APEX WHITEPAPERS

HOW PRIVATE EQUITY WILL PURSUE OPPORTUNITIES IN THE DECADE AHEAD

Applying an outcome lens to today's landscape during a period of considerable turbulence and deep uncertainty

Apex Group

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INTRODUCTION

There is no way to determine exactly how much impact Coronavirus ("COVID-19") will have on the global economy, but history offers some insight into what the crisis will mean for the private equity space. The performance of the private equity sector has been very strong over the past decade and outperforming its public market equivalents by most measures.

The sector in many ways has become a driver of efficient, responsible and sustainable capital allocation, helping investors, companies and their communities. Variability in performance remains substantial. However, the challenge and the potential of manager selection will continue to be key for institutional investors.

The shape of the industry has evolved as it has grown, with some general partners that once had a technology vertical team now starting to view technology as a horizontal theme cutting across many of their deals.

Historically, low interest rates and elevated public market valuations are likely to cause potential headwinds to traditional asset classes throughout 2020 and beyond. Over the next five years, 79%[1] of investors in private equity expect to increase their allocation to the asset class.

As private equity markets evolve over the coming years, we expect to see a number of issues shaping it. One area is the mounting level of dry powder. Private equity firms have been holding onto a record pile of cash which has the effect of driving up asset prices. With increased competition, it might make it harder to spend.

The industry had a total $1.45 trillion in dry powder to invest at the end of 2019. And amid the global economic disruption caused by the COVID-19 pandemic, total capital raised in Q1 2020 was up 12%[2].

Such record levels of dry powder will lead to increased competition and will continue to be a driving factor behind private equity firms circling the mergers and acquisitions market and keeping valuations elevated.

If fewer partners are putting less pressure on their external managers to deploy that capital, we will start to see an increase in multiples. This is likely to lead to some external managers doing deals that they might not otherwise do, at multiples they might not otherwise pay.

The private equity strategies most impacted by strong inflows of capital are likely to be those that can accommodate large, single investments without investors reaching maximum ownership limits – and these will typically be larger funds.

Even despite growing macroeconomic and political uncertainty across global markets, the private equity industry will continue to make and sell investments, raise capital, and generate relatively strong returns.

Overall, we see a positive outlook for the performance of new commitments to private equity in the coming years. While large buyouts and unicorns may look expensive, segments with high barriers to entry – especially at the smaller end of the market – may look more compelling.

Investors' emphasis on environment, social and governance ("ESG") will increase further in 2020, aligning well with private equity's long time frames and higher engagement.

As social and environmental issues increasingly affect consumer attitudes and business conditions, there's growing evidence that ESG programs can improve returns and limit risk.

In this paper, we discuss how over the coming years amid ongoing economic, geopolitical and market uncertainty, the private equity market will need to think, plan and invest in new ways. There will need to be a greater focus on value, an emphasis on digital, and a commitment to evolving internal and portfolio company business models.

The market has grown exponentially, becoming a $4 trillion sector globally in the space of four decades. The industry future will require the industry to think more deeply and creatively about how to attract and retain the skills needed and, more fundamentally, about who the private equity sector wants to be, according to the World Economic Forum[3].

> "Private equity firms are set to pounce in 2020, armed with a record level of cash."
>
> Bloomberg

Dominating high-growth niches

With mega funds, large sovereign wealth and pension funds – and select private equity funds allocating landscape-shifting sums of capital – the gap between large providers and the rest of the field will widen. The same strategies that worked over the past decade will not work going forward.

Large funds will need deeper diversification, not just across industries, but also across geographies and asset classes. Smaller firms will need to resist attempting to service the entire value chain and instead look to dominate high-growth niches.

Cross-deal-team integration

As funds get larger and investment more diverse, private equity will require proficiency from multiple domains. Cross-deal-team integration around assets that have complementary characteristics will be crucial. Firms also need to manage the tension between longer holding periods and near-term value creation.

This balancing act will require building out the processes and culture to enable fail fast and learn quickly environments, while continuing to back transformational capabilities within their firm and across their portfolio companies.

Digital transformation at scale

To help targets incubate new products and services, achieve competitive cost performance and fine-tune their commercial strategies, businesses will need to aggressively implement digital capabilities. Private equity leaders are uniquely positioned to pinpoint high-value opportunities.

Companies will need to scale these insights across their targets – tapping advances such as machine learning, natural language processing and process automation – to gain needed reach and dexterity.

Replenished by a new generation

The next ten years will see a plethora of talent as big firms scale and smaller ones diversify. The ambitious, can-do culture that attracted the sharpest minds over the last two decades will need to be replenished by a new generation that will redefine and keep the industry rejuvenated.

Leaders will need to think creatively and develop career paths to build the firm's digital competencies and provide the innovation edge needed. Building teams that feature greater diversity in terms of background and expertise will be crucial.

Demonstrate holistic value creation

As a direct and indirect employer of millions of workers globally, the PE space will need to embrace their role as all-inclusive value creators and industry stalwarts. Good corporate stewardship will be essential. Greenwashing will remain an ongoing investor concern.

To demonstrate credibility, managers are going to need to make a concerted push to incorporate ESG metrics into their investment methodologies and demonstrate the financial value that comes from this approach.

Force for good

Leaders that embrace these imperatives outlined can turn private equity into a force for good, with virtually no limit to how much they can grow. In 2019, the industry raised $919 billion, which was approximately in line with 2018's record. Despite the small dip, 2019 was the second-strongest fundraising year ever, trailing only 2018.

Prior to the COVID-19 pandemic outbreak, the early prognosis for 2020 was more of the same. By the end of 2019, large firms had announced targets collectively approaching $350 billion, exceeding the $300 billion target at this point last year[4].

Private Credit

Globally, private credit is an increasingly important market component for both investors and businesses in the real economy. The term 'private credit' tends to refer to anything that is directly negotiated with the borrower and is probably unrated.

Private credit is an asset defined by non-bank lending where the debt is not issued or traded on the public markets and has been one of the fastest-growing asset classes. It is an asset class comprised of higher yielding, illiquid investment opportunities that cover a range of risk and return profiles.

This also includes debt that is secured and senior in the capital structure, with fixed income-like characteristics and distressed debt that has very equity-like risk and returns.

As a result of banks de-banking or retrenching from financing many segments of the economy over the last several decades, this is one of the key drivers that has led to the industry increasing at the rate it has been.

Non-bank Lending

Non-bank lending has its own source of wholesale funds and lends those funds out with an added margin for profit. The providers are not considered full-scale banks because they do not offer both lending and depositing services.

By borrowing their funds at wholesale prices, it means they have a larger margin to work with and can often provide lower interest rates than the banks. Since they are smaller and subject to a different set of regulations, non-banks tend to be more flexible in their approach to lending.

Typically, you will also find they are often more prepared to lend to higher-risk borrowers. Non-bank banks also engage in credit card operations or other lending services, provided they do not also accept deposits.

Alternative Lending

Between credit concerns and lack of collateral, most traditional lenders are wary of lending to growing businesses. Alternative lending refers to any lending practice that happens outside a traditional banking institution.

The different types of alternative lending these lenders provide include short-term business loans, medium-term business loans, lines of credit, invoice financing, equipment financing, merchant cash advances, and more.

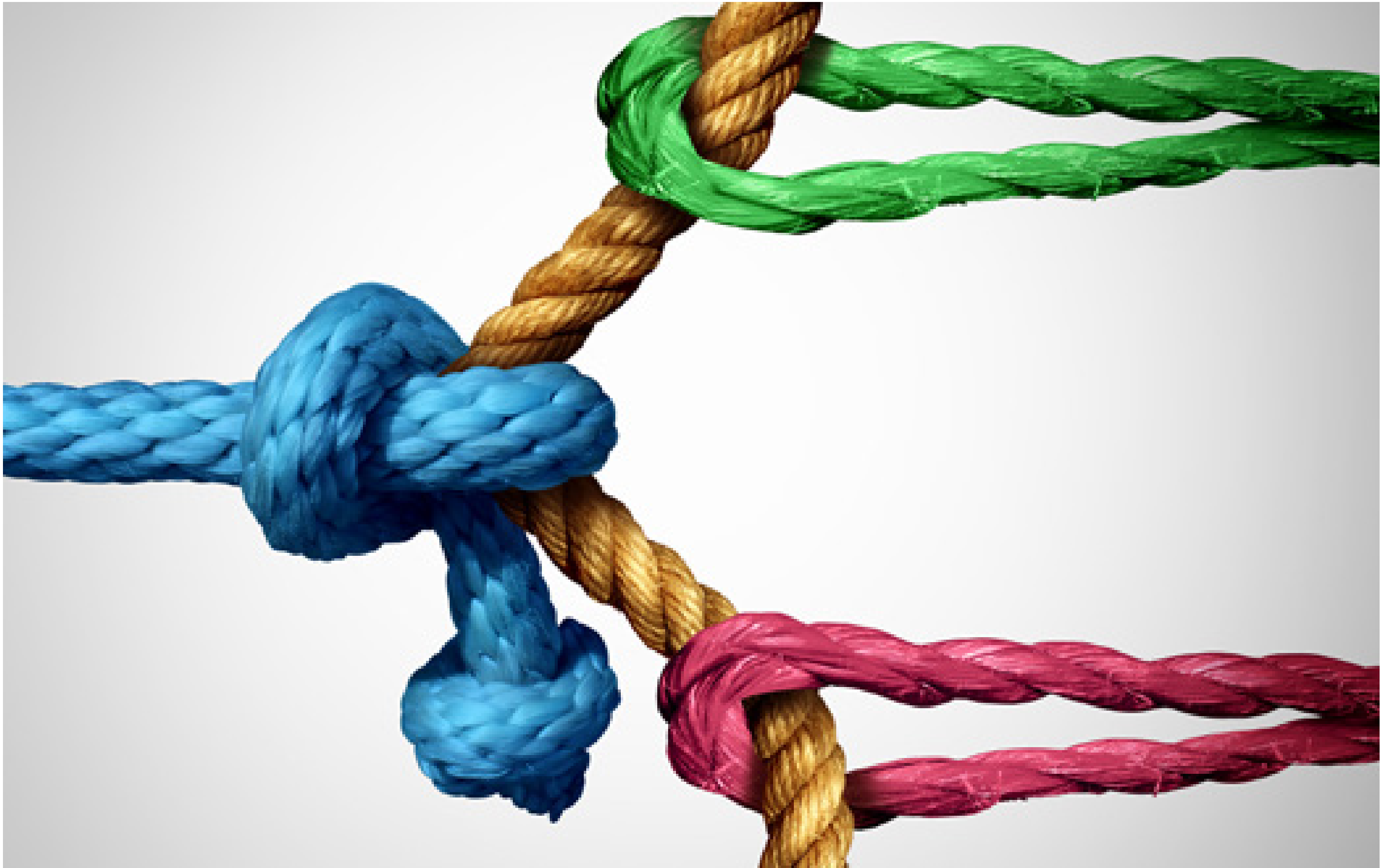
Some non-bank lenders operate online using a peer-to-peer model. This system, also referred to as 'marketplace lending', connects business owners seeking capital with established investors willing to provide it.

Shadow Lending

Shadow lending is a term that can apply to a range of activities, from unregulated activity by banks to lending by non-bank institutions.

These also include investment banks, structured investment vehicles, hedge funds and money market funds that operate outside the regular banking system and often beyond the reach of regulators.

Although these entities do not accept traditional deposits offered by banks, they do provide services similar to what commercial banks offer.



Private credit has become an increasingly important vehicle in more recent years, as many private equity firms' fundraising focus has not just been concentrated on buyouts. In an era when stringent capital requirements have curtailed bank lending, private credit funds have increasingly stepped in to provide loans.

Private credit, like many other asset classes, is cyclical in nature. However, the travel of direction for private markets is currently most pronounced in the private equity space, with the sector deploying ever larger volumes of capital into the economy over recent years.

Financing for a pool of transactions

As a result, we believe this will create a significant opportunity for private credit managers who are able to offer financing for a pool of transactions such as mergers and acquisitions, leveraged buyouts, recapitalisations, and corporate restructurings that underpin many private equity strategies.

In a highly valued, competitive market, private equity firms need to be increasingly aware of the need to examine which strategy can best deliver strong returns. As fewer but larger funds dominate the market, it will be essential that firms find new ways to compete.

Better match for assets and liabilities

Sponsors leaning towards long-hold funds is another trend that we expect to see evolving. The result of this will mean that more private equity funds will be able to hold onto profitable companies for longer.

This will give limited partners the ability to deploy larger amounts of capital into attractive investments for longer periods of time. Reinvestment risk reductions will also provide a better match for their assets and liabilities.

Differentiated growth and income opportunities

Further expansion of the asset class over the next decade should see other factors support the growth of private credit. For investors, the increasing attraction of private markets, reduction of the banking sector and the appeal of direct lender relationships to borrowers is set to create further expansion.

Capital allocations by private credit managers to the asset class will be driven by an ability to offer differentiated growth and income opportunities, especially in a low-yield environment, as well as the potential downside protection in times of market turbulence, witnessed by the COVID-19 pandemic.

Access to multiple private credit strategies

Within a broader private credit label, there will need to be a greater expansion and diversity of markets and strategies. Over the coming years, we expect to observe an increased differentiation between private credit managers focused on niche markets and those who can provide investors with access to multiple private credit strategies.

Future credit and economic cycles will continue to influence the approach taken to underwriting practices, and the way deals price risk and structure will be a primary consideration for nearly all private credit managers.

Competing forces for the future talent pool

A capacity to deal with stressed loans is now a key point of differentiation for investors when assessing private credit managers, as they are looking to identify managers with resilient business models. As a result of these activities, the private credit sector will also experience the continued demand on a global scale for more skilled individuals.

Private credit jobs will attract some of the top talent in the financial services sector and will compete with the private equity sector. These competing forces for the talent pool will shape 2020 and beyond.

Greater flexibility towards each clients needs

Another challenge that needs to be considered in the coming years is that the private credit sector will be required to provide greater flexibility towards each client's needs. To deliver on this will mean an ever-increasing demand on operational infrastructure.

Over the coming years, one of the single biggest barriers faced by many private credit managers to the future growth of the private credit market will be the unique regulation in some of the jurisdictions where they operate.

New technology and engagement with policymakers

This will require significant investment in staff that have the necessary skills and experience. The introduction of new technology and engagement with policymakers to reduce regulatory barriers will ultimately be required to create greater efficiencies for the lending process.

The influence of institutional investors will continue to have a significant bearing on the development of private credit which has always been an institutional asset class. Expectations around risk management, portfolio monitoring and reporting will continue to drive investment by private credit managers.

Acceleration of more sophisticated data sources

This will lead to an acceleration of more sophisticated data sources and reputable performance benchmarks and the acceptance of private credit by institutional investors who have not yet allocated capital to private credit.

As the private credit sector continues to think about how it must evolve in 2020 and over the coming decade, we can expect to witness a move towards a longer-term buy-and-build strategy versus a short-turnaround acquisition strategy.

Supporting an evidence-led policy approach

One way the market will demonstrate the value of private credit to stakeholders over the coming decades is to establish better sources of market data and appropriate performance and risk metrics.

The coming decades will require the need for the sector to support investor and policymaker understanding of private credit. This will remain paramount at a time when concerns around late cycle dynamics increasingly influence perceptions of the market. It will become more important for private credit managers to support an evidence-led policy approach.

Ability to manage complex credit structures

Increasingly, we expect to hear a private credit narrative that looks to stimulate economic expansion and delivers value to its investors. In these types of deals, the ability of a lender to manage complex credit structures – while also providing flexible solutions and acting with speed – will be highly valued by private equity firms.

Given these factors, private credit managers are well placed to be the lenders of choice to the private equity industry as they continue to deploy the substantial capital that has been raised in recent years.

Larger corporates and non-sponsored firms

Sponsored lending will still represent a significant proportion of the private credit market. However, there is compelling evidence that this is changing, as managers are now starting to serve a greater number of larger corporates and non-sponsored firms.

The outlook for the global economy is becoming less certain at a time when there is an expansion of private credit. However, private credit strategies are continuing to expand beyond the traditional mid-market lending space, with a greater number of investors showing a better appreciation for the breadth of opportunities within the asset class.

Challenging circumstances in the near to medium term

Credit markets have started to tighten up but haven't frozen completely. The global economy at large, and lenders in particular, may be facing challenging circumstances in the near to medium term. However, history and current conditions suggest that funds will not remain static for long.

Private equity firms will continue to dominate the deal market and so continue to change both the way companies position themselves and, ultimately, how assets are valued.

An increasing body of evidence indicates that the inclusion of ESG criteria is positively related to investment performance. Investors have been voicing their concerns about sustainability for several decades, and this is increasingly translating into action. A structural shift in the attitudes of investors towards ESG considerations in private credit will increasingly come to the fore in future years.

Broader market practices and inconsistencies in how ESG elements are reflected in investment choices, and the absence of an accepted standard on data formats, have hindered the incorporation of ESG. We will see the industry continue in its effort to establish a consensus on what constitutes relevant ESG metrics or approaches and support investors' understanding and demands. Apex ESG Ratings and Advisory solutions can support the private sector in satisfying this growing requirement through scoring and rating companies based on quality ESG data, intelligence and insights. Through supporting our clients in measuring ESG we aim to influence significant behavioral change and support the drive of capital flow towards ESG centric companies.

As public awareness of, and activism relating to, ESG-driven investing increases, many prominent allocators to private equity will continue to take up the cause. General partners will be required to pass an ESG screen as part of their vetting process and demand more transparency into ESG policies, procedures and performance of portfolio assets.

Over the coming decade, private credit managers will need to make corresponding investments in their own systems to capture, monitor and report relevant data. Although firms represent a small part of the market, they are raising increasingly large funds with the explicit goal of investing in companies that can produce both ESG-style impact and market-rate financial returns.

The question of returns, of course, lies at the heart of whether ESG and impact investing will continue to gain traction in private equity.

Sustainable investing encompasses a menu of strategies that can be used in combination[5]

SEVEN COMMON STRATEGIES:

1. Negative/exclusionary screening (eliminating companies in industries or countries deemed objectionable)
2. Norms-based screening (eliminating companies that violate some set of norms, such as the Ten Principles of the UN Global Compact)
3. Positive/best-in-class screening (selecting companies with especially strong ESG performance)
4. Sustainability-themed investing (such as in a fund focused on access to clean water or renewable energy)
5. ESG integration (including ESG factors in fundamental analysis)
6. Active ownership (engaging deeply with portfolio companies)
7. Impact investing (looking for companies that make a positive impact on an ESG issue while still earning a market return)

Given the uncertainty surrounding the COVID-19 pandemic crisis, it is impossible to gauge the longer-term impact on industry performance. Much will depend on the duration of the global lockdowns and the type of subsequent recovery. The impact will not be known for several quarters, as market-to-market moves lag public equities and private equity funds report quarterly.

The current economic outlook has meant general partners are accessing the challenges and looking to ensure their portfolios are stable. Sellers, meanwhile, will be reluctant to part with assets given the steep drop in equity values. The combination of extreme market volatility and uncertainty will continue in the short term to disrupt transactions.

"Private equity had a strong finish to the decade. Global PE-backed buyout volume reached nearly $400 billion by year end, which represented a 20% decline relative to 2018 but was still quite robust by historical standards, fuelled by a number of megadeals, significant dry powder and record-low interest rates[6]"

Filling some of the gaps left by banks

There will be opportunities for some private lenders to fill some of the gaps left by banks as they move away from the buyout market. A number of private debt funds have emerged since the global financial crisis, with substantial capital amounts waiting to be put to work.

Private equity portfolios will continue to offer both a source of attractive returns and diversify investors' equity allocation when constructed properly. Concentrated private equity portfolios exhibit lower correlation – and with a deliberate fund selection process, over-diversification can also be avoided.

Benefits of diversification in the future

The fundamental differences in the private and public equity investment models are set to remain, implying that the diversification benefits of investing in private equity will persist in the future. For the purpose of asset allocation, many institutional investors will treat private equity as part of their equity allocation.

Private equity returns are expected to show some correlation to public markets due to purchase and exit prices, as well as valuations being influenced by the public market. Modern portfolio theory suggests that each investment decision should not only be regarded on a stand-alone basis, but also in the context of the entire investment portfolio. This is where correlation plays a crucial role.

Opportunities to finance for new deals

This period of volatility is also a time for lenders to work through how to assess today's risk. There will be further focus on the underwriting process that will increase dramatically as they work out how much to lend and at what price. Dealmaking and lending activity may slow in the short term. However, expect opportunities to finance for new deals and provide liquidity to businesses that are experiencing short-term dislocations.

With the public markets continuing to remain depressed for the foreseeable future, and potential corporate buyers holding onto their cash, private equity funds are well positioned to be the buyer for any asset that does come up for sale.

Extended holding periods for some assets

Exits will inevitably fall, and holding periods for some assets will extend, as sellers sit tight and wait for the markets to recover. Once market conditions improve, exits could rebound faster than we saw coming out of the global financial crisis.

We don't see institutional investor confidence being affected in private equity, but the number of structural factors could limit the amount of new capital flowing into private equity funds for a period of time.

CONCLUSION

Providing liquidity to markets during the COVID-19 crisis presents significant opportunities for the private equity sector. Funds have money to invest, and companies will need new capital. As the sector discovered during the global financial crisis, locating money to work during market downturns can produce higher returns on average than during up-cycles.

As funds get back to deploying capital, they will likely have to change the way they evaluate opportunities and build models for the future, in light of this truly unique demand shock. No one knows exactly when normal business activity will resume, making it difficult to assess the full impact of this on the global economy, let alone specific target companies.

Private equity firms will inevitably play an important role in providing liquidity to a global market in shock and will help companies across the economy navigate their way through these choppy waters. However, investing during a period of considerable turbulence and deep uncertainty will call for new skills and approaches to due diligence.

After ten years of dynamic growth, private markets settle in for the next decade. At the Apex Group, we believe the success will require a well-reasoned understanding of short-term impacts and longer-term structural changes to companies and industries.

More than ever, it will also require a clear-eyed understanding of how to add both value and mitigate risk as unique investment opportunities emerge. As firms look to restructure debt there are various vehicles available to leverage new opportunities in the current climate - we are able to support our clients in finding a route to market in a matter of weeks, with tax efficient solutions.

We work locally alongside clients to provide a fast, effective and locally tailored service – to find out more, please contact us.

Source data

[1] Source: Preqin, Schroder Adveq, 2019. Large buyouts: funds with fund sizes at or above €/$2 billion – Preqin, Schroder Adveq, 2019. Small buyouts: funds with fund sizes below €/$500m; mid-sized buyouts: funds with fund sizes above €/$500m and below €/$2 billion.

[2] https://www.preqin.com/insights/quarterly-updates/preqin-quarterly-update-private-equity-venture-capital-q1-2020/26816

[3] https://www.weforum.org/agenda/2020/01/new-leadership-agenda-private-equity/

[4] A new decade for private markets McKinsey Global Private Markets Review 2020: includes funds with a target of more than $1 billion that have had at least one close but not a final close by end of 2019. Excludes one large fund with a target that has been publicly revised downwards, and three state-backed funds.

[5] https://hbr.org/2019/05/the-investor-revolution

[6] https://corpgov.law.harvard.edu/2020/02/08/private-equity-year-in-review-and-2020-outlook/

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