DIRECTIONS IN **PRIVATE EQUITY**

Hot sectors for FY17

- Health & allied services
- Education & child care
- Experiential (Leisure & Tourism)
- Technology
- Turnaround & transformation capital opportunities
- Buy & build

Trends in fundraising

- New fund managers flourishing
- Prevalence of offshore investors
- Strategic sector analysis before tapping investors
- PE agri investment on the rise

Hot sectors for FY18

- Service providers to the disability and aged care sector
- Technology / Software
- Buy & build
- Financial services

Private Equity exits FY17

Number of exits	Average time held
37	**55** months

Average sell value

A$**359.98**

Total value

A$**8,999.54M**

Factors that shaped Private Equity in FY17

- Government funding in health-related sectors
- FIRB exemption certificates
- Private M&A techniques adopted in Public M&A deals
- Surge in technology M&A
- Chinese investment
- Superfunds flexing their low cost of capital

Acquisition finance themes

- Capital call facilities becoming popular
- Interest rate movements - lag times and inflation
- AUD Term loan Bs back in vogue

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Factors that shaped private equity in FY17

Follow the money

Whilst transaction activity was buoyant during FY17, it is fair to say that average multiples being paid for quality assets remain high, which indicates a sellers' market resulting in constrained supply of assets, particularly in the >A$500 million enterprise value range. The larger, historically buy-out focused, funds may broaden their investment mandates to consider taking smaller stakes, through co-investment arrangements, with smaller players upsizing their stakes alongside larger players if they have originated the deal.

As usual, sector analysis will remain critical. In our view, a hot spot to watch will be service providers to the disability and aged care sectors. The consistent theme in this space is Government funding. As long as Government stated policies remain, this sector should remain attractive. While listed aged care providers have underperformed (with high prices for residential facilities a contributing factor), there is scope for PE investment in adjacent areas. In particular, with Federal Government funding moving to a consumer directed care funding model for both the NDIS and its MyAgedCare programs, we expect to see significant growth in activity to take advantage of the revised funding regimes.

We also anticipate there being growth in expansion capital investments in SaaS products and platforms (e.g. Better Caring, Care Seekers and Five Good Friends) and also growth in the tangible offerings in the home care space (e.g. St Ives Home Care).

GPs will continue to look for 'buy & build' opportunities, acquiring businesses that are below their ideal equity cheque size but which can be used as a platform for thematic investment in fragmented sectors e.g. travel & tourism, financial services, engineering services and food & agribusiness.

The Chinese exit strategy

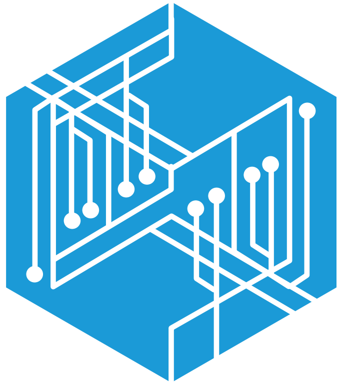
The general trend is that Chinese investment will change the landscape of the PE industry. While this is a trend across all aspects of M&A, it has become particularly prominent in the PE and VC space in recent years. Chinese corporates and funds have been acquirers in numerous PE exit transactions and other transactions where Australian PE funds were outbid in recent years in Australia, including:

- China Resources acquiring a majority stake in Genesis Care from KKR;
- Luye Medical Group acquiring Healthe Care from Archer;
- CITIC Capital and Humanwell Healthcare acquiring the Ansell condom business; and
- Pagoda Investment & Goldman Sachs consortium acquiring Icon Cancer Care.

We are seeing a changing trend in investment targets by Chinese acquirers, moving away from traditional sectors such as energy and resources (i.e. asset heavy sectors) into more service based sectors, and we expect this trend to continue to impact the PE industry.

Increasing Chinese wealth, appetite for foreign assets and investor sophistication have seen an increase in outbound Chinese PE deals globally. The growth of China's high net worth individuals outpaces most developed countries. There is an increased eagerness for Chinese sponsors to invest in businesses that have potential growth opportunities in China, which is likely driven by a perception that foreign resources and products are of better quality. However, the willingness for Chinese sponsors to do deals is sometimes thwarted by government / regulatory approvals that are cautious of Chinese controlled businesses, particularly in sectors that are considered to be of a sensitive nature.

Technology M&A



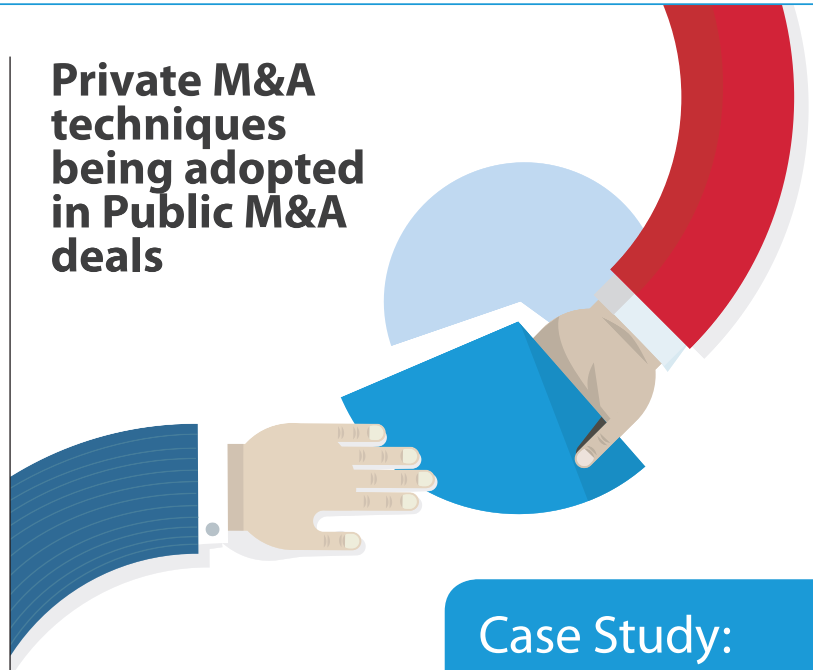
Investment in technology businesses is no longer the exclusive playground of VC funds, with buy-out funds increasing their investments in this space. In the United States, there was a record number of tech focused PE transactions in the past year (with 26% year-on-year growth in Q1 alone), and we expect this trend to follow and gain momentum in Australia.

Recent examples in Australia include:

- CHAMP Equity's acquisitions of Containerchain and Pepperstone; and
- The Growth Fund's investment in Planit Software Testing.

Of particular interest will be targets that provide cloud/SaaS based solutions as these are regarded as being scalable with 'sticky' revenue models.

Private M&A techniques being adopted in Public M&A deals



With the search light for quality assets continuing to be shone on the public market, PE suitors of listed companies are increasingly adopting private M&A techniques in public market deals. For example, the roll-over equity structure adopted by Pacific Equity Partners in relation to the Patties Foods take private. In addition, the requirements of both financiers and, where relevant, warranty and indemnity insurers, means that reliance on the ASX continuous disclosure regime is inadequate and not a substitute for fulsome, private M&A style, legal, tax and accounting due diligence.

Novel break fee structures are also being adopted to provide cost coverage for debt ticking fees that are incurred early on in the context of a public M&A transaction (for example, in relation to the take private of SAI Global by Baring Private Equity Asia).

We advised both Patties Foods and Baring Private Equity Asia on these transactions.

Case Study:

Changing trend for break fees in schemes

The scheme in the SAI Global deal provided Baring Private Equity Asia with the unusual protection of a 1% break fee in traditional circumstances, as well as a mechanism to incentivise target bidder compliance. This increased the target's liability cap to approximately 2% if the target knowingly breached the scheme implementation agreement.

In our view, this established a new market trend for target liability caps by providing added deal certainty and cost recoupment protection for knowing or wilful breaches of exclusivity provisions.

Key themes in fundraising

Superfunds finally flexing their low cost of capital

The past year has seen a number of superannuation funds putting the benefit of their low cost of capital to work by making direct investments.

For example:

- Commonwealth Superannuation Corporation's acquisition of Canberra Data Centres from Quadrant Private Equity;
- IFM Investors several direct investments, including Genie Solutions and Colette by Colette Hayman; and
- OPTrust's investment in Aviator Group, alongside Boab Capital (we advised OPTrust on this transaction).

We expect this trend to continue, particularly in relation to assets that deliver infrastructure-like returns.

New fund managers flourishing

Since 2008 there has been a strong consolidation of PE managers. In some cases, this was due to circumstances in their underlying investor base (who had wound up their PE programmes or no longer had capital) and, in other cases, was due to fewer deals and being unable to raise new funds.

It has been a long time since we have seen new managers enter the market. The past 12 months, however, has seen this change significantly with a number of new managers at the institutional level. Examples of new entrant funds include Adamantem Capital, Odyssey Private Equity, 5V Capital and Axle Equity Partners, amongst others. This influx of new funds has, in turn, resulted in a changing of the guard in relation to key personnel within established funds.

Our view is that the trend towards consolidation of fund managers has come to an end, with fresh capital flowing through the industry.

We have also seen a number of new players of significant power and size in the high net worth market, including Quintet Partners and Armitage Associates. It is encouraging to see new managers enter and for investors to be committing to them, however the total number of managers is not necessarily increasing, as some of those that leave existing managers come from other managers that will now either not be viable or may otherwise retreat.

Prevalence of offshore investors

Offshore investors continue to be the most important source of capital for Australian managers providing approximately 70 - 80% of each major fundraise. Australian superannuation funds continue to face internal pressures over how much of their 'fee budgets' can be spent on PE and VC. A number of superannuation funds have stated they will be cutting back allocations because of the manner in which fees are treated for PE. This is unfortunate for investors in those superannuation funds because PE continues to outperform other asset classes. So if retirement saving is underpinned by creating better wealth for retirees, then reducing PE allocations appears to be at odds with this objective.

PE agri investment on the rise

Investment by PE funds in agriculture is now starting to gain real traction, with managers like Roc Partners and Boab Capital managing some significant pots of capital. Vertical integration and business optimisation (e.g. distribution and supply chain improvements) are key investment themes in this space.

Strategic sector analysis before tapping investors

We are seeing PE funds come back to the fundraising market significantly quicker than has historically happened. While this could be said to be indicative of strong deal pipelines - which has been the case – it is more a case of managers becoming more sophisticated in how they approach deal flow. Gone are the days of waiting for funds to close and then starting the search for deals. Instead, managers like Quadrant Private Equity and Allegro Funds, are spending a significant amount of time researching markets and assets, and targeting where they want to play, before they tap investors. In doing this, some interesting thematic plays have occurred.

We expect this trend to continue, as well as the trend of managers developing and building in-house teams of industry experts that will move from deal to deal (e.g. operational partner model).

Fees & costs - the impact of RG97

We have worked extensively with AVCAL and ASIC to ensure that enforcement of RG97, which regulates fees and costs disclosure for the industry, recognises the different ways in which the PE and VC funds industry works. ASIC recognises these differences and is assisting to ensure a level playing field of product comparison amongst asset classes. There will be continued focus on fee and cost disclosure as the superannuation industry harmonises, and while PE and VC are expensive strategies to operate, net returns over the last 10 years have far exceeded other asset classes, despite these fees and costs.

Acquisition finance

Capital call facilities

Capital call facilities enable PE funds to use bridging finance for their investment needs, pending calling on investors for their commitments. They are becoming increasingly popular. Some features to be aware of include:

Some lenders offer an ‘umbrella’ commitment whereby the lender performs all of its due diligence on the fund and agrees umbrella loan terms leaving individual loan terms (including pricing) and commitments to be resolved later on a needs basis. The advantage is that facility fees do not apply until closer to the time that an actual loan is required. The disadvantage is that, perhaps in theory, such a lender could change their mind and decide not to commit to an individual loan at a later stage, notwithstanding there being no change in fund structure or investors.

Capital call lenders take security over the fund’s right to call on investors and any proceeds from such calls including the proceeds account. It is a legal requirement that such security needs to be notified to investors to be effective. For funds that are dominated by a small number of large institutional investor funds, this should not be an issue as the managers of those funds are sophisticated and will take receipt of such a notice in their stride. There are, however, funds that comprise of large numbers of individual investors and family offices, so issuing a notice to each investor would involve more administrative work and perhaps more explanation.

With the ever increasing growth and complexity of funds and funds-of-funds, managers need to be mindful of restrictions in their capital call facility terms. For example, there may be an occasion for a fund to invest in another fund by way of a convertible note which is classed, until the date of conversion, as finance debt. Ideally, the capital call facility terms will permit such a convertible note provided it contains terms that subordinate the loan on insolvency to the capital call lender’s loan.

In addition to cash loans, capital call facilities should have the flexibility to provide for bank guarantees as, on occasion, it will make sense for a fund to provide a bank guarantee.

Positive developments by Australia’s foreign investment regulator

Following broad consultation and the announcement of changes to Australia’s foreign investment framework on budget night, the amended Foreign Acquisitions and Takeovers Regulation 2015 (Cth) came into effect on 1 July 2017. The changes are aimed at simplifying and addressing some key concerns regarding the regime since it was overhauled in December 2015.

One of the key changes, strongly advocated by AVCAL, is the introduction of the new business exemption certificates. The certificates would allow foreign investors to obtain an up-front clearance to acquire low sensitivity companies and businesses without the need to seek specific clearance on a deal-by-deal basis. The certificates will be particularly helpful for PE fund managers, whose limited parties may include ‘foreign government investors’ and therefore need FIRB clearance for all deals regardless of value.

FIRB has issued some guidance in relation to the appropriate sectors, timeframes and other parameters for the certificates, though it is fair to say there is still significant scope for interpretation. FIRB expects to effectively negotiate business exemption certificates with applicants on a case-by-case basis, and is willing to engage in discussions prior to lodgement of a formal application.

In order to maximise the utility of any exemption certificate, fund managers will need to carefully formulate an engagement strategy with FIRB and other relevant agencies, particularly the Australian Taxation Office, the Australian Competition and Consumer Commission and Critical Infrastructure Centre. If successful in obtaining an exemption certificate, fund managers will not only save time and money but will also be able to execute deals with greater certainty.

Term Loan Bs in vogue

Aussie dollar Term Loan Bs are coming into vogue in Australia. Recent examples include:

- a Barclays led syndicate providing a A$250 million Term Loan B to Iron Mountain Australia in late 2016;
- HPS Investment Partners funding PEP and Carlyle’s acquisition of INova; and
- more recently, the reported arrangement by Goldman Sachs of a Term Loan B to refinance Bain Capital’s after care roll-up, Camp Australia.

Whether all of the B loans organised to date could be described as truly ‘term loan B’ is debatable, but it would seem such loans are a game changer for the Aussie market.

Some key features of Term Loan Bs include:

- generally targeted at institutional investors, particularly super funds, insurers and sovereign wealth funds;
- leverage may be up to 6x earnings (institutional investors don’t have the same regulatory constraints that apply to banks);
- increased leverage comes with increased pricing, range would be a margin of 4.50% - 6.50% over the bank bill swap rate;
- unlike senior secured loans that have maintenance financial covenants that are tested quarterly, there is generally a single leverage covenant (if any) and it only springs to life if the revolving credit facility is drawn above a certain level.

Term Loan Bs are not necessarily appropriate for everyone and not all deals will need that kind of leverage or want the pricing that goes with it. However, they certainly do provide borrowers and sponsors in particular, with a welcome source of new funding.

One issue yet to be fully resolved in the Australian market is the position of the working capital facility provider. In the UK bond market, such working capital lenders generally share the Term Loan B security but on a senior secured basis. That is, on enforcement they get paid out first and they have preferential treatment when it comes to instructing the enforcement process. That does not seem to be how things are necessarily unfolding in Australia, where working capital lenders on some deals rank equally with Term Loan B providers and do not have special voting rights on enforcement. Some deals with these terms have been underwritten and then sold down, so perhaps the eventual working capital lender was not there on day one to voice its views.

Either way, it is expected that this issue still has some way to play out in the Australian market.

Increases in interest rates expected by the RBA – but when?

Lag times and inflation

In August 2017, the Governor of the Reserve Bank of Australia, Dr Philip Lowe, told the House of Representatives Standing Committee on Economics that *'[T]he average level of interest rates in the future is going to be higher than it is today – rates are more likely to rise over time…'* Don't expect the rise any time soon though. According to Dr Lowe *'current market pricing implies…that the next move in interest rates is a long way out…I don't want to dissuade anyone from that particular view. It's likely to be some time.'*

An extended period of easy monetary policy (and, conversely, unwinding of that policy) affects most prices across the economy but with different lags. Asset prices (as we have already seen in this cycle) tend to respond much more quickly. PE firms factoring asset price inflation and CPI inflation into their risk analyses and models need to allow for different lag times.

An interesting regression analysis of data covering a 32 year period from the Euro Area, the USA and 6 other OECD countries, including Australia, was undertaken by Frederik NG Andersson in 2011. The analysis showed substantial differences in how quickly different price indices respond to monetary shocks. Of these, the CPI was the stickiest (and this is one of the reasons central banks prefer to use it as an inflation measure). Using three different horizons: the short run (up to 2 years), medium run (2 to 8 years) and long run (8 years and more), the findings were that money growth correlated with financial asset price inflation in the short, medium and long run. House and other real asset price inflation and money growth are correlated over the medium and long run and the CPI correlation is only over the long run. The spectre of CPI inflation, when raised from time to time by commentators, often fails to take into account this surprisingly long likely lag time.

According to the RBA Governor's testimony to the House of Representatives Standing Committee on Economics, while households are feeling pressure from the cost of living, it is the *'lack of wage growth and income growth that's the issue not…[costs] rising at an unusually rapid rate'*. He went on to say further that it comes back to how we get stronger growth in incomes.

He also provided a good clue to investors wanting to track when there is likely to be a rise in inflationary pressure (and interest rates) in Australia by saying: *'There are two elements to the answer to that. One is just gradual strengthening of the labour market. The demand for labour picks up relative to supply, and wage growth will pick up. That's a cyclical element. The structural element is policy reform to generate stronger underlying real growth in the economy….[which is] really up to the parliament and to business.'*

So PE houses should look out for meaningful movement on both of those two elements.

What about the impact of this on hedging? In the currently benign interest rate environment, hedging requirements are less pressing and it is proving easier for borrowers to maintain desirable flexibility. We see a number of borrowers deferring hedging. Borrowers are preserving potential price competition by the ability to introduce a Hedge Counterparty (from outside the syndicate, if necessary) to the security trust structure and there is increasingly an agreed series of amendments to a conventional security trust deed to enable this to happen.

Tax reforms

Recently released reforms to income tax consolidation will, if enacted, play a role in both transaction structuring and the tax assumptions underpinning financial models. The new measures are designed to address cost base uplifts on acquisitions where deductions are available not only on the uplifted cost bases of acquired assets, but also on liabilities in the target that are incurred post-completion. Landholder duty continues to be a transaction issue that yields surprises, and detailed attention in initial structuring can save considerable anxiety as a transaction progresses towards signing.

The industry has worked hard to ensure that the ATO treatment of exit proceeds flowing through domestic PE funds to foreign investors is consistent with guidance but it has been observed that the ATO continues to improve its capability and standardise the approach to ensure treaty benefits are available to appropriate investors.

It remains to be seen whether domestic PE will seek to adopt the proposed Corporate CIV vehicle to house new funds; analysis and investor awareness still needs to be gathered and the outcomes of consultation with the government should be understood before a new fund structure is offered to prospective investors.

MinterEllison's market leading private equity group is a trusted adviser to Advent Private Capital, Affinity Equity Partners, Anchorage Capital Partners, Allegro Funds, Armitage Associates, Baring Private Equity Asia, BOAB Capital, CHAMP Private Equity, Mercury Capital, M.H Carnegie, Next Capital, OPTrust, Pemba Capital Partners, Odyssey Private Equity, Quadrant Private Equity and Yorkway Equity Partners, among others.