# «Private Equity Co-Investments in a changed market environment – opportunities for attractive returns with high downside protection»

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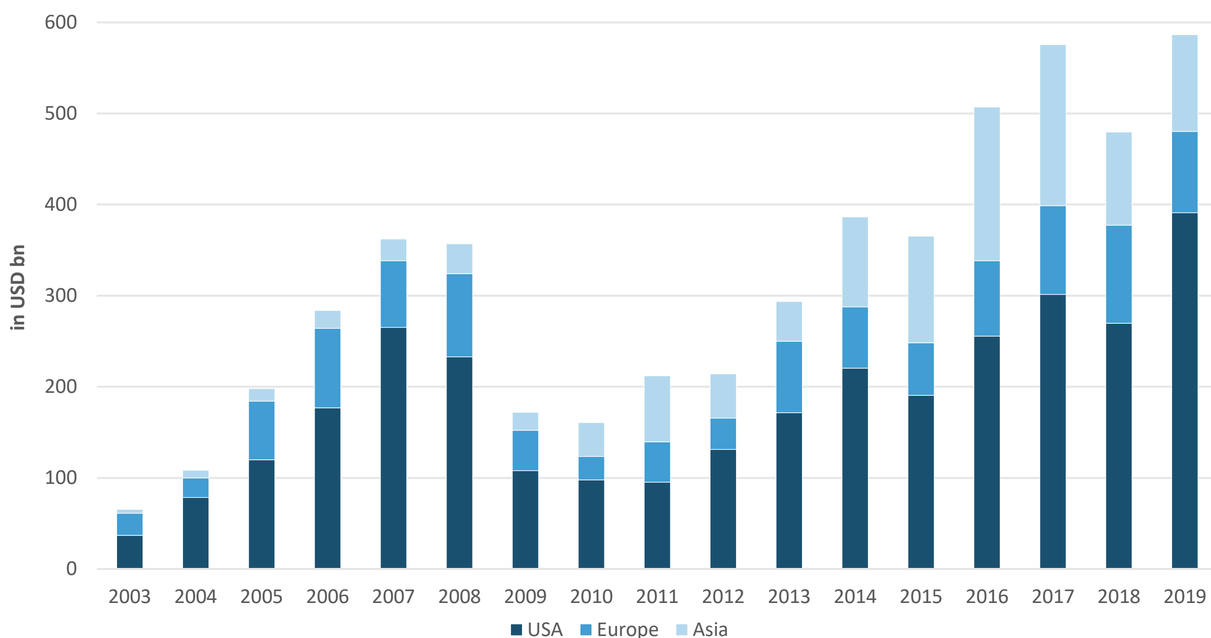
***After more than 10 years of uninterrupted economic upswing, Covid-19 caused an external shock that poses enormous challenges to the world economy. The private equity asset class must also face this new environment. The number of traditional buyouts focusing on healthy, growth-oriented companies is expected to fall significantly in the short to medium term, while complex transactions are likely to increase. The focus will be on rescue financing and restructuring (balance sheet and/or operational). This environment offers attractive investment opportunities especially for managers with a focus on special situations. The following article is intended to show how co-investments can also offer attractive returns in the current phase of the cycle while at the same time providing a high degree of downside protection.***

**Private Equity – Market overview**

Despite macroeconomic and political uncertainties that began as early as 2018, the private equity industry continued to grow strongly in 2019. As can be seen in the following figure from Preqin, the capital inflow for private equity investments (buyouts, growth, turnaround, special situations, distressed debt, venture capital) has almost reached the USD 600 billion mark for 2019, thus reaching a new high.

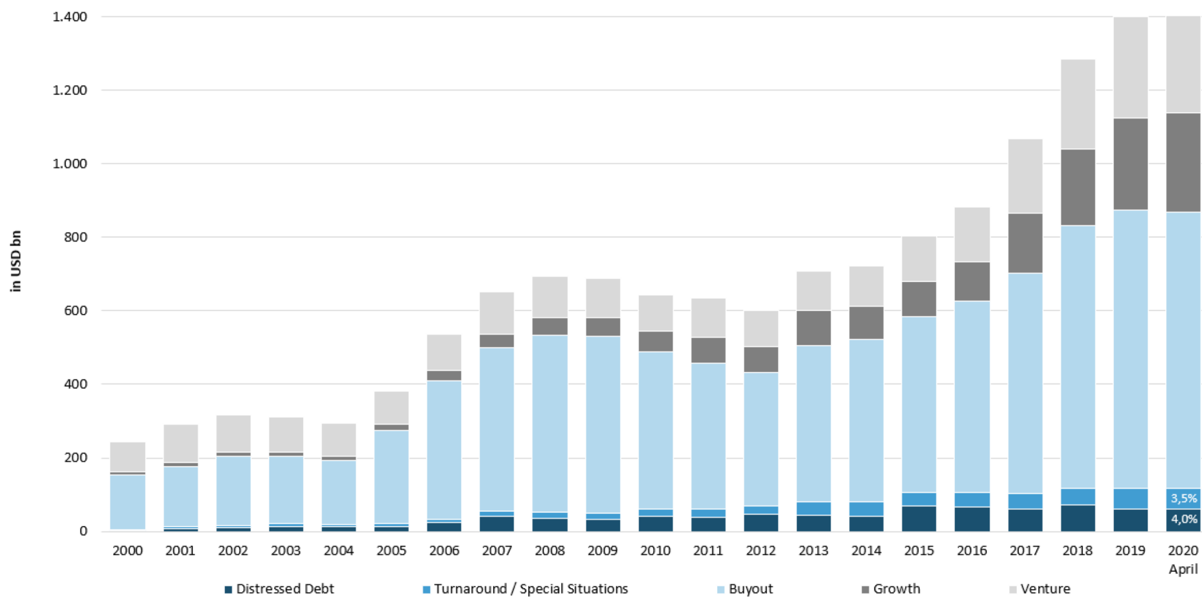
**Figure 1: Global Private Equity Fundraising**




*Source: Preqin, 2020, YIELCO 2020*

As a consequence of the strong fundraising activities, the "dry powder", i.e. the capital available for investments, also continued to increase and reached a new record level with an estimated volume of approximately USD 1,400 billion.

**Figure 2: Global Private Equity Dry Powder Volume**



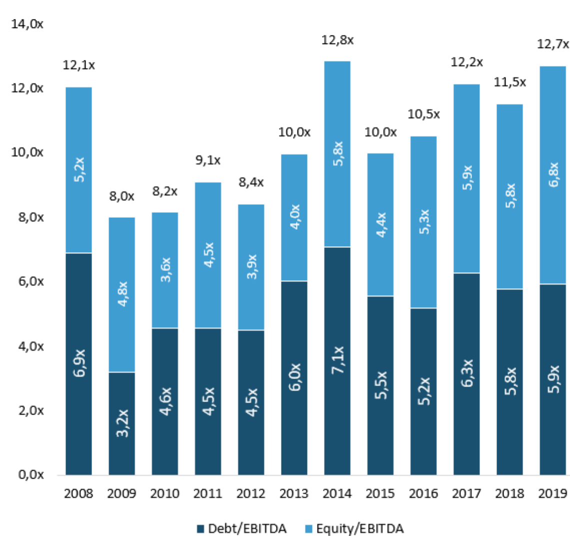

*Source: Preqin, 2020, YIELCO 2020*

While the "dry power" has increased by approx. 75% in the last 5 years, both the number of transactions and the capital invested have only risen slightly on a long-term average and have now levelled at approx. 3,500 transactions and approx. 550 billion USD per year (source: Bain, Global PE Report 2020). This imbalance, combined with the strong activities of strategic/corporate buyers, has led to increasingly dynamic competition on the buyer side. At the same time, low interest rates and a growing number of private debt funds (more than 400 funds according to Preqin, March 2020) have created attractive conditions and additional record liquidity in the financing market.

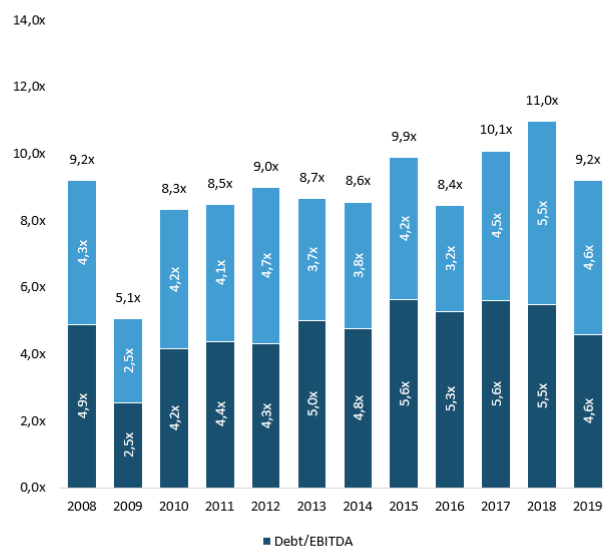
As a consequence of this development, both the entry prices (multiples of corporate earnings) and the leverage ratios gradually increased over time. According to Bain (based on Thomson) more than 75% of the private equity transactions carried out in the USA in 2019 had a leverage ratio of more than six times EBITDA. This figure compares to less than 25% in the years following the global financial crisis. The actual leverage of many companies might even be higher, as the financing providers have increasingly based the issued debt amount on forecasts or adjusted operating income, and the leverage ratio is often reported on the basis of these adjusted values. A similar, albeit not quite as strong, picture is also evident in the European market. These regional developments are also confirmed by the data from Pitchbook.

**Figures 3 and 4: Development of entry valuation and debt levels**

**PE entry multiples/leverage (Median EV/EBITDA) US buyouts**




**PE entry multiples/leverage (Median EV/EBITDA) European buyouts**




*Source: Pitchbook, YIELCO 2020*

With the spread of Covid-19, the several-year boom phase on the financial markets came to an abrupt end. Since the outbreak in Europe in January 2020, global stock indices have lost between 15% and 25% of their value. The drop in share prices will lead to a corresponding revaluation of private equity portfolios, although with a certain time lag. At the same time, the economic development has deteriorated considerably. In Western Europe and the USA, GDP is expected to decline by between 10% and 15% in 2020 (source: UniCredit Research), which will have a corresponding impact on the operational performance of most business models. As a result, many companies and private equity managers will face enormous challenges in the next 24-36 months. This is further reinforced by the fact that (i) the acquisition activity of buyout managers in recent years did not match the corresponding exit activity, which has resulted in a high number of portfolio companies to be supported and (ii) many of these companies will require intensive support.

## Co-investments in the current environment

Co-investments have enjoyed increasing popularity in recent years. According to Cepres (data set June 2019), the number of global co-investments rose from less than 200 (after the global financial crisis) to more than 600 transactions per year, of which about two thirds are in the classic buyout sector.

Many of these co-investments are now being negatively affected by the above-mentioned factors - declining operating income and increasing leverage combined with lower company valuations. As already seen during the global financial crisis, we expect co-investments to show higher valuation volatility and therefore higher value adjustments (compared to the average of all private equity transactions). In our opinion, two factors in particular are responsible for the higher volatility:

- Greater focus in co-investments on large cap transactions (definition of enterprise value >500 million dollars): According to Cepres, 54% of all co-investment transactions to date have been in the large cap sector (investment volume correspondingly higher)
- Large cap and mega funds with higher volatility and poorer returns: An analysis of the quarterly valuations of private equity funds (source: Preqin) has shown that large cap and mega funds had higher value corrections in the global financial crisis than small and Mid-Market funds.

Based on the current situation, we expect a significant decline in "traditional" LBO co-investments in 2020, particularly as the current market environment is characterised by a high degree of uncertainty. The operational performance of a target company is difficult to forecast, which tempts many buyers to wait and see. Furthermore, although the valuation discounts on the stock exchange result in potentially lower entry valuations, the sellers' only slowly adjusting purchase price expectations are unlikely to be met in many cases, which in turn leads to delays and/or discontinuations of sales processes.

In addition, managers will have to invest considerable resources in the portfolio management due to difficulties of the companies, some of which are clearly over-levered. At the same time, the more restrictive availability of debt capital will severely limit the traditional LBO business model (i.e. generating returns through strong leverage of transactions) for new investments. As a result, managers will find it increasingly difficult to invest their sometimes very large fund volumes. As a result, fewer co-investments can be offered. In addition, we also expect a reduced willingness of co-investors to support corresponding transactions.

While the traditional LBO private equity investors are likely to slow down investment activity, we expect a significant increase in complex/special situations transactions and a corresponding co-investment deal flow over the next 12 to 36 months. The special situations segment comprises a broad spectrum of investment strategies, which are shown below in Figure 5.

**Figure 5: Spectrum of private equity investment strategies**

| | Entry via Equity | | | Entry via Debt |
|---|---|---|---|---|
| | **Leveraged Buyouts** | **Complex Buyouts** | **Distressed / Turnarounds** | **(Distressed) Debt-for-Control** |
| **Condition of the company/ Type of transaction** | ▪ Profitable<br>▪ Solid growing<br>▪ Simple transaction | ▪ Operational problems<br>▪ Complex succession<br>▪ „Carve-out“ | ▪ (Threatening) bankruptcy<br>▪ Indebtedness<br>▪ Illiquidity | ▪ Objective: control of the restructuring<br>▪ Objective: to control the company |
| | | ▪ Remaining companies in PE-portfolios („orphans“) | | |
| **Valuation** | ▪ > 10x EBITDA | ▪ 4-7x EBITDA | ▪ < 4x EBITDA | ▪ NA |
| **Indebtedness** | ▪ ~ 6x EBITDA | ▪ 0-3x EBITDA | ▪ Usually no debt | ▪ Usually significant |

*Source: YIELCO 2020*

In a ***first phase (immediately)*** investment opportunities arise as a result of liquidity bottlenecks due to falling sales and/or working capital shifts. Despite government aid, sufficient liquidity is often not secured. In this case, various attractive investment opportunities will become available for co-investors:

- "Rescue capital": In many cases, private equity houses will be forced to provide additional equity to ensure the necessary liquidity. In such situations an additional co-investor might be needed because (i) the invested fund has already been fully invested, (ii) concentration limits within the respective funds are exceeded, or (iii) existing co-investors are not willing or able to support the required capital increase.
- Debt-for-Control": In addition, investors increasingly have the opportunity to buy up non-performing loans in order to gain access to equity (Debt-for-Control). According to LCD, the share of non-performing loans (loans are traded at less than 80% of their nominal value) in the US has increased from 2% in March 2019 to 38% in March 2020.
- "Failed Fundraising": Although only to a limited extent, opportunities for co-investments in the traditional LBO segment will continue to arise in the medium term. Due to the reluctance of investors to commit to funds, we expect situations, as seen in 2009/2010, in which a envisaged first closing of funds cannot be realised in time. However, some of these managers are already in the process of signing / closing a transactions, hence, co-investors are sought as they (i) can either take a long-term stake in the company and / or (ii) are willing to bridge the financing until successful fundraising. In the first phase, we see companies from more defensive sectors with stable business models (e.g. fast moving consumer goods, healthcare, software), which offer attractive entry scenarios in highly distorted and volatile markets. New investments in special situations: Despite the fundamentally positive economic development in recent years, a broad field of special situations investors has constantly developed. This group of investors has the appropriate skills and experience to implement attractive transactions in the current market environment. These are typically turnaround specialists who take advantage of operational failures and liquidity bottlenecks to gain full control of the company, either immediately or step-by-step.

In the ***second phase (estimated from mid-2021*)**, we expect to see a significant increase in traditional balance sheet restructurings, even for companies with fundamentally good business models. However, the expected decline in the operational business over the next few months will lead to a further increase in leverage and the associated risk of covenant breaches. Balance sheet restructurings will become necessary, but traditional debt solutions will not solve the situation. Existing shareholders might not participate in full in these financing rounds, hence external investors might be needed. The reasons for the non-participation can vary, as already explained above (see rescue capital section). These situations offer opportunities for co-investors to close corresponding capital needs.

In addition to a classic capital increases, history shows that flexible capital solutions (e.g. mezzanine, PIK notes or preferred capital) will be increasingly used in such occasions, as especially the underlying company valuation will lead to a wide range of discussions. Once new financing partners are added to the capital structure, a commonly agreed basis for the company valuation must be found. Existing owners typically tend to value the company higher (to keep the potential dilution of their shares low),

while new parties joining the financing round are usually looking for lower valuations based on the reduced operational results. This discrepancy can be resolved by flexible capital solutions, as such instruments do not represent a shareholding in the company, but rather have a fixed yield component (often combined with so-called "warrants" or "equity kickers") and a senior position compared to common equity. As a co-investor, it is also important in this phase to offer a flexible product range, as otherwise a large number of potentially attractive transactions cannot be addressed.

In the ***third phase (from 2022)*** we expect economic normalisation. Due to the previous economic distortions, attractive opportunities should continue to arise. The new economic environment will force industrial companies to review their group structures / subsidiaries and adapt them to the new reality. This increases the opportunities for attractive carve-out situations. In addition, the need for innovative solutions, particularly in the area of small and medium-sized transactions will continue, regardless of the economic cycle (for example for succession issues or complex structures, which are often valued at attractive levels). Co-investor solutions will continue to be in demand in many of these situations.

We expect a significant increase in the number of refinancings from 2022 onwards. Early refinancing at better conditions, which have continuously shifted the maturity wall to the back in recent years, is not to be expected in the short/medium term. For this reason, most of the funding provided between 2015 and 2018 will continue until the actual maturity date. According to the S&P / LSTA Leveraged Loan Index, this volume will increase significantly over the next few years. For the US market it is estimated that the volume to be refinanced will increase from currently less than USD 50 billion per year to more than USD 200 billion in 2023. Companies will then be forced to consider flexible equity solutions, opening up another opportunity window for co-investors.

**Ingredients for successful co-investments**

According to YIELCO´s estimates, there are about 300 specialized managers worldwide who are positioned to successfully invest in companies with operational and/or financial challenges (especially stretched leverage). With the exception of a few larger managers, the fund volumes managed by these players specialising in complex transactions are still comparatively small (generally < 2 billion USD/EUR per fund). Due to the special requirements, with regard to operational restructuring and value creation, these set-ups can only be scaled moderately, despite high investor demand.

While the US market has always had a number of well-known managers, especially in the small and mid-cap market, an attractive spectrum of regional special situations managers has also been established in Europe in recent years. According to YIELCO analyses, globally around 80-100 teams have strong operational and/or financial restructuring skills and a proven track record. In addition, about 15-20 new managers can be observed in the market every year, mostly spin-offs of teams from established groups.

According to YIELCO estimates, a total of around 25-30 managers in the USA and around 15-20 groups in Europe are currently very well positioned to identify attractive investment opportunities, gain access to them, reposition them and ultimately lead them successfully to exit. The placement power for

investors with these managers is limited and also difficult to scale up, especially due to their fund sizes, which are often below one billion USD/EUR.

The key factor for participation in respective co-investments is a deep understanding of the market segment and the positioning as a significant LP / anchor investor in current and future funds of the leading managers (e.g. via significant allocations, participation in early closings, seat on the LP Advisory Boards, personal relationships with the Managing Partners). As many of the leading managers are restricted in terms of access, broad networks and long term relationships are an absolute prerequisite for access and significant allocations.

A flexible investment mandate is also required for the implementation of attractive co-investments in complex transactions, which allows for appropriate leeway in the selection of the financing instrument and enables both equity and selectively structured debt-like capital solutions. Strong risk protection from an investor's perspective can be negotiated and ensured comparatively well, especially in the current environment, thanks to a bundle of elements. The focus here is on relatively low entry prices, moderate levels of debt and often a preferential positioning in the capital structure (as preferred equity or senior debt).

In addition, when building up a co-investment portfolio, a broad spread (over approx. 12-15 individual investments), solid time diversification (over several vintage years) and broad coverage of several industrial or sectoral sectors are essential.

**Summary – Outlook**

The short and medium-term environment will continue to offer opportunities for very attractive co-investments, but the types of transactions will differ significantly from those of the pre-crisis period. While recent years have been characterised by highly leveraged, growth-focused "traditional" LBO co-investments, the next few years will see particularly complex transactions across the entire special situations spectrum as well as structured debt capital solutions with a high degree of risk protection. Investors who have long-standing relationships and access to leading managers with high operational and/or financial restructuring expertise are excellently positioned to participate in these attractive transactions. In addition, they should have competent resources to quickly evaluate offered opportunities and implement them within the framework of flexible mandates.

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