KEYNOTE INTERVIEW

Driving value during extended hold periods

Private equity firms are strengthening and leveraging their internal skill sets and focusing on value creation within their tech portfolios while they wait for exit conditions to improve, says Baker McKenzie's Eric Schwartzman

Q How is the current exit environment impacting the way PE firms approach value creation within their tech portfolios?

Deal volumes and values are down significantly from their peak in 2021. Data from S&P Intelligence shows global PE exit values totaled $81.2 billion in the first quarter of 2024, marking the lowest quarterly total since the onset of the covid-19 pandemic. Such a drop is partly a reflection of recession fears and partly due to increased interest rates, both of which have made financing deals more expensive and valuation discussions more challenging.

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Against this backdrop, sponsors are focusing on creating value in their tech-focused portfolio companies while they wait for the exit environment to improve. They are looking to streamline expenses and drive growth, with a focus on creating upside during what may be an extended holding period while also being able to demonstrate continued upside for the next owner or investor.

Q What value creation levers are at firms' disposal?

Tech innovation and enhancement are paramount. While that encompasses the use of technology to improve a business, in the context of tech companies specifically, it means creating better products and services. There has been a pullback in IT spending over the past couple of years due to recessionary concerns and high interest rates. Once those pressures abate, PE funds and their portfolio companies that have focused on improving products and service offerings will be well-placed to benefit from pent-up demand in the market, capture increased IT spend and drive value creation.

This segues neatly into the next value

creation lever, which is sales and revenue optimization. Firms are focusing on building and professionalizing their sales teams, which is directly linked to price optimization. They are also using every bit of data available to price their product or service appropriately.

Perhaps the most interesting value creation lever available to tech companies right now is the ability to improve profit margins by monetizing data. Tech companies hold huge swathes of data about their customers and markets. Selling that data to third parties comes with challenges in terms of ascertaining how much the data is worth and navigating legal complexities surrounding privacy laws and cybersecurity. If successful, data monetization strategies can be a major driver of revenue and growth.

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Q To what extent do you expect M&A to be a part of value creation strategies?

Add-on acquisition targets typically trade at lower multiples to the platform so can be immediately value-accretive, and they are often easier to finance. Buying smaller competitors also allows firms to increase market share and earnings, while vertical consolidation can increase efficiencies and lower costs.

However, there are challenges associated with these transactions. There is always the question of where the capital to fund these deals will come from: will it come from the platform company, or will the sponsor contribute more equity? And then there are integration issues to consider. IT systems, ordering systems and customer and supplier contracts all need to be integrated. Working with advisers that can help support that process is critical.

Antitrust has also become an increasingly significant challenge for the private equity industry. When it comes to evaluating add-ons, antitrust issues will always be a consideration because the platform is expanding its footprint.

Another M&A value creation opportunity is to take advantage of the global stage, not only by looking at targets in other regions of the world but by building cross-border, multi-jurisdictional platforms. Portfolio companies that can scale globally can drive growth and exit opportunities. Of course, to execute on such a strategy, sponsors and their advisers need to appreciate a patchwork of regulatory regimes, data privacy laws, local employment laws and the like to avoid execution pitfalls.

Q What role do you expect artificial intelligence to play in value creation?

AI has an important role to play in helping companies become more efficient. AI companies represent potential investment targets for private equity firms, either at the platform or add-on level, and AI itself can be a phenomenal driver of growth for PE firms when used internally.

It will be interesting to see how sponsors leverage the power of AI within their own organizations. There is a lot of work being done around the use of AI to analyze the vast amounts of data private equity firms process; to assist in forecasting; to sift through potential targets in a specific field; to decide which industries to pursue; and to carry out financial modeling.

The risk, of course, is that when garbage goes into the system, garbage comes out. You must have reliable inputs and professionals who are skilled and experienced to make judgment calls. With that, I believe the use of AI within PE firms represents a huge opportunity and we are watching such developments with interest.

Q What resources and expertise do private equity firms have to execute on these value creation strategies?

In addition to financial engineering, PE firms now know they need to be partners with their portfolio companies, not just to win deals but to help create value for their LPs. As a result, sponsors have brought in seasoned industry experts and many have developed dedicated portfolio support teams.

We have also witnessed a move towards greater sector specialization. For example, there are funds that focus purely on software-as-a-service (SaaS) or telecom deals where the teams have developed a playbook for operating within those spaces and can leverage their sector expertise to help new portfolio companies grow.

This level of specialization and expertise is not limited to the big buyout houses. Small-cap and mid-market funds are often very resourceful and can be nimble value creators, particularly when operating within a specific niche.

Q To what extent do you see tech playing a pivotal role in value creation in all portfolio companies, rather than just within the tech vertical?

I think all companies can be considered tech companies. The vast majority of companies use technology to develop or deliver their products or services, as do their suppliers and customers. By extension, that means all companies are global, because technology enables you to deploy your product or services anywhere in the world. Technology is therefore impacting the entire business landscape and has a pivotal role to play in creating value across sectors. ■

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