Private Equity and Its Response to COVID-19

BY MYRA THOMAS

Key players discuss how the pandemic and its economic fallout are affecting PE and other types of alternative financing and what they foresee for the short term.

The onset of the pandemic has certainly changed the fundraising and investing landscape for private equity and other types of alternative financing. While most acknowledge that the lack of face-to-face meetings has made the fundraising process and due diligence on deals more difficult, the PE industry and related players remain a resilient lot. Even with the country's shutdown and the resulting economic problems, private equity firms are prioritizing their existing portfolios, working to figure out ways to shore up these companies.

I believe this will change how we do business going forward. The influx of stimulus money has reduced our outstanding and has put our clients in a more favorable loan-to-collateral position to get through this situation. Bottom line: we needed to over-communicate with each other to get these changes in place and to fully utilize the technology available to us to do it.

Not surprisingly, the strategy has created a slowdown in deal activity. According to PitchBook, a financial data and software company, U.S. private equity deal activity dropped almost 20% in the first half of 2020. As PE players sought to weather the proverbial storm and deal with the uncertainty of the pandemic, exits decreased too. PitchBook research revealed that announced global PE exits fell about 70% in May 2020 as compared to May 2019.

Flight to Safety

Instead, it was "all hands on deck" and the focus moved to the existing portfolio when the coronavirus hit its peak in March and April, says Michael W. Rubel, managing director at RFE Investment Partners, a private equity firm focused on the lower middle market. The liquidity of portfolio companies remained the biggest issue. Fortunately, notes Rubel, the financial environment did begin to stabilize in May, especially with the federal government stepping in to shore up the economy with the CARES Act funding for businesses and individuals. But federal government assistance, says Rubel, will run out and coronavirus cases could increase.

The public market continues to seemingly brush off that possibility and the inevitable double whammy to the economy. Rubel is taking a more cautious and long-game approach, as it seems many private equity players and other alternative lenders are doing. "Private equity is still a cash game," he says. "You have to plan for a rainy day. We hope the worst is behind us, but our efforts need to be well funded just in case we hit another roadblock."

The economic environment has brought add-on sellers to the table, and PE firms couldn't be happier. The add-on sellers are noting the benefit of having a private equity firm there to facilitate an acquisition into one of PE's existing and strong platform companies. "You have to be opportunistic in the right areas," Rubel adds. While there is a flight to safety, private equity still needs to do deals, and that means partnering with sturdy companies that are somewhat COVID-19 proof and ensuring the capital structures on all deals have low debt levels and ample liquidity.

Roundtable Participants

TOM ARONSON
Monroe Capital

DENNIS O'ROURKE
Moritt Hock & Hamroff

MICHAEL W. RUBEL
RFE Investment Partners

STACEY J. SCHACTER
Vion Investments

BRIAN SHLOSS
Summit Investment Management

All Things Are Not Equal

Certainly, the focus has been on existing borrowers, says Tom Aronson, partner, head of originations for Monroe Capital, a middle-market lending platform providing senior debt financing to businesses, private equity sponsors, and special situation borrowers. "The immediate requests after the virus hit involved draws on revolvers to ensure adequate liquidity for companies," he notes. Whether it's asset-based lenders, commercial banks or unitranche financing, the focus remained on the existing portfolio companies.

The economic impact on portfolio companies was, and still is, uneven at best. “Some businesses weren’t affected at all or may have been positively impacted, and their purchase multiples remain high,” Aronson notes. For companies in the travel, event, hospitality, and construction sectors or businesses dependent on them, the negative ripple effect will continue for quite some time. “The impact wasn’t felt by all of our portfolio companies in the same way,” he says. “That’s why Monroe Capital continues to work closely with each of our portfolio companies to do our best to get them through the COVID-19 crisis.”

The best deals continue to percolate to the top. “Software, healthcare and business services remain relatively COVID-resistant, with strong valuations,” says Aronson. “They’re acting as the primary area for deal flow.” For companies not doing as well—entertainment, travel, leisure, and retail—if they were looking to be sold, they’re sitting on the sidelines now. Deals are structured for the times, with leverage lower for a more conservative covenant package. And, says Aronson, the lender community, by and large, is scaling down the size of holds, resulting in more club transactions.

The Long-Range Perspective

According to Brian Shloss, chief operating officer, Summit Investment Management, it’s smart to take a longer-term view of the assets underwritten. Summit invests in under-performing and distressed debt, corporate restructurings, and complex opportunistic credits and joint ventures. “Maybe two years from now or so, an asset may come back to pre-COVID levels or maybe it will be irreparably harmed and will need to be sold off in pieces,” he says. “We’ll have to make those determinations in our investment decisions.”

The determinations will impact the hold periods, of course. Discount rates may rise depending on expected returns. However, the current situation is a big unknown. “There’s a certain amount of risk that you factor into the deal at any time and especially given the situation now,” says Shloss. “We’ve just come out of a strong bull cycle with good credits. There’s always been distressed companies, but it’s been leaner the past few years.” That may change, especially if COVID-19 cases once again rise, bank lending standards tighten, and liquidity issues arise.

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Many more hospitality, travel, retail, restaurant, and oil and gas companies are likely to fall into the “distressed” category, if they haven’t already. “It’s a hallmark of the time,” says Shloss. “There are restaurants and hotels etc. that will inevitably go out of business, and other big projects that simply may not get off the ground.” But banks are doing something they didn’t necessarily do in the financial crisis of 2007, when the government stimulus was directed at them versus stimulus being directed at the consumer and affected businesses this time around. They’re already taking large loan loss write-offs and being relatively proactive when it comes to the balance sheet and the risk.

Shloss expects banks to use their reserves somewhat aggressively in 2020, in order to sell off their current inventory of distressed assets. The reason, he notes, is that they may be anticipating more delinquencies and defaults to come, especially as the government stimulus money burns off. “We then can envision a period in which bid-ask spreads are disconnected, at least at the beginning of 2021,” adds Shloss. “Banks will need to evaluate what they want to do with a new inventory of distressed assets. Expect bidders to remain cautious about the macro environment too, particularly if COVID remains a problem through the winter or if there is political fallout from the election or both.”

A Foot on the Brake

The economy is better suited to handle a major hurdle than it was 12 to 13 years ago during the financial crisis. Still, it was inevitable that banks would tighten their lending standards during the current economic downturn. Despite the uncertainty, valuations have yet to be largely impacted by the financial shock of COVID-19, notes Dennis O’Rourke, partner at Moritt Hock & Hamroff LLP. “Private equity may be doing less deals and multiples have come down to spread the money out more efficiently, but deals are still getting done,” he adds.

However, many of the deals getting done were struck pre-coronavirus.

O'Rourke projects there just may be a valuation gap coming down the road. Sellers are still going to be expecting pre-COVID multiples. "Private equity won't want to continue paying as high a multiplier for a portfolio company, given the virus, especially if things get worse," he notes. "Complicated earn outs and backend payments may be coming." Plus, he worries that there will be a tightening by lenders funding PE firms. The unpredictable nature of the situation is what's keeping many deals on the backburner.

Stacey J. Schacter, CEO of Vion Investments, contends, "There are opportunities no matter the time, and there are always winners and losers in any market." Vion Investments provides liquidity solutions for companies based on their cash-flowing assets. In the medical sector, for instance, the demand for PPE has pumped tons of cash into companies producing these medical supplies and distributing them. Online retailers and grocers also enjoyed a significant bump in revenues, given the shutdown. "The real losers aren't going to recover, even with credit support, so we're chasing large, troubled companies and buying assets," he says. "Liquidation scenarios are good ones." The rules have changed, and alternative lenders are adjusting to the new dynamic.

The word of the day is "patience", says Schacter. "There's no reason to jump in thinking you just need to deploy capital. Let the water settle a bit. The first people in may not be making the most money anyway." He believes valuations are bloated and likely to fall. For now, hold times aren't changing for Vion Investments. "We stress proformas to determine what we think would happen in any situation and see if the company fits within our investment profile. One thing you don't deviate from are your principles."

"Everyone is working together more closely," he says. "There's good dialogue between PE sponsors and borrowers—a 'we're all in this together' approach." It's all about working together to get good structures and to do transactions that make sense.

A Look Ahead

As the country enters flu season, no one is sure what's ahead for coronavirus infection rates in the U.S. The progress of vaccine research does offer a glimmer of hope but getting a safe vaccine to the public is still an arduous and drawn-out process, even with President Donald Trump's Operation Warp Speed in place. The one thing that industry players are certain about is that private equity needs to stay disciplined to weather the ups and downs of 2020 and beyond.

No one knows for sure, but everyone is hoping the current economic crisis is relatively short lived and companies end up structurally sound. The low Fed funds rate and the way that the Fed and Treasury stepped up to put cash into the economy did mean there wasn't a devastating and cascading economic effect in the U.S. As things begin to settle and infection rates drop, private equity is still moving forward and looking for the right opportunities in an uncertain market. Aronson notes, "PE and private debt firms are looking to deploy cap with good sound investments out there. And they are there."

It's a vastly different situation from the downturn of 2007 and 2008, which was largely lender-inflicted. "Private equity sponsors came to us then and were more demanding of what they could ask for," says Aronson. Now, no one knows what will happen, and no one has control over the situation. Add in political uncertainty, and it's a risky proposition. "Everyone is working together more closely," he says. "There's good dialogue between PE sponsors and borrowers—a 'we're all in this together' approach." It's all about working together to get good structures and to do transactions that make sense.

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Myra Thomas is an award-winning editor and journalist with 20 years' experience covering the banking and finance sector.