



Post-COVID private equity: Thriving in a bifurcated world of opportunity

A podcast series

Interview with Dwight Hooper, Lead Partner, Private Equity, Deloitte Asia Pacific

Transcript

Greg Jarrett: Welcome to Deloitte's podcast series on thriving in a bifurcated world of opportunity post-COVID in the private equity industry. Today, we're speaking with Dwight Hooper, Lead Partner, Private Equity Deloitte, Asia Pacific. We're talking about how private equity firms can refocus their efforts to thrive in the new normal post-pandemic. What good is dry powder if it's never fired? That's the question some private equity investors have been asking in recent years as the amount of uninvested capital in the industry, also known as dry powder, reached record levels.

Competition for deals was heated, and many funds chose to sit on their hands rather than pay premium prices that would hurt their ability to deliver on historically attractive returns. Investors could take solace in the theory that once the economy hit a soft spot, valuations would fall in line, then there'd be plenty of opportunity for target. Dwight, I need you to tell the future here, any view on when the economic impact from COVID-19 will subside and activity might return to normal in Asia?

Dwight Hooper: One of the interesting things about being in this part of the world is, we were first to go into the crisis, but also the first to emerge, touch wood. For example, domestic flight activity in China is actually nearing pre-pandemic levels which would've seemed impossible just a few short months ago. There is no doubt that there are some industries that continue to remain heavily affected in Asia, but as case numbers continue to remain low in some of our key economies like Australia, Singapore, China, Korea, and even Japan is having less than 300 cases per day, there's definitely an air of optimism and determination to get back to business in this part of the world.

As to the crystal ball and when we will see a complete return to the new normal, I don't think I'm alone in saying I think we're still waiting on a global vaccine. But, you know, hopefully things are starting to look a lot more familiar by the start of 2021.

Greg Jarrett: Adjustment might be an understatement here; everybody's had to adjust, whether it's somebody who's working from home, somebody's who's teaching their children from home, or a major industry and people just can't get together and sit face-to-face across a

conference table in most instances anymore. How about the PE industry, Dwight, will it adjust and how will it adjust?

Dwight Hooper: It's been a tumultuous year for us. I mean, we absolutely saw a pull-back in M&A activity from PE funds when the pandemic first emerged with the vast majority of deal processes being put on hold, and I think there were a couple of drivers of that. Firstly, obviously uncertainty around earnings profile with no one really being able to take a view on the length or severity of the pandemic. Coupled with this was just the disappearance of available credit. Lenders were unwilling to deploy their capital amid the uncertainty, or at the very least, not without a significant expansion in margins and fees which were making the deal economics difficult.

So, during this time, PE firms quickly turned their intention inwards, focusing on insuring that their portfolio companies and affected sectors had sufficient access to cash, drawing down lines of credits and just contingency planning around operations more generally. You know, one of my favorite stories, one of our PE clients spent the first few weeks of the pandemic trying to acquire 10,000 WiFi dongles to enable the BPO [business process outsourcing] business to continue to operate in South East Asia, with the entire workforce working from home, but not necessarily having the same level of internet connectivity that we might take for granted in first world countries. It just gives you an idea of some of the impacts and day-to-day fires that our PE clients have to deal with.

There is no doubt that there are a few industries including travel, leisure, automotive, bricks and mortar, retail, to name a few, where the appetite for transactions is going to remain low and that's unlikely to change in the near term, pending the development of a vaccine. But some of our traditional preferred industries for private equities such as business to business services, healthcare and supply chain education, and I'm talking domestic here, obviously not international which is a disaster, are still an attractive place to look for returns.

I think on the M&A deals side, we're also seeing a big focus on operational excellence within the funds themselves, focus on shared services and, and cost out. But also the increase in the attention they're paying to their limited partners, their LPs, including transparency, frequency of reporting to keep, keep the LPs nice and close and informed as the pandemic evolves.

Greg Jarrett: Dwight, for months now we've been hearing about the extreme levels of capital or dry powder as noted by your analysis. Could you help me explain the impact of the situation on fund returns, and even more broadly, on this particular asset class?

Dwight Hooper: We are at record levels of dry powder globally, and there's certainly maybe a temptation by some PE funds to lower their return targets in order to deploy that dry powder. But I think in reality, the PE industry as a whole has been quite disciplined around being willing to return dry powder to LPs in the event that suitable investment opportunities do not present themselves in the fund life. I think where you see a lack of discipline, those PE funds struggle to raise additional capital in the future, in the numbers we sort of see a flight to quality with a larger aggregate amount of dry powder being allocated to a smaller number of PE funds.

So, in many ways, the industries actually self-regulating in the sense that only those firms that can provide a consistent track record of returns over a long period of time continue to be awarded with additional capital allocations from LPs. However, you know, these are extraordinary times, and I think everyone accepts that returns in equities, real estate

bonds, debt, are all going to be tougher to come by, and so naturally, we shouldn't be surprised if we do see some downward pressure on alternative asset returns as well.

One interesting point, and you talked about the pandemic presenting an opportunity, is just the comparison between the economic unrest we're experiencing with the current COVID-19 pandemic versus the global financial crisis we went through 12 years ago. Private equity returns, and this is well known, in the years immediately post the onset of the crisis, and I'm talking 2009 to '11, '12, were actually very good years for private equity. They used the depressed valuations to find good solid companies to buy at an attractive price. So on that basis you would assume the current pandemic may actually present similar opportunity.

The one difference I would note is that following the onset of the financial crisis in 2008, we saw stock markets take a couple of years to recover, and as stock markets represent kind of a transparent earnings multiple comparison for a vendor who's looking to sell their company to private equity, and depressed stock market actually gives private equity a comparative advantage when trying to become the preferred bidder for an asset.

With COVID-19, we're already seeing stock markets bounce back to valuations equal to or even exceeding the pre-pandemic levels. And so therefore this crisis may not present the same level opportunity for PE as we saw in 2008, but it'll certainly be an interesting one to watch how that plays out.

Greg Jarrett: Do you feel these large levels of dry powder could affect the valuation or even the multiples paid for by market operators, and if so, how so?

Dwight Hooper: Yeah, I'm going to contradict myself here because I just said that PE funds have historically been very disciplined. That much is true and they need to be to survive in the long run, but I do think for specific, highly attractive assets there is a willingness to push down expected returns to secure a particular asset. You know, we sometimes joke about a 12 times multiple being the new 10, and I think one of the themes is the bifurcation in terms of opportunity in these times. It's going to continue to come down to an industry by industry thing for the medium term where, you know, an asset's relatively unaffected by the crisis, in a traditionally hot PE sector we're likely to see, you know, strong competition and upward pressure on, on multiples. But similarly, for those sectors that remain exposed to the pandemic, we may see little to no interest at all, which is an example of how the bifurcation of opportunity resulting from the pandemic is going to play out.

Greg Jarrett: You know, it's always true when you're getting involved in a deal that you have to be very careful that you know exactly what's going on in that deal, but it seems like it would be even more so now, more of the spotlight. In fact, in a recent Deloitte POV, you've actually outlined some of the impacts of the current environment on due diligence. Could you further comment on what you see happening in the market so far this year as well as what might be expected for Q4 2020, and even beyond?

Dwight Hooper: We've absolutely seen an uptake in demand for due diligence and there are a number of trends that we're seeing which are probably here to stay. One is just a focus on better analytics, both in understanding the historical trends underpinning a business' performance, but then leveraging that knowledge into scenario planning and what the future might look like. Another one that springs to mind is actually the way people are viewing IT due diligence and the whole technology set. You know, previously, this has not necessarily been a hot topic, but I had a PE client say to me the other day that they wouldn't consider buying a company again that was not on the cloud and able to operate

virtually in case something like this happens again in the future, or at the very least, price putting that technology in place into the valuation of the deal.

So, we're definitely seeing areas of focus spring up which were previously considered more tick the box exercises. And look, I'm not sure I can explain the reasons for it, but 2020 seems to have accelerated the focus on ESG being environmental, social and governance investing and due diligence around that. Maybe the pandemic has reminded us of the importance of being good corporate citizens and how far reaching the consequences can be when things could go wrong. But it's definitely come into the limelight in 2020.

Greg Jarrett: Part of any due diligence, there seem to be a lot of white boarding or scenario playing. Dwight, as these funds initially scramble to assess the impacts of the current crisis on portfolio companies mostly through scenario planning, what do you see happening in terms of those scenarios? And let me give you an example here, are there significant variations from one industry to the next, and which industries ended up better or perhaps worse than expected?

Dwight Hooper: Yeah, absolutely, and for me this is probably one of the most interesting trends and outcomes that we're seeing this year and how the pandemic has reshaped markets, channel, customer fundamentals. PE funds are trying to work out which changes will survive the pandemic and be long lasting. And firstly from a societal perspective, what has changed in consumer behavior that will last? I think all of us have an experience moving online whether it's through our work or consumption over the last nine months, and how that move online will impact supply chains and also the need for hard assets including both distribution versus bricks and mortar and how your hard asset mix might change.

These are all considerations that need to be brought into the investment decision and those companies and sectors that are most adaptable to those changes are going to be the most interesting to PE. TMT [Technology, Media & Telecommunications] is obviously another sector we're seeing a lot of potential activity, online's becoming more prevalent and it's easier to see how private equity can get comfortable with that business case. Economic, political considerations are also starting to play out more prominently than we have seen previously. I think each government's response to the pandemic is quite visible, and so where previously we may not have priced in a geography risk to a particular investment business case, that's something that PE firms are not starting to think about.

Greg Jarrett: We've had an interesting juxtaposition of events here, we've got an exogenous shock as they like to say that a possible serious effect on the future economy. But we also have an environment of extremely inexpensive money. So given the fact that companies who could, drew down aggressively on their credit facilities to secure that cash in preparation for difficult times ahead, many companies are sitting on giant pools of cash to invest. Combined with what you've described in your recent POV, do you feel this could affect forward M&A activity? What could be the implications for PE funds invested in those companies?

Dwight Hooper: Yeah, look, it's a great point you raise, Greg, and when you think about corporates with cash on balance sheet combined with record levels of dry powder, it could lead to significant competition for M&A opportunities. I think this is where we'll see a bifurcation down industry and sector lines. You know, attractive sectors could see a lot of M&A interest and have a resulting impact on valuations. But this could literally play out as

having double the amount of capital chasing opportunity in half the amount of industries and sectors. So as far as timing goes, I think we are going to need to wait to see a vaccine before those corporates will have the confidence to deploy that cash knowing that the worst is over. So, I think between now and then, you know, the activity will largely be opportunistic.

Greg Jarrett: Well, Dwight, that brings us to this, what's your prognosis for the health of PE as an asset class compared to the other broad categories like public equities or even the bond market?

Dwight Hooper: Well, Greg, as the lead of our Asia Pacific Private Equity practice, I am absolutely all in on PE. But seriously though, I think there is a lot to play out globally in terms of the withdrawal of government support, how that will flow through to the real economy and then to markets. There is no doubt that there's currently a disconnect between financial market valuations and the real economy, and that naturally presents risks for public equities and bonds, etc.

As we've discussed during this podcast, PE has demonstrated long history of being able to provide above market alternative asset returns and, and their expertise in analyzing the impact of the current challenges facing the global economy is going to put them in an excellent position to make the best capital allocations amongst, you know, affected industries and sectors which should continue to see these fantastic returns be generated into the future.

Greg Jarrett: Thanks to Dwight Hooper, Lead Partner, Private Equity, Deloitte, Asia Pacific, for talking to us about how the private equity industry will thrive coming out of COVID-19. For more insight on similar topics, stay tuned for the next Deloitte podcast. I'm Greg Jarrett, until next time.

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