

ASC

INSIGHT

RAPID EVOLUTION

How the growth and maturity of strategic capital solutions are fueling a new approach to value creation

Private equity general partners (GPs) are incredibly busy, although M&A volume might suggest sponsors aren't as active as they were in 2021 and 2022. Their focus, however, has been on efforts to accelerate and enhance value creation within their existing portfolios.

Key Takeaways

The data bears this out. For one, the median hold period at exit continues to stretch longer, according to Pitchbook, and exceeded seven years based on exits completed in 2023. Moreover, the proportion of add-on acquisitions as a percentage of total investment activity reached 75%, and the volume of add-ons in the first half of 2024 was easily on pace to eclipse last year's total.¹

At ASC, we think of strategic capital as investments in seasoned situations, or mid-hold equity solutions, where we can bring speed and flexibility to bear in building equity value.

The market, to be sure, is a factor, but sponsors have shown they are willing to extend hold periods if they can continue to drive value from their best investments, and add-ons increasingly are becoming a key ingredient in the private equity playbook.

None of this should come as a surprise, as sponsors are increasingly looking inward to find conviction. While the economic and geopolitical backdrop play a role, another contributing factor is that

Evolution of the Asset Class: The growth of the strategic capital segment represents the evolution of the asset class, as GPs have more capital solutions at their disposal to manage their portfolios and drive value creation.

Mid-Hold Equity: Mid-hold equity, within the broader strategic capital segment, is emerging as a capital solution for 'seasoned' situations in which a sponsor is multiple years into its holding period and requires flexible capital to drive ongoing portfolio company growth and ensure interests and investment timelines remain aligned.

Solutions for PortCo Growth: Mid-hold equity can extend the runway for growth through supporting priority acquisitions, organic growth initiatives and augmenting portfolio company balance sheets.

Enhanced Portfolio Management: Mid-hold equity also provides tools for GPs to convert minority stakes to control, provide liquidity to non-control shareholders, facilitate cross-fund transactions, and manage concentration limits.

Expanded Capital Markets Tool Kit: Mid-hold equity is an all-weather tool for GPs to optimize their approach to value creation and their ability to further invest behind the winners in their portfolio.

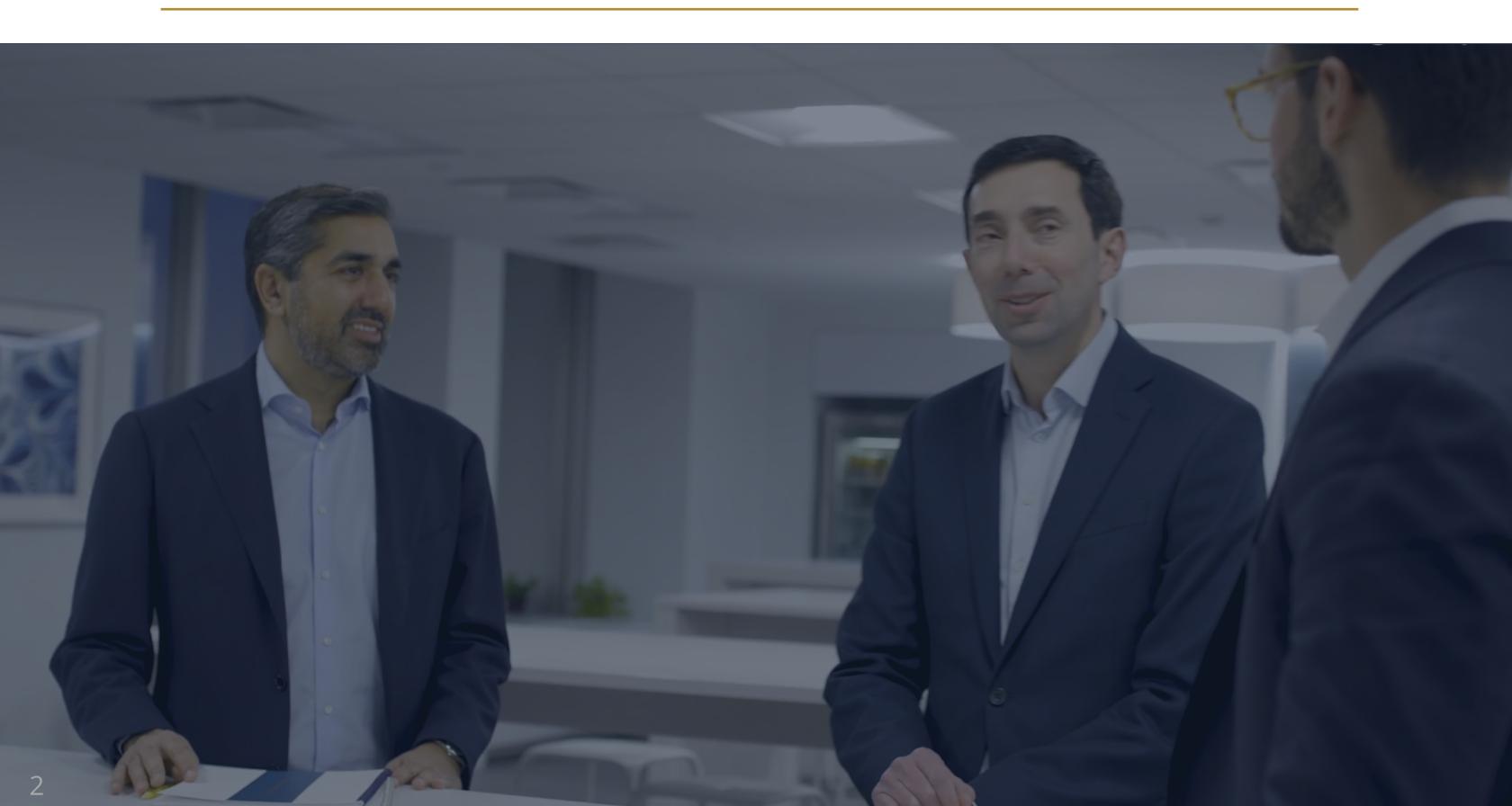
GPs have never before had so many tools at their disposal to extend the growth runways of their existing investments or navigate the obstacles that often get in the way. In this sense, strategic capital solutions are facilitating mid-hold value creation efforts that 10 or even five years ago were not always available.

Consider, for instance, the roadblocks most sponsors would historically encounter that would limit the extent to which they could re-invest in existing portfolio companies. These might include concentration limits that require LPAC approval; dwindling fund reserves that might restrict a sponsor's ability to commit more equity; or co-investors with different motivations, investment timelines, or objectives. A traditional secondaries solution or a single-asset continuation fund might provide some relief, but in a capital constrained, difficult fundraising environment, these alternatives offer little certainty and can take a year or longer to arrange and structure.

Enter strategic capital. To be sure, as the market develops, this can still mean different things to different people and currently represents a very large tent that contains sometimes vastly

different strategies — from NAV loans to growth capital and a lot of things in between. At ASC, we think of strategic capital as investments in seasoned situations, or mid-hold equity solutions, where we can bring speed and flexibility to bear in building equity value. Our solutions seek to facilitate M&A or organic growth initiatives, cross-fund investments, shareholder consolidation, or other similar initiatives.

While many strategic capital providers pursue a specialization or niche, one common thread is that, by design, the value proposition rests in the flexibility afforded to GPs. For instance, some strategies may be focused on providing liquidity solutions, whereas others are geared for distressed situations. ASC's specific mandate is centered on minority, non-control investments — alongside existing private equity sponsors — to facilitate tangible opportunities for predictable value creation within their portfolios. Said another way, mid-hold strategies are premised on helping GPs capitalize on the work they've already put into their portfolio companies to drive further equity value in the business.



MID-HOLD EQUITY IN ACTION

To appreciate the flexibility, it can help to understand the types of investments these strategies facilitate. For instance, in one transaction last year, ASC invested preferred equity into a private equity-backed business services company that used the capital to complete a priority acquisition. This opened up a new end market, extended the company's product suite, and unlocked cross-selling opportunities that are driving new channels of organic growth. Audax invested alongside the existing sponsor, which had owned the company for several years, and invested new capital into the business.

In another example, in the education space, ASC's common equity investment facilitated a transaction that allowed the existing sponsor to invest fresh capital into the company through its new fund, while bringing on a co-control investment partner. The ASC investment, beyond allowing the sponsor to maintain joint control, included an unfunded equity commitment for future M&A.

And in Europe, in an investment in the business services sector, ASC's common equity equipped the sponsor to execute on an attractive and actionable pipeline of M&A opportunities that can drive product line expansion and geographic growth.

The connection across these investments, beyond the flexibility required, is that ASC is backing strong, performing PE-backed companies seeking to pursue another phase of growth. In each case, too, the investment solved a complex challenge that would have otherwise prevented the sponsor from taking advantage of potential upside opportunities.

Each of the investments also leveraged Audax' history and track record executing its Buy & Build playbook that brought to bear speed and decisiveness for the sponsor to capitalize on opportunities that could otherwise be fleeting.

Not every investment, however, will necessarily be premised on a specific add-on. In some cases, it can be about re-aligning interests to try to push forward growth strategies already in place. In these situations, the capital is dedicated to clearing a path for M&A and growth opportunities, versus being channeled directly into new transactions.

For instance, in one case, ASC supported a dental support organization through a convertible preferred investment. The investment was premised on helping the sponsor maintain the company's de novo and M&A growth momentum entering the sixth year of its hold period.

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Mid-hold equity solutions, in this sense, are a way to meet the needs of today's sponsors in driving long-term value.

A STRATEGY FOR ANY MARKET

The value proposition of mid-hold equity, generally, is to provide another tool that allows sponsors to drive long-term growth and draw on private equity's role as a provider of truly patient capital. And while an accommodating monetary policy in the years between the great financial crisis and the end of the pandemic may have fueled an accelerated exit environment, marked by shorter hold periods and elevated IRRs, a higher-for-longer- interest-rate environment, even as the Fed adopts a more dovish stance, is seeing sponsors drill into value creation as the primary driver of returns.

This focus on value creation is also informing new investment decisions, as valuations remain historically high. This means sponsors aren't generally counting on multiple expansion unless they're able to materially drive top- and bottom-line growth. As such, many are underwriting their investments with longer hold periods in mind.

Another factor that supports the maturation of

strategic capital generally — and the mid-hold equity segment more specifically — is that while financial engineering as a sole driver of returns may be a thing of the past, sponsors are increasingly building out their internal capital markets functions to bring deep proficiency and expertise to fund ambitious theses centered around value creation. And as more sponsors adopt Buy & Build strategies trying to effect organic and inorganic growth, they will require sophisticated tools to engender the financial flexibility required. Mid-hold equity solutions, in this sense, are a way to meet the needs of today's sponsors in looking to drive long-term value.

While dislocated financing markets and interest rate volatility may accentuate the need for flexible capital solutions, we believe the recent growth of the segment is untethered to the current economic and market backdrop. Instead, it speaks to the evolution of the larger private capital asset class in which sponsors are seeking predictable paths for value creation and want to continue to invest behind the winners in their portfolios.

About Audax Strategic Capital:

Based in New York and London, Audax Strategic Capital is a flexible partner to private equity sponsors seeking customized equity solutions to drive continued growth at their portfolio companies. ASC's capital solutions support add-on acquisitions and organic growth initiatives through bespoke structures that enable Private Equity sponsors to maintain continued control and ownership of performing assets, while aiming to keep interests aligned in pursuit of future growth. ASC is part of the Audax Private Equity platform, a capital partner to middle market companies with \$19 billion of assets under management, over 270 employees, and 100-plus investment professionals. For more information, visit www.AudaxStrategicCapital.com

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 **Audax Strategic Capital**

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