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Interview with Robert Olsen, Global Financial Advisory Deloitte Private Leader

Transcript

Greg Jarrett: Welcome to Deloitte's podcast series on thriving in a bifurcated world of opportunity post-COVID in the private equity industry. We're joined today by Rob Olsen, the global Deloitte Private leader for its Financial Advisory practice and the Private Equity leader at Deloitte Canada. Today, 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 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. Rob, let me start by asking you just what did occur when COVID-19 hit?

Robert Olsen: Well, the first thing that happened is debt dried up. So, we saw debt for new deals almost fall to zero and debt for existing clients was scrutinized more significantly by their lenders. And as soon as debt dries up, M&A activity follows very quickly. So, we went from probably one of the busiest times in the M&A world in February to basically no M&A come beginning of April. And so private equity funds had to turn their attention away from new deals and into their existing portfolios. So, more time focused inwardly than outwardly. It was focused on things like raising government support for their companies, or accessing debt from their lenders, or at least pacifying their lenders—not to pull back any of their lines of credit, furloughing staff, closing offices, really developing survival plans.

Greg Jarrett: Rob, there are a lot of speculators out there trying to figure out just how this thing's going to turn out. With all of your analysis and with all your teams who're looking at this, do you have any view on maybe when the economic impact from the pandemic will subside and activity could return to some sense of normality in Canada?

Robert Olsen: Well, what the new normal looks like is certainly hard to predict, but we can certainly speak to a bunch of things that we will see and are seeing. We'll start with the economy. Our economists would expect a year to two years of a more difficult environment, particularly once the quantitative easing subsides. With that happening though, we're seeing right now, a bunch of things that we can speak to. Firstly, certain sectors are trading down, whether that's travel, or storefront consumer, or energy, or even commercial real estate. And so one of those sectors will start to perform again, probably not until we see a vaccine or more rapid testing, maybe a saliva testing for COVID that you can get the results in five or 10 minutes might help.

But until then, those sectors are going to trade down. But that doesn't mean there's no activity. There's certainly lots of activity. We're already starting to see, particularly over the last seven weeks and whether it's healthcare or FSI or tech, even things like business services. If you've been to a hospital recently and you can't get to administration without going through an army of guards—guarding is everywhere. So business services has picked up dramatically. And so we see lots of activity, but that doesn't mean we're going to go back to what was the old normal.

Greg Jarrett: Everybody's had to make some adjustments in this current pandemic environment, Rob. Do you have any thoughts on how the PE industry will adjust?

Robert Olsen: They've been really good at adjusting, I would say. Firstly, it caught everyone off guard. So the first two months was kind of again, inwardly focused, but as soon as they turn their attention away from just focusing inwardly, you can start to see some of the way they were thinking about the world. They've had to adjust their investing strategies like everybody. So what geographies they focus in on has changed. They've had to become way more creative in the types of structures they might use to invest at the sectors that they're going to look at. Their existing portfolio, they had to make big adjustments. They've added value creation expertise, whether that's external support or they've hired people to extract more value out of the existing investments that they've made—they had to do that. And they've done it very quickly. And they're trying to share best practices across their portfolio. We've never seen as much as we have now on sharing of best practices at private equity funds; that could be shared services, that could be sharing CFOs, or that's just sharing things that are being done smartly at one portfolio company with another. We've seen them focus on supply chain. And another area of focus we've seen, and really a big adjustment for them, is even more attention to their investor base. So more transparency of reporting, more robust reporting. And then there are other stakeholder lenders, which is critical to their existence is being able to borrow cheaply with partners in the banking environment. You're spending a lot more time making sure that lenders are comfortable with their investing strategy and what they're doing with their existing portfolio companies.

Greg Jarrett: Rob, given the levels of capital as has been noted in your analysis, could you explain the impact of this situation on fund returns and even more broadly on this particular asset class?

Robert Olsen: Well, broadly we expect returns to come down, but we'd expect the same thing in the public equity or bond markets where we would honestly expect a much bigger drop; particularly if as I started, the economy starts to falter with quantitative easing kind of going away. So we expect a general drop in returns, but the alternative asset category, where private equity sits, we see as actually this will be relatively a better time for private equity, whether that's private equity, pure private equity or infra, or venture capital or even private debt. We see this actually as a very good time. Actually, look back to any of the investments made post-crisis. So go back to the credit crisis. Usually the year or two coming out of a crisis or a downturn typically are the best returning investments that a private equity fund has. So investments made coming out of this pandemic we see is probably outperforming anything else in the market, whether it be public bonds or public equity. So we think that's actually a very good time for returns for private equity.

Greg Jarrett: In a lot of places, the more cash on hand people know you have, the more they're going to charge you for a particular good or service. Do you feel these levels of dry powder could affect the valuation of multiples paid for by market operators? If so, how so?

Robert Olsen: So we talked about significant dry powder in private equity, and that absolutely is huge and it's grown dramatically every year, some $1.5 trillion. There's also significant money sitting in the hands of corporates. They've raised money and it's sitting in their balance sheets getting ready for a downturn in the economy; either the fund losses or taking advantage of acquisitions, which is what will end up competing with private equity. So what does that mean for the world, if you will? Well, if you're in those sectors that are in hot demand, we actually see valuations at, or similar levels that we've seen pre-COVID. However, if you're in some of the sectors that haven't done as well, some sectors like energy or, or storefront consumer or travel, in many cases, there's no bids in the current environment. Going forward, we expect to see bids once we have normalcy to the markets and quantitative easing has gone, but for the moment you're not seeing much money rally around some of those tougher sectors.

Greg Jarrett: In this current environment, I've got a feeling that there's one particular employment practice that is receiving a lot of attention and a lot of offers and that would be transactional attorneys. In a recent Deloitte POV, you've 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 could be expected for quarter four in 2020 and beyond as far as due diligence is concerned?

Robert Olsen: We've never seen as much diligence and work, and granular diligence as we're seeing currently. We think that's here to stay. There's more sophistication of analysis, greater use of data analytics in diligence, broader scenario planning, greater assumptions-based forecasting being used, greater scrutiny on management. When you're trying to analyze management, you're trying to see how will they perform in various scenarios, well, we haven't had a lot of CVs out there that have had experience working through a pandemic like we do now. Not good that that happened, but it's very helpful to management to be able to show private equity funds that they have that expertise to build and manage through tough times.

So for private equity funds, this is actually a time that they're really doubling down on due diligence and they have that ability to do so. And they're going to take the time they need to find the right deals for them. They've got to figure out how to distinguish between what's a COVID-related impact and what are underlying business issues that they have to manage through. We're also seeing private equity funds start to ask tough questions, like what kind of social impact is the company making? We've seen companies perform better where they've been able to build trust more quickly, and that's starting to play into the investing strategy of private equity funds. We've seen valuations definitely tilt towards more discounted cashflow analysis than comparable based analysis. And that's partly because you see suspended guidance from public companies. You've seen an absence of deals over the last six months, so you don't have comparable transactions. And the overall market volatility makes it very difficult to use those kinds of valuation approaches.

And then on deal structuring, we're seeing way more creativity out of private equity funds. So on their diligence, they file, and then they starting to think about how do we structure the deal. They're using that diligence to tailor what they're going to come back with from an investment perspective. Greater use of things like earnouts as an example, where you can bridge the gap on valuation with an earnout mechanism using structured equity instead of control equity. So all kinds of mechanisms to actually come up with a smart investment in this current environment.

Greg Jarrett: There's been a lot scrambling going on out there to try and assess the impacts of the current health crisis on portfolio companies, mostly through scenario planning. Just what do you see happening in the terms of those scenarios? For example, are there significant variations from one industry to the next and which industries end up better or worse than had been expected?

Robert Olsen: On the scenario planning side of things, it's pretty interesting. Firstly, the private equity funds are trying to figure out which changes will survive the pandemic and are going to be long lasting. So they've kind of looked at it from a number of factors, but I'll just speak to maybe three or four of them. From a societal perspective, what's changed in consumer behavior that will last? So that plays to the kind of industry that will work, whether it's on the consumer side, which companies are showing a long-term, sustainable change that's positive, and then those become the sectors that become interesting to private equity.

Technological—seeing great run up in what they call the FAANG stocks publicly. But it's the same thing happening in the private equity industry. Which technological changes are going to impact the industry such that a private equity will say, O*kay, that's a sector that makes sense to me. I see that that's long lasting*. *There's going to be greater adoption of that technology.* And hence, you're going to see greater investment in those areas. Same thing on economic, same thing on political. All these things are being used to help the private equity funds analyze, determine which industries make the most sense for them and which sectors, more importantly of those industries, make the most sense.

Greg Jarrett: Given the fact that the companies who could drew down aggressively on their credit facilities to secure cash in preparation for difficult times expected ahead, a lot of companies are sitting on extensive pools of cash to invest. Combined with what you 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?

Robert Olsen: Yeah. So if you look at the amount of money drawn down, as you say on lines of credit from the corporate sector portfolio companies or private equity funds, and then you add that with the dry powder of private equity funds generally, there's a massive amount of capital waiting to invest. And so when is the right time to invest? When they're certainly in the market is when we'll see an avalanche of that capital invested. Once quantitative easing starts to fall away and we see what the new normal looks like, it'll be very obvious to funds and corporates where to invest the capital. We've talked about some of those sectors already, but that will become even more obvious. That's going to have a massive impact on M&A activity.

And we'll see that in valuations. So in the sectors that we like, we're going to get to valuations, better than we've seen pre-COVID. Because if you think back to this bifurcated world where all that money, instead of being invested across multiple industries, now it's focused on half those industries because they're resilient. So more companies chasing the same deals is going to result in greater valuations for those companies. And so we see it as actually a very good time for private equity generally. Private equity is going to have to compete with strategics to win deals, but that's going to be great for companies selling and for those private equity funds that have been pretty good at finding companies that fit their aspirations, that should be a really terrific time for private equity.

Greg Jarrett: It seems like there have been a lot of rumbles about increasing deal activity. Do you see a return to significant levels of deal activity happening in the short term, and will these deals be mostly defensive or offensive? What are the differences from industries and geographies?

Robert Olsen: Well, for sure we're seeing a steady increase. If you went back to April, we talked about almost zero M&A activity. I was talking to a couple of private equity funds yesterday and they're referencing how deal activity is as high as it has ever been over the last kind of month or so. So we're already starting to see that. That's not across all industries and it's not across all private equity funds, so we're not there yet. For us to have tremendous M&A activity on par with any of the great vintage years for M&A activity, the only way that happens is certainty in the market. So right now we have certainty where there was resilient industries have done well and you can feel comfortable they're going to continue to do well post-COVID.

In the other sectors, it's hard to determine how long will it take for people to feel trust again, get on an airplane, get into a building, a crowded shopping mall, all those things are very difficult to determine just yet. So until that happens, you won't see a lot of private equity money going in some of those tougher sectors, but we're absolutely seeing a great M&A activity already beginning in the better sectors. With a crisis, if we ended up in a tougher credit environment, because we're seeing more bankruptcies as a result of quantitative easing falling away, and it's a more difficult environment, that won't be a bad thing for private equity. We will see significant opportunity because all that dry powder plus all the stress and distress funds have been raised, invested in that environment, will be ready to pounce. So we actually see great M&A activity and it will be necessary for many of those companies to find liquidity options if they don't have a robust business going forward or a sector that's in favor. So it should be a good time for M&A generally.

Greg Jarrett: And in summary, Rob, what's your prognosis for the health of PE as an asset class compared to other broad categories, such as public equities or the bond market, for example?

Robert Olsen: It's smart money. Smart money that has the time to diligence companies until they decide that it makes sense or not. They're not forced to fall under some defined timetable that's too short to get comfortable. So they actually have the time, they have the knowhow, they have the ability to assess, and they use external help where they need to make a decision. You put that together with an environment where there shouldn't be more companies looking for capital, which you had all those companies looking to sell pre-COVID that now have been waiting. So there's pent up supply of companies looking to do things once the market becomes more normal and then all that money that's sitting on the sidelines, there should be a very good market for private equity.

Then you compare that with or contrast it with the public markets. Public markets have been doing really well. That probably doesn't continue if we see a tougher environment with more bankruptcy, similar to the bond market. We're not going to see yields, 30-year yields at one and a quarter percent for very long, that will start to increase again. And so that just points to the relative performance of private equity, looks very good over the future and I feel super excited by the opportunity for private equity funds.

Greg Jarrett: We've certainly learned a lot about the possibilities in a post-COVID world for private equity. Thanks to Rob Olsen for joining us to talk about how the private equity industry will thrive coming out of COVID. For more insight on similar topics, stay tuned for the next Deloitte podcast. I'm Greg Jarrett until next time.