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2013 Private Equity Year in Review

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Editor's Note: Andrew J. Nussbaum is a partner in the corporate department at Wachtell, Lipton, Rosen & Katz. The following post is based on a Wachtell Lipton firm memorandum by Mr. Nussbaum, Steven A. Cohen, Amanda N. Persaud, and Joshua A. Feltman.

Private equity deal activity ebbed and flowed, often unexpectedly, in 2013. Despite some slow periods, strong debt and equity markets helped support first nine-months numbers that are well ahead of 2012, although Q4 2013 is unlikely to match Q4 2012, where activity was stimulated by anticipated changes in the tax laws. Successful sponsors again demonstrated their ability to perceive and exploit changing market conditions. Moreover, the private equity industry posted its best fundraising numbers in years. It was a year that showed that *Semper Paratus* may indeed be the industry's new motto.

What Types of Deals Are Getting Done? Lots of deals got done in 2013, although only two topped $20 billion and barely a handful exceeded $5 billion. But the volume totals do not reflect the many challenges of getting a deal over the finish line. While deal activity was helped in some cases by announced or behind-the-scenes activism—which may motivate listed companies to exit certain areas of the portfolio or consider a public-to-private for the entire business—there is no question that deals are getting harder to do (*e.g.*, Dell), and attractive assets have multiple suitors (*e.g.,* BMC Software).

Perhaps not surprisingly, in an environment of rising stock prices, cheap financing and cautious economic optimism, private equity sponsors faced ample competition for attractive targets, including from strategics willing to borrow and pay all cash. The winning bidder needed an edge—speed of execution, deal philosophy or capital structure creativity, or all of the above. Sponsors who focused on a substantive investment theory as to how the deal makes sense (*e.g.*, Neiman Marcus and Albertsons), or how to cleverly put it together (*e.g.*, Heinz), achieved potentially hallmark transactions.

Private equity sponsors also reacted to challenging market conditions by increasing the proportion of "add-on" acquisitions and minority investments. The latter types of investments can fly under the radar of other private equity firms, resulting in less competition, and typically require less time and fewer resources from the private equity sponsor after the investment is consummated.

Dry powder in the private equity industry remains high, the investment window is closing on funds raised in 2007 and 2008, and the Federal Reserve seems to be moving away from the policies that let the historically cheap financing of 2012 survive through 2013, all suggesting that sponsors will want to continue to put capital to work even in challenging market conditions.

What About Exits? The trend toward private equity sponsors selling to other private equity sponsors continued in 2013, but for the first time in 4 years the volume of sponsor-to-sponsor activity declined. The public equity markets were solid for much of the year, which permitted certain very large deals (*e.g.*, Seaworld and Hilton) to launch. In the first half of the year there appeared to be more dual track processes than in the second half, perhaps a result of the buoyant public equity markets and sponsors becoming less interested in chasing them. These trends should continue as long as stock market valuations remain strong.

Fundraising and Limited Partners. After a prolonged period of contraction, private equity achieved in the first three quarters alone the highest fundraising totals since 2009. Particularly noteworthy is that a number of sponsors raising multi-billion dollar funds hit their target much quicker than anticipated, and in some cases high investor demand has resulted in sponsors increasing fund sizes.

Sponsors successfully raising capital have adapted to the balance of power having tilted in favor of limited partners. Not uncommon these days are customized arrangements for significant investors, various discounts to the 2 and 20 model, sector specific funds and co-investment and direct investment platforms. While the numbers are still small, some sponsors are raising capital through the public markets by employing novel structures to manage the complicated retail regulatory regimes. Others are managing platforms that invest in small cap managers who often have the ability to post higher returns than larger funds. Regardless of the amount of assets under management, sponsors are working harder to maintain investor relationships in the hopes of maximizing commitments to future capital raises.

Consolidation Ahead? The alternative asset management industry is highly fragmented, with the top 25 sponsors controlling less than one-third of assets. We expect that institutional investors, in particular, will continue to direct most of their capital to sponsors with top brand names and diverse product offerings. These sponsors often have stronger internal governance and controls to effectively manage the myriad of US and foreign regulations affecting their business. They also tend to be more adept at handling complex fund structuring arrangements. The ever-increasing regulatory burden also drives consolidation, as costs and the need for sophisticated risk management personnel raise challenges for smaller managers.

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We have predicted since 2007 that the post-recession private equity industry would reward focused endeavors and distinctive strategies. 2013 was a case in point. Successful fundraising required clear articulation of specific strategies, and, ideally, the track record to prove the thesis; the M&A and IPO markets rewarded “bespoke” dealmakers and those nimble enough to move quickly in response to markets. We see reason for optimism for the well-prepared in the coming year.