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# Analysts Advise on Key Trends to Watch as Markets Return to Turmoil

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

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## Introduction

Markets returned to a state of turmoil in the first half of 2022. Inflation is surging, interest rates are on the rise, there is a war in Ukraine, and supply chains are bottlenecked by the lingering effects of COVID-19. At the time of writing, the S&P 500 has lost about 17% year-to-date and the Nasdaq just over 26%, putting it squarely in bear market territory.

The private markets haven't been immune to this volatility. Formerly high-flying VC-backed companies have announced layoffs, and others have delayed their next fundraises. Private equity (PE) firms smell blood in the water but are also figuring out how to cope with the real possibility of a recession. How will these trends play out, and where should investors be paying attention? We've asked our analysts how the current macro backdrop is affecting their coverage areas.

Questions or feedback about the analysis? Please feel free to get in touch at [pbinstitutionalresearch@pitchbook.com](mailto:pbinstitutionalresearch@pitchbook.com).

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## Expectations of greater monetary tightening have shifted the asset valuation paradigm

The impetus behind the recent sell-off in public equities has been a sharp increase in the market's expectations of future interest rate increases by the Fed, which in turn has led to a material repricing of asset valuations. Over the first four months of 2022, the market-implied federal funds rate at year-end 2022 increased by more than 2%, from 0.9% to 3.0%. During this time, the S&P 500 Index fell 13.3%. The performance of the broader market, which is at worst a mild drawdown, has masked what is truly happening within the equity market: Stocks with relatively high implied growth rates and valuations are being repriced, while stocks with relatively low implied growth rates and valuations have performed well. According to data from Kenneth French, Professor of Finance at Dartmouth College, a portfolio of stocks in the top valuation quantile, which consists mainly of high-flying technology stocks, has returned -7.1% YTD through March. Meanwhile, a portfolio of stock in the bottom valuation quantile has returned +5.2%.<sup>1</sup>

These market movements provide strong evidence that rising discount rates are at the center of the current turmoil. Assets that gain most of their value from expected revenue and earnings growth are more sensitive to increases in discount rates, given that cash flows will be realized well into the future. We believe the repricing dynamics that are playing out in public markets are also happening in private markets to differing degrees across asset classes and industries, although it may take several quarters for this to show up in the data. Venture capital (VC) is particularly susceptible due to its high degree of exposure to young companies that will require significant growth to reach profitability, as well as the surge in valuations over the past few years. Historically, private equity investments have been in companies with fairly strong and consistent earnings, which makes them less sensitive to rising discount rates. However, [as we recently noted](#), the trend in PE over the last several years has been more capital invested into technology companies and growth equity deals, which has likely increased its sensitivity to rates.

### Market-implied federal funds rate at year-end 2022



Source: PitchBook | Geography: US  
\*As of May 12, 2022

1: "Current Research Returns," Kenneth R. French, n.d.

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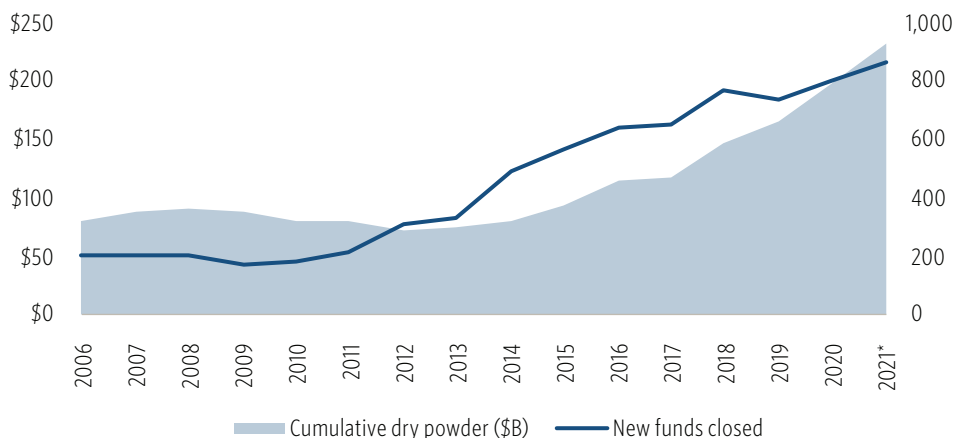
## The US VC deal machine will keep churning, though deal size and valuation trends will change

The sentiment around the venture market is noticeably different in 2022 than it was over the past couple years, with bearish commentary filling the airwaves and Twitter feeds about how frothy the market has become and the likely repricing of the market. The talk is warranted, though recent market conversations haven't produced much change. For example, the market was turning toward profitability after the WeWork (NYSE: WE) IPO debacle, but valuations climbed ever higher as revenue multiples expanded. VC is facing the onslaught of economic headwinds that are plaguing every other market, and for many reasons, this feels like a true market shift. Startup valuations should come down, and deal sizes will likely retreat from the highs of the past couple years.

However, the venture market has a new insulator that it hasn't had in past downturns. Dry powder is easy to look at—\$230 billion+ ready to deploy from US VCs alone—but it doesn't tell the whole story of why deal counts will likely continue at such high levels. Since the beginning of 2020, nearly 2,000 venture funds have been raised in the US. That is more than was closed in the seven-year period from 2006 to 2013. Even though we expect fundraising to slow through the back half of 2022, the market is looking at around 3,000 funds still within their investment period. Looking at most recent data, 2018 vintage funds have around \$20 billion left in their coffers, which is roughly 30% of the total raised that year.

2021 isn't a great barometer for market comparison. The five years leading up to 2021 were trending to put deal count somewhere around 13,000. Instead, 2021 saw the enormous amount of market exuberance close more than 17,000 venture financings due to increased participation from nontraditional investors, which led more than 2,600 deals throughout the year, alongside the rise in venture funds over the past few years. If 2022 deal activity were to return to the pace from 2016 to 2020, we could expect around 14,000 deals to be closed, which would constitute a roughly 18% decline from 2021 but would be the highest recorded outside of that year.

### VC dry powder and new fund count



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

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## **The challenges facing public equities have led VC-backed public listings to decline drastically**

In Q1 2022, European exit value from public listings fell drastically from the highs of 2021. Record exit value was generated in Europe in 2021, as founders and investors accelerated exit plans to capitalize on pandemic-induced growth and deliver enhanced returns amid an increased desire for tech businesses. In contrast, the exit market in 2022 has been sluggish, volatile, and hampered by a tech public equity sell-off in Q1, as markets entered correction territory.

The majority of the sell-off has been caused by a pricing-in of slashed economic growth forecasts and rising interest rates in major economies. Several big tech companies' share prices have struggled in recent months, as significant portions of their value are derived from future earnings and potential growth. As long-term sentiment has become bearish, price estimations have fallen, leading tech stocks to trade below the high multiples witnessed in recent years.

While VC-backed companies are relatively insulated from daily price swings and fluctuations from quarterly earnings calls, operators and investors are being cautious instead of risking an exit that could prove costly and negatively affect a valuation built over several years. The sell-off has also increased scrutiny on the veracity of lofty private market valuations of VC-backed companies. Investors may feel that VC-backed companies that have raised capital in the past few years may have done so at valuations that are not aligned with current market expectations. Therefore, we anticipate public listing exit activity to remain muted in 2022 until confidence picks up.

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## The war in Ukraine catalyzes some support and much scrutiny of sustainable investing

The efficacy and propriety of sustainable investing in the private markets have been questioned increasingly in the past few years, with events such as the COVID-19 pandemic, the “Great Resignation,” and COP26 demonstrating both its strengths and deficiencies. More recently, the war in Ukraine has sparked debate around how companies with environmental, social, and governance (ESG) and climate-related commitments ought to respond to the war and the effects of the resulting oil supply shocks. One of the first questions raised on this topic was how the war in Ukraine affects who should be permitted to give and receive investment capital. Generally, awareness increased around exclusion of sanctioned entities—a relatively uncontroversial regulatory compliance issue. More contentious were calls to divest from unsanctioned Russian companies and refuse unsanctioned Russian investment capital—a far more difficult task for private market investors due to lack of liquidity. Another question that arose was whether investment in weapons manufacturers would now align with ESG-oriented portfolios. While most in the industry rejected the idea, many cited this query as further evidence of the subjectivity of the ESG framework.

In addition, oil price hikes resulting from supply shocks have renewed the attractiveness of investments in so-called “dirty energy.” Not only are investments in oil anticipated to yield outsized returns in the wake of the shortage, but other fossil fuels may see increased demand as energy security concerns become paramount.<sup>2</sup> Although the EU has made it clear that the green economy is a long-term priority, diversifying energy sources to increase security in the short term may mean utilizing more coal and natural gas. The potential outperformance of fossil fuels has forced investors to confront the fact that climate commitments and [purist and pragmatist](#) forms of ESG—which preclude investments in industries such as oil, coal, and gas—may not align with optimized returns. This has been a central argument against ESG from lawmakers and industry participants in the US, highlighting that investing using the principles of ESG may involve concessionary returns, and, as such, a breach of fiduciary duty. Conversely, these same events emphasize the repercussions of oil dependency, which may further accelerate investment in clean energy and sustainable infrastructure.

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2: “The War in Ukraine Is Scrambling the World’s Ability to Fight Climate Change,” *CNN*, Alicia Wallace, April 7, 2022.

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## Rising inflation is neither wholly good nor bad—it will depend

How inflation will affect a portfolio depends on many factors. We've learned from history that inflation is bad, though many of us have not experienced rampant inflation during our professional lives. There are some scenarios, however, where some private market funds may benefit. I would never advocate for market timing with a private market allocation, as once due diligence has been performed, a commitment date has been scheduled, and the commitments begin to be called down, the signal that led to the commitment will likely have reversed. But existing portfolios, depending on a number of factors, will have different reactions to inflation.

For those with something to sell, such as oil & gas or other natural resource portfolios, they will likely be able to command a higher price than was originally modeled, which is why many seek out real asset portfolios for inflation protection. Also able to benefit are PE leveraged buyouts (LBOs) with fixed rate debt that can benefit from increased revenues because of rising prices, but their debt obligation will remain the same, thus leading to improved cash margins. There will be those who suffer, however. Newly purchased companies in a portfolio may no longer have the prospects that were modeled before inflation hit—particularly those with heavy expenditures contemplated as part of the value-add proposition of the GP. In addition, companies making physical goods will find their input costs rising with inflation, and they may be unable to fully pass along these increases.

In some cases, the degree to which a private market fund is positively or negatively affected by inflation will depend on how far into the investment cycle the fund is. If a value-add real estate fund is in the early years of its lifecycle, it may still have major capital improvements to make on its properties, which will mean costs beyond those originally planned, thereby squeezing margins and returns. But a fund that made its upgrades before the inflation hit might be able to benefit from rapidly rising rents without many accompanying increases in costs.

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## Given the persistent downside volatility in liquid markets, take-privates will be a standout PE theme

For a few reasons, sponsors are likely circling many take-private opportunities for companies that are cyclically—but not secularly—under pressure. First, the quickly changing liquidity paradigm through interest rate increases, soaring inflation, and quantitative tightening is causing substantial downside volatility in public markets, which is breeding massive opportunities for sponsors to cheaply buy assets. At time of writing, the Cboe Volatility Index (VIX) has an enormous reading of 33, which is near YTD highs. As a rule of thumb, a VIX reading below 20 suggests a stable and low-risk environment. Until inflation eases, which would push central banks to reverse course, volatility is expected to persist in liquid assets. Second, opportunistic sponsors will look to take advantage of quickly falling valuations. Through April 2022, the Nasdaq-100 has declined more than 20%, while the EURO STOXX 50 and S&P 500 have seen falls in excess of 10%. We're currently witnessing one of the most aggressive sell-offs in recent years, especially in high-growth technology companies. This has caused the Nasdaq's trailing 12-month (TTM) PE ratio to drop to around 28 at time of writing—down from 36 one year ago.<sup>3</sup>

Third, one of the big differences between now and 2008 is the sheer volume of dry powder that sponsors have on hand, which must be deployed. Despite the hawkish policy environment and the very real risk of recession, sponsors will continue to be cautiously aggressive in deploying large sums, and take-privates offer great opportunities. In addition, debt financing is expected to remain broadly available through private credit funds and syndicated loans to support such deals. The recent proposed de-listings of Twitter (NYSE: TWTR), UK-based Pearson (LON: PSON), and New York-listed GreenTree Hospitality Group (NYSE: GHG) highlight this very trend.

Lastly, several companies that went public in the IPO and special purpose acquisition company (SPAC) frenzy of 2021 were a little too early and are now being punished. For instance, Sweden-based Desenio (STO: DSNO) listed in 2021 at around SEK 89 per share but now trades in the SEK 5 per share range, having lost 79.7% of value YTD. More public companies will tap the private markets for liquidity after deeming they're better off away from the quarterly reporting pressures and analyst scrutiny in what appears to be a market moving toward recession.

<sup>3</sup>: "P/Es & Yields on Major Indexes," *The Wall Street Journal*, May 10, 2022.



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## Private equity fundraising activity set to struggle

For several reasons, PE deals are slated for a pullback in activity. Higher interest rates are leading to higher borrowing costs and discount rates, thus pushing down valuations. Public comparables have slid in recent months as well, which means that some business owners are delaying selling until pricing is more favorable. However, public share price weakness may lead to an uptick in take-privates. Exit activity is similarly weak. Firms are loath to exit an investment that was worth substantially more on paper just a few months prior. However, the GP-led secondaries market is still deep and allowing for liquidity transactions in many cases.

Fundraising activity is tapering as demand outstrips supply. PE firms have been quickly returning to market, thereby overwhelming LPs' ability to fund these re-ups. Some top-decile buyout firms with track records of 20 years or longer are struggling to raise capital. However, this has been largely contained to buyout managers, especially those with heavy exposure to US public pension plans. These plans have been inundated with requests for capital, and many large sponsors are delaying fund closes and/or launches as a result. We expect many firms will have to delay fund closings or accept smaller fund closes. This is pressuring firms to seek out capital from retail, insurance, family offices, and overseas LPs to meet fundraising targets. During this turbulent time, at least three middle-market buyout shops are pursuing GP stakes deals to help shore up their balance sheets and expand their LP bases.

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## **PE's appetite for IT remains unwavering despite hiccups from inflationary pressures**

Growth in technology and digitalization across industries drove private equity to record deal and exit activity in 2021, only to face several headwinds early in the new year. Inflation soared, and tech stocks tumbled throughout the first quarter of 2022 as fears of interest rate hikes put pressure on the lofty valuations enjoyed by the information technology (IT) sector during the last few years. Growth-oriented tech companies fell out of favor because higher interest rates would reduce the net present value of expected earnings that relied heavily on future profit growth. Public comparables drove down valuations in private markets, and some investors feared that PE activity in IT will be stunted from market uncertainty, value dislocation between buyers and sellers, and PE firms holding onto their portfolio companies for longer to wait out volatility.

Despite concerns about how IT will fare in an inflationary environment, PE capital still flowed into the sector, with US PE deal activity in IT pushing forward with a greater deal value than in Q4 2021. The appetite for IT deals remained strong as investors focused on attractive secular growth prospects amid adjusting valuations. With deep consumer reliance on tech and the focus on technological innovation and efficiency front and center in business strategies for growth, the opportunity set in IT remains robust to draw in PE. Some investors, especially middle-market PE firms, even saw the market turbulence as an opportunity to secure reasonable valuations in a sector that has been pervaded by frothy valuations.

Inflation alone does not meaningfully change PE's appetite for tech investment. Strong tech companies are well-positioned to withstand inflationary pressure, with pricing power and stable cash flow growth. PE firms can adapt to these macroeconomic headwinds by pursuing companies at lower valuations and not listing portfolio companies on the public market as fervently as they did in 2021. Despite the volatility, PE's affinity for IT remains stable.

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