PE Horizons 2022:
volatility means opportunity

In PE Horizons 2021, we predicted the year could be one of, if not the, busiest years ever for dealmakers in Australia.

Although our prediction proved to be correct, to the surprise of many, traditional PE investors had a relatively mixed year. While many of the axioms that have characterised PE investing in Australia over the last five years remained in place (ie strong fundraising conditions, readily available debt finance and a favourable environment for M&A), suggesting that dealmaking would be elevated, there can be little doubt that PE investors did not keep pace with the broader equity market and other investors with access to cheaper pools of capital.

With listed company valuations soaring to new heights, most PE investors looking at ASX-listed companies were either rejected early by target boards, or unable to justify their initial valuation and therefore walking away from the opportunity. As a result, long term infrastructure investors and cashed-up strategic buyers accounted for almost all significant public M&A activity in 2021. A similar story unfolded in the private M&A space, where most of the big-ticket M&A involved acquisitions by acquisitive long term investors and cashed-up strategic acquirers.

Only a few months ago, these conditions looked almost certain to continue in 2022. However, only a few months can feel like a lifetime in M&A. The war in Ukraine and consequent dislocation in global energy markets has led to the spectre of rising inflation, increased interest rates and significant market volatility.

As blue skies have been replaced with dark clouds, it's an opportune time to ask: what does this mean for PE activity in 2022? Our response is a simple one – volatility means opportunity.

Market volatility to spur take private transactions

Despite 2021 being a record-breaking year for Australian public M&A, it was disappointing for most PE sponsors who attempted take-privates. The only exception to this trend was the successful acquisition of large-listed companies by long term infrastructure investors, either alone or in consortium arrangements with superannuation and pension funds.

Sky high capital market valuations discouraged many sponsors. Those who were brave enough to make initial offers often found it difficult to justify initial valuations when given access to diligence, or were outbid by interlopers, typically trade buyers with more aggressive valuations, as seen in The Carlyle Group being outbid by Dye & Durham for the Link Group.

> **With capital markets in 2022 already wobbling and further falls predicted, we anticipate an increase in both PE take-private approaches and the number of successful PE take-privates.**

PE sponsors continue to sit on record levels of dry powder (with fundraisings ongoing), all while the corporate deal-making cycle may be winding down as companies grapple with the compounding impacts of geopolitical crises, inflationary pressures and lingering pandemic effects.

> **We also predict that PE sponsors will increasingly focus their efforts on innovative pre-bid lock up mechanisms, including those with management, such as BGH's co-operation agreement with Hansen's CEO.**

These go beyond (but in many cases are in addition to) traditional mechanisms such as pre-bid stakes and shareholder support statements. These types of lock-up agreements are a natural fit for financial sponsors given there is often a need to remain close to existing management post-transaction, which is generally less relevant for strategic bidders. Although lock-up devices received considerable attention in 2021 (in particular, the practice of bidders having their target sign up to a 'no talk' restriction that is not subject to a fiduciary out), our expectation is that PE sponsors will continue to test the boundaries of market practice, particularly with key management shareholders who hold significant stakes in the target. Combined with volatile market conditions, we expect these devices to enhance the prospects of PE take-private bids.

PE to continue to favour trade sale exits

2021 saw a flurry of successful PE exits driven by PE sponsors' willingness to accelerate sell-side deals to take advantage of high valuations and strong demand for quality assets – including the spate of exits by PEP (AutoPacific, LifeHealthcare, Evolution Healthcare, WINconnect and Intellihub), ICG's sale of Everlight to Livingbridge and Affinity's sale of MedicalDirector, to name just a few.

> **Despite geopolitical and inflationary headwinds, we expect to see high performing, PE-backed assets continue to be listed for sale in 2022.**

Technology and healthcare assets will continue to be popular, as well as sectors supporting post-pandemic consumer behaviour, such as online retail and logistics. Investor pressure will likely also encourage divestments of any 'ESG-challenged' assets.

Despite the record-breaking M&A market last year, the much-touted IPO window of 2020 did not continue for PE sellers in 2021. With increased volatility in the ASX and the global markets, it will be challenging for PE to undertake exits via IPO or even dual track processes this year. Scepticism from investors will make IPO exits particularly challenging for technology or other growth-focussed assets with a lighter history of earnings, as opposed to more stable asset classes such as financial services.

> **Trade sales will remain the favoured exit route for PE managers and we also predict an increase of secondary exits in 2022.**

Historically, secondary sales (that is, sponsor-to-sponsor sales) are less prevalent in Australia (comprising 15% of FY21 private equity exits, compared with 52% comprising sales to strategic buyers*), as compared to the US or Europe where PE markets are deeper and more mature. However, we expect a shift in this landscape, as PE sponsors continue to accumulate dry powder – with fresh funding rounds following deployment of record levels of capital in the last couple of years – and as listed and other corporate bidders take a less bullish approach to M&A.

* BDO Australia: https://www.bdo.com.au/en-au/privateequity2021/exits.

Warranty and indemnity insurance trends

Unprecedented demand for warranty and indemnity insurance caused delays in deal execution and premiums to soar in 2021. Insurers could not keep up with the explosion in M&A - timelines were pushed out and deals even turned away. Some transactions were forced to incorporate sub-optimal warranty and indemnity (W&I) conditions precedent and the need for post signing underwriting or other novel risk allocation techniques.

> **2022 has seen some capacity and stability return to the W&I market, but turnaround times are still slower than prior years and an extra week or so should be factored into transaction timelines.**

W&I insurance premiums in 2021 trended steeply upward, moving the baseline well north of the historic 'low 1%' of policy limit. Higher rates are here to stay in 2022, though there are some welcome signs of stabilisation.

Demand for W&I is not just being driven by PE sellers seeking 'clean exits', with W&I having gained widespread popularity among corporate and founder vendors attracted by the risk reallocation. W&I is also being used in a wider variety of deal types, increasingly seen on real estate, infrastructure and renewables transactions. It also continues its evolution as a deal tool in public M&A, where it's used to de risk take privates carried out by way of scheme of arrangement. With a number of PE plays for listed targets already announced this year, others expected, and a backdrop of volatility, look for more policies to be taken out in this space.

While there are some question marks around the W&I value proposition given high premiums and an increasingly long list of exclusions, the reality is PE sponsors must now take out – and price – buy side policies on most auctions they find themselves in. Uptake of title and capacity excess insurance remains more subdued, particularly on bigger deals where it can be cost prohibitive and parties can usually get comfortable with the risk proposition.

Another strong year expected for leveraged finance and funds

The record breaking year for M&A in 2021 saw strong issuances of PE backed buyout deals in the Australian leveraged loan market. The volume of Australian dollar 'term loan B' financing issuances was the prevalent feature of the Australian leveraged loan market in 2021, as investment banks successfully executed their originate-to-distribute business model by unlocking pools of liquidity parked with APAC funds and accounts. Notable 2021 transactions include EQT's acquisition financing of Icon Cancer Care and KKR's acquisition of ProbeCX. Issuances by Australian issuers of Australian dollar tranches of 'term loan b' financings soared and, for the first time, achieved a greater market share (58%) than financings in other currencies.[1] We predict this trend will continue in 2022, particularly for strong credits backed by global sponsors, though liquidity and borrowing conditions may deteriorate should supply chain, inflationary and geopolitical headwinds intensify.

The direct lending market also experienced a robust upswing in PE backed activity following a relevantly benign 2020. In a vigorously competitive M&A market, direct lenders demonstrated the value of their take-and-hold business model by supporting financial sponsors in pre-empting M&A timelines with certainty of funding costs and terms and removal of the inherent market risk of syndication. Direct lenders were also a predominant source of capital for PE backed issuances for recapitalisations and refinancings. Key transactions included TPG's recapitalisation of Novotech and Livingbridge's acquisition of Waste Services Group; the latter was funded by Ares, announcing itself as a significant new entrant to the Australian direct lending market given the size and scale of its presence in the US and European direct lending market.

With M&A volumes anticipated to continue to be strong in 2022, we predict volume in both of these financing markets to grow.

This is fostering an interesting dynamic where aspects of the covenant flexibility of a 'term loan B' financings is emerging in the direct lending market. Our financial sponsor clients, buoyed by the demand for financing opportunities across both the 'term loan B' and direct lending market, are arbitraging terms to seek to introduce 'covenant-lite' financings to large cap deals in the direct lending market. Global direct lending funds, supported by an accommodating LP investor base, are willing to explore exporting incurrence style covenant technology and terms to gain market share in the Australian leveraged loan markets. While mid-market deals will continue to follow the more traditional structure of a leverage covenant, this is one development to watch in 2022 for the large cap space.

[1] Source: Debtwire Par

PE, portfolio companies and midmarket acquisition targets provide fertile ground for cyber criminals

Ransomware groups are moving beyond 'big-game hunting' to target midsize companies that have been, or are about to be, acquired by PE.

> **Poor cyber hygiene and well-publicised access to funds (for ransom payments) from sponsors anxious to preserve their investment value, has made PE portfolio companies lucrative targets.**

If the operational and financial consequences of cyberattacks weren't bad enough, regulators in Australia and abroad are also taking enforcement action when they identify deficient post-acquisition cyber governance practices.

It doesn't end there – threat actors are also targeting investors and other participants in M&A processes to obtain confidential client and market sensitive information and misdirect payments.

All of this points to a growing need to reduce PE sponsors' overall cyber risk exposure by securing their own environments, implementing robust cyber governance and preparedness arrangements across their portfolios, and embedding cyber considerations in M&A processes.

ESG matters but so does greenwashing

ESG focus has quickly become the new normal across all asset classes, including PE, and is no longer seen as the exclusive preserve of impact or social responsibility funds. From a fundraising perspective, Australian institutional investors, led by superannuation funds, are increasingly focussed on environmental, social and governance issues associated with their investments.

A recent Responsible Investment Association Australasia research report reveals that 86% of Australians expect their superannuation or other investments to be invested responsibly and ethically, and a number of super funds have actively trumpeted a focus on responsible investment as the dominant feature of their mass marketing campaigns.

This focus is now manifest in the fundraising process, with institutional investors increasingly seeking to conduct ESG-focussed operational due diligence on PE sponsors, and to impose associated conduct and reporting obligations.

These requirements are also impacting the operation of PE funds - ESG risks and opportunities must often now be taken into account as a key part of the investment process (with associated monitoring and reporting requirements) and LPs must be informed of any material ESG issues arising at the portfolio company level.

Developments in Europe have seen the introduction of a regulatory regime focussed on disclosure, which seeks to reduce so-called greenwashing and distinguishes impact funds, for which ESG matters are their raison d'être, from funds whose managers claim to take ESG considerations into account in their investment processes (the regime applies to both, and will apply to Australian sponsors marketing their funds to European investors). While a regime of this nature is yet to be introduced in Australia, ASIC is currently conducting a review into greenwashing, with a view to improving governance and accountability in the market, and this is likely to be an area of regulatory focus going forward.

The global perspective for 2022

Here are the trends that Linklaters' leading financial sponsor team expect to play out globally in 2022:

1

2021 broke M&A records and 2022 is expected to be strong, but the crisis in Ukraine and its knock on effects will compound with existing inflationary pressures, supply chain challenges and the withdrawal of stimulus to replace COVID-19 as headwinds.

2

Fundraising activities continue to overcome logistical challenges presented by the pandemic and are expected to remain strong in 2022, with increasing amounts of dry powder to fuel competition for opportunities.

3

Financial sponsors continue to behave opportunistically: diversifying into new asset classes/ strategies, acquiring stakes in each other and becoming public companies themselves.

4

Competition for transactions will see an increased focus on creative deal sourcing, including by exploring proprietary opportunities, corporate carve-outs and public takeovers.

5

ESG considerations and policies continue to gather momentum and take an increasingly prominent role in the assessment of acquisition opportunities.

Our key Private Equity deals in 2021

Vocus – on the acquisition for 100% of its shares capital by way of scheme of arrangement by financial sponsors MIRA and Aware Super for A$3.5 billion.

BGH Capital – on the proposed acquisition of all the share capital in ASX-listed Hansen Technologies Limited for A$1.3 billion by way of scheme of arrangement.

KKR, OTP and PSP Consortium – on the A$5.2 billion acquisition of Spark Infrastructure by way of scheme of arrangement.

Temasek and Equilibrium Capital – on the acquisition of a majority interest in Australian agribusiness Perfection Fresh.

Pacific Equity Partners – on the $1.167 billion sale of medical devices business, Lifehealthcare Group, to EBOS Group Limited.

Crown Resorts – on its response to the A$9 billion takeover proposal from Blackstone, the merger proposal from The Star and the US$3 billion funding proposal from Oaktree Capital.

Brookfield and Grok Ventures – on the $9 billion proposed acquisition of AGL Energy by way of scheme of arrangement.

TPG Asia – advising portfolio company Pathology Asia Holdings on the acquisition of TissuPath.

Livingbridge – advising global private equity sponsor Livingbridge on the acquisition of Waste Services Group from The Riverside Company, The Silverfern Group and other shareholders.

Quadrant Private Equity – on the acquisition of Australia's and New Zealand's leading supplier to the civil construction and infrastructure sector, Jaybro.

Pacific Equity Partners – on the acquisition of a majority interest in Transmedic Pte Ltd, a leading medical devices business headquartered in Singapore.

Cerberus Capital Management – on its acquisition of Westpac's car-loans and dealer-finance portfolio.

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

Pacific Equity Partners – on the sale of WINconnect to Origin as part of the related investment by Brookfield in Intellihub.

Livingbridge – on its acquisition of Everlight Radiology from Intermediate Capital Group, following a competitive sale process.

Penten – advised Penten and its shareholders on a sale of a minority stake in Penten to Five V Capital.

Shareholders in Zimmermann International Pty Ltd – on the acquisition by Italian private equity sponsor, Style Capital, of all the issued share capital in Australian-based luxury fashion brand, Zimmermann, and issue of rollover equity to the founder shareholders in Zimmermann in the new holding entity for A$540 million.

PEXA – advised Morgan Stanley Infrastructure Partners on the competitive dual track (trade sale and IPO) exit process for PEXA, Australia's national real estate transaction settlements exchange, culminating in a successful IPO.

Bingo Industries – acting for GIC, which is a member of the consortium acquiring BINGO by way of a scheme of arrangement (with an interest of approximately 29% in the consortium).

Hg Capital – advising portfolio company Litera, Inc on its acquisition of software business DocsCorp.

TA Associates – on the A$417 million acquisition of BetaShares, a leading provider of exchange traded funds.

Hg Capital – on its acquisition of Zenith Investment Partners from 5V Capital.

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