finnCap GROUP

2021 in review
A year of remarkable success

JANUARY 2022

Our entrance into 2022 brings with it a good time to reflect on the events of the year that was. 2021 offered an unparalleled level of deal flow. Despite three national lockdowns, the private equity industry continued from strength to strength in the face of adversity, and its prospects for the future look ever better.

Continued overleaf.

2021 in review

Despite the immense pressure and damage limitation for portfolio businesses (in some cases), lockdowns actually proved more of an opportunity than an obstacle for many investors. The volume of successful completed transactions and the flood of PE sector deals shows private equity is still a massive driver behind keeping the British economy afloat.

During the government furlough scheme, private equity played a key role in ensuring their portfolio companies were well capitalised and management teams of their assets were well supported. This helped to bolster and support certain parts of the economy through what would always have been a challenging year. Notably, this included aiding certain parts of the consumer sector, especially within leisure and hospitality, to recover quickly from the loss of business in the first half of 2021.

A sign of confidence

Private equity has often been tarnished with a bad name. The past 12 months has proven that, rather than being the villain of the piece, private equity has helped aid financial recovery due to the amount of dry powder deployed and helping the government furlough. This was flagged in Chancellor of the Exchequer Rishi Sunak's vote of confidence in the last budget meeting at the end of October 2021, where he stated that "private equity interest should be seen as a sign of confidence in the UK economy."

In many cases, working for a PE-backed business gives the employees faith in the future, reassured that risks will be mitigated, and opportunities seized. This stems from the fact that private equity investors will always have a constant eye on the asset's future, in order to achieve the trajectory of growth – how it progresses not only in terms of changes in personnel and management, but also, and importantly, revenue growth and EBITDA uptick leading to a strong financial return for their investors on realisation. This approach doesn't just benefit the shareholders and those invested in the funds or assets, it benefits the employees. Ultimately the people who make those portfolio companies are a key part of generating revenue and making sure the returns multiples on those investments remain high.

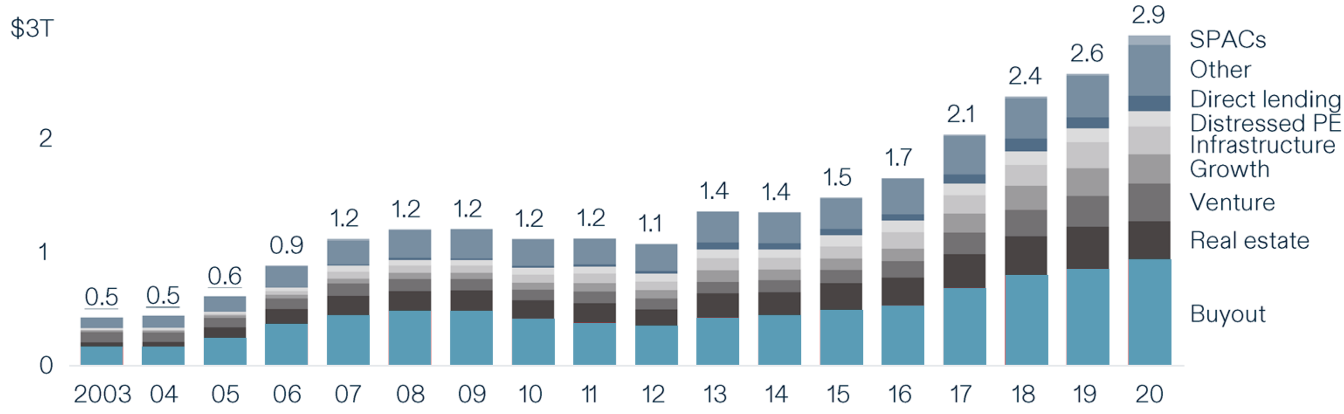
2021 in review Cont.

Record levels of dry powder that were ready to deploy in Q1 of 2021, by virtue of dividend recapitalisation and portfolio realisation, has allowed limited partners to reinvest equity into new funds. This fund activity not only shows promise for Q4 of 2021, it also points to a positive outlook for excessive levels of growth in the coming year. And alongside these future growth prospects, there are a variety of major trickle-down effects.

First, the fundraising cycle is being accelerated. Larger funds than ever are being raised. In 2021, the average PE fund size reached around £600m, the highest valuation since records began in 2006. In addition to this, PE allocations are being increased as investors begin to realise the pay-off in a sector where its performance is becoming increasingly lucrative.

Meanwhile, we are still seeing the continued rate of committal of capital from the first two quarters carry well into Q3 and the beginning of Q4, with no view of slowdown. This leads to an issue that we see time and again – that valuations are sky high, but the scarcity of high-quality assets coming to market means that clients are potentially paying at inflated prices. Aside from this, investors will see risky valuations on multiples, which means it is harder to get the deal away.

Global private uncalled capital, by fund type



	2003	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20
Buyouts ($B)	199	188	275	398	479	515	512	453	417	386	460	476	527	568	724	829	891	970
Buyouts and buyout SPACs ($B)	199	188	276	400	485	517	512	453	417	386	461	477	529	570	729	834	898	1,012

Notes: Other includes fund-of-funds, secondaries, natural resources and mezzanine; buyout includes buyout, balanced, coinvestment and coinvestment multimanager funds; SPACs fund-raising used as best proxy for SPACs dry powder; buyout SPACs estimated as approximately 50% of total SPACs directed to buyout deals; discrepancies in bar heights displaying the same value are due to rounding
Sources: Preqin; Thomson Reuters; SPACInsider; Bain analysis

"We experienced exceptional levels of deal activity on both the buy and sell side in 2021 and we are optimistic about 2022 prospects as deal flow and momentum continues to be strong."

Michael Coupland
Investment Director at Connection Capital

The major players

How business services and TMT drove deal flow and investment in 2021

The first half of the year showed business services and TMT were the key drivers for H1 within mid-market private equity, with 62% of investments being in these two sectors (KPMG, Aug 21). Not only did they account for the largest deal volume, but TMT was a clear leader in terms of the deal valuations, with TMT deal values soaring from £2.8bn in 2020 to £5.1 bn in H1 of 2021. Alongside excessive deal volume and value, there has been a flourishing number of mid-market multiples, as they reach the highest they have been since 2017 of up to 11.9x earnings.

For Q3 of 2021, private equity has continued to chase the technology sectors - which offer high levels of performance. Furthermore, in the changed landscape of a post pandemic Britain, tech-enabled and software as a service (SaaS) products provide an appealing route for investors. This is partially propelled by a move to hybrid working, with many offices adopting a reduced office work week and encouraging more to work from home. For younger generations, the benefits of remote education can also be observed.

The popularity for MBOs and investment within tech-enabled and SaaS companies is shown through a tangible increase in growth from £3.3bn in 2019/20 to £8.4bn in 2020/21. This colossal flow within AIM has largely been driven by deals within the tech sector, and private equity is at the forefront here. In 2021, AIM serviced the interests of the tech sector and the assets within that sector successfully. Major tech players as well as actors in the private equity sphere are now monitoring for future targets of acquisition in the AIM space.

All other research points to the main source of the boom in the private equity market being driven primarily by the tech sector. The growth rates within UK technology have done a full turnaround during the pandemic, progressing from seven-year lows to seven-year highs. Likewise, the acceleration of growth since the pandemic is demonstrated by EV and EBITDA multiples trading at elevated levels. The current state of the technology sector and its performance in the past 12 months points to a promising 2022. If current trends persist then a continuance of growth in the tech sector can only indicate a positive outlook for the coming year within private equity industry, too.

Forecast for 2022 and beyond

If we delve deeper into the world of SaaS globally, it's clear this sub-sector of tech will be the vanguard for deals in 2022. In 2021 alone, the global private equity industry invested over £13 billion into only 106 enterprise tech companies, that's an average of £122.6m per deal. The top five most active firms for investing within tech, according to data prepared for Protocol by Pitchbook, are HG Capital, Vista Equity Partners, Providence Equity Partners, ABRY Partners and TA Associates Management, respectively. However, the increase in tech deals provides a wealth of opportunities due to this increase in competition from the amount of SaaS assets in the space available. Higher acquisition costs have made the task of acquisitions of smaller SaaS businesses more difficult. This links to the previous issue of not enough high-quality assets coming to market, with an excess of capital pursuing an insufficient amount of assets or potential deals.

The future of SaaS

The future of SaaS as it evolves may have some influence over the potential trends of 2022. First, there needs to be an increase in the calibre of SaaS products. No matter what service the software provides, if the tech behind it works smoothly and is easily applicable, then SaaS may start to be accountable for a large part of our lives. The pervasive nature of SaaS means that, potentially in the future, there will not be an initial sub-sector of SaaS because most software will be delivered along these lines. The beauty of SaaS also lies in its cross-sector appeal. It can be software as a service for business services, consumer (in particular D2C and e-commerce), or anywhere where its application can be of use. We may begin to see similar patterns with tech-enabled assets as we enter 2022, and as SaaS pervades more corners of our day-to-day life, it is up to PE investors to monopolise on this phenomenon as it expands.

Growth capital drives progress

Growth capital is another key driver for trends in 2022. Mergermarkets and Dechert have coined it as one of the fundamental sources for progress in the private equity industry for 2022. A survey they conducted showed that 84% of the PE fund managers interviewed currently invest in growth capital deals from their funds. The appeal of growth equity also lies in the idea that the asset is already generating profit and the model is reliable. This also benefits the asset, which on receiving an extra injection of capital, can work on further acquisitions and expand its market or product range in order to build out the business and increase revenue. The small downside to this is growth equity investors will not have a controlling stake in the business, whereas leveraged buyout (LBO) investors could more easily steer the future of the company and have more authority over the outlook of the asset. However, overall growth equity is increasing from well-established PE firms due to the prospects of accelerating the growth of the asset. In 2022, an escalation in growth capital deals in terms of returns on investment is looking more appealing than ever for investors.

Forecast for 2022 and beyond Cont.

SPACs: An attractive investment class

The proliferation and rise of the special purpose acquisition company (SPAC) was a hot topic in Q1 of 2021. In the past eight years, the number of SPACs has risen from 10 in 2013 to over 200 in 2020. SPACs bring both challenges and opportunities for private equity; many PE firms have a history with SPACs. The beauty of SPACs is that they can work in conjunction with PE houses, as 30% of companies identified by SPACs were owned by PE. SPACs can help bring equity investment to an asset through use of sponsors, as sponsors seek not only to deploy more of their capital but also to put it into a range of different asset classes. PE sponsors' use of SPACs is attractive as an alternative investment class. They also offer exciting investment potential. This is demonstrated by TPG and the Gores Group (two well established PE firms) having in aggregate backed nine SPACs from 2015 onwards (as of April 2020).

SPACs function in all sections of the market in private equity, from mid-market firms such as LCatterton ranging all the way to J.F Lehman and Company and the Blackstone Group. These private equity firms have exited their investments of their portfolio companies and sold them on to SPACs. The relatively small primary investment followed by a more short-term horizon of the investment and the potential for high returns hold a large part of the appeal of SPACs, for Private Equity investors. The interests of SPACs and the private equity industry often align, as private equity houses hold key skills and resources for the smooth running of a SPAC deal; ranging from the private equity firm's ability to conduct thorough and proper due diligence, through to the use of the PE firm's extensive network to drive through the deal and contribute to the growth narrative of the SPAC. The rise of the SPAC as an investment vehicle should be capitalised upon in 2022, as we have seen from the past year an increasing number of PE firms, sponsors and investors see them as a preferential deal type.

"The various UK lockdowns during 2020 and early 2021 created significant opportunities for some sectors but presented challenges for many UK SME's, however as the initial disruption subsided and the economy bounced back, many businesses then found supply chains stretched and they encountered challenges on scaling up operations. Many businesses through this period have taken the opportunity to re-evaluate business models, shorten and simplify supply lines, adjust to hybrid working and have focussed on driving operational efficiencies as the economy has rebounded. Surprisingly, through this disruption the M&A market has been extremely buoyant, albeit polarised, those businesses with strong fundamentals have traded at record multiples whilst many impacted by the fallout from Covid put exit or M&A plans on hold. Evaluating businesses in what has been a sellers' market has been challenging with investors seeking to determine the 'new normal' for businesses both positively or negatively impacted by Covid. Looking forward to 2022 with many sectors returning to pre-pandemic levels, longer trading periods to assess and shareholders revisiting their exit plans, it is likely the M&A market will continue to thrive in 2022. We may also start to see the long heralded balance sheet recapitalisations as businesses seek to refinance debts taken on during the pandemic and they may look to take on growth capital to support their expansion plans. There are however headwinds, with higher levels of inflation and increased interest rates putting pressure on the wider economy and supply chains and talent continuing to be a challenge in the board room."

Charlie Pidgeon, Partner at NVM Private Equity

Forecast for 2022 and beyond Cont.

Risky business

It would be remiss not to acknowledge that barriers to the excessive deal flow and growth we have seen within 2021 may arise in the next six months. The obstacles to growth within the private equity industry could, in part, emerge from the excess of dry powder currently circulating. Funds are facing excess pressure to deploy their capital. As we enter into Q3, shareholders and investors in the funds want to see that deployment. Supply exceeds demand in this case and it's a question of time - could this lead to more risky investments as fund managers pushed for time may make riskier moves to get the money deployed in time?

According to a Mergermarkets study, over 35% of individuals questioned signalled that the quantities of dry powder and ability to put capital to work is 'one of the biggest challenges facing the industry'. Any changes to this supply of capital may shift come March 2022, with some economists predicting a change in Capital Gains Tax. Chancellor Rishi Sunak has been accused of 'swerving' previous changes at the end of October 2021, indicating that perhaps he will be held accountable to increase these taxes in the next budget meeting. An increase in CGT would reduce the amount of breaks in tax available to PE houses and investors, that could reduce the amount of capital available to deploy come Q2 of 2022 if these changes go ahead. However, Sunak's approach to private equity, as previously mentioned, seemed positive at the last budget meeting in Q3 of 2021. This could suggest that the current Conservative government and leadership does not want to limit the capabilities of a section of the economy that has buoyed the nation through the past two years of economic insecurity and furlough.

A surge of investment

Support for AIM and in particular private equity isn't only coming from government officials and policy formulators; it is also coming from investors.

A recent study by the FT highlighted a surge of investment into private markets. This will have significant consequences not only for the outlook for 2022, but for private equity for the next five years. Private capital investment is forecast to mature dramatically in the next four years amounting to £12.7 trillion dollars, based on current levels of growth.

In the alternative asset class, private equity is the dominant growth sector, with PE anticipated to increase at 15.6% a year until 2025. The next highest sector is private debt coming in at 11.4% with other alternatives projected at around 5% or less per annum. This is down to an assortment of factors, ranging from reduced levels of volatility with private assets (especially pertinent in the case of recent lockdowns affecting the markets) to higher returns in exchange for liquidity. These statistics indicate that AIM, and private equity in particular are progressively becoming the preferential asset class for investors looking for a reliable return on their investments in a thriving industry.

Carbon reductions and ESG

ESG is growing as a key deal driver. It's been shown to be not only for investors and PE houses but for any company that wants to be seen as a sustainable prospect. This means that companies should not only be financially sustainable, but also socially, environmentally and climatically sustainable. Corporate social responsibility is at the top of most PE houses' and investors' agendas.

Measuring the corporate carbon footprint and environmental impact during the private equity buyside process is a primary part of this, as part of the ESG due diligence and the expectation for associated reporting will become more and more prominent. finnCap Group now has a company carbon tracker tool using our ESG Scorecard and Guidebook in order to help businesses monitor and report on their ESG goals. In the wake of the recent Glasgow COP26 meeting, world leaders have been pressed to follow-up on implementing policy pledges. Considering the PM's current pledge for carbon neutrality in the UK by 2050, it is likely that further policy changes will come into play in the UK. This could affect how assets function as they are held to account by new government rules and regulations on carbon measurement and reporting. The government is moving to make corporate net-zero transition plans mandatory, and investors are being pushed to use their influence to encourage more ambition or accelerated progress.

Sustainable business models

ESG is also at the forefront of limited partners' minds. A Mergermarket study has shown that in the EMEA region, 49% of people expect LP scrutiny of ESG reporting and ESG issues to significantly increase in deals over the next three years, with 31% believing there will be a moderate increase. ESG in terms of mergers and acquisitions has become more pertinent as companies are now utilising M&A to improve their ESG credentials. Within the M&A deal scope, this can be seen through the financing and due diligence processes. It can also be seen at the very start of the process with the selection of the target, as almost 90% of target companies are reviewed on their ESG credentials and framework.

The emphasis on ESG within investment banking is shown by newly created roles solely for ESG analysis alone, something that even ten years ago would have been almost unheard of. It shows the positive aspects of not only the companies and assets, but also the investors and PE firms taking a forward-thinking approach based on sustainable principles. It can be shown that investing in sustainable companies or solutions, not only protects natural resources and prevents climatic deterioration, it also drives superior financial performance. For investors, opportunities range from the increased shift away from investment in fossil-fuel based energy sources to renewables. Another aspect is the rising popularity in climate tech, with investor appetite for this leading to predictions of 500 to 1000 unicorns in this industry coming to the fore in the next three years. On a smaller scale, it can be as simple as making sure that the asset invested in has the right credentials or strategy for it to uphold scrutiny from shareholders on ESG matters, and that it will adhere to any associated government policy changes.

2022: A bright future

Looking ahead through 2022, it is clear that private equity as an alternative investment vehicle provides an exciting prospect and fast-paced market, not only for investors but also for those working within the industry. In 2021, private equity emerged from the global pandemic better positioned than ever to adjust and evolve to changes within the market and monopolise on opportunities presented. With unparalleled amounts of dry powder poised to deploy this year, we can hope to see the incredible amounts of deals over the past 12 months potentially being surpassed. PE houses can deliver the ambition promised to investors whilst themselves profiting from the current state of the market, safe in the knowledge that investment has been conducted in a sustainable fashion.

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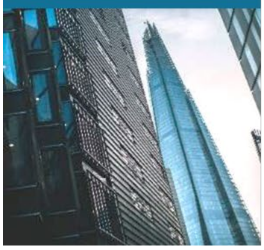

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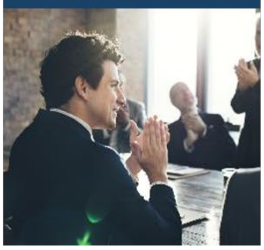

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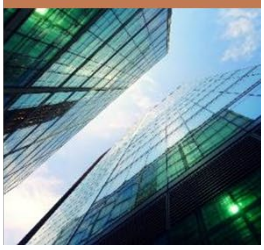

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