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Private Equity Practice

Private equity exit excellence: Getting the story right

While a successful exit has many elements, a clear and evidence-backed equity story detailing the asset's potential may be the most important. Three key principles can help funds maximize exit returns.

by Guillaume Cazalaa, Wesley Hayes, and Paul Morgan

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In the pursuit of healthy returns, most private equity (PE) investors are primarily focused on making great purchases. Many also understand the need for great business transformations for their assets. But they often pay less attention to making a great exit. While there is often pressure to hold onto an asset—stemming from fee incentives, market timing, or a desire to give performance improvements time to take effect—this pressure should not preclude preparing for the eventual exit. A 2018 McKinsey article emphasizes exit preparation throughout the ownership period.[1] One of the most important elements of great exit preparation is constantly honing a well-developed, well-articulated, and evidence-backed view of why an asset represents an exciting investment opportunity.

Funds often wait too long to conceive of and gain consensus on an equity narrative that articulates why a business is a great asset, how it's going to improve (the upside for the next owner), and why it's strategically beneficial. These weighty issues cannot be satisfactorily addressed with a traditional vendor-diligence report in the last couple months of ownership. That approach leaves insufficient time to make meaningful corrections to the business, assemble the required evidence, or even achieve real alignment between PE owners and management teams.

Many investors spend most of their energy on acquiring assets. For others, exits may be influenced by market opportunity and happen on short notice. Yet even when exits are foreseeable, fund managers tend to focus on improving an asset's immediate performance and achieving strategic objectives, often with an eye toward the exit—but not always with an eye toward what needs to be in place to *support* the exit. As they approach their exit window, an asset's management team or sponsor might have a story in mind they'd like to tell. At that point, however, it's quite difficult to assemble the necessary evidence to reinforce that story.

We interviewed more than 30 decision makers across a range of established PE funds to better understand their exit strategies. Their insights, along with our firsthand experience, reveal a wide variety of approaches—and levels of effort—on the exit process. The best practitioners don't wait to build the components of the story until the exit is imminent. Rather, they work to ensure the alignment of their business and exit strategies all along their asset journey. They proactively assemble the evidence necessary to tell a simple but powerful story by adhering to three key principles: keep it simple, start early, and tailor the messaging.

The exit landscape is changing

In the past decade, IPOs have represented a small fraction of PE exits (Exhibit 1). As the capital flowing to alternative investment managers—especially those in PE—continues to grow, we expect sales to PE buyers and trade sales will continue to be PE investors' most common exit paths.[2]

While on its face the increased competition for deals should make exits easier and more lucrative, the timing of a sale is critical. Across industries, the delta between exit multiples at a market peak and a trough can be enormous (Exhibit 2). Poor timing on deals therefore can wipe out enormous value.

In the first quarter of 2019, the PE market was at an all-time high. As such, nearly all the fund managers we interviewed at least insinuated that an inevitable correction weighs heavily on their minds. A more challenging (and potentially less liquid) market further underscores the importance of preparing for exits. This preparation will be critical in sustaining returns.

Discipline is the heart of a great exit

Our interviewees consistently expressed a desire for more rigorous, methodical exit preparation

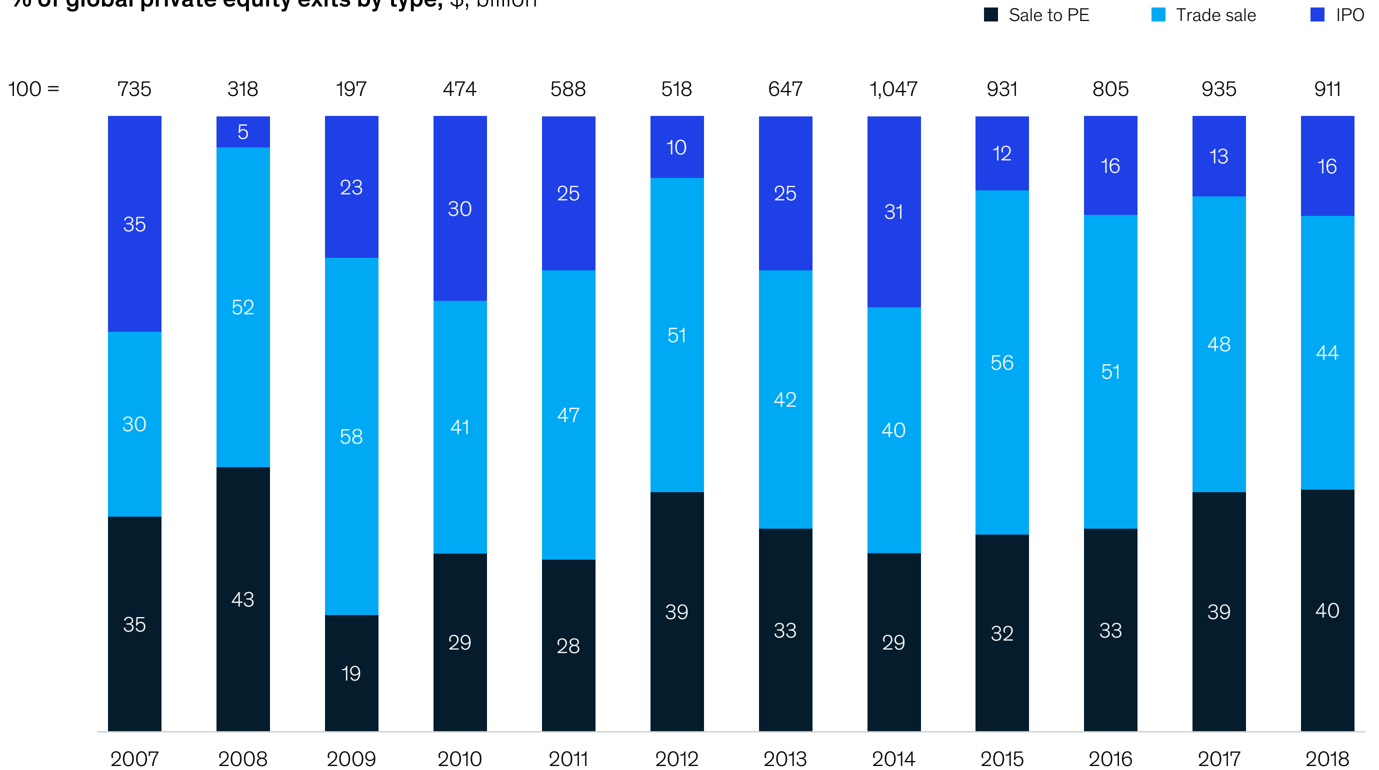
[1] For more on the overall exit process, see Alastair Green, Wesley Hayes, Laurens Seghers, and Eyal Zaets, "Private equity exits: Enabling the exit process to create significant value," July 2018, McKinsey.com.

[2] "Trade sale" is defined by Preqin as "The portfolio company is sold to another company." See *Glossary of terms*, Preqin, accessed July 2019, docs.preqin.com.

Exhibit 1

Trade sales and PE buyouts have historically been the option of choice for private equity exits.

% of global private equity exits by type, $, billion



Note: Pitchbook uses the terms “Strategic M&A” and “Financial acquisition,” which, for consistency, we’ve adapted to equivalent terms “Trade sale” and “Sale to PE.”
Source: Pitchbook

processes. For example, the best practitioners are much more systematic in pursuing operational value. Where possible, they work to reposition a business toward higher-multiple segments, such as tech, during their ownership. They recognize the need to complement short- to midterm value creation initiatives with bolder moves that will underpin value creation for future owners. And they meticulously gather evidence of operational improvements and integrate them into a compelling narrative to share with future bidders, often beginning at least 18 months before they wish to sell. These are all characteristics of great exits.

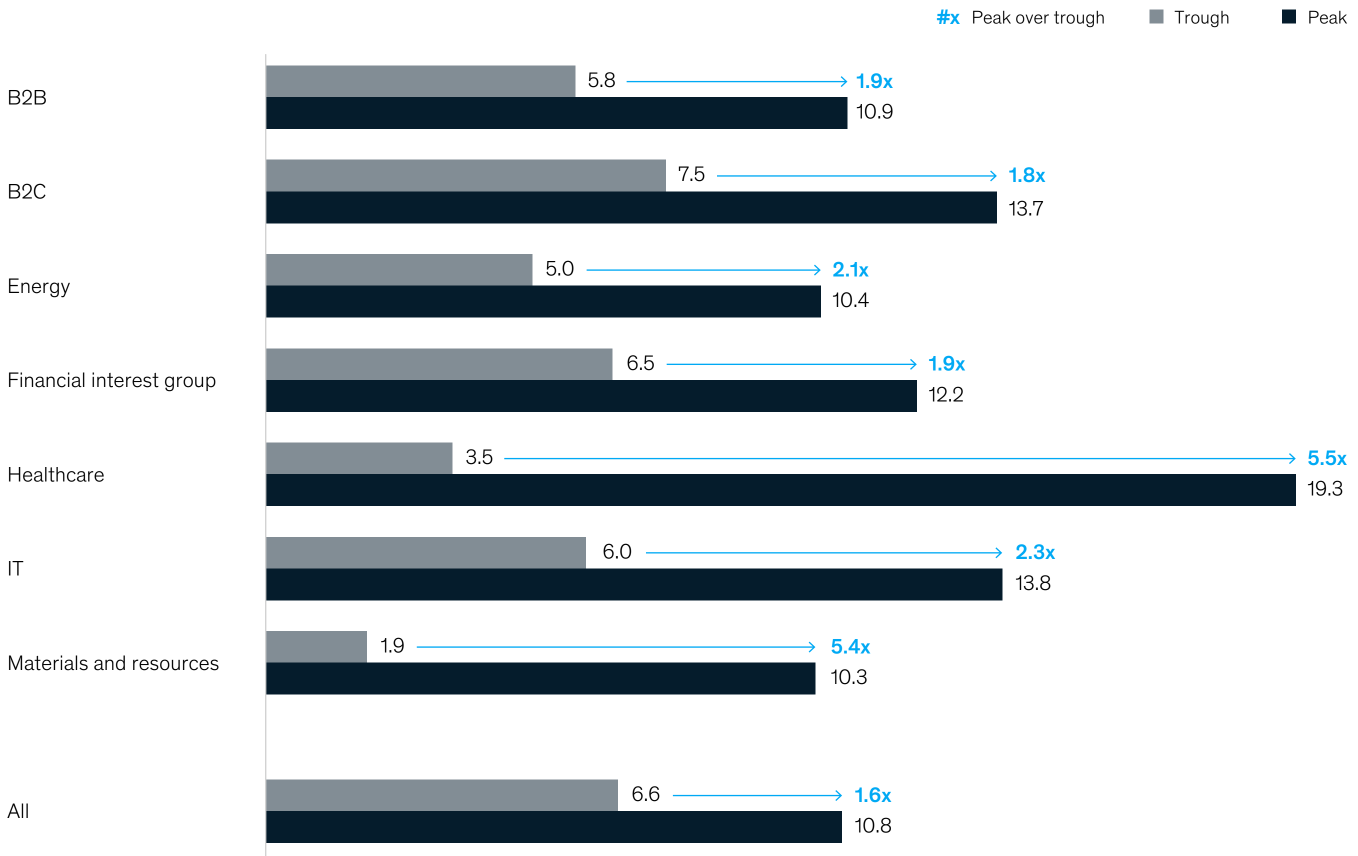
Still, we see considerable opportunity for improved exit preparation. Unlike the industry’s buttoned-up approach to buying assets, few funds have standardized, repeatable exit-preparation processes. Rather, exits vary drastically as each tends to be designed by an individual deal team. These teams work autonomously and rely on gut feeling and sentiment. Many fund managers expressed a desire to better focus on the exit preparation process and equity story throughout an investment’s lifetime.

A set of best practices can help any team maximize value but is particularly relevant for sales to PE buyers. In short, the most successful fund managers have solid governance practices, including key performance indicators and dashboards that track exit readiness, all of which

Exhibit 2

Timing is important and increases the need to promote operational value in the business before exiting to minimize impact of the economic cycle.

Global private equity exit multiples, 2007–18, median valuation/EBITDA



Note: Figures may not sum because of rounding.
Source: Pitchbook

draw on their firm's collective experience to inform the best possible exit approach. They formalize the midterm review process, carefully evaluating the pathway to exit, adjusting their asset strategy as required. They capture hard evidence of future value-creation opportunities. The best fund managers ensure there is absolute alignment with the fund and the management team on the equity story, backed by high-quality communication materials to tell that story.

Developing the equity story

The most important thread that must run through all the exit materials is the narrative of how an asset will create value under future ownership and beyond. This narrative must be clear and concise, consisting of ample supporting evidence—and that evidence must be boiled down to key facts and ideas that are accessible to prospective buyers. This means the process of developing the exit narrative needs to begin well in advance—typically at least 18 months before the exit. It can help to consider three primary objectives: tell a simple yet powerful story, take time to assemble the evidence, and tailor the messaging to the audience.

Tell a simple yet powerful story

The most successful equity stories focus on performance today, in the near future, and in the

long term, allaying three of buyers' most common concerns:

1. *Am I buying a solid asset?* Every description of an asset's performance should include a comprehensive view of details of the business, its fundamental value proposition to customers, and the asset's financial profile. Funds must ensure their numbers are truly analytically sound, encouraging management to address potential problems head-on and give straightforward answers to buyers' difficult questions. This legwork can also serve to show buyers that these have not only been considered but properly addressed,[3] inspiring confidence in the business.
2. *Will I be able to deliver value creation during my ownership?* Investors must prioritize and demonstrate the potential of a manageable number of value creation initiatives. Rather than presenting a laundry list of unsubstantiated ideas, the initiatives must be described in detail and contain ample evidence to support the claims. Funds must begin assembling this evidence early to attract the most value.
3. *Can I tell a compelling story to the next owner, as well as the ones beyond?* It pays to think long and hard about the longer-term strategic imperatives for the business. What unique characteristics, assets, and capabilities will hold strategic value for the business, and what macroeconomic conditions are necessary for value to be realized in full?

Equity stories often manage to address the first of these questions but fall short of providing hard evidence to underpin near-term value creation initiatives. A robust and visionary articulation of how the asset is positioned to capitalize on long-term trends is often absent. Great equity stories address all three questions in a clear and sequential manner. Few assets benefit from a complex equity story, and few buyers have the patience to absorb hundreds of pages of reports.

Potential buyers can easily get spooked by a discrepancy between the story being told and current trading (the latest company financials). There is often a time lag between when sales materials are prepared and when they are presented, which can cause particular trouble where markets and businesses are volatile. For instance, one large international firm recently went to market with strong historical growth. It reached the final round of a sales process with a handful of committed bidders but had to halt final negotiations when market volatility caused a serious slowdown in current trading. The resilience of the business was a central component of its equity story, but the PE seller failed to make the volatility of the business known in its equity story. Because the PE seller didn't tackle this potential volatility risk head-on, the financial decline took bidders by surprise—leading them to question the lack of transparency and wonder if there were other parts of the story on which the sellers were opaque—and the sale process collapsed.

Take time to assemble the evidence

We found that the process for assembling the components of a compelling equity story is often unstructured. Typically, the deal team retains responsibility for the asset and sketches out an idea of how the story components might fit together; more often than not, it does so in conjunction with the management of the business. Ideally, an asset owner would conduct a readiness scan 18 months prior to anticipated exit, and they should have already agreed on the critical components of the equity story and how they fit together. A year or two of runway allows management and investors to flesh out those components by crafting the most compelling equity story for the business.

The most compelling narratives are underpinned by real evidence. A crisp evidence-based story might describe a future management initiative to expand

[3] For more on preparing management to address potential problems and handle tough questions, see Green, Hayes, Seghers, and Zaets, "Private equity exits: Enabling the exit process to create significant value," July 2018.

into new markets or launch adjacent products. The story is more powerful when management can point to pilots, field trials, or other evidence that confirms the potential for creating value. One fund that owned a European entertainment business, for instance, believed a dynamic pricing model (like those of airlines), could create significant value. While there was insufficient time to roll this model out across their network ahead of the exit, they were able to run a series of pilot programs that confirmed the new pricing model could result in a meaningful increase in revenue. What had been perceived as a rather tricky asset in a challenged industry was successfully and rapidly exited.

Tailor the messaging to the audience

Understanding who will be interested in buying and why is crucial and should materially influence the asset's storyline. For example, yield-based businesses are completely different from development businesses. Consider software companies: if growth slows, multiples fall and investors care less about the operating margin. Similarly, an asset's story would be drastically different when targeting institutional investors on the stock exchange versus discussing a trade sale to a competing PE player.

At a more tactical level, it's necessary to tailor an equity story to the level of sophistication and awareness of the buyer universe, educating them where necessary. Whether a fund is selling to the most sophisticated buyer or to one who is less so, the way a fund crafts an equity story provides a chance to shape the way buyers think about the opportunity.

Because exits are critical in securing overall value, PE funds should consider how to instill the same level of discipline and rigor to exits as they apply to purchasing assets. We are encouraged by examples of great exit practices—but we also note that funds do not consistently adhere to the basic elements underpinning a solid exit: articulating a clear equity story with evidence of both the current and future potential of the asset, preparing ahead of time, and adjusting for context and buyers.

No one does this perfectly every time. But when PE investors approach their exits and craft their equity stories more strategically, they have a much better chance of extracting the greatest possible value from their investments.

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