

A New Private Equity Model for the Lower Middle Market

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Singapore-based private equity firm Novo Tellus Capital Partners explores the impact of huge structural change on Southeast Asian opportunities across various verticals including software, hardware and wider manufacturing sectors

Fig. 1: Side-by-Side Comparison of the Traditional PE Playbook and the Novo Tellus Playbook

	<u>Traditional Playbook</u>	<u>Novo Tellus Playbook</u>
Use of Leverage	Moderate to high: 3-5x+ EBITDA	Nil to low: less than 2x EBITDA
Use of Free Cash Flow	Debt repayment & maintenance CAPEX	Growth CAPEX and small bets in R&D, new market entry, tuck-in acquisitions
Focus of Engagement with Management	Improve value – working capital improvement, margin improvement, workforce efficiency, IT systems, etc.	Create value – strategic pivots to expand TAM, technology road mapping (investment in R&D/ acquisitions), new channel development, customer-focused business processes, etc.
Investment Metrics	KPIs, Dashboards	Objectives and Key Results (OKR) to push strategic pivots
Private Equity Involvement	Mainly governance and monitoring	Actively involved in vision and strategy, OKR execution, M&A
Buy-and-Build	Yes – financial accretion focused, potentially large mergers with leverage	Yes – technology and capabilities focused, small tuck-ins and often without leverage
Sector Focus	Generalists	Sector experts

The Playbook Revisited

The traditional private equity (PE) playbook of finding companies with predictable cash flows and acquiring them with leverage has worked well over time. As the private equity playing field has evolved, entry multiples have increased along with the amount of leverage. This, in turn, has compelled PE firms to add operational teams to ‘squeeze’ efficiency out of companies to make debt payments. While the conventional game plan has worked for larger and more diversified PE firms, smaller players struggled with diversification and depth in their management bench.

At Novo Tellus, we developed an investment philosophy that we term SPEAR – Strategic Private Equity for Absolute Returns. It is an industrialist approach that partners with management teams to build companies that last (Fig. 1).

Industry Structural Changes with 5G, AI and Industry 4.0

Much has been discussed about the Fourth Industrial Revolution and how it will transform the value chains of multiple industries across geographies. The impact of which spans from how companies engage with their customers to how goods and services are developed and delivered.

Before Industry 4.0 and its transformation across value chains can become a reality, the massive infrastructure that connects sensors to processors (edge and cloud) to databases (machine learning, AI training and inference) need to be in place. Therefore, we believe 5G infrastructure will be a key enabler in unlocking the full potential of Industry 4.0.

The investment themes of 5G, artificial intelligence (AI) and Industry 4.0 are present across many 'stacks' of the value chain. They range from the physical development of technology to companies embracing digital strategies to disrupt existing business models.

Today, software captures up to 80% of the value in the technology stack, while hardware makes up the remaining 20%. However, with the adoption of 5G and AI, it will level the playing field and steer the ratio to nearly 50:50 between hardware and software. As devices need to be intelligent and connected, this shift will likely create new growth opportunities for many of the world's more traditional engineering companies that are willing to pivot and work with a partner to grasp such opportunities.

Opportunities Abound in Southeast Asia

Southeast Asia has emerged as a significant economic bloc for world trade. The rapid industrialization of developing countries, such as Indonesia and Vietnam, has given rise to an affluent middle class that now spends on consumer staples, education and healthcare. The brownfield infrastructure in these economies is also fertile ground to implement new digital business models and payment modes. As such, venture capital and private equity funds are emerging to tap this digital transformation.

Against the bright lights of technology disruption and sleek digital models is Southeast Asia's often-forgotten history in advanced manufacturing for the world's leading multinationals (MNCs). The manufacturing verticals span across electronics, semiconductors, automotive, healthcare, aerospace, pharmaceuticals and oil & gas, to name just a few.

At Novo Tellus, we found the manufacturing and hardware companies ripe for the taking. These companies present many fundamentals that we seek in our SPEAR investment strategy, including:

1. Passionate founders looking for stewards to take over businesses that they founded 20-30 years ago.
2. Mature companies with a history of utilizing innovation to remain competitive as suppliers to global players.
3. Stable management teams, often trained at leading MNCs, that have steered their companies across many business cycles.
4. Respect for ESG principles and intellectual property as part of their MNC training.
5. Sector expertise to unlock value through strategic pivots, which often result in attractive entry valuations.

As the value capture of the technology stack shifts from software to hardware and global supply chains move away from China, macro factors are looking favourable for the manufacturing sector in Southeast Asia. When the right fundamentals work in tandem with favorable macro trends, we believe that creates the potential for outsized returns for investors.

Novo Tellus

Novo Tellus is a Singapore-based private equity investor focused on buyout and growth capital opportunities in lower-middle-market companies in Southeast Asia. Since its inception in 2010, it has built long-term partnerships with business owners, creating value from new product offerings and customers.

It prides itself on being more than financial investors, but also founders and former engineers with deep operating experience building companies in the industrial technology sector. Novo Tellus has honed its SPEAR investment philosophy over time and delivered successful returns. On average, its portfolio companies have increased in value by over 300% in the years after Novo Tellus's initial investments.

*This blog is part of the **Preqin Markets in Focus: Private Equity & Venture Capital Southeast Asia** report. To access the report, please [click here](#).*