PRIVATE EQUITY INSIGHTS

RSM AND PITCHBOOK

The changing investor landscape under COVID-19

EDITION 1: 2021

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INTRODUCTION

A common sentiment in today's market is that COVID-19 will have an impact on what types of investors will be active over the next few years. Many industry experts expect private equity (PE) sponsors to be especially active. However, as the PE industry has grown over the decades, competition from other investor types has increased. Alternative buyers such as family offices and Canadian pension plans are now established players in the market, while sovereign wealth funds have become permanent equity providers to buyouts as well. Traditional leveraged buyout firms also face stiff competition from specialized PE firms, distressed investors, first-time funds and an array of other niche investors that have carved out their own pockets in the market.

While traditional PE firms cater to limited partners (LPs) and have fixed investment timelines, other investor types enjoy a permanent capital structure. For these players, time isn't necessarily of the essence. While 2021 may turn into a feeding frenzy for PE, longer-term investors can remain as selective as they've always been. Corporate acquirers, meanwhile, won't simply buy market share because acquisition targets have lower valuations, but they will align their mergers and acquisitions (M&A) strategy on both the buy side and sell side with their long-term business plan, particularly as business models evolve. "Strategic acquirer" will take on a more literal meaning in 2021, as we'll see specific and significant synergies and accretion opportunities driving corporate M&A. Traditional PE firms will face different competition over the near term for highly coveted assets.

PRIVATE EQUITY

Set to surge?

> "WE ALWAYS USED TO TALK WITH PE FIRMS ABOUT RECESSION-PROOF BUSINESSES. NOW WE'RE TALKING ABOUT PANDEMIC-PROOF BUSINESSES. "
>
> BEN GIBBONS, RSM CANADA'S PRIVATE EQUITY TEAM LEADER

PE deal activity came to a virtual halt last summer amid pandemic anxiety, according to PitchBook Data. As expected, though, it started to perk up later in the year and has carried momentum forward into 2021. Aggregate deal value was higher in both October and December 2020 than in January 2020, before COVID-19 became a market factor. Deal count, however, has not recovered to pre-pandemic levels, which means deal sizes have risen significantly. The median PE deal size in 2020 was $440 million compared to $100 million in 2019, according to PitchBook Data.

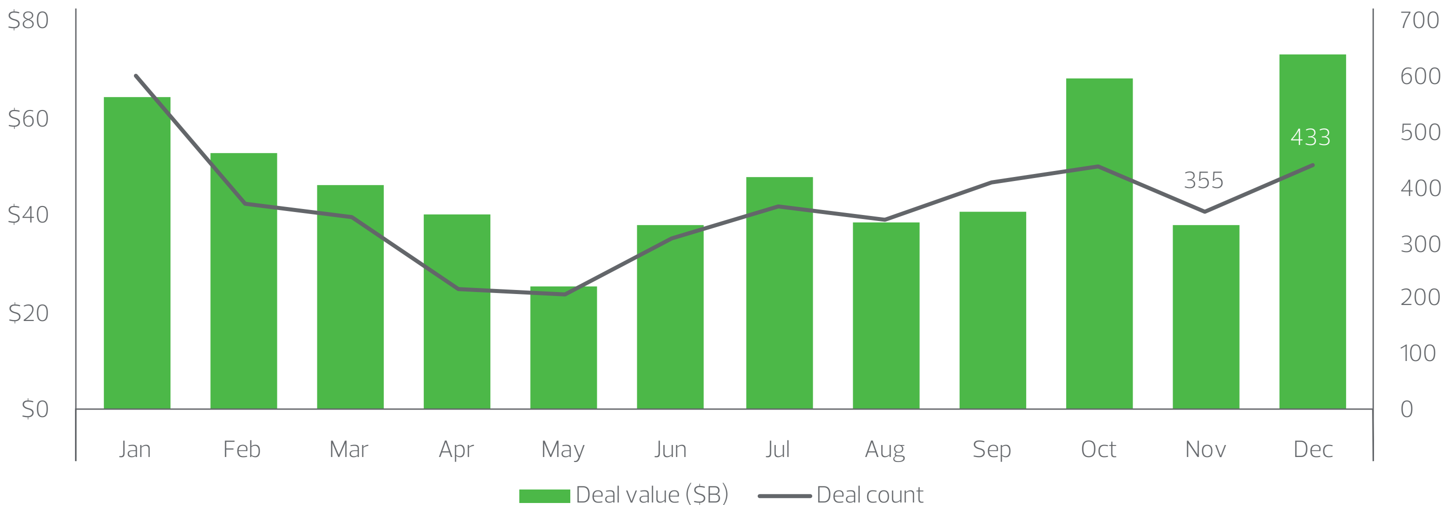
2021 coming into focus

In the United States alone, PE firms had about $721 billion of unspent capital as of June 30, 2020, and because of the slowdown in 2020 deal activity, much of that capital is now behind schedule. PE firms are anxious to put it to use as valuations have stabilized and uncertainty continues to diminish. There are reasons to believe valuations will increase in 2021 as competition for assets heats up. Accompanying buy-side momentum will be a wave of delayed PE exits coming to market that are healthy enough to justify higher valuations, while those that don't meet this threshold will remain on the sidelines. Distressed opportunities will be visible, however. With the potential for further government funding programs to wane over 2021, alternative sources of capital will come in the form of special situations groups. If vaccines can't be distributed as efficiently as planned, PE may gain a stronghold in deal flow over the next six months.

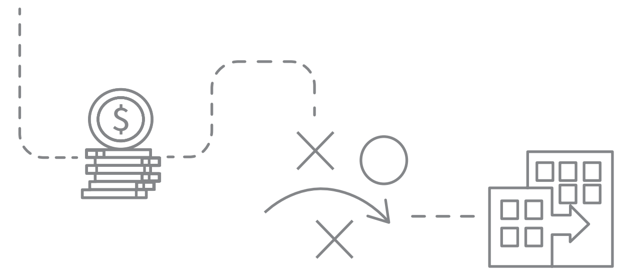
We also see first-time PE managers recovering in 2021 after being virtually shut out of the fundraising trail in 2020. LPs chasing outsized returns will fund new managers with pedigrees and track records. Some LPs are also receptive to new private lending funds, and a group of funds is emerging specifically to take advantage of 2021 deal flow.

> IF VACCINES CAN'T BE DISTRIBUTED AS EFFICIENTLY AS PLANNED, PE MAY GAIN A STRONGHOLD IN DEAL FLOW OVER THE NEXT SIX MONTHS.

U.S. PE deal activity in 2020



Source: PitchBook



STRATEGIC ACQUIRERS

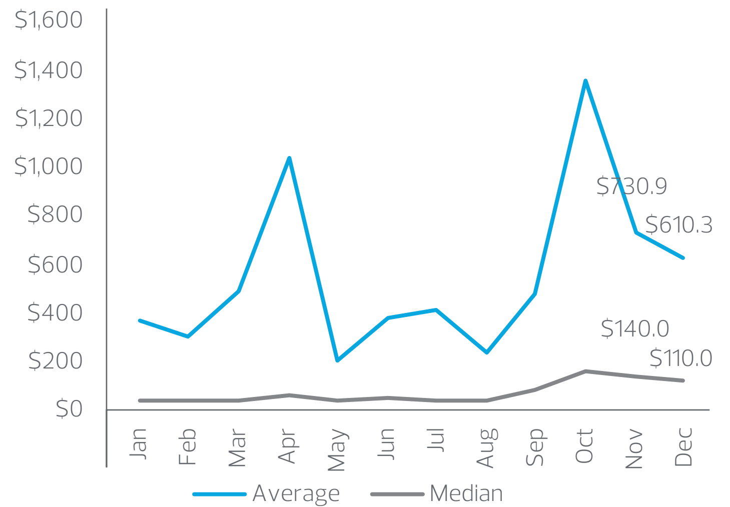
Not everyone wants to buy

Strategic M&A activity slowed to a crawl in the early summer of 2020. Low valuations didn't necessarily translate to buy-side opportunity, since would-be targets couldn't forecast revenue confidently and the "new normal" was continuously being reforecast. At the same time, many would-be buyers were hamstrung by their own internal problems amid the economic downturn, and spending time and cash on acquiring other companies wasn't a possibility. Other potential buyers lacked any kind of playbook for distressed acquisitions, even if they had the capital and wherewithal to do them. However, M&A activity began to gain steam through the summer. Corporate buyers have carried some momentum forward into 2021, but a large number remain hesitant to buy in the current environment.

What we're seeing

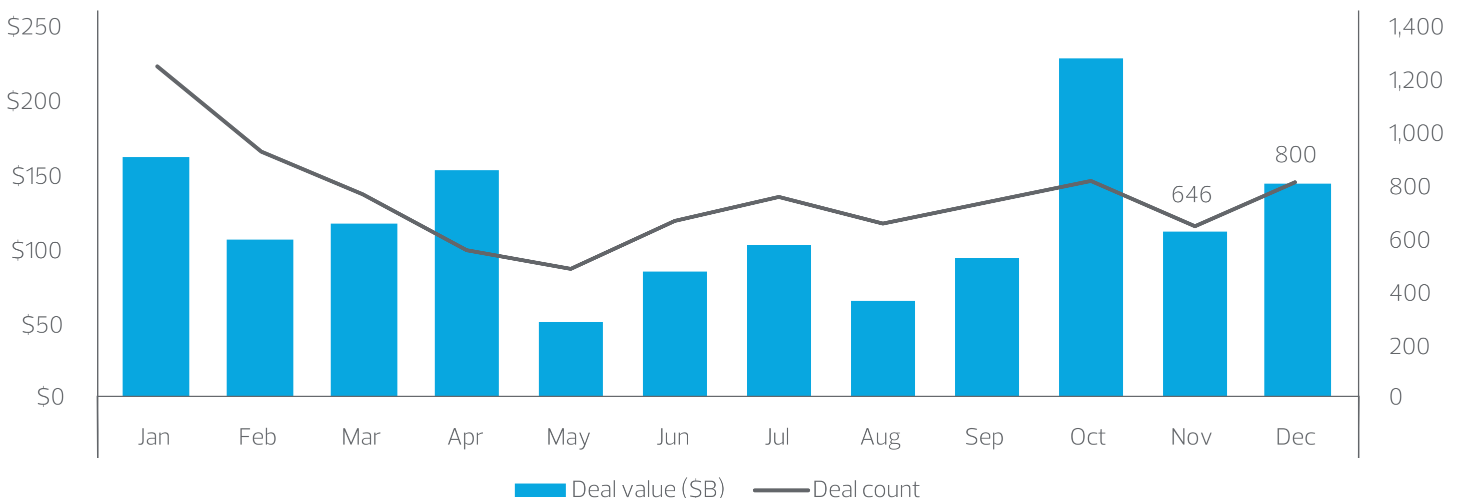
One trend that's already visible is sell-side carve-out deals. Sellers are rationalizing operations and deciding to split apart businesses or products as a way of maximizing their individual valuations and focusing on core business. This is a trend we expect to continue throughout 2021, as both opportunistic competitors and PE firms alike will capitalize on this trend. One major factor is sector. Some business lines and products are less affected by COVID-19 than others. Many subsidiary companies have actually benefited from the lockdowns but aren't a core focus of the parent company; selling those business lines through carve-outs has allowed parent companies to gain both liquidity and efficiency to support their core focus.

Average and median U.S. M&A deal sizes ($M) in 2020



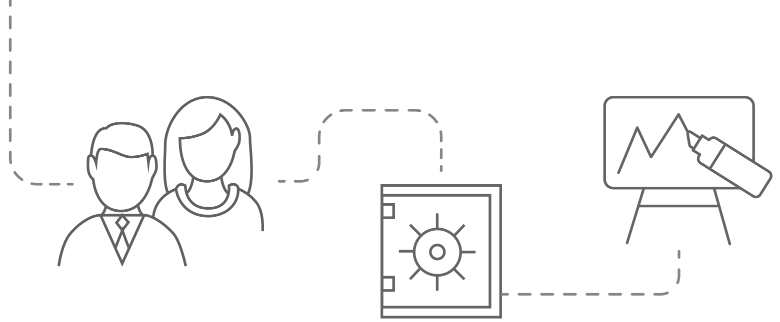
Source: PitchBook

U.S. M&A activity in 2020



Source: PitchBook

FAMILY OFFICES



Sticking to their values

Family offices have been active in the PE market for years. Like Canadian pension plans, many family offices pivoted to the direct investment model as a way of reducing manager fees without sacrificing exposure. The majority of family offices, however, don't pose direct competition to traditional PE firms. Their investments tend to reflect their mission statements and values. Their portfolio companies also tend to be family-owned businesses and are held longer by family offices, precluding a wide swath of the PE market from meeting their investment criteria. In addition, today's family offices are navigating a generational shift in ownership. Older generations were more focused on generating yield and growing their asset bases. Newer generations are turning their firms' attention to companies that promote good behaviors that benefit both themselves and the world. Mission statements and values are slowly redeveloping.

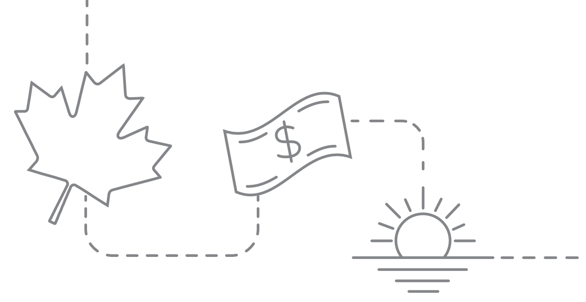
Did COVID-19 change anything for family offices?

We expect to see more family offices form in the years ahead, thanks to the IPO boom and more billionaires being minted. We also expect to see more deal opportunities emerge given the nature of the health care crisis, which has led to a willingness on the part of many family-owned businesses to sell to family offices specifically. A significant number of family-owned businesses don't want to sell to traditional PE firms right now. Concerns around layoffs and the impact they would have on local communities make traditional buyouts a nonstarter. Family offices, on the other hand, represent potential buyers for families looking to hand over control after a tumultuous year.

That said, family offices are likely to be just as selective as they were pre-COVID-19. Because of their chartered mission statements and permanent capital structure, family offices tend to be more patient and less opportunistic than traditional investors. We think those tendencies will continue in 2021, despite a massive amount of disruption in family-owned businesses across multiple sectors. Because family offices operate without the constraints of LP funding, we also see potential for creativity in 2021. Family offices can offer unique equity contributions to distressed businesses, partnering with operational-focused investors who can take majority stakes in hard-hit companies.

BECAUSE FAMILY OFFICES OPERATE WITHOUT THE CONSTRAINTS OF LP FUNDING, WE ALSO SEE POTENTIAL FOR CREATIVITY IN 2021.

CANADIAN PENSION PLANS



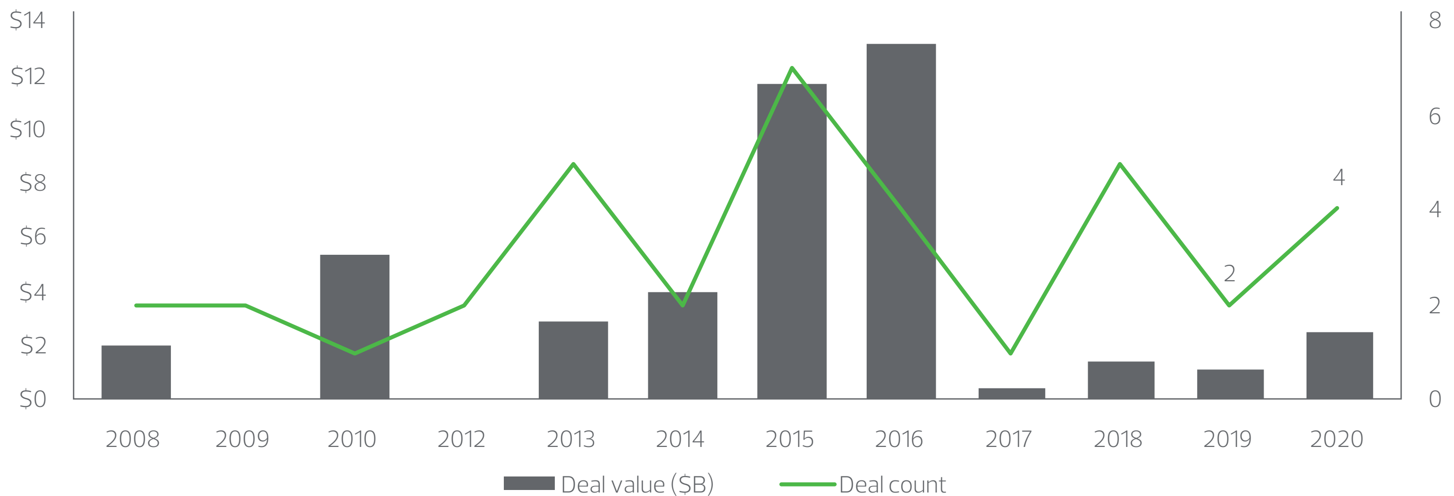
The value of permanent capital

Canadian pension plans have moonlighted as nontraditional PE firms for over two decades. Like family offices, Canadian pension plans have historically been active LPs in PE funds but have shifted focus to more direct and co-investments to minimize manager fees and generate further returns. For several reasons, US pension plans have not transitioned to direct investments, opting instead to remain LPs only. Because of their permanent capital bases, Canadian pension plans can be selective in which deals to pursue, which can lead to uneven trends in deal activity.

Patience and creativity

As a whole, Canadian pension plans will enjoy comfortable levels of liquidity heading into 2021. The majority of plans, according to Fitch Ratings, have "sufficient cash and short-term investments to repay all outstanding debt." With healthy liquidity and no LP agreements, Canadian pension plans can approach 2021 with a creative mindset around what types of deal structures they'd like to pursue and more. We expect these firms will have a larger appetite for co-investing, supporting more existing deals instead of sourcing them on their own. We also expect them to remain active as direct investors, since pension plans on a broader level will have more pressure in 2021 to provide returns for their members. If PE market activity resurges, Canadian pension plans will have significant opportunities to co-invest on deals they find particularly attractive.

U.S. PE deal activity with Canadian pension plan participation



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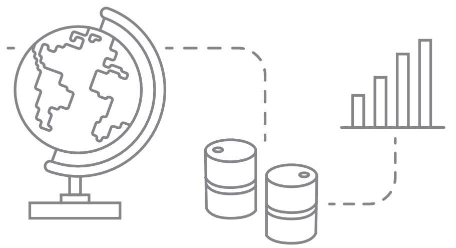


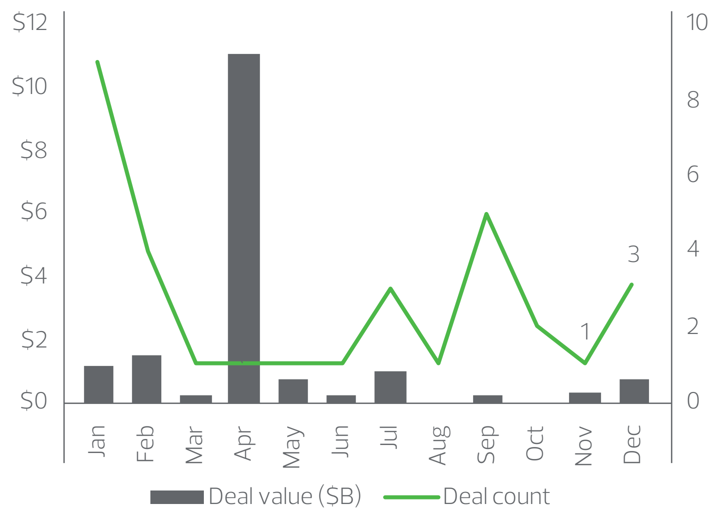
SOVEREIGN WEALTH FUNDS

SWFs have become a reliable source of capital for PE buyouts. As LPs of the funds themselves, SWFs have negotiated their way into co-investments in certain deals. The past decade reflects how successful those negotiations have been, rising from just four co-investments in 2010 to 43 in 2019. Those minority deals have almost exclusively been upper-market deals, given the close relationships between SWFs and blue-chip firms such as Apollo and Blackstone.

Little appetite going into 2021

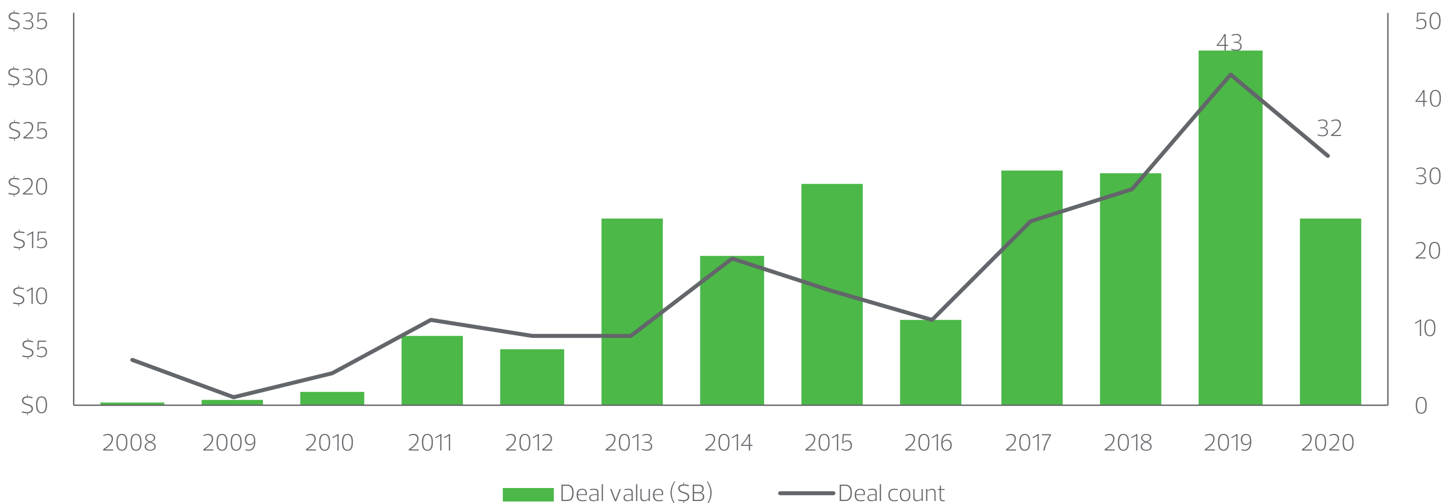
Coming off a record 2019, SWF co-investment activity slowed dramatically in 2020. Six of 12 months in 2020 saw only one transaction apiece that included SWF participation, according to PitchBook Data. The value generated by deals with SWF participation in 2020 was half of what it was 2019, sitting at $16.9 billion. Unlike the broader PE market, however, SWF deal activity did not see any momentum swings in the back half of the year. SWFs are selective by nature, and the drop in upper-market deal activity gave them fewer options to consider. Some of them were also hamstrung by the steep decline in energy prices, and asset allocation adjustments became a bigger priority than opportunistic co-investments. Whether deal flow picks up for them in 2021 depends on the health of the $1 billion-plus buyout market. High-end valuations recovered more quickly compared to the core middle market and lower middle market, which propelled deal volume during COVID-19. Once attractive opportunities resurface, we expect SWFs to return to pre-COVID-19 PE activity levels.

U.S. PE deal activity with SWF participation in 2020



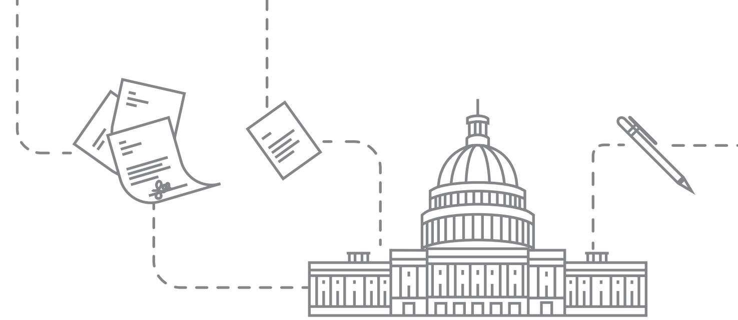
Source: PitchBook

U.S. PE deal activity with SWF participation



Source: PitchBook

IMPLICATIONS OF A NEW ADMINISTRATION



Change is coming, but how much?

Investors of all stripes have voiced uncertainty around taxes and regulations as a new administration takes power. Because the U.S. Senate is now split evenly at 50—50, with a tie-breaking vote for the Democrat Party, gridlock is expected despite a unified government. As a candidate, President Joe Biden vowed to increase the corporate tax rate from 21 percent to 28 percent, in addition to raising taxes on businesses and the wealthy. Large-scale tax increases will be viewed as divisive, according to RSM US LLP Tax Principal James Alex, and any significant piece of legislation will require the Democrats to keep all 50 Senators on the same page. The last time this scenario played out was in 2001 under former President George W. Bush. The Republicans' legislative agenda was constrained in that term, and we expect a similar scenario to unfold over the next two years. In a recent on-demand webcast, What will unified government mean for tax policy in 2021?, James Alex is joined by RSM Public Affairs Leader Dan Ginsburg and National Industry Tax Leader Matthew Talcoff to discuss a range of potential developments in 2021 and 2022.

Federal spending has intensified due to COVID-19, and the federal budget will need additional tax revenues to meet its obligations. Democrat legislation could spur general partners to sell certain portfolio companies ahead of schedule. Another option is carried interest, a perpetual political football that will once again be scrutinized. Changes to long-term capital gains rates are also under discussion. Those proposals, which would have an impact on family offices as well, are potential revenue generators for legislative items such as infrastructure spending.

As Biden's SEC chairman, Gary Gensler will be able to influence rule-making around transactions and whether those transactions can be approved or not. In the meantime, the Treasury Department recently finalized the carried interest rules of the 2017 tax law. The rules surrounding the definition of raising or returning capital continue to be somewhat unclear, eliciting potential issues for family offices and similar arrangements. For more information, please see RSM's recent piece, IRS and Treasury release final carried interest rules.

In addition, the IRS and Treasury Department have finalized additional regulations around business interest expense limitations. 2021 Final Regulations provide relief for certain self-charged lending transactions when a partner, who owns a direct interest in a partnership, lends money to that partnership, thereby creating interest income. To learn more, please read RSM's recent tax alert, IRS partially finalizes passthrough interest limitation regulations.

On the deal-making side, we continue to see a divergence in actual and perceived market prices. Anthony DeCandido, an RSM partner in financial services, expects reconciliation to come in the form of deal terms typically seen in recessionary environments. Tools such as deferred consideration mechanisms, indemnification, opt-out terms and earnouts are expected to be used more often in 2021.

OTHER RESOURCES

The Real Economy

A monthly publication to help the middle market anticipate and address the distinct issues and challenges facing its businesses and the industries in which they operate. Recent issues feature the impact and responses to the COVID-19 pandemic. Read more.

Industry Outlooks

A collection of sector-specific insights developed by RSM's industry senior analysts, that offer a data-driven approach to industry research, examining the impact of economic factors, including earnings, competitive landscape, consumer behavior, capital flows, mergers and acquisitions activity, supply chain, labor and more. Read more.

RSM US Middle Market Business Index monthly updates

To better track the impact of COVID-19 on middle market business sentiment, RSM is measuring and reporting the MMBI monthly during the pandemic. Find the monthly updates here.

Developed in partnership with PitchBook

Focusing on the middle market, RSM has been working closely in with independent private equity and venture capital research firm PitchBook to keep up to date with trends and strategies happening in the private equity industry. Together we seek to bring our clients relevant and impactful information that can help them navigate the challenges they face and move forward in their business with confidence.

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