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Private Equity in 2023—A Year (Not) to Remember

In our memo early last year, we noted that private equity investors and dealmakers faced considerable uncertainty heading into 2023 following a challenging 2022. Indeed, the headwinds that slowed private equity in 2022—among others, rising interest rates, persistent inflation, widely divergent valuation expectations, market and geopolitical upheavals and heightened regulatory scrutiny—endured in 2023, and new challenges emerged. Private equity continued to show resilience, however, as sophisticated dealmakers deployed innovative approaches to fill financing gaps and get deals done, and as a number of sponsors continued their transformation from buyout shops to alternative asset managers offering a broad range of capital solutions both in the M&A context and beyond, including private credit.

Financial sponsors are likely to face many of the same challenges as 2024 begins—but where it ends is anyone's guess. Not many would have predicted the rebound in equity markets in the second half of 2023 or the rising (for now) prospects of a soft landing for the broader U.S. economy, and 2024 is similarly unpredictable. Some sponsors are hopeful for an uptick in activity this year amid a more favorable borrowing environment, as interest rate increases wane and recession fears subside, while others are resigned to another year of relatively low activity. In such an environment, flexibility and careful planning will continue to be essential to creating and exploiting opportunities.

Acquisitions and Exits

Buyouts and Exits Stall, For Now. Private equity deal volume continued its decline from its pandemic peak, notching $1.3 trillion in 2023, compared with $1.7 trillion in 2022 and a record $2.2 trillion in 2021, as sponsors facing choppy financing markets increasingly focused on smaller deals and minority investments. Dealmaking did gather some momentum in the second half of 2023, which was far busier than the first two quarters, perhaps reflecting an emerging consensus that interest rates were approaching their peak. Beyond interest rate and financing market challenges, valuation fundamentals and the "expectations gap" between sellers and buyers also deserve their due for the slowdown. Heading into 2024, with growing talk of a soft landing, some market participants anticipated that buyer and seller expectations will converge as market factors influencing prices stabilize.

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Sponsors fared little better on the sell side. With M&A activity continuing its lower volumes globally and the IPO markets slow, although slightly thawing, sponsors saw diminished exit opportunities in 2023. Global private equity exits shrank in value from approximately $783 billion in 2022 to approximately $574 billion in 2023, down more than 25%. Continuing a trend of the past several years, the secondary market remained a popular alternative path to monetization, with continuation funds accounting for an increasingly dominant share of sponsor-initiated secondary deal volume. We also observed more diversified alternative-asset managers moving capital and fundraising into these areas, continuing to validate them as properly part of the core private equity market.

As investors gain greater conviction on interest rate trajectories, the syndicated loan market continues its rebound from a tumultuous first quarter, and IPO activity shows green shoots, optimists see reasons to expect relief in the new year from some of the downward pressures seen in 2023.

Shift from Take-Privates to Carveouts and Add-Ons. Notable take-privates in the first half of 2023 included Apollo's $5.7 billion acquisition of Univar Solutions and Blackstone's $4.1 billion acquisition of Cvent, both announced on the same day in March 2023. As public equity markets rallied in the second half of the year, other transaction types took center stage, including corporate carveouts, such as GTCR's acquisition of a majority stake in FIS's Worldpay Merchant Solutions business at an $18.5 billion valuation—one of the year's largest private equity transactions. Sponsors also pursued add-on acquisitions as part of a "buy-and-build" strategy to scale up existing portfolio companies, building a foundation for higher multiples upon an eventual exit. Significant add-ons included the $4.6 billion acquisition of Diversey Holdings by Solenis, a Platinum Equity portfolio company, and the $1.2 billion acquisition of Avantax by the Cetera Financial Group, a Genstar Capital portfolio company.

A hallmark of both carveouts and add-ons is the added complexity and bespoke nature of dealmaking, which provided experienced sponsors opportunities to leverage their scale and operational expertise to differentiate themselves in an otherwise challenged deal landscape.

Everything Old Is New Again—Sponsors Pooling Capital with Each Other, and with Activists. Private equity "club deals," which made a comeback during the pandemic, continued to feature prominently in 2023, as sponsors joined forces in a number of notable transactions, most significantly the $13 billion bid for eBay-backed Adevinta by a consortium of investors led by Permira and Blackstone. Club

deals offer sponsors a means of diversification amid economic uncertainty and may improve access to debt financing by leveraging a consortium's enhanced bargaining power to reach more favorable terms with lenders.

As in previous years, traditional activists participated in several high-profile club deals, as sponsors showed a continued willingness to partner both with each other and with other classes of investors. Examples included the $7.1 billion acquisition of Syneos Health by an Elliott-led consortium that included Patient Square Capital and Veritas Capital, and Apollo's $5.2 billion acquisition of Arconic, which included a minority investment from Irenic Capital Management.

Deal Financing

Private Credit Dominates LBO Financing . . . and Asset Managers Continue to Expand Their Private Credit Offerings.

2023 was a challenging year for sponsors seeking new financing. Rates, of course, remained elevated. Average leverage levels for new LBOs declined to 5.9x from 7.1x in 2022. Correspondingly, the average equity contribution for large LBOs reached 52% in 2023, an all-time high.

With traditional leveraged financing markets choppy, direct lenders dominated. Through the third quarter of 2023, 86% of loans for leveraged buyouts were made by direct lenders (compared with 65% in 2021). Examples included the Adevinta acquisition noted above (funded by a record €4.5 billion unitranche loan from a direct lender group including the Canada Pension Plan Investment Board, Blackstone's credit unit and GIC), as well as Maxar Technologies' acquisition by Advent and BCI (supported by a $2.3 billion debt package from Sixth Street, Blackstone's private credit unit and Goldman Sachs).

However, just as private lenders have been edging into the turf of traditional banks, in 2023 banks took notice of private credit's returns and began pushing into the space. Some announced partnerships with existing alternative asset managers, such as Wells Fargo's strategic relationship with Centerbridge Partners and Société Générale's global partnership with Brookfield, while others, including JPMorgan, are reported to have set aside significant amounts of their own capital for direct lending efforts.

We expect a continued blurring of lines between "traditional" and alternative lending, as alternative asset managers seek to finance more than just LBOs, while traditional banks work to win share in the rapidly growing direct lending asset class.

For sponsors and borrowers, the right financing solution will depend on market conditions and deal specifics.

A Sharp-Elbowed Financing Market—Debt Default Activism in the Higher Rates Environment. In last year's memo, we discussed creative strategies that acquirers could use to keep low-rate debt of target companies in place following an acquisition. But just as a rising interest rate environment makes existing low-rate debt more valuable to borrowers, it also makes such debt more of a burden to lenders. 2023 resultantly saw a meaningful increase in "debt default activism"—previously discussed in our memos *The Rise of the Net-Short Debt Activist*, *Default Activism in the Debt Market* and *Debt Default Activism: After* Windstream*, the Winds of Change*—as debtholders deployed legal arguments and maneuvers to seek to force borrowers to refinance existing low-rate debt on new market-rate terms. In the current sharp-elbowed financing markets, we encourage sponsors structuring corporate transactions that leave low-rate debt in place to build a record with defense in mind and carefully review not only obviously applicable provisions in debt documentation, but also those that might seem like insignificant "boilerplate."

Liability Management Booms. Sustained higher interest rates and challenging financing markets, coupled with increased sophistication and precedent, drove a major increase in out-of-court "liability management" transactions. Commentators counted 21 liability management transactions in 2023, more than double the previous peak of 10 in 2020. Debt investors not previously known for aggressive tactics proved willing and eager to participate in priming transactions (perhaps out of fear of being primed themselves), while sponsors who had previously stayed on the sidelines, facing challenges at their portfolio companies, took the plunge.

Liability management technology also continues to evolve, with 2023 seeing the emergence of "double dip" and "*pari* plus" transactions, which offered new pathways for borrowers to parlay their existing debt baskets for additional credit support in return for correspondingly cheaper debt.

In picking the best liability management path for a distressed portfolio company, sponsors should carefully consider not just the upfront transaction analysis, but the likelihood (and cost) of any litigation that follows a disputed transaction.

Funds and Fundraising

Fundraising Faces Headwinds . . . While Dry Powder Accumulates. Private equity sponsors faced a lean fundraising environment in 2023, as institutional

investors—with the notable exception of sovereign wealth funds—continued to slow their investment pace and shift their focus toward other asset classes. Private equity firms raised approximately $556 billion globally in 2023, roughly even with 2022 levels and down from approximately $620 billion in 2021, as many brace for a sustained fundraising downturn and tightened competition for capital in the year ahead. More established sponsors were able to capitalize on their track records to attract an outsized share of the investor dollars allocated to private equity. Sovereign wealth funds also continued to be a bright spot, both filling fundraising gaps and increasingly participating in transactions as co-investors. Even as fundraising remained tight, however, uncommitted capital continued to accumulate amid a dearth of deals.

Fund-Level Financing Considerations. The elevated interest rate environment has driven NAV loans and margin borrowing to newfound prominence. The NAV financing market, approximately $100 billion at present, is projected by some commentators to triple in size by 2025. Despite NAV loans in particular drawing some hand-wringing (a common phenomenon when a new financing product gains traction), we believe both technologies have appropriate roles in the fund financing toolkit, for instance by providing capital for follow-on acquisitions at existing portfolio companies while leaving cheap company-level debt structures untouched.

Regulatory Developments

Antitrust Regulators Up the Ante. As we anticipated in our memo last year, private equity has become a key focus for the U.S. antitrust agencies, and recent developments suggest that increased scrutiny of the industry will continue in 2024. Following the DOJ and the FTC's calls in recent years for increased antitrust enforcement targeting private equity roll-up strategies, in September 2023 the FTC filed its first lawsuit based on a "serial acquirer" theory against private equity investor Welsh, Carson, Anderson & Stowe. The FTC's complaint alleges that, beginning in 2012, Welsh Carson directed a "roll-up scheme" to monopolize and reduce competition for anesthesia services in Texas through the acquisition of over a dozen anesthesia practices. The complaint seeks unspecified "structural relief" that could include unwinding prior consummated deals, which mostly were small enough not to require filings under the HSR Act. In case sponsors had difficulty finding the complaint, FTC Chair Lina Khan penned an op-ed article in the *Financial Times* about the "serial acquisition" theory a few days after filing.

In support of this strategy, in 2023 the agencies embarked on an effort to equip themselves with better tools to detect and challenge "roll-up" strategies through formal and informal rulemaking. The agencies announced proposed revisions of the HSR Act notification form that would require notifying parties to disclose acquisitions in the same industry in the 10 years prior to the notification. The agencies recently issued new Merger Guidelines that include a new theory of harm based on "serial acquisitions" and make clear that the competitive effects of private equity roll-ups cannot escape scrutiny "even if no single acquisition on its own" is anticompetitive. Instead, where a transaction is part of a series, the agencies will consider whether the cumulative effect of the trend or strategy of serial acquisitions may result in a violation of the antitrust laws.

European FSR Regime. New EU regulations relating to foreign subsidies, which became effective in October 2023, may raise additional filing burdens for sponsor deals by firms whose portfolio companies have substantial sales to government entities (even if the target does not). Under the new regime, the foreign subsidies review process will run in parallel with the traditional merger review, and the European Commission will have new investigatory powers and the ability to impose measures to mitigate the effects of foreign subsidies. The new regulation defines government contributions very broadly, including sales of goods or services to any government entity, thus increasing the risk that private equity firms that manage multiple portfolio companies will be subject to a notification obligation.

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2024 holds the potential to reverse two years of deal-volume declines, especially if interest rate cuts and the much-hoped-for soft landing materialize. But, as the last several years have shown, the only market feature that is predictable is surprise, particularly in an election year. As in the past, we expect that sponsors will continue to find innovative wedges to new dealmaking and adapt as market conditions inevitably change.

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