Competing interests for private equity

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Private equity has lots of money at the ready—the question is what they will use it for. In the months ahead, investors will be looking at an unprecedented opportunity to buy. On the other hand, they're also in very familiar territory of keeping their current crop of companies healthy. Both scenarios will benefit from the stockpile of capital the industry has accumulated but will also be hamstrung by a lack of reliable information until the dust settles, and no one knows precisely when that will happen.

PE firms don't operate in a vacuum, especially in a fast-moving scenario like this one, and they'll need to work hand-in-hand with lenders (and perhaps their limited partners) if the next few months are to go smoothly.

It appears inevitable that many portfolio companies are going to be in pain this year. Hundreds will need help from their PE sponsors, who will urge lines of credit to be tapped first. Other situations will require capital infusions from the PE sponsors themselves, which investors will avoid if they can. If they can't, a portion of that dry powder will have to be earmarked for existing investments, in the form of recapitalizations or of unplanned growth rounds to refurbish their balance sheets.

Making capital calls to their limited partners brings its own set of headaches. LPs like pensions and sovereign wealth funds are tending to their own crises and might not pick up the phone right away. Concerns are forming that LPs will slow-walk their capital calls, especially if those phone calls mean they have to sell other positions at deep discounts just to come up with the money. Similar concerns were voiced during the financial crisis but, to their credit, most LPs stepped up to the plate last time. Bear in mind that other asset classes are banking on the same thing, including venture capital and real estate.

As we outlined in our recent analyst note on the COVID outbreak, we think well-funded PE vehicles will be forced to inject liquidity into existing portfolio companies and ultimately reduce the leverage that provides the enhanced returns that LPs are looking for. We also think firms will be forced to underwrite deals to lower return profiles, which might remove a significant portion of viable target companies overnight.

PE-backed companies aren't the only ones that can use a quick capital infusion. Opportunistic buyouts can be lucrative, but they can also represent a financial lifeline to unsponsored companies that may otherwise go under. Thousands of employees would benefit from that, as well.

Again, however, those scenarios need to have the backing of lenders or they'll have a hard time getting done. Some lenders are blanching and hoisting up the gate; others are still taking calls. PitchBook data shows more than $240 billion in private debt dry powder as of Q2 2019, and we see direct lenders investing through a downturn alongside the PE funds that will pivot toward opportunistic sourcing in the public equity markets and in distressed situations. Activist hedge funds may be an X factor for the foreseeable future, as public equity stakes have become relatively cheap to accumulate. As we've seen more regularly in recent years, activists are acquiring toeholds and pushing for management changes, followed shortly by private equity takeover offers to do just that. The lines between public and private equities have already become blurred, with PE funds holding stakes in public companies and hedge funds raising dedicated private market vehicles. We'll likely see a confluence of actors bearing down on the public markets and a variety of scenarios pop up to take advantage of the unprecedented opportunity.

As we speak, PE firms are dusting off the records of companies they've passed on recently. The diligence is already done—in many cases the prices were too high at the time. That's no longer the case, and phone calls can be made and companies financed rather quickly. But they'll need to convince lenders to come along and get their LPs on the phone before anything happens.