

Private Equity & Principal Investors Practice

Preparing for private-equity exits in the COVID-19 era

Exits have all but stopped, for the moment. Leading firms are taking advantage of the extra time.

by Alastair Green, Ari Oxman, and Laurens Seghers



The global coronavirus pandemic, a humanitarian crisis with few precedents, is exacting a toll on lives and livelihoods alike. Private equity (PE) firms, like all other companies, have been working diligently on both fronts: ensuring the safety of employees and customers, and shoring up portfolio companies so they can ride out the crisis. Now that these first few months have passed, firms are turning to other challenges. For the hundreds of founders and sponsors contemplating a sale in 2020, that means contending with four enormous uncertainties the COVID-19 crisis has produced seemingly overnight:

- ***Substantial barriers to deal execution have emerged.*** For example, it is now difficult to conduct due diligence face-to-face or to visit production facilities (assuming that they are open), and financing to support deals costs more.
- ***Valuations have suddenly shifted.*** For the most part they are lower because the performance of businesses, at a time when demand has been collapsing, is uncertain and public equity multiples are volatile.
- ***Humanitarian, health, and business disruptions have proved overwhelming.*** These concerns are occupying all available management time and attention; firms have rightly deprioritized exits.
- ***New weaknesses have been revealed in many companies.*** This includes companies that appeared attractive in good times but are now less so to buyers. Many companies have suffered an economic hit from the COVID-19–led recession. Some, such as service providers that once described themselves as “mission critical,” have discovered that many customers view their offerings as discretionary.

The results of the pandemic have been startling. With a couple of exceptions—such as structured transactions and deals signed before the crisis—traditional PE exits have slowed significantly

since mid-March of this year. Announced PE exits dropped almost 70 percent globally in May 2020 versus May 2019.

Hundreds of sponsor-backed companies preparing for imminent exit now find themselves in a waiting state: unable to exit but with additional time to prepare. To find out when exits might return, and how CEOs and sponsors can use the additional time, from March to May we interviewed more than 40 sponsors, investment bankers, and CEOs, mostly based in Europe and the United States. The range of estimates was wide; most said exits might come back in six to 12 months; few respondents said more than 18 months. Exits for PE investors through traditional leveraged buyouts will remain difficult for at least an additional four to six months, and many sponsors are spending far more time than normal on preparing exits. The last point came as a surprise. Our 2019 survey of 30 US-based private equity firms found that, on average, mid- and senior-level deal professionals spend only 3 to 5 percent of their time actively preparing for exit.

Many sponsors told us that they are taking unusual steps to prepare for exits. In this article, we will spell out these emerging best practices to help companies make the most of their exit preparations during the COVID-19 era. In our conversations, we observed four major tactics CEOs and sponsors are now pursuing. Of course, each company is different and each may pursue a different combination of these tactics.

Investing in growth areas

Many companies have seen significant growth in certain categories (such as personal protective equipment and other healthcare-related goods and services); many have also seen growth in online sales. Others have been less fortunate: COVID-19 has spurred many companies to open new business models to stay relevant in the next normal.

For instance, we spoke with one service company that had a small-scale delivery business. The head of the delivery unit was surprised to see an uptick in orders of all kinds beginning in mid-March. In addition, a growing number of smaller merchants wanted the company to distribute for them and were willing to share profits. Instead of viewing the distribution revenues as a one-off event, the company is investing in its distribution model and creating a delivery-loyalty program. It now expects the new revenue stream to account for more than 20 percent of gross profits by the end of 2020.

As another example, the chief revenue officer (CRO) of a specialty janitorial company described how employers are pushing to disinfect work environments more frequently than they did before COVID-19. The increased rate of cleaning has helped the company to grow, but that growth has come with requests from customers for a dashboard to track and monitor the cleanliness of their facilities in real time. The CRO recognizes that investing in the appropriate customer-facing technology will soon become a critical enabler to continue servicing the growing janitorial market.

Capturing value—or signaling its potential

Creating more value is an integral part of the holding-period playbook, but the crisis is giving companies a chance to pursue such efforts more

deeply than they did before. We spoke with the CFO of one technology company nearing the end of the holding period. It is now bringing forward a program it planned for the next holding period, should it have been necessary. The company is renegotiating its third-party spending and proactively cross-selling in its major accounts. As a result, it appears to be on track to lift its earnings before interest, taxes, depreciation, and amortization (EBITDA) by more than 15 percent. While the current crisis did not precipitate the value-creation effort, it did provide the time to change the back-office model—and helped its customers understand the need for change now.

Other companies focus on demonstrating their value-creation potential to buyers rather than capturing it themselves. One business-service company with double-digit growth broke down its growth prospects in every product category and for each of its top 250 customers. By studying three historical trends—the growth rate in new-product cross-sells, the pace of new-client introductions, and the typical “ramp” of customer spending over five years—it has developed a far more detailed revenue forecast, which it will use to reallocate its resources. The analysis took a few weeks—time it did not have earlier but now does.

Another portfolio company, active in manufacturing, introduced natural-language processing to extract key terms rapidly and accurately from its thousands

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of contracts and to help monitor expiration dates. This information helped the company to realize cost savings in both long- and short-duration procurement contracts. The digitization of terms makes it possible to manage vendors in real time, without the need to reference original contracts—again saving time and resources.

A third company—a healthcare payer—is contemplating a multiyear transition to a fixed price per patient, after years of charging variable costs. While the company cannot migrate all its customers to the new model, it is carrying out experiments at a handful of them to demonstrate better medical outcomes for patients, as well as more attractive margins for future buyers. The crisis has created a window for experimentation.

Hard pivots

As we mentioned, the recession has revealed material weaknesses in some business models, such as those of specialty retailers that mistakenly saw themselves as essential to consumers and of retailers that lack bargaining power with suppliers. After solving their immediate liquidity issues, forward-thinking sponsors are making the hard choices now to pivot to a stronger and more resilient business model.

One technology company preparing for exit sold predominantly into the real-estate and hospitality sectors. It had generally priced on a pay-per-use model, which was attractive to many customers. It had previously resisted attempts to move to a fixed-fee software-as-a-service (SaaS) model, as many similar companies have done. Although it has sufficient cash on hand to withstand a protracted downturn, it is now taking the plunge, moving many of its customers to fixed-price or take-or-pay contracts that will provide an even greater cushion in the next downturn (and will probably support better financing).

Some portfolio companies are also diversifying revenues to reduce cyclicity and improve resilience. For an infrastructure-services company focused on logistics and installation of capital equipment, this means a shift toward recurring revenues tied to services in operations and maintenance. Similarly, an industrial-equipment company shifted its mix to include more digitally enabled services.

Strategic planning for a changed future

A handful of companies we spoke with said that in the years ahead, their customers and competition will look very different. They also acknowledge that they do not yet have all the answers about how to prepare. Rather than adjust the existing model, they are fundamentally rethinking their strategies and building them around clear-eyed visions of the future.

Take the example of a real-estate-finance company that leverages its 15-year history and database of past deals to underwrite its loans. It has seen, firsthand, that the cost of capital is rising in its industry—and this is putting pressure on many smaller competitors that lack its underwriting sophistication. The company is securing additional sources of capital and investing in data scientists to serve its customers even more efficiently by more accurately underwriting the risk in their projects. Demonstrating greater efficiency and the ability to scale is now a core part of the company's road map for the future.

Another example comes from a media-service business with a large international exposure. It was gearing up for exit in the near term, but the deal team and management quickly realized that timeline was unsustainable. Instead, they opted to recommit to the future of the company and to review its end markets strategically. This drastically increased

the ambition of the business: the deal team and managers identified many M&A targets at attractive valuations. Pursuing these should help turbocharge growth in the years ahead and may also allow entry into adjacent market segments that were out of the picture only two months ago.

The impact of COVID-19 on companies will differ greatly, both in direction (a positive or negative impact on performance) and the degree of change (small or drastic) required to adapt to the next normal. Smart companies and their sponsors—probably in touch with their investment bankers—should invest the time to understand which strategies can help create value and then begin planning accordingly.

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