PERSISTENCE WILL PAY OFF

Q4 2023

Overview

2023 was a challenging year for the private equity industry, equivalent to running uphill into a stiff wind. Interest rates continued to rise in developed markets as central bankers fought persistent inflation, while geopolitical tensions heightened around the world.

Both investment and exit activity fell for the third successive year. Surprisingly, it was a record year for fundraising in terms of volume but a nine-year low in terms of number of funds raised. This increased concentration in fundraising suggests that the flight to "mega cap" safety continues. The current situation raises a number of intriguing questions for 2024: (1) How will investors resolve their liquidity pains? (2) Which segments of the market should see the best dealflow? (3) Will private equity returns remain robust? We are in store for another exciting year.

Down and Down

Private equity investment activity was down by over 30% at almost USD 500bn[1]. This was mainly driven by a big fall in North America (-39%) and APAC (-34%), while Europe was marginally up (+8%).

Exit activity also fell in 2023, by 10% to USD 439bn. This was driven by North America (-11%) and APAC (+13%), while Europe was up (+13%)[2].

In absolute terms, investment and exit activity are close to 2018/2019 levels. However, given that industry aggregate assets under management (calculated as aggregate NAV plus dry powder) have more than doubled since 2018, relative investment and exit activity are the lowest in over a decade.

Part of this can be explained by the elevated fundraising activity for large and mega funds in recent years, which led to an acceleration in industry AUM. In 2023, a record $387bn was raised globally for buyout funds, 34% higher than 2022 However, last year the 15 largest funds accounted for almost 50% of the total[3]. Simply put, many of these large and mega cap managers are fundraising more quickly than they can invest the capital, and then exit.

Paul Newsome

Head of Investment Solutions, Private Equity

Key Points

1. Despite low levels of investment activity globally, we continue to see strong exit activity across all of our maturing portfolios. Over the last two years, we have now achieved eight exits from our direct funds at an average multiple of 3.6 x (3.0 x net)
2. We expect exit activity to increase in 2024 but a record number of auctions will fail, leading to attractive investment opportunities. GP-led continuation funds will be the main driver behind growth in the secondary market
3. Mid-market returns should be materially higher than large cap returns during 2024 and reshoring, healthcare innovation and education services are tipped as the key investment themes

[1] Preqin, as at January 2024
[2] Preqin, as at January 2024
[3] Preqin, as at January 2024

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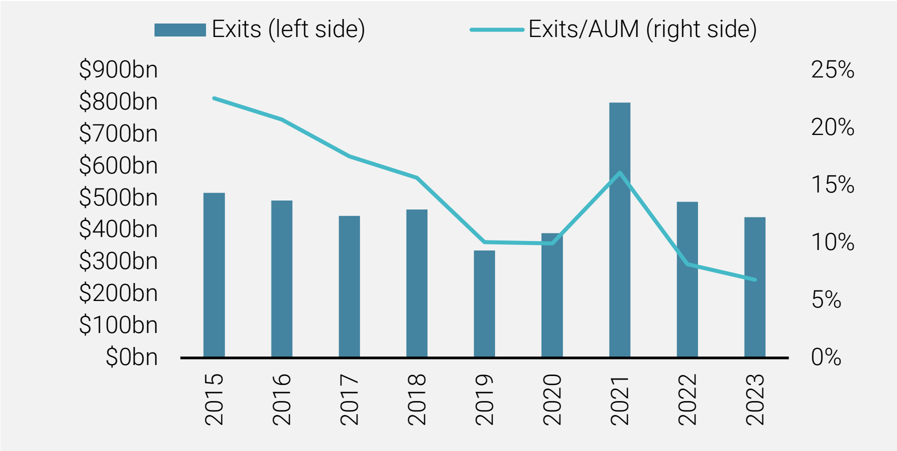
Figure 1: Exit activity



Source: Preqin, January 2024

In 2023, we continued investing our third Directs strategy, taking the portfolio to seven investments. Despite the difficult environment we have remained disciplined and have been able to invest in high quality, high growth companies playing our key investment themes at attractive valuations.

Furthermore, we have already seen promising development within the portfolio. On average, over the calendar year 2023, the seven portfolio companies grew revenues by 27% and EBITDA margins from 24.6% to 24.9%.

While all companies are doing well, the two standout performers are Frontier Waste Solutions and Bradford Health Services. When we invested in Frontier Waste, a Texas-based provider of solid waste services to the municipal, residential, commercial and industrial markets, the company was already an emerging leader having posted 23 consecutive quarters of revenue growth. We also had high confidence in the GP, Summer Street Capital, with whom we scored a 4.8x (4.5wx net) realised return with Florida-based Coastal Waste in 2022. For the 12 months to the end of Q1 2024, the company is projected to deliver EBITDA of over USD 45m, more than double the EBITDA at which we invested in October 2022. This was achieved through multiple contract wins and a large landfill acquisition.

Similarly, we originally identified Bradford Health Services as a sector leader in the provision of substance use disorder treatment with over 40 facilities in five states. The GP, Lee Equity, had previous form with two other specialist treatment clinics where they achieved over 4x (3.3x net) realised returns on both companies. For the 12 months to November 2023, Bradford delivered EBITDA of over USD 46m, more than three times the EBITDA at which we invested in October 2022. This was achieved through a combination of organic growth and three add-on acquisitions.

On the back of this strong performance, we conservatively expect the portfolio to be valued at 1.4x (1.3x net) cost. We expect to have a final close for this strategy at the end of August 2024.

As we have written previously, we continue to see strong exit activity across all of our maturing portfolios. Over the last two years, we have now achieved eight exits from our direct funds at an average multiple of 3.6x (3.0x net). With several more companies ripe for exit, we anticipate that 2024 should be an even stronger year for exits, with as many as four exits expected from our second Directs strategy.

On the secondaries front, in 2023, we launched the fundraising period for our sixth secondaries strategy, targeting EUR 1.5bn. We had a first close in October 2023, enabling us to complete our first deal, Project Pandora, a sidecar fund consisting of three high growth enterprise software companies with Avataar, an Indian growth capital manager.

Project Pandora consists of Capillary, a global leading loyalty SaaS business, Chalo, India's number one bus transport technology provider and Amagi, a global leading cloud-based provider for content creation, distribution and monetisation.

Project Pandora is a typical Unigestion secondary deal: it consists of leading assets in sectors with strong tailwinds, we are entering at an inflection point where growth is expected to accelerate due to concrete initiatives, early exits are expected from at least one of the assets, we know the GP extremely well having invested previously with them and, given this relationship, we have negotiated favourable terms with no management fee and tiered carried interest.

Given the broader malaise in exit activity, the secondaries market continues to be highly attractive. We will discuss the specific trends in the market in the coming quarters.

Our Private Equity outlook for 2024

It was largely predicted by market participants that 2023 would bounce back after a lull in 2022. This clearly did not come to pass and begs the question whether the bounce back is simply being delayed until 2024. We do not think it will be quite so simple.

However, despite the continued slowdown in activity, our 2023 predictions were directionally correct, if not right in magnitude.

First, while at time of writing it looks like the secondaries market was slightly higher in 2023 than 2022 (USD 115bn vs USD 110bn), it will be short of the record set in 2021 (USD 135bn)[4]. Given that LPs are not yet motivated enough to sell at any price, the bid-ask spread remained wide enough to dampen the growth in secondaries activity, especially at the large end of the market[5].

Second, we were correct that entry prices would shrink in the mid-market. In fact, median mid-market multiples in North America and Europe fell from 13.0x EBITDA in 2022 to 11.4x EBITDA, the lowest since 2016 and well below the peak of 14.3x set in 2019[6]. Given that investment activity was muted across the board, dry powder still grew by 7% among small and mid-market funds. Meanwhile, dry powder grew over 15% among large and mega cap funds, taking it to a record USD 500bn.

Third, secondary buyouts as an exit route did see an increase in 2023 against an overall decrease in exit activity - but only marginally. The number of exits via secondary buyouts increased from 663 to 680[7]. Based on our own experience of the large cap players often being prepared to outbid the trade buyers (4 out of 8 of our direct exits were to private equity buyers), we expect this trend to continue into 2024.

Fourth, while evidence is only anecdotal, family offices were, on average, willing to increase their allocation to private equity in 2023 (as reported by UBS, 38% wanted to increase while 13% wanted to decrease)[8]. Institutional investors, except for some of the largest sovereign wealth funds, were typically constrained by a lack of distributions.

For obvious reasons, it is extremely difficult to make predictions in the current environment. Nonetheless, we hope that our 2024 outlook provides some interesting reading and rationale behind the potential short- and long-term opportunities in the private equity market.

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[4] PJT PCS Market Intelligence, January 2024
[5] Preqin, January 2024
[6] Pitchbook, Apollo, Data as of 30 September 2023
[7] Pitchbook, Apollo, Data as of 30 September 2023
[8] UBS Global Family Office Report 2023 published in May 2023

Exit activity will increase but a record number of auctions will fail, leading to attractive investment opportunities. Given the slow level of exit activity over the last two years, the aggregate exit pipeline has become more crowded than ever. Only the most attractive companies with strong financial fundamentals, clean balance sheets and demonstrable sustainable growth will make the cut in 2024. In addition, GPs may be over-ambitious on valuations. Therefore, while we expect the sell-side intermediaries to have a very busy year bringing private equity-backed companies to the market, we expect that a large number of auctions will not produce the desired price for the GP. Thus, in many cases, GPs will look for other alternatives for liquidity.

GP-led continuation funds will be the main driver behind growth in the secondary market. Given the overflowing exit pipeline mentioned above, many GPs will seek to use continuation funds as an alternative to provide liquidity for their best performing assets. This should provide a rich seam of attractive GP-led deal flow for secondary investors. Meanwhile, the growth in LP-stake activity will be constrained by LPs unwilling to accept material discounts. In addition, with higher interest rates, the large secondary investors are less able to execute on the large portfolio transactions which have traditionally been reliant on leverage. Nevertheless, the savvy secondary investor will still be able to selectively target high quality single fund LP-stakes, especially in cases where LPs can get liquidity without crystallising material losses.

Mid-market returns should be materially higher than large cap returns. In 2023, mid-market net annual returns were on average 15%, marginally higher than large (11%) and mega cap (14%)[9]. However, going into 2024, the relative advantage of mid-market over large and mega cap has never been stronger. Firstly, dry powder of large and mega cap funds continues to grow at twice the rate of that of mid-market funds. Secondly, mid-market EV/EBITDA multiples have fallen more quickly than overall market multiples (see above for both these points). Finally, overall debt to EBITDA multiples have fallen from 5.9x in 2022 to 5.0x in 2023[10]. Leverage is a much more important driver of returns for larger managers than for mid-market managers. Taking all of this together, we believe that mid-market returns should show clear outperformance in 2024.

The key investment topics for 2024 will be reshoring, healthcare innovation and education services. With increasing geopolitical tensions, supply chains are under scrutiny more than ever. This will lead to opportunities around reshoring and logistics services. Meanwhile, healthcare innovation is undergoing a boom, particularly in biopharma and life sciences, which will only increase with further AI penetration into this sector. Finally, with the continued shift to digital content, application of AI and the increasing skills gap amongst workers, innovative education services companies will benefit. We believe that there will be a notable uptick in deal flow in all of these sectors, especially in the mid-market.

Whatever happens, the diligent and persistent investor will be sure to find attractive opportunities in the face of continued challenging conditions. Limited partners and private equity managers will need to work hard to create alpha and, in some cases, will be forced out of their comfort zones. We are excited to embark on another year of deal doing and exit generating.

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[9] Preqin, January 2024 (performance for the 12 months to 30 September 2023)
[10] Pitchbook, Apollo, Data as of 30 September 2023

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Unigestion Private Equity activity

Here are the highlights of some of the investments that we completed in Q4:

In October, Cow Corner I, a portfolio fund of Emerging Manager Choice I, sold ISMS.online to ECI after a successful four-year investment partnership. ISMS.online is a market leading SaaS Information Security Management System (ISMS). ISO 27001 certifications have increased by 450% in the last ten years, and ISMS.online provides global SMEs and enterprise customers with an easy-to-use cloud-hosted ISMS to facilitate the adoption of ISO 27001 and over 100 other standards. Following the investment by Cow Corner in 2019, ISMS.online has built a best-in-class platform and became a market leader in the ISMS space. The exit was at 11.0x (10.3x net) TVPI and resulted in distributions to Emerging Manager Choice I of around EUR 8 million.

In October as well, Unigestion completed a co-investment in Evora alongside Farview Equity Partners. Founded in 2011, Evora is a London-headquartered provider of environmental sustainability consulting, managed services and software, offering end-to-end solutions for commercial real estate funds. The client base is headquartered mainly in the UK, North America and Germany. The company is the largest contributor of reporting into GRESB standard and offers specialist knowledge around Net Zero Carbon, Green Finance, TCFD, and SFDR with the ability to frame into financial outcomes. The company is uniquely positioned as a strong provider of an integrated consulting and software product to benefit from strong tailwinds stemming from strong regulatory pressure and requirements to exploit emission data into actionable actions to reduce building emission.

Also in October, after a holding period of just under three years, Unigestion, together with Afinum, sold Germany-based ERP software implementation and consulting firm Yaveon to VOLPi Capital. Yaveon is a leading ERP software and consulting company specializing in the Microsoft Dynamics ERP platform. It serves small and medium-sized companies operating in the biotechnology sector and offers a proprietary suite of industry extensions for process manufacturing. Headquartered in Germany, the company employs approximately 200 people and has a global customer base of over 600 active customers. The exit was at 3.3x (3.0x net) TVPI and resulted in distributions to Euro Choice Secondary II of around EUR 38 million.

In the same month, Gilde Equity Management IV, a portfolio fund of Euro Choice VI, exited Team Eiffel to Towerbrook. Team EIFFEL is a high-end contingent workforce solutions provider serving a wide variety of end-markets with over 2,500 professionals. During Gilde’s holding period, a leading industry platform consisting of specialized business units has been created and together with eight add-ons over the past years, EBITDA has grown from EUR 8 million to expected EUR 45 million in 2023. The exit was at 3.7x (3.4x net) TVPI and resulted in distributions to Euro Choice VI of around EUR 11 million.

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CARBONFREE

At the end of October, we completed a direct secondary investment in CarbonFree Chemicals alongside Braemar Energy Ventures. Founded in 2005 and headquartered in Texas, CarbonFree has developed a technology, so-called SkyCycle, to directly capture CO_2 emissions from a variety of hard-to-abate industry processes and convert the captured CO_2 into carbon free chemicals - precipitated calcium carbonate (PCC) and hydrochloric acid (HCl) - with lower energy usage and costs than the market standards. CarbonFree has therefore a dual climate impact – the company significantly reduces GHG emissions from high emitting industries and serves the market with a carbon free product that will reduce Scope 3 GHG emissions of manufacturers across several industries, e.g. paper, paints, food, pharma. The company currently operates one facility in San Antonio, Texas, which has been profitably operating at full capacity for two years and a second facility is under development.

HCA Healthcare Australia

In December, Unigestion invested in Healthcare Australia through a single asset continuation fund managed by Crescent Capital Partners. Healthcare Australia is the #1 healthcare staffing and workforce management company in Australia. The business was founded in 1972 and covers healthcare staff recruitment, age care services, National Disability Insurance Scheme (NDIS) and training courses with more than 16'000 healthcare professionals. Healthcare Australia is the largest player in the workforce solutions business in Australia and is expected to see steady grow underpinned by the growing aging population increasing prevalence of chronic disease and treatment intensity.

CGS MANAGEMENT the business builders

In December as well, CGS III, a portfolio fund of Euro Choice V, has listed R&S International Holding AG on the Swiss Exchange via a majority sale to VT5 Acquisition Company AG. VT5 was founded as an Special Purpose Acquisition Company (SPAC) and listed since 2015. R&S International Holding AG is one of the leading suppliers of electrical infrastructure products in key markets in Europe and the Middle East with more than 700 employees worldwide. With six production facilities and offices in Europe and the Middle East as well as a broad global partner network, R&S International Holding AG offers customers high-quality service and prompt support. Strong innovation skills and a high degree of flexibility enable the development of modern products and solutions that meet the demanding needs of customers. The exit was at 6.0x (5.6x net)TVPI and resulted in distributions to Euro Choice V of around EUR 17 million.

LEE EQUITY

Also in December, Unigestion committed to Lee Equity IV. Lee Equity is an established New York-based private equity firm that targets US mid-market businesses. The firm focuses on three core sectors: financial services, healthcare services and business services. It specifically targets growth opportunities, corporate carve-outs, public to privates, and buy-and-build platforms. Unigestion has built a strong relationship with Lee Equity since 2016 through a secondary and stapled primary investment, and several co-investments (including its recent exit of Captive Resources at 3.2x (3.0x net) TVPI) over the years.

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