

KEY TRENDS IN PRIVATE EQUITY

A look into five recent trends in private equity and the drivers contributing to their increased importance to financial sponsors

Macroeconomic conditions have become increasingly volatile due to rising inflation, interest rate increases, Russia's invasion of Ukraine, tensions with China and the 1H23 financial market uncertainty. As such, private equity (PE) deal value and count in the U.S. dropped by 19.5% and 2.5%, respectively, in 2022 from the record-breaking year of 2021.

PNC CORPORATE BANKING

As of 1Q23, deal value was at \$261.4bn and deal count was at 2,177, a 21% and 0.5% decrease, respectively, from the same period the year prior. Despite all the turmoil, PE remains relatively tenacious, with 2022 being the second-best year for PE performance and with 1Q23 metrics well above the pre-pandemic averages of \$180bn in deal value and 1,400 deals. One reason for this success was the immense amount of dry powder that the global PE market has accumulated (\$1.3tn at the end of 2022).

In times like these with uncertainty and economic concerns, sponsors are likely to hold investments for longer periods of time until markets recover and expected returns can be generated. According to Pitchbook data, the median holding period increased from 5.01 years in 2021 to 5.40 years as of June 2023. With longer hold times, sponsors are optimizing all areas of operations to maximize the value of a portfolio company.

Furthermore, the private equity industry has continued to navigate periods of distress and adapt to these changes. As a result, companies have shifted their focus to deposit diversification and stability, long-term value creation and debt management amid tightening, and whether to participate in the secondary market as a means of securing alternative sources of capital.

Below are a few of the trends in the industry that have arisen as sponsors continue to adapt to changes in the market and investor preferences.

- Deposits Diversification and Stability
- Portfolio Company Value Creation
- First-Out Last-Out Unitranche Facilities
- Investor Preferences: Larger and More Diversified Funds
- Secondary Liquidity Trends for Sponsors



\$261.4BN

Deal value as of 1Q23



2,177

Deal count as of 2Q23



5.40 YRS

Median holding period as of 2Q23

DEPOSITS DIVERSIFICATION AND STABILITY

Liquidity remains a critical component for financial sponsors as firms look to maintain the ability to make investments and ensure stable operating cash accounts for their portfolio companies. Following the stress in the banking system in the first half of 2023, sponsors have been focused on ensuring that deposits are safe and stable. The granularity and percentage of insured deposits has become important. The Federal Deposit Insurance Corporation (FDIC), a U.S. government corporation, insures up to \$250,000 in deposits per entity per bank. Consequently, companies started focusing on liquidity and excess deposits solutions that optimize their returns but minimize risk.

There are several options that sponsors and companies are leveraging. One of these solutions is a money market deposit account (MMDA), an on-balance sheet bank account similar to a corporate savings account. It generates a market-competitive interest rate while keeping funds on the bank's balance sheet. As such, it is subject to the FDIC insurance limit, with any balances greater than that amount being backed by the full faith and credit of the associated bank. The management of excess funds can be automated, whereby balances above a customer-selected target are transferred into the MMDA with full visibility into the account.

Another good investment option is money market funds (MMFs), whereby a diversified money fund portfolio is directly invested in multiple money market instruments and therefore backed by the value of those instruments. There are

several types of MMFs, with the most common being prime, government and treasury funds. Each of these has a slightly different underlying risk profile and corresponding market return.

An emerging trend points to insured cash sweep (ICS) accounts that gained more attention recently whenever decision-makers prefer to maximize FDIC insurance compared to other more traditional options. This financial product is similar to other existing deposit accounts in that it earns interest on cash balances but is offered by IntraFi, a partner of more than 3,000 U.S. financial institutions, to maximize FDIC insurance coverage for large deposits. With this solution, one would deposit a large sum of money to its bank, and that fund is divided into amounts up to \$250,000 and these smaller, insured deposits are transferred to banks in the IntraFi Network. However, this solution uses a third party that cuts into the rates offered, resulting in a lower yield than the solutions listed above which also provide that low-risk component.

PNC remains uniquely positioned to offer liquidity and cash management solutions beyond the products mentioned above for operating, reserve and strategic needs to both sponsors and their portfolio companies, which has been a relevant topic of discussion in recent months.

PORTFOLIO COMPANY VALUE CREATION

In an increasingly competitive environment further driven by lower valuations and higher cost of debt, many PE firms began focusing on creating value for their portfolio companies in a more systematic way over the last few years. This concept, also referred to as value creation, has



been one way that firms differentiate themselves and optimize the value and return from their investments.

Historically, sponsors focused primarily on financial engineering, cost reduction and add-on acquisitions. While this does reduce costs and increase earnings, those levers do not always offer long-term or sustainable growth. Sponsors are realizing the need to go beyond traditional levers and adopt more advanced solutions. Private equity firms are recognizing the importance of dedicated teams that work closely with management teams from diligence through exit — or value creation teams. These value creation teams have different structures to meet the needs of the sponsors, including internal teams, industry-focused operating partners and affiliate consulting groups.

With longer hold times, sponsors are optimizing all areas of operations to maximize the value of a portfolio company.

Although there are many ways that firms create value and drive efficiencies for their portfolio, three of the more common areas of focus include technology/digitization,

human capital, and environmental, social, and corporate governance (ESG). Digitizing a portfolio company's processes from manual-based operations to a more automated or technology-enhanced operating model allows for increased efficiency, cost cutting and scalability, supporting both organic growth and M&A integration. Talent and retention continue to be a hot topic, and companies have been looking at solutions beyond compensation such as robust benefit packages, including personal financial wellness programs as differentiators. Finally, ESG has been a progressively more important focus for firms to address, and sponsors are working to create a standardized form of reporting.

PNC's Financial Sponsor Coverage (FSC) group helps to solve the needs of PE and other financial sponsors across the investment life cycle. FSC works closely with value creation and portfolio operations/resources teams to further execute value creation initiatives, automate manual processes and implement products that can be leveraged to maximize impact.

FIRST-OUT LAST-OUT UNITRANCHE FACILITIES

First-out last-out (FOLO) unitranche facilities typically combine a first-lien and second-lien credit facility into one single secured loan. While the unitranche is secured by a single lien on a common pool of collateral, the first-out lender, such as a bank, would have priority in recovering certain payments, such as interest, principal, fees, costs and other charges ahead of the last-out provider.

The direct lending community has raised a substantial amount of capital in recent

With unitranche facilities, borrowers benefit from revolving bank liquidity, a more competitive total cost of debt and a full suite of bank products.

years and has aggressively filled the role once controlled by the banking community. Direct lenders have the ability execute quickly, take large holds in transactions and avoid many of the hurdles experienced by a regulated institution. Other attractive features of the unitranche include higher leverage profiles, flexible covenants, minimal payback requirements, simplicity (single loan document) and scalability.

In most cases the last-out lender is the majority provider of the debt quantum, but often welcomes a first-out to provide ongoing liquidity for the company. First-out and last-out lenders have different risk appetites, and the unitranche combines these two parties in a one-stop arrangement. Given the first-out's position in the capital stack and perceived lower risk, they would receive a lesser rate than the last-out lender. The ability to customize the financing solution among institutions with different risk/return appetites, while maintaining seamless execution via a single loan to the borrower, has added to the popularity and acceptance of the unitranche product.

PNC Business Credit's Steel City Capital Funding division works with a network of private lenders to offer clients/sponsors a full solution. Borrowers benefit from revolving bank liquidity, a more competitive total cost of debt and a full suite of bank



products. Direct lenders benefit from keeping a higher portion of their commitment funded, offloading non-core loan administration requirements and yield enhancement created by the first-out funding, allowing them to "sharpen" the overall pricing of the unitranche.

INVESTOR PREFERENCES: LARGER AND MORE DIVERSIFIED FUNDS

Investors have shifted their focus to larger funds as firms look to invest in high-quality assets in an effort to mitigate risk. One of the major factors in this shift in investor sentiment is the impact of the denominator effect on the industry as private markets outperform public markets. Rising inflation and interest rates along with declining public market performance led to limited partners (LPs) scaling down on new commitments, particularly for smaller and newer funds. The median size of PE funds started growing in the past couple of years, and as of 1Q23, the median fund size increased to \$305mm from \$137.3mm in 2022. Total fund count for funds under \$200mm also dropped from 72.7% in 2021 to 64.0% in 2022 and to 47.9% in 1Q23, reaching below 50% for the first time.

Despite the impact of the denominator effect and a slowdown in distribution from general partners (GPs) to LPs, researchers do not expect a large



50%

of overall secondary transaction volume are GP-led deals

decrease in private market capital commitments. There were 497 funds closed in 2022 compared to 790 in 2021, but the capital raised was very comparable at \$361.6bn and \$362.7bn respectively. This data shows that funds are still being raised and closed, but investors are being selective and choosing sponsors with proven performance or staying with their existing managers.

Investors are also making even larger allocations to private credit and permanent capital-aligned investment strategies than in the past. Many funds are investing in broader offerings and businesses across a variety of asset classes and fund structures to keep investors and attract new ones. There are also expectations of further acquisition of niche platforms by larger asset management platforms to augment their business and gain access to private investor pools and alternative investment strategy differentiated products. These trends favor funds with the capital and talent to run these businesses successfully given the fixed costs for technology, compliance, regulatory, risk management and investor relations / business development.

A 2023 Private Equity Outlook Survey by S&P Global Market Intelligence showed 45% of PE executives expect fundraising conditions in their location to deteriorate

in 2023, with 34% expecting that conditions will remain the same. However, investors are reportedly less concerned than they were during the global financial crisis 15 years ago due to the development of more advanced systems to manage volatility in portfolio construction. Moreover, with investors being capital-restrained, some may sell certain funds through the secondaries market and reallocate to new private fund investments (see Secondary Liquidity Trends for Sponsors in the next section for more information).

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The Diversified Financial Institutions team at PNC works closely with sponsors to foster ongoing, strategic dialogue and share sector experience and best practices. The team assists clients in accessing leverage and gaining

performance efficiencies through a variety of capital markets, structuring and value-add capabilities.

SECONDARY LIQUIDITY TRENDS FOR SPONSORS

2022 marked the second consecutive year in which the global private secondary market eclipsed \$100bn of transaction volume (\$134bn in 2021; \$103bn in 2022), securing the market's permanence as a critical liquidity outlet for both private fund LPs and GPs. The transformation of this cottage industry, which saw total deal volume of approximately \$50bn five years ago, into a dynamic and evolving marketplace, has been largely driven by the increased adoption and use of secondary transactions by the GP community. These GP-led deals have grown to represent roughly 50% of overall transaction volume compared to approximately 20% in 2016.

In deciding to tap the secondary market, GPs have at their disposal a suite of liquidity options at both the fund and company level that can supplement or replace traditional capital markets channels. The most notable of these options in the current environment has been the continuation vehicle (or CV) transaction, which accounted for an estimated 80% of all GP-led transaction volume in 2022. A CV is a tool used by the sponsor to recapitalize an asset or group of assets that is currently held in an existing sponsor-managed fund or vehicle. These transactions provide a liquidity option for LPs while securing more time and growth capital for the GP to optimize the ultimate exit of such asset(s).

While the technology to recapitalize existing fund assets has been around since

the 2000s, the expanded use of the CV product was accelerated post-COVID as GPs sought to provide liquidity to their investors, particularly when more traditional exit channels, namely, an M&A sale or IPO, became challenged. The CV solution has the added benefit of allowing GPs to hold on to their best asset(s) for longer and generate incremental sponsor economics. The era of CV transactions for “trophy assets” continues to grow in prevalence as both single- and multi-asset CVs dominate the overall market for GP-led secondary activity.

The increased use of alternative GP-led financing solutions is helping to drive the evolution and expansion of the secondary market as a highly effective liquidity management tool for private equity sponsors.

Another trend developing in the secondary market is the re-emergence of alternative GP-led transactions, specifically fund-level financing solutions. These financings, typically in the form of preferred equity or NAV loans (loans secured against the current assets of a fund), provide access to capital which can be used to reinvest in or support a portfolio of assets, return capital to LPs (akin to a dividend), or even bridge a portion of the capital needed to close a CV transaction.

NAV loans offer better asset coverage and traditional covenant protections for lenders — features which, in turn, benefit the borrowing GP in the form of lower pricing. Preferred equity at the fund level will generally come with more flexibility and fewer or no covenants but at a higher cost of capital. The growth in these products is the result of (i) GPs seeking alternative capital sources when access to traditional capital markets is constrained or less attractive, as it currently is, and (ii) a byproduct of the increasing number of lenders participating in the fund finance market with dedicated sleeves of capital.

Alongside the growth in continuation vehicle transactions, the increased use of alternative GP-led financing solutions is helping to drive the evolution and expansion of the secondary market as a highly effective liquidity management tool for private equity sponsors.

Harris Williams’ Private Capital Advisory group, a PNC subsidiary, provides leading advice and execution to private equity sponsors and institutional investors seeking secondary liquidity and related capital solutions. A high-touch advisor of choice known for its execution, positioning and structuring expertise, Harris Williams has extensive experience in innovative GP-led secondary solutions, including CVs and NAV-based loans as well as fund recapitalizations, preferred equity, asset spin-outs and primary staples.



CONCLUSION

The financial sponsor space continues to grow and thrive amid the current economic cycle, marking its second-best year ever in 2022, only behind 2021. Sponsors are discovering new solutions and expanding partnership opportunities in areas like liquidity and capital solutions through unitranche structures and secondary liquidity options. They continue to enhance their capital commitment from investors and focus on long-term value creation for their portfolio companies.

PNC and its subsidiaries have a long-standing track record of achievement and a full arsenal of financial products and services to help sponsors and their portfolio companies throughout every fund life cycle phase, including the solutions referenced herein. This is accomplished by working strategically to enhance liquidity and propel growth through all economic cycles.

READY TO HELP

PLEASE CONTACT OUR TEAM WITH ANY QUESTIONS OR INQUIRIES.

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CIB BC IMC 0224-0102-2421401