

PitchBook 2019 Private Equity Outlook

Forecasting the primary trends that will shape PE in years to come

PitchBook is a Morningstar company. Comprehensive, accurate and hard-to-find data for professionals doing business in the private markets.

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2019 predictions

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2018 predictions scorecard

Buyout multiples will remain elevated.	PASS	Multiples remained elevated and even rose despite a decline in public market multiples.
SBOs will continue gaining in stature.	FAIL	SBOs declined in terms of deal sourcing as non-PE-backed sourcing options gained share.
PE investment in software will proliferate further.	PASS	Software enjoyed a banner year and set a record in terms of proportion of deal flow.
Niche fundraising will continue its rise.	SPLIT	Fundraising for secondaries, first-time funds and GP stakes grew while private debt fell.
LP net cash flows will subside.	FAIL	GPs returned a record amount of cash to LPs despite flat exit activity, and net cash flows rose.
The number of active US PE investors will shrink.	PASS	Active US PE investors shrank for just the second time as a shakeout period is underway.

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Prediction: GP stakes will experience ongoing innovation.

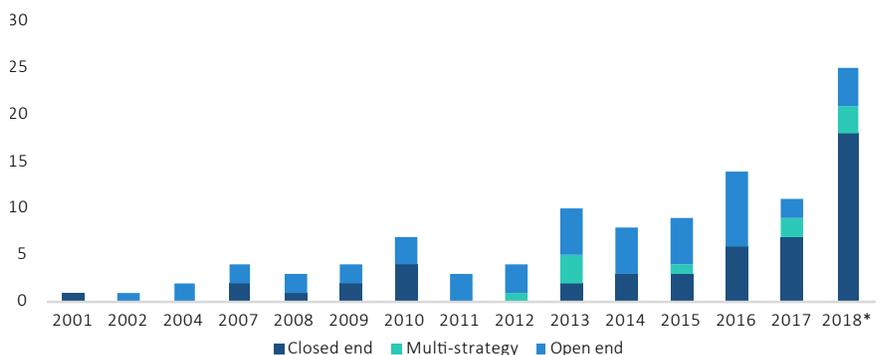
Rationale: Early adopters of the GP stakes strategy have been successful in expanding their investing into more niche areas of alternatives, including transactions in 2018 targeting VC and real estate firms. In 2019, we expect to see further innovation in dealmaking, with GP stakes funds continuing to develop new ways to tap into smaller targets and promising emergent managers. We also anticipate concerted efforts to realize investments and predict a major liquidity event—likely an IPO—of a portfolio of GP stakes as pioneering investors seek out viable liquidity options for early LPs.

Caveat: Several firms have tried and failed to launch GP stakes teams and funds. The highly specialized nature of the strategy could mean there’s only enough room for a handful of deep-pocketed managers. If this is the case, it would almost certainly curtail innovation.

As alternative investment strategies have proliferated, one of the most intriguing innovations has been [GP stakes](#)—which involves investing in an alternative asset manager’s underlying management company, as opposed to committing capital to their fund(s). The forbearers of this strategy have now raised several multi-billion-dollar funds and have [focused their attention on large, established targets](#). Activity in recent years has accelerated at a fever pitch, with 2018 setting an all-time high for GP stakes deals by a wide margin. October alone saw seven transactions—more than the annual total for each year prior to 2013.

GP stakes dealmaking hit a new record in 2018

Global GP stakes deals by target firm’s fund strategy



Source: PitchBook
*As of November 30, 2018

Newcomers have been popping up more regularly, with many trying to differentiate themselves through their deal structuring or by targeting firms at earlier stages of development. Sixpoint Partners, for example, has spawned a “private equity seeding platform” with a \$200 million fund. The strategy is being led by Jeff Lavoie—a veteran of Dyal—who will focus on spinout managers and structure deals with a “defined path to exit,” as opposed to the permanent capital structure typical of GP stakes. Newly formed Meteor5 Capital is also bringing a novel approach with a focus on first-time managers; instead of establishing a stake in the entire GP, Meteor5 only takes a stake in the manager’s first two to three funds. We expect to see more innovation on this front, as seeding has traditionally been more difficult for private market strategies than hedge funds given the [structure of the vehicles involved](#).

Much of the recent attention in GP stakes has focused on fundraising and dealmaking, but exits deserve similar attention. GP stakes is widely viewed as a viable alternative to a public listing, which many PE firms chose to do in the mid-2000s to provide liquidity to founders, to expand their investor base and to help facilitate succession planning. While some PE firms, including EQT, continue to flirt with the idea of listing, TPG and others have decided against going public and the disclosures that brings, opting instead to pursue a GP stakes transaction.

While few companies enjoy the spotlight of public markets, all investors need liquidity at some point—and GP stakes is no different. One middle ground option being explored by GP stakes investors is to create and list a holding company with the initial assets being a portfolio of minority GP interests. “The likely plan is to put it all together, get the benefit of scale and diversity, and list that,” said Michael Rees, head of Dyal, in October 2018. “We certainly are monitoring the attractive valuation that firms are achieving now in the public markets. And so, while I would have said it’s a very long-term plan ... The markets are pretty attractive right now, so there’s a good chance that we’ll accelerate that program.” While an event like this would certainly be a milestone for the GP stakes strategy, it has already been done in some capacity through conglomerates such as Affiliated Managers Group.

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Prediction: Secondaries activity will hit another all-time high.

Rationale: Sustained strength in secondaries fundraising and high levels of dry powder, combined with increasingly sophisticated market participants that have shown a willingness to experiment with new deal structures, should foment secondaries activity for the foreseeable future.

Caveat: Some in the industry have called into question the motivations and alignment of incentives associated with certain secondaries transactions. This could lead to renewed skepticism from potential secondary market participants as well as increased regulatory scrutiny, which could dampen activity.

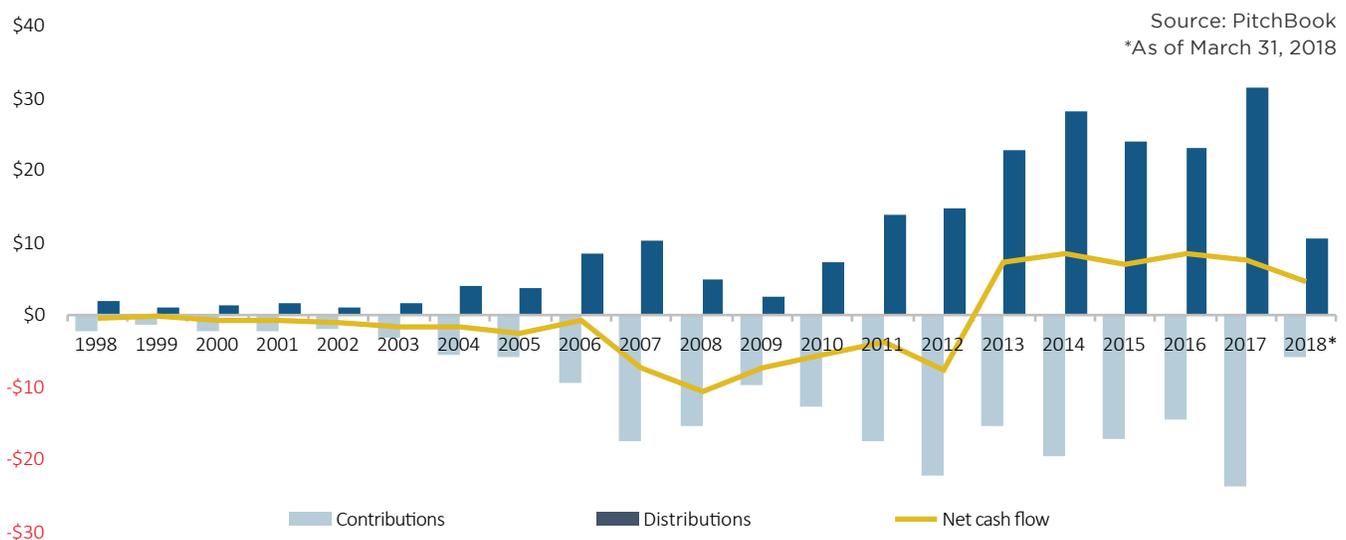
The secondary market, once viewed as a fringe area only used as a last resort, has morphed into a widely accepted mechanism of the private markets. Aggregate contributions and distributions from secondaries funds hit record highs in 2017, and we expect this momentum to sustain throughout 2018 and into 2019.¹ Despite rampant growth in recent years, secondaries dry powder still represents less than 3% of the current potential opportunity set.²

Due to the bespoke nature of secondaries transactions, deal structuring is one of the most-discussed topics in the industry. In 2018, GP-led transactions—whereby the GP orchestrates a secondaries deal for all or a portion of a fund’s LPs—attracted much of the attention, with the sentiment toward these deals improving as more of the situations have involved reputable GPs

1: Fund cash flow data is reported on a two-quarter lag.
2: This is defined as total unrealized value of private market funds.

Secondaries cash flows continue at a record pace

Global secondaries fund aggregate net cash flows (\$B)



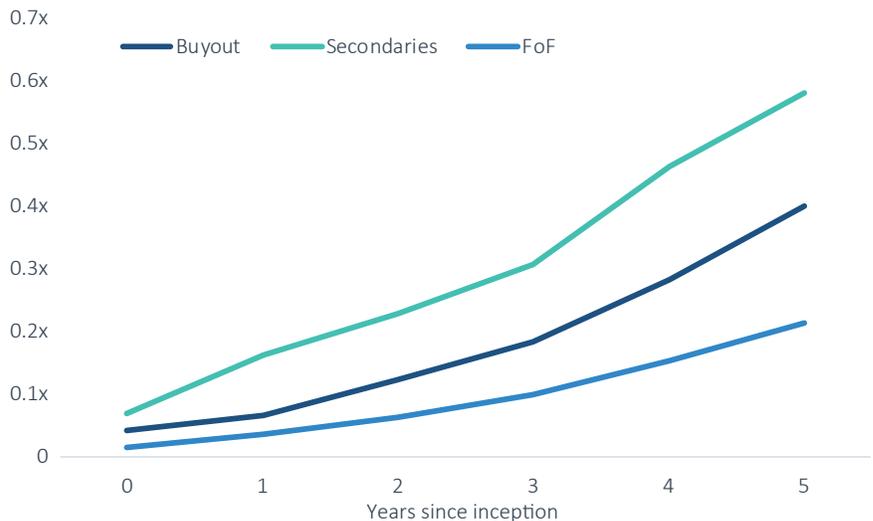
operating from positions of strength. When funds have eclipsed a typical investment timeline but still hold quality assets, GP-led restructurings have also proven an effective means of aligning incentives between LPs and the GP. As market participants become more comfortable with GP-led transactions and other formerly stigmatized deal structures, we think it will only lead to increased secondary activity.

As transaction volume has risen, so too has the use of leverage by secondaries funds. To be sure, debt usage in secondaries is much lower than in primary PE strategies, but it allows GPs to stretch their funds further than they have in the past. While we do not think this will be enough to curtail aggregate contributions, it is a trend worth watching.

On the distribution front, secondaries funds have traditionally returned cash back to LPs more quickly than other private market strategies, and we see no reason for this to change. This historical distribution pattern, combined with the strong capital deployment of recent years, leads us to believe that distributions will remain at elevated levels. In 1Q 2018, secondaries funds distributed more than \$10 billion back to investors—putting the year on track for a new record by a wide margin.

Early distributions from secondaries funds help mitigate the J-curve

Average global DPI multiple by strategy



Source: PitchBook
*As of September 30, 2017

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Prediction: Short-term returns fall for PE funds, but performance will improve relative to public equities.

Rationale: PE returns historically have been highly correlated to public equity markets, but that relationship tends to break down in periods of high volatility, as well as sustained run-ups or drawdowns in the market. Given the recent gyrations and downturn in public equities, we anticipate that PE will see short-term absolute return compression from the elevated levels seen in recent years; however, we expect that performance will improve relative to public equities.

Caveat: Investments in private markets are not insulated from macroeconomic forces, and any fundamental changes to business conditions will inevitably affect them. With the relatively calm nature of markets in recent years, funds have been hesitant to bake in any of the few periods of negative public market performance. If equity markets continue to encounter difficulty, PE managers may feel compelled to adjust their marks accordingly.

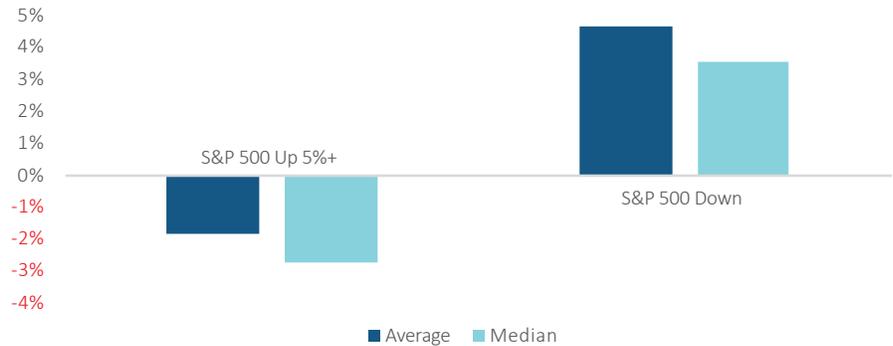
Our recent research has corroborated previous findings that PE funds are more correlated to public equity markets than conventional wisdom would lead many investors to believe. In light of this and the tumultuous year for public equities in 2018, our initial inclination was that private market strategies would follow a similar downward trajectory. Our hypothesis changed, however, when examining the data more closely. We think that returns will remain solidly in positive territory; however, we still believe that absolute returns for PE funds will fall throughout reporting periods in 2018. Furthermore, we anticipate performance relative to public equities to increase.

Since 2001, PE funds have outperformed in 19 of the 20 quarters in which public equity returns were negative.³ Skeptics will claim that PE firms are simply being overly optimistic (or even naïve) during these public market drawdowns, but we find a hesitancy by PE funds to aggressively mark to market regardless of the direction of the change. Indeed, in the 20 quarters since 2001 when public equity returns exceeded 5%, PE returns have trailed 15 times.

³: For this analysis, quarterly public equity returns are calculated using the average level of the S&P 500 TR Index during a given period.

Down is the new up

Relative global PE quarterly performance when S&P 500 TR gained 5%+/posted a loss (2001 to 1Q 2018)



Source: PitchBook
*As of March 31, 2018

In the first three quarters of 2018, the S&P 500 produced quarterly returns of 6.0%, -0.6% and 6.0%, with 4Q appearing primed to end with a negative return. It is periods like this when we have traditionally observed the biggest breakdowns in correlation. Particularly given the volatility underpinning public equity movement and the continued strength of fundamentals and the macro backdrop, we expect PE managers to be cautious when marking to market existing investments through the next several reporting periods.

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Prediction: PE fundraising will grow for China-focused funds.

Rationale: Investors demand exposure to the Chinese economy—and private markets are no exception. Meanwhile, GPs recognize China and other developing economies as fruitful opportunities to launch new strategies and grow AUM. In terms of capital commitments, PE fundraising for China-focused funds more than doubled from 2017 to 2018.

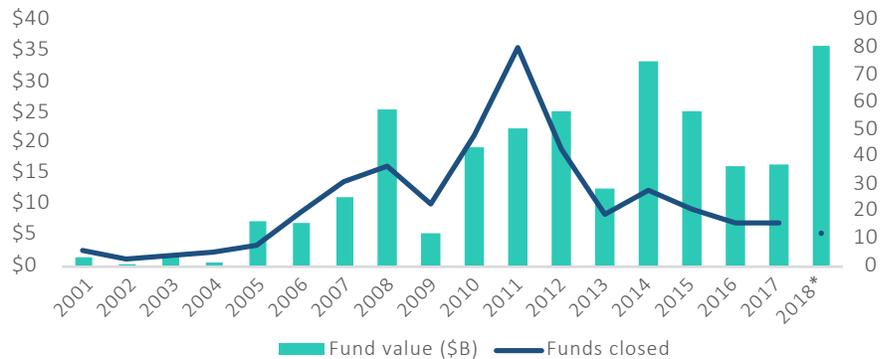
Caveat: Ongoing geopolitical tensions may make investors hesitant to enter PE's multi-year partnerships. 2018 has proved to be a poor year for most emerging markets (including China) in terms of public equity returns and currency depreciation relative to the USD. Given the relatively small size of the Chinese PE market, many LPs may have fulfilled their allocations in last year's fundraising surge.

Traditionally, PE markets have been concentrated in North America and Europe, but that may be beginning to change. As the PE landscape has become more crowded over the last few decades, GPs have branched out, opening overseas offices and providing investors with exposure to various geographies in addition to strategies (i.e. equity, debt, real estate, etc.). Advent International and Goldman Sachs' Merchant Banking Division were some of the first western PE shops to raise funds targeting China and Asia Pacific, beginning in the early 1990s. Other US and European investors followed, in addition to the many homegrown PE offices that opened in various developing markets.

Fundraising for buyout and growth equity vehicles in Greater China (including mainland China, Hong Kong and Taiwan) totaled \$35.9 billion in 2018, more than double the previous year's total and the highest figure on record. The wave of capital flowing into the region seems set to continue; there are currently 188 open or announced buyout and growth equity funds targeting a cumulative \$24.8 billion, with more fund announcements sure to follow. A [recent PitchBook survey of LPs](#) also portends growing interest in the region. 36.5% of LPs expected to increase target allocations to Asia/Oceania, higher than any other region.

Capital raised hits new high for China-focused funds

Greater China PE fundraising activity

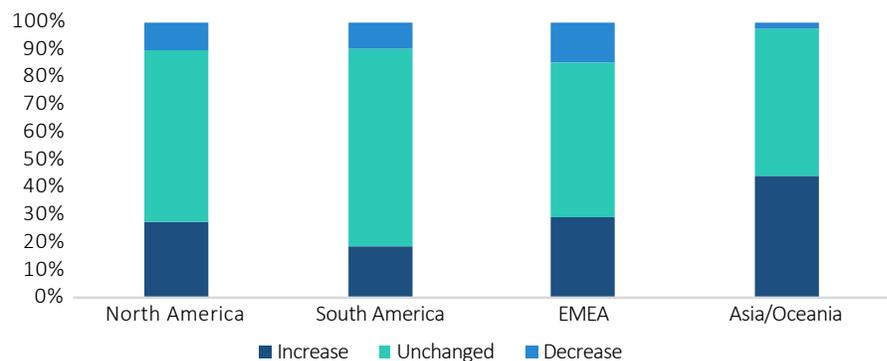


Source: PitchBook
*As of November 30, 2018

Though we expect growing demand for private market strategies across most regions outside of North America and Europe, a few factors could dampen fundraising in the near term. First, further trade tensions between the US and China could spook GPs hoping to raise capital for China-focused funds and LPs looking to increase target allocations in the region. Second, the lackluster performance of public equities in most developing economies, in addition to the depreciation of various emerging market currencies relative to the US dollar in 2018, could keep allocations focused elsewhere.

LPs most likely to increase Asia/Oceania allocation in next year

How do you expect your target allocation to private market strategies in the following regions to change over the next 12 months?



Source: PitchBook
*As of December 2018

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Prediction: Private debt fundraising will rebound but remain below 2017 levels.

Rationale: While there are few funds in the market that would allow next year's fundraising totals to match 2017's high, there are still plenty of reasons to be bullish about investor demand for private debt vehicles. First, benchmark interest rates, though rising, remain relatively low, driving continual demand for higher-yielding debt products. Additionally, the floating rate nature of most private debt instruments protects investors from future rate hikes, while demand for new issuances from the buyout market should remain strong. Last, worries of a broader downturn are likely to drive renewed interest in distressed debt funds.

Caveat: US leveraged loan regulations were pulled back in late 2017, leading to increased competitions from bank lenders. Federal Reserve officials have recently expressed concern regarding systemic risks posed by cov-lite issuances, which could lead to further regulation. Industry leaders have recently referred to credit markets as being in "bubble status."

Fundraising for private debt funds (including mezzanine funds) grew at an even faster rate than that of private equity funds following the financial crisis, accelerating at a CAGR of 19.4% since 2009 (compared to 9.8% for growth equity and buyout funds) to hit a record total of \$124.0 billion in commitments across 121 vehicles in 2017. Fundraising slowed dramatically this year, with just 71 funds holding a final close on a combined \$75.6 billion through December 4, 2018. However, there are currently 40 open or announced private debt funds in the market targeting at least \$1 billion each, indicating that fundraising for the strategy is likely to rebound.

Over the last decade, fundraising for the direct lending strategy—now the largest sub-strategy of private debt—benefited from the GFC-era banking regulations, which created stronger demand for [non-bank lenders](#). While interest in that strategy cooled in 2018, totaling just \$26.7 billion across 18 vehicles through December 4, 2018, distressed debt managers picked up some of the slack, raising more capital than in any of the last four years, perhaps in expectation of a broader downturn.

Private debt fundraising falls dramatically in 2018

Global private debt fundraising activity



Source: PitchBook
*As of November 30, 2018

The growth of leveraged loan issuance in recent years has spurred worries around pricing and terms. By August of this year, a record 78.6% of new issuance was considered covenant-lite, according to the S&P/LSTA Loan Index, affording fewer protections to creditors. In addition to a lack of covenants, add-backs and incremental facilities have given pause to some in the industry. Todd Vermilyea, Senior Associate Director at the Federal Reserve, recently expressed concern that the trio “may lead to safety and soundness concerns.”

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Prediction: Multiples in public and private markets will converge further.

Rationale: The discount applied to private market companies is diminishing. The growing number of PE firms offering multiple private market strategies with a need to invest vast sums of dry powder keeps increasing. With so many large players in the industry, transactions are likely to receive multiple bids as GPs must bid aggressively to win price auctions.

Caveat: Public equity markets can be volatile; a dramatic upward move in pricing could pull multiples up at a faster rate than could reasonably be achieved in private markets.

Multiples continue climbing in private markets as a rising sum of capital flows in and dealmaking remains robust. Such an influx of capital has led to buyout multiples rising in tandem with public multiples in most years since the financial crisis; however, 2015 saw a divergence in multiples that has remained relatively steady. While 2018 saw public equity markets flat-to-down, with multiples slightly contracting, PE saw the median buyout multiple expand marginally; the longer-term trend of multiples converging looks to continue.

Public and private valuation divergence since 2015 continues
 Median EV/EBITDA multiples for US PE buyouts and S&P 500



Source: PitchBook
 *As of November 30, 2018

Note: The S&P 500 multiple is calculated using the aggregate values of the underlying companies, whereas the PE buyout multiple is the median value.

Transactions are receiving multiple bids and the discount—the spread between public and private multiples—is once again disappearing as the oft-overstated phrase “too much money chasing too few deals” rings true. Deal sizes are also rising, and larger buyouts tend to transact at higher multiples. The higher proportion of large deals is skewing the composition of deal multiples, and thus the median, upward.

Another factor that could bring down public equity performance is rising interest rates. Discounted cash flow models are commonly used to value both public and private companies. Even though they may use the same valuation technique, the prices of public companies change more quickly compared to PE portfolio companies, which are typically marked to market on a quarterly basis. Furthermore, public market investors often overshoot when buying and selling, meaning, for example, a 5% decline in fair value may lead to a 10% sell-off. PE tends to be significantly less volatile; since 2001, PE has registered 16 quarters with returns above or below 5% compared with 40 for the S&P 500. Furthermore, PE returns were flat-to-positive in 19 of the 20 quarters in which public markets were in negative territory.

Additionally, certain parts of the yield curve are currently inverted for the first time since 2007—though the most-followed 10-year/2-year spread remains positive. The inverted yield curve often speaks to a coming recession and may precipitate a market sell-off as investors in public equities rush for the exits to lock in gains after a near decade-long bull run. This aspect makes many believe the inverted yield curve is a sort of self-fulfilling prophecy.

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Prediction: Take-privates will increase in prominence.

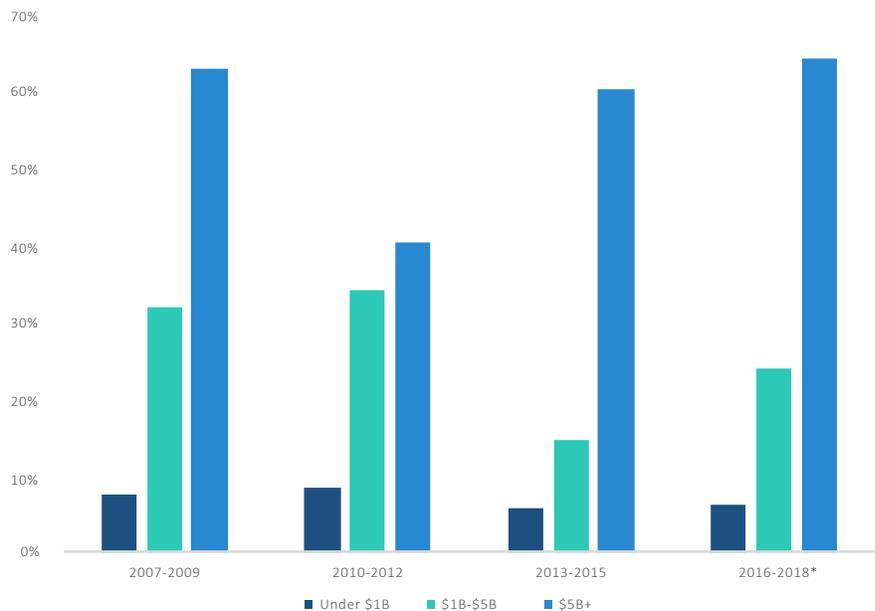
Rationale: The US PE industry is seeing an increasing number of mega-deals and mega-funds close. Larger funds typically execute more sizable buyouts, and the proportion of take-privates rises in tandem with deal size. The EV/EBITDA multiple valuation gap between public and private markets contracted in 2018, reducing the premium on take-private targets.

Caveat: Public equity valuations could rise dramatically, causing many potential take-private targets to become too expensive for a leveraged buyout to pencil out. Additionally, with the number of public companies in the US halving in the past 15 years, many attractive targets have already been bought out.

We expect take-privates, including carveouts from public companies, to increase in prominence. Recent years have seen these transactions decline substantially in terms of both count and relative proportion of buyouts. However, take-privates tend to be much larger than other buyouts. The median take-private size in 2018 is \$977.0 million, more than five times larger than the median non-take-private size of \$175.0 million. This is important because buyout sizes are rising, and the count of buyouts closed above \$1 billion eclipsed 70 in back-to-back years for the first time ever. As more mega-deals are occurring, the number of take-privates above \$1 billion will rise.

Larger deals are more likely to be take-privates

Take-privates as proportion of total US PE deals (#) by size



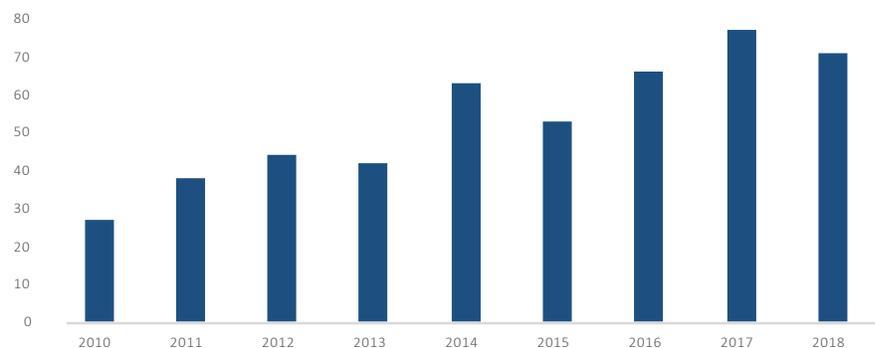
Source: PitchBook
 *As of November 30, 2018

Not only have mega-deals been closing at a record pace, but fund sizes are ballooning as well. In fact, the total count of mega-funds closed in the past three years is higher than any other three-year period on record. Many funds closed in this timeframe are still sitting on substantial amounts of dry powder and will be looking to deploy it efficiently on sizable deals. Additionally, TPG is raising a \$12 billion fund, and Vista Equity is raising a fund targeting between \$12 billion and \$16 billion—for which they have already held a first close at \$11.4 billion.

The expansion in buyout multiples, contrasted with the recent contraction in public market multiples, makes take-privates relatively less expensive. PE multiples expanded to 12.3x, while the S&P 500's comparable multiple shrank to 12.7x. Any sustained fall in the stock market—though not something we are predicting—would make for a fertile hunting ground for PE firms. Buyers are ready to pounce on any signs of weakness in stocks. On that note, Apollo, which has completed eight take-privates in the last three years, agreed to undertake two take-privates in the third quarter of 2018: the \$2.6 billion take-private of Aspen Insurance Holdings and \$5.6 billion acquisition of LifePoint Health. Apollo is also likely to emerge as the winning bidder for the take-private of Arconic, which could value the enterprise at up to \$16 billion.

Count of \$1B+ buyouts is trending upward

US PE \$1B+ buyouts (#)



Source: PitchBook
*As of November 30, 2018