CRITICALEYE
The peer to peer Board Community

EXITING THROUGH TURBULENCE

For several years, private equity ownership has appeared to be one of the most effective pathways to accelerated growth. This article by Criticaleye's **Jacob Ambrose Willson** explores how the high interest rate environment is impacting PE-backed businesses gearing towards an exit

Much discussed macroeconomic headwinds continue to depress dealmaking activity across markets globally this year, with ballooning interest rates ramping up the pressure on the private equity (PE) model in particular, which relied on cheap debt for many years.

Those sky-high interest rates and broader economic volatility has created a significant degree of caution for PE-backed businesses. While some investors have chosen to delay their exit timelines, there's also an acknowledgement that returns need to be generated within the lifecycle of specific funds for investors. For many PE firms, the clock is ticking.

This is perhaps borne out in EY's latest [Private Equity Pulse] figures, which revealed a rebound in the second quarter of 2023. Exit transactions announced by firms combined to total $84 billion in the period, up 42 percent by value from Q1.

Alastair Mills, Managing Director & Head of European Business Services at H.I.G. Capital, says: "Ultimately, private equity firms are measured on realisations. Generating exits is particularly important if a firm is planning to fundraise in the relatively near term; >

realised exits are a particularly important measure for investors in private equity funds. Depending on what realisations they've had, a given firm might well prioritise exiting one, two or more businesses to increase the number of realised returns in order to enhance the probability of raising their next fund."

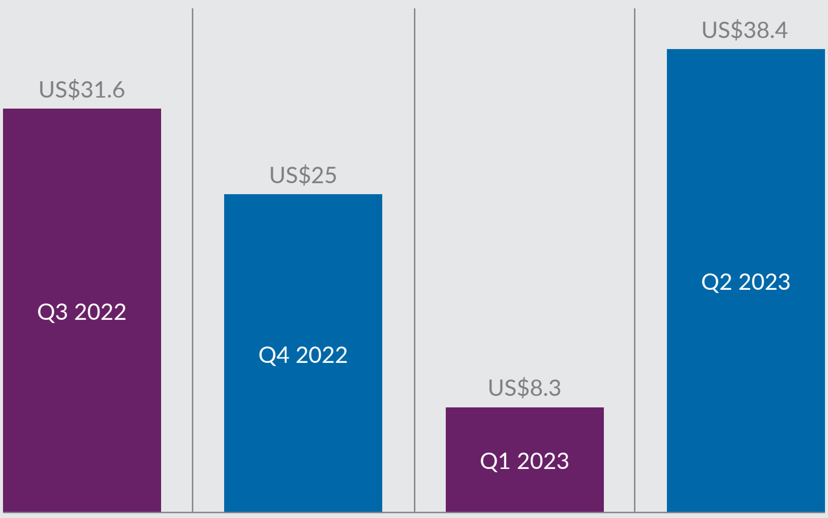
The likelihood of a successful exit in the current environment is increased if those investments are sitting in more resilient sectors, such as IT and business services, financial services, healthcare and certain areas of industrial services, according to **Alastair**.

"If you have a portfolio company which just happens to be in that 'utopia' zone, i.e. demonstrating both growth and resilience, and if it is otherwise ready, there's significant logic in actually bringing it to market right now. There are fewer available investment opportunities and investors are looking to deploy in the right circumstances.

> *" If you're prepared to take a longer-term view, then you certainly bake those [macro headwinds] into your projections. But you don't stop doing deals "*
>
> Nick Burns

In this case, a seller might achieve an exit multiple ahead of the level that could be achieved when the market opens up and there's more choice."

PE activity sees uptick in Q2 on European resurgence - European PE acquisitions over the last 12 months



Note: Figures above = billion

Source: EY Private Equity Pulse, Q2 2023

Trade Sales

Considering the growing challenges associated with highly debt leveraged PE houses and the dearth of PE firms completing IPOs this year, a trade sale appears to be the most attractive route for those businesses looking to complete an exit.

Nick Burns, CEO of employee engagement platform Reward Gateway, led a £1.15 billion sale of the business from former PE firms Abry Partners and Castik Capital to listed international payment service provider Edenred in May of this year.

Reward Gateway had already had two rounds of PE ownership prior to Abry and Castik's 50:50 investment in August 2021. The co-owners planned a five-year investment window with an exit scheduled for 2025/26, however within months of landing the CEO role, **Nick** learned of concrete interest from Edenred to acquire the business.

After a rapid period of C-suite changes, preparing an execution plan and a detailed briefing of advisors; the trade sale was agreed at a price that was acceptable to all parties.

"We had around a week to create a complete pitch deck and start to load the data room. We appointed two sets of lawyers and two firms of auditors," he says. "I had to quickly assemble a team of analysts from the private equity houses, our COO, CTO and Global Head of Sales. I had to cover the roles of both CEO and CFO. Edenred had been tracking Reward Gateway for a long period and had a good understanding of our business already. This was advantageous to all parties. >

"It [the successful exit] just goes to show that you can overthink things. Keeping the story high level and understanding how the business would strategically fit either inside or alongside the buyer was where we focused our collective energies."

For management teams in sale mode, the complexity usually arises when there are multiple exit scenarios, be it another PE house, a trade buyer or an IPO. "You're always juggling when you're in sale mode with multiple interested parties," says **Nick**. "Who am I speaking to? Who's my audience? What do they want to hear?

"The beauty of this deal was there was just one audience. Everything we were preparing was on the basis that we would become part of Edenred's already stated strategic plans. That did make the process easier, quicker and far more focused."

Ultimately, a key driver of the deal was Edenred's strategic desire to acquire a "very profitable, high-quality business, with valuable employee engagement software that could be deployed across its own successful global footprint over the coming years".

Despite inevitable concerns around the difficult global economic environment, the deal still made sense for all shareholders due to Edenred's conviction in the strategic rationale behind the acquisition. "If you're prepared to take a longer-term view, then you certainly bake those [macro headwinds] into your projections. But you don't stop doing deals," **Nick** insists.

"We were of significant strategic interest to Edenred because our software business has very high client retention and recurring subscription revenues and, critically, is capable of being deployed globally. These were strong indicators for them that despite market challenges, if you look after clients, you should keep generating revenues, whichever country you are operating in."

> *"The fishing in this market is mainly for the big boys with strong balance sheets, who can write out cheques and haven't got to raise debt"*
>
> Paul Lester

Chairing an Exit

Paul Lester, currently Chair of FTSE 250 manufacturing firm Essentra, along with the PE-backed companies McCarthy Stone, Funeral Partners Ltd and Telent, has unrivalled experience in leading exits, having fulfilled the role of Chair in the sale of four PE-backed businesses in the last two years.

All completing within months of each other, the sales of FirstPort, Appello, Marley and Readypower generated a combined value of £1.2 billion, with return on funds ranging from four to six times for the investors. **Paul** concedes that "it was a unique period where prices were high and we got lucky because three of the businesses were trade buyers who had cost and revenue synergies".

The environment has certainly shifted since these deals were struck. In the current climate, only the largest PE houses or trade buyers will have the financial ability to acquire businesses, according to **Paul**: "The fishing in this market is mainly for the big boys with strong balance sheets, who can write out cheques and haven't got to raise debt."

The Chair is appointed by a PE house to provide in-depth knowledge of the market in which the invested business sits in and is often also tapped up for their contacts within the industry and the potential for those connections to eventually deliver an exit, when the time is right.

Paul explains: "The Chair plays the dual role of being on the side of the PE and on the side of management, and making sure that any conflict gets smoothed out. Sometimes you have to protect the management from 'over enthusiastic' PE people."

There will also be times when an executive team is going through an exit for the first time. In these instances, the onus is on the Chair to take them through the process, from presenting the sale proposition to calculating take-home multiples and managing the succession plan.

Paul recounts his honest approach with the PE house during the sale of a property management company last year. The then CEO had been in the >

business for a decade and was ready to step away post-exit. "I told the potential buyer up front and the PE were a little surprised in case it put the buyer off. We did have a great person to move up from the management team who the buyer got to know and was very happy with. Being fair and honest is absolutely key for any Chair in an exit."

Lessons and Advice

Returning to the present, **Alastair** discusses some of the economic factors that are dampening motivations towards exiting in the immediate future. "Interest rates have increased from practically zero to more than five percent within the last year. This factor alone means valuations should come off, the cost of debt has increased and all things being equal, a financial buyer has to adjust for that.

"The cumulative effect of the multiple increases in rates won't fully feed through into the economy for another 12 months or so, and this combined with corporate profits still being under pressure from the effects of inflation make for a difficult investing environment."

Alastair's advice to leadership teams looking towards an exit route is this: "Think about all of the questions that could be asked. Change the things that you can change that might make a difference to valuation, particularly around the quality of reporting, management information and trying to address any management succession concerns.

Nick believes subscription-based businesses are certainly more desirable in the current market, based on consistent revenue predictability. On the other hand, project-based businesses could struggle: "Until interest rates and inflation start to come down, I think they [project-based models] are going to have a very challenging time getting their businesses away, unless there is a very strong strategic fit."

In terms of advice to fellow executives, **Nick** says: "Get yourself very clear, very early, what the appetite is for your existing investors to sell and at what price. There are not enough management teams who spend time having that conversation with their existing investors.

"Second, you'll need to ask the PE house what a realistic time horizon is [for an exit]. Third, you'll need to align the incentives accordingly between management and the PE house. Everyone within senior leadership roles need to treat the business as an investment, removing any emotional connections."

Paul admits that it's a 'different world' at the moment for Boards seeking an exit. "I think you've got to be very targeted. You should consider talking to potential buyers to gauge their interest prior to a formal process. It is important not to have a failed process, otherwise you are out of the market for 18 months.

"The market to sell businesses is currently very difficult because debt is so expensive. However, very good and well managed businesses that are still growing can be sold, but the dilemma will be whether to wait until the wider market picks up and prices improve. My guess is this will be in the first half of next year." ■

PRIVATE EQUITY VIRTUAL ROUNDTABLE: LEADING A SUCCESSFUL EXIT

Nick Burns will discuss Reward Gateway's recent exit in a Criticaleye Virtual Roundtable, taking place on 18 October 2023.

Please click here for more information or to register to attend the session.

Featuring commentary from:

Alastair Mills
Managing Director
& Head of European Business Services at H.I.G. Capital

Nick Burns
CEO
Reward Gateway

Paul Lester
Chair
Essentra plc

Contact the contributors through:
www.criticaleye.com