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Foresight

Navigating the uncharted

How can private equity investors respond to the COVID-19 crisis?

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Navigating the uncharted

How can private equity investors respond to the COVID-19 crisis?

Private equity investors are in uncharted territory, but history can offer some lessons that may prove a useful guide in deciding the most prudent next steps.

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In addition to the humanitarian crisis, efforts to contain and mitigate the COVID-19 outbreak have resulted in a historic stock market correction and seems to be leading the world into a global recession¹. Implications for financial markets are wide ranging, and variables numerous, so that many investors do not even know which questions to ask, let alone what the answers they need might be.

The first and second order effects and the timeline of the crisis remain highly uncertain. However, our experience with two previous major crises - 2000-03 and 2008/09 - means we believe we can offer some insight on the risk and liquidity management issues institutional private equity investors may encounter in the coming weeks and months and can help them to navigate through this crisis.

We break down the implications for all of the following:

- Existing investments overall and by strategy, region and industry
 - Valuations
 - Cash flows (contributions, distributions)
 - Reserves for follow-on financings
 - ESG considerations
 - Monitoring and risk management questions to ask
- Private equity allocations
- New investment opportunities
- Possible long term effects

Base case scenario: Several months of economic impact from lock-downs

The base case scenario underpinning our views is that lock-down measures - lasting up to several months - will have a significant economic impact. Although our views are subject to change, simply put, if the situation turns out to be less severe than we have assumed, everyone will express relief and will not regret, for having prepared for greater downside risks.

What can history teach us?

When searching for historic events that resemble the current crisis, 2008/09 seems to be a closer comparison than 2000-03.

Both now and in 2008/09, entire industries required a bailout. Banks, auto manufacturing and insurance firms required government intervention in 2008/09. Travel, mobility and hospitality firms (amongst others) are vulnerable today and will rely on government interventions.

In addition, fair market value accounting and mark-to-market rules (such as SFAS 157 in the US) were already largely in place for private equity during the 2008/09 crisis, but not yet in 2000-03.

Additionally, both in 2008 and in 2019, large buyout valuations and leverage levels were at high levels and fundraising was robust.

¹ Schroders economic forecast, March 19, 2020: "Coronavirus to spark severe global recession"

Using 2008/09 as a foundational template, we believe we can expect the following:

Table 1

Topic	Current expectation
Valuations	<ul style="list-style-type: none"> – Private equity to prove more resilient overall than stock markets – Meaningful corrections for private equity between half and the full level of stock market corrections, depending on the strategy (e.g. 15-30% in case of a 30% stock market correction) <ul style="list-style-type: none"> – Highest correction (more than stock markets) for secondary focused funds that aggressively utilize fund-level leverage and third-party financing on underlying transactions – High correction for large buyouts and late stage growth (in line with public market sector equivalents) – Lower correction for small buyouts and early stage venture (about half of stock market corrections) – Strong difference in valuation impact by industry – Adjusted valuations only to become visible for Q1/2020 and Q2/2020 valuations (in May and August 2020) with the full valuation impact realized several quarters following the stock market trough
Contributions	<ul style="list-style-type: none"> – Initial spike for rescue financing and paying down subscription credit facilities – Slow-down of >50% in investment pace for new opportunities – Higher slow-down for buyouts than for venture capital
Distributions	<ul style="list-style-type: none"> – Exit window closed – Distributions to come to a halt across private equity strategies
Reserves / follow-on financing	<ul style="list-style-type: none"> – Wave of top-up / annex funds – Equity cures for some direct/co-investments – Follow-on financings much more complicated due to prevalence of co-investments with different shareholders who might have different abilities to fund follow-on financings
ESG considerations	<ul style="list-style-type: none"> – Environmental, social and governance (ESG) focus to rapidly shift from “E” to “S” and “G”. – Investors who are directly invested in funds and direct/co-investments will pay increasing attention to headline risks
Monitoring and risk management priorities	<ul style="list-style-type: none"> – Focus on social distancing as a new risk dimension – Increased focus on management of subscription credit facilities and other types of fund financing structures (that are much more prevalent today than in 2008/09) – Emphasis on identifying companies with follow-on financing needs
Private equity allocations	<ul style="list-style-type: none"> – Return of the “denominator effect” – No good choices for investors who feel forced to react to denominator effect (secondary sales at steep discounts, LP defaults) – Private equity allocations will benefit from environment with record low interest rates
New opportunities	<ul style="list-style-type: none"> – Flight to quality / focus on established providers and fund managers – Primaries to benefit from new valuation environment – Opportunity to increase access to and allocation with exclusive fund managers – Top-up / annex funds with attractive deal structuring – Attractive secondary opportunities expected to emerge as early as second half of 2020 – Direct/co-investments as most immediate opportunity with the need to apply additional selection filters
Possible long-term effects	<ul style="list-style-type: none"> – Increased focus on risk exposure measurement and management – Some level of government mandated de-globalization – Broader diversification of supply chains – Increased emphasis on healthcare innovation and preparedness – Boost for digitalization of industries and communication – More flexible work environments

Implications for existing private equity investments

Valuations

Private equity valuations will likely correct less than stock markets for most private equity strategies

In 2008/09, private equity valuations overall experienced a value correction between two-thirds and half the level experienced by listed equities.

The tendency for buyout valuation to not fully track public valuations is due to valuation practices that tend to smooth valuations. These practices include using an average from a collection of relevant listed companies and comparable transactions (which do not change with stock market price changes). In addition, it is not uncommon for the valuation of a buyout investment to utilize normalized EBITDA figures over several historical quarters to further smooth valuations and limit the downside impact.

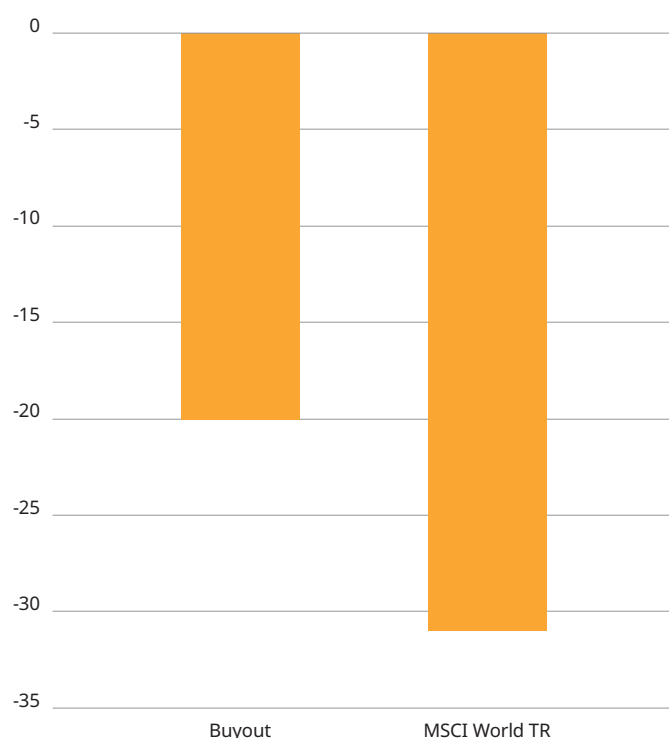
In contrast, venture capital investments, in particular early stage investments, will have the tendency to rely on the valuation from the most recent financing round to base valuations, particularly if the company has not experienced a material degradation of its business prospects. This also contributes to a smoothing of valuations. Furthermore, as early stage companies often have no or little revenues or tend to grow very strongly, often there is no direct impact on company financials from a degradation of general economic conditions.

Late stage and growth financings are expected to experience greater valuation volatility compared to early stage companies, as these companies tend to be valued on a multiple of revenue. In this risk off environment, the momentum propelling late stage valuation metrics is expected to quickly contract yet with some of the same smoothing elements as for buyout investments, but with a revenue focus.

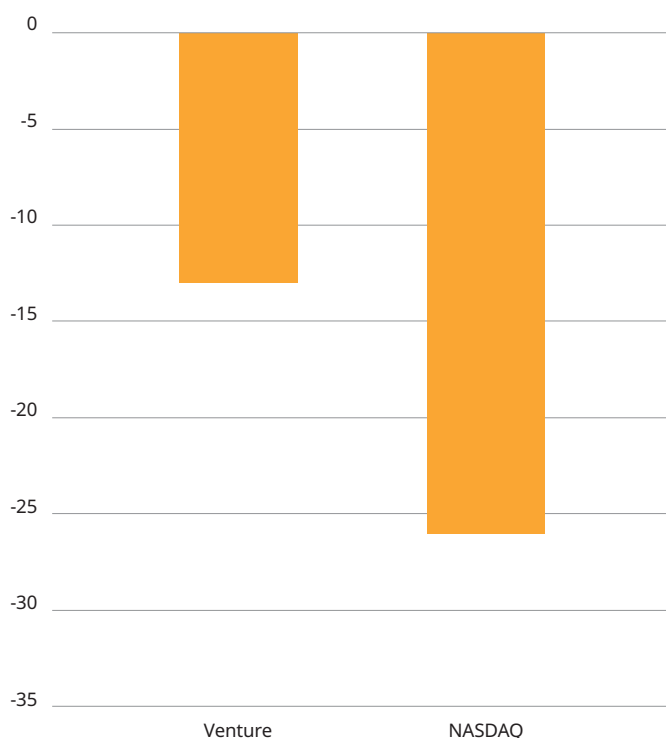
Lastly, it will be interesting to see to what level general partners (GPs) seek to side step valuation declines, by changing valuation approaches from the prevalent aforementioned comparable based approach to the discounted cash flow approach (DCF approach). The DCF approach, a valuation method that discounts future cash flows by a specified discount rate, will seek to look beyond the current crisis and attempt to invoke certainty to vague and uncertain exit events years in the future. With more oversight and guidelines surrounding valuations that were introduced since the 2008/09 crisis, the freedom to change valuation policies is, however, more limited today than it was in 2008/09.

Figure 1

% Valuation correction buyout vs. listed equities (2008 - 09)



% Valuation correction venture vs. listed equities (2008 - 09)



Source: Preqin, Schroder AdvEq; valuation correction shown is maximum valuation correction for period of 09/2008 to 09/2009

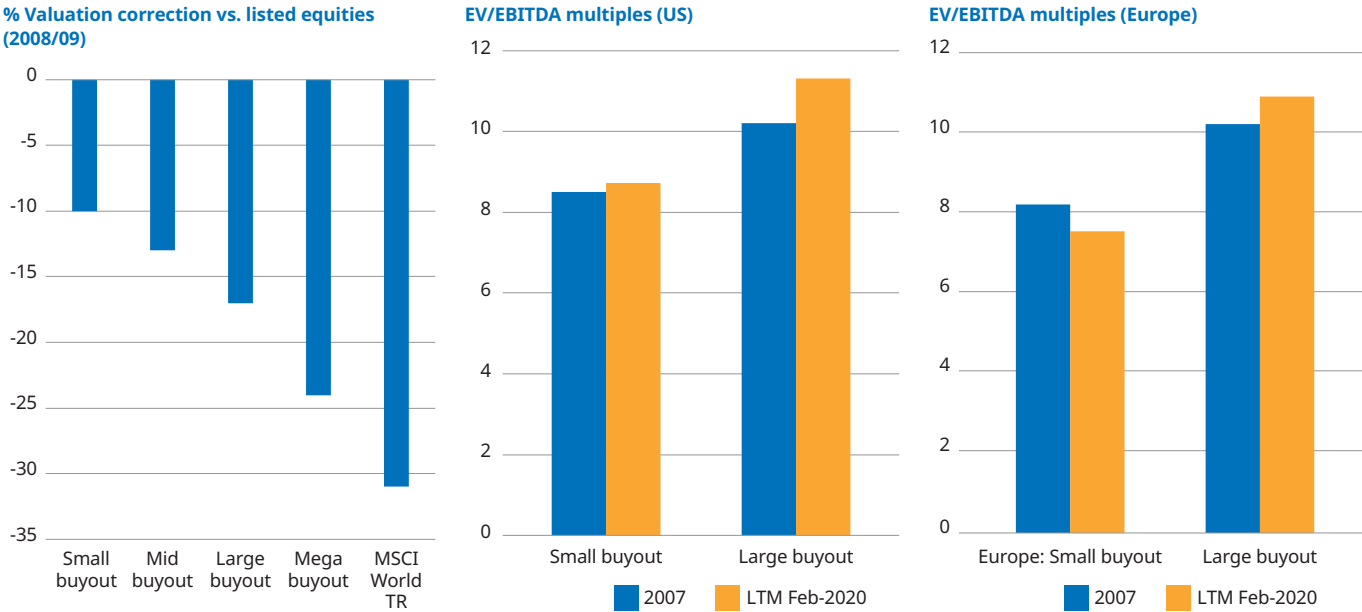
Some private equity strategies will likely correct more and could turn out to be more volatile than in 2008/09, while others are expected to be more resilient

If the 2008/09 crisis is any guide, large buyout funds – which have entered transactions at higher valuations and which apply more leverage than smaller funds – are likely to experience the highest valuation corrections in the current crisis. In 2008/09, the valuation correction of large/mega buyout funds was twice as high as the valuation correction of small buyout funds as shown in the graph below. As large buyout entry multiples were even higher before this crisis than before the 2008/09 crisis and

small buyout valuation multiples were slightly lower in Europe and slightly higher in the US than before the 2008/2009, the differences in resilience between small and large buyout can be even more pronounced in this crisis (see figure 2).

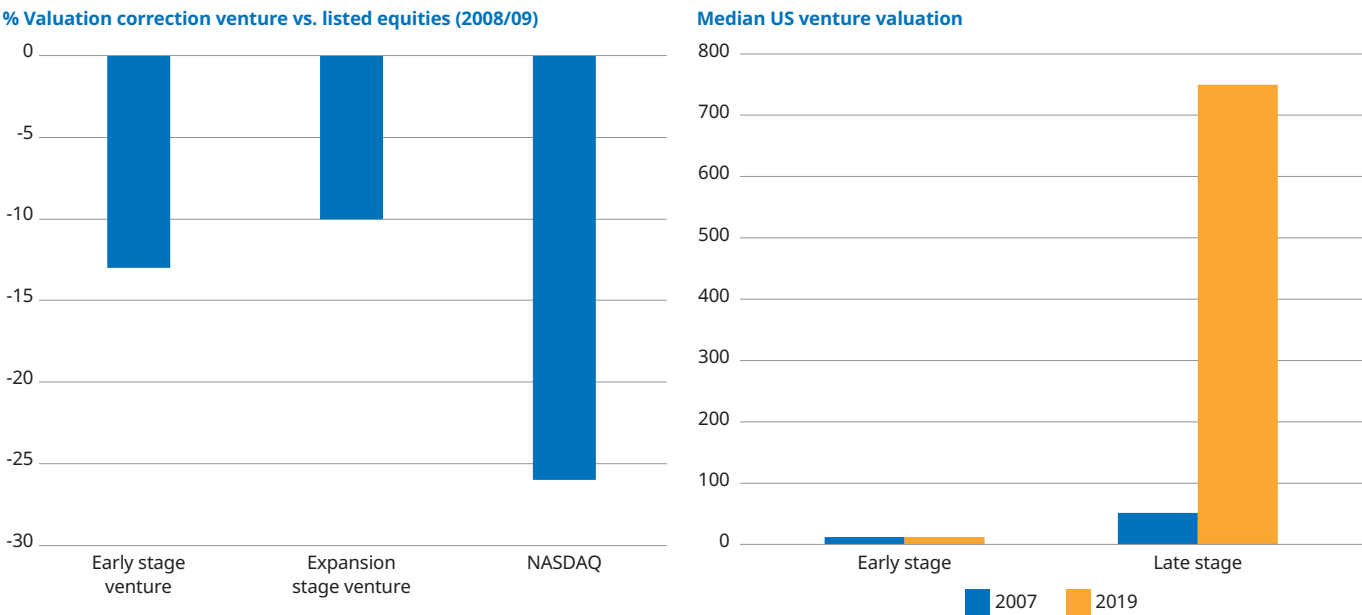
In 2008/09, venture capital valuations corrected only half as much as the comparable stock market index. Valuations of expansion stage investments have proven even more resilient. However, in this crisis, corrections for late stage/expansion stage investments can be expected to be more severe than in 2008/09 due to the explosion in late stage valuations in recent years (see figure 3).

Figure 2



Source: Preqin, Baird, S&P, Schroder Adveq 2020, valuation correction shown is maximum valuation correction for period of 09/2008 to 09/2009

Figure 3



Source: Preqin, VentureSource, Schroder Adveq, 2020, valuation correction shown is maximum valuation correction for period of 09/2008 to 09/2009

The valuation impact is expected to vary significantly by industry sector

As countries go into lock-down, some industries will be significantly more impacted than others. This will also be visible in private equity valuations.

Industries that we expect to be most impacted from social distancing are:

- Travel / hospitality / leisure
- Aviation
- Automotive / mobility
- Oil / gas
- Discretionary consumer goods
- Consumer and business lending

Industries that we expect to be least impacted include:

- Consumer staples
- Healthcare
- Online media / entertainment
- E-commerce
- Enterprise software

Large levered secondaries funds at especially high risk of value corrections

The secondary market has undergone tremendous growth and development since the 2008/09 crisis. The growth in secondary focused capital created a highly competitive secondary transaction environment. The elevated valuations across private equity drove many secondary investors to utilize additional leverage at the transaction level to ensure investments penciled out to adequate pro-forma returns. As most of the secondary volume was centered on large and mega buyout funds, the leverage on leverage aspect of these transactions should be expected to lead to heightened valuation volatility during this crisis.

It will take until end of May or August 2020 before the initial valuation impacts become visible

As the economic impact of COVID-19 is a post Q4/2019 event that did not start and was not known until after Q4/2019, we expect no correction to Q4/2019 valuations based on the current situation. Therefore, the impact of the crisis will only become visible in Q1/2020 and Q2/2020 valuations, which will be available towards the end of May and then end of August 2020, respectively.

Cash flows

An initial spike in capital calls, then a dramatic slow-down

Over the coming month or two, investors are likely to experience a spike in capital calls as some GPs pay down fund-level credit facilities and seek to shore up portfolio company balance sheets.

The desire to pay down fund-level credit facilities will be driven by a GP's intent to reduce the risk of an outstanding loan balance in the midst of declining valuations that may impede upon loan covenants. In addition, declining valuations coupled with a sizable outstanding loan balance will amplify the decline in the LPs capital account. The most dramatic scenario is if a fund is early in its life with modest capital invested, the GP will be faced with the risk that some limited partners decide to default on their commitment instead of funding below cost investments previously funded by the fund credit line.

The second driver of near-term capital calls is a GP seeking to improve a portfolio company's financial position in the face of a declining business. This financing need can run the spectrum of urgency, where in the most urgent scenario a GP managing a fund that is fully drawn may need to raise capital for troubled companies by initiating a rescue top-up fund with punitive terms for those limited partners that chose to not participate.

Aside from the near-term capital needs, we expect a major slow down in new buyout investments until the economic crisis abates, and businesses are back on steadier ground, while, in contrast the investment pace of early stage venture investments is expected to continue largely unaffected if history is any guide. Late stage venture investment volumes, however, can be expected to drop significantly in this crisis due to more selectivity of investors and smaller rounds. The chart below shows the very different impact on buyout and venture investment pace during the 2008/09 crisis (see figure 4).

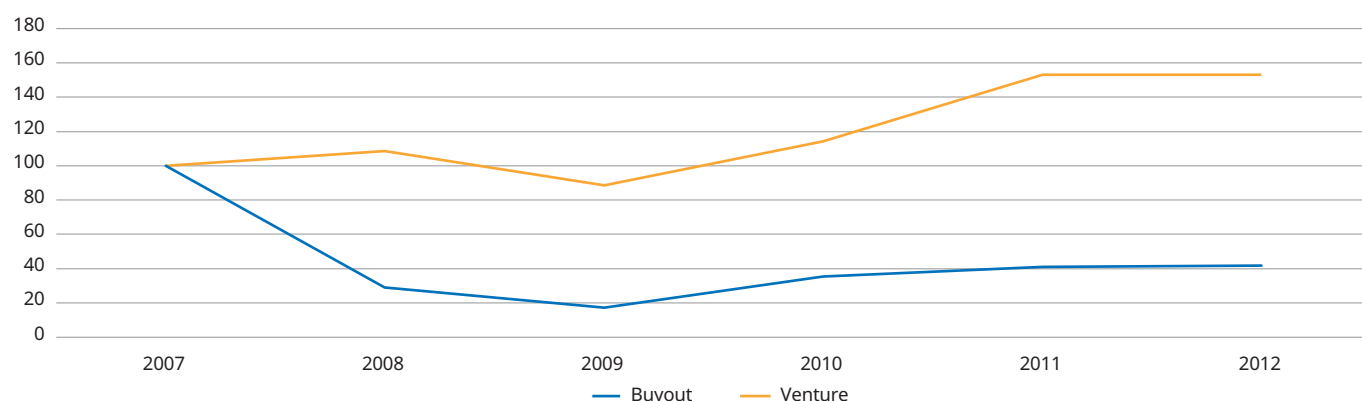
Distributions are expected to drop significantly and remain low for several quarters

The exit window has closed abruptly and – based on prior experience – is unlikely to reopen until markets recover. How long the exit window remains closed depends on how long the economic impact resulting from the lock-down measures endures and how fast stock markets recover. In 2008/09 it took about 1.5 years for distributions to return to prior levels.

Even the public holdings in private equity portfolios (which are typically investments in lock-up post-IPO) are unlikely to be sold by underlying fund managers as long as depressed market conditions persist.

Figure 4

Deal volume during the 2008/09 crisis (2007 = 100%)
Index=2007



Monitoring and risk management questions to ask

Investors should proactively seek periodic, portfolio-specific updates related to COVID-19

A proactive approach will allow investors to be better positioned to respond to dynamically changing capital needs from their private equity commitments.

Typically, investors will get this information through their private equity providers and fund managers they are invested with. Balancing its provision is also challenging. Although frequent communication is ideal, fund managers need to also ensure adequate focus on managing their existing portfolios in this special situation.

It is also important to focus information requests on the most important holdings in the portfolio. Having a consistent framework for monitoring activities will help to make results comparable across investments and to aggregate those and allow for result aggregation.

A useful framework is to categorize all investments into four categories

We have developed an assessment framework that is specific to the COVID-19 situation, which categorizes investments into four different groups (see Table 2).

When assessing fund investments, look-through to the company level and beware of leverage

As the use of fund level leverage has increased significantly over the past ten years, it is important to look through to the underlying portfolio companies and to assess additional layers of leverage in an investment (i.e. subscription lines, NAV based facilities, additional leverage for secondary investments).

Reserves and follow-on financings

Investors are well advised to reserve capital to ensure the ability to participate in fund and co-investment rescue financings

Some companies will go through this crisis unaffected (categories 1 and 2 above) and others will face a temporary decline in activity without requiring additional capital

(category 3). Certain companies however, will need additional capital injections to weather the storm (category 4).

As external financing sources may be difficult to find in times of crisis, fund managers will use uncommitted capital in their funds, recycling provisions or credit facilities to inject capital in existing portfolio companies if and where needed. In some cases, fund managers might also decide to raise top-up funds to finance existing portfolio companies.

As rescue financings often have preferential economic terms, investors should be prepared to participate in top-up funds or in rescue financing of direct/co-investments. This might mean reserving additional allocations in their portfolios.

Organizing rescue financing for portfolio companies will be more complex today than it was in 2008/09 due to the prevalence of co-investments with various shareholders that might have different views on investments and abilities to fund follow-on investments. This can increase potential conflicts of interest, make term negotiations more difficult and might require more complex structuring to execute a rescue financing.

ESG aspects

Investor ESG focus is expected to temporarily shift from the "E" to the "S" and to the "G"

In times of crisis, a topic like ESG – which was high up on the agenda of many investors until very recently – risks dropping of that agenda as other more pressing issues get more attention. At the same time the "E" in ESG (which was the main focus before the crisis) is expected to become subordinated to the "S" and the "G" which will become very much in focus. These factors relate specifically to possible bankruptcies of and layoffs in portfolio companies, as well as potential conflicts of interests in relation to equity cures, or carried interest clawbacks etc. There is also the topic of possible headline risks, especially for direct/co-investments and direct single fund investments, that will likely garner close investor attention.

Table 2

Company category	Description	Mitigation measures during crisis
1 "Anti-fragile" companies	Companies that benefit from the current situation	Growth acceleration
2 Robust companies	Companies that will demonstrate robustness with regard to revenues and profitability, but might experience a valuation decline driven by market comparables.	Heightened risk management
3 Fragile companies	Companies that will experience some level of revenue and profitability impact, but have no or low financing risks.	Cost reductions
4 Companies with permanent impairment risks	Companies that will require some type of additional financing to support their business during this situation.	Cost reductions, additional financing measures

Implications for private equity allocations

The “denominator effect” could suppress new commitments and possibly risk an investor’s ability to maintain key GP relationships

Investors who have significant allocations to listed equities are experiencing a relative increase of their private equity allocations. This is because private equity valuations adjust over a longer period compared to listed equities and, as discussed earlier, are expected to adjust to a lesser degree, than listed equities.

For many investors, the sudden increase in private equity allocations will not be a problem as their actual private equity allocations are below their target allocations. Some investors will also be able and willing to tolerate a temporary overshooting of their target private equity allocations. However, for some investors this can be a problem, for example if they run into regulatory limits.

Investors that need to mitigate the denominator effect face hard choices

For investors that feel forced to reduce their private equity allocation in this crisis and where temporary commitments stops are not sufficient, there are no good choices. They could sell LP stakes in the secondary market, but would need to accept steeper discounts. They could also choose to default on LP commitments, but would risk losing their existing exposure, hurting their reputation in the private equity market and their access to fund managers’ subsequent fundraises.

The COVID-19 crisis could lead to an increase in private equity allocations in the mid-term

Given the aggressive measures by central banks with regard to interest rate reductions and quantitative easing, the attractiveness of private equity as an asset class could increase further. Other sources of return and alpha in a portfolio are likely to grow even more difficult to find, as observed in the post-2008 environment. We also expect that certain private equity strategies and certain private equity firms will navigate through this crisis largely unaffected, which will further increase investor interest in these strategies and in these firms.

New opportunities

The current situation will be transitory and can provide for attractive investment opportunities for investors who are well capitalized and disciplined. The outlook for new private equity investments especially depends on the investment type:

- **For primary investments**, the economic impact of COVID-19 can lead to more favourable entry valuations. Furthermore, primary fund investments benefit from time diversification during the typical investment period of 3–4 years. The current crisis can be an opportunity to further increase allocations with and access to exclusive fund managers.
- **For secondary investments**, economic and financial market turbulences can create buying opportunities. In the short-term, traditional LP sales and GP-led opportunities may be limited, however, given the widening of bid-ask spread between buyers and sellers on price. The current private equity valuations do not yet reflect the full impact of COVID-19 on underlying portfolio companies, and it may take multiple quarters for those valuations to fully correct. The market will eventually stabilize, at which time the optical discounts will be more palatable for sellers, albeit based on lower valuations relative to pre-COVID-19 levels. Secondary deal volume will rebound in turn, consisting of a significant number of opportunities to acquire portfolios at attractive entry points. In the meantime, there will be opportunities to participate in select secondary transactions, as well as in top-up funds and structured rescue financings that have some secondary-like characteristics.
- **New direct/co-investments** can benefit from less competition for deals, more favourable entry valuations and the possibility to select investments that are little affected by the current crisis or that have the prospect of a prompt recovery. However, high selectivity will be paramount. We see direct/co-investments as the most immediate opportunity in the new market environment.



Possible long-term effects of the current crisis

It is too early to fully assess the long term effects of the current crisis; however, as issues that were uncovered in past crises led to adjustments of government policies, regulations and investor behavior, the same can be expected for this crisis. The below table summarizes some initial observations, which are intended as food for thought (see Table 3).

Table 3

Issue surfacing in this crisis	Possible long term effect
Certain private equity investments and investment structures with hidden or too much leverage	More focus on look-through leverage and risk profiles of private equity investments
Overleverage of certain large corporates	Renewed focus on corporates' core business and need to raise capital leading to increased deal flow from corporate carveouts
Global supply chain disruptions	Better supply chain diversification Government mandated de-globalization in certain areas
Need for social distancing leading to experience with work from home	More flexible work environments with more work from home
Need for social distancing leading to more online transactions	Permanent growth boost for online services and online commerce
Healthcare supply shortages, lack of pandemic preparedness	Increased demand for certain healthcare goods and services



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