Private Equity Investing in a New World Order

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The start of this decade will likely go down in the annals as one of many challenges. What had started almost innocuously in 2020 as a mysterious disease confined to one part of the world rapidly extended its tentacles across the globe. Before we knew it, lockdowns became the policy tool of choice for governments around the world in a hapless and at-times futile race to break the transmission chain of COVID-19.

Such measures, while arguably necessary then, profoundly impacted economic productivity and global supply chains. We might still remember days of supermarket shelves being wiped clean by stockpiling consumers, contrasting starkly with those of farmers who, without any means to ship their produce, chose to cut losses by entirely foregoing harvests.

Two years of stimulus measures, bolstered by the longest period of economic expansion since the 1960s, have ensured that consumer demand around the world stayed undampened despite the pandemic. However, it also created the catch 22 of a perfect storm – runaway inflation.

Wage-price spiral

A then-unforeseen but far-reaching outcome of the pandemic is that of labour shortage. COVID-19 didn't just rob us of our sense of smell; it also changed at an existentialist level how many of us view work. The "Great Resignation" has inadvertently stoked wage inflation. According to International Labour Organization data, nearly every single economy in the world has experienced nominal wage inflation between 2015 to 2022.

A plethora of unfortunate events in 2022 folded into labour and supply crunch issues have ultimately led to a spike in prices across all manner of goods and services. In the US, annual inflation hit a 40-year high of 9.1% in June 2022, and while having eased since, remains roughly 3 times above the Federal Reserve's target 2%. Elsewhere, 60% of advanced economies are wrestling with annual inflation rates of over 5%. For central banks globally, this is deeply concerning.

Closer to home in Southeast Asia, to support purchasing power, various countries have raised minimum wages, with Malaysia leading the pack with a 25% hike to RM1,500 (approximately US$350), and Jakarta following suit with a 5.1% rise to IDR4.64 million (approximately US$310), more than five times the increase required by law.

Away from runaway inflation

Faced with decades-high inflation, the US Fed decisively changed tack in summer 2022, raising benchmark rates relentlessly to 4.25-4.5% by December 2022 – the highest since the Great Financial Crisis. Most central banks around the world followed suit. Such policy actions have certainly been priced into global markets; in last year alone, S&P lost US$8 billion of its market value, while the MSCI China, Emerging Markets and World indices shed roughly 20% across board in 2022.

Fuelled by the rate hikes and a perennial investor pursuit for safe-haven assets, the US dollar climbed to multi-year highs against most global currencies, including those of Southeast Asia. This only but put additional pressure on our local central banks to adopt hawkish monetary policies, so as to avert runaway inflation.

Implications for businesses and private equity

In the earlier days of the pandemic, mobility restrictions and border closures impacted every segment of the industry value chain – from constricting labour supply and input materials to shipment of output. China, termed the world's factory, steadfastly stood by its zero-Covid policy, which certainly did not help matters. Adding frost to snow, international geopolitical tensions further restricted access to commodities, energy supplies and raw materials. It is with great clarity that we now see the reasons that have led to the multitude of economic issues the world is experiencing today.

In an affirmation of our worst fears, the World Bank recently revised global growth forecasts for 2023 downwards from 3.0% to 1.7%. They further warned in the *Global Economic Prospects* report that any new adverse event could upset a delicate balance and tip the world into recession. Southeast Asia, while still a bright spot globally speaking, is also likely to see lower-than-previously-expected growth of 4.7%, forecasts the Asian Development Bank.

Private equity investments in a new world order

It is without question that businesses operating in such an environment will increasingly find it challenging to meet productivity and profitability goals. In a bid to pass on cost increases to customers, revenues may well be compromised. And where companies are unable to do so, the inability of the business to withstand narrowing or even negative margins may annihilate some companies.

Within such circumstances, we think companies must seek to create value for customers beyond price increases, justifying higher value-per-unit costs. For instance, shrewd food and beverage businesses operators may adapt their menus or adjust portion sizes in order to meet the desire outcome of cost control. When done well, the perception of value increases, retaining and even attracting customers who are also willing to pay more. On the other hand, oft-used tactics such as downsizing portions (also known as shrinkflation) may in fact backfire. This is simple consumer psychology at play; value is perceived to be more important than absolute pricing.

Similar considerations extend to private equity. Higher input costs and wage pressure will weigh on profit margins, and the rising costs of borrowing will, in turn, increase the costs of capital. However, resilient sectors such as education and business services will continue to perform well if companies can alleviate cost pressures. Applying the right pricing levers and strategies, through efforts like automation, process improvements and having differentiated products may help the industry ride the trend of inflation and stay resilient.

The macroeconomic challenges and financial market volatility that we see today will likely continue well into the near-term future ahead. Creating value at the portfolio company level is therefore the crux to delivering private equity-type returns even through such a market. At Tower Capital Asia, we do this through the two-pronged approach – digitalisation and regionalisation.

Perception of value

Digitalisation of education is not a new concept. For many schools and education businesses, however, the pivot from offline to online is relatively recent, provoked by pandemic-induced lockdowns. For **I Can Read**, a leading children English literacy business and Tower Capital Asia portfolio company, offering classes online has been an intrinsic part of the programme even before the pandemic, started as a solution to offer classes in markets where it does not have a physical presence.

The company launched I Can Read University (ICRU) in 2019. Designed initially to reduce and later to overcome the absence of in-person training, the programme delivers effective training online to teachers, safeguarding an even and high quality of teaching.

But there is more that technology can do. Notably, I Can Read gamified learning through e-platforms like *ICR Heroes* and *ICR Champs*, which personalise students' learning using their own speech patterns. These engaging games and activities, which complements I Can Read's 15-year-old, research-based literacy programmes, have a far stronger pedagogy and commands a level of student engagement higher than most literacy apps in the market today as seen from its MAU (monthly active users) and retention rates.

To our mind, I Can Read's proposition encompasses value far beyond lesson hours. Leveraging technology to ensure a consistent teaching quality and high student engagement are demonstratable ways to augment the customer experience and improve learning outcomes, with or without COVID-19. I Can Read's parents and students certainly recognise such value, and have remained loyal to the brand despite moderate price increases.

Leveraging automation

Digitalisation can also help productivity, especially through automation. During the pandemic, traditional Chinese medicine-based health and wellness brand **Eu Yan Sang** implemented an updated Enterprise Resource Planning system which further

optimised production, inventory and delivery management and reduced the order fulfilment time for its e-commerce and retail platform significantly.

Another example of this can be seen in **Poh Tiong Choon Logistics**, Singapore's oldest third-party logistics services company. Through real-time data management systems and close communication with all customers, the company could continue providing essential services to all its consumers despite border closures affecting labour supply from Malaysia and China.

Regionalisation

Asia is a diverse region and succeeding here requires understanding each market's laws, both written and unspoken. Regionalisation can help create stability and value for businesses. One of Asia's largest providers of corporate services, **Boardroom Group**, meets this demand. Diversified regionally across offices in Singapore, Australia, Malaysia and Hong Kong, it offers accounting, payroll and corporate secretarial services.

Such aspects of businesses are mission-critical regardless of their absolute value within the cost base of organisations. The diversified regional base of Boardroom Group has allowed it to continue serving customers in various geographies seamlessly, even during lockdowns. Resources are shared within the group effectively, and regional systems and platforms are maintained round the clock to ensure seamless and consistent service delivery to our customers in all markets.

COVID-19 brought to the fore the disruptive effects that real-world events can have on companies, as well as catering to a permanent need to offer hybrid online-offline options today. Being adaptable and flexible to different localities add tremendous value to a globalised business, while the converse could hurt it.

Boardroom's success in helping its customers rethink corporate and shareholder services in a new environment enabled the company to not only win new accounts, but also continue growing its market share through the pandemic, further proving that customers recognise the value in consistency and quality.

Opportunities for Southeast Asian private equity

While Southeast Asia's growth should moderate somewhat in the years ahead, its economy is still underpinned by a youthful and digitally connected population hungry to scale the consumption curve. Additionally, Southeast Asia could also benefit from a rise in commodities prices and geopolitical tensions elsewhere. These may lead to interesting opportunities in the consumer, services, and manufacturing sectors, buoyed by strong underlying economic fundamentals.

The silver lining for a private equity investor today is that an inflationary environment still presents opportunities. More specifically, it has been observed that equity valuations are historically lower during inflationary periods. However, merely counting on buying in cheap is no longer a fail-proof strategy for alpha creation in private equity.

Ultimately, the fundamentals of sourcing, evaluating and diligencing the right businesses with cycle-proof business models, resilient financial positions and strong talent will always determine the success of a private equity portfolio. A skilful private equity investor does not rest on the laurels even when this is done. We look to apply relevant and appropriate value creation strategies, such that our portfolio not merely survives, but thrives in a down cycle and beyond, after our exit.

This makes all the difference to the outperformance that we seek to deliver to not just our investors but employees, customers and business partners (essentially all stakeholders) as responsible private equity managers.

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