How private equity is refining exit strategies for stronger valuations

2021 Global Private Equity Divestment Study

ey.com/divest/PE
PE exit activity is returning with vigor after the dramatic, pandemic-induced capital markets slowdown in the first half of 2020.

Key findings

Factoring ESG into exits

- 72% of PE executives say they expect to capture an ESG premium in businesses they are considering exiting.
- 57% say social impact policy, including diversity and equality commitments, is a critical area of ESG focus in their exits.

Driving value through digitalization

- 52% say digitalization of the business was important to developing their value story and divestment thesis in their last major exit.
- 51% of PE firms regard artificial intelligence as a critical value lever for portfolio companies over the next 18 to 24 months.

Growing focus on tax

- 52% say adjusting tax planning and transfer pricing associated with changes to portfolio company supply chains has the largest impact on structuring of dispositions.
- 65% of PE executives globally expect changes in tax policy to impact the timing of their exits.

Working capital improvements on the agenda

- 58% report they experienced a visibility gap in portfolio companies’ access to capital as a result of the pandemic.
- 31% say working capital and operating cash improvements created the most value in their exits over the last 12 months.

Improving value by refining exit strategies

- 40% say a lack of fully developed diligence materials caused value to erode in their last exit.
- 63% say they are opportunistic about determining the right time to sell.
Market outlook

PE exit activity is returning with vigor after the dramatic, pandemic-induced capital markets slowdown in the first half of 2020.

Half of private equity (PE) executives surveyed are planning exits to public markets through initial public offerings (IPOs) or special purpose acquisition companies (SPACs) in the next 18 to 24 months, according to the EY 2021 Global Private Equity Divestment Study.

PE exits jumped roughly 40% to nearly US$600b during the 12 months ending March 2021, with strength in IPO markets and sales to SPACs contributing to a spike in deal value and volume not seen in a decade, Dealogic data shows. That compares with US$426.7b in PE exits during the 12 months ending March 2020. As the pandemic’s immediate impact recedes, and its long-term effects on consumers, markets and geopolitical trends become clearer, PE firms’ transactions are likely to remain robust given their access to capital. PE, excluding venture capital funds, had approximately US$1.7t in dry powder as of 31 March 2021, according to Preqin.

The study reveals that digitalization of businesses’ operating models or routes to market has become a leading driver of higher deal valuation – more important than proven organic growth. But the study also shows working capital improvements, a traditional value driver, is still key.

Respondents to the survey reveal that PE priorities over the next 12 months are expected to be dominated by the need for accelerated exits. These will all be affected by the impact of the pandemic on the portfolio businesses themselves, their markets, M&A processes and investor appetite. Other changes are afoot, including greater relevance of environmental, social and governance (ESG) factors and tax concerns.
Factoring ESG into exits

As external concerns weigh on decisions in the near term, nearly three-quarters of PE firms (72%) say they expect to capture an ESG premium in businesses that they are considering exiting based on specific ESG qualities.

While social impact policy, including diversity and equality commitments, appears to be the area of greatest focus globally (57%) for PE firms seeking to capture an ESG premium in exits, the value attributed to ESG qualities at point of exit is evolving. Furthermore, PE firms say they are actively courting potential buyers with a strong ESG record to capture a premium. By region, 57% of Asia-Pacific PE firms indicate they are seeking a buyer with a strong ESG record; 50% in the Americas; and 41% in EMEA.
Driving value through digitalization

Digitalization of a business ranked as a critical component of the value story and divestment thesis in the last major exit for 52% of respondents. Arguably accelerated by the pandemic, digitalization is a key value driver that:

- Impacts the operating model, cost base and break-even point for a business
- Enables revenue growth through better customer service, pricing and margin
- Allows new routes to market that expand the addressable customer base

The ability to harness and analyze data to improve automation, strengthen predictability and drive targeted improvement in supply chains, marketing, operations and other areas makes artificial intelligence (AI) an attractive area for M&A. More than half (51%) of PE firms regard AI as an important value lever for portfolio companies over the next 18 to 24 months. In addition to increased automation of processes and controls, AI can also support forecasting and decision-making that directly impact margin enhancement and cash conversion.

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

- Digitalization of the business 52%
- Acquisitive growth 46%
- Strength of the management team 41%
- Product innovation 34%
- Organic growth 27%

Over the next 18–24 months, in which of the following areas will your portfolio companies be focused to drive value? (Select all that apply.)

- Artificial intelligence (AI) 51%
- Supply chain diversification 49%
- Pricing improvement 42%
- New products/geographies 41%
- General and administrative (G&A) cost reduction and outsourcing 37%
- Cybersecurity 35%
- Salesforce effectiveness 28%
- Transfer pricing 18%

Many portfolio companies have learned to operate with an increasingly remote workforce. Among companies that rank security as a top priority, more than half (53%) say cybersecurity concerns are now acute, given the demands of cloud computing, connected devices and the remote workforce.

Portfolio companies are already required to show how their cost profile and revenue growth prospects are likely to trend. Apart from digitalizing their operating models, our experience shows the highest performers are using data analytics to communicate the equity story to buyers. For 45% of PE firms with a primary focus on digital growth, digital analytics are the top priority for their portfolio companies’ digital development. Concurrently, they are investing in centralized data repositories, including data lakes, that enable them to bring insightful opportunities to portfolio companies to improve KPIs or change operating models.
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Growing focus on tax

Tax is a big value driver on exit, and depending on an investor’s rate, tax can either contribute significantly to or sap returns.

Transfer pricing exposures on intercompany transactions ranked highest (41%) among tax items that affected exit value the most. Non-income tax exposures (28%) and income tax exposures (25%) also ranked among tax issues that can reduce value.

Conversely, certain tax planning may enhance the value of a portfolio company on exit. Adjusting tax planning and transfer pricing associated with changes to portfolio company supply chains has the most significant impact on how dispositions are structured, according to more than half (52%) of respondents. Delivering a step-up in the tax basis of assets (43%), efficient placement of bank and shareholder financing into a structure (38%), post-close restructuring (34%), and simply remediating or indemnifying tax exposures before a sale (33%) also rank as levers for tax-efficient dispositions.

65%

of PE leaders now expect changes in tax policy to impact the timing of their exits.

Given the current political climate in the US, with anticipated tax increases that may influence other countries, two-thirds (65%) of PE leaders now expect changes in tax policy to impact the timing of their exits.

Which potential tax items have affected exit value the most? (Select all that apply.)

- Transfer pricing exposures on intercompany transactions: 41%
- Inability to repatriate cash proceeds (e.g., through a holding company structure) in a tax-efficient manner: 39%
- Nonresident capital gains or withholding tax imposed on exit: 37%
- Use of tax receivable agreements: 30%
- Non-income (VAT, sales and use, social, payroll, etc.) tax exposures: 28%
- Income tax exposures: 25%

Which tax items have the largest impact on how dispositions are structured? (Select all that apply.)

- Adjusting tax planning and transfer pricing associated with changes to portfolio company supply chains: 52%
- Delivering a step-up in the tax basis of the assets: 43%
- Pushing bank/shareholder financing into the structure in a tax-efficient manner: 38%
- Restructuring planned for post-close: 34%
- Remediating or indemnifying pre-close tax exposures: 33%
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Working capital improvements on the agenda

The pandemic exposed some portfolio companies’ structural weaknesses and, according to 58% of respondents, required fast action to access capital. This included bridge loans and temporary credit facilities as markets and supply chains seized up. Also, 44% of PE firms reported a visibility gap in linking profits to cash flow.

Nearly a third (31%) of PE firms say improvements in working capital management and EBITDA cash conversion formed the basis for significant value on exit, ranking ahead of organic and inorganic growth and manufacturing cost improvements.

Working capital optimization continues to take center stage in successful exit preparation. Nearly two-thirds of PE firms (63%) rank it among the top three factors of importance to their exit strategy. The focus on working capital is expected to continue in PE exits across sectors facing significant disruption, including entertainment, tourism and energy.

Improving value by refining exit strategies

When the right deal comes, moving fast may be as crucial as a well-developed and data-backed exit equity story for the business.

Nearly two-thirds (63%) of PE firms say they are opportunistic in terms of choosing their exit timing. However, most of the causes of value erosion point to the need for speed to execute the exit over the readiness of the business and its management.

Forty percent of PE firms cite a lack of fully developed diligence materials, including product/service road maps, as a source of value erosion that leads buyers to reduce price. Other areas of negative impact on exit value include a high level of debt (36%), deteriorating performance (35%) and lack of time to manage the process with buyers (35%).

Thinking about your exits over the last 12 months, which pre-sale initiative to improve business performance created the most value? (Select one.)

- Made working capital and operating cash improvements: 31%
- Grew organically through product/service innovation or channel expansion: 14%
- Formed new alliances, agreements, acquisitions, partnerships or JVs: 13%
- Manufacturing cost improvement (lean, plant rationalization, etc.): 11%
- Expanded digital operations: 9%
- Reduced personnel costs by rightsizing and/or outsourcing: 8%
- Improved systems and technologies: 7%
- Reduced third-party spend through strategic sourcing: 5%
- Made additions to the management team: 2%

What caused value erosion in your last exit? (Select all that apply.)

- Lack of fully developed diligence materials (including product/service road map), leading buyers to reduce price: 40%
- High level of debt in the target/significantly high financial leverage: 36%
- Performance of the business deteriorated during the exit process: 35%
- Lack of time to manage an effective process with buyers: 35%
- Lack of preparation in dealing with tax risk: 31%
- Lack of flexibility in structure of sale: 20%
- Limited number of buyers: 4%

When do you determine the right time to sell?

- Opportunistic (e.g., right before sale): 14%
- Two years before a sale: 22%
- One year before a sale: 63%
- At purchase: 1%
Conclusion

Significant short-term uncertainty and market volatility have changed the divestment landscape for PE owners. They are actively in a phase dominated by opportunistic exits while buyers seek out quality assets and capital markets are buoyant.

The pandemic effect is still playing out – both short and long term. It has accelerated changes in attitudes to factors that are now affecting the attractiveness and valuation of businesses – notably digitalization and ESG metrics. But traditional factors remain important, including tax and cash – they remain kings.

By continually refining and changing, PE firms have reacted fast to the pandemic and are now well positioned to build strong valuations and achieve exits that take advantage of the market conditions.

About the 2021 EY Global Private Equity Divestment Study

This annual survey of more than 100 private equity executives from around the world is conducted by Thought Leadership Consulting, a Euromoney Institutional Investor company. The survey gathers their perspectives on exit strategy, preparation and execution.

PE participant profile:

- Results are based on an online survey of 106 global PE executives conducted between February and March 2021.
- Nearly all (90%) of respondents are PE deal professionals, from firms across the Americas (38%), EMEA (32%) and Asia-Pacific (30%).
- More than two-thirds (67%) of respondents’ firms have US$30b or more in assets under management (AUM).
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