Covid-19: Changing Private Equity Forever

Social impact takes center stage and launching new funds gets more complex.

Our roundtable participants have a range of views regarding Covid-19's changes. But all say private equity will reach new levels of popularity and employ resources more effectively - whether in the form of rolled-up sleeves or slimmed-down expertise - as a result of the crisis. There's also a conviction that social impact is finally coming into its own as a serious investment consideration. Our participants describe an industry that's more intensely competitive with increasingly specialized fund teams, big groups getting larger, and the bar rising for new entrants. As they see it, Covid-19's economic fallout will keep asset prices high, while managers traditionally focused on volatile public markets cast a covetous eye on newly popular, resilient and high-fee private equity.

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How will Covid-19 transform private equity? Is the crisis permanently changing how people invest in private equity?

HELEN STEERS: In at least three ways, yes. From day one, managers with exceptional levels of expertise and staffing in digital technology, business operations and capital markets proved more adept than traditionally resourced rivals at taking defensive actions; they also shifted earlier to being acquisitive. That's hugely increased the appeal of staffed-up and specialized managers. The second big impact is commitment to environmental, social and governance [ESG] best practice. For years, environmental impact has been a key criterion for investments, while good governance is a byproduct of private equity's alignment of investors, managers and portfolio company executives. With the suffering caused by Covid-19, commitment to the "S" – social impact – is coming into greater focus. It's leading to far-reaching measures to improve the wellbeing of portfolio company employees, and the communities in which companies operate. Finally, there's greater remote due diligence. We've learned – permanently – how to prioritize travel.

JIM STRANG: Niche expertise within specialties is coming to the fore. Healthcare, for example, is a mile wide, but during the crisis the most rapid, effective reactions have come from funds focused on very particular types of healthcare companies. Going forward, we're likely to see managers concentrate on much more acutely honed areas of expertise than was the case pre-Covid-19. While specialist street cred has been reinforced, the most effective responses to crisis-driven operational challenges have not been dependent on costly in-house armies. The strength of top managers is asking the right questions and then, frequently, bringing in effective outside resources to deal with an issue. Managers win when they efficiently use the options at their disposal, given a particular set of circumstances.

RAINER ENDER: We'll see the proportion of assets allocated to private equity rise to unprecedented levels as a result of the crisis. As with the global financial crisis, disruption will prove more damaging to the passive, public market holdings of investors than to their activist, invest-for-control private equity holdings. Private equity has always been more focused on next generation business models – the secret sauce dividing outstanding investments from mediocre ones. Covid-19's fallout is highlighting this. Lastly, Covid-19's uneven effect across industry sectors – for example, healthcare versus leisure or

even within sectors, i.e. vaccine producers versus retail dental clinics – and Covid-19's staggered impact from Asia to North America, means there will be a new emphasis on creating highly diverse private equity portfolios, across strategies, sectors and geographies. The days of investing two-thirds of your portfolio in North American buyout are over.

Covid-19 is putting the emphasis on creating highly diverse portfolios.

Rainer Ender, Schroder Adveq

On balance, will the crisis offer opportunity to smaller managers and first-timers, or will it simply reinforce the trend towards consolidation and ever greater fund sizes?

JS: Whenever there's an economic crisis – regardless of the origin – there's a reshuffling in private equity, typically with the strong getting stronger. With Covid-19, some of the ablest larger groups will pull away from the pack, doing what they do now on a larger scale. There will be opportunity for smaller managers and new managers, but securing it will be tougher. That's due to the increased sector expertise managers will have to display and the greater competence they'll need to rally resources – whether that's the broader internal assets Helen referred to, or the more flexible outsourcing I spoke about. All of this implies growing cost and time devoted to both fundraising and operating. Outside of big brands, it will take more meticulous marketing to convince investors to commit and it will – in one form or another – cost more to shepherd and grow investments.

RE: We're likely to see a cycle that will first favor big groups and then later smaller groups. Investors are struggling to get money out the door because of Covid-19 travel restrictions and the inability to carry out due diligence. In the short-term that's leading to large investments with big, familiar brand-name managers. But it's leading to a situation where too much money is chasing too few opportunities at the large end of the market. In the medium-term this will create spinouts from large groups and new opportunities for smaller managers and first-timers.

HS: I'd say Covid-19 stacks the deck for top-tier quality. Superior managers, regardless of size, with impeccable track records and – crucially – very desirable offerings given the current context, have managed to close in record time. Managers in sectors negatively affected by the crisis and those lacking resources to quickly deal with challenges have seen their growth thwarted and their survival threatened. As time passes, there will be an increase in spinouts, especially from troubled teams. As noted, emerging managers will be more nimble and more sector focused, while developing areas such as sustainability and ESG will experience disproportionate growth. Private equity's remarkable characteristic – driven by how its incentives operate – is that the best fund managers continually learn lessons and reinvent themselves on a stronger base.

To return to a subject briefly raised by you, Rainer, to what extent will the crisis impact private equity's appeal, particularly versus the stock market?

RE: The lion's share of investors that we're talking to at the moment are raising their allocations to private equity, particularly investors like insurers who've traditionally limited their exposure to illiquid investments. With risk-free interest rates dropping to less than 1 percent in North America and to less than 0.5 percent in Western Europe and no prospect of higher rates in the foreseeable future, every basis point of potential private equity outperformance is more highly prized. Combined with the low volatility we're seeing versus the stock market, that's neutralizing illiquidity concerns. Most investors' risk/return models indicate that they should have a lot more invested in private equity.

HS: It's worth recalling that the heightened attraction Rainer is talking about is happening against a background where the number of public companies has dropped some 50 percent over the last 20 years, with the typical listed company older, larger and slower growing than was the case two decades ago. At the same time, private equity is becoming increasingly growth-oriented and diversified – thanks to those specialists we've mentioned. This is true even in a formerly cost-cutting-focused strategy like buyouts. Investors are seeking higher long-term growth than listed stocks can provide; inevitably that means investing more into private equity, including buyouts.

JS: I agree with Rainer and Helen. I'd highlight that stock market volatility when contrasted with the amazing resilience of private equity is one of the most effective arguments in favor of PE investment. Studies show that over the entire history of private equity, only a small percentage of buyout funds – the category's core strategy – have actually lost money.

Moves by asset managers into PE will be accelerated by Covid-19.

Helen Steers, Pantheon

Will the crisis affect how public market asset managers develop private equity and could there be consequences for PE's existing managers and investors?

HS: Moves by traditional asset managers into private equity will only be accelerated by the heightened attractiveness of PE in the Covid-19 era. But, public market-focused asset managers have been developing high-margin private equity internally, buying private equity managers or creating partnerships with PE general partners for a while now. That's been driven by the expanding revenue share within traditional asset management of low-margin, high-performing passive index investment and the crowding out of more profitable, actively managed stock funds. Partly in anticipation of heightened competition, private equity managers are increasing their financial muscle by going public; while others are broadening the areas in which they compete by offering PE expertise to retail investors. Our firm, for example, offers investment products designed principally for the U.S. defined contribution pension market.

JS: For all that large traditional asset managers may want to get into private equity because of Covid-19's acceleration of trends, they face exceptionally tough prospects breaking into the established, institutional end of the market. Rather than engaging in aggressive acquisition campaigns or trying to build up complex organizations from scratch to break into a super competitive marketplace where clients are already well served, they're more likely to expand by meeting largely unfulfilled – and as Helen implies, highly promising – retail investor needs. Retail investment in private equity is at an embryonic stage and it's spottily served, but its potential is absolutely enormous, with trillions of investment dollars as the prize.

RE: I agree that the current crisis has enhanced private equity's pull for traditional asset managers. But as the head of the acquired and now fully integrated private equity arm of a diversified traditional asset manager, I think there's a topic we've missed here. That's the ability of a global cross-asset manager to be a highly creative and efficient one-stop shop for investors. As investors diversify across asset categories and geographies, the number of their financial relationships can reach unmanageable proportions. For managers that successfully combine traditional and alternative asset operations, the ability to be the principle partner for such investors is a huge opportunity.

How will Covid-19 impact the use of leverage in private equity?

JS: The short answer is not much. That's because the type of leverage offered today and the institutions providing it have changed dramatically since we faced the last truly dire downturn, the global financial crisis. Today, most debt is provided by sophisticated private loan funds – not banks – which have largely remained calm and kept credit spigots open. Moreover, the covenant-lite leverage that accounts for the vast majority of credit now, gives companies and their private equity managers greater flexibility to deal effectively with challenges than was the case during the GFC. There are relatively new forms of leverage – preferred equity and net asset value loans – that are being used by fund managers and portfolio companies to generate liquidity. Such leverage represents an unknown frontier that hasn't been fully stress-tested, but the evidence so far is that it's useful and working smoothly.

HS: Keep in mind that the big reason leverage has remained sheltered from crisis and freely available is because the world's central banks began lowering interest rates and buying corporate credits of all types on an unprecedented scale. Pricing and volatility for leveraged loans threatened to spin into meltdown in early March, but central banks engaged in massive – highly welcome – coordinated action to supply global credit markets with liquidity.

RE: Covid-19 has clearly prolonged a period of easy credit that began with the GFC. One of the biggest challenges resulting from that for private equity managers and their investors is continued asset price inflation and, most likely, even higher purchase price multiples.