Listed & Unlisted Private Equity ‘Plays’

Perspectives: May 23rd, 2020

An old saying comes to mind about ‘too much of a good thing’. When it comes to investing it applies to **gearing** as well as **concentration**.

In the past 10 years or so we observed the increased arrivals of stock exchange listed companies pursuing a ‘private equity’ mindset, as well as unlisted special purpose investment structures. The ready availability of cheap and easy credit, equity funding and investor interest no doubt played its part in creating these vehicles.

It would typically result in their owning large influential stakes or outright control of a handful of investee companies, thereby resulting in a highly concentrated portfolio.

Paying high prices meant investee companies needed to be highly geared to make the numbers work. Furthermore, a portfolio of investee companies can also be geared at the portfolio holding level. If this were not enough excitement, off-balance sheet gearing could be added at the holding and each investee company levels. We can think of the result as gearing upon gearing or multiple gearing layers.

Given the risk associated with owning and financing multiple gearing layers in a highly concentrated portfolio, they focused on industries with deemed ‘predictable’ free cash flows. Examples include airports, toll roads, hospitals, gambling, private education, hotels, gyms, or commercial real estate.

The problem is the following. When the virus pandemic hit the world these investee companies, which were supposed to be bullet-proof, were immediately impacted. Their revenues and profits declined and impaired their ability to service their on and off-balance sheet debts, pay their suppliers and employees and generate free cash flow. This pressure telescoped up the daisy chain to the holding company level, ultimately resulting in their severely declining share prices.

There are many examples, some obvious and others perhaps not so obvious, of listed private equity 'plays' that are now in significant distress. It would probably be fair to imagine the same is occurring in the unlisted ones.

They are being undone by the same two things that made them successful and popular in the past – gearing and concentration. These movies will likely not be ending with '*and they lived happily ever after*'

Our work continues…

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