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PRIVATE EQUITY

As a result of macroeconomic and geopolitical uncertainty, dealmaking in the private equity market notably slowed in the last 18 months. Among a number of challenges, a less familiar environment resulted in anaemic growth for many portfolio companies and less attractive exit alternatives due to the higher cost of debt capital. But with the factors destabilising deals improving, the market anticipates an increased appetite for acquisitions in the months to come, heightening competition for assets. ■

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FW: Reflecting on the last 12-18 months in the private equity (PE) market, how would you characterise recent activity and general developments? Where are PE firms focusing their efforts?

Howard: The last year has been a period of notable decline in private equity (PE) M&A activity. In the UK, we have seen deal volume and value fall by 20 percent compared to 2022. The well-known culprits of macroeconomic uncertainty, geopolitical tensions, inflation and interest rates have all combined to create the perfect storm for M&A caution and a period of retrenchment. That said, there are still a number of bright spots in terms of sectors, with resilient, defensible businesses in technology-enabled business services, FinTech, healthcare and education remaining in high demand. There was also a notable shift toward portfolio bolt-ons, being a somewhat derisked strategy compared to platform deals.

Bartell: PE funds are faced with a less familiar environment than ever before, including anaemic growth of many portfolio companies and less attractive exit alternatives given the higher cost of debt capital. This has forced many PE funds to get creative with financial engineering, for example selling a portfolio company to a continuation fund or merging two private companies to generate synergies prior to exiting in 2025-26.

Nayyar: On the one hand, we have seen rising interest rates and geopolitical unrest create an inhospitable deal-doing environment. On the other, PE sponsors are sitting on record amounts of capital. Firms have looked to demonstrate to their limited partner (LP) investors that, notwithstanding market headwinds, they can still effectively deploy those funds for their current portfolios and with an eye to future fundraising. On exits, we have increasingly seen PE houses shift from a full exit to now partaking in partial cash outs and reinvestments. And why would they not? A known business and well-loved management team is a comforting and intuitive port in a stormy market. PE funds are doubling down on their 'favourite' sectors to drive returns.

Gray: M&A has been subdued, particularly larger transactions where raising financing has been more of a challenge. Debt has been pricier and larger facilities have been trickier to raise. After a flurry of deal activity during and after the coronavirus (COVID-19) pandemic, many general partners (GPs) are showing caution when bidding in the current environment to ensure they are maximising pricing and debt terms. In certain sectors there have been specific issues facing portfolio companies, such as overstocking, which has been a material issue for some retail businesses post-COVID-19. In other sectors we have seen increased activity. After a lull in technology and software-related opportunities, we have seen activity building through the start of 2024 and the financial institutions group sector remains extremely active.

Dambre: It is no secret that dealmaking slowed in the last 18 months, as the industry faced a number of challenges. On the one hand, buyout funds have amassed record levels of dry powder, but on the other hand, they have had difficulty deploying it, due to high valuations, limited quality assets on the market and tight financing conditions. On the exit side, many funds are under pressure to return money to their LPs, as they reach the end of the investment lifecycle on many portfolio companies bought between four and seven years ago, but they have faced a disconnect with buyers on the pricing of their assets. However, I am optimistic that 2024 will see a rebound in deal activity, as both buyers and sellers adjust to the current market realities and find more alignment on valuation expectations. We see a lot of continued interest in certain sectors, such as energy, infrastructure and life sciences.

FW: What strategies are PE firms using to source, structure, finance and complete deals in the current market?

Bartell: More PE funds are over-equitising their new buyouts in the anticipation of lower interest rates and higher availability of debt in late 2024 and 2025. At this point, a PE sponsor will use credit markets to finance add-on acquisitions, or take out a one-time dividend to rebalance the capital structure and enhance investor returns.

Nayyar: With comparatively few tasty assets coming to market, PE sponsors increasingly need to demonstrate an edge in order to be the winning bidder. This involves more than just paying sticker price, as ever, the key determinant. Sponsors need to demonstrate real added value. Execution readiness by fully equity-funding deals, lack of friction on regulatory consents, flexing internal networks with industry leaders to provide access to key players, favourable co-investor terms for an exiting house looking to retain a minority stake, and pointing to credible track records in taking businesses into international markets, are all strategies that the savvy investor will marshal to get that edge.

Gray: We have seen sponsors working on creative angles for bilateral deals, including identifying creative opportunities for carve outs and all-paper transactions, particularly for more mature complementary businesses. Private credit helped many transactions through 2023, though the traditional debt markets are showing signs of life this year which, alongside more attractive terms and pricing, is promising for larger transactions to get going again. We are starting to see these signs ramping up more intensely, particularly in the US. A drop in base rates will only help to move this along.

Dambre: Financing deals using traditional bank debt has proven to be challenging in the high interest rate environment of the last 18 months. However, with the hope that the Federal Reserve will cut rates later this year, we have observed a notable resurgence in leveraged buyout financing activity since the end of 2023, which is expected to bolster PE dealmaking prospects. Sponsors also found alternative ways to finance deals in the meantime, through private lending of course, but also via seller financings, rollovers and preferred equity. To alleviate sellers' concerns

over financing risk, sponsors were often willing to backstop deals with full equity commitments, with plans to syndicate the equity between signing and closing and finance a portion of the purchase price with debt once rates come down. The ability to tap into capital from existing LPs, sovereign wealth funds and pension plans has been more critical than ever to a sponsor's ability to bridge that gap.

Howard: There has been a noticeable shift toward bilateral transactions, with a decline in participation in the highly competitive auction processes prevalent in 2021 and 2022. This trend aligns with the increased level of due diligence required by PE investment committees, leading to longer deal processes. Bilateral negotiations offer a more accommodating environment for this comprehensive review process. Furthermore, the current cautious economic climate has resulted in greater flexibility in deal structures. We have seen a rise in earnout transactions, with an element of the purchase price being contingent on the future performance of the target company. This shared-risk approach is often employed to meet valuations requested by sellers. Additionally, the high-interest rate environment is contributing to a larger equity component in deal financing.

FW: What methods are PE firms deploying to create value and generate returns from portfolio companies?

Nayyar: While 'innovation' is a cherished concept, the reality is that sponsors have always looked to strategies that are tried and tested to create value as efficiently and productively as possible. At the lower-cap end of the market, investee companies – particularly fast-growth – can still benefit hugely from process improvement units within their PE investors to help professionalise processes such as procurement and contract renewal. Although not glamorous or 'cutting edge' necessarily, this can provide real, tangible value. Of course, 'buy and build' strategies have been particularly active as a way of building market share within an already proven portfolio concept. Like a good director of football and a club manager, the best investors work closely with their management teams and develop processes that allow multiple acquisitions to take place and, crucially, be well integrated. Examples include the multiple PE roll-up plays we have seen in the last 18 months in the accountancy and professional services sectors.

Gray: Although capital markets and private exits have been quieter, GPs have been looking at alternative ways to return capital, such as private credit, dividend recaps and fund-level financings. Continuation funds remain a neat route to liquidity or a means to hold on to desirable assets. Plus we have seen a lot of activity in the secondaries market. In terms of optimising their portfolio, many larger GPs have looked to big data, which has shown significant promise both as part of investment and origination processes, as well as during the lifecycle of the portfolio to help enhance returns.

Howard: Portfolio bolt-ons have emerged as the main strategy for enhancing the value of portfolio companies. In its most basic form, this approach leverages multiple arbitrage, where a smaller company is integrated into a larger platform, potentially benefitting from a more attractive valuation. However, the true value proposition of bolt-on acquisitions often extends beyond this. Cost synergies, achieved through operational consolidation, are a common benefit. Additionally, revenue synergies can be realised through customer base sharing, cross-selling opportunities and expanded market access. Beyond portfolio acquisitions, we have witnessed a growing emphasis on data-driven insights for portfolio companies. This approach involves the deployment of advanced analytics to drive operational and financial improvements. A significant area of focus within this strategy is customer profitability analysis, which can be surprisingly challenging for many businesses. By leveraging data analytics, companies can gain a clearer understanding of customer value and make informed decisions regarding customer retention strategies. This can result in a streamlined portfolio and improved overall financial performance.

Dambre: For nearly a decade, PE firms benefitted from a low-interest rate environment, which mechanically boosted exit multiples regardless of underlying profitability metrics at the portfolio company level. However, the landscape has shifted. To unlock value, investment teams have to focus more than ever on enhancing operational efficiencies and strengthening

> WHILE THE NUMBER OF AUCTION PROCESSES HAS BEEN DOWN – WITH SOME AUCTIONS PAUSED PENDING A MORE FEBRILE BIDDER ATMOSPHERE – 'HOT' ASSETS ON THE MARKET ARE STILL LEADING TO BUSY PROCESSES.
>
> GEORGE GRAY
> Skadden, Arps, Slate, Meagher & Flom (UK) LLP

balance sheets. With the exit market constrained, despite rising book values, firms are retaining investments longer and facing mounting pressure from LPs for liquidity and returns. While moving high quality assets into continuation funds was a prevalent trend during the deal slump, many firms do not have capacity to do more as they have to navigate potential conflicts of interest and asset concentration limits. Consequently, PE firms have turned to alternative financial engineering tools such as net asset value financings or dividend recapitalisations to return capital to LPs. But these methods are under increasing scrutiny from LPs and the regulator, making traditional exits a priority now more than ever.

> "DIFFERENT GPS ARE AT VERY DIFFERENT STAGES OF THEIR ESG INTEGRATION – BUT IT IS A JOURNEY EVERY FUND MANAGER IS ON. THIS DEMOCRATISATION OF ESG PRACTICES IS A POSITIVE TREND FOR THE REPUTATION OF THE SECTOR."
>
> AMIT NAYYAR
> Shoosmiths

Bartell: PE firms are deploying methods such as continuation funds, corporate carve outs and transactions such as platform acquisitions to create value and generate returns from portfolio companies. It also depends on the industry and the environment, as the companies that will get premium valuation multiples in 2025 exits will have demonstrated they can organically grow the top line in a difficult operating environment. Continuation funds allows a portfolio company more time to grow beyond the typical three to four year exit time period and provide liquidity for existing LPs and opportunities for secondary investors. This approach can provide a much higher exit multiple for growing companies. Corporate carve outs provide for a moderate acquisition multiple with PE attention that can lead to higher profitability and size, resulting in a higher valuation at the end. Platform acquisitions have been challenging in the last 18 months, due to high valuations and the overall quality of companies. Significantly smaller company add-on activity has carried the day in building up existing platform portfolio companies to create scale and higher valuations.

FW: Are PE firms achieving expected returns from available exit routes? How would you describe the outlook for trade sales, secondary buyouts and IPOs?

Gray: While the number of auction processes has been down – with some auctions paused pending a more febrile bidder atmosphere – 'hot' assets on the market are still leading to busy processes. Although the number of exits is down, we expect to see more refinancings and recapitalisations to release liquidity and tide sponsors over until a more favourable exit environment emerges. Sponsors are starting to talk about initial public offerings (IPOs) as routes to exit again, which is positive, and we hope to see more of that translate into London IPOs in time as regulation is eased. We have also seen a lot of interest in planning and implementing the much talked about 'private IPO', which is a neat liquidity option for larger businesses in advance of an IPO. It essentially acts as 'share shop' for investors, allowing them to transfer interests between themselves periodically to allow shareholders some access to liquidity before the ultimate IPO.

Dambre: Securing exits will be the top priority for sponsors in 2024-25 as they need to return cash to LPs and stimulate fundraising. The exit market continues to be largely subdued, with multiple sale processes stalling or being pushed until market conditions stabilise. We expect interest rate cuts to act as a catalyst for M&A and IPOs, but cannot ignore political and macroeconomic uncertainties that could further postpone a rebound. While high quality assets in attractive sectors will continue to be highly sought after and command high multiples, we expect the market to experience some pockets of softness. In this context, GPs will continue to think creatively about their liquidity options, with top-quality, single-asset continuation funds and secondary stake sales being top of mind.

Bartell: For high-quality companies, the sell-side route is achieving and exceeding in many cases return expectations. Although the quality of companies that have come to market in the last 12 to 18 months has been lower, we are seeing an increase in quality companies coming to market for sale in the last two months, as many have seemed to accept – for now – the inflationary and interest rate environment. Those quality companies also may have moderated their valuation expectations, which should still achieve expected returns. Reddit, for example, priced its IPO at the high end of its targeted range, a sign that investor enthusiasm could be returning for new issues. Reddit ended its first day of trading with shares up 48 percent, pushing its value close to $10bn. The recent debuts of Reddit and Astera Labs, which priced on 19 March 2024, may embolden more companies to go public.

Howard: We have definitely seen large parts of the PE community take a 'wait and see' approach to exits, as market sentiment and resulting valuations in the past year have meant returns would be below the historical norm and expectations. As a result, exits were down. However, this cannot continue as GPs are under increasing pressure to return capital to LPs as well as demonstrate their ability to generate returns ahead of the next fundraising cycle. Therefore, exits are expected to increase, with the outlook for trade sales and secondary buyouts looking positive. A recent trend that is expected to persist is the use of continuation funds, enabling investors to retain a stake in a business but, at the same time, enabling capital to be returned to others.

Nayyar: Auction processes for the most investible sectors are more competitive than ever. In such an environment, everyone on a deal team, including advisers, must be on the front foot to stand out from the competition. This has been particularly prevalent in 'hot sectors' like healthcare and technology. For those industries less loved by financial bidders, trade buyers and trade exits are, of course, still a way forward – and a route to the best prices – as well as routes to equity capital markets. There are many ways of approaching these exits, though they often tend to be through trade party introductions. That said, for businesses still in a growth trajectory, financial sponsors that have the right combination of price, deliverability, lack of regulatory friction and, crucially, management incentive plans are often still the 'go-to' option.

FW: How has PE fundraising fared in the last 12 months or so? Under current market conditions, what characteristics are LPs looking for in GPs?

Bartell: Fundraising is quite difficult right now. LPs are hesitant to deploy more capital into private markets given the alpha returns currently being generated in the public equity markets. As a result, fundraising may be as challenging as the PE market has seen it over the past five to 10 years or more. LPs are also paying close attention to how GPs communicate with them about troubled assets and uncertain timing of exits. The challenging fundraising market started in 2022 and is expected to continue for most of 2024. The bigger are getting bigger, and the first-time funds and mid-market generalist funds are facing serious headwinds for their long-term fundraising viability.

Howard: The past year has presented significant challenges for PE fundraising. This can largely be attributed to the decrease in deal activity, which has resulted in a reduction of capital returned to LPs. Consequently, LPs have adopted a more cautious approach to reinvesting capital, particularly given the current macroeconomic climate. LPs are increasingly prioritising GPs with a proven track record over a sustained period. This track record should encompass successful management during downturns and other challenging market conditions, effectively showcasing GPs' ability to adapt and make sound investment decisions regardless of the environment. Furthermore, a strong focus on value creation is important. Identifying and implementing strategies to improve the performance of portfolio companies beyond basic financial engineering will be critical for attracting LP capital. GPs that can clearly articulate a value creation strategy that aligns with environmental, social and governance (ESG) objectives will be particularly well-positioned for fundraising success.

Nayyar: Overall, the fundraising environment is a very mixed one depending on performance and size. Generally speaking, the biggest funds are getting bigger and we have seen world record individual fundraisings in the past 12 months. This is in direct contrast to smaller challenger funds which, without a proven track record over multiple fund cycles, have struggled badly to meet fundraising targets – in some cases leading to smaller funds. In others, there has been a move to a deal by deal model or close down of the fund strategy entirely. European GPs are subject to a raft of new legislation designed to help the European Union meet its obligations under the '2030 Agenda for Sustainable Development'. Different GPs are at very different stages of their ESG integration – but it is a journey every fund manager is on. This democratisation of ESG practices is a positive trend for the reputation of the sector.

Dambre: While the amount of PE capital raised in 2023 was high by historical standards, fewer funds were fully subscribed overall, suggesting that more capital went to a smaller number of PE

> MORE PE FUNDS ARE OVER-EQUITISING THEIR NEW BUYOUTS IN THE ANTICIPATION OF LOWER INTEREST RATES AND HIGHER AVAILABILITY OF DEBT IN LATE 2024 AND 2025.
>
> BOB BARTELL
> Kroll Financial Advisory

firms. In a nutshell, the mega funds that were successfully raised are very much the trees hiding the forest, and fundraising has been challenging for most. Overall, there is a pretty material mismatch between the demand for capital from GPs and the capital available from LPs due to some overallocation of pension funds to PE from prior years, public equity valuations becoming more attractive and the lack of exits constraining capital that is tied up in existing investments. On their end, LPs have generally favoured larger funds and established managers. So, some funds are facing tough choices about how to pursue growth. We also expect large funds to pursue retail and private wealth investors on a more meaningful scale.

> SECURING EXITS WILL BE THE TOP PRIORITY FOR SPONSORS IN 2024-25 AS THEY NEED TO RETURN CASH TO LPS AND STIMULATE FUNDRAISING.
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> ROMAIN DAMBRE
> Allen & Overy

Gray: Riskier markets have led to LPs becoming stricter about deploying capital. This has meant LPs gravitating toward sponsors with an iron-clad track record and ability to offer differentiated strategies. LPs like to see a proper strategy, a real understanding of one or more sectors and the ability to demonstrate consistent performance. We have also seen more deal by deal opportunities, such as cherry-picking assets for investment, and with traditional exit routes continuing to experience reduced levels of activity, GPs are increasingly turning to secondaries for liquidity while they continue to own high-quality assets beyond typical holding periods to fully realise their investment value. Secondaries growth has also been driven by the denominator effect, where decline in public asset valuations has forced some LPs whose holdings were overallocated to private assets to partially sell-down their investments in private funds, although this alleviated over the course of 2023 versus 2022.

FW: What legal and regulatory issues are shaping the PE industry at present? How can the related risks and challenges be mitigated at the fund level?

Dambre: The Securities and Exchange Commission (SEC) has been quite active over the past year, proposing a number of rules that directly impact private fund managers and require significant changes to comply. Notably, the new Private Fund Adviser Rules have had a significant impact on PE firms' operations and investors' demand for information and data. In particular, the SEC has been focused on regulating conflicts of interest in GP-led secondary transactions, requiring GPs to commission a fairness opinion when offering existing LPs the option to either sell their interests or roll them into a new vehicle. Regulatory developments affecting cyber security risk management and ESG compliance need to be carefully monitored as well. Finally, the Federal Trade Commission and the US Department of Justice have released new merger guidelines that provide a basis for increased scrutiny on PE acquisitions, particularly those that are considering roll-up strategies.

Nayyar: Environmental, antitrust and national security considerations are key legal and regulatory issues shaping the industry. There is increased scrutiny of foreign direct investment (FDI) within sensitive sectors. This can be seen at all levels of the market – including high-profile examples such as the current heavy focus on TikTok's ownership in the US. But even further down the value chain, FDI issues are also impacting on day to day dealmaking, adding more complexity to the process and bringing these points to the front of the deal considerations queue. Funds need to hold accurate and well-curated data regarding their fund size, revenues and jurisdictions so that they can respond to queries quickly and map where the regulatory challenges are likely to bite. A more on the ground issue is an increased bearishness from sponsors with respect to management terms. Management incentive plans have become increasingly stringent in recent years. Somewhat perversely, higher interest rates have not led to a significant softening of prices for the best assets. As a result, management terms and teams have felt the pinch, being less generous in terms of pot size, governance terms and leaver provisions.

Howard: The ESG regulatory environment is demonstrably reshaping the PE industry. Investor demand for ESG integration within PE firms' investment decisions is steadily rising. This has necessitated the development of robust ESG frameworks encompassing ESG due diligence, portfolio company ESG practices and impact reporting for GPs. The ESG regulatory landscape is tightening further, with the phased rollout of a new sustainability disclosure requirements (SDRs) framework. This framework aims to establish a more comprehensive and standardised approach to ESG reporting, with full implementation anticipated by

2025. SDRs are likely to require businesses to disclose sustainability risks and opportunities, their management strategies for these factors, and measurable goals and objectives. In response to these challenges, GPs are demonstrably addressing them by investing in the development of in-house ESG capabilities and increasing their use of external ESG advisers.

Gray: Geopolitical tensions are driving heightened scrutiny of certain investors, even at the LP level. Funds may look to ensure that their LP agreements allow them to exclude potentially sensitive investors from investments that might be impacted. While this is a practice that some LPs are increasingly reluctant to agree to, PE funds will continue to be well-placed to offer potentially sensitive investors with co-invest opportunities that permit minority participation where a majority stake is not viable – sometimes at the cost of diminished management and governance rights for the co-investor. As European FDI regulators become even more sophisticated in their approach to mitigation, funds that accommodate structuring and security requirements in mitigation agreements or orders have an opportunity to build regulatory capital and position themselves as trusted operators of defence-sensitive assets.

Bartell: Over a year after its initial proposal, the SEC voted to adopt rule changes relating to the private fund industry on 23 August 2023. The new rules will provide investors with additional information about their private fund investments and provide them with enhanced control over certain activities, fees and expenses engaged in by private funds and their advisers. The final rules retain many of the core themes of the proposal, such as increasing transparency for private fund investors, and requiring enhanced disclosure by private fund advisers. Notably, the SEC exempted securitised asset funds from each rule other than the compliance rules.

FW: What trends do you expect to shape the PE industry, and related activity, in the months and years ahead?

Nayyar: I think we will continue to see more PE funds clubbing together – in particular incumbent sponsors reinvesting alongside an incoming investor – in the market due to the benefits resulting from fund diversification, combined expertise and the benefits of sharing the cost and workload in respect of such portfolios. By extension, nascent market terms on managing multiple sponsors will continue to evolve. It is my belief that the PE market is not far off a need for steering committees, which are already common practice within the banking industry and venture capital market. Management teams need clarity on governance lines, strategy and time horizons. Arguably, where an investee company has multiple sponsors invested, such clarity can only realistically be achieved through an agreed committee process or similar.

Howard: The PE industry anticipates an increased level of deal activity in the coming months, stemming from the stabilisation or improvement of factors that negatively impacted deals in 2023. As a result, we can expect heightened competition for acquisitions, particularly given the significant amount of capital available for investment. Looking toward the longer term, a consolidation of PE firms, especially smaller players, is a potential consequence. Rising regulatory burdens and a challenging fundraising environment may be key drivers of this. In seeking opportunities, PE firms will likely increasingly target niche sectors. These sectors may benefit from long-term trends, such as technology-enabled businesses or those catering to the growing elderly population. No discussion of the future would be complete without mentioning artificial intelligence (AI). While the broader impact of AI on business and society remains uncertain, PE firms are increasingly leveraging AI technology to enhance deal sourcing, due diligence and portfolio management processes. This trend is expected to continue as PE firms seek to differentiate themselves within a competitive environment.

> WHILE THE BROADER IMPACT OF AI ON BUSINESS AND SOCIETY REMAINS UNCERTAIN, PE FIRMS ARE INCREASINGLY LEVERAGING AI TECHNOLOGY TO ENHANCE DEAL SOURCING, DUE DILIGENCE AND PORTFOLIO MANAGEMENT PROCESSES.
>
> CHRISTY HOWARD
> Accuracy

Gray: AI is a hot topic at the moment, with many sponsors racing to implement AI technology and associated data infrastructures in their portfolio offering, as well as seeking out AI-related investment opportunities. This is an interesting topic for a number of reasons. The regulatory framework is shifting quickly, and ensuring enhanced commercial, technical and legal diligence of these businesses is key. Many targets are purporting to be AI businesses and AI-enabled, whether validly is

another question. We also expect to see a continued surge of activity in the financial institutions group space as more sponsors turn their attention to asset management and insurance assets, and creative ways of recalibrating their fund structures to participate in this space. The sector offers many attractive options for investment, including consolidation plays and the ability to access long-term capital and leverage it for creative credit strategies.

Bartell: There is a great push to provide US-defined contribution plan participants with access to PE and alternative asset portfolios in a diversified manner. This will transform PE funds from a traditional institutional investor base to a more retail, main street investor base. With this, PE returns may go down as supply of capital will exceed the supply of deals available to put the money to work. We also expect the continued growth of fundless sponsors on one-off deals as there are many seasoned M&A, PE and operational professionals that know how to deploy capital and generate alpha returns.

Dambre: The outlook for private markets will continue to be dictated by interest rate expectations and uncertainty over economic growth in 2024. In particular, greater certainty regarding the outlook for borrowing costs could unlock deal financing opportunities and encourage exits. Certain macro trends such as energy transition, digital disruption and AI will offer major investment opportunities in the coming years. The technology, energy and healthcare sectors are likely to remain attractive for PE. Infrastructure deals, in particular in the digital infrastructure and data centre space, will continue to attract firms that are seeking stable and cash-generative investments with less volatility. There is no shortage of opportunities, but sponsors will need to focus on operational improvements to unlock multiples. ■

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