5 Shapers Of Private Equity In 2013

Law360, New York (February 27, 2013, 1:53 PM ET) -- While U.S. and global private equity investment activity remained somewhat stagnant in 2012, the deal environment for leveraged acquisitions recently has been more favorable. Although economic uncertainty, particularly the debt ceiling resolution in the U.S., may continue to negatively affect overall M&A activity, we view the outlook for PE investing as more positive because of continued confidence in credit availability and the reported trillion-dollar level of PE purchasing power (or “dry powder”) worldwide.

Some of the key topics likely to shape the PE deal landscape in the year ahead include (1) PE fundraising/fund formation trends, (2) the impact on PE activity of the substantial dry powder, (3) the prevalence of limited partner (LP) co-investment in PE deals, (4) the decreased number of “mega/club deals” and (5) other trends, including increased “add-on” investments and secondary buyouts as well as use of standardized deal terms to allocate financing risk.

Fund Formation

The PE fundraising environment seemingly has stabilized, with the aggregate number of new funds raised (by number and amount of capital) remaining constant in 2010, 2011 and 2012, according to Preqin data. However, recent fundraising levels still are substantially below the peak years. We expect this trend to continue in 2013, and we expect that PE sponsors will continue to form geographic-specific and industry-specific funds. In addition, although investors in PE funds may plan to cut the number of fund managers they commit to over the near term, many investors continue to be bullish on the asset class generally.

Dry Powder

Some reports indicate that the dry powder, or callable capital reserves, of PE funds could be as high as $400 billion worldwide in 2013 (with $200 billion required to be invested this year) — which equates to more than a trillion dollars of purchasing power applying conservative leverage assumptions. PE funds have a strong incentive to invest this capital before the expiration of their fund investment period — at which time, without an extension from their limited partners, the PE funds lose the ability to call this committed capital and earn the corresponding carry.

At the same time, due to the financial crisis and other market factors limiting exit alternatives, PE funds typically have held portfolio companies for longer than the usual holding period and are actively seeking exit opportunities. The confluence of these factors, along with greater availability of credit, should provide a meaningful backdrop for increased PE activity in 2013, including through “secondary buyouts.”

Increase in LP Co-Invests

We have seen a significant increase in the number of transactions in which LPs have participated in PE buyouts as direct co-investors. Co-investment transactions serve many important purposes for their participants.

For the PE fund, co-investments can help fill funding gaps created by tight debt markets, reduce the fund's risk exposure in any particular deal, increase the deal size the PE firm can pursue and solidify relationships with important LPs.

For co-investors, these investments offer diversification, a chance to achieve better investment returns (including by investing capital into a PE fund on a no-fee (or very low-fee) basis), the acceleration of capital deployment, the ability to invest larger amounts in deals they find particularly attractive, and the opportunity to deepen relationships with the PE funds and benefit from the sponsors' diligence and expertise in executing the investment.

Given the dynamics in the PE industry that we see for 2013 (e.g., dry powder, absence of mega/club deals, LPs having increased bargaining power during fundraising), we would expect these co-investments to continue, as the participants seek to capitalize on the associated benefits.

Decreased Number of Mega/Club Deals

Multibillion-dollar, mega-size buyouts that captured headlines during the peak of the credit bubble did not reappear in 2012 and are unlikely to return in the foreseeable future. PE investment activity largely has settled into — and been concentrated within — deals between $100 million and $5 billion, with an overwhelming percentage of deal volume occurring within the $100 million to $1 billion range.

While some market observers have predicted that the need for PE funds to invest in new deals could result in a revival of the mega-buyouts since these deals allow more money to be deployed faster, there are many countervailing factors that may continue to impede the re-emergence of the mega-buyout in 2013 and beyond, including (1) smaller size of PE funds and corresponding inability (or hesitancy) to allocate large percentage of fund capital to any one deal, (2) reluctance of PE funds to participate in club deals, given the difficulty in managing the investment with multiple sponsors and view from the LPs that club deals undermine their diversification objectives, since they may be invested in each member of the club, and (3) LPs increasingly limiting the PE fund's ability to make investments over certain dollar thresholds.

Other Trends

- "Add-on" Investments. PE firms are continuing to invest in add-on acquisitions involving businesses that are complementary to existing portfolio companies or investing in smaller companies in closely related businesses to increase the scope of their presence in an industry.

- Secondary Buyouts. PE firms increasingly have been selling portfolio companies to other PE firms. These secondary buyouts accounted for 30 percent of 2012 aggregate PE deal value (up from the record level of 25 percent in 2011), according to Preqin data. This increase likely is driven by uncertain IPO markets and the pressure on PE firms to return capital to investors on deals made during the buyout boom. While secondary buyouts are vulnerable to criticism (e.g., lack of investment thesis to improve results obtained by prior PE owners), given the normal uncertainties surrounding the IPO market and lack of other available exit alternatives, we would expect secondary buyouts to continue to represent a significant portion of PE deal activity in 2013.

- Standardized Financing Risk Allocation. In 2011 and continuing into 2012, PE deals significantly trended toward a "standard" set of deal terms to allocate

financing risk — no financing-out, a reverse-termination fee (ranging from 3-9 percent) as the sole remedy if debt financing is not available despite the buyer's efforts, and a limited specific performance right to force the buyer to close only if the debt financing is available. While there have been (and will continue to be) certain exceptions — e.g., competitive auctions where PE firms may be willing to take more risk with a higher reverse-termination fee, more expansive "flex" provisions, a requirement to increase the equity portion of financing or an obligation to "take-down" bridge financing in lieu of bond financing, etc. — we expect this standardized set of deal terms to continue in 2013 and beyond.

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