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The PE Market Rebound and the Rise of Supply Chain Pressures

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The private equity (PE) market has rebounded from a severely disruptive Q2 2020 to post record deal values in H2 2020 and 2021. As the asset class moves on from pandemic-related headwinds, PE managers are now focused on rising inflation and global supply chain strains on current portfolios as well as prospective deal pipelines for the next 12 to 18 months.

PE firms saw a remarkable surge in deal and fundraising activity in late 2020, which continued at an even stronger pace in 2021. Capital piles mushroomed, and dealmakers posted new records for buyout and exit activity.

According to Mergermarket, global buyout and secondary buyout deal values broke through the US$1 trillion threshold for the first time on record in 2021—and that was in the first nine months of the year. Restrictions around COVID-19 were being eased even as PE managers had adapted to execute deals remotely, which gave them greater reach and opportunity. There was an eagerness to make up the ground that was lost in 2020, spurring deals across the board.

The results are staggering, by any measure:

- Deal activity began to rebound in Q3 2020 and finished strong at the end of the year. By the end of Q3 2021, global buyout value was already 85% up from the US$629.2 billion in deals secured in the whole of 2020, per Mergermarket data. Buyout deal volumes were up 20% over the 2020 calendar year.

- Exit deal values reached unprecedented heights, coming in at US$442.2 billion in the first nine months of 2021, around 17% above 2020's full-year figure. Exit volumes of 1,812 deals for the first three-quarters of this year were 18% higher than the 1,535 exits recorded in the whole of 2020.

- Investors, noting PE's ability to steer portfolios effectively through pandemic uncertainty while continuing to deploy and return capital to investors, have been eager to increase allocations to the asset class. As a result, PE managers are replete with cash, sitting on more than US$2 trillion of dry powder, according to S&P Global—up from the US$1.6 trillion recorded in December 2019.[1]

At the same time, the changing shape of global supply chains—due to demand-driven shortages and subsequent bottlenecks, as well as rising commodity prices—has influenced the targets being considered.

Headwinds that may affect supply chain costs, from inflation to the threat of interest rate rises, will likely pose additional challenges for portfolio companies in the months ahead, especially those that have taken on increasing levels of debt to navigate the pandemic. This could have an influence on valuations and pricing if the cost of capital increases and the supply of leverage tightens.

Shortages and breaks in the supply chain

As well situated as PE is moving into 2022, investors are aware of the risks posed by shortages of key commodities and energy, as well as ongoing strains on global supply chains.

Distribution chains and supplies of key goods and services came under increasing pressure in 2021 as economies rebooted post-lockdown and demand skyrocketed. Manufacturers and distributors that mothballed operations when demand shrank under lockdown have struggled to bring production back to pre-pandemic levels in the face of labor shortages, tight commodity supplies and a squeeze on logistics capacity,[2] further exacerbated by similar squeezes on shipping, transportation and distribution capacity.

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>
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This is a global issue. China has been hampered by power outages,[3] and there have been shortages of truck drivers in both the United States[4] and United Kingdom,[5] where trucking industry groups believe that another 80,000 and 100,000 truck drivers, respectively, are needed to fill current shortfalls. This has affected supplies of everything from consumer goods to fuel and carbon dioxide.

Global shipping capacity has also been stretched to the maximum, prompting significant hikes in shipping costs. Analysis by Debtwire Par shows that container rate costs have tripled year over year, with heavily trafficked routes—such as the corridor between China/Eastern Asia and the west coast of North America—seeing costs more than quintuple.[6]

If supply chain pressures persist, PE firms will see sustained impact on the performance of their portfolio companies.

"There's been a lot of pressure at the portfolio company level due to supply chain issues. Sourcing products from suppliers has become harder, and the cost of manufacturing—even just creating supply at the portfolio company level—has gone up markedly," says New York-based Ropes & Gray PE partner **Carolyn Vardi**.

London-based Ropes & Gray PE partner **Elizabeth Todd** adds that portfolios in Europe have seen similar supply chain headwinds. Brexit added an additional layer of complexity, especially for sectors that relied on workers entering the United Kingdom from Europe. "There has been additional strain on labor due to Brexit, with a number of EU workers leaving the United Kingdom and returning home. This has been particularly felt in the retail and food sectors," she explains. "The double impact of Brexit and global supply chain pressures has proven really difficult."

> "We've seen a number of deals where there has been a lot of volatility and variation in EBITDA caused by supply chain concerns. This is significant, and disciplined players are now working hard to factor this volatility into their models. This is feeding into due diligence, and dealmakers are scrutinizing supply contracts even more closely."
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> *—Tsuyoshi Imai, Private Equity*

Supply chain issues are even having an impact on new investment opportunities, says Tokyo-based Ropes & Gray PE partner **Tsuyoshi Imai**: "We've seen a number of deals where there has been a lot of volatility and variation in EBITDA caused by supply chain concerns. This is significant, and disciplined players are now working hard to factor this volatility into their models. This is feeding into due diligence, and dealmakers are scrutinizing supply contracts even more closely."

Deeper diligence of supply chains has also emerged as a theme in European and U.S. markets. "Private equity players are much more sensitive to how difficult supply chain and labor issues are going to be for a business as volume and demand increase post-pandemic," says Todd. "Dealmakers are spending a lot of time on this. They're looking at the whole procurement process to assess how reliable key suppliers are."

In some cases, risks have been so acute that deals have stalled due to supply chain issues.

The large pools of dry powder available to PE managers may mean that it is a seller's market, but Imai points out that vendors are still able to pass on supply chain risk to buyers by leaving material adverse change clauses related to supply chains out of deal documents.

Vardi adds that many firms will walk away from a deal if they are unable to build sufficient comfort on supply chain, rather than try to chip away on price or mitigate risk in deal documentation.

Amid supply chain pressures, however, there are also opportunities. Firms with large portfolios have been able to support companies and add value by leveraging portfolio scale to lock in supplies and keep a lid on rising costs.

On the investment side, meanwhile, opportunities to reengineer and near-shore supply chains are emerging, as are options to invest in exit logistics and distribution assets, many of which have strong technology angles.

For example, Blackstone and New Mountain Capital secured a US$7.1 billion exit of supply chain management software group Blue Yonder to Japanese electronics giant Panasonic.[7] On the new deal side, investments in supply chain companies included Thompson Street Capital Partners backing warehouse management system platform Made4net.[8]

Rising prices, inflationary pressures and interest rates

Rising inflation has been a direct consequence of the global supply chain bottlenecks in 2021.

In the United States, inflation has reached 30-year highs,[9] European inflation has climbed to its highest level since the introduction of the euro,[10] and prices in China are climbing into the double digits.[11]

Although a World Economic Forum poll showed that most economists believe current levels of inflation are a direct consequence of COVID-19, with price increases linked to specific product markets rather than general inflation,[12] central banks are signaling their intentions to tighten liquidity by scaling back bond-buying programs and, in time, increasing interest rates.[13]

For PE firms, the jury is still out on how long inflation will persist, says New York-based Ropes & Gray finance partner **Jay Kim**, but PE managers are nevertheless building higher inflation into their scenario planning and portfolio management.

"Buyout firms are modeling inflation into projections, and while much of that is related to near-term supply chain issues, managers will continue to assess where inflation is headed and what it means for their investment strategy and portfolio management," says Kim. "The big question is whether to pass on increased cost to customers or absorb it. For now, portfolio companies appear to be absorbing some of the increases in the hope that this is a supply chain hiccup, but if inflation becomes more entrenched, you will see firms start to take more aggressive measures."

New York-based Ropes & Gray business restructuring partner **Ryan Preston Dahl** says wage inflation, prompted by tight labor markets, is especially significant for dealmakers managing their portfolios and interrogating the profitability of deal targets.

"Wage inflation can be particularly challenging, as wages are sticky. The situation is very different from input costs with respect to commodities or goods, where prices go up and down. It's difficult to reduce wages once they've gone up," says Dahl. "If wage inflation persists, it will become a major consideration for a number of businesses."

Dahl adds that even if portfolio companies can pass on wage and other price increases to customers, it is entirely possible that rising input costs will outpace the rate at which costs can be passed on, leaving businesses with eroding gross margins.

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>
> *—Jay Kim, Finance*

In addition to the direct consequences of inflation on portfolio and target company profitability, rising inflation and its role as a spur for interest rate hikes could also affect portfolio company capital structures.

In 2020, total debt for non-financial businesses climbed by 9.1% to reach US$17.7 trillion in the United States, according to figures compiled by Deloitte. This was almost double the average annual 5.5% growth rate observed between 2010 and 2019.[14]

Low interest rates have given companies a degree of breathing room to deleverage, post-pandemic panic, with minimal disruption. However, should rates rise, capital structures that were sustainable in a low-rate environment could start to dip underwater—especially in levered PE-backed companies.

Kim says companies with one- to three-year refinancing horizons will have the biggest exposure to inflation and interest rate rises. PE managers will focus on refinancing as a matter of priority to push debt maturities and avoid the risk of a liquidity cliff edge.

For now, however, default levels remain at near all-time lows. According to Fitch Ratings, there was an 85% fall in U.S. leveraged loan default volume in 2021, putting the default rate at just 0.6%.[15]

While a meaningful move in interest rates will absolutely correlate to higher default levels, says Dahl, many borrowers were previously able to secure covenant testing holidays during the pandemic and push out covenant compliance testing. This adds a further layer of protection should rate hikes push up debt servicing costs.

"A rising interest rate environment may result in lower free cash flow in the near term, but that may not produce immediate defaults, as companies will have the covenant headroom that offers breathing spells to let them see if they're going to survive with their existing capital structures intact," Dahl says.

Pricing pressures and supply chain issues are no doubt on the radar for PE firms and may signal more turbulent waters ahead. The real challenge is to keep a close eye on these macroeconomic trends as they develop to determine the right time to invest, given the various risks discussed above.

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ENDNOTES

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