10 years LPEA
THE LUXEMBOURG VOICE OF PRIVATE CAPITAL

Private Equity & Venture Capital investing in times of extreme uncertainty and extraordinary circumstances

THE VIEW FROM LPEA

Luxembourg, April 15th 2020

1. General assessment of PE/VC industry

There has already been much written and published by various firms on the impact of Covid-19 on Private Equity (PE), the growing “darling” asset class of investors since the Global Financial Crisis (GFC) in 2008. The question for many is whether PE will remain in favour after the unfolding coronavirus-crisis reveals its full extent in terms of damage to the economy.

In truth, the long-term nature of PE and the continued uncertainty surrounding the length and extent of the lockdown around the world make it difficult to assess its impact short term. PE-backed company valuations are not, like public equities, marked to market daily, but rather assessed quarterly, so the most telling quantitative impact will be known once Q2 valuations are issued, in late summer 2020. Nevertheless, regarding existing investments, there will most certainly be an adverse impact on performance and jobs, with great variations by sector and vintage. Maybe not as pronounced, on average, in PE as e.g. in the public markets but certainly correlated.

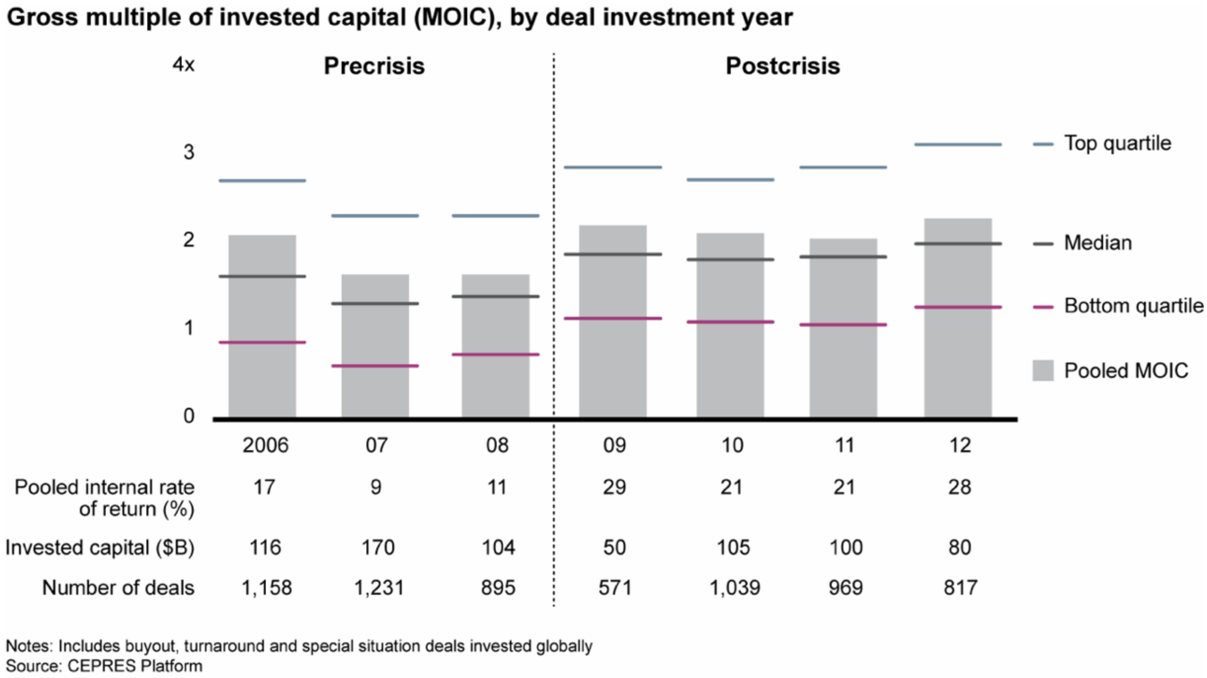
Overall, General Partners (the teams that run the PE funds) have been quick in action to develop “contingency plans” and support their investee companies, determining which ones would need most support depending on their sector of activity, zone of operation, the strength of their balance sheets and their dependence on global value chains (e.g. production in China, or frankly any geography subject to lock-downs).

Most GPs certainly come better equipped than during the GFC which taught a generation of practitioners how to be operationally effective also in crisis situations. This means the higher the expertise the better the chances to preserve the business. We expect the most obviously (travel, retail) cyclically exposed (and leveraged) to suffer first and the most, in tandem with those businesses with particularly tight cash balances, which includes thinly capitalized start-ups with high cash burns, typically those who are generating low revenue and spending a lot to acquire customers. The question for their shareholders will be whether to save them or let them go. On the flip side, investments in less cyclical sectors (e.g. food retail), defensive sectors and those that are disruptively innovative will fare well, e.g. healthcare, cloud-based B2B software, cybersecurity.

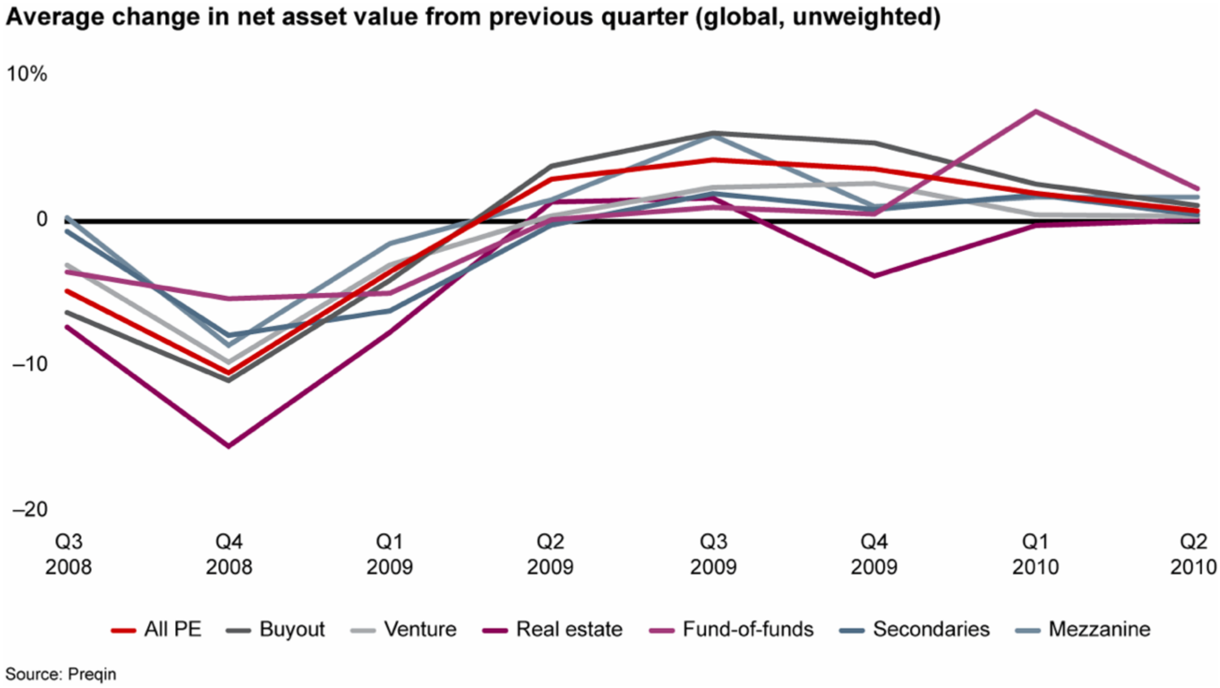
GPs have also raised significant cash over the past few years, accumulating a war chest (in PE alone) of over one trillion dollars, which means PE funds will be well positioned to invest in businesses that will have suffered from Covid-19 and will therefore need fresh capital injections but have strong fundamentals. This is where the opportunity lies for PE to prove its worth and deploy its full expertise to generate outsized returns in a sustainable manner, thus living up to its promise to deliver over the long run. Historically, PE Alpha (outperformance over public benchmarks) has been the relatively highest during periods economic downturns.

2. Comparison to the Global Financial Crisis (GFC)

Based on the GFC we expect the newly raised funds to perform well post-crisis, while recent vintages should fare less well as per the below graph:

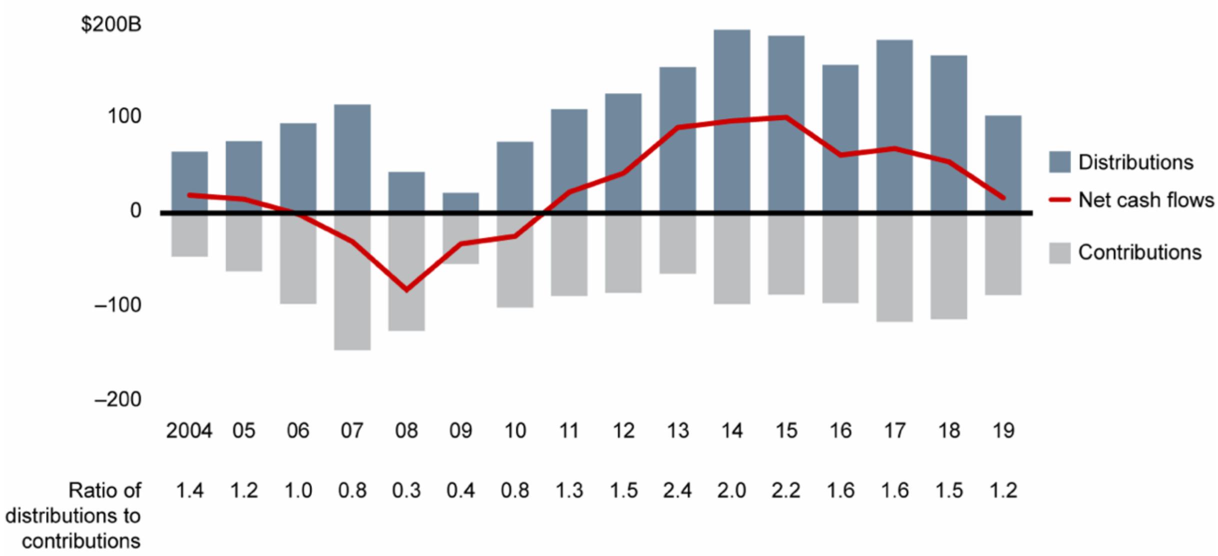


In terms of valuations, the typical cycle expected may follow what we saw back in 2008, with a drop of up to 20% in NAV, before a stabilization once public markets return to “normal”, albeit with a lag:



Last but not least, the liquidity squeeze may impact LPs (investors in PE funds) over a period of 1-2 years, where capital calls exceed distributions in any given period, but this follows a continuous 8 years during which net cashflows for investors were positive.

Capital contributions and distributions for global buyout funds



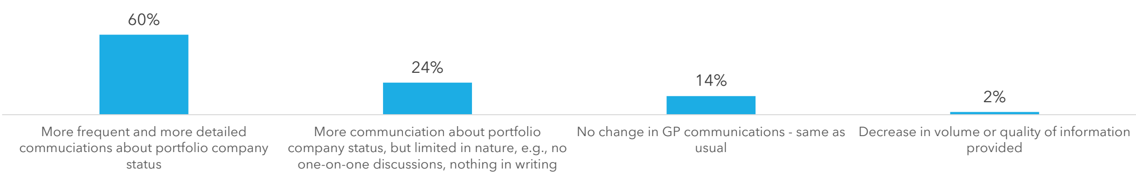
Note: Data for 2019 is through the third quarter
Source: Cambridge Associates Private Investments Database

3. Conclusion for the global PE/VC industry

All in all, open Covid-19-related issues that are in every PE investor´s mind concern (i) the timing of exits for investments that are mature (typically 4-5 years), which impacts returns (at least IRRs), (ii) the postponement of ongoing fundraising and deal making, and more philosophically, (iii) how they can learn from this unprecedented crisis to improve their processes and become even more resilient to future disruptions. This concerns in particular the digitalization of the value chain, which has been somewhat slow coming in PE administration itself.

GPs will be expected, more than ever, to communicate regularly to their investors (LPs) during this time, which provides also an opportunity to increase transparency that is often called for by ILPA, the institutional LP Association, which LPEA knows well. An April 8th report indicates this increase in reporting from GPs. (Full ILPA survey available here.)

Changes to the volume or quality of information being provided by GPs about portfolio companies in response to COVID-19



4. Specific observations relative to Luxembourg PE / VC

At Luxembourg´s level, PE investors on the ground share the same concerns as any other, in an economy that is fully open and globalized. In parallel, the deep pool of experts, from leading legal to accountancy firms and fund administrators, has been busy advising their PE clients, while coming up with contingency plans for their own teams. LPEA also stresses the importance of the presence of Single Family Offices (SFO) in Luxembourg, which are estimated to be approx. 100. They will play a key role of stabilization during this difficult time. SFOs are by definition long term focused and bring deep operational expertise to portfolios, beside representing a sizeable amount in AuMs, as they often have industrial roots. Their commitment to Luxembourg should be preserved at all costs.

Last but not least, the PE / VC expects strong government support, which has been great so far. Ultimately it is the positive coordination between public and private sectors, now more than ever, that will show Luxembourg´s ability to adapt to the current extraordinary times, thus preserving our stable economy and competitive operating environment over the long run.

So far, based on a survey completed over 8th-15th April 2020, by 60 PE/VC firms, which represents 25% of all members and of which almost 50% are investors (GPs and LPs including funds, family offices, law firms and fund administrators), the LPEA can relay the following observations in terms of how the industry is faring in the current Covid-19 context:

- Over 90% don’t anticipate a change in staff counts from Covid-19 impact
- 89% feel ready to deploy contingency plans and ensure business continuity
- Close to 80% are looking for insights from experts to guide them through the crisis
- Respondents assess current impact of Covid-19 to be medium (51 out of a scale of 0-100) while expecting year-end impact to go slightly down (46 out of the 0-100 scale).

Qualitatively what emerges strongly from the survey is the desire from PE/VC practitioners in Luxembourg to see the government step up for support in terms of:

- Support small and medium sized firms with subsidies and job preservation measures
- Clear relaunch plans for the economy
- Provide assistance when it comes to teleworking for cross border staff
- Tax relief wherever possible
- Enhanced flexibility from CSSF in terms of regulatory and reporting requirements
- Accelerate digitalization of operations and approval processes
- Prepare for legal disputes and restructurings, which may increase.

5. Looking ahead for Luxembourg PE /VC

We are staying close to our community, via regular webinars that include expert interviews and debates launched late March 2020. All public replays can be found on the LPEA YouTube Channel.

Over the next weeks and months, the LPEA will continue monitoring the evolution of the impact of Covid-19 on our industry, with a special focus on:

1. Employment stability amongst local PE/VC players, especially the larger firms (Big4, Law firms)
2. Impact of Covid-19 on Q2 valuations (NAVs) across PE / VC holdings domiciled in Luxembourg
3. Liquidity management on the part of Limited Partners´ who receive capital calls (default risk)
4. Large buyout investments in terms of their ability to continue repaying debt (covenant breach)
5. VC funds emergency measures to shore up the more fragile portfolio companies
6. New business activity for fund admin providers, as fundraising slows down or halts.

Rajaa Mekouar, CEO