DON'T BE AFRAID OF A RECESSION

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As a banker whose career has spanned three recessions, I am always looking around the corner wondering when, not if, the next recession will occur. With robust GDP growth, high business and consumer confidence, a strong (albeit volatile) public equity market and interest rates still below average historical levels, one might start to wonder what could cause a reversal of fortune. There is clearly some level of exuberance and maybe a blind eye turned towards the past among capital providers within the private equity community. Acquisition multiples, leverage levels and loosely structured (i.e. covenant-lite or covenant-less) financing packages seem eerily similar to those in 2007, before the Global Financial Crisis (GFC). Could this credit bubble cause a recession, or is it more likely to be triggered by a domino effect as a result of trade wars or other geopolitical events?

While management teams and GPs may continue to ride the wave of optimism, many LPs have been altering their private equity portfolio construction and underwriting processes to hedge against a macro downturn. We are almost nine years into the current expansion, so it is easy to forget how a recession can impact businesses in unexpected ways. There have certainly been some dramatic, sector-specific shocks (for example in the energy and retail markets), but a broad economic downturn, especially a global recession, can create widespread issues. LPs are examining specific sectors, reaching deeper into historical track records, analyzing capital structures and trying to figure out derivative impacts of sector downturns or geopolitical shocks as they recognize that we are near the top of the market.

When a GP claims that they only invest in non-cyclical businesses, it should be a red flag for investors. Consumer-focused funds felt comfortable until tastes shifted dramatically, buying habits changed, delivery methods were disrupted and acquisition prices skyrocketed. What used to be considered a safe, stable sector can now be just as volatile as the more traditional cyclical industries (such as manufacturing, automotive or retail). Two of the hottest sectors today in private equity are healthcare and technology. Technology has outpaced GDP growth for as long as we can remember, and healthcare will continue to be bolstered by our ageing demographic, so investing in these sectors is a can't-miss proposition…or not.

Experienced LPs are not afraid to invest in funds focused on cyclical or rapidly changing industries; they just know how to ask the right questions regarding portfolio construction and to look at how historical portfolios have been put together. Are the companies well diversified within the sector; are their customer bases well diversified by geography, type and number of companies; and do they have separate business lines that will flourish in different environments (i.e. new products vs. maintenance and servicing)? Investors are also analyzing how a trade war or some other exogenous factor may have an impact up or down supply or sales channels. Successful GPs consider these factors, but this type of high-level questioning can be instructive as it reveals how thoughtful and forward thinking a GP is and how they will anticipate and react to a downturn. We do see some LPs shying away from the more cyclical sectors, and we think that may be a mistake as a responsible manager can effectively invest at the top of the market while also being able to take advantage of wounded companies when the market turns.

LPs have been doing deeper dives and are asking more questions about how managers performed through the GFC. This has become an increasingly difficult task as we are now nine years removed from the downturn and 10-15 years from the relevant vintage year funds, and GPs have potentially raised and invested multiple funds since the GFC. In many cases, the teams that invested the pre-GFC funds have changed or, given the surge in first-time/spin-out funds, emerging managers may not have a track record that extends through a broad downturn. Experienced GPs may become frustrated when LPs start asking about older funds with lower returns as, despite their greater experience, they feel penalized relative to newer funds, which have been investing only in a growing economy. Investors will forgive a poor-performing fund, but they want to understand why there may have been volatility in the portfolio.

In the end, consistency of returns will always be more attractive to investors than a higher-returning, but higher-volatility, fund. If there are zeros in the track record, it is important to determine if the write-offs were caused by irresponsible leverage levels or poor response time to softening portfolio company performance. LPs want to know their managers are close enough to their companies to anticipate a changing environment and take aggressive action, or bring in operating help to reposition the company for leaner times. Some of the best stories are from companies that were almost lost but through active management recovered and ended up providing great returns on the initial investment.

For those GPs that have not had to manage through a recession, LPs must infer how the manager will react given their less mature portfolios and track records. One measure of portfolio risk is the embedded flexibility of a company when faced with a shock to its performance. Excessive leverage killed companies across all industries in the GFC, and then took out many energy companies when oil prices collapsed in 2014/2015. Investors are digging into portfolios and assessing whether the level of leverage is appropriate given factors such as company size, industry focus, revenue stability and flexibility of the cost structure. They also want to make sure GPs are thoughtful about keeping capital available to support struggling companies while not underinvesting the fund. Another indication of how well a manager is prepared for a downturn is how they react to questions around preservation of capital and downside protection – just running a downside forecast is not a sufficient answer. The best and safest managers can articulate how each investment is positioned, whether structurally or competitively, to protect investors' capital.

Additionally, LPs are assessing the level of transparency provided by fund managers not only to investors but also to their management teams. Thorough and thoughtful reporting packages, open lines of communication and early notification of issues are all indicators of a GP close to its companies and well positioned to anticipate and address problems early.

There is a recession coming, we just do not know when. LPs sense we are at the top of the market and know turbulence is coming. Those investors that are asking the right questions, doing the appropriate level of diligence and not shying away from taking calculated risk will flourish.

ABOUT CAPSTONE PARTNERS

Founded in 2001, Capstone Partners is a leading independent placement agent focused on raising capital for private equity, credit, real assets and infrastructure firms from around the world.

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