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OPINION

How to climb through the exit window

Developing a way out for continuation assets continues to be a challenge, writes Dan Ginsberg, managing director, private equity, SGS Maine Pointe.

By Dan Ginsberg, SGS Maine Pointe

With hundreds of portfolio companies in continuation patterns still struggling to achieve exit, the question for those portco CEOs and investors is how to effectively turnaround these situations, generate positive returns and create a compelling path to exit.

For various reasons these executives and investors have not been able to exit over the past five or so years, throwing off the original investment thesis and time horizon. This is often due to one-time, exogenous complications (for example, a global pandemic affecting quarterly performance) and not necessarily a systemic decline in customer demand or operating abilities. Eventually, most institutional investors must separate the asset from a fund structure, at which point it enters a "continuation pattern." Historically, this has often led to a slow downward spiral due to limited access to cash and other resources needed to resuscitate the asset while also missing the "exit window" as interest rates and market context change over time.

With the complication of managing a continuation asset plus a "higher for longer" interest rate environment, the key is to find new methods for unlocking EBITDA and cash in a manner that enables an exit for the long-holding investors and a new path for growth for future investors.

Dan Ginsberg, SGS Maine Pointe

Companies in a continuation pattern typically have had to refinance their debt loads in the past two years (as debt on PE typically matures in five years or less) and are unlikely to permit a profitable exit because interest rates on refinanced debt are 3 to 5 times higher than the interest rates they paid before. They also struggle to attract investors because pricing and valuation expectations do not match up and often lose priority status from investors due to a lack of positive path to exit.

The path to a compelling exit – for sellers and buyers

The key, in our experience, is to deploy a "special situations play" model that generates a positive return on the continuation asset, rather than breaking-even or worse. This model provides a roadmap for turning-around or changing the narrative on assets and increases EBITDA and frees-up cash from working capital. It also rationalizes and controls costs in a sustainable manner while raising exit valuations and providing a constructive roadmap for new investors.

Continuation companies often have a disequilibrium; supply chain and operational inefficiencies have put them in this position even though the underlying company still has solid business characteristics. After identifying those supply chain and operational inefficiencies through a "special situations play model," they can be rectified with a total value optimization approach that helps breaks the continuation pattern and boosts EBITDA by up to 15% to 20% or more.

How the model works

The "special situations play" model highlights significant imbalances in a company's supply chain and operations, where noticeable opportunities for quick cost reductions signal potential underlying problems. Historically, these imbalances reveal deeper issues and stagnation that, when addressed, can improve EBITDA and increase cash flow.

A total value optimization approach takes an objective look at what a company needs to do to attract investors and buyers. It involves:

- Reversing underperformance by clarifying the vision of the management team, identifying the low-hanging fruit, and enabling data-based decision

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making
- Identifying the red flags causing disequilibrium in a portfolio company's supply chain and operations and enabling rapid financial gains
- Deploying a pre-exit analytics to identify opportunities across the portco's end-to-end supply chain and operations, then implement expedited initiatives to drive measurable financial results.
- Upskilling planning, procurement, operations, and logistics functions to ensure that the results of intervention are sustainable, future value creation initiatives have been identified and the stabilized company is attractive to potential buyers
- Reducing the downside financial risk through our 100% guarantee of engagement fees based on annualized savings

In one case, a manufacturing company was undervalued and struggled to exit as the market did not appreciate its full value due to issues deep within its supply chain. A "special situations play" analysis showed the future investor base that the issues were one-off and improvements were possible. The company had already found cost savings and efficiencies; but the PE owners wanted to increase EBITDA at a faster rate than their management team had planned. An augmented plan ultimately led to improved metrics, accelerated cash realization, and decreased supply chain risk, among other procurement and operational improvements. EBITDA increased 26% enabling the company to exit at a higher than expected multiple.

There is hope for the hundreds of portfolio CEOs and investors who are still held up in a continuation pattern. A path to generating positive returns and creating a compelling path to exit is attainable. Executives and investors can rapidly reverse financial stagnation, break the continuation pattern, avoid future losses and exit with grace and profit. Indeed, fixing one underperforming asset could improve the results of the entire fund, attracting investors and buyers.

This approach aligns well with continuation assets: fast, low downside risk and a high ROI. ■

Dan Ginsberg is managing director, private equity, at SGS Maine Pointe (dginsberg@mainepointe.com)

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