Will you set the exit pace, or try to keep up with it?

Private equity
Global Divestment Study 2019

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Introduction

In the past 12 months, we have seen attractive valuations and competition for assets as private equity (PE) firms divest portfolio companies. After an extended period of elevated dealmaking, PE exits leveled off in 2018. However, by historical standards, exit activity remains high and many firms anticipate this strong pace to continue in 2019.

PE firms are focused on exit value and speed while deal conditions are favorable. They are prepared to move quickly as market volatility, particularly on the debt side, picks up and sector convergence continues to transform businesses across industries.

Preparation is critical, as it helps portfolio companies focus on long-term growth potential once PE has exited the picture, and supports the value story for the next owner of the business. Data and analytics will play a crucial role.

About this study

The EY Global Private Equity Divestment Study focuses on how PE should approach their exit strategies in a resilient yet volatile marketplace. The 2019 report is based on 100 interviews with global private equity executives. The survey was conducted between September and November 2018 by Acuris.

- Executives are from companies across the Americas (45%), EMEIA (30%), Asia-Pacific (20%) and Japan (5%).
- Managing-level partners make up 60% of executives surveyed.
- 14% of the PE executives represent firms with greater than US$50b in assets under management (AUM); 9% represent firms with US$30b-US$50b AUM; 45% represent firms with US$10b-US$30b AUM.
Key findings

Private equity

Driving forces

41% of PE firms say reaching EBITDA targets triggered their most recent exit.

74% say unsolicited bids will drive exit plans over the next 12 months.

Seeing the exit at acquisition

54% say market position is one of the top two considerations of exit strategy when making an acquisition – up from 37% last year.

16% consider organic growth potential to be an important aspect of their exit strategy when making an acquisition – down from 43% last year.

Identifying paths to greater value

62% of PEs say digitalization of the business was an important element of the value story in their last exit.

38% say new products and geographies will be most important to portfolio companies’ strategies over the next 18-24 months.

Leveraging analytics from strategy through execution

80% say applying data-driven analytics consistently is a significant issue in their portfolio reviews – up from 64% last year.

22% say they are very effectively using analytics when it comes to positioning and validating a business for potential buyers.
Despite uncertainty from tariffs, a trade war, desynchronized growth and geopolitical concerns, the market offers sellers a resilient yet competitive environment. PE firms continue to be active sellers, exiting businesses that have hit performance targets and responding to opportunistic approaches. They are scrutinizing hold periods and divestment strategies to avoid missing out on attractive valuations.

Market data underlines the message that a heated PE exit environment has shifted to a normalized but brisk pace, with volumes leveling off. In 2018, PE firms made 1,175 exits globally, slightly above the total volume of 1,149 exits seen in 2017 – down from a peak in 2014. Deal values remained strong in 2018, hitting US$385.2b and on par with US$385.8b in 2017.

At the same time, IPOs have seen increasing interest. Fourteen percent of firms say their last major divestment involved taking an asset public, up from 2% the year before. Perhaps most significantly, 27% expect their exits to IPO in the next 18-24 months.

In the current market, we have to work much harder to create value. If we reach the EBITDA target or anything opportunistic comes to us, we will decide to exit. There is no point waiting for better and higher multiples as the market is volatile and it will not be wise to expect higher multiples even after we reach our EBITDA target.

Partner, UK-based PE firm
What will influence the next wave of exits?

Over the past 12 months, PE has taken a pragmatic approach to exits: 41% say their last divestment was triggered primarily by a business achieving its EBITDA goals, while 20% say it was driven by a portfolio company’s weak competitive position. But other market forces are at work, potentially influencing the next wave of exits.

More than half (54%) of PEs believe geopolitical uncertainty and macroeconomic volatility will affect exit decisions in the next 12 months. Cross-border trade agreements, Brexit, non-tariff barriers and tax policy changes such as the incoming OECD/G20 Base erosion and profit shifting (BEPS) project will all factor into decisions.

Eighty-two percent of firms expect these geopolitical shifts to push operational costs higher. This will require PEs to factor these rising costs into their divestment strategy and timing.

At the same time, the majority of firms (59%) are anticipating the impact of sector convergence on their portfolios. Technological advances are driving the need to redefine business strategies and the capital investments required to support technology for future growth in their portfolio companies.

PEs say opportunism will continue to influence divestments, with 74% ready to jump at unsolicited bids. This underscores the importance of preparing businesses for sale early to maximize exit value and speed in an unplanned divestment scenario.

Overall, few PEs (23%) say they expect a reduction in multiples in the next 12 months, but the majority (78%) say they are prepared to exit portfolio businesses quickly in the event of a market correction over that same period.
How are exit strategies changing?

This year’s survey suggests a change in emphasis for many PE firms. When acquiring businesses, their top two exit considerations are the company’s market position (54%) and the potential exit timing (36%). During this extended period of competitive valuations, buyers have shifted focus away from organic growth potential (16%), a top priority a year ago for 43% of PE firms.

While exit timing is a key consideration right from the point of acquisition, 42% say they determine the right time to sell one-year pre-sale, down from 61% last year. Instead, a growing number (38%, up from 21% last year), say their exit timing is becoming more opportunistic.

Against this backdrop, PE firms are primarily working with portfolio businesses to reshape strategy and create value during their period of ownership. More than half (58%) say strategy is the area where they get most involved with their portfolio companies, followed by M&A (42%), well ahead of any other areas.

“Relying on the management team to drive the exit process and identifying the right exit time, with help from the management team, is something we have been doing for years. Their knowledge about the portfolio helps in the exit process. They are the right people to decide on exit timing and drive the process efficiently.”

Managing Director, US-based PE firm
Where are the value creation opportunities?

PE firms tend to be hands-on owners, with 81% reporting they interact, at minimum, monthly with portfolio companies to drive value. And while cost reduction and improvements to working capital top the list of value creation strategies, PE firms are also actively involved with helping companies plan for channel expansion, making changes to products and service offerings, and bolt-on acquisitions.

However, there are other areas where PE might be leaving money on the table. Most notably, while 62% of PEs say digitalization of the business was an important element of the value story in their last divestment, only 11% cite digital enhancements as the most important element of their portfolio companies’ strategy.

In other areas, PE clearly applies their experience as owners of many businesses – 78% say innovation is one of the most important elements of their companies’ business strategies, reflecting PE’s determination to help portfolio companies drive sustainable growth.

However, PE firms will need to show buyers that their value creation plans have been implemented if they expect to achieve their anticipated returns.

Q For which of the following do companies in your portfolio have a strategy? Select the one that will be MOST important over the next 18-24 months.

- New products/geographies: 38%
- Cost reduction: 29%
- Pricing improvement: 12%
- Digital enhancements: 11%
- Outsourcing: 3%
- Use of artificial intelligence (AI): 2%
- Transfer pricing: 2%
- Cybersecurity: 2%
- Supply chain automation: 1%

Q Which of the following is part of your value creation strategy? Select all that apply.

- Cost reduction: 90%
- Improving working capital: 80%
- Bolt-on acquisitions: 69%
- Changes to product/service offering: 63%
- Synergies: 60%
- Renegotiating supplier contracts: 54%
- Channel expansion: 50%
- Supply chain reorganization: 37%
- Plant rationalizations/closings: 28%
- Offshoring: 4%

“Our portfolio companies are not just investments, they are a valuable partnership. We believe that the more we interact, the better the relationship and coordination between us all. We prefer to engage every two weeks with a focus on planning various aspects that helps produce a broad consensus about the company’s strategic plan, with clearly understood objectives and milestones for value creation.”

Partner, UK-based PE firm
Revealing the exit playbook

PEs largely agree on the most critical elements of their exit playbook — the vital areas of focus during divestment execution where pre-planned strategies and practices can deliver greater value in the sales process.

Tax now heads up the list. Nearly three-quarters (74%) of PEs highlighted potential tax upsides for purchasers before putting their most-recently divested asset up for sale. At the same time 79% of firms say tax structuring is an important part of the exit playbook.

In practice, that means addressing tax early and considering country-by-country requirements when applicable. Sellers need to determine how the transaction should be structured to minimize tax exposure on the deal and start executing tax structuring changes to accelerate the exit while minimizing tax costs.

For example, one PE seller took steps prior to marketing a business to understand potential exposures and value drivers associated with tax attributes and tax costs around the transaction structure (e.g., trapped cash, transfer taxes). By addressing these issues, the seller was able to plan for, and articulate responses to, the buyers’ claims regarding tax negatively impacting value. Preparing early allowed the seller to wrap up any negotiation around tax matters far sooner than if these steps had not be taken.

However, tax is not the only important element of the PE exit playbook. Working capital optimization remains standard for 70% of firms, and 73% of firms cite the need for commercial, legal and intellectual property reviews.

This makes sense: business valuations are increasingly impacted by intangible assets, meaning IP should be a value-accrue consideration in the exit process, rather than a potential stumbling block. Commercial reviews represent the seller’s opportunity to highlight value opportunities to buyers — and to identify potentially problematic areas. Working capital optimization will help ensure a smooth transition from seller to buyer.

Perhaps surprisingly, only 36% of PE firms say cyber/technology is an element of their exit playbook. This may need to increase in importance as buyer diligence should focus on the digitalization of target companies as well as potential cyber risk or outdated legacy technologies.

In your last major exit, which of the following were important to developing your value story and divestment thesis. Select all that apply.

- Product innovation
- Acquisitive growth
- Digitalization of the business
- Strength of the management team
- Organic growth

What does your exit playbook include? Select all that apply.

- Tax structuring
- Legal/IP
- Commercial review
- Management structure review
- Working capital optimization
- Sell-side preparation
- Cyber/technology

“Without customer satisfaction, no company can progress and sustain their business, so we want the management team to monitor that data. A high level of customer satisfaction also increases the value in the market significantly. Factors like margin, sales volumes and pipeline outline the strength of the portfolio company and how well it is doing against the market conditions.”

Partner, Sweden-based PE firm
Data and analytics can drive better outcomes at every stage of the private equity value chain, from management of portfolio companies to better decision-making at exit. But this requires investment both in technology and talent.

### Analytics at the fund level

PE firms are using analytics tools to uncover critical insights on both the way into and out of portfolio investments. While most (87%) of firms say they used analytics to make their latest exit decision, they also point out that most value was created during the diligence process prior to acquisition and in pre-sale preparation at exit.

But many are still working through this process: applying data-driven analytics consistently in their portfolio reviews is still a significant issue for 80% of PE firms — up from 64% last year.

Data standardization is also a challenge for PE firms — working with dozens or even hundreds of portfolio companies across multiple industries, each with their own KPIs and reporting protocols, makes it difficult to get an overall view. However, firms have made progress — 75% of PEs now have access to portfolio management tools that enable them to standardize reporting across the portfolio, while two-thirds (66%) use technology that gives them real-time access to management performance.

### Case study: Read the writing on the wall

One of the world’s largest musical instruments retailers used social media analytics to analyze 600,000 social posts and create a detailed breakdown of its customers. In learning about their customers’ musical preferences by geographic region, the company was able to adjust its inventory by store and better curate in-store displays to increase sales across various regions in advance of the exit.
At the portfolio company level

How can firms use data and analytics to drive EBITDA and growth to position an asset for sale? And how can analytics help sellers present the value story to buyers?

Many firms are improving their use of data, but with tacit acknowledgement that there is room for improvement. Less than a third (30%) say they are very effectively managing portfolio businesses real-time and capitalizing on customer and margin opportunities. Less than a quarter (22%) are very effective at using data tools to position and validate their businesses for potential buyers. For example, social media analytics can be applied to transaction scenarios to uncover and anticipate trends throughout the portfolio. “Social listening” – where data from social media channels are captured and reviewed – can monitor customer buying patterns and preferences, as well as spotting and rectifying reputational risks and customer complaints before they get out of hand.

Giving potential buyers access to portfolio business data makes a big impression. According to 66% of PE firms, providing more detailed information – including the outputs from advanced analytics exercises such as stress testing and predictive modelling – can help underpin the valuation and provide an evidence-based value story during an exit. Sales volumes, customer churn and pipeline are important, but items like customer service and satisfaction – key indicators of both vulnerabilities and success – should also be on management’s radar.
The market continues to offer opportunities to trade assets at attractive valuations, with PEs looking to take a more opportunistic approach to divestments.

However, to maximize value, PE firms will need to be prepared to move quickly when these opportunities present themselves. They also need to be adaptable, as they expect a shift in buyers — including more strategics — competing for their assets.

PE firms are building up their exit playbooks, with more discipline and rigor in the portfolio review process to prepare for their next wave of exits.

In building, executing and monitoring more wide-ranging value creation strategies for each asset, PEs can articulate a detailed value story to buyers.

Analytics is providing a huge opportunity for PE firms, with many only just beginning to tap its potential. Analytics tools provide a way to make more informed decisions throughout the exit life cycle, from identifying long-term growth strategies for portfolio businesses to securing greater divestment value.

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Contacts

To learn more and to have a conversation about your exit strategy, please contact us:

Andres Saenz
EY Global Private Equity Leader
andres.saenz@parthenon.ey.com
+1 617 478 4619

Bill Stoffel
EY Americas Private Equity Leader
william.stoffel@ey.com
+1 212 773 3141

John Van Rossen
EY EMEIA Private Equity Leader
jvanrossen@uk.ey.com
+44 20 7951 6026

Luke Pais
EY APAC Private Equity Leader
luke.pais@sg.ey.com
+65 6309 8094

Andrew Wollaston
EY Global PE Transactions Leader
awollaston@uk.ey.com
+44 20 7951 9944

Chris Le Roy
EY Americas PE Transactions Leader
chris.leroy@ey.com
+1 212 773 5496