Private Equity

Buyouts

Major Trends

The buyout market confronts a new environment with elevated interest rates and less abundant debt and equity capital. We believe sponsors now have more certainty around the forward-looking deal environment, given the cost of debt has consistently remained at c.12% for the past two years. We continue to believe that the paradigm shift we described last year, a shift from industry tailwinds driving broad-based buyout returns to manager-specific alpha being required to meet return expectations, will persist for the next several years. The current environment of elevated interest rates, lower debt availability, and limited multiple expansion will put pressure on the factors that drove more than half of buyout industry returns over the last decade[1]. We believe that the best performing firms of the future are those that generate the most earnings growth through initiatives to drive revenue growth, margin expansion and accretive M&A in their portfolio companies. Many firms have not developed the in-house operating capabilities necessary to be successful in this new paradigm.

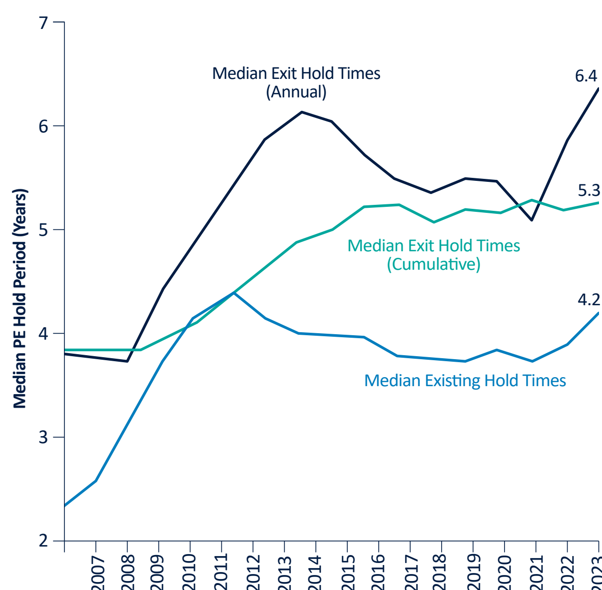
Buyout transaction volume picks up as seller price expectations adjust to this new reality. We expect buyout transaction volumes to increase in 2024. This will be driven by the record volume of $2.6T of dry powder, sponsors facing pressure to generate liquidity for their investors, and sellers lowering price expectations accepting this new market environment[2]. We have likely passed the nadir of deal activity, and buyer and seller value expectations are increasingly aligned. Pro-forma EBITDA addbacks now represent c.5% of the purchase price compared with c.20% at the post-pandemic peak.

1 Bain Global Private Equity Report 2023.
2 S&P Global Market Intelligence and Preqin Data.
3 Pitchbook 2022 Annual US PE Breakdown.
4 Ibid.
5 Ibid.

Sponsors are holding onto assets for longer. In 2023 there was a decoupling of deal and exit activity. Deal activity in the US remained relatively strong with $645B invested across >6,600 platform and add-on transactions, which represents a c. -29% decline from 2022 but only a -4% decline from the pre-pandemic peak.[3] Exit activity declined by -24% from 2022 to $234B, representing a -72% decline from the 2021 peak and a -39% decline from the pre-pandemic peak (2017).[4] The exit backlog in PE is at an all-time high with the median company exited in 2023 held for 6.4 years, the first year since 2015 that this statistic eclipsed 6 years.[5] The steep decline in exit activity, both in terms of headline decline and PE firms holding companies for longer, is shown in Exhibit 1 and Exhibit 2.

Exhibit 1

2023 saw weak exit activity and an increase in portfolio company hold times

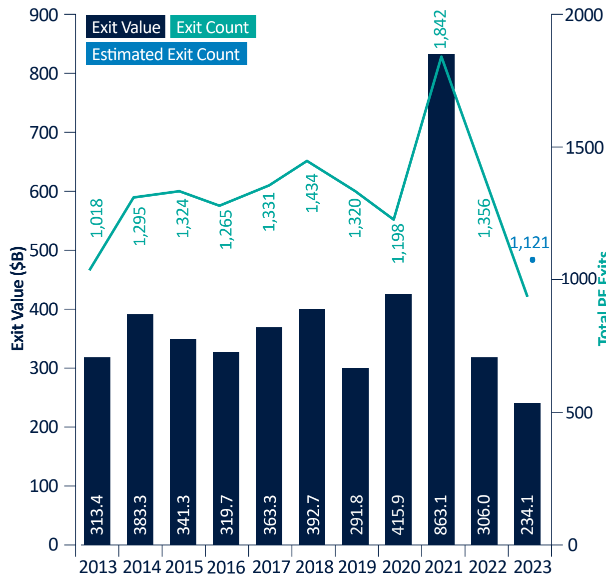


Source: *Size 10 - Pitchbook*

Portfolio company operating performance remains robust. Despite the headwinds facing broader equity markets, US buyout assets have consistently generated earnings growth above the risk-free rate, which we view as indicative of PE's ability to drive post-acquisition operational value-add ("PAOVA"). Across a middle market sample

Exhibit 2

US PE exit activity



Source: *Size 10*

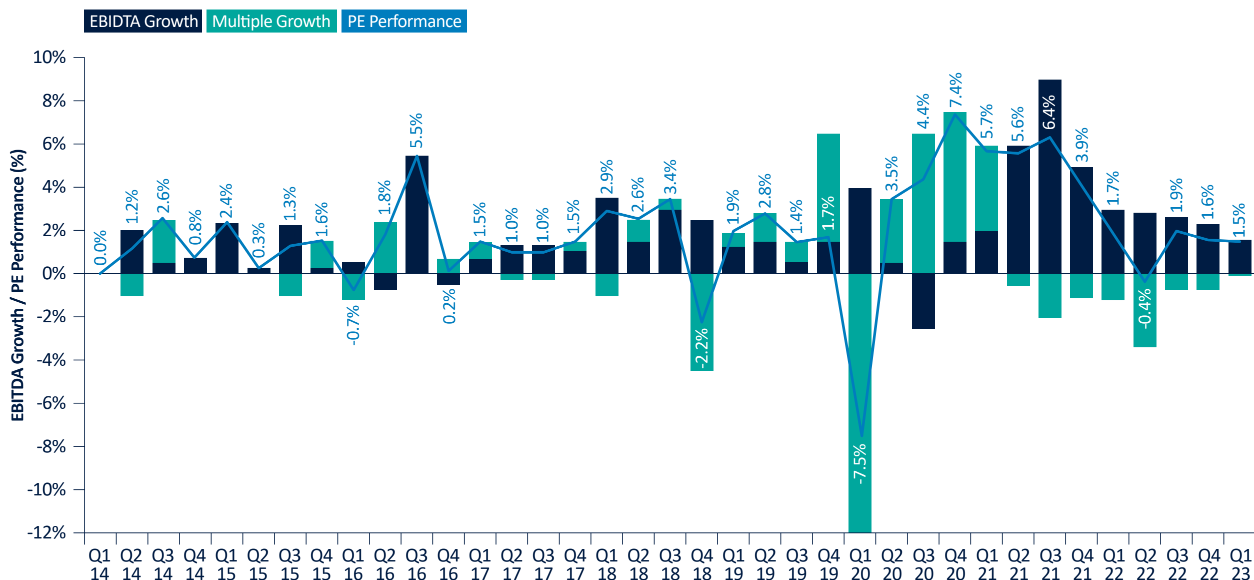
of more than 4,000 companies, PE firms have generated positive earnings growth in 19 of the past 20 quarters and between +1.7% and +2.9% EBITDA growth in each of the past 8 quarters (even while holding flat or marking down companies in each quarter since Q3 2021), as shown in Exhibit 3.

Purchase price multiples and leverage multiples continue to decline. After peaking in 2021, valuations and leverage multiples continued to decline in 2023. Global PE multiples declined c. -15% from 12.5x to 10.9x, but this still represents a significant increase from the c.8x EBITDA GFC trough[6]. Alongside the 'flight to quality', which we reported last year, involves PE firms only selling their top assets that command higher purchase prices, we believe this backlog of dry powder has reduced the rate of decline in purchase price multiples. **Equity contributions for buyouts surpassed 50% of total enterprise value for the first time due to higher interest expenses and a tighter financing market while leverage multiples declined c. -17%**

6 Pitchbook Annual 2023 PE Breakdown; Bain DealEdge.

Exhibit 3

PE portfolio companies continue to generate strong earnings growth



Source: *Size 10*

Private Equity
continued

from 5.9x to 4.9x[7]**.** We believe the current deal environment is more compelling than last year given the lower valuations and lower leverage levels.

Strong headline fundraising conceals a challenging environment for emerging managers: Fundraising is taking longer but remains strong, with fundraising in each of the last three years hovering between $370B and $380B.[8] However, the number of funds raised declined by -51% in 2023, an unprecedented drop and the lowest total number of funds raised in the past decade. An even more precipitous drop occurred for first-time funds, where just 54 managers raised their first fund.[9] Megacap funds (>$5B) account for >50% of capital raised.[10] At 14.2% of fund closings, the first-time fund market was the weakest on record in 2023, as allocators attempted to consolidate relationships while confronting an uncertain environment and the 'denominator effect.'[11]

Golden Rules

Our golden rules for investing in buyouts are unchanged from prior years:

- Invest with managers who have demonstrated post-acquisition operational value-added capabilities.
- Invest in lower middle market strategies where the greater market inefficiency resides and where there is greater potential for asymmetric returns.
- Invest with sector specialists who have competitive advantages in sourcing and value creation due to deep industry insights.
- Invest with young, hungry teams trained by top-tier private equity firms or who are former business owner-operators.
- Co-invest with those whom we believe to be best-in-class managers to increase returns through avoiding fees and carry, to mitigate the 'J-curve,' and to concentrate exposure in what we view as exceptional investments.

Sub-Strategy Attractiveness

By Sub-Asset Class:

- **Lower middle market (LMM) buyout:** Favourable view. In an environment where we believe the scope for post-acquisition value creation is critical, LMM buyout investors have greater opportunity to grow and stabilise the earnings of smaller companies that generally have not benefitted from professionalising management, cost rationalisation, investments in institutionalising processes (IT, sales and marketing, automation, etc.) or strategic M&A. We believe more deals can be sourced proprietarily or through a 'long tail of intermediaries,' reducing competition. There is also a multiple arbitrage opportunity created from growing LMM companies into middle market companies, often by selling them to larger buyout firms or strategic buyers. Across a sample of nearly 17,000 partially realised/realised deals since 2000, lower middle market deals, which we define as those with platform entry total enterprise value of <$125M, generated a gross IRR of +20.6% versus +18.2% for the broader PE market.[12] Top quartile LMM deals generated a +46.4% gross return versus +41.2% for the broader market, indicating a higher level of dispersion which we believe enhances the prospect for alpha through manager selection.[13]

7 Axios, Pitchbook LCD.
8 Ibid.
9 Ibid.
10 Ibid.
11 Ibid.
12 DealEdge, includes all realised and partially realised buyout deals from 2000 through 2020; LMM defined as platform entry TEV of <$125M.
13 Ibid.

- **Growth equity:** Neutral view. We define growth equity as minority or control investments in high-growth companies that are breakeven or approaching profitability (i.e., companies that sit between late-stage venture capital and buyouts). The ongoing correction in high-growth company valuations is a headwind for growth equity investments. Existing investments may require additional time to grow into their valuations and near-term new deal flow is a concern, as many companies in this market are "bootstrapped" and do not require institutional capital. However, these companies should also be in a better position to weather the current environment, as they do not have the capital requirements of higher growth venture-backed companies or the debt burden of software buyouts. Skilled investors will find opportunities to create transactions with founders seeking a generational transition or partial realisation, through corporate carveouts, and by acquiring companies that have fallen out of favour with VCs.
- **Secondaries:** Neutral view. Average discounts in private equity secondary transactions tightened over the year, from -19% in 2022 to -16% in 2023. This remains wider than 2021 levels of -8%, and the recent average of -10% (2017-2021). Wider-than-usual discounts reflect buyers' expectations that future NAV growth will be lower than in recent years.[14] Industry dry powder (including access to credit facilities) relative to annual deal volume stands at 2.3x, which is in line with the 2016 average[15]. We expect secondary deal volume to continue increasing due to the growth of assets in mature private equity funds; total AUM in primary funds 10+ years old is at a record high of $907 Billion.[16] As a result, we believe traditional LP secondaries are becoming more attractive, with supply/demand dynamics favouring buyers and continuing larger-than-average discounts.

- **Large market buyout:** Cautious view. The combination of persistent inflation, elevated interest rates, lower availability of debt, macroeconomic uncertainty, and limited anticipated multiple expansion fundamentally affects the math of a large cap LBO model. A 20% gross return a few years ago is equivalent to a 10% gross return today, absent a change in purchase prices, with multiples needing to contract by 3-4 turns to achieve the post-GFC results. Given the secular headwinds in this segment, we believe only managers with outsized operational capabilities will continue to generate a consistent and compelling illiquidity premium over public equities. We also believe sponsors with an ability to execute corporate carve-outs, which frequently involve cost-cutting, may be well-positioned. In a sample of c. 500 carve-outs completed since 2000 ($84B of invested capital), the median return generated was 2.4x gross MOIC, 26% gross IRR with nearly 60% of deals generating gross IRRs of 20% or higher and nearly 65% of deals generating positive margin expansion (versus c. 55% for the market).
- **Distressed/turnaround:** Cautious view. We prefer to allocate to complex situations generalist buyout managers through market cycles to obtain comparable exposure, but we will opportunistically commit to distressed managers during what we believe are prolonged periods of market dislocation. We believe there is a limited window of opportunity for distressed debt funds, as indicated by the fact that it has only outperformed buyouts in four vintages between 2000 and 2020.[17] In the years distressed debt has underperformed, it has lagged broader buyouts by c. -7% per annum.[18]

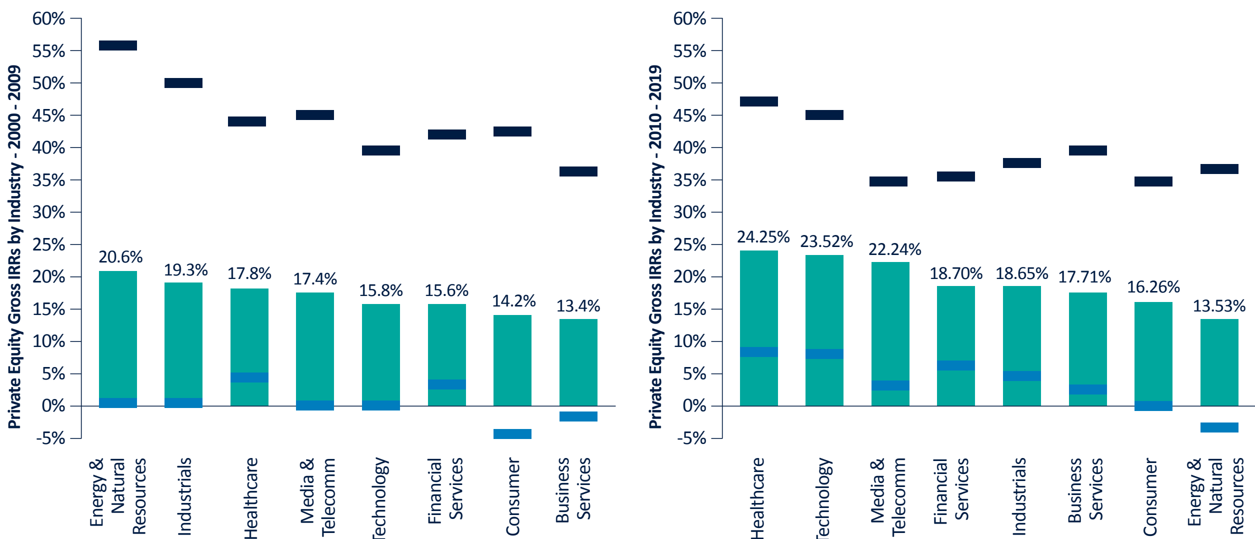
14 Jefferies Global Secondary Market Review - January 2023.
15 Ibid.
16 Preqin Private Equity Online.
17 State Street Buyout Index; State Street Distressed Index; as of 30 June 2023.
18 Ibid.

Private Equity
continued

By Strategy:

- **Complex situations buyout (LMM / MM):** Favourable view: Within the lower middle market / middle market, we retain our conviction in our 'buy complexity' theme articulated last year, which we define as situations where weak operating performance, capital intensity, or process dynamics (e.g., broken auctions, mispositioned businesses) enable PE sponsors to acquire fundamentally strong businesses at discounted valuations. Within our 'buy complexity' theme, we have a favourable view of both value-focused generalists and more growth-oriented 'growth at a reasonable price' generalists (many of which focus on business services). In a sample of c. 1,500 LMM / MM deals acquired for <7x EBITDA, average gross returns were 26%, more than +7% higher than the broader market.[19] The core opportunity in this space is asymmetric return relative to risk in improving unprofitable or underperforming companies. Despite comparable rates of write-offs/impairments, a top quartile deal generates a 54% gross return in these deals versus 41% for the broader market.
- **Sector specialists:** Favourable view. We continue to believe that specialist capabilities in sourcing, due diligence and post-acquisition value creation can help to offset the impact of the highly competitive deal environment. Our specialist allocations target five sectors: technology, healthcare, industrials, consumer, and energy transition. We have a particularly favourable view of technology, healthcare, and energy transition specialists. Healthcare and technology have generated strong post-GFC performance, as shown in Exhibit 4. For technology, we continue to believe in (1) outsized end-market growth in software

Exhibit 4
We focus on sectors with the highest top quartile returns post-GFC - Healthcare, Technology, Industrials and Business services



Source: *DealEdge; Includes all partially realised and fully realised buyout transactions; includes 8,400 transactions from 2000-2009 and 7,171 transactions from 2010-2019*

19 Ibid.

and (2) the advantage of portfolio group based PAOVA in the category. In healthcare, provider businesses (c. 50% of the market) are under inflationary pressures, but we see clear advantages of specialism, demographic tailwinds, and significant opportunity in other areas such as value-based care, life sciences outsourcing, healthcare IT, and the biopharmaceutical supply chain. We also believe there are strong secular tailwinds behind the 'mega trend' of industrial decarbonisation, particularly for managers pursuing a 'picks and shovels' or 'second derivative' approach to investing.

By Region:

- **US buyout:** Favourable view. We continue to prioritise US buyouts given what we view as more favourable supply-demand dynamics around innovative technology and healthcare deals, as well as a larger total addressable market and more actionable emerging manager pipeline.

- **European buyout:** Neutral view. We are upgrading our view on European buyouts given the higher degree of valuation reset in Europe and the strong historical performance of LMM deals in Europe 21.% versus 20% for US LMM in the Bain sample.[20]

- **Asia/emerging markets buyout:** Cautious view. We believe we can generate comparable or better returns in US buyouts with lower degrees of currency, regulatory, and/or geopolitical risk. There are specific sub-segments, such as value-oriented generalists investing in Japan and growth equity firms based in India, where we are opportunistically evaluating allocations.

2024 Strategic Priorities

- **Prioritise buyout firms with extraordinary operating (PAOVA) capabilities.** We will redouble our focus on identifying and investing in managers with proven capabilities and demonstrated success in driving operational improvements in their portfolio companies, leveraging our 10+ years' experience sourcing and evaluating those managers that we believe truly excel in this area. As other LPs become increasingly interested in this skillset, we must ensure that Partners Capital is top tier in identifying those rare managers with the greatest ability to generate PAOVA and in being a value-added partner to those GPs. We most commonly identify managers with strong PAOVA capabilities in value-oriented lower middle market managers and sector specialists in technology, healthcare, business services, and industrials.

- **Exploit the current environment to gain access or increase allocations to managers with scarce capacity.** We believe that fundraising headwinds will persist for managers in our target sectors. We are actively working to source new relationships with 1) high-performing managers who were previously capacity constrained or 2) high-potential emerging managers. We believe most of these managers will either be sector specialists in our five core verticals (technology, healthcare, industrials, consumer, and energy transition) or value-oriented LMM buyout managers.

20 Bain DealEdge; LMM defined as deals < $125M of total enterprise value at entry; fully and partially realised deals only.

Private Equity
continued

- **Co-invest alongside high-conviction managers in the sub-sectors and value-creation strategies in which they excel.** We plan to increase our largely fee-free managers co-investments alongside who place high value on our participation and are well-known to our program. We constantly work to increase deal flow by positioning Partners Capital as the co-investor of choice in an environment of consolidating sources of capital. Co-investing provides an excellent source of returns by increasing our exposure to what we believe to be top buyout assets and managers in a fee-advantaged manner. In addition, co-investing strengthens our primary funds program by deepening our insights into managers' diligence approach and analysis in live transaction situations.
- **Bring our US buyout playbook to Europe.** Our US buyout portfolio is organised around two core archetypes: (1) lower middle market generalists with a value orientation and (2) sector specialists in specific verticals, both with high conviction post-acquisition operational value add capabilities. Our Europe portfolio has historically been more concentrated in upper middle market or large cap generalists that could invest across geographies and sectors. We now see a growing opportunity in Europe to invest in LMM value-oriented generalists and specialists with strong PAOVA capabilities as the market has matured and our sourcing has deepened. Themes we are particularly excited about include 1) spinouts of approved sponsors executing comparable strategies at smaller equity investment sizes, 2) generalists focused on value-oriented industrials and business services across geographies, 3) industrial decarbonisation funds and those executing PE-like approaches to infrastructure, and 4) software in the Nordic, Benelux, and DACH regions.

Long-Term Expected Return

We expect our clients will earn an average 11.5% annual return over the long term from private equity: 4.0% beta return (based on an equivalent net equity beta of 1.0), 3.0% driven by the illiquidity premium, and 1.5% of additional manager alpha.

Exhibit 5
Based on our 10 year forecasts, we target the following long-term expected returns for Private Equity

	Private Equity
Risk-free Rate	4.0%
Risk Premium	3.0%
Illiquidity Premium	3.0%
Manager Alpha	1.5%
Total Return	**11.5%**

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Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.