INVESTMENT
PERSPECTIVES

Capital Dynamics
TRULY INVESTED.

MARCH 2021

GLOBAL TRENDS IN MID-MARKET PRIVATE EQUITY INVESTING

We are delighted to share our perspective and insights on some of the major industry trends influencing our private equity business, and what this means for 2021 and beyond.

As we reflect on 2020, it is clear that this was a year of two halves. Private equity deal-making fell sharply as the pandemic took hold. Sponsors quickly turned their attention to their portfolios rather than commit to new investment opportunities. Indeed, there were winners, such as tech and healthcare companies that benefitted from healthy capital markets and the IPO window, and losers, such as travel and leisure companies hurt by the lock-down restrictions. However, on balance, most portfolio companies adapted well to the new conditions and mid-market firms actually fared better than many larger companies. As a result, new deal activity picked up sharply in the second half of the year.

The private equity industry saw the development of various trends over the past 12 months that are expected to accelerate in the coming years, largely due to the repercussions of the pandemic. These include increasing digitization and the so-called “flight-to-quality” by investors. The experience gained during the global financial crisis (GFC) and its aftermath has helped the industry react swiftly to the pandemic by paying immediate attention to key aspects in the management of portfolio companies: workers’ safety, cost control, and supply chain maintenance. In particular, managers, with the support of a banking system that showed more flexibility compared to the last recession along with a greater role of private credit capital as a buffer, particularly in the middle market, ensured portfolio companies implemented important measures aimed at safeguarding liquidity. In addition, managers have taken full advantage of programs made available by national governments, including tax breaks, social security safety-nets and other economic support tools.

The asset class as a whole, particularly the buyout segment, has been able to influence management decisions, intervene with capital to support portfolio companies’ liquidity crises and seize possible acquisition opportunities. Additionally, with managers taking a more hands-on approach and appointing operating partners to look after the assets day to day, private equity has developed a model providing for closer collaboration with portfolio companies’ management, allowing for a rapid intervention on organizational and operational changes, often necessary in emergency situations.

There are macro developments that give us reason to be optimistic. In December 2020, within days of the transition period deadline, a new Brexit deal was agreed between the EU and the UK, removing significant uncertainty and volatility from the market. As the global vaccine rollout gathers pace and life returns to some form of normality, increased consumer spending will have a direct benefit on consumer-facing businesses, albeit gradually, which simulates the performance of companies coming out of a recession. History shows that this is an excellent time to invest.

A low interest rate environment coupled with sizeable levels of available capital paves the way for continued high prices for attractive corporate assets, particularly for businesses that have shown that they can adapt to the impact of the restrictions brought on by the pandemic. Historically low rates will also mean that companies should be able to deleverage more quickly and therefore generate equity value.

PRIMARIES

MARKET OVERVIEW

Investors have shown a willingness to continue to invest capital in private equity during the most volatile time in the market with global fundraising reaching over USD 500 billion in 2020. In this context, we have observed a growing bifurcation between top-tier access-restricted managers who are able to meet their fundraising targets despite the pandemic, and the rest who are experiencing longer fundraising periods.

Many investors that were historically willing to commit capital only after conducting in-person meetings, now feel more confident in finalizing diligence processes remotely, particularly with respect to re-ups. Similarly, across the primaries strategy at Capital Dynamics, the team has not made any fund investments since the onset of the pandemic without having already previously met the managers face-to-face pre-pandemic. Capital Dynamics believes in the importance of its primaries team's ongoing engagement with managers in between their fundraising processes.

Throughout 2020, deal making decreased following the spread of the pandemic. Starting with Asia, the geographic area with the first COVID-19 cases, Capital Dynamics saw a drop in the number of deals as early as February, while in Europe and the U.S. a contraction of about 35% occurred from March and April onwards. However, Asia, led by China, saw the fastest recovery in activity levels, ending the first half of the year with a higher number of deals than the previous year. In Europe and the U.S., activity started to bounce back substantially from June and increased over the course of the year.

INCREASING SHIFT TOWARDS DIGITIZATION

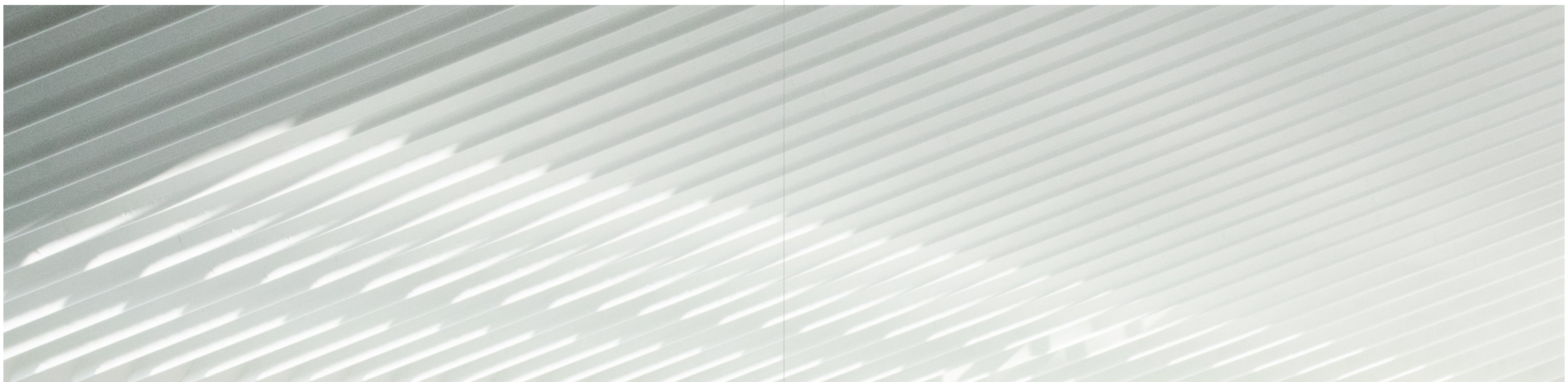
As highlighted in the introduction, a major trend we have witnessed over much of the past year is the industry's increasing shift towards digitization, both at a manager and portfolio company level, particularly since the onset of the pandemic. Many private equity managers have been able to adapt quickly to a new working environment. Virtual annual meetings and due diligence video calls with investors and portfolio companies' management teams became routine fairly swiftly.

Managers are progressively adopting new technology platforms to deliver more insights to investors and operating metrics in order to facilitate investment decisions. More tech and growth-oriented managers have been investing in digital and artificial intelligence tools to effectively screen the investible universe and refine their pipelines in real time. Furthermore, we have observed an increasing focus on managers supporting their portfolio companies in their digital transformation process. An increasing number of managers have engaged with digital operations specialists to support companies on a number of different projects, ranging from IT and business integration tasks to digital marketing, data analytics and e-commerce development.

GREATER SECTOR SPECIALIZATION

Another major trend that has become more pronounced since the pandemic is greater sector specialization. In 2006, for instance, the percentage of European buyout deals in the technology sector was just 9%. This increased to 24% in 2019. This trend has been accelerating during the pandemic, supported by the so-called "flight-to-quality" by investors, with technology sector deals accounting for 27% of all private equity deals – the highest on record according to Preqin data. Managers have focused even more closely on companies that are industry leaders, particularly in countercyclical sectors, such as healthcare, technology and food & beverages.

The expectation for the next few years is for an increase in sector-focused funds: in 2008, the amount of capital raised by technology-focused managers represented only 3% of total fundraising globally, while in 2019 this proportion grew to more than 20%. Despite the ramifications of the pandemic, this "flight-to-quality", together with high valuations in the public markets, kept entry prices at high levels in the first half of 2020, with overall buyout entry valuations in Europe reaching 11.7x. This compares with 9.3x for the mid-market, which suggests greater value in that segment of the market.



SECONDARIES

MARKET OVERVIEW

The secondary market has seen rapid growth in recent years. Transaction volume has more than tripled over the last decade, while the public markets experienced the longest bull market run in history. Even though these volumes have been driven mostly by large transactions, there have been a number of trends that have significantly contributed to this growth. This includes:

(i) An increase in active portfolio management by investors;

(ii) Persistent strong pricing;

(iii) A growing supply of General Partner (GP)-led deals (over a third of annual deal volume); and

(iv) An increase in both the number and type of participants joining the market.

However, the secondaries market did experience significantly reduced activity from the onset of the pandemic up until late summer 2020, where buyers and sellers had misaligned pricing expectations. This major disconnect led to many GP-led processes and large portfolio transactions being put on hold- until late Q3 when the market regained stability.

Contrarily, fundraising in 2020 hit record highs as investors expecting a perfect buying opportunity poured capital into multi-billion dollar secondary funds such that there was likely twice as much capital raised than deployed last year. Looking ahead, we believe that this large amount of available capital will drive a highly competitive secondaries market on larger deals and on large GP-led transactions. It is possible that this effect will be even more pronounced in the future as secondary buyers look to deploy aggressively. Conversely, Capital Dynamics will continue to focus on the smaller end of the market, which is characterized by an abundance of deal flow, a need for leadership in structuring and underwriting more complex transactions and less intermediation. By focusing on the small-end of the market, buyers are well positioned to avoid this heightened competition.

OPPORTUNITIES

Over the coming quarters, we expect to continue to see numerous investment opportunities driven by a strong flow of motivated sellers, many of whom did not transact in 2020, as alluded to earlier. A number of these investors will need to manage their private equity portfolios, for both allocation and administrative purposes. Furthermore, there is also a pent up supply of GP-led deals as an increasing number of funds are ageing and exits opportunities remain challenging.

We also expect to find opportunities where there are liquidity issues, given that the pain from the pandemic will be ongoing for a while. Firms with proprietary sourcing capabilities will be well positioned to take advantage of such opportunities, as sellers in distressed processes often wish to remain discreet and prefer confidentiality – potentially bypassing the auction channel altogether.

In the aftermath of this market dislocation, a diverse set of market opportunities are likely to materialize. It is difficult to predict the exact shape of those opportunities today. While we expect large portfolio transactions to eventually make a comeback, these will likely encounter strong demand due to the record amounts of capital raised and hence be sold through very competitive processes. Capital Dynamics' focus will remain on the smaller end of the market where market inefficiencies persist and supply-demand dynamics benefit experienced buyers.

Below are some examples we are particularly excited about:

(i) Transactions facing limited to no competition. For example, we see GP-led deals with Asian managers as being attractive as they tend to be complex and hence require significant structuring expertise while the assets often have a lot of growth potential;

(ii) Opportunities with sellers who are facing liquidity requirements or are facing operational pressures on their operating budgets due to COVID-19, such as university endowments;

(iii) Portfolios with companies that have resilient capital structures and overall lower amounts of leverage given the potential for rising default levels;

(iv) Preferred securities deals with downside protection that address the liquidity needs of investors or funds;

(v) Single asset deals that allow for deep and detailed due diligence.

DIRECT INVESTMENTS (CO-INVESTMENTS)

As with the private equity secondaries market, the market for direct investments has grown significantly over the last decade. Although this may mean greater competition for attractive direct investment opportunities, the COVID-19 pandemic has provided a number of positive outcomes for investors with proven experience, including:

(i) Many of the management teams of private equity portfolio companies have been able successfully to re-engineer their businesses during the pandemic, entering new markets or setting up new sales channels, and hiring great talent from larger, less nimble competitors. This has provided plenty of attractive investment opportunities and increased the value of many existing mid-market holdings;

(ii) Sponsors of multi-manager direct investment funds remain agile vis-à-vis sectors and countries, specifically in sectors that are likely to be beneficiaries, and in the countries that are better insulated from COVID-19. As we have illustrated in past research, intelligent portfolio construction (i.e., prudent diversification by sector, country, manager and vintage) mitigates risk of loss materially. We are particularly rigorous about how we do that at Capital Dynamics;

(iii) Transient players – who use co-investment when times are good and leave the market when times are bad – are disappearing from the market, with all-weather sponsors of multi-manager direct investment funds remaining firmly committed;

(iv) A consequence of fewer market participants is a supply-demand imbalance (i.e., less capital to meet the demands from managers looking to preserve liquidity to protect their existing portfolios). We are seeing this dynamic play out, where many good sponsors in our network are turning to us for capital. As a result, we made a relatively large number of attractive direct investments in the second half of 2020 and we are positioned to do the same in the first half of 2021; and

(v) In addition to this supply-demand imbalance, multi-manager direct investors like us have been able to negotiate preferred terms with sponsors, improving pricing and structure. These enhanced transaction structures being deployed (e.g., use of convertible or preference share/warrant instruments) provide downside protection, mitigate valuation volatility and bridge valuation gaps.

The pandemic has provided direct investment teams with more deal flow as well as the ability to pick-and-choose companies in industries that have benefitted from the pandemic or where management teams have reacted well to the changed environment and have improved the value of their underlying businesses.

ESG FOCUS

As supported by ever-increasing data, Capital Dynamics strongly believes that sound, fundamental ESG underwriting will translate into meaningful value creation through closer alignment between the objectives of institutional investors, business stakeholders, and society-at-large. Through our rigorous approach to ESG investment diligence and disciplined screening processes, the Firm has established a high standard across the private markets industry globally.

Our proprietary ESG scoring system, the R-Eye™, developed in 2018, and implemented across our investment strategies in 2019, helps ensure that the Principles for Responsible Investment (PRI), the United Nations Sustainable Development Goals (SDGs) and other ESG factors are included throughout the full investment cycle starting from investment appraisal to post-investment monitoring. The unique R-Eye® scoring system scores each investment from 0 to 5 based on a set of criteria developed in conjunction with the UN Sustainable Development Goals and helps ensure a consistent and transparent approach to RI due diligence.

While incorporating ESG principles across all investment decisions is vital, it is equally important to ensure all existing investments, Firm partners and vendors continue to abide by these principles as well. By engaging RepRisk, a leading business intelligence provider that specializes in dynamic ESG risk analytics, we can monitor our suppliers and investments making sure that they adhere to our responsible investment tenets. We believe that we can do well by doing good.

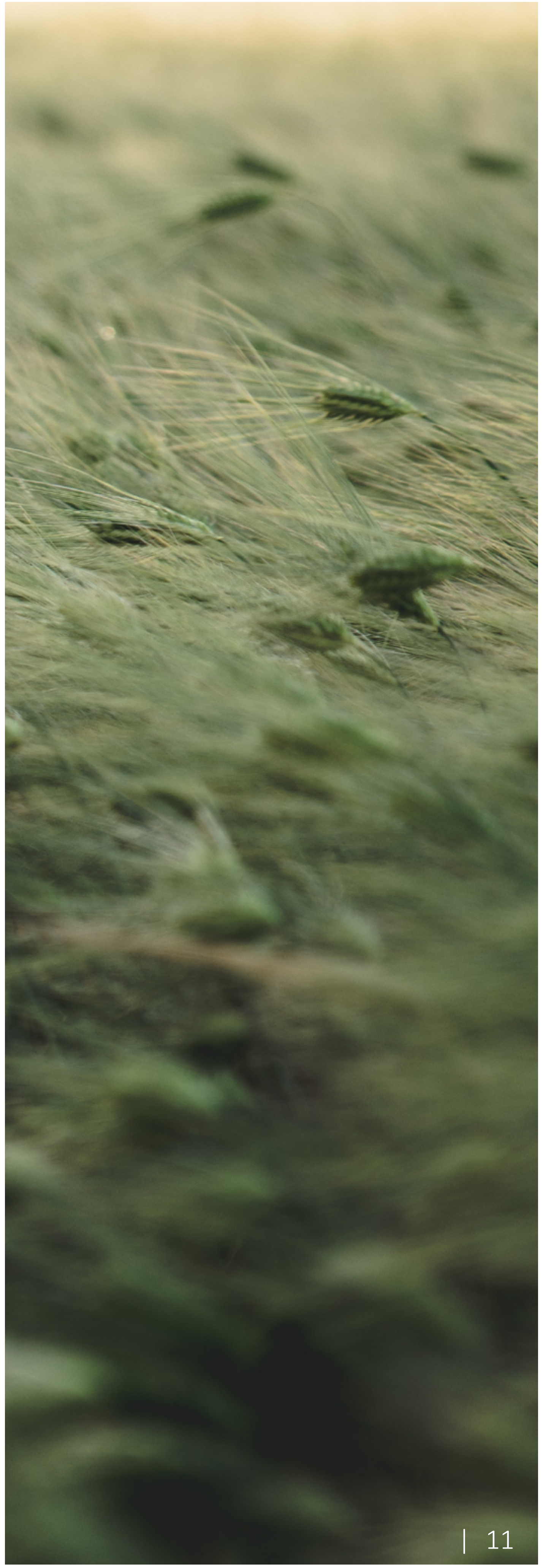
We have a longstanding commitment to responsible investment and we are dedicated to maintaining the utmost transparency with our investors and business partners when it comes to these topics. As the ongoing initiative to improve RI reporting and the associated drive to collect meaningful and accurate metrics continues, we are proud to have issued our first annual Task Force on Climate-related Financial Disclosures (TCFD) Report in 2020, an initiative set up to develop a set of recommendations for voluntary and consistent climate-related financial risk disclosures in mainstream filings.

Capital Dynamics is committed to reinforcing its investment in the middle market, an area where we have deep capabilities. Small and mid-sized companies are among the most affected by the COVID-19 pandemic and would benefit greatly from the capital and operational expertise of experienced private equity investors. Importantly, these investment opportunities are not only socially responsible, but due to the market dislocation, they have the potential to deliver differentiated risk-adjusted returns. This return profile is consistent with our core message that good ESG practices translate into long-term outperformance for investors.

PRI Principles for Responsible Investment

Top rating (A+) for Private Equity strategy

PENSION BRIDGE
INSTITUTIONAL ASSET MANAGEMENT AWARDS
WINNER
Private Equity Manager of the year
Capital Dynamics
Capital Dynamics Private Equity



CONCLUSION

The latest crisis – the COVID-19 pandemic – has once again tested the resilience of the private assets industry. Further, major recent macro developments – a Brexit deal, a new U.S. Administration, acceleration of a global vaccine rollout – give us reason to be optimistic.

Private equity managers with robust operating models and the experience of past crises have largely been able to benefit from the "new normal", working in close collaboration with their investors and portfolio companies. As an experienced manager dedicated to global private equity for over three decades, we remain focused on investing in middle-market companies that help drive local and global economic growth and job creation.

Private equity as an asset class proved to be resilient during the global pandemic, with managers benefiting from the investments they have made in operating capabilities, a lesson learned during the GFC. These skills, combined with the expansion of private equity across more flexible capital structures, helped PE-backed companies better navigate through the COVID-19 pandemic. Private equity managers were also busy on the investment side as the pandemic created several unique investment opportunities.

While still early, 2021 is shaping up to be the year of a new recovery cycle that we believe will present many attractive investment opportunities for private equity investors. In particular, private equity investors can benefit from emerging demand trends captured by innovative companies in the middle market as well as by identifying targets that may have experienced temporary disruption in demand due to the nature of their services but nevertheless have fundamentally sound business models. Lastly, and also importantly, the global pandemic demonstrated that the private assets industry has embraced a more sustainable business model, with the integration of comprehensive and formalized ESG standards supporting value preservation and creation during challenging times.

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ABOUT CAPITAL DYNAMICS

Capital Dynamics is an independent global asset management firm focusing on private assets including private equity, private credit, and clean energy infrastructure. Capital Dynamics offers a diversified range of tailored offerings and customized solutions for a broad, global client base, including corporations, family offices, foundations and endowments, high net worth individuals, pension funds and others. The firm oversees more than USD 15 billion in assets under management and advisement[1]. Capital Dynamics is distinguished by its deep and sustained partnerships with clients, a culture that attracts entrepreneurial thought leaders and a commitment to providing innovative ideas and solutions for its clients.

Capital Dynamics roots go back to 1988, the year our predecessor (Westport Private Equity) was founded in the UK. Our headquarters were established in Zug, Switzerland in 1999. The firm employs approximately 160 professionals globally and maintains offices in New York, London, Paris, Tokyo, Hong Kong, San Francisco, Munich, Milan, Florida, Birmingham, Dubai and Seoul.

In 2020, Capital Dynamics was awarded the highest rating (A+) from the Principles for Responsible Investment for (i) Strategy & Corporate Governance, (ii) private equity strategy and (iii) clean energy infrastructure strategy. For more information, please visit: www.capdyn.com

[1] As of December 31, 2020.

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