FEG INSIGHT

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A DISRUPTION OF MASSIVE PROPORTIONS

Private Equity and Managing COVID-19

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investment advisors

"If you're trying to achieve, there will be roadblocks. But obstacles don't have to stop you. If you run into a wall, don't turn around and give up. Figure out how to climb it, go through it, or work around it."

— Michael Jordan

A DISRUPTION OF MASSIVE PROPORTIONS

As a self-proclaimed Indiana Pacers fanatic, it pains me to reflect on any inspirational quote from a member of the 1997-98 Chicago Bulls. But, as the ESPN documentary *The Last Dance* repeatedly reminded us, Michael Jordan won six NBA Championships, so we should probably hear him out.

The COVID-19 pandemic has set up countless roadblocks for both the economy and society. As of the publication of this document, the number of confirmed cases in the U.S. stands at roughly 4.5 million and more than 140,000 Americans have died from the disease, the highest death toll in the world.[1] The national unemployment rate, which sat at historical lows a mere 9 months ago, has since skyrocketed above 11%. Many businesses remain closed, while those fortunate enough to reopen face obstacles related to limited capacity, tepid customer demand, and ensuring employee and customer safety.

Private equity investors have been dealing with the impact of COVID-19 since mid-January. At that time, the virus was primarily isolated to China. As efforts to contain the outbreak failed, the Chinese government mandated the closure of factories and sent workers home. These actions resulted in unforeseen supply shocks for portfolio companies with supply chains linked to China, causing auto parts, medical equipment, electronics, rubber, plastics, textiles, and other key components to be in short supply. By early March, nearly 75% of U.S. companies were reporting disruptions due to COVID-19.[2] In response, private equity fund managers worked collaboratively with portfolio company management teams to control their existing supply chains while simultaneously seeking out new, more local alternatives.

OPERATING WITH UNKNOWNS AND UNCERTAINTY

For the most part, China's shutdown was successful. Workers stayed healthy and returned to the factories when they reopened. Industrial production rebounded and capacity utilization returned to acceptable levels.

Unfortunately, as portfolio companies were emerging from a supply-related crisis, COVID-19 spread to the U.S., forcing state and local governments to issue stay-at-home orders and close all "non-essential" businesses. The resulting demand shock created new roadblocks and new obstacles. One private capital manager shared that companies operating in sectors such as hospitality and leisure had witnessed revenue declines by as much as 80%. Healthcare providers were forced to cancel elective surgeries and—despite converting operating rooms to intensive care units to prepare for a surge in COVID-19 patients—furlough healthcare workers due to declines in other treatments.

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No stranger to operational crises, experienced private equity investors acted quickly. For example, some companies deemed non-essential either filed appeals or pivoted to producing personal protective equipment (PPE) for healthcare workers. To preserve liquidity, many private equity firms directed their portfolio companies to tap their revolving lines of credit. Anecdotally, from our discussions with private credit managers, some saw drawdowns peaking near 70% of total credit available, for perspective, those same managers shared that they witnessed a maximum of 45% drawdowns during the global financial crisis.

Chief financial officers (CFOs) managed working capital and preserved cash by accelerating collections, stretching payables, and delaying CapEx spending. Some portfolio companies filed for government assistance via the CARES Act and the Paycheck Protection Program (PPP). Despite early confusion and miscommunication, private equity-backed portfolio companies with 500 employees or fewer were able to access the loan program. Salaries and working hours were reduced in the most optimistic scenarios, while massive furloughs or layoffs were conducted in the most dire scenarios.

Increased uncertainty during the first quarter led to a broad sell-off in public market equities. Trailing revenue and EBITDA multiples contracted, and private equity valuations fell with them—though by less than the public markets. The Thomson One US Private Equity Market Index fell 9.2% during the quarter, besting the S&P Total Return and NASDAQ Composite index.[3] This is not surprising, given that private equity is structured to be a long-term asset with the potential to outperform during periods of heightened market volatility and economic slowdowns. As observed in a recent note by Pitchbook: “Since 2001, private equity funds have outperformed in all 21 of the quarters in which the S&P 500 Total Return was negative over that period.”[4] This pattern is expected to hold in the current environment.

July is still too early to determine what private equity valuations will look like for the second quarter. CFOs are currently assessing the impact revenue and EBITDA declines may have on marking to market their investments in accordance with fair value accounting standards. Overall, the results are likely to be mixed. Unlike the first quarter, this will be the first full reporting period where performance was influenced by lockdowns and social distancing. Some managers factored in earnings adjustments for March 31 valuations. Those who did not will be forced to reconcile both trailing and forecasted earnings for the second quarter. Investors concerned about aggressive write-downs may add back COVID-19 related expenses when assessing performance. For example, we might see managers use earnings before interest, tax, depreciation, amortization, and coronavirus (EBITDAC) in some measures. This practice, when combined with a recent rebound in public market indices, suggests additional valuation declines may be mitigated. However, it is still too early to provide meaningful commentary on second quarter performance.

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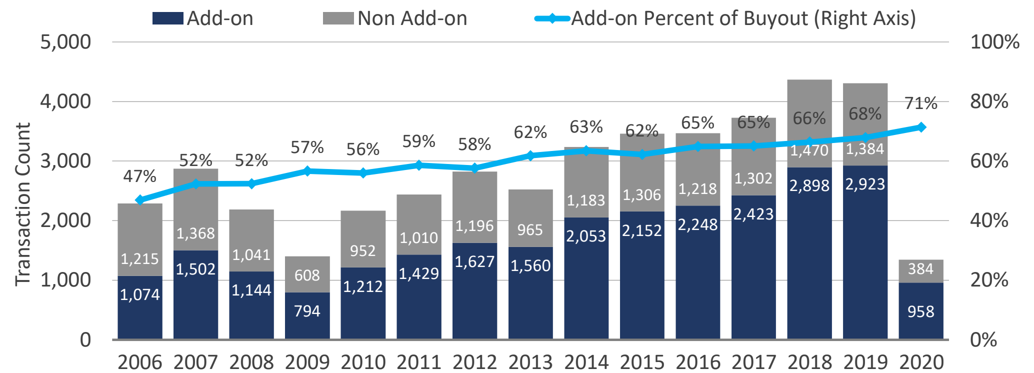
A NEW NORMAL

Investors, management teams, consultants—no one knows for how long and to what extent the pandemic are expected to alter portfolio company operations. Economic uncertainty and market disruptions will likely lead to lower deal volumes, more opportunistic transactions, delayed exits, and slower fundraising.

Through June 30, 2020, deal volume was down nearly 45% year-over-year, according to Pitchbook data.[5] Many of the deals closed in the second quarter were negotiated prior to the COVID-19 pandemic. In the near term, private equity investors may see an uptick in opportunities to acquire distressed assets from motivated sellers. However, these deals may be difficult to close due to economic uncertainty, restrictive due diligence processes (e.g., facility visits), and wide bid-ask spreads on valuations. Consequently, continued uncertainty is predicted to slow private equity deal activity for the foreseeable future.

With time, FEG anticipates private equity firms will be active with operational turnarounds, corporate carve-outs, public-to-private transactions, and financial restructurings. For now, however, private equity firms are expected to prioritize add-on acquisitions, as these deals are often easier to complete since they are smaller and less dependent on debt financing. During the second quarter, add-on transactions accounted for more than 70% of total deal value. This is a notable increase from 2019 when add-ons accounted for just over 55% of total deal value.[6]

ADD-ONS ARE THE MAJORITY OF DEAL ACTIVITY



Data source: Pitchbook. Data as of June 30, 2020

The COVID-19 pandemic will clearly slow down exit activity for existing private equity-backed portfolio companies. Holding periods for assets will extend as investors wait for valuations to recover and merger and acquisition markets to thaw. This same trend was exhibited during the global financial crisis. From 2006 to 2014, the median holding time for private equity buyouts climbed from 3.7 years to roughly 6.2 years.[7] This negatively impacted internal rates of return for existing investments held in private equity funds and investors starved for distributions had few options at their disposal.

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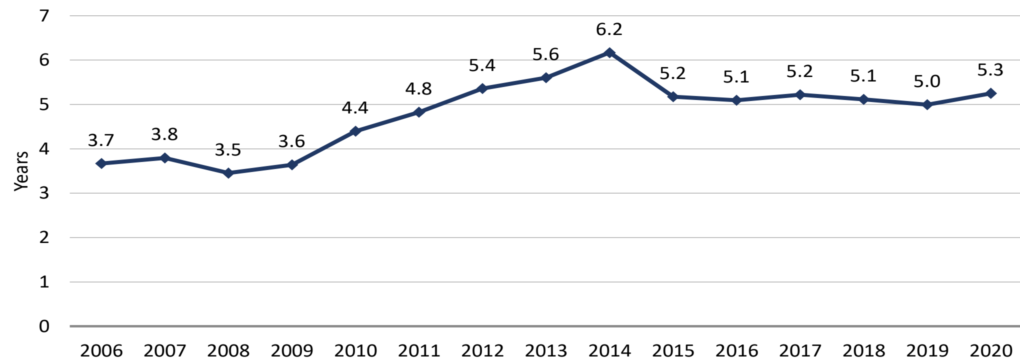
LONG HOLDING PERIODS ARE GETTING LONGER



Data source: Pitchbook. Data as of June 30, 2020

Today, however, there are other methods for general partners to generate liquidity. GP-led secondaries such as fund restructurings and tender offers, for example, can be used to provide partial or full liquidity on investments. Over the coming quarters, FEG expects private equity secondary volume to increase as general partners seek to provide their limited partners with distributions.

Slowdowns in capital deployment and exit activity are expected to adversely impact private equity fundraising activity. As of June 30, U.S. buyout funds raised $83.1 billion, representing a decline of more than 13% from the same time period last year.[8] FEG expects this trend to continue as private equity firms manage through their existing uninvested commitments (i.e., dry powder). Managers who began fundraising pre-shutdown may have fewer issues than those new to the market, as limited partners are likely to allocate capital to established managers with a clear track record rather than emerging managers raising their first fund.

DEAL-MAKING IN A POST-COVID ECONOMY

A post-COVID economy presents new challenges to how private equity funds invest. A greater reliance on technology could present opportunities, though it is a competitive space. Greater emphasis on downside protection through structured securities is also emerging.

What deal-making will look like in a post-COVID economy remains unclear. Every crisis is different and this one has been exceptional. The pandemic has resulted in a quick, widespread disruption of not only the global economy but of social life in every corner of the world. Early expectation is that the new buzzword to enter the private equity lexicon will be "essential businesses." When considering a new platform investment, private equity investors are increasingly likely to scrutinize whether the company provides goods or services vital to everyday life.

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More interest in technology is all but certain, specifically in software, due to the need for social distancing and ways in which this pandemic has permanently altered the work-from-home landscape. Software companies with reliable cash flows, variable cost structures, and low CapEx requirements have fared well thus far during this crisis.

Further, COVID-19 could accelerate the adoption of automation technologies to improve productivity and reliability. Software companies with cost-effective applications could be well positioned to benefit in the "new normal." The recurring revenue software-as-a-service (SaaS) model has demonstrated stability during the crisis, however, these companies are valued with expectations for high growth. Investors should closely monitor these companies for any signs of reduced growth rates, particularly those in which the company's end market has been heavily disrupted, as that could be the shoe yet to drop.

Structuring in traditional leveraged buyouts is also expected to see some near-term pressures related to the pandemic. With tighter-than-normal leveraged finance markets, some financial sponsors may find it difficult to raise debt to close deals. Underwriting standards for sponsor-backed transactions could see heightened levels of scrutiny. Companies linked to retail, leisure, auto parts, and upstream oil and gas production are likely to be most impacted, as these sectors have seen significant demand erosion due to stay-at-home orders. When coupled with an overleveraged capital structure, companies operating in these sectors face potential bankruptcies or forced asset sales. Private equity investors considering opportunities in these sectors may be forced to use more equity to capitalize their deals with the idea of refinancing once things start to recover.

Lastly, in order to deploy capital, FEG projects that some firms may broaden their investment scope to include minority ownership and complex situation investments. The number of private investments in public equity (PIPE) and structured equity investments is likely to increase. During the second quarter, Roark Capital announced a $200 million investment in publicly traded Cheesecake Factory (NASDAQ: CAKE). The investment was structured as convertible preferred stock with a 1x liquidation preference and a preferred rate of 9.5% per annum.[9] In April, Apollo Global Management, Inc (NYSE: APO) and Silver Lake collaborated to purchase $1.2 billion of preferred stock in Expedia Group Inc. (NASDAQ: EXPE).[10] Trive Capital recently acquired publicly traded Seven Aces (TSXV: ACES), a gaming company and route operator.[11] These anecdotes reveal how, when faced with a challenge, private equity investors can "figure out how to climb it, go through it, or work around it."

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CONCLUSION

Private equity is the epitome of active portfolio company management. The model provides investors with the ability, flexibility, and incentives to identify and resolve problems in real time. Undoubtedly, this crisis will expose the true capabilities of private equity managers. Limited partners who remain cautious and continue to partner with managers focused on creating value via operational improvements, not financial engineering, should be well-positioned to benefit in the new, post-pandemic world.

[1] http://coronavirusstatistics.org/
[2] https://www.instituteforsupplymanagement.org/news/NewsRoomDetail.cfm?ItemNumber=31171&SSO=1
[3] Thomson One US Private Equity Market Index; First Quarter 2020 (Preliminary Returns)
[4] Pitchbook; Analyst Note – First Quarter 2020; "COVID-19 The Sell Everything Trade and the Impact on Private Markets"
[5-8] Pitchbook; Data as of June 30, 2020
[9] https://www.institutionalinvestor.com/article/b1l8wy1pcmy36c/Cheesecake-Factory-Turns-to-Private-Equity-Firm-Roark-in-Coronavirus-Crisis
[10] https://peprofessional.com/2020/06/86969/
[11] https://www.reuters.com/article/expedia-group-stake-idUSL3N2CA3M2

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