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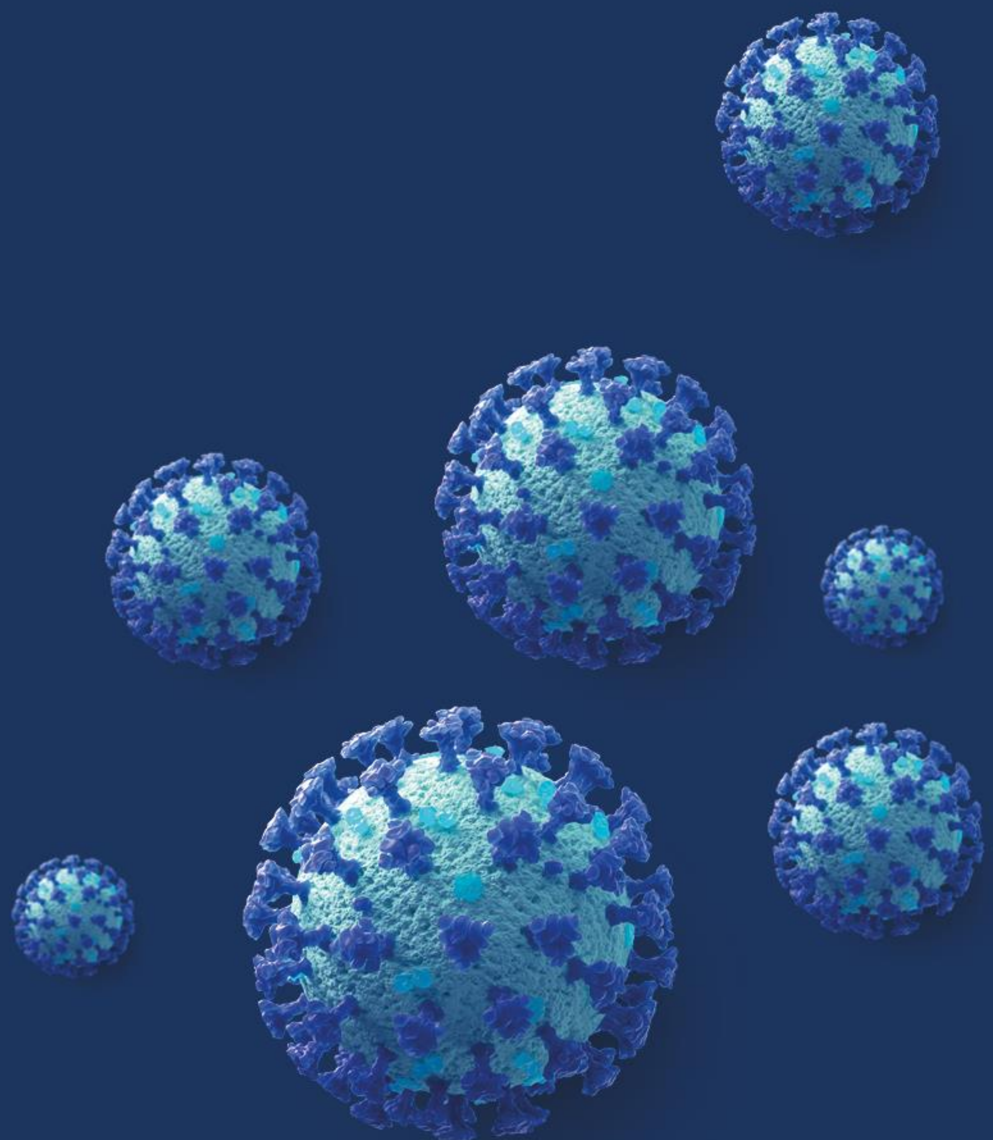
The impact of COVID-19 on alternative assets

Investment implications



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The impact of COVID-19 on alternative assets

The rapidly evolving COVID-19 crisis is continuing to create severe political, social, and economic uncertainty that is translating into significant public market volatility worldwide. While the impact on alternative assets is less observable to-date, it is likely to be as significant as that for public markets. As the full severity of the COVID-19 crisis is unknown at this time, the complete impact across alternative markets is difficult to conclusively assess. In the sections below, we discuss observations of the current situation as well as potential developments resulting from the crisis.

Sector/geographic impacts

The U.S. Private Equity (PE) Market. Buyouts and growth equity are likely to show an impact sooner than other sectors due to their higher correlation to public markets. Companies and industries with recurring revenue models as opposed to transactional revenue models will likely fare better, at least in the short term. Small companies will be the most challenged to survive a sustained downturn. However, private equity firms are sitting on a record $2+ trillion of dry powder and are well equipped to deploy capital at more attractive valuations and manage existing portfolios, with many of them dusting off their Global Financial Crisis (GFC) playbooks. Transaction volume will slow down, but that will not show up in the statistics for a quarter or more, however deals in process are still likely to generate capital calls in the near term. The quality of General Partners' (GPs) operational value-add will be tested and more obvious. Also, GPs' decisions of which deals to pursue and which management teams to back will play an increasingly significant role in investment outcomes.

The U.S. Venture Capital (VC) Market. Early-stage companies are typically less affected by market cycles. Moreover, some of the most significant venture-backed tech companies were established in economic downturns or shortly thereafter. Mid to late-stage startups typically have higher burn rates and are still seeking profitable customers so consequently must be well-financed to endure. Growth stage businesses use little to no leverage and do not have the extra burden of creditors demanding repayment at a time when cash resources may be tight. From a sector perspective, consumer-related startups may experience the largest negative impact in the short term whereas enterprise software companies should fare better. Biotech funds are likely to see a delay in exits due to the stress the COVID-19 situation is placing on the healthcare system.

The European Private Equity Market. GPs are assessing what actions they can take to maximize short-term liquidity. We expect to see restructurings, asset sell-offs, and headcount reductions from the more affected portfolio companies. The impact looks likely to be concentrated in certain industries and geographies, but the situation is extremely fluid. Many GPs tend to target non-cyclical, highly cash-generative businesses, which should help but this is not universal. Contractions of multiples will likely lead to exit challenges for even high-performing portfolio companies from recent vintages. Fundraising in 2020 was expected to be slow due to the natural fundraising cycle and that may slow even further. GPs may move more towards distressed special situations strategies if they can.

The Asian Private Equity Market. GPs are working with portfolio companies to shore up financials for the next few quarters in order to ride out the immediate volatility, emphasizing cost control, conserving cash flow, and reassuring key employees. Many GPs are also helping portfolio companies tap into new and lower cost borrowing sources through new banking relationships. Many are also sharing research on government policies, while applying for subsidy programs launched to support small and mid-size enterprises (SMEs). In certain situations, GPs will provide companies additional time through follow-on funding, either through bridge loans, banks, or by contributing more equity. Fundraising slowed in 2019 and is expected to be even slower in 2020 due to travel bans and/or investment committees not willing to sign off until there is more visibility on the COVID-19 timeline.

The Energy Market. We expect COVID-19's impact on the energy sector will layer a demand shock on top of the existing supply shock. Slower economic growth, especially reduced travel and the temporary shutting of workplaces and factories, will reduce demand for fossil fuels. Drastically lower oil prices will quickly impact activity, as drilling and production slow. Asset sales and realizations may be delayed and significant energy portfolio mark-downs are likely should oil prices remain near current levels. Additionally, the closure of factories in China has posed supply chain issues to the renewables sector, as companies are facing procurement and installation delays.

The Infrastructure Market. European shipping and port segments have been directly impacted by factory shutdowns and travel restrictions. Major European airports are expected to see drastic drops in passenger numbers following both governmental lockdown and US travel bans. Conversely, telecommunication assets are expected to be amongst the most resilient to the adverse market events. The COVID-19 outbreak is expected to have a significant impact on the social infrastructure sector, with potential benefits for some healthcare facilities while other assets like aged-care facilities face challenges.

The Private Debt Market. The income performance of companies in direct lending portfolios will likely differ according to the cyclicality of their respective industries, their supply chains, revenue, and operating models. It is probable that deployment will slow with a number of deals in the pipeline being put on hold, as GPs look to re-price and re-underwrite. Portfolio realizations are also likely to slow, particularly for corporate acquisition-related activity. The competitive landscape for private debt deals is also expected to change, following a prolonged period where the negotiating position between borrowers and lenders favored borrowers.

The Real Estate Market. It is expected that the assumptions for cash flow and risk used to determine value will be negatively impacted by recent events. A greater risk premium will be applied to all risk assets. Rent growth will be impacted for the foreseeable future, with more severe consequences within property types that have been rapidly impacted by quarantine and social distancing. High quality, well-leased assets utilizing moderate leverage will provide the most protection. Assets with weak fundamentals and that are economically sensitive will see the greatest declines. The industry will face difficulties in terms of both income and valuation but, as always with negative disruptions, opportunities exist.

The Hedge Fund Market. For funds that manage risk well through the COVID-19 and oil price wars there will be no shortage of dislocations from which to take advantage. These events could also trigger the onset of the next distressed cycle. Hedge funds are well-positioned to take advantage of greater discernment among credits given their ability to make such fundamental assessments and position themselves both long and short. Additionally, specific countries/regions/sectors will be impacted in very different ways and could result in a variety of opportunities for macro investing in rates and FX. The risk to hedge funds would be from synchronized and coordinated monetary and fiscal actions that allow for a quick, V-shaped beta-driven rebound that blunts the distinction between winners and losers through bailouts and an overabundance of undiscerning credit. Such an environment would act more as a muddle-through scenario for hedge funds. We are inclined to believe that investors who had well-structured hedge fund programs going into these events will be rewarded accordingly.

Overall implications

For private markets, the 2016-2019 vintages will be impacted the most since they have the largest unrealized portfolios. Returns for earlier vintages are pretty well baked-in and will be less impacted. Hold periods will likely be extended as sellers wait for price recovery. For secondaries, pricing off the December valuations will be challenging and, as a result, we would expect to see lower transaction volumes through to at least March and possibly June.

While most recent secondary activity has been driven by portfolio management considerations, near-term transactions may be more the result of managing private market allocation levels. We expect co-investment transaction levels to mirror the expected drop in private market transactions due to the increased uncertainty and the need for GPs to focus on navigating their existing portfolio companies through challenging market conditions.

The COVID-19 crisis has taught PE/VC players to pay more attention to crisis management, business continuity plans, and downside protections. The severity of the impacts across alternative asset classes will likely depend on both the depth and breadth of the crisis. If the crisis resolves in the near term, it is possible that the impact on alternative assets will be modest. If the crisis extends, however, it is likely that many alternative asset valuations will be more challenged and face significant headwinds.

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