PitchBook

COVID-19's Influence on the US PE Market

How GPs and LPs are dealing with the recent economic crisis

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Key takeaways

- In the near term, GPs will be mostly focused on keeping portfolio companies afloat amidst the economic tumult created by the spread of COVID-19. As more is understood about the full effects of this pandemic, we expect GPs to pursue PIPE deals, growth equity transactions, and carveouts and divestitures in greater numbers.

- GPs are likely to hold portfolio companies during the pandemic rather than sell at deeply discounted prices. In past economic crises, such as the global financial crisis (GFC), PE firms chose to hold and median time to exit leapt by several years. We believe GPs will utilize GP-led restructurings to keep portfolio companies under their ownership, even if it is near the end of a fund's life.

- Fundraising has already slowed markedly and looks to continue this trend for another two quarters. Multibillion-dollar funds are expected to find continued success with an established LP base. However, nascent managers, spinouts and new strategies are unlikely to find success because of LPs' current due diligence limitations.

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Overview

Because PE is in many ways a levered bet on future economic growth, current portfolio companies will likely experience serious economic carnage stemming from the COVID-19 fallout. In addition to keeping themselves and their families healthy and safe, most GPs are focused on keeping current portfolio companies afloat, rather than sourcing new opportunities. Assistance may come in the form of additional equity infusions, short-term bridge financing or government-backed loans to small and medium businesses,[1] but layoffs, bankruptcies and lower returns will almost certainly come as a result of the slowdown. The median buyout in 2019 was done at 5.5x debt-to-EBITDA. Conservative estimates put Q2 2020's GDP decreases at around 20% on an annualized basis, which could easily put many sponsor-backed businesses in double-digit debt-to-EBITDA for at least a quarter or two in 2020.

Moving to future investment opportunities, there are a few distinct ways we believe PE funds will capitalize on the current environment. First, there are likely to be more private investments in public equities (PIPE) in the near term, particularly as cyclical businesses look for cash when credit is hard to come by. Many PE firms, such as KKR and Apollo, can invest quickly from their own balance sheets and may be able to secure substantial stakes in publicly traded firms, which tend to experience valuation declines more quickly and more severely than those in private markets. Though full-blown take-privates in the near term are unlikely due to the difficulty of gaining shareholder and regulatory approval in such uncertain times, we are likely to see PE funds build toehold positions in publicly traded firms in preparation for take-privates once the dust settles.

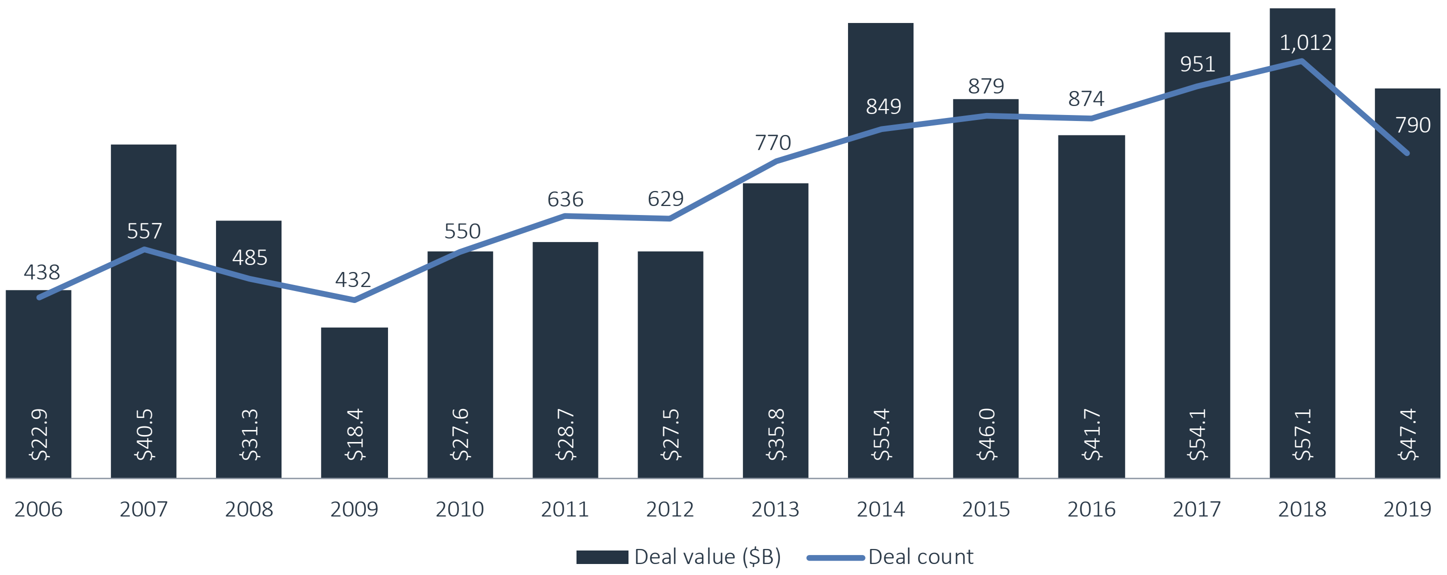
Second, we expect growth equity deals—which had already been on the upswing—to become a much-needed source of financing in this difficult time. Though there may be less (or more likely, negative) economic growth in the short term, minority stake equity investments—"cash infusions"—in private businesses will allow PE firms to deploy capital at attractive prices without the need to secure new debt financing. Third, we anticipate additional deal flow to come from carveouts and divestitures from conglomerates that were too acquisitive in recent years and are willing to part with non-core businesses in exchange for cash.

While LBOs remain the bread and butter of PE, how these deals will be financed in a stressful environment remains a serious question. If past downturns are any guide, PE firms will use more equity in these deals to get them across the finish line. In 2008, median equity contributions were 42.9%, but skyrocketed to 60.1% the following year. However, the saving grace for PE firms hoping to finance buyouts in this downturn will be the (relatively) recently emergent private debt industry, specifically direct lending funds. Currently, a higher proportion of LBO financing comes from dedicated

[1] Though early indications are that the US stimulus bill will not apply to sponsor-backed companies if the sponsor's total portfolio employs more than 500 people.

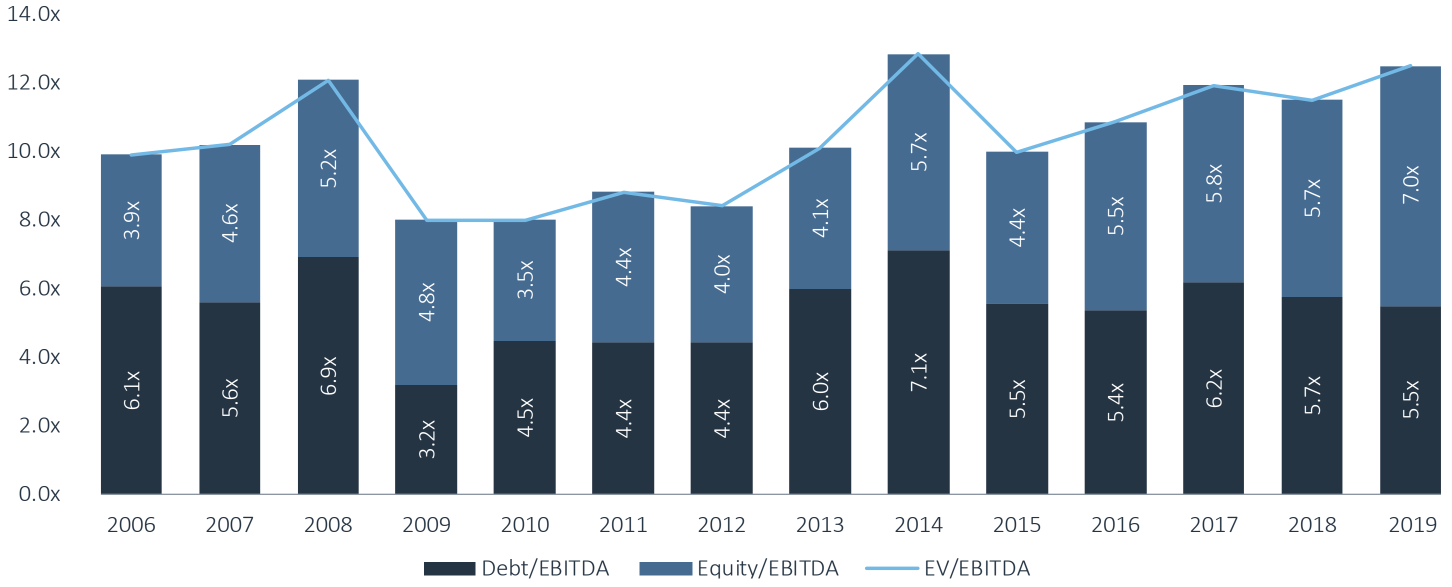
direct lending funds (as opposed to banks) than a decade ago. Private debt funds are sitting on $241.4 billion in dry powder globally as of Q2 2019 and are more likely than banks to continue investing through a downturn. As such, we don't expect debt financing for LBOs to dry up to the same extent it did during the GFC. However, the largest deals still rely on bank-arranged syndicated leveraged loans, so those may be more affected by a credit crunch. While we expect a reduction in LBO activity as GPs favor the aforementioned strategies, buyouts will continue to be a mainstay in private markets once volatility subsides.

Growth equity deal activity



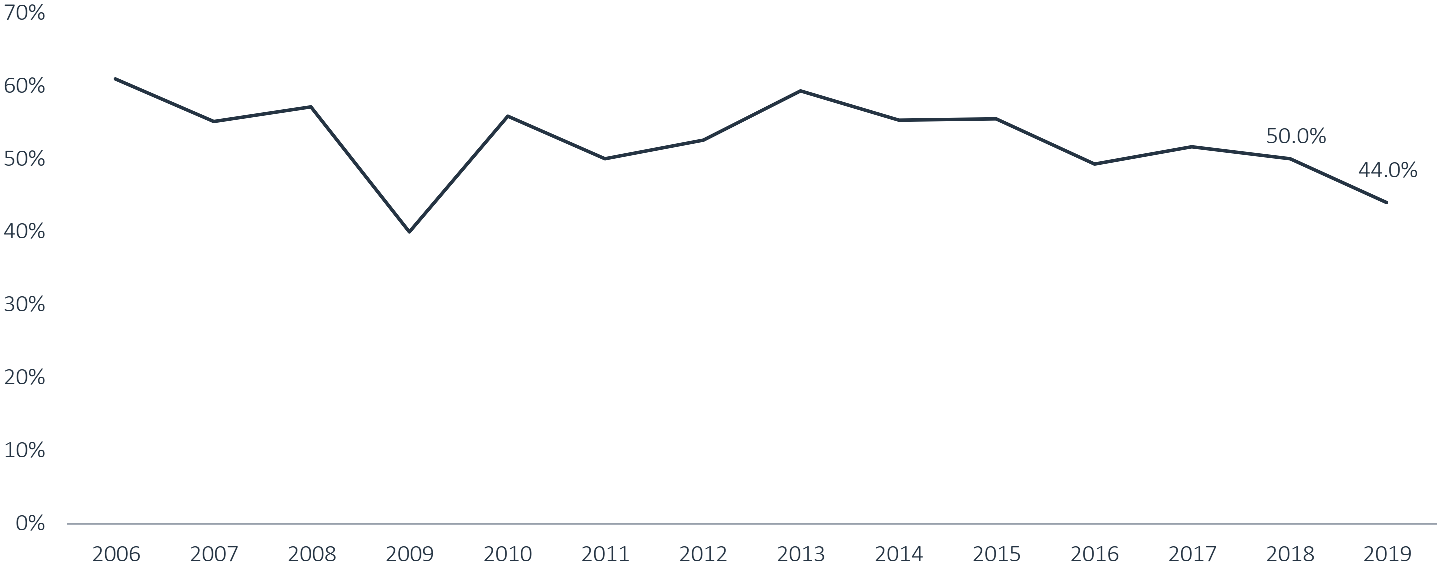
Source: PitchBook | **Geography:** US

Median EV/EBITDA buyout multiples



Source: PitchBook | **Geography:** US

Median proportion of debt in PE buyouts



Source: PitchBook | **Geography:** US

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Exits

Exit activity is likely to see a substantial deterioration in 2020, continuing a multi-year trend. On the sellers' end, a freefall in public equity markets and on valuations in the private secondaries market show markdowns between 25% and 40%, and in some cases more. GPs loathe to see years of growth during an economic boom disappear in a few weeks' time and are unlikely to commit to an exit process at current pricing levels. Potential buyers are also hitting snags. With so many GPs in "wait and see" mode, exits via sponsor-to-sponsor transactions are likely to slow to a dribble. This impact will be outsized because currently more than half of all PE exits are to other PE firms. Strategics, too, are pausing because it is so difficult to perform due diligence via video conferencing, let alone complete on-site visits, with most companies banning business travel. IPOs are also out of the question with public indices down by a third[2] and volatility spiking to the highest readings in a decade. Across the board, exits will be delayed until we see a recovery in asset prices and economic fundamentals.

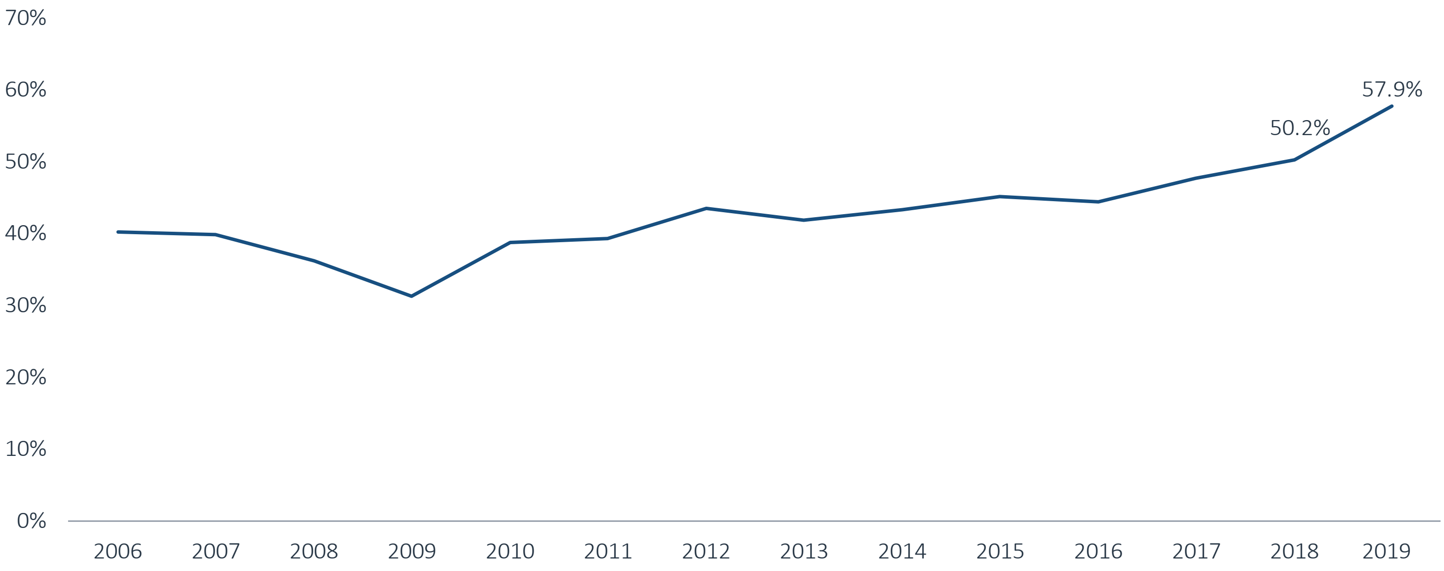
We expect the delay for exits that have already been negotiated and are further along in the process may be limited to weeks or a couple months. However, transactions in more preliminary stages are likely to be pushed out six months to a year or more, depending on the circumstance and how long this crisis persists. This is not unprecedented, though, with holding times steadily rising after the global financial crisis. Between 2009 and 2014, median US PE holding times expanded from 3.7 years to 6.2 years as GPs held on to battered companies and took extra time to enact value creation measures and ride the economic expansion, eventually selling in a more amenable environment. Extending holding times is likely to further punish funds that invested heavily leading up to the crisis because IRR rewards speedier returns of capital. Pre-crisis funds—especially 2005–2007 vintages—performed dismally; holding periods stretched far beyond what GPs had modeled and it took years to recover losses. We expect 2015–2018 vintages to be the most negatively affected by the pandemic, as it comes at a time when many of these funds would traditionally be looking to exit portfolio investments.

The dearth of exits will affect funds differently depending on their age. For younger funds (e.g. 2017-2020 vintages), the impact will likely be milder as they hold and potentially reinvest in their portfolio companies. Middle-aged funds (e.g. 2014-2016 vintages) will be hit harder, and the effects may be felt down the road because many funds in this phase of life begin thinking about their next fund. These funds often choose to liquidate some of their early winners to show healthy DPI and IRR figures to LPs looking to reup or commit for the first time, but now these GPs will be forced to hold. And funds at the tail end of their lives (e.g. 2013 vintages and earlier) will likely be hit the hardest because they have less optionality around holding assets longer. Some of these funds may be running up against the clock and approaching the end of their contractual fund lives. In these cases, GPs may be forced to provide liquidity despite their desire to hold. For these reasons, we expect to see a further boost in GP-led secondaries transactions during this time, whereby the GP rolls one or more portfolio companies into a

[2] As of March 23, 2020.

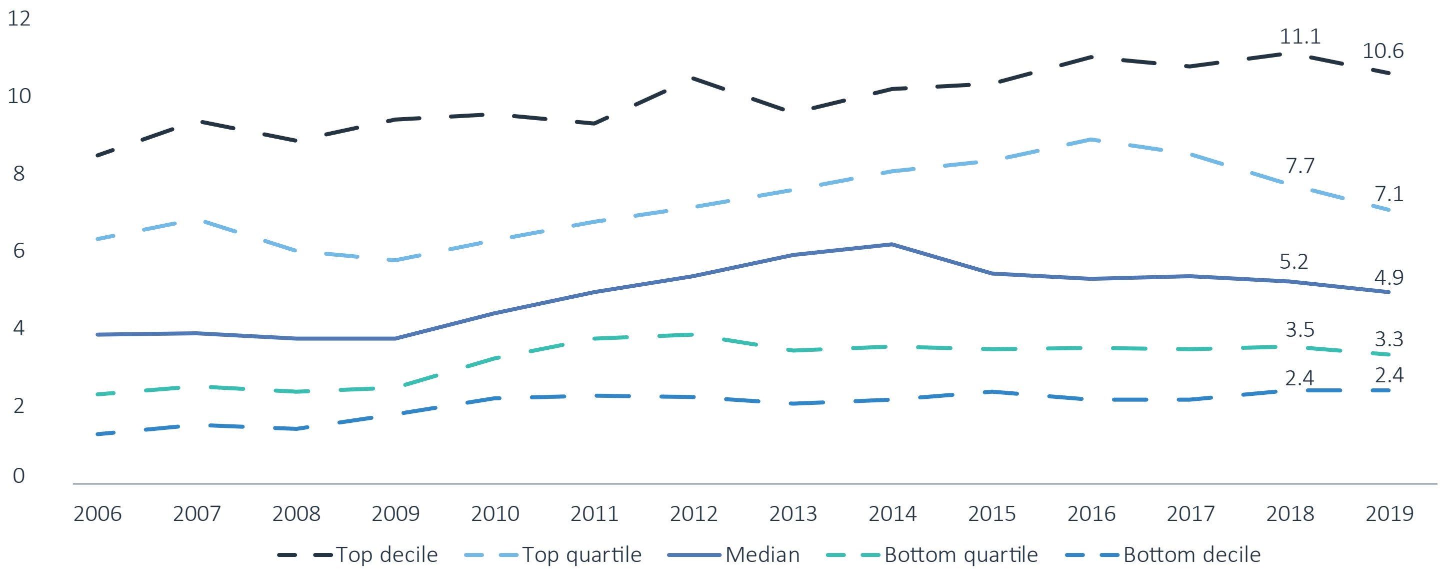
special purpose vehicle (SPV). This offers LPs a liquidity option and gives the GP another three to five years to manage the portfolio. These transactions have already become the norm for GPs looking to extend holding times for their top-performing holdings, and the current environment bodes well for an uptick in their usage. Overall, LPs should expect fewer exits leading to lower distributions from PE funds in the coming quarters.

Proportion of PE exits (#) to other financial sponsors



Source: PitchBook | **Geography:** US

Quartile and decile distribution of buyout holding periods (years)



Source: PitchBook | **Geography:** US

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Fundraising

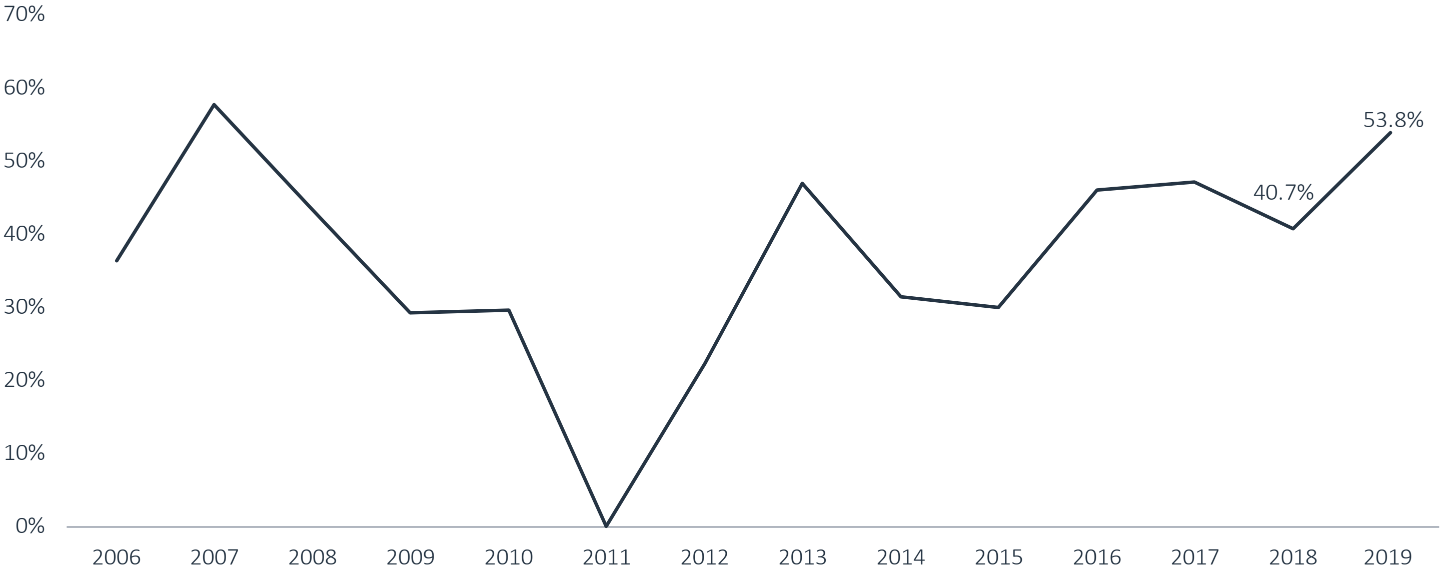
We expect this to be a difficult time for most firms fundraising, though the impact may not be seen in the data until Q2 and Q3 2020. LPs that had already completed much of their due diligence checklist and mapped out new commitments are likely to follow through. Additionally, mega-fund managers, such as Silver Lake and Bain Capital, can secure capital for new funds with their current LP base. With PE mega-funds ($5 billion+) accounting for more than half of the fundraising total last year, we believe overall fundraising numbers will fare better than if this crisis hit even just a few years ago.

Although mega-funds are likely to find continued success, most GPs trying to raise funds will be engaged in a Sisyphean struggle in the current environment. Fresh fundraising for middle-market GPs will prove difficult as most LPs are pushing these decisions out several months. For first-time funds and nascent managers without an established LP base expecting to begin the fundraising process during this crisis, we expect raising capital will prove to be a nearly impossible task. Additionally, funds trying to return to the top quartile or break in for the first time will be hit especially hard. In this environment, LPs are putting their energy toward triage and assessing their current holdings rather than committing to new funds. As discussed earlier, those hoping to turn paper gains into realized profit and prove their value to LPs will need to be patient; trying to win over new LPs without completing a couple of successful exits is a moot point.

The already difficult task of fundraising in the current environment may be compounded because of second-order effects in LP portfolios. With public equities down by 20% or more across the board, the denominator effect[3] may come into play when LP portfolios rebalance at the end of Q1 2020. Although this time will be different. Most LPs learned their lesson from the GFC and adjusted portfolio targets to encompass a wider range and to give them a quarter or two of buffer time before selling fund stakes. Further, many institutional investors are currently underweight their target allocation, muting the impact. The denominator effect, to the degree it does come into play, is likely to cause LPs to pause new commitments rather than exit current funds. In addition, distributions are expected to dry up because recaps cannot be financed, and GPs are not selling portfolio companies at deeply discounted prices. As many LPs expect to recycle distributions back into the strategy, we may see LPs think about future liquidity needs and forego committing to new funds—capital calls from their current fund commitments may be all they can handle. Industry wide, cumulative capital raised may not dip as much as anticipated as LPs commit to funds that have been through the diligence process months ago, though most firms will struggle to raise capital at this time.

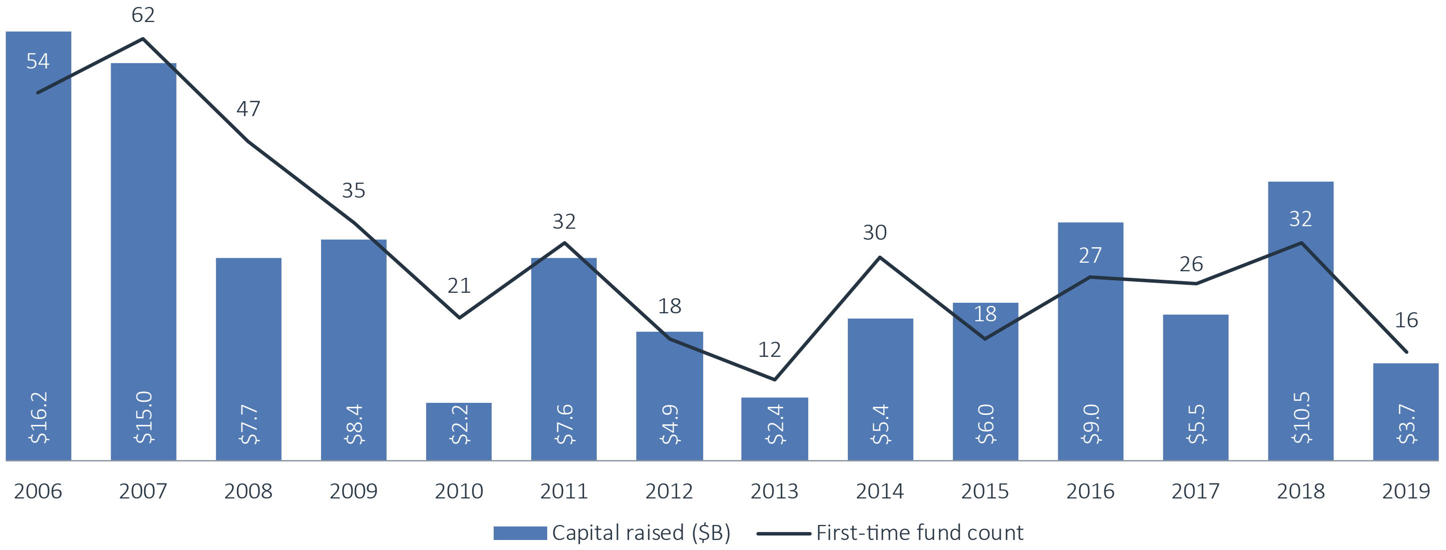
[3] 3: The denominator effect may occur because public equities, which are usually the largest allocation in many institutional portfolios, dropped substantially. This causes portfolio weightings to shift as private market valuations can lag by several quarters. In many cases, PE allocations may go from underweight or at target weight to overweight, causing LPs to pull back allocating to new funds or to liquidate some current PE funds on the secondaries market.

Proportion of mega-funds ($) compared to overall



Source: PitchBook | **Geography:** US

First-time fundraising activity



Source: PitchBook | **Geography:** US