BDO’s 7 Private Equity Predictions for 2022

Driven by a fast economic recovery, pent up demand, low interest rates and a race to get deals done ahead of potential tax changes, deal making at the end of 2021 rebounded from pandemic lows and set new records. According to [BDO's Fall 2021 Private Equity Capital Pulse Survey]() 42% of private equity fund managers said they'll direct the most capital to new deals. That number was just 19% in Fall 2020.

Is that pace of activity anticipated to continue in 2022? What trends do fund managers need to be aware of as they plan deals, develop and execute value creation strategies and exit plan in 2022?

Here are 7 private equity predictions for 2022

Prediction #1

Supply chain issues, inflation and higher interest rates could pose a challenge

While deal makers will continue to search for quality deals, the deal environment will continue to be uncertain. Supply chain delays continue, and with them have come higher prices and inflation. Federal reserve officials have indicated they're planning to raise interest rates sooner rather than later, which could help control inflation but will make borrowing more expensive. The firms that will succeed amid uncertainty will be able to model risk with tools such as supply chain simulation or digital twins, and adapt accordingly with a strong and resilient supply chain.

Takeaway: Ongoing supply chain issues mean private equity will need to stay focused on creating enterprise value for portfolio companies and deploy a variety of operational initiatives, including considering nearshoring their supply chains, upgrading their supply chain visibility or exploring alternative suppliers. Transitioning supply chains from low-cost, to resilient and dynamic, is paramount moving forward.

An anticipated rise in debt capital interest rates also means the sooner the better when it comes to locking in acquisitions, in order to secure lower interest rates. Funds will need to accurately model risks and adapt accordingly.

48% of CFOs at private equity-backed companies say supply chain disruption poses significant risk to their business[1]

43% of of fund managers say they are identifying and implementing supply chain efficiencies to generate value from their investments[2]

1 According to BDO's 2022 CFO Outlook Survey

2 According to [BDO's Fall 2021 Private Capital Pulse Survey]

Prediction #2

Amid record fundraising, LBO volume may be tempered by rising interest rates

Leveraged buyout (LBO) activity will remain strong, following record leveraged loan sales in 2021. Private equity firms with funds focused on the U.S. are sitting on an estimated $960 billion in dry powder that needs to be deployed, according to research firm Preqin. While funds pursued add-on acquisitions as a pandemic deals strategy in 2020, a strong recovery means that new deals and LBOs have a longer runway. Sales of U.S. leveraged loans are expected to stay strong, with 435 deals already in the pipeline in January, according to PitchBook.

Takeaway: With abundant dry powder, 2022 is looking promising for LBOs. However, federal reserve officials have stated they expect to raise rates three times this year and again next year. As rates rise, leveraged loans will get more expensive and could thwart strong returns. Funds could consider accelerating deal timelines now, before interest rates rise. Otherwise, they may need to finance deals with more cash.

$960 billion

The amount of dry powder available for U.S. deals in H1 2021

Prediction #3

Technology and healthcare will continue to be industries of interest, but private equity may need to rethink how it invests in retail

Private equity's interest in investing in tech will continue. 2021 saw a record volume of private equity-backed tech deals, with more than $400 billion in U.S. tech deals last year, according to Dealogic. There's no sign that this will slow down in 2022. Other industries of interest are healthcare, life sciences and retail. Private equity activity in consumer retail totaled about $13.7 billion during just the first three quarters of 2021, outstripping each of the last three full years.

15% of retail companies

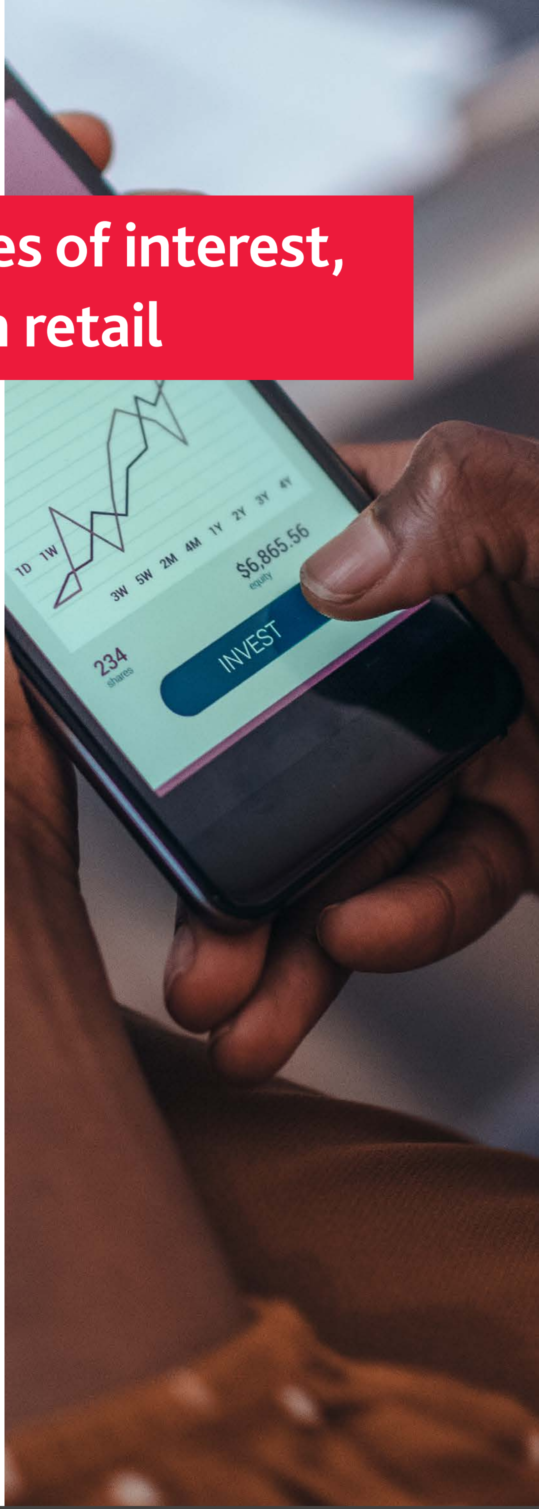
14% of healthcare companies

13% of tech companies

were backed by private equity in 2021[3]

Takeaway: Tech will continue to be an industry of interest due to the reliable recurring-revenue model and consistent returns, particularly promised by software-as-a-service businesses. Compared to other industries, technology is also not as capital intensive and often has lower fixed operating costs.

The healthcare and life sciences industries present attractive profit potential. However, when it comes to retail, funds may need to rethink their traditional strategy, due to high valuations and a low appetite for credit risk. There is evidence that credit markets are willing to lever traditional retailers only up to 2.5x EBITDA, down from up to 4.5x EBITDA in the first half of 2021. Retail has also been plagued with supply chain disruption and labor attraction and retention issues. Brick-and-mortar retail is less resilient to a COVID-19 resurgence. For funds investing in retail, having a strong integration and value creation plan and operations strategy will mean the difference between a successful investment and a failed one.



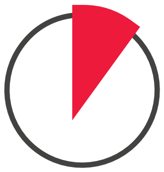
3 According to BDO's 2022 CFO Outlook Survey

Prediction #4

The SPAC boom may be calming down

In 2020 and 2021, special purpose acquisition companies (SPACs) exploded, becoming a viable alternative to the traditional IPO. But the pace began to slow by the second half of 2021. In 2022, we can expect the SPAC excitement to moderate.

10% of **CFOs** at private equity-backed companies said they are **considering a SPAC** in 2022[4]



58% of **fund managers** said their exit strategies over the last 18 months have shifted to include greater **consideration** of a SPAC[5]

Takeaway: Data suggests that of the nearly 200 companies that have gone public via SPAC in 2021, about 75% have share prices below the SPAC's listing price, according to SPAC Research. Nearly 40 companies have lost more than 50% of their value. The SEC is also looking to place more regulations on SPAC IPOs. SEC chairman Gary Gensler has voiced concerns that institutional investors may be getting early access to information and better share pricing than the general public, and that retail investors may have to pay sponsor fees or have their shares diluted without being alerted. He has also expressed general concern about the trend of celebrity-endorsed SPACs and other marketing tactics.

While the SPAC frenzy may be abating, it will still be the vehicle of choice for the right targets, given faster execution and lower costs of marketing, among other benefits specific to SPACs.

4 According to BDO's Fall 2021 Private Capital Pulse Survey

5 According to Pitchbook's 2021 sustainable investments survey

Prediction #5

Adoption of ESG and impact investing will gain traction

The public has criticized private equity for buying up fossil fuel projects and acting as a lifeline to coal plants, with just 12% of fund investments in the energy sector going to renewable energy. The industry will face increased pressure to report climate-related risks to their businesses and demonstrate how their investments are supporting a transition to a green future.

Limited partners do have growing interest in environmental, social and governance (ESG) considerations:

64% of GPs and service providers said that LPs had expressed increased interest in sustainable investment issues over the last period from 2018 to 2021[5]

Just **58%** said the same in 2020[5]

Interest in ESG is not driven solely by ethics; businesses, investors and funds alike recognize the value of sustainable business practices, which mitigate risk and improve performance while optimizing the positive impact of a company on its communities. A majority of ESG funds outperformed the wider market over 10 years, according to MorningStar. As the global economy attempts to transition to green energy, relies more on electric vehicles and seeks carbon reduction solutions, firms that prioritize ESG are setting themselves up for success in the new sustainable economy.

However, interest in ESG goals, and even a demonstrated success of ESG funds, doesn't mean funds understand how to accurately report on their impact, or have a holistic strategy for continuing to build ESG efforts.

Takeaway: Private equity should get out in front of ESG by releasing a report on how their investments and activities are supporting ESG goals. That could include establishing a climate-focused fund. However, more industry standards are needed. There is currently no uniform standard on what and how to report on ESG. Furthermore, what one firm may consider to be an ESG fund may be different from what investors or other firms consider when building an ESG fund.

For now, the best recommendation is not to fall prey to "greenwashing" — making ESG efforts out to be greater than they truly are. Instead, funds should make a genuine and concerted effort to consider how their investments are impacting people, communities and the planet.

5 According to Pitchbook's 2021 sustainable investments survey

Prediction #6

More GP-led secondary transactions in 2022

In 2021 we saw more general partner (GP)-led secondary transactions. When a GP wants to hold onto a portfolio company to make potentially greater returns but LPs need liquidity, a GP-led secondary transaction can satisfy both parties. LPs can choose to sell a portion or all of their fund interests back to the GP or roll their funds into a new, secondary vehicle.

Fully implementing a GP's value creation plan may require more time than the traditional 10 years, and portfolio companies might not increase in value according to the fund's timetable. Secondary transactions allow a GP to further execute on value creation, while the LP gains greater precision in overall portfolio management.

The secondary market is poised to exceed **$100 billion** in volume for the first time in 2022[6]

Takeaway: GPs increasingly view the secondary market as a viable alternative to traditional company exit paths. Given that there is still significant dry powder to be deployed, and GP-led transactions are growing in size and becoming more common, more complex deals are requiring multiple lead investors. In 2022, this will afford well-positioned secondary buyers to gain access to more secondary deals.

6 According to Private Equity International

Prediction #7

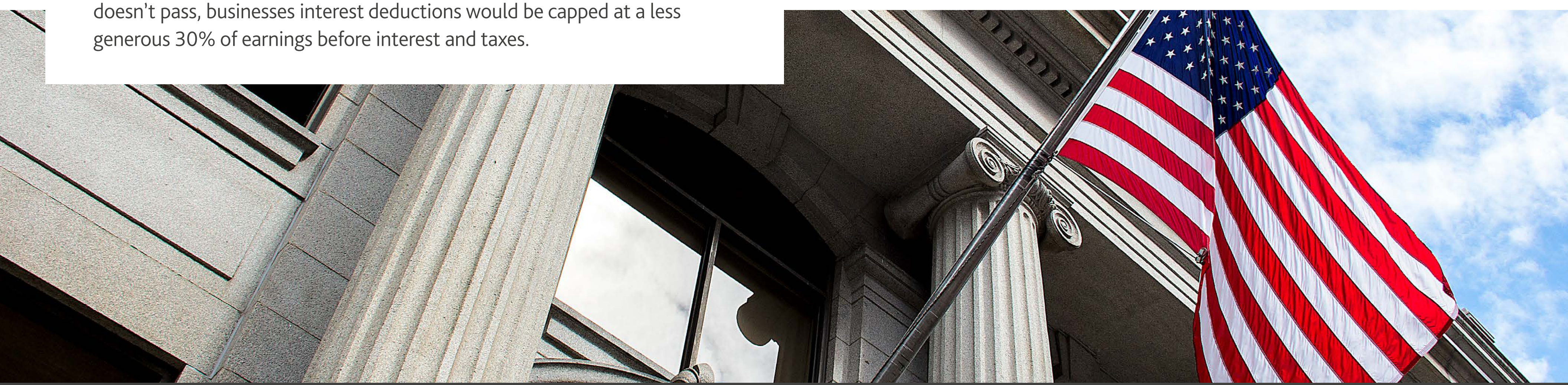
Partnerships breathe a sigh of relief: Major tax changes look increasingly unlikely

While the anticipation of major tax changes was a factor in accelerating deal closures in 2021, Biden's Build Back Better Act (H.R. 5376) looks unlikely to pass in its current form. Proposals to extend the holding period requirement for long-term capital gain treatment or tax carried interest allocations as ordinary income, above $400,000, were not included in the current text of the bill.

That doesn't mean changes to taxes, or even changes to the capital gains rate, are completely off the table. Negotiations continue within the Democratic party as the White House tries to reconcile demands by Sens. Joe Manchin and Kyrsten Sinema with its own agenda. Meanwhile, some Republican representatives are looking to revive the formula for capping deductible business interest expenses at the sum of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) that was enacted in the 2017 Tax Cuts and Jobs Act but expired at the end of 2021. If this bill extension doesn't pass, businesses interest deductions would be capped at a less generous 30% of earnings before interest and taxes.

Takeaway: Funds should continue to watch how bills to change taxes evolve through the House and the Senate but shouldn't expect significant tax changes in 2022. Although some changes are still possible, it will be more important to understand how to operate within the existing tax regime.

In addition to watching legislators, funds should stay aware of potential regulatory changes. In February, the Securities and Exchange Commission (SEC) passed a proposal that would require private equity funds to disclose fund performance, compensation, fees and expenses to investors. SEC chairman Gary Gensler has also said he wants to require additional disclosures on the Form PF filing, including requiring funds to report within one business day significant losses they have incurred. Funds should be aware of how these regulatory changes evolve in order to ensure compliance.



2022: An exciting environment for private equity – but not without its challenges

With plenty of dry powder available, a strong resurgence of LBOs and new opportunities, such as value in the secondary market, we expect 2022 to be an exciting year for private equity and expect the investment class to perform well overall.

However, there will be potential challenges. With supply chain disruption ongoing, having a strong value creation plan in place is a must-have. GPs need to bring operational and supply chain understanding and skills to any portfolio company.

With the rise of GP-led secondary transactions, there are more opportunities for exit planning, especially if the value creation timeline exceeds 10 years. At the same time, don't fall prey to trends if they aren't strategic. We've seen that with the rocket-fast rise of SPACs, but poorer performance and potential regulations may turn investors back to the traditional IPO.

Finally, ESG has come into focus both for firms that may be considering setting up an ESG fund, if they don't have one already, and investors that are looking to do well by doing good. However, the industry needs to align on a standard of ESG reporting, as well as how to define an ESG fund in order to avoid potential greenwashing.

The private equity firms that succeed in 2022 will have a strong value creation plan. They will understand risk and quickly adapt to changing scenarios.

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