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# US PE Breakdown

Q2 2021


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*Published on July 9, 2021*


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# Executive summary

US PE dealmaking notched a record-setting pace through Q2 2021. Feverish activity in both mega-deals ($1 billion+) and the middle market is being driven by continued economic recovery, cheap debt, and ample dry powder on the buy side, and by the imminent possibility of a capital gains tax hike and elevated pricing on the sell side. PE dealmaking in software continued to attract capital at an unprecedented clip, with cybersecurity an increasingly popular investment theme. And in healthcare, PE firms are deploying capital into greenfield opportunities that have come into sharper focus post-pandemic.

PE exit activity through H1 2021 is also on track for a record-setting year. Exit activity among $1 billion+ assets was particularly zealous in Q2 2021. Bullishness and attractive multiples in the public markets have made PE firms more aggressive in listing portfolio companies through both IPOs and SPAC mergers, and strategics are also pursuing bold M&A strategies. PE's recent emphasis on inorganic growth is also bearing fruit as platforms that saw significant expansion under PE sponsors are now coming to market, with many achieving healthy valuation step-ups.

US PE fundraising continued its recovery in Q2 as institutional investors moved away from the conservative decision making they adopted in 2020 and increased their alternatives allocations. Mega-funds ($5 billion+) continued to account for the bulk of capital raised, but both middle-market managers and first-time funds are also finding success as the increased appetite for PE benefited funds of all sizes. With mega-funds in the market seeking over $100 billion, fundraising activity may be backloaded in the year. Additionally, distributions to LPs—much of which are typically recycled into new allocations—and lofty return numbers across all fund sizes ought to provide additional tailwinds.

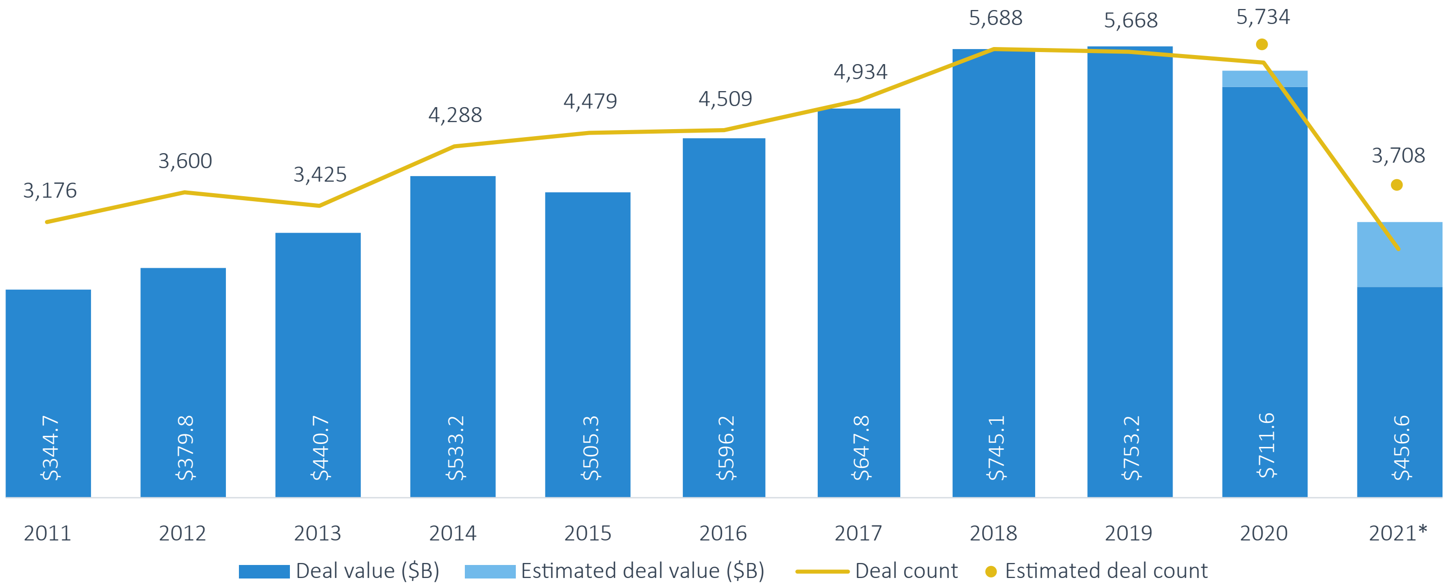
**Wylie Fernyhough**
Senior Analyst, PE Lead

**Rebecca Springer, Ph.D.**
Analyst, PE

**Jinny Choi**
Analyst, PE

# Overview

## PE deal activity




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

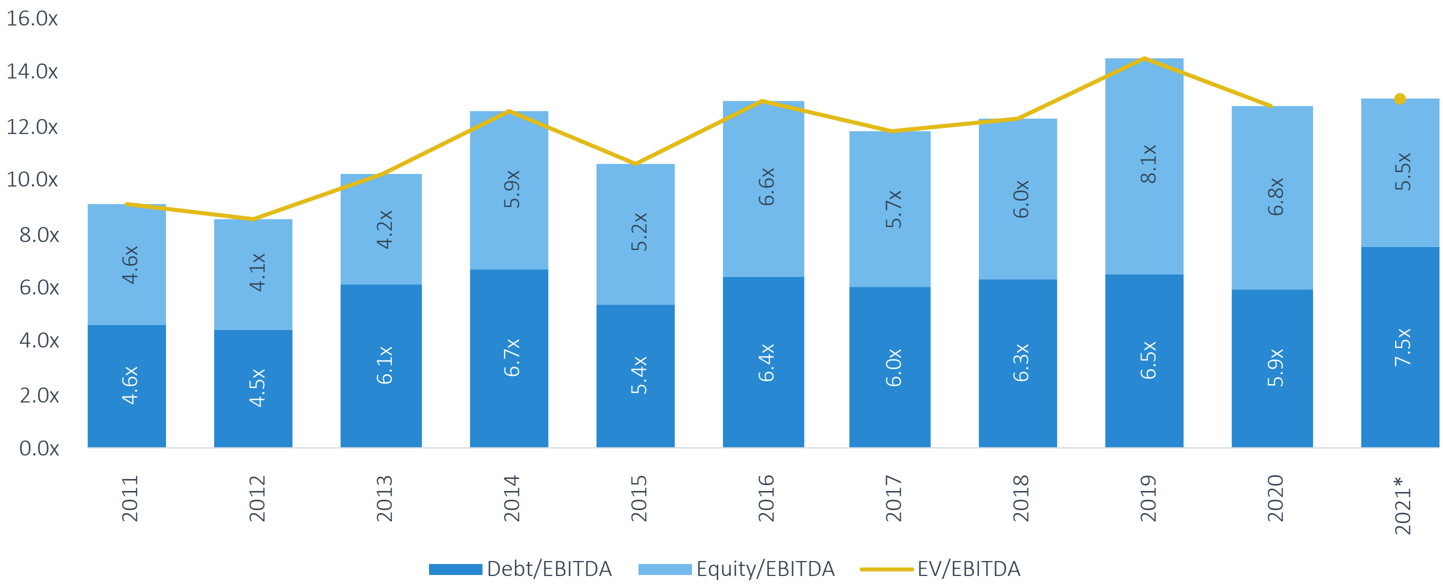
In Q2 2021, PE dealmaking continued at a frenetic pace for the third quarter in a row. Through the first half of the year, PE firms have closed on 3,708 deals, worth a combined $456.6 billion—nearly two-thirds the deal value we recorded in all of 2020. Q2 2021 registered the second-highest deal activity in a decade after Q4 2020. While it may be too early to predict with certainty, dealmaking and exits are easily on pace for a record-setting year, while fundraising is tracking close to 2019's elevated levels.

Several factors drove this unprecedented rally in PE activity. According to the Centers of Disease Control and Prevention, over 50% of eligible US residents are fully vaccinated, and the economic recovery has continued apace. Inflation rose significantly in May, and the Labor Department reported that unemployment claims fell to their lowest levels since before the pandemic. Investor confidence remains high as equity markets continue to move up and to the right. Additionally, even riskier companies are enjoying favorable conditions as the high-yield credit spread fell to a post-global financial crisis (GFC) low point in June.

Investors continue to be attracted to high-yield debt due to low treasury yields and the prospect of rate hikes on the horizon, and collateralized loan obligation (CLO) issuance has skyrocketed. (CLOs, which represent around 70% of the leveraged loan market, are typically floating-rate instruments. Additionally, the current mix of high-yield debt outstanding has a significantly shorter average duration than investment-grade bonds, which makes high yield less exposed to value degradation as rates rise.) This has caused PE firms to take advantage of the demand through record-setting new leveraged loan issuance. Corporate bonds and private debt have also seen significant activity in Q2. In order to finance its $6.0 billion take-private by Stone Point Capital and Insight Partners, real estate software provider CoreLogic is offering a $4.0 billion corporate bond. And Owl Rock Capital Partners (NYSE: OWL) is leading a $2.3 billion loan to help Thoma Bravo buy Calypso Technologies.

PE firms are taking advantage of the frenzied demand for high-yield debt not only to fund leveraged buyouts (LBOs), but for record levels of dividend recapitalization and refinancing activity as firms look to utilize low rates before an anticipated 2023 Federal Reserve interest rate hike. Accordingly, the median buyout leverage multiple ticked up above 7x EBITDA for H1 2021. Although caution is warranted due to low data counts, 2021 could see the highest median leverage multiple since 2008 for large deals. In the lower middle market, which is dominated by private lenders, mild leverage creep has been driven primarily by the uptick in EBITDA multiples, with debt-

## Median PE buyout EV/EBITDA multiples



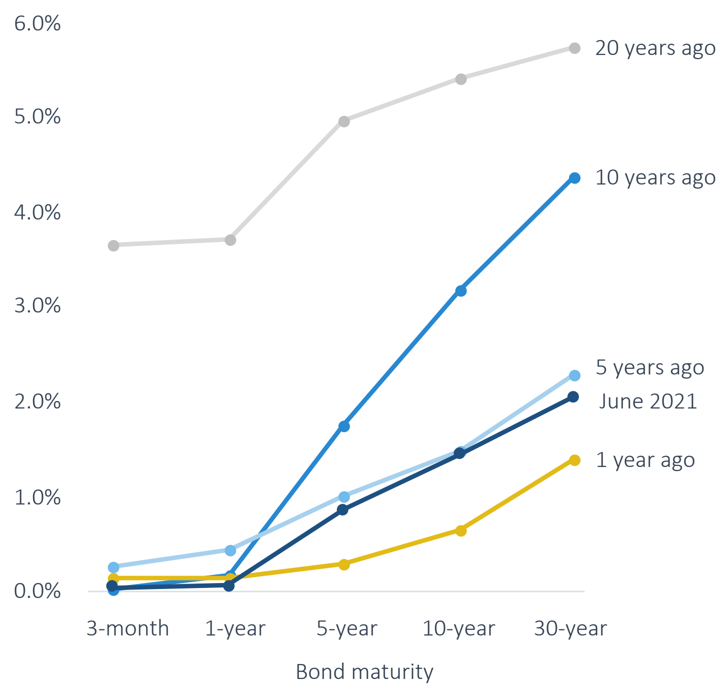

**Source**: PitchBook | **Geography**: US
*As of June 30, 2021

to-EV ratios remaining near 50% on average. According to Rich Christensen, senior partner at Twin Brook Capital Partners, leverage multiples and loan covenant structures have broadly reverted to 2019's trends.[1]

Finally, the Biden administration's proposed increase in the marginal capital gains rate—from 20% to 39.6%, although the final number may be negotiated down—has spurred a dealmaking frenzy, with business owners racing to realize profits from sales before the year's end. Investment banks and other service providers are reportedly overwhelmed and staffing up for more activity in the second half of the year. Some bankers are now passing on deals they normally would pursue because their pipeline is so full, a reversal from 12 months ago. We are likely seeing the effects of this specter in Q2 2021's numbers already. And even if the tax hike is applied retroactively or abandoned altogether, it is likely that many sales processes that have already been put in motion will conclude in the next several quarters, meaning that elevated activity will likely continue.

The counterpoint to these encouraging signs is that the Fed, surprised by the Q2 inflation pop, has begun to gingerly signal a move toward tapering and implementing a potential rate increase by the end of 2023. The core consumer price index rose by 3.8% YoY in May, the largest increase since 1992. In the medium term, the prospect

## US Treasury yield curve*




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

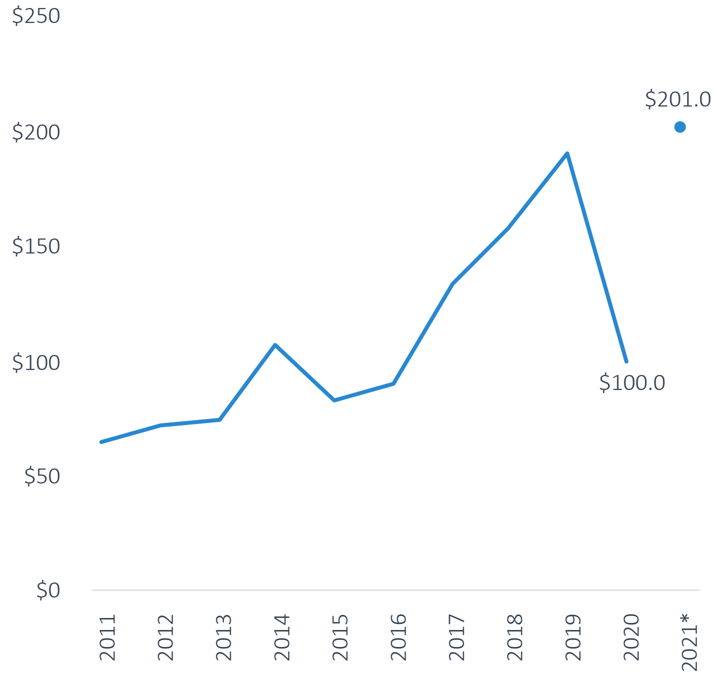
1: Rich Christensen, telephone interview with Rebecca Springer, June 25, 2021.

of a higher risk-free rate, which would pull up discount rates, could pressure buyout pricing. Higher discount rates typically have a greater negative impact on high-growth sectors such as tech and healthcare, which have seen increasing PE favor in recent years. It remains to be seen whether the current inflationary movement will be transitory. A sustained inflationary environment could draw increased PE attention toward value sectors—such as financial services, industrials, and natural resources—but this would be a significant reversal from years-long industry trends.

The club buyout of healthcare supply company Medline Industries, announced in early June, exemplifies this risk-on dealmaking environment. Clocking in at an astonishing $34.0 billion EV, with The Blackstone Group (NYSE: BX), The Carlyle Group (NASDAQ: CG), Hellman & Friedman, and GIC participating, the deal inspired myriad comparisons to the mega-deals of 2006 and 2007. Although the deal constitutes the largest LBO financing since the GFC, it will be roughly half debt and half equity, representing a much more conservative debt-to-equity ratio than was typical in the pre-GFC mega-deal heyday. Medline attracted PE attention for several years before benefiting from demand for PPE during the COVID-19 pandemic.[2] Moreover, the company's family owners were no doubt motivated in their timing of the deal by the looming capital gains hike. It is a noteworthy sign of macroeconomic optimism that Blackstone and the other dealmakers foresee an exit route for a company of this size, presumably in the public markets, in the next three to five years. There are also signs that the largest PE firms are seeking other gargantuan deals: After CVC made an initial bid to take Toshiba private at around a $20 billion valuation, which Toshiba rejected, Bain is reportedly exploring an offer for the company. The buyouts of Cloudera, Proofpoint, Culligan International, and Verizon Media Group are four additional examples of $5 billion+ deals announced in Q2 2021.

Although the burgeoning pipeline of mega-deals has grabbed headlines in recent months, the runaway deal flow numbers posted by US PE in Q2 are largely attributable to feverish activity in the middle market, especially in deals under $500 million. Middle-market deals accounted for 64.8% of overall PE deal count in the first half of 2021, the highest annual proportion on record. The tax policy environment is no doubt driving much of this excess middle-market activity. We have also

## Median PE buyout size ($M)



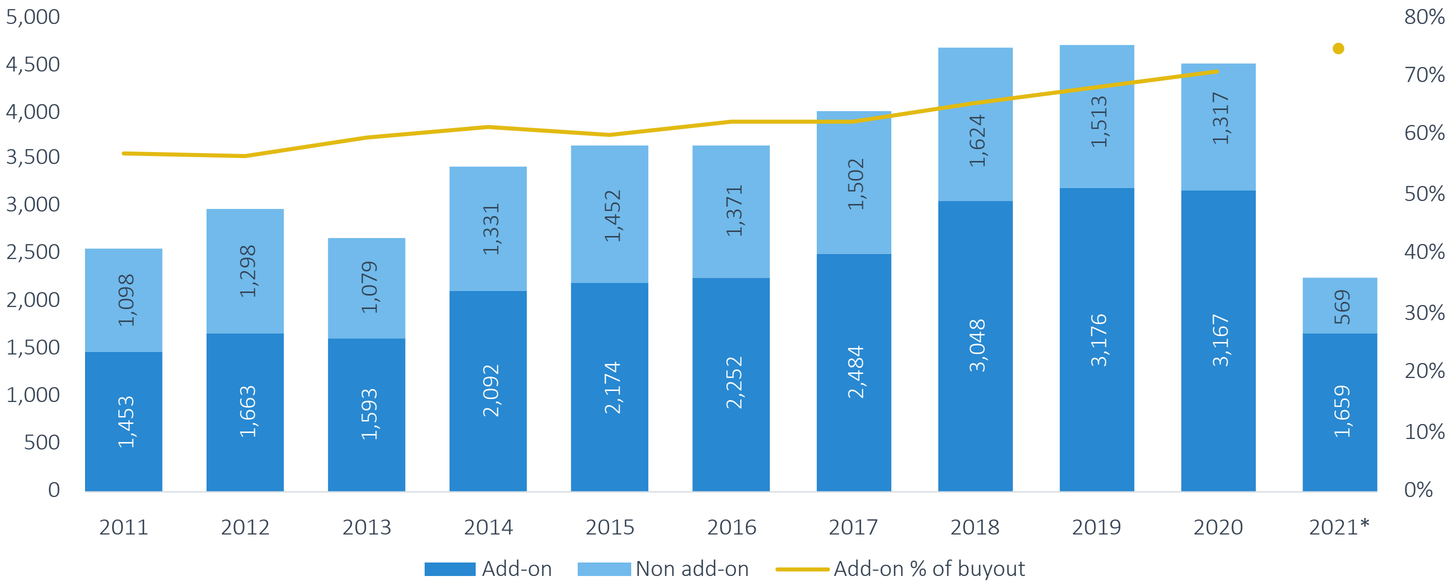

**Source**: PitchBook | **Geography**: US
*As of June 30, 2021

reached a point in the broader economic recovery from the pandemic where firms can get a clearer view of the balance sheet health and market outlook for small and medium-sized businesses that may have initially been affected by the downturn. This helps sellers feel confident that they will receive a fair price. For companies that are recovering but still showing some pandemic effects on the bottom line, seller earn-outs can help to mitigate downside risk for the PE buyer while incentivizing sellers with the chance to continue profiting from the company's growth one to two years after close.

The competitive sales processes currently playing out for many middle-market assets are evidence of a flight to quality, with the businesses that proved most resilient through 2020's market turmoil commanding lofty multiples. We are hearing from GPs that they are hardly looking to "get a good deal" on purchase prices in the middle market, instead moving downmarket through add-on acquisitions in order to take advantage of multiple arbitrage and seek unbanked, less competitive deals. The proportion of buyouts that were add-ons hit an all-time high at 74.5%. According to Christensen,

2: "Private Equity Firms Strike $30 Billion Deal for Medline," Axios, Dan Primack, June 7, 2021.

## Add-ons (#) as a proportion of PE buyouts




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

building a high-conviction inorganic growth strategy has become essential for PE firms making aggressive bids to win competitive deals: "We believe being able to execute on a well-defined M&A strategy from day one has become critical in today's investment environment."[3]

PE dealmaking in software continued to post exceptionally strong numbers in Q2 2021, with cybersecurity emerging as a particular area of focus. Cloud-centric cybersecurity services are cementing themselves as a major need as organizations continue to grapple with the digitization of business infrastructure and the security challenges of remote work. Proofpoint (NASDAQ: PFPT) entered agreements in April to be taken private by Thoma Bravo at a valuation of around $12.3 billion, the largest deal in cybersecurity history. PE firms are attracted to the sticky customer base, strong cash flow generation, and revenue growth potential of big players like Proofpoint, which became the first SaaS-based cybersecurity and compliance company to surpass $1.0 billion in revenue in 2020.[4] As cybersecurity gains more momentum, major leaders are restructuring to drive further growth and specialize as niches emerge and become strongly defined market opportunities. For example, FireEye sold its products business to a consortium led by Symphony Technology Group (STG) for an all-cash deal of $1.2 billion to prioritize its cloud-first security product portfolio. This deal comes soon after McAfee's (NASDAQ: MCFE) carveout of its device-to-cloud cybersecurity enterprise business for $4.0 billion to a consortium led by STG.

Another cybersecurity subsector poised for rapid growth is zero trust, a concept centered on no trust across networks, users, and devices, as well as real-time authentication. Thoma Bravo added to its growing cybersecurity portfolio, leading a $225.0 million Series F in Illumio at a $2.8 billion post-money valuation in late June. This was Thoma Bravo's first foray into late-stage venture, an arena where several large firms, including Silver Lake, TPG, Insight Partners, and KKR (NYSE: KKR), have increasingly sought earlier access to high-growth technology companies. The deal also comes against a backdrop of several major cyberattacks in the last year, including the SolarWinds (NYSE: SWI) and Colonial Pipeline hacks. In May, President Biden signed an executive order to improve cybersecurity, calling on the private sector to work with the US government and for federal agencies to move toward a zero-trust architecture.[5] In this context, we believe zero trust will likely attract continued PE attention.

The network detection and response (NDR) and privileged access management (PAM) spaces are two other key spaces to watch. In June, ExtraHop, a Seattle-based NDR platform, announced its acquisition

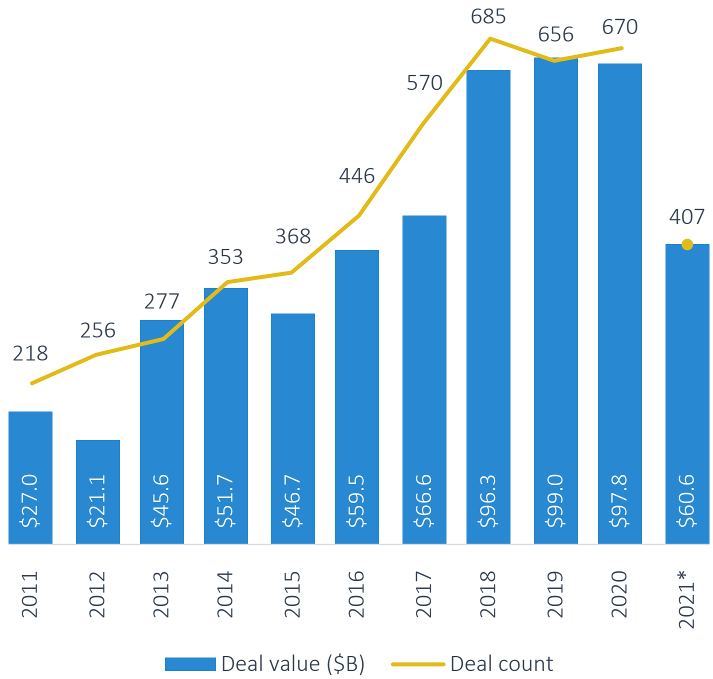
3: Rich Christensen, telephone interview with Rebecca Springer, June 25, 2021.
4: "10 Things to Know About the Thoma Bravo-Proofpoint Deal and Stock Hike," CRN, Michael Novinson, April 26, 2021.
5: Executive Order 14028 of May 12, 2021.

by Bain Capital and Crosspoint Capital Partners for $900.0 million in an LBO. This deal is the second major deal involving an NDR leader in the quarter, following Darktrace's (LON: DARK) IPO. Additionally, Thycotic and Centrify, both major companies focused on PAM strategies and technology, completed their merger in April to form a leading identity security SaaS platform with comprehensive PAM solutions.

Healthcare is another industry that not only proved resilient during 2020 but has seen new greenfield opportunities emerge over the past several years. For example, mental health providers are attracting significant PE attention, according to Nathan Ray, partner in West Monroe's healthcare & life sciences group. Behavioral health services have increasingly become culturally normalized within a more holistic view of health and wellness—a trend which predates, but was also accelerated by, the pandemic—and reimbursement rates are improving. PE firms are embarking on consolidation plays in niches focused on intellectual and developmental disabilities and autism services, as well as in basic psychology services.[6] In June, KKR's Healthcare Strategic Growth Fund announced the creation of a mental health consolidation platform that will target both in-person and virtual service providers. The same fund has supported platforms focused on consolidating clinical trials sites, ophthalmology companies, and medical device companies. The IPO of LifeStance Health (NASDAQ: LFST), a virtual and in-person behavioral health provider backed by Summit Partners, Silversmith Capital Partners and TPG, underlines the investment conviction in the space.

Another key theme, clinical data sharing, saw a sizable PE-backed merger announced when New Mountain Capital agreed to merge its portfolio company Ciox Health with Datavant, valuing the combined company at $7.0 billion. A growth round with participation from Sixth Street Partners, Goldman Sachs, and several venture and CVC groups is supporting the acquisition. Private and nonprofit groups have been working for years to connect clinical data silos to advance medical research—a notoriously difficult challenge due to privacy concerns, disparate systems, and varied data quality. Going forward, PE firms may look to match mature data management technology providers with vertical use cases, similar to Inovalon Holdings' (NASDAQ: INOV) exclusive partnership with home health provider Homecare Homebase, according to Ray.[7]

## PE software deal activity

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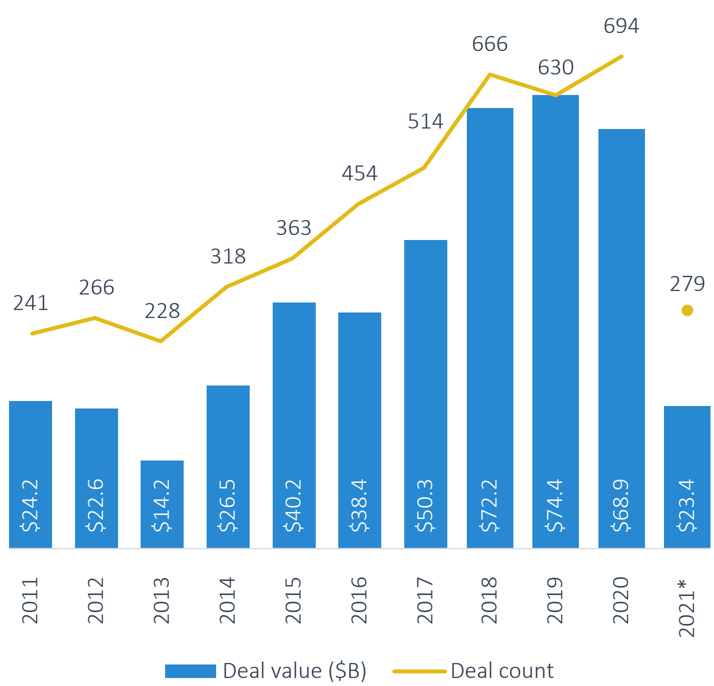
## PE healthcare services deal activity




**Source**: PitchBook | **Geography**: US
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6: Nathan Ray, telephone interview with Rebecca Springer, June 28, 2021.
7: Ibid.

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# Q&A: A partner through cycles

*The first two quarters of 2021 have proved to be busy ones for PE sponsors and direct lenders alike, and many expect that pace to continue as we head into the latter half of the year. This comes in sharp and welcome contrast to early 2020, when the outbreak of the COVID-19 pandemic resulted in an abrupt slowdown in M&A. Twin Brook Capital Partners' Pete Coffin, Nick Fessler, and Aaron Pontsler discuss their experiences working through the pandemic, the state of the market today, and their expectations for the future.*

**Pete Coffin** (left) | *Vice President*

*Pete Coffin is a Vice President at Twin Brook, focusing on the origination, evaluation, structuring, and negotiation of new healthcare lending opportunities with PE sponsors.*

**Aaron Pontsler** (middle) | *Vice President*

*Aaron Pontsler is a Vice President at Twin Brook, focusing on the origination, evaluation, and structuring of new loan opportunities with PE sponsors across a broad range of industries.*

**Nick Fessler** (right) | *Vice President*

*Nick Fessler is a Vice President at Twin Brook, focusing on the origination, evaluation, and structuring of new loan opportunities with PE sponsors across a broad range of industries.*

**The past 12+ months have been eventful to say the least. What are your key takeaways from working through the height of the pandemic and beyond?**

**Nick:** I think this experience really shined a light on the importance of the detailed diligence we do during initial underwriting and our high-touch approach to ongoing portfolio management. Our deal teams put in a lot of work getting to know these companies at the outset and maintain ongoing dialogues with their management teams and sponsors. This was key through the pandemic, as I think the strong relationships, open lines of communication, and deep knowledge of each of our borrowers that we already had in place proved vital. Having that foundation positioned us to respond quickly, supported our ability to proactively work with borrowers and sponsors to navigate any potential issues, and allowed for greater flexibility when it came to generating solutions and helping them execute on opportunities as their focus returned to growth.

**Aaron:** I think the resilience of our portfolio companies through the pandemic also speaks to Nick's point about the importance of underwriting and our focus on credit selection. Much like our PE clients, we look to support businesses that are cycle-agnostic and have compelling value propositions. As a result, these companies were able to survive mandated shutdowns and other pandemic-related challenges and come out the other side—in some cases, even stronger than before. In my view, this situation also demonstrated why experience and relationships matter. Our senior leadership team has worked through multiple cycles in this space, cultivating extremely deep sponsor relationships, and that experience has certainly informed how we operate. From our immediate response as the pandemic erupted in the US last March, reaching out to assure borrowers and sponsors that Twin Brook was there for them, to working hand-in-hand to make sure those businesses had what they needed to navigate the initial shock and beyond, our commitment to being a reliable, long-term lending partner was clear.

**Pete:** Expanding on Aaron's point about the value of longstanding relationships, I think this proved to be true for lenders and sponsors alike. Having trust that your counterpart will make the right decisions in a challenging environment and the alignment of expectations that comes from developing those relationships is invaluable. And I think it is very difficult to establish that dynamic if you take a commoditized, transactional approach to selecting who you work with. I think the events of last year also highlighted the importance of being thoughtful when it comes to structuring deals, with a focus on ensuring companies have the ability to maintain adequate liquidity through both periods of growth and distress. Looking to the broader market, the companies that we have seen run into trouble have often been those that were aggressively structured in terms of leverage or pro forma EBITDA adjustments. Although looser terms and more aggressive structures have become increasingly common in recent years, Twin Brook has long remained consistent and disciplined in its approach, and I think we saw the benefits of that during the pandemic.

**How would you describe the market environment today?**

Aaron: I would say it has been, and we expect it will continue to be, a very active and competitive environment. Beginning around September of last year, transaction activity started to pick up, and the pace has continued to accelerate since then. We had an extremely busy fourth quarter and a record first quarter in terms of deployment, and we are hearing similar commentary across the market and from investment banks. In terms of the types of transactions we are seeing, it has been a healthy mix of existing portfolio or add-on activity as well as new deals.

Pete: Activity in the healthcare space, in particular, has been consistently high over the past few quarters. There are some businesses that performed well through the pandemic and are now looking to opportunistically consolidate their respective subsectors and capitalize on rebounding market conditions, as well as some smaller companies that are looking for the resources and expertise that can come with rolling into an established, PE-backed platform. Additionally, we're operating in a constantly evolving regulatory and reimbursement environment, which I think has and will continue to drive robust deal activity in the healthcare space.

Nick: Looking to the economy broadly, you hear a lot of commentary about pent-up demand, and I think that concept also rings true for PE firms and direct lenders. There was an abundance of dry powder in both spaces in 2019 and early 2020; then the pandemic hit, and markets ground to a halt as sponsors and lenders alike turned inward to focus on their existing portfolios. Now that some of the uncertainty plaguing markets last year has subsided and there is more visibility around company performance, I think many are looking for ways to put their money to work.

**What do you expect deal flow to look like through the balance of this year?**

Nick: Our pipeline has been robust through the first half of 2021, and we expect that intensity to continue in the months ahead. We covered many of the reasons for this before, in our discussion about the current market environment, but there are a few additional points I think are worth highlighting. There were a lot of transactions that were put on hold last year, as companies and their sponsors waited for the environment and financial performance to stabilize. Many of those businesses fared better than initially anticipated and, with the country reopening and vaccination rates increasing, they are now coming to market. Additionally, we expect concerns about the impact of potential changes in tax policies may motivate some businesses to pull forward sales.

**In this environment, what do you think PE sponsors and their middle-market companies are looking for in lenders?**

Aaron: Given how competitive the market has been and is expected to remain, deal processes have been moving extremely quickly and, in many cases, PE firms don't necessarily have time to run a full debt process and entertain multiple lenders. I think they are looking for a reliable lending partner that understands their value creation strategies for their portfolio companies and will do what they say they will, when they say they will. Being able to offer the best pricing and terms is essentially meaningless if you can't get the deal to close. In this environment, I think being able to hold the entire facility, work under an accelerated timeline without cutting corners, and provide surety to close is really important to sponsors.

Pete: Having a proven track record as a lending partner and wealth of experience have, in my view, also become meaningful differentiators in the eyes of PE firms. Being able to demonstrate that you have successfully managed your portfolio and supported borrowers through cycles, that you consistently deliver on your commitments, and that you have the appropriate expertise, infrastructure, and resources to support their growth strategies and work with them through whatever may happen post-close is critical.

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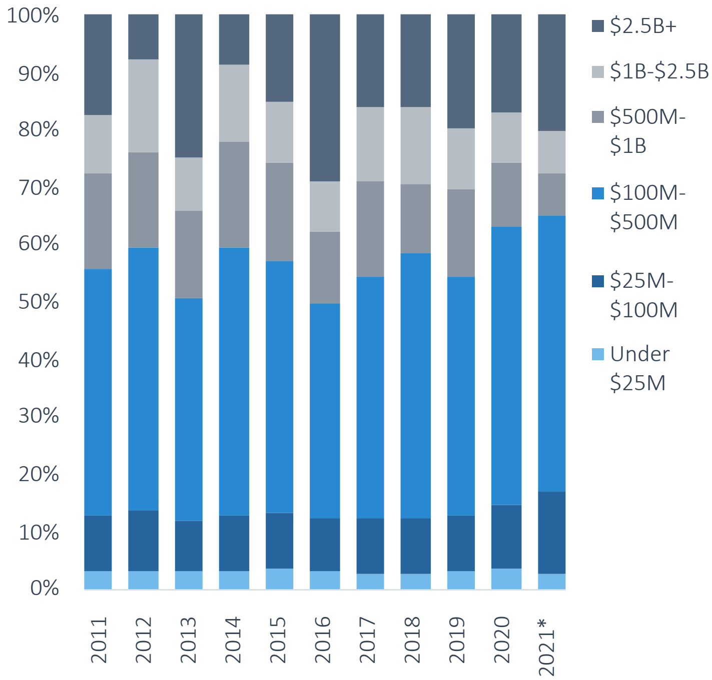
*To learn more about Twin Brook and its cash-flow based financing solutions for the middle-market PE community, visit www.twincp.com.*

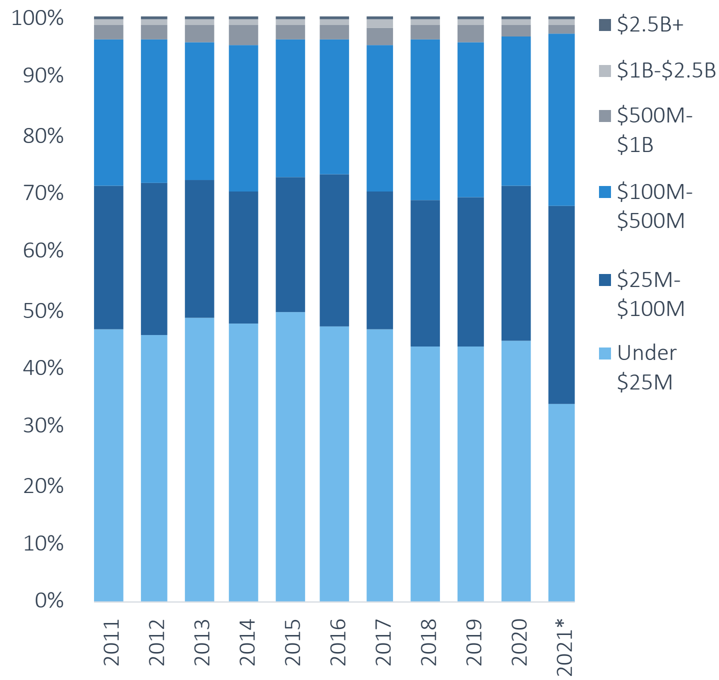
# Deals by size and sector

## PE deal value by size




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

## PE deal count by size

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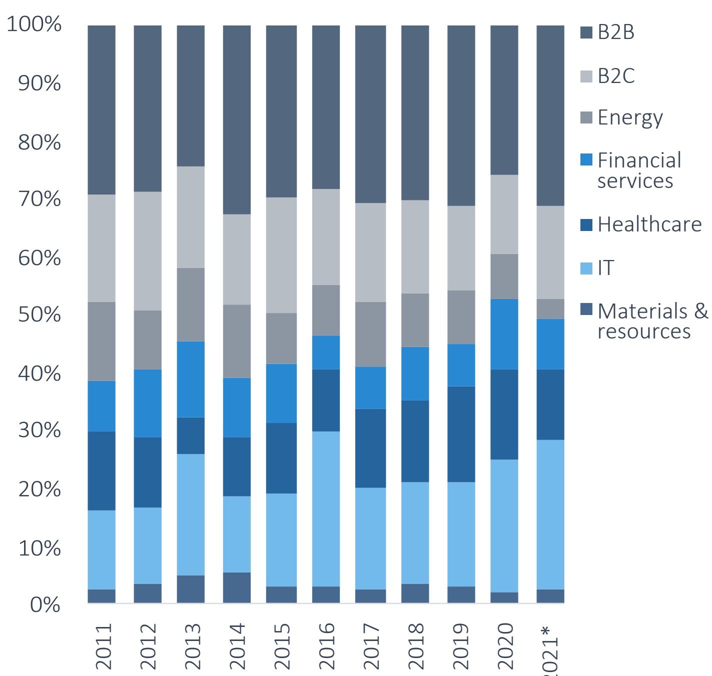
## PE deal value by sector

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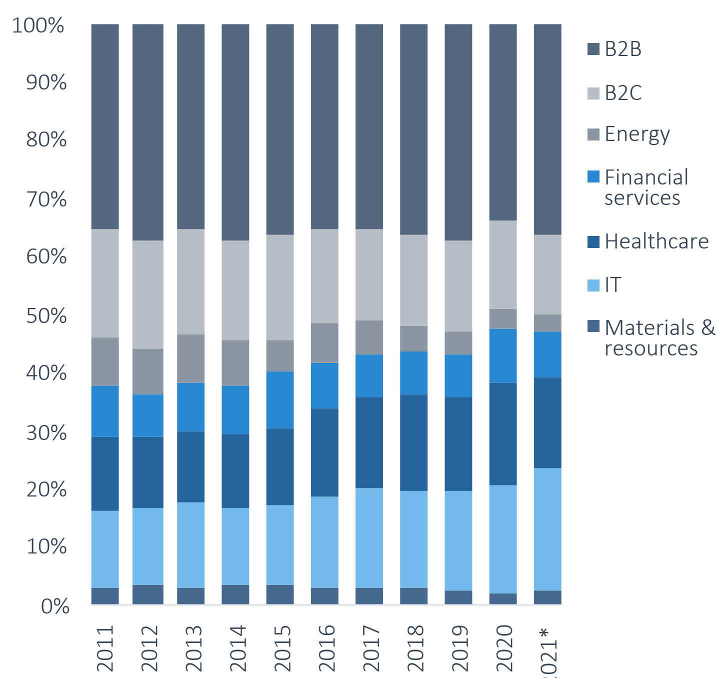


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# Q&A: Q2 activity trends

*West Monroe supports more than 400 private equity transactions every year, performing buyside operational, technology, and market diligence. This experience, combined with our multidisciplinary approach—which looks at each situation through the lenses of industry, operational, and technology expertise—helps dealmakers plan for and manage the complexities of mergers, acquisitions, and divestitures.*

Sean Adkins
*Managing Director*
*West Monroe*

*Sean delivers value for private equity clients across a wide range of investment by working at the intersection of technology and operations. He believes in challenging common thinking patterns with new ideas that are grounded in data-driven decision making.*

Brian Jacobsen
*Managing Director*
*West Monroe*

*Brian leads the firm's co-investment arm, West Monroe Capital, which aligns our interests with private equity clients by investing in select businesses where West Monroe will be able to drive value post-investment. He is a former partner of several private equity firms and a long-time West Monroe client.*

**What are the most underrated origins of alpha/value creation for PE fund managers in the current environment?**

**Sean:** Everyone talks about using data, but it is usually in the context of operations and running the business better. I think many fund managers are missing an opportunity to use their data to optimize revenue from an existing platform by identifying cross-selling and upselling opportunities. Add-on acquisitions have become an increasingly common value-creation strategy. But I would challenge investors to consider this question: If you weren't able to make another acquisition, how could you use data to optimize revenue? The data is there, as are the capabilities for analyzing it.

**Brian:** Another is the discipline with which investors combine businesses when executing on an acquisition-led growth strategy. Investors are consistent with respect to the intent to integrate businesses to achieve that goal. But there is still a lot of inconsistency in execution and, surprisingly, a lot of value left uncaptured from these add-on acquisitions.

**How do those drivers vary across sectors, and which ones are best primed in the current environment, given broader macroeconomic and market factors?**

**Sean:** I think the biggest variance depends not so much on the sector but on the underlying complexity of the business. Companies—typically in the consumer products, manufacturing, and retail sectors—that have large numbers of customers and/or stock keeping units or offering types are probably under-optimized with respect to revenue growth potential. Thus, they have the biggest untapped opportunity to benefit from data.

**Brian:** One area that I see as particularly well-primed to use data to grow revenue is around the convergence of retail and healthcare. Whether that is with the application of retail principles to healthcare or vice versa, it is about doing more with the same consumer. Looking at the healthcare consumer as a "customer" is a new concept for many providers. Technology and data are game changers. Think about how you could use customer information to understand and predict the market (with consideration for regulatory requirements, of course)—not just selling, but focusing on health.

**Given the overall levels of competition, what are the best practices for balancing between speed in closing and due diligence? How do priorities stack up today?**

**Brian:** The speed at which today's market is moving requires investors to set priorities for the diligence process and determine what makes a go/no-go decision, or when something may cause them to want to pay a materially different price. Of course, you want to avoid the catastrophic risks: "I won't buy if these certain things don't check out." But below that is a second tier of risks, the potential impact of which can be estimated, ring-fenced, and dealt with post-closing.

**Sean:** Back to the topic of data, another important practice is to go into the process armed with data-modeling capabilities, whether your own or a partner's tools, that you can deploy quickly. For example, what if you had the ability to ingest transaction data quickly and predict future demand or the strength and potential of

specific customer segments? That capability is out there.
**Brian:** A third good practice is simply thorough preparation and doing your work ahead of time — understanding the industry and players before diving into a process that you know is going to move quickly. In other words, know the pond in which you are fishing so you are not navigating in the dark. Have your market diligence done and your thesis on the sector complete, or at least well-advanced.

**What are the biggest challenges in post-merger integration for PE buyers today?**

**Sean:** Systems and people. It sounds simple, but it often comes down to that. Particularly in situations where you are integrating multiple companies, not just two, you need to get them all on a single sheet of music. That is not easy or inexpensive. Sometimes, we see investors choose to defer integration because of the complexity. If you have 20-year-old systems, you will need to fix that, but sometimes the integration work is left as upside for the next owner.

**Brian:** I agree on people. The biggest challenge I see is the buy-in of senior people and leaders when a PE firm is leading the charge on add-on acquisitions. Say a CEO or a couple of division heads don't fully believe in doing what it takes to put the businesses together. If you don't have leadership support around the "why," then the "how" becomes much more difficult.

**Sean:** Systems should be downstream from that. Some integration efforts start with implementing a common enterprise resource planning system but struggle because the support at the top isn't there.

**Brian:** In situations where the investors and executives are completely on-board with integration and spend the time and money to make sure the businesses are truly integrated, amazing results can happen. It can be really powerful.

**How do those challenges vary across target company size, as well as by type of transaction—for example, carveouts versus add-ons?**

**Sean:** The challenges of people, culture, and processes are the same, regardless of size. Size, though, may determine the resources available to focus on integration. Smaller companies tend to be very lean. It is hard to run the business and focus on the integration. On the other end of the spectrum, with bigger deals, people tend to be more locked into established ways of working. It can be like trying to change the course of the Titanic.
**Brian:** We do see some differences when it comes to types of transactions. Carveouts generally don't have competing priorities. So, in that sense, they are relatively straightforward, provided you are working with advisors who have done it before and understand where the pitfalls lie and how to get around them.

Similarly, small tuck-ins are about adding on to an established platform. The challenges there are usually lack of resources or of a playbook for how to onboard and integrate a smaller acquisition. If you are attempting multiple add-ons, then the complexity goes up, and it becomes critical to have a well-conceived process in place for moving them onto the go-forward platform.

Mergers of equals tends to be the most challenging because you have to define the go-forward team and platform. That's where you are most likely to run into the challenges of buy-in and culture.

**What are PE fund managers not talking about that they should be considering?**

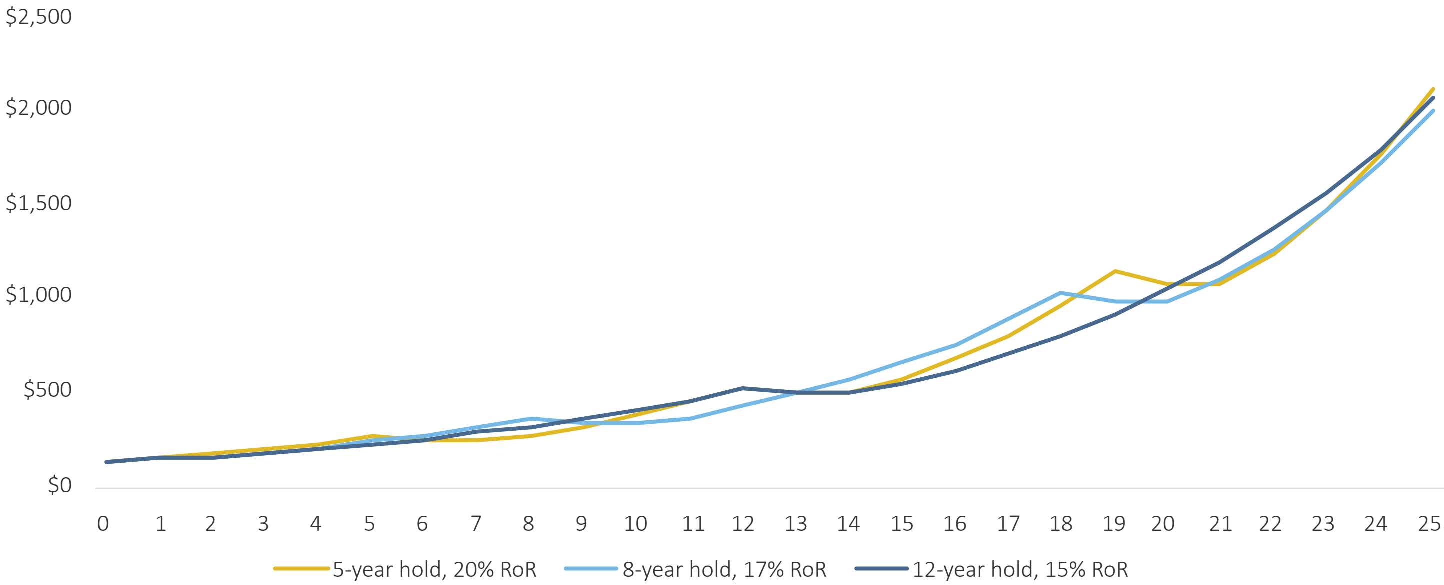
Sean: We can't really say firms are not talking about technology, because they have been for years. The issue is that, in many cases, they're just talking about it—many still do not have a technology strategy across the portfolio. Every PE firm needs to understand technology and how to apply it to optimize investments. Investors have been able to get away with not having a technology strategy and expertise, but five years from now, that will not be the case.

Brian: From a market perspective, it looks like today's high volume will continue at least for the next couple of quarters, but we don't know what comes after that, especially given the rumblings about tax law changes. Investors will need to think more critically about how they can make the business better in a way that another buyer cannot. You need to have a point of view about why you are the best owner for this business versus another firm.

Sean: The investors who are most successful stay within their area(s) of expertise. They know the industry and have the right executives to deliver on the thesis. It is more critical than ever to ask the question: Are we the right firm to buy this company? Finding new ways to assess revenue optimization and improve performance during the hold period is imperative, not just for PE firms but for the partners that provide them with services.

# Spotlight: Long-dated PE funds

## Hypothetical 25-year growth of $100 million committed to a series of funds ($M)




**Source:** PitchBook

*Note: This spotlight is abridged from our Analyst Note: Exploring Long-Dated PE Funds. Please see the full note for further analysis.*

As the PE industry has matured, variations on the traditional 10+1+1 buyout fund structure have emerged. Some companies reward long holding times: They are non-cyclical, consistent cash generators that can compound growth over a long time horizon. Long-dated PE funds—defined as closed-end buyout or growth funds with a duration of 15 years or more, excluding extensions—are one of several innovations in PE fund structure meant to capture the economic opportunity.

The principal attraction of long-dated funds is that they can generate MOIC returns comparable to investing in traditional PE while achieving a lower internal rate of return (IRR) and presumably incurring lower risk. This is because they compound investment returns over a longer period than would be possible in a traditional fund, while also deferring the transaction costs and inefficiencies associated with buying and selling companies. LPs may also find long-dated funds attractive because they reduce reinvestment risk, meaning they are less likely to receive and redeploy capital into a lower return environment and less time is spent holding on to cash in anticipation of capital calls.

Long-dated funds can be broadly categorized into two buckets: core funds and other (non-core) long-dated funds. Core funds, which are offered by some of the largest PE firms, invest in companies with a lower risk/return profile than traditional PE but seek to compound that capital over 10+ years to achieve a comparable multiple on invested capital (MOIC). Non-core long-dated funds, which are run by emerging managers, invest in companies with traditional PE risk/return rates and anticipate holding only a proportion of these companies for 10+ years.

In evaluating the prospects of long-dated funds, one key question is whether market forces will continue to advantage long-hold strategies. There are several competing factors at play. Many of the companies which long-dated funds have invested in are clear buy-and-build plays, an increasingly popular strategy in PE. Our data reveals that the largest roll-ups are overwhelmingly passed from one sponsor to the next. Long-dated funds represent an alternative to this, allowing firms to continue driving inorganic growth for a successful buy-and-build


rather than passing it along to the next sponsor. At the same time, median holding times are on the decline across PE overall, especially for technology and tech-enabled companies. Going forward, the PE industry could see these trends growing in parallel, with more GPs finding ways to compound steady cash flows over longer time horizons while others focus on shorter investments in high-growth companies. The largest firms, of course, can play both games at once, and have already begun to do so.

Another key question in evaluating the outlook for long-dated funds is whether the growing popularity of LP direct investments, GP-led secondaries, and single-asset strategic partnerships/joint ventures represents a competitive threat. Many LPs with extended investment horizons would prefer to make long-term investments directly, and will do this to the extent that resources allow. However, only a handful of LPs have developed internal teams that can successfully execute a direct investment strategy on a large scale. This means that many LPs that want exposure to a long-term appreciation strategy will allocate to long-dated funds even if they partially view them as a "fee grab" by the largest managers. It is also why the co-investment opportunities offered by some long-dated funds have been particularly attractive to LPs.

GP-led secondaries represent another avenue for LPs to gain access to long-term compounding gains without committing to a traditional long-dated fund. For one thing, LPs can now invest in single- or multiple-asset continuation vehicles, some of which have a long or perpetual life. We've heard there are more continuation funds currently in the market than ever before. While the types of assets purchased by continuation funds vary, they include companies with a comparable risk/return profile to that targeted by core funds. Additionally, some LPs have also teamed up with GPs on strategic partnerships, recycling pools of capital through multiple deals over a long time horizon.

The rising popularity of GP-led secondaries may also change the calculus for LPs in a different way. It erodes the differentiation between a long-dated fund, which is essentially a more concentrated buyout fund with built-in long-hold optionality, and a traditional buyout fund that is willing to run a restructuring process at the end of the fund's life. Of course, not all managers are willing to run secondaries processes on their funds. (Large managers with core funds may be particularly wary of transferring fund assets into continuation vehicles because of the risk of cannibalizing potential core fund investments.) Moreover, the potential conflicts of interest that can arise when assets are sold from one fund to another managed by the same GP may steer LPs away from this option. Still, the growth of GP-led secondaries means that long-dated fund managers must differentiate themselves through exceptional deal sourcing, discipline, and execution.

# Q&A: The growing use of tax liability insurance

## Cross-border transactions lead the list of reasons for increased prominence of this type of cover

Five years ago, almost no standard deals would have incorporated a standalone tax liability policy into the cover for the deal. Now, at least 10% of transactions will consider tax liability cover. Awareness of what tax liability insurance can provide has been growing for many years, expanding the use of the product in M&A and internal reorganizations or restructurings.

Tax liability insurance is one of the newer tools in the M&A advisor's toolbox. We see increased interest for cross-border deals, where both buyers and sellers are subject to separate home taxation regimes and where there may be tax consequences or effects in other international jurisdictions where one of the operating companies involved is located and taxed.

While many might consider that tax liability cover is applicable only in inherently risky opportunities, it can also be used when there are multiple ways to structure a deal, giving rise to two or more possible tax outcomes. One or more of the counterparties in the transaction may prefer one tax structure, even if it comes with more uncertainty. In this scenario, tax liability insurance transfers all or a portion of that risk or uncertainty away from the deal, helping all parties get comfortable without increasing the likelihood of a taxation event. In this context, the tax liability cover can function like a representations and warranties policy, helping take the sting out of a potential standoff and offering an amicable resolution on a reasonably quick timeline.

There may also be situations in which a remote, but material, tax risk is identified within a transaction. Here, the cover can help to prevent "buyer/seller fear" from halting progress. In addition, the involvement of PE investors can sometimes result in novel transaction structures, and such parties also tend to be more innovative with tax planning than a founder-owned business for example.

**Michael Saitta**
*Senior Underwriting Counsel*
*Tax Liability Insurance*

*Prior to focusing on the Tax Liability product, Michael was an underwriter on the Liberty GTS Representations & Warranties team. Before joining Liberty GTS, Michael worked at PwC, where he oversaw tax due diligence and provided tax structuring advice for PE and corporate clients on variety of M&A and internal transactions.*

Alongside the increased use of standalone tax liability insurances, we have seen a parallel increase in the use of hybrid representations & warranties (R&W) and tax policies for certain entities or business types. These are common to structures that may have inherent tax compliance "headaches" despite other advantages and, in some cases, a standard R&W policy might not cover the full suite of potential tax issues.

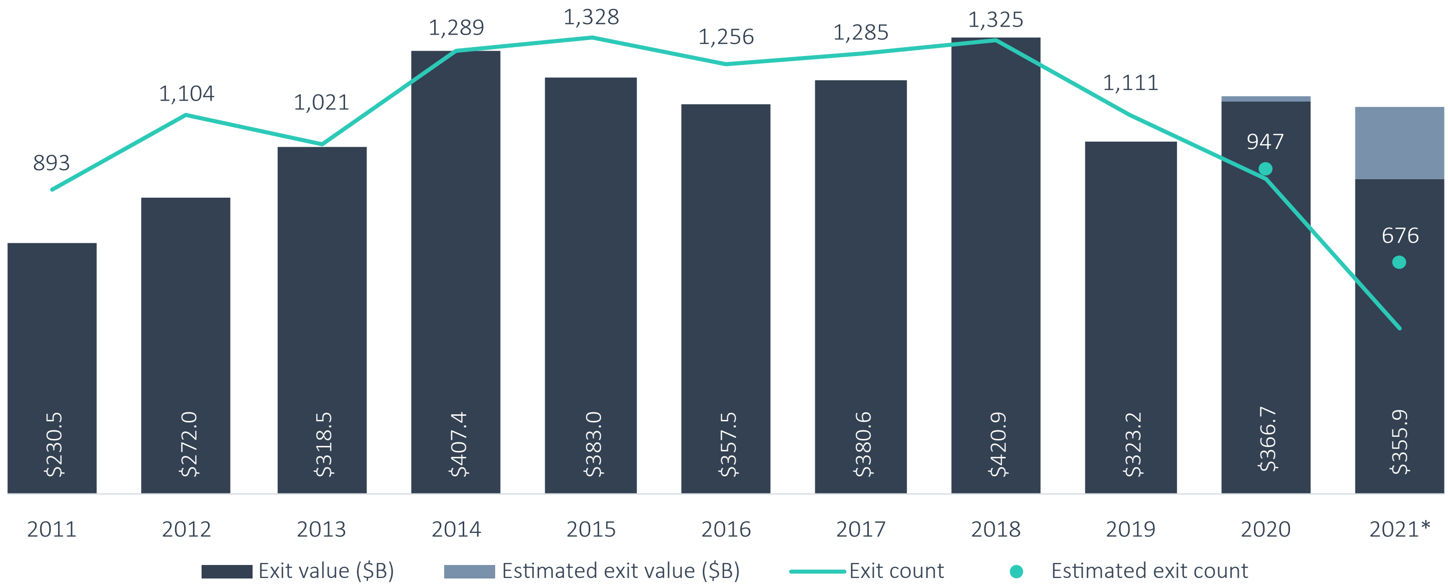
One of the most common uses of tax liability policies are certain types of tax credits—particularly energy tax credits, locking the value of these into a deal even where the credit has not yet been issued.

Real estate investment trusts (REITs) also have a favorable tax treatment built into their structure.However, these come with increased compliance considerations and, in the case of a REIT being sold, the new owner may have concerns about inheriting liability for retrospective taxation being levied on preclosing tax periods. In this situation, the transacting parties have traditionally used R&W products, even though the cover given may be incomplete for certain tax liabilities. R&W insurance is also not designed to cover tax issues that arise from the deal itself. These examples highlight how tax liability insurance, in some instances married to a R&W policy, can solve some of these concerns.

For all sides, tax liability insurance is an increasingly useful tool, and it can help smooth the path of certain types of deals in a way that a standard R&W policy cannot do alone, in addition to many of its standalone benefits outside of a deal setting.

# Exits

## PE exit activity




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

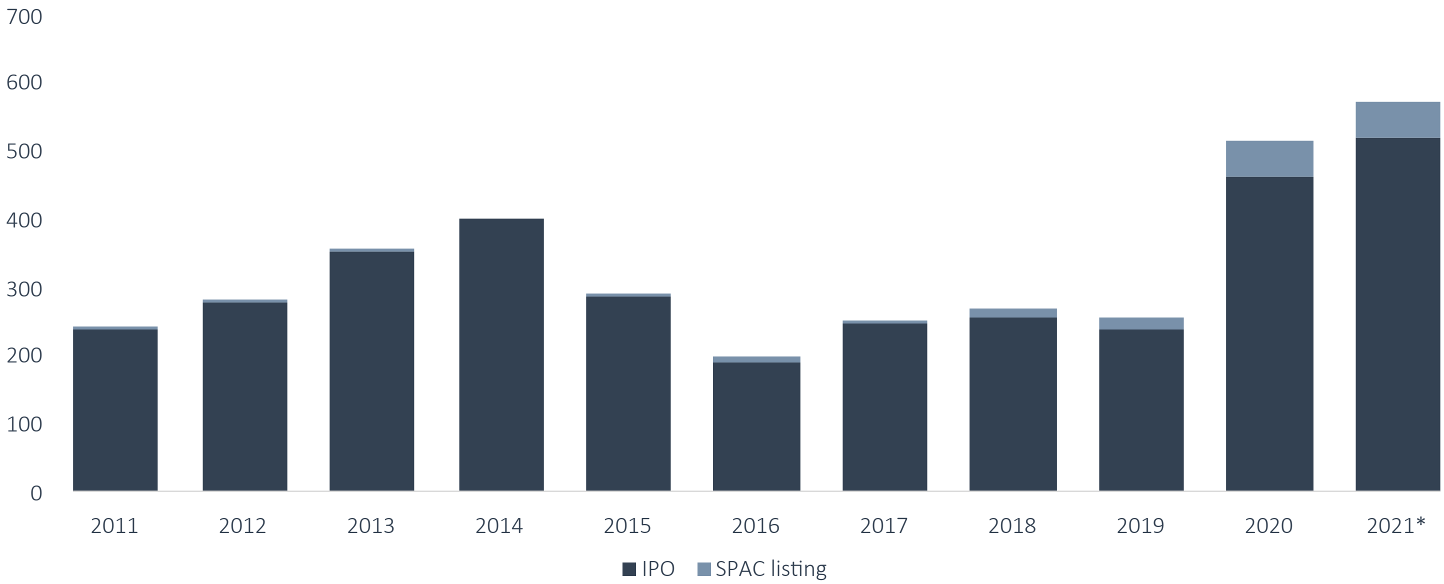
Like dealmaking, PE exit activity in H1 2021 is on track for a record-breaking year. Halfway through 2021, combined US PE exit value has already exceeded 2019's annual figure at $355.9 billion. Exit count also notched a robust 676 exits. Unlike the trend we are seeing in dealmaking, 2021's excess PE exit value so far is primarily attributable to a rush of large exits, especially public listings (primarily IPOs; we discuss the small number of SPAC mergers below). Public listings accounted for a noteworthy 12.1% of PE exit count.

Public listings of PE portfolio companies lagged in the years leading up to 2020 as the spread between public and private markets favored exiting to strategics or other sponsors. In 2019, many PE firms shied away from listing portfolio companies in the public markets due to widespread fears that the market cycle was nearing a recession. Because PE firms typically retain a significant portion of their equity in a company after it goes public for several quarters—if not years—they believed the downside risk was too great in many cases. However, since the recovery from the public market trough in 2020, and with multiples now substantially higher in public markets, PE firms have been more aggressive in listing portfolio companies.

As the number of SPACs in public markets has swelled, many PE firms see an expedited exit route to public markets for larger portfolio companies. Merging a portfolio company with a SPAC allows the GP to exit its stake more quickly than in a traditional IPO process, since SPACs typically have less stringent lock-up periods. Firms may also be able to negotiate access to founder shares and warrants as part of the merger. Accordingly, Q2 2021 began to see a trickle of SPACs closing deals with PE-backed companies after 2020's fervor for SPAC IPOs. Some two dozen additional SPAC mergers with US PE-backed companies have been announced. Since SPAC governance requires the companies to find and secure deals within 18 to 24 months, we will likely see uncommitted SPACs pursue targets even more aggressively as they become anxious to push out capital before expiration. At the same time, the challenges many recently de-SPACed companies have faced in dealing with the regulatory burdens and investor scrutiny of public markets represent a cautionary tale for firms considering taking less mature companies public.

Healthcare and technology companies together accounted for the majority of PE-backed IPOs and SPAC mergers in Q2 as public markets continued to place a premium on growth sectors, inflationary signals notwithstanding. Tech IPOs included the massive $26.6 billion listing of Applovin (NASDAQ: APP), a provider of mobile app developer tools in which KKR made a $200.0 million growth investment in 2018 at a $4.0

## Public listings of US-based companies (#) by type

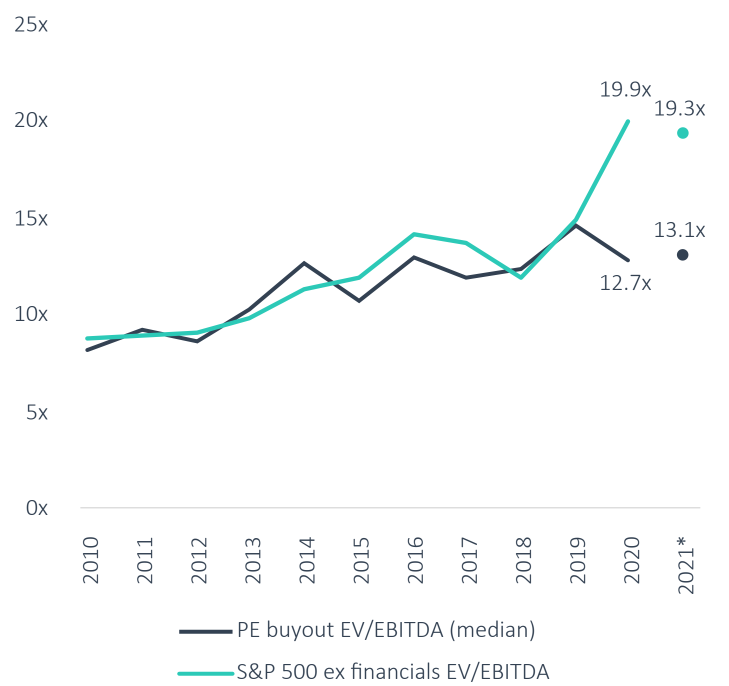



**Source**: PitchBook | **Geography**: US
*As of June 30, 2021

billion valuation. Healthcare has seen several secular tailwinds provide attractive public exit opportunities. The stabilization of the Affordable Care Act as the status quo for the foreseeable future has increased investor confidence in the sector, and the Biden administration continues to embrace key policy themes that emerged over the past decade or so, including home care and value-based care (VBC). The IPOs of TPG's Convey Health Solutions (NYSE: CNVY), J.H. Whitney Capital Partners and Penfund's Aveanna Healthcare (NASDAQ: AVAH), and Clayton, Dubilier & Rice's Agilon Health (NYSE: AGL) speak to these trends. Notably, TPG listed Convey Health Solutions, a platform that supports Medicare Advantage and other government plans, less than two years after its 2019 buyout—an indication of propitious market conditions. We are also beginning to see downstream effects from this new crop of public companies: Shortly after InTandem Partners' Cano Health (NYSE: CANO), which operates VBC primary care centers for seniors, went public via SPAC merger, the company acquired University Healthcare, a Florida-based provider network, for $600.0 million.

Many of the large exits in Q2 are the product of buy-and-build strategies, in some cases executed by two or more sponsors in succession. With multiples elevated over the past five years or so, firms have pursued inorganic growth strategies to build middle-market platforms into substantial regional or national players, and many of

## Median PE buyout versus S&P 500 multiples




**Source**: PitchBook, Morningstar, iShares | **Geography**: US
*As of June 30, 2021
*Note: S&P 500 data is as of March 31, 2021.*

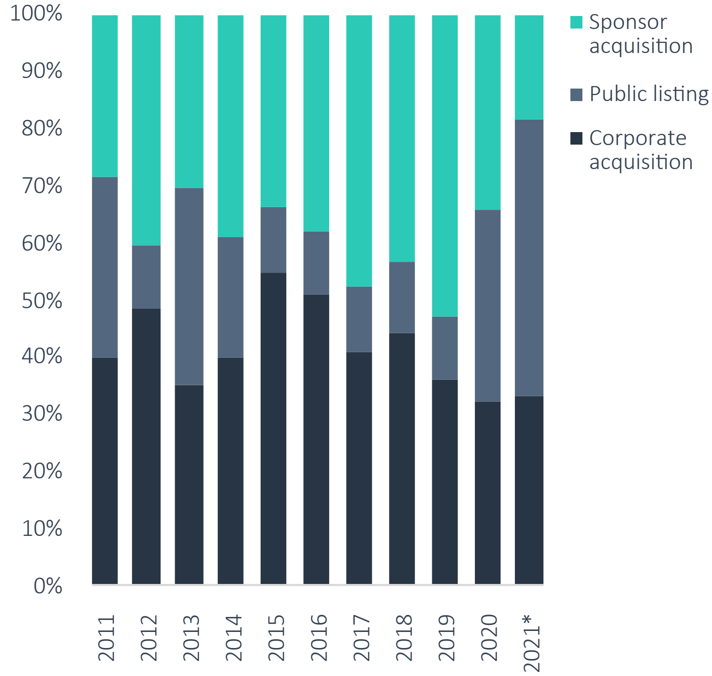
these companies are now coming to market. For example, in late June, Leonard Green & Partners took Mister Car Wash (NYSE: MCW) public at a pre-money valuation of nearly $4 billion. Mister Car Wash was already the largest car wash chain in the US when Leonard Green purchased it from ONCAP in 2014; ONCAP had more than doubled the company's size during its seven-year ownership.

Sponsor-to-sponsor transactions are another key exit opportunity for rapidly growing companies, since PE firms tend to highly value platforms with proven acquisition and integration capabilities. For example, Mavis Tire Supply changed hands in an approximately $6 billion sponsor-to-sponsor deal in May after a competitive auction process. BayPine, a first-time fund manager that combines a technology focus and orientation toward longer holding times, led the club purchase from Golden Gate Capital, which had purchased the company from ONCAP in 2018. As discussed in the spotlight section, although many PE firms are increasing the speed with which they can execute buy-and-build strategies, inorganic growth plays are also popular targets for long-dated funds and, increasingly, funds whose sponsors are willing to run a continuation process down the line. In an environment where an operational edge is critical, it will be interesting to see whether part of BayPine's conviction on the deal comes from a digital transformation strategy in addition to continued growth through acquiring more locations.

Other noteworthy sponsor-to-sponsor deals completed this quarter include American Industrial Partners' sale of Cabinetworks Group to Platinum Equity and Charlesbank Capital Partners' sale of Ensono, a managed IT services provider, to KKR. Both companies have grown significantly under their previous sponsors, in part through significant acquisitions. Charlesbank grew Ensono from a $190.0 million EV in 2015 to $1.7 billion in 2021, while AIP sold Cabinetworks for $3.5 billion after purchasing the company for a mere $27.0 million in 2012.

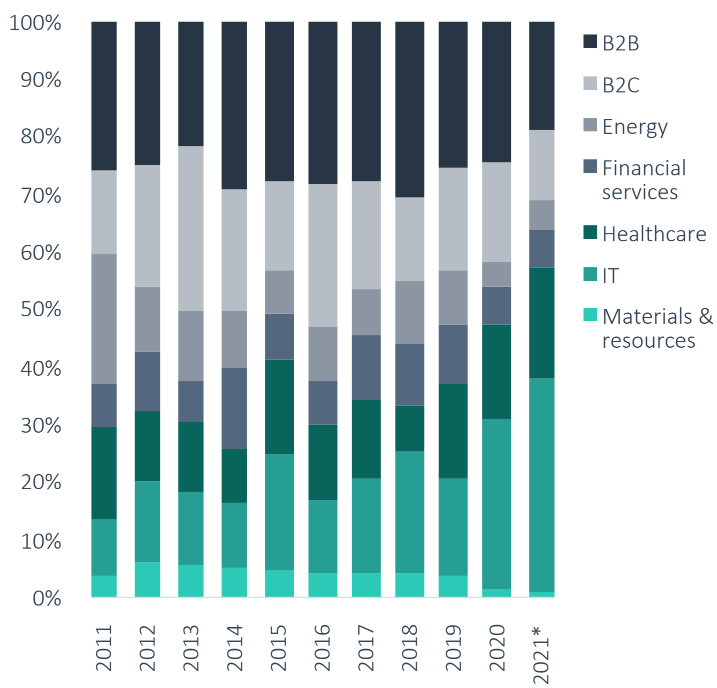
Finally, the first half of 2021 has seen substantial exit activity driven by corporate acquisitions. Although the effects of this in the data are mostly obscured by the excess public listing activity, the median EV of PE-backed companies exited to corporate sponsors rose sharply from 2019 and 2020's levels to a record $300.0 million. CFO confidence has climbed rapidly since Q2 2020, with survey respondents indicating optimism about their own firm's financial prospects approaching Q4 2019's record high, as well as positive outlooks on the US economy as a whole. Higher confidence levels typically translate into more acquisitive corporates. EQT's (STO: EQT)

## PE exit value by type




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

## PE exit value by sector



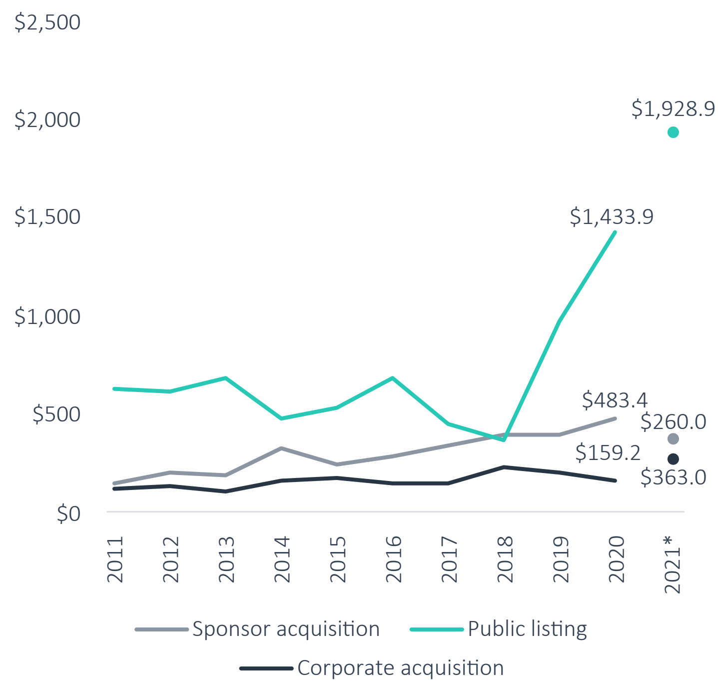

**Source**: PitchBook | **Geography**: US
*As of June 30, 2021

## CFO optimism index


**Source**: Duke University, FRB Atlanta and FRB Richmond, The CFO Survey | **Geography**: US
*As of March 31, 2021
*Note: Index is scaled from 0 to 100.*

announced $9.6 billion sale of Aldevron, a maker of biologics used in genetic medicine, to Danaher (NYSE: DHR) underscores the exit opportunities firms are finding with deep-pocketed corporate acquirers. Danaher's all-cash offer comes less than two years after its $21.0 billion cash deal for General Electric's (NYSE: GE) biotechnology business. A month later in July, EQT announced another pharmaceuticals mega-deal, partnering with Goldman Sachs' Merchant Banking Division to buy Parexel from Pamplona Capital. The deal values the contract research organization at $8.5 billion including debt—a healthy increase from its $5.0 billion take-private in 2017—and underlines how the red-hot exit market is driving firms like EQT to double down on high-conviction themes.

## Median PE exit size ($M) by type




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

# Q&A: Baker Tilly

**Ken Fleming, CPA, CVA**
*Partner*
*ken.fleming@bakertilly.com*

*Ken finances events and complex equity transactions across a wide variety of industries. Ken's practice specializes in buy- and sell-side transaction support, including financial due diligence, quality of earnings, seller preparation assistance, carveouts, integration, and structuring and negotiation in connection with M&A.*

**Brian Francese, CPA**
*Partner, Private Equity Practice Leader*
*brian.francese@bakertilly.com*

*Brian takes pride in helping drive fund and portfolio company growth, leveraging his experiences along with the advisory, tax, and assurance services Baker Tilly has to offer. Brian's clients have come to rely on his guidance and recommendations as they assess business and accounting issues experienced throughout the PE transaction lifecycle.*

**What are some of the key trends that PE fund managers and their portfolio companies are paying attention to coming out of the COVID-19 pandemic period?**

Five things are looming larger this year:

- Workforce—attracting and retaining top talent
- Sourcing of raw materials
- Changing dynamics of business ownership
- Environmental, social, and governance (ESG) criteria
- Possible federal tax code changes

**Workforce** – There is a shortage of labor, which can be attributed to a combination of factors, including workplace health and safety concerns, extended unemployment benefits, and lack of childcare and eldercare options. In addition to the operational challenges that the talent shortage presents, businesses have seen a deterioration in profitability as many companies are paying higher wages to stay competitive and have higher costs associated with recruiting and overtime pay for the existing workforce. Another concerning trend is employee morale. Burnout is prevalent across companies regardless of industry or size. Rewarding and retaining top talent is a critical risk right now for many companies.

**Sourcing of raw materials** – Investors looking at manufacturing companies are paying more attention to the sourcing of raw materials. Investors are aware of how manufacturers and other businesses were affected in the early months of the pandemic as their supply of raw materials or finished goods dried up when shipping from and into countries was put on hold. The diversification of supply chains—not only at the supplier level, but also at the country/geography level—has become even more important.

**Changing dynamics of business ownership** – Another dynamic coming out of the pandemic concerns baby boomer generation business owners who are ready to sell or transition ownership to the next generation. It is not uncommon for generational transitions in ownership to lead to changes in overall business strategies, including taking on investors, whether that be at a minority or a majority level. This "rush to the exits" of sorts is leading to more competition among PE investors and deals with higher valuations that are closing faster than before.

**ESG** – While ESG criteria are generally not part of official financial reporting, we are beginning to see LPs inquire more frequently about the ESG positions of PE funds as they look to commit capital. On the flip side, we are also seeing sellers ask PE funds about their current ESG position. Considering the amount of buy-side competition in the market, sellers may be faced with multiple offers, and ESG positions may be a differentiator. PE is taking notice of the ESG conversation, and operating companies need to be aware investors are beginning to make ESG part of their due diligence process, whether that be at the platform level or at the bolt-on level.

**Possible federal tax code changes** – PE investors are aware that the Biden administration has proposed changes to the federal tax code, including taxing capital gains for wealthier taxpayers at ordinary rates. This may provide more incentive to pursue and close deals in 2021 if changes to the capital gains tax rate are not made retroactive.

**Has there been an increase in carveouts by larger companies?**

We have seen an uptick in carveouts by large public and private companies over the past year, along with an increased interest in these deals by PE firms. We are experiencing a vibrant market of buyers with vast amounts of capital in the marketplace chasing deals.

With strong demand and high valuations, many sellers are choosing to monetize certain assets and realize value for shareholders. These carveout transactions provide buyers with strategic assets that can serve as platform or bolt-on transactions. In the early months of the pandemic, companies may have pursued a carveout to focus on core-business assets and shed non-core or underperforming business segments as they prepared to shelter the pending storm. In a September 2020 update to the Department of Justice's (DOJ) Merger Remedies Manual, the DOJ called PE investors the "preferred" purchaser of divestiture assets in some instances because the PE investor's flexible investment strategy, commitment to the divestiture, and willingness to invest more when necessary were key to the success of a divesture.

It's important to note a carveout isn't limited to a company seeking to sell a non-core part of their business. A company may ultimately decide to divest its core business if it believes that industry or service is experiencing a permanent decline.

**Is there a stronger incentive to close deals before the end of 2021?**

Companies may be more likely to exit because of concerns over possible federal tax code changes and overall competitiveness in the marketplace. There are more deals closing, involving more funds and fund sponsors, with higher valuations and shorter timeframes to carry out due diligence before closing. The speed to close may lead to an increase in bad deals. Deals are closing in 60 days, and when deals are done that quickly, due diligence may not be as thorough.

Investors don't want to hold off on deals because, on the buy side, they see acquisitions as a way to grow. Even though valuations remain high, investors are aggressive as they seek top-line growth. With that said, investors are concerned about a possible valuation bubble. Traditional economic indicators such as unemployment or national debt seem to not matter as much in the moment. Investors who are consolidating businesses and concerned about a bubble need a clear view of their horizon.

**How has due diligence changed because of the pandemic?**

Investors didn't have as much in-person contact with a target company's management team and employees over the last year, causing a significant change in due diligence. Company culture is a key ingredient in the success or failure of M&A. The past 18 months have proven difficult to engage with companies and evaluate factors such as employee morale, culture, and quality of workforce. But not all things have been bad—there are benefits in working remotely. Now, many firms are evaluating how to operate remotely while still incorporating more second- and third-level employees in their evaluation of potential acquisitions.

Financial due diligence looked different over the past year in this largely remote environment. We believe the due-diligence process going forward may include a mix of recent trends and the "way it was done before." So, while efficiencies realized through Zoom meetings will continue, the benefits of on-site diligence (such as meeting with executive teams, evaluating culture, or observing operations) will remain important.

**Post-close, what are the areas of focus that you're seeing most frequently regarding performance optimization at portfolio companies?**

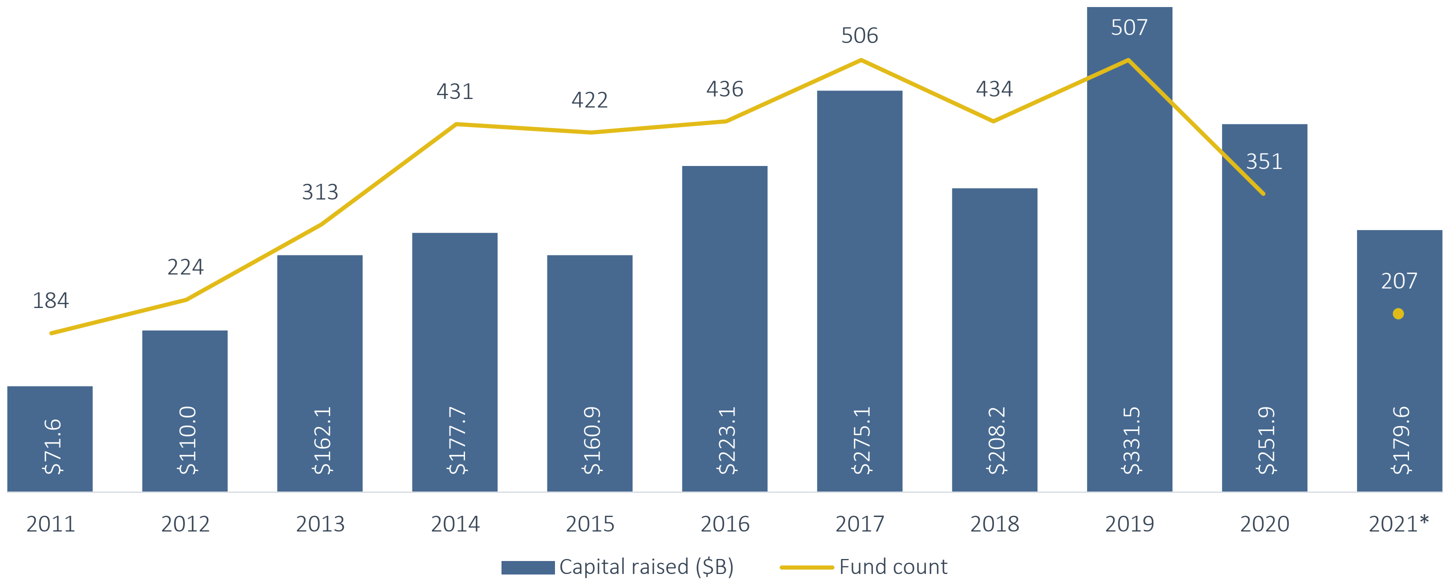
As PE firms look for appropriate portfolio acquisitions, we have seen an increased focus on firms understanding a target company's ability to not only speak about, but to demonstrate, data maturity. Data maturity is a shift from a backward-looking, tactical approach regarding data to a forward-looking strategic approach. An organization that gets better at harnessing its data will see transformation in its people, processes, and overall business results. Advanced data analytics can support both PE investors and portfolio companies through every stage of a transaction's lifecycle.

Additionally, finding the right talent has posed and ongoing challenge before and through the pandemic. The remote environment many companies shifted to over the past year has made the issue more acute. Post-close, making sure key positions at portfolio companies are filled with the right people will be crucial for long-term success.

One of the keys to M&A success is the new management team post-close. Quality, highly capable CFOs are in high demand in certain industries with the flurry of activity over the past 12 months. The ability to identify and hire high-performing leaders is an important focus area for investors and executive teams.

# Fundraising and performance

## PE fundraising activity




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

Fundraising activity maintained a healthy trajectory in the first half of 2021 with 207 funds amassing $179.6 billion. The industry's long-term tailwinds continue to facilitate fundraising efforts as many large institutions seek to boost allocations to alternatives, a decades-long trend. Additionally, with the return of in-person due diligence meetings and LP investment committees firmly focused on the future, rather than stabilizing the portfolio, 2021 should remain a blockbuster year for GPs. Surveys covering institutional capital allocators back this narrative. According to Seward & Kissel's recent reporting, PE is one of the areas in which investors are most interested in boosting their allocations.[8] The survey tends to cover mostly smaller institutions. Among LP types, funds of funds and consultants were most concerned with growing their PE allocations. Another recent study by Natixis provides similar insight on a different segment of LPs. The firm found that 38% of respondents planned to lift PE allocations, with 50% holding steady, and just 12% planning to reduce exposure.[9]

PE mega-funds continue to account for the bulk of capital raised despite only a handful closing. Q2 saw four mega-funds close for a combined $39.5 billion. TA Associates' $12.5 billion growth equity fund led the pack—the firm's largest-ever fundraise—followed by Bain Capital's $11.8 billion flagship vehicle. TA also raised $1.5 billion for its second Select Opportunities vehicle, a fund that will invest in recaps of high-performing TA portfolio companies, perhaps holding minority stakes. This unique strategy proved prescient, with TA reaping huge gains from the exit of Aldevron (discussed in the previous section). TA retained a minority stake in Aldevron after selling the company to EQT in 2019. With the rise of GP-led secondary deals—which include LP tender offers, single- or multi-asset continuation funds, and more—PE firms have been able to hold assets longer when advantageous, capitalizing on high-quality companies that have room to run. Several other continuation funds closed in Q2 2021. Leonard Green & Partners closed a $2.5 billion continuation of its 2007-vintage flagship,

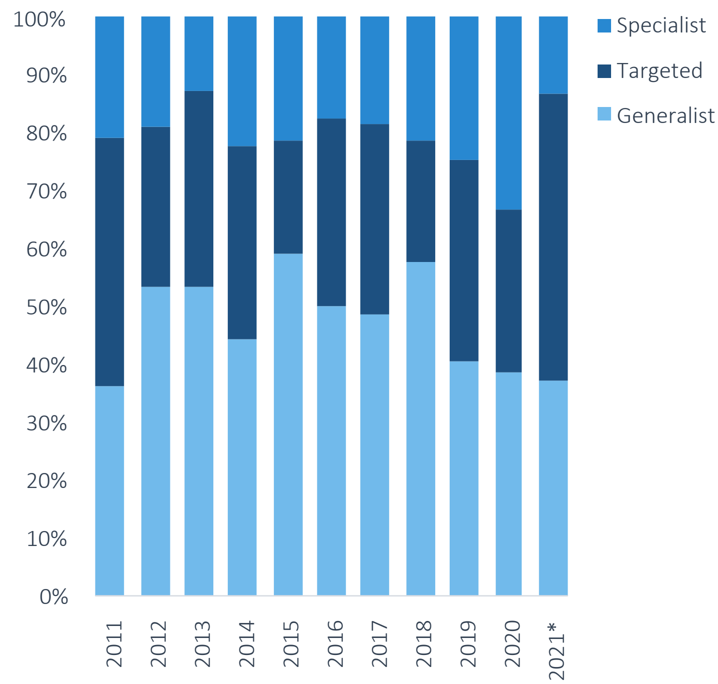
8: "Seward & Kissel's Alternative Investment Allocator Survey," Seward & Kissel, April 8, 2021.
9: 2021 Global Institutional Investor Outlook, Natixis, Dave Goodsell, 2021.

which retained stakes in two portfolio companies that had already gone public, while Clearlake Capital Group finalized its fourth single-asset restructuring in recent months, a $2.0 billion vehicle for the firm's stake in DigiCert.[10]

Two other mega-funds closed in Q2 2021, including flagship offerings from Genstar Capital and Madison Dearborn Partners. Genstar's $10.2 billion flagship fund closed alongside a $1.5 billion overage fund, bringing the total capital raised to $11.7 billion. The overage fund will coinvest with the flagship fund in larger deals. The use of an overage fund to pool co-investment capital appears to be strategy growing in popularity: Charlesbank Capital Partners also raised an $800.0 million overage vehicle alongside its $3.75 billion flagship in Q1 2021. This fund structure could help these firms better plan their co-investment capital, collect additional fees, and expedite the co-investment process for LPs that are understaffed in the investment department but still want co-invsetment exposure.

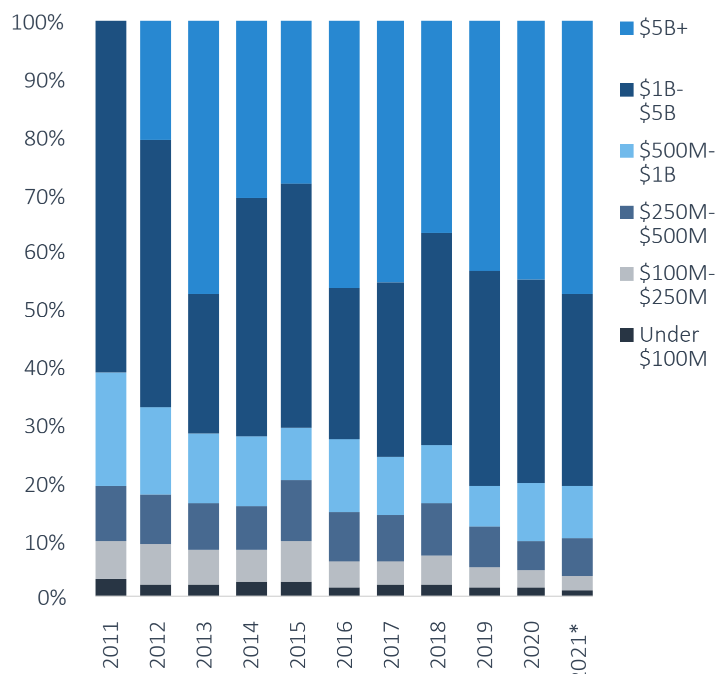
Middle-market managers are also finding success in 2021. During the quarter, a number of trends we have discussed in previous reports continued to develop. There were at least two additional examples of massive PE firms closing non-flagship offerings targeting the middle market. Veritas Capital closed on its first Vantage Fund in May after just two months of fundraising, hitting its hard cap of $1.8 billion. The fund will invest in smaller companies than the flagship fund, which collected $6.5 billion and closed in 2020. Other firms, including Thoma Bravo, Leonard Green, Vista Equity Partners, and more, have also raised smaller funds to complement their flagship offerings in recent years. Additionally, Audax Group closed on its largest-ever mezzanine fund in Q2, collecting $1.85 billion. While this strategy differs from Veritas', Silver Lake and some others also raise mezzanine funds in addition to flagship offerings to offer more flexible deal structures and expand their investable universe. Growth-oriented investment funds, whether structured as growth equity funds or funds with a more flexible mandate, also raised capital. Bertram Capital Management closed on $940.0 million for its Growth Capital IV vehicle, while Shamrock Capital Advisors secured $1.0 billion for its Growth Fund V.

## PE fund value by style




**Source**: PitchBook | **Geography**: US
*As of June 30, 2021
*Note: For methodology, please see our analyst note on PE manager style.*

## PE fund value by size




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

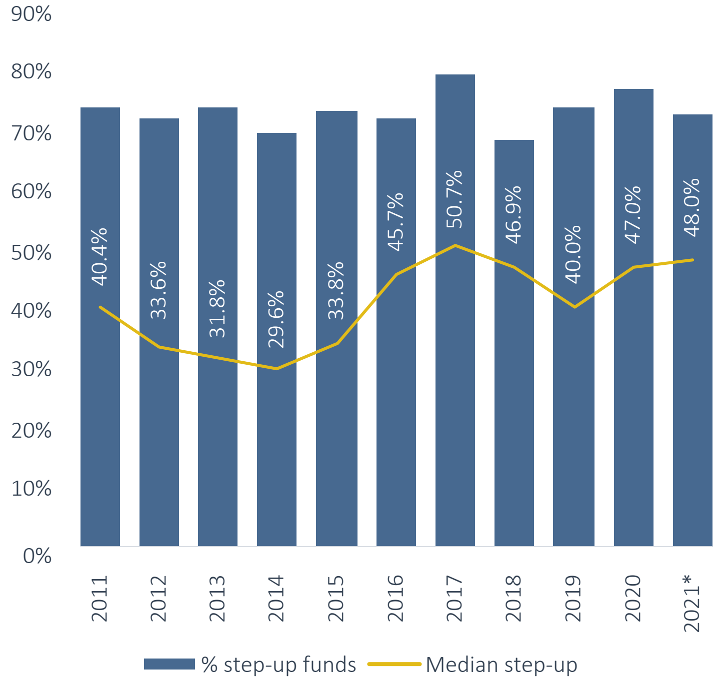
10: "The 20 largest continuation funds mapped," Secondaries Investor, Rod James, June 9, 2021.

The movement toward more specialization, especially by emerging managers, was also on display in Q2. For example, less than a year after the close of its debut fund, MiddleGround Capital, a Kentucky-based industrials firm, brought in $736.0 million for its second flagship, a parallel co-investment vehicle, and an additional overage fund focused on future automotive trends. And Revival Healthcare Capital, an Austin-based healthcare firm, closed on $500.0 million for its second fund. An analysis we ran earlier in 2021 looked at the trend toward specialization and its popularity among newer managers. As competition for assets rise, some managers are finding alpha by leveraging expertise in a given sector or subsector. Established managers with broader investment mandates are also raising more focused funds. For example, Warburg Pincus is seeking $2.5 billion for its second financial services-focused fund. Turning to the data through the first half of 2021, targeted funds have dominated fundraising as two of the largest firms in this category, Silver Lake and TA Associates, closed flagship funds. In the long term, we expect the trend toward specialization to continue and for more capital to flow to the focused and specialist firms and funds.

PE funds have continued to expand fund sizes, with just over 70% of vehicles raised in 2021 achieving a step-up—in line with the 10-year trend. The median fund size increase from the previous fund in the family was near 50% in H1 2021. For example, San Francisco-based Luminate Capital Partners, a tech buyout firm, raised $1.0 billion for its third fund in June, a significant jump up from its previous $425.0 million fund. Similarly, Seattle-based Frazier Healthcare Partners closed its tenth growth buyout fund with $1.4 billion in commitments, nearly twice the $782.0 million the firm raised with the previous fund. Both these examples are also specialist managers. At the same time, we are seeing some middle-market funds pursue much more conservative step-ups, presumably to avoid drifting too far from their core market segment. For instance, Madison Dearborn Partners has hewed consistently to the upper end of the middle market since the GFC, stepping up from a $4.4 billion Fund VII to a $5.0 billion Fund VIII that closed in May.

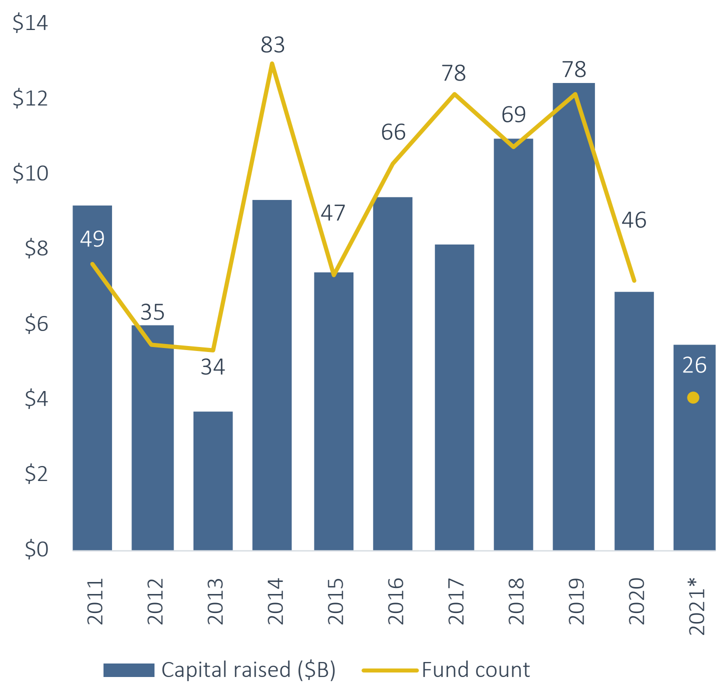
Nearly two dozen first-time funds closed in the first half of 2021. During 2020's market volatility, the ability to add new GPs to the portfolio was minimal as LPs focused on their current allocations. But robust recovery in both the public and private markets and growing PE allocations are increasing LP appetite to find new strategies and GP relationships. So far in 2021, first-time fund closes as a percentage of all US PE funds sit slightly below the figures for recent years, even 2020, as renewed activity

## Proportion of step-up funds and median size increase



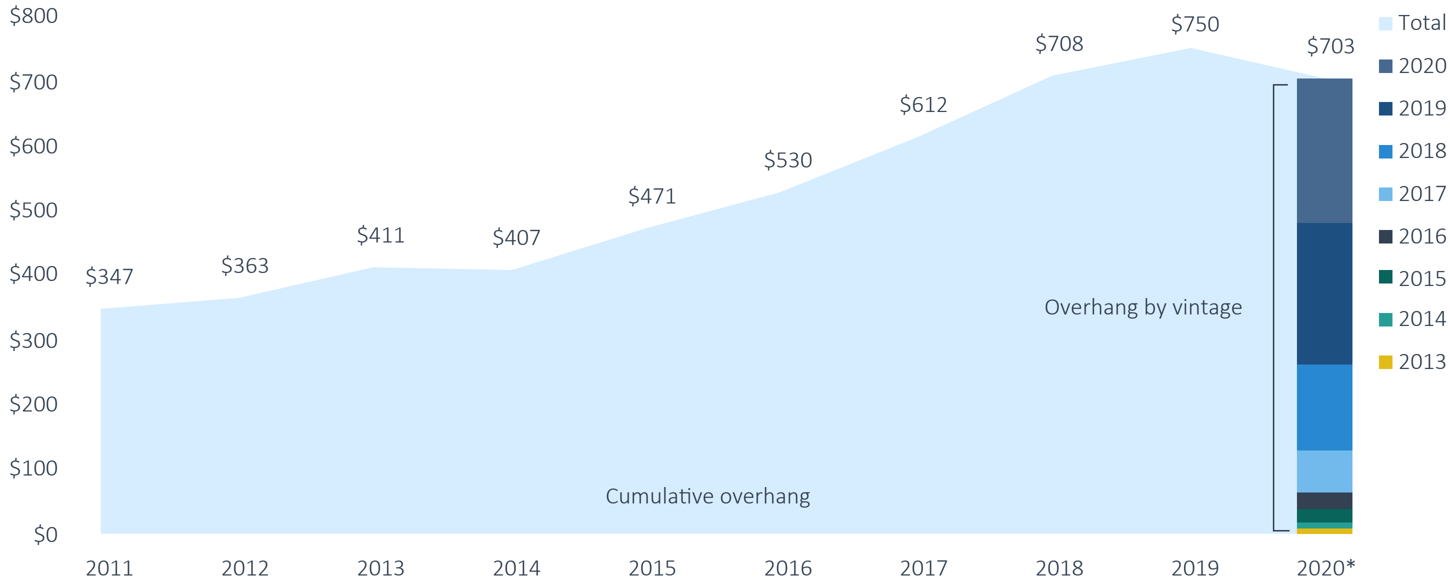

**Source**: PitchBook | **Geography**: US
*As of June 30, 2021

## First-time PE fundraising activity




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

## PE dry powder ($B)



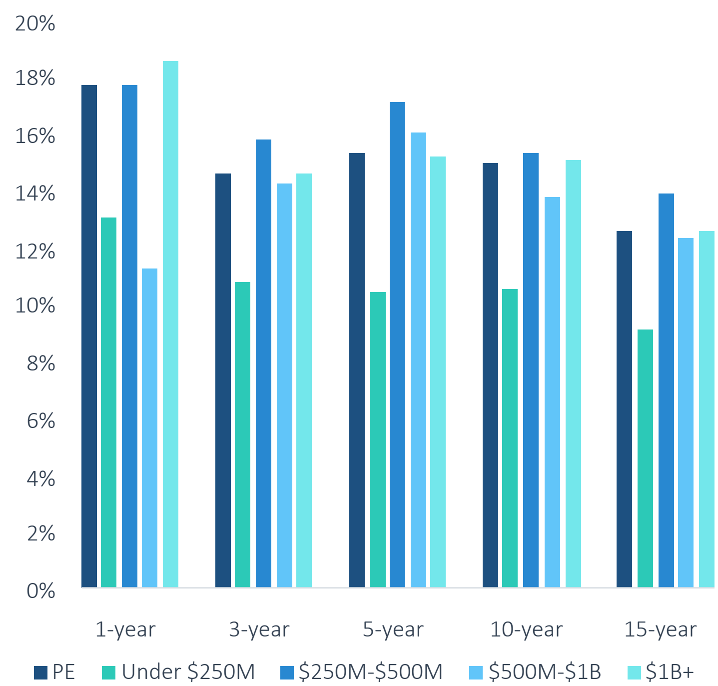

**Source**: PitchBook | **Geography**: US
*As of December 31, 2020

and interest in PE spread to first-time funds. Looking at the capital raised, however, first-time managers have closed on $5.4 billion, indicating that larger first-time funds are closing than in 2020. For example, Crosspoint Capital Partners, a cybersecurity- and privacy-focused firm, closed the largest first-time fund so far in 2021 with $1.3 billion in commitments in April.

These robust fundraising trends mean the US PE industry is careening toward three-quarters of a trillion dollars in dry powder. However, in the past couple of years, the rate of dry powder expansion has cooled. Dealmaking remained red hot while fundraising could not keep up, especially in 2020. It remains to be seen how these figures will change as we trend toward record-setting dealmaking activity in 2021. Additionally, this dry powder figure likely understates the true amount of buying power of PE firms. With deep-pocketed LPs looking to allocate more capital into co-investments, US PE firms likely have closer to $1 trillion in capital available to deploy.

Looking ahead on the fundraising side, just eight of the largest funds in the market are together seeking to amass nearly $100 billion, including Hellman & Friedman's next flagship offering, which is pursuing up to $22 billion in commitments. This would be the San Francisco-based buyout firm's largest fund ever. For its part, KKR has already amassed $18.5 billion for its North America Fund

## PE horizon IRRs*

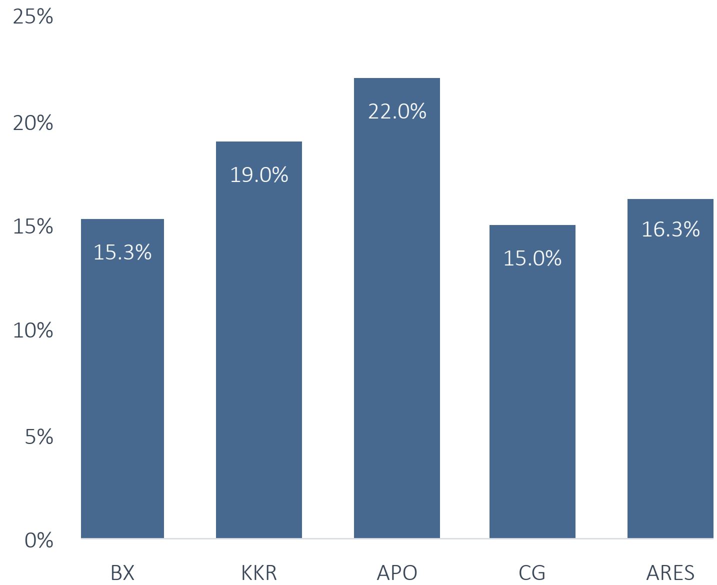



**Source**: PitchBook | **Geography**: US
*As of December 31, 2020

XIII in just five months.[11] About $17 billion was raised from outside investors and $1.5 billion was put up by the firm and employees, continuing KKR's balance-sheet-heavy investment thesis. Funds from Carlyle, Insight Partners, West Street Capital Partners, and a few other firms may also eclipse the $10 billion threshold and will likely close in 2021 as well, which could push the year's fundraising figure to record levels.

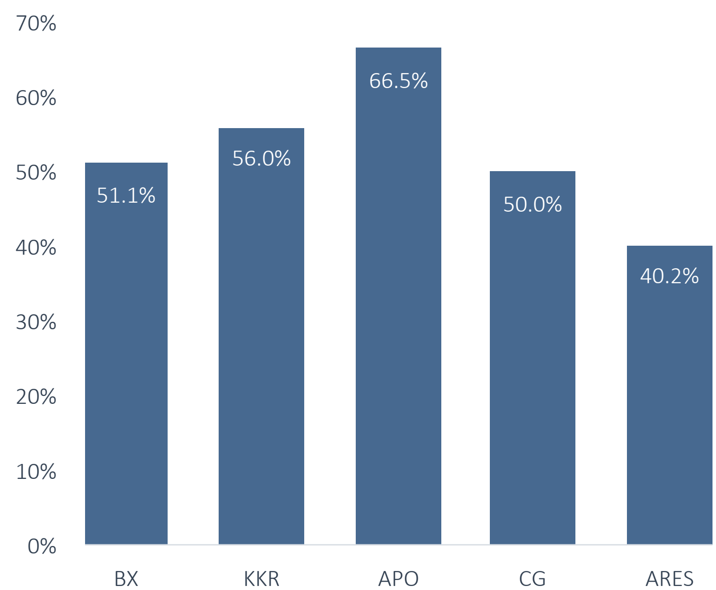
US PE performance posted remarkable results through Q4 2020. (Our performance data lags by one to two quarters due to reporting mechanisms.) As the US economy has come roaring back and public equity indices have leapt upward, US PE returns have followed suit. The returns also appear to be broad based, with multiples and EBITDA rising in many cases. According to the Golub Capital Altman Index, earnings growth in Q1 2021 was above 15% for the middle-market companies the firm tracks.[12] This is the third consecutive quarter of approximately 15%-plus growth for earnings and illustrates how bottom-line results, rather than simple financial engineering and multiple expansion, are driving returns in PE. Golub's results indicate revenue expansion was heterogenous across sectors, with technology and industrials delivering the best results, while consumer and healthcare had flat-to-down revenue growth. Looking at our returns data through Q4 2020, we see the same trends. The prevailing performance trend is up and to the right across all size buckets. While middle-market funds bounced back and posted healthy returns, larger funds notched the best returns over the trailing four quarters. Mega-funds in particular saw an exceptionally rapid recovery after Q2 2020, and returns remain elevated in Q4. These funds have the best access to credit markets and can most easily mark portfolio companies to the higher multiples exhibited with public comps. Using performance returns from a handful of public managers (Blackstone, KKR, Apollo, Carlyle, and Ares) as a bellwether, we see this trend of healthy performance as slated to continue into at least the first quarter of 2021. Each of these managers posted 15%+ gross returns in Q1 for their respective PE funds, though which funds are included varies by manager. Looking ahead, we will be watching to see how long the mega-funds outperformance trend lasts and how interest rates and public markets influence future returns across all fund sizes.

## Quarterly gross corporate PE returns for select managers*




**Source**: Public filings | **Geography**: US
*As of March 31, 2021

## Annual gross corporate PE returns for select managers*




**Source**: Public filings | **Geography**: US
*As of March 31, 2021
*Note: Because Ares does not publish results, we multiplied its previous four quarterly results.*

11: "Exclusive: KKR raises $18.5 billion for flagship North America buyout fund - sources," Reuters, Chibuike Oguh, May 3, 2021.
12: Golub Capital Middle Market Report, Golub Capital, Q1 2021.