Q&A

WEATHERING THE STORM

Pantheon Partner **Helen Steers** discusses private equity's immediate response to the impact of the Covid-19 pandemic – and what we can expect as we emerge from the crisis.

Private equity has benefited from the long bull market over the past decade, with strong fundraising, deal-flow and exit activity in recent years[1,2]. But how have managers coped in the face of the severe economic disruption caused by Covid-19 – and what can we expect as the industry emerges from the effects of the pandemic? Helen Steers, Head of Pantheon's European Investment Team, shared her views.

How have private equity managers responded to the pandemic?

The global spread of Covid-19 – and the economic shutdowns put in place around the world to contain the outbreak – have created a simultaneous supply and demand shock. This has been devastating for the global economy and many businesses, including private equity-backed companies, have seen an immediate impact on their operations.

In response, private equity managers (GPs) have taken rapid action to protect their portfolios. That is part of their duty as responsible investors – and their efforts have extended beyond their concern around protecting value, to workforce health and safety, wellbeing of customers and suppliers, and longer-term business sustainability. This evidences the real advantages of private equity: focused response to challenges, sharp attention to detail on operations, heightened governance, and long-term alignment of interest with underlying businesses.

Based on activity across our own universe of GPs, we have seen increased contact with portfolio company management teams, an immediate focus on the security of staff, assessment of the impact on company sites and supply chains, and concentrated efforts to understand demand implications and to reinforce key customer relationships. Our GPs have taken early action to shore up companies' balance sheets and ensure that they have sufficient liquidity to weather the storm.

What specific liquidity actions have been taken?

First and most obviously, managers have worked with companies to cut non-essential spending, optimize working capital needs, and stress-test capital structures and business models. They have also pursued negotiations with lending institutions and, where necessary, have typically been able to secure covenant waivers, amortization holidays and extended debt maturities.

GPs have also secured new financing for businesses that are most severely affected, including new lending from banks and, in some cases, equity infusions through capital raises – although that isn't something that has been required widely across our portfolios.

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How were private equity portfolios positioned before the crisis?

Fund managers had been preparing themselves for a downturn, given that we had experienced a decade-long bull market. They capitalized on fundraising while times were good (see chart 1) and amassed significant capital for investment and liquidity. Similarly, they had taken advantage of strong exit conditions to sell portfolio companies and rationalize their portfolios (see chart 2). Many had also capitalized on favourable lending conditions to refinance debt for a number of their portfolio companies on improved terms.

No-one knew what the trigger for the downturn would be – and certainly nobody expected that we would see the extent of human and economic damage that has been wrought by Covid-19. But generally, portfolios have fared relatively well so far through the crisis in part because of these preparations and the actions taken since the pandemic emerged.

Are we seeing any new deal activity in the current market?

New deal activity has definitely slowed and is likely to remain subdued in the near term. Pricing for new transactions is problematic, since the lasting impact on company earnings can be hard to assess. Due diligence and negotiations are difficult to carry out while lockdowns are still in place. In certain cases, there is also a significant gap in pricing expectations between buyers and sellers. Valuations had been getting quite toppy pre-pandemic – entry valuations had been running at more than 11x earnings in 2019[3] on average – and adjustments to prices take time to develop.

However, GPs are beginning to move from a defensive position to more of an acquisitive position. For example, we are seeing some managers pursuing weaker and less well-funded competitors as add-on targets for their existing portfolio companies. There is also a sense that some interesting new opportunities are beginning to emerge to acquire companies that managers might have been tracking for some time, but that are now available at lower prices.

Chart 1: Global private equity fundraising 2010-2019. Data from Preqin as of 1 June 2020

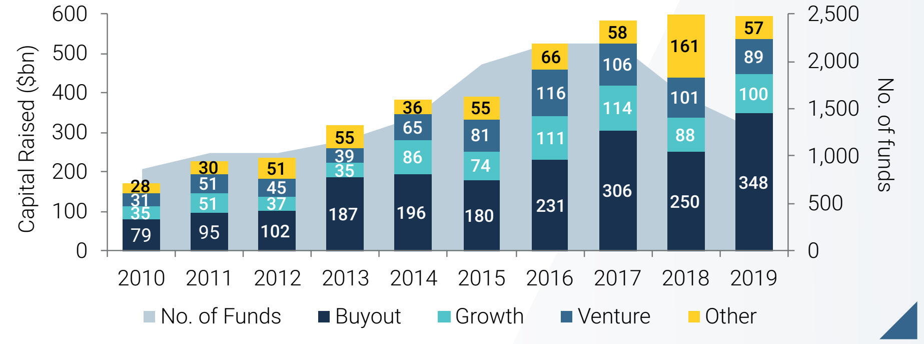
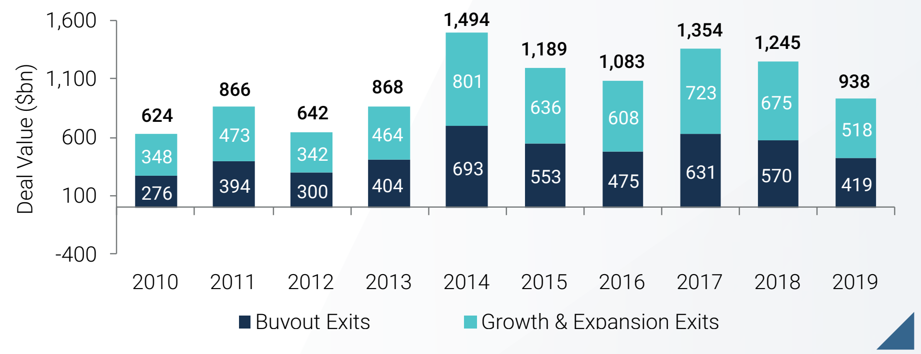


Chart 2: Global private equity exit volume. Data from pitchbook, 31 December 2019



Are there any new market dynamics in terms of dealflow?

Industry sectors are not created equal. There is a very big difference between technology-focused and tech-enabled sectors, as well as healthcare, online consumer services and industries benefiting from remote working, versus the hard-hit consumer discretionary, leisure, travel and hospitality segments. We expect to see more deals in the next six months in those areas that have been less impacted by the pandemic, building on a movement that was already underway before the crisis of GPs taking advantage of sectors undergoing a transformation due to digitalization and demographic trends.

In terms of the types of deals we will see, it is a fact of life that GPs that don't need to sell, won't sell. They will hang on to their businesses until there is a better exit environment. That probably means that secondary buyouts, which had been growing as a share of the market and accounted for the largest share of realizations by value in Q1 2020[4], will probably slow markedly. In terms of new activity, we are likely to see more take-privates, buy-and-build transactions and growth investing.

What does all of this mean for private equity investors?

Fewer secondary buyouts, coupled with an expectation of reduced M&A among corporate buyers and more volatile public markets, is likely to mean that there will be fewer exits in the months ahead. And that means there will likely be lower distributions to LPs.

Later in the year, if there is another downturn in public markets, LPs may also be worried about the "denominator effect". This is because falling public valuations push up the relative weightings to private markets, which in theory could have an impact on investors' ability to commit to new funds and result in some LP positions being sold on the secondary market.

However, before the crisis a survey by Preqin found that 95% of investors intended to maintain or increase their private equity allocations over the long term. And a recent ILPA survey found that the largest share of LPs surveyed – 30% – expected to make no change in their commitment activity. Just 12% were completely pausing on new commitments.

What is the outlook post-pandemic?

What those survey findings suggest is that investors and GPs have learned from the 2008/2009 Global Financial Crisis that steady deployment over a longer period in a long-term asset class like private equity is really the best way to go about things.

During the recent bull market from 2010 to 2019, the MSCI World delivered an annualized return of around 8.8%, versus 10.4% on average for private equity – and 19.8% for top quartile funds and managers. But during the bear market between 2007 and 2009, the MSCI delivered an annual return of -4.4% – and private equity outperformed the index on average by almost 15% for those vintages. The top quartile outperformed by more than 20%[2,5].

Obviously, we can't know how the current crisis will play out in terms of performance. But in a low-interest rate environment where investors are chasing after higher returns, the track record of private equity during difficult years may be compelling[2]. Investors will also take confidence from how the industry has responded to the disruption so far and the way in which it is positioned for the future. Our view is that with its superior governance model and focus on long term value creation and performance, private equity has the credentials to emerge strongly from the crisis.

Endnotes

[1] Data on fundraising and dealflow from Preqin, 1 June 2020. Data on exits from Pitchbook, 31 December 2019.

[2] Past performance is not indicative of future results. Future performance is not guaranteed and a loss of principal may occur.

[3] Pitchbook, 31 December 2019. Data reflects average (mean) LBO multiples of EV/EBITDA in North America and Europe.

[4] Pitchbook Q1 European Private Equity Breakdown report, published April 2020.

[5] MSCI All-Country World data from Bloomberg, 20 May 2020. Private equity data from ThomsonOne PE Index as of Q4 2019. Annualized public market return is on a total return basis. Private equity returns quoted are net of fees.

Biographies

Helen Steers, Partner

Helen leads Pantheon's European primary investment activity and chairs the European Investment Committee. She is also a member of the International Investment Committee and the Co-investment Committee. Helen joined Pantheon in 2004 from Russell Investments in Paris where she was Managing Director with overall responsibility for private equity in Europe. Prior to joining Russell in 1999, Helen spent five years as Director, European Private Equity with the Caisse de dépôt et placement du Québec. From 1989 to 1994, Helen was a senior investment manager at the Business Development Bank of Canada in Montréal. Helen received a BA and an MA in Engineering from the University of Cambridge and an MBA from the University of Western Ontario in Canada. Helen is a Past Chair and Council member of the British Private Equity and Venture Capital Association (BVCA). She has also served on the Board and LP Council of Invest Europe. Helen is a co-founder and Board member of Level 20, a non-profit making organisation that has been set up to encourage women to succeed in the private equity industry. Helen is bilingual in English and French. Helen is based in London.

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