Private Equity:

A victim of its own success?

onefourzero

Looking back on the mid market investment year 2016-17

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The continued fall out of the financial crisis combined with a year of political uncertainty across some of the biggest markets in the developed world have altered the characteristics of M&A activity.

Politics and Interest Rates

The political change we have seen worldwide over the last year not only stifles economic growth but feeds uncertainty in the markets. Uncertainty breeds stock market volatility, which, in turn, inhibits IPO activity.

Interest rates have also been at record lows since the financial crisis of 2008 to encourage borrowing for investment and spur growth. This means that investors have been attracted to the long-run, double digit returns of the private equity asset category, and you can see why - private equity investors have seen annualized returns of 16.4% since FY 2014-15.

These new market entrants have contributed to the $681bn record amount of capital committed last year to traditional funds, co-investments, separate accounts and direct deals.

And this shows no signs of slowing; investors have a healthy appetite for private equity, with 84% having a positive perception of it, greater than any other asset class. Indeed, 95% of investors believe that their private equity portfolios have met or exceeded performance expectations over the past 12 months and nearly half plan to increase their allocations to the asset class.

Similarly, Venture Capital investment reached record highs for the second year in a row last year, surpassing $100bn.

Victims of their own success?

In some ways, both private equity and venture capital funds have been “victims of their own success” by outperforming other asset classes.

More participants and increasing allocations to private equity combined with a dearth of available assets are driving up competition in the market. The levels of capital raised are increasing, in conjunction with the relative ease at which GPs can borrow, due to the low interest rate environment.

Market research company, Prequin, estimates that $167.8bn was raised during 2016 in private equity worldwide. This was the highest level of 'dry powder' - highly liquid cash-like assets - since the 2008 peak.

The abundance of capital is resulting in higher prices for assets with their returns bid down. Good deals are harder to find and even harder to close. With limited external sources of growth (market beta), such as GDP, and while the deal exit rate has finally adjusted to a new normal since the financial crisis, the M&A market has been characterised by restraint.

As a result, fund managers are holding on to assets for longer and are taking the time to improve their assets. Therefore, the last few years have been typified by fewer 'quick flips' and more median holding periods of around five years, compared to a pre-crash average of three years. Quick flips comprised only 18% of all buyouts in 2016 in comparison to 44% in 2008, according to a market report by Bain.

More competition, more caution

The margin for error is as small as it's ever been, but the increasingly competitive market driven by the dry powder increases the need for speed in critical diligence without compromising on accuracy.

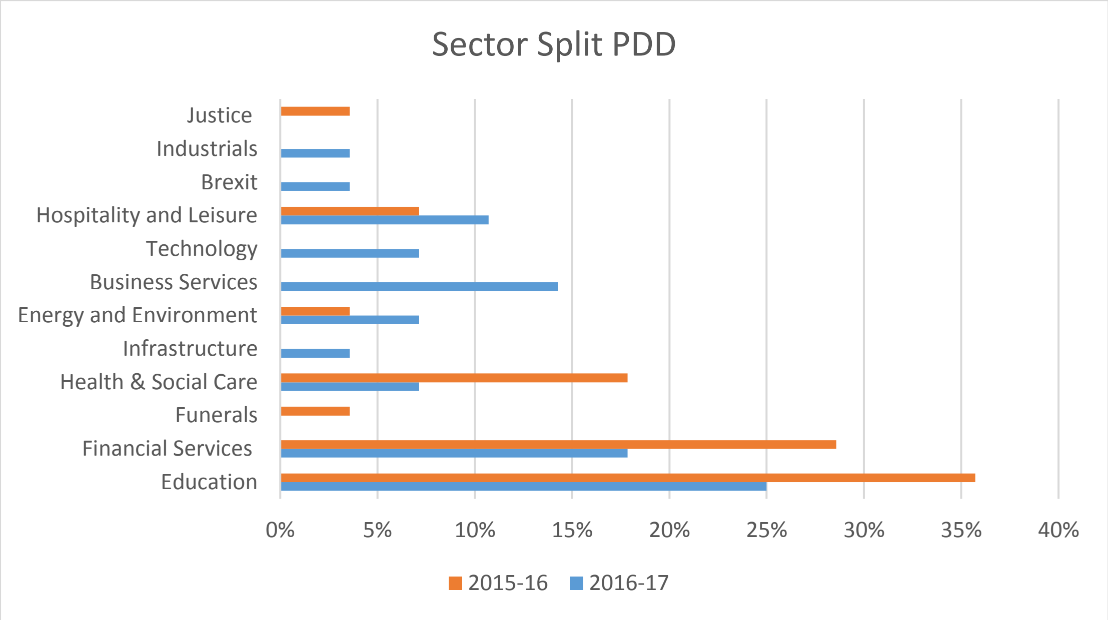
To quote a recent article in Forbes, "If a private equity fund underestimates full potential, it will lose the deal in a highly competitive bidding environment. If it overestimates, the fund may win the auction, but the deal will not deliver the anticipated returns".

Furthermore, the divergence between the vast capital reserves held by funds and number of deals closed may be set to continue in a self-fulfilling spiral; the less capital expended, the greater the upward pressure on prices, the more cautious fund managers will be when spending funds.

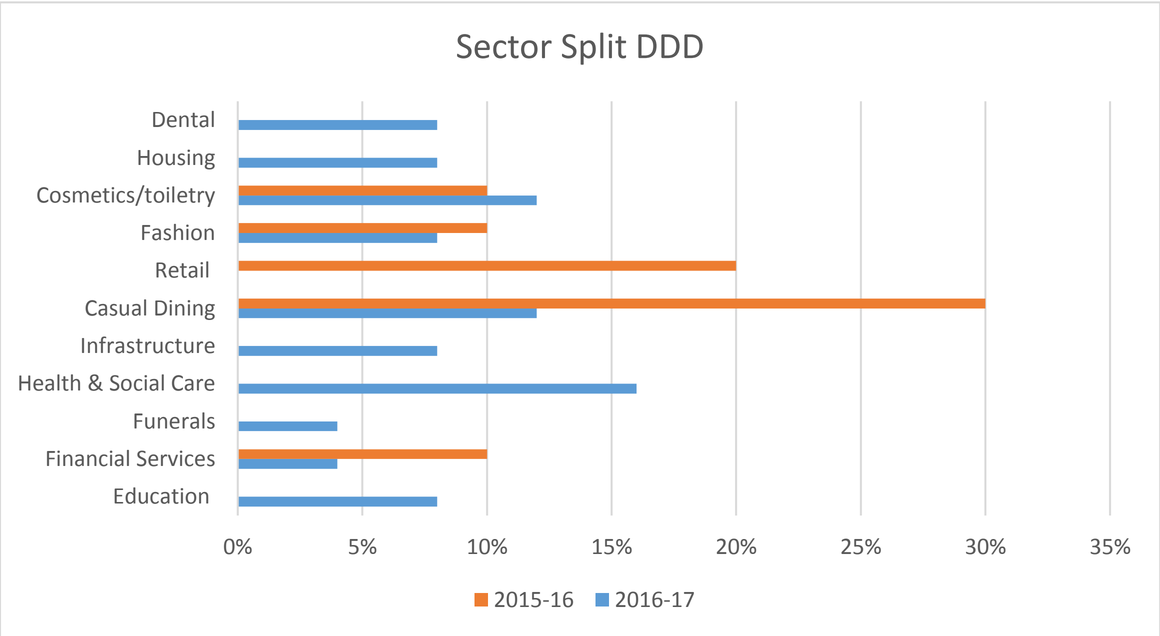
In this restrained climate, there is increasing focus on objective and comprehensive due diligence.

The increasing need for detail in the diligence process has seen the rise in importance of the quality of Commercial Due Diligence (CDD) and Operations Due Diligence (ODD), and the emergence of a new work stream: Digital Due Diligence (DDD).

Looking at the projects completed over the past two years by our sister agency, GKI, who specialise in Political Due Diligence, highlights a drop in volume but a diversification in the focus of projects. There were fewer deals, but the diligence was more detailed and we were often brought in before exclusivity, indicating a higher degree of caution from investors amid more turbulent political times.



The trend for increasingly detailed due diligence and development as digital as part of the operations or commercial work-streams is demonstrated by the increase in digital projects commissioned by the private equity community. The competition and uncertainty plaguing the mid-cap deal markets is evidenced by the sector diversification from the previous financial year to 2016-17.



So what is Digital Due Diligence?

It's the step beyond digital monitoring that applies strategy and commercial thinking to all areas of a business.

DDD involves looking at online search and traffic data, platform analysis and social sentiment on social media to provide comprehensive analysis of an asset's market share, brand equity, marketing effectiveness and conversion.

In the context of the Private Equity world, it feeds into Financial, Commercial and Operations Due Diligence on both the buy and sell side by revealing new verticals, audiences and opportunities and modelling and forecasting potential revenues from this expansion.

The current competitive climate has seen DDD being brought in earlier on in the deal process, and as part of the ODD and CDD work stream.

Similarly, longer holding periods call for monitoring measures to be taken after the sale of an asset. Digital post-sale consulting helps maintain a commercial eye on performance against competitors and can be used to inform a productive 100 day strategy as well as longer term planning.

The turbulent macro-economic climate coupled with limited opportunities for organic growth means that nothing can be left to chance. Evidence based approaches relying on big data and insights are the only means to uncovering and realising potential growth.

2016-17 has seen DDD used in an increasing number of transactions for online and offline assets and this year will only see that grow.

By not considering digital in your suite of diligence tools, you are playing one card short of a full deck. This will only result in basing investment decisions on an incomplete picture.

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