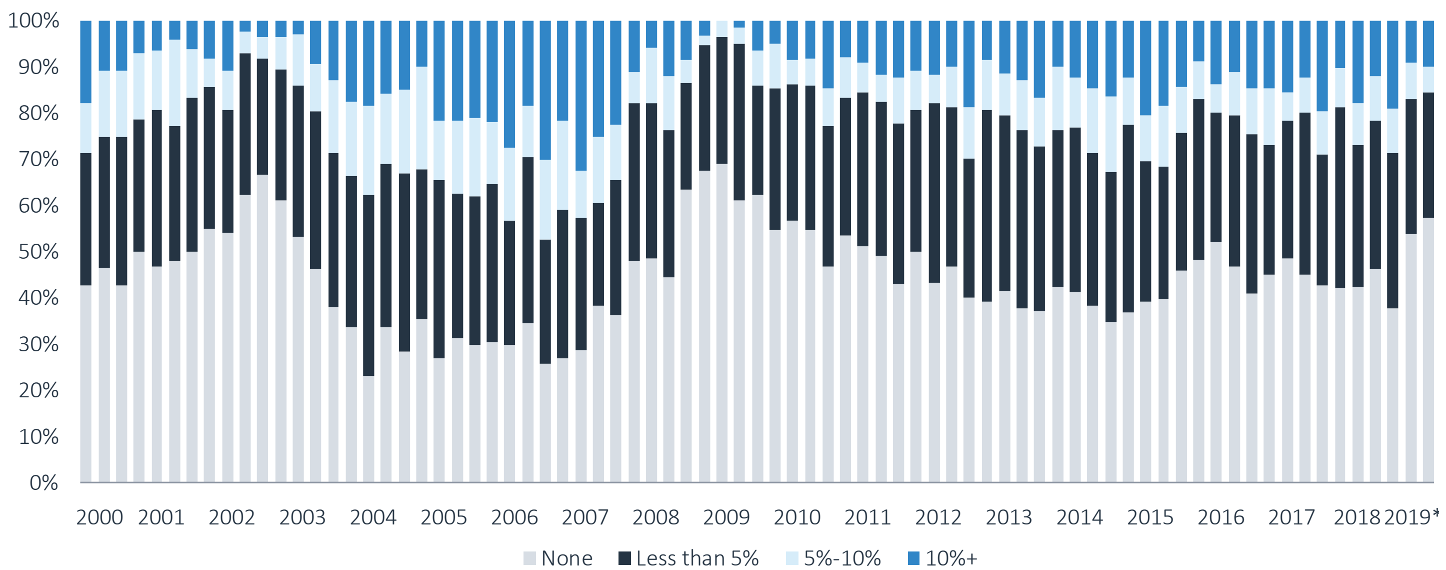
Data supplement

Capital calls (#) by size for funds 0-5 years old by quarter



Source: PitchBook | **Geography:** Global
*As of June 30, 2019

Distributions as a percentage of fund size (#) for funds 4-8 years old by quarter



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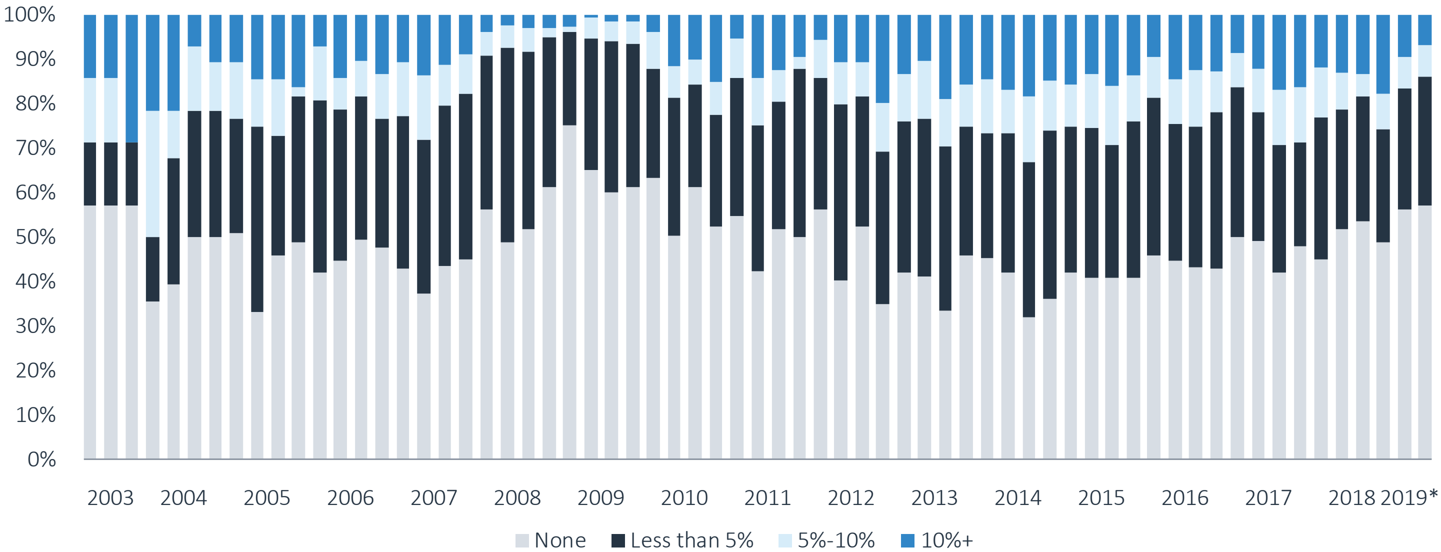
*As of June 30, 2019

Distributions as a percentage of fund size (#) for funds 8-12 years old by quarter



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