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PE Market Poised To 'Unclog' In 2024, Hopeful Attorneys Say

By **Jade Martinez-Pogue**

Law360 (January 1, 2024, 8:02 AM EST) -- Private equity attorneys are optimistic that dealmaking and fundraising are poised to pick up in 2024 as the market seemingly stabilizes after a few difficult years, pointing to the cyclical nature of the industry, which has historically shown the ability to withstand ever-changing market challenges.

After a pandemic-spurred boom in the industry in 2021, private equity activity took a plunge in 2022 and into the first half of 2023 as global uncertainty and rising interest rates brought out caution in investors. But from a historical perspective, the drop in deal activity over the past year and a half shouldn't be cause for too much concern, according to Troutman Pepper private equity partner Bruce Fenton.

"Remember that coming out of the pandemic were two of the busiest years on record for the industry in 2021-22, so while there's been a pronounced drop-off this year, it hasn't been so bad from a historical perspective," he said.

With large amounts of dry powder, which refers to the amount of unspent funds that are set aside for transactions and investments, and deal activity on the rise toward the end of the year, attorneys say that the private equity cycle is beginning to unclog.

As of the end of November, there was roughly $2.7 trillion of dry powder floating around the private equity space, up from the $2.3 trillion reported at year-end of 2022 and soaring past the $1.5 trillion reported five years ago at year-end of 2018, according to Preqin data.

"Despite the deal activity this year, there still remains substantial dry powder compared to, say, five years ago," Scott Joachim, vice chair of Paul Hastings LLP's private equity practice group, told Law360. "Capital calls are starting to pick up so we're seeing that momentum. Our hope is that heading into the first quarter of the year, the prices will start to stabilize and more deals will be transacted."

There may be optimism toward the future of the private equity space, but in order to capitalize in the new year, attorneys will need to be educated on the major trends that made their mark on the industry in 2023. Here, Law360 breaks down the trends PE attorneys should be aware of heading into 2024.

Stretched Out Fund Closings Show Need for New Investors

While fund sponsors have had varying levels of success in raising new funds over the last year, the funds that did close have taken longer to do so than in previous years. Citing Preqin data, the co-head of Dechert LLP's private equity practice, Markus Bolsinger, pointed out that the average time from launch to final close grew to 19 months, compared to the 15-month average time frame reported in 2019.

Fundraising took longer and "was more painstaking," so some of the negotiations behind fundraising were dragged out, Ken Rosh, head of Fried Frank Harris Shriver & Jacobson LLP's private equity funds group, told Law360.

"There were many large institutional investors that spent greater time on due diligence while working their way to get to their final close," Rosh said. "Overall, it has been a challenging and time consuming fundraising market."

While a longer fundraising period is indicative of the challenge that general partners face in securing investments, it has also paved the way for firms to open themselves up to new investors. Bolsinger noticed a trend in retail investors, or people who have significant net worth but don't quite make it to the minimum fundraising requirements to have significant interest in the fund, contributing to funds.

"A lot of sponsors have started to serve those wealthy individuals and brought them into funds, creating a broader network of investors," he said. "People have seen the returns on alternative investments and have been shut out of a huge part of the investment economy in the U.S., and this is giving more people access to those private investments that are not on the stock exchanges."

One issue that has impacted fundraising, which Fried Frank asset management partner Becky Zelenka told Law360 is not talked about often with regard to private equity, is the U.S. political situation, with "more than ever" state-by-state legislation and proposals monitoring investments.

"Whether it's where the states can invest — so whether state pension plan money and state funds can invest in particular types of investments — or who can make investments in a U.S. state in certain properties, we think and talk about that with our clients all the time," she said.

"It's looking at whether and when those considerations exist," Zelenka added. "Some states will see environmental social governance-type funds maybe falling out of fashion, and some states will have more focus on those and showing that those types of endeavors can be profitable. It's shifted a lot in some respects in ways that you might not have expected but are true driving forces of fundraising right now."

PE Firms Getting Creative in Deal Structure

In mid-2023, valuation gaps in deals seemed to give buyers an upper hand in deal activity, which caused both buyers and sellers to get more creative with the tools they utilized to bridge those gaps.

"When there's a gap in relative downturns, tools such as earnouts and other contingent payments are often utilized," Paul Hastings' Joachim said. "One tool would be to acquire less than 100% of a company, create some option value and encourage, if not require, the previous investors to take on more significant rollovers so that there is an alignment of interest in pursuing growth."

The tricky environment has given way to an increasing amount of carve-outs and other complicated deal structures, such as sponsor-to-sponsor minority interest deals, explained Marni Lerner, co-head of Simpson Thacher & Bartlett LLP's private equity mergers and acquisitions practice.

"For example, a sponsor could sell a minority stake of a portfolio company to another sponsor, which will allow the original sponsor to get some immediate liquidity," she said. "That's something that we haven't really seen historically."

Dechert's Bolsinger noticed an increased appetite for take-private transactions, citing data from the firm's 2023 end-of-year private equity report showing that 94% of respondents surveyed expressed interest in pursuing take-private transactions, compared to only 13% last year. The increased interest in those sorts of transactions shows the adaptability of private equity and how firms are able to see value where others are maybe sitting on the sideline, Bolsinger said.

Tech, Healthcare and Infrastructure Markets Remain Resilient

Despite the choppy waters plaguing the private equity industry over the past few years, certain sectors have remained resilient and continued to realize transactions.

"In terms of industry verticals that are performing well, regardless of the market, technology has been a favored asset class for quite some time," Joachim said, adding that enterprise software has remained a very attractive asset because of the "very stable, sustainable and scalable" revenue that comes with it.

The merging of technology with other traditional verticals is a feat that has been interesting to watch play out, Lerner said, adding that retail deals involve technology, healthcare deals involve technology, and agricultural deals involve technology. Infrastructure also appears to be an area of growing interest worldwide, she added.

Michael Wolitzer, head of Simpson Thacher's investment funds practice, said that funds tend to be an indicator of which sectors remain healthy, and that healthcare is another one at the forefront of fund and deal activity.

"People seem to want to deploy into that sector in all environments," he said.

Troutman Pepper attorneys said they expect to see accelerated transactions involving artificial intelligence, environmental services, food and beverage and hospitality, which has made a comeback following the COVID-19 pandemic, according to a rundown of trends the firm sent to Law360 in November.

Potential SEC Battle Over New Disclosure Regulations

The U.S. Securities and Exchange Commission in August approved vast new rules increasing oversight over private equity and hedge funds that firms will have to prepare for when the regulations take effect in September 2024.

The new regulations center around detailed disclosure requirements and other measures aimed at bolstering transparency and mitigating conflicts. Wolitzer said that, at least for his firm's clients, the disclosure aspects of the regulations won't have as much of an impact as may be expected because "everyone's pretty much already doing it per agreements with LPs."

What he is interested in seeing, however, is how the industry's challenge to the validity of those rules will shake out. Litigation has already been filed challenging the requirements, and Wolitzer said that questions remain on how specifically private equity firms will comply with certain aspects if the regulations are not ruled invalid.

In September, the American Investment Counsel joined a lawsuit along with the National Venture Capital Association and the Alternative Investment Management Association, among others, challenging the SEC's Private Fund Advisers final rulemaking, saying that the commission's attempt to restructure the business arrangements is unwarranted and unlawful. The new statute has also received pushback from the Institutional Limited Partners Association, which expressed its concerns in an open letter to the SEC but did not tag onto the lawsuit.

"There are things in the final rule that are really difficult and expensive, and it's not clear that there was an objective benefit to sponsors or limited partners by some of these new burdens," Fried Frank's Rosh said. "Firms are still trying to navigate how they can comply with some of these requirements, perhaps by hiring more people. To some extent, this was meant to foster competition, but it will make fundraising and sponsoring funds more expensive, which could hurt competition."

Rosh added that law firms have been working diligently to work through the regulations to ensure they understand what the SEC is pushing toward.

"This is a very collegial effort as law firms work together, collectively, to think through approaches that make sense for everybody," he said.

An Optimistic Outlook For the Year Ahead

While a challenging market has defined the better part of the past two years, there remains ample opportunity for buyers and sellers to transact in 2024, given the dry powder and fundamental strength of companies in rising industries.

"People don't like uncertainty, so I think a lot of pieces will start to fall into place when people think interest rates have topped," Bolsinger said. "There has been a huge impact on the market driven by inflation. Since the PE industry's job is to buy portfolio companies and grow and sell them, there is a need to transact, it's just a cycle that needs to be unclogged."

As deal activity has begun to pick up over the past few months, Zelenka said that many investors are either coming back to the market or talking about coming back to the market, and she feels optimistic that fundraising levels will come back into balance.

Lerner said that 2024 will be an interesting year, but if the market stabilizes and debt financing stabilizes, she predicts that there will be a wave of exits from private equity firms that would foster more deal activity.

"In my career, whenever there has been a little bit of a lull or a slowdown, the floodgates always open at some point," she said.

--Additional reporting by Tom Zanki. Editing by Alyssa Miller.
