Private Equity and Public Companies

Private Equity: Accomplishments and Challenges
Greg Brown, University of North Carolina; Bob Harris, University of Virginia; Tim Jenkinson, University of Oxford; Steve Kaplan, University of Chicago; and David Robinson, Duke University

Private Equity and Portfolio Companies: Lessons from the Global Financial Crisis
Shai Bernstein and Josh Lerner, Harvard University; and Filippo Mezzanotti, Northwestern University

Board 3.0: What the Private-Equity Governance Model Can Offer Public Companies
Ronald J. Gilson, Columbia University and Stanford University; and Jeffrey N. Gordon, Columbia University

The Growing Blessing of Unicorns: The Changing Nature of the Market for Privately Funded Companies
Keith C. Brown and Kenneth W. Wiles, University of Texas at Austin

EQT: Private Equity with a Purpose
Robert G. Eccles, University of Oxford; and Thérèse Lennehag and Nina Nornholm, EQT AB

Private Equity and the COVID-19 Economic Downturn: Opportunity for Expansion?
David Haarmeyer

University of Texas Roundtable on LP Perspectives on the State of Private Equity
Panelists: Chris Halaska, Memorial Hermann Health System; Tom Tull, Employees Retirement System of Texas; Russell Valdez, Wafra; and Shelby Wanstrath, Texas Teachers Retirement System. Moderator: Ken Wiles, University of Texas at Austin

Columbia Law School Roundtable on Public Aspects of Private Equity
Panelists: Emily Mendell, International Limited Partners Association; Chris Cozzone, Bain Capital Double Impact; and Donna Hitscherich, Columbia Business School. Moderated by Aamir Rehman, Columbia Business School

A CEO’s Playbook for Creating Long-Term Value: Ten Essential Resource Allocation Practices
Harry M. Kraemer, Jr., Northwestern University; Michael J. Mauboussin, Counterpoint Global; and Alfred Rappaport, Northwestern University

A Tale of Leadership in Value Creation
Greg Milano, Fortuna Advisors

What Public Companies Can Learn from Private Equity Pay Plans
Stephen O’Byrne, Shareholder Value Advisors

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Private Equity and the COVID-19 Economic Downturn: Opportunity for Expansion?

by David Haarmeyer, Independent Consultant*

The global private equity industry, with almost $4 trillion in assets under management, faces its biggest challenge to date with the coronavirus pandemic, which has shuttered large parts of the economy, caused stock markets to contract significantly, and raised economic uncertainty. The global lockdown of businesses, employees, and consumers appears to represent an extraordinary demand shock. Neither the speed nor scope of the economic shock caused by the coronavirus outbreak has a historical precedent. The resulting economic and financial dislocations are creating shockwaves that have left no industry untouched, but with especially severe effects on industries such as hospitality, entertainment, and energy. Economists are predicting a Great Depression-era like slump, with U.S. gross domestic product expected to contract nearly 11% during 2020 (National Bureau of Economic Research) and unemployment potentially running as high as 30%.

This crisis differs in important respects from the 2007-2009 global financial crisis (GFC), when the sheer volume of “toxic assets” created by the global banking sector—with considerable help from regulators, including the U.S. Fed—created a global liquidity shortage. Unlike the GFC, the economic damage caused by the COVID-19 pandemic does not represent a “finance-led” structural problem, but is linked to a viral outbreak that is expected to be mitigated during the next year or two. And optimistic forecasts of the cumulative impact of the macro shock suggest it will turn out to be both shorter-lived, and considerably smaller, than that suffered after the GFC. Nevertheless, this outcome is conditioned on containing the virus and providing enough private capital as well as government stimulus funds to enable businesses, particularly small businesses, to make a recovery.

PE’s Position of Strength

Since the onset of the GFC in 2008, the PE industry has been riding a rising wave of growing transaction volumes, valuations, fundraising, and permanent capital, driven by PE’s continuing outperformance and diversification benefits. PE has been a clear beneficiary of global monetary authorities’ program of quantitative easing, which pushed interest rates down to historical low levels to stimulate investment. Such low rates have also contributed to a record bull market for public equities, with plentiful low-cost capital also stimulating private market deal-making.

Private equity, when seen as comprising buyouts, growth capital, and venture capital, represents approximately 60% of the estimated $6.5 trillion under the management of total private markets. And the growth rate of private markets in 2019 (as reported by Preqin in Figure 1) was a remarkable 12.2%. The PE industry alone experienced four consecutive years of annual inflows exceeding $500 billion, with a distinct trend toward megafunds—capital pools greater than $10

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commentators predicted massive defaults of PE-backed companies and a sharp contraction, if not even the end, of the industry. But this scenario failed to materialize as the industry’s better access to capital, adaptability, and stronger incentives to respond to risks early and effectively put PE portfolio companies on a stronger footing than their peers. This resiliency will prove invaluable in navigating the present economic turmoil.

Here are some of the factors that are likely to ensure this outcome:

**Magnitude of Dry Powder**
In 2007, the amount of PE capital raised but not used totaled more than $1 trillion. More than a decade later, dry powder sits at $2.3 trillion, in part reflecting record fundraising,
The secondary market for PE fund stakes increased from $16 billion in 2007 to what Coller Capital expects to reach $90 billion for the full year in 2019. With no clear view into valuations during the pandemic, buyers with more than $150 billion in dry powder expect deal volume to contract initially before resuming. While this market was once driven mainly by LPs’ interest in gaining early liquidity, GP-led secondaries have recently become popular as fund managers have seen value in restructuring their funds, in many cases to hold onto top-performing portfolio companies beyond the life of the particular fund that first acquired them.

Public Company Investments Become Attractive
The pandemic’s initial negative impact on public equity values ignited interest in PE investments in public companies. With their surplus of capital, PE firms are well positioned to make minority investments, initiate take-private deals, or facilitate mergers. In April 2020, for example, Silver Lake and Sixth Street Partners made a $1 billion equity-and-debt investment in Airbnb Inc. Also in April, Blackstone’s Life Sciences group invested $2 billion of debt and equity in the public company Alnylam Pharmaceutical to help the firm bring its drugs to the market faster. By the end of March 2020, such private investments in public equity, or PIPES, had reached $17 billion. And the fact that these deals hit a record $120 billion for the full year of 2008 suggests that we will see more of them.

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New and Maturing Strategies—Credit and Secondaries
Partly as the result of the changing regulatory environment established after the GFC, banks retreated particularly from lower- and middle-market lending, thus leaving a void for private capital to fill. Assets invested in private debt reached a level of more than $812 billion in 2019, with dry powder dedicated to such lending exceeding $270 billion (again, according to Preqin). In addition to direct and mezzanine lending, private credit includes distressed and special situations lending, both of which are likely to play a critical, countercyclical role during the present financial turmoil. A growing number of the top-ranked PE firms—among them, Apollo Global Management, KKR, Oaktree Capital Management, and a joint venture between credit investor Iron Park and PE firm General Atlantic—are expected to raise private credit funds. In some cases, they will be lending to the PE-backed companies of their competitors.

1 For example, new regulations requiring traditional banks to increase their capital base and tighten underwriting standards have made it more expensive, and less profitable, for banks to lend to smaller borrowers.

Figure 2
Private Equity Secondary Transactions, 2010–2Q 2019

Private equity secondary transactions have risen in the past decade, with 2018 and 2019 being years of considerable activity.

Source: Coller Capital, The Private Equity Secondary Market

1 For example, new regulations requiring traditional banks to increase their capital base and tighten underwriting standards have made it more expensive, and less profitable, for banks to lend to smaller borrowers.
increasingly saw a demand for and the value of raising permanent or perpetual capital. PE groups have taken different paths to achieve this: going public, selling minority stakes, launching longer-term or perpetual funds, and acquiring insurance companies with stable annuity streams. This capital becomes especially valuable during times of financial distress when liquidity is in short supply. While PE firms have tended to use this capital to seed new investment ideas, facilitate succession, and enter new markets, it is expected to become especially valuable in the near term to support portfolio companies and make opportunistic investments.

Leading up to shutdown of the economy, PE firms had been sharpening their due diligence, avoiding cyclical sectors, and creating playbooks to take advantage of down-cycle opportunities.

As buyout firms that have since become public companies roughly a decade ago, large global alternative asset players such as Blackstone, Apollo, and KKR are today focused on generating a growing stream of locked-in fees by launching new funds and strategies. Indeed, some of this more permanent capital can in fact be invested in perpetuity. Blackstone reported that 18% of its $576 billion in AUM year-end 2019 was perpetual. The insurer Athene Holding, which Apollo established in 2009, is currently one of the top fixed-annuity providers in the U.S. and is estimated to account for 25% of Apollo’s overall value. By making their organizations stronger, perpetual capital increases the scale and survivability of these platforms during crises.

Industry Preparedness: Operational Capabilities and Sector Expertise

Although its cause, severity, and scope could not have been predicted, an economic downturn was long anticipated, given the record 11-year economic expansion. Leading up to shutdown of the economy, PE firms had been sharpening their due diligence, avoiding cyclical sectors, and creating playbooks to take advantage of down-cycle opportunities. Critical to the industry’s preparedness is its deeper operational experience and sector expertise. According to EY, PE firms have 30% more operating partners than they had five years ago, many of which are senior industry executives. An analysis by McKinsey found that during the GFC, PE firms with operational teams achieved an additional 5% higher internal rate of return (IRR) and raised more funds than PE firms without such teams.

Current Challenges

Investing Uncertainty and Challenged Price Discovery Conditions

As in past crises, the priority of PE firms is survival of their portfolio companies. This requires proactive decisions to preserve liquidity, reduce costs, prepare for an extended downturn, and separate marginal from long-term viable enterprises. Under extreme market volatility conditions, the price discovery required to close deals becomes more difficult, as buyer and seller expectations diverge. In the first quarter of 2020, global deal-making fell 28% from the prior year. Assuming a period of stabilization and valuations reset, PE firms could quickly return to making investments, particularly in struggling companies that other investors may be forced to sell. Experienced GPs with surplus capital, as already noted, will be especially attentive to opportunities to purchase otherwise strong companies at discounted values.

Exits and Distributions to Investors

As happened during the GFC, industry observers expect exits and cash distributions to investors to fall while capital calls increase at least initially, as GPs take defensive measures. The economic contraction and uncertainty about recovery will limit GPs’ ability to generate cash, as few will be willing to sell their portfolio companies at deeply discounted prices or be able to initiate dividend recaps. The constraint on exits will be felt particularly hard by 2012-2013 vintage funds at the tail ends of their lives with the obligation to return capital to investors. But both distributions and capital calls are expected to rebound, again assuming the market is on solid ground and valuations stabilize.

Fundraising and the Denominator Effect

The abrupt and severe lockdown of much of the global economy and uncertainty about asset valuations have prompted many investors to take a “wait-and-see” approach to fund commitments. The larger, established fund managers with long-standing LP bases are likely to have an easier time securing capital than smaller and emerging managers. For example, Silver Lake Partners is moving ahead to raise Fund VI, targeting as much as $18 billion to $20 billion. Distressed debt funds and those specifically designed to respond opportunistically to dislocations will also have an advantage in attracting capital. Finally, the large fall in public equity values may make investor portfolios appear overweight in PE assets and discourage further commit-
ments to the asset class. Experienced investors are expected to have preempted this denominator effect by taking into account slower adjusting PE asset values. The $114 billion Washington State Investment Board has a 40% allocation to private market strategies and, as one of the longest-running pension investors in the asset class, it has declared its “plan to stay the course.”

Performance of Vintage Funds
At least in the short term, unrealized PE returns are likely to fall as fund managers discount their portfolios in line with the drop in public valuations. Consistent with historical experience, funds with vintage years 2012 through 2017 will be challenged, given that they were investing at elevated prices during the top of the market; and now their holding periods will likely be stretched and exits come at a market low. Generally, the best vintages coincide with dislocations in public equity markets when assets can be acquired near the bottom of the pricing curve and later exited once markets recover. As examples, 2008 and 2009 vintage buyout funds had median net IRR of 13.4% and 14%, respectively, higher than those of the three previous years.

Conclusion
Prior to the pandemic, the PE industry showed signs of late-cycle behavior, including record high purchase multiples, greater use of leverage, large and growing dry powder, and return compression. With real and financial markets in turmoil, PE firms are doubling down on their support for their hard-hit portfolio companies, but their next order of business is to take advantage of deeply discounted values to purchase quality private and public assets that were only recently out of reach.

Larger alternative asset groups with greater diversification by strategies, geography, and investors, and increasing amounts of permanent capital, will likely be in the most advantageous position to weather the coronavirus-related financial storm and move quickly to put capital to work and expand AUM. Moreover, as nimble organizations attentive to risks and opportunities, the asset class in general can be expected to take an active role reshaping the post-virus economy, which is likely to differ in important ways from the pre-crisis version.

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