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PRIVATE EQUITY AND VENTURE CAPITAL REPORT 2014

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Challenges accepted

Lead contributors **Shaun Lascelles** and **Steven Daniels** from **Skadden Arps Slate Meagher & Flom** consider the major issues affecting the global private equity market

The financial crisis and its aftermath arguably have presented (and in many respects continue to present) the global private equity (PE) industry with the greatest set of challenges it has faced during its history. In recent years, some commentators have suggested that these challenges might cause a significant shake-out in the PE industry or possibly even lead to its partial demise. However, contrary to these predictions, the industry appears to be gradually emerging from this prolonged period of unprecedented market unrest and economic instability.

Despite the uncertainty of recent periods, the industry appears to be reasonably intact and fundamentally unchanged in terms of its primary objectives. Moreover, in recent months, the private equity industry has enjoyed robust levels of activity in many key markets and sectors, with funds raising record levels of capital from investors.

US

The US remains a key jurisdiction for PE activity among both domestic and international investors. Having maintained relative economic stability in the wake of the global economic crisis, the US has benefited from a perception of safety among investors in the global market. As a result, investment in US PE funds and the total value of PE investment in US targets both increased in 2013.

Record levels of capital available for investment and a historically low interest rate environment should promote US PE activity in the short term as sponsors deploy vast amounts of capital for acquisition-related investment and PE portfolio exits continue to build momentum.

Unsurprisingly, the US PE market remains highly competitive. While increased capital levels have resulted in greater competition for assets, funds have exercised increased discipline in terms of target quality and purchase price multiples. Many sponsors have focused on improving their portfolio companies through smaller add-on acquisitions, while others have taken advantage of low interest rates and accessible debt markets to engage in leveraged recapitalisations and refinancings. In the legal and regulatory arena, US PE funds face continued debate regarding matters ranging from information disclosure to carried interest taxation.

Europe

Having experienced a number of lean years, the European PE industry is beginning to recover, with the UK forming the vanguard of this revival. Activity in the Nordic countries and in southern Europe also has contributed to Europe's recent PE resurgence, with sponsors drawn to the financial stability of the former and the opportunities for cheaper acquisitions and growth in the latter.

Many sponsors operating in Europe, particularly larger alternative asset managers, have reaped the benefits of improving macro-economic conditions and current market trends such as the availability of various debt financing alternatives, including high-yield bonds, asset-based finance and non-bank debt, on more borrower-friendly terms, a range of viable exit routes (particularly IPOs on European stock exchanges), an improved, albeit bifurcated, fundraising environment and a very robust secondary market.

These favourable market conditions have assisted sponsors by significantly improving their European deal flow which, in turn, has enabled them to raise record levels of what is known as dry powder that's now ready for future deployment. In recent months, European PE activity has taken a variety of forms, including leveraged buyouts, refinancings, flotations and follow-on sales, trade sales, secondary buyouts, bolt-on deals and secondary transactions, with sponsor-backed flotations on European stock exchanges particularly prevalent.

If sponsors operating in Europe continue to exercise discipline as the industry recovers, while remaining ready to adapt to changing economic or market conditions, the prospects for a sustainable revival are strong.

Asia-Pacific

In common with other emerging markets, the Asia-Pacific region experienced a slowdown in M&A activity following the financial downturn, a trend exacerbated by the strong focus of large Chinese and Japanese corporates and financial sponsors on outbound investments in the US and Europe. Lately, however, PE has become an increasingly important feature of the Asia-Pacific region's M&A landscape.

Successful fundraisings by Asia-Pacific-focused PE funds have led to a gradual increase in the levels of capital available for investment in the region. As a consequence, both global and regional sponsors have become increasingly active in the region, particularly in China, Japan and Hong Kong.

In certain key countries in the region, the low-hanging fruit is quickly disappearing and difficulties remain in conducting due diligence, obtaining financing and regulatory approvals and achieving successful exits. In the short-term, the already challenging investment environments in these countries are likely to become more competitive, as investors vie for the relatively scarce number of well-managed businesses likely to deliver sustainable growth. However, as these countries begin to rebalance their economies and introduce important legal and regulatory reforms and the Asia-Pacific PE industry continues to mature, the medium to long-term prospects for PE investment in the region look promising.

Latin and Central America

In recent years, factors such as slower economic growth, political uncertainty, differing price expectations and the levying of taxes on foreign capital have dampened the appetite of sponsors to invest in Brazil. However, sponsors remain reasonably upbeat about Brazil's medium to long-term prospects given its large population, burgeoning middle class and relatively investor-friendly regime and the recent announcement of major regulatory reforms and a multi-billion dollar infrastructure modernisation programme.

As Brazil fell out of favour, other Latin and Central American countries such as Mexico, Colombia, Peru and Chile, whose economies are expected to outpace the average global economic growth rate in the coming years, witnessed considerable interest from regional and international sponsors. If these countries can continue to implement policies designed to improve their key industries, promote cross-border trade and foreign direct investment and facilitate tax-efficient acquisitions and disposals, their popularity among sponsors and their limited partners should remain strong.

"Many sponsors have focused on improving their portfolio companies through smaller add-on aquisitions

In the race to attract regional and international PE investment, those Latin and Central American countries with strong demographics, considerable infrastructure and energy deficits and governments keen to promote economic stability, sustainable growth and inward investment should outperform their neighbours.

Rising to the challenges

While the global PE industry is undoubtedly in a much-improved state, the recovery remains delicate and the industry continues to face a significant number of formidable challenges. These range from political, economic and regulatory challenges including political risk and increased regulatory burdens on sponsors to market-driven challenges such as intensifying competition in the fundraising market.

Those sponsors who apply the hard lessons learned from the financial crisis, avoid the excesses of the recent past and adapt to the dynamic investment landscape stand the best chance of rising to these challenges and reaping the benefits of what will hopefully be a sustained recovery for the global PE industry as a whole.

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