HOW PRIVATE EQUITY CAN CAPTURE THE UPSIDE IN A DOWNTURN

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The private equity industry enjoyed a strong 2018, with a healthy level of deal activity and robust inflows of capital. However, change may be on the horizon. Economists have severely downgraded their growth forecasts, global trade has lost momentum, and concerns about escalating trade wars have undermined business confidence. These potential destabilizers have prompted a number of private equity executives to ask us for our outlook: if the boom market is coming to an end, will a bust follow?

With apologies to Mark Twain, we think that reports of the length and severity of the next downturn may be greatly exaggerated. In our view, a slowdown, not a recession, remains the most plausible scenario. Yes, growth has begun to decelerate in many major economies, and that sluggishness is likely to persist for some time. The wild card, however, is the increasing tension caused by geopolitical and trade issues. That tension could deepen the slowdown, at least in the short term. Still, the drivers of this slowdown have little in common with the structural imbalances that drove the 2007–2009 global financial crisis.

Not only is the economy different from what it was a decade ago, but many private equity firms and portfolio companies are much different, too, with higher levels of liquidity, greater portfolio diversity, and a more systematic and operationally focused approach to value creation.

Their stronger economic footing gives top firms and portfolio companies the opportunity to enter this slowdown with a different strategic mindset. Instead of freezing investment activity and retrenching, as many did during the previous recession, top players will use their strong capitalization and operational health to capture the upside of a downturn—pursuing growth and accelerating business transformation.

In this first part of a two-part series, we share our outlook on the economy and on the PE industry, along with recommendations about how to make the downturn a time of opportunity.

A Slowdown Is Coming, but a Crash Is Unlikely

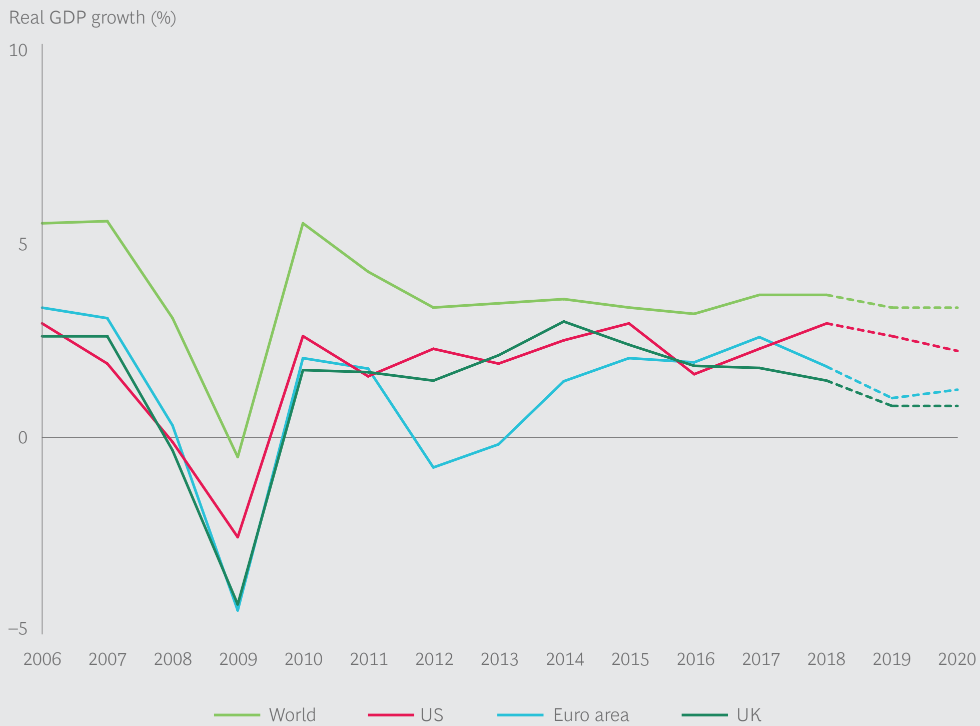
BCG's analysis suggests that the coming downturn will not be as severe or as protracted as the one that followed the 2007–2009 financial crisis. (See Exhibit 1.) The unraveling of massive structural imbalances and elevated debt levels triggered the deep recession of a decade ago, but we see few signs of similar imbalances now.

Deliberate policy decisions are key drivers of the current slowdown, which comes in the final phase of a long post-crisis recovery. Steps taken by the US Federal Reserve to raise interest rates toward more normal historical levels throughout 2018 and moves by the Chinese government to address unsustainable credit growth in shadow banking have had the predictable effect of slowing economic momentum.

Conditions do not point to a severe downturn. First-quarter growth numbers were better than many analysts and economists expected, consumer spending remains robust, and many CEOs report solid business. Other indicators seem to be holding reasonably firm as well. Labor markets, in particular, are still steady, which will bolster the purchasing power necessary to maintain consumption growth, a key driver of economic momentum. Corporate capital spending is also likely to remain stable, given pent-up demand for replacing equipment following a decade of low investment.

The main concerns now involve policy risks, especially with regard to trade, and their repercussions on broader economic sentiment. But policymakers are already responding. For instance, toward the end of 2018, as the possibility of a slowdown increased, the US Federal Reserve paused interest rate hikes and balance sheet runoffs, and the European Central Bank pulled back from plans to reduce quantitative easing. Elsewhere, the Chinese government has worked to promote economic stability by enhancing credit flow in the official banking system, encouraging debt-financed spending, and reducing corporate tax burdens.

Exhibit 1 | GDP Will Slow, but Not Precipitously



Sources: OECD March 2019 Outlook; BCG Henderson Institute: Center for Macroeconomics.
Note: Dashed lines indicate forecasts.

Although we don't expect a recession, a return to pre-2007 growth rates seems equally unrealistic. Debt levels (defined as net debt over EBITDA) are rising. (See Exhibit 2.) Leveraged loans have grown sharply in the US over the last couple of years. They have risen in Europe too, albeit to a slightly lesser extent. For companies that have taken on this debt—especially those whose loan quality is weak—a contraction will increase financial pressure.

As covenant-lite loans become more prevalent, permissive clauses that allow borrowers to incur more debt and issuers to pay more dividends may lower debt quality. If policy risks become reality, the robustness of these arrangements will be tested.

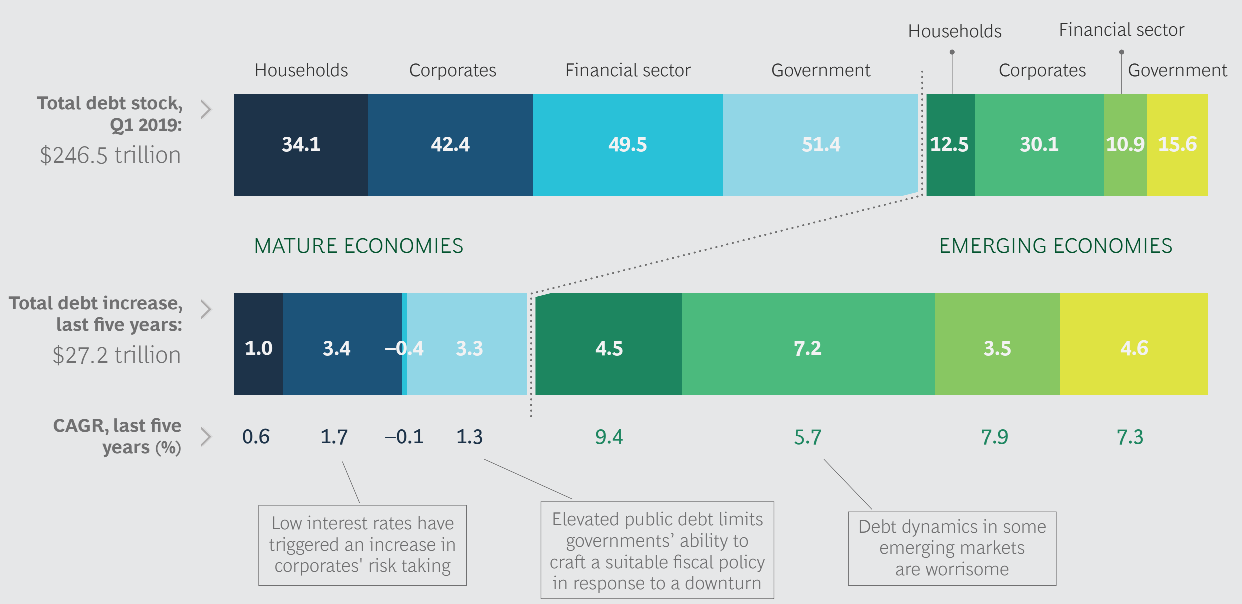
All things considered, the outlook for the next few years suggests that firms and portfolio companies should proceed with caution, but not get paralyzed. A downturn will increase pressure, but it will also create significant opportunities for forward-looking players whose fundamentals are healthy.

The PE Industry's Resilience Has Greatly Improved

The PE industry is in a much different position heading into this downturn period than it was during the 2007–2009 recession. Changes made in the intervening years have given firms and portfolio companies at least four important advantages.

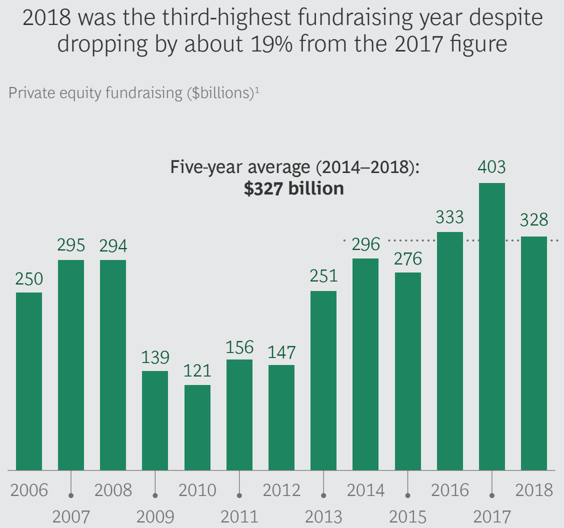
Liquidity and deal activity are stronger. Fundraising and deployment levels are far more robust than they were a decade ago, indicating that the PE industry environment is active and healthy. (See Exhibit 3.) Leading players have raised funds at regular one- to two-year intervals since the financial crisis, with the top five firms bringing in a combined $100 billion in 2017 and 2018 alone. Megafunds—those with more than $5 billion in assets—have fueled much of this fundraising activity, accounting for 40% of total value in 2018. Absolute dry-powder levels (investable assets) have grown steadily, too—reaching a total of $1 trillion in 2018, with an average overhang of one year for equity buyout funds. Just as

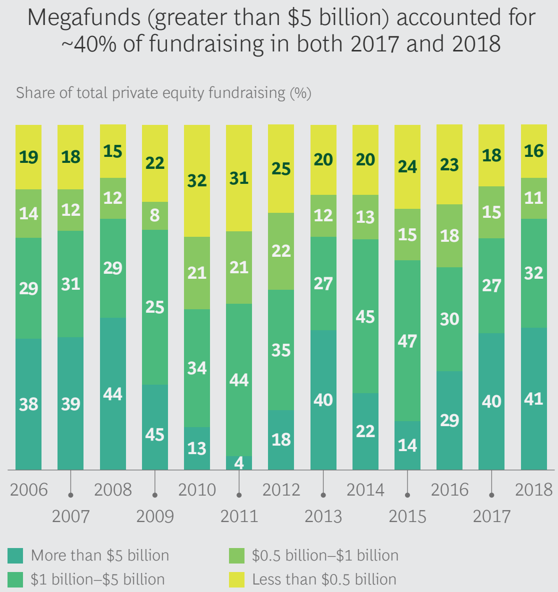
EXHIBIT 2 | Debt Levels Are Rising, but Not Enough to Trigger Alarm



Sources: Global Debt Monitor, IIF; BCG Henderson Institute: Center for Macroeconomics.

Exhibit 3 | Fundraising Performance Remains High by Historical Standards





Source: Preqin.
Note: Because of rounding, not all percentages shown add up to 100.
[1]Includes balanced, buyout, co-investment, and private investment in public equity, growth, and turnaround funds.

important, firms have continued to find productive uses for their funds. From 2013 to 2018, investment deployment rose at an average compound annual rate of 10%.

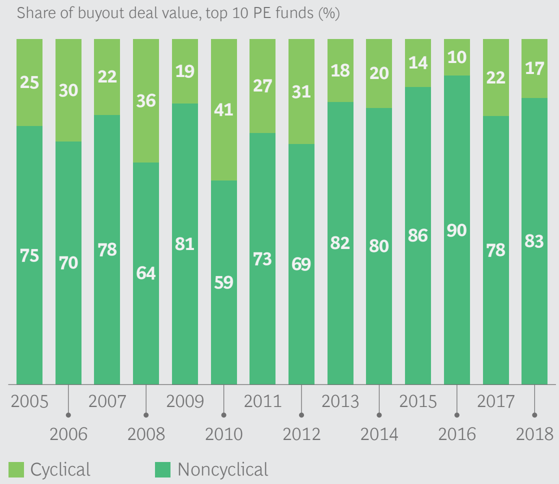
The strong performance of PE portfolio companies relative to the rest of the market is likely to attract continued investor interest. What investors once saw as a niche sector is becoming a trusted and mainstream destination for wealth and capital. In light of these factors, we expect the industry to be well positioned to raise and deploy capital successfully, and to generate investment and deal opportunities, even in the face of a weakening economic climate.

That said, the steady increase in deployment and investment does not come without risks, given rising valuations and debt leverage levels. Although these risks are largely in line with what we would expect in an environment characterized by high fundraising and low interest rates, they nonetheless bear watching.

The portfolio mix is more recession-proof. PE firms are much less exposed to cyclical swings than they were during the previous recession. From 2005 to 2007, cyclical industries represented 25% of buyout deals for the top 10 PE firms. But in the years 2016 to 2018, that percentage fell to just 17%. The level of PE investment in retail and in hospitality and leisure—industries that tend to move in lockstep with the economy—is now half what it was prior to the last financial crisis. It comprised 3% of the average portfolio in 2016-2018 versus 6% in 2005-2007. (See Exhibit 4.) During the same period, PE firms invested a greater share of their funds in technology and related sectors, which are less sensitive to economic swings. Firms had other factors besides cyclicality in mind when recalibrating their portfolios—considerations such as reducing exposure to digital disruption in the retail sector and taking advantage of the booming high technology space. Nevertheless, the rebalancing also reflects firms' efforts to take potential downturn impacts into account in their returns expectations.

Exhibit 4 | Firms Are Building Relatively Recession-proof Portfolios

Top 10 private equity funds



Industry	Average share of buyout deal value (%) 2005–2007	2016–2018	Delta (percentage points)
Restaurants, hotels, and leisure	5.9	2.9	–3.0
Retail	5.6	2.5	–3.1
Semiconductors	4.5	0.0	–4.5
Energy	3.0	6.5	3.5
Consumer durables	2.5	0.1	–2.4
Industrial	2.1	4.0	1.8
Transportation	1.3	0.4	–0.9
Materials	0.6	0.0	–0.6
Total cyclical	**25.5**	**16.5**	**–9.1**
Commercial products and services	21.5	27.1	5.6
IT/software	21.1	27.9	6.8
Healthcare/pharma	11.3	10.6	–0.6
Media	8.1	1.3	–6.9
Utilities	5.3	0.0	–5.3
Consumer Nondurables	2.9	2.8	–0.1
Financial services	2.8	11.5	8.6
Other	1.4	2.3	0.9
Total noncyclical	**74.5**	**83.5**	**9.1**

Source: Pitchbook.
Note: "Other" includes agriculture, containers and packaging, other consumer products and services, and textiles. PE funds included The Carlyle Group, Blackstone, KKR, Apollo Global Management, CVC Capital Partners, Warburg Pincus, EQT, Neuberger Berman Group, Silver Lake, and TPG. Data includes completed deals only. Because of rounding, not all percentages shown add up to 100.

Firms are taking a systematic approach to value creation. Over the past decade, PE firms have placed much greater emphasis on the operational performance of their portfolio companies, which contributed to the industry's overall resilience coming out of the 2007–2009 recession. A study comparing the performance of more than 700 UK-based, PE-owned portfolio companies to a relevant set of non-PE owned peers found that PE portfolio companies earned 8% higher market share during the financial crisis and attracted roughly 6% more investments (normalized to assets) in the years immediately following.[1] Roughly 70% to 80% of value creation for leading firms now comes from EBITDA growth, whereas multiples and financial engineering account for just 10% to 15% on average. The push for operating excellence is especially pronounced among top PE players, many of which are appointing operating partners and bringing on external advisors to strengthen their operating management expertise. In addition, firms are increasingly adopting full-potential plan development and "100-day" plans as standard procedures, and many such plans include detailed work streams designed to make the portfolio company more downturn ready. The emphasis on operational improvements and value creation has created stronger companies and greater optionality, improving the industry's ability to withstand economic headwinds.

Format diversification has increased. PE firms are embracing new investment formats that take advantage of nonequity instruments and reduce the risk of having to hold "fire sales." For instance, many firms have introduced long-hold funds of 15 or more years. Popular with lead partners, such as sovereign wealth funds and pension funds, that have longer-term liabilities, these funds also appeal to general partners, who appreciate the chance to hold onto profitable companies longer. The increase in holding period options gives firms a more versatile and resilient fund structure for weathering the business cycle's ups and downs. Firms are also more open to multi-asset strategies, including growth equity funds, credit, and infrastructure. A Mergermarket survey published in September 2018 reported that 42% of senior PE executives had expanded their firm's exposure to new asset classes in the previous three years and that 54% planned to do so going forward.[2] Beyond creating opportunities for additional AuM growth, diversification reduces the impact of volatility in different asset classes and can help firms achieve substantial operational synergies; for example, a real estate operations team can advise on buyouts of companies with sizable property holdings.

Instead of Slowing Down, PE Can Go on the Intelligent Offense

Although the PE industry largely froze investment during the previous recession, healthy PE firms and portfolio companies can approach the coming slowdown far differently. Instead of treating a contraction as a time to pull back, well-positioned players should use this time to advance their market position, embrace new investments, and fast-track business and operating model improvements. Here are four strategies that can help the PE industry find the upside in a downturn.

Adopt a winner-take-all mentality. In a slowdown, heterogeneity among companies and industries matters more. A boom economy or a severe downturn tends to affect all players regardless of their performance quartile, but a shallow slowdown splits the playing field. Weaker companies must devote themselves to shoring up their balance sheets and operations, while stronger ones can focus on strengthening their positions and growth prospects. For example, by channeling investment dollars into strategic acquisitions, such as M&A platforms, portfolio companies can grow their sector leadership and significantly outpace their competition.

Pursue new investment opportunities. Public-to-private deals have been growing in volume and value in recent years. The combination of low interest rates and high liquidity can make it easier for PE firms to take advantage of that shift and buy out underperforming corporations. An economic slowdown can also create attractive opportunities for PE firms to redirect distressed and turnaround assets into new deal flow. For instance, in a downturn the number of carve-outs often rises, as corporations refocus on their core business. Exercising due diligence, firms can exploit the lower multiples and untapped value creation opportunities that these assets present. Given the risks, firms need to manage these deals with care. Thus, in carve-out diligence, firms must complete incremental activities to understand the parameters of the deal and develop the correct baseline assumptions.

Accelerate organizational transformation. The secular forces shaping the world will not go away. When it comes to digitization, ramping up environmental, social, and governance (ESG) practices, and advancing diversity and inclusion, the race is on. Firms that curb the temptation to pull back on these initiatives during the downturn will emerge in a much stronger competitive position. Leading players will use the slowdown to build capabilities around artificial intelligence, machine learning, and advanced digital tools to help future-proof their portfolio companies and boost portfolio value and performance. Incorporating ESG metrics into capital allocation and stewardship criteria is becoming more important, too. BCG analysis of more than 300 companies found that valuation multiples and profit margins were higher and risk was lower for companies with leading ESG practices. Equally important is the need to continue to advance diversity and inclusion initiatives. Research shows that the EBIT margins of organizations with diverse management teams are nearly 10 percentage points higher than those of organizations with below-average diversity. By accelerating progress in each of these dimensions, PE firms and their portfolio companies can create a virtuous cycle that enables them to attract strong talent, nurture innovation, and create a foundation for sustained growth.

Continue to shore up resiliency levers. Focusing on growth is crucial, but PE industry players cannot afford to ignore the fundamentals either. Commercial optimization, a zero-based approach to costs, and effective cash management can help firms and their portfolio companies maintain resiliency and optionality. Leaders need to take an end-to-end view to understand what products and services are responsible for driving the majority of portfolio company profitability. Winnowing a company's commercial portfolio down to its highest-value products can sharpen management focus, make valuable resources available, and accelerate development times for key features and initiatives. That focus has helped some portfolio businesses boost sales by 3% to 8%.

Companies need to be similarly strategic with regard to cost optimization. Seemingly discretionary budgets such as research and marketing are easy targets during a downturn, but trimming them too much can cripple a firm's efforts to jumpstart growth later. To avoid cutting in the wrong areas, portfolio companies should take a zero-based approach that enables them to set top-down targets on the basis of factors such as affordability and historic best and competitor benchmarks. This technique gives companies greater flexibility and can deliver cost savings in the range of 10% to 15% (and as much as 30% for underperforming portfolio companies).

Finally, although strong cash management practices are necessary at all times, they are especially crucial during a slowdown. For example, in order to know whether deferring sustenance capex is better than stopping an investment outright, leaders must acquire the data and analytics to look at EBITDA, capex (sustenance, productivity, and growth/new product development), inventory, receivables, payables, debt repayments, and asset disposals in an integrated way. By taking a holistic view of its finances, a company can unlock as much as 10% to 25% in working capital.

Although the prospect may seem counterintuitive, the coming slowdown could be a time of significant opportunity for the PE industry. Not only is the underlying economy more structurally sound than it was a decade ago, but also PE firms and their portfolio companies have much stronger baseline fundamentals. And while an environment of heightened policy risks creates challenges, it also offers opportunities for those that have the resilience and foresight to navigate the new context. By capitalizing on bold plays and doubling down on operational improvements, the PE industry can make itself more recession proof and future ready.

Note

[1] Gianfranco Gianfrate and Simone Loewenthal, "Private Equity Throughout the Financial Crisis," Journal of Private Equity 19(1) (Winter 2015), pp. 14–26, https://www.jstor.org/stable/43967366?seq=1#page_scan_tab_contents.

[2] "2019 Global Private Equity Outlook," Mergermarket, September 24, 2018, https://www.mergermarket.com/info/2019-global-private-equity-outlook.

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