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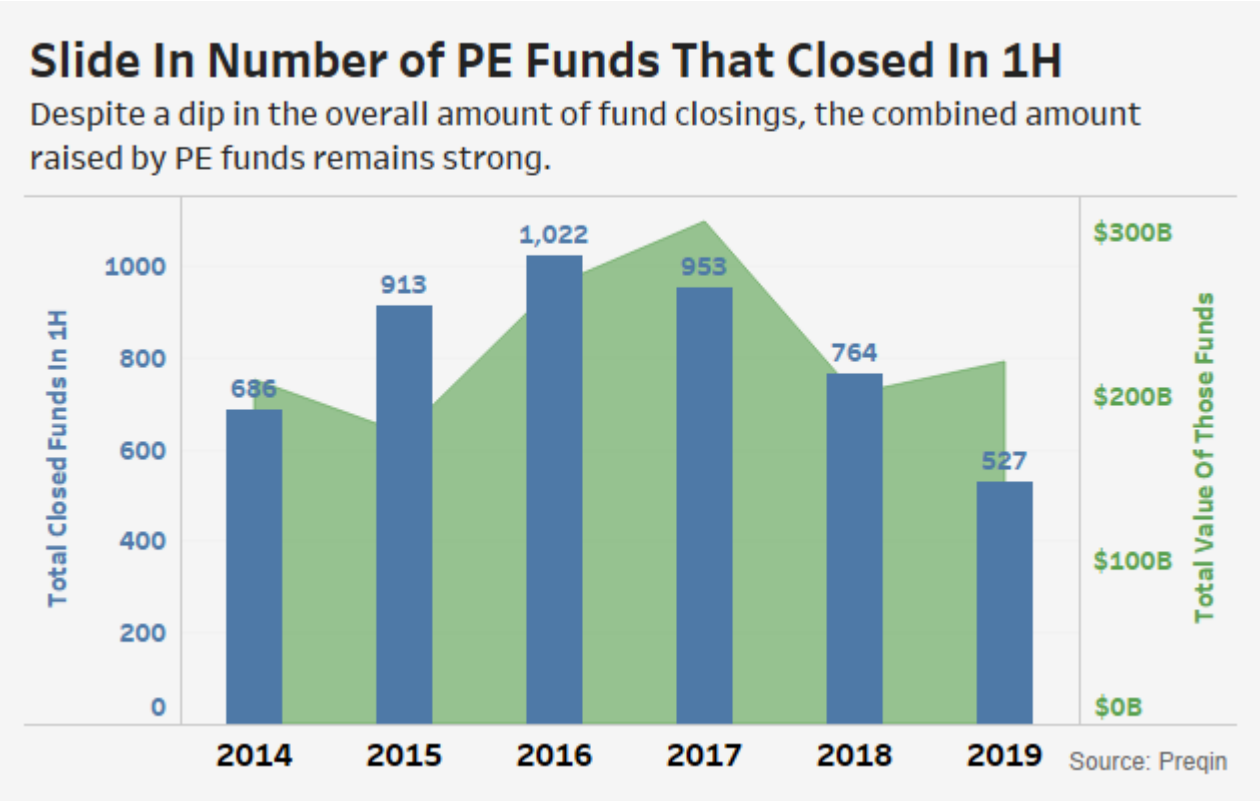
6 PE Trends That Are All The Rage Right Now

By **Benjamin Horney**

Law360 (July 19, 2019, 9:55 AM EDT) -- The private equity industry is constantly evolving as fund managers seek to continue producing strong returns, and the first half of 2019 has seen firms try novel approaches such as holding onto investments longer and choosing to forgo initial public offerings for technology businesses.

Although some reports have suggested a slowdown in private equity activity, and some of the numbers back that up — such as a dip in the total volume of PE funds that have closed through the first two quarters of 2019 — these figures don't necessarily have much of a bearing on the workload that is going to pile up on private equity attorneys' desks.



"There's still a lot of activity," said Todd Boudreau, a partner in Morrison & Foerster LLP's private funds group and co-chair of the firm's global private equity investments and buyouts practice. "People are still

aggressively pursuing transactions and continuing to try and get creative to win those deals."

Private equity clients still want to raise funds and do deals, and they don't care if reports say things have slowed down. Thus, it's important for attorneys to have a finger on the pulse of the PE industry.

Here, Law360 explores six trends that have been all the rage through the first two quarters of the year.

Some Companies Are Being Kept Private Longer

The private equity industry has always been fascinated with the realm of technology, and that trend is only growing as the world becomes more reliant on tech in multiple ways. Artificial intelligence, blockchain, software-as-a-service, cloud storage and data infrastructure are just a handful of the types of businesses that PE players have their eyes on.

However, while these tech companies have historically raised a couple of rounds of capital and then launched IPOs, some are now choosing to stay private longer. The public markets can be a bit of a gamble; it's hard to know which businesses will price above their targeted range and have an explosion in value, and which ones will price at the bottom of their targeted range and struggle.

"You're seeing a lot of these pre-IPO companies staying private longer," said Michael Wolitzer, a partner at Simpson Thacher & Bartlett LLP and head of the firm's investment funds practice. "However, they still need capital to grow, and they are tapping the private markets."

Where up-and-coming tech businesses used to make plans to go public after their Series C or D rounds, nowadays it is becoming more normal to see Series E and F investment rounds while companies are still private, Wolitzer said.

"The late-stage venture growth equity area is expanding," he said.

Private Equity and Venture Capital Firms Are Competing for the Same Assets

The pace at which the lines are blurring between private equity and venture capital firms — which have long been competitors for the same deals — has picked up considerably. No longer do private equity firms solely focus on businesses that are already generating revenue while venture capital firms target early-stage companies that might not be making money yet.

Instead, both are looking to become early investors in businesses they believe could have transformative technologies — think self-driving cars or virtual reality. Today, private equity fund managers are being forced to compete against venture capital players that, in some cases, have the ability to use far more money on a given deal than they ever would have in the past.

"Is it still a venture fund, even if they are cutting a $1 billion check?" Boudreau said. "Venture firms are getting bigger, and are looking at new opportunities."

Meanwhile, it isn't just private equity and venture capital firms that are competing against each other and pushing up prices. Auctions for assets in the modern era involve other entities, ranging from hedge funds and limited partners themselves to sovereign wealth funds and family offices.

"You're seeing a morphing of asset classes," said Jay Freedman, a partner at Ropes & Gray LLP.

LPs Are Investing With Fewer Fund Managers

It has never been easy for first-time fund managers to raise capital, but with people beginning to wonder whether there might be a recession on the horizon following a long period of economic expansion, many limited partners are choosing to dial back the number of fund managers with which they'll invest.

That said, there will always be opportunities for new fund managers to enter the market, but in the current environment, new entrants are likely to struggle unless they have either carved out a specific niche or can point to a track record from places they worked at in the past. It's not novel to say that limited partners are seeking the strong returns they have historically been able to nab via private equity investment, and they are more likely to invest their money with people they are confident can put it to work.

"There's a flight to quality, a concentration of capital in fewer hands," Wolitzer said. "Established fund managers seem to have an advantage over others in the marketplace."

Unconventional Fund Terms Are Continuing to Take Root

As fund managers try to find ways to continue raking in the profits they and their limited partners desire, there has been a shift in recent years toward the offering of unconventional fund terms. In particular, more and more fund managers are setting up investment vehicles with longer holding periods for investments.

"There's an overall trend of a greater number of funds with longer holding periods," Wolitzer said.

This has become more popular, in part, because as deals become more expensive, it gets increasingly difficult to reach the returns fund managers have historically been able to generate upon exiting a portfolio company.

"Firms like having the flexibility to hold assets longer if the market tells them they should," Boudreau said.

Although the returns with longer holding strategies may be lower, the capital is at work for the entire holding period, which creates the opportunity for greater multiples of invested capital over time, Wolitzer said. And while longer holding periods have been taking root in general, the trend has been especially noticeable in a few select industries, such as insurance, financial services and asset management.

“You can hold these assets and produce strong steady returns, while giving partners the flexibility of redemption,” Boudreau said.

Infrastructure is another area where longer holding periods seem to naturally make sense. While the industry standard for PE funds has long been 10-year life spans and five-year holding periods, those timelines don't add up when you're investing in, for instance, a major highway project that might not even be completed for 10 years.

"In some asset classes in private funds, the nature of the assets are long term holds," Wolitzer said.

"Infrastructure is a good example. By its terms, infrastructure investments can end up being a 10- to 20-year asset."

The Secondary Market Is More Popular Than Ever

The private equity secondaries market involves the sale or acquisition of investors' existing interests in investment vehicles, and its popularity as an asset class has grown in recent years because secondaries funds provide limited partners with increased flexibility in their investment portfolios.

There are many reasons LPs might want to get out of an investment commitment early, be it regulatory issues, changes in their investment strategy or a general need for liquidity.

"There's a very robust secondary market, and I think that will continue to grow," Boudreau said.

The legal work on secondaries funds necessitates expertise in both mergers and acquisitions and private equity fund formation, so typically lawyers that are only well-versed in one or the other will want to call upon their colleagues for assistance. Because the practice is expanding in popularity, attorneys need to get up to speed on what is required to form a successful secondaries fund.

"There are always ways to get out of your investment," Boudreau said. "Typically, we try to draft the documents so that if somebody wants an exit they can make it happen."

Attorneys will be key in helping to draft such clauses, whether that means there is a provision stipulating the general partner will assume the responsibility to find someone to buy out a limited partner's investmentt or that the LP has the ability to go and sell its interest on the secondary market, according to Boudreau.

More Fund Managers Are Considering the Impact of Their Investments

Impact investing has been on the rise for a few years now, but the stigma that the practice will always result in lesser returns is melting away, and causing more and more fund managers to consider raising funds that will specifically focus on environmental, social and governance issues.

In the most recent Annual Impact Investor Survey from the Global Impact Investing Network, 82% of the 229 respondents said that their investments have met their expectations for impact, while 76% said their investments have met their expectations for financial performance. Roughly 15% said that their investments outperformed their expectations for both of those categories.

"I definitely see that this will continue to grow in popularity, especially now that we have data on the returns that show this is a compelling investment asset," Boudreau said.

Where it used to be a niche that particular firms focused on, in today's world even some of the most well-known private equity shops are building in impact.

"You see some of these major firms trying to figure out and get involved in impact, and considering environmental, social and governance factors when making investments," Boudreau said. "People are trying to figure out how to differentiate themselves, and impact funds are one unique way to do that. If you don't have a mission driven investment fund, you can still have ESG reporting and goals for your portfolio companies, such as diversity, carbon footprint, etc."

Impact funds are not all sunshine and rainbows, however, and they can bring about issues that attorneys might not be used to. For example, lawyers may need to be careful in structuring tax aspects of an impact fund if there's a charitable organization associated with the investment vehicle in some meaningful way and have procedures in place to follow investment mandates, such as mission over profit if required.

"You have to make sure you're following the proper protocols and requirements of the partners, some of whom are mission driven foundations," he said. "For example, there can be a number of issues with respect to charitable organizations depending on their affiliation with the fund, and it can become quite complicated."

--Editing by Brian Baresch.