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A growing opportunity set

Covid-19 looks set to further accentuate secular private-equity trends towards add-on activity and sponsor-to-sponsor exits.

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_ Finding ways to capture more of the return potential from emerging performers remains a priority for sponsors.
_ One increasingly popular approach has been to scale platform companies with further, "add-on," acquisitions.

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How will private equity (PE) cope with Covid-19? As with most areas of economic activity, it remains too early to say. However, skeptics might wish to consider the experience of the past 20 years, which saw, among other events, the burst of the Dotcom bubble, the great financial crisis and numerous natural disasters. Yet, by any metric, buyout PE has had a great run since the turn of the millennium. Strong performance relative to public markets over this period has driven impressive industry growth with buyout net asset value (NAV) at $1.7 trillion as of the end of 2018.[1] "Value of private equity deals hits post-crisis high," the Financial Times declared in a headline at the end of last year.[2]

To be sure, the rapid growth has brought challenges. The global pandemic will reinforce some of them, while alleviating others. For one thing, rising PE allocations had driven valuations up as more capital competed for deal flow. As a result, the last few years have been a great "seller's market" with consistently strong investment returns. But while sponsors have found it easy to sell platforms, i.e. companies or groups of companies they previously bought, finding attractive targets had become hard.

One increasingly popular approach has been to scale platform companies with further, "add-on", acquisitions.[3] While this approach has been around since the early days of PE, its use has grown in popularity. Add-ons have grown from representing about 35% of buyout transactions in the early 2000's to almost 60% in 2018 (see chart). They allow sponsors to further invest in performing assets they have been managing for a few years.

In the post-Covid-19 world, we expect this trend to continue and perhaps even accelerate further. In 2018, 26% of add-ons represented the 4th or later add-on acquisition for a platform company.[4] In the pre-Covid-19 environment of robust valuations, the strategy often served as a way to average down the entry valuation of the initial platform by taking advantage of the market's tendency to assign higher multiples to larger companies. In the current global economic downturn induced by the pandemic, we expect to see a growing number of attractively priced opportunities, i.e. to achieve a similar benefit more cheaply. This is an important consideration for sponsors seeking to support their best assets in a more capital-constrained environment.

[1] PitchBook Data, Inc. as of 12/2018. All data in this note is from this source, unless otherwise stated.
[2] https://www.ft.com/content/6fee67b0-2a9b-11ea-bc77-65e4aa615551
[3] Investing in a platform company by acquiring ("adding on") another company that complements/extends the platform's services or products (usually with the aim to integrate it).
[4] Brain 2019 Private Equity Report.

Finding ways to capture more of the return potential from emerging performers remains a priority for sponsors. Examining buyout performance at the deal level helps explain why. Over the past 20 years, 29% of deals have been either written down or written off.[5] We believe this is a reflection of the inherent information asymmetry which characterizes the initial acquisition of a platform company – it is very difficult to fully capture the risk profile of a company until you have owned it for a few years. On the other hand, around 30% of deals have generated a return on invested capital of 2 times the initial investment or greater, and close to 20% have generated a 3-times return to investors.

Another emerging trend is to extend the holding period for strong performing assets. One example of this trend is the increasing popularity of partial exits. In recent years, sponsors have become reticent to sell a company they believe may have further upside potential. Partial exits allow sponsors to take some of their chips off the table while booking a partial return and distribute capital to investors, called limited partners (LPs). Furthermore, the sponsor is able to maintain their controlling stake in the asset and continue to execute on their value-creation thesis.

While there are a variety of capital sources available to sponsors to support these transactions, funding has primarily been sourced from operating earnings of the platform company in question, as well as additional debt, supplemented by fund reserves set aside by the sponsor. Each of the traditional external capital sources has unique advantages but also certain disadvantages that may limit the attractiveness to the sponsor. Moreover, raising capital from any external source has obviously become harder in recent months.

One of the obvious sources of follow-on capital[6] to continue backing emerging performers early in the life of the fund would be the LPs in that fund. After all, they know the sponsor as well as the company. Among the challenges associated with this option is the conflict in setting the valuation on a transaction between a sponsor and the LPs invested in the platform via the fund. Effectively, it often means having to negotiate with an affiliated entity that has a LP position. In speaking with sponsors, these opportunities are often missed as a result of their discomfort with the embedded conflict and optics of what looks like an "inside deal."

Another alternative may be to invite a competitor (another buyout sponsor) to invest in the asset. Sponsors are often hesitant to pursue that alternative due to the need to share governance rights and potential misalignment on exit timeframes. We believe this may be one of the factors driving the growth of full exits represented by sales to other sponsors. In 2018, almost 1/3 of buyout exits were sponsor-to-sponsor sales – often a smaller sponsor selling a strong performer to a larger sponsor able to further invest in the asset.

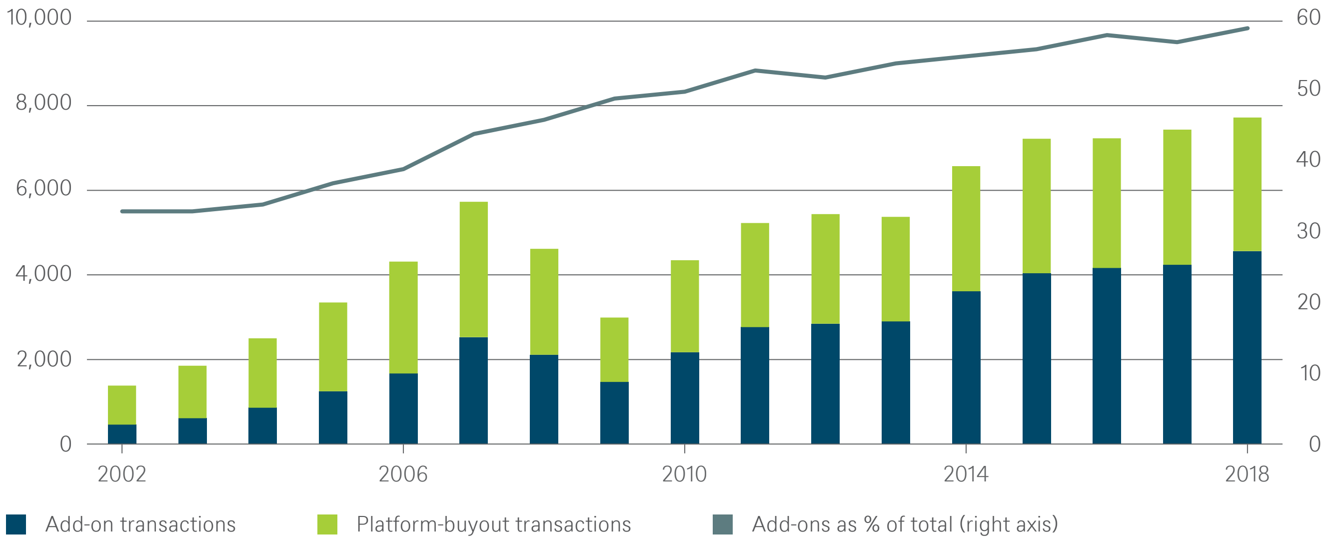
The downturn may well encourage more such deals, not least by prompting smaller sponsors to consider at least partial exits of assets that they believe have further upside potential by bringing in incremental non-control capital. From the perspective of the capital provider, such deals can also have important risk-mitigating elements, notably reduced information asymmetry associated with investing in seasoned platforms backed by incumbent sponsors.

For control sponsors, the appeal of investing further in emerging performers is stronger than ever. Providing sponsors with the capital to pursue that strategy is, in our view, a compelling opportunity which looks set to grow further, supported by the secular industry trends of increasing add-on activity and sponsor-to-sponsor exits.

[5] Hamilton Lane 2018/2019 Market Overview
[6] Subsequent investment by an investor who has already invested in the company.

ADD-ONS AS A PERCENTAGE OF GLOBAL BUYOUT TRANSACTIONS

Recently, the use of add-on acquisitions to scale platform companies has been strongly increasing.



Source: PitchBook Data, Inc.as of 12/2018

GLOSSARY

A buyout is a purchase of shares in order to gain controlling interest in another company.

The dotcom bubble refers to the rapid rise and eventual collapse of equity market valuations of technology stocks from the late 1990s to 2001.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Limited partnerships (LPs) are a form of partnership where one or more partners has only limited liability and no management authority. Private equity operations often exist in this form.

A multiple is a ratio that is used to measure aspects of a company's well-being by setting various of the company's metrics against each other and thereby building indicative ratios.

Net asset value (NAV) is the value of an organisation's assets minus the value of its liabilities.

Private equity (PE) is a direct or indirect investment by a financial investor in a substantial part of a company's equity. Usually the company invested in is not listed.

A private-equity investment firm is also considered the sponsor (of a leveraged buyout transaction).

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