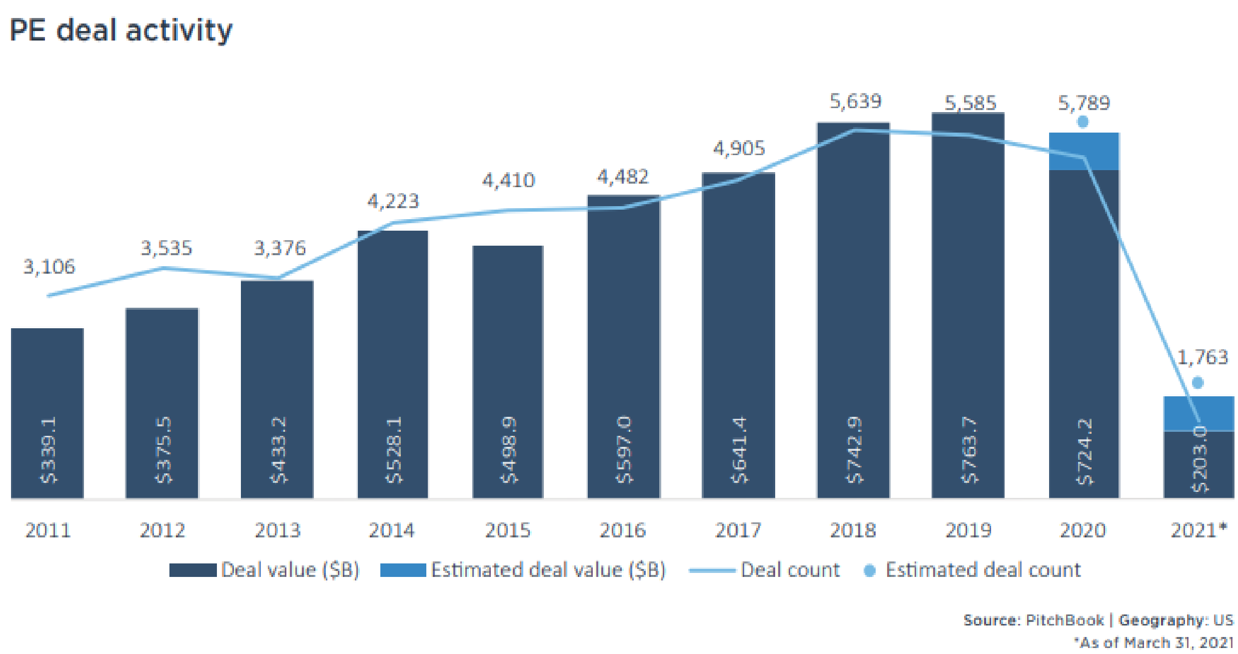
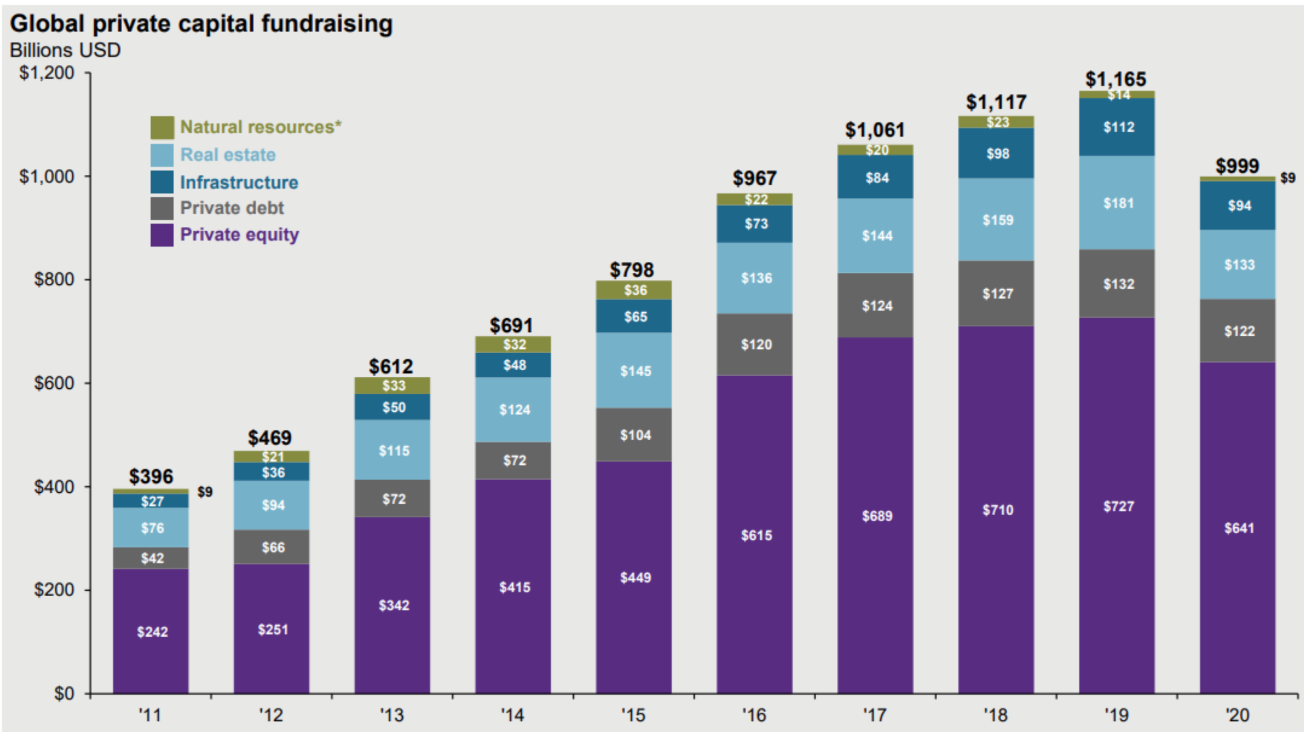
Private Equity Review June 2021

Despite the lockdowns in the global economy in 2020, private equity continued to thrive, with deal activity, exits, and fund-raising in-line with five-year averages. After being down 85% in the second quarter of 2020, North American buyout activity rebounded sharply in the second half of the year, with nearly $600 billion in deal value being completed. Although total deal value declined -5.1% from 2019's level, it was +11.7% higher than the five-year average of $648 billion. In terms of deal activity, the second half of 2020 was one of the most active in recent memory with managers taking advantage of distressed prices. Through the first quarter of 2021, demand remains strong and is expected to drive significant deal flow over the next 2-3 years. The quick rebound is a reminder that private equity tends to perform well during periods of increased stress, as capital is withdrawn by the banks and credit becomes more difficult to access. For vintage years 2002 and 2009, following the last two recessions, IRRs averaged 17% to 21%, a healthy premium to the 12-14 % long-term PE average.



Fund Raising totaled $999 billion in 2020, a 9% decline from 2019's record $1.165 trillion. Still, the 2020 fundraise was the third highest on record, with institutions, endowments, and family offices affirming their commitment to private assets. Since 2016, private assets managers have raised $5.3 trillion in capital, with private equity (purple bars in the graph below) accounting for nearly two-thirds of the total capital raised. According to Private Equity International's LP Study, 80% of investors, including high net worth families, believe private equity will remain a core holding in portfolios, with 40% expecting to increase their allocation to the asset class in the years ahead. An important caveat, however, is that investors expect to be more selective and consolidate allocations, investing in fewer managers and funds going forward.



Source: Preqin, J.P. Morgan Asset Management.
Fundraising categories are provided by Preqin, and represent their estimate of annual capital raised in closed-end funds. Data may not sum to total due to rounding. *Natural resources include natural resources and timber funds. 2020 fundraising figures are as of 4Q20.
Data is based on availability as of February 28, 2021.

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Dry Powder is at record levels with nearly $3 trillion in uncalled capital vs. $1.2 trillion after the GFC. Wellspring expects the high level of uncalled capital to be a headwind to future returns, putting pressure on sourcing models, value creation, and ultimately exit valuations. Absent well-defined sourcing models and a clear path to value creation, managers may find themselves at a distinct disadvantage in buying the right asset at a reasonable price. We estimate about two years' worth of dry powder is currently sidelined in search of an attractive property to buy.

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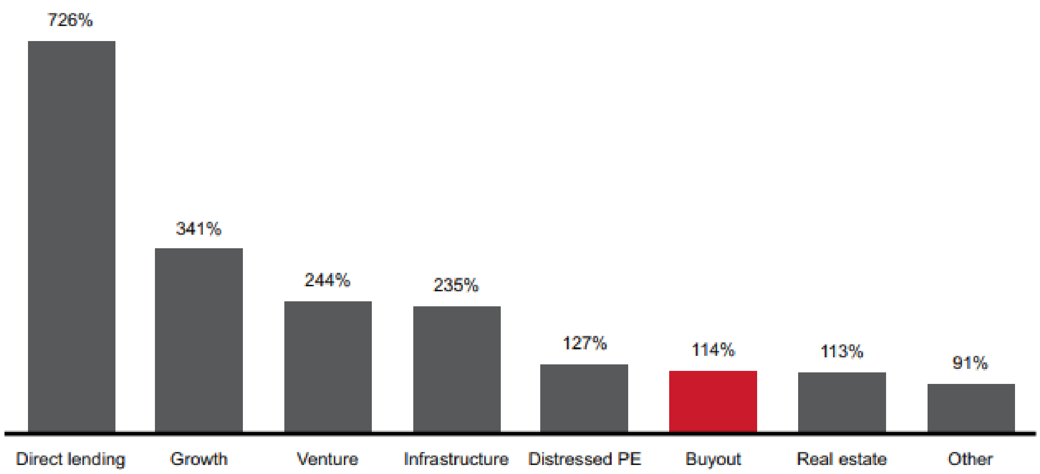
Figure 12: While buyout dry powder has been growing steadily, capital aimed at other alternative asset classes has been piling up faster

Growth in dry powder, 2020 vs. 2010, by fund type

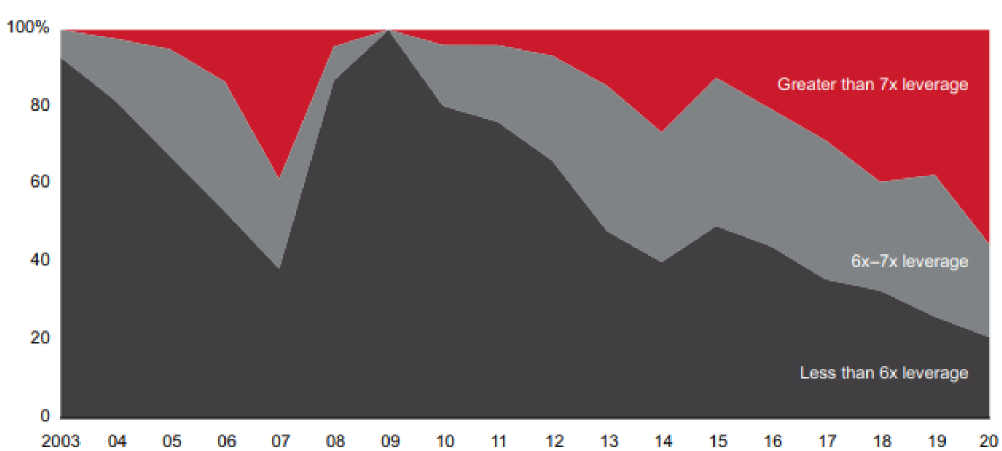


Notes: Buyout includes buyout, balanced, coinvestment and coinvestment multimanager funds; includes SPACs
Sources: Preqin; Thomson Reuters; SPACInsider; Bain analysis

Leverage: despite increased volatility in 2020, leverage ratios also increased, with ~80% of all deals levered at 6x EBITDA or more. Following the 2008-2009 GFC, it was nearly unheard of for deals to carry this much debt. But in today's low-rate environment, low-cost funds play a more significant role in determining the optimal capital structure as more managers seek to finance an increasing percentage of deals with tax-advantaged debt.

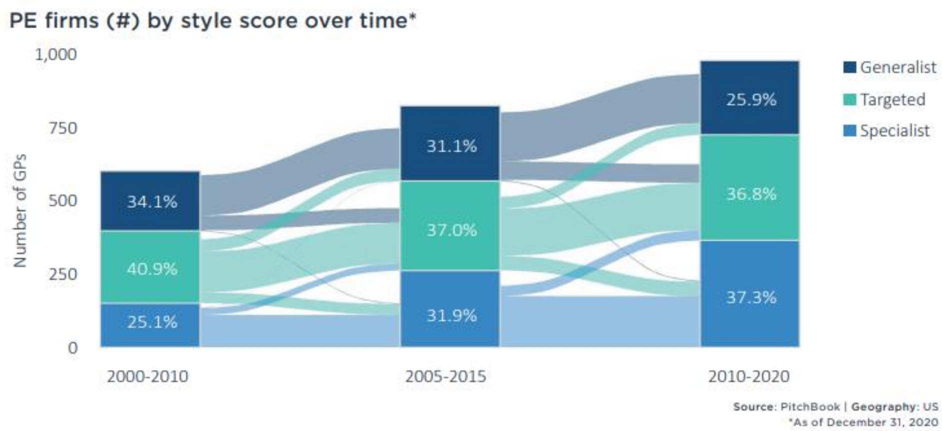
Figure 10: Buyout leverage ratios have been trending upward for years, and the pace accelerated in 2020

Share of US leveraged buyout market, by leverage level



Source: Refinitiv LPC

The Rise of Sector Specialist: Wellspring believes one of the lasting effects of COVID-19 on the private equity industry will be an increased demand for industry specialists. Sector specialists are increasingly out maneuvering generalists in fundraising, risk management, and return generation, and 2020 was no exception. Firms with industry-specific knowledge and well-developed deal pipelines performed better than those dependent on a general network of advisers. The more a manager understands the competitive dynamics of an industry, the better they can anticipate changes and position a company to benefit accordingly. According to Pitchbook, firms that focus less than 50% of their deal activity in a single sector are considered Generalists. Firms that transact between one-half to two-thirds of their activity in a sector are considered Targeted. And finally, firms that do more than two-thirds of their deals in a single sector are deemed specialists. Wellspring favors partnering with specialists when possible.



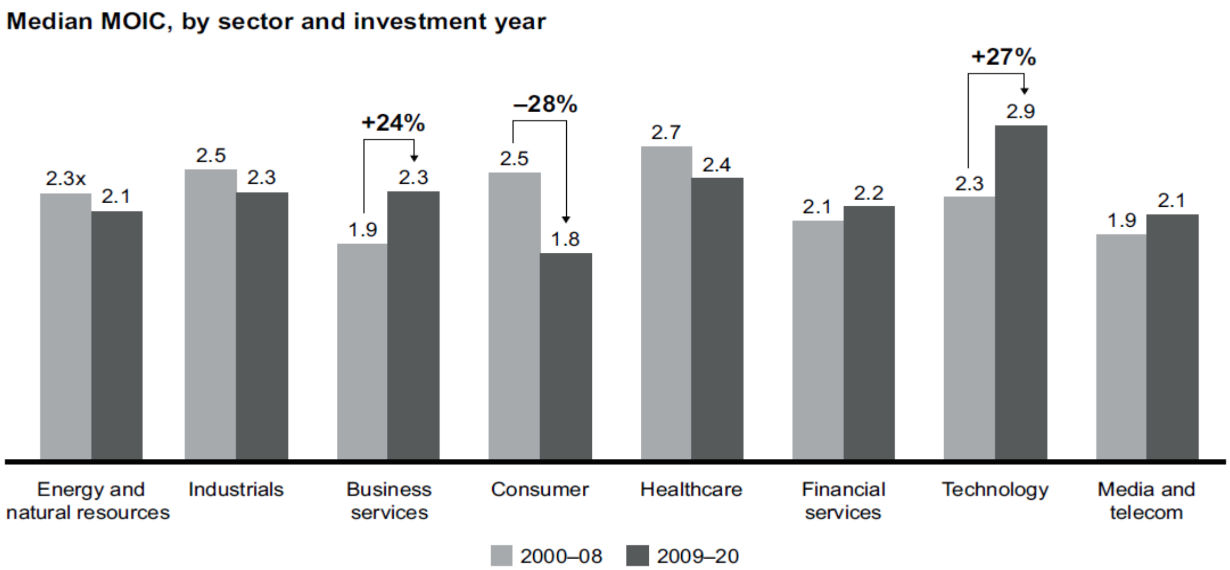
Healthcare: telemedicine and noninvasive procedures thrived during the pandemic, with outpatient and home care deals more than tripling to $3.9 billion in 2020. At the same time, hospitals and elective surgery centers saw a 50-70pct decline in traffic. Understanding the role technology could play in medicine allowed some managers to thrive while others were forced into triage.

Technology: The tech sector attracted the most capital in 2020 (29% of total buyout deal activity), with managers targeting SaaS-based platforms with strong recurring revenue models. Gaming was also a big winner, with a consortium led by KKR, Baillie Gifford, and Blackrock raising $1.5 billion for Epic Games. According to Pitchbook, the top 20 gaming companies raised over $17.8 billion in financing in their latest round. Collectively, post financing valuation for these companies is estimated at nearly $50 billion.

Fintech: deals involving payments companies made up 24% of total financial service investment value in 2020, increasing over 800 basis points as consumers demanded more non-touch, highly secure, remote transactions. Managers with deep subsector knowledge and industry experience in remote payments systems were able to capitalize on this trend announcing exits of over $3.25 billion in 2020. To date in 2021, exits totaling $11.3 billion have been announced.

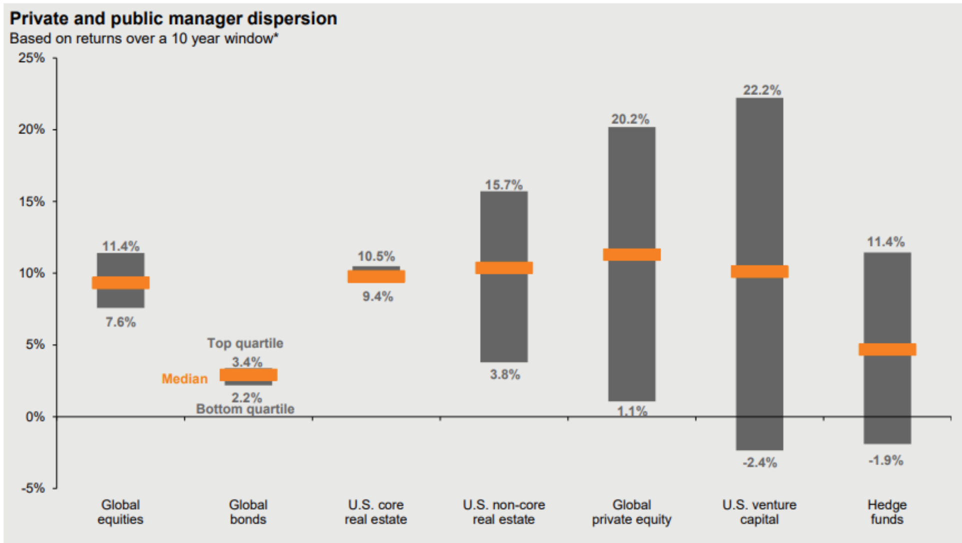
Wellspring expects sectors that proved resilient during the pandemic will continue to attract capital, and those that struggled will face new challenges. Before the pandemic, many companies in some of the fastest growing sectors, including technology, business services, and health care had already adopted artificial intelligence, big data, and web-based analytics to facilitate decision-making. Today, these tools are increasingly being applied to identify new or emerging trends to better position companies for the challenges ahead.

Figure 27: Performance across sectors has been highly variable, both in absolute terms and relative to the previous cycle



Notes: MOIC is multiple on invested capital; includes fully realized global buyout deals with more than $50 million in invested capital
Sources: CEPRES Market Intelligence via DealEdge; Bain analysis

Returns: Private equity performance varies significantly between managers and across industries, making diversification an essential characteristic of successful alternative investing. While low capital-intensive industries like technology and business services performed well in the last cycle, other industries such as consumer, industrials, and natural resources struggled. Performance also varies within industries, suggesting above-average returns cannot be guaranteed even if allocated to the right sector. Research shows that manager selection remains one of the most important factors in performance when allocating to private equity. Firms with well-developed sourcing models, experienced operating teams and industry-specific knowledge were most likely to avoid missteps and outperform peers.



Sources: Lipper, NCREIF, Cambridge Associates, HFRI, J.P. Morgan Asset Management.
Global equities (large cap) and global bonds dispersion are based on the world large stock and world bond categories, respectively. *Manager dispersion is based on: 4Q 2010 – 4Q 2020 annual returns for global equities, global bonds, and U.S. core real estate. Hedge fund returns are based on annual returns from 4Q 2010 – Nov. 2020. U.S. non-core real estate, global private equity and U.S. venture capital are represented by the 10-year horizon internal rate of return (IRR) ending 3Q 2020.
Data is based on availability as of February 28, 2021.

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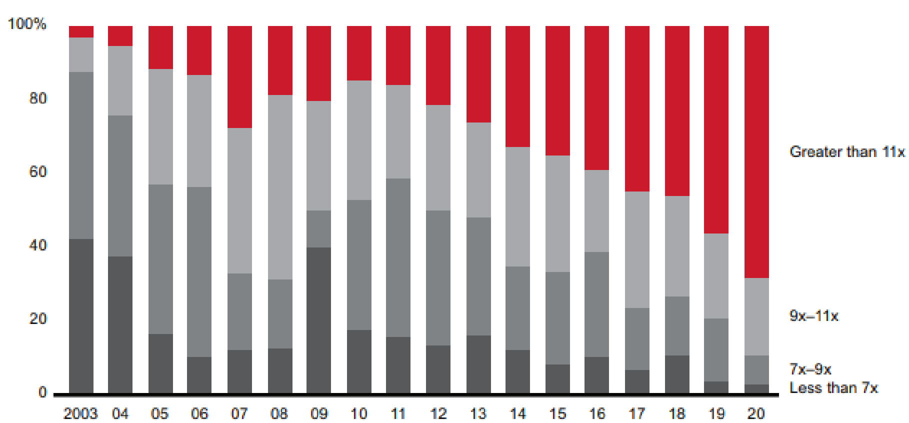
Risks: According to a December 2020 Preqin survey, investors see asset valuations as the most significant challenge for private equity fund managers. Wellspring expects elevated valuations to act as a headwind to returns in the years ahead. At current levels, managers will need to be even more disciplined in acquisitions with a clear focus on how they intend to create value. Attribution analysis by Bain Capital showed that the two primary drivers of PE return over the past decade had been multiple expansion and revenue growth. Add-on activity and tuck-in acquisitions were drivers of revenue growth, highlighting the importance of a well-developed, deep sourcing model.

Figure 9: More than two-thirds of all US buyout deals had purchase prices of more than 11 times cash flow

Average EV/EBITDA purchase price multiple for US buyout deals



Note: Includes deals with disclosed purchase price and leverage levels only
Source: Refinitiv LPC

Conclusion

- Private equity is an attractive asset class offering differentiated cash flow in a segment of the market expected to grow 2-3x that of the broader market.
- Institutional, Endowments and Family Offices remain committed to private equity, with the majority expecting to either increase or maintain the level of current allocations.
- Two primary risks to private equity are elevated valuations and higher leverage ratios. While the former may act as a headwind to returns, the latter should help boost returns, albeit with more risk.
- Firms making use of advanced analytics, including big data and web-based analytics appear better positioned to meet the challenges of the changing marketplace.
- Sector specialists are the fastest-growing segment of private equity as value creation depends even more on deep industry knowledge and anticipating where the industry is headed.

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