As private equity firms hold onto investments, investors get restless

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The coronavirus pandemic hasn't slowed interest by private equity firms putting their cash to work in distressed firms. Although deal activity was down from March to April, general partners in private equity firms are still searching for value wherever they can find it.

Declining valuations have created a push and pull in the private equity market of whether to sell or hold.

And they have the means to do it. After years of solid fundraising — which resulted in $316 billion of capital raised in 2019, according to PitchBook — private equity funds are overstocked with capital and are under pressure to put large amounts of money to work.

But as that stockpile has increased, threats of the coronavirus have continued to mount, creating uncertainty and leaving private equity firms in a holding pattern.

It's creating a push and pull in a private equity market that has switched from what was unmistakably a seller's market in 2019 and before, to a buyer's market in early 2020.

At issue are the lower valuations of companies that are suffering COVID-related losses. Sending a lifeline now offers general partners the largest long-term financial upside and helps drive the type of returns that their investment base mandates.

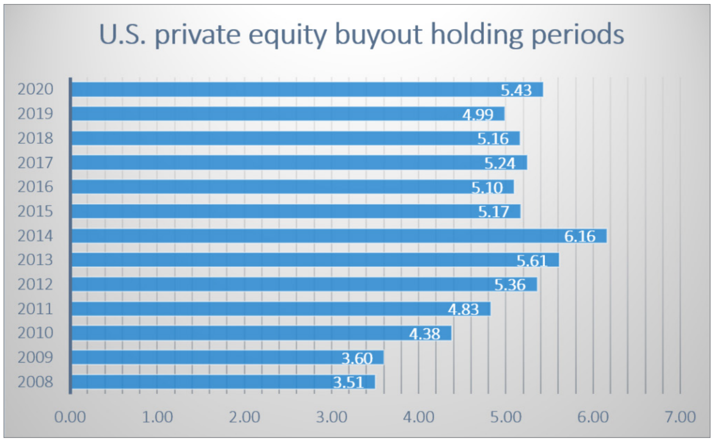
But at the same time, the lower valuations are making private equity firms more reluctant to sell the companies they do control as they wait for the market to recover. And in the near term, general partners will need to take steps to recession-proof and fortify business operations at the portfolio level. Addressing working capital will be an immediate priority.

The result has been a notable change in private equity holding periods and the number of investments to exits that general partners have made.

As of April, the median investment holding period was 5.43 years, a 9% increase from 2019, and the highest reading since 2014, when the median holding period was 6.16 years. An increased reading implies an unwillingness of general partners to exit investment holdings while a decreased reading suggests a willingness to exit investment holdings.

From 2015 to 2018, a bull economy had private equity firms exiting positions more quickly, with holding periods ranging from 5.10 to 5.24 years, compared to 2012 to 2014, when those ranges were 5.36 to 6.16 years.

As holding periods have increased during the coronavirus...



Source: PitchBook

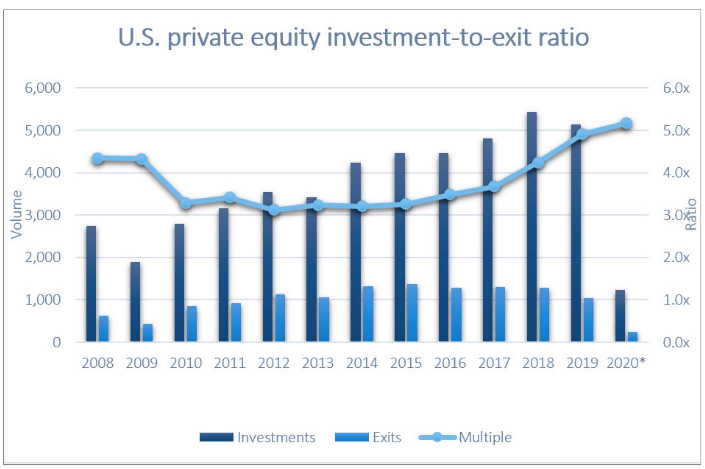
This implies that private equity firms with set three- to five-year holding periods dictated by their partnership agreements held onto their investments longer following the Great Recession, but sought swifter exits as the economy recovered and valuations increased.

But the recent reading hints at general partners' fading confidence to strike favorable exit terms. General partners are instead seeing the value of holding onto quality companies for as long as is needed to create maximum upside for fund performance.

This dynamic is reflected in another measurement used in tracking changes in general partner investment sentiment — known as private equity investment-to-exit ratios — that further demonstrates the ill effects of the health crisis.

From January to April, 1,231 investments were made, with only 238 exits realized, representing an implied ratio of 5.2x, the highest such reading over the past 10 years. What's more, 283 investments were made and only 42 investment exits took place during March, or an implied ratio of 6.7x, compared to a reading of 4.7x in January and February, respectively.

... the investment-to-exit ratio has also risen



Source: PitchBook

This suggests that general partners were more willing to put money on the table for companies with a perceived upside versus taking money off the table for companies that had not yet realized their investment potential.

General partners are seeing the value of holding onto quality companies for as long as is needed.

Again, general partners observed fewer favorable exits and instead focused on their current portfolio of companies that required active management to slow COVID-related losses. And as many buyout companies continue to struggle, general partners will continue to make strategic add-ons to salvage those deals that were already made rather than pursuing exits on companies that are enduring financial harm.

Key takeaways

- **General partners must remain focused on their founding purpose** — to generate long-term returns — but will contend with restless limited partners who increasingly request that capital be deployed. The general partners will seek answers to slowing short-term returns, just as investors have in public markets.
- **General partners will need to work closely with their limited partners** to renegotiate investment periods where needed to provide ample time to make measured investment decisions. The pendulum will likely change with more limited partner-friendly terms and conditions observed, including reduced or customized management fee and incentive fee rates.
- **General partners will need to consider possible recycling provisions** in instances where limited partners are either unwilling or unable to finance capital commitments.
- **And limited partners will increasingly seek help** from secondary private equity funds that are nimble and can provide realizations quickly.

For more information on how the coronavirus is affecting midsize businesses, please visit the RSM Coronavirus Resource Center.

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