Professional Perspective

Private Equity Challenges Necessitate Reevaluating Strategies

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Private equity sponsors have enjoyed a strong deal environment during a period of sustained economic growth. But PE firms are now facing significant challenges. Sponsors remain under tremendous pressure to deploy capital against continuing high multiples and resulting high enterprise values. Amidst a continuing proliferation of investment dollars competing for fewer good deals, the PE industry and its portfolio companies must deal with rising inflation within a generally uncertain economy, increasing geopolitical tensions, renewed regulatory gauntlets, and swelling social impact pressures. Successful transactions will require that PE sponsors become nimble, move quickly, and readjust strategies.

Current Challenges

Competition For Deals From Within

Based on the PE activity reported to date, we anticipate that 2022 will continue to be another sellers' market, with financial buyers challenged to find acquisitions at a price that will be attractive and accretive. With more than 8,000 private equity firms and billions of dollars to spend in the U.S. alone, one of the biggest problems private equity faces today is competition among themselves.

The number of firms and dollars under fund management or available continues to grow, but the number of targets cannot keep pace. There simply is too much interest and money chasing too few deals. With competition among strategic buyers, PE sponsors, large family offices and SPACs, the price tag goes up, and so does the intensity of the process.

A middle-market PE firm may look at more than 1,000 deals in a year and seriously consider 100. It takes a significant amount of effort and human capital to consider this deal volume. And time frames can become very tight.

Of course the challenge is to counteract these competitive problems. Each firm wants to present itself as unique, and frankly often needs to differentiate itself. Most firms have undertaken to degeneralize (i.e., specialize in specific industry niches), and we anticipate the pace to do so will accelerate. More industry concentration is taking place. It seems not enough anymore to focus on as broad an area as low tech or industrials. The industry targets for many are narrowing. And the sponsors who desire to remain industry agnostic appear to be focusing more on other forms of niche plays, for example turnarounds or companies emerging from bankruptcy.

Often the differentiator can be the facility within which the PE firm can move through the due diligence process. Pre-diligence can be used to speed up the process, but more importantly can sell the seller and its investment banker that the buyer means business and will close the deal. Pre-diligence can also be used to support more competitive pricing.

Another source of pressure comes from the proliferation of SPACS through 2021. While the SPAC deal momentum will undoubtedly wane in 2022, the dollars must be spent, creating what we call the de-SPAC boom. The de-SPAC boom will also fuel deal activity. SPACs accounted for over $600 billion in transactions last year, and they need to find private operating companies in which to deploy that capital. This means a continuing influx of capital inflow into an already highly competitive deal market. This process has driven up acquisition prices, and SPACs' "use it or lose it" structure only further exacerbates the problem.

The good news for private equity firms: The marketplace for new SPACs has declined appreciably. In March 2022, the Securities and Exchange Commission (SEC) announced its proposed new rules and amendments that, if adopted, would impose additional disclosure requirements on initial public offerings by SPACs, including, among other things, disclosures about SPAC sponsors, potential conflicts of interest, and sources of dilution of shareholder interests.

In addition, the proposed new rules and amendments would require disclosure of the background, material terms, and effects of the de-SPAC transaction. The heightened disclosure requirements could make SPACs less attractive to investors going forward. The not-so-good news for PE: It will take a couple of years at least for SPACs to loosen their grip on the market.

Given last year's record-breaking number of PE transactions, we anticipate that there will be a growing pressure and demand on PE sponsors to consummate deals as the ratio of deal money and interested players to the number of deals widens.

High Multiples Support Strong Deal Prices But Inflation Puts Pressure on Returns

In 2021, M&A deals reached a record-breaking year, with more than 62,000 deals announced globally. The fierce competition between strategic buyers, PE firms and SPACs continues to push up multiples to an all-time high, leading to higher prices for deals. And abundant liquidity and “dry power” are continuing to drive high levels of PE deal activity in 2022.

The recent rise in inflation has added additional complication to the deal marketplace, chipping away at projected returns and challenging debt to equity ratios. According to an article published by S&P Global Market Intelligence, several key factors are contributing to the rising inflation, including, among others, labor shortages, supply chain disruptions, and higher oil and gas prices. More so, government spending, pumping an estimated $5.2 trillion into the economy as a federal stimulus, is perhaps the most significant contributor to rising inflation. As a result, too much money is chasing too few goods and services.

The increase in inflation means higher interest rates, and higher interest rates can lead to a correction, as the rates inevitably reduce the PE sponsors’ future cash flows. This may take the form of lower valuations in high-growth sectors. At the same time, higher inflation can lead to a fall in EBITDA multiples, and, as a consequence, decrease the exit opportunities for PE firms. While sponsors could theoretically stay in the game longer to recuperate their investments, or may find themselves locked in to doing so, the pressure from limited partners for average five-year returns makes a longer hold unattractive at best.

In a recent survey published by Eaton Partners, 89% of the limited partners surveyed are concerned about heightened inflation. Given the leverage models employed industry-wide, it's a sine qua non that the higher the borrowing cost, the lower the IRR. However, some have predicted that, despite the current trend, long-term inflation and interest rates, while higher, will still remain relatively low by historical standards.

Nonetheless, to maintain the growth momentum during this inflation surge, many PE sponsors are increasing their focus on add-on acquisitions. We have seen add-on investments, a value-creation strategy, enjoy greater attention among PE firms as these acquisitions tend to provide better pricing and a more competitive advantage in the face of economic uncertainty.

Because add-on acquisitions tend to be smaller in size and interesting to a smaller audience, there is less pressure on pricing. PE firms can often close add-on deals for a lower multiple of EBITDA, making the overall adjusted return of their portfolio more profitable. The accretive nature of the add-on, coupled with relatively lower multiples, acts as a buffer to the otherwise hostile nature of the inflationary environment.

We are also seeing some PE sponsors meet the headwind of the current market environment by interconnecting their diverse portfolios. Rather than treating businesses in a portfolio as isolated, individual investments, forward-thinking PE firms are managing these portfolios as a “business ecosystem.” This approach allows PE sponsors to link previously unrelated goods and services in different industries to unlock new value for each business in the portfolio.

For example, two or more unrelated portfolios could coordinate the procurement of common services, such as insurance coverage, to reduce costs. By coordinating collateral relationships to the extent feasible, PE firms leverage their portfolio networks to obtain scale discounts and boost cash flow. While this approach may be deployed after PE firms have already acquired their portfolio businesses, we expect to see greater value creation recognized before the acquisition, by evaluating a new target's individual investment potential as well as its capacity to add value to the business ecosystem.

Geopolitical Tensions Drive Supply Chain Changes, Force Regionalization & Present National Security Concerns

In addition to rising inflation, PE firms are also feeling the impact of heightened geopolitical tensions. For example, supply chain vulnerabilities in the world economy have accelerated the trend of regionalization by forcing companies to take a closer look at local production.

Prior prolonged lockdowns during the peaks of the pandemic forced many manufacturers to stop production entirely or reduce it significantly, which caused an unprecedented disruption in supply chains across many industries worldwide. In response to this and the subsequent bottlenecks, many companies regionalized their supply chains or have prioritized the shift to regionalization in their supply chain footprints. Indeed, in a survey conducted by McKinsey & Company, close to 90% of the respondents indicate that they expect to pursue some degree of regionalization in the next three years, particularly those in the healthcare, engineering, construction, and infrastructure sectors.

Prefatory to the supply chain disruptions, the trade war between the U.S. and China had already caused some investors to miss out on compelling opportunities due to containment policies imposed by the U.S. Recently, BlackRock has ranked the power competition between the U.S. and China, particularly with respect to global technology decoupling, as the second most serious factor likely to affect acquisition prices. Easily understood, given that the two countries account for over 75% of the world's top 100 most valuable companies. The combination of an increased focus on domestic supply chain resilience, and the power competition between top economies, will no doubt present additional challenges and complications for many PE deals.

The invasion of Ukraine is another reason for increased regionalization of supply chains. International conflicts can trigger sanctions, many of which are strict liability offenses. Failure to comply, either on the buy-side or the sell-side of a cross-border activity, can have severe consequences. Yet, ascertaining a target's connection to a sanctioned entity or individual may not always be possible, given the use of shell companies. Relatedly, evasion of financial sanctions often gives rise to money laundering activities, adding more complications—and expenses—to the due diligence investigations of many cross-border deals.

Furthermore, we anticipate that cross-border activity will be challenged by national security considerations, given the current geopolitical uncertainty. Scrutiny of foreign investments into U.S. businesses has significantly increased in recent years, particularly investments with links to critical technology, infrastructure, sensitive personnel data, and real estate located in close proximity to certain government properties. This increasingly aggressive governmental review has already caused divestments of acquisitions in significant deals—e.g., the TikTok merger—on national security grounds. Given the current geopolitical instability, we expect the intensity and rigor of such scrutiny to continue in 2022.

To successfully navigate through the increasingly complex geopolitics, PE sponsors have placed heightened focus on the various components of a cross-border deal and any attendant geopolitical frictions and risks associated with them. As examples, more recently we have been asked by our PE clients to use our global reach to consider local regulatory schemas, regional protectionism, and the role of government intervention in a particular country. We are also being asked by PE sponsors to assist in performing a more focused review of their multi-national portfolios, with heightened awareness and increased sensitivity, to identify any emerging geopolitical risks associated with their investments.

Renewed Regulatory Gauntlets Pose New Compliance & Reporting Pressures

Deal scrutiny and fund scrutiny by regulators are also on the rise. Since 2020, regulatory scrutiny on "killer acquisitions," where a large company acquires targets only to discontinue their innovative projects as a way of preventing future competition, has increased. Deal scrutiny has also expanded to include issues such as data ownership and access to critical technology due to concerns for national security interests, making it harder to clear certain deals.

In January 2022, SEC announced its proposed amendment to Form PF, a confidential reporting form for certain PE advisers, in order to "enhance the Financial Stability Oversight Council's (FSOC) ability to assess systemic risk as well as to bolster the Commission's regulatory oversight of private fund advisers and its investor protection efforts in light of the growth of the private fund industry." The proposal would decrease the reporting threshold from $2 billion to $1.5 billion for applicable large PE advisers, and steeply increase the compliance burden by requiring current reporting within one business day after a triggering event.

Two weeks later, the SEC announced another set of proposed new rules and amendments aiming to "enhance the regulation of private fund advisers and to protect private fund investors by increasing transparency, competition, and efficiency in the $18-trillion marketplace." The proposed rules would require, among other things, registered private fund advisers to provide investors with information regarding fund fees, expenses, and performance, on a quarterly basis. Additionally, private fund advisers would be prohibited from engaging in a list of activities, such as seeking reimbursement, indemnification, and exculpation, to name a few.

These recent proposals demonstrate the SEC's increasing appetite in regulating PE transactions. If adopted, they would change the regulatory regime for the PE industry, including private funds' ability to negotiate terms that have long been commercially negotiated for decades, creating additional obstacles for PE sponsors.

We anticipate there will be significant pushback on both the scope and the breadth of the proposed rules from the PE industry. However, in the event that the proposed rules are adopted, PE sponsors should be ready to embrace the old adage, "If you can't fix it, feature it!" Since the primary aim of the recent proposals is to enhance the "transparency, competition, and efficiency" of PE investments, PE sponsors should feature this to their advantage in future deals by noting the increased protection offered to investors.

Social Impact Pressures

In addition to delivering value on investments, many PE firms that want to stand out to investors are taking environmental, social, and governance initiatives into consideration. While heretofore not a major factor in many deals, 2022 may see ESG capturing additional attention in deal selection.

According to a Bain & Company Report, 88% of the limited partners surveyed consider ESG performance in their investment decisions, and 87% have invested in companies with reduced near-term returns due to allocation to ESG initiatives. Approximately 56% of the participants in the PWC Global Private Equity Responsible Investment Survey reported turning down investments on ESG grounds. Participants in the Eaton Partners Survey also echoed the importance of ESG initiatives, with 73% of the participants indicating that they are either focused, or will focus, on ESG factors in 2022.

It's unclear whether the heightened attention to ESG is due to increasing social awareness or PE sponsors' begrudging submission to the demands of the limited partners. One thing, however, is clear—the increasing demand on sustainability, social welfare, and good governance is here to stay. Consequently, this area warrants additional consideration.

ESG initiatives present a unique set of challenges for PE sponsors. For one thing, ESG initiatives are imprecise, thus improvements from a commitment to diversity and inclusion is hard to quantify, especially given the proliferation of approaches and the lack of standardization in ESG reporting. Some argue diversity is to improve performance, but others demand it as a goal in and of itself. In August 2021, Nasdaq imposed a new "comply or disclose" framework requiring all listed companies to hire at least one woman on their board of directors and at least one person who is racially diverse or self-identified as LGBTQ+. While the NYSE has yet to announce any board diversity listing rules of its own, there will be pressure to establish some sort of framework through its Board Advisory Council.

Similar to DEI initiatives, it is also difficult to show financial improvements with sustainability investments over a period of less than five years—the median hold horizon for PE investments, making PE portfolios with sustainability investments less attractive at the time of exit, given the pressure to deliver high returns. Thus, most ESG investments do not generate enough returns for PE firms, unless they are subsidized by the government.

A growing number of limited partners view companies with strong ESG policies more favorably because they are thought to be better equipped to address issues associated with diversity and inclusion, as well as other sustainability-related challenges. Relatedly, good corporate citizenship and environmental stewardship will be the key to attract the next-generation investors, e.g., Millennials and post-Millennials, groups with a total of over $30 trillion investment potential who have been very vocal about more socially-conscious corporate behaviors.

In addition, investors often equate strong ESG performance with value creation. A company that prioritizes "doing good", according to Forbes, will create "a positive feedback loop with compounding benefits," as such company "is more likely to attract top talent and a loyal following, which unlocks the door to innovation and growth." Finally, the right ESG profile, as some limited partners believe, will signal a business's commitment to long-term growth—a critical component in gaining market shares and raising capital.

Some commentators suggest ESG will be the future of value creation and a central factor in raising money—at least on paper. By focusing on ESG metrics, PE firms might actually generate more value and therefore higher multiples than the traditional approach of boosting EBITDA, some say. We believe this view may be somewhat exaggerated. Indeed, there are equal numbers of commentators who are skeptical about this win-win argument, and believe that, over a realistic time horizon, the performance of portfolios with ESG initiatives remains inconclusive. But for now ESG is a reality that must be faced.

To get started, a number of PE firms will look for government-backed deals to offset some of the challenges discussed earlier. In addition, based on what we are seeing, many PE funds will engage in more extensive reviews of their portfolio companies by honing in on ESG initiatives that are linked to revenue growth, starting with those portfolio companies that are closest to exit to make sure that they align with market expectations.

Conclusion

The road ahead will be bumpy for PE sponsors as they face myriad challenges. They will need to become nimble, move quickly, and readjust strategies in order to successfully navigate through the changing investing landscape. The door has not closed by any means, however, and for those that are able to meet the increasing demands imposed on PE firms, deals will continue to abound.

