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OPERATIONAL VALUE CREATION: THE MOST IMPORTANT SOURCE OF RETURN FOR PE ASSETS

FEBRUARY 2025

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Operational Value Creation: The most important source of return for PE assets

Private equity (PE) markets in Australia have seen growing popularity and accessibility in recent years, both for retail and institutional investors. Per the Australian Prudential Regulation Authority (APRA), regulated super funds now have a 4.5+ percent allocation to unlisted equities on average, equivalent to approximately A$115 billion in capital invested in the asset class. Further, an increasing number of direct investment platforms offer retail investors the opportunity to tap into what was once an asset class reserved for the elite, professional investor. But just as exposure has grown, so have the near-term headwinds.

Now firmly established as mainstream investments, PE portfolios today are under the same pressures that weigh on other asset classes given challenging macroeconomic conditions. Uncertain inflation expectations and elevated interest rates have slowed M&A deal activity and exits in recent months due to wide bid-ask spreads and a lack of confidence in underwriting long-term margin stability.

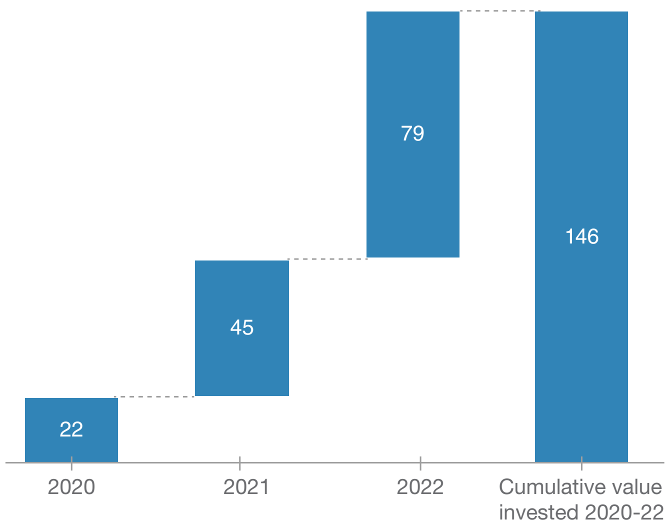
According to A&M calculations, a combination of multiples and margin compression could wipe over A$25 billion off the valuations of those PE assets acquired in Australia during the Covid-19 era deal boom. The impact of higher-for-longer interest rates on free cash flow and lower-for-longer (or more volatile and uncertainty) economic growth could drive even more value loss.

In this paper, we examine the state of the PE market in Australia and discuss how PE firms should reset their strategies to safeguard their investments and obtain exit value in the current environment.

A surge in PE investments during Covid years

Figure 1: PE capital invested

Total value of PE transactions in Australia, in A$ billion



Source: S&P CapIQ, A&M analysis

PE transaction activity in Australia surged between 2020 and 2022 as dealmakers capitalised on the economic rebound following the easing of Covid-19 restrictions, strong domestic demand in certain sectors and record low interest rates.

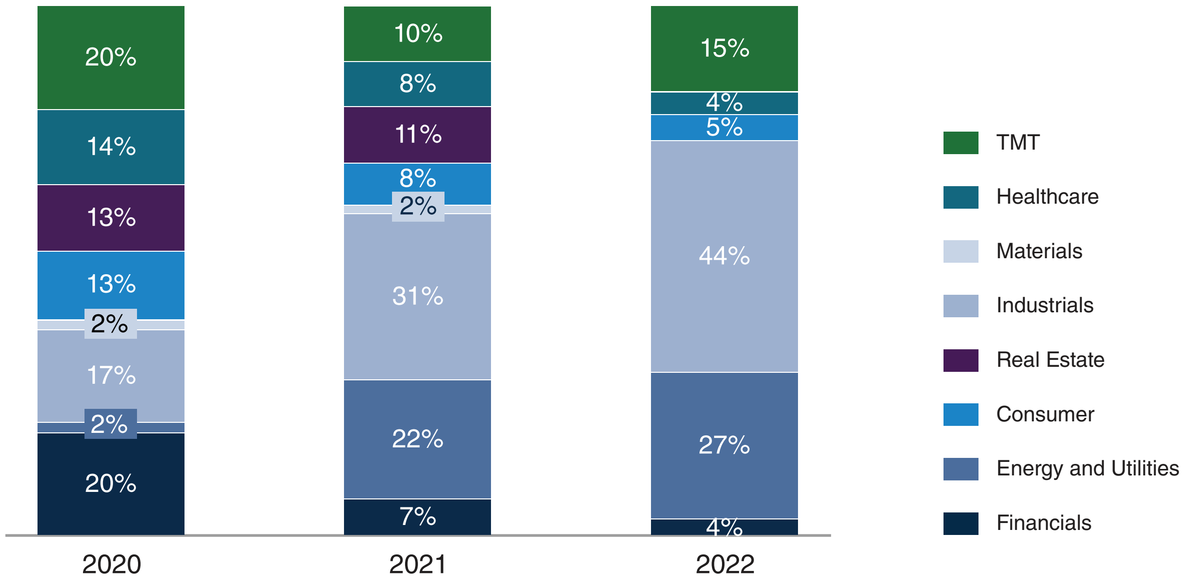
According to S&P Capital IQ (CapIQ) data, PE investments in the region more than tripled between 2020 and 2022, reaching approximately A$146 billion in cumulative value invested in the period. (See Fig 1)

The Industrials, Energy & Utilities and Technology, Media & Telecommunications (TMT) sectors were the focal points of investment activity during this three-year period, accounting for 72% or approximately A$105bn of total investment. This was followed by the Healthcare, Real estate, Financials and Consumer sectors which collectively accounted for 27% or approximately A$39bn of the remaining PE investment capital deployed. (See Fig 2)

Many of these sectors have since faced a raft of challenges attributed to the changing economic climate in Australia and globally. Volatile supply chains, depressed consumer sentiment, rising input and energy costs, as well as changing demand patterns and geopolitical uncertainty have put pressure on most industries' margins outlook.

Figure 2: Private capital investment by sector in Australia

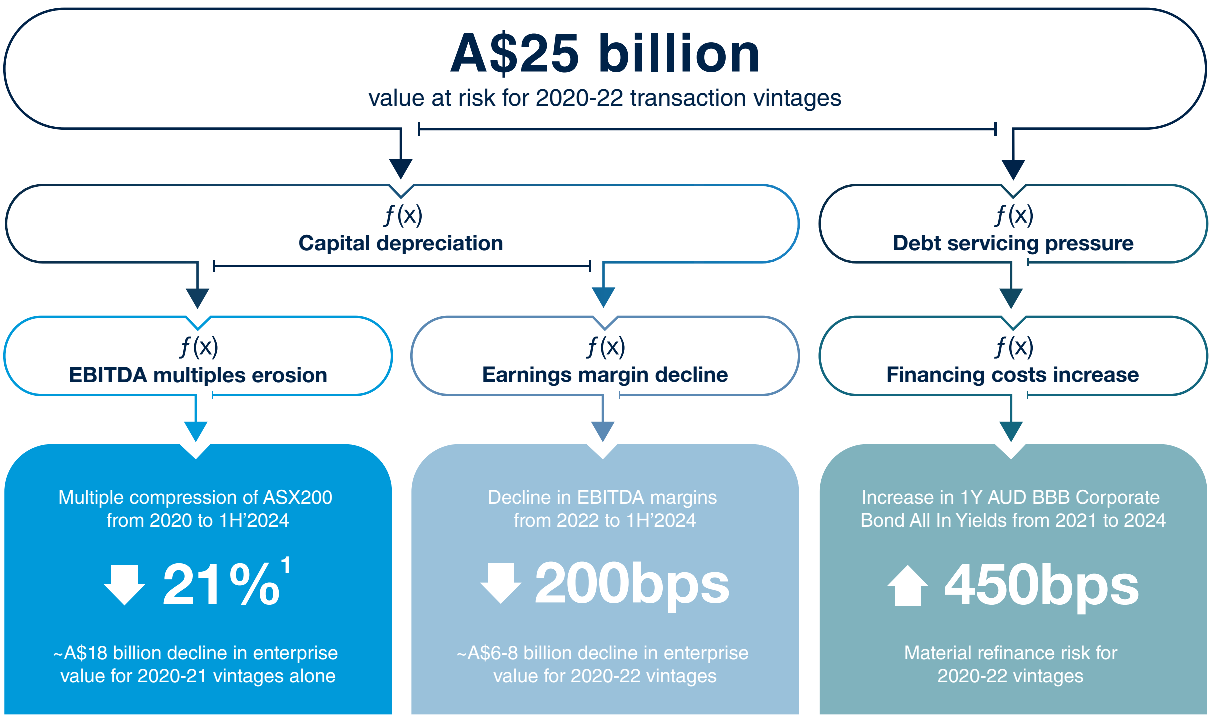
Percentage of total investment value by sector



Source: S&P CapIQ

PE portfolio valuations under pressure

PE portfolio returns are a function of changes in valuation multiples, earnings margins and debt financing costs, which together equate to A$25 billion of portfolio value at risk for 2020-22 PE vintages:



Source: S&P CapIQ, Bloomberg, A&M analysis

Note: [1]ASX200 sector multiples used as proxy for private market multiples, as of 18/12/2024

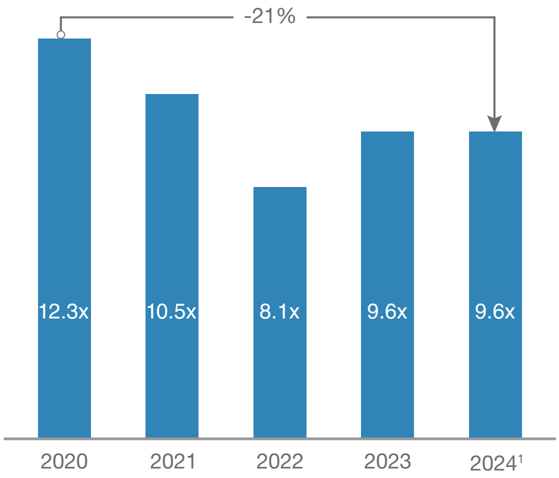
The PE industry is confronting significant headwinds that are impacting asset valuations and making it harder for funds to achieve target returns. Below, we explore how these challenges are affecting each driver of portfolio value, with a particular focus on PE investments made between 2020-22.

1 EBITDA multiples compression

Transactions completed in 2020-21 occurred at relatively elevated EBITDA multiples. These deals accounted for 45%, or A$67 billion, of the total capital invested in the 2020-22 period.

Our analysis, which takes current ASX200 next twelve months (NTM) EBITDA trading multiples as a proxy and adjusts sector weights according to private capital transactions during the period, suggests that 2020 vintage PE investments have seen a 35% compression in multiples compared to 2024, while 2021 vintages have compressed 23%. By comparison, the ASX200 has seen multiple compression of 21% from 2020 levels.

Figure 3: Multiple compression PE multiples proxy:
ASX200 NTM EV/EBITDA multiples 2020-1H2024



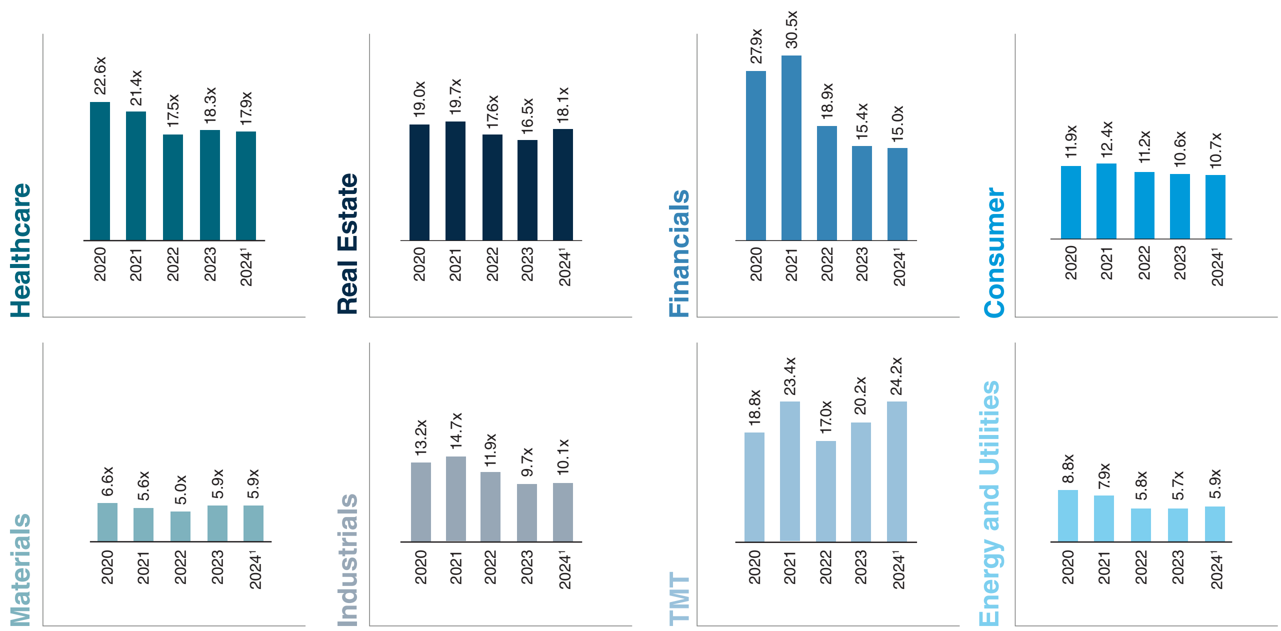
Source: S&P CapIQ

Note: 1. ASX200 sector multiples used as proxy for private market multiples, as of 18/12/2024

Multiple compression has been particularly pronounced in the Energy, Industrials, Healthcare and Consumer sectors. These sectors have likely seen volatility as a result of softening household balance sheets as well as changing regulatory and geopolitical environments.

As a result, we estimate that 2020-2021 PE investment vintages, weighted by deployed capital by sector, have seen ~A$18 billion of value destruction from multiple compression.

Figure 4: Multiple compression by sector
ASX200 NTM EV/EBITDA multiples by sector



Source: S&P CapIQ, A&M analysis
Note: (1) as of 18/12/2024

We observe the following drivers of multiple compression across the hardest-hit sectors:

Energy and utilities

- Geopolitical uncertainty due to international conflicts
- Variation in local government approaches to the energy transition
- Disruption to traditional business models and adoption of renewable energy technologies

Healthcare

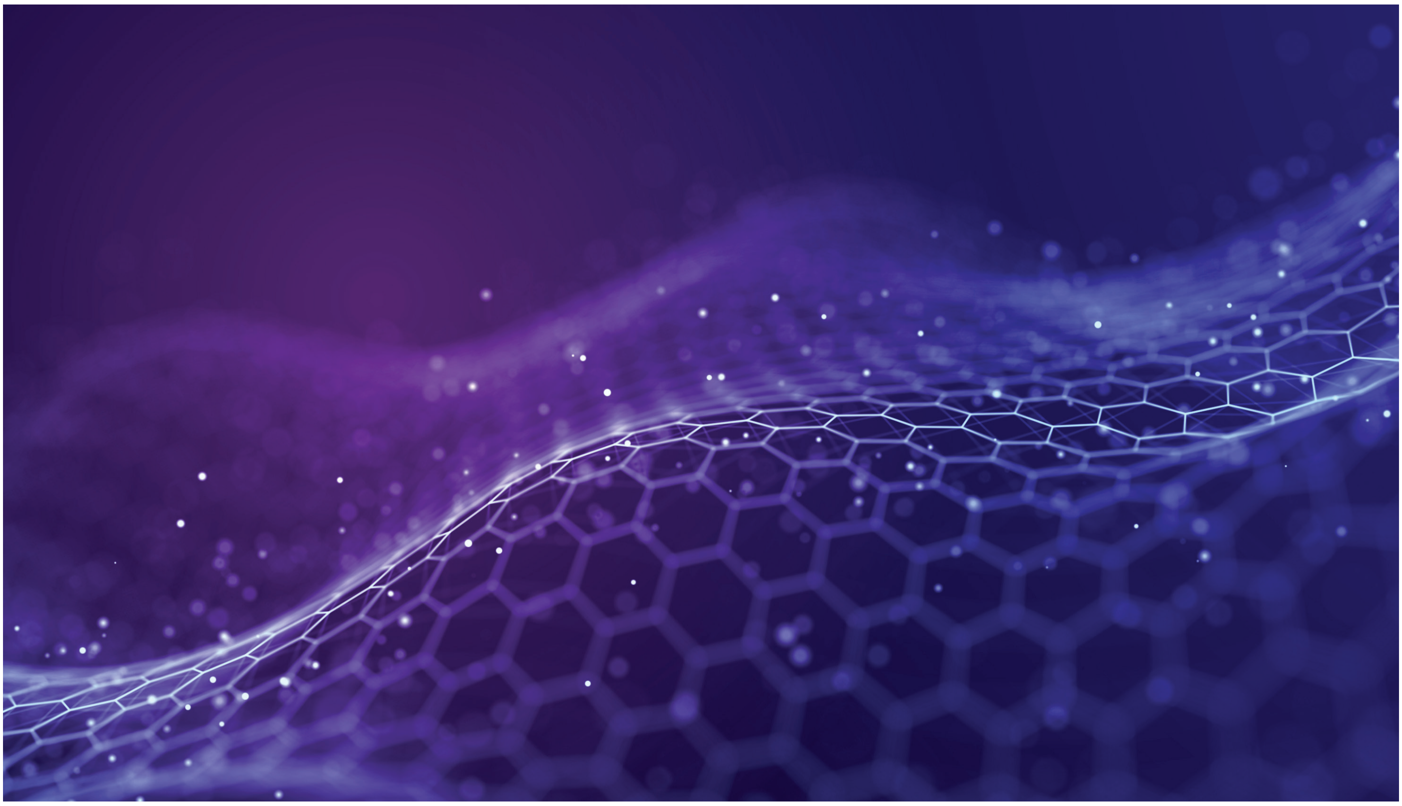
- Skilled labour shortages driving wage inflation and negative margin impact
- Decline in demand for healthcare services amidst post-Covid normalisation and increasing prevalence of gap fees to push through cost inflation to consumers
- Market consolidation attributed to significant M&A activity is limiting opportunities for attractive investments

Industrials

- Supply chain disruption driving higher input costs for materials such as steel, aluminum, and other raw materials, on top of higher fuel costs
- US-China trade tensions have led to the imposition of trade barriers disrupting the flow of goods and materials
- Fall in service exports through 2021 and 2022 and current decline in commodity prices

Consumer

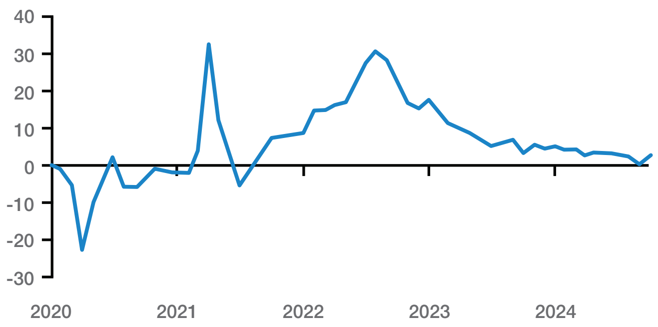
- Household essentials' price inflation amidst higher mortgage costs are shifting consumer spend patterns away from discretionary items
- Fluctuations in raw material prices, influenced by global supply-and-demand dynamics
- Rising logistics and distribution costs driven by fuel prices and labour shortages pushed through to consumers



2 Earnings margins contraction

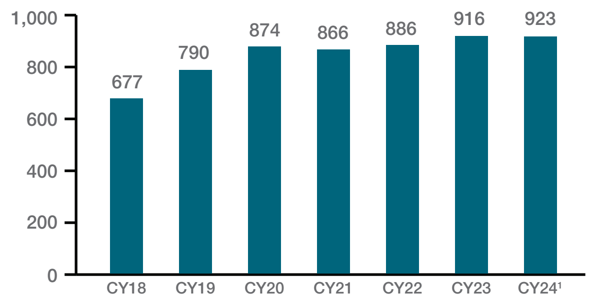
Macroeconomic conditions have slowed since 2022, a year marked by accelerating economic activity driven by low interest rates, expanding corporate margins, rebounding consumer confidence, and ongoing federal government stimulus (e.g., handouts or tax cuts). While recent data suggests some global resilience among consumers, leading to the possibility of a rebound in inflation, 2023-2024 has largely seen post-Covid normalisation as monetary policy lags were finally felt and household balance sheets softened. Data from the Australian Bureau of Statistics (ABS) on household spend, as well as government expenditure illustrate the shift in the economic environment and the diminishing role of fiscal spend as an ongoing economic boost.

Figure 5: Seasonally adjusted change in household expenditure from 2020-24 in %



Source: ABS (October 2024) household expenditure, seasonally adjusted

Figure 6: Government expenditure from 2018-2024, A$bn

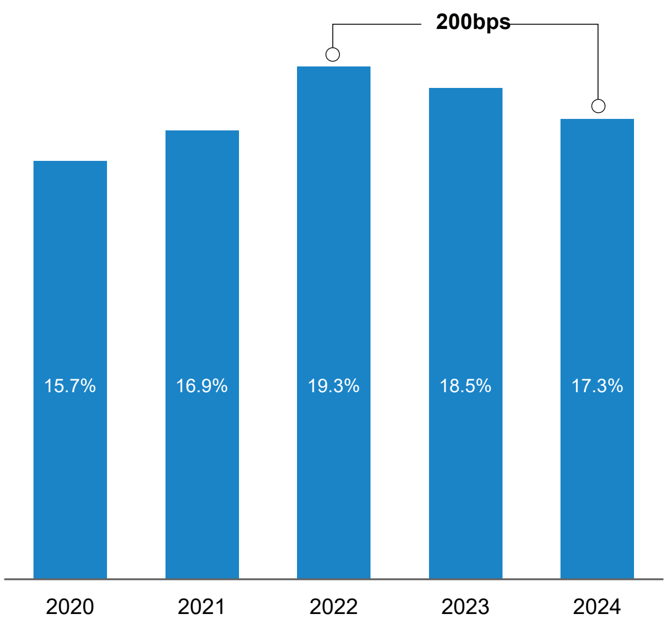


Source: ABS

Notes: 1. CY24 represents Q1-3 annualised

Figure 7: ASX200 companies EBITDA margins

Weighted average EBITDA margin



Source: S&P CapIQ

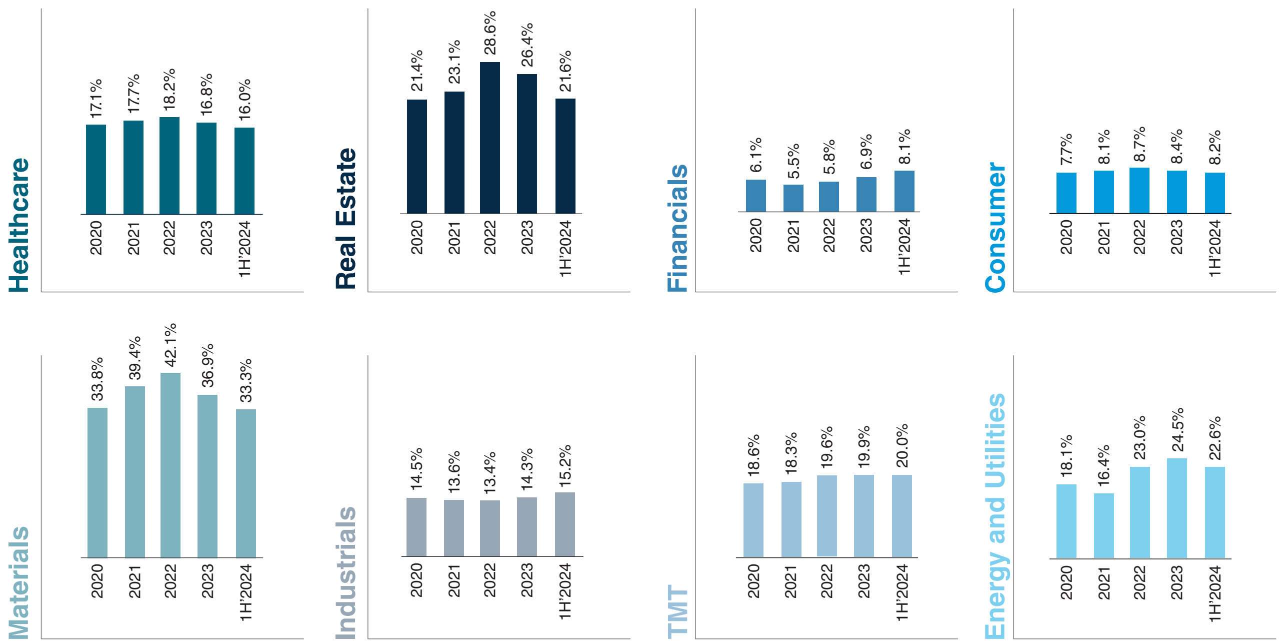
Note: 1H'24 data used as most recent ASX reporting disclosure

Inflation has driven worsening economic conditions and margins as companies have struggled to fully pass through cost inflation via price increases. This is evidenced by an 8% revenue CAGR but only a 2% EBITDA CAGR for ASX200-listed companies from 2022 to 2024, with year-to-date earnings margins for ASX200-listed companies declining 200bps since 2022 peaks.

The earnings strain was particularly pronounced across the Healthcare, Materials and Real Estate sectors:

Figure 8: ASX200 EBITDA margins by sector

Average EBITDA margin by sector



Source: S&P CapIQ EBITDA margin by ASX200 sector, A&M analysis

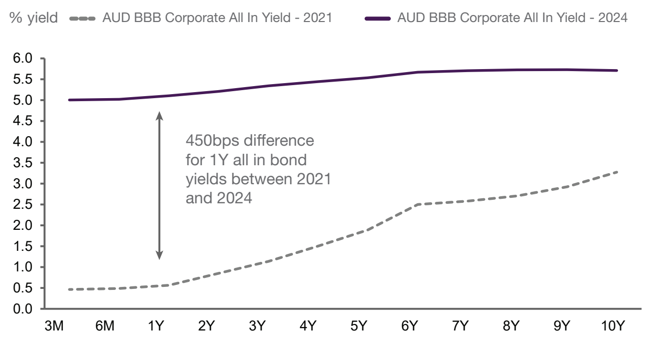
For PE investments completed between 2020-2022, a 200bps reduction in margins could result in a further A$ 6-8 billion in value destruction, in addition to multiple compression. This amount could accelerate if margins have not yet fully normalised post-Covid.

3 Rate hike pressure

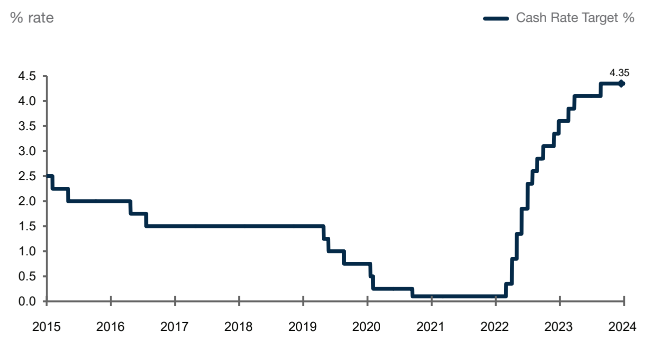
As interest rates rose to combat inflation in the aftermath of the pandemic, Australian debt markets saw a material shift in liquidity and appetite for debt. Borrowing costs have shot up as demonstrated by the higher "all-in" yield for AUD BBB-rated corporates seen in Figure 9 below.

The step-change rise in both credit margins and base rates has led to an increase in the total debt cost burden for PE portfolio companies seeking to refinance. The surge in debt-servicing costs has, in turn, impacted the cash flow of portfolio companies, creating a precarious operating environment for PE firms. They must decide between holding investments for longer but risk refinancing, or sell their companies now in a market characterised by wide bid-ask spreads.

Figure 9: All-in yields have increased as restrictive RBA policy seeks to contain inflation



Source: Bloomberg



Source: Reserve Bank of Australia

4 What does it mean for PE?

The compounding effects of compressing multiples and margins have the potential to wipe out over A$25 billion of value from 2020-22 vintage PE investments in Australia.

For PE owners, this market reality has several critical implications:

1 Lower exit valuation

As EBITDA multiples compress, the valuations at which PE owners can exit their investments are likely to be lower, thereby affecting returns

2 Extended holding periods

To achieve target returns, PE owners may need to extend asset holding periods, waiting for market conditions to improve or buying time to improve the asset. This extended holding period can tie up capital that could otherwise be deployed in new opportunities as well as dilute returns to LPs

3 Dependency on value creation

To counteract value destruction, PE owners will need to place a greater emphasis on operational efficiencies within their portfolio companies. For example, common levers are cost-cutting measures, process optimisation, and strategic initiatives focused on ROIC to enhance profitability. Making meaningful change to the business 12+ months prior to sale, to show a track record, becomes paramount

4 Strategic repositioning

PE owners may need to provide LPs with a repeatable playbook to drive margin improvement through portfolio companies and be able to communicate where potential opportunity exists amidst challenging economic circumstances (e.g., shifting focus to sectors that are more resilient to current economic pressures)

An opportunity to seize value creation opportunities and embrace a mindset shift has emerged for PE firms

As the industry continues to evolve through this new reality, PE investors must pivot their value creation strategies to focus on improving profitability in existing portfolio companies. They should pursue a broad suite of levers across cash, cost and revenue to drive free-cash-flow (FCF) and offset the impact of multiple compression. Each lever has a different time to realisation and "size of the prize", and may involve the initiatives outlined below:

Faster benefit realisation

Longer benefit realisation

1 Working capital and liquidity management

- Plan to optimise allocation of capital through cashflow forecasting and liquidity buffers
- Optimise cash payment and collection timing
- Maintain minimum order quantities, closely report on inventory impact, and ruthlessly weed out slow turning inventory
- Capitalise on opportunities to re-negotiate provider agreements, consolidate suppliers and increase focus on spend control

2 Operating and capital expenditure

- Optimise distribution network and implement sourcing strategies to optimise OPEX spend
- Focus on S&OP, labor and asset utilisation levers to drive efficiency increases
- Identify overhead efficiencies and reduce fixed cost structures
- Assess infrastructure needs for short-to-long term scalability and right-size third party spend

3 Revenue optimisation

- Identify sustainable sources of increased revenue and margin improvement opportunities
- Focus on product portfolio, pricing and go-to-market levers to increase revenue and profitability
- Improve sales team performance, customer segmentation and sales channel optimisation
- Re-align brand positioning, digital and content marketing

As the investment cycle enters a new phase, adopting a refreshed mindset offers a vantage point to capitalise on latent opportunities. The following principles equip PE investors with a comprehensive playbook to navigate and execute future investments amidst market uncertainties:

1. **Cash is King, Queen, and the Joker**
   Install a highly-disciplined, cash-conscious organisation that drives cashflow-accretive decisions with rapid paybacks
2. **Bankers and lenders are your best friends**
   Protect cash lines and liquidity arrangements through diversified sources of funding and ongoing short-term loan profiles
3. **An "ok CEO" is ok, but an "ok CFO" is not!**
   Be mindful that CFO is key to success in tough times – bring an interim solution if you need to
4. **Planning is dead... Long live planning!**
   Focus on monthly/quarterly planning, given annual planning loses its relevance due to volatility
5. **Do not let a good crisis go to waste**
   Clean up the business portfolio, including stores, facilities, and other unprofitable BUs, migrating to a variable cost structure
6. **Focus on the metrics that matter**
   Identify and reorient management KPIs towards balance sheet and cash preservation
7. **Build resilience for the worst**
   Assess 'conservative' and 'worst case' scenarios to understand likelihood of survival
8. **Cost management is the art of the possible**
   Foster new "out-of-the-box perspective" to drive cost excellence through "What is essential to be retained"
9. **Maker vs. checker**
   Establish integrated review and reporting protocols to increase compliance and governance
10. **Execution, execution, execution!**
    Champion execution – inaction has an immense cost in downturns

How A&M can help

A&M supports PE owners with developing practical value creation programmes and shaping exit strategies. Our new PE Exit Product prepares portfolio companies 18-24 months prior to sale with everything from margin expansion to working capital improvement, delivering early success that proves credibility as well as showing ongoing value creation potential that appeals to potential buyers.

Note: All public market data as of 1H'CY24 filings

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