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## 2024 Outlook: GPs who have been diligent about developing, pursuing, and executing on value creation processes have the opportunity to generate private equity returns at historical levels

By: David Miller | December 21, 2023

### KEY POINTS

1. We believe value creation through operational enhancements will be crucial to drive EBITDA and profitability.
2. The higher cost of debt is clearly a headwind for private equity (PE), but is not insurmountable.
3. In our view, companies in the middle market may be afforded a wider variety of exit opportunities .

### What We Are Seeing

Over the past decade, private equity (PE) has performed well on the back of low interest rates and multiple expansion. However, it's unlikely that general partners (GPs) can rely on those drivers as much as they did over the last decade. Moving forward, we believe a focus on value creation through operational enhancements to drive cash flow and profitability growth will be crucial for PE investments.

Additionally, we are seeing the opportunity set widen for private equity. Public equity markets are materially bigger than the PE market, but the number of publicly-traded companies is shrinking. A recent paper by our colleague Michael Mauboussin, Head of Consilient Research at Counterpoint Global, says the number of U.S. publicly listed companies is now just over 4,200 (down from a peak of 7,300 in the 1996)<sup>1</sup>, compared with ~735,000<sup>2</sup> private companies in the U.S. The latter are staying private longer and private equity is increasingly providing the capital to do so.

### What We Are Doing

GPs who have been diligent about developing, pursuing, and executing on value creation processes should continue to have access to reasonably priced financing and attract new capital. GPs with overleveraged portfolio companies, and/or those who have shown little EBITDA growth, may face challenges in these areas. In particular, we expect to see this in small- and mid-cap GPs, who tend to invest in companies better positioned to benefit from operational improvements, leadership enhancements and growth driven acquisitions.

A higher cost of debt is clearly a headwind, but it is not insurmountable. Within Morgan Stanley Investment Management (MSIM) mid-cap PE portfolios, we have modeled a ~400-500bps increase in financing costs and find that the impact can be offset by a ~7-10% increase in EBITDA from entry to exit. Another way to offset the current higher cost of capital is to pay one turn less on the multiple at entry.<sup>3</sup>

### What We Are Watching

**Will PE funds mark down their assets?** Valuations could remain robust for high quality, appropriately leveraged assets where EBITDA is growing according to plan. Typically, there is a greater opportunity to generate alpha through operational enhancements in the small- and mid-cap segment, which should boost valuations or at least provide insulation in a broad-based multiple contraction. Over the past decade, average change in revenue and EBITDA from acquisition to exit for this segment was 115% and 124%, respectively.<sup>4</sup>

**Outlook for PE exits?** Muted capital markets activity remains a challenge, however small- and mid-cap GPs benefit from flexible options at exit. Companies of an appropriate size may choose to sell to a strategic or financial buyer, or pursue a secondary sale through single asset extension vehicles which continue to rise in prevalence. A recent development is net asset value (NAV) lending, where a loan is issued against the underlying assets of a fund rather than a single portfolio company, and loan proceeds can be used to provide liquidity to limited partners (LPs). The winners will likely be GPs focused on top line and margin growth through hands-on operational improvements and sensible M&A.

<sup>1</sup> Birth, Death and Wealth Creation, July 25, 2023.

<sup>2</sup> NAICS Association, as of March 2023. Includes firms with over 20 employees.

<sup>3</sup> Based on the analysis / views of Morgan Stanley Private Equity team (based on 4y holding period).

<sup>4</sup> MSIM database of transaction level information. Represents a sample of portfolio companies that report on EV, Revenue, EBITDA, Net Debt, Public/Private Company. MSIM analysis/data as of September 30, 2023. Given the sample universe and size, there is potential for selection bias. Past performance is not indicative of future results. The statements above reflect the views and opinions of the portfolio manager as of the date hereof and not as of any future date and will not be updated or supplemented. Middle Market from 2000-2009 is defined as enterprise value of \$300MM or below and \$750MM from 2010 to 2022. 373 middle market transactions, 66 large cap transactions. Data excludes outliers.

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"In this current rate environment, value creation through operational enhancements to drive EBITDA and profitability growth will be crucial for private equity (PE) to generate alpha"



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