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Private Equity—2023 Outlook

Despite the challenges the year presented for investors (rising interest rates, tumultuous financial markets, geopolitical upheaval, etc.), private equity showed resilience in 2022. Deal activity declined from 2021, but finished the year above pre-pandemic levels. Although fundraising similarly slowed, sponsors still closed 2022 with approximately $2 trillion in dry powder. And while private equity continues to face headwinds in 2023, market dislocations often provide compelling opportunities for the most thoughtful and sophisticated investors. Now more than ever, creative financing and careful transaction planning are essential.

We review below some of the key themes that drove private equity deal activity in 2022 and our expectations for 2023.

Acquisitions and Exits

Deal Activity Down From 2021, But Above Pre-Pandemic Levels. As we described in our recent memo, Mergers and Acquisitions—2023, after a record-shattering year for M&A in 2021, last year represented a reversion to the mean.

- *Deal volumes down.* Announced global private equity M&A deal volume declined from $2.1 trillion in 2021 to $1.4 trillion in 2022, with dealmaking tapering in the second half of the year as credit markets weakened and became more volatile. Private equity's share of overall M&A volume was steady year-over-year (approximately 36%), and deal volume in 2022 exceeded the pre-pandemic level of $1 trillion in 2019.

- *Public buyout boom continues*. While aggregate deal volume shrank, sponsors were active in public company buyouts in 2022, supported by the significant decline in public company market valuations and sponsors' desire to deploy large amounts of capital. 2022 capped a two-year take-private boom, with 2021 and 2022 each, by both deal count and value, marking the highest levels of public company buyout activity since the 2008 financial crisis.

As always, many sponsors were agile in reacting to the dynamics of the broader economy and financial markets. Those that did deals were generally perceived as pressing their advantages of access to capital, relationships and comfort with complexity to create and exploit opportunities—from the increasing use of continuation funds to manage timing of an exit, to obtaining deal flow from hedge fund activism, to deploying sophisticated financing structures that allow portfolio companies to manage through challenging market conditions. We discuss some of these trends in greater detail below.

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Sponsors Choosing Alternative Exits. The aggregate value of private equity exits globally was down 32% from 2021. Responding to the challenging IPO and corporate buyer markets in 2022, sponsors pivoted to alternative exits. Sponsor-to-sponsor sales (including continuation funds) accounted for approximately 45% of U.S. private equity deal volume in 2022, an uptick from the 10-year average of approximately 39%.

- *Continuation funds a source of liquidity.* Many sponsors elected to hold on to portfolio companies rather than sell into a down market, or to transfer assets to continuation funds. While continuation fund transactions require dealmakers to navigate potential conflicts and are the subject of increasing SEC focus, they provide an alternative path that can be attractive to both managers and limited partners. With $125 billion of capital currently being raised to target continuation opportunities, we expect this trend to continue into 2023, particularly if the challenging market backdrop for IPOs and sales to strategics continues.

Tech Still Prominent. As in 2021, the technology sector was a key area of interest for private equity.

- *Software popular.* Software companies with a “recurring-revenue” business model remained a notable area of focus for private equity buyers. As software valuations declined sharply as part of a broader tech selloff, sponsors launched a number of public company buyouts targeting the space. Examples include Thoma Bravo’s $6.9 billion acquisition of SailPoint and $8 billion acquisition of Coupa Software, and Vista’s $8.4 billion acquisition of Avalara.

- *Looking ahead.* We expect tech to continue to be an area of focus for sponsors, who increasingly see the sector as a way to gain exposure to broad swaths of the economy, as digitalization and technology permeate an ever-wider range of industries.

Importance of Activism. Activism by hedge funds continues to be a source of deals for sponsors, including through joint bids or complementary playbooks, and being invited into a deal process when activists are already on the scene.

- *Activists catalyzing buyouts.* Activism increased in 2022, and as activists took advantage of declines in valuations to agitate for sales, sponsors often emerged as buyers. Notable campaigns included JANA’s campaign at Zendesk preceding the company’s $10.2 billion sale to a consortium of investors led by Hellman & Friedman and Permira, and Sachem Head and Corvex Management’s campaign at Anaplan preceding the company’s $10.7 billion sale to Thoma Bravo. We expect that hedge fund activists will continue to push for M&A in various sectors in 2023, and sponsors will increasingly take advantage of the opportunities this may create.

- *And also opposing them.* Activists also continue to advocate against agreed M&A transactions, highlighting the increasing importance to sponsors acquiring public companies of planning ahead for possible campaigns seeking to disrupt agreed buyouts. For example, after Nielsen agreed to be acquired by Evergreen Coast Capital Management (the private equity arm of Elliott Investment Management) and Brookfield Asset Management, The WindAcre Partnership sought to oppose the take-private transaction. WindAcre ultimately joined the buyout consortium and the transaction closed.

Deal Financing

Creative Transaction Structuring. Responding to the 2022 credit market turmoil, sponsors increasingly turned to creative financing structures to pursue new deals.

- *Buy now, borrow later.* Some sponsors followed a "buy now, borrow later" path—up to and including all-equity deals, such as KKR's buyout of April Group—writing large equity checks and planning to increase leverage when markets improve.

- *You can take it with you…* Also en vogue were deal structures that allow a target's existing debt to stay in place post-transaction—for instance BDT Capital's purchase of Weber. This approach, while "debt-efficient," can limit buyout opportunities to more modest transactions, such as capping the new investment below 50%, and otherwise moderating consent and board rights to avoid tripping change-of-control provisions. Such was the case, for instance, in Kohlberg's "secondary" transaction to buy a 50% stake of USIC from Partners Group.

- *Seller notes.* In certain situations, *e.g.*, where the seller is a large strategic shedding non-core assets, buyers looked to "seller notes" and other forms of seller-provided financing to close the funding gap. For instance, Searchlight Capital Partners' and Rêv Worldwide's acquisition of Netspend from Global Payments was funded, in part, by Global Payments-provided financing.

Liability Management Transactions: The Modern Dynamic. The market and rate environment has created challenges—and liquidity needs—for many businesses, and sponsor-owned companies have not been immune. But under modern debt documents, sponsors and their portfolio companies have a diverse array of debt transaction tools available to obtain liquidity for their cash-strapped portfolio companies, often while capturing discount and extending maturities in the process.

- *Uptiers and dropdowns*. One such tool is the so-called "uptier," in which a majority lender group consents to the incurrence of priming senior debt (and often exchanges a portion of its existing debt for such priming senior debt). Alternatively, sponsors may consider a "dropdown" in which company assets are transferred from the debt credit

group to an "unrestricted subsidiary," which then raises its own financing (sometimes in connection with a discounted exchange for the debt of its parent company). When successfully implemented, these transactions can materially improve the balance sheet where lenders may be reluctant to participate in a refinancing.

- *Meticulous analysis essential.* Liability management transactions have also spawned complex legal disputes—see, *e.g.*, *Serta, Boardriders* and *Revlon*, all situations involving liability management transactions by sponsor-controlled companies in which litigation is currently ongoing. Careful advance planning, and a proper board process that evaluates conflicts and insulates board members (and the sponsor) from attack, are essential.

The Rise and Rise of Direct Lending. As challenging syndicated markets failed high-yield issuers, "direct lenders" partially filled the breach.

- *Prominent in PE.* Once limited to the middle market, direct lenders reportedly provided some or all of the debt financing in six of the 10 largest announced buyouts of 2022.

- *And still some room to grow.* The pace of direct lending slowed in the second half of 2022, but still remained relatively robust when compared to traditional single B financing markets. As top direct lending players raise bigger funds and make increasingly large commitments, their prominence may only increase.

Funds and Fundraising

Fundraising Down, But Capital Reserves Remain Robust. After private equity funds reported record inflows from investors in 2021, fundraising was estimated to be down approximately 22% for 2022. But global private equity and venture capital dry powder remains robust, standing at nearly $2 trillion, with approximately one-third earmarked for traditional leveraged buyouts.

Private Equity Opening Up to Retail. 2022 saw private equity firms pushing to develop private capital retail offerings, with asset managers such as Apollo, Blackstone and KKR looking to grow assets under management and high net worth individuals seeking higher-returning investments. Notwithstanding recent challenges posed by higher-than-expected levels of investor redemption requests, leading some sponsors to implement redemption gates as permitted by fund documents, we expect the number of retail-accessible alternative asset products to continue to expand, as asset managers pursue a huge and largely untapped market.

Innovations in Fund-Level Debt Financings—NAV Loans. While fund-level debt facilities—in particular "capital call" facilities—have long been a feature of PE fund structures, 2022 saw net asset value ("NAV") loan facilities, fund facilities which are

secured by the collective portfolio company equity interests held by a fund, become increasingly popular. NAV facilities can provide important financing for mid- and late-life funds, when most or all of their capital has been called.

Regulatory Developments

Increasing Antitrust Scrutiny. As we anticipated in our memo last year, private equity has moved into the spotlight of the Antitrust Division of the Department of Justice and the Federal Trade Commission.

- *DOJ targeting roll-ups.* In an interview with the *Financial Times* given in mid-2022, Jonathan Kanter, the assistant attorney general in charge of the Antitrust Division, indicated that private equity roll-ups would be a particular area of focus for DOJ.

- *Concerns with interlocking directorates.* DOJ has also indicated that it is ramping up efforts to enforce Section 8 of the Clayton Act, which prohibits officers and directors from simultaneously serving with competing companies. Private equity sponsors have become a target of enforcement, under a theory of corporate deputization, which focuses on whether the firm (as opposed to an individual) has overlapping competitive board interlocks. For example, in October 2022, seven director resignations were announced in response to concerns raised by DOJ, including three relating to Solarwinds, a Thoma Bravo portfolio company, even though only one Solarwinds board member was also a director at another Thoma Bravo portfolio company.

- *Expect increased focus on regulatory deal terms.* With regulators scrutinizing private equity, sponsors will need to devote increasing attention to the regulatory risks posed by their transactions and the contractual terms that allocate those risks, as will their counterparties. We expect some sellers to push on the traditional sponsor position that existing portfolio companies are off-limits for any sort of contractual obligation, leading to bespoke arrangements.

Greater Regulatory Attention to ESG. Attention to environmental, social and governance issues remains elevated, and continues to have implications for sponsors. In May, the SEC proposed new disclosure requirements for ESG-related funds and to require a registered fund with ESG terminology in its name to invest 80% of its assets consistent with that focus. 2022 also saw the SEC bring the first actions by its Enforcement Division's Climate and ESG Task Force, which was established in early 2021 to focus on "greenwashing," or misleading statements by firms regarding their ESG-related commitments and practices. Sponsors with ESG-focused funds will need to pay close attention to the SEC's evolving views of ESG disclosure and compliance.

Carried Interest Tax Changes Off the Table—Again and For Now. Earlier versions of the Inflation Reduction Act contemplated extending the holding period of

investments eligible for carried interest tax treatment from three to five years. These changes were removed from the final bill to secure passage in a 50-50 Senate.

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Private equity heads into 2023 facing considerable uncertainty. Nonetheless, we expect markets to continue to present attractive opportunities for creative dealmakers, and to reward sponsors that can bring real value to the table with counterparties in the form of thoughtful structuring, access to capital and a reputation and record of successful execution in challenging markets.

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