ROPES & GRAY

PERSPECTIVES

PRIVATE EQUITY INDUSTRY INSIGHTS

SPRING 2021

WELCOME TO THE SPRING 2021 ISSUE OF *PERSPECTIVES*. The past year has been a roller-coaster ride for private equity, as the industry navigated the ups and downs of the global pandemic and adjusted to major political changes across the globe, including a new administration in the U.S. and the withdrawal of the UK from the EU. As COVID-19 (hopefully) nears its end, and as the political climate settles, private equity investors and their portfolio companies are gearing up for the many opportunities and challenges ahead.

In this issue of *PErspectives*, we offer our clients a glimpse into the future. We open with a detailed look at the state of private equity in a post-pandemic market, focusing on valuations, capital solutions and restructuring opportunities. We then take a detailed look at the forward momentum of the U.S. financing markets, the telehealth investment landscape, the use of long-hold investment strategies, and the risks and rewards associated with IP in tech deals. For a global perspective, we provide updates on the UK Listings Review, the new tax regime for UK holding companies and the Asia private equity market.

We also share insights on how the new U.S. administration may impact the business and regulatory climate. For more information about this topic, we encourage you to visit Ropes & Gray's Capital Insights microsite (click the tile below).

We hope you find this issue timely, engaging and informative. As always, we encourage you to reach out to your Ropes & Gray team (or to the authors noted herein) with any questions regarding this newsletter or any other legal developments of interest to you. We look forward to seeing you in person again soon—until then, stay well.

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LAW360

"PRACTICE GROUP OF THE YEAR"

Private Equity ▪ Fund Formation ▪ Healthcare

(PE 2017-2020; FF 2019; HC 2019-2020)

Only firm named "Practice Group of the Year" for private equity, fund formation and healthcare in 2019 (and private equity and healthcare in 2020)

PE MARKET UPDATE

Private Equity in a Post-Pandemic Market

Private equity (PE) firms may have weathered the worst of the pandemic to date, but the impact of COVID-19 will continue to shape valuations and capital structures and may bring new restructuring opportunities.

DESPITE A TUMULTUOUS YEAR, the PE sector in the United States came through 2020 in relatively robust shape, leaving it well prepared to pursue growth opportunities in 2021. Even though global buyout and exit deal value fell by approximately 30% and 60%, respectively, in Q2 2020—as lockdown measures were being imposed across much of the globe and entire sectors were effectively shut down in the process—PE dealmaking rebounded to end 2020 on a high.[1]

Boosted by an estimated US$2.5 trillion in dry powder to invest, global buyout deal value climbed 3.3% from US$589 billion in 2019 to US$608.7 billion in 2020, according to data from Mergermarket.[2] Buyout volumes were only marginally down year-on-year, falling from 3,789 deals to 3,509 transactions.[3] Exit deal value rose 5.3% year-on-year to US$555.1 billion—despite the fact that deal count fell by 17% during the same period.[4] The rise in PE transaction value stands in contrast to a 6.6% annual decline in overall global M&A value, illustrating the resilience of the asset class.[5] PE sponsors were bidders in more than a quarter of all M&A deals globally, the highest annual figure on Mergermarket record.

"M&A activity came back pretty well in the second half of the year, as PE dealmakers adjusted to doing deals in a different way," says **KIRAN SHARMA**, a PE partner at Ropes & Gray in London. "Deals for good assets that spoke to the market continued to be done. If anything, because there were fewer deals, there was a much more competitive marketplace, which pushed overall deal value even higher."

That resilience means the asset class is in a strong position for deal-making. A number of deals that were put on hold because of COVID-19 are expected to come back to market, and firms that paused to focus on portfolio management in the first stages of the pandemic have been moving actively to get their deployment schedules back on track. Buyout firms, meanwhile, are expected to continue setting the bar high for deal targets. Through the pandemic, PE dealmakers have clustered around assets that provide downside risk protection as well as growth potential.

As a result, buyout activity has skewed toward deals in the technology, life sciences and healthcare sectors. PE firms did 913 technology deals worth US$158.7 billion in 2020, up from 845 deals worth US$117.8 billion in 2019, according to Mergermarket data. The 436 life sciences and healthcare deals (including pharma, medical and biotech deals) were valued at US$70.6 billion, and also surpassed 2019 volume figures (374 deals).[6]

VALUATIONS HOLD FIRM

THIS FOCUS ON STABLE BUSINESSES in resilient sectors is expected to remain a theme in what is still an uncertain macroeconomic environment. At the same time, the appetite for quality assets among PE firms is forcing buyout dealmakers to achieve higher valuations in order to secure transactions despite wider economic dislocation.

Expectations that valuations would fall due to the pandemic have not materialized, with median EBITDA multiples for buyouts standing at 12.1x in 2020, in line with the previous year's multiples.[7] The market has, however, bifurcated between high-quality businesses in desirable sectors and those in more challenging industries hit particularly hard by the pandemic, such as travel, hospitality and leisure, as well as physical retail. In desirable sectors, such as technology and business services, PE investors have continued to pay median EBITDA multiples of 16x and 14.3x, respectively.[8]

"COVID-19 had an uneven impact on different industries," says **PENG YU**, a Ropes & Gray PE partner based in Hong Kong. "Certain industries, particularly TMT and healthcare, have done very well during the pandemic. Valuations for some of the companies in these industries are at record highs."

CHAU LE, a Ropes & Gray PE partner based in San Francisco, adds that there has been "a huge shake-up in terms of what is considered valuable and what is not. A big event like COVID-19 changes the way our world looks and feels. Businesses that weren't receiving much attention suddenly turned out to be crucial in a post-pandemic world, and you saw valuations change to reflect that."

For example, companies with a focus on remote learning suddenly found themselves in the spotlight as schools around the world went virtual. Similarly, telehealth systems that were of moderate interest pre-pandemic have taken on far greater importance as people continue to seek medical attention remotely.

Buyers, meanwhile, have taken steps to build comfort when acquiring assets at full price by assessing a target's earnings over a longer time period and undertaking a deeper analysis of how a business has steered through pandemic disruption.

Larger vendor and management team rollovers, as well as earnouts, were used to nudge buyers to close during the first round of lockdowns, but as activity levels have recovered, it has been easier for vendors to sell assets at high prices without having to take such measures.

"In March and April 2020, you saw more creativity around how to price assets, and we saw the use of earnouts and similar structures," says New York-based Ropes & Gray PE partner **SCOTT ABRAMOWITZ**. "But toward the end of the year, it felt like buyer concerns went away. From an M&A perspective, it felt like we were right back to where we were at the beginning of the year."

CAPITAL STRUCTURES STRETCHED

STRONG DEAL ACTIVITY, however, does not mean that PE portfolio companies are in the clear. Many businesses are still grappling with reduced earnings and uncertainty around future growth, prompting ongoing discussions with lenders around amending capital structures. This is expected to remain a trend in the market, even as vaccine programs are rolled out and economies reopen.

FOCUS ON FINANCE

U.S. Financing Markets – Forward Momentum

- Positive sentiment driven by the announcement of COVID-19 vaccine approvals buoyed the institutional markets in late 2020.
- After pausing in early November for the U.S. elections, activity resumed and has continued at a brisk pace into 2021, with repricings increasingly common as demand remains elevated (in some cases, despite the applicability of 1% soft call premiums).
- The high yield market remained red hot and hit an annual volume record of $435 billion for 2020.
- The institutional loan markets in Q4 maintained the elevated primary levels first seen in Q3, with supply increasingly driven by the recent uptick in M&A activity, and prices in the secondary market have rallied to return to approximately pre-COVID levels; nevertheless, annual volume ($288 billion) in 2020 was down 7% from 2019, largely driven by the slowdown in Q2.
- In a sign of resurgent investor appetite, the syndicated second lien loan market has again become attractive to borrowers (in lieu of privately placed second lien loans).
- Overall, credit documentation terms have started to resemble those from the early 2020 pre-COVID era.
- On the other hand, companies in sectors particularly negatively affected by COVID-19 that obtained financial covenant relief in 2020 may require an extension later into 2021.

"The liquidity issues that companies face remain, and the residual impacts of the pandemic will probably continue for some time," says Boston-based Ropes & Gray finance and capital solutions partner **ALYSON GAL**. "Pandemic shutdowns are still with us, and modifications to suspend financial covenants and amortization are very much factors, as are establishing liquidity tests in lieu of financial covenants."

LEONARD KLINGBAUM, a partner in Ropes & Gray's finance group in New York, adds that the "overwhelming ask has been that there be liquidity covenants as opposed to relying strictly on leverage or other EBITDA-related covenants" in new deals and where current terms have been amended.

"I think there's a growing recognition that certain financial covenants—especially with adjusted EBITDA and add-backs—do not necessarily provide a true picture of a company's situation," says Klingbaum. "We have also seen shorter maturity dates, which allow lenders to revisit situations as the pandemic unfolds."

When PE firms have required more headroom from investors, however, banks and private lenders have been willing to provide flexibility to see credits through.

"Governments around the world have leaned on banks quite heavily to support businesses, rather than pull the plug," says **SAMUEL NORRIS**, a partner in Ropes & Gray's capital solutions and finance group in London. "Following the financial crisis, lenders realized that aggressive strategies aren't always effective and a more collaborative approach to stressed and distressed situations can yield a better outcome. Sponsors have also tightened 'white lists' over the years and exercised more control over who comes into their debt. The result is that loan-to-own strategies are harder—or need to be more creative."

DISTRESS DELAY

THE WILLINGNESS ACROSS THE LENDER COMMUNITY to amend and extend terms, as well as government financial support measures and a moratorium on creditor enforcement, have helped PE firms nurse portfolio companies through the crisis.

"There has been a lot of kicking the can down the road," says New York-based Ropes & Gray restructuring partner **CRISTINE PIRRO SCHWARZMAN**. "Rather than extending terms for the usual quarter or six weeks, we have seen borrowers successfully negotiate extensions of up to two years."

With borrowers able to buy more time, restructuring activity has oscillated through the year, and restructuring volumes have been lower than anticipated, given the scale of COVID-19's impact on businesses.

"The COVID-19 environment has been characterized by radical swings in restructuring activity," says New York-based Ropes & Gray restructuring partner **RYAN PRESTON DAHL**. "Late Q1 and Q2 2020 saw a tremendous upswing in the volume and velocity of corporate restructurings. But this activity has subsided to a significant degree as we continue to see almost unprecedented levels of liquidity being injected into the market from private, public and quasi-public investors, as well as an ever-increasing risk appetite for investors chasing yield."

As lockdown restrictions are lifted and government support measures are wound down, more clarity will emerge around which companies are sustainable in a post-COVID-19 world.

"There will come a time when a lot of businesses will have to acknowledge that they are not going to return to 2019 numbers for a couple of years, and that they are going to have to restructure to reflect that. It's going to get a lot more active from a restructuring point of view as the year progresses," says London-based Ropes & Gray restructuring partner **MATTHEW CZYZYK**.

Whether restructuring or pursuing new deals, PE dealmakers are facing a busy year ahead. ■

CAPITAL INSIGHTS

Perspectives on the New Administration

In this feature, partners from various practice groups share their insights on how the new administration may impact the business and regulatory climate.

Private Equity

"The new administration's potential impact on the governmental and regulatory environment for the private equity industry is clearly a focal point," said partner **Neill Jakobe**. "I think this focus is heightened following the extensive government relief programs being implemented in response to the COVID-19 crisis and a sense that regulatory enforcement activity is picking up."

Asset Management

"The list of 2021 priorities for the SEC's newly named Division of Examinations is expansive—also because a new SEC chair has been named—but fund boards can still take clues from the release of a 42-page book that broadly covers several areas," said partner **Paulita Pike**. "At a time of transition such as now, covering more rather than less allows for the agency to focus and prioritize down the road and be flexible along the way. That's exactly what you want."

Healthcare & Life Sciences

"At some point, the plans will have to look at where telehealth goes in terms of reimbursement and how that develops, whether as part of a fee-for-service or part of a capitated structure or other risk arrangement," said partner **Timothy McCrystal**.

"President Biden is wasting no time taking steps to bolster protections under the Affordable Care Act, including increasing the level of premium subsidies and extending the open enrollment period. Efforts also include expanding Medicaid to cover a larger percentage of lower-income adults, as well as freezing a number of the prior administration's reforms involving drug pricing," said partner **Michael Beauvais**. "We are seeing companies that focus on these subsectors attract significant interest from investors."

Capital Markets

"If you look at the significant flow of transactions, there has to be a limit at some point on investor capital and to the number of available targets," said partner **Paul Tropp**. "I don't think that we're at that point yet. There's still a sense that there are a meaningful amount of targets for SPACs."

Litigation & Enforcement

"Presuming the Biden administration engages more proactively globally than the Trump administration, we can expect to see more international coordination and cooperation," said partner **Ryan Rohlfsen**. "Hopefully, we will also see coordination in resolutions to give companies greater transparency and clarity around multijurisdictional enforcement actions."

ESG

"The private equity industry has been working to adapt ESG diligence review processes and ESG-related fund marketing materials to comply with the DOL's final ESG regulation," said partner **Joshua Lichtenstein**. "In March 2021, the Biden administration's DOL provided a respite from these requirements when it announced that it will not enforce the rule until it finishes reevaluating it."

"The Biden administration will likely push to standardize and structure ESG disclosure," said partner **Michael Littenberg**. "Since the term 'ESG' is loosely defined, fund managers should be clear in their disclosures about which elements of ESG they're taking into account and how they screen for such factors."

Data, Privacy & Cybersecurity

"The new administration may be able to build on recent momentum to sway companies to report data breaches that do not involve personal data. Nothing would work faster than articulating a new policy giving companies safe harbors or liability protections for information sharing," said partner **Edward McNicholas**. "The administration will need to have a clear set of rules and standards if it hopes to persuade companies to freely supply it information." ■

GLOBAL MARKETS OUTLOOK

UK LISTINGS REVIEW

Overdue Commitment to London Financial Markets

EVEN FOR BREXIT SCEPTICS, a long-held hope was that the UK's exit from the EU would pave the way for a reform of the UK financial markets. Over the past few years, a number of growth companies (including tech and life sciences companies) and SPACs have opted for the more flexible U.S. listing regimes over the London Stock Exchange.

The current differences between the U.S. and the UK are stark—whilst 2020 saw a U.S. SPAC boom (c. $80 billion in proceeds raised from over 200 IPOs, with the pace accelerating in Q1 2021), £30 million was raised in the UK in the same period. In addition, Amsterdam is now looking to establish itself as the European hub for SPACs—ESG Core Investments was the first SPAC listing of 2021 on Euronext Amsterdam, but there are many more in the pipeline.

"Instances like fashion retailer Farfetch choosing New York for its IPO rather than its home jurisdiction of the UK were felt keenly in the UK," said Ropes & Gray London PE partner **ELIZABETH TODD**. "If the UK can close the gap between its regulatory regime and other global centers, it will become much more competitive as a listing destination."

The UK Listings Review, launched by UK Chancellor Rishi Sunak and led by Lord Hill, was published on 3 March 2021. The Review has recommended:

- Modernizing the UK's listing rules to allow dual-class share structures in the London Stock Exchange's (LSE) premium listing segment (which would allow founders to have enhanced voting rights on certain decisions but still trade on the most liquid exchange).

- Reducing free-float requirements from 25% to 15%.

- Liberalizing rules regarding SPACs, including removing a requirement for trading in SPAC shares to be suspended at the point an acquisition is announced (currently, investors are locked in even if they do not approve of the potential purchase; this has dampened investor appetite for SPACs subject to UK rules).

- That the Chancellor report annually on the competitive position of the City of London (which would be a natural prompt for further improvements).

- A fundamental review and reform of the prospectus regime, including treating admissions and offers to the public separately, with an aim of drastic simplification and increased flexibility.

"Even just the publication of the report seems to have had an effect," said Todd. "Food delivery company Deliveroo chose London as the venue for its $7.59 billion IPO, focused on the fact that its dual-class structure aligned with the findings of the Lord Hill review on the benefits of allowing founders to keep more control."[9]

Some investor organizations have, however, urged the government to be cautious with any changes, noting that a balance will need to be struck between protections for investors (particularly retail investors) and flexibility for issuers.

The UK government has committed to move quickly to act on the recommendations, so we expect next steps shortly, with public consultation on legal and regulatory changes to commence within the next couple months. ■

Author: Elizabeth Todd

GLOBAL MARKETS OUTLOOK

ASIA PE MARKET TRENDS 2021

2020 SAW A STAGGERED RECOVERY from COVID-19 across Asia. Deal flow dropped and bounced back higher. According to provisional data from *AVCJ Research*, despite a record-low Q1, the total PE capital deployed in 2020 totalled $198.5 billion, 17% higher than in 2019.[10]

Overall, growth capital investments in the technology space remained center stage among PE deals in 2020,[11] and investments in the healthcare sector showed strong growth, given the untapped demand in the region, the cultural shift following the pandemic and exit success stories.[12] Investors also saw control deals (including several auction processes) rebound in late 2020, a trend that may continue in 2021.[13]

The Asia market has been resilient in the face of geopolitical tension in 2020. According to *Asia Private Equity Review*, in a year mired in China-U.S. frictions, China-focused GPs secured undiminished interests from U.S.-based institutions,[14] and China became the top destination receiving foreign direct investments, surpassing the U.S. for the first time.[15] A pattern of "regionalization" also emerged, with China, Japan and South Korea funds actively investing in Asia outside their home markets.[16] Fundraising for pan-regional strategies, China VC funds and Japan funds showed year-on-year increase in 2020, but there was a general decline of 16% for the total amount raised in Asia.[17] Investors congregated to established GPs for perceived quality, as travel restrictions hindered diligence efforts.[18]

It remains to be seen how the new U.S. administration may affect the PE market in Asia. And with the global economy expecting an uptick in activity post-vaccine, the atmosphere among investors is tentatively optimistic. ■

Authors: Peng Yu; Oliver Nip; Leon Huang

HEALTHCARE CORNER

Talking Telehealth: Shaping Your Investment Strategy

RECAP FROM R&G VIRTUAL DISCUSSION PANEL ▪ NOV. 2020

As the global pandemic has forced cities, states and countries to embrace new ways of doing things, services such as telehealth have come into the spotlight. Even before the pandemic, telehealth was attracting investor interest. Over the past year, PE firms and strategic investors have stepped up their evaluations of this burgeoning sector.

Our panel of industry leaders comprised of investors, payors, providers and legal advisers examined the outlook for telehealth. Here are some of their observations:

PERSPECTIVES ON THE ROLE OF TELEHEALTH & THE DELIVERY OF HEALTHCARE

- Because of COVID, we've accelerated the use of telehealth by years. In many ways, there's no turning back. Providers have embraced telehealth, and by extension, patients are more accepting.

- As we come out of the pandemic, we'll get better data on whether telehealth is a substitute [for in-person office visits] or an addition. It's possible that telehealth will replace the need for general health visits, along with prescription refills and even some high-level diagnoses.

- Some specialties, such as behavioral health, will be faster to adapt. You've also got demographic factors—younger generations are much more comfortable with telehealth.

Value-based care is essential.
We need to ensure we're not increasing total medical expenses (e.g., readmission to a hospital for the same diagnosis).

- There will also be regulatory hurdles. We have 50 states, each with its own priorities, which could make it difficult to scale nationwide.

KEY REIMBURSEMENT CONSIDERATIONS

- Some states want payment parity for a telehealth visit and an in-person office visit, but forcing reimbursement parity may not lower medical expenses.

- Value-based care is essential. We need to ensure we're not increasing total medical expenses (e.g., readmission to a hospital for the same diagnosis).

- If you're able to get providers in front of chronic populations, that's where you have an opportunity to cut costs, because right now they're not being treated at all. The extent to which we can drive preventive care will determine appropriate reimbursement levels.

KEY CHALLENGES IN INVESTING IN NEW SERVICES

- The challenge for investors is determining valuations and questioning whether gross margins are tracking to be valued like a technology business. Right now, the long-term economic or margin profile for these businesses remains unclear.

- We're still in the early innings of using technology to manage patients, improve provider efficiency and drive down costs, but there is an opportunity to fix demand/supply imbalances and create value within the provider landscape.

- On regulation, states need to be more flexible about exchanging information, allowing doctors across lines, etc. On privacy, there will be some rollbacks. The key will be what they will do on enforcement, and what providers will do on compliance.

ACCESS TO TELEHEALTH

- Technology is important in expanding access to telehealth within certain communities and parts of the country.

- The challenge coming out of COVID is that we're likely to see rollbacks (e.g., HIPAA and privacy considerations). Folks in rural areas who don't have access to broadband may need to go to clinics because services aren't reimbursable.

- We may see payors become more willing to invest in infrastructure and partner with companies to help broaden access in rural areas and underserved communities.

COST SAVINGS TO THE HEALTHCARE SYSTEM

- Pre-COVID, there was no real data. Since COVID began, some payors have committed to reimbursing telehealth at the same level as an office visit, but these concessions may not be sustainable.

- One area to focus on is remote patient monitoring for chronic care conditions. Some payors want to see savings before they're willing to pay, so it's a value-based care model where you have to hit certain savings thresholds to get paid. For certain high-cost populations, technology can be beneficial.

- There is at least a three- to four-year lag in value-based arrangements, including in reimbursement models. We need a partnership between providers and payors to test these models. That's an iterative process.

THE PATH FORWARD

- One of the key barriers to the adoption of telehealth prior to COVID was provider reluctance. COVID has gotten providers more comfortable with telehealth. This shift should allow telehealth to be maintained post-COVID at much higher levels than before.

- We may see more traction four or five years down the road as providers understand how best to manage high-cost groups with chronic conditions through telehealth. ■

ASSET MANAGEMENT ANGLE

Using Long-Hold Investing as a Competitive Advantage

IN A HIGHLY COMPETITIVE transactional environment, price is key to winning attractive investment opportunities when competing against other financial buyers and has historically been the most important factor where PE buyers compete with strategic and other potential suitors. For some investment targets, such as family- or founder-owned businesses, however, an offer from a buyer with a long-term investment horizon can sweeten an otherwise comparable pricing offer and, in some circumstances, outweigh better pricing (at least within reason).

The traditional PE model, including its structural incentives, is not well suited to long-duration investing. The traditional 10-year fund term drives PE sponsors to holding periods that are often much shorter than sellers want, particularly for investments that are acquired later in a fund's investment period. While the power of the carried interest model as a value maximization incentive is not lost on sellers, this incentive drives PE buyers to maximize value during the holding period, which may—but does not necessarily—align with value maximization on a long-term basis. These factors can lead to a cycle of repeat sales among PE firms every three to five years, which can create inherent frictions and costs of ownership transfer.

TAX TIME

A New, Improved Tax Regime for UK Holding Companies

HMRC has launched a second-stage consultation on the tax treatment of UK holding companies in fund structures. The UK already has an attractive regime for equity investments that is widely used for UK transactions and for some international transactions. However, there are some drawbacks to the current UK regime, particularly for debt investments or investments including a combination of debt and equity.

Recent changes following the OECD's BEPS project have also led a number of managers to pursue a strategy of making investments through a master holding company, often in the same jurisdiction as the main fund vehicle. The combination of these and other factors has led a number of UK-based managers to prefer to structure funds and investments through non-UK vehicles in jurisdictions such as Luxembourg, Ireland and the Netherlands, and to expand their operations in those jurisdictions.

The consultation seeks to promote the use of UK vehicles by establishing a special regime for "asset holding companies." The regime would apply in the context of widely held fund structures—and so apply to most, but not all, structures that UK fund managers might establish. Ambitiously, it would apply across asset classes, with UK real estate being the only real exception. Given the increasing focus on substance in the tax world, the use of UK vehicles by managers that have their main European operations in the UK is a natural fit.

The regime envisaged in the consultation—no tax on capital gains, no tax on dividends, deductibility for results-dependent interest, no withholding tax, no stamp duty, predictable transfer pricing, treaty qualification—sounds extremely attractive. Asset holding companies will pay "no more tax than is commensurate with their intermediate role in the fund structure."

However, the consultation document also expresses reservations about the risk that such a regime could be used for tax avoidance. This creates cause for concern that the regime will be excessively complicated. The UK certainly has form for this.

If HMRC is able to curb this tendency to complexity, this is a well-timed and well-directed consultation that could result in an attractive and user-friendly regime that will significantly help to support the attractiveness of the UK as a hub for asset management. ■

Authors: Brenda A. Coleman; Andrew Howard

These considerations can drive sellers to favorably view non-PE buyers that offer a longer-term solution and reduced likelihood of resale between PE sponsors. For example, large family offices, sovereign wealth funds and similar single-investor-backed investment vehicles can serve as alternatives to PE funds while avoiding the holding period constraints of the traditional PE fund model. To address these limitations, some PE sponsors have abandoned the traditional finite-term fund model in favor of long-dated or permanent capital vehicles that permit extended or indefinite holding periods, though this remains a small subsection of the market overall.

For the vast majority of PE firms that remain committed to the traditional finite-term fund paradigm, it is worth considering options to incrementally change the classic PE model in ways that help satisfy desires for a longer-term investment horizon and better allow funds to compete on grounds other than price. Unlike more dramatic shifts to long-dated, permanent capital and similar models, these changes can be done without major structural changes for the PE firm itself or for its core investors. For example, the simplest change can involve lengthening the fund's term. Approximately one-third of recent PE funds either have base terms exceeding 10 years or are pre-wired to allow sponsors to unilaterally extend the term beyond 10 years. Though relatively easy to implement, this change doesn't fully address—and only marginally extends—the limited duration of the classic private fund model.

On the other hand, the proliferation of GP-led secondary transactions, including single-asset transactions, indicates the growing acceptance of longer-term ownership of high-performing assets by a single sponsor. GP-led secondaries permit continuity of sponsorship to be retained substantially longer than the term of the original fund through the sale of a portfolio company from an existing fund to a new vehicle with a different time horizon. Since these vehicles are created with a specific company or companies in mind, the time horizon can be directly shaped to the circumstances of the relevant company.

However, such transactions can be complicated and raise conflicts of interest and other investor-driven and regulatory considerations. They also represent an inherently back-ended solution to the long-term hold issue. Because sponsors cannot make a commitment to undertake a GP-led secondary at the time of initial investment in a portfolio company, the prospect of such a transaction offers relatively little comfort of long-term partnership to target company sellers. Nevertheless, sponsors raising new funds can augment contractual provisions and disclosures designed to facilitate these transactions at the time of fundraising, which can both lessen the approvals required to undertake such transactions and signal intent to prospective portfolio companies.

In some ways, the most noteworthy recent development regarding long-hold structures is the incorporation by a few sponsors of flexibility to extend ownership within the traditional fund structure. By pre-wiring long-hold, continuation vehicle-type structures into their fund agreements, these sponsors maintain flexibility over how assets are held while offering a more compelling and credible long-term offering to target company sellers from the outset. These sponsors also avoid having to employ both dedicated traditional and long-hold structures and, as a result, are positioned to make decisions over time as to the right approach to realization timing on a portfolio company by portfolio company basis.

The nature and extent to which sponsors can change their fund terms will depend on internal and external factors, including the preferences of key investors. However, as longer duration investing continues to grow in popularity and buyers without the constraints of the traditional PE model grow in prominence, PE sponsors may want to consider whether to seek additional flexibility that will help them compete for some of the most promising assets available in the market other than on the basis of price. ■

Authors: Arthur A. Andersen III; John B. Ayer

SPOTLIGHT ON TECH

Intellectual Property in Tech Deals: Risks and Rewards

TECHNOLOGY remains at the center of many private equity transactions—whether involving an investment in an emerging-technology company or one in a more traditional industrial company utilizing a unique technological differentiator in its products and processes. This appetite for technology deals and differentiating technology seems unlikely to wane any time soon. But as this type of investment activity remains competitive, private equity sponsors should continue to remain diligent in protecting against IP risk while also being open to new opportunities for increasing the value of an investment through the strategic use of IP.

VALUABLE TECHNOLOGY IS OFTEN TARGETED IN IP SUITS

In cases where technology provides value and a competitive advantage for an acquired portfolio company, that technology becomes an attractive target for both competitors and IP holders who may see a financial opportunity. One study highlighted how patent assertion entities were targeting companies specifically around the time of their IPO. Moreover, in the past few years, litigation funding has become a major force, funding lawsuits that previously might never have been brought, because litigation (especially patent litigation) is inherently risky and is often expensive and time consuming. But with a large amount of capital being deployed by funders on a regular basis, the potential for more IP-centered lawsuits is real. Indeed, the price for patents on the secondary market has been increasing as U.S. federal courts have become less willing to dismiss patent suits at the early stages of a case. For private equity sponsors, this technology litigation risk has led to cases where they have actually been named as defendants, with opportunistic plaintiffs seemingly chasing dollar signs up the ownership chain.

So where does this leave a sponsor considering a technology-based deal? Of course, traditional diligence should continue to be conducted to identify any lack of adequate IP protection for the target's own products, as well as to consider whether any competitors present a high litigation risk (based on their own IP holdings and/or their willingness to litigate in the past). But sponsors should also have a plan in place to quickly assess and deal with any IP risks that are harder to identify and quantify—especially from non-competitors, including non-practicing entities, who may be emboldened with new access to litigation capital and view a recently acquired technology company as a prime target. This plan should include, at least:

- Quickly assessing risk and developing substantive defenses (subjective belief of non-infringement and/or invalidity can help defend against a later allegation of willful infringement).

> **Significant value** can come from a company's IP assets, which often sit unused (or exist in a less-than-optimal, unmanaged state)—so-called Rembrandts in the attic.

- Taking "patent troll letters" seriously, as seemingly insignificant patents/patent holders may now be backed by more significant sources of funding.
- Considering whether strategic licensing can reduce risk, including through amendment, renegotiation or termination of existing agreements.
- For portfolio companies with key product lines that are vulnerable to being attacked by a competitor, looking for areas where patent protection (or trade secret protection) could be strengthened, particularly surrounding differentiating features, and investigating whether any competitor patents could be vulnerable to preemptive challenge at the U.S. Patent Office's Patent Trial and Appeal Board ("PTAB").

TECHNOLOGY CAN ALSO PROVIDE A REAL OPPORTUNITY FOR UNLOCKING ADDITIONAL VALUE

Certainly not all technology deals involve only risk avoidance. In fact, beyond protecting a company's key products or processes, significant value can come from a company's IP assets, which often sit unused (or exist in a less-than-optimal, unmanaged state)—so-called Rembrandts in the attic.

An important first step is understanding what IP assets a portfolio company has, the scope of those assets and their importance to the relevant industry, and how they have been maintained. Have appropriate patents been obtained? Has the company obtained protection in key foreign geographies? Does competitive intelligence indicate that other companies might be infringing any of these patents? And if so, how easy is infringement to prove using public information? Are there pending applications that might soon issue as valuable patents that can be asserted strategically? Do those pending applications include disclosures that would allow a new, more strategic set of patent claims to be pursued? Has this portfolio company relied heavily on trade secrets to maintain a competitive advantage in the marketplace—and if so, how strongly has it protected such secrets?

In an ideal scenario, once potentially valuable IP assets have been identified, a subset could be asserted against a vulnerable competitor, through either licensing or litigation, to increase market share, secure a monopoly right for a key product or feature, and/or generate revenue based on the use of that IP. One example might be to identify IP directed to a differentiating product feature, and then assert that IP against competitors to prevent them from mimicking that feature. Additionally, IP could be licensed to an adjacent industry, allowing for an additional revenue stream that does not compete or conflict with revenue from the company's patent-protected product. But even if a portfolio company does not have the right IP assets in place to clear out a competitor through an affirmative patent assertion, that company may instead determine that a key competitor has vulnerable patents of its own that could be attacked in the PTAB to clear the way for a new or existing competitive product.

IP assets are often underutilized and can ultimately provide value to a portfolio company (and its sponsor) in a variety of ways, depending on the scope of coverage, dynamics of the particular industry in which the company operates, and the willingness of the portfolio company to take opportunities to create value from otherwise dormant assets. ■

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END NOTES

[1] Mergermarket Global & Regional M&A Report 2020 Including League Tables of Financial Advisors. *See pages 10-11.*

[2] https://www.bain.com/insights/the-2-5-trillion-question-podcast/.

[3] Mergermarket Financial League Table Report. Q4 2020. *See page 10.*

[4] Ibid. *See page 11.*

[5] Ibid. *See page 4.*

[6] Ibid. *See page 5.*

[7] Ibid. *See page 5.*

[8] Ibid. *See page 12.*

[9] A poor first day of trading on 31 March 2021 (shares down 31% at the time of writing) has led commentators to question whether this was the right decision.

[10] Tim Burroughs, "4Q Analysis: Growth Spurt," *AVCJ* (Jan. 22, 2021), https://www.avcj.com/avcj/analysis/3022530/4q-analysis-growth-spurt.

[11] *Id.*

[12] Tim Burroughs, "2020 in Review: Surprise Guest," *AVCJ* (Dec. 17, 2020), https://www.avcj.com/avcj/analysis/3022212/2020-in-review-surprise-guest.

[13] Tim Burroughs, "Buyouts in 2021: Winners and Losers," *AVCJ* (Jan. 13, 2021), https://www.avcj.com/avcj/analysis/3022413/buyouts-in-2021-winners-and-losers.

[14] "Pivot in Asia," *Asia Private Equity Review*, Dec. 2020 at 19.

[15] Paul Hannon & Eun-Young Jeong, "China Overtakes U.S. as World's Leading Destination for Foreign Direct Investment," *The Wall Street Journal* (Jan. 24, 2021), https://www.wsj.com/articles/china-overtakes-u-s-as-worlds-leading-destination-for-foreign-direct-investment-11611511200.

[16] "Playbook Revised," *Asia Private Equity Review*, Dec. 2020 at 7.

[17] Tim Burroughs, "4Q Analysis: Growth Spurt," *AVCJ* (Jan. 22, 2021), https://www.avcj.com/avcj/analysis/3022530/4q-analysis-growth-spurt.

[18] *Id.*

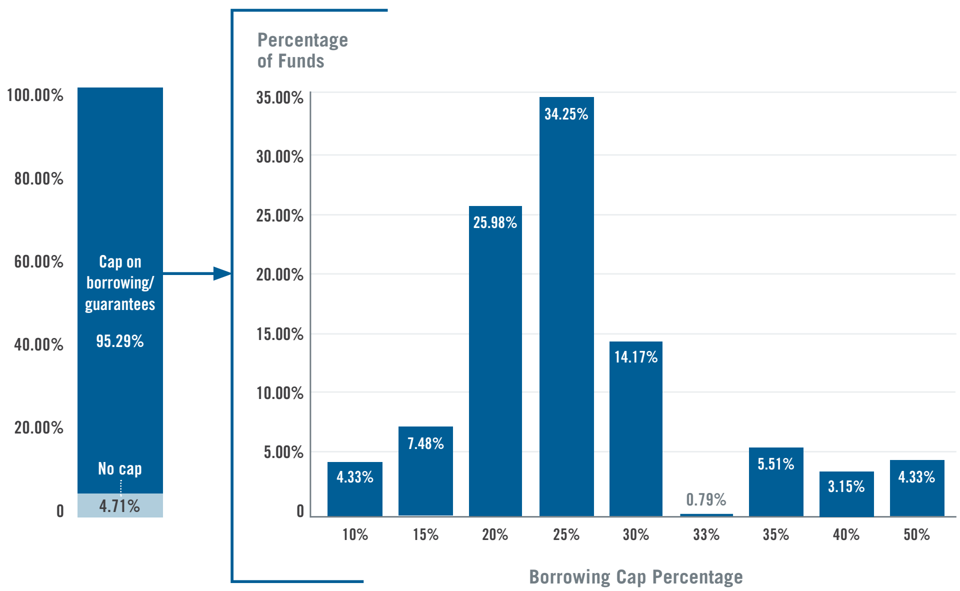
MARKET WATCH

We collect data from private investment funds to enter into our proprietary database, which contains information and analytics on fund terms from more than 3,500 buyout, credit, venture capital, growth equity and infrastructure funds.

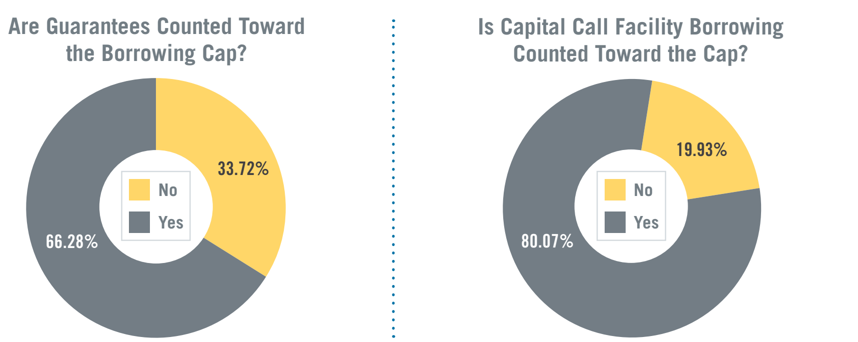
The charts represent data on borrowing for buyout funds vintage 2016 through 2021. The overwhelming majority of funds have a cap on borrowing, and the cap typically ranges from 20% to 30% of commitments. Further, the data shows that most funds include both guarantees and capital call facility borrowing when calculating the overall cap.

Our access to market and industry insights at a granular level gives sponsors the advantage of unsurpassed visibility into the private equity fund landscape, along with the valuable acumen needed to stay a step ahead.

LIMIT ON OUTSTANDING BORROWING/GUARANTEES



BORROWING CAP DETAILS



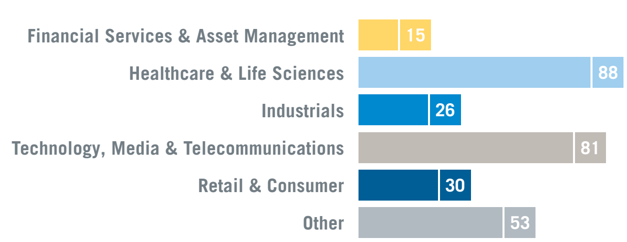
PE BY THE NUMBERS

A Global Private Equity Transactions Practice
Since Jan. 1, 2020 (announced PE-related transactions)

293 Deals

$240+ Billion in transactions

19 Countries



NOTABLE FUNDRAISES

Represented **AlpInvest Partners** in the formation of AlpInvest Secondaries Program VII, which closed at $9 billion	Represented **Antares Capital** in the formation of its first Senior Loan Fund, which closed with $3 billion of purchasing power	Represented **ArcLight Capital Partners** in the formation of ArcLight Energy Partners Fund VII, which closed at $3.4 billion	Represented **B Capital Group** in the formation of its second fund, which closed at $820 million	Represented **BV Investment Partners** in the formation of Fund X, which closed at $1.1 billion
Represented **Constitution Capital Partners** in the formation of Ironsides V, which closed at $1 billion	Represented **Cowen** in the formation of Cowen Healthcare Investments III, which closed at $493 million	Represented **Cyprium Partners** in the formation of its fifth fund, which closed at $445 million	Represented **Gauge Capital** in the formation of Gauge Capital III, which closed at $800 million	Represented **Gridiron Capital** in the formation of Gridiron Capital Fund IV, which closed at $1.35 billion
Represented **Hamilton Lane** in the formation of Hamilton Lane Secondary Fund V, which closed at $3.9 billion	Represented **Index Ventures** in a $2 billion fundraise across two funds, Index Ventures Growth V and Index Ventures X	Represented **Kohlberg & Company** in the formation of Kohlberg Investors IX, which closed at $3.4 billion	Represented **LongRange Capital** in the formation of its inaugural fund, which closed at $1.5 billion	Represented **Manulife Investment Management** in the formation of Manulife Private Equity Partners, which closed at $1.5 billion
Represented **Neuberger Berman** in the formation of NB Strategic Co-Investment Partners IV, which closed at $2.1 billion	Represented **Oberland Capital** in the formation of Oberland Capital Healthcare Solutions Fund, which closed at $1.05 billion	Represented **Pacific Equity Partners** in the formation of PEP Fund VI, which closed at AUD$2.5 billion (US$1.79 billion)	Represented **Sculptor Capital Management** in the formation of Sculptor Real Estate Fund IV, which closed at $2.6 billion	Represented **Shoreline Equity Partners** in the formation of Shoreline Equity Partners Fund, which closed at $300 million
Represented **Siguler Guff** in the formation of Small Buyout Opportunities Fund IV, which closed at $1.575 billion	Represented **Thomas H. Lee Partners** in the formation of THL Automation Fund, which closed at $900 million	Represented **The Vistria Group** in the formation of Vistria Fund III, which closed at $1.11 billion	Represented **Welsh, Carson, Anderson & Stowe** in the formation of a joint venture with Humana's Partners in Primary Care	Represented **Wynnchurch Capital** in the formation of Wynnchurch Capital Partners V, which closed at $2.277 billion

NOTABLE TRANSACTIONS

Represented **Advent International** in its acquisition of Forescout Technologies

Representing an affiliate of **American Industrial Partners** in the pending sale of Gerber Technology to Lectra S.A.

Represented **Aquiline Capital Partners** in its investment in Elm Street Technology

Represented **Arsenal Capital Partners** in its acquisition of BresMed Health Solutions

Represented **Audax Group** in its acquisition of Kofile

Represented **Avista Capital Partners** in its acquisition of Xifin

Represented **Bain Capital** in its acquisition of Showa Aircraft

Represented **Baring Private Equity Asia** in its acquisition of Lumenis

Represented **The Carlyle Group** in the sale of Hermes Transportes Blindados to affiliates of CVC Capital Partners

Represented **CCMP Capital** and the parent company of **The Hillman Group** in the merger with Landcadia Holdings III, a SPAC

Represented **Cove Hill Partners** in its acquisition of Kalkomey Enterprises

Represented **GHO Capital** in its acquisition of Envision Pharma Group

Represented **GI Partners** in its acquisition of Clinical Ink

Represented **H.I.G. Capital** in its investment in SMTC Corporation

Represented **Harvest Partners** in its acquisition of a majority interest in Galway Insurance Holdings

Represented **Intermediate Capital Group** in its acquisition of a minority stake in Workhuman

Represented **Kohlberg & Company** portfolio company **Sara Lee Frozen Bakery** in the acquisition of Cyrus O'Leary's Pies®

Represented **Monomoy Capital Partners** in its acquisition of Astro Shapes LLC

Represented **New Mountain Capital** in its acquisition of Inframark

Represented **Partners Group** in its acquisition of a major equity stake in Rovensa

Represented **TPG Capital** and its portfolio company **TE Asia Healthcare Partners** in the add-on acquisition of Beacon Hospital

Represented **TPG Capital** in its investment in DirecTV with AT&T

Represented **TSG Consumer Partners** in its acquisition of Pathway Vet Alliance

Represented **The Vistria Group** and **Excellere Partners** in the investment in SCA Pharmaceuticals

Represented **Welsh, Carson, Anderson & Stowe** in the sale of a 49% stake in InnovAge to Apax Partners

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