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What We're Seeing – 2022 Dealmaking Outlook

WRITTEN BY

Bruce K. Fenton | Matthew M. Greenberg | Christopher S. Miller | Hayden S. Baker

The Rearview Mirror

Robust multiples and fear that the Biden administration might succeed in passing tax laws resulted in 2021 being one of the busiest years ever in the private equity space. Within the capital markets, while the year was strong, the speculative market cooled off tremendously in the 4th quarter, particularly in pharma and biotech.

Headwinds appeared toward the end of the year as buyer-side representations and warranty insurance (RWI) coverage became tough to get, and very expensive when available, freezing some deals until 2022, and forcing other buyers either to use more traditional approaches to indemnification protection, or to self-insure. While January and February traditionally are quiet, we expect to see accelerated dealmaking later in the first quarter of 2022 as the RWI ice jam thaws and new companies come to market that did not get to market in Q4 2021.

2022's Known Unknowns

Going into 2022, we see several unknowns that may affect deals. Chief among them:

- What legislative changes may come down the pike in 2022 that could impact tax and regulatory considerations, or will the upcoming mid-term elections distract Congress from making any meaningful changes?
- What will the impact be of SEC Chair Gary Gensler's push for increased transparency for private funds? See the latest developments in our January 26, 2022 Client Alert.
- How will the RWI market continue to evolve? Insurance companies have done a great job in making RWI irresistible. The result, however, was that by year-end 2021, buyer-side RWI was so popular that underwriters stopped issuing policies in particular industry verticals, and raised prices in those still being underwritten.
- Inflation and labor and supply chain issues may pose additional challenges. How will this impact multiples and valuations?

What Will Be Hot…

A lot of cash is still sitting on the sidelines, hoarded by both larger strategic buyers and PE funds. Some estimates are as high as nearly $2T of dry powder.

We believe that M&A will remain hot. Now some might say it's a seller's market based on 2021 data, but we believe there are a lot of sellers in the markets and there's a chance the market could flip this year, giving buyers the advantage to pick and choose deals to their liking. Further, these sellers offer good assets which could fuel competition in the entire M&A space.

The IPO market will continue to be vibrant for very strong companies, but not every company that wants to go public will succeed. Exits might be industry-specific – tech and health care are hot. Within tech, blockchain has doubled and will double again. Larger health care IT private equity-backed companies will continue accessing the public markets as a way of getting liquidity to their private equity investors.

Deals involving larger health care IT will continue to use stock as a much bigger percentage of the overall deal consideration. Investors are putting vesting provisions around stock as a retention tool for the founders and key players the buyer wants to ensure stay on for several years.

Expect a continued increase in earnouts, which were used in up to 60% of private company acquisitions in the life sciences, and as high as roughly 20-30% in other sectors, according to a study by SRS Acquiom covering 2008-2019. Buyers essentially need to know that the selling company is worth the price tag, with the seller proving it through its performance post-closing.

…And What Will Not

SPACs aren't dead, but there is clearly a lull as compared to their meteoric ascension in Q1 2021. SEC guidance on accounting of SPACs was a known item for 40 years, and then the sharp rise in SPAC deals prompted the SEC to step in, advising that it reviews SPACs just as closely as it reviews traditional IPOs, and warning investors that they should be aware of the risks of investing in SPACs. Future SEC regulation of SPACs may cover several specific areas of concern, including predictions of financial performance, conflicts of interest among SPAC management teams, insider trading, and antitrust violations. But SPACs can still be an easier way to go public, so we aren't counting them out.

PE Heeds the Call on ESG and DEI

ESG (Environmental, Social, and Governance) issues are increasingly important to investors, and we see PE firms working to be more effective in the area.

ESG metrics have become commonplace as PE firms have come to appreciate the importance of measuring progress against defined ESG benchmarks. Initiatives like the ESG Data Convergence Project are helping investors and firms standardize those metrics to improve comparative reporting. More recently, however, investors are moving past measurement to impact, especially as they consider the lifecycle of investments and not just the initial screening decision. To some extent, this trend reflects PE firms seeking to differentiate themselves in the marketplace and replicate the success of impact and sustainable infrastructure funds by investing in impactful ESG outcomes. But we also see investors adhering to the rationale that has accelerated ESG concerns in the public markets – that strong ESG performance correlates to long-term, sustainable financial success.

ESG considerations have migrated from risk management and mitigation to business opportunity and value creation. We see this migration propelled by investor pressure, but also by the opportunities afforded by major sustainability trends such as the circular economy, the energy transition, decarbonization, waste reduction, resource efficiency, and social inclusion. And increasingly, particularly among firms with a buy-and-build growth strategy, we are seeing PE firms emphasizing ESG improvements as they execute operational and growth plans at the portfolio company level.

On the regulatory front, the SEC plans to require climate change disclosure regarding what is ESG-effective and what isn't. We will be watching how the SEC moves to set ESG disclosure requirements for public companies in 2022, as this could offer a model for the PE industry to emulate.

Nudged by public pressure and large institutional investors, DEI (Diversity, Equity, and Inclusion) also is now on the radar of PE funds. Funds are increasingly looking to add diverse members to the boards of their portfolio companies and we also are seeing noninvestment-related activity that will assist in improving their overall DEI profile, and expect the desire to do so will continue to increase.

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