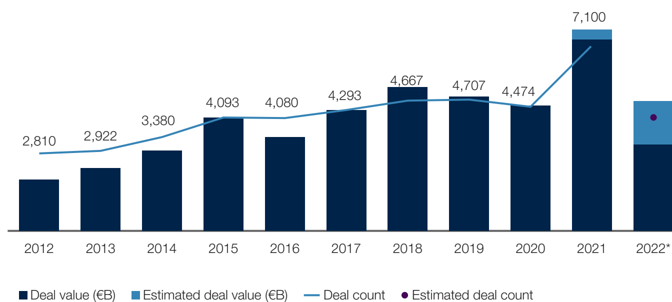
A&M INSIGHTS

Planning and Navigating the Storm: How Should Private Equity Firms Respond to Market Uncertainty?

Introduction

After almost a decade of continuous growth, private equity (PE) dealmaking is set to slow down materially in 2022 compared to last year's record-breaking numbers.

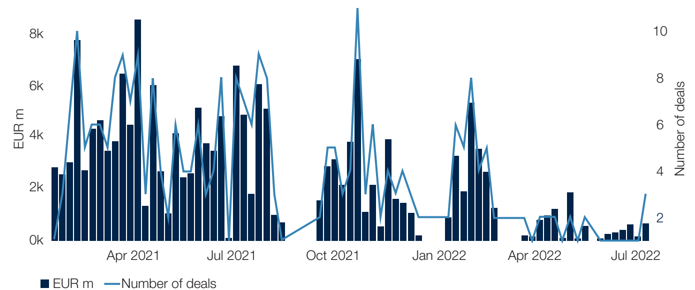
The decline in M&A activity reflects the radically changed macroeconomic environment that dealmakers are operating in following the pandemic, characterized by record inflation, persistent supply chain disruptions, geopolitical instability and tightening financial conditions. Economic indicators in Europe and the US are already signaling an impeding recession, with significant impacts on portfolio companies' growth and profitability in the coming quarters and years.



Moreover, the era of cheap financing that fueled PE dealmaking over the past decade is winding down as central banks hike interest rates and banks show less appetite to fund leveraged buyouts or refinance existing debt. The higher cost of borrowing and uncertain economic outlook have made sponsors more prudent when bidding for new assets. For example, we increasingly see a widening valuation gap between buyers and sellers, with many deals stalling as a result.

In this sluggish M&A environment, PE firms will become more reliant on value creation activities – rather than leveraging and/or buy-and-build strategies – to drive up profits and generate above-market returns for their investors.

Critically, a deeper value creation playbook will have to tap into levers that address the new market reality, including higher raw material costs, wage pressures and soaring energy prices, as well as the scarcity of talent across the business including expert blue collars.



Source: Debtwire

The good news is that PE firms and portfolio companies are not starting from scratch. During the first Covid shock in 2020, they were quick to stress-test and prepare their investments for the upcoming economic slowdown. At that time, many management teams cut down on discretionary expenses or set up working capital and cash-saving programs for better cost efficiency. This has also enabled them to increase the break-even elasticity of their businesses for when demand swung back after the peak of the pandemic.

Faced with a similar scenario of turbulence and disruption today, PE firms should start preparing their portfolio companies with the same urgency they showed in 2020.

A “diagnostic and mitigation” approach to assessing the risk

PE firms should adopt a structured approach to assess the impact of an economic downturn on portfolio companies, alongside mitigation measures available to PE and management teams to immediately act upon the changing conditions. Key steps include:

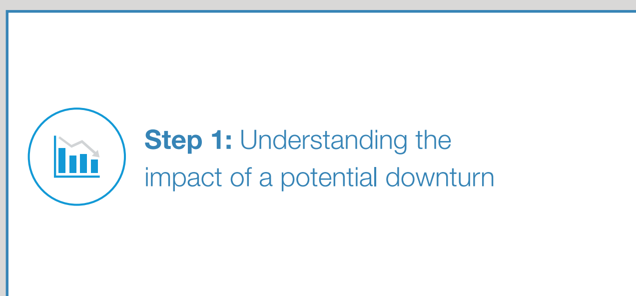
01

Understanding the impact of a potential downturn: A review of existing business plans is conducted to assess their robustness against different inflation and recession scenarios. Specific performance drivers and sensitivities are identified to understand the risk factors sectors and companies are exposed to.

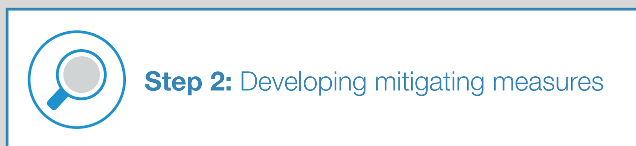
02

Developing mitigation measures: As part of the action plan, tangible countermeasures are developed and made available for each scenario. Trigger events will also be clearly defined to allow rapid implementation of the mitigation measures. Recommended actions span various areas and levels of complexity: from price increases and SKU rationalization to right-sizing of the cost base and reduction of supply chain complexity, to name a few.

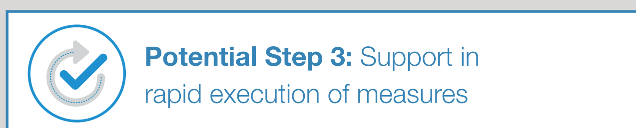
Assessing impact and preparation of countermeasures



Output: Understanding of operational and financial impact on portfolio company, based on specific scenarios



Output: Tangible action plan to mitigate market-driven impact, which is readily available for implementation once certain “trigger events” occur



Source: A&M

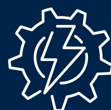
Risks on several fronts require rapid downturn diagnostic and planning

PE managers should be pressure-testing their portfolio companies against several critical areas as part of their diagnostic and mitigation exercise, including:

Raw material prices

Companies from most sectors have been exposed to dramatic increases in input prices recently, as the raw material and commodities market comes under severe strain as a result of reduced supply and the Ukraine war. This will put likely pressure on their margins as they struggle to pass through the cost increase to their customers, especially in sectors such as manufacturing and automotive.

In our view, it is critical for businesses to be able to have effective pricing pass-through to avoid margin squeezes. If a full pass-through is difficult due to specific industry circumstances, management teams should negotiate shorter binding periods (e.g. 3-6 months instead of 12 months) that allow prices to be increased in shorter cycles.



Energy costs

While companies should evaluate options to reduce energy consumption through cost avoidance, initiatives in energy sustainability can generate a big pot of saving opportunities for the longer-term.

These include, for example, investments to build-up their own hydrogen plants to become independent from energy suppliers as well as more “green.” Moreover, businesses can take advantage of grants and subsidies which are available in some countries.

Apart from energy cost increase developing contingency plans for business continuity are key in our view to de-risk supply chains.

Direct & indirect labour costs

An acute labour shortage, ranging from low-skilled jobs to management positions, is hitting the economy of developed countries since the pandemic, with sectors such as hospitality and travel especially affected. PE companies are typically savvy in adopting short-term measures to control labour costs such as hiring freezes, delay of salary increases and full-time equivalent (FTE) optimization in particular.

However, when economic growth comes back, it will be essential to be able to respond by scaling back up quickly whilst keeping the level of customer service high. In many industrial settings, a push towards more automation in production can be a measured forward-looking approach, with paybacks likely to be achieved in two to three years. For example, we have seen companies achieving productivity gains of up to 20% through the automatization of back-office processes.

R&D and engineering

When looking to achieve short-term savings, research and development (R&D) is an area typically targeted by PE firms. However, a more cautious approach is recommended when assessing R&D spending. Companies should focus on prioritizing R&D initiatives based on qualitative and quantitative criteria, instead of applying a widespread effort to cut R&D expenses. By doing that, once each stage-gate process is completed, high-priority projects can be accelerated, and new products and services can be brought to the market quicker to generate sales; on the contrary, projects not meeting performance goals can be discontinued.

In addition, companies can review opportunities to free up engineering resources through standardization and modularization initiatives which will help reduce operational complexities. Management teams should also look for opportunities to reinvest their technical know-how back into the business, for example by the building-up and internationalization of technical service.

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Conclusion

PE firms should acknowledge that the world is once again changing quickly, with risks emerging on several fronts. To weather the upcoming turbulence and to take full advantage of the recovery to come, they should take initiative to get ahead of the wave.

A thorough diagnostic and mitigation planning exercise will help portfolio companies to not only navigate the storm safely but also to adjust value creation plans to exploit the altered market opportunity. This will allow them to preserve the valuation of their investments and deliver above-market returns to their investors – even during challenging times.

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A&M's private equity-focused professionals understand the need for agility and the importance of speed to execution in order to prioritise the key areas of improvement that will positively impact EBITDA and ensure sustainable cash generation at the portfolio company level. Ensuring a successful transformation requires strong leadership at the top that can then be exemplified and reproduced throughout the organisation. Leadership requires definitive action, which then leads to positive results for all.

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