Adams Street

Buyout Managers Can't Lean on Leverage Amid Higher Rates, Slower Growth

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KEY TAKEAWAYS

- Rising interest rates aimed at curbing generationally high inflation are contributing to a slowdown in growth, creating headwinds for buyout portfolios.
- Buyout managers who have relied on leverage to generate returns are more likely to be negatively impacted in a rising interest rates, slower growth environment.
- Buyout managers who focus on scaling companies through growing revenues, improving EBITDA and operational efficiency are more likely to outperform.
- The outlook for new buyout investments is likely to improve towards the end of 2023 as sellers rein in their valuation expectations.
- Exit opportunities are expected to remain muted for several quarters.

While buyout managers enjoyed a 13-year tailwind from accommodative monetary policy following the Global Financial Crisis (GFC), the rapid rise in interest rates during 2022 created a headwind for portfolio valuations, liquidity, and new deal activity.

As in prior cycles, we believe buyout managers who have relied on high leverage for return generation are likely to see a disproportionate negative impact on returns.

In a higher interest rate environment, our expectation is that buyout returns will increasingly be driven by growth in revenue and earnings before interest, taxes, depreciation, and amortization (EBITDA). Such an environment favors managers who are deep sector specialists and have the capability to improve portfolio company operations.

‘Sticker Shock’ Slows Buyout Activity

Buyout deal activity began to slow in the second half of 2022, following record levels in 2021 and early last year (see Figure 1). A key reason has been a wide bid/ask pricing spread between buyers and sellers of private companies, which often occurs following public market corrections when private market valuations are adjusting. The higher cost and more limited availability of credit from banks and other lenders also contributed to the slowdown.

Figure 1: Global Buyout Deal Value Slowed in 2022 From Record Levels[1]

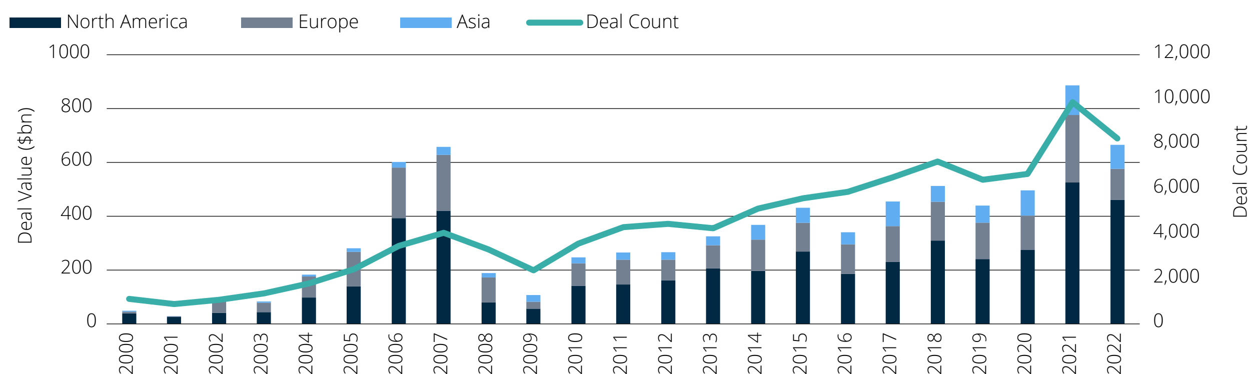
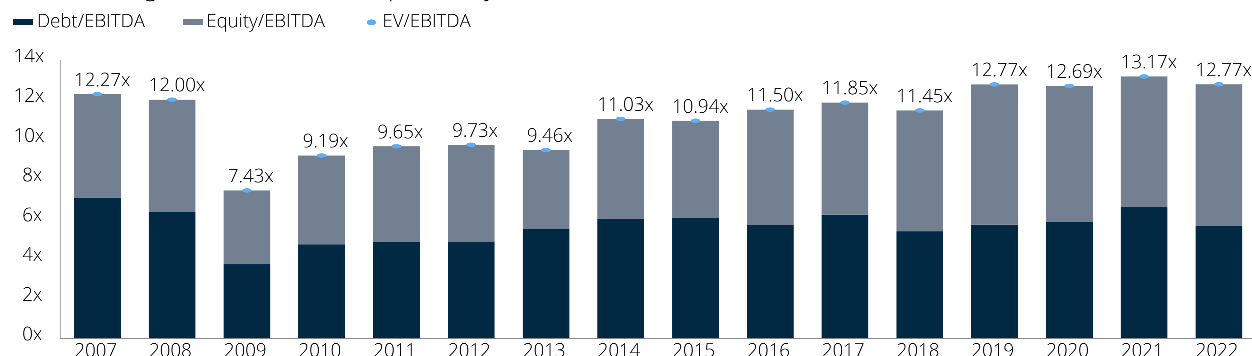


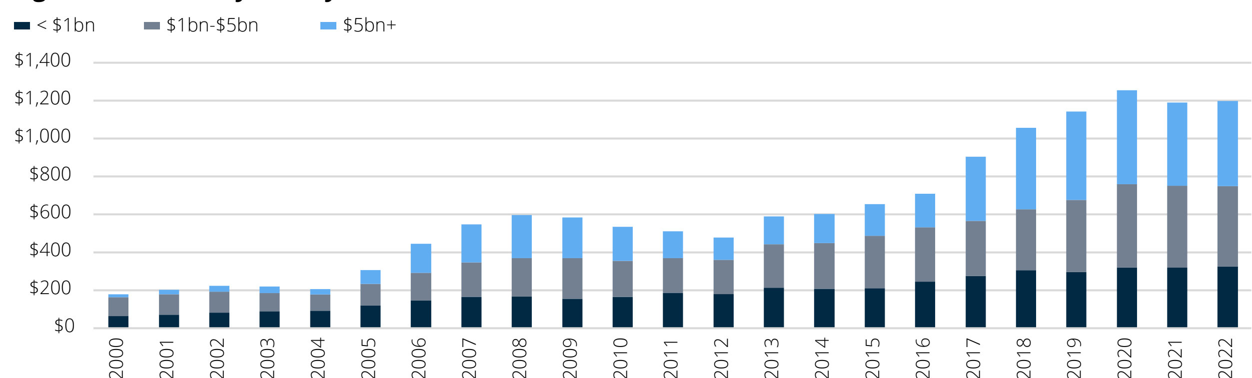
Figure 2: Buyout Valuation Multiples Remain Elevated[2]

Sustained high valuations over the past few years amidst a historic bull market



Despite this, valuations for buyout deals completed in 2022 remained elevated compared with prior years (see Figure 2). We suspect this is because only the highest-quality companies were sold, and because valuations were bolstered by significant dry powder in the industry (see Figure 3).

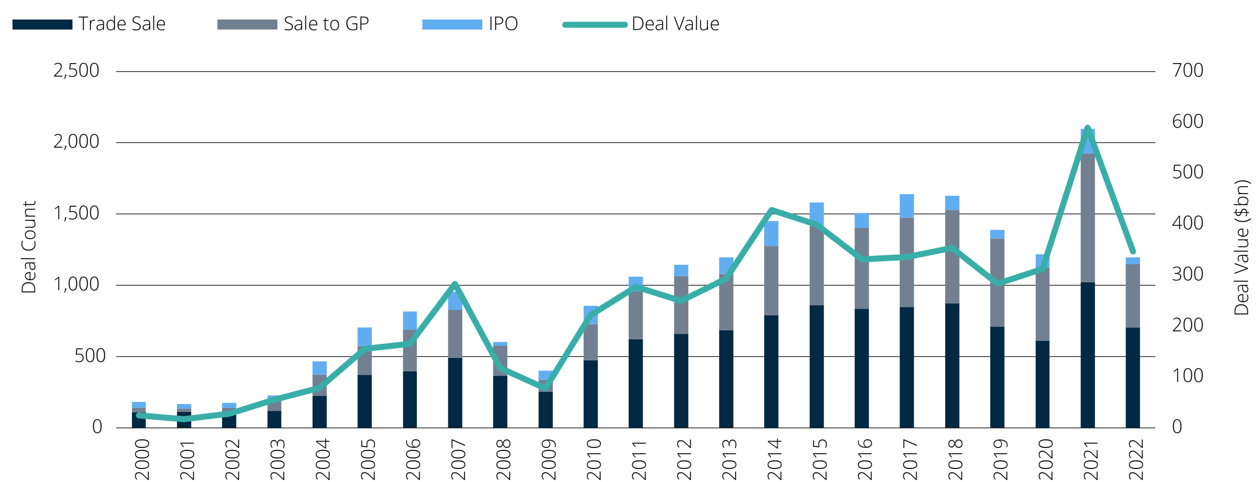
Figure 3: Global Buyout Dry Powder Hovers Near Record Levels[3]



For similar reasons, exit activity globally also slowed significantly in 2022, from record levels in 2021, indicating that buyout sponsors are content to hold onto assets until the environment improves (see Figure 4).

Figure 4: Significant Pullback in Exit Activity in 2022[4]

Exit activity has slowed in response to market volatility and limited appetite for public listings



At an operational level, fundamental revenue and EBITDA growth across Adams Street's portfolio companies continues generally to be strong. However, there are indications that certain companies are seeing a slowdown in orders, resulting in some softening in revenue growth, while higher labor costs are putting pressure on margins. It is also becoming more difficult to pass through price increases.

Higher Leverage, Lower Cash Flows

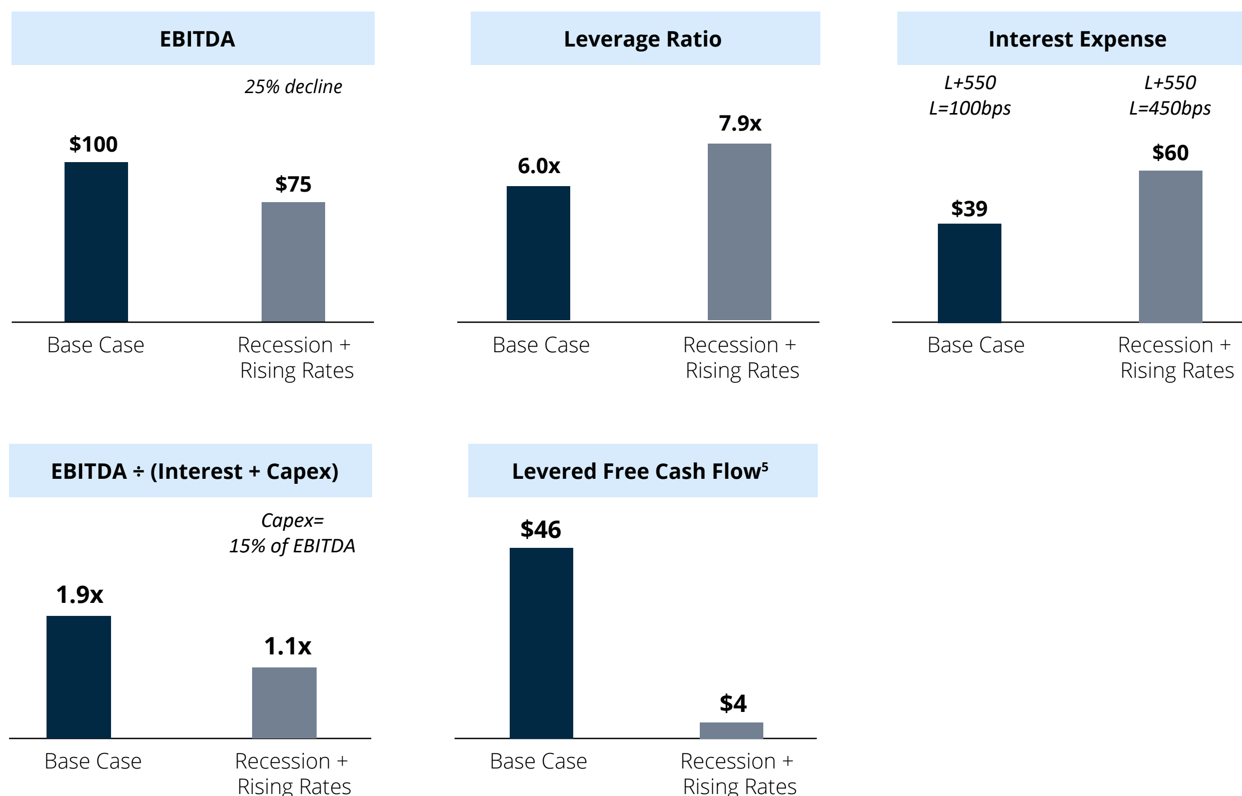
Change has arrived swiftly after more than a decade of monetary and fiscal stimulus that contributed to sustained economic growth after the GFC. Many developed countries have seen base rates rise significantly over the past year, meaningfully lifting the cost of debt capital for buyout transactions, which typically use floating rate loan structures.

Higher debt service costs put downward pressure on cash flows for buyout portfolio companies that use leverage, and the impact is pronounced for more highly leveraged companies. Surging interest rates also function as a governor on the availability of debt in leveraged buyout (LBO) transactions, lowering the prices that buyers are willing — and able — to pay.

Figure five highlights the impact on a hypothetical LBO transaction when EBITDA declines by 25% and rising interest rates lift the cost of debt. The analysis assumes a debt to EBITDA ratio of 6x, in line with the industry average over the past several years. If EBITDA drops 25% and the cost of debt increases to above 10% for senior debt, the impact on leverage ratios and cash flows is dramatic. Leverage ratios climb to almost 8x, while free cash flow is barely positive.

Figure 5: Lower EBITDA, Higher Debt Service Costs Erode LBO Returns

The combination of a recessionary environment with rising interest rates creates challenges on "LBO math" → significant pressure on cash flow generation and potential returns



In a slower growth or recessionary environment, we would expect many companies to face cash flow issues if performance softens, particularly in cyclical sectors that are interest rate sensitive. Higher leverage ratios and lower cash flows also make it more difficult for companies to finance acquisitions.

Buyout Outlook – Improving Deal Flow, Muted Exits

As buyer and seller expectations converge, we expect to see valuations becoming more attractive, boosting deal flow. Most of our GPs tell us that they expect deal flow to pick up more broadly in the second half of this year.

On the exit side, we expect activity to remain muted this year due to the current disconnect between buyer and seller valuation expectations, and to broader market uncertainty, which makes buyers more hesitant. In addition, a number of exits were pulled forward into 2021 and early 2022 as investors exited many of the highest-quality companies ahead of plan. In 2021, Adams Street generated record distributions across its global primary buyout portfolio, in an amount that was almost double the level we would normally expect.[6]

Fundamental, Growth-Oriented Focus

At Adams Street, we seek to generate consistently attractive performance by investing with the highest quality managers, who generate value at their companies largely through fundamental performance and growth versus reliance on leverage to drive returns. Such companies often possess the following traits: revenue growth in excess of their sector and competition; pretax cash flow margin growth that matches or exceeds revenue growth; and the potential to graduate to a higher valuation multiple category due to increased scale.

We believe this strategy positions us to perform well across cycles, including through uncertain times like today. We have a long-standing emphasis on managers that are real sector specialists in areas with strong secular tailwinds, such as recurring revenue software and healthcare. In addition, from a portfolio construction standpoint, we are overweight smaller to mid-market funds within our thematic areas of focus, because these funds often have companies with lower entry valuations and higher growth profiles that provide more opportunity for upside.

As the tide turns, buyout managers can no longer rely on low cost leverage or monetary and fiscal stimulus to bolster their performance. We believe an unerring focus on growth and improving business fundamentals, rather than significant leverage, will be an important difference maker. ■

1. Source: Preqin data as of December 31, 2022. Global refers to North America, Europe, Asia. Preqin accessed March 11, 2023.
2. Source: PitchBook's 2022 Annual Global M&A Report. Data as of December 31, 2022.
3. Source: Preqin data as of February 2023. Includes North America, Europe, Asia, Africa, Australia, Middle East & Israel, and Diversified Multi-Regional.
4. Source: Preqin data as of December 31, 2022. Global refers to North America, Europe, and Asia.
5. Levered Free Cash Flow represents EBITDA less capital expenditures and interest expense.
6. Distributions are not necessarily an indication of overall return and past performance is not a guarantee of future results.

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