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# Private equity flips its economic defibrillator

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With the heart-beat of the global economy stopping in unison on March 2020, the general public, government and financial services industry experienced a cardiac arrest caused by COVID-19, that saw immediate home schooling; stopped airplanes; oil prices plunge and Tik Tok become the new 'work'. A spectre of death caused sadness and hardship to many, later developing into a two speed economic effect as hotels, restaurants and clothing operations closed putting their workers into government pay schemes with reduced and uncertain salaries, back logs of hospital appointments and death tolls that pushed funeral services beyond their capacity. As this happened, the corporate world converted to WFH and continued in a 'new normal' of Zoom calls, experiencing a kind of indigestion that continues but with both sides having to switch to online services as customer demands, no matter the sector, shifted.

Andreas Rotheli, Head of Corporate and M&A, Lenz & Staehelin

Whilst this has been the short-term impact; the long-term impact is yet to be understood. Will it be a fundamental social and economic shift to a Big Society as predicted by Sam Bosanquet, Family Office Services Director at SandAire in a Citywealth Live YouTube Session? Will it lead to innovation and swift cuts of ailing businesses as new businesses emerge? Anecdotally companies are talking of reduced staff to operate in a more efficient, digital environment, court hearings and medical consultations are preparing for a permanent shift to digital, alternative lending, which has been carrying businesses through this period has triggered huge growth in the lending industry. We have also seen private equity moving into listed companies to help with restructuring and medium-term P&L stress. With COVID-19 still amongst us and fears of second spikes, how do we get a real time review? There have been comparisons to past historic events, like the 1920 Spanish flu but in the financial world the most recent 'poster boy' is the 2008 economic crash caused by a financial institutional melt down. Karen Jones, Editor, Citywealth, spoke to leading experts dealing with corporate M&A to ask their thoughts on the reactions and response they are seeing particularly in the private equity sector



## Will COVID-19 be the same as the 2008 crash in impact?

Ariel Sergio Goekman Davidoff, Lindemann Law

Is COVID-19 expected to resemble 2008? No, says Jon Kirk, Partner at Redburn who have supplied analysis and paid research to private equity houses for many years and whose minority stakeholder is investment bank Rothschild & Co, "The current situation is very different to the 2008 Global Financial Crisis for a number of reasons including that the financial system is far stronger, allowing it to act as a source of stability this time where it was the heart of the problem back in 2008. Also, policymakers now have a much more comprehensive set of tools for dealing with economic shocks, and they were able to deploy them much more rapidly. That has, in turn, meant that financial markets have bounced back faster and the availability of capital, in particular, debt, has also recovered much earlier. That said, in some ways the ultimate economic impact of the COVID-19 crisis is as uncertain now as it was then." Ariel Sergio Goekmen-Davidoff, who is a Partner of Lindemann Law in Zurich agrees with this sentiment saying, "I agree the repercussions are as yet unknown. COVID-19 has triggered a man-made crisis and we cannot fathom its extent in consumption yet." Ogier partner, Richard Daggett, who is Jersey based adds, "COVID-19 is certainly different. In 2008 the crisis was caused primarily by the financial system itself whereas this is an external crisis that has prevented the financial system operating normally. there is not the lack of credit seen during the 2008 crash, deals are ready to be done when the time is right. The other big difference we will see from 2008 will be in the timing. In 2008, PE firms, for instance, waited too long before acting and missed some of the double digit returns that fast movers could have enjoyed. Those lessons have been learnt and the best placed firms won't repeat those mistakes.

## Swift government intervention and pro-active liquidity

Laura Brunnen, Partner, Reed Smith

Laura Brunnen and Mark Sanders, Partners at Reed Smith say, “Although the huge uncertainty and immediate market reaction may have been similar to 2008/9, we agree with Jon Kirk that the world’s banks and financial systems are stronger and better regulated and managed than before. The Government reaction to the COVID-19 crisis has also been swift with financial support on a massive scale.” The key difference this time they say, “is the world’s financial system and investment funds will be able support economic recovery rather than needing help themselves.”

Mark Sanders, Partner, Reed Smith

## Not firing on all cylinders

Andreas Rötheli, Head of Corporate and M&A at law firm Lenz & Staehlin in Zurich says, “In 2008, the key was to know how far the shockwave of a financial crisis would go in the "real economy". In today's crisis, the "real economy" has been hit immediately by a sharp decrease in supply and demand, as a result of a lockdown which was close to global. The direct consequence in Private Equity is a massive attrition in the order books of operating portfolio companies and uncertainty on whether they will be able to supply when business is back. The question now is when can the "real economy" function at 100% capacity again? Although the negative effects of the Covid crisis may have been more abrupt than those of the 2008 crash, most governments have taken measures aiming at mitigating these negative consequences and, provided that certain conditions are met, the economy may well reboot as suddenly as it crashed. That being said, PE funds have done rather well in the 2008 crisis and will likely have a satisfying performance also in the COVID-19  crisis.” , Richard Daggett agrees “From our discussions with PE firms and their advisors, we anticipate that they are well-placed to take advantage of targets at deeply discounted prices at the right time. Dry powder or cash reserve, has, in many cases, already been raised for these acquisitions.”

Andreas Rotheli, Head of Corporate and M&A, Lenz & Staehelin

## Capital calls in COVID-19 times

The cash available in Private Equity funds is by all reports bountiful, “after a period of record breaking fundraising activity coming into 2020” say Laura Brunnen and Mark Sanders, at Reed Smith but even bounty can have its limits, will the businesses feel the draft of their PE investors as the economic downturn really bites?

Rötheli at law firm Lenz & Staehlin, says yes. “Although PE investors continue to hold substantial amounts of cash, dry powder is not unlimited as many portfolio companies concurrently need more cash, some of them for several months. We should also not discount the possibility that foreign investors and most PE investors in Switzerland are foreign, especially those from across the Atlantic, may be drawn to their domestic markets for some time”. Suggesting that global PE investment will also re-nationalise even if temporarily. Kirk of Redburn agrees with Rötheli’s view. “The industry does have large amounts of dry powder, but they naturally have to be mindful of the returns they can deliver to their investors and other fund constraints. The idea that GPs (private equity partners) will bail out any and all distressed businesses that they own is unrealistic. They will be making the same decision as any investor would, by assessing what return will be made on the capital that’s injected. When it comes to new investments, typically periods of acute distress unearth new investment opportunities: new business models, companies that are well placed to adapt and thrive but lack capital and have more realistic valuations. That’s when the industry’s dry powder will really come into its own.”

Richard Daggett, Partner, Ogier, Jersey

Daggett at law firm Ogier sees things slightly differently, “The ongoing investment by funds into their portfolio companies is what generates the long term returns on exit. However, that use of dry powder is not always about the growth of a company, sometimes it's about keeping that company going during tough times. For those PE firms invested in sectors that are particularly suffering like hospitality, travel and retail, there decisions will need to be made as to where suitable triage or treatment can be administered when there are a large number of patients. This will be for companies where there are good long-term prospects. Where the patient is beyond help, then it would be a case of good money being thrown after bad. It means investors will be analysing their portfolio with a fine toothcomb to determine which approach to take. Effectively used dry powder now on a company in difficulty but with strong fundamentals is money well spent.”

## A grown-up private equity industry

Laura Brunnen and Mark Sanders, Partners, Reed Smith add that “Despite the bad news, even after the growing impact of the COVID-19 pandemic was seen around the world, private equity fund managers have continued to close large fundraisings,” and make an insightful point. “The private equity industry itself is not in triage, although individual firms may have been in triage mode with their portfolio companies in recent weeks to identify the businesses most affected by COVID-19. They are implementing financial and operational strategies for those companies but since the global financial crisis of 2008/09 many private equity firms have increased their focus on building better businesses and portfolio company operations. The combination of funds already raised and focus on portfolio company operations will mean private equity firms are ready to face a downturn and support their existing portfolios.”

## Government intervention for tourism

Rötheli shares an aside thought. “Although there is plenty of dry powder and the measures taken for instance by the Swiss government have kept the tourism industry under artificial respiration during the lockdown, this sector has been hit very hard by the COVID-19 crisis and the lockdown.

Although the hospitality business will start getting back to semi-normal activity as the situation eases in an environment of travel restrictions and cost reductions for companies, Swiss hospitality, and global hospitality, will likely be confronted by the absence of foreign business and leisure travellers. Governmental measures may then need to be taken to reduce defaults."

## Extended timelines for flips

Creating value for investors is one of the remits for private equity during a certain time period, so as a large amount of investments mature, how does the private equity deal with this as restructurings and re-negotiations hit business, therefore making their usual exits unavailable?

Brunnen and Sanders of Reed Smith say private equity investors will reconsider their target returns on existing investments and that exit timelines will be extended. "Private equity is a long- term strategy," say Brunnen and Sanders, "and so we do not expect to see forced sales. Investors will support their portfolios and wait until the current uncertainty stabilises and they are better able to forecast recovery and future performance. Investors will want at least to put in place a clear recovery strategy before seeking an exit. They may face a crunch with fund vintages approaching the end of their cycle and LPs or investors expecting distributions. We see private equity firms approaching this proactively and, in particular, considering secondaries or other routes to realise value or to amend LPAs (investor agreements) to extend the life of a fund and facilitate a longer hold period to see them through."

Rötheli expects the same. "Exits will inevitably drop as PE sellers will wait for their portfolio companies to recover. According to a recent survey, 80% of PE houses said that they will not sell their holdings over the next year. They will thus not sell unless they really have to. That being said, PE investors hold a mature group of assets that would normally be up for sale, so we may see sales increase sharply as soon as market conditions improve."

## Govt liquidity relieves cash stress

Jon Kirk, Partner, Redburn

Kirk, says, despite the COVID-19 panic, the PE market is steady. "PE capital is far more patient and mandates are often extended and so are far less likely to have to sell assets against their will than, say, public equities investors who may become forced sellers as a result of losses. The difference from 2008 is the markets are being flooded with liquidity by policymakers, so there is less pressure for investors to sell assets to meet cashflow obligations."

## The rise of lending

One area of finance that has seen substantial headway in the last few years is private lending and this has taken on a new headwind during COVID-19. Jon Kirk comments. "It's hard to know for sure how the private lending market will develop but we can expect private credit investors to be as innovative and bespoke as ever in what they can provide to their clients." Sergio Goekmen-Davidoff is more effusive. "Anything will go. If in distress, current owners are willing to accept deals which allow them to see the light." Brunnen and Sanders add, "There are now more types of institutional and alternative lenders than ever before, which means borrowers have a wider choice of potential refinancing options. We are seeing alternative lenders and credit funds increasingly looking for equity upside in their deals. As well as taking a secured lender position, they will want to participate in the returns generated by the recovery of the businesses they support. We are seeing requests for convertible instruments, warrants or other subscription rights, with equity-style shareholder rights alongside typical lender terms under the loan documentation."

## Where next?

With PE houses holding steady, some fast and furious portfolio housekeeping, less sales but pent up cash, are there any opportunities to invest or is it navel gazing for now? Kirk anticipates growth in listed companies "a strong possibility that PE houses will be stepping in to buy out, or perhaps provide capital to, listed companies whose medium term prospects are good but where a lengthy period of restructuring and P&L stress will have to be endured first. For similar reasons, PE could play a significant role in the consolidation of more distressed, now over-supplied industries where demand has been permanently impaired."

Sergio Goekmen-Davidoff expects opportunities in, "consumables, luxury, travel and businesses that are connected to them like real estate." He adds other areas of distress are expected to be hotels that newly opened before COVID-19 or are ongoing builds like luxury resorts especially in Italy and Spain." Brunnen and Sanders agree, saying, "We are already seeing distressed deals in retail, leisure, travel and some areas of manufacturing."

## SME and listed company opportunities

Rötheli at Lenz & Staehlin sees smaller targets. "In the short term, interesting opportunities may sit in large SME, which have not built sufficient cash reserves and are in dire need of liquidity" This is a sentiment Brunnen and Sanders agree with. "We believe that initial buying opportunities for private equity investors will be in bolt-on acquisitions which means clipping on smaller companies to add them to existing portfolio companies rather than new deals. There are likely to be opportunities for portfolio companies to acquire competitors or expand strategically with depressed target valuations. We think it will take longer to see entirely new deals. Investors are finding new ways to diligence and complete transactions in a remote-working world, but we expect deal timetables to extend and investors are likely to wait for more valuation certainty before committing to substantial new investments." As per Kirk's comments above, the pair agree with a strong move from private equity into listed companies. "We are anticipating an uptick in "PIPE" transactions (selling stocks or shares to private investors) as these companies seek alternative sources of liquidity and investors look to deploy capital. This will be helped by temporary pre-emptive issue thresholds which means that listed companies can issue more share capital than usual without a rights issue in the UK following the recommendations by institutional shareholder groups, increasing investments to 20% from 5%."

## Re-visiting deals

Ogier partner Richard Daggett thinks some re-runs of passed over investments may occur. "Investors may well be re-examining deals they considered too expensive just months ago. However, there is no use in pursuing a deal for a target simply because it is now within the investor's price appetite. Careful analysis will need to be undertaken to ensure any acquisitions can still be considered viable in a post-COVID-19 world. It will be quality over quantity."

## Further warnings ahead

Rötheli warns though that, "There has been a substantial contraction on deal making in the last two months and even though private debt funds, have emerged since the last crisis who may now be able to put substantial capital to work, competition will very likely weaken as strategic buyers hold onto their cash (to the benefit of private equity). We also expect that leverage levels or borrowed money for buyout deals will drop."

## Take-away; My way or the digital highway

As the effects of COVID-19 have bedded down it has become clear that many business models are being challenged by fear, the rapid change in demand and consumers tougher views which are being openly expressed on social media and picked up by the news. One big change has been restaurants, schools and supermarkets adapting to online delivery which has seen a mixed response for various reasons including a trend for smaller operations to adapt rapidly whilst larger corporates struggle with staff and tech. Despite this, Brunnen and Sanders, say that the private equity world looks good. "The long-term view taken by private equity investors, with available committed capital and increased support for portfolio company operations means private equity backed businesses are well placed to weather any downturn and Ogier partner Richard Daggett agrees. He says "amongst the panic, stress and distress caused by COVID-19, he has seen rapid redeployment and flexibility with cash. "We have seen examples of portfolio companies hugely benefiting from PE-backing during this time because of their ability to scale up quickly through investment and to take advantage of a large surge in demand because of the lockdown like home crafts, food delivery, home physical exercise and tech-focused companies taking advantage of our move to living, working and socialising through screens. There was swift deployment of dry powder in recent months to avoid missing any opportunity to profit during the sharp spike in demand for their services."

## Steady recovery

Andreas Rötheli, Lenz & Staehlin summarizes the current concerns, at top of mind, for private equity houses going forward. "The three main drivers will be finding new investment opportunities, based on post COVID-19 valuations and parameters; discussing with lending institutions some, temporary, flexibility as regards financing ratios where financing are in place and finally renegotiating transaction terms and conditions where deals are not yet signed or closed."

Whatever the financial outcome of COVID-19, it seems the private equity industry, despite substantial dry powder is experiencing triage and shock with the rest of the world but it has learned hard lessons from the 2008 contraction and built in future proofing. It seems the private equity industry is not having a cardiac arrest but instead a visit to a Harley Street health clinic for a check-up and who knows if, once they have reconfigured, they may end up being a COVID-19 life saver for others?

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