Private equity edition

Global Capital Confidence Barometer

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How does private equity find clarity in the midst of a crisis?

Addressing the "now" is critical, but anticipating the "next" and "beyond" is the optimal response to COVID-19.

The better the question. The better the answer.
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Why PE firms are well-prepared to recover and resurge from this crisis

Lessons learned from the Great Recession help position PE firms to support companies in a time of massive disruption.

Private equity (PE) firms have been preparing for some sort of recession for the last several years. However, few could have predicted the economic impact of a global pandemic. As PE firms wait to see what shape the economic recovery takes, they remain confident in the lessons they learned from the Great Recession more than 10 years ago, and in their ability to adapt and respond to today's challenges.

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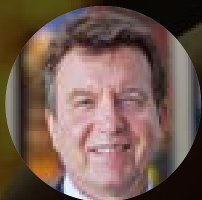
During the global financial crisis, PE firms missed an opportunity to put more money to work. The PE model has evolved since then. Will PE make the same mistake again?



Andrew Wollaston
Global Private Equity Transactions Leader

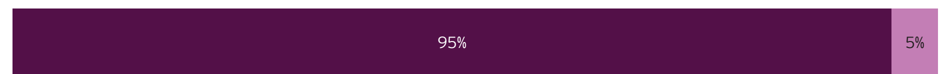
With a sharp market contraction and looming recession, PE firms consider their options as they plan for a post-pandemic world.

In February 2020, the longest bull market since World War II was losing steam and a number of macro indicators were suggesting an impending economic downturn. According to the results of the latest EY PE pulse survey, 40% of PE firms were modeling a recession to hit sometime in the year. An additional 16% reported they were modeling a recession to hit sometime in 2021. However, by mid-March, we were watching an erosion of confidence in real time. As the global scope of the pandemic crisis became known, the proportion of respondents anticipating a recession in 2020 jumped to almost all (95%).

Q Are you including a potential 2020 recession in your investment models?

Before COVID-19 impacted the market (Feb 10–26)

After COVID-19 impacted the market (Mar 12–24)



Yes No

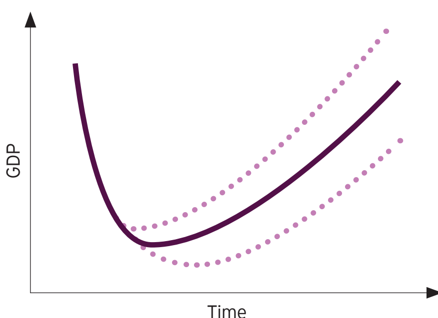
Two months later, all PE firms are responding to what's evolved into one of the most dramatic and deepest downturns on record. As of April 2020, the International Monetary Fund (IMF) was forecasting the global economy to contract by 3.0% this year.[1] This is in stark contrast to the 3.3% growth the IMF was predicting at the beginning of the year.[2]

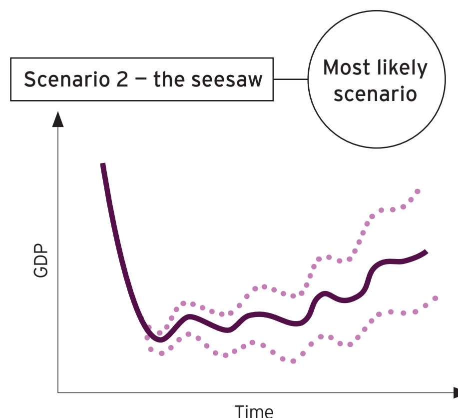
The only questions now are around the length and the scope of the economic fallout from the pandemic. Initial optimism around the ability to contain the outbreak through the rapid development of successful medical interventions had many believing the global economy could rebound quickly. However, as the breadth and depth of the pandemic has become known, optimism for a so-called V-shaped recovery has given way to scenarios that anticipate deeper and more lasting macro dislocation, with protracted collapses in supply and greater deterioration in consumer and business confidence.

Now, the most likely recovery shape is that of a "seesaw," with expanded ups and downs as various regions lock down periodically in response to flareups in the number of cases.

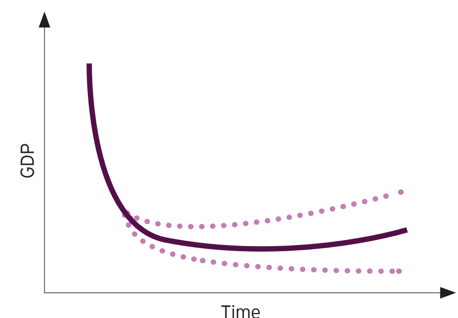
Economic scenarios

Scenario 1 – the V shape





Scenario 3 – the L shape



M&A outlook cools, but opportunities exist amid the disruption

With lending markets stalled and a limited ability to perform site visits, management team meetings and other in-person travel required for most deals, PE firms anticipate some measure of slowdown in the deal markets.

While Q1 saw an increase in PE deal activity of 10% vs. 2019, activity was concentrated in the first six weeks of the year. April saw just US$4.0b in new PE deals announced, a drop of more than 90% from the year prior. Now more than ever, "cash is king" holds true in the current market. PE firms with kegs of dry powder and loads of firepower are well-positioned to seize opportunities as they arise.

With a four-to-six-year hold period, and a recession on the horizon, PE firms were fully prepared to carry assets though some kind of a downturn. Most firms had underwritten steep potential earnings before interest, taxes, depreciation and amortization (EBITDA) declines of 25%–35% into their models. Few anticipated that entire industries could be shuttered overnight.

Q What do you think are some of the most likely effects of the virus on your business?

After COVID-19 impacted the market (Mar 12–24)

For the last several weeks, PE firms have been focused on their portfolios — putting out fires, sourcing alternate supply chains, and most importantly, making sure portfolio companies had access to liquidity amid a slowdown in the lending markets.

In the coming months, PE firms will increasingly turn their attention to deployment and identifying pockets of opportunity. Already, PE firms are actively investing in publicly traded assets — credit investments and minority equity positions in companies where transparency is high, valuations have dropped markedly, and where PE firms can play a role in providing capital to companies undergoing a measure of distress. As logjams in the deal markets resolve in the coming weeks, specifically around the ability to finance larger transactions and to conduct the required diligence, firms will concentrate on more traditional buyouts. In particular, take-privates could be a compelling starting point, given some of the valuation disconnects between publicly traded companies, many of which have fallen dramatically in recent weeks, and private companies, which tend to fall more slowly.

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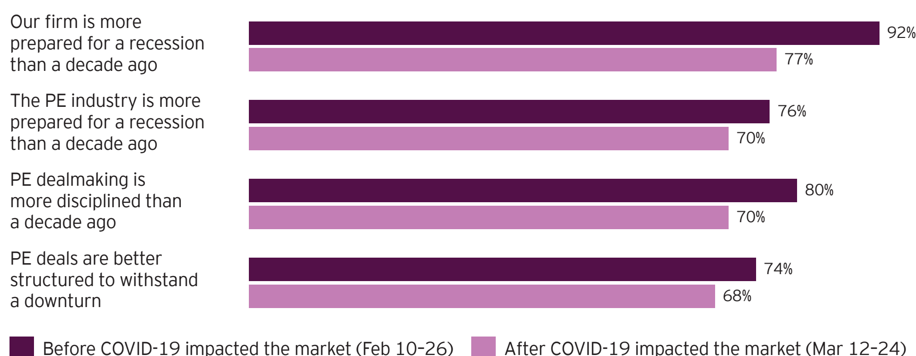
Valuable lessons from the Great Recession leave PE firms with more robust capabilities to weather the next downturn.

In the coming months, as the M&A market begins to move again and PE firms move toward increased deployment, the industry will be well-prepared. PE firms learned valuable lessons from the Great Recession that have helped them feel more prepared for the current economic downturn at both the firm and industry levels.

However, their confidence declined over the course of the PE pulse survey. Between 10 and 26 February, 93% of PE respondents surveyed expressed confidence in their firm's preparedness for a downturn vs. 10 years ago. Between 12 and 24 March, confidence among respondents surveyed dropped to 78%. At an industry level, confidence dropped from 76% in February to 70% in March. Nonetheless, it's clear that confidence remains high, even as the scope of the crisis has become known. At a firm level, 87% of PE firms agree that they are better-positioned for a recession, while 77% agree the PE industry as a whole is on firmer footing.

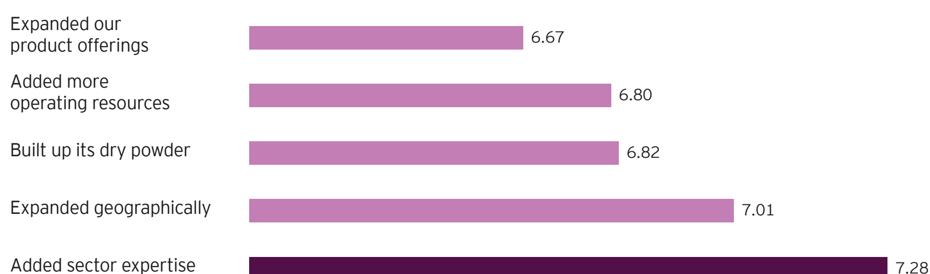
Q PE firms remain confident in their ability to respond to the crisis. Percentage that agree, or strongly agree, with each statement at each response date.



Indeed, PE firms feel more capable of weathering the current storm than they were 10 years ago at both the firm and industry levels for the following reasons:

1. Increased capital. PE firms have more capital at their disposal than ever before. PE funds are estimated to hold more than US$1.4t in immediately deployable funds.[3] When other adjacent asset classes are added, capacity rises to more than US$2.6t.[4]
2. Increased diversification. The rapid rise of private credit, which has become a US$800b industry,[5] puts PE in a stronger position to provide long-term flexible capital across the entire capital structure. Firms have likewise expanded their global capabilities — once the province of a small handful of global managers, an increasing number of firms are seeking opportunities outside their home regions.
3. Expanded operating capabilities and increased sector expertise. While many firms had significant operating capabilities before the Great Recession, their ubiquity has increased markedly over the last several years. Currently, PE firms have 30% more operating partners than they had five years ago.[6] Moreover, firms have added significantly to their sector capabilities.
4. Access to better tools for limited partners. PE limited partners have more tools available, such as an expanded market for secondary interests. This allows them to rebalance their portfolio to adjust to changing market conditions.

Q On a scale of 1–10, at what level has your firm added the following capabilities since the last downturn?



1 = Not at all   10 = Significant   These numbers are average scores.

Differing areas of focus lead funds and portfolios to distinct points of view

Fund- and portfolio-level respondents are focused on different risks and are taking different actions to prepare for a potential recession.

PE firms have taken a number of leaps since the Great Recession more than 10 years ago to prepare for the next downturn. Now that the downturn is here, there are some key strategic differences in the actions that PE professionals are taking with respect to their reactions to the pandemic based on whether they're focused more on the fund or the portfolio.

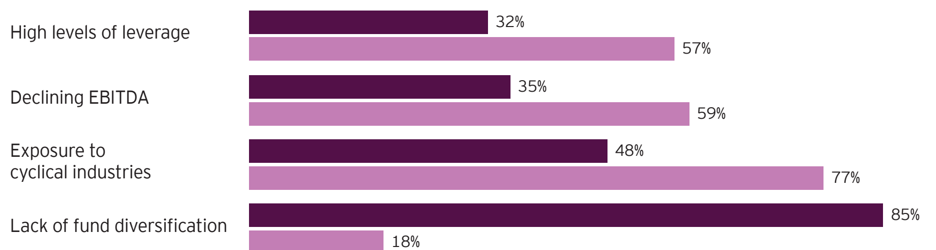
At the fund level

In our research, respondents who tend to focus on fund-level issues represent 42% of those surveyed. Among their key concerns is a lack of fund diversification. In response, they're working to diversify revenue streams and proactively communicating with limited partners (LPs) about the extent of disruption in the portfolio. They're having conversations about new opportunities and any flexibility required in limited partnership agreements (LPAs) they may need to execute on those ambitions, including extensions or additional flex in investment mandates.

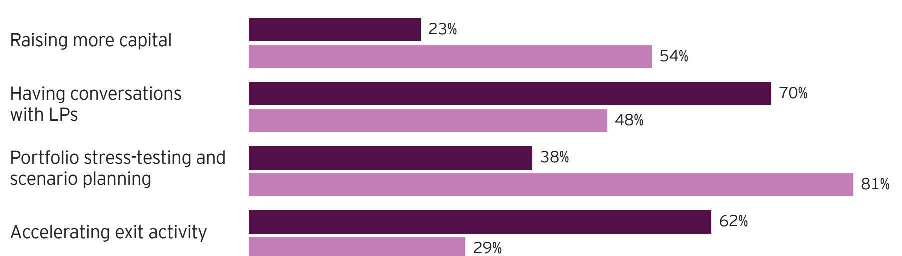
At the portfolio level

Respondents whose concerns weight more heavily on the portfolio, who represent 58% of those surveyed, see margin pressure, high levels of leverage and exposure to cyclical industries as primary areas of concern. To manage these risks, respondents say they are stress-testing their portfolios and working to make sure that companies have sufficient liquidity and working capital under a range of different pandemic scenarios. For some companies, corrective actions will be available, while others may require additional equity from the sponsor. Overall, 72% of respondents indicate that they were preparing for fresh capital injections. In particular, fund-focused professionals are anticipating the need to renegotiate credit lines (60% vs. 45% of portfolio managers); whereas portfolio managers are focused on reducing overall leverage (63% vs. 44% of fund managers).

Q What do you see as some of the greatest areas of risk for PE firms in the next downturn?



Q At the firm level, what are you doing to prepare for a potential downturn?



Fund-focused | Portfolio-focused

Q At the portfolio level, what are you doing to prepare for a potential downturn?

Percent ranked as first or second step

Fund level | Portfolio level

Portfolio focused are 43% more likely than fund focused to rank **optimizing working capital** as the first or second most important step in preparing their portfolio companies for a potential downturn.

Fund level are 91% more likely to rank **diversifying revenue streams** as first or second.

The evolution of the PE model to include credit and sector platforms, flexibility in structuring and hold periods puts PE into the driving seat for deals during this recession.

Although governments are experimenting with ways to mitigate the stress on the health care system, experts' consensus suggests that an effective vaccine is still 12 to 18 months away. As a result, PE firms will need to consider a path toward a post-pandemic normal for their funds and portfolio companies that is nonlinear. A seesaw-shaped recovery will require a series of short-term adaptations that will differ by sector.

PE firms have an important role to play in providing capital, knowledge and capabilities to companies that need it. In the short-term, they can help their portfolio companies prepare to manage the economic impacts of the pandemic and build resiliency.

As they plan for what's next and think about what lies beyond, PE firms have ample stores of dry powder to help stabilize markets and seize opportunities amid the disruption that position them to thrive in the economic resurgence that will come.

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1. Sarker, Shrutee, "Global economic contraction to be steepest on record, recovery U-shaped: Reuters poll," *Reuters*, www.reuters.com, 23 April 2020.
2. Ibid.
3. Preqin private market data, March 2020.
4. Preqin private market data, March 2020.
5. Preqin private market data, March 2020.
6. EY research, March 2020.

About the survey methodology and EY Advanced Insights

The *Global Capital Confidence Barometer* gauges corporate confidence in the economic outlook, and identifies boardroom trends and practices in the way companies manage their Capital Agendas – EY framework for strategically managing capital. It is a regular survey of senior executives from large companies around the world, conducted by Thought Leadership Consulting, a Euromoney Institutional Investor company. The panel comprises select EY clients across the globe and contacts and regular Thought Leadership Consulting contributors.

In collaboration with the EY Advanced Insights team, the EY Private Equity team analyzed the responses of over 300 senior private equity executives. The research is part of the 22nd edition of the EY *Global Capital Confidence Barometer*. Respondents were clustered into two groups with distinct PE management strategies using latent class segmentation based on their expressed views on firm level preparation, portfolio level preparation, anticipation of a recession and reaction to the COVID-19 pandemic. Reported differences are statistically significant using Pearson's Chi-squared test with multiple comparison correction (FDR=0.05).

The EY Advanced Insights team brings together EY services leaders, thought leaders and data scientists to develop a data-driven understanding of the challenges and opportunities driving the economic and dealmaking landscape. This team leverages advanced analytics and big data approaches to unlock deeper insights from data and create proprietary products and services to engage the market and EY clients.

- Respondents represented firms with investments across 13 sectors, and assets under management of US$50b and above (24%), US$30b-$50b (19%), US$10b-$30b (35%) and less than US$10b (22%).
- Survey fieldwork was conducted from February 10 to March, 24 2020.

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