PitchBook

COVID-19's Influence on Private Market Strategies and Allocators

How public market volatility affects private markets

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Contents

Key takeaways	1
Introduction	2
Limited partners	2-4
Secondaries	5-6
Private equity	7
Venture capital	8-9
Private debt	10
Real assets	10-11
Continuing coverage	11

Key takeaways

- LPs as a group are better positioned to combat the denominator effect today because many entered 2020 underallocated or at their targets to private markets. Additionally, many institutional investors have updated their investment policy statements to allow for more flexibility in volatile markets, like the one we're currently experiencing.
- The inability to perform in-person due diligence will be a major impediment to fundraising. While many funds currently on the road seem likely to reach a final close, new fundraising efforts will be significantly hampered.
- In VC, more recent vintages have been deploying capital more quickly than in the past, often relying on new fundraises to support follow-on financings. We anticipate that many VC funds will shift their capital deployment, concentrating more on supporting existing portfolio companies and adjusting their reserve capital accordingly.
- Coming into 2020, private debt fundraising had experienced its best three-year period in history, having raised $388.9 billion globally since 2017. Dry powder had ballooned too, reaching $276.5 billion as of Q2 2019, all signaling that private debt funds have plenty of capital to deploy in these trying times.
- LPs allocating to PE and VC can expect net cash flows to turn negative, a break from the norm of recent years.
- We have heard of several secondaries deals being reconsidered in recent weeks, as buyers underwrite deals to the new realities of the market. It will take months—possibly even until the end of the year—for transaction volume to rebound given the need for recalibration from parties on both sides of the table.

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Introduction

Naturally we are all wondering what the effects will be of COVID-19 forcing billions of people to stay home for weeks or months. We have already seen furloughs or layoffs for factory laborers, restaurant workers, airline employees and so many others who cannot do their work from a computer attached to the internet. It is inevitably going to have an impact on economies as businesses close their doors, even if temporarily, and as people halt spending that requires them to leave the house. It does not seem too early to say that, at the very least, a shock has struck economies around the globe that will almost certainly lead to a recession.[1]

While people speculate about potential economic ramifications down the line, financial markets are undergoing massive daily swings as both investment managers and allocators evaluate the situation and what it means for their current and future investments. Given their illiquid and slow-moving nature, an outstanding question is: What will this mean for private market investors?

Our 2019 Annual Private Fund Strategies Report spoke of record fundraising. What will that mean for the investors now locked into those funds, and what can we expect of fundraising and investment going forward? This note provides insights into the current situation supported by data perspectives from prior disruptions. Below we discuss cash flows, deal activity and performance expectations across the private markets strategies we cover at PitchBook.

Limited partners

While we'll discuss some opportunistic ideas for LPs in the various strategy sections throughout this note, we wanted to explicitly discuss what the allocators are thinking and experiencing in this time of market upheaval.

One principal of which people took serious note in the last crisis was something called the "denominator effect." Nearly every LP operates within a target allocation framework for their selected asset classes. Simplistically, an LP may intend 20% of its total portfolio for private equity and 40% each for public equity and fixed income. When the stock market falls dramatically, the public market investments fall in value immediately. But private market investments don't reflect the changing environment for a quarter or two because they require a manual valuation process.

While the total portfolio drops in this scenario, the value of the private investments does not move right away, which can cause issues. Circling back to our example, if the portfolio was $100 million before the crisis and a 40% public equity stake dropped 35%, then the total portfolio dropped by $14 million to reach $86 million. Before the crisis point, the private equity target was $20 million, but it becomes 20% of $86 million, or $17.2 million. If the investor was at or above the 20% allocation target before the stock market drop, then the LP now finds itself overallocated.

1: Calling recessions is the responsibility of the National Bureau of Economic Research based on a number of factors, but the working definition most use is two consecutive quarters of declining GDP.

This is a known phenomenon, of course. After the last crisis, some LPs made their investment policy statements more flexible. Instead of a hard 20% target with a tight allowable band of drift, ranges were widened. In some cases, a time element was added to allow for the portfolio to be outside of the targeted zone for two consecutive quarters before the investment staff must consider options for how to bring the portfolio back to the desired allocation. This allows time for the private market portfolio to reset to the new normal and perhaps time for the stock market to also gain back some ground as time passes and market participants come to an understanding about what different investment opportunities should be worth in relation to each other. In addition to this new leeway, LPs as a group are better positioned to combat the denominator effect today because many entered the 2020 under allocated or at their targets to private markets.[2]

LPs are, of course, not homogenous in their governance or objectives—both of which can have a significant impact on the reaction an investor may have to a crisis. In the case of a Chief Investment Officer who has full control over investments, that person may be able to move quickly and opportunistically into areas likely to benefit from a market displacement. On the other end of the spectrum are pools of capital governed by boards with little to no investment experience. Those committees meet infrequently and tend to be risk averse even in the best of times, particularly regarding alternative investments.

The type of institution matters as well. An endowment or sovereign wealth fund investing for perpetuity might be willing to take longer term risks by doubling down on risky assets when they seem inexpensive, but a pension that was underfunded with a growing base of retirees going into the crisis is now in an even worse position. In the latter case, the company or public entity responsible for funding the pension may be extremely wary of assets perceived to be riskier when they are already being required to increase their contributions to the pool at a time when revenues may also be suffering.

Even when an investment committee is made up of savvy investors, they typically meet only quarterly. They are undoubtedly having ad hoc update calls, but scheduling conflicts and the need, at least for public pensions, to hold meetings in a public forum make it difficult to have off-cycle meetings where decisions can be made. It is highly likely that the agenda for the meeting scheduled in April or May is going to be focused on triage: What does the meltdown mean for funding ratios or spending/granting programs? What can they do to be opportunistic right now? What areas of the portfolio are most exposed to the worst part of the current crisis? New commitment recommendations are unlikely to make the next agenda unless the investment staff was far along in the diligence process and a final close was imminent. It will be another quarter or two before the committee is ready to consider changes or additions to the portfolio's asset managers.

We have yet to meet an LP who believes they are comfortably staffed; most have very lean investment teams. They are currently focused on assuring stakeholders that all is under control and the long-term nature of the plan means immediate action is not merited. At this time, when LPs suddenly

2: "Private Equity Braces for the Denominator Effect," Private Equity International, Isobel Markham, March 19, 2020

become unresponsive to external communication, it is because they are busy answering all of the questions from their constituents and creating report investment committees will be demanding for their first quarter meetings. In crisis times, this takes quite a lot of time away from business-as-usual commitment recommendations.

In terms of partnership commitments already signed, some LPs seeing the dramatic decline in their portfolio may wonder what would happen should they find themselves unwilling or unable to meet capital call demands from GPs. Whether it be a cash crunch or a loss of confidence in the GP or the strategy, most LP agreements have severe penalties designed to deter defaults. According to a paper written by legal firm Proskauer Rose, GPs often have the following options:[3]

- Allowing late payment with interest and related expenses charged back to the LP
- Requiring the LP to sell its stake to other parties at a discount
- Diluting the LP's fund interest by redistributing some of the LP's stake to other LPs
- Redeeming the LP's interest with no payment or a promissory note of nominal value payable when the fund liquidates
- Suing for damages

Despite the potential consequences, some LPs still chose to default during the global financial crisis (GFC) because it was early in a fund's life and because some found allocating limited liquidity to a strategy that no longer seemed advisable to be anathematic.

One of the more specific impacts of the current crisis is the fact that working from home bars LPs from performing what for some is mandatory in-person due diligence. This will have a number of follow-on consequences. First, beyond the logistical issues stated above about packed agendas and distracted investment committees, the pace of commitments will slow from the record levels seen in 2019 if in-person due diligence requirements must be upheld. Second, funds for which the LP had already completed due diligence prior to the crisis may still be approved. Third, GPs coming back to market with strategies in which the LP has invested previously may require a lesser level of due diligence, so these "re-ups" may have a better chance of garnering commitments than strategies new to an LP. Finally, GPs with poor performance histories or ones hoping to start a new fund or broaden their investor base will be disadvantaged, as their targeted LPs will be unable to get comfortable with them during this time.

We think looking to raise capital right now should be patient. LPs are going through a lot, other parts of the portfolio are taking up a lot of their brain power, and making new fund commitments—particularly if it is not ideally positioned to benefit from turmoil--is probably not a high priority. But each situation is unique. If GPs have a strategy that might be a good opportunistic bet, and if the investor seems to be nimble enough to take advantage of it, now could be the time to reach out.

3: "Facing Up to Reality," Private Equity International, Howard Beber, Scott Jones and Ira Bogner, n.d.

Secondaries

For secondaries transactions to take place, it takes both willing buyers and sellers. While buyers are salivating at the discounts they believe will come from the market reset, everyone but forced sellers are quite likely to table any discussions to sell private market interests. We have heard of several secondaries deals being rethought in recent weeks, as buyers underwrite deals to the new realities of the market. It will take months—possibly even until the end of the year—for transaction volume to rebound given the need for recalibration from parties on both sides of the table.

On the buyer side of the equation, Setter Capital has already published the results of a survey conducted in March 2020 asking secondaries buyers about their expectations going forward in the new environment.[4] Findings from that survey show that the 39 investors polled are already facing up to a new reality, anticipating a recession, a drop in fundraising activity and substantially lower deal volumes following 2019's record transaction totals. In terms of pricing, while 2019 saw LBO stakes purchased at a slight premium to NAV, early estimates from buyers show that their bids are likely to be down almost 25% from the most recently reported, pre-crisis NAVs. Areas such as real estate, energy and clean tech had even more pessimistic estimates.

On the other side of a secondaries transaction are the current LPs of the fund stake. To some extent, the record volume of transactions in 2019 was facilitated by what LPs saw as a seller's market, where record dollars were chasing the limited supply of stakes for sale. With prices falling, that portfolio management rationale will step to the sidelines. Any near-term offerings for the secondaries market today are likely to come from forced sellers, but LPs are better positioned today to combat the denominator effect than they were in the prior crisis, as we mentioned earlier. While some may feel that their best course of action will be to sell off private market interests, the vast majority will find the new pricing environment to be distasteful and will hold off selling.

There are a variety of other reasons we believe LPs will retreat from the secondaries marketplace. First, they are currently overwhelmed fielding questions from their stakeholders about the impact of the market moves on the overall portfolio. With full agendas for the next investment committee meetings in April or May, they will not prioritize any nonessential secondaries transactions. Also, while secondaries buyers provided estimates of pricing in the Setter survey, their discounts are based on the most recent NAVs provided by GPs, which are as of September or December of 2019. LPs will want to hear the GPs' views on valuation before agreeing to any pricing offered by a third party. Finally, LPs with a long-term focus will generally not feel that it makes sense to sell such assets during a volatile downward trend, a time that historically has allowed some private market managers to shine.

4: Setter Capital Special Buyer Survey, March 2020

What may investors expect from the performance of secondaries funds raised around the time of a crisis? From our most recent PitchBook Benchmarks report, the following IRRs resulted from secondaries funds raised in the vintage years surrounding the GFC:

Vintage year	Pooled IRR	TVPI	Number of funds
2005	5.93%	1.32x	8
2006	6.48%	1.38x	9
2007	4.40%	1.19x	9
2008	11.24%	1.56x	15
2009	11.89%	1.55x	9
2010	13.86%	1.56x	7
2011	15.27%	1.60x	10

Source: PitchBook | **Geography:** Global

The funds raised going into the financial crisis did not fare well, as much of their outlay happened while prices were climbing. Funds that could buy after pricing reached a new equilibrium were able to garner excellent low double-digit net IRRs. IRRs continued to climb even for funds raised after the depths of the GFC because the time horizon to realized returns was shortening. The 2008 and 2009 funds saw a good pricing environment but had to wait a long time for the underlying funds to wind down. On the other hand, prices remained depressed through 2010 and 2011, but private markets deal activity had picked up again, leading the underlying GPs to reach realizations more quickly, time being a key component to IRRs. During this entire period, leverage on secondaries purchases (i.e. GPs borrowing portions of secondary purchase prices) steadily increased, helping to boost performance from both the IRR and multiple perspectives.

The parallels between the GFC and the pandemic-induced crisis of today are not exact. The former rolled out slowly; the first indications appeared in early 2007, but the most serious market turmoil happened in October 2008. The COVID-19 crisis unfurled over roughly two months before hitting a tipping point when a nearly complete shut-off of consumer spending was almost instantaneously felt and seen in the public markets. We hope that the virus will wind down fairly quickly, allowing the pain, though sudden and deep, to be felt only briefly. A return to some semblance of orderly capital markets may mean only a temporary cessation in secondaries deal flow.

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Private equity

Heading into 2020, we predicted less capital to be raised and fewer funds to close. Several gargantuan funds closed in 2019, so we expected fewer to return to market the following year. Facing COVID-19 fears in addition to already reduced expectations, PE fund managers appear to be headed for a difficult time. We believe they are likely to fare better than others might anticipate given the circumstances. Mega-fund managers, such as Vista Equity Partners and Advent International, can secure capital for funds currently in market with their existing LP base. In 2019, funds sized over $5 billion garnered the bulk of PE capital in the US, and we foresee further concentration at the upper end of the market. Given these factors, total commitments made may not dip as much as total funds raised volume.

On the cash flow front, LPs allocating to PE can expect a break from the norm of recent years where distributions outstripped contributions, which led to positive net cash flows. During a time of crisis, GPs loathe realizing investments at diminished valuations. Instead, they tend to further invest into existing portfolio companies, or at least hold those companies longer, which leads to reduced distributions. Moreover, with the cost of leverage financing rising as lenders regain some control, recaps may become more expensive—if they even pencil out at all. On the other side, GPs also tend to call down capital more slowly during times of market crisis because deal making slows to a trickle.

LPs evaluating their current or prospective commitments will want to probe their GPs to determine their approach to a crisis. The more passive GPs will generally hold tight, assuming the environment will eventually resume a semblance of normalcy. Their funds may do well but will fail to take full advantage of dislocated markets, resulting in bottom-half IRRs for affected vintages. On the other hand, some GPs will seek out platform investments and take this opportunity to eliminate weaker rivals, setting themselves up to exit the recession in a very strong position. Putting money to work during a crisis is risky, but historically the best funds from crisis years took measured chances that resulted in top-quartile performance.

The exact repercussions the crisis will have on PE fund performance will remain murky until we know how long the lockdown will endure and how deeply the virus will affect global economies. However, we do believe private markets will fare better than public markets, which have posted PE-matching results for the first time over the past 10 years, as of Q2 2019. Our research indicates that while PE exhibits high correlation with public market performance over longer periods of time, in times of volatility—especially to the downside—it tends to drop less and subsequently outperform. Strategies targeting consumers are apt to see their portfolio companies hit the hardest because widespread layoffs and furloughs are happening quickly, which ought to depress consumer spending; even employed consumers may spend less in a time of so much uncertainty. In the most insulated industries, an extension of holding times and lack of recaps will probably lead to somewhat lower IRRs. Funds deploying cash through the crisis are in a favorable position to deliver elevated returns given the higher likelihood of finding a bargain in a crisis and multiple expansion accounting for nearly half of total PE fund returns. Previous crisis funds, such as the 2001 or 2009 vintages, posted top-tier metrics.

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Venture capital

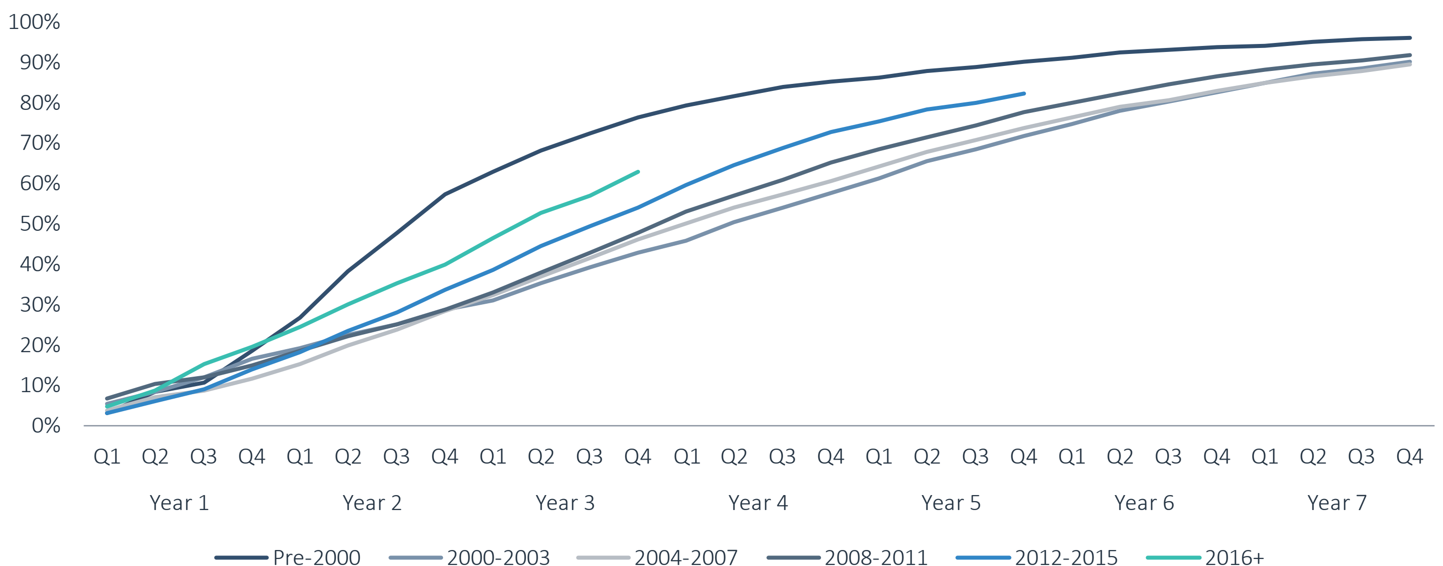
Coming into 2020, we anticipated a strong year for VC fundraising. Activity through Q1 has been strong, with more than $20 billion raised in the US alone. The number of funds closed remains on a downward trajectory, however, as capital is increasingly concentrated in larger vehicles. The strength of prominent VC firms has been on display in recent weeks, with NEA and KPCB both announcing sizable closes in March. Roughly a dozen funds of $500 million or more have closed so far in 2020, with more than 50 open funds in the US seeking $300 million or more. Fundraising has proved to be more challenging for newer GPs. Just seven first-time funds have closed so far in 2020, while more than 40 have been raised in each of the last three years.

If anything, this bifurcation will only be exacerbated in the current environment. The main headwind seems to be the potential for a prolonged hiatus of in-person meetings, which could delay approval processes that are critical to consummate a fund commitment. First-time managers and smaller GPs that need to engage new investors are likely to struggle due to travel restrictions and similar impediments. Newer VC firms are particularly susceptible because their small size and high-risk strategy provides them with little buffer. Name-brand VC firms, on the other hand, not only have significant resources but benefit from consistently strong demand from LPs, as well as longstanding relationships that can streamline the fundraising process, particularly if onsite due diligence requirements can be suspended for follow-on commitments.

We think that the denominator effect will play a factor in depressing fundraising further, but the risk is somewhat mitigated because many LPs entered the downturn under allocated to VC and the strategy assumes a relatively small proportion of most allocator portfolios. This, combined with the high demand for access to premier VCs, leads us to think that VC fundraising in aggregate should be resilient. One concern, however, is that the persistently higher valuations in VC financings have led to paper gains and inflated VC holdings; the median RVPI value is 1.25x or above for every vintage from 2012 to 2016. While the denominator effect in itself may not cause dire issues for LPs, rising VC valuations on the other side of the equation—call it the “numerator effect”—could definitely pose a problem.

LPs have benefited from positive net cash flows from VC funds in recent years, but contributions are likely to outstrip distributions in the coming quarters. More recent vintages have been deploying capital more quickly than in the past, often relying on new fundraises to support follow-on financings. As with PE, we anticipate that many VC funds will shift their capital deployment, concentrating more on supporting existing portfolio companies and adjusting their reserve capital accordingly.

Average capital called as proportion of VC fund size



Source: PitchBook | **Geography:** Global

On the performance side, VC funds have posted the best horizon IRR of any private market strategy in recent periods through mid-2019, but performance has been dropping. Even prior to the March sell-off in public equities, VC valuations plateaued and dipped a bit at the late stage in 2019; the current environment should sustain that trend, which will likely dampen the aggressive portfolio markups and concomitant strength in short-term fund performance seen recently.

Our research has shown that PE and VC funds raised in the run-up to a downturn, wherein prices are rising and excess capital is raised, tend to underperform. The best-performing vintages tend to be those that invest at the nadir of a downturn and into the early stage of recovery. As a result, VC funds willing to deploy capital posted strong relative returns; 2009 is the first vintage since the 1990s where VC funds produced a median IRR in the double digits, and returns have remained strong for vintages through the 2010s as well.

Based on distribution rates, it currently appears that performance is largely baked in for vintages 2010 and earlier for VC. Funds centering on the 2017 vintage are most susceptible to long-term underperformance should a sustained macroeconomic downturn occur. Performance for these vintages has been trending well, but paper gains account for the lion's share of those funds' returns. The validity of private market valuations (i.e. the unrealized value in funds), particularly in the VC space, has been questioned for some time. It is likely that depressed valuations in public equities will limit VCs' ability to exit at marked prices in the near term, necessitating protracted holding times that would hamper IRRs. This consternation increased following the sell-off of several prominent and newly listed VC-backed companies in 2019 and will only be further stoked by recent market volatility.

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Private debt

Coming into 2020, private debt fundraising had experienced its best three-year period in history, having raised $388.9 billion globally since 2017. Dry powder had ballooned too, reaching $276.5 billion as of Q2 2019, all signaling that private debt funds have plenty of capital to deploy in these trying times. Direct lending funds—many of which lend exclusively to sponsor-backed companies—had been the standout strategy of the last decade, accounting for 56.9% of capital raised in 2019. These nonbank lenders will continue to be a critical source of debt financing for middle-market companies, particularly as the (mostly bank-arranged) market for broadly syndicated leveraged loans dries up due to the current liquidity crisis stemming from COVID-19-related demand shocks.

Distressed debt and special situations funds, though, are likely to see more investment opportunities in the coming months, which could lead to increased capital calls for LPs. Fundraising for distressed strategies had lagged in the last couple years due to a plethora of capital already raised and waiting for the now defunct 10-year bull run to end. These investors are now seeing the price dislocations on which the strategy depends; leveraged loan indices have fallen precipitously since the beginning of March 2020. That said, a wild card for distressed investors is likely to be the prevalence of covenant-lite loans issued in recent years, which make it less likely that issuers breach these covenants and trigger a technical default.

When it comes to the performance of existing loan portfolios, those same covenant-lite loans are a double-edged sword. On the one hand, they allow borrowers more flexibility, potentially increasing the chances they make it through the upcoming credit squeeze. On the other hand, issuers (and their financial sponsors) will have greater ability to steer cash away from the creditors if they sense that the company is no longer a going concern.

Real assets

Fundraising for vehicles dedicated to oil & gas companies has been in decline for half a decade and is likely to fall further in 2020. Around the same time that COVID-19 demand shocks began to hit the global economy, Saudi Arabia and Russia began a price war, flooding the market with crude oil and sending the price below $30 per barrel. The last time oil markets saw such severe shocks, back in 2014 and 2015, capital raised for these funds skyrocketed, with fund managers betting on a rebound in prices. But the industry's high fixed costs and recent struggles to service high debt loads are likely to keep investors on the sidelines for the time being, resulting in lower contributions and distributions for fund LPs. As we profile in our recently released Real Assets Report, short-term performance of oil & gas funds is correlated with changes in WTI crude oil prices (R^2 = 0.53), so existing portfolios are likely to take a hit in the coming quarters. Recent performance for the strategy was already in negative territory (horizon IRR of -3.1% for the year ending June 30, 3019) but has posted annual gains of 14.3% over a 15-year horizon.

Infrastructure funds—which are also in the real assets bucket but with an entirely different risk-return profile than most oil & gas players—are coming off a record year of fundraising, which saw $91.4 billion raised across 29 funds globally. Though infrastructure assets are generally thought of as producing a steady income stream regardless of market environment, fund distributions could dry up as their performance in an economy hampered by COVID-19 will vary depending on the specific assets. For example, ports and airports with floating revenues will struggle as trade and travel are restricted. Conversely, digital infrastructure is likely to see equivalent—if not increased—demand in the coming months, which bodes well for performance.

As we covered in our recent Real Assets Report, the impact of the health crisis is reverberating throughout the real estate industry. The halt in business travel and tourism has decimated hotel occupancy rates, and social distancing policies have left retail foot traffic anemic in many cities around the world. As more companies become comfortable with having a mobile workforce, a secular shift in office demand is a real possibility. How long the crisis will last is still up in the air, as are its lasting impacts. However, in our upcoming note on real assets investing during a crisis, we will dive deeper into what GPs and LPs might expect.

Continuing coverage

We at PitchBook are working (from home) diligently to provide coverage and analysis on the private market impacts of the COVID-19 crisis. The News & Analysis section on our website already boasts a number of articles and notes, and we have several more in the pipeline. We also invite questions for our data analysts that may help our clients uncover their own insights into any aspect of private markets investing and dealmaking.