MIDDLE MARKET
Growth
// SPECIAL EDITION

2021 Guide to Deal-Making

Industry headwinds and tailwinds, plus **top sectors** to watch in the new year

ACG surveyed more than 600 deal-makers to gain insight into expectations for M&A activity in 2021

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From the Editor

No Crystal Ball? Try Crowd-Sourced Wisdom Instead

KATHRYN MULLIGAN
Editor-in-Chief,
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After a year that was full of surprises, making predictions about 2021 feels like a fraught exercise. Yet for business leaders and deal-makers, winging it isn't an option. Using the best information available to plan for a range of scenarios will have to do.

In an effort to crowd-source insights about the coming year, *Middle Market Growth* and its partners surveyed M&A professionals and middle-market leaders about their outlook for 2021. In this special report, you'll read what they're anticipating for deal activity, business risks, hiring, real estate, and environmental, social and governance (ESG) investing.

None of our survey respondents had a crystal ball, but combined, their answers offer clues about what's ahead. On some topics, there was consensus. For example, most expect the high volume of private equity dry powder to spur continued competition for deals. Other questions provoked a mixed response, such as whether firms hiring in 2021 will be doing so in order to expand, or to fill roles of employees who've left the organization.

Of course, there are variables that could impact these projections. At press time, COVID-19 cases are on the rise, even as promising vaccine results suggest the end of the pandemic is in sight. On the political front, control of the U.S. Senate is still up for grabs, pending run-off elections in Georgia. If Democratic candidates were to win two seats, single-party control of the executive and legislative branches could signal sweeping changes for financial regulation, health care policy and more.

To explore the logic and assumptions behind the survey data, we spoke with members of private equity firms, lenders, advisors and other M&A professionals about their 2021 outlook. By pairing aggregated data with individualized perspectives, our goal is to deliver a thorough and nuanced snapshot of the year to come. We've also partnered with Grata, a search engine for identifying middle-market investment targets. The final section of the report highlights emerging investment areas, powered by Grata data, to aid your deal sourcing efforts.

This is the first of a series of special reports that *Middle Market Growth* will publish each year to dive deep into topics impacting the middle-market economy. The reports will be published in addition to the quarterly issues of *Middle Market Growth* magazine. Combined, the reports and magazine issues underscore ACG's commitment to our print offerings and the growing suite of ACG media.

We hope you find the Outlook Special Report valuable as you plan for 2021, and we look forward to sharing more targeted coverage with you in the year ahead. //

Executive Summary

No Matter the Challenge, ACG Perseveres

TOM BOHN,
CAE, MBA
President and CEO,
ACG

A year unlike any other, 2020 brought new challenges to each one of us, both personally and professionally, and demanded that we all come together while staying apart.

Through all of the trials and tribulations, our underlying need to connect has remained consistent. Since becoming CEO of ACG just one year ago, I have been humbled to witness the way our community banded together to navigate the new world before us.

If you're reading this as an active member of ACG, thank you. Thank you for serving as the backbone of this one-of-a-kind community during one of our toughest years on record. If you aren't a member, you are receiving this special report because you have connected with us in some way, whether you've attended an ACG chapter event, subscribed to one of our newsletters, or been a member in the past. But 2021 is a brand-new year, and ACG has evolved, so I hope you will allow me to take this opportunity to personally invite you to join. Our network will be even stronger with you in it. And you'll instantly gain the strength of our middle-market allies.

Throughout the unprecedented disruption of last year, ACG remained focused on our mission to serve our community and facilitate growth in the middle market, no matter the landscape. And though we've adapted—pivoting to virtual deal-making summits and investing in platforms to further accommodate our newly virtual world—it is you who rose to the occasion. Each one of you exemplifies the true power of ACG. We leaned on each other and learned from one another. And while I'm in awe of all that we accomplished together, there will always be new challenges to face, goals to achieve, and connections to make.

Heading into 2021, we're continuing to invest in the member experience with exciting new benefits on the horizon that further leverage the power of our exclusive network.

We'll also be launching an Industry Insiders program, starting with Health Care, Software/Technology and Industrial/Manufacturing. If you're an active stakeholder in one of these industries and are interested in being a part of our Industry Insiders pilot program, please reach out to membership@acg.org for more information. Otherwise, I encourage you to review the benefits, scope out your local chapter, and sign up for membership today at acg.org.

Thank you for being a valued part of our community, and I wish you health and prosperity in the year ahead. //

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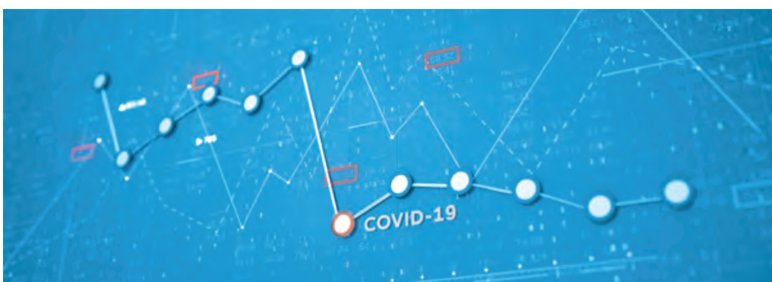

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Inside the Report

For its 2021 Outlook Special Report, *Middle Market Growth* and its partners surveyed the middle-market deal-making community about what they are expecting in the coming year.

From mid-September through mid-October, *MMG* surveyed a cross-section of more than 600 deal-makers on various topics, from M&A activity to emerging risks, and interviewed a number of industry professionals about their outlook. Below is some information about the survey findings and the partners we worked with for this report.

OPTIMISTIC DEAL-MAKERS READY FOR M&A ACTIVITY IN 2021, PAGE 10

In partnership with Dixon Hughes Goodman, *MMG* surveyed M&A professionals on their feelings about deal-making in 2021. The good news is, despite a pandemic and uncertain political climate, most respondents felt bullish about deal-making in 2021.

About DHG: DHG is a leading professional services firm offering assurance, tax and advisory services to clients nationwide and internationally. The firm's strength lies in its technical knowledge, industry intelligence and future-focused approach combined with its drive to help clients achieve their goals, both today and tomorrow. DHG's professionals are passionate about providing an unparalleled client experience as they listen, innovate and act to help clients. DHG ranks among the top 20 professional services firms in the nation, providing assurance, tax and advisory services. With more than 2,000 professionals across the United States, the DHG team serves clients in 50 states and internationally.

DHG is registered in the U.S. Patent and Trademark Office to Dixon Hughes Goodman LLP.
www.dhg.com

THE SEARCH FOR TALENT CONTINUES EVEN AMID THE PANDEMIC, PAGE 20

In partnership with Globalization Partners, *MMG* surveyed deal-makers about hiring trends in 2021. In the midst of a pandemic, hiring new talent will certainly have its challenges, but the show must go on and firms are finding creative ways to hire and train new talent.

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PANDEMIC STILL A MAJOR THREAT TO MIDMARKET COMPANIES, PAGE 32

COVID-19 has presented a major threat to business health this year, but it's not the only risk to watch. *MMG* partnered with QBE Insurance and surveyed U.S.-based middle-market C-suite leaders about the risks of doing business in 2021. Some of the risks that business owners are worried about include the impact of the pandemic, retaining talent, cyberthreats and insurance risks.

About QBE Insurance Group Limited: QBE is the largest ASX Listed Insurer by both gross written premium and market capitalization. It provides insurance services mainly to Australia, North America, Europe and the Asia Pacific region. In 2019, QBE had over 11,700 employees in 27 countries worldwide.
www.qbe.com/us

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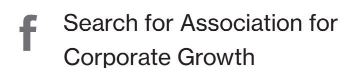

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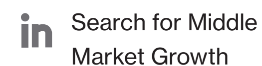

Search for Middle Market Growth

SALE-LEASEBACK POISED TO PLAY A LARGER ROLE IN M&A, PAGE 42

For a look at real estate trends, *MMG* partnered with STNL Advisors to learn how private equity firms are using their real estate in this unprecedented time. Survey responses suggested that sale-leaseback transactions could play a larger role in M&A in 2021 as many companies look to take advantage of low interest rates while freeing up capital. Yet, many respondents haven't even considered this route.

About STNL Advisors: STNL Advisors is a real estate consulting group that specializes in unlocking hidden value related to leasehold and fee-owned real estate assets. STNL provides private equity firms with the ability to reduce acquisition multiples and immediately increase EBITDA. STNL also works directly with portfolio companies on lease negotiating, restructuring and repositioning services targeted toward improving liquidity to grow core businesses, improve cash flow and borrowing capacity, and create long-term operational efficiency, whether on a single-asset or portfolio-wide basis. With 21 years of operating history, STNL has a track record of closing over $17 billion in sale-leaseback and over $500 million secured through rent relief and landlord contributions. www.stnladvisors.com

ESG TAKES CENTER STAGE: THE MIDDLE MARKET FOCUSES ON NEXT STEPS, PAGE 54

Environmental, social and governance (ESG) issues have come to play an increasingly important role with deal-makers today. *MMG* worked with S&P to look at how deal-makers view ESG topics going into 2021. The bottom line is private equity firms say that want to work with companies that are taking ESG issues into account. The question is no longer whether implementing ESG practices is good for the firm and investment thesis. Instead, organizations are asking themselves: How can we implement best practices going forward?

About S&P: S&P Global Market Intelligence understands the importance of accurate, deep and insightful information. S&P integrates financial and industry data, research and news into tools that help track performance, generate alpha, identify investment ideas, perform valuations and assess credit risk. Investment professionals, government agencies, corporations and universities around the world use this essential intelligence to make business and financial decisions with conviction.

S&P Global Market Intelligence is a division of S&P Global (NYSE: SPGI), the world's foremost provider of credit ratings, benchmarks and analytics in the global capital and commodity markets, offering ESG solutions, deep data and insights on critical business factors. S&P Global has been providing essential intelligence that unlocks opportunity, fosters growth and accelerates progress for more than 160 years. For more information, visit www.spglobal.com/marketintelligence.

7 SECTOR WORTH WATCHING, PAGE 64

MMG's work with Grata Data complements this report's other sections. After reviewing Grata's data, our editorial staff and Grata analysts identified seven industries that are seeing growth in employment numbers and the number of clients, and that are set to see growth in the near future. Sectors such as telehealth, online corporate training and technology for customer service are all ripe for investment in 2021.

About Grata: Grata is a modern company search engine for proprietary deal sourcing. www.gratadata.com

We hope you enjoy reading this special report as much as we enjoyed putting it together for you. Happy new year! //

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Optimistic Deal-Makers Ready for M&A Activity in 2021

Even with the uncertainty of what's to come in 2021, private equity professionals are feeling bullish about the year, according to a survey conducted recently by ACG and sponsored by Dixon Hughes Goodman (DHG)[1], a national advisory firm. Almost 75% of survey respondents said they had a positive outlook on M&A activity going into 2021. Although their reasoning varied, most respondents pointed to dry powder and favorable credit conditions. Private equity firms have more than $1.7 trillion of dry powder heading into 2021.

"OUR MACRO ECONOMIC FORECAST REMAINS A 'NIKE SWOOSH' SHAPE, CONSISTENT WITH A WORLD ECONOMY THAT WANTS TO GET BETTER AND DOES SO WITH A STEADY RECOVERY."

STEWART KOHL
Co-Founder, The Riverside Company

"I'm bullish about 2021, especially for companies that performed well through COVID. In 2021, we should have a stable government, improving the COVID situation, including additional government aid and continuing low interest rates," says Stewart Kohl, co-founder of The Riverside Company. "Business and consumer confidence should be fairly high, and there will be M&A activity. Our macro economic forecast remains a "Nike Swoosh" shape, consistent with a world economy that wants to get better and does so with a steady recovery."

Deal-makers believe that in addition to favorable credit conditions, other factors will play into increased deal activity. "Another thing that will drive M&A is the aging population. Baby boomers, born post-World War II, are often in positions looking to sell their businesses or assist with management-led leveraged buyouts," says Brett Hickey, a founder of Star Mountain Capital, a lower middle-market investment firm with private lending, private equity and secondary funds.

Heather Madland, a partner with private equity firm Huron Capital, agrees baby boomers will play a large role going forward. "The baby boomers have lived through three cycles, this pandemic included, and if their businesses have held up or were only slightly impacted by COVID, they are ready to sell. COVID is getting would-be sellers off the bench," she says, adding that Huron has six companies under letter of intent that are pushing to close so as not to risk further impact.

M&A deal activity had rebounded from the first and second quarter and most expect this trend to continue going into 2021. Deal activity in Q3 surged to 2,714 deals for a total deal value of $361.1 billion, notching quarter-over-quarter gains of 23.5% and 7%, respectively, according to Pitchbook Data. This bodes well for 2021.

Additionally, while this survey was conducted prior to the U.S. presidential election, most respondents expected the outcome to have very little impact on M&A activity. In fact, more than 65% of respondents said a Biden win would lead to more M&A activity or have no change to M&A activity. Only about 30% of respondents felt a Biden win would lead to less M&A activity.

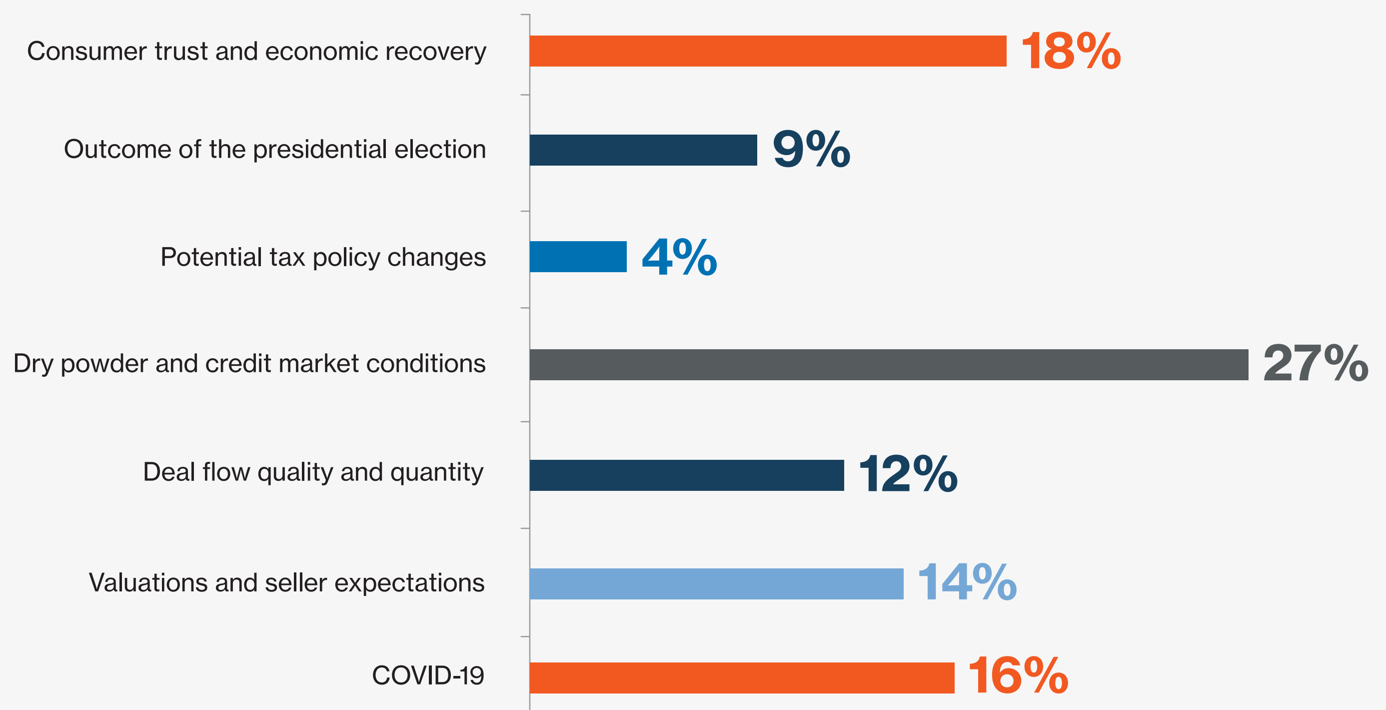
Graeme Frazier, a partner with Private Capital Research, a buy-side investment and M&A firm, agrees that dry power will play a strong role in the M&A market in 2021 and that the election won't change that. "I have a positive outlook for private equity and M&A activity regardless of the election. The amount of investable capital out there is a gigantic catalyst that is not going away. The scarce resource is the number of deal opportunities that are worthy of institutional private equity capital," he says.

Steven Frank, a partner with DHG

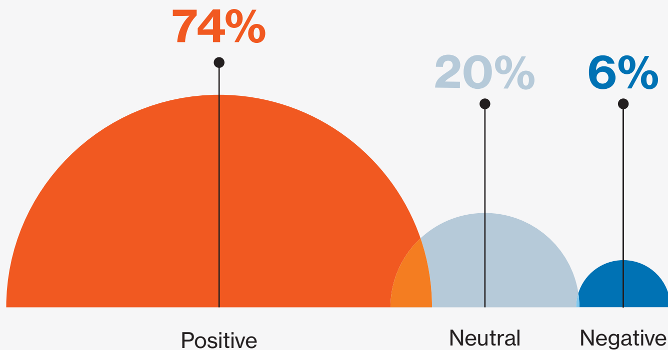
Transaction Advisory, also expects deal activity to continue to be strong and to see an increase in deal flow. "Many of our clients and investment bankers are noting a significant percentage of current deals stem from sellers trying to preempt an expected rise in taxes as they anticipate capital gains will soon be treated as ordinary income. Given discussions with our private equity clients and the variety of trends we are seeing, we anticipate deal volumes returning to, or near, pre-COVID levels at some point in 2021," says Frank.

In terms of deal flow, respondents overwhelmingly believe that add-on acquisitions will be the most common type of deal that gets completed. More than 60% said they expect add-ons to take center stage. This builds on what was already a strong trend for the past couple of years, including in 2020. With the onset of COVID-19, many private equity firms turned to add-on acquisitions to put capital to work with less risk involved. Add-on deals are often smaller than platform buyouts, and allow private equity firms to grow their portfolio companies via inorganic growth. These smaller companies are less likely to be institutionally backed, unlike platform companies, and are more likely to be struggling from COVID-19-related effects, making them especially attractive to private equity firms. Thus, it is no surprise that add-on deals made up 73.4% of private equity buyouts in Q3 2020, the highest number on record, according to Pitchbook.

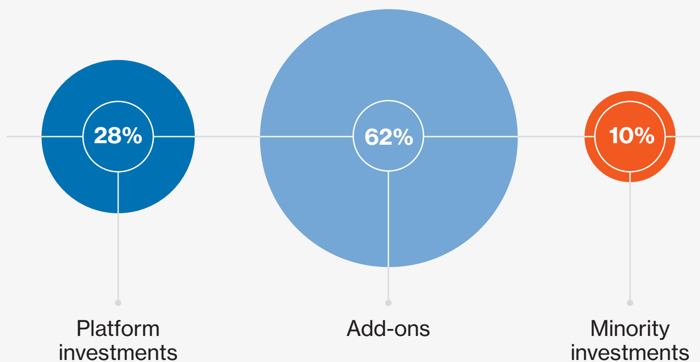
Huron Capital closed 15 add-ons through the first three quarters of 2020—13 since April 1—and Madland expects this trend to continue for private equity in general, as well as at her firm. "It's potentially easier to underwrite an add-on, as you are already seeing the impact of COVID on the platform company and can leverage what you know about how that specific industry is responding to »



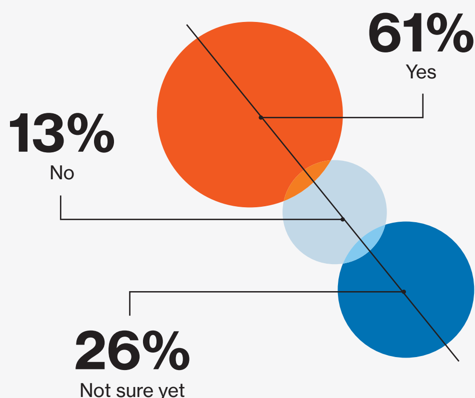
WHAT IS YOUR OUTLOOK FOR M&A IN 2021?



WHICH TYPE OF DEALS WILL BE MOST COMMON IN 2021?



WILL YOU ACTIVELY PURSUE AN ACQUISITION WITHIN THE NEXT 12 MONTHS?



COVID," she says. "Overall, I believe buy and build will continue to be a critical aspect of our growth strategy going forward, perhaps especially now."

Deal-making in most of 2020 was largely driven by smaller transactions. During the first three quarters of the year, deals under $100 million accounted for 68.7% of all M&A activity—the highest level since 2016. Deals in the $1 billion to $5 billion range made up only 1.2% of the deal count, which is the lowest percentage for this size category since 2013, according to Pitchbook. The pandemic has led deal seekers to scour the lower middle market for returns that may have been overlooked by other acquirers who have been priced out of the middle market, according to Pitchbook.

"You can often get better value from lower valuation add-on acquisitions in the lower middle market, which is a big driver of deal demand. Roll-ups can be a good way to increase EBITDA valuation multiples as companies grow into more competitive and higher valued market segments," Hickey says. "It's a strategy we also use. There are many smaller, high-quality businesses that don't want to go through the grind of another recession."

He points out that one-third of the U.S. population is around or over 60 years old. Business owners may be willing to accept a lower price in order to reclaim free time as they age, opening the door for prospective buyers. "These types of businesses can make great add-on acquisition opportunities, where the sellers also want to retain a more passive role and remaining economic interest, and therefore alignment of

interest with us as the investors," Hickey says.

INDUSTRIES TO WATCH

Asked about their expectations for the types of companies coming to market in 2021, most folks, 64%, said they anticipate medium-quality opportunities, while 29% of respondents expect there to be high-quality deals available. More than 60% of respondents expect to actively pursue an acquisition within the next 12 months.

For her part, Madland reports seeing a disproportionate number of higher quality assets coming to market. "Since we tend to invest in generally healthy, profitable and growing companies, much of the more actionable deal flow we are seeing is COVID-resilient or has been minimally impacted by COVID," she says. "With lots of equity capital eager to be deployed and continued ready access to credit and leverage, valuations are holding up and, in some cases, rival the pre-COVID valuations we were seeing."

Perhaps not surprisingly, when asked which sectors deal-makers expect to focus on in 2021, responses were all over the map. Some of the hotter sectors include business services, consumer products and services, health care and pharmaceuticals, and technology—all sectors that have become increasingly important since the spread of COVID. Madland expects industrials and utilities to be of interest, too. "Businesses that provide critical infrastructure or critical systems maintenance and repair can be very attractive, given their resiliency to swings in economic activity. Also, businesses that provide products or services to warehouses—or play at all in the logistics space, particularly as it relates to grocery—can be appealing, too," she says.

Logistics and transportation is an industry that's also expected to garner interest. "There are a lot of products being moved around as people are having more delivered to their homes," Hickey says. "They are also buying more products for home use, like educational products to help their kids with education, exercise equipment or consumer electronics. I think we will continue to see an uptick with things being delivered."

Industries that will likely receive less attention in 2021, according to survey respondents, include automotive, entertainment and retail.

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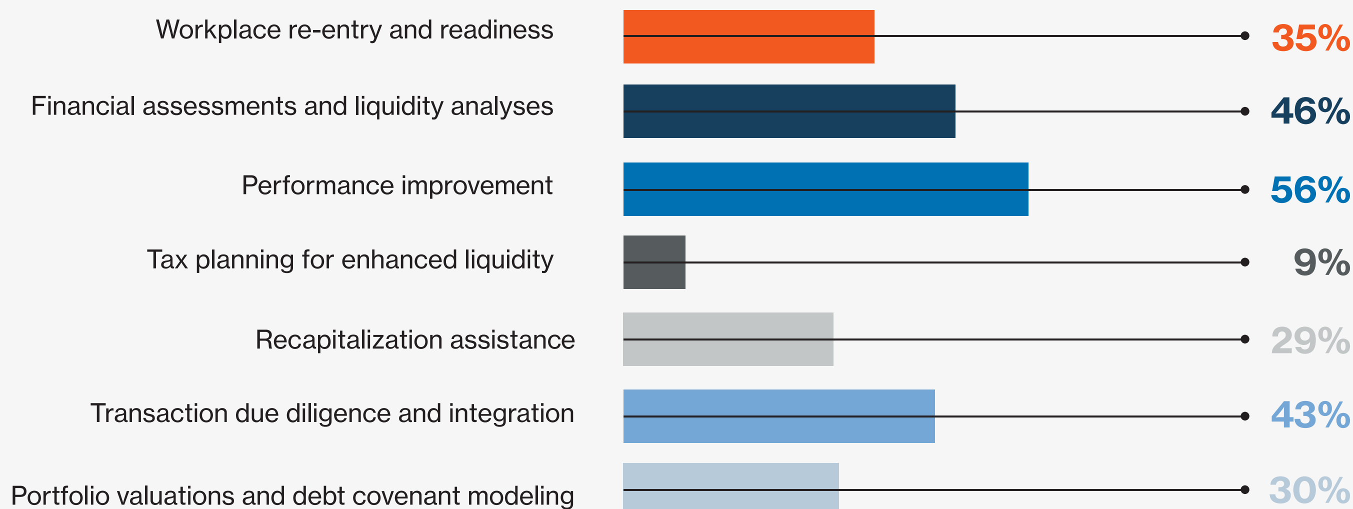
WHAT WILL YOU FOCUS ON IN 2021?

Respondents were able to select all that apply



As far as working with portfolio companies, most deal-makers believe their time will be spent working on performance improvement, workplace re-entry and readiness, financial assessments and liquidity analyses. Scott Linch, a managing partner of DHG Private Equity, says performance improvement is key to enhancing EBITDA and unlocking sources of cash flow. "For many businesses, COVID-19 has illuminated the need to remaster the basics of performance improvement in a world that demands extraordinary agility and adaptability," Linch says.

Individual businesses will have different needs in the coming year, says Private Capital Research's Frazier, and private equity approaches to portfolio management vary. "Every company and portfolio is situational. No one wants to admit how much time they are putting into managing the portfolio. Some firms have teams dedicated to that, others don't," he says.

> "FOR MANY BUSINESSES, COVID-19 HAS ILLUMINATED THE NEED TO REMASTER THE BASICS OF PERFORMANCE IMPROVEMENT IN A WORLD THAT DEMANDS EXTRAORDINARY AGILITY AND ADAPTABILITY."
>
> SCOTT LINCH
> Managing Partner, DHG Private Equity

One thing to expect from all private equity investors in 2021 is a focus on identifying high-quality, well-priced businesses. "In addition to the things survey respondents mentioned, I think deal flow will be a priority for everyone," Frazier says. You have to find companies to invest in that are worthy and where you don't have to pay crazy multiples." //

[1] Between September 8 and November 3, ACG surveyed deal-makers about their outlook for 2021 and other topics. More than 600 people responded to the ACG surveys.

Steven Frank
Partner, DHG Transaction Advisory

M&A Trends & Outlook

DHG

As M&A professionals consider what deal-making activity will look like in 2021, Steven Frank, a partner in DHG's Transaction Advisory group, and Scott Linch, a managing partner in DHG's Private Equity group, discuss what they are expecting to see in 2021 and where they think deal-makers will be placing their bets.

Q Tell us about recent M&A trends and where you see the market heading in 2021.

A In late Q3 2020 and into Q4, we saw significant deal flow return. The increase in deal flow was driven by the re-emergence of paused deals, pent-up demand from private equity due to significant amounts of dry powder, an urgency for some sellers to close a deal prior to year-end to preempt an expected rise in capital gains taxes, as well as some distressed opportunities arising as a result of the pandemic.

In 2021, I expect there may be a short-term pullback followed by various surges of deal flow beginning in Q1 for companies that performed exceptionally well during the pandemic, and then we may eventually get back to some level of normalcy mid-year. However, I do anticipate sustained volatility for some time. The most common obstacles to deal flow next year are economic and political uncertainty, the availability of quality acquisition targets, buyer competition and valuations. The presidential election may result in some short-term volatility, but I suspect it may not be that impactful.

Q Which industries have experienced the most investment interest during the last year and what do you expect in 2021?

A Technology and business services have remained relatively strong. The software, technology, digital and telecommunications space likely continue to lead the charge as they are generally more resistant to short-term disruptions, and their valuations have performed well in 2020. We see plenty of opportunistic deals in growth segments such as internet and streaming services, cloud computing services, remote working technologies, cybersecurity and fintech. On the telecom side, we are seeing significant growth in managed services as companies move away from on-premise solutions and high capex investment models to a recurring managed services model. This shift marks the growing adoption of cloud-hosted solutions. The overall growth in technology and telecom is driven by broader economic and consumer demand, but also the appeal to investors of the recurring revenue model.

Private equity groups are showing a high level of interest in the business services industries, particularly for companies with recurring revenue and scalable margin, often in industries in a fragmented market that is ripe for roll-up strategies. As such, there has been a significant amount of consolidation and add-on investment opportunities. We have seen increasing activity in tech-enabled business services and commercial and residential services, such as HVAC servicing and repair, pool services and maintenance, and repair or renovation services. Buyers are seeking smaller add-on deals in the lower middle market at lower multiples of EBITDA and with synergistic opportunities to drive value.

Q Which due diligence considerations will be key in 2021?

A One of the biggest challenges is assessing the impact of COVID-19 on operating results. In all transactions, we continue to see varying degrees of acceptance on normalizing for COVID-19 results in valuation discussions. Consideration should also be given to the impact of COVID-19 on working capital as we continue to see challenges with buyers and sellers agreeing on the appropriate level of target working capital at closing. Other key considerations are PPP loans and changes in accounting policies, especially revenue recognition and the new lease accounting standard. //

Scott Linch
Managing Partner, DHG Private Equity

Emerging Strong in 2021

DHG

Q In times of uncertainty and disruption, companies often focus on optimizing cash flow and working capital. What did you see from the middle market in 2020?

A When COVID-19 came to the U.S., private equity was very focused on updating forecasts, cash flow modeling and profitability roadmaps with all their portfolio companies, and now most groups are maintaining and updating those models.

As for the Paycheck Protection Program, many portfolio companies did not receive a loan; however, many of the businesses not backed by private equity did, and they eventually need to consider the right number of employees and other cash expenses once their PPP loan has been used. During the pandemic, some businesses retained more employees than possibly needed due to the stipulations of the PPP loan, and we later saw profitability was not as high in those months.

In terms of working capital, there was greater focus on cash flow considerations related to timing of payments, extended terms and recurring business, particularly for software and services companies. We also saw delayed purchases and renewals on certain government and municipal agreements. Throughout the year, we knew to distinguish between situations that were delays rather than a lost customer base.

Some examples of industries most adversely impacted in 2020 were fitness studios, restaurants, retail businesses and other brick-and-mortar companies.

Q Which value drivers received the most attention from private equity in 2020 and what do you expect to see in terms of performance improvement in 2021?

A Monitoring business performance is crucial for all businesses, but private equity seemed most focused on performance improvement in 2020. We saw many investors interested in optimizing the effectiveness of their sales force, including efficiency and compensation. In the specific event of add-ons, there were typically situations in which the sales force was compensated very differently, and the goal was to find a solution involving consistent compensation. This can be particularly true for software businesses and other subscription-based businesses with a large and widespread sales force.

Going into 2021, we expect to see more activity related to financial management. Financial management becomes a focus on Day One for many portfolio companies since it can take months to implement. Likewise, good forecasting requires a proper finance team in place to measure growth and performance. Often, this may involve adding an industry CFO, implementing an ERP system or establishing new reporting. Many founder-owned businesses do not have the sophistication required of private equity when it comes to KPIs and monthly reporting.

Q How are you seeing the recent market uncertainty affect valuations?

A In the middle of 2020, many private equity groups had to mark down their portfolios, some adjusting nearly 20%. Despite the portfolio markdowns, acquisition multiples and valuations are still very high and future-focused. Run-rate revenue and future EBITDA often have increased importance rather than the previous last 12 months of EBITDA. The pent-up demand for deals along with the surplus of dry powder continues to drive deal activity and valuations.

Q What types of deal issues do you envision playing a large role in 2021 M&A regardless of the industry?

A The biggest issue for transactions in 2021 is COVID-19. How companies adjust, whether positive or negative, continues to play a large role as companies attempt to determine the new normal. Businesses also need to reconsider their go-to-market strategies, particularly customer acquisitions and business operations in a virtual environment. Another top issue is e-commerce platforms and digital visibility and reach. This may result in increased technology investments to enhance touchpoints and communication with customers. //

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The Search for Talent Continues Even Amid the Pandemic

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The Search for Talent Continues Even Amid the Pandemic

Pandemic or not, private equity firms and their portfolio companies have to keep moving forward, and sometimes that requires hiring new talent. Prior to the COVID-19 outbreak, many investors and their portfolio companies had already incorporated the use of technology to help them make hiring decisions. Those tech-enabled capabilities have since become key in a world where meeting candidates face-to-face is no longer a viable option.

"THE BIGGEST CHANGE IS THAT WE ARE HIRING ALL VIRTUAL, SO WHILE HIRING NEEDS HAVEN'T CHANGED, HOW WE HIRE, ONBOARD AND MAINTAIN OUR CULTURE WHILE THE OFFICE IS CLOSED HAS."

LISA KNAPP
Talent Manager, NewSpring Capital

"Like everyone else, we had no idea in March what was going to happen. No one has lived through anything like this before," says Lisa Knapp, talent manager for NewSpring Capital, a middle-market private equity firm. "We put the brakes on to see how busy we were and what our portfolio companies needed. By the summer, it became apparent that this wasn't going away and we needed to do what we needed to do."

NewSpring has continued to add to its staff this year, although the hiring and onboarding process looks a bit different than it has in the past. "We are hiring as planned for 2020 to replenish our analyst program, and adding additional senior team members as necessary," Knapp says. "The biggest change is that we are hiring all virtual, so while hiring needs haven't changed, how we hire, onboard and maintain our culture while the office is closed has."

NewSpring is not alone in moving ahead with its hiring plans. Almost 50% of deal-makers say that the pandemic hasn't affected their appetite to hire, according to a recent survey conducted by ACG and sponsored by Globalization Partners[1], a company that helps businesses hire globally. Additionally, the majority of respondents said they expect to hire in 2021 at the portfolio level, because their portfolio companies will be expanding or replacing talent.

"We've been fortunate that the pandemic has not negatively impacted our hiring. We are doing more virtually, and not meeting candidates live before offers, so it means more reference calls, but we have to keep our recruiting and hiring levels the same," says Melissa Guttman, a principal and head of talent at JMI Equity, a middle-market private equity firm.

In addition to leaning on technology like Zoom to help with new hires, many firms are turning to their own networks and headhunters to find new talent, according to the survey. More than 40% of respondents said they rely on an existing network of advisors to help them identify candidates, with 24% saying they use a headhunter. Using personal networks isn't necessarily a new practice, but it's perhaps more comforting today when you're less likely to meet someone in person.

Adam Miller, a managing director and head of global talent management with The Riverside Company, says his firm relies on both methods. "We have a strong network of individuals who are well-networked and referrals tend to work in our favor. There are no recruiting fees and the candidates are usually very strong—everyone wants to refer someone that is a good reflection on themselves," he says. "The senior-level positions with sector specificity are harder and fewer to come by, so sometimes recruiters can pull the levers and are good to lean on in these instances."

Guttman adds that using recruiters can help diversify the candidate pool, which is an important initiative for the Baltimore-based firm. "We use a search firm quite regularly. It doesn't mean we will not reach out to our network, but the search firms have broader reach and it helps us gain diversity at the firm, which we are focused on. They go beyond our network," she says.

Overwhelmingly, private equity firms look to hire when they expect to expand into new markets and need teams on the ground, according to the survey. Additionally, most firms start searches for new hires prior to closing on a deal; however, they tend not to make a final decision on hiring until after the transaction closes and there has been an assessment period to evaluate the company's needs.

Miller agrees with survey respondents and says Riverside's deal teams target a blended approach as well. "Pre-acquisition, the transactors are meeting with management and understanding the operation and where the synergies lie," he says. "Generally, the search for talent in our portfolio companies is done post-acquisition, when boots are on the ground, and our operating partners can truly see how the company operates and can onboard the right talent. They can start the search prior to a deal closing, but not pull the trigger until after you get a feel for the operation in action."

C-suite-level individuals are the most sought-after talent for portfolio companies, according to the survey, with 36% of respondents saying that these senior-level positions are the ones they're looking to hire most frequently. The importance of having the right C-suite talent cannot be overlooked. Private equity firms want to replace top positions soon after the transaction is complete because effective management teams often »

HOW DO YOU USUALLY SEARCH FOR NEW TALENT?

24%
Use a headhunter

42%
Rely on an existing network of advisors

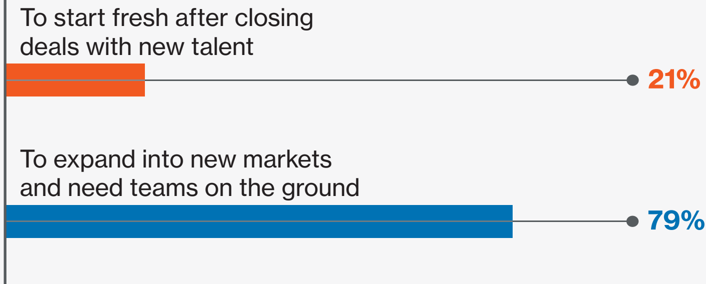
10%
Advertise online

19%
Don't have a defined method

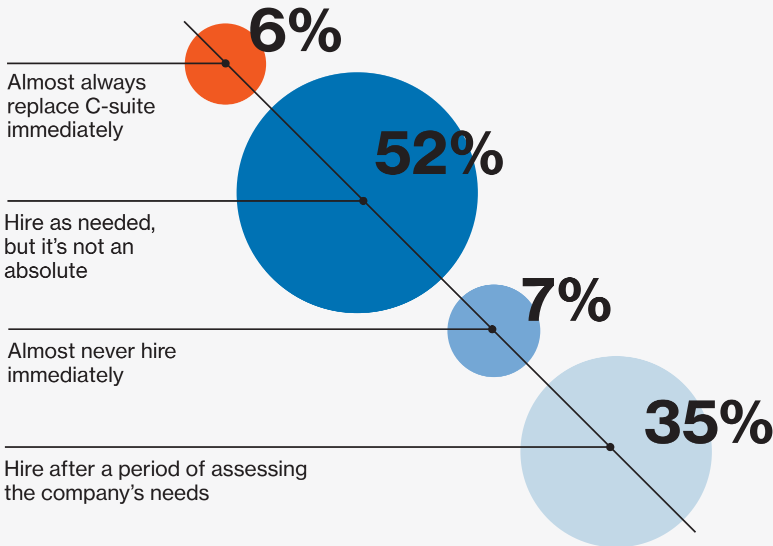
5%
Other

Hiring Initiatives

WHAT IS THE MAIN REASON YOU MIGHT HIRE NEW TALENT?



HOW QUICKLY AFTER TRANSACTIONS CLOSE DO YOU HIRE TALENT?



DO YOU EVER START SEARCHING FOR NEW HIRES PRIOR TO THE DEAL CLOSING?

30% Yes, we like to be ready when the deal closes

45% We may start searching but make the final decisions after closing

25% No, we don't dedicate any time to hiring prior to close

lead to strong returns. "The C-suites of the portfolio companies drive the vision. If you have the wrong people in these roles, it can eat away at growth," Miller says. "If it takes too long to identify the right person, the company will be that much further along in the holding period and it will impact the company's growth and performance."

He stresses that time is of the essence, creating urgency for private equity firms to hire new leaders quickly. "Our private equity funds typically have a three- to seven-year window to help grow a portfolio company. The more efficiently you can hire or replace executives, the better the company performance will be long-term. These individuals play an important role when making decisions at your company. Their importance can't be underestimated," Miller says.

When it comes to acquiring a carve-out, buyers want to be sure that they will be able to retain key talent. To do that, most respondents said that they offer performance and retention bonuses as well as incentive plans.

"First, assess talent to determine if you want to retain, then offer retention bonuses payable in six to 12 months. You can also offer incentive plans as well," offered one survey respondent.

Others try to forge strong relationships with talent, reinforce the executives' value in the organization, and assure them of their future within the business—and perhaps even offer promotions.

"We talk to each key person individually to discuss the long-term strategy for the business, solicit their ideas on how to add value, and determine their aspirations on how they see themselves fitting in.

If their only motivation is getting a better compensation package, we write them out of the go-forward plan," one respondent wrote. "If they see the vision, we look to get them deeper involved."

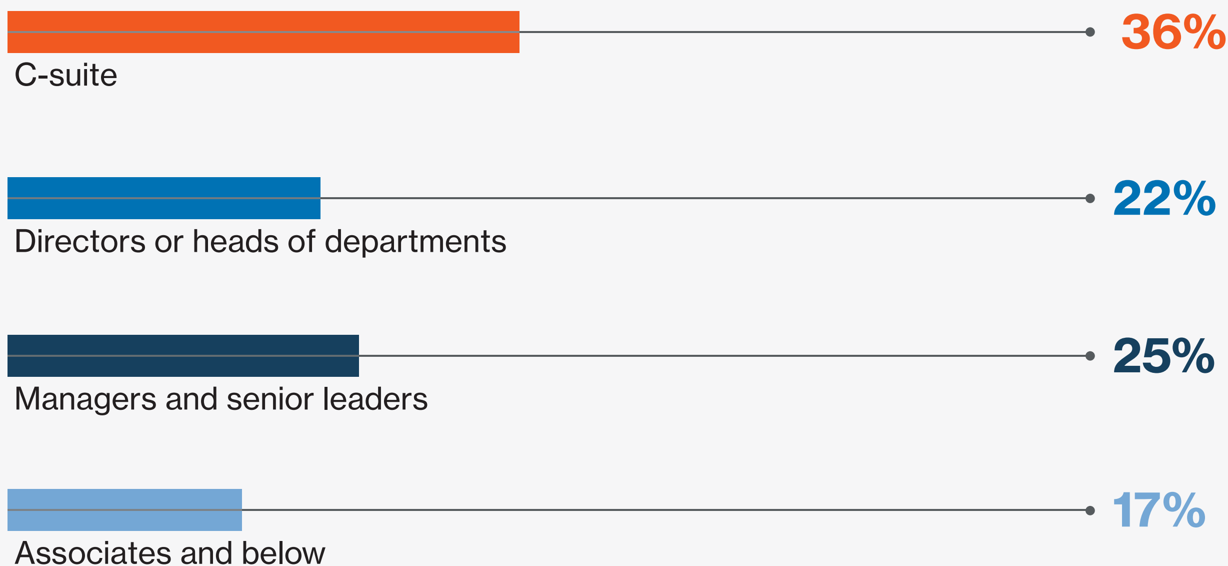
Another respondent offered, "Ensure a clear understanding of the strategy along with well-defined expectations of the role, provide an incentive-based approach, and involve senior leaders in the interview process to ensure a good cultural fit of the candidate."

> "WE USE A SEARCH FIRM QUITE REGULARLY. IT DOESN'T MEAN WE WILL NOT REACH OUT TO OUR NETWORK, BUT THE SEARCH FIRMS HAVE BROADER REACH AND IT HELPS US GAIN DIVERSITY AT THE FIRM, WHICH WE ARE FOCUSED ON."
>
> MELISSA GUTTMAN
> Principal and Head of Talent, JMI Equity

Many respondents stressed that retention of key employees is critical in a carve-out situation.

Respondents' outlook for hiring talent in 2021 was evenly split between hiring to expand and hiring to replace talent that has moved on. Riverside's Miller admits he will be approaching the new year cautiously when it comes to hiring. "Without a vaccine or herd immunity, we are not running into 2021. We will see where the winter months take us and where we are with the needs of our companies," he says. "At the private equity level, there is usually some organic attrition as a result of bonus payouts at the end of the year or in the first quarter. I don't think we will see as much of that with all the uncertainty. We will do what we need to do to keep our businesses profitable."

Additionally, some expect changes to the ranks of job seekers in the



future as a result of COVID. "It is too early to tell, but my guess is that the candidate pool for associate classes will look different," says JMI's Guttman. "There might be less investment banking analysts than in prior years, so a smaller pool there, but as a result we may have access to more candidates for our analyst class, which we hire straight from undergrad. There could be a shift in the number of candidates available, which could give hiring firms an advantage, depending on what position you are hiring for."

Few things about the market are certain as firms make plans for the new year, and many are doing their best to forge ahead amid the continuing pandemic. "We are just going to have to wait and see how things play out," says NewSpring's Knapp. "We are moving forward with the reality that this will drag on longer than we thought, so we've focused on how we can stay efficient through hiring and training new talent and keeping a positive culture." //

> "THE MORE EFFICIENTLY YOU CAN HIRE OR REPLACE EXECUTIVES, THE BETTER THE COMPANY PERFORMANCE WILL BE LONG-TERM."
>
> ADAM MILLER
> Managing Director, The Riverside Company

[1] Between September 8 and November 3, ACG surveyed deal-makers about their outlook for hiring talent in 2021 and other topics. More than 600 deal-makers completed the surveys.

Hiring Initiatives

The Power of Geographically Distributed Teams

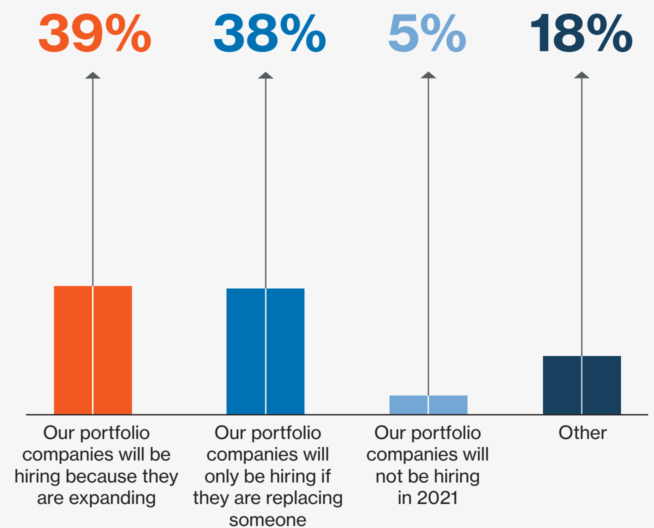
Globalization Partners

Teams with distributed geographies have proven benefits for business resilience. Whether part of an expansion or to test demand further afield, hiring internationally enables companies and private equity portfolios to increase returns faster.

Even before the start of the pandemic, global teams were struggling to feel connected to their company headquarters, Globalization Partners' 2020 Global Employee Survey found. International employers have long grappled with the challenges associated with building strong teams, such as relying on technology for meetings and day-to-day communication. This year's limitation on travel, office use and socializing made the disconnect even more poignant. We asked the experts: Should this be a deterrent to going global in 2021?

In the current economic climate, it is easy to be pessimistic, but the International Monetary Fund projects global growth in 2021 to hit 5.4%. In comparison to global growth of 2.3% in pre-pandemic 2019, these numbers are extremely encouraging. In fact, only 5% of private equity firms reported that their portfolio companies will not be hiring in 2021; 77% fully expect hiring to continue as we emerge from the global lockdown.

WHAT IS THE OUTLOOK FOR YOUR PORTFOLIO COMPANIES IN TERMS OF HIRING IN 2021?



Virtual-first workplaces translate into savings for companies and individuals.

While expansion is not cheap, employers will be making hard cash savings in the coming years if they establish remote working policies across all regions. Employers can save $11,000 per employee working remotely six months of the year, according to Global Workplace Analytics.

Parallel to employer savings, employees spend $2,500 - $4,000 less by working remotely half the year. These savings could be tenfold if employees were empowered to move to any city or country they choose.

Going global did not previously demand a remote workforce, but now that remote work is a necessity for most, 2021 may, in fact, be the best time to explore new talent sources and markets that would enhance your portfolio. Moreover, inclusion, collaboration and resilience within international teams improve when companies have leaders in different geographies, and the research supports this.

Q How do companies benefit from globally distributed teams?

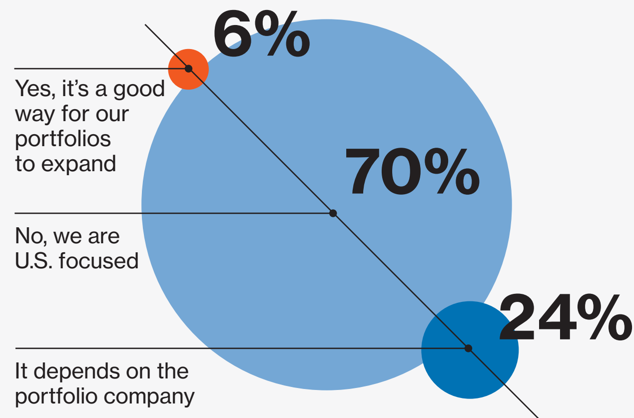
If your portfolio companies want to grow internationally in 2021, the benefits of internationally distributed teams should encourage them to look for talent around the world.

Hiring abroad may be born from necessity, but it is a positive business move.

"As a company with offices in every corner of the globe, I've seen the incredible business advantage in hiring and building diverse teams," says Nicole Sahin, CEO of Globalization Partners.

There is a clear correlation between innovation and diversity. Research firm Gartner found that companies hiring

DO YOU OFTEN LOOK FOR TALENT OVERSEAS?



people with varied ways of thinking and perspective—or cognitive diversity—generate high-performance teams.

In September, Gartner predicted that 75% of organizations with frontline decision-making teams in distributed geographies and with diverse mindsets will exceed their financial targets by the end of 2022. Building teams spanning age groups, ethnicities and geographies makes good business sense—employee performance is 12% higher in diverse companies than in homogenous teams.

Hiring unique individuals in different geographies mimics the real world.

Companies rarely service multiple clients that fit one buyer persona, so it's important to have a diverse workforce to keep in touch with varied clientele. Diversifying teams should be a business priority, not a mere side effect of international growth. As businesses become more customer-centric, many are hiring closer to their clients and therefore recruiting teams that embody their buyer personas.

International recruitment expands the talent pool.

Demand for permits, such as the U.S. H-1B or Australia's Temporary Skill Shortage visa, are evidence that companies cannot always find the talent they need in their backyards. With COVID-19 prompting various governments to limit visa programs amid the pandemic, companies may look outside their headquarters to fill skills gaps.

Q What headwinds do companies face with a remote global workforce?

Tempered cultural inclusion is not a new problem, but it is more evident.

More than 90% of people working in global organizations describe their companies as diverse. It should be surprising, then, that many organizations lack know-how on managing a disparate and diverse workforce. Globalization Partners found that 30% of employees surveyed in 2020 did not feel a sense of inclusion or company belonging.

This negatively impacts employee engagement and staff turnover. Globalization Partners also uncovered that international teams are struggling to make communications work for them. For example, 46% of employees still rely most frequently on email, but only 31% find it effective. Email does not allow for the bonding necessary to build strong teams, when international colleagues may never meet in person.

Diverting revenue streams to feed expansion is daunting.

Perhaps bolstered by COVID-19 globalizing professional customs, CFOs continue to promote global expansion. However, what concerns CFOs remains consistent year-on-year: 79% agree that legal, HR and tax compliance is a substantial barrier to global expansion.

When asked about global expansion, 74% of executives surveyed by Globalization Partners expressed concern with navigating international banking systems and payroll in these volatile times. In support of their portfolio's growth, private equity firms may choose to delegate global hiring management to an external partner. This ensures predictability in terms of costs, and cuts risk for their portfolio companies.

"The biggest issue facing companies as they expand globally is the time and cost involved with establishing legal entities abroad. Our clients can easily hire in another country while ensuring compliance with international laws," says Charles Ferguson, general manager, Asia-Pacific, at Globalization Partners.

Talent needs to keep up with technology.

Today's world demands high levels of skill and adaptability to technology and few companies have prepared for employees not being tech-savvy. The European Commission estimates that 37% of workers in Europe lack basic digital skills, suggesting that many businesses will need to focus on upskilling their employees.

Another argument for providing training in technology is

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that this benefits engagement and cuts turnover in remote teams. According to LinkedIn's Workforce Learning Report, 94% of employees say they would stay at the same company longer if management invested in their learning. To this point, private equity firms can support their portfolio companies by contracting coaching sessions in work-from-home tools. They can also share remote leadership tips learned from personal experience in 2020.

Q What can companies do to ensure inclusion among remote and cross-border teams?

Two-thirds of companies reported to Globalization Partners that they find it challenging to align with local culture and communication styles, especially when a company spans multiple geographies. This tracks with employee sentiment: Nearly nine out of 10 employees say their company would benefit from outside expert assistance to help with cultural and cross-organization training.

So, what plan can company stakeholders put in place to ensure diversity and inclusion?

1. **Actively search differently.**
   The 2020 Talent Survey by ACG and Globalization Partners indicates that most leaders rely on an existing network of advisors for global hiring, which is not conducive to recruiting from fresh talent sources. Your portfolio companies' recruiters should explore new methods, such as identifying colleges with diverse student bodies and reaching out to graduates from those institutions.

2. **Interview with diverse screen panels.**
   In 2014, Intel began requiring interview panels to include a minimum of two women and/or members of underrepresented communities. Over the following two years, Intel's diversity hires grew from 31.9% to 45.1%. This same tactic worked at Cisco, too, resulting in a 70% increase in the chances of African American/Black women completing the interview process.

3. **Educate on the benefits of inclusion.**
   Empower employees to discuss inclusion in weekly meetings. Integrate inclusion into your learning platform. Speak to your portfolio companies about the benefits of inclusive behavior and outsource experts to provide sensitivity and awareness trainings.

4. **Develop trust through vulnerability.**
   Be brave enough to voice your struggles when working toward inclusivity. Whether you are an investor in a company, an external consultant, or a key part of internal leadership, sharing your story can debunk stereotypes and encourage empathetic discussions across global teams.

Q Which regions will companies favor in 2021?

According to a study by Oxford Economics, 90% of developed nations will face talent shortages in 2021, including North America, Russia, Japan, Australia and much of Europe. Many companies will need to look further afield for talent to keep operations running.

North American private equity firms, while primarily focusing on U.S. talent, see hiring abroad as a source of portfolio expansion. According to finance executives surveyed by Globalization Partners, after North America, the Asia-Pacific region is the top target in 2021 expansion plans; more than 50% are interested in adding operations in the region. The same findings indicate that 83% of CFOs are looking to a remote, global workforce model as a solution to challenges brought about by COVID-19.

And what's driving this? Companies primarily want to capture market share, diversify investments and acquire the best talent for their growing teams. The digital age has made it possible for employees to communicate seamlessly—regardless of their country of residence.

Global expansion is an opportunity to diversify in so many ways. Why not start with your teams? //

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COVID-19

Pandemic Still a Major Threat to Midmarket Companies

Pandemic Still a Major Threat to Midmarket Companies

The coronavirus outbreak has disrupted virtually every type of business—especially those within the middle market, according to a recent survey conducted by HawkPartners on behalf of ACG and sponsored by QBE Insurance Group Limited. Middle-market business professionals were asked about their biggest perceived risks going into 2021[1]. "Pandemic" was mentioned more often than any other concern. For Simplura Health Group CFO James Caruso, the frequent mention of COVID-19 in the survey is very telling of the times.

> "IF YOU TOOK THIS SURVEY A YEAR AGO, PANDEMIC WOULDN'T BE THERE. WHAT THAT SHOWS YOU IS IT'S THE UNKNOWN RISKS THAT ARE POTENTIALLY THE MOST DISRUPTIVE."
>
> JAMES CARUSO
> CFO, Simplura Health Group

"If you took this [survey] a year ago, pandemic wouldn't be there," Caruso says. "What that shows you is it's the unknown risks that are potentially the most disruptive."

The risks that the coronavirus pandemic posed seeped into all facets of business, including M&A. Orchestrating a transaction in a normal year is challenging in its own right, but the pandemic certainly makes matters worse, Caruso says, citing travel restrictions and how the typical meet-and-greets all went virtual, making M&A transactions harder to complete.

Despite these obstacles, Simplura's private equity owner, One Equity Partners, was able to successfully sell the home health care agency to Providence Service Corp. (Nasdaq: PRSC) for $575 million in September.

Simplura's sale was part of a surge of deals in the second half of the year. Although M&A activity was down significantly in the first two quarters of 2020, the market rebounded in Q3, when deal count in the U.S. rose to 2,714 with a total value of $361.1 billion, according to Pitchbook Data. Still, the third-quarter spike failed to make up for the slow year where global M&A deals, overall, slipped 21% to $2.2 trillion throughout the first nine months of 2020, according to *Reuters*.

This trend was illustrated in the survey. A majority of companies said M&A strategies were negatively impacted in 2020. About 21% of respondents reported having "general concern about risk" related to deal-making. Some 17% said financing would likely dry up, 13% said deals would likely be delayed, and 10% said deals would disappear altogether.

"When a transaction makes fundamental sense strategically, the coronavirus pandemic can be kept in perspective as a short-term anomaly, rather than a reason not to do a deal," Caruso says. "When both the acquirer and the acquiree share a vision and have the desire to proceed, where there's a will there's a way, as the saying goes. Technology—and, more importantly, trust that builds on reputation and relationships—enables the parties to navigate the obstacles posed by COVID-19 and run a successful process."

The pandemic's effects were not exclusive to any one sector. Survey respondents worked in a diverse group of industries, including construction; electronics; finance/banking; food and beverage; health care; hospitality; insurance; manufacturing; professional services; real estate; retail and consumer goods; technology/computer services; and wholesale/distribution.

The pandemic will likely continue to disrupt these industries as the number of new coronavirus cases reported in the U.S. climbs.

REMOTE WORK

Going forward, 33% of survey respondents said that cash flow was a top

concern, followed by employee safety, the ability to interact with employees, customer safety and travel restrictions.

Jeffrey Kadlic, co-founder of Evolution Capital Partners, took each of these risks into consideration at the start of 2020 and continues to evaluate the threat they pose going forward.

His Cleveland-based private equity firm had become aware of how devastating COVID-19 was in China as cases spiked in Wuhan and across surrounding regions at an alarming rate.

"We are invested in some companies that source product in China and they were experiencing disruptions in their supply," says Kadlic. "By early March we began to recognize that the virus was undoubtedly going to impact the United States, but were uncertain as to the extent and how Evolution or the rest of the country was going to respond."

For Evolution Partners, traveling to China was no longer an option. The firm's top priority became employee safety. And so it responded like everyone else and adapted to the new work-from-home culture.

This was a major challenge, Kadlic says. From a technology perspective, the small-business PE fund moved quickly to get its portfolio companies the necessary tools to be as effective at home as they were at the office.

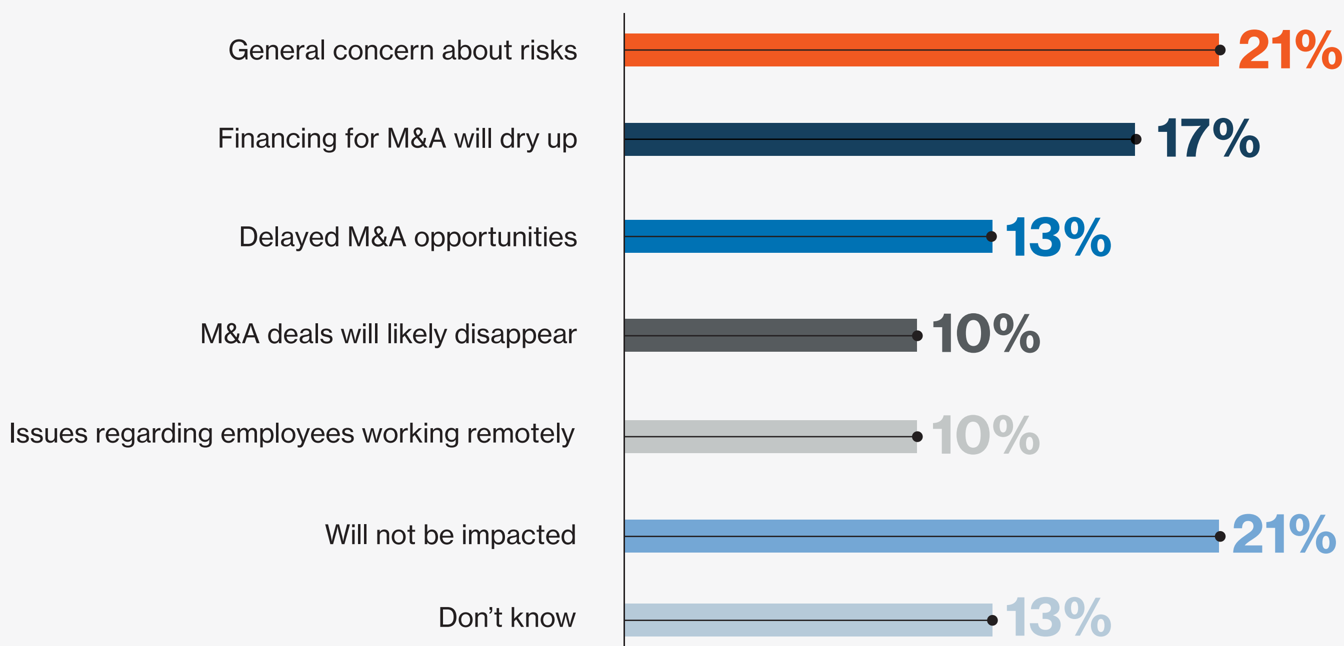
"Every company subscribed to Zoom, Microsoft Teams or Google Meet to facilitate communication," Kadlic says. "The usage of video conferencing as the standard way to communicate was greatly accelerated due to the pandemic and will likely be a permanent change."

Kadlic and his colleagues had to adjust how they interact, and they're preparing for more of the same in 2021.

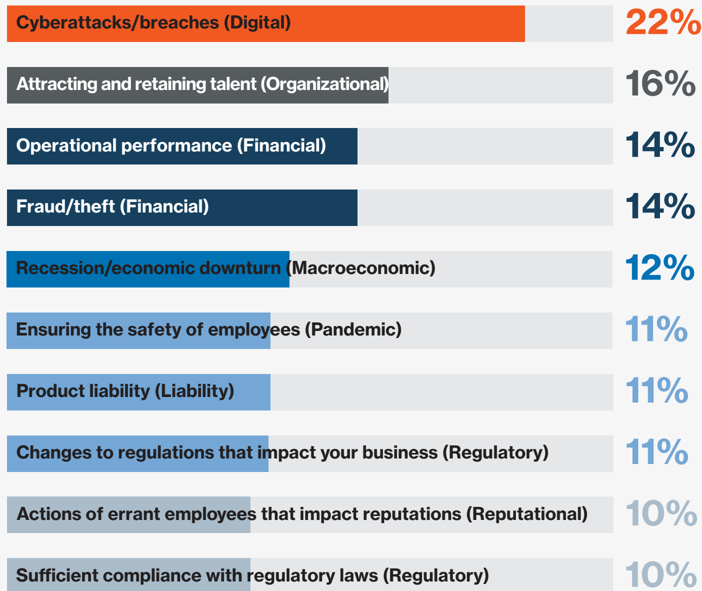
"Communicating in person, particularly around sensitive topics, is still the preferred method to communicating, but that simply is not possible at this point," Kadlic says. "It is important to put more emphasis not only in what you say, but how it's communicated, so it is received the way it was intended." »

MOST CONCERNING RISKS THAT COULD IMPACT M&A STRATEGIES IN 2021

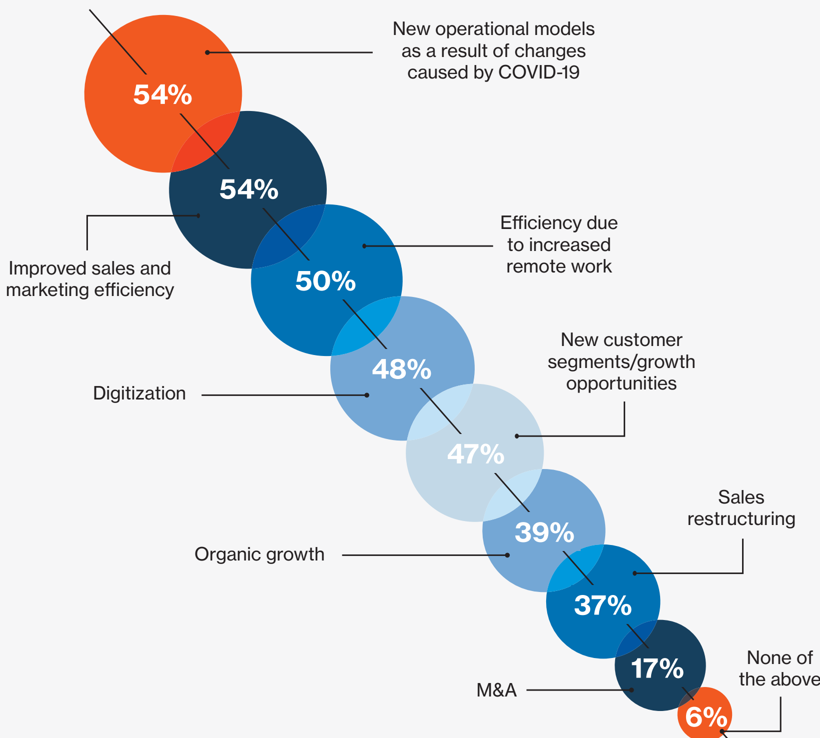
Respondents were able to select all that apply



MOST CONCERNING MICRO RISKS IDENTIFIED



OPPORTUNITIES, MOST NOTABLY CAUSED BY COVID-19, FORESEEN BY MIDMARKET BUSINESSES



CYBERSECURITY

Midmarket business professionals in the survey also expressed concern about their cybersecurity preparedness. Digital risks are dire for all industries. Most respondents find cyberattacks and breaches to be a significant risk factor, one compounded by companies' reliance on virtual communication.

About 37% of respondents said that cyberattacks and digital breaches were the most concerning digital risk, while 35% said data integrity issues were a top issue.

Considering how many high-profile beaches there were over the past several years, it's not surprising that cybersecurity is so prominent. In 2019, major companies like Zynga, the tech firm behind mobile games such as "Words With Friends," and Capital One Bank reported breaches that affected 218 million accounts and 100 million accounts, respectively.

The breach at Quest Diagnostics and its billing and collections vendor, the American Medical Collection Agency, was especially devastating. The security breach exposed private medical information, as well as financial and personal information of about 11.9 million customers.

For those like Caruso who work within the health care sector, cybersecurity is always top of mind.

"Any data breach that would happen to us is more significant because we're in health care—it's protected health information," Caruso says. "I feel like we're adequately protected and we're insured for potential breaches, but it's still always a concern. The people that commit these types of crimes are looking for ways around the current defenses. It's like your house. You put the alarm on, but if someone wants to get in, they can find another way."

HIRING NEW TALENT

In addition to cybersecurity, some 27% of respondents said the ability to attract and retain talent was a concern, with 47% calling it the "top risk," according to the survey.

Indeed, the pandemic complicated matters, namely in the way employers onboard and exit workers.

"We are big believers in healthy communication and positive culture. Maintaining these during the pandemic requires more effort," Kadlic says. "Think of situations like onboarding a new employee who knows no one at the company. If culture is important, then how will the new employee be exposed to that culture when they work remotely for most, if not all, of the time? Conversely, how do you exit individuals from a business without it feeling undignified or unprofessional?"

"BY EARLY MARCH WE BEGAN TO RECOGNIZE THAT THE VIRUS WAS UNDOUBTEDLY GOING TO IMPACT THE UNITED STATES, BUT WERE UNCERTAIN AS TO THE EXTENT AND HOW EVOLUTION OR THE REST OF THE COUNTRY WAS GOING TO RESPOND."

JEFFREY KADLIC
Co-Founder, Evolution Capital Partners

In addition to those challenges, facility shutdowns occurred more frequently despite the financial rescue efforts of Congress. Roughly 25% of survey participants said this was a top concern, along with critical infrastructure breakdowns.

Closures inevitably led to furloughs and mass layoffs. The U.S. unemployment rate hovered at 3.5% in February. It spiked to over 14.7% in April, and came down to 10.2% in July.

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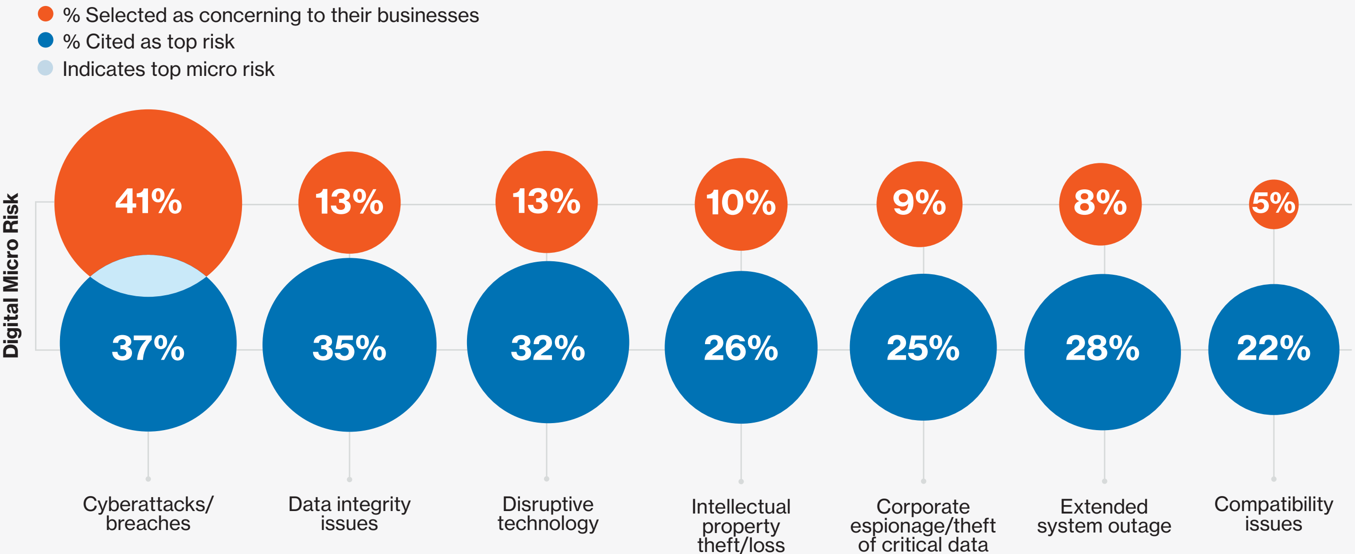
DIGITAL MICRO RISKS

Among digital risks, cyberattacks are by far considered the biggest concern



FUTURE BUSINESS OPPORTUNITIES

Middle-market companies also foresee upcoming opportunities, stemming from changes that were brought about because of COVID-19, including improved business efficiency and digitization.

About 54% of the survey's respondents said there will be new operational models as a result of COVID-19. The same percentage of respondents anticipate improved sales and marketing efficiency, while 50% expect remote work to be more efficient going forward.

For 2021, pandemic risk will be something midmarket pros take into consideration as companies expand their definition of disaster recovery.

"THE 2020 LESSON REALLY HAS BEEN TO EXPECT THE UNEXPECTED."

JAMES CARUSO
CFO, Simplura Health Group

"This year has been a lesson in crisis management," Caruso says. Cloud-based systems, data storage applications and other high-tech infrastructures were already in place to allow employees to work from home. To reduce risk, it would be wise to test those systems periodically.

"In general, people always thought of disaster recovery as primarily IT systems going down or a physical business interruption, such as a hurricane or flood—something like that," Caruso adds. "The 2020 lesson really has been to expect the unexpected." //

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[1] HawkPartners surveyed 303 midmarket decision-makers at companies with revenue ranging from $200 million to $3 billion. QBE Insurance Group Limited, Australia's second largest global insurer, sponsored the survey.

Assessing and Managing Risk

QBE North America

As the volatile risk environment drives up insurance rates, how can companies get the most value from their insurance program?

In 2020, companies faced an unprecedented array of risks, including the repercussions of the COVID-19 pandemic, record-setting storm and wildfire activity, and civil unrest. As those and other risks evolved, putting increased financial stress on many, companies also had to contend with the rising cost of insurance.

In 2021, we will likely see a continuation of this trend due to the events of 2020 and long-term issues at work before the COVID-19 pandemic. The most recent report from the Council of Insurance Agents & Brokers (CIAB) notes that premiums increased by an average of 11.7% overall in the third quarter of 2020, which was the 12th straight quarter to increase.

To best navigate this situation, insurance buyers should understand the factors driving increased rates and the services available from leading insurance providers that maximize the performance of their insurance programs.

Insurance price trends* and drivers by line of business:

Line of business	Price trend	Drivers
Commercial Property	+14.2%	Increased loss from natural disasters, especially since 2017, has been a key factor in driving property rate increases. The trend continued in 2020, with the addition of civil unrest. The continuing impact of climate change may cause natural disasters to grow in frequency and severity.
Commercial Auto	+11.0%	Distracted driving continues to be an issue, while high-tech sensors in the latest vehicles designed to reduce accident frequency also drive up the cost of repairs. Increased medical treatment costs and hostile juries contribute to higher damages when third party liability is involved. Some reports indicate decreased mileage due to the pandemic has helped mitigate increases, but mileage will rise again with economic recovery.
Workers' Compensation	+1.5%	Q3 of 2020 saw the second quarterly increase in workers' compensation rates after 21 consecutive quarters with decreases. Looking ahead, uncertainty exists about the impact of COVID-19, especially in occupations in which catching COVID-19 is assumed to have happened on the job.
General Liability	+6.7%	Liability lines have been affected by the long-term trend known as "social inflation," which has led to increased hostility towards businesses, increased litigation activity, and so called "nuclear verdicts" for the extremely high amounts of damages awarded.
Umbrella Liability	+22.9%	
Directors & Officers Liability (D&O)	+16.1%	In addition to the factors listed above for General Liability and Umbrella Liability, D&O rates have been especially affected by increased securities litigation, which is often tied to M&A and IPO activity. Concern also exists about the potential for increased litigation tied to COVID-19 related bankruptcies and business impact disclosures.

*Q3 2020 from CIAB report

Other lines such as Trade Credit and Transactional Liability for M&A deals have also been undergoing rate increases as loss costs continue to escalate. Trade Credit has been especially affected by the pandemic. For companies with self-funded health insurance plans, rates for Medical Stop Loss had been rising before COVID-19 but have recently softened, partly due to deferred medical treatment utilization.

Due to the rate increases, many companies are asking their insurance brokers to help them review their carrier relationships and look for more cost-effective solutions to managing risk. In a June/July 2020 survey that QBE jointly commissioned with The Association for Corporate Growth, 68% of midsize businesses said they considered switching their property and casualty insurance providers at least once per year.

As they work with their brokers, companies can benefit by looking beyond price and coverage and considering carriers' industry knowledge and pre-loss and post-loss services. These capabilities will help insurance buyers build a program that is tailored to their unique risks, while helping to minimize the frequency and severity of loss.

Key questions to ask include:

Do they understand the unique risks of the industry?

Are they responsive and willing to take a tailored approach?

As QBE's Mid-Sized Company Risk Survey found, risk concerns can vary widely by industry. For instance, manufacturers are significantly more concerned about liability risk, especially product liability, than tech/computer services companies are.

At a very high level, examples of some of the risks more prevalent in certain industries are listed below.

Industry	Risks
Manufacturing	supply chain management, business interruption, equipment breakdown, product liability, worker safety
Wholesale	commercial auto, property, liability
Retail	premises liability, property, supply chain management, worker safety
Hospitality	premises liability, property, worker safety
Financial Institutions	fraud, foreclosed on vacant properties, D&O, E&O

With greater industry knowledge, an insurer can more accurately tailor insurance programs to the company's risk profile and act with greater confidence and agility to changing circumstances. For instance, the COVID-19 pandemic rapidly changed the risk profiles of many businesses. Hotels no longer had guests. Non-essential retail closed. Factory operations shut down, slowed or moved to shifts to allow greater social distancing. While some insurers took a blanket approach to premium adjustments for all customers, others took a bespoke approach on how to adjust premium mid-term for each customer based on their unique circumstances, and industry knowledge played a role in that capability.

Does the insurer have robust services to help minimize the risk of loss?

If midsize companies, insurance brokers and carriers can agree on one thing, it is that the best loss is the one that never happens. For this reason, carriers offer services to help prevent or reduce losses. Ironically, many midsize businesses express an interest in engaging with these services but fail to do so frequently. In QBE's Mid-Sized Company Risk Survey, 99% of midsize businesses reported being either very interested or somewhat interested in engaging their insurance provider's loss control services, but 26% said they interacted with the department only once a year or less often—unless the company had recently filed a claim.

Midsize companies should ask about these services during the annual review when their policies come up for renewal. The best insurers will have a wide range of services backed by trained experts and the latest technology. Examples include:

- **Fleet safety programs:** These programs offer proactive policies and procedures to guard against vehicle damage, worker injury and third-party liability.
- **Worker safety:** Advances in ergonomics and utilization of mobile and wearable technologies are revolutionizing the methods for helping ensure worker safety. In one case, a mobile phone app using AI can analyze videos of worker activities, such as stocking shelves, and identify stress points that could lead to injury. Wearables can help employees recognize and reduce higher-risk bending or twisting motions.
- **Return-to-work:** These programs help employees who

have suffered a work-related injury or illness return to work in a safe and timely manner by providing temporary, modified jobs suited to their physical limitations. Studies show that such programs help lower both the risk of litigation and the number of lost workdays, and raise workers' return rate.

- **Property risk:** Loss control experts can advise on a range of issues such as sprinkler protection, fire protection impairment, new construction design and builders' risk.
- **Business continuity planning:** Loss control experts can assist companies in developing a plan to promote worker and customer safety during a disaster while maintaining business continuity.
- **Product safety:** Risk assessment and control services by trained loss control consultants can help companies minimize the risk of product liability and errors and omissions liability.
- **Employment practices advice:** An insurer may provide complimentary access to professional services that can advise on specific employee issues as well as help build employment policies, guidebooks and employee training to navigate the complex and rapidly changing regulatory environment for employment practices.

Does the insurer offer Claims service that pays claims quickly and fairly while also minimizing costs that can lead to higher rates?

Insurance has always been based on a commitment by the insurance carrier to deliver on its promises when a claim is made—the proverbial moment of truth. Aside from the table-stakes reassurance that the insurer will have the financial capacity to pay the claim, how can companies feel confident that claims will be paid accurately, swiftly and with ease?

Companies will certainly depend heavily on their broker's advice, but they can also probe deeper to understand the insurer's claims service philosophy and capabilities. Areas to ask about include:

- **Claims relationship management:** Insurance buyers should understand the relationship between broker and carrier claims teams, and how that may impact the claims process. The best relationships feature dedicated teams. Sophisticated insurers will offer a tiered service structure that includes claims relationship managers to coordinate all aspects of the carrier's service, not just claims. This can include periodic claims reviews to identify loss trends and recommend steps in concert with Loss Control to reduce risks and help keep premiums from increasing.
- **Feedback mechanisms to drive constant improvement:** How seriously does the company gather and act upon feedback on service after a claim has concluded? Service-minded carriers will have systematic processes to gather feedback through a variety of mechanisms and offer transparent data on how likely other companies would recommend the carrier based on their claim experience.
- **Effective worker injury treatment:** When a worker gets injured, the choice of treatment provider can factor greatly in the length and cost of recovery. But the information to make the best decision has historically been hard to access. Advances in big data and AI are changing that. Pioneering insurers are leveraging these tools to identify the most effective treatment providers at an early stage to better manage costs and get the worker back on the job quicker.
- **Medical risk management team:** For companies that use Medical Stop Loss insurance for their self-funded health insurance plans, the expertise and services of the insurer's medical risk management team can make a material difference. These services include case management oversight and facilitation of referrals to outcome-based providers with the goal of ensuring that the claimant always receives the highest quality of care at the most appropriate cost.
- **Mediation services:** Mediated claims typically result in better outcomes than litigated claims. Innovative insurers are leveraging new tech platforms that engage opposing parties in creative ways to speed the arbitration process.
- **Major case team:** Just one loss involving serious injury and/or high stakes litigation can upend an insurance program and put company management under stress. Sophisticated insurers will have a team of highly experienced experts dedicated to handling these types of claims. Such teams can help make sure all available defenses are being contemplated, stage mock trials to help polish the defense and negotiation strategy, and much more—all to achieve the best possible outcome.

As companies look ahead in 2021 and consider how to manage risk, knowing the right questions to ask when choosing an insurer can make a significant difference in getting the best protection while mitigating against the impact of rate increases. //

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Real Estate Financing

Sale-Leaseback Transactions Poised to Play a Larger Role in M&A

Three years ago, J.C. Penney Co. was in dire straits. To raise cash, the 118-year-old department store chain opted to sell its three-story headquarters in Plano, Texas, spanning 1.8 million square feet.

> "FOR MIDDLE-MARKET PRIVATE EQUITY, THERE IS USUALLY AN ACCRETIVE OPPORTUNITY TO SELL REAL ESTATE."
>
> ERIK KORSTEN
> Managing Director, Branford Castle Partners

Silos Opportunity Partners LP paid $353 million for the campus and subsequently rented it back to J.C. Penney as part of a sale-leaseback agreement.

Fast forward to 2020, and J.C. Penney is again in need of liquidity, citing the coronavirus pandemic for exacerbating its financial woes. The retailer is shopping its real estate and hoping to cut more sale-leaseback deals like the one it made in Texas in 2017.

J.C. Penney's situation is a familiar one today. Thousands of companies with retail space have been hit hard by the pandemic. As a result, shareholders are hustling to unlock whatever value they can.

Now could be an opportune time to consider a sale-leaseback transaction, according to Branford Castle Partners Managing Director Erik Korsten. With low interest rates, capitalization rates are trending down.

"For middle-market private equity, there is usually an accretive opportunity to sell real estate," says Korsten. "Current cap rates remain favorable — at least for more stable industries."

Branford Castle was in the midst of closing a sale-leaseback deal in the manufacturing space in the fourth quarter—one of many the New York-based private equity firm has successfully completed over the years.

Here's how a typical sale-leaseback transaction plays out: A facility gets sold, and the seller becomes a tenant under the new owner. Proceeds from the sale may then go toward bolstering the seller-tenant's operations or strengthening shareholder value.

"The frequency of sale-leaseback transactions are increasing," Korsten says. "It's now a mainstream strategy for generating equity value."

Although more private equity firms seem to be employing a sale-leaseback strategy, there are still many that are not taking advantage of this opportunity and could be leaving money on the table. Per a recent survey[1], conducted by the Association for Corporate Growth and sponsored by STNL Advisors, a real estate consulting group, 80% of respondents said they had never done a sale-leaseback transaction. Yet, more than 40% have mortgaged debt on their real estate. Additionally, more than 50% of respondents have done nothing to negotiate their leases since the pandemic—leaving room for better financing options.

There are plenty of case studies besides J.C. Penney to reference for successful sale-leaseback transactions. Bed Bath & Beyond Inc. and Big Lots Inc. each completed sale-leasebacks this year.

In January, Bed Bath & Beyond sold approximately 2.1 million square feet of commercial real estate space to Chicago-based Oak Street for $250 million. The assets included retail stores, a distribution facility and Bed Bath's headquarters in Union, New Jersey.

The company is now renting the properties back under a long-term lease agreement.

Oak Street also inked a $725 million sale-leaseback deal with Big Lots. The deal allowed the retailer to pay down debt, while Oak Street gained control of four distribution centers.

The market is ripe for sale-leasebacks. "I truly believe this is the best environment since the [financial crisis] for the execution of sale-leasebacks, both from a buy-side and sell-side perspective," says Oak Street

CEO Marc Zahr. “Broadly speaking, investors are moving into higher quality assets as a result of the pandemic. There is a flight to safety.”

On a risk-adjusted basis, Zahr says long-duration, triple-net leased, investment-grade rated properties are the best place to allocate capital today for firms like his.

And from a seller’s perspective, corporate prioritization has largely shifted due to COVID-19. Twelve months ago, most investment-grade companies were primarily focused on shareholder return initiatives such as buybacks, dividend growth and M&A.

“However, COVID has afforded the strongest of companies an opportunity to further fortress their balance sheets,” Zahr says. “In fact, shareholders throughout this period have rewarded companies for being able to raise capital and increase their liquidity.”

Big Lots, for example, saw its stock price increase nearly 30% on the heels of Oak Tree’s sale-leaseback announcement.

“Many investment-grade companies are using this time to rationalize their real estate footprints and execute sale-leasebacks to optimize their balance sheets,” Zahr says.

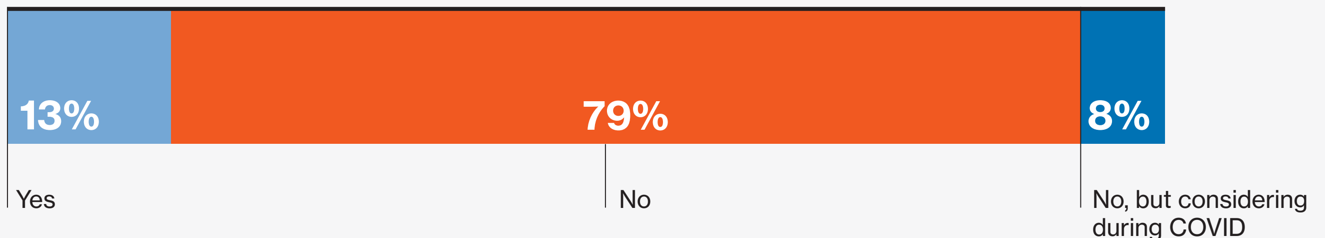
Columbia Care Inc., a pharmaceutical company specializing in cannabis products, completed a sale-leaseback this year. In July, New York-based Columbia Care sold its entire plant in Vineland, New Jersey, totaling some 54,000 square feet, to Innovative Industrial Properties Inc. (IIP) for about $14 million. It agreed to manage the property as part of a long-term, triple-net lease agreement.

This was Columbia Care’s second sale-leaseback deal with IIP. Another deal occurred in Massachusetts. And in both states, it was able to get a significant amount of investment “in the form of tenant improvement money” to put toward expanding manufacturing facilities, Columbia Care VP Joshua Snyder says.

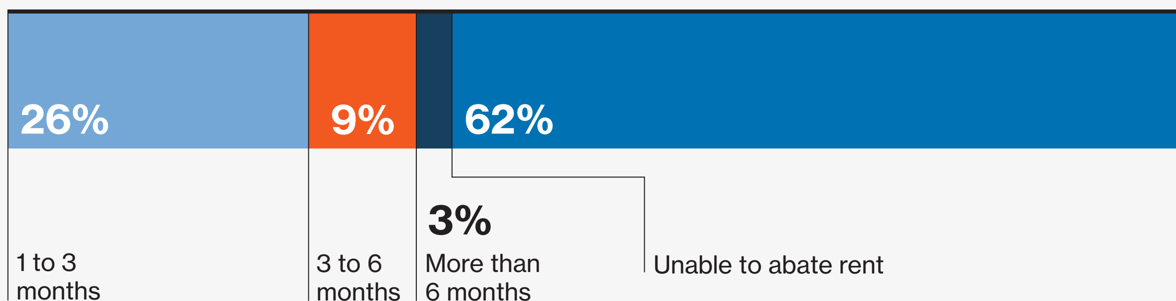
IIP completed a similar deal with Holistic Industries.

In September, Monson,

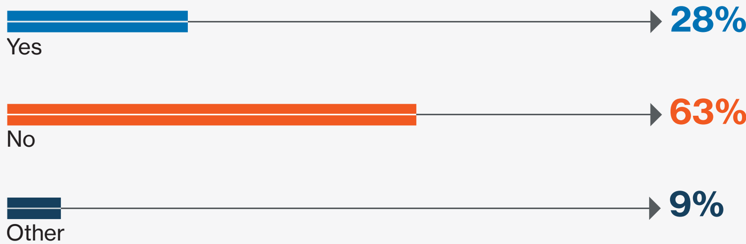
HAVE YOU COMPLETED A SALE-LEASEBACK TRANSACTION PRE-COVID TO FINANCE OR RECAPITALIZE YOUR COMPANY?



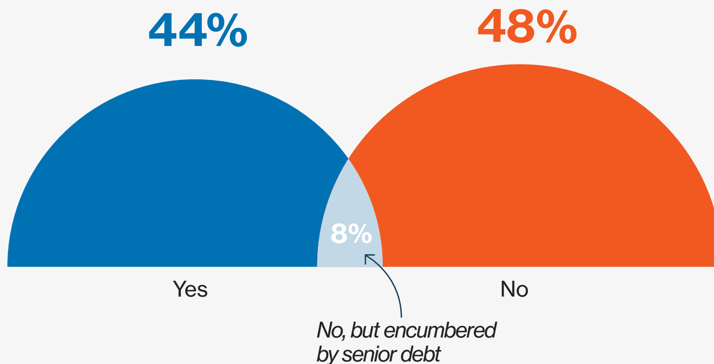
IF YOU NEGOTIATED YOUR LEASES DURING PANDEMIC, ON AN AVERAGE, HOW LONG WERE YOU ABLE TO ABATE RENT?



HAVE YOU CHANGED YOUR FINANCING STRATEGIES DUE TO THE PANDEMIC AND CURRENT DEBT MARKET?

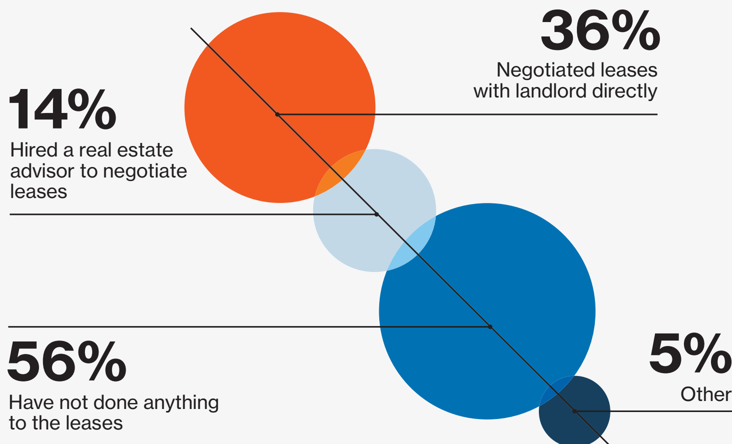


HAVE YOU MORTGAGED DEBT ON OWNED REAL ESTATE?



HAVE YOU TRIED TO CHANGE YOUR LEASE AGREEMENTS DURING THE PANDEMIC?

Respondents were able to select all that apply



Massachusetts-based Holistic sold a complex in New Castle, Pennsylvania, to IIP for $8.9 million. The deal included 7.4 acres, with 108,000 square feet of industrial space. IIP agreed to provide up to $6.4 million in reimbursements should Holistic make any improvements or renovations.

"They underwrite the transaction as though they're making a loan to the company, so the underlying credit is as important as the real estate," says Holistic CEO Josh Genderson.

Holistic opts to buy real estate and hold on to the asset until it needs the capital. Or, it will find a friendly landlord up front who will buy their property and then lease it back.

"It doesn't make sense for us to keep real estate on our balance sheet long-term," says Genderson. "So even if we do buy a property initially, we will usually monetize it eventually in order to provide more capital for the operating business."

Chicago-based Green Thumb Industries also sold a chunk of its real estate to IIP over the course of three sale-leasebacks.

"Given the constraint in the capital markets today, sale-leasebacks are a beneficial way to get additional capital to build out some of our operations," says Andy Grossman, EVP of capital markets at Green Thumb.

The most recent deal was based in Illinois and earned Green Thumb $50 million.

Although many companies see the benefit of sale-leasebacks, some have opted to do nothing. According to the survey results, more than 56% of respondents haven't even tried to have their leases changed, 36% have worked to negotiate leases directly with their landlords, while 14% have hired a real estate advisor to negotiate

their leases. Additionally, some said too many sale-leasebacks can put the seller at a disadvantage.

"You don't want to just do unlimited amounts of deals. You don't want to tip over," says Grossman.

Also, in a sale-leaseback, the seller-tenant no longer has an ownership interest. They essentially forfeit the right to receive any appreciation on the property's value. And if they can't make payments, they would have to renegotiate the lease or risk getting evicted.

"It's essentially debt," Korsten says. "Each month the [seller-tenant] has to come up with cash flow to make rent. The more burden you put on the company, the less flexibility they have in the future. It's a careful balance."

A long-term lease can also be problematic. If it goes for, say, 15 to 20 years, companies have less flexibility during tough times—such as the current economic downturn.

"I TRULY BELIEVE THIS IS THE BEST ENVIRONMENT SINCE THE [FINANCIAL CRISIS] FOR THE EXECUTION OF SALE-LEASEBACKS, BOTH FROM A BUY-SIDE AND SELL-SIDE PERSPECTIVE."

MARC ZAHR
CEO, Oak Street

"The biggest downside to a sale-leaseback is that you can get locked into a long-term lease at a rate that will someday be above market," Genderson says. "[But] by the time that happens, we expect our real estate cost to be a pretty small component of our overall profit and loss."

For others, real estate costs are a major component and these hefty leases end up getting renegotiated.

According to the ACG survey, during the coronavirus pandemic, 36% of respondents said they negotiated leases with landlords directly. Some 56% of respondents have not done

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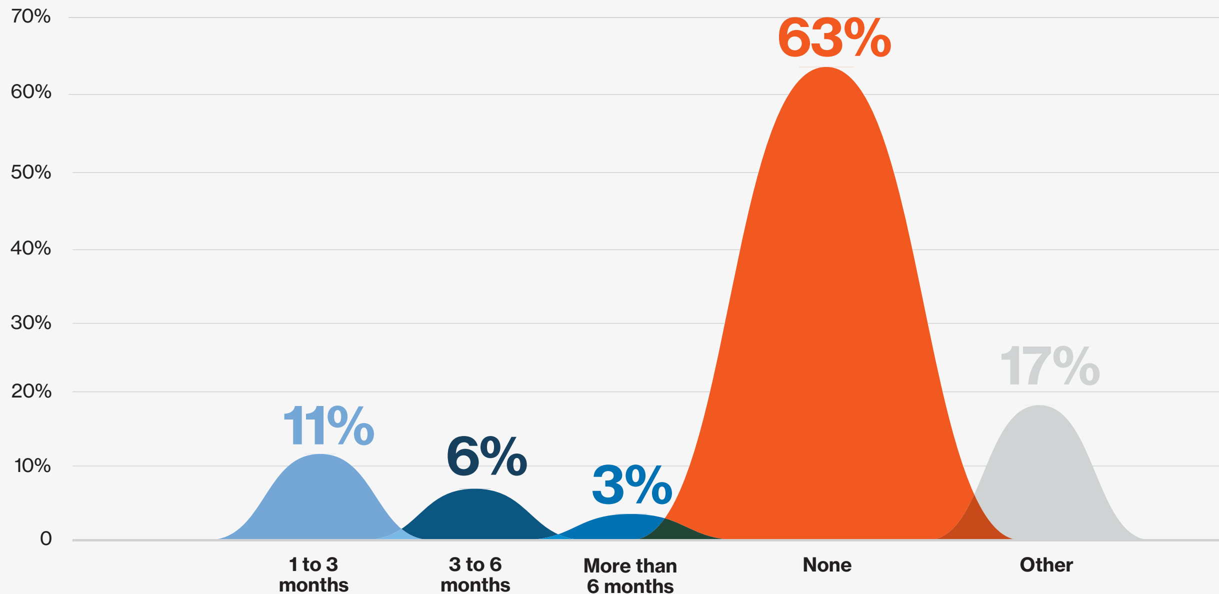
FOR OWNED REAL ESTATE, WERE YOU SUCCESSFUL IN GETTING MORTGAGE DEFERRAL DURING THE PANDEMIC? IF SO, FOR HOW LONG?



anything, while roughly 14% hired real estate advisors to negotiate leases on their behalf.

Over 60% of survey respondents said they weren't able to get any months deferred when they tried to negotiate the rent. More than 25% said they were able to get one to three months deferred, and 9% managed to get a three to six months deferral. In addition to trying to negotiate deferments, businesses also try to renegotiate lease terms. For example, some successfully negotiated prepaid leases for the next two years and the ability to leave the lease terms in place for one year after stabilization.

Some landlords were open to rent abatement agreements, where they worked out a contract granting a period of free rent.

Despite some of the challenges that may come with sale-leasebacks, more deal-makers may find it to be a worthwhile strategy.

"There are still a few real estate assets on our books and when we can monetize them at a good rate, we will," Snyder says. "I wouldn't be surprised if there are more sale-leasebacks as a component of M&A." //

> "GIVEN THE CONSTRAINT IN THE CAPITAL MARKETS TODAY, SALE-LEASEBACKS ARE A BENEFICIAL WAY TO GET ADDITIONAL CAPITAL TO BUILD OUT SOME OF OUR OPERATIONS."
>
> ANDY GROSSMAN
> EVP, Capital Markets, Green Thumb

[1] Between September 8 and November 3, ACG surveyed deal-makers about real estate financing trends in 2021 and other topics. More than 600 people responded to the ACG surveys.

Real Estate Financing

Lease Restructuring Strategies During COVID and Beyond

STNL Advisors

COVID-19 has presented unprecedented challenges for operating businesses throughout the country. Companies are trying to stop losses/revenue decline, while navigating new guidelines and restrictions. Cutting costs is a necessity and real estate obligations including rent, taxes and upkeep are major part of that burden.

The results of the ACG survey show that 50% of the PE firms that owned portfolio companies asked their landlords for rent deferrals or abatements. (See chart on p. 46). Of those operating companies that sought relief, only 14% used a real estate advisor or seasoned real estate consultant. The majority of firms utilized their in-house staff (financial controllers, counsel) to reach out to landlords even though these employees have little to no knowledge or experience of leases or general market conditions surrounding their own real estate. This took away the employees at the most inconvenient time when the operation of the business needed their attention the most.

Property owners and their asset managers were bombarded with outreach during the months that followed the COVID shutdown. Many of these conversations took the approach of simply asking landlords for help. Very few tenants understood the landlord's situation and how these negotiations could potentially add long-term value to the landlord. This is most likely the reason that only 36% of the respondents achieved any type of rent abatements or deferrals. Professional real estate advisors recognize that understanding who the landlord is and their profile and how to speak their language is the key to getting short-term and long-term results. From interviews with many tenants and sponsors who took on these initiatives on their own, we found of the 36%, most achieved only a short-term deferral. Although these deferrals seemed helpful during the lockdown with no potential relief in sight, they only shifted this additional burden over to the next several quarters or fiscal year; abatements or restructures would have been a permanent help.

Firms that engage a real estate advisor with a prudent strategy for rental abatement and overall lease restructuring are much more likely to get both permanent abatements and long-term rental savings. Understanding who the owners are and how they view the property and addressing the overall market condition helps the advisor work through what may otherwise be a period of unproductive negotiations and grandstanding. Knowledgeable real estate advisors understand the situation of the landlords, who are also in the business of making money through collecting rent. An advisor can help work through the landlord's emotions, which can highjack productive conversations. The restructure process may be less about dollars and cents than most tenants or business owners think.

> "TENANTS SHOULD UNDERSTAND THAT LEASES CAN BE CONSTANTLY MINED FOR VALUE CREATION, AND THAT LANDLORD OUTREACH IS AN ONGOING PRACTICE."

Real estate advisors understand the lease and property fundamentals, as well as how landlords' financing situation can impact the outcome. Additionally, advisors enable landlords to benefit from improving the financeability of the assets to ensure long-term value. Qualified real estate advisors have capital markets teams that can help provide landlords with refinancing options, further creating a win-win option for the landlord and the tenant.

In conclusion, sponsor firms benefit by hiring a professional real estate advisor over the long term to understand the tenant's business, the underlying real estate, and the profile of the landlord. The firms that engaged real estate advisors pre-pandemic, as well as during the pandemic, were able to achieve the most beneficial outcomes. The pandemic was unprecedented, and companies did whatever they could, and quickly. It seems the firms that hired professional advisors pre-COVID were more equipped to mobilize quickly with their landlords than others. Tenants should understand that leases can be constantly mined for value creation, and that landlord outreach is an ongoing practice, not just an exercise during unprecedented times. As real estate advisors, we cannot stress enough how important it is to secure a long-term solution for value creation. As we start to see light at the end of the tunnel in regard to the pandemic, it is not too late to engage an advisor to obtain long-term rental savings. //

Sale-Leasebacks During COVID and Beyond

STNL Advisors

Sale-leasebacks have long been an effective capital solution for private equity groups, operators, franchisees and franchisors in many industries including restaurants, industrial and manufacturing facilities, general retail and medical properties. With the debt market being more conservative during the pandemic, the financing options have become limited. Many companies are increasingly looking at sale-leaseback as an alternative source of financing, as other financing markets are trending back.

The sale-leaseback market continues to remain strong during the pandemic. For 70-80% of the property types, cap rates have been consistent to what they were pre-COVID. The cap rates have improved for manufacturing and distribution facilities, as well as many other businesses that have proven to operate strongly or thrive during the pandemic. We have also seen cap rates tightened in sectors like automotive services, gas stations, convenience stores and QSRs during the pandemic. The sale-leaseback market for the hospitality sector and for some of the big box retailers has suffered, but the transactions are still getting done at higher cap rates.

Getting a sale-leaseback valuation from a credible real estate advisory firm that understands the market is usually as easy as getting a traditional debt quote and there is no charge to get a general market assessment. If a PE firm or an operating company wants to get a sale-leaseback valuation for the real estate in their portfolio, a real estate advisor can usually provide the valuation within a week. Typically, the information required for the pricing assessment would be the current financials of the company including income statement and balance sheet, the basic real estate fundamentals like address of the property/ies, building size in square foot and land in acres. If the firm decides to move forward with the sale-leaseback, then the entire process can be completed as quickly as 30 days, but usually within 60 to 90 days, which is not different than a typical financing.

Another important thing to note is that the appraised value of the property is not necessarily the sale-leaseback value. Based on historical transactions, companies have completed sale-leaseback transactions for anywhere between 20% to 100% more than the traditional appraised value. Comparatively, traditional real estate financing only yields proceeds between 60% and 80% of the appraised real estate value, which is usually tied to replacement cost. In several instances, sale-leaseback value of the real estate can be greater than the purchase price of the operating business and the underlying real estate.

“IN SEVERAL INSTANCES, SALE-LEASEBACK VALUE OF THE REAL ESTATE CAN BE GREATER THAN THE PURCHASE PRICE OF THE OPERATING BUSINESS AND THE UNDERLYING REAL ESTATE.”

The survey results show that almost 80% of the PE firms have not conducted a sale-leaseback in the past. Interestingly, 60% of the respondents have owned real estate in their portfolio companies. This may be the result of other forms of debt being more easily available during the past few years. Many of them most likely did not even explore a sale-leaseback as a viable option. As more than 25% of the PE firms have changed their financing strategies due to the pandemic, sale-leaseback activity could increase among sponsor companies as a viable alternative.

As the demand to own commercial properties for the long term has increased for both institutional as well as private investors over the past few years and especially during the pandemic, the supply and demand curve will most likely be in tenant and operating companies’ favor and it will continue to compress cap rates. Sale-leasebacks will continue to be a useful tool for sponsors and tenants to finance M&A transactions, reduce debt and fund capital expenditures. //

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ESG Takes Center Stage: The Middle Market Focuses on Next Steps

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ESG Takes Center Stage: The Middle Market Focuses on Next Steps

The Black Lives Matter and #MeToo movements have grown in recent years in response to a wave of stomach-churning events and tense demonstrations. These calls for greater equality and diversity, coupled with severe storms and wildfires, underscore the move by many middle-market private equity firms to look beyond the balance sheet when evaluating investment opportunities. Environmental impact, social criteria and corporate governance (ESG) are undoubtedly playing a larger role in the private equity world today, according to a recent survey conducted by the Association for Corporate Growth and sponsored by S&P Global, a provider of independent ratings, benchmarks analytics and data to the capital and commodity markets[1].

"I'M NOT GOING TO BE INVESTING IN A COMPANY THAT'S MAKING VIDEO GAMES ABOUT VIOLENCE. I JUST WON'T DO IT."

LIDDY KARTER
Managing Director, Mizzen Capital

Commonly known as ESG, this set of criteria for evaluating companies is regularly becoming part of the due diligence process. Investors are increasingly asking about a company's environmental risk factors, how it treats its employees and the community at large, and how it is governed with regards to executive pay, tax audits and shareholder rights.

A little more than 50% of those surveyed said they are implementing ESG best practices at their firms. According to business advisory firm FTI Communications, references to terms like "sustainability," "ESG," "climate change," and "human capital" more than doubled in 2020 disclosure forms compared with two years ago and more than tripled compared with five years ago.

Howard Morgan, partner and co-founder of Argand Partners, a New York-based middle-market private equity firm, is surprised that the number of firms implementing ESG best practices isn't higher. "I think the devil's in the details as to what is 'best practice,'" he says. He added that while his firm is implementing ESG best practices, "the whole area is still fairly young."

The extent to which private equity firms will change anything about their governance, hiring practices or their impact on the community is almost always driven by their need to improve their portfolio companies' performance and push for stronger returns, says Liddy Karter, a managing director with Mizzen Capital, a lower middle-market private equity firm.

Mizzen only invests in socially responsible businesses. "I'm not going to be investing in a company that's making video games about violence. I just won't do it," Karter says.

Although more than half the firms surveyed said they are implementing best practices at their firm, when asked if their firms have ESG guiding principles laid out, about 40% either did not have a plan or were working on putting together guiding principles.

Karter says that changes need to be fundamental and of course that takes time. "Some of my peer group funds are saying more frequently, 'Gosh, we need to get some more minorities in our partner ranks. We need to get more women—as though suddenly that's going to change anything. It should not be an overlay. It needs to be thought out," she says. "If you think about something, you write it down because that's how you clarify your thoughts. I don't know why anyone would not write it down except that they're not serious about it."

While many middle-market private equity firms may not be quite at the implementation phase yet,

61% of firms said that they were planning to adopt ESG guidance because it was the right thing to do—not because they were forced to by investors. More than 20% believe adopting these principles and best practices would lead to better returns.

For example, Argand Partners implements ESG practices with its investments because the firm's management team believes it will result in better outcomes, better earnings, higher margins and a better multiple upon exit. "There is an element of doing good, but we're fiduciaries for our LPs. Ultimately, our responsibility is to look to deliver a good result," says Morgan.

Karter says it's only realistic for firms to be keeping an eye on the returns with everything they do.

"You have to maximize your returns. If you're not, you're probably not doing a good job running whatever you're running," she says. "If you don't maximize returns, what are you doing?" Karter added that it's not just the returns to the investors that need to be considered. They should also focus on creating a stable place for employees to work and being a good community member.

ESG IN ACTION

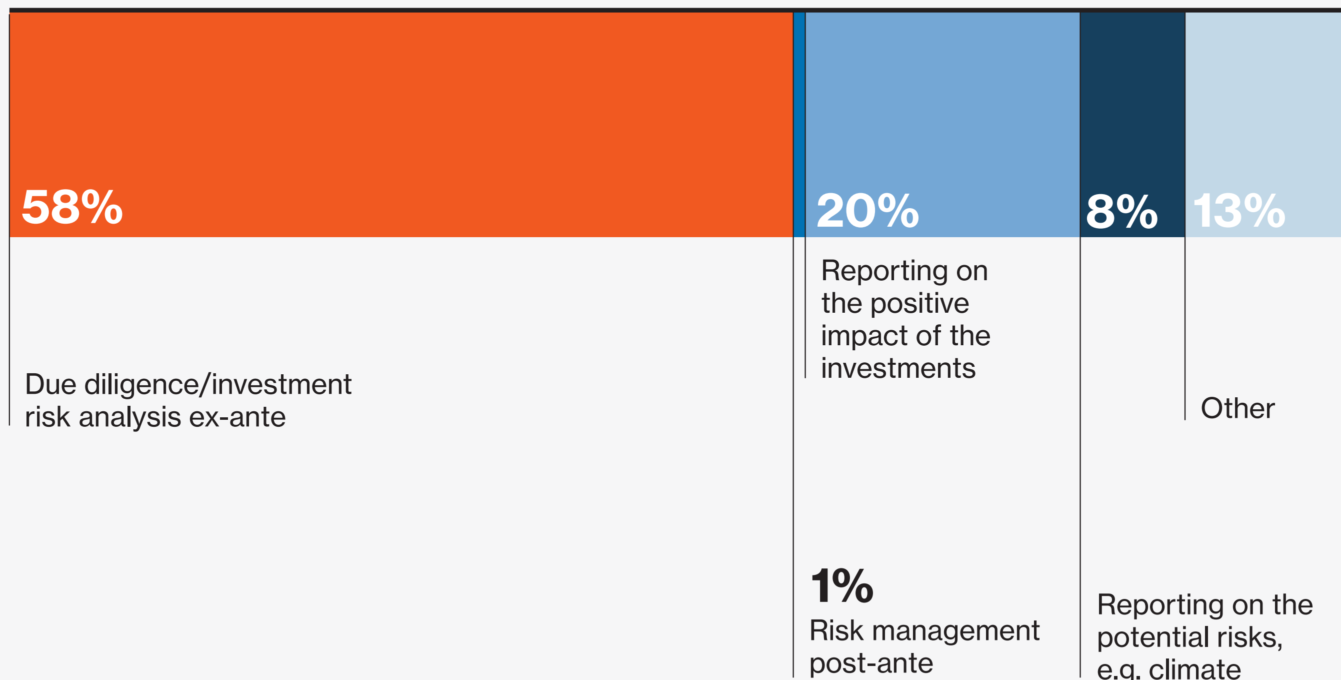
Overwhelmingly, private equity firms say they want to try to work with companies that are taking ESG issues into account.

Nearly 60% of respondents said they incorporate ESG into due diligence and/or investment risk analysis.

Morgan calls ESG a "mandatory topic" in all of his portfolio company's investment papers and has since he founded Argand five years ago.

"If there's an environmental problem or labor and governance issues in the past, the lawyers and accountants always focused on the downside. What we're trying to do »

WOULD YOU OR DO YOU INCORPORATE ESG INTO:



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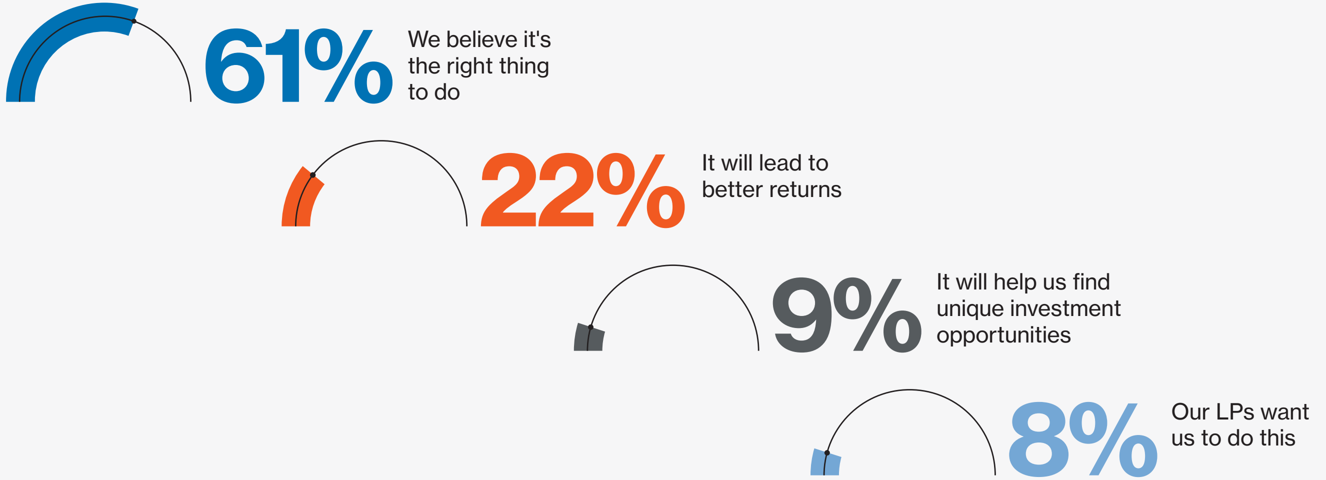

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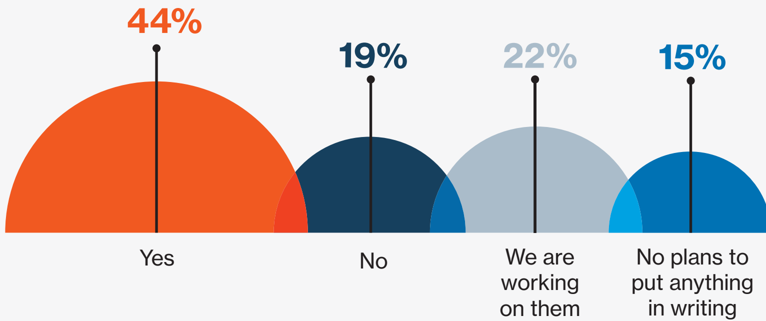

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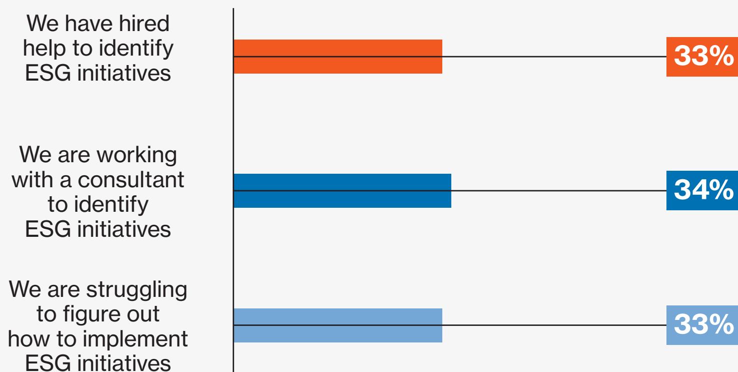
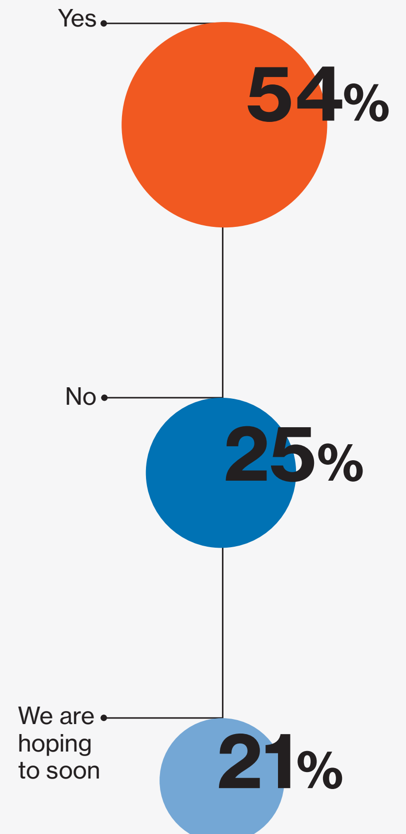


ARE YOU IMPLEMENTING ESG BEST PRACTICES IN YOUR FIRM?



is find the upside opportunity," says Morgan, adding that one of his portfolio companies is one of the few competitors in its sector that recycles materials. While most believe in that particular industry that recycling is a disadvantage because of the cost, the investment has "turned out to be a fabulous business and investment for Argand," says Morgan. "Putting an optimistic view on what can be done with the business, that's where private equity should go."

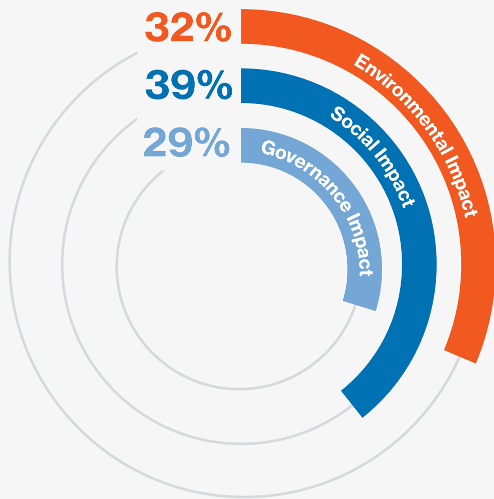
"THERE IS AN ELEMENT OF DOING GOOD, BUT WE'RE FIDUCIARIES FOR OUR LPS. ULTIMATELY, OUR RESPONSIBILITY IS TO LOOK TO DELIVER A GOOD RESULT."

HOWARD MORGAN
Partner and Co-Founder, Argand Partners

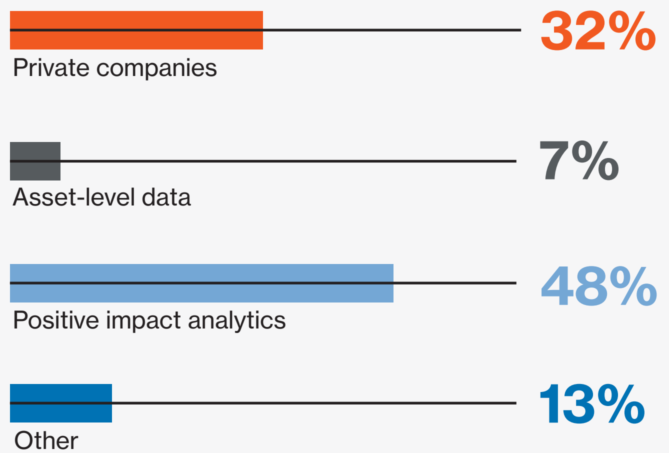
As the private equity industry continues to evolve, it's clear from the survey results that the question is no longer whether implementing ESG practices is good for the firm and investment thesis. The question has evolved into: How can we implement best practices going forward? Survey respondents were nearly evenly divided on their implementation methods: 34% of respondents are working with a consultant to identify ESG initiatives while 33% said they are "struggling to figure out how to implement ESG initiatives."

There's no question that implementing ESG best practices comes with a price tag. As a result, larger firms with more resources have been leading the charge. "I'm not sure this is an outsourced silo, but nonetheless it takes resources and time to make these initiatives successful. At our firm, we want everybody personally to be driving this forward," says Morgan. »

OUR FIRM CARES MOST ABOUT



WHAT IS THE NEXT FRONTIER OF ESG DATA?



ESG OPPORTUNITIES IN THOUGHT AND ACTION

Even after firms figure out how to move forward with guiding principles, putting ESG principles into practice will take time, patience and constant education. It can often be a challenge for people to push past their own experiences and move forward anew. There's often defensiveness when it comes to change, Karter warns.

"I'm on the board of an oil field services company and they cannot tolerate it when I drive up in my Tesla. They just hate it because they feel like that's just somehow missing the point of their company," says Karter. "And I'm saying, no, your company's done a great job for what it's done all those years— but there's maybe a new way to think about things."

With all the work that needs to be done, ESG initiatives continue to evolve. Senior management never gets to announce that they have reached ESG fulfillment.

"ESG is evolving and it's a journey," says Morgan. "We have to continue to push forward." //

> "ESG IS EVOLVING AND IT'S A JOURNEY. WE HAVE TO CONTINUE TO PUSH FORWARD."
>
> HOWARD MORGAN
> Partner and Co-Founder, Argand Partners

[1] Between September 8 and November 3, ACG surveyed deal-makers about trends in ESG in 2021 and other topics. More than 600 people responded to the ACG surveys.

A Deeper Look at the Survey Results

S&P Global Market Intelligence

The nature of corporate value creation is changing rapidly as ESG market opportunities accelerate and ESG risks intensify across industries. The recent survey of deal-makers conducted by the Association for Corporate Growth and sponsored by S&P Global Market Intelligence shows this also holds true for private equity. Here, S&P provides a deeper analysis of how respondents answered some of the key questions that were asked.

Q: Which aspect of ESG does your firm care more about? Interestingly, 39% of respondents to this question point to the "S," or social impact component of ESG, which includes how businesses interact with and care for their workforces, communities and geopolitical environments. The COVID-19 pandemic has certainly pushed the "S" into the spotlight, highlighting a range of social issues—from access to health care to occupational health and safety—that present important considerations for private equity investors.

Social impact can be the most difficult element for investors to assess, as it is often perceived as less tangible than environmental and governance factors (the "E" and "G" in ESG, respectively), and data on how the "S" impacts company performance is less mature.[1] Social factors are becoming more material for many industries, however, as they are increasingly being linked to a company's reputation and brand equity. As such, the investment community is pushing Wall Street's biggest data providers for more information.[2]

Q: How do you measure the impact of ESG investing? Over one-third (38%) responding to this question said they use the United Nations Sustainable Development Goals (SDGs) to measure ESG impact. Formally adopted by 193 countries in September 2015, the SDGs outline a set of objectives to be achieved by 2030 that aim to end poverty, hunger and inequality, while tackling climate change, improving health and education, and spurring economic growth. According to the Business and Sustainable Development Commission, putting the SDGs at the heart of the world's economic strategy could unlock $12 trillion in opportunities and 380 million jobs a year by 2030.[3]

Other approaches are being used by 61% of firms responding to this question. Over the past five years, more companies across industries have been publishing sustainability reports, with 90% of the largest 500 companies in the U.S. reporting in 2019—an 11% increase since 2015.[4] A range of frameworks are being used, including those provided by the Taskforce on Climate-related Financial Disclosures (TCFD) and Global Reporting Initiative (GRI).

Q: What is the next frontier of ESG data? Almost half (48%) responding to this question said positive impact analytics will be the next area of focus, with 20% already reporting on this for their investments. One way to measure positive impact involves looking at the contribution a company is making to the SDGs, which tends to be through the sale of SDG-aligned products and services. Currently, 71% of the 500 largest U.S. companies and 63% of the 1,200 largest global companies have business models that support the SDGs.[5]

Q: How do you incorporate ESG? Most respondents (58%) point to due diligence/investment risk analysis ex-ante, where ESG considerations are embedded into investment policy, analysis and decision-making. There are also increasing requirements for ESG reporting, including disclosure of the ESG risk and opportunity profile of portfolio companies, the approach to assessing environmental and social benefits created by portfolio companies, as well as how the risks and opportunities of climate change posed to portfolio companies are being assessed.

The survey results show that ESG is gaining momentum at private equity firms, with two-thirds (66%) of respondents having guiding principles in place, or in the works. With more attention paid to the perceived lack of ESG data on private assets and financial materiality for the industry, sustainability issues should continue to gain a stronger voice in the decision-making process of sponsors and their investors. //

[1] "ESG Integration: How Are Social Issues Influencing Investment Decisions?", PRI, www.unpri.org/download?ac=6529.
[2] "Investment community calls for more data on the S in ESG", S&P Global, June 13, 2019, www.spglobal.com/marketintelligence/en/news-insights/trending/KjqcrWw8gfzkZYlsX6wGyw2.
[3] A release from the Business and Sustainable Development Commission, January 16, 2017, http://businesscommission.org/news/release-sustainable-business-can-unlock-at-least-us-12-trillion-in-new-market-value-and-repair-economic-system.
[4] "90% of S&P 500 Index Companies Publish Sustainability Reports in 2019, G&A Announces in its Latest Annual 2020 Flash Report", G&A, July 16, 2020, www.globenewswire.com/news-release/2020/07/16/2063434/0/en/90-of-S-P-500-Index-Companies-Publish-Sustainability-Reports-in-2019-G-A-Announces-in-its-Latest-Annual-2020-Flash-Report.html.
[5] United Nations Programme Development, 2020, www.undp.org/content/oslo-governance-centre/en/home/sustainable-development-goals/goal-17-partnerships-for-the-goals.html.

A Perspective on ESG and Private Equity

S&P Global Market Intelligence

Namtse Namgyal, head of institutional sales for North America at S&P Global Trucost, addressed a number of questions we asked about the relevance of ESG to private equity firms. Trucost assesses risks relating to climate change, natural resource constraints and broader ESG factors, working with clients across numerous industries, including private equity.

Q: What is driving the increased interest in ESG at private equity firms? There are a number of different factors. New regulations are important, especially in the European Union. For example, in early November of this year the U.K. announced that it will make it mandatory for companies to disclose climate risk within the next five years. This will be broad sweeping and include U.K. registered large private companies. Of course, there are also voluntary initiatives in place. In addition, increased investor demand is a key driver, as large asset owners are becoming more educated on ESG issues and are looking for additional reporting —not just on risks, but also on potential opportunities.

Q: What is the value to private equity firms of addressing ESG issues? ESG analysis can be incorporated into due diligence and risk management practices, helping firms identify investment opportunities that can potentially translate into better returns. Asset owners are also asking more questions about general partners' (GPs) ESG strategies in order to meet their own needs for disclosure, so being able to clearly articulate a position can help GPs with fundraising. This is happening at a time when the COVID-19 pandemic has magnified a range of problematic societal issues, making ESG considerations "the right thing to do" for many.

Q: What are some of the challenges for private equity firms? There are definitely data challenges given the private nature of the business. Benchmarking is also an issue, since there is limited information available to do peer group analysis to help a firm understand how it is faring relative to others.

Q: How can private equity firms do more on ESG? We suggest firms start by creating a baseline to understand a fund's footprint today (i.e., its exposure or impact), which can be used as a point of reference to monitor progress year-over-year. This can also help identify potential companies of concern through a hotspot analysis, which can be followed by a deeper dive into a select number of companies for further evaluation. Customized questionnaires can also be created for portfolio companies to have data collected for future analysis.

While data availability may be a concern, there is often some data to be used that can then be supplemented with modeling techniques to fill in the gaps. Modeling at Trucost involves looking at a specific company and its different business activities and matching each activity with an environmental profile we have created. The profiles are then aggregated to create an overall picture for the company or a total fund. We recommend focusing on what is material to the company in question, what can be quantified and, then, what can help produce actionable insights. What is most valuable is how firms turn that information into something financially material that can help drive investment decisions.

Q: Are there other considerations? In addition to setting a baseline, we recommend that our private equity clients take a forward look to help identify any hidden risks. For example, there may be transition risks for a company as we shift to a low-carbon economy, such as unpriced carbon risk that can affect a company's valuation. There may also be physical risks based on where a company's assets are located and how vulnerable those locations are to climate-related events, such as wildfires, hurricanes, droughts, floods and sea-level rise. In addition, we suggest that firms look at both sides of sustainability—exposure and impact. Exposure could be a risk associated with child labor laws in certain countries, for example, while impact could be an opportunity based on selling products to an area of high need. //

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7 Sectors Worth **Watching**

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7 Sectors Worth Watching

By now, it's clear that the fallout from the COVID-19 pandemic will have long-lasting effects on nearly all industries. Some ACG members have described the outbreak as a "great accelerator," which has taken trends expected to unfold over the course of years and compressed them into a few months. Nowhere are these changes coming into focus more than in telehealth, online education and customer service.

In partnership with company search engine Grata Data, *Middle Market Growth* has broken down these industry segments to reveal sectors that have seen extraordinary growth or could present significant interest to private equity investors and strategic acquirers in the near future.

> "EARLY ANALYSIS INDICATES BETWEEN 20% AND 35% OF OFFICE, EMERGENCY ROOM AND HOME HEALTH VISITS WILL TRANSITION TO TELEHEALTH IN 2021."
>
> MICHAEL COLE
> Managing Director, Alvarez and Marsal

TELEHEALTH

Like other tech-enabled industries, telehealth providers were already trending in a positive direction when COVID-19 provided a boost in demand. However, once COVID hit, physicians used telehealth services to track vitals of coronavirus patients across multiple geographies, and patients used telehealth to connect with caregivers virtually.

Early analysis indicates between 20% and 35% of office, emergency room and home health visits will transition to telehealth in 2021, according to Michael Cole, a managing director with Alvarez and Marsal. Not only is telehealth more convenient for many patients—not to mention safer with COVID still a threat—it is also cost effective. "Telehealth utilization creates alignment with providers and payers in that it can bend the cost curve—which makes telehealth a compelling area of investment interest," he says. Many experts predict that payers will increasingly push patients to have a virtual visit with a doctor before setting foot in an office.

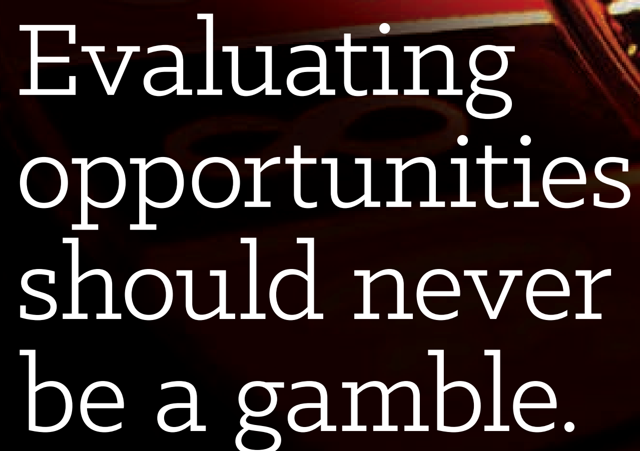
According to Grata, there are currently 108 hospitals delivering telehealth services to patients over virtual platforms in the market today. The telehealth market is expected to generate $10 billion in 2020, with high year-over-year growth of around 80% due to the pandemic, according to market research from Arizton. Brigham and Women's Hospital, Duke Health System and Baystate Health all deliver telehealth to their patients and have seen good results. On one day in April, Duke Health conducted around 1,030 video visits and 3,400 telephone consultations—up from around 100 visits per month prior to the COVID-19 outbreak.

"Over the last five years we've had some level of telehealth, but it's really been accelerated," says Simon Curtis, vice president for Ambulatory Services with Duke's Private Diagnostic Clinic, which includes most of Duke's specialty physicians.

Because offering telehealth is an added expense, it's no surprise that many hospitals able to support the technology tend to be larger hospital systems. Nearly 20% of the hospitals offering telehealth are large hospitals that have more than 250 employees. However, the largest segment of hospitals offering telehealth—38%—remain in the middle market. A telling sign that this is a growing industry is that overall employment at hospitals offering telehealth has increased by an average of 12% over the last year.

While the large majority of hospitals with telehealth offerings—89%— remain in private hands, investment in the sector is growing and that is a trend that is expected to continue.

While a majority buyout of a hospital system might be a steep purchase, »



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chances are good that hospitals might be looking for partnerships with investors that can provide them with additional capital to further develop their telehealth services, says Mark Claster, a managing partner at investment bank Carl Marks.

"There's going to be a lot of opportunities for private equity in this space," he says.

The adaptation and growth in the telehealth sector overall has been staggering over the last six months, Cole says, but he doesn't expect to see such dramatic changes in the next year. Rather, he expects continued refinement in platform roll-out and continued development in how telehealth will make the next leap forward.

TELEMEDICINE NETWORKS

Hospitals are only one avenue for telehealth. For physicians, nurses and other health care personnel not affiliated with a large hospital system, there are a large number of emerging telehealth networks offering services that connect caregivers with patients remotely.

Grata identified 54 such companies, averaging 1.2% in employment growth over the last year. These companies frequently exceed $100 million in revenue. Examples of telemedicine networks include Teledoc Health, a telemedicine provider located in Purchase, New York, that's seen total visits increase by 206% to 2.8 million in 2020.

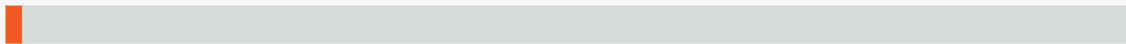
Additionally, the market for telemedicine is expected to be key in mental health. The COVID pandemic has caused demand for virtual mental health care to soar. About 19% of the companies included in Grata's database mention some type of psychiatry element in their offering.

What's more, the market for telemedicine networks is virtually untouched by private investment. Almost 90% of companies in the space are independently owned and have no formal backing.

But investors seem to be getting more interested in the sector. The number of investments in the sector has nearly doubled since 2019 and the total annual amount of funding has increased from $57 million to nearly $500 million in the same time, according to Grata. »

TELEHEALTH HOSPITAL OWNERSHIP

3%



Private Equity Platform

89%

Independent

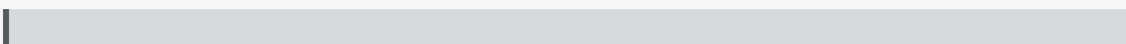
3%

Public Subsidiary

2%

Private Subsidiary

<3%



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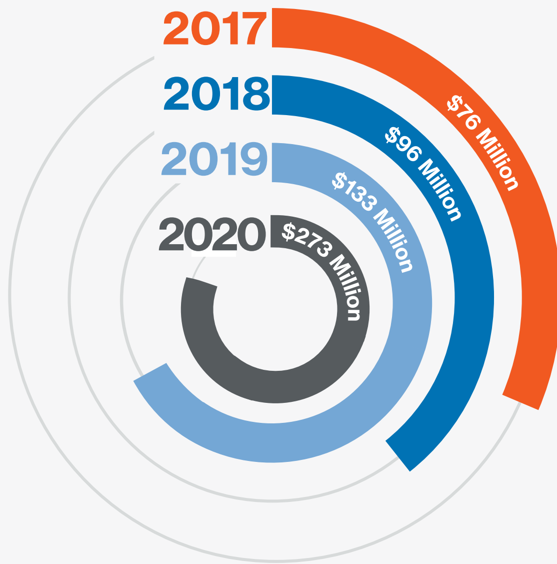
TELEHEALTH ENABLERS TOTAL FUNDING



“TECHNOLOGICAL ADVANCEMENTS—FOR EXAMPLE IN THE AREAS OF BIOMETRIC SENSORS, ADVANCED CAMERA AND AUDIO DATA CAPTURE AND EVEN AI—OFFER VERY INTERESTING OPPORTUNITIES TO TAKE TELEHEALTH TO THE NEXT LEVEL.”

MICHAEL COLE
Managing Director, Alvarez and Marsal

TELEMEDICINE ENABLERS

Nearly as important to telehealth platforms as the health care personnel is the information technology infrastructure and other backend management systems that make telehealth work. Known as telemedicine enablers, Grata has identified 114 of these businesses that average about 3.6% employment growth per year—a sure sign of strong growth.

Telemedicine enablers include companies like Meditab, a software business based in Sacramento, California, that helps physician offices manage electronic medical records and billing.

Providers that had existing telehealth infrastructure before March 2020 capitalized on this investment and thrived relative to their competitors in terms of being able to access patients, according to Cole.

“Technological advancement—for example in the areas of biometric sensors, advanced camera and audio data capture and even AI—offer very interesting opportunities to take telehealth to the next level,” he says, adding that there are opportunities for physician note transcription and prescription-writing to be automated as well.

Continued innovation is needed to increase access and usage, which will likely require federal and state support to broaden WiFi access to allow usage via mobile applications, potentially increasing the need for telehealth IT.

The market size of telemedicine enablers remains concentrated at the lower end of the spectrum, with more than half of companies employing 50 or fewer workers. However, 86% of companies in the market are independently owned—leaving plenty of opportunity for investment.

While the pace of funding activity has remained relatively stable over the last year, investors are committing more to the space. Total annual funding for telemedicine enablers nearly doubled in 2020, increasing to $273 million from $113 million from the year before.

ONLINE CORPORATE TRAINING

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“WHETHER IT IS VIRTUALIZATION RESULTING FROM MORE GLOBAL OPERATIONS OR COVID-19, IT IS SIMPLY BECOMING UNSUSTAINABLE OPERATIONALLY AND FINANICALLY TO PULL PEOPLE TOGETHER IN A ROOM FOR LIVE LEARNING.”

NEHA GUPTA
CEO, True Corporate Learning

“Whether it is virtualization resulting from more global operations or COVID-19, it is simply becoming unsustainable operationally and financially to pull people together in a room for live learning,” says Neha Gupta, CEO of corporate training platform True Office Learning.

Employment growth for companies offering online corporate training has remained relatively static over the last 12 months, but 94% of the nearly 100 companies Grata identified are independently owned, leaving plenty of room for investors to buy companies and get into the market.

VitalSmarts, a top 20 leadership training company, was acquired by Leeds Equity Partners at the end of 2019. The deal was inked to allow VitalSmarts to increase its research and product development efforts while growing its digital and online product offerings.

Perhaps Leeds got in at precisely the right time. The corporate training market in the U.S. is expected to grow 10% compound annual growth rate (CAGR) and reach more than $19 billion by 2024, according to market research firm Technavio.

Over the next year, Gupta expects to see an acceleration of growth for True Office Learning and the broader corporate training industry as companies adapt to and rebound from the pandemic. As organizations develop their strategic focus, she also expects an increase in demand for trainings around unconscious bias, diversity and inclusion and regulatory compliance.

Gupta says investors should look at companies that focus on training technologies like adaptive learning and behavioral insights rather than just educational content. “Increasingly, content is becoming a commodity and gets outdated or repetitive quickly.”

ONLINE EARLY CHILDHOOD ALTERNATIVES

Even with the likelihood of a vaccine in 2021, it’s clear many parents will still choose to keep their children out of school. This has put a spotlight on companies that can deliver online or hybrid versions of education for school-age children. Grata has identified more than 2,600 companies offering early childhood education alternatives.

The early childhood education market is projected to reach over $480 billion by 2026, at a CAGR of 10.5%, according to market research firm Facts & Figures.

Online early childhood alternatives

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are mainly made up of lower middle-market companies with nearly 95% employing fewer than 50 workers. This makes the industry ripe for consolidation. However, nearly all of the listed organizations are independently owned with no formal backing. Investors will be paying attention.

For investors interested in a niche undergirding the online early childhood alternative education space, they might be interested in businesses that provide online educators with the software to make remote learning possible, according to Jeff Lieberman, a managing director at Insight Partners, a private equity firm focused on software for education and corporate training. "Software will reshape learning both in and out of the classroom well beyond the pandemic," he says. "As companies move to fully remote or hybrid office settings and as parents continue to take on the role of partial or full-time teachers, demand for software in early childhood education and corporate training will continue to boom."

OUTSOURCED CUSTOMER CONTACT CENTERS

Customer service is key to the success of any business. That said, in-house customer service centers are costly and can be a drain on a company. Outsourcing customer contact centers has become a trend. They allow companies to cut costs and focus their attention and resources on the primary functions of their business at a time when companies are trimming budgets and streamlining operations.

Grata identified 351 outsourced customer contact centers, with employment in the sector growing by 10% over the last year. Market research firm Technavio projects the outsourced customer contact center market will grow by 3% CAGR to over $13 billion by 2023.

Unlike the trend to outsource customer contact centers to places like India, outsourced customer contact centers are increasingly based in the U.S. and Canada and are growing at a rapid pace, according to Michael Lamm, a managing partner at investment bank Corporate Advisory Solutions.

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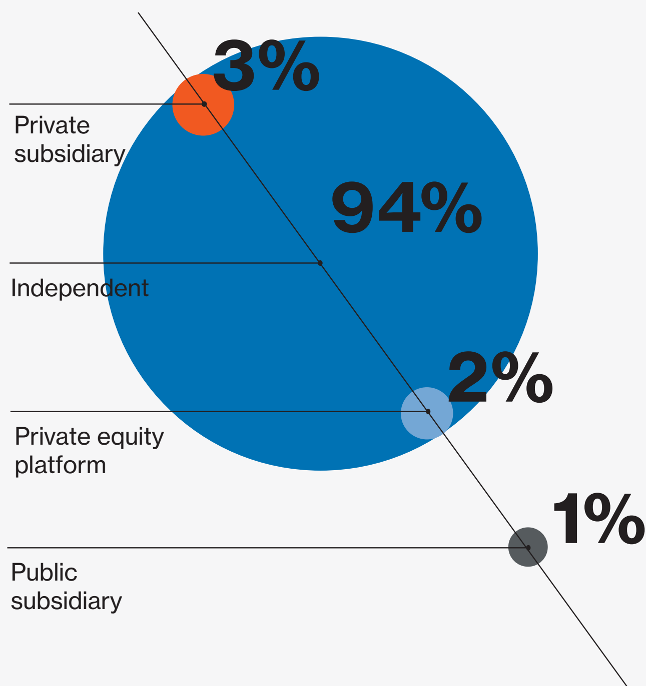
ONLINE CORPORATE TRAINING OWNERSHIP



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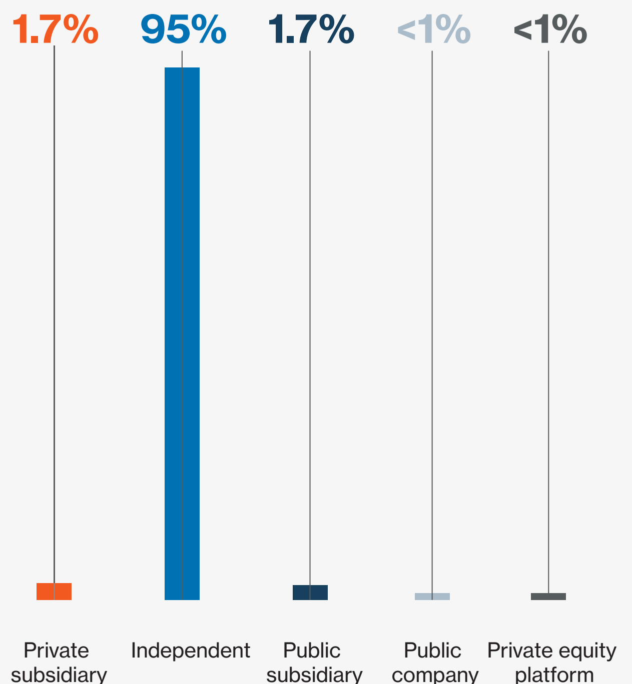

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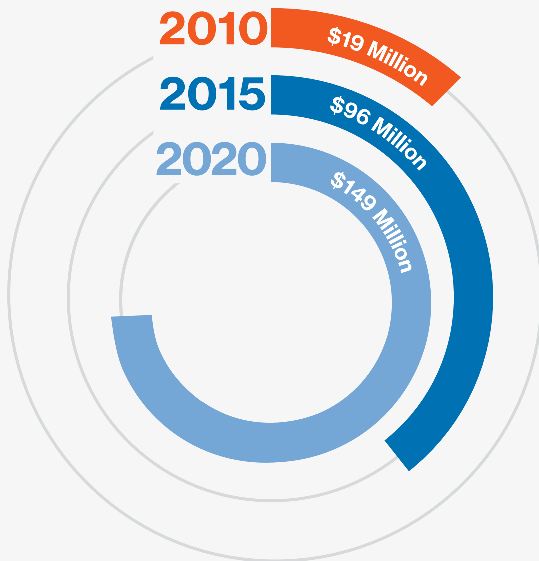
TOTAL FUNDING FOR CHATBOT AND AI CUSTOMER SERVICE COMPANIES



"Companies today want to be focused on what they do really well, rather than be focused on customer service," he says.

The size of these companies varies widely, with nearly half of those counted by Grata on the smaller side with fewer than 50 employees, while the remainder are midsize or large firms.

The potential for outsourced contact centers to investors is also evident. About 96% of companies are independently owned with no private capital investment.

Several private equity firms are already active in the space, a trend Lamm expects will continue as more companies offload work from their customer service divisions to third parties or divest them completely, even after a vaccine arrives. "Private equity and strategic groups want to expand these capabilities," he says.

CHATBOTS AND AI FOR CUSTOMER SERVICE

The explosion of demand placed on online retailers throughout the pandemic put significant strain on the human workers who traditionally staff customer contact centers— fielding questions and resolving disputes— prompting many companies to seek the help of robotic counterparts.

Even as the outbreak enters what is hopefully its later stages, companies offering chatbots and AI-enabled software have been elevated to a group with promise for investors because some can field a virtually unlimited number of calls.

After observing some of the technology available today, including AI that can convincingly mimic human voice patterns, Lamm expects growth of usage to increase in the coming years, especially as companies pivot to other technologies like data analytics and algorithms that can anticipate product breakdowns to tailor demand for customer service resources.

"In the next three to five years, the contact center industry is going to look more like a technology company," he says.

Grata has identified 50 companies in this vertical, with an average employment growth of 12% since 2019, implying rapid growth in the segment. The chatbot market is expected to grow from $2.6 billion in 2019 to $9.4 billion by 2024 at a CAGR of 29.7%. The client care industry is fundamentally growing with the influx of chatbot assistance to consider and cater to customer needs. As indicated by Grand View Research, 45% of end clients lean toward chatbots as an essential communication method for questions regarding client care.

Funding activity for chatbots and customer service AI has trended upward in recent years, with very little activity before 2012 and reaching nine private funding events representing $149 million by 2020.

An overwhelming majority of companies—66%—are smaller with just 50 workers, indicating that many may still be in the startup phase. However, a significant number of companies exist in the middle market—14%—and upper middle market—12%.

This is a market that's ripe for investment: According to Grata, 96% of companies offering chatbot services are independent with no formal investment backing. //

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