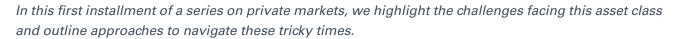


TAKING STOCK

Private Markets (Part One): Today's Market Dynamics

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Private markets are not immune to the struggles currently facing the investment landscape.

With public markets taking a tumble this year—the S&P 500 Index has plummeted 19%, technology stocks are down 30%, and fixed-income returns have declined between 15% and 38%—we are keeping a watchful eye on private markets, which typically lag their publicly-traded counterparts by a couple of quarters. The underlying economics of private debt, real estate and private equity should be similar to their public market counterparts, with public market returns subsequently flowing through to private market valuations.

Investment managers are preparing to mark down portfolio holdings in the face of falling public markets valuations, costlier debt, slowing deal activity and lengthier fund raises. But the imminent volatility brings with it opportunities. Historically, some of the most promising returns have been generated in vintage years with environments like today. As a result, we are

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implementing a framework to help clients manage their private market programs so they can benefit from the illiquidity premiums on offer without compromising their liquidity needs.

To that end, pacing plans are a vital component of our portfolio management process. Our plans are designed to guide disciplined, measured commitments and manage illiquidity risk. Whenever possible, we suggest maintaining regular and consistent pacing. We urge continued commitments to strong general partners. If capital is constrained, consider writing a smaller check but still showing up, as access may be lost permanently if a fund is skipped.

We also encourage proactively meeting with your NEPC consultant to discuss managing your private markets portfolio through these turbulent times. So far, these are our observations of the current private markets landscape:

I. VALUATIONS

We expect public market returns to flow through valuations of private debt, real estate and private equity. As a result, we believe general partners will mark down their portfolio company holdings by 2% to 15%, depending on the type of private markets strategy.



Drilling down, GPs estimate markdowns of 75 basis points to 150 basis points in the private debt space. That said, loans will reset based on the movement in LIBOR/SOFR, which will lead to a pickup in income. Valuations reflect the rate change immediately, while the income from the contractual coupon lags a quarter. Although private debt portfolio companies have seen slight mark downs, fundamentals today remain healthy with interest coverage ratios over 2.0x, steering clear of default territory. However, interest expense will jump significantly in the fourth quarter.

Meanwhile, in real estate, marks will vary significantly by property type and the particular asset. Core real estate funds may see markdowns of 10% to 15% as industrial and residential sectors continue to experience gains, while office and retail valuations are declining.

In the absence of comparable sales, appraisers will likely make adjustments based on long-term cap rate assumptions for terminal values. This means owners that don't need to sell will not sell; they also won't aggressively mark down their assets, given their expectation that the spike in interest rates will be temporary (and, as a result, so will the uptick in cap rates/cost of debt).

Some property types are still sought after, including residential, industrial, medical office, self-storage, and portfolios with strong credit and cash flow profiles. But forced sales on properties such as dated office buildings could start pushing observed market values lower.

Within private equity, GPs expect valuations to drop, on average, by 8% to 10%. Write-downs could be higher if a fund has public equity exposure (which many do). Also, technology-heavy funds will be on the higher end of this range. Venture capital fund marks will depend on the pace of drawing down cash reserves of the fund's portfolio companies. When these companies need additional capital, they may experience down rounds of fund raising, which will impact valuations. However, this may not occur until later in 2023.

II. FUNDRAISING

Fundraising is taking longer, even for high-quality GPs. In general, there is less interest from limited partners. For example, one GP described typical indications of past interest totaling nearly 1.5x target fund size; today it is struggling to reach its target. GPs report that LPs are delaying commitment decisions, and as an LP said, "re-up is the new up."

III. LIMITED PARTNER LIQUIDITY

While most LPs are not struggling to meet their capital calls, they are worried about their liquidity positions. We are hearing of a few discussions of secondary sales. Some GPs say they are fielding questions from LPs around the timing of future distributions because they need the capital; some LPs have breached internal liquidity guardrails and are not making new commitments.

IV. DEBT

Bank liquidity is drying up, causing a paucity of capital. GPs need to either source financing elsewhere or pay a significant premium. Lenders are exercising a greater level of caution and looking closely at cash flows or cash flow coverage ratios.

The cost of debt for most buyout deals has doubled and is touching the teens. Merger and acquisition activity is heavily dependent on debt and, while GPs are sitting on significant dry powder, they can't use equity to invest in existing companies because they are hitting the concentration limits set by their limited partnership agreements.

V. DEAL ACTIVITY

Deal activity has slowed on both new investments and exits. Some deals are getting done at 2021 prices, bolstered by the tremendous dry powder supporting valuations. However, valuations are starting to come down. It used to take one-to-two months to get a deal done, and that timeline is now lengthier because bids are low.

At NEPC, we believe it is important to be cognizant of market conditions, but we encourage investors to not attempt to time their private market investments. We take this opportunity to remind you that some of the most lucrative returns in private markets have

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come from vintage years marked by volatility and unrest, similar to what we are seeing today. At the same time, we advocate ensuring your overall investment pool has the appropriate asset allocation to necessary liquid funding sources to meet capital calls and spending requirements.

Please reach out to your NEPC consultant to discuss your private markets portfolio and for any questions you may have.

—Josh Beers, Principal, Head of Private Equity Investments; Oliver Fadly, Principal, Head of Private Debt Investments; and Matt Ritter, Principal, Head of Real Assets Investments contributed to this piece.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques are not guaranteed to ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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