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.

As proven by the COVID-19 pandemic, the private equity ("PE") industry is versatile, malleable and resilient as sponsors continue to source, fundraise and execute new investment opportunities. Over the past decade, private equity markets have grown 170%, with assets under management ("AUM") now exceeding $6.5tn globally and with North America accounting for more than half of the global AUM at $3.4tn.[1] In recent years, dry powder has soared to new levels, topping $1.2tn globally. Further supporting this trend, the five-year Compound Annual Growth Rate ("CAGR") for dry powder is nearly 16%[2], making private equity an exceedingly relevant capital source. This ongoing growth has enticed private equity leaders to explore creative liquidity and financing solutions provided by banks and other financial institutions that are tailored to fit their portfolio. For example, first-in, last-out ("FILO") structures leverage banks' accounts receivable ("A/R") securitization and execution capabilities, while first-out structures offer greater flexibility than traditional bank lending.

Further, PE firms are continuously considering ways to maximize returns on their investments, including creative means of generating offensive and defensive liquidity and investing dry powder in meaningful ways. Use of special purpose acquisition companies ("SPACs") can provide flexible hold periods, secondary market solutions offer fund liquidity, and deal volume in the technology sector continues to thrive. Highlighted below are several of the trends that have arisen as a result of financial sponsors' continued focus on fundraising and investing capital to support existing or new fund strategies.

- **SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS)**
- **SECONDARY LIQUIDITY SOLUTIONS FOR SPONSORS**
- **FILO STRUCTURES IN A/R SECURITIZATIONS**
- **FIRST-OUT STRUCTURES IN PARTNERSHIP WITH PRIVATE CREDIT**
- **TECHNOLOGY SECTOR DEAL ACTIVITY**

RECORD SPAC MARKET ACTIVITY

The SPAC market hit new heights in 2020, presenting expanded access to capital and liquidity as SPAC issuance and business combinations have each reached record levels. Through the first nine months, 122 SPAC IPOs have raised $47bn in proceeds, representing 50% of all IPO volume YTD.

Announced and completed SPAC merger volumes are also tracking at record pace, with 44 announced and completed mergers expected to represent more than $87bn in total transaction volume. As of 3Q20, there are over 140 SPACs outstanding actively searching for a business combination with nearly $50bn in trust capital. The current SPAC structure has been stable for several years, allowing for a new record of successful business combinations, aftermarket returns and new capital being raised.

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A SPAC is a publicly traded blind pool of capital that has been raised for the sole purpose of combining with one or more operating companies to create a new public entity. SPAC IPO buyers invest in a unit which includes a share and a warrant in some proportion, allowing them to buy additional shares. Upon pricing the IPO, these proceeds are placed in trust investing in U.S. treasuries, only to be released upon the closing of a business combination or upon the expiration of the SPAC. The founders of the SPAC have 18–24 months to complete the business combination, which is approved via vote by shareholders. In addition to the right to approve the business combination, SPAC IPO buyers have a redemption right allowing them to surrender their share ownership for their pro rata trust value ($10.00 + interest). SPAC sponsors pay for the friction cost of the IPO through funding risk capital typically in exchange for warrants or units, along with founders stock. With few exceptions, most SPAC IPOs have a founder stock pool that represents 20% of the post-IPO shares outstanding. Historically, concerns over the dilutive nature of the SPAC warrants and founder stock and uncertainty on the level of redemptions and expectations for the future shareholder base of the company have made traditional IPO or sale process more attractive for sellers of assets.

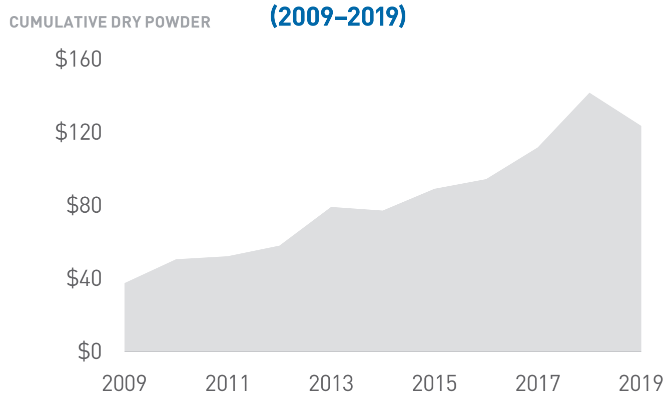
The increase in SPAC activity can be attributed to a number of factors which have elevated the entire ecosystem. Larger companies are merging into SPACs, creating scaled, public opportunities at average levels of 3–5x the size of the SPAC trust value. The larger transactions have mitigated some dilution concerns, allowing impact associated with warrants and founders stock to be distributed across a broader base and making SPACs a more attractive exit vehicle for higher quality private companies. Importantly, fundamental institutional investors, including some of the largest mutual funds, have begun to participate in SPAC IPOs and are participating in even larger ways in private investment in public equity ("PIPE") offerings during de-SPACings. The PIPEs are typically committed to before public announcement of the merger and have allowed for market price discovery and certainty of capital earlier in the SPAC process. In addition, this provides important validation around value by way of the higher quality institutional participation. Approximately three out of four SPAC mergers since 2019 have included a PIPE to de-risk execution, with PIPEs ranging from 25 to 250% of the SPAC trust value.

Given the recent successes and positive feedbacks within the system, the backlog of SPAC IPOs and merger opportunities is expected to remain elevated in the near term. However, with robust outstanding IPO supply, market participants are watching closely for continued successful merger activity. This allows the traditional sources of SPAC IPO capital to recharge for subsequent issuance and to extend the recently observed feedback loop with continued positive returns across the ecosystem.

SECONDARY LIQUIDITY TRENDS FOR SPONSORS

The global private secondary market continues to scale and evolve, reaching a peak of $80bn of transaction volume in 2019, representing a 220% increase from $25bn in 2012 and a more than 500% increase from $13bn in 2009. A large component of this growth has been the proliferation of transactions led by private equity sponsors, or general partner ("GP") led transactions, which currently comprise approximately 35% of the market. Market participants predict that GP-led deals may overtake traditional limited partner ("LP") portfolio sales in 2020 or 2021.

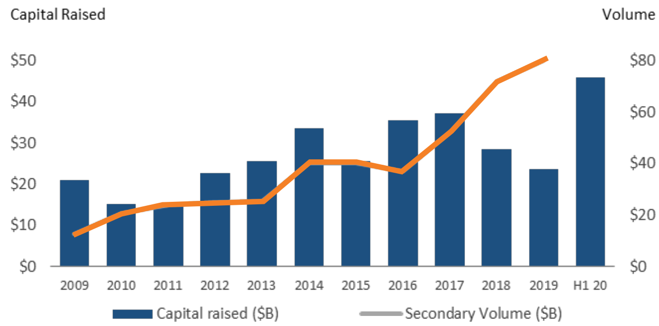
SECONDARY MARKET CAPITAL OVERHANG ($BN) (2009–2019)



Another key driver contributing to the increase in secondary transaction volume has been the large quantity of capital raised by buyers. Secondary funds raised $46bn in the first half of 2020 alone, adding to more than $100bn of existing dry powder in the secondary market, which will need to be deployed over the next three to five years. Many secondary funds have three- or four-year investment periods instead of the five-year investment period buyout that funds typically have.

These dynamics have created an opportunity for private equity sponsors to tap into the secondary market to address both offensive and defensive fund and company-level liquidity needs, creating an alternative source of capital to supplement existing capital markets channels. Secondary transactions offer sponsors access to flexible capital, new economic incentives and extended hold periods to create value within a broader portfolio or for a specific asset. The global COVID-19 pandemic advanced these dynamics, as sponsors sought access to additional liquidity for their portfolio companies via fund-level financings, such as NAV-based loans and preferred equity. These securities use the broader portfolio's equity as collateral to command a lower cost of capital — a trend that is expected to continue over the coming months.

SECONDARY MARKET CAPTIAL RAISED & VOLUME ($BN)



As the markets begin to reopen, the opportunity for sponsors to raise capital through the secondary market remains strong, with high-quality sponsors and resilient, concentrated portfolios leading the charge. Continuation vehicles for multiple and single assets continue to be prevalent, with the latter becoming increasingly popular amongst sponsors as an alternative to a traditional M&A exit for top-performing portfolio companies. These transactions provide optional liquidity for LPs while securing more time and growth capital for the GP to optimize ultimate exit value. LPs have been increasingly welcoming to alternative liquidity options, particularly when they have unfunded commitments to newer private equity funds in their own portfolios.

Given the market volatility, opportunities in defensible sectors, such as enterprise software, technology-enabled business services, IT infrastructure, healthcare, and essential services (i.e., food supply chain and utility services), are particularly compelling. Such companies and portfolios are seeing the most interest from the secondary market in the current transaction environment.

The secondary market will continue to serve as an attractive and consistent source of capital for sponsors driving liquidity innovation for an illiquid asset class. GP-led solutions are expected to play a key role as they continue to adapt to meet the needs of sponsors within one of the fastest growing and most innovative segments of private equity.

FILO STRUCTURES IN A/R SECURITIZATIONS

While A/R securitization has long been a tool that corporate borrowers have employed to optimize their debt capital structures, 2020 has created an environment for this type of financing to flourish. In March, as COVID-19 descended on the United States, corporate borrowers rushed to tap the bank and institutional financing markets for additional liquidity. Much of that financing was executed in traditional markets such as bank revolvers, term loan structures and bonds. Many borrowers, however, eschewed the traditional markets (or supplemented their issuances in those markets) by establishing A/R securitizations.

An A/R securitization is traditionally a bank-provided financing which leverages a corporate borrower's accounts receivable into a borrowing base-driven loan. The structure generally entails a company selling its accounts receivable to a new wholly owned bankruptcy remote subsidiary (a special-purpose vehicle), which then enters into the financing arrangement with the bank. This ring-fenced structure makes these financings non-recourse to the estate of the corporate borrower. The non-recourse nature of the loans generally make these financings more favorably viewed by other lenders in the capital structure, who regularly provide companies with the ability to execute A/R securitizations in loan agreements. A/R securitizations are typically permitted by a company's other financing agreements, with baskets that are totally separate and distinct from the provisions that govern how much additional term loan, revolver or bond debt a company can maintain. While the interest cost savings from lower coupons and the ability to obtain large amounts of capital from a single provider has always been a benefit of A/R securitization, the turbulent environment in 2020 has amplified these benefits.

A/R securitization structures have been common among companies from all industries for many years. Companies large and small, those that are investment grade and also those that are high yield or unrated, as well as public and private companies alike, have utilized these financings to optimize their capital structures. Historically, highly leveraged borrowers had been somewhat underserved by the traditional bank A/R securitization market. However, more recently, these leveraged borrowers have turned to direct lenders to fill the financing void.

In 2020, a new trend has emerged in the A/R securitization market, bringing together direct lenders and traditional bank financiers. Banks, as first-out lenders, are partnering with business development companies ("BDCs"), private credit firms and specialty finance companies, as last-out lenders, to deliver A/R securitizations in FILO structures, with significant benefits to both borrowers and fund partners as shown in the table below.

BENEFITS OF A FILO SECURITIZATION TO:

BORROWERS	FUND PARTNERS
• Lower cost of financing than traditional private debt • Enjoys a bank-provided servicing and administration platform • Potentially establishes a new commercial banking partner • Provides incremental financing capacity relative to traditional bank-only A/R securitizations	• Leverages a bank's A/R securitization structuring and execution capabilities • Hands-off administration of the facility with an ability to offer a more flexible financing than competitors with same-day borrowings funded by a bank-swingline

FIRST-OUT STRUCTURE

After the 2008–2009 financial crisis, many middle market companies sought capital to execute necessary strategic growth initiatives. Yet these businesses were unable to obtain the flexible term loans they needed due to new regulations impacting traditional lenders. As a result, private debt solutions became a more practical alternative, as the financing offered by these direct lenders offered more flexibility than traditional bank loans.

History repeats itself today as middle market businesses battle the challenges brought about by the COVID-19 crisis. Private equity sponsors are looking for larger funding amounts and certainty of close. More private debt investors exist today, backed by large amounts of capital, and again offer these companies another option for pursuing growth.

UNITRANCHE LENDING HIT AN ALL-TIME HIGH OF $9.2BN IN 2019

These private credit funds now hold a dominant position in an uncertain economic market. The increase in dry powder in the market also raises the competitive stakes, which increases valuation, leverage and debt. With much flexibility in their deployment of capital, direct lenders are well suited to handle financing of this nature and are able to provide favorable terms.

As a complement to these financing structures, senior secured lenders have increasingly been participating in the first-out of a unitranche facility to streamline the process under the direction of one direct lender while bringing down the cost of capital. That lender provides a single point of contact, breaking out the different tranches and syndicating the facility behind the scenes. Financial sponsors benefit from speed and confidence of execution, greater access to senior debt, lower costs and reduced syndication risk.

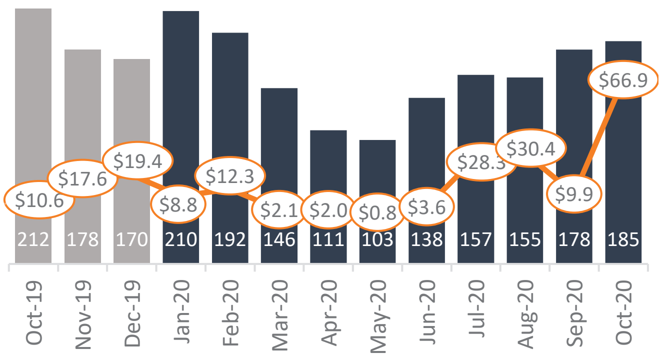
Typically in this structure, the first-out lender underwrites its portion of the unitranche facility based on their leverage preference. The first-out tranche drives down blended pricing, given its position at the top of the capital stack, while the last-out and direct lenders are still able to hurdle their return requirements. This structure allows direct lenders to participate in first lien financing for which they typically wouldn't have an appetite given the suboptimal pricing. First-out structure facilities are also convenient for the borrower because they only have to negotiate one set of loan documents for both the first-out and last-out portions of the credit facility. Additionally, the first-out structure is advantageous to senior lenders because they have priority in recovering collateral in the case of a default. First-out structures are beneficial to all parties involved and are increasingly being requested by sponsors.

TECHNOLOGY SECTOR DEAL ACTIVITY

Technology sector mergers and acquisitions ("M&A") activity continued to pick up meaningfully from levels at the COVID-19 onset, though volume continued to trail last year's totals. However, for the deals announced, buyers took bigger swings in the second half of 2020. In the first half of the year, 399 deals totaled $62.4bn in value. In the second half of the year, 486 deals totaled $319.6bn. That's an average deal size of $157mm vs. $658mm. 2H20 presented 41 "mega-deals" (deals >$1bn), with 32 coming after August. Prior to this, there were only 14 mega-deals in the first half of the year.

M&A in technology totaled $382bn for the year, down 11% from 2019. Most of the focus was on software, and to a lesser extent, IT consulting. Software continued to be a bright spot, with 299 deals accounting for $123bn of value.

NORTH AMERICAN TECHNOLOGY M&A ($BN) (OCT. 2019 – OCT. 2020)



However, the biggest change between 2019 and 2020 was in the data processing & analytics space, which includes fintech deals. Last year, mega fintech deals from Fiserv, Fidelity National Information Services, and Global Payments accounted for $112bn alone. Perhaps the most interesting sector performance of 2020 was semiconductors. Across only 19 deals, the sector accounted for $119bn of transactions announced throughout the year. Three of the top five largest semiconductor transactions of all time were announced over a three-month span — totaling $98bn. Hardware, conversely, had a tough year due to a backdrop tainted by trade wars, COVID-19 supply chain disruptions, and tighter liquidity on the buyer side.

Over the last several years, one in three M&A exits in technology went to private equity or a private equity–backed strategic buyer. The number of sponsors, coupled with their prolific fundraisings, increasing appetite, and evolving expertise has proven to be forceful competition to traditional strategic buyers. Digital transformation and interest from historically non-technology companies is increasing private equity-backed interest, as well. Large private equity firms known for sectors outside technology are also rapidly expanding their focus in this sector. For example, Blackstone just hired a former Amazon & Microsoft Corporate Development executive to focus on technology deals. Technology-focused private equity firms are sitting on over $1tn of dry powder, which can be leveraged to more than quadruple the buying power, yielding a significant opportunity for financial sponsors in this space.

CONCLUSION

Financial sponsors value the continued focus on new solutions to enhance their capital investment. The current turbulent environment has opened and expanded partnership opportunities within the financial industry. Trends such as a robust technology M&A market, SPACs, secondary liquidity solutions, and partnerships between traditional banks and direct lenders are among the most prevalent opportunities from which financial sponsors benefit.

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 each fund life cycle phase, including the solutions referenced herein. This is done by working strategically to enhance liquidity and propel growth through all economic cycles, as evidenced by PNC's greater than 750 private equity relationships, more than $60bn in financial sponsor commitments under management and significant investment in technology resources to be one of the top five treasury management providers in the United States.

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S&P Capital IQ for Technology section

WE ARE HERE TO HELP. PLEASE CONTACT:

Danica Griffith
Head of
Financial Sponsor Coverage
412-995-1727
danica.griffith@pnc.com

Aimee LeWinter
Managing Director
Financial Sponsor Coverage
954-745-1412
aimee.lewinter@pnc.com

CONTRIBUTING AUTHORS:

John Haynor
Solebury Capital
jwh@solecap.com

Eric Zoller
Sixpoint Partners
ezoller@sixpointpartners.com

Andrew Gulotta
Sixpoint Partners
agulotta@sixpointpartners.com

Imad Naja
PNC Asset Backed Finance
imad.naja@pnc.com

Walt Hill
PNC Business Credit
walter.hill@pnc.com

Matthew Embacher
PNC Technology Sector
matthew.embacher@pnc.com

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