Insight Article: Creating Value in the Current Environment: Still a (Challenging) Possibility

The abundance of private equity "dry powder" persists as a recurrent theme in 2017. As we note in this week's blog, there is approximately US$749 billion in North America. That's a lot of dry powder! And if we factor in leverage, with median debt financing running at 50.5% of U.S. M&A deals in 2016, buying power doubles to about US$1.5 trillion. But rather than simply reporting on the level of available capital, we'd like to dig below the surface and consider the causes and implications, if any, for private equity investors.

A recent McKinsey Private Markets report provides some useful insights[1]. According to the authors, factors that are driving the sustained higher levels of capital include:

1. An increasing number of participants (investors)
2. Healthy, sustained fundraising

So there is more "powder" …but why is so much of it still "dry"?

Increase in Competition

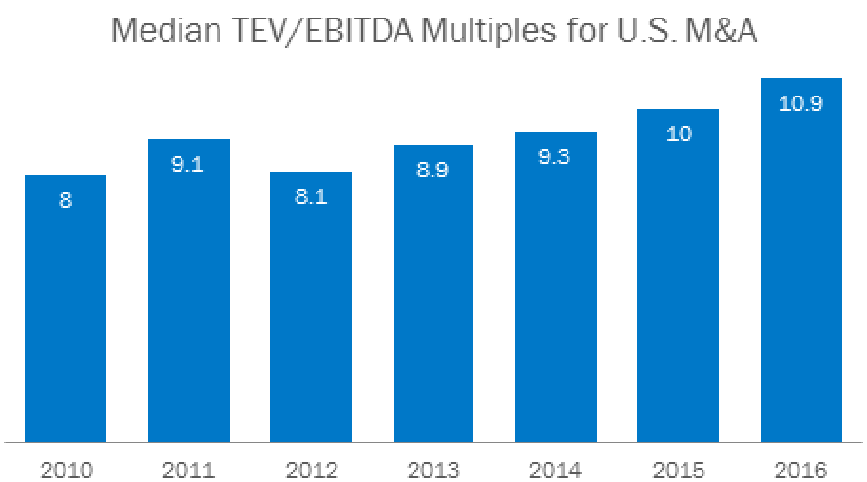
In the past, we've pointed our finger at strategic buyers as an increasing source of competition for M&A targets. While this continues to be the case, there are other factors at play:

i. Limited Partners (LP's) are expressing a greater interest in certain segments of the private markets, specifically in Private Equity (PE) and infrastructure investment. The McKinsey authors suggest that in the face of anxiety about future public market returns, LP's are looking to private markets to invest their capital[2]. In addition, high net-worth individuals are demonstrating increased interest in private market investing, with the result that PE funds are launching new products tailored to that demographic. A further significant factor contributing to competitive pressure is the likely increase in private equity allocations by both U.S. pension funds and Sovereign Wealth Funds;

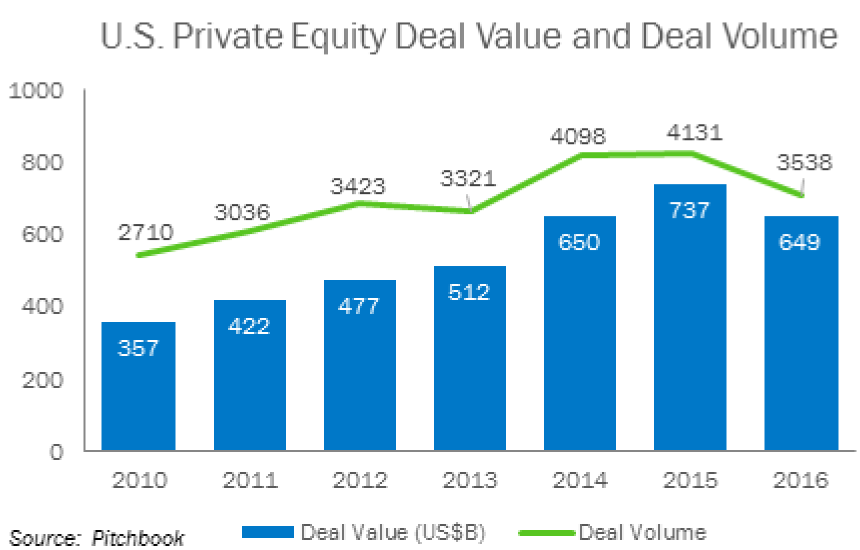
ii. Fundraising in private equity increased in 2016 over already high levels. North American private equity fundraising increased 6% from 2015; and

iii. Somewhat related to (i) and (ii), the number of PE firms continues to increase.

The heightened competition for potential acquirers has, not surprisingly, driven up multiples to ten year highs, with the U.S. median TEV:EBITDA increasing from 10X in 2015 to a 2016 level of 10.9X.



As we've discussed in previous articles, higher valuations have inhibited deal activity, with U.S. private equity deal volume and value decreasing 14% and 12% respectively in 2016.



And now we're back to the dry powder. In an environment with more suitors looking to create value through their acquisitions, from a pool of highly priced potential targets, it is no surprise that the powder is still dry.

As the fundamentals that have created this environment are still at play, we expect these conditions to be sustained through 2017. So what is a PE investor to do?

A Couple of Suggestions to Consider

i. Last week, we wrote about the [importance of post-merger integration (PMI) to value creation](). "Extraordinary acquirers" – that is, firms that deliver shareholder value independent of industry, specific senior management or target – engage effectively and consistently in PMI.

ii. An "add-on" strategy can also increase the probability of value creation in the current environment. In pursuing add-ons to an existing platform, PE's can take a strategic buyer perspective. The platform company already has infrastructure and management in place, and there is the potential benefit of cost-side and distribution synergies and multiple arbitrage. In addition, there is a clear relationship between valuation and size of target. With valuations reaching lofty new heights, the pursuit of smaller, add-on acquisitions at lower multiples is an effective gateway to value.

Our optimistic but pragmatic conclusion: while valuations remain high, PE investors that adapt their strategies and approaches effectively can invest some of that dry powder and continue to create value in this competitive market.