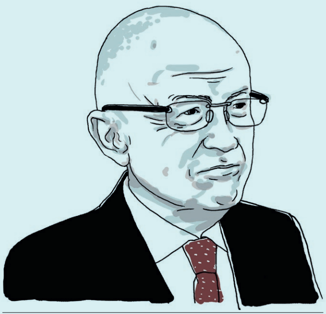
Jon Moulton's Diary

Continuation funds could change the world of exits. Plus, the risk of AI showing its ugly face



Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

'Continuation funds offer the potential for really long-term lucrative ownership'

Numis have just done a poll of mid-market private equity firms in the UK. It shows some very interesting results.

The compulsion felt by the need to do deals is illustrated by the odd fact that 53% of PE managers felt that private assets are more overvalued than public assets whereas their appetite for buying public assets has fallen drastically from 73% in 2022 to 14% today.

It seems the GPs are trying to buy the more expensive assets – presumably because they are easier deals than the expensive and complex public-to-private ones.

There is lots more of interest in the Numis paper. What really caught my eye was the GP's preferred exit routes for deals. In descending order of preference GPs now rate exit options as below:

- Continuation funds (*in my view only just an "exit"*)
- Dual track
- IPO
- Private auction (worst)

Given that not all fund managers have continuation funds this is a notable result.

It seems increasingly the case that buyout funds really want to be – as near as makes very little difference – industrial conglomerates with the most obvious benefit over the old conglomerates of being able to secure high fees, avoiding public company spurious reporting and regulation, and having a much lower risk of being thrown out as managers when compared to running a publicly listed conglomerate.

Holding on for longer

Continuation funds offer the potential for really long-term lucrative ownership by a private equity fund. However, are they a good thing?

I'm sure a case can sometimes be made for longer ownership being a good idea. Perhaps a large new contract is expected or a marked improvement in performance is awaited. But these are really the exception not the rule. A short fund extension would mostly address such issues.

But mainly the key beneficiary of a continuation fund will be the GP who sees continuing revenues and perhaps does not really want to test the valuations in a sale process.

Does the greater holding period of assets under one manager benefit the larger economy? My guess is that sometimes a needed change of business direction could be only achieved with a change in ownership so there a continuation fund would not be a good thing. Conversely, a more stable ownership will sometimes have clear benefits – if only reducing the costs of regular changes of ownership.

One thing it will definitely do will be to gradually reduce the annual numbers of exit transactions as assets accumulate into the sticky hands of continuation funds. It will however be a few years before such an effect would be material.

Beauty bias

A change of subject. The joy of private equity has always been the arrival of new issues and opportunities. Recently we have seen new risks that come with transactions. An obvious example is inadequate cyber defences.

If humans have a bias towards paying the physically attractive more money, then what are the dangers that AI will do the same?

Other new risks also include failure to follow all kinds of (almost unknowable) regulation – especially health and safety and increasingly employment issues where liabilities arise in a number of areas, most notably equal pay and conditions – who wants to rescue Birmingham Council? Discrimination claims may also pop up after completion. Never a dull day!

I came across a new, possible discrimination very recently. *The Journal of Economics and Business* (January-February 2023 issue) looked at research into executive pay – especially bankers – that shows that facially attractive bank CEOs get 24% more pay than the less attractive ones. You might wonder how you define ugliness versus being gorgeous? No problem, you train artificial intelligence to do it.

You can see where this leads. The computer works out that high pay correlates with attractiveness and feeds this into its recruitment model. Staff selection will then discriminate against us ugly ones.

Just hope you are not the proud owner of a business that does this, because the lawyers will shortly be coming to a location near you.