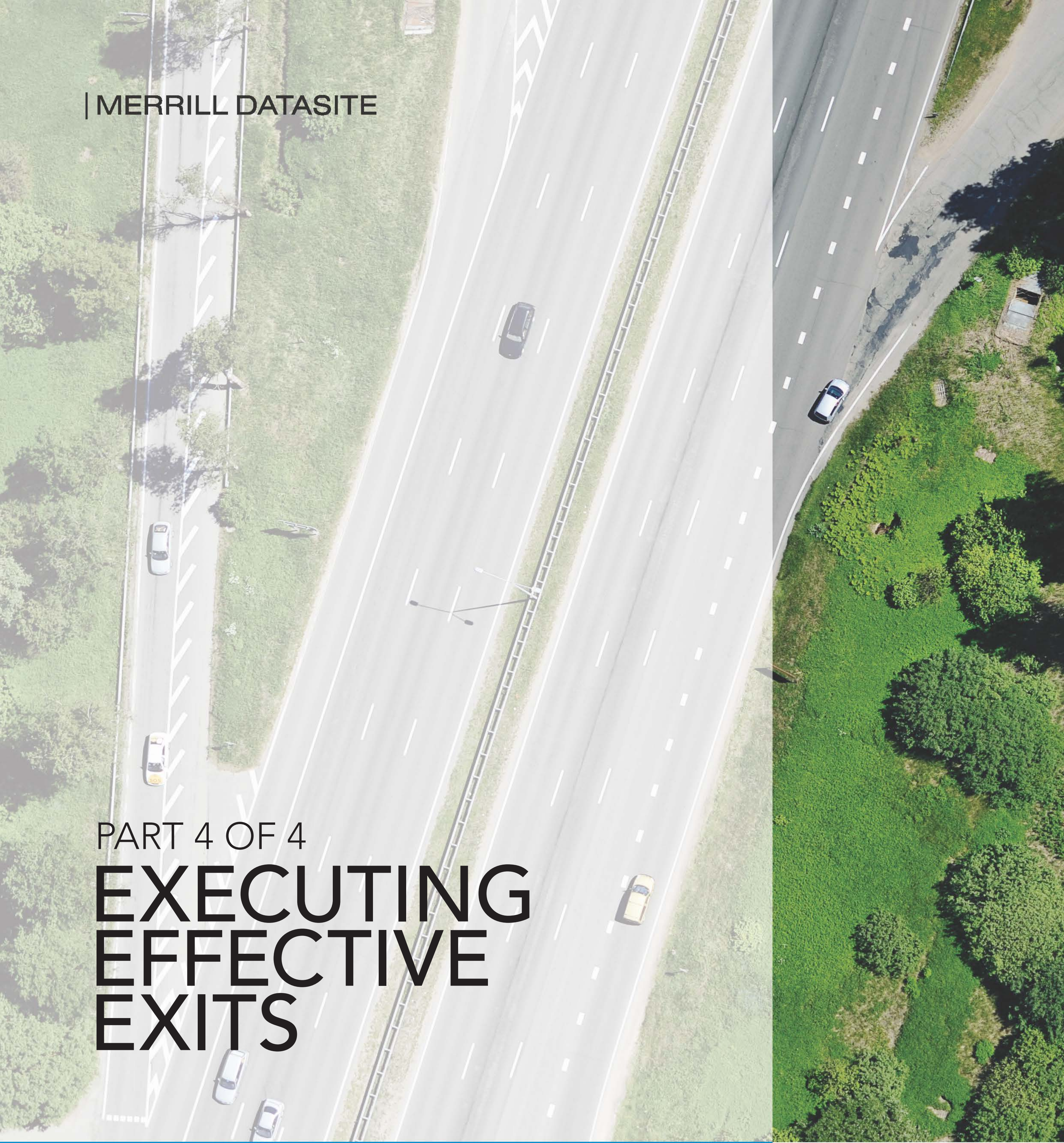

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PART 4 OF 4

EXECUTING EFFECTIVE EXITS

MERRILLCORPORATION
SECURE SUCCESS

EXECUTING EFFECTIVE EXITS

Contents

INTRODUCTION

For private equity firms, the market in which to sell portfolio assets in 2015 proved resilient. However, with the global economy taking a turn for the worse in 2016, a sense of caution has returned.

Exits could become problematic once more and only those that are fully prepared are likely to succeed.

ONLY PRIVATE EQUITY FIRMS WITH THESE FINELY TUNED EXIT STRATEGIES AND REPEATABLE VALUE-CREATION MODELS WILL LIKELY PROSPER IN THIS STRAITENED ENVIRONMENT.

Yet with sufficient forethought, positioning and execution, profitable exits can still be achieved.

EXECUTIVE SUMMARY

It may be the end point of the journey, but exits are the lifeblood of the private equity industry.

Successful exits are critical to ensuring attractive returns for investors and the objective of every private equity investment. Without exits, there are no returns to a fund's investors; without returns, there will be no money invested in the private equity firm's next fund.

Private equity firms need to be skilled at selling businesses and well thought-out exit strategies must be developed from the outset of any private equity lifecycle.

Harsher market conditions may also make it harder to execute effective exits in the coming months and years. PwC warns in its *Private Equity Trend Report 2016*[1] that because the exit market is procyclical, the recent boom in private equity exits is set to dissipate in 2016. Only private equity firms with these finely tuned exit strategies and repeatable value-creation models will likely prosper in this straitened environment.

This white paper will set out the optimal exit strategy for private equity firms, showing how networking, communication and the right technology all play their part in establishing a winning exit.

THE STATE OF THE MARKET

Exit activity was surprisingly buoyant in 2015. Against a backdrop of a global slowdown, increased volatility in equity markets and feverish competition that drove investment multiples to new highs, private equity turned in another solid year.

The number of private equity-backed exits reached 2,320 in 2015; up from a low of 719 in 2009, according to research firm PitchBook[2]. It was the sixth consecutive year of growth and the total exit value for 2015 came in at a record $554 billion, a year-on-year increase of 7%.

However, behind the headline figures there still persists an air of caution.

Exit multiples dipped to just 1.9x in 2015; compared to 2.1x in 2014 and 3.9x in 2009, according to PitchBook[3], indicating an increase in strategic sales.

Bain and Company's *Global Private Equity Report 2016*[4] also warned that there is likely to be a decrease in exit activity in the next five years due to slower investment activity between 2011 and 2015.

In addition, the private equity arena is still suffering from an overhang of pre-crisis boom-era investments remaining on balance sheets. Data provider Preqin estimates there are 1,180 of these funds, mainly of a 2003-2008 vintage, still in investor portfolios[5].

PRIVATE EQUITY FIRMS GENERALLY TARGET A TIME SPAN OF BETWEEN THREE AND FIVE YEARS TO HOLD ON TO INVESTMENTS

These so-called 'zombie funds' continue to create substantial challenges and have played their part in the average holding period for investments gradually increasing from 4.1 years in 2008 to 5.9 years in 2014; although this dropped back slightly to 5.5 years in 2015, according to Preqin[6].

Private equity firms generally target a time span of between three and five years to hold on to investments–the sweet spot for optimal returns.

Of course, exits can occur just six months after an investment if the right buyer or economic conditions present themselves. But, the longer an investment remains in a portfolio, the higher the required exit price to meet target internal rates of return. Fire sales can also ensue as investments near the end of the traditional 10-year term of a private equity fund.

It remains to be seen how the rest of 2016 will play out, but with the global economy in danger of sliding back into recession the year hasn't started brightly in terms of exit activity.

There were just 53 exits globally in the first month of 2016, which marks the least the industry has racked up for a January since 2010, according to data provider Dealogic[7]. These exits were valued at around $14bn, which is 25% lower than similar deals in January 2015. Valuations then may also start to slip as fund managers find it more difficult to exit portfolio companies.

Although, with an abundance of 'dry powder' at their disposal, Preqin estimates private equity firms are sitting on $752bn globally at the last count[8], there could still be an active market in secondary buyouts; traditionally perceived as a last resort for private equity firms. According to PwC[9], there were 285 secondary buyouts worth $56.7bn in 2015, a year-on-year increase of 5% in volume and 45% in value.

THE PATH TO HIGHER RETURNS

For private equity firms, focusing in on specific sectors and industries–rather than looking to acquiring almost any company–can go a long way to improving returns.

While it has yet to gain widespread acceptance as a strategy, sector-focused managers can, over time, develop a more intimate knowledge of an industry. This, in turn, can lead to outperformance.

AROUND 30% OF EXITS INVOLVED A SALE TO ANOTHER PRIVATE EQUITY FIRM WHILE FEWER THAN 20% OF DEALS EXITED THROUGH AN INITIAL PUBLIC OFFERING (IPO).

A 2014 study by Cambridge Associates[10] found that sector specialists in consumer, financial services, healthcare or technology returned an aggregate 2.2x multiple on invested capital; outperforming more generalist private equity funds invested in the same sectors, who returned 1.9x multiples. These sector-focused funds also recorded fewer losses than generalists.

ESTABLISHING A WINNING EXIT

The most successful exits require considerable planning, although preparation for exit should really begin at the due diligence stage of the acquisition process, long before any fee has been agreed.

Once a portfolio company has been bought, having the discipline to put plans to work almost immediately after the acquisition can bring about rapid performance improvements on a business, increasing its value over the long term and ultimately making the asset more attractive for someone else to buy it.

A 2014 report by KPMG[11] listed the most important strategies for successful private equity exits as buying right; embedding strong corporate governance principles; successful market timing when determining an exit; value uplift and earnings growth; and the usefulness of good management and a clear succession plan.

The actual exiting of a business, though, can be a fluid process–taking into account the dynamics of the market and also opportunities for value add. All exit options need to be considered and pricing should be kept realistic. The exit process itself usually takes anywhere between three and six months, depending on regulatory requirements.

A 2015 Harvard Business School paper entitled *What do private equity firms say they do?*[12] found that roughly half of all private equity exits concluded with a trade sale to a strategic buyer in the same industry. Around 30% of exits involved a sale to another private equity firm while fewer than 20% of deals exited through an initial public offering (IPO).

This, despite IPOs generally being the most sought-after exit for private equity firms as they generally realise the highest return on investment. But with the IPO market deteriorating in 2016[13], exit activities may be further restrained for private equity firms.

For the winners, though, success really will breed success. A number of profitable exits achieved by a private equity firm can have a strong influence on its ability to attract future investors and raise funds.

TODAY'S INVESTORS IN PRIVATE EQUITY FUNDS WANT TO SEE EXITS THAT LEAVE CASH GENERATIVE COMPANIES, WITH EXPONENTIALLY IMPROVING EBITDA AND INHERENT SUSTAINABILITY.

IMPORTANCE OF BRAND AND COMMUNICATION

Private equity firms have much to gain from developing their marketing strategies. More traditional PR, printed literature and corporate websites will continue to play their part, but today general partners (GPs) can reach their intended audiences through a wide spectrum of different channels–from blog posts to videos and social networks.

And the message conveyed needs to be slick. Any exit story should be about more than just the returns made; focusing on what the GP has added to achieve success. Today's investors in private equity funds want to see exits that leave cash generative companies, with exponentially improving EBITDA and inherent sustainability. They also want to see portfolio returns being fairly consistent across an entire fund–not just relying on one overly successful exit.

By building a brand and engaging with investors on what they want to hear, it will show the fund manager to be meticulous and prudent–and will also showcase why any new limited partners should invest in a fund.

VALUE OF STRATEGIC NETWORKING

With trade sale activity of private equity-backed exits hitting record levels in 2015, according to Preqin[14], it underlines the importance of GPs building a presence within their portfolio companies' industry networks.

Whether that is in person, through the industry press or at trade events, it pays to build an awareness about the portfolio company so as to alert potential buyers in the sector when it's time to exit.

HAVING THE RIGHT TECHNOLOGY IN PLACE

Today's most progressive private equity firms are adopting sophisticated technology solutions to manage the entire lifecycle of their portfolios. Long gone are the days of supervising operations using a simple spreadsheet.

Customer relationship management platforms can help private equity firms manage their network of buyers, advisers, sellers and agents more effectively, while data mining tools can assist firms proactively source deals and identify potential buyers when they are ready to exit.

Virtual data rooms (VDRs) are also assuming an increasingly important role as the command centre for every stage of the private equity process. These VDRs are an integral part of any private equity firm's ability to showcase portfolio companies it is preparing to exit.

By using a market-leading VDR solution, private equity firms can conduct exits in a simple, smart and seamless manner; protecting the privacy of corporate documents all the while keeping potential buyers engaged, yet anonymous and segregated. A VDR will eliminate risk; allowing a private equity firm to be in total control of the level of access it grants for each document.

BY USING A MARKET-LEADING VDR SOLUTION, PRIVATE EQUITY FIRMS CAN CONDUCT EXITS IN A SIMPLE, SMART AND SEAMLESS MANNER

And by having the data of all portfolio companies securely stored and ordered–and in one place–it allows private equity firms to move fast once the exit process commences.

Having the right technology in place will deliver significant time and cost savings.

So, with market conditions for exits quite possibly taking a turn for the worse in 2016, it underlines the significance of remaining nimble and agile–and could be the difference between generating exceptional returns over ones that disappoint.

[1] https://www.pwc.de/de/finanzinvestoren/assets/private-equity-trend-report-2016.pdf
[2] http://www.valuewalk.com/wp-content/uploads/2016/02/2015_Annual_PE_Exits_Company_Inventory_Report.pdf
[3] http://www.valuewalk.com/wp-content/uploads/2016/02/2015_Annual_PE_Exits_Company_Inventory_Report.pdf
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