Private Equity Virtual Roundtable:

Value Creation in the New Order

Discussion Summary

Digital Roundtable
28 April, 2021

Value Creation in the New Order

Moderator

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What We Learned

Transacting During A Crisis

The conversation began with a reflection on how attendees had managed deal-making during the pandemic, and what lessons will be taken moving forward.

One participant noted that the causes and conditions of the great recession and most recent pandemic are different. The 2008 credit crunch was systemic; caused by a lack of liquidity, and the pandemic event driven. Despite this, lessons have been taken and measures applied, with a strong focus on costs to help with operating leverage and profitability, the need to react quickly, a premium being paid for resilience and growth highlighted.

The speed of decline and rate of recovery was also unprecedented with three key phases identified. At the start of the pandemic, PE firms focused on public companies with strong balance sheets and downside protection, "*a focus on stronger balance sheets in great companies at pretty attractive prices with downside protection was of phase one of the pandemic*". Phase two was the unprecedented reaction of central banks, "*the second point was is that if we thought the expansion of the monetary base around the world was large in 2008, it is dwarfed by what has happened in the last year.*" The consensus among participants was that the recovery would be swift, with pent up demand and savings driving a "V" shaped recovery, however, competition for good assets would be fierce moving forward.

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What We Learned

The evolution of deal making

The conversation then moved onto future trends that will drive the strategic agenda, because *"the future arrived early*", and participants highlighted that mega trends were accelerated by the pandemic. Interestingly, the crisis led to a bifurcation of winners and losers in different segments of the economy, with one participant commenting, "*a crisis that was so bifurcated, you really have segments of the economy that are true beneficiaries of the current circumstances and others that were really impacted by the pandemic and by the actions that have been taken".* Companies processing mortgage payments, pet care, and online schooling were success stories.

Over the next twelve months, the hunt for "resilient assets" will become a key battle ground for PE firms, with many prepared to pay a premium because, *"we can underwrite their future".*

Participants also noted that the window of opportunity had narrowed, and the life cycle of transactions shortened, therefore "*being agile, reacting to circumstances*", was a key strategic imperative. One cited distressed assets, that might not necessarily fit into a remit, which had very short windows as an example. Strong management teams that took decisive decisions came out stronger. The need for speed was also compounded by digital trends. Previously, people would only deal with those they knew face to face, but now must adapt to digital deal-making and due diligence.

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What We Learned

One lawyer noted that savvy dealmakers had taken advantage of clauses in merger agreements, stating, *"breaches of interim operating covenants, that people were taking advantage of in order to walk away from deals that look less attractive*", was common practice, and so there is a need for to think carefully about legal documentation. Another key theme to emerge was the importance of operational value, because financial engineering was no longer a viable means to create asset value, and given that no bargains exist, "*for our asset class, more and more the value creation comes from the operational value created during the ownership, so I am a very, very big believer that sector to sector knowledge and expertise is crucial to private equity firms to drive long term value.*" In addition to this, having robust supply chains, and people on the ground across complex Jurisdictions in Europe, would be crucial.

Finally, the importance of a strong capital markets function to drive value was also discussed, given these shorter windows of opportunity, accessing revolvers and having diverse finance in place would enable firms to be proactive.

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What We Learned

How are dealmakers managing the SPACS phenomenon?

Practitioners agreed that SPACS are becoming a mainstream tool in the equity markets, and its use would depend on the client, timing, and circumstances. Despite the drawback of IPOS, in terms of pricing and execution, clients must understand the legal and structural complexities of SPACS.

Transactions have slowed in recent months, however, some felt it can be a good option for a small to mid-sized company, who would benefit from the right partner and operational excellence.

Talk of the “PIPE” model, a key determinant to setting a price , and how it is financed/ evolving dominated the conversation, with one practitioner observing a possible bubble arising, *“the PIPE is very, very important, and as a result you've seen the pipes cool off… the pricing is 60% of them, and I believe is now less than the offer price…there’s an immense amount of capital that's sitting there, and as a result, there's a bubble that's going to pop in a lot of people will probably get washed out”*

That said, delegates felt that with a quality sponsor, asset, and PIPE investor, the SPAC option makes sense and will be a legitimate methodology to bring a company public. One PE firm was asked whether they were looking to sponsor a SPAC, or sell to the SPAC, and indicated the former.

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What We Learned

It was clear that the future of the product therefore depends on finding a long-term model to finance the PIPE. One solution mooted was utilising the fixed income team to provide the PIPE and or to construct it as a convertible instrument. Participants discussed who should fill this vacuum, whether a fund would step in, and one participant questioned whether there is a fundamental defect in the instrument; “does that just point to a long-term defect in the SPAC model, this is a kind of opportunistic thing that works, right now, but is it ever going to work”.

The boundaries between traditional players are also becoming blurred, with institutional investors bringing their firepower to the table, yet questions were raised over the relationship between GPS and LPS and does holding public equity create conflict, “*so how do you justify holding a public company to your limited partners?”.*

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What We Learned

Headwinds for the year ahead

Despite a bumper start to the year, delegates highlighted two main concerns keeping dealmakers awake at night. Multiple compression because of competition was a key concern, *“You can't grow cash flow enough to offset multiple compression, particularly if you drop 3,4,5 multiples, it's very, very difficult to do”,* and the issue is being felt in both the private and public. The problem could be compounded by corporate tax hikes in the US which would filter into corporate valuations.

The second area discussed was an inflationary scenario where rates rise, increasing the cost of financing, *“it's a tail risk, I think we're at a point right now with the amount of stimulus that's out there, and we could see some overheating”.* With many of these transactions underpinned by the assumption of low rates, how can increased funding costs alter the type and pace of transactions?

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Guest List

We welcomed top private equity practitioners, along with representatives from the FT and Pillsbury.

The companies and institutions included:

- Apax
- Blackrock
- The Carlyle Group
- ICG
- Neuberger Berman
- Pantheon
- Thoma Bravo

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