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Do you hate volatility? You will love growth Private Equity

Public markets have gone through major ups and downs in the last few month. Movements have been amplified in both directions by investors panic and major Central bank interventions. Looking back the last three major crisis in the last 20 years can bring interesting lessons:

- The dotcom bubble in 2001 was a pure valuation crisis. While most stock listed companies suffered in the short-term, Private Equity markets suffered as well because many companies are valued based on these public comparable or M&A markets. VC's performance in particular has been impacted by a much more difficult fundraising market and financing rounds for companies that took much longer to close.
- The Sub-Prime crisis was a classical financial crisis that primarily impacted the financial sectors, but had long term repercussions on how the economy functions. Valuations of Private Equity post this crisis also corrected but much less than in 2001. Venture-backed companies usually do not use debt instruments and most VC's came through the crisis after managing to raise funds between 2007-2009.
- The COVID19 crisis led to a massive production stop, border closure in most countries across Europe, the Americas and Asia, no travel of persons. In the Private Equity sectors many Private Debt funds will suffer as well as smaller non cash flow positive companies. Companies with a weak shareholder base (without enough cash reserves) will find fundraising tough, and valuations will suffer as a consequence.

In all three cases Private Equity showed 50% less volatility than broad indices such as S&P 500.

The main difference between publicly listed companies and private ones is that prices are only paid in 1-2 years rhythm. Valuations in between are typically done on a quarterly basis (not daily like public stock market) and based on last paid price or discounted cash flow models. This limits volatility significantly. Typically, Venture and Growth investors are active during these critical times. This means that they are well aware of the details of each specific company they invest in. This allows for very quick decision-making and actions. The alignment of interest between management and investors is usually well crafted enabling a well-balanced execution of the strategy. Teams who have already gone through the above-mentioned three crises are definitely better tooled to fight the current situation.

Liquidity

Private Equity despite investing in unlisted companies has become a quite liquid market. Secondary funds have grown significantly both in the company direct investments as well as fund participations segments. New investors often offer exit to older ones as part of a financing round. The discounts to NAV in this maturing industry have seen significant reductions, in particular in the transaction of larger sizes. In the venture space we have even seen transaction with a premium to NAV in the Biotech space.

The years 2018 and 2019 have seen a record activity in fundraising (CHF 2.3bn in 2019). Funds are sitting in record level of committed cash. A good situation to get through a crisis. With interest rates at historical lows and debt markets flooded with “free” money it hard to see a liquidity crisis at the horizon.

Written by Jean-Philippe Tripet, Founder of Aravis SA

Economic Outlook

Data for the month of March, April and May 2020 shows significant slowdown in Europe and the USA with a massive rise in unemployment. As often when the economy slows down, the smaller less capitalized companies suffer most. Currently, it is still hard to see at what speed the economic activity will recover. PMI (Purchase Managers Index) still do not show any comforting signs of a recovery. Looking back at 2001 and 2009, we expect it will take between three to five years to recover. Pressure on company valuations is to be expected. In particular in the current phase, cash is king.

Investment outlook

The years 2002 and 2003 have not a become particularly great vintages years, whereas 2009 and 2010 proved to be excellent years to invest in Private Equity. We believe that 2020 and 2021 will be good vintage years for the following reasons:

- Negative interest rates, no/low growth are hell for savings but heaven for entrepreneurs.
- De-globalization: Observing the tension between China and the USA as well as other countries focused on their own issues, it can be expected that the wave of globalization of the last 20 years will see a difficult and more protectionist environment. Conclusion bad for large global corporation, good for smaller regional companies.
- Europe, including Switzerland, have been generating a large number of quality high-tech companies. Given the unsecure economic environment each new investment will have to be looked at in a very professional and detailed fashion before a decision can be made. Rounds of financing will take longer to close compared to the previous years.

What investments should you look for?

SME's in traditional businesses, focused on growing sales with a strong competence in software for Marketing, logistics marketing, client communication, data analytics. Moving from loss making at time of investment to profitable at exit. Exit target timing about 5 years.

Look for PE managers who are active investors, lead round of financing and participate in company boards of directors. Prefer regionally focused managers rather sector focused ones. Maximise your amount co-investment to reduce costs.

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