Private equity during COVID-19: opportunities emerge for long-term returns

1 June 2020

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Private equity (PE) funds have stepped into the current crisis riding a decade-long growth wave in transaction volumes, valuations and fundraising. The pandemic, however, has sharply eroded the value of some investments and dampened investor confidence.

If history is a guide, then the global financial crisis of 2008-09 could provide a few insights into how PE funds might navigate the fallout from the pandemic. During the last global financial crisis, many PE funds stayed on the sidelines a little too long and missed out on investment opportunities.

Although there could be a sharp fall in deal-making in the short-term, PE funds are expected to learn from the past as high returns often emerge in times like these and can offset the losses during the downturn. The returns over the next five to six years will depend on how fund managers react over the next six to 18 months. There is a significant difference between the current situation and the 2008-09 crisis, however. Today, PE firms have massive amounts of unused funds – the 'dry powder' that is readily available at their disposal – money that has been raised but not yet invested. A large part of this money is expected to be earmarked for emerging markets such as India. Additionally, unlike in 2008-09, private debt funds and special situation funds are more visible in the market and can help provide liquidity to businesses that are experiencing cash crunches.

While several investors are holding back until the ramifications of the pandemic become clearer, a few distinct themes are emerging that could shape PE deal activity as the new normal evolves.

Deferment of deals: deals have been deferred as investors are waiting to see the extent of damage the COVID-19 pandemic has caused. While the deal pipeline is robust, deal flow is expected to be slow specifically in the second quarter of financial year 2020-21. There could be a V-shaped recovery in deal-making in the fourth quarter of this financial year and early 2021-22 given the amount of dry powder available with PE funds.

Protection of existing portfolio: the primary goal of funds in the short term will likely be to look after portfolio companies. This should take precedence over the search for new investment opportunities as some portfolio companies may need additional financing amid liquidity concerns.

Difficulty in managing the valuation conflict between buyer and seller: financial markets have been significantly disrupted across the globe. The pandemic has triggered a rout in the stock markets and market volatility has increased. Although PE investments are generally less volatile than public investments, there might be valuation challenges as sellers may be reluctant to part with assets given the precipitous fall in valuations. This could delay deal activity in certain cases.

Availability of leverage for buyout deals: of late, higher amount of leverage has been used in buy out deals. The availability of debt financing from banks could be a challenge and may cause a slowdown in buyout deals. Given the significant amount of dry powder, of which a large part is for buyouts alone, deal-making could see an uptick, especially in distressed asset situations.

Private debt funds and special situation funds expected to be more active: there is expected to be liquidity pressure on businesses owing to COVID-19 related disruption in demand. PE funds are expected to capitalise on this opportunity through innovative solutions such as debt restructuring and bridge financing.

Increase in private investment in public equity (PIPE) transactions: as valuations in public markets decline, PIPE transactions are expected to pick up as PE funds take positions in quality assets at significantly cheaper valuations.

Sector expertise will become more critical than ever: PE funds are expected to focus on sectoral themes with pharmaceuticals, technology, digital and healthcare expected to drive interest whereas the revival of sectors such as financial services, real estate and non-essential consumer goods and services may take some time. It will remain difficult to form an investment thesis for sectors such as aviation, travel, tourism and hospitality.

Expected change in scope of due diligence: the current crisis highlights the importance of factoring in multiple scenarios and modelling unpredictable disruption in due diligence. Hence, the scope of due diligence will change significantly over the near term.

In light of these circumstances, PE funds will need to respond swiftly and strategically to the new business normal and drive transformation for companies. The pandemic has brought about an extraordinary combination of quality assets going cheap and investors being cash rich. The funds that can find the right investment opportunities in this difficult time will not only emerge stronger but also generate significant returns in the coming years.