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Three Myths of Private Market Valuations (Last of Three Parts)

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We conclude our special series on private market valuation myths with:

Myth 3: Leveraged capital structures lead to conflicts of interest amongst private equity sponsors and lenders that can create negative outcomes and lower valuations.

We asked Ron Kahn, Lincoln International's valuation chief, to help parse this issue.

"If you look at public company capital structures," he told us, "they often have complicated financings across various layers of debt and equity. These capital providers don't usually share investment priorities, so economic interests can go crossways if market sentiment changes.

"For example," Kahn continued, "if a public company needs more equity, it's hard to find it outside of a potentially dilutive raise. And it's very rare for shareholders or bond holders to work together towards a mutually beneficial resolution. This divergence of interests is the thing that can greatly exaggerate volatility in public valuations.

"In contrast, private debt markets are now where private equity sponsors go to finance their deals instead of broadly syndicated loans. Direct lenders typically have structures with small clubs, making portfolio company workouts easier to get better outcomes."

A good chunk of private credit financings are unitranches. Does that help valuations?

"One tranche structures are certainly simpler," Kahn said, "with fewer conflicting interests. Simpler is better for quicker resolutions of any borrower issues. As you know better than anyone, private equity can support lenders in challenging situations. Yes, there's a lot of capital coming into private debt, but sponsor relationships are critical to lenders getting their capital back in troubled situations.

"Maintaining loan value in portfolio companies is all about carefully evaluating and monitoring those businesses. Understanding how much and what kind of capital or flexibility they need. What will it take to avoid swings in performance before they occur."

So Ron, you need to know what's behind private and public valuations before judging the numbers.

"That's right," he concluded. "Their fundamental structural differences give private equity and credit investors some stability. We think that will persist for a while, given all the uncertainty around rates and the economy. Thanks to all the headline noise, we think private markets will be subject to many of the same challenges as public ones. But because of the unique characteristics we've been talking about these past few weeks, their valuations will likely continue to be more stable."