Mutual value creation and synergy between Private Equity funds and portfolio companies

Research Pulse

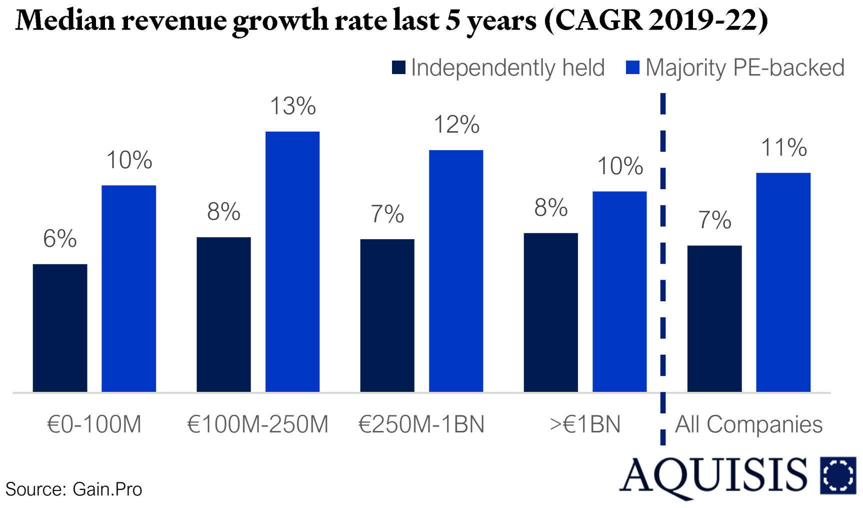
Private equity has evolved significantly, growing from a niche sector in 1989 to accounting for 2–5% of GDP in recent years. PE firms create value through productivity gains, managerial improvements, and market expansion, driving sales growth and innovation. They target both turnaround and high-profit firms, leveraging capital and expertise. Despite significant challenges like stagnant exits, volatile IPO markets, and higher interest rates, the sector adapts by emphasizing longer-term strategies. These include operational turnarounds, corporate carve-outs, and collaborations with experts.

Why PE-backed firms outperform: Financing, expertise, and connections

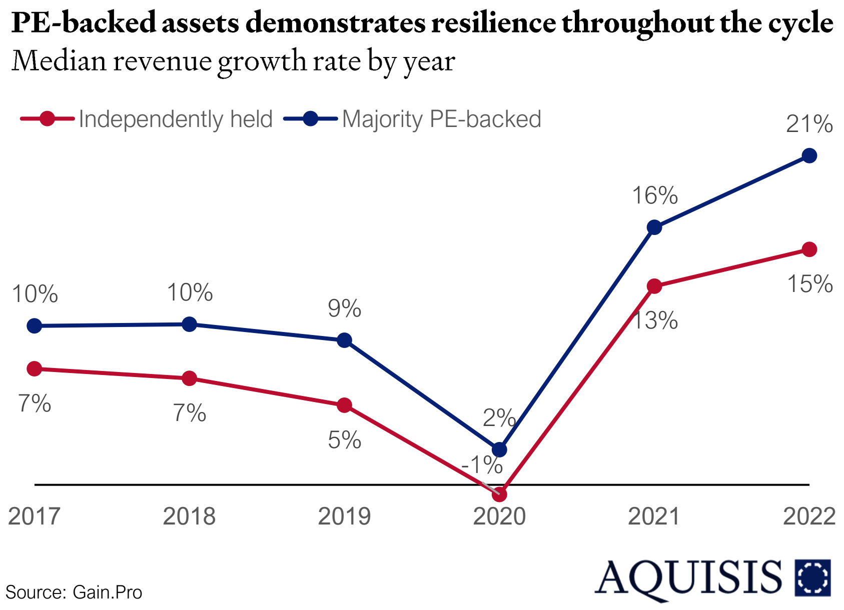
Private equity has undergone significant transformation over the past three decades. In 1989, the industry was largely a niche sector, with aggregate annual deal volumes close to 1% of GDP according to OECD data. In contrast, over the past four years, this figure has consistently ranged between 2% and 5%.

Private equity firms operate with a straightforward objective: acquire businesses and exit with substantial gains. However, the mechanisms by which they achieve these gains remain a subject of debate. Do PE firms simply redistribute wealth from stakeholders, or do they generate value through operational improvements?

Research suggests that PE firms enhance total factor productivity, refine managerial practices, focus patenting activity and mitigate agency problems. Following a buyout, target companies experience a 50% greater increase in sales compared to comparable control firms (Cesare Fracassi, 2020). This trend holds true across businesses of all sizes. However, as companies grow larger (exceeding €1bn in revenue), the growth differential tends to diminish (Jani, 2024). This growth is primarily driven by an increase in sales volume rather than by price adjustments.



How do firms achieve this increase in units sold? First, PE-backed firms introduce more new products, significantly increasing the number of items ordered. Second, they innovate by entering new consumer categories. Finally, their products reach a broader audience by expanding into new stores, retail chains, and geographic regions. Private equity plays a key role in this process by providing access to financing, managerial expertise, and valuable business connections. These resources enable younger, private companies to expand their product lines and achieve more effective growth.



In addition, regardless of the macroeconomic environment, private equity-backed companies consistently outperform independently held firms in terms of growth. These companies typically pursue more aggressive growth strategies and maintain their investment activities throughout the economic cycle (Jani, 2024). While some of that growth differential will be inorganic, a similar trend is observed in margin (EBITDA margin on average ⅓ higher).

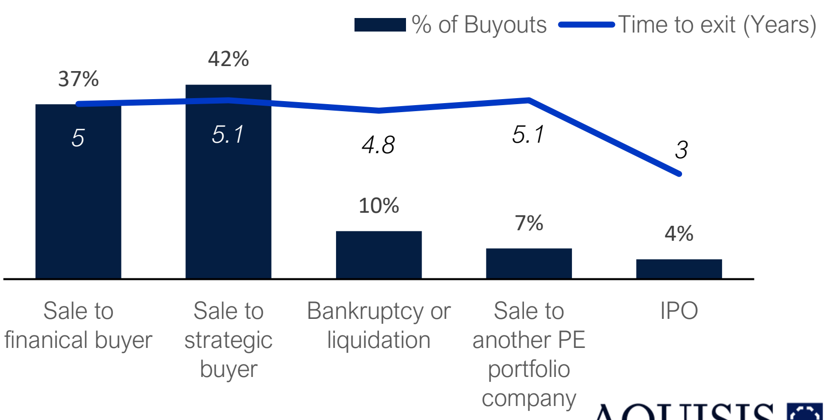
The private equity focus: Targeting high and low profitability firms for strategic growth and exits

Private equity acquirers exhibit a pronounced focus on firms situated in the highest and lowest quintiles of profitability within a broader sample of private companies. Firms in the lowest profitability quintile are likely targeted as turnaround opportunities, while those in the highest quintile may serve as growth platforms, given that high average profitability often signals strong potential marginal returns on investment. Among highly profitable private firms, PE acquirers are particularly inclined to target those with significant leverage operating in industries reliant on external capital. These firms often possess lucrative growth opportunities but lack the financial resources to capitalize on them effectively. Simply adding cash is still not enough to capitalize on these opportunities, PE funds need to understand how they can contribute to the success of potential targets and what they can add to the equation in terms of expertise and connection.

Addressing this gap goes beyond simply injecting capital. Private equity funds must understand how they can actively contribute to the success of these potential targets, bringing not only financial resources but also a comprehensive value-creation strategy. This often includes providing strategic guidance, access to networks, operational expertise, and industry connections. By integrating these elements, PE firms ensure that their involvement adds meaningful value to the target company, enabling it to realize its growth potential in a sustainable and impactful manner. A notable trend in recent years is the growing involvement of multiple investors in private equity deals. Collaboration among PE firms has long been a feature of the industry, especially through so-called club deals, where resources and knowledge are pooled to target larger privatization opportunities. However, every investor eventually seeks an exit (Jenkins, 2024).

Data shows that 86% of firms exit through a sale, whether to a strategic buyer, another PE firm, or a portfolio company. Bankruptcy accounts for 10% of exits, while only 4% of firms exit via IPO. Exiting is increasingly challenging, particularly as public markets are less receptive to listings of highly leveraged companies with inflated private valuations. Even in the booming technology sector, recent IPOs by private equity-owned companies have been cautionary tales. Notably, bankruptcies do not typically occur in the early post-buyout years; for firms that do file for bankruptcy, the median time to bankruptcy is 5.5 years. This pattern reflects the proactive efforts of PE firms to mitigate risks and avoid failures during the critically years of ownership (Jonathan B. Cohn, 2022).

Exits from a sample of 240 buyout transaction by PE firms



Source: (Jonathan B. Cohn, 2022)

The future of Private Equity: Balancing long-term growth and cash distributions

The private equity industry is facing significant challenges, with a noticeable shift from the traditionally favored IRR (Internal Rate of Return) to DPI (Distributions to Paid-In Capital) as the key performance metric. According to Goldman Sachs' analysis, funds from the 2019-2022 vintage have returned only about 15 cents on the dollar, well below the more than 50% return typically seen at this stage in earlier vintages. While DPIs may improve over time for well-managed portfolios, the days of achieving 20%-plus IRRs appear to be behind the industry.

This shift in performance metrics is largely due to the stagnation in private equity exits. Volatile IPO markets and cautious corporate buyers have made it difficult to sell portfolio companies, limiting the funds available for distributions. Stagnant company valuations dilute IRRs, and the lack of cash returns further hampers fundraising, particularly for smaller, less diversified funds. While exits may eventually recover, IRRs are heavily impacted by timing and investment nature, especially with the industry's transition from quick-turnaround "fix-and-flip" strategies to longer-term roll-ups and industrial turnarounds (SeongJoon, 2024). However, with higher interest rates affecting company valuations and complicating exits, private equity firms are under greater pressure to focus on returning capital to investors. As reported by Bain & Company, private equity firms globally are holding a record 28,000 unsold companies valued at over $3trn, further underscoring the industry's current exit challenges (Memento, 2024).

The prolonged period of low interest rates following the 2008–2009 financial crisis catalyzed significant growth in private equity. During this time, firms capitalized on readily available, low-cost debt to drive acquisition sprees. Declining interest rates elevated asset valuations and lowered the cost of capital, creating optimal conditions for strong returns. However, replicating this formula will prove increasingly difficult in the current economic climate.

Looking ahead, private equity is expected to refocus on its foundational strategies: identifying high-quality deal opportunities and executing transformative operational improvements to unlock value. These efforts often target underperforming divisions of large corporations or private companies with unrealized potential. Reflecting this shift, bankers and industry leaders anticipate a rise in corporate carve-outs, where private equity firms acquire business units from large corporations, and an increase in collaborations with industry experts to drive performance enhancements (Agnew, 2024).

This evolving landscape underscores the imperative for private equity funds to redefine their value proposition beyond merely injecting capital. While access to financial resources remains critical, future success will hinge on the ability of PE firms to deliver actionable value-add strategies tailored to the unique challenges of each investment. As returns face increasing pressure, funds will need to delve deeper into identifying and capitalizing on opportunities at the extremes of quartile performance: targeting struggling companies for turnaround potential or high-performing firms with opportunities for scaling further. This redefinition of private equity's role will not only enhance returns but also solidify its position as a catalyst for innovation and value in the broader economic ecosystem.

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