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In focus

# How can private equity investors ensure capital is put to work through the Covid-19 crisis?

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## The Covid-19 crisis may interfere with the steady deployment of private equity capital. Investors will need to evolve their traditional view of the market to keep their money working as hard as possible.




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Covid-19 has brought economies around the world to a standstill, and private equity deals have not been immune to the market slowdown. Global mergers and acquisitions (M&A) and private equity (PE) deal volumes have declined meaningfully in 2020, forcing investors to evaluate how to best allocate capital in an unprecedented market environment.

Consistent deployment of capital in private equity portfolios across market cycles is important, and a contributing factor in its strong long-term performance. Private equity often thrives in times of disruption, as it has the flexibility to take advantage of complex situations. Some of the best private equity vintages followed the global financial crisis (GFC) in 2008/2009, during which private equity funds deployed capital over the course of a cycle at relatively lower valuations.

If traditional private equity opportunities do not materialize in the near-term, what options do limited partners (LPs) have in putting capital to work?

### Private equity alternatives in the current market environment

Private equity deal flow has been meaningfully impacted by the economic aftershocks following the pandemic lockdowns. Valuations are declining, M&A activity is stalling and the capital markets are tightening, causing general partners (GPs) and LPs to seek out alternative forms of capital to triage their portfolios. Secondaries have proven to be a flexible capital provider across market cycles, and are well-positioned to take advantage of dislocations and liquidity requirements in the current environment.

Dropping valuations result in more attractive entry points for investors, particularly secondary buyers who are purchasing off valuations from prior quarters. While secondary activity has slowed during H1 2020, due to the widening of bid-ask spread between buyers and sellers amid speculation on further portfolio write-downs and market volatility, the consensus is that volumes will rebound in the latter half of the year when those dynamics stabilize. Secondary investors then will be acquiring private equity portfolios at lower valuations, even if optical discounts end up in-line with pre-crisis levels.

The slowdown in M&A activity will encourage GPs to seek out secondary solutions. Portfolio companies may require additional time and capital to re-grow, and secondary investors will structure GP-led transactions to provide that additional runway for a manager to maximize value across a given pool of assets. GP-led opportunities have been the fastest growing segment of secondary volumes, and we expect this trend to continue in the current market environment.

The capital markets have yet to re-open fully, and the cost of any asset-level financings is currently high. GPs are turning to the secondary market to provide fund-level solutions, ranging from preferred equity structures to NAV facilities, depending on the risk profile, strategy and diversification of the portfolio. We have seen an uptick in these opportunities, which we expect to continue for the near-term. However, sponsors will eventually revert to raising traditional forms of financing via the capital markets when they become more accessible.

The landscape for secondaries, primaries and co- investments has become more intermingled, and GPs have increasingly utilized all of these strategies to raise capital at the fund – and asset-levels. With a focused and proactive approach to deal sourcing, we believe there are opportunities which will provide different cash flow characteristics and ensure consistent deployment across market cycles.

### What will opportunities look like in the current environment?

The key deal types we believe will be the most relevant for LPs to ensure capital deployment in the turbulent market environment are the following:

- GP-led secondary transactions
- Late primaries
- Co-investments
- Structured solutions
- Select LP secondary sales

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## GP-led secondary transactions

The rise in GP-led transactions started post GFC and reached one-third of the overall secondaries transaction volume in 2019. Initially, GPs aimed at restructuring challenged portfolios held for longer periods beyond the legal term expiration of a fund (so called 'zombie' funds). Over time, GPs have increasingly utilized secondaries as a tool to provide additional time and capital to maximize value for a portfolio, including higher quality assets, while offering liquidity options to existing LPs. GPs have also pursued single-asset solutions for their funds alongside secondary investors. These transactions provide an exit alternative for a select portfolio company while creating runway for the GP to further maximize value.

Given the decrease of valuations in Q1 2020 and uncertainty around further market volatility, GP-led transactions have currently been on hold. GPs are primarily using the secondaries market to provide capital injections to their portfolio companies, and such transactions typically include some form of structuring, offering minimum IRR and multiple returns to capital providers. GP-led secondary activity is expected to resume later this year, along with the broader secondary market, as valuations normalize and investors have a stronger sense of portfolio company performance on a go-forward basis. Sponsors will likely seek longer holding periods, as more funds will have entered their 'harvest' or 'extension periods'.

We also expect to see further flight to quality, in which local and longstanding GP relationships will be increasingly important. GPs prefer to work with trusted LPs to ensure transaction execution speed and certainty. Schroder Adveq has already received a number of inbound opportunities for potential transactions alongside sponsors, given its local footprint and strong GP network globally.

## Late primaries

Late primaries are another strong tool within a portfolio. Late primaries minimize and can eliminate the 'J-curve' by putting capital to work quickly. After the GFC, Schroder Adveq was able to take advantage of situations where GPs had started investing before the crisis, but had not yet held a final close.

Regardless of the economic environment, Schroder Adveq is always tracking late primaries and expects interesting opportunities with funds whose investors have fallen away from the final close. Here, investors can either increase their commitment in a fund, having participated in an earlier close, or enter the fund in the final close with increased visibility on the portfolio with assets in the ground on day one. In addition, we believe there will be opportunities to acquire LP interests in funds that began investing before the pandemic but still have large open commitments. LPs seeking a release of drawdown obligations present opportunities to acquire such positions at attractive prices.

## Co-investments

Co-investment dynamics today are taking on similar dynamics from those in the GFC, in which GPs prefer to work with LPs they know well that can act quickly. We maintain close relationships with all our GPs, which has generated favourable and proprietary deal flow for consideration. In addition, given the majority of a co-investment commitment is invested at the closing of a transaction, the J-curve is shortened for a portfolio, which is valuable during times of slower deployment more broadly.

We expect to see a range of co-investment opportunities, including but not limited to companies needing more working capital for growth, strategic M&A or quality assets with modest cash flow needs requiring additional time to generate value creation. In some cases, co-investment opportunities will look like GP-led deals, and in many cases, the GPs may implement structured solutions.

## Structured solutions

Structured solutions come in the form of LP and GP-led transactions and the structures range from preferred equity, earn-outs, joint-ventures, and NAV financing. The idea of a structured solution is for an investor to provide capital for a portfolio, which has substantially higher value than the structured investment, and then to receive a disproportionate share of cash flows until a given minimum return is achieved. The seller retains the vast majority of the upside, benefitting from the uplift in future valuations and exits. Structured solutions thus offer liquidity to LPs or GPs without the need to sell the portfolio at potentially steep discounts.

We have recently seen such opportunities through our network and executed several attractive structured transactions, as GPs have been looking for capital injections for their portfolio companies as a result of the pandemic. We expect to see a range of these opportunities going forward, although the structured capital injections will be available for a limited time period of distress and lack of bank financing. The structured transactions are in many cases open to existing investors only and a broad network of GP relationships is paramount for successful deployment of capital in such transactions.

## Select LP secondary sales

LP interest secondaries have always been a driver of transactions across market cycles. In 2019, even with the rise in GP-led transactions, LP sales continued to account for two-thirds of market volume. The current environment should provide more interesting LP opportunities to acquire exposure at attractive entry points as assets are repriced.

## Secondary market evolution since the GFC

We often receive the question how the current environment is similar to or different than the GFC for secondary investors. They key observations are: capital availability, market sophistication and adoption of secondaries as an asset class.

The secondary market today is much larger than it was 10 years ago. At the end of 2019, secondary deal volumes rose to a record $88 billion vs. less than $20 billion prior to 2010. The investor universe has also expanded and become more sophisticated. Prior to the GFC, there were less than 30 active secondary investors, and transactions often took the form of LP sales. Sellers were distressed, requiring liquidity to right-size their portfolios. Now, sellers utilize the secondary market as a portfolio management tool and are open to a wide variety of structures, including GP-led situations, single-asset sales, preferred equity structures, NAV financings, deferrals and earn-outs. Furthermore, secondaries emerged from the GFC as a flexible asset class, providing liquidity to funds when the capital markets had shut down indefinitely. Secondaries also were the natural solutions for financial institutions, which were forced to sell their private equity exposure due to regulatory compliance following the GFC. All of these factors fuelled growth for secondaries over the last ten years.

As mentioned above, the bid-ask spread between buyers and sellers widens in uncertain markets, as most sellers are not ready to liquidate at heavy optical discounts. This occurred in the GFC, causing secondary volumes to drop by 50% in 2009 but rebound the following year to pre-crisis levels. The effect in the GFC was more severe than it has been in the current environment, as many investors then did not know when the market would bottom out. The banking system is more stable now and the public markets have been more resilient to date. Investors anticipate that deal flow will return to pre-pandemic levels more quickly this time around.

The denominator effect also drove seller volume in the GFC, when LPs were overallocated to private equity. There had been a meaningful lag in private equity valuation adjustments, and investors placed a premium on liquidity, particularly with levered portfolios. This time around, NAV adjustments are quicker and LPs have more flexibility around their mandates.

### Complexity needs experience, experience means trust

We have evaluated and executed a number of interesting investment opportunities resulting from the pandemic and expect many more to emerge. We believe it will be important to consider a variety of opportunities and structures to continue investing across market cycles. Given the complexity of deal dynamics and evolution of the secondary, primary and co-investment markets, coupled with availability of GP-led situations, late primaries, structured solutions and select LP secondary sales, we believe there will be a number of interesting opportunities for investors to evaluate in the current environment.

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