



AUXADI

RECOVERY TO REDISCOVERY:

# Capitalizing on a Changed US Private Equity Landscape



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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 North America and Europe, 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 - of which a third were based in North America - to understand how private equity firms are navigating the current situation, how they're positioning themselves for 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, North American private equity investors are keen to make up for lost time, with significant interest in international 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%<sup>1</sup>, with US growth forecast at 8.6% in Q2 2021 and further acceleration predicted for Q3<sup>2</sup>. The US can expect some stability as a result of the Presidential election, and North American private equity investors, now sitting on an estimated \$976 billion of dry powder<sup>3</sup> - more than half of the estimated \$1.9 trillion globally<sup>4</sup>, are demonstrating a bullish outlook for the industry.

Rapid expansion will bring greater administrative and compliance burdens.

<sup>1</sup> "World Economic Outlook, April 2021: Managing Divergent Recoveries", published 23 March 2021 by the IMF.

<sup>2</sup> "Economic Forecast for the US Economy", published 7 May 2021 by the Conference Board.

<sup>3</sup> "What Private Equity's Record Dry Powder Haul Means for the Industry", published 7 April 2021 by Preqin.

<sup>4</sup> "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, global 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. In the US in particular, M&A activity saw an increase in distressed transactions, including debt restructurings, defensive M&A deals and other transactions aimed at strengthening balance sheets, due to the uncertainty associated both with the pandemic and the level of government support<sup>5</sup>. 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 digitized 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 a third (33%) expecting a full normalisation before the end of 2021. A further 45% expect this to happen in 2022, while 9% expect it in 2023.

This shows that confidence in North America is slightly lower than in other regions, with 37% of all respondents expecting normalisation by the end of 2021. 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%) 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 United States and UK.

<sup>5</sup> "COVID-19: the Global Outlook of Cross-Border M&A", published on 4 May 2021 by First Law International.

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 in North America, identified by almost half (45%) of respondents, is the desire to expand beyond the firm's domestic market to capture attractive opportunities abroad.

### Expected lifetime acquisitions of a fund

There's no doubt that there's a growing appetite for cross-border investment opportunities. North American private equity investors believe that the average fund will make 20 acquisitions during its lifetime, with over half (57%) of these involving a cross-border element. This is above the global average in terms of both volume (18) and international spread (52%).

This means that the average North American fund portfolio company will make between 11 and 12 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 the UK and Europe (91%) over the coming five years, although interest in Latin America (91%) is also significantly high.





Impact of technology

Respondents also predict that technology will continue to have a major impact on deal flow - improvements in technology and e-commerce that make it easier to reach new customers was selected by 42% of North American respondents; this was in line with the economic rebound following Covid-19 (42%) and a growing appetite for risk (39%). 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?

- 45% Desire to expand beyond a firm's domestic market to capture attractive opportunities abroad
- 42% Economic rebound following Covid-19
- 42% Improvements in tech and e-commerce are making it easier to reach new customers
- 39% Growing appetite for risk
- 36% Gradual exit from travel restrictions imposed during the pandemic
- 30% Cheap debt
- 27% Easing of trade and tariff wars
- 15% Increased number of PE funds designed to pursue cross border deal flow
- 15% Large amounts of dry powder to deploy
- 6% Decline in levels of economic, social and political volatility





# 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 45% of North American investors cited cultural differences as the greatest. Misalignment on valuations between buyer and seller (42%) continue to provide challenges for North American investors, ahead of different compliance regimes (39%), highlighting that 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 in the region include insufficient levels of transparency in information supplied during due diligence (36%), operational complexities (36%) and distribution challenges affecting vaccine rollout (33%) for example. One issue that doesn't appear to be a challenge for private equity firms in North America is rising inflation, which was selected as an issue by only 15% of respondents, compared to

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

Cultural differences	45%
Misalignment on valuations between buyer and seller	42%
Different compliance regimes	39%
Insufficient levels of transparency in information supplied during due diligence	36%
Operational complexities e.g. payroll, HR etc.	36%
Distribution challenges affecting vaccine rollout	33%
Jurisdictional difference in law and regulatory frameworks	27%
Government-sponsored protectionist policies	27%
Rising inflation	15%
Number of stakeholder organisations involved	12%
Incompatible technology systems	9%
Increased competition for prized assets	6%

36% in other regions. 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.

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 73% of respondents), due diligence (67%) and increased competition for assets (58%) 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 IT, with 100% of North American respondents stating that they're planning to invest in the sector over the coming five years. More than three quarters (76%) stated that they were 'extremely likely' to invest in IT, reflecting the huge opportunities presented by recent advances in technology and the role it played in keeping businesses operating during the pandemic. Materials and telecommunication services (both 97%), are the joint-second most popular industry sectors to invest in, ahead of industrials and energy (both 94%).

Although technology, materials and telecoms are the front-running investment sectors, there's a strong interest across all sectors, with even the least attractive sectors - utilities and consumer discretionary - being viewed as potential targets for investment by 85% 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'll 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	76%	24%	0%	0%
Materials	64%	33%	0%	3%
Telecommunication services	48%	48%	3%	0%
Energy	70%	24%	3%	3%
Industrials	64%	30%	3%	3%
Healthcare	58%	33%	6%	3%
Consumer staples	61%	27%	12%	0%
Financials	52%	36%	9%	3%
Real estate	58%	30%	9%	3%
Utilities	45%	39%	12%	3%
Consumer discretionary	58%	27%	15%	0%

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 . Nowhere is this view more prominent than in North America. Thanks to its geographical proximity and the high volume of diaspora in the region, North America is in pole position to capitalise on the huge opportunities presented in Latin America, with 91% of private equity firms in North America planning to invest in the region over the coming five years - making it more attractive than Asia Pacific and the Middle East (both 76%), markets that are at different stages of economic maturity and opportunity than Latin America.

This high proportion is in contrast to the UK (75%) and Europe (46%), which display lower levels of interest in investing in the region.

<sup>6</sup> "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 97% of investors stating that they believe the outlook for such investments is positive and almost a half (48%) say that it is ‘very positive’. This makes North America the region with the most positive outlook for renewable energy, ahead of Europe (89%) and the UK (81%) and appears to endorse the Biden administration’s Plan for Climate Change and Environmental Justice. 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.<sup>7</sup>

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

Very positive	48%
Positive	48%
Neither positive nor negative	3%
Negative	0%
Very negative	0%

Significant investment in renewables is likely to follow the pandemic. Almost three quarters (73%) of investors also state that pandemic-driven government commitments to green infrastructure investment, such as the \$2 trillion clean energy infrastructure plan introduced by President Biden, are most likely to influence investor allocations to private equity over the coming two years. This is expected to be a more significant factor in North America than elsewhere in the world, with Europe (66%) and the UK (47%) less likely to feel that it will influence allocations to private equity.

Other influential factors are seen as the drive towards higher allocations in sustainable investment strategies and falling costs in construction of renewable energy assets (both 64%), and post-pandemic government pledges to invest in green energy (55%). However, only 12% 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.

<sup>7</sup> \*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 almost three fifths (58%) of respondents. This is significantly higher than the next greatest challenge - ensuring the business is directed and managed in the jurisdiction (cited by 30% of respondents).

What is clear is that economic substance has had a significant impact on private equity funds’ outsourcing requirements, with North America leading the way in maximising the efficiency of their operations. Since its introduction, almost four fifths (79%) of investors’ companies have needed to start outsourcing company secretarial support to regional partners, while 73% have started outsourcing accounting and 52% now requiring 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 cash monitoring and reconciliations support, followed by loan administration (45%), legal entity administration (42%) and regulatory reporting (39%). Overall, 100% 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, loan administration and company secretarial support (all 94%).

↓ 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
Accounting	73%	27%	0%
Company secretarial support	79%	15%	6%
Loan administration	48%	45%	6%
Cash monitoring & reconciliations	45%	48%	6%
Regulatory reporting	52%	39%	9%
Legal entity administration	48%	42%	10%
Loan agency	52%	27%	21%



# 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 across North America 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 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, of which 33 were based in North America. The average stated AUM of respondents in North America stood at €19.9bn.

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





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