U.S. Private Equity:
2021 Market Outlook

This year should combine both commercial opportunities and regulatory risks for private equity. Deal multiples are high and will probably stabilize or continue to go a little higher given the combined effect of a scarcity of sellers in the market and money continuing to flow into private equity. While 2020 was strong, particularly the second half, many funds focused on managing their portfolio companies through the pandemic rather than going to market. We expect this to change in 2021, certainly for those companies that weathered the uncertainty and challenges that 2020 brought. While clearly some industries (such as travel, hospitality, and retail) are still down, many have a clearer path forward and can demonstrate how they came through 2020 stronger and more resilient than before. Thus, there should be a greater number of investment opportunities this year, particularly in the middle market, as private equity funds look to monetize investments and public companies look to sell non-core assets. Meanwhile, U.S. funds should expect stricter tax and antitrust implementation from the new administration.

Here's what we think you can expect this year, and how these changes might impact your fund or your business.

Government Stimulus; Stock Markets and Record Fundraising

Much has been written in 2020, and so far in 2021, about the possibility of a stock market "bubble." These concerns come as markets continue growing, despite widespread economic disruption and uncertainty. This is mostly likely attributable to Federal Reserve policies and the trillions of stimulus dollars that the U.S. government has already funneled into the economy and will likely continue to funnel into it. The economic impact of this debt will likely have a reckoning in the future, but the short term impact should benefit all asset classes thus keeping the markets strong in 2021. Even though these concerns are primarily directed to the public markets, they have implications for private companies and investors too: targets are more expensive, but funds also stand to gain from IPOs and other more typical exits. Indicating just how expensive acquisitions have become, Pitchbook's 2021 US Private Equity Outlook expects 20% of buyouts to be priced above 20x EBITDA.

While a market correction could erase years of preparation and force funds to hold onto certain portfolio companies longer than they otherwise would have, this seems unlikely in 2021 and thus should lead to more exits this year.

Pitchbook also expects fundraising to surpass $330 billion, setting an all-time high, as more institutional investors look to alternative investments for better returns. As these investors increase their allocations, given that private equity typically is the largest component of alternative investments, funds are poised for record fundraising.

Funds could find opportunities arising from carve-outs, distressed assets

Due to the disruption caused by the pandemic, some companies are trimming certain parts of their business. There are many reasons a company might make this decision:

- The assets are non-performing, under-performing or distressed.
- Assets no longer are considered core to the company's focus (due to changes fostered by the pandemic or longer-term company evolution).
- The company wants to generate liquidity, without raising funds.
- The spin-off is required by antitrust regulators, either to break up a dominant market position, or to prevent such a position from being created by a transaction.

Carveouts are more likely in 2021, particularly under a Biden administration, as antitrust enforcement is expected to tighten. Funds should watch the tech sector (FAMGA) in particular, because it's expected to be an antitrust enforcement priority. In addition, we certainly expect bankruptcy practices to remain busy with potential 363 sales being more available for funds seeking these types of opportunities.

Middle market industry expectations are diverse

The term "middle market" refers to a wide range of firms, of many sizes and strategies. For the upcoming year, this diversity will be reflected in PE firm strategies. According to Grant Thornton, middle market firms globally are looking at online training and education, telehealth, e-commerce, pharmaceuticals, food-tech, and distribution and delivery.

Deal size might still be muted, continuing a trend observed in 2020. According to Pitchbook, "middle-market add-ons have accounted for nearly half of all US PE deals through Q3 2020, which has resulted in smaller deal sizes across the board." Likewise, the market will no longer be split between industries that are sensitive to COVID-19 and those that are more protected from it. This will be a gradual process, as the end of the pandemic approaches.

SPACs to remain popular M&A tool, despite overcrowding risk

Special Purpose Acquisition Companies, or SPACs, are so popular that a recent article in the New York Times said these are "the hottest tickets in M&A." There are many reasons SPACS are a popular M&A tool, explained as follows:

"The appeal to buyers and sellers is apparent. Sponsors generally get a 20 percent stake at very little cost—known as the "promote"—which turns into a big stake in the target company after a merger. Sellers can go public without the hassle or restrictions of a traditional IPO, a benefit that attracts venture capitalists in particular. "This translates into a significant volume trend, with Pitchbook anticipating that in 2020, "at least 20 PE-backed companies will enter US public markets through a reverse merger with a SPAC."

What's the catch? SPACs are almost too popular. At the moment, SPACs are underperforming relative to the S&P 500, but the S&P 500 is trading at nearly 30 times profits, which could be a vulnerability. Notwithstanding these circumstances, investors remain undeterred and continue investing in both.

New laws on tax, healthcare and the environment will require adjustments

There are many ways in which a Biden administration may shape deal making, though not necessarily in 2021. The new administration's priority is likely to be geared toward the pandemic, as suggested by PwC before the election (and this rationale has not changed). The other factor is the time required to make political appointments. While Gary Gensler already is rumored to be the next head of the SEC, there are many other positions to be filled in the lower tiers of the acivil service, that will be needed to support more expansive policymaking beyond pandemic response.

Despite these challenges, the U.S. no longer has a divided government, and this makes broader regulatory intervention more likely over the next two years. Here are some potential impacts for PE and individual fund managers, particularly if/when the government repeals the 2017 Tax Cuts and Jobs Act:

- A higher corporate tax rate.
- A higher capital gains tax, which might incentivize funds to offload certain assets they would have otherwise held on to.
- A "carbon enforcement mechanism" that would encourage consolidation in the fossil fuel industry, due to limited earnings prospects.
- A "green stimulus" plan that would encourage investment in green technology.
- Enhanced antitrust scrutiny, which might prevent certain mega-deals from taking place, while also creating potential carve-out opportunities.
- Higher taxation of fund managers' earnings.

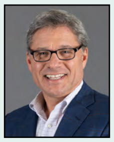
While some of the changes listed above would eliminate rules that have only been in place for three years, others could potentially upend rules the PE industry has been accustomed to for longer, particularly capital gains treatment on carried interest.

Abundant middle market opportunities for 2021

This year should be strong for middle market mergers and acquisitions. Even though the pace of policymaking is uncertain, there is enough information about the current administration's priorities that funds can start thinking about their investment strategies—particularly in the energy sector—and about tax planning. Depending on the fund's strategy, there also will be opportunities arising from carve-outs, spin-offs and distressed assets. After a difficult year for many in 2020, there are strong growth prospects for 2021, due to the stimulus packages, the rollout of several COVID-19 vaccines and low interest rates. The same is true for potential target companies, whose valuation is supported by economic recovery.

We're here to help. With substantial experience in the middle market, we offer a full range of services that can assist your firm in reaching its objectives. We have a long-term successful track record with mergers, acquisitions and divestitures as well as helping businesses in their day-to-day operations. We also represent companies seeking investment from, or acquisition by, a private equity firm.

Reach out to any members of our Private Equity Group, where you'll find dedicated attorneys that understand your firm's commercial objectives.



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