February 7, 2022

Private Equity – 2021 Year in Review and 2022 Outlook

Private equity dealmaking reached historic heights in 2021. Building on a strong rebound in the second half of 2020, private equity set new annual records in global deal volume and transaction value. With private equity funds sitting on an estimated $2.3 trillion of dry powder and prominent firms raising funds of unprecedented size, capital supply is robust and continues to grow. However, changes to monetary policy, a shifting regulatory landscape, increased focus on EESG (employee, environmental, social and governance) and the possibility of tax reform on the horizon are likely to raise headwinds for private equity dealmakers in 2022 and beyond.

We review below some of the key themes that drove private equity deal activity in 2021 and our expectations for 2022.

Record Buyout Activity; Record Exit Activity. As we described in our recent memo, Mergers and Acquisitions—2022, private equity was a key driver behind the record-setting levels of overall M&A activity in 2021. Global private equity transaction volume ended the year at approximately $1.2 trillion, representing approximately 20% of overall global M&A volume and an approximately 111% increase over 2020. The increased activity levels primarily resulted from a record volume of buyout activity, driven by a plentiful capital supply, easy access to debt financing with low interest rates and favorable terms, as well as the deployment of massive amounts of cash that private equity firms had been amassing in recent years. Private equity firms also exited their investments at a record pace in 2021, with 3,895 exits with a total deal value of approximately $665 billion, surpassing 2020's 2,594 exits totaling $521 billion.

The Rise and Rise of Tech. 2021 continued the sharp upward trend of the last five years in the proportion of private equity activity represented by tech transactions. Private equity backed a record volume of tech deals in 2021, announcing over $400 billion in U.S. tech deals, compared with $196 billion in 2020 and $146 billion in 2019. Significant private equity-backed tech transactions included Thoma Bravo's $10.1 billion acquisition of cybersecurity firm Proofpoint, the $14 billion acquisition of McAfee by a consortium of private equity investors, and the $17 billion acquisition of healthcare technology company Athenahealth by Bain Capital and Hellman & Friedman. The recent announcement of Vista Equity Partners and Elliott Investment Management's deal to take cloud-computing company Citrix private in a $16.5 billion transaction may be a harbinger of continued robust private equity activity in the tech sector in 2022, fueled in part by digital adoption trends accelerated by the Covid-19 pandemic that show no signs of slowing down.

SPAC Slowdown. One exit path for private equity investors that narrowed somewhat in 2021 was the SPAC market. SPAC IPOs priced at a blistering pace in the first quarter of 2021, with 298 SPAC IPOs raising nearly $88 billion during the quarter, exceeding the roughly $83 billion raised by 248 SPAC IPOs in all of 2020, followed by a significant downturn in the SPAC market during the rest of the year. Among the reasons for the decline in SPAC activity has been concern over recent underperformance by a number of post-de-SPAC target companies, as well as heightened scrutiny by the SEC, with changes in accounting guidance and several notable enforcement actions brought by the SEC against SPACs, their sponsors and/or target company executives. The plaintiffs' bar has also begun to focus its attention on SPACs' public disclosures and sponsors' potential conflicts of interests with public SPAC investors. It is too early for the impact of the recent Delaware Chancery Court decision in *MultiPlan*—suggesting that de-SPAC transactions may be subject to the heightened "entire fairness" standard of review—to be seen, but the decision is likely to be part of a re-evaluation of the SPAC model by courts and regulators in the years to come. Despite the uncertainty ahead, SPACs will likely continue to represent a frequent exit path for private equity investors, with approximately 575 SPACs currently looking for targets and highly incentivized to complete deals before the expiration of the time periods specified in their charters (generally 18 to 24 months). Many private equity firms have also been prolific sponsors of SPACs, some of which announced high-profile transactions in 2021. Private equity firms are likely to continue sponsoring SPACs and competing with other SPAC sponsors, including other private equity firms, for high-quality targets.

The Return of Club Deals. Private equity "club deals," which had fallen out of favor following the 2008 financial crisis, may be coming back as private equity firms look for opportunities to deploy significant capital in transactions involving large targets while strategic buyers face an increasingly uncertain regulatory environment. Indeed, 2021 witnessed the largest buyout involving a consortium of private equity firms since the financial crisis, the $34 billion acquisition of Medline by Blackstone, Carlyle and Hellman & Friedman. Firms' willingness to share coveted transactions with other sponsors is somewhat counterintuitive, given the large pools of available capital, but is likely driven at least in part by the practical limitations of fund concentration limits, as well as the need to "show the target the money" at signing, even if post-signing syndication may be preferred by the buyer. For the participants other than the lead bidder, participation allows for a means to deploy potentially significant amounts of capital. In addition, "showing the money" to employee-sellers at closing to provide both liquidity and funds for reinvestment as partners in these deals also remains important to retaining talent in this competitive market. We note also the participation of traditional activists in many deals, especially Elliott, with its Evergreen Coast Capital fund partnering with private equity firms on several high-profile transactions since its formation in 2015. The recently announced bid for retailer Kohl's by a Starboard-led consortium of investors suggests these partnerships will continue to proliferate in 2022. The net result is that we expect more large deals, stimulated by available capital pools, high valuations and a renewed willingness of sponsors to partner with each other and other classes of investors.

Fundraising Rebounds, Adding to Already Robust Capital Reserves. Private equity fundraising rebounded in 2021, reaching record levels by year end with approximately $940 billion raised. Blue-chip names had particular success: Hellman & Friedman raised $24.4 billion for its tenth buyout fund, KKR $15 billion for its fourth Asia fund (the largest ever for the region) and Bain Capital $11.8 billion for its latest flagship North America buyout fund. This fundraising momentum is likely to continue into the new year, as major private equity players are planning additional capital raises projected to result in record-sized funds and unprecedented levels of deployable capital. Carlyle is reported to be targeting $22 billion for its flagship private equity fund, and Blackstone and Apollo are preparing for major fundraising efforts as well (with Blackstone reportedly planning to target as much as $30 billion and Apollo $25 billion).

Debt Markets Remain Highly Constructive. High-yield debt markets remained highly borrower-favorable throughout 2021 and acted as a key driver of private equity activity. And while the Federal Reserve has signaled that multiple rate increases may be on the horizon, thus far in 2022, markets continue to be a source of strength for borrowers, with floating rate leveraged loans staying white-hot and high-yield bond spreads remaining tight.

One ongoing trend is the rise of "direct lenders," who have become an increasingly important presence in LBO financings. Many private equity funds have sought to deepen their ties with direct lenders, cultivating ongoing relationships with these sources of capital much as they have long had with traditional banks.

Debt covenant packages also continue to rapidly change. While the market still expects most high-yield issuers to agree to the traditional full suite of negative covenants, the *exceptions* to those covenants, and the means of calculating compliance with them, have significantly evolved. For instance, "multi-purpose" baskets that can be used as exceptions to multiple covenants are on the rise, as are "run rate" revenue adjustments to ratio tests and exclusions of "working capital" debt from leverage calculations. Such individual revisions may seem technical on their own, but their aggregate impact can be powerful, particularly when borrowers face headwinds.

Continued EESG Growth. As in the public markets, EESG continued to gain momentum in the private equity space as investors and asset managers increasingly recognize EESG as a lever for value creation (in addition to being a tool for risk mitigation) and seek to integrate EESG considerations within fund processes. A number of private equity firms have launched impact funds dedicated to EESG-oriented investments, and recent surveys indicate that investors are willing to allocate increased capital to sustainable investments, particularly investments that support the transition to a low-carbon economy. The availability of decision-useful and comparable data remains a challenge for sponsors: in September 2021, the California Public Employees' Retirement System and Carlyle rallied a group (including other "traditional" asset managers like Apollo, Ares and Oaktree) now totaling nearly $9 trillion in assets seeking to collect data and standardize EESG reporting on a number of metrics, including greenhouse gas emissions, workplace fatalities and women in board seats of portfolio companies. The recent formation of the International Sustainability Standards Board and the expected release of global disclosure guidance later this year, while voluntary, will likely help establish uniform global reporting standards. The rollout of the EU's Sustainable Financial Disclosure Regulation and Taxonomy Regulation will also result in mandatory disclosures for sponsors. We expect investor interest in impact-focused strategies and attentiveness to EESG issues generally to remain elevated through 2022.

Shifting Fee Structures. 2021 was a year of significant change for publicly traded private equity funds, with some of the industry's biggest names restructuring their finances to respond to a public market valuing private equity management fees at a premium. In the first wave of private equity IPOs, beginning over a decade ago, funds such as Blackstone, KKR, Carlyle and Apollo split management fees and performance-based fees roughly evenly with the public. Over time, however, valuations of private equity fees diverged, with public markets valuing the smaller, but more predictable management fees more highly than the irregular, but outsized performance-based fees. Performance-based fees' lack of predictability has led them to be discounted by analysts and investors—but not by private equity employees and executives themselves, who are incentivized by the significant profits that come from successful investments. The implications (and possibilities) of this shift became clear in 2019, when Stockholm-based EQT Partners successfully went public offering shareholders all of its management fees but only one-third of its performance-based fees. In doing so, it earned the highest valuation multiple in the industry. In 2021, mega-funds took note, and responded. In February 2021, KKR revealed that it would move to a model in which only up to 25% of management fees, but up to 70% of performance-based fees, would go to KKR insiders. Apollo and Blackstone announced similar changes before year end. TPG's successful IPO in January of this year, which was accompanied by a restructuring resulting in shareholders receiving 100% of management fees but only 20% of performance-based fees, reflects what may become the default model for funds going public in 2022: one in which performance-based fees remain largely in the hands of insiders, while management fees go to public shareholders.

These considerations are also reflected in the increasing role of insurance in the private equity playbook. For sponsors, insurance businesses offer steady streams of cash, an increase in assets under management and an opportunity to manage so-called "permanent" capital that does not need to be re-raised. For insurers, who typically rely on interest income from corporate and government bonds, private equity presents an opportunity to exit or reduce exposure to product lines whose profitability has disappointed in a low-rate environment. Notable insurance transactions in 2021 included Apollo (a leader of the insurance strategy) merging with its long-time affiliate Athene in an all-stock deal valuing Athene at $11 billion and Blackstone's purchase of a 9.9% stake in AIG's Life & Retirement business for $2.2 billion. In connection with the investment, Blackstone and AIG also entered into a long-term strategic asset management relationship in which Blackstone will manage an initial $50 billion of AIG assets, increasing to more than $90 billion over the next six years.

Spotlight on Antitrust. Increased antitrust scrutiny of acquisitions, including acquisitions by financial buyers, may present a new challenge to private equity sponsors in 2022. As we explained in our recent memo, under the Biden administration, new leadership at the Federal Trade Commission and the Department of Justice's Antitrust Division have ushered in a new, more aggressive and more unpredictable era of merger enforcement. While historically private equity has seen more lenient antitrust review, in her September 2021 memo Visions and Priorities for the FTC, Lina Khan, the FTC's new chair, singled private equity out for criticism, stating that regulators must consider how "the growing role of private equity and other investment vehicles . . . may distort ordinary incentives in ways that strip productive capacity and may facilitate unfair methods of competition and consumer protection violations." We anticipate that the FTC's increasing focus on human capital issues may further implicate reviews of private equity transactions. The combined effect of this increased scrutiny is likely to affect private equity activity in 2022, complicating efforts to close pending transactions and potentially inhibiting transactions that parties might otherwise have pursued. At the same time, however, we expect financial buyers will continue to enjoy a regulatory advantage over strategic buyers, who are likely to face an even more challenging merger enforcement environment. The regulatory landscape in 2022 may thus prove advantageous to agile sponsors who are able to deploy capital without the delays and uncertainties faced by their strategic counterparts.

Increasing Disclosure Obligations. Further clouding the regulatory outlook, private equity has become a target of the SEC as part of its broader efforts to decrease the public-private disclosure gap and expand the agency's oversight of private markets (as we described in a recent memo). In January 2022, the SEC voted 3-1 to issue a proposed rule that would increase the amount and timeliness of confidential information that private equity funds must report on Form PF. The SEC's proposed changes would require funds to file reports within one business day of the occurrence of events relating to advisor-led secondary transactions, general partner or limited partner clawbacks, the removal of a fund's general partner, the termination of a fund's investment period or the termination of a fund. The SEC's proposed rule would also decrease the reporting threshold for large private equity advisors from $2 billion to $1.5 billion in assets under management and add reporting obligations regarding the use of leverage and treatment of portfolio companies.

Tax Changes on the Legislative Agenda. President Biden's tax agenda has raised the specter of a number of potential tax changes affecting private equity. While the version of the Build Back Better Act approved by the House in November dropped the previously proposed increases in the long-term capital gains rate (from 20% to 25%) and in the holding period required for carried interest to qualify for long-term capital gains rates (from three to five years), it would expand the reach of the net investment income tax and introduce new tax "surcharges" on individuals with income in excess of certain thresholds (5% or 8%, depending on income levels). It remains unclear whether, or in what form, these tax changes will come into effect.

* * *

Private equity had a remarkable 2021. Low interest rates, ample dry powder and a robust fundraising environment all contributed to record activity levels. Although rate hikes, an end to historic stimulus and potential tax reforms are on the horizon, the fundamentals remain in place for a strong 2022. Looking ahead, the strongest headwinds for private equity may be regulatory, rather than economic, as sponsors face increased antitrust scrutiny and more burdensome disclosure obligations. We expect that private equity dealmakers will continue to innovate, and seek investment opportunities of increasing scale and complexity. Along the way, dealmakers will be rewarded for careful planning and thoughtful transaction structuring.

Andrew J. Nussbaum
Steven A. Cohen
Jodi J. Schwartz
Nicholas G. Demmo
Igor Kirman
Andrea K. Wahlquist
Benjamin M. Roth
Joshua A. Feltman
Karessa L. Cain
Gregory E. Pessin
Mark F. Veblen
Victor Goldfeld
Tijana Dvornic
John R. Sobolewski
Alon B. Harish
Benjamin J. Nickerson
Charles C. See