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Looking ahead: Private Equity trends for 2021

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Foreword

2020 presented unprecedented challenges arising from the Covid-19 pandemic. Like many other industries, the private equity (PE) industry was not immune to the resulting market volatility and uncertainty. However, PE firms have embraced the new reality by adjusting their operating models, strengthening their operational improvement capabilities and by leveraging skilled advisors to adapt business models to become more agile and resilient.

Throughout the crisis, the industry has proven its ability to not only navigate difficult market conditions, but to also position itself for accelerated growth. In Asia, General Partners (GPs) remain overwhelmingly bullish on the outlook for 2021, as demonstrated by the large amount of capital that continues to be raised and that is to be deployed in the Asia Pacific region. Limited Partners showed their confidence by continuing to allocate to alternative asset classes in record amounts, leading to the significant amount of investable capital in the region. The market opportunity for GPs is reflected in the increasing amount of deal activity and the increasing average deal size. While there have been some difficulties in originating new deals in the region during the pandemic, activity has continued to grow steadily, providing a bullish outlook for 2021.

The industry's resilience has been further evidenced by several landmark transactions in 2020, with more expected to come to market this year. Despite the impact of Covid-19, valuations have also held up across most asset types as government support programmes were administered to steady economies. Many GPs spent significant time this year cultivating existing relationships for opportunities as travel restrictions made building new pipeline a challenge. A major theme for the year will be filling pipelines with new opportunities as travel restrictions seem likely to remain.

Another trend that built momentum during the year and should accelerate further is successful GPs diversifying into other alternative asset classes, such as private credit, real assets, distressed and special situations, ESG and social impact, as well as other thematic specialty funds. This product diversification has enhanced the ability of many funds to grow their assets under management.

Given the capital available, the wider range of asset classes that GPs can invest into and the ability of GPs to invest across the capital structure, coupled with PE's value add partnering model, I am confident the industry will continue its strong growth trajectory in China and the rest of Asia in 2021.

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Executive Summary

The 2020 market environment challenged even the most successful private equity (PE) businesses. Despite the market volatility and business uncertainty throughout the year, the PE industry was able to adapt practices and prosper. This helped the industry to continue to deliver on its important role to help drive economic growth, enhance business value and deliver returns for investors.

Although it was a challenging year for many in the industry, the Asia Pacific PE market remains poised to continue the success it has enjoyed over the last decade, with the amount of capital allocated to the region at record highs.

Throughout these unprecedented times, PE firms have demonstrated the ability to continue to deploy capital, help guide portfolio companies through the pandemic, and return capital to their investors. All of this has led to advantageous fundraising opportunities for the top performing managers, proving the resiliency of the industry to thrive even in extreme uncertainty.

There were several notable trends from last year, including increasing allocations to alternative assets and specifically PE and Venture Capital (VC), as indicated by Asia dry powder growing at 22% over the 2019 to 2020 period.[1] Deal activity continues to benefit from the low interest rate environment.

Early on, key themes included general partners (GPs) focusing on existing investments and bringing expertise to portfolio company management teams in order to help them navigate the new environment. PE firms used their internal operational expertise, as well as specialised advisors to assist portfolio companies on areas such as customer behaviour changes; recapitalising the business and raising additional capital; reconfiguring supply chains; making strategic acquisitions and portfolio company bolt-ons, among many others. Significant drivers in deal activity included portfolio company bolt-on and tuck-in transactions, take-private opportunities and PIPE investing, as well as revisiting prior uncompleted transactions.

For GPs looking to monetise investments this year, the Asia Pacific IPO market continues to show strong investor-led demand. Strong investor demand for IPO opportunities is also expected to continue in 2021 with the China IPO market having over 800 companies in its pipeline[2]. This is after both the mainland China and Hong Kong exchanges registered their most active IPO markets since 2011.

It is expected that Asia Pacific exits by way of trade sale should increase significantly over their 2020 levels, given that these were only in the region of US$29.5 billion[3], the lowest figure in several years.

Although some volatility and uncertainty will remain in 2021, the industry track record for successfully adapting to and navigating changed landscapes suggests the industry is well positioned for a robust 2021 and beyond.

[1] Source: Preqin, 2021

[2] Source: 'Mainland China and Hong Kong 2020 review: IPOs and other market trends', KPMG China, December 2020

[3] Source: Preqin, 2021

Private Equity trends for 2021

In our view, the following trends will have a significant impact on the PE market in Asia Pacific in 2021:

Dry powder: Asia continues to outperform capital raising, setting new dry powder records.

Asset class diversification: As Limited Partners (LPs) increase their exposure to Asia Pacific, PE firms will look to expand the breadth and depth of their investment strategies to grow assets under management.

Socially responsible investing: Environmental, Social and Governance (ESG) investing is poised to have a breakout year as investors drive adoption and the asset class is increasingly viewed as a value driver.

Tax themes for Asia: Shifting tax and regulatory landscapes are leading to thematic opportunities and a need to manage emerging risks.

Deal activity: 2021 is positioned to be an active year for PE deal activity as record high dry powder coupled with the anticipated pent up demand should help drive acquisitions.

Value creation: A greater emphasis on value creation identification and capture capabilities as PE seeks to increase alpha opportunities.

Exits: 2021 is anticipated to be a record year for exits as investors seek to monetise their investments through multiple channels.

Technology, digitalisation and consumer adoption: Consumers are rapidly driving disruption and investment focus by accelerating technology adoption, prioritising value for money and becoming more digitally savvy.

Private debt: Asia Pacific private debt looks to become more significant in the next year by offering flexible solutions to address growing borrower demand.

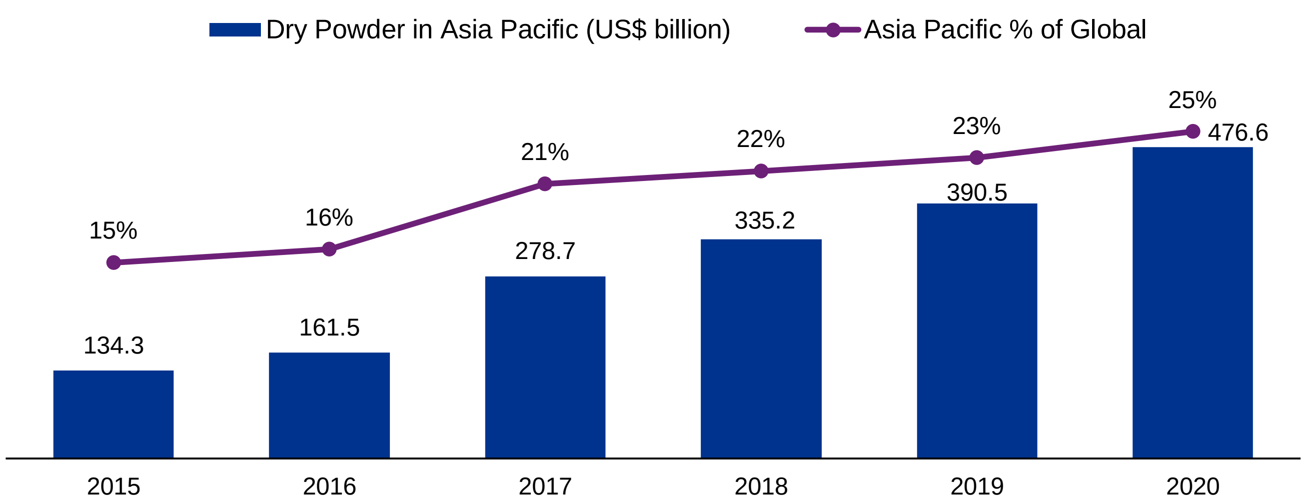
Real assets: Asia infrastructure, distressed real estate and renewables are expected to drive the real asset category in 2021.

Asia continues to outperform in capital raising, setting new dry powder records.

Asia Pacific PE and Venture Capital (VC) dry powder has reached a record level of more than US$476 billion[4] as of November 2020. Asia Pacific's PE/VC dry powder market share now represents 25% of the global total, above Europe (19%). We expect dry powder allocated to the region to continue to outgrow the US and EMEA in 2021 as institutional investors continue to increase allocations toward Asia PEVC.

Capital raising remains robust with successful GPs benefiting from the ability to raise large Asia dedicated funds. Reported examples include KKR's US$13.1 billion Asian Fund IV (to date the largest pan-Asian PE fund); GL Ventures at US$1.4 billion; and Baring's US$6.5 billion BPEA Fund VII (its largest fund to date).

PE and VC dry powder in Asia Pacific and its global share %



[4] Source: Preqin, 2021

As Limited Partners increase their exposure to Asia Pacific, PE firms will look to expand the breadth and depth of their investment strategies to grow assets under management.

Over the last decade, some PE firms embarked on a journey to transform themselves into multi-asset class managers. PE firms have grown their product offerings to encompass other asset classes such as private debt, real estate, infrastructure and ESG, among other strategies to offer a wider product selection to LPs that are seeking to allocate larger amounts of capital to select managers. We expect that this trend will increase in velocity as managers seek to differentiate and grow assets under management, further bifurcating the market into large multi-asset class managers and smaller niche players.

Thematically, another trend has been the move towards Asia Pacific specialty offerings as managers look for competitive advantages, building out local teams and associated track records. Capitalising on the appetite for and shift towards Asia Pacific exposure from LPs, managers are ramping up capabilities in other asset classes such as credit, growth, infrastructure, and specialty Asia funds such as Bain's Japan Middle Market Fund I, and KKR's anticipated Asia technology fund, which continue to generate interest from investors. ESG and social impact funds are also seeing significant investor appetite as the region embraces the socially responsible investing phenomenon.

Environmental, Social and Governance (ESG) investing is poised to have a breakout year as investors drive adoption and the asset class is increasingly viewed as a value driver.

ESG investing has increased as the environment and climate change have taken on more significance for LPs and governments in major markets. According to the Global Sustainable Investment Alliance, from 2014 to 2018, total sustainable investment assets rose from US$18.3 trillion to US$30.7 trillion.[5] Preqin estimates that US$3 trillion has been raised across more than 5,400 funds managed by firms that subscribe to ESG principles. ESG-related funds should see another year of rapid growth, setting new records along the way.

ESG reporting is becoming more of a priority for regulators and has the opportunity to offer differentiation for PE investors. Initial indications from the capital markets show that ESG investments have performed at least as well as mainstream funds as the pandemic has intensified. Investors have flocked to these funds given the focus on solving societal problems, providing an opportunity to bring forth bold new thinking and by having new capital continuing to flow into them. The search for long-term, resilient businesses that are not susceptible to changes in social expectations, new disruptive technologies or future regulatory changes are at a premium and ESG criteria is, and will continue to be, a competitive and differentiating factor in accessing capital in the post-pandemic world.

ESG is increasingly being seen as a value driver. The pandemic has accelerated investors' need for indications of long-term business sustainability, as well as financial performance. As such, investors are now actively seeking ESG indicators as part of their investments and incorporating ESG investment analysis as part of diligence. This trend is set to increase in 2021 as ESG becomes more of a 'must have' for investors.

[5] Source: '2018 Global Sustainable Investment Review', Global Sustainable Investment Alliance, March 2018

Shifting tax and regulatory landscapes are leading to thematic opportunities and a need to manage emerging risks.

Tax authorities have increased their scrutiny in investment holding company substance, the vehicles that grant tax treaty benefits, leading to onshoring of funds and investment platforms in Asia. This scrutiny primarily affects dividend withholding taxes and capital gains taxes. Given the increased costs and substance requirements for "offshore" structures, funds have been focused on "onshoring" fund activities to where core substance is located; both Singapore and Hong Kong have introduced onshore fund structures that are proving popular with the market. Singapore has introduced the Variable Capital Companies (VCC) regime, while Hong Kong has introduced a new Limited Partnership Fund regime and has recently revised the Open-Ended Fund company rules. This trend to onshore funds and investment platforms in Asia will continue to gain traction, especially given that the new regimes in both Hong Kong and Singapore provide for a very competitive funds framework.

Carried interest developments have helped to provide clarity to funds onshoring in the Asian hubs.
Hong Kong has recently announced a new zero percent concessionary tax regime for carried interest, which will commence retrospectively from April 1, 2020. This is an important development for the PE industry given the Inland Revenue Department's (IRD) long-standing position has been to treat carried interest as income for services rendered and therefore subject to tax. The effect of the concessionary regime will be to effectively exempt eligible or qualifying carried interest received by the fund manager and its employees.

Mainland China continues to reform its fund rules to promote the alternative investment market.
The Qualifying Foreign LP (QFLP) regime is increasingly being used by foreign PE investors to invest in PE and other asset classes in mainland China, including real estate. Introduced several years ago, it was created to enable foreign LPs to directly hold interests in a China PE fund, but it now also allows foreign PE funds to establish their own fund management vehicle in China to manage a qualifying QFLP.

Concern over related tax complexity and risk anticipated to come from BEPS 2.0 implementation.
In late 2020, the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) released its blueprint for Pillar One and Pillar Two (BEPS 2.0), reflecting the effort to solve some of the tax challenges arising from the digitalisation of economies. The proposed new rules and framework are complex, but they do include a proposed minimum effective tax rate on profits, as well as providing increased taxing rights to jurisdictions with respect to payments to low taxed or exempted recipients. Although funds may be carved out of some of the proposed rules, fund managers will nevertheless need to monitor the impact of the BEPS 2.0 developments on their portfolio investments and their expected investment returns.

2021 is positioned to be an active year for PE deal activity as record high dry powder coupled with the anticipated pent up demand should drive acquisitions.

Covid-19 slowed deal activity in the early part of last year, but activity picked up and accelerated throughout the second half. Sectors such as education, logistics, healthcare and technology saw strong demand as they benefited from structural changes due to the pandemic. We expect continued momentum in 2021 within these business models and others that benefit from the new environment. Additionally, Special Purpose Acquisition Companies (SPACs) are to grow in importance and help drive activity as Hong Kong has emerged as the largest SPAC market outside the US.

There is expected to be an enormous recapitalisation opportunity, although specific timing remains uncertain. The market has proven challenging for certain sectors, damaging some fundamentally sound business models. These businesses will increasingly face the need to seek out solutions to repair capital structures as government stimulus programmes slow and banks tighten lending standards. The pandemic has emphasised that well capitalised and supported companies will grow faster than businesses that need to repair their capital structures. As a result, 2021 may be one of the best investing periods in a generation.

Asia Pacific witnessed a few mega deals in 2020, and this trend is expected to accelerate in the coming year as asset owners evaluate divesting non-core assets and PE sponsors look to monetise current investments. Some reported notable deals in 2020 included: China's largest online classified market, 58.com's privatisation (US$8.7 billion), Bain Capital's Virgin Australia buyout (AU$3.5 billion) and Blackstone's JPY 250 billion (US$2.3 billion) acquisition of Takeda's OTC Pharmaceutical business. The anticipated Asia large cap PE pipeline in 2021 looks likely to be driven from China, Southeast Asia and Japan. For growth deals, China, India and Southeast Asia are expected to continue to be key markets.

> *"The pandemic has emphasised that well capitalised and supported companies will grow faster than businesses that need to repair their capital structures. As a result, 2021 may be one of the best investing periods in a generation."*

A greater emphasis on value creation identification and capture capabilities as PE seeks to increase alpha opportunities.

Fund managers have focused on business agility and resilience to help accelerate growth and reduce vulnerabilities arising from the crisis. PE firms leaned heavily on their internal teams to identify and capture value opportunities within the portfolio and in some cases to help stabilise businesses. Operational teams are helping portfolio companies to identify appropriate capital structures to stave off liquidity or solvency issues, digitalise business models, drive top-line growth and cut costs. The use of data and analytics has also increased as this is helping portfolio companies better understand customer needs, reduce costs and identify growth opportunities.

Covid-19 changed the way diligence is conducted, resulting in a longer diligence process and greater target transparency. As a consequence of travel restrictions, target diligence was largely driven virtually or in combination with advisors who could provide local resources. The inability to physically conduct diligence and get to know management teams led to transactions taking longer to close as more intensive analysis was often needed for approval processes. As a result, many target management teams were motivated to provide greater transparency, including a growing number hiring advisors to support processes, articulate the equity story, optimise data rooms, provide sell-side diligence reports and other supporting analysis. As this year progresses, we expect to see a growing number of investors performing more extensive commercial and operational diligence on purchases, as well as asset owners utilising sell-side advisors for sales processes.

2021 is anticipated to be a record year for exits as investors seek to monetise their investments through multiple channels.

Impacted by Covid-19, PE trade sale exits in Asia Pacific decreased dramatically to an aggregate value of US$29.5 billion in 2020.[6] Travel restrictions are limiting many buyers from performing in person due diligence and meeting in person with management teams. This has led to elongated acquisition timelines and delays in closing transactions. With virtual meetings commonplace and with vaccines distributed throughout the year helping to ease cross-border travel, we anticipate the exit market, both IPOs and trade sales, to be healthy. Bolstering this sentiment is the fact that valuations have remained steady, thus supporting seller pricing.

The IPO market has been less affected by the pandemic and has seen surging interest since June as markets quickly bounced back and trade sales declined. The 2019 launch of the Science and Technology Innovation Board at the Shanghai Stock Exchange, which serves as Asia's Nasdaq-style tech board, and the various stock exchanges in Shenzhen, Shanghai and Hong Kong, facilitated a strong capital markets platform for IPO exits in China in 2020. In fact, the three China exchanges were all in the top 5, producing IPO proceeds of US$118.7 billion[7], a 50% increase over the amount produced by the American exchanges. The Asia Pacific market is poised to generate significant IPO proceeds this year with strong pipelines expected in China and India, and some large companies anticipated to IPO in Southeast Asia.

We expect a robust year as GPs seek to monetise current investments through IPO listings, trade sales and secondary transactions. Given the inventory of delayed exits added to the anticipated 2021 pipeline, coupled with strong public market valuations and the IPO market, and the low rate environment, we expect solid growth for exits in the year ahead.

[6] Source: Preqin, 2021

[7] Source: 'Mainland China and Hong Kong 2020 review: IPOs and other market trends', KPMG China, December 2020. Note: IPO proceeds calculated on a prorata basis from 6 to 31 December 2020.

Consumers are rapidly driving disruption and investment focus by accelerating technology adoption, prioritising value for money and becoming more digitally savvy.

Technology was the dominant sector for Asia Pacific funds in 2020, representing over 30% of the total deal value.[8] Covid-19 was certainly a catalyst, which has transformed consumer behaviour, driving rapid technology adoption, significant shifts in preferences, and the acceleration of digital products and services. These trends are set to continue to accelerate well into 2021, with fund flows targeting the sector.

The impact of Covid-19 is set to have a profound effect on Fintech as a disruptor in 2021. The rapid emergence of Covid-19 was a major black swan event, sending ripples throughout public markets and driving changes in customer and business behaviours on an unprecedented scale. Fintech investment during the early part of 2020 put a spotlight on long-term trends, including the growing importance of application programming interfaces (APIs) and open data, as well as blurring the lines between Fintech, big tech and platform providers.

The rapid acceleration of digitalisation will continue to be a major theme in 2021, including the use of digital payments and the shift towards more digitally-based business models. Payments will likely continue to be a very competitive sector for investment, while Wealthtech adoption has accelerated due to the need to offer superior investing experiences for consumers, the democratisation of market data, and buoyancy of equity capital markets.

Demand for online purchasing and for companies to operate remotely is driving digital transformation at a faster rate, and having a real economic impact. The ability of companies to digitise their business model, including logistics, payments and e-commerce, will have an increasingly significant financial impact. Equally, consumers increasingly prioritising personal safety due to Covid-19 has transformed consumer behaviour, supplier selection and channel use. Overall, the combination of basic consumer needs of value and convenience indicates significant consequences this year for the economic fortunes of individual markets.

[8] Source: Preqin, 2021

Asia Pacific private debt looks to become more significant in the next year by offering flexible solutions to address growing borrower demand.

As one of the fastest growing asset classes, Asia private debt funds have more than doubled from US$28 billion in 2014 to US$64 billion in 2019.[9] This momentum is set to accelerate through 2021, driven by funding needs for Asia businesses, the withdrawal of government liquidity programmes, and the tightening in bank lending requirements. As a result, Asia is observing larger and more numerous private credit funds that provide financing solutions.

PE managers and institutional investors are actively increasing their role in providing debt and structured products to corporates, real estate projects and infrastructure developments primarily in Australia, China and India. Private lending has traditionally been driven by banks. However, Asian banks are applying stricter lending standards, making lending more difficult. In addition, as they have been less focused on the small to medium market segments due to credit risk, regulatory concerns and group economics, alternative credit providers are expected to increasingly fill the financing needs of growing Asian companies in 2021.

Private debt solutions are offering Asia portfolio companies more flexibility as the traditional banks retrench and tighten requirements, providing investors with higher yields. With a diverse product offering that includes direct lending, mezzanine financing, sponsor lending, and distressed and special situations, private debt is enabling greater and more flexible solutions in respect to traditional bank lending. This solution-based approach along with the tightening supply should help drive funds toward the asset class.

> *“Alternative credit providers are expected to increasingly fill the financing needs of growing Asian companies in 2021.”*

[9] Source: Preqin, 2021

Asia infrastructure, distressed real estate and renewables are expected to drive the real asset category in 2021.

With support programmes likely to slow and access to traditional sources of capital becoming more difficult, distressed office, retail and hospitality property opportunities are expected to increase as asset owners seek to pay down debt through asset sales. With public institutions and banks increasingly motivated to clean up balance sheets, there is likely a broad array of distressed assets that will come to market. As the year progresses, it is anticipated that we will see a significant uptick in transactions, acquisitions and consolidations as investors seek to acquire distressed assets. Valuation prices are expected to remain a key issue if assets are not appropriately priced.

We expect investors to continue to increase allocations to infrastructure as governments continue to provide incentives and investor demand remains strong. AUM in private infrastructure vehicles is predicted to increase globally by 25% to US$795 billion in 2025[10]. As a result of unprecedented economic difficulties, governments have delivered historic levels of economic stimulus. Governments are hoping these large-scale capital investments provide stimulus to their populations. Given the high levels of spending, infrastructure is one that has broad support. It is therefore anticipated that Asia Pacific infrastructure will remain a key focus for investors, both on greenfield and brownfield projects.

Renewable energy projects and the logistics sector are expected to help propel increased inbound investment into Asia Pacific during 2021. A major emerging theme in the last two years has been investor appetite for exposure to renewables in Asia as many look to local partnerships and joint venture opportunities. Southeast Asia and India saw significant activity and are expected to be leading markets in 2021 for opportunities.

[10] Source: ‘Future of Alternatives 2025: Laying the Foundations for Infrastructure Growth’, Preqin, November 2020

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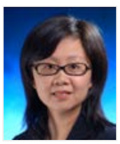

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