PRIVATE CAPITAL QUARTERLY

THIRD QUARTER 2020

INSIDE THIS ISSUE

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investment advisors

Transitions are hard. No one knew this better than the late singer and songwriter David Bowie. In his song, "Changes," Bowie reflects on his personal struggles with a successful music career. The self-deprecating lyrics describe an artist grappling with an identity crisis (see Ziggy Stardust). He expresses anxiety about transitioning to the next stage of his life and worries about the future. Ultimately, Bowie acknowledges that change is inevitable, its timing cannot be controlled and should not be feared. The only constant is change.

Asia's private equity markets are managing through their own "ch-ch-ch-changes." Until recently, the region's ascent to prominence in the global private equity markets seemed unstoppable; however, that growth story slowed in 2019. Heightened geopolitical risks, trade disputes, a global pandemic, and lower expected growth rates deterred institutional investors' decisions to allocate more capital to the geography. Fundraising, capital investment, and liquidity have fallen short of expectations. As investors evaluate these near-term challenges, Asia's private equity markets are facing an identity crisis. What role should they play in investors' private equity portfolios?

Asia Private Equity: Opportunities in Transition

ASIA'S GROWTH STORY

Asia's economic transition from emerging geography to major market player is not news. For more than a decade, the future growth prospects in Asia have far exceeded those of developed markets in Europe and the U.S. Countries in the region have consistently generated above-average real gross domestic product (GDP) growth rates. In 2019, the World Economic Forum forecast Asia's GDP would overtake the GDP of the rest of the world combined by the end of 2020. By 2030, the region is expected to contribute nearly 60% of global growth.[1]

China and India are responsible for the bulk of this projected growth. With populations of roughly 1.4 billion each, they are over 4 times more populous than the U.S. Collectively, the two countries account for more than a third of the global population.[2] More than 800 million millennials live in China and India.[3] As this generation ascends to the middle class, they are expected to have a profound impact on the economy.

To capitalize on this economic and social transformation, institutional investors increased private equity commitments to private equity firms focused on Asia. Assets under management for Asian-focused funds grew at an annual rate of 31% from 2015 through 2019—versus 12% for funds focused on North America and Europe during the same period.[4] The region's share of the global industry increased to 28% from roughly 17%.[5] To date, most of the capital has been allocated to venture capital and growth equity strategies. These firms tend to seek out early investments in technology-enabled consumer; technology, media, and telecom (TMT); and healthcare companies. Investors posited that these high-growth sectors should benefit from the growing middle class, their increasing disposable income, and their penchant for consumption.

MARKET HEADWINDS

Last year, investor sentiment and willingness to participate in the Asian growth story waned. Fears of an economic slowdown, geopolitical tensions, and a lack of distribution activity from legacy commitments forced investors to reevaluate their strategies. Many institutional investors paused new commitments to the region. During 2019, fundraising activity in the region fell 20% year-over-year.[6]

The COVID-19 pandemic and increasing U.S.-China trade tensions have only further depressed investor demand. A core of well-positioned, "brand name" private equity firms have raised capital with support from existing limited partners, but overall fundraising remains depressed. Through June 30, 2020, Asia private equity fundraising was off 14% from the same period in 2019.[7] As Asia contends with "growing up and out of it," market participants will need to address these challenges before investors will be comfortable allocating more capital to private equity managers in the region.

SLOW DISTRIBUTION ACTIVITY

Another challenge Asian private equity markets will need to address is the lack of distributions. Despite robust fundraising and attractive performance over the years, distributions to limited partners in Asia have been anemic. As of March 31, 2020, the median distribution to paid-in (DPI) ratio for a 2009 vintage, Asian-focused private equity fund was 0.7x.[8] By comparison, the median DPI ratios in Europe and the U.S. were 1.4x and 1.5x, respectively.[9] This comparison lends credence to the criticism, "Performance looks great on paper, but when do we get our money back?"

We believe there are several reasons for this slower relative distribution activity. First, as mentioned above, the majority of investments in the region are in venture capital and growth equity funds. Firms executing these strategies tend to hold assets longer to maximize valuations before exiting. Second, venture- and growth-stage companies have few options for generating early liquidity. Most companies have negative free cash flow, so there is little to no ability to pay investors early dividends. Unlike more mature assets, the capital structures of early- and growth-stage investments are not likely to support leveraged recapitalizations. Additionally, regulatory constraints and restrictions from government entities like the Committee on Foreign Investment in the United States (CFIUS) have delayed or cancelled merger and acquisition activity. Finally, lock-up periods for Asian-based initial public offerings (IPOs) for certain shareholders can be as long as three years. All of these factors contribute to lower and slower DPI ratios in Asia relative to other regions.

To combat these issues, the Chinese government recently launched the Shanghai Stock Exchange Science and Technology Innovation Board. Known as the STAR Market, the exchange seeks to provide an easier, less stringent path for technology companies to go public. Unlike other Chinese exchanges, the STAR Market accepts listings from unprofitable companies and from companies with unequal voting rights. Additionally, the exchange introduced a registration-based IPO mechanism for listing. Companies seeking to go public only need to be reviewed by the Shanghai Stock Exchange, they no longer require approval from the China Securities Regulatory Commission (CSRC)—a process which can take more than a year. Further, the CSRC recently relaxed the minimum market capitalization requirements for "red chip" companies incorporated outside of China.

These market innovations have transformed the outlook for exit opportunities in Asia. Venture-backed companies should have an easier time accessing the public markets and generating liquidity for investors. Since launching in August 2019, the STAR Market has listed more than 180 companies, second in volume only to the Nasdaq.[10] Notable listings include SMIC, Kingsoft Office, AMEC, and Montage. Alibaba spinout Ant Group recently announced its plan to dual list in both Hong Kong and Shanghai. Early estimates suggest the listing could raise more than $34 billion, making it the largest IPO in history.[11]

INCREASE IN CONTROL TRANSACTIONS

To date, traditional buyout transactions have largely been confined to Asia's more developed markets like Australia and Japan. However, as Asian private equity markets mature, the proportion of control buyout transactions in developing economies such as China is likely to increase. PricewaterhouseCoopers recently estimated that there are more than 25 million private enterprises in China, the majority of which are family-owned.[12] Many of these businesses were formed in the early 1990s under China's one-child policy. As China's population ages and business owners retire, many do not have heirs who want to run their businesses. As a result, owners are likely to consider partnering with a private equity firm to provide liquidity and assist with generational transitions.

Structural and government reforms across Asia are likely to lead to an increase in control-oriented, corporate carve-out transactions. In recent years, the South Korean government has enacted several policies aimed at curbing the influence of the country's "chaebol"—large, family-owned conglomerates. Collectively, the revenues of these institutions—which include Samsung and Hyundai—account for more than 80% of South Korea's GDP.[13] Chaebols are characterized by their complex ownership structures, nepotism, and corruption.

Regulations on financial reporting, transparency, and improved corporate governance will likely force the chaebol to divest from non-core assets. Private equity firms stand ready to partner with these conglomerates to execute these complicated corporate carve-out transactions.

Similarly, Japan is expected to see an increase in recapitalization, restructuring, and corporate carve-out activity. The world's third largest economy continues to be negatively impacted by an aging population. The average age of business owners and managers in Japan is 59.5 years, the highest average age in history.[14] Like in China, many aging Japanese business owners have no succession plan and will need to seek out a partner to assist with generational transitions. Further, corporate reforms and increased international competition are pushing large corporations in Japan to strategically divest non-core business assets. In August 2020, Takeda announced its plans to sell its consumer healthcare business unit to Oscar A-Co KK, a Blackstone Group Inc. portfolio company.[15]

Conclusion

"TIME MAY CHANGE ME, BUT I CAN'T TRACE TIME."

Asia's private equity markets are likely to undergo a major change in the next decade. But as Bowie understood, transitions are hard. Lower growth, social unrest, and structural reforms are just a few of the challenges Asian governments will be forced to address. Our expectation is that private equity, which serves as transition capital, should be well-positioned to benefit during these shifts. FEG feels that Asia should be considered a core private equity market for institutional private equity portfolios. That said, we caution investors to remain vigilant and continue to be selective with commitments. Investors who can look past the near-term headwinds should be able to capitalize on the trends shaping the future.

[1] World Economic Forum, December 2019, https://www.weforum.org/agenda/2019/12/asia-economic-growth/
[2] Pew Research, July 2018, https://www.pewresearch.org/fact-tank/2018/07/11/world-population-day/
[3] United Nations. 2019. "2019 Revision of World Population Prospects."
[4, 5] Boston Consulting Group (BCG), August 2020, https://www.bcg.com/en-us/publications/2020/navigating-growing-asia-pacific-private-equity-market
[6, 7] Asia Venture Capital Journal (ACVJ), June 2020
[8, 9] Thomson One, Data as of March 31, 2020, Includes Buyout & Growth Equity, Venture Capital[10] Zero2IPO Group, S&P Global Market Intelligence, September 2020
[10] Zero2IPO Group, S&P Global Market Intelligence, September 2020
[11] Barron's, October 2020, https://www.barrons.com/articles/chinas-ant-group-to-raise-34-billion-in-record-ipo-51603727148
[12] PwC's Global Family Business Survey, September 2019
[13] Korea CXO Institute, June 2020, http://english.hani.co.kr/arti/english_edition/e_business/949236.html
[14] Nippn, Teikoku Databank, February 2019, https://www.nippon.com/en/japan-data/h00397/average-age-of-japanese-corporate-presidents-continues-to-rise.html
[15] Pharma Manufacturing, August 2020, https://www.pharmamanufacturing.com/industrynews/2020/takeda-to-sell-japan-consumer-health-unit-to-blackstone/

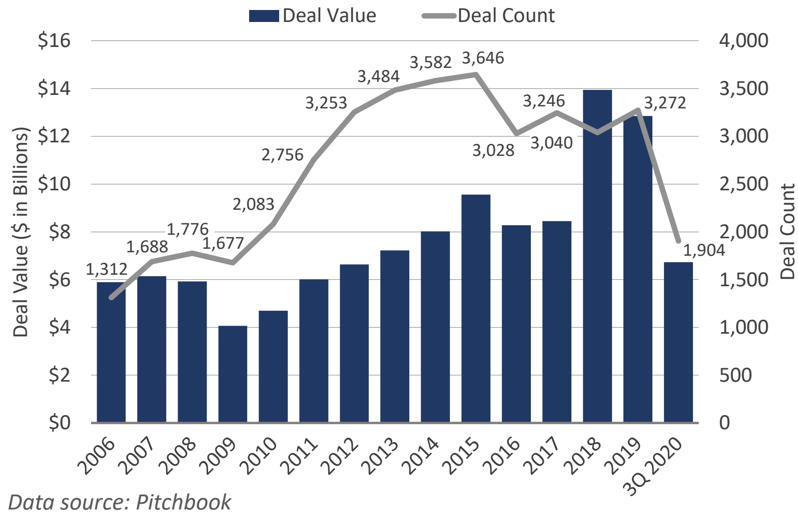
PRIVATE EQUITY

Venture Capital

- Several trends emerged during the COVID-19-impacted second quarter which continued—and in some cases accelerated—in the third quarter. Venture firms sought to allocate capital to segments experiencing growth or showing resiliency in the face of COVID-19-related restrictions on society, while pulling back on areas that might be viewed as higher risk in the current environment.
- The number of first financings by venture capital funds in the first half of 2020 was well off the levels seen in 2018 and 2019, as funds continued to support existing companies versus new companies.
- Late-stage financings continued at a robust pace and were driven by the 223 mega-deals—financing rounds of over $100 million—this year. As companies remain privately held longer, they continue to attract attention from corporate venture programs and crossover investors.
- Traditional venture capital sectors of enterprise software, consumer internet, and life science all saw robust investment activity in 2020. As more people work and shop from home, the need for better solutions increases. Life science investment activity has accelerated under COVID-19 as firms look for specific COVID-19 therapies and vaccines and recognize the need for antivirals and antibacterial therapies.
- IPO activity came roaring back in the third quarter with several significant offerings, including Palantir and Snowflake.

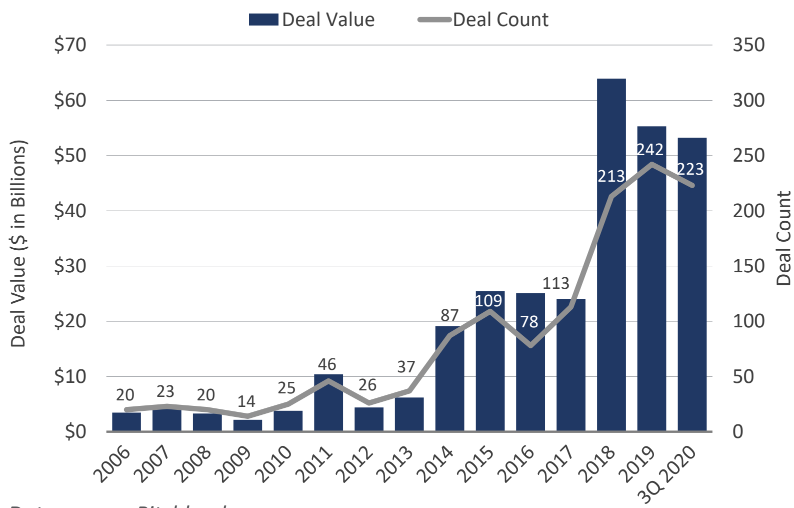
INVESTOR IMPLICATIONS: We believe investors should expect volatility in near-term performance and a choppy investment and exit market due to the high valuations and capital flows.

U.S. VENTURE CAPITAL FIRST-TIME FINANCING INVESTMENTS PULLED BACK SIGNIFICANTLY IN 2020



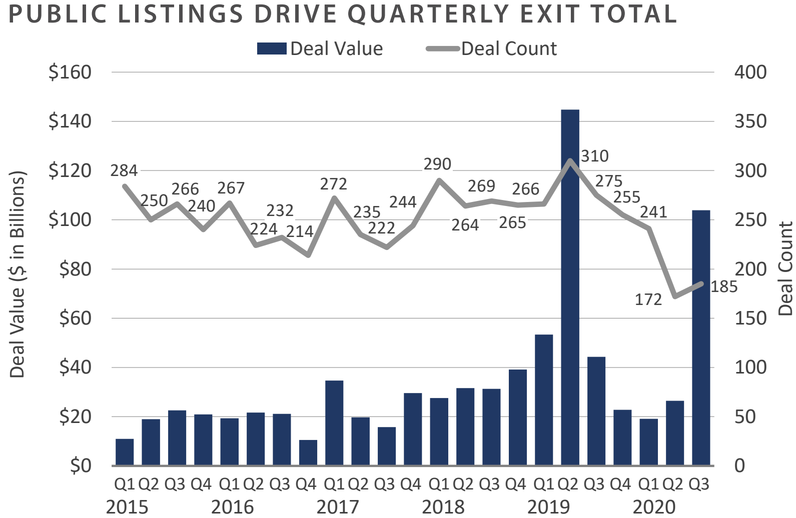
Data source: Pitchbook

U.S. VENTURE CAPITAL MEGADEALS DRIVE LATE-STAGE



Data source: Pitchbook

PUBLIC LISTINGS DRIVE QUARTERLY EXIT TOTAL



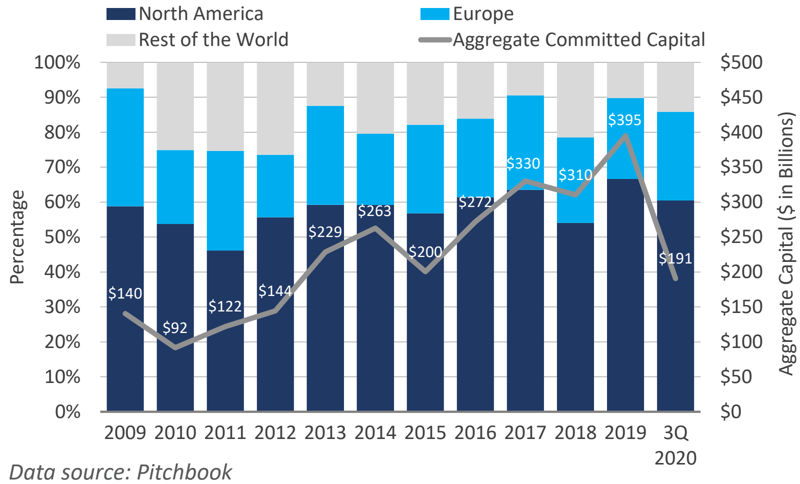
Data source: Pitchbook

Buyouts

- Investor fundraising totals have slipped year-to-date in 2020 versus recent years. Through September 30, 2020, global leveraged buyout funds raised roughly $191 billion of aggregate capital commitments, a 19% decrease from the same period in the prior year.[1]
- Private equity firms continue to prioritize add-ons, which have accounted for more than 70% of year-to-date transaction volume.[2] Private equity investment deal value and volume were down substantially, declining 37% and 33% year-over-year, respectively.[3]
- The median purchase price multiple for a U.S. buyout transaction was 12.7x earnings before interest, taxes, depreciation, and amortization (EBITDA). Leverage ratios remained relatively constant at 5.7x EBITDA.[4]
- Despite a surge in initial public offering (IPO) activity, overall U.S. private exit value and volume were down 36% and 43%, respectively, from the same period in the prior year.[5] FEG anticipates that holding periods will likely increase for recent vintages.
- Private equity fund performance was strong through the second quarter. Several holdings were marked up relative to first quarter valuations, as the financial impact from the COVID-19 pandemic was less severe than anticipated.[6]

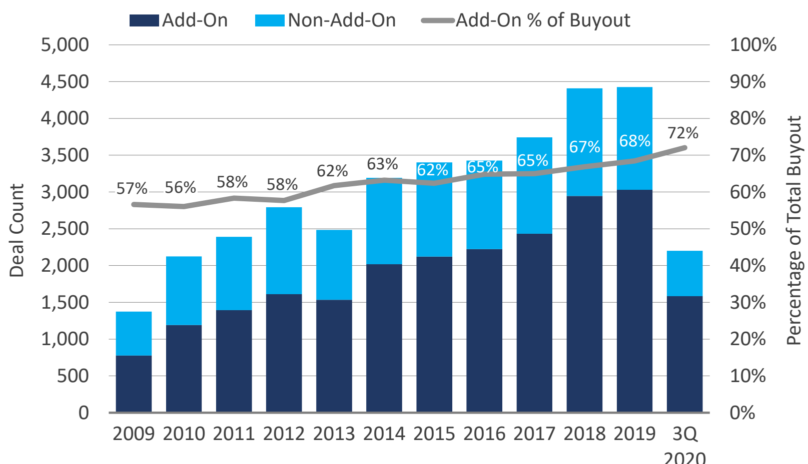
INVESTOR IMPLICATIONS: Investors are encouraged to remain cautious and partner with managers focused on creating value via operational improvements, not financial engineering. Disciplined general partners should be well-positioned to benefit in the new, post-pandemic world.

GLOBAL FUNDRAISING DECLINES
Global Private Equity Buyouts Fundraising



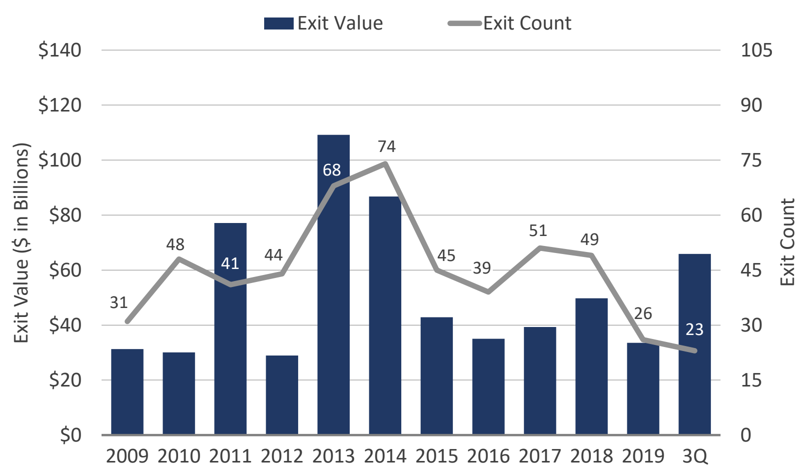
Data source: Pitchbook

INCREASED FOCUS ON ADD-ONS
Add-Ons as a Proportion of Total U.S. Private Equity Buyouts



Data source: Pitchbook

INCREASED IPO EXIT ACTIVITY
U.S. Private Equity IPO Activity



Data source: Pitchbook

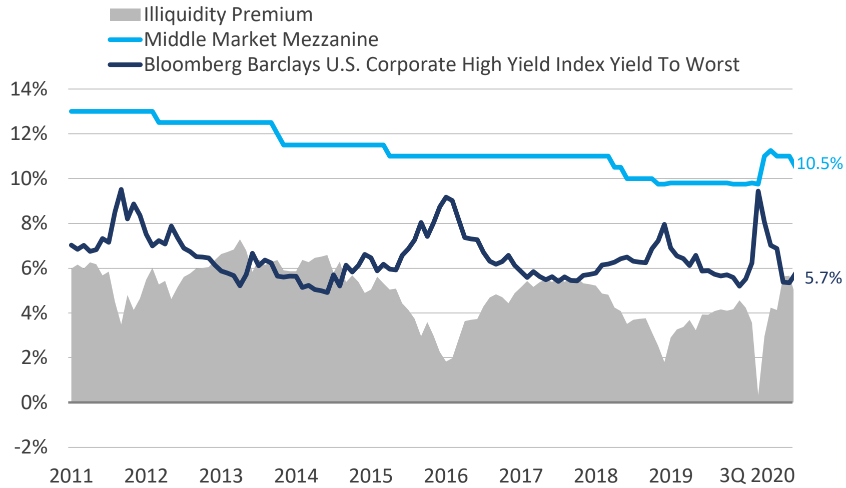
[1-5] Pitchbook; Data of September 30, 2020
[6] Thomson One; Data as of June 30, 2020

PRIVATE DEBT

- The public credit markets continued to improve in the third quarter, with high yield bonds gaining approximately 4.7% and bank loans earning approximately 3.4%. With average mezzanine debt yields steady at approximately 10.5%, the spread between private and public debt once again favors private lending.
- The economic impact of the global pandemic created a pause in the willingness of investors to allocate capital to private debt. Only twenty private debt funds closed during the third quarter, raising an aggregate $8.4 billion, which is a fraction of the 60 funds closed (raising $38 billion) in the previous quarter.[1]
- Of the $8.4 billion raised in the third quarter, $8.2 billion was targeted to North America, $6.4 billion was raised for private lending, and $2 billion was raised for distressed debt and special situations.[2]
- The pause in fundraising was clearly temporary, as the return to lower yields in the public credit markets and renewed interest in distressed debt led to record amounts of capital now being raised in the private debt category. As of October 2020, more than 520 funds were actively fundraising, collectively targeting $295 billion in commitments.

INVESTOR IMPLICATIONS: COVID-19-related challenges have led to lower leverage levels, better pricing and covenants, higher up-front fees, and more equity capitalization, all of which favors private lending in the coming years.

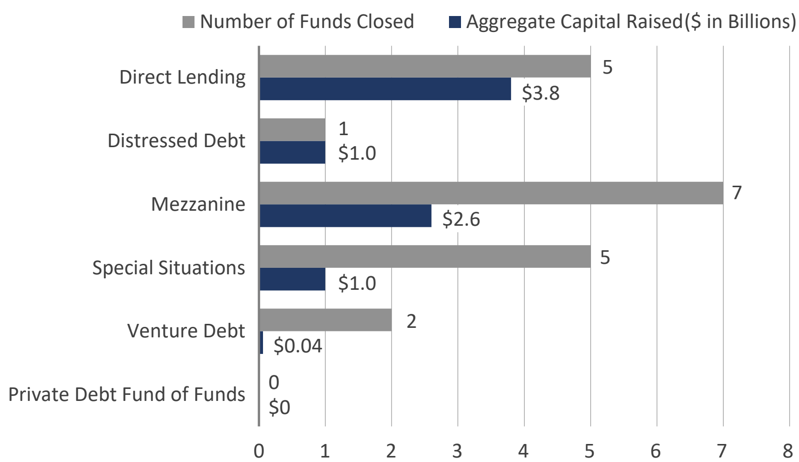
ILLIQUIDITY PREMIUM HAS RE-EMERGED AS PUBLIC MARKETS HAVE RALLIED



Data sources: Bloomberg, L.P., SSP Capital

THIRD QUARTER FUNDRAISING WAS ANEMIC

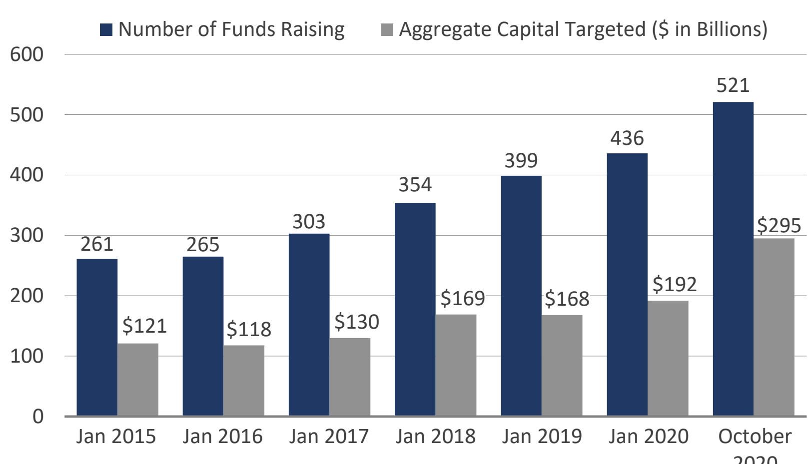
Private Debt Fundraising – 3Q 2020



Data source: Preqin Pro

FUNDRAISING EXPERIENCING A RESURGENCE TO FINISH 2020

Private Debt Funds in Market Over Time – 2015-2020



Data source: Preqin Quarterly Update Q3 2020; data as of October 31, 2020

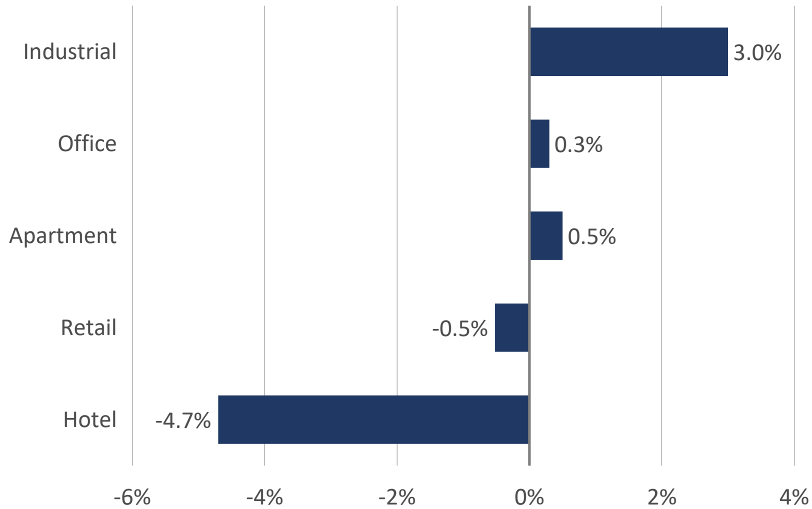
[1-2] Preqin Quarterly Update: Private Debt Q3 2020

PRIVATE REAL ESTATE

- Commercial property transaction volume fell 57% in the third quarter, continuing the trend from earlier in the year.[1] One factor driving lower transaction volume was a decline in deal flow in major metropolitan markets. In the wake of the pandemic, investors are reevaluating the fundamentals of urban centers, as individuals and companies may begin relocating away from large coastal markets to more affordable secondary markets.
- The National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI) was almost flat during the third quarter, posting a slight gain of 0.7%, following a 1.0% decline in the second quarter of 2020. The third quarter gain was mostly attributable to strong performance of industrial properties (+3.0%). Conversely, retail properties (-0.5%) and hotel properties (-4.7%) continued to post declines.[2]
- The wide disparity between public and private returns could indicate future declines in private real estate property valuations. As an indicator, the REIT market finished the third quarter with a slight gain of 1.3% but was down 12.3% year-to-date, significantly more than private real estate indices over the same period.[3] Additionally, there continues to be a wide disparity in performance of property types. Notably, "niche" property types such as data centers, self-storage, and single-family housing continued to outperform "core" property types such as office, retail, and hotels.[4]
- As of September 30, 2020, there were over 1,000 private real estate funds in the market seeking to raise $297 billion in aggregate capital.[5] This is nearly double the number of funds in the market in early 2017. The amount of capital to be deployed will likely continue to create competition for deal flow.

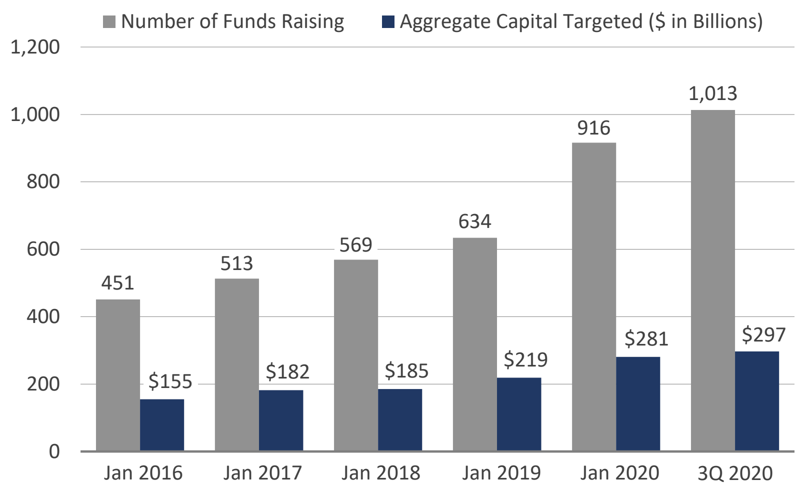
[1] Real Capital Analytics, Third Quarter 2020
[2, 4] NAREIF, Data as of September 30, 2020
[3] NCREIT, Data as of September 30, 2020
[5] Preqin, Data as of September 30, 2020

COVID-19 IS DRIVING REAL ESTATE PERFORMANCE
Private NCREIF Property Index Returns



Data source: NCREIF

REAL ESTATE FUNDRAISING DOUBLES OVER FIVE YEARS
Private Real Estate Funds in Market – 2016-2020



Data source: Preqin

INVESTOR IMPLICATIONS: With record-low interest rates and significant capital for private real estate on the sidelines, return expectations for "traditional" real estate may need to adjust lower. While development is typically viewed as more risky, opportunistic returns may need to include more development deals as opposed to traditional property repositioning. In the current environment, investors should be cognizant of the wide variation between property type fundamentals and position real estate allocations accordingly. We believe areas to consider should include those benefiting from pandemic-induced disruptions. FEG expects the distressed opportunity in real estate to unfold slowly and that it will require patient capital to selectively target deals with attractive returns.

NATURAL RESOURCES

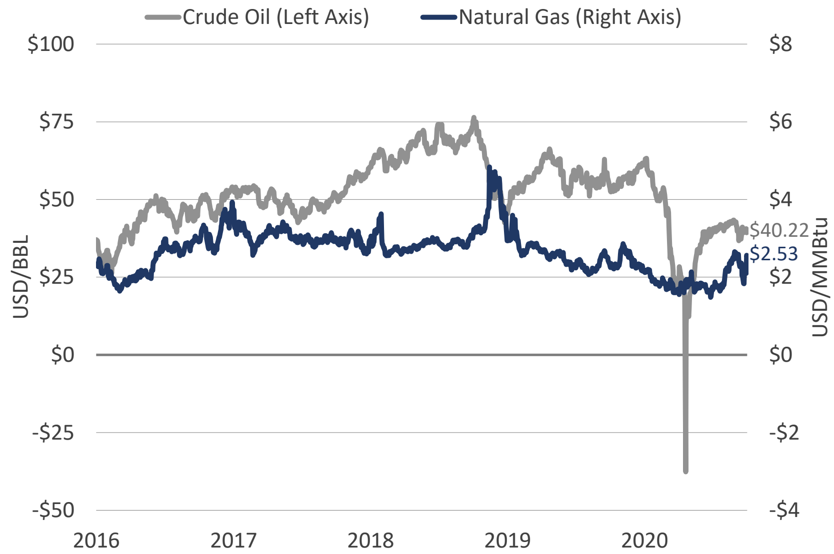
- Following a 92% gain in oil prices during the second quarter, oil rose 2.4% in the third quarter to close at $40.22/barrel as of September 30. Natural gas prices posted a significant gain of 44% in the third quarter, to close at $2.53/MMBtu.[1] Natural gas prices benefited from an improving supply/demand outlook driven by U.S. liquid natural gas (LNG) export demand and production shut-ins due to hurricanes in the Gulf of Mexico.
- Through September 30, 2020, deal volume in the energy sector totaled $21 billion, a significant increase from the second quarter's $2.6 billion. The most notable upstream deal was Chevron's $13 billion acquisition of Noble Energy, which accounted for 60% of the total value of deal volume in the third quarter.[2] Bankruptcies continued through the third quarter, with 17 upstream companies filing for Chapter 11, a trend which is expected to continue in the coming quarters due to high levels of debt.
- The decline rate in the U.S. oil rig count was tempered during the third quarter after falling tremendously earlier this year. The rig count finished at 183 rigs, down from 188 rigs at the end of the second quarter, but year-over-year, the oil rig count declined almost 75%. Similarly, the natural gas rig count was unchanged at 75 at the end of the third quarter but was down 49% year-over-year. Upstream energy companies continued to curtail production in response to record low prices in the first quarter.[3]

INVESTOR IMPLICATIONS: The lack of capital available in the energy sector is unprecedented. The industry continues to right size after years of overspending and the focus has shifted to paying down debt and focusing on cash flow generation. Nevertheless, the ongoing wave of bankruptcies is expected to continue into year-end 2020. This distress should create attractive deal flow for managers with capital to deploy. We believe this distress should create a more favorable supply/demand picture in 2021.

1 Energy Information Administration www.eia.gov; September 30, 2020
2 EnCap X Third Quarter Report; September 30, 2020
3 Baker Hughes; Data of September 30, 2020

OIL AND NATURAL GAS PRICES HAVE STABILIZED

Crude Oil and Natural Gas Prices



Data source: Bloomberg, L.P.

INDICES

Bloomberg Barclays US Corporate High Yield Index represents the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets are excluded but, Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. The index includes the corporate sectors: Industrials, Utilities, and Finance, encompassing both US and non-US Corporations. See www.bloomberg.com for more information

The Russell Indices are constructed by Russell Investment. There are a wide range of indices created by Russell covering companies with different market capitalizations, fundamental characteristics, and style tilts. See www.russellinvestments.com for more information.

The FTSE NAREIT Composite Index (NAREIT) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded REIT securities in the U.S. Relevant real estate activities are defined as the ownership, disposure, and development of income-producing real estate. See www.ftse.com/Indices for more information.

The S&P 500 Index is capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The NCREIF Property Index is a quarterly time series composite total rate of return measure of investment performance of a very large pool of individual commercial real estate properties acquired in the private market for investment purposes only.

HFRI ED: Distressed/Restructuring Index — Distressed/Restructuring strategies which employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.
Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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All data is as of September 30, 2020 unless otherwise noted.

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Research and Portfolio Management Team as of date of publication.