PRIMEIRO PARTNERS

The Daily Dispatch

Weekly Special Feature

June 18, 2021

Private Equity's Mid-Life Crisis

By: Karim Khairallah and François Mann Quirici – Harvard Business Review *(Published on June 9, 2021)*

Daniel Grizelj/Getty Images

There's trouble on the horizon for private equity. As the 50-year-old industry matures, investment returns are falling. In fact, for the past three decades, average buyout performance — the return a buyout firm generates from buying, improving, and then selling a company — has been on a downward trend. A study by Harvard professor Josh Lerner, State Street, and Bain, for example, found a meaningful drop of six percentage points between the 10-year annualized return in 1999 and the comparable return in 2019.

What's ailing the industry? Simply put, the traditional tools of private equity for generating performance have become less effective, which is a natural evolution for a maturing industry. First, financial tools — leverage and price arbitrage — are less potent than in the past and hard to control. As the number of active PE firms reaches record levels, returns from the former are largely competed away. And with PE firms paying more for businesses than ever before (on average, relative to the businesses' underlying earnings), the return potential is meaningfully reduced.

Second, operational tools — margins and growth — have become harder to capitalize on. Global competition and commoditization make it harder for products to command a premium price, which squeezes margins, and often a business's easy-to-accomplish cost savings have already been collected by previous owners. A classic PE strategy — integrating small acquisitions into an existing business — still offers revenue growth and other benefits, but its popularity raises the prices of these acquisitions, so returns naturally fall.

Faced with a maturing, more efficient market that is chipping away at their returns, PE firms have innovated — operationally and financially — to create value. For example, they have upgraded their operational capabilities and created new forms of financial engineering, such as introducing debt at different levels of their groups (i.e., at the portfolio company, fund, and manager levels). But these incremental moves are not sufficient to halt the structural erosion of industry returns.

What is called for is a novel way for PE firms to think about — and create — value.

PE's Next Frontier of Value Creation

The current PE approach is to treat the businesses in a firm's portfolio as a bunch of isolated, individual investments, and to focus on how the stand-alone performance of each one can be improved over time. Of course, this approach is about diversifying risk, and it is how PE investors create value vertically. At the top are PE owners, which drive the improved performance of their portfolio businesses (in the middle) via strategic, operational, or management changes. At the bottom, bolt-on acquisitions are absorbed into those portfolio businesses to extract more value.

Conversely, we believe the next frontier of value creation is to design and manage PE portfolios as a business ecosystem. In this approach, which is largely unexploited, a PE firm orchestrates a network of relationships between some of its portfolio companies, linking previously unrelated goods and services across industries, and helping the companies unlock new value in each other. As a basic example, two businesses could coordinate the procurement of common services (such as employee health insurance) to

reduce costs. The incremental value derived from leveraging the portfolio this way complements vertical value very well — the horizontal links between companies give PE firms more, and novel, options for increasing their portfolio's worth.

This value is primarily created through revenue enhancements, cost efficiencies, higher valuation ratings, and some downside protection. In one basic area, procurement, a large PE fund has generated $550 million in cumulative savings over five years through coordination across its portfolio. Another player generated a 2.3x return on investment in three and a half years in a significantly declining sector, driven in large part by revenue relationships between interacting businesses. In sophisticated cross-portfolio arrangements, we find that operating profit can be increased by 15% or more.

The proposed value creation system is specifically adapted to PE's unique buy-to-sell strategy — the firms' practice of buying businesses and then, after driving meaningful operational and other improvements over a certain number of years, selling them. That means that while some portfolio businesses will form collaborative relationships with each other, they must remain operationally autonomous. This is to diversify portfolio risk and give PE owners the flexibility to sell them at any time. So building such business ecosystems is a balancing act between value on one side, and risk and flexibility on the other.

Basic elements of this approach may be deployed opportunistically after PE funds have acquired their portfolio businesses, without having planned in advance how to link the parts together. However, the greatest opportunity for value creation is when those links are considered before acquisition, as funds can carefully select and arrange the ecosystem's parts into a high-performing whole. In this approach, PE investors would, at the outset, design a roadmap of potential links between their businesses, and then use it to evaluate potential investments. So the new screening process would consider not just a target's individual potential but also its capacity to form new connections. The ambitious vision is for a fund to build, with each acquisition, a virtuous business ecosystem, continuously enhancing value without compromising risk or flexibility.

How an Ecosystem Approach Creates a Competitive Edge

Shaping their portfolios as business ecosystems can secure different kinds of competitive edge for PE investors, beyond just the direct improvement in financial performance.

For one, a sourcing and price advantage can be gained. For example, a family-owned business could collaborate and connect with a PE portfolio company that complements its activities, allowing it to innovate better, grow faster, or defend a market position. The PE firm looking to invest in the family business can therefore secure a meaningful price discount by arguing that the proposed partnership would create far more value for the family owner than any other prospect would.

Another competitive edge is in auctions, where PE firms can have a bidding advantage over rivals. Because they have a unique plan to make more from an investment — through an ecosystem with existing portfolio businesses — they are justified in paying more for it. Combining this ecosystem approach with higher financial leverage can also enhance a PE firm's ability to compete with corporate buyers, which are natural builders of synergistic ecosystems.

Moreover, this value creation system is a major source of alpha (the industry term for outperformance). Based on a data set of 30 buyouts, we find that, on average, an increase in revenue growth of only 5% — created through the portfolio ecosystem — increases the alpha by 50%, which in this context means outperformance over average industry revenue growth. Therefore, this system has an outsize impact on the value PE creates in excess of key benchmarks such as public equity returns.

Overall, PE's risk/return profile can be meaningfully enhanced. We find that, crucially, value-creating relationships that cut across the portfolio can often be maintained after portfolio businesses have been sold, so they can increase the sale price. Yet portfolio risk is unchanged, as portfolio firms still operate autonomously and are not intertwined in a way that would thwart their owners' ability to spin them off at any time.

As the PE industry matures, adopting an ecosystem

as opposed to a firm-focused one, greatly expands the possibilities for PE value creation. Despite the perceived challenges, significant and sustainable value can be unlocked by connecting businesses that are complementary or that share certain characteristics. Implementing this horizontal thinking will require PE firms to become ecosystem orchestrators. They will need to embrace new organizational structures, a harmonization of systems, new skills, changes to remuneration arrangements, and a culture of cross-business coordination. As industry returns continue to dwindle over time, PE innovators that build ecosystems to maximize their portfolios' performance can secure a leading competitive edge.

Source: Karim Khairallah and François Mann Quirici (2021) 'Private Equity's Mid-Life Crisis,' *Harvard Business Review*. Available at https://hbr.org/2021/06/private-equitys-mid-life-crisis (Accessed 17 June 2021)

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June 18, 2021
TODAY'S TOP NEWS

Vivant allots P5 bn for power projects until 2023

Vivant Corp. said on Thursday that it is allocating P5 billion in capital expenditures (capex) to finance its power projects until 2023, as the listed energy company detailed its plans to focus on renewable energy (RE).

PH slumps to lowest competitiveness in 5 years

The Philippines slipped seven spots in an annual global competitiveness report, the steepest decline in Asia after its economic performance slumped amid the coronavirus disease 2019 pandemic. Switzerland took the top ranking overall in this year's World Competitiveness Index, followed by Sweden, Denmark, and the Netherlands.

DoE expects more red alerts in Luzon until July

The Luzon grid will likely experience more red alerts until July, raising the possibility of more "brownouts" as several power plants undergo maintenance work, according to the Energy department. A red alert is declared if the supply-demand balance deteriorates further, bringing the possibility of power interruptions.

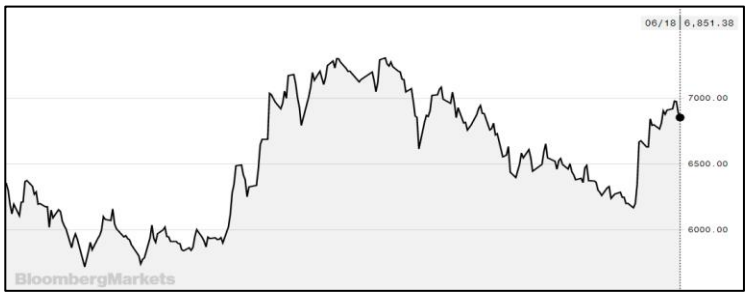
PAL operator expects positive monthly cash flows

PAL Holdings, Inc., the listed operator of flag carrier Philippine Airlines, expects positive monthly operating cash flows this year after its net loss after tax widened to P73.08 billion in 2020 from P9.70 billion previously due to the "extraordinary impact" of the global health crisis on the company's operations.

Agriculture remains lowest contributor to GDP

Based on its latest Agriculture Indicators System, the PSA reported that the agriculture, forestry and fishing (AFF) sector accounted for a 10.2 percent share, a slight increase compared to its 9.2 percent GDP contribution in 2019.

Philippine Stock Market Update



Previous Close:
6,887.92

1 Yr Return:
9.87%

Open:
6,878.99

YTD Return:
-4.04%

52-Week Range:
5,691.74 - 7,432.40

Source:
Bloomberg

Foreign Exchange

As of June 17, 2021

US Dollar	Philippine Peso
1	48.38

BVAL Reference Rates

As of June 17, 2021

Tenor	Rate
1Y	1.643
3Y	2.379
5Y	3.093
7Y	3.551
10Y	3.926
20Y	5.005

Daily Quote

"You can change.
And you can be an agent of change."
-- Laura Dern

MORE LOCAL NEWS

EDC starts selling green bonds

Lopez-led Energy Development Corp. (EDC) has started selling three- and five-year green bonds. The bonds are slated for listing on the Philippine Dealing and Exchange Corp. (PDEx) on June 25. The offer period for the initial tranche, which covers P3 billion with a P2-billion oversubscription option, will end on June 18.

Megaworld plans biggest REIT IPO worth P27.3B

Andrew Tan-led Megaworld Corp. has jumped into the lucrative real estate investment trust bandwagon, with a planned P27.3-billion REIT offering slated this year. MREIT Inc., a subsidiary of Megaworld, submitted yesterday its registration statement with the SEC for an IPO.

PAL incurs loss of P73 billion in 2020

Flag carrier Philippine Airlines seeks to improve its financial condition and restore its ability to service financial obligations through a financial restructuring plan after it joined major carriers in the region in incurring massive losses last year.

D&L to issue P5 billion bonds

D&L Industries, the listed chemicals and food ingredients manufacturer, is offering up to P5 billion in fixed-rate bonds. The base offer size is P3 billion but there is an oversubscription option of P2 billion, according to the registration statement filed with the Securities and Exchange Commission (SEC).

Dyson of UK eyeing full R&D center in PH

The Board of Investments and British lifestyle consumer appliance manufacturer Dyson Ltd. are in talks over the the firm's plan to expand its research and development office in the Philippines after five full years of sales growth.

Imported vehicle sales up 59% in five months

The Association of Vehicle Importers and Distributors Inc. said Wednesday sales by member-companies jumped 59 percent in the first five months to 25,217 units from 15,811 units a year ago.

BSP stays calm on expected US Fed rate hike

Bangko Sentral ng Pilipinas Governor Benjamin Diokno said Thursday the possibility of an early interest rate hike by the US Federal Reserve will not have any significant impact on the Philippines because of the country's solid and strong macroeconomic fundamentals.

Govt ready to assist airlines – Dominguez

Finance Secretary Carlos Dominguez 3rd reiterated that the national government stands ready to assist the struggling airline industry. According to him, government financial institutions (GFIs) Land Bank of the Philippines and Development Bank of the Philippines were involved in Cebu Air Inc.'s P16-billion 10-year term loan.

PH to deepen trade ties with Switzerland

The Philippines reaffirmed its commitment to expand trade and investment ties with Switzerland and deepen cooperation in clean techology and renewable energy, infrastructure, life sciences and digital healthcare sectors.

AGI banking on international operations to grow

Alliance Global Group Inc. (AGI), the holding firm of businessman Andrew Tan, said it is banking on the growth of its foreign operations, as it struggles to regain its footing in the domestic market during the pandemic.

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TODAY'S TOP ASIAN NEWS

S.Korea's largest mobile carrier plans $5b splurge

SK Telecom, South Korea's largest mobile carrier, wants to shed its staid image and take on a more dynamic role as an investor in tech startups à la SoftBank Group.

Shell, JTC plan for solar farm on Semakau Island

[SINGAPORE] A solar farm the size of 112 football fields, one of Singapore's largest yet, is being planned on Semakau Island.

Malaysia's biggest IPO in 2021 draws Aberdeen, AIA

MALAYSIA'S CTOS Digital Bhd, which operates a credit reporting agency, is in talks to sign up Aberdeen Standard Investments and AIA Group as cornerstone investors for its planned initial public offering, according to people with knowledge of the matter.

Japan consumer prices rise for 1st time in 14 months

Consumer prices rose slightly in Japan in May for the first time in 14 months, data showed Friday, but analysts said they were unlikely to soar above pre-pandemic levels. Japan has long battled to hit a two percent inflation target seen as key to turbocharging the world's third-largest economy.

Asia's leading investment platform thrives in Sg

Futu Holdings, which owns the popular investor app moomoo, is looking to take self-directed trading to a new level and sees Singapore as a launch pad for its expansion into South-east Asia

TODAY'S TOP GLOBAL NEWS

Fed ripples hit hardest in Asia, outlook shifts

The Federal Reserve's new outlook for interest rates ricocheted through Asian markets as the dollar and Treasury yields surged, easing pressure on some of the region's biggest central banks and complicating the outlook for others.

Vita Coco owner plans IPO at over US$2b value

THE owner of coconut water company Vita Coco is planning to go public this year after investors rushed to back Oatly Inc's initial public offering, according to people with knowledge of the matter.

Saudi Aramco raises $6b in debut Islamic bond sale

[RIYADH] Saudi Aramco on Thursday said it raised US$6 billion from its first dollar-denominated Islamic bond sale, as the energy giant seeks capital to fund its hefty dividend payments.

China-made Tesla Model Y sales jump

Tesla sales of China-made Model Y cars more than doubled last month, allaying for now concern that a high-profile protest and a ban on some of the automaker's vehicles from government buildings due to security concerns may have hurt demand.

ThoughtWorks' parent company files for US IPO

Software consultancy company ThoughtWorks Inc said on Thursday its parent Turing Holding Corp had confidentially submitted paperwork for an initial public offering in the United States.