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PE Horizons 2023

An optimistic view of the year ahead

2022 was a challenging year for Private Equity (*PE*) dealmakers. It was a year of two-halves, where the optimism and favourable investment conditions that characterised the back-end of 2021 quickly gave way to market turmoil, geopolitical instability and economic conditions that few could have foreseen only a few months earlier.

Although we expect 2023 to remain choppy, particularly in the first half of the calendar year, the near-term uncertainty is likely to present considerable investment opportunities.

Our expectation is that PE investors will see through the short-term volatility by targeting high-quality assets that can capitalise on domestic and international trends. Businesses that can deliver on long-term investment objectives by benefiting from the transition to a low-carbon economy, widespread technology adoption and demographic shifts will be in high demand in 2023.

Despite some obvious headwinds, we are optimistic about activity levels for the year ahead.

Key themes

The key themes we expect to see in 2023:

1 Increased use of takeover bids as a means to acquiring ASX-listed targets. In the circumstances where there is a valuation opportunity, no due diligence will need to be undertaken and PE bidders may be prepared to go 'hostile'.

2 The use of continuation funds will grow in prevalence, particularly if the IPO market remains closed and exit conditions remain challenging.

3 Mega-deals will return as confidence returns to the leveraged loans market.

4 The ATO's clampdown on equity rollover CGT relief means that PE sponsors will pay increased attention to the structuring and documentation of rollover terms.

5 At a portfolio company level, PE sponsors are currently focused on supply chain issues, leveraging technological advancements and ESG considerations. However, we expect cybersecurity to become the number one portfolio company risk.

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M&A: expect a more aggressive approach

It's said that PE sponsors only wish to pursue takeovers that are friendly and agreed with target boards. That might be generally true, but where target boards don't wish to engage or might need some encouragement to do so, some PE sponsors see no choice but to take matters into their own hands. We have already seen this play out to some extent in recent times (particularly in listed technology companies) but with bid-ask spreads on price widening (including the rising cost of capital, further dislocating valuation expectations between bidders and target boards), we're expecting 2023 to see more PE sponsors play that little more aggressively to win over listed targets.

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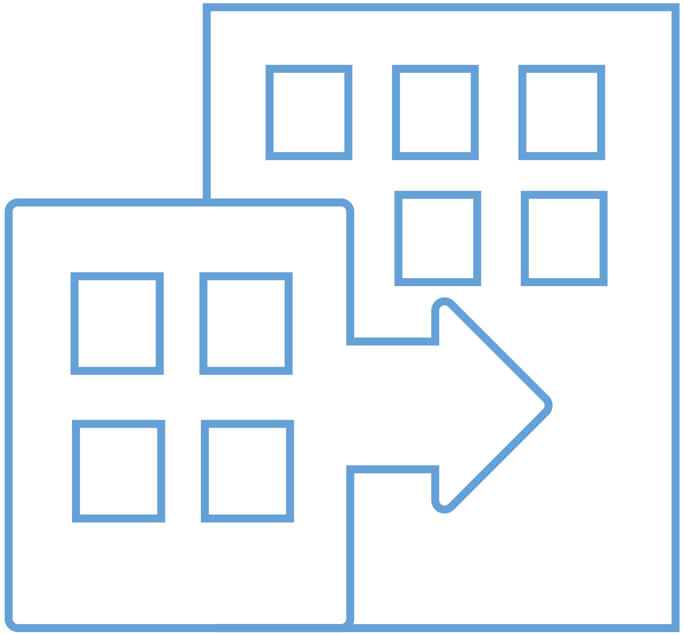
In the more traditional sense, we expect to see more PE sponsors entering into pre-bid acceptance or call option agreements with major target shareholders, and rallying the broader target shareholder base to privately or publicly pressure target boards to facilitate a deal. We anticipate more pre-bid stake building by PE sponsors, both directly and via derivative instruments—thanks also to the recent proliferation of the different types of structured derivatives available to bidders. We further expect to see more legal challenges by PE sponsors in the Takeovers Panel and at first or second court hearings in schemes. Their objective remains ultimately to twist the target board's arm to permit due diligence and secure a recommended deal, but where that looks at real risk, we expect that PE sponsors will increasingly not shy away and take these extra steps to demonstrate their high conviction.



Continuation funds: growth to continue

There has been significant recent growth in the PE secondaries market—a global phenomenon which is becoming a major trend in Asia Pacific in general and Australia in particular.

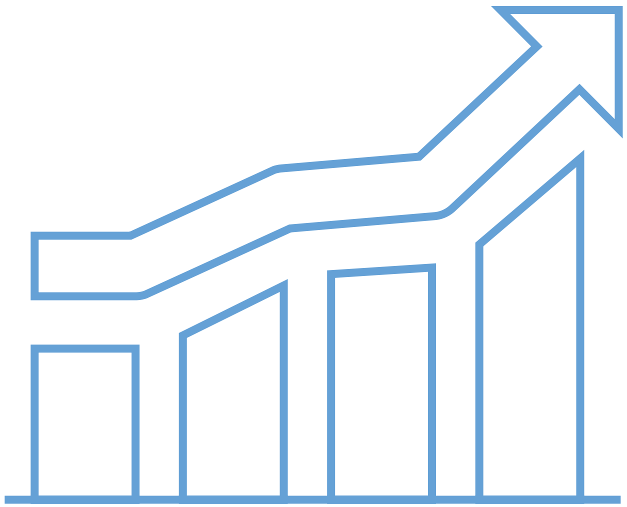
In addition to LP-led secondary transactions (being investor-initiated sales of interests, which slowed in the second half of 2022 but which we expect to rebound as investors gain a clearer picture on PE portfolio valuations), continuation funds (or GP-led secondaries)—vehicles established by a sponsor to acquire one or more assets from an existing vehicle operated by the same sponsor—have traditionally been used to facilitate the disposal of problematic or distressed assets. However, there has been a proliferation in their use as a means to achieving two key benefits:

1. providing liquidity to investors in the existing fund; and
2. allowing managers (and investors in the continuation fund, including existing investors electing to roll their interest rather than cashing out) to retain high-performing assets beyond the fixed-term life of a fund and benefit from continued upside.

A recent high-profile example, on which Allens advised, is Pacific Equity Partners' $1.5 billion Smart Metering Fund, which in 2022 acquired a 50% stake in Intellihub (a business originally acquired in 2018 and which took out the Australian Investment Council's Large Cap Investment Award in 2022 for that initial investment and the sale of the other 50% to Brookfield).

Given the inherent conflict involved in this type of GP-led restructure (with the sponsor being both the seller and the buyer), there are a number of key commercial (and legal) considerations required to be addressed. It is common for fund documents to provide for investor advisory committee or, less commonly, general investor approval for conflict transactions, which acts as a means of addressing this inherent conflict and affording comfort to investors in the selling fund. When considering whether to grant any approval (and deciding whether to roll over into the continuation fund), the key focus is typically valuation to ensure fairness for investors on both sides of the transaction and because the sale will typically crystallise a right to carried interest for the sponsor in respect of the selling fund. In this regard, investors expect an independent expert valuation to be obtained (with bonus points where that valuation is supported by indicative third-party bids or a parallel sale process).

Provided these considerations can be addressed, we see continued growth in the use of continuation funds as managers seek to provide liquidity for their investors.



Debt finance solutions: investor confidence set to return

One of the factors that challenged PE dealmakers in 2022 was the significant contracting in the Australian leveraged loan market. Inflationary and geopolitical headwinds led to successive interest rate rises which dislocated the favourable pricing and borrowing conditions in the market at the commencement of 2022. The higher borrowing costs and downward spiral in trading prices of syndicated leveraged loans led to a drop in Australian M&A loan activity in 2022, particularly in the latter half for widely syndicated 'term loan b' issuances. This volatility experienced in the local market was not as drastic as that in the US and Europe 'term loan b' capital market, with new issuances in these offshore markets—which hold deep pools of capital—chilling during 2022. The inaccessibility to these offshore markets presented PE sponsors with a significant hurdle in executing large cap public-to-private transactions.

This dislocation presented great opportunities for private capital/direct lenders and commercial banks in 2022 who, supported by a rise in Australian super funds allocation to this asset class, filled the funding void. Key transactions included IFM Investors' acquisition of PRP Diagnostics and HRL Morrison, Brookfield and Commonwealth Superannuation's acquisition of Uniti Group. We foresee these sources continuing to dominate market share of event-driven financing activity in the Australian leveraged loan market in 2023 given the greater certainty on terms and pricing relative to the 'term loan b' market.

> **Lenders will continue to be selective on credit opportunities, with quality credits in inflationary resilient sectors—such as healthcare and infrastructure—warranting substantial interest from PE sponsors and debt providers alike.**

Credit assessments will continue to stress-test leverage levels, though these have and will continue to be moderate as the focus on debt-servicing capacity intensifies given the higher funding costs. While we do anticipate lower levels of refinancing activity due to these higher funding costs, this will be offset in a higher volume of middle-market financing activities which private capital/direct lenders and commercial banks—willing to lend at smaller ticket sizes—will support.

The key to progressive return in depth of the local TLB market will be flattening of the interest rate and inflationary upward curves to remove volatility and restore investor confidence. We are optimistic that this confidence will grow over the course of 2023 with volumes of A$ and US$ 'term loan B' issuances by PE-backed borrowers likely to rebound and grab market share of Australian event-driven financing activity towards the latter half of 2023.

We are also increasingly seeing 'equity' solutions to M&A funding issues. These take many forms, the most straightforward of which is non-contingent deferred consideration paid either at a specified time after completion or in tranches over several years. Earn-outs and other contingent payments are also much more common now than a year or two ago, and we've also seen more novel structures being explored such as buyer promissory notes and vendor loan notes. All of these structures are designed to reduce the amount of upfront consideration and, therefore, the amount of debt financing required to fund acquisitions.

Increased ATO scrutiny on rollover relief

The availability of scrip-for-scrip rollover relief can be a critical issue for any deal where vendors receive equity consideration. Where available, scrip-for-scrip rollover relief defers any capital gain or loss that a vendor shareholder might otherwise make on the sale of their shares.

There is significantly more flexibility under the CGT rollover rules for scrip offered under takeover bids/ schemes compared with private treaty deals. This is because there are additional requirements that have to be satisfied for private deals – including that participation in the deal by vendor shareholders was available on 'substantially the same terms'.

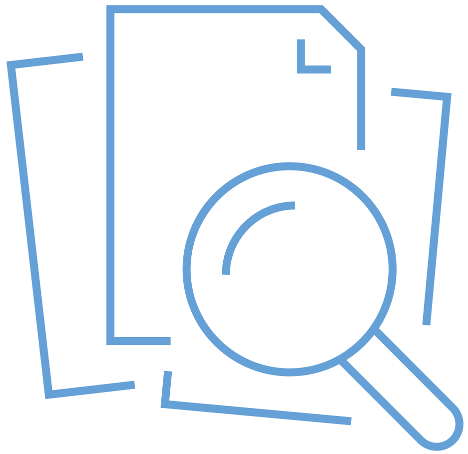
To date, participation on 'substantially the same terms' has generally been understood to mean that the buyer in a private deal needs to provide every vendor shareholder with the same range of options in relation to the consideration for their shares. As long as the offer is on substantially the same terms, a vendor can elect whatever consideration mix it prefers without failing this requirement.

However, the Australian Taxation Office seems to be moving towards a more restrictive approach to the requirements for rollover relief for private deals where shareholders elect to receive different consideration.

A common scenario is that management shareholders may elect to receive scrip due to their continued involvement with the business, whereas a cornerstone investor may choose to exit their investment and receive cash.

In such transactions, the ATO seems to be testing whether participation was genuinely available on the same terms, or whether the transaction was designed so that only select shareholders would take scrip consideration.

The proposed shareholders agreement (that will govern the scrip to be issued as part of a private deal), and any other offer terms, needs to be carefully drafted to ensure that all vendor shareholders can genuinely participate in the scrip offer on substantially the same terms. To the extent that the shareholders agreement grants rights to, or imposes obligations on, select vendor shareholders (eg management shareholders) and not other vendor shareholders in material ways, it raises the risk that the ATO will view the scrip offer as failing to allow all vendor shareholders the opportunity to participate on substantially the same terms.



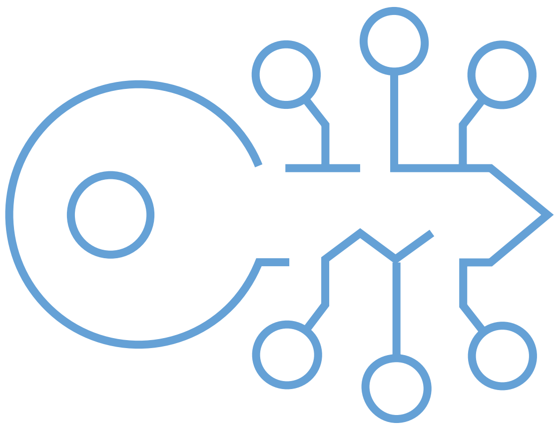
PE devotes increased attention to cyber resilience, but risk remains acute

PE sponsors and their portfolio companies remain an attractive target for cyber criminals, particularly those organisations which are slow to remedy known vulnerabilities or whose operations are compromised by poor cybersecurity hygiene.

Encouragingly, however, PE sponsors report devoting growing attention to cyber risks and allocating higher priority to cyber resilience when assessing prospective acquisitions.

This focus is timely. Australian and international regulators continue to scrutinise cyber governance practices. Following several high-profile cyberattacks in 2022, privacy law reforms have seen the Australian privacy regulator granted additional information-gathering and sharing powers, and significantly higher penalties now apply to serious or repeated privacy breaches.

2022 also saw an Australian-first ruling by the Federal Court[1] that failing to adequately manage cyber risks constituted a breach of Australian Financial Services Licence conditions (laying the groundwork for regulators to apply growing pressure to boards and senior management to ensure organisations have appropriate cyber readiness and response management in place).



This regulatory pressure, coupled with a tightening cyber insurance market, reinforces the need for PE sponsors to devote increased attention towards their (and their portfolio companies') cyber capabilities, as well as those of potential acquisitions. Against this backdrop we expect to see 2023 bring:

- greater technical interrogation of targets' IT systems and processes during the due diligence stage;
- higher priority given to the implementation of cyber risk management and resilience uplifts post-acquisition; and
- more emphasis on reviewing and maintaining robust and consistent cyber standards across PE sponsors' investments.

1 *Australian Securities and Investments Commission v RI Advice Group Pty Ltd* [2022] FCA 496.

Our 2022 deals

Sydney Airport – on its $23.6 billion acquisition by the Sydney Aviation Alliance.

HRL Morrison & Co and Brookfield Asset Management, and Commonwealth Superannuation Corporation – on the $3.4 billion acquisition of Uniti Group Limited.

Pacific Equity Partners – on the $1.167 billion sale of Lifehealthcare to Australasian healthcare group EBOS Group.

Blackstone – on the $1.5 billion sale of La Trobe Financial to Brookfield Asset Management.

IFM Investors – on its acquisition of PRP Diagnostic Imaging, including the debt financing aspects of the transaction.

Pacific Equity Partners – on the sale of WINconnect to Origin Energy Ltd and certain assets to Intellihub, as part of the related investment by Brookfield in Intellihub.

KKR-led consortium – on the proposed take-private of Ramsay Health Care.

Quadrant Private Equity – on the acquisition of Jaybro, a leading supplier to the civil construction and infrastructure sector, including technology aspects.

Pacific Equity Partners – on the sale of Patties Food Limited to PAG.

Bain Capital – on the $450 million sale of early childhood education care provider, Only About Children.

Pacific Equity Partners – on the establishment of PEP Secure Assets Fund II, the Smart Metering Continuation Fund (which acquired a 50% interest in Intellihub), and a number of co-investment vehicles.

Livingbridge – on the acquisition of Waste Services Group, including the debt financing aspects of the transaction.

Equilibrium Capital-led consortium – on the acquisition of a majority interest in Australian agribusiness Perfection Fresh.

Pacific Equity Partners – on the $744.6 million sale of automotive parts and manufacturer AutoPacific Group to GUD Holdings.

EQT-Regal Consortium – on the proposed consortium acquisition of Perpetual Limited.

Nitro Software Limited – on the proposed scheme of arrangement and simultaneous takeover bid from KKR-backed Alludo.

TA Associates and Viburnum – on the proposed acquisition of the outstanding shares in Infomedia.

Fortitude Investment Partners – on the sale of Woolworths Group Limited, including technology aspects.

Global private equity firm – advising the portfolio company of a private equity firm following a data breach and in connection with law enforcement interactions.

Adamantem Capital – on the acquisition of Retail Zoo, owner of Boost Juice and Betty's Burgers, from Bain Capital.

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