The impact of coronavirus on the UK private equity market

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Introduction

Introduction

Context

The global outbreak of coronavirus continues to adversely impact financial markets worldwide. The full extent of the global impact of the pandemic is still uncertain, and the advice and reaction of the UK government is continuously evolving. Coronavirus has already had, and will continue to have, serious implications on financial markets, including the private equity (PE) industry. Prior to the crisis, PE enjoyed a sustained period of booming deal flow, performance and fundraising; European PE deal volumes even hit a record high in Q1 2020. Within the UK lower mid-market more specifically, PE has been an important part of the economy, supporting SMEs in growing and achieving their ambitions.

As the situation has developed in the UK, PE funds initially turned their attention away from deal making, instead ensuring that their portfolio companies are well equipped and funded to weather the immediate storm. As we continue to adjust and establish new ways of living and working, PE firms are turning their attention to how they will be able to build (or re-build) value in their portfolios, as well as how best to deploy their vast levels of dry powder into new deals.

Basis of preparation

To understand the situation more clearly, we conducted a survey in May 2020 of 151 PE professionals, representing 84 mid and lower-mid market General Partners (GPs) across a range of strategies. This report analyses the results, and gives a snapshot of UK PE market sentiment during the coronavirus pandemic. Supplemented with insights from a panel of leading PE investors, the report will discuss the steps that PE firms have taken to safeguard their portfolios, as well as the ambition and challenges of completing deals in the aftermath of the pandemic.

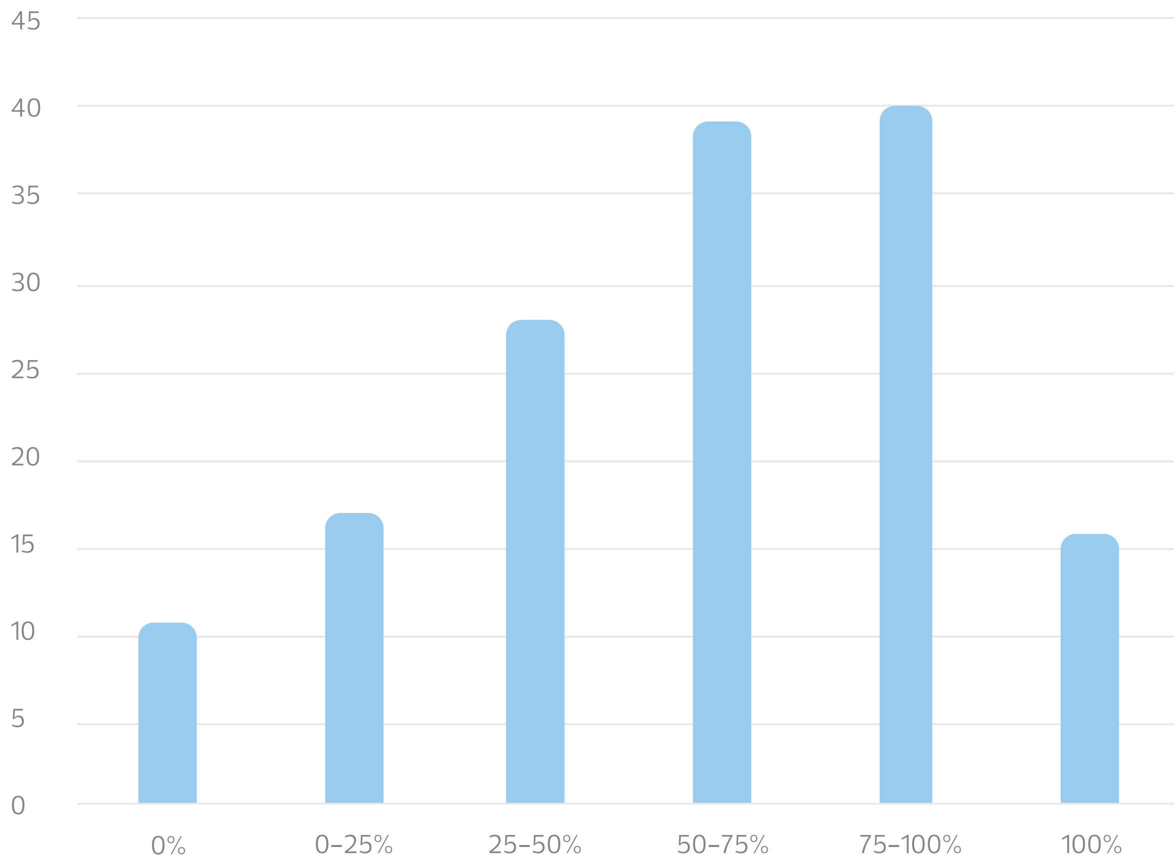
watch the webinar here

Key findings

1. The Coronavirus Job Retention Scheme (CJRS) has had significant uptake from PE portfolio companies.
2. Uptake of government funding schemes, such as Coronavirus Business Interruption Loan Scheme (CBILS), has been muted amongst PE-backed businesses and there have been challenges for PE-backed businesses to access these funds.
3. As a result, many PE firms have deployed, or expect to deploy, further capital to support their existing investments with funding requirements.
4. PE firms are very bullish about their future investment activity, with the majority expecting to complete new platform deals in processes that have already begun or will commence later in the year.
5. Bolt-on activity is expected to be a key feature of PE deal making this year, with over three quarters of PE firms expecting to support a portfolio company in completing an add-on acquisition.
6. PE deal volumes are expected to decline dramatically across the market despite individual optimism.
7. Robust sectors such as technology and healthcare are expected to remain attractive.
8. The biggest challenges to completing deals this year will be the impact on company performance caused by coronavirus, as well as a lack of time spent with management teams due to social distancing measures.
9. PE firms will face further challenges with exit plans expected to be pushed out, as well as a challenging fundraising environment.

Supporting the portfolio

Supporting the portfolio

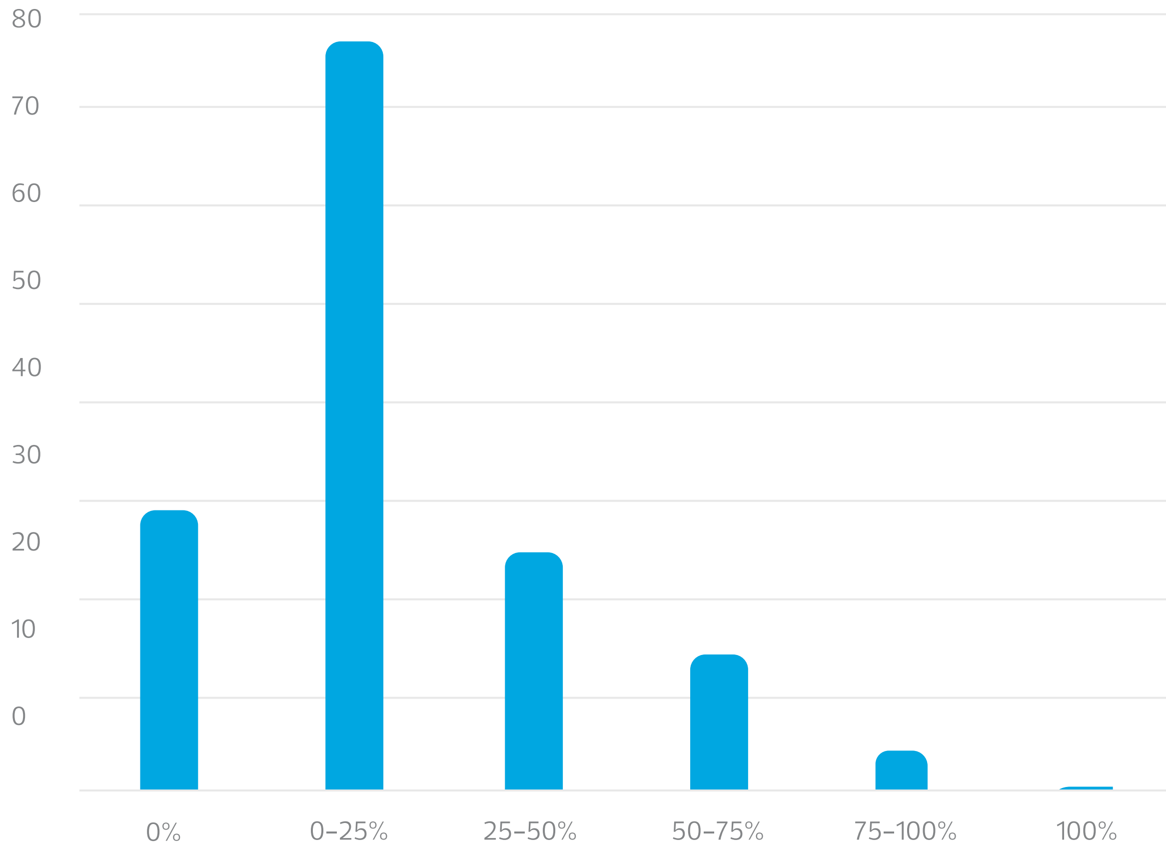


What proportion of your portfolio companies are utilising the Coronavirus Job Retention Scheme?

Utilisation of the Coronavirus Job Retention Scheme has been widespread

In the days immediately after the UK lockdown was announced, PE firms turned their attention away from new deals, and instead looked towards their portfolio companies' short-term requirements. Much of this support was focused on stress testing, forecasting and cash management to ensure that companies had the short-term liquidity to survive a significant reduction in trading. Where possible, PE firms have also taken advantage of government reliefs to support their investee companies.

Our survey found that 92.7 per cent of respondents have utilised the CJRS in at least one portfolio company, which has undoubtedly helped businesses in saving operating costs and, as in most other areas of the economy, provided an alternative to a wave of job losses. The majority of PE firms surveyed (62.9 per cent) are using CJRS in 50 per cent or more portfolio companies, indicating how far reaching the adverse impacts of coronavirus have been.



What proportion of your portfolio companies has applied or is likely to apply for a CBILS or CLBILS loan?

The need for additional liquidity is common but the uptake of CBILS has been muted

The Coronavirus Business Interruption Loan Scheme (CBILS) and Coronavirus Large Business Interruption Loan Scheme (CLBILS) were also introduced by the government in March to provide a vital line of financing to support the liquidity of many businesses, including those backed by PE. However, many PE portfolio companies were initially deemed ineligible for the loans by banks as their perception of the rules stipulated that turnover was calculated on a group basis, taking into account the portfolio as a whole. This rule was later clarified to allow portfolio companies to apply as separate entities for the government-backed loans.

Our survey found that 80.8 per cent of PE firms have applied for a government supported loan in at least one of their portfolio companies, demonstrating its attractiveness as a source of company liquidity, as opposed to injecting further equity. A very low proportion of portfolio companies have applied for such schemes though, with 65.4 per cent of respondents having applied for loans in 0-25 per cent of portfolio companies. This low proportion demonstrates that PE funded companies are typically well capitalised and government funding hasn't been necessary for the most part. Additionally, for businesses where there is a fundamental trading issue, adding more leverage is not a sustainable solution.

We have been really supporting our portfolio companies in developing well thought-through plans as there's a need to adapt very quickly. This is unchartered territory.

Zoe Clements, Palatine Private Equity

Have any of your portfolio companies been successful in an application for a CBILS or CLBILS loan?

42.6% – Yes **57.4%** – No

> The CBILS scheme in its first wave, and since then, has been difficult to navigate.
>
> **Lawrence Dean, LDC**

Between now and the end of 2020 how likely are you to deploy further capital to support your existing portfolio companies with funding requirements?

42.6% – Very likely **23.8** – Unlikely
57.4% – Likely **5.3%** – Very Unlikely

Accessing government funding has been challenging, and many PE firms expect to deploy further capital to portfolio companies

For those that have applied for CBILS or CBILS loans it appears that it has not been easy to successfully secure funds. Less than half (42.6 per cent) of those PE firms that have applied for at least one government-backed loan have successfully secured funds. A substantial barrier to portfolio assets in accessing the government-backed loan schemes has been that, under EU state aid rules, firms that had accumulated losses greater than half their subscribed share capital as at 31 December 2019 are not eligible for government support as they are deemed to be a 'business in difficulty'. Due to the use of loan notes in structuring PE deals, which for most purposes are treated as equity as interest is rolled but for the CBILS test are treated as debt, the leveraged structure of many PE-backed companies has made them ineligible.

From our conversations with the PE community, it also seems that different banks are varying in their level of supportiveness towards PE-backed companies.
The goalposts are continually moving, and the British Private Equity and Venture Capital Association (BVCA) is lobbying the EU Commission to change the rules. However, as financial investors sitting on vast levels of 'dry powder' (money raised by funds that is yet to be deployed), PE firms are unlikely to be top of the government's agenda for support due to their ability to deploy more of their own capital to support investee businesses.

70.8 per cent of PE firms do anticipate investing further capital to support their existing portfolio companies between now and the end of 2020. Many of these PE firms will have already taken other measures to support the cash position of portfolio companies, however, with sustained periods of depleted trading, many businesses will require further injections of equity to give them enough headroom to continue operating. Many PE firms have additional capital that they are able to deploy but will no doubt seek cheaper financing options first, such as bank debt. Investing further equity capital into portfolio businesses will have an adverse impact on returns upon exit, dissatisfying their own investors, known as Limited Partners (LPs), as well as jeopardising potential carried interest for GPs.

> In normal times, private equity will hope that any additional funding that is going to be required for their investments is perhaps reserved for growth capex, bolt-on acquisitions or for more strategic projects, rather than crisis cash management and funding trading losses, which I suspect has been the purpose of the additional money more recently.
>
> **Richard Harrison, Endless**

Looking ahead to deal making

Looking ahead to deal making

Accessing government funding has been challenging, and many PE firms expect to deploy further capital to portfolio companies

Having addressed the short-term needs of portfolio companies, PE firms have now pivoted their attention back towards their core focus: sourcing and executing attractive investment opportunities. The majority of survey respondents (73.5 per cent) expect to complete a new platform investment in a deal process that had commenced before the implications of coronavirus; likely a deal that was already well progressed before the lockdown restrictions, where the PE firm has spent a considerable amount of time with the management team of the target company. We have seen deals complete over the past few weeks, however, timelines are likely to be elongated due to the challenges posed by remote working on finalising due diligence. Many pre-coronavirus deal processes have been cancelled or paused, particularly for companies that have seen performance adversely impacted, and consequently may no longer be attractive targets in the short-term.

There is also a lot of confidence amongst PE investors that they will complete a deal that had not commenced ahead of the coronavirus lockdown, with 69.6 per cent of respondents believing that they are more likely than not to complete a platform before the end of 2020. New deal processes appear to fall into a few categories:

1. Robust businesses that are trading in line with or ahead of business plans, despite the disruption, that may kick off a PE process as originally planned.
2. Growth capital deals that have seen plans accelerated in order to provide further funding to support businesses that are seeing excess demand in their product or service.
3. Distressed opportunities where businesses have experienced trading challenges as a result of the pandemic.

PE firms are unlikely to pivot their strategies despite the varied deal opportunities. For example, a growth focused PE firm is unlikely to invest in a distressed business, but there are a number of special situation focused funds who are highly experienced in investing in such situations. The PE market is diverse and there is an availability of capital and support for businesses, regardless of their current situation.

Between now and the end of 2020 how likely are you to deploy further capital to support your existing portfolio companies with funding requirements?

25.2% – Very likely
48.3% – Likely
17.9% – Unlikely
8.6% – Very Unlikely

Between now and the end of 2020 how likely are you to deploy capital to complete a platform investment in a deal process that had NOT commenced pre-COVID19?

21.9% – Very likely
47.7% – Likely
25.8% – Unlikely
4.6% – Very Unlikely

We look to understand the challenges that [businesses] are going through and what they're looking to achieve going forward – where the opportunities are for them.

Lawrence Dean, LDC

Between now and the end of 2020 how likely are you to deploy capital to support a portfolio company in making a bolt-on acquisition?

32.5% – Very likely
45.7% – Likely
18.5% – Unlikely
3.3% – Very Unlikely

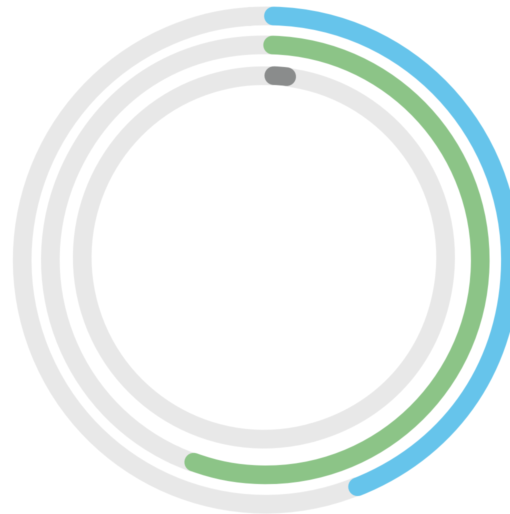
Bolt-on acquisitions will play a key part in PE firms' near-term investment activity

Over three quarters of survey respondents (78.2 per cent) believe that it is likely that they will support an existing portfolio company in making a bolt-on acquisition before the end of 2020. With there potentially being far fewer attractive new investment opportunities for platform deals, add-on acquisitions could provide the chance for PE firms to deploy their large volumes of capital. Given the uncertain environment, bolt-on deals may be lower risk as PE firms will already have a strong commercial understanding of the target company's industry, competitors, customers and challenges.

Additionally, organic growth within portfolio companies may be challenging as new sales will be difficult in a market where corporates are concerned with cutting costs; growing portfolio companies through acquisition may be the best route to acquiring new customers or adding efficiency through supply chain synergies. There is also likely to be a high volume of bolt-on activity driven through acquiring distressed businesses, giving PE-backed businesses the opportunity to acquire a competitor that has fallen victim of the impacts of coronavirus at a relatively low valuation. Whilst PE firms are unlikely to flex their strategies to do distressed platform deals, they will fund their portfolio companies to acquire both healthy and stressed businesses. A big challenge however may be in effectively integrating the operations of the combined business post-acquisition if social distancing measures are sustained for a long period.

> The nuance between standalone investments and bolt-ons is an in interesting one. It's definitely going to be easier to undertake bolt-on acquisitions. There will be management teams [that private equity firms] know and trust. Those management teams may have a successful track record in integration and I think the crisis will present opportunities for those investors.
>
> **Richard Harrison, Endless**

How do you expect the volume of UK private equity deals completed in 2020 to compare to 2019?



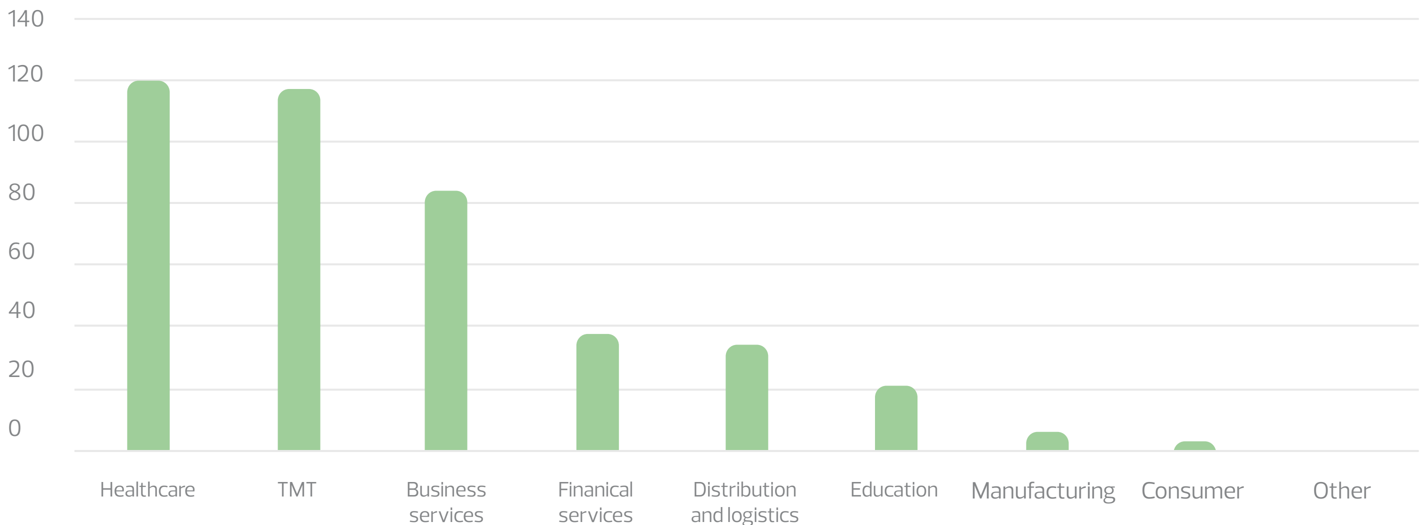
Overall deal volumes are expected to crash but optimism remains

Despite huge optimism from PE firms about their own ability to complete new deals amid the coronavirus pandemic, there is large expectation that UK PE deal volumes will decline on the whole, with 98.7 per cent of respondents expecting to see a fall and 43.7 per cent predicting that the drop in deal completions will be very severe with at least 50 per cent fewer deals than in 2019. The fact that many PE firms believe that it is likely that they will complete platform and add-on deals appears at odds with their perception of the market as a whole, suggesting a degree of hubris amongst UK deal-doers.

The type, as well as the volume, of deals that we see is also likely to deviate dramatically compared to recent years. Many professionals in the UK PE market are expecting to see a number of distressed and turnaround deals to support companies that have been adversely affected by the pandemic. These situations may take some time to materialise though as government funding and support has enabled many businesses to stay afloat; most companies that go through a distressed sale in the short term will have been facing issues long before coronavirus, and the pandemic has been the final issue to tip these businesses over the edge. Some businesses that were considering a PE deal to provide shareholders with liquidity may shift from considering a majority buyout deal towards a minority stake sale or refinance. If PE deal multiples decline in the current market, such a deal could provide an effective intermediate step for a business owner to realise some value in their business before making a full exit a few years down the line, by which point the M&A market may have recovered. There will also still be a catalyst for many businesses to consider going through a sale, such as retirement or a change in personal circumstances, that will maintain a steady flow of deals.

Whilst I think that volumes are going to be down across the board this year, there remain some really interesting businesses to invest in, some business that are resilient and growing through this period, but also business that have been impacted but are actually finding some really interesting opportunities coming out of this situation, whether that's organic or acquisitions that they want to make.

Lawrence Dean, LDC



Which three sectors do you think will see the highest deal volumes in 2020?

Robust sectors will remain attractive and there will be investment opportunities even in the worst hit industries

Many sectors of the UK economy have seen an immediate impact due to coronavirus and the resulting lockdown. A number of businesses operating in the travel, retail and restaurant industries, for example, have been mothballed by owners, due to revenue falling to zero almost overnight. Correspondingly, our survey found that PE investors expect the consumer sector to receive little PE investment in 2020, with only 4.6 per cent of respondents expecting it to be one of the top three sectors by deal volume. There are however areas of consumer markets that are performing well; many e-commerce businesses have seen an uptick in sales and demand as customers adjust to purchasing online. The volume of consumer sector deals may also be boosted in the year ahead due to distressed hospitality and retail sales. The high street was already under pressure before coronavirus, and the impact of lockdown has accelerated some sale processes which will appeal to turnaround PE investors. SCP Private Equity's acquisition of TM Lewin may well be the first of a number of similar distressed transactions to occur over the coming months.

We look to understand what [management teams] are looking to achieve, where the opportunities are and where we can support. This is an opportunity to learn how [a PE deal] could work to achieve your objectives.

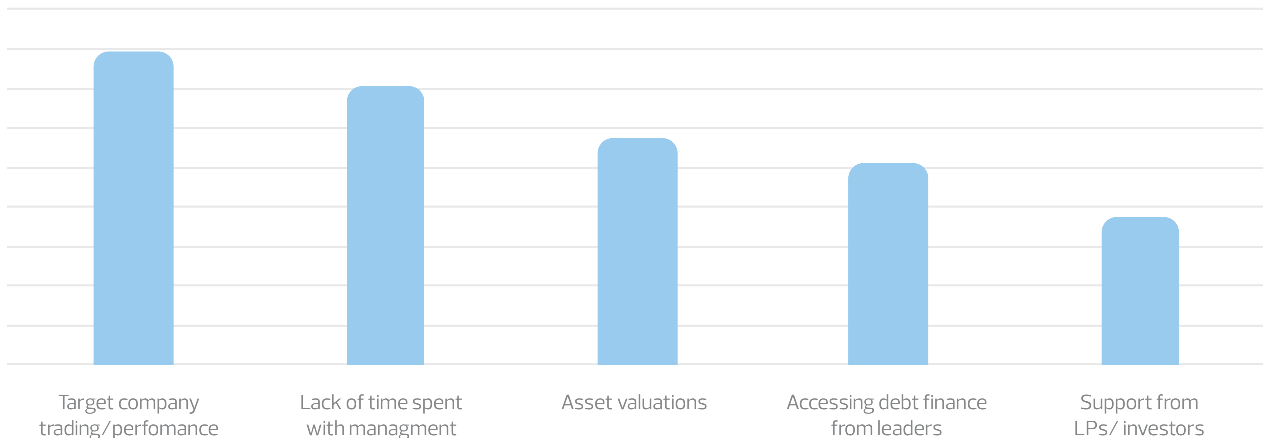
Zoe Clements, Palatine Private Equity

Whilst some businesses have been adversely impacted, certain markets have seen surging demand and performance as a result of the new way of working. With many people now working from home, services such as Zoom and Microsoft Teams are now commonplace in every day life. Unsurprisingly, many of our survey respondents (78.1 per cent) selected technology, media and telecoms (TMT) as a sector that they expect to see a large volume of PE activity in 2020. Businesses providing mission-critical software or services to enable remote working are likely to trade well through the downturn, and their robust business models underpinned by contractual recurring revenue will likely make them attractive targets for PE investors.

The healthcare sector ranked as the industry that survey respondents expect to see the most PE deals in the coming months, with 79.5 per cent expecting it to rank in the top three sectors for PE deal volume. Healthcare businesses that provide outsourced services, such as testing and diagnosis, which would otherwise be undertaken by the NHS will see high demand, as the NHS continues to focus on protecting the health and lives of the UK population, and non-essential procedures are delayed. Additionally, we are likely to see increased activity amongst digital healthcare operators that enable diagnosis and support in a socially distant environment.

The challenges ahead

The challenges ahead



What do you see as the biggest challenge in completing a transaction between now and the end of 2020?

There will be a number of hurdles in completing deals in the year ahead

Target company performance was seen by respondents as being the biggest challenge in completing a deal between now and the end of 2020. As discussed earlier, businesses in different sectors have seen a wide-ranging impact on their usual level of trading, impacting both revenues and profitability. As a result, businesses that would in a usual environment be an attractive investment target for PE firms, may require some level of recovery and return to performance to sustain interest from PE.

Approaching valuation is an art and not a science. We would always consider a number of factors and look to understand the business, look at the growth opportunity and make an overall assessment.

Zoe Clements, Palatine Private Equity

The issue of valuing businesses is closely linked to trading performance, as PE firms will have to assess how they go about valuing a business that has seen a short term spike or trough in performance in the immediate aftermath of lockdown. Some businesses will see performance rebound fairly quickly, and as a result will not accept a deal at a low valuation at this time. Similarly, PE firms may be unwilling to overpay for a business that is performing well now by pricing in short term strong trading that might not be sustainable once we return to a normal way of working. The PE market does remain competitive though, with record levels of dry powder in the UK market. This dry powder is chasing an even smaller pool of high-quality deals, and PE firms may be prepared to pay strong entry multiples for businesses that have proven that their model is robust even in these exceptional circumstances.

A lack of time spent with the management team of a target investee company is also seen by PE investors as a big hurdle to executing a deal. A PE deal is a partnership between the investor and the company, not merely a financial injection, where the alignment of interests between both parties is fundamental to executing the business plan and providing a return to the shareholders. As a result, it is crucial that the PE firm trusts the management team that it is backing to drive the business forward for future success. Similarly, because a PE partnership is typically a three to five year process and the PE firm will exert an element of control over the business, it is imperative that a management team finds a PE firm that is aligned to their strategy, understands their business, and that they like and trust. Although PE firms are meeting teams for the first time using video conferencing tools, it may be the case that is not feasible for both parties to build the necessary rapport without spending time together in person, which may hold up PE deal processes. It appears very unlikely that PE firms will back a management team that they haven't met in the flesh.

Although seen as a lesser factor, PE firms may also find completing deals more challenging due to difficulty in accessing finance from banks to fund deals. PE firms often structure deals with some level of third party leverage to enhance the eventual returns to shareholders. Banks are currently overrun with supporting existing clients with financing needs, and processing government funded loan applications, such as those made through CBILS, and as a result many do not have the capacity to consider funding new deals. However, like the PE market, there is a surplus of capital in the private debt market, and debt funds may be a supportive source of financing. Additionally, we may see more deals completed in which the PE firm underwrites the full capital requirement before refinancing at a later date.

Despite being seen as the smallest challenge in completing a deal by our survey respondents, PE firms may find that they are pressured not to deploy capital at the moment remove LPs. LPs (such as pension funds, family offices and insurance companies) will likely have had other investment allocations, such as public markets exposure, severely impacted by coronavirus, and as a result dissuading GPs not to draw capital for new deals. Our survey found that the issue of support from investors was more prominent for 'deal by deal' PE investors who need to source investment for each new deal that they do, compared to those that have a committed fund.

Every investment that we make through this period, we'll have spent time with management beforehand, over the past few months or year or two.

Lawrence Dean. LDC

The risk appetite of banks and debt funds is going to be a very big challenge for private equity deals over the coming couple of years.

Richard Harrison, Endless

The PE exit market will be subdued

Outside of challenges captured as part of our survey, we also expect the exit environment for PE firms to be challenging as they attempt to offload existing investments and make healthy returns. Whilst company performance will be one factor that halts planned exit processes, the appetite from potential buyers may also be subdued in the medium term. Strategic buyers are likely to be focusing their efforts on existing operations and less willing to engage in M&A as a route to growth. Public markets have also seen an immediate shock as a result of the pandemic, so it may be difficult for businesses that were considering an Initial Public Offering (IPO) as an exit route to attract public investor support. As our earlier analysis has identified, there is still appetite from PE firms to deploy capital at the moment, and as a result, we are likely to see secondary buyouts becoming an increasingly common route of exiting portfolio companies. The challenging exit market will likely mean that asset holding periods for PE firms elongate as they allow portfolio companies to return to a strong level of trading before reassessing exit plans. Returns to investors upon exit will be adversely impacted by, not only lengthened hold periods, but also situations where PE firms have had to commit further capital to portfolio companies during ownership as a result of coronavirus.

The recent fundraising boom will not be sustained

PE firms themselves generate revenue by earning a management fee on funds committed by LPs, so is there a chance that their longevity will be impacted by coronavirus? PE fundraising has experienced a bull run in recent years, with fundraising breaking records year-on-year, resulting in the vast levels of dry powder across the industry. Due to the pandemic, investors into PE funds are likely to be more cautious and reduce their allocations to the strategy as they internally focus on assessing their own investment portfolios; some investors will have been badly burnt by their public market allocations, and sell-offs in public equities will reduce the overall asset pool available for allocation to the private markets

Conclusion

The coronavirus pandemic continues to impact the way in which we all go about our day to day lives, and its impact on the UK PE industry has been vast.

In the short-term, PE firms are focused on, and will continue to support, their portfolio companies in managing their operations. Government schemes, such as CJRS, have been utilised by PE firms to support cash flow, and such schemes have no doubt supported PE firms in safeguarding the jobs of many portfolio company employees. Financial support packages offered by the government, such as CBILS, have been more difficult to access by PE firms, and many funds have, or are expecting to, deploy further capital to existing portfolio companies, enhancing PE firms' credentials as supportive and collaborate partners to businesses.

PE firms have began to turn their attention towards focusing on new deals and building the medium to longer term pipeline of opportunities, and most are confident that they will be able to execute deals in the coming months, despite an expectation of depressed deal volumes across the UK market as a whole.

For businesses that are trading well in attractive sectors such as technology and healthcare, there will be a large pool of interested suitors eagerly waiting to deploy their vast mountain of capital. For business that are experiencing challenges too, PE can be an effective and supportive partner to assist companies in navigating short-term challenges towards future growth. PE firms themselves will experience a number of challenges in the coming months in their ability to complete new deals, exit portfolio companies and raise new funds.

Ultimately, PE has become an important fixture in supporting businesses in the UK economy over recent years and will continue to do so as we navigate the turbulent time ahead.

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