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Why boring is beautiful amid private equity's 'exit crunch'

If you believe the bears, private equity could be one of the first things to crack because of surging bond yields.

While this is a sector that's become expert at using debt to juice returns, it is also an industry, as Howard Marks pointed out last week, whose entire history has played out in an era of falling interest rates.

Nitin Gupta, managing partner of private equity manager Flexstone Partners, has heard the doomsayers plenty of times during his 25-year career in the sector – during the Long-Term Capital Management crisis in 1998, during the dotcom bust, during the global financial crisis and, most recently, in the COVID-19 crisis.

The private equity sector is looking for safe ports amid a interest rate storm. **David Rowe**

While he doesn't shy away from the fact higher rates make life harder for private equity, there are parts of the sector that will prove resilient. "They're what I like to call the boring businesses that you're not going to talk about at a cocktail party," he tells Chanticleer during a visit to Australia.

These mid-sized companies are enmeshed in what Gupta calls Main Street; Flexstone's investments include a port-a-loo company, a manufacturer of plastic bottle caps, and lots of healthcare and healthcare service businesses, a sector Gupta points out accounts for about 18 per cent of the US economy.

"If I need a medical procedure, I'm not sitting there saying, 'gosh let me wait till the Fed lowers the interest rates before I go in to see my doctor.' Smaller, middle market businesses are humming along because the Main Street economy in the US is relatively stable."

That may change, of course, but Flexstone's investment processes requires it to stress test any deal for a recession, giving Gupta comfort about what's coming.

Private equity's 'exit crunch'

Flexstone has a little over $US10 billion ($16 billion) in funds under management and counts superannuation giants Hostplus and AV Super among its clients; Australia is its third-largest institutional market. The firm specialises in putting together portfolios of private equity managers for its clients, and also makes co-investments in individual assets.

But it steers clear of both the mega-private equity deals that have become popular in recent years, and the venture capital sector. Its portfolio is also underweight technology, a sector where Gupta says, "a lot of bad decisions were made" during the pandemic frenzy.

It is these parts of private equity that Gupta says are exposed to what he says is the worst of the "exit crunch" that has led to IPOs, trade sales and secondary sales falling sharply in the last two years. Preqin Pro research shows were 1294 global private equity exits in JanuarySeptember, down 35 per from the boom year in 2021.

There were some signs that exits are becoming easier, with a smattering of IPOs in the US in recent months and some thawing of the banking sector's recent aversion to providing private equity credit. But whether the recent surge in geopolitical risks and another jump in bond yields slam the exit window shut again remains to be seen.

Gupta feels insulated from the worst of this. In his smaller, more boring part of the market, 90 per cent of portfolio companies are sold to trade buyers or larger private equity companies.

He says Australian super funds are sharpening their private equity focus in this difficult environment and increasingly want access to newer managers with specialist skills.

A big part of the reasoning, Gupta says, is that research shows a private equity firm's first few funds tend to have the greatest probability of delivering top quartile returns, which reflects their size (it's harder to outperform with a larger fund), their ability to find off-theradar and cheaper deals, and the fact the managers tend to have a lot of their own money at risk.

Flexstone's emerging managers program has delivered a net return of over 20 per cent since it launched in 2019.