Client Alert:

2021: Deal Fever and its Implications for Private Equity Investing

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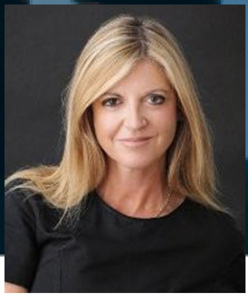
By Sarah Keeling, Jack Martin and Alexander Moss

2021 has seen an unprecedented tide of deal-making, with private equity leading the way. Analysts have predicted that, for the first time, global buyout deal value will surpass US$ 1 trillion in 2021 – the previous record was US$ 804 billion (2006), before the global financial crisis. Whereas the number of deals in the first half of 2021 rose by 16%, compared with the first half of 2020, the average deal value jumped from US$ 718 million to US$ 1.1 billion – an increase of 48%.[1]

The UK has been particularly fertile ground for investment. It has been estimated that, in the nine months to September 2021, more deals were completed than in the whole of 2020, with 517 companies, worth US$ 71.3 billion (£51.6 million), being acquired.[2] *Reuters* reported that private equity has accounted for 85% of British take-private deals in the eight months to August 2021,[3] whilst the number of UK buyouts is also up 60%, compared with the corresponding period in 2019, according to financial data provider *Refinitiv*.

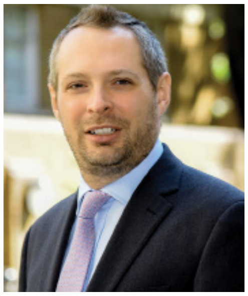
Record Dry Powder and its Deployment

But what has led to this 'deal fever', which could result in the private equity industry tripling in size since 2011, despite the onset of Covid-19? Many believe the answer is down to the mountain of dry powder that firms are sitting on – estimated to be US$ 3.3 trillion worldwide[4] – which was not invested in 2020. Whilst firms have more capital, there is also *"a surplus of distressed companies on the offering block"*, according to Ed Gascoigne Pees, a partner at communications firm Camarco.



Sarah Keeling
Partner, StoneTurn
skeeling@stoneturn.com
+44 (0)20 7427 0417

Jack Martin
Executive, StoneTurn
jmartin@stoneturn.com
+44 (0)207 898 3425



Alexander Moss
Senior Manager, StoneTurn
amoss@stoneturn.com
+44 (0)20 7427 0410

Whilst the increase in deal activity is welcome news, there are concerns about how firms are deploying capital. As business information provider *S&P* notes, firms may have to deal with increased valuations which could lead to diluted returns or they may come under pressure to invest "*from LPs, who want to see their capital at work.*" Recent bidding wars between Clayton, Dubilier & Rice and Fortress Investment Group over UK supermarket chain Morrisons; and between EQT and Hellman & Friedman for online pet platform Zooplus, could both be examples of increased dry powder driving up deal prices.[5]

In the race against competitors, or to deploy capital, private equity firms may hasten to complete deals. However, in the rush to achieve an adequate return on investment, firms should not lose sight of regulatory and compliance procedures, and the need to perform sufficient due diligence, particularly in the face of continuing changes in the regulatory landscape.

Challenges Posed by the UK's new National Security and Investment Act

One such change is the National Security and Investment Act ("NSIA"), which was enacted in April 2021 and comes into force on 4 January 2022. Under the act, the UK government's Department for Business, Energy & Industrial Strategy will have the right to scrutinise, impose conditions and remedy or, as a last resort, block any deal if there is deemed an "*unacceptable risk to UK's national security.*" Investors in UK companies, which operate in 17 defined 'sensitive sectors', including defence, energy and artificial intelligence will have to notify the new dedicated Investment Security Unit in advance of any deal or "trigger event" – defined by the NSIA as an increase in greater equity interest, or "material influence," to more than 25%, 50% or 75% of an entity. The UK government expects between 1,000 and 1,800 notifications each year, with approximately 70-95 transactions selected for a full national security review – a sizeable increase from the 25 transactions reviewed by the UK government in total since 2003, under previous regimes.[6]

Under the NSIA there is no concept of a foreign investor, and all UK investors will be subject to the same considerations. Furthermore, the new law could even capture investments in non-UK entities, if they supply goods or services to the UK. It is therefore paramount that investors perform proper due diligence to identify any UK connections if they are dealing with an entity that operates in any of the 17 sensitive sectors.

Described as "*one of the broadest and most aggressive investment review regimes globally,*"[7] the NSIA is indicative of the government's increased focus on deal activity and enforcement. In August 2021, the UK's Competition and Markets Authority was ordered by Business Secretary Kwasi Kwarteng to investigate a bid by Advent-owned Cobham for Ultra, which sells torpedo and radar systems to the Royal Navy, on "security grounds," as Advent is US-based.[8] During the same month, the sale of Welsh microchip manufacturer Newport Water Fab to Chinese-owned Nexperia, for £63 million, was "unwound" after the intervention of UK ministers. Ministers were reportedly concerned by China furthering its interest in semiconductors produced at the Newport plant, which can be used in everything from missile systems to toothbrushes.[9] In November, the UK government's willingness to intervene in transactions was further seen when it was reported that Nvidia Corp.'s acquisition of chip designer ARM would be investigated on antitrust and national security grounds.[10]

Failure to comply with the NSIA could lead to severe punishments, such as the cancellation of a transaction, heavy fines and even criminal penalties. Now, more than ever, private equity and other dealmakers must understand the operations and activities of any target company, and whether they need to notify the UK government, in advance of any deal.

With increased deal activity and tougher regulations, private equity firms must ensure they deploy their record dry powder wisely, in order to avoid costly consequences. StoneTurn is well placed to help navigate this new landscape, offering forensic due diligence as part of a wider business intelligence brief.

How StoneTurn Can Help?

1. **Enhanced and Investigative Due Diligence**
   Enhanced due diligence and the use of sophisticated business intelligence and investigative techniques aim to uncover any concealed information gaps ahead of any transaction; as well as helping to remedy any issues or minimise any risks identified after a transaction is complete.

2. **Post-acquisition Review**
   Once a deal is closed, the new owners will have access to significantly more information than was available pre-acquisition. At this juncture, a deeper dive into the health of the company is advised to identify any red flags, accounting irregularities, regulatory issues or pre-deal misrepresentations.

3. **Review of Internal Controls**
   After an acquisition, reviewing the strength of internal control framework and identifying any gaps within them is especially important to ensure effective decision making; especially in meeting the rigour of ever evolving, complex financial reporting rules.

About the Authors

Sarah Keeling, a Partner with StoneTurn, is a former senior British government official with more than 20 years of experience in national security and intelligence matters in the U.K. and overseas. She assists companies, family offices and their counsel on operational, reputational and investment risk matters worldwide.

Jack Martin is an executive with StoneTurn and specialises in business intelligence and investigations. Focusing on litigation support, asset tracing and recovery, strategic and cross-border investigations, investigative and pre-transactional due diligence.

Alexander Moss, a Senior Manager with StoneTurn, has more than 12 years of experience in investigations, government advisory, internal audit and tax engagements. He has managed teams on several high-profile projects, both in the U.K. and overseas. Alex has worked on projects across various industries, including financial services, oil & gas, construction and the public sector, among others.

[1] "*Private Equity's Wild First-Half Ride*", Bain & Company (2021)

[2] "*Takeover! The private-equity billionaires ripping up the City rulebook*," The Times (5 September 2021)

[3] "*UK for sale: Britain's year of private equity buyouts*," Reuters (16 August 2021)

[4] "*Private Equity's Wild First-Half Ride*", Bain & Company (2021)

[5] "*Private equity firms all want the same thing: British companies*," New York Times (31 August 2021); "*Private equity rivals join up with EUR 3.7bn bid for petcare group Zooplus*," Financial Times (25 October 2021)

[6] "*UK Government issues further updates on national security regime: a comprehensive state of play for investors*," Gibson Dunn (8 September 2021)

[7] "*National Security and Investment Act to enter into full force on 4 January 2022*," Baker McKenzie (23 July 2021)

[8] "*Private equity firms all want the same thing: British companies*," New York Times (31 August 2021)

[9] "*China's Wingtech warns Newport Water Fab deal is at risk*," CNBC (19 August 2021)

[10] "UK to investigate Nvidia's ARM deal on national security grounds - The Sunday Times," Reuters (14 November 2021)