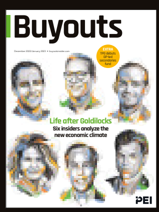
Buyouts

Six private equity insiders give a fireside chat about short-term gloom, long-term opportunities, ESG and what to look out for in 2023.
By Kirk Falconer, Iris Dorbian, Gregg Gethard and Chris Witkowsky



Cover story

Nate Taylor
Co-head of Americas private equity, KKR

Markets

Anjan Mukherjee
Managing partner, BayPine

After breaking records last year, the private equity market hit a wall in 2022.

Economic uncertainty, fueled by high inflation and rising rates, put a crimp in dealmaking and all but shut down exit avenues. Fundraising also slowed, as GPs roared back to market with new offerings only to encounter LPs with major cash constraints.

Will 2023 see more of the same? Or will a recession compound the challenges faced by GPs and LPs? Will deal and fundraising markets remain sluggish or bounce back? Will dislocation inhibit or inspire investors?

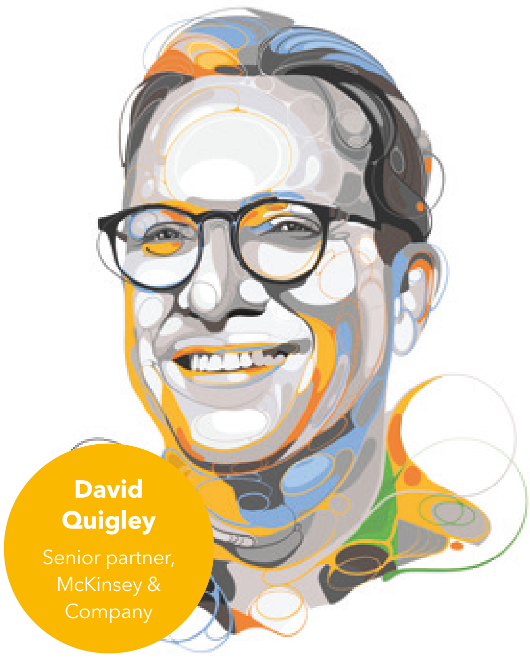
To help answer these questions, *Buyouts* in November spoke to six prominent members of the PE community: Nate Taylor, KKR; John Maldonado, Advent International; Scott Voss, HarbourVest; Anjan Mukherjee, BayPine; David Quigley, McKinsey & Company; and Jennifer Choi, ILPA.

Jennifer Choi
Acting CEO for the Institutional Limited Partners Association (ILPA)

Scott Voss
Managing director, HarbourVest

after Goldilocks

John Maldonado
Managing partner, Advent International



David Quigley
Senior partner, McKinsey & Company

2023

In its World Economic Outlook report, the IMF projects global growth to slow to 2.7% in 2023 (from a projected 3.2% in 2022)

Q Will PE dealmaking continue to slow in the year ahead?

Scott Voss: We learned long ago not to be market-timers. We try to be systematic on how we allocate to private markets across vintages and maintain a long-term perspective.

2022 has clearly been a year where we've corrected. It started with liquidity tied to public markets declining. Transaction activity fell off mid-year as investors sobered up to the new reality. And there was a bid-ask spread between buyers and sellers at that point.

We're faced with this moment now where Goldilocks meets the three bears. Goldilocks was this perfect environment that we rode into covid and then because of a lot of stimulus continued through covid. And now we're faced with interest rates, inflation and geopolitics, which I call the three bears.

The consensus seems to be, at least in the US, that rates are going to continue to rise through next year. Inflation continues to barrel ahead. And it's not clear that just slowing the economy through rate hikes is going to fix inflation because there's this supply side that's affected by geopolitics. So, everybody's talking recession, recession, recession.

Anjan Mukherjee: Private equity is a game of microeconomics, but every once in a while you have to take macroeconomic factors into account, and now is one of those times. We'll continue to be in a rising-rate environment into next year because inflation will remain stubbornly difficult to tame and, as a result, the Fed will continue to tighten.

Deal activity will continue to be muted. You typically see a pickup in activity after there's some evidence of broader recovery and economic green shoots. But we haven't even entered into the recession yet so deal activity will remain depressed for some time.

Nate Taylor: Crystal balls are dangerous to peer into, but our hope is that we'll see the market begin to find its bottom sometime over the next six to nine months. Then we'll start to see some of the pressure that the market's anticipating begin to manifest itself in earnings reports and actual outcomes that we're going to see in the economy.

If you believe that at a high level, it means that we should begin to see deal levels pick back up post that market-bottoming. We've got to have buyers and sellers feel comfortable with pricing levels. And it takes a bit of time for those values to season. But as we begin to find the floor in the market, it should manifest a better dynamic for buyers and sellers to find a way to transact.

We're going to need, at least in part, more health and robustness in debt capital markets. We know there's a lot of capital sitting on the sidelines and at some point they'll get back into the market and facilitate a more fulsome capital structure that right now is hard to come by.

John Maldonado: Things are going to get worse before they get better. I'm hopeful that they do get better at some point in 2023 but the direction of travel, at least at this moment in time, indicates there's more pain to come from rising rates.

It's not to say that there won't be opportunities that are born of that pain. When we reflect on the experience that we had coming out of the Global Financial Crisis, it was one of our most active periods. And if you think about the vintage that will be born of this uncertainty, if private equity can find deals in which they can put capital to work, my guess is this is a terrific vintage to be investing in, as was the case on the hills of the financial crisis.

David Quigley: It's important to take a bit of the three-year mindset on this. If you look across 2020, 2021 and 2022, *"Goldilocks was this perfect environment that we rode. And now we're faced with interest rates, inflation and geopolitics, which I call the three bears"*

SCOTT VOSS
HarbourVest

the average deal volume for those three years is consistent with prior years. So, in a way, we've had a bit of a swing up and a bit of a swing down, and we all feel it. It's busy – it's busy in funds, it's busy on the portfolio, and it's been busier than ever because there's more value at stake and there's a lot to think through in terms of market conditions.

Q How are GPs managing challenges in this environment?

Nate Taylor: The most important thing we did in 2021 to prepare for 2022 was to not over-deploy in 2021. We made a point, even when the market was ripping, to pull back on the reins and make sure that we were sticking to ratable deployment discipline.

A lot of funds did over-deploy in 2021. They over-deployed into one type of investment, oftentimes a high-growth, tech-oriented investment. We continued to diversify not just across the vintages, but also across the types of companies we invested in.

The best we can do as investors is orient around a base case. We have to scenario plan. We have to prepare ourselves for more challenging environments by getting lean, getting our capital structures in the right place, making sure we've got the right teams running the businesses. As we head into 2023, we're thinking hard about how to pivot if demand comes back quickly and how to pivot if we find ourselves in a situation where demand is more compromised.

John Maldonado: GPs are always working hard to generate returns, but they're going to have to work harder. The last 10 years has seen an unabated increase in multiples. We may be coming to the end of that era, where multiple expansion is not going to be the driver of returns, and the predominant driver is going to be the improvement of operating earnings.

We've always been laser-focused on that. But it's going to require a greater intensity of focus. GPs that have built portfolio support organizations and a network of operating advisers and partners which can drive fundamental performance are going to be the ones over this next period that will generate outsized alpha.

If you think about private equity cycles and the age of the folks that are dealmakers today, it skews younger. You've got no small number of dealmakers who over their career have never seen anything but up and to the right. The punch bowl has been available to all comers. Now it will invariably be harder across every dimension.

The duration and durability of the partnership, and whether the individuals have had to lock arms and tackle thorny problems and difficult macro, is a great indicator. What you need is alignment. You need a shared vision of what you're going to do together to get through it. And then you need violent execution.

Anjan Mukherjee: We'll see continued pressure on multiples, and so pricing a deal will have to take into account the potential for future compression. We've been assuming that rates would increase, so we've been building

Cover story

Harmonic convergence

Jennifer Choi, acting CEO for the Institutional Limited Partners Association (ILPA), talks about the SEC, LP strategy and the ESG Data Convergence Initiative.

"LPs will be making tough choices and potentially scaling back their allocations"

JENNIFER CHOI
Institutional Limited Partners Association

How could SEC proposed regulations addressing transparency impact LPs?
ILPA continues to be broadly supportive of the intent behind many of the proposed rules. Our goal as an organization has always been the pursuit of greater transparency, governance and alignment of interests across the private markets, all policy objectives in evidence across the various rule proposals.

In particular, ILPA's members have emphasized the importance of stronger fiduciary duties. They've left no doubt as to the value they see in more consistent reporting on fees and expenses. And they've made abundantly clear to SEC staff that side letters are absolutely essential for LPs to be able to invest in funds, thus fulfilling their organization's investment objectives and obligations. At the end of the day, we anticipate a rule that could fundamentally alter the industry, in positive ways. We also recognize that there will be an implementation period of at least one year once the rule is finalized next year.

Talk about the denominator effect
LPs are feeling the denominator effect, and it is certainly impacting strategy and planning for next year. In navigating what this environment means for portfolio construction and allocations over the near to medium term, LPs are reaping the dividends of the lessons from the last financial crisis, such as the utility of flexibility on allocation targets and the ROI on educating stakeholders on the merits of discipline and vintage year diversification.

In past times of stress, we've observed a flight to quality or familiarity, which raises the bar for emerging managers, even more challenging where track record is limited or problematic, eg, with a spinout where portability is at issue. LPs will realistically be making tough choices and potentially scaling back their allocations, even with existing established managers, in the year ahead.

ESG has become a hot-button political issue
Consideration of factors that present potentially material risks has been a part of deal diligence since well before the term 'ESG' was coined. ILPA believes that anything that would restrict an investor's ability to conduct sound due diligence is problematic. We also believe that enhanced access to quality, comparable decision-useful metrics is positive. That's why we're involved in efforts like the ESG Data Convergence Initiative, to better track and understand the role that consideration of factors such as climate, worker engagement and safety, and diversity play in investment outcomes across our industry.

multiple compression into our financing models. Our returns have to clear the bar assuming that multiples will further contract and that we're selling the future at a lower multiple than the purchase multiple.

The days of getting bailed out by multiple expansion are over. The next cycle will really separate the wheat from the chaff because investors will have to generate returns the old-fashioned way, which is to say through superior asset selection and deep portfolio value-creation capabilities.

David Quigley: Up to this point at least, we're in a very different form of correction. We did a bunch of research on what made the difference last time around. And we saw that firms who were more aggressive in M&A, moved capital more aggressively and deployed it more quickly, and made bigger bets, did better.

We talk about this idea of passing on the wet. Race drivers talk about this. It's hard to pass in the dry. The great drivers can pass in the wet. So, the idea that conditions are trickier, therefore there is actually room for distinction, for people to open up.

Q What types of deal opportunities will investors see next year?

John Maldonado: If capital can be deployed in 2023, it's going to be deployed at multiples that are empirically lower than what they were in 2022. And in situations that are less levered. That moves the other way from an equity return perspective, but also increases the room for error and degree of safety. So, the capital that is able to get deployed, it's doing so in what seems to be an attractive backdrop.

Every private equity firm, I suspect, has a shopping list of opportunities that a year ago was unavailable. Some terrific companies were trading in rarefied air – some public, some not. And now you look at the public markets and every one of our sector teams is licking their chops. The hard part is finding those instances that are transactional.

Corporate carveouts will be a theme. And a real opportunity set is those high-growth tech companies that are now trading down meaningfully because there's been a rotation to focus on profitability, not just growth. The most obvious way for GPs to deploy capital right now is through the portfolio. We are first and foremost thinking about ways we can support the portfolio in offensive M&A.

For us, now is not the time to hang back. Now is the time to be creative, to be on your front foot, to reconnect with CEOs of companies. You never know who's in need of capital. You never know which GP really needs to return money and might be needing to transact, even though their circumstances aren't ideal. Just because it's hard is not a reason to hang back and wait for something to come to you. You've got to go find it.

Nate Taylor: We believe our job is to go and ratably deploy across vintages the funds that we manage. It forces you

> *"A lot of funds did over-deploy in 2021. They over-deployed into one type of investment, oftentimes a high-growth, tech-oriented investment"*
>
> **NATE TAYLOR**
> **KKR**

to be brave when everyone's afraid and to be a little bit fearful when everyone's brave. Even if markets continue to stay volatile, there are ways to get capital to work.

The challenge is, in dislocated markets, people typically don't want to sell. They're only sellers if they have to be. And in many cases, the machinery of getting a deal done is sort of gummed up. One of our insights coming out of the Global Financial Crisis was to be more flexible with respect to the way we get capital to work during those moments.

When you're fortunate enough to have a large and healthy portfolio, you can put more equity behind businesses to help them grow, both through acquisitions and organically. To the extent that full buyouts are difficult, there are also opportunities to get money to work where we still have governance and protections.

There'll be opportunities to go and buy into good businesses with bad balance sheets. That was some of what we saw during covid. These were good businesses available for sale, but for whatever reason they found themselves in a pinch. Being there as a capital provider, as a trusted partner, is exactly the type of thing that our industry and our firm should be doing.

"If there's a moment for now, and probably for next year, it is to focus on value creation"

DAVID QUIGLEY
McKinsey

Anjan Mukherjee: We've always believed that cash-yield is a north star, and as we look for cash-flowing companies, we look for those where we can buy quality growth at a discount. I guess you could call ours a bit of a throwback strategy, but we believe this strategy outperforms over the cycle.

Over the coming years, once the financing markets stabilize, you're going to see the complexion of deals start to shift back towards good old-fashioned buyouts. And what we're seeing today is, despite the dislocation, there are some really attractive investment opportunities if you know where to look.

At the moment, exits are significantly impaired. Public markets are effectively shut for new equity issuance. Credit availability is also impaired. So, in a private sale, if you're thinking about a secondary sale to a sponsor buyer, you know valuations either have to come down for that buyer to meet their return thresholds or you choose simply to hold until financing markets get more robust.

Scott Voss: Periods of dislocation may turn out some of the better vintages. You're probably getting better value on the buy. We think of our portfolio in the context of growth and value and, for a long time, growth was materially outperforming any kind of value-oriented strategy. There is a case that value strategies, at least for the near-to-mid-term, will again have their day in the sun and will be able to compete with growth ideas.

We continue to have a global approach to investing, but when you think about those macro factors that we're all considering now, different parts of the world might be better positioned from a relative advantage standpoint than other parts of the world.

Parts of Asia have become very challenging. In Europe, the view is they may be the first to enter into a recession if they're not there already. The US has its own challenges, but investors view it as arguably a safe haven. Emerging markets are challenged because of dollar strength. So, there's all of these macro forces that create this relative advantage as you look at global allocations.

David Quigley: If there's a moment for now, and probably for next year, it is to focus on value creation in the portfolio. Coming off a big investment cycle last year, it means many portfolios are fuller than they ever have ever been. And it means there's a lot of focus on how we help those companies. How do we help them to grow? How do we help them to navigate this? How do we help them to come out the far side of this stronger?

"Things are going to get worse before they get better. There's more pain to come"

JOHN MALDONADO
Advent International

Q Will fundraising conditions remain tough in the year ahead?

Scott Voss: Through 2021, we saw fundraising cycles accelerate, we saw fund sizes increase dramatically, we saw platforms introduced – so, it's not just one firm, one fund, it's multiple products.

In 2022 and definitely next year, there will be a consolidation that happens, where fundraising cycles will be elongated. Fund sizes may grow, but they're not going to grow at the same rate they did. And we may see some of these platform extensions or multi-strategy ideas either consolidated or retired, where the manager decides, "I've gotten too far away from my core."

LPs will continue to look at new relationships, but it's going to be a high bar and it's going to be the obvious ideas. Unless somebody has dedicated capital to invest in emerging managers. If you don't have a dedicated allocation, and an emerging manager needs to challenge the incumbent for the long-standing relationship, that will be scrutinized to a greater degree. Because I don't think LPs are going to add relationships at the same rate that they did in the recent past.

There's a scenario where fundraising in 2022 will still be a record year, just because of how fast we came into 2022, but that has quickly changed. Next year, we could see maybe 50 percent of what we saw 2021 and 2022 from a fundraising standpoint.

John Maldonado: There's going to be a continued denominator issue for LPs, and distributions are not likely to increase meaningfully with that backdrop. On top of that, a lot of investors borrowed from their 2023 allocations, meaning they did work in 2022 but held the docs into the first day of the fiscal year to close. With the combination of those things, fundraising challenges will continue into 2023.

Nate Taylor: Big picture, we remain incredibly bullish on where alternatives, generally speaking, and private equity, specifically, will go. We're still in the early innings of that. In the short run, as portfolios have been revalued, we've seen a little bit of a pullback in the fundraising market.

Someone coming back who's just raised capital two years ago, and asking today for more capital – that's being met with a more circumspect reaction. And that's a very reasonable response from an LP. They deploy this capital in most cases with an understanding that it would be invested over four-to-five-year periods of time, not over two-to-three-year periods. And those who have tried to shorten that cycle have gotten caught in a bit of a squeeze.

This is where there'll be a flight to quality. LPs will continue to consolidate

2023

"With 60% of low-income countries and 30% of emerging market economies in or near debt distress, the possibility of a global debt crisis is high." UN Trade & Development report

around managers who have delivered for them over time. They'll be more judicious about who they're talking to, and they'll probably gravitate to GPs who have a source of competitive differentiation and have been in moments like this before.

Q Are challenging market dynamics putting strains on GP-LP relations?

John Maldonado: In markets like these, we're having more frequent dialogue with our LPs. It's cementing the relationship. We want them to feel comfortable that we're focused on our backyard and we're being good stewards of their capital.

Separate from that is the pace of fundraising. That has created some strain, but it has also happened during a period when private equity was generating outsized performance. Investors were and are trying to thread this needle, where they're trying to maintain core relationships, even if those relationships are raising more often, but maybe doing so by keeping the sizing flat or even reducing it.

This has been a very acute problem for them to navigate over the past few years. But things are slowing down quite a bit in 2022 and 2023 given the volatility. That should ease some of the pressures on LPs.

Anjan Mukherjee: I've heard from LPs who feel that GPs have been slow over the last couple of quarters to mark down their portfolios. You've got the denominator effect in full effect, and it'll take a year for the system to digest and for valuations to reflect reality – which is to say, decline further to come in line with where public markets are. That'll release some of that pressure on the denominator effect.

LPs really value transparency. They want GPs to be transparent with respect to everything they do, but it's especially important with respect to the valuation process. If LPs feel GPs are not being transparent, they begin to lose trust and that puts a strain on relationships in multiple ways – fundraising, co-investments, etc. Our position has been to be very clear with our LPs about exactly how our valuation process works. That's best practice and GPs are coming around to that, being open with their LPs on how they mark their portfolio companies.

Nate Taylor: We thankfully are not experiencing that strain. If anything, now is an opportunity to get even closer. On the sunny days, everybody can be a good friend. It's on rainier days where relationships are really reinforced. At moments like this, we lean into the relationship side, try to be good listeners, and help facilitate the goals and de-bottleneck the issues that LPs are running into.

Q Is private equity making progress on the ESG and diversity front?

David Quigley: In our report on the state of diversity in global private markets, one thing we see is more willingness on the part of LPs to invest in private equity firms who can demonstrate a track record on diversity. The dynamic that LPs have the ability through dialogue with GPs to reinforce what matters for where we should be heading is a great thing.

On sustainability, we see this as a meaningful shift. This is the largest capital reallocation of our time. We're seeing exciting opportunities to invest to reduce emissions while improving other aspects of performance. The combination of Russia's invasion of Ukraine, and how that has disrupted energy in Europe and energy supplies globally, and then the incentives provided by the Inflation Reduction Act, make sustainability a big priority for the industry overall.

Nate Taylor: Our orientation as a firm is always going to be substance over

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>
> **ANJAN MUKHERJEE**
> **BayPine**

form. We're going to drive substantive change and not chase acronyms or fads or fashion – to do the right thing for the businesses in which we invest, the customers which we serve and the communities in which we participate.

We have a strong focus on broad-based ownership, a movement that started a decade ago in our industrials team. We feel so passionate about it that we've open-sourced the concept and put it into a third-party organization called Ownership Works to help other like-minded GPs roll this out across their portfolios.

I look at the work we're doing on climate, and the work we've done in our own population as well as our portfolio companies to build more diverse teams – for example, by adding more diverse talent to boards. It's good business, it ultimately drives better decision-making for us, better outcomes.

John Maldonado: The industry is making progress. It has to because LPs have demanded it. That's why the ESG focus within private equity on a large scale was born, because our customers said this is something that matters to them. Fortunately, it has evolved from that to a recognition. We recognize that we can generate more alpha, generate more dollars of returns, by virtue of having an ESG focus. They're not mutually exclusive.

For our current fund, every deal we do is going to be benchmarked by the S&P 500 Sustainable Index. We've got a clear scorecard of our companies and how they do against that, allowing us to create a pathway for what we want to accomplish along ESG dimensions over the course of our hold.

Diversity starts with tone at the top. By virtue of that cascading down, it's a real and palpable goal we have set for ourselves, which is every year increasing the percentage of organizational diversity we have at every level. We recognize you can't change the partner percentages overnight, but the only way you do so is to get religion around your hiring, because these are long-dated moves.

Scott Voss: There's definitely a value proposition in ESG. While it's early in the ESG lifecycle, we're seeing a lot of interesting strategies and there are macro tailwinds that will help build great companies that can not only drive positive social impact but also performance for LPs.

Our firm was founded with the belief that diversity and inclusion is core to our basic values and ongoing success. We also have ESG embedded in the DNA of our portfolios. Both topics are at the top of the list of what's important to our investors and what's important to us as we think about investing.

There needs to be some measuring body that relieves anxiety around how ESG is reported. Because there's this big concept of green washing – which is real – but there's also this grey area of interpreting and valuing ESG. There's no algorithm that completely solves for that. It's top of mind for LPs. I expect we'll work towards getting a framework that is broadly agreed-upon to allow ESG strategies to be officially blessed. ■