INVESTMENT PERSPECTIVES

CapitalDynamics
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COVID-19: PRIVATE EQUITY PRIMARIES MARKET OPPORTUNITY

KEY COMMENTARY

The global pandemic caused by COVID-19 has had an unprecedented and not yet fully appreciated impact on the global economy. The private equity asset class is no exception. Private equity primary fund investments ("primaries"), however, can exhibit strength for a variety of sustainable, structural reasons. Primaries focused on the mid-market can be even more attractively positioned post COVID-19 and maintain strong prospects for continued relative market outperformance.

Furthermore, historic crisis and post-crisis vintages have shown not only relatively higher returns but also a greater dispersion in returns between the best and worst performing fund managers.[1] This indicates that asset managers with intelligent portfolio construction principles and strong investment selection capabilities can boost returns for investors by identifying opportunities in fund managers ("General Partners" or "GPs") who can find and create value during this period of financial uncertainty.

"ASSET MANAGERS WITH INTELLIGENT PORTFOLIO CONSTRUCTION PRINCIPLES AND STRONG INVESTMENT SELECTION CAPABILITIES CAN BOOST RETURNS FOR INVESTORS DURING THIS PERIOD OF FINANCIAL UNCERTAINTY AND MARKET DISLOCATION."

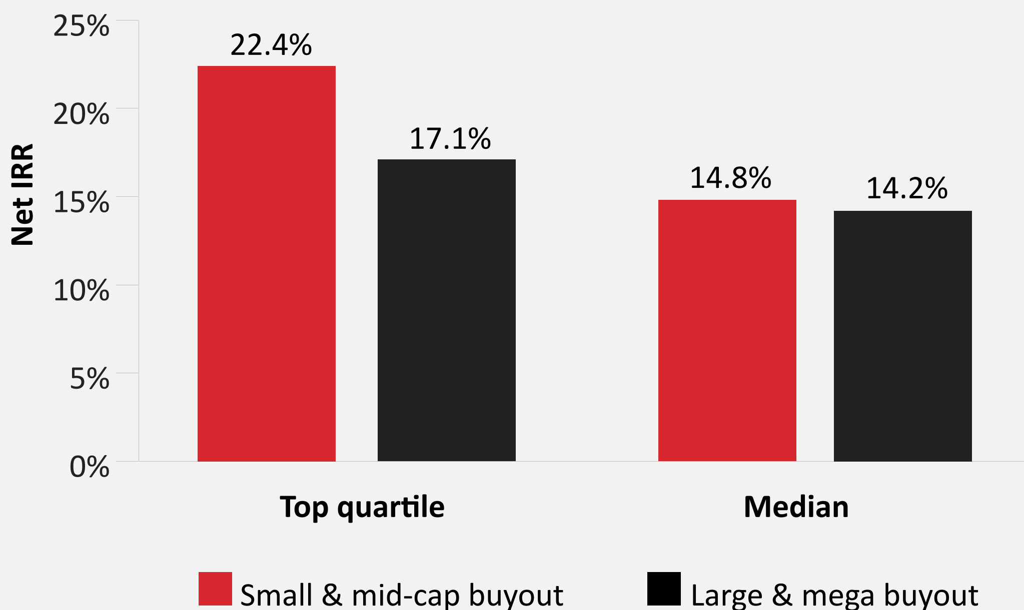
[1] CAPITAL DYNAMICS RESEARCH OF PRIVATE EQUITY PERFORMANCE.

MARKET OVERVIEW

Private equity primary investments have several structural advantages for investors that support continued outperformance over public equities. First, primary private equity fund managers deploy capital over three to five years, which avoids the risk of deploying all capital at the peak of the cycle. While private equity investment activity was robust during 2019, both the volume and number of transactions slowed down as private equity GPs were more cautious in the high-priced environment, coupled with an uncertain economic outlook. This also contributed to the increase in dry powder during 2019, which is now available to be deployed to pursue attractive opportunities and support existing investments. Investment activity during the first half of 2020 indicates private equity managers continued deal making despite headwinds. Add-on acquisitions are proliferating as GPs position existing portfolio companies to gain increased market share. Second, GPs have proven to be good sellers. As fund structures provide flexibility for exit timing (unlike panic selling in public markets), private equity exit activity tends to slow down during times of uncertainty, as was the case during the first half of 2020. Finally, active ownership and capital support make private equity investments more resilient during downturns, resulting in attractive exit positioning post-crisis. All three of these elements are key drivers of private equity outperformance.

In past crises, mid-market managers and their private equity-backed companies showed greater resilience to downturns and experienced less headwind for making new investments. This is attributable to more sustainable capital structures, a broad target universe, and less reliance on capital markets (compared with the larger end of the market). As shown in **Figure 1,** top quartile, mid-market buyout funds from vintage years 2009 to 2012 delivered approximately 500 basis points higher net Internal Rate of Return ("IRR") than their larger peers. Past market experience suggests that funds formed

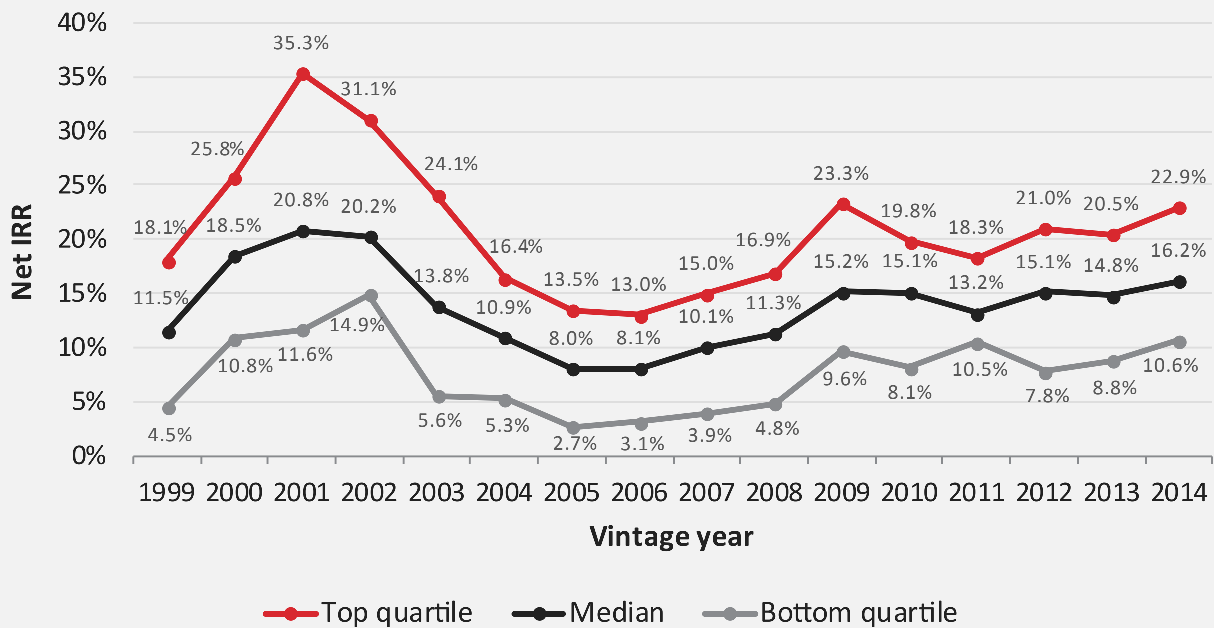
FIGURE 1: SMALL & MID-CAP BUYOUT FUNDS OUTPERFORMED LARGE & MEGA FUNDS



Source: Capital Dynamics based on Thomson One Cambridge Associates, as of June 9, 2020. Performance data for buyout funds from vintage years 2009 to 2012, as of December 31, 2019 – the latest available reporting period. Small and mid-cap buyout funds are of fund size USD 1 billion or below. **Past performance is not indicative of future results.**

following downturns tend to outperform, as shown in **Figure 2.** Furthermore, the returns increase across all quartile fund rankings although the dispersion of returns between the best and worst performing managers also increases as the best managers make the most of adverse situations. Selection skills also gain in significance during a crisis and in subsequent years.

FIGURE 2: PRIVATE EQUITY OUTPERFORMANCE FOLLOWING MARKET DISLOCATIONS



Source: Thomson One Cambridge Associates, as of June 9, 2020. Performance data as of December 31, 2019 – the latest available reporting period. **Past performance is not indicative of future results.**

PRIMARIES PILLARS OF STRENGTH

During this time, it is important to construct primaries portfolios to be resilient to uncertain market conditions, applying intelligent portfolio construction principles, the most important of which are strong manager selection and a deliberate melding of prudent strategy and sector diversification. It is also important to have a team that has weathered multiple prior economic downturns. Institutional knowledge is brought to bear in both manager and emerging manager selection, as well as determining when to walk away from an existing manager relationship. This experience provides a strong pillar protecting portfolios on the downside.

It is important to select managers that have been through multiple market downturns and stress test their experience and capability as part of investment underwriting at the time of due diligence. Structuring an all-weather portfolio, with respect to manager capability, strategy and sector focus, bolsters against a market downturn (and may even position thoughtful investors to profit from the market uncertainty and dislocation). Intelligent portfolio construction exhibits elements of what the renowned author Nassim Taleb terms "antifragility," which he defines as, "beyond resilience or robustness. The resilient resists shocks and stays the same; the

> **"ANTIFRAGILITY IS BEYOND RESILIENCE OR ROBUSTNESS. THE RESILIENT RESISTS SHOCKS AND STAYS THE SAME; THE ANTIFRAGILE GETS BETTER."**
> ***NASSIM NICHOLAS TALEB***

antifragile gets better." in his 2012 book, Antifragile: Things that Gain from Disorder.[2] Specific aspects of underlying companies in portfolios, such as sound capital structures, reserves, and uncalled capital to withstand a downturn, can exhibit elements of both resilience and antifragility.

Where companies' debt packages and covenants need restructuring and repricing, high-quality managers are defensively positioned and receive preferential treatment with lenders because they are credited with the skills and experience to withstand these difficult periods. In many cases, they have been through prior economic downturns with these same relationship lenders. This reputational strength is proving valuable in the current environment both in restructuring and in securing financing for new investments.

Given Capital Dynamics' tenure in the market, our extensive network of relationships and robust historical dataset, we find ourselves with an advantaged viewpoint in the private equity space. Our investment experience further provides a strong knowledge base of macro trends from which to critically assess managers' go forward investment strategies, the inherent viability of sustainable high-growth characteristics, and further identify the best-positioned managers in various sectors whose people, strategies, skillsets and networks provide them with an advantage on a relative basis.

The benefits of such diversified sector exposure stand out in periods of economic distress. Currently, Information Technology ("IT") / Software as a Service ("SaaS") portfolios have experienced less than 5% fall in net asset value ("NAV") across the board, commensurate with the much lower impact on this sector in the public markets. While restaurants and non-essential healthcare businesses, like dental service organizations, are experiencing significant adversity (in some cases up to 90% fall in NAV), other areas of consumer and healthcare portfolios are proving more resilient including food logistics, e-commerce based essential goods and pharma research organizations.

> **"OPTIMAL DIVERSIFICATION IS NOT ACHIEVED VIA INDIVIDUAL COMPANY OR MANAGER SELECTION BUT FURTHER BY IDENTIFYING MANAGERS WITH DIVERSE SECTOR SPECIALTIES."**

This also speaks to the benefits and importance of disciplined portfolio diversification. A portfolio may have exposure to an "at risk" sector, such as fast casual dining, but this risk may be offset by exposure to direct-to-consumer, at home meal preparation investments. Such optimal diversification is not achieved via individual company or manager selection but further by identifying managers with diverse sector specialties – exposure to a fast casual restaurant chain may come from a more traditional consumer-focused buyout firm, while a direct-to-consumer meal kit company may come from exposure to a software-focused growth firm. While one cannot safeguard against the unknown with complete confidence, it is possible to construct a portfolio of private equity managers with relatively heterogeneous characteristics as a hedge against unseen market risks, such as this global pandemic.

[2] TALEB, NASSIM NICHOLAS. *ANTIFRAGILE: THINGS THAT GAIN FROM DISORDER*. NEW YORK: RANDOM HOUSE, 2012.

OPPORTUNITY

Investors have a unique opportunity to allocate to managers deploying capital in funds focused on investing during and in the aftermath of the COVID-19 pandemic. A new economic cycle of recession and recovery is underway which will lead to market dislocations and differentiated investment opportunities over the near to medium term. Managers looking for opportunities to invest in the current market can, and according to our market observations, already are taking advantage of decreased valuations, attractively priced add-ons and increased investment opportunities.

> **"A NEW ECONOMIC CYCLE OF RECESSION AND RECOVERY IS UNDERWAY WHICH WILL LEAD TO DIFFERENTIATED INVESTMENT OPPORTUNITIES OVER THE NEAR TO MEDIUM TERM."**

In particular, mid-market companies are increasingly receptive to engagement from these managers in the current environment. Experienced mid-market managers can provide these companies with capital (especially important due to the relative scarcity of capital from traditional sources), operational enhancements, value creation and sophisticated financial expertise. Managers also have a greater volume of investment opportunities to consider, as no critical component and engine of the global economy has been more affected by the Great Lockdown than mid-market companies. Growth-oriented buyout and buy-and-build managers looking to execute their strategies through mergers and acquisitions ("M&A") are finding themselves in a more attractive pricing environment. Turnaround and distressed managers, who had maintained a slower investment pace in the recent up-markets through 2019, are now finding themselves in a target-rich environment.

The greatest barrier to a recovery of private equity deal execution volume is driven by two key inputs to transaction pricing:

(i) deriving certainty in target companies' revenue forecasting, and

(ii) accurately predicting the duration of the pandemic toward restoration of revenue growth, even at more modest expected future rates.

Where possible, managers are leveraging their operating, structuring and financial expertise to renegotiate pricing gaps in their existing deal pipelines, especially in cases where the purchase price gap with sellers or company owners had previously been too great to consummate a deal. Their efforts to maintain valued dialogues with these sellers of attractive businesses over multi-year periods now places them in pole-position to continue, or re-open, such dialogues with a stronger prospect for success in this environment. Industry experience, particular expertise and customer relationships in some verticals are also differentiators that business owners are considering in selecting a transaction partner. The strongest managers in particular industry verticals possess long-standing end-customer and supplier relationship-oriented advantages that portfolio company management recognizes can supplement their own efforts toward much-needed future revenue growth for their businesses.

Thought leading managers are rigorously discussing key questions driving their go forward investment strategies in their sectors of focus post-COVID-19. They are making predictions as to what will have changed as a result of what is happening now, both to assist in re-evaluating strategies in their existing portfolio companies and for evaluating new investment opportunities – when the crisis ends, what will the new normal be? What consumer behaviors will be permanently impacted and changed? What will supply chains look like, especially if there is a further retrenchment in globalization? What will have changed as a result of effective / necessary health system changes and / or policy responses? What are newly possible, and important, effective public to private partnerships? Will greater surveillance and related technology innovation be tolerated in all parts of the world? What new opportunities will emerge as a result of remote collaboration needs and innovation? These dialogues are generating a plethora of new ideas and will

catalyze exciting change, growth and innovation in private equity-backed companies. Attractive sectors include initiatives across healthcare and pharma services, IT / SaaS businesses in online education and distance learning, remote work solutions and collaboration, broadband connectivity as a utility, essential services and value added distribution of essential goods, supply chain solutions and logistics, pet foods and products, consumables and consumer services, and financial technology (“fintech”).

Experienced mid-market managers are also well-positioned to deploy capital despite some headwinds from capital markets. In the middle market, there is a broad opportunity set of target companies enhancing deal flow for mid-market private equity managers and the ability to be selective and pivot. Capital markets are also less important due to the lower levels of leverage required to execute deals in this space compared to transactions in the larger end of the market.

Such managers have a proven history within the mid-market as they have already established themselves as the partner of choice for management teams, entrepreneurs and family-owners of mid-market companies. This position may better help bridge gaps in pricing expectations between sellers and buyers. This competitive advantage combined with the operational and strategic expertise, network and capital necessary to transform businesses into market leaders, should translate into higher and more consistent value creation for investors.

Such operational expertise combined with an enhanced Environmental, Social, and Governance (“ESG”) approach to portfolio management and focus on long-term growth can provide an advantage particularly in a challenging market environment. ESG focused GPs are typically faster to react, starting with the safeguarding of the employees of portfolio companies by addressing health and safety measures. Moreover, ESG data collected by managers in the due diligence phase and actions implemented during ownership provide a competitive advantage in critical areas such as production, supply chain and distribution – resulting in fewer disruptions to operations. Stronger ESG private equity-backed companies should also benefit from a better governance and ownership model, and we expect them to outperform through this next phase vis-à-vis their peers.

> **“EXPERIENCED MID-MARKET MANAGERS ARE ALSO WELL-POSITIONED TO DEPLOY CAPITAL DESPITE SOME HEADWINDS FROM CAPITAL MARKETS.”**

COVID-19 has amplified a public outcry for societal change across the globe. The precise form and nature of this change is still unknown, but it is our view that recovery from this global pandemic will be greatly aided by managers who operate with integrity, transparency and fair treatment of their constituents and apply these same principles to their portfolio companies. As a whole, Capital Dynamics believes that the private equity managers in our portfolio have acted thoughtfully in making tough decisions with existing companies and in deploying capital to new investments. We are inspired by many of the charitable actions our managers and their portfolio companies have taken to benefit their constituents and communities. We anticipate that our managers will be strong contributors to the recovery and restoration of growth in our global economy and will experience continued long-term financial outperformance in a post-COVID-19 environment at the portfolio and fund level.

CONCLUSION

While the duration of the effects of the COVID-19 pandemic remain unknown, economies will eventually stabilize and reward thoughtful investors. Fully predicting what will transpire from the current situation remains challenging, but we know investors will continue to benefit from strong and sustainable elements of antifragility in intelligently constructed, global primaries portfolios. Mid-market companies were engines of economic growth during recoveries following past downturns and delivered outsized returns for private equity investors. This crisis and the years ahead could be particularly attractive as mid-market investors can capitalize the most during market dislocations. The number of investable mid-market opportunities has vastly increased and such companies are in great need of capital and expertise to restore growth. The number of mid-market managers we track and maintain relationships with has continuously increased over three decades helping us to create well-diversified portfolios across mid-market managers with the best fit. Private equity GPs' value creation and particularly operational skill sets have strongly improved since the global financial crisis, which gives us optimism that our managers will emerge even stronger thinkers and investors from this experience. We have been selecting managers who are able to demonstrate strong operational value creation, an ability to identify and profit from secular growth trends and an enhanced ESG approach to portfolio management. In the post-COVID world, we believe the value-add of strong ESG practices will have a material impact on returns resulting in outperformance compared to their peers.

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Capital Dynamics' roots go back to 1988, the year our predecessor (Westport Private Equity) was founded in the UK. Our headquarters were established in Zug, Switzerland in 1999. The firm employs approximately 160 professionals globally and maintains offices in New York, London, Tokyo, Hong Kong, San Francisco, Munich, Milan, Birmingham, Dubai and Seoul.

In 2019, Capital Dynamics received an A+ in Strategy and Governance from the UN-supported Principles for Responsible Investment, while the Clean Energy Infrastructure platform received top rankings from GRESB, the ESG benchmark, for its commitment to sustainability.

For more information, please visit:
www.capdyn.com

[1]As of March 31, 2020.

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