Private equity exits: Enabling the exit process to create significant value

Investors can capture more value by focusing on three best practices in private equity portfolio company exits.

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The last critical step of the private equity (PE) investment process, the exit, can greatly affect the final return on investment. Even after years of doing all the right things—including taking a proactive approach to ownership, aligning performance incentives, and being thoughtful about M&A—a poorly planned or executed exit can turn a good deal into a mediocre one.

Moreover, regardless of the exit strategy, and despite rising multiples, exits are becoming more challenging. Buyers are more sophisticated—and more demanding—than ever. Rapid technological change makes it tough for buyers and sellers to reach a shared understanding of risks as well as potential sources of value. And many owners struggle to create value past the initial one to three years of the holding period, during which the primary value levers are pulled. Together, these challenges make the exit process trickier to successfully execute and lead to a widening spread between strong and weak exits.

Despite the complicated environment, PE investors can overcome these obstacles and achieve exit excellence through three distinct actions. First, they should perform a readiness scan 18 months before the intended time of exit. Second, to demonstrate further potential to possible new owners, they should instruct management to focus on value-adding performance improvements that continue to create value while preparing for the exit and posttransition stages. This process may include the somewhat counterintuitive step of leaving some value-creation opportunities on the table for potential buyers to execute. Finally, they should also prepare to disclose and actively manage unpleasant surprises and give forthright answers to buyers' difficult questions. Investors that take this advice may drastically improve their exit performance, both by reducing the risk of exit process derailment and by helping to realize the full potential value of the transaction.[1]

Exits: The most critical—and sometimes the most difficult—step

For the past four years, the global value of PE exits surpassed $500 billion per year. In 2017 alone, PE firms completed 2,475 exits.[2] As the number of exits grows and the market remains "hot," the list of challenges has increased, making successful exits tougher and more complex:

As multiples get higher, so does the bar for a successful exit

In 2017, overall M&A multiples in the United States, including PE multiples for secondary buyouts, remained at their highest levels in more than a decade at 10.5, compared with 9.4 in 2014.[3] In such an environment, deals are expensive and sellers expect increasingly better terms.

Buyers have become more sophisticated and methodical and have expanded their institutional understanding

As the PE industry has matured, buyers are seeing fewer deals that are the first of their kind. Often, deal teams that specialize in particular industry verticals are intimately familiar with the space and the companies that operate within it. This exhaustive knowledge has made the typical due diligence process

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more detail-oriented. During the sale process, most teams now focus on building a deep understanding of a company's operations, which leads to challenging questions for management.

All sectors face ambiguity related to technological disruption

Industry 4.0, for example, is changing manufacturing, connected cars are changing the automotive world, and retail is dealing with the challenge of digital natives such as Amazon. In the future, additive manufacturing looms large for manufacturers and distributors alike. Often, potential buyers and sellers or company management have divergent perspectives on how future scenarios will play out, making it hard to reach a common understanding about not only the true risks to the business but also the potential sources of value.

Management becomes distracted in the back end of the holding period

In the beginning of the holding period—generally the first two to three years—excitement to kick-start the value-capture process is high. Often, management rolls out large performance-transformation programs, such as turning fixed costs into variable ones, reducing overhead expenses, and making commercial improvements in activities such as pricing. In the following years, and as the company moves toward an exit, many owners shift focus toward stabilizing the earnings pattern or strategic M&A. This change carries the risk of reducing the energy and ambition for fundamental business improvement—or to put it differently, during the second wave, owners sometimes stop pulling those important value-creation levers.

For many investors, these hurdles have been difficult and costly to surmount.

Some exits completely derail, some do not fully achieve market-conforming multiples, and still others exceed expectations—all within the same industries and market environments. Of course, myriad factors are at play in these instances, such as the underlying dynamics of the subsegment and the market position of the company. Yet in our experience, successful sellers tend to adhere to a few common best practices that increase the chances of a successful exit.

Three best practices for exit excellence

At the beginning of every deal, best-in-class PE firms have a vision for both the exit route and timing that they continue to refine. Indeed, successful sellers force themselves to regularly revisit this exit vision—often every six months—through the duration of the holding period, as the constellation of influencing factors is always in flux.

In addition to frequent checks against the original exit strategy, the most successful PE investors undertake three critical activities that lead to exit excellence.

1. Perform a readiness scan 18 months before the exit

As part of exit preparation, successful sellers execute a readiness scan of the company and the exit environment 18 months prior to the anticipated exit and refresh it a year later. The initial scan is close enough to the anticipated exit that owners can have market and cycle visibility, and it is also still far enough out to address potential weaknesses in the investment story and establish a meaningful performance track record. Say a scan uncovers production delays in the launch of a new product or an increase in customer churn. Over the course of 18 months, it is reasonable for management to fix those problems and get performance trending in the right direction before these issues might turn off potential buyers.

The readiness scan should address a few key questions:

- Is the proposed timing still right? What is the expected near-term market situation and performance trajectory? Is there noise in the market about the company's industry? Are exit valuations in the sector attractive, and how are they trending?

- Is the originally anticipated exit route—a dual listing, IPO, or trade sale, for example—still valuable and still the best path forward?

- Beyond the sources of value identified upon acquisition and in the first one or two years of the holding period, what other performance improvements might lead to capturing more value? What performance milestones must be reached to confidently engage in discussions with potential buyers or investors?

- Does the company have a healthy pipeline of value-creation initiatives that could extend after the sale to the next owners? And is the management team ready to commit to executing those initiatives after the change of ownership?

To perform the readiness scan, many of the most successful PE investors create an exit committee, which often consists of the fund's investment committee members, the responsible deal team, and, if applicable, the head of portfolio operations and other members of the operating team.

2. Focus management on continuing to capture value while preparing for the exit and posttransition process

Creating value through performance improvements in the first few years of the holding period is critically important, but the best owners continue to push hard on value creation throughout the entire period. Indeed, as potential acquirers look closely at the final 12 to 18 months prior to exit, management must ensure that the company demonstrates a track record of performance improvement that can be carried forward to create future value.

The ability to further improve performance will depend on current market conditions and, of course, on what value levers have been pulled. Consider, for example, a company that has captured all potential upside from transactional pricing optimization in the initial one to three years of the holding period. Management may then shift to consider additional value-based pricing opportunities for particular client situations or services. Similarly, when a company has already streamlined its supplier base and renegotiated major procurement contracts, it might consider ways to remove risk from its supplier base.

While the main focus of the management team should be on pulling the remaining value levers that result in immediate impact, it should also work to identify additional long-term ways to create value. Transactions attract buyers only if buyers are convinced that they will be able to add value throughout the upcoming ownership period. That means to motivate buyers, sellers must leave a few clear, strategic options and performance-improvement opportunities on the table.

Sellers should maintain this sometimes counterintuitive mind-set throughout the entire ownership period and develop concrete, actionable strategies that a new owner can execute from day one. Sellers and management should also be prepared and willing to openly discuss why these opportunities have not been pursued. Perhaps market timing was not quite right for certain opportunities, for example, or the company has not yet attained the required level of technology maturity or scale.

3. Prepare management to address potential problems and give forthright answers to buyers' difficult questions

Obviously, investors are disconcerted by unpleasant surprises such as poorly explained risks. Nasty surprises often crop up in nonoperational matters such as substantial unfunded pension liabilities, pending litigation or labor disputes, pending changes in regulation, or particular exposure to certain macro risks. Also, sellers must be diligent in their analysis of how a company is positioned in its market and realistic about value-creation potential. For fear of souring a potential sale, many PE investors are not as forthcoming as they should be. In our experience, however, buyers almost always uncover such material issues, and the more sellers and company management are prepared to talk through these, the better. So just as an auditor should analyze and reveal the good and the bad to a client as soon as they are uncovered, sellers—and company management—should disclose issues to potential buyers as quickly as possible and preempt their questions.

For example, in its first sale attempt, one PE-held building materials company that supplied products only to a specific niche construction segment failed to determine its exact exposure to fluctuations in the overall construction cycle. At that moment it was in a favorable position, with more fundamental headroom for near-term growth than the broader construction industry. Despite this advantage, the failure to disclose its full risk exposure to potential investors killed the potential transaction. In its second attempt, however, the company's management spent a significant amount of energy appropriately articulating the nature of the cyclical risk and its underlying drivers. This effort led to a more informed buyer and, ultimately, to a closed deal.

In addition, certain operating or back-office issues, often related to IT, are recurring concerns for strategic buyers. Problems with IT integration and past underinvestment have proved to be ordeals during many integration efforts. Any signs of potential IT integration issues tend to either deter buyers or substantially lower valuations.

By putting themselves in potential buyers' shoes and by taking care of these issues—even if doing so might postpone the exit—sellers are doing the right thing. It both takes the burden off the buyer, which now doesn't have to deal with potential problems, and it tends to reflect favorably in a buyer's valuation of the company. Further, it demonstrates management's ability to deal with complicated matters.

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Exits are rarely easy. But a concerted effort to improve exit performance—one focused on readiness, continuing value creation, and transparency—can ultimately have a huge impact on returns. And of course, the best possible exits set up new investors to continue to create value. ■

[1] In the past five years, top-quartile transactions by cash-on-cash returns tended to achieve up to two times the additional cash-on-cash returns over third-quartile exits in the same industry. Private equity professionals and industry experts consider the exit process to be a critical—yet not sole—factor contributing to this discrepancy. Source: Preqin Transaction Database, Preqin, accessed April 2018, preqin.com.

[2] For more on trends in global private markets, see *The rise and rise of private equity,* February 2018, on McKinsey.com.

[3] Joshua Mayers, "The state of the US PE industry in 13 charts," PitchBook, October 24, 2017, pitchbook.com.

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