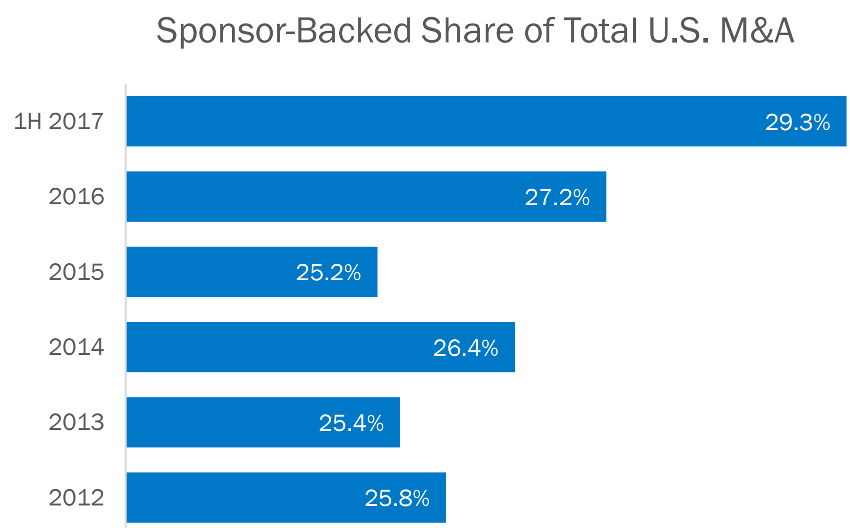
Valitas Capital Partners

Valitas Insights: Private Equity: Evolving to Meet Current Challenges

Sky high valuations, fierce competition, and scarcity of quality targets…the oft-repeated description of our current deal environment. But in the face of that, private equity firms remain resilient, continuing to invest (as they must) and outperforming their public market peers. According to a recent Pitchbook report, U.S., sponsor-backed acquisitions have increased from 24.7% of all transactions in Q1, 2016 to 29.8% in Q2, 2017. As for performance, the data indicates that even bottom-ranked PE firms are outperforming the public markets over a one and fifteen-year time horizon, and their top-ranked peers are generating considerably higher returns.



In the first half of 2017, U.S. PE fundraising continued to thrive, bringing along the associated need to invest. As one industry observer points out: "The simple fact is that if sponsors don't do deals, they fade away"[1]. But how do they do it in this seller's market? Based on a review of several industry reports[2] and our own experience, several clear trends emerge:

1. Behave more like strategic investors

This strategy is multi-faceted, and while it includes the pursuit of add-on acquisitions (which comprised 64% of buyouts in H1, 2017), it also includes sector specialization and operational expertise.

A push for value creation through operational change is driving increased sector specialization. The data supports this realignment; one report that examined PE returns over a ten-year period found that sector specialists realized higher multiples on invested

[1] Oliver Brahmst, Partner at White & Case

[2] Including: https://pitchbook.com/news/reports/2017-analyst-note-tracking-the-persistence-of-pe-managers-performance, https://www.themiddlemarket.com/news/special-report-on-private-equity-7-ways-pe-firms-are-evolving, https://www.whitecase.com/publications/insight/private-equity-adapts-sellers-market

capital and internal rates of return than their generalist peers. Sector specialization promotes operational expertise, an essential value driver in an environment where multiple expansion is no longer a reliable option.
Finally, and loosely falling within this trend category, PE firms are leveraging relationships with management teams and prospective sellers to try and pre-empt auction processes.

2. Offer more creative deal structures

To access deal flow on the one hand, and meet LP demand on the other, PE firms are investing through a broader range of structures. In addition to the traditional control investment, firms are more inclined to make minority or debt investments, co-invest, or do deals with longer holding periods. As one article notes, several large firms[3] have raised long-term private equity vehicles, with fund lives of fifteen years or more. We have also seen structures that provide for a majority PE investment with the seller retaining a minority along with board control.

3. Industry Consolidation

While U.S. PE assets under management continue to grow, the number of firms decreased by 1.3% from 2015 to 2016, a decline driven primarily by industry consolidation. It's reasonable to surmise that this consolidation is fueled by the trends described above. Firms might buy competitors with sector expertise, or with the ability to offer additional investment structures to clients, facilitating a one-stop shopping platform for LP's.

While PE investors continue to face the challenges of our current deal environment, we expect these trends to be sustained, as firms evolve to meet their objectives in a difficult market.

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[3] The Carlyle Group, Blackstone, and CVC Capital Partners