RECOVERY TO REDISCOVERY:

# Capitalising on a Changed Private Equity Landscape

While cross-border investments are undoubtedly attractive in the current economic conditions, the risks of committing to new deals shouldn't be underestimated.





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## INTRODUCTION

A series of factors are converging to create a unique situation for the global private equity sector. There's pent-up demand for investment opportunities, which has been driven higher by the pandemic and a general slow-down in activity. Meanwhile, low interest economies, especially in Europe and North America, have curtailed the opportunities for return on investments, opening up a renewed interest in cross-border transactions into countries where there are riskier but potentially higher returns to be seized.

However, another impact of the pandemic is that investors have been unable to travel, particularly overseas. While cross-border investments are undoubtedly attractive in the current economic conditions, the risks of committing to new deals without being able to meet management teams or view physical assets shouldn't be underestimated.

We commissioned research with a global panel of 100 senior private equity fund managers to understand how private equity firms are navigating the current situation, how they're positioning themselves for short to mid-term future growth and how they're working with outsourcing partners to bridge any existing gaps. This report identifies the industry's response to the main challenges and indicates which industries and sectors are most likely to be on the receiving end of private equity investment as the world normalises.

As highlighted in the report, private equity investors are keen to make up for lost time, with significant interest in global deals spanning numerous industries. However, with this rapid expansion will come greater administrative and compliance burdens which will need to be properly addressed in order to ensure time and resources aren't wasted.

The good news is that there are already green shoots of recovery being identified: global economic growth projections for 2021 currently stand at up to 6%[1]. Some stability is expected in both the US and UK following the results of the Presidential election and completion of Brexit respectively, and private equity investors, now sitting on an estimated $1.9 trillion of dry powder[2], are demonstrating a bullish outlook for the industry.

Rapid expansion will bring greater administrative and compliance burdens.

[1] "World Economic Outlook, April 2021: Managing Divergent Recoveries", published 23 March 2021 by the IMF.
[2] "2021 Global Private Equity Outlook", published on 2 March 2021 by S&P Global Market Intelligence.

# Cross-border outlook





## THE OUTLOOK FOR CROSS-BORDER TRANSACTIONS

With cross-border activity so important to private equity deal flow, the pandemic posed significant practical barriers to the industry: due diligence became more difficult to complete while the curbing of international travel made face-to-face meetings much scarcer.

As a result, the impact of Covid-19 has been felt keenly across all industries, not least those involved in cross-border M&A due to the myriad complexities and factors that already contributed to international transactions.

Unsurprisingly, M&A activity declined in the first half of 2020, both in terms of value and volume, with the former dropping by 49%, and the latter decreasing by 22% compared to pre-Covid levels[3]. Unlike the global recession of 2008, when private equity activity was significantly reduced, the sector has been able to continue operating and completing transactions, thanks to increasingly digitised processes.

Nor do most private equity fund managers expect there to be a significant hangover on cross-border deal flow as the global economy recovers, with over a third (37%) expecting a full normalisation before the end of 2021. A further 40% expect this to happen in 2022, while 16% expect it in 2023.

UK-based private equity firms are most confident of a fast recovery, with 44% of respondents believing that normalisation will occur by the end of 2021, while their European (34%) and North American (33%) counterparts are slightly more conservative. Overall, Europeans are most pessimistic about a fast recovery, with 23% believing that it won't arrive before 2023 and a further 6% expecting it to be beyond that. This pessimism is likely to be a result of the current recession and the slower vaccine rollout implemented by the EU in comparison to that being managed by the UK and United States.

Compared to previous crises, the downturn is therefore expected to be relatively shallow and short-lived, with recovery driven by the surge in demand for investments. Indeed, the major driver for a recovery in cross-border deal flow, identified by over half (53%) of respondents, is expected to be the economic rebound following the end of the pandemic.

### Expected lifetime acquisitions of a fund

There's no doubt that there's a growing appetite for cross-border investment opportunities. Private equity investors believe that the average fund will make 18 acquisitions during its lifetime, with just over half (52%) of these involving a cross-border element. UK investors expect funds to have the highest number of acquisitions at 23 - significantly more than Europe (13). North American investors, meanwhile, are most likely to expect to engage in cross-border acquisitions, stating that 57% of deals over the course of a fund's lifetime will be done overseas - ahead of the UK (51%) and Europe (48%).

This means that the average fund portfolio company will make between nine and 10 cross-border acquisitions over the course of the fund's lifetime. The most attractive overseas markets for investments continue to be the established Western geographies, with most respondents planning to invest in Europe (92%), the UK (85%) and North America (76%) over the coming five years.



[3] "COVID-19: the Global Outlook of Cross-Border M&A", published on 4 May 2021 by First Law International.



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## Impact of technology

Respondents also predict that technology will continue to have a major impact on deal flow - improvements in tech and e-commerce that make it easier to reach new customers was selected by 43% of respondents; this was ahead of the gradual exit from pandemic-imposed travel restrictions and a desire to expand beyond a firm's domestic market to capture attractive overseas opportunities (41% respectively). There has clearly been a mind shift change within the sector about how private equity deals can be managed using digital channels adopted through necessity during lockdown.

### WHAT DO YOU THINK ARE THE MAIN REASONS THAT WILL DRIVE A REBOUND IN CROSS BORDER DEAL FLOW?

**53%** Economic rebound following Covid-19

**43%** Improvements in tech and e-commerce are making it easier to reach new customers

**41%** Gradual exit from travel restrictions imposed during the pandemic

**41%** Desire to expand beyond a firm's domestic market to capture attractive opportunities abroad

**35%** Growing appetite for risk

**26%** Easing of trade and tariff wars

**23%** Cheap debt

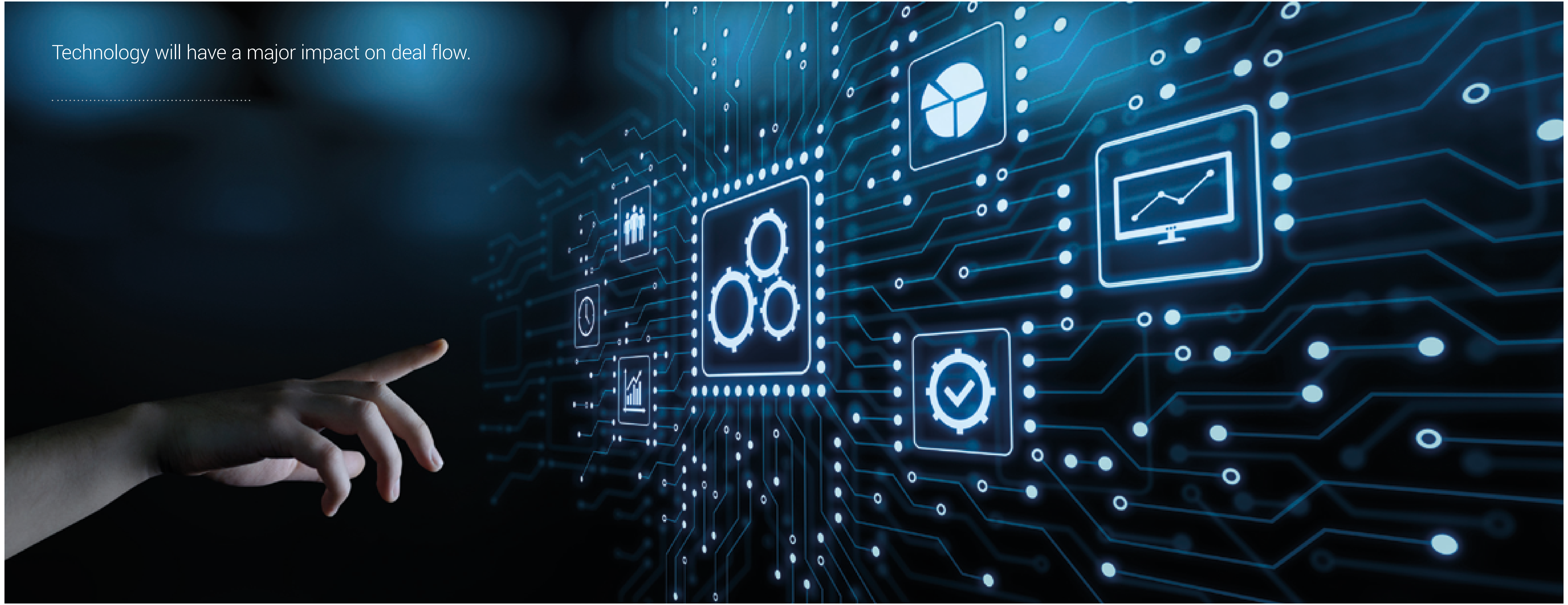
**20%** Increased number of PE funds designed to pursue cross border deal flow

**19%** Large amounts of dry powder to deploy

**11%** Decline in levels of economic, social and political volatility



Recovery to Rediscovery: Capitalising on a Changed Private Equity Landscape



# Cross-border deal flow





## OBSTACLES FOR CROSS-BORDER DEAL FLOW

Despite a positive outlook, the recovery isn't without its challenges, especially when it comes to cross-border deals. When asked what the biggest obstacles are when engaging in cross-border deal flow 41% of investors cited different compliance regimes. Cultural differences (40%) continue to provide challenges for investors, narrowly ahead of insufficient levels of transparency in information supplied during due diligence (39%).

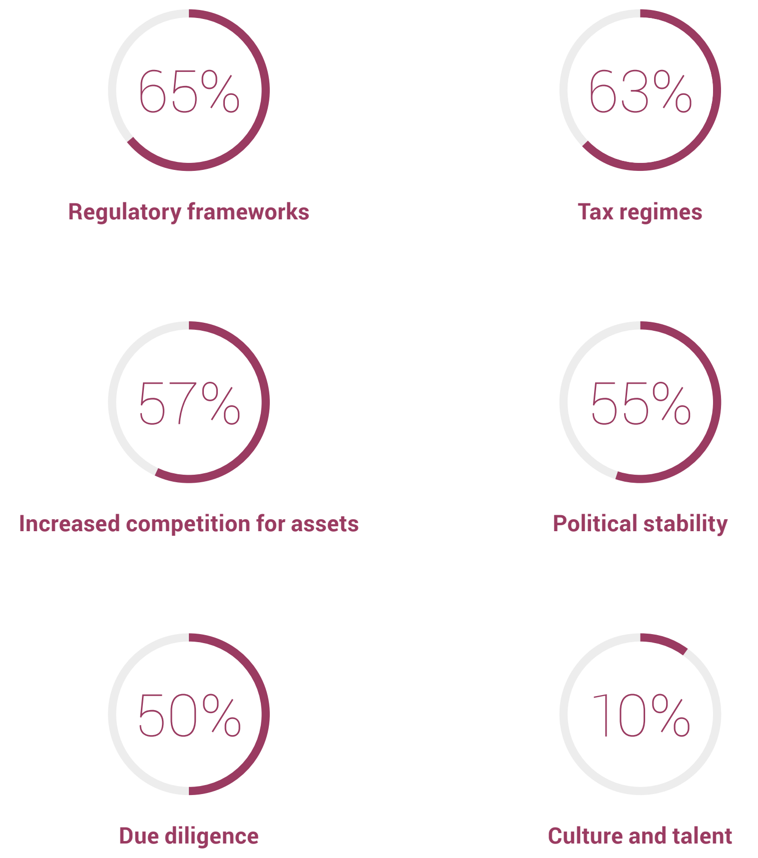
While from the outside the deal-making process can look and feel the same in every region, the truth is that there are many nuances that firms need to be aware of. Other common challenges include valuation misalignment between buyer and seller (37%), jurisdictional difference in law and regulatory frameworks (32%) and operational complexities (29%), for example. Such challenges have been made more difficult by the lack of face-to-face meetings and due diligence, making it even more important to rely on expert administrative support to ensure deals are completed quickly and efficiently.

### WHAT ARE THE KEY CHALLENGES FACING PRIVATE EQUITY FIRMS ENGAGING IN CROSS BORDER DEAL FLOW?

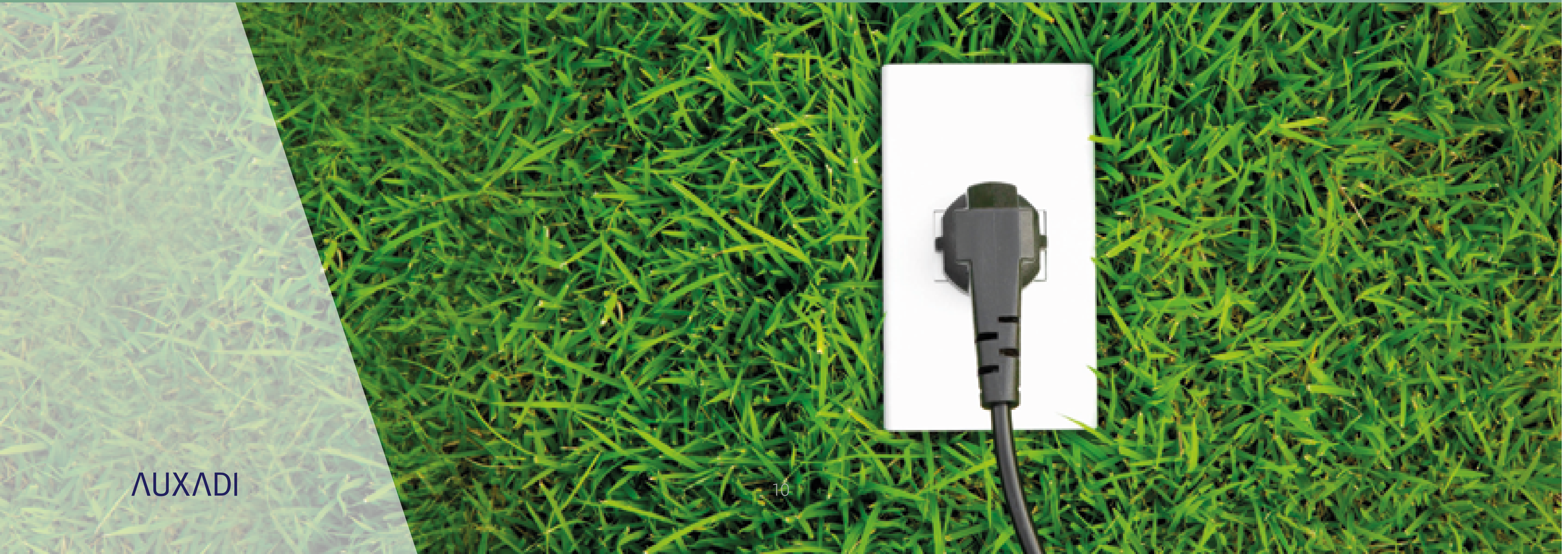
| | |
|---|---|
| **Different compliance regimes** | 41% |
| **Cultural differences** | 40% |
| **Insufficient levels of transparency in information supplied during due diligence** | 39% |
| **Misalignment on valuations between buyer and seller** | 37% |
| **Jurisdictional difference in law and regulatory frameworks** | 32% |
| **Operational complexities e.g. payroll, HR etc.** | 29% |
| **Distribution challenges affecting vaccine rollout** | 29% |
| **Rising inflation** | 29% |
| **Government-sponsored protectionist policies** | 28% |
| **Incompatible technology systems** | 17% |
| **Number of stakeholder organisations involved** | 14% |
| **Increased competition for prized assets** | 7% |

A similar picture emerges when firms identify the biggest complexities they face when engaging in cross-border investment activity. While investor appetite is high, respondents also acknowledged that the complexities they face are many and varied; regulatory frameworks (cited by 65% of respondents), tax regimes (63%) and increased competition for assets (57%) were just a few of the complexities mentioned, suggesting a pressing need for expert and comprehensive administrative support on the ground.

### WHAT ARE THE BIGGEST COMPLEXITIES YOU FACE WHEN ENGAGING IN CROSS-BORDER INVESTMENT ACTIVITY?



# Attractive sectors









## ATTRACTIVE SECTORS FOR PRIVATE EQUITY ALLOCATIONS

While Covid-19 may have made deal-making more complicated, it certainly didn't dampen investor appetite. Appetite is buoyant across sectors that have both thrived and struggled throughout the pandemic, suggesting that there are opportunities for distressed assets in the latter category. The most attractive sector to investors is seen as energy, with 93% of respondents stating that they're planning to invest in the sector over the coming five years. More than half of respondents (51%) stated that they were 'extremely likely' to invest in energy, reflecting the massive transition that's underway towards renewables and zero carbon emission targets set by governments and regulators. Information technology, which has played such a vital part in keeping businesses operating during the pandemic, is the second most popular industry sector to invest in. While technology's now an integral element of any organisation's growth strategy, it will of course be a major enabler of the green revolution too.

Although energy and technology are the front-running investment sectors, there's a strong interest across all sectors, with even the least attractive sectors - real estate and consumer discretionary - being viewed as potential targets for investment by 77% of respondents. While real estate is looking to face a longer recovery period following the pandemic, trends such as reformatting space to support flexible working and the need to meet the needs of the green agenda will continue to provide opportunities. Consumer discretionary spend presents a mixed picture: it will be released along with the end of lockdown, but potentially dampened by the end of government furlough schemes and rising interest rates.

### WHICH OF THE FOLLOWING SECTORS DO YOU INTEND TO INVEST IN OVER THE COMING FIVE YEARS?

| | Extremely likely | Moderately likely | Not very likely | Not at all likely |
|---|---|---|---|---|
| **Information technology** | 61% | 31% | 7% | 1% |
| **Industrials** | 59% | 33% | 6% | 2% |
| **Energy** | 51% | 42% | 5% | 2% |
| **Materials** | 47% | 44% | 7% | 2% |
| **Telecommunication services** | 39% | 51% | 8% | 2% |
| **Consumer staples** | 37% | 48% | 11% | 4% |
| **Financials** | 48% | 35% | 13% | 4% |
| **Utilities** | 38% | 44% | 14% | 4% |
| **Healthcare** | 45% | 36% | 14% | 5% |
| **Real estate** | 37% | 40% | 19% | 4% |
| **Consumer discretionary** | 32% | 45% | 21% | 2% |

North American-based investors appear to be leading the charge, with 91% planning to invest in Latin America between now and 2025.



### Growing appetite for investing in Latin America

Seen by many as the next investment 'hidden gem', Latin America is a region with huge potential for private capital, with its growing middle class and early pension reforms having created a significant pool of assets in which to invest[4]. This is reflected by the fact that 70% of private equity firms plan to invest in the region over the coming five years - making it more attractive than Asia Pacific (62%) and the Middle East (60%), markets that are at different stages of economic maturity and opportunity than Latin America. North American-based investors appear to be leading the charge, with 91% planning to invest in Latin America between now and 2025. This is followed by three quarters (75%) of UK respondents, although only 46% of European investors plan to invest in the region.

[4] "Latin America's Growing Appetite for Alternative Assets", published on 24 March 2021 by Preqin.

## Focus on renewable energy

The importance of the pivot towards renewables is clear, with 89% of investors stating that they believe the outlook for such investments is positive and a third (33%) saying that it's 'very positive'. Private equity investment in renewables totalled $2.7 trillion between 2010 and 2019, and the trend is set to accelerate in 2021 as renewable generation is expected to surpass oil and gas to become the largest area of energy spending.[5]

HOW WOULD YOU DESCRIBE THE OUTLOOK FOR PRIVATE EQUITY FUNDS INVESTING IN RENEWABLE ENERGY?

| | |
|---|---|
| Very positive | 33% |
| Positive | 56% |
| Neither positive nor negative | 10% |
| Negative | 1% |
| Very negative | 0% |

Significant investment in renewables is likely to follow the pandemic. Around two-thirds (62%) of investors state that pandemic-driven government commitments to green infrastructure investment, such as the $2 trillion clean energy infrastructure plan introduced by President Joe Biden in the US, are most likely to influence investor allocations to private equity over the coming two years.

Other influential factors are seen as post-pandemic government pledges (54%), a drive towards higher allocations in sustainable investment strategies (52%) and falling costs in construction of renewable energy assets (51%).

However, only 26% of investors believe that meeting carbon reduction and climate goals will have a tangible influence on allocations to private equity in the next two years.

[5] "The greening of private equity, the watt and the why", published on 2 November 2020 by Buyout Insider.







# Demand for outsourcing





## THE GROWTH IN DEMAND FOR OUTSOURCING

Since the introduction of economic substance criteria on 1 January 2019, many fund managers have had to justify their business in all their fund domiciles. The legislation was designed to ensure that income streams from certain activities are based on actual local activity to substantiate the use of low tax jurisdictions. The regulations require documentation of how an entity might be impacted by substance regulations in any given jurisdiction. However, as we enter the third year of economic substance regulations, our study suggests that some firms are still struggling to meet the requirements imposed by the legislation.

The greatest challenge to private equity companies posed by the economic substance regulations is ensuring the business undertakes core income-generating activities in the jurisdiction of tax residence - this was selected by more than two thirds (43%) of respondents. This is significantly higher than the next greatest challenge - ensuring the business is directed and managed in the jurisdiction (cited by 24% of respondents).

What's clear is that economic substance has had a significant impact on private equity funds' outsourcing requirements. Since its introduction, more than half (54%) of investors' companies have needed to start outsourcing company secretarial support to regional partners, while 53% have started outsourcing accounting and cash monitoring services, and 51% now require loan agency support.

Furthermore, many investors plan to start outsourcing various functions to cope with the demands of economic substance regulations, with 45% planning on bringing in external loan administration and legal entity administration support, followed by accounting (39%), regulatory reporting (38%) and cash monitoring and reconciliations (37%). Overall, 92% of private equity managers have or will soon start to rely on outsourced accounting support to meet the challenges of economic substance regulations in their jurisdiction, followed by cash monitoring and reconciliations (90%) and loan administration (89%).

### WHICH OF THE FOLLOWING ELEMENTS HAVE YOU STARTED, OR PLAN TO START, OUTSOURCING AS A RESULT OF THE IMPLEMENTATION OF ECONOMIC SUBSTANCE REGULATIONS IN YOUR JURISDICTION?

| | Have started outsourcing | Plan to start | No plans to start |
|---|---|---|---|
| **Company secretarial support** | 54% | 31% | 15% |
| **Accounting** | 53% | 39% | 8% |
| **Cash monitoring & reconciliations** | 53% | 37% | 10% |
| **Loan agency** | 51% | 33% | 16% |
| **Loan administration** | 44% | 45% | 11% |
| **Regulatory reporting** | 44% | 38% | 18% |
| **Legal entity administration** | 39% | 49% | 16% |

Overall, 92% of private equity managers have or will soon start to rely on outsourced accounting support to meet the challenges of economic substance regulations in their jurisdiction.

# Conclusion

**Despite the challenges posed in 2020, private equity investors weren't afraid to seize opportunities when they saw them, as illustrated by the significant spike in deals being completed in Q3. This appetite doesn't appear to have decreased as we head into Q3 2021, with widespread enthusiasm for deals covering broad sector and geographical ranges.**

However, while investors have been successful in adapting to Covid-19 shocks over the past 12 months, more commonplace hurdles, such as economic substance regulations, are proving to be a substantial barrier to operations, resulting in an expected heightened reliance on outsourced specialist support to manage the administration requirements of a fund and its investments.

The study shows that a sizeable proportion of private equity firms have already taken steps to outsource the running of some elements of their fund to third parties, with many more planning to either start or increase the level of outsourcing they undertake in order to maximise their chances for securing new acquisitions in the potentially fruitful post-Covid landscape.





## ABOUT AUXADI

With more than 40 years' experience, we're experts when it comes to working with multinational companies, private equity and real estate funds.

### How we help private equity firms

Auxadi is a specialist provider of tailored international accounting, tax compliance and payroll services. Operating in 50 jurisdictions across Europe, the USA and Latin America, we provide an end-to-end solution through cloud-based technology to make your lives as easy as possible. Our IT platform, employees and methodology are all designed to act as a seamless extension of your accounting departments to ensure that your administrative requirements are met across your private equity investment portfolio, no matter the volume of deal flow.

Our culture is based on ethics, excellence and exceeding the expectations of our clients and we achieve this through flexible and efficient solutions developed by a motivated, committed, and solid team. With more than 40 years' experience, we're experts when it comes to working with multinational companies, private equity and real estate funds.

### Research methodology

Research was conducted via an online survey amongst a panel of 100 senior-level private equity fund managers in April 2021. The sample was split evenly between decisionmakers at firms based in the UK, Continental Europe and North America. The average stated AUM of respondents stood at €14.4bn, with UK (€17.2bn) and North American (€16.3bn) respondents coming from slightly larger firms than European respondents (€10.2bn).

*Note, some percentages may not add up to 100% due to rounding.



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