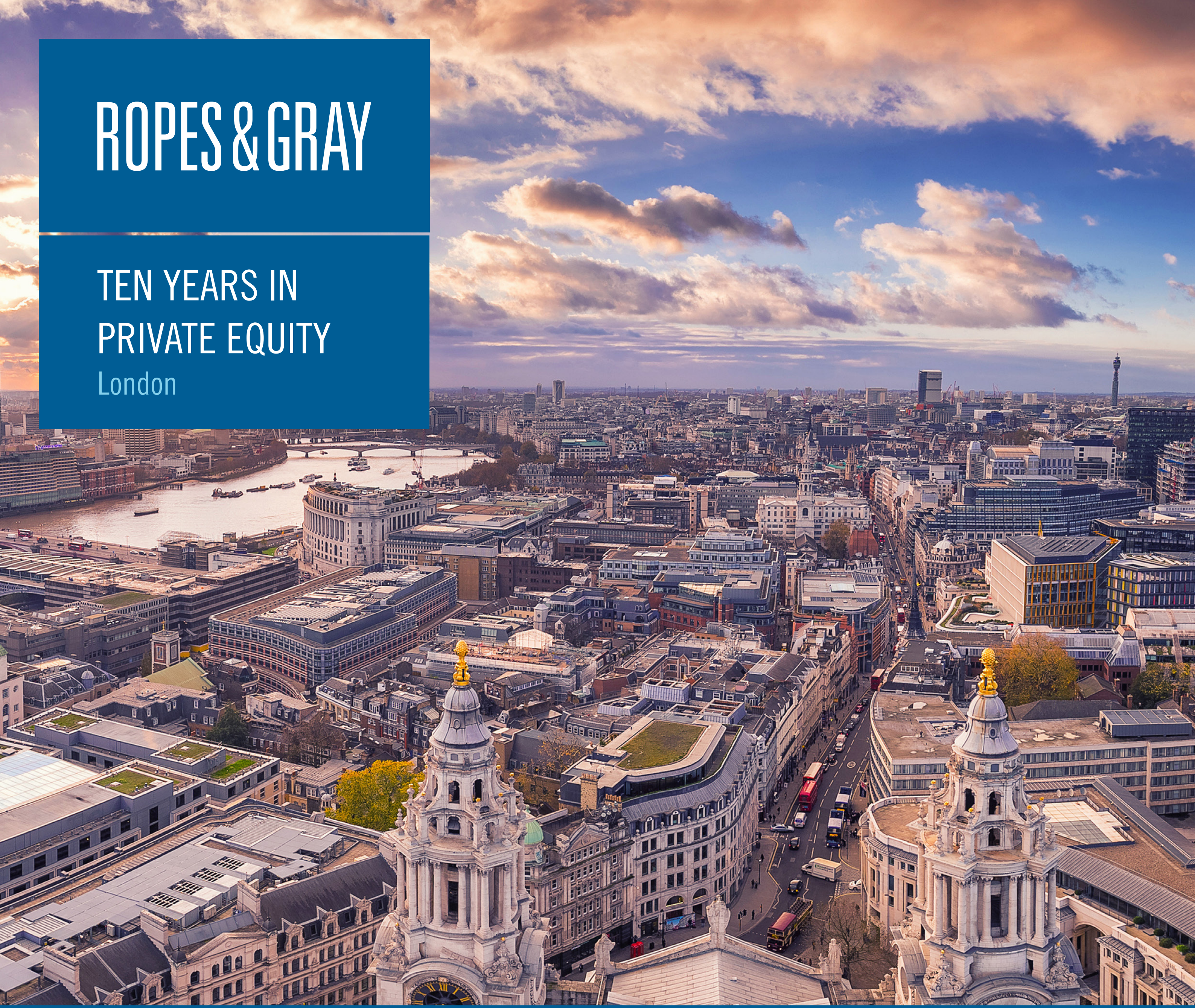
ROPES & GRAY

TEN YEARS IN PRIVATE EQUITY

London



10 YEARS IN LONDON

155 YEARS STRONG

TEN YEARS IN PRIVATE EQUITY

To mark our ten year anniversary in London, the private equity team reflects on ten developing themes since 2010, and provides bold forecasts and predictions for the decade to come.

TIPPING POINT FOR ESG

The industry is at a tipping point for authentic ESG action

With so much recent focus on geo-politics – Brexit, populism and trade wars – it is easy to be surprised by the developments in corporate and investor responsibility over the last decade. These, ultimately, may have a more fundamental, enduring impact. 2008 left many questioning pure capitalism, 'homo economicus' and the lack of global corporate responsibility. This – and the growing concern over the climate and environment – is leading to a profound change; agreed standards on corporate responsibility, a greater dialogue over stewardship, investor prescription, and the emergence of environmental, social and governance accreditation bodies, such as the B Corp process and PRI. As one PE GC succinctly put it: "We're spending other people's money. Of course ESG is now front and centre of our job."

The cynics ask about the resulting actions. From our conversations with the market, we believe it is at a tipping point. Not only will every PE portco be analysed by ESG criteria, we believe ESG stewardship will come to the forefront of our industry's argument for purpose.

CLEAN BREAK

SPA terms have shifted to the benefit of sellers

Across Europe, and now increasingly in the US, deals are being structured with a reduced level of risk sharing between the seller and the buyer. Locked Box mechanics facilitate diligence – diligence not financial recourse is now the buyer's primary source of comfort. This is in part due to the M&A market terms being impacted by private equity exits – and the desire of PE sellers to avoid recourse. The buyer market has needed a white knight and over the decade this has come in the form of warranties and indemnity insurance, which we cover below.

Will this trend last? Yes, we believe it will. An almighty correction will be needed in the way businesses are sold for the clean break to the broken.

WHITE KNIGHT

The white knight proving its worth

From niche to ubiquitous in a decade. From a mere handful of insurers – and even fewer brokers – to 25 W&I underwriters and managing agents looking for USPs and white knight status. USPs both in terms of price (although premiums currently settled at c.1% (RoL)), retention (0.25% tipping to nil in some cases) and ease of process. USP combat on legal terms too: knowledge scrapes, 'phantom' tax covenants, alternative loss regimes and non-disclosure of buyer diligence and data rooms, to name a few.

The big question for many buyers remains: Is it worth it?

Cognisant of this scepticism, insurers and brokers have started publishing their claims data, as have some PE houses. Continuing with this open approach will be crucial to answering the question of worth. Perhaps more cumbersome will be the next challenge – to reduce the time and cost spent on diligence while maintaining a sensible scope of cover. The 'wasted' cost of a policy involves the time spent diligencing non-critical matters.

Having benefited from some serious growth over the past decade (c.35% p.a. based on number of policies placed, c.300 in 2011 to 3,200 in 2018 Aon Report 2019), the signs are that the product is now here to stay.

WORTH THE PAPER IT'S WRITTEN ON?

The value of Legal VDD is rightly questioned

Have we come a full circle on legal vendor due diligence (VDD)? It has become commonplace during the previous decade, but many buyers (particularly in the US) have remained cynical about it. Towards the end of the decade fewer helpful legal VDD reports are being provided in auctions and our analysis suggests legal VDD actually adds to the cost of legal process.

We predict legal VDD will fall out of fashion except in particular circumstances where businesses are more legally complex and such a report can genuinely help buyers understand the business more accurately and more quickly. For most deals, a comprehensive legal Q&A in the data room will become sufficient.

MANAGING MANAGEMENT

The negotiation of the management terms has become more sophisticated – and this is a good thing

The management term sheet and the role of management advisers, both financial and legal, has become a feature of the European private equity market – and rightly so. Management are critical to success, and it has to be right that they are advised in what is being sold to them as their 'life changing' opportunity. Has the advice led to significantly worse deals for private equity clients? In our view, No. It has more often ensured that the specialist-led negotiations are more consistent (advisers know the market) and that management teams are not inadvertently prejudiced. We do not believe equity terms have become more management friendly. Indeed, leaver provisions have, if anything, become more sponsor friendly.

Our prediction is that the management adviser role as facilitator will grow further in the next decade, in Europe and in the US market.

BUY, BUILD, SELL

Whilst the industry will continue to drive organic growth in its portfolio, getting the buy-and-build strategy right may be the difference between winning and losing

Search 'PE Buy and Build' and be struck by the headlines containing words and phrases such as 'boom', 'the New PE Model' and 'a strategy of the times'. This is reflected in our clients' portfolios. It is perhaps an inevitable consequence of an economic environment where exponential organic growth is rare. We believe the trend will run unabated over the decade to come, but challenges will appear as these consolidated businesses are sold. Are the businesses properly integrated? In an age when the 'cultural' strengths and conformity of businesses will deliver value and mitigate risks, will the buy and build generation sell well?

Our prediction is that the industry will focus more on the management challenges around a consolidation strategy and look to more holistic approaches across portfolios.

DEBT FUNDS

The availability of the flexible debt solutions continues to grow

Debt leverage is fundamental to the PE business model, and debt markets have evolved rapidly to meet GP demand whilst conforming to ever-changing regulation.

The rise of private debt funds has been a defining feature of the last decade, and AUM in that asset class continues to grow strongly. Debt funds are now typically the debt providers of choice to midcap PE deals, and the role of banks is now largely limited to working capital facilities or a debt underwrite for large cap transactions (broadly, those which require $350m or more of debt) which is then distributed in the CLO and institutional market. We expect debt funds to continue to expand, and to raise ever-larger funds, but it may be that IRR expectations need to be recalibrated in the longer term if supply outstrips GP demand. The weight of debt capital that is seeking a yield has allowed GPs to demand flexible, cost-effective terms from their debt providers, and we see nothing to suggest that this trend will weaken in the short term. Traditionally, only a recessionary correction has allowed the pendulum to swing back in the lenders' favour.

Debt is now seen as a tool capable of meeting a variety of needs beyond deal-related leverage, and in particular is used within fund structures to bridge LP commitments and, in some instances, to enhance LP returns. We expect that trend to continue, and that GPs will continue to evolve their reporting standards to ensure that LPs have a clear picture of underlying fund performance.

Every GP has unique requirements, be they driven by LP demands or by the nature of the assets in the fund's portfolio.

We predict that the debt markets will keep pace with sponsors, and innovate as the private equity sector continues to mature.

REGULATION

A game-changing decade for private equity

Regulation for private equity managers has evolved significantly over the last decade. In particular, the Alternative Investment Fund Managers Directive (AIFMD) really was a game changer for many in the industry. This EU rule altered the regulatory landscape and required substantial adjustments for many managers across the global market. Changes include increased capital requirements and the introduction of obligations which firms hadn't previously been subject to, such as rules on remuneration, valuation, leverage, liquidity and risk management. AIFMD has also fundamentally changed how funds are marketed, having a great effect on both European and non-European managers.

Other relevant developments include the introduction of – or changes to – rules on individual accountability, culture and governance, financial crime, sustainability, investor protections and product governance. These and other developments mean that regulation has to be a key agenda item for firms' senior management.

Looking ahead to the next decade, we predict that whilst it is unlikely we will see another change as dramatic as AIFMD, there will be little slowdown on regulatory issues firms need to grapple with. And Brexit will likely complicate the position even further.

DATA

The regulation of data protection will keep moving

Personal data and cyber security are now firmly at the top of the corporate, public and government agendas in ways that would have been unthinkable in 2010. And for the PE industry, data and cyber considerations have gone from after-thought to red flag, particularly in the diligence of tech, pharma and retail targets.

The risks, opportunities and challenges facing businesses in the use and security of data will also continue to evolve in the coming decade, with increasing extra-territorial regulations and the exploitation of data in ever-more novel ways.

We expect the penalties for poor data protection – be they regulatory fines, class action claims, or reputational damage – to have greater material impact on both the operation of businesses as well as enterprise value.

Regulators are now taking failures in diligence or early remediation of known issues into account when calculating fines. Whilst this approach has primarily been adopted in the context of data breaches, it is likely to broaden to a much wider range of data-related failings in the near future.

This, we predict, creates a long tail risk impact on the value of investments or the timing of exit.

ANTITRUST

Antitrust in the 2020s will remain a vital consideration for private equity firms

In merger control, private equity firms will continue to face an ever-expanding array of approval requirements (and foot fault fine exposure) and lengthier approval timelines, as the trend towards proliferation of agencies continues. We expect those agencies to continue to scrutinize transactions using traditional and non-traditional theories of harm, including theories that focus on the impact of minority stakes on incentives to compete, which may implicate Limited Partners and institutional investors, largely at the behest of certain high-profile academic professors.

Private equity is also likely to pay attention to the increasing role and prominence of the UK's Competition and Markets Authority in merger control, not only as a result of Brexit, but also because of its current enforcement and intervention/challenge policy, including for closed transactions. The challenge rate for transactions that go to Phase II is now at the highest levels since the early 2000s and that seems unlikely to change in the near future.

Some antitrust agencies have a set idea about private equity when it comes to their suitability to buy divestiture assets. Simply speaking, there is a presumption that the industry uses unduly high levels of debt and has a short-term outlook, making it an unsuitable buyer in many cases. But it remains to be seen whether these presumptions can be challenged in appropriate cases.

In antitrust, sophisticated private equity firms are now largely familiar with the Prysmian jurisprudence and know that it is incumbent on them to ensure that portfolio companies have effective antitrust compliance programs in place (with the risk of director disqualification and criminal sanction if things go wrong). But throughout the 2020s, private equity will need to be alive to new fronts, as agencies investigate novel abuses, expand the boundaries of impermissible information exchange, explore the impact of hiring and non-solicit policies on senior management and key employees, and investigate techniques – such as algorithmic pricing – that companies use to improve efficiency.

RISK MANAGEMENT COMES TO THE FORE

Risk management has gone through major developments over the last few years. This is sure to continue over the next decade

While self-regulation within corporates and industries – giddy with ESG zeal – will increase, the risk of non-compliance with often extra-territorial regulation has grown tremendously over the decade. Note in particular the inevitable rise of initiatives designed to produce a more diverse and representative workplace and the 'why has it taken so long?' policies arising out of #MeToo.

We predict it will continue to dominate the dialogue between GCs and their international counsel. Below are a number of the focus areas.

- **Speak up – and listen**

  Organisations subject to recent enforcement usually either excluded legal and compliance from key decisions, or outright ignored their concerns. In some cases, employees knew about but did not raise serious issues. This underlines a crucial aspect of a healthy culture: firms must not only set clear standards for conduct, but also seek to build a 'speak up' culture which empowers employees to raise concerns and responds to them.

- **Tone and behaviour to strengthen anti-bribery and corruption compliance**

  Corruption is often correlated with other ESG failures, such as environmental damage and human rights violations, where bribes are paid to win business or skirt regulations. 'Tone from the top' has long been recognised as key to implementing an anti-corruption culture, but it is not only what is said, it's the messages leaders send through behaviour that makes the difference.

  Earlier this year, the Serious Fraud Office published guidance on evaluating compliance programmes. It reiterated how a 'bonus culture' can encourage poor behaviour and suggested companies regularly evaluate programme effectiveness. In the US, in its 2019 guidance, the Department of Justice gets more specific, suggesting companies 'seek input from all levels of employees' to determine whether a compliance culture is working.

- **Sanctions risk to broader financial crimes**

  The US implements sanctions on narcotics traffickers and 'Magnitsky sanctions' (named after Russian lawyer, Sergei Magnitsky, who died in prison after alleging fraud against local officials) against those suspected of human rights violations and corruption. Both the UK and EU have announced their own plans to implement Magnitsky-style sanctions. The expanded scope of sanctions and lessons from combined AML/CFT/Sanctions enforcement makes it clear that sanctions risk must form part of a broader compliance programme.

- **Behavioural science and compliance culture**

  Because risk is – and is increasingly perceived to be – inextricably linked to underlying issues with culture, we predict much more focus on the cultural aspects of risk management, and away from the more tick-box, two-dimensional approach. The question becomes how to make the core principles of internal communication, training, and procedures meaningfully affect culture. Behavioural science tries to understand why people make certain decisions, and we anticipate companies increasingly using lessons from behavioural science to help identify why culture goes wrong and how they can implement more effective compliance programmes.

PRIVATE EQUITY BECOMES PRIVATE CAPITAL

The industry remains full of potential. Indeed, the years since the downturn have illustrated the growth that can be achieved using a PE platform and model

Much has been said about the maturation of the private equity industry, but we believe it is only just beginning to realise its potential as a global industry. Boutique, region-focused, sector-focused private equity GPs will remain successful. However, the industry is increasingly dominated by those platforms that have already grasped the nettle of building a premium investment platform across the breadth of private capital and the decade to come will see global alternative asset managers fighting it out for AUM across a seemingly ever-broadening range of opportunities. This decade has seen an evolution of debt funds, growth funds, co-investment programmes, special situation investing and long-term capital. This widening of the bandwidth will keep shaping the industry. But – not least, with the rise of the millennials and differing career expectations – the best focused boutiques will continue to thrive.

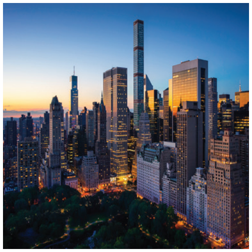
– Ropes & Gray Team

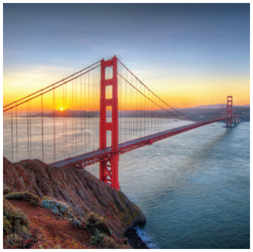

BOSTON


CHICAGO


HONG KONG


LONDON


NEW YORK


SAN FRANCISCO


SEOUL


SHANGHAI


SILICON VALLEY


TOKYO


WASHINGTON, D.C.

LONDON PARTNER CONTACTS

PRIVATE EQUITY

Helen Croke
helen.croke@ropesgray.com

John Newton
john.newton@ropesgray.com

Will Rosen
will.rosen@ropesgray.com

Phil Sanderson
philip.sanderson@ropesgray.com

Kiran Sharma
kiran.sharma@ropesgray.com

Elizabeth Todd
elizabeth.todd@ropesgray.com

PRIVATE EQUITY REAL ESTATE

David Seymour
david.seymour@ropesgray.com

FINANCE

Robert Haak
robert.haak@ropesgray.com

Malcolm Hitching
malcolm.hitching@ropesgray.com

Michael Kazakevich
michael.kazakevich@ropesgray.com

Aditya Khanna
aditya.khanna@ropesgray.com

Alex Robb
alexander.robb@ropesgray.com

Jane Rogers
jane.rogers@ropesgray.com

Carol Van der Vorst
carol.vandervorst@ropesgray.com

ROPES & GRAY

© 2020 Ropes & Gray LLP. All rights reserved. Prior results do not guarantee a similar outcome. Communicating with Ropes & Gray LLP or a Ropes & Gray lawyer does not create a client-lawyer relationship.

60 LUDGATE HILL
LONDON
EC4M 7AW
ropesgray.com