Impact of COVID-19 on Private Equity Co-Investments

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The COVID-19 pandemic has roiled financial markets in recent weeks and its impact has begun to be felt more directly within private markets. While the full economic toll of the COVID-19 pandemic is uncertain, public equity markets have been extremely volatile in recent weeks with the S&P 500 ending Q1 down approximately 24% from the peak and 20% from year-end. Within the private capital domain, the extent to which companies will be impacted by COVID-19 is yet to be determined, but it is widely recognized that the pandemic is now putting significant stress on the demand drivers, supply chain, human capital and other factors affecting portfolio companies owned by private equity sponsors. These conditions are shifting the focus of sponsors toward managing existing portfolio companies and away from new platform deal making in the near- to mid-term. So, what does COVID-19 and its associated market distress mean for private equity co-investments?

In the Near-Term...

- Sponsors that signed purchase agreements prior to the crisis without fully securing co-investment capital may create co-investment opportunities several months down the road as sponsors look to sell down their equity once the market stabilizes. These opportunities may be compelling for limited partners if they are able to evaluate business performance through the market disruption. However, depending on the degree of recovery, it could be challenging for co-investors to accept deals priced and structured before the downturn.

- Non-binding acquisition offers with financing packages that are yet to be fully secured are likely to fall apart given the current condition of the credit markets. As such, limited partners that have earmarked co-investment capital to these deals will likely miss such opportunities in the short run. However, for those deals that were priced prior to the COVID-19 pandemic, this could be beneficial to limited partners. In addition, broken deals resulting from failed financing may resurface once the market stabilizes.

- As private equity sponsors and management teams turn their attention to managing existing portfolios and businesses, new investment activity is expected to be largely on hold. We expect this to continue until greater clarity regarding the impact and duration of the crisis is understood, and assets can be valued and underwritten with conviction. Exceptions to this dynamic appear to be deals that were under contract and had financing secured prior to the disruption. The limited number of new deals anticipated, in turn, will translate into fewer co-investment opportunities. Given that acquiring new platform investments traditionally takes months to complete, a pause of a month or two now could have a long tail and translate into limited new transactions through Q2 2020.
• As sponsors evaluate the level of potential liquidity and other stress points in their portfolios, co-investment may be sought to support existing portfolio companies. For these transactions, comprehensive due diligence will be crucial for limited partners to ensure that sponsors are not investing capital into portfolio companies to fix unfixable issues. In addition to the opportunity to co-invest “defensively” in rescue financing rounds for challenged portfolio companies, sponsors may look to take advantage of lower valuations and greater levels of distress by increasing “offensive” efforts to identify accretive add-on acquisition opportunities for well-capitalized portfolio companies.

In The Mid- to Longer-Term...

• The credit markets are already showing signs of tightening up, which will likely lead to lower leverage levels moving forward. With leverage levels potentially coming down, more equity might be required from sponsors, which in turn could lead to more co-investment opportunities once deal-making activity picks up. However, this is likely to be somewhat offset by lower valuations. The key question here is – will leverage come down more than valuations? If so, more equity could be available to co-investors.

• If the COVID-19 pandemic leads to a slower fundraising environment, sponsors will likely be forced to be more selective with dry powder. This could also lead to more co-investment opportunities for limited partners as more capital may be needed for existing portfolio companies and less may be available for new platform investments.

Impact to Limited Partners...

• Organizations with large private capital exposure are likely to be over-allocated to private investments as the value of public investments have come down in recent weeks (the so-called “Denominator Effect”). Limited partners for whom co-investments have been an adjunct to their program in recent years may be more likely to pull back or completely stop participating in co-investments for some period of time. Additionally, limited partners without dedicated teams to manage a co-investment strategy may find their bandwidth consumed with managing the rest of their portfolio and may have less capacity for executing co-investments. This may create more opportunities for seasoned and consistent co-investors, as well as well-capitalized limited partners new to the co-investment arena that are looking to build out programs.

• Finally, as some investors may find themselves over-allocated to private markets (and specifically to co-investments) due to the decrease in public equity markets, there could be increased opportunities to buy existing co-investment interests on the secondary markets. However, arriving at a valuation acceptable to both buyer and seller could be challenging with the current high levels of volatility and uncertainty.
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