

Private Equity & Principal Investors

Lessons for private equity from the last downturn

Adding value to portfolio companies and buying cheap still matter.

by Jeremiah Connolly, Bryce Klempner, Paul Maia, and Tucker Ward



One phrase heard often these days in (video) conversation with private equity professionals is, “We have been expecting a downturn for a long time—just not this one.”

Of course, the havoc that COVID-19 has wrought on lives and livelihoods the world over is much more than a downturn; it is a global crisis whose human toll is yet to be understood, much less accounted. But it is also an economic downturn. This raises the question: To what extent are the lessons of previous downturns relevant?

The private equity (PE) industry is still fairly young, though old enough to remember 2008. We looked briefly at two aspects of how the industry

confronted the last economic downturn for hints on what may drive value in this one. In brief: operating groups appear to matter; and “buying low” is great, if you can.

PE firms with portfolio value-creation teams outperformed in the last crisis

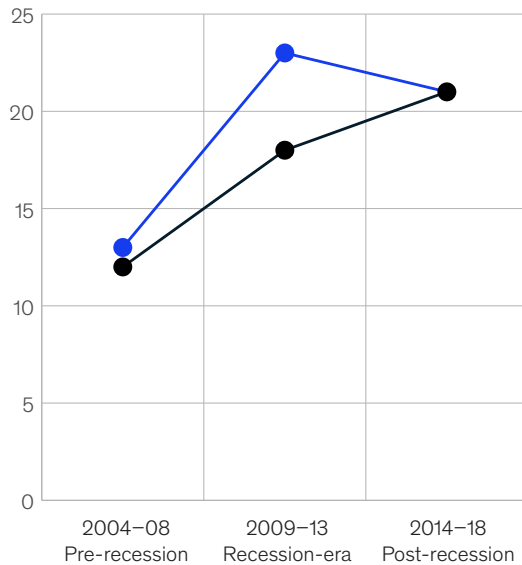
We analyzed 120 of the largest PE firms, which included many with specialist teams focused on driving value creation in portfolio-company operations, and many without such teams. We compared their investment returns and their fundraising over 2004–18, looking at five-year periods before, including, and after the global financial crisis that started in 2008 (Exhibit 1).

Exhibit 1

General partners with value-creation teams produced higher returns during the last recession, and raised more capital afterwards.

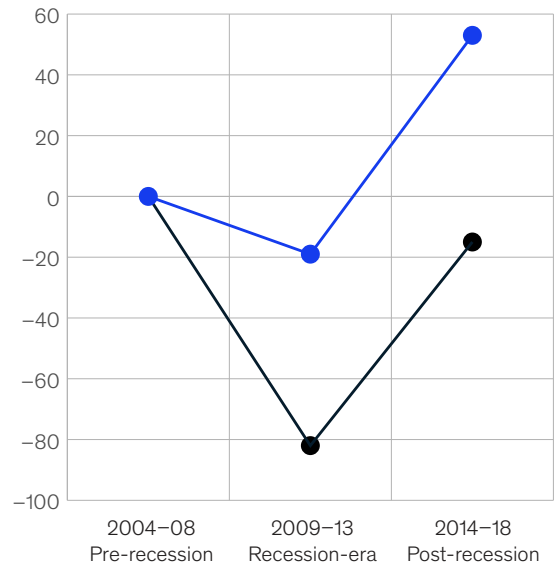
Average internal rate of return across funds, %

● With value-creation team ● Without value-creation team



Average fund size (indexed), % change (2004–08 = 0)

% change (2004–08 = 0)



Data source: Preqin

In brief: operating groups appear to matter; and ‘buying low’ is great, if you can.

Before and after the crisis, both groups of firms performed comparably (about 13 percent net internal rate of return (IRR) for vintages 2004–08 and about 21 percent for vintages 2014–18). But during the crisis years, firms with value-creation teams meaningfully outpaced the others, achieving about five full percentage points more in IRR (23 percent) than firms without portfolio-operating groups (18 percent).

Firms with value-creation teams also saw less disruption in fundraising in the crisis period, with their fund size falling 19 percent on average versus 82 percent for general partners (GPs) without an operating team. This fundraising advantage proved durable, as firms with value-creation teams saw fund size rise by 53 percent in the post-crisis years, while those without experienced 15 percent further declines in fund size.

The lesson for GPs today is self-evident—albeit hard to put into practice once already under duress. While correlation is not causation, there appears to be a strong relationship between having a portfolio value-creation team and outperforming in tough times. PE firms without such a team will likely find that assembling, let alone deploying, a high-caliber group in the midst of a global crisis may not be possible. As firms consider their options, they should note that a big team is not necessarily needed: a separate McKinsey research effort has found that the size of the operating group is not

clearly correlated to fund performance or fund size. Larger firms tend to have slightly bigger teams, but there is no hard and fast rule.

Other options for GPs without these internal capabilities are to redirect dealmakers with operational bona fides toward the portfolio, or seek to bolster portfolio companies with strong operators to meet pressing needs. (Many firms also maintain strong links to trusted third-party advisers, who can play a part.)

Meanwhile, GPs that have an operating team can take some comfort in their prescience. The data suggest that firms’ substantial investments in these groups have paid off. This analysis also validates the decision making of limited partners (LPs), who have voted with their feet in the same direction.

It is easier to sell high when you’ve bought low

There are many ways to lose out in a crisis. Common ones include deploying too much capital at the peak; selling too much in a panic at or near the bottom; and, often as bad or worse, sitting nervously on the sidelines as prices resume their climb. During the GFC, many investors made all of these mistakes, paying multiple times for what in hindsight is dubbed a “lack of discipline.” Thus chastened, GPs and LPs alike have pledged over the last decade to “maintain pricing discipline” and “avoid vintage risk” and “stick to pacing plans.”

This logic appears to be borne out by the data. Our analysis of 500 PE firms confirms that those which maintained their capital-deployment rate tended to outperform (Exhibit 2).

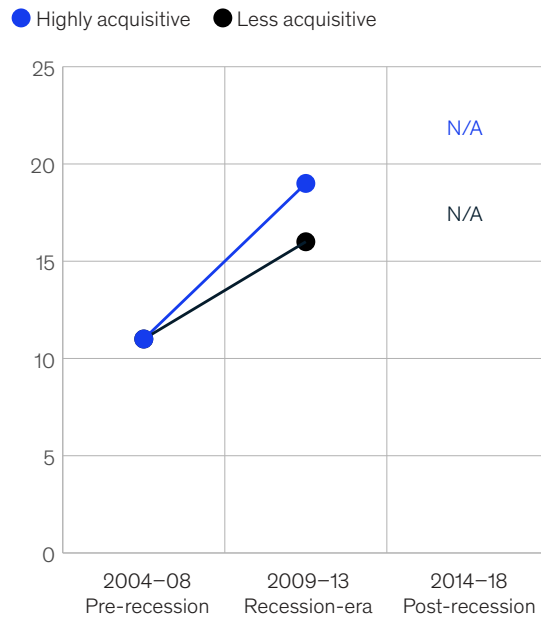
It is hard to be entirely wrong when arguing that investors should seek to buy low and sell high. Yet it is, of course, not quite that simple. Today's "low" may turn out to be tomorrow's "not yet that low." The cheap debt financing that was so plentiful a few months ago is suddenly scarce. Many sellers are less excited to exit at current prices.

At the same time, it is a fact that public-market comparables are lower than they have been in several years. It is a fact that the PE industry has a historically large stockpile of dry powder. And it increasingly appears that for every newly unmotivated seller, there may be one or two others that find themselves with previously unexpected financing needs. So, notwithstanding the recent slowdown in deal activity, it is reasonable to imagine that many PE firms will seek to continue deploying capital despite the current tumult and uncertainty.

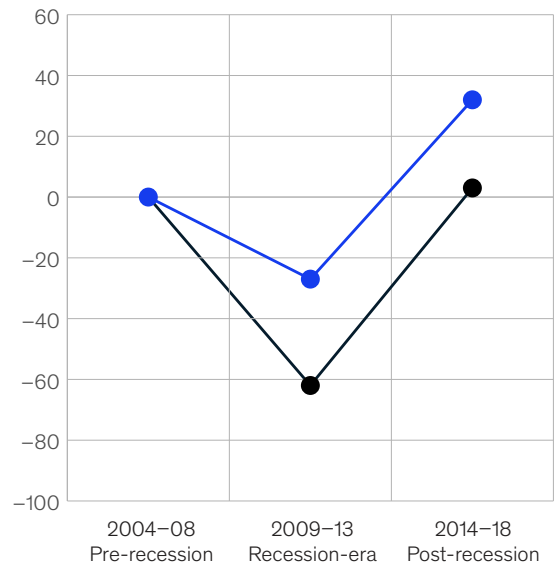
Exhibit 2

General partners that were more acquisitive during the recession performed better and raised more capital.

Average internal rate of return across funds, %



Average fund size (indexed), % change (2004-08 = 0)



Data source: Preqin

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