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Navigating the Private Equity landscape post today's affairs

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3.1 INTERVIEW

In opaque, illiquid, and local small and middle private equity markets, how relationships coupled with a disciplined due diligence can address the information disadvantage to the benefit of the investors

Interviewer

Mathew Croft,
Content Producer,
Clear Path Analysis

Interviewee

Eric Deram,
Managing Partner,
Flexstone Partners

SUMMARY

- *It is a commonly held misconception that in private equity - both generally and more specifically within the SME market – there is a lack of transparency and information*
- *In private equity, there tends to be a greater alignment between principal and agent.*
- *It is integral to SME market investing that you have right local network and advisors to not only source these types of transactions, but strike the right tone with the sellers and ensure that the due diligence process is completed properly and respectfully.*
- *In the investment business you have to recognise that there will be risks whatever you do. Even if you carry out the best and most thorough due diligence*

Mathew Croft: What is the concept of information disadvantage and to what extent does it exist in private equity?

Eric Deram: Firstly let me provide a bit of context with which to frame my response. Flexstone Partners operates in the Small and Medium-sized Enterprise (SME) market and we invest either in funds or directly into companies.

I think it is a commonly held misconception that in private equity - both generally and more specifically within the SME market – there is a lack of transparency and information. This is almost by definition, as the word private suggests that there is no publicly available information or, if there is, there is very little of it. This is where the concept of 'information disadvantage' stems from.

Logically, it follows therefore that 'information disadvantage' must be particularly acute in SME markets because the companies that we buy or invest in are less sophisticated. They have fewer tools at their disposal to monitor their own information, let alone to ensure it is available to the firms interested in acquiring them.

However somewhat paradoxically, and as any private equity practitioner will tell you, you often have more information available to you than you would have invested in publicly traded companies. And this is even more pronounced in the SME market for a variety of reasons.

When a private equity transaction is being assembled, there is typically a period of exclusive one-to-one negotiations between the buyer and the seller. This period can last for several weeks, if not months, and a sophisticated buyer will use this time, not only to negotiate the terms of the transaction, but also to conduct forensic due diligence on every aspect of the business and market. They will hire consultants, accountants, lawyers and will spend an enormous amount of time to explore every corner of the business and ensure that everything is proper and accurate.

As a result, when we look at a due diligence report, whether it is on a fund or company, they are often extremely detailed. What's more, in the SME segment of private equity, transactions tend to be less intermediated. As a result, you have more time to conduct the due

> IT SOUNDS OBVIOUS, BUT ENSURING YOU HAVE PRECISE INFORMATION AND AN IN-DEPTH UNDERSTANDING OF THE GPS AND CAN CORROBORATE THEIR TRACK-RECORDS TO IDENTIFY IF THEY FAILED WHY THEY FAILED, IS NO MEAN FEAT

diligence. There is less time pressure from bankers, that are sometimes more interested in wrapping up the deal so their commission is paid.

To capitalise on this paradox however, you clearly need to be both experienced and qualified. After all, you need to ensure you have expert lawyers, consultants, and accountants on side.

So, although from the outside looking in the world of Private Equity can look opaque and mysterious, in reality, if you are a practitioner there is actually a lot of information to go by.

Mathew Croft: What about the much publicized principal-agent problem within private equity, how does this impact the concept of information (dis)advantage?

Eric: This is the famous principal-agent problem that you learn in business school is best illustrated in the book 'Barbarian's at the Gate' – a book about leveraged buy-outs in the heydays of the 1980's. It shows that in publicly traded companies, while the CEO is ultimately the agent i.e. they are appointed by the board, and they have a number of stakeholders which they are required to report to, they still have a significant degree of autonomy.

In private equity however, there tends to be a greater alignment between principal and agent. The private equity investor i.e. the principal, is typically the majority shareholder. They acquire the company from a seller who often will be paid partially in the form of 'earn-outs' that will depend on the future performance of the company. In addition, the acquired company will be managed by a management team that reports to only one principal (the lead GP) and that will be remunerated directly according to the performance of the investment. As such, there is a strong alignment of interests between principal and agents in private equity transactions. Therefore, we observe that information circulates freely between the parties to a transaction.

In our case, at Flexstone, we typically focus on co-investments, which means taking minority investments in privately owned companies together with a lead General Partner (GP) fund manager. This means that we are one degree removed from the transaction and are therefore reliant on the work of the GP. As a co-investor, we also face more time pressure because the GP will generally first finish their due diligence and then come to us with the investment opportunity and the additional funds they require, often giving us just a matter of days to decide.

This means that the choice of lead GP is of critical importance. We must be convinced that they are qualified to carry out such a transaction. Information is therefore key. We have been active in the SME market for many years and so we know the strengths and weaknesses of almost every GP out there. We are therefore well placed to judge the transactions that fit into their sweet spot i.e. the type and size of investment that best suits their individual characteristics and expertise.

It sounds obvious, but ensuring you have precise information and an in-depth understanding of the GPs and can corroborate their track-records to identify if they failed why they failed, is no mean feat. But doing so will ensure that you can convert the principal-agent problem into an opportunity not a risk.

Mathew: In addition to information, what else is important for Private Equity firms operating in the SME segment?

Eric: When you are investing directly in companies, the lifecycle of the transaction is important. Ultimately, the aim is to sell the company for

a higher price than you bought it. In our view, this should come from value creation and operational improvement, not financial engineering or multiple arbitrage. This implies that the company needs to have become a better company over the period of your ownership.

To do this, it is vital, especially in the SME market, for the investors to have a strong local network of relationships whether they are consultants, advisors, or intermediaries. This segment of the private equity market is a filled with human stories - successful entrepreneurs who are selling their companies.

This means that having the right local network and advisors to not only source these types of transactions but striking the right tone with the sellers and ensure that the due diligence process is completed properly and respectfully. You cannot underestimate the importance of networks and relationships in this business, while we may have a global footprint, we feel part of a small community.

At the larger end of the market, it is very different. The stories of successful entrepreneurs and family-run businesses are replaced by corporate behemoths run by emotionless executives. This is why we are so passionate about the SME market. It's more human and therefore a more enjoyable and rewarding segment in which to operate in.

Mathew: How can you minimise the risks of operating in the SME segment, whether these stem from information, due-diligence, or relationships?

Eric: When you are in the investment business you have to recognise that there will be risks whatever you do. Even if you carry out the best and most thorough due diligence, there will occasionally be mistakes. The key message is that you need to have a very rigorous process and you must stick with it to limit & mitigate the risks.

Time and again, where you see mistakes, when you look back, there will be a flaw in the process. You will have made an exception. For example, even though you were unfamiliar with a particular sector or company, you will have somehow fallen in love with the idea and made an exception. Alternatively, you might have been overly reliant upon the seller or under time pressure to make a decision and tried to find a short-cut in your process. All of these are examples of making exceptions.

Most of the mistakes you make i.e. an investment resulting in a capital loss, can be pin pointed to a specific failure in your investment process and very often it is one of due diligence. And then, even if you carry out due diligence, occasionally you will join the board and realise that all is not what you thought and there was clearly fraudulent activity on behalf of the seller.

We have thousands of portfolio companies in our fund-of-funds portfolios and we have about 100 companies in our co-investment portfolio. Out of the 100 companies that we have invested in over the last 12+ years, we have had 3 cases of capital loss so far. Most of these losses can be rooted back to due diligence flaws from the lead investor*.

For co investors such as ourselves, the process is actually almost a bit simpler conceptually because we rely on the lead investor. We only invest with lead investors that we know very well and only in areas in which we consider their strength - what we term 'sweet spot' investing. We receive hundreds of investment opportunities into SMEs every year and we eliminated more than 80% of these opportunities within a few days because they come from a lead investor that we don't know or it is a transaction which falls outside of what we would define as their sweet spot. Therefore our 'sweet spot' analysis process allows us to be extremely efficient in initial deal selection and internal resource allocation.

We then build a diversified portfolio of investments so each of our funds has over 20 different investments and we try to diversify these across parameters including sectors, types of companies and size of companies. This is important because mistakes are bound to happen or unforeseen events occur. The Covid crisis is the perfect example of this. You therefore need to have a diversified portfolio and one that doesn't use too much leverage, so that in times of difficulty, such as we're witnessing currently, leverage isn't going to harm you and the companies you have in your portfolio.

Finally you need to have experienced people. Our six managing partners each have more than 25 years' experience in private equity and we feel this is very important. If you get all that right, you will reduce the risks of failure significantly but never entirely. We have made 100 investments since 2008. Out of these 100, we have lost money in just 3 investments so far – which in private equity circles is very low*.

Mathew: Thank you for sharing your thoughts on this topic.

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