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PRIVATE CAPITAL: ADVERSITY AND OPPORTUNITY

CAPITAL FLOWS
Part of the Horizon Scanning series

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Financial sponsors have enjoyed an unprecedented era of benign market conditions. A powerful combination of cheap debt, assets in plentiful supply and comparatively light-touch regulation have supercharged investment activity, valuations and returns. However, as Oaktree's Howard Marks observed over the summer, "the easy times – and easy money – are largely over".

Harder fundraising markets, increased regulatory scrutiny and less favourable macro-economic conditions will undoubtedly present challenges in 2024. There is, however, overwhelming pressure for financial sponsors to transact. Some are under pressure to liquidate investments and return capital to investors who may be over-exposed to private equity due to the so-called denominator effect triggered by the sell-off in public equities. The value of un-exited assets is at a record high, with limited partners increasingly impatient and pushing sponsors to achieve realisations rather than waiting longer for valuations to rise. Others will feel recently raised funds burning a hole in their pocket, as the industry as a whole seeks targets for more than $1 trillion of dry powder. For many, it will be both.

ADVERSITY

As the private capital industry looks to 2024 and beyond, there are a number of significant challenges on the horizon:

- **Uncertainty:** The macro-economic environment remains volatile. Ongoing geo-political instability is a source of great concern; upcoming elections in the UK and US introduce considerable uncertainty; and fiscal and financial policy agendas to combat inflation, implement extensive quantitative tightening and manage ballooning national debt all reduce conviction in financial models, requiring more prudent assumptions at the expense of up-front valuations.
- **Availability of capital:** For many, it is proving harder to raise new capital as investors are increasingly selective about who they choose to back. A trend towards fewer, larger funds, raised by an elite group of sponsors, will fuel consolidation amongst asset managers. We saw several of these transactions in 2023, including TPG's acquisition of Angelo Gordon and Bridgepoint's acquisition of Energy Capital Partners, and anticipate more over the next 18-24 months.
- **Increased regulatory intervention:** The private capital industry is high on the regulatory agenda. Financial regulators are seeking to improve transparency and impose more extensive protections for investors. Competition regulators have a stated agenda to investigate so-called 'platform' or 'roll-up' strategies involving the acquisition of multiple, smaller businesses that would not typically trigger regulatory approvals.

We have already seen direct intervention in some markets, such as dentistry, laundry services and veterinary clinics, and may see more as regulators broaden their focus. All of this in addition to a harder stance on the application of general merger control powers. Since its commencement in October 2023, the EU's FSR will also add a new, complex, and potentially onerous dimension to the scrutiny and clearance of larger deals.

- **An evolving financing market:** Although the end of the cheap debt era has not yet resulted in the wave of casualties gloomily predicted a year ago, we have seen both borrowers and lenders reassessing previously available borrowing multiples. The high interest rate environment has led to a focus on free cash flow and a borrower's ability to meet higher levels of debt service now operates as a constraint on borrowing (alongside financing EBITDA). Whereas previously, interest cover covenants (if included in documentation) did not attract much commercial attention, we now see both borrowers and lenders focusing on these covenants much more closely (and the potential for breach of existing covenants arising). The challenge for dealmakers will be to find the means to bridge the gap between the valuation multiples attaching to assets and available borrowing multiples.

OPPORTUNITY

Over the next 12-18 months, we anticipate a significant increase in the volume of transactions backed by private capital. Within these deals, we expect to see a number of themes emerge:

- **Competition for quality:** Current market conditions favour the strongest operating businesses. This will, in our view, renew focus on true 'alpha' investing, requiring detailed operational due diligence and post-acquisition enhancement as the primary route to generate value, rather than buy-and-build strategies reliant on multiple arbitrage (in effect, buying low and selling high). We expect real competition for assets displaying these characteristics, as we saw recently when acting for Inflexion on its sale of Chambers and Partners.
- **Smaller deals, harder fought:** We anticipate a trend towards comparatively smaller deals – something we have already observed in the P2P market as interest in FTSE350 and AIM companies has intensified, including from larger sponsors through acquisitions funded entirely by equity. We may also see greater complexity in transactions as sponsors seek to realise arbitrage opportunities. This may occur at the asset level (e.g. complex carve-outs) or through the capital structure of investments (e.g. increasing use of complex capital instruments such as convertible preferred securities in lieu of more conventional mezzanine finance).
- **Investing through the stack:** Sponsors with multiple strategies covering private equity, tactical/strategic opportunities and private credit are likely to be well-positioned to take advantage of current conditions. As seen in several recent, larger deals (EQT and ADIA's £4.5 billion offer for Dechra Pharmaceuticals plc and Permira's £703 million offer for Ergomed plc), sponsors have shown a willingness to deploy capital from different pockets across their business to support investment throughout the capital stack. This arguably simplifies underwriting and execution, minimises fee leakage and supports sponsors' global AUM.
- **Fund liquidity solutions:** With a period of slow market conditions, sponsors will continue looking for innovative solutions to generate liquidity for their investors while the M&A market slowly picks up, such as through NAV facilities and other fund financing products or GP-led secondaries transactions. This is more likely to provide shorter-term solutions, as LPs put pressure on asset realisations and increasingly assess sponsors on performance measures (such as distributed paid in capital) that seek to assess returns generated by the asset rather than relying solely on IRR.
- **Financing:** The wave of financing activity that occurred during COVID-19 is now approaching maturity, with a number of borrowers expected to need to refinance, or seek an amendment and extension package, within the next 12 months. This presents opportunities across the credit spectrum. In particular, we see the growth of funds targeting 'special situations' and 'hybrid capital' as offering opportunities for private capital to step in and provide risk-adjusted bespoke solutions to complex or stressed credits.

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