PAVILION

# PRIVATE EQUITY MARKET OUTLOOK FOR 2015

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**Each year, we assess trends and market opportunities in private equity. Our philosophy and approach is rooted in developing a highly selective portfolio diversified by investment stage, type, vintage year and geography. While we place a significant amount of importance on diversification, we believe manager selection also should be a primary focus as each sub-strategy will have managers with demonstrated ability to generate value across multiple economic cycles.**

One challenge with implementing a private equity strategy is related to the length of time that private equity managers deploy capital under the typical fund structure. Investment periods are typically between three and six years, plus the holding periods and time required to liquidate holdings.

As it is difficult to react quickly and capitalize on temporary market dislocations, our outlook must be longer term and will typically focus on more structural market changes.

With that as backdrop, in this article, we review several trends in the private equity industry and highlight the opportunities we see as we move into 2015.

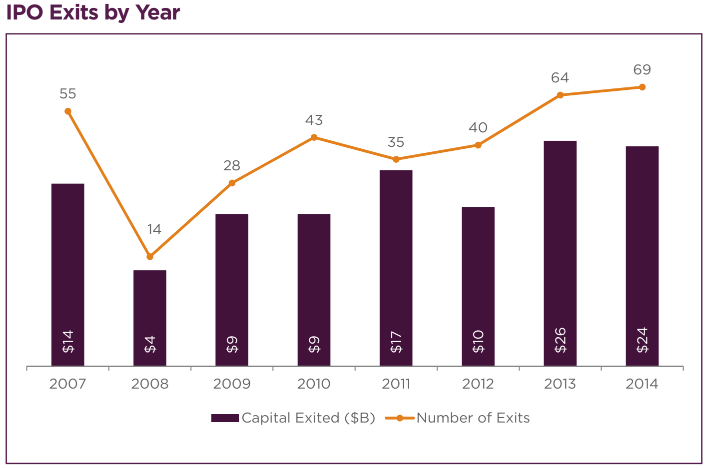
## Favorable Trends

**STRONG EXIT MARKET** Private equity managers exit investments through sales to strategic or financial acquirers or through the public markets subsequent to taking the company public. In 2014, exits to strategic acquirers reached their highest dollar level in the last eight years. This was driven by the continued desire of corporations to grow through M&A activity, which has been supported by large cash balances and relatively easy access to the credit markets. Adding to the strong exit market is the continued demand for secondary buyouts, where a private equity-owned company is sold to another private equity firm. The large amount of dry powder in the private equity market, currently estimated at $535 billion as of December 31, 2014, along with the strong prior performance of these deals have made secondary buyouts appealing despite the criticism from limited partners. Lastly, the IPO market, while down from the level reached in 2013, has remained strong, driving $24 billion of exit proceeds in 2014. While public equity volatility accelerated in December and into January and the credit markets have become choppy, the two largest contributors to the trend (corporate M&A and secondary buyouts/dry powder) remain well intact. As a result, while there may be an occasional slowdown at certain points during the year and in certain segments (energy in particular), we expect the relatively robust exit markets to continue throughout 2015.

**Acquisition Exits by Year**


Source: Pitchbook

**IPO Exits by Year**




Source: Pitchbook

SBO Exits by Year


Source: Pitchbook

**OIL AND GAS PRICES** The energy boom in the U.S. has had tremendous economic benefits, creating jobs and spurring economies in the central and northern U.S., driving manufacturing back onshore and creating a level of energy independence the country has not seen before. Energy supplies now well exceed demand and are expected to do so for the foreseeable future, resulting in even lower prices. The rapid decline in prices has been more significant than most expected and has created a number of opportunities.

The energy market is extremely capital intensive and relies heavily on the public equity and high yield markets. According to JP Morgan data, energy-related businesses accounted for approximately $290 billion of high yield issuance from 2008–2014, or approximately 15%, the largest weighting of any sector. Those markets are now effectively closed, which has increased the attractiveness of private equity. While spending will decrease as capital budgets are slashed, particularly for new projects, capital needs will remain far in excess of current cash flow available to support continued production and maintenance. Private equity stands to benefit in a number of ways:

1. *financing new businesses with models that succeed at lower prices;*
2. *financing certain development projects;*
3. *participating in rescue financings;*
4. *acquiring distressed debt; and*
5. *participating in restructuring/turnaround opportunities.*

**INSTITUTIONALIZATION OF EMERGING MARKETS** Emerging markets in China, India, Brazil, the Middle East and Southeast Asia are becoming more regulated and organized, and are attracting increasing amounts of private equity capital. The macro and geo-political risks of investing in these markets, while not at the level of their Western counterparts, continue to decrease as countries become more integrated into the global marketplace. However, not all of these markets present the same risk/return tradeoff and should be approached with diligence and caution. In aggregate, emerging markets private equity generally has failed to deliver returns in excess of those in the developed markets (predominantly the U.S. and Europe). As a result, investors should be highly selective when approaching these markets to ensure that their expectations match the actual risk/return profile of a particular market.

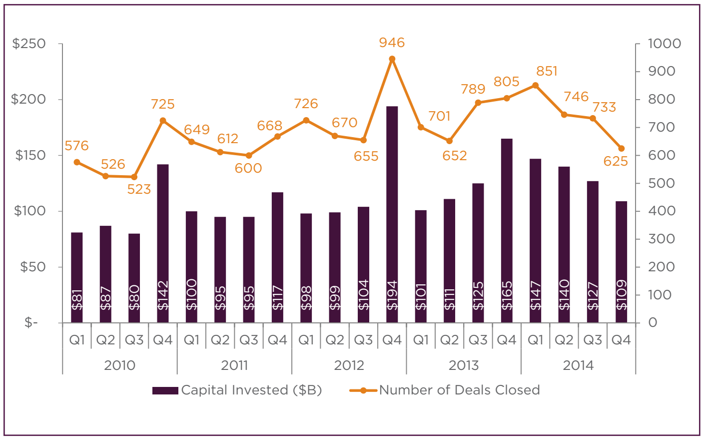
**CO-INVESTMENTS AND SECONDARIES** Co-investment and secondary transaction volume has increased significantly in the last few years, leading to more liquid and transparent markets and transactions. This has allowed institutional investors to rebalance their portfolios, mitigate J-curve effects and blend down management fees, all of which were difficult to do in the early days of private equity. According to the Probitas annual survey, 45% of respondents reported that they have an active internal co-investment program versus 35% in the prior year. Further, only 4% of the large investors surveyed indicated that they did not pursue co-investments or direct investments at all. As the number of investors and amount of capital available for co-investment increase, the amount of dry powder in the private equity market also increases. This has the potential to drive managers to deal sizes and strategies that may be different than what drove past success and distort what investors think they are getting. For example, many investors classify their fund commitments by size and, according to recent surveys, have a strong desire to invest in the middle market. However, investors should be aware of the approach and potential for co-investment in any particular fund, as a $500 million fund that expects to generate $500 million of co-investment is effectively the same size as a $1 billion fund. As a result, while there are a number of benefits to co-investing, there are also risks that should be considered prior to launching a program.

## Unfavorable Trends

**HIGH VALUATION MULTIPLES** While the amount of activity in the private equity market has recovered from the lows of the global financial crisis and generally remained strong, the underlying characteristics have evolved and are beginning to look very similar to the pre-crisis vintages of 2005–2007.

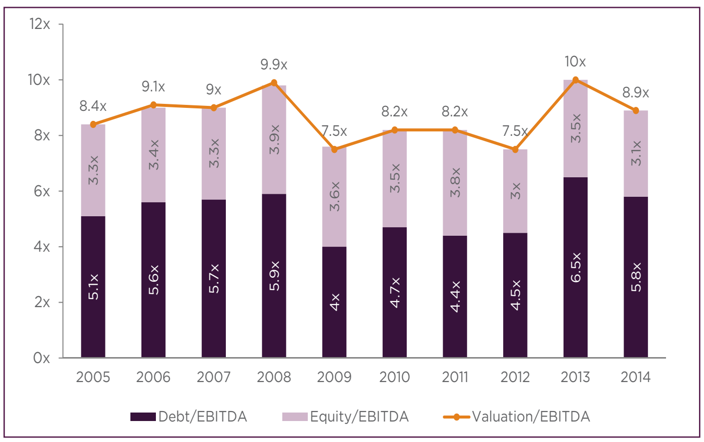
The abundance of credit and capital, combined with a strong M&A market are leading to higher purchase price multiples that, in turn, are increasing portfolio risk, particularly given the lower growth prospects of portfolio companies relative to historical standards. The robust credit markets have driven debt ratios to levels seen in 2005–2007 (although lower than in 2013) and the equity contribution in deals down to the lowest levels since 2005.

### U.S. PE Deal Flow by Quarter



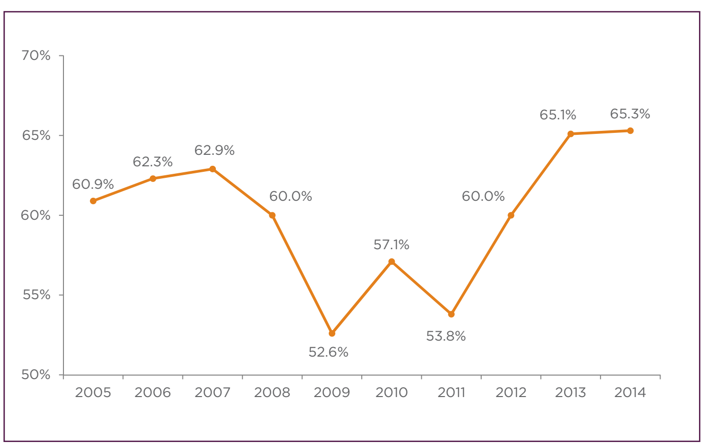

Source: Pitchbook

### Median EBITDA Multiples for Buyouts




Source: Pitchbook

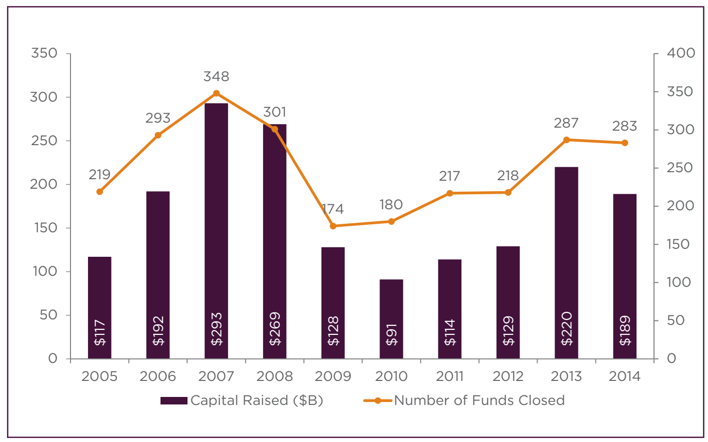
### Median Debt Percentages for Buyouts




Source: Pitchbook

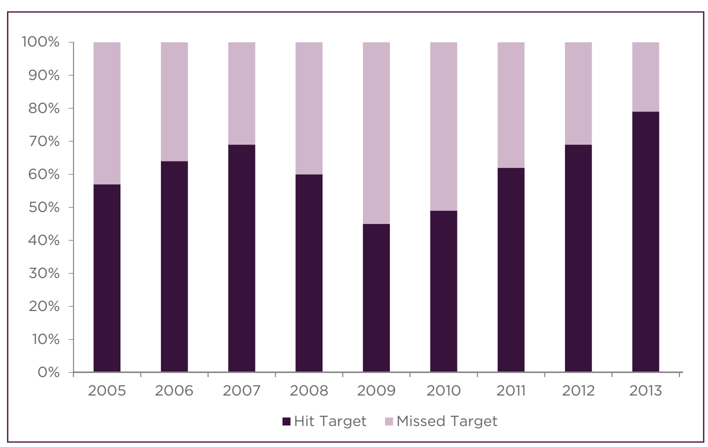
**MORE CAPITAL IN MARKET** As overall asset balances have recovered and underlying fund distributions have increased, investors are committing capital to investment managers at higher rates than in previous years. Many recent fund opportunities that we have reviewed have been significantly oversubscribed, including those at the large end of the market (over $5 billion). Part of this is due to institutions ramping up commitments (that may have been reduced during the downturn) in order to maintain their allocation, and the desire of investors to concentrate their commitments around a core group of strong performing managers. In an ironic twist, the benefits of receiving more distributions and attempting to concentrate portfolios around the best managers create more challenges for investors as they seek to redeploy capital. The more robust fundraising market has tilted term negotiations back in favor of the harder-to-access managers. Competition among managers to deploy recently raised capital may be increasing the pricing of underlying deals.

### U.S. PE Fundraising by Year




Source: Pitchbook

### % of Funds That Hit Fundraising Target




Source: Pitchbook

**REGULATORY PRESSURE** Since the financial crisis, the SEC is paying more attention to the activities of private equity managers. Some of the areas have minimal impact on investment quality and returns, but may increase operational fees and administrative burdens (e.g., taxation of carried interest, transparency on fees, RIA requirements, etc.). Others involve legislative reactions to social or political issues (e.g., bans on investing in certain types of companies). We expect this trend to continue and even accelerate as private markets evolve into a more mainstream asset class.

**EMERGENCE OF LARGE ASSET MANAGERS** The last five years have seen massive growth in the platforms of the largest private funds, turning them into publicly-traded companies with large platforms and teams. While a healthy debate is possible on the long-term implications of this trend, it is now apparent that private equity is no longer a cottage industry and is subject to new growth pressures that are likely to alter the higher end of the market.

## Opportunities

Having reviewed the favorable and unfavorable trends in the PE market, we see the most opportunity in the following areas:

**FLEXIBLE AND SPECIALIZED APPROACHES** Good absolute returns regardless of overall economic and capital markets conditions have been found in value-oriented buyouts, operational turnarounds and distressed-for-control approaches, and certain sector-focused, growth equity plays in software and healthcare. Firms that have the flexibility to create or force deals during periods of volatility or distress often have access to opportunities that may not be available to others with purely equity-oriented strategies. Further, specialist firms in sectors that are growing at two or three times the rate of GDP can generate attractive returns using lower levels of leverage, creating a much more attractive risk/return tradeoff for investors.

**ENERGY-FOCUSED OPPORTUNITIES** Certainly, while there will be negative implications for existing portfolios with energy assets, opportunities going forward will be diverse and cover both equity and debt strategies. There is a broad range of managers beyond those that are pure energy investors that may participate, such as generalist buyout funds, credit specialists and turnaround/restructuring firms. However, the energy market has a number of unique characteristics that require specialized expertise than the broader industrial markets to succeed, particularly in times of volatility. A parallel can be drawn to the opportunities in the financial services industry that arose early in the global financial crisis. Certain firms had the expertise and approach to navigate the opportunities, while others with strong investment capabilities but more limited financial services expertise, lost significant capital. As a result, it will be important for investors to identify those managers with expertise.

**LATIN AMERICA** While macro-economic headlines and the impact of significantly lower oil prices may create a negative bias toward investment opportunities in the region, our view is that the next several years could be attractive vintages for Latin American private equity funds. In Brazil, the government and capital markets are more focused on large-cap companies; consequently, middle market companies are more capital deprived. Interest rates for debt capital can be greater than 20% according to market sources, making private equity a more feasible source of capital. Additionally, around the region there are likely to be pockets of distress that flow through various sectors of the economies as a result of sustained lower oil prices creating additional opportunities. However, given the rapidly changing opportunity set, it is important to invest with managers that have deep experience and resources, as well as a broad and flexible mandate.

**PRIVATE DEBT** This approach includes opportunistic debt strategies where the manager can craft solutions using a breadth of capital structures to execute an investment. These investments tend to have a lower return profile than private equity, with top managers typically generating net returns in the 13% to 16% range. The risk of capital loss is lower and many of these funds provide ongoing liquidity with cash quarterly distributions.

## Areas that are less attractive on a relative basis include:

**VENTURE CAPITAL** Today, indicators in the venture market cycle (valuations, fundraising, and IPO activity) are near cyclical highs, which may signal the approach of a peak. These factors correlate historically with the poorest vintage years for venture funds (i.e., funds raised during venture boom cycles tend to perform poorly).

**MEZZANINE** This sub-asset class suffers from low coupon rates and the ability of companies to refinance on reasonably attractive terms, decreasing the holding period and making it more difficult for funds to generate attractive returns.

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