A WORD FROM CHERRY BEKAERT

Navigating the “New Normal”

Value creation challenges and drivers in a dynamic marketplace

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How has the rapidly changing macroeconomic landscape impacted private equity firms and valuations of private companies?

Between the aggressive interest rate hikes instituted by the Fed to combat surging inflation, and a decline in the S&P 500 of more than 19%, public equity and fixed-income markets faced significant challenges throughout 2022. These macroeconomic headwinds have continued into 2023, and, when combined with recent instability in the banking system, have resulted in an elongated period of volatility in public markets not seen since the global financial crisis. While imprecise and delayed, public market trends ultimately trickle down to private markets. As economic pressures and banking industry uncertainty continue to play out in M&A markets, many PE firms are assessing the impact of these issues on their own balance sheets.

Fund managers are sitting on a historically high number of portfolio company investments, many of which were acquired at near-peak market conditions that predated the Fed’s 2022 shift in monetary policy. While private market valuations have historically demonstrated less volatility and relative strength when compared with their public market counterparts, the performance disparity is drawing skepticism from many who claim that private fund managers are presenting overvalued balance sheets.

Historically, assessment of fair value of portfolio companies has been conducted by internal deal teams using infrequent, subjective asset testing, which many believe keeps impairment write-offs out of quarterly reporting. However, with increasing scrutiny from regulators, LPs, boards of directors, and independent audit firms, funds are shifting to the use of third-party valuation firms to provide independent appraisals of portfolio company valuations. Regardless of whether the valuation assessment is completed internally or by a third party, the market approach has traditionally been the standard in determining fair value. This approach focuses on guideline public company and/or transaction multiples to assess fair value. Based on rapidly changing economic conditions and reductions in public market valuations, there is a risk that the guideline company approach may not incorporate these factors into fair-value assessments and could therefore result in unjustifiably higher valuations of private companies. Accordingly, analysts may begin to place greater reliance and emphasis on the income approach, which uses a discounted cash flow model to assess fair value. This approach would incorporate the expected impact of higher interest rates and increased levels of inflation on overall cash flows, thereby yielding a more accurate view of portfolio company fair value.

Regardless of the approach, continued volatility and unpredictability in public markets and the banking sector will require PE funds to undertake more frequent and comprehensive assessments of potential asset write-downs throughout their investment portfolios.

How can private equity funds enhance portfolio company growth and profitability during periods of economic uncertainty?

Headwinds seldom impact all vertical markets and customer segments equally, thus increasing the importance of doubling down on winners. Doing so requires both a thorough mapping of the markets in which the investment portfolio is exposed, and a one-by-one assessment of each portfolio investments' exposure and risk in the next 12 to 24 months.

Winners are firms in segments wherein demand is relatively inelastic and supply chain challenges, rising interest rates, and macro uncertainty are less pronounced. Despite the downturn, for example, continued resilience has been observed in certain sectors, including medical & life sciences and nondiscretionary durable goods, among others.

For portfolios consisting of winners, PE firms can create effective optimization strategies to drive growth and increase portfolio company valuations over the investment lifecycle. These strategies can include, among other things, expanding wallet share with existing clients. Funds can enhance key client account management strategies and tactics to maintain relationships with current buyers and agents, and, where possible, extend into new buyers—for example, in multisite, multidivision clients.

There is also a built-in incumbency advantage that managers can use to lock in longer-term, more predictable contracts for existing products and services, as well as exchanging volume commitments for pricing concessions where it is advantageous to do so. In some sectors, managers can explore and test recurring, subscription-based business models for existing offers to increase stickiness and improve predictability of revenue. They can also examine any unmet customer wants and needs as the foundation for developing variants or new products and services to cannibalize their own success—and stay ahead of competitors.

Another important strategy involves the acquisition of new clients by exploiting the weaknesses of lagging competitors. In these uncertain economic times, supercharging competitive intelligence gathering to understand where competitors may be struggling to deliver threshold customer value (due to supply-chain challenges, for instance) can pay huge dividends.

Having commercial teams hunt in priority customer segments to identify, qualify, and pursue leads with a current vendor/supplier can also provide organic growth opportunities.

Every portfolio likely also has some losers with greater exposure and risk to current headwinds. There, fund managers should apply their well-worn playbook to reduce complexity, improve operational efficiency, cut costs where practical, and limit investment expenditures to manage for cash flow. In addition, more sophisticated strategies such as strategic carveout acquisitions/divestitures and bolt-on acquisitions may also be warranted.

Can add-on acquisitions bolster the overall value of a platform business?

Private equity has long used add-on deals to amplify and unlock the value of existing platform investments. These bolt-on transactions are often smaller, carry lower valuation multiples, are subject to less LP scrutiny, and are easier to finance than their platform counterparts. Therefore, during periods of economic uncertainty, add-on acquisitions often account for a larger percent of total M&A activity. A recent PitchBook report found that add-ons accounted for almost 80% of buyout deals in the middle market.

Add-on transactions frequently focus on smaller competing businesses, which allows the buyer to better manage costs and realize synergies. Growth coming in the form of both a larger revenue base and improved profitability often leads to EBITDA multiple expansion at exit, thereby bolstering the overall investment return for PE investors.

While the healthcare sector might be most well known for its ability to execute the add-on acquisition strategies, the model is also gaining popularity in other, highly fragmented segments. Currently, numerous PE firms are undertaking roll-up strategies in home service segments such as HVAC, pest control, and landscaping maintenance. The wealth management sector is also experiencing a consolidation at the hand of PE buyers.

Add-on transactions often require a different approach to due diligence, which may include a focus on operational aspects of the business, not just the financial aspects. With the goal of creating a clear integration playbook, players in the add-on space are looking to accelerate value-realization strategies.

The benefits of integrating an add-on acquisition depend on the industry and context in which the add-on is acquired, but can include greater brand recognition, increased geographic expansion, realization of revenue and cost-saving synergies, improved pricing power, and improved technical capabilities. Ultimately, the strategic rationale for an add-on is that it will complement the platform's existing portfolio of product or service offerings and drive revenue growth. When done well, these strategies boost portfolio company valuations and generate increased investment returns for PE firms.