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INSIGHT: Impact of Covid-19 on Middle-Market Private Equity M&A

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Covid-19 and the resulting market volatility and uncertainty has disrupted middle-market dealmaking. Per PitchBook, provider of private capital market data, after a strong Q1 with nearly 3,000 announced U.S. deals, deal volume plummeted to 538 in April and 390 in May.

For many middle-market sponsors, focus over the last few months has been on managing the crisis and preserving value at existing portfolio companies, but funds continue to hold record amounts of dry powder. As of Q2 2019, approximately $740 billion was held by U.S. funds. (PitchBook, "Quantitative Perspectives U.S. Private Equity During Economic Turmoil.") The pressure to deploy this capital exists across the market, including those with recent fund closings and mature funds seeking to deploy the last of their committed capital.

Challenges

■ For many sellers, planned or current sale processes have been put on hold or slow-tracked. High-profile sale processes such as Imprivata, Finastra, and Visma have been shelved. This pause has extended to the middle market, where sponsors report that inbound confidential information memoranda have dropped by 95%. Even as lockdown restrictions ease and public markets start to rebound, many sellers expecting buyers to demand lower post-Covid-19 pricing will continue to defer an exit until valuations recover or some sense of longer term stability exists.

■ For buyers who remain active, many have struggled with the practical difficulties of conducting traditional due diligence, lack of in-person access to management, and restrictions on travel and scheduling required for physical site visits. While some buyers may initially seem willing to work through these issues, a remote process could stall deals due to roadblocks that, under different circumstances, might be resolved with face time among buyers, sellers, and management teams.

■ While direct lenders have filled some of the gaps caused by bank-lender reticence, the most significant and continuing challenge is that access to debt markets is considerably tighter. In many cases, deal timelines for both new platform and portfolio company add-ons have become protracted with extended exclusivity or diligence periods in the absence of competitive auctions.

■ Despite recent market rebounds and optimism about recovery, a key issue faced by both parties and lenders remains risk allocation and valuation.

Implications for Traditional Leveraged Buyout Deals

■ We have seen, and continue to expect in the near term, buyer-friendly deal terms and processes for transactions that are still under consideration.

■ Buyers have been using protracted deal timelines to conduct diligence and maintain discussions with sellers before signing definitive agreements while waiting for debt markets to ease.

■ While many deals closed on a no-seller-indemnity basis before Covid-19, varying levels of seller indemnification coverage are being considered. That said, in many transactions, we expect the continued use of representation and warranty insurance as a way of allocating and managing risk. Rates do not appear to have been impacted by Covid- 19 as of yet; however, depending on the sector and specific impact on the target, there may be increased focus on underwriting and the buyer's diligence process.

■ Parties can bridge a valuation gap through staged purchase price payments, contingent performance mechanisms (such as earn-outs), seller notes, and increased seller rollover investments. Some of these deal features, including earn-outs and increased rollover investments, were already in wide use—if not increasing—prior to the current crisis.

Alternative Transactions and Opportunities

■ Larger sponsors have responded quickly over the last few months by shifting focus and raising funds for opportunistic investing. This has taken the form of funds focused on credit investing, distressed investing, or buying back portfolio company debt, such as Apollo's use of $1 billion across 10 such transactions (Bloomberg, ''Apollo Snaps Up Portfolio Company Debt, Touts 250 Ways to Profit,'' March 24, 2020.) We are also seeing an increased volume of sponsor-backed private investments in public equity (PIPEs). However, smaller funds may not be able to pivot so quickly or access similar options, given size constraints, timing considerations, or fund mandates.

■ Many sponsors may continue to focus on add-ons for existing portfolio companies that can be acquired with little or no debt.

■ Will we see a rise of growth equity and minority investments? Growth equity was already an appealing strategy before Covid-19, even for traditional buyout funds. $367 billion was raised globally from 2014 to 2019 for growth equity strategies, and performance has been similar to buyout funds. The risks can be substantially lower than venture investing and do not require significant leverage to generate returns. (Bain 2019 Private Equity Report and the State Street Global Exchange Private Equity Index.)

■ Because of Covid-19, many companies remain in dire need of liquidity, including sponsor-owned portfolio companies that have a proven business model and established profitability. A source of capital may be sponsors who participated in auctions, either as an unsuccessful bidder or a bidder in a stalled auction. Such sponsors have already vetted management and conducted thorough diligence, and in many cases, deals were fully negotiated and parties were ready to sign an acquisition agreement.

■ Lack of experience/expertise, fund mandates, and other hurdles may exist if equity financings are not part of a sponsor's existing investment thesis. Sponsors may also face additional competition from family offices or others, particularly in more resilient sectors. Yet, while leverage remains difficult to access, such minority investments may be attractive opportunities.

The longer term impact of Covid-19 on private equity dealmaking is still unclear, but with challenges, there will inevitably be opportunities for proactive sponsors.

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