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A rolling disruption: COVID-19's implications for private equity and portfolio companies

The pandemic has triggered seismic economic and societal changes. New research can help sponsors assess the strength and direction of these tremors.

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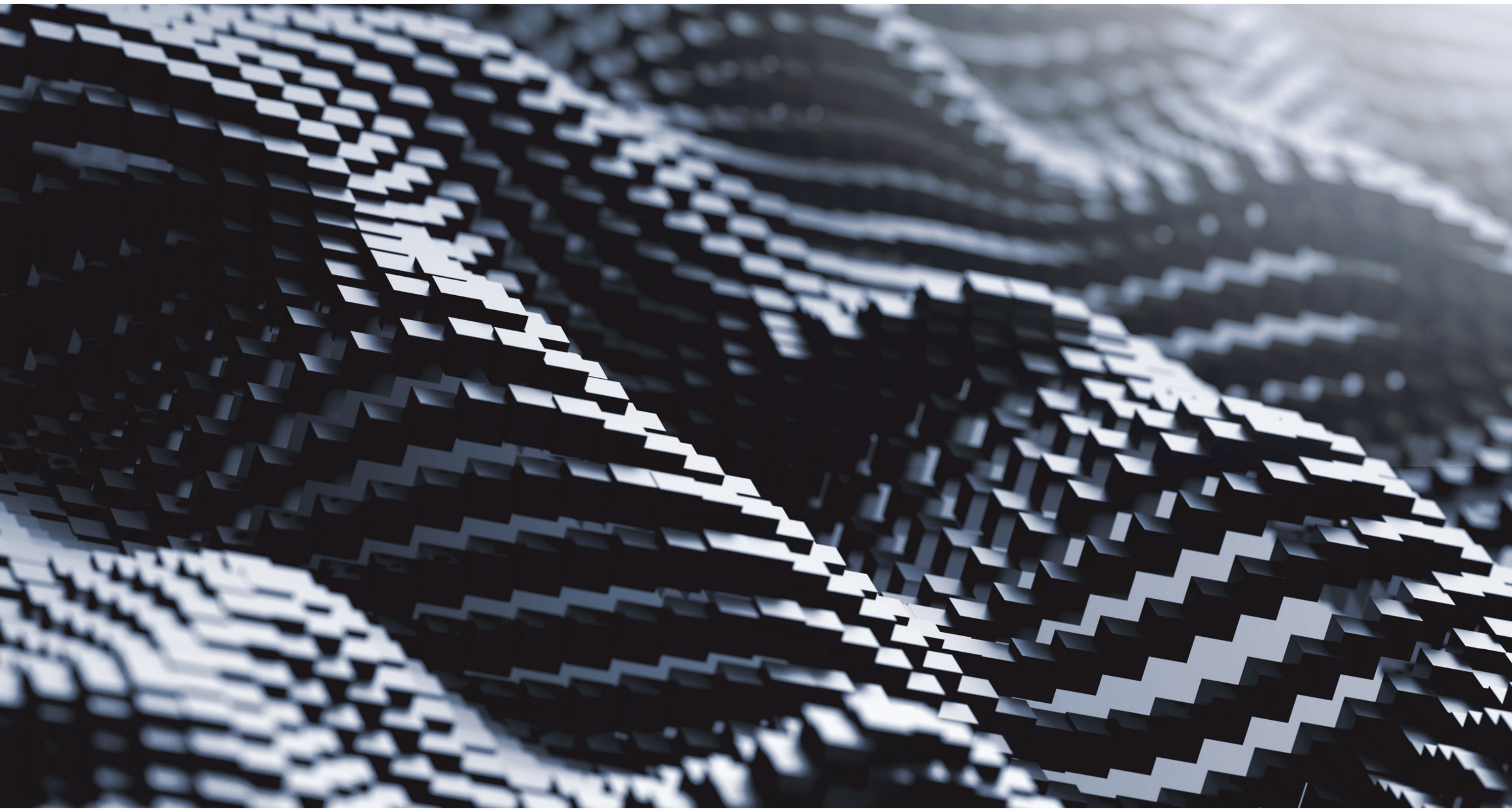


September 2020

The global COVID-19 pandemic shows few signs of relenting—in fact, in addition to its dual burden on lives and livelihoods, it is triggering civil unrest, new concerns about economic inequality, geopolitical tensions, and many other effects. The pandemic is more than an epidemiological event; it is a complex of profound disruptions.

Despite the massive and growing uncertainty, private equity (PE) firms are already adapting—looking both for ways to salvage adversely affected parts of their portfolios and for new bets that emerging trends could support. Even as wild swings in equity and debt markets have become the next normal, leading investors are pivoting their strategies away from the ephemeral and toward what they believe will sustainably succeed in postpandemic markets.

Unlike previous recessions and displacements, the pandemic will probably have many second-order and even longer-term effects on business models, consumer behavior, national and local policies, and operations. While the first-order effects are evident, the long-term shifts remain shrouded. This obscurity makes any projections about the value of displaced businesses highly speculative. Furthermore, central banks around the world have made unprecedented moves to inject as much as $9 trillion into financial assets, far outpacing the approximately $2 trillion used for that purpose during the global financial crisis of 2008–09. As a result, equity markets have enjoyed a befuddling recovery and are now only slightly lower than they were at the start of the year. But the additional liquidity serves to obscure the true health of companies and sectors; it's not yet clear which ones will thrive in the next normal and which have merely delayed the inevitable reckoning.

Amid the uncertainty, PE firms are adopting a range of stances. Managers are pivoting some portfolio companies into future growth; at others, they are riding out the storm with cost cuts. They are "hibernating" some businesses with sufficient reserves, and they are simply handing over the keys of a few companies to banks so they can focus on the future.

The stakes could not be higher for PE managers. The performance of the industry (not to mention future allocations) depends on its ability to steer a highly diverse portfolio of about 65,000 companies to safety. Our new research offers insights into the industry's current portfolio and the global pandemic's sectoral and regional effects so far, ideas about the potential shape of the economic recovery and the longer-term effects of the COVID-19 complex, and the divergent views of bond and equity investors. We conclude with some reflections on what all this might mean for PE sponsors and their companies. The only certainty is that tough choices lie ahead for managers. Picking long-term survivors may be more important than picking short-term winners.

The pandemic is more than an epidemiological event; it is a complex of profound disruptions.

PE-portfolio exposures going into the pandemic

Today, PE firms have about $5.7 trillion in assets under management (AUM). More than 95 percent of that is concentrated in 20 sectors and subsectors (Exhibit 1). Six sectors (real estate, energy and utilities, business and professional services, software, industrial equipment and machinery, and healthcare) account for more than half of total AUM. Over the past ten years, real estate and healthcare have displaced not only travel and hospitality but also media in the top six sectors.

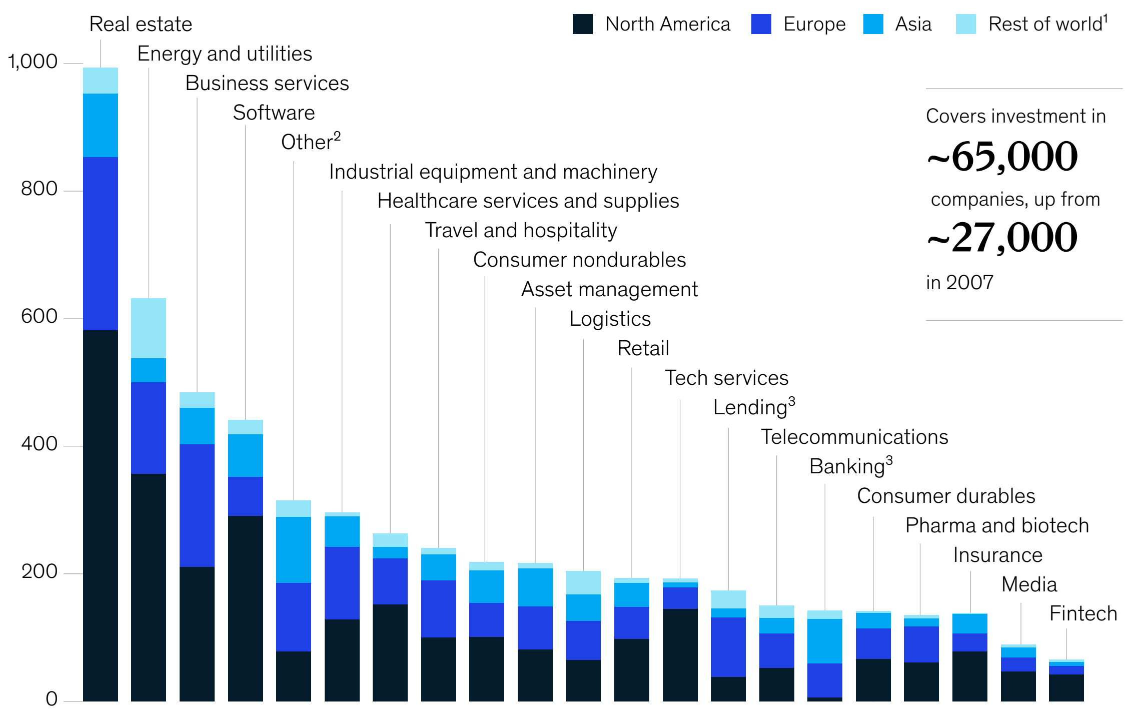
Privately owned companies often look to their public-market equivalents (PME) as a guidepost to valuations. This year through July 31, market caps have fallen by about 25 percent in travel and hospitality and by about 24 percent in banking (Exhibit 2). Sectors such as pharma/biotech, retail (including e-commerce), and software have gained.

If we apply these PME changes to the AUM of private equity firms in a crude way, the global PE portfolio declined by 4 percent as of July 31, up from a drop of about 20 percent as of March 31. Of course, the relative strength of business models, balance sheets, governance, management teams, and response measures could place many PE firms in a stronger position.

Exhibit 1

Private equity firms have about $5.7 trillion in assets under management.

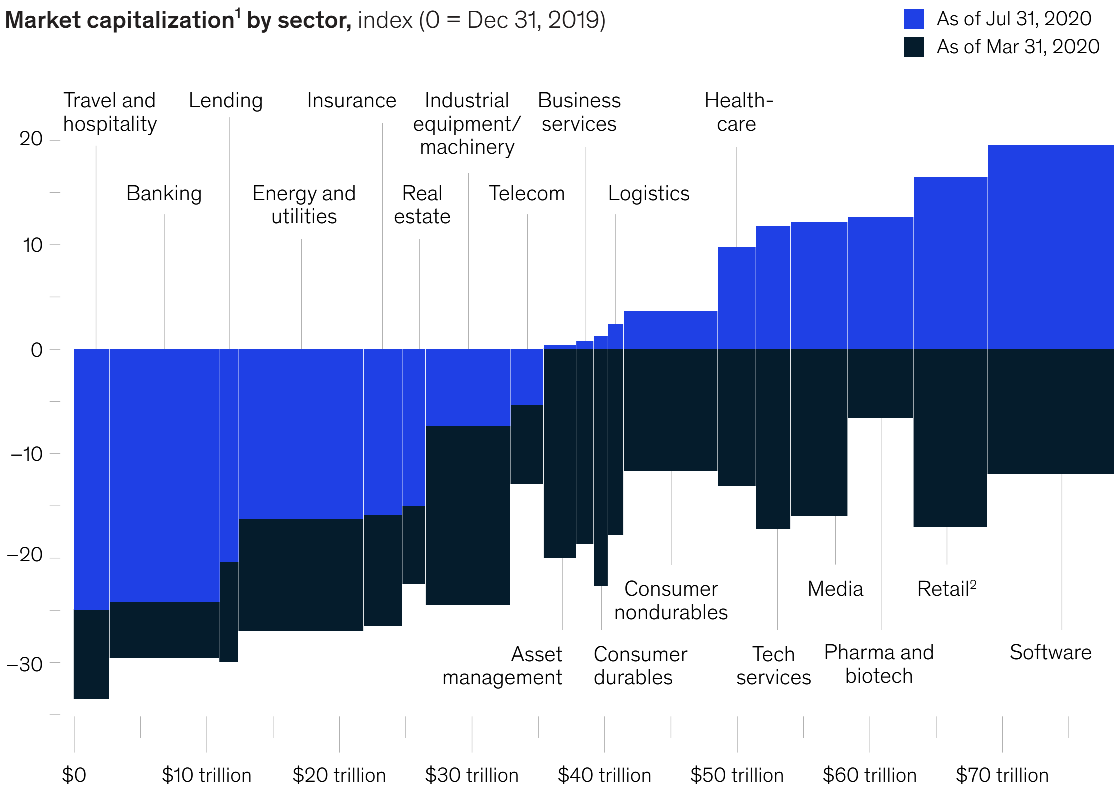
Global private equity assets under management (AUM), March 31, 2020, $ billion



[1]In some deals, geography is not specified.
[2]Other includes chemicals, minerals and natural resources, construction equipment, agriculture, and other business products and services.
[3]Lending includes stand-alone nonbank financial companies and lending companies; banking includes commercial banks.
Source: Pitchbook; Preqin; McKinsey analysis

Exhibit 2

Global market capitalization declined in all sectors and has since rebounded in some.



[1] For 15,500 public companies with revenue of more than $100 million in their sectors. Adjusted for dividends and buybacks. Width of bar equals proportion of all value as of December 31, 2019.
[2] Including e-commerce.
Source: S&P Capital IQ; McKinsey analysis

Location matters as much as sector

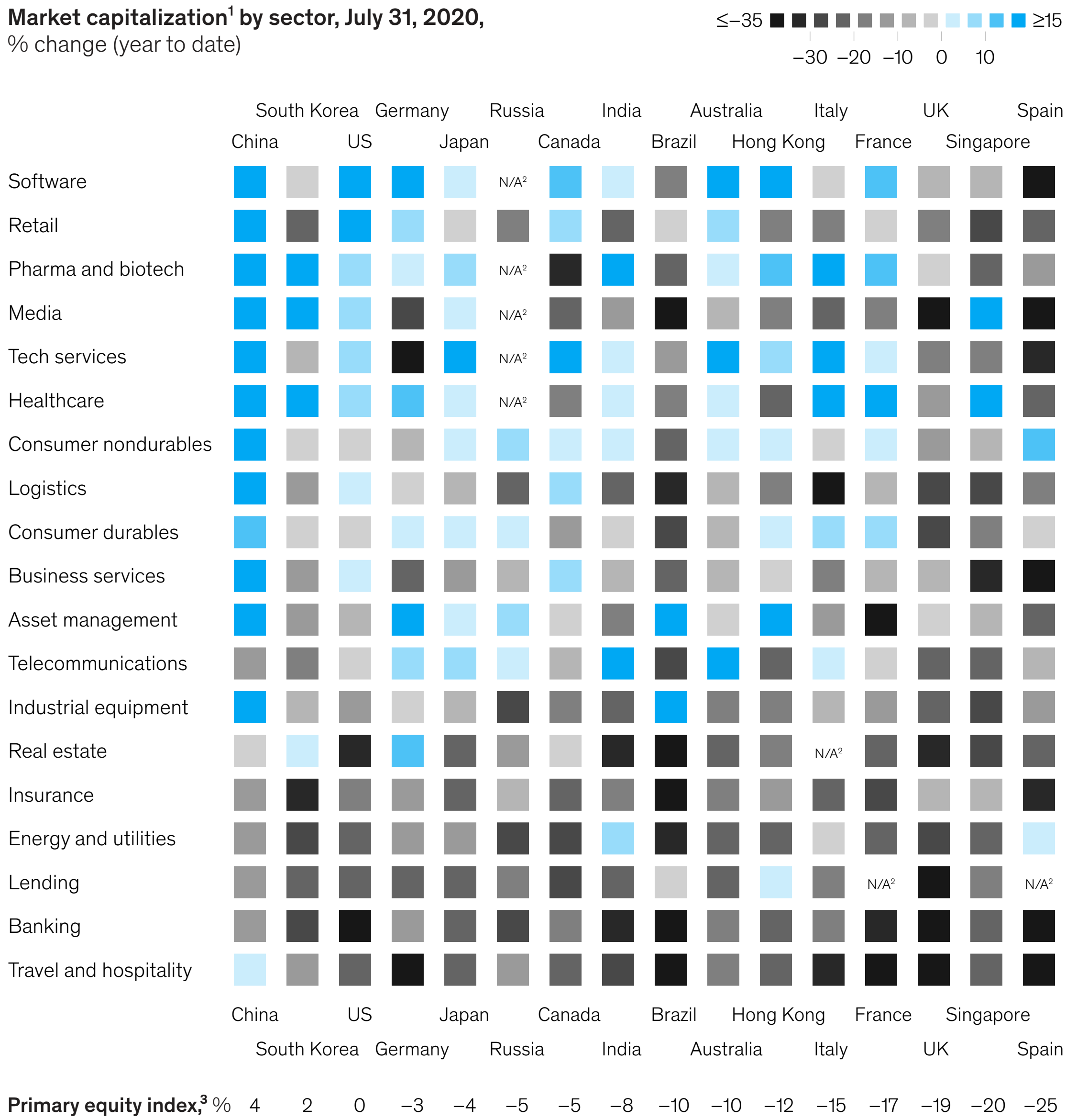
Lockdown policies, central-bank responses, low oil prices, interest rates, and trade-flow disruptions are creating significant structural differences among national economies: for example, the banking sector's market caps have fallen by 10 to 15 percent in some countries and by more than 30 percent in others (Exhibit 3). The industrial-equipment and machinery sector has experienced similar differences, from –27 percent to +19 percent.

Understanding this wide variance requires more than a knowledge of near-term supply-and-demand trends. Other factors are at work, including the starting positions of businesses before COVID-19, their degree of digitization, the extent of the resilience provided by automation, and dependencies on markets locked in geopolitical disputes. Local factors, such as the size and nature of the government stimulus and the duration of the lockdown, have also affected swings in market capitalization.

Changes in these factors generate frequent revaluations and re-ratings of regions and sectors. These re-ratings are then reflected in sector valuations and country indexes, so they affect asset allocations and portfolio choices for general and limited partners (GPs and LPs, respectively).

Exhibit 3

Change in sector value varies across countries.



[1]For some 15,500 public companies with revenue of more than $100 million in respective sectors of respective countries.
[2]No company in this sector and country has revenue of more than $100 million.
[3]Primary equity index of country as per Bloomberg.
Source: S&P CapitalIQ; Bloomberg; McKinsey analysis

What comes next?

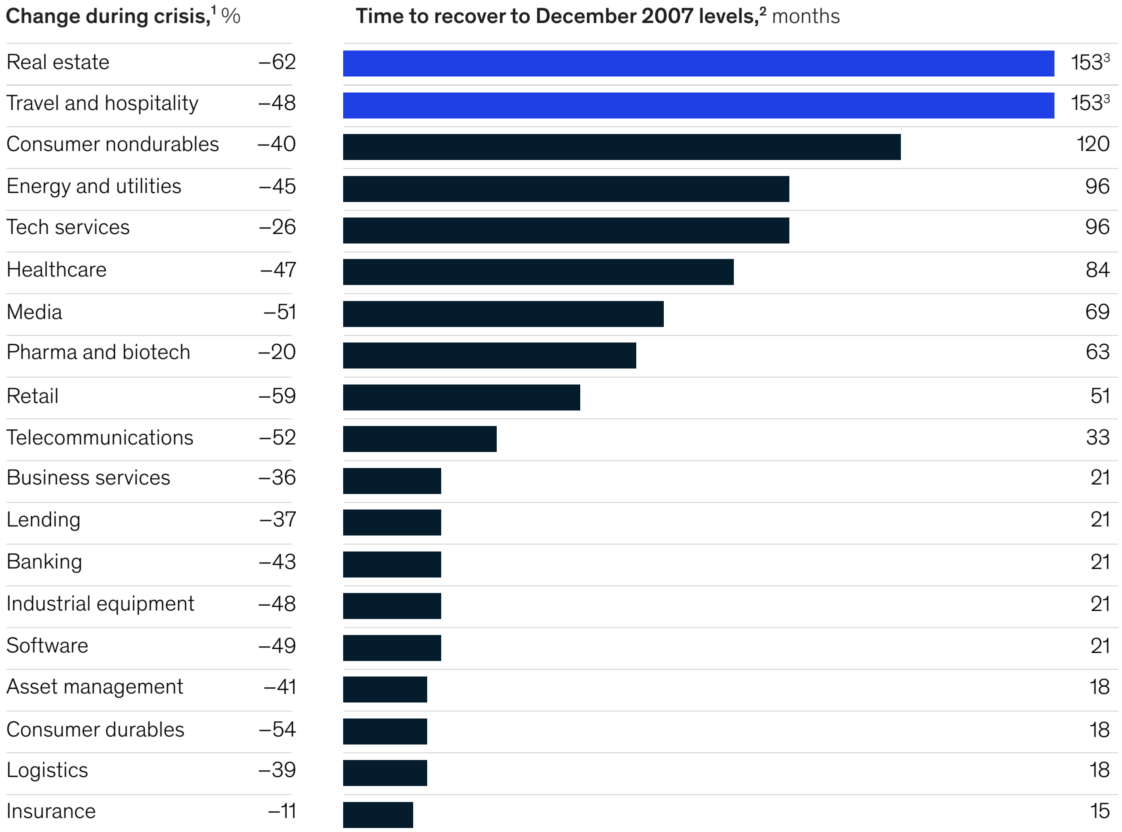
Six months into the crisis, people are still undecided on the shape of the recovery curve: L, U, V, W, or "swoosh." Even in our most recent survey of global executives, opinions remain mixed. As time passes, it seems that the return to predisruption cash flows and valuations could be a long haul. Major disruptions (such as the Great Depression, the two world wars, and the 2008–09 global financial crisis) reset the trajectories of most industries, and some undergo structural shifts.

Exhibit 4 shows the aftermath of the 2008–09 crisis. In some industries, P/E multiples snapped back quickly. In others, that took seven to ten years. Some have still not recovered; in other words, their

Exhibit 4

The recovery from the 2008 crisis varied by sector.

P/E-multiple disruption during and rebound from 2008 financial crisis



[1]Publicly listed companies around the world with revenue of more than $100 million in their sectors. Change is measured December 2007–December 2008.
[2]Defined as achieving and sustaining at least 90 percent of December 2007 levels.
[3]Not recovered as of September 2020.
Source: S&P CapitalIQ; McKinsey analysis

P/E multiples have been re-rated downward for good. Will the same dynamics unfold in the recovery from COVID-19? Possibly. But this crisis is different. Managers will need to consider the broader macro and sectorial prospects when they make decisions on investments and exits—specifically, if and when the recovery will come to the sectors of their portfolio companies and how strong it will be.

Impact of the pandemic and cascading effects

Interviews with policy makers, consumers, top executives, and industry experts helped us identify the ten specific themes most likely to affect investors. Each has first- and second-order effects and potential business implications (Exhibit 5). One truth about the pandemic is that it is accelerating existing trends, such as the *digitization of customer channels and workflows*, as well as amplifying the need for *low- to zero-touch operational models*. The pandemic is also giving rise to new trends—for instance, a need for *real-time tracking and traceability*. Other pressing needs include business models that adapt to *shifts in consumer preferences*, notably a preference for value and essentials; changes in *credit*; and changes in *government regulations and policies*, such as trade embargoes, sanctions, and other restrictions.

Exhibit 5

The pandemic has already reset the trajectory of most sectors, and more change is likely.

Disruption themes[1] and evolving implications: an illustration

	1st-order impact	2nd-order impact	Further implications
Labor availability	New operating models based on reduced or remote workforce	Need for self-help equipment, robots, autonomous vehicles	Demand for underlying tech ecosystem and engineering
Credit	Changes in credit worthiness at sector or subsector level	Shift to real-time, data-driven analysis and decision making	Demand for data exchanges and platforms
Physical distancing	Underutilization of social infrastructure; constraints in home offices	Demand for cloud kitchen, AR/VR[2] meetings, sanitization	Need for wider and faster connectivity; disinfectants
Public health and safety	Mobility constraints; push for community screening	Community immunization; management of at-risk population	Demand for sterile capacity; microgeography health infrastructure
Tracking and tracing	Source tracking (people, goods, services)	Investment in tech (IoT,[3] drones, blockchain, big data)	Need for smart supply-chain infrastructure and real-time analytics
Government regulation/support	Shift in trade policies; stimulus packages and allocations	Emergence of new services or manufacturing hubs	Reallocation of capital and rebalancing of portfolio risk
Low- or zero-touch operating models	Shift to digital channels and related automation	Remapping customer engagement; need for aggregators	Demand for reskilling, new talent to work with technology
Digital and automation	Investment in cloud, user interfaces, user experiences, IoT	Cloud-storage proliferation; focus on cybersecurity	Localized hyperscale data centers, data-center REITs[4]
Supply-chain derisking	Deglobalization, local sourcing	Product-design modifications; repurposing capacities	Application of AI and machine learning to supply-chain management
Consumption behavior	Value buying; focus on safe and trusted brands	Focus on loyalty management; e-services and unified platform	Analytics-driven hyperlocalization and personalization

[1]This analysis may not cover all factors generating local or regional variations in sector impact.
[2]Augmented reality/virtual reality.
[3]Internet of Things.
[4]Real-estate investment trusts.

Investors must interpret these themes and understand the ones that will probably have a material impact on business models, revenues, costs, future investments, working capital, and the cost of capital. To assist that investigation, we assessed the impact of the ten themes on 20 sectors and subsectors (Exhibit 6). Some sectors, such as fintech, healthcare, and pharma and biotech, appear less affected. Others, such as real estate, travel and hospitality, and some parts of logistics, may need to rethink their business models.

Measured another way, we see that indebtedness constrains some sectors in the near term (Exhibit 7). A comparison between the relative disruption of sectors during the pandemic and their debt-service coverage ratios (DCSR), suggests that about 50 percent of the PE industry's AUM is

Exhibit 6

Some sectors seem less affected by the pandemic, while others may need to rethink their business models.

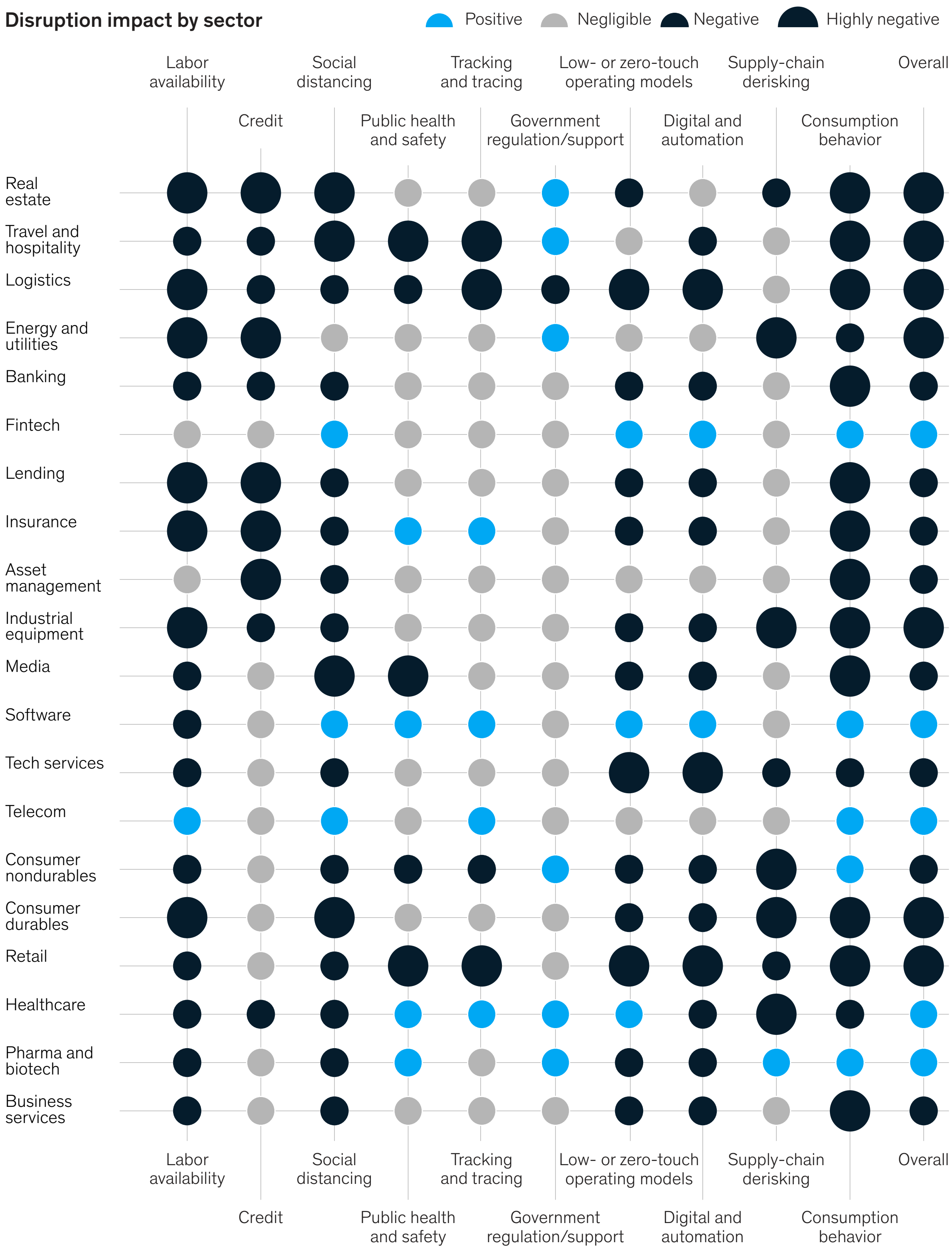
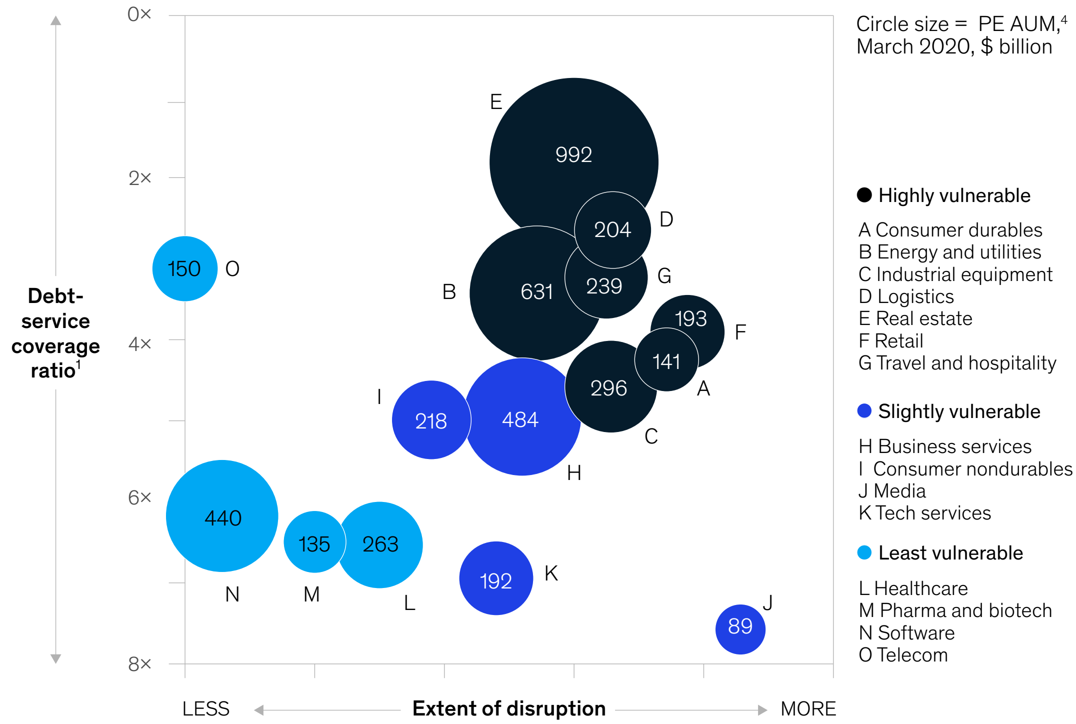


Exhibit 7

Real estate, logistics, and industrial equipment are among the most disrupted and financially vulnerable sectors.

Debt-service coverage ratio[1] and disruption,[2] by sector[3]



[1]As of March 31, 2020. Calculated as (EBITDA April 2019–March 2020) / (current debt April 2019 + interest expense April 201 9–March 2020); sector average.
[2]Qualitative assessment of disruption from COVID-19, geopolitical tensions, economic inequality, and other factors.
[3]Excludes banking, lending, and insurance, where capital-adequacy ratios or solvency ratios are more relevant.
[4]Private equity assets under management.
Source: Pitchbook; Preqin; McKinsey analysis

in highly vulnerable sectors. Significantly, some of them may be "too critical to fail" in certain countries given their contribution to GDP and jobs. Managers must therefore carefully consider the impact of the economic stimulus on all investments—especially stimulus programs that have injected capital directly into financial assets whose underlying real performance does not provide sufficient support. Managers should not confuse the availability of liquidity with the health of the balance sheet and a business model that can lead to sustained success.

Meanwhile, equity markets provide another perspective (Exhibit 8). In March 2020, the median P/E multiple had fallen in almost every sector. Since then, the multiples of leading companies at the start of the year have held up better than laggards in many sectors.

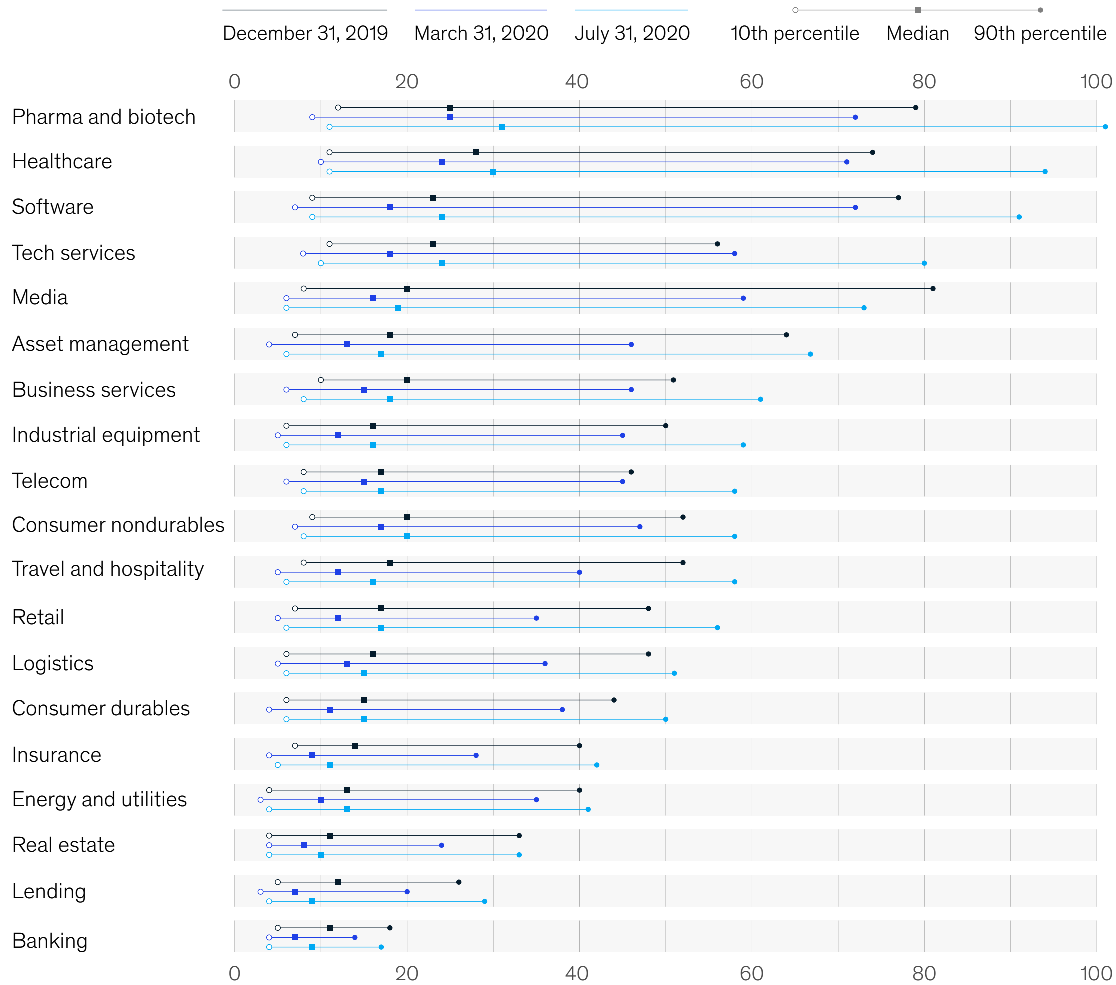
To be sure, some of the frothiness of the high P/E multiples that top companies enjoyed vanished momentarily. But equity investors seem to be engaged in a flight to safety as they continue to back top companies in each sector. More specifically, they favor companies that were well positioned (in their capitalization and leverage) going into the crisis and companies that have experienced less disruption than others because of their earlier investments in digitization and automation.

Off course, equity markets have partly recovered from their trough—a rise that is largely attributable

Exhibit 8

Each sector's P/E ratio has evolved in a different way in 2020.

A recent history of P/E ratios[1]



[1]For some 15,500 public companies around the world with revenue of more than $100 million in their sectors.
Source: Pitchbook; Preqin; McKinsey analysis

to stimulus packages and regulatory interventions, and much less to the fundamentals of the assets traded on them.

Reading the tea leaves: Implications for PE managers

What are markets telling us? How can PE firms prepare their portfolio companies for the extraordinary uncertainties of the coming months and, let us hope, the postvaccine world?

In our view, the leaders of firms need to focus on four imperatives:

Do your homework: second- and third-order effects matter. Disruptions unleashed by the pandemic are creating dark and bright spots in several industries, such as mobility, where second- and third-order effects are likely to play out. Over the short to medium term, investment in micro- and shared-mobility providers might drop. However, over the long term, autonomous vehicles, micromobility solutions, and other technologies that support physical distancing could benefit.

One second-order effect across industries has been to cast an intense spotlight on racial and gender equity. As PE companies seek to improve their record on these issues, they might consider the correlation between the financial performance of companies and the racial and gender diversity of their executive teams. In fact, companies in the top quartile for diversity are 25 to 35 percent more likely to have above-average profitability than companies in the fourth quartile.

Recognize that there could be more survivors than winners. Downturns have historically created winners and also-rans. Given the nature of this pandemic and its impact on the economy, we expect fewer "green shoot" areas where companies can grow and emerge victorious. Instead, the story is more likely to be about survival. Companies may need to rethink their business models rapidly to survive the current crisis. PE managers should aim to back medium- to long-term survivors rather than to unearth new models.

Watch bailouts and beware of zombies. Bailouts and stimulus packages are both necessary and distorting. The impact on managers is twofold. First, even as the real-world economy freezes in the short term, a flood of liquidity buoys financial markets and distorts valuations. Second, managers will need to disentangle the effects of temporary measures and assess the postcrisis prospects of companies and their customers with a cold eye. While some believe that the stimulus is a bridge to revival, others think that no amount of liquidity will prevent (or compensate for) the inevitable collapse of real-world economic activity.

At the end of the day, investors should brace for increased volatility, downgrades, and defaults. However, this also creates an opportunity for a well-calculated approach to credit investment if PE managers can choose wisely.

Understand that a lot more work lies ahead for operating teams. A recent McKinsey analysis outlines key actions for PE operating groups in the crisis. The initial priorities were to ensure the safety of employees and the continuity of basic operations and to reassess the future at a time when prepandemic worst-case scenarios had turned out to be too optimistic. Next up: PE firms are putting in place transparent systems to manage spending and savings and to build greater resilience.

Deal teams and operating teams are also reviewing their asset-management plans (such as investment theses and plans for exit), revising them for the new reality and establishing milestones for the next three, six, and 12 months. This reevaluation has significantly changed the plans for many assets. The guiding principle, in all cases, is not just to survive the crisis but also to strengthen the competitive positioning of portfolio companies by focusing on areas that can fundamentally shift operating models, customer interactions, and cost structures. In addition, PE firms can use the opportunity to reassess their interactions with (and governance models for) portfolio companies.

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