Allens › ‹ Linklaters

PE Horizons 2020

Record levels of capital and a turning market

This year brings opportunities and challenges for private equity in Australia. High levels of committed capital and a drive to raise more among a growing group of sponsors in the market will see competition intensify. Opportunities will present themselves as new technologies create constant disruption. Of course, there are some headwinds, as the global geopolitical landscape changes, and crises such as novel coronovirus impact global trade, supply chains and broader prosperity.

LOOKING BACK: SNAPSHOT OF RECENT ACTIVITY IN AUSTRALIA

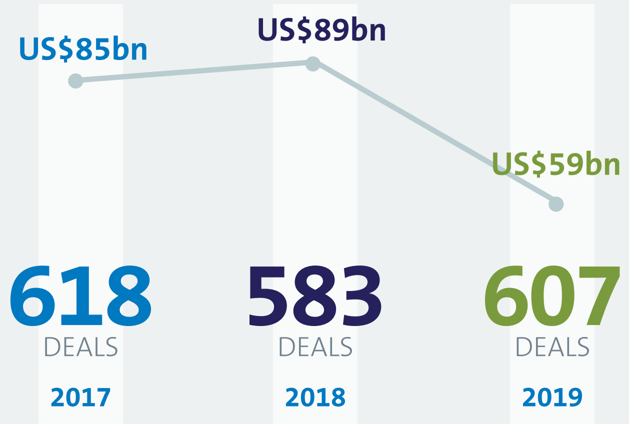
M&A deal volume and value in 2019

Deal volume was **up** on 2018

Deal value was **down** on 2018

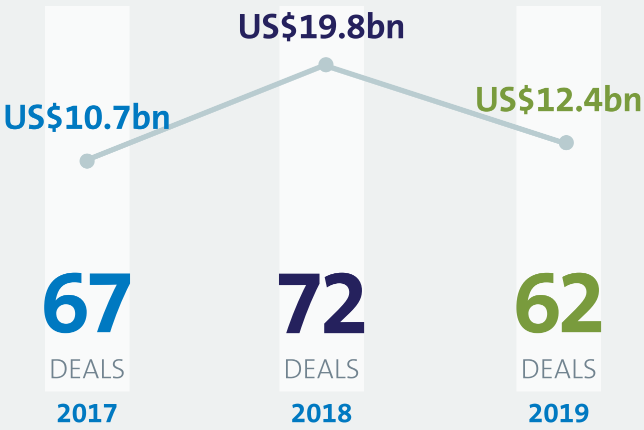
Domestic M&A deal value **plunged by almost 58%** in 2019, to the lowest it has been in 7 years

Offshore Australian outbound activity jumped 61% in 2019, with inbound activity remaining relatively stable, dropping only 2.3%



INVESTMENT

Annual private equity buyout activity and value



DIVESTMENT

Annual private equity exit activity

32 DEALS 2017	**35** DEALS 2018	**25** DEALS 2019

Source: MergerMarket

LOOKING FORWARD

We expect the private equity industry to have a busier 2020, in contrast to activity levels in 2019, which experienced a drop in completed deals. In the last year, dealmakers responded to elevated valuations by maintaining a disciplined attitude towards pursuing investment opportunities. Despite favourable conditions for increasing buyside activity – including domestic and global funds raising record amounts, low interest rates, and an increased appetite from superannuation funds and other private capital sources to directly participate in private equity opportunities – we saw fewer deals above $200 million complete in the past 12 months, compared with the previous year.

The big question for 2020 is: how much longer can private equity sponsors remain cautious?

In our view, competition for high-quality assets is unlikely to erode, as domestic sponsors compete with pan-Asian and global sponsors who continue to see the advantages of increased capital deployment rates in a relatively stable Australia. Private equity sponsors should be able to find considerable secondary opportunities, with a number of sponsors still holding on to assets for well over the usual period. Of course, with recent global crises such as novel coronavirus, there may be reason for pause in sectors such as tourism and education, and others where global supply chain reliability is significant. Despite these headwinds, we expect both buyside and exit activity levels to pick up in 2020.

WHO NEEDS TO KNOW ABOUT THIS?

- Private equity sponsors
- Advisors in the private equity market
- Other private capital funds

Key trends in 2020

The private equity team at Allens reports on key trends and sectors to watch.

CARVE-OUT OPPORTUNITIES WILL REMAIN RIPE FOR PRIVATE EQUITY BIDDERS

Private equity bidders continue to have a competitive advantage over corporates and other bidders in carve-out transactions, due to their agility and experience grappling with complex separation issues. Amid strong competition generated by record levels of dry powder are private equity bidders who are increasingly turning to corporate carve-outs to generate returns. In 2019 we saw KKR acquire certain international assets from Campbell Soup Company (including iconic Australian biscuit brand Arnott's) and PEP acquire Horizon Global's Asia Pacific business. These significant transactions follow the sale of Brambles' IFCO reusable plastic containers business for US$2.51 billion, in early 2019, to a private equity-led consortium.

We expect more carve-out deals in 2020, as increased regulatory scrutiny in Australia drives large corporates to simplify their businesses to ease the regulatory burden. Offshore, we are also seeing similar trends, as organisations look to sell off non-core assets and realise value for shareholders, often driven by shareholder pressure.

The significant disentanglement challenges carve-outs raise will continue to give private equity buyers – who are experienced in grappling with these issues – a strong advantage. The days of a 'clean break' on completion between the seller and target business will be tempered, as parties must contend with how to split out or allocate shared supplier and customer arrangements, shared employees, facilities and business functions, joint R&D, combined permits and licences, and shared IP. In particular, the growing complexity of IT systems (and businesses' reliance on them) mean that an orderly IT separation may be critical to the success or failure of a deal. Similarly, as data becomes increasingly central to buyers' acquisition strategies, clearly defined agreements are necessary to govern each party's rights to access and use valuable datasets post-acquisition.

Seasoned private equity buyers who are experienced in handling these challenges and flexible in their approach may be able to outpace competition on carve-out deals.

TRANSFORMATIONAL BOLT-ONS ACCELERATE GROWTH AND NEW MARKETS

Bolt-on acquisitions are a staple strategy following any private equity buyout. Often, potential bolt-ons fit into a broader growth strategy and are pursued opportunistically. Occasionally, however, bolt-ons are fundamental to the investment thesis, such as in a buy-and-build strategy where numerous bolt-ons are pipelined. In almost all cases, the bolt-on involves the acquisition of a smaller player. More recently, however, we are seeing more private equity portfolio companies executing transformational or significant bolt-on acquisitions. These are implemented by the portfolio company but are sponsor led, and typically require additional acquisition financing. Recent examples are KKR-sponsored GenesisCare's acquisition of 21st Century Oncology, which would, reportedly, almost double the earnings of GenesisCare and significantly extend its footprint in the U.S., and KKR-sponsored Australian Venue Co's Queensland hotels joint venture with Coles Group, which saw Australian Venue Co double the number of its venues.

Interestingly, bolt-ons are somewhat akin to these portfolio companies behaving like strategic/corporate buyers. We may soon see portfolio companies pursuing take-privates and seeking to swallow targets larger than themselves. Indeed, sponsors occasionally target a smaller player in the market as a proposed stepping stone for that smaller player to pursue a larger rival. Transformational bolt-ons accelerate growth and access new markets, but they

Key trends in 2020

are not without material risk, particularly around integration. Generally, they need to be implemented reasonably well in advance of an exit, to allow the enlarged portfolio company to demonstrate an uplift in combined performance prior to exit. Our sense, however, is that with the significant amount of available capital at private equity sponsors' disposal, we're likely to continue to see sponsors be bold and pursue more transformational bolt-on opportunities. In our view, an assessment of anti-trust issues in the early stages of such strategies will be increasingly important to better understand execution risk.

DATA OPPORTUNITIES AND RISKS ARE ON THE RISE

Over the past 18 months, we have seen data become increasingly important in private equity transactions, and M&A deals more broadly. We expect this trend to continue in the private equity space throughout 2020. The demand for data services businesses remains strong, as does interest in the data-rich assets of businesses not traditionally seen as technology or data businesses (particularly in the healthcare sector). As a result, complex negotiations around data sharing and commercialisation (eg rights to cross-market products and services to shared customer lists) are becoming more commonplace, often going directly to deal value.

In addition, the exponential growth in data consumption has led to an upsurge in 'core-plus' asset deals that offer stable, long-term returns. Heightened investor interest in 'infrastructure-like' opportunities has resulted in an increased demand for connectivity infrastructure (such as high-bandwidth, interactive and online services), cellular towers, smart metering, data centres and other innovative data storage services.

However, we have also seen examples of data-related liabilities significantly eroding value, such as buyers failing to identify or factor in the costs of historic data breaches or cybersecurity vulnerabilities, penalties arising from data-related competition law breaches, and costs associated with the imposition of restrictions by FIRB on data access by foreign investors.

Going forward, we expect data opportunities and risks will continue to impact the headline price, risk-allocation profile and the value ultimately realised from private equity transactions in all sectors. Private equity deal participants who can recognise and properly value data assets – and identify any contingent data liabilities – will be best placed to take advantage of these opportunities.

TERM LOAN B CONTINUES TO EXCEL IN THE MARKET

Private equity-driven leveraged buyouts were robustly supported by local debt markets flushed with liquidity in 2019. Publications* suggest that the combined market volume of private equity-backed leveraged buyout loans for Australian (and New Zealand) assets raised towards the end of 2019 by way of unitranche or Term Loan B (TLB) debt structures exceeded those by traditional commercial bank loan.

We expect this growth in the overall debt market to continue in 2020, particularly in the private equity buyside, and the cycle into capital deployment. Sponsors will also continue to lock in debt capital at the low interest rates available. Unitranche or TLB debt structures remain prominent, as sponsors, supported by arrangers, seek innovative and flexible positions on leverage multiples, financial covenant 'lite' or 'loose' profiles and restrictive covenant terms. The market share of traditional commercial bank loans will remain stable and continue to co-exist, offering competitive pricing relative to unitranche or TLB debt structures, and meeting capital expenditure or working capital funding needs.

* Source: Debtwire

Key trends in 2020

PRIVATE EQUITY IPO MARKET – CHALLENGES FOR PRIVATE EQUITY-BACKED LISTINGS

Consistent with previous years, the 2019 calendar year saw few successful private equity-backed IPOs. Indeed, the depressed levels of activity were not limited to private equity-backed assets: the number of IPOs and dollars raised was significantly down, making it one of the worst years for IPO activity in the past decade.

Although 2019 started promisingly with the potential IPO of Latitude, its ultimate withdrawal resulted in considerable commentary about addressing the perceived misalignment between sponsors and investors. Indeed, Latitude ultimately joined a number of other pulled IPOs, including PropertyGuru, Retail Zoo and Onsite Rental Group.

Despite this, we think there will be opportunities in 2020 for sponsors to successfully exit quality businesses via an IPO at the right price. For example, the success of Propsa's IPO, despite its private equity backing, proved that public market investors may be prepared to support an IPO at the right price. Given the significant negative media coverage surrounding financial sector assets following the Banking Royal Commission, our expectation is that the private equity shareholders of Latitude may look to retest the market's appetite when things settle.

NEW FEES AND COSTS DISCLOSURE REGIME TO IMPACT PRIVATE EQUITY

For those that have followed ASIC's efforts to update the fees and costs disclosure regime that applies to issuers of Australian superannuation and collective investment products to retail clients (***Product Issuers***), the regulator has released a number of changes to RG97. In many cases, these changes will have important flow-on consequences for private equity funds and underlying portfolio companies in which Product Issuers invest. The new regime will apply from 30 September 2020 for product disclosure statements. For other disclosure documents (periodic and exit statements), the changes will apply for reporting periods commencing on or after 1 July 2021 (with an ability to opt in early). Here's how the proposed regime impacts private equity:

- in some cases, **Product Issuers** will need to **collect and disclose different fee and cost** information in relation to private equity funds and portfolio companies;
- the changes may impact which **types of investment or investment structures look relatively more expensive** in Product Issuers' fees and costs disclosure (noting the focus on fees and costs in a vacuum, rather than a more holistic focus on net returns). This may affect the most desirable investment and cost structures for private equity funds and assets looking to attract Product Issuers as investors; and
- the new regime requires **enhanced disclosure of performance-based fees**. This will be on a 'look through' basis for any private equity entity that is an 'interposed vehicle' of a Product Issuer (which depends on a complex 'interposed vehicle test'). In particular, Product Issuers will need to make itemised disclosure of the performance-based fees for each private equity entity that is an 'interposed vehicle', generally based on an average over the previous five years. This is significant, as it potentially requires the disclosure of commercially sensitive information.

It remains possible to make submissions to ASIC. However, having already sought expert recommendations and industry consultation, ASIC will be reluctant to make many further changes at this stage of the process. In the new regime's current form, we expect Product Issuers to be even more focussed on fees, including information and disclosure rights, in side letter negotiations. On the plus side (or not, depending on perspective), there will, at least, now be increased certainty.

Key trends in 2020

THE ONGOING EFFECTS OF NOVEL CORONAVIRUS

The impact of and global response to novel coronavirus (or COVID-19) has been startling. As the virus spreads outside of Asia and around the world, we expect the crisis to be a further headwind into the already complex macroeconomic environment. Global supply chains will be affected and there will be an impact on trade. While, at the time of publication, the spread of the virus in Australia has been slow, we are already seeing the effect on the tourism and education sectors. There will be impacts on those businesses reliant on components and materials from China and elsewhere, as well as those Australian businesses trading globally. It is an area to watch and an x-factor for 2020.

GLOBAL PERSPECTIVE FOR 2020

Large amount of unspent capital, which will drive a healthy deal flow

Pursuit of a diverse range of asset classes, investment models and execution strategies

Mega deals, private transactions and demand for LP co-investment will feature

Private equity-backed corporate carve-outs will continue

Fundraising activity remains strong

Global macroeconomics and coronavirus will cause uncertainty

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GLOBAL PERSPECTIVE

Here are the trends that Linklaters' leading financial sponsor team expect to play out in 2020.

While buyout activity in 2019 didn't quite hit the historic value or volume highs of 2018 (and slowed in the back half, particularly in the US), private equity houses have amassed a record war chest of unspent capital, which we expect will continue to drive a healthy deal flow this year.

Under pressure from LPs to deploy this dry powder, sponsors look set to continue to pursue an increasingly diverse range of asset classes, investment models and execution strategies. With persistently cheap debt on offer, equity market volatility and unrelenting competition for private opportunities, look for mega (and consortium) deals, take-private transactions and demand for LP co-investments to continue to be a feature this year.

Last year saw a significant number of private equity-backed corporate carve-outs and similar opportunities are set to remain on the agenda, as corporates look to spin off non-core business units to free up cash and pay down debt. A sellers' market for exits (save for IPOs) should also continue in the short term, with an urgency among GPs to take advantage of current prices and competitive markets and run the ruler over asset classes most vulnerable to a downturn.

Fundraising activity should remain strong (and the big GPs / mega funds dominant); however, it will be hard pressed meeting the recent peaks, while longer-hold funds (and, in turn, asset classes) are likely to continue their rise in popularity.

Conversely, macroeconomic uncertainty and geopolitical headwinds appear set to continue in 2020, with suggestions the top of the economic cycle may be in sight, and the US election, Brexit transition and ongoing global trade wars, among other issues, all cause for some caution.

OUR KEY PRIVATE EQUITY DEALS IN 2019

KKR – advised Arnott's, and certain other Campbell international operations, on its acquisition for US$2.2 billion. Also advised on subsequent sale and leaseback of Arnott's Australian manufacturing facilities to Charter Hall and Centuria Property Funds.

Cerberus – advised on its acquisition of the Axsesstoday specialist SME lending business.

Pacific Equity Partners – advised on the A$340 million acquisition of towing and trailering products of Horizon Global Corporation's Asia Pacific business.

Advent International – advised on the acquisition of a majority stake in Transaction Services Group. Also advised on the bolt-on acquisition of MyXplor.

QIC Private Capital – advised on its acquisition of Pacific Energy and also on its acquisition of Sea Swift.

KKR and **Australian Venue Co** – advised on the establishment of its Queensland hotels joint venture with Coles Group.

Goldman Sachs Special Situations Group – advised on the sale of its 40% interest in Evolution Healthcare Group to Pacific Equity Partners for US$212million.

Brookfield – advising its private equity business on the acquisition of IndoStar Capital Finance.

Quadrant backed APM – advised on its acquisition of ASX-listed Konekt by way of a scheme of listed arrangement.

Advent International – advised on Australian aspects of its acquisition of Cobham Plc by way of a scheme of arrangement.

Bain Capital – advised on the Australian aspects of the sale of its interest in Kantar, a global data, research, consulting and analytics business.

Pacific Equity Partners – advised on the Patties group reorganisation and re-financing.

Advised a broad range of Australian institutional investors on their commitments to, and co-investments alongside, Australian and offshore PE funds. We have also advised on a number of secondary PE portfolio sales.

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