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Private Equity 2020

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Expert Chapters

1 **2020 and Beyond: Private Equity Outlook for 2021**
Robert Darwin, Siew Kam Boon & Adam Rosenthal, Dechert LLP

4 **Defensive Strategies for Sponsors during Periods of Financial Difficulty**
Eleanor Shanks, Bryan Robson, Mark Knight & Matt Anson, Sidley Austin LLP

Q&A Chapters

8 **Australia**
Atanaskovic Hartnell: Lawson Jepps

19 **Austria**
Schindler Attorneys: Florian Philipp Cvak & Clemens Philipp Schindler

29 **Bermuda**
Kennedys Bermuda: Nick Miles & Ciara Brady

38 **Canada**
McMillan LLP: Michael P. Whitcombe & Brett Stewart

47 **China**
Zhong Lun Law Firm: Lefan Gong & David Xu (Xu Shiduo)

58 **Hungary**
HBK Partners Attorneys at Law: Dr. Márton Kovács & Dr. Gábor Puskás

67 **Ireland**
McCann FitzGerald: Rory O'Malley, Ben Gaffikin, John Neeson & Elizabeth Maye

77 **Italy**
Legance – Avvocati Associati: Marco Gubitosi

87 **Luxembourg**
Eversheds Sutherland (Luxembourg) LLP: Holger Holle & José Pascual

95 **Nigeria**
Udo Udoma & Belo-Osagie: Folake Elias-Adebowale & Christine Sijuwade

103 **Norway**
Aabø-Evensen & Co: Ole Kristian Aabø-Evensen

125 **Portugal**
Morais Leitão, Galvão Teles, Soares da Silva & Associados: Ricardo Andrade Amaro & Pedro Capitão Barbosa

133 **Spain**
Garrigues: Ferran Escayola & María Fernández-Picazo

142 **Switzerland**
Bär & Karrer Ltd.: Dr. Christoph Neeracher & Dr. Luca Jagmetti

150 **Taiwan**
Lee and Li, Attorneys-at-Law: James C. C. Huang & Eddie Hsiung

157 **United Kingdom**
Dechert LLP: Ross Allardice & Robert Darwin

168 **USA**
Dechert LLP: John LaRocca, Dr. Markus P. Bolsinger & Allie M. Misner

2020 and Beyond: Private Equity Outlook for 2021


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I. Introduction

2019 was another active year for the global private equity (PE) industry. Transaction volumes and values continued at levels only slightly lower than those of 2018, despite some anticipation of a global economic slowdown in the near term. Deal multiples remained historically high in the US and Europe, driven by the same intense competition for assets that has characterised the market in recent years, itself caused by the presence of significant levels of dry powder and a relative scarcity of targets on which to deploy it. Holding periods slightly decreased in 2019, as sponsors sought to avail themselves of more favourable exit conditions before the expected onset of recession. Take-private transactions remained a significant component of market activity, especially in the technology and healthcare industries. Much of this buoyancy continued into Q1 of 2020. However, for most of the globe, the abrupt arrival of the COVID-19 pandemic was accompanied by a sharp recession, which included the end of long bull markets in US and European equities and sharp falls across a number of Asian markets. COVID-19 has been a defining influence in the trends affecting the PE market in 2020 and will also affect the outlook for the next year.

II. Trends in the PE Market

Deal terms to bridge the valuation gap

Ongoing uncertainty caused by the turbulent economic outlook and a lack of "business as usual" trading information from targets has damaged the confidence levels of both buyers and sellers. To bridge the difference in valuation expectations caused by this uncertainty, we expect to see a return of deal terms more usually seen in recessionary environments, such as deferred consideration mechanisms that have been more rarely used in the period of growth between the 2008–2009 global financial crisis and the start of the COVID-19 outbreak. We are also seeing the emergence of various COVID-specific financial measures, e.g. "EBITDAC" – where the "C" stands for coronavirus.

Minority investment

The recent trend of deploying capital in minority and non-controlling positions further down the capital structure is also likely to continue and potentially accelerate, as PE sponsors are driven by challenging market conditions to seek innovative investment structures that allow the deployment of capital at attractive valuations while permitting a greater degree of downside protection (such as preferred equity or convertible debt) than is afforded by more typical control investment transactions.

Deal termination and disputes

One trend that emerged quickly in the weeks following the outbreak of the COVID-19 pandemic was that of buyers attempting to terminate or renegotiate transactions entered into prior to the pandemic but that had yet to close. Initially, buyers focused on arguments that material adverse change clauses contained in their purchase agreements had been triggered. This was followed by a number of claims being brought by buyers who argued that actions taken by targets in response to the pandemic (e.g. the furloughing of staff or drawing down on loans to support capital needs) constituted a breach of the common interim operating covenant that requires the seller to operate the target in the ordinary course of business consistent with past practice or for the seller not to incur additional indebtedness. Even where such a breach would not give rise to a termination right exercisable by the buyer, litigation in respect of an alleged breach has been used as a strategy to renegotiate deal terms and defer closing of the transaction to gain more time for the buyer to assess unfolding events. We expect this to be a relatively short-term phenomenon, which only affects transactions that had signed but not closed at the time the pandemic started, as newly signed transactions tend to reflect COVID-19-related business risks.

COVID-19 diligence issues

COVID-19 has required increased attention to be given to certain legal due diligence topics. In particular, due diligence has focused on those terms of a target's commercial contracts that may impact revenue certainty, the impact of any implemented or available governmental measures on the target's business (e.g. in respect of furloughing staff or providing emergency state funding) and the target's access to additional funding under

its existing financing arrangements and any potential breaches of borrower debt covenants that may have arisen as a result of COVID-19. Buyers are behaving cautiously in assessing targets that have been (or are likely to be) negatively affected by the pandemic and we are seeing investment and credit committees increasing the duration and depth of their review of buyout transactions accordingly.

Buy-out finance

Credit markets tightened in response to COVID-19 and obtaining high degrees of leverage for buyout transactions may become increasingly challenging. This may result in buyers contributing more equity to fund transactions or accepting less favourable debt terms than have been common in recent years.

W&I market

Due to the decline in transaction volume, the W&I insurance market became very competitive in the weeks following the COVID-19 outbreak, especially as to premium rates. After an initial period during which insurers applied broad COVID-19 exclusions to policy coverage, many insurers are now taking a more nuanced view and are moving away from broad COVID-19 exclusions to more tailored exclusions that focus on the aspects of the target's business that may be particularly affected by the pandemic, such as supply chain issues, material contracts and employee issues. Several of the W&I brokers we deal with are expecting the competitive W&I market to continue for the remainder of the year.

Secondaries transactions

2019 was another highly active year for transactions in the secondaries market. In the context of the worsening macroeconomic climate, we expect to see growth in the secondaries market continue, as distressed investors look for liquidity, and LPs seek to rebalance their portfolios and free up capital to meet revised investment theses. PE sponsors are likely to continue to set up continuation or specific asset funds to allow them to continue to hold particularly successful investments that were originally acquired by funds that are approaching their liquidation period. We expect this trend to continue throughout 2020, especially if less seller-favourable exit conditions become more common.

The increase in Foreign Direct Investment (FDI) controls

A number of jurisdictions have introduced FDI controls for the first time in 2020, and several more, including the US, have enhanced those FDI regimes that were already in place. These investment controls are not limited to national defence infrastructure (as was typically the case historically), but in many cases extend to finance, healthcare, infrastructure, transport, media, agriculture and technology industries, too. The increasing number and strength of these regimes will necessarily become a feature of analysing whether a transaction is feasible and will certainly feature in transaction documentation as conditions to closing where mandatory governmental approvals apply. This represents a step back from globalisation and a resurgence of the importance of national borders that has also been particularly apparent in governmental responses to the immediate challenges posed by COVID-19 to national healthcare infrastructure, the supply of medical equipment and the right to obtain vaccines, when available.

Opportunity for those with sector expertise

Our closing comment in last year's edition of this chapter, that global events may also provide significant opportunities for investors to acquire distressed assets at advantageous valuations, has proved true in ways few of us predicted. Deal teams with the deep sector expertise required to understand the effects of the pandemic on their target industry, and the ability to execute transactions in distressed environments, will be best placed to take advantage of the opportunities presented by corporates divesting non-core businesses to bolster their own balance sheets in response to revenues damaged by lockdown. This is particularly true in the life sciences and healthcare industries, where those with the expertise to navigate the complex interplay of factors that are relevant to targets in these industries (which have, in many cases, been at the forefront of the response to COVID-19) will be able to compete most effectively for those high-quality assets that become available.

III. Outlook

After a promising start to 2020, the outbreak of the COVID-19 pandemic caused a significant pause in deal-making and a sharp decline in transaction volumes in Europe and the US, as many deals went on hold. Although there are signs that market activity is picking up again, we expect the PE industry's return to deal-making to be cautious, as the effects of the pandemic continue to ripple through a global economy that was already poised to enter a period of contraction. We have seen most resilience in those industries least affected by the pandemic, such as technology, financial services and e-commerce. Fundraising in the first half of 2020 marginally outstripped the equivalent period in 2019, and levels of dry powder remain very high. The challenge for the PE industry in 2020 will be how to deploy this capital effectively in an uncertain market.

Acknowledgment

Thomas Clarke, an associate based in Dechert's London office, also contributed to this chapter.

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