Global Research
& Risk Solutions

CRISIL
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Creating portfolio value in the private capital markets

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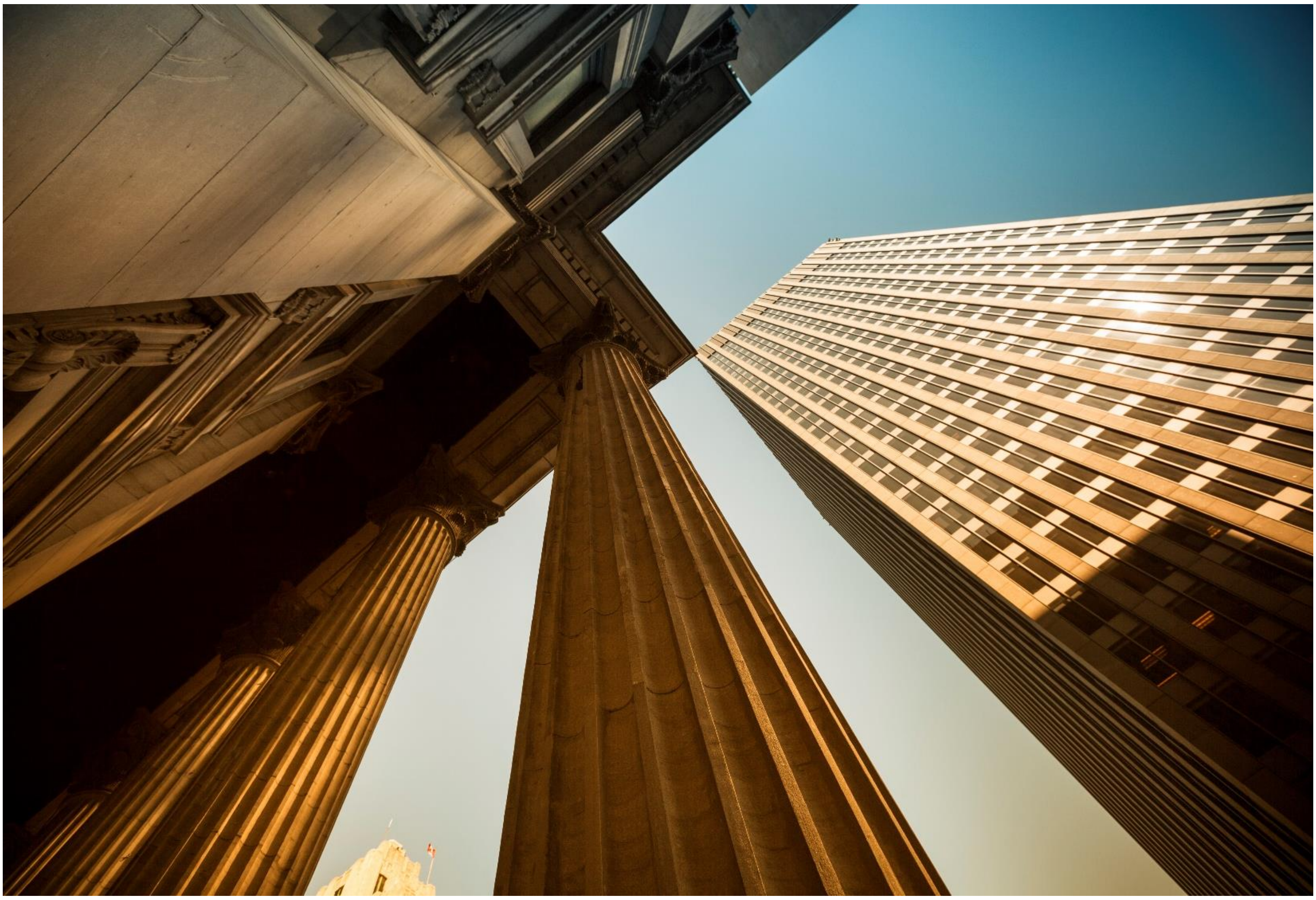


Analytical contacts

Abhik Pal
Global Head of Buy-side, Research and Sustainability Practice
abhik.pal@crisil.com

Akshat Ruia
Global Head of Buy-side
akshat.ruia@crisil.com

Umasis Tripathy
Associate Director of Buy-side Private Markets
umasis.tripathy@crisil.com

Vallabh Patil
Sector Lead of Buy-side Private Markets
vallabh.patil@crisil.com

Executive summary

Private capital managers are manoeuvring through a difficult terrain marked by elevated interest rates and sluggish growth, which are affecting fundraising and deal activities. Further, intensified competition and discerning limited partners (LPs) are making it difficult to secure fresh funding.

Private equity (PE) firms can no longer rely solely on leverage and ever-growing valuation multiples to achieve profitable exits. Additionally, with constrained exit options and growing macroeconomic uncertainty, PE managers are compelled to sustain valuations.

A CRISIL study also suggests that private capital managers continue to double down on inflation- and recession-prone sectors, thereby seeking alternative strategies to deliver returns to the LPs.

Conventional value-creation approaches, such as operational enhancement of the portfolio company, are becoming less effective, necessitating a pivot towards innovative and resilient strategies essential for navigating these uncertain times.

Drawing from our extensive market research and hands-on experience of collaborating with numerous PE managers, we recommend the implementation of the following industry best practices aimed at maximising portfolio value in the short to medium term:

- **Strategic cash management:** Private capital firms can enhance their portfolio companies' liquidity position by implementing advanced enterprise resource planning (ERP) systems and driving operational optimisation through measures such as streamlining payables, inventories and receivables to bolster cash flows. Additionally, leveraging scale for more favourable negotiations can lead to an improvement in return on invested capital (ROIC)
- **Deepen ESG integration, and target emerging and sustainable themes:** Private capital managers can look to integrate environmental, social and governance (ESG) considerations into portfolio companies to enhance resilience, performance and market appeal, thereby boosting valuations. Portfolio companies can also enhance value by extending their offerings into related domains that offer scalability and long-term earnings potential, ultimately leading to higher valuations
- **Strategic technological imperatives:** Private capital managers should encourage portfolio companies to embrace unified data platforms, generative AI tools, and automation to improve operational efficiency and margins. Additionally, portfolio companies can prioritise the creation of centralised data repositories to improve decision-making

An amalgamation of these strategies will fortify these portfolio companies amidst an uncertain economic landscape, leading to improved margins, higher return on investment (ROI) and, in turn, increased valuation.

This whitepaper covers the current macro environment and examines the incremental sectoral allocation by private capital managers in Section I.

In Section II, it explores the renewed imperative for portfolio value creation and the evolution of private market value-creation practices. Additionally, it discusses the key drivers of value enhancement, providing actionable insights and real-world use cases based on CRISIL's market engagement and experience.

This whitepaper also extends our series of publications within the realm of value creation. Please see the relevant links on pages 6, 7 and 10 for references to our previous research.

Section I

A. Private capital markets facing turbulence

Muted deal activity amidst increased market volatility

In 2023, deals were few and far between because of elevated interest rates, which increased the cost of capital for debt-dependent PE buyouts. Despite a gradual easing of inflation, numerous developed countries continue to grapple with economic growth hurdles and persistently high interest rates. As a result, deal activity remains subdued, especially in sectors most vulnerable to prevailing macroeconomic challenges.

High rates curtail new fund flows into private capital markets

Aggressive rate hikes by central banks have hardened market-wide base rates, leading to a notable rise in yields on directly originated loans. The yields on senior secured loans in the United States (US), primarily featuring a floating interest rate structure, currently surpass 12%, compared with ~7% in mid-2022, driving a flight to these 'safer' instruments.

The US Federal Reserve's tightening measures have further constrained credit availability for businesses, favouring private lenders with capital reserves and deployment capabilities. While deployment opportunities seem limited in the near term, particularly for PE-focused strategies, many firms still possess ample dry powder to capitalise on environment-driven opportunities.

Slowdown in private capital fundraising

The upswing in interest rates and heightened market volatility constrained PE fundraising in 2022, and this trend persisted more prominently into 2023. Private debt (PD) fundraising, especially within the direct lending sector, has closely mirrored the trends of PE fundraising since the global financial crisis (GFC). PD lenders play a significant role in supplying debt capital for PE-sponsored buyout transactions. Given their interconnected nature, the decline in PE fundraising has had a cascading effect on PD fundraising.

The Russell Investments Private Markets Survey, 2023, covered 32 firms collectively representing $1.6 trillion in assets under management (AUM). As many as 73% of the survey respondents highlighted high interest rates, inflationary pressure and recession risk as their primary investment concerns.

B. Limited profitable exits amidst challenging market conditions

Unlike in historical periods, PE firms can no longer rely solely on leverage and ever-growing valuation multiples to deliver superior returns to their investors. In the PE space, the pertinent challenges include uncertain global economic performance, rising inflation and recessionary fears. The macro uncertainty is compelling these firms to transact at discounted valuations, with sellers increasingly willing to adjust their valuation expectations.

Considering the above-mentioned market challenges, we have identified the sectors *(refer to the table below)* that are susceptible to inflationary and recessionary risks, based on our study of previous market cycles and financial crisis periods. In this study, we evaluated the incremental investments of the top 15 PE and PD global firms, managing a combined AUM of $1.6 trillion over 1Q21-2Q23.

Our findings underscore that, in the absence of portfolio rebalancing, exposure to inflation-sensitive and recession-prone sectors, coupled with a sector-concentrated approach, would exert pressure on valuations. Hence, PE sponsors need to consistently create value in their portfolio companies to ensure a profitable exit.

Sectors prone to inflationary and recessionary risks

Inflationary	Recessionary	Neutral*
Manufacturing and industrials	Manufacturing and industrials	Utilities
Energy (excluding utilities)	Energy (excluding utilities)	Healthcare
Metals and mining	Construction and real estate	Consumer staples
Consumer discretionary	Metals and mining	
	Information technology	
	Financial services	

Methodology: *We evaluated the sensitivity of each sector to the key macro parameters resulting in inflationary and recessionary risks. These parameters were analysed starting from the onset of the Covid-19 pandemic to the post-pandemic period to understand the effect of these macro variables on each sector. The impact of historical crisis periods, such as the double-dip recession of the 1980s and the 2008 GFC, on these sectors was also assessed.*

**Refers to sectors which are neutral to both inflationary and recessionary risks*

Key findings from CRISIL's PE study

- Surprisingly, incremental investment continued in the recession- and inflation-prone sectors*. For manufacturing and industrials, allocation increased to 34% in 2Q23 from 21% in FY21
- The information technology sector dominated capital allocation with ~27% of incremental PE investment
- Incremental investment in the healthcare sector fell to 6-7% in FY22 and 2Q23, from a peak of 22% in FY21, affecting diversification

**During the earlier recessions, sectors sensitive to high inflation, such as manufacturing and industrials and energy (excluding utilities), were impacted significantly. However, during the GFC, these sectors witnessed quicker recovery as demand rebounded. The information technology sector was resilient during both crisis situations.*

Sectoral allocations of capital deployed by PE firms during 2021-2Q23

PE sector allocation — by value	2021	2022	2Q23
Incremental investment ($ million)	**386,455**	**404,480**	**117,926**
Manufacturing and industrials	21%	32%	34%
Consumer discretionary	20%	6%	7%
Energy (excluding utilities)	6%	4%	16%
Financial services	9%	15%	3%
Healthcare	22%	6%	7%
Information technology	18%	35%	27%
Metals and mining	3%	1%	7%

Source: Pitchbook

Key findings from CRISIL's PD study

- As of end-2Q23, PD funds continued to invest in information technology and business services that typically provide insulation against inflation and demonstrate high-growth trends, strong cash flow profiles and low capex requirements
- Capital allocation is highly skewed towards information technology and business services, with lower exposure to industrials and energy
- The business development company (BDC) universe has not reported any significant increase in requests for amendments, waivers or payments-in-kind so far. However, BDCs are engaging in meaningful discussions with portfolio companies and their sponsors in anticipation of credit deterioration due to higher interest costs, rising labour costs and decelerating top-line growth

Sectoral allocations by direct lending firms during 2021-2Q23

PD sectoral allocation — by value	2021	2022	2Q23
Information technology	21%	22%	22%
Healthcare	15%	15%	16%
Industrials	20%	12%	12%
Financials	11%	13%	12%
Consumer discretionary	14%	6%	6%
Others (including business services)	19%	32%	32%

Source: Cliffwater Direct Lending Index

This conclusion aligns with our previous research, titled '<u>Time to reinforce ringfence around private credit</u>'. This research emphasised significant exposure to high- and medium-risk sectors within the sampled private credit portfolio, indicating elevated sector and borrower concentration risks. The research underscored the necessity for robust monitoring, early-warning systems and bespoke scorecards.

According to the findings from our current study, private capital managers continue to double down on inflation- and recession-prone sectors. In the current macro environment, PE managers are finding it difficult to achieve superior returns given the levers of leverage and increasing valuation multiples are no longer available. With constrained exit options and growing macroeconomic uncertainty, PE managers are increasingly recognising that boosting the core performance of portfolio companies is the only controllable way to improve performance and sustain valuations. We discuss this in more detail in Section II.

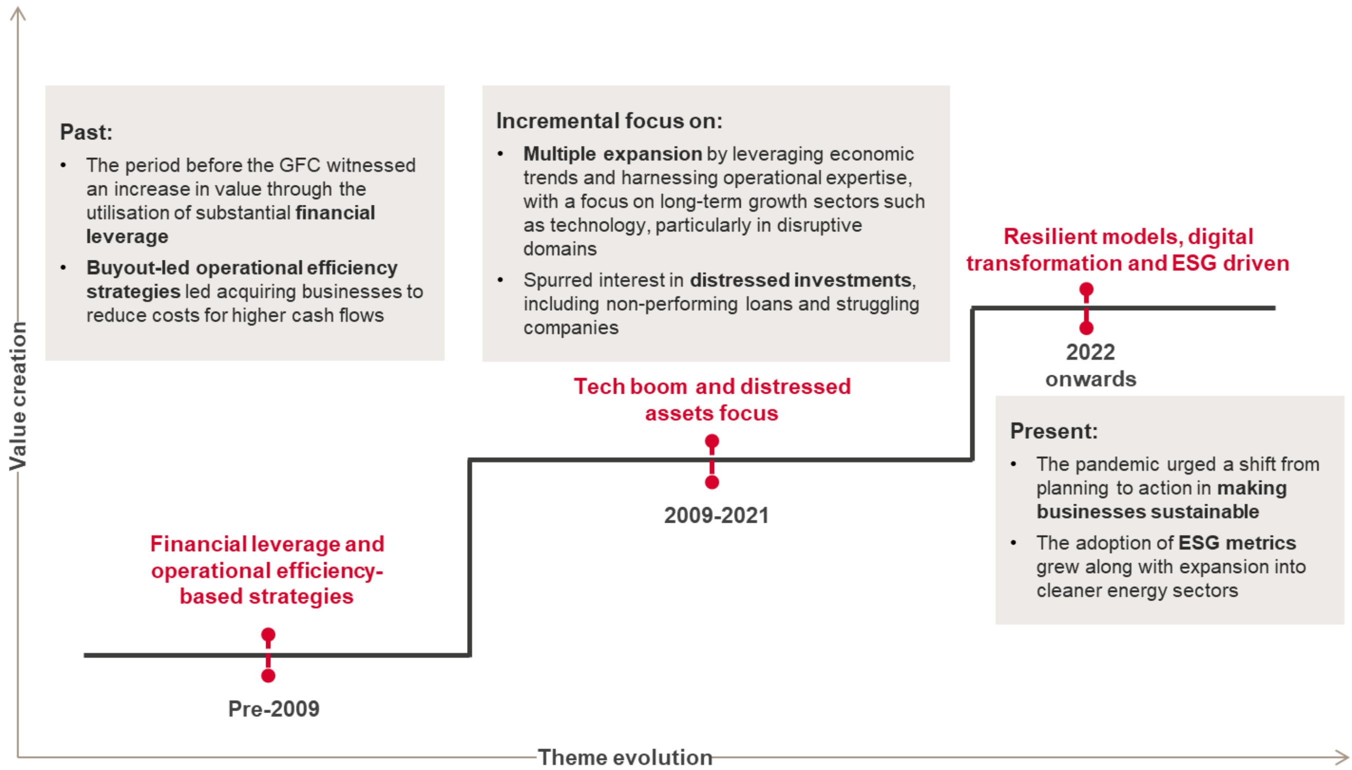
Section II

Strategising for portfolio value creation

As discussed in the previous section, conventional value-creation approaches such as operational enhancement and cost-cutting measures are becoming less effective, encouraging PE sponsors to collaborate closely with their portfolio companies to make their business models more resilient. Given the challenging market environment, the need for portfolio value creation has never been more crucial.

At this juncture in the economic cycle, private capital fund managers may encounter difficulties in maintaining resilience in terms of portfolio company performance, underscoring the importance of prioritising value creation. They are increasingly acknowledging the significance of a robust value-creation programme that should organically align a fund's objectives with the actions of the portfolio company. Consequently, they are transitioning towards a role of portfolio activists, rather than solely relying on leverage and multiple expansion.

CRISIL analysis: Evolution of private market value-creation practices



The art of value creation is emerging as a winning formula for many large PE and PD firms. A structured value-creation approach — that is consistent across sectors, interlinking strategic priorities and the path to realisation — is key to success.

We echoed similar sentiments in our earlier research, titled '[The valuation conundrum]'. In this research, we emphasised how PE firms are redesigning their value-creation strategies for profitable exits. The research underscored PE firms' sharpened focus on profitability by restructuring and enhancing operational efficiency.

Based on our experience of working with multiple PEs on accelerating their portfolio value-creation strategy, we have presented below the key levers that would enable private capital-led portfolio companies to make informed decisions, foster growth, maximise profitability and enhance value.

1. Transforming cash management process of portfolio companies

Effective cash management plays a crucial role in portfolio value creation by optimising the allocation and utilisation of funds of portfolio companies.

Private capital-backed small/mid-sized portfolio companies have encountered challenges in optimising their cash flows, leading to elevated inventory levels. Difficulties in cash flow management often result in higher accounts receivable for these companies, thereby exacerbating working capital issues due to an elongated cash conversion cycle.

CRISIL has helped portfolio companies conduct analysis of the demand trend, aiding in optimisation of inventory levels. Additionally, we have simplified and standardised their workflow processes, analysed vendor contracts, revamped cost structures, established metrics for improved visibility, and enhanced reporting.

These efforts have significantly contributed to clients' ability to turn around their cash flow management cycle. Below are specific examples that support this assertion.

Ease of implementation in cash management process	Receivables	Payables	Inventory
Easy	• Review grace period extensions • Optimise order-to-cash process by eliminating inefficiencies	• Optimise procure-to-pay (P2P) process, supplier credit limits by eliminating inefficiencies	• Link product demand to macro factors for better inventory forecasts • Actively monitor inventory KPIs to remove inefficiencies
	• Review credit terms for non-core clients • Identify payment delays and suggest corrective actions • Assess credit ratings for all customers to flag negative scores	• Review credit agreements with secondary suppliers • Assess supply chain finance option to ease liquidity strain • Analyse to set up alternative supply routes for seamless business operations	• Assess supplier schedule to cut lead times, minimising warehousing needs • Leverage inventory financing for financial assistance
Complex	• Initiate automation to improve efficiency of the order processing system • Suggest renegotiation of credit terms with key clientele • Reinvent customer credit thresholds	• Predict cash flows through proactive planning • Identify gaps in credit terms with main suppliers	• Conduct research on sourcing materials or products locally • Consider automation for better inventory visibility and explore strategies to reduce slow-moving inventory

CRISIL case studies

A. A US-based retail company under PE ownership, specialising in diving equipment and gears, was looking to optimise its monthly cash flows. Despite the cyclical nature of demand, the company continued to hold high inventory throughout the year. Based on a detailed monthly end use-based demand trend analysis, CRISIL identified the optimum inventory levels for each month. Following this analysis, a purchase schedule was prepared, which helped enhance the company's 13-week cash flow. This resulted in lower borrowing costs and improved ROIC.

B. A US-based PE-backed firm sought to streamline its cash flow management cycle and processes, which had been hindered by strained relationships with vendors under previous ownership. Consequently, there was a build-up of accounts payable balances and cut-offs by vendors, which halted operations and delayed milestone-based cash collection. These challenges exacerbated the firm's working capital issues. We staunched the cash haemorrhage by enhancing reporting, establishing key metrics for operational visibility, and revamping the cost structure and purchasing procedures. These efforts enabled the firm to renegotiate favourable terms with the vendors, resulting in improved gross margins/ profitability.

Insights gleaned from our research and discussions with private capital firms indicate a notable emphasis on enhancing cash management processes.

Market insights

- Our study indicates that leading private capital fund managers such as Carlyle are making their portfolio companies' cash flow management processes more efficient by adopting modern ERP systems and streamlining operations. They have also implemented several working capital management programmes aimed at reducing inventory levels, enhancing receivables collection and extending payables terms, leading to significant improvement in cash flow. Implementation of centralised cash management operations, enhanced cash flow visibility and optimised liquidity for portfolio companies are ultimately reducing borrowing costs and improving cash flow
- Some private capital market firms are cross-leveraging the services of their portfolio companies to improve the efficiency of the cash flow generation cycle. Moreover, these firms are implementing several cash flow management initiatives, such as automating tasks and improving customer service. Large firms such as Brookfield are capitalising on their size and expertise to negotiate more favourable contracts with suppliers and customers, thereby reducing costs and enhancing cash flow
- A few firms are providing interim financing to their portfolio companies looking to build a resilient liquidity/ working capital construct

2. Exploring sustainability and ESG themes

Portfolio company management should prioritise emerging and sustainable themes and integrate ESG factors to enhance valuations.

Our market experience suggests that PE firms face significant challenges in effectively integrating ESG principles across their portfolio companies and enhancing the sustainability value proposition of investee companies. By conducting ESG maturity assessments and developing ESG policy playbooks, private capital managers can identify laggards in the portfolio and accelerate ESG adoption.

To address the above challenges, we have engaged closely with management of the portfolio companies and reviewed their business models — to identify relevant impact metrics and develop a custom framework to help them communicate the sustainability value proposition to investors.

Below are select case studies covering these aspects.

Stakeholder management

a. Actively engage with the investee companies to improve ESG practices, reduce carbon footprint, mitigate sustainability risks and build resilient companies
b. Provide access to proprietary ESG resources and training platform to manage ESG risks effectively and implement reporting best practices

ESG-linked financing

a. Green bonds and sustainability-linked loans incentivise ESG-related targets in portfolio companies
b. Assist borrowers in advancing their sustainability strategies by establishing well-defined KPIs

ESG benchmarking

a. Compare the ESG performance of portfolio investments against industry peers/ benchmarks
b. Leverage third-party ESG rating agencies and data providers to augment their analysis

CRISIL case studies

A. A US-based PE firm was facing challenges in enhancing ESG integration across its portfolio companies through ESG benchmarking and stakeholder management. CRISIL conducted an ESG maturity assessment across the portfolio using bespoke criteria, developed an ESG policy playbook to help build ESG policies for investee companies identified as laggards in the portfolio, and conducted workshops for select investee companies to instil a top-down commitment.

B. A PE-backed Asia Pacific-based satellite broadband provider wanted to enhance its sustainability value proposition to investors. CRISIL identified relevant impact metrics, set credible targets based on peer benchmarking, and drafted an impact reporting framework. The efforts helped effectively communicate the sustainability value proposition of the company, and the impact reporting framework was used to raise additional funds.

C. A PE-backed fossil fuel-based power utility firm sought to enhance its valuation by upgrading to clean energy alternatives. CRISIL identified carbon capture, utilisation and storage (CCUS) as the ideal clean energy option after detailed industry research, economic analysis of CCUS technologies, and evaluation of their implementation methods. As a result, the portfolio company initiated the first CCUS facility in the region, leading to a 20% increase in its valuation.

In our earlier research, titled '[Breaking out]', we provided a bespoke approach to addressing existing data/ framework challenges and enhancing ESG integration in fixed-income investing.

Insights from our research and discussions with private capital firms suggest they are collaborating closely with their portfolio companies to enhance ESG capabilities.

Market insights

Many private capital players actively support their portfolio companies in incorporating ESG metrics. Rather than viewing ESG as merely a compliance obligation, these players aid portfolio companies in improving their ESG performance and delivering sustainable value to all stakeholders. Below are some examples:

- TPG launched a new ESG programme that provides its portfolio companies with resources and support to implement ESG best practices
- KKR is working with a portfolio company, Envigo, to reduce environmental impact and improve social performance. It is also working with another portfolio company, WESCO, to implement several ESG initiatives, including reducing carbon emissions, increasing diversity and inclusion, and improving workplace safety
- Apollo Global is working with Cox Automotive, a portfolio company, to reduce environmental impact and improve social performance. It is also working with another portfolio company to enhance safety features and reduce environmental impact

3. Utilising unified data platforms and building interactive dashboards

The integration of technology into portfolio companies' operations can play a critical role in driving operational efficiencies and growth. Hence, the application of unified data platforms, generative AI tools, and automation are expected to be crucial in increasing their valuation.

Based on our market experience, it is evident that private capital firms face significant challenges in integrating and analysing extensive data from various sources to derive valuable insights on their portfolio companies, the industries they operate in, and their target markets.

In light of these challenges, our initiatives to develop scalable automated solutions, manage data effectively and construct interactive dashboards have helped private capital firms establish centralised repositories to support their portfolio companies.

Below are select case studies covering the above aspects.

CRISIL case studies

A. A UK-based PE consumer-focused firm was finding it difficult to integrate large volumes of data to gain useful insights on operating metrics of its portfolio companies. To address this issue, CRISIL leveraged unified data platforms for enhanced operational intelligence in portfolio companies. Using these platforms, standardised data was extracted from diverse sources to build interactive Tableau dashboards. The efforts resulted in a centralised data repository to gain operational insights on portfolio companies, thereby reducing processing efforts by 90%.

B. A US-based PE firm was unable to effectively analyse the omnichannel behaviour of customers of a portfolio company. CRISIL standardised and integrated semi-structured data using an automated process, created a consolidated data mart to generate patterns and reports on various parameters, and used the Oracle database to develop a central data repository and Tableau for visualisation and insight generation. The analysis of customers' buying habits guided the firm's decision-making, resulting in efficient transaction processing across several sales channels.

Our interactions with private capital firms and insights from our research suggest that a few leading private capital firms want to incorporate technology into their portfolio companies' operations in a big way.

Market insights

Industry leaders such as TPG, Carlyle, KKR and Apollo Global have evinced interest in companies offering software and automation solutions. They want to explore the synergistic benefits by integrating these solutions into their portfolio companies to enhance customer service and innovate products and services. This emphasises the potential for businesses to tap into new opportunities by integrating technology, collaborating with portfolio companies and expediting their digital transformation journey to develop innovative solutions tailored to the evolving digital work environment.

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About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the United States (US), the United Kingdom (UK), Argentina, Poland, China, Hong Kong, Singapore, Australia, Switzerland, Japan and the United Arab Emirates (UAE).

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