

## KEYNOTE INTERVIEW

## The changing state of private equity



*The current market environment is unique compared to previous cycles, says Goldman Sachs Asset Management's [Bradley Gross](#)*

**Q To what extent has a higher interest rate environment impacted the types of deals you are pursuing?**

The dramatic rise in interest rates experienced since early 2022 has had an irrefutably chilling impact on M&A activity, particularly sponsor-related activity. However, we have seen a higher proportion of proprietary transactions take place as companies and owners seek solutions to their needs, driven either by a need to restructure, a desire to raise capital to finance acquisitions, or to fund opportunities presented by nearshoring, the climate transition and supply chain resilience. This is in stark

---

SPONSOR  
**GOLDMAN SACHS  
ASSET MANAGEMENT**

---

contrast to the change of control, heavily intermediated processes that dominated the market prior to the last 12 to 18 months.

**Q How have higher rates impacted the way you structure deals and your approach to risk management?**

We have always had a strong risk management philosophy around hedging rates and other macro factors, such as currency, that lie beyond the scope of

our underlying investment process. The current environment has heightened our focus on risk management even further.

Recent transactions have demonstrated lower leverage in absolute terms to achieve acceptable debt service coverage levels. This has generally been offset by lower valuations, structural protections, or a combination of the two, which in my view create a more interesting risk-reward dynamic.

It is exactly this need for valuation recalibration that has hampered recent M&A activity and increased the need for creative dealmaking. There have been several instances where we have effectively played the role of what would

have been subordinated debt in earlier incarnations of the capital structure, but with full equity upside participation.

There have also been situations where we have focused on high-growth platforms in the education technology and technology consulting sectors, for example, that have not required significant leverage at the outset, but where there is optionality for leverage at a later date when the companies have scaled and the interest rate environment is more accommodating.

### **Q How is this environment impacting exits?**

We are a mid- to upper-mid-market investor, typically seeking to acquire businesses valued at between \$500 million and \$1 billion. Initial public offerings are not a prevalent exit mechanism in that space. Historically speaking, our exits have been fairly evenly split between sales to strategic acquirers and financial sponsors. However, strategic appetite is currently significantly higher than sponsor appetite because it is less dependent on leverage.

I would add that, for us, the key to navigating the exit environment is optimising operating performance – building better businesses through supporting our management teams with the full breadth of resources available to our platform. If that is achieved, the exit will generally work itself out. If we were focused on significantly larger companies that are more reliant on IPO exits or multi-billion-dollar sponsor commitments supported by high absolute levels of leverage, our narrative would be somewhat different. Those channels are certainly severely compromised right now.

However, the challenging exit environment is also creating some interesting investment opportunities. We are increasingly seeing high-duration portfolios pursuing alternatives to outright sales. An enormous number of private assets have been acquired over the past five to 10 years and a large proportion are not readily saleable today

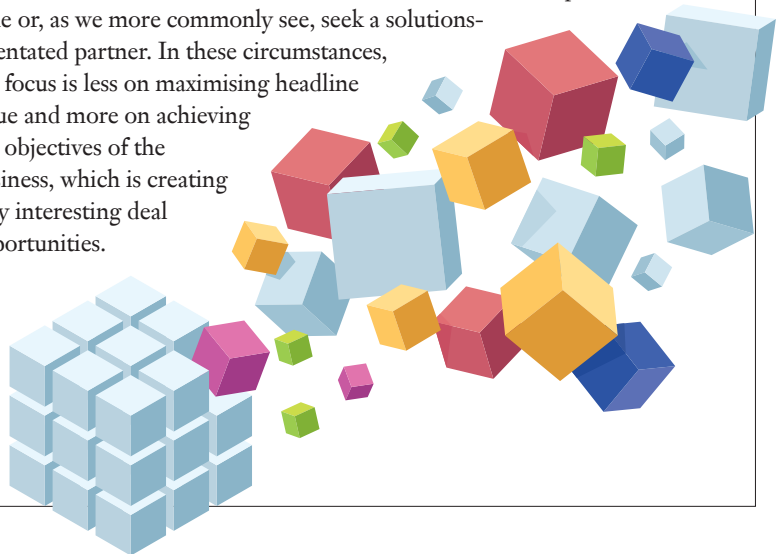
### **Q What buy-and-build opportunities are present in today's market?**

Many of our most successful investments have involved buy-and-build strategies that have enabled us to buy down valuations over time. Underlying growth characteristics that may command a premium in a platform company can be accessed at lower valuations in bolt-on acquisitions.

Buy-and-build also plays to the strengths of private equity practitioners. The model is driven by deal sourcing, due diligence, documentation and negotiation – all skills that the asset class has in abundance. Meanwhile, the success of a buy-and-build strategy relies on enhancing organisational capabilities and improving systems and processes. These are all areas where private equity can lend its strength.

Obviously, buy-and-build programmes are voracious consumers of capital, which is more expensive today. We are finding situations where business growth is constrained by the existing capital structure, or where a high level of leverage put in place in a prior era is no longer sustainable or refinancable.

In either situation, the business must either sell at a sub-optimal time or, as we more commonly see, seek a solutions-orientated partner. In these circumstances, the focus is less on maximising headline value and more on achieving the objectives of the business, which is creating very interesting deal opportunities.



at levels that achieve the objectives of their owners. These companies require a degree of re-equitisation to right-size capital structures and fund growth opportunities. Providing solutions that meet these needs is a very active area for us right now.

### **Q In which sectors are you seeing the most interesting new investment opportunities?**

For us, the covid-19 pandemic and its aftermath only reinforced the importance of focusing on a core set of

subsectors that benefit from long-term above-GDP secular growth trends and mitigated cyclicity, including healthcare, business services, financial services, technology and climate transition. While in recent years, the capital formation pursuing investments in these sectors – exacerbated by a low-rate environment – had stretched valuations, we are now seeing a more rational market backdrop.

For example, take-privates of dislocated technology companies represent an interesting opportunity set. While private markets have typically lagged

public markets in their willingness to capitulate on value, we are increasingly seeing attractive opportunities in minority equity and structured solutions.

### **Q Which other areas of portfolio company support are taking up a lot of your time?**

The current environment has certainly been challenging and unprecedented relative to the experience set of most management teams. That being said, we found that the global health crisis in 2020 enhanced relationships between management teams, boards and our investment teams, catalysing greater engagement and an openness to transformational change.

We have since found that our breadth of capabilities across end markets and geographies has proven to be extremely helpful in dealing with the challenges posed by inflation, which can be re-interpreted as opportunities around pricing. Combining procurement and pricing resources has enabled companies to be more thoughtful in defining and articulating price changes to customers.

Supply chain issues have also been widespread. We have found that sharing best practices and leveraging our supply chain resources has led to meaningful improvements in dealing with short-term challenges. We expect this focus on operational excellence to

continue to bear fruit in a more normalised environment.

I would add that weaknesses in data, processes and controls have been shown to be extremely costly in this environment. We have spent considerable time on organisational structure, devoting resources to supporting financial planning and analysis, as an example. Additionally, the need to interact with employees and customers remotely, and the acceleration of the omnichannel operating environment that began during the pandemic, has evolved into an expectation for businesses.

Digital transformation has therefore become an even more pressing need and is a significant area of engagement and application of resources. However, this transformation doesn't occur in isolation, so we are providing support across the investments needed in infrastructure, talent and strategy necessary to differentiate ourselves from the competition.

Finally, we think that the work done with portfolio companies around digital opportunities will translate naturally into opportunities to leverage artificial intelligence as a source of competitive advantage. We currently have a dozen pilots spanning customer engagement and communication, R&D productivity and workflow automation.

### **Q Is this environment markedly different from previous cycles when the market was deemed to be easier?**

Having invested through previous cycles, from the aftermath of the dotcom bubble and September 11 to the global financial crisis, I would say that none of those environments felt particularly easy at the time. It is true that valuations in public markets and debt securities corrected more dramatically and for a more extended period of time than the brief window we witnessed in 2020, but this is a reflection of the overall economic environment and the strength of capital markets that we enjoy today.

In each of those prior periods, broad public markets company operating performance was meaningfully more challenged than is currently the case. Excluding the most restricted periods of covid, we have generally experienced healthy earnings growth. Looking at broad market metrics, for instance the S&P 500, there was some softness in the first half of 2023, but we moved towards mid-single-digit earnings growth in the second half and are anticipating something closer to 10 percent earnings growth in 2024. While industry veterans may yearn for the halcyon days of five to six times EBITDA multiples, the reality is those were always few and far between.

We have far deeper and more resilient capital markets today and many more sources of private investment, which gives us more tools to work with than were available in prior cycles. It is precisely because operating performance across most sectors has remained reasonable and because capital structures generally have duration – lessons have been learned and there are not a lot of unnatural holders of risk – that I believe we have not yet seen the full impact of this cycle. That does not diminish the scale of the opportunity, but has merely deferred its realisation.

The opportunity set we face today also needs to be considered in the context of the various structural changes that have taken place over the past few decades. In 2000, there were around 7,000 listed companies in the US – today that number has fallen to 4,000, according to data from the Center for Research in Security Prices. Combine that with the vast sums of private capital required to fund reshoring, the energy transition and other transformative trends that are taking place across various industries, and I believe the market environment ahead of us may be looking even more attractive than it did in previous cycles. ■

Bradley Gross is global co-head of private equity at Goldman Sachs Asset Management

*“The challenging exit environment is also creating some interesting investment opportunities”*