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Private Capital Managers Optimistic on 2021 Economic Rebound

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Private equity and venture capital fund managers are anticipating the economy will improve in 2021 but are actively preparing for the impact of a second wave of the pandemic, according to BDO's Private Capital Pulse Survey.

Three-quarters (74.5%) of all fund managers surveyed expect the economy to improve next year—28% expect it to be "much better" and 46.5% "slightly better." Only 15.5% of PE and VC fund managers surveyed said they expect the economy to perform worse in 2021, and the remainder, 10%, said the economy would fare about the same.

At the same time, PE and VC fund managers are preparing for a potential second wave of the coronavirus in various ways: by conducting a business continuity risk assessment (55%), by making changes in forward-looking valuation metrics (47%), by activating a crisis response task force (39.5%), by considering applying for a government loan (36.5%), and by assessing EBITDA for asset impairments (32%). Just 4.5% of respondents say they are not doing anything to prepare for a second wave.

Key drivers of deal flow

Given the economic fallout of the pandemic, funds today are decidedly more bearish on pursuing new deals than they were last winter: Just 23.5% of fund managers say they will direct the most capital toward new deals or investments in the next six months. That represents nearly a 20% decline from BDO's last survey released in December.

"With the road to recovery shrouded in uncertainty, deal makers are grappling with an unfamiliar landscape," said Scott Hendon, National Leader of Private Equity at BDO. "Deal flow will remain comparatively muted for the balance of 2020, but, in line with industry expectations, we believe M&A will pick up as the economy turns around in 2021."

While activity during the balance of 2020 likely will not catch up to deal flow in 2019, transactions are picking up steam, and nearly half (49.5%) of survey respondents expect private company sales and capital raises will be the key driver of deal flow in the next six months. Among other top key drivers of deal flow are public to private transactions (39%), succession planning (37%), exiting current investments (34%) and corporate divestitures (32%).

Last winter, 40% of fund managers indicated distressed business deals would be a key driver of deal flow, up from 4% the previous year. Now, 46.5% of fund managers believe investing in distressed businesses will be a key driver of deal flow. We expect to see distressed deal activity pick up in Q4 2020 and into 2021 as businesses that are still experiencing disruption deplete their coronavirus federal relief loans.

Jim Loughlin, BDO's Business Restructuring & Turnaround Services National Leader, remarked, "Private capital outperformed the public markets during the recovery from the Great Recession, but the asset class was slow to make new acquisitions and missed on the returns that would have come from buying quality assets at a steep discount. If they are looking for an opportunity to correct the so-called sins of the past, now is the time."

Price dislocation signals upside for the opportunistic

Modeling a business' future cash flow and revenue stream is an uncertain process in the midst of an unprecedented global pandemic. However, reflecting an institutional perspective that the public market remains overvalued, more than three-quarters (77.5%) of private equity and venture capital fund managers say assets today will trade 10% to 20% lower than they would have pre-COVID, though there are certain sectors that have performed quite well. For PE and VC funds, price dislocation will translate into higher returns, but boost the trend toward longer holding periods.

"The impact of the COVID-19 pandemic and election season uncertainty have changed the landscape of exit activity. Rather than private to private trades between fund sponsors, we are seeing more exits from companies accessing the public markets —that includes private equity shops that before the pandemic may not have considered IPOs as viable exit strategies," said Kevin Bianchi, BDO's Asset Management Industry Group Co-leader. "The IPO pipeline is building, which is perhaps an unexpected outcome of the crisis, and may offset other investment and financing strategies."

The survey also found that the challenges to close a deal are many, and topping the list are risk exposure uncovered during due diligence (53%), followed by lack of transparency into deal information (44.5%), gaps between buyer/sell or investor expectations (40%), lack of in-person meetings (38.5%), ability to secure financing (36.5%) and increased competition (32.5%).

Additional findings include:

- **Deployment of Capital:** New deals/investments are still the top choice for capital deployment (23.5%), down 18% from last winter, and only slightly edge out add-on acquisitions/follow-on investments (22.5%). Investing in distressed businesses (20%) and applying equity relief to portfolio companies (19.5%) closely follow. The close results point to funds diversifying strategies in the pandemic economy. In the next six months, just 13.5% say they are de-levering portfolio companies balance sheets.
- **Top Investment Strategies:** General partners (GPs) are pivoting to venture-focused investments of early stage VC (62%) and late stage VC (45%), as well as growth equity (57%). Other popular investment strategies being employed are structured credit (31%), leveraged buyout (24.5%), private investment in public equity, or PIPE (20%), investments, and mezzanine (12%) deals.
- **Top Competition for Deals**: The most competition for deals is expected to come from strategic buyers/investors (48.5%) over the next six months, a change from last year's survey which indicated hedge/mutual funds would pose the most competition. After strategic buyers and investors are other PE/VC firms (45%), hedge/mutual funds (38.5%), sovereign wealth funds (36.5%), and family offices (30%).

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