A Sector-by-Sector Look at the Buyout Market

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While the world economies frozen by COVID-19 have begun a gradual thaw, considerable economic and market uncertainties still persist. However, it is not too soon to begin asking how the buyout market – and the private equity managers who focus on that market – will perform in a post-pandemic climate. We believe the concise answer is that industry sectors, not geography, will largely determine how portfolio companies will fare as economic activity emerges from quarantine.

Consider that buyout funds in both the US and Europe experienced an aggregate valuation markdown of approximately 10-15% in the first quarter 2020 versus the fourth quarter 2019. Contrast that with a Q1 decline of 20% in most public market indices, as well as a median decline of approximately 17% in the portfolios of the four publicly traded private equity houses. In our conversations with GPs, we've received preliminary guidance on what to expect in Q2, and it appears that valuations may hold up better than anticipated, yet we continue to see divergence in performance by sector.

Assessing the Impact of COVID-19

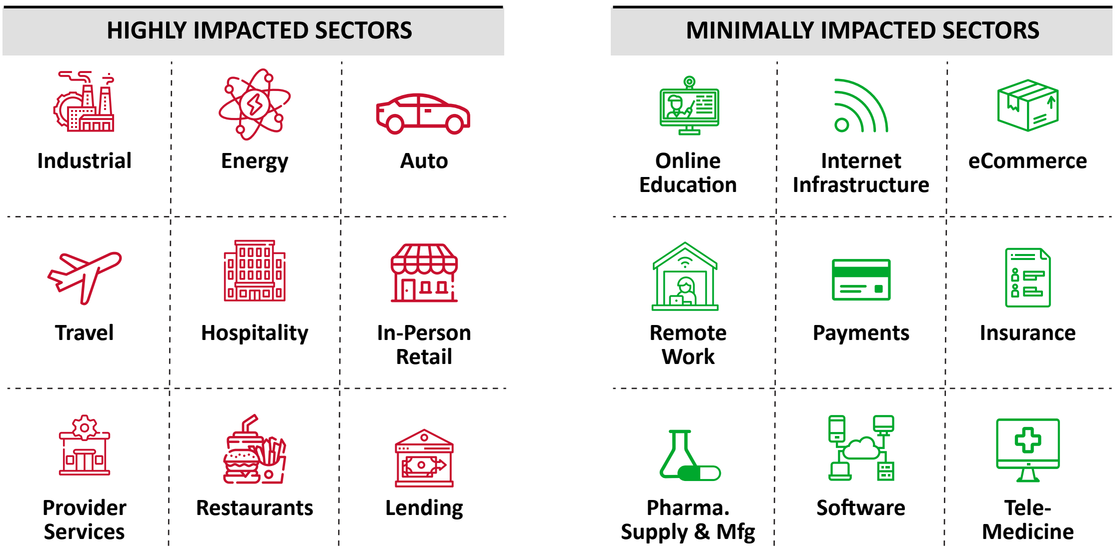
In thinking about the resiliency of PE buyout portfolios (our own and the market in general), we divided companies into four categories.

- **High Concern** companies operate in industries where the demand for products or services face strong impact and revenue is expected to be impacted in the short to medium term. Sectors or businesses classified under High Concern include offline retail and hospitality, travel and tourism, live entertainment, passenger transportation, SME and consumer lending, manufacturing and industrial, automotive, and logistics.
- **Moderate Concern** companies operate in industries where demand for products or services face modest impact and a portion of their revenue may be impacted in the short to medium term. Sectors or businesses classified under Moderate Concern include healthcare services, financial services, and real estate. In addition, this category includes business services or technology companies that serve high concern sectors.

- **Some Concern** companies' demand for products or services did not change significantly but may be affected by the suspension of work in the short term. In addition, this category includes companies that have yet to determine the scope of the impact on their business.
- **No Concern** companies' demand for products or services are unaffected or may experience an increase in the short to medium term. Sectors or businesses classified under No Concern include online education, online gaming and entertainment, online ecommerce and groceries, online social networks, remote work and collaboration, and telemedicine.

While the Moderate Concern and Some Concern buckets are important to continue analyzing, we believe the greatest amount of transformation to business models will stem from the highly impacted and minimally impacted sectors, and therefore they warrant the majority of our focus.

Impact of COVID-19 on Sectors in Private Equity Buyout Portfolios



Highly Impacted Sectors

As we view the US and European buyout markets overall, the sectors facing the greatest challenge include energy, hospitality, travel, and in-person retail, which were hit the hardest by the lockdowns and will take the longest to recover. Some companies in these sectors will need to permanently alter their business plans, and we believe we will see major innovation and transformation. Other areas, such as restaurants, were more nuanced. If a business was able to quickly pivot to a drive-thru or a carry-out model, or if management was ahead of the curve in adopting a mobile ordering system, it is positioned to take share as the economy reopens. However, mall-based restaurants and retail will likely face impairment.

Healthcare requires a deeper exploration. One might expect that a healthcare company would hold up fairly well through a pandemic, and we've recently **conducted research** on how the sector overall has been resilient during prior downturns. However, we've seen a great divide in performance by company sub-sector. Provider services companies, such as dental and eye care practices, were initially deemed non-essential, as differentiated from a company that sells a physical product that is still needed by patients. Patient visits to these practitioners have been delayed, but cannot be put off indefinitely, so we're expecting a V-shaped recovery in these provider businesses as patient volumes return and those delayed procedures are performed.

Manufacturing industrial companies, too, require a nuanced approach. For example, a company that makes equipment or parts for the auto or airline industries will find its recovery curve is much steeper. However, an industrial company or industrial service company that operates in freight logistics or infrastructure is considered an essential business and saw only a modest impact from the pandemic.

Minimally Impacted Sectors

As for the sectors that are of lesser concern, they broadly fit into two categories. One is technology and internet-related sectors. Many such companies are benefiting from business and lifestyle shifts that have been catalyzed by the pandemic, accelerating the move from offline to online in areas such as online education, e-commerce, remote work, and payments. Other sectors that are benefiting operate in the hardware and software area, including internet infrastructure.

In this category, we also find companies involved in the medical field, such as suppliers to pharmaceutical and biotech companies, suppliers to hospitals, and makers of protective equipment. As we noted earlier, health care service providers like dentists or ophthalmologists are a bit of a mixed picture right now. They are suffering from the fact that clinics and offices are closed, so providers physically cannot perform their services. But we think this is a very short-term phenomenon and health care service providers will benefit from recovery much faster than any other businesses. We also should note that we believe investors should have less concern and more optimism about health care businesses based in Europe, since the provision of health care services is organized differently. As European governments play a relatively large role in their health care markets, the pandemic has had fairly limited impact on these services compared to what one might see in other geographies.

The Role of Industry Expertise and Sound Management

Compared to the Global Financial Crisis, buyout-backed companies seemed better prepared this time around. In most cases, our managers moved swiftly to assess their liquidity position and improve it where possible, contain costs to better match their revised revenue outlook, and proactively reach out to customers to work together to preserve future revenue opportunities.

Why are buyout-backed companies more resilient in this cycle? We believe our researched-based approach to manager selection has led to a more rigorous focus on industry expertise. Private equity managers that take an operationally intensive approach in industries where they have worked throughout their career appear to have better prepared their companies for cyclicality, even as acute as experienced during the COVID-19 pandemic.

The Deal Environment

It is important to remember that every crisis brings opportunities. This was true after the Great Financial Crisis and we expect it to be true following the pandemic. If history is any guide, we think the present environment for investors will result in good vintages with the potential to deliver very attractive returns going forward.

In fact, we are seeing deals close, even in this environment. We have recently seen deals closed by GPs in sectors such as those described previously, which are positioned to benefit from the current crisis. Recent transactions include add-ons for existing platform companies, where there is an opportunity to fold a product or service into an existing platform. Growth capital deals are also getting done, particularly those that entail buying a minority stake in a company and therefore require less financing. Finally, the pipeline is starting to fill up with “regular” LBOs. We believe that companies whose growth path or performance demonstrate resilience through the crisis will be the next ones to be sold.

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On the fundraising side, capital raises at the private equity fund level have been remarkably resilient. We have seen a substantial number of closings, both in the US and Europe, many of them oversubscribed. It is important to note that that this trend might not continue into the second half of 2020 or into 2021, since many of the closings that took place at the beginning of this year were already in process in the pre-COVID environment.

In conclusion, the pace of recovery is still unclear. It is reasonable to expect that the road to recovery will be uneven and will take some time. However, this is an important time to reflect on how various businesses are performing, identify which managers and types of companies are able to mitigate risk, and analyze how certain businesses are able to transform their business models in light of the current challenges. Given our access to industry-wide data going back more than 40 years, we are able to understand and project trends across sectors, allowing us to double down on our commitments in areas we believe are best positioned for future success.

What inspires confidence is that, in our view, the private equity model is showing itself in a good light, with smart selection of companies in attractive sectors and proactive ownership leading the way to future performance and value. ■
