Global Supply Chains to Private Markets

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Global supply chains are under pressure as never before, presenting challenges – and opportunities – to private equity managers with the experience and ability to re-engineer businesses and drive profit growth. Meanwhile, the real estate sector also abounds with opportunities.

Although the lockdowns associated with the COVID-19 pandemic hugely disrupted global supply chains, they have also accelerated key developments, such as digitalization, which is boosting efficiencies dramatically. These trends are taking place at the same time as the logistics sector is growing rapidly – driven largely by the rapid expansion of e-commerce around the globe.

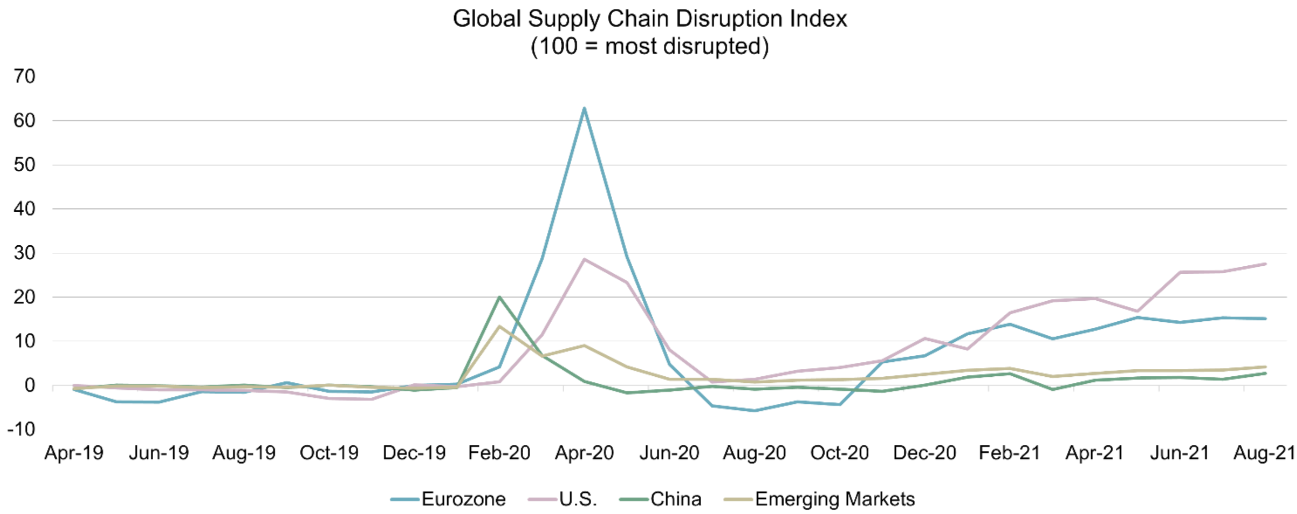
The global digital logistics market alone is expected to grow from US$17.4 billion in 2020 to US$46.5 billion by 2025, a compound annual growth rate of 21.7%. Opportunities to re-engineer near-shore supply chains are emerging, as are options to invest in logistics assets, many with a strong technology angle. Private equity has been very active in the sector, and opportunities are also emerging around the globe in logistics real estate. We expect this trend to continue. Petiole, for example, has already invested in logistics real estate in China with reliable local partners and is conducting due diligence to expand a modern logistics platform to about 30 assets across the country.

The Challenges

Investors should be aware that supply chains are increasingly complex and difficult to navigate. U.S.-China trade tensions and the broader global trend towards protectionism have been adding strain to cross-border trade for a number of years. Meanwhile, pandemic-associated supply-chain disruptions have heightened awareness of the vulnerabilities in this area, accelerating the move towards reliance on local and regional, rather than global, supply chains.

Russia’s invasion of Ukraine is also exacerbating global supply difficulties, affecting industries ranging from semiconductors to cars to food. Consequently, the war is likely to accelerate the trend by which Western companies are seeking to reduce their dependency on China for components and finished goods and on Russia for raw materials, and boost more localized or regional sourcing strategies, says the Harvard Business Review. If China decides to back Russia in the Ukraine conflict, it would only fuel that movement, adds the publication.

In 2022, shortages of both labor and materials, as well as inflationary pressures, continue to disrupt supply chains.



Source: International Monetary Fund

It is also important to recognize that supply chain issues present a challenge to private equity investors across the economy. Many companies have come under pressure due to problems with the supply chain, ranging from simply sourcing supplies to absorbing higher manufacturing costs.

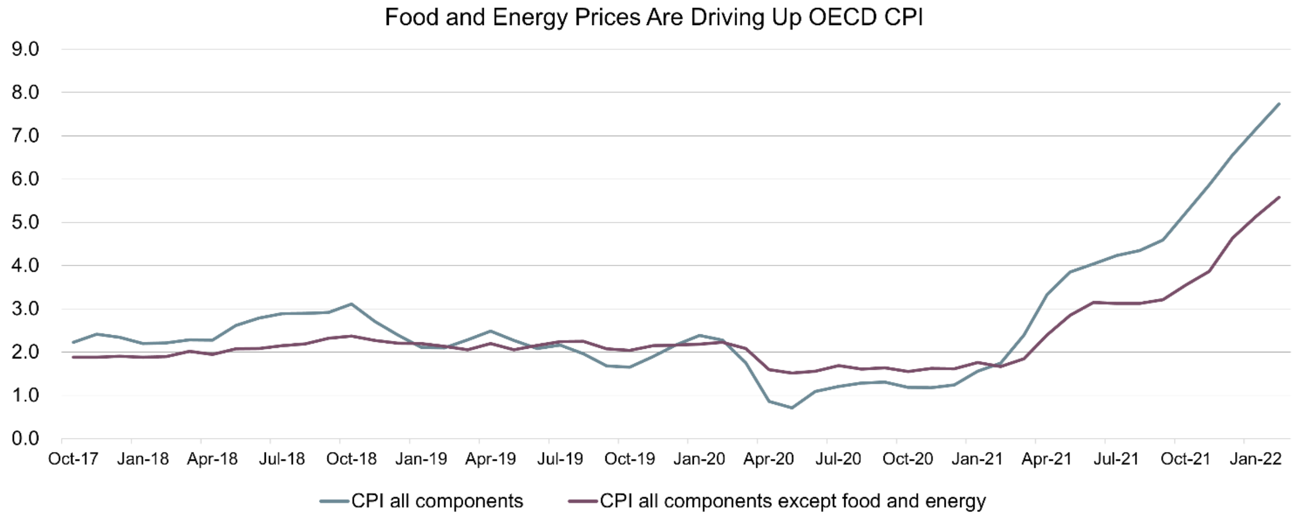
Consequently, investors are spending more time on due diligence of supply chains and are even seeking to change the types of businesses they are acquiring. In some cases, the risks have become so acute that deals have been delayed or have even collapsed. In the long run, however, this extra care in analyzing potential deals will pay off for investors.

Meanwhile, there is no shortage of potential deals, with many companies keen to attract the capital and expertise provided by private market managers. Private equity managers, for instance, certainly have plenty of dry powder to invest as their ability to steer companies through troubled times attracts capital.

Inflation: An Added Complication

Supply chain bottlenecks have caused inflationary pressures to build globally, with inflation jumping to 40-year highs in the U.S. and is trending to move even higher over the remainder of 2022. The war in Ukraine is intensifying these difficulties. For example, Russia is the world's largest exporter of fertilizers, and the sanctions imposed on Russia have caused fertilizer prices to spike, fuelling food prices globally. Since food is such a basic item, that will add to the upward pressure on wages, further stoking inflationary pressures.

As a result, private market managers are focusing on how inflation will affect profitability, and what it means for their investment strategy and portfolio management. Wage inflation is a particular concern in some sectors and companies, and for managers seeking to determine whether a deal will prove viable. Targeting companies with the ability to pass on price increases is just one way of countering the effects of inflation on investors.

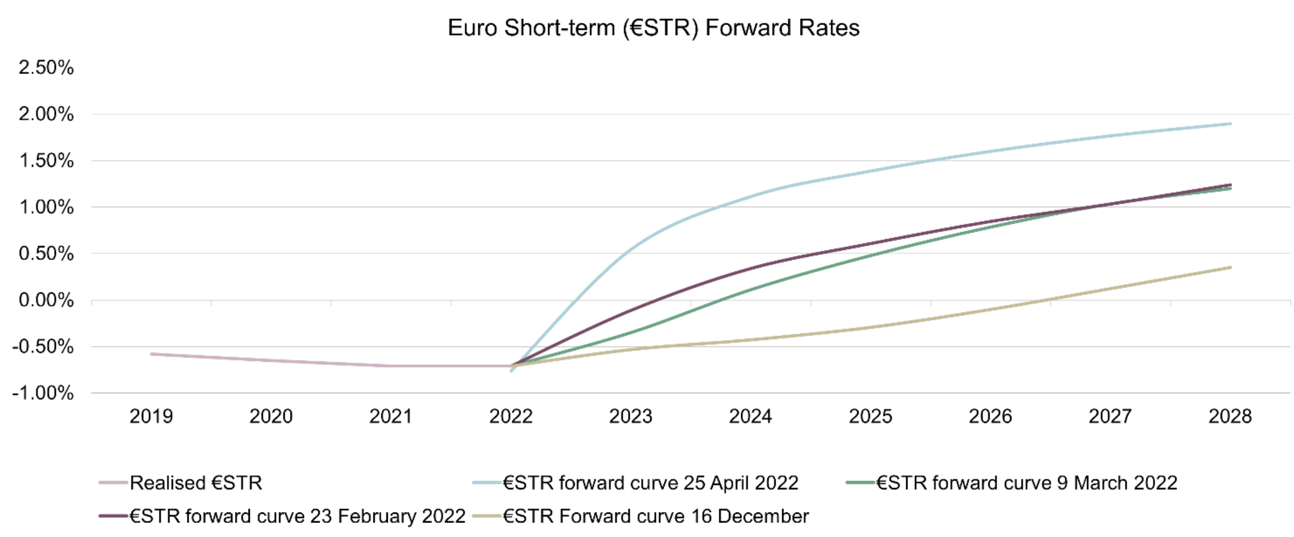


Source: OECD

Investors must be aware that inflation has consequences on borrowing costs. Should rates rise significantly, capital structures that were sustainable in a low-rate environment could start to dip underwater – especially in leveraged PE-backed companies. Given that many analysts believe inflation will remain elevated for some time, and with central banks making increasingly hawkish comments, this is a critical concern. Furthermore, higher interest rates could cause economies to slow down sharply, or even head back into recession, which could damage many businesses.

Borrowing Costs Heading Higher

That is certainly the view of the U.S. money markets, according to Reuters. Following the Federal Reserve's decision to raise interest rates in March 2022, the news agency reported that the money markets were signalling that the Fed's aggressive posture on inflation would put the brakes on the economy, forcing central banks to cut rates perhaps as early as the second half of next year, and definitely by 2024. Expectations of how borrowing costs in the Eurozone are also rising. The euro short term rate (€STR) is a benchmark rate that reflects the unsecured overnight borrowing costs in euro of major euro area banks.



Source: European Central Bank

The Opportunities

The challenges facing the logistics industry worldwide also provide opportunities for private equity and real estate investors. Tech-enabled companies that help to improve inefficiencies and ease bottlenecks in supply chains, for example, are likely to emerge as big winners in this environment. Technological advancements in 5G, real-time data analytics, and the Internet of Things improve logistics managers' ability to identify and even anticipate problems, potentially reducing supply-chain disruptions. Meanwhile, demand for warehousing grows as e-commerce explodes.

One of Petiole's private equity co-investments with BPEA Real Estate is in Forest Logistics, one of the largest and fastest-growing real estate logistics platforms in Asia. This attractive co-investment benefits both from the supply and the demand side of the Chinese logistics sector, and the e-commerce boom in China has also accelerated the demand for modern warehouses with higher specifications.

Key Takeaways

- Global supply chains have faced unprecedented disruption in recent years and that looks set to continue.
- However, the industry is set for explosive growth, driven largely by e-commerce.
- This presents opportunities for experienced and skilled investment managers who can help re-engineer businesses and identify real estate sites set to benefit from changing consumer demand patterns.

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