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After the storm: Private equity after COVID-19

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Methodology

In the third quarter of 2020, Mergermarket surveyed 30 senior executives from private equity firms. All respondents had AUM of US$500m-US$5bn and none were first-time fund managers. 70% of respondents were US-based and 30% were based in EMEA. The survey included a combination of qualitative and quantitative questions and all results were analyzed and collated by Mergermarket. All responses are anonymized and presented in aggregate.

Foreword

These are turbulent times for private equity. COVID-19, political uncertainty, trade tensions and economic upheaval continue to disrupt markets and unsettle investors. This has been reflected in a so-far rollercoaster year for the PE industry. After two quarters of plunging values and volumes, aggregate deal value soared in Q3 2020 to US$313.97bn, Mergermarket data shows.

Yet this should not be heralded as a return to normality. First, the value of exits globally in Q3 exceeded the value of buyouts – a rarely seen inversion. Second, volume was notably subdued – deals were fewer in number but larger in value. Finally, and perhaps most significantly, the value of secondary buyouts in Q3 leapt to US$55.6bn – a near record high.

The rising tide of secondary buyouts reflects challenges both in deal sourcing and exits. On the sourcing side, the rapid expansion of PE over the last decade means it is getting harder to find targets that are not already in (or have been in) PE ownership. On exits, trade sales and initial public offerings are becoming harder to pull off. For funds approaching maturity, the lure of a secondary exit is clear.

There is also the question of how best to support portfolio companies through the pandemic and subsequent economic contraction. Concurrently, firms are under pressure to respond to new demands from investors and regulators, including alignment with environmental, social and governance (ESG) goals and calls for greater transparency.

This report shows that two issues preoccupy PE managers. The first is protecting portfolio companies from increased liquidity risks. The second is volatility in valuations – a concern for buyers and sellers alike.

Respondents don’t expect deal flow to return to the levels seen at the beginning of 2020, even in 2022. Low growth is seen as the foremost threat for the next five years, followed by regulatory risk, changing investor demands and failing to keep pace with technology.

Despite these headwinds, most respondents to our survey intend to raise a fund over the next year, albeit smaller than before. Searching for growth, many are looking to adapt their business models, and more than a third intend to diversify their asset class exposure.

Respondents are also tapping into advanced digital technologies. Aside from simplifying compliance, respondents are using technologies such as artificial intelligence and machine learning to drive value in areas such as due diligence, portfolio analysis and deal pipeline monitoring.

However, our survey suggests PE firms are equivocal when it comes to dealing with growing demands for transparency. While nearly three-quarters expect appeals for greater transparency, the proportion of respondents advocating standardized reporting is smaller. Indeed, many respondents express reservations about greater disclosure.

We hope you find this study useful in demystifying the myriad challenges facing the PE industry as it looks to tap into new opportunities amid an increasingly complex set of circumstances globally.

Key findings

37%

of respondents say they will be prioritizing managing downside risk in their portfolio companies over the next 12 months.

57%

believe the PE industry should adopt a standardized reporting policy for fund performance to combat instances of fraud and improve transparency.

When asked which parts of their businesses have benefited the most from new technologies, the top three answers are:

- **regulatory reporting**
- **due diligence**
- **portfolio analysis**

60%

of respondents are looking to raise a fund over the next 12 months. Among those, 44% expect to raise a fund between the next three to six months.

Part 1: Moment of truth – Stick or twist

The COVID-19 pandemic and the economic and political pressure it has exerted have left PE firms in a quandary – they have to protect their portfolio companies while, at the same time, searching for new opportunities in a depressed and difficult market.

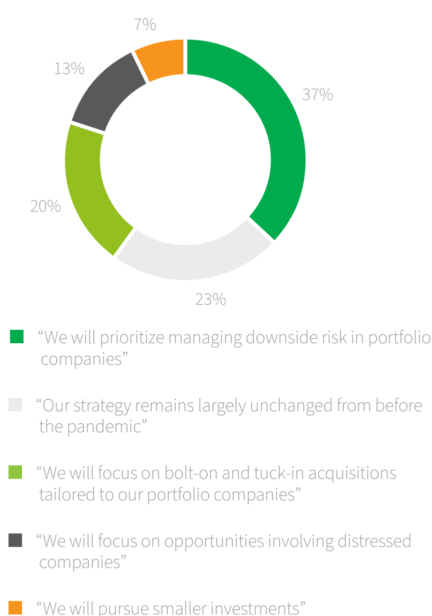
Our survey found that a small majority are favoring the former. More than a third (37%) of respondents say they will prioritize managing downside risk in portfolio companies over the next 12 months (Chart 1).

At one level, this means being prepared to support vulnerable portfolio companies impacted by COVID-19. But it also acknowledges the need to manage risks embedded in portfolio companies, including ESG risks, in light of growing scrutiny from investors and regulators. Either way, managing downside risk requires significant management resources.

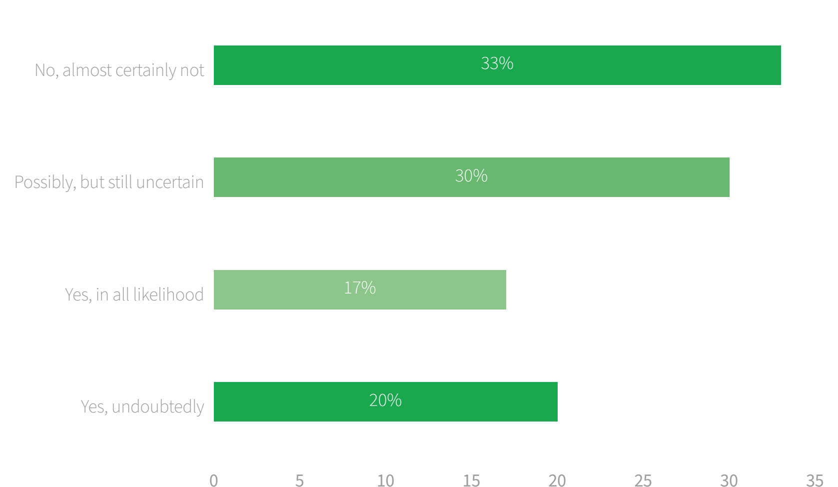
Meanwhile, 23% of respondents say their strategy over the next year will remain largely unchanged from before the pandemic, while one-in-five will focus on bolt-on and tuck-in acquisitions tailored to their portfolio companies.

While this suggests that PE managers are taking a somewhat pragmatic approach, the risk appetite remains undimmed for many, particularly when it comes to diversification. Our survey shows that more than one-third of respondents (37%) plan to diversify their asset class exposure over the coming year, including 20% who will certainly do so (Chart 2A).

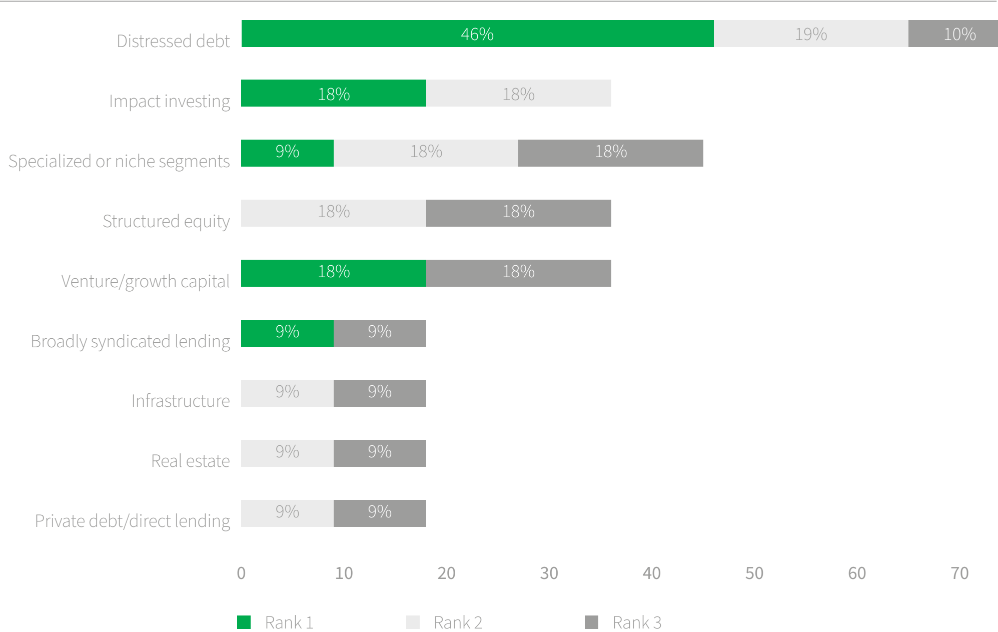
1) Which of the following best describes the strategy you are most likely to follow over the next 12 months? (Select one)



2A) Over the next 12 months, do you intend to diversify your asset class exposure?



2B) If 'yes, undoubtedly' or 'yes, in all likelihood', which asset classes are you intending to expand into? (Select top three and rank 1-2-3, where 1 is the highest priority)



Given the current economic turmoil, it is unsurprising that nearly two-thirds (65%) of the PE firms who plan to diversify say that distressed debt is one of the top-two asset classes they intend to expand into (Chart 2B). Aside from the fact that distressed debt is one of relatively few new growth areas, fund managers are responding to demand from investors who have an increasing appetite for distressed opportunities.

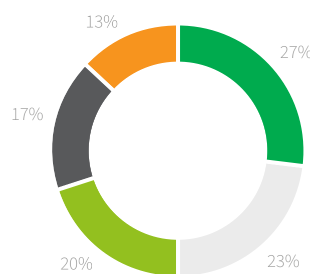
With PE firms under pressure to improve transparency and an increasing desire to be seen as a force for good, it is equally unsurprising to see that more than one-third of respondents (36%) plan to expand into impact investing (Chart 2B). Impact investing – in sectors from healthcare to sustainable food brands and renewable energy – could capture significant gains as consumer attitudes evolve post-pandemic.

Diversification motives

Venturing into new asset classes presents risks and is not a step managers take lightly. But for 27% of respondents, taking advantage of larger scale (Chart 2C) is one good reason for doing so.

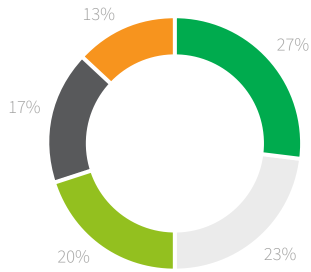
Size clearly matters – only 7% plan to pursue smaller investments as part of their strategy

2C) What is the main reason you are considering/ might consider expanding into new asset classes? (Select most important)



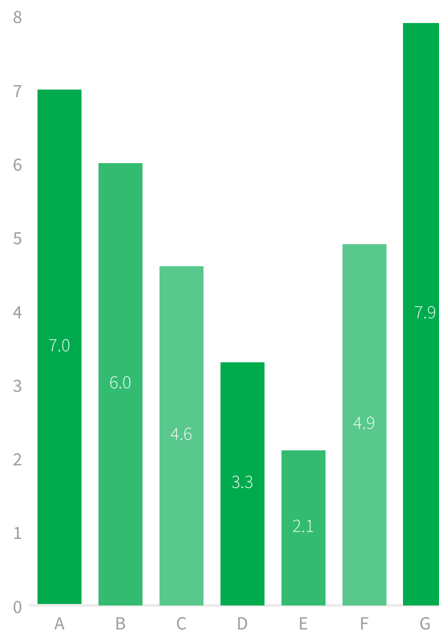
- Seeking advantage of larger scale
- Seeking higher returns/specific opportunities we perceive in non-traditional asset classes
- Investors' interest in new asset classes
- Hedging of risk
- ESG considerations

2C) What is the main reason you are considering/ might consider expanding into new asset classes? (Select most important)



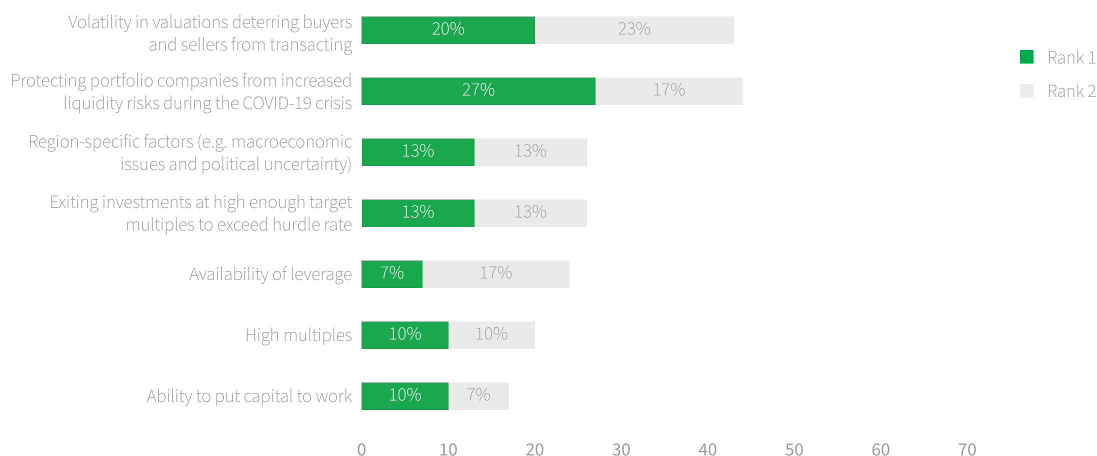
- Seeking advantage of larger scale
- Seeking higher returns/specific opportunities we perceive in non-traditional asset classes
- Investors' interest in new asset classes
- Hedging of risk
- ESG considerations

3) On a scale of 1-10, where 1 stands for 'very low levels', 5 represents 'normal or average levels' and 10 stands for 'very high levels', how would you rate deal flow or expect deal flow to perform in the following time periods? (Answer for each timeframe): (mean shown)



A In 2022
B In H2 2021
C In H1 2021
D In Q4 2020
E At the height of the COVID-19 crisis in your region
F At the onset of the COVID-19 crisis in your region
G At the start of 2020

4) What are the greatest challenges facing the PE industry? (Select top two and rank 1-2, where 1 is the greatest challenge)



over the next 12 months (Chart 1). Yet PE buyers may have little choice but to pursue larger acquisitions (often secondary buyouts) given the scarcity of smaller primary buyout targets.

There was certainly an appetite for larger buyouts in Q3 2020 (notably secondary buyouts) compared with recent years. According to Mergermarket data, the average value of a PE buyout in Q3 was US$201m, up sharply on the previous eight quarters, which posted a US$148.8m average.

The search for new sources of growth is likewise propelling the trend towards diversification. It is easy to see why respondents see diversification as necessary – given current circumstances, sectors such as real estate, leisure, hospitality and retail seem perilous.

Among our respondents, 23% say they are diversifying to seek higher returns and specific opportunities in non-traditional asset classes (Chart 2C). Reputational factors could also be spurring the shift into new asset classes, a point underlined by respondents' interest in impact investing.

Deal dilemmas

While average deal values this year have been among the highest recorded, deal volumes slid in the H1 2020. Indeed, Q2 saw one of the sharpest volume declines on record, falling to just 872 deals from 1,258 in Q1. Volumes have since staged a modest recovery (1,028 deals in Q3), although they remain well below the quarterly average (1,400) of the past two years.

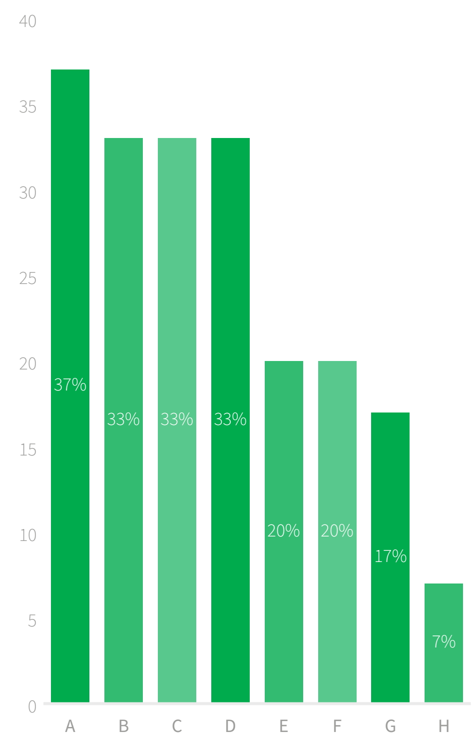
Respondents do not expect deal flow to return to levels seen at the start of 2020 any time soon, even in 2022 (Chart 3). They rate the deal flow seen in 2020 as 7.9 out of 10 (where 10 stands for "very high levels") before it dropped markedly due to the COVID-19 crisis. They give expected deal flow in 2022 a score of 7 out of 10.

Diminished deal flow is hardly the only headache for PE firms. Among executives surveyed, 44% cite protecting portfolio companies from increased liquidity risks during the COVID-19 crisis as one of the industry's greatest challenges currently, while 43% say volatility in valuations is deterring buyers and sellers from transacting (Chart 4).

Lockdowns, uncertainty around the US presidential election and questions around the terms of the UK's departure from the European Union are all contributing to volatility and making it more likely for deals to be delayed until next year.

The long-term outlook is seen as equally taxing, but for different reasons. Key concerns for the next five years identified by respondents include low growth, cited by

5) What are the biggest challenges facing the PE industry over the next five years? (Select top two)



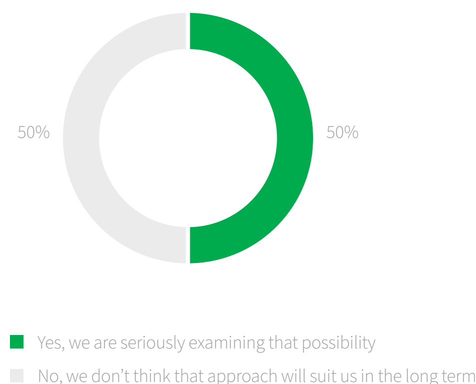
A Low growth
B Heightened regulatory risk
C Changing investor demands
D Failing to keep up with the pace of technological change
E Reputational risk
F Competition for deals/Paying an equitable price when many firms compete for an asset
G Cybersecurity-related concerns
H Attracting and retaining key talent

37% as being among the top-two challenges (Chart 5). Failing to keep up with the pace of technological change, shifting investor demands and heightened regulatory risk are also highlighted, each identified by 33% of respondents.

Pandemic challenges

A more immediate concern for PE firms is maintaining internal operations during the COVID-19 crisis. Remote working can help, although this entails ensuring that sensitive data remains secure, which can be difficult if staff work remotely. There is also the basic need to forge and sustain relationships with

6) In light of COVID-19, are you considering downsizing any of your physical office spaces and/or transitioning to a mostly remote-working approach?



partners, conduct due diligence and closely scrutinize assets, all of which are much harder to achieve at a distance or via Zoom. Respondents are divided over the best approach. Half are seriously considering closing or downsizing some of their office spaces and/or transitioning to a mostly remote-working approach in light of the COVID-19 crisis. The other 50% do not think this approach suits them in the long term (Chart 6).

Turning to COVID-19 measures for portfolio companies, nearly two-thirds of respondents who commented advocate remote working or minimal office use where feasible. Others are providing portfolio companies with guidance on maintaining safe procedures, as the Operating Partner of a US-based PE sponsor explains: “Cleaning crews, high-grade protection equipment and sanitization methods will be crucial. We’ve recommended that portfolio companies do not try to cut costs in these areas. The safety and security of employees and clients is the prime concern right now.”

Fundraising outlook: Smaller for longer

Even in the current climate, PE firms will continue to raise funds, but these will be smaller and timeframes are being extended

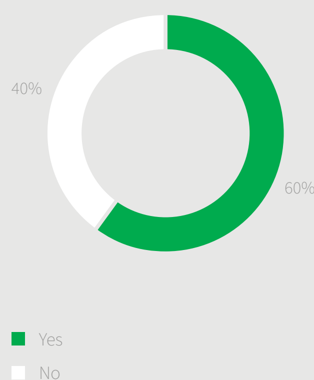
Deploying capital at the tail end of a downturn has the potential to generate strong long-term returns. But PE fundraising in a recessionary environment can be a challenge. The situation is complicated by the scale of the current dislocation, which includes not only the COVID-19 emergency, but also economic contraction, trade wars and geopolitical ructions.

COVID-19 health measures are a significant impediment to PE firms embarking on fundraising exercises. Travel restrictions, local lockdowns and social distancing all add to the trials and tribulations of raising capital.

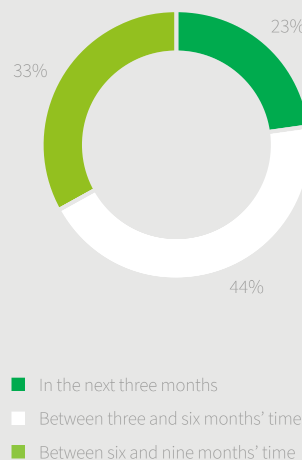
Headwinds aside, most respondents (60%) are looking to raise a fund over the next 12 months (Chart 7A). Among those, less than a quarter (23%) expect to do so in the next three months, underlining the point that most PE firms and potential limited partners are waiting for the dust to settle. Almost half (44%) expect to raise a fund between the next three and six months and a third expect to do so in six to nine months (Chart 7B).

While there is clearly still an appetite for fundraising, PE sponsors are remaining realistic. Half of respondents say the next fund raised will be smaller than the previous one, while only 22% envisage a somewhat larger fundraising (Chart 7C).

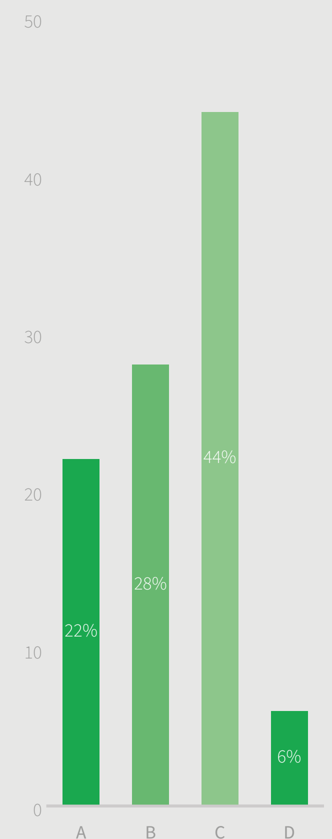
7A) Are you planning to raise a fund over the next 12 months?



7B) If 'yes', in what timeframe do you expect to raise a fund?



7C) If 'yes' to part A), do you expect it to be roughly equal to, smaller or larger than the fund you most recently raised?

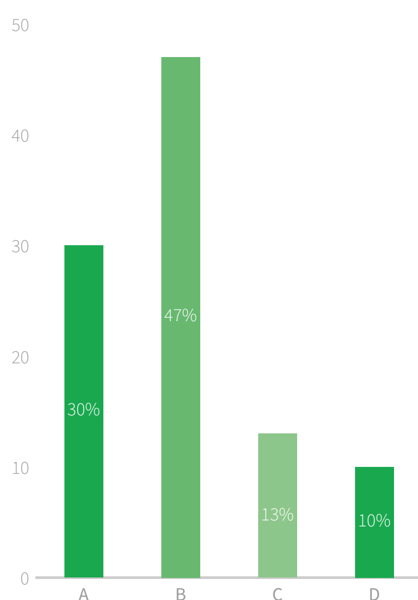


Part 2: Technology uptake – Digital solutions

New technologies, including artificial intelligence and machine learning, have the potential to transform every facet of a PE fund's life cycle. Applications include evaluation of portfolio candidates, post-investment value creation, fulfilling compliance obligations and fine-tuning exit strategies.

Managers are adopting new technologies for various reasons, including the need to respond to increasing regulatory scrutiny. From fee disclosure to guarding sensitive data, PE firms need ways to monitor and account for their actions. New digital tools can help to manage regulatory complexity.

8A) How optimistic are you about your ability to leverage technological advancements and digitalization for growth?



A Very optimistic
B Optimistic
C Neutral
C Pessimistic

"Regulatory technologies and due diligence collaboration tools have been by far the most beneficial for our business activities," says the CFO of an Italy-based PE firm. "They provide support to the business by bridging the gap in communications and dealing with compliance complications systematically."

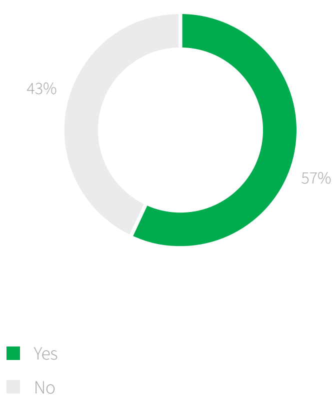
Data holds the key

The uptake of advanced technologies and the adoption of data science techniques are also being driven by shifts in the competitive landscape. Bidding processes are increasingly pressurized and, in many cases, investment teams have only a short time to learn about the operations of a target company. Typically, all bidders will have access to more or less the same raw data. Gaining a competitive advantage increasingly hinges on being able to combine this with third-party data sets to gain new insights – and to do so rapidly. Data analytics holds the key. Armed with better information, sponsors can push assumptions and make better-informed bids.

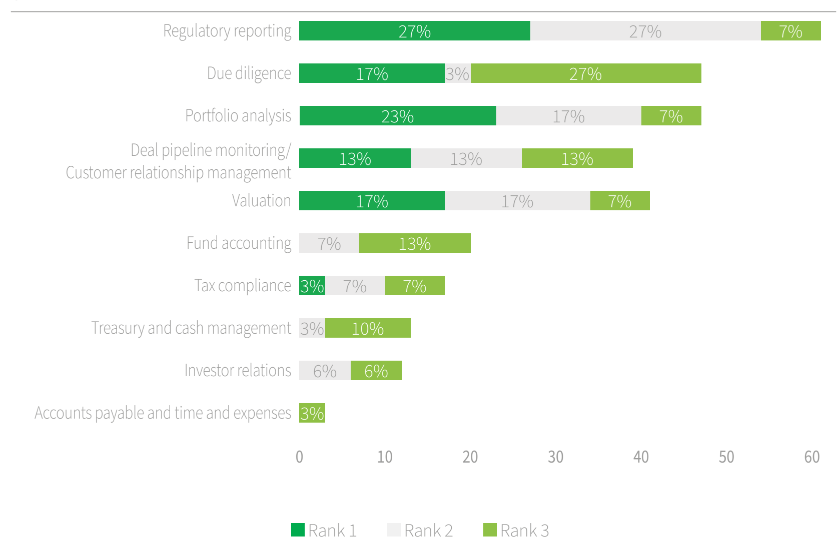
"For competitive differentiation, we are trying to reduce manual tasks and automate more processes. It reduces the burden on our teams, so they can focus on their core tasks."

Operating partner at a US-based private equity firm

8B) Has that outlook been impacted or informed by the previous adoption of a new technology or technologies?



9) In which areas of your business has the adoption of advanced technologies had the greatest effect? (Select top three and rank 1-2-3, where 1 is the area that has seen the greatest benefits)



Underlying all of this is the trend towards diversification. As noted in the previous section, more than a third (37%) of respondents intend to diversify their asset class exposure over the coming year. Digital tools will increase in importance as PE managers race to weigh up investments across new geographies and unfamiliar sectors. They will also help monitor and boost the performance of diverse portfolio companies throughout the holding period.

Growth drivers

Our survey shows that more than three-quarters of respondents (77%) are optimistic about their organization's ability to leverage technological advances and digitalization for growth (Chart 8A). Most (57%) say they arrived at this view as a result of their previous experiences adopting new technologies (Chart 8B).

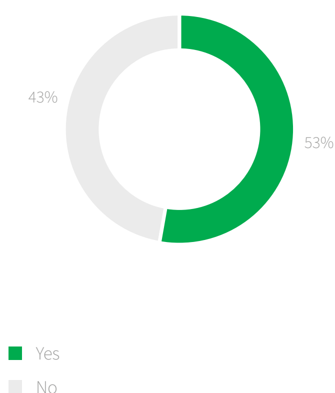
PE's increasing preoccupation with compliance is palpable. When asked which parts of their businesses have been impacted the most by new technologies, 61% of respondents cite regulatory reporting in the top-three areas (Chart 9).

Although regulatory reporting is highly rated, the survey underlines the extent to which respondents see digital tools as key to driving business value. They point to due diligence (47%) and portfolio analysis (also 47%) as areas of their business where technology is proving beneficial.

New technology for valuation (highlighted by 41%) and deal pipeline monitoring/customer relationship management (cited by 39%) are also ranked highly in terms of delivering the greatest benefits.

Lower scores are given to tools broadly associated with bookkeeping. Among these are fund accounting (mentioned by 20%), tax compliance (17%), treasury and cash

10) Do you consider your uptake of technological advancements and digitalization a competitive differentiator?



management (13%) and accounts payable/time/expenses (3%). These low scores likely reflect the fact that digital technologies are already well established in these areas.

Most respondents (53%) see their uptake of technological advancements and digitalization as a competitive differentiator (Chart 10). Analytical functions are highly prized. The COO of a PE sponsor based in the United Arab Emirates says: "Artificial intelligence and machine learning technologies have become an integral part of our due diligence process. Research data is transformed into actionable information with these applications."

The competitive benefits are tangible, says the CFO of a US-based firm: "We use technology to source suitable targets with maximum accuracy – it assesses the effectiveness of business models based on sector and market characteristics."

ESG issues: A braver, cleaner, greener new world?

COVID-19, climate change and societal shifts are forcing firms to concentrate on environmental, social and governance (ESG) considerations. And if they don't, they risk being left behind.

The COVID-19 pandemic is accelerating change in all fields, including PE. Attitudes towards how and where money is invested are shifting, prompting both limited and general partners to re-evaluate their priorities.

Unsurprisingly, limited partners are increasingly turning their focus to ESG considerations, particularly where there is a need to align investments with the aims of their sponsor's corporate social responsibility strategies. Pension funds, for example, comprise the biggest group of PE investors and are rapidly embedding ESG concerns in their investment criteria.

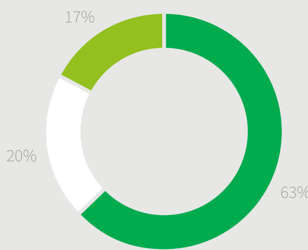
An increasing number of PE firms are screening portfolio candidates against ESG yardsticks to identify potential issues. "Companies that consider active contributions to sustainable development will be preferred. Investment choices will be further filtered in cases where the ESG standards do not meet our expectations," says the CFO of a France-based PE firm.

Most respondents (83%) agree that the COVID-19 crisis will raise meaningfully the profile of ESG issues in the PE industry (Chart 11). The same proportion of respondents intends to escalate efforts to manage and track the ESG performance of their portfolio companies (Chart 12).

Although ESG is still perceived in some quarters as just another hurdle, several respondents point to business and reputational upsides.

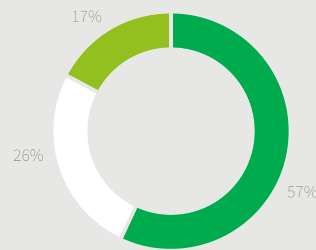
"We have understood the greater value ESG plays when associating with a target company," says the COO of a Swiss-based sponsor, while the CFO of a PE firm based in Germany says: "Environmental due diligence is being given more

11) To what extent do you agree with the following statement: “The COVID-19 crisis will raise meaningfully the profile of environmental, social and governance (ESG) issues in the PE industry”?



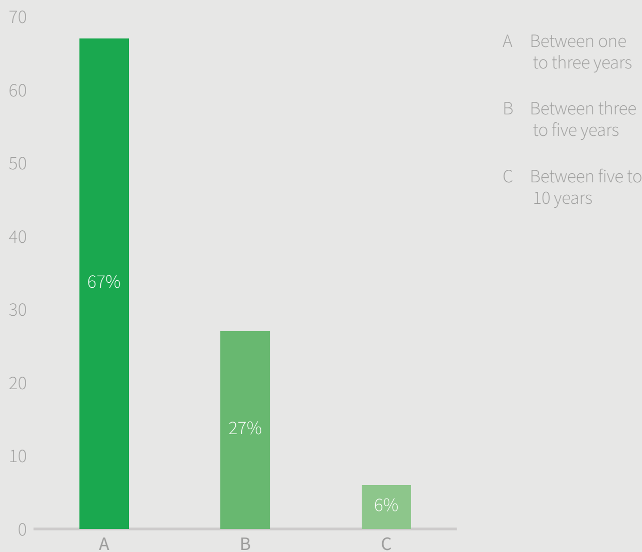
- Strongly agree
- Agree
- Neither agree nor disagree

12) Over the next 12 months, do you intend to escalate efforts to manage and track the ESG performance of your portfolio companies?



- Yes, we intend to dedicate significantly more resources to tracking ESG performance
- Yes, we intend to dedicate some more resources to this, though it's not a priority
- No, we are satisfied with our current ability to track ESG performance

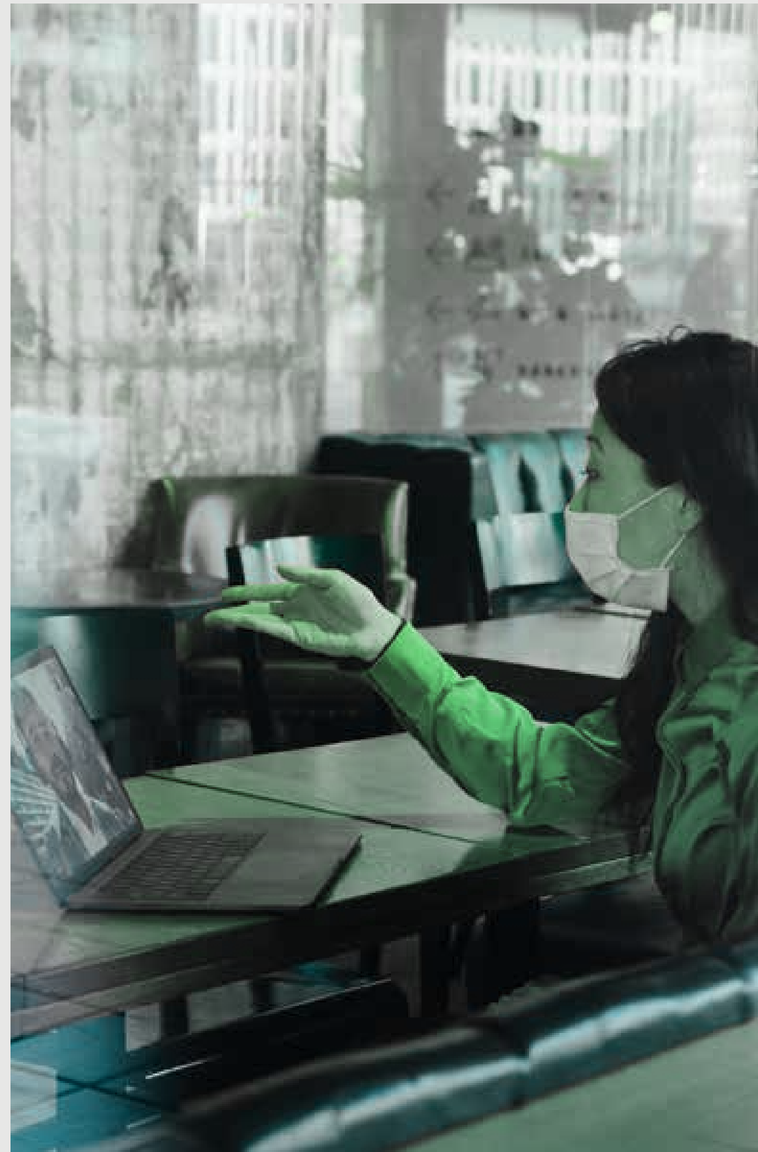
13) How long do you think it will be before a standardized approach to managing ESG data and measuring ESG performance is adopted across the PE industry as a whole?



A Between one to three years

B Between three to five years

C Between five to 10 years



importance because this will define how the company is viewed in the market.”

The lack of consistent ESG evaluation frameworks remains a stumbling block. But respondents expect this to change sooner rather than later: 67% think a standardized approach to managing ESG data and measuring ESG performance will be adopted across the PE industry in the next one to three years (Chart 13).

Part 3: Transparency in private markets – Cards on the table

Transparency is a long-standing issue for the PE sector, and one that is being brought more into focus by the pandemic. With markets tightening and the economic outlook uncertain, investors, regulators and politicians are demanding a higher level of disclosure by PE firms.

In our survey, 63% of respondents have perceived a change in the depth and breadth of reporting requirements their stakeholders will require or demand in the near future (Chart 14). Meanwhile, 70% expect appeals for greater transparency in private markets to intensify over the next 12 months (Chart 15). In short, the need to provide timely and accurate reporting is becoming increasingly urgent.

Disclosure outlook

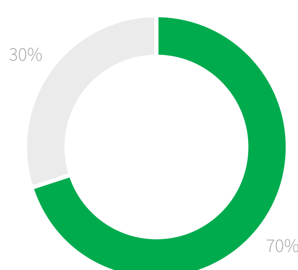
So, what kind of data is being collected by stakeholders now, and how do respondents expect this to change? Respondents' comments reveal the current emphasis is confined mostly to providing financial information. Spending figures, quarterly performance data and provisions for portfolio companies predominate.

Looking ahead, demand for non-financial information is predicted to come to the fore, particularly ESG data. "Sustainability reporting is expected to increase," says the COO of a Switzerland-based PE firm. "As companies adopt new ESG guidelines and their policies undergo change, limited partners and boards of directors will want to be updated about progress on a regular basis."

In addition to ESG reporting, respondents point to a probable increase in demand for disclosures around technology integration by portfolio companies, customer engagement strategies, supplier/employee productivity, talent management and reasons for exits.

14) Have you perceived a change in the depth and breadth of reporting requirements your stakeholders will demand in the near future?

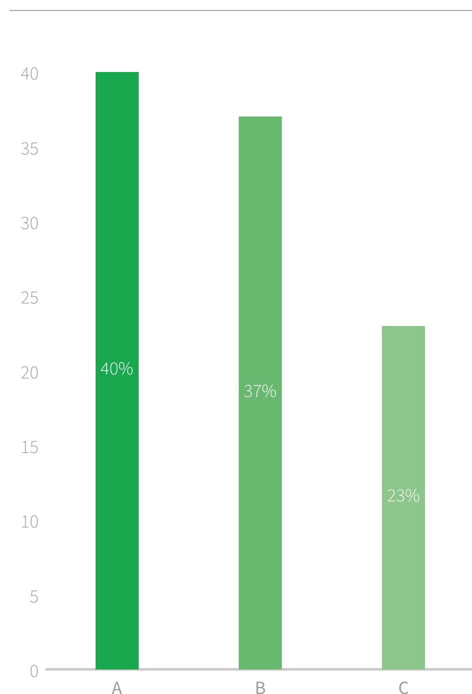
15) Do you expect appeals for greater transparency in private markets to intensify over the next 12 months?



> *"More streamlined sell-side processes can be attributed to allowing experts to intervene. Legal, financial, human resources, and IT teams were involved closely in important decisions in a recent deal."*

Managing director at a US-based investment bank

16) How do you predominantly share data/information with stakeholders? (Select one)



A Static files (PDFs and Excel documents) sent via email
B Through shared business intelligence software
C Customizable online investor portals

Stakeholder demand for data is clearly rising. However, survey responses suggest the PE sector may be lagging when it comes to best practice for sharing information with interested parties, at least as far as platforms are concerned. 40% of respondents depend on emailing out static files, such as PDFs and Excel documents, while 37% use shared business intelligence software. Only 23% have deployed customizable online investor portals (Chart 16).

The reliance on static documents suggests that reporting for stakeholders is being put together ad hoc, rather than being compiled routinely, and that data is not as readily available as it might or should be. Yet limited partners and other stakeholders increasingly expect to access data easily via a single platform that offers a unified view.

Transparency concerns

Given the absence of standardized reporting frameworks, it is perhaps unsurprising that respondents are currently using myriad methods to share data and information with stakeholders.

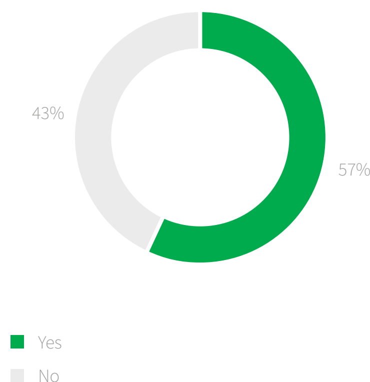
Behind all of this is a wider uneasiness within the PE sector about what is meant by transparency and how far it should go. "The main operational hurdle would be to identify the level of transparency expected and provide necessary guidelines for the protection of information," says the CFO of a US-based PE firm. "Not all information can be disclosed upon request, because we also hold sensitive data."

Respondents highlight several specific concerns about transparency. Among these are threats to client information, worries about data theft, confidentiality risks in target sourcing, and delays in transactions. Another worry is diversion of management resources, a point made by the Operating Partner of a US-based sponsor: "Priorities are more likely to change from maintaining relationships with limited partners to addressing concerns associated with transparency."

Despite this – or perhaps because of it – a majority of respondents (57%) believe the PE industry should adopt a standardized reporting policy for fund performance to combat instances of fraud and improve transparency (Chart 17). This contrasts with the somewhat greater proportion (67%) who believe a standardized approach to managing ESG data will be adopted in the next one to three years (Chart 13).

ESG and transparency goals are not so far removed from one another. Ultimately, it could be the market-led push for ESG rather than regulator-driven demands for transparency that will deliver the standardized reporting that stakeholders increasingly expect.

17) Have you perceived a change in the depth and breadth of reporting requirements your stakeholders will demand in the near future?



Yes
No

Conclusion: A new landscape

From COVID-19 to Brexit, challenges abound for the PE community, but our survey reveals that most firms are up for the fight. First, PE firms are actively managing downside risk in their portfolio companies – including operational risks associated with COVID-19. Second, a significant proportion of respondents are looking to tap into higher returns by diversifying their asset class exposure. Third, firms are increasingly adopting advanced technologies to acquire a competitive advantage. "Technology provides an edge when it comes to taking important decisions," confirms the CFO of a Germany-based PE firm. "Predictive analysis and automation have been the most functional and advantageous technologies."

However, risks remain. Evidence suggests PE buyers are being pushed into progressively larger secondary deals as primary buyout opportunities dwindle. The long-term implications of this are unclear, but there is a risk that the scope for improving the performance of portfolio companies that have already been through PE ownership may be limited. Political risks also stalk the horizon. The controversy surrounding the use of government loans and stimulus spending to shore up portfolio companies is just one example. The case for PE is not helped by the sector's perceived opacity.

Yet our survey shows that attitudes within the sector are shifting. Nearly three-quarters of respondents expect demands for greater transparency to intensify. Meanwhile, an even greater proportion intends to escalate efforts to manage the ESG performance of portfolio companies. All of this bodes well as PE looks to the future and pivots to reap the post-pandemic rewards.

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