Allens > < Linklaters

Private Equity Horizons 2019

Market update

The busy run experienced by private equity managers in Australia in the last couple of years slowed down considerably in 2019. Last year we saw fundraising by Australian managers more than double to a record US$8.3 billion across at least 10 vehicles. In addition, dealmakers were able to take advantage of pricing opportunities created by a more stringent regulatory environment and pricing opportunities in the public markets, particularly at the back end of 2018, capping off one of the strongest years for private equity on record.

However, the good news story has shifted in the first half of 2019, with the level of dealmaking activity dropping substantially amid fierce competition for assets, soaring deal values and economic headwinds. As a result, having raised record sized funds, private equity managers will be under considerable pressure from their institutional investors to start deploying more capital in early 2020.

The private equity team at Allens reports on some key trends and sectors to look out for.

1 LEVEL OF BUYSIDE LIKELY TO PICK UP

Although Australia entered 2019 riding on a wave of positive economic growth and with investor confidence intact, a highly competitive and contested investment environment and increasing geopolitical and economic headwinds has resulted in private equity deal volumes dropping substantially from the previous year. Based on a recent report by the Australian Investment Council and EY, private equity managers have completed just 20 private equity deals in Australia in 2019, well below the 107 completed in 2018. Interestingly, the same report suggests that spending could end broadly level, with A$10.1 billion deployed so far, compared to A$17.5 billion last year.

Given the limited number of opportunities, the larger end of the market was particularly competitive in 2019, with few sponsors being able to ward off competition from other managers or cashed-up strategics. In the case of the long-running sale by Campbell Soup Company's of a material part of its international business, KKR successfully fended off competition from both financial sponsor bidders and strategics in a hotly contested auction process. Australia's largest buyout fund manager, BGH Capital, secured its maiden deal by acquiring education business Navitas for A$2.1 billion. Quadrant also kept dealmakers busy, with a number of investments in 2019 from both its core and new growth fund, demonstrating its willingness to play to its core strength of continuing to pursue founder-led opportunities in the mid-market.

General partners are no doubt feeling pressure from their limited partners who are keen to see more money being put to work while also weighing up the risks of a broader market correction. The underpenetrated levels of capital deployment so far combined with record levels of dry powder means that private equity managers will need to become increasingly innovative in their investment and deal execution strategies in 2020.

2 THE PE INVESTMENT THESIS – LARGER DEALS MEANS NO ROOM FOR ERROR

The consistent theme for private equity deals in Australia in the last three years has been that sponsors are targeting larger assets. Seven of the 20 largest private equity transactions over the past five years were completed in 2018 or later, with three of the top five occurring this year. Brookfield's acquisition of private hospital operator Healthscope for A$4.1 billion, KKR's acquisition of certain Campbell Soup Company international businesses (including iconic Australian biscuits brand Arnott's) for A$3.1 billion, BGH Capital's acquisition of education business Navitas for A$2.1 billion and KKR's acquisition of MYOB (the third time the business has traded separate private equity hands in 10 years) were the largest private equity deals in the five-year period, behind only KKR, Värde and Deutsche Bank's A$5.9 billion deal for Latitude Financial Services in 2015.

Supportive fundraising conditions, combined with favourable debt markets and the increasing number of institutional investors who are keen on pursuing direct and/or consortium opportunities has resulted in an abundance of capital which is allowing general partners to target opportunities at the larger end of the market in order to deploy for more meaningful equity cheques. However, larger assets combined with elevated valuations means increased risk for investors. Based on our discussions with general partners, given the size of the assets which private equity are now pursuing, dealmakers are being required by their internal committees to demonstrate how the investment thesis can be realised quickly following completion (eg in the case of a buy-and-build strategy, by having a pipeline of bolt-on opportunities identified, and potentially progressed, prior to committing to the main deal).

3 PE-STYLE CLEAN EXIT STRUCTURES NOW BEING USED BY LARGE CORPORATES

Warranty and indemnity (W&I) insurance has become a common feature of transactions in recent years, in a market where for corporates, public companies, real estate funds and private equity clients are seeking to limit tail liability and shift risk onto buyers. More frequently this year we have seen W&I insurance introduced by such sellers as a non-negotiable part of deals and at the beginning of auction processes. In fact, on numerous transactions insurers have become increasingly proactive in their engagement with sellers so as to allow the W&I underwriting processes to run in tandem with the sale process.

The W&I market will continue to develop and grow in Australia over the next 12 months, particularly given its use by corporate sellers and founders seeking to make a clean exit. It is becoming an increasingly attractive proposition and competitive premium pricing is contributing to what is an ongoing trend for corporates and the world of private equity.

4 INSTITUTIONAL DEBT MARKETS – HERE TO STAY

The upward trend of institutional investors and private debt funds participating in the Australian leveraged finance market can no longer be categorised as an 'evolution'. The deep liquidity and innovative debt products these market participants bring are readily accessible and are now permanent features of the market. Both investment banks and sponsors have been successful in 2019 at leveraging this. Investment banks by increasing their willingness to underwrite institutional debt products with distribution in mind. Sponsors by arbitraging terms across institutional unitranche and term loan B debt products, and by running debt solutions for a financing event competitively against one another.

THAT'S THE WAY THE COOKIE CRUMBLES

Although financial sponsors in Australia are generally perceived as sector agnostic, the key sectors where they are showing the most appetite are general industrials, food, healthcare and technology.

The food sector is proving a particularly attractive source for capital deployment, highlighted most recently by KKR's US$2.2 billion acquisition of the Arnott's biscuit business from Campbell Soup Company, one of the largest successful transactions in the Australian private equity market to date in 2019.

KKR's agreement with Campbell Soup Company will see it acquire Arnott's (the iconic Australian biscuit brand and a major driver of Campbell International's sales), Campbell's simple meals and snacking brands in markets including Australia, New Zealand, Indonesia, Malaysia, Singapore, Hong Kong and Japan, and Campbell International's manufacturing operations in Australia, Indonesia and Malaysia.

In past years, large scale unitranche financings were often on a club basis with a significant portion directly lent by institutional market participants with managed funds or accounts with flexible single asset exposure. Investment banks are delivering large scale debt underwrites for event driven financings, acutely aware of the deep pool of liquidity that exists by combining institutional managed funds or accounts with inflexible single asset exposure. Sponsors will pay a pricing premium for the investment bank carrying distribution risk but obtain leverage, covenant and repayment flexibility of a unitranche financing with the ease and certainty of execution that a sole (or two) underwriters bring. Recent examples of this were seen in Goldman Sachs' financing package provided for the dividend recapitalisation of Quadrant Private Equity's portfolio company, The Entertainment and Executive Group, and the financing by Credit Suisse and UBS of TPG's acquisition of Greencross Limited.

Convergence is a common theme globally in debt markets and the Australian leveraged finance market is no different. Sponsors leverage market liquidity and accessibility to run financial solutions competitively against one another, including any existing financings against the asset. This fosters a convergence of terms and the conventional rules of thumb as to leverage, financial covenant profile and terms preserving the credit for a particular debt product are evolving. Commercial banks are aware of the competition that this creates and continue to be innovative on financing solutions, often focusing on delivering flexibility on terms to meet the sponsor's specific business plan, as opposed to a broad brush approach. The spread on all-in-pricing between bank debt deals and institutional deals also allows commercial banks to remain active and competitive in the market. We anticipate continuance in convergence as the competition for assets and financings in the private equity secttor continues.

5 CARVE-OUT OPPORTUNITIES ON THE HORIZON FOR PRIVATE EQUITY BIDDERS

Despite the strong valuation challenges for quality assets, private equity bidders tend to thrive and outpace competition from corporates and other bidders when the asset presents complexity such as carve-out transactions or where the asset presents complicated separation issues. In the first half of 2019, we saw KKR acquire certain international assets from Campbell Soup Company (including iconic Australian biscuits 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 at the end of 2018 to a private equity-led consortium bidder.

The effects of the Banking Royal Commission and the focus of institutional investors are forcing large corporates in Australia to divest non-core and often higher risk, assets and focus on their core business. The big four banks have been the most active sellers with a number of divestments already completed or planned in 2020. However, the fallout from the Royal Commission has been more far reaching than just financial services, resulting in increased regulatory scrutiny across a number of industries and, as a result, large corporates are increasingly looking to simplify their business and 'ease' the regulatory burden. Offshore, we are seeing similar pursuits albeit for different reasons. Increasing political uncertainty, trade wars and economic nationalism in the US, Europe and Asia are driving corporates to divest assets in non-core geographies and focus their attention on a handful of key geographies giving private equity bidders an opportunity to acquire quality assets.

Given the current political and regulatory climate in Australia and abroad, we see do not see the pressure which large multinational corporates are feeling abating in the near future. As such, we think that private equity bidders will continue to find opportunities by acquiring challenging or non-core assets where value can be realised through less regulatory scrutiny and increased operational efficiency.

6 LEAD UP TO THE FINISH LINE

We think the significant pressure being exerted on large corporates by both their shareholders and key regulators means we are likely to see more opportunities for private equity bidders. As another example, in the second half of 2019 we saw Pacific Equity Partners successfully acquire the Asia Pacific business of Michigan-based towing and trailering products maker, Horizon Global. Corporate carve-out opportunities should continue to provide fertile grounds for private equity bidders who are prepared to acquire challenged or non-core corporate assets. In addition, the impact of the Banking Royal Commission and tighter APRA lending standards is likely to continue to keep the major banks on a tight rein and open up opportunities for PE-backed non-bank lenders. Cerberus Capital Management's acquisition of SME lender Axcesstoday was its second successful acquisition in Australia in the financial services sector, having previously acquired Bluestone Group's mortgages business in 2018.

As such, despite the fierce competition and significant challenges for the private equity industry in Australia, we are seeing a solid pipeline of opportunities out there which are likely to keep dealmakers busy.

Allens > < Linklaters

OUR SPONSOR SIDE EXPERIENCE IN 2019

We are pleased to have played a role in some of the most transformational transactions in the Australian private equity market this year.

KKR – advised on its US$2.2 billion agreement to acquire iconic Australian biscuit brand Arnott's, Campbell's simple meals and snacking brands in markets including Australia, New Zealand, Indonesia, Malaysia, Singapore, Hong Kong and Japan, and Campbell International's manufacturing operations in Australia, Indonesia and Malaysia.

Pacific Equity Partners – advised on the successful acquisition of Horizon Global Corporation's Asia Pacific business, for approximately A$340 million.

Cerberus – advised on the acquisition of certain subsidiaries of Axsesstoday Limited, an Australian provider of equipment finance solutions to small and medium businesses.

KKR – advised KKR and its portfolio company, Australian Venue Co., on the establishment of an incorporated joint venture, Queensland Venue Co., with Coles Group.

APM – advising Quadrant-backed APM on its acquisition of Konekt via scheme of arrangement.

QIC – advised on its proposed acquisition of Pacific Energy.

QIC – advised on its acquisition of Sea Swift.

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

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

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

TPG Capital – advised on the acquisition of pathology business Safe Work Laboratories.

Pacific Equity Partners – advised on the acquisition of ASX listed LifeHealthcare Group Limited by scheme of arrangement.

Pacific Equity Partners – advised on the establishment of the PEP Secure Assets Fund (its first infrastructure fund) and PEP Fund VI.

CONTACTS

Sponsors

Tom Story
Partner, Co-head PE
T +61 2 9230 4812
Tom.Story@allens.com.au

Mark Malinas
Partner, Co-head PE
T +61 3 9613 8485
Mark.Malinas@allens.com.au

Emin Altiparmak
Partner
T +61 3 9613 8510
Emin.Altiparmak@allens.com.au

Noah Obradovic
Managing Associate
T +61 2 9230 5301
Noah.Obradovic@allens.com.au

Greg Lawson
Senior Overseas Practitioner
T +61 3 9613 8956
Greg.Lawson@allens.com.au

Leveraged Finance

Mark Kidston
Partner
T +61 2 9230 4419
Mark.Kidston@allens.com.au

Tom Highnam
Partner
T +61 2 9230 4009
Tom.Highnam@allens.com.au

Rita Pang
Partner
T +61 2 9230 5836
Rita.Pang@allens.com.au

David Couper
Managing Associate
T +61 7 3334 3226
David.Couper@allens.com.au

Funds

James Kanabar
Partner
T +61 2 9230 4130
James.Kanabar@allens.com.au

Marc Kemp
Partner
T +61 2 9230 4991
Marc.Kemp@allens.com.au

Tax

Joseph Power
Partner
T +61 2 9230 4698
Joseph.Power@allens.com.au

Craig Milner
Partner
T +61 2 9230 4063
Craig.Milner@allens.com.au