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The valuation conundrum

PEs redesigning value-creation strategies for profitable exits

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Competition intensifies as uncertainties abound

Rising macroeconomic uncertainty presents numerous hurdles for the private equity (PE) market, causing significant and diverse impact on fundraising, performance, and assets under management. This has intensified overall competition, restricted opportunities, and put profitable exits on hold for PE firms.

Deal activity plummeted

PE deal count declined 10% on-year in 2022, while deal value declined 35.4%

Capital raised declined 17.6% on-year in 2022, while fund count declined 47.1%

Dry powder soaring high

Global dry powder stood near record high at $3.7 trillion at the end of 2022

Dry powder inventory spiked to 1.4 times, highest since 2013

Exit trends on a decline

Exit count declined 35% on-year in 2022

IPOs declined 70% globally

Sponsor-to-sponsor accounted for material share of exits

Source: Bain Capital, PitchBook, PwC

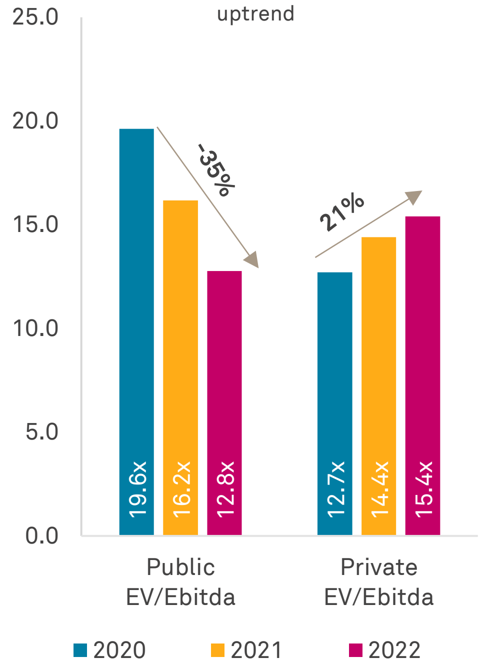
Sluggish activity in investment, exits and capital-raising across the board demands a strategic shift towards a new playbook that prioritises minimising valuation gaps, optimisation initiatives, sustainability, and profitable returns.

To be sure, PE has been a resilient asset class and outperformed the public market for over a decade (Figures 1 and 2). The private market index logged a compound annual growth rate of about 11.0% (vs 5.9% for S&P 500) between 2007 and 2022.

Figure 1: Public and private market comparison

Source: PitchBook, Investing.com

Figure 2: Public EV/Ebitda trending down, but PE EV/Ebitda (US) on uptrend



Source: Bloomberg, Croft & Bender

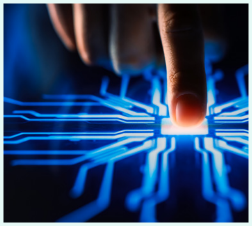
The macroeconomic uncertainty has resulted in valuation gaps that, combined with risks associated with portfolio-company activities, are driving the transformation of the PE value-creation playbook.

That said, PE firms will need to pivot their strategies and add value to demonstrate their potential to prosper beyond this downturn.

The private market will have to closely monitor functional performances by tracking granular key performance indicators (KPIs), standardise reporting frameworks, accelerate growth levers, and optimise cost structures.

Levers of value creation

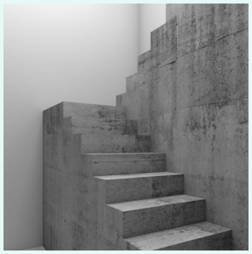
PE firms are focusing on profitability by restructuring and enhancing operational efficiency. In doing so, they are embracing new levers for value creation.



#1

Integrated due diligence to uncover value-creation opportunities

- To achieve novelty and success in deals, PEs need to place great emphasis on understanding industry dynamics and the competitive landscape
- For this, deal teams need to undertake a detailed and integrated due diligence process
- The traditional scrutiny is evolving beyond asset quality and transitioning towards a value-focused approach



#2

Centralised repository to shore up monitoring and advanced analytics to mitigate valuation gaps

- PE firms are turning to automation to drive performance, monitoring and operational initiatives
- They are using cognitive automation and analytics, including natural language processing and artificial intelligence, to analyse large data sets and identify trends, thereby boosting the accuracy of their assessments
- Analytics and statistical modelling to forecast revenues for better valuation assessment and enable efficient cash-flow management

#3

Operational enhancements to deleverage and improve margins

- Leverage operational engineering to enhance general and administrative functions, supply-chain initiatives, product development, and asset efficiency to improve margins
- Identify gaps in portfolio companies relative to best practices and use strategic KPIs to track performance
- Strategic focus on improving cash and, thus, deleveraging to expand Ebitda margin and create higher earnings multiple

#4

Scaling sustainably to capture long-term value

- Systematically integrate ESG factors into due diligence and identify key risks around reputational damages or cash outflows
- Active monitoring throughout holding periods, enhancing transparency, and leveraging ESG initiatives for exit premium
- Identifying opportunities for diversifying revenue streams, led by sustainability

Conclusion

- As the macroeconomic environment becomes increasingly uncertain, dry powder accumulates, and the demand for transparency rises, it is crucial for PE firms to adapt their due diligence processes and portfolio monitoring methods
- Expertise, best practices, innovation, and execution speed are crucial for implementing key value-creation levers
- PE firms are adopting new operating models and partnering with external experts and vendors for deep industry knowledge, skilled manpower, and innovative technologies to achieve the right balance between cost and efficiency

Sources

1. Global private equity report 2023, Bain Capital, February 2023
2. As recession looms, history shows PE's resilience, Moonfare, May 2022
3. Global Private Market Fundraising Report, PitchBook, February 2023

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