THE LUXEMBOURG VOICE OF PRIVATE CAPITAL

Investing despite the uncertainty: "Stay the course"

THE VIEW FROM LPEA AT THE TIME OF COVID-19

by Rajaa Mekouar (CEO)

Luxembourg, July 27th 2020

1. PE / VC in the Macro context

At end June 2020, GDP forecasts for 2020 remain poor (-4.6% globally and -10% for Eurozone) but public markets have recovered to pre-Covid-19 levels, as they were supported by massive liquidity injections and fiscal stimulus packages reaching to up to 20% of GDP, across the Board. This took government bond yields even lower (0.6% in the case of Treasuries).

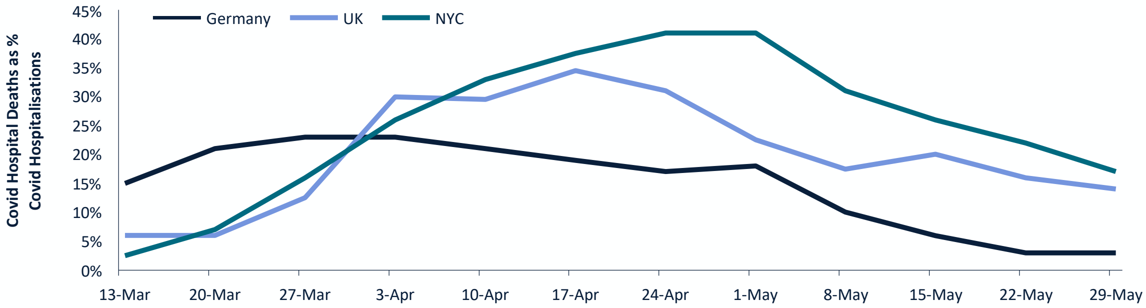
Equity Markets Performance as of 30 June 2020

Equity Index	YT-30 June	Decline from 2020 peak	Increase from 2020 low
MSCI World (LC)	-4.9%	-8.9%	35.1%
S&P 500	-3.1%	-7.8%	39.3%
China A-Shares	1.6%	-1.0%	17.9%

Source: Bloomberg

There are marked differences between sectors, with Healthcare, Technology, Utilities and Consumer Staples faring best, while Energy and Manufacturing remain battered, alongside Discretionary Consumer and Consumer Services.

As we entered Q3 on an uncertain note due to a resurgence in cases in Luxembourg and other parts of the world / Europe we hold our breath as to where macro numbers will point by year end, but the severity of the pandemic has reduced, at least in Europe, while it continues to be under control in SE Asia and is not contained in the US. It is Emerging Markets that are the biggest source of concern right now, with flare-ups and out-of-control outbreaks in India, Brazil etc.



Source: ECDC and CDC

All hopes are pinned on a vaccine being developed over the next 6-12 months, with a handful of initiatives reaching Phase III under an accelerated FDA approval schedule. Meanwhile, certain drugs are now clear to have positive effects to reduce symptom severity and mortality, which makes the situation more manageable on the whole.

For 2021, consensus forecasts show a marked recovery in terms of GDP growth (+6.1% on average, and +7.1% for the Eurozone).

2021 Real GDP Growth Forecast						
Source	IMF	JP Morgan	Goldman Sachs	Deutsche Bank	Capital Economics	Average
As of:	24-Jun	15-Jun	15-Jun	09-Jun	12-Jun	
Global	5.4%	5.6%	6.5%	5.0%	8.0%	6.1%
DM	4.8%	4.3%	6.5%	3.4%	7.5%	5.3%
US	4.5%	2.9%	6.4%	2.6%	7.0%	4.7%
Eurozone	6.0%	6.2%	8.1%	5.0%	10.0%	7.1%
Japan	2.4%	3.5%	3.3%	1.5%	2.5%	2.6%
EM	5.9%	6.4%	6.5%	6.1%	9.2%	6.8%
China	8.2%	8.5%	7.7%	9.4%	12.0%	9.2%

Source: IMF, JP Morgan, Goldman Sachs, Deutsche Bank, Capital Economics

Still, for now, we know for a fact that:

In terms of our daily lives:

- Social distancing and associated measures remain the new norm
- Travel remains curtailed
- Large gatherings will not resume before well into 2021

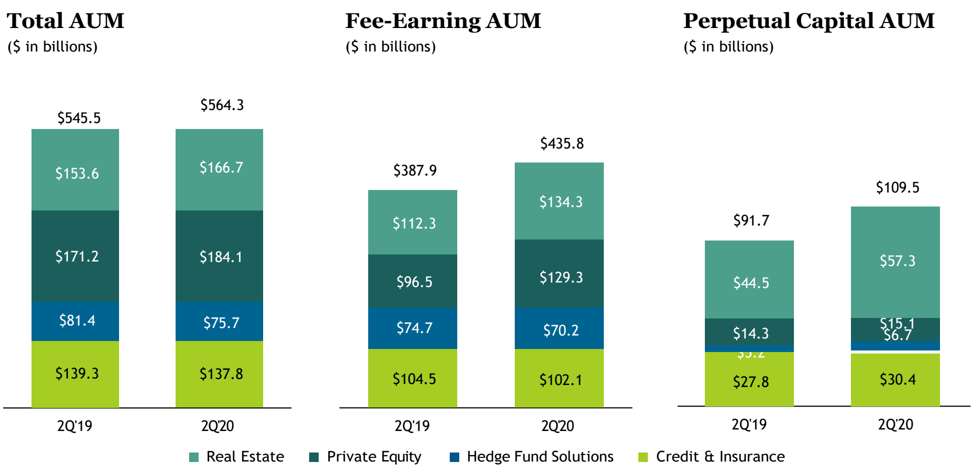
In terms of the economy:

- Interest rates will remain at record lows
- Austerity is no longer the overriding principle
- Inflation will not peak any time soon.

The looming US election (November 3rd) adds to the ongoing uncertainty surrounding the macro-economic context in which the PE industry is evolving. In any instance, while PE remains favoured by its long-term horizon it cannot ignore its broader context nor can one assume to that it is fully decorrelated from other asset classes.

2. The bellwether: Blackstone

Q2 earnings of Blackstone who was first to release its performance data show a clear improvement, with continued fundraising activity and dealmaking resuming, despite distributions still slow. Noteworthy is the increase in perpetual capital to over $100bn, an indication of key investors (LPs) accepting long-term horizons.



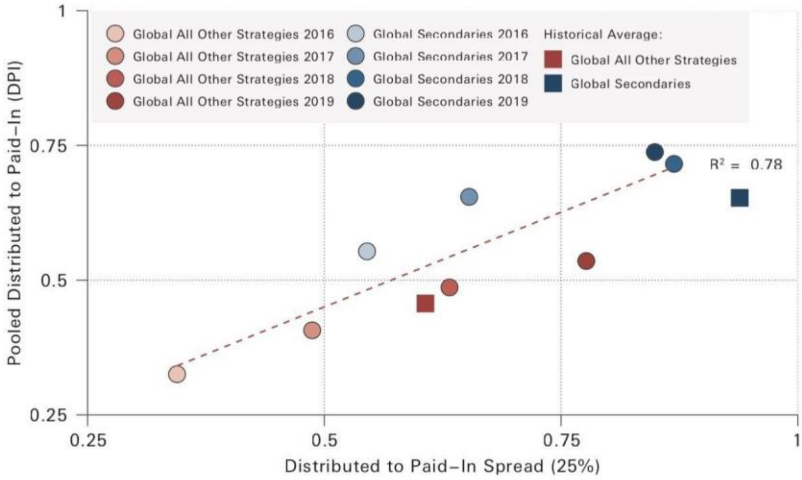
Total AuM in PE are +8% and performance of NAV recovered to +12% (v -21% in Q1), with the best performing strategy being Secondaries over the LTM period: +20.8%. Secondaries also attracted most of the new inflows of capital in PE (75% of the $5bn over Q2 2020).

+

	2Q'20	2Q'20 LTM
Real Estate		
Opportunistic	1.6%	0.6%
Core+	3.0%	4.7%
Private Equity		
Corporate Private Equity	12.8%	(7.7)%
Tactical Opportunities	10.8%	1.9%
Secondaries	3.8%	20.8%
Hedge Fund Solutions		
BPS Composite	6.0%	(0.6)%
Credit & Insurance		
Credit Composite	10.1%	(2.1)%

Adding to this perspective, it is worth noting that Secondaries are a strong performer relative to others as per the graph below.

Fig. 14: Compared evolution of active Global Secondaries funds with other private market strategies

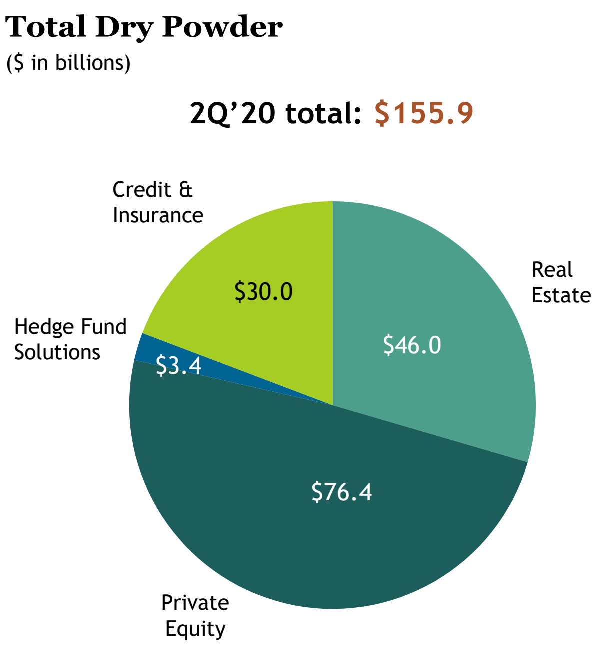


This matrix compares the evolution of the realized risk-return profile of active Global Secondaries funds with other private market strategies, as well as with the historical risk-return of the same strategies. Identical vintage years are represented in both samples.

Funds further outperformed their historical average both in terms of realized performance and performance dispersion.

Source: Cambridge Associates, Wellershoff & Partners

Importantly, with $155bn in dry powder, half of which in PE, Blackstone is very well positioned to capitalize on future opportunities as they emerge. This represents about 10% of total cash accumulated by PE firms globally, of $1.7 trillion.



NB : The other listed PE firms will publish their Q2 Earnings between July 30th and August 5th 2020. (Carlyle, KKR, Ares and Apollo).

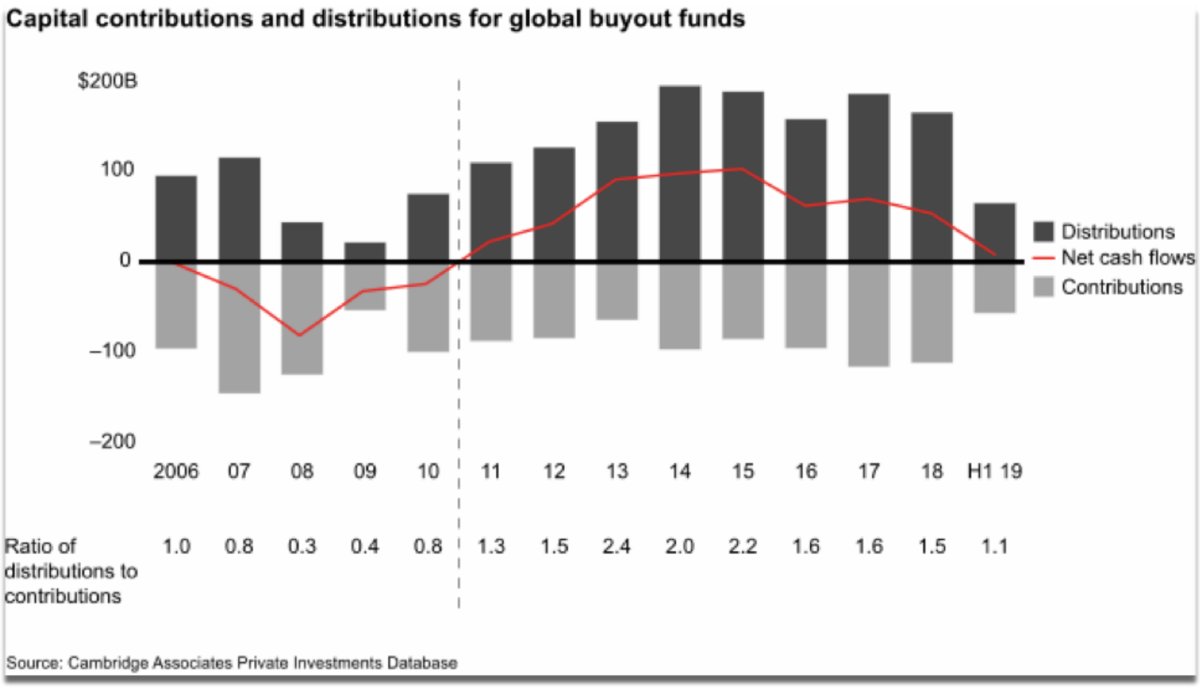
3. Silver Linings all around

LPEA estimates that a number of trends constitute “silver linings” underpinning continued attractiveness of the PE/VC industry for investors:

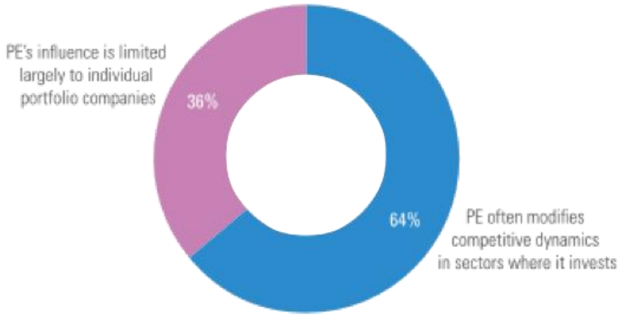
- Long-term and “patient” nature of PE;
- No forced selling means recovery will help alleviate NAV impact;
- Investment environment is getting better with attractive valuations;
- Leverage loan access and terms remains favourable;
- Accumulated war chest by GPs over the last 2-3 years provides solid ammunition to shore up portfolio companies as and when.

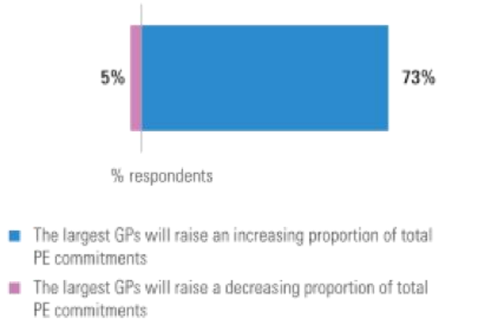
Exposure to private markets to continue its steady increase as low yields push investors to seek higher return asset classes, despite their less liquid nature

Globally, a positive statistic comes from the recently published Bain PE report (2020) where it appears that for the 9th year running, PE net cashflows from global LBO funds are positive.

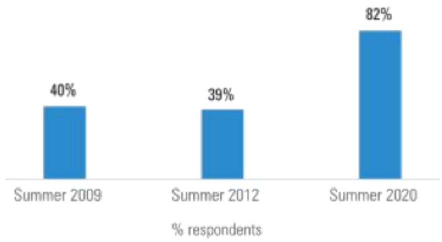


Importantly. LP´s are happy with GPs, with 82% of those surveyed by Coller Capital in their Summer Barometer (2020) declaring to be satisfied with the level of transparency of GPs, which surely drives their trust in the asset class. LP´s surveyed represent the top 74% investors in the world.

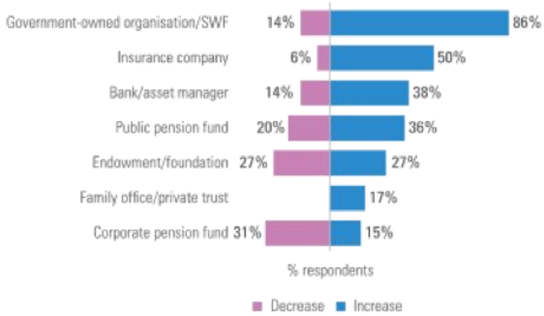




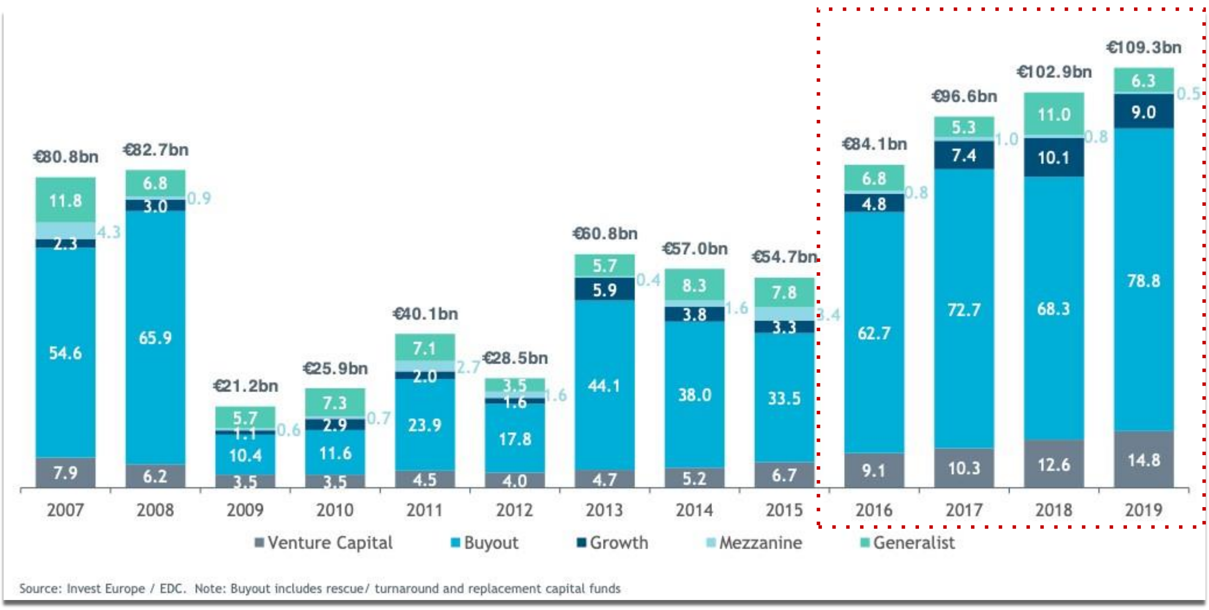
Proportion of LPs satisfied with the level of transparency displayed by most GPs



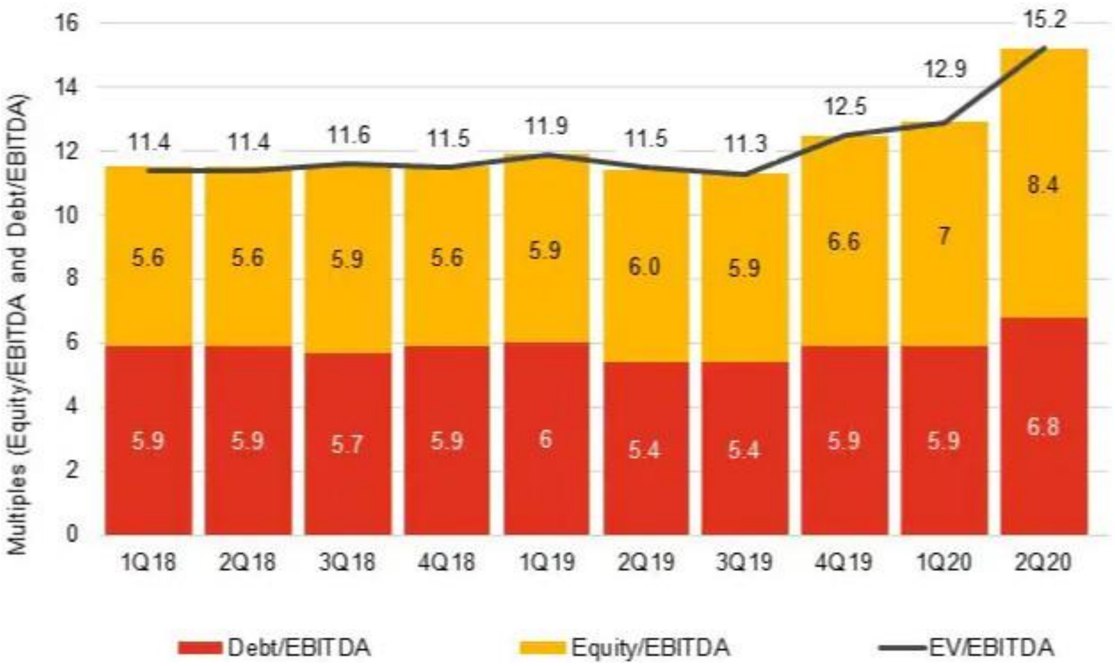
LP plans for their number of GP relationships in the next 2-3 years – by institution type



At European level, dry powder levels are also a welcome positive as published by Invest Europe, with over €109bn sitting in the sidelines, waiting to be deployed by PE firms.



Last but not least, a recently published PwC report on US LBOs shows price multiples ticking up in Q2 2020, due to the tightening of debt financing conditions. This indicates, as per PwC that i) prices will fluctuate during this crisis period where more complex transactions -albeit fewer- are being concluded, and also that ii) there is a bias towards sectors that command higher prices (eg TMT). On the whole, PwC believes that “PE firms will have a key seat at the table, and the choices they make in the pursuit of value creation could have a broader effect on our economy as a whole“.

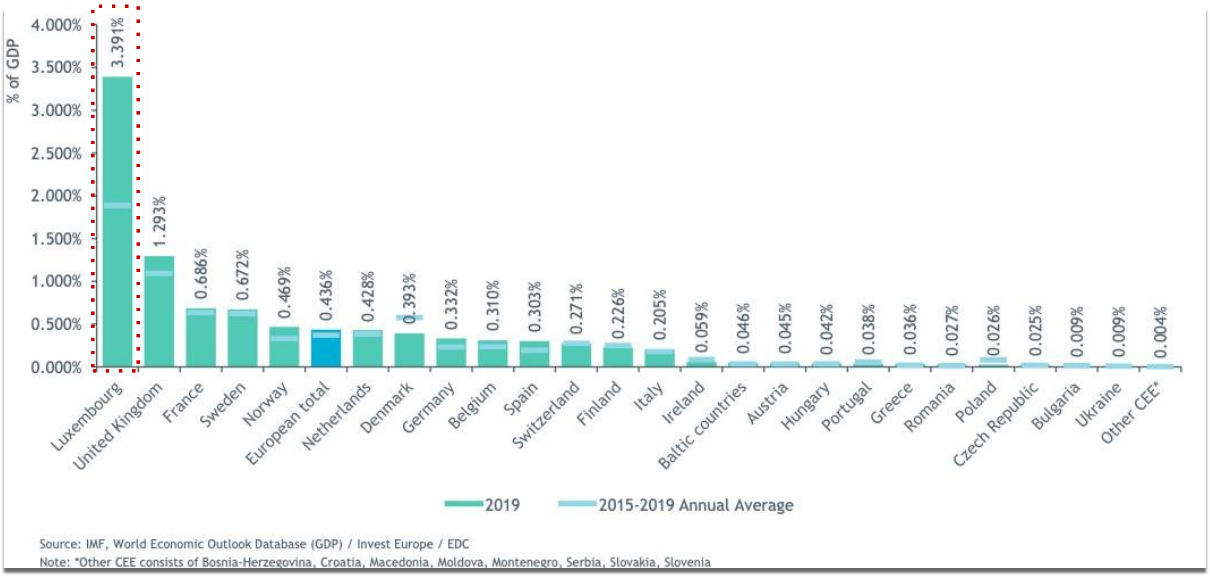


Source: PwC

All in all, PE is well equipped to perform well in the years ahead, having learned from the GFC and with total dry powder of $1.7 trillion. The industry should be able to convince public stakeholders of its intrinsic value to the economy, as its public image remains battered by a few large deals gone wrong or LBOs in sensitive sectors grabbing media and political attention. At the Invest Europe level it is an item at the top of the agenda, which the LPEA is supporting fully. At Luxembourg level too, we are launching a host of projects to boost the PE profile amongst key politicians and socio-economic entities.

4. Qualitative observations relative to PE / VC in Luxembourg and LPEA survey

In Luxembourg, caution is still in order, after a gradual deconfinement and recent new spikes in infections due to large-scale testing. What is clear is that Financial Services have been relatively sheltered – so far- and that PE in particular represents the highest % of the GDP relative to other countries.



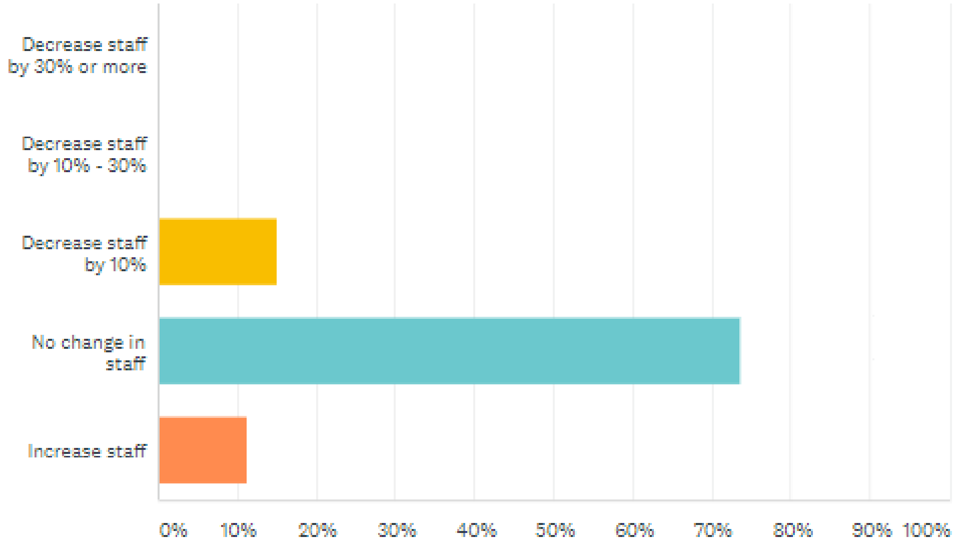
Our second survey, which was answered by over 50 LPEA members, the majority of which are GPs and LPs, provided further guidance as to the local "mood" of PE practitioners. In particular we highly value the fact **that 10 Single Family Office members took part in this edition, which is a welcome first.**

Overall, **the impact of Covid-19 has not worsened for 85% of respondents** on the back of improved visibility while recognizing that the most hit area is new business. And **they expect the YE NAV to land at -5 to -25%.**

From a more macro perspective, **respondents expect unemployment to rise to up to 8% while GDP could shrink by 10% on average**.

The bright point in the survey concerns job preservation with 75% of members who responded to survey declaring that they do not expect a decrease in staff numbers and 11% even planning to increase staff count.

Did or will Covid-19 impact your staff number in the short / medium term?



Respondents also indicate the opportunity to better tackle ESG and the Tech opportunity from Luxembourg´s standpoint.

5. The long-term view

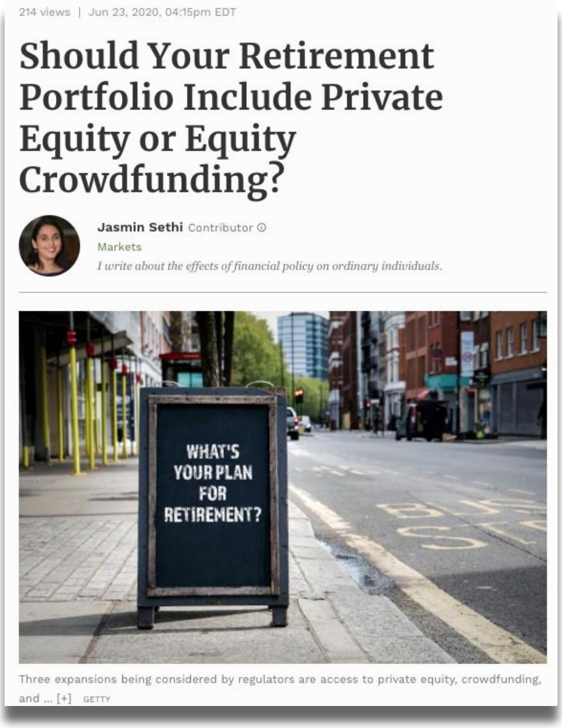
Above and beyond Covid-19 consequences, LPEA firmly believes that:

- PE attractiveness will continue, and more studies confirm the asset class ability to drive returns
- PE investing in Tech will only grow over the next year, on the back of strong performance and acceleration of the digitalization of the economy and our lives
- PE is also increasingly digital, with the rise of online investment platforms, which will help provide access to a wider range of investors
- ESG is gaining ground as a legitimate source of performance that enhances long-term returns
- Family Offices will continue to pile into PE.

In terms of PE attractiveness reaching the public at large:

A recent study by Georgetown Center for Retirement Initiatives projected that allocating 20% of a target date fund's portfolio to PE can increase median retirement income by 13%.

Source: https://cri.georgetown.edu/wp-content/uploads/2020/02/Georgetown-CRI-Policy-Report-20-01.pdf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Should Your Retirement Portfolio Include Private Equity or Equity Crowdfunding?

Jasmin Sethi Contributor
Markets
I write about the effects of financial policy on ordinary individuals.

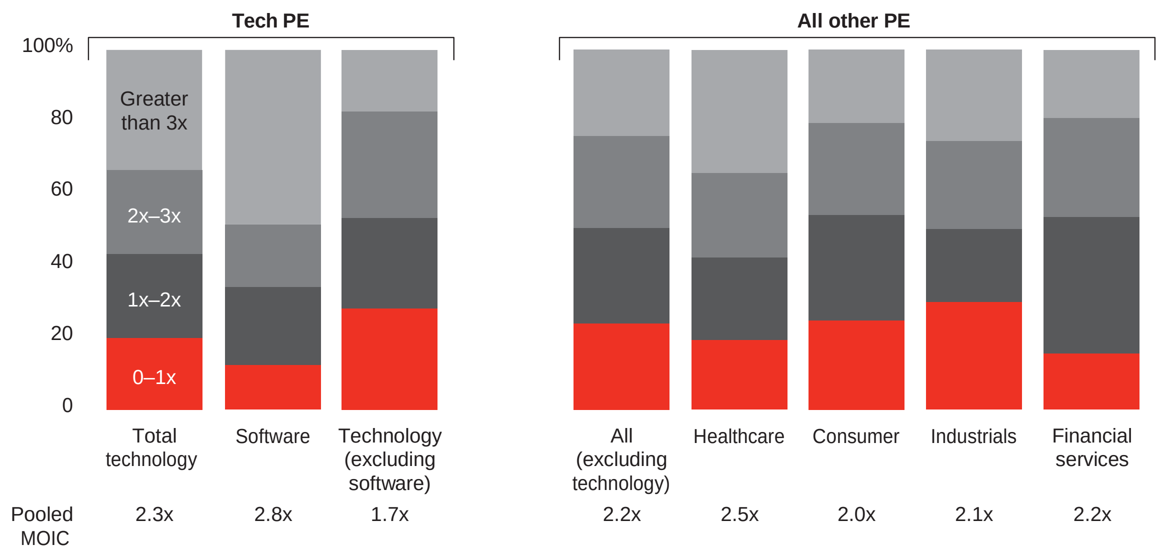
Three expansions being considered by regulators are access to private equity, crowdfunding, and ... [+] GETTY

In terms of Tech investments increasingly favored by PE firms:

„For most of its history, private equity has put its money on legacy tech businesses - long-established companies with lower organic growth - that have a track record of high margins and steady earnings. In recent years, however, a new generation of born-on-the-cloud software and service companies have been attracting more and more investment."

Bain PE Report (2020)

Pooled MOIC for fully realized buyout deals, 2010–18



Note: Includes leveraged buyouts only
Sources: CEPRES Platform; Bain analysis

In terms of democratization of PE thanks to digital alternatives:

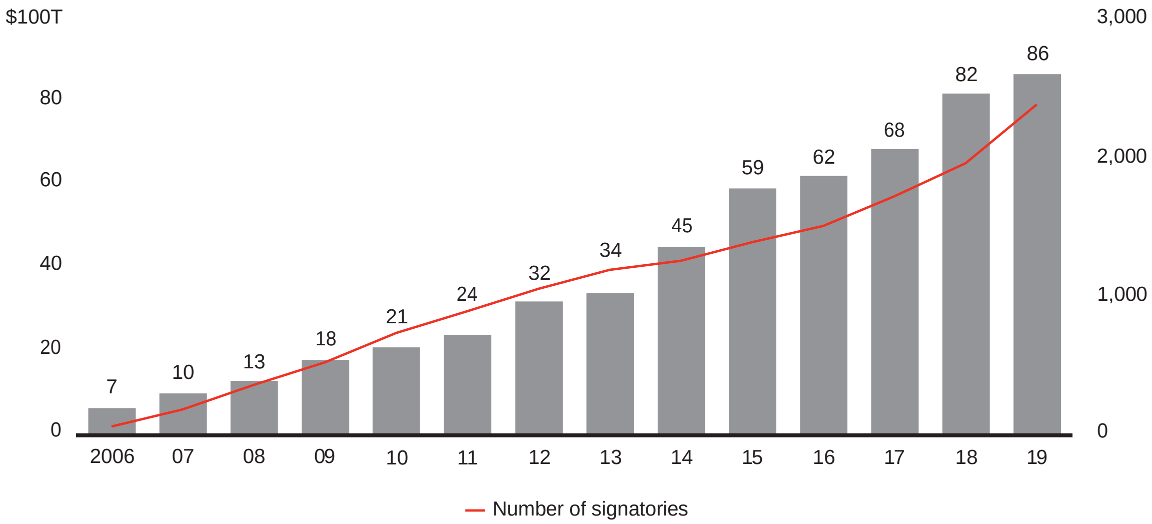
The number of online platforms providing access to retail or High Net Worth investors is exploding, the leader of which is iCapital Network in the US and Moonfare in parts of Europe.

In terms of the unavoidably growing influence of ESG:

Since 2012, the number of signatories to the UN-supported Principles for Responsible Investment has grown from 1,050 to almost 2,400 funds, a group that controls a staggering $86 trillion in capital (see Figure 2.7). Those funds, a mix of institutional investors and fund managers, have committed to six principles, including a pledge to incorporate ESG issues into how they choose and manage investments.

To date, institutions have put less pressure on private equity funds than on public funds to adopt ESG programs. A survey by RBC Global Asset Management found that LPs are less inclined to build ESG criteria into their portfolio choices for private equity than they are for their public, fixed income, real estate

AUM of Principles for Responsible Investment signatories

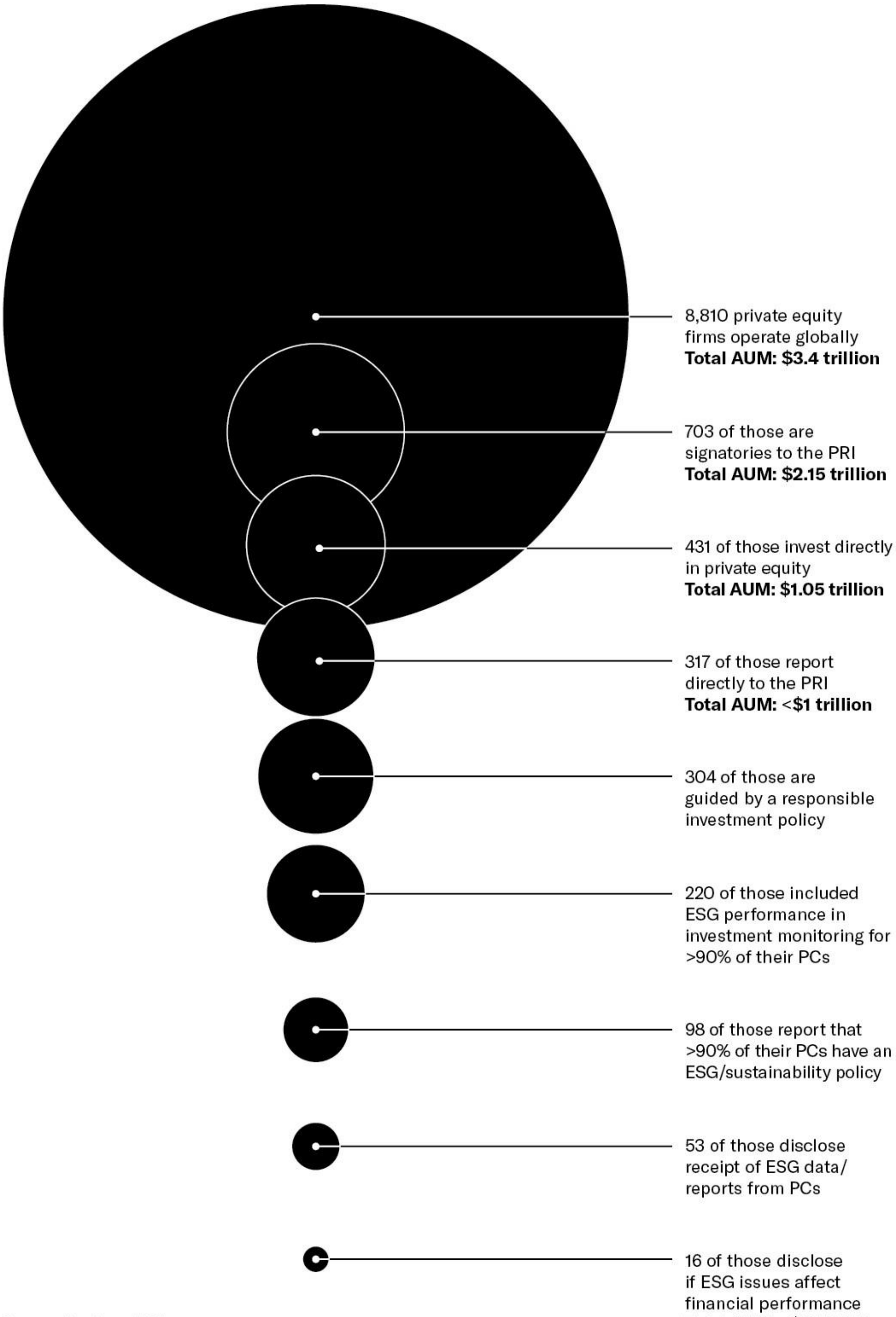


Note: Data as of November 2019
Source: Principles for Responsible Investment

We recently participated in a [webinar on ESG and PE] organized by Intertrust, alongside State Street and LuxFlag, which underlines this trend.

It is important to point, however, that actual GPs adopting ESG standards systematically is still at embryo stage, as displayed by this graph of PREQIN, so this is a slow process due to take years to complete.

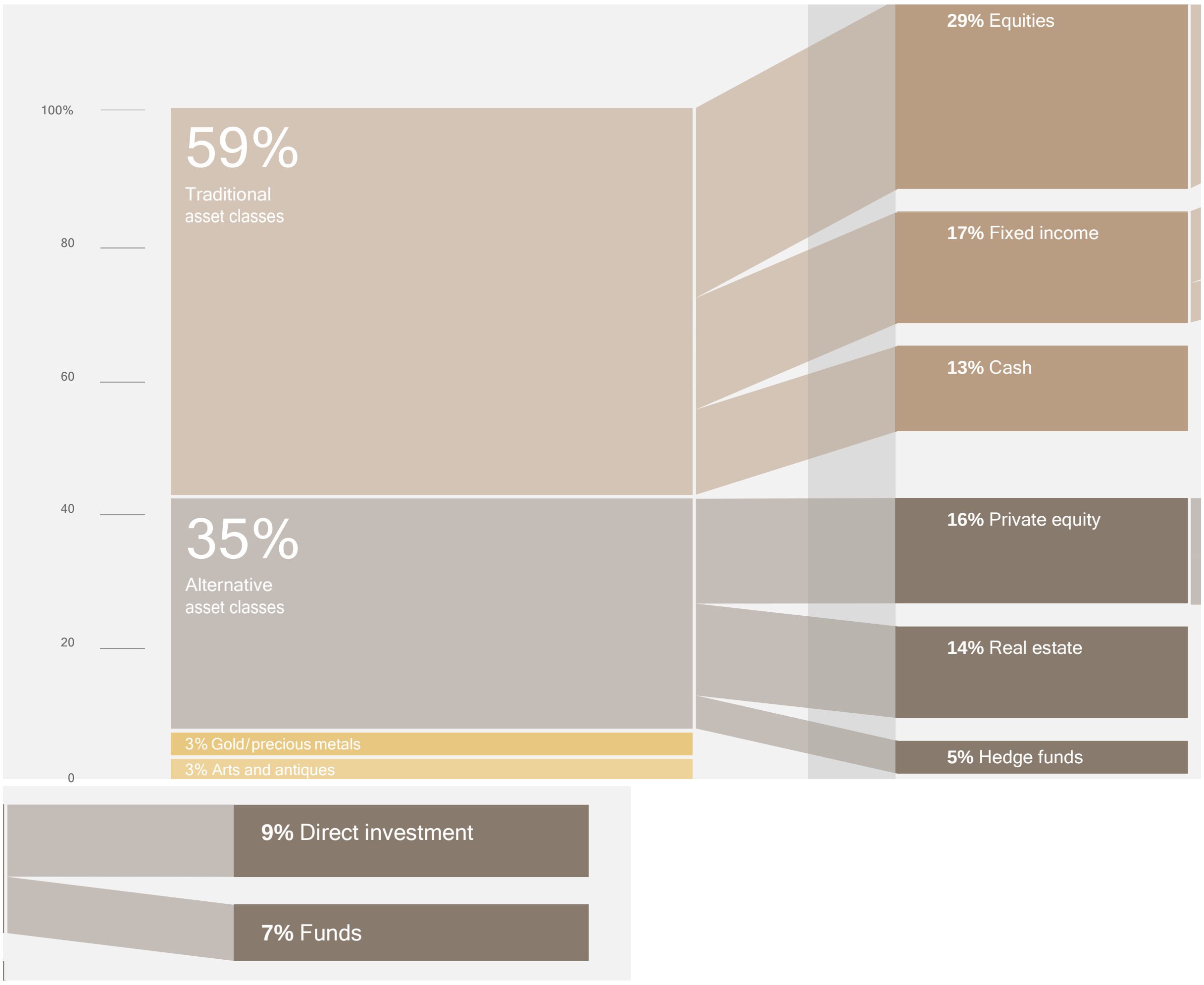
Private Equity ESG Bubble



Sources: Preqin and PRI.

In terms of Family Offices piling into PE:

The annual Global Report of UBS on Single Family Offices (over 100 of them with average AuM of $1.6bn) is clear when it comes to how they wealthiest families in the world are viewing PE, to which they allocate 16% of their wealth, including 9% in Direct investments and 7% in Funds.



- 69% of family offices view PE as a key driver of returns
- Portfolios of FO´s are broadly diversified, with 35% allocated to alternative investments
- PE is in the blood. 34% of family offices describe it as a passion for the owner
- After the onset of COVID-19, 35% regard the greater control offered by PE as a plus, against 27% beforehand
- 73% of those investing expect private investments to deliver higher returns than public investments

6. Conclusion

We remain confident for PE over the long term but expect the months ahead to be challenging for the industry as a whole, albeit not as much as it is for public markets where volatility continues to prevail.

Our mission, more than ever, is to closely monitor the evolution of the market and to stay close to our growing community of members (280 and counting), all the more so as it is constantly diversifying.

Thank you to all of you, especially those who took time to answer this second edition of the Covid-19 Survey!

When we are back in September, the LPEA will officially welcome its new CEO, Stéphane Pesch, who will provide more guidance on the initiatives contributing to raising the profile of PE.

For now, the entire LPEA team wishes you a great summer break, stay safe and keep social distancing measures!

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10 years LPEA

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