Brookfield

INSIGHTS
February 2023

PRIVATE EQUITY

Private Equity Investing: Acquiring for Value

The goal of investing for value may seem obvious—everyone wants to find a “good deal.” But accomplishing it can be tricky, especially if someone is looking to invest in high-quality companies.

That’s because companies that consistently produce durable and stable long-term cash flows tend to trade at a premium in the market. Yet value is a key part of successfully investing in private equity.

Investors can take an opportunistic approach to find situations where they might be able to acquire such high-quality businesses for value. These may be complex situations where an investor’s expertise makes them one of few competitors who are able to navigate the associated challenges, or situations where they can take a contrarian approach to an out-of-favor sector or region. In addition, many businesses today have been mismanaged, and this creates an opportunity for those who have the expertise to drive operational improvement.

When investing in private equity, three factors—quality, value, and the ability to drive operational improvements—come together to make an opportunity an attractive investment. Here, we break down the second step of our private equity strategy: How investors can find value investments in any market environment.

Defining Value

The underlying business attributes—and the quality of the business—will clearly factor into an investor's determination of the purchase price. All else being equal, a higher quality business should warrant a higher purchase multiple. Thus, it's important to buy for relative value based on where the market would otherwise transact.

To establish what qualifies as good value, investors can determine the relative value by analyzing the peer set, including both publicly traded companies and precedent transactions. To compare buy-in multiples among the peer set, they should consider several metrics. These include total enterprise value (TEV)/earnings before interest, tax, depreciation and amortization (EBITDA), price to book, cash flow yields, and growth expectations.

Ultimately, acquiring a business for value means that the purchase price is less than the intrinsic value, which takes into account the future cash flow potential of the business.

Three Steps to Investing in Private Equity

- Identify high-quality businesses
- Acquire them for value
- Meaningfully enhance their cash flows through operational improvements

Identifying Complex Situations

Great businesses can be overlooked due to situational complexities. But those complexities can also present some of the best opportunities to acquire for value.

These include, but are not limited to, businesses that have a large-scale global footprint, have an overleveraged capital structure or are part of a complicated carve-out transaction:

- For a business with a large-scale global footprint, performing due diligence can be complex and require substantial resources. Having on-the-ground resources in key operating regions and local market insights provides a competitive advantage.
- Many businesses have high-quality business attributes but for one reason or another need to undergo a restructuring of their balance sheet—which requires certain investing expertise.
- Buying a business out of bankruptcy is typically a lengthy and complex process, involving multiple stakeholders. Having the experience to navigate such situations can create deep value opportunities.
- Corporate carve-outs are often lengthy and require expertise to separate from the parent company and set up standalone business functions. Having a track record and qualified team to execute on time and within budget is critical.

Such situations naturally limit the pool of investors who can compete for the acquisition to those who have the proper resources, investing expertise and transactional experience and typically result in attractive entry pricing.

Investing From a Contrarian Perspective

In addition, taking a contrarian approach and actively pursuing opportunities within the market where one believes the consensus view is wrong or misinformed can result in great value opportunities. In our experience, the best opportunities are often found in out-of-favor sectors or regions.

Perceived headwinds or situational complexity often deters many investors, but having the operating expertise and local market knowledge to underwrite a transaction can enable one to invest with conviction where others may be wary.

Capitalizing on Market Dislocation

Volatile or declining markets can often present opportunities to acquire for value. In these periods, widespread uncertainty causes a dislocation between perceived value and inherent value. This has played out many times—from the global financial crisis, to the collapse of energy markets, to the impact of the global pandemic. Value investors need the conviction to go against the prevailing sentiment and view it as an opportunity.

Distress in the capital market, be it debt or equity, can lead to attractive buy-in multiples because pricing typically declines irrationally. But these opportunities can come and go quickly, so executing on them requires preparation and speed. Value investors need to identify potential opportunities and perform their diligence in advance and be prepared to move swiftly.

Public markets today are contending with concerns around a looming recession and increasing interest rates. Value investors should be closely monitoring investment targets for both distress-for-control and recapitalization privatization opportunities. In certain scenarios the entry price may be significantly discounted relative to the future cash flow potential.

Being a Partner of Choice

Having the requisite experience and global reach across alternative asset classes can allow investors to position themselves as a partner of choice who can surface value where others may not.

In addition, bringing more than just capital to a situation—and instead providing strategic direction and oversight to a business—often results in a bilateral transaction between buyer and seller. In other words, these transactions can be negotiated outside of auction processes, often through direct outreach and collaborative dialogue, to create more of a “win-win” situation. Counterparties tend to see such investors as partners of choice because they take an active management approach and provide ongoing support to management teams.

Next Steps

Investing for value can be challenging, especially when targeting high-quality companies—obviously, the competition for investment is high. Capitalizing on complex or contrarian situations can allow investors to execute on transactions without bidding up the price. Moreover, given that equity and debt valuations have traded down over the past year, more opportunities for value and even distressed investing are emerging.

Focusing on companies where an investor can create additional value through operational improvements can result in an effective buy-in valuation that is often less than the headline price. Such knowledge and expertise will also position that investor well to meaningfully enhance cash flows through operational improvements—the third step of our private equity strategy.

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Contact Us

BrookfieldInsights@brookfield.com

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