PE Hub

By: Mary Kathleen Flynn
PUBLISHED: 18 August 2023

NEWS & ANALYSIS

Churchill’s Anne Philpott: Businesses with these three factors can succeed in any economy

‘All-in-all, for those with dry powder, we believe it is an excellent time to be deploying middle market private capital.’

Market and economic volatility, inflation and higher interest rates made dealmaking tough for many private equity firms in the the first half of the year. PE Hub is asking private equity thought leaders for their perspectives on dealmaking in the second half of 2023 for our ongoing series of Q&As.

Here, we feature insights from Anne Philpott, a managing director on the private equity and junior capital team at Churchill Asset Management.

Anne Philpott, Churchill Asset Management

Q Where are you seeing opportunity for the remainder of the year?

Despite macroeconomic uncertainty, we are seeing LBO transactions continue to be completed for the best, most highly coveted assets. There has been a meaningful uptick in add-on activity, as the best and healthiest companies often play offense and seek to grow through M&A. Private capital managers with large existing portfolios and flexible mandates are well positioned to benefit from this trend.

Private equity firms are reevaluating how they structure transactions to ensure optimal capital structures in today’s higher rate environment, and so we have actually seen dealflow increase 20 percent across our junior capital and private equity solutions business this year. In many instances, sponsors are looking for fixed cash and payment-in-kind (PIK) coupons, or to increase equity through equity co-investment partners.

It is also difficult to ignore what many are calling the “Golden Age of Private Credit,” thanks to higher interest rates, more conservative capital structures, and the market share gained from the broadly syndicated market. All-in-all, for those with dry powder, we believe it is an excellent time to be deploying middle market private capital.

Ultimately, we do believe the M&A market will normalize, and so do our sponsors. According to a recent proprietary survey we conducted, which garnered responses from 95 of our core private equity relationships, 54 percent said they believe M&A activity will return to normalized levels in the first half of 2024.

Q The Churchill Junior Capital Opportunities Fund II closed in January. Why is now a good time to invest in junior capital?

We believe the junior capital opportunity has always been there as a space to generate attractive risk-adjusted returns. It is just heightened today because of higher interest rates, lower loan-to-value, and more conservative structuring. That said, we aim to have an all-weather investment strategy and have been deploying junior capital through the most bullish credit markets because there have always been private equity firms looking for it. In fact, our high watermark investment vintage was during the most aggressive senior lending markets.

Given our reputation as a top tier LP in private equity funds through our $13 billion fund portfolio, our sponsors continue to show us abundant opportunities. This means that even in today’s environment, our junior capital pipeline hasn't relented, and we can continue to be highly selective.

Q What's driving demand for equity co-investments today?

According to Churchill's recent private equity survey, about 95 percent of respondents said their usage of equity co-investments has stayed the same or increased in today's environment.

Market complexity can lead to very attractive opportunities for institutions that have co-investment capabilities. As distributions from primary programs have decreased, we're beginning to see a lot of co-investment capital sitting on the sidelines. Many institutions are ill-equipped to transact or have not built the required scale. At the same time, you have a constrained lending market, and valuations for best-in-class companies are not necessarily correlating to what is available in the debt market. Coupled with a difficult fundraising environment, sponsors have been looking to equity co-investment from trusted LPs to continue doing deals.

Q What types of businesses are you seeing transact the most?

Many investors have been positioning their portfolios in anticipation of a downturn for several years, seeking to back non-cyclical assets. What does it mean to be "non-cyclical" in today's world though? The last five years have shown that performance during negative GDP growth is not the only factor to consider when evaluating the durability of businesses. Pandemics, inflation and rising interest rates all have the potential to wreak havoc on profitability and growth.

The businesses transacting today are those that investors believe can succeed in any macroeconomic environment. In our case, we look for businesses whose products and services are a) non-discretionary; b) purchased on a recurring basis; and c) comprise a small percentage of customers' overall cost structure but command a high cost of failure. We think companies that demonstrate a combination of these three factors – many of which are business services – are the most likely to provide downside risk mitigation protection in a variety of market conditions.

In our survey, over 70 percent of private equity respondents said they were increasing their allocations to business services companies this year.

Q Which private capital managers are best positioned in this environment?

The best positioned firms in this environment are those that have exhibited discipline, consistency and diversification over a long period, so that any issues, which are inevitable, are minimal as a proportion of NAV.

After sound underwriting and portfolio construction, I would point to those with scale and sticky relationships. Managers with a multi-strategy platform and a large portfolio of incumbency positions can benefit from today's opportunities. Those with long-standing, trusted private equity relationships will see continuous, quality dealflow, no matter where we sit in the economic cycle. ■