SHIFTING GE

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Last year may have been challenging for dealmaking, but with a wealth of capital sitting on the sidelines, could 2024 bring new opportunities? **Anthony O'Brien** writes.

01:
José Luis González Pastor
managing director, private equity
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Over the past decade, private equity (PE) and venture capital in Australia has yielded an 18% return on investment compared to 9% for the ASX 100 and 8% for the ASX Small Ordinaries, according to the Australian Investment Council. It's an exceptional result. One that has seen the global venture capital investment market reach $US33.9 billion in 2022 – a figure expected to nudge $US708.6 billion by 2028 – a possible compound annual growth rate (CAGR) of 20.29%.

Fueled by years of easy access to cheap money, the PE market had to adjust to a very different set of conditions in 2023. S&P Global Market Intelligence data confirms that last year saw PE and venture capital deal values and volumes hit their lowest levels in at least five years. Transaction value declined 34.7% year on year, while deal count fell to 12,016, down from 17,549.

The key stumbling blocks are well-known – high inflation, rising interest rates and the dual spectres of economic and geopolitical uncertainty. The upshot was that plenty of investors stepped back from dealmaking. But as we head into 2024 with a wealth of capital – or 'dry powder' – waiting in the wings, can we expect PE to return to the path of generating strong absolute and relative returns?

Looking back

José Luis González Pastor[01] is a managing director of Neuberger Berman in the firm's private equity team and a senior member of the firm's Private Investment Portfolios group. He believes there is a case for investing in private equity in 2024 though with some disclaimers.

"When interest rates are low, it is easy to finance your buyouts, and if you pay down debt you are creating value on your equity at the exit," González Pastor says.

"In a market where multiples have been going up, basically you are going to benefit at the exit."

Nonetheless, as González Pastor observes, there is an enormous amount of dry powder on hand.

"It is at an all-time high on an absolute basis. But when it comes to a relative basis, in looking at the deployment over the last three years, the ratio is very similar to what it was in 2009," he notes.

Looking back over 2023, Aware Super portfolio manager, private equity Alex Satchcroft[02] agrees that conditions in private equity tightened both globally and domestically on the back of strong inflation and the resulting rise in interest rates.

"It was a year of consolidation," he says.

"And we observed a slowdown in realisations, new deal activity and consequently fundraising. Underlying performance of the portfolio held up well however, and this adjustment of course followed a long period of robust growth, so it needs to be considered in this context."

Federation Asset Management chief executive Cameron Brownjohn[03] is quick to point out what he describes as "increasing evidence" that returns (on PE) dramatically outperformed the listed market in 2023 but adds that this must be regarded in the context against deal flow in the year.

"There was not as much merger and acquisition (M&A) activity, so certainly not as many acquisitions by private equity firms relative to recent years, and a dramatic decline in exits," explains Brownjohn.

"So private equity valuations would rightly come under the microscope. Returns of outperforming deal flow was far more muted. And capital raised dramatically fell off a cliff."

He agrees that with private equity volumes down significantly through 2023, "people are sitting on a bunch of dry powder".

"I would say more people have been patient," notes Brownjohn.

"With an equities manager, you have a benchmark for quarterly results. That doesn't apply to PE. So, you can afford to take long-term views and take a long-term judgement."

Marina Pasika[04] leads the private equity program at Rest, and makes the point that "when we talk about how the market performed, we need to be aware that it is a less relevant concept for PE than it is for listed markets."

She notes that one of the most defining characteristics of PE compared to other asset classes is the "enormous dispersion in returns between managers". This, Pasika believes, makes it difficult to view the market in the same way as listed and other markets.

"To put a bit more colour around that, the interquartile range, which is the difference between top and bottom quartile performance in PE, can be as high as 20% or 30% compared to listed markets where it is significantly lower," she explains.

"So, it is difficult to talk about the median. We don't invest in median PE exposure in the way that you may invest in another asset class where the performance is less bifurcated, and where it makes sense to gain broad asset class exposure to add to your portfolio."

Nevertheless, Pasika says that overall, the fall in multiples seen in listed markets in 2022 made its way into the private markets in 2023, and this affected short term returns for PE.

Looking ahead

"I think we will continue seeing similar sorts of levels of investment in 2024 because capitalised investors like ourselves are benefiting from the current situation," says González Pastor.

"We do not see the market changing substantially."

González Pastor adds that 2024 may not bring

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02:
Alex Satchcroft
portfolio manager,
private equity
Aware Super

03:
Cameron Brownjohn
chief executive
Federation Asset
Management

Table 1. PE deal activity by sector – percentage of total deal value

Sector	2022	2023
Consumer	12%	14% ▲
Financials	5%	11% ▲
Healthcare	7%	9% ▲
Industrials	14%	4% ▼
Materials	7%	10% ▲
Oil and gas	1%	1% =
Real Estate	13%	3% ▼
Retail	0%	1% ▲
Technology	26%	31% ▲
Telecom	5%	7% ▲
Utilities	8%	7% ▼

Source: EY Private Equity Pulse: Key takeaways from Q4 2023

Table 2. Expectations for 2024

Expectation	Score
More financing will shift back to the syndicated market from private credit	5.72
IPOs will increase from 2023 levels	5.81
Higher interest rates will predicate an LP allocation shift from equity to credit	5.91
Commercial real estate will offer compelling buying opportunities	6.12
Alternative financing arrangements and investment structures (such as seller paper) will become more common	6.19
Consolidation across GPs will increase	6.38
Tech will remain a dominant investment theme	6.64
Secondary sales and continuation activity will increase	7.03

Source: EY Private Equity Pulse: Key takeaways from Q4 2023

massive opportunities on the IPO market, and M&A are likely to be limited to the best companies that were right on the moment to exit.

Satchcroft holds a broadly optimistic view.

"We continue to see compelling opportunities with our existing managers and are actively looking to add new manager relationships globally," he says.

He is quick to point out that superannuation funds, such as Aware Super, are long term investors, investing through the cycle rather than trying to time it.

"Over the long term, private equity has been one of our most successful asset classes, generating strong returns in excess of those from equities and contributing to us being a top-performing fund," adds Satchcroft.

Viewed in this context, he says that while short-term themes matter, they are less important than longer-term trends combined with prudent asset selection and deft asset management.

Even so, the issue of high interest rates cannot be dismissed.

Federation's Brownjohn sees potential for the trajectory of interest rates to play a role over the year ahead.

"There's an expectation that rates may start to abate in America, but it's quite interesting to consider whether or not corporate balance sheets will start to flex," he says.

"I believe there is a wall of corporate debt that will start to need to be matured from the back-end of this calendar year. It will be interesting to see what this does to the global market."

Overall, Brownjohn sees the prospect for more of the same in the PE market through 2024, and he anticipates a relatively low level of deal flow.

"It is certainly not going to be one of those knockout years where private equity guys are buying here, there and everywhere nor exiting here, there and everywhere," says Brownjohn.

"I think it is going to be the same from the capital allocators perspective. A lot of these people are sitting on allocated but uninvested amounts. They have written big commitments to the PE firms around the world, which have not been drawn. These guys are reluctant to open up the purse strings to write more cheques."

He adds that until there is a return to normality or performance in the listed market, investors are unlikely to allocate to PE owing to the prospect of exceeding their weightings.

Key themes for 2024

A recent EY report noted that private equity remained resilient through 2023, as firms opportunistically deployed capital across a range of verticals, asset classes, and transaction types.

Although higher interest rates have made financing deals more challenging, EY observes that investors also expect rates to be a tailwind for certain types of activity in the coming year.

The tech sector was especially attractive through 2023, with EY noting that it accounted for almost one third of PE investment by value last year (see Table 1).

Neuberger Berman's González Pastor believes tech will continue to be an important sector for private equity.

"Prices are high at present," he explains.

"But there are plenty of opportunities in IT, and I expect them to continue to be there."

When it comes to healthcare, a sector that saw a 9% increase in PE deals last year, González Pastor anticipates a degree of variation over time.

"Healthcare tech has already come up in terms of importance, and as area of opportunity since COVID," he notes.

"There are many opportunities in the healthcare space related to technology and software, and it's a compelling sector. However, it is significantly more complicated because it is heavily regulated.

"People are making money out of healthcare. We will continue seeing tech as a significant sector where private equity will continue investing, and healthcare tech will be one of those sectors."

Meantime, Aware Super's Satchcroft points to what he describes as "key mega-trends" likely to drive sustainable, long-term returns. These include the digital economy, ageing demographics, and the energy transition.

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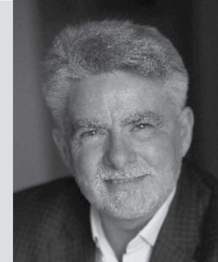
> **Cameron Brownjohn**

04:
Marina Pasika
head of growth alternatives
Rest



05:
Vince Scully
chief executive
Life Sherpa

"These trends are delivering investment opportunities with strong growth profiles across many asset classes, and private equity is no exception," notes Satchcroft.

"While we pay attention to these themes, we remain focused on 'bottom-up' analyses of specific opportunities across a variety of industries, each with idiosyncratic growth drivers and opportunities to add value."

He adds that Aware partners with industry specialists with "genuine domain expertise" who can identify opportunities and deliver value.

Rest's Pasika takes a similar view, saying that while risks around a particular sector are considered, the super fund is more focused on managers with a proven playbook in whatever sector or deal is being addressed.

"We partner with managers who are not just looking for attractive opportunities, they are looking for opportunities that are right for them and where they can add value," says Pasika.

Pasika says that from a whole of fund point of view, there are themes Rest is looking to get behind. These include decarbonisation, deglobalisation, and climate change.

"They are not necessarily hot sectors for this year," she adds.

"They are what we believe are likely to form major tailwinds in the future decade or more. PE can play the role of providing access to those themes, and strategies that are not always readily available in listed markets."

Pulling levers for value

Given the potential for interest rates to remain higher for longer, González Pastor believes PE managers really need to focus on "what they can actually do with a company".

"That is where we believe we are going to be able to differentiate exceptional managers from others – and in particular, I'm talking about investment selection," he says.

In terms of selection, González Pastor points to choosing the right companies, management incentivisation and getting the right management on board to implement value creation initiatives. He says it is all about "having, and making available, the resources and capital to support growth – whether that is to enter into new markets to expand the range of products or services, or to upscale the go-to marketing strategy or sales strategy."

> *We continue to see compelling opportunities with our existing managers and are actively looking to add new manager relationships globally.*
> **Alex Satchcroft**

The lower levels of new dealmaking in the current market may be creating even greater opportunities for established and well-capitalised investors. In Australia at least, that's likely to mean superannuation funds.

Vince Scully[05], chief executive of online advice platform Life Sherpa, says super funds now own around 38% of the ASX, and as a result are starting to look offshore.

"The next attractive base for funds is unlisted markets, which should deliver high returns," he notes.

By definition this sees funds casting around for international opportunities.

"The PE market in Australia is very small, especially when compared to the pool of capital," says Scully.

"And this is a real problem for the big super funds.

"Finding accurate performance data in the PE market is not easy. This may be fine for a big fund manager. But the lack of transparency is why we discourage retail investors from investing in the PE space."

Meanwhile, Federation's Brownjohn sees potential opportunities created by high interest rates.

"It will be interesting to see what a higher interest rate environment means for corporate balance sheets and the ability to service debt," he says.

"I wonder if there will be pockets of liquidation, or change of control, driven by credit factors distress, for example."

He believes it may be possible that we could see private investments in public entities, or managers jumping in to help even listed entities with their balance sheet.

"It is an interesting trend that could happen through the backend of this year," adds Brownjohn.

Although Scully believes the lion's share of PE opportunities are to be found in the broader global market, Australia may still have an ace up its sleeve. Brownjohn says he is seeing global allocators risk off on China while still wanting to allocate capital to Asia.

"If you're not allocating as much as you were to China, where does the money go?" he asks.

"It is markets like Australia and Japan that are increasing in prominence to some of these global allocators. Hopefully markets like Australia should benefit."

Satchcroft agrees.

"There continue to be compelling opportunities in Australian private equity," he notes.

"With that said, we invest globally and along the full-value spectrum – from early-stage emerging businesses to larger mature growth businesses – as well as investing in turnaround opportunities."

Over at Rest, Pasika says, "We tend to look at the market as a global market, and our PE program as a global program."

"We are always looking to support the local market where we can, providing return-generating opportunities are available."

EY's *PE Pulse Survey* (Q4 2023), which surveyed PE investors, commented that firms with capital to deploy should still find select opportunities, especially in distressed assets, as the environment shakes out weaker companies. However, the EY report also suggests that higher interest rates will drive a growing focus on operational value-add.

González Pastor agrees that this may be the case. He notes that the last decade has seen PE shift more towards a focus on operational improvement, and in some cases, value creation through M&A to make a larger company and extract synergies.

"We think this is where PE will be focusing," says González Pastor.

"The best managers – the ones that are more prepared for doing so – will excel. The ones that have been relying more on market conditions and that don't have this focus, may struggle." FS

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