Mill Creek Private Equity

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Insights into the Evolving Private Equity and Venture Capital Markets

Interview participants

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Executive Summary

- Transaction activity in private equity and venture capital markets peaked in 2021–2022 and has normalized significantly since then across fundraising, deals, and exits.
- Valuations have come down but are still relatively high compared to historical levels.
- Opportunities going forward include specialized buyout firms and infrastructure services.
- Secondary transaction volume, especially GP-led, was strong in 2022 and is expected to continue to grow.

MICHAEL CROOK: Let's start with an overview. Can you provide some perspective around the size of the private equity and venture capital markets right now?

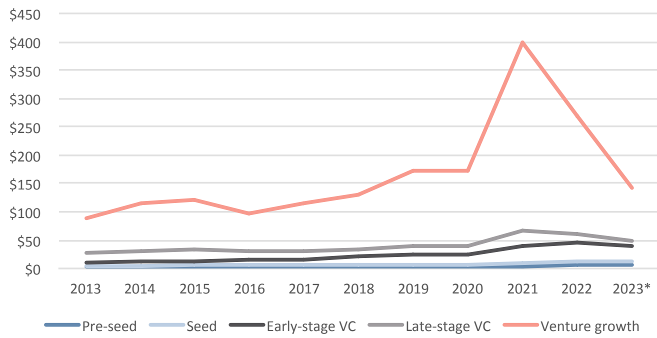
ANDREW MURRAY: The private equity and venture capital market size can be viewed in different ways. One clear perspective comes from PitchBook's recent report, which states that the total net asset value (NAV) across these funds represents just over 6% of the public equity market cap. Additionally, Wilshire estimates there are around 12,000 private equity managers in the US, while Preqin's database suggests there are 30,000 managers, including venture. However, focusing on the percentage of public equity market cap provides a meaningful understanding of the industry's scale. At nearly 10% of public equity values, it highlights the industry's significance while acknowledging it remains relatively smaller compared to mega-cap public companies.

MICHAEL: The bear market of 2022 and higher interest rates in 2022 and 2023 seemed to slow down transaction volume, fundraising, and exit volume. Did you see that continuing through the end of 2023 and do you have a sense of what to expect this year?

BILL BRACAMONTES (WILSHIRE): Yes, Michael, it's an important topic we've been closely monitoring. To answer your question, there was indeed a continued slowdown through Q4 of last year, evident across various aspects of the market, especially within broader private equity. Fundraising, investment activity, and exit activity have all seen a noticeable decline, with peaks in 2021 or 2022 followed by significant drops in subsequent quarters (see Fig. 1, next page).

In private equity, global fundraising decreased by about 40% from the mid-2021 peak to Q4 of last year. Deal value plummeted by approximately 60%, from around \$600 billion to \$250 billion during the same period. Exit activity also declined, although it has remained relatively consistent with pre-COVID levels over the past two years.

Fig. 1: Median US VC pre-money valuations ($M) by stage



Source: PitchBook, NVCA, The Q4 2023 PitchBook-NVCA Venture Monitor, Mill Creek.
*Data reflects the period of 2013-2023.

Using Preqin, we estimate there are 30,000 private equity managers worldwide and 12,000 private equity managers within North America.

Venture capital experienced even sharper declines, with fundraising down by around 60% from the peaks of 2021 and 2022. Deal activity decreased by about 45%, while exit activity took a substantial hit, dropping by nearly 90% from its peak. Much of this decline in exit activity can be attributed to the slowdown in IPOs, which are a significant part of the venture ecosystem.

Overall, these trends clearly show the market dynamics over the past year, reflecting notable decreases across various metrics.

MICHAEL: Can you provide insights on the current activity within funds or management firms specifically focused on AI developments? There seems to be a lot of excitement by investors in the space.

ANDREW: Certainly, this rings true—especially for venture capital. Within our own portfolios, we've observed firms that have been investing in machine learning or natural language processing for years essentially rebranding themselves as completely dedicated to the evolving AI ecosystem.

Reflecting on this shift, it's apparent that while discussions about AI were not uncommon in the past, the extent of this transformation wasn't widely foreseen. The pace of innovation and market adoption has accelerated rapidly, with speed to revenue and product launches becoming increasingly crucial.

It's always been an industry that's moved fast. It's now moving at warp speed.

MICHAEL: Great. Andrew, sticking with you for a second—private equity fund valuations were quite high during late 2021 and heading into 2022. How have you seen this impact market performance and what should we anticipate in 2024?

ANDREW: Yes, and since then, we've observed a notable impact on interest expenses. According to the latest data from McKinsey, purchase multiples in private equity buyouts have decreased by nearly one turn, from 11.9 times earnings before interest, taxes, depreciation, and amortization (EBITDA) to 11.[1] Similarly, public market multiples have also contracted, with publics dropping from just over 12 to 11.3 for the nine months ending in 2023. Overall, while returns in private equity typically aren't assessed on a single-year basis, there has been a slight improvement with a 5% net internal rate of return (IRR) through September 30 of last year.[2] Despite the decline in entry multiples, the overall economic health reflected in macroeconomic statistics throughout 2023 has helped to sustain portfolios. Looking ahead to early 2024, we anticipate this trend to continue, especially given the fast start to the year and the absence of an anticipated recession. As a result, market performance hasn't been as negatively impacted as initially expected at the end of 2022 or the beginning of 2023.

MICHAEL: Bill, what's your perspective on valuations across private equity, growth equity, and venture capital right now?

BILL (WILSHIRE): There are several positive developments amidst the current market situation. Despite challenges and corrections in recent portfolio performance and investments, there's an encouraging adjustment in broader market expectations. This includes a reevaluation of purchase price multiples and pre-money valuations for venture investments, which can influence the deployment of new capital and potential returns for private equity and venture going forward.

On the buyout front, it took some time for average purchase price multiples to adjust, but we've seen a significant correction from the previous highs. In contrast, the venture landscape has seen a more pronounced correction in later-stage and growth rounds compared to early-stage investments.

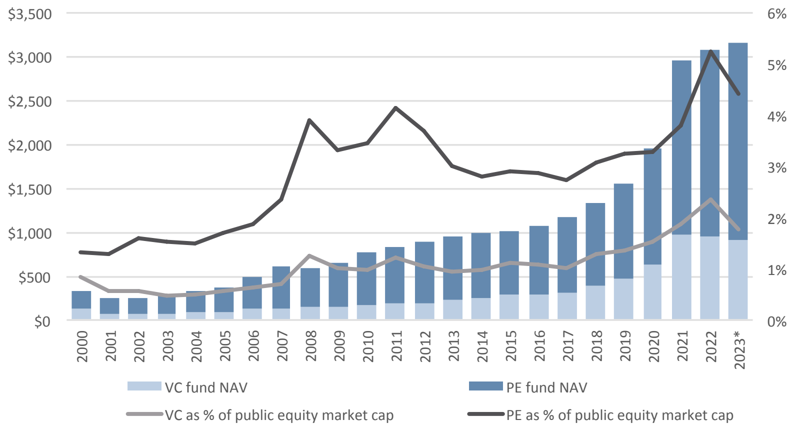
Late-stage growth-round valuations have decreased by approximately 25% to 60%, while early-stage corrections have been more modest, typically in the single digits. Pre-seed and seed stages show mixed results, with some

[1] A decline in purchase multiples represents lower prices for assets paid by private equity firms.

[2] The net 5% IRR return is for the buyout sub-asset class within the Private Equity asset class. The return is net of all fees and expenses. It is important to note that individual private equity investments may have experienced higher or lower returns during this period. Source: "[Private markets: A slower era | McKinsey]"

Fig. 2: PE/VC represents a growing market opportunity

PE/VC Net Asset Value as % of public equity market capitalization



Source: PitchBook, The Q1 2024 Quantitative Perspectives: US Market Insights, Mill Creek.
Public equity market cap can be found here: https://siblisresearch.com/data/us-stock-market-value.
Performance data as of 12/31/2023.

maintaining consistent valuations or experiencing slight increases.

Overall, the market correction across private equity signifies a positive shift amidst recent challenges.

MICHAEL: Andrew, what do you see as potential opportunities looking forward in 2024 and 2025?

ANDREW: Two key considerations stand out. First, in the realm of bio-opportunities, specialization, resources, and team capabilities are paramount. With a competitive market, sponsor sourcing skills, operational capabilities, sector expertise, and preparedness for swift changes and M&A are crucial.

Second, there's been a shift in the global fundraising landscape. While overall private equity fundraising dipped by about 22% last year, larger funds have expanded significantly. Notably, Asia experienced a sharp decline in capital formation, while North American buyout fundraising remained robust. This indicates that in the lower end of the market, ample opportunities exist for improvement and exits to other sponsors, reinforcing the market's structural health despite challenges.

MICHAEL: Bill, anything you'd like to add?

BILL (WILSHIRE): I'll add a couple of points. First, technology buyouts have caught our attention. While we've historically favored this sector, recent price increases prompted caution. However, we're now observing compelling opportunities in mid-market and lower-middle-market firms with proven control-oriented approaches. The correction in the tech market has made valuations more reasonable, which is a positive development.

Another area of interest is infrastructure services within the buyout space, which is relatively underexplored. This presents a lower-risk investment opportunity due to the nature of the end markets involved. Both technology buyouts and infrastructure services offer potential portfolio diversification benfits and align well with our investment objectives.

ANDREW: One additional point to consider is the evolving definition of infrastructure services.

Traditionally, this term conjures images of long-term projects like bridges and roads. However, in the US, there's a broader scope that now includes cloud computing infrastructure, disaster response, and climate resilience efforts.

This expanded definition encompasses initiatives to enhance the resilience of cities and buildings against weather events. It's important to note that these services cannot be outsourced to low-cost labor markets and require significant coordination and resources. With bipartisan support, there's a growing focus on upgrading infrastructure and expanding cloud computing capabilities domestically.

MICHAEL: I want to touch on the digital infrastructure side and infrastructure services. Our clients are increasingly asking about the impact of AI and language learning modules (LLMs) on energy demand. This ties into the broader conversation about digital infrastructure and its implications.

BILL (WILSHIRE): Digital infrastructure is a significant growth area in the market, attracting both private equity and infrastructure investors. The integration of AI further fuels this momentum. Approximately ten specialized groups are deeply involved in this sector, while more generalist infrastructure funds are expanding their portfolios to include digital infrastructure assets such as data centers and fiber networks. Our positive experiences and successful investments in this space, including a co-investment in a towers business, underscore our confidence in its potential.

MICHAEL: Thanks, Bill. Final question, and we'll start with you. Secondary transaction volume was strong in 2023, particularly for GP-led transactions. What do you see in the secondary market right now? Why did we see this kind of pickup in GP-led secondaries?[3]

BILL (WILSHIRE): To clarify, GP-led secondaries involve creating a continuation vehicle for high-quality assets with further growth potential. Typically, GPs pursue these transactions when the existing fund lacks the necessary runway for growth execution. LPs benefit from additional liquidity options at potentially fair valuations.

These transactions also provide an alternative source of deal flow, akin to co-investments, albeit with distinct dynamics. While continuation vehicles incur fees and carry, they generally offer better terms than traditional fund commitments. However, it's crucial to assess potential returns and ensure alignment with the GP's objectives on a case-by-case basis.

MICHAEL: Andrew, do you have any closing remarks?

ANDREW: The real-time market chatter indicates that digital assets are now an integral part of the market, with significant volumes traded. Forecasts suggest the sector's market volume may reach $300 billion in the next five years. We've actively participated in both liquidity options and investment opportunities in this space, adapting our approach based on circumstances. Ignoring their presence would be naive, as digital assets are here to stay and likely to increase in number. We maintain a neutral stance and prioritize understanding each asset as it emerges.

On a final note, I think the interest rate calls are crucial for understanding the impact of interest expenses. A single year of high expenses can be manageable, but if they persist over multiple years, it becomes increasingly burdensome. We'll have to monitor whether elevated rates persist and affect private equity P&Ls. Additionally, there's a lot happening in the market overall.

BILL (WILSHIRE): The market has been volatile, like a roller coaster. It's important to recognize that private markets are cyclical, especially in venture capital. As a long-term investor, we believe it's crucial to stay the course by determining your desired portfolio allocation between buyouts and venture, based on your risk tolerance, and ensuring proper vintage year diversification. Focus on selecting top-performing managers and avoid trying to time the markets, as there will be both good and challenging years in venture.

MICHAEL: Evergreen advice. Thank you, Bill and Andrew.

[3] GP-led secondaries involve the general partner of a fund selling or restructuring portfolio assets, providing liquidity to limited partners.