Dealmaking in an uncertain economy

Private equity firms find opportunities as volatility continues to dominate the financial markets

Stepping into uncertain times

The White & Case Private Equity group discusses how well equipped the private equity industry is for the uncertain conditions investors face today

There has been much political upheaval in the last 12 months, from the change in the US administration to questions over the future unity of Europe. Anecdotally, there's a sense of uncertainty about future policymaking, how this will impact the economy and what it will mean for investors, including private equity funds.

Recent research confirms this sense of unpredictability. The Economic Policy Uncertainty Index, devised by economists from Stanford, the University of Chicago, and Northwestern, measures the occurrence of words in newspaper articles that relate to economic uncertainty and politics, as well as the number of expiring tax laws and the spread among economic forecasts. The change in presidency is the third-biggest source of uncertainty since the Index was introduced more than 30 years ago, ahead of both the 2008 financial crisis and the 1987 stock market crash.

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Investors like certainty. It helps them to deploy capital with confidence. Private equity funds are no different in this respect, however they are also some of the most tenacious investors in the world and possess a knack for turning uncertainty, and even market disruptions, to their advantage.

In recent years, funds have not only become more operationally minded, creating lasting value in investments by genuinely transforming companies, there has been a growing tendency to think longer term. Funds with extended life cycles are beginning to be raised, and we would expect this to smooth out the effect of uncertainties or market swings as divestment schedules become more flexible.

While the details of much of the new administration’s policies remain to be seen, many sectors stand to benefit from new tax and regulatory rules, and investment programs. For instance, America’s infrastructure is likely to receive substantial investment, and this will benefit funds that are targeting these assets as well as the construction businesses required for them to be built and renovated.

More generally, any reduction in regulation and a lowering of corporation tax would be a boost for business. Of course, there is concern that protectionist measures designed to make America more competitive relative to other countries may have unforeseen, undesirable consequences such as raising import costs. Such knock-on effects have the potential for investors to lose confidence, which could depress what have become frothy stock markets and filter into private market valuations. This would certainly give cause for caution. However, stock market turbulence can play to private equity’s advantage, as IPOs become more challenging and such sales divert to buyout funds.

Furthermore, so-called PIPEs (private investment into public equities) and take-privates become more attractive to the buy-side, and an easing of private valuations would be welcome after a period of persistently high purchase multiples.

Not only that, we have seen a healthy pipeline of corporate divestments to private equity in recent years as businesses continue to home in on their core products and services. If uncertainty continues, so will the pressure on corporates to sharpen their focus through such disposals.

Clearly private equity, like every other investor type, would like to see a clear, predictable path ahead. But the tools and know-how at its disposal mean that, even in the period of uncertainty that we find ourselves today, the industry will remain very much open for business.

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Preparing the ground

Josh Lerner of Harvard Business School on private equity's knack for navigating uncertainty

Every day investors face risks of all kinds in the pursuit of returns, from the political to the economic, from changing consumption trends to technology disruption. Broadly speaking, investors do not like uncertainty, and it is not generally healthy for public markets.

The political shifts of the last 12 months towards economic populism and nationalism—discussed at great length elsewhere—are likely to be associated with a rise in uncertainty.

If we are indeed entering an era where a lot of things we took for granted in places like the US, such as the rule of law, are no longer guaranteed, this could present challenges in the long term for equity investors of all types.

Similar concerns might be raised regarding the prospects for private equity, whose performance has historically been quite correlated to that of public equities. At the same time, few industries thrive on disequilibrium like private equity. When you look at many of the successful investments that private equity has made, they tend to be in industries in transition, whether due to regulatory changes, such as in telecommunications and healthcare, or due to changes in patterns of global competition.

Forecasting market tops is a perilous business. I recall a bunch of venture capital groups getting out of the market for internet start-ups in 1996, as they saw valuations as unsustainable. They were right—but they nonetheless succeeded in severely damaging their reputations, and even firms' futures, by missing out on four years of the boom before the dotcom bubble eventually burst.

That said, there are big differentials between private equity vintage years. Those vintages that turn out to be the market tops, such as 1986 (prior to Black Monday the following year) or 2006 before the global financial crisis, substantially underperform. Only tomorrow will we know how today's vintage will perform.

> “Few industries thrive on disequilibrium like private equity.

Some comfort should be taken from a recent working paper we released. We matched British companies backed by private equity with counterparts not owned by financial sponsors by industry and size to see how they performed in the financial crisis.

We found that the firms with private equity backing undertook capital expenditures and other kinds of investment at substantially greater rates in the wake of the crisis.

Their ability to invest more appeared to be due to their ability to raise capital relative to the others. The firms backed by private equity firms have more equity investment—which presumably reflects the fact that private equity firms themselves had deep pockets to continue to fund those companies, while their counterparts had to rely on declining public markets and other alternatives, which was a more difficult row to hoe. They were able to access debt financing, as well.

One suggested explanation for the latter pattern was that their private equity backers had developed strong relationships with banks over many years.

While the others were grappling with credit lines being pulled after the financial crisis, the private equity-backed firms got more forbearance from the banks and a greater willingness to extend credit lines, reflecting their sponsors' deep relationships with the financial institutions.

Whatever the precise reason for this continued investment during hard times, it is fair to assume that whatever lies ahead in this period of uncertainty, private equity firms' active engagement in the companies that they own will prepare them for—and help them to manage—the worst.

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Josh Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School and head of the Entrepreneurial Management unit. He founded and runs the Private Capital Research Institute, a nonprofit devoted to encouraging access to data and research about venture capital and private equity.

Currency risk: Here to stay

Tom Speechley, Partner at The Abraaj Group, examines how private equity GPs are managing the associated risks of currency volatility in emerging markets

There is no doubt that currency volatility has been one of the major challenges for international private equity investors over the last two or more years. Emerging markets, in particular, have been buffeted, as monetary policies in the US and Europe have resulted in volatile global capital flows and related nominal FX rate instability. Countries with structural current account deficits and those reliant on the export of commodities have been hardest hit. And yet private equity is uniquely well placed to navigate such difficulties. Unlike macroeconomists, finance ministers and central bankers, a private equity investor need not worry about an entire economy or monetary system. By definition, private equity is about cherry picking and, in the context of increased FX volatility, that can include selecting companies that are more resilient to nominal FX depreciation than others.

For example, a Nigerian fertilizer producer that exports the majority of its output actually benefits from depreciation of the naira to the extent that its dollarized revenues hedge out its local currency cost base. For companies that cater to a local consumer market and thus have local currency earnings, inflation may provide some relief through increased consumer prices that absorb the depreciation over time. Conversely, a market leader may be able to take additional market share by holding prices at the lower level to weed out less strong competition. On the cost side, certain companies are able to switch a supply chain element from one source and currency to another and thus hedge out some exposure. Even companies that are not operationally hedged may be growing so rapidly in local currency terms that the US dollar equivalent growth is still at a level that provides exceptional returns for the investor.

FX-specific considerations are not confined to the operational profile of the company concerned, and the private equity investor can also structure or model some resilience into an investment. For example, contractual distributions will reduce the exposure before a full exit. Similarly, deferring deployment of an entire growth equity package until utilized by the company reduces the period of exposure to FX risk. Whether such features can be negotiated into a transaction is, of course, case-specific.

On the other hand, one structuring tool that all investments can incorporate is a conservative assumption of depreciation into the investment case itself. In doing so, the investor is, in effect, screening out companies that have insufficient base-case growth potential and operational hedging capacity to withstand the assumed level of depreciation.

For all of the reasons given above and more, a private equity investor is not simply concerned with the nominal FX rate for a given day or period. Between structuring, inflation adjustments and the operational hedging capacity of the companies in which it invests, a private equity investor has much more to consider and to leverage in risk reduction.

Perhaps counterintuitively, formal hedging instruments have not been mentioned above. The reality is that traditional instruments are not well suited to hedging equity exposure in emerging market currencies over a period of several years, and aside from short-term price hedging at entry and exit, they do not figure prominently as a risk-mitigating tool.

Looking beyond the individual investments made, a private equity investor will also have the opportunity to hedge the FX risk by portfolio diversification.

Undoubtedly, many emerging market currencies are directionally correlated in terms of their relationship to the US dollar, especially when the driver of volatility is US monetary policy, rather than something germane to the country concerned. But that does not exclude diversification benefits. Indeed, several emerging market currencies have been relatively strong performers against the US dollar in the last two years, such as the Indian rupee (3.5 percent annual depreciation) or the Indonesian rupiah (3.8 percent annual depreciation), while others, such as the Saudi riyal and the United Arab Emirates dirham, remain robustly pegged to the US dollar. As a result of diversification alone, The Abraaj Group basket of more than 30 currencies outperformed the euro, Canadian dollar and Australian dollar in 2015, and comfortably outperformed sterling in 2016, reminding us that 2015 and 2016 were less about weak emerging market currencies and more about a strong US dollar. Moreover, the diversification effect described here merely reflects the nominal FX position and does not factor in any of the company-specific resilience described earlier.

When building a truly hedged portfolio, an investor should also bring together companies with high baseline growth levels that can simply outpace depreciation and those with operational hedging resilience. Portfolio construction will also incorporate vintage diversification to smooth out short-term volatility.

Capital allocators should not be too despondent when scanning the FX screen on their Bloomberg terminal; private equity offers several solutions to reduce the impact of nominal rate movement. For general partners that are new to these markets, steep currency falls over the last two years or more may suggest a buying opportunity, but history has shown that individual emerging markets are not easily timed. A long-term approach based on growth, careful portfolio construction and active currency management will more likely yield repeatable and desirable results.

The Abraaj Group, founded in 2002, is a leading private equity investment firm operating across Latin America, Africa, Asia, Turkey and the Middle East through more than 20 offices with assets under management in excess of US$10 billion. It has achieved more than 80 exits.

> **“Monetary policies in the US and Europe have resulted in volatile global capital flows and related nominal FX rate instability.**

To hedge, or not to hedge?

David Fann, President and CEO, TorreyCove Capital Partners outlines some possible options for currency risk management within a private equity portfolio.

> **In most cases, a well-structured, diversified private equity portfolio can mitigate currency fluctuations.**

One of the most striking macro-trends of recent years has been the appreciation of the dollar versus currencies in both mature and emerging markets. Uncertainty in Europe—with last year's Brexit vote adding to the mix—combined with China's slowdown, has made the dollar a relative safe haven for investors, to the detriment of other currencies. But what does this mean for the US private equity investor committed to non-dollar-denominated funds? Should they be hedging their investments to stem losses?

In most cases, a well-structured, diversified private equity portfolio can mitigate currency fluctuations.

As investors make both contributions and receive distributions over the 10-year lifespan of a fund, this acts as a natural, inbuilt hedge that evens out currency swings over time. Across an entire portfolio, this effect is magnified.

However, recent years have witnessed a persistent appreciation of the dollar, which poses a greater challenge for US investors exposed to non-dollar currencies.

We believe that if an investor strongly expects a local currency to which they are exposed will fall into secular decline, there may be a valid case for a hedging strategy.

By its nature, private equity is illiquid and its cash flows (drawdowns and distributions) are unpredictable, making it incredibly difficult—although not impossible—to hedge at the individual fund level. Indeed, investors should analyze to what extent the private equity managers with which they are invested already hedge at this level, as doing so themselves may be redundant. Because of this, we advise clients eager to dampen the effect of currency movements to install hedges at the portfolio level, where estimated cash flows are more stable. Even then, it is far from an exact science.

Proprietary analysis has shown us that projected compared to actual net cash flows range from anywhere between 3 percent and 95 percent, with an average of more than 35 percent. This means the portfolio would be substantially over- or under-hedged most of the time.

For those willing to embark on a program, there are a number of solutions open to investors, including forward contracts, futures, options, swaps and exchange-traded funds that focus on currency exchange rates, and each comes with its own pros and cons.

We believe that futures contracts are unsuitable for most institutions since mark-to-market adjustments require that any gains and losses are settled daily. Aside from the fact that private equity assets are valued on a monthly or quarterly basis—making fair market valuations imprecise and potentially increasing risk in the hedged portfolio—many investors lack the time and resources required to manage such daily settlements.

For this reason, a more suitable alternative may be options, which effectively act as an insurance policy against major losses. However, options are not without their drawbacks, namely the premium required to purchase them, a cost that increases as currency markets become more volatile and more investors seek insurance.

We advise investors to carefully ascertain their currency exposure, as they may already have a degree of cross-currency hedging in place. For example, a euro-denominated fund investing in a Swedish company will have kroner exposure.

Furthermore, today's globalized economy means that many businesses' cost and revenue streams are diversified by currency, helping to mute volatility. Additionally, in the case of buyouts, which represent the majority of private equity investments by value, the leverage taken out on acquisition targets may act as an inherent hedge at the company level, since a weakened local currency will be partly offset by a fall in the value of the debt denominated in that same currency.

Over the long and medium terms, the effect of currency movements in mature, diversified private equity portfolios tend to be moderate. The more diverse the portfolio, the less impact FX risk is likely to have, assuming that currency exposures are actively monitored and managed.

Arguably one of the most effective hedges is selecting a pool of talented fund managers able to identify companies with diversified costs and revenues, who can differentiate between macroeconomic challenges and company-specific currency risks, and who can support the growth of their investee companies in spite of market volatility. It is these managers who will deliver returns during uncertain times.

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TorreyCove is a non-discretionary specialist advisor focusing exclusively on private equity and real assets.

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