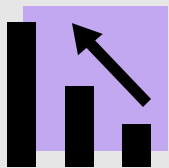


Private Equity and Inflation



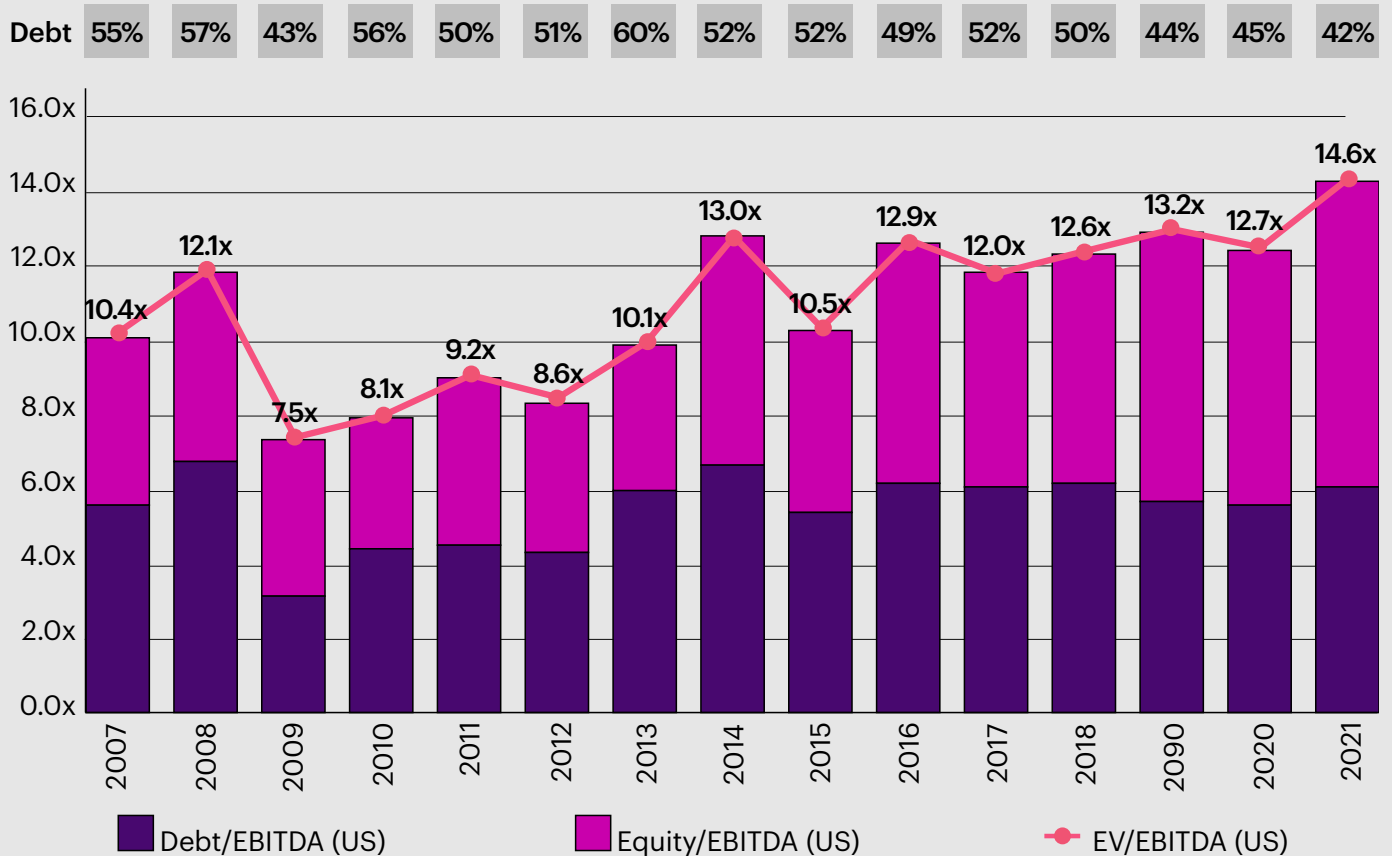
In the first of our series looking at Private Equity, we explore the impact of Inflation and how private equity investors can respond.

41 years.

That is how long it has been since US consumer inflation last saw a level higher than what it reached in June 2022 (9.1%). On June 15th, 2022, the Federal Reserve raised its benchmark interest rate by 0.75%, in its most aggressive hike since 1994.

For an entire generation of investors in the private equity industry, this macro environment is, literally, unprecedented. Whether the current inflation environment is “transitory” or not is a subject beyond the scope of this article, and frankly, our ability to predict. But what if, heaven forbid, high inflation is more persistent than fleeting and interest rates need to keep rising to bring it back down? The implications on the private equity industry could be profound.

Figure 1: Rising buyout multiples



Sources: Pitchbook as of Q1 2022

Average valuation multiples¹ have been steadily increasing for buyout transactions over the last 15 years, particularly post GFC (Exhibit 1), thanks to increasing levels of dry powder; competition for high quality deals; and cheap/covenant-lite debt financing fueled by ultra-easy monetary policy.

Generating return potential in a market buoyed by rising multiples is like walking on a moving walkway in an airport. You are moving considerably faster than your normal pace, without even breaking a sweat, because the conveyor belt does a lot of heavy lifting for you. In fact, that is very much the story for buyout returns over the past decade. Per [Bain and CEPRES Market Intelligence](#), multiple expansion has been the largest contributor to private equity buyout returns over the past decade, accounting for around 50% of the total value creation.

Just imagine what happens when the moving walkway slows, stops, or even moves in the opposite direction!

While we again refrain from making predictions, we believe investors should not dismiss the possibility of a scenario like this, for a few reasons. First, higher discount rates in theory means lower price multiples. That is just investing 101. Second, the rise in financing rates would increase interest expenses and to keep interest coverage ratios at acceptable levels (assuming same debt-to-equity ratio), buyout investors will likely seek deals at lower valuations. Last, most investors typically do not expect the market pendulum to forever swing in one direction.

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If something cannot go on forever, it will stop.

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Generating return potential with market headwinds will undoubtedly be harder. In an environment of rising rates leverage and multiple expansion tend to be the first two drivers of returns to fade away. When the moving walkway stops, in order to keep the same pace, we have to walk faster. From the standpoint of private equity investing, it means seeking to grow portfolio companies faster and profitably. It means seeking to select strong, resilient businesses and building operational value-add capabilities are now front and center in generating returns (as it should have always been, in our view) as opposed to relying on multiple expansion or financial engineering.

The private equity research team at WTW recently invested in a compelling US based buyout strategy active in the lower middle market, from a generalist manager out of California, which we believe is well positioned to cope with an uncertain macro environment for the years to come, persistent inflation or not.

As an opportunity set, the smaller end of the market is riper for operational value-add. As we showed in a [white paper](#) we published in 2021, value creation drivers differ across transaction sizes with small- to mid-cap deals relying more on revenue and earnings growth while large-cap deals are more reliant on leverage. Smaller companies are often less professionalized and benefit more from additional resources, improved corporate governance and management teams, more well-defined business strategy, broader industry networks, and access to sector experts. In addition, smaller companies are often ideally placed to serve as a platform company and offer private equity managers a chance to consolidate and grow the company externally.

For the investment we just made, the manager has a full-time operating team structured as functional experts with diverse business management skills, ranging from capital and cost efficiencies to strategic and add-on M&As. In our experience, this is rare for a small fund at this end

of the market. It is even more rare to have operational experts who can dig into specific issues at a portfolio company as in depth as this manager does, which we believe is a significant differentiator. Managing businesses in a potential inflationary environment is going to be challenging. We believe this manager is as experienced as any in this market segment in enabling and incentivizing portfolio company management to drive growth while maintaining market competitiveness.

We were also impressed by the manager's deal sourcing capabilities, supported by a dedicated deal sourcing function. It has sourced over 2,000 deals that fall within its investment parameters over the last four years. It allows the manager to (1) fish in a large opportunity set to select attractive businesses that can typically maintain pricing power to offset inflationary pressures with strong margins and (2) seek to acquire companies for good value. Average pricing for deals it has done in its previous fund is substantially lower than the comparable market average, which could be valuable if the market enters a new phase of multiple contraction. The manager also takes a conservative approach to leverage use. Only a few deals used leverage and even for those deals with leverage, debt usage is lower than market average. That allowed us to gain comfort heading into a potentially high interest rate environment.

Warren Buffett once made a now-famous remark: "only when the tide goes out do you discover who's been swimming naked." At this crossroads where the tide of multiple expansion might realistically go out, we believe it is a safer bet to partner with managers who focus their energy on helping portfolio companies navigate a potentially turbulent environment. Don't be caught naked!

¹ In the world of private equity, this is normally expressed as a ratio of enterprise value (EV) over EBITDA, or earnings before interest, taxes, depreciation, and amortization, a measure of a company's overall financial performance.

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