CARLYLE

By **Ruulke Bagijn**
December 17, 2024

*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition features guest author Ruulke Bagijn, Global Head of Investment Solutions for Carlyle and Head of AlpInvest, and highlights the evolving landscape of private markets.*

Navigating Valuations and Exits

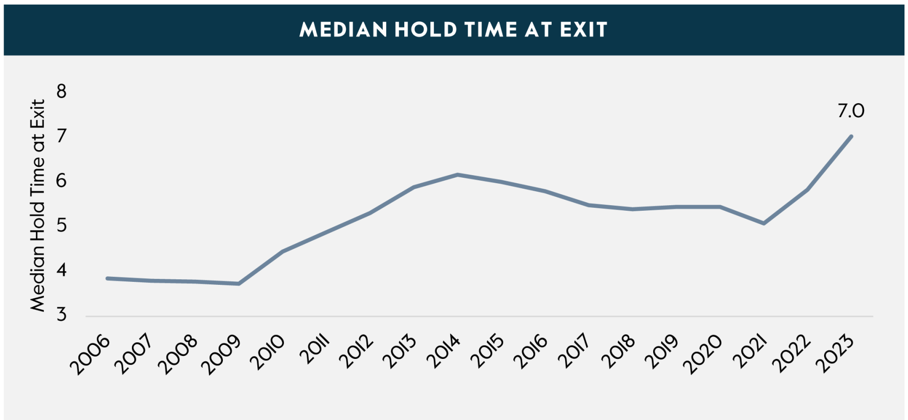
In 2022, public markets corrected sharply in response to the steepest series of rate hikes since the 1970s, while private equity valuations remained notably resilient, adjusting only modestly (global buyouts declined 1.6% over the year vs. an 18% decline for the MSCI ACWI on a total return basis). This raised questions among the investor community about whether private equity valuations were realistic or artificially maintained.

Our experience shows that GPs tend to be conservative and avoid overly aggressive valuations. GPs consider selling below fair market value (FMV) undesirable, as it could call their valuation practices into question by their LP base. What we have seen instead is that the *pace* of FMV gains in private equity has slowed since 2022 compared to prior years. Since 2021, GPs who paid top-of-the-market valuations have seen multiple compression, but often this was offset by continued healthy EBITDA growth. As a result, we saw positive but more limited value creation on paper.

This point is further supported by exit data. In our own global buyout portfolio, more than 90% of all exits in 2023 and 2024 have been at or above the mark. This is consistent with prior years: of the 1,800 exits in our portfolio from January 2018 through the first half of 2024, more than 90% were above the mark, with no degradation seen in 2023 or 2024, which stand at 91% and 92%, respectively. Rather, the uplift in valuations upon exit has been more muted. Total market multiple (TMM) uplift at exit has averaged +0.4x since 2018, with peak uplifts of +0.5x in 2020 and +0.7x in 2021. More recently, uplifts have ranged from +0.2x to +0.3x TMM since 2023.

While GPs have largely exited above the mark, this trend may not tell the entire story. A common refrain is that this is more a reflection of self-selection, with GPs choosing to exit only those companies that can achieve strong valuations. That is certainly part of the story. We are seeing longer holding periods, with the median holding period for exited deals reaching seven years at the end of 2023—the longest on record (Figure 1). GPs are waiting for valuation multiples to increase and bid-ask spreads to narrow again before exiting. This is evident from the fact that only 9% of deals made in 2021, a period of peak multiples, have exited; by contrast, an average 20% of deals exited within three years for 2015–2019 vintages. But the ability to optimize exit timing is an advantage and hallmark of private equity: GPs are not forced sellers. As long as underlying portfolio companies continue to perform, they can accrue value over time and be exited when the window opens.

Figure 1: Longer Holding Periods

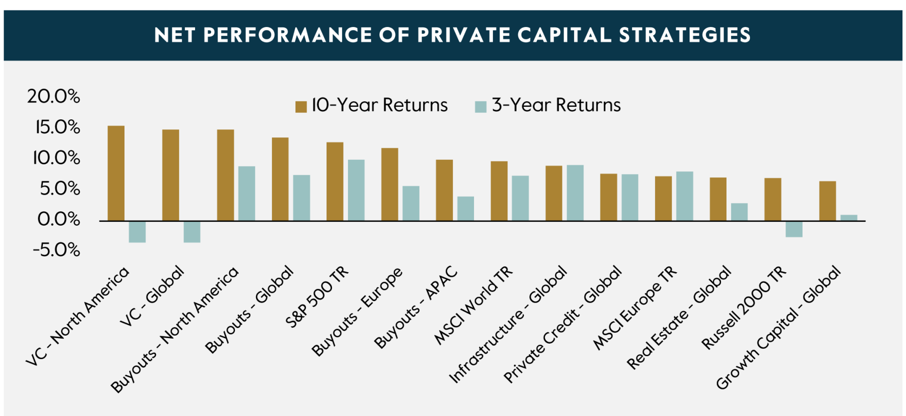


Source: Pitchbook, Q3 2024 US PE Breakdown, accessed November 2024. There is no guarantee any trends will continue.

Public vs Private Market Performance

Given the distinct dynamics of public and private markets, how is this reflected in performance? If we look at a 10-year period, private equity continues to outperform public markets, with North American buyouts and the S&P 500 returning 15% and 13%, respectively (Figure 2).

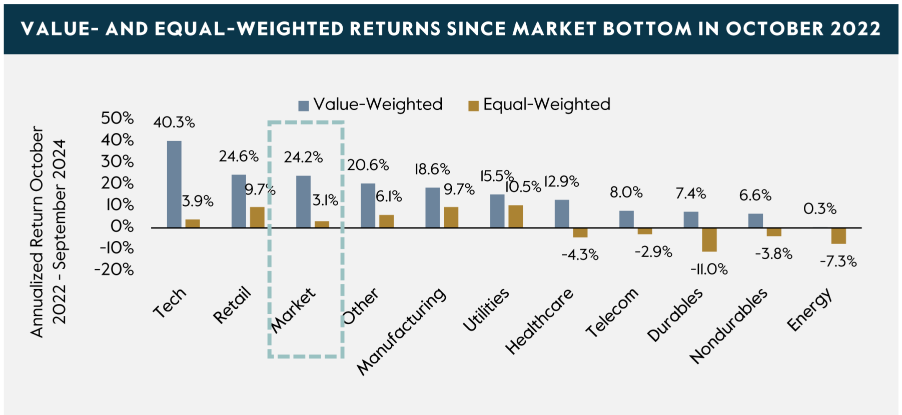
Figure 2: Private Equity Still Outperforming Public Markets



Source: Carlyle Analysis; MSCI, Bloomberg, accessed 10/7/24. Valuations as of 6/30/24. There is no guarantee any trends will continue.

Over the more challenging three-year horizon, North American buyout funds have, for the first time, slightly underperformed the S&P 500, trailing by just 1 percentage point. However, the S&P 500's performance has been heavily driven by the "Magnificent Seven" tech giants, a phenomenon that suggests a nontrivial level of concentration risk. Since 2022, these seven stocks have accounted for 54% of the S&P 500's return. This skew becomes particularly apparent when considering value- vs. equal-weighted returns: since the market bottom in October 2022, value-weighted returns across the U.S. equity market have outpaced equal-weighted returns by over 20 percentage points on an annualized basis (Figure 3). This marks a sharp departure from historical trends: during the previous decade, value-weighted and equal-weighted performance was roughly equal. Notably, the 9% annualized returns of North American buyout funds over this three-year horizon appear highly favorable when compared to the broader Russell 2000's annualized negative return of 2.6%.

Figure 3: Value-Weighted vs Equal-Weighted Returns: A Sharp Departure from Historical Norms



Source: Carlyle Analysis, CRSP, Ken French, November 2024. There is no guarantee any trends will continue.

Private equity is not immune to changes in financial markets or rate changes. As with other markets, it is cyclical; it is not an asset class you can rotate into and out of successfully. Deal volumes decline when there are shocks, like we are seeing now. However, capital deployed during challenging periods has historically performed well, oftentimes benefiting from lower entry multiples and shifts in the business cycle. For example, the 2001 and 2009 vintages of U.S. buyout funds have each delivered median net IRRs above 20%, with upper quartile returns in excess of 25%.

These cyclical variations are likely to persist. However, we believe that private equity will continue to outperform. Private equity has done surprisingly well when faced with headwinds. Over the 20 years through 2019, global buyouts have delivered stronger results than their public market equivalents (PMEs) every year except for one, when public markets showed a slightly stronger recovery coming out of the Global Financial Crisis (GFC). Vintages since then are not yet sufficiently seasoned to demonstrate conclusive performance data, but early indications suggest that buyouts have held up well.

When benchmarked against the Global Equity Markets Morningstar Index, global buyout funds have outperformed by 21% on average across vintage years 2000–2023. Notably, recent academic research finds no evidence of negative trends in private equity performance, and, contrary to some claims, there is little indication that public and private market returns are converging. The correlation between global buyout returns and the MSCI World Index has been stable at about 70%; when comparing to the S&P 500 and MSCI Europe, the correlation coefficients are even lower, at 67% and 65%, respectively.

Performance and Interest Rates

We expect this trend to continue, even if interest rates decline less than expected or increase in the face of renewed inflationary pressures. This is because private equity returns do not depend on leverage. Private equity has historically demonstrated the ability to adapt and consistently add value through governance and operational improvements. Research from BCG shows that top-line growth and margin expansion have contributed nearly half of the value creation in leveraged buyouts (LBOs) in the post Global Financial Crisis (GFC) era, almost tripling since the 1980s. This aligns with what we see in our co-investment portfolio. And if we only look at what we call “home run” deals (deals generating a >3x MM or a gross IRR >30%), deleveraging does not significantly contribute to value creation. Instead, we find that on average, debt is unchanged over the holding period, as cash flows are used for funding the growth of the portfolio company. Higher rates may impact the performance of existing assets but our expectation is that PE will continue to out-perform.

RUULKE BAGIJN
Global Head of Investment Solutions for Carlyle and Head of AlpInvest

This material is provided for educational purposes only. Nothing herein constitutes investment advice or recommendations and should not be relied upon as a basis for making an investment decision. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors.

Economic and market views and forecasts reflect our judgment as of the date of this presentation and are subject to change without notice. In particular, forecasts are estimated, based on assumptions, and may change materially as economic and market conditions change. Carlyle has no obligation to provide updates or changes to these forecasts. Certain information contained herein has been obtained from sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purpose used herein, Carlyle and its affiliates assume no responsibility for the accuracy, completeness or fairness of such information.

Past events and trends do not imply, predict or guarantee, and are not necessarily indicative of, future events or results. This material should not be construed as an offer to sell or the solicitation of an offer to buy any security, and we are not soliciting any action based on this material. If any such offer is made, it will only be by means of an offering memorandum or prospectus, which would contain material information including certain risks of investing including, but not limited to, loss of all or a significant portion of the investment due to leveraging, short-selling, or other speculative practices, lack of liquidity and volatility of returns.

Recipients should bear in mind that past performance does not predict future returns and there can be no assurance that an investment in a Carlyle fund will achieve comparable results. The views expressed in this commentary are the personal views of certain Carlyle personnel and do not necessarily reflect the views of Carlyle. Investment concepts mentioned in this commentary may be unsuitable for investors depending on their specific investment objectives and financial position; each recipient is encouraged to discuss such concepts with its own legal, accounting and tax advisors to determine suitability. Tax considerations, margin requirements, commissions and other transaction costs may significantly affect the economic consequences of any transaction.

In connection with our business, Carlyle may collect and process your personal data. For further information regarding how we use this data, please see our online privacy notice at https://www.carlyle.com/privacy-notice.