2021 European Private Capital Outlook

Forecasting the primary trends that will shape the European PE and VC industries in 2021

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2021 predictions

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Prediction: European PE deal activity to top €480 billion and set a new high in 2021.

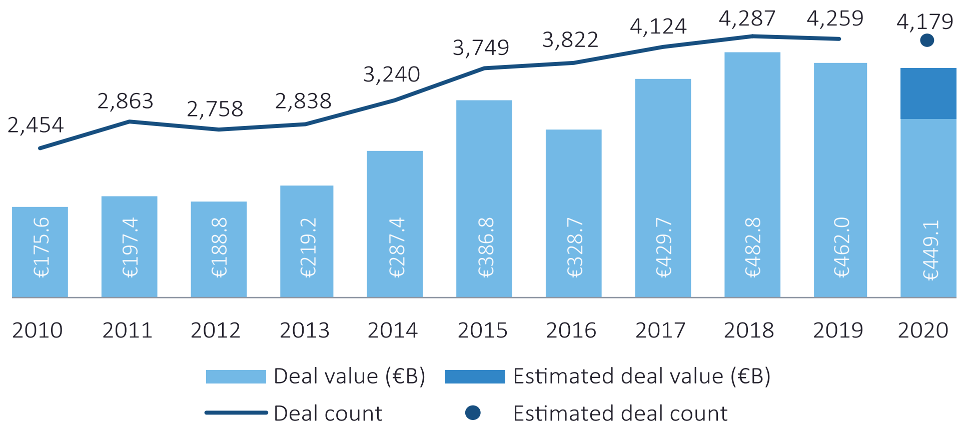
Rationale: The bulk of 2021 will be a year of reopening not lockdowns, recovery not recession, risk on not risk-off, and vaccine not virus. While sponsors focused on liquid markets and portfolio companies in Phase One and Phase Two of the COVID-19 crisis, respectively, the focus in 2021 will be on regular way control deals. Many managers have stated their deal pipelines across all strategies is particularly robust going into 2021, and recent GP surveys indicate deploying capital in 2021 is the main priority for managers. With interest rates at all-time lows, tepid inflation, and record dry powder levels on hand, we expect dealmakers to act with cautious aggression. There are no signs of slowing fiscal and monetary support, and the recovery in the leverage finance markets has been remarkable, illustrated by institutional investors' soaring demand for higher-yielding leveraged loans and high-yield bonds. For example, Blackstone received over €8.2 billion ($10 billion) of demand for a €2.3 billion ($2.8 billion) bond and loan offering to fund its planned acquisition of Ancestry.com. When analyzing previous downturns, it took managers around one year post-crisis to deploy capital at scale, and we expect outsized figures in 2021 to reflect that trend. Finally, pent-up demand from sponsors that were not able to hit deal volume and capital deployment targets in 2020 will also contribute.

Managers will likely transact more as opportunities for industry consolidation across multiple sectors such as financial services, energy, healthcare and TMT occur. We believe managers will utilize these opportunities to create European champions; drive scale, margins, and distribution channels; and seek to survive the market volatility. The combination of these factors almost creates the perfect environment for PE dealmaking in 2021.

Caveat: COVID-19 has already caused further rounds of lockdowns due to a more transmissible variant of the virus ripping through Europe. This will lead to considerable dispersion across European economies and dampened economic and PE deal activity. The new skeleton Brexit deal will likely see European geopolitical tensions continue as services, which contributes the bulk of UK GDP output, is yet to be negotiated. This will cause material disruption to PE deal activity in Europe's largest PE market. In addition, should inflationary pressures return, the landscape for PE deal activity will quickly change, as interest rates could rise, meaning financing buyouts and debt servicing becomes prohibitively expensive and unsustainable.

Fiscal programmes such as furlough schemes are set to end or taper in 2021, which could see unemployment increase as the recovery loses momentum and becomes even more uncertain and choppy. This could potentially mean zombie companies are forced into bankruptcy, leading to a reduction in demand for goods and services as unemployment numbers rise. The knock-on effects of substantial headwinds in valuing businesses would lie ahead, which could counter any resurgence in PE deal activity.

European PE deal activity



Source: PitchBook | **Geography:** Europe

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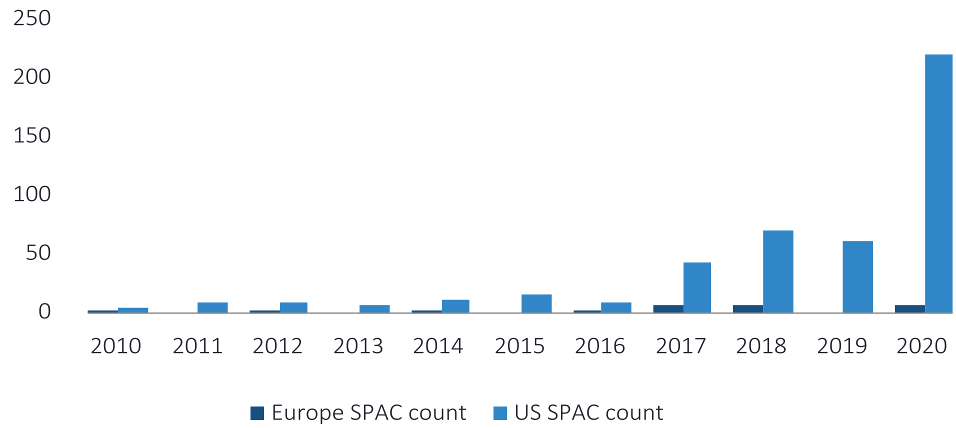
Prediction: European SPAC listings to hit double digits in 2021.

Rationale: While 2020 was the year of the US SPAC, a substantial opportunity for sponsor European SPAC vehicles has emerged as a viable option to raise capital outside the traditional close-ended commingled fund structure, and as a route to exit portfolio companies. Only four European SPAC listings closed in 2020, while the US has seen over 220. The outsized activity in the US means a portion of that market share will inevitably move to Europe. Multiple European exchanges and regulators are now competing to become the most favourable exchange and jurisdiction to list a European SPAC. They are working to change rules around SPACs that allow vehicles to look and feel like a US structure in order to entice a robust investor base. For example, the Nasdaq Nordic exchange expects to launch a US-type SPAC structure imminently. Furthermore, as the UK looks to redefine itself post-Brexit, the London Stock Exchange (LSE) is working to reverse takeover rules, which currently cancels a listing of SPAC shares where it completes a reverse takeover. This means, if the SPAC listing is to be maintained, the enlarged entity will have to publish a prospectus or AIM admission document outlining information on the acquisition and the new expanded group in order to be readmitted to trading.

Duplicating the favourable portions of the US SPAC structure, improving upon its weaker areas, and changing exchange rules will be crucial in unleashing European SPACs as an option for sponsors and institutional investors. With the potential of an oversupply of US SPACs chasing fewer quality deals, the European target opportunity set is compelling. If one of the initial European SPACs in 2021 trades well post-acquisition, we expect others will quickly follow suit and a listing frenzy will begin. Harvester Holdings Ltd is set to raise €750.0 million and list on the LSE in 2021. Subject to the performance of Harvester Holdings Ltd and shifting exchange rules, this could catalyse widescale adoption in the European market.

Caveat: A thinner investor base in Europe, a perceived lack of credible managers, and key structural and regulatory challenges continue to plague the European SPAC market. European sponsors will continue to move into the US SPAC market until they see material regulatory changes. Institutional investors simply won't commit to a structure they're not familiar with. In the UK, stock being suspended and shareholders' inability to vote on an acquisition target are major structural problems. Furthermore, while redemption features can be inserted into UK SPACs, the traditional structure does not allow investors to redeem shares should they disapprove of the target acquisition. Heightened activity in the European SPAC market largely relies on regulators and exchanges amending rules to almost mimic the US structure.

European versus US SPAC volume



Source: PitchBook | **Geography:** Europe & US

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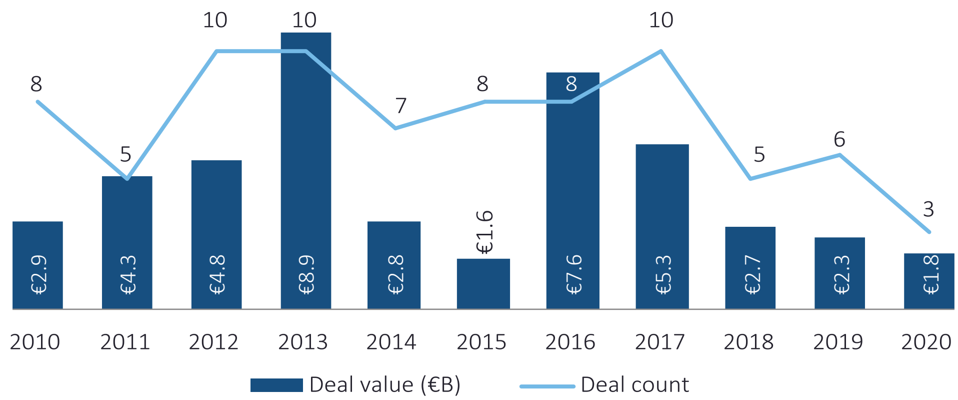
Prediction: European distressed and restructuring/turnaround capital raised to hit a new record.

Rationale: The COVID-19 crisis has created considerable disruption across European economies. While the unprecedented fiscal and monetary support from global governments and central banks has kept distressed activity depressed, distressed opportunities typically take time to play out and will likely pick up in 2021. We expect to see bankruptcies, defaults and downgrades swiftly spike for zombie companies, especially those in the small to mid-sized enterprise (SME) space for a few reasons. First, 90% of respondents in a recent survey by Dechert LLP expect more distressed deal making in 2021,[1] and we have already seen robust deal flow in rescue and bridge capital solutions in 2020. Liquidity bridges built from March 2020 to December 2020 have probable depleted for many SME's. The tapering down of fiscal and monetary stimuli programmes in 2021 and the potential of inflationary pressures and further lockdowns will put highly levered SME's under profound stress. Many companies that were struggling pre-pandemic have been kept afloat by extremely generous government fiscal programmes such as furlough schemes, grants, and tax holidays. In addition, unsustainable leverage levels and weak balance sheets going into the pandemic will contribute. Further, less access to liquidity and fewer exit opportunities to corporates will add to this spike. For example, we have already seen legacy retailers in the UK, such as Arcadia and Debenhams, file for bankruptcy in Q4 2020. These secular and cyclical declines in high street retail will only intensify in 2021. Once the cheap, predictable, and ample access to liquidity dries up, distressed investing will rise substantially, pushing GPs to close more distressed funds in 2021 due to robust LP demand. For instance, Monarch Alternative Capital—which is based in New York but likely has a global mandate—recently closed an oversubscribed €2.5 billion distressed fund.

Caveat: The rise of the European direct lending or private credit space has meant mid-market companies or SME's have liquidity options beyond traditional banks, which have shied away from lending to these riskier entities since the global financial crisis (GFC) due to regulatory requirements. The €76.7 billion in European private credit dry powder means transitional, rescue, or flexible capital solutions are available for such entities. Continued low interest rates and inflation, accommodative central bank policy, and the extension of government fiscal programmes should the recovery lose momentum could mean some zombie entities stay in business for longer and less distressed investing opportunities emerge.

1: "2021 Global Private Equity Outlook,"Dechert LLP, December 9, 2020.

European distressed debt and restructuring/turnaround fundraising activity



Source: PitchBook | **Geography:** Europe

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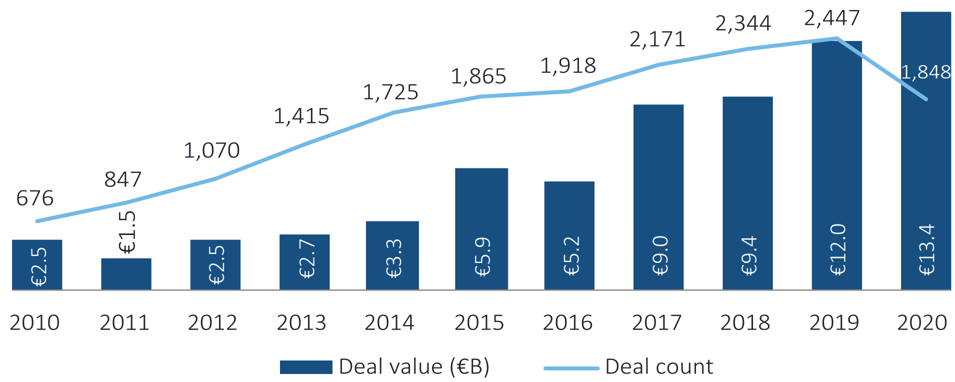
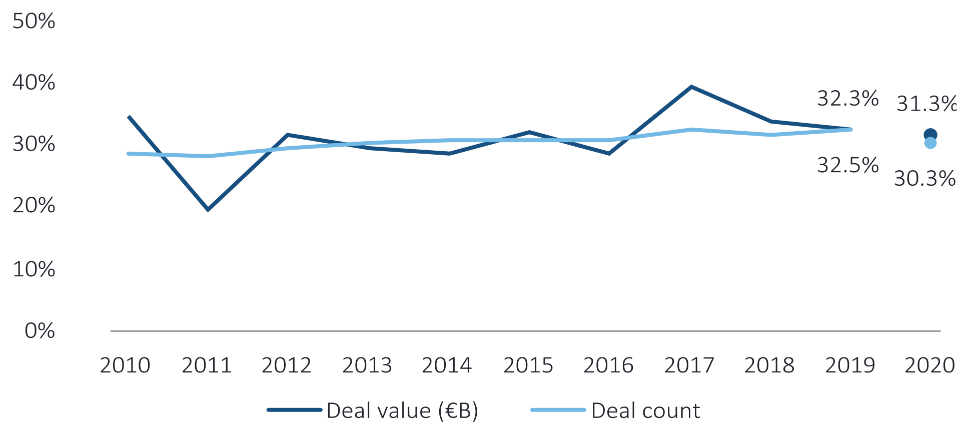
Prediction: Brexit will not stifle VC deal value in the UK; it will remain the largest contributor in Europe with over €10 billion invested.

UK VC deal activity



Source: PitchBook | **Geography:** UK

UK proportion of overall VC deal activity



Source: PitchBook | **Geography:** Europe

Rationale: Despite Brexit finally taking place, we expect VC deal value in the UK to remain strong as well-established highly valued startups underpin investment in the region. Since the referendum in June 2016, Brexit uncertainty has not dampened VC deal value. Consecutive annual records have occurred in the last three years, and 2020 has beaten them all despite COVID-19. Capital has flooded into specialist sectors such as fintech, as ample opportunities have emerged in Europe's most developed ecosystem, and we do not foresee a collapse in 2021. Companies in such sectors are unlikely to shift entire operations out of the UK, as the region accounts for a large proportion of their European market share.

The timing of COVID-19 may have helped delay mass office relocations and a sharp exodus from the UK in light of Brexit as companies and individuals opt to move back into the EU bloc. However, the allure of vibrant and diverse clusters in cities like London—equipped with academic institutions, job opportunities, and capital resources—should retain top quality talent and will allow businesses that provide the foundation for VC investment to remain strong. The UK has been a natural steppingstone for US-based companies to invest or expand operations in Europe, and we do not anticipate that Brexit will alter these existing relationships, strong corporate ties, and cultural and logistical norms.

Caveat: A host of regulatory changes will affect how the UK interacts with the EU going forward, potentially forcing the hand of businesses and investors in the region. For example, the loss of passporting rights means financial services firms must set up within the EU bloc to tap into the EU market. Currency risk associated with the devaluation of the pound could result in VC deal value rapidly constricting. The sterling has previously fallen sharply amid crucial Brexit dates, and this may put off investors in the near term, delaying rounds that are commonly denominated in euros or US dollars.

With an agreement reached, the terms of the deal will now dictate how the EU treats the UK and vice versa. Nuances within the deal could see operations shift out of the UK for many businesses as new rules come into force across borders. Therefore, the UK could be competing on a more level playing field rather than complementing the much larger Asia and North America ecosystems for investment. Conversely, international investors may feel startups in regions not facing costs and complexities stemming from Brexit could be a better bet. Capital could flow into alternative European ecosystems such as Germany and France, which have both developed impressively alongside the UK in recent years.

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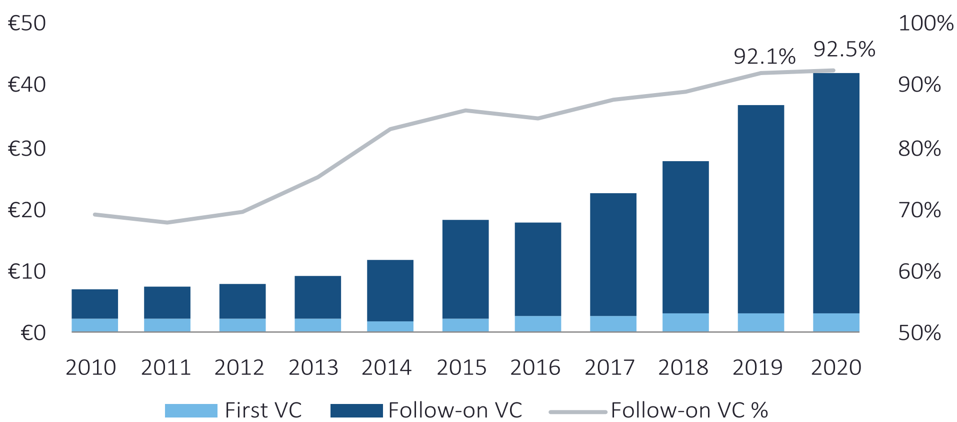
Prediction: VC follow-on rounds will remain above 90% of overall capital invested across Europe.

Rationale: Investment runways for VC-backed companies have evolved during the last decade as capital deposited into first-time rounds has remained consistent, whereas capital within follow-on rounds has soared. Startups are fully maximising VC financing and valuation growth across different stages in their lifecycle before an exit, and this will likely continue in 2021. Capital has not been siphoned away from first-time rounds. Rather, there is a wider array of sources and greater amounts of capital flowing into the European VC landscape, with particular focus on the early and late stages. We do not expect the tap at each financing stage the shut off anytime soon.

Over 90% of overall VC deal value took place within follow-on rounds for the first time in 2019 and 2020. Currently, there are over 50 VC-backed companies valued at €1 billion or more (known as "unicorns") based in Europe, the largest number ever, as companies of this size have dipped frequently into VC investors' pockets to raise outsized rounds in recent years. Median VC deal sizes and valuations have also grown handsomely during COVID-19. We expect late-stage companies to drive follow-on investment upwards as some capitalize on growth witnessed during the pandemic, while others seek capital to consolidate existing positions and commence rebuilding processes.

First-time and follow-on VC deals (€B)



Source: PitchBook | **Geography:** Europe

Caveat: COVID-19 has not cooled valuations or round sizes in the European VC ecosystem, and investors may feel it is an opportune time to put capital to work in new startups that could demonstrate improved growth potential. Before the pandemic, there was much discussion around overheated private market valuations, and haircuts have been isolated rather than widespread. Therefore, we could see follow-on round investment flatten as growth becomes harder to capture during an uncertain period characterised by rising unemployment figures and limited sustainable macroeconomic growth. Pandemic-induced startups have been founded, and backers will attempt to unearth and nurture the next batch of new startups to generate improved returns.

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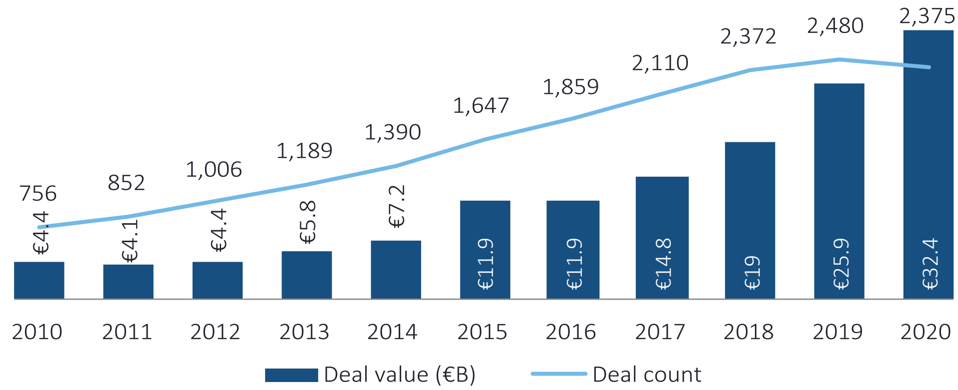
Prediction: VC deal value with nontraditional investor participation to reach a new record in 2021.

VC deal activity with nontraditional investor participation



Source: PitchBook | **Geography:** Europe

Rationale: VC has become a major financial instrument in Europe as global interest has been stoked and nontraditional investment has been drawn in from multiple sources—such as sovereign wealth funds, PE firms, and family offices. The pull of flagship startups has never been greater, and it has become trendy and lucrative for nontraditional investors to invest heavily in new-age startups that could fuel future growth in emerging industries. Startups such as Deliveroo and Klarna are synonymous in consumer markets, and have successfully scaled into multiple regions with the help of technology and investment from high-profile backers. Certain tech-enabled startups have demonstrated remarkable pandemic resilience as online reliance propagated in 2020, further enticing capital from nontraditional investors.

The pandemic has ruthlessly highlighted that long-established companies, such as those on the high street, need to adapt and future-proof themselves ahead of future black swan events. The pandemic accelerated sticky trends, with areas such as sustainability, remote working, and e-commerce gaining significant prominence. As a result, we expect nontraditional investors such as CVCs to take note and invest heavily heading into 2021 to leverage synergies with startups and stay ahead of competitors to ensure future revenues remain healthy. CVCs have also targeted specialist startups to outsource R&D efforts, as it has proven more cost-effective than setting up new internal research business units. Especially in the tech sector, huge incumbents armed with cash reserves have invested in new technologies that can be integrated into existing operations to drive efficiency gains.

Caveat: The effectiveness of vaccination programmes and the subsequent rebuilding process earmarked for 2021 will shape macroeconomic trends and the wider financial market's appetite for VC moving forward. The long-standing rhetoric that the stock market is not the economy currently seems more relevant than ever, as recent recoveries in share prices have not always reflected the underlying financial health of companies, and as daily news appears to influence global swings. Volatility can trigger investment decisions and cause disruption to capital flows from nontraditional sources into VC rounds. As nations emerge from restrictions, short-term pandemic winners such as video-conferencing tools could see usage plummet. Furthermore, nontraditional investors in battered sectors such as energy and airlines could reduce spending on investments as they evaluate the effects from cost-cutting measures and budgetary restraints.