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# Outlook for private equity – challenges and opportunities

FW discusses the challenges and opportunities for private equity with Laura McIntosh at CMS Cameron McKenna Nabarro Olswang LLP and Jennifer Bellah Maguire at Gibson, Dunn & Crutcher LLP.

# Q&A:

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## THE PANELLISTS

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Laura McIntosh is a partner in CMS's corporate group. She specialises in M&A and private equity transactions and has acted on a large number of high value and complex transactions in the Scottish, wider UK and international markets across a range of sectors. She also has experience of joint ventures, reorganisations, restructurings and insolvency and general corporate matters.

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Jennifer Bellah Maguire is a partner in Gibson, Dunn & Crutcher's Los Angeles office and co-chair of the firm's investment fund group. Ms Bellah Maguire's practice focuses on private equity fund formation and mergers and acquisitions, including public company transactions and divestitures. 'Chambers Global: The World's Leading Lawyers for Business' has recognised her as a leading lawyer in the areas of private equity buyouts and investment funds.

**FW: Could you provide an overview of the key themes driving private equity (PE) over the past 12 months? How would you characterise recent deal activity?**

**Maguire:** Broadly speaking, in over 50 sectors we have seen vibrant merger and acquisition activity over the past year which can be grouped in broader categories. Some key themes from a sectoral perspective are healthcare and related industries, technology and software, construction, home and related consumer and financial and insurance. We have seen numerous successful public exits in the form of direct listings sponsored by their private equity (PE) owners, including LegalZoom, Duckhorn Wine, Leslie's Poolmart, Joann's Fabric and Mister Carwash. We have also seen a plethora of PE special purpose acquisition company (SPAC) exits as well. The velocity of transactions in the capital markets sector has been extraordinary. Deal activity has been frenzied and the introduction of the SPAC juggernaut both enhanced exit opportunities and clearly drove up multiples and prices, and in turn offered a new channel of fundraising opportunities to PE shops themselves, which many either explored or undertook.

In addition, the looming spectre of potential changes in the taxation of carried interest has proved to be a powerful incentive to drive deal traffic. The broadest and most pervasive theme to have gained hegemony in the investment sector is the widespread if not global embrace of environmental, social and governance (ESG) as an essential and overarching theme on the part of investors, consumers, and political and business leaders. From side letter provisions in fund formation to Securities and Exchange Commission (SEC) filings, the need for investors to articulate and address the three extraordinarily broad topics in their strategies and management of investments had been growing and took a major leap forward in the past 12 months. Consulting on diligence and compliance, promoting diversity and benchmarking of peer and industry performance is a wide area of increased activity and has triggered dialogue with respect to the perceived status quo and priorities of corporate stewards.

**McIntosh:** When the pandemic struck in Q1 2020, the attention of most PE houses was firmly on their portfolio companies. Many PE houses worked with their management teams in a fast-changing environment to quickly put in place contingency plans to be able to continue operations, model the potential impact of COVID-19 on the business and ensure access to working capital, where required. Deals inevitably went on hold in the initial phase of lockdown and sales processes in terms of which assets would have been actively marketed were put on hold. As travel and other restrictions started to ease in the summer of 2020, confidence returned, and activity has rebounded strongly. While we may have seen fewer auction processes, we have seen off-market deals and secondaries. With PE continuing to offer favourable returns in comparison to several other asset classes, some PE houses have also raised significant funds in the past 12 months which would suggest that activity will continue to be strong.

**FW: To what extent has the coronavirus (COVID-19) impacted PE capital deployment? Since the outbreak of the pandemic, what strategies have general partners been using to create value?**

**McIntosh:** COVID-19 has undoubtedly reduced the opportunities for traditional forms of capital deployment as deal processes were put on hold and timelines to full reopening of the economy became difficult to predict. General partners (GPs) operating in the mid-market have, to some extent, focused on preserving value in their portfolio companies, which may have required changes to the business plan and pursuing opportunistic bolt-ons. Where deal opportunities have arisen, the impact of COVID-19 on the business plan and revenues has been a key focus of due diligence. Keeping management incentivised, as the potential timelines to exit for some may have increased, has been key. Secondaries, in terms of those assets which are not at the stage of exit are transferred into new funds or stakes in the existing fund are transferred to new investors, have been a key strategy for GPs looking to extend the life of a fund and return value to investors.

**Maguire:** Following the early chill in deal flow and accelerated catch-up, we saw during 2020 that GPs were typically able to pivot from a stabilising toolkit, which may have included ensuring ample access to credit or even to modest amounts of follow-on equity investment, back to capital deployment and harvesting mature companies in a robust market for both public and private exits. Many portfolios either experienced relatively little pressure or rebounded quickly, with a few 'problem children' that were hopefully offset by 'pandemic Cinderellas', meaning companies in industries related to home-based activities such as craft, home improvement or home building, as well as construction and infrastructure that goes beyond just home building, along with education, related software, healthcare and wellness. Even fitness companies and restaurant chains survived better than expected.

**FW: Drilling down, what types of opportunities are PE houses generally targeting? Have any deals in particular caught your eye?**

**Maguire:** Most of the themes PE houses successfully pursued prior to the pandemic remain their favoured sectors or themes, but it is clear that the purported shift from material goods to valuable experiences as an evolutionary concept had to shift significantly away from shared, in-person experiences to potentially distributed or virtual experiences and online meeting tools. One trend that fascinated M&A lawyers was the manner in which the pandemic played through the 'material adverse change' clause of agreements that were executed pre-lockdown but not yet closed. Another theme was the continued activity both in fund formation and major investments into the asset management sector, with the headline grabbing Dyal and Owl Rock SPAC transaction resulting in a well-known GP stakes investment firm becoming publicly traded. Other intriguing 2021 transactions include the Sycamore/Victoria's Secret transaction and the recent acquisition by Stepstone, a publicly traded private markets investment of privately held Greenspring Associates, a leading venture capital and growth equity platform.

**McIntosh:** PE houses are continuing to focus on backing high quality management teams with ambitious plans for growth. Investments in tech, financial services and market disrupters have proved particularly attractive and we may begin to see more appetite in the months ahead from some PE investors for turnaround investments where targets are distressed because of COVID-19 and lockdown restrictions. As governments begin to turn their attention to investment in large scale infrastructure projects as part of a focus on a positive rebound, we will see more investment in the infrastructure and service providers that help facilitate these projects too. PE houses are also increasingly focusing their attention on green investments and there will be a continued appetite for investments in renewables.

**FW: To what extent are technologies such as artificial intelligence and data analytics being utilised to assist with target identification and digital transformation both in PE houses and their portfolio companies?**

**McIntosh:** PE houses have always been interested in identifying targets in the hope of gaining an opportunity to do an off-market deal ahead of an auction process, but it can be a slow burn with no guarantee of a successful conversion. Technology has certainly made the process of identifying and monitoring potential targets more efficient. However, it is unlikely to displace the role of the corporate finance adviser in making introductions where a PE house and management team may be a good fit for one another and potentially testing the price through a competitive auction process. Digital transformation has accelerated because of the challenges of the pandemic and technology will continue to be a huge focus.

**Maguire:** Data analytics is omnipresent and expanding in the toolkit of many portfolio companies and businesses in general, with the gathering and utilisation of consumer data giving rise to increasingly complex and legally intensive regulation. Artificial intelligence (AI) does not have the same broad application, though this is likely evolving. Rather, anecdotally at least, AI appears to be deployed more intensively in technology-driven businesses and in life sciences, to some extent. Even law firms are using AI in various areas, including some aspects of due diligence on the corporate side and discovery on the litigation side. We are seeing increased deal volume focused on data monetisation and efficiencies created through the implementation of AI-driven strategies. We expect to see AI continue to be a deal driver for PE firms and their portfolio companies, including the use of data analytics to identify value-enhancing synergies among prospective target and business models.

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> JENNIFER BELLAH MAGUIRE
> Gibson, Dunn & Crutcher LLP

**FW: In your experience, has there been a shift in the way PE firms structure and negotiate their deals, with a view to reducing risk and maximising future returns?**

**Maguire:** There has certainly been no shift of paradigmatic proportions, in my experience. Rather, some of the major trends that were already manifest, namely the use of representation and warranty (R&W) insurance as a default choice, the strength of the secondary market for both private equity securities themselves and interests in successful privately held positions, as well as the creative use of platform construction to partner capital and industry thought leaders in potentially innovative ways, which was certainly a subsidiary theme of the SPAC phenomenon. Investors always sought to risk-adjust returns and prized the ability of a PE firm to foresee and opportunistically identify trends, be they in businesses as banal as the stunningly successful car wash firm, which recently underwent an initial public offering (IPO) by Leonard Green, or the zeitgeist capturing household product provider The Honest Company, both of which were successfully listed by their PE stakeholders. Two trends that have been embraced by multiple firms that result in extended or perpetual holding periods are worth mentioning, because they can be viewed both as mitigating the risk of exit and short-termism and maximising ultimate value creation. These trends are, on the one hand, the formation of evergreen funds that would not require liquidation at any particular time, and, on the other, 'GP-led recapitalisations' which have a similar impact by repositioning long-held portfolio companies into a rebooted fund vehicle with fresh capital, terms and holding periods. While the technology to have one's cake and eat it is still under development, these trends bring both investors and sponsors a bit closer. Another trend we have been seeing in the current hot market for good targets is the competitive advantage of pursuing a bid without any financing contingency, which has become an increasingly useful component of the successful buyer's toolkit lately.

**McIntosh:** Deal structure has always been key to PE firms, and we continue to see structures being implemented in accordance with the corporate finance and tax advice which is tailored to the deal. Each PE house tends to have its own approach and particular provisions of its investment documentation which are key to it and therefore reflects its position from which it can be difficult to depart in the absence of deal dynamics. On exits, warranty and indemnity (W&I) insurance continues to be a significant feature of the market, reducing risk to management teams and maximising returns.

> **"INVESTOR APPETITE FOR HIGH-QUALITY ASSETS, EVEN WHERE IMPACTED BY COVID-19, WILL CONTINUE TO PROVE STRONG AND WE WILL START TO SEE MORE OF THOSE EXITS WHICH WERE PUT ON HOLD IN 2020 COMING TO MARKET."**
>
> LAURA MCINTOSH
> CMS Cameron McKenna Nabarro Olswang LLP

**FW: Have any recent legal or regulatory developments affected PE firms' approach to executing deals or optimising their portfolio companies?**

**McIntosh:** We have seen PE firms thoroughly diligencing any COVID-19 support and furlough support received by targets as a new workstream forming part of their due diligence. There is also an increasing focus on considering ESG aspects, including the sustainability aspects of a target or portfolio company's business, as investors in funds look to consider ESG as part of their investment criteria. Alternative, more sustainable solutions may need to be deployed in the business and a new generation of customers is increasingly taking these aspects into consideration when making purchasing decisions. Those investing in particular sectors in the UK must also be mindful of the UK's new National Security and Investment Act 2021 and any potential impact it may have on a future exit should clearance of the sale to a potential purchaser be required. Any increase in the rate of capital gains tax by governments looking to raise tax revenue once we fully emerge from the pandemic will impact management teams and PE houses and may result in some changes to traditional PE deal structures.

**Maguire:** The broad concept of ESG has clearly had an impact though the metrics and measurement of the effects will probably provoke further development and debate in coming years. The major development likely to impact US-based sponsors and investors would be a change in the taxation of capital gains or carried interest. Clearly, the latter has already been impacted by the extended holding period now applicable to carried interest if nothing else. Further, we are seeing increasing acceptance of a laddered approach to carried interest beyond the sectors where it was more typically seen, such as real estate, to provide that after achieving a specified level of return, the carried interest increases to a 'premium' level. The combined impact of increased taxation and outsized returns has driven this phenomenon to the point where the standard 80/20 is taking its place as more of a menu item than a prix fixe.

**FW: With PE exits having stalled during the COVID-19 crisis, what are PE houses doing to prepare for exit? What challenges do they face?**

**Maguire:** Aside from companies that were so adversely impacted that they are not likely to be resuscitated in the near term, the robust market for exits has more than compensated for the relatively brief stalled phase for many PE houses in the US and overseas. The single challenge we hear about the most, and indeed, some businesses are designed to address, is that of talent acquisition and development. The demand for workers at numerous levels of skill and across many industries has returned to the pre-pandemic fore with great force, and in areas such as hospitality, agriculture, construction and many other fields it continues to be a challenge to growth. Supply chain disruption, which was extreme in the beginning, has certainly not disappeared, and the wave of demand for both raw and finished goods has continued to place strain on the system and result in both delay and increased cost, which has and will erode profit.

**McIntosh:** PE investment tends to bring a further level of professionalisation to a business, with an increased focus on financial reporting and rigour in how the business operates and is managed, with revenue and costs being key drivers. PE houses continue to have a strong focus on revenue and costs in the period leading up to an exit. Any issues identified during due diligence are typically addressed quickly post completion so that they do not prove to still be an issue on exit, and it is important to ensure that a business is ready for sale and any potential issues have been addressed. It is also important to ensure during the exit planning process that the right management team is in place to be able to deliver that exit with a clear strategy for future growth. Travel restrictions which impact on the ability to hold face to face meetings have continued to be a challenge in the context of an exit. The impact of Brexit and COVID-19 also appears to be giving rise to greater movement among employees, such that recruitment and wage pressures could prove challenging in certain sectors. The age-old question of exit pricing may be a challenge for some and conversations with stakeholders and corporate finance advisers will be continuing around timing to maximise returns on exit.

**FW: As the world continues to recover from the pandemic, what are your expectations for investor appetite in the months ahead? How bullish is the outlook for PE activity through the remainder of 2021 and beyond?**

**McIntosh:** Investor appetite for high-quality assets, even where impacted by COVID-19, will continue to prove strong and we will start to see more of those exits which were put on hold in 2020 coming to market, as well as new opportunities born out of COVID-19. With funds to invest, the outlook for PE is extremely positive through the remainder of 2021 and beyond.

**Maguire:** My expectations are very positive overall, as shellshock has clearly given way to a sense of demonstrated resilience on the part of sponsors and their management teams, of the awe-inspiring power of technology to adapt and integrate business and human endeavour, and the equally well demonstrated value of asset diversification, with a strong performance by both the capital markets and the 'alternative' investment categories. Certainly, with the spectres of adverse taxation, inflation and multi-faceted labour challenges of unfilled demand on both the employer and employee sides of the equation driving both increased labour costs and social exigencies, there are going to be new challenges facing PE firms. ■