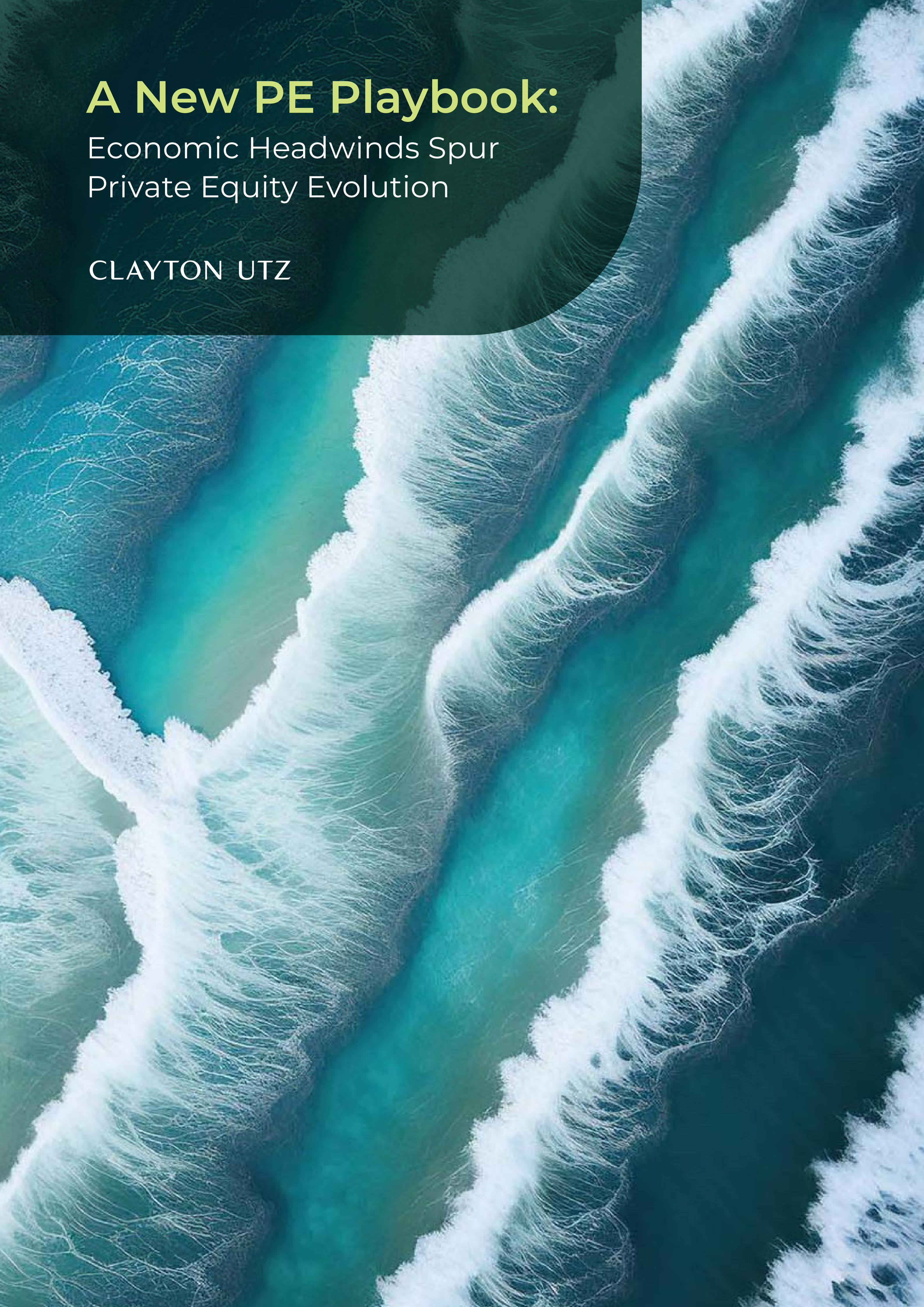
A New PE Playbook:

Economic Headwinds Spur Private Equity Evolution

CLAYTON UTZ



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About this Report

A New PE Playbook: Economic Headwinds Spur Private Equity Evolution is prepared by Clayton Utz in partnership with The Action Exchange, a thought leadership and stakeholder engagement agency.

This report explores the ways in which PE firms are adapting to a changed economic environment where IPOs and exits are challenging, and why this is leading to a broader PE market evolution. It highlights some of the creative solutions being adopted to maintain cashflow and delay selling assets, the benefits and potential risks of these structures, and how PE firms are managing changes to valuation fundamentals. As the PE market's traditional value creation playbook changes, this report also explores the innovation that PE firm managers are employing to continue to realise returns during a challenging economic environment.

Given the discreet nature of the private equity market, several people interviewed for this paper asked to remain anonymous. Clayton Utz and The Action Exchange would like to thank them, as well as the following people who agreed to be attributed in this research:

- **Marcus De Kock,** Alternatives Investment Director, Pacific, Mercer;
- **Katerina Kimmorley,** Head of Commercial and Investments, Boundless Earth;
- **Chris McDermott,** Head of Private Equity and M&A Services, Pacific, Marsh McLennan; and
- **Mitchell Schauer,** Managing Director, Corporate Finance & Markets, Jarden.

We acknowledge the Traditional Owners of Country throughout Australia and recognise their continuing connection to land, waters and culture. We pay our respects to their Elders, past and present.

Executive Summary

The record returns that PE funds achieved in the last decade by capturing value from cheap capital and healthy equity markets are receding. In the present and likely immediate future, higher interest rates and inflation, and softer equities, have changed the fundamentals of PE market return drivers. The traditional exits formula of restructuring and selling assets, and distributing the proceeds, no longer applies, and the PE funds' value creation playbook is being rethought.

As the market evolves and adapts to this new economic reality, PE firms are getting innovative. As they increasingly employ creative deal structures to enable them to delay selling assets and maintain access to liquidity, they are also looking at new ways to effect large-scale corporate transformation and new markets for future growth. This innovation can benefit the PE firms and their investors, but the risks from potential conflicts of interest have highlighted potential challenges with asset valuations and PE firm governance. Some market commentators have also questioned the potential for risk as PE firms explore debt and retail markets for new avenues of value creation.

This PE market evolution echoes some of the changes evident following the Great Financial Crisis. But it also demonstrates the innovation and flexibility that sets PE firms apart in their pursuit of the best possible returns for their investors. As large PE firms expand into new markets, and niche PE firms become increasingly attractive acquisition targets, many market analysts predict that sectoral consolidation may lead to a leaner, more innovative market in the wake of these challenges.

Highlights from this paper include:

New economic reality disrupts PE market fundamentals. Rapid interest rate rises and volatile equity markets have made IPOs scarce and PE funds with portfolios coming to the end of their life cycle are finding it increasingly hard to exit with high returns.

Exits become creative. As the costs of capital have risen, PE firms are increasingly employing innovative deal structures, like continuation funds, margin loans and net asset value lending, to delay selling assets at a loss and realise yield from their investments.

Risk and valuations are under scrutiny. Some financial market leaders have warned that these structures open PE firms and their investors to increased risk. The lack of transparency in new deal valuations, and the validity of existing portfolio valuations, are also being questioned.

Investors become nervous. As higher interest rates become entrenched, many fund investors, including sovereign wealth funds and pension providers, are adding to the pressure on PE firms by openly questioning when their capital will be released and linking distribution to reinvestment.

Appetite grows for sophisticated governance structures. Although non-traditional exits attract scrutiny, most market participants believe that the sophistication of PE firms and their investors, along with existing fiduciary controls, prevent most deals from becoming a significant problem. However, the disruption has highlighted underlying market challenges, including a lack of transparency and the role of relationships in deals.

New markets increasingly attractive. PE firms are increasingly looking to new jurisdictions that are economically and politically secure and have a sophisticated finance sector—like Australia—for new market opportunities. They are also expanding into private credit and exploring expanded opportunities in retail channels.

Innovation from disruption becomes apparent. Longer term, the adjustment may lead to sector consolidation as larger firms acquire smaller, niche PE funds that can provide new revenue opportunities. It is also likely to further hasten the expansion of artificial intelligence to transform enterprise-scale internal PE fund operations, to achieve strategic and operational improvements in acquired companies, and to further sharpen investment identification and decision-making.

Introduction

After a period described as "decades of triumphalist money making",[1] 2023 heralded a significant adjustment for Private Equity (PE) funds globally. Inflation surged, central banks raised interest rates at a record-breaking pace,[2] and volatility in public equity markets grew. Used to a simple exits formula that involved selling assets, counting the profits, and distributing the proceeds, the traditional PE funds' value creation playbook was severely disrupted.

Higher borrowing costs and volatile markets have made financing deals and negotiating valuations more difficult, while Initial Public Offerings (IPOs) are at record lows. As deal values and volumes have stalled,[3] so too have PE fund returns globally. Distributions as a percent of net asset value fell to 11.2% in 2023, the lowest average returns since the 2007/08 Great Financial Crisis (GFC) and far below the 25% average achieved over the last 25 years.[4]

The limited opportunities for profitable exits have continued into 2024 and only increased the pressure on global PE firms. PE firms find it increasingly difficult to execute deals, while the pool of "dry powder"—or uninvested liquid capital—in the PE market was estimated to have reached a record US$2.6tn at the end of 2023.[5] As geopolitical and economic uncertainty compounds the problems, fundraising in 2023 was 20.5% lower than in 2022,[6] and pressure from investors for returns from previously invested capital has amplified.

In response, PE firms have employed increasingly creative ways to keep investors happy and realise yield from their investments within defined time frames. Continuation funds, margin loans, and cross-collateralising assets with net asset valuation lending are not new strategies for private investment exits, but they are being applied with growing vigour by PE firms keen to capture value and distribute capital to anxious investors without taking a hit on asset prices.

Many firms are also expanding their operations into new areas, with large groups like BlackRock[7] and KKR[8] growing their private credit business and others like Blackstone introducing retail funds that target high net-worth individuals.[9]

If managed well, non-traditional exits and new markets can be a win-win for private capital and investors on both sides of a transaction and a lucrative opportunity. However, they can raise questions around valuations and transparency, as well as whether these new return drivers potentially add unnecessary risk to the value creation playbook for a PE firm.

Mitchell Schauer, Managing Director for Investment Banking at Jarden, an Australian and New Zealand investment and advisory group, says PE firms are simply showing what makes them stand apart from traditional investment houses by adapting to a market where deals are harder to originate, harder to execute, and harder to complete. "These structures ensure that dealmaking can continue. There is the potential for conflicts of interest, but experienced, sophisticated, reputable PE managers, and their underlying investors, should be able to ensure that those conflicts don't eventuate," he says.

Regardless of which side of the fence people sit on, the changing economics is forcing PE firms to innovate, and is likely to lead to a period of evolution in the market, both in the way value is created, and the markets it is created in. "It will be very interesting to see the change in the market over the next 18 months, and what the next generation of PE firms will look like," says a Managing Director at a large US investment bank, who asked for anonymity.

"The bid/ask spread has become more complex. A lot of work goes into valuing something, and two very sophisticated stakeholders can come to quite different views on what something is worth."

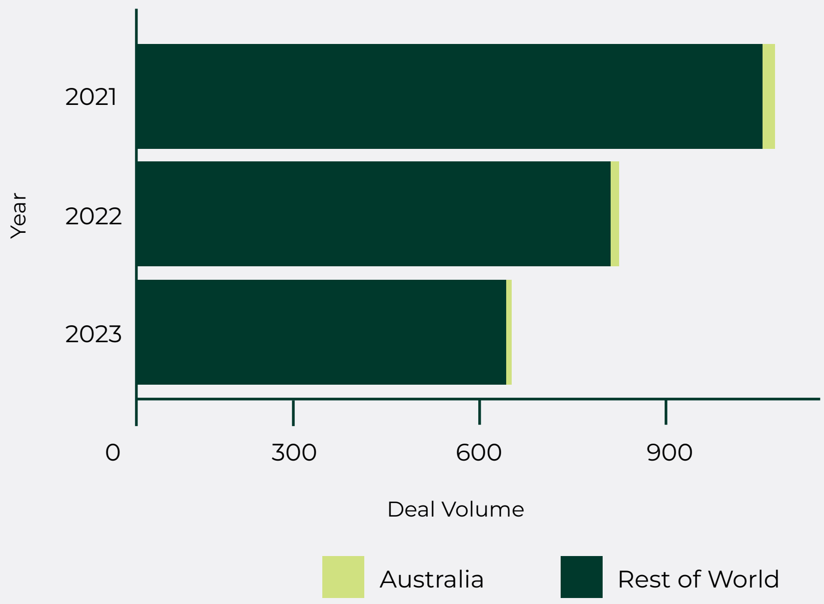
A New World of Private Equity

PE funds have often relied on debt to succeed, with the economics of deals dictated by the cost of money. Reflecting this, the loose monetary policy and record low interest rates that resulted from the GFC's economic fallout ensured that the global equities market was strong and PE firms could regularly return high yields from buying, restructuring, and refloating businesses in the past decade.

Yet as business conditions changed and the geopolitical impact of wars in the Ukraine and the Middle East became more apparent, interest rates have increased at speeds not seen since the 1980s.[10] Together, these factors have upended traditional PE exits, and firms now face a new economic epoch littered with dealmaking obstacles.

The first and arguably most difficult of these is exits. The decline in global equities saw IPO volumes fall dramatically, and PE exits have followed suit. While 6,194 private equity deals were transacted globally in 2021, this fell to 4,019 in 2023, with PE deal values down 60% from a 2021 peak and exit values down 66%.[11] The fall in exits was even more pronounced in Australia, with 2023 deal volumes 48% lower than 2021's figures.

Private Equity Deal Volumes



Source: GlobalData 2024

As PE funds adapt to the new economic realities, valuations have become increasingly contentious. Arriving at a valuation for uniquely positioned PE assets has never been straightforward, and although the secondary market has grown stronger in the wake of the IPO collapse, economic and geopolitical uncertainty has compounded valuation challenges.

"The bid/ask spread has become more complex. A lot of work goes into valuing something, and two very sophisticated stakeholders can come to quite different views on what something is worth," explains Mr Schauer.

This has also led to extended deal lead times, for while the negotiations on a price now take longer, the due diligence required to close a deal has also become more complex. "When the cost of capital is more volatile, deals come under more scrutiny, and there is more uncertainty to account for, so the work takes longer," Mr Schauer adds.

A recency bias is also impacting valuations, according to a senior executive from a large PE fund who asked to remain anonymous. They say the speed of rate rises means that many of the partners that manage PE funds—called General Partners (GPs)—are waiting for a clearer indication of what future economic policy changes may be.

As deals stagnate, investors into PE funds—called Limited Partners (LPs)—who are used to receiving regular, healthy distributions, are becoming increasingly agitated. Some have begun to publicly voice their concerns about having their money tied up in old deals,[12] especially as they see continued declines in their distributed to paid-in capital (DPI) metrics—or their cash returns as a proportion of their original up-front investment.[13]

Faced with these significant market changes and investor pressure, many PE funds have begun exploring structures like continuation funds, net asset value (NAV) loans, and collateralised fund obligations to delay selling their investments in a soft market.

David Wilkie, a partner at Clayton Utz, says that while none of these financial strategies are new, their growing use has been necessitated by the change in economic circumstances. "Necessity really is the mother of invention," he says.

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A Return to “Pray and Delay”?

Although the financing deals preferred by PE firms have different structures, they all have a similar aim: To enable PE firms to extend ownership of an asset, or assets, until the market picks up and avoid selling it at a discount, and to maintain cash flow to investors while liquidity is tight. In market parlance, this has become known as “pray and delay".[14]

Structured financing can also help PE firms plan for new investments when the economic fundamentals change. “These deals reflect the importance of timing for PE firm success and may help smart firms accurately time their market re-entry,” says Katerina Kimmorley, Head of Commercial and Investments at Boundless Earth.

A surge in non-bank financing,[15] or private credit, has seen net asset value (NAV) loans used by a growing number of firms. These enable PE funds to raise cash by borrowing against their assets, and NAV financing groups, like 17Capital, are reporting rapid growth.[16]

Many medium-sized PE Firms—PAI Partners,[17] Carlyle Group,[18] Vista Equity Partners and Nordic Capital,[19] among others—have used NAV financing in the past year.

But while NAV loans give these funds breathing space, it is an expensive option, with present interest rates between 8% to 10%.[20] Some PE market insiders, like Holden Spaht, Managing Partner of US private equity firm Thoma Bravo, have also raised concerns that NAV loans may signal an erosion of risk discipline in the sector.[21]

Buying Time

Number of "amend-and extend" loan deals:

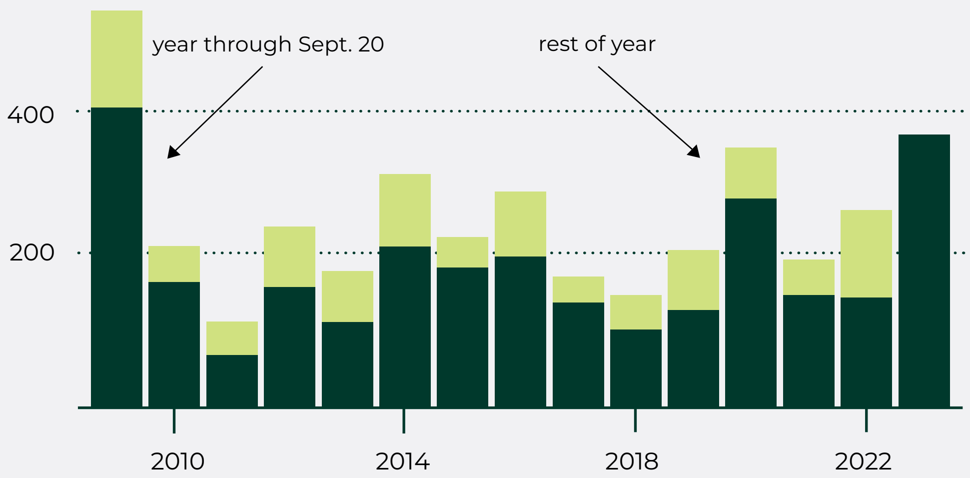


Chart: Liz Hoffman/Semafor   Source: Semafor analysis of PitchBook LCD data

Continuation funds, where a manager of an existing fund sets up a new vehicle (the continuation fund) and rolls either a single asset or multiple assets from an existing fund into the new vehicle, can enable PE firms to extend their ownership period for assets in funds that are about to mature, so they can avoid selling them at a discount. They can also provide investors exiting the deals with easy access to cash.

Continuation fund transactions have proliferated on the $US112 bn PE secondary market in the wake of rising interest rates. They accounted for 88% of General Partner-led (GP-led) transactions in 2023 and 12% of sponsor-backed exit volumes, up from 7% in 2022.[22]

Continuation funds can be a natural part of managing closed-ended funds and may benefit all parties of a transaction, from the sponsor to the exiting investor and the continuing investor. However, the lack of transparency and their growing popularity with PE funds saw the Institutional Limited Partners Association, a PE investor group, issue guidance in 2023 to ensure that these secondary market transactions were conducted using a competitive process and disclosed any conflicts of interest.[23]

Private Equity collateralised fund obligations (PE CFOs) are another, more complicated structure that is growing in popularity and which also provides PE funds with the ability to hold onto an asset and access cash.[24] Resembling mortgage-backed collateralised debt obligations—the write-down of which helped catalyse the GFC[25]—PE CFOs enable companies to bundle stakes in PE funds into a bespoke debt- or equity-based securitised instrument that can then be sold onto other investors.[26]

Many large PE firms, including KKR, Blackstone, and Ares have established CFOs,[27] with insurance companies their main investors. And although these securities are intended to diversify risk, in 2023, the US regulatory group, the National Association of Insurance Commissioners, was so concerned with the lack of transparency and risks associated with these vehicles that it took over the role of assessing the risk of individual CFOs from credit ratings agencies.[28]

They are not alone in their concern about the liquidity risks associated with a concentration of novel PE assets. In its November 2023 Global Financial Stability Note, the International Monetary Fund warned that US insurance companies with a high proportion of complex structured PE assets such as CLOs were more vulnerable in challenging market conditions. The IMF has also suggested that regulators step up their monitoring of the practice through “liquidity stress testing” to avoid “possible contagion risk to other parts of the financial system and in the real economy”.[29]

Lessons in Australian private capital

Creativity among PE firms is nothing new, but as General Partners look for ways to manage distributions during a period of financial uncertainty, they need to be aware of the potential risks from the solutions they employ, says Brendon Lamers, a partner at Australian law firm, Clayton Utz. Citing the evolution of Australia’s private capital markets, he says precursor companies to PE firms in Australia used many of the same financial structuring tactics during a challenging economic environment in the early 2000s, often to their own detriment.

In the 2008 fall out, companies that had previously been seen as Australian financial “market darlings”—like Babcock and Brown[30] and Allco Financial Group,[31] both of whom used financial engineering to turn equity into debt to fund cash flow—collapsed. Other funds started to struggle under the weight of their structures and were stripped of their management by concerned investors, who then internalised corporate leadership, says Mr Lamers.

This was the case with Macquarie Atlas Roads, which was rolled out to become Atlas Arteria,[32] and property fund Dexus, which started as a series of Deutsche Bank property trusts before undergoing a sweeping restructure in 2008.[33]

The GFC was a significant catalyst to this disruption, but the resulting court cases, which took years to resolve, highlight the role the complex financial structures played in sealing their demise. The tight relationship between the players in the Australian market at the time also exacerbated the challenges.

And as many commentators highlighted in the aftermath, when intervention finally came, it wasn’t from regulators—who were accused by some of “dropping the ball"[34]—but from investors who pulled their money or instigated wholesale management change. “Regulators did step in on the extreme end, with the MFS mortgage fund for example, but at the end of the day it was investors who intervened,” explains Mr Lamers.

The Bounds of Financial Innovation

As the PE sector turns to more structured financial solutions to solve their exit woes, some in the broader financial services industry are beginning to question the inherent risks that can occur if these deals are not carefully managed, as well as what the medium-term impact on the PE sector may be.

Most market observers see the evolution of the deals as a reflection of PE firms adjusting to the new market fundamentals. Rather than being inherently risky, when done well, the new deals are often a sign of resilience and demonstrate the ingenuity and initiative that set PE firms apart.

"It's a fiduciary duty as an investor to explore other opportunities and these deals are often successful," says the US investment banker. "It's a necessary thing for PE investors and advisers to come up with other ways of creating value rather than a full sale or a float. They just need to be managed on the back of good advice."

"As market conditions change, GPs adapt what they do to continue to do the best for investors. The use of earn out structures, or deferred or staged consideration, is quite common now and quite effective," Mr Schauer adds.

A market is never one-sided, and some of these alternative deals are also driven by both the buyer and the seller. There are risks, but PE firms who have a long-term relationship with a law firm as part of their transaction advice often avoid potential pitfalls.

Some structures, such as continuation funds, can also be a smart tool for PE funds to manage assets and investments that change over time. A company that was once a start-up with higher risk and higher growth may be better funded through private credit once it has grown and become a more mature business with less risk, for example. It therefore makes sense to move these from an equity portfolio to a debt fund.

Well-managed continuation funds benefit both PE firms and their investors, who typically expect lower risk and returns from debt funds than equity funds. Businesses can also potentially benefit from the increasing number of PE firms entering private credit and competing directly with investment banks.[35]

The private credit boom has been lauded as a means of freeing up capital to fund projects that aim to resolve globally pressing challenges, like decarbonisation and affordable housing. However, there are concerns that it removes a large portion of corporate borrowing from the regulatory radar in public markets, and potential conflicts of interest can emerge when an entity that owns a private credit and a private equity fund lend to each other.[36]

Marcus De Kock, Alternatives Investment Director for the Pacific region at Mercer, says he is comfortable with GPs who operate in both the private debt and private equity world, but warns against deals where obvious conflicts of interest may arise. "We certainly would not want to see a GP on the same side of a deal," he says.

Conflicts can be one of the most significant challenges for many of these deals, but Mr De Kock says that good PE firms now have strong, established governance policies, which combined with more implicit measures from investors in the funds, usually provide effective guardrails.

"These fund managers have fiduciary obligations to their investors, but they also face enormous pressure to fulfil the capital raising for their next fund. They're not going to get more capital commitments from their investor base if they mess it up," he explains.

Mr Lamers agrees and says most PE firms are now well aware of the need to keep on top of their governance structures. "You need independent boards, and you must transact outside your circle of friends for governance and independence," Mr Lamers says. "The funds that didn't have good governance did not survive the GFC, even if they had strong assets, so they know that it is key to their survival."

Mind the transparency gap

Good governance and public accountability often go hand-in-hand, yet one of the key issues with structured deals in the PE market is a lack of transparency. By its very name and nature, PE is extraordinarily private, as PE firms invest in large, unlisted, unique projects. Like a piece of fine art, these have a limited market, subjective valuations and the buyers and sellers prefer discretion.

In many ways, the lack of transparency works well for private markets, as it removes some of the reporting obligations that public companies face.

"I think part of the attraction of private markets is you can get rid of the white noise from public markets and really focus on the fundamentals of the company. I wouldn't necessarily call it a lack of transparency. It's more about getting on with the business and value creation plans than worrying about the next quarterly earnings call, or investor sentiment," explains Mercer's Mr De Kock

However, the risks that may arise from the transparency gap are one of the biggest challenges for NAV loans, CFOs and continuation funds. Many of these structures have the potential for conflicts of interest, but while market participants rely on the expertise and sophistication of the PE funds and the influence of investors, it is hard to determine levels of governance when entities are closed to external scrutiny.

Many deals may also be open to partiality, with PE funds in Australia and overseas often offering their key LPs the opportunity to do a "sidecar". This type of deal—where an investor with an existing direct interest in a fund is offered the opportunity to co-invest with the fund into a new, secondary fund—can reinforce the lack of transparency and accountability in such a market.

A lack of transparency also goes to the heart of some of the challenges with PE valuations. A senior investor with a large fund says the unlisted valuations in many of these organisations are presently inflated, which leaves the fund and their investor at high risk. She says getting valuations right and having proper transparency around them is critical, and that the lack of this in the past five years could potentially lead to a mark-to-market moment for unlisted assets.[37]

A Dry Powder Genie

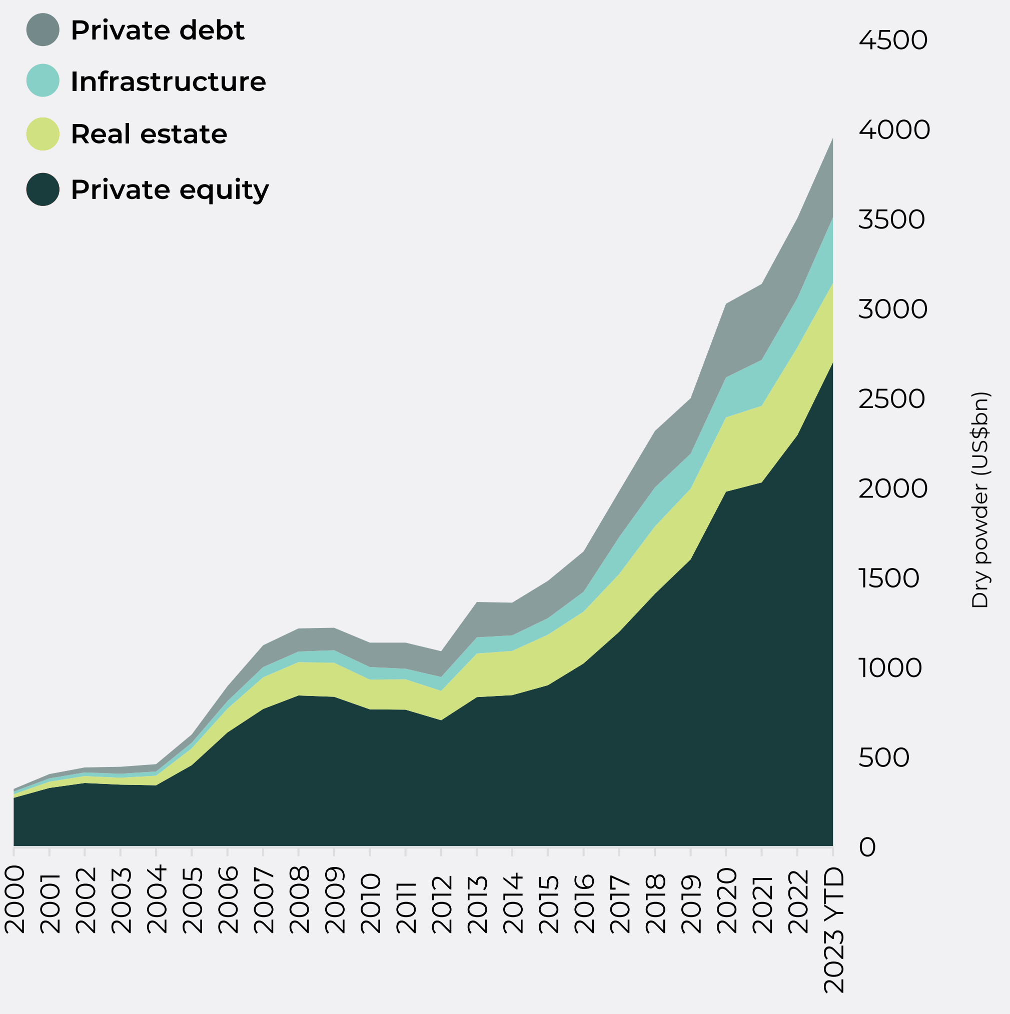
Views on the inherent risks in the financial deals keeping PE funds liquid in a difficult market may differ but there is almost universal acceptance that the record levels of dry power—or uninvested capital—that has accumulated while exits have stalled will make for an interesting PE market in the coming years.

Kylie de Oliveira, a partner at Clayton Utz, says although there hasn't been a wholesale recession around the world, the economy hasn't normalised yet.

"Timing of the much anticipated uptick in deal activity continues to be a key focus of GPs, LPs and advisers alike, all of whom are looking for green shoots in the generally subdued conditions. Deal activity is taking longer to rebound than many expected, as the bid-ask spread standoff remains for all but the most sought after assets," she explains. "The expectation is that deal activity will revive once the market reaches a more consensus view that cost of capital has stabilised and inflation has been tamed."

On the Sidelines

Dry powder is increasing as investors remain selective



Source: BlackRock[38]

Many echo Mr De Kock, who says that as the economy settles and GPs and LPs adapt to the higher interest rates, deals will flow again. They will likely move away from structured finance back to traditional IPOs as the equities market strengthens, but he believes the secondary market will stay strong and continue to be an alternative exit route.

He says GPs will be “champing at the bit” to deploy their dry powder and get deals done again, because they will need exits to continue with their fundraising cycles. “We expect some level of stability in interest rates and we're seeing the equity markets tick up. So I think there's probably deals that we might see getting done in the short- to medium-term, from 2024 to 2025, save any unexpected market event,” Mr De Kock says.

Energy transition, technology and real estate are likely to be key asset areas that will see an increase in investment, according to Jarden’s Mr Schauer, who says technology will be driven by the rapid growth in AI.

“The recovery may be slower and steadier and over a longer period than the size of the dry powder stockpile and pressure to deploy may suggest in view of the ‘higher for longer’ rates environment and global macroeconomic and geopolitical uncertainty,” adds Ms de Oliveira. “It may also be unevenly spread across sectors, with long term thematics coming into play as we have already seen with deal activity in tech, energy transition and digital infrastructure such as data centres.”

Many PE firms will also be increasingly looking for opportunities outside of their home countries and traditional markets, according to Mr Schauer and the US investment banker, who all said that countries with relative stability and a growing renewables market—like Australia—have become increasingly attractive.

Read more about emerging opportunities in Australian energy transition infrastructure in our report Net Zero Exceptionalism

“When I speak to my international colleagues, they see Australia as a premier destination for Asia Pacific exposure,” explains Chris McDermott, Head of Private Equity and M&A Services, Pacific, at Marsh McLennan. “Australia has a developed economy, a stable government, stable regulatory framework, and is generally quite investor friendly, so I think we’ll be seeing a lot more inbound activity from that perspective.”

Deals may be getting done, but it won’t all be business as usual, and there are potential risks for investors if some of the strategies employed to survive the PE market downturn become embedded. PE funds looking to tap investors in retail markets,[39] for example, could see less sophisticated investors exposed to assets that may not be accurately valued.

The disruption to the PE market is also expected to spark longer-term change. The application of artificial intelligence to find new value drivers, for example, is likely to accelerate and reshape the market, both in terms of its growing application in PE firms beyond the back office, and in its ability to drive large-scale transformation in acquired organisations.[40]

Operational value creation levers like revenue growth and margin expansion are also expected to become greater determinants of returns in what is expected to be an era of slower economic growth.[41] This is likely to lead to a stronger market in the future, but there is likely to be some level of discomfort for PE firms as valuations settle and the large number of companies created in the boom consolidate.

“There is a lot of dry powder, and I think we will see a lot of inter-sector buyouts and consolidation. There is also a need for more innovation in financing and capital structures, particularly for assets and sectors that will help decarbonisation,” says Ms Kimmorley.

We need to move a lot of these technologies from venture equity to PE and infra assets in two years, not 10,” she adds. “It’s a huge opportunity, and we often see great innovation emerge out of challenging times like this.”

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Get in touch

Paul Sutherland
Head of External Comms

T: +61 434 136 256
psutherland@claytonutz.com

CLAYTON UTZ

www.claytonutz.com