Mill Creek Private Equity

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Private Equity Remains Resilient Amid Tech Sector Downturn

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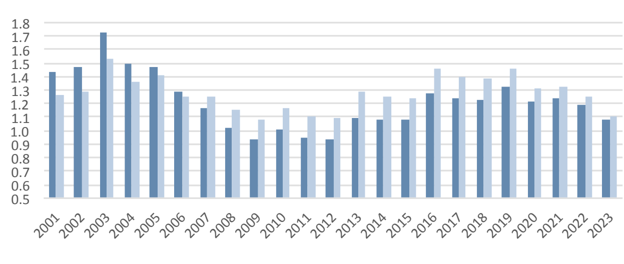
As 2023 begins to unfold, we remain optimistic about the overall state of the global private equity market. While macroeconomic forces continue to play out, most middle-market companies have thrived in the post-pandemic era. For example, middle-market private companies in the Golub Capital Altman Index experienced year-over-year earnings growth of 9% and revenue growth of 11% during the first two months of the fourth quarter of 2022.[1] Though there are clear signs of slowdowns in subsectors such as growth equity, the industry's overall health and deal activity remains robust. For investors, we point to three key trends when considering additional commitments to the asset class: 1) the persistence of private equity performance; 2) the sheer amount of capital and activity in the market as compared to prior periods; and 3) the challenges throughout the entire venture capital and growth capital ecosystem.

Persistence of Private Equity Performance

While much has been made to distinguish good vintage years from bad ones, consistent private equity investors have been rewarded with outperformance in nearly every vintage over the past 20 years. In Fig. 1, we show Public Market Equivalent (PME) by vintage year. PME approaches are developed to measure the investment success of private equity funds in terms of public markets. A value >1 implies outperformance of private equity versus public market indexes. The data represented in Fig. 1 employs the Kaplan-Schoar (KS-PME) methodology using the global pooled private equity performance. Although the magnitude of outperformance has declined since the early 2000s, we have no reason to believe that the illiquidity premium will disappear anytime soon.

Fig. 1: PMEs have generally remained >1

Public Market Equivalent (PME) by Vintage Year (VY)[2]



Source: Pitchbook. Geography: Global. Data as of 6/30/2022.

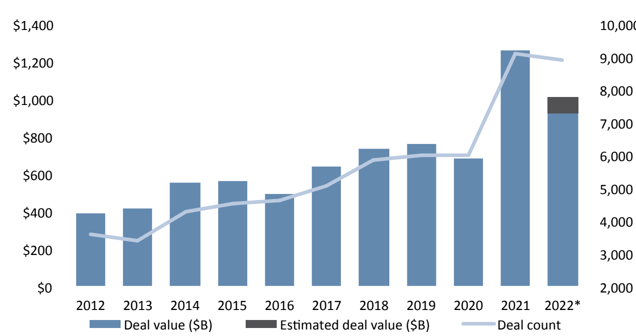
Allocators can increase their odds of outperformance further via manager selection and tactical strategies such as co-investments, secondaries, and other opportunistic and fee-mitigating activities, including scaling commitment sizes to achieve fee discounts.[3]

Deal Activity Remains Robust

The outperformance of the asset class has led directly to increased capital formation across the board and sustained a healthy level of deal activity throughout 2022. While fourth-quarter deal volume dropped below $200 billion for

Fig. 2: Deal activity remains robust

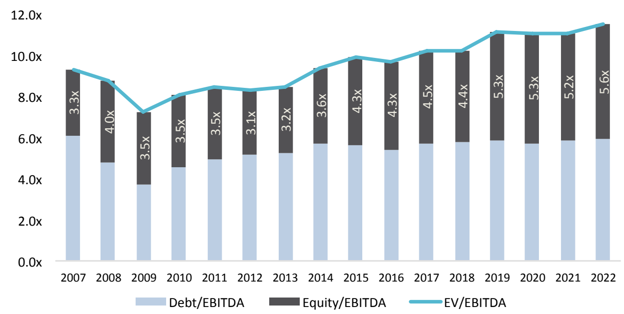
US PE deal count and value by year



Source: 2022 Annual US PE Breakdown Summary. Data as of 12/31/22.
*2022 deal count is estimated based on preliminary 4Q data.

Fig. 3: Transaction multiples remain elevated

US PE buyout EV/EBITDA multiples by year (median)[4]



Source: LCD. Data as of 12/31/22.

the first time since 3Q20, it remains well above historical levels (Fig. 2).

Furthermore, valuations have yet to come down meaningfully, at least as they relate to the observable public data set. We know that certain subsegments, such as technology and financial services, have experienced slowdowns as sector-specific forces change the risk appetite for fresh capital.

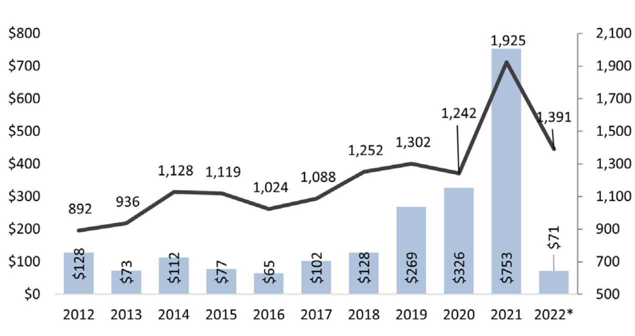
It has also become clear that capital structures have become more equitized as the cost of leverage has increased and lenders have grown more cautious (Fig. 3).

Challenges in the Venture Capital and Growth Equity Segments

As we dig into segment-specific trends, the most apparent subsector on the watch list remains the venture capital and growth equity segments. The most stunning reversal in 2022 was the complete evaporation of exit activity in the venture capital segment. As shown in Fig. 4, the high-flying private technology unicorns that raised capital in the pandemic were quickly closed off from exit market alternatives. This is the most significant trend we are following across 2023. How this problem sorts itself out will have massive impacts on investor balance sheets. With notable stalwarts such as Stripe raising capital at significant discounts to their prior valuations, there are clear signs that this will be a prolonged and painful process that will take place over several quarters, or perhaps even years, between investors and management teams.

Fig. 4: Exit alternatives have narrowed substantially

US VC exit activity (deal count and value by year)



Source: Q4 2022 Pitchbook, NVCA Venture Monitor Summary. Data as of 12/31/22. *2022 deal count is estimated based on preliminary 4Q data.

In our view, private equity remains an important source of return and diversification for investors. We believe that investors should continue making targeted commitments to the asset class to achieve and maintain strategy and vintage year diversification.

[1]The Golub Capital Altman Index, which is produced by Golub Capital in collaboration with credit expert Edward I. Altman, PhD, is the first and longest-running index based on actual revenue and earnings (defined as earnings before interest, taxes, depreciation, and amortization, or "EBITDA") for middle-market companies. It measures the median revenue and earnings growth of approximately 110–150 private US companies in the loan portfolio of Golub Capital, a leading middle-market lender.

[2]Public Market Equivalent (PME) approaches are developed to measure the investment success of private equity funds in terms of public markets. A value >1 implies outperformance of private equity versus public market indexes. The data represented here employs the Kaplan-Schoar (KS-PME) methodology using the global pooled private equity performance.

[3]A co-investment is a minority investment into a portfolio company alongside a private equity fund. Secondaries involve the purchase of an interest in a private equity fund from another investor.

[4]EV/EBITDA represents Enterprise Value divided by Earnings Before Interest, Taxes, Depreciation, and Amortization, the most common valuation metric used in private equity.