PE gets ready for game day

M&A trends in private equity

Q2'23

kpmg.com

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Introduction

Building value in a quiet M&A marketplace

More than a year of interest rate hikes has put about a third of private equity returns at risk. Uncertainties about where rates and the overall economy are headed, and other pressures, including banking leverage conservatism, higher costs of labor, energy and other costs, have slowed the pace of mergers and acquisitions.

Valuations are coming down from market highs in 2021 and exit levels are the lowest since the pandemic struck. The number of exits went down 12% from Q1 to 247 and down 29% from the same quarter in 2022.

While deal making has slowed to a crawl, many PE portfolio companies have stuck with their original deal theses and are now as busy as ever strengthening themselves via buy and build acquisition strategies; add-on transactions represented 48% of all deal value. In addition, they are using their own capital, since lenders have become more cautious, and focusing on integration, cost containment, and working capital management.

Private equity leaders know that the most anticipated recession in history may soon be behind us, and that buyers will emerge as the market stabilizes, running hard at high-quality assets as they need to deploy capital.

"The question is whether PE firms will be positioned properly in time for the anticipated thaw," explained Dean Bell, Market Activation Leader, Deal Advisory & Strategy at KPMG.[1]

In this report, we take deep dives into three PE teams' efforts to create value now in their portfolio companies as holding periods have become extended.

In an uncertain marketplace where lenders are more cautious, many PE firms turn to performance improvement to create value

Inflation appears to be easing but remains high enough that the Fed may keep raising interest rates, leaving some observers with continuing concerns about a possible recession.

Banks remain cautious, for example, making it more difficult for some PE firms to fund deals. Until interest rates stabilize and normal debt and lending conditions return, we expect many PE firms to create value by improving the performance of portfolio companies.

The number of PE exits continued to fall, declining from 281 in Q1 23 to 247 in Q2. Of those deals, 33 percent were sponsor-sponsor and 45 percent were sponsor-corporate. We expect this trend to continue until macro conditions improve and valuation pressures ease (Exhibit 2).

Joe Hartman
Partner
Deal Advisory & Strategy
PE Leader

Q2'23 highlights

1,594 deals

▼17% decrease QoQ

5,018 total deal volume (PE+strategic)

32% PE deals as a % of overall volume

Exhibit 1. PE deal activity by sector (# of deals)

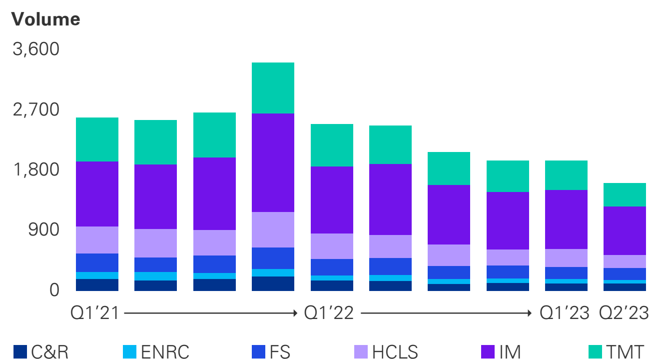
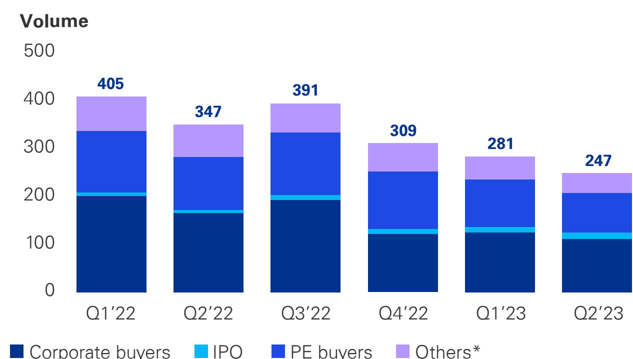


Exhibit 2. PE exits by buyer type (# of deals)



* Others include: buyout, secondary buyout, investor buyout by management, merger of equals, reverse merger, and secondary offering

[1] For more on how KPMG experts are helping PE clients think about an economic rebound, please see our June 2023 webcast, "Anticipating the M&A thaw."

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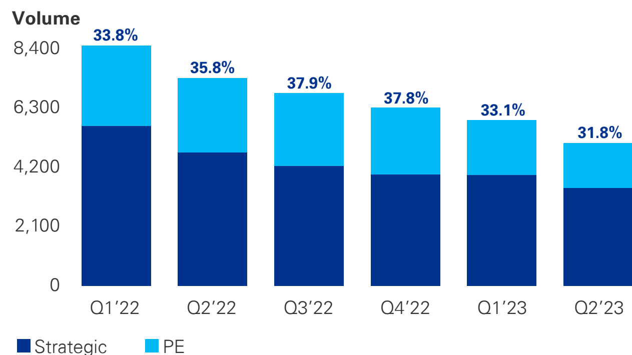
Exhibit 3. PE deal volume



On the Apollo Global – Arconic deal
As aluminum continues to win share in markets seeking sustainable, high-performing material across a wide variety of applications, we believe there is a strong runway for growth in markets throughout the world."

—Gareth Turner, Partner at Apollo Global Management

Top PE deals

Acquirer	Target	Rationale	Value (billions)
Elliot Investment Management, Patient Square Capital, and Veritas Capital	Syneos Health	Expedite Syneos's growth plan, improve customer service, and transition to more tech-driven company	$7.1
Brookfield Infrastructure Partners, Ontario Teachers' Pension Plan	Compass Datacenters	Enhance Compass's ability to cater to the expanding demand for hyperscale data centers and campuses	$5.5
Apollo Global Management	Arconic	Invest capital in Arconic to maintain its competitive edge and offer excellent products, fortifying its position in the market.	$5.2

Deal data has been sourced from Pitchbook and KPMG analysis and excludes asset purchases/minority purchases. Q2 2023 covers all U.S. deals announced from April 1, 2023 to June 30, 2023. Deal values are presented based on publicly available deal data and might not be exhaustive. Previously published statistics may be restated to incorporate new data and/or any changes.

On the Brookfield Infrastructure – Compass Datacenter deal
The need for data storage continues to grow at an exponential rate across the globe, and Compass complements our existing platforms in South America, Europe and Asia Pacific."

—Sam Pollock, CEO at Brookfield Infrastructure

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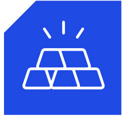
Deep dive



Value-creation opportunities abound in portfolio companies

Many PE companies have put their own teams into portfolio companies with three main goals: driving growth, which often includes highly targeted M&A; lowering costs to free up cash for investment; and building the tech stack and harnessing the right technologies to improve data analytics, customer experience, and other competitive advantages. Indeed, we find that a superior tech stack is the “golden thread” that helps companies drive growth while managing costs.

We also find that the most effective PE teams orchestrate these and other improvements quickly, without disrupting operations, using clear-eyed analysis and full-time teams with an array of specific capabilities and expertise.

Our ongoing work with three clients illustrates proven approaches to strengthening balance sheets and identifying and seizing new growth opportunities that drive differentiation and advantage—and significantly raise valuations.

Case study

Helping a technician-based services provider harness its own data for growth

A middle-market PE firm acquired a regional technician-based services provider in the spring of 2022. Since then, the portfolio company has acquired more than a dozen smaller providers. With a wide range of data formats and back-end operating systems, a simple process of downloading recent and historical sales data took two or three hours per system and required extensive manual rework; the company was too small to have its own data and analytics team.

Managers had to rely on the company’s accounting system to track performance across more than 15 cities in 10 states without any operational, sales, or marketing analytics or KPIs. Hence, they couldn’t recognize problems with branches, customers, or their own technicians until weeks or months after the fact—too late to take corrective action.

A KPMG diagnostic revealed that the company was spending at least 500 percent more than necessary on data processing and getting little value in return. A KPMG analytics team stepped in, using its application programming interface (API) to connect more than half a dozen disparate data streams in the cloud.

> Managers now use simple dashboards to track appointment cancellations, technician evaluations, and other metrics in near real time at the touch of a button.

“By automating the back-end of our systems and streamlining key business KPIs for an interactive PowerBI dashboard, we were able to save approximately 8,000 man-hours from our Finance, IT and Field Operations teams” said the CFO of the PE portfolio company. “KPMG’s tool will enable and accelerate our M&A growth journey.”

Since the new tool came online, the field sales and operational leadership could respond in real-time to issues and opportunities, such as contract customer retention, technician productivity management, effective marketing to new customer, and many more tactical value creation areas.

The new data analytics are also helping the company improve invoicing and payments, correct inventory imbalances, and rationalize customer care based on the number and locations of agents.

The company is using the savings in data processing and other costs to invest in growth, including targeted acquisitions. At the time of this writing, the platform’s EBITDA has almost tripled from the initial acquisition.

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Case study

Advancing a global publisher’s move from paper to digital-first

For over 500 years, books have been printed, distributed, and read on paper. But major publishers are now scrambling to become tech companies, heralding the end of an era and creating extraordinary new opportunities. New editions can now be released worldwide in seconds, for example, without paper, ink, printing presses, trucks, warehouses, or shelves. They can be customized for hundreds of audiences or even for individual readers.

Compelling content, the sole province of authors for centuries, may soon be drafted by generative AI. Simply put, the publishing business hasn’t changed this much since Johannes Gutenberg introduced movable type in Europe.

KPMG is helping a global publishing company, acquired by a private equity firm before the pandemic, pursue a new growth strategy and improve performance to compete in the new era.

> The aim is to transform the publisher into a digital-first business that is far more agile, efficient, and productive.

The first step was identifying more than a hundred pain points that required costly manual labor, slowed processes, and hampered growth. KPMG recommended process improvements but also new technical capabilities to boost efficiency.

In the first initiative, a quote-to-cash and IT transformation in 2022, KPMG addressed those pain points by evaluating strategy, end-to-end processes, technical capabilities, and data governance. With these initiatives, the team has found efficiency opportunities that would materially expand earnings.

Follow-on initiatives are now underway, including standardizing and streamlining content development and procurement, and speeding product development and launch—crucial in an industry that is now moving faster than ever and where customers increasingly demand up-to-date content. The company aims to bring new offerings to market in days rather than years by reducing back-end delays, such as in provisioning SKUs and ISBNs.

“In today’s age, content is being consumed differently and the needs of customers are rapidly evolving. Through evaluating the content value chain we’ve been able to uncover a wide range of opportunities for our client to improve the way they are delivering content to their customers. These opportunities will support reallocation of resources’ time towards top-line growth and profitability,” said Dmitriy Kagan, Deal Advisory & Strategy Partner at KPMG.

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Case study

Improving corporate performance from tee to green

A nationwide operator of private clubs faced challenges in visits and revenues at more than a hundred of its facilities during the COVID-19 pandemic, along with higher costs. The owner, a private equity firm, aimed to turn the portfolio company around as the pandemic eased in early 2022.[2]

The PE operating team, recognizing that the operator needed hands-on help, called in KPMG to identify areas of value leakage and design and launch performance-improvement processes to raise earnings and set the stage for more profitable growth.

KPMG assessed that the company could grow because its tens of thousands of members valued its outstanding offerings. But this is a highly competitive industry—those customers also expected the membership experience to remain exceptional without significantly higher fees.

In a six-week diagnostic, the KPMG team analyzed more than ten million lines of transaction-level member data and interviewed current and former executives at comparable companies across the country.

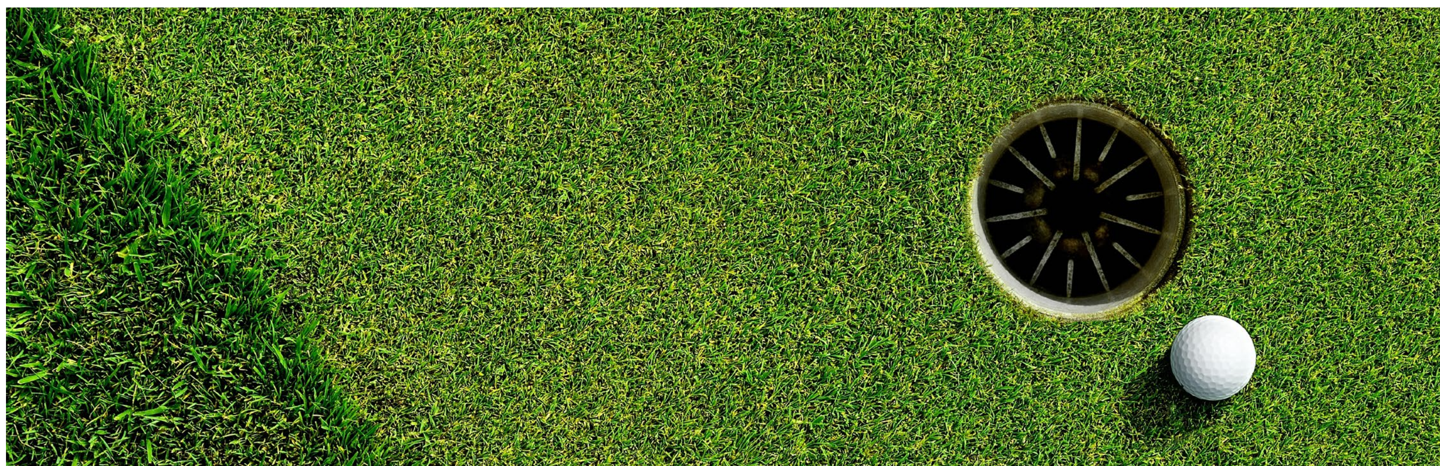
With this unique qualitative and quantitative information, the team benchmarked each of the client's clubs against industry best practices, and identified key cost buckets in overhead and functional areas, including headquarters, third-party spending, and staffing models, along with corporate and four-wall profitability, pricing, and loyalty programs.

Armed with new insights about growth and efficiency opportunities that could expand current EBITDA levels, the KPMG team worked hand in hand with the portfolio and sponsor companies to craft more performance improvement initiatives and pilot them in two dozen clubs. Using a customized KPMG dashboard, the teams tracked which initiatives worked best, how others could be improved, and how well changes met members' expectations.

Based on what it learned in the pilots, the company strategically rolled out the proven approaches across its properties. KPMG developed processes and tools to help the portfolio company and sponsor track implementation progress and sustain associated EBITDA impact, supporting the project-management office for three months before transitioning the processes and tools to the client.

Cost improvements included new process efficiencies, such as streamlining back-office processes, consolidating some overlapping departmental functions, and reducing third-party spend that duplicated internal corporate capabilities. The company also off- or near-shored some less-critical back-office functions.

The business performance has improved significantly with profitability higher at nearly every club across the country. The sponsor is delighted. "It's coming together extremely well in such a short time," wrote the portfolio company's SVP of finance.



[2] Deaths began to fall sharply in the U.S. in early 2022: CDC COVID Data Tracker: Trends by Geographic Area

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Outlook

Anticipating the market thaw

With interest rates high and valuations low, exits are at their lowest since the pandemic, declining 12 percent from Q1. Most transactions in the next quarter or two will be small and strategic.

Inflation fell faster than expected, so the likelihood of a recession has slimmed. Retail sales are still growing, but at a much slower rate and the unemployment rate is remaining steady. With the Fed's recent (July) .25 percent interest rate raise, KPMG Economics expects one more hike in 2023. We expect inflation and debt markets to stabilize then. As valuations recover and investors look for opportunities to use dry powder, a recovery in lower mid-market deals is likely to begin in Q4 this year, with larger deals picking up in Q1 and Q2 of 2024, followed by an acceleration of portfolio company exits in the last half of the year.

Since rates will remain higher than usual, many buyers may continue to look for public-to-private moves and alternative funding arrangements. In Q1, about 80 percent of leverage came from direct lenders rather than syndicated debt, for example.

Expensive financing should also spur many potential buyers to look for significant post-transaction value-creation opportunities. We foresee more efforts to improve portfolio company performance, including capital structure reviews and cash flow management, which we believe will help private equity continue to outperform public markets.

Key considerations as we look ahead

As economic uncertainties continue and dealmakers await a thaw in the M&A market, they should consider:

1 PE companies will continue to find value in portfolio assets.

Performance improvements could include adjusting capital structures and strategic add-on acquisitions.

2 High-potential assets will continue to attract large suitors, especially at relatively low valuations.

About 54 percent of PE exits were corporate acquisitions in Q1, and we expect this trend to continue.

3 A pause in rate hikes could mean growth in the share of syndicated debt.

Private and direct debt to syndicated debt ratios have soared with the Fed's successive rate hikes, but that tide could begin to turn this year.

4 Deal making processes may pick up faster than closings.

Volatility and uncertainty could mean that more buyers will abort or defer transactions in the year ahead.

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How we can help you

At the KPMG Private Equity practice, we understand the unique requirements of private equity. Our team works with your fund, operating partners, and portfolio companies to help you realize your ambition to buy, sell, finance, and drive performance, on both the buy side and sell side. KPMG helps its clients overcome deal obstacles by taking a fully integrated approach to delivering value, leveraging its depth in the PE industry, data-supported and tools-led insights, and full M&A capabilities across the deal lifecycle.

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