27 FOUR

Private markets

All the Pieces Matter
Exits

"You only do two days. That's the day you go in, and the day you come out." -Avon Barksdale, The Wire

March 2023

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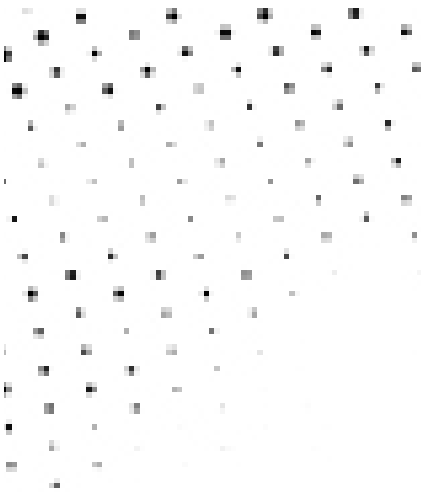
Introduction

When preaching the gospel that is private markets investing, the message is premised on the promise of commercial returns, along with social impact in most cases (true for all mandates under 27four management). But like with most gospels, the journey that leads to redemption (mind the pun), must be followed with discipline if you expect to be one of the saved.



Although in life we don't know when our time will come, in private markets investments with a limited life fund vehicle construct the lifespan is well defined, requiring investors and fund managers alike to exercise discipline through planning to achieve the best investment outcomes.

Risk, liquidity and returns in the context of private markets

The illiquid nature of the private markets asset class, when contrasted to public markets, makes exiting inherently complex. A ready market of willing buyers and, sellers is not pre-existing like it is on a listed exchange. This creates challenges for any investor to exit their private markets investments in a timely manner and at a market value which they consider fair. Developing a well-thought-out exit strategy for each investment is a crucial step for increasing the likelihood of realisation at a time and value that leads to maximizing returns.

One of the foundational elements to creating an exit plan is understanding the liquidity profile of the instruments held relative to the underlying risk and expected returns.

A high-level summary of the most common instruments used in private market investments in South Africa are presented on the next page.

Instrument	Downside protection	Liquidity profile	Targeted returns	Risk
Equity Refers to ownership in a company and can take the form of common stock or preferred stock. Equity investments provide the potential for ownership in the company and the ability to share in its profits, but they also come with the highest level of risk as they are the last to receive any returns.	Limited or no downside protection	Low liquidity May receive some liquidity through dividends during the holding period. Exit routes can include: ▪ Sale to a strategic buyer (Trade sale) ▪ Sale to another financial buyer ▪ Sale to management/existing investors ▪ Initial Public Offering ▪ Recapitalization	High potential return	High potential risk
Hybrid / Mezzanine Refers to a hybrid form of debt and equity financing that is typically used to fund the expansion or acquisition of a company. Hybrid / Mezzanine financing provides the lender with the potential for both interest payments and a share of the company's profits, but also carries a higher level of risk than traditional debt financing.	Limited to high downside protection	Some liquidity but can differ based on bespoke structuring. Settlement through contractual terms, amortising or bullet, with upside formula driven.	Moderate to high potential return	Moderate to high potential risk
Senior debt Refers to the lending of funds, typically in the form of a loan or bond. Senior debt financing provides the lender with the potential for fixed interest payments but carries lower levels of risk than equity or hybrid /mezzanine financing.	Typically, high downside protection through security and first right to cash flows of the business.	Moderate liquidity Settlement in line with contractual term, either amortising or bullet.	Moderate potential return	Low to moderate potential risk

Note: It is important to note that the performance of these instruments can vary depending on several factors, including the specific industry and market conditions. As such this is illustrative only, it is important for investors to conduct thorough due diligence and carefully consider their options when structuring a private market investment.

The balance of this article focusses on the exit considerations of privately held equity positions.

Setting out a disciplined private markets exit plan

Consider exit on entry and be clear on your objectives at exit: It's important for fund managers to understand their goals around exit from all perspectives to ensure alignment of the exit plan to the desired outcomes. This includes the expectations from investors (driven by contracted investment objectives), as well as other shareholders and potentially portfolio company management and other stakeholders.

While it may be a long way off, considering exit as a part of the initial deal structure is essential for fixed life investments. Being clear that an exit will be sought is important to align expectations and interests with other stakeholders, as well as building in the required contractual rights and protections to best position the company for a variety of exit options. The earlier this is done the better, as this should assist in the ability to make informed decisions through each stage of the investment and help ensure that there is sufficient time to identify and prime potential buyers and prepare the portfolio company for sale.

Focus and deliver on "value add": Many private equity fund managers stress the importance of their "value-add" approach as a key differentiator and driver of returns. This should not only be a page in a pitch deck. How actively an investment is managed in most instances results in improved performance and increased value of a portfolio company at time of exit. Some commonly cited initiatives can include:

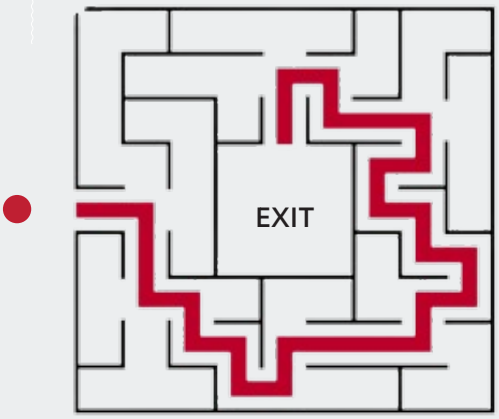
- **Operational improvements** with the aim to increase value. This, simplistically, can involve implementing cost-saving measures, streamlining and automating processes, and investing in new technologies for greater efficiency or quality.
- **Diversification of revenue streams** to reduce risk and /or drive top and bottom-line growth. This can involve pursuing consolidation opportunities, expanding into new markets, launching of new products / services etc., for better exit positioning.
- **Provision of strategic guidance** by giving management access to specialised expertise that can assist with business planning and execution, as well as helping to build relationships with key stakeholders.
- **Improved governance and standards** in particular where investments have been made in owner-managed businesses where controls may not be as robust. By enhancing governance and assisting with improving business processes, fund managers can reduce risks and improve the reputation of the business, building trust with stakeholders.

Continuous reflection on the exit plan: The attractiveness of an investment to the potential buyer universe may not evolve as originally anticipated. Reflecting on the assumptions around exit on a regular basis can prompt early interventions in order to course correct. This may include seeking support from industry experts from time to time to ensure better ultimate sale positioning when the time comes to push for an exit. Overall adherence to process, practicing self-control, avoiding impulsive decisions based on emotion are key to successful exit strategy.

Preparation for the exit process: While the initial plan for the exit is considered upfront and should be periodically reviewed, once the portfolio company is nearing the exit time there are several concrete steps to be taken to prepare for a and execute on the exit process.

Close deal & distribute proceeds
- Fulfil conditions
- Transfer ownership
- Realise investor returns

Determine timing
- Market conditions
- Performance of the company
- Universe of potential buyers



Due diligence & term negotiation
- Be prepared, have a data room
- Know parameters to deal terms: price, financing terms, structuring, other conditions

Refine list of potential buyers
- Networking with industry professionals
- Research
- Engage investment banks / advisors

Having a plan doesn't mean everything goes to plan

While the need for a plan is undeniable, no amount of planning can prepare you for all eventualities, especially in South Africa's turbulent socio-economic environment.

When things diverge from plan, it may necessitate the need for restructuring; in order to preserve value and ultimately create a viable and attractive sale prospect to take to potential buyers.

Restructuring is the process of reorganizing a company's operations, assets, or debts in order to improve its financial stability or increase its value. Restructuring can involve a range of actions including:

- **Cutting costs** in order to improve a company's financial performance or viability, which can in some instances mean laying off staff, closing unprofitable business units, or renegotiating contracts. Some employees may be negatively impacted. However, resizing the business to ensure it can return to a sustainable level of profitability not only ensures that the majority of employee roles are preserved, but that any negative impact on suppliers and services providers is also limited preventing any knock-on impact as a result.
- **Refinancing** a company's debt in order to reduce or delay capital and interest repayments to improve its financial stability or access to cash flow. This could mean negotiating new terms with creditors or raising new debt financing.
- **Divesting** non-core assets in order to focus on the company's core business and improve its financial performance. This can involve selling off subsidiaries, real estate, or other assets that are not central to the company's operations.

Restructuring does impact on exit planning in several ways from delaying exit processes, possibly increasing the exit deal complexity to reducing valuations over a short to medium term before a revised exit plan can be executed.

These actions should be undertaken with the ultimate aim of preserving value and maximising future exit prospects.

Is it better to follow a targeted approach or subject myself to an auction?

There are two main approaches that can be followed in realising an investment:

- **Targeted**, where, as the name suggests, potential buyers are being approached directly.
- **Auction**, where multiple potential buyers are invited to submit offers for the investment through an organised sales process typically run by a corporate finance adviser.

Which one is ultimately chosen will depend on the specific circumstances around the transaction and the targeted outcomes relative to the investment objective at point of entry. Consideration is given to certainty of a deal, speed of execution and maximising value along with softer issues which may affect the deal:

Auction	Targeted
Transaction dynamics	
Creates competitive tension between a wide range of buyers, including strategic buyers (e.g. competitors or complementary businesses), financial buyers (e.g. private market firms) and sometimes even high net worth individuals. Note, this approach does not preclude the need to do due diligence on the ultimate buyer.	Approach based on pre-canvas of the market and due diligence of potential identified buyers, which involves evaluating the financial stability and track record of potential buyers, as well as understanding their plans for the portfolio company post-exit.
Speed of execution	
If the particular asset has broad appeal then an auction can be a faster way to exit, as it forces potential buyers to compete for the asset in a defined process.	A targeted process can result in a quick exit where potential buyers have been primed over time for a potential deal.
Maximising value	
An auction can lead to a higher price for the asset, as it allows for multiple potential buyers to bid on the investment creating competitive tension during the process.	A targeted sale is by its nature less competitive, which may result in a lower price. However, where the targeted buyer is a strategic investor concerned about the asset being offered to its competitors, a good price can be achieved.
Certainty of a deal	
An auction opens the deal to more potential buyers, which increases the chance of a sale. However, there is less control for the seller, as the process is also normally facilitated by a third party. This process does mean that potential buyers understand that they are one of many potential suitors, and they may not fully engage until they get exclusivity.	Allows the seller to have more control over the sale process, as they can negotiate directly with specific buyers and have more input into the terms of the sale. While this targeted approach has more binary outcomes, the open communication means that each conversation is more likely to result in a deal.
Confidentiality of the transaction	
An auction may be more suitable if the seller is willing to have the sale more widely publicized in order to attract a larger pool of potential buyers.	A direct deal may be more suitable if the investor wants to maintain confidentiality around the sale, as it allows for a more discreet and controlled process.
Fit	
If the investment is more straightforward and there is likely to be a broad pool of potential buyers, an auction process may be more appropriate.	If the investment is a large, complex asset it may require a more tailored approach better suited to a direct deal.

Is management friend or foe?

Although management's involvement in a private markets exit process can vary widely, the ideal scenario is where company management is supportive of the exit process and willing to work closely with the incoming investor to ensure a smooth and successful transition.

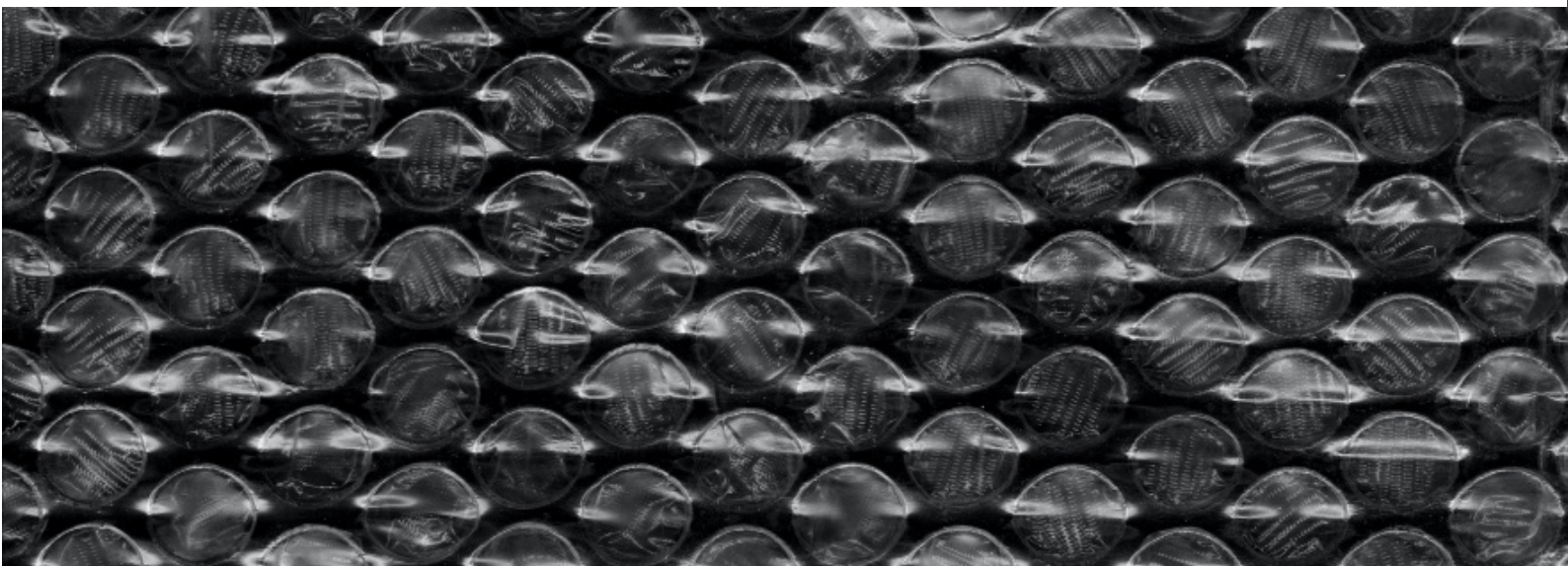
However, the news of an exit process is not always received by management with kiss and a warm hug. This is where the strength of the relationships fostered during the investment holding period will impact massively on the exit outcome achieved. Proactively addressing any issues with management and ensuring that there are no conflicting goals or priorities will help the process to remain on track.

A fair maiden she is

"I'm looking for a knight in shining armour, but all I'm finding are morons in aluminium foil." - Anonymous

The negotiation of what is fair value is the single most important thing to consider during an exit process, without it there will be no willing buyer, nor a willing seller, which only results in one outcome – NO SALE.

So what valuation methodology is best suited to determine value, you ask, without a clear answer, because specific circumstances come into play. Below are the most common approaches, noting in some instances using a combination of valuation methodologies may be the most appropriate to value an investment accurately:



Valuation methodology	Pro's	Con's
Market approach: The market approach involves using the sale prices of comparable transactions or trading multiples of listing companies or assets to determine the value of the investment. This approach can be useful when there is a sufficient number of comparable transactions or portfolio companies to draw from.	Easy to understand and use and based on recent market views.	Transaction and trading multiples of comparable companies may have different business structures, accounting policies, etc, or the businesses may be of different risk profiles.
Income approach: The income approach involves estimating the present value of the future cash flows that the investment is expected to generate. This approach can be useful when the investment is expected to generate a steady stream of income over time.	More flexible in determining value of investments in different stages of growth.	Can be highly subjective in terms of key assumptions used to determine value, e.g. WACC and terminal growth rate.
Cost approach: The cost approach involves estimating the cost to recreate the investment, including the cost of materials, labour, and overheads. This approach can be useful when the investment has a unique set of assets or characteristics that are difficult to value using other methods.	It is most reliable for newer investments with relatively modern design in a stable market.	It is less reliable for older investments as it is difficult to estimate the depreciation of properties that are older.
Asset-based approach: The asset-based approach involves valuing the investment based on the value of its individual assets. This approach can be useful when the investment consists of a diverse range of assets, such as real estate or intellectual property.	A combination of the above income and cost approaches.	

A dialog about conflict between LP & GP

LP
What about the conflict of interest?

GP
There is no conflict.

…followed by confused look on LPs face and questioning of life choices, or at least investment choices.

Conflicts of interest management around exit processes is often considered too late or not at all by fund managers. There seems to be a lack of appreciation of the need to identify, acknowledge and manage conflicts of interest early on in any process, and to trigger any required governance procedures. This can make the process frustrating for LPs when the fund manager scrambles to "back solve" an inherently conflicted situation.

Some of the matters that can result in conflicts during exit processes include:

- The most sensitive of all the issues is a conflict driven by **misalignment of interests**. For example, the fund manager may prioritize maximizing their own management fees and/or carried interest ahead of the outcomes for investors. This becomes a particularly sensitive issue when a fund is approaching the end of its life and has been underperforming.
- The issue of **wearing two hats** but viewing it a fashion statement rather than recognising it as a conflict. For example, the fund manager may prioritize selling an asset to another fund they manage, rather than to the highest bidder. This does not only go for the fund manager itself, but conflicted IC members and/or team members participating in both sides of the negotiation or with economic interest on both sides of the argument.
- **Disregard for the mandate.** For example, the fund manager may prioritize maximizing the sale price, while the investment mandate may prioritize preserving the long-term value of the portfolio company.

In most instances, if managed appropriately, risks to the process can be mitigated to the satisfaction of all parties. Look out for our next APM publication where the issue of conflicts are analysed in more detail, including best practice with respect to the management thereof.

"Timing is everything"

This is just as much true with exits, as it is in life. As mentioned throughout this article, a well-planned exit strategy can help investors maximize the returns on their investment by allowing them to sell at the most opportune time, whilst helping to manage risk by providing a plan for how to handle potential challenges or setbacks. The timing of an exit can be impacted by several factors, for example: market conditions, performance of a portfolio company, stakeholder behaviour and legal and regulatory considerations. It is therefore especially important for fund managers within limited life structures to

continually evaluate exit plans relative to the constraints of the investment vehicle through which they raise capital. "It wasn't my fault" or "the current market is not conducive to selling" is not a good enough explanation, nor does it excuse managers of their accountability and personal responsibility for the outcomes.

All things considered

In an event that fund extensions are sought from investors to allow more time for exits, it should come with the realisation that "time" itself may erode value. Factors like opportunity cost, inflation, movement in market conditions, changes in management (at portfolio company and fund manager), additional fee drag etc, may all impact negatively on ultimate net returns and are considered by LPs when asked for investor consent for such extensions.

While the main consideration is the how well the investments are positioned for exit, LPs are also evaluating the suitability of the fund manager to continue managing the assets for value and asking a number of questions such as:

- Is the existing fund manager complying and / or the degree of non-compliance resulting in the working relationship still being maintainable?
- Would removal of the fund manager be value additive or destructive over planned exit horizon?
- Does the current fund manager have the necessary skills for realization of the portfolio?
- Would supplementing of the fund manager skill be enough to ensure exit at value?
- Can the fund manager operate sustainably and are they still aligned to the investor?
- Is the fund manager the only one in the market able to manage the fund?

For LPs it is suggested that a clear exit framework/policy be drafted to distil thinking and allow for fairness and transparency of any extension requests or similar considerations. Having designed and drafted this before for clients, we have seen how useful it can be.

Conclusion - You are only as good as your last exit

Harsh, but true. "In the world of private equity, exits are the ultimate measure of success. A well-executed exit can mean the difference between a profitable investment and a costly mistake." – Preqin. The ripple effects of such a costly mistake should not be underestimated.

One of the main reasons LPs invest in limited life partnerships is in order to access the expertise and resources of the fund manager's investment team, because they believe that this will maximise their returns. A manager's track record as a measure of future success therefore becomes a reference point for any future commitments they may seek to obtain. It is therefore safe to assume that non-performance would impact negatively on an investor's decision to commit in future.

Always remember "You only do two days. That's the day you go in, and the day you come out." -Avon Barksdale, The Wire

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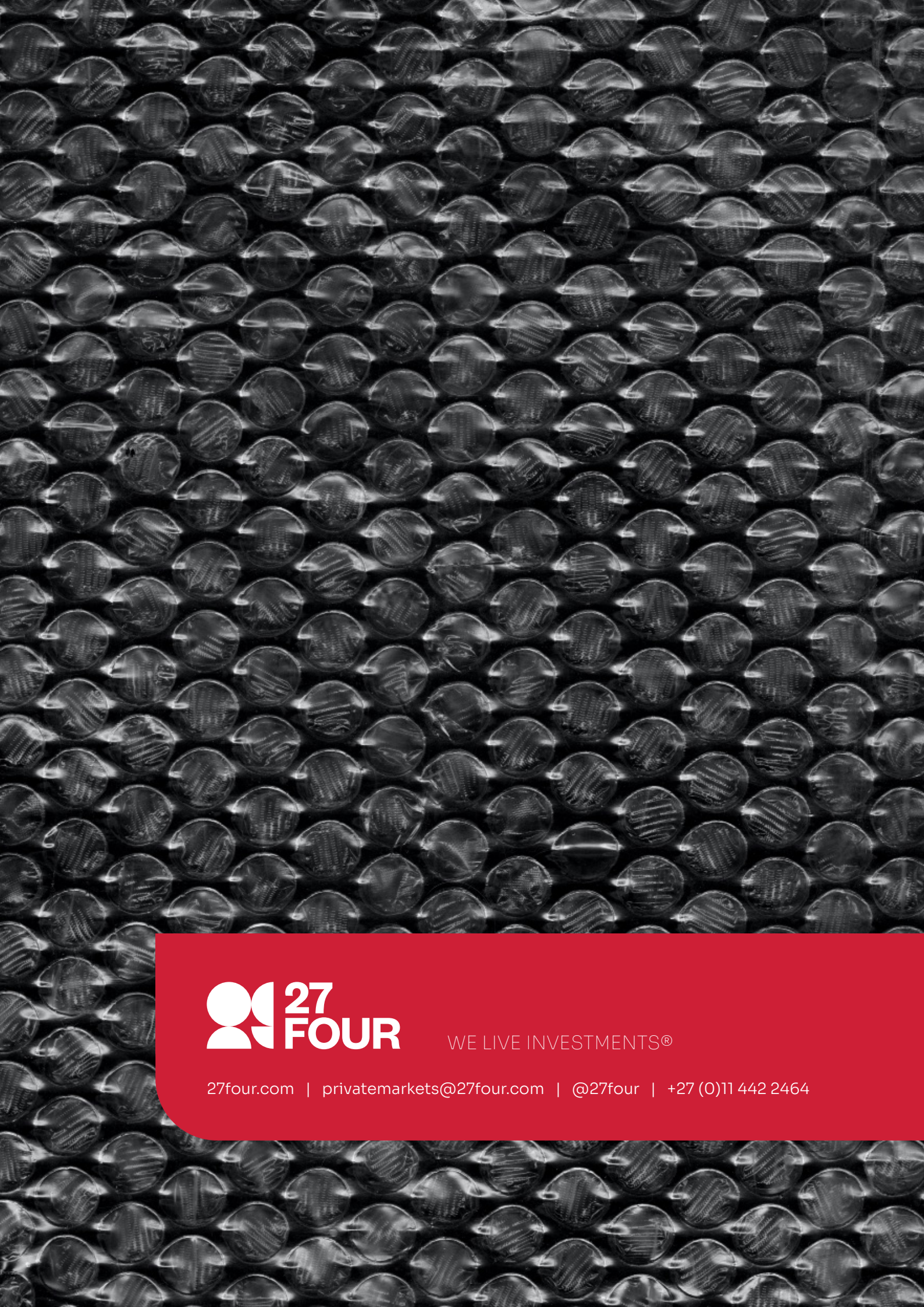

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