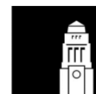

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Private Equity Exit Strategies During the Global Pandemic

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Synonyms: Private Equity; COVID-19; M&As; IPOs; Secondary Sales.

Definition: Private equity (PE) firms generally provide equity finance to business organisations. Although PE is grouped with venture capital as an alternative source of finance, it is different from the later as it invests mostly in mature companies as opposed to venture capital which invests mostly in startups. PE firms work as general partner to manage a large pool of funds which comes from various institutional sources such as pension fund, insurance companies etc. PE firms buy private or publicly listed firms who are in need of capital to grow. In addition to injecting required capital, PE firms also take part in the management of the acquired company. PE firms keep the acquired firms for about five to seven years before they sell them to new investors. The selling price is generally much higher than the purchase price and the difference is treated as the gain for the PE firms. As the gain from PE investment comes from selling the portfolio company, economic cycle and market condition play important role. Any uncertainty in the economy might have significant impact on the final value of investee firm at the time of exit of PE firm. As such, PE firms should pay particular attention to timing of exit and mode of exit during any economic uncertainty to maximise the gain from their investment.

Private Equity:

Private equity (PE) is a special type of equity financing for the unquoted firms that are in need of capital. The providers of PE are called PE firms who get the funding through debt and equity from institutional investors such as pension funds, insurance companies, high net worth individuals, sovereign wealth funds, hedge funds and so on. PE firms generally acquire significant equity stake of an existing business, generally called the target company or portfolio company, and participate in the management of the target firm with a view to create value within a defined period of time which ranges between 3 to 7 years (Cumming and Walz, 2010). Although, PE firms use both debt and equity to acquire target firms, the proportion of debt is far more than equity. Stowell (2018) states that use of equity generally ranges between 30 – 40% while the remining comes from debt. The use of relatively high proportion of debt increases the return on equity for the private equity buyers (Stowell, 2018).

Private Equity Exits:

As the PE firms invest for a finite period of time, appropriate time to exit and selection of exit vehicle are very important to PE firms to recoup maximum possible value from their investment. Cumming and MacIntosh (2003a) mentioned that PE can exit using five different exit vehicles that include initial public offering (IPO), trade sales or mergers and acquisitions (M&As), secondary sales, buyback and write-off. The choice of the appropriate exit vehicle depends on information asymmetry between the buyers and the sellers as the level of information asymmetry gives rise to over or undervaluation of the target firm which eventually determines the extent of capital gain for the PE firm at the time of exiting the investment in the target firm.

The level of information asymmetry aggravates during any external shocks such as financial crisis, natural disaster etc. In the recent global pandemic, the financial markets all over the world had experienced unprecedented level of uncertainty (Baker et al., 2020) that affected firms' revenue and cash flows. The pandemic affected level of information asymmetry within PE industry more than any others as the lockdown and social distancing compelled the PE firms to cut down face to face meetings and physical visits to target firms. The increased level of information asymmetry within PE industry eventually affected the appropriate valuation of target firms. As such, the importance of exit vehicles became paramount so that the adverse effect of information asymmetry could be curtailed by adapting appropriate exit vehicle.

Trends of Private Equity Exits

Figure 1 shows the yearly sum of PE exits filed and their modes for sixteen years. Therefore, the figure captures a comparative picture of PE exits between the financial crisis-2008 and COVID-19, where it is observed that the number of exits declined due to the uncertainty triggered by the crisis and pandemic. For example, announced PE exits dropped almost seventy per cent globally in May 2020 versus May 2019 (Green et al. 2020). Financier Worldwide (2020) made a special report on PE exits during the pandemic, where a panellist responded, 'Under the given circumstances, nobody sells who is not forced to sell' and 'It is truly a question of reaching the fair market value'. However, the total number of exits filed during COVID-19 in 2020 exceeded the financial crisis-2008.

The data in Figure 1 also includes various choices of PE exit. The trend suggests that PE managers prefer to exit via Mergers and Acquisitions (or Trade Sales) than other exit modes, which is true even during uncertain periods like the pandemic. Between 2005-20, Trade Sales accounted for around sixty per cent of exits. Secondary sales and IPOs are the next two preferred exit modes, accounting for about twenty and thirteen per cent of exits.

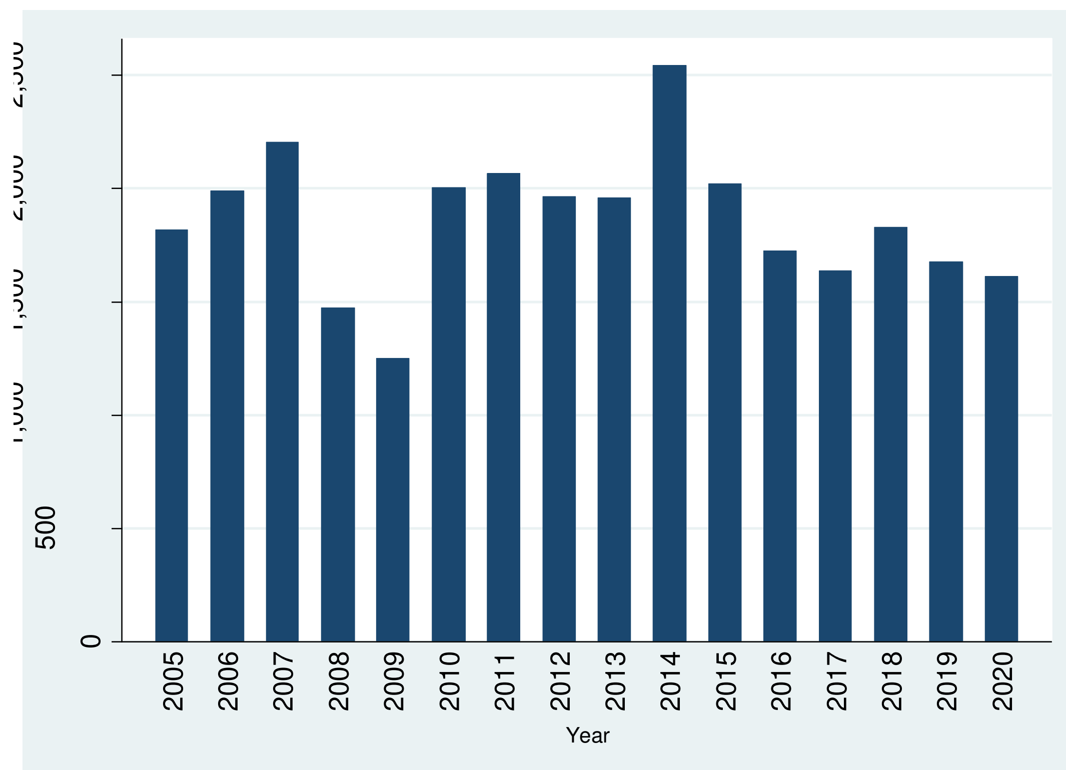

Figure 1: Yearly sum of modes of Private Equity exits from 2005-2020

PE Exits and Pandemic

COVID-19 has caused a sudden and unprecedented shock to economic activity and economic growth. Moreover, the speed and scope of this shock had no historical precedent (Haarmeyer 2020). Therefore, eccentric responses were observed in PE markets during this pandemic. For example, VCs redirected their investments to companies developing technologies to support the new environment of social distancing and health pandemic concerns (Bellucci et al. 2023). In fact, like all other companies, Private Equity firms were working persistently by seeking new investment, cutting costs, and growing revenue to overcome the COVID-19 crisis. However, four major uncertainties caused by the pandemic paused a challenge to their ride (Green et al. 2020) — first, barriers to deal execution due to a lack of face-to-face meetings or factory visits. Second, lowering of deal value due to low performance of businesses. Third, significant disruptions in health and business, including management time and attention, hence firms had deprioritised their exits. Fourth, new weaknesses had been revealed; the COVID-19-led recession significantly hit companies that appeared attractive in good times. Gompers et al. (2022) present a survey finding from 200 PE managers to support these uncertainties in PE markets. As a result of the pandemic, managers expect the performance of their existing funds to decline – 40% of their portfolio companies are moderately negatively affected, and 10% are very negatively affected.

Green et al. (2020) found that hundreds of sponsor-backed companies ready for immediate exit now find themselves in a waiting state due to the pandemic. Many sponsors had to spend far more time than normal on preparing exits, up to six to twelve months. However, in 2019, deal professionals used to spend only 3 to 5 per cent of their active time preparing for an exit. In addition, exit through traditional leveraged buyouts remained difficult during the pandemic. Mergermarket (2020), on the other hand, reported a surge of secondary buyouts during the early pandemic, which reflects challenges both in deal sourcing and exits. In this line of thought, Haarmeyer (2020) observed an

interesting aspect in PE markets during COVID-19: PE managers were looking to take advantage of deeply discounted valuations to buy companies that had until recently been out of reach.

A study directly addressing PE exits during COVID-19 has been conducted by Uddin and Chowdhury (2021). They reported that the pandemic has had a significant negative impact on the value of exit deals, and the finding is robust to three different deal values. Regarding the choice of an exit strategy, it is different during the periods with and without an exogenous shock. The study finds that the most preferred exit strategy during global pandemic was mergers and acquisitions. Finally, they found PE managers slowed down exits during the pandemic and when compared with the financial crisis-2008, exit duration is longer during COVID-19.

Conclusion:

PE exit strategies has been an important issue for both academics and practitioners. PE exit is important as appropriate exit vehicle maximise the value gain for the PE firms. The level of information asymmetry is an important determinant for exit strategy as higher degree of information asymmetry represents higher level of misvaluation of target firm. As the global pandemic contributed to a significant rise of information asymmetry within financial markets, choice of appropriate exit vehicles for PE firms became even more important to preserve the value for the PE investment companies. It has been evident from various available research that mergers and acquisitions was the most popular exit vehicle during the global pandemic and the exit time was generally longer during the same period.

Cross-Reference:

- Performance of Private Equity Funds Post Covid.
- Private Equity During Global Recession.
- COVID-19 Impact on Venture Capital.

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