Newsletter (5) - Exit Strategies in Private Equity

(1) Introduction

In this week's edition of our weekly newsletter, we take a closer look at some of the key exit strategies for Private Equity (PE) portfolio companies, and how General Partners (GPs) are trying to navigate through today's changing buyout landscape.

The following article examines three of the most common exit strategies for GPs: Initial Public Offerings (IPOs), trade sales, and secondary sales.

(2) Initial Public Offering

Historically, one of the most lucrative and important methods for private equity firms to exit investments has been through Initial Public Offerings. This strategy often provides immediate access to liquidity, and enhances the reputation of both the portfolio company and the private equity firm. According to Pitchbook, over the past decade, IPOs have been providing higher median EV/EBITDA multiples compared to exits through strategic or financial buyer acquisitions.

Success in an IPO requires rigorous preparation. It is important that the portfolio company is operationally efficient and financially streamlined. Portfolio companies create an in-depth prospectus to highlight their growth story, financial health, and market opportunity. This, together with roadshow campaigns, becomes vital in building investor interest and confidence. Investment banks, and other advisors, will gather demand during the book-building process and finalize the IPO price. Once regulators approve the IPO, the company begins trading its shares on a public stock exchange.

The process is long and costly, but the greatest limitation lies in the success being determined by exogenous factors. Market volatility, rising interest rates, and broader economic uncertainty can make a big difference to valuations, reducing investor demand and making PE firms more cautious about pursuing IPO exits. Additionally, even if the IPO is successfully launched, lower-than-expected trading post-release can lead to reputational and financial risks for the portfolio company and PE firm, reducing the overall appeal of IPOs in uncertain market conditions. According to S&P Global, In the first three quarters of 2024, 152 PE backed IPOs were launched, up from 72 in 2023, but still below the levels achieved in 2021. In recent years, this has led to PE firms opting for other exit strategies or putting on hold any IPO plans.

Looking ahead into 2025, easing borrowing costs, strong equity markets, and favorable regulations are expected to fuel a rebound in PE-backed IPOs. Eddie Molly, global co-head of equity capital markets at Morgan Stanley, has noted that large PE-backed IPOs will be one of the most important trends of the year. Particularly, many scaled companies in IT and healthcare are being considered as ideal IPO candidates.

(3) Trade Sales

Trade sales, where portfolio companies are sold to strategic buyers, remain a pillar of private equity exit strategies. Such transactions take advantage of the buyer's ability to unlock synergies, expand market share, or meet strategic milestones. Unlike financial buyers, who have investment cycles and target returns, strategic buyers focus on long-term operational benefits. The prerequisite for successful transactions is alignment between the goals of the portfolio company and those of the strategic buyer.

The most frequent strategic buyers are usually competitors or companies operating in related industries, and this group is mainly driven by how well the target fits into their core business strategy. Most often, acquisitions support broader goals like targeting new markets, consolidating positions in those markets, or expanding operations globally. As these acquisition decisions align with strategic objectives rather than short-term financial metrics, timing is less of a concern. Instead, it's about how the acquisition will strengthen the buyer's position and operations in the long term.

However, economic pressure has made strategic buyers more selective. Higher interest rates have increased the cost of financing, and buyers have begun reviewing opportunities with greater care, focusing only on companies that precisely fit their strategic needs. Sellers, in turn, have resisted price adjustments, leading to wider bid-ask spreads, further slowing the frequency of transactions.

For private equity sellers, success in value maximization lies in showing how a portfolio company can align with the strategic priorities of a buyer. Sellers should demonstrate synergies, growth opportunities, and the capability to contribute to expansion goals by positioning the company as an irreplaceable piece of the buyer's long-term vision. To maximize outcomes, private equity sellers may adopt a dual-track approach, simultaneously preparing the portfolio company for a trade sale to strategic buyers while exploring IPO opportunities, ultimately pursuing the path that offers the highest value.

Strategic buyers remain focused on acquisitions that will help them expand market presence, increase efficiencies, or achieve transformative growth, objectives often immune to short-term market fluctuations. However, such deals are often subject to scrutiny by anti-monopoly watchdogs and regulatory bodies, which aim to prevent anti-competitive behavior.

Looking ahead, trade sales will likely remain crucial in the private equity world, with industry consolidation at an all-time high and the strategic imperative more pressing than ever. Success will depend on sellers' ability to anticipate the specific needs of potential buyers and position themselves appropriately to ensure that each transaction meets the buyer's broader operational objectives.

(4) Secondary Sales

Continued sales to financial buyers, including private equity firms, have emerged as a common exit strategy in the form of secondary buyouts (SBOs). With constrained exit opportunities, SBOs have emerged as an alternative strategy offering predictable and efficient exits. They are often considered a fallback option when other exit strategies face challenges. As suggested by Pitchbook, 30.5% of PE exits in Q1 2024 were attributed to SBOs, up from 25.5% in 2023. While these deals provide speed, liquidity, and portfolio management benefits, they are not a first choice as they may not always yield the highest returns.

The increase in secondary buyouts reflects the necessity for GPs to return and recycle capital, as well as the desire of LPs for the distribution of capital. These exits are more predictable and less likely to fall through because they often involve parties familiar with the private equity process and valuation methods. In contrast, IPOs require extensive regulatory work, while strategic sales carry risks such as antitrust concerns, misaligned interests, and lengthy due diligence. Elevated dry powder levels and the maturity of the private equity market form the foundation of this trend. An example of a large secondary buyout is Ardian's sale of a majority stake in UK-based Audiotonix to PAI Partners in April 2024 for nearly £2 billion ($2.51 billion), with Ardian retaining a minority stake alongside management (PE Hub, 2024).

However, the interest rate environment presents challenges for SBOs. High transaction and borrowing costs have driven equity portions of LBOs to an all-time high average contribution of 52% in 2024, affecting SBOs (Pitchbook, 2024). That trend is a sign of tighter credit markets and lenders taking a more cautious approach, which has impacted the purchasing power of financial buyers.

In this context, looking ahead, SBOs will continue to be a popular exit option, as their execution speed and efficiency are easier to predict with a lower risk profile, especially when selling to another PE firm with a shared understanding of value creation. This attractiveness of SBOs is further driven by the liquidity needs of GPs and pressure to deploy record levels of dry powder within the constraints of closed-ended funds. However, the pick-up in IPO markets or strategic buyers returning could widen the avenues to exit, and the reliance on SBOs would then be relatively lower over time.

(5) Conclusion

The Private Equity buyout scene is evolving as firms confront obstacles in pursuing exit strategies. However, IPO activity displays signs of revival, fueled by lower borrowing costs, strong equity markets, and supportive regulations. Trade sales, focusing on operational coherence and strategic alignment, stay appealing despite rising interest rates and regulatory hurdles. Secondary Buyouts (SBOs) provide liquidity options, with SBOs gaining favor due to high dry powder levels and reduced IPO activity. Choosing the right exit strategy requires meticulous evaluation of all alternatives, factoring in market dynamics, economic conditions, and the strategic objectives of the portfolio company to guide the ultimate decision.