TX Office: (817) 416-6842
NV Office: (702) 565-2727

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Exit Planning Takes Priority in Softening Market

Buyers demand more transparency with potential risks

As valuations soften amid ongoing market volatility, private equity fund managers are turning to more strategic exit planning. Coming off a year of explosive M&A growth and exits in a high-valuation environment, fund managers absorbing inflation and interest rate data may delay exits. In a market that continues to be dynamic and unpredictable, portfolio managers will need to prioritize several aspects of exit planning to ensure they generate attractive returns and, by extension, secure follow-on fundraising.

Maximizing returns through due diligence

The pace at which deals were taking place, and the faster deal timelines, in 2021 have resulted in a heightened awareness of risks that may not be revealed until after deal close. Today, prospective buyers want sellers to be more transparent and thorough in their assessment and disclosure of potential risks. Prior to a transaction, the sell-side will want to ensure that they're doing the most they can to bring the highest value to the sale. By performing proper due diligence ahead of a sale, the sell-side may not only maximize their returns, but also accelerate the pace at which they're able to close the deal. With the market showing signs of softening, it's worth considering if there's the same sense of urgency to close deals that there was as compared to the record-setting pace we saw in 2020 and 2021. However, it's still critical to take the proper steps ahead of a sale to set both sides up for success.

Proper due diligence maximizes value realization. Sellers should be implementing a sales process that is tailored to an asset's unique value proposition and market position. Exit readiness assessments, deal marketing, and buyer identification, among other factors, are necessary to help generate targeted returns on investment. In a dynamic market, it's imperative that sellers have their proverbial ducks in a row.

Ensuring compliance in a shifting regulatory landscape

Like any investment transaction, private equity transactions have regulations that govern them. With the SEC proposing new transparency rules that will target private equity advisors, it's imperative to stay compliant with them as they shift. In addition to the usual set of due diligence activities that a seller needs to perform ahead of a transaction, the sell-side must be aware of any compliance requirements that are in place or coming down the pike. For example, the SEC's new rules will place heavy emphasis on cybersecurity, record keeping, and reporting – so it would be prudent for the sell-side to be invested in these areas of due diligence.

However, tight compliance activities aren't just a positive for the sell-side – they're also a major plus for the buy-side as well. If a portfolio company has a comprehensive cybersecurity infrastructure in place and has cohesive records of all their activities, they can paint a clear picture of the financial situation for a potential buyer and help a deal cross the finish line.

SPACS and Exit Planning

While the market for SPACs (Special Purpose Acquisition Companies) has cooled a bit since last year, they're still considered a viable exit path for some assets. SPACs offer the chance for portfolio companies to have significant cash on hand, which can help the portfolio company cover future expenses or purchase assets. Additionally, the management behind a SPAC is often highly motivated to complete a deal. However, those on the sell-side should consider the waning interest in SPACs that's taken place over the last year or so, after record-highs of activity. Much of this loss of interest is due to interest rates and softening company valuations, particularly those in the tech space. Additionally, the increased regulatory scrutiny of SPACs, which has included enhanced disclosure requirements and liability provisions has led to a decrease in SPAC interest.

What Lies Ahead?

There are a few predictive trends to keep an eye on in the months ahead. A top challenge to deal completion is the gap in expectations between buyers and sellers. Additionally, the last year or so has shown an increased emphasis on ESG issues in the private equity industry. The deal market is evolving quickly. As BDO's survey in the spring of 2021 revealed, 94% of fund managers reported that their limited partners wanted ESG criteria to be included in fund investment strategies. Since then, ESG has become a major underpinning to core strategy. With fund managers needing to employ more value creation strategies than ever, they are finding that ESG can not only help create value, but also serve as a deeply rooted part of a firm's purpose. In an uncertain M&A market, fund managers need pull all the levers at their disposal to ensure their exit plans get to the finish line.

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