



Why private equity can endure the next economic downturn

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CONTENTS

02	Summary	04	The macro backdrop	06	Lessons from the GFC
08	Development of the PE model over the last decade	12	Expectations for the next downturn	16	Social impact and the transparency imperative



The last decade has been one of unprecedented growth for private equity (PE). Assets managed by the industry have more than doubled since the global financial crisis (GFC), with firms now managing more than US\$3.8t in assets. During this period, long-established funds have become significantly larger and a wide range of new entrants have joined the market. Indeed, PE has been an undisputed beneficiary of 10+ years of monetary easing as ultra-low interest rates have led institutional investors to reach for yield.

However, we now enter a period where the outlook is more mixed and uncertain. On one hand, we have a picture of robust, albeit slowing global GDP growth. On the other, there are mounting concerns over the potential for an economic downturn driven by geopolitical instability, changing societal expectations, pockets of market excess and sector disruption, and the overall length of the current economic expansion. In aggregate, it's a picture of increasing uncertainty.

The big questions for PE are:

- ▶ What did the industry learn from the GFC?
- ▶ How has the industry model developed since?
- ▶ How will PE respond differently next time?

SUMMARY

In a number of important ways, PE firms are better prepared than they were a decade ago:

The industry has more capital at its disposal

As longtime LPs in PE increase their exposure to the asset class and a wide range of new entrants - including family offices, sovereign wealth funds and high net worth investors - invest in PE for the first time, PE firms have more capital at their disposal than even before. PE funds are currently estimated to hold more than US\$1.4t in immediately deployable funds, and when other adjacent asset classes are added - credit, infrastructure, real estate, growth capital, etc. - the aggregate amount of committed capital PE can readily deploy stands at more than US\$2.6t.

The industry has diversified in ways that increase its resilience

As banks shifted away from lending to small and medium-size enterprises in the wake of the GFC, PE firms and other private capital providers stepped in to fill the void. The rapid rise of private credit, which has become a US\$800b industry, enables PE to be in an even stronger position to provide long-term flexible capital across the entire capital structure.

PE firms have expanded operating capabilities

While many firms had significant operating capabilities in place well before the GFC, their ubiquity has increased markedly over the last several years. Currently, PE firms have 30% more operating partners than they had just five years ago. As such, firms are better prepared not only to help weather a downturn, but effectively to capitalize on the investment opportunities it's likely to present.

LPs are more sophisticated and have access to better tools

Not only have GPs become more sophisticated over the last decade, but LPs have made improvements as well. LPs have more tools available, such as an expanded market for secondary interests and the ability to co-invest alongside a fund on a co-deal basis, which allow them to rebalance their portfolio in order to adjust to changing market conditions.

Focus by PE firms on management of tax cash flow at the portfolio level

Against a backdrop of ever-increasing legislative changes and tax authority scrutiny, there is an increased emphasis by companies on undertaking tax reviews, together with interaction with advisors, to manage tax cash flow and leakage.

In the following pages we'll unpack some of the current and future dynamics as they relate to PE's preparedness for increased volatility and a potential period of limited growth. Indeed, in many ways, the industry has evolved and taken forward-focused actions that, for many firms, means the next macro correction is more likely to be perceived as an opportunity than a threat.



BY THE NUMBERS

US\$3.8t
in PE assets

US\$800b
in private credit

up 3x from 2010
30% more operating
partners since 2014

US\$1.4t
in PE dry powder

Median return of a **2006**
vintage fund:

8.1%

Median return of a **2009**
vintage fund:

13.9%

THE MACRO BACKDROP

While predicting the timing of the next downturn is inherently difficult, it's likely to be different than the last.

Most of the world continues to experience steady, albeit slowing economic growth. Advancing wages, readily available credit and the strength of global equity markets are all signs of continued global economic strength. Consumer spending remains strong, particularly in the US, where it accounts for more than two-thirds of economic activity, buoyed by low unemployment, rising home values and limited inflationary pressure.

Nonetheless, there is uncertainty around trade policy (between the US and China in particular), a weakening Chinese economy, concerns around Brexit, rising levels of corporate debt, an inverted US yield curve, and uncertainty related to the impacts of COVID-19 are leading many to take a more cautious stance. However, it is important to note that this isn't the first time we've seen the global macroeconomic environment soften only

later to rebound. In 2012 and 2015, global growth fell to around 2.5%, roughly where it is now, but in both cases, the global economy recovered to extend the expansion. Furthermore, across much of the world, policymakers have made clear their intentions to move aggressively at signs of deterioration in key indicators, and there is a strong consensus that US and European financial institutions are in better shape today than a decade ago.

It must also be recognized that over the last 10 years, companies have faced significant disruption to business models caused, for example, by commodity price volatility (oil and gas, metals and mining); digital transformation (retail, fast-moving consumer goods (FMCG)); supply chain disruption (manufacturing, pharma); and sector convergence (auto/tech, telco/media, retail/health





care). Reshaping strategies has already started by some companies that are well capitalized and have a resilience building mindset.

In 2008-2011, we experienced a global financial crisis affecting many countries, markets and consumers at the same time and at a rapid pace. This downturn was significant because it hit with a sudden switch from positive to negative growth in many economies, the far-reaching impact it had on volumes and the global central banks' responses of quantitative easing and low interest rates.

We consider that the next macro correction will be a series of downturns that are more localized to specific countries, industries, sectors and markets. Some will deliver low or no growth for extended periods of time as sovereign/central bank intervention will be more limited (as interest rates are already low).

As this paper is being finalized in Feb 2020, the world is closely watching the outbreak of COVID-19 in China. Its impact is already being seen in supply chains and the movement of labor. At this time, its very uncertain as to how the issue will either stabilize or become a more globally serious threat. Clearly, if its the latter, it may be a trigger that puts additional pressure on the global economy at a time when its already slowing.

For corporations it will be one that exposes weak or outdated business models. For those corporations that have adapted to change and built resilience, the next downturn will present opportunities, for those that have not, it will challenge their ability to exist.

LESSONS FROM THE **GFC**

Introspection and postmortem analysis by capital markets participants and the PE industry in particular suggests an overly cautious approach during the GFC undermined one of the best buying opportunities of all time.

The role of cyclical

The rapid growth of PE in the years prior, and the relatively narrow scope of the 2000 dot.com bust meant that for many PE firms, the GFC was their first experience in managing significant macroeconomic headwinds and possibly their first experience of a major correction.

An important starting point to identifying key lessons that PE has learned through the GFC is that the PE industry has an element of cyclical and is vulnerable to the credit cycle. Median IRRs for global buyout funds show relatively low performance just prior to the 2000 and 2007 recessions, and stronger performance during both recoveries as PE deployed capital in a lower valuation environment.

Recognition of this pattern is keeping firms disciplined in today's market and has many looking at the next downturn as a time to be

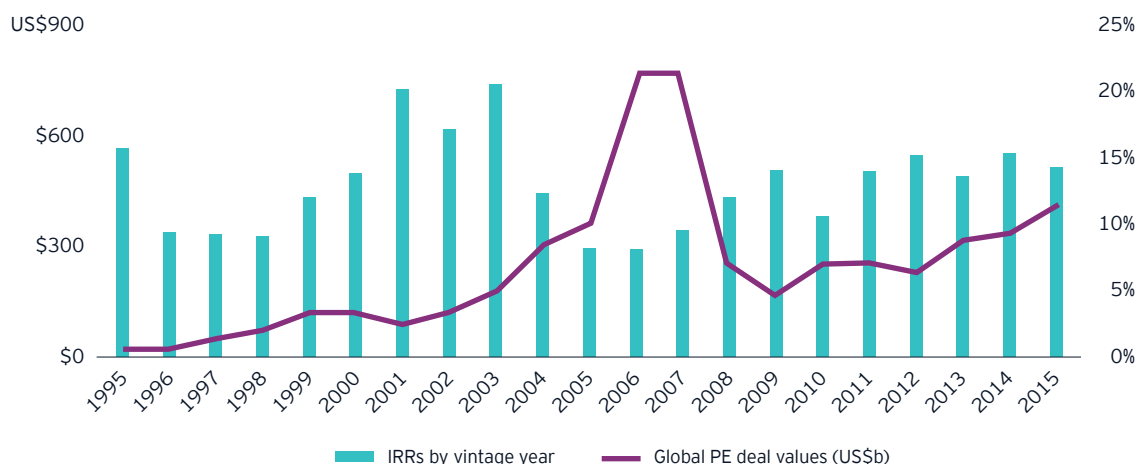
ready to react accordingly and capitalize on the potential significant opportunity. Indeed, at many firms, today's senior leadership is populated by professionals that were in the junior and middle stages of their careers during the GFC, and for whom its lessons are still fresh.

Fund and portfolio company resilience

As the GFC began to unspool in the second half of 2008, pushing much of the global economy into decline, the media turned a spotlight on the "refi cliff" of more than US\$570b in loans that PE portfolio companies needed to refinance. Credit agencies and others were pessimistic on the industry's survival, predicting massive defaults.

While a handful of defaults did indeed occur, the doomsday scenario by and large never came to pass. Empirical research provides insight into

PE's best returns tend to follow recessionary periods



Source: Pitchbook, Dealogic

why this occurred. One of the more widely cited papers by professors at Stanford Graduate School of Business and Kellogg School of Management looked into whether PE contributed to the economic fragility during this period. It found that PE-backed companies actually increased capex investment relative to their peers. At a time when many non-PE backed companies were financially constrained, PE's access to capital - both from its own funds and from longstanding relationships with banks and other lenders - allowed PE firms to support companies in ways that others couldn't, and possibly wouldn't. The PE model appeared to provide additional flexibility and access to capital even during times of broad economic and financial market distress, an outcome that can reasonably be expected to play out once again, although the "when" is unknown.

At the GP level, there were relatively few casualties, which was in contrast to the many financial institutions that exited, were forced to merge or became reliant on government support. Nor did PE contract in the same way as the hedge fund industry, which was particularly exposed to redemptions, having investor funds that were locked up for much shorter periods than PE.

The result - a test of the model, and newfound appreciation for PE's resilience

As a result, coming out of the financial crisis, there was a newfound appreciation for some of the asset classes' key advantages, including:

- ▶ Its ability to access long-term, locked-in institutional capital that positioned PE to be buyers of forced sales by asset managers such as hedge funds, mutual funds and banks who were pressured by their investors, depositors and regulators to redeem or optimize capital.
- ▶ The degree to which the greater alignment with investors, management teams and other stakeholders, and the relatively longer time horizons of PE investors, likely played an important role in enabling them to more agile, and quickly and successfully respond to economic dislocation.

The tumult of the GFC offers a number of actionable lessons for PE firms next time around: apply caution as the credit market weakens and stay clear of cyclical industries at market peaks. Perhaps most importantly, once economic dislocation hits, don't be overly cautious, but instead seize upon a rare buying opportunity.

DEVELOPMENT OF THE PE MODEL OVER THE LAST DECADE

PE is a vastly different industry than it was 10 years ago. Four significant changes are likely to play an important role in determining how well PE performs in the next economic downturn.





From LBOs to incentivizing management to operational value creation to fully diversified platforms, private equity is infinitely adaptable.

Private equity manager

1. A superabundance of capital

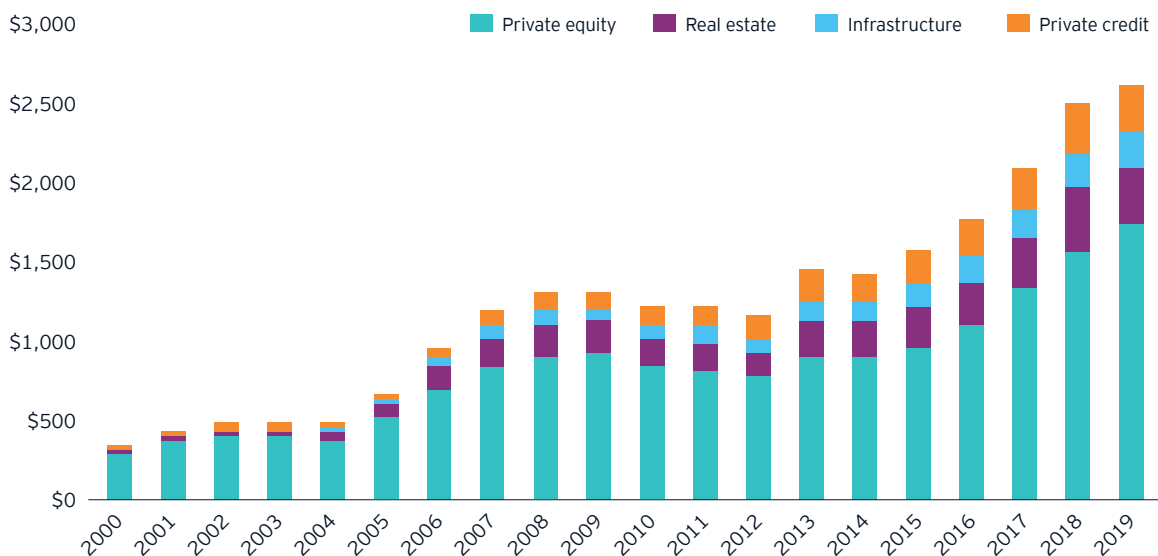
PE was once seen as a niche asset class attracting a few sophisticated institutional investors such as pension funds and family offices. The industry's long track record of strong, uncorrelated returns is now widely appreciated throughout the investment community. What's ensued is a massive buildup in PE's assets under management and more importantly, the dry powder available for investment.

Today, PE firms have reached a record US\$3.8t in AUM, a figure predicted by Preqin to hit nearly US\$5t by 2023. The trend toward larger fund sizes has added to the industry's growing level

of dry powder, now estimated at US\$730b for buyout funds alone. From 2014-18, one-third of the buyouts were done by funds with more than US\$10b in commitments. When other adjacent asset classes are added - credit, infrastructure, real estate, growth capital, etc. - the aggregate amount of capital PE can readily deploy is estimated at more than US\$2.6t.

Furthermore, the significant growth of direct investments, co-investments and separate accounts - so called "shadow capital" - in recent years means that PE firms and other private capital investors have even more capital at their disposal than is commonly understood or reported.

The growth of private capital dry powder



Source: Preqin

2. Growth in new private capital strategies - in particular, credit

Private credit, in the form of direct lending, distressed, special situations and other strategies has become a US\$800b industry, and is expected to double to more than US\$1.4t by 2023, according to Preqin estimates.

The demand for private credit accelerated dramatically post-GFC as banks retreated from lower and middle-market corporate lending. For PE firms, entering this market was a natural step forward. Today, private capital managers have moved into financing larger corporations and other asset classes such as venture capital, infrastructure and real estate.

As demonstrated during the last downturn, distressed lending proved particularly useful as a countercyclical source of capital, and together with private credit's significant dry powder, represents an important credit buffer during times of weakness in the traditional credit markets.

3. Increasing sophistication of PE LPs

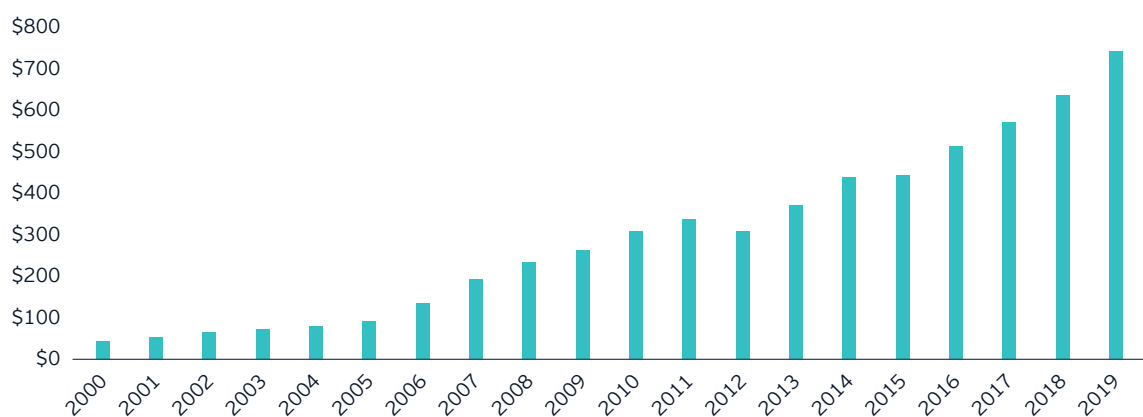
During the last crisis many LPs were constrained from investing additional capital in PE by the "denominator effect," which happened when the valuations in their public portfolios fell dramatically, and many LPs found themselves suddenly overallocated to private investments relative to their target allocations.

Today, many LPs are closely monitoring their pacing in the event of a potential fall in public equities, and others are tweaking their investment process to allow for greater flexibility.

The market for LP secondaries – the buying and selling of limited partnership fund interests – has also seen significant growth over the past decade. During the GFC, the market for secondaries was emerging but especially thin and was used primarily (and often discretely) by investors looking for an early exit to a fund partnership, often at a deep discount.

Today, the market has become a tool that is used widely by LPs and GPs alike looking for liquidity or to make adjustments to existing portfolios. Indeed, 2018 saw record levels of transactions. The result is more flexibility for investors to adjust to volatile market conditions.

The growth of private credit - AUM over time (US\$b)



Source: Preqin

4. Expanded operating capabilities

As competition for deals continues to increase and valuations continue to climb, the imperative to reshape portfolio companies via continuously improving their operating capabilities (whether it is adding operating partners, improving technology or developing sector or functional expertise) has become more significant and is likely to continue trending in this direction. What started as a handful of firms employing senior industry executives to work side-by-side with management teams to lend their experience, connections and expertise has since developed into a wide range of models spanning various seniority levels, skill sets, backgrounds and objectives. Currently, PE firms have 30% more operating partners than they had just five years ago.

Over the last decade, firms' operating resources have developed into a robust model with a wide range of variations, as illustrated below.

As such, firms are better situated than ever before to respond to and to leverage and capitalize on the challenges of economic dislocation. Many PE firms have significantly expanded the depth of their sector expertise. And with their increasing global reach, PE firms today have better local market intelligence to help improve investment decision-making and are better positioned to see the first indications of economic trends and to respond quickly and decisively. They're using data and analytics to build tested playbooks to accelerate the value creation process. And many are using a shared services model to drive efficiencies across the portfolio in areas like procurement.

What it means for PE's current positioning

In aggregate, PE has evolved significantly over the last decade, and this evolution will continue. PE firms now have access to more capital in order to double-down on promising companies experiencing temporary distress from macro forces. Funds have improved operating capabilities to help companies make more informed decisions. And their wholesale expansion into adjacent asset classes - credit in particular - gives funds new means of providing support in ways they largely didn't just a decade ago.

Level	Type	Skill set
Retired CEO/executive in residence (EIR)	Advisor	Generalists
Peer-level resources	Partner	Industry professionals
Junior analyst	"Arms and legs"	Functional professionals
Background	Working style	Purpose
Operator	Mentor	Strategic
Consultant	Doer	Tactical

EXPECTATIONS FOR THE **NEXT** **DOWNTURN**

The PE industry is a larger, more mature and better resourced industry with a broader set of strategies and the wherewithal to prevail in the next downturn.





While many investment committees still carry the scars from the post-GFC recovery, today they are much better equipped to make these trade-offs.

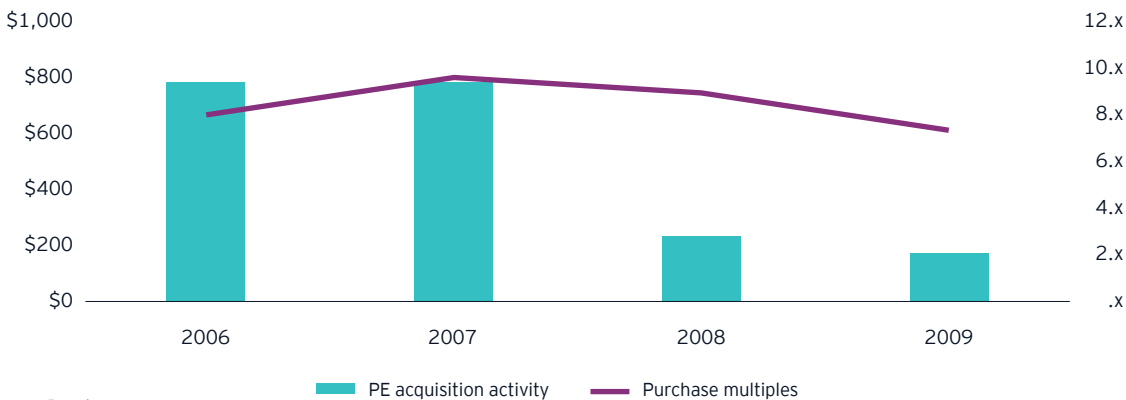
John van Rossen
EY EMEA TAS Private Equity Leader

PE's No. 1 priority - putting capital to work more quickly

While PE firms were active during the last recession in terms of supporting their existing portfolios, they were less active in pursuing new opportunities. Between 2007 and 2009, new PE acquisitions fell almost 80%, from a peak of nearly US\$800b to just US\$170b. In hindsight, the industry missed a significant opportunity to acquire high-quality assets at deep discounts.

Today, PE's ability to invest for longer periods of time, coupled with its tremendous levels of dry powder and more permanent capital indicate that it has the wherewithal to execute on this strategy. The big questions are around the capacity, courage and patience to ride out an uncertain period of slow growth. Indeed, summoning the conviction to act and invest when others are fearful or standing pat is far easier said than done. We recently spoke with a senior MD who observed that "it is hard to lean forward into a crisis."

PE deal activity fell dramatically just as purchase multiples dropped



Source: Preqin



Firms with a clear focus on what data to harvest and the right analytical tools to evaluate this data will have a significant advantage over competitors as we move into the next cycle.

David MacKinnon

Private Equity Partner, Ernst & Young LLP, Transaction Advisory Services

Preparations are already underway

Consensus has grown over the last couple of years regarding the lateness of the current macro cycle. Consequently, PE is already planning for a potential market correction and the opportunities it might afford. With valuations for PE deals exceeding the peak of the GFC for the last several years, the investment decision itself has become more comprehensive in its risk considerations. In particular, firms are continuously evolving and adapting to the markets as needed, and doing so in various manners, including:

Defensive posturing in sector selection

With the threat of an economic downturn, PE firms are refocusing on more resilient and noncyclical sectors and avoiding more vulnerable cyclical industries. More recession-proof and defensive industries with lower fixed costs and high recurring revenues are among the key targets. Companies in the technology and business services sectors have seen tremendous interest from PE over the last two or three years, while more sensitive sectors such as retail and energy have seen declining interest. Currently, PE is prepared to pay a premium for resilient businesses. Since the beginning of 2018 for example, PE firms have invested US\$181b into tech - more than double the amount invested into retail and energy combined.

Debt levels and hold periods

PE firms are making certain that leverage levels are resilient and covenants are not so tight that economic weakness could push a company immediately into a debt restructuring. While a number of high-profile deals have recently featured higher leverage, the industry as a whole has remained largely disciplined, with debt ratios in the 6.0x EBITDA range.

The possibility of a near-term downturn is also causing PE to hold its investments beyond the standard three to four years. Funds are working with LPs to structure fee arrangements and co-investment rights that can allow for longer hold periods. Longer duration funds, available permanent capital and the more liquid secondaries market are expected to provide enhance operational and financial flexibility to outlast future economic dislocations.

Leveraging advisor relationships

Firms are also working more closely with advisors to prepare their portfolios across a range of areas. By focusing on them now, firms are working to ensure that solutions are in place well ahead of a potential downturn and ready to be deployed when they're most needed.

- ▶ One of the major challenges during the GFC was accessing working capital. As supply chains faced a credit squeeze and short-term lending markets began to freeze, many companies found themselves significantly constrained. Companies are currently taking the lessons from the last crisis and working now to build flexibility into their funding mechanisms and improve key working capital metrics.
- ▶ PE firms are also working with their advisors to sharpen their diligence of potential deal targets. They're starting the process earlier and running robust downside scenarios that include coping with protracted economic downturns and the potential for digital and sector disruption. Firms are commonly modeling the potential for a 20% to 25% decrease in EBITDA, as well as a flat or contracting multiple environment. Firms are running scenarios for how the recovery will play out and the opportunity to grow market share as other competitors to the target weaken or fail.
- ▶ The last decade has seen PE firms invest heavily into data analytics and the ability to drill deep into the financial and operating metrics of their portfolios. In recent years, data analytics technology has advanced from analyzing past events to predicting future ones, maximizing the value of data and providing actionable insights. In a recession, the need and value of such real-time data and insight becomes particularly acute and is a true competitive advantage. With the growing availability of a wide range of software and a reduction in storage and processing costs, solutions are increasingly cost effective, enabling firms to deploy broadly across the portfolio.
- ▶ Other digital enablers can similarly add outsized value during times of economic volatility. Social sentiment analysis can provide real-time customer feedback on performance relative to a company's peers; machine learning can uncover hidden trends and structure in data

and enable solutions that might not be apparent from traditional analysis; and robotic process automation (RPA) can provide increased flexibility in a company's staffing model when it's most needed.

Strengthening the GP platform

GPs have been focused on strengthening their platforms in two meaningful ways: improving the quality of balance sheets and ensuring the skills of investment and operating teams match future challenges. Recent efforts to increase permanent capital are expected to be a safeguard if and when liquidity dries up across financial markets. There is an urgent need to address downside events and PE's close relationships with financial institutions are likely to be tested.

Flexibility to invest across the capital structure

The rise of private credit strategies has enabled PE to be in an even stronger position to provide flexible capital across the entire capital structure. During the GFC, distressed debt and special situations funds proved highly effective in both restructuring and rescuing companies as well as in generating returns for investors. By leveraging PE's limited partnership fund model, both these and the many more direct lending funds today can be expected to act as sophisticated, sector-focused and disciplined lenders to mitigate distress and provide an important buffer to potential economic shocks – both to companies and the broader economy.

A decade ago, much of the lending to PE-backed companies was underwritten by banks and then syndicated to a wide range of fixed income investors. Today, a growing proportion of the debt that's backing the PE portfolio has been provided directly by private credit funds disintermediating the banking market.

SOCIAL IMPACT AND THE TRANSPARENCY IMPERATIVE

Because of its growth and the increasing role it is playing in the global economy, PE is under more scrutiny than during any other time in its history. This also extends to their and their portfolio's tax matters from multiple stakeholders. Should a downturn occur, it is highly likely that such scrutiny may increase, as PE firms work to usher their companies through disruptive headwinds, often having to make difficult decisions in the process.

Currently, wide variations exist in the breadth and depth of the measurement and reporting of the social impact of PE investment. Some firms report

comprehensively on ESG, jobs and other portfolio metrics, while others are less forthcoming. However, as the industry becomes more accountable to a growing numbers of stakeholders, the imperative for greater transparency is increasing. Putting into place a robust, consistent, accountable approach that tracks and reports on the externalities that are created in the course of the portfolio life cycle, can help these stakeholders better understand what the industry does, how it operates and how it can help contribute to a more sustainable economy.



Conclusion

Perhaps only one thing is probable about the next economic downturn - whatever its origin or extent - it will not look like the last. While today's economic climate is defined by continued, albeit waning strength, there are many factors that indicate change may indeed be on the horizon.

Whenever, or however, the current expansion ultimately gives way to economic contraction, more certain, we feel, is the notion that PE is in a significantly stronger and more agile position to anticipate and react than going into the GFC. Not only does it have the experience of that crisis, but the innovations, insights and evolution it has experienced since then provides new tools that were largely absent a decade ago. For PE, it represents a chance not just to invest in attractive companies at compelling valuations, but for the industry to further assert itself as a foundational bedrock of the modern global economy.

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