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Private Equity Market Insights

BlackRock

Q2 2022

BlackRock Private Equity Partners

Key considerations in today's environment

Investors around the world face unique circumstances, and we at BlackRock Private Equity Partners (PEP) are proud to partner with many clients as they consider the challenges and opportunities in the current market environment.

As the situation in Ukraine escalates and Russia is met with sanctions, we expect continued market volatility. We are fortunate our portfolios have little to no exposure to Russia or Ukraine, but are monitoring the situation to be sure we understand any risk in the portfolio. In particular, we believe that fast-rising energy prices will affect many businesses, and potentially exacerbate supply-driven inflation; therefore, it is important to have an understanding of the current context when making investment decisions.

Based on our conversations across the industry, private equity investors are laser-focused on:

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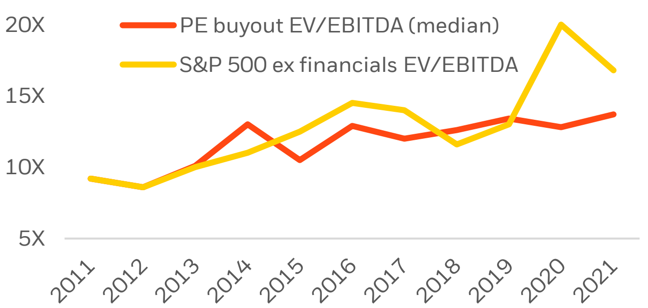
1. **Assessing valuations, interest rates and inflation**
   How can investors make sense of elevated valuations, rising rates and inflationary pressures?
2. **Evaluating the impact of COVID-19 on labor and supply chains**
   What are the implications of rising labor costs, labor shortages and stressed supply chains?
3. **Understanding the investment landscape in China**
   What meaningful opportunities exist in China given the regulatory uncertainty?

Assessing valuations, interest rates and inflation

Valuations across the spectrum of private equity remain elevated as a result of sustained investor appetite for high-quality assets. Still, all markets are expensive, and private equity multiples generally continue to trend at a discount to those of public companies.

PE buyout multiples versus S&P 500 multiples



Source: Pitchbook, US PE Breakdown 2021 Annual Report. Data as of 31 Dec 2021. Accessed 1 Mar 2022.

When conducting due diligence on a new investment opportunity, we believe it is important to assess not only company-specific characteristics, but also industry valuations through multiple cycles to understand the risk associated with potentially paying a high multiple at the peak of a cycle.

Our investment team takes a conservative approach for most traditional leveraged buyout transactions and models multiple compression when conducting sensitivity analysis, essentially assuming our exit multiple will be lower than our initial entry point and in line with long-term industry averages.

In the growth equity space, we anticipate innovative companies will continue to raise additional capital to fuel growth before going public.

We are monitoring the volatility in the tech sector and the potential knock-on effects on private valuations, and look to negotiate attractive terms and structural protections, such as preferred securities that offer downside mitigation in the form of a liquidation preference.

Inflationary pressures also impact our private equity portfolios. We evaluate our portfolio companies closely for potential EBITDA margin compression which could indicate that a business is having a hard time passing through rising costs. In general, our companies have maintained the ability to pass through price increases to date, but we are focused on assessing the sustainability of pricing power during a protracted inflationary period. In evaluating new investment opportunities, we model in inflationary pressures around wages, raw materials/commodities, shipping costs, and other inputs that are unique to each operating company.

From a more proactive cost-mitigation point of view, we are working with management teams and reviewing opportunities to apply technology, automation and best-in-class operations to drive efficiencies and to help offset inflationary costs. It is likely inflation will persist for an extended period of time so we must be confident that we have the right strategies and business models in place to grow margins and take market share.

Rising interest rates are no longer a matter of "if" but "how quickly and to what degree." Rising rates have an impact on the cost of borrowing for private equity-backed leveraged buyouts and on the valuation of assets, as interest rates impact terminal values in discounted cash flow models, possibly implying lower valuation multiples. This is another reason we assume some degree of multiple contraction when running sensitivities for new investments. In addition, capital structure becomes even more important to understand in this environment, and we are carefully evaluating covenants and flexibility around covenants should there be softness in the business.

As we evaluate new investments, we are modelling steady rate increases and assessing interest and debt coverage ratios in a rising rate environment. With all investments, we are further analyzing downside scenarios associated with a rising rate environment, and we always assess a company's ability to de-lever through free cash flow.

Evaluating the impact of COVID-19 on labor and supply chains

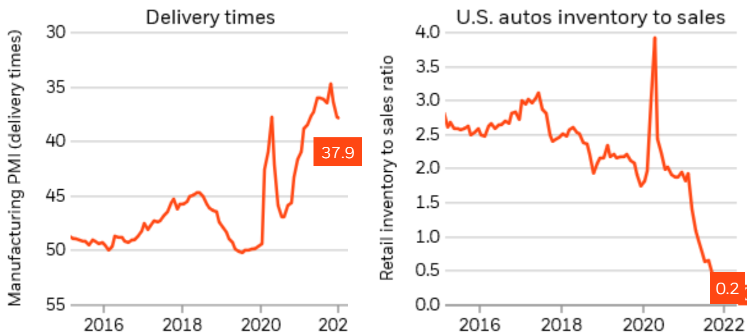
Today's labor situation is complex as businesses across industries struggle to retain talent. As a result of the strong demand for labor, we are seeing rising labor cost as businesses attempt to keep pace in the competition for talent.

When evaluating investments, we prioritize the sustainability of companies' hiring and retention programs and assess opportunities to leverage technology to boost workforce productivity. We take into consideration industry-specific nuances to the labor situation as well. For example, healthcare providers are facing worsening clinical labor shortages with many clinicians leaving the workforce. As result, these businesses are experiencing substantial increases in clinical labor expense driven by wage inflation and use of contract labor.

More broadly, as we keep a finger on labor market dynamics, we are identifying certain outsourced services businesses that might be well-positioned to benefit from customers seeking to mix-shift their labor cost structure from fixed to variable by outsourcing to address labor shortages. Navigating these labor challenges will be critical to success in the current environment.

Supply chain interruptions pose significant potential investment risk as they impact topline revenue, gross margins and EBITDA margins.

Global supply chain indicators



Source: Refinitiv Datastream, BlackRock Investment Institute. Feb 25, 2022.

Across our current portfolios, this comes in the form of raw materials, semiconductor shortages, shipping delays of consumer products, and generally longer raw material lead times. We monitor these supply shocks and collaborate with company management teams to navigate through these turbulent conditions. Successful companies are those that have built sustainable, resilient logistics operations, including the ability to tap into onshore and near-shore resources. Consistent with that theme, we are seeing strong demand for real estate and manufacturing capabilities in Mexico.

We prefer to partner with PE sponsors and management teams focused on continuously improving and modifying their supply chains to diversify their supplier base and maintain an appropriate level of control over operational execution.

"Just in time" is becoming "just in case," and while this strategy requires some degree of commitment to fund additional working capital, for many companies it has been worth the additional investment. The supply chain chaos that the world faces can yield opportunity, particularly for domestic manufacturing companies for example. We are focused on sourcing new investment opportunities that can deliver much needed products and services to companies in need of more sustainable supply chain solutions.

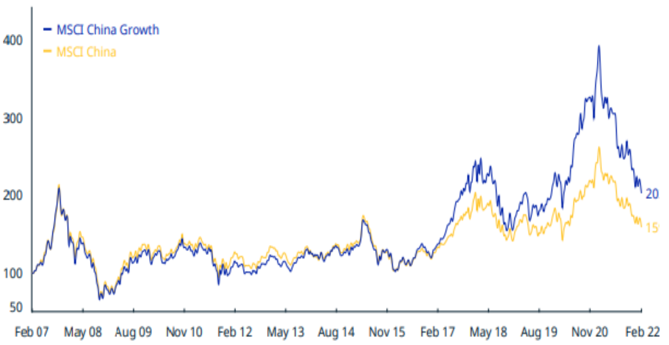
Understanding the investment landscape in China

The private equity industry in China is established and growing, and the opportunity set is significant given that the country represents the world's second largest GDP.

We consistently take a fundamental approach to evaluating opportunities in the Greater China market. Despite the current regulatory uncertainty, most of the key growth drivers that attracted us to China remain unchanged: the growing middle-class, rising discretionary income, increased demand for services and content, and a well-built infrastructure network that enables future growth.

As a result of the more cautious short-term market sentiment towards China in 2021, valuations of Chinese stocks have retreated meaningfully and largely squeezed out the froth that accumulated in the past economic cycle, as seen below.

Cumulative Index Performance – Price Returns (USD) MSCI China Growth & MSCI China



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Chart Source: MSCI. MSCI China Growth Index (USD). Feb 24, 2022.

The broad valuation adjustment has rippled into the private markets as well, where we see strong performing sectors and fast-growing, high-quality private companies now priced at more reasonable valuations. We think 2022-23 could be an attractive vintage for making selective, high-quality investments in China at reasonable entry prices.

In order to monitor real-time economic, market and regulatory considerations, BlackRock has developed extensive private equity capabilities in the region led by an experienced team of Asia-based investment professionals. We believe that it is essential to partner with leading sponsors that are deeply rooted in China, leveraging their expertise and insights as well as the views of BlackRock professionals on the ground.

These insights are invaluable, and help us to navigate through a nuanced environment and target assets in areas that are either less likely to attract regulatory scrutiny, or are promoted by current domestic policies. We see such opportunities in advanced manufacturing, green initiatives, as well as innovative medicines and devices. More broadly across Asia, we are seeing interesting deal flow in Korea, SE Asia and Australia. We anticipate the exit environment to remain robust, albeit with less focus on the IPO market given market volatility.

Ultimately, while investors understandably are focused on China's near-term regulatory uncertainty, we believe that private equity investors must take a longer-term view when evaluating the risk-return for potential new investments, and remain vigilant in their due diligence and regulatory assessment.

Want to know more?

The BlackRock Private Equity Partners team will continue to monitor all of the dynamics discussed in this Market Insights edition, including emerging considerations such as the ongoing conflict in Ukraine. We welcome the opportunities to engage further with our clients to discuss our private equity outlook as well as our differentiated origination of attractive investment opportunities in the current environment.

In order to navigate these market dynamics successfully, many clients choose to partner with experienced, cycle-tested private equity solutions providers. With 22+ years of experience sourcing, underwriting, executing and monitoring direct investments through a variety of economic and market cycles, the BlackRock Private Equity Partners' historical perspective on the private equity markets can lead to more informed investment decision making.

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Source: BlackRock. All views expressed are as of March 2022.
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