

PRIVATE EQUITY: PLAYBOOK FOR A NEW ERA



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Examining the private equity landscape of the past 18 months, a casual observer may conclude that the impacts of the COVID-19 pandemic were short-lived, and that the environment ahead is smooth sailing. Deal activity and exits are at all-time highs. Returns rebounded strongly since the nadir of the pandemic, and in 2020 the asset class posted its highest return in 14 years.¹ However, this smooth surface hides significant turbulence beneath. The dispersion between individual funds' performance has widened compared to the experience of the past decade, reflecting broader differences in trajectories of companies, sectors and segments of the economy.

This dispersion may be a harbinger of a turbulent era ahead—with complexities different from, and in some ways greater than, those that many investors have previously experienced. Some challenges, like digitization and automation, are accelerations of pre-pandemic trends. Others, like inflation volatility, may be reemerging after a quarter-century—but a vastly changed economy and market structure compared to prior periods of volatile inflation mean that history may offer limited guidance. Still others, such as a political and social environment in which private equity may find itself in a spotlight after years of operating in opacity, are new. All these changes are taking place in the context of record-high valuations in private markets, with attendant implications for the way managers must select and manage their investments.

Macroeconomic Environment

As the COVID-19 pandemic ebbs and flows, and societal and government responses vary by region, the path of the global macroeconomic recovery is uneven and once again highly uncertain. Expectations for growth vary across geographies. Inflation has risen to a decade high in the Eurozone and to levels not seen since the early 1980s in the U.S., making investors wonder whether an inflation regime change may be materializing—with greater volatility of inflation if not an outright resetting of inflation trajectories.

Dispersion of Returns Has Widened

Dispersion Between the Top Quartile and Bottom Quartile 1-year Returns Across All Funds Reporting in the Given Year (%)

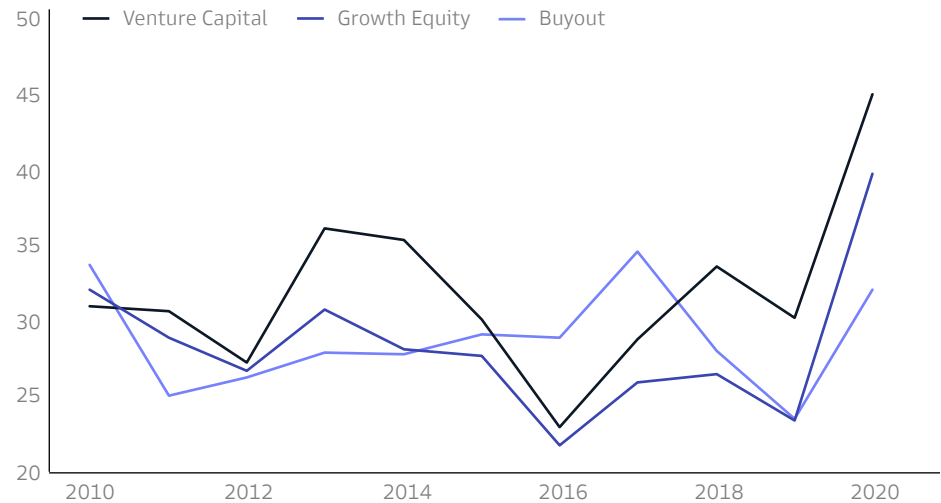


Chart Source: Cambridge Associates.

A portion of the recent spike in CPI is particular to the post-pandemic recovery and should prove temporary. Some recent wage pressure is due to concerns about virus transmission, lack of childcare, and temporarily enhanced unemployment benefits. Price increases have been most prominent in select categories of consumer goods experiencing supply chain disruptions and demand surges. However, some factors might have longer-term impacts. Wage levels may see some recalibration, as incomes at the lower end of the wage distribution have not kept pace with inflation or economic productivity. To the extent that companies reorient supply chains for long-term resiliency, some upward pricing pressure on consumer goods may remain. Even if these issues prove to be one-time resets in price levels rather than an ongoing acceleration that defines inflation, they may still impact corporate profitability.

To further complicate the picture, these economic developments are occurring against a backdrop of one of the most significant transformations in history. The development and adoption of new technologies is creating massive new opportunities to transform businesses and disrupt the status quo in everything from customer acquisition and retention to productivity enhancement throughout

the value chain. Technology is reshaping every industry. New markets and sectors are being created while others are being reinvented. Some are becoming more resilient while others are disrupted. This, too, is contributing to the unevenness of the recovery.

To a large extent, these challenges are multiple sides of the same coin. Companies whose businesses are well positioned relative to secular trends, whose products are seeing demand in excess of supply, and whose intellectual property is safeguarded by patents and other structural protections are better positioned across a range of potential economic scenarios. Companies that treat their employees well may have an easier time hiring and retaining workers in a tight labor market. Companies that are taking advantage of digitization and automation to streamline internal processes and supply chains may be well positioned to constrain operating costs and enhance margins. On the other hand, companies with outdated products or processes, a lack of structural protections, and poor employee relations will find they must adapt quickly to have a chance at survival.

Keys to Success: Discipline, Differentiation, and Data

Recognizing these dynamics, private equity General Partners (GPs) have come close to a consensus on backing structurally advantaged, environmentally and socially responsible, technology-driven businesses as a strategy for protecting against unpredictable macroeconomic forces. The prevailing view is that the old adage that “there’s no bad company, just a bad price” does not hold true today. As such, private equity investors have been willing to pay a premium for companies on the right side of the bifurcation—secular winners in attractive spaces and companies with a clear path towards success. As one expression of this strategy, many buyout managers have increased their investments in the technology sector and in technology-driven segments of other sectors (e.g., fintech in the Financials sector, healthcare technology in the Healthcare sector)—which tend to trade at higher multiples due to greater growth prospects. The investment thesis is that despite higher entry multiples, well-positioned companies can generate more value over time than is the case for deep value plays that are increasingly likely to turn into “value traps.”

The result has been record-high acquisition multiples, exacerbated in the current environment by a vibrant public equity market which, in turn, has been driving the frenetic pace of corporate acquisition activity. As multiples have climbed, seasoned GPs have come to recognize that multiple expansion is an increasingly unreliable potential source of future returns, and have been underwriting to multiple contraction as their base case investment thesis. However, this makes maintaining investment discipline more challenging, especially in well-auctioned competitive processes in which submitting the winning bid often means underwriting to lower threshold returns.

Expertise in creating value via technology should already be in the GP’s arsenal—the market is evolving too quickly to be building expertise on the go.

In this environment, proprietary sourcing channels, investment process integrity, and operational value creation take on significantly greater importance than they had in the past. Successful outcomes depend on accurately quantifying potential value creation in initial deal underwriting, maintaining underwriting discipline with consideration of these metrics, and successfully executing value creation plans.

Importantly, each value-creation plan must leverage the GP’s existing expertise. GP teams must be intellectually honest throughout the underwriting process, candidly assessing the knowledge, tools and resources they bring to portfolio companies. What assumptions are implicit in the investment underwriting process? Are plans challenging but achievable by the organization, or are they overly ambitious or outright make-believe? What is the specific path to execution on these assumptions? How will the investment leverage the GP’s insights, network, and execution capabilities?

Value creation plans will increasingly depend on GPs’ ability to harness the power of technology across the full spectrum of sectors and industries. Much of this expertise should already be in the GP’s arsenal—the market is evolving too quickly to be building expertise on the go. At the same time, GP teams should continuously enhance their expertise across areas such as data and analytics, omni-channel sales strategies, cybersecurity, and machine learning. They must recognize that the next phase of digital transformation will involve more complexity and require more insight, skill, and agility than had been the case to date.

Given that more resource-intensive value creation plans imply more active portfolio company involvement, GPs may find it advantageous to run more concentrated portfolios than may have been the case in the past, perhaps in a more focused set of industries, sectors, and/or investment

theses. One expression of this has been recent growth in buy-and-build strategies. According to PitchBook, add-on investments have made up 72% of all U.S. buyout deals over the past 18 months, compared to around 55% at the start of the decade.² Buy-and-build strategies may help mitigate higher valuations—smaller, more niche companies may trade at lower multiples—and can enable portfolio efficiencies and synergies, especially for GPs who focus on specific areas of expertise. In these aspects, financial sponsors may become more akin to strategic buyers.

We believe a target-rich environment should act as a tailwind for private equity managers. Through our investment banking franchise, we have observed that large corporations are reassessing, reimagining and reshaping their businesses for the post-pandemic landscape. Following years of robust corporate acquisition activity, the average large company has more distinct business lines today than had been the case coming out of the prior two crises. Now, many companies are looking to simplify their business mix. Candidates for divestiture are likely to be smaller business lines that may have been under-invested in by their corporate parent, their size and value-creation potential making them attractive private equity targets. Coupled with mergers and acquisitions (M&A) activity driven by potential tax changes in the U.S., the M&A and divestiture environment is in a “super bloom.”

Socio-Political Environment

The focus on environmentally and socially responsible business practices has been accelerating. Within the last two years, the Business Roundtable of CEOs of leading U.S. companies has formally redefined the purpose of corporations to serve the wider set of stakeholders, including customers, employees and communities, and the number of companies that have committed to net-zero targets has reached as much as one-fifth of the world’s 2,000 largest public companies. As part of this mega-trend, asset owners are increasingly holding businesses and their managers accountable for their practices.

After years of operating in relative opacity, GPs may now face more scrutiny from both legislative and regulatory organizations, as well as from Limited Partners. Future allocations may be contingent on investments and practices that are

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satisfactory to LPs' governance boards and socially-conscious consumers and beneficiaries. GPs would be examined both as individual asset managers and collectively as an industry. Are their environmental practices rooted in sustainability? Are portfolio company workers at the lower end of the wage spectrum participating in the value they are helping to create? Is private equity exacerbating or mitigating inequalities in society? What is the impact on consumers?

As part of this scrutiny, we expect GPs to face demands for dramatically higher levels of transparency and disclosure of their operations and their portfolios' underlying positions, operational plans, metrics, and progress. GPs who lag in transparency may encounter significant headwinds when raising funds, even if their historical performance has been attractive.

Key to Success: Walking the Talk

GPs will need to prove themselves to be sustainability- and socially-conscious partners to their businesses and communities. They must be systematic in addressing environmental, social

and governance issues in their portfolio companies, with clearly identified goals and specific metrics to track progress. It will be important for GPs to view these considerations not just through the lens of risk management (which is now merely "table stakes") but rather from the lens of proactive improvement of their portfolio companies along multiple dimensions of impact. As sole (or majority) owners of businesses and prominent voices on governance boards, private equity GPs are uniquely positioned to effect change—and their Limited Partners will look to them to do so.

GPs will need to budget for the transition to sustainability in the value creation plans for their portfolio companies and to develop the personnel and processes to manage this critical lever of value creation. Retrofitting existing properties for energy efficiency, redesigning transportation processes and supply chains to enhance sustainability, maximizing energy efficiency, and switching to renewable energy sources will all require investment.

Evidence suggests that a focus on environmental and social initiatives has meaningful positive impact over longer-term horizons, but as with all investments, defining objectives, focus, and prioritization will be critical as this domain matures and more objective criteria are established for measuring success. Private equity GPs should take advantage of their long time horizon and multi-asset scale to assume a leadership role and to position their portfolios to benefit from these long-term supportive secular trends.

Closely related is the need for GPs to identify and track relevant, measurable metrics to quantify their impact. The challenges of identifying the right metrics to track, balancing tailored relevance with aggregable portfolio-level metrics, is appreciated by many. In some areas, regulatory bodies and industry groups have offered guidance; in other areas, such efforts are in earlier stages, leaving GPs with more latitude but less guidance.

Increased transparency will necessitate more comprehensive data collection, analysis and reporting processes—which

will require significant investment in technology to streamline these functions and improve efficiency. According to a study by IHS Markit, more than half of private equity firms now use or expect to use next-generation data and analytical tools, and half now use or expect to use artificial intelligence, with reporting being a key area of focus.³

A Greater Urgency

Adapting to the new era has taken on increasing urgency for private equity managers. Until now, GPs have been able to rely on accommodative capital markets and fairly straightforward operational improvements to drive returns. This paradigm is now shifting. The ability to deploy capital in a disciplined manner and to generate alpha from complex operational value-add may be tested in unprecedented ways. GPs who are taking a leadership position in proactively addressing these challenges and building the necessary skills and capabilities are likely to be rewarded in both performance and heightened investor interest. The laggards may face increasing headwinds. The stakes to get it right have never been greater. ■

Sources:

1. Cambridge. Pooled returns for the year 2020 for the universe of buyouts, growth and venture strategies, compared to annual pooled returns since 2000.
2. PitchBook U.S. PE Breakdown, Q2 2021. Data through June 30, 2021.
3. IHS Markit. "Tech Adoption In Private Equity Is Accelerating - Here's Why," 6/8/2021.

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