SQUIRE PATTON BOGGS

Private Equity Landscape H2 2020 Onwards

UK – 24 June 2020

Faced with a debt burden that is larger than the size of the country's economy for the first time since 1963, the UK's economy is clearly in need of a brisk bounce back. On June 19, 2020 the Office of National Statistics reported that the government borrowed a record GBP £55 billion in May, pushing the total level of debt over the last year to 100.9% of Gross Domestic Product (**GDP**).

In this week's Testing Time webinar, we were joined by Tom Wrenn, partner at ECI Partners and John West, Managing Editor EMEA at MergerMarket and Dealreporter to discuss the role that private equity (PE) can play in helping companies navigate their way through the recovery phase and to asses any market trends. James Collis and Paula Laird, partners in our Global Financial Services team, also joined the discussion to address the importance of practical and legal considerations in a period of economic recovery.

The Road to Recovery

The short and sharp shock to the markets caused by COVID-19 has rattled the PE industry. Q2 saw a decline in deal activity with the number of PE buyouts falling by two thirds. However, as the UK progresses through the unlock timeline, John has noticed an increase in market activity with PE shops such as KKR, Blackstone and Cinven all contemplating bids for Unilever's tea business, for example. But this small glimpse of normality is coupled with a word of caution from John – the idea that Q3 or Q4 will make up for lost ground is "fanciful."

Nevertheless, the road to recovery has begun and PE houses are not "shutting up shop" because there is too much risk, Tom confirmed. The day job of a PE house is too often overlooked- it is their role to invest in companies, after all that is what the pension funds providing the capital expect them to do. But volatility in the market will ultimately place more pressure on the evaluation of target companies and key to this is forecasting. Given the short and long term impacts of the pandemic on businesses, Tom explained that it is essential that PE houses' evaluation models are able to look past the immediacy of current trading and consider the target's performance over the medium term. Forecasts are a moving feast in these uncertain times and investors must be prepared to take a longer term view.

Tom cited the example of a premium pet food business that ECI are invested in. In the midst of the panic buying months of April and May, the business saw record levels of sales, however, fast forward to June and these levels have normalised. Tom also noted that with many small and medium sized companies (**SMEs**) accessing government assistance such as the Job Retention Scheme and the Bounce Back Loan Scheme (**BBLS**), this could paint a flattering picture of short term financial performance of software and services providers to SMEs (i.e. artificially reducing churn) making it harder to assess real profitability until those schemes are removed.

Is There a Debt Problem?

In his first 100 days as Chancellor of the Exchequer, Rishi Sunak put the UK economy on life support with the implementation of unprecedented financial assistance schemes. With the government guaranteed BBLS and Coronavirus Business Interruption Loan Scheme (**CBILS**) for small companies receiving criticism for its light touch assessment approach and consequently high approval rate, it is unsurprising that James foresees a risk of delinquency.

The treasury has revealed that BBLS lending reached GBP£28.1 billion up to June 21, 2020 for 921,229 businesses, from 1.12 million applicants. Lending via the CBILS scheme which was launched before BBLS, reached GBP£10.53 billion for 50,482 businesses. The risk of delinquency for larger firms should be much lower, because the Coronavirus Business Interruption Loan Scheme (**CLBILS**) for larger companies lent just GBP£2.1 billion to only 315 firms.

Any future bad debt problem, however, may be manageable. "At least the government can see the iceberg coming," James remarked. This makes dealing with the problem much easier although undoubtedly, a solution is exercising the policymakers' minds. The idea of the government potentially taking equity investments in businesses with GBP£50,000 loans seems fraught with difficulty and hard to administer. Companies that are recipients of this government support may also need advice on business turnaround strategies, as Tom pointed out, and this is a key part of some Private Equity firms' offering. In James's view, the PE sector has an important role to play as a future phase of the recovery could see various government stakes in private companies managed through government sponsored PE funds.

Rise of the Zombie Company

The "zombie company", a company which is unable to cover their debt-servicing costs from profits in the long term, is not a new phenomenon but the government's financial assistance schemes have created the potential for a multitude of new cases and this is a "real issue for the economy" in Tom's opinion. PE backed zombie companies that are over leveraged and struggling to develop often limp along unable to invest or repay their debts resulting in the mentality of the management team switching to short term goals and chasing covenant payments. Such companies, in Tom's opinion, have little prospect of growing value for the owners or broader economy and a solution must be sought to enable the long term investment that can drive growth and value.

Policymakers have a challenging task on their hands – they must encourage investment in productive companies to ensure the current corporate liquidity crisis does not evolve into an insolvency crisis that overwhelms the wider economy. Paula suggested that a core element of the government response should be working with lenders to ensure that this unprecedented level of government support is matched by efficient transmission mechanisms so that as much liquidity as is necessary is injected directly into the economy.

The consensus view is that the current 'economic' crisis is quite different from 2008, which was really a 'financial' crisis. In this respect the current contraction should be short and sharp in nature. The immediacy of the impact of lockdown on companies is intriguing for Tom. There has been quite high levels of investment in the economy over a prolonged period and corporates are generally not under so much underlying stress. But challenges lie ahead, particularly for good businesses that do not experience a brisk bounce back to pre-COVID-19 levels. The difficulty here, Tom explained, is for current investors and management teams to accept that a successful bounce back may require new investors to come on board. Existing investors must be able to deal with any resultant dilution, "they may have a smaller piece of the cake, but the cake will be a lot bigger in five years time."

Environmental, Social and Corporate Governance (ESG) Considerations

There is no doubt that ESG considerations are increasingly influential in companies today. John cited the corporate response to the recent Black Lives Matter campaign as an example – diversity matters in today's business world. Tom agreed explaining that ESG considerations have changed with each generation and today's is far more engaged. The pace of the agenda is "ramping up" and Tom noted that an effective inclusion and diversity culture within a human resources team is now essential. In 2010 ECI were looking to invest in a company that had a call centre located in India. Tom confirmed that central to the investment decision were considerations such as what the culture was like there; whether they were treating their employees fairly; and if ECI felt comfortable with it. The ESG dynamic is shifting continually and accordingly such considerations play a prominent part in ECI's long term investment decisions as they search for sustainable businesses.

Final thoughts…the sharp shock of the pandemic on the UK economy is clearly presenting its challenges especially given the pre-existing concerns around Brexit. However, the official policy response has been unprecedented and the potential implications are at least quite visible. There is no doubt that the PE sector continues to have a significant role to play in unlocking opportunity and value in business. This is the industry's 'bread and butter' and it will for sure rise to the challenge.

Contacts

Matthew Kirk
International Affairs Advisor, London
T +44 20 7655 1389
E matthew.kirk@squirepb.com

James Collis
Partner, London
T +44 207 655 1355
E james.collis@squirepb.com

Paula Laird
Partner, London
T +44 207 655 1255
E paula.laird@squirepb.com