Note to clients
UK private equity mid-market update

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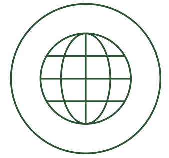

The UK private equity mid-market is facing its greatest challenge since the global financial crisis (GFC) of 2008-09. Depending on the age and sector composition of sponsors' respective portfolios, combined with where sponsors are in their fundraising cycle, the COVID-19 crisis will potentially have a more significant impact than the GFC on the UK private equity landscape.

However, as we saw back in 2008-09, a significant disruption to market conditions also brings opportunity in the short-term, primarily driven by liquidity and cashflow issues, and in the medium-term driven by a fundamental shift in human behaviour. Despite the short-term requirements to support portfolio companies and keep their Limited Partners (LPs) fully informed of actions being taken, mid-market sponsors are already turning their minds to what the future investment focus should be, as historic thematics or sub-sector focus may no longer represent the best investment opportunities.

Where we are today

Summary of market conditions:

- Almost all existing mid-market private equity sales processes are on hold and no new sales processes are commencing due to a combination of:
  - the lack of confidence in the ability of companies to hit financial forecasts given underlying market conditions
  - the uncertainty from buyers as to their own short-term trading conditions and their ability to access equity and debt markets.
- A limited number of mid-market sales processes are ongoing, primarily where:
  - the deal is very well progressed and the seller and buyer both believe the deal is fundamental to the medium-term success of both businesses
  - it is a growth capital investment where there is no requirement to raise third party debt; the private equity house can invest in a relatively low-risk, downside-protected structure; and the existing shareholders will benefit in the medium-term from the upside of the capital injection
  - there are distressed situations where the company has short-term liquidity issues and raising private equity is the only funding solution.
- For deals that are ongoing, a significant number of challenges exist over and above the current trading of the target company. These include the ability to undertake site visits, the return of material adverse change (MAC) clauses where there is a split exchange and completion, and the value of warranty and indemnity insurance policies given the increased number of warranties being carved out.
- Interestingly, it is already evident who is open for new investment opportunities and who is not. There is a strong correlation with how private equity houses reacted following the GFC.
- The short-term focus of all private equity houses is maximising liquidity in portfolio companies, including fully drawing down on existing debt facilities, working capital management and the reduction in discretionary expenditure.

> More than ever, our clients will need a thorough understanding of the potential changes to the UK private equity landscape before commencing a process.

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- Private equity houses are also very keen to pursue bolt-on acquisitions for existing portfolio companies, particularly where current market conditions create opportunities to acquire fundamentally good businesses which have the wrong balance sheet structure to survive.
- There is a difference in views between private equity houses about the impact of the crisis on their portfolios depending on sector exposure and age of portfolio. To oversimplify the different positions:
  - sponsors with relatively young portfolios (average life of less than two years) with a focus on B2B tech-enabled services and TMT sectors see the key impact as pushing future exits out by 12 to 18 months based on a short, sharp V-shaped impact on the UK economy
  - sponsors with a more mature portfolio (average life of greater than two years) that has greater consumer sector exposure are more concerned about short-term liquidity issues and whether certain portfolio companies can be saved.
- With a limited number of exceptions, debt providers seem to be supportive of existing customers as they recognise the issues being experienced by companies are the responsibility of both the lender and the sponsor. In addition, neither the banks nor the debt funds have the internal resources to take a more aggressive approach, as was seen by some lenders during the GFC. Given that we continue to operate in a very low interest rate environment, the expectation is that as long as businesses are not running out of cash, covenant breaches will be waived and interest and debt repayment dates will be deferred (for a fee!).
- Current private equity fundraising processes have paused, primarily because the LPs are experiencing greater issues and more volatility in other asset classes that require more attention in the short-term. However, the knock-on impact of this is that certain private equity houses which deferred fundraising processes given the Brexit uncertainty in 2018 and 2019 will not be able to pursue new investment opportunities until the fundraising environment improves.
- The impact of the inability to raise a new fund in the short-term combined with the need to potentially allocate more capital from the current fund to existing portfolio companies will mean that some private equity houses will be less aggressive in pursuing new deal opportunities when stability returns to the market.

The medium-term impact

There is greater scrutiny on private equity houses today from their LPs compared to the GFC. There is already more focus and reporting requirements on areas such as corporate and social responsibility, GDPR, cybersecurity, and internal monitoring and reporting systems.

Whereas the majority of LPs took the view that the impact of the GFC was unforeseeable and unavoidable, the current view is that sponsors should be more ready to manage the impact of global issues such as the COVID-19 crisis. Therefore, sponsors' success in managing the current market conditions and how well they communicate with their LPs may impact their ability to raise future funds. As a minimum, the performance of current funds is likely to be negatively impacted and this will affect the number of funds that get into carried interest, which is a key employee incentivisation tool for private equity houses.

Although many predicted the GFC would reshape the UK private equity landscape, very few private equity houses actually disappeared. However, the COVID-19 crisis may have a more fundamental impact on the private equity industry in the UK.

On a more positive note, our expectation is that in the coming days and weeks, everyone's focus will turn to new business development initiatives. There is still a huge amount of dry powder sitting in private equity and debt funds that will need to be deployed. The UK private equity industry will have a significant role to play in kick-starting the UK economy and creating future jobs and wealth.

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> The COVID-19 crisis will result in private equity houses reassessing their investment focus. As a result, premium valuations will apply to certain sectors whereas discounted valuations will apply to others.
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