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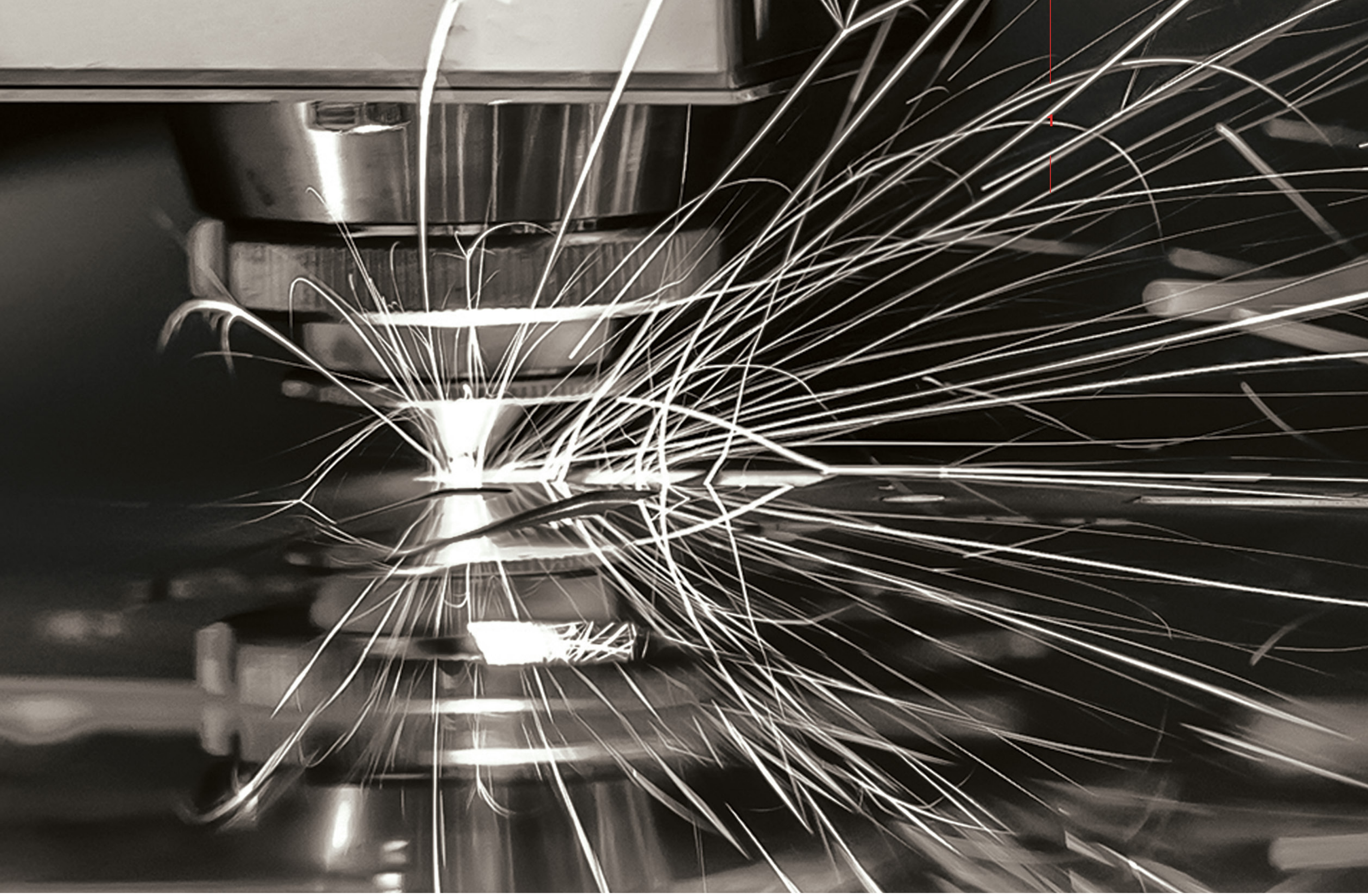


Private Markets Mythbusters Series

This record isn't broken

How private equity buyouts can continue to succeed in the new macro regime

Strong tailwinds from stable growth, abundant financing, and low interest rates and inflation have helped propel private markets into an unprecedented era of expansion in the last decade. But this benign environment has changed. With higher interest rates and sticky inflation, a new macro regime is at play, with consequences to all asset classes across both private and public markets.

Against this backdrop, we are launching a **Private Markets Mythbusters Series** that will address some of the most common misconceptions about private markets investing arising in these uncertain times. Our objective is to present a balanced perspective and help private markets investors navigate the risks and opportunities of this new regime.

In the first paper, we focus on private equity buyouts. This strategy, which has almost become a synonym for private equity investing, has attracted deep scrutiny since the taps of cheap financing were turned off, with some going as far as heralding its death. We will therefore try to answer the following question: after generating strong returns for so many years, is the buyout model doomed to succumb in an environment of higher financing costs and lower debt availability?

“While higher rates will certainly have an impact on buyout models and reduce the room for error on the execution front, investors will not be bidding farewell to this strategy any time soon”

What are buyouts and how do they generate returns for investors?

At its core, a buyout transaction is the acquisition of a company financed through a combination of equity and debt. This process has been refined over time by private equity firms, who have turned it into an investment strategy in its own right, creating the ‘buyout model’, a cornerstone of private equity investing.

In the buyout model, private equity managers generate returns through three key levers:

Textbook buyout example for the broader market

The basic steps taken by a buyout manager in a supportive macro environment.

1 The underwriting

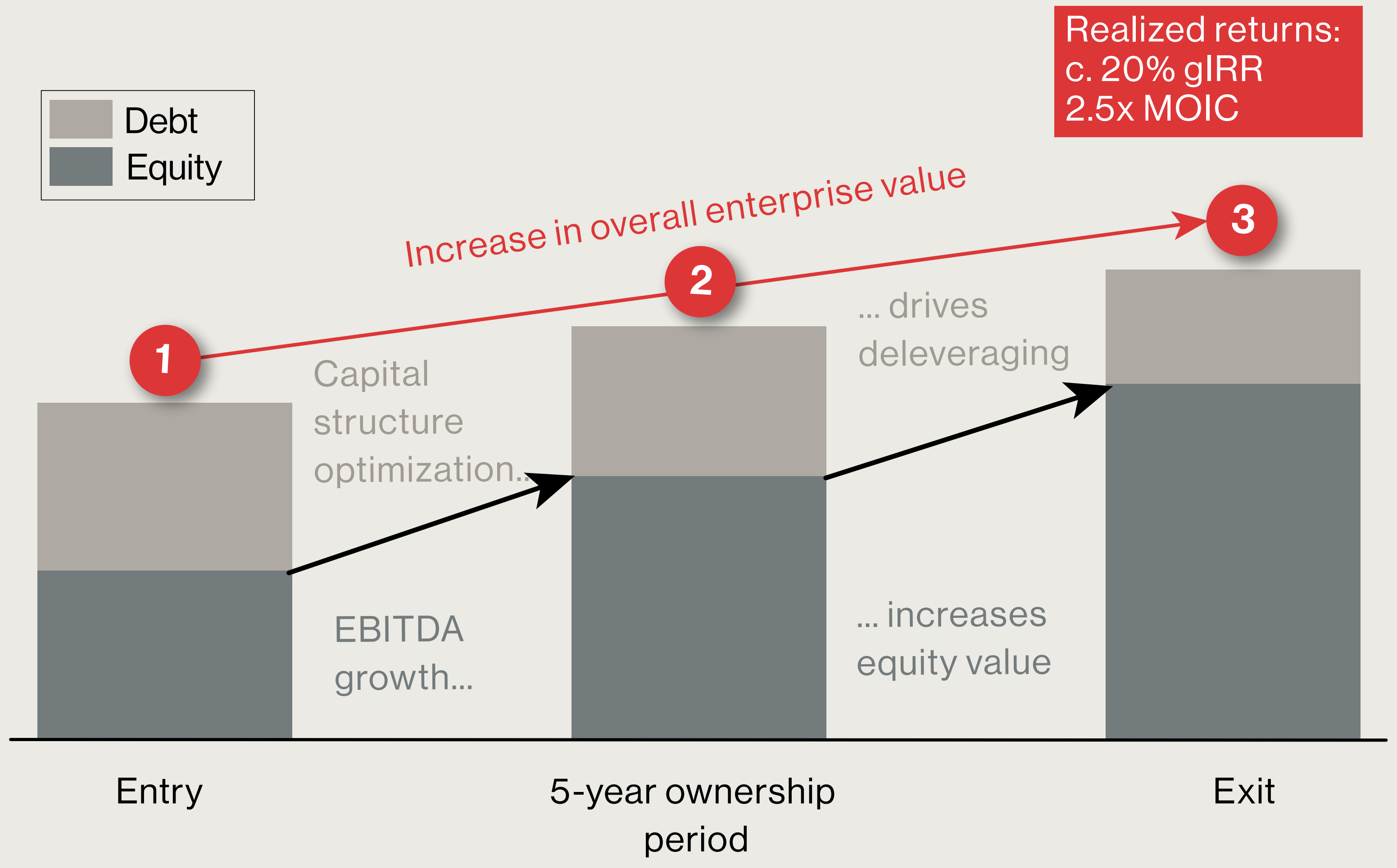
The buyout manager identifies an attractive target and acquires it for an enterprise value measured by a multiple of the company's EBITDA. In this case 12x[1].

The investment is financed with equity and debt, the latter secured at a rate of c.5% pa. In this example, a 50/50 equity-debt split is used.

2 Value creation and capital structure optimization

The company's EBITDA expands at market rates - about 4%[2] in this example; a well-executed value creation plan unlocks additional growth of c7.5%[3].

Capital structure optimization through active deleveraging and EBITDA growth help increase the company's equity value, shifting the equity debt split to 75/25.



3 Exiting and realizing returns

Given exit valuations are often determined by market conditions, a prudent manager would assume a 15-25% multiple contraction over the holding period in an environment characterized by high valuations. In our example, this would result in an exit multiple of 10x EBITDA.

At the end of the holding period, the investment would yield returns close to 20% gIRR and 2.5x MOIC[4] – even with a drop in the valuation multiple. Value creation efforts play an important role but the strategy also benefits from a favorable financing and growth environment.

[1] Source: PitchBook (2023) Buyout average entry multiple in last five years.
[2] Source: World Bank (June 2023) Global average GDP growth in USD, 2011-2021.
[3] Source: Partners Group Expected Return Framework (May2023) value creation calibrated for the broader market.
[4] Multiple on invested capital.

Operational value creation: driving top-line and bottom-line growth by improving governance, operations, productivity, making strategic acquisitions and developing new business models.

Capital structure optimization: efficiently using debt capital at entry and deleveraging through the ownership period.

Change in valuation multiples: value is created by the expansion of the asset's EV/EBITDA multiple; this can be driven by company-specific and/or general market dynamics.

The most successful private equity firms have evolved their approach to buyouts over time and acted on many different fronts of value creation. But, fundamentally, the three value creation drivers underpinning the model have benefited from a supportive environment:

- Positive macro conditions for growth helped managers improve profitability through operational changes and platform expansion.
- Relatively abundant and cheap financing supported leveraged buyouts, while resilient growth helped deleveraging.
- An overall rise of valuation multiples offered the perfect environment for successful exits.

All these tailwinds contributed to growing returns, especially in investments in high-quality, mature businesses.

The chart above shows the mechanics of a hypothetical buyout transaction executed in the supportive environment of the past decades. While it is presented in a simplified manner, this textbook example is based on historical data and points to a gIRR[1] of around 20%, in line with the returns generated by the broad buyout segment over the past 20 years[2].

[1] Internal rate of return over the investment holding period gross of fees charged by the investment manager.
[2] Preqin Private Capital Benchmarks (June 2023).

The buyout model in the new macro regime

Since 2022, buyout investors in various regions and market segments have been facing a more challenging macro environment, which directly impacts the key drivers of returns they have been relying on until now. In particular:

● **Higher interest rates and debt scarcity**
Following a series of interest rate hikes by major central banks, the cost of financing acquisitions has soared, with floating rates for senior loans – a debt instrument typically used in buyouts – doubling to 10% in just one year.

With heightened uncertainty, many banks have also reined in their lending offerings. While private lenders have stepped in to partially fill this void, overall financing capacity is decreasing, with debt availability largely directed to high-quality businesses.

● **Valuation correction**
On the back of lower transaction volumes and higher uncertainty, buyout valuations started to decline in 2022 and continued to correct in early 2023[3]. EV/EBITDA multiples in the broad buyout space are down 5-15% compared to 2021 peak levels, data from Burgiss, PitchBook, LCD and Partners Group research show. Buyout investors can no longer rely on steadily growing asset prices and multiple expansion to generate consistent returns.

Against this backdrop, can the buyout model continue to generate attractive returns for investors?

3 Source: PitchBook (April 2023), Burgiss (2023).

Returns sensitivity analysis (gIRR in %)

Higher financing costs and lower debt availability can hit return expectations...

Interest on debt \ Debt level in the capital structure	30%	35%	40%	45%	50%	55%	60%
5%	17.1%	17.8%	18.6%	19.6%	**20.6%**	**21.9%**	**23.5%**
7%	16.8%	17.4%	18.1%	18.8%	**19.7%**	**20.8%**	**22.1%**
8%	16.6%	17.2%	17.8%	18.4%	19.2%	20.2%	21.3%
9%	16.5%	16.9%	17.4%	18.0%	18.7%	19.5%	20.5%
10%	**16.3%**	**16.6%**	**17.1%**	**17.5%**	18.1%	18.8%	19.6%
11%	**16.1%**	**16.4%**	**16.7%**	**17.0%**	17.5%	18.0%	18.6%
12%	**15.9%**	**16.1%**	**16.2%**	**16.5%**	16.8%	17.1%	17.5%

...but these impacts can be offset by lower entity multiples...

Exit multiple \ Entry multiple	12.5x	12.0x	11.5x	11.0x	10.5x	10.0x	9.5x
11.5x	19.0%	20.6%	22.3%	23.9%	25.7%	27.5%	29.4%
11.0x	17.9%	19.5%	21.1%	22.8%	24.6%	26.4%	28.3%
10.5x	**16.7%**	**18.3%**	**20.0%**	**21.7%**	**23.4%**	**25.3%**	27.2%
10.0x	**15.4%**	**17.1%**	**18.7%**	**20.5%**	**22.2%**	**24.1%**	26.0%
9.5x	**14.1%**	**15.8%**	**17.5%**	**19.2%**	**21.0%**	**22.9%**	24.8%
9.0x	12.7%	14.4%	16.1%	17.9%	19.7%	21.6%	23.5%
8.5x	11.3%	13.0%	14.7%	16.5%	18.3%	20.2%	22.2%

... and returns can further increase through higher EBITDA growth.

EBITDA growth	7.0%	9.0%	10.5%	11.5%	12.5%	14.0%	16.0%
	15.5%	17.7%	19.3%	20.5%	21.6%	23.2%	25.4%

Source: Partners Group (2023).

Going back to our textbook example on page 2, we estimate that a more unfriendly debt financing scenario could result in a drop of around 300-500bps in gIRR. This total is broken down into the following two components. Lower availability of financing – with the share of debt in the company's capital structure reducing from 50% to 40% – could cut gIRR by 200bps. Higher costs of debt could further reduce returns by approximately 200bps (100-300bps). Keeping all else equal, gIRR could decrease from around 20% to an upper mid-teen figure, as shown in the box above.

Reassess and refocus

Despite these headwinds, we believe it is not time to bid farewell to private equity buyouts. As experienced investors know, changing dynamics bring not only challenges, but also opportunities.

● **Taking advantage of uneven price corrections**
Buyout transactions in early 2023 have seen an average decrease of 5-15% in entry valuations. Our model shows that this cut in prices (assuming a reduction in entry multiple from 12.0x to 11.0x) can increase gIRR by 300-500 bps and largely offset the negative impact of lower debt loads and higher interest costs.

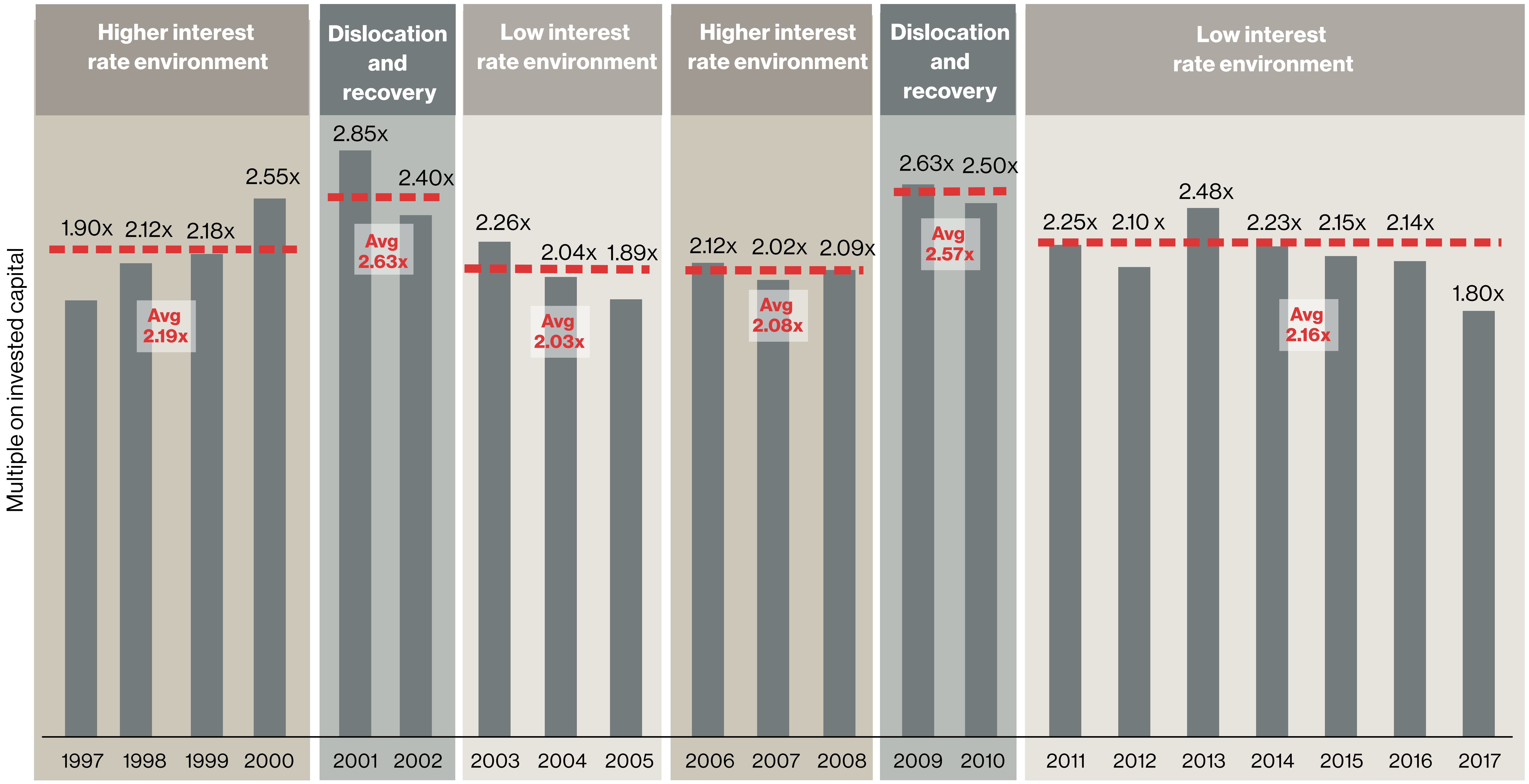
The average decline, however, masks some marked differences between industry sectors and market segments, which investors need to carefully factor in at underwriting. Investment managers with a differentiated approach to sourcing are best positioned to identify pockets of opportunities and take advantage of a correction in asset prices.

Recent examples of acquisitions completed by Partners Group demonstrate that disciplined underwriting and a thematic approach to sourcing – underpinned by deep research on the most attractive transformative trends across sectors – has allowed us to acquire long-known, high-quality companies at entry multiples c.2-3x lower than what we observed in 2022 during the early stages of due diligence[4]. We believe that, now more than ever, a proactive and disciplined investment process is key to generating top-quartile buyout returns.

[4] Source: Partners Group (June 2023).

Top-quartile buyout performance in different macro and rate regimes[5]

Stable returns over cycles indicate selectivity and value creation capabilities are key to outperformance



[5] For illustrative purposes only. The actual development depends on many factors and may differ significantly. There is no assurance that similar results will be achieved. GDP growth is represented by the GDP CYOY Index. Source: Partners Group, Bloomberg (May 2023), Cambridge Associates.

● **Doubling down on value creation**
Driving operational value has become even more important in the current environment. Governance and productivity improvements as well as strategic platform expansion can help assets to overcome macro challenges and increase returns.

Supported by Partners Group's hands-on entrepreneurial ownership approach, our portfolio companies have achieved organic growth levels that are 2-3x higher than global growth rates, with a historical average annual EBITDA growth of 14% since 2015, approximately ten percentage points above public equity market companies[5].

Navigating the cycles

The buyout model has proven its relevance over time, and historical data shows that the most successful managers have generated relatively stable returns across different cycles and rate regimes. This suggests investment excellence can deliver solid performance despite macro headwinds. But managers will need to adapt their approach as debt financing tightening creates less room for error.

More than ever, disciplined underwriting –acquiring high-quality companies at attractive entry valuations through a thematic approach to sourcing – is paramount. With multiple expansion also arguably out of the equation in most cases, operational value creation will be central to any strategy. Only those buyout investors who can adapt to the forces shaping the current investment environment will prove resilient and come out stronger on the other side.

[5] EBITDA growth for Partners Group's portfolio company refers to average annual EBITDA growth for the period 2015 to 2022 for private equity direct investments, where Partners Group' s role is lead or joint lead. Public equity market EBITDA growth is represented by the MSCI World Index, which recorded an average annual EBITDA growth of 4% over the same period. Source: Partners Group, Bloomberg (2023).

Next time in our Private Markets Mythbusters Series

While buyouts still represent the lion's share of private markets activity, the number of strategies available to investors has broadened significantly in recent years, allowing them to make tactical allocations across asset classes and look for relative value upside in different market environments.

In our next paper, we will assess the sensitivity of cash flows across business cycles for different asset classes within private markets. Our aim is to help investors evaluate the potential cyclicality of their portfolios and inform a pro-active repositioning in a changing environment.

Subscribe here to receive the other papers in our Mythbusters Series.

The authors

Andrei Vaduva
Co-Head Portfolio Management

Federica Cazzaniga
Portfolio Management

Igor Macedonski
Portfolio Management

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Media relations contact
media@partnersgroup.com

Client contact
clients@partnersgroup.com