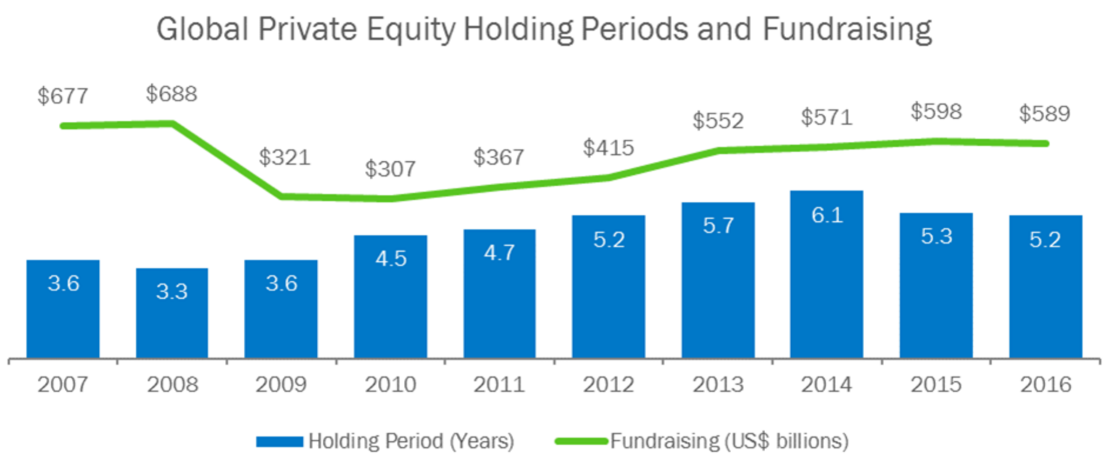
Valitas Insights: Strong Advisor Network, Investment Strategy Focus and Due Diligence – Key Differentiators for Private Equity Returns

US management consulting firm Bain & Company's 2017 Global Private Equity Report summarizes key changes in the PE industry in 2016. The primary finding? PE firms are putting more emphasis on the importance of a strong advisory network, investment strategy focus and due diligence. These are factors Valitas regards as critical at a time when returns are ebbing to the downside, holding periods are lengthening, and competition for quality targets is rising, supported by high levels of available capital.



Top-ranked PE firms are citing three key strategic differences that are crucial to outperforming the competition.

1. Having a strong network of formal and informal advisors

Having a strong team of advisors with industry-specific expertise helps PE firms uncover the right opportunities by expanding their deal sourcing capabilities and providing valuable insights. Even those PE firms in the top quartile of deal sourcing see only 26% of relevant deals, so having advisors who know the target industry well is crucial to effective deal sourcing.

In addition, an advisor with industry expertise can identify opportunities to expand product lines, optimize revenue, or reduce costs, which can turn a mediocre investment into a great one. Advisors may also play a significant role in identifying add-on acquisitions and other growth opportunities for the portfolio company after its acquisition.

2. Maintaining investment strategy focus

Focusing on a narrow "sweet spot" where the investment team has executed deals and possesses expertise is one means to achieving superior returns. Examples of this approach include contrarian investing (targeting industries that are out-of-favour or in a down stage of the business cycle), transformational investing (investing in firms a PE firm can transform, either through operational improvements or using it as a platform for add-on acquisitions), macro investing (investing in companies that benefit from an effect of a macro trend that the market has not yet anticipated) and cross-pollination investing (applying investment approaches that were highly successful in one geography to another one).

3. Superior operational due diligence

Over two-thirds of portfolio companies acquired in 2011 did not achieve the EBITDA margin expansion projected by the PE firm over their holding period. PE returns have been strong, yet this is largely attributable to the significant expansion in EBITDA multiples that portfolio investments have realized in recent years. For investments made in 2010-11, PE firms assumed an average exit multiple of 8.8x EBITDA, much lower than the average realized exit multiple of 10.9x EBITDA.

Needless to say, relying on EBITDA multiple expansion to generate high returns is unsustainable. Going forward, having strong and comprehensive due diligence capabilities will be crucial to sustaining current returns as margin expansion, inevitably, becomes the main driver of PE firm returns.

What Bain & Company's findings suggest, consistent with Valitas' experience, is a three-pronged strategy for PE firms: working with expert advisors who add value through their networks and specialized knowledge; maintaining a disciplined and focused investment strategy; and executing superior due diligence capabilities when making acquisitions.