When buyout funds face a crisis

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The Financial Crisis of 2008 was a manmade one, which gave us a degree of confidence that strict regulatory changes could prevent a sequel. The current crisis arose from nature itself, which is quite a bit harder to regulate. The impact of this crisis is changing our day-to-day lives in ways that 2008 never did.

That's a new problem facing private equity, as we detail in an upcoming PitchBook analyst note around buyout funds and financial crises. Even if this scenario is short-lived, some of the damage will be permanent in sectors that survive on thin margins and depend heavily on cash flow. Investors have some tools to mitigate the bleeding—capital call facilities have grown in popularity and will help GPs meet near-term funding needs without having to drawn down capital. Other companies will need more than that, and we're already seeing significant capital infusions for the most vulnerable. Capital calls are catching LPs off-guard—many weren't expecting those phone calls this early in the year.

If there is a silver lining, capital call sizes tend to go down in the immediate aftermath. Fewer standard deals get done while the dust settles, and the capital calls that are issued revolve around PIPEs, capital infusions and other transactions that involve smaller check sizes. The average capital call size went down between 2007 and 2009, from about 5.5% of commitment size per quarter to around 2.5% by 2009. Between Q1-Q3 2009, capital calls of at least 10% of total commitment size were a small fraction of what they were between 2006 and 2008, according to PitchBook Data.

On the other side of the coin, we don’t expect significant distributions back to LPs any time soon. GPs will be hard-pressed to sell assets at 20% discounts of what they were three months ago. We expect money to flow in one direction for the time being. LPs need to have a plan in place to fund those capital calls without the normal assistance from distributions. Net cash flows are bound to go negative, just as they did in 2009. The problem is exacerbated for LPs invested across other private markets. The same cash flow conundrum is barreling down on venture capital and real assets, as well. Some hedge funds are temporarily closing redemptions while others are finding dislocations that will be tempting to double down on. The money will have to come from somewhere, and private equity will be one asset class among many chasing much-needed capital.

PE invests heavily in the most impacted sectors of the lockdown: restaurant chains, hospitality, entertainment. Market predictions depend on how long the lockdowns last. And there’s always the potential of unknown ripple effects that haven’t been detected yet. Private equity is much more global today and new hotspots keep emerging. 2008-09 data offers several useful clues on what lies ahead—the question is how big an impact this black swan will have on the private markets, and to what degree they can all stay ahead of it.