GLOBAL PRIVATE EQUITY REPORT 2024

BAIN & COMPANY

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The Dark before the Dawn

Dear Colleague:

The year 2023 was one of portent. Deal value fell by 37%. Exit value slid even more, by 44%. Fund-raising dropped across private capital, as 38% fewer buyout funds closed. Interestingly, dollar commitments in buyouts surged as a number of high-performing funds came to market. But it was truly a year of haves and have-nots. Just 20 funds accounted for more than half of all buyout capital raised.

The word for this market is *stalled*. Cutting through all of the macro noise was the 525-basis-point increase in US central bank rates from March 2022 to July 2023. The speed and magnitude of this rise caused general partners to hit the pause button.

The good news? Interest rates appear to be stable and have been for a few months. Record dry powder is stacked and ready for deployment. A sizable chunk of this dry powder is aging and needs to be put to work. Looking into portfolios, nearly half of all global buyout companies have been held for at least four years.

In short, the conditions appear to be shifting in favor of hitting the go button. We will see what 2024 brings.

Best wishes,

Hugh MacArthur
Chairman, Global Private Equity

Private Equity Outlook 2024: The Liquidity Imperative

Spiking interest rates derailed dealmaking in 2023 and left the capital flywheel sputtering. Getting unstuck is job one in the year ahead.

By Hugh MacArthur, Rebecca Burack, Graham Rose, Christophe De Vusser, Kiki Yang, and Sebastien Lamy

At a Glance

- Private equity continued to reel in 2023 as rapidly rising interest rates led to sharp declines in dealmaking, exits, and fund-raising.
- The exit conundrum has emerged as the most pressing problem, as LPs starved for distributions pull back new allocations from all but the largest, most reliable funds.
- The long-term outlook remains sound, but breaking the logjam will require more robust approaches to value creation and rapid innovation in liquidity solutions.

It's safe to say the private equity industry has never seen anything quite like what's happened over the last 24 months.

While the sharp drop-off in deal activity in late 2022 and into 2023 echoes the period following the 2008–09 global financial crisis (GFC), the situation the industry faces today is largely unprecedented.

The numbers are all very GFC-like: Deal value and deal count have fallen 60% and 35%, respectively, from their peaks in 2021. Exit value is down 66%, and the number of funds closing is off by nearly 55%

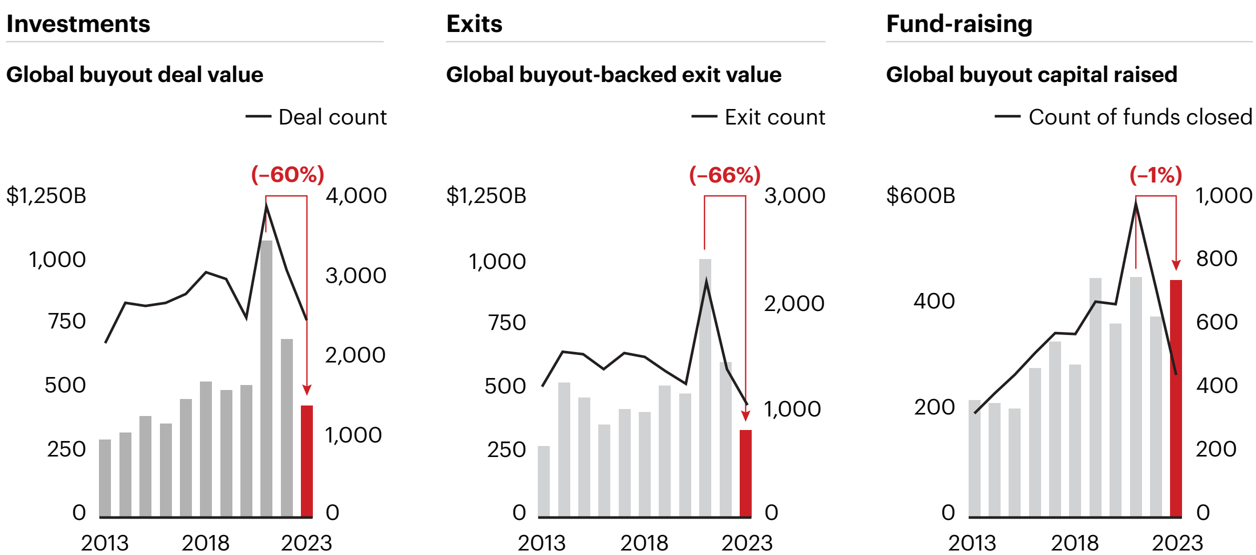
(see Figure 1). Yet what's driving these declines couldn't be more dissimilar to what was happening in 2008–09, and making sense of it requires a different lens altogether.

As difficult as it was, the aftermath of the GFC followed a predictable pattern: To cope with the crisis, central bankers slashed interest rates to spur activity, the economy slowly stabilized, and private equity was able to claw its way back from what many predicted would be its unraveling. The resulting period of growth in the years that followed created a private equity industry that is vastly larger and more complex than anyone in 2008 could have reasonably expected.

Yet today that size and complexity magnify the challenges the industry faces. Business conditions are more perplexing than predictable. Interest rates have risen faster than at any time since the 1980s, and it remains unclear when the US Federal Reserve will reverse course or where rates will eventually settle *(see Figure 2)*. Concerns about what we dubbed last year "the most anticipated recession in history that hasn't happened yet" continue to linger. Yet to the surprise of most analysts, the economy is chugging along nicely. Record-low unemployment, reasonable growth, and surging public markets in the US suggest the possibility that we might just escape these months of turmoil with nothing worse than a soft landing.

These crossed signals have left private equity hamstrung. The sheer velocity of the interest rate shock was something few in the industry had ever experienced, and the impact on value has driven a wedge between buyers and sellers.

Figure 1a: Investments, exits, and the number of buyout funds closed all continued to slide in 2023 as the industry reeled from rising interest rates



Notes: Investments—excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; Exits—includes full and partial exits; bankruptcies excluded; IPO value represents offer amount and not market value of company; Fund-raising—data grouped by the year in which funds held their final close; count is of all funds, including those for which final close data is unavailable; buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; excludes SoftBank Vision Fund
Sources: Dealogic; Preqin

Figure 1b: Activity during the second half of the year was an improvement on the first, but not by much

Investments

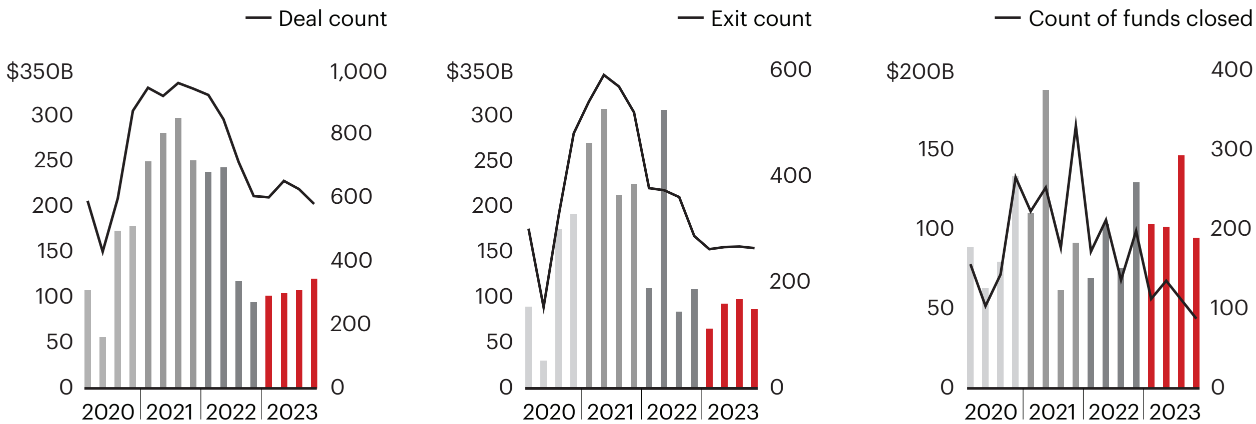
Global buyout deal value, quarterly

Exits

Global buyout-backed exit value, quarterly

Fund-raising

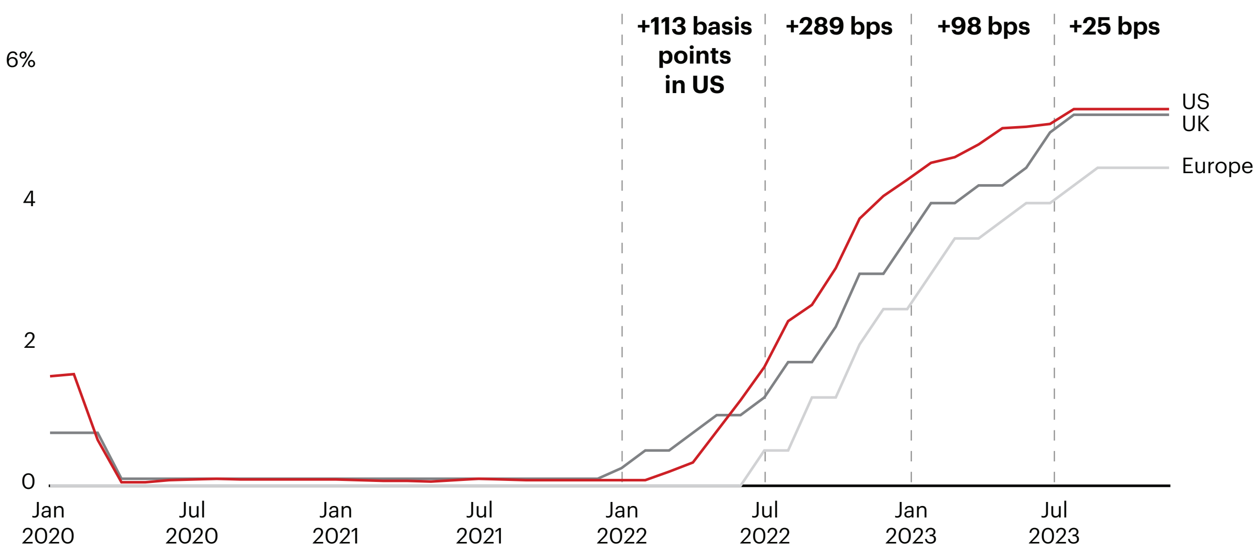
Global buyout capital raised, quarterly



Notes: Investments—excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; Exits—includes full and partial exits; bankruptcies excluded; IPO value represents offer amount and not market value of company; Fund-raising—data grouped by the year in which funds held their final close; count is of all funds, including those for which final close data is unavailable; buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; excludes SoftBank Vision Fund
Sources: Dealogic; Preqin

Figure 2: The 525-basis-point rise in interest rates from March 2022 to July 2023 was the sharpest monetary tightening in decades

Central bank interest rates by region (monthly average)



Notes: US shows federal funds rate; Europe shows euro short-term repo rate; UK shows clearing banks base rate (middle rate); basis point changes over a six-month period are displayed for the US only and calculated based on the increase in average interest rates between the end of June and December of each year
Source: LSEG

Price multiples, which tend to move inversely to interest rates, have tipped downward over the last year, but only slightly so far. That's because sellers are bringing to market only the highest-quality assets, those they are confident will move at a reasonable return. Otherwise, the exit channels have largely dried up, leaving general partners (GPs) with a towering $3.2 trillion in unsold assets and stanching the flow of capital back to limited partners (LPs).

These declines in activity have had a chilling effect on fund-raising. Slower distributions have left LPs cash flow negative, crimping their ability to plow more capital back into private equity. The industry still raised an impressive $1.2 trillion in fresh capital in 2023, and the buyout category attracted $448 billion. But LPs were highly selective. While capital flowed to the largest "reliable hand" buyout funds, fund-raising for most was as hard as it's ever been.

Slower distributions have left LPs cash flow negative, crimping their ability to plow more capital back into private equity.

Until GPs can begin moving assets out of their portfolios in a timely fashion, raising the next fund won't get any easier. And the threat to returns is real. Buyouts typically involve term loans that expire in five to seven years. Already, interest coverage ratios among buyout-backed portfolio companies in the US have dropped to 2.4 times earnings before interest, taxes, depreciation, and amortization (EBITDA), the lowest level since 2007. That is pressuring GPs to both find liquidity solutions and devise new ways to generate profits through operating leverage—not just the multiple expansion and revenue growth the industry has leaned on for years.

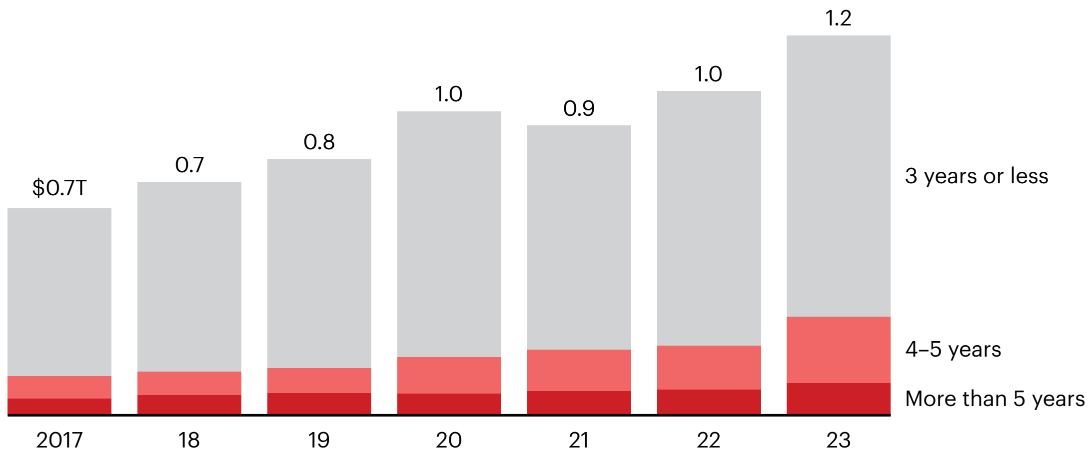
Early signs of a turnaround? The most difficult aspect of this gridlock, of course, is predicting what will happen next. But in our view, the green shoots of a recovery are starting to poke through. Perhaps the most important is that, barring any new macro shocks or geopolitical crises, rates are more likely than not to moderate in the coming year.

Even slight cuts are likely to spur on dealmaking as long as the macro outlook remains relatively stable. Buyout funds alone are sitting on a record $1.2 trillion in dry powder, and 26% of that is four years old or older, up from 22% in 2022 *(see Figure 3)*. That creates a heavier incentive than normal for GPs to get off the sidelines and start buying, even if conditions aren't ideal. Activity is already ticking upward, and with help from the Fed and the European Central Bank, the bias in 2024 is likely to the upside when it comes to deal count and value.

Exits are another matter. Barring a sharper-than-anticipated drop in rates, sellers will continue to face high hurdles to unloading companies to strategic buyers, other sponsors, or the public markets.

Figure 3: With a record 26% of global buyout dry powder now four years old or older, general partners are under growing pressure to do deals

Global buyout dry powder, by years since capital raised ($T)



Share of capital that is at least 4 years old (%)	19	19	18	19	23	22	26

Notes: Buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; assumes average investment period of five years; percentage split of capital raised in 2023 is as of Q2; discrepancies in bar heights displaying the same value are due to rounding differences
Sources: Preqin; Bain analysis

With sponsors struggling to send cash back to their LPs, 2024 will likely be defined by how creative the industry can be in finding ways to generate liquidity.

Action required. What's clear is that passively waiting for conditions to recover is not a viable strategy. Much of this report is devoted to exploring how these dynamics are playing out and what the most forward-thinking GPs are working on. Getting unstuck will demand action in several directions at once:

- **Doubling down on value creation.** The exit situation is shining a bright light on how critical it is to generate operating leverage in a market where tailwinds from multiple expansion have turned into headwinds. You can't control the direction of rates. But you can get better at underwriting value and capturing it through crisp execution. We've talked about it for years: The industry has relied disproportionately on rising multiples and revenue gains to generate returns while margin improvement has contributed practically nothing. That no longer works when rising rates serve as ballast for asset multiples.

  The portfolio companies that will stand out in this difficult market are those that have used every means possible to boost EBITDA efficiently and can demonstrate to the next owner that there's money left on the table. That means funds have to get sharper at finding and pulling the value-creation "levers" that generate organic growth—pricing, salesforce effectiveness, and product innovation, to name a few. If these insights weren't part of the original value-creation plan, now is the time to focus on them. The market has been abundantly clear on this. The companies that are selling are not those that have merely gotten bigger and/or leaner. The premium is on generating strong, profitable, organic growth.

- **Managing across the portfolio.** While strategies focused on EBITDA growth take time, a ballooning exit backlog also presents more immediate concerns. Funds need to develop a clear-eyed, pragmatic appraisal of where each portfolio company sits in terms of its return profile, its capital structure, and its future prospects. As long as rates stay elevated, GPs have choices to make: Which companies will reap an acceptable return if we sell now? Which should we sell anyway so we can return cash to LPs? Which companies face loan expirations, and where can we effectively "amend and extend" to reshape a balance sheet without too much pain? What are our options for generating liquidity through the burgeoning secondary market?

  If the industry's growing inventory of unsold assets isn't going to be a problem, there are a few things you have to believe. First, with a large volume of portfolio companies facing refinancing hurdles, it will be critical that debt holders take the stance they did in 2008–09. Lenders clearly didn't want the keys to a bunch of troubled portfolio companies then and probably don't want them now. That leaves open the opportunity to pay a penalty, add some equity, and arrive at a workable capital structure.

  The second thing you need to believe is that there are enough innovative solutions like continuation funds, securitizations, and NAV financing to help GPs recap prized assets and wait for returns to ripen while keeping economic interest aligned between GPs and LPs. The secondaries space is still small and somewhat controversial. But it is growing rapidly and represents the kind of financial innovation that is private equity's specialty.

- **Professionalizing fund-raising.** An effective portfolio scan should lead to a clear, practical roadmap for steering the fund through an immensely difficult period. The next step is communicating to LPs how portfolio managers are using all the tools at their disposal to act as a trusted steward of investor capital. GPs aren't particularly adept at this kind of communication because they haven't had to be in the past. Ad hoc, anecdotal conversations about a single portfolio company were sufficient when performance overall wasn't really in question.

  Now performance is everything, and the competition for a limited pool of capital has never been more fierce. This is spurring the most proactive funds to consider making a step change in how they approach investors by professionalizing processes and honing their go-to-market capabilities. The firms out-raising others are strategically mapping out who their LPs should be and developing the capabilities and tools necessary to understand what it takes to win with them and expand share of wallet. They are building the kind of commercial organizations the best B2B sellers rely on daily.

None of this is easy, of course, but none of it is insurmountable. Private equity survived the overexuberance of the RJR Nabisco years. It lived through 9/11 and the subsequent recession. It took the worst blows of the global financial crisis and came out even stronger. The industry, in other words, has consistently demonstrated its resilience. This is one of those moments. Time to get to work.

Here's a more detailed look at what happened in 2023.

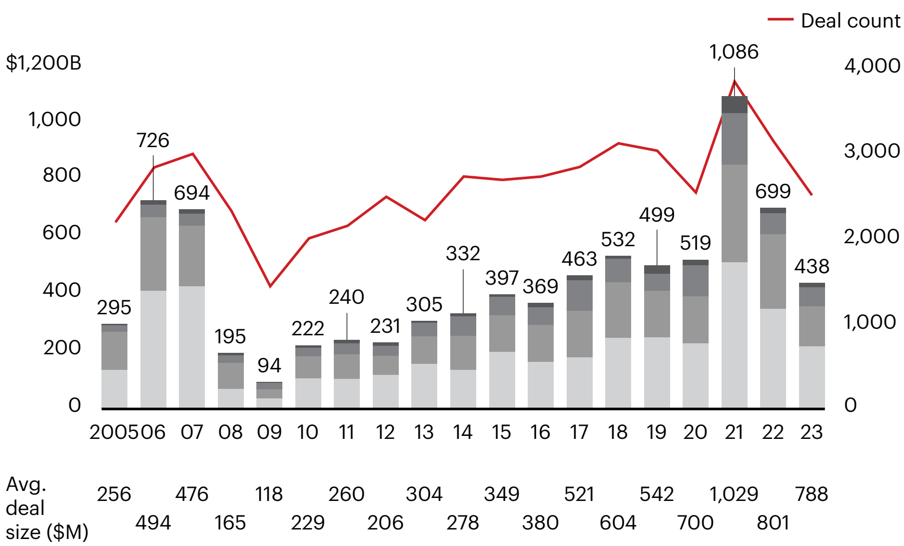
Investments

Private equity dealmakers tend to make the most of the cards they're dealt. As long as they have reasonable confidence in what's coming, they'll find a way to make a good deal work. But confidence was the first casualty when the Fed jacked rates at the fastest pace since the 1980s, leaving the industry gasping for air. The falloff that started in the second half of 2022 bled over into 2023.

Excluding add-ons, buyout investment value dropped to $438 billion, a 37% decrease from 2022 and the worst total since 2016 *(see Figure 4)*. Overall deal count dropped 20% to around 2,500 transactions. The steep slope of the decline was something the industry hadn't experienced since the global financial crisis. The malaise infected regions across the world, with Europe and Asia-Pacific both experiencing significant declines *(see Figure 5)*.

Figure 4: The two-year falloff in global buyout deal value marks the steepest decline since the global financial crisis

Global buyout deal value, by region

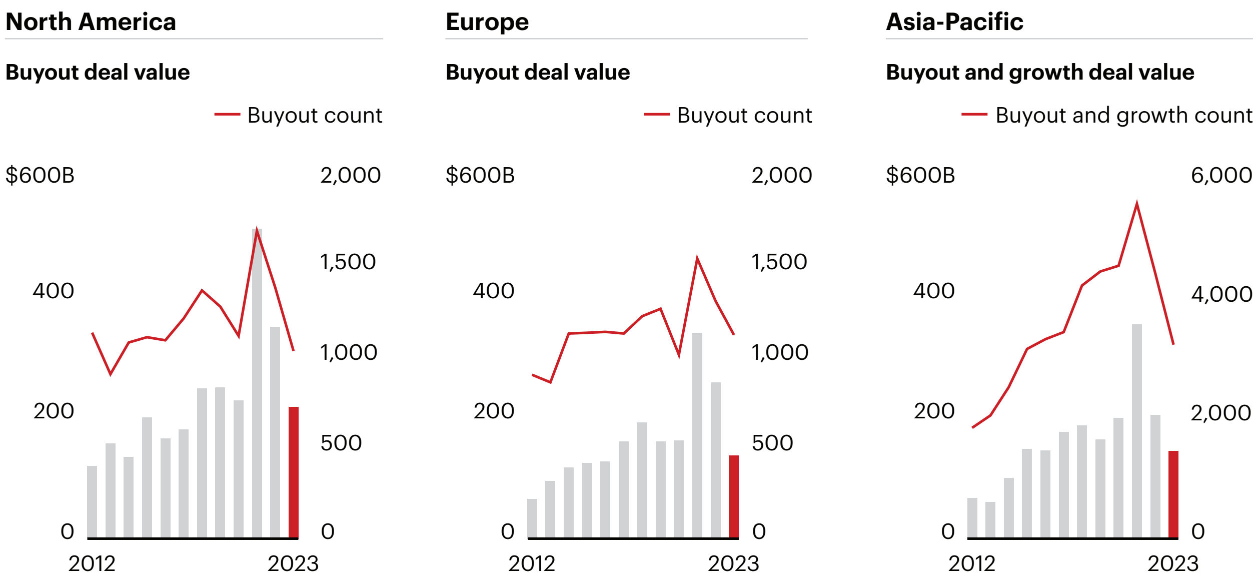


Change in deal value

	2023 vs. 2022	2023 vs. 5-yr. avg.
Rest of world	–22%	–47%
Asia-Pacific	–8%	–32%
Europe	–46%	–38%
North America	–38%	–31%
Total	**–37%**	**–34%**

Notes: Excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location; average deal size calculated using deals with disclosed value only
Source: Dealogic

Figure 5: Deal value and activity declined globally



Notes: North America and Europe—excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location; Asia-Pacific—includes buyout, growth, early-stage, private investment in public equity, and turnaround deals; excludes add-ons; excludes real estate; deal value excludes deals with announced value less than $10 million; includes investments that have closed and those at agreement-in-principle or definitive agreement stage
Sources: Dealogic; AVCJ; Bain analysis

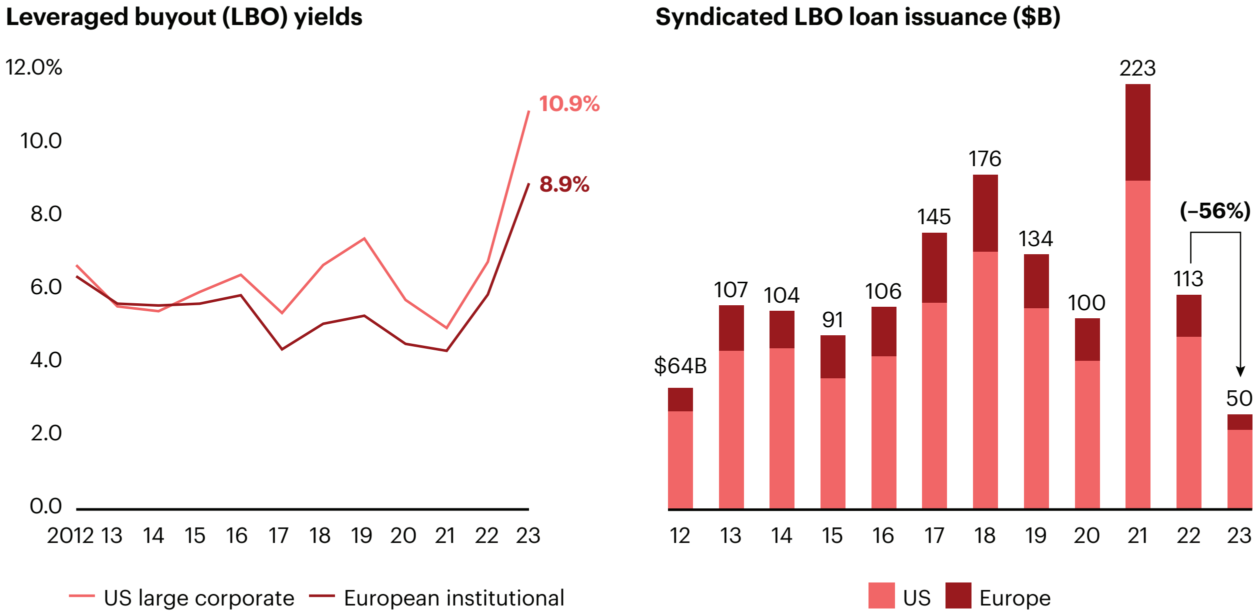
Deals of all kinds felt the impact, but those that depended on bank financing suffered the most. As yields on large syndicated loans approached 11% in the US and 9% in Europe (both 10-year highs), banks retreated and issuance of new loans plunged *(see Figure 6)*.

The lack of affordable leverage cut the number of megadeals—those over $5 billion—by almost half, and the average deal size dropped to $788 million, down from the peak of $1 billion in 2021. Buyouts broadly saw double-digit declines in deal count *(see Figure 7)*. Technology deals, which by nature require less leverage than deals in other sectors, maintained their dominant share of total buyout count, but asset-heavy traditional industries like industrial goods and services expanded their share slightly, benefiting from a flight to safety among investors looking for stability wherever they could find it *(see Figure 8)*.

The growth and venture capital segments, meanwhile, continued to drift sideways. Both focus on riskier, earlier-stage companies whose growth-based valuations are particularly vulnerable to interest rate pressure. They were also buffeted by the lingering impact of the crypto collapse in 2022 and the implosion of Silicon Valley Bank in 2023 *(see Figure 9)*.

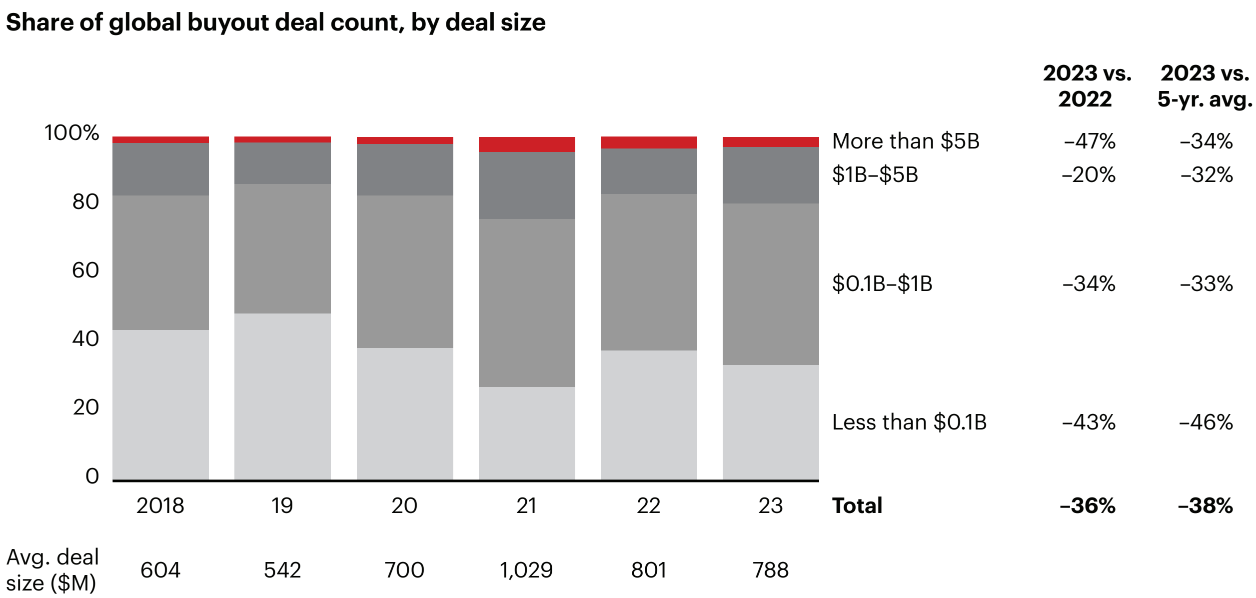
Elevated interest rates contributed to several other important shifts in the financing environment. Private credit continued to aggressively fill gaps left by the big banks and captured 84% of the middle

Figure 6: With yields on leveraged bank loans shooting through the roof, LBO loan issuance plunged in 2023, making it hard to finance transactions



Notes: European institutional spread includes all tracked LBO deals, regardless of size; US large corporate defined as LBOs with more than $50 million in EBITDA; Europe syndicated loan volume converted using euro/US dollar conversion rate of 1.076
Sources: LCD; LSEG

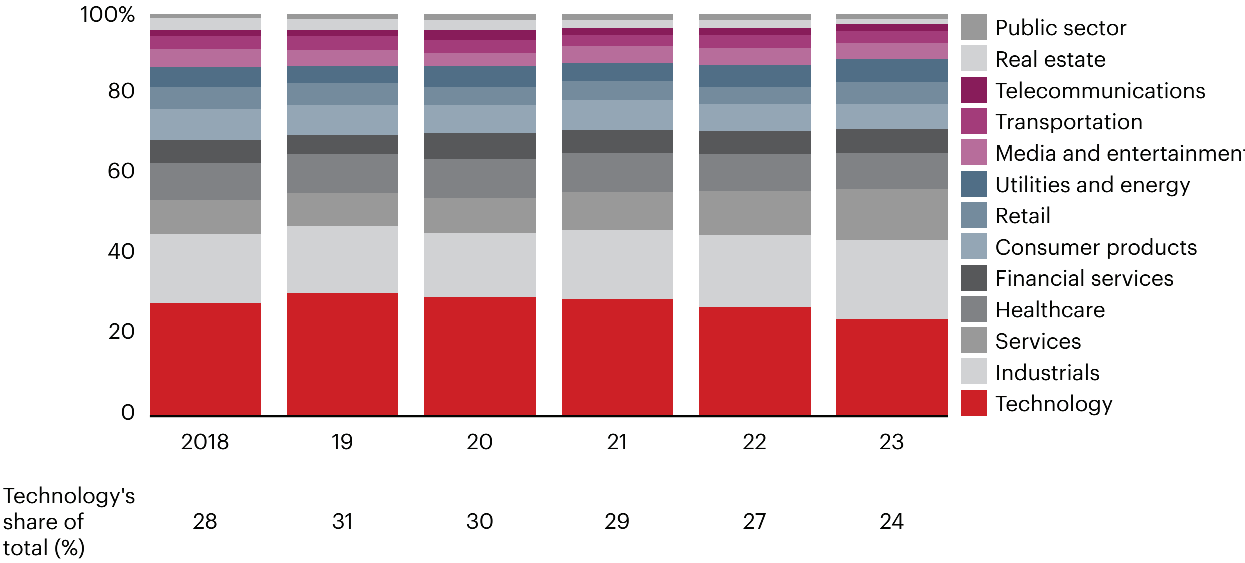
Figure 7: Deals of all sizes declined in 2023 and were well off five-year averages



Notes: Includes deals with disclosed value only; excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; average deal size calculated using deals with disclosed value only
Sources: Dealogic; Bain analysis

Figure 8: Technology remained the leader in deal count, but industrials increased share as investors looked for stability in a traditional sector

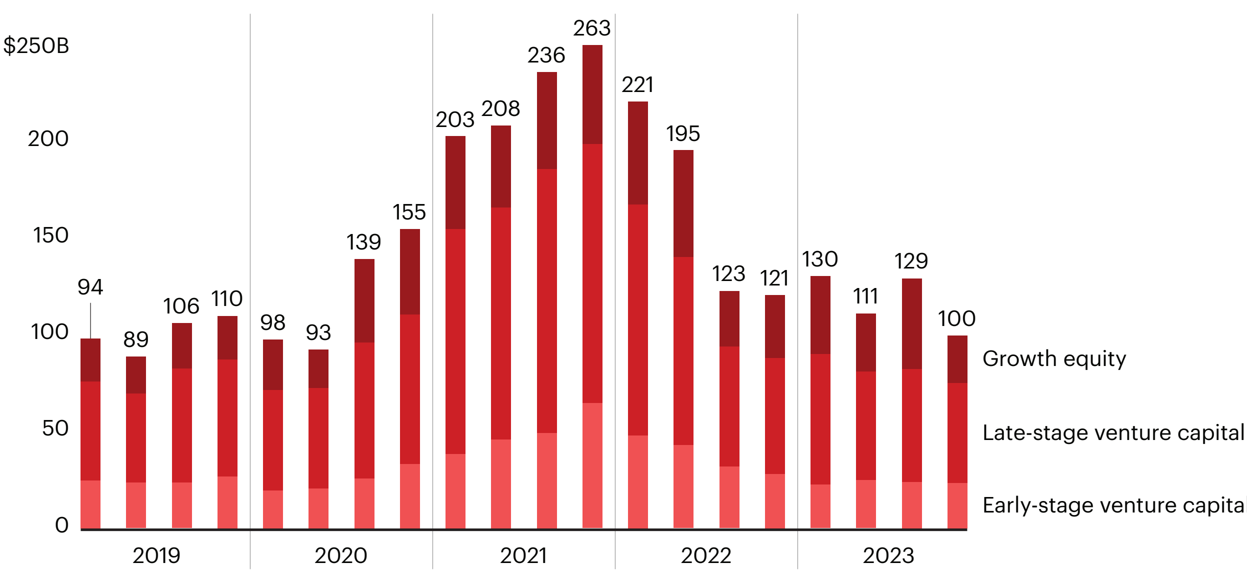
Share of global buyout deal count, by sector



Notes: Excludes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change
Source: Dealogic

Figure 9: After soaring during the pandemic, growth and late-stage venture investing has come back to earth

Global growth capital invested, by investment stage, quarterly



Notes: Late-stage venture capital defined as financing by a VC firm in Series B through Series Z+ rounds and/or more than five years after the company's founding date; growth equity defined as a noncontrol, equity investment by a PE firm into a company, with cash received by the company
Source: PitchBook

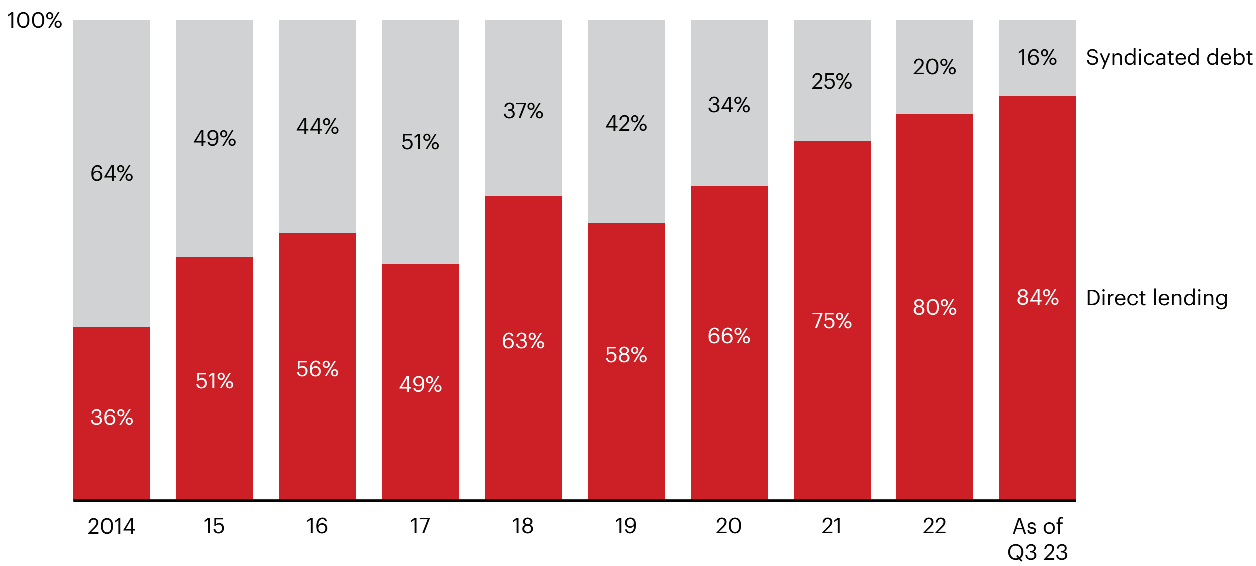
market—deals with a total loan package of less than $500 million *(see Figure 10)*. At the same time, investors responded to the increased financing costs by using less debt and more equity overall. Debt multiples in 2023 dropped 17% from 2022 to 5.9 times EBITDA, the lowest level since 2012 *(see Figure 11)*. That's not surprising given that interest coverage ratios in both the US and Europe were the worst they've been in years (as we'll discuss more fully in the following section on exits).

High interest rates, in and of themselves, make acquisitions harder to pencil by raising the cost of capital. But they've also complicated dealmaking over the past year by promising to put downward pressure on price multiples (even if prices remain relatively high historically). This is essentially a math issue: When rates go down, multiples of cash flow go up, and vice versa. Because of that, rock-bottom rates for the past decade have provided a tailwind for deals by keeping price multiples growing. That made acquisitions pricey, but if buyers could count on selling an asset for more than they paid, the math still worked.

Now the calculation is harder. Price multiples have, in fact, declined slightly over the past year, but they still sit at almost 11 times EBITDA in the US and around 10 times in Europe as sellers seek to unload the strong assets they're confident will sell *(see Figure 12)*. That makes the average target company expensive on a historical basis, yet it's hard to assume that multiples will do anything but continue to ease off until interest rates begin to moderate.

Figure 10: With banks pulling back, private lenders continued to expand their share of financing middle-market deals

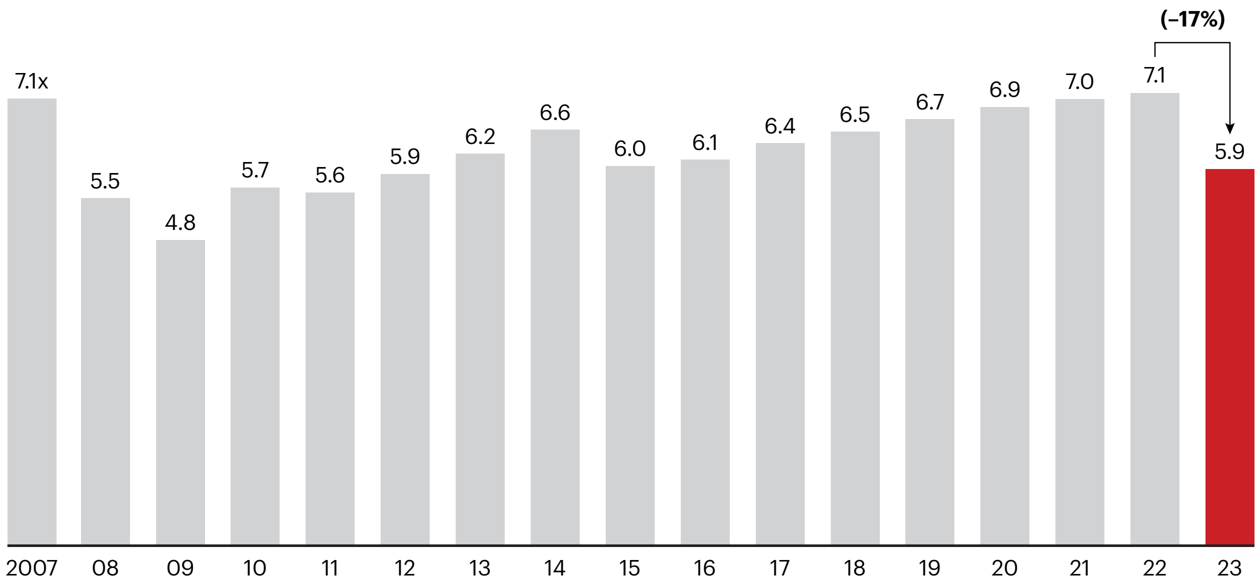
Share of US middle-market LBO loan issuance, by debt type



Notes: Middle market includes issuers with revenues less than $500 million and total loan package less than $500 million; direct lending includes nonsyndicated facilities, including club lending
Source: LSEG LPC

Figure 11: Debt multiples fell to a 10-year low as rising interest rates made it harder to pile on leverage

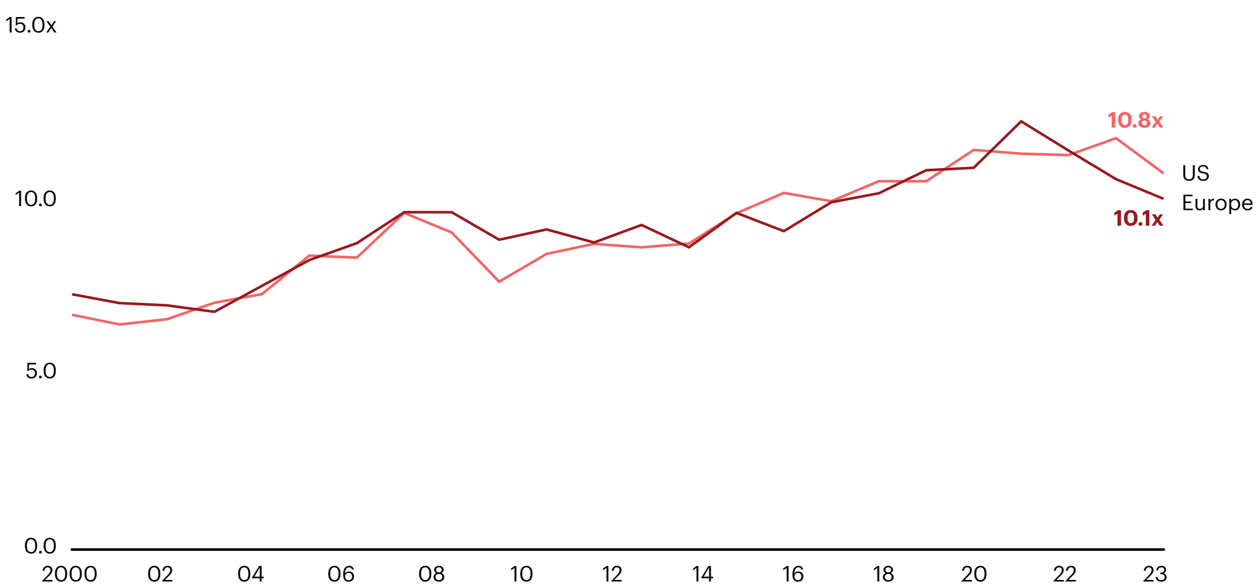
US large corporate debt to EBITDA ratio for LBO loans



Source: LSEG LPC

Figure 12: Purchase price multiples softened slightly in response to rising interest rates, but not enough to counterbalance the increased cost of capital

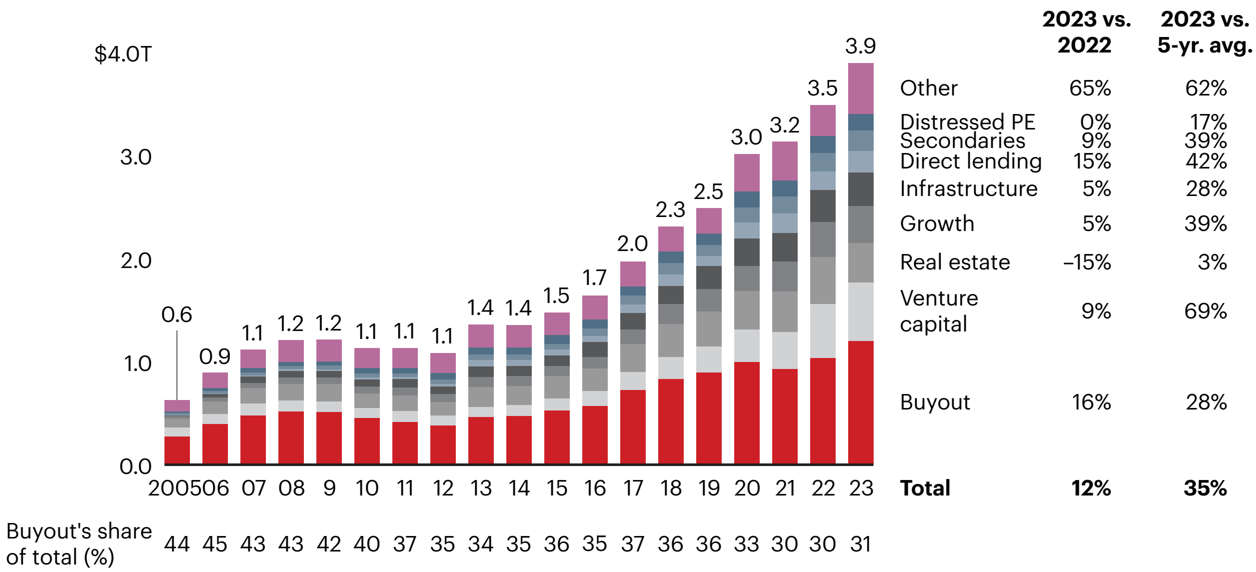
Average EBITDA purchase price multiple for LBO transactions



Source: LCD

Figure 13: Global dry powder across private asset classes has been stacking up for almost a decade and set another record in 2023

Global private capital dry powder, by fund type



Notes: Buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; other category includes fund-of-funds, mezzanine, and hybrid; discrepancies in bar heights displaying the same value are due to rounding differences
Source: Preqin

The good news, as we said earlier, is that some moderation is likely on its way in 2024 as inflation stabilizes and central bankers try their best to bring the global economy to a soft landing. Barring further shocks, a more stable—even favorable—outlook will help GPs get more comfortable with what they are underwriting. The level and age of the dry powder in their funds is also creating a heavy incentive to get moving. The industry is sitting on an unprecedented $3.9 trillion in unspent capital, the largest share of it ($1.2 trillion) in buyout funds *(see Figure 13)*. The slowdown in dealmaking has also increased the average age of that buyout capital; around 26% of it is four-plus years old and aching to be deployed.

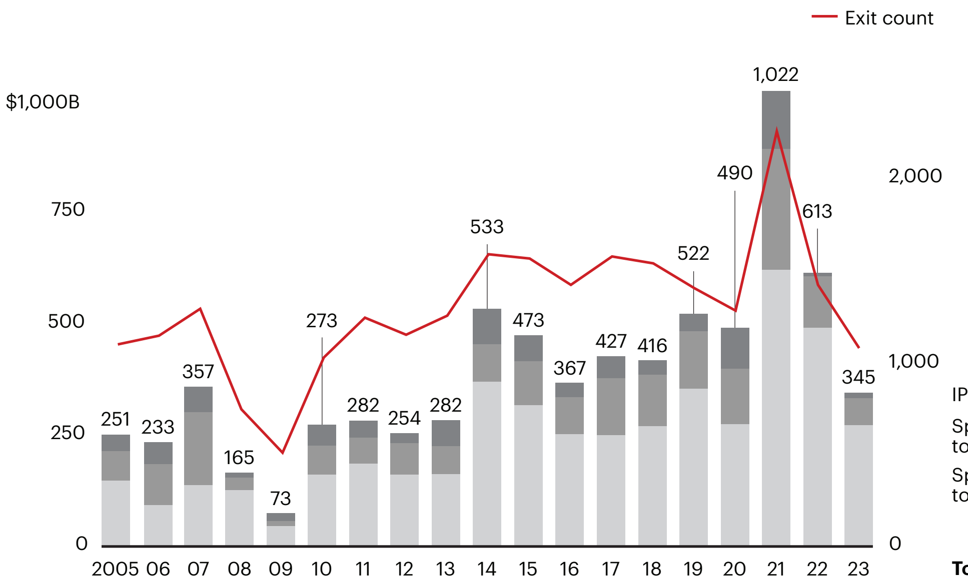
The potential for easing rates and the need to put money to work are why we believe investments may improve incrementally in 2024 (unless, of course, the macro environment takes a turn for the worse). But it's equally likely that rates aren't going back to zero any time soon, meaning pressure on multiples will endure.

Exits

Exit activity fared even worse than dealmaking in 2023, as rising interest rates and macro uncertainty left buyers and sellers at odds over valuations. Buyout-backed exits came in at $345 billion globally, a 44% decline from 2022. The total number of exit transactions fell by 24% to 1,067 *(see Figure 14)*. Activity was slack across all geographies.

Figure 14: Buyout-backed exits sank to their lowest level in a decade as the industry's two biggest exit channels contracted

Global buyout-backed exit value, by channel



Change in exit value	2023 vs. 2022	2023 vs. 5-yr. avg.
IPO	72%	–80%
Sponsor to sponsor	–47%	–59%
Sponsor to strategic	–45%	–32%
Total	**–44%**	**–44%**

Notes: Includes partial and full exits; bankruptcies excluded; IPO value represents offer amount and not market value of company
Source: Dealogic

While corporate buyers remained the largest channel—accounting for nearly 80% of total exit value in 2023—the value of these strategic deals fell off 45% from 2022, to $271 billion. This was part of a broad corporate mergers and acquisitions pullback in 2023 as harried executives tried to make sense of rising rates and the uncertain macro environment.

Bain & Company research shows that corporate buyers may begin to get more active if rates stabilize and the economic outlook improves. But company executives also indicate that they plan to be significantly more selective about the assets they purchase, focusing on scale deals to accomplish consolidation objectives before returning to scope-oriented capability investing to drive growth. That suggests any recovery in strategic exits will be tentative.

The sponsor-to-sponsor channel (deals between private equity firms) was similarly challenged in 2023. The value of these transactions dropped to $62 billion, a 47% decline from 2022's total. Higher rates meant that a potential buyer of a given portfolio company faced the prospect of spending more to borrow less as a multiple of EBITDA than the seller did when it bought the company. That left buyers and sellers facing different economics for the same asset, resulting in an unbridgeable spread between bid and ask.

Amid surprisingly strong public equity markets in 2023, the IPO exit channel showed some signs of life, rising to $11.8 billion from $6.9 billion in 2022. But it still made up just 3% of total exit volume and is unlikely in the coming months to provide consequential relief for an industry struggling to generate higher distributed to paid-in capital (DPI).

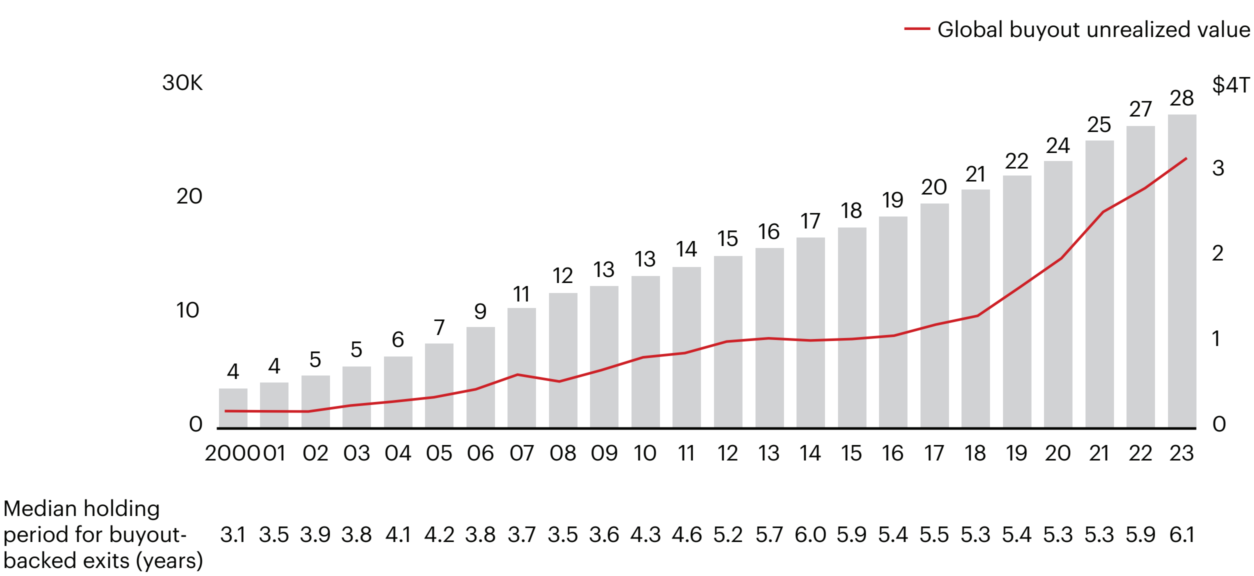
Indeed, unless rates drop meaningfully in 2024, none of these exit channels is likely to rebound vigorously in the short term, and the deals that do close will skew toward large companies and those with the strongest fundamentals. Buyout funds, meanwhile, will be challenged to make a meaningful dent in the $3.2 trillion in unexited assets sitting in their portfolios *(see Figure 15)*.

This will focus GPs on two overarching objectives. First, they will need to boost DPI in the near term by determining which assets they can sell (both old portfolio companies and newer ones) and aggressively chasing those opportunities. Second, they will need to manage the balance sheets of the companies they hold and develop strategies to increase EBITDA.

Over the past two years of inflation followed by monetary tightening, interest coverage ratios among buyout-backed companies have dropped sharply to 2.4 times cash flow in the US and 2.6 times in Europe *(see Figure 16)*. Those are the lowest levels since 2008 and suggest that, for the average buyout-backed portfolio company, paying off interest has already gotten significantly harder. In 2023, according to Dealogic, $95 billion in leveraged loans came due and presumably had to be refinanced at higher rates. And by year-end 2025, loans worth more than three times that amount (approximately $300 billion) will mature, making life difficult for GPs who have yet to exit them *(see Figure 17)*.

Figure 15: The record-high number of aging unexited companies in buyout portfolios has stanched the flow of capital back to investors

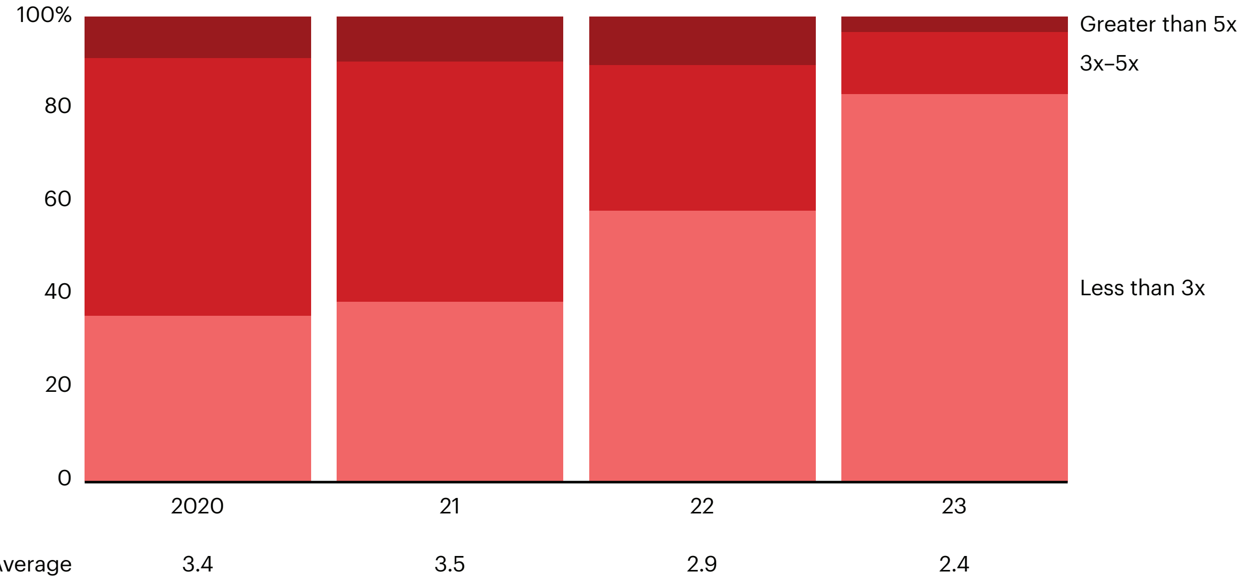
Global active buyout-backed companies



Notes: Shows data through FY 2023 for global active buyout-backed companies and average holding period and data through Q2 2023 for unrealized value; excludes add-ons; buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds
Sources: PitchBook; Preqin

Figure 16: Interest coverage ratios declined in 2023, given the higher cost of debt and inflationary margin pressure

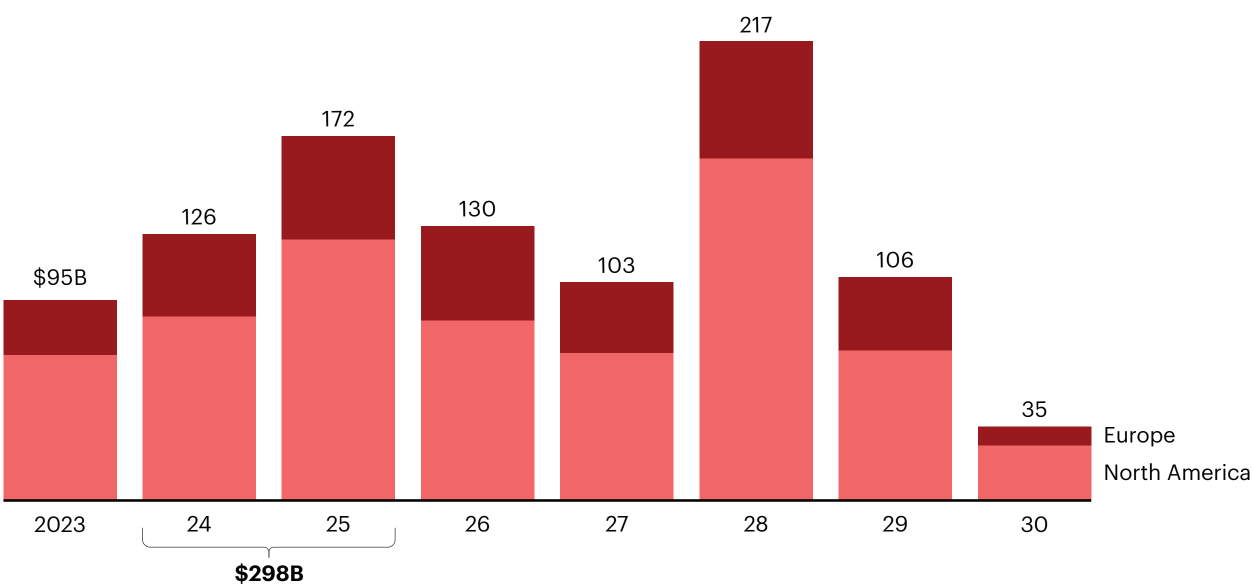
LBO interest coverage ratio for US portfolio companies (EBITDA/cash interest)



Note: Includes all LBOs from large corporate (more than $50 million in EBITDA) to middle market (less than $50 million in EBITDA)
Source: LCD

Figure 17: Close to $300 billion in leveraged loans is coming due by the end of 2025, dialing up the pressure to generate EBITDA

LBO loan value, by upcoming maturity dates ($B)



Source: Dealogic

Because boosting EBITDA is the most potent bug spray against higher interest expense *and* the best foundation for a stronger exit story over time, the most proactive GPs are doubling down on value creation as they wait for the exit channels to improve. But what if refinancing needs outpace the firm's ability to generate stronger cash flow?

During the GFC, many GPs bought back debt in their portfolio companies that was trading at a deep discount amid the economic malaise. The bet was that those companies would outlast the recession and the debt would eventually bounce back, actually enhancing the overall return.

With rates high and recession at bay, that's not an option today. But GPs are actively exploring other solutions. A few examples:

- For those with undrawn equity capacity, one alternative is to inject enough new equity into a company to make debt affordable, avoid diluting returns, and maintain 100% control—essentially kicking the can down the road for the price of the equity infusion.
- Another strategy is to use NAV loans to borrow against the portfolio—not individual companies—to effectively cross-collateralize assets. That's using strength to mitigate exposure, but it does lock in a potential drag on the entire fund.
- Other funds are creating new securities out of single assets in need of refinancing through innovative continuation vehicles that take out debt and reset the cap table. LPs can roll their positions or not, and the GP retains economics in the new structure.

Weathering this period of exit stress will clearly depend on innovation. GPs need to sell what they can and buy time to hold good assets while maintaining aligned incentives with LPs and management teams.

Fund-raising

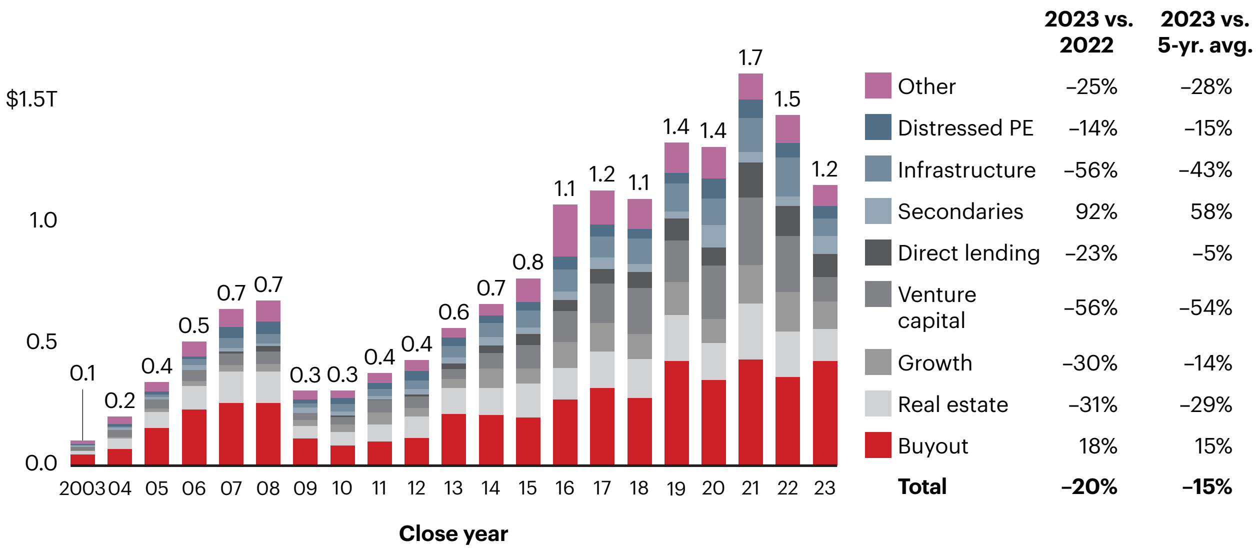
Probably the most generous way to think about 2023 fund-raising is that it contributed an impressive $1.2 trillion to the stunning $7.2 trillion in fresh capital the industry has accumulated since 2019 *(see Figure 18)*. Whether you saw any benefit from that windfall, however, depended on where you sat.

The amount raised in 2023 was actually the least the industry has pulled in annually since 2018—down 20% from 2022 totals and almost 30% off the all-time high in 2021. The decline reflects the cash flow constraints LPs are facing due to the exit slowdown and accelerated drawdowns in recent fund-raising vintages (more on this below).

Buyout funds, which raised 18% more capital year over year, were the only major category to post gains as LPs focused allocations on the funds they trust most. The exception was secondaries, which roared ahead by 92% (off a smaller base) as investors spotted opportunity in a category of funds aimed

Figure 18: Private fund-raising contracted in 2023 with the notable exceptions of buyout funds and secondaries

Global private capital raised, by fund type



Notes: Includes closed-end and commingled funds only; buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; data includes funds with final close and represents the year in which they held their final close; other category includes fund-of-funds and mezzanine; excludes natural resources; excludes SoftBank Vision Fund
Source: Preqin

at solving the industry's liquidity woes. Other than that, however, funds struggled. The darlings in the run-up to 2021—growth, venture capital, and infrastructure funds—all declined sharply.

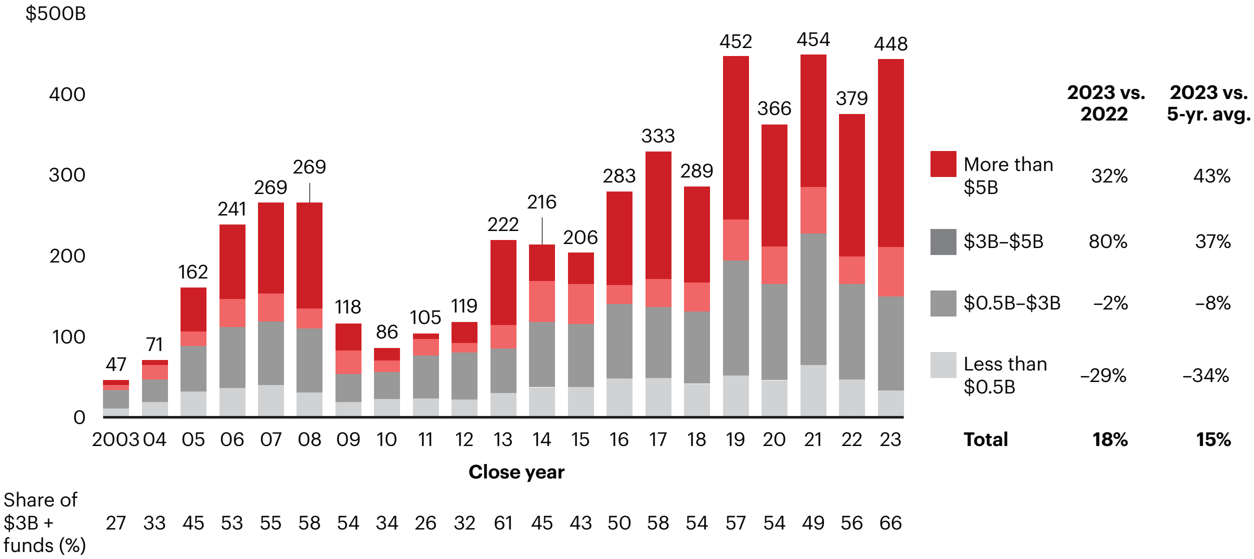
Even within buyout, there were distinct winners and losers as LPs gravitated to size and perceived quality *(see Figure 19)*. Allocations clearly favored large funds, with the top 20 funds raising a disproportionate 51% of capital aimed at buyout. But girth wasn't all that mattered; the premium was on performance and balance. Several lagging megafunds had to cut targets, and LPs pulled back a bit from their decade-long affinity for technology. Diversified funds like CVC Capital Partners ($29 billion) and Clayton, Dubilier & Rice ($26 billion) dominated the top 20.

Investors' preference for large funds obscured a sharp decline in overall fund-raising success during the year. While the average size of a buyout fund closed in 2023 was $1.2 billion—an 83% increase from 2022 and by far an industry record—the number of funds closed (449) declined 38% year over year *(see Figure 20)*.

Competition for capital has never been more intense. Private capital's breakneck growth over the past decade has led to a highly diverse industry with $14.5 trillion in assets under management *(see Figure 21)*. Yet it's become clear in recent years that there isn't enough capital to go around. As of January 2024, approximately 14,500 funds across the industry were on the road seeking $3.2 trillion in capital, and

Figure 19: Buyout limited partners focused most of their attention on the sector's largest, most experienced funds

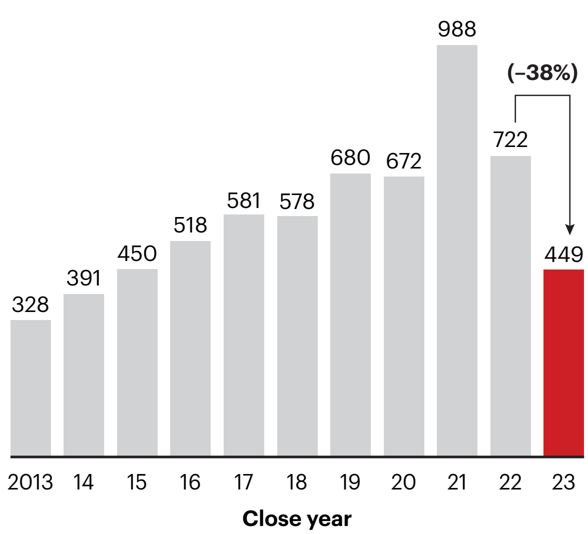
Global buyout capital raised, by fund size



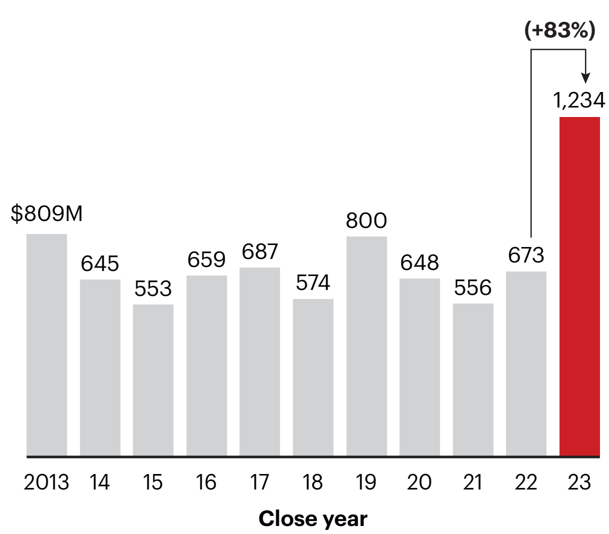
Notes: Includes closed-end and commingled funds only; buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; data includes funds with final close and represents the year in which they held their final close; excludes SoftBank Vision Fund
Source: Preqin

Figure 20: While far fewer buyout funds closed in 2023, the ones that did skewed larger, driving average fund size to its highest level in a decade

Count of buyout funds closed globally



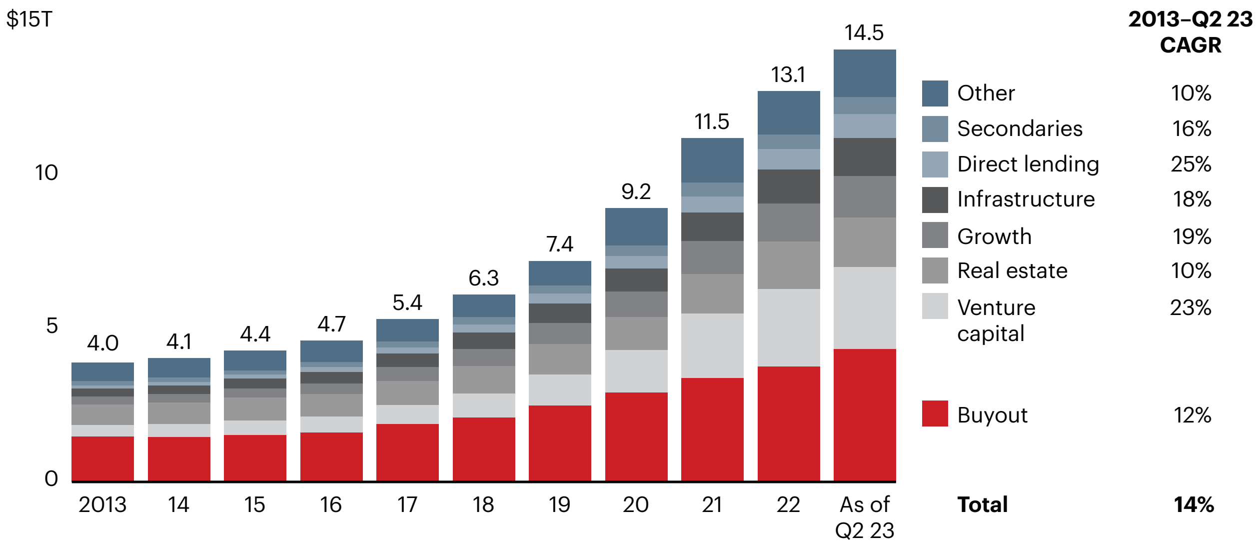
Average size of buyout funds closed globally ($M)



Notes: Includes closed-end and commingled funds only; count of buyout funds closed includes all buyout funds closed, including those for which the value of final funds raised is not available; average size of closed buyout funds is total funds raised across all buyout funds for which the value of final funds raised is available, divided by the total number of buyout funds for which only the value of funds raised is known; buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; excludes SoftBank Vision Fund
Sources: Preqin; Bain analysis

Figure 21: After a year like 2023, it's easy to forget that private capital has grown in stunning fashion over the past decade

Global AUM, by asset type



Notes: Buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; secondaries includes real estate secondaries, infrastructure secondaries, direct secondaries (PE), and secondaries (PE) fund types; other category includes fund-of-funds, mezzanine, natural resources, hybrid, private investment in public equity, and real assets; excludes distressed private equity
Source: Preqin

only $1 closed for every $2.40 targeted, marking the worst supply/demand imbalance in more than a decade *(see Figure 22)*.

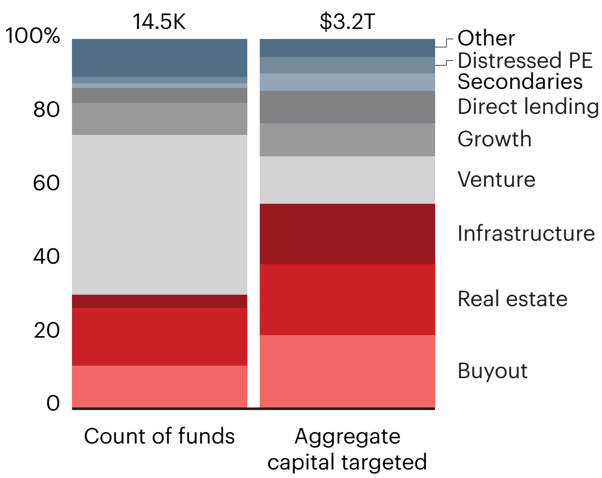
Surveys suggest that LPs remain committed to private equity, both short term and long term *(see Figure 23)*. But as a practical matter, increasing allocations will come down to cash flows. LPs have been cash flow negative for four out of the last five years, as unexited assets began to pile up and DPI lagged *(see Figure 24)*.

It's also true that the pace of drawdowns from recent fund vintages has been rapid by historical standards, largely because of the post–Covid-19 boom in dealmaking. On a normalized basis (accounting for the difference in industry size), drawdowns from 2020–21 buyout fund vintages are tracking the 2006 vintage, which had the steepest pace of outflows in the industry's history and an abnormally slow payback period amid the post-GFC recession.

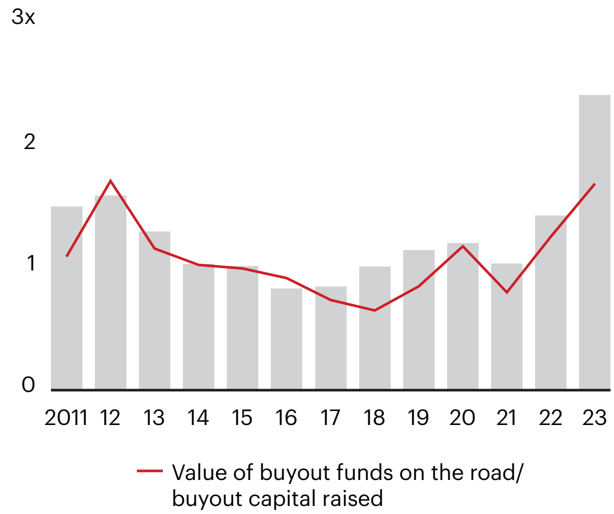
As we explore later in this report, there are reasons to believe the 2020–21 vintages will eventually break with this pattern. But the concern among LPs is that, because this capital was invested at peak price multiples right before rates took off, it may be trapped for longer than is typical. Getting exit markets unstuck will likely take two things: meaningful easing by the Fed in the year ahead and efforts to justify those high multiples through the hard work of creating new value at portfolio companies.

Figure 22: But competition for new capital has never been so intense, creating the worst supply/demand mismatch in more than a decade

Share of global private capital funds on the road, by type of fund



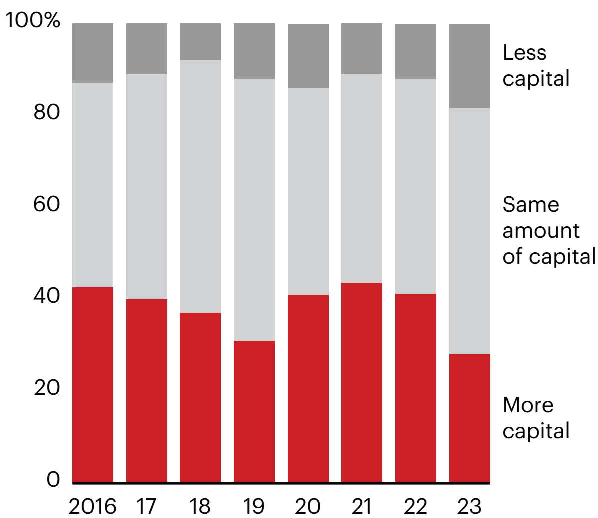
Value of private capital funds on the road during the year, divided by value of funds closed that year



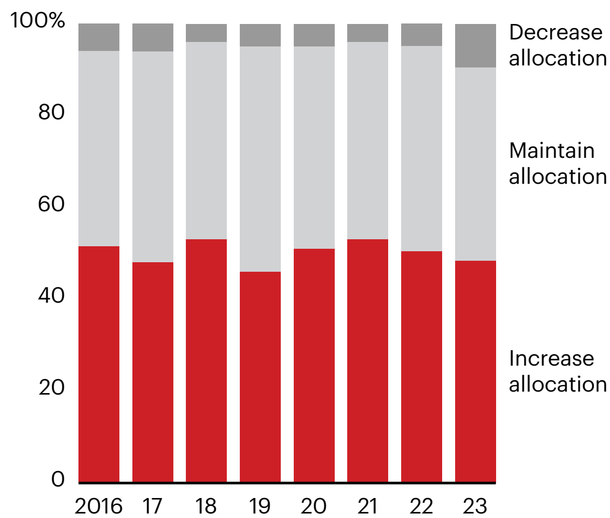
Notes: Buyout category includes buyout, balanced, coinvestment, and coinvestment multimanager funds; includes closed-end and commingled funds only; other category includes fund-of-funds and mezzanine; excludes natural resources
Sources: Preqin; Bain analysis

Figure 23: Despite the challenging market environment, limited partners remain largely bullish on private equity

Q: In the next 12 months, do you expect to invest more, less, or the same amount of capital in private equity than the last 12 months?



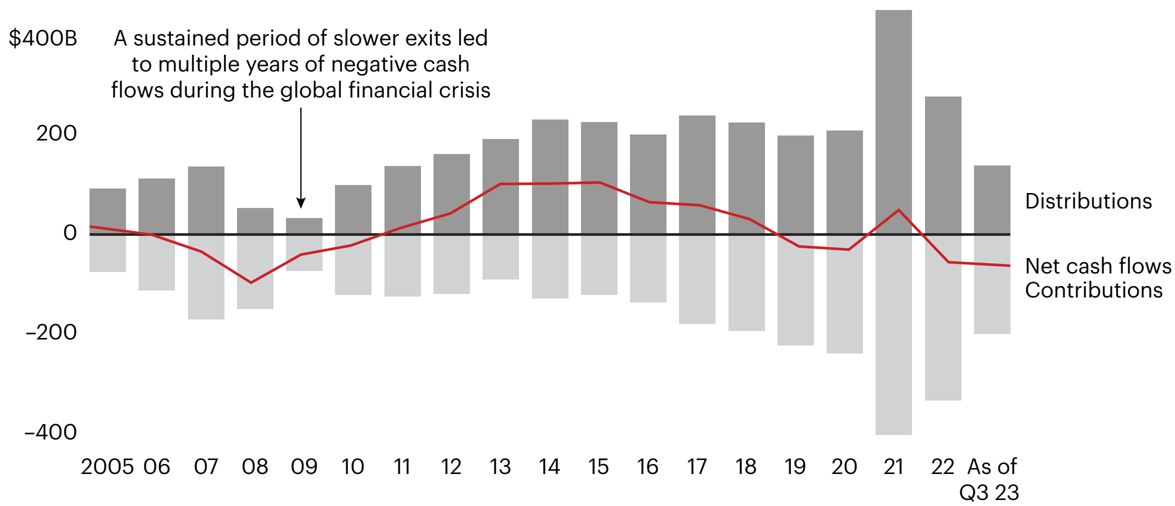
Q: In the longer term, do you expect to increase, decrease, or maintain your allocations to private equity?



Source: Preqin investor survey (2016–23)

Figure 24: But with more capital going out than coming back in, negative cash flows for limited partners are crimping new allocations

Global buyout fund capital contributions and distributions



	2005	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20	21	22	As of Q3 23
Ratio of distributions to contributions	1.2	1.0	0.8	0.4	0.4	0.8	1.1	1.4	2.1	1.8	1.9	1.5	1.3	1.2	0.9	0.9	1.1	0.8	0.7

Note: 2023 represents aggregation of distributions, contributions, and net cash flow from Q1 to Q3 2023
Sources: MSCI; Bain analysis

Returns

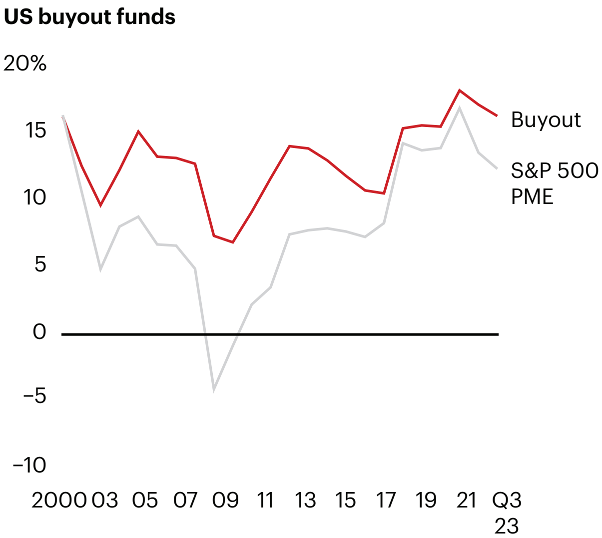
For LPs, of course, private equity's enduring appeal boils down to steady long-term returns and diversification. In 2023, the industry continued to shine on all counts.

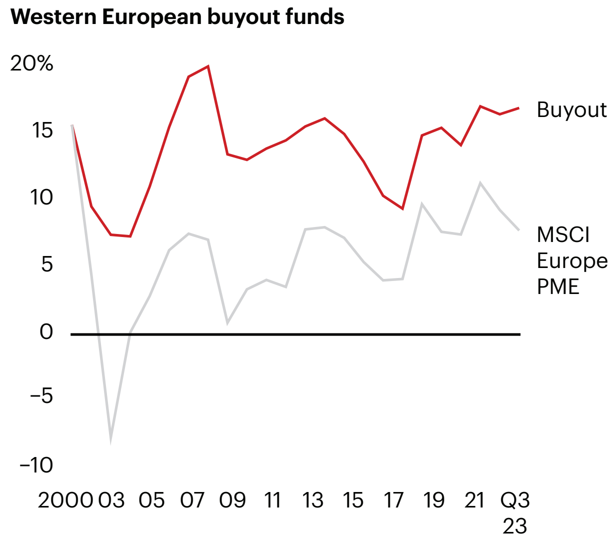
The 10-year horizon internal rate of return (IRR) for buyout funds in both the US and Western Europe has trended downward slightly since 2021. But the industry still beat public-market proxies over that period and handily outperforms the more volatile public sector for time periods greater than a year *(see Figures 25 and 26)*. And with the so-called Magnificent Seven technology stocks now accounting for 28% of the S&P 500 Index and driving its performance, private equity funds are also playing an increasingly vital role in helping LPs maintain diversification in their portfolios.

In a period of sustained high (or at least higher) interest rates, however, maintaining performance will likely call on GPs to raise their game when it comes to value creation. Buyout funds on average have essentially ignored margin growth as a driver of value over the last decade and have been carried along by multiple expansion *(see Figure 27)*. Top-quartile deals, however, tend to have a different mix. While these industry stars have also leaned on multiple expansion for half the upward movement in the enterprise value of their portfolio companies, margin improvement plays a significantly larger role than it does for the average fund *(see Figure 28)*.

Figure 25: Buyout funds in the US and Western Europe have outperformed public markets despite slight declines in 2023

10-year horizon IRR vs. public markets

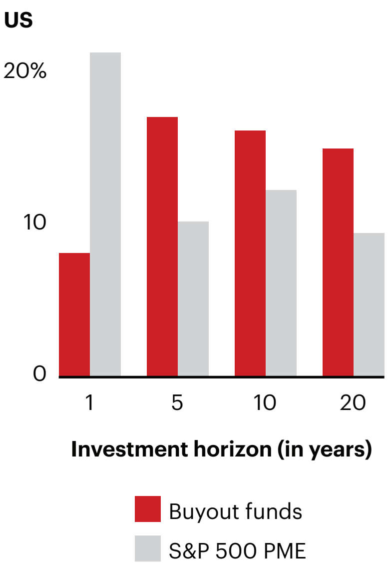


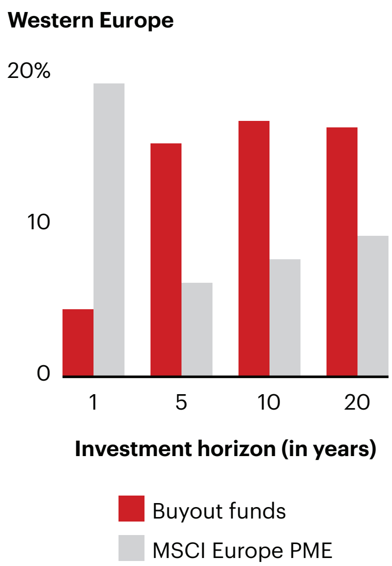


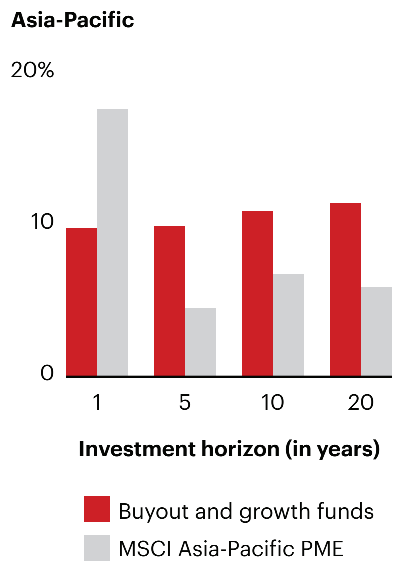
Notes: ICM internal rate of return calculated using public market equivalents via the Long-Nickels index comparison method, an IRR-based methodology that makes meaningful comparisons between private capital investments and indexes; assumes buying and selling the index according to the timing and size of the cash flows between the investor and the private investment; Western Europe as defined by MSCI, includes 32 countries
Source: MSCI

Figure 26: And this outperformance persists over time horizons longer than a year

End-to-end pooled net IRR (as of Q3 2023)



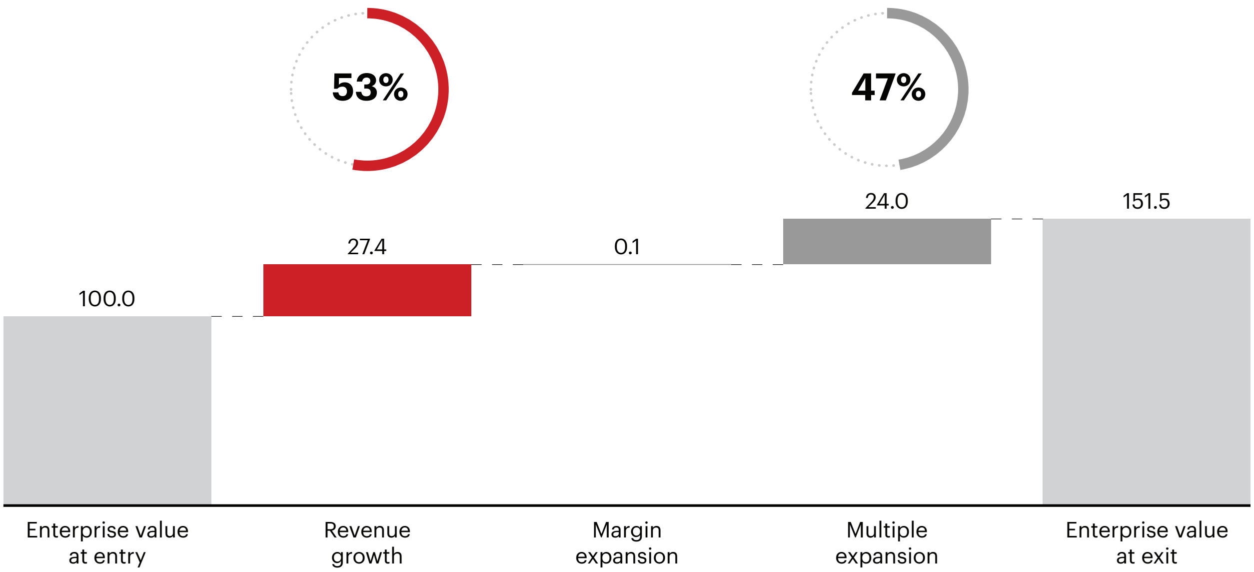




Notes: Data for US and Asia-Pacific calculated in US dollars; data for Europe calculated in euros; ICM internal rate of return calculated using public market equivalents via the Long-Nickels index comparison method; Western Europe as defined by MSCI, includes 32 countries
Source: MSCI

Figure 27: Sustained higher interest rates may take away the steady multiple expansion that has fueled buyout returns for the past decade

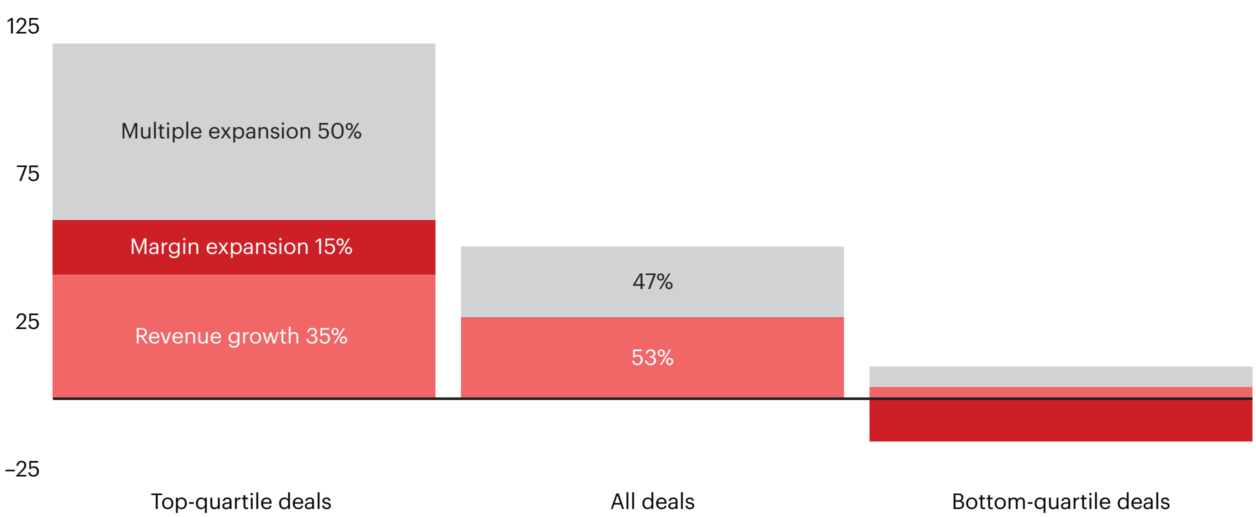
Median indexed value-creation drivers for global buyouts (deal entry years 2013–23)



Notes: Indexed to enterprise value at entry; includes fully and partially realized global buyout deals by year of entry; includes deals with invested equity capital of $50 million or more; excludes real estate; all figures calculated in US dollars
Sources: DealEdge powered by CEPRES data; Bain analysis

Figure 28: Margin expansion is part of what gives top-quartile deals their edge

Median indexed value-creation drivers for global buyouts, by quartile performance (deal entry years 2013–23)



Notes: Top- and bottom-quartile deals by internal rate of return; top and bottom quartiles include only deals with IRR data available; includes fully and partially realized global buyout deals by year of entry; includes deals with invested equity capital of $50 million or more; excludes real estate; all figures calculated in US dollars
Sources: DealEdge powered by CEPRES data; Bain analysis

This suggests that, to drive the steady performance LPs increasingly demand, GPs will need value-creation strategies that increase operating leverage by boosting revenue *and* margins, not just revenue alone. This will be especially critical as higher interest rates put the brakes on the multiple expansion that the industry took for granted in the era of 0% rates. Figuring out how to generate performance without those macro tailwinds is what will separate winners and losers in 2024 and beyond.

Move-In Ready: Renovating Your Growth Strategy

To sell in this challenging market, show buyers why the best is yet to come.

By Brian Kmet, Lars Dingemann, and Allison Gans

At a Glance

- With global exits at a 10-year low, it's safe to say it has rarely been harder to sell a portfolio company.
- That's challenging sellers to think harder and earlier about how to demonstrate the value they've added during hold and what's left on the table for a new owner.
- For many, the time is now to refresh the value-creation plan (or develop a new one) and start showing early results to build credibility.

It seemed promising enough when the sale process started.

A successful midsize fund had put a profitable portfolio company up for auction, and a group of 10 to 12 bidders had quickly RSVP'd to the management presentation. For a moment at least, it looked like all systems go.

Then came the presentation itself. As the bankers worked through the exit story and management tried to answer one tough question after another, the potential bidders began to fidget and look at their phones. Within days they had all disappeared, except for two or three bottom fishers hoping to capitalize on a broken process by snatching the asset at a discount. While the firm was too disciplined to take the bait, the message was clear: The exit motions that had worked so reliably over the previous decade simply weren't going to cut it in a market turned upside down by stubbornly high interest rates.

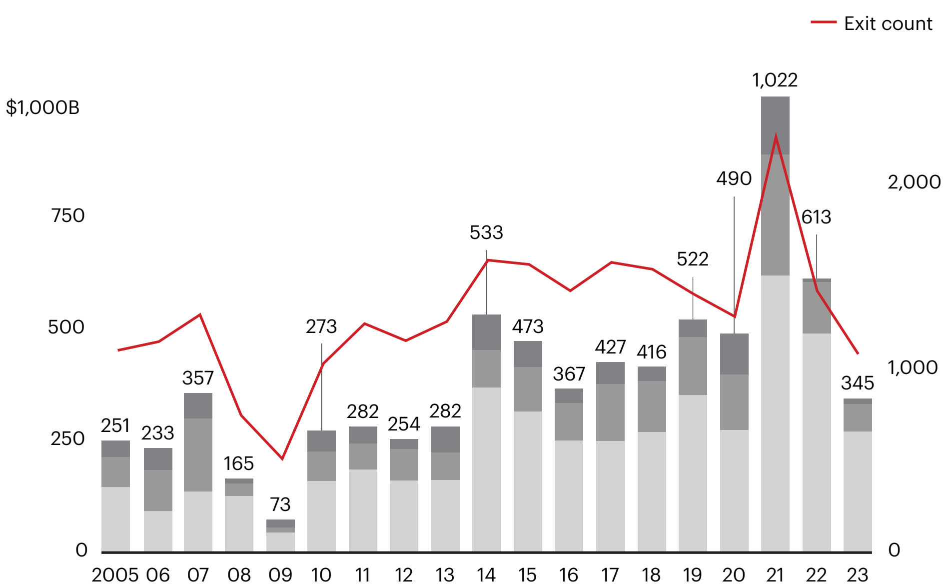
Amid the most challenging environment for closing deals in a generation, some version of this story will doubtless sound familiar to almost any private equity investor. With the cost of debt skyrocketing and multiple expectations still at record highs, exits are at their lowest level since the global financial crisis *(see Figure 1)*.

On the buy side, the problem is simple: In the years when multiple appreciation could reliably provide almost 60% of buyout returns, deal teams and their investment committees were willing to take considerably more risk on speculative upside cases. But that kind of thinking has gone the way of 0% interest rates. Today's higher financing costs and macro uncertainty mean the margin for error in underwriting a deal has contracted sharply. Buyers are reluctant to bid without convincing evidence that every dollar of projected earnings growth is plausible and achievable.

For sellers—most of whom have never seen a market as paralyzed as this one—the increased scrutiny can be a rude awakening. They're discovering the hard way that selling anything in today's market requires much more "show me the money" than most are used to. Over the past year, we've seen

Figure 1: Global exit value and count declined significantly in 2023, marking the worst year for selling a buyout-backed company in a decade

Global buyout-backed exit value, by channel



	2023 vs. 2022	2023 vs. 5-yr. avg.
IPO	72%	–80%
Sponsor to sponsor	–47%	–59%
Sponsor to strategic	–45%	–32%
Total	**–44%**	**–44%**

Notes: Includes partial and full exits; bankruptcies excluded; IPO value represents offer amount and not market value of company
Source: Dealogic

management presentations falling short in several ways that might not have mattered as much in a more forgiving dealmaking environment:

- The plan doesn't draw a clear link between actions and results to date.
- It asserts confidently that growth will accelerate or outrun the industry without convincing rationale for why or how.
- Those growth projections are overly reliant on potential adjacencies where the company has yet to demonstrate traction.
- The plan poses an M&A thesis that is heavy on "buy-and-build" and light on evidence that the strategy will accelerate organic growth or drive meaningful margin improvement.

Ideally, of course, a strong exit story is an extension of the original value-creation plan, meaning the company has, in fact, made a step change in performance and effectively positioned itself to capture a new, robust phase of growth. But more often than not—especially in a macro environment like this one—reality intrudes in any number of ways: Things simply don't work out as planned (can you say pandemic?). The core strategy stalls and/or an adjacency has yet to bear fruit. Maybe the original three-year plan has played out perfectly and the company needs a new strategy to power the next phase of growth.

In these cases, deal and management teams have work to do to refresh their value-creation plans and recalibrate how they are approaching the market. The teams that are closing transactions these days build credibility among buyers in three important ways:

- They provide evidence of **action-driven success** during the holding period by linking positive results to specific management initiatives.
- They demonstrate that there's still **money on the table** by laying out a clear path to future value creation.
- Finally, they present clear **reasons to believe** by highlighting how the company has put points on the board with a new plan to accelerate revenue or improve profitability in the years to come.

These are attributes that strengthen an exit story in any kind of market. The difference today is that they are compulsory, not "nice to have."

Action-driven success

One of the more difficult hurdles to get over in the current market is the suspicion that even strong company performance owes more to economic and monetary tailwinds than true operational excellence. Getting past that perception requires a clear demonstration of how a company's performance has improved and why that is a direct result of the steps management has taken to make it a more efficient competitor.

A good example is Prelios, an Italian alternative asset manager that Davidson Kempner (DK) acquired in 2017. In the four-plus years that DK held the company, earnings before interest, taxes, depreciation, and amortization (EBITDA) had grown by a multiple of 9. Yet in early 2023, a buyer could have easily concluded that the party was over.

One of the more difficult hurdles to get over in the current market is the suspicion that even strong company performance owes more to economic and monetary tailwinds than true operational excellence.

Although it started life in the 1990s as a real estate investor, Prelios had successfully evolved into a credit servicing specialist working for both debt investors and banks to help them claw back returns from portfolios of nonperforming loans (NPLs). Two major tailwinds had supported its growth in the wake of the European debt crisis. First, the European Central Bank pressured Italian lenders to sharply reduce their portfolios of NPLs, leading banks to outsource servicing of a large volume of these bad credits. Second, the Italian government helped that effort along by backstopping billions of euros worth of securitizations.

But by the time DK wanted to exit the business in 2022, Italy's volume of nonperforming debt had slowed. Banks had gotten their balance sheets under control, and investor portfolios had started to level off, raising the question of where Prelios's next phase of growth would come from.

DK's answer was to show how the company had changed for the better during ownership and to highlight its established ability to enter new businesses. DK drew a direct link between earnings growth and the work management had done during the firm's holding period to make Prelios investment professionals more productive. The company had instituted a detailed playbook that included target setting at a granular level, "performance dialogues" that institutionalized workout routines, hot lists of positions to be addressed, slippage monitoring, and coaching on how to fill performance gaps. Leadership also instituted a pay-for-performance plan to incentivize teams and individuals. The outcome was a much cleaner, results-driven organization.

At the same time, Prelios had developed a new plan to leverage its expertise in credit analysis and debt collection in order to move into new businesses. The company had already transitioned from real estate to credit servicing in the early 2000s, and when the NPL business peaked, it had rapidly built an Engine 2 business in servicing unlikely-to-pay loans (UTPs). UTPs are a notch up the troubled-debt ladder from NPLs in that the bank still has a relationship with the borrower. While the credit analysis challenge is similar, the workout process involves a much higher degree of nuanced negotiation, which requires a different kind of talent. To build this new capability, Prelios hired professionals from different industries and backgrounds, trained them in the same operational improvements it had made in the NPL business, and quickly became Italy's premier UTP specialist. The evolution allowed Prelios to more than double its assets under management.

These initiatives not only led to a steep ramp-up in profitability, but they also preserved revenue growth and created a significantly more efficient culture of performance. When DK agreed to sell Prelios in 2023 for €1.35 billion (giving the firm a fivefold return on investment, according to public sources), the bet was that the company could continue to apply its workout expertise and its business-building skills in mining new asset classes, both in Italy and abroad.

Money on the table

It's clear that resolving the current disconnect between buyers and sellers can often come down to presenting new sources of value on a platter. Hinting at growth opportunities or regurgitating generic industry research won't be sufficient. The most effective plans lay out in detail how the next round of initiatives will accelerate revenue growth or capture new efficiencies. To the extent that's not clear, it will likely require going back to the drawing board in the presale period to either refresh the original value-creation plan or devise a new one.

It's clear that resolving the current disconnect between buyers and sellers can often come down to presenting new sources of value on a platter. Hinting at growth opportunities or regurgitating generic industry research won't be sufficient.

When The Sterling Group merged two companies to create Safe Fleet in 2013, the combined entity manufactured a portfolio of branded equipment used across different types of vehicles and fleets to enhance safety—products like mirrors, lighting, and grab handles—as well as more sophisticated equipment like video surveillance and telematics to track fleet movement. The strategy was to expand this platform with strategic M&A.

Over the course of Sterling's hold, the company made more than 10 acquisitions that materially expanded the business. But finding attractive M&A targets had gotten harder, and Sterling knew this would be an issue for potential buyers concerned about maintaining growth. So it encouraged management to start working on a new roadmap—one that not only defined new sources of revenue but also demonstrated why Safe Fleet had a right to win in those areas.

Safe Fleet had successfully established itself across a range of fleet types that included school buses, fire trucks, emergency vehicles, railroad cars, and commercial trucks. The most obvious source of new growth was to expand the roster of products it sold into each vertical. The strongest exit story would have three components: a list of promising new products for each fleet type, a realistic measure of the total accessible market globally, and a justification for why Safe Fleet could expect to thrive in those adjacencies.

An essential part of the "right to win" story was that the company had deep relationships with customers and supply chain partners that often made a big difference in closing what were invariably complex sales processes. In the school bus vertical, for instance, Safe Fleet had relationships with the original equipment manufacturers, dealers, and, critically, school districts, which often have convoluted sourcing procedures. This had enabled a strong record of upselling. Starting with simple hardware like stop signs and hatches, it had successfully moved into selling school districts on the need for fleet management and routing software. That deepened the relationships and enhanced stickiness.

Building a similar story for each of seven fleet types resulted in a new value-creation plan that the next buyer could use to hit the ground running. That helped Sterling sell the company to another fund in 2018 at a return that made Safe Fleet one of the best performers in Sterling's portfolio.

Reasons to believe

Both Safe Fleet and Prelios were able to provide buyers with objective, fact-based evidence that they know how to succeed in the businesses and activities that would drive growth into the future. But given how reluctant buyers are these days to underwrite value-creation initiatives on spec, the easiest way to build confidence is to produce some early wins.

Since Brad Fauvre and Conan Barker cofounded Velocity Vehicle Group in Southern California 25 years ago, the company has built a global chain of commercial truck dealerships through a proven model of buy, integrate, and improve. It has steadily added new outlets in attractive markets and uses strong process improvement capabilities to speed up service and product delivery, leading to increased regional market share. Its outlets provide the full range of new and used commercial vehicle sales, service, and parts distribution, as well as vehicle rental and leasing.

By the time Velocity partnered with The Cranemere Group in 2019, it had already expanded into Arizona and Nevada. Cranemere, a holding company with permanent capital, shared the founders' vision to accelerate growth through M&A, and Velocity continued to acquire US dealerships, adding operations in five Southeastern states.

The bolder move, though, was international expansion. Betting that its best-in-class operating model would translate around the world, Velocity acquired dealerships in Australia, Mexico, and Canada, rapidly applying the process improvement formula that had worked so well in the US. Since joining forces with Cranemere, Velocity has more than tripled revenues and meaningfully expanded margins, particularly in the newly acquired dealerships. Roughly half of that growth has come from its international expansion, and, in 2024, Velocity will be generating more revenue internationally than it was from its entire US operation just five years ago.

The international expansion opportunity promises to deliver additional growth for many years to come and is the kind of proven initiative that would demonstrate to a buyer how Velocity can build on its past success. While for many investors this would present a chance to sell and declare victory, Cranemere and the shareholders providing its permanent capital are focused on working in partnership with a world-class management team to reap powerful long-term compounding.

Addressing today's challenges

The shared moral of these stories is that, in a market as difficult as this one, action is required. Faced with a steadily building exit backlog, it's going to be important for funds to evaluate—asset by asset—where the current value-creation plan stands, how potential buyers are likely to view a company's future prospects, and what needs to be done to make each asset stand out in an increasingly crowded market.

Fund managers can start to set priorities by asking a few key questions about each portfolio company:

- Have competitive or market dynamics changed (or will they change), and are we aligned with management around what to do about it?
- Do we know how much gas current strategies have left in the tank, and have we developed a data-driven perspective on the value left to pursue?
- What new initiatives is management working on to spur the next phase of growth, and how much traction has there been so far?
- If those initiatives or traction are lacking, what needs to happen to develop a new plan that will show buyers why this company has potential?
- Is the team in place the right one for the next stage of growth, and are we confident that buyers will see it the same way? What functions or capabilities do we need to strengthen to increase credibility?

All of this helps zero in on one overarching concern: Do we really understand how potential buyers will perceive this company's performance to date, and have we drawn clear links between specific initiatives and their impact on EBITDA?

Every business is different, and determining what's working—or what needs to work—is a process. But the time to start developing a bulletproof exit story is now. Spinning a great yarn might have impressed suitors in the past. But objective evidence of both past performance and future potential is what will attract and hold a buyer's attention today.

Have Secondaries Reached a Tipping Point?

Private equity needs liquidity. Expanding the market for secondary funds may be the solution.

By Hugh MacArthur, Brenda Rainey, Or Skolnik, and Alexander De Mol

At a Glance

- Given the industry's liquidity crunch, it's no surprise that secondary funds grew faster than any other asset class in 2023.
- These funds provide an array of tools GPs and LPs can use to manage their own liquidity needs as well as those of their stakeholders.
- Secondaries remain puny relative to the rest of the industry, but there's every reason to believe they will find a way to scale.

One number—$3.2 trillion—goes a long way toward explaining why secondary funds raised 92% more capital in 2023 than they did in 2022 (albeit from a very small base).

That's the unrealized value represented by the 28,000 unsold companies weighing down buyout portfolios globally, more than 40% of which are four years old or older.

This backlog is massive by historical standards—four times by value what it was during the global financial crisis—and a flash point in the liquidity crunch plaguing private capital markets broadly.

With exit markets dormant across the alternatives industry, funds of all kinds are badly in need of ways to get cash back to investors and keep the private capital flywheel spinning.

Enter secondaries, a catchall term for funds that help general partners (GPs) and limited partners (LPs) sell or restructure private capital holdings to generate liquidity. While the asset class is small, it is growing rapidly. At the moment, secondary transactions provide only about $120 billion in liquidity annually for an industry with over $20 trillion in assets under management globally (this vs. US public equity markets, which turn over more than $200 billion in assets *daily*). But given the rapidly expanding need for liquidity solutions in private capital, the potential for continued growth is exponential. The challenge: devising the innovative structures needed to capture the opportunity at scale.

With exit markets dormant across the alternatives industry, funds of all kinds are badly in need of ways to get cash back to investors and keep the private capital flywheel spinning.

Secondary funds have been around since before the global financial crisis. They started as pools of capital formed to let LPs sell GP positions when they needed cash faster than GPs could provide it. In those early days, growth was limited by the stigma attached: Abandoning a GP was akin to acknowledging you'd somehow made a mistake.

But as the industry has exploded and the need for liquidity solutions has grown, rapid innovation has produced a wide variety of tools that both LPs and GPs can use to manage the increasingly complex needs of their stakeholders.

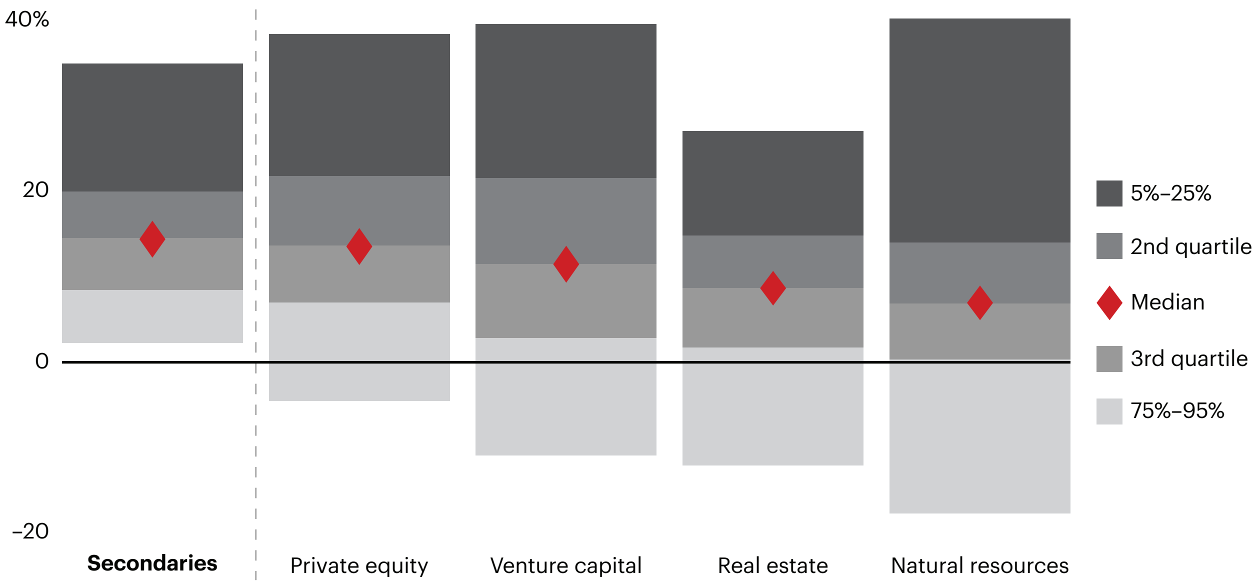
LPs have embraced secondaries to rebalance portfolio exposure across strategies, geographies, vintages, and funds. They can now securitize positions via structured portfolios traded on the bond market. GPs are using direct secondaries, continuation funds, and "strips" of portfolios to generate liquidity when exit markets sputter (as they're doing today). Tools are also available to raise cash for firm-level objectives like succession management or expansion.

Utility, however, isn't the only thing fueling the growth of secondaries. Because the fund and company positions at the heart of these products are initially sold at a discount to market value, they also deliver strong, consistent returns for investors with less volatility. Indeed, secondaries are the only alternative asset class in which even the fourth quartile of funds ekes out a positive return *(see Figure 1)*.

GP-led secondaries generally contain solid assets backed by high-quality managers and are expected to deliver strong performance. They also have a shorter payback period (or J curve) than typical private

Figure 1: Secondaries post strong returns relative to other private asset classes, with even the fourth quartile above water

Net IRR dispersion, by asset class (vintage years 2000–19, as of Q2 2023)



Notes: Private equity includes buyout and growth equity; natural resources includes private equity energy, upstream energy and royalties, and timber
Source: Cambridge Associates

capital investments because the assets are already approaching maturity. And buying exposure to private capital through secondaries offers a quicker path to a diversified portfolio for investors who are new to private markets.

While the liquidity crunch behind the secondaries growth spurt will eventually subside as exit markets slowly recover, there are plenty of reasons to believe demand for these products will continue.

One potential driver: a shift in the sponsor-to-sponsor channel, which currently accounts for nearly 30% of all buyout-backed exit activity. These deals are fine, but GPs increasingly question why they should sell their best assets to a peer, just to watch the buyer capture future returns. A secondary fund presents an alternative by stepping in with a continuation vehicle that allows a sponsor to sell off part of a company but maintain control and continue to realize the upside. This way, the GP can offer liquidity to LPs who want to get out at a price set by an independent third party, while the secondary sponsor finds a consortium of new LPs or GPs who want a chance to get into the company (or companies) at a new price.

Today's secondary funds typically lack the scale to underwrite sizable transactions on their own, so they tend to recruit other, similar funds to participate in big deals. But that's changing as buyout funds seek to close the funding gap. A recent example is Accel-KKR's investment in LEA Partners' continuation vehicle, which extended LEA's ownership of two portfolio companies, Zvoove and OneQrew. Variations on this theme of a buyout firm backing a peer's continuation vehicle have the potential to dramatically transform the sponsor-to-sponsor exit channel.

Another stimulus for secondaries demand is private capital's ambition to court wealthy individuals—specifically, sophisticated investors who are increasingly hungry for diversification and stronger returns than public markets can deliver. Right now, individuals account for only around $4 trillion in alternatives assets under management, but the industry is poised to expand that to $12 trillion over the next decade.

One major hurdle to this growth is liquidity, but secondary firms are already stepping up to address the problem. Lexington Partners, for instance, teamed with Moonfare, a digital platform that offers individual investors access to private markets. Lexington participates in Moonfare's secondary market, enabling its clients to periodically cash out of their private capital investments.

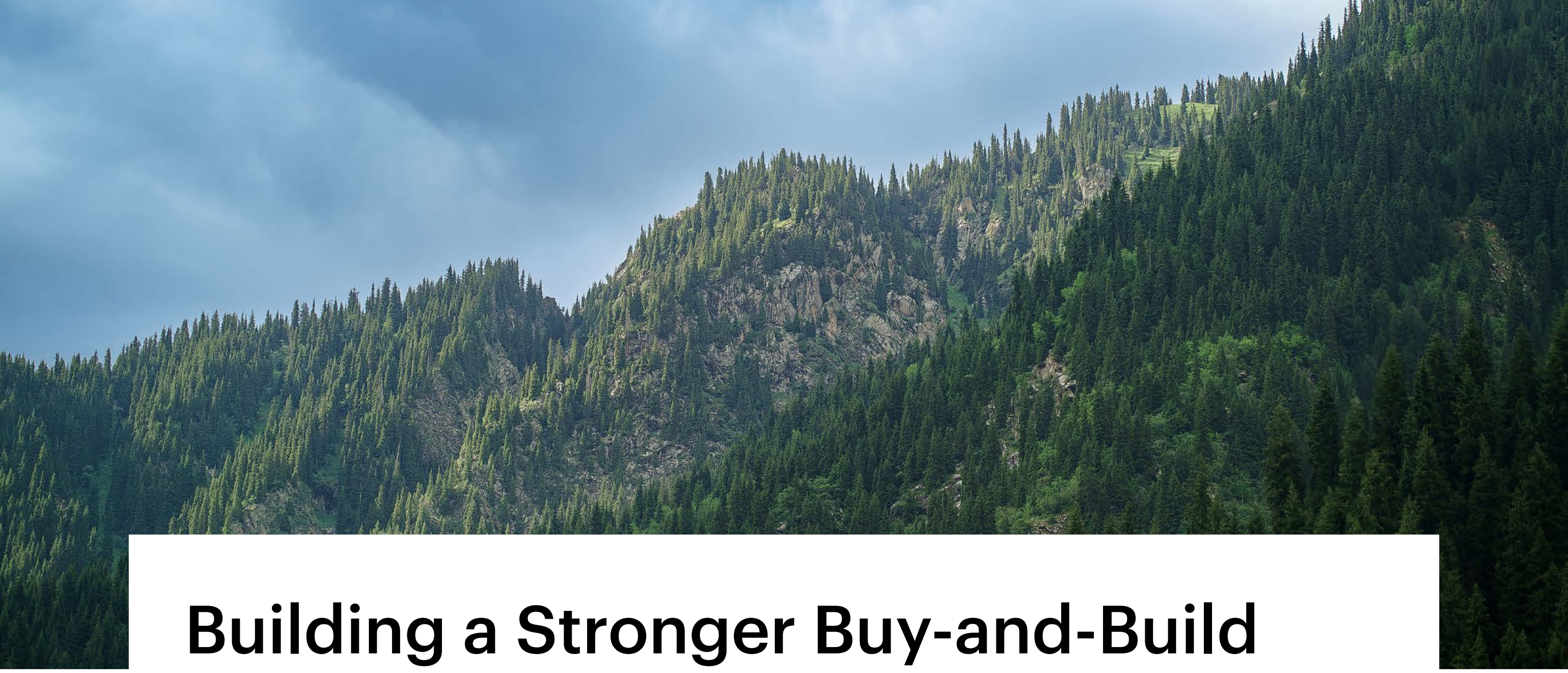
The critical thing in any of these scenarios is the presence of an honest broker. All sides of a transaction need to know that a trusted third party is determining value and structuring deals fairly. As happens too often today, a GP will set up a continuation fund to restructure a portfolio company, recapitalize the balance sheet with a swath of new equity, and essentially cram down the existing LPs, giving them the choice of getting out at a big discount or staying in on the bet that a hoped-for return will eventually materialize. Such stories have often left a bad taste in the marketplace, something new structures will have to solve for with independent valuations based on rigorous due diligence.

It will also be critical to rapidly increase the amount of capital flowing into secondaries and build out the infrastructure underpinning scale. In a world where most other strategies draw concerns for having too much dry powder, the secondaries space is undercapitalized. Currently, the asset class has about $200 billion of dry powder, or enough to fund only about 20 months' worth of transaction volume.

Given private capital's propensity to fill a vacuum profitably, however, this state of affairs is unlikely to last long. For large investors like sovereign wealth funds, the returns and flexibility offered by secondaries will become more and more attractive. The same could be said for the giant investment houses managing trillions in wealth for individuals eager to access alternatives.

Already, we are seeing major private fund managers positioning themselves to grow in the space. Deals like CVC's acquisition of secondary player Glendower Capital, TPG's acquisition of NewQuest, and Oaktree's investment in 17Capital are reshaping the marketplace.

The landscape tomorrow will look very different from the one we see today. But it's a safe bet that smart people will find a way to match the market's massive need for liquidity solutions with the equally massive pool of capital available to fund them at scale.



Building a Stronger Buy-and-Build

Winning now demands an intense focus on organic growth and margin improvement.

By Cédric Bovy, Colleen von Eckartsberg, Emily Miller, and Thomas Hood

At a Glance

- Buy-and-build continues to be one of private equity's most popular strategies.
- But a sustained period of higher interest rates is making it a lot harder to drive returns, especially for platforms that were relying heavily on multiple arbitrage.
- Generating a strong exit in this environment will require doubling down on a strategy to produce organic growth and better margins—or finding one fast.

There's a good reason buy-and-build has been a core private equity strategy for as long as the industry has been around: When it works, it works beautifully.

The trouble in today's market is that making it work can be a major challenge.

We define buy-and-build as an explicit strategy to increase value by using a well-positioned platform company to make at least four repeated add-on acquisitions of smaller companies. The idea is to ensure that 1+1=3 by capturing the benefits of scale and scope.

Historically, the market has encouraged these combinations by assigning higher valuations to larger companies than it does to smaller ones. This opens the door to multiple arbitrage—the practice of creating a large, high-multiple company by tucking in add-on acquisitions at lower multiples. That brings down the average cost of acquisition, sweetening the return at exit.

The recent spike in interest rates, however, disrupts this virtuous scenario in several ways.

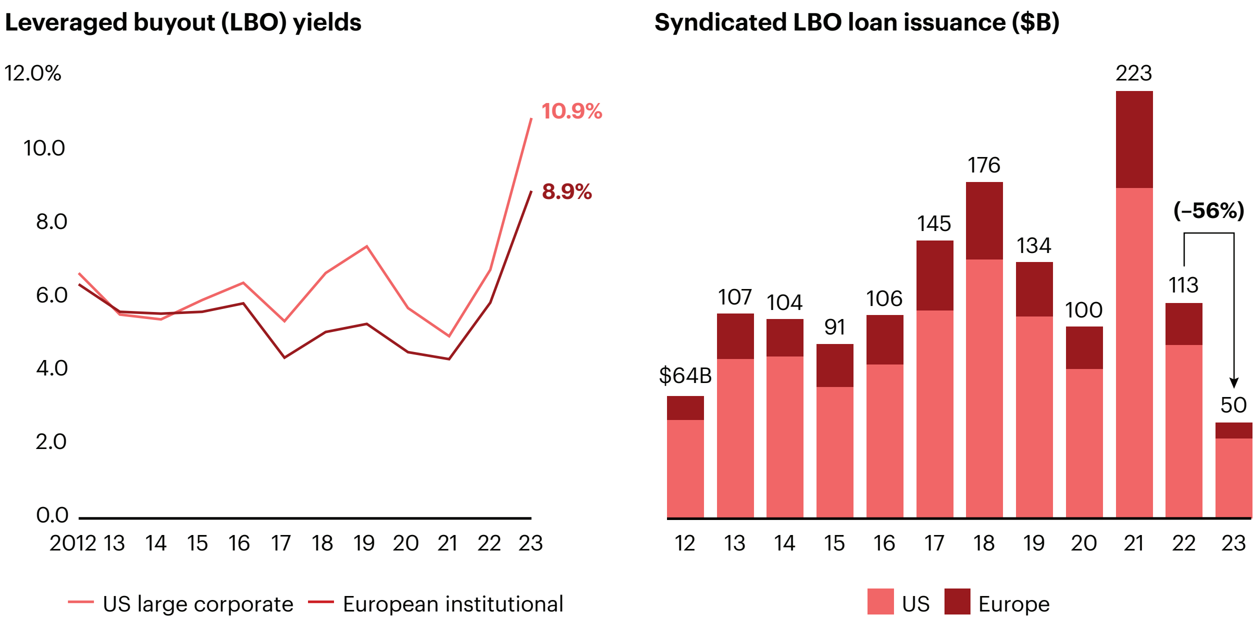
Consider a typical platform company acquired several years ago at 12 times earnings and financed with 7 turns of variable-rate debt. The cost of financing today is approximately double what investors were modeling in 2020, meaning it has gotten significantly harder for this company to service its existing debt, let alone fund an opportunistic acquisition strategy to meet growth projections *(see Figure 1)*.

At the same time, multiple arbitrage for this platform is harder to capture. Because higher interest rates are putting downward pressure on asset prices—particularly leveraged assets—a platform acquired and added to in a low-rate environment is probably worth less today than it was a year or two ago. That might upset the anticipated multiple-arbitrage opportunity relative to assets acquired today.

Adjusting to the new reality

For buy-and-build strategies launching today and adjusted for current economics, the math might still work. But many platform deals were started in a low-rate environment and aren't yet completed. For them, generating an acceptable return has gotten a lot harder.

Figure 1: Interest rates on leveraged loans have shot through the roof, and issuance has fallen dramatically



Notes: European institutional spread includes all tracked LBO deals, regardless of size; US large corporate defined as LBOs with more than $50 million in EBITDA; Europe syndicated loan volume converted using euro/US dollar conversion rate of 1.076
Sources: LCD; LSEG

The data suggests that these uncompleted deals comprise a substantial portion of the market. When we last wrote about buy-and-build in 2019, we noted that more than 30% of add-on deals represented at least the fourth acquisition by a single platform company, up from 21% in 2003. Today, that number is close to 50% *(see Figure 2)*. At the same time, the total value of add-ons has declined over the last two years. The implication is that more sponsors are hustling to try to complete buy-and-build strategies than are trying to launch new ones.

Making these deals work at exit is going to require doubling down on organic value creation.

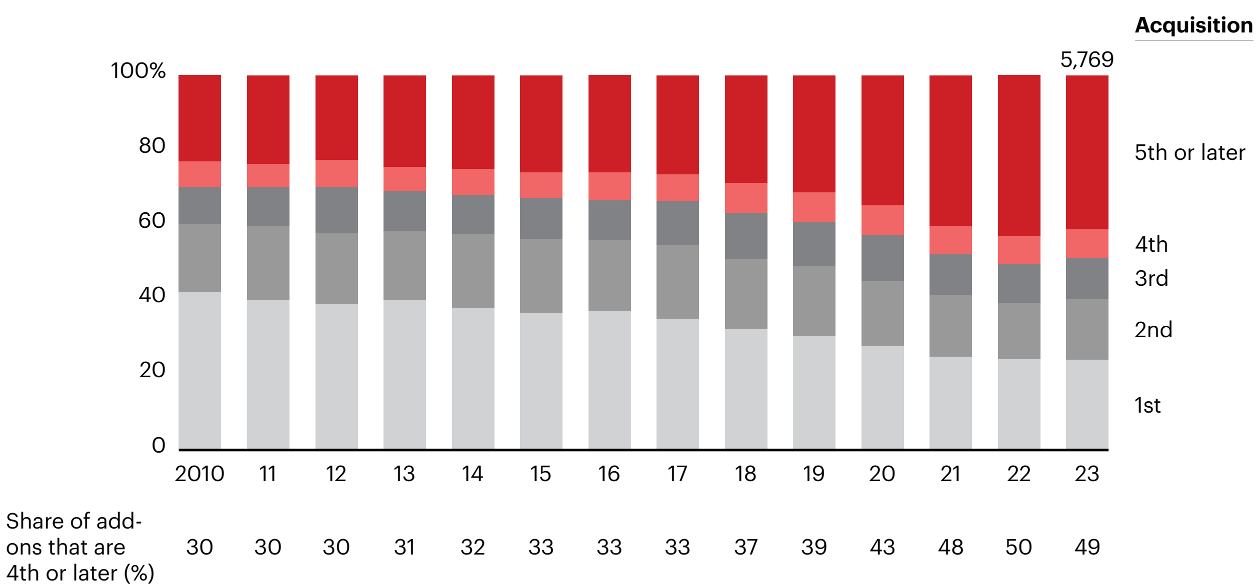
For many, that will mean recharging the deal's underlying strategic foundation. For others, it will mean finding a new one soon. In the absence of a multiple-arbitrage boost, those that had flimsy strategic rationale from the start are in a particularly difficult place. Looking at a set of 44 buy-and-build deals made between 2010 and 2019, those that depended on multiple arbitrage alone to generate returns had an average multiple on invested capital (MOIC) of 1.4x. Those with a strategic rationale driving accelerated organic growth or meaningful margin improvement had an MOIC of 2.2x.

The deals generating the highest returns start with an essential gating question: What value are you really capturing by making this *particular* set of acquisitions with this *particular* platform company?

It's certainly important that the platform company is in a sector with ample growth potential and sufficient white space for acquisitions. But that's really just table stakes. What's critical is a detailed

Figure 2: Add-on transactions that are part of a broader buy-and-build strategy have grown steadily and now make up around half the global total

Share of global add-on transaction volume, by sequence for platform company



Note: Represents the year in which add-on was acquired
Source: PitchBook

blueprint for how consolidation will open up new customer segments, add lucrative new geographies or channels, expand the customer offering, or substantially improve operations. Even if those opportunities do exist, success ultimately relies on M&A expertise, thoughtful integration, and the capabilities to execute a clear and actionable value-creation plan. Strong returns in today's market will also require an especially compelling exit story, including clear evidence that what you've built will continue to outperform in the years ahead.

What does good look like? Let's examine three different flavors of success.

EIS: ensuring bigger is, in fact, better

The right strategic logic isn't always obvious from the outside in and has to be tailored to the business. When Audax Private Equity carved out a noncore distribution business from Genuine Parts Company in 2019, determining the best path forward required some nuance.

At the start, Audax split the business into three parts. It spun off one right away and kept the other two—Genuine Cable Group (GCG) and Engineered & Industrial Solutions (EIS)—as buy-and-build platforms.

Most rollups focus on capturing regional market share, but EIS was inherently more complex. As a value-added distributor of materials and components used in electrical and electronic applications, the company sold to large original equipment manufacturers (OEMs) of products like motors and transformers. The basis of economics in this business lay in expanding the company's share of a given end product's bill of materials—selling more materials, components, and value added-services into the same transformer, for instance.

EIS had expertise in these markets, but underinvestment over the years had led to a lack of focus and weak performance. Audax saw an opportunity to rekindle growth by sharpening the company's focus on its core OEM customers while expanding into related aftermarket channels and cracking promising new end markets such as electric vehicle batteries and alternative energy.

To get there, Audax recruited a new team of executives and challenged them to closely define where EIS should be playing and to create the right go-to-market organization to attack each type of customer differentially. The company supported this focus with a targeted M&A agenda that included acquiring a set of distributors to add scale to the core and expand access to OEM customers, as well as several scope acquisitions like Norberg and Power Grid Supply that opened access to key aftermarket segments.

Bringing all this together has been a process. EIS has transformed its commercial capabilities, adding digital tools, inside selling resources, and a new pricing platform. It has also zeroed in on integration, creating value by unifying enterprise resource planning and IT systems across the full business. There's still work to do, but earnings at EIS have grown threefold since Audax got involved, and the gross margin profile continues to improve. Most important is that EIS has linked its M&A strategy to a clear commercial roadmap that will drive future growth strategically.

Culture change at scale

It's axiomatic that scale can reliably drive superior economics for a platform company. But lasting value often comes from marrying scale with a broader strategy of performance improvement. Consider the case of Caliber Collision, which started its journey under private equity ownership in 2008, when Canada's ONCAP acquired it. Since then, the company has grown steadily through a succession of private equity sponsors and is now owned by Hellman & Friedman, which bought it in 2019 and merged it with another portfolio company called ABRA Auto Body & Glass. Today, it has more than 1,700 centers in the US and has expanded into auto glass and maintenance.

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It would be a mistake, however, to view Caliber as a simple growth play. While the original chain was good enough at fixing cars from a quality perspective, it put little emphasis on customer service. That was a liability—not only for customers deciding on where to take their cars but also for their insurance companies, which Caliber relied on for a large share of its business.

Realizing that substantial value lay in creating a better customer experience, new management launched what amounted to a cultural transformation. Adopting the tagline "Restoring the rhythm of your life," Caliber installed systems and processes to firm up estimates, shorten turnaround time, and improve customer communication. Managers and technicians were not only trained in technical skills but also coached in how to communicate timelines to customers, while explaining everything and showing them empathy at an especially difficult time.

This mission-driven model still sits at the center of Caliber's growth strategy. For each new Caliber shop, the company deploys a "tiger team" to train up the staff while replacing IT systems and implementing new dashboards to monitor operational key performance indicators (KPIs) like capacity utilization. This repeatable model leads to big jumps in efficiency, high marks for Net Promoter Score^{SM}, and low employee turnover—all competitive advantages in an industry never known for warming up to customers.

Size does matter, though. Having a national footprint and strong operations allows Caliber to be a provider of choice for insurance companies, which like to push volume through large, integrated operations that consistently provide high-quality, efficient service. The larger platform also let Caliber expand into branded auto glass and maintenance centers, adding new revenue streams. Increased scale, in other words, has been a critical strategic goal. But without continuous improvement at the shop level, it wouldn't mean much for long-term performance.

Partner in Pet Food: M&A as a transformation tool

Using M&A strategically to broaden scope can set the right platform company on a new trajectory in terms of where growth is coming from and how profitable it is.

Partner in Pet Food (PPF), for instance, was plugging along just fine when Cinven acquired it in 2018. The company was Europe's leading private-label pet food operation and had a steady—albeit lower-margin—business. Cinven saw an opportunity to take it up a notch by adding new products, channels, and purchase occasions (snacks, for example). That would create a more vibrant competitor with superior economics.

The firm's targeted Partner in Pet Food M&A strategy laid out four key objectives: improve efficiency by adding manufacturing expertise in the core business, boost margins by expanding into branded products, open new growth channels (e-commerce, specialty retail), and increase scale by expanding geographically.

The first step was to build a dedicated M&A capability to find and evaluate targets. The team launched a continuous market-screen process to identify companies that would address one of the four strategic focus areas. The highest-potential targets were then evaluated based on a defined set of KPI benchmarks, potential synergies, and the ability to generate a strong return on investment.

A good example was Doggy, a Swedish company PPF acquired in 2020. As Sweden's largest manufacturer of branded cat and dog food, the company gave PPF quick access to the Nordic region with a lineup of high-margin products sold in specialty stores. A complementary acquisition in Italy opened up that market and pushed PPF into dog and cat snacks, another high-margin product category.

Five key acquisitions over three years have transformed a low-growth commodity pet-food manufacturer into a diversified, branded company with much stronger earnings potential. Revenue has tripled since Cinven bought it, and the company's new M&A capability has burnished its exit story by ensuring that PPF can pursue more acquisitions in the future.

What these three stories have in common are not the specific levers the deal teams pulled to create value. The right initiatives will always fit the platform company like a bespoke suit. The common denominator is a recognition that "bigger is better" alone isn't a strategy. Neither is multiple arbitrage. More than anything else, succeeding at buy-and-build is about harnessing benefits of scale and scope to drive sustainable, profitable growth. And that's never been more true than it is today.

Harnessing Generative AI in Private Equity

Investors are already using these technologies to transform companies, make better decisions, and boost returns.

By Richard Lichtenstein, Gene Rapoport, Richard Allinson, and Karen Khalaf

At a Glance

- Generative AI is asserting itself as a game-changing technology across the global economy.
- The private investors taking full advantage are already using it to transform portfolio companies, sharpen due diligence, and make investment professionals smarter.
- They are also finding that focus is key: Targeting investment toward a few strategic or operational objectives is essential to producing measurable improvements at the bottom line.

A year into the explosive advent of generative AI, it's become increasingly obvious that these technologies truly do promise game-changing disruption for many industries and business functions.

While there's been no shortage of wild-eyed exuberance since ChatGPT launched in late 2022 and showed the world what generative AI is capable of, there's been no shortage of substance, either.

Generative AI is a critical reasoning engine capable of having an open-ended conversation with a customer, producing rich marketing content, and scanning vast stores of data to provide deeper insights. The impact across industries and business functions is already plain *(see Figure 1)*.

Figure 1: Generative AI's dramatic ability to transform work is evident across a range of occupations and industries

Knowledge tasks

47%

of worker tasks in the US could be accelerated using generative AI–based software and tools

Contact centers

14%

productivity boost across call center agents using a generative AI–based assistant (measured in resolutions per hour)

34%

productivity boost for the lowest-skilled agents

Software

56%

faster coding achieved by developers using GitHub Copilot

Writing

37%

faster completion of tasks like press releases, short reports, and emails by professionals using ChatGPT

21%

higher quality score on occupation-specific writing tasks (assessed by experienced professionals in the same occupations)

Quality of output

79%

of healthcare professionals **preferred a chatbot to physician responses** to about 200 medical questions

Sources: OpenAI, OpenResearch, UPenn (March 2023); National Bureau of Economic Research (November 2023); Microsoft, GitHub, MIT (February 2023); MIT (March 2023); JAMA Internal Medicine (April 2023)

In private capital, we see firms mobilizing in three important ways:

- **Within the portfolio,** they are wasting no time gaining insight into the potential impacts and opportunities across companies and industries. Will these technologies disrupt a portfolio company's value chain or economic model? Is there a chance to lead the change by leveraging generative AI? With a short list of companies in hand, firms are producing results by linking initiatives to strategy and executing through rapid test-and-learn efforts. They're finding that focus and change management matter—a lot.

- **In due diligence,** leading teams are developing scorecard-based protocols to assess generative AI threats and opportunities in every diligence the firm takes on. The aim is to make it as routine as legal or commercial diligence. Firms are also using AI tools to speed up and sharpen the underwriting process. In many cases, generative AI presents the unique opportunity to build prototypes in diligence that can rapidly prove (or disprove) a disruption thesis.

- **At the firm level,** generative AI offers plenty of ways to streamline or automate back-office functions. But its real power is to dramatically expand the scope of information that the firm brings to bear on investment decisions. These tools can leverage a firm's scale by making institutional knowledge instantly available to everyone who needs it.

Drawing a bead on value in the portfolio

Like any technology, generative AI is best deployed as a tool in service of strategy. It doesn't create value by itself but by linking explicitly to pragmatic business objectives. How can we better serve our customer? Which metrics are we trying to inflect, which processes are we trying to improve, or which people are we trying to make more efficient?

Scattershot initiatives will not drop any money to the bottom line, but a series of use cases targeted at a specific role or process very well might. While starting now with a test-and-learn mindset is critical, it's as important to prioritize investment against the initiatives most likely to deliver the highest value.

Like any technology, generative AI is best deployed as a tool in service of strategy. It doesn't create value by itself but by linking explicitly to pragmatic business objectives.

For CVC, that meant applying a generative AI lens to more than 120 of its portfolio companies across geographies and investment strategies. Starting from an industry perspective and drilling down to the company level, the firm asked several key questions for each asset: Is the underlying customer need likely to change? Is the business model under threat? Will generative AI enable new competitors? And what barriers to entry or competitive moats exist to protect against disruption?

CVC sorted companies into three buckets: those that face revolution in the very short term, those whose business is likely to transform over the next few years, and those where meaningful disruption is unlikely. This analysis helped the firm prioritize which companies would benefit most from investment, and when.

One of them was Italian online educator Multiversity Group. Education is widely viewed as a sector with potential generative AI applications, and CVC saw that Multiversity was uniquely positioned to develop a strong AI-enabled business model. The company had robust market share, fully accredited content, and participation in a highly regulated university landscape. Even before generative AI came along, it was developing a set of initiatives to improve everything from how students enrolled in classes to how they interacted with professors.

The million-dollar question was how the company could accelerate those efforts using generative AI. The answer was setting up an "MVP accelerator" to identify generative AI applications, develop the business case, build a minimum viable product (MVP), and test and learn to refine a solution.

One example was using generative AI modules to answer routine questions from students about class content or administrative issues that take an inordinate amount of a professor's time. The initiative removed 80% of those questions from professors' plates, allowing them to redistribute that time to more value-added activities like course planning and one-on-one interactions with students. This benefit to instructors helped ensure their adoption of the technology.

The MVP accelerator put as many as 30 initiatives in motion and institutionalized the company's ability to innovate. It not only buttressed Multiversity against competitive incursion but will also burnish the company's exit story. Going through this exercise at Multiversity and other companies in its portfolio, meantime, has turned into a master class in generative AI for CVC. Scanning the portfolio is making the firm smarter and enabling it to be more responsive when it comes to deploying these technologies.

Bolstering due diligence

Many of the questions around threat and opportunity in a portfolio scan are also foundational to the most effective generative AI diligence scorecards. Additionally, it's important to assess organizational readiness. Has the company developed a vision for how it can deploy these technologies? Does it have a data strategy, and has it developed use cases? Is the right talent in place to execute, and does the company have a track record when it comes to innovation?

As generative AI gains speed, it will become increasingly critical for firms to institutionalize this kind of scrutiny. Deal teams should be doing a fast analysis of any target company, asking whether generative AI is likely to have an impact—positive or negative—in the years ahead. The quick answer may be no. But anything other than that is worth investigating further.

As generative AI gains speed, it will become increasingly critical for firms to institutionalize this kind of scrutiny. Deal teams should be doing a fast analysis of any target company, asking whether generative AI is likely to have an impact—positive or negative—in the years ahead.

For one firm targeting an IT services company, that meant determining whether generative AI could make key functions more efficient. Given the company's rapid growth, the objective wasn't to cut staff. But the potential new owner wanted to project whether future growth could be made more profitable using AI.

An analysis of various knowledge-work tasks across the company suggested that several departments could do more with less by automating certain activities and using AI to speed up others. That could generate margin improvement of 10% to 15% in the midterm as revenue expanded—enough to give the buyer an added layer of conviction that the target would be able to justify its multiple.

Due diligence teams can also use generative AI to get a more complete picture of a target company's prospects. Powerful tools are rapidly emerging to scan reams of data in a fraction of the time it would take a human to do the same job. One Bain & Company tool can ingest 10,000 customer reviews, print charts, and summarize findings within minutes. Another can summarize interviews with customers and market participants, converting unstructured text data into structured formats. These tools widen the aperture to more information, more quickly, so deal teams can focus on generating insights and testing their investment theses. Generative AI helps them pinpoint the market research and competitive analysis needed to underwrite specific opportunities.

Unlike many technologies, generative AI also lends itself to building live models in diligence that can help "prove disruption." This came into play recently when one large buyout firm was considering the acquisition of a company that had built a proprietary AI-based tool for a highly technical industry vertical.

The tool was designed to transcribe and summarize data to create efficiency in the customer's workflow. The company had trained it extensively on proprietary data, and the selling point was that it could process this complex technical information with a standard of accuracy critical to the company's customers.

Very quickly, however, the diligence team demonstrated that the tool faced a serious threat in the marketplace. In a matter of days, the team built a series of prototypes using OpenAI's GPT-4 API and other open-source models. They then tested these "competitors" against the target's solution and found that all of them performed significantly better in a number of ways. This allowed the fund to quickly make a call on the opportunity.

Sharpening fund insights

What's becoming increasingly clear to general and limited partners alike is that generative AI can have a transformative effect on all manner of fund operations. Many firms are looking at how AI tools can take out costs in the back office and otherwise make internal operations more efficient. But more and more are thinking strategically: How can we use generative AI to supercharge our investment professionals across the full value-creation cycle, from sourcing, screening, and diligence through to portfolio management and exit?

The goal here isn't to fill seats with less expensive robo investors but to make investment professionals smarter and faster at what they do. One large investor at the forefront of thinking through these issues is backing generative AI initiatives that cut across the investment cycle. The most advanced is a project to help investment professionals become more productive by speeding up (and improving) the bread-and-butter busywork that is critical to sourcing and evaluating deals. The firm also hopes to vastly expand their access to information and sharpen insights about both target companies and the macro conditions in which they operate.

Generative AI tools are ideal for scanning massive pools of data for insights using the firm's preferred screening criteria. In deal sourcing, this can be invaluable. Currently, this fund's professionals tend to look at 10 deals to find 1 worth investigating further. Armed with a set of seven key criteria linked to the fund's strategy, they spend a full day on most "looks," or half a day if they're lucky. Generative AI can not only help produce the initial list faster but can also bring down the screening time per company from a day to an hour. This makes team members significantly more productive and frees them up to focus on the more qualitative work involved in analyzing the potential gems that make it through the funnel.

What's becoming increasingly clear to general and limited partners alike is that generative AI can have a transformative effect on all manner of fund operations. Many firms are looking at how AI tools can take out costs in the back office and otherwise make internal operations more efficient.

Gaining conviction around those potential winners also benefits from generative AI. Chatbots can help investment professionals easily leverage the firm's scale by sorting through its prior internal work on the subsector or market. They can crawl through more data—both internal and external—than deal teams could ever do on their own. Consider that, for most midsize target companies, you can't find a published source of Net Promoter Score data or any other objective measure of customer loyalty. Scanning a selection of customer reviews might get you somewhere. But AI tools allow you to scrape every review ever posted to the Internet within minutes, organize the comments meaningfully, and then generate a clear, analytical report. You end up smarter than you would be otherwise in a fraction of the time.

Getting started

For funds asking themselves how to start using generative AI to improve investments and investing, now is the time to get educated on potential impacts and begin planning for them. Here's a practical priority list:

- Even if you do nothing else, scanning your portfolio is critical. Generative AI is moving fast enough that you need to understand today which companies might face major disruption and which may be able to ride that disruption to better performance.

- With a short list of companies in hand, link AI initiatives to clear strategic objectives that can boost performance, like customer satisfaction, revenue generation, or cost reduction. Centering on a specific product, process, or group of workers will have much more impact at the bottom line than a diffuse approach leading to small gains that are difficult to bank.

- Don't neglect change management. Clear governance and a detailed execution plan are essential to making change that sticks. People are nervous about AI. If you don't make it obvious how the technology will improve jobs (rather than eliminate them), frontline employees will refuse to embrace the technology or actively undermine it.

- Bring what you are learning to sourcing and due diligence, and start building fluency in the generative AI tools that can make you smarter. It's obviously critical to avoid walking into disruption, but you're missing an opportunity if you aren't thinking strategically about how generative AI can drive better returns in your area of focus.

- Begin thinking about how generative AI can transform your own shop by giving investment professionals a leg up on the competition. It's still early days, but now's the time to start adopting the AI-enabled tools and processes that can corral data and information in powerful new ways.

As with any disruption, generative AI is both unnerving and exhilarating. But it pays to get moving. Zeroing in on the handful of companies and initiatives that will create real impact is the best way to start turning these disruptive technologies to your advantage.

The Year Cash Became King Again in Private Equity

Future fund-raising will depend on the industry's creativity in returning cash to investors.

By Hugh MacArthur, Rebecca Burack, Alexander Schmitz, Brenda Rainey, and Mike McKay

At a Glance

- With exit channels in deep freeze, unsold assets are piling up in private equity portfolios, preventing distributions to investors and threatening future fund-raising.
- If rates ease in the coming year, exits should recover faster than they did in the wake of the global financial crisis.
- Even so, GPs need to prioritize getting capital back to LPs by developing comprehensive, pragmatic strategies to generate near-term exits.

The 2006 vintage of buyout funds will always be remembered with a certain measure of dread by private equity investors who lived through the global financial crisis (GFC).

Things turned out all right in the end, but getting there was a slow-motion slog through the mud.

Most fund vintages follow a predictable "J curve" that plots cash flows from inception to close. General partners (GPs) call the capital, it gets invested, and then it takes around seven years to generate distributions that exceed the original capital outlays.

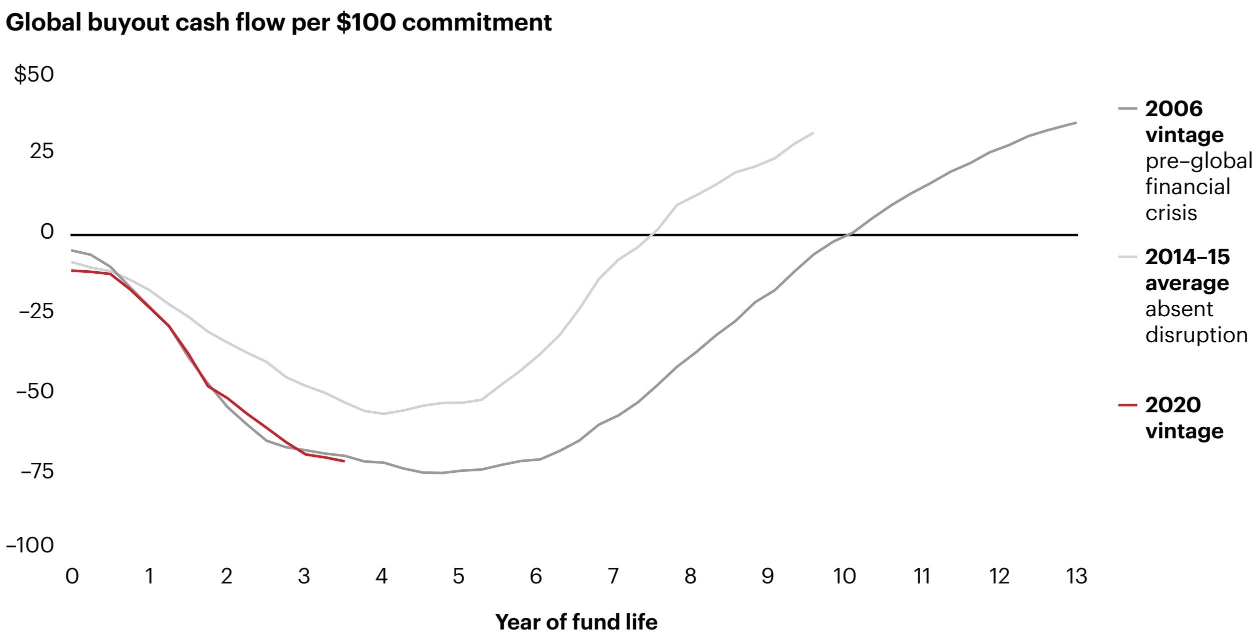
But 2006 was different *(see Figure 1)*. In the lead-up to the GFC, a record amount of capital got called and invested just before the financial markets collapsed. Amid the ensuing recession, exit markets seized up, deals transacted at peak valuations suddenly faced trouble, and all that investor capital froze in place. It took 10 years for the vintage to start generating positive cash flows, leaving 2006 as the poster child for what happens when unusually rapid investment is followed by sudden economic disruption.

Why dig up such a painful episode? Because drawdowns from recent fund vintages are tracking the 2006 vintage closely (adjusted for industry size). After an initial flurry of postpandemic investment activity (also at record-high multiples), exit markets abruptly shut down amid rising interest rates, stanching the flow of capital back to limited partners (LPs). Now the trajectory of recent fund vintages is raising fears that the massive bolus of capital laid out in recent years is trapped and won't come back to fund new allocations in a timely fashion.

What can fund managers do about it? A good starting point is to take a breath and recognize that conditions in the years following 2006 were very different from what we're facing today.

The 2006 vintage was loaded with massive public-to-private deals intended to exit back onto the public markets eventually. But the sharp recession torpedoed earnings for many of these companies, and holding periods stretched out as funds scrambled to justify those high multiples. Sponsors had to wait for opportune IPO windows to free up capital, and because fully exiting through an IPO can take years, cash flows were delayed even longer.

Figure 1: Drawdowns from recent fund vintages, such as 2020, are mirroring those from 2006, causing anxiety among cash-strapped limited partners



Note: Data through Q3 2023
Sources: MSCI; Bain analysis

Today's private equity portfolios are built differently. Absent is the public-to-private overweight, and exit strategies are overwhelmingly geared toward sales to corporate buyers or other sponsors. With corporate M&A slumping and sponsor-to-sponsor deals cooled by the rapid rise in interest rates, exits are suffering for now. But the economy has so far avoided recession, and as inflation moderates, the rate bias in early 2024 is down, not up. Absent additional shocks, easing rates could improve exit conditions rapidly. It will help that GPs have a record $1.2 trillion in buyout dry powder available for sponsor-to-sponsor deals and that the buoyant stock market is propping up corporate buying power.

The growing cash mandate

Sitting still and waiting, however, would be a mistake. With buyout funds sitting on 28,000 unsold companies worth a record $3.2 trillion, the current threat to investor cash flows is very real. Buyout fund-raising hit a near record in 2023, yet allocations were targeted narrowly at the largest funds with the best returns over time. For the average buyout fund, this is a period of fund-raising scarcity and hardship.

That means GPs need to focus on what they can control—which doesn't include interest rates. In 2024, taking charge of your own destiny will likely boil down to how creatively you can manage your portfolio to generate distributions, so LPs can reinvest in your next fund.

The latest data shows that over half of all the unsold assets (54%) have been held for three years or less. But companies held five years or longer grew 18% year over year in 2023, and companies held for four years or longer comprised 46% of the total, the highest level since 2012 *(see Figure 2)*.

Advancing age is not necessarily a bad thing. The problem is when valuations and prospects for future gains have stalled. According to MSCI, 36% of companies acquired six years ago or more are now just at breakeven or below *(see Figure 3)*. Another 34% are marked at a 1.0x to 2.5x multiple on invested capital (MOIC), adding up to a modest internal rate of return. The numbers are slightly better for companies held four years or longer (29% at or below 1x, and 41% better than 1x but below 2.5x). Overall, 70% of the companies four years old or older are doing just OK or worse. These are the deals LPs are particularly focused on.

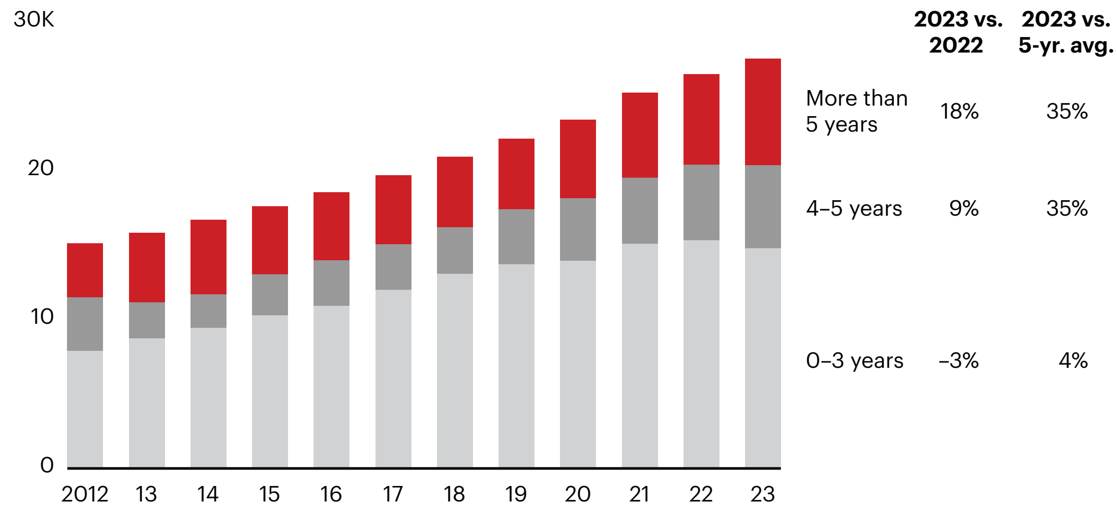
Exit strategy, writ large

The value trapped in these aging companies isn't enough to solve the distributions issue on its own. Indeed, generating more liquidity is a years-long process, not a quick fix. What's required of GPs right now is credibility building. For firms looking to raise capital in the next 24 months, LPs are almost certainly going to be asking for a well-defined blueprint for generating near-term distributable cash—a holistic, portfolio-wide strategy that uses every tool at the firm's disposal to boost distributed to paid-in capital (DPI).

What likely won't work is business as usual: managing directors making isolated exit-or-hold decisions based on some variation of "we'll sell when the time is right." GPs will also have to recognize that not

Figure 2: The proportion of long-held companies in buyout portfolios is growing and hasn't been this big since 2012

Global active buyout-backed companies, by time in portfolio

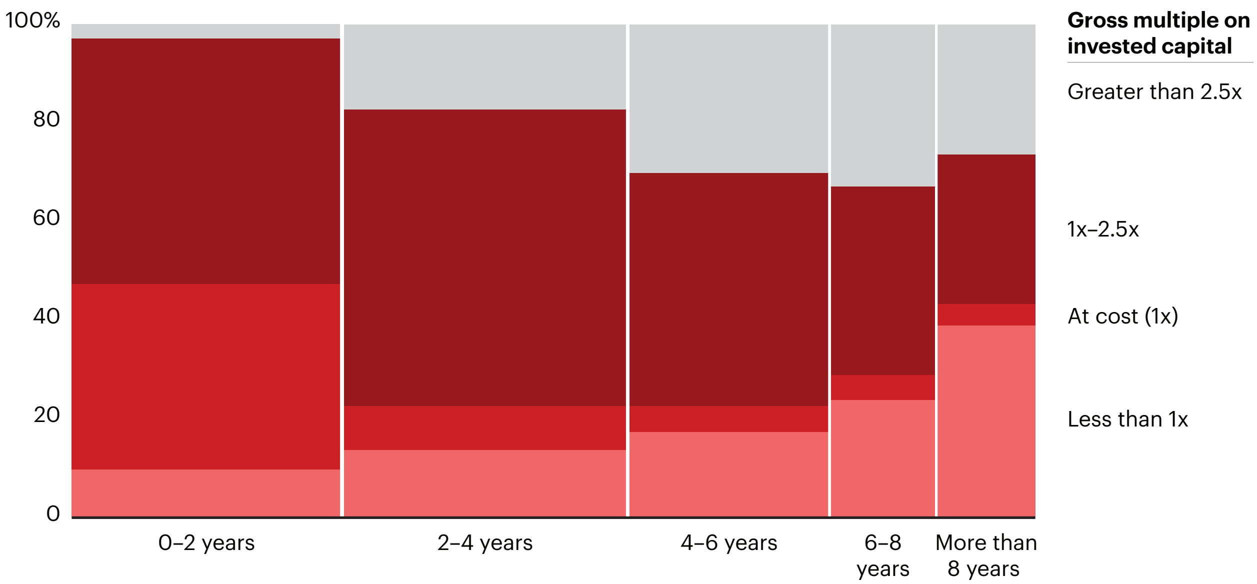


	2012	13	14	15	16	17	18	19	20	21	22	23
Share held for at least 4 years (%)	48	45	43	42	41	39	37	38	40	40	42	46

Note: Excludes add-ons
Source: PitchBook

Figure 3: Some 70% of buyout portfolio companies held four years or longer have yet to break through as clear winners

Share of buyout holdings, by age and performance



Notes: Includes North America and Western Europe; data as of Q3 2023
Source: MSCI

all distributions are the same. LPs are sensitive to tactics like funding distributions with NAV loans that generate cash now but obligations later. Continuation vehicles are evolving and gaining currency, but LPs are often wary of the terms, and, on an industry scale, these vehicles are cash flow neutral. Some LPs are getting checks; others are writing them.

All of this is to say that raising meaningful cash across a fund's portfolio will require a nuanced approach that balances the need to protect returns with the need to increase DPI. On the investment side, GPs typically have a firmwide investment committee to think strategically about putting money to work. Increasingly, firms will need to consider an analogous exit committee, charged with planning exits strategically based on a clear assessment of shifting LP cash requirements.

Developing a comprehensive strategy starts with the obvious: determining which assets the firm can sell now for an attractive return. What may need some adjustment, however, is how you define "attractive." While the deal team for a particular company will typically want to hold out for an extra half turn of MOIC, the GP's interests overall may be better served by generating cash now to burnish relationships with LPs.

Next come the companies that would benefit from a defined program to improve earnings before interest, taxes, depreciation, and amortization and shore up the exit story. A significant drop in interest coverage over the past year is just one indicator that there may be fewer companies than usual poised for a "strong enough" exit right now. For these companies, LPs will want to understand what specifically you plan to do to get them back in the game.

Some companies will need a formal "re-underwriting"—and there will be some hard questions here. Is this a business in which we still see long-term potential? What will it take to realize it? If the balance sheet is broken, renegotiate with the banks to buy time until conditions improve. If the company requires capital to reinvigorate a stalled acquisition program or organic growth plan, this is the time to inject it, pay down debt if required, and give the fresh capital a chance to earn its return.

If the strategy is still good but the return is going to take three or more years to pay off, the answer might be some flavor of continuation vehicle or secondary that allows current investors to cash out if they want, while giving the GP and more patient investors a chance to harvest better returns up the road.

Finally, there will be a group of companies with broken strategies—those muddling along at negative or subpar returns with no plausible plan for improvement. The question to ask with these: Are the time and resources needed to fix this company better spent supporting a different asset with more chance of generating a meaningful distribution?

What's critical here is demonstrating to LPs that your firm is a responsible steward of capital with a disciplined, unemotional plan for getting assets unstuck. Cash—or, more precisely, DPI at the best possible return—is clearly king right now in private capital. If generating more of it isn't at the top of your agenda, it may be time to make it your priority.

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