JEGİ | CLARİTY

European Private Equity: market views in turbulent times

April 2020

In light of the rapidly changing market environment following the Covid-19 outbreak we have spoken to over 20 UK and European Private Equity firms, across the mid-market, to gain insights as to the impact of this pandemic as well as to understand investment appetite over the short to medium term. The following is a summary of responses to the questions that were asked.

1

HOW IS YOUR PORTFOLIO PERFORMING GIVEN THE CURRENT ECONOMIC CLIMATE?

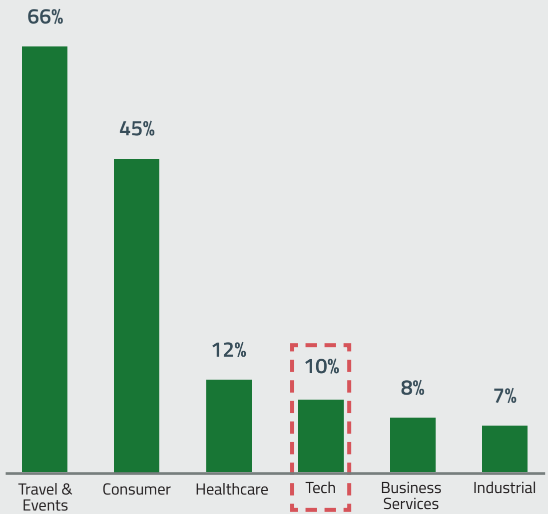
Overall media, information and technology-led businesses are holding up with the exception of those businesses directly exposed to challenged end-user markets and those reliant on in-person engagement for delivery of their solution. More broadly, whilst there is a recognition that 2020 will be difficult on multiple fronts, over the medium-term the underlying tailwinds across the sectors should drive recovery and growth.

All funds we spoke to have undergone rigorous financial and commercial reviews across their portfolio companies to ascertain near-term liquidity requirements, levels of credit risk and any operational changes that need to be implemented immediately. Across the board, companies are being advised to draw down credit facilities, manage debtors, push out payables and aggressively manage operating costs, principally people.

Whilst it is early days in the current crisis, the sense is that B2B information, data and technology portfolio companies are proving reasonably resilient. Marketing-led businesses are feeling the revenue impact much more significantly as client spend has been turned off. So far, many of these businesses are managing the EBITDA impact, principally through active cost control, for example, switching off freelancers and furloughing employees.

That said, certain companies have seen a much more negative impact, specifically: (i) companies with significant exposure to challenged end-user verticals such as retail, hospitality and travel; (ii) companies for whom SMEs are a significant part of their client or user base; and (iii) companies for whom in-person engagement is a critical component of their solution. The latter includes companies where the engagement is part of the product itself (e.g. events, experiential), part of the delivery of the product (e.g. DX and martech on-site implementation) or part of the sector supply chain (e.g. VFX via film and TV production). It is clear that a number of these businesses will face very significant liquidity and credit risks through Q2 2020.

Verticals and sectors impacted most severely[1]



Source: (1) BVCA survey of 55 private equity firms (628 portfolio companies) ranking the severity of the Covid-19 impact on a scale of 1 (least severe) to 5 (most severe). The chart above shows the percentage of companies within each sector ranked as 5

A recurring investor theme is that while there is undoubtedly short-term pain which will make FY20 very difficult on multiple fronts, the medium-term prospects for the majority of their portfolio companies in the sector are strong. Many investors expect a re-shaping of the competitor landscape as a result of Covid-19 and also expect the crisis to accelerate the transition to digital at a pace faster than many thought likely – there is a strong sense that both of these will benefit a number of portfolio companies across the sector.

> *“Post the crisis we will see a greater acceleration to digital – it’s inevitable.”*

It is, of course, worth noting that all funds observed that we are still at the very early stages of the pandemic and whether ultimately we see a V-shaped recovery or a much more prolonged recession will have a material impact on their perspectives over the coming months.

2 HOW IS YOUR PIPELINE OF NEW INVESTMENT OPPORTUNITIES?

Existing pipelines have largely dried up with most funds working internally on research projects towards building actionable opportunities for when the market comes back.

Unsurprisingly, active M&A pipelines have largely dried up with the vast majority of M&A processes being placed on hold or being pulled from the market. This is a combination of the need for management teams to focus solely on their businesses at the moment, material uncertainty about financial forecasts, as well as equity and debt capital market volatility meaning that investors are unable to price transactions in the current environment. Where transactions are continuing, these are typically bilateral deals, and even in these the pace has slowed significantly.

> *“Our existing pipeline has collapsed, those deals that we were working on have gone on hold, albeit with the expectation that the majority of them will come back.”*

With “WIP lists” of potential new investment opportunities at the lowest in many funds’ memories, virtually all funds are deploying their internal resources to simply research new sector opportunities and prospects with the aim of building an actionable pipeline for when “normality” returns.

3 WHERE DO YOU SEE OPPORTUNITY TO DEPLOY CAPITAL OVER THE NEXT SIX MONTHS?

Capital deployment in the near term is likely to focused on three areas specifically: (i) opportunity / situation investments (e.g. restructurings and turn-arounds); (ii) bolt-on acquisitions for portfolios companies; and (iii) those sectors and business models which can demonstrate resilience through this crisis.

While there was a wide range of responses to this question, the majority of funds believe that new platform deals will be scarce over the next six months. Given that many funds continue to sit on significant amounts of dry-powder, the view is that they have to be more opportunistic and situation specific over the coming months, as well as more flexible on the terms on which they are prepared to invest (for example, all equity deals).

For performing portfolio companies, funds will be looking hard at the opportunity for bolt-ons which add capability, gain market share and hire good people as competitors struggle. Again, the sense is that these are likely to be opportunistic as much as strategic.

With debt capital markets effectively closed in the near-term, as banks and debt funds focus on and deal with credit risk across their own portfolios, the expectation is that funds will need to be prepared to finance transactions on an all-equity basis over the next six months. This will clearly have an impact on valuation levels and deal pricing where funds are investing either directly, or on behalf of portfolio companies.

All of this said, a key challenge remains that until current European restrictions on movement are relaxed, it will be practically difficult for funds to really move forwards or execute new transactions – a number of funds highlighted that a meaningful period of face-to-face engagement with management teams of targets is a critical part of their investment case.

> *“Bolt-on acquisitions will be key in the near term. Lots of these are smaller deals, they won’t just be opportunistic and don’t need debt.”*

> *“We are still open for business, they will be different type of deals we are investing in over the coming months. Situations are likely to be opportunistic but we can take a longer-term view.”*

> *“We are looking to invest in fundamentally good businesses that should recover quite quickly.”*

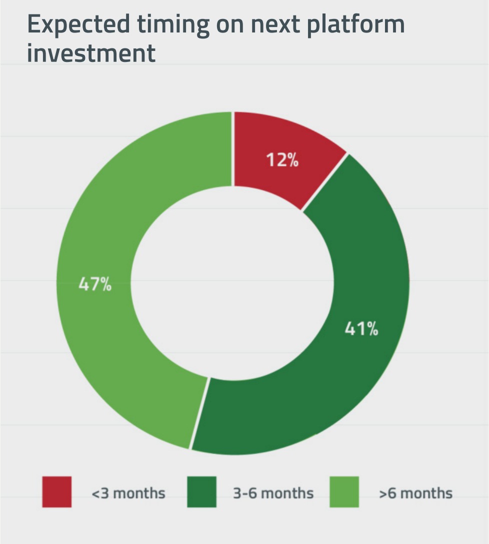
4 WHEN DO YOU EXPECT TO MAKE YOUR NEXT PLATFORM INVESTMENT?

Most funds are expecting a six-month hiatus given the uncertainty with the view being that markets will re-open in September for platform investments. A small number of funds believe that there will be opportunities which fit their profile in the next three months however.

Many firms (47%) felt that it would be at least six months before their next real platform investment of scale. The more optimistic view held by 41% of funds was that new deals may open up in the next three to six months.

Many funds want to see a sustained period of positive trading post the crisis to evidence the recovery, particularly if they are being asked to pay a good price. Focus will be on the recovery in customer spend and forward commitments and the resultant impact on cash generation and profit. Realistically for some funds this will push them into 2021 before they invest in new platforms.

> *"New platform investments look like being early 2021, we will need time to get out of crisis mode and back into growth mode. If we are being asked to pay a good multiple, we will want to see a sustained period of solid trading, particularly on the customer side."*

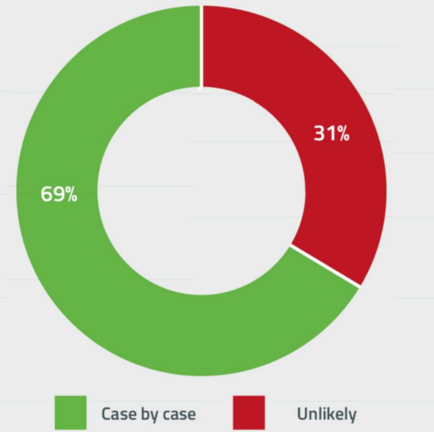


5 ARE YOUR PORTFOLIO COMPANIES LIKELY TO BE ACQUISITIVE IN THE COMING MONTHS?

Funds remain open minded about add on acquisitions, acknowledging that there will be situations to add capability, scale and talent as competitors struggle.

The majority of firms will still look at acquisitions on a case by case basis. The same caveats will apply around uncertainty, wanting to have face to face discussions with principals and seeing green shoots on the trading side. There will be good opportunities to increase market share, add capability and talent, particularly where competitors are running into financial issues.

Likelihood of near-term bolt-on acquisitions



IN SUMMARY

- Overall media, information and technology-led businesses are holding up and whilst there is a recognition that 2020 will be difficult on multiple fronts, over the medium-term the underlying tailwinds across the sectors should drive recovery and growth
- Navigating the current environment with significant amounts of dry powder is a challenge that many European private equity funds across the board have highlighted
- In theory, a record amount of cash being available to spend should allow firms to be opportunistic. In practice however, the economic, social and financial uncertainty coupled with logistical challenges around deal execution means that new investments will be very difficult to execute in the near-term
- Having said that, in the last week alone we are now seeing private equity funds start to put their heads above the parapet and look to future investments rather than inwards at their portfolio and we expect this trend to continue over the coming weeks to ensure they are able to act quickly when the market "reopens"