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2021 and Beyond: How Private Equity Can Prepare for Life After COVID-19

In addition to the terrible human toll, the COVID-19 pandemic has wreaked havoc on economies around the world, disrupting the global supply chain, cutting into customer demand and leading to spiraling government spending in numerous countries. Many industries have been left reeling, struggling to assess the damage of 2020 as well as what it all means going forward.

Private equity (PE) is no exception. Across the industry, many are wondering what 2021 will bring and how it all might impact their investors, their portfolio companies and their own futures.

COVID-19 Accelerated Private Equity Changes Already in Motion

In some ways, however, COVID-19 is not solely responsible for what is happening in private equity. This experience has in fact served only to exacerbate existing changes that were already taking place across the industry. Investor interest had been shifting heading into 2020, portfolio companies were already facing headwinds related to macroeconomic forces and many firms were looking ahead with a cautious eye, expecting a broader downturn on the horizon.

In this white paper we will seek to answer questions including:

- What impact has COVID-19 and the resulting economic fallout had on private equity?
- How do these challenges fit into longer-term trends in the industry?
- What steps should private equity firms take going forward to adapt and evolve to the new reality?

Improving Performance by Improving Governance

For private equity, the challenges created by the market and exacerbated by the pandemic are coming from a number of different angles; portfolio companies are seeing their revenues drop as sales channels dry up, while interest from limited partners in the asset class is expected to level off. The industry is facing complex problems without easy answers, even among those professionals who have been through downturns before and yet still found ways to prosper.

As with everything in 2020, this time is different.

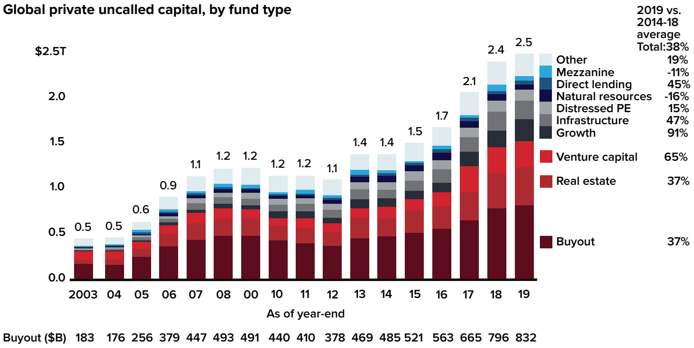
The answer here is two-sided: Private equity must improve investment performance by focusing on firm governance. In less volatile times, private equity firms have been able to do very well without having to pay as much attention to internal controls. If there is anything to learn from the pandemic, it is that those days are over. To some extent, the best way for private equity to prepare for the post-COVID market is by drawing on good governance practices now and incorporating them into their operations going forward.

The State of Private Equity at the End of 2020

Private equity entered 2020 in a strange place.

At the end of 2018 the industry capped a record year for deal-making[1], with dry powder at never-before-seen levels as deal valuations continued to rise. More than $300 billion was raised that year, with large funds worth $5 billion and above accounting for nearly 54% of all deals, the highest in a decade.

Global private uncalled capital, by fund type



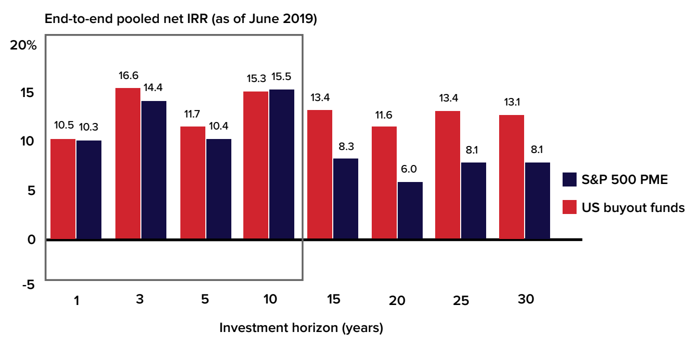
Notes: Other includes fund-of-funds, secondaries and coinvestments; buyout includes balanced and buyout funds; discrepencies in bar heights displaying the same value are due to rounding.
Source: Prequin

The party continued into 2019, with total assets under management (AUM) reaching an industry record of $4.11 trillion by June of last year.[2] By the end of the year, private equity firms had completed more than 5,000 deals worth in excess of a combined $600 billion.[3]

Valuations Under Pressure

Since the 2009 financial crisis, private equity returns have not been what they used to be. For decades the industry has enjoyed results that far outperform the public markets, but the S&P 500 surge that followed the Great Recession has all but eliminated that premium, with both public stocks and private options returning roughly 15% annually.[4] That's a strong result, but investors don't look to private equity simply to match the S&P. Outperformance is expected.

US buyout returns have converged with public equity returns over the current cycle, closing a three-decade gap in performance



Notes: PME is a public market equivalent based on the Long-Nickels methodology; other PME methodologies exist to compare the opportunity cost of investing in private equity vs. other vehicles, including the Kaplan Schoar model (KS-PME) and the Direct Alpha methodology.
Source: State Street Private Equity Index

This is on top of the fact that buyout returns for average PE performers have been falling for decades. In fact, 10-year returns as of 1999 were actually 6% higher than they are today, and this trend shows no sign of slowing down. Top-quartile firms continue to exceed expectations, but that success is coming at the expense of smaller, less-well-capitalized funds.

1. https://docs.preqin.com/press/Fundraising-2018.pdf
2. https://docs.preqin.com/samples/2019-Preqin-Global-Alternatives-Reports-Sample-Pages.pdf
3. https://pitchbook.com/media/press-releases/us-pe-fundraising-hit-record-highs-in-2019-despite-slight-dip-in-dealmaking-activity
4. https://www.bain.com/insights/public-vs-private-markets-global-private-equity-report-2020/

A Market Grounded in Uncertainty

At the same time, 2020 has presented challenges that few could have ever predicted.

Before COVID-19 and the resulting economic fallout even arrived, private equity leaders were watching as global markets began to slow amid trade wars, political events such as Brexit and other headwinds.

According to a Preqin survey[5] conducted in spring 2020, roughly 57% of PE general partners already believed pre-COVID that the economy had reached a cyclical peak and 14% were worried that a recession had already begun. The same survey found that overheated asset valuations were the #1 source of concern across the industry.

As Bain & Co. wrote in its 2020 Global Private Equity Report in February: "The private markets also continue to throw up challenges. Prices set all-time highs in the U.S. and remained near record levels in Europe, raising the bar for investors looking to create value. Holding periods declined as investors attempted to take advantage of higher prices on the sell side and exit before any impending recession."[6]

Despite all that, however, private equity began the year in a good place, continuing to invest, raise capital and generate what Bain called "relatively strong returns."

But it was a market skewed toward larger, more established firms with the infrastructure and experience to profit in challenging times. That includes advantages ranging from access to deal flow that others don't enjoy, ready capital to deploy when opportunities arise and also good governance practices internally that ensure the underlying firm is strong and capable of weathering any challenge.

The overarching lesson is that those best prepared for the difficult times do the best when those times arrive.

Modern Governance for Private Equity Firms

Modern governance empowers private equity firm leaders with the right tools, insights and processes for better long-term operations and decision-making.

- **Secure Communication:** Sensitive documents and conversations related to deals and strategies are shared securely among permissioned users – not through email.
- **Board Effectiveness:** Board operations and meeting materials – whether for the firm itself or across its portfolio companies – are centralized on one secure platform, which supports all the necessary board functions (i.e., remote voting and signatures, evaluations, minute-taking and approvals).
- **Portfolio Governance:** Performance, cap tables and KPIs are tracked across portfolio companies from a central dashboard supporting real-time updates.
- **Market & Portfolio Intelligence:** Advanced news monitoring tools are in place to track and synthesizes market trends, competitor movements and portfolio company news – complete with health scores for early risk identification.
- **Business & Sustainability Reporting:** Clear reporting to investors around the private equity firm's commitment to ESG (environmental, social and governance) initiatives across the portfolio.

Diligent's Governance Cloud supports the capabilities above.

In that way, good governance has emerged as a differentiator in private equity that can be directly attributable to success, both pre- and post-coronavirus. This includes broad corporate practices such as documenting processes and procedures, developing systems to ensure effective board reporting, and establishing policies in line with applicable regulations, as well as those specific to private equity such as establishing governance policies for portfolio companies and documenting how the firm works with its investors, partners and other stakeholders.

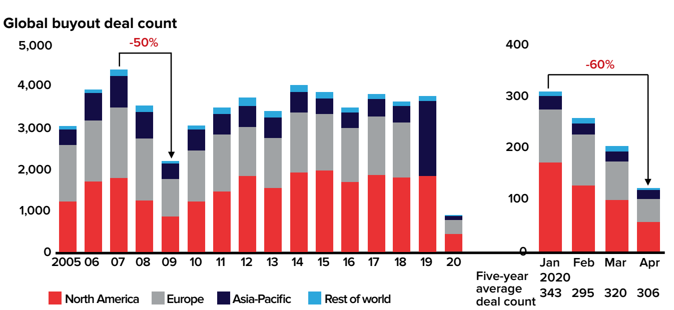
5. https://docs.preqin.com/quarterly/pe/Preqin-Quarterly-Update-Private-Equity-Q1-2019.pdf
6. https://www.bain.com/insights/hugh-macarthur-letter-global-private-equity-report-2020/

The COVID-19 Effect

When the scope of the pandemic became clear in April 2020, its impacts on private equity were swift and steep. For a time, deal volume almost shut down, fundraising looked to be in trouble and portfolio companies suddenly found themselves fighting for survival. Unlike other industries, where cost cuts and pivots can help stave off the worst of the damage, private equity found itself in the precarious position of helping steer some 65,000 portfolio companies[7] industry-wide, in a diverse range of industries, to safety, along with its own firms.

The immediate impacts on investments, exits and fundraising were wide-ranging.

Investments: Between January and April 2020, the total number of global buyout transactions fell 60% and was, as of spring 2020, trending at just over 30% of the five-year monthly average.[8] By Q3, private equity managers were taking a pessimistic tone, telling the National Bureau of Economic Research that as much as 40% of portfolio companies were "moderately negatively affected" and 10% of them were "very negatively affected" by the pandemic.[9] Across the board, the managers surveyed expect the performance of their existing funds to decline, with the expectation that, according to McKinsey, "the return to predisruption cash flows and valuations could be a long haul."[10]



Notes: Includes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location; average deal size calculated using deals with disclosed value only; 2020 results include data from January through April.
Source: Dealogic

Fundraising: Initially, COVID-19 did not have a marked impact on fundraising, with private equity as a whole raising $287 billion through April 2020, roughly in line with 2019's $900 billion on an annualized basis. However, as the pandemic wore on, the decline in actual fundraising began to accelerate. According to Prequin, only 237 funds closed in Q3 2020, down 18.3% from Q2, with investors increasingly seeking security in larger managers with larger funds, driving average fund size up 26% quarter-to-quarter.[11]

Exits: Given the drop in overall deal volume, it's no surprise that the total number of exits fell 72% from the start of the year to the middle of spring 2020. The mantra among fund managers became "hang back and hang on," with 83% of general partners telling Investec in May that they did not expect to make any deals within the next 12 months.[12] This attitude didn't last long, however, with global buyout deal flow rebounding strongly by Q3 2020, down just 0.5% when compared to the same quarter in 2019, as managers sought to deploy dry powder.[13]

Oversight: Governance has emerged as a key differentiator for firms in the midst of the pandemic, as is typically the case in any crisis. In times of uncertainty, governance provides both an infrastructure and a game plan that's rooted in the larger strategic vision – and it can serve as an insurance policy. According to one 2011 study of U.S. commercial banks following the financial crisis, governance factors were found to be better predictors of bank financial performance in times of crisis than many other metrics, indicating that those institutions with strong oversight in place performed better during the downturn.[14] This time, language such as "sustainability" and "stakeholder governance" is becoming popular in governance reform discussions, reflecting a new focus on the connection between business success and broader social trends that has been highlighted by the pandemic.

7. https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/a-rolling-disruption-covid-19s-implications-for-private-equity-and-portfolio-companies
8. https://www.bain.com/insights/covid-19-hits-private-equity-the-early-data-is-not-pretty/
9. https://www.nber.org/system/files/working_papers/w27889/w27889.pdf
10. https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/a-rolling-disruption-covid-19s-implications-for-private-equity-and-portfolio-companies
11. https://www.preqin.com/insights/research/quarterly-updates/preqin-quarterly-update-private-equity-and-venture-capital-q3-2020
12. https://www.investec.com/en_gb/welcome-to-investec/press/gp-trends-2020-preview.html
13. https://www.preqin.com/insights/research/quarterly-updates/preqin-quarterly-update-private-equity-and-venture-capital-q3-2020
14. https://onlinelibrary.wiley.com/doi/toc/10.1111/(ISSN)1467-8683.Crises-VI

No one in private equity has been able to avoid this event, but those with sound governance practices in place – with better visibility, better security, better reporting – aren't feeling the same level of pain as less-prepared firms.

Looking Ahead to a Post-COVID World

Whatever happens, one thing is sure: The economic fallout will be damaging and widespread. McKinsey has predicted that over the long term the pandemic will "intensify gender inequality, further threaten the economy, and raise hurdles for the health industry," given the fact that the 2020 global economic contraction has been far faster and steeper even than the Great Recession.[16]

Following COVID-19, successful private equity firms will be those that:

Focus on governance

This crisis has shown many in the industry the importance of risk strategy and informed decision-making, both hallmarks of good governance. Private equity firms must rely on technology to enhance their visibility into company performance and emerging trends; likewise, portfolio companies need mechanisms for environmental scanning, competitive intelligence and data protection. All of these components tie back to better governance and a better tech stack.

In a world of prolonged social distancing, securing the virtual workplace (e.g., protecting sensitive conversations, documents and strategies) becomes increasingly important. Board communication and engagement also becomes a heightened priority, as firms must ensure they have the infrastructure to support secure collaboration and reporting.

Finally, investors expect a greater focus on environmental, social and governance (ESG) initiatives – and they want to know how these initiatives align with better firm performance. As of September 2020, U.S. assets in ESG investment products have more than quadrupled over the last three years to now represent 20% of all index fund investments, according to Morningstar.[17] COVID accelerated this shift toward ESG due to increasing interest in stakeholder capitalism, with ESG investments outperforming most other asset classes in 2020. Whether related to diversity, social or environmental impact, private equity will need to have the data and processes in place to effectively oversee and report on ESG across the portfolio.[18]

Lessons from 2020

The 2008-09 recession was a similar event for private equity, putting investments and fundraising at risk as the result of a larger macro event.[15]

- Deal-making fell off by more than 50% in the immediate aftermath the financial crisis but recovered about 20% of that by 2010 and was at pre-crisis levels within two years.
- Fundraising shrunk by more than 50% in 2009, but had jumped back to nearly where it started just a year later.
- Exit activity dropped sharply in 2008 and 2009 but that lull was partially due to the business cycle. Today, many funds are coming off of several years of strong deal activity, sitting on assets that need to be sold, driving a quicker expected recovery this time.
- Following the 2008 financial crisis, many firms were slow to return to the market and remained on the sidelines out of fear. As a result, many missed out on opportunities that their competitors were quick to exploit. Those lessons have been learned.

15. https://www.bain.com/insights/the-impact-of-covid-19-on-private-equity/
16. https://www.mckinsey.com/business-functions/risk/our-insights/covid-19-implications-for-business
17. https://www.morningstar.com/lp/passive-esg-landscape
18. https://www.rbcwealthmanagement.com/gg/en/research-insights/why-esg-investing-is-on-the-rise-in-2020/detail/

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Focus on improving investment performance

As mentioned, these are troubling times for many portfolio companies. They may be facing revenue falloffs, workforce uncertainty and even cash flow concerns. For their private equity owners, protecting these investments is of critical concern, and the best way for many to do that is by stepping in and offering guidance. It may be time to fully reevaluate some business models and rework how certain portfolio companies function in this new reality. Those conversations need to be led by private equity professionals that have the experience and track record to effectively manage organizational transformations such as these.

For instance, incorporating a portfolio governance platform that brings portfolio company KPIs, HR documentation, customer survey data and other details together in one place will enable private equity partners to better monitor the health of their investments while simultaneously gaining a window into the full range of stakeholders, including customers, employees and more.

Focus on opportunities the right way

It can be tempting to look at a downturn as a target-rich environment, ripe for the picking by those firms that are best positioned to profit. But capitalizing on these opportunities must be done carefully and thoughtfully. Reduced asset values are worth nothing if the underlying asset is worth less than ever before. That's why the firms that do the best in the wake of COVID will be those that don't overlook their existing due diligence standards and maintain good internal decision-making controls.

Businesses large, small and in between – including many of the world's largest employers – are feeling the effects of the COVID-19 pandemic, which is why it is imperative for private equity firms to take steps now to address this crisis.

Protect critical processes: In times of uncertainty, organizational health matters more than ever, including everything from team morale to governance practices to internal systems and processes. Those firms that have strong internal decision-making and implementation processes in place are better prepared to emerge stronger on the other side.

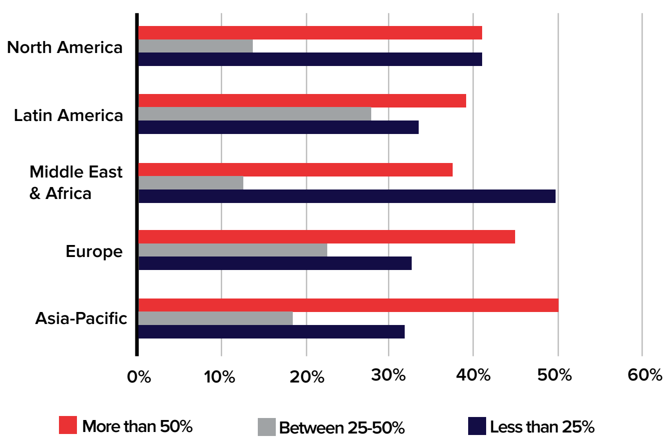
Assess investment strategies: Investment theses that worked before COVID may need to be adjusted to the new reality and opportunities coming next. Although 76% of firms have said that they have no plans to deploy new strategies over the next six months as a result of coronavirus, with distressed assets and special situations emerging as likely targets for any pivots, successful firms are at least already having those discussions and preparing in advance.

Support limited partners: Private equity is a people and relationship business and, although investor interest remains strong in the asset class, troubling times like these call for a more personal approach. Like portfolio companies, limited partners may be experiencing the downturn differently than fund managers and could benefit from support, whether it is in the form of additional communication about the state of the portfolio, updates on trends that managers are seeing, or simply reinforcement of the value and existing risk management practices. The firms that do best will be those that don't leave their limited partners wondering what is going on.

Prioritize portfolio health: Portfolio companies are typically in a range of different industries and might be experiencing different fallout from the pandemic and the associated downturn. Though these companies are likely taking steps of their own to survive, private equity firms can step in and help with access to liquidity, risk assessment and strategic help for leadership.

According to a survey conducted by S&P Global Market Intelligence in September 2020, 40% of private equity leaders said they were worried about portfolio company liquidity and finance in the wake of COVID, 21% said they were worried about the impact on those companies' workforces, and 17% said they were more focused on supply chain and operational issues.[19] These concerns are well warranted, given that the same survey found that less than 25% of portfolio companies had business continuity plans in place before COVID-19 in nearly the majority of North American firms. Many of these companies simply weren't prepared for a downturn like this.

Approximately how many of your portfolio ccompanies had business continuity plans in place before the COVID-19 impact?



Source: S&P Global

Private equity's long time horizons set the industry up well to weather an extended downturn, provided leadership takes the right tack and avoids making costly mistakes.

As Intertrust Group's chief commercial officer, Ian Lynch, explained in June: "The beauty of private equity is that investing in closed-end funds mitigates volatility. For GPs, time is on their side and they can manage their assets through the crisis. Operational excellence has always been core for a lot of buyout firms."

Lynch continued: "In a difficult financing market, it will only become more so as the financial engineering piece isn't going to be as easy to execute. Improving margins organically through, for example, technology efficiencies, will be key to sustaining management team and asset performance."[20]

The private equity firm of the future looks a lot like its peers in the past, with one key differentiator: tighter control. As the market starts to come back and investors return to the asset class in force, the onus is going to be on firms to more strictly define their strategic positioning and maintain focus on risk management and portfolio health. Limited partners will demand more accountability and communication, portfolio companies will demand more support and guidance, and investment theses will demand more oversight and attention. Just doing things the way they have always been done will no longer be enough.

One thing we know for sure is that some funds will disappear. But this won't be industry-wide. They will fall victim to their own mistakes, such as relaxing due diligence standards in favor of quick deals, trying to do too much without the necessary support and overextending themselves into too many portfolio companies or industries. Funds that can't clearly add value for investors or investments will fall by the wayside.

19. https://www.spglobal.com/marketintelligence/en/news-insights/research/the-impact-of-the-covid19-pandemic-on-the-private-equity-market
20. https://www.intertrustgroup.com/news-and-insights/insight-news/2020/intertrust-keynote-victoria-robson

Turning Crisis Into Opportunity

The post-COVID environment could be a golden age for private equity. Many of the "greatest periods of outperformance in the private markets relative to public markets are as you're going through and coming out of a downturn," Andrew Schardt with alternative investment manager Hamilton Lane told Bloomberg in August.[21]

In this white paper, we discussed:

- That the private equity industry was in uniquely strong shape heading into 2020 with record levels of dry powder.
- However, that there were headwinds on the horizon even before COVID-19, including a narrowing of outperformance vs. the public markets.
- That portfolio companies and limited partners were the largest risk factors for private equity as a result of the pandemic.
- How focusing on good governance practices will help firms both weather the ongoing downturn and succeed in the post-COVID world.

There is another key difference to consider between 2020 and 2008: The global economy is in much better shape now than it was more than a decade ago. Many structural changes were made following the Great Recession that should buoy the system to a quick recovery, including increased oversight and new financial requirements. When ready, the global economy will likely come roaring back.

Yet, this pandemic is also an opportunity for private equity to step back and create stronger systems for itself as an industry. The downturn has highlighted a number of issues that have been lingering for a while, but that now need to be addressed, including everything from cash controls, to due diligence standards, to portfolio diversification and more. Strong governance is emerging as a differentiator as never before.

Those firms that address these shortcomings and adopt the governance practices needed to maintain and implement them will emerge from this time stronger than they were before and positioned for long-term growth.

21. https://www.bloomberg.com/news/articles/2020-08-25/hamilton-lane-says-private-equity-debt-to-outperform-post-covid

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About Diligent

Good governance is a competitive advantage, but implementing it doesn't need to be difficult.

The right governance technology empowers your organization to act strategically while maintaining compliance, mitigating risk and driving efficiency.

- Companies with better board and governance operations report **stronger financial performance** than organizations without those processes.
- New challenges and opportunities arise every day. Organizations with strong governance operations in place can **adapt to the evolving landscape** – faster and with more agility than their competitors.
- Modern governance empowers leaders with the **technology, insights and processes** required to fuel good governance.

At Diligent, we produce the modern governance tools to help you maintain security, ensure visibility and act with agility in order to mitigate risk and seize new opportunities. Our platforms facilitate seamless board and committee management, secure collaboration, C-suite efficiency and improved compliance with access to industry trends and insights that help you make data-driven decisions in real time. With the largest global network of corporate directors and executives, Diligent is relied on by more than 19,000 organizations and nearly 700,000 leaders in over 90 countries. With award-winning customer service across the globe, Diligent serves more than 50% of the Fortune 1000, 70% of the FTSE 100 and 65% of the ASX.

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