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VALUE CREATION OF PORTFOLIO COMPANIES

"Only private equity can still deliver double-digit annual returns."

Carsten Geyer, Managing Partner of SGT Capital, a mid-market private equity firm, discusses current challenges in the private equity industry and how the firm's investment strategy aims at market leaders with growth potential.

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Carsten Geyer, Managing Partner of SGT Capital. **Photo: SGT Capital**

Mr. Geyer, what challenges do Private-Equity firms currently face?

Carsten Geyer: In the second half of 2022 and the first half of 2023, important indicators such as buyout transaction volumes, exit volumes, and fundraising volumes decreased. However, challenging periods like the current one also offer exceptional opportunities for investors who

can provide solutions to the current problems and have the courage to prove their investment hypotheses not only during good times. They are rewarded with better buyside conditions and higher value-creation opportunities.

After years of setting new records in the number of deals and deal volume, the private equity industry is now at an inflection point moving towards selective, discerning investors with unique concepts for increasing the value of portfolio companies.

How does the limited access to leverage affect transactions and concepts in the private equity industry?

Geyer: The end of loose monetary policy in Europe and the United States has significantly raised interest rates and slightly reduced the willingness to provide debt finance. As a result, for one thing, the financing and refinancing options for current portfolio companies and buyouts are limited and, for another, the scarcity of acquisition debt questions private equity business models that rely heavily on leverage to generate the targeted returns.

The geopolitical landscape has also changed. The Russian invasion of Ukraine was a watershed moment: At least in Europe, energy and commodity prices rose rapidly, triggering an economic shock, in addition to pandemic-related supply chains disruptions. However, many companies in sectors such as software, data & analytics, MedTech, or healthcare are not affected by this or even benefit from the structural changes. Therefore, we are optimistic.

In this framework, how does the limited access to bank debt affect the private equity industry?

Geyer: First of all, the limited availability of debt increases the demand for equity investments. And that is what private equity firms like us offer. The fact that we usually leverage equity investments with debt to increase equity returns – something that nowadays only works to a limited extent, and which has slightly increased in terms of cost - should not overshadow the fact that this is merely a side effect. This is particularly true for investments in growing companies that were only moderately leveraged even before the interest hike. In our view, the achievable equity returns are only marginally and the positive effects of better buyside conditions outweigh the downsides.

Were the past years considered to be a new heyday for large leveraged buyouts, the market demands today more conservative debt-to-equity ratios and moderate transaction sizes.

The availability of bank debt is limited, but debt supply from private debt funds remains intact – at least for good assets. Especially in North America add-on acquisitions financed from the balance sheets of portfolio companies have recently dominated the number of transactions, which increased the prominence of buy-and-build strategies. In our experience, however, successful add-on and buy-and-build strategies require thorough due diligence, integration planning, and a clear value-creation thesis.

Buyout multiples in the US have remained stable despite lower growth valuations, indicating persistent competition for high-quality deals. Yet in Europe, multiples are starting to decline. Buyers are still willing to pay reasonable prices for good companies, but as mentioned, with a higher equity component.

How has SGT Capital positioned itself in this volatile environment?

Geyer: With our focus on the mid-market buyout segment and growth companies in structurally growing markets that require limited acquisition debt to achieve highly attractive double-digit equity returns, we are well positioned for the coming years. As with our team's first fund, SGT Capital invests the current fund, SGT Capital Fund II, in market-leading medium-sized companies with additional untapped growth potential. Our investment strategy is focused exclusively on market leaders. We are convinced that they can take advantage of the current environment to expand their market position vertically and horizontally, as well as in terms of their geography. Moreover, they often have pricing power, which makes them less vulnerable to increasing inflation rates.

The current market situation also presents new M&A opportunities at portfolio level. After the flood of cheap debt has dried up, many companies with complementary product portfolios are seeking mergers and equity.

You follow a three-pronged investment approach. What does that entail?

Geyer: The core of SGT Capital's investment approach is to acquire market-leading companies, align them strategically with specific value drivers, further improve their operations, and accelerate their growth. SGT Capital focuses on acquiring leading companies in Western Europe, Israel, and selectively in North America. We only target companies operating in robust and growing markets with superior products and competitive advantages.

How does the acceleration of growth in acquired companies take place?

Geyer: We develop a value-creation plan and implement it promptly after investment, with a particular focus on expanding into new sales geographies and channels. Asian markets, with their enormous potential, are often one of the main growth drivers, as mid-sized Western market leaders are oftentimes still underrepresented in these markets, considering their product quality. Establishing strategic partnerships and acquiring add-on companies also supports accelerated growth.

How does SGT Capital reduce risks and dependencies on regions and industries?

Geyer: Through targeted selection of sectors and target companies, as well as a focus on internationalization and the growth potential in Asia, as well as through add-on acquisitions (M&A). By selecting companies in the field of software, business services, data and analytics, healthcare and medical technology, and advanced industrials, SGT Capital diversifies the portfolio across different growth domains.

SGT Capital's disciplined investment strategy also contributes to risk mitigation. The investment team only invests in companies that meet the fund's defined investment criteria and sectors without exceptions.

What holding periods do you target for your investments?

Geyer: Compared to other players in the private equity business, SGT Capital aims for a shorter holding period for deals. This is because SGT Capital typically works closely and constructively with the existing management of the acquired companies and does not replace them, which would require additional time. Although private equity holding periods have generally increased over the last years, an average holding period of less than four years in our funds has been sufficient to generate equity annualized net returns of over 20% for our investors.

However, it is important to understand that the specific holding period can vary from deal to deal and is not predetermined prior to the investment. Each deal is assessed individually, and the decision on the holding period depends on various factors, such as the company's growth potential, strategic goals, and the overall market situation.

How do you assess the outlook for the private equity asset class?

Geyer: Regardless of the current market environment, both the short-term and long-term outlook for private equity remain very positive. While fixed-income investments have lost attractiveness due to the increased inflation and real estate investments due to rising construction costs and interest rates, low initial rental yields, and above all, structural shifts in office and retail demand caused by remote work as well as online shopping, profitable companies have gained prominence as an investment. Public equity, the stocks of publicly traded companies, offer some good entry opportunities.

Private equity appears even more attractive than public equity...

Geyer: ...yes, because privately held companies often have more untapped value creation potential and do not suffer in the same way from the principal-agent problem, meaning misaligned incentives between management and shareholders. Currently, this asset class is the only one where it is possible to achieve a sustainable double-digit annual return at a high probability. However, this asset class is difficult for retail investors to access, and even institutional investors require good decision making when selecting the appropriate private equity funds.

The current market conditions bring additional opportunities and risks for private equity investments. We continue to strive for net returns of over 25% per year after costs for our investors, as we have achieved in recent years.

For more information, click here.