INSIGHTS

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FEBRUARY 2024



IN MOTION

DISRUPTIVE TECHNOLOGY MEETS A TRANSFORMING PRIVATE EQUITY INDUSTRY

EXECUTIVE SUMMARY

Cambridge Dictionary's word of the year for 2023 was 'hallucinate', while Collins cut straight to the chase with 'AI' topping its list. It's safe to say the GPT-4 buzz has been fever-pitched, and sustained. And we're already hearing murmurs about GPT-5.

While disruptive tech debates have explored all manner of potential applications – from the mundane to the very far-fetched – many have centred around the fact that AI's reliability and customisability challenges will take time to iron out. Sam Altman himself agrees (see p11).

In the world of private equity (PE), where information asymmetry is a decisive factor, being able to rely on data and personalise analysis is critical. Nearly a third of PE firms believe AI solutions have fallen short of the expectations, while another 48% say they have only somewhat lived up to the hype.

Were expectations too high, or does AI still have a long way to go? In section one, we hear from operational and digital leaders in the industry, on how they're leveraging AI to improve their firms' in-house operations, and where the room for improvement lies. Most are in the pilot phase, but there are fascinating developments underway.

Section two looks at the intersection of AI and PE assets. Firms are experimenting with using the former to create value in the latter, but there is also a more fundamental transformation underway – firms are considering an asset's existing digital infrastructure and capacity to transform before making a purchasing decision. And around a quarter (25%) have, or are planning to, set up funds specifically to focus on tech assets.

Many – including Blackstone boss Stephen Schwarzman – have said AI can and will completely transform the PE competitive landscape. This may not yet be the case, but the perspectives and stories in this report outline how we're likely to get there.

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HEAD OF PRIVATE MARKETS CONTENT

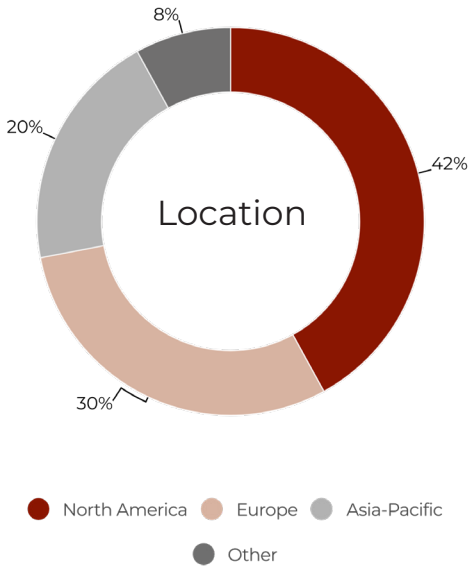
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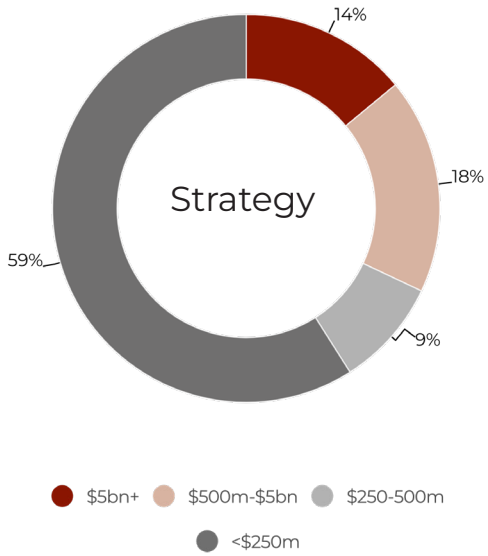
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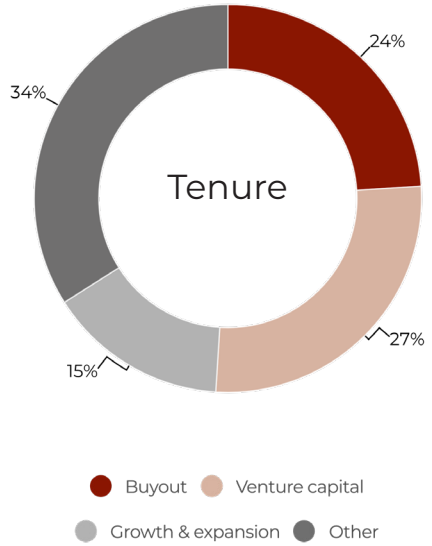
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AI AND ASSETS

Breakdown of respondents to Private Equity Wire's Q3 GP Survey by firm location, strategy, and tenure:







METHODOLOGY

Analysis in this report is based on a Q4 2023 Private Equity Wire GP survey that gathered responses from C-suite, director-level and management professionals at over 80 private markets organisations. Commentary was gathered from industry professionals through qualitative interviews, while supplementary insight was gathered from a range of news and research sources, including Bloomberg, Financial Times, Reuters and others.

KEY FINDINGS

1

Tech reviews

More than half (51%) of private equity firms are actively reviewing their in-house technology, as the general buzz around AI and other disruptive tech has provided new impetus to transformation efforts. Most of these firms (46%) are reviewing back office technology, while 34% are looking at the middle office and 29% the front office.

2

Beyond the buzz

Nearly a third (30%) of firms say AI solutions have not at all lived up to the hype, with another 48% saying they only somewhat have. Reasons vary: AI models need time to learn and adapt, in the lead up to which they can be biased and inaccurate. Also to consider is that the buzz around generative AI created unrealistic expectations for many.

3

Enabling with tech

Value creation is in the spotlight this year, and technology is more central to these efforts than ever – 57% of firms say the majority of their value creation strategies revolve around tech-enablement. Eroding feasibility of financial engineering in the current environment has coincided with the AI boom to put operational efficiency in the spotlight.

4

Targets acquired

AI advancement is not just helping improve existing assets, it's changing the way firms think about new deals. Nearly two-thirds (64%) of firms say tech companies are important to their investment strategies, while one in four firms either have launched a specific tech fund/strategy, or plan to do so. Non-tech assets are also being considered for their transformation potential pre-purchase.



SHAKING UP FIRM OPERATIONS

Private equity firms remain at very early stages of experimentation with AI, though examples are emerging of its transformative potential

Often enablers of operational efficiencies, private equity firms famously lag behind other sectors, and other segments of asset management, when it comes to using tech to streamline their own operations.

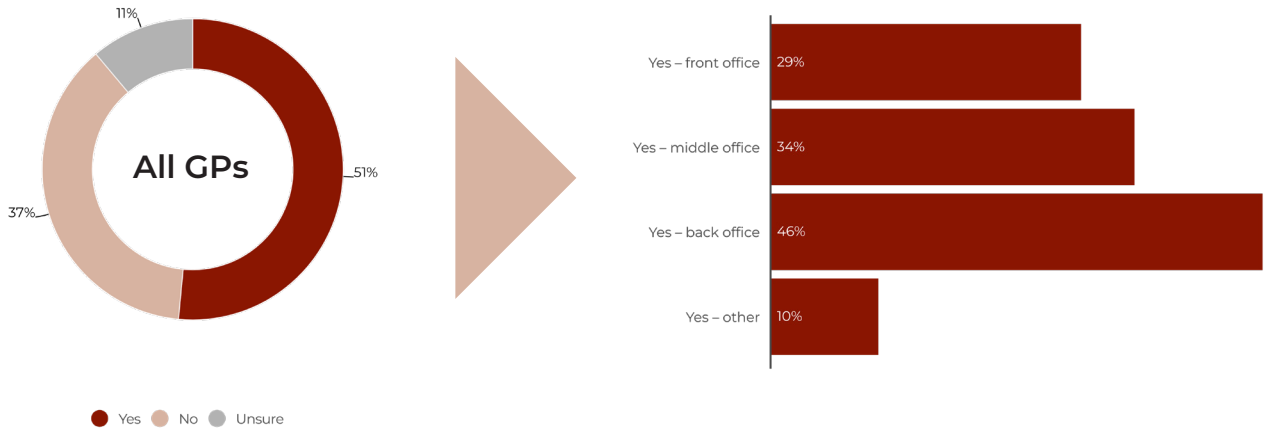
In the last decade – what Singaporean sovereign wealth fund GIC's Chief Investment Officer, Jeffrey Jaensubhakij, described to the FT last year as the "golden age" of private equity – conditions didn't quite demand an efficiency mindset at the firm level.

But times have changed – Jaensubhakij went on to say the era of high valuations, lower leverage costs and minimal interest wouldn't be "coming back any time soon."

As the market evolves and new strategies come into focus, firms need to pivot and innovate in real time. All of a sudden, the agility that comes with tech-enabled operations is in the spotlight. Private Equity Wire's Q4 2023 GP survey reveals 46% of firms are actively reviewing their back-office tech, in addition to 34% reviewing their middle-office tech and 29% their front-office tech.

At the heart of this fresh gusto for transformation is the AI rush of the last two

Figure 1.1 Private equity firms that are actively reviewing their in-house technology



Analyst note: *Survey respondents were asked in December 2023, 'Is your firm actively reviewing its in-house technology? Please select all that apply.'*

Source: Private Equity Wire GP Survey Q4 2023

years. Between 40-60% of firms of all sizes and strategies are actively exploring the monetary benefits of AI.

According to Ross Morrison, a Partner at Adams Street who heads up the firm's global tech efforts, it's very early to see tangible results. "It's like someone has set off the starting gun on a massive global race, but this is a marathon, not a sprint – over time we'll see clear leaders emerging as innovation journeys play out." Those who fail to grasp AI's importance will risk being leapfrogged, Morisson says.

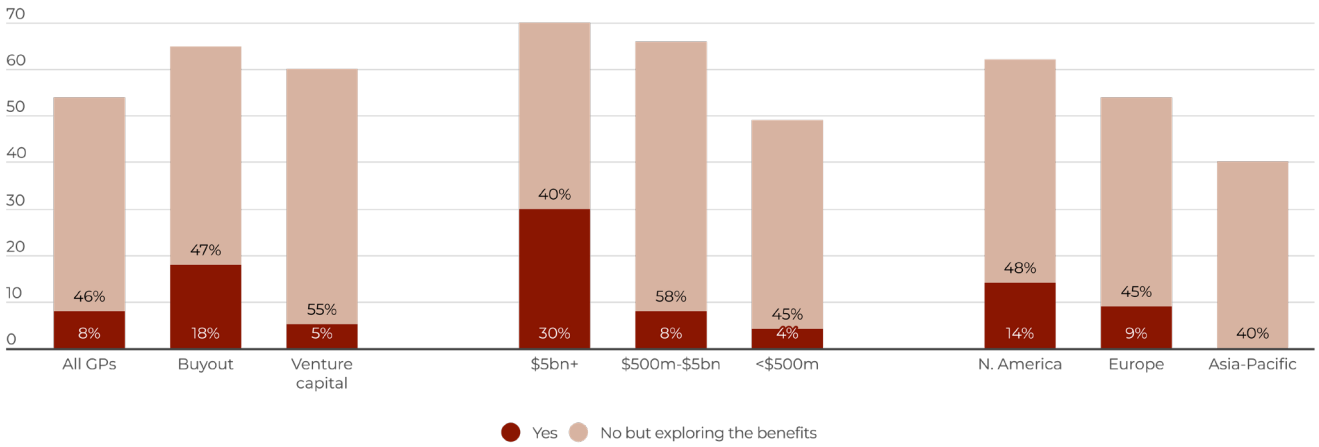
Still, conversations with a range of private markets firms reveal many are in the pilot phase of implementation, experimenting with quick wins and efficiencies that can boost productivity. The higher pursuits of gleaning more intelligent insight through AI remain, largely, in the distance.

Most GPs agree the use cases of AI are numerous. Among the more commonly anticipated impacts is that it will level the competitive playing field – generative AI's penchant for analytics at speed is expected to challenge the information asymmetry that forms the private equity competitive edge.

Indeed, more than a quarter (28%) of PEW's respondents report their firm onboarded new software to improve the origination process in 2023.

But if we've learnt anything from the very public, often comical and sometimes disturbing experimentations with AI this year, it's that throwing data and AI into a pot and hoping for the best doesn't always work out. Models

Figure 1.2 Proportion of private equity firms using AI to generate returns



Analyst note: *Survey respondents were asked in December 2023, 'Does your firm use AI/machine learning to generate returns?'*

Source: Private Equity Wire GP Survey Q4 2023

need to learn, not only to avoid bias and false positives, but also to understand the user's specific needs.

An example of what AI can do in the origination space, if given the time to learn, is presented by Jolt Capital – a deep-tech focused firm that manages over $600m in assets. One of the firm's Managing Partners, Guillaume Girard, explains: "Around 10 years ago, LPs started asking us how big the growth tech marketplace really was. The simple place to look was Google, but that had its limitations for scaling up.

"We decided to create our own search and aggregation tool, which has approximately 3.8 million companies in the database. It automatically searches the web and gathers companies that meet our criteria in terms of size and business model. It also pulls from the patent database. The result is that at the click of a button, I have all the information I need about a company's board, its patents and competitive landscape, its financials, and the extent to which its available. We can then add more intelligence to this."

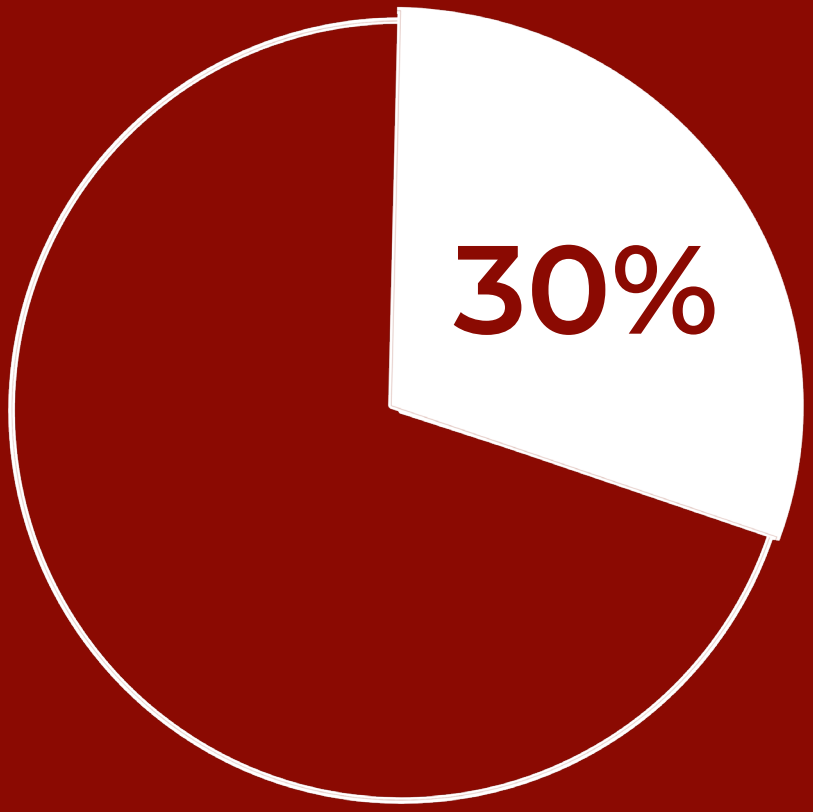
More than half of the companies thrown up by the system are of genuine interest, Girard says – a hit rate that can't be taken for granted. "Every time I speak to a company, I enrich the database – not just with what I liked but, just as importantly, what I didn't like about it. And the machine continues to use these inputs to learn what we're really looking for."

Origination aside, the tool acts as a single source of truth for all data on companies – including in the post-deal phase – acting as a

KEY FINDINGS

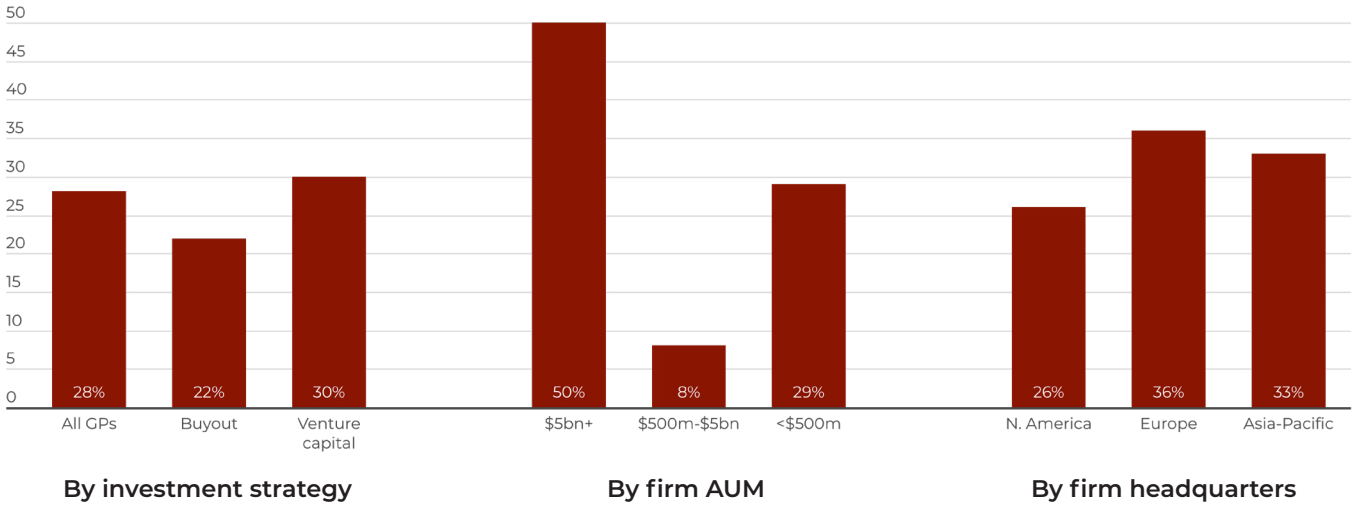
Beyond the AI buzz

Nearly a third of GPs say AI solutions have not at all lived up to the hype



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Figure 1.3 Private equity firms that onboarded new software to improve origination in 2023



Analyst note: *Survey respondents were asked in December 2023, 'Have you onboarded new software to improve your origination process in the past 12 months?'*

Source: Private Equity Wire GP Survey Q4 2023

productivity tool and what Girard describes as the "backbone of our organisation."

What Morrison's marathon analogy and Girard's emphasis on learning demonstrate is that AI takes time to deliver significant, tangible value. This might explain why 30% of PEW respondents said AI hadn't lived up to its hype at all – a number that jumps significantly to 54% when considering firms with AUM between $500m and $5bn, compared to just 20% in the $5bn+ category.

Indeed, larger firms tend to have more digital talent and innovative resource to deploy – EQT's Motherbrain programme comes to mind.

But the example of Jolt demonstrates that AI's benefits have wider accessibility, putting the spotlight on other potential reasons for wider disappointment.

Morrison suggests two causes. One is that firms are in a rush to adopt but aren't entirely sure how, in addition to friction when adoption does finally get underway. The second is that AI's potential, while vast, is still at early stages – it's application while things are changing at pace makes implementation a challenge.

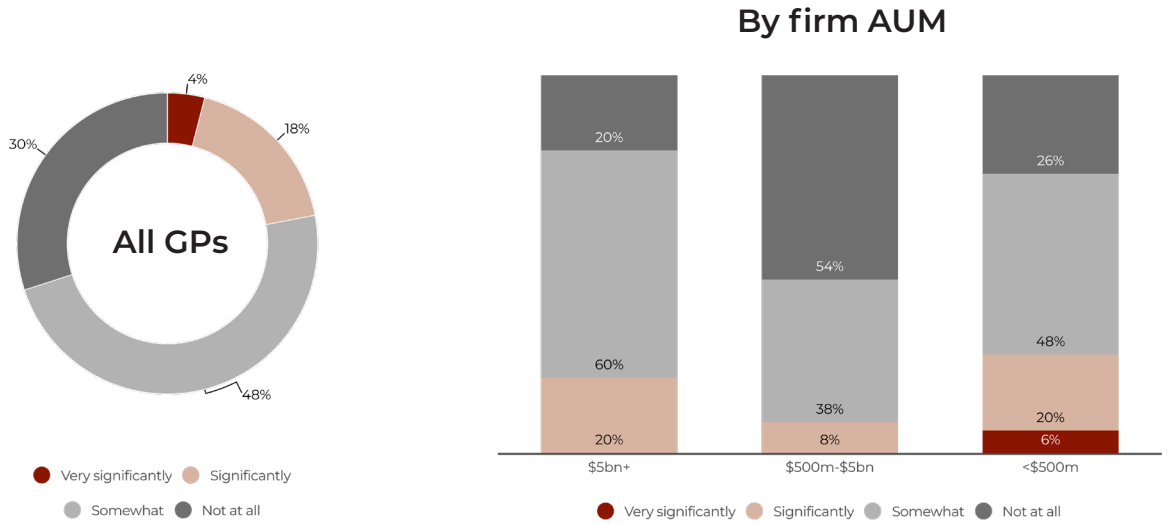
David Tse, Senior Vice President at Thoma Bravo, alludes to reliability as a big source of frustration when it comes to AI – particularly at the portfolio

“

It’s like someone has set off the starting gun on a massive global race, but this is a marathon, not a sprint

Ross Morrison
Partner, Adams Street Partners

Figure 1.4 Private equity firms' views on whether AI solutions have lived up to the hype



Analyst note: *Survey respondents were asked in December 2023, 'To what extent have AI solutions lived up to the hype?'*

Source: Private Equity Wire GP Survey Q4 2023

level. "The first challenge is bias – AI leverages human generated data, and so perpetuates human bias when analysing this information.

"The second is precision: software companies serving critical industries such as healthcare need data to be correct and precise 100% of the time. These companies cannot afford to go lower on reliability of the data, even just by a small percentage."

Still, as we've seen from examples above, time will likely smooth over many of these glitches. Ryan Lanpher, a Partner in Permira's technology team, suggests the idea that AI is falling short of expectations is "too harsh". He continues: "This is going to be a very long game and we are in the early days of the adoption cycle. Today in the portfolio, the single biggest inhibitor to growth are legal and security concerns as regulatory frameworks remain embryonic – we expect to see significant adoption over the next 12-18 months."

KEY TAKEAWAY

AI models need time to learn and adapt to firms' specific needs, so the earlier the better when it comes to investing in firm-level use cases

GPT-5: What's coming!

In January, Open AI CEO, Sam Altman, sat down with Bill Gates to discuss the future of generative AI, laying out three areas of improvement for the next iteration of GPT.

The first is multimodality – the ability to interact with the technology via speech, text, audio, images, and eventually video. "Clearly people really want that," said Altman.

The next is reasoning ability, which Altman says is very limited in GPT 4. One out of thousands of responses produced by the technology is suitable and reliable right now – the goal is to make significant improvements in this space.

And the third most important development area is customisability. People want to interact with the technology in their own, personal ways, based on different parameters and sets of assumptions. The next iteration should have a greater ability to understand people and how they like to operate.

Morrison of Adams Street says: "We're already trying to grasp what GPT 4 is capable of, but such is the breakneck speed of development that the next iteration is already in the works."

When we can expect the launch of GPT 5 remains uncertain.

> "More than a quarter (28%) of PEW's respondents report their firm onboarded new software to improve the origination process in 2023

FINDING VALUE IN AI

The AI rush of last year is transforming more than just value creation efforts, it's changing the types of assets in focus, and the approach firms take to their investments

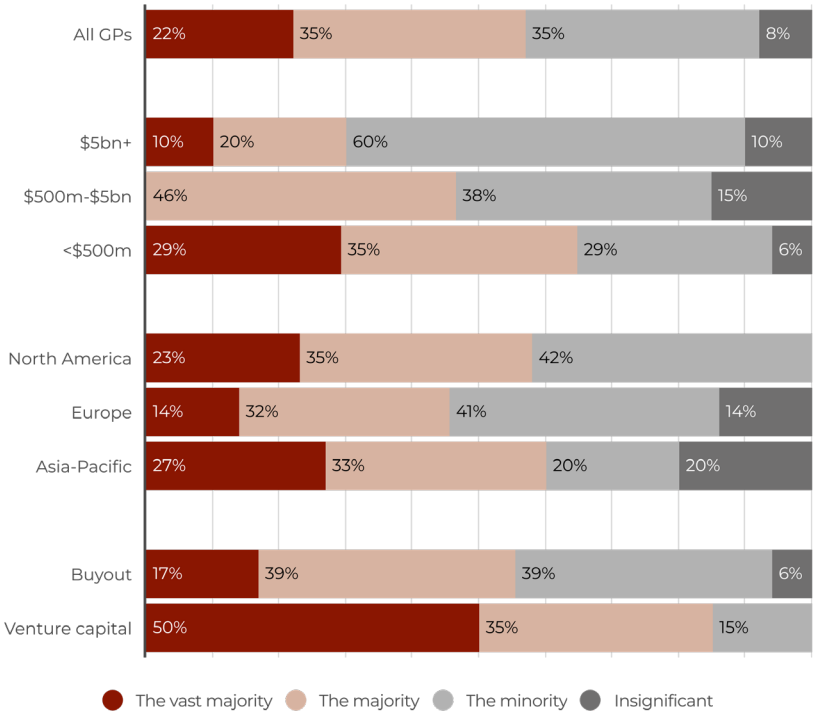
Value creation is in sharp focus in 2024 – as firms adjust to the valuation reset and look to boost portfolio returns. Last year's elevated interest rate environment, which persists for now, pushed financial engineering out of contention, throwing operational improvements, strategic pivots and other levers in the spotlight.

Against this backdrop, AI's rapid advancement and a host of new use cases for savings and profitability captivated the world of business – PE included. A remarkable 57% of GPs surveyed for this report say tech-enablement makes up the majority of their value creation efforts.

David Tse, Senior Vice President at Thoma Bravo, says: "Tech can strategically add value across all functions of a company – from sales to renewals to customer success, boosting the speed and accuracy of each. We go through a digital transformation journey with each portfolio company, also providing them with tailored solutions to help in that process."



Figure 2.1 Reliance on tech-enablement among private equity value creation strategies



Analyst note: *Survey respondents were asked in December 2023, 'What share of your value creation strategies are reliant on tech-enablement?'*

Source: Private Equity Wire GP Survey Q4 2023

AI has the potential to be a significant catalyst here. Amy Yateman-Smith, a Partner at mid-market PE firm Livingbridge, stresses the importance of value creation in the current environment, and tech is paramount. "We have a dedicated value creation team – made up of investment professionals and functional experts – that collaboratively build a strategic plan for each business and then develop capabilities against this to drive value, both organically and through M&A.

"Often this involves investing in people, but data and technology also play a critical role both from a revenue generation and an operational efficiency viewpoint. AI is a powerful tool here. We work with portfolio companies early after investment to improve their data quality, which is the first step to harnessing the benefits of AI."

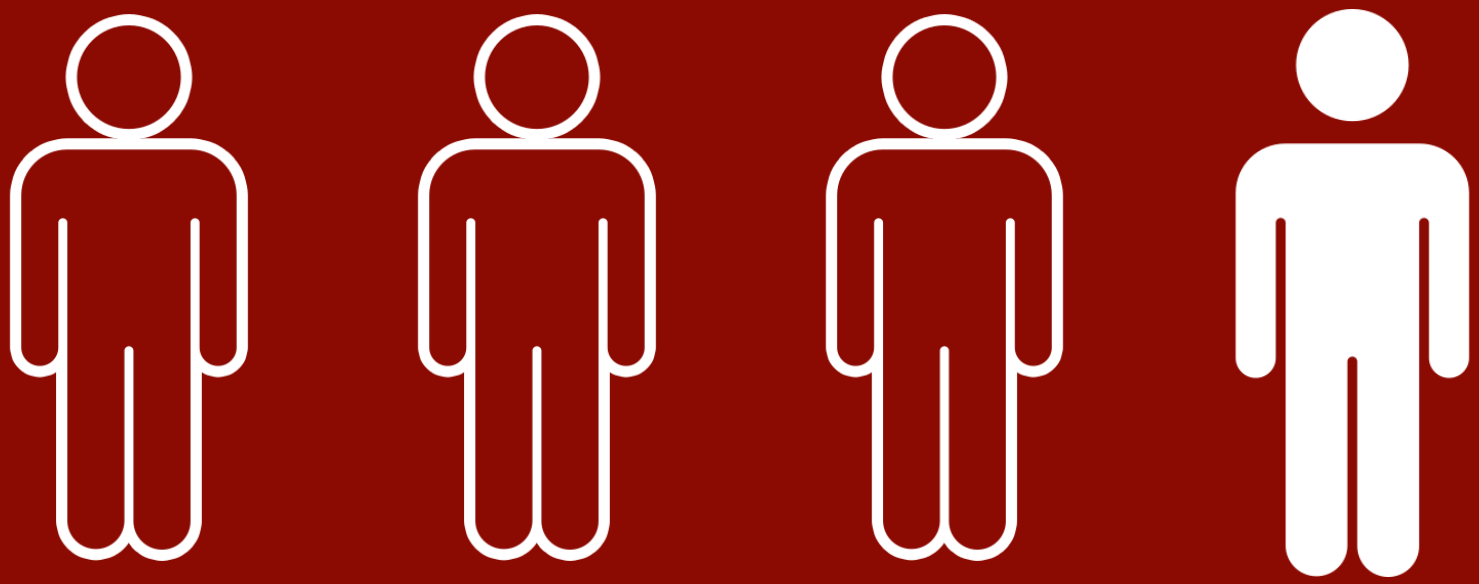
Many are at similarly early stages of AI investment in their portfolio – laying the groundwork to ramp up in the future. Asked about the state of digital transformation in the majority of their portfolio companies, 20% of GPs reported a fully integrated tech stack, and only 10% say most of their portfolio companies are leveraging advanced technology. Of the rest – a small share (10%) is still working with basic tools, while the majority (60%) is engaged in ongoing transformation initiatives.

Progress is slow and steady. As discussed in the previous section, the technology itself has a long way to go before it can produce objective and reliable results. But an equally important factor is the business structure of an asset,

KEY FINDINGS

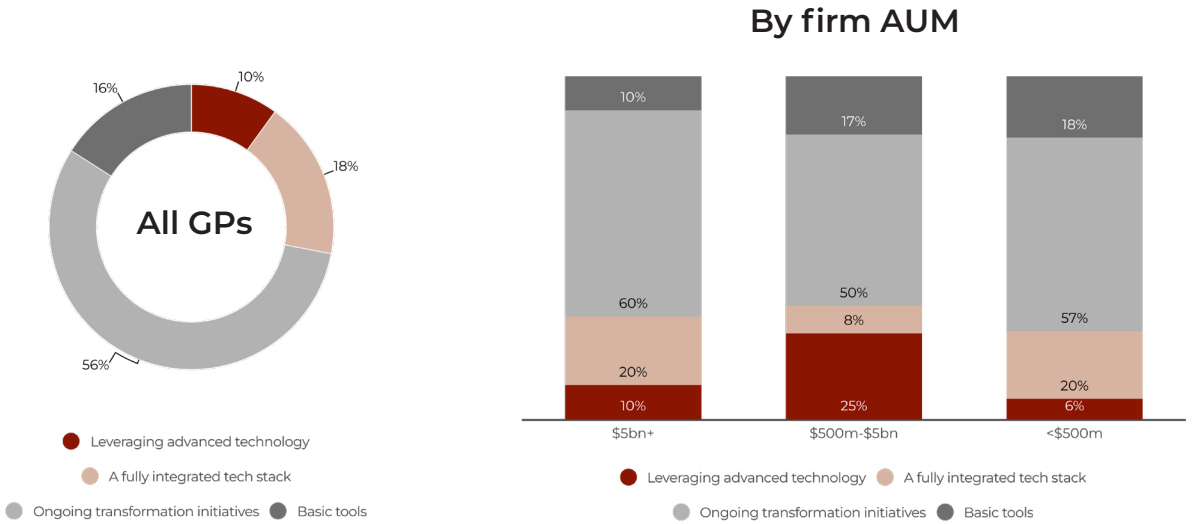
Tech spotlight

One in four managers have either launched a TMT-focused fund or plan to do so



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Figure 2.2 Stage of tech investment among private equity portfolio companies



Analyst note: *Survey respondents were asked in December 2023, 'At what stage of tech investment are most of your portfolio companies?'*

Source: Private Equity Wire GP Survey Q4 2023

and its inherent capacity to transform. As such, this is an increasingly important factor in firms' decision-making, even at the due diligence phase.

Ryan Lanpher, a Partner in Permira's technology team, says: "We have a long-standing bias towards investing in companies where product leadership will be a core driver of the success story, regardless of the sector.

"Specifically in our tech portfolio, the companies are leaders in their respective spaces and early adopters of advanced technology. In the board room, we are actively advocating for a more experimentation versus optimisation mindset – as development continues at a near exponential pace.

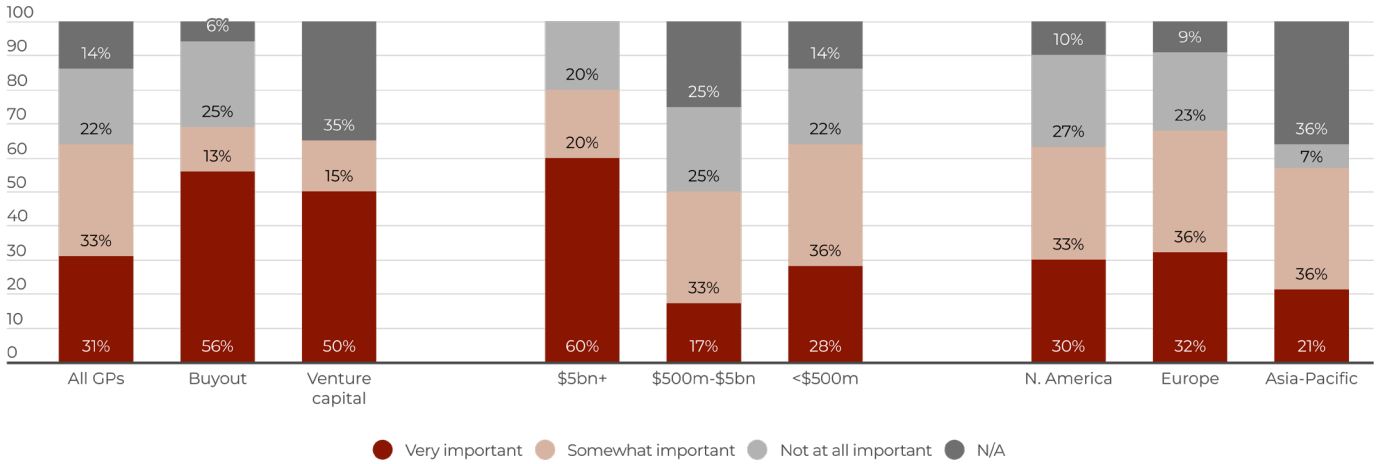
"Being on the 'right side' of the disruption curve forces our companies to focus not only on the future but also foundational elements – such as their data strategy – to be in a position to capitalise on future opportunities."

In a world where tech is disrupting most business models, lines are being blurred between software companies, tech and deep tech assets. The one common denominator is that businesses across this spectrum are once again being perceived as premium investment opportunities.

Nearly two-thirds (64%) of GPs surveyed for this report said tech companies were important to their investment strategies – a figure that climbs even higher (69%) when considering buyout-focused firms. Going one step further, more than a quarter (26%) of all firms surveyed either already have or plan to launch a specific PE tech fund or strategy.

Tse, who works in Thoma Bravo's London office, uses the European investment

Figure 2.3 Importance of tech companies to private equity firms' buyout investment strategies



Analyst note: *Survey respondents were asked in December 2023, 'How important are tech companies and the tech sector to your buyout investment strategy?'*

Source: Private Equity Wire GP Survey Q4 2023

landscape to highlight tech's fundamental appeal. He says: "Recent years have seen accelerated digital adoption across Europe, spurring innovation and encouraging traditional industries to digitise their businesses faster in response to changing consumer behaviour and a competitive global landscape.

"Current challenges facing the European economy have intensified the need to accelerate this shift further, requiring more tech investments. Within that, software – with one of the most interesting and scalable business models – is an attractive sub-sector for PE. It's also mission critical, which is why it can typically thrive no matter the macroeconomic conditions."

Tech has long been an integral part of investment portfolios, taking managers through booms, busts and bubbles over the last two decades and more. The current focus on AI has the potential to drive another growth cycle, as long as a focus on quality assets remains the bedrock of investment strategies.

Ross Morrison, a Partner at Adams Street who heads up the firm's global technology efforts, says: "We've long been investing in the development of AI itself, predominantly through early stage venture capitalists who are at the frontier of the technology. It's not a new phenomenon, but it is getting a lot more airtime now, and rightly so.

"Within the VC space, we're wary of firms that are caught up in the rush and are setting up funds just to buy their way into AI – there are many pitfalls in that approach. What we want to do is invest in the best VCs that attract quality global entrepreneurs who are either AI native, or have a problem where AI can accelerate the solution."

Another important distinction to draw, Morrison says, is between the profiles involved in the

“

Software – with one of the most interesting and scalable business models – is an attractive sub-sector for PE. It’s also mission critical, which is why it can typically thrive no matter the macroeconomic conditions

David Tse
Senior Vice President, Thoma Bravo

world of AI. “It’s technically heavy, there’s deep theory around it, so a lot of technologists are attracted to AI. But typically many of these experts don’t have knowledge of how to build an enduring business, and will take a decade to scale up to their potential.”

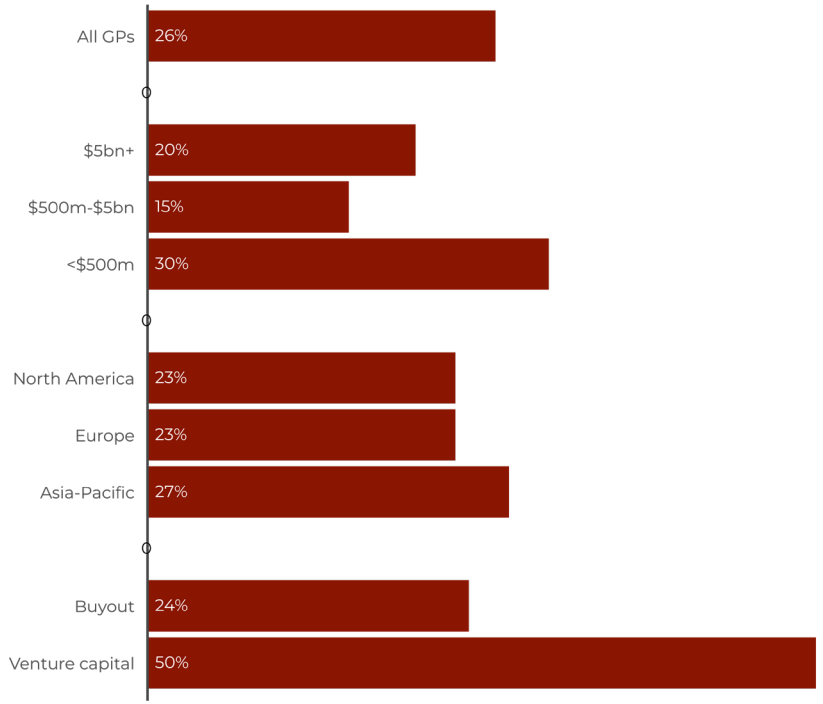
As such, the world of tech assets is complex, particularly when abuzz with AI hype. It’s important to have a clear set of parameters, as explained by Tse, once again using the European landscape as an example. “A wave of institutional capital has flowed into European tech in recent years, but there has been a lack of capital at the stage we’re pursuing – ambitious, mid-market tech companies looking to grow beyond their home market and pursue profitable growth.

“That said, there is plenty of room in the tech space for many different types of buyers and sellers – European tech is a $3tn industry with a growth rate of 27%.”

KEY TAKEAWAY

Tech assets are a lucrative space in the current environment, but investments need to be approached in a considered manner, with a clear route to value

Figure 2.4 Private equity firms to launch or plan to launch a specific tech fund or strategy



Analyst note: *Survey respondents were asked in December 2023, ‘Do you have or plan to launch a specific tech fund (including TMT) or fund strategy within private equity?’*

Source: Private Equity Wire GP Survey Q4 2023

> Outside of gen AI, more traditional tech modernisation and dealing with tech debt are still high on the agenda



JOURIK MIGOM

Global Head of Private Equity
Endava

"Is the market back up? Are there more deals in the pipeline?"

These must be some of the most-asked questions when you mention today you are working in private equity. While sentiment has improved, the short answer is that the market is not 'back to where it was before'. But when zooming out and looking at the full PE lifecycle, we see a significant change happening in the post-deal space.

More specifically, in recent months we have noticed an increase of funds with an appetite to get under the hood of the tech that drives their portcos. We also see more ambitious technology change agendas as part of value creation plans. And it is specifically in these value creation opportunities that we see a lot of effort going into understanding the disruptive nature of generative AI alongside the more traditional topics of tech debt and rationalisation of systems.

Rather than viewing AI as a silver bullet to solve all problems, we see funds rapidly maturing their understanding of what gen AI can bring. Questions are almost always centred around how gen AI could improve top-line or cut down costs. And the starting point is often to get in diligence a first view on the gen AI maturity of the target.

Deal teams and portfolio operators keep betting on tech as driver for value

In the report, we saw reference to deal teams and operating partners looking at technology as an active part of the value creation plan. We see this daily across tech-enabled and product software companies. The hype of gen AI seems to have settled, but access to some of its benefits could create a disproportionate advantage for those who implement it smartly versus those who stay behind.

Outside of gen AI, more traditional tech modernisation and dealing with tech debt are still high on the agenda. We see organisations on the lookout for simplification and rationalisation of platforms, modernisation of front-ends to improve customer experience, and reduction of tech debt in aging back-end systems. Integrations and customisation on the edge of large COTS packages are other trending topics. When these changes are done at pace and in the right sequence, PE funds can help drive dramatic change to the 'engine' of their portcos, often resulting in improvements of core revenue and cost KPIs.

Tech investments on the PE level remain moderate with a focus on operational efficiencies and rationalisation of IT spend

We don't see massive investment on the PE level. The actual tech that powers PE funds is not that complex. Most PE fund COOs are looking for stability and trustworthy data, which often can be found in a good fund admin platform combined with some rigor around the use of Excel. The hype around SaaS offerings helping with deal generation seems to have slowed down.

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