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Elston Insights

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Private equity faces a tougher environment

- The pursuit of yield pre-2021 was supportive for private equity
- Conditions are now hostile on a number of fronts
- Lack of demand prompts a meaningful discount to NAV

The goldilocks period for private equity

In the ultra-low interest rate environment that ran for almost 13 years in the wake of the global financial crisis, the risk appetite of yield-starved investors ramped up and one of the areas to benefit was private equity. Once the domain of institutional investors only, where minimum allocation thresholds could be £100m or more, vehicles that allowed retail investors to gain exposure to both private equity funds and/or unlisted businesses – namely private equity investment trusts – saw the money pour in. Investors seemed comfortable sacrificing valuation transparency and accepting higher volatility for the potential rewards on offer. A goldilocks environment for private equity investing helped: debt was exceptionally cheap, there was a wash of liquidity in the market thanks to monetary easing programmes and there seemed to be no end of willing buyers to facilitate profitable exits.

Higher interest rates spoil the party

However, as inflation has gathered pace in the wake of the pandemic, interest rates have risen from 0.1% to 5% in 18 months, the fastest and steepest climb since the 1980s. And this bodes ill for private equity on a number of fronts. Leverage, which private equity owners embrace in order to juice returns, is now considerably more expensive to service. For anyone who didn't lock in a long-term fixed rate, repayments could now be punitive, forcing owners to divest, even at a loss.

From a macro perspective, economic growth is hampered by inflation and high interest rates, making for a more challenging environment in which to grow a business in anticipation of an IPO or secondary market sale. And in terms of potential buyers, what was previously a sometimes frenzied market both public and private is now remarkably quiet as buyers lapse into wait-and-see mode. In the first quarter of 2023, the volume of secondary market deals halved year on year.

A further corollary is the fact that the higher the return on cash, the more compressed valuations become.

Lack of appetite opens up discounts

It is perhaps understandable then that many private equity investment trusts currently trade at a significant discount to NAV. Although in a number of cases a deep dive into the underlying value of a trust's holdings suggests that the discount is not wholly justified, what it indicates is the sheer lack of demand for private equity investments at present.

Summary

The private equity sphere is highly cyclical. When the macro-economic environment is right (as it was when interest rates were at rock bottom), returns can be outsized. But equally, when exuberance is tempered by the twin realities of rampant inflation and steep interest rate rises, the pain can be substantial. For investors with adequate risk appetite, it can be a valuable diversifier as an alternative allocation within a wider portfolio but volatility is to be expected, as is an acceptance that where there can be great highs, there can also be great lows. Direct private equity investors will often sign up to lock-up periods of 10 years; for those with patience, there can be rewards.

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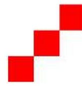

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