Deloitte. Insights

FEATURE

Opportunities for private equity post-COVID-19

How can private equity firms help reverse the economic damage?

Jason Menghi, Bhuvanesh Abrol, and Eric Savoy

More than a trillion dollars of dry powder has been accumulated in private equity funds. With COVID-19, that money may be poised to come off the sidelines.

THE COVID-19 CRISIS has had a damaging impact on the economy—in a matter of weeks, once-safe assumptions about the economy have evaporated. Government policymakers are racing to pump billions of dollars into small businesses to help keep them from shuttering or laying off workers. The impacts will likely reverberate for months to come.

In time, perhaps this year or next, it is hoped, the virus will subside, and economic life will begin to return to normal. But by whom? Other than governments and central banks, very few entities have the kind of dollars that may be needed to help restart company growth, make vital investments, rehire workers, and restructure debt. Even then, deciding where to invest and what to save is a rare skill.

That's why it's important to recognize the role private equity firms can play in this environment. While they are perhaps best known for buyouts—and the political fire such deals often inspire—private equity firms can create far more value through their work in particularly challenging economic moments. The firms have the ability to take positions in out-of-favor companies and sectors, guide portfolio company management, and help grow businesses steadily over several years. The outsized returns these firms are able to generate—and for which they are sometimes reviled—often only emerge when the economy, and the companies they own, fully recover. In short, private equity firms often invest when so many others are afraid to act.

Stepping up to the plate

Such fear is in full force. An increasing number of companies and economic sectors are under severe pressure. Even if they were healthy and well-capitalized before COVID-19, today is a different story. Millions of jobs have been lost and thousands of businesses are at risk.

This is a classic scenario where private equity can play a role. Those with the greatest prospects may not have been for sale before; now, they may be considering additional funding alternatives. Private equity can bring capital to the table, potentially preserving jobs, restructuring debt, and helping managers lead their companies through these next few months.

In these first few weeks of confronting the COVID-19 crisis, perhaps it was hard to see that outcome, but some of the leading private equity firms are already envisioning how to get there. What's more, they're collectively sitting on at least US$1.5 trillion of dry powder to help keep their existing portfolio companies going, potentially investing in firms suddenly in distress, helping transform companies and entire industries, as well as pursue other growth and value-creating measures.

Sizing up the opportunities—and impediments

Capitalizing on this opportunity requires significant effort and care. The near-term outlook for many private equity firms is obscured by several challenges. Some investors have become suddenly wary of the long-term lockups required by private equity. Many funds that were in the midst of raising capital may not hit their initial targets. Investors often must maintain certain ratios in their overall portfolio mix, and, with equities so beaten down, some investors may need to reduce their exposure to private equity.

These are hurdles, not walls. Much depends on the specific private equity fund. A fund that completed a round of funding last fall and has yet to deploy much of that capital may be in an advantageous spot; if a fund was scheduled to begin fundraising now, it is harder to see a path to success.

Still more challenged are those funds that were planning to exit their portfolio companies through initial public offerings in the coming year or so. With financial markets volatile, such an exit strategy would be difficult.

Another key dividing line among funds may be their operational capabilities. Funds will likely need to multitask, and some firms are creating dedicated teams for specific goals. For example, while one team focuses on helping their portfolio companies through the crisis, another team might develop debt-financing strategies, including the evaluation of federal small-business bailout packages, for their portfolio companies. Additionally, yet another team may be dedicated to restarting conversations with deal targets that went silent as valuations rose too high, and still another team might focus on sharing details of key strategies and other insights with fund investors such as pension funds and insurance companies.

Not all funds are prepared to do all these things, and still more may not have the in-house capabilities to anticipate special issues. These issues often include tax matters, both the evaluation of complex tax savings and refund opportunities created by the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed by the United States Congress in 2020, as well as the potential tax consequences of various debt-financing strategies. Such strategies—which often revolve around a portfolio company modifying terms of its debt with lenders, or a private equity firm buying up underpriced debt of a portfolio company—may make sense on paper, but they can trigger significant tax implications later if not properly structured.

The bottom line: If there’s an opportunity out there, private equity firms are likely working around the clock to discover it.

Avoiding a repeat

What’s more, many private equity firms have seen these challenges before—even if not on this scale. During the last major economic crisis—the global financial recession of 2007–08—many firms and their investors ratcheted back rapidly and stayed on the sidelines a beat too long. That meant that these funds missed out on opportunities that existed when things looked bleakest.

Those lessons were not forgotten. We have heard from private equity executives that the kinds of returns expected to be captured—historic double-digit annual returns that are the basis for the strong reputations of private equity firms—will depend on what they do in the next six to 18 months. So long as a firm has dry powder and knows how to source deals, it may have plenty of opportunities ahead.

Several paths to deal-making are open to firms in the months to come, in addition to taking growth equity positions: Some public companies may be amenable to going private; some could look to make minority cash infusions in public equities

If there's an opportunity out there, private equity firms are likely working around the clock to discover it.

(so-called PIPE transactions); and others may look to shed noncore assets. Many strategic finance roads are likely to present themselves.

That doesn't mean, however, that the race will be to the swift. Many funds are not rushing to put their capital to work right away. They need more information about COVID-19's impact and progress toward containing the virus. This is likely only the first wave of economic pain from the response to the virus; as those impacts cascade through the economy, private equity firms may be tested to first perform triage on their own portfolio companies. The need to dust off relationships, reengage in conversations, and reconsider deals that seemed unaffordable only a few months ago may be critical. In the end, the volume of merger and acquisition activity may not increase in quantity as much as in quality. The firms willing to invest their dry powder in this environment may take their time and choose their targets carefully. Given the relative absence of competition from other investors, they can afford to hold their fire.

There is yet another reason firms may take things slowly. Some portfolio companies—in fact, some entire subindustries—may need a full rethink given the systematic impacts of COVID-19 on economic life. Shutting down major events and public spaces, moving a majority of the global workforce to working remotely, shifting huge portions of communications to virtual spaces: each of these things represent massive new opportunities for transformation, even when COVID-19 is finally contained.

A test of leadership

Life will most likely be different, and private equity firms should want to make sure their portfolio companies respond to the new reality. Every aspect of running a business—sourcing talent, engaging customers, building supply chains, honing digital brand strategies, ratcheting up cybersecurity and data controls—may have to be rethought and redesigned. Private equity firms should drive those conversations and lead transformation where necessary.

Doing all of this can test any private equity firm and its leadership; not all will be able to take this on at once. That's to be expected, especially given the still-developing scale of the crisis and its aftermath. There may well be a shakeout in the private equity space as a result.

But that neither guarantees success for larger firms, nor dooms smaller ones. Much depends on how they approach the coming tsunami of challenges and opportunities. In fact, the competitive landscape in private equity may well be reshaped by this moment; those who recognize the potential opportunities—and act on them efficiently and strategically—may be able to leapfrog those who merely retrench and wait out the next few months until the water seems calmer. Either way, those firms that emerge stronger in the post–COVID-19 period are likely to find their reputations, and that of private equity in general, easier to defend.

About the authors

Jason Menghi | jmenghi@deloitte.com

Jason Menghi is an Audit & Assurance partner at Deloitte & Touche LLP with more than 20 years of experience. As the national leader of the Audit & Assurance Private Equity business, he delivers premium services to private equity firms and their portfolio companies as a single, strategic client. He has led many teams in executing audit and advisory services for some of Deloitte's largest private equity clients and SEC registrants. Connect with him on LinkedIn at www.linkedin.com/in/jasonmenghi/.

Bhuvanesh Abrol | babrol@deloitte.com

Bhuvanesh Abrol is a leader in Deloitte's Corporate, Competitive, and M&A Strategy practice. His expertise is in addressing issues ranging from new and adjacent market entry, global market assessments, customer segmentation, new product and services strategy, mergers and acquisitions, commercial due diligence, competitive analysis, and new business models and their implications for organization models and design. Connect with him on LinkedIn at www.linkedin.com/in/bhuvanesh-bhuvy-abrol-aa46375/.

Eric Savoy | esavoy@deloitte.com

Eric Savoy is the leader of the M&A Tax practice for the East coast. He has 19 years of experience with Deloitte, primarily serving the firm's largest private equity clients on complex acquisition and disposition transactions. Savoy has experience in advising private equity buyers and related portfolio companies on various tax structuring and diligence issues involving domestic and cross-border acquisitions, dispositions, refinancing, and joint ventures.

Contact us

Our insights can help you take advantage of change. If you're looking for fresh ideas to address your challenges, we should talk.

Industry leadership

Jason Menghi
National Audit & Assurance Private Equity leader | Audit & Assurance partner | Deloitte & Touche LLP
+1 516 918 7842 | jmenghi@deloitte.com

Jason Menghi is an Audit & Assurance partner at Deloitte & Touche LLP with more than 20 years of experience. As the national leader of the Audit & Assurance Private Equity business, he delivers premium services to private equity firms and their portfolio companies as a single, strategic client.

Deloitte Audit & Assurance's Private Equity Portfolio Company program provides services to private equity (PE) firms and their portfolio companies through a collective relationship approach and serves the portfolio companies at each PE with consistency and quality. We apply our understanding of each PE's business model across its entire portfolio and extend our exceptional service delivery model throughout with high performance. We understand that one business solution doesn't fit all. Each PE and its portfolio companies have needs and issues that are unique to its business sector and stage of maturity. As we serve you, we bring in professionals with industry and sector knowledge and expertise. Quality is our top priority; our approach to client service focuses on serving growing companies that may be in transition, and a commitment to the private equity community.
Read more about our Private Equity Portfolio Company program on Deloitte.com.

Deloitte.
Insights

Sign up for Deloitte Insights updates at www.deloitte.com/insights.

Follow @DeloitteInsight

Deloitte Insights contributors
Editorial: Aditi Rao, Blythe Hurley, Sayanika Bordoloi, and Abrar Khan
Creative: Sylvia Chang and Molly Woodworth
Promotion: Hannah Rapp
Cover artwork: Alex Nabaum