The corona crisis is challenging, but it also presents opportunities

Exclusive interview

Dark clouds may currently fill the sky, but at some point they will begin to lift. Here, **Christian Frigast,** DVCA's Executive Chairman, **Christian Schmidt-Jacobsen,** Axcel's Managing Partner, and **Lars Rebien Sørensen,** Chairman of the Novo Nordisk Foundation and of Axcel's Advisory Board, give their take on where we stand.

EFFECTIVE VACCINE NEEDED

Everyone is asking how long the crisis will last. What are your thoughts?

"Although no one knows the precise answer, we can already see that the repercussions will extend well into 2021," says Lars Rebien Sørensen. "The length of the crisis will be determined by how we address the risk of infection, and I don't think we'll return to normal until we have an effective vaccine. That could take a year – perhaps more."

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"The crucial thing is being able to balance our efforts," says Christian Frigast. "Up to now, we've prioritised health over all other considerations, which has been essential. Now we've reached the point where we also need to consider young people's education, the job situation and companies' finances. Denmark has a lot to gain if we can bring other facets into the decision-making processes."

"I'm an optimist by nature, and I'm pleased that Denmark and a few other countries will soon be open for business again," says Christian Schmidt-Jacobsen. "But undoubtedly there'll be some fundamental changes in our economy that will require adaptation."

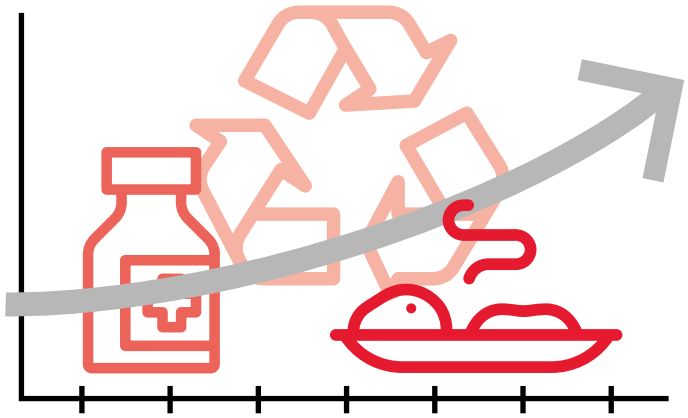
The big paradox right now is that we're looking at a future that is more uncertain than ever with the prospect of disastrous financial statements and sky-high unemployment, yet share prices are pretty much normal. But can that last until we're out of the shadow of corona?

"THE 90% ECONOMY"

"Many companies that are exposed to generally robust sectors like food are operating on the basis of scenarios of lower activity levels for years to come, which *The Economist* recently dubbed 'the 90% economy'," says Christian Frigast. "At some point, this could also affect share prices, especially if fear of another wave of the epidemic starts spreading."

The fact that share prices are seemingly not aligned with future earnings prospects has caused Lars Rebien Sørensen to reflect on what is actually going on:

“It’s my impression that some tech stocks are priced on the high side,” he says. “Even before the crisis, many of them had very high PE ratios, but it’s hard to see how this can continue now that demand is falling. It may well be that more people are watching Netflix and shopping on Amazon, but advertising revenues at Google and Facebook have to fall when the advertising disappears, and investors will be forced to reckon with that sooner or later.



“In the future, the USA especially will be affected by the fact that someone has to pay the bill for this historic crisis. Other lucrative markets for Danish companies in, for example, the Middle East are also being affected by the plummeting oil price, and all in all this is bound to put earnings under pressure in future. That could make me a bit nervous. But Danish companies aren’t too badly placed in the export markets. Medicine, foods and green solutions, which are Danish strengths, will not be any less sought after in future.”

"I think we need to look at the traditional stock index from a new angle," says Christian Frigast. "Some tech and pharma shares have broken away from the traditional industrial and service companies and become the new gold where investors are seeking refuge, so I don't think you can use the S&P, or the Danish C25 for that matter, as a guide to the general health of companies.

COMPANIES GOING UNDER

"The corona crisis will result in a lot of companies going under, either due to the lockdown or from the lack of export opportunities. If Denmark is to re-establish the private-sector jobs we've lost during the crisis, we need to promote new ideas and new businesses in Denmark.

"It's no good being reliant on a single supplier in China – we've learnt that now."

We should make it even easier to set up a company, because it's probably become too costly and complex to get started. However, we also need to recognise that we're in the middle of a demand crisis and that the economy won't really get going properly until the demand returns."

Protectionism and shorter value chains are the new black

"We're looking at a world where value chains are getting shorter and we need far greater security of supply," says Christian Schmidt-Jacobsen. "It's no good being reliant on a single supplier in China – we've learnt that now. It might mean slightly higher costs than we've been used to, but we need to be sure we're in control of our supplies. We're making plans for that now in many of our companies."

When it comes to more complex production, such as pharmaceuticals, Lars Rebien Sørensen is sceptical about whether you can simply break up the value chains as we know them:

"The USA will probably be able to cope on its own because it's a huge market, but in Europe it will be hard because, even though the EU as a whole is a big economy, we're still not sufficiently integrated, which means we're dependent on the world economy functioning," he says.

"But it's clear that the global order as we know it has come under pressure. That was the case before corona, and now it's really been amplified.

INTERNATIONAL RACE TO COME UP WITH A VACCINE

"At the moment, there's an international race to see who can come up with the best corona vaccine, and although we can't rule out Danish researchers producing something that can be used, we must support international solutions, and I think there'll be more than one type of vaccine. However, we need to follow the rules of clinical testing, because you don't fool around with a vaccine like that, especially not when the entire world population needs it. Conversely, this crisis has shown us that there's a need for an independent Danish preparedness so we don't run out of vital medicine and personal protective equipment, and I think we can do that in a public-private partnership where the government identifies the right partners."

We turn now to the opportunities for Denmark in international cooperation. Of Denmark's GDP of around DKK 2,300 billion, DKK 1,300 billion comes from exports, and that makes us vulnerable to a lack of sales opportunities. Even optimists suggest that exports could fall by at least 10-15% in 2020 and that there is a risk that there will be no significant improvement in 2021. How can the EU help resolve this historic crisis?

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"I think we need to make sure that the EU remains united. The USA and China will become more inward looking, and Europe needs to drive growth itself," says Christian Frigast. "A Europe divided between south and north would be toxic for that. It goes against the grain for us to write blank cheques for those who don't keep their own house in order, but we're going to have to look at restoring southern Europe. The alternative is an EU with low growth in which we all become poorer. One instrument that's been used before might be perpetual bonds with a fixed low interest rate. There's also the risk that populism will flare up to an uncontrollable level, and we can't let that happen."

Lars Rebien Sørensen agrees in principle, but adds:

POLITICAL SUPPORT?

"Obviously we need stronger EU cooperation as a counterbalance to the USA and China. But if the Italians expect us to make loans available without any covenants, that's just naive and, politically, it simply can't be done. We should help the Italians so they don't go bankrupt, but it's problematic that we know that their private wealth is considerable because it suggests they can't get their tax system to work. So one of the conditions for cheap loans must be that they get to grips with this sort of thing, otherwise there'll be no political support for it."

"Even during this crisis, we deemed the investment opportunity too good to pass up."

What does one invest in during a historic crisis?

It came as quite a surprise to the market when, around Easter, Axcel decided to invest in the Norwegian IT company SuperOffice. How dare anyone invest in companies when the whole world has come to a standstill?

"It was a process that had been ongoing for some time and before corona really emerged in Europe, and obviously we considered putting it on hold when the crisis hit," says Christian Schmidt-Jacobsen. "But after considerable deliberation, including further discussions with the seller, we decided to proceed. Even during this crisis, we deemed the investment opportunity too good to pass up."

A SOLID PLATFORM

"There's no doubt that at the moment everyone who can is digitalising their business models, and that new players are lying in wait everywhere, which could create considerable upheaval during a crisis like this one," says Christian Frigast. "So I'm delighted that in the past four to five years Axcel has built up a solid platform in industries such as IT, both in terms of networks and skills. That's worth building on further."

FORMING AN OVERVIEW

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"In the next six to eight months, we'll probably be a bit restrained – and we'll definitely avoid overly cyclical companies or those that face challenges due to social distancing," says Christian Schmidt-Jacobsen. "On the other hand, we'll keep an eye on some of the companies that will benefit from this crisis in the longer term, and we're well underway forming an overview of that.

"It's interesting, though, that many of the funds raised on the brink of a crisis have delivered really good returns historically. As investors, we'll have some opportunities to invest in companies whose biggest problem is perhaps just a lack of capital, so there we can perhaps create a return by helping them. Naturally, there will also be pitfalls, because the biggest problem right now is that it's become hard to predict what the macro prospects are."

THE FUTURE

"The number of transactions in the M&A market has fallen drastically," says Christian Frigast, "which we also saw during the financial crisis. It will improve when we know the future a bit better, and it's beneficial for the process that the Danish government – and governments in leading countries – are now revealing how they're going to open up more.

"For many of the small and medium-sized companies, we must recognise, however, that there's a need for them to be recapitalised if they are to survive. So it's vital that things are now opened up so that private money can be brought into play and it becomes attractive to invest directly in companies. The government must help by providing the right framework."

What are investors saying?

Many investors are unsure about the future, and this could also impact on private equity firms' opportunities to invest – especially Axcel, which is in the middle of raising a fund. What does this mean for Axcel?

"In the present situation, it's a strength for Axcel that we've invested only 75% of our capital, because the firm now has capacity to support its companies," says Christian Frigast. "This also meant, in particular, that we were able to put extra impetus into raising Axcel VI, where we've now completed a first closing of more than EUR 500 million. There'll be many opportunities to invest now, because equity in many companies is under pressure. And from time to time it'll be necessary to have new owners. Here, private equity firms can play a role – with regard to both turnaround and delivering equity solutions. In any case, there won't be any fewer opportunities for private equity firms as a result of corona."

Christian Schmidt-Jacobsen is also relieved that Axcel got Axcel VI up and running:

PORTFOLIOS

"We can see that the investors are now sitting and pondering what the crisis means for their portfolios, and the vast majority are finding it difficult making decisions at present. Some of them – but only a few – are hardly investing at all for the time being. Then there's a broad middle group who need time to condense the changes and primarily want to invest together with those they already know. The final group – again, a small group – is largely unaffected. The bottom line, however, is that while we might have hoped that Axcel VI would be fully raised around the summer, we now have to recognise that we won't be done until the autumn."

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We must all show restraint – but it is returns that keep investments going

The private equity model is often associated with stories of big personal returns for a small group of investors, and for some years there has been widespread debate about remuneration for senior executives that can seem out of step with ordinary people's income. In the current situation, the European Commission has put forward proposals that companies in receipt of support packages should not be able to award bonuses to senior executives or pay dividends to their shareholders.

This is a line that the Danish government is also supporting. What do you think about that?

EVERYONE HAS TO TIGHTEN THEIR BELTS

"I listen to the debate and for the most part I understand the thinking on restraint, which I think will happen automatically," says Christian Schmidt-Jacobsen. "Many CEOs and directors in our companies have already taken a pay cut because everyone has to tighten their belts if we are to get through this crisis. We can't pay out money that isn't there."

Christian Frigast is slightly more sceptical about the philosophy of not paying dividends:

"It's particularly important to be really careful, whatever the form of ownership, when using support packages."

"I fully agree with the need for everyone to show restraint, and that there's a need right now to build up capital. It's particularly important to be really careful, whatever the form of ownership, when using support packages. But if you imagined for one moment stopping paying dividends, it would have huge consequences for the whole financial system. After all, it's through dividends that you release capital so that new money can flow into companies. If you lose that option, it could put the brakes on economic growth in society."

"We were in no way prepared to have to sit in one crisis meeting after another."

Was Axcel properly prepared for the crisis?

The crisis hit Axcel extremely quickly, but just 14 days before the lock-down no one had seen it coming. How has Axcel responded to the challenge?

"Even in the middle of February we were taking the threat relatively lightly; it was something out in Southeast Asia, and it would doubtless pass, as was the case with SARS and MERS," says Christian Schmidt-Jacobsen. "We were in no way prepared to have to sit in one crisis meeting after another just a fortnight later, because we'd listened to the experts and they didn't think the virus would reach Denmark. But we were prepared inasmuch as we were able to recall the last crisis. After all, it's only 12 years since we faced similar challenges during the financial crisis.

"We immediately established a crisis team and identified which of our companies would be worst affected. We went through their cost bases with a fine-toothed comb and nailed down their cash flows. It's been a relief to get the support packages from the government, which we've obviously drawn on heavily, and this has meant we've been able to hold back on redundancies. At the same time, we've received good support from the banks, which have shown the necessary flexibility.

"We've deliberately not invested in companies that are too cyclical. We have no shop chains or restaurants in the portfolio, even though it might obviously be tempting to invest in that type of thing under more normal circumstances."

Everyone can see this is an extraordinary situation, and it's a good thing we have some banks with the muscle to support companies.

"But imagine if we'd started out with the rather thin capitalisation that we have in our companies; we'd have been in a bad way in a very short time – support packages or not. Private equity firms prefer to put their money to work rather than having it sitting around gathering dust. The precondition for that is being able to provide capital and insight on how to get out of a hole when it's needed. In that regard, it's also pertinent that over the years we've built up solid relationships with financial partners, so we're able to come up with solutions together that enable us to look 12-24 months ahead. Furthermore, in both Axcel IV and V we've deliberately not invested in companies that are too cyclical. We have no shop chains or restaurants in the portfolio, even though it might obviously be tempting to invest in that type of thing under more normal circumstances.

"The way we've designed our response means that we can now spend time assessing which of our companies need to make changes and which we think can carry on as before when we get through this. That's another strength of the private equity model, because we have insight into how different business models respond in stress situations. All the

same, we're looking at 2020 being a lost year in terms of creating returns, and that's a long time if you want to keep your ownership down to around five years. But that's just how it is – it's the same for all private equity firms.

NON-VIABLE BUSINESS MODELS

"The first wave of companies to run into difficulties is probably also those with business models that are no longer completely viable, and unfortunately we've already seen the first examples. We won't invest in that type of company. But in six to eight months' time, I dare say there'll be companies appearing on the radar whose only problem is a lack of capital. That might well present opportunities because, even though there's lots of cash out there, the amount of risk capital is extremely limited during a crisis like this one," Christian Schmidt-Jacobsen concludes.

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