WHITE PAPER

Deals down under: why private equity investors should look to the Australian mid-market

With institutional investors reliant on private equity allocations to drive returns through a sustained low-yield environment, private equity markets are deploying record levels of dry powder at a record pace.

by Adrian Kerley

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PRIVATE EQUITY

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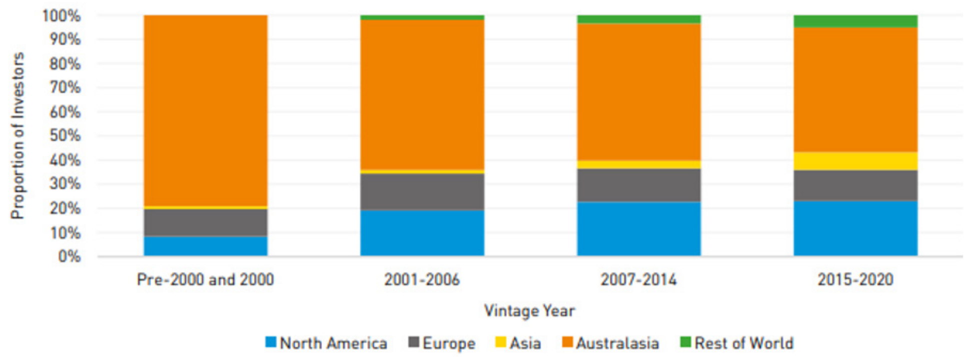
With strong competition and high prices in their home markets, many investors have been searching the world for investment opportunities.

But not all regions are created equal for private equity investors who look for areas with effective government and legal systems, combined with environments supportive of technology development and innovation. Arguably the chief market condition is a strong economy. As countries come out of the COVID-19 public health crisis, governments' abilities to keep their countries open for business have also been under close scrutiny (see Economic Insight on page 2).

To find these favourable conditions, private capital investors are increasingly looking southwards to the land down under. In addition to ticking all these boxes, private capital investments in Australia have historically delivered robust returns at lower risk.

Offshore investors now represent around 50% of Australian private capital funds (see Figure 1), suggesting an increasing recognition that investments in Australian businesses

FIGURE 1 SINCE 2000, THERE HAS BEEN A GROWING PROPORTION OF INTERNATIONAL INVESTORS IN AUSTRALIA-BASED PRIVATE CAPITAL FUNDS



Source: AIC Prequin Yearbook 2021

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ECONOMIC INSIGHT
Australia's recovery from COVID-19

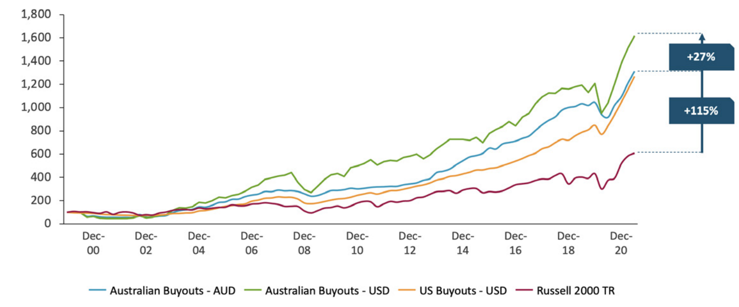
As we entered 2021, Australia's economic recovery from the pandemic was among the best in the world. This was characterised by a smaller direct economic impact of the pandemic, as public health restrictions were enforced in 2020, than observed in other countries (and despite Australia's material economic exposure to international services trade). And Australia had a more pronounced rebound once restrictions were lifted. As at the June quarter 2021, the economy was around 1% larger than it was heading into the pandemic.

Also a distinct positive was the rebound in the labour market, with the participation rate rebounding strongly while the unemployment rate declined materially. This demonstrated that aggressive monetary and fiscal policy action to support the economy was effective. The recovery was supported by relatively low COVID-19 case numbers - a situation that was to deteriorate markedly with the onset of the Delta variant of COVID-19, with outbreaks in NSW and Victoria (Australia's economic powerhouses, representing two-thirds of the economy) forcing another prolonged period of public health restrictions.

While the Omicron variant has created a relatively high caseload on a per capita basis, mortality rates throughout the pandemic have been extremely low compared with like countries. And while Australia was a slow starter in terms of the vaccine rollout, it has gained rapid momentum and now has some of the highest vaccination rates in the world.

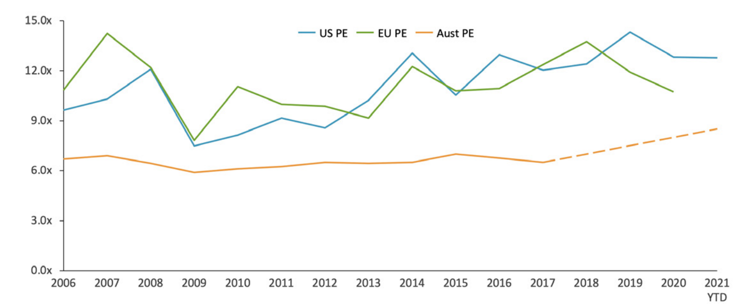
This facilitated the lifting of the majority of public health restrictions through the December quarter that will give rise to a rebound in economic activity after an enforced contraction in the September quarter. Economic growth will continue to recover well, driven by strong household spending (underpinned by a large accumulation of cash on household balance sheets) and the resumption of population movements and inflows – based on the assumption that the public health crisis continues to recede. The outlook will also be supported by a central bank committed to keeping interest rates low for an extended period of time and only a moderate unwind of fiscal stimulus over coming years that will facilitate household tax cuts in 2024.

FIGURE 2 AUSTRALIAN PRIVATE EQUITY HAS RETURNED 1.3X RELATIVE TO US OVER 20 YEARS



Source: Burgiss Private IQ database; Returns as at 30 June 2021; Australian Buy-out funds exclude Asian pan regional funds
Past performance does not guarantee future results.
1. TWRR Index of net returns assuming investment in every fund

FIGURE 3 MATERIALLY LOWER ENTRY VALUATIONS IN AUSTRALIA (MEDIAN ENTRY EV/EBITDA VALUATION)



Source: Pitchbook Annual PE Breakdown for US and EU data; AVCAL for ANZ data. AVCAL, now AIC, stopped collecting deal metric data in 2018

can contribute to a global portfolio. However, despite growing attention, Australia represents a far less competitive market for investors, especially in the lower-middle market, which offers the largest opportunity set.

Robust returns with lower risk

Investments in the Australian buy-out market between 2000 and 2019 outperformed other global private equity markets, including the US, United Kingdom, Western Europe and Asia, on a local currency, time-weighted return basis. Australian private equity out-performed the small cap listed market in the US as tracked by the Russell 2000 Total Return Index (See Figure 2).

Lower investment risk driven by lower valuations and company debt

Analysis of investment valuations and leverage as a proxy for risk shows that in addition to Australian private equity delivering higher returns historically, it's also done so with relatively lower risk.

The median entry price for Australian private equity investments has been largely consistent over the past fifteen years, with EBITDA multiples almost always below those of both US and European markets - except for the period

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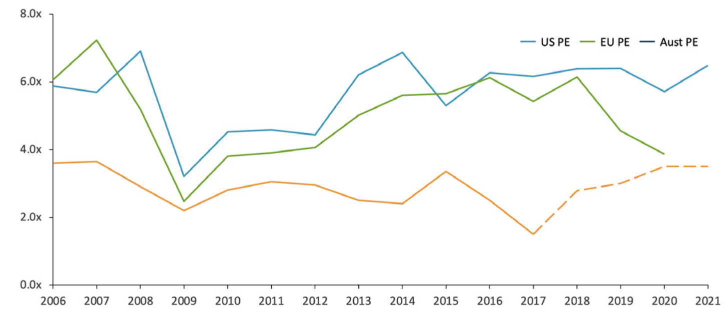
of the Global Financial Crisis (see Figure 3). This lower pricing contributes to lower debt, a factor helping to reduce investment risk.

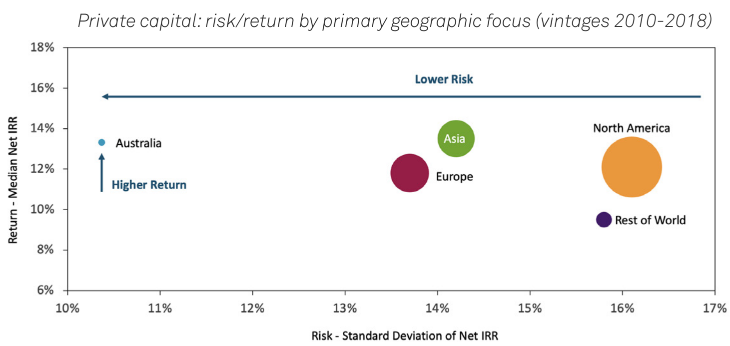
While the Australian Investment Council stopped compiling data in 2018, we believe that, although median debt levels would have grown since a low in 2017, they would still be below those in the US and Europe (see Figure 4).

FIGURE 4 **LOWER LEVERAGE REDUCES RISK IN AUSTRALIAN INVESTMENTS (MEDIAN ENTRY NET DEBT/EBITDA VALUATION)**



Source: Pitchbook Annual PE Breakdown for US and EU data; AVCAL for ANZ data. AVCAL, now AIC, stopped collecting deal metric data in 2018

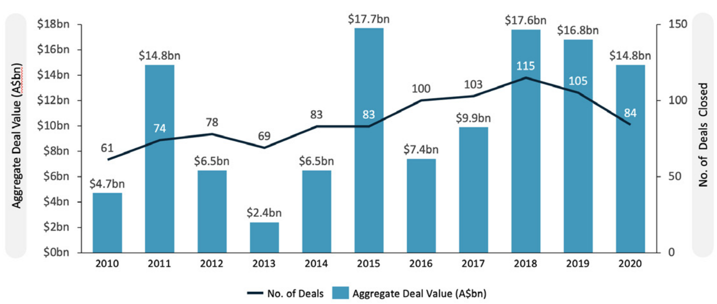
FIGURE 5 **AUSTRALIAN PRIVATE EQUITY HAS OUTPERFORMED OTHER REGIONS**



The size of each circle represents the capitalization of private capital funds used in this analysis.

Source: AIC: Private Capital Market Overview: A Preqin and AIC Yearbook 2021; Private capital includes the following strategies: private equity, venture capital, infrastructure, private debt and natural resources; Funds raised between 2010 and 2018.
Past performance does not guarantee future results

FIGURE 6 **AUSTRALIAN PRIVATE EQUITY MARKET IS SIZEABLE WITH 80+ TRANSACTIONS COMPLETED PER ANNUM**



Source: Australian Private Capital Market Overview: A Preqin and Australian Investment Council Yearbook 2021

Lower pricing and lower debt are factors that have supported Australian private equity performance and contributed to Australian private capital asset classes outperforming other regions. An analysis of returns and risks (as measured by standard deviations) across a range of regions between 2010 and 2017 indicates that Australia has historically delivered higher returns at lower risk compare with other regions globally (see Figure 5).

Australia's burgeoning private equity market

The Australian private equity market is sizeable, with more than 80 deals completed per year between 2014 and 2020 (see Figure 6).

Several mega deals between 2015 and 2020 impacted the dataset. These include the $8b deal for GE Consumer Finance in 2015; the Sirtex and iMed healthcare deals and MYOB public-to-private transaction in 2018; and four deals (Healthscope, Arnotts, Navitas and Ticketek) which comprised over half of the 2019 deal value (ie $10b out of $16b). The mega deals led to public-to-private transactions representing more than 50% of private equity investment in 2019.

Even excluding these eight mega deals from the mix to create a more normalised data set, the average deal size (enterprise value) between 2015 and 2020 was ~$140m, and deals of this size have been largely consistent over that period.

The data also indicate the sectors that are driving the most deals (see Figure 7). Transaction numbers in the information technology and business services sectors, for example, have been growing steadily over the last few years, while deals for consumer sector businesses have reduced by almost 50% since 2017. Healthcare has been the most consistent sector in the last three years – regularly representing 30% to 45% of overall deal value.

The lower-middle market opportunity set

Putting the few larger mega deals to one side, the consistent deal volumes are largely attributable to the Australian market being predominantly a lower-middle market.

This market segment includes enterprises with annual revenue of between A$10m to A$250m per annum.

There are more than 20,000 companies in Australia with this revenue profile.[1] By comparison, only 1,366 businesses in Australia have revenue over AU$250m, of which

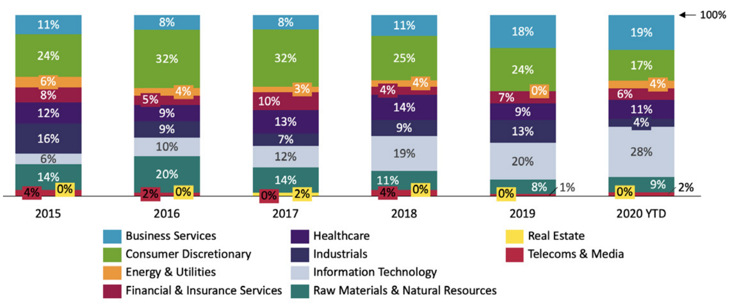
[1] Australian Taxation Office data

many are publicly listed and others are local subsidiaries of multi-national corporations (see Figure 8). The number of lower-middle market companies continues to grow, and this market segment has increased by 5.3% pa between June 2013 and 2019 (compared with 3.8% pa increase in the number of companies with revenue over $250M).

This is the weightiest market segment in Australia, with opportunities spanning family-owned business, corporate carve outs, secondary sales and public to private.

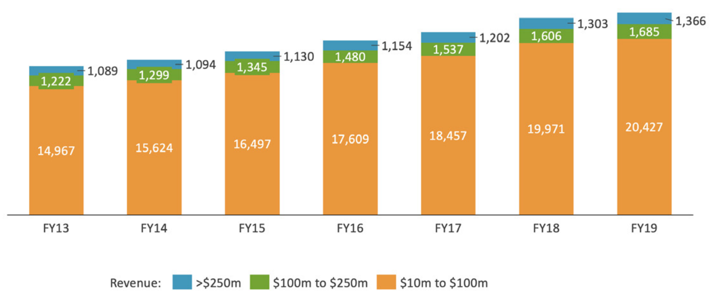
Despite this significant opportunity set, the lower mid-market also attracts less competition than other segments. The number of deals completed over the last three years by the 50 PE firms active in Australia (see Figure 9) were, on average more than four deals per active investor in the lower mid-market, compared to 2.3 deals per investor in the upper mid-market and 1.5 deals per investor in the large caps market. We see good opportunities for large scale private investments but these may be better unlocked with a different approach than typical high leverage, mega-buyouts.

FIGURE 7 **TRANSACTION NUMBERS ARE TRENDING TOWARDS TECHNOLOGY SERVICES AWAY FROM CONSUMER (DEALS PER SECTOR)**



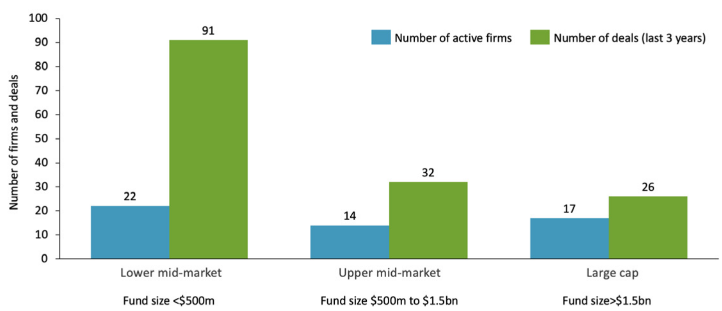
Source: Preqin accessed 1 December 2020; Deals completed by sector in Australia by PE managers

FIGURE 8 **THE LOWER-MIDDLE MARKET OFFERS THE LARGEST OPPORTUNITY SET IN AUSTRALIA (NUMBER OF COMPANIES BY REVENUE)**



Source: Australian Tax Office; Fiscal year end June, As at 29 November 2021

FIGURE 9 **THE LOWER-MIDDLE MARKET IS THE LEAST COMPETITIVE SEGMENT (NUMBER OF ACTIVE FIRMS VS DEALS (EXCLUDING BOLT ONS) COMPLETED BY SEGMENT)**



Source: Preqin, Mergermarket, CapitalIQ, Firms websites; As at 13 November 2020 Active firms are PE firms either with and Australian investment office or fly-in offshore firm who has invested in Australia in the past 3 years; Data based on publicly available information and may not be complete; Lower mid market defined as funds under $500m, mid-market funds $500m to $1.5bn and Upper market $1.5bn+ & pan regional managers

Opportunities amid disruption

The COVID-19 public health crisis and its flow on effects for domestic economies has had unprecedented impacts on businesses and their resilience has been tested like never before.

But the pandemic has also driven positive changes for mid-market companies, which we believe will lead to strong investment opportunities over the near term. The kinds of trends emerging across the Australian mid-market include:

- capital-light, technology-based businesses taking share from more asset-intensive traditional businesses
- increasing importance of company agility in order to respond to continuing spontaneous threats and opportunities that arise due to the evolving covid pandemic
- the risk of high debt levels (generally associated with larger, slower growing businesses) has been exposed and is increasing in light of potential interest rate rises.

As the business landscape continues to evolve, many company founders could now be motivated to find equity partners that can help them leverage growth opportunities and provide risk management expertise. Other opportunities could also emerge from a wide variety of corporates looking to divest non-core assets as they pursue updated strategies or repair balance sheets. Regardless of the motivation, Australian businesses that are now coming to market are typically those that have performed reasonably well through COVID - and in some cases very well. The emerging market opportunities serve to further bolster the appeal of Australia's mid-market, which we believe represents an area that may have flown under the radar for global private equity investors.

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