Normalcy Returns to Private Equity with Rising Exits

This two-part Knowledge@Wharton podcast looks at key trends in private equity, including a rising emphasis on organic revenue growth versus financial engineering, a shifting view of mergers, acquisitions and initial public offerings, changing management roles, and a return to normalcy regarding limited partners expectations. Those partners once again expect investments to be returned to them within the three-to-seven-year time horizon that existed before the financial crisis, thanks to a better environment for exits. Stephen M. Sammut, a senior fellow and lecturer at Wharton, and Michael Rogers, EY's global deputy private equity leader, help shed light on these and related issues.

An edited transcript of their conversation follows:

Knowledge@Wharton: We are going to look at some key issues in private equity [PE] today, including the outlook for IPOs, fundraising, and merger and acquisition activity. First let's note a recent EY study — part of an ongoing series titled "How Do Private Equity Investors Create Value." It looked at most of the PE exits in 2013, based on analysis of public filings, interviews and performance data on some 440 exits. Exits are sales of companies owned by PE firms to strategic investors through IPOs, secondary buyouts or bankruptcy. Today, more and more revenue growth is being created organically in portfolio companies as opposed to purely by financial engineering as in the past. How widespread and significant is the trend?

Michael Rogers: It is interesting that cost cutting clearly remains an important part of the PE playbook. But over the last several years it has taken a backseat to organic revenue growth and transformational changes to the business. That includes things like geographic expansion and new product lines.

In our recent study we conduct an attribution analysis of the sources of EBITDA [earnings before interest, taxes, depreciation and amortization] growth and PE-backed companies. We found that the majority of the growth comes from initiatives designed to spur organic growth, and over our entire study period — 2006 to 2013 — organic revenue growth has accounted for 46% of total EBITDA growth and it has been particularly important in the post-recession years. M&A activity accounted for 24% of the growth and cost reduction was about 25%.

It is interesting that [cost reduction] is falling quite a bit because when we first started doing the study it was about 40% percent. In the boom years, most of it was around cost savings, but post-recession it is down to about 16%, so we are clearly seeing a big change. When we look specifically at the types of initiatives that a lot of the firms are using to drive organic growth, it is things like geographic expansion that has been the biggest driver in recent years, but it is [also the addition of] new product lines. That adds maybe 15% of organic revenue growth. They have continued to build out that side of the component. Things like price increases, better sales process and operating efficiency also are adding to that.

You are seeing a change in the marketplace where PE recognizes that a lot of these companies have been owned by either good corporate management or by PEs that have squeezed a lot of cost out. So the new frontier is revenue growth and that was borne out in the study's results.

Stephen M. Sammut: Those are very important observations as to what is going on in private equity and it is nice to have hard data that supports that — sometimes we are merely speculating. A very important point is that many of the companies that were purchased by PE firms – either just before the market correction in 2007 and 2008 and shortly thereafter – probably were acquired having had significant cost reduction already done, especially if they were in the hands of PE firms that had then flipped them over to another PE firm.

Moreover, it became clear to the management of these companies before they were acquired by PE firms that they had to change the way they were doing things as well. So using the expression from *The World According to Garp*, these companies were pre-disastered in a way, and that really put the emphasis on organic growth as the next step to achieving alpha or returns. As a narrative it fits together. It makes a lot of sense….

Knowledge@Wharton: Right after the fallout there was talk of the "wall of [PE] debt" that was going to have to be paid back. A lot of that has been taken down now and things look better over the last year or two.

Sammut: The macro factors look better. As discussed in our last podcast, there had been an increase and a shifting of capital flowing into the developed country buyout funds or PE firms. And although there was not a drastic reduction from emerging markets, there definitely was a shift and that probably was a forecast of better things to come.

But if you speak with PE fund managers you will find that many of them still see this as a very challenging fund-raising environment, and capital still tends to flow on a preferential basis to the larger-branded funds. I don't know if EY's current data is bearing that out but that is certainly anecdotally what I have learned in speaking with PE fund managers. Moreover, the apparent liquidity that the IPOs of 2012 and 2013 created is not necessarily in fact liquidity. So I am not sure that the funds are out of the woods just yet as they manage their public positions in these companies and how to best harvest liquidity.

Knowledge@Wharton: Could you drill down into that liquidity issue – they appear to be more liquid but perhaps are not as liquid as they appear?

Sammut: This is a phenomenon that confronts venture capital funds as well. And that is, when you have an IPO, the good news is you are getting the confidence of a public market to infuse more capital, but in most instances neither the PE funds nor the venture capital funds can sell their positions in that initial public offering. And even if they can they have a lock-out period. So in many instances the portion of the offering that the VCs hold, or the PE funds hold – their positions of privately held stock — are still relatively high.

Also, the floats are dropping when companies go public, possibly because the valuations are so much higher, a smaller percent of the companies are being listed, and that puts more and more burden on the funds – be they PE or VC funds – to rely on secondary offerings. And there you are at the mercy of the market, which could be good or dreadful.

Rogers: To touch Steve's final point first, we have seen a lot of what we would call successful IPO exit activities by PE over the last 12 to 18 months and I think Steve hit it on the head. While a lot of them have issued equity, they have issued a tranche of equity, got a position made in the marketplace, got people following the stock, and they still are holding significant pieces of that.

Now interestingly, in a rising market that actually can be good because most follow-ons that have occurred since then, were issued at higher prices as the market has stepped up over the last 12-24 months. But as Steve also rightly points out, there is inherent risk in that. It does not always go in your favor. And if we get a little bit of a down draft you would see many of these funds still have significant exposure to some of these entities that went public and they are sitting on the step component of the shares if you will

even if they, in many cases, majority blocks sometimes. So that is a bit of a risk from a market and environment perspective.

We definitely see a bar-belling of fund-raising. If you are successful, had a good track record and look appealing to the markets – maybe you have a niche that is very attractive and you have invested successfully – we see over-subscription almost as strong as you saw in the hay days in the mid-2000 period. But the challenge now is the lower end. Oftentimes these folks are struggling. So you would have to be a small niche player that really has a unique skill and a strategy to bear – and you can convince the market of that – or you are really large and you are playing a different game.

But there are many of those funds in the middle that are struggling. One of the overall themes is that we were very worried a few years ago about the huge pent-up number of companies that were stuck in some of the PE portfolios around the country and around the world. At one point a few years ago – at the pace we were exiting it would take about seven years to unwind the U.S. – or North American –portfolio and that number was about 13 years in Europe. We have seen that come down as a result of the exit activity that has taken place. There has been strong secondary activity. There has been strong IPO activity.

What we see in general is the industry returning to a bit of normalcy – that the expectations of LPs [are that] that they can invest – that the GPs will take those proceeds and apply them in a fashion that earns a reasonable return, and that they can expect their money to be returned to them in the normal three-to-seven-year time horizon that they have grown accustomed to. That has returned to the market, which we think is healthy and I would classify that all as a kind of liquidity if you will. It does not mean liquidity like overnight liquidity. It means: I anticipate getting a normal flow of funds coming back to me as an LP from the investments we make in normal course. So from that perspective the industry is on more solid footing.

Sammut: I agree. There is another factor contributing to liquidity: The major corporations have returned to the table to do acquisitions of their own. The good news is, in many cases, they acquire from the portfolios of the private equity funds. In other instances they are competing head-to-head for these acquisitions and sometimes strategic buyers might be willing to pay more than a private equity fund. Nevertheless, that puts energy into the market and improves liquidity, and gets the market conditioned for, in addition to this organic growth, to also grow through acquisitions.

Knowledge@Wharton: How would you describe the current state of buy-and-build in PE versus just a few years ago?

Rogers: Over the last decade or so I think PE firms focused efforts on working with companies to accelerate growth from their core businesses. In 2013 we saw a marked uptick in exits, which pursued a buy-and-build strategy, and the last five years I think we had counted that they were about 21% of deals in our study. In 2013 they represented 31% exits. So lower valuations, a lack of strategic competitors, and a number of industries where consolidation and fragmentation is ongoing really provided an accommodating environment for the rollouts. And so we saw a lot more of those.

We are likely to see a return to PE firms really focusing on improving their core businesses and M&A rollups will clearly be a part of that, but with valuations trending higher, the role of builds-outs like that has been diminished a bit. And we really have seen that and heard that anecdotally from folks when we did the study, and that seems to be less of the model these days.

Sammut: In other words, the strategy of acquiring a core asset and then doing a rollup around it – whether or not it was attractive during the dark period – was nevertheless a strategy that many funds followed. It is a very difficult one for both the management as well as the PE fund itself. For the management teams of the portfolio companies it means that they are constantly in the process of integrating new businesses and

new assets into their existing business. Anyone who has managed an integration process knows just how distracting that can be from meeting the needs or your customers in a timely fashion.

By the same token, it generally means that the private equity funds are in a constant barrage of having to raise additional leverage or writing ever-greater equity checks into the portfolio companies. And that starts to render the return picture much cloudier than it otherwise would have been. So we do see this tension relaxing with more of a focus on operations. Now the way funds execute on improving operations is yet another set of questions.