How will private equity (PE) cope with Covid-19? As with most areas of economic activity, it remains too early to say. However, skeptics might wish to consider the experience of the past 20 years, which saw, among other events, the burst of the Dotcom bubble, the great financial crisis and numerous natural disasters. Yet, by any metric, buyout PE has had a great run since the turn of the millennium. Strong performance relative to public markets over this period has driven impressive industry growth with buyout net asset value (NAV) at $1.7 trillion as of the end of 2018. “Value of private equity deals hits post-crisis high,” the Financial Times declared in a headline at the end of last year.

To be sure, the rapid growth has brought challenges. The global pandemic will reinforce some of them, while alleviating others. For one thing, rising PE allocations had driven valuations up as more capital competed for deal flow. As a result, the last few years have been a great “seller’s market” with consistently strong investment returns. But while sponsors have found it easy to sell platforms, i.e. companies or groups of companies they previously bought, finding attractive targets had become hard. One increasingly popular approach has been to scale platform companies with further, “add-on,” acquisitions. While this approach has been around since the early days of PE, its use has grown in popularity. Add-ons have grown from representing about 35% of buyout transactions in the early 2000’s to almost 60% in 2018 (see chart). They allow sponsors to further invest in performing assets they have been managing for a few years.

In the post-Covid-19 world, we expect this trend to continue and perhaps even accelerate further. In 2018, 26% of add-ons represented the 4th or later add-on acquisition for a platform company. In the pre-Covid-19 environment of robust valuations, the strategy often served as a way to average down the entry valuation of the initial platform by taking advantage of the market's tendency to assign higher multiples to larger companies. In the current global economic downturn induced by the pandemic, we expect to see a growing number of attractively priced opportunities, i.e. to achieve a similar benefit more cheaply. This is an important consideration for sponsors seeking to support their best assets in a more capital-constrained environment.

A growing opportunity set

Covid-19 looks set to further accentuate secular private-equity trends towards add-on activity and sponsor-to-sponsor exits.

By any metric, buyout private equity has had a great run since the turn of the millennium.
Finding ways to capture more of the return potential from emerging performers remains a priority for sponsors.
One increasingly popular approach has been to scale platform companies with further, “add-on,” acquisitions.

One increasingly popular approach has been to scale platform companies with further, “add-on,” acquisitions. While this approach has been around since the early days of PE, its use has grown in popularity. Add-ons have grown from representing about 35% of buyout transactions in the early 2000’s to almost 60% in 2018 (see chart). They allow sponsors to further invest in performing assets they have been managing for a few years.

In the post-Covid-19 world, we expect this trend to continue and perhaps even accelerate further. In 2018, 26% of add-ons represented the 4th or later add-on acquisition for a platform company. In the pre-Covid-19 environment of robust valuations, the strategy often served as a way to average down the entry valuation of the initial platform by taking advantage of the market's tendency to assign higher multiples to larger companies. In the current global economic downturn induced by the pandemic, we expect to see a growing number of attractively priced opportunities, i.e. to achieve a similar benefit more cheaply. This is an important consideration for sponsors seeking to support their best assets in a more capital-constrained environment.

1 PitchBook Data, Inc. as of 12/2018. All data in this note is from this source, unless otherwise stated.
2 https://www.ft.com/content/6fee67b0-2a9b-11ea-bc77-65e4aa665551
3 Investing in a platform company by acquiring (“adding on”) another company that complements/extends the platform’s services or products (usually with the aim to integrate it).

Alternative investments may be speculative and involve significant risks including illiquidity, heightened potential for loss and lack of transparency. Alternatives are not suitable for all clients. All opinions and claims are based upon data on 5/8/20 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. DWS Investment GmbH
Finding ways to capture more of the return potential from emerging performers remains a priority for sponsors. Examining buyout performance at the deal level helps explain why. Over the past 20 years, 29% of deals have been either written down or written off. We believe this is a reflection of the inherent information asymmetry which characterizes the initial acquisition of a platform company – it is very difficult to fully capture the risk profile of a company until you have owned it for a few years. On the other hand, around 30% of deals have generated a return on invested capital of 2 times the initial investment or greater, and close to 20% have generated a 3-times return to investors.

Another emerging trend is to extend the holding period for strong performing assets. One example of this trend is the increasing popularity of partial exits. In recent years, sponsors have become reticent to sell a company they believe may have further upside potential. Partial exits allow sponsors to take some of their chips off the table while booking a partial return and distribute capital to investors, called limited partners (LPs). Furthermore, the sponsor is able to maintain their controlling stake in the asset and continue to execute on their value-creation thesis.

While there are a variety of capital sources available to sponsors to support these transactions, funding has primarily been sourced from operating earnings of the platform company in question, as well as additional debt, supplemented by fund reserves set aside by the sponsor. Each of the traditional external capital sources has unique advantages but also certain disadvantages that may limit the attractiveness to the sponsor. Moreover, raising capital from any external source has obviously become harder in recent months.

One of the obvious sources of follow-on capital to continue backing emerging performers early in the life of the fund would be the LPs in that fund. After all, they know the sponsor as well as the company. Among the challenges associated with this option is the conflict in setting the valuation on a transaction between a sponsor and the LPs invested in the platform via the fund. Effectively, it often means having to negotiate with an affiliated entity that has a LP position. In speaking with sponsors, these opportunities are often missed as a result of their discomfort with the embedded conflict and optics of what looks like an "inside deal."

Another alternative may be to invite a competitor (another buyout sponsor) to invest in the asset. Sponsors are often hesitant to pursue that alternative due to the need to share governance rights and potential misalignment on exit time-frames. We believe this may be one of the factors driving the growth of full exits represented by sales to other sponsors. In 2018, almost 1/3 of buyout exits were sponsor-to-sponsor sales – often a smaller sponsor selling a strong performer to a larger sponsor able to further invest in the asset.

The downturn may well encourage more such deals, not least by prompting smaller sponsors to consider at least partial exits of assets that they believe have further upside potential by bringing in incremental non-control capital. From the perspective of the capital provider, such deals can also have important risk-mitigating elements, notably reduced information asymmetry associated with investing in seasoned platforms backed by incumbent sponsors.

For control sponsors, the appeal of investing further in emerging performers is stronger than ever. Providing sponsors with the capital to pursue that strategy is, in our view, a compelling opportunity which looks set to grow further, supported by the secular industry trends of increasing add-on activity and sponsor-to-sponsor exits.

---

5 Hamilton Lane 2018/2019 Market Overview
6 Subsequent investment by an investor who has already invested in the company.

Alternative investments may be speculative and involve significant risks including illiquidity, heightened potential for loss and lack of transparency. Alternatives are not suitable for all clients. All opinions and claims are based upon data on 5/8/20 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. DWS Investment GmbH
ADD-ONS AS A PERCENTAGE OF GLOBAL BUYOUT TRANSACTIONS
Recently, the use of add-on acquisitions to scale platform companies has been strongly increasing.

Source: PitchBook Data, Inc. as of 12/2018

GLOSSARY

A buyout is a purchase of shares in order to gain controlling interest in another company.

The dotcom bubble refers to the rapid rise and eventual collapse of equity market valuations of technology stocks from the late 1990s to 2001.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Limited partnerships (LPs) are a form of partnership where one or more partners has only limited liability and no management authority. Private equity operations often exist in this form.

A multiple is a ratio that is used to measure aspects of a company’s well-being by setting various of the company’s metrics against each other and thereby building indicative ratios.

Net asset value (NAV) is the value of an organisation’s assets minus the value of its liabilities.

Private equity (PE) is a direct or indirect investment by a financial investor in a substantial part of a company’s equity. Usually the company invested in is not listed.

A private-equity investment firm is also considered the sponsor (of a leveraged buyout transaction).

Alternative investments may be speculative and involve significant risks including illiquidity, heightened potential for loss and lack of transparency. Alternatives are not suitable for all clients. All opinions and claims are based upon data on 5/8/20 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. DWS Investment GmbH
Important Information

The brand DWS represents DWS Group GmbH & Co. KGaA and any of its subsidiaries, such as DWS Distributors, Inc., which offers investment products, or DWS Investment Management Americas Inc. and RREEF America L.L.C., which offer advisory services.

This document has been prepared without consideration of the investment needs, objectives or financial circumstances of any investor. Before making an investment decision, investors need to consider, with or without the assistance of an investment adviser, whether the investments and strategies described or provided by DWS, are appropriate, in light of their particular investment needs, objectives and financial circumstances. Furthermore, this document is for information/discussion purposes only and does not and is not intended to constitute an offer, recommendation or solicitation to conclude a transaction or the basis for any contract to purchase or sell any security, or other instrument, or for DWS to enter into or arrange any type of transaction as a consequence of any information contained herein and should not be treated as giving investment advice. DWS, including its subsidiaries and affiliates, does not provide legal, tax or accounting advice. This communication was prepared solely in connection with the promotion or marketing, to the extent permitted by applicable law, of the transaction or matter addressed herein, and was not intended or written to be used, and cannot be relied upon, by any taxpayer for the purposes of avoiding any U.S. federal tax penalties. The recipient of this communication should seek advice from an independent tax advisor regarding any tax matters addressed herein based on its particular circumstances. Investments with DWS are not guaranteed, unless specified. Although information in this document has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness or fairness, and it should not be relied upon as such. All opinions and estimates herein, including forecast returns, reflect our judgment on the date of this report, are subject to change without notice and involve a number of assumptions which may not prove valid.

Investments are subject to various risks, including market fluctuations, regulatory change, counterparty risk, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you may not recover the amount originally invested at any point in time. Furthermore, substantial fluctuations of the value of the investment are possible even over short periods of time. Further, investment in international markets can be affected by a host of factors, including political or social conditions, diplomatic relations, limitations or removal of funds or assets or imposition of (or change in) exchange control or tax regulations in such markets. Additionally, investments denominated in an alternative currency will be subject to currency risk, changes in exchange rates which may have an adverse effect on the value, price or income of the investment. This document does not identify all the risks (direct and indirect) or other considerations which might be material to you when entering into a transaction. The terms of an investment may be exclusively subject to the detailed provisions, including risk considerations, contained in the Offering Documents. When making an investment decision, you should rely on the final documentation relating to the investment and not the summary contained in this document.

This publication contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. The forward looking statements expressed constitute the author’s judgment as of the date of this material. Forward looking statements involve significant elements of subjective judgments and analyses and changes thereto and/or consideration of different or additional factors could have a material impact on the results indicated. Therefore, actual results may vary, perhaps materially, from the results contained herein. No representation or warranty is made by DWS as to the reasonableness or completeness of such forward looking statements or to any other financial information contained herein. We assume no responsibility to advise the recipients of this document with regard to changes in our views.

No assurance can be given that any investment described herein would yield favorable investment results or that the investment objectives will be achieved. Any securities or financial instruments presented herein are not insured by the Federal Deposit Insurance Corporation ("FDIC") unless specifically noted, and are not guaranteed by or obligations of DWS or its affiliates. We or our affiliates or persons associated with us may act upon or use material in this report prior to publication. DB may engage in transactions in a manner inconsistent with the views discussed herein. Opinions expressed herein may differ from the opinions expressed by departments or other divisions or affiliates of DWS. This document may not be reproduced or circulated without our written authority. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject DWS to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions.

Past performance is no guarantee of future results; nothing contained herein shall constitute any representation or warranty as to future performance. Further information is available upon investor’s request. All third party data (such as MSCI, S&P & Bloomberg) are copyrighted by and proprietary to the provider.

For investors in Bermuda: This is not an offering of securities or interests in any product. Such securities may be offered or sold in Bermuda only in compliance with the provisions of the Investment Business Act of 2003 of Bermuda which regulates the sale of securities in Bermuda. Additionally, non-Bermudian persons (including companies) may not carry on or engage in any trade or business in Bermuda unless such persons are permitted to do so under applicable Bermuda legislation.

© 2020 DWS Investment GmbH All rights reserved. I-076343-1