

Manager Selection in a Frothy PE Market Environment

By the end of 2020, private equity (PE) valuations reached their highest levels since 2007. Record-setting dealmaking continued through Q2 2021, as investors moved away from traditional decision-making to aggressively listing portfolio companies via both Initial Public Offerings (IPOs) and Special Purpose Acquisition Company (SPAC) mergers.

According to PitchBook data, private equity firms closed over 3,700 deals in the first half of 2021, worth an estimated \$456 billion, and also representing nearly two-thirds the deal value recorded for all of 2020. Q2 2021 registered the second-highest deal activity in a decade, subsequent to Q4 2020, demonstrating the exuberance in recent investor sentiment.

PE deal activity



On the buy-side, dealmaking is being driven by the continued economic recovery, inexpensive debt and excess dry powder, while on the sell-side, by elevated pricing and the fear of a capital gains tax increase. While it is still too early to tell, dealmaking and exits are on pace for a record-setting year, and fundraising is tracking close to 2019's record level.

While a high-valuation environment is a positive sign, such conditions only bode well for owned entities. Private equity returns at record levels threaten future returns as high valuations make the decision to sell much easier than the decision to buy.

In this issue of the Thinking Man, we summarize the current state of PE valuations, and the three primary ways that PE sponsors can create value in buyout transactions, as well as some of the most important factors to consider when navigating manager selection in a frothy market environment. Lastly, we also illustrate the results of a performance attribution analysis conducted for some of our client's largest private equity allocations.

The Thinking Man's Approach



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- By the end of 2020, PE valuations reached their highest level since 2007.
- PE firms closed over 3,700 deals in the first half of 2021, worth ~\$456 billion. Over 27% of these PE deals have been transacted at multiple levels greater than 20x EBITDA.
- On the buy-side, dealmaking is being driven by the continued economic recovery, inexpensive debt and excess dry powder, while on the sell-side, by elevated pricing and the fear of a capital gains tax increase.
- Competition amongst PE firms is fierce, and buyers must find new ways to create value to maintain returns, as valuations leave little room for error.
- At BigSur, we believe it is important to collaborate with General Partners (GPs) who can withstand downturns in market and credit conditions, as well as those that drive the most value accretion from operational improvement.

For more on how we are positioning our portfolios, please contact your investment advisor or:

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Where Are Valuations Today?

While private equity buyout pricing has risen across the board, Information Technology (IT) has been the most expensive sector, with a median EV/EBITDA multiple reaching a peak of 20.1x in 2020 – doubling from a decade ago. Over the same period of time, the Healthcare sector saw multiples increase by an estimated 50%, with a median EV/EBITDA multiple of 15.5x.

According to PitchBook data, multiples north of 20x across the IT, Healthcare and B2C sectors are levels needed to win auctions for the most resilient assets, and over 27% of private equity transactions in the first half of 2021 have been transacted at levels greater than 20x EBITDA.

Competition amongst buyout firms is fierce, and private equity buyers must find new ways to create value in order maintain their returns, as today's valuations leave little room for error. Private equity firms are competing against newer and larger fund vintages with significant dry powder, deep pocketed and highly acquisitive strategic investors, and hundreds of uncommitted SPACs. By the end of 2020, there was over \$700 billion in PE dry powder, as illustrated in the graph to the right. SPAC sponsors in particular are expected to become aggressive in their pursuit of targets as time passes since they are required to merge with a company within an 18 to 24 month period.

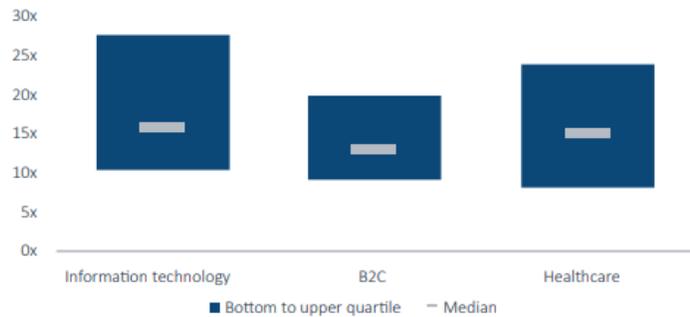
Simple math shows that GPs buying companies at these prices will have to generate more value if they hope to meet return expectations. Should inflationary pressures persist and interest rates increase to 3%–4%, these lofty buyout prices may become unsustainable. However, most major market participants expect the zero-rate environment to persist for the foreseeable future, and for inflation to be largely transitory, making the case for continued investment.

Private Equity Return Drivers

A fundamental question in PE has always been how dependent returns are on high leverage, and whether the investment returns represent appropriate compensation for the risk.

Pricing dispersion

2018–2021* EV/EBITDA buyout multiple dispersion

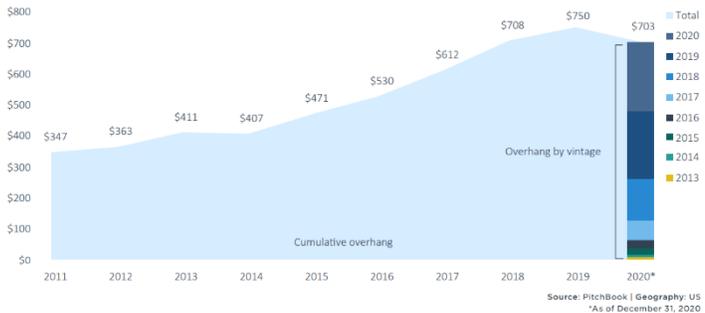


Sector multiples and outlook

Sector	Bottom to upper quartile EV/EBITDA buyout multiple ranges	12-18-month outlook
Information technology	10x–27x	Positive
Healthcare	8x–23x	Positive
Business to consumer (B2C)	9x–20x	Positive

Source: PitchBook | Geography: Europe and US
Note: Date range is 2018–2021

PE dry powder (\$B)



Source: PitchBook | Geography: US
*As of December 31, 2020



Studies show a negative relationship between deal leverage and PE returns during prolonged periods of easy credit, as they result in both larger amounts of debt and higher transaction prices. Leverage and risk are intrinsically linked, and hot credit markets typically lead to high leverage, breeding an increase in default rates as the market tide shifts. Discounted debt will continue to fuel a price climb in valuations, and those businesses that survived beyond the height of COVID-19—namely IT and healthcare—will continue to command the highest dollars.

Below we dive into the three main variables for value creation across any buyout transaction:

1. **Operational Improvement:** this category would include the whole spectrum of levers available to fund managers for increasing EBITDA such as: raising prices, identifying revenue adjacencies, instituting cost structure discipline, accretive bolt-on acquisitions, and working capital improvements.
2. **Leverage & Debt Paydown:** this category includes both the determination of an adequate initial debt level that prices-in realistic downside scenarios, as well as the prioritization of free cash flow generation to amortize the debt over the holding period, resulting in greater overall equity value.
3. **Multiple Expansion:** this category includes manager discipline in underwriting entry multiples with a clear line of sight towards contemplated exit strategies, with the objective of transacting at a market multiple premium upon exit.

Control What You Can Control

In terms of BigSur's PE manager selection process in a frothy market environment, we believe it is important to partner with GPs that can withstand downturns in market and credit conditions – meaning those that derive the most value creation in transactions from operational improvement.

BigSur's primary focus is in working with specialized, "hands-on" managers that serve as true partners to their portfolio companies beyond just being capital providers. Specialized managers typically hold a number of board seat positions, and help portfolio teams attract expert management teams, provide new corporate customer introductions, and serve as a strategic guide for finding and negotiating accretive add-on acquisitions. In many cases, specialization creates the ability to pay a lower entry multiple for an asset versus being the highest bidder in an auction process, given that portfolio companies see value beyond just the money and many deals take place "off-market". Another interesting point is that true specialists can sometimes appear to "overpay" for an asset, but perhaps know better than anyone else its true intrinsic value and how to uncover it.

When underwriting managers, we also look for consistency in returns, meaning managers that have predictable and repeatable exit outcomes. Our preference is to see very few outlier winners and little to no losers in the portfolio. Similarly, we look for managers where the majority of underlying portfolio holdings are within a narrow Internal Rate of Return (IRR) and Multiple on Invested Capital (MOIC) range, demonstrating the repeatability and quality of those returns as the market environment changes over time.

In the post-Covid environment, we also believe it is crucial for managers to be thoughtful on understanding the sustainability of recent growth, particularly in the IT and healthcare sectors.



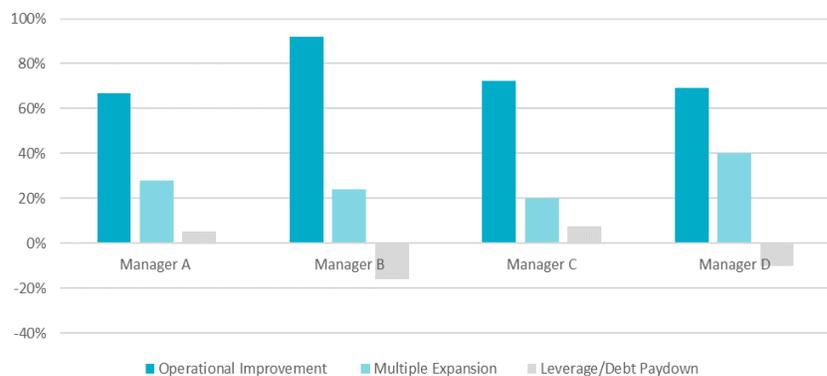
We believe many prudent managers are hedging a portfolio company's ability to sustain their significant growth levels by implementing creative deal structuring, such as extending earnout periods, therefore, potentially providing more flexibility and upside for significantly exceeding targets. This can help bridge valuation expectations and protect buyers.

Lastly, we are continuing to recommend secondary strategies across buyout, growth equity and late stage venture, as we believe these transactions offer attractive portfolio diversification benefits (both in terms of the number of underlying managers and vintage year exposures) and discounts to current net asset values, which can serve as portfolio ballast in a downside scenario. These discounts also help with the avoidance or mitigation of the J-curve effect (contrary to primary commitments), and typically result in a shortened portfolio duration given the maturity of the assets being acquired. Secondaries managers are also able to avoid investing in a "blind pool" as they know the constituents of underlying holdings and can underwrite their own expected future values of these assets for the remainder of the holding period.

Conclusion: BigSur PE Return Attribution Analysis

BigSur seeks to gain a deeper understanding of the quality of returns generated by alternative investment managers by proactively requesting them to share with us the breakdown of their historical returns, Operational Improvement, Leverage & Debt Paydown, and Multiple Expansion. We recommend clients to always request return attribution data from private equity sponsors when analyzing any buyout manager allocation or equity co-investment opportunity. Below are the results of our analysis for some of our client's largest private equity holdings, diversified across numerous industries:

As mentioned in the previous section, we seek to partner with managers that "control what they can control." Regardless of industry focus, we believe that operational improvement is a critical component for manager selection, as it helps determine a manager's ability to navigate through a higher valuation market environment.



Manager	AUM	Industry Focus	Operational Improvement	Multiple Expansion	Leverage/Debt Paydown
Manager A	\$650 Billion	Highly Diversified Across Industries	67%	28%	5%
Manager B	\$77 Billion	Software: Enterprise Software, Technology-Enabled Businesses	92%	24%	-16%
Manager C	\$20 Billion	Energy: Oil & Gas Exploration and Production	73%	20%	7.5%
Manager D	\$16 Billion	Consumer, Distribution, Industrials, Communications, Business Services	69%	40%	-10%

Note: Manager performance attribution data was provided directly by each underlying manager. The negative free cash flow (FCF) for Manager B & Manager D can be explained by the fact that these managers often re-invest their FCF to grow EBITDA (either through CapEx or M&A). These "re-investments" correspond to the negative FCF in their value creation bridges. Please also note that the above information has been reviewed by BigSur which it believes is reliable, but, however, has not been independently verified or audited. See back page of this commentary for other additional disclosures and disclaimers.



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