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Beyond yesterday's gains

Why private equity must reimagine its route to value creation by **Mark Veldon**

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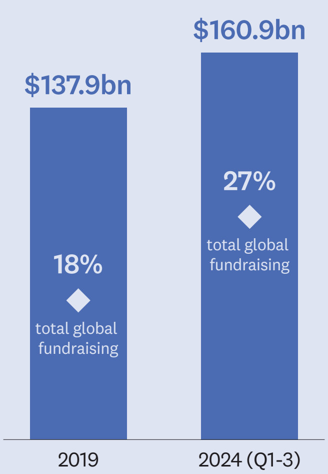
Big funds gain more

Ten largest funds as a percentage of global fundraising total: 2019 versus 2024



Source: Private Equity International

Private equity's once-reliable playbooks are showing signs of wear, and it's time for firms to rethink their strategic approach.

Private equity has bucked the old economic adage that "past performance is no guarantee of future results" over the years. Ironically, in this sharpest of finance-focused spaces, tried and tested strategies have proved an exception to this rule time and again. The traditional principle of optimising capital structure and expanding multiples in a more welcoming economic environment have shown little resistance in delivering returns.

But that is changing, and the pressure to deliver tangible results within existing portfolio companies (portcos) is intensifying.

A market in transition

The European market has displayed cautious optimism in 2024, with a rise in fund availability and strong fundraising in those funds performing well.

Large deals involving crown-jewel assets are resurfacing, despite deal volumes remaining below the peaks of 2021 and 2022. Firms are capitalising on tighter corporate funding conditions and hesitant public markets to drive carve-outs and public-to-private transactions, reflecting strategic adjustment for the current climate.

However, portco leaders still face elevated interest rates and slower economic growth – which are unlikely to change materially in the UK following the recent Budget, while the macro European outlook remains unclear.

Exits remain challenging, too. Higher capital costs continue to complicate new deals, and historically low IPO activity prompts expectation of a necessary rise in sponsor-to-sponsor exits in 2025; this has surpassed 50% of exit activity in the first three quarters of 2024, a record high for the last decade.

More capital, fewer funds, and greater complexity

Many LPs have worked to streamline GP relationships to enable greater deployment, fuelling greater concentration of capital within the largest PE firms.

The number of funds raising capital has declined over the last six years, yet the aggregate sum has grown, reflecting more money in the market but fewer funds capturing it. The top 10 funds globally now absorb 27.3% of total value raised in 2024, versus 18% in 2019.

Such deal size growth adds to their complexity and the expertise levels necessary to navigate such transactions. Large deals are finite, though, so some large-cap funds will need to pivot to mid-cap – along with funds struggling to fundraise more broadly. In this respect, the mid-cap space will likely become more competitive, mandating a differentiated offer or approach, and different skill sets from PE firms.

Deals will require more complex capital structuring, catalysing more intense due diligence requirements, particularly amongst more risk-averse investment committees seeking deeper, earlier insight on potential targets.

As large firms strive to maximise returns on complex investments and lubricate the market, the pressure to create value intensifies. With considerable resources at hand and fewer traditional avenues for returns, larger firms are entering uncharted territory.

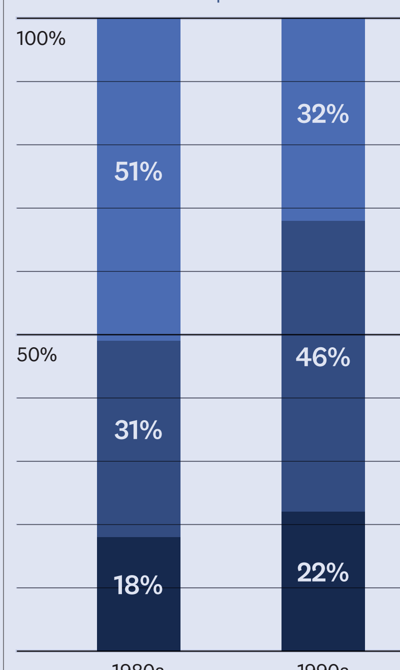
Operational excellence is key

To manage larger portfolios, firms must leverage their scale and capital to drive tangible value. They must build the internal capabilities to execute exits effectively, which necessitates new strategies and skillsets, prompting structural and cultural change.

Operational excellence will therefore be key. Growth and margin improvement through operational improvement already accounts for close to half of PE value creation – 2.5 times more than in the 1980s. That trend will only strengthen as elevated interest rates keep the cost of servicing debt high, dampening the returns from this lever. Increased competition and potential implications for UK portcos from the Autumn Budget make it even harder to rely on multiple expansion, while GPs also face mounting pressure as LPs negotiate lower fees and carried interest taxes rise.

Ways of creating value

Drivers of value creation in PE investments: 1980s to present



1. Revenue growth and/or margin improvement

Routes to value creation are diverse

Saying that value creation is critical is one thing; executing on that promise is another.

PE leaders and portco executives must coordinate a set of structural and tactical initiatives to meet the demands of today and build future capabilities.

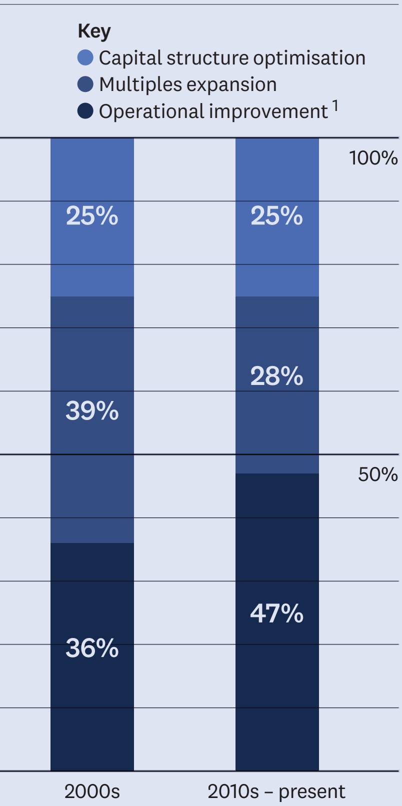
In our experience, certain levers have the greatest potential to derive the value investors expect over longer holding periods, especially in an era when strategic planning is likely to be blindsided by unexpected disruption. However, rather than relying on financial engineering, these strategies require nuanced, hands-on execution.

Plan to exit – from the outset

As deal sizes grow and complexities mount, robust exit strategies will be paramount. PE firms must cultivate a "plan to exit" mentality from deal sourcing through to exit, continuously reassessing deal theses throughout the investment lifecycle.

Firms deploying AI and advanced analytics can drive strategic advantage, streamline operations, and uncover novel innovation and efficiency opportunities. AI can transform due diligence, customise products, enhance transparency, reinforce the security of transactions, and build early investment confidence.

All told, though, AI will unlikely deliver on the many promises proclaimed during the recent hype cycle, so they must be intrinsically linked to tangible business benefits.



Source: Institute of Private Capital

Foster collaboration during onboarding

Effectively interlinking sponsor and portco financial and operational systems will lay the foundations for collaboration. Co-creating strategic plans and incentives with management teams and external advisors – and actively measuring their performance – will help dismantle silos, ensuring alignment and shared accountability.

As deal activity further unlocks in 2025, forging strategic partnerships becomes invaluable. Whether through collaborations with fellow PE firms, alliances with strategic investors, or joint ventures, these partnerships can catalyse new opportunities for synergy and growth.

Such alliances allow firms to pool resources, share expertise, and bolster capabilities to tackle the large-scale deals and intricate investments that characterise current industry activity.

Nurture human capital

The most successful players have long recognised talent as a core component of true value creation, and it will always rise to the top as a differentiator.

Building leadership teams with deep industry expertise and fostering a culture of

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learning, inclusion, and diversity are pivotal for attracting top-tier professionals and driving outstanding performance.

Promoting specialist rather than generalist roles will drive sector-specific gains, and we also see some firms incorporating psychographic assessments of portco management teams to ensure tight alignment with a sponsor's ethos and objectives.

Monitor performance systematically

Rigorous approaches to portfolio monitoring and evaluation are non-negotiables. Leveraging GenAI and machine learning – for the right business outcomes – can garner deeper insights and enable more strategic decision-making.

The importance of proactive scenario analysis and robust surrounding risk management frameworks cannot be overstated, too. Anticipating and mitigating risks, whether from regulatory changes, technological disruptions, or market volatility is key to preserving stability and protecting investor interests. Building multiple plans of attack for different economic outlooks allow leaders to shift to action quickly and avoid value erosion through inertia.

Prepare for exit

As firms gear up for exit, thorough pre-exit due diligence is essential. Aligning stakeholder incentives to market expectations for company performance will ensure deal and operational teams are vested in the success of an exit strategy.

Leveraging analytics to forecast industry and portfolio trends can also optimise exit timing and value. By creating smarter feedback loops, firms can ensure that lessons learned at exit flow back to deal sourcing and structuring, facilitating continuous improvement.

Tell a strong value creation story

A compelling value creation narrative is arguably more important than the strategy itself. Firms need to stand out in a competitive market and withstand heightened scrutiny during diligence phases.

Bid-ask spreads remain uncomfortably wide in many areas, making it essential that projections of sustainable future performance are built on a bulletproof fact base. Showing is always better than telling.

Eyes on the prize

Growth and operational excellence are now the dominant cornerstone of value creation. A lack of competency here comes with consequences, in the shape of eroded value, but the dynamic of longer hold periods is an opportunity to double down and maximise value; misuse this time, and returns are at risk.

More positively, concerns over the market's looming maturity wall have eased as the percentage of high-yield debt set to mature in the short term has fallen. Any reduction in refinancing pressure will give portcos greater room to grow into their capital structures.

Ultimately, PE firms' ability to articulate and execute value creation strategies will determine their resilience and sustainability. Embracing agility, technology, collaboration, and specialised expertise will help them harness new avenues of growth, equipping them to thrive as the industry continues to transform.

While past performance may have proved to be a reasonable indicator of future performance in years gone by, it will be the action taken now that dictates the results that are delivered in 2025 and beyond.