Buyouts

'Creativity will be at a premium'

Cover story

Macro uncertainty and a tough market will continue, but five industry veterans say there are opportunities to be found in the shadows.
By Kirk Falconer and Chris Witkowsky

For a second year in a row, private equity in 2023 faced down tough markets for raising and investing capital.

Economic uncertainty and spiking interest rates continued to weigh heavily on deal activity and exits. Fundraising slowed further, as strong GP demand was matched against weak LP supply.

While private equity's long-term outlook is sound, the industry is today grappling with challenges unseen in more than a decade. What does 2024 hold? Will the downturn continue? Or will there be relief? If challenges persist, will there also be opportunities?

To help answer these questions, *Buyouts* spoke to five top private equity leaders: Seth Boro of Thoma Bravo; John Bradley of the Florida State Board of Administration; Stephanie Geveda of Coalesce Capital; Suyi Kim of the Canada Pension Plan Investment Board; and Matt Nord of Apollo Global Management.

Cover story

"AI is an interesting opportunity... Everybody's using it, working with it, thinking about it"

SETH BORO
Managing partner
Thoma Bravo

Q Will the deal market remain slow in 2024?

Seth Boro: The reason that deal volumes have been down is cost of capital is up quite a bit – especially debt. It has definitely taken buyers out of the market.

We've taken the view that we'll continue to remain active as a buyer, but it's not enticing to borrow 13-14 percent debt. We've chosen to limit that and put more equity into our companies. GPs believed this year would be a lot better than it was. There was probably an assumption the market would recover. Now everybody expects borrowing costs to remain high for quite some time.

There is also a bid-ask spread that at some point will have to shrink. Some boards have been holding on to a view of what used to be, but as time goes on, reality will set in. We may be in the early stages of that.

Suyi Kim: We're seeing a delayed impact from interest rate hikes. We haven't seen things crack yet. What I mean by crack is the multiple adjustment – as the base rate goes up, the multiple of businesses being traded should come down. We haven't seen that adjustment happening in private equity. I expect it to happen, but it is slowly taking place.

In the second half of last year and the beginning of this year, deals that have gone through were still at elevated multiples. You have to believe those businesses were of high quality and that people were willing to pay a premium and can still make the returns work. But that's not going to happen all the time. Things will have to adjust.

Matt Nord: To me, it seems like something needs to correct. Either interest rates are going to remain elevated and equity multiples need to fall or – in order to justify the prices that sellers want – people are going to have to assume a reduction in rates. Until that resolves itself, private equity activity is going to continue to be depressed.

Creativity will be at a premium over 2024 to help solve some of the bid-ask challenges we're seeing in processes.

Stephanie Geveda: What we've seen is a year of dealflow stagnation. There are signs that the dam is beginning to break as we look ahead into 2024, as debt markets have re-opened and are starting to function again, peak rates are now in sight and covid aftershocks have largely subsided.

There is, however, a still uncertain world, increasing geopolitical strife, persistent higher rates and an upcoming presidential election. All these things could portend a dormant deal market for a slightly longer period.

While some GPs may wait to see the absence of the proverbial February groundhog's shadow before re-entering risk markets in earnest, I am cautiously optimistic about the shorter term. Some sellers largely sat out the 2023 downturn and that will change when they start to accept that 2021 pricing is not coming back.

Q Will exit markets also remain tight?

Suyi Kim: Exit markets have been challenging. We're seeing the bottom and people are talking about DPI being the new IRR. That's a mantra in private equity now. How that's going to be unlocked involves M&As or strategic sales, secondary sales, the IPO market – there are different themes, but it all comes back to having some adjustment in valuations so we can breach the buyer-seller gap.

The bigger end of the deal market probably faces more challenges. One of the lessons GPs have been learning over this cycle is that just relying on public markets for exits is not the way to go. Having exit flexibility across different options is key. As company sizes get larger, it becomes more challenging for strategics and other private equity firms to digest.

John Bradley: Distributions in 2023 have been down. We were probably down 50-60 percent from peak 2021 distribution activity, with contributions also down at a similar rate. Over the last nine years, we've been net positive in our cashflows, and distributions have always outpaced contributions. This year, we're break-even.

I expect distributions to pick up slightly in 2024. It feels like the market is starting to adjust to the reality of today – that this is where rates are and where multiples are. GPs are starting to say, "I might have been able to sell this company for two turns more a year or two ago, but that's not happening in the next couple years, so what I have is what I have – maybe it's time to sell and move on."

Matt Nord: We're starting to see a re-opening of the IPO market. I can see toward the end of this year and into next year – as there's greater clarity around the outlook for rates – the IPO market continuing to open. It might be more of an option going forward than what it has been over the last 12-18 months.

Q What will be the impact of an impending wave of debt maturities?

Matt Nord: The notion of higher interest rates having an impact on the ability of companies to extend their capital structures or refinance is going to be one of the largest private equity themes.

Given the move in rates, businesses can support about two to three turns less leverage than they had prior to the move in rates – meaning those that were levered at 7x in a low-rate

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>
> **SUYI KIM**
> Senior managing director
> **CPPIB**

environment can really only be levered around 5x today.

As companies need to refinance, unless they have materially grown and deleveraged the balance sheet through earnings growth, they're going to have a hard time extending their capital structure. That is a massive challenge for a lot of sponsors that will continue to play out over the course of 2024.

Stephanie Geveda: As borrowers approach maturities associated with capital structures established over 2017-2019 that have five-to-six-year durations, they'll face a reckoning as they're not going to be able to replicate the borrower-friendly terms that were previously available.

In many cases, these capital structures haven't required covenants. They offered EBITDA adjustments that were very generous, which allowed these companies to kick the can down the road in some instances. Unless they had liquidity pressures, meaning that they ran out of cash or needed to refinance at maturity, there hasn't been a catalyst there yet.

But those maturities are coming, and when they do, they'll likely be a catalyst for sponsors to make some hard decisions: support companies by infusing more equity, suffer dilution by selling a stake, or exit some portfolio companies outright in what may be a less than ideal environment.

Q How are GPs managing challenges in this environment?

Suyi Kim: It's not as easy as in the prior 10-15 years when we had a good tailwind with multiple expansions, when you could leave things and still generate good returns. Going forward, value creation will be even more important to increase the value of your holdings.

It's going to be more work for private equity firms, for portfolio companies, for senior management teams. And GPs are going to have to take a harder look at whether these are the right teams to lead a company to the next level or what more needs to be done to create value.

This is where private equity has competitive advantages. Because of the governance structure – the fact that we're controlling businesses – there are more things you can do versus public markets from an investor's perspective. There are several levers that GPs can pull.

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> **STEPHANIE GEVEDA**
> Founder and managing partner
> **Coalesce Capital**

> *"There are firms that have only been around 10-15 years and they only know one environment – the environment of low rates"*
>
> **MATT NORD**
> Partner, co-head of PE
> **Apollo Global Management**

Matt Nord: There's a narrative about sponsors turning inward, which is a function of two things. One, they don't have a competitive advantage to deploy capital in this environment. Two, they probably have challenges in their portfolio, particularly as many GPs that paid high multiples for assets and used a lot of leverage may not have swapped or hedged their rate exposure.

Many sponsors are bearing the brunt of that move in rates. Interest is consuming much of the cashflow of businesses, which means there's less to reinvest for growth or use to pay down debt. Many are focusing on operational improvements – generating increased earnings or cashflow – to chip away at the debt stack on these companies to create some value and give them more exit flexibility.

There has been so much stimulus for so long that there are firms that have only been around 10-15 years and they only know one environment – the environment of low rates, lever beta and the momentum trade. Price and structure didn't really matter.

We've been in business for 30-plus years and seen many cycles. Even when other sponsors were paying full prices and using significant leverage, we maintained our discipline. This is core to our strategy. So, heading into the volatility, our companies have stronger balance sheets.

Seth Boro: GPs have been worried about company performance. We continue to see resiliency in software because it underpins digital transformation, which every business in the world needs to go through at some point.

But we're spending more time with our portfolio companies to make sure we're achieving the operational results we need to deliver. We've always had an intense focus on operations – transforming companies into best-in-class across every metric. We've moved even faster in this environment, similar to what we would have done in the financial crisis of 2008-2009. There's pattern recognition around that.

In a world where you've got budgetary constraints and money is not free anymore, if you can delay spending, you're going to do it. Even in the software sector. The places we're looking to invest in are businesses that can deliver a very quick ROI to their customers, so it can be justified in the budget as mission-critical spend. That's different than it was 24-36 months ago.

We also want to make sure we've got capacity on the balance sheet to do M&A, to take advantage of opportunities that we expect to see in the market. Software is a super fragmented

Cover story

space, and there's a lot of consolidation to do.

Q Are there opportunities for generating superior vintage returns?

Matt Nord: We've been extremely active over the last year, particularly in take-private transactions. That continues to be a meaningful source of dealflow and capital deployment. CEOs and management teams that might have been less intrigued or excited about a take-private years ago have become much more open to it.

At the same time, we've focused on deleveraging transactions where we can use our capital to reduce debt on a company's balance sheet. These are good companies with bad balance sheets. And we're having many conversations with strategics around carve-out opportunities. Each of those indicators is flashing green.

The biggest consideration we have looking at a new opportunity is relative risk-reward. The question we ask ourselves is what's the appropriate rate of return on equity such that you want to take levered equity risk with all of this uncertainty. We've been incredibly selective in this environment, even as we have seen increased dealflow.

Seth Boro: Take-privates have been our bread and butter. We've always been active in this space, especially in our large fund, where they've been the majority of deals in all markets. As boards adjust to the reality of the present and future and not the past – which many are still hanging onto – we expect to see an increase in opportunity.

We're spotting more add-on opportunities. This is where we're seeing the bid-ask spread perhaps come to a reasonable place. I don't know if we're at the beginning or in the middle of a price reconciliation for several of those smaller companies, but the value discussions we've had are much more reasonable.

AI is an interesting opportunity because it allows you to do things very differently. Everybody's using it, working with it, thinking about it. Generative AI is what people are talking about today because it has become a consumer-facing technology that is part of daily life.

For us, AI is an enabling technology. We see it in the portfolio enabling talent – for example, in R&D it helps you write code more efficiently. It certainly provides information to businesses and executives in a new way. The flip side is that our security software companies

> *"When you have longer fundraising periods, things get interesting. Difficult environments mean access"*
>
> **JOHN BRADLEY**
> Senior investment officer
> **FSBA**

More than box-checking

Q Is private equity making progress on the ESG and DEI front?

Stephanie Geveda: Progress is being made. The data also tell you that the industry has a long way to go to achieve the appropriate levels of gender and minority representation, especially at the most senior levels. There's a statistic from McKinsey that if we continue to make progress at the same pace, it'll be another six decades before private equity resembles the US working population in terms of demographics.

We're not going to be able to move the needle on DEI until leadership at the top firms are diverse themselves. There's a body of research that shows diverse leadership attracts diverse talent. Women and underrepresented minorities want to see role models that resemble them and that demonstrate achieving career progression in the industry is possible. They need to have leaders that intuitively understand where they're coming from rather than leaders who check the box by taking a mandatory HR course.

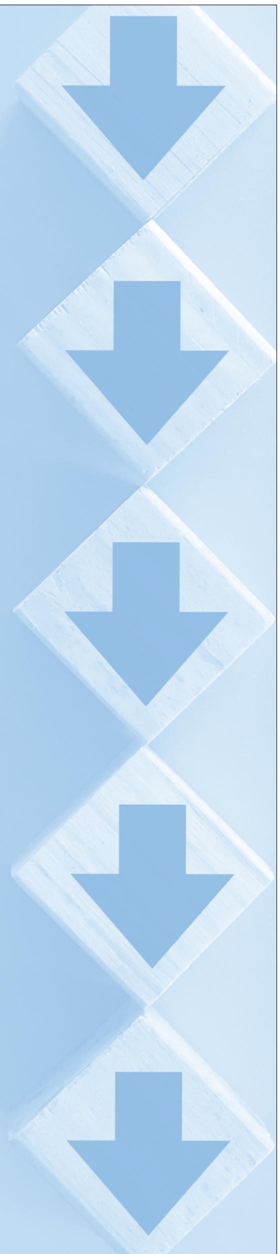
Seth Boro: We're making progress. Our four incoming associate classes have averaged roughly 80 percent underrepresented groups. So it's showing up as we're hiring and continuing to build the firm. More generally, I believe the industry is taking steps forward, but it's going to take some time before we see the kind of progress that we're all working toward. We're focused on building companies through operational efficiencies and innovation, and that includes thinking about ESG risks and opportunities. For example, a lot of the customers of our software companies view ESG as a need-to-have for doing business.

Right now, a priority area of ours is AI and AI governance – working with portfolio companies to make sure that we're capturing the upside of generative AI while also protecting against the downside. That's an interesting part of ESG that many people don't really think about.

Matt Nord: This is more than just a box-checking exercise. For us, it's about driving incremental value. These are tools. You want a more diverse team because all the studies have proven that more diverse teams outperform, that there's more diversity of thought. Our team is more diverse today than at any other time in our history. We've always had a promote-from-within culture. The majority of our partners started as associates. The last couple of associate classes have been about 80 percent diverse. Roll forward the clock a couple of years, and those are going to be our principal classes, and a couple of years after that, those are going to be our partner classes.

Suyi Kim: We've made progress in that private equity firms are aware of the importance of sustainability and diversity and agree they can have a positive impact. That's our view. We look at these factors as integral to our investment process and our risk-return perspective. GPs seem to have gotten their head around the issue, but we're still in the early innings in terms of how they incorporate it.

Cover story



50%+

Decline in FSBA's distributions from peak 2021 amounts, per John Bradley, FSBA (contributions declined at a similar rate)

43%

Decline in year-on-year fund closings through Q3 of 2023 versus 2022 (Buyouts data)

$390bn

Raised by buyout, growth equity, venture capital, secondaries and other PE funds through Q3, down 11% from a year earlier (Buyouts data)

are needing to do things to address attack vectors driven by AI. So, it's both an opportunity and a threat.

Stephanie Geveda: There is an abundance of fresh capital that has been raised over the past few years and increasing incentives for GPs to invest it. Nonetheless, some of the best buyers right now are emerging managers that are not hamstrung by large, un-exited portfolios. They don't have fires they need to put out and can focus all their energies on investing capital.

During periods of uncertainty, GPs tend to shift focus toward businesses that are more resilient in terms of their demand drivers, have stable free cash-flows and benefit from secular growth trends that generally transcend cycles. Essential service businesses represent an attractive area. These companies can focus on playing offense when others are having to play defense.

The mid-market has been attracting more attention as a result of challenges in capital markets. Smaller deals are easier to finance and they often have more compelling entry valuations.

There's a huge opportunity when someone does the hard work and they're able to identify an off-the-radar smaller company that has a compelling, rock-solid offering. In many cases, these companies are newer to private equity's value-add, so exposure to those tools and resources can accelerate their earnings growth.

Suyi Kim: Across a range of strategies, we're seeing the secondaries strategy picking up first, starting with LP secondaries. And the continuation vehicle market will open up again once the valuation expectations of buyers begin to match more closely those of sellers.

When a public market adjustment or dislocation happens, that's the time for take-private transactions. Those have been squarely in our pipeline since the beginning of last year. We're seeing a valuation gap there too, but as the stock price seasons, discussions with a company become clearer.

The world needs to transition its energy, so that will continue to be an opportunity. For GPs, the energy transition might be a bit challenging because it's on a different time frame and is rather asset-heavy. But there are segments private equity is well-positioned for, such as climate technology or the software side, which have the potential for high returns. For investors with capital, there should be things you can pick and choose. We're in a good position in that we continue to have large, permanent capital.

Q Will the pace of fundraising remain slow next year?

John Bradley: GP demand for capital is much greater than LP supply today.

Many LPs remain overallocated to private equity or are pushing the upper limits of what they've allocated to the asset class. This overallocation remains despite public markets rallying this year.

Should we get some kind of correction in the equity markets, or if there is a recession, or if the impact of higher interest rates is finally felt – it could be even worse. Also, as distributions have not been very big this year, absent a flood of them back from GPs in the next quarter or two, 2024 will continue to be a very difficult fundraising environment.

This year is characterized by more time: we've had more time to source new relationships, to do due diligence, to go through LPAs and negotiate agreements. The past three to four years was a much quicker, more frenetic pace in trying to get work done and access funds. Closing timelines were much more compressed, GPs were having one-and-done closes. This year is the exact opposite.

When you have longer fundraising periods, things get interesting. Difficult environments mean access. If LPs have a manager they've tried to access in the past, or a manager they've been tracking or targeting – one that might have been closed to new LPs – that's not the case in this market. That manager is likely open to new LPs. Investors have more options.

Suyi Kim: Here's the dilemma: if GPs need to raise money, they have to exit first. If they don't exit, then LPs don't have the money to commit. There are pockets of investors who can continue to commit to funds, but there remains lots of capital that's waiting to be exited.

Right now, LPs do not have much bandwidth, so it's hard to add new relationships. Instead, in challenging times, we tend to see bifurcation in fundraising and capital mostly going to high-performing funds. Some GPs who cannot raise capital will either have to wind down – though it takes a long time for any private equity fund to disappear – or we may see more acquisitions at the smaller end of the market.

Matt Nord: Sponsors are going to need to demonstrate an ability to generate outsized returns in order to get new commitments for their funds.

If you're a GP that's been around 10-15 years, you've never operated in this environment before. It's even more of a leap of faith for investors to say, "OK, your strategy worked in a market where interest rates were low and everything just went up. But in this market – where rates are higher, where you're not going to have the same multiple expansion, when there's economic uncertainty – is your toolkit going to work?"

Q Do conditions support more co-investment opportunities?

John Bradley: We think this is a great time to be a co-investor. GPs are putting more equity in given where rates are, and sometimes that necessitates more co-investing capital. GPs are also very hesitant to come back to market today, so if they can extend the life of their fund and do that by syndicating some co-investments – which also makes their LP base happy – it's a win-win situation. And it's definitely creating more co-investment dealflow.

We've grown our allocation to co-investments over the years. It's an activity that increases the expected return of our private equity program. The no-fee, no-carry element is meaningful to LP performance. It allows us to develop a deeper relationship with our GPs: we can view their team, we can see what they do – their ability to manage a deal, their ability to create value.

In addition, co-investments allow us to be a bit more tactical with our program, to add exposure more quickly to a GP or a sector that you might not be able to do quickly through fund investing.

Suyi Kim: Deal activity has been very slow, but when it recovers, we're well-positioned. The easy money is behind us, so our dollars speak louder. There are co-investments that are passive, and we do some of those, but in our program of co-sponsorships we can invest 50:50 with our GPs and set the valuations. We're able to underwrite complicated deals with a large check size. This is a unique proposition we have in the market.

Q Are challenging dynamics putting a strain on GP-LP relations?

Suyi Kim: That's certainly not the case for us. We view our GPs as our long-term partners and believe that when they make money, we make money as well. Looking at the overall market, when things get tougher, on the margin LPs may have more transparency concerns because they need to think through and analyze what they're holding. There will be more questions.

Matt Nord: These are incredibly important relationships where trust is key. It's going to be crucial for GPs to be transparent in this environment. Many sponsors, particularly those that overpaid for assets in the last couple of years, may be marking their positions at pretty full valuations. It's important that they are transparent about what's going on in their portfolios, where they're focused and where they're looking to deploy capital.

Seth Boro: The issue is about returning capital to LPs. We've always been focused on that and the current environment has amplified its importance. We have great partners that have grown with us over the years and we try to understand their businesses well. A big part of that is providing liquidity back to them. ■

Quotes have been edited for length and clarity