HMC CAPITAL

Asset Allocation Report

Investors around the globe have been increasing their exposure to Alternatives investments in the last decade, given the **outperformance** over public markets, **higher absolute returns**, and **diversification** benefits, among others. However, investors should adjust their playbook because private markets today differ from what they were some years ago.

In that sense, this Asset Allocation report aims to show the **evolution** of private markets in recent years and mention some **perspectives** toward 2023. In this first edition, this report will focus on **Private Equity**. Other strategies will be covered in subsequent reports.

Introduction

While it is relevant to look at the recent economic events and where the economy is going to formulate an asset allocation view for the upcoming months, investors should recall that private assets are long-term in nature. Therefore, it's more appropriate that investors assess the medium-to-long-term outlook before making any decisions.

In 2022, high inflation has forced Central Banks to raise policy rates aggressively, leaving the global economy on the brink of recession. In addition, the energy shock in Europe, the geopolitical tensions, and the weak performance of China due to its zero-Covid strategies and fragile property markets have not helped at all.

That said, 2022 has been a challenging year for the global markets and investors, filled with uncertainty, and this trend will likely continue into 2023. Despite this, private markets have delivered solid results over the long term, even during downturns; consequently, investors should remain **optimistic**, focus on **high-quality**, and engage in a **diversification** strategy to achieve their target returns.

At HMC, we are confident that investing in managers with a strong track record and deep moats, combined with portfolio construction discipline, is the best approach for navigating the uncertain environment.

Private Equity

As mentioned above, weaker macroeconomic conditions and geopolitical events have created a challenging environment for risk assets.

However, private equity funds have offered **resilience** regardless of the economic cycle due to the flexibility to deploy capital and the positive impact of active management.

The fact that private equity fund investments are a long-term asset class and deploy their capital commitments over several years gives managers the flexibility to time their entry and exit points. In addition, having a large amount of **dry powder** allows private equity funds to navigate better recessionary periods by injecting liquidity into portfolio companies (if needed), supporting companies in their value creation plans, or acquiring companies at lower valuations.

Although the private equity **dry powder** has dropped from US$ 1.45 tn in 2020 to USD 1.26 tn in 2022, these amounts are still high and reasonable now that dealmaking is less hectic. As a reference, trading volumes began to slow towards the end of the first half of 2022 as the macroeconomic outlook became more uncertain and valuation gaps emerged.

According to Preqin, the **deal activity** in the first half of this year declined by 18% versus 2021, a modest drop considering that 2021 was by far the busiest year for PE firms. In the third quarter, however, activity declined 55% relative to Q2 in 2022.

It was also driven by the turmoil in the leveraged financing markets; consequently, GPs faced limitations in the size of deals they could execute. As interest rates continue increasing, firms will seek creative ways to deploy capital, such as NAV financing options.

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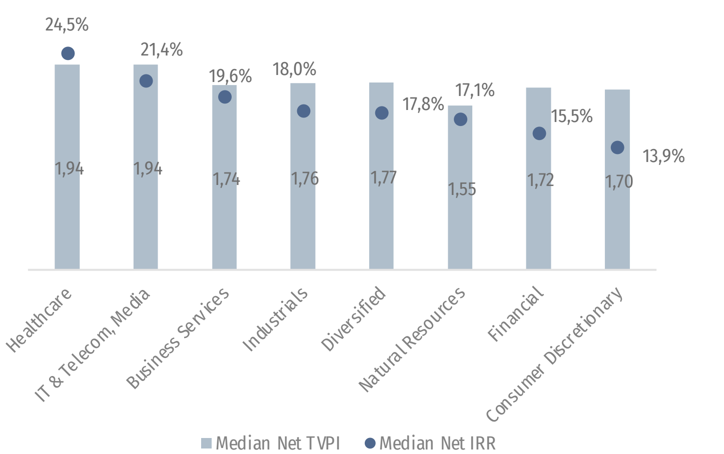
In terms of sectors, considering the trailing six-month PE deal trends in the Pitchbook dataset, more than 80% of the deal value has been concentrated in **business products & services** (34.8%), **information technology** (19.2%), **consumer products & services** (15.4%) and **Healthcare** (13.2%). Most of these sectors continue to attract capital given the strong resilience that these industries demonstrated during the pandemic, as well as in times of volatile market conditions historically.

The overweight in resilient sectors comes with an outstanding performance of those industries. To give a sense of it, the graph below shows the median performance of buyout funds from the 2000 vintage to 2019.

Exhibit 1. Performance by core industry



Source: Preqin Pro, HMC. 1,536 buyout funds with primary focus North America and Europe, as of September 2022. Sectors correspond to the core industries' exposure of each fund. Equally weighted from vintage 2000-2019

By type, **add-ons** transactions have dominated the buyout marktet. A softening of valuations from the current environment have represented an attractive opportunity for PE firms to buy smaller and cheaper business to add to their platform companies. This is especially true for companies in fragmented markets.

In the case of harvesting activity, **PE exits** fell 67% in the third quarter versus the last year, explained by depressed valuations and the widening gap in the expectation of prices between buyers and sellers. This situation is likely to persist in 2023.

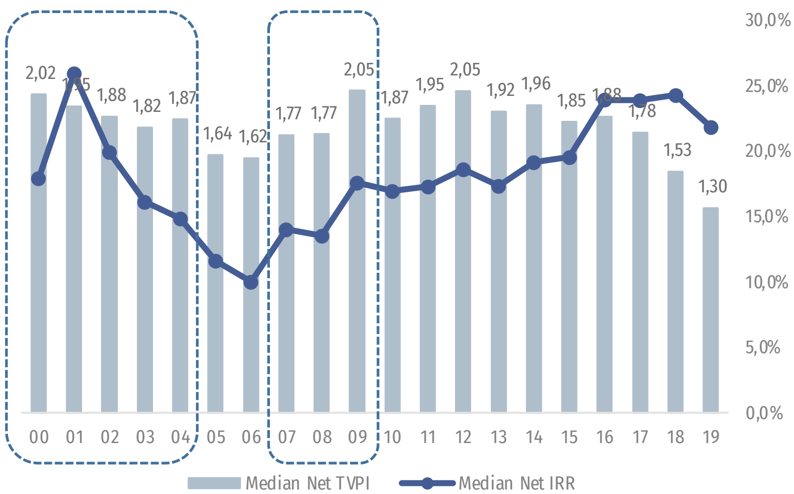
With limited exit routes, many PE firms hold on to their investments longer, mostly waiting for a more attractive exit environment. However, the secondary market could help mitigate some slack from decreasing exits, which we'll see GP-led exits continue to rise.

That said, there is no question that these are testing times. Despite this, historical data have shown that private markets have delivered better returns following the start of market downturns.

Moreover, Private Equity managers can take advantage of a lower entry point; therefore, they can acquire companies with solid fundamentals at attractive prices and then activate a value creation plan (usually called a 100-day program). As a result, portfolio companies can capitalize on operational improvements such as revenue growth, EBITDA improvement, and even multiples expansion.

The following exhibit shows that private equity funds that did the bulk of their investing at lower prices in past downturns could record higher returns.

Exhibit 2. PE Performance by vintage year



Source: Preqin Pro, HMC. 1,536 buyout funds with primary focus North America and Europe, as of September 2022.

On top of that, selecting top-performers managers becomes critical to take advantage of the current environment since the dispersion between the median and top quartile managers makes the difference.

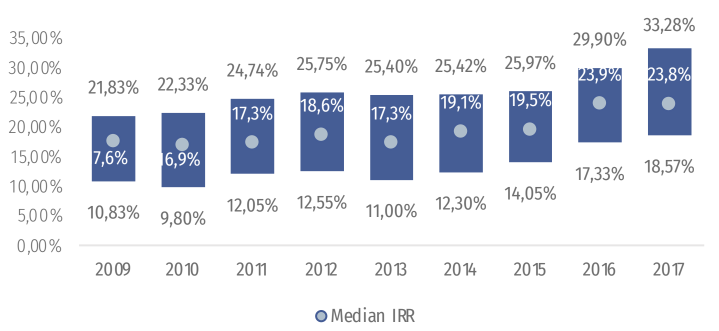
Exhibit 3. Performance equally weighted from vintage 2000-2019

Vintage 2000-2019	Net IRR	Net TVPI
Top quartile	26.8%	2.24x
Median IRR	18.2%	1.77x
Bottom quartile	10.8%	1.42x

Source: Preqin Pro, HMC. 1,536 buyout funds with primary focus North America and Europe, as of September 2022.

From another perspective, exhibit 4 shows Net IRR dispersion where PE funds vintaged between 2009-2017 have delivered returns in a range of **17.55% and 23.87%.**

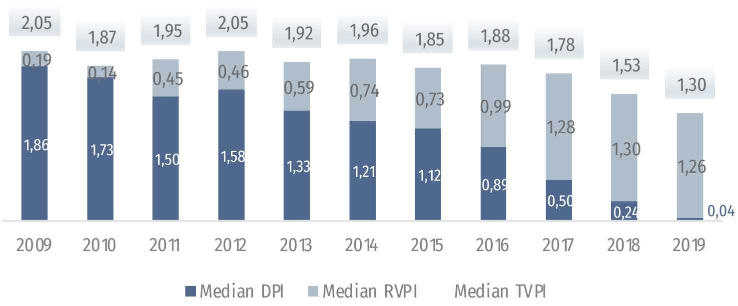
Exhibit 4. Private Equity Net IRR Dispersion



Source: Preqin Pro, HMC. 1,536 buyout funds with primary focus North America and Europe, as of September 2022. The boxes size indicates the difference between top and bottom quartile returns.

Regarding **multiples**, the median TVPI has fluctuated between **1.30x** and **2.05x** since vintage 2009. It is worth mentioning that in recent years where the RVPI represents the most significant portion given the early stage of funds, the TVPI has been impacted by lower valuations. However, those funds still have enough space to reverse the current trend.

Exhibit 5. PE Multiples

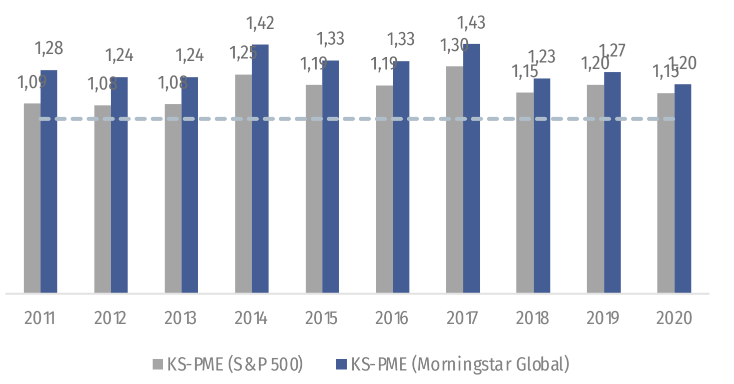


Source: Preqin Pro, HMC. 1,536 buyout funds with primary focus North America and Europe. Distributed to Paid-In Capital (DPI) measures the total capital that a private equity fund has returned thus far to its investors. Residual Value to Paid-In Capital (RVPI) measures the residual value of a private equity fund as a multiple of the capital paid in by the investors. Total Value to Paid-In Capital measures the total value—both realized profits and unrealized future profits—that a fund has produced for investors relative to the amount of money contributed.

As a complementary topic, it is well-known that another benefit of private equity investing relies on the outperformance over public markets. To conduct a fair comparison, we leveraged the **Public Market Equivalent (PME),** specifically the, which provides a market-adjusted cash multiple. As a result, if the end value is higher than one, the private market fund has outperformed the respective public market index.

Exhibit 6 shows that private markets have **consistently delivered higher returns** than public markets in the last decade.

Exhibit 6. PE PME



Source: Pitchbook, preliminary data as of Q2 2022.
KS PME is a ratio-based methodology, that compares the relative performance of the private investment to that of the index. The calculation discounts all distributions and the residual value of the fund using the index, and then divides the resulting value by the sum of all contributions to the fund, which are discounted using the index.

Lastly, in order to give more tools to investors to identify investment opportunities, HMC conducted further analysis using the Preqin Pro database.

Regarding primary region focus, we did not find any material differences in performance between funds focused on North America or Europe for either of the relevant metrics. This also applies to the top and bottom quartile managers.

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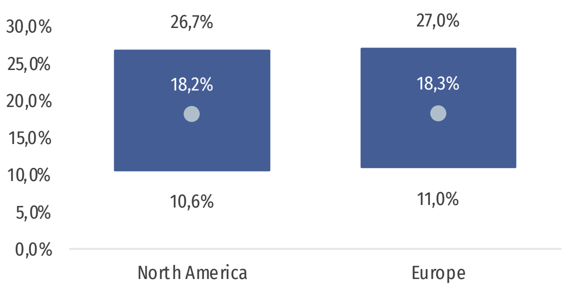
Exhibit 7. PE Net IRR by primary region focus



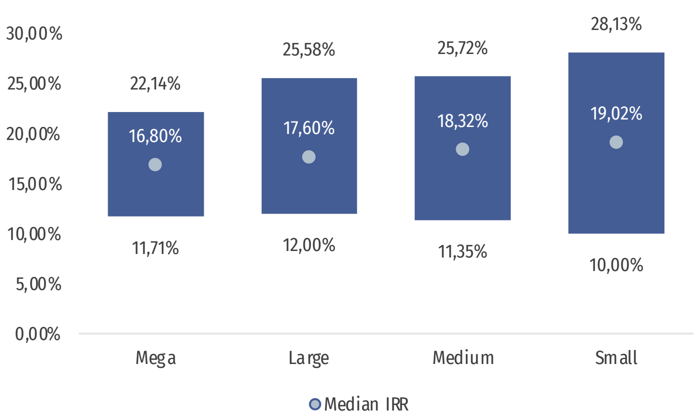
	Net IRR		Net TVPI		DPI (%)	
	North America	Europe	North America	Europe	North America	Europe
Top quartile	26.7%	27.0%	2.25x	2.18x	191.47	190.00
Median IRR	18.2%	18.3%	1.77x	1.76x	131.08	135.34
Bottom quartile	10.6%	11.0%	1.41x	1.42x	61.96	67.77

Source: Preqin Pro, HMC. 1,536 buyout funds with primary focus North America and Europe, as of September 2022. Performance equally weighted from vintage 2000-2019. The boxes size indicates the difference between top and bottom quartile returns.

Running an additional analysis regarding funds size, HMC found that small buyouts have shown higher returns, but dispersion is more significant. Therefore, investors seeking to invest in these type of funds should allocate more resources and time to conduct an extensive due diligence process.

In addition, performance between Large and Mid Buyouts is not quite different, and although Mega buyouts have shown lower returns, their performance has been more homogenous between managers.

Exhibit 8. PE Net IRR by Fund Size



Source: Preqin Pro, HMC. 1,536 buyout funds with primary focus North America and Europe, as of September 2022. Performance equally weighted from vintage 2000-2019. The boxes size indicates the difference between top and bottom quartile returns.
Small funds are smaller than US$ 500 Mn, Medium funds are between US$ 500 Mn and US$ 1.5 bn, Large funds are between US$ 1.5 bn and US$ 4.5 bn, and Mega funds are greater than US$ 4.5 bn.

TVPI	Mega	Large	Medium	Small
Top quartile	2.00x	2.08x	2.15x	2.41x
Median IRR	1.72x	1.74x	1.72x	1.82x
Bottom quartile	1.47x	1.43x	1.42x	1.42x

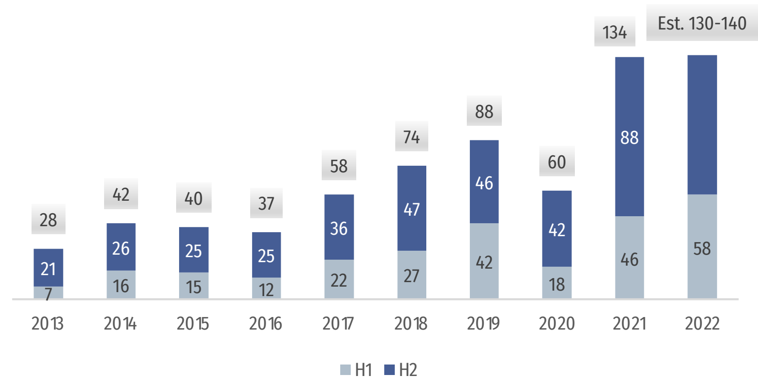
DPI (%)	Mega	Large	Medium	Small
Top quartile	165.98	174.07	183.14	210.00
Median IRR	109.21	127.64	123.56	145.00
Bottom quartile	42.29	51.46	56.94	80.44

Secondaries

During 2022, the **secondary activity** has been substantial. In the first half of the year, the volume stood at US$ 58 bn, representing an increase of 26% compared to last year. According to Greenhill, the outlook for the second half of 2022 remains positive. The total volume is expected to reach US$ 130-140 bn by the end of the year.

In contrast to previous years, **GP-led** transactions have slowed, representing 34% of the total volume compared to 44% and 46% in 2020 and 2021, respectively. It means the LP-led transactions represented 66% of the total.

Exhibit 9. Secondaries volume



	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
GP-Led	7%	19%	18%	24%	24%	32%	30%	44%	46%	34%
LP-Led	93%	81%	82%	76%	76%	68%	70%	56%	54%	66%

Source: Greenhill, as of August 2022

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The **LP portfolio management** activity is explained by the denominator effect (especially in US public pensions and endowments & foundations), fewer distributions given the slowdown in exit activities, and the need to make space for allocations to many core GP relationships who came back quickly to the market.

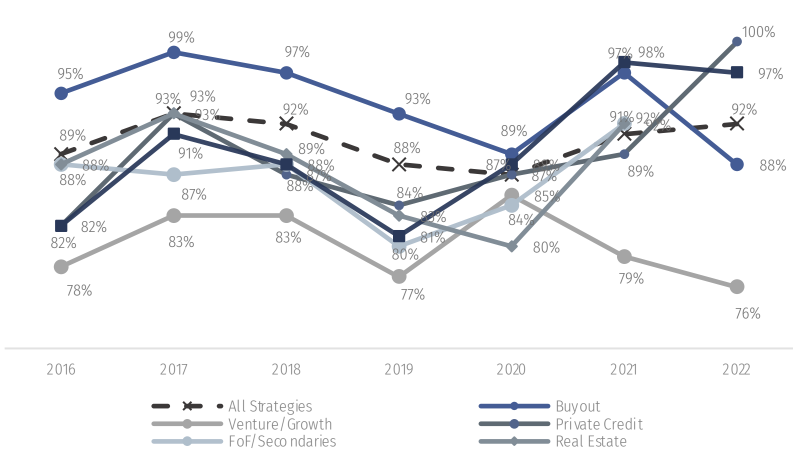
On the other hand, public market volatility and geopolitical tensions have impacted **secondary pricing**. According to Greenhill, the median high bid across all strategies in 1H 2022 was 92% of NAV, roughly flat compared to the 91% we observed in 2021.

By **strategy**, pricing for buyout funds faced the most significant decrease going from 97% of NAV in 2021 to 88% in the first half of 2022. The pricing expectation gap widened due to lower comparable multiples and more uncertainty.

In the case of venture and growth funds, pricing dropped from 79% in 2021 to 76% in Q2 2022. However, compared to 2020, it decreased by 8% due to these strategies starting to correct in late 2021 before the broader public market correction. Buyers have been cautious, given the uncertainty of whether sector valuations (especially in tech companies) have now reached a minimum level.

In credit, funds increased significantly to 100% in 1H 2022 from 89% of NAV in 2021, explained by a higher demand, which is partially met with the supply of quality funds

Exhibit 10. Secondaries Pricing



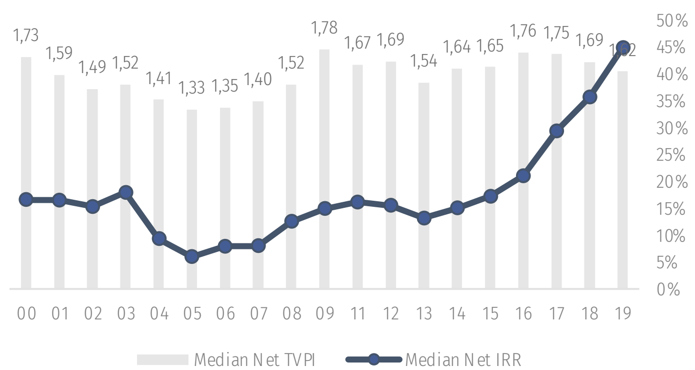
Source: Greenhill, as of August 2022

In the following months, secondary buyers would be more selective and prefer less concentrated transactions (LP-led interest bias), given the more cautious outlook for 2023.

HMC anticipates a strong buyer desire for high-quality fund portfolios (top-quartile managers and portfolios starting their harvesting stage). Buyers will also prioritize funds and assets they know best. In addition, as pricing data shows, there will also be an appetite for Private Credit and Infrastructure.

Regarding **performance**, secondaries net IRR in recent vintages is still influenced by market dislocations since LPs seek liquidity despite depressed pricing (which allows fund managers to buy interest at lower prices and then mark them up right away), and early distributions that positively impact cash flows. As funds maturate, return converges to its long-term level.

Exhibit 11. Secondaries performance by vintage year



Source: Preqin Pro, HMC. 239 secondaries funds with primary focus North America and Europe, as of September 2022. Out of date funds reduces the size of the universe.

It is worth mentioning that secondary funds have exhibited less dispersion than other PE funds. The median Net TVPI of funds between 2000 and 2019 (equally weighted) is 1.62x, and Top quartile managers have reached 1.8x Net TVPI, considering the same period.

Exhibit 12. Secondaries performance equally weighted

Vintage 2000-2019	Net TVPI	DPI (%)	Net IRR
Top quartile	1.80x	151.69	24.1%
Median IRR	1.62x	121.58	16.5%
Bottom quartile	1.43x	82.47	11.1%

Source: Preqin Pro, HMC. 239 secondaries funds with primary focus North America and Europe, as of September 2022. Performance equally weighted from vintage 2000-2019. Out of date funds reduces the size of the universe.

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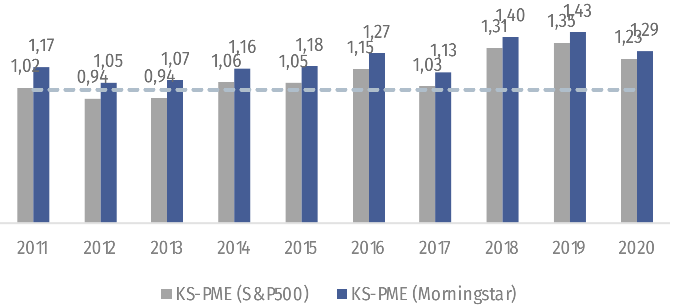
In terms of **PME**, secondaries funds have outperformed public markets in the last decade except in 2012 and 2013, where S&P500 delivered higher returns. 2012 was the best year since 2009 for the index, driven by the Federal Reserve's decision to continue supporting the economy with loose monetary policies.

Exhibit 13. Secondaries PME



Source: Pitchbook, preliminary data as of Q2 2022.

Outlook

- Although there are concerns about valuations and macroeconomics trends that could challenge exit activity and returns over the near term, Managers who focus on **high-quality deals** (with better ability to defend their margins), **fast-growing businesses** with low **leverage levels,** and **value creation plans** would be able to stay away from the volatility of public markets and provide stability to their portfolio as the cycle matures. Indeed, strong earnings growth has mitigated the mark-to-market impact thus far.

- Private companies often have more **flexibility to adapt operationally** to the changing economic environment. Without the pressures of investor redemptions, in 2023, private equity fund managers will be more likely to have dry powder to invest opportunistically as company valuations decline.

- Allocation to vintages raised at the turn of cycles and the start of recessionary periods have shown **outstanding performance**, mainly due to their investments being made while valuations decline. In that sense, although the current environment could impact current portfolios, the **2023 vintage could benefit** from the valuation reset.

- Investors who can identify **top-quality managers** could see more significant potential for alpha. It is expected a larger dispersion of returns between top-quality and poor-performing funds.

- 2023 could be also an exciting year for secondaries, both for GP-led transactions as well as for traditional LP secondaries. **GP-led transactions** can benefit from the fact that other **exit routes** (like IPO and M&A exits) are dried. In addition, it is expected that LP stakes opportunities from distressed sellers will arise during the following months. Secondaries benefit from high diversification, pricing visibility, and lower loss ratios.

Allocation

The allocation to private markets depends on the investor's specific goals and internal/legal thresholds/requirements (if any). However, private equity investments have played a vital role in the investors' portfolio construction, given their diversification properties and higher absolute returns, resulting in portfolios with an attractive risk-return profile.

Global institutional investors (especially in the US and some European countries), family offices, and endowments who usually do not face external restrictions (e.g., regulator constraints) typically allocate around 40% of their AUM to Alts, recognizing the benefits of investing in private markets.

Moreover, according to different sources, investors expect to increase their allocations to alternatives over the next 12 months since private markets have provided outsized returns regardless the economic cycle. For example, in the Intralinks 2023 LP survey 29% of the respondents, on an absolute basis, said they expect to be overweight in Private Equity.

That said, and considering all the data presented in this report, HMC encourages investors seeking consistent long-term investment returns to avoid reducing or eliminating their private equity commitments during challenging market periods because they can miss good vintage years.

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However, further commitments might focus on Private Equity managers with vast experience navigating challenging environments. Additionally, a seasoned private equity team could also take advantage of favorable investment conditions when they occur (effectively, buying low, selling higher, and taking advantage of secular growth along the way).

The following table shows an indication of the areas of focus in 2023 regarding PE investing:

	Underweight			Neutral		Overweight		Comments
Buyouts Control-Oriented						●		Control-oriented managers usually have high involvement in the companies' governance, seeking to align interests properly. It allows them to manage opportunities and risks proactively and prepare companies to challenge environments. On the other hand, operationally-focused funds benefit from outside expertise and operational support for sustainable and long-term growth, which can, in turn, attract a higher exit premium.
Buyouts Minority Investments			●					
Operationally-focused buyouts						●		
Diversified Buyouts funds						●		More diversified funds across individual positions, sectors, and geography will tend to fare better than funds holding more concentrated investments during market stress. Nevertheless, sector-specific funds could deliver stunning performance when the underlying sector has shown resiliency.
Concentrated Buyouts funds				●				
Small Buyouts			●					Larger funds usually have more capacity to invest in sizeable companies, typically less dependent on the economic cycle and better prepared to face turmoil environments. However, historical data shows that small funds have delivered higher returns, but the dispersion is wider, while larger funds have shown higher consistency. As a result, investors willing to invest in small caps funds should devote more resources and time to conduct an extensive due diligence process.
Mid-Large Buyouts						●		
Mega Buyouts					●			
GP Led Secondaries				●				Although both strategies will benefit from the deal activity perspective, diversified funds could be better equipped to navigate downturns. Given the secondaries funds attributes, it is still a strategy for investors seeking to mitigate the J curve.
LP Led Secondaries						●		

About us

HMC Capital is a global alternative investment firm with US$14 billion in assets under management and advisory from institutional and private investors. Founded in 2009, HMC Capital invests across multiple asset classes and geographies with a focus on Private Equity, Credit, Real Estate and Venture/Growth.

We operate in 7 countries with a team of 80+ professionals across the United States and Latin America providing local experience, market know-how, independence and commitment to capture and structure the best investment opportunities worldwide.

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