BLOG

Private equity investing unlocks: from pure-play to blended

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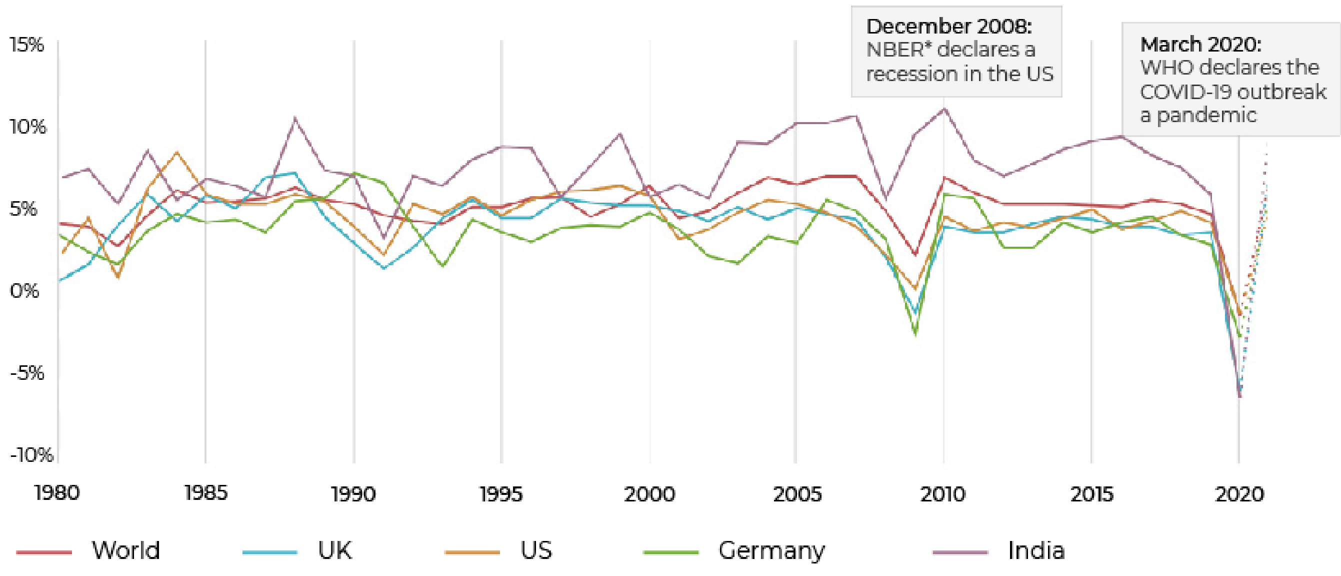
Good tactics can save even the worst strategy. Bad tactics will destroy even the best strategy.

– General George S Patton Jr.

The COVID-19 impact on the world economy

The coronavirus outbreak is slowly pushing economies into recession. The IMF expects the world economy to shrink by 4% in 2020, the lowest since the global depression of 1929. With 59.8m infections , we wonder what the recovery would be like and how long it will take for things to normalise

The following chart shows GDP data for the world and a few major economies from 1980 to 2020



*National Bureau of Economic Research
Source: www.imf.org

Impact of lockdowns

In March 2020, WHO declared the coronavirus outbreak a pandemic, and governments across the globe were compelled to impose lockdowns and restrictions to contain the spread of the virus. This meant confining people to their homes and suspending economic activity. Some of the sectors worst hit by these measures were hospitality, real estate, oil and gas, transportation and apparel.

Winds of change:

Businesses were unprepared for the pandemic at first, but the digitalisation it led to made companies realise that they need to re-think their strategies to adjust to the new normal. However, with slow to zero economic activity and, thus, reduced cash inflow, they would need surplus cash to do so and modify operations.

- *In May 2020, Sanofi SA offloaded its investment in Regeneron Pharmaceuticals Inc. for USD11.1bn to adjust its drug pipeline*

The role and reaction of private equity firms

Erring on the side of caution:

A number of private equity (PE) activities were impacted by the pandemic. PE exits have halted, and PE firms are cautious about their investments. The pandemic has affected their risk-taking ability, given the uncertainty about the future of business, with return-on-investment or cashflow estimates no longer a safe measure by which to gauge or project the market value of an investment.

Just as PE firms shifted course earlier in the year, they have shifted course recently towards a more blended form of investing that would ensure a minimum return on investment, namely convertible preferred stock.

Examples of recent investments:

- In June 2020, US-based beauty company Coty Inc. sold USD750m worth of preferred shares to KKR, to finance its restructuring initiatives
- In May 2020, Apollo Global Management and Silver Lake Partners provided “anchor funding” to Expedia Group, in the form of USD1.2bn worth of perpetual preferred stock, for Expedia to strengthen its liquidity position
- In April 2020, KKR purchased USD500m worth of convertible preferred shares in US Foods Holding Corp. (a US-based firm providing catering services) to fortify its balance sheet until the situation improves

An emerging investing trend?

With valuations taking a hitamid the current scenario, PE firms have considered switching from pure-play equity to interest-bearing convertibles that have the potential to ensure a minimum return on investment. This could prove to be advantageous to PE firms:

Ensured return
Having an interest-bearing component in investments, along with equity, would ensure a minimum return on exit

Calculated investment
The PE firm can gauge the capital needs or debt-bearing capacity of a target and opt for a blended investment and opt out of pure equity, which is vulnerable to risk

Flexibility
Based on the financial performance of the target, the PE firm may or may not choose to change the convertible portion of the investment

A win-win scenario:

Create thriving enterprises:

Agreed, the times are tough and companies are struggling to survive. However, supporting them through a blended capital investment (and not entirely through equity since there is a risk element involved) could help them restructure their business operations and maybe flourish in the foreseeable future. This is where PE firms can play a critical role, as they are known to create thriving enterprises through appropriate capital injection.

Turn calamity into opportunity:

Adopting a blended investment approach can safeguard PE investments from the effects of an unexpected event, as having a convertible or fixed risk-adjusted investment plan could ensure some safety of return and depending on this, investments could be converted. Thus, the PE firm could continue with fundraising and investing, without having to worry about returns, even in a distressed scenario.

PE firms have significant amounts of capital and see an opportunity to deploy large chunks of it for good risk-adjusted returns.

How Acuity Knowledge Partners can help

We have a strong track record of assisting our global PE clients with a number services including portfolio valuation, portfolio management, collateral management, RFP services, and other PE verticals such as investor relations and business development.

For more relevant offerings, please visit our Solutions page.

To help our clients navigate both the people and business impact of the crisis, we have created a dedicated hub of topics including our latest insights, thought-leadership content and action-oriented guides and best practices.

Sources:

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We empower our clients to drive revenues higher. We innovate using our proprietary technology and automation solutions. We enable our clients to transform their operating model and cost base.

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