

# Lessons learned: insights from the COVID-19 crisis for middle market private equity sponsors

New York Life Investments  
ALTERNATIVES

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## Executive Summary

The COVID-19 crisis forced middle market private equity sponsors to make rapid changes to core business and investment processes to keep their businesses running and their portfolios intact. Because many of these changes proved successful under the most trying circumstances, some will remain in place long after the pandemic recedes, permanently altering the industry.

To better understand how the crisis affected the middle market private equity industry, and how sponsors responded to COVID-19-related challenges, New York Life Investments Alternatives (NYLIA) partnered with Coalition Greenwich to conduct more than 100 in-depth interviews with senior professionals at U.S. middle market private equity sponsors. This report presents the complete results of that research, including an assessment of the most important changes triggered by the crisis across core functions such as investing, deal sourcing, transaction financing, exit strategies, and fundraising. It also provides a deep analysis of which changes will persist into the post-pandemic era, as well as key learnings, including:

- A sharpening of the investment process
- New ways of using technology
- The importance of relationships
- Opportunities in ESG and DEI

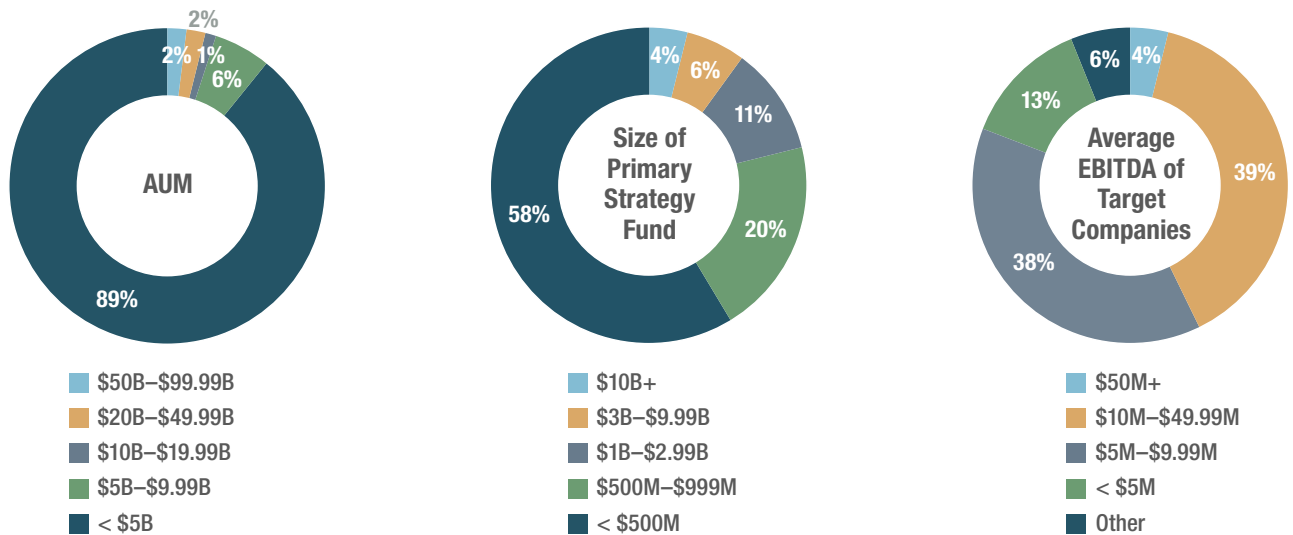


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## Methodology

Between February and April 2021, Coalition Greenwich, in partnership with NYLIA, conducted a study to examine the effects of the COVID-19 crisis on middle market private equity sponsors. Coalition Greenwich interviewed 100 managing directors and partners at middle market private equity sponsors in the United States. These in-depth phone conversations centered on the impact of COVID-19 on investment trends, exit strategies, funding sources, and emerging challenges and opportunities.

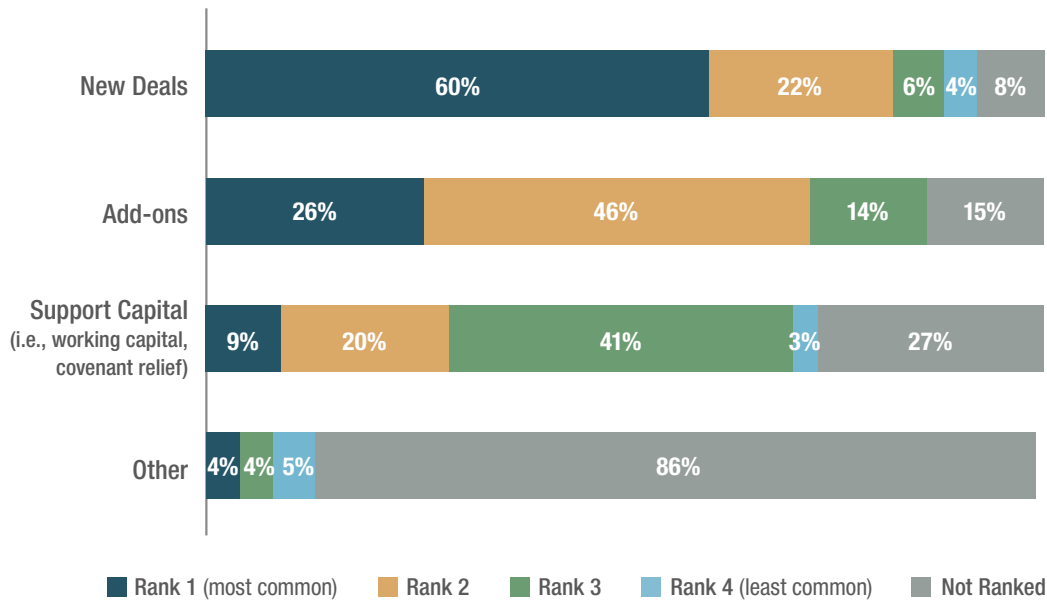
**Figure 1: Participant profile**



## Introduction

When the COVID-19 pandemic sent the global economy into lockdown in early 2020, middle market private equity sponsors feared the worst. In reality, after some initial, terrifying disruptions, markets rebounded, and sponsors quickly returned to the business of deploying capital to new middle market deals. When all was said and done, U.S. middle market private equity broke its all-time record last year with approximately \$480 billion in deal value—albeit across fewer deals than the prior year and with uneven distribution across quarters, according to Pitchbook.

For 60% of the middle market private equity sponsors participating in the study, new deals represented the most common driver of capital deployment in 2020, with add-on investments a distant second (see **Figure 2**). Fortunately for the industry, the combination of a quick turnaround in the economic environment, powerful government stimulus, active liquidity management, and close coordination with lenders at the start of the crisis alleviated the need for significant amounts of capital support for portfolio businesses. In fact, support capital, including working capital and covenant relief, represented the top use of deployed capital for only 9% of middle market sponsors last year.

**Figure 2: Into which areas did you deploy capital during the crisis?**

Nevertheless, the pandemic has had a profound impact on the industry. In many ways, the COVID-19 crisis represented the first real stress test for private equity in more than a decade—and it was a doozy. Private equity sponsors were tested on every level. Work-from-home requirements forced firms to shift nearly all workflows to digital and remote channels, posing a real-time test for IT capabilities, compliance processes, and firm management and culture.

For an industry built on relationships, the pandemic also brought a sudden stop to in-person meetings with liquidity providers, current and prospective investors, and the management teams of portfolio companies—forcing sponsors to adopt video conferencing and other online solutions on the fly, simply to maintain regular business activities. Meanwhile, the crisis disrupted the operations of portfolio companies and upended investment teams’ economic and financial projections by shuttering entire industries and injecting historic levels of volatility into financial markets.

Many of the shifts sponsors made to overcome these challenges will remain in place long after the pandemic subsides. In the following sections, we present our analysis of how COVID-19 affected the industry, how middle market private equity sponsors responded, and how sponsors view market conditions going forward. Our goal in this effort is to help middle market private equity firms learn from the experiences of their peers during COVID-19 and apply these lessons to the post-pandemic environment.

*In the following sections, we present our analysis of how COVID-19 affected the industry, how middle market private equity sponsors responded, and how sponsors view market conditions going forward.*



## COVID-19 challenges forced sponsors to sharpen their investment process

COVID-19 will leave a lasting mark on middle market private equity investment processes. In the simplest terms, the global pandemic forced sponsors to sharpen their skills and tighten procedures.

### A return to fundamentals

Operational and financial disruptions left no room for error, demanding new rigor and attention to detail, forcing sponsors to return to fundamentals in their analysis. Almost 30% of sponsors in the study report that the crisis and subsequent rebound prompted them to tighten their discipline on valuations. Sponsors say they started looking more closely at cash flows, liquidity, and cost structures, and placed more focus on tail risk and extreme events in the investment process.

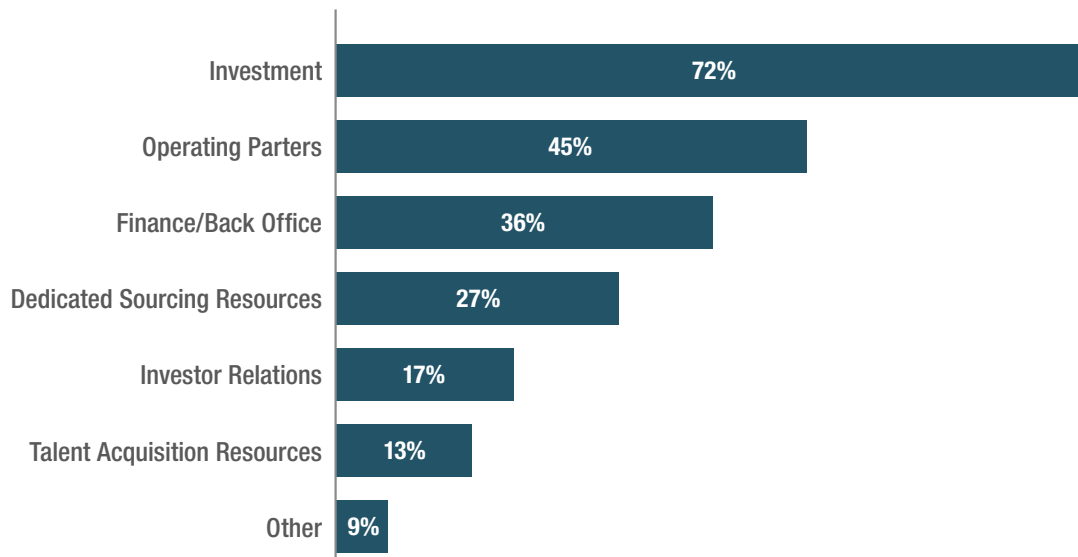
As one sponsor explains, her firm is paying more attention to “whether an investment has good viability when hit with an unexpected quarter.” Another says the crisis opened his eyes to the fact that “companies can run leaner in certain areas. COVID-19-related cost-cutting forced a reevaluation of cost structures.” Unsurprisingly, downside modeling, in general, took on a much higher priority during the crisis, and study participants say they plan to maintain their stepped-up focus on factors such as supply chain resiliency and customer “stickiness.”

**Figure 3: What impact did rising valuations have on your strategy and execution?**

Responses	Quotes
<b>Increased Discipline on Valuation</b> (28%)	<i>“Have a year-one angle for value creation to downside-protect overpaying.”</i> <i>“Difficult to win an acquisition transaction. We need to find unloved companies that are not turnarounds.”</i> <i>“It requires us to perform additional validation of value-add strategies, and it is also harder to win new deals.”</i>
<b>No Material Impact</b> (22%)	<i>“We complain about it a lot but we continue to buy a mix of A and B companies in A and B industries.”</i> <i>“It hasn’t. Each deal we pursue is typically proprietary, or at a fair valuation. We don’t bid in auctions.”</i> <i>“Focus on proprietary origination; avoid frothy process.”</i>
<b>Shift in Target Market</b> (15%)	<i>“Spending more time forging relationships with founders and owners directly.”</i> <i>“Going down market where it is less competitive.”</i> <i>“We are looking more at underperforming businesses that may not attract premium valuations.”</i>
<b>Capital Deployment Challenges</b> (13%)	<i>“Stuck to our discipline and did fewer deals as a result.”</i> <i>“We tend to stick to our guns on valuation even if it means a slower pace of deployment.”</i> <i>“Very difficult to deploy capital into new platforms.”</i>

Finally, the pandemic also delivered a stark reminder about the value of talent management and expertise, especially in times of duress. With in-person due diligence limited during the crisis, sponsors made greater use of external industry experts and consultants to supplement information and analysis about prospective investments. Looking ahead, sponsors name operating partners as second only to investment talent in terms of the skill sets they are looking to add to their organizations in the coming year.

**Figure 4: What skill sets are you seeking to add to your team next year?**



### Lasting benefits of new ways of working

The workarounds sponsors used to navigate the pandemic could represent some of the most permanent changes to middle market private equity. Technology proved highly effective under the most trying conditions. Not only were sponsors able to maintain operations with digital solutions, but in some cases they were able to do so more efficiently and at a reduced cost. The technological impact was felt across almost every workflow, including deal sourcing, due diligence, portfolio management, and internal operations.

Sponsors emphasized that switching to video conferencing and remote workflows during COVID-19 was not just a question of swapping in-person meetings and touchpoints for virtual replacements. During the pandemic, sponsors took advantage of the efficiencies of these digital channels to increase the frequency of both external and internal communications. For example, one sponsor says her firm added new weekly calls with company management teams to “keep the firm in the flow” and “get people together more to share information.”

As with all industries, it remains to be seen how far private equity sponsors will be willing to go after the pandemic when it comes to decisions like shifting investment team and other staff to permanent or hybrid remote work, and whether to continue using remote due diligence. At present, about one in five sponsors say they plan to reduce travel due to lessons learned during the pandemic. However, sponsors in the study make clear they intend to extend at least some of the tech-related efficiencies achieved during the crisis.

“We are looking to implement technology across a broader spectrum of activities,” says one middle market sponsor. That includes “utilizing remote diligence and local capabilities.”





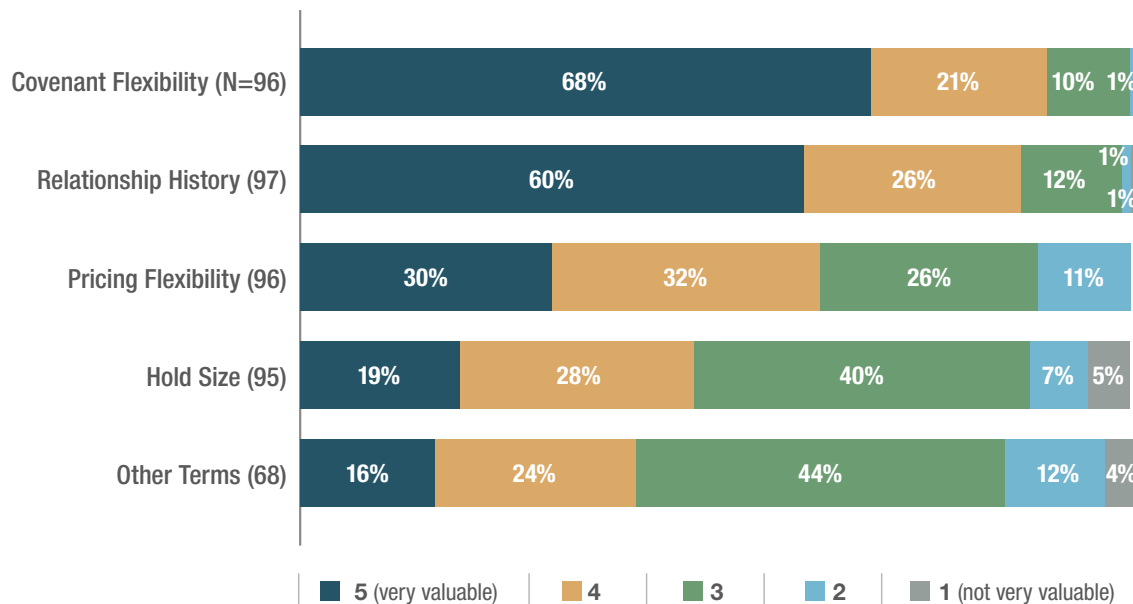
## Relationships prove their worth in crisis

Despite the increased use of video conferencing, sponsors continued to hold critical meetings in person throughout the pandemic, including meeting with management teams ahead of signing up a new platform. Sponsors realize that face-to-face interactions are essential to building relationships, and that relationships are the bedrock of a private equity franchise.

On the investing side, relationships played a critical role in proprietary sourcing during the market disruption. In the face of rising valuations, proprietary sourcing has helped put capital to work at more reasonable multiples by helping avoid competitive auction processes.

Nowhere were relationships more important than in the area of deal funding. During COVID-19, and especially in the crisis' earliest days, middle market private equity sponsors coordinated with lenders to their portfolio companies to manage through unprecedented shutdowns, highlighting the importance of these relationships.

**Figure 5: Which attributes do you prize most in financing partners?**



**Figure 5** shows the attributes middle market private equity sponsors see as most important in an uncertain market environment. At the top of the list are covenant flexibility and relationship history. One sponsor in the study said his firm's go-to provider impressed them during the crisis with its "collaborative approach to covenant breaches and credit amendments." As another study participant put it, "The best of them offered covenant relief and principal deferral—before we had to ask for it." In terms of relationships, sponsors say they were won over by providers who "never overreact during challenging times and trust our management style" and by partners who proved they "are always there when we need them."

During the recent market turbulence, relationships with lenders were just as critical when transacting on new deals, as sponsors turned to familiar partners who were responsive, collaborative, and capable of operating in an extended, remote due-diligence environment. This experience of working closely with lending partners during such challenging times should support the existing trend toward smaller financing groups. Almost 95% of sponsors in the study say they prefer direct-lending execution over broadly syndicated loans.



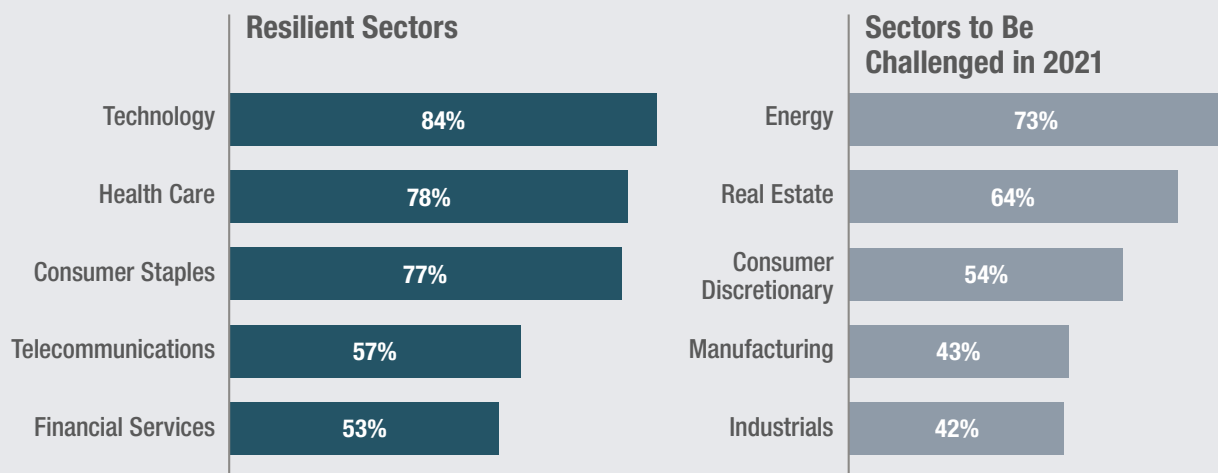
## Pandemic had mixed effects on exits

Study participants report a range of effects on exits and holding periods during 2020, based in large part on variations in market conditions from industry to industry. As one sponsor summed up, the pandemic meant “longer holding periods for some holdings, shorter for others.”

More than a third of middle market private equity sponsors say the COVID-19 crisis delayed exits and extended holding periods. Sponsors report delays ranging from a few months to up to two years. “They’ve been extended by at least the year we lost from COVID-19,” says one study participant. The most common reason for those delays is that due to the pandemic, portfolio companies needed additional time to meet growth expectations.

At the same time, almost a quarter of plan sponsors say the events of 2020 actually accelerated exits. The biggest driver of that acceleration was soaring valuations, especially those in specific industries such as technology and health care.

**Figure 6: Most resilient and challenged sectors**





## Specialists vs. generalists during the pandemic

Although the COVID-19 crisis affected all middle market private equity sponsors, the impact was not consistent across firms. In particular, the pandemic experiences of generalist and specialist sponsors differed in three important ways:

### Specialists devoted more capital to new deals

Specialists were far more likely than generalists to name investments in new deals as their biggest use of deployed capital last year. Generalists were more likely to name add-ons, support capital for portfolio businesses, and other uses as primary drivers of capital deployment. This differential likely reflects several variables. Many specialist firms focus on industries that proved most resilient during the crisis, such as technology, health care, insurance, financial services, and telecommunications. Also, specialists' industry relationships can provide a proprietary avenue for deal sourcing, and sector-specific knowledge can enhance speed to close—factors that could have played a meaningful role in a competitive deal environment.

### Generalists reported more disruptions in fundraising

Approximately half of all middle market private equity sponsors say the COVID-19 crisis had a disruptive impact on fundraising. That includes 39% of firms that say the pandemic made fundraising more difficult but not impossible, and 12% who placed fundraising on hold altogether. However, experiences vary considerably according to sponsor strategy. Generalist sponsors were more likely than specialists to say the crisis had at least some negative impact on fundraising. At the extreme, one in five generalists said market conditions and operational limitations during the pandemic caused them to place fundraising efforts on hold entirely, compared to only 3% of specialists. Across both groups, sponsors gravitated to capital providers capable of delivering a range of integrated capabilities.

**Figure 7: What impact has the COVID-19 crisis had on raising funds?**

	Total (N=85)	Generalists (30)	Specialists (34)
More difficult, but still possible	39%	33%	32%
Limited impact	27%	23%	35%
No impact	15%	17%	24%
Fundraising has been placed on hold	12%	20%	3%
Other	7%	7%	6%

### Specialists saw increased interest in continuation funds

Almost 60% of specialist funds say they're seeing increased interest in continuation funds versus only about 30% of generalist funds. That differential likely reflects perceived opportunities among specialists to capitalize on their depth of knowledge about a particular asset or industry in an environment of elevated purchase prices.



## Assessing limited partner (LP) sentiment on market conditions

Sentiment among the LP community was best summed up by one sponsor, who described his firm's LPs as "concerned about valuations, but excited about growth prospects." More than half of the participants believe the LP community remains optimistic about the investment climate. "LPs feel good; there is a lot of money to be put to work," says one study participant. Another sponsor agrees, adding that most LPs "are fairly bullish for the back half of 2021 and beyond."

However, a minority of about 30% of study participants say LPs are turning negative on the environment—mainly based on valuation concerns. "Very risky climate with valuations unbelievably high for average businesses," says one sponsor, describing his take on LP attitudes.

At the time of our interviews in Q2 2021, study participants said they continued to face questions from LPs about the performance of portfolio companies during the COVID-19 crisis and the steps the sponsor took to maintain operating company performance and overall portfolio performance through the pandemic.



## Middle market private equity: driving job creation and positively impacting communities

Private equity sponsors looking to highlight the positive impact on the economy and attract investors to the middle market should highlight the segment's strong track record of job creation. The middle market sponsors participating in the study estimate that between 75% and 100% of their portfolio companies add net jobs during their holding periods. This speaks to the "Social" component within an ESG framework as portfolio companies tend to have a positive impact on their employees' lives and within their communities. If those numbers are even close to accurate, the more than 35% of study participants who say they don't track job creation among portfolio companies should consider adding a formal process for doing so and start reporting results to LPs.

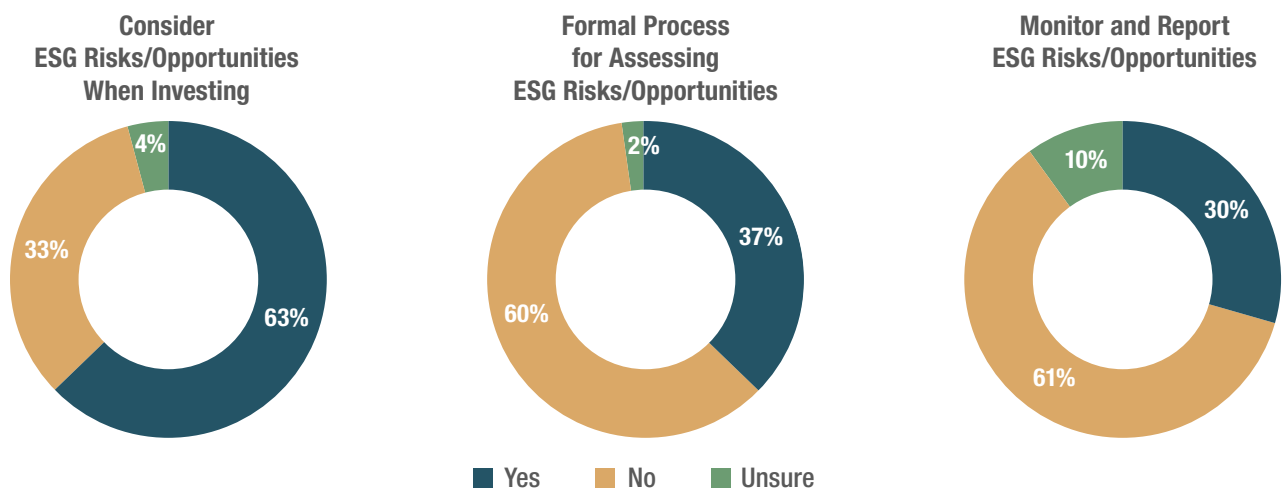


## Opportunities in ESG and DEI

Professional and individual investors are increasingly recognizing the importance of environmental, social, and governance (ESG) factors in investment decisions, not only for risk mitigation but for the potential for outperformance. The pandemic and some of the social unrest experienced during that time shifted the focus from the “E” to the “S” in ESG, highlighting the importance of diversity and inclusion. Middle market private equity sponsors looking to position their firms for the post-pandemic period have an opportunity to differentiate themselves by committing to ESG goals in their investment processes and diversifying to meet diversity, equity, and inclusion (DEI) standards in hiring and employment practices—at both their own firm and portfolio companies.

This opportunity exists because, relative to other parts of the asset management industry, middle market private equity sponsors are still in the early stages of adopting formal procedures for both ESG and DEI.

**Figure 8: Middle market private equity sponsors slow to adopt formal ESG policies**



Almost two-thirds of middle market private equity sponsors consider ESG risks when making investment decisions. However, most sponsors have yet to establish formal processes for assessing and reporting ESG risks and opportunities.

Three-quarters of specialist sponsors and half of generalists say they take ESG factors into account when making investments. However, across all study participants, only 37% have a formal process in place for assessing ESG risks and opportunities, including 57% of specialists and only about one in five generalists. Overall, less than a third of the sponsors formally monitor and report ESG risks and opportunities, a share that includes more than 40% of specialists and less than a quarter of generalists.

The situation is similar when it comes to DEI. Although most private equity sponsors acknowledge its importance in today's marketplace, many study participants report they have no formal processes for incorporating DEI factors into their investment strategies, firm operations or portfolio company business practices.

However, given that more than 80% of sponsors say interest in these issues is being driven by pressure from LPs and investors, the focus on these areas is likely to increase. Sponsors can differentiate themselves in the eyes of investors through more fully and formally integrating both ESG and DEI into their investment processes and portfolios, as well as robust data tracking and reporting.

One way middle market private equity sponsors can convey a deep commitment to ESG and DEI standards to their LPs and other important constituencies is by adopting the UN Principles for Responsible Investment (UNPRI)—a step taken by only 4% of the surveyed sponsors to date. Those that had signed the UNPRI often had dedicated ESG professionals overseeing the efforts and reporting.

**Figure 9: Are you a signatory to the UN's Principles for Responsible Investment (UNPRI)?**



## Conclusion

As the global economy reawakens from its COVID-19 lockdown, we believe the middle market private equity industry is strongly positioned. Last year's crisis posed a host of market and operational challenges to private equity sponsors—especially to generalist firms, many of which experienced disruptions in fundraising efforts. Nevertheless, across both generalists and specialists, sponsors are emerging from the pandemic with their portfolios intact, deal volumes at record levels, and with significant amounts of dry powder to put to work. Looking ahead, middle market deal flow looks to be gaining momentum. In addition to pent-up demand from 2020, both buyers and sellers of middle market companies are facing potential tax changes that could motivate them to act sooner rather than later.

Sponsors are poised to take advantage of these favorable conditions thanks to decisive actions last year that allowed them to weather the initial volatility caused by the crisis and then, in many cases, participate fully in the rapid market rebound. Those actions included adopting remote work and other new technologies to maintain business operations, adapting core investment and portfolio management functions to meet new challenges created by the pandemic, and leveraging established relationships with financial providers, sourcing networks, and investors. Last year's economic and social upheavals also prompted many sponsors to increase their focus on ESG as a means of better aligning portfolios with investor values, enhancing performance, and differentiating their firms from competitors.

Sponsors' success in enacting these and other changes enabled middle market private equity to continue closing deals, exiting investments, and raising new capital in one of the most tumultuous market environments on record. Now, lessons learned during the crisis could help sponsors remain diligent and prudent in capital deployment as markets recover and valuations rise.

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This Report was compiled by Coalition Greenwich, which partnered with NYLIA to conduct over 100 in-depth interviews with senior professionals at U.S. middle market private equity sponsors. Coalition Greenwich was compensated by NYLIA to perform this research. Respondents were offered an overview of the key themes identified from the research as an incentive to participate. This report presents the complete results of that research, including an assessment of the most important changes triggered by the crisis across core functions such as investing, deal sourcing, transaction financing, exit strategies, and fundraising.

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