KEY CAPITAL
uncompromising commitment

How Private Equity is Taking Advantage of Turbulent Markets

1. Introduction

Private equity managers are no strangers to investing in turbulent market environments but the challenges of fundraising, investing, and driving value creation during a period of high inflation and interest rates, geopolitical uncertainty and a depressed IPO market can appear daunting. The consensus view in Q4 2022 was that things were going to get worse and that a recession was likely, with Europe in particular feeling the impact of the war in Ukraine and the resulting energy crisis. This has not transpired and instead growth has been muted, with the US and EU economies expected to grow by 2% and 1% respectively in 2023[1]. Against this backdrop, leading private equity managers are taking advantage of the opportunities that have been created.

2. Fundraising

On the fundraising side, as illustrated in Figure 1, the first half of 2023 has seen a total of $183bn raised by private equity managers globally, this is an increase of 20% compared to the first half of 2022 and fundraising would appear to be well on track to exceed the average fundraise across the last 10 years of $268bn.

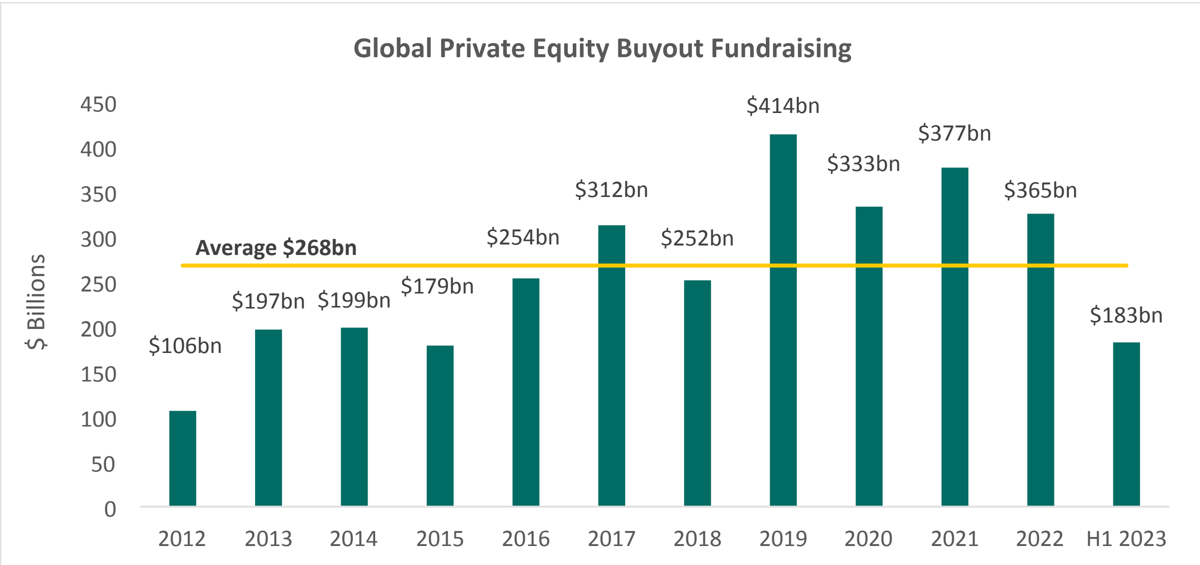

Figure 1: Preqin Global Private Equity Buyout Fundraising 2013 to H1 2023, accessed August 2023

For institutional investors, a slowdown in making fund commitments tends to be driven by a decrease in distributions, the impact of the denominator effect[2] on allocation and caution in the face of market uncertainty. This has resulted in some private equity funds seeking extensions to their fundraising periods beyond the typical 1-year period. From an investor's perspective this can be advantageous as often companies will have already been acquired by private equity managers and value creation plans are being implemented. This results in greater visibility that the outlined investment strategy is being executed on and the companies acquired may also have experienced an uplift in valuation that an incoming investor benefits from.

Notably, some of the top private equity managers who have outperformed across multiple vintages and continue to generate exits despite current market headwinds can still achieve strong fundraising outcomes in relatively short periods of time. CVC Capital Partners (CVC) are one such example, who in July 2023 closed its ninth flagship fund CVC IX at €26bn, exceeding the €25bn target just 6 months after launch. Similarly, Clayton, Dubilier & Rice (CDR) are poised to close $26bn for CDR XII after asking investors to increase the hard cap on the fund size by an additional $500m. This is encouraging and the magnitude of these fundraises highlights the breadth of the investment opportunity in today's market. It is also indicative that investors are favouring established private equity managers with strong track records and that access to this cohort of managers is key to taking advantage of the current market environment. By way of comparison, there have been just 8 first time private equity funds closed in Europe so far this year which compares to 21 in 2022 and 46 in 2021[3].

3. The Opportunity

Private equity managers are taking advantage of the current market environment. While the volume of transactions has fallen by c.50% in H1 2023 compared to H1 2022[4] what remains tends to be less competitive. As such, leading private equity managers that have the ability to manage complexity when it comes to valuation and leverage should outperform. Figure 2 illustrates that purchase price multiples for companies decreased in Q1 2023 as private equity managers were able to acquire companies at more attractive valuations. Target companies lean towards experienced private equity managers that have demonstrated an ability to navigate more difficult markets, while still driving value creation, and can be willing to accept a lower valuation to bring the right long-term partner on board.

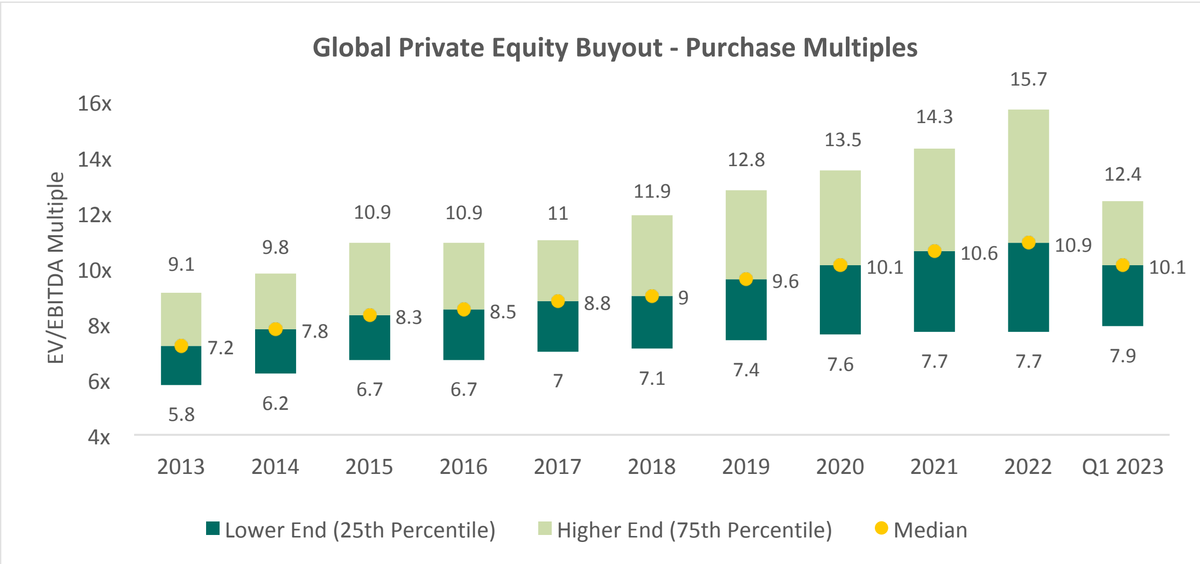

Figure 2: Burgiss Company Fundamentals Review Q1 2023

The ongoing volatility in the public markets has also created opportunity for leading private equity managers to take high quality public companies trading at a discount private. 2022 was a record year for public-to-private transactions which had an aggregate value of $229bn which compares to $181bn in 2021 and $71bn in 2020. While rising interest rates have slowed this trend somewhat into 2023, public-to-private transitions are still on pace to match 2021 with transitions such as Qualitrics (acquired by Silver Lake), Univar Solutions (acquired by Apollo) and Ergomed (acquired by Permira) taking place. The key point is that private equity managers can react to the market environment unfolding in front of them and pursue the most attractive opportunities in their target geographies and sectors.

4. Investing Selectively and Creating Value

Top private equity managers exhibit a distinctive investment approach which is highly selective and involves meticulous scrutiny. Extensive networks built over years combined with significant resources devoted to origination results in a stream of quality deal flow from which they will distil only a handful of investments each year. The discerning nature of private equity manager's is evident in the analysis they apply to potential investments, forensically assessing a company's financial health, the specific sector dynamics, the ability of the management team and the potential fit with their own strategy. Such a selective and deep analytic approach lends itself well to this market environment, enabling companies with growth potential and strong fundamentals to still be identified.

Private equity managers also utilise a broad toolkit of strategies to create substantial value within the companies after they are acquired. They adeptly identify operational inefficiencies, strategic gaps, and growth opportunities, initiating transformative changes that optimise performance. They also bring significant strategic expertise, guiding companies in repositioning their market offerings and expanding into new markets or consolidating existing markets through M&A. Additionally, private equity managers utilise their networks to recruit top-tier talent and strengthen management teams, with experienced individuals who can further drive growth and innovation. The ability to pull on multiple value creation levers is crucial in the current market environment where a more flexible and opportunistic approach is required.

Figure 3 below illustrates the contribution of different value creation levers across €58bn of invested capital in c.230 companies from a selection of leading private equity managers. It highlights that the significant majority of value creation is derived from revenue and EBITDA growth, rather than relying on multiple expansion or a reduction in net debt.

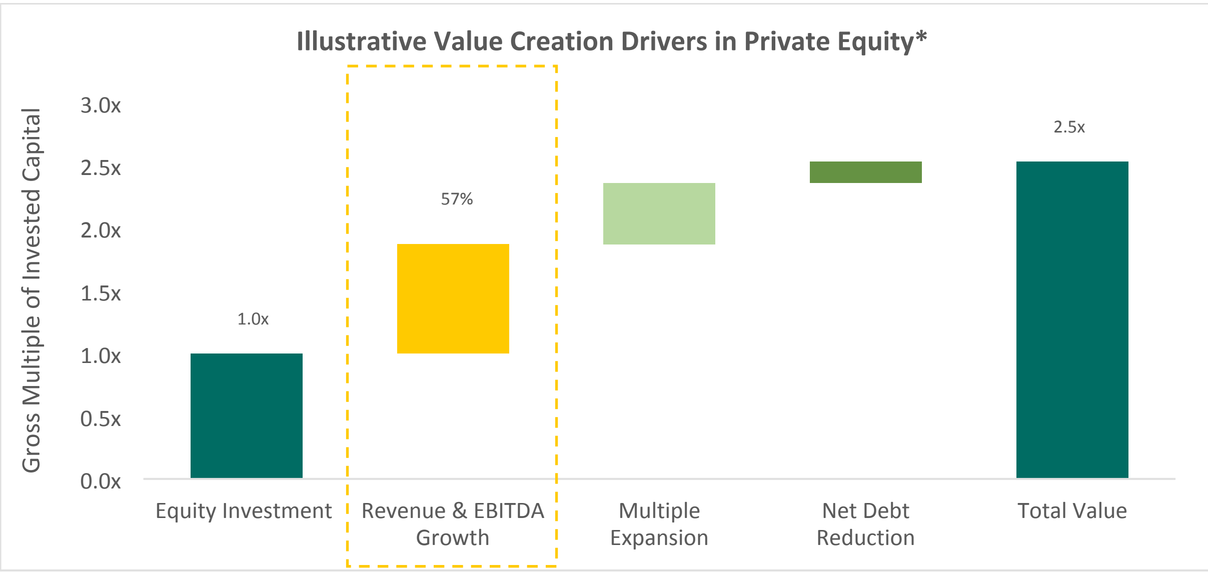

Figure 3: Illustrative value creation drivers for €58bn of equity invested across 233 companies (acquired between 1999 and 2022) as analysed by Key Capital Investment Management.

**The graph is illustrative to highlight the value creation component over the period and is not meant to imply any guaranteed, predicted or forecasted return, over a similar period.*

Another advantage that private equity managers with active majority ownership have demonstrated in this environment is their ability to react quickly and systematically to challenges such as rising inflation or the cost of financing. This has allowed them to help portfolio companies navigate these inflationary pressures by effectively adjusting their business models accordingly and rapidly passing through cost increases. On the other hand, companies with more fragmented ownership, both private and public, can potentially face difficulties in reacting swiftly to inflationary pressures, resulting in slower adaptation and a potential squeeze on margins. Private equity managers can also act decisively to finetune capital structures and have the ability to call on a wide array of lenders, beyond traditional banks, who can provide increased flexibility.

5. Conclusion

More challenging markets provide unique openings for private equity managers to acquire companies at more attractive valuations and execute transformational changes, which in turn can drive strong returns. However, the dispersion of performance between top and bottom quartile private equity managers tends to be more pronounced following market corrections. So, while there is great opportunity in the current market, it is important to partner with leading private equity managers who can truly seize this opportunity and drive meaningful outperformance in the years to come.

Footnotes

1. *European Commission Spring 2023 Economic Forecast and Conference Board for US Economy August 2023.*
2. *Some investors are facing private market over-allocation challenges as their public market portfolios have reduced materially over 2022 while the valuation of their private market assets has remained relatively stable, known as the denominator effect.*
3. *Pitchbook Value and Number of European First-time Private Equity Funds to Close, August 2023.*
4. *Preqin Quarterly Buyout Transaction Volume H1 2023 and H1 2022, as accessed August 2023.*