

2018/2019 Private Equity Year End Review and Outlook

Introduction

Private equity made another strong showing in 2018, limited only by the fierce competition for deals. To find opportunities while maintaining discipline, funds have gotten creative—through roll-up and add-on strategies, in the financing arrangements they offer acquisition targets, and in increased interest in new markets, such as impact investing.

While markets have continued to be largely positive, some challenges emerged on the tax and regulatory fronts. US investors and funds have been busy digesting the implications of the Tax Cuts and Jobs Act, while in the UK, a number of favorable tax strategies have been narrowed or eliminated and the Brexit drama finds new ways of prolonging itself.

In our 2018/2019 Private Equity Review and Outlook, we offer perspectives on these and other events, and what our private equity clients should be thinking about as we head into the new year.

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The private equity fundraising market remains strong after 2017's record-breaking activity levels. Through the third quarter of 2018, there have been nearly 800 fund closings globally, raising aggregate capital of over \$300 billion. Although the figures for 2018 are unlikely to surpass those of last year, this year will almost certainly be among the more successful years since the financial crisis. Furthermore, there are no signs that fundraising activity levels will be slowing down in 2019. At the start of the fourth quarter, there were over 3,900 funds in the market targeting over \$950 billion of aggregate capital.

One of the most notable trends in the 2018 fundraising market is the rising level of capital concentration. The five largest funds currently in the market are collectively seeking approximately 20 percent of the total aggregate capital targeted globally. As of the end of September, the average capital raised per fund in 2018 was \$386 million (up from an average of \$343 million in 2017 and more than 50 percent higher than the average of \$250 million sought in 2016). Along with capital concentration, we are also seeing increasing activity in venture and growth fundraising. Although buyout fundraising continues to dominate the market (over half of the aggregate capital raised through the third quarter of 2018 was raised by buyout funds), venture and growth funds make up nearly 80 percent of all the funds currently in the market and just over 60 percent of the funds that closed through the third quarter. Venture and growth funds also account for approximately 35 percent of the aggregate capital raised this year and 40 percent of the aggregate capital currently targeted.

In addition to strong levels of fundraising activity, 2018 has also witnessed a highly active secondary market. GP-led processes, including fund restructurings, tender offers, stapled deals and other types of liquidity solutions are occurring with increasing frequency as GPs look for ways to actively manage fund portfolios while simultaneously providing liquidity options to investors. Some of the largest fund secondary transactions to date took place in 2018, with global secondaries fundraising for the year surpassing \$25 billion in November. We expect that the secondaries market will continue to thrive into 2019 as GPs continue to seek creative solutions to satisfy investor needs.

While secondary offerings can be highly effective, they also involve a number of complex elements. Debevoise has had the opportunity to help bring a number of recent secondaries to market, notably the tender for limited partnership interests in Providence Equity Partners VII; the recapitalization of Leeds Equity Partners Fund IV; and Glendower Capital's role as the lead investor of a consortium of institutional investors that provided liquidity through a novel transaction to investors in a number of Argonne Capital Group portfolio companies acquired on a deal-by-deal basis.

Fund Financing



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There are an increasing number of fund financing products on offer from an increasing number of finance providers. As fund structures become more bespoke, banks and other finance providers continue to develop sophisticated financing solutions, such as GP facilities. Non-banks are now entering the fund-level lending market.

Net asset value facilities and hybrid facilities (where the borrowing base is a combination of uncalled investor commitments and fund investments) are becoming increasingly popular and are now being raised by a range of funds – not just credit and secondaries funds, but also infrastructure, real estate and private equity funds. The terms of these types of financings remain bespoke, depending on the reason for their use, the relevant asset class, the negotiating position of the parties and the relationship between the parties.

As customized side letters between fund investors and sponsors become increasingly common, sponsors and their counsel should be aware of the impact that side letter provisions can have on any existing or future subscription financing. For example, the provisions of an investor’s side letter may preclude the uncalled capital commitment of that investor from counting towards the amount that a fund can borrow under a subscription financing or, worse still, prevent a fund from raising financing at all. Lenders have been focusing more on side letters as the fund finance market develops and becomes more sophisticated. Lenders to separately managed accounts (“SMAs”) pay even closer attention to side letter terms given their greater exposure to risk from a single SMA investor.

M&A and Leveraged Finance



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The passage of the Tax Cuts and Jobs Act toward the end of 2017 removed an overhang of uncertainty for the PE M&A market heading into 2018, and we saw another year of strong deal volume. High valuations continued to present a challenge to getting deals done, forcing sponsors to get creative. For example, we saw an increase in the use of add-ons by existing portfolio companies, allowing sponsors to capture the synergies available to strategic buyers. Portable capital structures, another 2018 trend, permitted legacy target debt to remain in place, facilitating sales without the buyer needing to access the debt markets.

For most of 2018, the debt markets were open for new issuances, with increasingly borrower-friendly terms helping to facilitate deal flow that included some of the largest deals in recent years, such as the buyouts of BMC Software, Refinitiv and Envision Healthcare. However, we also saw more contentious disputes between borrowers and activist debt investors in 2018, spurred in part by the activists' position in credit default swaps. Further, in the fourth quarter, outflows from loan and high yield funds have introduced significant volatility into the markets, presenting challenges both in terms of obtaining debt commitments and placing syndicated debt.

Time will tell whether these challenges in the debt markets persist and finally slow what for several years has been a robust PE M&A environment. However, whatever the state of the debt markets, sponsors are still sitting on a great deal of dry powder to deploy. We would bet on them continuing to be creative in figuring out how to do so, even if debt financing for traditional LBO structures is not as readily available in 2019 as it was for most of 2018. And finally, if debt market conditions turn more favorable, we expect sellers to seek to include portability provisions in financing agreements, so that their flexibility for future exits will be less susceptible to changes in debt market conditions.

US Tax



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While last year saw the passage of the much-anticipated Tax Cuts and Jobs Act (TCJA), 2018 brought a slew of guidance interpreting many of the newly-enacted measures, including several of particular interest to private equity firms. Proposed regulations were released regarding the new limitations on interest deductions, which include a broad definition of what constitutes “interest” and how partnerships and partners apply these rules. Another set of proposed regulations addressed the deduction for certain pass-through businesses on their qualified business income, clarifying which types of businesses are eligible for the deduction and how the limitations based on W-2 wages and tangible investment will apply. Firms investing in real estate noted the designation by the IRS of Opportunity Zones throughout the United States and the release of proposed regulations that allow taxpayers to defer, and in some cases eliminate, gain.

In the international tax arena, the TCJA moved the US away from a worldwide tax scheme to a territorial system, under which (i) significant US shareholders of foreign corporations are required to pay tax on all prior non-repatriated earnings and profits (E&P) from those foreign corporations, but at reduced rates and with the option to spread the payments out over eight years, (ii) E&P may now be repatriated without US tax and (iii) a new “GILTI” regime was added to currently tax US shareholders of controlled foreign corporations (CFC) on E&P that exceeds a baseline return measured from a CFC’s tangible investments. Several of these new international rules were clarified through proposed regulations, including rules for calculating the new GILTI inclusion and its interaction with the foreign tax credit rules. Still more proposed regulations were released to clarify the operation of the deduction for GILTI and its counterpart, “FDII,” which aims, through a reduced tax rate, to reward investment in intangible property housed in the U.S. Treasury also released proposed regulations interpreting the new BEAT rules and provided a sensible proposed rule that effectively neuters the reach of the section 956 rules (i.e., the rules that frustrated lenders from getting foreign subsidiary guarantees and foreign stock pledges).

Of particular concern to private equity fund sponsors is the change to the CFC attribution rules that effectively converts almost all foreign corporations to CFCs. This is troublesome for US individual investors that have a GILTI inclusion because, while the GILTI rules include reduced rates and foreign tax credit offsets for US corporations, neither of these favorable provisions apply to US individuals. While there has been discussion in Congress to “fix” the CFC attribution rule through legislation, the Treasury has yet to signal that it will address this issue in regulation or other guidance.

Foreign investors in US partnerships saw some relief in the saga of the now-overturned *Grecian Magnesite Mining* case in the form of an IRS Notice. The Notice provides a safe harbor from withholding upon the sale of an interest in a partnership engaged in US business in the event that either the foreign seller or the partnership can make certain certifications about the income of the partnership or its assets. Additional proposed regulations in this area are expected shortly and may correct many of the Notice’s weaknesses. Tax exempt investors were also offered a new safe harbor in a Notice clarifying that, for purposes of calculating UBTI under new rules requiring losses from separate unrelated trades or businesses to be basketed, certain investment activities, including passive investments in partnerships, may be treated as a single business and the losses of one investment in a partnership may be used to offset gains from another.

US Tax (Continued)

Treasury and the IRS should be commended for issuing necessary guidance interpreting the TCJA in a relatively short period of time. However, there has been virtually no guidance on the unfavorable rules that convert carried interest on investments held for less than three years to short-term capital gain. Private equity sponsors have been left to their own devices in attempting to interpret how these provisions work and whether certain strategies can be used to minimize their impact. Guidance in this area may be issued in 2019.

Next year promises to be a busy one on the tax front as private equity firms and their advisors work to digest these many proposed regulations and other guidance and assess the impact to their businesses. The passage of the TCJA helpfully removed uncertainty regarding tax reform and includes a number of attractive stimulus measures and ways to optimize tax structures. But it also brings potential pitfalls that need to be considered when sponsors are structuring their deals and financing.

UK Tax



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Private equity firms that invest in the UK, have UK-based fund structures or have principals who are UK resident will face some combination of increased complexity, uncertainty and liability in their tax affairs by virtue of rules proposed by the UK Government in summer/autumn 2018.

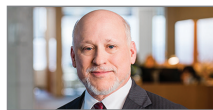
Starting next April, non-UK resident investors and holding vehicles in fund structures will become subject to UK capital gains tax on both direct and certain indirect disposals of UK real estate. Fund managers will need to swiftly react to this change, which brings the UK in line with most onshore jurisdictions, as there will be no “grandfathering” of existing structures. Careful planning will be required to ensure that pension plans, sovereign wealth funds and other tax-exempt investors do not bear additional tax liabilities and to avoid tax liabilities on a single disposal arising at multiple layers in a holding structure. Investors will be watching closely to see how fund managers handle these exposures. Separately, fund managers ought to assess how these rules will affect the taxation of their carried interest returns from UK real estate investments. The final rules are expected to be published in the next few weeks, with guidance to follow in early 2019.

In a blow that will be felt most acutely by UK resident senior managers of portfolio companies, the eligibility criteria for entrepreneur’s relief have been significantly narrowed. This relief, which can reduce a seller’s effective UK capital gains tax rate on the disposal of an interest in a trading business from 20 percent to 10 percent, now requires the seller to hold a 5 percent real economic interest in a relevant company within the portfolio group, in addition to the previous, more easily satisfied requirements of holding a 5 percent interest in both the voting rights and share nominal value. Furthermore, the period for which the economic interest, voting rights and share nominal value must be held prior to a disposal has been increased from one to two years. These changes were effective for disposals from November 2018 onwards, with no “grandfathering” of existing structures.

The UK Government will not be introducing new laws to help GPs overcome certain obstacles to using losses from prior periods, it has confirmed after an ultimately unfruitful dialogue with the UK private equity industry. Following the introduction of new UK tax rules in 2017, carried forward losses can now only offset a maximum of 50 percent of profits (above a £5m *de minimis*) in a given period. This restriction is especially significant for UK GPs, whose structures have for years assumed the ability to make full use of losses that a GP incurs early in a fund’s life to offset later profits. Affected fund managers should act quickly to evaluate possible bespoke solutions to mitigate this development.

Finally—at least for the UK—new “profit fragmentation” rules are being introduced, effective from April 2019, that seek to counteract the movement of excessive business profits offshore by UK residents. Where a UK resident individual makes a transfer of value deriving from a UK business to an offshore entity and they (or someone connected to them) are able to enjoy that value while paying no, or very little, tax on it, their UK tax liabilities will be increased to counteract this avoidance. However, arrangements that are compliant with transfer pricing guidelines should not be challenged under these measures. UK resident principals who hold interests in a fund manager or funds through non-UK offshore could be caught by these rules and should review their holding structures from a UK tax perspective. The final rules are expected to be published in the next few weeks, with guidance to follow in early 2019.

US Regulatory



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The focus of the Securities and Exchange Commission (SEC), at least for the first half of 2019, will likely continue to be on retail investors. We expect that the SEC will focus on finalizing its April 2018 proposals that would impose an obligation on broker-dealers to act in the best interest of their retail customers. 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. Certain aspects of the proposed fiduciary duty guidance proved to be controversial, particularly in questions it raised concerning the efficacy, in certain circumstances, of addressing conflicts of interest through disclosure.

The SEC has previewed certain topics that might be the focus of SEC examinations in the coming year. The SEC's Office of Compliance Inspections and Examinations (OCIE) recently published a risk alert on the compliance issues relating to various forms of electronic messaging used by investment advisers and their employees. The risk alert, which reflects the result of a limited-scope or "sweep" examination initiative commenced in 2017, addresses the record retention and oversight challenges presented by personal email and text/SMS messaging platforms. We expect that this area will be a focus of OCIE examination in the coming year.

In addition, in a speech on December 13, Chairman Clayton focused on disclosures relating to sustainability and environmental, social, and governance (ESG) topics. Chairman Clayton noted that the SEC is increasingly seeing disclosure of ESG information by issuers and requests for ESG information by investors. He noted that in complying with SEC disclosure rules, companies should focus on providing material disclosure that a reasonable investor would need to make an informed investment. In the context of asset managers, the Chairman noted that investment advisers have a fiduciary duty to act in the best interest of their clients. While the Chairman seemed to be focusing on the obligations of advisers to vote on shareholder proposals relating to ESG matters, we would not be surprised if OCIE puts increased focus on ESG matters in their examinations of private fund managers.

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.

CFIUS Reform



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The year also saw the enactment of the long-awaited legislation—the Foreign Investment Risk Review Modernization Act (“FIRRMA”)—to reform and expand the process by which the Committee on Foreign Investment in the United States (CFIUS) reviews foreign investment in the United States. CFIUS review has always applied to acquisitions of control of US businesses that give rise to national security concerns. Now, FIRRMA potentially covers any equity investment, regardless of size, by a foreign person in a US business involved with “critical infrastructure,” “critical technology” or that collects sensitive personal information of U.S. citizens. In addition, under regulations that became effective in November, foreign investment in critical technologies in certain sectors, whether or not controlling, is subject to a mandatory declaration to CFIUS, not just filing a voluntary notice.

Although this expansion of CFIUS’ remit has given rise to concerns for private equity funds with foreign GPs or foreign limited partners, the effect of the expansion is mitigated in two important respects. First, a noncontrolling investment in one of those three types of businesses is covered only if the foreign person thereby has access to material nonpublic technical information, a board/observer seat, or the ability to exercise substantive decision-making authority with respect to the US portfolio company. In practice, a foreign limited partner often does not have any such rights. Of perhaps even greater significance for funds that have foreign limited partners is FIRRMA’s “investment fund safe harbor.” Investment by a foreign limited partner through a fund with a US general partner is not subject to CFIUS review if the partner is passive with respect to investment and the US portfolio company’s substantive decisions, has no access to the company’s material nonpublic technical information and has no control over the GP, though membership on the advisory committee is still possible. Investments in national security-sensitive US businesses often can be structured to avoid having to make a filing with CFIUS.

European Regulatory



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As it did last year, Brexit provided constant background noise for private equity firms in the UK during 2018, with the pitch rising as we approach year end.

Preparing for the possibility of a “no-deal” Brexit has dominated the UK regulatory agenda and has tended to crowd out other issues. The continuing uncertainty has given firms little choice but to think hard about how a disorderly departure of the UK from the European Union would affect them.

For some firms operating in the UK, the regulatory impact would be minimal: the UK made a conscious decision to “onshore” all European legislation with no substantive changes. This has been a mammoth legislative exercise, but the result is that the rulebook won’t change dramatically for UK-regulated firms, even if the UK does crash out without a negotiated deal. As for non-UK European firms that have been relying on their “passport” to access UK-based investors or to operate a UK branch, British regulators have given them time to adjust, allowing them to carry on more-or-less as normal using a “temporary permission.”

In contrast, UK-based firms that want to access European markets are up against considerable challenges. They still face significant business disruption if they lose their European passport in March, or if they have EU investors that want (for regulatory or policy reasons) an EU structure. UK-based firms have tended to respond in one of three ways. Some have been working hard to make fairly substantial changes to their structures, including establishing new offices in Luxembourg, Ireland and elsewhere in the EU. Further impetus to those efforts was given earlier this year by the European Securities and Markets Authority, when it stated that such offices in member states needed to have real substance and that delegation of all material activities to the UK will be unacceptable. Other firms have taken a more modest approach, avoiding moving staff to new offices or changing customer contracts and instead relying on contingency plans that they will implement in the event of a no-deal Brexit. Still other firms have elected to remain in “wait-and-see” mode, hoping that the UK and the EU will conclude an agreement that includes a transitional period during which nothing much changes until at least December 2020 – or even that Brexit will be deferred or cancelled.

But although Brexit has been a continual distraction, it has not been the only issue keeping firms busy in 2018. MiFID II – heralding significant changes for many European asset managers – created a compliance headache at the beginning of the year, quickly followed by the substantial work generated by GDPR compliance.

As for 2019, all UK-regulated asset managers will need to turn their attention quickly to the Senior Managers and Certification Regime – SMCR, an acronym that may become as familiar to private equity firms as GDPR. Banks and insurance companies in the UK have already had to grapple with these new regulations, and all other UK firms will have to do so by December 2019. SMCR will be an important change because it will require a small number of senior managers to explicitly accept responsibility to the UK’s Financial Conduct Authority for different aspects of the firm’s business. It is intended to make individuals more accountable for shortcomings in the firm and will re-focus some minds on how their regulated businesses are governed and controlled. Although designed for large financial services organizations, the FCA is confident that it is fit for the purpose for all types of asset managers, including subsidiary UK offices of US private equity firms.

European Regulatory

(Continued)

For the EU, perhaps the most significant development in 2019 (Brexit chaos excepted) will be the European Commission's attempts to make sustainability a factor in investment decisions not just for "green" funds but for all EU regulated investors, including pension funds, insurance companies and alternative asset managers. The final shape of those rules is not yet clear, but they are a priority for European policy-makers responding, among other things, to obligations in the Paris Agreement to reduce carbon emissions.

This year finally brought some good news for those seeking to market funds in the European Union. Since the AIFMD was implemented in 2014, the lack of harmonization between the various national rules on marketing has been a source of constant frustration. To take just two important examples: the definition of "pre-marketing"—what can be done before triggering an obligation to make a filing—differs from country to country, as does the meaning of "reverse solicitation." But the European Commission is responding and the signs are that it will do so in a helpful way, by harmonizing the pre-marketing definition following some sensible principles. However, firms should beware: the harmonized rules are not yet settled—and could still result in stricter conditions for pre-marketing that currently exist in many states. In any case, they will probably preclude the use of reverse solicitation following any pre-marketing.

2019 may be the year that navigating Europe's fund marketing rules get a little easier, both for those with an EU passport, and probably also for those using national private placement regimes. Meanwhile, the scheduled review of the AIFMD itself got underway in 2018, but major changes to that regime are not expected any time soon – another reason for compliance chiefs to breathe a sigh of relief.

SEC Enforcement



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The US Securities and Exchange Commission’s (SEC) much discussed “pivot to retail” has not yet materially impacted the agency’s scrutiny of the private equity industry. The number of enforcement actions against private equity firms in 2018 remained consistent with the year prior, and the SEC’s Division of Enforcement brought a number of high-profile cases this year that confirm that the agency continues to be aggressive, particularly when evaluating disclosures and conflicts of interest. Indeed, the year concluded with two cases that alleged that fund managers had failed to adequately disclose expense allocation practices between advised funds and the manager, confirming that this issue remains a focus at the SEC that is likely to continue into 2019.

Other issues that led to SEC enforcement actions in the past year include disclosures around valuation, cross-transactions, accelerated monitoring fees, and conflicts between managers, their employees, and advised clients. For 2019, we expect continued scrutiny of these conflict issues, as well as a focus on anything potentially impacting retail clients—resulting in a heightened focus on publicly listed advisers and business development companies.

Cybersecurity and Data Privacy



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Perhaps the most significant cyber-enabled threats currently faced by private equity firms are those designed to initiate or divert wire transfers. This is typically accomplished through a phishing email to the firm itself or to a business partner or counter-party to a transaction, resulting in a “business email compromise” or “BEC.” The target is often not chosen by chance, but selected as someone identified through public sources as having authority over finances and payment functions. Once the attacker gains control of the mailbox, a common modus operandi is to look for examples of outbound wire instructions. Another variant focuses on watching email traffic to look for draft invoices. The end game, however, is generally the same – to insert oneself into the flow of communications by initiating or altering a wire, so that the destination account is one controlled by the attacker.

PE firms are also targeted by ransomware and other extortion schemes, as well as by attempts to steal investor information and other sensitive data. More sophisticated hacking groups are also interested in intellectual property into which the firm may have insight for investment purposes, as well as the timing of M&A activity. Although it is hardly a new area of information risk, insider threats continue to pose challenges in various sectors.

Business Integrity: Impact Investing



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Impact investing – investing in companies, organizations and funds with the intent to generate positive social and environmental outcomes alongside a financial return – has received significant attention recently from both mainstream investors and mainstream investment firms. Impact investing has a longer history, however, than recent headlines suggest, with roots tracing back decades to when development finance institutions played a leading role in impact investing in emerging markets.

There are several reasons why impact investing has experienced tremendous growth in the last few years. Investors are attracted to the economic potential of the expanding global middle class; many recent impact funds have a consumer focus and target investments in companies that provide essential services such as healthcare, energy and financial services to underserved markets. Furthermore, impact investing is viewed as a crucial competent in achieving the United Nations’ Sustainable Development Goals (the “SDGs”), which were released in 2015, since there’s an acknowledgment that governments and intergovernmental organizations alone do not have the resources or capacity to fund the implementation of the SDGs and the private capital coming from impact investors can help bridge the gap.

In addition to these financial and non-financial motivations for mainstream investors to explore impact investing, the industry has evolved in recent years to give investors increased comfort on issues that have caused concern. Chief among these has been the lack of a common understanding of the definition and segmentation of the impact investing market as well as how impact is to be measured.

A major development in this area took place this autumn, when the International Finance Corporation (the “IFC”) released a consultation draft of Operating Principles for Impact Management (the “Principles”). The Principles aim to provide funds and institutions with reference points for assessing their impact management systems. Among other things, the Principles call on managers to clearly define their strategic impact objectives by tying them to measurable social, economic, or environmental effects aligned with the SDGs or other widely accepted goals. And indeed, managers seem to appreciate the importance of reporting impact in a widely recognized framework; the Global Impact Investing Network reported in its most recent annual Impact Investor Survey released in the spring of 2018 that 55 percent of respondents used the SDGs to track the impact performance of some or all of their investments. In addition to providing their stakeholders with standardized data that shows tangible outcomes, benchmarking performance to SDGs also indirectly combats concerns regarding “impact washing” (that is, using the “impact” label without a true commitment to effecting positive social and environmental change), an issue that has become increasingly acute as impact investing becomes more mainstream. As discussed above, disclosures concerning ESG policies are beginning to get the attention of the SEC and other regulators.

The release of the Principles is just one of several developments signaling the maturation of the impact investing industry. Earlier this year, Debevoise formed an Impact Investing Working Group to focus our involvement and to continue to meet the needs of our clients in this area. We look forward to seeing how the industry continues to evolve in 2019 and to supporting those in the industry during this dynamic time.