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Navigating Value Creation in Private Equity

Over the past few decades, private equity has generated strong absolute returns and has meaningfully outperformed public equity—but that was in a world largely characterized by macroeconomic and geopolitical stability, declining interest rates and equity market tailwinds.[1]

Can private equity continue to generate strong absolute and relative returns against a background of greater uncertainty, higher-for-longer rates and full valuation multiples?

When we identify the range of levers that private equity managers can pull to create value and generate returns, we find that some are likely to remain effective today while others have lost much of their power. We think this has important implications for investors.

[1] This has been a consistent finding across many studies using various data and methods. For example, see Bain & Company, *Global Private Equity Report 2020*, p.82, which compares U.S. buyout funds' returns with the returns of the S&P 500 Index adjusted with the Long-Nickels public market equivalent (PME) method, as of June 2019, and finds the buyout funds outperforming over all time horizons out to 30 years with the exception of the 10-year horizon, where the annualized returns are 15.3% and 15.5%, respectively. https://www.bain.com/globalassets/noindex/2020/bain_report_private_equity_report_2020.pdf

We identify seven levers that private equity managers use to generate returns depending on the idiosyncrasies of investee companies and general market conditions.

1. **Investment Selection:** Selecting companies that stand to benefit from secular tailwinds, resilient business models, high barriers to entry, recurring or re-occurring revenue and the potential to create sustainable earnings growth.
2. **Management Incentivization:** Recruiting, retaining and motivating experienced managers to oversee the business operations of a company. Meaningful management incentive plans increase alignment and can improve exit outcomes for private equity investors and senior management teams.
3. **Resources and Capital to Support Growth:** Allocating the operating resources and/or capital to a company to expand products and services, augment distribution and sales efforts, and/or increase geographic footprint. If properly implemented, these tools can bend the growth curve of a company upwards.
4. **Operational Improvement:** Providing resources for optimizing revenue and pricing, cutting costs, enhancing procurement and consolidating vendors, re-tooling sales incentives and otherwise improving margins.
5. **Strategic M&A:** Sourcing, executing and integrating corporate acquisitions—preferably at accretive valuation multiples—to bolster supply chains, expand products and services, and access new customers. M&A can also be utilized to deleverage capital structures and provide interest coverage relief.
6. **Free Cash Flow Generation/Debt Paydown:** Using a company's free cash flow to pay down debt both increases equity in the capital structure and lessens future interest costs.
7. **Multiple Expansion:** Participating in an increase in the multiple of earnings at which a company is valued.

While all seven value-creation levers are relevant across time, the effectiveness of each lever is determined by not only the idiosyncratic nature of each transaction, but also the prevailing market and operating conditions during the ownership period.

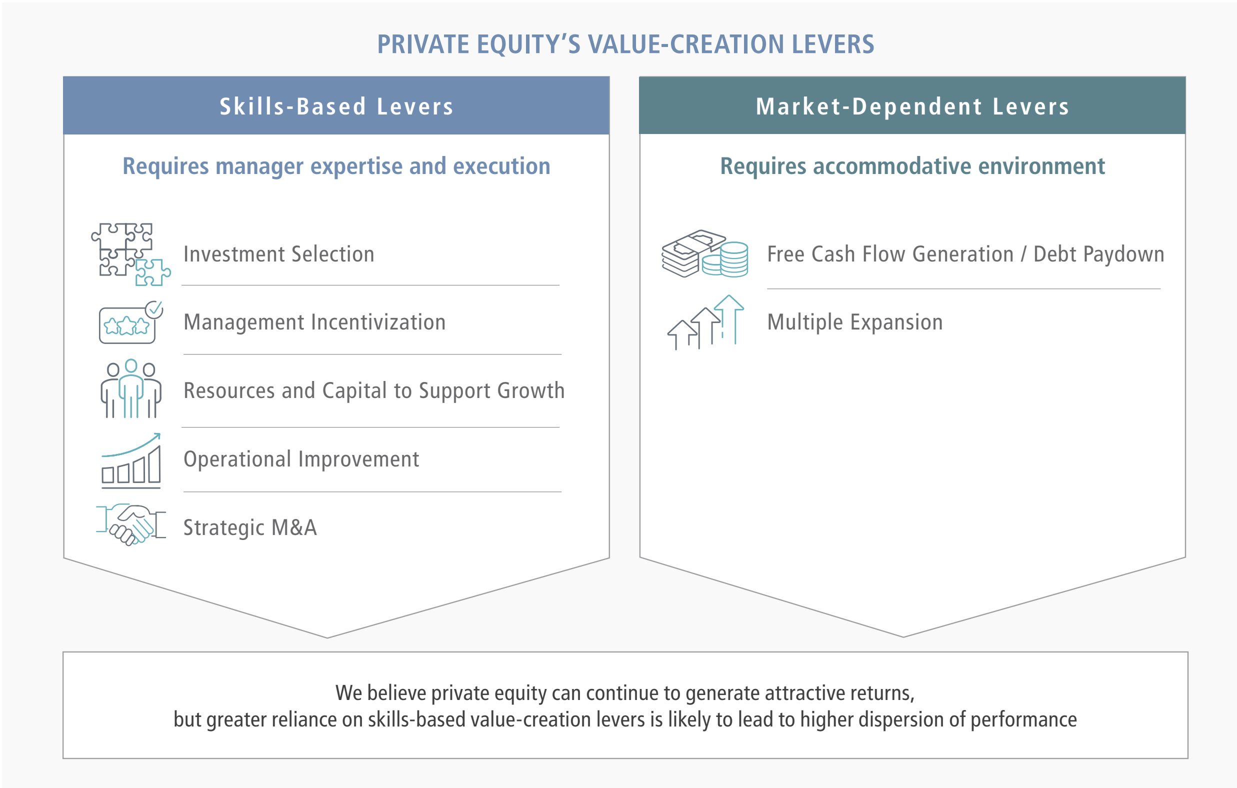
Accordingly, investors need to consider which levers are most likely to be effective today and over the lifetime of their current holdings.

Selection and Skills-Based Levers Remain Highly Effective

The first five levers—Investment Selection, Management Incentivization, Resources and Capital to Support Growth, Operational Improvement and Strategic M&A—are all about investing in companies that have the potential to grow their earnings and then helping them to do so. Pulling these levers requires significant skills and resources that in our view not all private equity managers possess, which means execution will vary widely. These levers are also very transaction-specific and much less reliant than the last two levers on market conditions. This means managers who do have the necessary capabilities can still pull these levers to create value, even in today's more challenging environment.

Market-Dependent Levers Have Largely Fallen Away

Unlike the selection and skills-based levers, Free Cash Flow Generation/Debt Paydown and Multiple Expansion are primarily market-driven and not meaningfully dependent on manager skill or company quality. Today, high interest rates are consuming the free cash flow available for debt paydown and full valuation multiples make it less likely that managers will be able to sell a company they buy today at a higher multiple tomorrow.



Selectivity Is More Important; Due Diligence Is Harder

With two value-creation levers out of action or even detracting from returns, and the remaining ones dependent on idiosyncratic asset-selection and skill-based capabilities, we believe there will be a higher dispersion of performance across managers and transactions.

Given the wider band of expected outcomes, we believe strong due diligence skills and a highly selective investment approach are essential in the current environment. But we also think wider dispersion means selectivity needs to be balanced with diversification; portfolios should be sufficiently diversified to mitigate risk, but not so diversified that they become private equity indexes. In our view, achieving this balance requires robust deal flow—the larger the opportunity set, the easier it is to be selective without becoming too concentrated.

While past performance has never guaranteed future results, we believe shifting market conditions make traditional analysis of historical track records even less relevant. Understanding how a manager generated returns in the past is as important as considering what those returns were. To further complicate this analysis, achieving past success by making full use of market dependent levers does not in itself disqualify a manager from achieving success prospectively—in our view, the best managers make money by pulling the most effective levers at the appropriate time. Complete due diligence now requires a holistic approach that incorporates selection and skills-based capabilities. This implies a full understanding of the manager's market outlook, sourcing capability, relationship network, industry expertise, operating toolkit and more.

Market Conditions Favor Co-Investing and GP-Led Secondaries

Finally, as part of a diversified private markets portfolio, we believe co-investments and GP-led secondaries are particularly well suited to present market conditions. Co-investing involves partnering with a private equity manager to provide equity capital for a single company outside of a traditional fund structure. A GP-led secondary involves investing in a new vehicle set up by a private equity manager to acquire one or more investments from older funds.

These methods of implementation can deliver critical insights into a manager's command of the value-creation levers, particularly those we believe to be more effective in the current market environment. When thoughtfully implemented, these strategies offer the opportunity to own high-quality businesses alongside top-tier managers in their core areas of expertise.

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