This year had no shortage of headline-grabbing developments of importance to the private equity community. Tax reform in the United States will be signed into law, while the United Kingdom still faces the possibility of a “hard Brexit.” Fundraising had another blockbuster year, while fund-level financing was broadly discussed and increasingly used. And new leaders took the helm at the U.S. Securities and Exchange Commission (SEC), which now must grapple with budget cuts.

In our 2018 Private Equity Review and Outlook, we offer perspectives on the year’s key events and what our private equity clients should be thinking about as we head into 2018.

The healthcare reform debacle increased the pressure on the Republican-controlled Congress to show that it can govern and produce legislation. All eyes, then, were on the competing House and Senate tax reform bills, and a reconciled version was agreed to after weeks of negotiations. As we write, The Tax Cuts and Jobs Act has been approved by both chambers and is headed to the President. In addition to reducing corporate tax rates and providing a special deduction for business income earned by non-corporate taxpayers, the Act upends many long-standing principles of the U.S. income tax system. It will eliminate most itemized deductions, limit the deductibility of business interest expense, change the taxation of foreign earnings and cross-border transactions and introduce broad measures to mitigate erosion of the tax base.

The reconciled bill contained several elements of particular interest to private equity firms. Unfortunately, Grecian Magnesite Mining was overturned in favor of codifying the IRS position that non-U.S. investors are subject to U.S. tax on gains from the sale of partnerships engaged in U.S. business. But there was good news as well: The proposal to
tax state pension plans on unrelated business taxable income (UBTI) did not survive the conference committee, and the treatment of carried interest, which has been the subject of discussion for decades, remains mostly intact. Indeed, the provision to tax carry on investments held for less than three years at ordinary rates may bring some finality to this long-running saga.

With tax reform moving from discussion to reality, private equity firms and their tax advisors will need to carefully think through how to structure and finance deals. Because the House proposal to allow immediate expensing of business assets made it into the final bill, we will see significantly more transactions structured as asset acquisitions. While the business income deduction generally does not apply to management companies or their owners, it may provide some planning opportunities on downstream investments. Cross-border transactions will merit special attention to navigate the many tax changes made in this area. And new partnership audit rules will go into effect with the new year, allowing the IRS to collect taxes from a partnership rather than from the partners, unless a “push-out election” is made. In a welcome twist, the IRS relented on its position that the push-out election would not be available in tiered partnership structures. Welcome to a brave new world.

With $541 billion in commitments raised globally through the third quarter, 2017 is on pace to be the most successful year for private equity fundraising since the financial crisis. As demand for private equity investment opportunities remains high, sponsors increasingly have been able to raise larger funds in shorter periods of time; the average fund size has grown from $768.8 million in 2016 to more than $1 billion in 2017, while the length of the average fundraise has dropped to 13 months. This year also saw a dramatic increase in the number and size of mega-funds (including the largest buy-out, venture capital and infrastructure funds ever raised) as investors allocate even more capital to well-known sponsors with proven track records. North American and European-focused buyout funds have also seen a significant uptick in fundraising activity while fundraising for energy and real estate focused funds has remained depressed compared to years past.

With private equity dry powder reaching a record $942 billion as of September 2017, we expect deal flow to remain robust in 2018. However, the record levels of capital may result in a general slowdown in the pace of fundraising as sponsors turn their attention to sourcing deals and finding attractive investment opportunities. Investors have increasingly expressed concerns regarding sponsors’ ability to deliver consistent returns; as average fund size grows, competition for deals increases and valuations climb. Nevertheless, as of October 2017, there were more than 3,200 funds in the market seeking approximately $1.2 trillion in commitments (including 32 funds with targets of $5 billion or more). We expect to see continued growth with respect to mega-funds as large institutional investors seek to streamline their private equity holdings by directing their capital to a slimmed-down list of the industry’s most recognized firms. With 170 infrastructure funds in the market as of the start of the fourth quarter (seeking a combined $118 billion), it is also likely that 2018 will also see continued growth in infrastructure-focused funds.
This year saw broad acceptance of fund-level financing take hold. In April, Oaktree Capital Management’s Howard Marks wrote a thought-provoking piece on the pros and cons of subscription lines, fueling public debate on the topic. When the Institutional Limited Partners Association (ILPA) subsequently published guidance on use of subscription lines, there was a risk that limited partners would seek to curtail the use of those lines by private equity firms. As time went on, however, it became clear that the majority of limited partners approved of the prudent use of this type of credit facility. Indeed, the end result of the debate was greater public awareness of the benefits of fund-level finance to private equity firms and their investors, and, not surprisingly, growth in the subscription-line market.

We anticipate that the types of fund-level financing and the purposes for which financing is used will diversify in 2018. Many private equity firms currently use subscription-line facilities to bridge capital calls and reduce administration for their limited partners. Going forward, private equity firms may find it worthwhile to consider broadening their use of subscription lines for purposes such as FX hedging, letters of credit, evidencing certain funds for acquisitions, gaining a competitive advantage in auctions, managing “equalization” of investors over multiple fund closes and effecting co-investment strategies. We also anticipate broader use of hybrid NAV/capital call facilities, particularly by credit funds implementing leveraged investment strategies.

Private equity M&A activity continued at a robust pace in 2017, although deal volume dropped in many regions compared to 2015 and 2016. The reluctance of some sponsors to pull the M&A trigger was understandable—political and regulatory uncertainty, real or threatened increases in economic protectionism and high valuations made for a very complex investing environment. As we move into 2018, however, tax reform is complete and markets seem to be operating with confidence. Even though many of the 2017 storm clouds remain, including a likely increase in interest rates, we believe the imperative to deploy fund capital will propel a very active deal market in the coming year.

We expect to see sponsors continue to look for angles beyond the traditional options of taking a company private or a full acquisition LBO. Minority investments, partnerships between PE sponsors and strategics (such as the just-announced Kindred Healthcare acquisition that brought together TPG, Welsh Carson and Humana on the bid), and investments through permanent capital vehicles such as SPACS will expand the number of possible transaction structures.

Regardless of the structure, however, sector expertise often will be the key to winning deals—witness, for example, the success of many sponsors in healthcare and in financial services. (We expect focus on these specialized industries will continue to grow in 2018, particularly as sponsors become more adept at pricing in regulatory risks that may have
Previously led some to avoid these sectors.) So it is that formerly generalist private equity firms are developing industry verticals, with deep sector expertise to rival strategic players.

Of course, those strategic players aren’t sitting still. Indeed, we expect private equity firms to encounter even steeper competition for M&A targets in 2018. With the stock market on a tear, strategies have the benefit of using their own equity as acquisition currency in price battles with sponsors, in addition to the usual price benefit that comes from synergy. Robust cash reserves on corporate balance sheets—potentially augmented by tax reform—will also make strategic players more confident. Many strategies are highly motivated to pursue M&A, given the flat line of organic growth in many industries. Sponsors will also face competition from long-dated funds, direct investing pension plans and family offices that can deliver a message of long-term investing to some family-owned businesses looking for partial monetization rather than complete exit.

Private equity firms will respond to these market conditions by doubling-down on the “buy and build” strategy, with even large sponsors moving to the middle market in the hunt for platform investment opportunities in fragmented industries with roll-up opportunities. Sponsors will also look beyond proprietary opportunities to develop strategies with their advisors to win at auction. Speed, preemption, representation and warranty insurance, a compelling pitch to management and the equity (or fund-financing) backstops offered will be as important in closing the deal as the operational opportunities and value creation sponsors hope to unlock after the closing occurs.

Although Brexit dominated the European regulatory landscape in 2017, the future relationship between the United Kingdom and European Union is still unknown. Clients marketing and managing private funds in Europe are therefore reevaluating their structure and the preferences of their investors. Notwithstanding the apparently successful conclusion of Phase 1, the overall slow progress in negotiations means that everyone must be prepared for a “no-deal” outcome and a “hard Brexit” in March 2019. Regulators in the EU are anxious to prevent “letter box” operations, in which UK firms, in an effort to benefit from regulatory arbitrage, nominally relocate to the EU while continuing most of their actual functions in the United Kingdom. Going forward, we expect additional regulation to further harmonize and improve EU rules regarding cross-border fundraising available to EU fund managers.

Meanwhile, the MiFID II rulebook update takes effect on January 3, 2018, affecting many advisers, some (UK) managers in Europe and, potentially, non-EU sponsors engaging with European regulated advisors and placement agents. Many have held off on implementing the necessary changes in the hope of receiving further guidance on a set of rules (such as, for example, the manner in which certain track records have to be presented and the taping requirement) that seem ill-suited to private equity’s business model and its largely sophisticated investor base. But those hopes have gone unfulfilled—meaning unwelcome work over the holidays for quite a few.
While the first wave of private equity enforcement cases arising from the initial exams is winding down, the SEC’s examination and enforcement programs will continue their focus on private equity. (Witness, for example, the recent filing of a case against a well-known private equity firm for misallocation of broken deal expenses, as well as several other cases based on less controversial liability theories.) We expect the agency will pay particular attention to private equity firms with adjacent credit, real estate and infrastructure strategies.

Nonetheless, while there may be more of a focus on retail investors than there was under the Obama Administration, private equity firms will continue to attract the SEC’s attention. Because of this, firms must continue to maintain a robust compliance program, including measures to prevent, identify and address conflicts of interest and cybersecurity vulnerabilities. Cybersecurity will remain a point of focus for the Commission, and sponsors should keep it high on their compliance agenda. In addition, the amendments to Form ADV that became effective in October 2017 require private equity firms, especially those that also manage separate accounts, to provide more information about their business.

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However, the agency is operating under significant FY2018 budgetary constraints. The Division of Enforcement (Enforcement), which had 1,400 employees in 2016, has seen its headcount reduced to less than 1,200 employees through attrition and a hiring freeze. As a result, Enforcement staff will be more discerning in which investigations to pursue. Examination staff—including the Private Funds Unit—will fill the breach, however: New OCIE Director Peter Driscoll is formerly of the Division of Enforcement, and Chairman Clayton expects a 5 percent increase in adviser exams in FY2018 (following a 40 percent increase in FY2017), so referrals to Enforcement will not decrease anytime soon. In addition, following the Supreme Court’s determination in Kokesh v. SEC that disgorgement, like penalties, carries a five-year statute of limitation, Enforcement will press exam staff to make referrals earlier in the examination process to avoid statute issues.
Business integrity continued to be an integral part of the private equity landscape in 2017. Investors are routinely evaluating a fund’s ESG (environmental, social and governance) policy before investing and many sponsors are signing up to the United Nations Principles for Responsible Investment (UN PRI), which carries its own due diligence and reporting obligations. A growing number of fund managers are actively seeking to manage ESG risks and opportunities in the belief that doing so delivers superior returns (and academic studies seem to support that conviction). Several toolkits, such as those from Invest Europe, the British Private Equity and Venture Capital Association (BVCA), the Emerging Markets Private Equity Association (EMPEA) and the American Investment Council (AIC), have been developed over the last few years to incorporate ESG considerations at each point in the investment cycle.

Not surprisingly, the focus on responsible investing has filtered down to portfolio company governance. As explained in research published by Simon Witney of our London office earlier this year, private equity governance structures can be an effective delivery mechanism for business integrity commitments.

Of course, larger portfolio companies are also coming under independent scrutiny. In the United Kingdom, for example, a new corporate governance code for large private companies is expected in the coming year, as are further requirements for environmental and human rights reporting.