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Contents

Insights into LPs' Approach to 2022's Market Challenges

PitchBook is a Morningstar company providing the most comprehensive, most accurate, and hard-to-find data for professionals doing business in the private markets.

Key takeaways

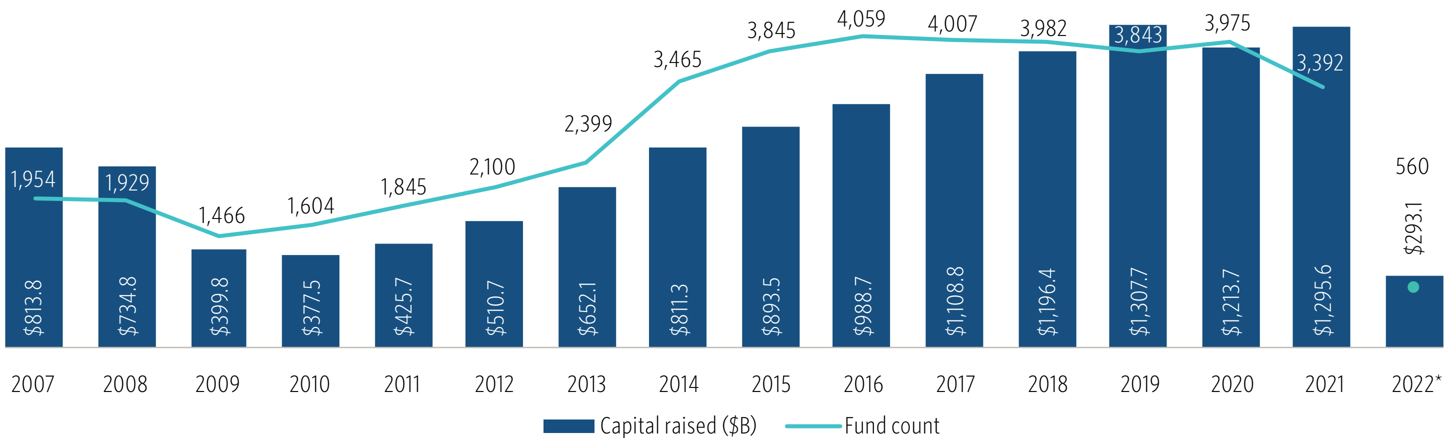
- Overall, there is still plenty of dry powder available to support existing portfolios, though that will vary from fund to fund.
- Inflation and rising interest rates can be destructive to investment returns, but LPs are tactically eyeing cash, real estate, real assets, and private debt for potential areas of relief.
- LPs are likely to take a breath at times of market volatility, though how long that breath lasts can depend on factors such as governance and the portfolio's purpose.
- Expect net cash flows to stay negative, putting a damper on LP fund commitments.
- For the vast majority of LPs, the denominator effect is not an immediate concern.

Introduction

Most market crises occur because we did not see them coming. Collectively we are pretty good at making the necessary adjustments if we anticipate a major disruption (for those of us around long enough, one example might be Y2K). We were blindsided, however, by poorly constructed collateralized mortgage obligations and, after so many false alarms, we did not expect that this variant of a transmissible disease would be the one to shake the world. In 2022 we didn't count on a Russian invasion of Ukraine and the rolling lockdowns of the pandemic combining to disrupt the global supply chain, causing shortages, inflation, and rapidly rising interest rates. That said, many in the financial markets had been predicting a resurgence of inflation since the massive stimulus coming out of the global financial crisis (GFC). Also, the statement that interest rates had nowhere to go but up had been a common refrain for over a decade. So, while many may have been early in anticipating these economic trends, they had at least given it some thought.

It remains to be seen if the supply-driven inflation can be rectified structurally before lasting damage occurs. Unemployment is, for example, still at historically low levels, so for the time being, many consumers are still in fairly good economic health. Reports are beginning to come in about layoffs and hiring freezes in some sectors, however, particularly in tech, a primary focus for many of our readers.[1] The Federal Reserve, which has never forgotten lessons learned in the late 1970s and early 1980s, has never abandoned inflation as one of its targeted objectives. Some would argue that they waited a quarter or two too long,[2] hoping inflation would be more transitory, but when they did act, they were ready with an aggressive game plan to raise interest rates. While the Fed has a long memory, most market participants today have never operated in an environment of rising rates and inflation, as that last occurred in the US during the Carter and Reagan administrations.

Private capital fundraising activity



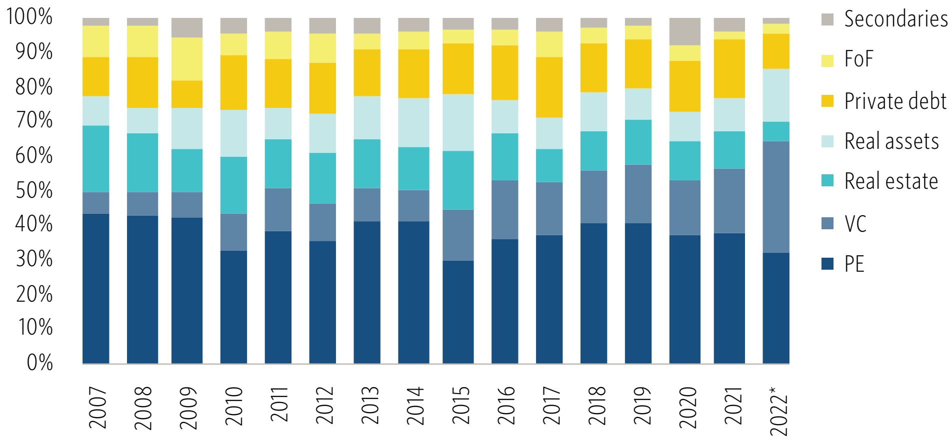
Source: PitchBook | Geography: Global
*As of March 31, 2021

1: "Klarna Layoffs Signal Trouble Ahead for Unicorns—and Consumers," *Fortune*, Jessica Mathews, May 24, 2022.
2: "Question for Fed: Has It Waited Too Long to Fight Inflation?" *AP News*, Christopher Rugaber, January 10, 2022.

Our quarterly Private Fund Strategies Reports have shown that fundraising barely slowed during the pandemic. While LPs did take a breath in Q2 2020, the fact that there was only a 7.2% decline in fundraising from 2019 to 2020 indicates that LPs have a longer-term mindset when it comes to consistently putting money to work into the private markets. That said, the mix did shift as allocators tactically decided to place their bets into more venture capital (VC) and private debt at the expense of private equity (PE) and real estate.

While people speculate about potential economic ramifications down the line, financial markets are undergoing large swings as both investment managers and allocators evaluate the situation and what it means for their current and future investments. Given their illiquid and slow-moving nature at that time, what will this mean for private market investments and their investors?

Share of private capital raised by strategy



Source: PitchBook | Geography: Global
*As of March 31, 2022

The denominator effect

One principal of which people took serious note in the GFC was the "denominator effect." Articles on this topic have resurfaced in 2022, but what is it? Nearly every LP operates within a target allocation framework for their selected asset classes. To explain the effect with an example, an LP may intend 20% of its total portfolio to be allocated to PE and 40% each for public equity and fixed income. When the stock market falls dramatically and interest rates climb rapidly, the public market investments will fall in value immediately. But private market investment values will not reflect the changing environment for several months because their very nature requires a manual valuation and reporting process.

When the total portfolio (found in the denominator of the equation) drops, but not the private market valuations, the private funds will become a larger portion of the total. This could cause issues if an LP has automatic rebalancing mechanisms for when an asset class becomes overweight. Circling back to our example, if the portfolio was $100 million before a crisis point and then the $40 million public equity stake dropped by 35%, the public fixed income went down 10% with rising interest rates, and the PE portfolio was unchanged, then the total portfolio value will have dropped by $18 million to reach $82 million. As is shown in the table, if the investor was at its target PE allocation before the stock market drop, then the LP now finds itself overallocated.

The denominator effect illustration

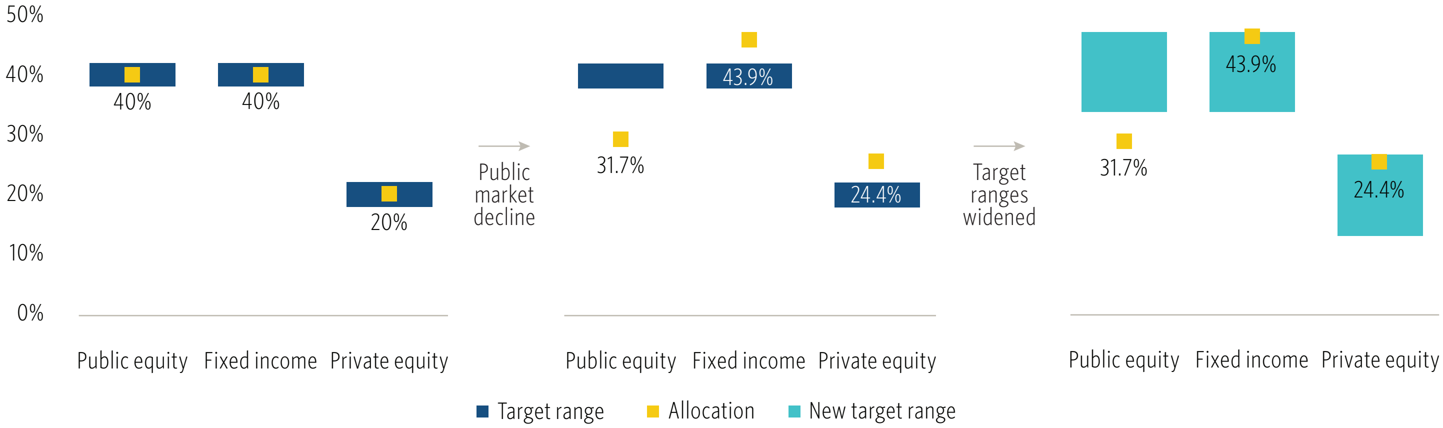
Asset class	Before value ($M)	Target allocation	After value ($M)	After allocation
Public equity	$40	40%	$26	31.7% (Under)
Fixed income	$40	40%	$36	43.9% (Over)
Private equity	$20	20%	$20	24.4% (Over)
Total (denominator)	$100	N/A	$82	N/A

Source: PitchBook
For illustrative purposes only

If these were liquid investments, the LP could sell where it was overweight, buy where it was underweight, and easily get back into compliance with targets. But would that be the right thing to do when private funds are involved? The PE positions do not operate outside of the economic realities that the public markets already reflect. It is highly likely that they will be marked down significantly, so the current valuations are not an accurate picture of the portfolio. In fact, if the LP did try to sell some PE at this point, the secondary buyer would insist on a deep discount from the most recent net asset value to reflect the new reality.

This is a known and generally understood phenomenon among LPs, of course. Following the GFC, some LPs rewrote their investment policy statements to be more flexible. Instead of a hard target such as 20% with a tight allowable band of drift, ranges were widened.[3] In some cases, a time element was added to allow the portfolio to be outside of the targeted ranges for one or two consecutive quarters before considering options for how to bring the portfolio back to the desired allocation. This allows time for the private market portfolio to reset to the new normal and potentially time for the stock market to gain back some ground as market participants come to an understanding about what different investment opportunities should now be worth in relation to each other.

A graphical representation of the problem and the solution that broadening the ranges provides is shown here:



3: One example of this is described in this article: "Calpers Widening Most Asset Allocation Ranges," *Reuters*, Jim Christie, December 15, 2008.

It is likely that some LPs will take a breath before making new commitments, waiting for the dust to settle and taking some time to examine the investment opportunities that may be best suited to the current environment. This is in contrast to GPs who have come back to market sooner with bigger funds and are finding that the spigot may have slowed from what they saw during their last fundraising effort.

Largely due to rising valuations linked to hot IPO markets, many LPs did enter 2022 overallocated to private markets. The drop in public market assets has likely exacerbated this, at least on paper. Given these forces, it is likely that some LPs will take a breath before making new commitments, waiting for the dust to settle and taking some time to examine the investment opportunities that may be best suited to the current environment. This is in contrast to GPs who have come back to market sooner with bigger funds and are finding that the spigot may have slowed from what they saw during their last fundraising effort.

LP decision making

LPs are, of course, not homogenous in their governance or objectives—both of which can have a significant impact on the reaction an investor may have to a crisis. In the case of a chief investment officer who has full control over investments, that person may be able to move quickly and opportunistically into areas likely to benefit, or at least be harmed less, from a change in market sentiments. On the other end of the spectrum are pools of capital governed by boards with little to no investment experience. Those committees meet infrequently and tend to be risk averse even in the best of times, particularly regarding alternative investments.

The type of institution and the funded status versus liabilities matters as well. An endowment or sovereign wealth fund investing with a perpetual mindset might be willing to act with a longer-term perspective, doubling down on risky assets when they seem inexpensive. A pension that is underfunded with a growing base of retirees, however, will find itself in an even worse position after a market drop. In the latter case, the company or public entity responsible for funding the pension may be extremely wary of assets perceived to be riskier when they are already being required to increase their contributions to the pool at a time when business or tax revenues may also be suffering.

Even when an investment committee is made up of savvy investors, it typically meets only quarterly. There are undoubtedly ad hoc update calls when turmoil arises, but scheduling conflicts and the need, at least for public pensions, to make decisions in a public forum make it difficult to have off-cycle meetings. It is highly likely that the agenda for the meetings scheduled in the third quarter will be focused on the evaluation of the current state: What does the collapse in valuations mean for funding ratios or spending/granting programs? What areas of the portfolio are most exposed to the worst aspects of inflation and rising interest rates? What can they do to be opportunistic in light of the new economic realities? New commitment recommendations may be rare in Q3 2022 unless the investment staff was far along in the diligence process and a final close was imminent. It will be another quarter or two before committees may feel ready to consider changes or additions to the portfolio's fund lineup.

Very few LPs believe they are comfortably staffed; most have very lean investment teams. While markets are still roiling, their time will be spent assuring stakeholders that all is under control and the long-term nature of the assets means immediate action is not merited. They are busy answering all of the questions from their constituents and creating the reports that investment committees will be expecting to get a good look at where the carnage has occurred. In crisis times, this takes quite a lot of time away from business-as-usual commitment recommendations.

We think those looking to raise capital right now should be patient. LPs are going through a lot, other parts of the portfolio are taking up a lot of their brain power, and making new fund commitments may not be a high priority.

We think those looking to raise capital right now should be patient. LPs are going through a lot, other parts of the portfolio are taking up a lot of their brain power, and making new fund commitments may not be a high priority. But each LP situation is unique. If a fund manager has a strategy that could be a good opportunistic bet in a time of high inflation and rising interest rates, and if the investor seems to be nimble enough to take advantage of it, now could be the time to reach out.

Regret and defaults

In terms of partnership commitments already signed, some LPs seeing the dramatic decline in their portfolio may wonder what would happen should they find themselves unwilling or unable to meet capital call demands from GPs. Regardless of whether it be a cash crunch or a changed perspective on where to allocate assets, most LP agreements have severe penalties designed to deter LP defaults. According to a paper written by legal firm Proskauer Rose,[4] GPs often have the following options:

- Allowing late payment with interest and related expenses charged back to the LP
- Requiring the LP to sell its stake to other parties at a discount
- Diluting the LP's fund interest by redistributing some of the LP's stake to other LPs
- Redeeming the LP's interest with no payment or a promissory note of nominal value payable when the fund liquidates
- Suing for damages

There is little to indicate that defaults are imminent at this point and the deterrents ensure that this has never become a meaningful problem.

Despite the potential consequences, some LPs still chose to default during the GFC because it was early in the fund's life, and because some found allocating limited liquidity to a strategy that no longer seemed advisable to be anathematic. That said, there is little to indicate that defaults are imminent at this point and the deterrents ensure that this has never become a meaningful problem.

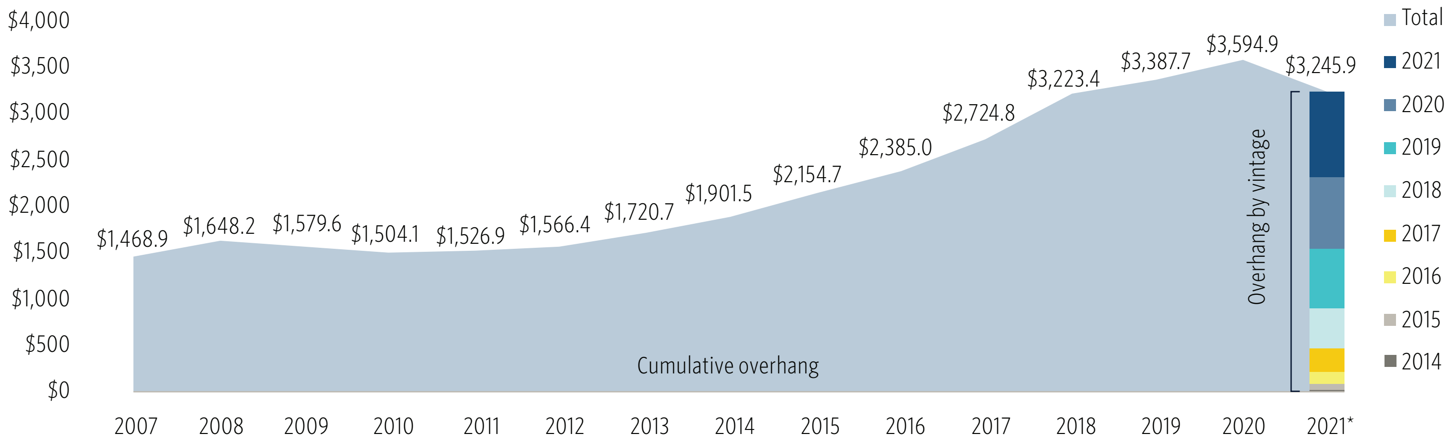
Net cash flows

One of the most challenging aspects of private market investing for LPs is managing the cash flows related to capital commitments.[5] For the last few years, rising dry powder has meant increases in capital calls and even record-setting distributions have not kept pace, putting LPs into a negative cashflow position overall. Net asset values have seen rapid increases, but LPs cannot spend write-ups.[6] Allocations to private funds could slow simply because LPs may want to ensure they can fund the calls from existing commitments without having to sell other assets when the market is down.

Net cash flows are, of course, a consequence of two opposing forces. So, what might LPs be facing in terms of inflows and outflows?

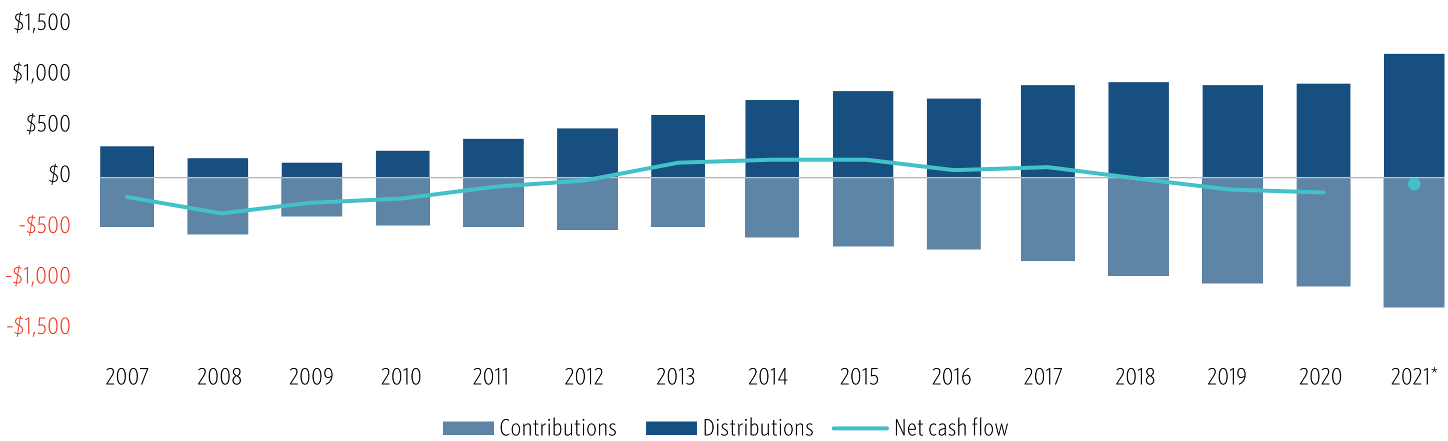
4: "Facing Up to Reality," Private Equity International, Howard Beber, Scott Jones, and Ira Bogner, accessed June 1, 2022.
5: For a detailed analysis on why this is a challenge, and solutions that PitchBook's Institutional Research Group has created, read Allocator Solutions Report.
6: For more on this subject, read PitchBook's Global Fund Performance Report.

Private capital dry powder ($B)



Source: PitchBook | Geography: Global
*As of December 31, 2021

Private capital cash flows ($B)



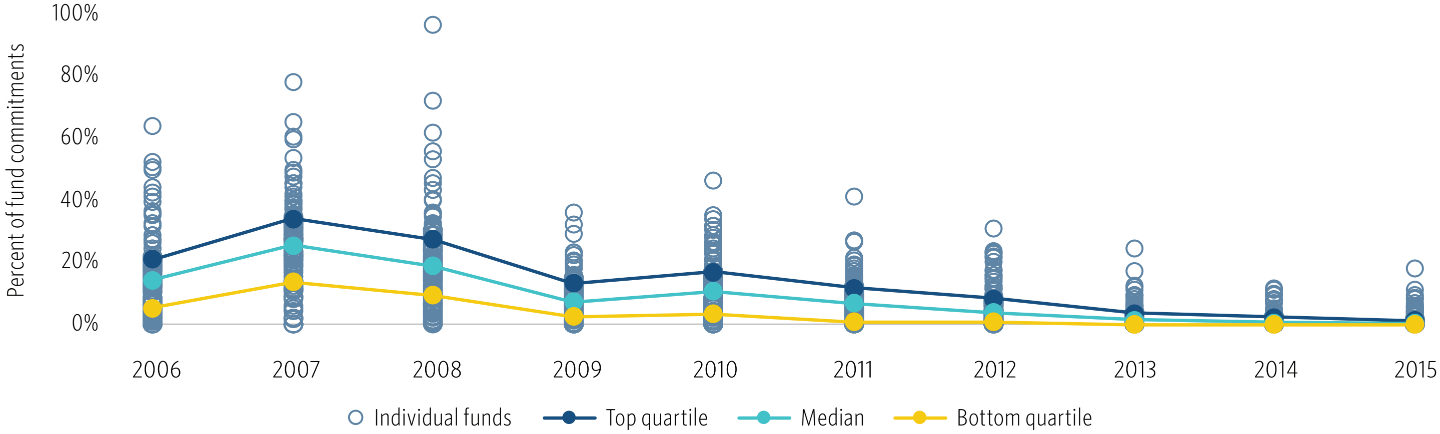
Source: PitchBook | Geography: Global
*As of December 31, 2021

Contributions

Given that there is over $3 trillion in capital committed, but not yet called, across all fund strategies, it does not seem like a very risky prediction to say that capital calls will continue. The focus may shift, however, as new investments may take a back seat as capital is called to shore up current investments or make opportunistic tuck-in investments that will improve the existing portfolio. For those who worry that crisis points lead to paralysis in the markets, our data is clear that fund managers continue to call commitments down even during the darkest hours. The accompanying chart below shows 2006 vintage funds continuing to make sizeable capital calls despite the environment, and we expect that recent vintages will continue to make calls in 2022 and beyond.

In our recent PE and VC notes, we discuss where we think the deal environment will pivot.

Yearly capital called by 2006 vintage PE funds



Source: PitchBook | Geography: Global

Distributions

The vast majority of cash back to LPs comes from the sale of portfolio investments, but this seems likely to slow in the near term. It always takes some time for market participants to settle into a new normal—buyers may be excited by the prospect of bargains, but sellers are slower to accept their most recent marks are no longer valid.

That said, some liquidity will likely come to LPs from secondaries, though this is largely at their discretion. Given the better handling of rebalancing requirements at LPs, it is unlikely that very much secondary deal flow will arise from distressed sales, at least not at this point. While secondaries deals operate in an extremely opaque environment, conversations with players in the space have indicated that in the summer of 2020, hardly anything transacted. That said, record commitments were made to secondaries funds that year, as LPs hoped to capitalize on potential distress, so significant dry powder is looking for something to buy.

The more likely source of deal flow for secondaries this year, and thus capital coming back to some LPs, will come from GPs offering liquidity in what is now called GP-led secondaries. For funds that are nearing the end of their contracted life, an uncertain exit environment may cause GPs to look for alternatives to locking in lower valuations in order to wrap up their funds. The GPs will partner with the secondaries funds to offer the choice to either buy out LP stakes or transfer their interest into a new continuation vehicle. LPs will need to consider cash needs and the potential annoyance of a 10-year relationship with a fund manager extending years further, but should also be critical of the price being offered, as these deals may be offered at significant discounts outside of a competitive bid process.

Opportunism

Every crisis is different and looking to the past to see what to expect in the current situation is always going to be an inexact comparison. Private market funds were not mainstream investments the last time the US saw appreciable inflation, so there is no available data to show a time when private funds had to operate in such an environment. Most LPs invest for the long haul—if they have matched their investments with the horizon of their liabilities, they should have a temperament that allows them to stick to their strategic objectives and not be tempted to reverse course during times of market stress. That said, there are areas around the margins where LPs believe they can find some protection and maybe even upside.

Some LPs are allowing cash balances to temporarily drift up. Distributions from private market exits and income-producing investments may be allowed to sit in cash while LPs take some time to assess their next moves. Not only is it comforting to have cash on hand during periods of volatility to be able to quickly take advantage of opportunistic ideas, but cash is finally paying more than a few basis points of interest again. That said, we do have to get used to thinking of returns in an inflation-adjusted environment again, and cash returns are definitely not covering the decline in the value of money this year.

Real estate has been seeing increased attention in the last six months as built-in rent escalation clauses found in many commercial real estate contracts provide at least some protection from rising inflation.[7] Not all of these are directly linked to inflation, so they may not keep up with the high single-digit inflation seen recently, but there is some protection to be had that is not as explicitly present in many other asset classes. Not all real estate offerings will have the same reaction to market forces, however. Many investors are particularly targeting Core and Core Plus real estate, which may benefit from increasing rents without the need to spend money on capital improvement or building projects at a time when costs are increasing. Many Core funds are offered with open-ended fund structures, allowing investors to avoid signing on for a 10+-year commitment during uncertain times.

Real assets strategies are also seeing interest, as rapidly rising prices mean higher revenues for commodities producers that may cover the additional costs required to extract resources from the ground. Infrastructure also falls into this category, and the stable income that these assets typically provide is also a balm to an allocator seeing volatility in other parts of the portfolio.

Private debt, which frequently utilizes floating-rate paper, could become very interesting to LPs looking for both increased income from higher rates and a chance to de-risk their portfolios by taking some equity risk off the table. While PE may decrease its usage of debt with rising interest rates, debt will remain a major component of the leveraged buyout model. The higher cost may even cause PE firms to be more selective in their acquisition targets, potentially raising the quality of the companies they own. This should be good news to debt holders, who are typically more focused on limiting downside since upside is often constrained to interest payments alone.

7: For more on this topic, read PitchBook's Private Markets Real Estate Fundamentals.

Final thoughts

While it is tempting to look at prior crises for parallels to current situations, 2022 is much different than either 2020 or the GFC. 2020 was abrupt, unfurling over two months before hitting a tipping point when a nearly complete shut-off of consumer spending was almost instantaneously felt and seen in the public markets. Then came immediate government action to address, as best they could, key parts of the economy impacted by the pandemic. The GFC, on the other hand, rolled out slowly; the first indications appeared in early 2007, but the most serious market turmoil happened in October 2008. Our current situation has causes that are fairly easily pinpointed, though things like revamping global supply chains and developing alternative energy at scale will take time to solve.

Institutional investors will typically pause to assess the situation, hold steady in their long-term thinking, and think about tactical ideas only around the margins. GPs should be patient with LPs, settling in for a longer fundraising cycle and taking good care of their existing portfolios.