Private Equity Perspectives H1 2024

Macro insights from our private equity experts

Lower-mid market: less capital, more opportunity

Federated Hermes

Private Markets

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For professional investors only

Lower-mid market: less capital, more opportunity

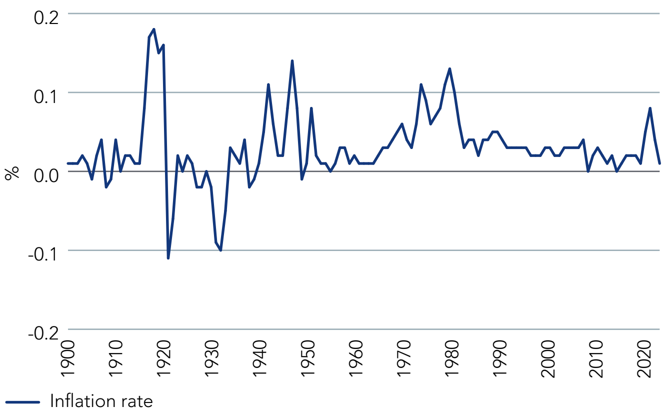
In an environment of higher interest rates, accelerating technological disruption, and geopolitical shifts – many of which have affected the broader private equity industry – we see highly compelling pockets of opportunity across the small and mid-market segment for investors with the right market access, discipline, and selection skill.

Compared to the large and mega-cap segment, these small and mid-market companies are showing signs of resilience amid the current economic headwinds and provide opportunities for genuine value-creation without relying on leverage to drive returns.

Macro realities are catching up with markets

While inflation has eased, interest rates and prices remain elevated[1]. The impact of this has begun to be felt in parts of the market over the last 18 months, but lag effects may mean continued headwinds for the wider economy in the years ahead.

US inflation since 1900 (%)



Source: US Bureau of Labour Statistics (CPI).

As monetary policy is likely to remain tighter than in recent history, with central banks continuing to shrink their balance sheets, we believe investors should prepare for interest rates to stay higher than they have been over the last decade.

Periods of reduced liquidity bring systematic risk and financial vulnerabilities to the fore. While these dynamics unfold gradually, they tend to catch up with economies over time, impacting business activity and increasing the likelihood of recessions.

Receding liquidity brings levered corporates to a crossroads

The pull-back in liquidity and the prospect of interest rates staying higher for longer will continue to cause major headwinds for the corporate sector. Larger companies with high levels of leverage are likely to see fewer opportunities to refinance their debt as borrowing nears maturity, and we can already see a gradual rise in defaults in certain segments of the market.

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Trailing six-month leveraged loan issuance for buyouts ($B)

Source: Pitchbook, October 2023

[1] Source of all market data is Bloomberg, unless otherwise stated.

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In the private equity space, this dynamic will impact the large and mega-cap segment in particular, where there tends to be higher dependency on leverage to drive returns. On the other hand, and in our experience, buyouts in smaller firms – with strong top-line growth – are less reliant on debt and provide additional value creation levers through professionalisation and targeted M&A.

Bifurcated fundraising creates opportunities at the lower end of the market

The pullback in private equity fundraising has hit smaller funds most, generating an attractive supply and demand equation at the lower end of the market for investors who can navigate it.

While 2023 likely saw a record number of mega fund raises, the number of small buyout funds raised is down almost 50% compared to prior years. Restrictive debt capital markets and fundraising difficulties have meant less capital is available to invest in smaller companies, and small and mid-market GPs are in need of reliable co-investors to complete deals. As specialists in the space, we have continued to see strong deal flow at this lower end of the market. Our team conducted a preliminary review of more than 770 deals over the last 18 months, despite a decline in activity at the industry level. The quality and quantity of the deals we are seeing remains high, allowing us to be selective in choosing investments and aligning ourselves with high-quality GPs with strong performance.

Since 2010, we have been developing a leading global platform that supports and partners with the highest-potential small and mid-market managers, particularly in the 'next-generation' space. Many of the best-aligned and best risk-adjusted deals that we currently see are emerging from this segment of managers.

The current vintages are likely to provide an attractive entry point into growth-oriented small and mid-market private equity, with the potential for outsized returns going forward.

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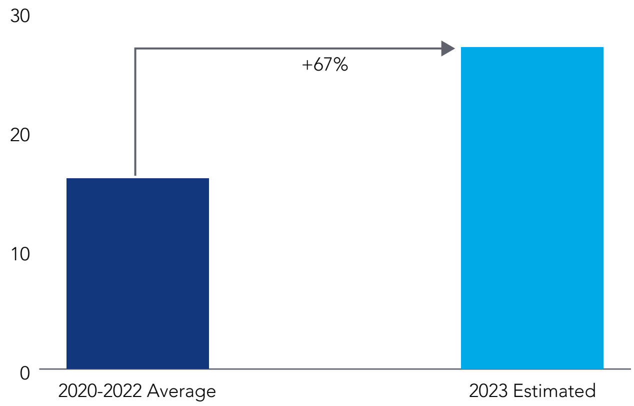
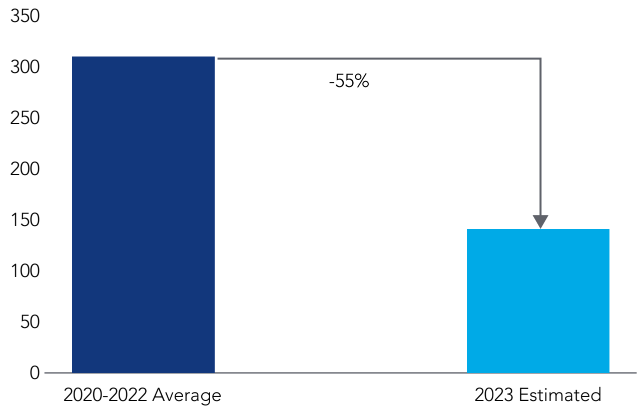
Opportunity set

Number of mega buyout funds raised



Number of small buyout funds raised

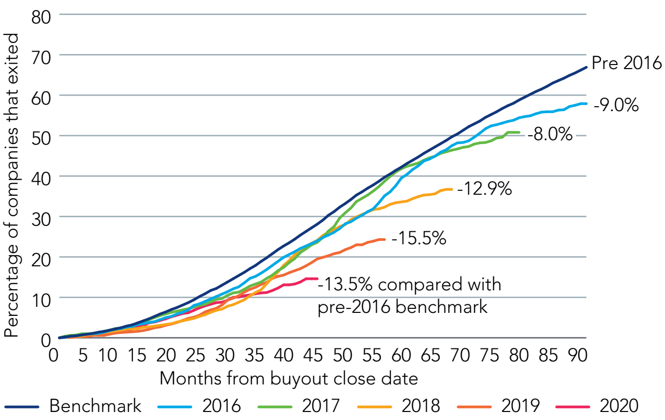


Source: Preqin, as at November 2023.

Active portfolio management in a challenging exit environment

The importance of proactively driving exits to return cash to investors has never been greater.

Buyout-backed company exit rates by deal year versus pre-2016*



Source: Pitchbook • Geography: US. *As of 23 October 2023.

Private equity is currently in its worst environment for exits in more than 30 years as the valuation gap between buyers and sellers remains stubbornly wide.

> **Alongside the rising cost of capital, the current slowdown in exits is likely to weigh heavily on the entire investment cycle for private equity.**

Alongside the rising cost of capital, the current slowdown in exits is likely to weigh heavily on the entire investment cycle for private equity. At an industry level, the ability to raise funds is directly influenced by how much capital has been distributed to investors given that some of these distributions are recycled into new funds. In addition, as holding periods get longer, value creation strategies for existing portfolio companies may be challenged, further impeding GPs' capacity to pursue new investments.

In this environment, focus should be on exits in mature assets across a portfolio, including through the secondary market for strong cash-on-cash returns. Our integrated secondaries team ensures we can take advantage of attractively priced liquidity opportunities for our investors.

A summary of our investment strategy in this environment

Looking ahead, profound secular shifts continue to redefine the global investment landscape. This process encompasses multiple themes – from the accelerating transition from a unipolar to a multipolar world to accelerating technological innovation as well as the much-needed transition to a net zero economy. In responding to these changes we continue to see the benefits of strong thematic and regional diversification.

Having a diverse international deal flow from regional and sector specialists allows investors to implement a forward-looking strategy effectively and to invest into the most attractive growth themes globally. Importantly, we believe investing alongside growth-oriented lower mid-market emerging and established managers allows investors to construct portfolios that combine a diverse set of value creation levers, resulting in a more resilient overall return profile, while maintaining high alignment towards investment success at the deal level.

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We aim to maintain a global, dynamic investment model. The next decade is likely to be very different from the last decade in private equity, and we seek to approach it with the following investment beliefs:

- Conscious risk-factor diversification is critical to achieving performance resilience amid the profound secular shifts reshaping the global economy.
- A forward-looking approach to isolating secular growth themes and business model quality remains paramount.
- Gap in funding vs market opportunity could imply strong vintage year returns for small/mid and 'next gen' GPs.
- A nimble global sourcing model can take advantage of diversification benefits across regions, particularly when adding next generation GPs to a portfolio.
- Investing alongside smaller managers, focused on growth-oriented investments with low leverage gives access to an attractive opportunity set, with strong alignment towards investment results.

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Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

Federated Hermes Private Markets

With a Private Markets track record spanning four decades, we have developed capabilities that bring investors closer to the companies, assets, communities and environments in which they invest.

Through a combination of heritage and innovation, we seek to connect investors to the industry's leading Private Markets opportunities in pursuit of delivering relevant, resilient investment returns over the long term.

Since our first Private Markets investment in 1983, our close connections, partnership mindset and deep understanding of client needs continue to define our client-focused approach across the asset classes and capabilities.

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