MARKET INSIGHT

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NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Private equity: reducing uncertainty

Increased transparency and defensive themes can provide comfort to investors.


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The outcome of investing is always uncertain, but rarely has it felt quite as uncertain.

In the current environment, prudent private equity houses – even those that have performed well over several cycles – can implement measures to ensure that returns continue to match investor needs.

Defensive themes support exit multiples in tough times

Flexstone is an opportunist investor, able to co-invest across sectors and geographies without restrictions. However, given the extreme nature of current risks, it has embraced defensive themes which it believes will support exit multiples.

These themes are answering rising interest rates, spiking inflation and ongoing digitalisation.

Rising interest rates reduce the present value of investments and lower exit multiples. "As an investor, you may be in a position to sell at market multiples that are lower than the average market multiples at the time of investment," says Eric Deram, Managing Partner at Flexstone Partners, a private equity co-investment specialist and affiliate of Natixis Investment Managers.

One solution is to buy at lower multiples, which is possible if you have a strong deal flow and operate in the mid-market where market multiples are intrinsically lower. In addition, in the mid-market, companies can be more readily refocused to grow faster, and then command higher multiples.

Another solution is buy-and-build. Buy-and-build involves acquiring a company and positioning it as a platform which can rapidly expand by acquiring competitors and complementary businesses. With buy-and-build, a larger company can be bought at, say, 10x earnings, while bolt-on acquisitions of smaller companies can be made at, perhaps, 6x to 8x earnings.

"If you make bolt-on acquisitions at lower multiples, you average down the entry multiple and create the conditions for a higher exit multiple." notes Deram.

The secret of passing on price rises

Inflation is rising and the consensus is growing that higher prices are entrenched. Companies in all sectors are trying to pass on price increases without friction.

"Not all of them can do that," says Deram. "If you sell a commoditised product and you're not the market leader, you will be unable to pass on cost increases until and unless the market leader does." That leads to probable loss of market share.

Flexstone targets companies which make components that are essential for the quality of the end-product but are inexpensive. "We call these products, 'mission critical, low cost'," says Deram.

Key takeaways:

- Amid highly uncertain markets, private equity firms can implement measures to help ensure that performance matches investor needs.
- Flexstone has embraced defensive themes such as "buy-and-build" and "mission critical, low cost", to support exit multiples amid rising interest rates and inflation
- For investors, greater visibility over where capital is allocated is gained through so-called late primary/early secondary investments.

"Because they are low cost, they can increase their prices with minimal impact to end users."

In Flexstone's portfolios, one "mission critical, low cost" company provides administration services to large publicly traded companies. The company's clients are satisfied with its services – none has changed provider in 25 years – and they are unlikely to worry about a moderate price increase in the services. Changing to a new provider would entail risks to clients and affect the performance of a regulated service that far outweigh a small rise in overall costs.

Other examples of Flexstone's "mission critical, low cost" deals include a producer of bottle tops for high-end perfume manufacturers, a business that makes the on-off button for iPad and a manufacturer of insoles for high-end sneakers.

Embracing digital – even in low-tech sectors

Digitalisation is the other key theme Flexstone employs to help protect and enhance growth. Pureplay tech companies are not a focus for Flexstone, given the high entry multiples, but it believes most successful companies are embracing digital trends.

"Given that technology is disrupting every sector, we like to see a significant digital component in the business model," says Deram. "We don't look to buy tech companies, but tech-savvy companies tend to be able to grow their market share faster."

One of Flexstone's portfolio companies, a freight brokerage business, has a technology platform that is demonstrably superior to its competitors. "In a low-tech industry, it has created a big advantage through tech," adds Deram.

The late primary/early secondary opportunity

In uncertain markets, visibility is clouded. Even when they know and trust GPs, investors are to a certain extent "blind" when committing capital to private equity. That is, in the early stages of private equity there are as yet no investments and LPs cannot know in advance which companies will be acquired, at what price and what value will be added.

Private equity firms which can increase transparency over investments, as well as identify defensive themes, are likely to assuage investors' heightened anxieties. Greater visibility over where capital is allocated can be gained through commitments to so-called late primary/early secondary opportunities. That is, investors can commit capital 12 to 18 months after launch, when a number of deals have already been completed. They are therefore able to see which companies have been purchased, at what price and how much – if at all – their value has risen or fallen since acquisition.

"Your investment sits somewhere between a primary commitment, as made on the first closing date, and a secondary investment, where you purchase interests in a mature portfolio," says Benoît Jacquin, Managing Partner at Flexstone Partners.

"Some institutions are happy to be anchor investors and commit capital at launch, but we totally understand that others prefer to have a flavour of what they can expect to get and take advantage of a late primary/early secondary opportunity," Jacquin adds.

Positive returns from Day One

There are a range of benefits to investors of late primary/early secondary investments. First, they buy into the assets in the portfolio at cost, meaning they benefit from unrealised gains if the value of companies has increased. If value has already been lost, the investor can simply choose to pass.

In addition to a potentially positive return on Day One of their commitment at a later closing, investors avoid the J-curve effect, which typically calls for an initial negative return as capital is called to pay for set up costs and management fees before deals have been executed.

Third, for such investor, its capital is deployed a lot faster if a sizeable number of deals have already been transacted. This means a sizeable share of their capital is put to work straight away rather than waiting to be called over time.

Finally, the maturity is shortened by 12 to 18 months, so late primary/early secondary investors get their capital and returns quicker.

The initial investors are generally happy with this arrangement too. They have secured a primary allocation and, with sizeable commitments, may have negotiated some terms of the offering. Furthermore, an influx of capital from later investors creates the conditions of greater portfolio diversification, and all else being equal, higher risk-adjusted performance.

Speed and volume of deals important for late-primary investors

Visibility is only increased to late primary/early secondary investors if a sizeable number of deals are transacted in the first year or two. Large primary portfolios may make only one or two deals a year, reducing any potential benefits for late primary/early secondary investors.

"Co-investment tends to invest faster than the average buyout portfolio and, at Flexstone, we are particularly diligent, completing 18-20 deals a year," says Deram. "We tend to deploy over three years because we have extensive deal flow and a process which facilitates rapid deployment."

In addition, Flexstone invests in the mid-market, which is a highly-active segment with strong deal flow. In fact, 97% of the private equity deals closed since 2008 in Europe and the United States are deals with a value equal or lesser than USD/EUR 500 million[1]. Flexstone's deal flow is further enhanced by operating a global team with local expertise which enables it to source opportunities across Europe, the US and Asia.

To speed the selection and execution of deals, Flexstone has created a proprietary selection tool which filters only those deals that are in the lead sponsor's sweet spot. The sweet spot being a deal in which the GP has a specific proven skillset.

The way Flexstone executes deals adds tangible value for late primary/early secondary investors. Deram says: "We are unique among our peers in being able to add value in the portfolio early on. We underwrite our investments at conservative multiples so when we value our investments at market prices there may be sizeable upticks."

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1 Source Pitchbook's 2021 Q4 US PE Breakdown and 2021 Annual European PE Breakdown.

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