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2021 and Beyond: Private Equity Outlook for 2022

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I. Introduction

In a year of unprecedented health crises and social upheaval, private equity firms and investors have had to adapt rapidly to sudden and ever-evolving economic conditions and cultural and political norms. With the global economy coming to an immediate and severe standstill at the onset of the COVID-19 pandemic, private equity fundraising and M&A activity halted in the spring of 2020. Almost as suddenly and surprisingly came a rebound in the second half of 2020, as pent-up demand sought new target assets. Private equity deal activity ultimately rose globally in 2020 compared to 2019 in terms of deal value, outpacing the overall M&A market rebound. This rebound has been continuing apace in 2021.

The ramp-up in economic activity has been met by new opportunities, with investors placing new emphasis on sustainable investing and finding new vehicles for portfolio company exits. Contractual issues triggered by the pandemic have also remained at the forefront, with private equity parties focusing on allocation of risks that would have been considered unexpected before 2020.

II. Trends in the Private Equity Market

ESG considerations

Private equity sponsors are facing a gathering set of ESG pressures from the regulatory and investor realms to address ESG issues in the economy. The EU has led the way on regulatory pressure, with one standout step being its Taxonomy Regulation, which seeks to establish a common sustainability language. In the U.S., the Securities and Exchange Commission has made several public statements highlighting the importance of accurate and robust ESG-related disclosure. With this increased regulation has come downward pressure on both public companies and private equity sponsors to prove their ESG credentials, driving a thirst for reliable ESG data. Pressures from the ground up have come from changes in shareholder and consumer ESG demands, employee expectations and popular attitudes.

Not least as a matter of competition, private equity firms are seeing the value in aligning their investments with prevailing sentiments on ESG issues. Recent surveys have suggested that a significant proportion of limited partners ("LPs") now expect a strong ESG policy to lead to greater long-term returns, and emerging analyses support that expectation. Another developing trend is the linking of some performance-related elements of return to ESG-goal achievement, a concept proving more acceptable in Europe.

COVID-related contract terms

In last year's edition of this chapter, we highlighted a trend in the spring of 2020 of buyers attempting to terminate or renegotiate pre-pandemic transactions that had yet to close. As a result, provisions in acquisition agreements regarding the buyer's obligation to close the transaction came under renewed scrutiny. In the year since, carveouts from the definition of a material adverse effect ("MAE") for the effects of pandemics and other health crises have become routine. At the same time, the Delaware courts have emphasised that short-term COVID-related declines in target businesses, even if severe, do not qualify as an MAE if their long-term effect is minimal, and that other, already common carveouts in the MAE definition might capture the effects of a pandemic-related slowdown.

Sellers have also begun insisting on contractual language in the interim operating covenant to allow them to take extraordinary action in response to extraordinary events. This language has proven critical for sellers in light of the Delaware court's ruling that authorisation for such action is not implicit in the typical operating covenant as traditionally drafted. Notably, not all jurisdictions have interpreted the covenant the same way. An Ontario court held that the operating covenant should be analysed contextually and that a seller's actions in response to the pandemic did not violate its obligations under the covenant.

SPACs

The strong growth in global and U.S. equity capital markets since the spring of 2020 has been led by the unprecedented boom in IPOs for special purpose acquisition companies ("SPACs"). A record 248 SPACs went public in 2020, raising $83 billion; both those figures were easily surpassed in 2021 by the end of the first quarter. The SPAC surge has predominantly been a U.S.-based trend, though the eye-catching economics of SPACs have

begun attracting significant interest in other regions. The UK government-initiated review of its listing regime recommended this year that the existing regulatory barrier to SPACs be lifted, albeit simultaneously with ensuring sufficient investor protections for those engaging in SPAC investment. This recommendation has been endorsed by the UK government and a consultation is currently underway.

Mergers with SPACs provide an alternative path for private companies to access public markets, giving them price certainty and a less complicated process than an IPO. As such, these "deSPAC transactions" constitute a fourth exit strategy for private equity sponsors, adding to the traditional paths of a portfolio company sale to a corporate buyer, sale to another private equity firm, or IPO. At the same time, though, with over 400 SPACs in the market searching for target companies, deSPACs may make for competition for private equity firms seeking target assets.

Recognising an opportunity in the SPAC market, some prominent private equity firms have taken to launching their own SPAC vehicles. This strategy is not without its challenges, however, as fund LPs may resent losing acquisition opportunities to the sponsor's SPAC. Transactions in which a sponsor directs its portfolio company to a merger with its own SPAC also raise questions of conflict of interest.

Increase in Foreign Direct Investment ("FDI") controls

A number of jurisdictions introduced FDI controls for the first time in 2020, and several more enhanced those FDI regimes that were already in place. This trend has continued in 2021, with the EU seeking to coordinate Member States with the FDI screening framework it put in place at the end of 2020, having advised its members to use their existing FDI controls to their fullest. Also notable is the UK's introduction of the National Security and Investment Act 2021 in April, which, although not fully implemented until the end of this year, unusually has retroactive effect in that relevant transactions that closed any time after November 12, 2020 may be called in for national security assessment. As with many other new FDI controls, these are not limited to the traditional transactions for national defence infrastructure assets, but extend to the finance, healthcare, infrastructure, transport, media, agriculture and technology industries sectors.

The increasing number and strength of these regimes will necessarily weigh into sponsors' due diligence into the feasibility of affected transactions and will require negotiation around the allocation of closing risk in transaction documentation where mandatory governmental approvals apply.

Dividend recapitalisations

Dividend recap activity has mirrored the private equity M&A cycle of 2020 and has continued its robust rebound in volume well into 2021. Sponsors almost entirely put plans for leveraged loans and high-yield bond offerings on hold in the first half of 2020, opting instead to make sure that their portfolio companies' balance sheets were strong enough to survive an economic drought. As the economic outlook improved, sponsors quickly revived their plans for dividend recaps, helped along by lenders and credit investors eager to make these loans in the prevailing low-interest-rate environment. Although the pace of dividend recaps would be expected to fall off as the M&A market revives, this has yet to happen through the first half of 2021.

It is worth noting, though, that in the U.S., some Congressional Democrats are taking a sceptical view of dividend recaps, viewing them as a tactic by sponsors to pile debt on portfolio companies to funnel payments to themselves. One proposed piece of legislation would, among other proposed changes to the private equity industry, prohibit sponsors from collecting dividends for two years after acquiring a target company.

W&I market

With the decline in transaction volume at the start of the COVID-19 outbreak and new entrants into the market, the warranty and indemnity (W&I) insurance market became more competitive with decreased premiums and broader coverage being offered by underwriters. The broad-brush COVID-19 exclusions initially applied in W&I policies became more refined as insurers looked more closely at the actual impact on targets' businesses. The general exclusions traditionally included in policies as a matter of course were also reconsidered, leading to a narrower set of standard exclusions with focus on specific areas of concern. As deal volume rebounded in 2020, the market remained competitive and innovative, albeit more discerning, with premiums increasing in line with demand.

W&I insurance products continued to evolve in 2021, with additional risks and alternative applications being considered, such as the use of such policies in secondary transactions. Other innovations include an increase in the use of synthetic warranty deeds, given by insurers based on buy-side due diligence, which can be useful in distressed deals and a possible option in auctions. This trend can be expected to continue as furlough and other financial-support schemes come to an end later this year.

III. Outlook

Private equity activity levels have returned from the spring 2020 low to levels last seen in 2007. As more populations are vaccinated, pent-up demand works its way through the global economy and robust private equity activity can be expected to continue through 2021. LPs are increasingly signalling the influence of sustainability and diversity considerations, which sponsors must take into account when making investment decisions. With fundraising continuing to show strength, the challenge for the private equity industry in 2021 and beyond may be more about navigating uncertain socio-political than economic terrain.

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