2021 Private Equity Outlook: H1 Follow-Up

Assessing our predictions as we emerge from the COVID-19 pandemic

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2021 predictions

Introduction

Coming in to 2021, many of our predictions hinged upon the pace of the US vaccine rollout and ensuing economic recovery. As of June 30, 2021, more than 180 million people living in the US have received at least one dose of a COVID-19 vaccination.[1] The speed has blown away our most bullish predictions and provided a tailwind to many of our outlooks. PE dealmaking is proceeding at a breakneck clip. Due diligence meetings for fundraising and dealmaking are now taking place in person, thus assuaging concerns that activity in these spaces may lag throughout the year. Additionally, LPs are in a much better position to make new fund commitments, which boosts the prospects for fundraising GPs—especially emerging managers. We look forward to 2021's remaining six months to observe how the market evolves and whether the PE industry can continue its current fervent pace.

1: "Coronavirus Pandemic (COVID-19)," Our World in Data, Hannah Ritchie, et al., July 6, 2021.

Prediction: PE fundraising will surpass $330 billion, thereby setting an all-time high.

> **Rationale:** Doubtlessly dampened by the pandemic, US PE fundraising slowed in 2020, but we expected it to rebound in 2021 and ultimately surpass the $316.9 billion high-water mark set in 2019. Both in surveys and anecdotally, institutional investors say they plan to boost their allocations to alternatives—of which PE is the largest chunk. GPs are also increasingly offering strategies that fall under the PE umbrella, such as additional buyout funds or growth equity. Lastly, the boom in public equities since March 2020 will likely be a boon for PE managers through a mechanism known as the reverse denominator effect.[2]
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> **Caveat:** The major unknown in any prediction for 2021 pertains to what happens with COVID-19. If the pandemic drags on, allocators—especially university endowments and healthcare systems—may pause new allocations to conserve cash. Further economic carnage could drive investors away from risky assets, which would hamper new fundraising efforts.

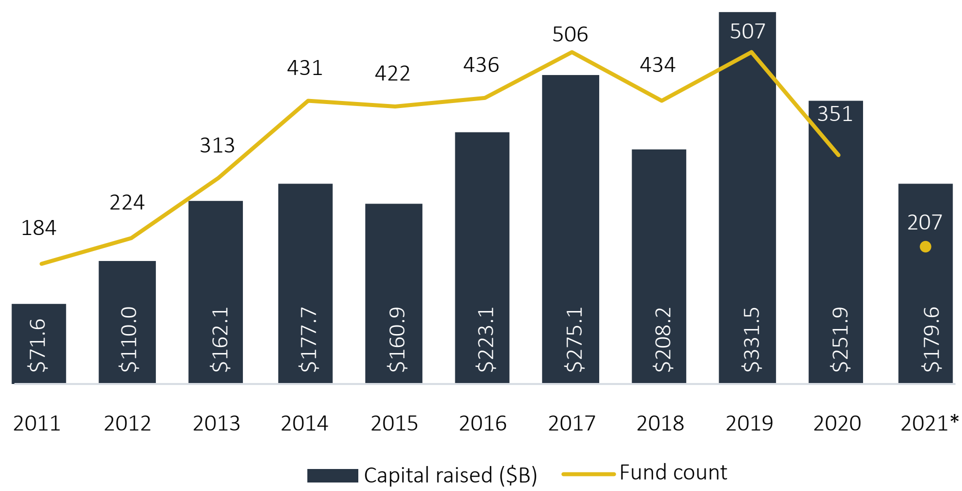
H1 2021 update: This prediction is on pace to come true.

We are on pace to break the all-time fundraising record and possibly surpass $350 billion. In the first half of the year, household names including Bain Capital, Silver Lake, TA Associates, and others closed on $10 billion+ funds. This propelled H1 2021 fundraising to nearly $180 billion in the US alone. However, the strength of the fundraising market was not limited to just the mega-managers. Middle-market and smaller firms benefited from a rising tide as LPs look to quickly deploy capital.

Looking to H2: Most of this record will depend upon a handful of massive funds. Hellman & Friedman closed on $24.4 billion in July. Firms including KKR (NYSE: KKR), Carlyle Group (NASDAQ: CG), Insight Partners, Veritas Capital, West Street, and others will play pivotal roles. Further, reports suggest KKR has effectively wrapped up fundraising. Another tailwind here is that fundraising tends to be back weighted, which means that Q3 and particularly Q4 of each year typically see more capital close than during H1.

2: The reverse denominator effect: When the value of other parts of an allocator's portfolio grow in value, the commitments needed to maintain a target allocation to PE grow in lockstep.

PE fundraising activity



Source: PitchBook | **Geography:** US
*As of June 30, 2021

Prediction: 20% of buyouts will be priced above 20x EBITDA.

> **Rationale:** Price multiples in both public and private markets have been elevated for some time, and we foresee no reason for this to change in 2021. The S&P 500 now trades well above median buyout multiples, thereby providing upward pressure on pricing. Buyout funds are also increasingly targeting growth-stage technology companies that tend to trade at a much higher multiple of earnings than the traditional PE target. Even if pricing remains the same for most businesses, a higher proportion of buyouts taking place in sectors such as software and biotech should boost the proportion of deals in this pricier range.
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> **Caveat:** If the world bounces back to normal after a COVID-19 vaccine arrives, we would expect to see multiple compression for those businesses that have benefited from the lockdowns—which would decrease the number of deals completed above this threshold. Alternatively, the COVID-19 pandemic could worsen, which would dampen not just economic activity but also the broader appetite for riskier assets.

H1 2021 update: This prediction is on pace to come true.

US PE has continued to trend toward elevated buyout multiples, with around 27% over 20x EBITDA so far in 2021.[3] Although our rationale for this prediction focused on larger or faster-growing companies, robust valuations are taking place up and down the market. For $500 million+ assets, PE firms are competing with both highly acquisitive strategics and hundreds of uncommitted SPACs. In turn, this has forced many firms downstream, thus pushing up the prices of lower-middle-market platforms.

During 2021, the COVID-19 pandemic's effects on multiples have been twofold. First, the pandemic drove a flight to quality, which further accelerated the industry's pivot toward high-multiple growth industries and increased the value of companies that proved resilient during the downturn. Second, because many deals were canceled or delayed during 2020, GPs are now racing to make up for lost time in deploying dry powder, thereby further increasing competition and driving prices upward. One caveat is that the proportion of US PE buyouts that are add-ons continues to climb and may top 75% by the end of the year. This is both a product of the high-multiple environment—because add-ons allow for multiple arbitrage—and a potential salve for it.

3: Data counts are low for 2021.

Prediction: At least 20 PE-backed companies will enter US public markets through a reverse merger with a SPAC.

> **Rationale:** More than 200 SPACs launched in 2020—more than tripling 2019's figure. These blank check companies typically have two years to complete a deal before returning their capital to shareholders, which means hundreds are hunting for deals. As PE firms become more comfortable with SPACs and the quality of SPAC sponsors rises, PE firms will look to this option with increased frequency. An additional point that could propel SPAC interest for PE firms is the rise in growth-oriented investments—especially in the tech and healthcare realms. These companies benefit from the ability to be priced on forward earnings in the valuation process—something that SPACs allow, while traditional IPOs do not
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> **Caveat:** PE firms may take longer to get acquainted with SPACs and therefore delay action until 2022. Further, the dynamic with founder shares could be seen as leaving too much capital on the table and thus dissuade PE firms from pursuing this exit strategy.

H1 2021 update: This prediction is on pace to come true.

In Q2, 15 US PE-backed companies merged with SPACs, and another 19 mergers were announced. Few predicted that the wave of SPAC IPOs that began in late 2020 would continue through March 2021, with a steady trickle of new SPACs still emerging despite regulatory backlog and cooling investor enthusiasm. Because SPACs are typically required to merge with a company within 18 to 24 months, SPAC sponsors will become increasingly aggressive in their pursuit of targets as the year progresses. Because SPAC mergers are popular with growth-stage companies, the expansion of growth equity as a PE strategy has also expanded the universe of PE-backed companies that are probable SPAC targets.

For their part, PE firms may be attracted to SPAC exits for three reasons: because they allow companies to go public more quickly than traditional IPOs, because the firms may be able to negotiate for founder shares, and because the postmerger lock-in period is typically less stringent than it would be post-IPO. On the other hand, favorable public market conditions mean that PE firms may be happy to hold public shares of a listed portfolio company within a fund—and collect management fees on them—for an extended period. The largest PE public exits in H1 2021 occurred via IPO, not SPAC. Although reaching 20 PE-backed SPAC mergers in 2021 is all but inevitable, PE's appetite for SPAC exits may wane by year's end.

Prediction: There will be at least one new type of exit from a GP stakes portfolio in 2021.

> **Rationale:** In recent years, more than 100 GP stakes deals have taken place, with innovation centering on deal types and target GPs—although innovation on the exit side has been lacking. A lift in pricing—whether it be through a strip sale, securitization, portfolio IPO, or something else—will help with future fundraising efforts and potentially draw more LPs. Funds including Dyal II and Petershill II are aging to the point that LPs may pressure them for additional liquidity options.
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> **Caveat:** Several fine options for monetizing GP stakes already exist, including sales to strategics or other sponsors. Fear of the unknown may dissuade GP stakes firms from experimenting with new options. Additionally, the GPs that sold stakes to those funds may push back on certain exit options if they believe they would be adversely affected.

H1 2021 update: This prediction is on pace to come true.

This prediction was written after Owl Rock and Dyal announced their merger and public listing as Blue Owl (NYSE: OWL), which has since taken place. Although this public listing of Owl Rock—when Dyal owned a roughly 20% stake in it—is a first and thus a new type of exit from a GP stakes portfolio, we are not counting it because it predated our prediction.

In late June 2021, Bridgepoint—a firm in which Dyal also holds an approximately 20% stake—announced its plans to go public on the London Stock Exchange (LSE) through an IPO. This transaction would be a new type of exit for a GP stakes portfolio because the manager going public is not merging with the firm that owns a stake in it. Despite this prediction coming true, we still believe another new monetization method will either be completed or announced in the remainder of 2021. Options here include a recap, portfolio IPO, and strip sale, among others. We detail all major monetization paths in a more detailed analysis on the subject here.

Prediction: Carveout deal value will hit the highest level on record.

> **Rationale:** Hundreds of large public companies are struggling because of the economic burden brought on by the pandemic. Further adding to the strain, many of these large companies increased their debt loads early in the pandemic, expecting this leverage to get them through to the other side. Nine months later, the revenues of these companies continue to be pressured, and they do not want to risk becoming overly indebted. While many large companies are struggling, PE firms have been raising hundreds of billions of dollars and sit on around $1 trillion in dry powder. These PE firms have seen dry powder mount throughout the pandemic as traditional leveraged buyout (LBO) activity diminished but fundraising remained healthy.
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> **Caveat:** Fed liquidity injections will keep rates low enough to dissuade large companies from selling noncore assets. Alternatively, a new administration could contain the spread of COVID-19 better than the previous administration. This, combined with an accelerated schedule for a new vaccine, could lead the economy to recover more quickly, thus negating the need to divest these businesses.

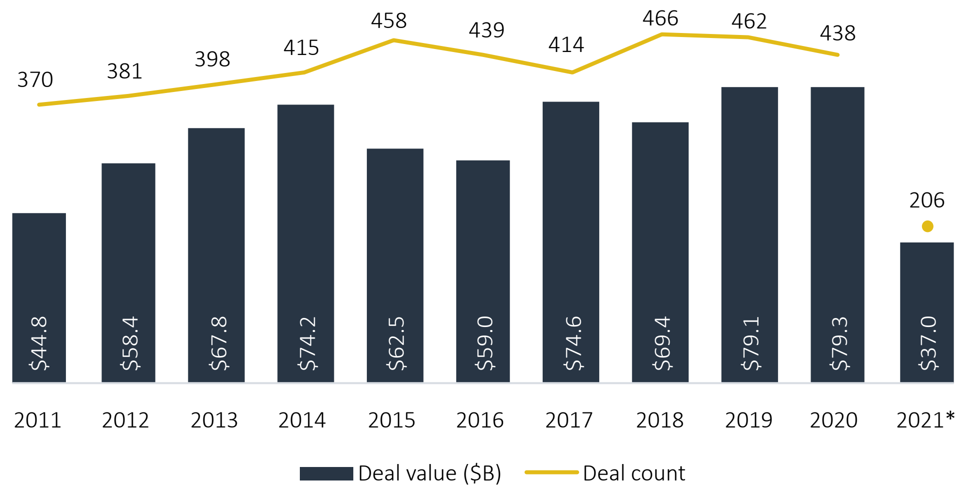
H1 2021 update: It is not yet clear whether this prediction will come true.

Carveout activity has flourished in 2021, though not for the reasons we predicted. Dealmaking of all kinds is red hot this year. Large carveouts, including Advent's $2.7 billion acquisition of NielsenIQ from Nielsen (NYSE: NLSN) and Francisco Partners' $1.1 billion carveout of Forcepoint from Raytheon (NYSE: RTX), have driven deal count and value higher through the first half of 2021. However, as a percentage of dealmaking activity, carveouts are actually marginally lower than during recent years. While this prediction may come true, it will be for different reasons than we predicted.

In each of the past few years, we have predicted a rise in carveout activity, and the deal sourcing method never quite breaks out. Bankers and PE firms laud the benefits of carveouts, with their increased complexity and potential to shore up cash on the balance sheet for large corporates. But that has not translated to a rise in deal activity. Corporate CEOs also extol running lean operations, but high confidence levels have meant that these leaders are far more often acquirers than divestors. Moreover, nearly four in five executives surveyed by Ernst & Young report that carveout pricing did not meet their expectations, thus making future deals less likely.[4]

4: "Global Corporate Divestment Study 2021: Can Divesting What Holds You Back Move Your Strategy Forward?" EY, 2021.

Carveout deal activity



Source: PitchBook | **Geography:** US
*As of June 30, 2021

Prediction: First-time fundraising in the US will be the strongest since the GFC.

> **Rationale:** First-time funds struggled throughout the pandemic—putting up numbers similar to 2010. The lack of in-person due diligence has put PE firms without existing LP relationships at a disadvantage, making each incremental commitment far more challenging than usual. Pent-up demand for this product, with dozens of funds still in the market, will likely lead to a healthy first-time fundraising environment. The number of new PE firms may see a boost as well, thus adding to the number of GPs seeking to close a first-time fund.
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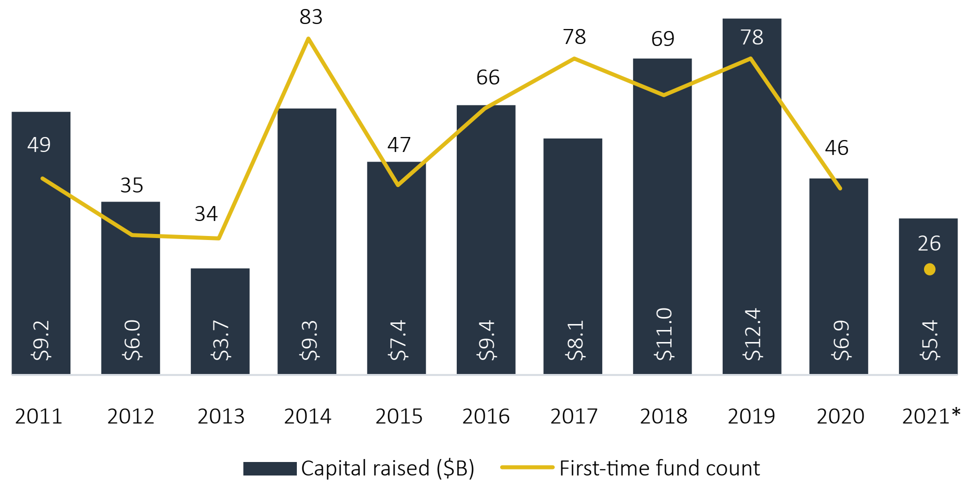
> **Caveat:** In-person due diligence will remain unfeasible for much of the year. A delay in a COVID-19 vaccine could mean no in-person business meetings for the entire year, which would dim prospects for first-time GPs. Further, a roaring public equity market may lift valuations in the private markets as well and thus boost carry for these GPs and help retain employees who otherwise may go launch a new fund.

H1 2021 update: It is not yet clear whether this prediction will come true.

First-time funds are experiencing a steady recovery in the US PE market, with over two dozen closings during H1 2021. We are seeing institutional investors move away from the cautious tactics undertaken during the pandemic, while increased interest is emerging for higher allocation to alternatives—specifically PE. LP appetite exists to both build new relationships and find new places into which to put capital. So far in 2021, first-time funds have already closed on $5.4 billion and are on pace to set a record. As a percentage of all US PE funds, first-time funds sit near those of recent years and are well below the rate during the strongest first-time fundraising years since the GFC.

While competition is higher for first-time fund managers, they now have more options to enter the market and fundraise. First-time funds are gaining access to first-close capital from various sources, including sophisticated family offices, anchor commitments, and dedicated seeding platforms, among others. With a larger playbook, new GPs are successfully raising capital despite challenges such as the lack of track records or strong networks.

First-time fundraising activity



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