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A Paradigm Shift: Top Private Equity Funds Using Less Debt and More Value Creation

Key Takeaways from SuperReturn International Conference 2023

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Topic: Balance Sheets

Insight #1:

High leverage is creating losers, not winners.

- **Covenants "coming home to roost":** Economic and interest rate conditions are putting many portcos and Funds at risk of failure – especially with fixed charge covenants.
- **These Funds will lose now and in the future:** Funds are squeezing costs and cutting growth investments, resulting in balance sheet trade-offs. New deal origination also suffering as Funds focus on fixing legacy actions.
- **Strong balance sheets will win:** Companies with the strongest balance sheets will exit first and outperform the market. Legacy Funds with challenged balance sheets can no longer sit on the sidelines and will bring deals to market in Q2 2023 and 2024 with adjusted valuation expectations.
- **Overall market activity to return:** Bank failures stalled the "return to normal" and the market has yet to reach a bid/ask equilibrium on valuations. But this is likely to change as Funds face the need to return capital over the next 12 months.

Topic: Value Creation

Insight #2:

Value creation is the future. Relying on debt to drive returns is history.

- **Debt markets have stalled:** Lenders have pulled back significantly from the market due to bank failures, interest rate outlook, and portco risk profiles, with some sectors not getting any financing at all.
- **New formula for success:** Top Funds are focusing on value creation, utilizing industry advisors more effectively, using ~3x leverage or lower (exclusively senior debt), including more earnouts, and making investments in high margin companies with strong cash flows.
- **The best Funds don't just "talk" about value creation:** Every Fund says they do value creation, but not every Fund actually does it. Bain and Silver Lake are good examples of Funds that have built organizations to support robust value creation.
- **It's all about risk-adjusted investing:** LPs are consolidating and reallocating capital to Funds with strong track records and more conservative approaches on financing.

Topic: Digital Transformation

Insight #3: Digital transformation is only accelerating with AI.

- **Digital transformation remains the opportunity:** AI is creating new opportunities for digital transformation. Those who understand it will win.
- **Invest in core value props w/ AI opportunities:** Funds should invest in companies that can augment their offerings with AI to widen the lead vs. competitors to improve margins. The market may over-rotate towards AI and underprice businesses with resilient value props.
- **Pure AI plays pose risks:** Generative AI can reduce costs and increase efficiencies, but it is also easily replicable at this stage—creating need for strong IP. Meanwhile, there is a high demand amongst investors with low supply driving up valuations.

Topic: Alternative Financing

Insight #4: Alternative financing sources are thriving in this market.

- **Rare opportunity in direct lending:** Direct lenders are meeting the needs of the market due to fewer financing constraints and the availability of dry powder. Higher interest rates will support their best performance ever in the next 12-24 months (13-15% with warrants, almost double historical performance.)
- **Structured equity Funds are "in the money":** Market conditions are creating strong demand for structured equity Funds with subject matter expertise who can provide "bridge financing" to companies in need. They will likely outperform the direct lending markets.