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2023 and Beyond: Private Equity Outlook for 2024

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Introduction

The global private equity (PE) industry, after enjoying record-setting years in 2021 and 2022, is now facing macroeconomic headwinds. Inflation and related rising interest rates, a tight labour market in the case of the United States, more robust anti-trust enforcement in various jurisdictions, as well as geopolitical uncertainty, and valuation expectations that do not yet reflect the economic realities of the moment have together served to slow PE deal activity. Through the first half of the year, 2023 PE deal activity in the United States, Europe, and Asia lags behind that of 2021 and 2022 in terms of deal count and deal value. Similarly, fundraising activity is down overall in 2023 so far. However, even as the deal environment is proving challenging, PE sponsors continue to hold record amounts of dry powder to deploy.

In this environment, PE sponsors have increasingly focused on platform balance sheets and more distressed sectors and companies, made use of consideration-deferment methods and more frequently turned to alternative sources of capital to complete transactions. In 2024, creativity and agility will continue to be key for PE sponsors to identify and win investments and to realise value.

Trends in the PE Market

The PE market focuses on restructurings

As a result of the current deal environment, PE sponsors have sharpened their focus on the liquidity of their existing portfolio companies. Higher borrowing and labour costs have left companies with floating interest rates and borrowing arrangements unprepared for the levels of cash-burn that we are presently seeing, forcing PE sponsors to concentrate their efforts on portfolio assets that can meet their capital requirements during this period of expensive debt. An increased demand for liquidity has in turn led to the question of how much support PE sponsors will give portfolio companies through capital injections (and if they will be willing to do so without a short-term positive return). Increasingly in some cases, restructuring is being seen as a viable alternative solution.

Businesses in sectors that have pricing power, and which are able to pass on increased costs of inflation to their customers, are in a better position, but those that cannot pass along such costs may benefit from a restructuring that deleverages their balance sheets. For this reason, some PE sponsors that focus primarily on restructuring and distressed businesses have sought more control opportunities in operationally sound businesses, particularly in sectors with higher cost structures, that struggle to pass costs related to wage pressures and inflation to end-consumers. PE sponsors operating in this space have focused particularly on the healthcare industry, due to the continuous pressure from increasing wages, lower reimbursement rate and regulatory uncertainty. Other sector focuses have included packaging businesses, airlines, real estate, and industrial businesses. In pursuing these opportunities, PE sponsors anticipate that, through the headwinds, these businesses have solid operational and management expertise and ample liquidity and resources to go through a restructuring process that will help ensure that the balance sheet and capital structure are set up for success. With the opportunities that distressed businesses present to PE sponsors, what will remain a challenge throughout 2023 and into 2024 is distinguishing which businesses present a successful opportunity and which will simply need to be managed, while ensuring that management can adapt to these new environments.

Bridging valuation gaps

One of the features of the present deal environment is buyer and seller disagreement on valuation. PE sponsors can try to resolve these disagreements by deferring some of the consideration offered. This deferment can take the form of an earnout or, somewhat more rarely, seller financing.

In transactions involving earnouts, sellers accept a mix of consideration that includes a contingent right to receive consideration in the future based on the performance of the acquired company. By contrast, in transactions involving seller financing, buyers issue promissory notes to the seller to cover a portion of the transaction consideration. In each case, part of the consideration is deferred. However, in the case of an earnout, the deferred consideration is typically contingent on the achievement of specific levels of performance by the acquired company, while seller financing is typically not conditioned in this way.

Seller financing has an additional potential benefit, particularly in the context of sales of distressed assets, in that should

the acquired business fall into bankruptcy, the seller as a creditor stands in line to collect the proceeds of any liquidation (where the seller stands in the line depends on whether its note is subordinated and/or secured (and if secured, on the nature of the lien)).

Between 2016 and 2019 (i.e., before the economic impact of COVID-19), roughly 16% of private sales of U.S. companies or businesses publicly disclosed in SEC filings included an earnout, rising to 21% during the high-inflation period beginning in 2022 to the present. While not as common, from the beginning of 2022 to date, roughly a dozen deals publicly disclosed in SEC filings have included some seller financing, usually in the form of a promissory note.

By pushing payment of some consideration into the future, buyers and sellers are able to bridge valuation gaps and navigate rough financing waters. This can help PE sponsors acting as buyers to decrease their capital costs in this less-attractive financing environment. Sellers, for their part, can enjoy higher valuations and a chance for more overall consideration. However, these tools, especially earnouts, increase the likelihood of post-closing disputes, so the deal parties – sellers in particular – have an interest in setting earnout targets, calculation methodologies and related efforts standards as clearly and unambiguously as possible in the deal documentation.

Private credit still growing

While the uncertain availability of debt financing was one of main factors leading to reduced deal flow in the PE industry in 2022, private credit's impact on PE continued to grow, modestly in absolute terms but significantly as a share of the overall debt market in the context of the aggressive pullback by traditional lenders. The flexibility and relative speed of private credit had already proved its value to PE sponsors in the middle market over the last several years, leaving private credit uniquely positioned to compete with traditional lenders and make a push into the larger-cap deal space as larger deals faced financing headwinds in the credit crunch of 2022 and rising interest rates. With more streamlined facilities that do not depend on syndication (though private credit group deals are also a growing trend), private credit has been an attractive solution for PE sponsors in the uncertain deal ecosystem of 2022 and early 2023, even for deals of sizes that historically were the exclusive purview of large banks.

This general growth trend was confirmed by the respondents to a recent Dechert survey, the majority of whom said that their firms' use of private credit financing has increased in the past three years. Other industry surveys also indicate that 2022 saw an 89% year-over-year increase in private credit investment in emerging markets, while private credit fundraising managed to avoid following other asset classes into decline in 2022, posting about 2% growth for the year.

Notwithstanding recent PE deal volume contraction, the historic levels of dry powder in the private credit industry are poised to be deployed. This strong position for private credit lenders is coupled with the unexpected bank weakness in the higher interest rate environment as evidenced by the bank failures of early 2023. If the uncertain time for banks makes traditional lenders more cautious as the recovery in deal flow picks up pace, private credit should have an opportunity to take even more market share in the PE debt-financing space. That said, the optimism for private credit is checked in the short term by some unease among investors about how this yet-untested industry would handle an economic downturn if one does ultimately materialise in the broader economy and brings with it borrower defaults and credit downgrades.

Outlook

Notwithstanding the slower first half of 2023 in terms of global deal count and, to a greater extent, deal value, the combination of historic amounts of PE sponsor dry powder, the dynamism of credit markets and availability of strong operating businesses with challenged balance sheets creates capacity for investment through the rest of 2023 and beyond. By focusing on strong, if distressed, platforms and other businesses, deploying consideration-deferment methods, and innovatively sourcing capital, PE sponsors can realise value and secure attractive returns for their limited partners.

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