What's Happening in Private Equity in Response to COVID-19? Q&A Session with Marc Friedberg of Wilshire Associates on COVID-19

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This is a first in a series of interviews with professionals to share information about how their businesses are reacting to COVID-19. Jordan Blask and Paul Welk of Tucker Arensberg, P.C. were the interviewers.

The impact of the COVID-19 pandemic has been felt across every cross-section of the world-wide economy. To get a sense of how different industries are coping with the virus' impact, Jordan Blask and Paul Welk of Tucker Arensberg, P.C., a Pittsburgh based law firm that represents clients both regionally and nationally, "sat down" via Zoom Meetings with Marc Friedberg of Wilshire Associates to get his perspective and outlook on how the Private Equity markets are addressing this unfortunate outbreak.

Marc Friedberg has worked at Wilshire Associates ("Wilshire") for the past 20 years. Wilshire is an institutional consulting firm and money management firm working with some of the world's largest public and private investors. Wilshire maintains offices in the United States, Europe and Asia. Marc is a Managing Director in Wilshire's Private Markets Group, where he and his team build private market portfolios for pension funds, endowments, foundations, corporations, and financial intermediaries. Marc's group also invests in everything from buyouts, to venture capital opportunities, to private real estate, and private infrastructure development through feeder funds or co-investment vehicles.

The following are excerpts from our recent interview with Marc.

Question from Tucker Arensberg: Marc, how would you describe the economy and investment markets prior to the COVID-19 pandemic?

Marc: It's been a very strong bull market, the strongest we've seen from a private equity standpoint. We've seen tons of capital being raised over the past five years. A lot of groups coming out of the woodwork, newer groups being formed, significant amounts of creep in terms of valuation run-up, and the amount of debt used in deals has also risen. There are huge amounts of dry powder [capital that is committed, but not deployed in any certain investment] both on the equity and credit side. This dry powder created a pretty robust environment where lots of deals were being done; different structures were being formed and generally, there were very strong returns across the board, not just in the public equity markets, but also in the private equity markets. With this sort of backdrop, coming into this year, our sense was that we were near the tail-end of the cycle. We were a bit concerned about where valuations would be when this cycle ended and we started shifting our portfolios a little bit to prepare for that eventuality. In preparation for a potential market shift, we began to raise capital for a private credit fund to invest in distressed funds that would focus in on investments in distressed assets and companies, and also alternative yield strategies such as music royalties, life insurance settlement funds, and Regulatory Capital funds. Now it's a tale of two investment worlds, on one side you have some investors frothing at the mouth for distressed opportunities, and on the other side you have folks that rapidly went into triage mode, or both scenarios when they have both capital deployed and capital waiting to be deployed.

Question from Tucker Arensberg: Prior to COVID-19, how did Wilshire allocate its investment capital?

Marc: We were active across the board. We looked at pretty much everything. We were trying to focus on things that were less consumer oriented in more recent times, just because of cyclical concerns. We took more defensive strategies in areas where we thought there was still a lot of room to grow. An example of this strategy is our recent equity deal with a Healthcare focused GP. They invest across the healthcare sector especially in pharmaceuticals, which we see as an area of additional growth. On the debt side, we've invested in real estate opportunities and we've been looking at aerospace and defense. We have looked at different types of industrial segments, including one with a specialty chemical focus. We consider ourselves a little bit of a value investor and don't like groups that pay a lot for companies. We generally like groups that are buying companies around 6 to 10 times earnings before interest, tax, depreciation and amortization ("EBITDA") not 12 to 20 times EBITDA. And when you see average multiples kind of creeping past 12 and 13, across the board, where 2008 levels were, even under that before the crash, you start getting concerned with these valuations and then the amount of debt that most of these acquisitions are taking on so we focus on investments in companies with less debt and lower valuations which tends to serve our clients well when a downturn happens. We like how our portfolios are positioned right now.

Question from Tucker Arensberg: So how has Wilshire been formulating a repositioning strategy in response to COVID-19?

Marc: So we've been doing the same thing as a lot of other folks. We spent some time early on in March doing triaging. Looking across our portfolios. We have exposure to over almost 200 different partnerships across the various industries and in different categories.

First phase, we started with trying to evaluate the areas of risk in our portfolios. The way that we went about it might have been a little different than others. We basically wanted to figure out what's going to be impacted in our pool of investments by looking at anything that's been invested in the last 2-3 years. We knew that these investments are going to be facing some problems. Specifically, we looked at our investment funds that had a high amount of drawn-down capital, what is called paid in capital. If an investment had a low amount of paid in capital, where they have not drawn down a lot of capital, we considered those invested funds lower risk. Those lower risk funds are actually going to be positioned very well. Then we did an overlay of the high risk funds with that of different industries. We looked through our 200 plus partnerships and deciphered what industries they are exposed to and started to stress test our investments around what the market was doing as some segments took a 30-40% hit in the early weeks of the outbreak.

So let's say the public markets were down 30% or 40% at any given time. You know the valuation expectation in private equity is going to lag because there is accounting diversification. Private equity assets are not marked to market in real time. People are not overselling these assets just because of what's going on in the market. Although private equity is going to lag, it is still going to go down because revenues are going to go down as a result of the stresses across the economy. If markets were down 30%, we assumed most of these private assets will go down 2/3rds of that amount. Then once we figured out which investments are high risk and low risk, that's when we start our qualitative analysis and began to make calls to each of the groups that we think were of higher concern.

Second phase we are telling our clients to invest in current market opportunities. Clearly the most obvious sign is the distressed markets. There are going to be multi-billion dollar funds that are going to be raised in the coming weeks that will invest in both traditional private and public market opportunities for special assets and turn-around stories and more obscure investments such as distressed toll roads. There are going to be opportunities in what we call distressed trading. These are public securities in debt positions being traded among individuals or institutions. That is the easiest way to transact. You can get in and out of it quickly. Hedge funds, typically, high yield managers and distressed players are in that space. That is going to be the first tranche where people are buying now and probably going to take advantage of that. Then, what you are going to start seeing is companies in distress, private companies in distress, kind of as a fallout, where people require liquidity and that is where these less liquid type of investments can be effective and will become available. This is the area where we like to invest when the economy takes a downturn. Things like more turnaround type of situations, special situation funds, and distressed for control investments.

In fact, we have decided to reallocate the investment grade direct lending component of one of our annual fund series which was targeting 40-50% of that fund to 100% distressed and opportunistic strategies across the spectrum of both private and public credit.

Question from Tucker Arensberg: With the onset of COVID-19, how will Wilshire balance capital allocations in terms of supporting what it has previously invested in versus using that "dry powder" to go out and take the opportunities that are going to be there in the upcoming weeks and months?

Marc: For us it's different. For us it's easy to do because we do not have to reserve capital. If I commit $5 million dollars to a fund I'm a Limited Partner ("LP") in that fund. I'm only committing that $5 million. But for the General Partners, they are where that threat assessment comes into play. If they have already drawn down all of their capital and they haven't had any realization, then they are going to face liquidity issues. They won't have additional money to draw down from their LPs. It is going to be hard to go to the market to raise funds and debt providers are probably not going to be there. I would tell you that their first priority is going to be triage. It is going to be saving the existing companies. If you have a buyout fund and you have 10 investments and you lose 2 of them your returns are underwater. They are going to be spending a lot of time triaging, making sure that they have the liquidity they need. My guess is that a lot of larger groups that have large existing portfolios, their dry powder for new investments won't be in the form of new platforms. They are probably trying to identify smaller companies for their existing platforms. They will likely look to consolidate the competition for their existing companies by moving into acquisition mode within the industries their current investments are focused to take advantage of pricing discounts.

Question from Tucker Arensberg: Is Wilshire asking its lawyers or advisors to put anything new in deal covenants or otherwise in light of what has happened over the last month? Additionally, how does Wilshire evaluate "business continuity" from the operational side in light of the worldwide pressures that we are dealing with right now?

Marc: We are re-evaluating deals that were in the process of closing. If we were ready to commit and we were getting the paperwork done and had not signed on the line yet, it is getting re-evaluated and we are asking to revisit data rooms. We are re-underwriting in a sense. But, from a legal standpoint, no, we have not asked for anything new in terms of deal terms. I would imagine that we will start to add questions in our RFQs related to the COVID response in terms of exposure levels and what they are doing, such as back-up plans, but most of this was already in our operational due diligence.

Additionally, we always do down case scenarios when we are looking at any investments. Our philosophy is that if you control the down side and control your losses, then you are going to do pretty well. So we spent a lot of time understanding how you can lose money in certain deals and you don't want that to be in areas where you don't anticipate it. We include that mostly in our operational due diligence. Our operations team goes in separately from the investment team to make sure they have the proper infrastructure in place. Not that much of an issue for us. Again, we are dealing with GPs mostly and not the underlying company.

Question from Tucker Arensberg: As a parting thought, what would you suggest that an opportunistic investor take a look at for their own portfolio over the coming months?

Marc: In the near term, we anticipate a significant opportunity in distressed and opportunistic investing strategies, particularly on the credit side. These range from specialized direct lending funds, dislocation funds across the credit continuum, straight distressed debt strategies, and special situation strategies.

*Thank you to Marc Friedberg of Wilshire Associates for sharing his insights on how the private equity markets are responding to COVID-19. We will be sharing interviews with other professionals in*cluding *our next interview with Nathan Agens, Managing Director, PNC Bank Assets and Liability Management Group. If you have suggestions for interview topics or professionals, please contact Jordan Blask.*

About Marc Friedberg

Marc serves on Wilshire's Associates' Management Committee and the Wilshire Private Markets Investment Committee. He leads the private equity advisory and customized solutions efforts. He is also responsible for sourcing, performing due diligence, and monitoring investments across private markets sectors within the U.S. Prior to joining Wilshire Private Markets in 2010, he was a Managing Director within Wilshire Consulting, which he joined in 1999. His investment experience began in 1997. He has consulting experience with many types and sizes of investment funds, including corporate and public pension funds, endowments and foundations. Marc has extensive experience structuring institutional portfolios across all asset classes for a broad range of client types and portfolio objectives. He received a Bachelor of Arts degree as a dual business/communications major and a Master of Business Administration with a concentration in finance and economics from the University of Pittsburgh. He also holds the Chartered Financial Analyst designation and is a member of the Pittsburgh Society of Financial Analysts. Marc can be contacted at 412-434-1580 or via email at mfriedberg@wilshire.com. To learn more about Wilshire Associates visit them at www.wilshire.com.

About the Interviewers

Jordan serves as the Co-Chair of Tucker Arensberg's Bankruptcy and Creditors' Rights Practice Group. He a member of the firm's Board of Directors, and its Chief Compliance Officer. Jordan is the shareholder in charge of the firm's COVID-19 Rapid Response Team and is the curator of Tucker Arensberg's COVID-19 "Answers to Business Challenges" blog. Jordan can be reached at 412-504-5597 or via email at jblask@tuckerlaw.com.

Paul serves as the Co-Chair of Tucker Arensberg's Mergers and Acquisitions Practice Group and as Co-Chair of the firm's Health Law and Long Term Planning Practice Group. Paul is also a licensed physical therapist. Paul can be reached at 412-594-5536 or via email at pwelk@tuckerlaw.com.

Thank you to Edward J. Grattan, II, Esq. for his assistance with authoring this article. Ed is an attorney within our Business and Finance Group and concentrates his practice on corporate finance, governance and compliance/regulatory issues.

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