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PE Horizons 2020

2020 market update: cautious optimism

No one could have predicted the first half of 2020 and it is a brave person who tries to predict the second half. We are in the midst of a global pandemic the likes of which we've not seen in over a century. Economies have slowed and large populations have been placed under strict social distancing measures. The challenges these circumstances present for dealmakers are profound. As COVID-19 moved across the world, PE managers pivoted away from doing deals to focus their attention on existing portfolio companies, drawing on debt facilities, preserving liquidity and exploring eligibility for government subsidies. Many deals in Q1 were abandoned, stalled or petered out.

Of course, those PE dealmakers around during the global financial crisis will recall that investments made during that time produced some of the best investment returns, and 'fund vintages' in that period are still spoken of as extraordinary. PE managers are now scouring the market for complex opportunities to drive returns. Complex carve outs of non-core businesses will continue to pique the interest of dealmakers. Some assets will be value buys and others will prove defensive in a time of risk. Despite the ongoing uncertainty, and there have not been times as uncertain as these in recent memory, we believe PE managers are well positioned to adapt and respond to the disruption and opportunities that present themselves during this pandemic. Deals have been inked during COVID and there will be more to come.

How the industry has fared during COVID-19

ACTIVITY STALLED BUT SIGNS OF OPTIMISM AHEAD

As the global impact of the COVID-19 crisis became apparent, Australia was – by June – experiencing its first recession in almost 30 years. This saw PE buyers abandoning some processes, trying to renegotiate deals or, on the odd occasion, calling a MAC or relying on termination rights.

However, despite the impact of the pandemic on PE activity, there are signs of optimism with many PE managers being prepared to invest significant amounts of capital in a highly uncertain economic environment. Major deals of the past six months include KKR's $1.7 billion investment into wealth management company Colonial First State in May, and Chicago-based Madison Dearborn's purchase of a controlling stake in disability and employment service provider APM from Quadrant Private Equity, valuing the business at approximately $1.6 billion. Mercury Capital's acquisition of a reported 10% stake in Silverlake's TEG and the proposed sale of Healius Limited's medical and dental centres also kept dealmakers busy.

FLIGHT TO CAPITAL

The downturn triggered by the pandemic required sponsors to seek immediate liquidity support and solve for default risk issues under their portfolio companies' existing financing arrangements. Debt markets experienced a flight to capital, with portfolio companies bolstering cash reserves by utilising undrawn committed funding lines in full (if drawdown conditions permitted) as part of sponsors' rigorous approach to liquidity preservation.

Other measures to support liquidity in the debt markets included amortisation relief, interest capitalisation or an increase in committed funding lines. Loans placed in the Australian leveraged finance market (unlike covenant-lite financings distributed to institutional investors in the US and European markets) predominantly include maintenance financial covenants tested on a periodic basis. As trading slowed or ceased, short- to medium-term financial covenant relief was often the catalyst for debt restructurings.

Sponsors and creditors worked collaboratively on these debt restructurings and waivers (which often also addressed anticipated default risk) with many, if not all, now successfully implemented. However, longer-term restructurings or refinancings with permanent financial covenant resets may feature in the market for those portfolio companies operating in sectors experiencing a prolonged or permanent trading downturn.

FUNDRAISING HELD UP, THOUGH LP APPETITE IMPACTED

Fundraising numbers during the first half of 2020 have held up (in particular, fundraising by the global megafunds) and we are starting to see renewed PE investment activity from LPs, with a number of global PE sponsors seeking to launch new funds.

However, the impact of the pandemic on fundraisings may not be felt until later this calendar year. LP appetite to commit further to PE is likely to be affected by the impact of the pandemic on cashflows, which may be compounded by reduced distributions and increased capital calls from existing PE fund investments. Given strict portfolio weighting requirements, the fundraising environment is likely to be impacted by any 'denominator effect' (the decline in the value of equities outpacing any decline in alternative assets, resulting in an overweight allocation to alternative assets). Australian superannuation LPs have taken the added hit of members accessing the early release of superannuation payments, impacting the amounts those funds would otherwise have committed to new PE fundraisings. That said, superannuation LPs have not been distressed sellers of alternative assets in the secondary market, which is a testament to the prudential strength of the sector.

The secondary market may also be viewed as a bellwether of sentiment for future PE fundraising activity. Latest international reports indicate that secondary fund raisings for the first half of 2020 were a record high. Additionally, market data indicates that there has not been a flood of distressed institutional sellers (with distressed sellers being limited to some family office or endowment fund LPs). As we report here, the combination of secondaries dry powder seeking out opportunities in the second half of 2020 and the upcoming release of Q2 NAV valuations will create a dynamic environment for active portfolio management by LPs. The secondary market presents LPs with the opportunity to recycle capital into new PE funds launched over the next 6 - 12 months, which may prove to be one of the most attractive vintages being launched in over a decade.

OUR KEY PRIVATE EQUITY DEALS IN 2020

- **Village Roadshow Corporation** – in relation to its role as major shareholder with respect to the take private proposal from BGH to acquire Village Roadshow Limited.
- **TA Associates** – on its acquisition of Honan Insurance Group.
- **Madison Dearborn Partners** – on its acquisition of a controlling stake in APM from Quadrant Private Equity.
- **Pacific Equity Partners** – on the successful acquisition of Horizon Global Corporation's Asia Pacific business, for approximately $340 million.
- **Pacific Equity Partners** – on the successful acquisition of energy network provider WINConnect.
- **Advent International** – in relation to its bolt-on of MyXplor following the acquisition of Transaction Services Group.
- **PRP Diagnostic Imaging** – advising the doctor shareholder group of PRP on the sale of that business to Crescent Capital.
- **Challenger Limited** – on the initial acquisition financing of CPE Capital's (previously Champ Private Equity) $120 million purchase of Marand, and the bolt-on financing for the acquisition of Levett Engineering.
- **Pacific Equity Partners** – on the establishment and ongoing operation of, and investments by, the Secure Assets Fund; and on the establishment and ongoing operation of, and investments by, PEP Fund VI.
- **Potentum Partners** – on the establishment of its first fund.
- **Various Australian institutional investors** – on investments into Australian and offshore private equity funds.

So what's ahead in the next 12 months?

In February 2020, Australia's private equity market was perceived as one of the most competitive in the world, characterised by record amounts of committed capital, easily accessible debt financing and a large number of local and global private equity firms actively pursuing opportunities in Australia. Now there is an air of caution, with sponsors assessing the continuously evolving health, regulatory and consumer environment and what that means for M&A opportunities.

Despite the short-term challenges, many domestic funds have recently raised large funds and the major global sponsors continue to see Australia as an attractive market. As the health issue abates and the investment landscape evolves, there are likely to be some 'winners and losers' with many PE managers revaluating old business models and investment cases, recognising that investment cases will need to respond to a post COVID-19 environment.

We are seeing profound shifts in consumer behaviour and market dislocations, which may create opportunities in sectors including hospitality, telecommunications, tourism and technology (to name a few). Pricing dislocations are already presenting opportunities (eg Australian theme park and cinema operator Village Roadshow entering into a recommended scheme of arrangement with BGH Capital notwithstanding a significant price revision following COVID). The Village transaction was highly structured and we expect to see similar trends develop as PE bidders attempt to bridge the price gap with vendors and boards, particularly in relation to businesses which have been more impacted by COVID restrictions.

The fallout from the Financial Services Royal Commission continues to generate opportunities for PE managers as the 'big four' banks continue to sell off capital intensive and/or non-performing assets. PE managers who are willing to put capital at risk in this uncertain environment may be rewarded when the market and broader economy recovers.

A RECOVERING DEBT MARKET

The institutional capital available for funding loans in the Australian leveraged finance market snapped shut during the early stages of the pandemic. Of the few M&A processes which continued, there were rare examples of sponsors electing to equity fund in full to close, but limited to sectors where credit run-rate metrics remained intact, allowing sponsors to take a view on the level of execution risk for a debt recapitalisation in a post-COVID-19 market.

While a positive path to recovery for the Australian leveraged finance market has emerged, it is at a slower speed than in the US or European markets. Successful debt financing outcomes were achieved for Madison Dearborn Partner's acquisition of Advanced Personnel Management, and BGH Capital's proposed acquisition of the medical and dental centres business from Healius Limited. The former of these is at the forefront of innovation in the Australian leveraged finance market – structured on a A$ first lien / A$ second lien covenant-lite basis and distributed to institutional investors in the Asia Pacific market.

A higher pricing premium (to compensate for the increase in distribution risk) may dislocate underwritten loans from the immediate market. Instead, sponsors may look to fund event-driven financings on a club basis through commercial banks or directly from institutional investors until depth in the Australian leverage market returns.

DATA AND DIGITAL TRANSFORMATION AS THE WAY FORWARD

The technology sector has managed to perform strongly relative to the rest of the economy, and is set to provide a range of opportunities for PE activity. While global M&A deal values declined by 36% in Q1 2020 (compared to Q1 2019), global tech-sector M&A activity increased by 2.85%.[1] Recent local tech-sector activity has included the proposed sale of leading Australian digital strategy and data analytics company, Lens10, to S4 Capital Group, and CBA's investment into, and strategic tie up with, leading Australian venture capital firm Square Peg Capital.

This continued investor confidence has, at least in part, been driven by increasing demand for technology services and products as a result of the pandemic (eg remote working technologies, food delivery systems and media streaming services). There has also been significant growth in demand for onshore data centres and cloud infrastructure – at least in part driven by regulatory requirements.

Further, the rapid pace at which some businesses have adapted to the new climate has generated confidence that ambitious digital transformation projects are achievable with sufficient business buy-in. Businesses are therefore investing in transformation efforts to enable better digital delivery of services, and are looking for new sources of data-driven revenue streams. This is likely to create opportunities for PE investments in the technology space.

GLOBAL PERSPECTIVE FOR 2020

The international PE market is seeing sponsors focus on triaging portfolio companies in sectors most exposed (hospitality, retail and tourism, among others) – stabilising operations, managing financial and liquidity (and ESG) risk and preparing for recovery and (re)focused growth. Deal volumes have dropped off sharply and a significant number of transactions signed pre-March have either been renegotiated or abandoned altogether, with legal implications of the latter likely to rumble on for some time.

Buyouts (and exits) have largely stalled due to reluctant sellers, internally focused GPs and uncertain debt markets. Sectors like healthcare, technology and infrastructure (excluding transport) have been more resilient than most, and some sponsors have been markedly more active than others, with many reflecting on the missed opportunities of the global financial crisis. There continues to be record global levels of dry powder that still need to be deployed and there is no shortage of acquisition targets (both public and private) for GPs of distressed, special situation and longer-hold funds to look at, with sponsor credit arms also well placed. Fundraising continues to be strong.

We are beginning to see many transactions dusted off that were parked during market uncertainty. Notwithstanding troublesome second waves of COVID-19, we expect activity to get busier into what we hope will be a robust Q4 and buoyant 2021.

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[1] Mergermarket, Global and Regional M&A Report 1Q20 - https://www.mergermarket.com/info/global-and-regional-ma-report-1q20.

Regulatory watchlist

MAJOR PROPOSED CHANGES TO FIRB REGIME FROM 1 JANUARY 2021

Proposed changes to Australia's foreign investment review (***FIRB***) regime (intended to take effect from 1 January 2021) should be a net benefit for private equity investors. Whilst the proposed changes will impose a permanent $0 threshold for all foreign investments in sensitive national security businesses (and the current temporary $0 threshold for all other foreign investments will revert to the previous thresholds), where foreign government investors hold greater than 40% ownership in aggregate and meet the relevant criteria (less than 20% ownership from any single foreign government, no management rights, no influence or control over the investment or operational decisions), such PE investors will no longer be deemed foreign government investors. PE fund entities which have a single foreign government with 20% or more ownership (without influence or control) will still be deemed foreign government investors, however they will be able to apply for a broad exemption certificate on a case-by-case basis. These are welcome changes for private equity funds that would otherwise be subject to $0 thresholds for certain types of investments.

ATO FOCUS ON TAX PROFILE OF FOREIGN INVESTMENT INTO AUSTRALIA

Overall, we are continuing to see a strong focus by the ATO on the tax profile of foreign investment into Australia.

Australia recently introduced a suite of measures designed to neutralise the effects of financing instruments that produce a 'hybrid mismatch' (eg that produce a tax deduction for the payor in one jurisdiction but non-taxable income for the payee in another, or a tax deduction for both the payor and payee in different jurisdictions). Further, in May 2020, the ATO published a Taxpayer Alert in which the Commissioner notes the potential application of the tax general anti-avoidance rules to these types of arrangements, and also potential referrals to FIRB where the instrument is taken to subvert the obligations that would otherwise be imposed on the foreign resident if the investment had instead been structured as an ordinary equity investment.

INCREASED ACCC ENFORCEMENT

The ACCC has indicated a marked increase in enforcement action and scrutiny around transactions on the horizon. PE investors, particularly when looking at bolt-ons, should consider enhanced competition and consumer law due diligence of targets to understand any possible exposure and not expect 'a different, or lenient approach to merger assessments during this crisis.' Minority investments do not escape the ACCC's scrutiny, as demonstrated by its investigation of Qantas' 19.9% investment in Alliance Aviation. Access to data is also subject to increasing ACCC analysis, evident in the Facebook/Giphy and Google/Fitbit acquisitions. Finally, the ACCC's campaign for merger reform is about to be made (more) public, against the background of its High Court appeal in Pacific National/Aurizon.

EMPLOYMENT REFORM

The pandemic has brought into sharp focus the need and opportunity for reform of the Australian employment law framework. In March the Government introduced urgent, temporary changes to the highly bureaucratic process of negotiating and approving variations to collective bargaining agreements, and the Fair Work Commission made temporary COVID-induced changes to industrial awards to 'provide greater flexibility'.

There is mounting pressure to see this flexibility become more permanent, with the Government commencing a process of consultation on systemic changes. We expect pay-rate complexity and management of underpayments will be significant topics of discussion. Liabilities for such underpayments remain a key issue in business acquisitions and are often difficult to assess during due diligence, although vendors are increasingly willing to agree to indemnities and other purchaser protections to address these risks.

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