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Q2 2022

US PE Breakdown

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Executive summary

US private equity (PE) deal activity remains weak in the face of a complex macroeconomic and geopolitical backdrop. Rising interest rates and falling public market indexes are having a direct impact on the pricing environment: In many cases, with the cost of debt rising, the proportion of equity has also risen. Multiples are coming down, and, until a more stable environment has been established, deal activity will likely remain tepid. One area of opportunity for deals is in take-privates. Public marks have fallen much more quickly than privates, and many sponsors are seeing attractive deployment prospects with so many public companies off 50% or more from their 52-week highs. A fragile funding situation in the venture capital (VC) market may also lead to more opportunities, as firms are either unable or unwilling to raise capital in down rounds and instead turn to PE funds for capital. Overall, deal activity will likely pick up as GPs feel pressure to deploy capital, but this eventuality may be several quarters out.

Exit activity is down a notable margin, YoY. With falling valuations in public and private markets, sponsors are choosing to hold portfolio companies when possible, rather than sell them for less favorable prices. The dramatic slide in public equities has effectively closed the door to public listings, a major driver of exit value in 2021. Activity in some sectors, such as energy and technology, is still occurring, though. Energy prices have shot up, and so, too, have valuations for many companies in the space. Many of the tailwinds in technology remain in place, despite the poor showing in public markets, and other sponsors or strategics have been willing to purchase PE-backed technology companies. Many PE firms are turning to GP-led secondaries transactions to hold on to their later-in-life portfolio companies, thereby taking advantage of the gargantuan sum of capital secondaries funds raised in the past 18 months.

Overall, fundraising continues to hum along, but changes are occurring below the surface. Nearly every PE firm either is currently fundraising, has just finished fundraising, or is about to launch its next fund. This surfeit of demand far exceeds the funding capacity for traditional institutional allocators, thus creating a backdrop that favors the largest PE firms with the deepest connections and most strategies. Nascent and middle-market managers will find it more difficult to source capital in this environment. However, a land grab is underway in retail, which is a huge opportunity for the firms that can triumph in this space. Additionally, there is healthy PE demand from non-US-based institutions, many family offices, insurance companies, and more. Moreover, we expect an uptick in managers using warehousing facilities, offering co-investments, and selling stakes to gain an edge in this competitive environment.


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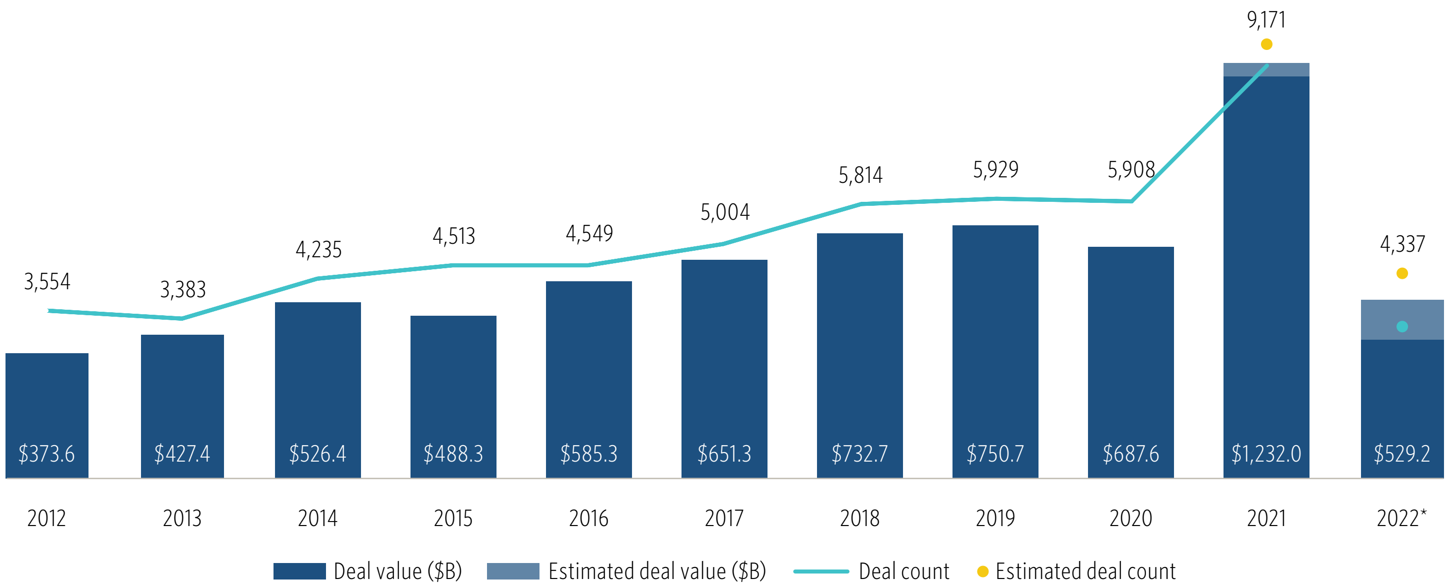
Deals

PE deal activity



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Macro backdrop

PE deal activity slowed relative to the torrid pace set in 2021, but it remains on pace for a healthy year by historical standards. Through the first half of 2022, US PE firms completed approximately 4,000 deals, with a cumulative value of just over $400 billion. Many of these deals were negotiated in 2021 or early 2022, before the current macroeconomic backdrop turned so bearish. Going into the latter half of the year, closed deal activity is expected to diminish as announced deal flow has slowed.

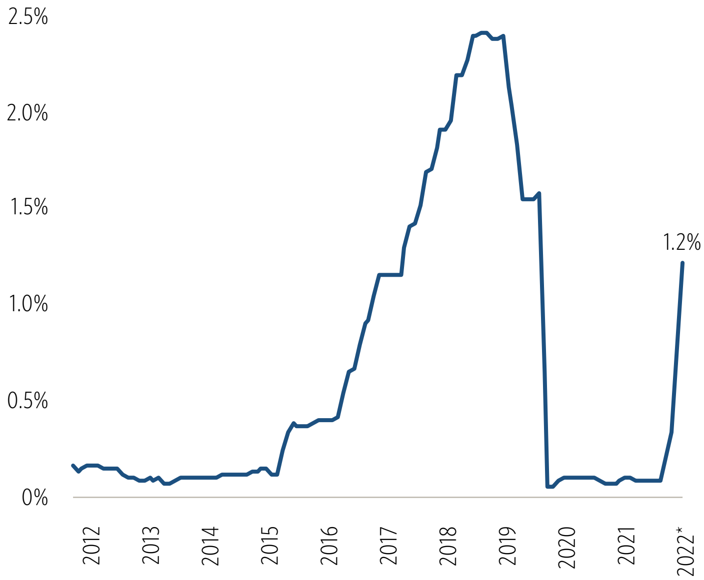
Sponsors are heading into a tricky environment, wherein multiple factors are creating poor dealmaking conditions. The inflationary environment is on the forefront of most industry participants' minds. The consumer price index (CPI) rose by 8.6% in May 2022, the highest reading since 1981, as costs from food, gasoline, and housing ballooned. A combination of COVID-19-induced supply chain disruptions and government stimulus has cut supply for many goods while simultaneously boosting demand. The cost of gasoline alone is up more than 2.5 times from the past two years. In response, the Federal Reserve System (the Fed) has been swift to rachet up interest rates, thus slowing the economy and lessening demand. In June, the Fed lifted interest rates by 75 basis points, the largest move since 1994. Despite the efforts to curb inflation, issues brought forth from logjammed ports, closed manufacturing facilities, and disrupted transportation of goods remain unaffected by the higher interest rates.

Higher inflation readings and interest rates have had deleterious effects on many critical metrics in the US. As the basis of calculating value in a discounted cash flow (DCF) model, higher interest rates lead to lower asset prices—all else equal. In the past six months, the prices of most assets have plummeted. US public equity indexes are in bear market territory, with the S&P 500 off 20.6% through the first six months of 2022, while the more tech- and growth-heavy Nasdaq has plunged 29.5%. Higher growth and more speculative assets have been hit the hardest. Biotechnology stocks have been hammered, with some trading for less than the cash on their balance sheets. Unprofitable tech companies have also been battered. Even privately held companies have been unable to escape the valuation pressures. Discounts on the secondary market for top-quality venture-backed companies are already hitting 50%+.[1]

Consumer and business sentiment has also added to the negative outlook across financial markets. Nondiscretionary expenditures, including housing and transportation, are skyrocketing, thus reducing the consumer's ability and desire to spend. Rising prices and falling financial markets are negatively affecting consumer spending, which is the driving force in the US economy. The University of Michigan Consumer Sentiment Index recently hit near global financial crisis (GFC) lows—even lower than at any time during the pandemic-induced recession. Similarly, business sentiment is turning more bearish. According to the Conference Board, a survey of CEOs and c-suite executives, conducted in May, indicates that more than 60% of respondents anticipate a recession in their region in the coming 12 to 18 months.[2] Bearish executives are much less likely to pursue M&A, perhaps providing less competition to sponsors sitting on mountains of dry powder.

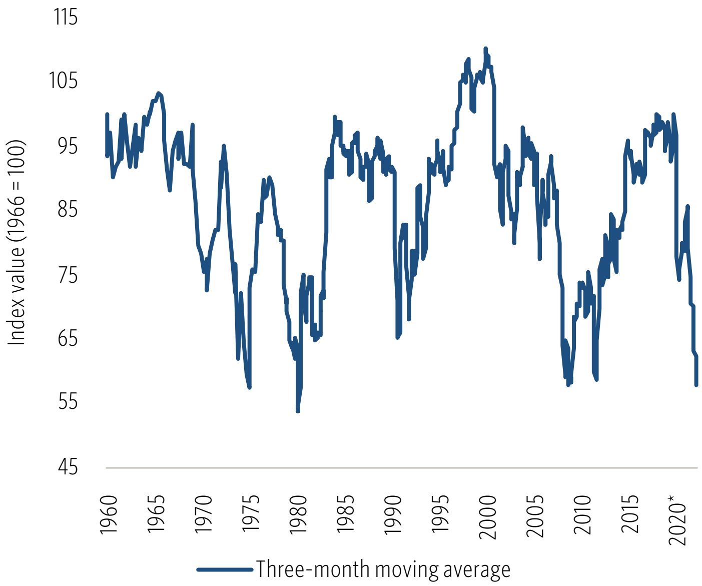
Concurrent with these economic shifts, the odds of a recession are on the rise, according to internal and external modeling. PitchBook's internal recession model shows a 19% chance of a recession occurring in the next 18 months based on data available at the end of May, although the probability of recession has been increasing over the past few months and will likely continue to do so in the near term as credit spreads and interest rates rise, as highlighted in our Q2 2022 Quantitative Perspectives report. Goldman Sachs and Morgan Stanley forecasted a higher probability of recession—around a 30% chance in the next 12 months—as the Fed rolled out its most recent interest rate hike in June, although some economists note that a recession would be shallow if it does happen.[3] It will be a challenging time for many companies and consumers, but difficulty can also present opportunities for cash-rich sponsors.

Federal funds rate



Source: FRED | **Geography:** US
*As of June 30, 2022

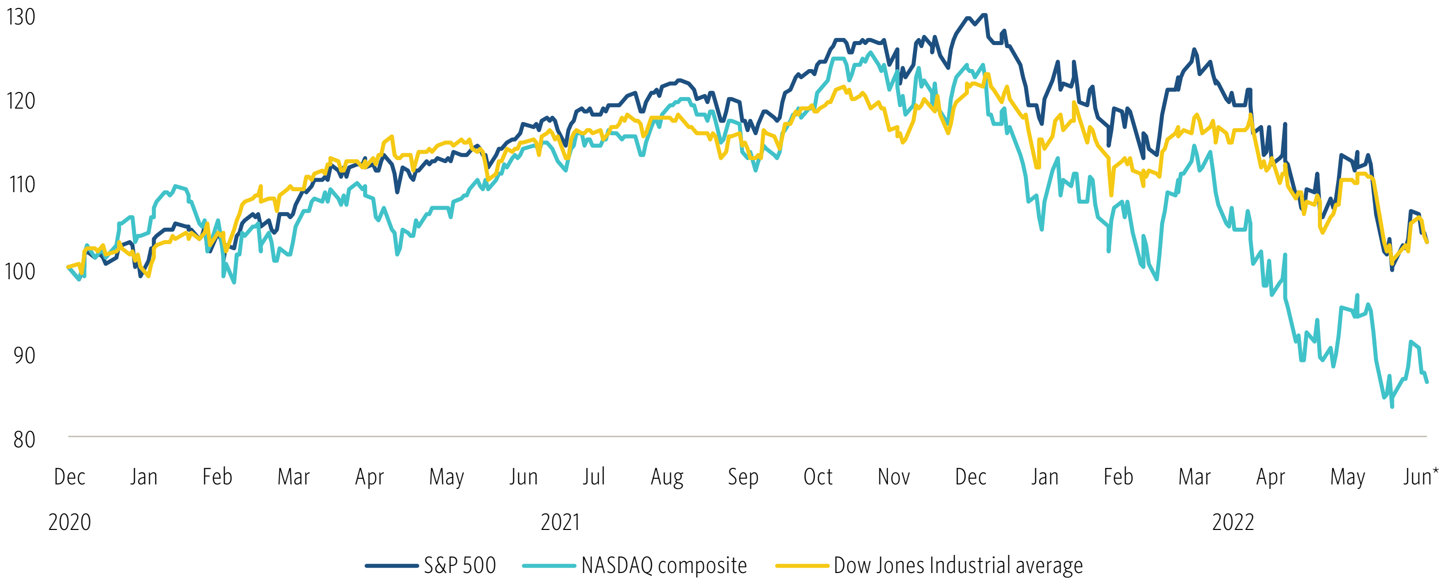
US consumer sentiment



Source: University of Michigan | **Geography:** US
*As of December 31, 2020

1: "Markets Update: Crypto Collapse, Russia/Ukraine Endgame, State of the Podcast," All-In podcast, Jason Calacanis, et al., June 24, 2022.
2: "C-Suite View of Volatility, War, Risks, and Growth for Global Business," The Conference Board, June 17, 2022.
3: "Wall Street Sees Higher Probability of U.S. Recession Next Year," *Reuters*, Pushkala Aripaka and Siddarth S, June 21, 2022.

Select stock indexes rebased to 100 in December 2020

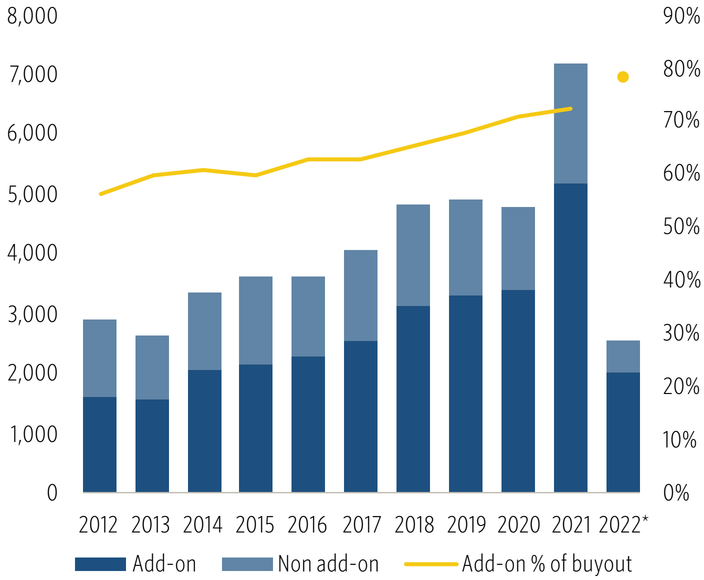


Source: Morningstar | **Geography:** Global
*As of June 30, 2022

Overview

We expect many opportunities for PE firms in the dealmaking arena, though navigating the macroeconomic and political backdrop will present unique challenges. With so many firms actively raising capital, and with corporates less bullish on the future, sponsors are likely to witness less competition from strategics in banked processes but could see more competition from other sponsors. Depressed stock prices mean public markets are also fertile ground for firms with multibillion-dollar flagship vehicles. However, after the frenzied 2021, in which dealmaking value nearly doubled the previous record high, PE firms are being pushed to be more predictable with their deployment schedule. Large institutional investors conduct sophisticated cash flow modeling on their portfolios, often expecting PE fund commitments to be drawn over a period of three to four years. During the dealmaking mania, many sponsors fully committed or invested their entire funds in less than two years, returning to fundraise much sooner than anticipated. This frustrated many large LPs, and another round of deployment at that rate by the industry may not be sustainable as investors look to raise cash from elsewhere in their portfolios to fund these commitments. Because of these pressures, sponsors will likely take a more measured approach to deployment in this cycle.

PE add-on deal count



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Increasingly, PE firms must take regulators into account when deploying capital and managing portfolio companies. The days of buyout shops flying under the political radar are largely over. US PE AUM has surpassed $2 trillion, and millions of those living in the US now work for PE-backed companies. Political awareness is rising as PE becomes a larger part of the economy. Political oversight will proceed much more quickly if PE firms continue their push to raise more capital from retail investors as well. The roll-up, a preferred PE tactic in many areas of the economy, has increasingly come under fire.

In June 2022, the Federal Trade Committee (FTC) took action against JAB Consumer Partners-backed National Veterinary Associates, forcing the firm to divest several veterinary clinics to complete a planned acquisition. The FTC also required JAB to receive approval for certain future acquisitions. The regulatory agency said the acquisition would have been illegal and anti-competitive without the divestitures. The Wall Street Journal also reported that the FTC is asking more questions during PE-backed company merger reviews than in years past,[4] suggesting more actions may be coming. This could be particularly problematic for bigger sponsors that pursue large-scale roll-ups. The strategy is attractive across sectors but is uniquely important to many healthcare-focused firms' strategies. From endodontist offices to optometrists, the roll-up seems to be the default strategy for most in the space. Going forward, this could pressure some of the larger players to think differently about value creation and perhaps increase the amount of de novo expansion that these firms pursue.

Rising financing costs promise to not only dampen deal activity but should also make such deals more expensive. According to LCD, pricing for first-lien term loans used to finance leveraged buyouts (LBOs) is regularly hitting 525 to 550 basis points above secured overnight financing rate (SOFR). All-in yields for recent deals have come in below 9% in some cases, but the unsecured portions are now regularly hitting double-digit yields. YTD, the cost of new debt has more than doubled for B-rated issuers.[5] A further 75 basis point rate hike could push these prices skyward. Materially more expensive financing means the equity proportion for many deals is likely to rise. Deal pricing will have to diminish for GPs to meet return targets—all else equal.

Take-privates

In 2021, PE firms found plenty of opportunities in the public market to invest in companies ripe for additional growth and innovation, and we anticipate take-private deals to continue in 2022 as sponsors look to pick up companies that are cyclically—but not secularly—under pressure. The markets are fraught with interest rate increases, soaring inflation, and quantitative tightening, which create significant opportunities for sponsors to buy less expensive assets. Extortionate valuations of previous years were arguably the biggest roadblocks for companies on PE target lists; now, with lower prices, deals could be struck more easily. In addition, sponsors are still equipped with plenty of dry powder, and take-privates offer great opportunities to deploy large sums of capital. 18 take-private deals have closed in 2022 so far, with $58.6 billion of aggregate deal value. Healthcare saw four take-privates during Q2, including Patient Square Capital's purchase of SOC Telemed, an acute care telemedicine provider, for $302.5 million in April, and Altaris Capital Partners' acquisition of IntriCon, a joint development manufacturer of medical devices, for $241.0 million in May. More public companies could reach out to sponsors for defensive capital during market turmoil as they feel pressure to tap the private markets for liquidity instead of continuing to face quarterly reports and analyst scrutiny in a challenging market.

Average new-issue yields

Source: Morningstar | **Geography:** Global
*As of June 30, 2022

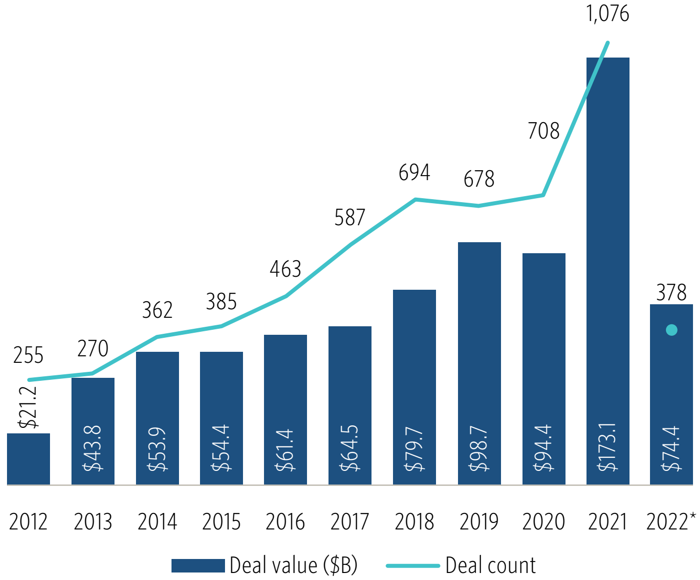
4: "Antitrust Authorities Take Aim at Private-Equity Healthcare Deals," *The Wall Street Journal*, Chris Cumming, June 14, 2022.
5: "Private Lenders Are Offering Cheaper Debt than Wall Street Banks," *Bloomberg*, Rachel McGovern, Lisa Lee and Giulia Morpurgo, June 29, 2022.

Technology

Technology deal activity remained healthy in Q2 despite the volatility that has been plaguing the tech stocks in public markets. Fears of interest rate hikes have been dragging down the lofty valuations at which many tech companies were trading since the beginning of the year, with high-growth tech stocks falling out of favor as high interest rates reduced net present value of expected earnings that relied heavily on future profit growth. Some investors worried that as public comparables drove down valuations in the private markets, PE information technology (IT) activity would be stunted from market uncertainty and value dislocation between buyers and sellers. However, PE's appetite for IT did not suffer a significant decline. Capital still flowed into the sector, with 256 deals closed during Q2 at an aggregate of $24.7 billion. While the number of deals declined for the second consecutive quarter, it stayed consistent with the historical quarterly average. Deal value dropped more meaningfully as tech valuations dropped, but IT deal value interestingly accounted for a whopping 27.7% of PE deal activity for the quarter. This demonstrates how valuations were dragged across the broader market and suggests that tech companies took the current market volatility in stride compared with other industries. Falling valuations are widely being viewed as both a buying opportunity for PE funds to secure tech companies that they previously saw as overvalued and a chance to gain greater runway to hit returns.

IT deal activity will remain strong thanks to attractive secular growth prospects within tech that continue to draw in PE investors. PE is focused on long-term growth and will continue to seek opportunities in strong investment themes of increasing digitalization and technological innovation. For example, opportunities in financial technology (fintech) companies that streamline transactions, provide insights on consumer behavior, and provide network security for businesses and consumers drove much of US IT deal activity during Q2. The increasing prominence of globalized markets and e-commerce, along with improvements in Big Data analytics and cybersecurity, have contributed greatly to the demand for digital services that can provide faster and more secure transactions. In May, Thoma Bravo completed its acquisition of Bottomline Technologies (NASDAQ: EPAY), a leading business products & services fintech provider, for $2.6 billion. Thoma Bravo sees tremendous opportunity for Bottomline to enhance its position as digital transformation of businesses accelerates; it plans to enhance its portfolio of business products & services payment options. Similarly, Integrum Holdings acquired Merchant eSolutions, a subsidiary of the Brazil-based payment processor Cielo (BVMF: CIEL3), for $290.0 million in May. With demand for digital payment services rapidly growing, Merchant eSolutions is well-positioned to take advantage of the rapidly changing payments landscape by providing full-stack payments and commerce solutions for middle-market business products & services customers.

Software PE deal activity



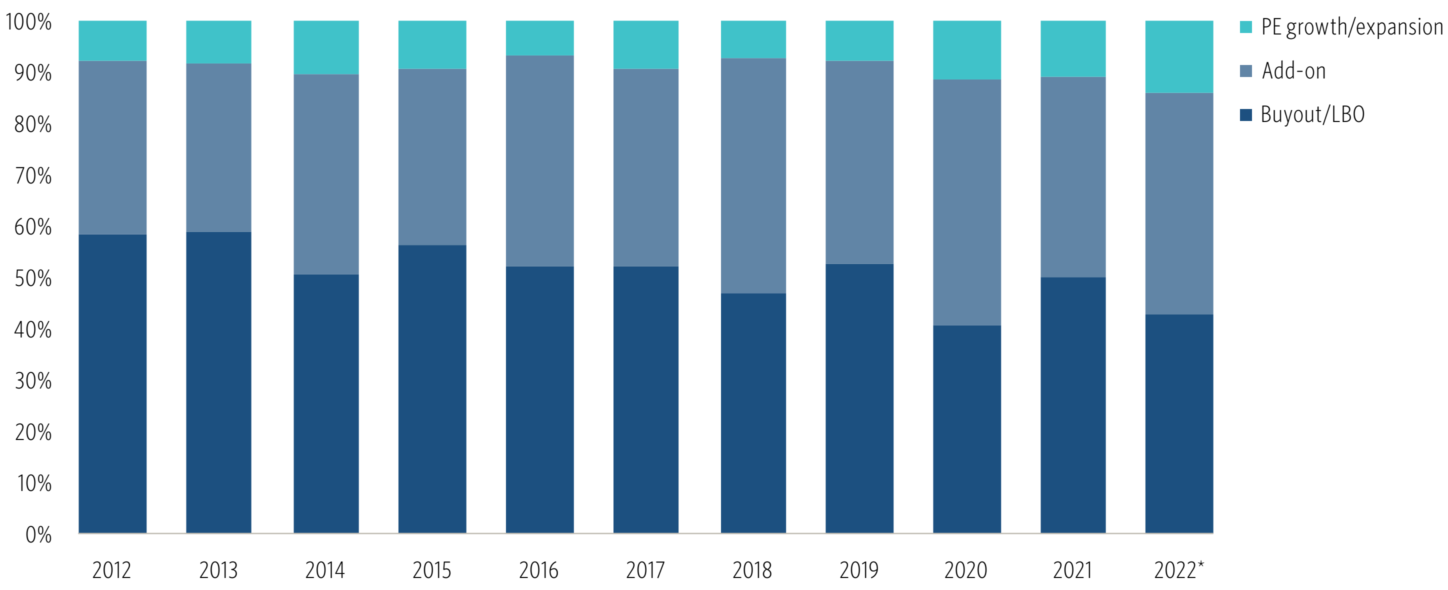
Source: PitchBook | **Geography:** US
*As of June 30, 2022

Industrials

Industrials saw strong deal flow to start the year, but activity slowed in Q2. With high-end manufacturing being an integral piece of the industrials ecosystem, supply chain disruptions can be debilitating for businesses. Industrials-focused PE firm MiddleGround Capital stated that the biggest challenges faced in the industry today are supply chain disruptions and the labor market. Founding partner John Stewart also mentioned how increased prices in commodities such as oil and steel have had a big impact on the supply chain, as it is difficult to get these commodities, and there is a premium paid to get them.[6] Industrials companies that are able to build greater supply chain resilience and pass off costs to consumers will be able to endure the current challenges. One way companies have been trying to secure value is through reshoring, which is bringing manufacturing and services back to the US from overseas. To avoid supply chain setbacks—such as the chip shortage, delays in good transportation, and increased freight costs—companies have been increasingly reshoring their manufacturing operations. As offshore manufacturing continues to increase in price with the current macroeconomic backdrop, reshoring manufacturing operations becomes a potential solution.

Automobiles and aerospace are two subsectors within industrials that, over the past few years, have seen a major shift in their growth trends. For the automotive industry, it has been all hands on deck to design, develop, and produce electric vehicles (EVs). Many major automotive brands already have hybrid vehicles and EVs on the roads, with the rest expected to follow suit. The myriad new, complex, and possibly locally manufactured components offer a huge upside for industrials sponsors in the automotive space. For years, the aerospace industry has seen a majority of its market accounted for by companies primarily involved with the military. The defense segment of the aerospace industry has been attractive as the use and development of new aerospace technology offers the opportunity for companies and investors to profit from long-term contracts with government agencies, but a newfound popularity has emerged in the commercialization of space. Beginning in 2021, multiple commercial space flights launched into orbit, led by Elon Musk's SpaceX and Jeff Bezos' Blue Origin, as well as fellow billionaire Richard Branson's Virgin Galactic. In February, aerospace-focused PE firm AE Industrial Partners reached an agreement to acquire a majority stake in Firefly Aerospace, a leading provider of launch and in-space vehicles. The Firefly Aerospace buyout demonstrates

Share of PE deal value by type



Source: PitchBook | **Geography:** US
*As of June 30, 2022

6: "MiddleGround Capital: Deal Activity Booms Despite Challenges," *Buyouts Insider*, Guest Writer, April 1, 2022.

that GP interest in the aerospace industry is there, despite current economic tailwinds—especially as new aerospace technology is developed and the commercialization of space continues to expand. The role of technology is instrumental to the long-term growth in industrials; not only do emerging technologies in EV and aerospace drive investment opportunities in the sector, improved IT networks, automated systems and processes, and artificial intelligence (AI) can increase efficiency and accuracy, and lower costs for industrials companies.

Sports

The business of sports has been on display for all of 2022. Recent matchups, including basketball's the Golden State Warriors (backed by Arctos Sports Partners and partially owned by several VCs) besting the Boston Celtics (partly owned by Bain Capital's co-chairperson) in the NBA Finals, illustrate how institutionalization and PE are permeating sports. Recent transactions, including the announced sale of football team the Denver Broncos for $4.7 billion in June and soccer team Chelsea FC trading hands for $3.1 billion (£2.5 billion) in May, highlight the ballooning value of premier sports franchises. Although the Broncos sale was to a single bidder, the consortium that purchased Chelsea FC was co-led by PE giant Clearlake Capital Group. With valuations continuing to rachet up, we expect future deals will need consortiums to raise sufficient capital, and PE is likely to play a sizable role. Some smaller sports deals are seeing PE as the sole bidder. In early June, RedBird Capital Partners announced its acquisition of a majority stake in soccer team AC Milan in a deal that values the club at $1.1 billion (€1.0 billion).

Several minority stake transactions in the sports realm have also closed or been announced in 2022. Ice hockey team the Tampa Bay Lightning sold a minority stake to Arctos Sports Partners in January. Harris Blitzer Sports & Entertainment (HBSE), which owns basketball team the Philadelphia 76ers and ice hockey team the New Jersey Devils, sold a 5% stake to Arctos in June. Another 10% of HBSE is slated to be sold as Michael Rubin, CEO of sports merchandise retailer Fanatics, looks to exit his ownership stake to avoid conflicts of interest as Fanatics gets into sports betting. Arctos or another PE player could be a natural buyer. We expect the number of minority stake transactions to expand going forward as majority owners seek liquidity and/or expansionary capital, minority owners look to cash out, and consortiums bring in PE capital during ownership changes. Currently, Arctos dominates minority stake transactions in sports; it has reportedly already amassed more than $1.1 billion for its sophomore fund.

Interest has been picking up in deploying institutional capital into leagues outside of the US and Europe; leagues outside of the Big Four of the NBA, NFL, MLB, and NHL; and in ancillary sports businesses. In January, an investment group, including MSP Sports Capital, agreed to buy the X Games from Disney. In February, New Zealand Rugby agreed to sell a minority stake to Silver Lake for $133.5 million (NZ$200 million). And in May, Elevate Sports Ventures—a sports and entertainment consulting firm—announced it had sold a minority stake to Arctos. Even some nontraditional capital is getting into the fray. LIV Golf, a challenger to the PGA Tour, is perhaps the best-known example here. The upstart, backed by Saudi Arabia's Public Investment Fund (PIF), has recruited several high-profile golfers and hopes to become the dominant golf tour.

International sports are increasingly becoming a globally available phenomenon. As more content is consumed via streaming services, sports is among the only remaining types of media still consumed live. Thus, advertisers pay a premium for advertisement spots during sports matches, thereby driving up the value of media rights. The return profile for media rights resembles a real estate investment in its stability and built-in escalators—making it perfect for PE underwriting. Over the past decade, the value of these media rights has soared, and so, too, has the value of sports franchises. In June, the Indian Premier League (IPL) netted $6.2 billion for its streaming rights, nearly triple the amount paid in 2017— the last time the rights were up for grabs. Crucially, the price for the streaming rights eclipsed traditional broadcast. The final figures put IPL cricket as the world's second-most-valuable sports league on a per-game basis—lagging only the NFL. Apple also jumped into the sports market and struck a 10-year deal with the MLS to stream all of its games, and Hulu provides live sports through its premier plan with Disney+ and ESPN+. The move suggests Netflix and Amazon, among others, may seek to pursue similar deals. With the largest spenders paying so much attention to sports broadcasts, the current valuation tailwinds are likely to persist. Moreover, other areas of sports, including sports betting, ticketing, sponsorships, and entertainment packages, are ripe for innovation and institutional capital, which means the current deal momentum will likely continue.

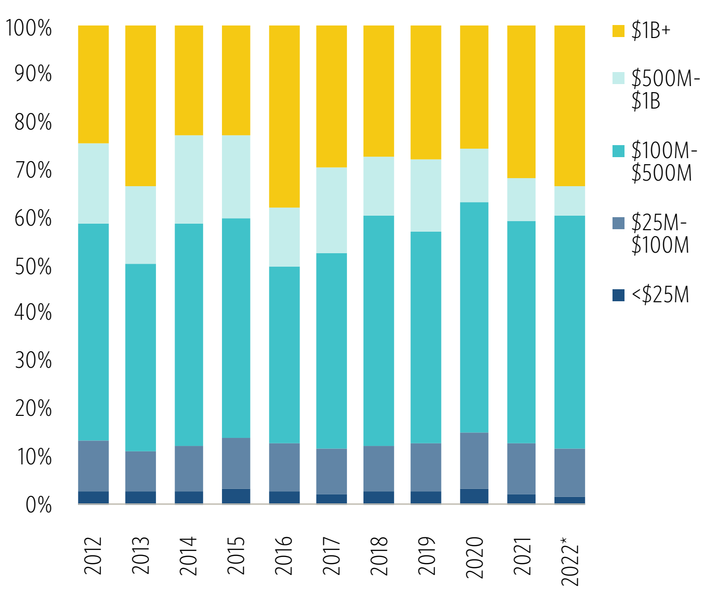
Growth equity

A shift is underway for growth equity in the US. After years of investors seeking growth at all costs, profitability and lower valuations have grabbed hold of the industry. Much of this is due to reverberations from public markets, wherein companies such as Snowflake have seen their stock prices drop by more than 50% in the last 12 months despite putting up healthy growth figures. According to entrepreneur and investor David Sacks, annual recurring revenue (ARR) multiples have dropped to 20x to 30x for companies growing at 3x YoY because of the falling public multiples.[7] Large public companies drive comparables for late-stage private companies because the companies are likely to either go public—and thus be valued in comparison—or be acquired by one of these public companies. Valuations for many private growth companies are likely to follow suit, with companies, including Klarna, cutting valuations by over half. Stakes in some of the best performing private companies are being offered at half off or more without finding buyers. Industry insiders suggest deals being negotiated today are likely to be at a much lower multiple than 12 months ago. Late-stage growth companies, which had massive hiring plans to hit aggressive financial projections, have had to switch up their plans, announcing layoffs. These adjustments should help these late-stage growth companies more quickly achieve profitability and lessen their burn rates, thus extending the time until their next funding rounds.

Venture funds are beginning to see markdowns, and more are expected in the coming quarters. The IPO window is also effectively closed, thus forcing companies to remain private.

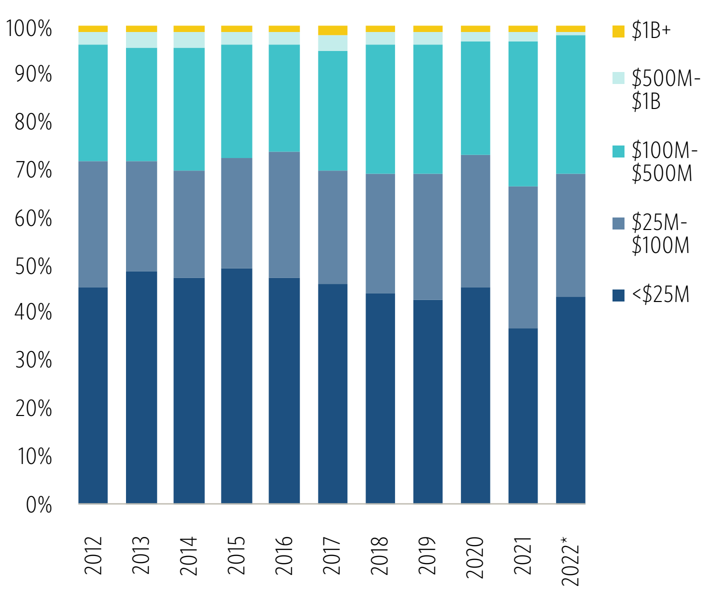
Growth equity deal activity is down in the first half of 2022 compared with 2021, but the drop has been less severe than for buyouts because of an active Q1. As the new valuation regime takes hold, we expect deal activity to diminish as only the top-tier companies, or those that need the cash to survive, will seek to raise capital in this environment. Anecdotal reports suggest that many of the large nontraditional investors, including Tiger Global Management and Coatue Management, are precipitously slowing fundraising and company funding activity. These firms have completed a healthy number of deals in 2022—but in much smaller companies than 2021. Some of the large PE platforms, including KKR, TPG, Thoma Bravo, and others, also continue to deploy capital but at a slower pace. We expect the next 12 to 18 months to prove difficult in the growth equity space as price discovery is delayed with companies slimming down and delaying new rounds for as long as possible. Viking Global Investors and Coatue are raising structured equity funds to help sate cash needs without markdowns. This could further push back the need to raise equity at lower valuations. Although there is plenty of dry powder to deploy, investors will be wary of catching a falling knife and deploying capital as prices continue to fall.

Share of PE deal value by size bucket



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Share of PE deal count by size bucket



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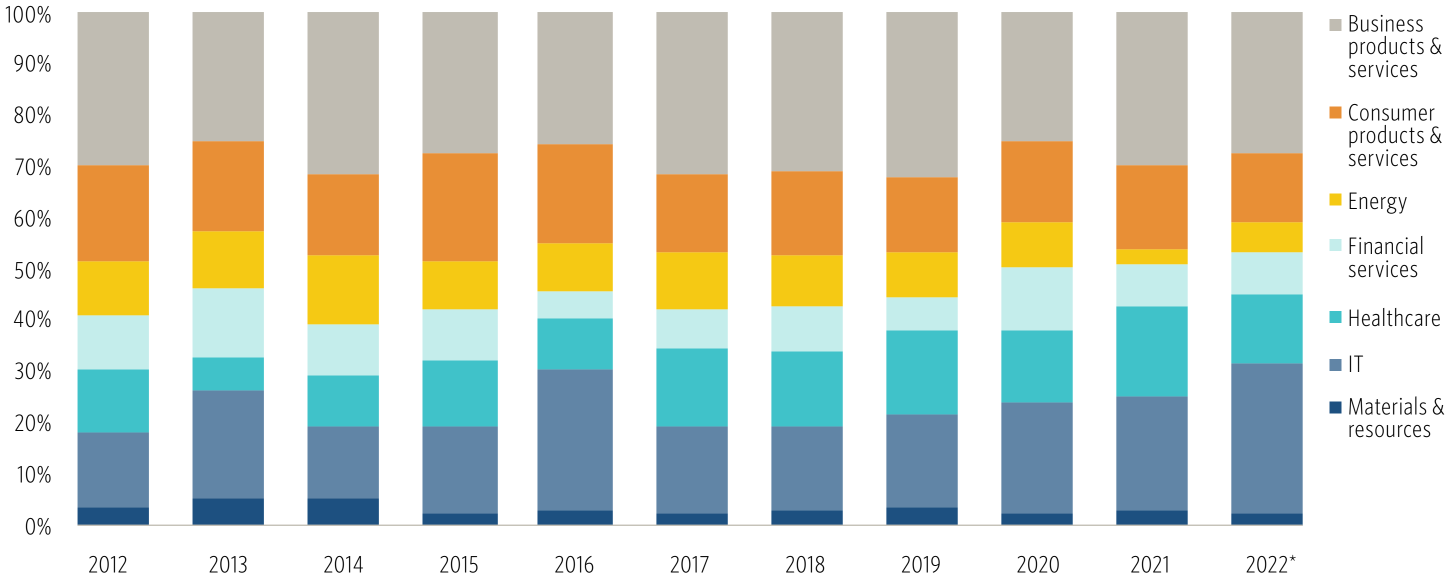
7: "Markets Update: Crypto Collapse, Russia/Ukraine Endgame, State of the Podcast," All-In podcast, Jason Calacanis, et al., June 24, 2022.

Share of PE deal value by sector



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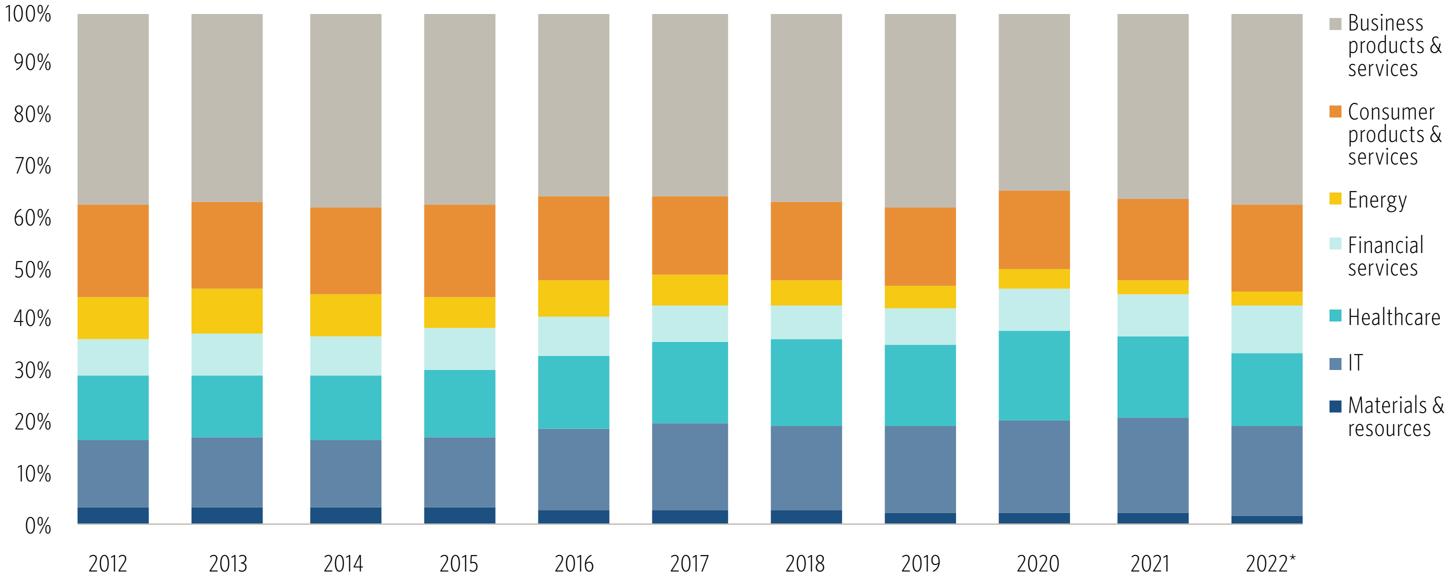

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A WORD FROM STOUT

Accounting and financial reporting throughout the transaction lifecycle

Steve Hills

Managing Director and Head of Accounting & Reporting Advisory

Steve has 20 years of experience in accounting and financial leadership roles, including the areas of technical accounting, financial reporting, and transaction advisory. His technical accounting experience includes business combinations, consolidations and variable interest entities, stock-based compensation, complex securities, revenue recognition, and lease accounting. He is also well-versed in the preparation and review of various SEC filings.

Simba Dutt-Mazumdar

Managing Director of Accounting & Reporting Advisory

Simba has more than 18 years of experience helping companies navigate complex liquidity events, transactions, restructurings, and transformations, with an emphasis on M&A integrations, accounting standards adoptions, and ERP implementations. He has significant expertise in post-merger integration within the finance function and across industry sectors, including industrial manufacturing, consumer goods, technology, and media & entertainment.

How do you expect current economic conditions to affect transaction volume and execution?

Steve: As it relates to M&A activity, we're not observing any slowdown. Transactions overall do not seem to be significantly challenged in terms of velocity and volume. What we are seeing is a shift in the distribution of transactions. For example, the SPAC market has all but dried up, and recent stock market volatility has stalled the IPO market. However, many of our clients continue to move forward with their IPO preparation efforts in order to be ready when the IPO "window" reopens.

Any commentary around future M&A or IPO transaction activity is speculative. What we do know is: (a) There is still a substantial amount of dry powder within the private equity ecosystem, and (b) our PE clients continue to maintain robust M&A pipelines. We're actively factoring this into our efforts to manage capacity for services that support M&A activity, particularly in the areas of accounting, financial reporting, and post-merger integration.

Simba: PE-driven activity continues unabated, specifically with respect to PE-backed companies that are approaching or have exceeded their hold period. We are seeing PE firms announcing their intent to sell portfolio companies or begin preparation, driving continued demand for financial statement preparation, sell-side due diligence, and other transaction-readiness type of activities.

How does accounting & reporting advisory fit into the M&A transaction lifecycle?

Steve: We recommend approaching a transaction with a holistic suite of accounting and finance services that are applicable throughout the deal lifecycle. Historically, accounting advisory firms focused on M&A-related compliance matters—for example, accounting for the acquisition under US GAAP, accounting for complex earnouts, or accounting for stock-based compensation awards. Our experience has shown that leveraging a mix of traditional accounting advisory professionals, as well as management consulting practitioners experienced in finance-focused process improvement and transformation, can help ease the integration experience post-close and potentially even accelerate the return on investment of a transaction.

Simba: Combining technical accounting and finance process expertise can help solve for any number of challenges that the accounting and finance departments might face in the throes of an M&A transaction across reporting, compliance, technology, service delivery model, and sub-processes.

What are the most important accounting issues for companies to consider toward the end of their hold periods and as they prepare for a sale transaction?

Simba: Being prepared for a full commercial diligence process is a key predictor of ultimate deal success. Additionally, sell-side preparedness, particularly with respect to earnings before interest, taxes, depreciation, and amortization (EBITDA) and net working capital positions sellers to effectively drive negotiations and avoid unexpected purchase price adjustments during the diligence process. Many companies engage a sell-side diligence provider to prepare a proactive Quality of Earnings analysis. The sell-side provider prepares management for the tough questions from the buyer and their representatives. In addition, sell-side diligence identifies issues that can be mitigated or resolved. If issues are uncovered that may be viewed as unfavorable, the diligence readiness process allows management to embrace first-mover advantage in terms of setting the parameters of discussion when issues are surfaced by the buyer. In some cases, it can make sense for the company to introduce those issues during the commencement of diligence to build trust and reduce churn in the negotiation process.

Steve: Some accounting issues that commonly cause problems during the sale process include contingent or unrecorded liabilities, revenue recognition, inventory and accounts receivable reserves, and capitalized costs. As relates to the deal structure, certain items can cause additional accounting complexity, including earn-outs, exchange of stock-based compensation awards, and equity-denominated purchase consideration.

Are there specific deal structure items that can cause accounting surprises?

Steve: Yes, there are a number of common deal structure items that can result in non-intuitive accounting treatment. In my experience, first on that list is earn-outs. Earn-outs are commonly used to mitigate deal risk and align future incentives between buyer and seller. These mechanisms can also serve as a bridge between disparate buyer and seller valuations. While they are often a practical solution, earn-outs can create significant accounting complexity, both with regard to purchase and post-transaction accounting. Depending on how they are structured, earn-outs may be treated as additional purchase consideration, post-combination compensation expense, or a combination of both. Earn-outs treated as post-combination compensation expense will impact future EBITDA and may need to be considered in deal models.

Another area that can cause accounting complexity is debt raised to finance a transaction. Oftentimes, transaction debt is complex, with various embedded features, including conversion and redemption options. These features may need to be accounted for separately of the debt, potentially on a fair value basis. In addition, transaction debt often includes discounts and deferred financing costs that must be accounted for as effective interest over the term of the instrument.

Finally, I'd point to stock-based compensation awards that are modified or exchanged for new awards tied to acquirer equity as part of the transaction. Depending on the specific fact pattern, modification or exchange of stock-based compensation awards can impact predecessor expense, purchase price, and/or post-combination expense.

Once a transaction closes, what are some of the most common challenges companies face when integrating back-office finance and accounting functions?

Simba: Within middle-market PE, portfolio companies typically reflect a platform company purchased at a relatively high EBITDA multiple with bolt-on and tuck-in acquisitions added at comparatively lower multiples. These platforms generally struggle with producing financial data for decision support on a timely basis and capturing synergies across the back office. This is driven by the presence of fractional full-time equivalents across administrative functions, multiple ERPs or general ledger systems, and back-office staff with varying levels of competency and capacity. These bolt-on organizations are rarely poised to meet the incremental challenges of being part of a larger concern.

Planning for day one readiness upon execution of either a letter of intent or binding purchase agreement can go a long way toward mitigating these issues and ensuring a more productive integration path.

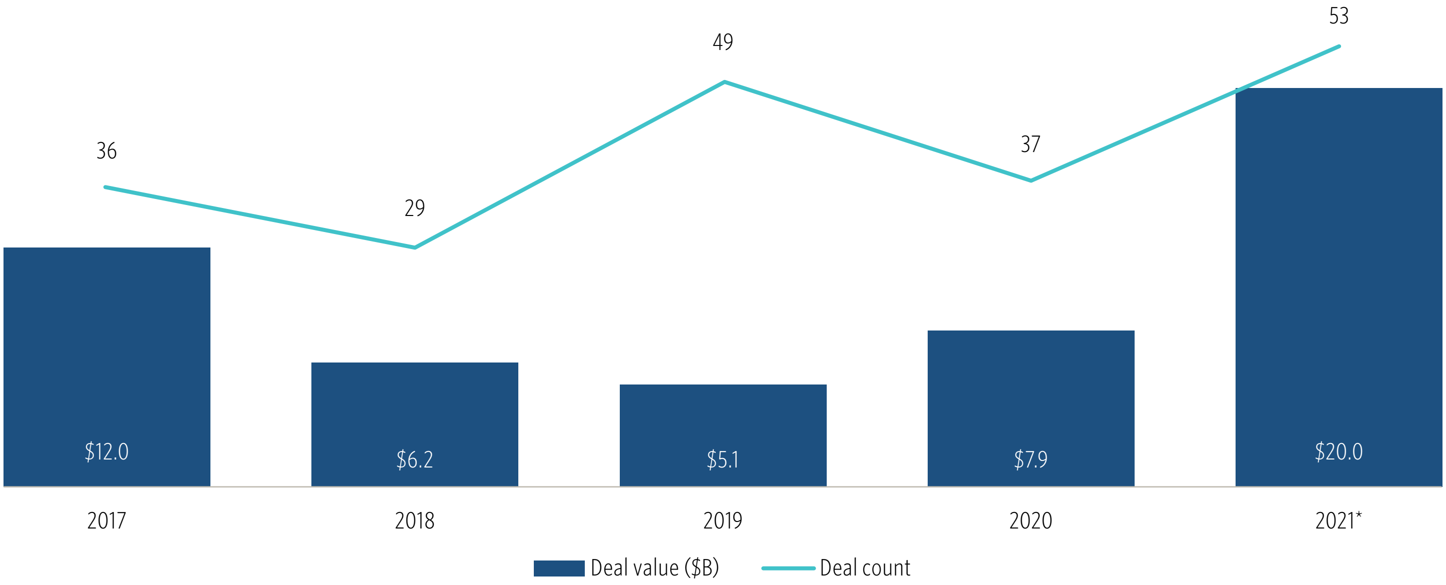
Traditionally, PE has not established a true Integration Management Office (IMO) to manage incoming businesses. However, in an era wherein bolt-on and tuck-in acquisitions are standard practice, the traditional PE integration playbook is no longer sufficient.

Realizing the above, PE companies continue to embrace establishing an IMO that is a mix of PE, platform, and external professionals.

SPOTLIGHT

Private equity's opportunity in supply chain technology

PE supply chain tech deal activity



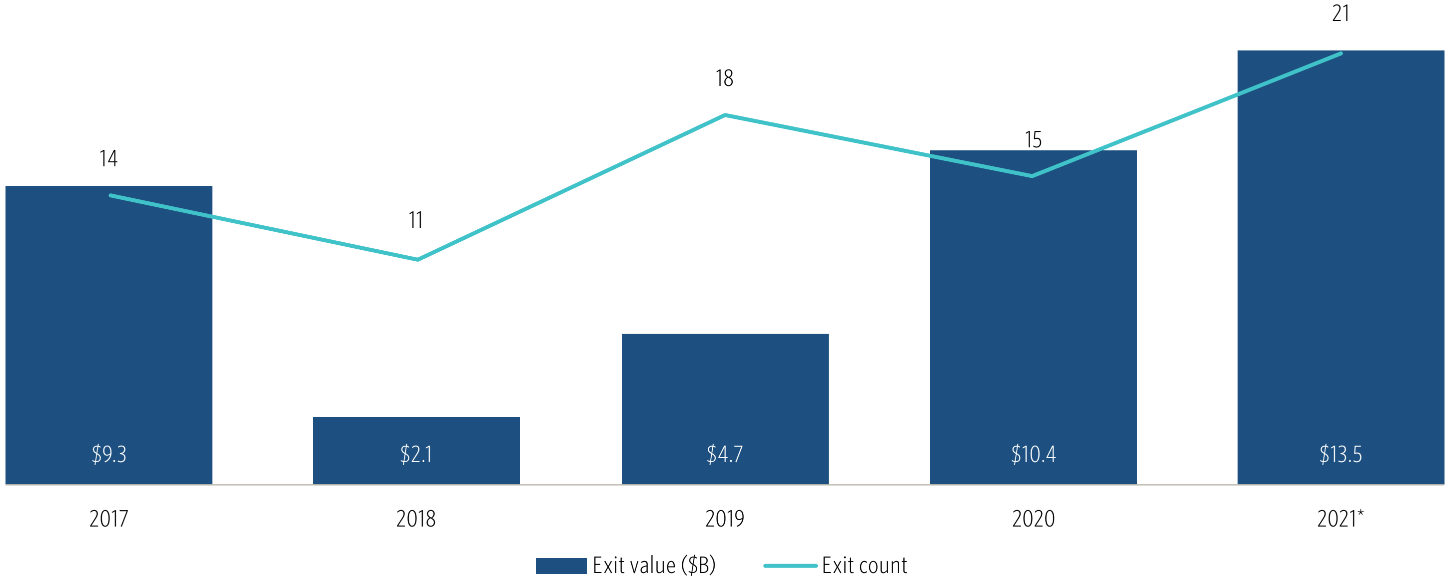
Source: PitchBook | **Geography:** US
*As of December 31, 2021

Note: This spotlight is abridged from our Analyst Note: Private Equity's Opportunity in Supply Chain Technology. Please see the full note for additional analysis on how private equity can benefit from investments in the supply chain tech space, and a look at the logistics and transportation subsegments of supply chain tech.

Supply chain technology is becoming an increasingly vital vertical of the tech industry to better streamline supply chains and create a stronger framework of operations. Modernizing supply chains is paramount, and companies and investors are turning to technological capabilities to drive the much-needed efficiency and optimization in their supply chains. Continued labor shortages and rising costs also mean that companies can rely on technology to successfully meet the growth in demand for e-commerce and delivery services while reducing costs related to manufacturing or logistics processes. As the pandemic tested the resilience and flexibility of the global supply chain to maintain essential operations, much of the stress resulted from the varying degrees of overlap in technical capacity across the links of the supply chain. Inefficient coordination between each leg of the supply chain to exchange vital information on orders and transportation capacity creates costly delays and gridlocks.

Supply chain tech—leveraging data and analytics, AI, and machine learning—is crucial to the transformation of the supply chain. First, improvements in data and analytics will provide increased visibility into the supply chain, helping better anticipate potential disruptions and minimize costs. Second, increased connectivity across networks means that different stages of the value chain can quickly respond to demand fluctuations or changes in production and distribution processes as data related to supply, demand, inventory, and capacity is coordinated and shared. Transportation Insight's (TI) acquisition of SwanLeap in November 2021 via its financial sponsor Gryphon Investors exemplifies this. By combining SwanLeap's proprietary transportation management systems (TMS) software with TI's tech-enabled logistics and freight brokerage solutions and

PE supply chain tech exit activity



Source: PitchBook | **Geography:** US
*As of December 31, 2021

nationwide network of shippers and carriers, the deal creates the largest one-touch transportation management platform. Third, increased digitalization is aligned with consumer behavior and expectations, as growth in e-commerce also increases the demand for visibility and control over delivery of goods and returns. For example, American Eagle Outfitters (NYSE: AEO) acquired Quiet Logistics for $360.6 million from Greenfield Partners and The Related Companies in December to help offer same-day and next-day shipping to its customers as part of its long-term vision for its supply chain capabilities and omnichannel presence. The opportunities to use technology to drive efficiency and stability in the supply chain have increased dramatically, positioning supply chain tech as a vertical ripe for growth and innovation, especially during the tremendous expansion of e-commerce.

Opportunities in PE

Supply chain tech has garnered interest across different subsectors and stages of development. PE investors are focused on more established technology platforms in which they can drive operational and product enhancements and execute value-add strategies through additional investments, add-on acquisitions, and market expansion. PE firms' approach to supply chain tech is to seek out mature supply chain tech companies that can be reinvigorated by capital and end-to-end transformation, or pursue deteriorating companies within the supply chain that can be made more efficient through modern technology.

Additionally, the tech-enabled services market remains largely fragmented, leading to many opportunities for investors to scale and consolidate attractive companies. PE firms can integrate smaller service providers that lack the resources to invest in technology by themselves with other tech-enabled companies to scale and deliver differentiated platform solutions for customers. PE investors could execute increased consolidation plays in supply chain tech as it becomes increasingly important for transportation and logistics providers to control their own capacity networks to provide reliable services to customers. PE firms could look to pursue strategic acquisitions to enhance capacity and services.

PitchBook

A WORD FROM WEST MONROE

Q&A: 2022 private equity trends

What are operating partners and portfolio companies thinking about the most if a recession happens? What is the broader sentiment among operating partners and portfolio teams as they look ahead to the rest of the year?

Brad: As the outlook darkens for the remainder of the year, private equity firms have been taking a more conservative approach. They'll spend more time working with their portfolio companies to make sure they're as recession ready as possible versus devoting most of their time to identifying new investment opportunities. We aren't seeing companies going into layoff mode yet—aside from some very high-growth tech companies that haven't reached sustainable profitability. But overall, the priority is on the businesses where they've already put capital to work.

Keith: Dealmaking is starting to slow for the summer, but our clients are divided on whether that will pick back up in the fall given the recession outlook. Good assets are not likely to go to market if valuations are depressed, IPOs are on ice, and the historically high-growth tech sector sees tailwinds.

Brad: We are seeing capital markets evolving rapidly. Lenders are also being more conservative about what businesses they're willing to fund and those companies' equity-to-debt ratios.

Keith: Operating partners have been spending a lot of time on labor challenges. That includes replacing portfolio company management teams, either in founder transitions or in recruitment for the next phase of growth. PE firms are also looking at building technology and other back-office capabilities in-house, or leveraging outsourcing, either offshore or nearshore. There are some creative strategies wherein PE clients are considering forming offshore arms to provide services that their portfolio companies can tap into.

What trends are you seeing in the evolution of portfolio teams?

Brad: PE firms have been raising bigger funds, and they're having to scale their own teams so they can work across these broader portfolios.

We're also seeing the evolution of portfolio operations teams at larger funds. They are closer to consulting organizations that work across the portfolio on both strategic priorities, as well as, at times, tactical needs, as opposed to traditional operating partners who spend most of their time coaching executive teams.

Keith Campbell

Keith is a partner in West Monroe's Mergers & Acquisitions practice, leading the firm's carve-out and merger integration offering. Under his guidance, clients see an average of 30% reduction in timeline and cost for their divestitures. Keith has led teams on more than 300 private equity and corporate carve-out transactions, and he uses that knowledge to quickly identify issues and opportunities, estimate standalone costs, and negotiate favorable TSAs—resulting in millions of dollars in value creation.

Brad Haller

Brad is a partner in West Monroe's Mergers & Acquisitions practice, leading the firm's extensive capabilities in post-merger integration. Brad specializes in highly complex deals involving multiple buyers, rapid add-on investments, hostile takeovers, multi-company mergers, and carveouts-to-integrations. A trusted advisor to many private equity firms and strategic buyers, he has led more than 500 M&A transactions in the last decade.

Keith: Some PE clients are building small, in-house analytics teams that support due diligence to gain an edge in the bid by identifying trends. Once they buy the company, that data can drive value for the firm. The concept of a digital operating partner is now becoming more and more prevalent.

Are you seeing a shift in how operating partners are partnering with their advisors or leveraging data in response to managing a larger breadth of portfolio companies? How could a recession affect this shift?

Brad: As operating teams scale up, they generally prefer advisors that can bring more breadth of expertise and offer multiple capabilities. Instead of looking for best of breed, operating partners are searching for the Swiss Army knives of the advisor landscape. For example, West Monroe can provide due diligence work and then improve a portfolio company's data capabilities or revenue operations. As our clients spend more time doing triage on their portfolios to guard against potential recession impacts, data will assume even greater importance. Their portfolios are larger, and the ability to ingest and analyze data in an efficient way across 30 or 50 companies can you give greater confidence around the health of those businesses.

PE firms are facing increased pressure in the due diligence process. They are seeing heightened competition, reduced access, and shorter deal timelines. What is the primary driver behind this change, and how are teams adapting? What changes will we see in the due diligence process over the next one to three years?

Brad: A lot of demand is chasing limited supply, creating a very competitive process.

Some of this is a holdover from COVID-19. While business travel has resumed, most diligence is still happening via Zoom and in virtual data rooms. That works to sellers' advantage because they can meet with more parties. Some clients are having all their advisors work together to solve a joint mandate, which can lead to greater focus and productivity within a tight timeframe.

Further out, new technology is being built to allow private equity professionals to do their jobs more efficiently using tools like optical character recognition to review documents for keywords. It's digitizing elements of the diligence process so they can focus on the questions necessary for them move forward in the deal.

Keith: Things that historically would have happened during normal diligence windows are now occurring even before companies are up for sale. PE firms are deciding what areas of the market they want to invest in, closing in on the winning companies, and building relationships with management teams. So, when those companies come up for sale, firms know the business and can just focus on key questions instead of starting from scratch.

Some deal aspects are shifting into post-close. Things you can fix about a company—such as replacing management and operational improvements—areas that PE firms have proven they can execute post-close and don't really impact valuation.

In today's volatile market, it's more important than ever for PE firms to leverage data assets to identify and drive value creation, especially given higher valuations. What steps are operating partners taking to use more data and automation to gain additional insight in the deal process?

Keith: There has been a push to use publicly available data because dealmakers' access is constrained. That includes data on jobs, labor spend, looking at employee sentiment or purchase data. You could show up at a meeting with the HR leader at the target company and already understand key metrics such as attrition and sentiment from sources such as LinkedIn.

For cyber due diligence, we can scan the dark web and tell companies whether they have critical infrastructure up for sale that they don't know about. With access to a retail business' internal data, we can use machine learning to identify opportunities for revenue growth, reallocating marketing span, and customer lifetime value—key metrics that help us figure out how we can drive company growth or profitability.

Which PE industry trends have been driven primarily by the prediction of a recession, and which existed prior and have merely accelerated? How are operating partners responding? What is the industry not talking about—but should be?

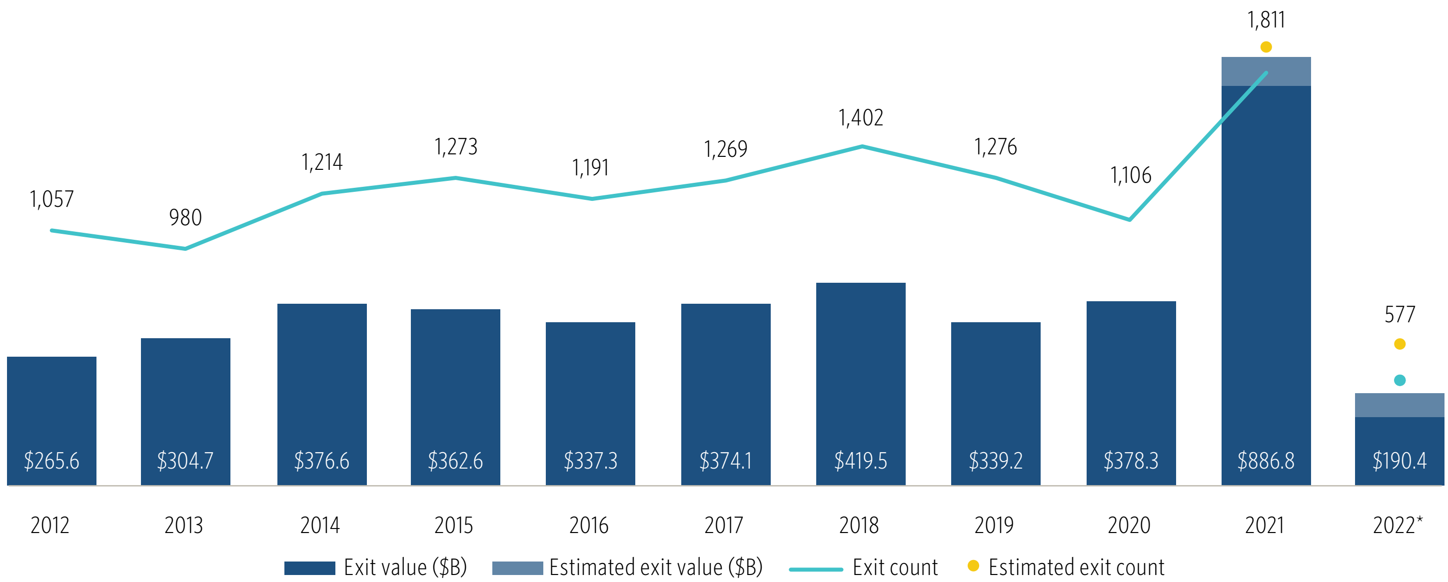
Brad: Many of these trends are based on a healthy economy and competitive private markets—whether it's doing more with less on due diligence or businesses working hard to drive value for a return because of a high cost of acquisition. If the economic situation devolves rapidly, dealmakers' attention would have to shift from future investments to existing investments. That would affect the transaction market.

As the clouds gather, one thing that's not being discussed is whether the move by some tech companies to cut their way to profitability is shortsighted. By slashing labor expenses, those companies could be missing out on a chance to retain or grow revenue—for example, by using customer success teams to upsell additional services or using support teams to retain existing customers by providing better training on tools or improving the user experience.

Keith: PE firms know how to finance and lead companies in times of distress, but I think they will jump at the opportunity to get some steals (for example, companies in bankruptcy and noncore assets). If a recession happens, public companies will have to prune their assets and divest for cash. Who do they divest to? Private equity.

Exits

PE exit activity



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Overview

US PE exit activity slowed for the second consecutive quarter as potential sellers chose to hold portfolio companies amid falling valuations and sagging multiples. Sponsors exited 293 portfolio companies during Q2, with a cumulative value of $94.5 billion. While the decline in exit activity is so far a reversion back to its historic long-term PE exit count trends, the sharp contrast with the fervent exit activity seen in 2021 demonstrates the intense headwinds driven by higher interest rates, geopolitical conflict, and subsequent market volatility. Public listings, which had been the main driver of exit value in 2021, dropped amid a steep stock market decline and valuation adjustments, with many GPs deciding to hold onto their investments rather than test the public markets. The returns of PE-backed IPOs have also lagged during 2022. Our PE-backed IPO index tracks the performance of portfolio companies recently publicly listed by PE firms, and the results have not been positive. An uptick in performance for these companies will be a leading indicator for more PE-backed public listings. Exits continued through sales to other sponsors or corporates looking to take advantage of lower valuations. With falling stock prices though, corporates are likely to be more selective and less acquisitive than 2021, thus further curtailing exit options. The median exit size was $343.0 million for H1 2022, which is still higher than pre-2021 values, suggesting that the sponsors have still been able to close a number of sizable exits despite a challenging exit landscape.

Continuation vehicles, which have been rising in popularity for the past several years, are a strategy that PE firms can employ to prevent unfavorable exits. Continuation funds are created to acquire one or more portfolio companies of a fund that is nearing the end of its lifespan and roll them into its own investment. GPs will do this if at the end of a fund they deem one or more investments has further upside and

PE-backed IPO index

Source: Morningstar | **Geography:** Global
*As of June 30, 2022

want to hold on longer. This process also allows for LPs to cash out and obtain liquidity from their investment should they choose. Some GP-led transactions are even beginning to happen earlier in a fund's lifecycle as certain investments perform exceptionally well. The deal to roll them out of a flagship fund is seen as a portfolio management tool to avoid overconcentration and allows for further growth capital to be injected. This trend of continuation vehicles is only expected to gain more traction as market conditions worsen, valuations remain low, and GPs look for new ways to offer their investors liquidity in a weaker exit environment. Continuation vehicles can also benefit LPs by providing GPs the ability to better time exits as they hold onto their investments for longer to wait out volatility.

Sponsor-to-sponsor

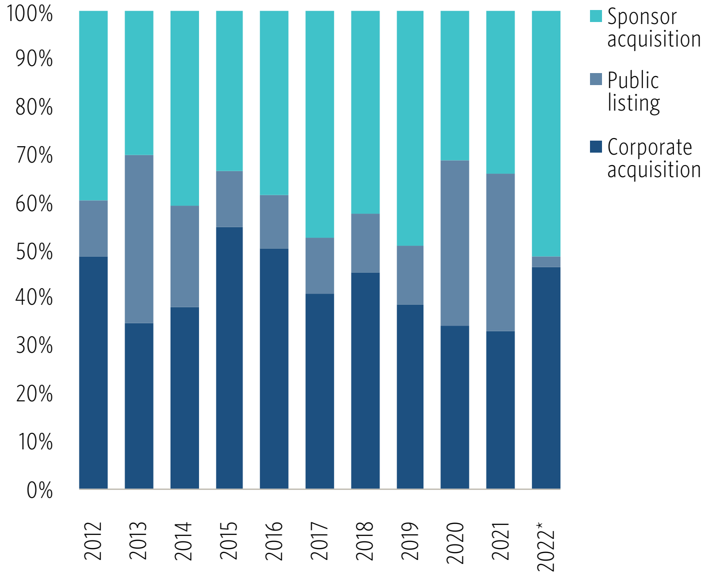
Compared with Q1, sponsor-to-sponsor exits dropped off in Q2, with just 114 exits at $24.8 billion in cumulative exit value. The decline in sales to sponsors mirrored that of Q2 and Q3 of 2020, as PE firms by and large held on to their portfolio companies as they waited for valuations to recover. Despite the challenging macroeconomic environment, we anticipate sales to sponsors to pick back up in the next few quarters, with other GPs looking for opportunities to deploy a near-record amount of dry powder. Healthcare saw a decent level of sponsor-to-sponsor exits during Q2, as PE firms were able to exit their portfolio companies to other GPs that continued their platform plays in a more attractive pricing environment. For example, Pritzker Private Capital and Vesey Street Capital Partners' sale of PathGroup, one of the largest independent laboratories in the US, to GTCR for $1.2 billion marked the largest sponsor-to-sponsor exit in the quarter. GTCR plans to further invest in PathGroup's commercial and customer service organizations, expand the company's geographical footprint, and employ strategic M&A to extend service offerings.[8] Additionally, Sheridan Capital Partners announced the sale of Dermatologists of Central States (DOCS) to SkyKnight Capital for an undisclosed sum in June. DOCS is a scaled provider of services to dermatology practices in the Midwest and Southeast US, having grown from one state to one of the largest dermatology group practices in the US under Sheridan's ownership. Under SkyKnight, DOCS plans to drive its next phase of growth as a market leading dermatology services platform across the country.

8: "GTCR Announces Recapitalization of PathGroup," *Cision PR Newswire*, GTCR, May 13, 2022.

Corporate acquisitions

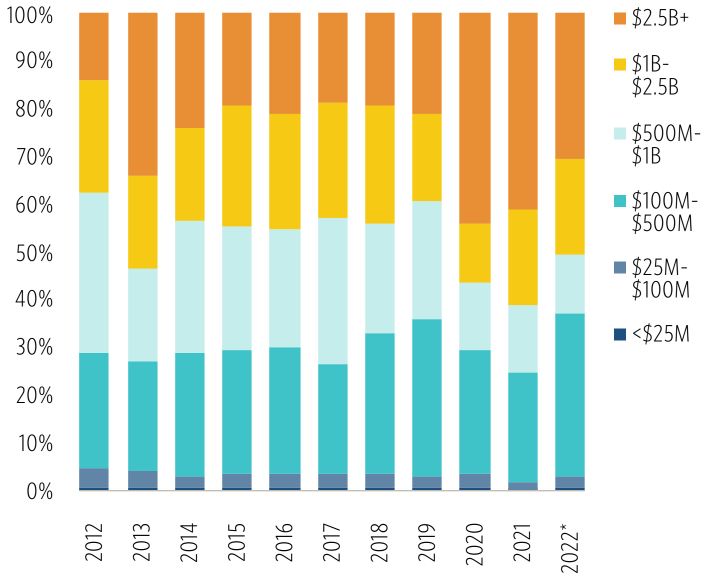
Strategics also continued to absorb PE-backed companies at a similar rate to Q1, with 77 exits at $36.1 billion in aggregate exit value. The proportion of exits to strategic buyers in Q2 was one of the highest figures seen in the post-GFC era, as sponsor-to-sponsor exits declined and public listings all but disappeared. High levels of balance sheet cash remain a key force for corporate acquisitions, although turbulent markets and concern for an oncoming recession make companies more cautious about transactions. GPs were still able to capitalize by exiting investments to companies seeking strategic acquisitions to position themselves for continued growth, such as Masimo's (NASDAQ: MASI) acquisition of Sound United for $1.0 billion in April. Sound United manufactures audio and entertainment products and will add established consumer and technology brands to Masimo's medical device business. The acquisition also allows Masimo to leverage Sound United's omnichannel go-to-market expertise to accelerate distribution of the combined company's portfolio of products.[9] Corporations are also finding opportunities for consolidation and geographic expansion. In April, PE-backed Kane Logistics was sold to ID Logistics Group (PAR: IDL) for $240.0 million. With Kane Logistics, a provider of third-party logistics and supply chain services for product distribution in the US, ID Logistics will have strong logistics capabilities across the US, Europe, Asia, and Africa and create servicing synergies in similar industry sectors.

Share of PE exit value by type



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Share of PE exit value by size bucket



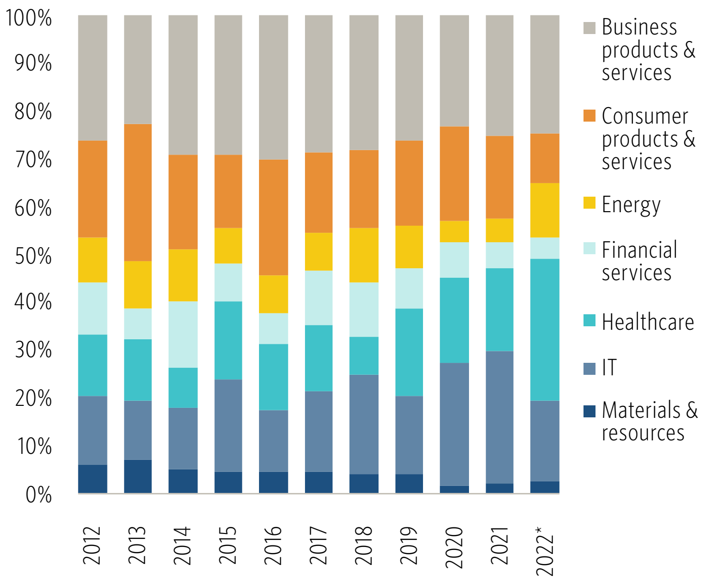
Source: PitchBook | **Geography:** US
*As of June 30, 2022

9: "Masimo Completes Acquisition of Sound United," *Mass Device*, Sean Whooley, April 12, 2022.

SPACs

Special purpose acquisition company (SPAC) IPOs and ensuing reverse mergers have seen a major slowdown in 2022. The frenzied 2021 saw 613 SPAC IPOs, and 47 PE-backed companies publicly list via a reverse merger with a SPAC. This type of listing gave sponsors the ability to use forward projections to achieve a listing more quickly than alternative methods. However, the Securities and Exchange Commission (SEC) recently published proposed regulations on SPACs that include new disclosures and financial statement requirements in certain SEC filings by SPACs. The new regulations are likely to remove or severely restrict the forward-looking projections, one of the most attractive features of this type of listing. Additionally, with falling multiples in public markets, public listings of any type are effectively shelved until further notice. The future for SPAC public listings remains uncertain. With the initial boom in SPAC IPOs kicking off in 2020, many of the blank check companies will be approaching their built-in two-year investment window—after which the entity must be dissolved, and capital is returned to investors. This could pressure SPACs to offer even better pricing to target companies, but in this macroeconomic environment, sponsors are likely to forgo listings, especially via SPAC.

Share of PE exit value by sector



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Energy

The energy sector continued to garner substantial buzz as inflation and persistent supply and demand mismatch created significant turbulence in oil prices. In June, the price of Brent crude oil, the global benchmark, shot up to $124 per barrel. The price has since softened as investors worried that interest rate hikes could push the economy into a recession and thereby dampen demand for fuel. Nevertheless, some energy investors are taking advantage of the opportunities born of the higher energy prices. In May, EIG Global Energy Partners, The Broe Group, and TPG sold Great Western Petroleum to PDG Energy (NASDAQ: PDCE) for $1.3 billion. Great Western Petroleum provides exploration and drilling services and will boost PDC Energy's oil and gas output and add new drilling locations in Colorado to its backlog. In the same month, SDW Investments exited its investment in ProFrac, an oilfield services company, via a public listing. ProFrac raised $288.0 million in its IPO, pricing its shares below target as new listings in the US continue to struggle in 2022. With oilfield services and exploration companies experiencing a hotter market, we can expect more exit activity as PE firms look to take advantage of a higher pricing environment. In the meantime, the Biden administration continues to tackle the rising costs, with the record release of 1 million barrels per day from the US Strategic Petroleum Reserve providing some short-term relief, and by proposing a federal gas tax holiday to reduce prices and accelerate production. However, these moves are not expected to substantially reduce consumers' energy costs. So long as prices remain aloft, we expect sponsors to continue reaping profits.

Technology

Through the first half of 2022, IT exit activity held on, with 77 exits completed at an aggregate exit value of $24.0 billion. The tech sector's exit activity took a sharp turn from the frenzy seen last year, with the quarterly exit value declining 79.6% from that of Q2 2021. Plummeting public tech stocks continue to beleaguer valuations for PE-backed companies. Big Tech stocks crumbled amid high inflation and interest rate hikes, and the Nasdaq 100 was down around 32% in June from its peak in 2020. As tech finds itself in bear market territory along with the broader market, PE firms are holding on to their portfolio companies in an effort to wait for some of the volatility to dissipate or exiting companies at lower valuations than they may have garnered several months ago. During Q2, no public listings in IT took place, as sponsors were cautious not to risk a disappointing debut in a struggling market. Instead, corporations and other sponsors continued to pick up PE-backed companies in tech, as private investors sought opportunistic investments at more attractive prices.

Several secular growth trends in IT remain and helped backstop exits for companies with long-term growth opportunities. For example, Thoma Bravo agreed to sell cloud securities services firm Barracuda Networks to KKR (NYSE: KKR) for a reported $4.0 billion. Cybersecurity continues to be a highly attractive space, and KKR plans to further expand Barracuda's offerings and push the company into key security markets to capture business in a growing market. The sale comes four years after Thoma Bravo took the company private in a $1.6 billion deal, having grown its security solutions portfolio and having achieved considerable revenue growth since then.[10] Burgeoning verticals such as supply chain technology are also seeing exits as sellers find buyers that can employ additional value creation strategies. In June, a group of sponsors led by Carousel Capital agreed to sell majority interest in Apexanlytix to KRR. Apexanlytix is a developer of supply chain risk management software and will continue to accelerate its product development and global expansion. KKR has made numerous acquisitions in supply chain tech, investing in the theme that sophisticated tech solutions can create operational efficiency and savings in fragmented global supply chains.

Corporate acquisitions also contributed to tech exits as reliance on data and analytics spurred exit opportunities for PE firms investing in tech companies focused on increasing digitalization within business operations. In June, BV Investment Partners sold GlideFast Consulting, which provides IT consulting and development services, to ASGN (NYSE: ASGN) for $350.0 million. GlideFast provides tailored solutions for ServiceNow implementations, and ServiceNow is a go-to operating cloud system of enterprises globally looking to optimize their processes. ASGN, which provides IT services and solutions across commercial and government sectors, anticipates growth and revenue synergies through the combined IT consulting offerings and an expansion of its business pipeline.[11]

10: "KKR To Acquire Barracuda Networks in Bid to 'Accelerate' Security Firm's Growth," *CRN*, Jay Fitzgerald, April 12, 2022.
11: "Why ASGN (ASGN) Is Buying GlideFast Consulting for $350 Million," *Pulse 2.0*, Amit Chowdhry, June 2, 2022.

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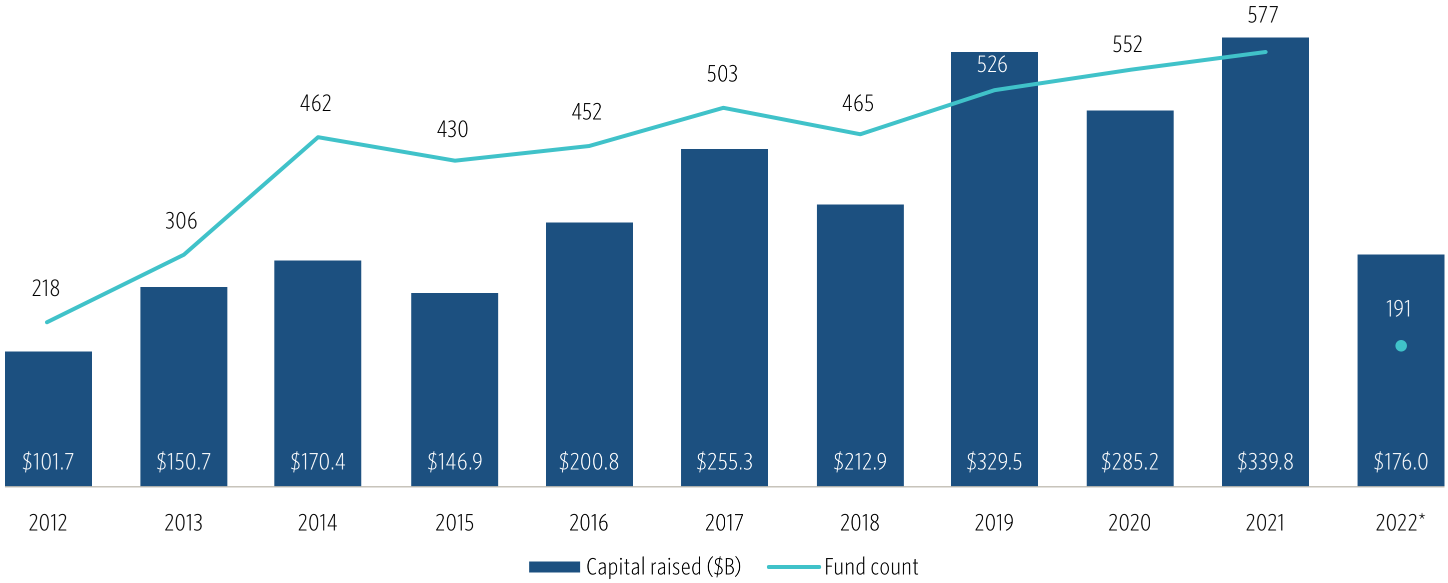
Fundraising and performance

PE fundraising activity



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Overview

Q2's fundraising started off sluggishly compared with the historic 2021, but activity abounds for managers of all sizes. Halfway through 2022, US PE firms have raised $176.0 billion across 191 funds. This is perhaps the most crowded fundraising market in history. After a record-shattering deployment year in 2021, most managers now either are back fundraising, are preparing to fundraise, or have just finished fundraising. Some firms even closed new funds in early 2022 and are reportedly targeting to launch follow-on vehicles by year-end.

For many firms, the fundraising process is being drawn out in the current environment for several reasons. For a couple quarters now, more sponsors have been returning to their investor bases seeking re-ups than there is capacity to fund these commitments. As is being widely reported and confirmed via anecdotal conversations with fundraising firms, many firms are pushing their final closing dates from late 2022 into 2023 as a result. Most of the large institutional allocators have already committed their entire 2022 PE allocation, so moving the final close date to 2023 allows GPs to target next year's allocation dollars. In other cases, managers are being asked to delay fund launches until 2023 for the same reason. In a crowded environment, many of the largest institutional allocators are prioritizing their existing and longest-lasting relationships. This means larger and more-established managers are poised to fare better in their fundraising efforts. This sentiment was echoed by most of the large public managers on their recent earnings calls and can be seen with many of the recent headline-grabbing funds holding final closes in the quarter, including KKR's $19.0 billion flagship fund and Advent International's $25.0 billion behemoth fund. Smaller firms are finding it increasingly difficult to even get in front of investment committees, thus forcing them to look elsewhere. Family offices and non-US-based LPs are major areas of interest for new capital sources.

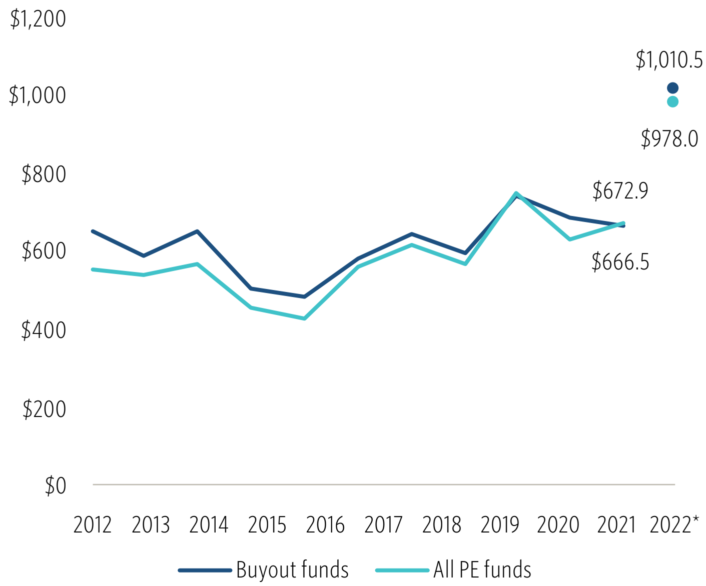
The denominator effect is also adding to current fundraising difficulties. Many public equity holdings are off by 20% or more in 2022, while many PE portfolios are down by mid-single digits. This has caused the private holdings to swell proportionately, thereby pushing the current allocations past target allocations for many large institutional allocators. Although many of these allocators made changes to mitigate the denominator effect following the GFC, these changes focused primarily on avoiding fire sales in the private side of the portfolio. Future allocations can still be negatively affected, and this exact phenomenon is being cited by investment committees across the country. As an example, the Alaska Permanent Fund is reducing commitments for fiscal-year 2023. The longer the current gap in pricing persists between public and private equities, the more difficult it could be for firms on the fundraising trail.

The dearth of exits, and subsequently distributions, is an additional element making fundraising more difficult. Much of the capital LPs receive is recycled into future commitments. If insufficient capital is flowing in from an LP's PE investments, the allocator could have to fund commitments by selling assets in the portfolio. These large institutions are loathe to liquidate public equities, with many holdings there far more than on the private side. In turn, this could be a boon for the secondaries market as many large LPs shed older assets to fund new commitments. To a certain extent, this is already happening. Netherlands-based pension giant APG is reportedly shopping a portfolio of PE fund stakes worth some €2 billion ($2.1 billion) in order to keep pace with fundraising in this environment.[12] Myriad smaller PE fund stakes are expected to come to market in the coming quarters as dozens of other allocators face a similar problem.

The overall crowding and difficulty fundraising is exposing the overreliance on pensions and endowments for many firms, pushing the industry to look elsewhere for new capital commitments. Individual investors—often called retail, wealth, or mass affluent—are a key focus for private capital firms of all strategies and sizes. According to comments made by Blackstone's Jon Gray in its Q1 2022 earnings call, the retail market is worth approximately $80 trillion with just 1% allocated to alternatives at the time of the call—though that $80 trillion has likely fallen due to declining equity markets in recent months.[13] A 10% allocation to private assets would allow the global alternatives industry to nearly double its AUM.

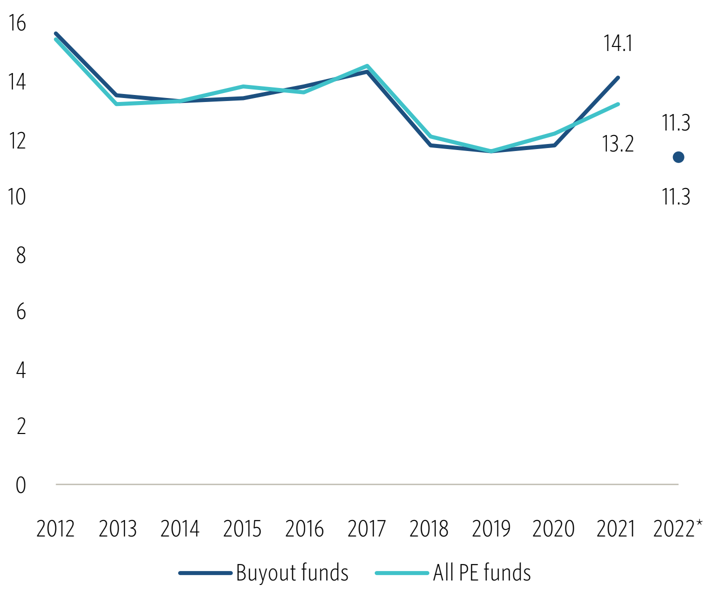
Armed with capital, the massive public managers have been building out their retail-focused offerings. Blackstone in particular has been scooping up $4 billion to $5 billion in equity capital from retail capital per month. The firm's nontraded REIT, known as BRIET, has more than doubled in size over the past 12-months to $68 billion NAV. Blue Owl, while not as impressive on an absolute basis, has been a

Average PE fund value ($M) by type



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Average time (months) to close for US PE funds by type



Source: PitchBook | **Geography:** US
*As of June 30, 2022

12: "APG Eyes Second Large LP Portfolio Sale as LPs Struggle with Fundraising Pace," *Secondaries Investor*, Chris Witkowsky, June 13, 2022.
13: "Blackstone First Quarter 2022 Investor Call," Blackstone, April 21, 2022.

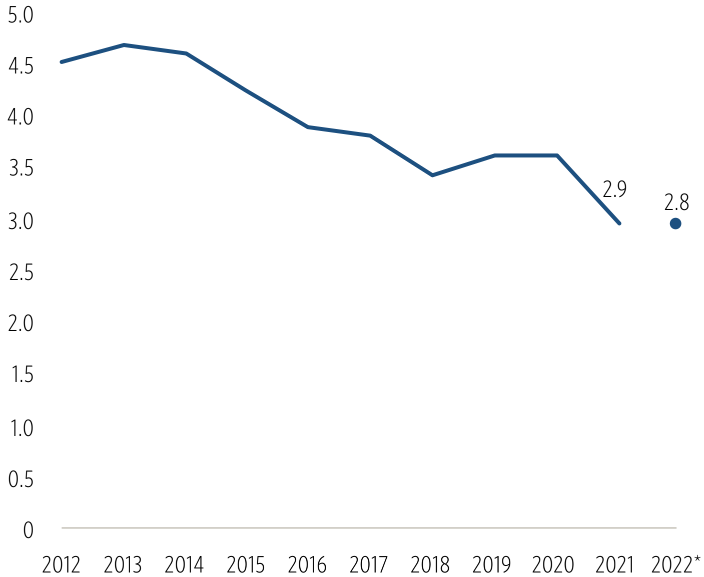
relative leader in the space; more than half of its $2.2 billion raised came from private wealth. Until now, most of the retail assets went into strategies and funds designed specifically for or better suited to retail capital—including real estate, GP stakes, credit, and infrastructure. Blackstone and Ares are both launching retail-focused private equity products, and, depending on their adoption and structures, this could be a game changer for PE firms. KKR's recent comments illustrate how bullish some managers are on the topic. As detailed on its year-end 2021 earnings call, private wealth has traditionally made up about 10% to 20% of its fundraising, and it hopes to lift that to 30% to 50% in the coming years.[14]

Going forward, PE firms will likely need to adjust deployment pacing and revert to historical standards. The one- to two-year deployment pace in 2021 challenged many cash flow models at large institutional allocators. Luckily, distributions were higher than average in 2021 as well. Recent conversations with LPs indicate that another "far too quick" deployment pace two funds in a row could seriously squeeze their cash balance and lead to certain relationships being reviewed. Whether GPs will heed this advice is unclear. Some firms that have held final closes on mega-funds in 2022 are reportedly already readying a follow-up vehicle, which could lead to some tension with pension and endowments. We will be closely monitoring this trend in the coming quarters.

Mega-funds

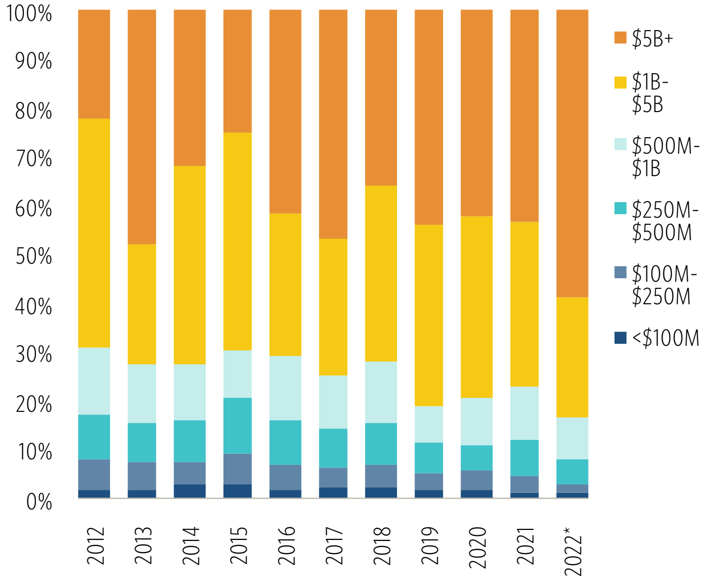
While mega-funds ($5 billion+) make up the smallest share of fund count, they unsurprisingly constitute a majority of total fundraising dollars. Mega-funds raised $102.8 billion in H1 2022, led by the aforementioned flagship funds of PE giants such as KKR, Clearlake Capital, and Apollo, to name a few. So far, seven mega-funds have closed funding in 2022, which is on pace to match the 14 mega-funds that closed funding in 2021. Other mega-funds, including KKR's $19.0 billion fund and Thoma Bravo's 15th flagship software fund, which already raised over $20 billion, are on track to close in the coming quarters. While these $5 billion+ funds often count on the largest pensions, endowments, and foundations for the bulk of their capital, many allocators are already maxing out their ability to write nine- to ten-figure checks. With so many gargantuan vehicles in the market and a slowing exit environment reducing capital flow back to LPs, it could become more difficult for GPs to find LPs willing to commit large amounts of capital with ease, or close mega-funds or raise funds as smoothly or as quickly as they used to.

Average time (years) between PE funds



Source: PitchBook | **Geography:** US
*As of June 30, 2022

Share of PE capital raised by size bucket



Source: PitchBook | **Geography:** US
*As of June 30, 2022

14: "KKR and Co., Inc. Fourth Quarter 2021 Results – Earnings Call," KKR, Craig Larson, Robert Lewin and Scott Nuttall, February 8, 2022.

Middle market

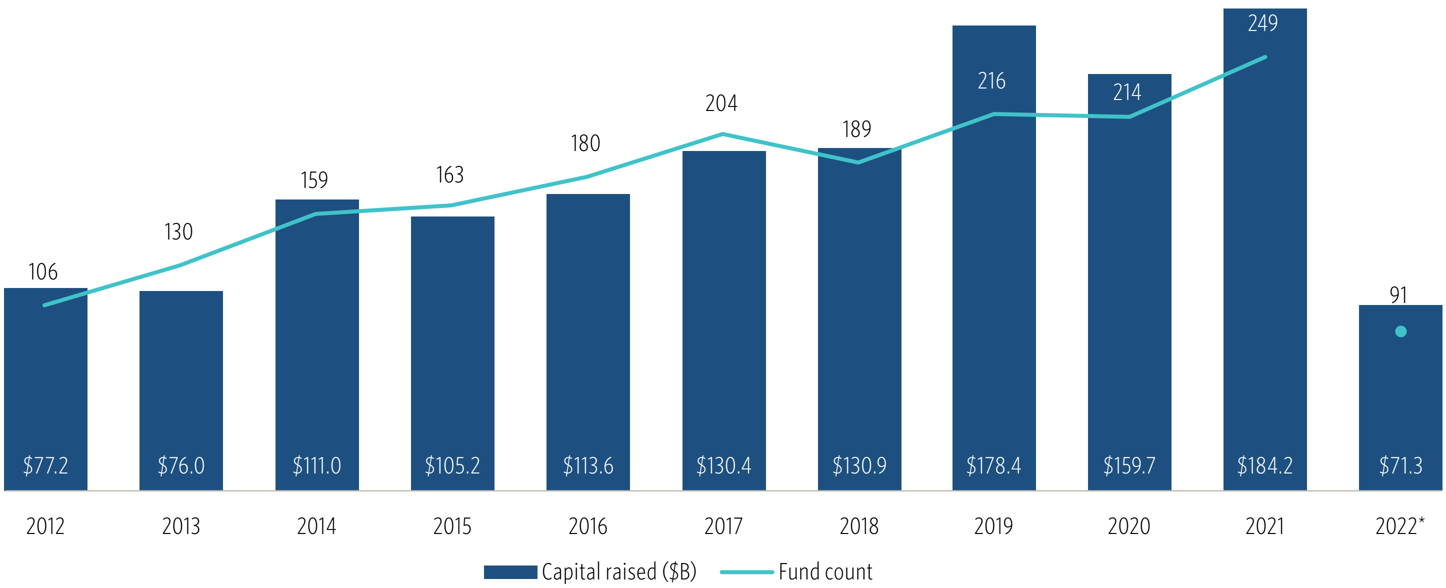
Fundraising for middle-market vehicles ($100 million to $5 billion) lagged compared with years past. Dating back to 2019, the middle market has raised over $150 billion across 200 funds each year. At the halfway point of 2022, the middle market has raised $71.3 billion across 91 funds so far this year. The middle market continues to feel the pressure from mega-funds by taking more fundraising from LPs and increasing their market share of fundraising. As a result, 2022 may end up being one of the most difficult fundraising years for middle-market GPs in about a decade. Small, niche managers could find success as well, as they require much smaller checks, and many large LPs are setting aside capital for such commitments for diversification. This means that middle-market GPs will either have to work harder and be more innovative to hit their fundraising targets or delay fund closings to gain access to some of the LP capital that will be available for allocations in 2023. Middle-market firms could find interest from other investor segments, such as family offices that are taking advantage of the challenging environment to seed new strategies. Retail capital, insurance firms, and other institutions in Asia and the Middle East are also eager to commit to US middle-market buyout managers.

First-time funds

First-time fundraising activity is seeing a decline compared with the historic activity witnessed in 2021. With a surfeit of established managers seeking to re-up with their LPs, the larger players are typically being prioritized in this frenzied fundraising market. Many first-time managers are finding it impossible to even get in front of the investment committee without first waiting several months. As we enter an even more uncertain economic environment, and with less capital available to first-time managers, newcomers with more pedigreed backgrounds or those targeting niches are most likely to receive funding. Many of the biggest first-time funds, both open and closed, have management with successful tenures at well-known firms. The third-largest first-time fund closed in 2022 is OceanSound Partners, which raised $780.0 million. OceanSound Partners is led by co-founder and managing partner Joe Benavides, who previously served as a partner at Veritas Capital and before that as a managing director at Blackstone.

LPs typically allocate to first-time funds in search of outperformance, differentiated strategy, and, in some cases, fee reductions. In this environment, LPs are unwilling to take

Middle-market PE fundraising activity



Source: PitchBook | **Geography:** US
*As of June 30, 2022

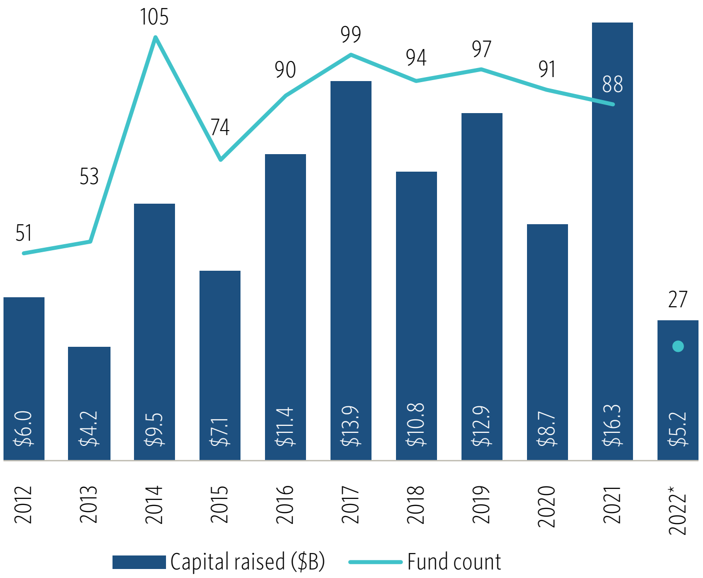
the same amount of risk that they were just 12 months ago. This could mean backing less speculative first-time managers, which could lead the firms seeking the largest debut funds to find more success. Halfway through 2022, four first-time sponsors have raised over $500 million, and two raised $1 billion or more in funds that have closed. In what is almost certain to be the largest-ever first-time fund, Patient Square, led by former KKR healthcare specialist Jim Momtazee, has already amassed $3.0 billion. The firm has reportedly set its sights on hitting $4.0 billion before it closes the fund. As detailed in previous research, most first-time managers coming to market—including many of the largest first-time managers to close in 2022—are specializing in one sector. Technology and industrials are often the most popular, but healthcare is also making its mark. Other niches are popping up as well. After Arctos Sports Partners raised the largest-ever first-time PE fund in 2021, another sports-focused manager, Dynasty, is seeking to amass $1 billion for its initial fund. Going forward, this will be a tough slog for many first-time managers, forcing them to seek out nontraditional funding sources, but the firms seen as "safe bets" will continue to find capital.

Performance

After delivering incredible performance for the past few quarters, fund investors are bracing themselves for markdowns in their buyout and growth portfolios. Valuations of high-growth companies fell as the Fed imposed multiple interest rate hikes throughout the year to combat raging inflation, and Russia's invasion of Ukraine created widespread uncertainty that further pressured public company valuations. This negative impact is likely to spread to private fund markets, although to a lesser extent than the downturn seen in public markets. The largest funds, which have performed the best during the COVID-19 rally, are expected to suffer the most during the current macroeconomic environment. The $1 billion+ portfolio companies that the largest GPs hold are marked to market, and the turn in public company valuations will greatly affect their path to liquidity through public listings.

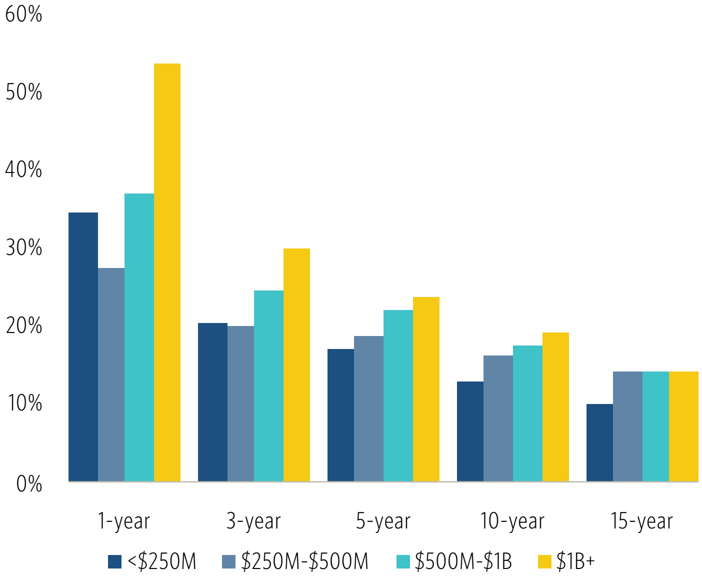
Middle-market funds, on the other hand, are expected to fare better because their mark-to-market valuations are less reliant on public company comparables. According to Golub Capital, the US middle market experienced YoY earnings growth in Q1 2022 for the companies it tracks.[15] Portfolio companies for which earnings growth outpaces multiple contraction could even see markups during the quarter. This was the case with several of the publicly available fund returns, including that of Apollo, which saw its PE portfolio appreciate 8% during the quarter. Overall, 2022 will challenge GPs and LPs of all sizes and disrupt the run of attractive returns that investors have been enjoying for the past several years.

First-time PE fundraising activity



Source: PitchBook | **Geography:** US
*As of June 30, 2022

PE fund horizon IRRs by size bucket*



Source: PitchBook | **Geography:** US
*As of December 31, 2021

15: "Earnings in the U.S. Middle Market Grew by 9% in the First Two Months of Q1 2022," Golub Capital, n.d., accessed on June 28, 2022.

A WORD FROM ONTRA

Unlock the benefits of contract automation

Many startups and tech companies throw around the phrase "AI-enabled," "machine learning-powered," or "technology-led" to help drive attention to their company and increase valuations. How does Ontra think about holding companies accountable regarding these claims?

Ontra has invested in artificial intelligence (AI) since 2017, when we hired our first machine learning (ML) engineer. Since that time, we've grown our ML team to about 10 people, covering disciplines such as machine learning science, engineering, and data infrastructure. No doubt, there are companies using AI as a buzzword to generate attention. But we've stayed focused on the measurable benefits of the features our AI team builds.

The main customer benefits we focus on are time savings, speed, and quality. We have a data set of almost one million tagged contracts that we've built over eight years—the largest of its type in the world. This unique asset allows us to create incredibly accurate AI models that let us build features with tangible benefits for our customers. For example, for each NDA we process for our asset management customers, we capture over 60 key terms of the final agreement in data format so that our customers can use our reporting tools to easily manage their obligations and benchmark against precedent. Some of these data points are simple, like term of the agreement, but some are nuanced and complicated, such as which parties a no-contact provision covers.

Traditionally, an experienced lawyer captured these data points by manually answering questions. Instead, using our AI models, we can automatically answer over 95% of these questions with near 100% accuracy. This saves a lawyer almost 10 minutes for each contract and improves the accuracy of the data, which our asset management customers rely on to comply with critical obligations, such as public securities standstills and non-solicits. Our AI outputs are also continually audited by experienced lawyers, which continues to refine and improve our AI features.

With more asset management firms thinking globally, special attention is being paid to their technology platforms. How are firms you work with approaching this task, and what are the benefits when done correctly?

Troy Pospisil
CEO and Founder
Ontra

Troy is the founder and CEO of Ontra. Prior to Ontra, Troy worked in private equity investing at H.I.G. Capital. Earlier, he worked in management consulting at Monitor Deloitte. Troy holds a Bachelor of Arts from New York University. In his spare time, Troy enjoys sailing, biking, reading, and spending time with his family.

As asset managers grow across asset classes and regions, the complexity of their operations is compounded by the effects of scale, regulation, LP requirements, and an increasingly complex technology and cybersecurity landscape. This coincides with a continued rise in the number and size of funds across the industry, leading to increasing competition and the need to be laser-focused on investment performance.

The most sophisticated asset managers are working hard to digitize their mission-critical workflows in partnership with vendors that can deliver comprehensive, global solutions tailored for the industry. This approach has a number of important benefits. First, by adopting a comprehensive solution that solves the whole problem, asset managers can quickly reallocate their precious internal resources to more strategic, high-value work that directly impacts investment performance. Second, by adopting a solution tailored for asset management, the implementation time and quality of the outcome are substantially better. The alternative is a high degree of customization and configuration, followed by continued education and hand holding of the vendor. Third, by adopting a global solution, firms can standardize processes across their global footprint, maintain a single source of truth for their valuable data, and lower the complexity of their operations by maintaining a relationship with a single, scalable vendor.

Speed has never been more important. What can firms do to work more quickly, and how can Ontra help?

The easiest way to let time and deals slip away is to move slowly on routine contract negotiations. Ontra is the global leader in managing high-volume, routine contracting for the private markets. We provide a comprehensive solution to automate contracts such as NDAs, joinders, release letters, and vendor contracts for more than 500 asset managers, including Blackstone, Brookfield, Bain Capital, Battery Ventures, and over half the PEI 300. We are maniacally focused on driving down contract turnaround times, so our customers can move faster than their competitors.

Another great way to work faster is to be able to easily track and reference the key terms and obligations in important agreements, such as Limited Partnership Agreements (LPAs), Side Letters, and Credit Agreements. Historically, referencing information in these contracts was a manual and incredibly time-consuming process. For example, knowing what actions your firm has to take to satisfy obligations to LPs if a key person leaves the firm used to involve hundreds of hours of finding and pouring through countless LPAs and Side Letters. Ontra's Insight platform digitizes these complex agreements into structured data and provides purpose-built workflow and reporting tools. Asset managers and their advisors can quickly and easily stay on top of and reference their obligations and benchmark against precedent.

There is a push to drive strategic value from all areas of an organization, including from corporate law departments. How should general counsels (GCs) think about their part in driving value and their role in the business?

Usually, GCs at private funds aren't involved in the negotiation and management of the agreements that matter most to the firm's executive team—fund and deal documents. Partners and deal teams work exclusively with outside counsel on these agreements. This leads executives to view legal departments as cost centers rather than a function that consistently delivers value on what matters most—raising funds, investing capital, and driving higher returns.

While there's an emerging trend at the largest asset managers to insource some funds and transactional legal work, most in-house teams will never have the capacity to drive the day-to-day execution of this type of work. GCs can, however, become important strategic partners by helping to organize the incredibly valuable data entombed inside the firm's most important agreements. By making this data more organized and accessible, business teams will be able to move faster, make better decisions, and negotiate more effectively.

For example, giving deal teams the ability to quickly answer questions about key NDA terms, such as whether they can share confidential information with other financing sources or contact a target's customers or suppliers to support their diligence efforts, will allow them to move faster and make better decisions. As another example, giving deal teams the ability to see which covenants other lenders have agreed to in similar credit transactions will allow deal teams to negotiate better terms, which could ultimately have a material impact on returns. Turning contracts into structured, actionable data is one of the most important things we do at Ontra, and we believe it's one of the most important steps GCs can take to drive value for their organizations.

What have we not talked about that you believe is relevant with the current economic backdrop?

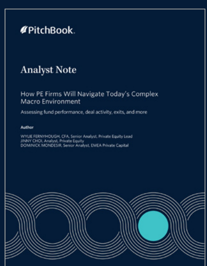
As the economic environment becomes more uncertain, the cybersecurity landscape becomes more complex, and the SEC becomes more focused on ensuring the resilience of the private funds industry, it's increasingly important for asset managers to put in place sophisticated vendor due diligence processes that select for financially and operationally resilient vendors.

Most asset managers do at least some amount of initial vendor due diligence around financial resilience and cybersecurity. However, there's a wide range of thoroughness across the industry. Sophisticated asset managers not only ask detailed questions but also verify the most important matters by reviewing the underlying data. And the most well-run firms have programs in place to periodically refresh their due diligence on vendors they deem mission-critical.

At Ontra, we've made major investments in our security infrastructure, including features such as two-factor authentication and single sign-on, and are proud of our many certifications, such as SOC 2. Additionally, because we provide mission-critical technology and services to our customers, we view our strong balance sheet and sustainable P&L as a necessary "feature." It's essential that our company can withstand any economic environment and continue to deliver for our customers.

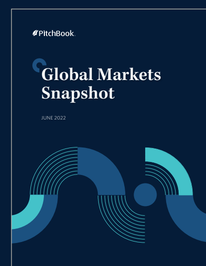
Additional research

Private equity



PitchBook Analyst Note: How PE Firms Will Navigate Today's Complex Macro Environment

Download the report here



June 2022 Global Markets Snapshot

Download the report here

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Q1 2022 US PE Middle Market Report

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