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Private equity and the new reality of coronavirus

Sponsors and their portfolio companies need to adjust quickly to the COVID-19 outbreak. Here's the new playbook.

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COVID-19 is an enormous global humanitarian challenge. Millions of health professionals are battling the disease, caused by the coronavirus (SARS-CoV-2), and putting their own lives at risk. Governments and industries around the world are working together to understand and address the challenge, support victims and their families and communities, and search for treatments and a vaccine.

The economic damage is becoming palpable. Every business, large and small, is coming to grips with the unfolding crisis (see McKinsey's global perspective on the implications for business on McKinsey.com). Private equity (PE) firms and their portfolio companies come into the crisis riding a decade-long wave of growing transaction volumes, valuations, and fundraising. That position of strength may prove a bulwark in the months ahead, especially for firms that have exercised prudence recently. But there are also fault lines in private markets: deal leverage recently reached a new high, and multiples paid in recent months reached a multiyear high.

Every industry needs to respond to the crisis—including private equity. This article provides an outline of the emerging playbooks for both PE firms and their portfolio companies.

Firm actions and priorities

For many experienced investors, a crisis is not uncharted territory. But the COVID-19 outbreak is fundamentally unique in its disruption of core working processes. Every sponsor needs to make five kinds of adjustments; some leading firms are already taking several of these steps.

Take care of employees

PE firms need to make sure that colleagues can prioritize their own and their families' health, energy, and stress levels, in line with guidelines from the relevant public-health organizations. Many firms are already investing heavily in the blocking-and-tackling needed to expand remote technology and back-office infrastructure (for example, by adding VPN access and extending help-desk hours). We have seen others planning to enhance virtual training (to come back from the crisis with a better-skilled team) and adding benefits such as telehealth services.

Many of the tools, even if they have been in use for a while, will be unfamiliar to colleagues. Firms need to provide appropriate training for all employees to get comfortable with this new operating model and to make sure they can do their jobs remotely.

Firm leaders need to role-model the emerging best practices and ensure their presence (through videoconferences or more frequent informal calls) to maintain both organizational connectedness and ongoing critical activities.

Ensure continuity of critical processes

PE firms need to keep crucial machinery running; they should continue to assess the investment pipeline, conduct investment-committee discussions, and manage all other essential processes through videoconferencing. Similarly, they can continue regularly interacting with portfolio-company leaders through videoconferencing and shift to conducting board and review meetings virtually.

Firms might consider increasing the frequency of interactions, thus reducing lead time on agreed actions. This would allow maximum flexibility and agility for responding to fast-emerging challenges and making quick, risk-mitigating decisions (such as halting an exit).

Prioritize the portfolio

Sponsors are looking for clarity on the areas in which portfolio companies urgently need support and, when appropriate, course correction. Of course, the industry sector in which a portfolio company operates will be a strong determinant of how it will be affected. Some portfolio companies in healthcare or retail are part of the front-line response or provide critical products and services; ensuring that their supply chains are operating at peak performance is essential. Others (such as travel and hospitality companies) are experiencing immediate and unthinkable drops in consumer demand. Since most sponsors have limited resources to share with their owned companies (such as liquidity, operating executives to provide leadership and execution support, and critical relationships with other organizations), they will need to decide where best to allocate time and resources.

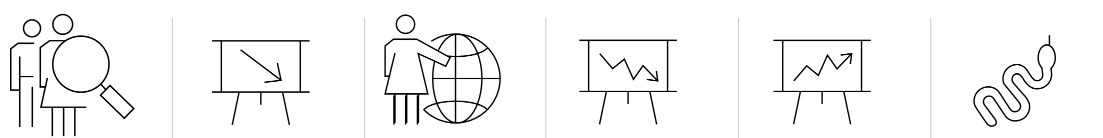
A handy way to prioritize is to consider six indicators of disproportionate risk or impact (Exhibit 1). These aren't exhaustive, and they may change as the crisis unfolds. But these are the six that sponsors are currently using successfully. These six dimensions can quickly identify portfolio companies that require more support. For example, some sponsors whose portfolio companies are dependent on international supply chains have rapidly identified a need to develop regional alternatives for critical parts to maintain operations.

While some portfolio companies require support to address risks, others may be experiencing countercyclical support. Some might be able to make incredible differences to society—say, through supply-chain improvements. And some may have opportunities to restructure their balance sheets in fluctuating financial markets. For example, some manufacturing companies have found ways to shift production toward critical necessities or medical products that are in short supply, while some retailers are finding innovative ways to meet unprecedented consumer demand in an orderly manner. For example, a field-services company is retraining its maintenance workers to handle break/fix calls to keep critical retailing infrastructure up and running.

Exhibit 1

Six indicators can prioritize support to portfolio companies.

Checklist of questions



Risks to employees' and customers' health, safety, and productivity

☐ Does the portfolio company have policies and procedures to minimize risk of infection? Is it in compliance?

☐ Are there confirmed or suspected COVID-19 cases among employees?

☐ Are there barriers to successful remote working? Potential to help customers or others?

Financial/ liquidity risk or customers seeking financing

☐ Is leverage (eg, near-term debt repayments, high-interest payments, tight covenants) high?

☐ Are counter-parties exerting pressure to extend accounts-receivable terms? Do customers have liquidity constraints?

☐ Have there recently been any abnormally high expenses?

Geographic considerations

☐ Are operations, customers, or suppliers based in today's riskiest areas? What about tomorrow's?

Short-term revenue and delivery risks

☐ Is revenue dependent on travel, foot traffic, events, and so on?

☐ Is revenue affected by social distancing or disease prevalence?

☐ Is the supply chain (in particular, raw materials) susceptible to disruption?

Longer-term risks and opportunities

☐ Will shifts in government policy present risks? Opportunities?

☐ Will changes in patterns of global trade, travel, and logistics offer opportunities? Risks?

☐ Will customer preferences change permanently?

Less tangible risks and opportunities

☐ Is the company or its business model susceptible to reputational or cultural risk?

☐ Does the company have sufficient redundancy in its critical functions? Can it provide capacity to others?

Now is the time to consider investment and portfolio actions in the context of the unfolding humanitarian crisis.

Finally, sponsors can use this prioritization exercise to bolster the confidence of their management teams, reassuring them that support will be provided where necessary.

Assess investment strategy, asset allocation, and financing

The current financial-market displacement and equity valuations have undoubtedly created potential investments for sponsors with dry powder. It is difficult to determine which of these will be actionable, not least because obtaining debt finance for buyouts could be challenging. In some cases, sponsors may move ahead, even with limited information. But many sponsors are preparing for a broader range of investments. These can include debt or other rescue financing for companies suffering the brunt of the crisis and other situations that are outside the norm for control-equity investors. Either strategy will require an agile investment process in order to move quickly when potential investments arise.

One final note on investment strategy: COVID-19 has proved again that black swans exist. Investors would do well to consider a wider range of disruptive scenarios when considering new investments.

Support your limited partners and consider your stakeholders

Limited partners crave insights from their investment managers during crises. Some sponsors are supplementing market updates with communication on additional topics relevant to their board and public stakeholders, reinforcing the value and credibility of in-place risk-management and preparedness practices.

Now is also the time to consider investment and portfolio actions in the context of the unfolding humanitarian crisis. At a time when public expectations of business's role in society are shifting rapidly, firms should consider doubling-down on their commitments to environmental, social, and governance (ESG)-related investing and evaluate their actions through a lens of social citizenship, taking a long view as they plot their course.

Portfolio-company actions and priorities

Many portfolio companies are engaging in some or all of five priorities: workforce protection and productivity, managing financial and liquidity risk, stabilizing operations, engaging with customers, and preparing for recovery and growth. Workforce protection is a must for every company; the others will vary by sector (medical companies and hospitals may focus their resources on supply chain and operations; travel and leisure companies, as well as oil and gas companies, on liquidity risk; tech companies on supply chain; and critical-goods retailers on customers and growth).

These five priorities are typically coordinated by a central team (Exhibit 2).

Exhibit 2

A coronavirus playbook is emerging for the portfolio company.

Portfolio-company COVID-19 response playbook[1]

A Establish central executive/team to coordinate	
Issue map and management	Provide single source of truth for issue resolution; tap surge resources where needed
Portfolio of actions	Develop trigger-based portfolio of actions across all work streams
Leadership and alignment	Align leaders and sponsors on scenarios; conduct "tabletop" exercises; delegate authority for agile decision making
Risk assessment	Identify and review business-continuity risks and single points of failure; develop backup plans for critical functions
Local guidelines	Understand local government guidelines; ensure compliance as situation evolves
B Ensure safety and productivity of workforce	
Workforce policies	Develop policy 2-pagers, escalation criteria, and call trees; build portfolio of preventative actions
2-way outreach	Ensure multichannel communications and confidential-feedback/reporting channels
Contractor management	Align contractor policies and incentives for real-estate contractors
Work-from-home infrastructure	Create 3 tiers (all, some, or none); ensure adequate training, VPN, telephony, and broadband
On-site-work norms	Stagger work shifts and times; promulgate social-distancing norms; run health checks; collect productivity ideas
Issue management	Create single-source-of-truth "issues map," with clear resolution owners and deadlines
Stakeholder engagement	Collaborate with local and federal regulators and public-health officials
C Stress-test liquidity and bolster balance sheets	
Scenario definition	Define relevant scenarios based on latest epidemiological and economic outlooks
Liquidity stress tests	Assess financial and liquidity outlooks under various scenarios
Adequate-liquidity assessment	Develop and implement appropriate cash-management strategy, given stress-test outcomes; stand up "cash war room"
Customer-risk assessment	Review client segments for liquidity and repayment risk
D Stabilize operations	
Supply-chain transparency	Ensure cross-tier transparency into suppliers' risks; identify critical parts; find alternative sources
Available-inventory analysis	Estimate inventory along supply chain, including spares and remanufactured goods
Production and distribution optimization	Optimize limited production capacity for critical parts
Logistics	Estimate and accelerate logistics capacity; consider new modes of transport and routes
Customer-demand estimate	Estimate true customer demand, using direct customer communication and external market insights
Manufacturing throughput	Safeguard employees and facilities; assess and mitigate potential disruptions to proficiency
Mix management	Consider shifting mix to higher throughput items (reducing changeovers), especially for critical items

Exhibit 2 continued

E Engage customers	
B2B transparency	Engage B2B customers (eg, through a microsite); use scenario-based risk communications
Customer protection	Protect customers at every touchpoint, with team training and execution monitoring
Customer outreach	Talk to customers about recommended practices related to COVID-19, using fact-based reports and situational communications
Brand	Anticipate potential challenges, take actions necessary to protect brand
F Prepare for recovery and future growth	
Overall strategy	Consider whether adjustments to overall strategy are necessary
Budget	Adjust budgets and goals for current environment; review and prioritize capital investments
M&A strategy	Develop and execute add-on strategy; consider divestiture of noncore assets
Growth investment	Judiciously invest to gain market share; prepare for long-term growth (as permitted by liquidity constraints)
Exit preparation	Build postrecovery exit narrative (for companies closer to end of natural holding period)

[1] Based on discussions with risk/health professionals and >200 companies across sectors and on insights from public and private corporations that successfully navigated the 2008–09 recession. Not exhaustive or applicable for every portfolio company; requires tailoring for specific circumstances.

In the following sections, we outline how portfolio companies are approaching some of these priorities.

Set up a 'cash war room' to manage financial and liquidity risk

Consolidation can only be successful with a deliberate approach.

Companies in sectors with especially tight liquidity or hugely reduced customer demand may benefit from standing up a dedicated "cash war room." This team typically focuses on three tasks:

— *Rapid assessment of risk and potential cash savings.* This assessment, based on internal data and some publicly available sources, includes modeling cash flow to view balances under different scenarios (Exhibit 3).

— *Identification of cash levers.* This step includes a review of the balance sheet and proposing cash-generation levers for major asset and liability categories. Many portfolio companies are exploring ways to restructure or refinance while debt is available and comparatively cheap. Simultaneously, a working-capital diagnostic can highlight potential short-term cash releases.

— *Collaboration with business leaders and outside experts.* This step allows companies to address urgent issues related to liquidity and crisis management.

The war room can work entirely remotely yet in constant cooperation with the portfolio company's CFO, treasurer, and executive team. A dashboard of balance-sheet and cash-flow diagnostics, shared virtually over any confidential platform, can help maintain oversight and keep focus on the most important levers.

Stabilize operations

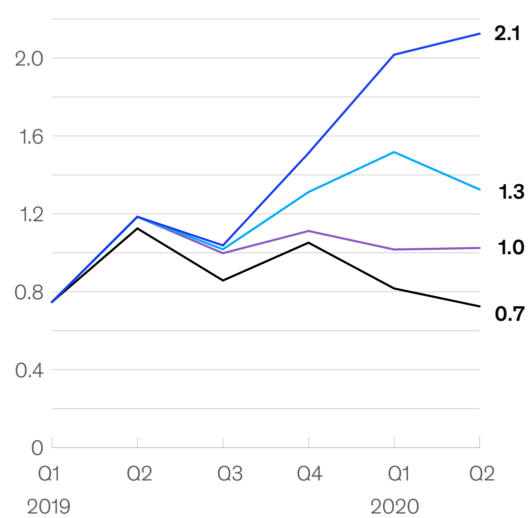
Portfolio companies should move to assess operational risk rapidly and, when necessary, stabilize their operations. This will vary widely by sector. For example, many manufacturing companies

Exhibit 3

Portfolio companies must stress-test their financials against a variety of scenarios.

Original projection — Effect of market risk — Effect of refinancing risk — Severe-downside scenario

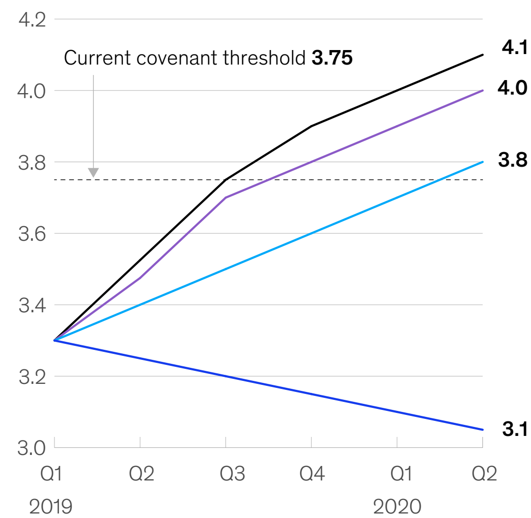
Illustrative cash projection by scenario, $ billion



Ending cash balance under severe-downside scenario, $ billion

Q1 2019	Q2	Q3	Q4	Q1 2020	Q2
0.75	1.12	0.85	1.05	1.27	1.06

Illustrative leverage projection, ratio of debt to cash and revolving credit



Net leverage under severe-downside scenario

Q1 2019	Q2	Q3	Q4	Q1 2020	Q2
3.3×	3.5×	3.8×	3.9×	4.0×	4.1×

are moving swiftly to create visibility into their supply chains, even in advance of potential issues, given the rapid shifts in customer demand. This can include analyzing available inventory (some is often hidden along the chain), comparing it with demand forecasts (which can be refined through direct customer communications and external market insights), and identifying alternative supply sources for critical parts. For example, some portfolio companies may look to source parts from vendors in regions with slower demand to supply more active factories. Manufacturers might also consider how to optimize production, distribution, and logistics. New production methods, vendors, and routes may be necessary to avoid supply disruptions.

For service-oriented businesses, capacity planning and demand management are important levers to consider to maintain effective operations. For example, for one communications-services business, maintaining call-center capacity was the most urgent operations concern.

It's also important to consider risks to critical counterparties, such as suppliers and customers. Portfolio companies may need to work closely with and even support counterparties, especially small- and medium-size businesses, to maintain stability. Several public companies have been noteworthy leaders in this regard.

Prepare for recovery and growth

After taking initial actions to recover and stabilize, portfolio companies can prepare for growth. In the last downturn, many portfolio companies had success by investing at greater rates than their competitors. In the United Kingdom, for example, one prominent study found that PE-backed portfolio companies cut investment by five to six percentage points fewer than their public-company peers did (in other words, they invested more), contributing to an average six to eight percentage points faster growth than their underlying markets.[1]

Commercially, portfolio companies could consider tailoring product or service offerings to help customers weather the downturn. An equipment business, say, could offer leases to lower customers' upfront investment costs (these may be especially germane in businesses in which leasing economics enhance the lifetime value of customers, irrespective of the macroclimate). Businesses might also reconsider contract structures and identify ways to increase customer "stickiness." For example, a rental and services business is offering near-term commercial concessions in exchange for increasing the minimum duration of the contract and tightening break requirements.

Portfolio companies should also prepare for M&A. McKinsey research shows that public companies that outperformed coming out of the last recession divested underperforming businesses faster than others did and made acquisitions earlier in the recovery phase.[2] Portfolio companies can utilize a similar strategy by planning and executing a through-cycle strategy for M&A and divestitures and by building a pipeline of potential strategic targets.

Finally, as strategy and goals evolve, companies will need to reset budgets and management incentives for the new environment.

The scale of human catastrophe from COVID-19 is yet to be seen. The economic damage is likewise uncertain. Given the range of potential outcomes, sponsors are right to move quickly and decisively on new-playbook initiatives, internally and with their portfolio companies, to help weather this storm and position themselves for the eventual recovery.

[1] Shai Bernstein, Josh Lerner, and Filippo Mezzanotti, "Private equity and financial fragility during the crisis," *Review of Financial Studies*, April 2019, Volume 32, Number 4, pp. 1309–73, academicoup.com.
[2] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 2019, McKinsey.com.

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