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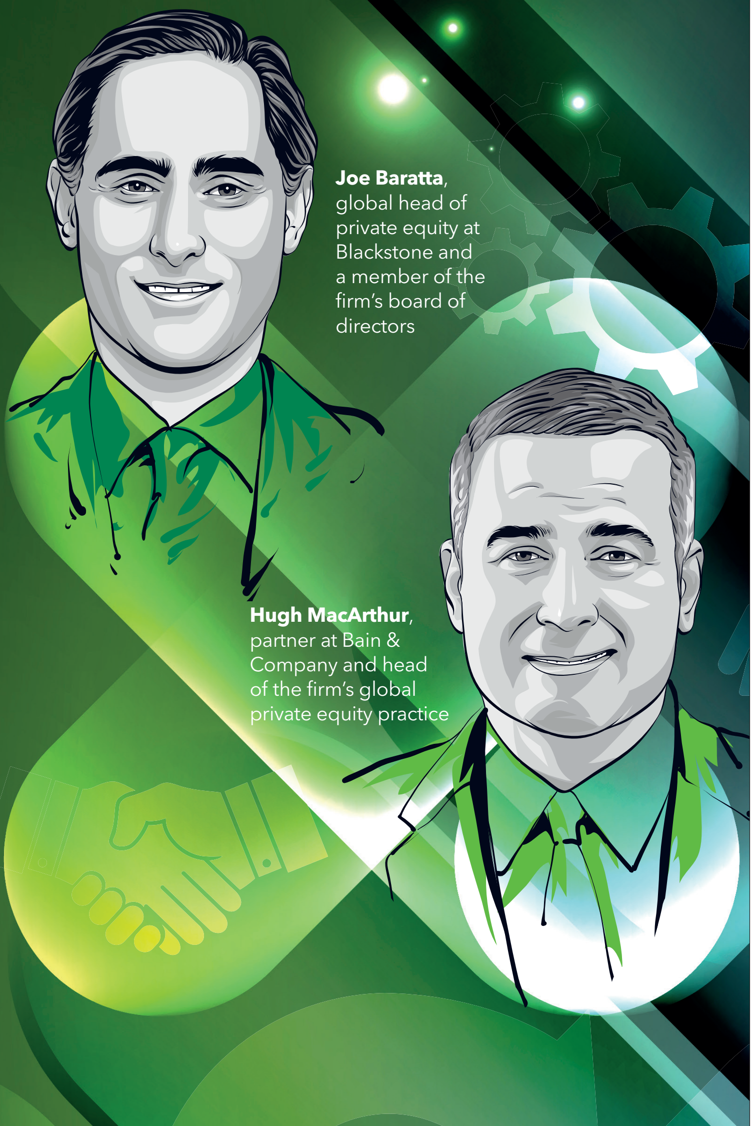
Forecast

Five industry insiders hash out whether 2022 will top 2021, a banner year in dealmaking and fundraising. High valuations, supply chain issues and inflation are all potential speed bumps.
By Kirk Falconer and Chris Witkowsky

Last year's private equity market was scorching hot, as the pent-up energies of 2020 were unleashed in a post-covid frenzy of investing. Dealmaking hit an all-time high. GPs competed fiercely for an expanded opportunity set. Fundraising broke records. LPs increased allocations and placed fresh bets, and dry powder rose to unprecedented levels. Will the next 12 months see more of the same? Or will the specter of inflation and rate hikes inject uncertainty? Will dealmaking roar on or will GPs instead exercise restraint? Will vigorous fundraising continue or will LPs pull back? And how will the industry manage a full agenda of pressing issues, including everything from ESG to transparency? To help answer these questions and get further insights on the road ahead, *Buyouts* spoke to some of private equity's top investors and thinkers.



Joe Baratta, global head of private equity at Blackstone and a member of the firm's board of directors

Hugh MacArthur, partner at Bain & Company and head of the firm's global private equity practice

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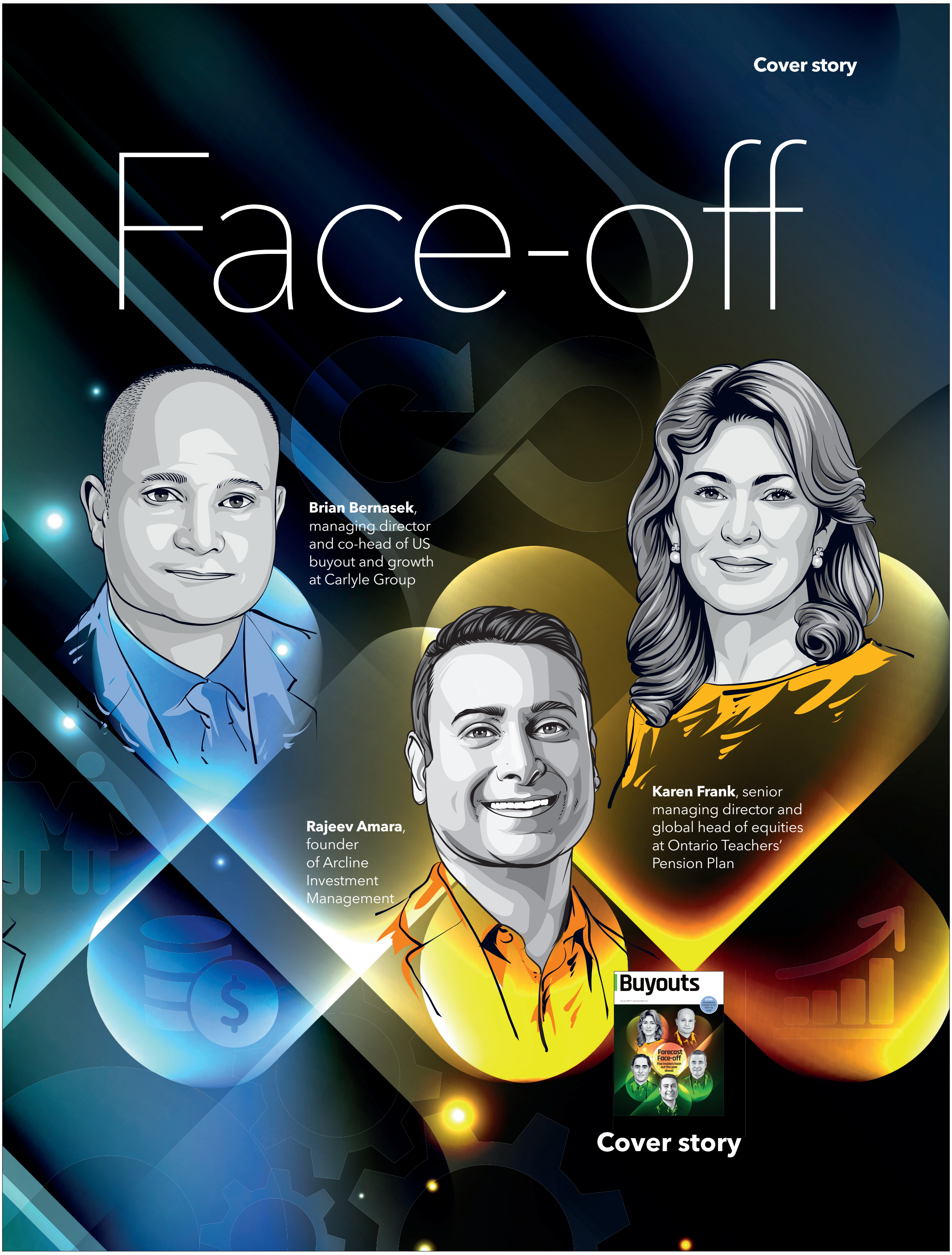
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Face-off
Brian Bernasek, managing director and co-head of US buyout and growth at Carlyle Group
Karen Frank, senior managing director and global head of equities at Ontario Teachers' Pension Plan
Rajeev Amara, founder of Arcline Investment Management
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Q Will PE dealmaking in 2022 match the robustness of last year?

Joe Baratta: I think 2022 will be slower than 2021. It would be hard not to be because 2021 was a record year in deal volumes. Part of what explains last year is a confluence of factors that starts with US tax reform, which brought different kinds of sellers to the market. Covid also showed that life is unpredictable, and people just decided if not now, when? This was manifested in consumer spending, in the housing market and in the deal market. Valuations have been robust and there's lots of liquidity.

All of that conspired to make 2021 a pretty strong deployment year. It's not because the private equity guys have all this money and they're losing discipline and they're just splashing out money. There has been this torrent of dealflow as a result of the factors I mentioned, which won't persist much into 2022.

Are buyers concerned about inflation, rising costs of capital, how stretched valuations are? The answer to all those questions is yes. I think you will see more caution on the part of buyers. There's a lot for sale right now. The good assets are going to find a market and will be priced well. It's just the less good, less differentiated assets that I think will suffer.

Karen Frank: Last year was a record year in terms of dealmaking, and private equity was a significant portion of that. I don't see that ending as long as the markets hold out. Part of this is the pace of fundraising and the total amount of dry powder that's available. People are keen to get that invested in opportunities.

I think that dry powder needs to go some place, and so far we have a deal environment that's very conducive to that. This is also an opportune time for companies and private equity to join into partnership and think about how they navigate the waters going forward.

Off-duty with Joe Baratta

What is your New Year's resolution?
Worry less.

If you weren't in PE, what job would you like to have?
General manager of the Dallas Cowboys.

How do you relax when you're not working?
Gravel biking.

What book are you reading right now?
Cloud Cuckoo Land (by Anthony Doerr).

Who in your career do you regard as a mentor?
Steve Schwarzman and Tony James.

Professionally, what was your toughest moment?
In the last long bull market (2001-08), it was easy to get overconfident. I lost the firm money in a restaurant roll-up in the UK – painful.

What was your most rewarding moment?
Helping build Merlin Entertainments from a small company operating aquariums and the London Dungeon in 2005 into a FTSE 100 company 10 years later – and we still own it!

Some with a view to accelerating disruption in areas where they are strong, some with a view to shoring up balance sheets and making sure they're well suited to weather the storms that may still come.

Hugh MacArthur: The deal market is incredibly busy and we don't see that slowing down, even into the first half of 2022. There are topical and secular trends driving that. The environment is favorable for getting deals done, raising money and generating good returns. That means interest rates remaining close to zero, borrowing and credit markets being very fluid, GDP and tailwinds in many industries continuing to push forward into positive territory.

Q Will inflation or other economic factors impede dealmaking?

Brian Bernasek: We're beginning to see this inflationary pressure. Most folks across the industry would say that they're seeing it actually coming through in their portfolio companies. The best businesses and the best management teams have been able to find ways to navigate that and to manage supply chains and manage their top lines in this environment. But it's hard to imagine a scenario where there won't be rates that clip up at some point, whether that's in 2022 or 2023.

Our view is this will probably take a little bit of the steam out of the system. But there is so much pent-up demand in the services economy – really, across the global economy – that, even with that steam out of the system, we believe there will be a lot of opportunity and that it will still be a pretty robust market. Just maybe not at the same level that we saw in 2021.

Joe Baratta: Wage pressures are real and persistent, and once wages go up they don't go back down. We believe there will be inflation and it will

Off-duty with Brian Bernasek

What is your New Year's resolution?
Focus on doing those few things that are most important really well.

If you weren't in PE, what job would you like to have?
College history professor.

How do you relax when you're not working?
I am happiest and most relaxed when with my family and having dinner or watching a game… especially a game one of my kids is in.

What book are you reading right now?
I am alternating back and forth between *The Splendid and the Vile* by Erik Larson and *The Psychology of Money* by Morgan Housel.

Who in your career do you regard as a mentor?
My father has been a great personal and professional guide in the game-of-life balance. I also learned so much about hustle and investment judgment from Greg Ledford, my mentor at Carlyle for over a decade. He recently passed away, and I miss him.

Professionally, what was your toughest moment?
Finding my footing and my voice in the early years with Carlyle. It is tough to break in, and to break through, in this business.

Your most rewarding?
I appreciate those times on the floor of the NYSE at the launch of a portfolio investment IPO. The camaraderie, joint appreciation and sense of accomplishment is very special.

likely result in a higher cost of funds and higher rates. The supply chain issues will abate, but pressures on wages, raw material costs and commodity costs I don't think are going to abate in the short run. I think that will have some drag on deal volumes and valuations over the course of 2022.

Karen Frank: If you think about it from the pension fund perspective, and you think about the low-to-negative rate environment and now the prospect of inflation, those are both big impetuses for us to stay invested – particularly in real assets and businesses with pricing power that keep pace with inflation. So, I don't see it necessarily as an abatement to the deal environment. I think the market adapts.

Hugh MacArthur: Are there pockets of uncertainty out there? Absolutely. Could we have interest rates suddenly going up? That's possible. Could we have a resurgence of the virus in some unexpected way impact the economy? Absolutely. Are there fears about tax policy changing, which is causing a bit of a rush to get more deals done? Yes. But the market is in strong shape, it has been in strong shape for more than a decade, and people are looking forward with confidence to doing deals in 2022.

Q Will asset pricing trends result in GPs working harder to generate returns?

Karen Frank: There's no doubt that prices are increasing given competitive dynamics in the market. We always revert back to a foundation of value creation, saying we need to be in control and supportive of management and our partners about how we organically create value. This gives us confidence to weigh in and still deliver a risk-adjusted return in a high-priced environment.

One of the ways that we're different from some funds out there is we're long-term investors. Sometimes the value creation playbook is going to

Planes, chains and automobiles

Rajeev Amara, who formed Arcline Investment Management in 2018, sat down with *Buyouts* to talk about the challenges of supply chain delays and looming inflation, as well as competing for deals in the high-priced markets. Arcline closed its second fund on $2.75 billion last year.

Q How are supply chain disruptions impacting your business?
We saw a little bit of it in Q3 but a lot of it is happening in Q4. We are seeing raw material and labor shortages and increasing freight costs and labor costs. We believe it will take much longer to clear up – maybe years.

The popular example of raw material shortages is in semiconductors. The automotive sector, which temporarily shut down during the pandemic, took the brunt of the chip shortage. A lot of the chips got substituted into consumer electronics markets where demand spiked during the pandemic. Semiconductor supply is going to catch up at some point, but it may take 18 months to two years to build chip capacity to absorb all that. But this is a multi-trillion dollar global industry that is being impacted by double digits on a multi-year basis! Freight costs are also an issue. There's a lot of pressure on seaborne freight because of the lack of wide-body airline traffic, which was a big source of freight capacity. That's going to unwind when the vaccination rates increase in the rest of the world. But that is going to take a lot of time.

Labor may be the biggest issue companies are facing. There are 10 million job openings but only 8 million people looking for jobs. That's unprecedented. Wages for the more portable categories of labor are going up materially, sometimes 20 to 30 percent. A lot of this could ripple through the economy [in 2022], as you will have an entire year of wage inflation.

Q How are you approaching sky-high prices in today's market?
There are a lot of factors. Private equity valuations [are] starting to be based a little bit more on VC narratives versus fundamentals. Stories have been part of the VCs' paradigm for a while, but they are now infiltrating private equity and providing a lot more valuation support than pure fundamentals. For example, climate change is the big buzzword today. If we believed what every company for sale is telling us, climate change would be reversed some time in Q3 next year. We may even be approaching the next ice age in 2023. Finally, the seduction of buying and quickly flipping a mediocre business, but a 10 percent concentration in a great end market like electric vehicles to a SPAC is also contributing to driving valuations up.

(Edited and shortened for space.)

take longer to execute, sometimes you need to be nimble around that as market conditions change. We're thinking about not the next 24 months and preparing a company for yet another sale, but about how we put it on a path to build long-term value.

Joe Baratta: Valuation levels are very high, particularly for on-theme sectors like technology and healthcare, and I think there's risk to the downside on valuations overall. If you believe that the 10-year Treasury was going to be higher than 1.6 percent sustainably over time then, by definition, valuations will come down.

To overwhelm the risk of some multiple compression – or at least not continued multiple expansion – we're all going to have to work harder to generate returns. We've made a huge investment in our portfolio operating capability focused on growth and transformation initiatives. You have to be invested in these capabilities to be able to generate good returns into the future because everything is pretty efficiently priced.

> *"I think you have to do some core things really well… I don't think it is a time for dabblers and generalists"*
>
> **BRIAN BERNASEK**
> **Carlyle Group**

Brian Bernasek: I think you have to do some core things really well. That's the important dynamic in today's market. The strong GPs are going to be the ones that have core capabilities that they can lean into. It can be a number of different things – knowing sectors is a very significant one. I don't think

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it is a time for dabblers or generalists. If you understand an entire sector, and you know the long-time incumbent businesses in that sector and you know the disruptive businesses, you're well-positioned to assess the risks to an incumbent and you're well-positioned to understand the opportunities of the disruptor. Having that deep knowledge is valuable, especially in the environment we're likely to face in the years ahead. It is also an important time to have diverse portfolios and to have portfolio construction that fits with a market that could have some uncertainty around valuations.

Hugh MacArthur: If you look at the numbers people are paying now and put them in a place 10 years ago and said 'You're going to be paying these numbers for businesses,' they'd have looked at you cross-eyed. But this is the world we're in. For anything that has technology, or ESG, or some kind of an angle that's on-trend behind it, you're going to have to pay a big number. That means getting more creative about ways of generating returns.

Q What do you expect the interesting deal opportunities will be?

Brian Bernasek: Technology is going to be a key driver of opportunities. I think there are a few areas where, when you get underneath, you see that every deal is a tech deal.

One area is in our traditional private equity-invested companies. Every opportunity we look at from a diligence perspective we review with digitization in mind. Is there a digital improvement opportunity in this business going forward? Is there a potential to improve the e-commerce, web-based revenue opportunity? Is there an opportunity to have a differentiated relationship with a supply base using digital tools?

Another is investing in disruptive technologies – technologies where the business model or product is so differentiated that you can create and develop share and opportunity that might not have been there just a few years ago. Finally, there's the healthcare revolution – with genomics and biopharma – where there are real growth trends and tremendous opportunities to bring in digital tools and data analytics to support companies.

> *"There's a big enterprise systems opportunity in addressing the need for ESG tracking, reporting and monitoring"*
>
> **JOE BARATTA**
> **Blackstone**

Karen Frank: We're excited about tech enablement. Rather than looking exclusively at a piece of software or a digitized platform, we're looking at companies and seeing where we can add those capabilities to take them on their journey and accelerate value creation. We think about technology not just as a standalone area of investment but as something that permeates all the sectors we find interesting.

Joe Baratta: In what I do, in corporate private equity, we have some specific themes that we're pursuing. We're not investing capital indiscriminately because we think it is a good time to buy things. We're investing behind narrow themes that we think have long-dated growth tailwinds. The whole life sciences ecosystem, for example, where it could take the form of a service provider, or supplier, or a manufacturer or distributor of drugs.

Another theme is corporate expenditure on ESG; if you're a manufacturing company using materials, you're reporting on carbon emissions as well as governance practices and diversity programs. There's a big enterprise systems opportunity in addressing the need for ESG tracking, reporting and monitoring.

The private credit markets are still attractively priced – lending money to private equity sponsors buying larger, high-quality businesses and earning five to six percent at the top of the capital structure. That's a good place to be. There is not a huge amount of capital arrayed against it. We've relied historically on banks to underwrite and syndicate these loans, but that model is changing, where now buyout funds can go directly to private lenders.

Hugh MacArthur: The secondaries market is getting more sophisticated, it's exploding in size and we're seeing more product proliferation. The challenge for private markets is that they lack what public markets have and that's liquidity. In some way, shape or form you may need liquidity, but it's not traditional liquidity and you may not want to sell a whole asset or sell an asset to get out of a fund. There are some new tools in the secondaries toolkit that are going to grow tremendously over the next couple of years.

Q Will the vigorous PE fundraising of last year continue into 2022?

Hugh MacArthur: LPs are trying to find more and different ways to invest, not pull back. There are many ways to play the game now, and as the industry matures, we're seeing sector-focused funds, long-hold funds, ESG funds, growth equity funds. LPs are excited

Off-duty with Karen Frank

What is your New Year's resolution?
To learn something new. I have always wanted to take up piano.

If you weren't in PE, what job would like to have?
Veterinarian.

How do you relax when you're not working?
Practice martial arts and hang out with my kids.

What book are you reading right now?
Quiet: The Power of Introverts in a World that Can't Stop Talking (by Susan Cain).

Who in your career do you regard as a mentor?
Barbara Byrne (former chairman of Barclays Bank and a board member of ViacomCBS, among other distinctions).

Professionally, what was your toughest moment?
Electing to stop working for a time when my kids were young, leaving a role in private equity. Unfortunately, I wasn't very happy at home, disconnected on the sidelines. I am likely the only person who returned to Goldman Sachs Invest Bank "for the lifestyle," as they were able to offer a degree of flexibility while I stayed engaged and progressing in my career.

Your most rewarding?
The days when my kids say they are proud of me and encourage me to keep going.

by that – they see opportunities and say, 'Boy, it's not just put money in the big, old buyout fund and decide which buyouts funds you like in Europe versus which ones you like in the US.'

Joe Baratta: People have deployed a lot of capital and LPs have budgeted an aggregate number of dollars to deploy in a given year to funds, and they're bumping against allocation pressures. There will be some constraints on how much money everybody can raise given that everybody has raised a bunch of money very recently. The good GPs will raise money and will have access to capital, but on the margin the pace of activity that was experienced in 2021 can't really persist.

Brian Bernasek: LPs are moving fast across re-ups, across new opportunities. I think we're going to continue to see this sort of accelerated timeframe and high velocity, and LPs will be managing that. Dealflow is going to continue to be strong, we believe, and I think that will drive a lot of it. The trick for GPs and LPs in this environment is one of prioritization and focus and where you're going to dedicate your resources.

Karen Frank: As we make commitments to funds, a couple of things are happening. One is the mega-funds – they come back with bigger and bigger equity tickets. The reality for us is that to be able to continue to make those commitments we have to have an expectation of realization on the other side. We can't continue to commit without having something come back.

Funds are also coming back faster and faster. They are segmenting their strategies, returning to the market with special [situations], credit, growth, regions, etc. We try to approach that with prudence, saying we have to manage aggregate exposure and build a diversified book on our end.

Many of us are about co-invest and driving the additional overall investment that comes with being a core or anchor LP. But as the funds themselves get bigger, you have to get bigger with them. So, the exposure to single managers is sometimes quite large. I think the exposure-versus-co-invest dynamic is one that will probably be an increasing trend in the market. It is one that we will balance quite proactively.

Q As private equity supersizes, should it be more transparent?

Karen Frank: I think all organizations have a duty of care to their stakeholders. And whether it is industry-based transparency, or regulation, or how those go hand-and-hand, I think additional transparency is a mutually beneficial way for us to work together. I hope that continues to be the direction of travel.

You're always going to have a bit of friction between seats on the LPAC, between the LPAC and the fund, transparency of fees and expenses, etc. Historically, we've done well to choose our partners thoughtfully, and the way they interact with us is important. We're on the right track but this idea of continuous improvement – being more transparent and involving us more – will hopefully be embraced.

As more funds become asset aggregators, through the proliferation of fund types and the fee-based model that they work to, in some cases that fundraising goes beyond institutions. It goes to private individuals, to family offices and down into the retail environment. As GPs start tapping on that type of stakeholder, transparency – really opening up about how they work and what their value proposition is – is key.

Brian Bernasek: When I reflect on 30 years of touching the business and see the progress, I think there's more institutionalization, more transparency and more competitiveness. These changes and the continued progression are here to stay. That's just the reality.

Q Will private equity make new inroads on the ESG front in 2022?

Joe Baratta: I think ESG has been a journey. What is expected of private equity GPs, rightly, by our LPs has increased. Our ability to report on the progress we're making is improving and it's a necessity. I think we've become more organized around it. Now we're putting into place specific programs to drive a specific set of results. And we need to continue to create a robust reporting and monitoring structure.

One area where we've been slower is: how do you have more diverse and equitable recruiting practices across portfolio companies with the objective of over time having more diverse workforces and management teams? The way we're tackling that is by looking at the basic recruiting processes – the schools from which we recruit, the academic requirements for certain roles, working with community-based organizations to find underrepresented groups from which we can recruit.

Karen Frank: For us, this has become a gatekeeping issue. E, S and G are all important to us. If we don't have commitments or visibility on how either funds or portfolio companies are leaning in, it gives us real pause for thought. We have a lot of data points to realize that diverse organizations, ones that are aligned with ESG, deliver better and sustainable returns to their shareholders. Not every company, not every situation, will be on the same trajectory, but we expect positive movement toward each of these goals. That is one of things that helps to support our investment case.

Despite COP26 [the 2021 UN Climate Change Conference] and the urgencies raised there, I think we're still early days in how the industry leans in on the environment – in terms of influencing portfolio companies, allocating investments and investing in solutions. We're still some ways away from doing it effectively or fully understanding what good looks like.

Brian Bernasek: We have made progress on ESG as an industry but there is a lot more to do. There is an old adage that you get what you measure. We're focusing more on metrics [through the ESG Data Convergence Project, led by Carlyle and CalPERS] and encouraging the industry to do so as well.

In our experience, businesses and management teams that embrace ESG are more thoughtful, more innovative and move aggressive. They are the teams that we want to partner with.

Q Is private equity doing enough to ensure diversity in its own ranks?

Karen Frank: I joined an organization where I've been pleased at the commitment to diversity. Women, for example, are well represented on the board, the executive team, in asset group leadership and on the investment team. Private equity has been focused on getting bigger intake but has yet to see all forms of diversity, including at the leadership level. That will be something important for us to break through on a more industry-wide basis.

It's a long road, but one where we're starting to get critical mass. We know the inherent benefits of diversity. I'm also keen that we open up the aperture. We can't just be talking about women, we need to be talking about all forms of diversity, equity and inclusion. The more progress we make, the more time and voice and mindshare we give to that, the more likely, I think, we'll eventually get there.

Brian Bernasek: We have made so much progress on the diversity of our teams – more than half of our assets under management are run by women. There is tremendous value in sitting around a table or being on a Zoom call with a diverse group and background of experience. That is helping us make better decisions today than we did a decade ago.

Joe Baratta: The industry for a long time recruited from the same dozen schools, the same majors, and that creates a pretty small pool. We expanded the number of schools, the types of majors and the backgrounds of candidates that we interview and want to access. Our new hires on the investment professional side and on the portfolio engagement side is approaching 50 percent female and diverse candidates.

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>
> **KAREN FRANK**
> **Ontario Teachers' Pension Plan**

Q Will the energy transition be a larger priority in 2022?

Brian Bernasek: Climate change is one of the most pressing issues of our time, and it is vital for us to see both the opportunities and the challenges. It is a market factor that has to be considered seriously in our industry, which is why, among our activities, we've carbon-footprinted close to 100 percent of majority-owned companies in primary private equity strategies globally.

Karen Frank: We recently announced our commitment to net zero [in the portfolio by 2050, with 2025 and 2030 interim targets]. For us, it's not about carbon-dumping. Some of the more recent investments we've made involved backing companies and management teams to help get to that transition. We're in some cases taking on carbon, but only in circumstances where there is a transition plan to ensure we're getting the business to a low-carbon environment.

In terms of the ability of private markets to put weight behind the technologies and capabilities that will help us crack this problem, I think there is a real opportunity. The industry is evolving very quickly. The way private equity will engage in climate and energy transition is probably going to accelerate because those opportunities are becoming more clear and more accessible.

Joe Baratta: The energy transition is a certainly a priority for us. Our job is to make the companies we own better and if they are generating carbon emissions to reduce them. We recently made a definitive target to reduce emissions by 15 percent in aggregate across our new control investments where we control energy usage. ■