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2022 and Beyond: Private Equity Outlook for 2023

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Introduction

The global private equity (PE) industry, riding a years-long boom in dealmaking that slowed only slightly at the onset of the COVID-19 pandemic on its way to a record-setting 2021, has remained resilient through the first half of 2022, despite oncoming economic headwinds. Though off its 2021 pace, PE deal activity by both U.S.-based and European sponsors in early 2022 remained in line with historical trends in terms of deal value and as a percentage of overall M&A activity, mostly buttressed by large-cap PE dealmaking. While global PE fundraising weakened in the first half of 2022 compared to 2021, fundraising in the U.S., particularly for buyout funds, kept pace with previous years, as PE returns currently represent a more attractive opportunity for investors than public equity markets do. Nevertheless, rising interest rates, surging inflation, the ongoing war in Ukraine, choked supply chains and the growing expectation of a looming recession have begun to take their toll on deal volume, with sponsors turning their attention to strengthening their existing portfolio companies over searching for new platforms.

The rapidly changing economic environment is also spurring a rise in general partner ("GP") -led secondary transactions, a creative strategy for GPs to extend the life of existing PE funds rather than being forced to exit investments on pre-set deadlines. Carveout transactions and deepening involvement by PE funds in private credit can also be expected to feature prominently in the second half of 2022 and into 2023. At the same time, distressed deal flow has been slower than expected coming out of the pandemic, though it may yet quicken if global political uncertainty and adverse macroeconomic conditions persist. Tougher antitrust regulation around the world, combined with government sanctions, unavoidable supply chain issues, inflation and interest rate rises may spur more forced sales and other portfolio restructurings. Creativity and agility are therefore key for PE sponsors, both to identify and win investments in a competitive market and to create value post-acquisition.

Trends in the PE Market

GP-led secondary transactions

In a secondary transaction, an investor sells its partnership interest to another investor, the secondary buyer. If the seller is a limited partner, its sale of its limited partnership interest is known as an "LP-led secondary transaction". By contrast, a "GP-led secondary transaction" is a sale of one or more portfolio companies by a fund to another fund set up by the same GP to hold those portfolio companies. The new fund set up by the GP will be underwritten by new lead investors and is referred to as a "Continuation Fund".

Since 2016, GP-led secondaries as a proportion of all secondary transactions have risen from under 30% to a majority. Market disruption caused by COVID-19 was a significant catalyst for this change, with GPs being forced to turn their attention from value-creation to value-preservation of portfolio companies. At the same time, significant value-creation opportunities presented themselves to funds coming to the end of their lives (particularly those formed in 2013–14), yet fixed fund terms acted as arbitrary deadlines by which GPs had to realise profitable exits. Furthermore, high-quality assets in the market have been at all-time high prices, motivating GPs to search for means to retain their best-performing, highest-growth-potential portfolio companies, rather than pay premiums in the market. A solution becoming increasingly common in the market is to form Continuation Funds led by existing GPs. The market for GP-led secondaries has already matured to the point that representations and warranties insurance – a product more commonly associated with M&A deals – is now available for GP-led secondaries as well.

Sustainability in PE

Sustainable investing has steadily risen over the last several years as a front-of-mind concern for investors, operating companies, consumers, employees, and regulators, having now reached a tipping point in which other market players, not within the scope of legislation or regulation themselves, are placing primary emphasis on environmental, social and governance (ESG) issues.

The EU has been the vanguard for regulating in this space, with its key aim of steering money flowing through the financial system towards sustainable activity. In this regard, the EU Action Plan on Sustainable Growth, the Sustainable Finance Disclosure Regulation (SFDR), and the Taxonomy Regulation have apparently had a desired dual effect. First, as they have begun coming into effect, with further key compliance dates in 2023, they have started a trend, inspiring comparable regimes

across the globe. In the U.S., the SEC, in March 2022, proposed long-anticipated and comprehensive climate-related disclosure rules, and followed such proposal up in the ensuing months with specific rule proposals aimed at investment advisers and funds concerning ESG investment practices.

The second effect is that not only are those within scope of the disclosure regulations focusing heavily on ESG concerns, but those needing to attract investment and who, at least for the moment, are not in scope of the regime, are focusing on ESG as well. Both corporates and GPs are increasingly realising that making it easier for market participants to accurately assess the sustainability of an investment makes the investment commensurately more attractive.

PE firms are now focusing on ESG issues not just to increase current return potential (such as, for example, creating value by decarbonising a portfolio company), but also for reasons of weighting risk and future-proofing. Investors are recognising that future investors and consumers are increasingly likely to make business and spending decisions with an eye toward their environmental impact. Firms equally want to avoid allegations of greenwashing that arise from a lack of seriousness about sustainability, as well as unanticipated costs of ESG mitigation.

Given the nascent stage of most ESG-driven regulation, their success in driving results will be iterative. Areas for improvement include harmonisation across regulatory regimes and granular clarity as to what needs to be disclosed under the regimes. In addition, the veracity and availability of sustainability data needs significant improvement, together with harmonisation of the ways in which that data is created and treated. It is also clear that an increase in resource capability for data-handling is needed.

Take-private transactions

The bear market in public equity markets has created buying opportunities for sponsors seeking new investment opportunities. This dynamic has already been reflected in 2022, with PE firms spending a record $226.5 billion globally on take-private transactions in the first half of 2022, up nearly 40% over the first half of 2021, and $117 billion on U.S.-based take-privates, up 72% from a year earlier, according to media reports. The same phenomenon has been taking place in Europe, where take-private transactions involving PE firms nearly doubled to $78 billion, up from $40.7 billion in the first half of 2021. Sponsors have also been active in the large-cap space, signing 10 deals for leveraged buyouts of U.S. public companies in deals valued at $5 billion or more, for an aggregate deal value of nearly $90 billion.

The disproportionate involvement of PE firms in take-private transactions reflects an alignment of incentives between sponsors seeking value and public companies struggling to meet market expectations under the weight of rising costs for labour and materials. Sponsors also found the market for debt financing to have still been relatively open in early 2022, a factor unlikely to remain in place for at least the near term.

Carveout transactions

Carveout transactions are where corporates sell off, or "carve out", only part of their business or assets, either via a sale of a subsidiary or division or following reorganisation under which various non-core assets are transferred into a newly formed entity. There has been a marked increase in this form of transaction in the last couple of years; as economic and trading conditions remain uncertain globally, that trend may continue into 2023. Reasons for such divestments include paying down additional debt taken on during COVID-19, streamlining businesses, complying with increased regulatory and antitrust requirements (through divestiture itself or to meet fines), navigating restrictions on foreign investment, and additional costs of doing business in certain markets.

On the buy-side there is appetite for such sell-offs from cash-laden PE funds competing for opportunities to invest, employing buy-and-build strategies and identifying synergies in their existing portfolio. Carveout transactions often present a greater degree of complexity than platform deals, but can offer PE investors real potential for returns, given that target assets and businesses in carveouts frequently have untapped potential without having received sufficient attention or capital investment as part of a diversified operation. The chance to unlock this potential is particularly manifest when the target is a good fit with the buyer's existing portfolio companies, helping unlock synergies and creating a cleaner transfer requiring no, or minimal, transitional services arrangements.

Private credit

The rise in use of private credit was fuelled during the 2008 financial crisis, when changes to regulation led to a lower risk appetite by traditional banks. This trend has continued through the more recent years of disruption, volatility and uncertainty in the market. With private credit proving increasingly popular for its relative speed, certainty, flexibility, bespoke solutions-based approach, and confidentiality, and now with record levels of fundraising as investors seeking higher returns put their money into private credit, larger and larger deals have been financed by credit funds. This is in step with the PE trend of closing increasingly large deals, as discussed above. The best evidence of private credit's popularity in the PE space may be found among EMEA-based sponsors, a majority of whom prefer private credit over traditional bank financing for their buyouts, according to a recent Dechert survey.

With this mainstreaming of private credit comes increased competition, given the pools available for investment, the arrival of new entrants, and traditional banks seeking more involvement in the space. Indeed, just as PE funds are finding a challenge in choosing among attractive assets in which to invest, so will private credit be jostling for the right deals to fund. As such, a willingness to take more risk and be more flexible in order to secure an investment can be expected. At the same time, having borne a level of risk that traditional banks post-2008 chose to avoid, the private credit system may find navigating the combined headwinds of high inflation, a potential recession and rising interest rates particularly challenging.

Outlook

Despite the signals of an oncoming economic downturn in the second half of 2022, as long as public equity markets remain in correction territory, investors' appetites for PE opportunities can be expected to continue. PE firms' success in attracting funds will therefore need to be matched with successful investment opportunities. Not surprisingly, auctions have become increasingly competitive, making it essential for sponsors to be fast, flexible and decisive. Alternative deal structures, the use of private credit and greater diversity in investments are becoming permanent fixtures of the PE landscape, as apparent in the rise in GP-led secondaries, take-privates, and carveout transactions.

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