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Research Paper

Private Markets Update

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October 2020

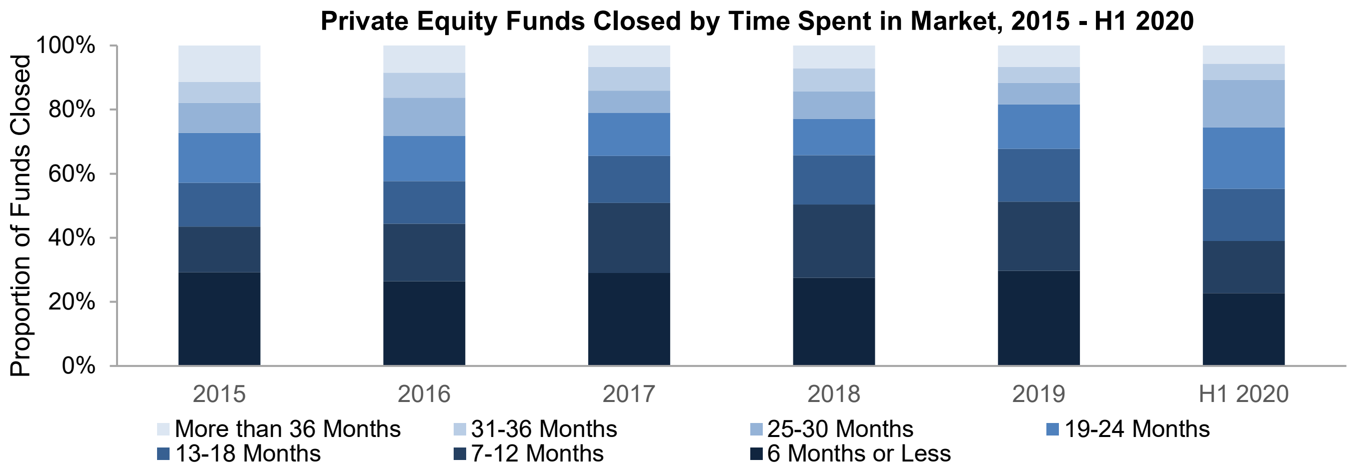
As the effects of the pandemic continue to ripple across markets and the economy, private market investors are getting a first look at actual data points from the second quarter. Everybody knew activity slowed, but by just how much was still relatively unknown as LPs and GPs both adapted to conducting diligence and day-to-day tasks in a virtual world. The sudden and dramatic slowdown in what was ultimately a pre-packaged recession had implications on capital deployment, fundraising and just about every other aspect imaginable. However, as we turn the pages into the third quarter, activity seems to be picking up again.

Private Equity

Global fundraising activity slowed in the first-half of 2020, albeit not to the degree that was seen within the Mergers & Acquisitions (M&A) and transaction market.

Private Equity (PE) saw a total of $259 billion capital raised in the first half of 2020, a 4.1 percent decline relative to $270 billion raised during the same period last year, according to Preqin's Private Equity Quarterly Update for Q2 2020. This was, however, still above the $236 billion recorded in the first half of 2018. Per the same report, 552 funds closed during Q1 and Q2 of 2020 marking the lowest number seen in the first two quarters of the last five years as well as a decline of 30.9 percent year-over-year (YoY). A spike in the number of "dislocation" or "opportunistic" funds attempting to take advantage of the sharp downturn in public markets aided the total fundraising numbers.

Despite a relatively benign drop in dollars raised, managers faced a more challenging fundraising market during the period as seen in Preqin data reporting that 23 percent of the funds closed spent six months or less in the market, while 39.0 percent of those closed within 12 months. This is in comparison to 30 percent and 51 percent, respectively, for the whole of 2019.

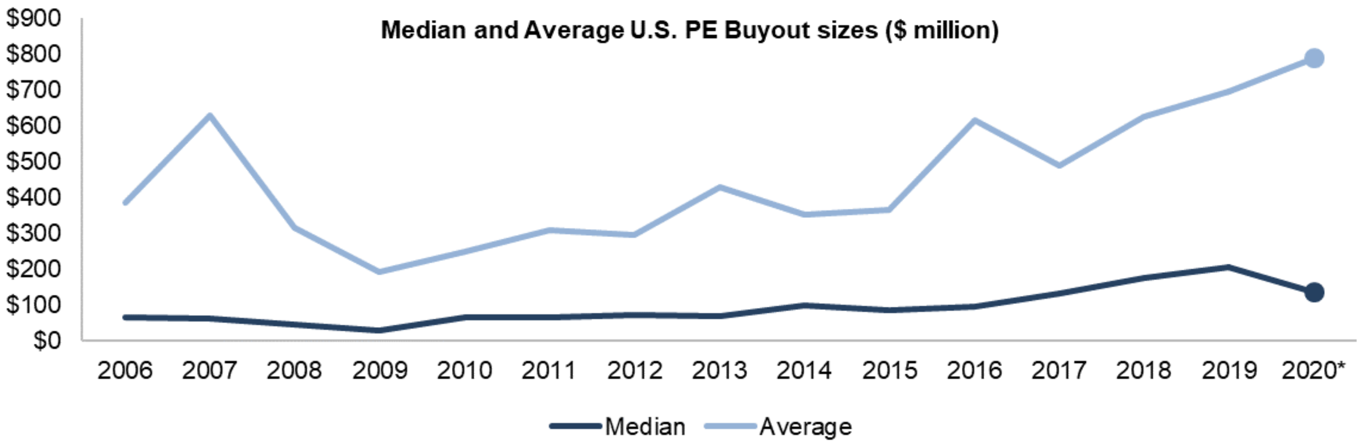


Source: Preqin Quarterly Update: Private Equity Q2 2020

Much of the lengthened duration is directly attributable to LPs determining their new budgets, according to Preqin's Private Equity Quarterly Update. Thanks to the wild swings in public markets, most portfolios felt the denominator effect which resulted in a larger than budgeted private equity allocation given the drop in overall portfolio value. This quickly reversed over the summer months, but serves as a good reminder to all LPs to ensure they have proper liquidity and risk positioning. Further, an inability to travel slowed some groups, as many LPs decided to focus on existing and established relationships rather than forging new ones during the uncertain time.

Transaction activity slowed drastically during the first half of 2020. Per Pitchbook, a total of 1,678 Private Equity deals raised $246.2 billion in the U.S. The greatest number of deals came from the Mid-Atlantic region at 302, followed by the Great Lakes and West Coast with 281 and 279 deals, respectively. The Southeast region raised more capital than others with $51.5 billion, followed by the West Coast with $44.9 billion. Furthermore, of the $246.2 billion raised by buyout deals in the U.S., 386 deals falling in the $100 million - $500 million range saw the largest inflow with $106.4 billion, while 825 deals falling under $25 million range saw the most number of deals raising just $8.4 billion.

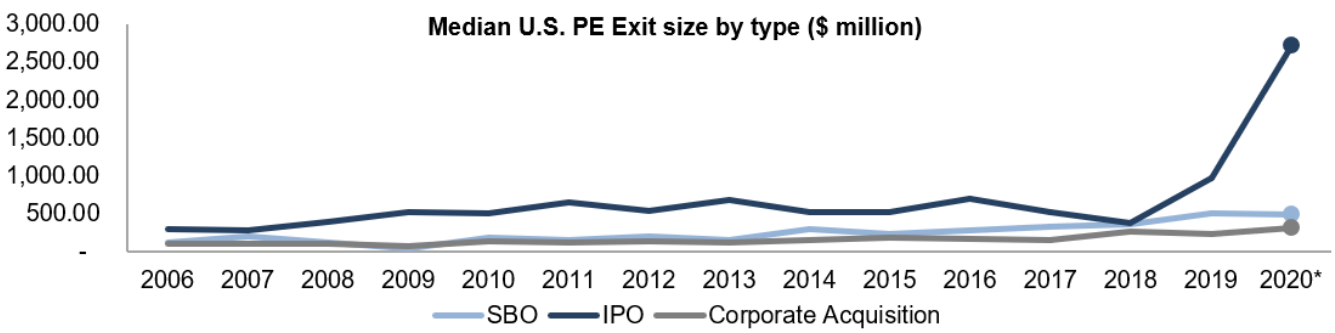
This reiterates our opinion of the attractiveness of the middle market and lower middle market space in the industry. As per Pitchbook, the second largest capital deployment was spread across seven deals that were valued more than $2.5 billion and raised around $58.5 billion, highlighting continued valuation disparity between larger deals and lower middle market deals.



*Source: Pitchbook's Q2 2020 U.S. PE Breakdown; *As of 06/30/2020*

Moreover, the Pitchbook data also showed that in the U.S., buyout transactions that made up for 23.5 percent of the total number of deals, had an average size of $786.6 million, higher than whole of 2019's $694.2 million. This is mainly the result of a few larger deals that were executed in the market by a consortium of larger funds. As you can also see, median deal size fell to a level equivalent with 2017. This is reflective of more add-on activity in Q2 and less investments in new platform companies. As a result, PE backed deals accounted for 17 percent in overall M&A activity, the highest share in the last 13 years[1].

Due to the upsurge of COVID-19 halting daily life and shut businesses, Q1 and Q2 of 2020 recorded a median U.S. PE buyout debt/EBITDA multiple of 5.4x and EV/EBITDA multiple of 14.3x, as per Pitchbook data. This increase in valuations is largely a result of decreasing EBITDA caused by a tighter economy.



*Source: Pitchbook's Q2 2020 US PE Breakdown; *As of 06/30/2020*

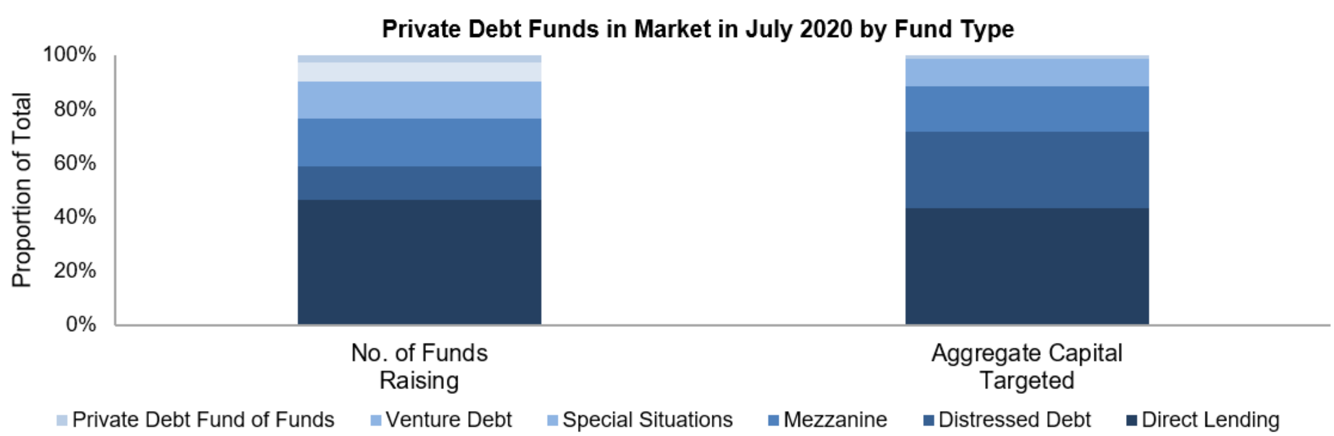
[1] According to data from Refinitiv

Interestingly, data from Pitchbook also showed that the first half of 2020 had 309 exits collecting $110.9 billion with a median size of $357.3 million relative to 2019's annual figure of $340 million. Given the more limited IPO market, the median exit size was larger for companies going public, but companies acquired by corporates or through a secondary buyout gained more exit value.

Private Debt

The number of funds raised in H1 2020, as reported by Preqin, declined to 85 funds relative to H1 2019's 95 funds. Capital raised during the period, however, saw an uptick with $55.5 billion compared to $54.4 billion raised in the first half of 2019, as per the same source. Of these, 39 funds or $31 billion were raised in North America, while 20 funds of $16 billion were European.

Preqin also reported that the first choice for a majority of the investors was direct lending platforms, which attracted $18 billion followed by special situations with $15 billion and distressed debt with $10 billion. The number of funds in the markets were also led by direct lending platforms with 28 funds, followed by venture debt with 13 funds and distressed debt with 12 funds, of which 9 funds raised $9.7 billion during Q2 2020. Special situations, on the other hand, had eight funds in the market during the first half of 2020 with five of these funds raising $12.2 billion in just Q2. In our opinion, the growth in special situations and distressed platforms was clearly driven by the economic conditions.



Source: Preqin Quarterly Update: Private Debt Q2 2020

Lastly, as of the end of the second quarter of 2020, there were 486 funds in market, led by direct lending and mezzanine platforms, looking to raise $239 billion. This was much higher than the 436 funds that were looking to raise $192 billion at the end of 2019.

Private Real Estate

According to Preqin, Global Closed-End Private Real Estate (PRE) activity slowed in the first half of 2020 as 131 funds raised $67 billion as compared to 196 funds that raised $88 billion during the same period last year. Most of those dollars came in during the second quarter even though the number of funds during the period declined relative to Q1 as investors committed more to lesser number of funds.

Per the same source, North America led the fund-raising efforts in PRE as well with 52 funds securing $30.7 billion followed by Europe with 35 funds raising $19.2 billion. Furthermore, value-add and opportunistic space raised $39.1 billion through 58 funds, more than any other space, as investors relied more on the opportunistic category in the second quarter.

As the semi-annual period for 2020 came to an end, PRE market had 903 funds looking to raise $273 billion, 52 percent of which were in the value-add and opportunistic space followed by 18 percent in PRE debt.

In conclusion, as the economy slugged through the COVID-19 pandemic, private markets experienced a plodding activity too. It is during these uncertain times that control-oriented investing is able to flex, thus capturing market share, growing earnings and ultimately creating a higher quality business. As we transition into the back half of 2020, we expect activity will return as investors look to deploy capital at what they hope will be depressed prices and LPs will continue to commit capital as everybody adapts to the newest set of challenges.

For more information, please contact any of the professionals at Fiducient Advisors.

About the Author

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As a member of the firm's Private Markets Research Team, Pooja is responsible for performing due diligence on private equity managers for potential inclusion in client portfolios. Prior to joining the firm in 2019, Pooja served as a Junior Analyst, Investment Research & Analytics at Aranca Pvt., Ltd. and an Equity Research Associate on the University of Rochester Simon Business School's student managed long-only Meliora Fund. Pooja holds a Bachelors of Business Administration from the Narsee Monjee Institute of Management Studies. She also earned a Master of Commerce, with a concentration in Accountancy, from the University of Mumbai and holds a Masters of Science in Finance (A STEM-Certified Program) from the University of Rochester Simon Business School. In her free time, Pooja enjoys writing short poems and traveling.