Private Equity Returns and Inflation

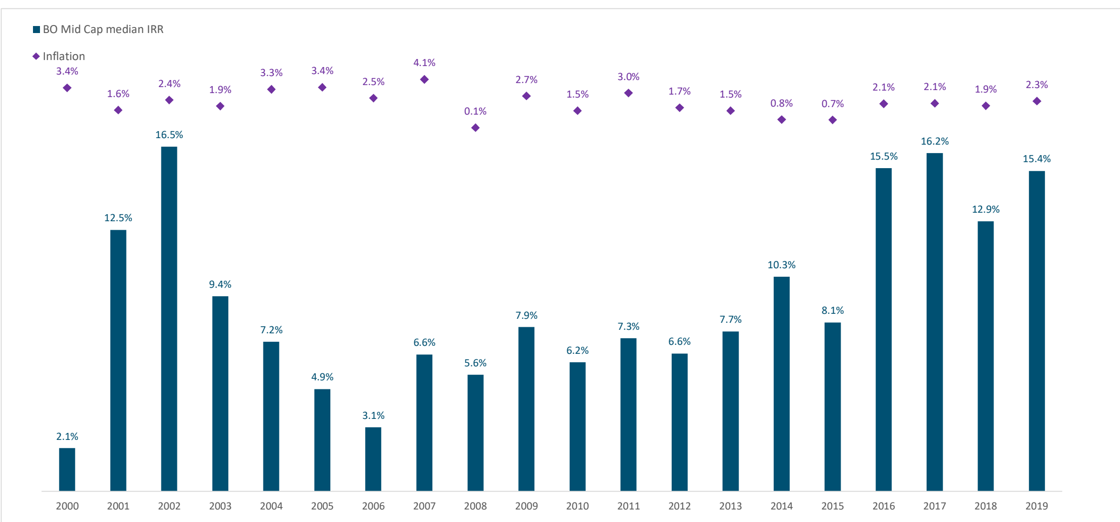
The “I” word has a unique place in the world of finance. Every hint of it accelerating usually triggers widespread equity sell offs and doomsday predictions of falling returns for investors. According to the OECD, global inflation reached 5.2% in Q4 2021. That was up from 2.12% twenty-four months earlier (pre Covid). It is also a much higher rate than we have been accustomed to over the last 30 years+. Inflation therefore is definitively back although by certain historical standards 5.2% does not sound that horrendous. I started my career in leverage finance in Brazil, back in 1990 when inflation passed 6’000% at one point!

A recent survey from Eaton Partners (October 2021) finds that 89% of PE investors “are at least somewhat concerned about heightened inflation”. More anecdotally, no meeting with existing or prospective clients of Flexstone Partners these days finishes without us being asked about how inflation is likely to affect the expected returns of our portfolios in addition to the more immediate concerns relating to the Ukrainian conflict.

Inflation and Private Equity Performance

The commonly accepted adage that in time of inflation one should be cash poor suggests that the closer to the assets, the more protected one is from value eroding inflation. Specifically for PE, a recent analysis from Preqin[1] has shown that periods of inflationary pressure had limited impact on private equity performance.

In the graph below we plotted inflation and the US mid-market buyout performance for year 2000 through to 2019 using Pevara[2]. Buyout performance does vary significantly over time but because of the bubble burst of 2000 or the Great Financial Crisis, not inflationary pressure. The same analysis for European data leads to a similar conclusion.



Historically, inflationary pressure has not posed a significant risk to long term PE returns. The counter argument to this statement would be that PE never really had to deal with a high inflationary environment. Indeed, over the last 20 years, the maximum inflation rate in the US was only 4.1% (in

[1] Alternatives Market Keeping and Eye on the Fed – Preqin – 1st February 2022
[2] Source Pevara, US Small & Mid cap, Median IRR returns in USD as of 30/09/2021.

2007[3]). We have to go back to 1981, at a time when private equity was just a fledging industry, for a US inflation rate higher than it is today. Should the PE industry inexperience with inflation worry us? Perhaps not. The OECD forecasts the US inflation to go back down to 2.5% in 2023, well within the range of the last 30 years, a period when PE has been flourishing. However, these optimistic forecasts were made before the conflict in Ukraine started. Today, as a result of increased inflationary pressure many continue to believe that interest rates will continue to rise this year but perhaps not as much as they would have without the conflict.

Regardless of whether you believe high inflation is here to stay or not, as an investor in the asset class, it is prudent to understand its potential impact on PE portfolios and how this risk can be mitigated.

Impact of inflation on Private Equity portfolios and ways to mitigate it

Let's look in turns at the three main specific risks to PE returns that could stem from higher inflation: 1. Higher financing costs, 2. Lower implied valuations and, 3. Slower earnings growth. These specific risks would be in addition to the general risk that, because of high interest rates or long-term geopolitical conflict, we could experience a significant slowdown of economic growth or even tip into a recession.

Higher financing costs: As inflation increases, central banks raise interest rates thereby raising the cost of floating rate debt. According to the latest Pitchbook data, the median debt to EBITDA ratio for PE (buyout) transactions was 5.8x in the US and 6.4x in Europe in Q4 2021, virtually all of it in floating rates. Needless to say, therefore that the cost of debt is an important factor of PE performance. How can investors be protected against the risk of higher interest rates?

- *Limit the use of debt:* There are three ways to create equity value in PE: 1. growth of the profits of the companies you invest in ("operational value creation"), 2. buy at a low multiple and sell at a higher one ("multiple arbitrage") and, 3. use of debt to magnify equity returns ("financial engineering"). Investors can generate significant PE returns through operational value creation only, without extensive financial engineering. The median leverage of our latest co-investment fund is 3.5x and 4.0x EBITDA respectively for the US investments and the European ones, much lower than the market average (6.4x and 5.8x respectively according to Pitchbook[4]);
- *Underwrite investments assuming interest rates hikes:* As part of due diligence before completing any new investments, investors should always build detailed financial projections including a variety of stress tests, one of which should be a meaningful increase of interest rates;
- *Do not leveraged PE funds:* Often forgotten is the fact that most buyout funds make extensive use of ironically called "equity lines" today. These are debt facilities used by PE funds to leverage themselves. This is in addition to the debt that is used for each investment (see above for the market median leverage ratio). These equity lines will be dearer as interests rise, putting pressure on returns. Flexstone Partners does not use equity lines; and,
- *Build a diversified portfolio across industries and strategies:* The rise in interest rates has a disproportionate impact on high growth businesses that garner much higher valuations in a low rate environment versus those same future earnings being discounted at a higher rate. Consequently, building a diversified portfolio of investments across stage (mature and higher growth) as well as different end markets should help insulate the portfolio.

[3] OECD
[4] Pitchbook Q4 2021

Lower implied valuations: Inflation fears have pushed most equity indices into red territory over the last few weeks as market-participants factor-in higher discount rates into their valuation models. The same logic applies to PE. Therefore valuation multiples should decline over the near term. How can investors be protected against the risk of lower future valuation multiples?

- *Buy conservatively*: The PE market has become very efficient over the last 20+ years. It has become more difficult for PE fund managers to compete on anything other than paying the highest price when making a new investment. According to Pitchbook[5] the current median PE acquisition multiple is 13.7x EBITDA in the US. With creativity and an opportunistic investment philosophy, it is possible to be more conservative. The median acquisition multiple for our latest co-investment fund is 12x for US investments, 1.7x lower than market;
- *Underwrite new investments assuming a multiple contraction at exit:* Prudent investors should generally assume that valuation multiples can go down over time. One of the stress tests that an investor ought to be conducting before any new investment should be a reduction of valuation multiples at exit;
- *Invest in the lower end of the market:* It is well documented that there is more dry powder and that acquisition multiples are higher in the large & mega cap segment of the PE market than in the smaller end of the market. By investing in the smaller end of the market, help portfolio companies grow for three to five years then selling to large & mega cap PE funds, investor should continue to benefit from multiple arbitrage value creation between the small and the larger end of the PE market; and,
- *Reducing the acquisition multiple of a company over the holding period:* The so called "buy and build" investment strategy whereby an initial investment is made in a "platform" company that is complemented with multiple add-on acquisitions of smaller competitors bought generally at lower acquisition multiples allows investors to reduce the blended acquisition multiple of the investment overtime. Six of the companies we recently invested in for our latest co-investment fund follow such an investment strategy.

Slower earnings growth: Increased input costs, including labour, energy and commodity as well as continuing supply chain disruptions can stress company margins and dampen earning growth for all companies. The war in Ukraine is compounding the negative consequences of Covid on the economy How can investors be protected against such risk?

- *Investing in companies which have strong pricing power:* Not all business models are treated equal in that respects and therefore the current environment demands greater attention to asset selection. B2B companies might be better at passing along price increases to their customers as well as market leaders and highly scalable businesses (where the labour input become less significant as the company grows). Similarly, companies which sell a critical component (or service) which represents only a relatively small proportion of the overall cost of the finished good (or service) are likely to be well protected against resurgent inflation. We believe such businesses will be able to pass through increased input costs relatively easily as their clients will be reluctant to change suppliers for critical components even if their prices increase somewhat. Four of our recent investments are "mission critical low cost to value" companies;
- *Steer portfolio companies toward more value-added products and services:* One company we recently co-invested in is a diversified provider of foam products used in bedding, furniture, transportation and medical end-markets with 30 manufacturing facilities across the US and

[5] Pitchbook Q4 2021

Mexico. In the second half of 2021, the company experienced higher raw material and chemical input prices, elevated freight rates and tight labour markets. In addition to implementing cost saving initiatives, under the leadership of the PE firm that leads the investment, the company shifted to producing more finished good inventory which carries higher margin; and,

- *Have strong operational skills in addition to financial expertise:* Owning and running a business in an inflationary environment is more complex than operating in stable conditions. Skills sets such as managing working capital efficiently and reallocating investments to higher margins products and services, in short, having strong operational experience could make the difference between positive or negative returns. We find comfort in the fact that most PE fund managers we partner with are battled-hardened industry specialists who understand the inner workings of the companies they buy and who can help them generate earnings growth even during stressed times. PE fund managers have improved their operational skills greatly since the Great Financial Crisis and are much better equipped today to steer their portfolio companies through turbulent environments. This was illustrated during the onset of the pandemic in 2020 where Flexstone co-investment portfolios saw much less impact on valuations relative to the overall market.

In addition to the investment tactics described above, we believe that remaining opportunistic and building a well-diversified PE portfolio would allow investors to generate strong risk-adjusted returns regardless of the macroeconomic, the pandemic or indeed the geopolitical environment.

Eric Deram
Flexstone Partner
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Performance data shown represents past performance and is not a guarantee of future results.

About Flexstone Partners ("Flexstone")[0]

Flexstone is a leading investment solutions provider in private assets with a global reach and local footprints in New York, Paris, Geneva, and Singapore. It specializes in the selection of private equity, private debt, real estate, and infrastructure fund managers for investment by Flexstone's clients. Flexstone manages primary and secondary investments as well as co-investments. Flexstone's expertise is distinguished by a high flexibility in building customized portfolios that are tailored to the unique needs and constraints of each investor whether institutional or private individual[1]. Flexstone offers a large range of services, from advising on private assets portfolio construction to the management of fully discretionary separate accounts and funds of funds. Flexstone, with more than 45 professionals, manages or advises $9.6 billion[*]. It is a majority owned subsidiary of Natixis Investment Managers, one of the largest investment managers worldwide.

Further information: www.flexstonepartners.com

* Source: Flexstone Partners at 31/12/2021 Assets under management and advisory made up of commitments for closed-end private placement funds, and sum of Net Asset Value and unfunded commitments otherwise.