

US PE Breakdown

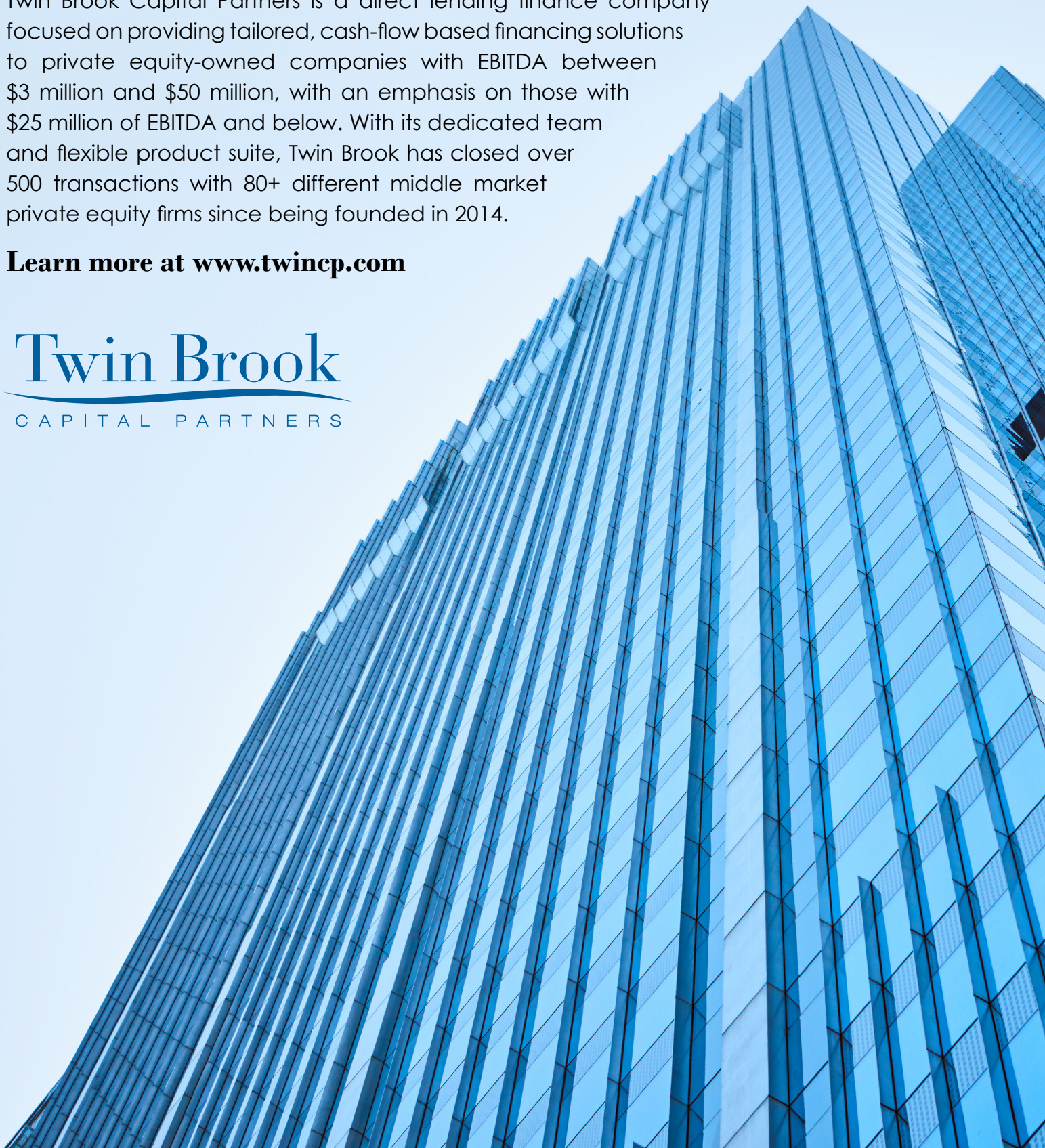
Q2 2020

Reliability and experience when it matters most

Twin Brook Capital Partners is a direct lending finance company focused on providing tailored, cash-flow based financing solutions to private equity-owned companies with EBITDA between \$3 million and \$50 million, with an emphasis on those with \$25 million of EBITDA and below. With its dedicated team and flexible product suite, Twin Brook has closed over 500 transactions with 80+ different middle market private equity firms since being founded in 2014.

Learn more at www.twincp.com

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Introduction

The velocity of PE dealmaking further diminished in Q2 2020 as dealmakers felt the impact of the COVID-19 pandemic. Moreover, many GPs sought to pull out of previously agreed upon deals, sometimes invoking the material adverse change (MAC) clause. PE firms swiftly pivoted, though, with many pursuing private investments in public equity (PIPE) deals while others with the in-house capability pursued distressed or other credit transactions. Of the deals that were completed, a high proportion were add-ons and subsequently smaller on average than platform deals. Because of this, add-ons made up the highest percentage of LBOs on record, and median deal size ticked down for the first time in five years.

Exit activity in the quarter collapsed to an even greater extent than deal activity as PE firms sharply marked down portfolio companies and chose to hold investments rather than sell. Following a rebound in public markets, a couple of outsized IPOs buoyed exit value, while sales to strategics or other financial sponsors lagged. Heavy debt loads and the pandemic crisis forced several portfolio companies into bankruptcy. Other portfolio companies may be headed that way, as credit rating agencies downgraded hundreds of PE-backed companies. PE holding times are likely to balloon as we saw during the global financial crisis as sponsors put off exiting until the future is clearer.

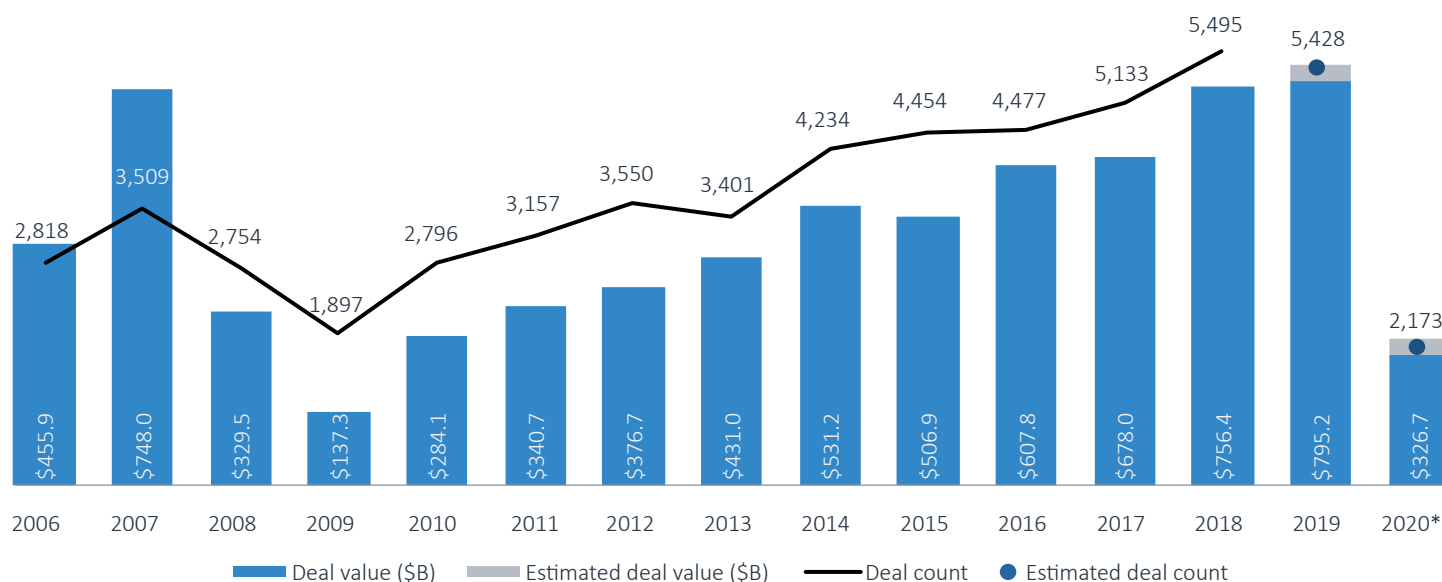
PE fundraising momentum looks to have slowed from 2019's record-setting pace, although it will likely remain healthy. Mega-funds (\$5.0 billion+)—which often have an established LP base—drove fundraising value totals, with several closing in the quarter. Moreover, a couple of mega-funds launched in Q2, exhibiting confidence that they will find success despite being forced to perform due diligence meetings by video rather than in person. PE firms also received promising news as the US Department of Labor (DOL) clarified rules around including PE funds in diversified funds—such as target-date funds—within 401(k)s. However, any changes to target-date funds are likely to take years, and PE will account for a minor share, meaning access to retail accounts may not be the spark some GPs had been hoping for.



Wylie Fernyhough
 Senior Analyst, PE

Overview

PE deal activity



Source: PitchBook | Geography: US
*As of June 30, 2020

Q2 2020 was the first full quarter in which global economies had to slog through the COVID-19 pandemic, and the slowdown in US PE deal activity became more apparent. Through the first half of 2020, US PE dealmakers closed on 2,173 deals totaling \$326.7 billion, meaning deal value was down by nearly 20% compared to H1 2019. Quarterly figures show an even steeper fall, with Q2 2020 deal value down more than a third from Q1 2019 values.

More broadly, the National Bureau of Economic Research announced in June that the US officially entered a recession back in February. This officially caps off the 128-month expansion, the longest dating back to at least 1854.¹ Further, COVID-19 cases in the US appear to show the nation heading for a second wave, whereas economic data points to the worst of the crisis being behind us, which only adds to the current economic uncertainty. A second wave could prolong our lockdown, pulling down 2020 deal activity as well as costing lives.

Not only was there a dearth of deals closing in the quarter, but several previously negotiated deals were broken, citing the MAC clause.² While these suits typically fail in courts, numerous PE firms are nonetheless pursuing them. According to Winston & Strawn LLP partner William O'Neill, there have been more major lawsuits over MAC

clauses since April 1, 2020, than in the previous 10 years combined.³ Although the chance of winning in court is slim, often a delay achieves the same outcome. In most cases, lenders can terminate their agreement—and will often do so if there is pending litigation—if a deal does not close by a certain date. Some notable deals where would-be buyers triggered the MAC clause include Carlyle and GIC's \$900.0 million minority investment in American Express Global Business Travel, Sycamore Partners' \$525.0 million acquisition of 55% of Victoria's Secret from L Brands, and Kohlberg & Co. walking away from its \$550.0 million buyout of Decopac, a cake decorations company.

Despite several higher-profile deals getting called off and COVID-19-related uncertainty, deal activity remained above the low points of the global financial crisis, even though deal activity was generally muted. GPs used alternative sources of deal flow that allowed them to deploy capital in today's environment, including PIPE deals, which were especially prevalent during the quarter. Ares and Providence Equity Partners purchased \$400.0 million in convertible preferred stock from Outfront Media (NYSE: OUT), Great Hill Partners and Charlesbank Capital Partners helped Wayfair (NYSE: W) raise \$535.0 million in five-year convertible senior notes, and Apollo and Silver Lake helped Expedia (NASDAQ: EXPE) raise \$1.2 billion. Silver Lake was

1: "Recession in U.S. Began in February, Official Arbiter Says," *The Wall Street Journal*, Kate Davidson, June 8, 2020.

2: The MAC clause is a contractual provision in an M&A agreement. It allows the buyer to walk away from a deal if the target company is materially negatively affected between the time the deal is signed and when it finally closes. However, adverse events mean different things to different people and are open to interpretation.

3: "Buyers Test Coronavirus Excuse for Ditching Unwanted M&A Deals," *The Wall Street Journal*, Chris Cumming, May 13, 2020.

Overview

Notable PIPE deals in Q2 2020

Company name	Ticker	Close date	Deal size (\$M)	Investor(s)
Expedia Group	NAS: EXPE	May 5	\$1,200	Silver Lake, Apollo
OUTFRONT Media	NYSE: OUT	April 16	\$400	Providence Equity, Ares
Covetrus	NAS: CVET	April 30	\$250	Clayton and Dubilier & Rice
Eventbrite	NYSE: EB	May 11	\$225	Francisco Partners
Alnylam Pharmaceuticals	NAS: ALNY	April 13	\$100*	Blackstone

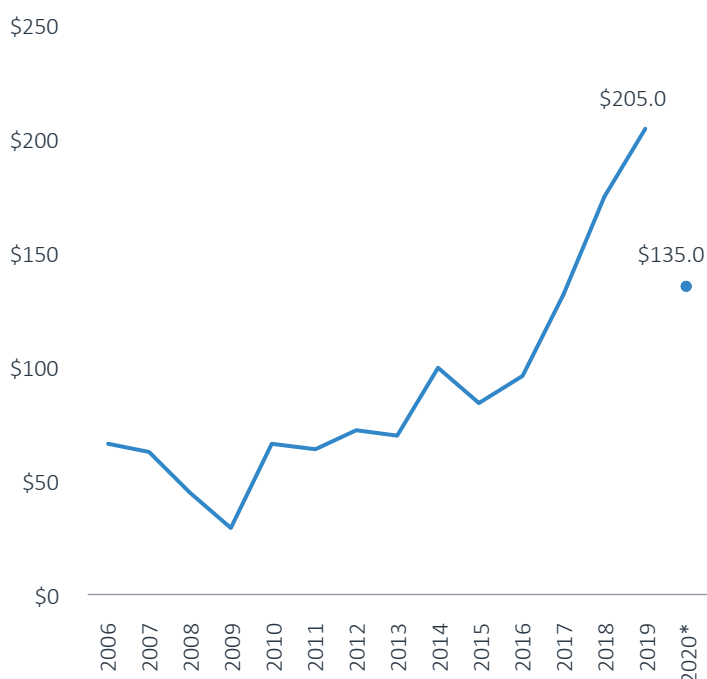
Source: PitchBook | Geography: US

*The full extent of the deal was \$2.0 billion. Beyond the \$100.0 million stock purchase, Blackstone agreed to \$1.0 billion in royalties, up to a \$750.0 million first lien senior secured term loan led by GSO, and up to \$150 million for development of new drugs.

particularly active in growth rounds to public and private companies. During the quarter, the firm also participated in a \$3.0 billion fundraising round for Google's (NAS: GOOG) self-driving car unit, Waymo, and a \$3.0 billion round for Airbnb. In fact, US public companies issued more than \$60.0 billion in shares in May 2020, marking the most ever in a single month.⁴ With so many public companies seeking cash, divestitures may be another fruit-bearing source of deals for PE firms. We are showing a slight uptick in divestitures as a proportion of closed deals, reversing a multi-year decline. Many other deals, such as cosmetic maker Coty's arrangement to sell a majority stake in its retail hair and professional beauty businesses to KKR for \$4.3 billion, are announced but yet to close—an indication that divestitures will continue to play a larger role this year.

PE firms have had to get creative with dealmaking beyond PIPEs and divestitures because so many of the traditional sources of deal flow have dried up. For instance, sponsor-to-sponsor transactions, or secondary buyouts (SBOs), have slumped to their lowest levels since 2009. PE firms are in triage mode, trying to determine which portfolio companies to save and how, rather than looking to sell.⁵ Companies with any kind of institutional backing are less willing to sell today. This means many PE firms have turned to companies without backing, which tend to be smaller, family-owned businesses and likely add-ons. This bears out in the data, as the median buyout size dipped for the first time since 2015, and the share of non-institutionally backed companies as a proportion of buyouts rose to the highest we have seen since 2009. Without as many large buyout targets, some firms, such as Apollo, have taken to investing through strategies other than buyout to deploy capital commitments. On its most recent earnings call, Apollo announced its 2017 vintage, \$24.7 billion buyout fund had pivoted from buyout to distressed-for-control transactions. Similarly, KKR is looking to deploy capital

Median PE buyout size (\$M)



Source: PitchBook | Geography: US

*As of June 30, 2020

through all available channels, including majority, minority, auction, carve-out deals, and more.⁶ In fact, the expansion into other private market strategies is serving US-based PE firms particularly well during this crisis. The largest US-based PE firms have been more active in dealmaking in this downturn as compared to the global financial crisis, and it is precisely because they can invest in so many ways.

Despite deal sizes falling, several massive business combinations still closed in the quarter. For example, HR management software firms Kronos and Ultimate Software Group merged to create an entity valued at \$22.0 billion.⁷

4: "U.S. Companies Issue Shares at Fastest Rate Ever, Selling The Rally," Business News, Joshua Franklin, June 1, 2020.

5: "Private-Equity Firms Scramble to Shore Up Coronavirus-Hit Holdings," The Wall Street Journal, Miriam Gottfried, April 13, 2020.

6: "Private Equity Steps in Where Others Fear to Tread During Pandemic," Financial Times, Kaye Wiggins, June 17, 2020.

7: "Kronos and Ultimate Software Enter Definitive Merger Agreement Creating Company Valued at \$22 Billion, Ultimate Software, February 20, 2020.

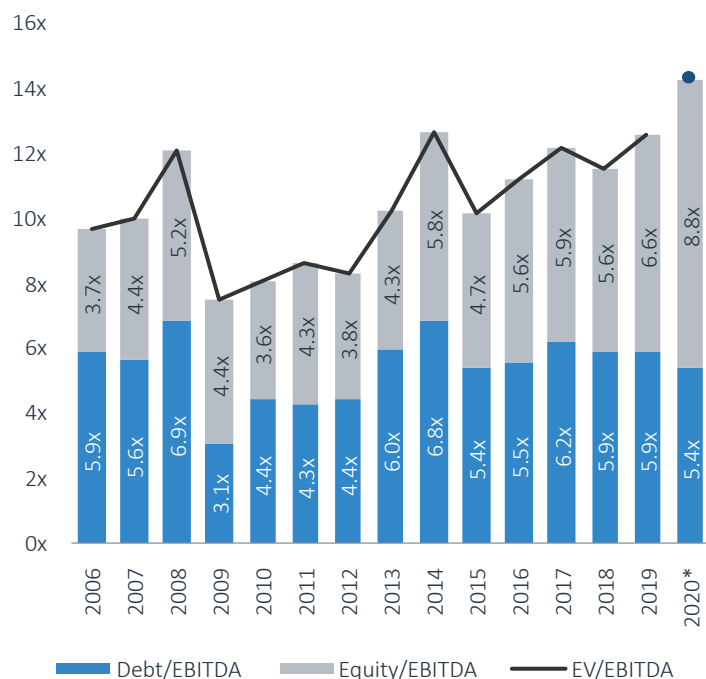
Overview

Both firms were controlled by Hellman & Friedman and had additional backing from Blackstone, GIC, and JMI Equity pre-merger. After the all-stock merger closes, H&F will remain the controlling shareholder while Blackstone will be the largest minority owner.⁸ In the next largest deal in Q2, JAB Holding's portfolio company, Compassion-First Pet Hospital, acquired National Veterinary Association for \$5.0 billion from Ares and OMERS. The family-owned, Luxembourg-based PE firm is better known for its vertical roll ups in coffee, fast casual dining, and more. JAB is likely to do additional add-ons in the pet-care space in the coming years to strengthen its position against VCA, an animal hospital company that Mars Inc purchased for \$7.7 billion in 2017.

Heading forward, we expect GPs to continue their investment binge in the technology sector. The sector has proven to be resistant to recession during the pandemic and is the most represented sector in terms of minority transactions, something we believe will be more common while valuations are suppressed. Through the first half of 2020, just under 20% of all PE deals have been in tech, and they represent just over 30% of PE deal value—both percentages on pace for annual highs. However, competition is likely to remain fierce because technology company valuations have held up better than other sectors, meaning fewer discounts are available. Further, many publicly held strategics remain cash rich and are likely to continue sourcing deals.

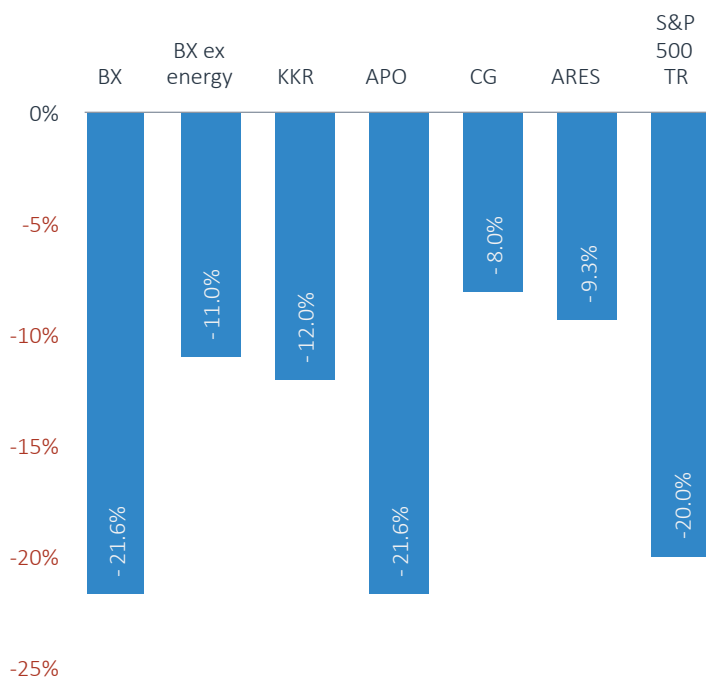
While they are not representative of the entire industry, **public PE markdowns** demonstrate just how widely markdowns may vary and how severe they may be in some portfolios. Blackstone and Apollo corporate PE portfolios were marked down to a greater extent than the S&P 500 during Q1 2020. However, the other managers, and Blackstone, excluding its energy holdings, had markdowns hovering around 10%. At such an uncertain time, when many business owners are not willing to sell, GPs may find better risk-adjusted returns and more opportunity investing in their own portfolios, although to be sure, there will be many portfolio companies that GPs allow to fail. GPs will also be limited by the amount of dry powder remaining in the fund, although some preferred-equity strategies can provide additional capital later in a fund's life. Research from the past crisis shows that GPs tended to invest in portfolio companies throughout a crisis and that PE-backed portfolio companies tended to cut investment spending less than their peers—public or non-sponsor-backed companies. Because of this strategy, PE-backed companies tended to outperform their peers because they could take advantage of the situation and act for the longer term.⁹

Median PE buyout EV/EBITDA multiples



Source: PitchBook | Geography: US
Note: Data count for 2020 are below 30.

Q1 2020 corporate PE markdowns by select manager



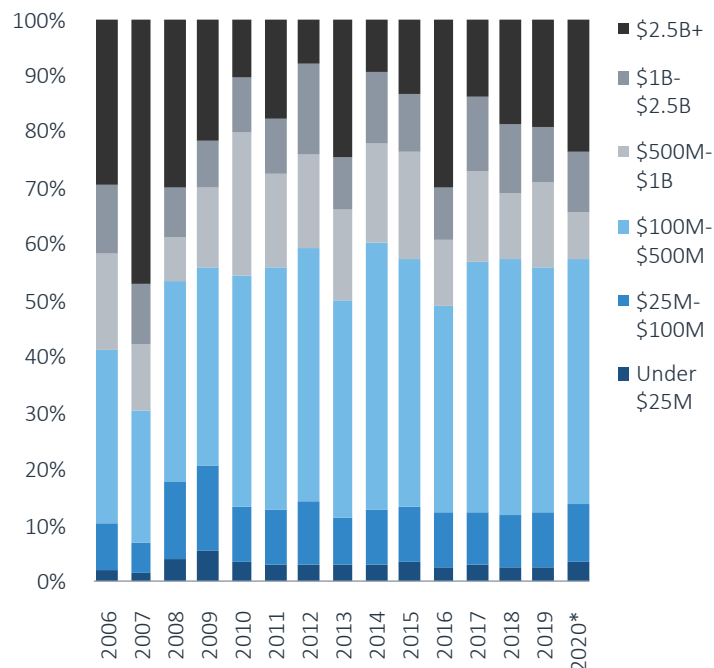
Source: Company filings | Geography: Global

⁸: "Two Big Workplace-Software Providers to Merge," The Wall Street Journal, Miriam Gottfried and Cara Lombardo, February 20, 2020.

⁹: "Private Equity and Financial Fragility during the Crisis," National Bureau of Economic Research, Shai Bernstein, Josh Lerner, Filippo Mezzanotti, July 2017.

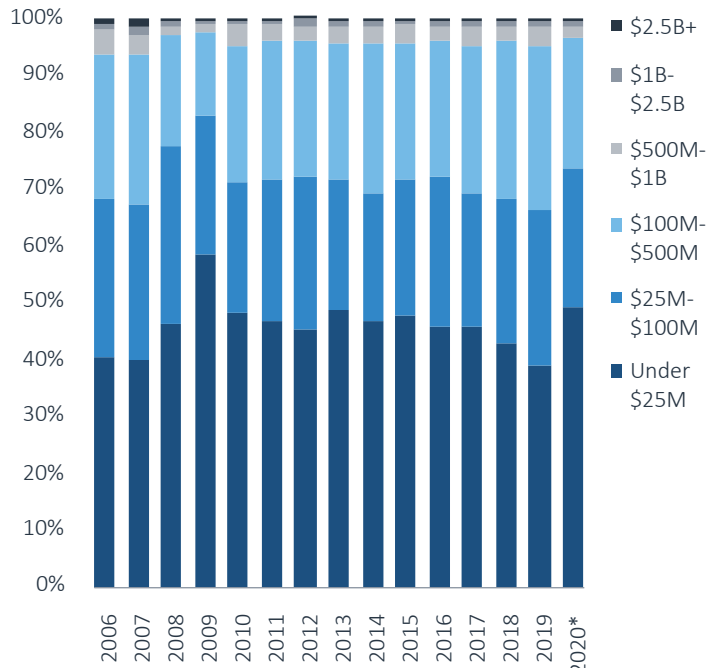
Deals by size and sector

PE deals (\$) by size



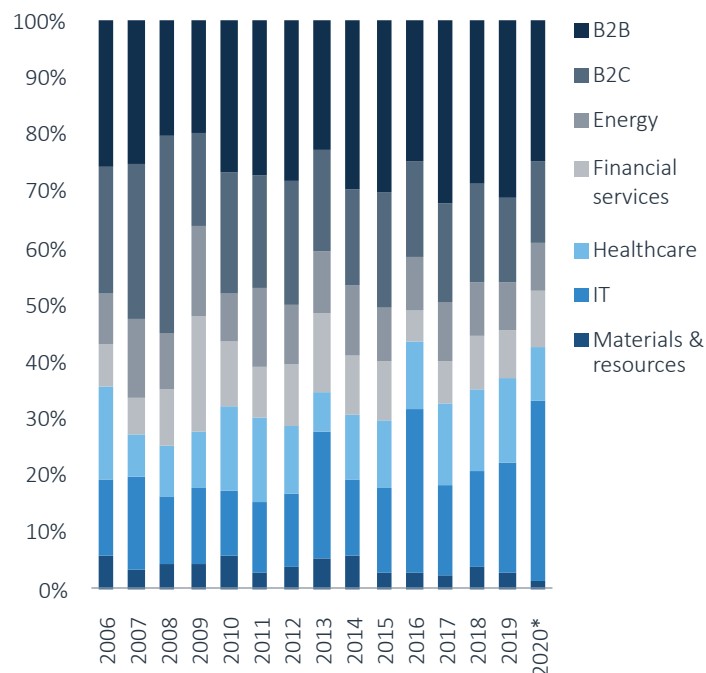
Source: PitchBook | Geography: US
*As of June 30, 2020

PE deals (#) by size



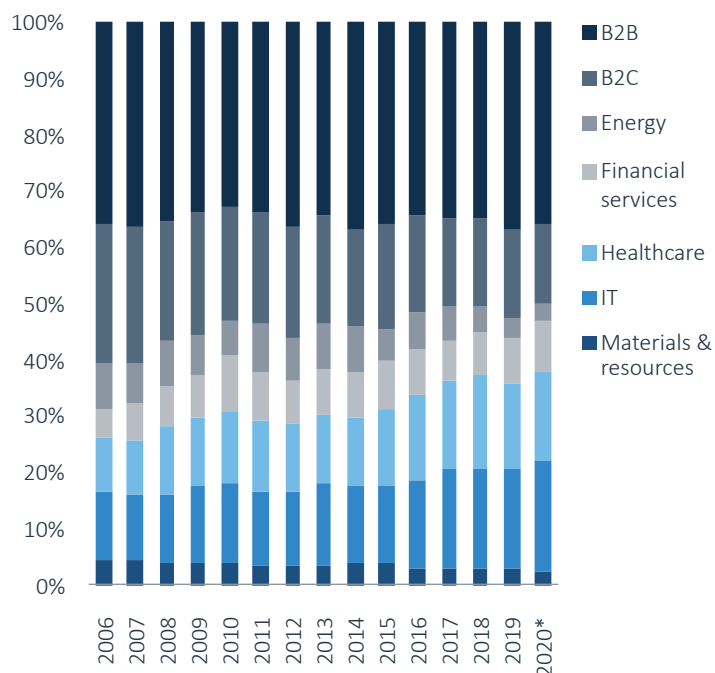
Source: PitchBook | Geography: US
*As of June 30, 2020

PE deals (\$) by sector



Source: PitchBook | Geography: US
*As of June 30, 2020

PE deals (#) by sector



Source: PitchBook | Geography: US
*As of June 30, 2020

Q&A: A partner for all times—uncharted waters and beyond

As middle-market companies and their private equity sponsors seek to navigate the uncertainty brought on by COVID-19, the importance of dependable partnerships has become increasingly evident. Twin Brook Capital Partners' Chris Martin and Pete Notter discuss the value of deep relationships and working with private equity clients and their portfolio companies through these unprecedented times.

Q2 and late Q1 2020 were marked by pandemic-related challenges and uncertainty. Did this force you to change your strategy or approach to working with sponsors and borrowers?

Pete: Since inception, Twin Brook's strategy has been consistent; we are focused on serving private equity firms and their portfolio companies in the lower-middle market, which we define as companies with \$25 million of EBITDA and below. For us, it is about more than just providing capital. We are here to support sponsors' growth strategies and be a reliable, hands-on lending partner. This strategy and how we execute on it have been shaped by the 20+ years our senior team has spent working in this part of the market, and our experience through multiple credit cycles has informed nearly every part of our high-touch approach—from the design of our teams to our underwriting process and ongoing portfolio management—which has not changed due to the pandemic.

Chris: The deal team that underwrites a new opportunity—including the lead originator—remain with that account for the full life of the credit, and we believe that team continuity provides not only greater surety of execution and a seamless experience for our PE clients and borrowers but also makes us better-positioned to both support them and manage the credit within our portfolio. We have long interacted with our borrowers, their management teams and their sponsors on a consistent basis—be it daily, weekly, or monthly—about all aspects of their businesses and their performance, which allows us to maintain a deep knowledge of these companies and the nuances that impact them. These regular interactions and the higher-quality, more timely information and analytics



Chris Martin

Partner
Twin Brook Capital Partners

Chris Martin joined Twin Brook in 2016 and is a partner responsible for the origination, evaluation, and structuring of new lending opportunities with private equity sponsors.



Pete Notter

Partner
Twin Brook Capital Partners

Pete Notter joined Twin Brook in 2016 and is a partner responsible for the origination, evaluation, and structuring of new lending opportunities with private equity sponsors.

that come from them are core to our approach of actively monitoring credits so we can identify potential issues early on and work together with our borrowers and private equity clients to proactively address them. In the face of the pandemic, this didn't change. Our frequent interactions continued and, given the mutual clarity in expectations when it came to working together, sponsors and borrowers were proactive in communicating and sharing the information we needed.

Looking back, is there anything you think the experiences of the past few months have highlighted?

Pete: I think this has definitely shined a light on the value of strong sponsor-lender relationships, particularly in the lower-middle market, which had not become as commoditized as the broadly syndicated loan (BSL) and upper-middle markets in recent years. Private equity firms focused on the lower-middle market generally have a more active ownership style,

Q&A: A partner for all times—uncharted waters and beyond

which is one of the reasons why relationships have been and continue to be so important. These sponsors are looking for ways to create meaningful value at their portfolio companies, and those initiatives often require additional financing and ongoing lender interaction. As a result, these private equity firms are seeking long-term lending partners that are both committed to working hand-in-hand with them as they grow portfolio companies and have a demonstrated ability to manage through multiple credit cycles in their part of the market.

In the face of the pandemic, those long-term relationships became ever more critical. Our experience working with our PE clients and their portfolio companies through numerous transactions and situations over many years has built a level of trust—on both sides—and fostered an open line of communication that allows for greater flexibility and has been especially key over the past few months. From the start, sponsors knew that we would be there to work alongside them through the challenges ahead and valued the operational support we bring to the table, and we had confidence in their ability to execute—having seen them successfully lead businesses through ups and downs—and had the consistent, robust information flow needed to both proactively support them and manage our portfolio.

How do you go about building these meaningful relationships?

Chris: Developing relationships can take years and involves significant work—reviewing transactions with sponsors, participating in management meetings and working with them on the portfolio side—through both periods of expansion and stress. It’s in those latter situations, working closely to get through issues or tough patches in a company’s growth, that you build some of your strongest connections. While having a proven ability to complete transactions and understanding what sponsors are looking for when it comes to the financing solutions needed to build on these businesses is certainly important, it’s about more than that. Any lender can close a deal. It’s the ability to work through the growing pains that deepens those partnerships and, as Pete noted, builds a strong working relationship and level of trust that are invaluable.

Clearly relationships matter, but what else do you think private equity firms will be looking for from lenders in the near term and moving forward?

Pete: Experience has long been a point of focus, but I think the past few months have served to demonstrate why it is so important. As I touched on before, many members of our nearly 70-person team have worked through multiple credit cycles in this space, which has taught us a lot of best practices and provided us with a wealth of knowledge on how to both manage credit risk during an economic contraction and work with sponsors to make sure companies emerge from a downturn with the best possible outcome for all parties.

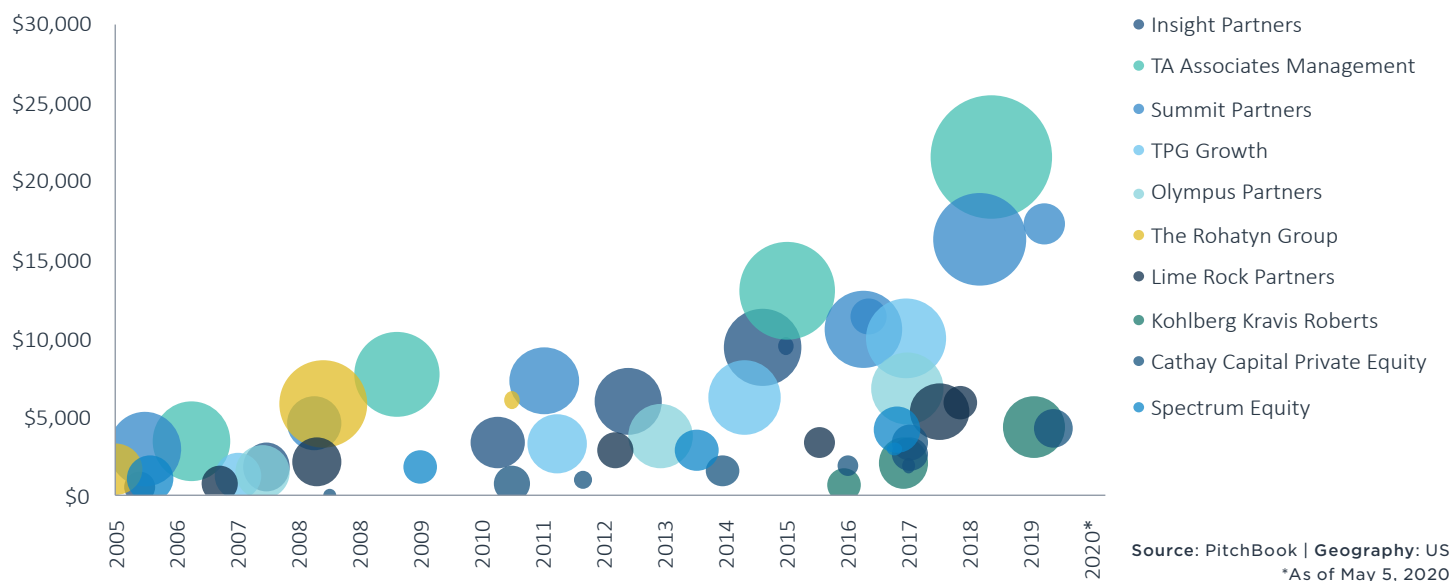
Chris: The importance of partnering with lenders that have not only relevant experience and expertise but also the business models, infrastructure, and resources needed to be reliable in the face of uncertainty has become increasingly clear. While there was an abundance of dry powder in the private credit market prior to COVID-19, much of which was available at very borrower-friendly terms, capital to support new direct lending opportunities is now harder to come by. In the early days of the pandemic, the impact of this was less evident, as private equity firms and lenders alike were focused on their existing portfolios while they sought to navigate uncharted waters. However, as businesses and the economy reopen and sponsors begin to consider situations where they can opportunistically pursue add-ons or new investments, they are also contending with a changed lending landscape.

At Twin Brook, we have approved over \$800 million of commitments since March and have substantial buying power to support our current and future borrowers. This, in combination with our robust, experienced team, made us well-prepared to navigate the unique challenges of the past few months and will support our ability to continue working hand-in-hand with sponsors through both the complexities of today and toward the opportunities that lie ahead.

To learn more about Twin Brook and its cash-flow based financing solutions for the middle-market PE community, visit www.twincp.com.

Spotlight: Growth equity

Select growth equity funds (\$M) by major investor



Note: This spotlight was abridged from an analyst note on growth equity funds. For a more detailed analysis of the subject, please read our [Growth Equity Overview](#).

Although PE fundraising has expanded between 2005 and 2019, the amount of growth equity capital raised has almost tripled and fund count has more than doubled over the same period. Simultaneously, growth equity—which often sits between PE buyouts and VC in its risk-reward tradeoff and in the maturity of the underlying companies the strategy targets—has become an established private market strategy of its own. Firms targeted for growth equity investment are often relatively mature, founder-owned, and market-leading companies that have had little or no prior institutional capital. These businesses usually have proven unit economics, positive cash flow, and substantial organic revenue growth (often more than 20% annually). These targets have usually reached an inflection point and require capital to scale an already sound business model. Lastly, these companies are usually EBITDA positive or expected to be in the next 12 to 18 months.

Growth equity investments often use little or no debt, use deal-specific terms, and frequently incorporate aspects of PE buyouts and VC deals. For instance, borrowing from VC, growth equity deals frequently include redemption rights.¹⁰

Top growth equity fund managers by total capital raised

Investor name	Investor HQ	Capital raised (\$B)
Insight Partners	US	\$25.4
TA Associates Management	US	\$21.5
Summit Partners	US	\$17.3
TPG Growth	US	\$10.0
Olympus Partners	US	\$6.9
The Rohatyn Group	US	\$6.1
Lime Rock Partners	US	\$6.0
Kohlberg Kravis Roberts	US	\$4.4
Cathay Capital Private Equity	France	\$4.3
Spectrum Equity	US	\$4.3

Source: PitchBook | Geography: US
*As of May 5, 2020

Growth equity deals also regularly feature protective provisions, taking a note from the buyout model.¹¹ These overlaps can make pinning down precise boundaries between growth equity, late-stage VC, and buyouts a nebulous task. However, growth equity has become a stand-alone private market strategy, with many fund managers marketing themselves as such.

¹⁰: Redemption rights allow investors to force the company to repurchase their shares after a specific amount of time has passed, if there has been a covenant default, or if a company has not satisfied performance milestones.

¹¹: Protective provisions are covenants that govern what the issuer of an equity security may or may not do without prior approval of the shareholder [investor]. An investor entitled to protective provisions essentially has veto rights over company actions, allowing them to exercise a degree of operational control without majority ownership of the company.

Spotlight: Growth equity

Given the attractiveness of the strategy for LPs, a wave of growth equity-focused funds emerged to invest in this space. In 2019 alone, growth equity fundraising totaled \$41.0 billion across 68 funds. As a result of the fundraising boom, growth equity dry powder has risen from 6.5% of all PE dry powder in 2005 to 16.3% of all PE dry powder through Q3 2019. This rapid growth indicates the maturation of the growth equity space and LPs' increased comfort in allocating to growth managers. We also noticed a large increase in average fund size in 2019 because of two large growth funds from TA Associates and Summit Partners and again in 2020 due to Insight Partners' \$9.5 billion growth fund.

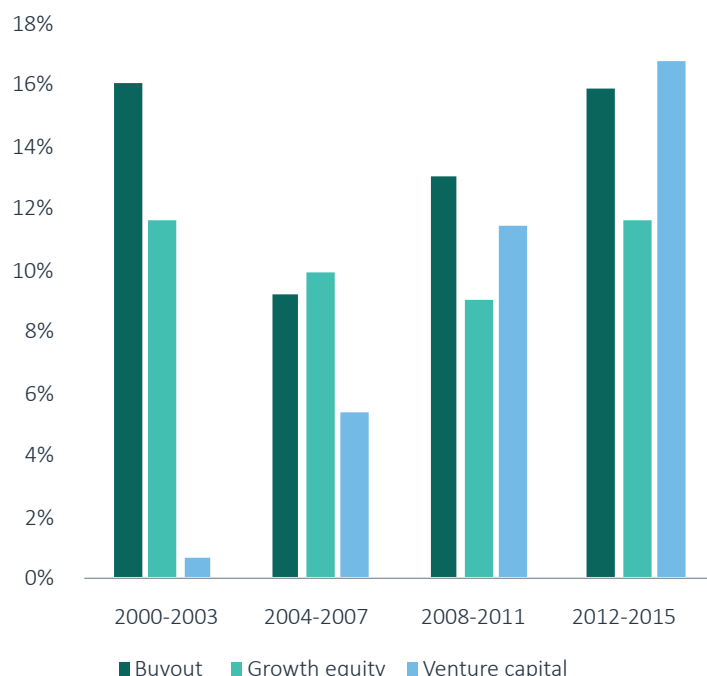
The surge in the size and number of growth equity funds has led to increased competition for assets. VC and buyout fund managers have both contributed to growth equity's rapid rise and subsequently increased competition, as GPs from VC and PE are looking to expand their strategy by rolling out growth equity funds. Concerns over the pandemic-related economic crisis may lead many GPs who formerly would have sought control investments to engage in minority investment deals (often with the hope of purchasing the company outright at a later date), further crowding the growth equity space. For their part, sellers are less willing to sell the entire company at depressed

prices but may still need growth capital. The heightened competition has also led to increases in entry pricing.¹²

Growth equity valuations frequently employ revenue multiples like late-stage VC deals, rather than the EBITDA multiples more commonly associated with buyouts because many growth equity target companies may be operating at intentionally depressed EBITDA levels, prioritizing reinvestment rather than profits. Between 2010 and 2017, the average LTM revenue purchase price multiple for growth equity investments grew from 2.9x to 4.9x.¹³ In comparison, the Russel 2500 Index price-to-revenue multiple ranged from 2.0x to 3.3x over the same period.

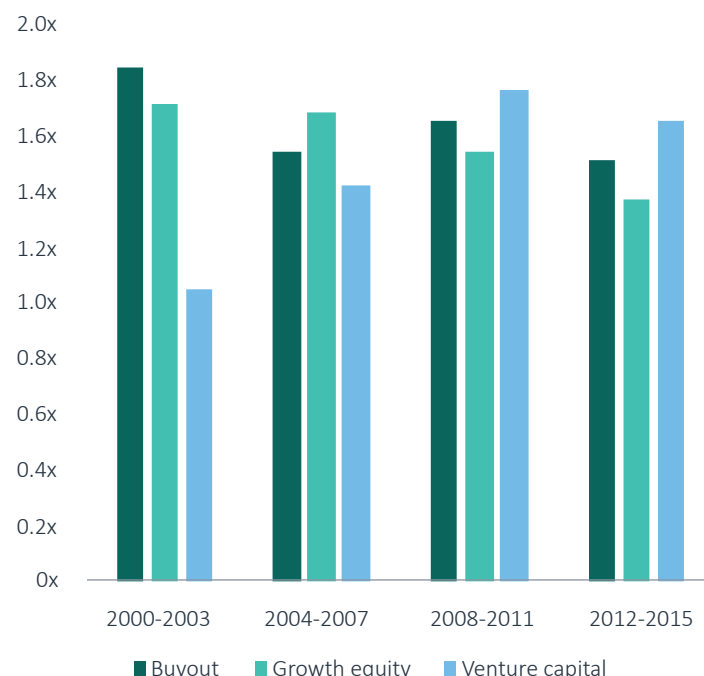
Growth equity investments give LPs a similar return profile to buyouts and VC, although with inherently less leverage than buyouts and a lower risk of loss than VC. This yields a private market strategy that acts as somewhat of a hybrid between VC and buyouts in terms of performance metrics. Buyouts and growth equity funds have relatively higher IRRs and cash multiples in earlier vintages (2000-2003 and 2004-2007) compared to more recent ones (2008-2011 and 2012-2015). In contrast, VC exhibits higher IRRs and cash multiples in later vintages, largely due to the mark-to-market gains and higher valuations driven by an influx of capital to the space.

Pooled IRRs since inception by vintage year and strategy



Source: PitchBook | Geography: US
*As of September 30, 2019

Pooled TVPI since inception by vintage year and strategy



Source: PitchBook | Geography: US
*As of September 30, 2019

12: It should be noted that asset values have also increased across the board, particularly for growth businesses.

13: "Growth Equity: Turns Out, It's All About the Growth," Cambridge Associates, January 2019.

Q&A: Q2 activity trends

On average, West Monroe supports more than 400 transactions each year. This experience, combined with our multidisciplinary approach through industry, operational, and technology expertise, helps dealmakers plan for and manage the complexities of mergers, acquisitions, and divestitures.

What is the broad sentiment among your PE clients now as they look ahead to the rest of the year?

Mike: PE investors are anxious to put their capital to work on investments or help existing businesses emerge from the pandemic in a stronger competitive position. Tuck-ins are being discussed more now, especially in the software space, where firms are looking at augmenting their product portfolio or acquiring competitors to expand market share. The timing of a return to more normal activity may still be a quarter or two away, but firms are preparing now.

Matt: The general sentiment from our clients is improving with each week that passes. When the pandemic hit in mid-March, our clients shifted a considerable amount of their time and energy to their portfolio companies. Specifically, they began addressing the immediate impact on their businesses—from cash flow and working capital issues, to people decisions, to debt covenants. It was a hectic few weeks to assess the risks and implement the necessary operational changes. As a result of this—plus the inability to predict cash flows coupled with apprehensive lenders—deal volume dropped by almost 80%. Since early June, our clients have been more optimistic about getting deals done, and we've seen a corresponding increase in deal volume at West Monroe. While COVID has had a big impact on businesses, there are some fundamental forces that you can't ignore: very favorable fundraising the last three to four years, continued record amounts of dry powder, and a competitive market to put money to work—all things that might pull us back quicker than some expect.

Which trends have primarily been driven by the rise of the pandemic, and which existed prior and have merely accelerated?

Matt: First, although digital was one of the top three initiatives in each C-suite boardroom, this timeline was accelerated by at least three to four years. There's nothing like a pandemic to get businesses operating in a truly agile manner—project timelines were measured in hours and days versus weeks, or months or years. We expect some businesses will fare better than others and will come out the back end much stronger. A clear



Matt Sondag

Managing Director
West Monroe

With almost 25 years of experience, Matt leads the national Mergers & Acquisitions practice at West Monroe. A trusted advisor to hundreds of clients throughout his career, Matt always begins relationships by understanding how clients define value, outcomes and success.



Mike Amiot

Senior Director
West Monroe

A highly respected senior business consultant and deep technologist, Mike advises clients on aligning technology investments with business strategies and plans. As a former interim CIO and CTO for several tech companies, Mike has an innate ability to help clients understand the monetary value of technology.

second would be cybersecurity—we've seen a significant increase in cyber activity and success by hostile actors. Criminal organizations have capitalized on the strained environments and security vulnerabilities. We've also seen an uptick in corporate carveouts, as more strategics are looking to use divestitures as a means to infuse cash into their business. We expect digital transformation, cybersecurity, and divestitures to all remain very relevant in the next 12 months.

Mike: The other major change we've seen is a hyper focus on data and the ability to drive business decisions through better analytics and data across the enterprise. Additionally, we've seen an uptick in private investment in public entities (PIPEs) and add-ons in general, which makes sense in the current environment given how much dry powder PE firms have and their intense focus on putting their money to work.

Matt: There is a greater emphasis on speed across many companies that have seen how high stakes can really get and how swiftly they have to move in times of crisis.

As they work through transactions, what are the biggest hurdles that have arisen primarily due to the

Q&A: Q2 activity trends

actions needed to combat the pandemic? What prior hurdles existed that have intensified as well, or perhaps decelerated?

Mike: Access has become very complex. Investors are not sitting face to face with management teams right now. Typically, there is a lot of time and energy invested in becoming familiar with organizations' culture and management style; now, that connection and familiarity is stunted.

Matt: On the transactional front, the unpredictability of cash flows can slow or stop processes. Credit markets are also more difficult to navigate right now. Finally, when it comes to reporting, there's a bigger spotlight here given the need to see data much more in real time. This hurdle has intensified with the pandemic given the heightened need for faster decision making.

Matt: There was a tendency among some companies to put everything on pause; other companies seized the moment and opted to pull forward some key initiatives, knowing the overall operational risk of the project was significantly reduced.

Mike: Companies are benefitting from diversifying their data sources. Many are investing in gathering attitudinal and behavioral data to innovate and better inform their approach to capturing or retaining consumers in this new environment.

What are the most intriguing strategies and tactics you have seen PE firms or portfolio companies embrace in response to the current market, especially about adapting products and services? Conversely, what do you see underemployed that you believe should be more widely adopted?

Mike: The most forward-looking firms have achieved balance quickly by striking the right mix of offensive and defensive moves. They have repositioned product lines, shifting more toward subscription models and presenting creative solutions to their clients. For example, some brick-and-mortar operators exhibited forethought and, rather than wait to be crushed, had begun transitions to a robust e-commerce presence years ago. Now, those early adopters are being followed en masse.

Matt: We have seen larger funds focus more on debt and PIPE deals based on market demand for additional capital. Other sponsors have gotten very creative to get things done remotely, including leveraging GoPro technology or drones for video footage of a warehouse or

operations. Some clients who might have struggled to get deals done in the last 12 months used this opportunity to differentiate themselves and get a deal done, especially as it relates to add-ons.

At the sector level, where have the most opportunities arisen in the current environment? Which trends were in place prior to the pandemic and have only accelerated due to its effects?

Mike: Recurring revenue models and nimble operating models allowed the software industry to be less impacted by the pandemic initially. Additionally, their digital and cloud-first operating models also enabled an easier transition to decentralized operations and remote working. Most clients proceeded as planned with their Q2 product releases. But they are carefully planning release timing for the remainder of the year through an evaluation of the market, how their customers are operating in the current environment, and any prior commitments made to customers.

Matt: Telemedicine has been growing over the past 12 to 18 months, but now it has accelerated as much as five years in terms of industry development and investor focus. For manufacturing clients, the priority has shifted from the lowest-possible procurement costs to a higher level of resiliency and flexibility across supply chains, likely sacrificing some margin that they weren't willing to accept prior to the pandemic.

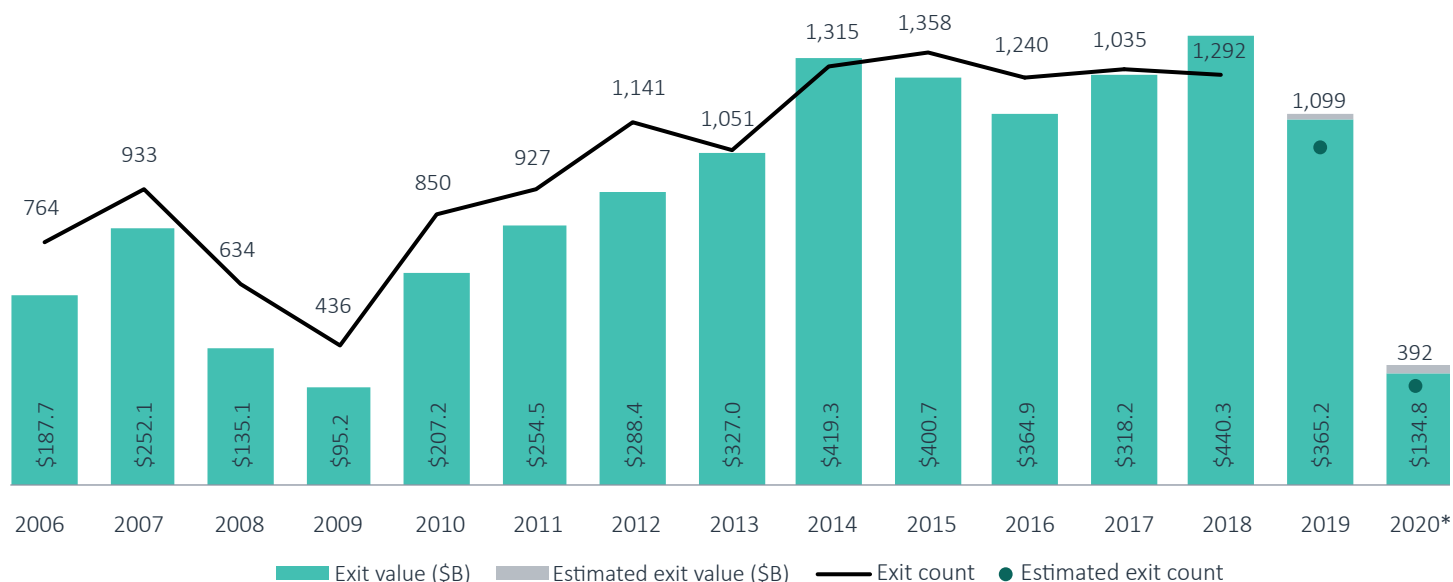
Looking at related hold periods, what is the tenor of discussion in the market around the extent of PE-backed company inventory and the need for liquidity from the fund manager's perspective? Are timelines tight, or is there more flexibility than generally perceived?

Matt: I don't think this is causing a rush to sell PE-backed companies; they have some built-in flexibility in each deal. Not to mention, this pandemic has presented common challenges to companies within the same industry, so most companies are in the same boat. However, this environment might cause some proprietary business owners to sell earlier than originally planned, as their life perspective might have changed or they may want to take some chips off the table.

Mike: I also suspect hold periods are going to be extended for some percentage of existing portfolio companies due to market volatility in valuations. How long it may take to resolve the degree of uncertainty is anybody's guess at this point, so fund managers will primarily ensure their companies can stay liquid and solvent.

Exits

PE exit activity



Source: PitchBook | Geography: US
*As of June 30, 2020

Just as we have observed in deals, COVID-19 has caused exits to fall, though to a greater extent. Through H1 2020, US PE firms have closed 392 exits valued at a combined \$134.8 billion. Announced global PE exits were down approximately 70% in May 2020 compared to May 2019. The main culprit here is a steep falloff in portfolio company valuations. Carlyle co-CEO stated on the company's recent earnings call, "Buyers traditionally mark to market faster than sellers," as he guided listeners to expect a dip in realizations, or exits, for the coming quarters. In fact, the five largest US-based public PE firms (Blackstone, Apollo, KKR, Carlyle, and Ares) guided shareholders to expect fewer realizations and less carry income for the year, something we expect private GPs will also experience. Outside of steep valuation declines, many GPs struggled to determine the actual value of companies in such a chaotic time, preventing potential sales.

Driving much of the exit value in the quarter were a couple massive IPOs. After public indices plunged by more than a third in March, a swift rebound emboldened some PE firms to move forward with plans to take portfolio companies public. One of the largest PE-backed IPOs in the quarter was Albertsons (NYSE: ACI), a grocery store chain owned by Cerberus Capital Management. The company priced 50 million shares at \$16.0, well below its plans for 65.8 million shares at \$18-\$20 per share. This gave the firm

an initial market cap of \$7.7 billion despite Apollo buying \$1.75 billion worth of convertible preferred shares a month prior in a deal that valued Albertsons' equity at \$10.0 billion. The underperforming IPO is not the first difficulty the PE shop has had with Albertsons. Cerberus tried to take the company public in 2015 and failed, then later tried to merge the company with Rite Aid but fell short due to investor and shareholder advisory firm opposition. It appears heavy debt loads from buyouts are causing many retail businesses to struggle or fail.

While Albertsons' IPO was not a resounding success for its PE owners, ZoomInfo's (NAS: ZI) was another story. TA Associates and Carlyle saw handsome returns when the firms listed ZoomInfo in mid-June. ZoomInfo raised nearly \$1.0 billion in the offering and nearly doubled its stock price on the opening day, putting its market cap around \$15.0 billion. TA Associates paid \$90.0 million for its stake in 2014, which is now worth north of \$6.2 billion, making this the largest paper gain in the firm's history. Carlyle also achieved an outsized return, collecting 13 times its investment in a little over a year. Elsewhere, Dun and Bradstreet is also looking to go public in the coming months. The firm was delisted after a \$6.9 billion buyout by a Thomas H. Lee Partners-led consortium in February 2019, meaning it will likely return to public markets around a year and a half later.

14: "Private Equity Exits Have 'All But Stopped,' McKinsey Says," Institutional Investor.

15: "Coronavirus Pandemic Scrambles Private-Equity Valuations," The Wall Street Journal, Preeti Singh, May 15, 2020.

16: "Albertsons IPO Raises Below Its Initial Plans At \$16 a Share," Axios, Dan Primack, June 26, 2020.

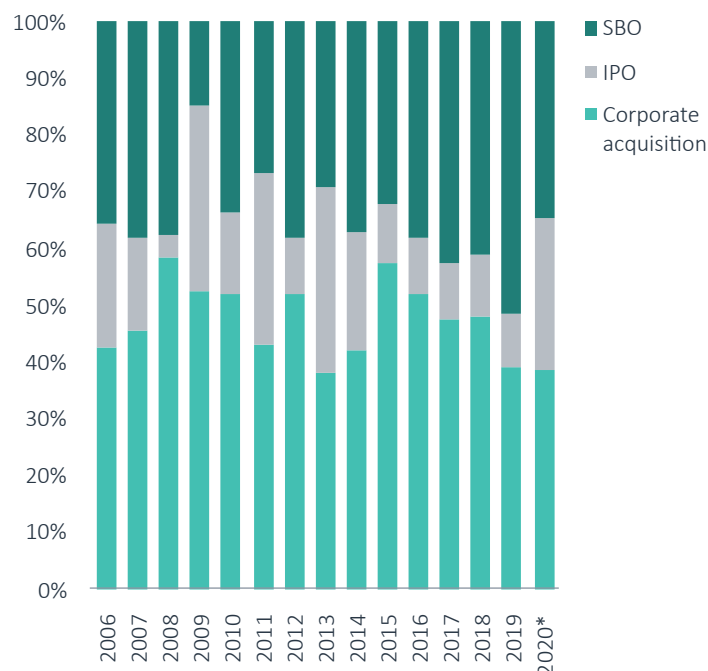
Exits

In addition to these outsized public listings, we saw several high-profile bankruptcies of PE-backed companies in the quarter. Many of the names, including J.Crew, Nieman Marcus, 24 Hour Fitness, and John Varvatos, are in the retail arena. However, non-PE-backed retailers such as JCPenny and Pier 1 Imports also filed for bankruptcy in the quarter as physical retail stores struggled to remain afloat during the pandemic. Heavy debt loads synonymous with LBOs have saddled many retail companies with debt that appears to have prevented them from being competitive, and in fact PE-backed retailers are in worse positions than non-PE-backed companies. More than 70% of the 38 retailers with the weakest credit profiles were PE-backed as of April 20, according to data from Moody's.¹⁷ PE has taken note as well, with retail buyouts dwindling in recent years as older deals continue to miss targets.

Further, a sweeping wave of downgrades also plagued PE portfolios during the quarter. Lenders have been willing to underwrite deals with few to no covenants and have accepted aggressive add-backs for years. This has led to portfolio companies being less able to survive during times of distress, as we are in now. The number of companies with ratings of B3 negative and lower has more than doubled in 2020 and now sits firmly above any point during the global financial crisis.¹⁸ Moreover, of the 412 companies with credit ratings of B3 negative and lower, 273—or around two-thirds—were PE-backed as of May 7, 2020. Although we have seen defaults accelerate in recent months, this data suggests we may see even more through the back half of the year, especially if the US sees a second wave of Covid-19 cases and some form of prolonged lockdown.

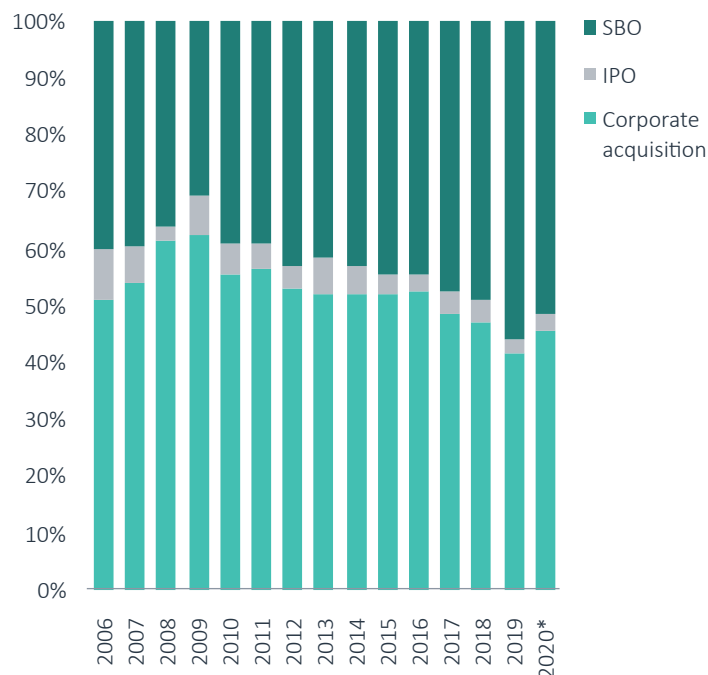
For all the reasons listed above, including portfolio markdowns, defaults, and credit downgrades, we expect PE-backed holding times to rise just as we saw following the global financial crisis. We began to see a lift in median time to exit last quarter and believe it will continue to tick up throughout the year. For this reason, GPs with older funds may need to use GP-led secondary transactions to prolong the life of the remaining portfolio companies. Early reports convey a sharp rise in the proportion of GPs requesting extensions to investment periods and fund lives. Additionally, we may also see lower IRRs out of funds that were raised before the crisis. Even if portfolio company values recover, GPs that take an extra year or more to return capital to LPs will exhibit lower IRRs. We saw this with pre-crisis funds where 2005-2007 vintage funds had pooled cash multiples slightly below other vintages, but their IRRs lagged by several hundred basis points because it took so much longer to return capital to LPs.

PE exits (\$) by type



Source: PitchBook | Geography: US
*As of June 30, 2020

PE exits (#) by type



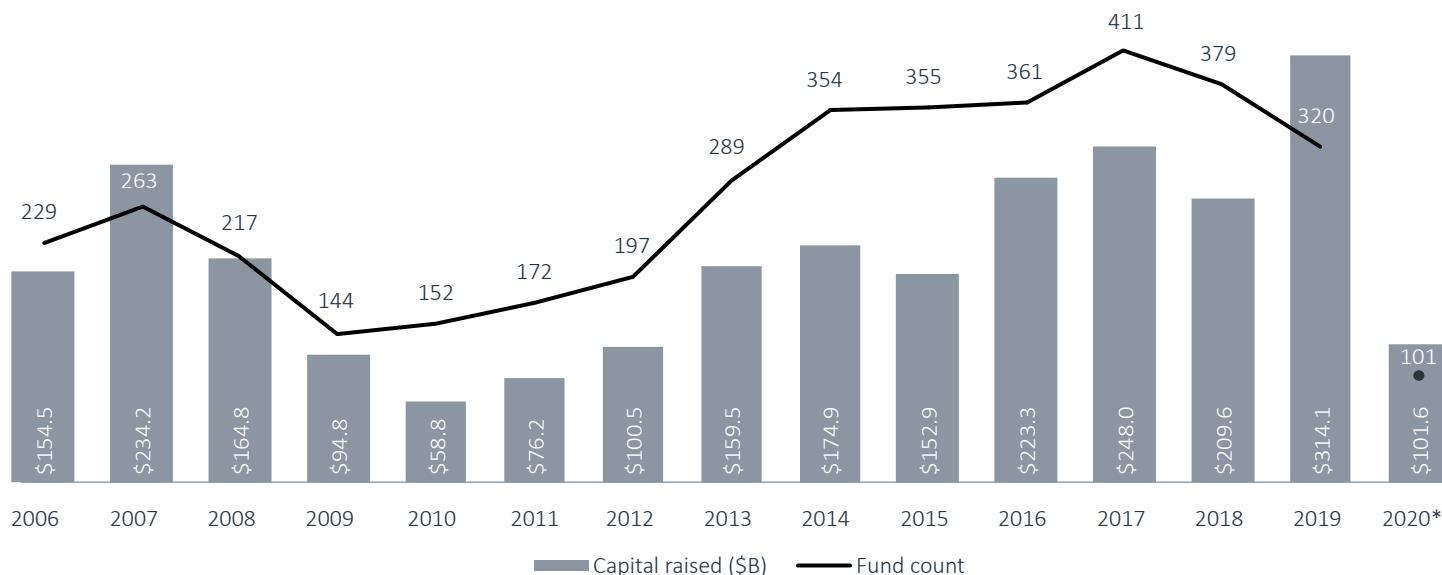
Source: PitchBook | Geography: US
*As of June 30, 2020

17: "Coronavirus Unravels Private-Equity Playbook for Some Retailers," The Wall Street Journal, William Louch and Laura Cooper, May 10, 2020.

18: "Private-Equity Backed Companies Dominate Lowest Depths of Junk," Financial Times, May 7, 2020.

Fundraising

PE fundraising activity



Source: PitchBook | Geography: US
*As of June 30, 2020

US PE fundraising activity posted healthy figures in Q2 2020. Through the first half of the year, 101 funds held a final close on a combined \$101.6 billion, putting 2020 on pace to approximate 2018's total-capital-raised figure. Despite the coronavirus effectively cutting off business travel and forcing due diligence to be done digitally rather than in person, PE firms raised more capital in Q2 than in Q1 when these restrictions were largely not present. This has occurred as the already bifurcated GP landscape continued to witness the most established managers fundraise seemingly at will. Despite raising more capital, fewer funds held a final close in the second quarter. Firms with established LP bases are finding it relatively easy to transition from in person meetings to Zoom calls, as Blackstone's chairman Steve Schwarzman put it on the company's recent earnings call. Regardless, the second largest fund to close in the quarter had almost no institutional capital, instead largely calling upon Byron Trott's rolodex. Trott, a former Goldman banker, heads secretive PE shop BDT Capital Partners, which raised \$9.1 billion for the firm's third fund. The firm advises family-owned businesses and often chooses to invest capital in these same companies, seemingly combining a merchant bank and buyout shop.

The second quarter saw several technology-focused investors either launch fundraises or close funds, though perhaps none were more impressive than Francisco

Partners. The firm officially launched fundraising on three funds and held final closes on all of them within six weeks in Q2, an almost unheard-of pace. Between two buyout funds and their first-ever credit fund, Francisco Partners raised \$9.75 billion. Raising a credit fund in the current environment seems prescient given the funding challenges many portfolio companies are facing and may help Francisco invest more efficiently in today's market, as we have seen with Apollo and others. Clearlake and Insight Partners, two other tech-heavy investors, also found success in the quarter. Clearlake closed on a \$7.0 billion buyout fund, nearly twice the size of the firm's \$3.6 billion 2018 vintage flagship fund. Insight Partners also held a final close in Q2, on \$9.5 billion. The firm's [growth equity strategy](#) is indicative of the increased interest we have seen LPs showing within the PE sphere. Growth equity grants access to quickly growing portfolio companies, which is a rare commodity in today's low-growth environment. As a sign of just how mature the space has become, Blackstone is currently fundraising for its first growth equity fund.

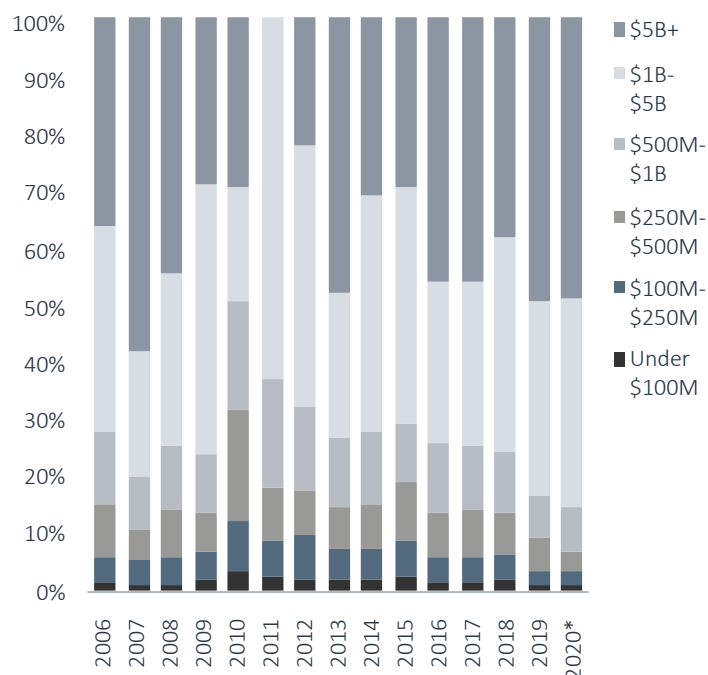
Beyond fund closings, several other massive GPs launched funds in the quarter, showing confidence in their ability to raise capital despite the global pandemic. Silver Lake, perhaps the best-known PE tech investor, debuted fundraising efforts for a \$16.0 billion-\$18.0 billion buyout fund and a \$4.0 billion mezzanine fund in April. Thoma

Fundraising

Bravo, another prolific technology investor, launched two buyout funds the month before and hopes to net nearly \$20.0 billion between the two. Additionally, Dyal Capital Partners debuted the first ever NBA-sanctioned fund targeting minority stakes in professional basketball teams. The firm hopes to raise \$2.0 billion for the strategy, which is enough to take approximately 10% stakes in 10 teams, going off recent NBA team value estimates.¹⁹ Despite its foray into investing in professional basketball teams, Dyal is better known for GP stakes investing. The firm closed on the largest-ever GP staking fund in 2019 at \$9.0 billion, though it originally targeted \$6.0 billion—and is on the road fundraising for another \$9.0 billion vehicle. Industry insiders believe Dyal will close on this fund in 2020, likely collecting more than \$10.0 billion before the final close. \$10.0 billion+ would be as large or larger than its two chief competitors, Petershill and Blackstone, are currently raising for the strategy—\$4.0 billion and \$6.0 billion, respectively.

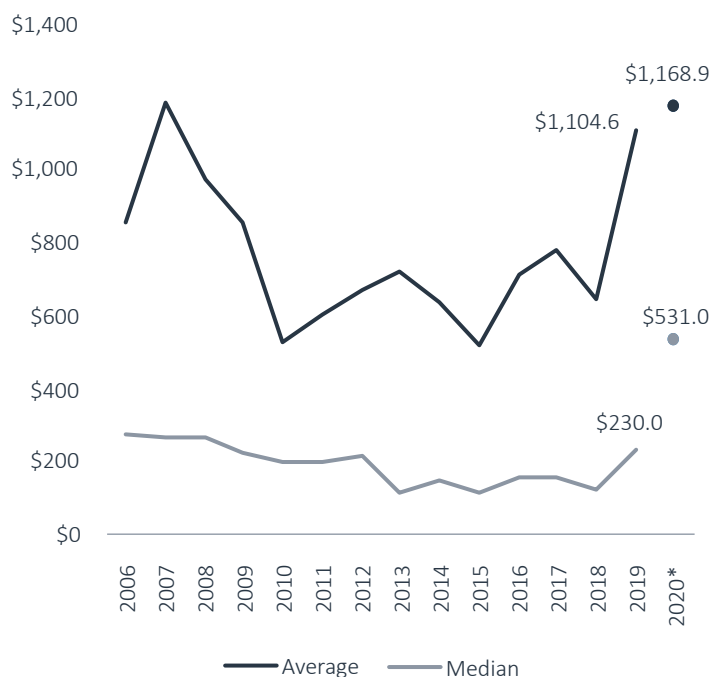
Fundraising options beyond a closed-end commingled fund gained traction in the quarter, as special purpose acquisition companies (SPACs, or blank-check companies) had the most active quarter on record. Although these entities raise capital through public listings, it is more akin to fundraising because the IPO provides SPACs with capital to acquire companies. For example, Pershing Square Capital Management has filed paperwork for the largest-ever SPAC, which could raise \$3.0 billion-\$6.45 billion, according to SEC filings. The intention is to pursue a “mature unicorn” tech company, which could place Pershing Square in competition with firms such as Silver Lake and Vista Equity Partners. However, the SPAC may assist PE firms in cheaply taking a portfolio company public while also allowing them to skip the IPO road show and 180-day lockups.²⁰ Taking a company public through a reverse merger with a SPAC can also save a listing candidate several months to a year compared to the traditional IPO.²¹ In 2014, Bill Ackman, Pershing Square’s CEO, said, “Every private equity firm should be banging down our door,” regarding how the SPAC may be of assistance.²² The Pershing Square-led SPAC later helped 3G take Burger King public. Multiple hedge funds and PE firms—including TPG Capital and Apollo—have SPACs now, too. SPACs could help hedge funds and PE firms alike expand income-generating sources while buoying future PE exit value.

PE funds (\$) by size



Source: PitchBook | Geography: US
*As of June 30, 2020

Average and median PE fund sizes (\$M)



Source: PitchBook | Geography: US
*As of June 30, 2020

19: “The Business Of Basketball,” *Forbes*, 2020.

20: PE- or VC-backed companies can complete a reverse merger (or backdoor listing) with SPACs, thereby taking them public. For example, when Virgin Galactic merged with blank-check company Social Capital Hedosophia, Virgin Galactic was able to raise \$800 million and become a publicly traded company in the process. The investment firm ended up owning 49% of the shares and Social Capital Hedosophia’s founder, Chamath Palihapitiya, became Virgin Galactic’s chairman.

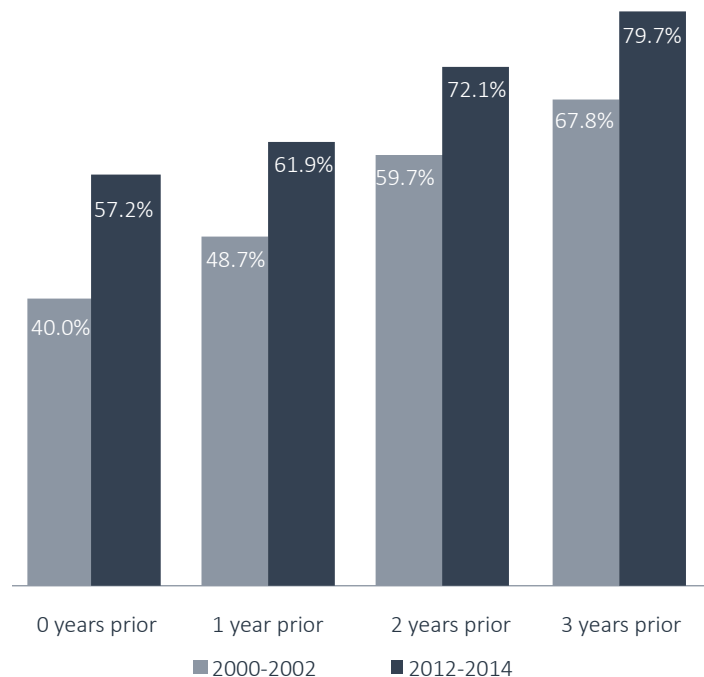
21: “Once Associated with Fraud, ‘SPAC’ Deals Now Are Rehabbed and Swapped for Failed IPOs,” *Los Angeles Times*, Crystal Tse and Liana Baker, December 29, 2019.

22: “In Burger King Deal, Ackman Gnaws on Old Bone,” *The Street*, Antoine Gara, April 4, 2012.

Elsewhere, the DOL issued clarifying remarks surrounding the inclusion of PE in 401(k) funds. While the inclusion of PE in retirement accounts had been legal for several years, plan sponsors thought the risk of lawsuits over fees in retirement accounts outweighed any benefit of including PE funds. Now, though, the DOL's response effectively greenlit plan sponsors to include PE in diversified investment vehicles, such as target-date funds. While the news likely means PE firms attain additional access to retail capital, including the \$6.0 trillion+ 401(k) market, the ruling may not lead to the tidal wave of cash some had been anticipating. Approximately one-third of all 401(k) assets are in target-date funds,²³ although that should rise over time because more than two-thirds of each new contribution tends to go into target-date funds.²⁴ In addition, of the approximately \$2.3 trillion in target-date funds, only half is in equity, or around \$1.1 trillion. Numbers being floated suggest target-date funds may seek to invest 10-15% of their equity allocation into PE funds, or around \$100.0 billion-\$150.0 billion. However, the annual lift in PE fundraising will be much smaller because any modifications surrounding target-date funds will take years. Some sponsors are ready, though. Pantheon and Partners Group have vehicles that are ready to go, and Vanguard has teamed up with Harbourvest to offer PE access, although Vanguard has limited access to institutional clients (i.e., foundations and endowments) for the time being.

Turning to performance, recent research and [PitchBook Benchmarks](#) show that PE funds have approximated public equity performance over the past 10-years, leading some to think LPs will temper demand. Other industry outsiders have claimed this illustrates that PE's high fee model is not worth it, although institutional investors are not shying away. Ben Meng, the CIO of CalPERS, published commentary in the Wall Street Journal detailing how America's largest defined benefit plan is seeking to further lift allocations to PE because the strategy is likely to deliver outperformance against the public market with less volatility in the coming years. CalPERS tends to act as a bellwether, meaning we may see more massive institutions pursue higher PE allocations. Some GPs are even taking steps that could boost, rather than cut, fees, and are still finding success. TA Associates and Thoma Bravo are raising funds without hurdle rates, which LPs are apt to dislike because hurdle rates are viewed as a tool to align interests. Without a hurdle rate, these firms could collect carry despite substandard returns.

RVPI as proportion of TVPI in years prior to the GFC or COVID-19 by vintage cohort for buyout funds



Source: PitchBook | Geography: US
*As of September 30, 2019

Through the remainder of this crisis, we expect fundraising to remain healthy as mega-managers close on capital at will, but fewer small GPs will find success. Many LPs count on PE fund distributions to be recycled back into the strategy to finance capital calls. During [times of crisis](#), LPs typically see distributions fall further than capital calls, and net cash flows often go negative—in other words, capital calls outstrip distributions. This will make fundraising more difficult for LPs, which will need to find liquidity elsewhere in their portfolios to fund capital calls in the short to mid-term. Further, recent vintages have been slower to return capital to LPs than early 2000 vintages. Coming into this crisis, 2012-2014 vintage buyout funds had 57.2% of their TVPI marks accounted for by RVPI, compared to just 40.0% for 2000-2002 vintage funds when the global financial crisis began to unfold. Funds are taking longer to return capital, making manager selection even more important because it takes more time for LPs to recoup their investment, and IRRs are likely to lag earlier vintages.

23: A target-date fund is a type of investment fund that changes its allocation over time. These typically come in mutual fund wrappers and are available in most large 401(k)s. The target-date fund is often around the date of the employee's future retirement and will slowly allocate from equity to fixed-income products as the employee approaches retirement age.

24: "CIT Target Date Assets Surging as Mutual Funds Hit Outflows," *Pensions & Investments*, Robert Steyer, June 24, 2019.

