Debevoise & Plimpton

2018 Private Equity Midyear Review and Outlook

Given how 2018 started—the changes brought by the Tax Cuts and Jobs Act, implementation of the revised Markets in Financial Instruments Directive (MiFID II), and with M&A and fund financing on fire—it is no surprise that the first half of the year has been a dynamic one for private equity. As we look ahead to its remaining months, a number of key themes stand out, including the continued record level of dry powder in fundraising, the increased use of subscription lines, competition for M&A deal flow, the Brexit-proofing of funds in Europe, and the Securities and Exchange Commission's focus on fiduciary duty. Here is a look at how 2018 shapes up across the PE landscape.

Tax

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We noted at the end of last year that the Tax Cuts and Jobs Act would create significant change in the US tax system. The corporate tax cuts and the tax incentives to invest in the United States brought about by the Act have no doubt stimulated the economy. However, many of the new tax provisions remain obscure or uncertain and the IRS has limited resources with which to provide guidance. The IRS has promised to issue more complete regulations prior to the start of the 2019 tax filing season. Tax practitioners will want to stay alert as guidance trickles in. The upcoming Summer Issue of the Private Equity Report will be dedicated to discussing the key areas of the Act and how they impact private equity in particular.

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There were over 475 private equity funds that held a final closing in the first half of 2018, collectively securing over $173 billion in capital commitments. While these numbers are slightly off the same period last year—one of the most successful years for private equity fundraising since the financial crisis—the trend is still quite positive: Nearly 80 percent of the funds that closed in the first half of 2018 achieved or exceeded their target and 60 percent were on the road for twelve months or less.

The fundraising market remains exceptionally competitive. With a record 3,037 private equity funds in the market at the start of the third quarter, current private equity fund investors have a wide variety of investment options. Only about 44 percent of the private equity funds in the market at the start of the third quarter of 2018 were North America-focused, compared with over half at the start of the third quarter in 2017. There has been a notable increase in Asia-focused funds, which accounted for about one third of the funds in the market in July 2018 as compared to only 19 percent twelve months earlier. This year has also seen an increased level of activity for growth funds and venture funds. Buyout funds, however, have seen a drop-off; the second quarter of 2018 only had 38 buyout funds reach a final closing, raising aggregate capital of $42 billion, well below the five-year historical quarterly average of 67 buyout funds raising $67 billion of aggregate capital.

The record accumulation of dry powder over the past several years continues in 2018, reaching $1.07 trillion in the second quarter. Buyout funds and venture capital funds account for the majority of this stockpile (59 percent and 19 percent, respectively), followed by growth (17 percent) and other private equity funds (5 percent). Sponsors have been active in putting this dry powder to use. During the first half of 2018, there have been over 2,300 private equity-backed buyout deals with aggregate deal value of $239 billion and over 7,000 venture capital deals with aggregate deal value of $125 billion. Given the amount of dry powder still to be deployed, we expect deal flow for the remainder of 2018 to stay robust.

Fund Financing

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In 2018's buoyant fundraising market, the use of fund-level subscription lines by private equity funds is becoming increasingly popular. Historically, many of these facilities have been relatively small in absolute money terms, but the flexibility they provide sponsors (and their investors) has led to an increase in both their prevalence and size.

Similarly, the increasing use by sponsors of separately managed accounts has led to the development of fund-level debt finance for single-investor funds. However, "funds of one" present a different risk analysis for lenders than co-mingled funds, given the increased exposure lenders have to a single investor. To address this, lenders typically look for assurance directly from that single investor that it will fund capital calls in order to repay fund level debt. As long as the investor is comfortable with, and recognizes the benefits of, a subscription line for its separately managed account, the structuring nuances are not typically an issue.

Given the increasing size of the fund financing market, market participants are placing greater focus on the core of the lenders' collateral package: The contractual relationship between a fund and its investors and, in particular, the investors' obligation to contribute capital when called to do so. It is increasingly important that partnership documents and side letters agreed with investors are negotiated on terms that will bear scrutiny from lenders, so that there are no issues for lenders to provide a subscription line financing should the need arise.

M&A

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On the heels of a relatively robust 2017, we have seen private equity M&A deal volume accelerate further in the first half of 2018. The Tax Cuts and Jobs Act resolved lingering uncertainties regarding tax reform, and the gradual increase in interest rates has proven to be manageable. With financing still readily available on generally attractive terms and dry powder plentiful, sponsors' ability to respond quickly and decisively to opportunity has become a differentiating factor in competitive auctions. To that end, we have seen full equity backstops become more common, as well as sponsors' willingness to do "no survival" deals backed entirely by representations and warranties insurance, even with corporate sellers. Competition among underwriters in a robust RWI market has kept rates relatively low and aided this latter development.

With these elements in place, we expect auctions for attractive assets to remain competitive and deal volume to remain high for the remainder of 2018.

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The Securities and Exchange Commission (SEC) continues its scrutiny of private equity managers' disclosures relating to fee and expense allocations and conflicts of interest. In the past several months, the SEC has brought cases in which it alleged that private fund advisers failed to offset fees as required by fund governing documents and failed to provide pre-commitment disclosure regarding the receipt of accelerated monitoring fees. While not new issues, these actions make clear that the SEC is continuing to bring enforcement actions against private equity managers for allegedly inadequate disclosures.

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It is fair to say that during 2018, the primary focus of the Securities and Exchange Commission (SEC) in the investment management area has been on retail investors. For example, in a major initiative in April, the SEC proposed a new rule that would impose an obligation on broker-dealers to act in the best interest of their retail customers. In addition, the SEC proposed a new Form CRS, which broker-dealers and registered investment advisers will be required to deliver to their retail customers, that will provide a brief relationship summary to inform retail investors about, among other things, the relationships and services the firm offers and specified conflicts of interest.

As part of this effort, the SEC issued proposed interpretative guidance regarding the standard of conduct for investment advisers and the fiduciary duty that an investment adviser owes to all—not just retail—clients. While certain aspects of this guidance clearly are consistent with current law, other elements raise significant concerns that the SEC is proposing an interpretation that goes beyond the common understanding of an investment adviser's fiduciary duty under the Investment Advisers Act of 1940. In particular, the guidance appears to raise a question concerning the efficacy of addressing conflicts of interest through disclosure in certain circumstances. The SEC requested comments on ways in which investment adviser regulation could be enhanced, such as through financial responsibility requirements. It is likely that this initiative will be subject to significant comment and criticism.

The SEC's recently published regulatory agenda may suggest that the SEC will begin to focus on ways in which unnecessary regulatory burdens may be reduced on private fund managers. For example, the SEC's Division of Investment Management may consider recommending that the SEC propose amendments to the Investment Advisers Act's advertising rule that would address provisions that have imposed unnecessary burdens on private equity fund sponsors. However, certain reforms that would benefit private fund sponsors (such amendments to Form PF and the Advisers Act custody rule) did not appear on the agenda, so the Commission's timing for them is unclear.

One additional regulatory development is worth noting. At the beginning of June, the SEC and other federal financial regulators (including the Federal Reserve Board) proposed amendments to the Volcker Rule regulations. The agencies seek comments on whether the scope of funds subject to the Volcker Rule should be "further tailored and exclude certain additional types of funds." It remains to be seen whether changes will be made to provide more flexibility for financial institutions seeking to sponsor or invest in private equity funds.

European Regulatory

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For many European and international private equity firms, the beginning of 2018 was dominated by their final preparations for MiFID II—Europe's new regulatory rulebook for investment firms—but it didn't take very long before GDPR replaced MiFID II as the number one priority for compliance teams. This pan-EU data protection regulation required significant changes across the business, including internal policies and procedures, contracts with customers and suppliers, and marketing mailing lists and customer databases—not to mention the internal training needed to support these developments. Undoubtedly these are two projects that firms will be pleased to see the back of, although changes to Europe's anti-money laundering rules—including registers of beneficial ownership of private companies—also had to be digested.

Most people now think that the chances of a disorderly "cliff-edge" Brexit (without a transitional period) in March 2019 have increased and are making sure that they are as ready for the outcome as it is possible to be. Firms that need an EU structure for their fund are getting on with implementing their Brexit-proof structure. So far, Luxembourg has been the big winner in this regard, although Ireland is also emerging as a popular choice. While Ireland still lacks a limited partnership option to match that of the UK and Luxembourg, its low corporate tax rate and cultural ties with the UK and the US have made it worth considering.

In the UK, the government remains busy trying to improve transparency and governance standards. Unfortunately, some of the proposals published so far this year are ill-thought out and worrying for British private equity firms. Proposals to change UK limited partnership law, a new corporate governance code aimed at large private companies and changes to insolvency law for those who try, but fail, to rescue a business are among the issues that have made headlines.

With all of these regulatory changes in the mix, the second half of the year is likely to prove to be at least as challenging as the first, for better or worse.

Business Integrity

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In the United Kingdom, the corporate governance of large private companies has been a hot topic for some time, but we now have some concrete reforms that will have a direct impact on the private equity sector starting next year. Many portfolio companies will be required to start explaining to the outside world how they achieve effective engagement with their key stakeholders—especially the workforce—and "very large" companies (which includes any UK company with more than 2,000 employees, or which exceeds certain financial thresholds) are being encouraged to adopt a new Corporate Governance Code drafted specifically with private companies in mind. Beginning next year, those companies will be required to say whether they apply a corporate governance code and, if not, to explain why. The expectation is that most will adopt the new Code, named the *Wates Corporate Governance Principles,* after the Chair of the group that produced it. The Wates Code, drafted by a coalition of experts and representative bodies—including the UK private equity trade body, the BVCA—lays out six core principles and provides reasonably detailed commentary on each. It is likely to result in many firms reviewing, and possibly upgrading, the board structures in place in their portfolio companies.

Meanwhile, the European Commission is actively consulting on ways to encourage private equity funds and other asset managers to consider sustainability issues as part of their decision-making process. Although arguably already the case, it is likely to become even clearer in the near future that a manager's "fiduciary duty" includes a requirement to consider material environmental and social risks, and investment managers will be required to explain—to investors and the outside world—how they comply with that obligation. They will also have to make efforts to discern the preferences of their investor base as regards such issues, and the Commission is also developing a "taxonomy" to assist in the classification of sustainable investment products in an effort to make them more accessible to prospective investors.

Investors into private equity and venture capital funds have continued to demand that their portfolio funds are focused on business integrity issues, and industry-specific guidance and toolkits have proved helpful to many GPs that are seeking to meet evolving investor demands. In that regard, a recent publication by the UN PRI, *ESG Monitoring, Reporting and Dialogue in Private Equity*, offers a useful framework and seems likely to facilitate GP/LP conversations.