Resilience Within U.S. Private Markets Amidst the Global Pandemic

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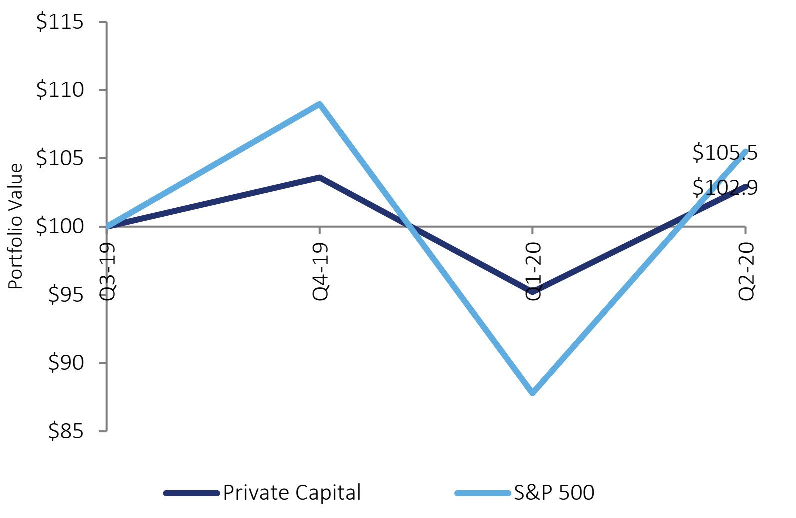
Economies around the globe continue to be adversely impacted by COVID-19. Although the full extent of the impact remains uncertain, this article examines how the different asset classes within private markets have performed in the U.S. throughout the COVID pandemic. In order to accomplish that, this article will examine both private and public markets quarterly returns between Q4 2019 and Q2 2020 to help guide the analysis.

The Backdrop

Generally speaking, public market investors experience greater liquidity with higher volatility, while private market investors experience greater stability with less liquidity. As such, the sudden economic shock triggered by the global pandemic has affected both private and public markets' returns in different ways. Here, the comparison between private and public markets helps put into perspective the impacts of COVID-19 on returns.

During the first quarter of 2020 when the first lockdown measures were put in place, private markets as a whole saw returns decline by 8.1% in the U.S. versus a much sharper decline of 19.4% for publicly-traded stocks – represented by the change in the S&P 500 index – as depicted in Exhibit 1.

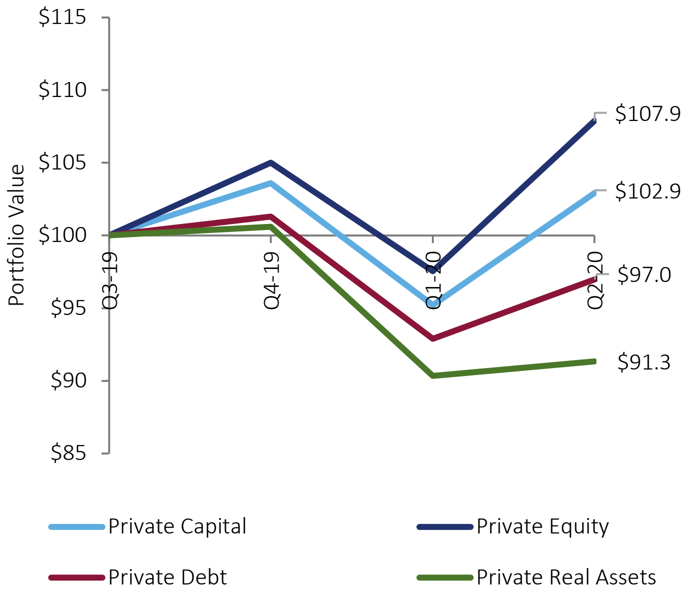
Exhibit 1 – U.S. Private vs. Public Markets Quarterly Returns*



Source: Burgiss Manager Universe as of June 30, 2020. Wilshire analysis. *Y-axis represents the market value of a fictitious portfolio valued at US$100.0 on September 30, 2019. Public markets performance represented by the quarterly change in the S&P 500 index.

There is a myriad of factors that could help explain such a gap in performance, including investors' overreaction, speculative forces, reporting lag, unorthodox valuation practices, etc. However, the goal of this article is instead to investigate which private markets strategy has been the most resilient throughout the pandemic, as well as to touch on potential reasons behind this phenomenon. To that end, Exhibits 2 and 3 dig one level deeper and assess relative performance of each U.S. private markets strategy for the first half of 2020. Notably, private equity has been the least affected strategy with a 7.1% decline in returns, versus a decline of 8.3% for private debt and 10.2% for private real assets. Why is that the case?

Exhibit 2 – U.S. Private Markets Quarterly Returns by Asset Class*



Source: Burgiss Manager Universe as of June 30, 2020. Wilshire analysis. *Y-axis represents the market value of a fictitious portfolio valued at US$100.0 on September 30, 2019.

Exhibit 3 – U.S. Private Markets Quarterly Returns Breakdown

Strategy	Q1-20	Q2-20
Private Capital	*-8.1%*	*8.1%*
Private Equity	*-7.1%*	*10.6%*
Venture Capital	*-3.0%*	*11.7%*
Growth Capital	*-6.7%*	*15.9%*
Buyout	*-9.1%*	*9.4%*
Private Debt	*-8.3%*	*4.4%*
Senior	*-8.7%*	*6.1%*

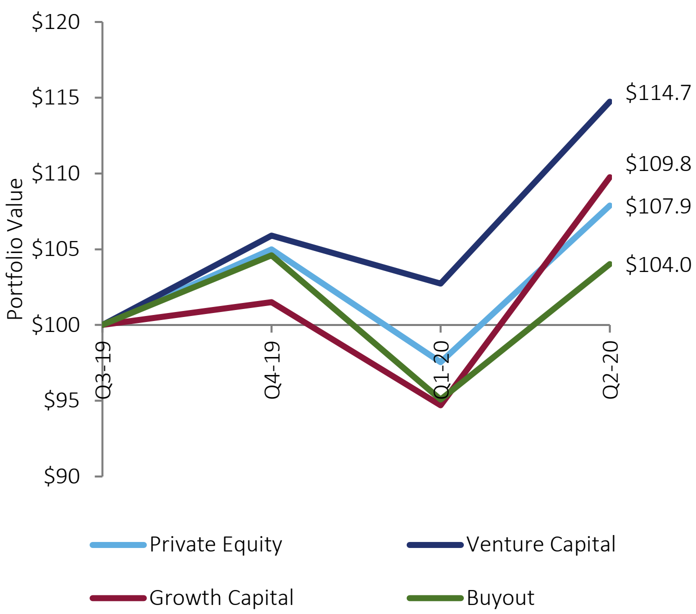
Strategy	Q1-20	Q2-20
Mezzanine	*-5.3%*	*3.4%*
Distressed	*-11.3%*	*5.5%*
Private Real Assets	*-10.2%*	*1.1%*
Real Estate	*-4.2%*	*-0.2%*
Natural Resources	*-23.1%*	*4.2%*
Infrastructure	*-7.3%*	*1.7%*

Source: Burgiss Manager Universe as of June 30, 2020. Wilshire analysis.
*Y-axis represents the market value of a fictitious portfolio valued at US$100.0 on September 30, 2019.

Double-Clicking on U.S. Private Equity

Exhibit 4 provides valuable insights and answers "why" by digging further into the performance of each individual private equity strategy, namely venture capital ("VC"), growth, and buyout. In the first quarter of the year, VC saw only a mild 3.0% drop in returns, while growth and buyout dropped 6.7% and 9.1%, respectively. Subsequent to the reopening of some parts of the economy, the overall private markets rebounded and gained 8.1% during the second quarter. Following the same trend, VC gained 11.7% in Q2 2020, solidifying its position as the single best-performing asset class within private markets in the U.S., returning 8.3% year-to-date as of Q2 2020, as shown in Exhibit 5.

Exhibit 4 – U.S. Private Equity Strategies' Quarterly Returns*



Source: Burgiss Manager Universe as of June 30, 2020. Wilshire analysis. *Y-axis represents the market value of a fictitious portfolio valued at US$100.0 on September 30, 2019. **Year-to-date absolute returns by strategy as of Q2 2020.

Exhibit 5 – U.S. Private Markets YTD Returns Breakdown

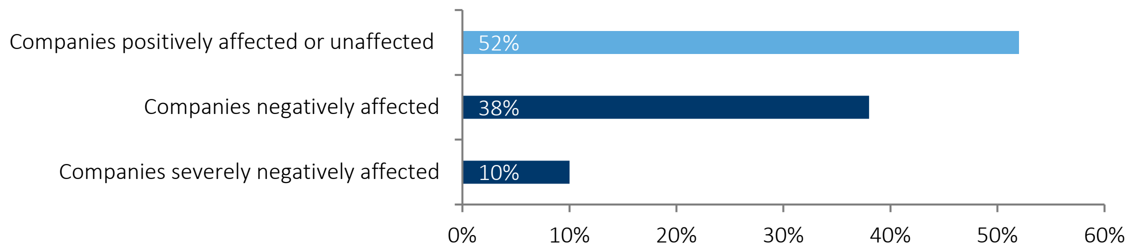
Strategy	YTD Returns**
Venture Capital	*8.3%*
Growth Capital	*8.1%*
Buyout	*-0.6%*
Mezzanine	*-2.1%*
Senior	*-3.1%*
Real Estate	*-4.4%*
Infrastructure	*-5.7%*
Distressed	*-6.4%*
Natural Resources	*-19.9%*

Source: Burgiss Manager Universe as of June 30, 2020. Wilshire analysis. *Y-axis represents the market value of a fictitious portfolio valued at US$100.0 on September 30, 2019. **Year-to-date absolute returns by strategy as of Q2 2020.

Venture Capital: Resilience Within U.S. Private Markets Amidst the Global Pandemic

In spite of the economic shock created by this "Black Swan" event, which led to business closures, mass layoffs, and government bailouts, the VC and startup ecosystem have shown resilience in 2020. In fact, a working paper[1] published recently by researchers at Harvard, Stanford, the University of Chicago, and the University of British Columbia found that VC investors expect the pandemic to only have a mild negative effect on their fund IRRs (-1.6%) and MOICs (-0.07x). In addition, the same study found that 52% of startups have been positively affected or unaffected by the pandemic as shown in Exhibit 6. On the other hand, 48% of startups have been negatively affected in some way, which suggests that a meaningful number of startups have had to reduce headcount, cut back on operational expenditures, and seek additional funding as a direct impact from COVID.

Exhibit 6 – Survey Results

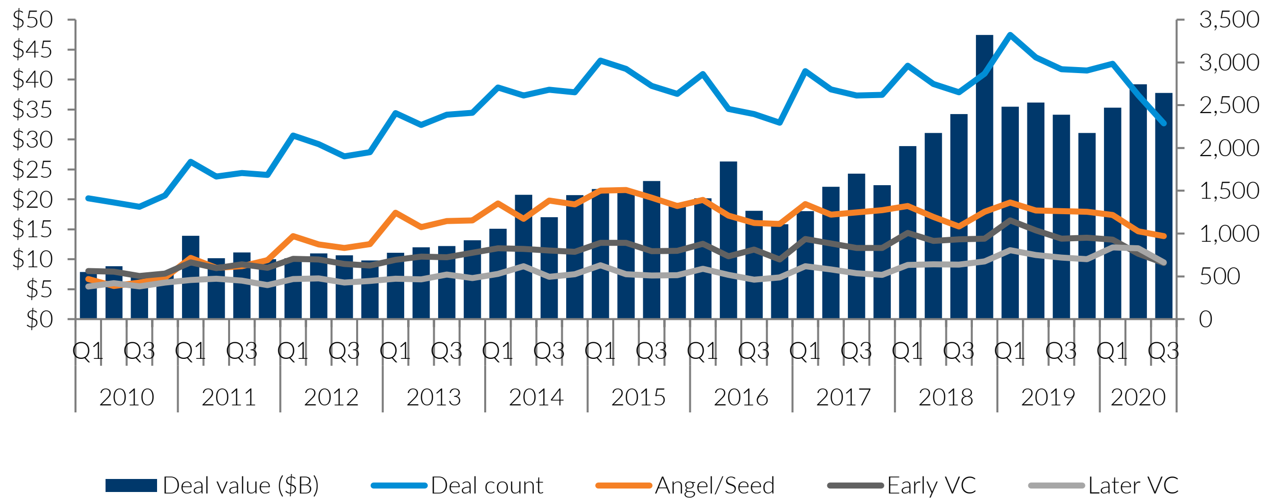


[1] https://www.nber.org/papers/w27824#fromrss

Deal Activity

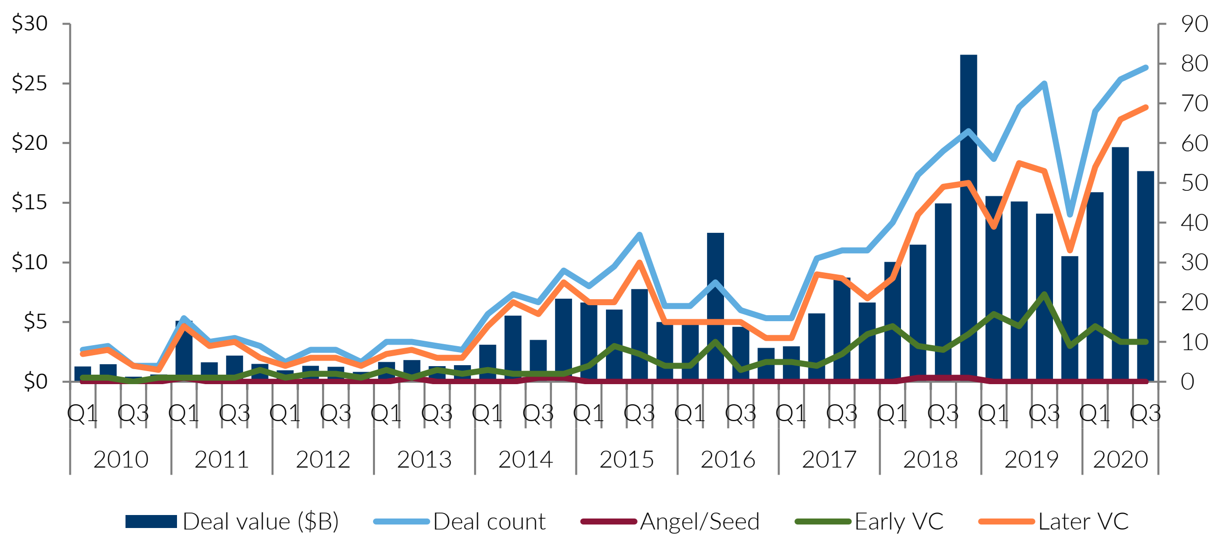
U.S. VC deal activity has remained resilient throughout the pandemic. Exhibits 7 and 8 show that VC managers have adapted well to virtual deal sourcing and due diligence. Remarkably, deal value is on track to surpass 2019 levels by the end of the year. In fact, annualized deal value through Q3 2020 represents a 9.5% increase compared to the prior year. It is worth noting, however, that even though total deal count is consistent with prior years, there has been a decrease in activity at the early stage coupled with an increase at the late stage in 2020 due to increased activity for megadeals ($100 million and above). According to some authors, the shift towards larger deals may have been accelerated by the pandemic as increased uncertainty in the markets may have driven investors to support larger, high-quality companies.

EXHIBIT 7 – U.S. VC Deal Activity



Source: PitchBook-NVCA Venture Monitor as of 9/30/2020.

Exhibit 8 – U.S. VC Mega-Deal Activity



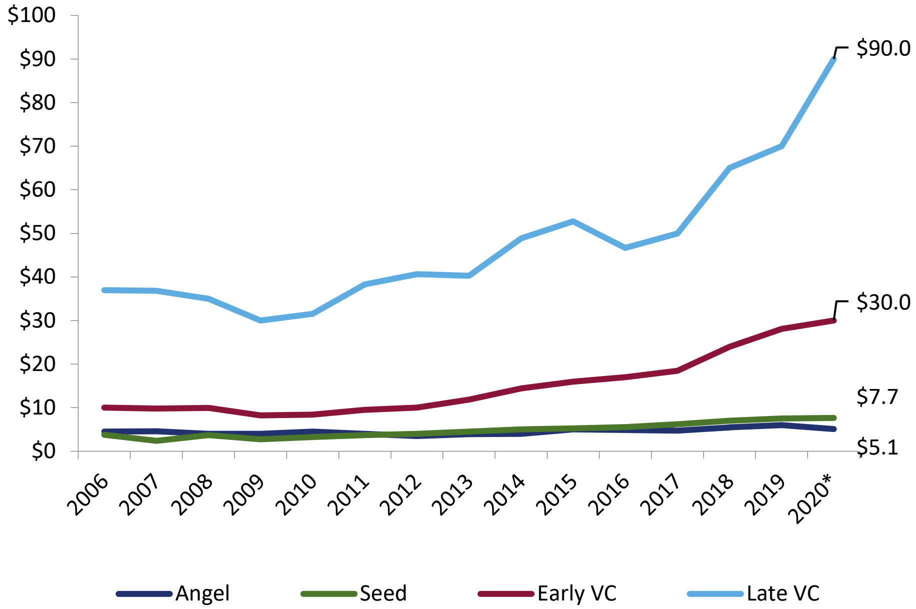
Source: PitchBook-NVCA Venture Monitor as of 9/30/2020.

Valuations

Valuations in the VC space have remained resilient and elevated in the face of the global pandemic. Specifically, median seed-, early-, and late-stage valuations continue to climb despite pandemic-related headwinds. Interestingly, angel deals were the only VC investment type to see a decrease in valuation. This dynamic suggests that investors are demanding increased compensation for the risk associated with providing angel capital for startups, or alternatively, less-risky companies displaying promising growth prospects – despite economic headwinds – are commanding a valuation premium.

In addition to a company's lifecycle stage, long-term trends within any given industry create another dimension of risk that is also incorporated by investors into their assessment of fair market value. As a result, valuations have behaved differently across sectors of the economy. More specifically, the upward trend in valuations depicted in Exhibit 9 has been exacerbated in companies that have benefited from COVID-related structural changes (e.g., e-commerce, media, gaming, video conferencing, etc.). Conversely, companies operating within sectors such as travel, hospitality, and retail have, generally speaking, not seen the same upward trend throughout the pandemic.

EXHIBIT 9 – U.S. VC Median Pre-Money Valuations by Stage ($M)



Source: PitchBook-NVCA Venture Monitor as of 9/30/2020

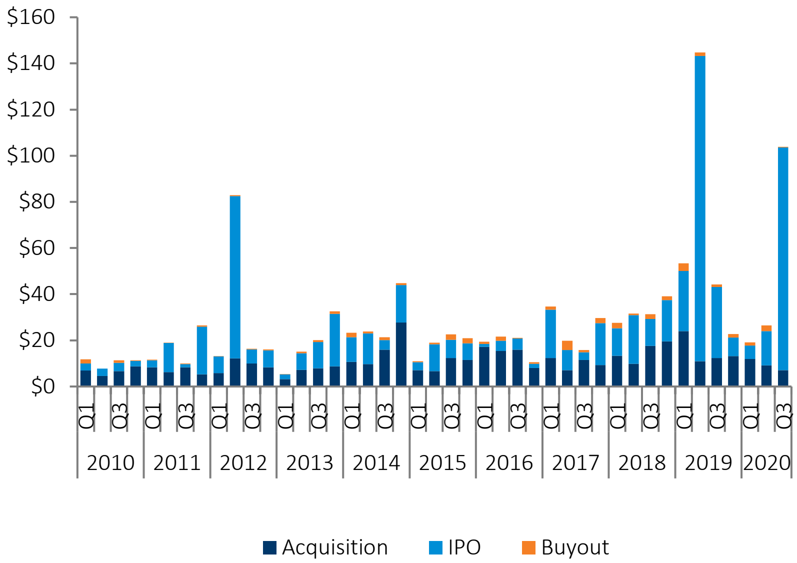
VC Exit Environment

Exits were the hardest hit aspect of the VC ecosystem through Q2 2020. However, the recent rebound in public markets over the past few months attests to investors' confidence in the recovery of the U.S. economy. This, in turn, translates into a positive environment for the startup ecosystem to flourish.

After a slow first half of the year, U.S. VC exit activity saw an enormous spike in Q3. Exhibit 10 shows a 292.5% QoQ increase in exit value as companies took advantage of the reopening of the IPO window. Specifically, Snowflake, Palantir, Asana, and Unity went public in Q3 2020, driving total exit value in the quarter to $103.9 billion, the second-highest quarterly total, only behind Q2 2019 at $144.8 billion. Notably, those four IPOs comprise 64.8% of total exit value, bringing the total number of IPOs above a $1 billion valuation in Q3 2020 to 13, which is more than the total number of VC-backed IPOs in Q1 2020.

Lastly, it is worth mentioning that in spite of the reopening of the IPO window in Q3, private markets participants continue to see special purpose acquisition companies ("SPACs") as an alternative exit route to traditional IPOs. Notably, Q3 saw the IPO of Pershing Square's SPAC, which according to Pitchbook, raised the largest-ever SPAC at $4.0 billion.

Exhibit 10 – U.S. VC Exit Activity by Type ($B)



Source: PitchBook-NVCA Venture Monitor as of 9/30/2020.

Final Thoughts

The COVID-19 pandemic has added unprecedented levels of uncertainty to the global economy, which in turn brought about the worst economic recession since the Great Depression. While some sectors have been severely impacted (e.g., airlines, hospitality, and retail), others have been able to capitalize on the opportunities created by the pandemic (e.g., healthcare and technology). Unsurprisingly, innovation is the common theme within the sectors that have outperformed year to date.

The global pandemic has also accelerated some trends already in progress pre-COVID, a phenomenon defined by Wilshire as “Distance-X”, where “X” stands for learning, working, health, playing, etc. This phenomenon may imply significant, long-term changes in consumer and business behavior, which will challenge the status quo and test companies’ ability to change and adapt to life post-COVID, or to the “new normal”. Here, once again, the most innovative startups will likely thrive and emerge from this turbulent time as new market leaders, proving once again that innovation is the x-factor behind the startup ecosystem’s resilience.

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