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

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What good is dry powder if it never gets fired?

That's the question some private equity (PE) 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 (or simply close and return money to investors) rather than paying 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 and there would be plenty of opportunities for target practice.

Then the COVID-19 pandemic happened. The economy came to a screeching halt as governments around the globe imposed shutdowns to curb the spread of the virus and people practiced social distancing. But rather than create a buying opportunity, the pandemic has only injected a new source of uncertainty that is threatening the survival of companies across many sectors. Government intervention, combined with relaxed loan covenants, have postponed the day of reckoning for many distressed businesses, giving their owners the ability to hold tight for now amid depressed valuations. The PE industry's response has been as you might expect:

they have pushed the pause button on investment and exit activities. While some funds remain opportunistically inclined, many PE funds are shifting their focus to preserving the value of companies in their existing portfolios, and they are working to strengthen relations with their limited partners and lenders.

COVID-19 is proving to be a crisis of a fundamentally different shape than those the PE industry has typically capitalized on in the past. Its cause, global economic impact, and possible recovery trajectories are unlike anything PE funds have had to deal with before. But, already, we are beginning to

see funds take concrete steps that will likely reshape their approach once the pandemic becomes more manageable and they are in a better position to put their dry powder to use. This perspective enumerates some of those changes, along with other trends and behaviors that are emerging amid the crisis, in the areas of fund structuring and administration, investing, portfolio company management, and exit strategies.

Global private capital fundraising (2009-2019) - by sources (in USD billion)

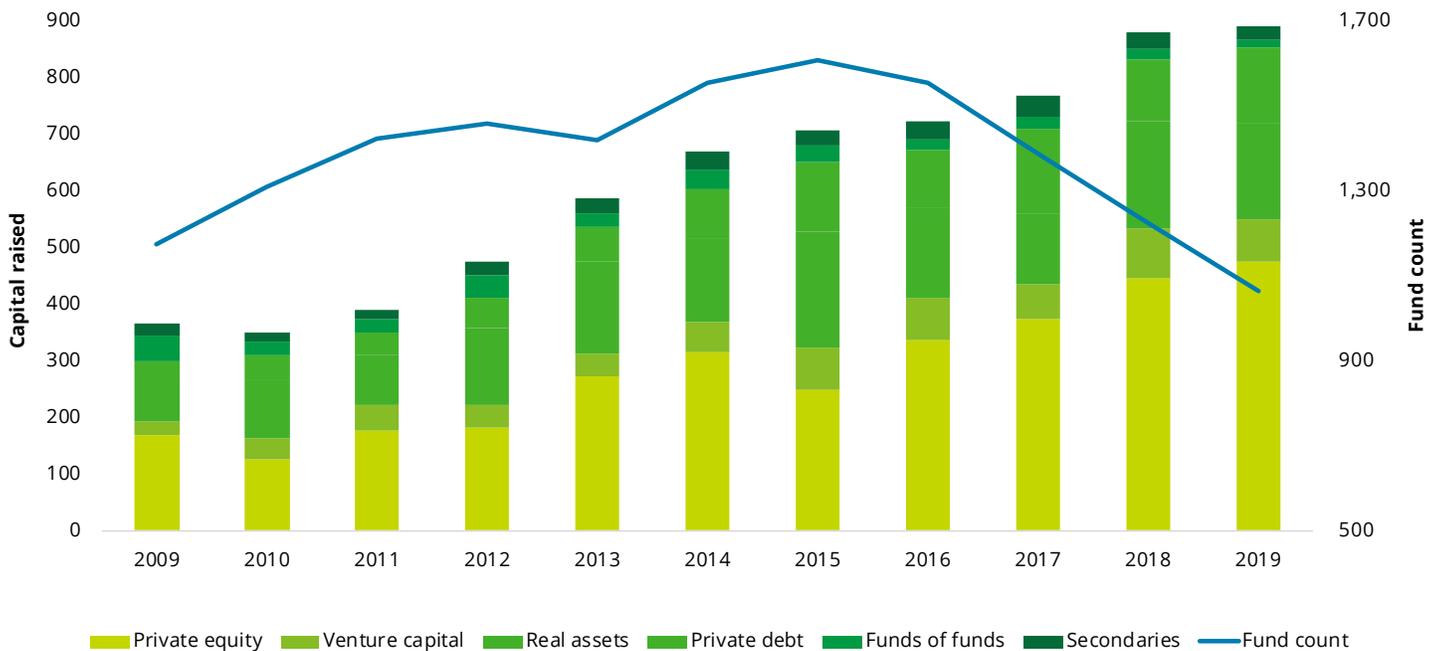


Figure 1: PE accounts for lion's share of private capital fundraising
Data source: Preqin

We believe that the more robust valuation processes being put in place during the pandemic are likely to be sustained as limited partners grow accustomed to receiving more regular updates that also account for more factors that could influence their future investment decisions.

Deeper dive into data

While the PE industry is still waiting to see the full effects of COVID-19's disruption on portfolio valuations, many funds have moved to more robust quarterly portfolio valuations in response to limited partners seeking more timely information and ultimately help guiding their asset allocation decisions.

To assess the impact of the current market environment on each portfolio company's fair value, funds are increasingly analyzing a number of factors:

- Multiple scenarios of cash flow forecasts based on the duration and magnitude of the crisis
- Credit risk and the resulting impact of discount rates (i.e., higher borrowing costs) for lower-rated debt
- The impact of market volatility on prices
- Multiples observed in the market.

Winners and losers are already emerging at a sectoral level: IT, communications, and food companies have benefited; energy, industrials, hospitality and leisure are among those that have suffered. Some PE funds have decided to be proactive and take the hit early for portfolio companies in the latter group, but others are waiting to see the full effect of the crisis before marking down their portfolios. We believe

that the more robust valuation processes being put in place during the pandemic are likely to be sustained as limited partners grow accustomed to receiving more regular updates that also account for more factors that could influence their future investment decisions.

In a related move, PE funds are taking a more active role in overseeing portfolio activity by putting increased emphasis on timely, accurate, and predictive financial and operational reporting to help direct triage activities. In the past, PE funds may have acquired a business with an understanding that such information might be limited for a while due to system constraints, reporting processes, or the lack of available data. But now, funds are expecting this reporting to be available in near-real time. To facilitate this, some are looking to embed operational analytics on top of portfolio company data, versus simply pushing down reporting to the portfolio companies themselves, in order

to generate predictive insights and embed sector-specific leading indicators for financial and operational health. Others are creating centers of expertise within their firms for on-demand use by portfolio companies. Data insights teams, corporate strategy and value creation teams, and even shared CFO expertise is helping to reduce the demands on individual portfolio companies to source such services.

When PE funds are limited in such capabilities, they are increasingly turning to third-party fund administration firms to surgically deploy shared services and shared contracts across their portfolio companies. As well, the use of common insurance providers, office commodity finance services such as accounts payable, professional services firms, telecommunications and office equipment vendors has become more common in recent years, and the crisis is likely to accelerate these efforts.



Changes to investing criteria

The PE industry’s available dry powder sits at roughly USD\$1.5 trillion after growing at almost a 14 percent annual rate since 2014¹, and PE funds could very well start to deploy it on distressed and other opportunistic acquisitions before 2020 comes to a finish. M&A activity appears set to resume, and it’s likely that a combination of defensive and offensive M&A strategies will emerge, according to our colleagues in Deloitte Global M&A Services (see Figure 2).

While PE funds are likely to join and possibly lead any resumption in deal activity, the criteria they use to evaluate targets could be significantly different. For one, investment strategies will likely now consider crisis resilience as a premium factor in obtaining adequate diversification. A new layer of risk management in evaluating deals should

give extra credit to business models that aren’t closely correlated to the economic cycle. Funds are already considering, at the investment and portfolio levels, the security of channels companies use to access customers, as well as of supply chains needed to obtain raw materials. They are giving the same consideration

to the resilience of the workforce and enabling infrastructure. And they are asking anew about the [societal value each business provides](#), recognizing that it has been the purpose-led organizations that have won over consumers and built trust during the crisis.

Figure 2²



Level of Impact assessment: Consider the impact of pandemic on economic recovery and market supply / demand dynamics, your people, customers and competitive environment.

Ability to act assessment: Consider your liquidity position, balance sheet strengths and ability to raise capital from the markets in relation to the resilience of your business operating model and those of your suppliers and partners.

¹ Preqin Quarterly Update: Private Equity & Venture Capital Q2 2020

² Iain Macmillan, Sriram Prakash, and Mark Purowitz, M&A and COVID-19: Charting new horizons, Deloitte, 2020, pg. 7.

Over the long term, PE funds may shift more of their attention to thesis-driven, sector-focused strategies to strengthen their portfolios' geographic diversification. One area likely to see renewed interest is environmental, social, and governance (ESG) investing. The percentage of both retail and institutional investors that apply ESG principles to at least a quarter of their portfolios jumped from 48 percent in 2017 to 75 percent in 2019.³ COVID-19 has sharpened the focus on corporate social responsibility.

More broadly speaking, PE funds are already considering what lasting changes will survive the pandemic by increasing their emphasis on four types of macroeconomic forces in play:

- **Societal:** Changes to consumer spending and behaviors wrought by COVID-19, as well as the level of trust society places in companies and institutions
- **Technological:** The speed of technology adoption, sources of technological innovation, and attitudes toward data-sharing
- **Economic:** The resilience of key markets, and the ability of various economies to fully recover
- **Political:** Appetite for fiscal and monetary support coming out of the crisis, as well as regulation of private and public markets.

When it comes to valuing acquisition targets, several factors – including medium-term volatility, the suspension of forward-looking guidance, and dislocations such as COVID-19 relief measures – are limiting the utility of market-based approaches. Buy-side valuations have tilted toward discounted cash flow approaches that consider multiple scenarios for financial forecasts, and access to (and the cost of) capital. As we begin to emerge from the crisis, investors should expect valuation ranges to narrow, but we expect the practice of scenario-planning in valuation to persist as resilience to crises remains a selling point.

Furthermore, due diligence processes are already being augmented in several ways during the crisis. Before the pandemic, due diligence was often narrowly focused on recent financial performance. Now, we are seeing an unprecedented level of scope and detail with diligence assignments, as funds work hard to distinguish between underlying business fundamentals and COVID-19 impact. They are starting to use more commercial and operational diligence to understand how the pandemic has reshaped markets, channels, and customer fundamentals.

Funds are also working to understand the business' revised potential and identify as best they can the long-term financial impacts of crisis-driven initiatives such as furloughs, layoffs, and other cost reduction programs. Investment committees are placing greater emphasis on empirical analysis around non-financial factors as well, such as the target's addressable market, its growth trajectory, and potential disruptors. Funds are not only asking for much more breadth and depth in the data they seek, but also

seeking to get a better understanding of potential risks, ranging from supply chain issues to cyberattacks to liabilities stemming from bringing employees back to physical workspaces. The expanded scope of due diligence enacted in the middle of the crisis will likely represent the new normal once the crisis passes, as funds grow accustomed to seeking such information and look to limit surprises in the future.

To solve for short-term economic uncertainty and bridge valuation expectations, buyers could increasingly demand that sellers include earn-out structures in which they earn a part of the purchase price based on the performance of the business after closing. Such clauses benefit buyers not only by deferring a portion of the purchase price, but also by ensuring that expert management teams will stay in place through the recovery and drive business performance. Meanwhile, sellers are able to realize the appropriate value for their business without having to accept depressed valuations.

Investors are starting to use more commercial and operational diligence to understand how the pandemic has reshaped markets, channels, and customer fundamentals.

³ BNP Paribas, "The ESG Global Survey 2019," 2019.

Expanding sources of liquidity

Coming out of COVID-19, some PE funds may not have the same access to capital as they enjoyed before the crisis or face issues related to Limited Partner (LP) and General Partner (GP) misalignment with respect to expectations around liquidity. PE fundraising slowed in the second quarter as the pandemic began to take hold around the world, with PE funds raising the lowest amount in a quarter since the first quarter of 2018, according to Preqin.⁴ One in five PE investors responding to a recent survey conducted by Private Equity International⁵ said they intended to make fewer PE fund commitments in 2020 compared with their plans coming into the year, and 12 percent said they planned to reduce their average commitment.

Some in the industry are beginning to expand their search beyond their traditional fundraising by pursuing alternate forms of liquidity:

- **Follow-on capital:** Older funds that are fully invested and cannot recycle existing capital are looking to raise structured equity or debt at the fund level to play defense by bolstering their portfolio assets, or go on offense by executing on accretive, bolt-on acquisitions.
- **GP financing:** Some GPs are seeking dedicated debt and/or equity solutions to launch or grow new platforms, buy out retiring partners or third-party investors, or make an outsized commitment to their next fund. Besides accruing more flexibility, these efforts are also expanding the GP's investor base to those who are more aligned with their investing style and strategic objectives.
- **LP tenders:** Facing longer hold periods caused by COVID-19, GPs could choose to proactively provide their LPs with an option to obtain liquidity sooner through a tender offered to all LPs or just those experiencing acute liquidity issues and are unable to honor future capital calls. This approach may also allow the GP to restructure an older fund to provide with a longer runway to maximize value, as well as a reset of fees and carried interest to ensure alignment between the remaining LPs and the GP.
- **Asset sales:** Funds could consider secondary asset sales as a pathway to get capital into the hands of LPs in more recent funds, or simply wrap up older funds. This could take the form of a minority interest sale, an outright sale of a single asset or a strip of the portfolio, or the creation of a continuation vehicle in which the LPs can choose to retain their exposure to a specific asset.
- **Leveraging the full portfolio:** Some portfolio companies have maximized their borrowing capacity but still need additional liquidity to survive the COVID-19 crisis or the post-COVID period. PE funds can borrow against their entire investment pool to generate additional liquidity and meet these needs.
- **More active debt management:** Even the most distressed portfolio companies may still be able to secure new debt or renegotiate their existing obligations, as the debt markets are still playing catch-up to the reality on the ground thanks to all of the government intervention. This window is not likely to remain open for long, though, as the market for available debt capital will likely become more crowded as downgrades and defaults rise in the months to come.

⁴ James Comtois, "Preqin: COVID-19 slows private equity fundraising in Q2," *Pensions & Investments*, July 9, 2019.

⁵ Carmela Mendoza, "Q1 fundraising shows strong start to year with covid-19 blow to come," *Private Equity International*, April 9, 2020.

Introducing “more active” management



Active portfolio management will continue on its pre-COVID growth trajectory, characterized by close, collaborative relationships between funds and resilient portfolio company management teams. But we expect funds to accelerate these efforts post-COVID, looking for new ways to create and preserve value, and to take a hard look at what strategies worked – and what didn’t – when the pandemic upended business as usual.

As the recovery takes hold, funds will likely put a magnifying glass to their portfolio companies’ performance through the crisis. The pandemic tested every incumbent portfolio company, whether they were fighting for survival or trying to capitalize on changing market conditions. Warren Buffett famously said, “Only when the tide goes out do you discover who’s been swimming naked.” This crisis should help PE funds shore up their weaknesses and identify behaviors that generated high performance, as they look to copy those successes across their portfolios to ensure they are amply prepared for the next cycle of prosperity.

As the PE industry embraces a deeper dive into data, it is likely going to change

the complexion of their talent resources, increasing their emphasis on value creation teams. This could be internal or hired on a case-by-case basis from third-party advisory firms, a concept that was popularized by large PE and pensions funds following the global financial crisis and which has garnered renewed interest among mid-market funds over the past few years. These teams – also referred to as “portfolio operations” – are typically comprised of dedicated specialists focused on improving the operations of portfolio companies to produce higher long-term returns. Their record during the last recession shows they did exactly that, even when deployed at a small scale. Given systematic stresses placed on entire portfolios due to COVID-19, value creation teams have once again proved invaluable during this crisis, marshaling a coordinated response and supporting management teams.

The increased use of value creation teams represents a heightened level of partnership between PE funds and their portfolio companies in solving their most complex challenges. We expect PE funds large and small to double down on these

efforts going forward, expanding beyond their traditional focus on fighting fires and working with the lowest-performing portfolio companies. In the short run, funds may also look to augment their existing value creation capabilities with turnaround and/or restructuring expertise to support a foray into distressed investing. Longer term, we see these teams emerging as centers of excellence for value creation initiatives across PE portfolios, contributing to strategy, operational excellence, digital deployments, data insights, and other critical capabilities.

Exit readiness is likely to gain fresh attention, as funds look to capitalize on narrow windows of opportunity post-COVID amid persistent increased volatility and uncertainty in global markets. PE funds are increasingly weighing multi-track exit scenarios, including IPOs, carve-outs or carve-ups, secondary sales, and, in cases of distress, managed wind-downs and liquidations. To ensure they are prepared for all of these options and to speed the process, funds are strengthening vendor due diligence and deploying analytics to that end, as they work to control the messaging about COVID-19’s impact on their portfolio companies during sales processes.

When an exit isn’t possible in the near term, GPs and LPs are likely to work together to extend the lives of funds—especially sector-specific funds—to avoid having to liquidate a portfolio in a down market. To be sure, delayed exits will have a negative impact on fund returns and potentially close the performance premium between PE assets and other asset classes. But exit delays may be considered a more attractive alternative to incurring an outright loss. The scale of the negative impact on fund returns is dependent on each fund’s lifecycle and ability to take advantage of market opportunities arising from depressed prices and multiples.



Ready to reengage

The COVID-19 pandemic has tested the PE industry in ways not seen before, handcuffing their ability to pounce when other investors remained overly cautious or complacent. But as the situation begins to stabilize, we expect PE funds will enthusiastically reengage and help lead the recovery, applying their historic expertise and value-creating capabilities to stand companies back up and position them for long-term success.

In some critical ways, though, the lessons taught by the crisis could reshape the way funds pick their investments, manage their performance, and work with portfolio companies and investors alike. A keen attention to detail and opportunity for improvement have been the calling card of the PE industry for decades, and one of the key reasons for its dramatic outperformance over that span. While it is true that COVID-19 is an unprecedented challenge in both size and scope, everything we are seeing suggests the industry is more than up to the task.

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