KEYNOTE INTERVIEW

Adapting to a new reality

Managers will need to focus on delivering alpha as the private equity industry faces a more volatile market, say Ares' Matt Cwiertnia and Scott Graves

The private equity industry has had to navigate stormy waters on several occasions during the 21 years that *Private Equity International* has been covering the market. Still, the industry has benefited from favourable economic conditions on the whole.

However, as high inflation and hawkish monetary policies return to markets for the first time in decades, the next several years could pose new challenges. Matt Cwiertnia and Scott Graves, co-heads of private equity at Ares Management, say that PE can handle those challenges, but firms will need to be able to generate alpha to do so.

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Q *PEI* launched in 2001, around the time of the dotcom bubble crash. Are there lessons learned from that period that are still relevant today?

Scott Graves: 2001 was an interesting time, right in the middle of a credit cycle. We learned a number of lessons from that cycle that still can be applied today, including our view that markets tend to over-react and over-adjust and that you cannot call the bottom. We believe that while the specific catalysts and circumstances of cycles change, certain themes and learnings can be applied across cycles.

Matt Cwiertnia: At the end of the 1990s, a lot of people were pouring money into the tech sector, based on what turned out to be an overly optimistic series of forecasts and a resulting herd mentality.

As most markets and valuations appreciated in 2021, we started to see certain dynamics that reminded us of the late 1990s. There were many signs of speculation in the marketplace, and we were seeing very optimistic forecasts on riskier investments, such as cryptocurrencies and meme stocks. Because the exuberance in the market reminded us of bubbles that we had seen previously, the Ares Private Equity Group focused on remaining disciplined with deployment in 2021.

Q The market has been favourable for PE across most of the past 21 years. How have market conditions played a role in a manager's ability to generate attractive returns?

SG: Until recently, most private equity professionals have been fortunate to have spent their careers investing in a period when interest rates and inflation have been low. We believe the low cost of capital created tremendous momentum in the business and investing cycles. Profits were enhanced in large part because companies could lever their balance sheets with cheaper debt and consumers could purchase more due to lower mortgage rates, easy to access credit and rising stock markets.

The only significant breaks were during the 2001 cycle, the 2008 cycle, the brief covid cycle in 2020 and now the down-cycle we are in today. The 2008 cycle was the longest of these, but the vast monetary and fiscal stimulus in the US brought us out of that cycle and created a sustained bull market led by balance sheet growth that lasted until 2020.

In hindsight, private equity managers generally could have maximised returns during this period by buying as much correlated market exposure, ie, beta, with as much leverage as possible, with a focus on pro-cyclical businesses. We think it was an environment for private equity where risk management wasn't rewarded.

Q Can managers use the post-global financial crisis playbook in this environment?

MC: We don't think so – our view is the paradigm for private equity has now changed. The post-GFC playbook was to buy great companies that were going to benefit from the recovery in the economy. It had a very supportive beta to it; a rising tide that would help lift all boats. Today, our opinion is that private equity managers need to generate alpha – instead of relying on beta. Managers need a playbook to help companies grow in an era that could be flat from a beta perspective for many years.

With our growth buyouts, we look to invest in companies where we believe that we can help them grow faster than their industries are growing and compound that growth over an extended period of time. Our average hold for buyouts has been about six years.

In addition, we invest in distressed across the public and private markets, and our deployment tends to ramp up during periods of heightened market volatility like today. This gives us an opportunity to invest in good companies with unhealthy balance sheets at what we believe are attractive creation multiples. Currently, we have been buying debt well below par value, and in the event of a debt-for-equity conversion, we could obtain control or significant influence of these companies for lower EBITDA multiples relative to recent transaction multiples.

At the same time, we can also use our public debt position in a company to develop a relationship with its management team or sponsor in an effort to create an attractive private capital solution outside of a formal restructuring process. In either distressed scenario, we seek to inject capital in companies for which we can be a catalyst for good and use our insights and resources to help them chart a path to growth.

Q What advantages does having integrated buyout-focused and special opportunities teams provide a PE manager?

SG: It enables a manager to have a strong relative value lens. Comparing and contrasting growth buyout opportunities with distressed opportunities in underwriting forces a manager to better reconcile risk and opportunity. We believe this is important as these investing strategies tend to be more attractive at different times. When the

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markets are healthy, that environment is more supportive for growth buyouts and healthy special situation investments. In a distressed market at the weaker part of the business cycle, we have an environment where stressed and distressed private transactions further up the capital stack tend to offer greater security, have potentially better risk-reward, and are often more actionable.

When you have a challenged economy, transaction volumes tend to drop. In our experience, you do not see the same levels of IPOs and M&A tends to slow down. Dealflow slows down because sellers still want to receive the old multiple and buyers want to acquire at the new multiple, so it takes time for M&A markets to return to equilibrium. In that period of time, we find we can source attractive distressed opportunities that can help portfolio diversification. ■

Q The term 'ESG' hadn't even been coined in 2001 but it has recently become something all PE managers need to consider. What does the future hold for ESG in PE?

MC: In the next few years, we believe there will be greater differentiation in the industry of who is truly committed to ESG. As times get tough, some managers will likely move ESG to the backburner. However, from our perspective, ESG is not a 'nice to have'; rather, it needs to be embedded in a PE manager's culture.

As a firm, Ares has sought to be a leader among alternative investment managers when it comes to our environmental and social impact, both by hiring senior resources and through ESG implementation in strategies. Additionally, we have partnered with peer firms in order to enhance the alts industry's focus on ESG. For example, a growing focus for Ares is what we refer to as shared prosperity, and we are a founding partner of Ownership Works, which is a non-profit dedicated to providing more employees with chances to build wealth through equity ownership.

The innovation and maturation of ESG programmes within the PE industry has been exciting to be a part of, and we are bullish on the long-term prospects for these initiatives.