FROM TRIAGE TO TRIUMPH: PRIVATE CAPITAL'S PHOENIX RISES AGAIN

BDO Private Capital Pulse Survey

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BDO

Contents

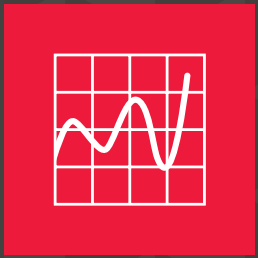
Introduction

Before the pandemic, private investors stood atop a mountain of dry powder—$2.5 trillion, double the amount just five years earlier. Today, that number stands at $2.9 trillion. Looking just at the bookends of 2020, that increase, given the recent pace of fundraising, would seem unsurprising, even expected.

But reading between the lines reveals the resilience and resourcefulness of private capital in the face of extraordinary odds: A pandemic that took an unthinkable toll on human lives, hobbled industries, tanked global economies and sent unemployment numbers to historic levels. The events of 2020 have changed the deal-making landscape and entire ways of working and doing business for the foreseeable future.

Private equity and venture capital fund managers are no longer in the triage mode of March–June 2020. But coming off a year in which deal value and volume were challenged—for private equity alone, 5,309 deals closed for a total of $708.4 billion, the first time since 2009 that both categories fell, according to PitchBook—private capital is ready to ignite that dry powder.

KEY TAKEAWAYS:



91% of fund managers expect **asset prices to rise** in the next 6 months, and half of them anticipate a 10-24% increase

LPs are clamoring for ESG: 94% of fund managers say incorporating ESG investment criteria into their investment strategies is a priority for their LPs

Taxation of digital services and products beats out concerns about changes to capital gains or the impact of the interest expense deduction calculation

The global pandemic will have lasting impacts on deal making, with **risk management and a target's digital capabilities** being a key factor

Growth equity rises to private equity's top investment strategy (63%), while **early stage VC** remains venture capital's top investment strategy (79%)

> *There was an inflection point about six months into the pandemic where funds were no longer spinning in the dark. Now, with pent-up deals finally coming to market and numerous drivers—from tax policy changes and economic stimulus to Baby Boomers looking to exit—propelling new deals, M&A is looking explosive in 2021. Quality deals in attractive industries will continue to garner outsized multiples.*

SCOTT HENDON
National Leader of Private Equity

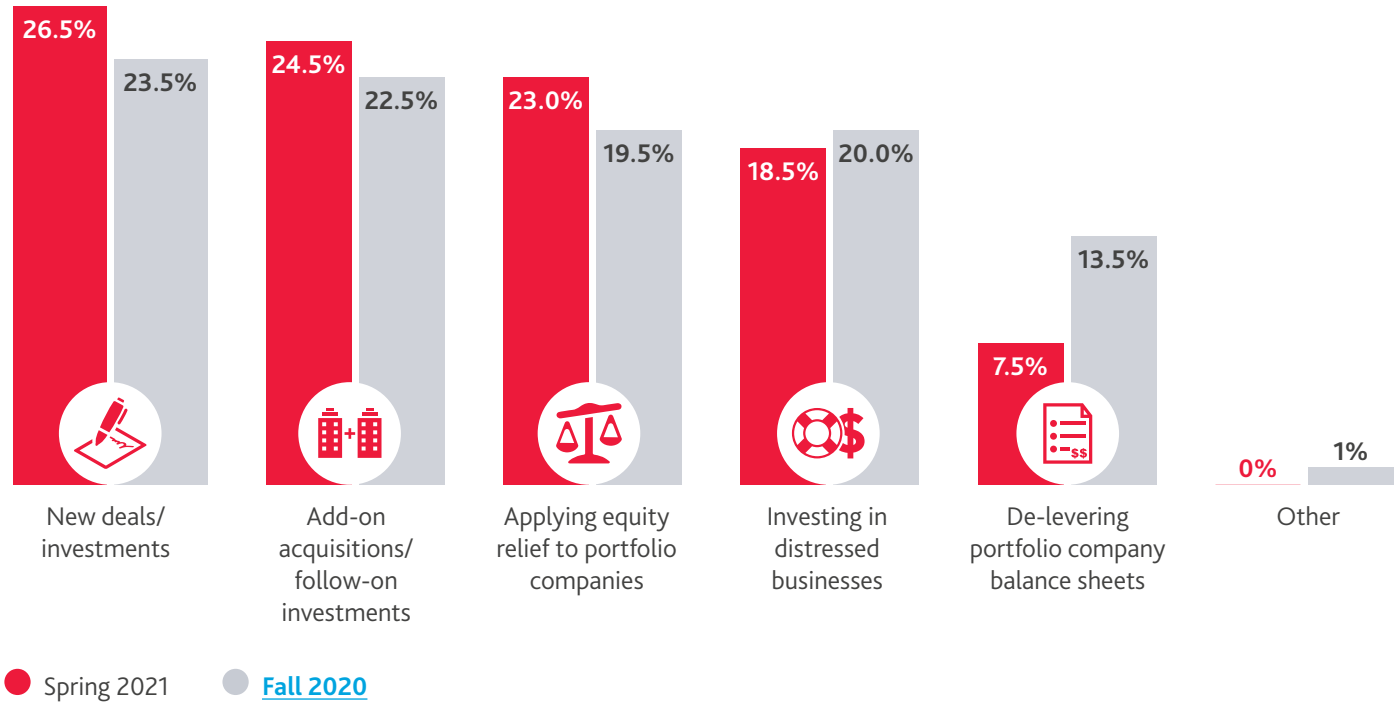
Fund managers anticipate intense competition and are expanding their investment strategies across the board. From early stage VC to mezzanine financing, more fund managers are engaging in more types of activity, a theme that underscores a year in which deploying committed capital required some creativity. Meanwhile, social unrest and environmental concerns, brought to the fore by the events of 2020, have accelerated limited partners' (LPs') environmental, social and governance (ESG) priorities, which, in turn, are influencing general partners' (GPs') priorities in their hunt for new deals.

The pandemic suppressed deal making for a relatively short amount of time. After righting their ships, private capital returned to the markets. The speed with which fund managers adapted to working remotely and the amount of dry powder raised in 2020 belies the incredible challenges that they had to overcome. Yet this asset class emerged not just unscathed but triumphant during a year in which GDP seesawed from -31.4% in the second quarter to +33.4% in the third, before ending the year down 3.5%.

2021 to Unlock Pent-Up Demand for M&A

The cycle of economic disruption and recovery created a heightened sense of urgency for sellers who placed deal plans on hold for a more optimal time to go to market, and imminent tax changes—namely the anticipated capital gains increase—are prompting owners who might otherwise have stayed at the helm to explore a sale. Indeed, global M&A in 1Q21 reached $1.3 trillion, the largest first-quarter figure ever and the second-largest quarter ever, according to Refinitiv. Of that amount, private equity-backed deals comprised $249 billion, or 19%, doubling the value of 1Q20 and representing a 57% increase in deal volume.

WHERE FUND MANAGERS* WILL **DIRECT THE MOST CAPITAL** IN THE NEXT 6 MONTHS



*Both PE and VC respondents

> *"The market for A assets is fantastic right now. B and C assets will try and take advantage of the rising tide, but companies that saw big impacts from COVID, for better or worse, will be harder to sell. A company that was negatively affected may not have seen its earnings fully recover and won't get as high a price in today's market versus waiting 12 months and seeing a full recovery. On the flip side, we've seen more companies for sale that had a record 12-15 months, but the reality is normalized earnings are yet to be determined and investors are being appropriately cautious."*
>
> **Rob Langley**, Co-Founder and Managing Partner
> Align Capital

> *"QofE and deep industry knowledge have always been important, but now they are critically so. Many businesses' projections are way up over last year, but not all will hit those numbers for 2021 --the year is already more than a quarter over. We'll assess COVID addbacks and whether there's a good chance earnings will bounce back, offer a good multiple off LTM and do an earnout on the delta. We want to position our companies to hit their earnouts, so we can accommodate the market uncertainty and give them a little more time to do so."*
>
> **Andy Cook**, Partner
> Southfield Capital

VC Focuses on Early Stage, PE Gravitates toward Growth

Averaging the responses of both PE and VC fund managers, **early stage VC is the top investment strategy**. Its no. 1 position is mostly due to a 12-point leap among VC fund managers from the fall to the spring (67% to 79%), compared to PE fund managers' 1-point increase (57% to 58%). Last fall, early stage VC and growth equity tied for first place among VC fund managers.

For private equity in the fall of 2020, early stage VC was the no. 1 investment strategy, but in spring 2021, growth equity has displaced it: 63% of PE fund managers said growth equity was the top investment strategy, up from 47% in the fall. After the Great Recession, growth equity grew in prominence in developed markets, in large part because debt lending had dried up and the investment strategy provided a vehicle for deploying capital. According to PitchBook, PE growth equity deal value hit $62.5 billion in 2020, an increase of 8.8% from 2019.

INVESTMENT STRATEGIES FUND MANAGERS ARE EMPLOYING

	GRAND AVERAGE			PE FUND			VC FUND		
	Spring 2021	Fall 2020	▼▲	Spring 2021	Fall 2020	▼▲	Spring 2021	Fall 2020	▼▲
Early stage VC	68.5%	62%	6.5%	58%	57%	1%	79%	67%	12%
Growth equity	59%	57%	2%	63%	47%	16%	55%	67%	-12%
Late stage VC	46.5%	45%	1.5%	38%	35%	3%	55%	55%	0%
Structured credit	44.5%	31%	13.5%	42%	32%	10%	47%	30%	17%
Leveraged buyout	30.5%	24.5%	6%	33%	26%	7%	28%	23%	5%
PIPE	30%	20%	10%	43%	25%	18%	17%	15%	2%
Mezzanine	14.0%	12%	2%	18%	11%	7%	10%	13%	-3%

> *Past periods of economic dislocation have produced unicorns and dragons—think Netflix in the early aughts and Airbnb's IPO in December 2020, which came off a year of tremendous volatility and echo this phenomenon. Venture capital's renewed focus on early stage venture investing signals that fund managers are looking to diversify risk and find that dragon to carry the entire fund.*

KEVIN BIANCHI
National Leader of Venture Capital

Risk is top of mind for both PE and VC fund managers. When it comes to the top challenges to deal making or investments, the possibility of uncovering potential pitfalls during due diligence—which, in a departure from precedent, has had to be conducted on a remote basis during the pandemic—is the biggest concern. Perhaps as a byproduct of greater risk concern, there appears to be an emerging trend of co-investment opportunities into some of the bigger technology deals, allowing funds to offload some of the risk while giving co-investors a larger dollar access to these companies without the fee and carry load.

TOP CHALLENGES TO CLOSING DEALS/INVESTING IN THE CURRENT ENVIRONMENT

	GRAND AVERAGE			PE FUND			VC FUND		
	Spring 2021	Fall 2020	▼▲	Spring 2021	Fall 2020	▼▲	Spring 2021	Fall 2020	▼▲
Risk exposure uncovered during due diligence (e.g., cybersecurity concerns, financial information and liabilities, litigation, etc.)	56%	53%	3%	56%	49%	7%	56%	57%	-1%
Increased competition from other buyers/investors	48%	32.5%	15.5%	47%	29%	18%	49%	36%	13%
Lack of transparency, including access to management team or complete financial information	46.5%	44.5%	2%	45%	46%	-1%	48%	43%	5%
Securing financing, including the availability of senior debt	46%	36.5%	9.5%	50%	34%	16%	42%	39%	3%
Gaps between buyer/investor and seller/target company valuation expectations	41.5%	40%	1.5%	42%	47%	-5 %	41%	33%	8%
Lack of in-person meetings and restrictions around business travel	35%	38.5%	-3.5%	39%	33%	6 %	31%	44%	-13.0%

Interestingly, despite the widespread belief that the debt markets are open, **50%** of PE fund managers said securing financing, including the availability of senior debt, was a top challenge to closing deals—up from **34% in the fall**—indicating that senior debt is not available at the multiples to support the valuations being paid.

Directing the most capital toward new deals or investments was the top choice among both those who said assets would trade 0-9% higher and those who said 10-24% higher. Add-on acquisitions or follow-on investments took the No. 2 spot, followed by applying equity relief to portfolio companies.

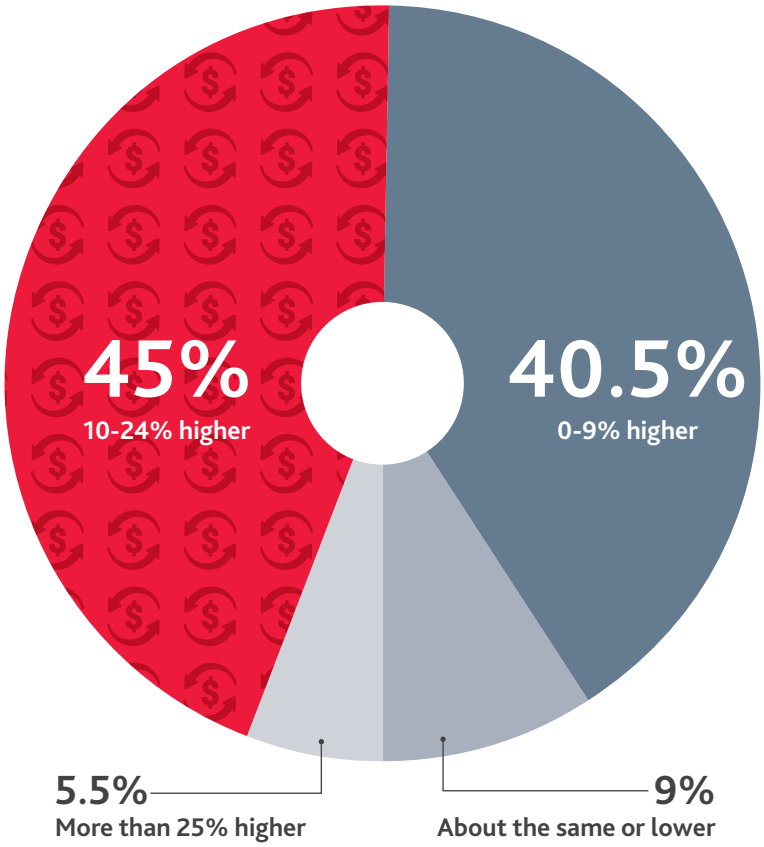
For both PE and VC fund managers, interest in investing in distressed businesses overall has fallen only slightly since the fall—from 46.5% to 44.5%—but nearly half (48.6%) of fund managers who think asset prices could rise as much as 24% said they would direct the most capital toward distressed businesses, followed closely behind by new deals or investments at 47.2%. Delevering the portfolio balance sheet was the third choice at 46.7%.

Among those who answered 0-9% higher, the most (44.9%) said they would direct the most capital toward add-on acquisitions/ follow-on investments, followed by new deals (43.4%), applying equity relief 39.1%), distressed businesses and delevering the portfolio balance sheet (35.1%)

Competition Heating Up Asset Prices

Both PE and VC fund managers pointed to increased competition as a top challenge to closing deals (see chart below). As competition for quality deals—a theme that continues from the fall—heats up, asset prices will as well: **91% of fund managers expect asset prices to increase over the next six months, more than half of whom anticipate a 10-25%+ increase.**

HOW **ASSETS WILL TRADE** IN 6 MONTHS VS. TODAY



At higher prices, the challenge will be extracting value from new acquisitions: Fund managers said **the top post-M&A challenge was performance improvement, reducing costs and enhancing revenue**, followed by leveraging digital tools for improved reporting and analytics and operational improvements—all of which tie closely to LPs' priorities. Funds' value creation capabilities also serve as their differentiators, and as LPs have more and more focused on these differentiators, the need for quantifiable reporting and measurement has grown.

Growing revenue through sales is a go-to value creation strategy. In times of economic uncertainty, however, introducing new products to market or achieving sales growth can be more difficult. Private capital may prioritize other strategies, including reducing overhead, improving the capital structure, finding cost savings, and creating cross-fund efficiencies.

TOP POST-M&A CHALLENGES OVER THE NEXT 12 MONTHS

Grand Avg. | PE Funds | VC Funds

45% | 42% | 48%

Performance improvement/ Reducing costs/Enhancing revenue

43.5% | 40% | 47%

Leverage digital tools for improved reporting and analytics

42.5% | 45% | 40%

Operational improvements (order to cash, procure to pay, supply chain)

40.5% | 41% | 40%

Technology/ERP integration and optimization

36.5% | 38% | 35%

Realize deal synergies and transaction-related savings within allotted time/budget

26.5% | 23% | 30%

Tax strategy

22.5% | 23% | 22%

HR/Culture integrations

19% | 22% | 16%

Exit readiness/sell-side due diligence

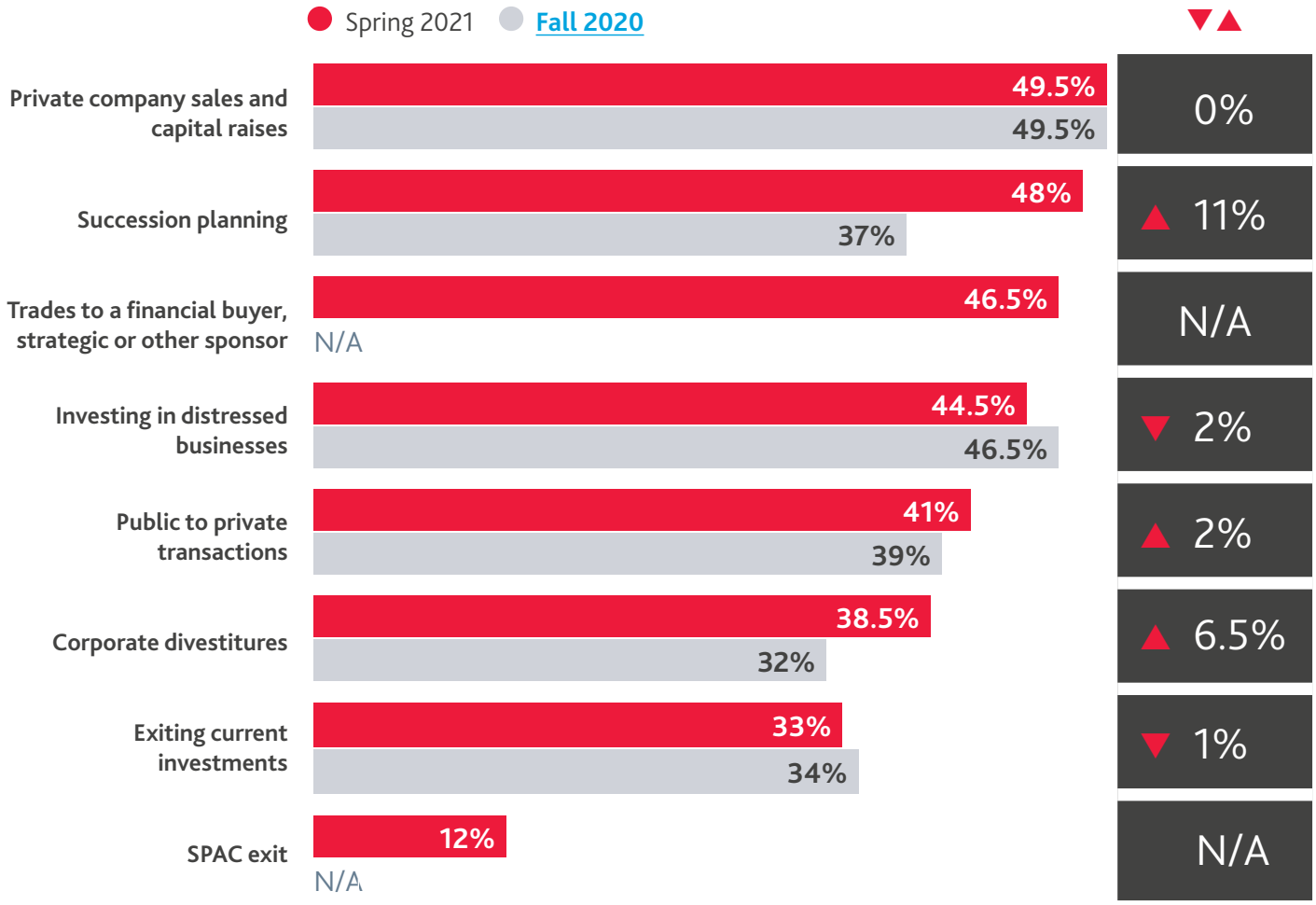
"COVID hit the reset button for many companies, particularly industrial businesses impacted by the manufacturing recession that existed prior to COVID. Now these businesses are bouncing back, and their valuations have increased as a result of more interest from acquirers, as well as from more aggressive lenders. For private equity firms looking at a business as a new platform, a strategic buyer or a PE sponsor with a holding in the space makes for a formidable competitor. To maximize the chances of winning a deal, it's important to identify the right opportunities and differentiate yourself very early in a process."

– **Chris Willis**, Managing Director, Industrial Opportunity Partners

Drivers of Deal Flow

Averaging both PE and VC fund managers' responses, succession planning as a key driver of deal flow or investment opportunities rose 11 points to 48% from 37% in the fall. This is an expected data point, given that the business impacts of the pandemic have prompted many owner/founders to consider accelerating the timing of a sale.

KEY DRIVERS OF DEAL FLOW/INVESTMENT OPPORTUNITIES IN THE NEXT 6 MONTHS



Among VC fund managers alone, however, succession planning experienced a 16-point increase to 53% and is the No. 1 driver of deal flow. For PE fund managers alone, succession planning takes the No. 3 spot (43%), behind private company sales and capital raises (50%) and trades to a financial buyer, strategic or other sponsor (44%).

> *"The most attractive targets for acquisitions are companies that have proof of concept, good customer relationships, and are profitable—but realize they are undermanaged or under-resourced to scale in their industry and need a partner. They know they won't get much bigger without making some significant changes. Buyers willing to roll up their sleeves, sift through less-than-perfect financials and work closely with these owners can unlock value and true potential. These companies are diamonds in the rough, so you may find yourself with fewer eggs in the basket, but if you watch them carefully, you can generate very compelling equity returns."*
>
> **Kenneth Heuer**, Principal, Kidd & Company

Space for SPACs?

Special purpose acquisition companies (SPACs) made headlines throughout 2020 as they broke fundraising records. Though SPACs as an alternative investment vehicle, or blank-check company, have been around for decades, their recent popularity has been fueled by the high levels of dry powder and their validation by well-respected investors, such as Bill Ackman, entering the space. According to data by SPAC Analytics, 248 SPACs raised $83.4 billion in 2020. The first few months of 2021 have already outpaced that activity, with 308 SPACs having raised $99.7 billion as of April 21.

Despite SPACs' record-breaking fundraising, PE and VC fund managers see strategic buyers and investors and hedge funds and mutual funds, respectively, as their top competitors. In fact, SPACs were last on the list among fund managers' biggest sources of competition, perhaps reflecting attitudes about the longer-term viability of the SPAC model. Many SPACs may need to secure a private investment in public equity (PIPE) deal to bring deals to fruition, as they may not have the cash on their balance sheets to make the acquisitions. Furthermore, the number of new SPAC formations fell during 1Q21, according to Refinitiv, a trend that continued into the second quarter, likely exacerbated by the SEC's guidance that it would classify SPAC warrants as liabilities: Just 10 SPACS were announced as of April 21, down from 109 in March, according to data from SPAC Research.

WHO POSES THE **MOST COMPETITION FOR DEALS** OVER THE NEXT 6 MONTHS?

	GRAND AVERAGE			PE FUND			VC FUND		
	Spring 2021	Fall 2020	▼▲	Spring 2021	Fall 2020	▼▲	Spring 2021	Fall 2020	▼▲
Strategic buyers/investors	52%	48.5%	3.5%	58%	42%	16%	46%	55%	-9%
Hedge/mutual funds	51%	38.5%	12.5%	53%	34%	19%	49%	43%	6%
Sovereign Wealth Funds	40.5%	36.5%	4%	37%	37%	0%	44%	36%	8%
Family Offices	37.5%	30%	7.5%	39%	29%	10%	36%	31%	5%
Other PE/VC firms	36.5%	45%	-8.5%	29%	48%	-19%	44%	42%	2%
SPACs	23.5%	N/A	N/A	20%	N/A	N/A	27%	N/A	N/A

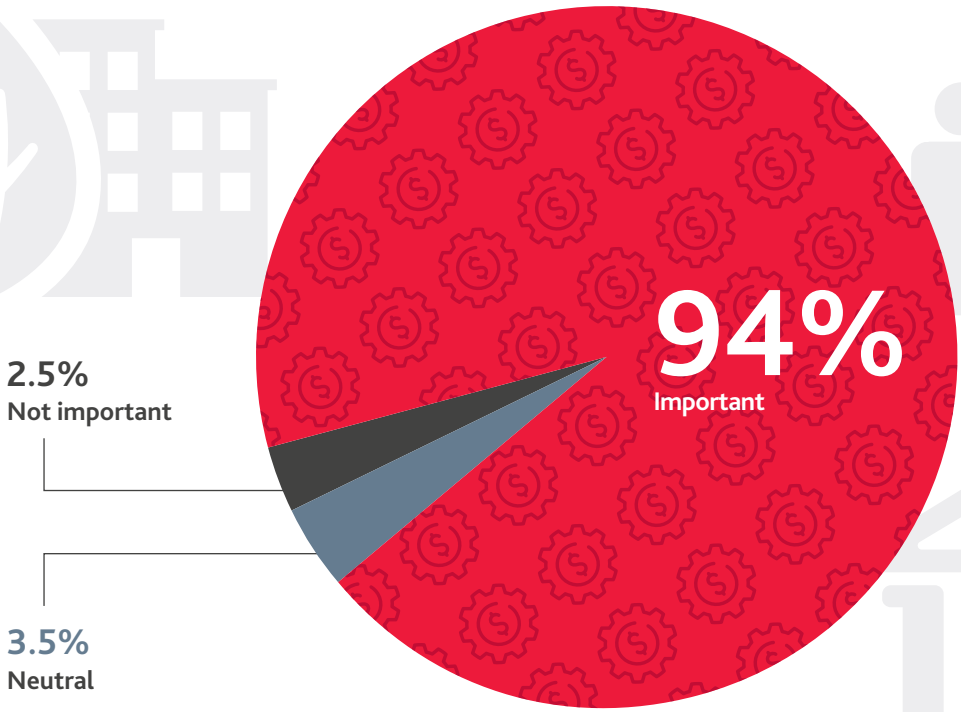
Given the parameters that govern SPACs—they must identify and agree to a deal within 18-24 months— and the amount of capital they have raised, it is fair to say SPACs' hunt for target acquisitions will be aggressive. That they are at the bottom of the list of competitors underscores how competitive fund managers believe the 2021 deal-making landscape will be.

> *"In times of dislocation, people flee to quality. Mission-critical companies that operate with vertical integration —such as B2B SaaS companies—proved their resilience through low churn rate during the height of the pandemic. Market volatility resulted in a lower volume of high-quality deal flow, as company owners decided to wait for market stability before selling. As a result, 2021 should be robust across different industries, sizes of companies, types of buyers, as many feel like they have a handle on the COVID era and are able to go back to rationally making capital deployment decisions."*
>
> **Jeremy Holland**, Managing Partner, The Riverside Company

With Great Power Comes Great Responsibility: ESG Takes Centerstage

No doubt aided by the events of 2020, **ESG investing has become a front-and-center priority**. Global ESG assets are projected to hit $53 trillion by 2025, according to a March 2020 survey of 2,800 CFA institute members. Asked how important it is to their LPs that their investment strategy incorporates ESG criteria, 94% of fund managers indicated it was either "very" or "somewhat" important.

IMPORTANCE TO LPS THAT **INVESTMENT STRATEGIES INCLUDE ESG CRITERIA**



In rank of importance for LPs, more ESG investment options (19%) are only a hair behind harvesting and realizing investment gains (20%) and co-investment opportunities (19.5%); these priorities are driving fund managers to direct the most capital toward new deals and investments.

While the prominence of ESG investing has grown in recent years, extreme weather events and nationwide protests against racial injustice and inequality have likely helped further concretize its presence in fund mandates. LPs see ESG investments as self-sustaining: They are an intrinsic value creator, generating (eco)efficiencies and improving both health and safety standards and corporate governance. At the same time, by nature ESG investments mitigate risks—for example, to reputation and brand—that might accompany non-ESG-related investments. These benefits, in turn, may improve fundraising opportunities and access to low-cost capital.

Taxation of Digital Products and Services Tops Tax Concerns

Tasked with developing a global framework for the taxation of digital products and services, the Organisation for Economic Co-operation and Development (OECD) expects to have its framework complete by this summer. In the meantime, jurisdictions around the world are taking matters into their own hands and enacting **unilateral tax regimes**: For many jurisdictions, taxing the digital economy is an expedient to recouping some of the damage to tax revenue incurred by the pandemic.

Asked what tax changes funds are planning for or most concerned about in the next year, the increased taxation of digital products and services was the biggest concern (58.5%), beating out concerns for a potential capital gains tax increase by 8 points. Taxation of digital products and services carries broader implications and uncertainties than some other tax concerns, as there are both domestic (state income tax) considerations as well as global implications for sales into foreign jurisdictions that funds may need to navigate.

Impacts of the interest expense deduction calculation being based on EBIT instead of EBITDA took third place for biggest tax-related concerns (50%). Changes to the ability to deduct business interest expense may result in the need to put more capital into portfolio companies, thus constraining, to a degree, firms' ability to be acquisitive.

Among those who said increased taxation of digital products/services was their biggest tax concern, most—73.3%—said they would direct the most capital to delevering portfolio company balance sheets, followed by investing in distressed businesses (70.3%), applying equity relief to portcos (63%), new deals/investments (56.6%), and add-on acquisitions/follow-on investments (42.9%).

Among those who said a capital gains tax increase was their biggest tax concern, most—54.1%—said they would direct the most capital toward distressed businesses, followed by delevering the portfolio company balance sheet (53.3%), add-on/follow-on investments (53.1%), applying equity relief to portcos (50%), and new deals/investments (45.3%).

> *"The current and future deductibility of business interest expense continues to disproportionately impact companies that are breakeven and imposes a cash strain while they're struggling to stay afloat. From a PE perspective, funds may have to respond by adding more equity, rather than leverage, into their deals, while sellers may not be able to fetch a desirable price and may decide against selling. While M&A will be strong this year, this might serve to temper some M&A activity in the short term."*

VERENDA GRAHAM
National Private Equity Tax Leader

CONCLUSION

Everything Has Changed, But Nothing Is Different

There is an immense amount of committed capital available to private equity and venture capital funds. That much has stayed the same. What has changed is where funds will prioritize their investments and, among those investments, what they place the most value on.

THE **TOP LONG-TERM IMPACTS OF COVID-19** ON DEAL MAKING

	PE FUNDS	VC FUNDS	GRAND AVERAGE
Digital capabilities of acquisition target	43%	56%	49.5%
Importance of robust risk management in acquisition target	46%	44%	45%
Higher long-term ongoing valuations for certain industries	34%	52%	43%
Clear/robust supply chain strategy	39%	44%	41.5%
Fewer in-person meetings throughout the process	38%	42%	40%
Lower long-term ongoing valuations for certain industries	34%	31%	32.5%
Shorter due diligence process	23%	26%	24.5%

On a basic human level, the global pandemic has made us all more aware of risk, whether that be to personal health or the health of an investment. For the retail investor, a greater sense of risk might lend to a greater sense of caution, but private equity and venture capital encompasses an asset class that crushes learning curves and adapts quickly. That is a necessity when operating within the kind of competitive environment private capital does. Private capital is poised to take its triumphant performance of 2020 and create a headline-making, record-breaking year for deals.

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