2017 PE Crystal Ball Report

Drawing from surveys of PE professionals & data from the PitchBook Platform
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The PitchBook Platform
The data in this report comes from the PitchBook Platform—our data software for VC, PE and M&A. Contact sales@pitchbook.com to request a free trial.
Introduction

The consistent decline we saw in private equity deal flow this year was driven by a multitude of factors. PE-backed company inventory remains inflated, yet the proliferation of transactions over the last three to four years means that much of that inventory is new. Consequently, competition increases as both strategics and financial buyers are fighting over a lower volume of deals coming to market. The valuations we expected to subside in 2016 didn’t, and for some, justifying those multiples given the concerns about company quality and growth prospects we’ve previously noted made it difficult to pencil out deals. Adjustments were made including a consistent uptick in the equity portions managers kicked in to complete deals, yet the combination of less leverage and higher purchase prices we think culminates in a future return profile for the industry that is much lower than what we’ve grown accustomed to. Despite the declines we’ve already seen this year, we think 2017 will give us more of the same, underpinned primarily by an impressive fundraising year with managers sitting on a significant amount of recently raised capital they will look to deploy.

In this second edition of the Crystal Ball Report series, we’ve combined both our own proprietary data with a survey we’ve put out to a wide group of PE investment professionals to help gauge 2017 industry sentiment. We hope the information in this report helps inform your decision-making process and as always, please contact us at reports@pitchbook.com with any questions or comments.

NIZAR TARHUNI
Senior Analyst
With over 100 respondents taking our Crystal Ball Survey this year, we were able to capture a fairly wide cross-section of the PE market. The typical respondent, however, pursues a buyout or growth strategy, could specialize in any number of industries or none at all, and is based in the US. The greatest number of respondents were in the middle market—28% said they manage between $1 billion and $5 billion.

Despite 85% of respondents having headquarters in the US, just 61% of responses indicated their firm will pursue most transactions in the US, suggesting significant cross-border activity. Besides the US, respondents report strategies targeting companies in Europe, Canada, Mexico, Central and South America, South Asia, and East Asia. Most of our survey respondents were fairly busy at the time of taking the survey in November and December of 2016, with 81% reporting that their firm was currently in the process of negotiating deals. Further, about 12% of respondents said their firm was currently negotiating more than 10 deals—though this is probably reflective of the 9% of respondents who reported AUM exceeding $5 billion.
The last edition of PitchBook’s Crystal Ball Report correctly predicted a decline in PE activity over the last year. Using data through mid-December, both PE deal volume and value have fallen by about 20% year over year. The value of PE exits is also down about 25%, while fundraising figures have fallen about 13%—a relative bright spot for the industry. 2016 has been marked by lofty purchase price multiples and competition from strategic acquirers that are ripe with cash and searching for external growth. Because of this, financial buyers are having to put up more equity in order complete deals at such high prices.

Moving into 2017, we expect deal flow to be more or less flat with 2016 levels. High transaction multiples and a lack of quality assets in the market will challenge dealmakers when it comes to sourcing, while high levels of dry powder and moderate expectations for economic growth—at least in the US—will keep them fairly active despite the aforementioned challenges.
Survey respondents identified “the state of the economy” as the most important driver of PE deal flow in 2017, followed by “PE-backed portfolio companies coming to market” and “sector-specific trends.” It goes without saying that nobody can predict the future state of the economy with certainty. Additionally, equity markets do not always reflect the state of the economy as a whole. That said, if the recent rally in public equities continues, it will benefit PE investments by kickstarting IPO markets for PE-backed companies.

We’ve seen an uptick in the percentage of PE-backed sales that are secondary buyouts this year, particularly in the middle market, and our survey respondents expect this trend to continue into 2017. “Other PE-backed portfolio companies coming to market” was ranked on average as the second most important deal driver. PE-backed company inventory has been increasing in recent years, so the number of portfolio companies up for sale should provide opportunities for managers who are looking to deploy capital.

In addition to the larger economic outlook and prevalence of SBOs next year, there are a few sectors that we believe are ripe for consolidation. We expect the heightened pace of deal-making in healthcare-related markets...
to continue, as potential policy changes collide with a blossoming health-tech industry. Whether you believe it’s for better or worse, the possibility of significant changes to the Affordable Care Act (ACA) will motivate a new wave of deals in that sector, just as the passing of the ACA boosted activity under the previous administration. Everything from insurance to biotech and pharmaceutical companies to SaaS firms which provide healthcare-related platforms could see their business environments altered. This view is supported by our survey respondents who mentioned healthcare more than any other sector when asked to elaborate on sector-specific deal drivers. Further, healthcare-focused funds like KKR’s new Health Care Strategic Growth Fund exemplify PE interest in the space.

Q8: What do you expect to be the most important driver of PE deal flow in 2017? (Please rank in order of importance.)

Q9: What do you anticipate to be the biggest challenge for PE dealmakers in 2017? (Please rank in order of importance.)

Q10: Do you expect to adopt any new deal sourcing strategies in 2017?

Source: PitchBook.

Responses

Yes 45
No 57

Source: PitchBook.
to see strong numbers again in 2017, particularly as more VC-backed companies are raising late-stage rounds and staying private for longer. Traditional buyout investors will start to target more growth-oriented strategies and the line between PE and VC will become blurred. What’s more, the seemingly unstoppable tech industry will prove more immune to any sort of macroeconomic troubles than, say, the manufacturing or consumer discretionary segments of the market which are more linked to GDP.

When it comes to challenges facing PE dealmakers in the coming year, survey respondents ranked “high transaction multiples” and “lack of quality assets in the market” as the most important. These two themes have been well-covered in our own analysis this year, and we expect them to continue creating obstacles for PE firms. With the median US M&A transaction trading above 11.0x EBITDA through 3Q 2016, many deals simply don’t pencil out. PE groups are having to contribute more equity as a percentage of the total capital stack, which will put downward pressure on future returns. In addition, diligence processes are becoming lengthier and more expensive, as firms must be certain they can justify the multiples they are paying.

Lastly, the lack of quality assets in the market is due in part to the buyout boom of the last few years, as the most obvious targets have already been acquired. The problem is exacerbated by the aforementioned lofty transaction multiples. A deal that makes sense at 8.0x EBITDA may be unjustifiable at 11.0x EBITDA. Interestingly, political uncertainty was identified by survey respondents as one of the least important challenges to PE deal flow. That is, a new administration in the US, the ongoing Brexit proceedings, and various oustings of global political elites this year don’t seem to have as big of an effect on deals as is commonly believed.

Q11: Which new deal-sourcing strategies will your firm be using? (Please select all that apply.)

- Investment banks: 38.6%
- Own network (e.g. personal referrals): 34.1%
- Leveraging an outside data provider: 63.6%
- Other: 9.1%
- Conduct own outreach in person and via media outlets: 27.3%

Q26: Which sectors do you think will grow in popularity in 2017? (Please select all that apply.)

- Energy: 28.3%
- Financial services: 10.6%
- Healthcare services: 11.7%
- Biotech: 13.3%
- Manufacturing: 15.0%
- Technology (media, cleantech, software, etc.): 9.4%
- Media (television, print): 11.7%
- Other: 17.2%
- Manufacturing: 16.4%
- Technology (media, cleantech, software, etc.): 12.6%
- Biotech: 7.6%
- Media (television, print): 17.2%
- Other: 20.6%

Q27: Which sectors do you think will decrease in popularity in 2017? (Please select all that apply.)

- Energy: 5.2%
- Financial services: 2.2%
- Healthcare services: 18.4%
- Biotech: 11.7%
- Manufacturing: 10.6%
- Technology (media, cleantech, software, etc.): 9.4%
- Media (television, print): 11.7%
- Other: 15.0%
Supported by both survey responses and market data from the PitchBook Platform, we expect PE fundraising to decrease substantially in 2017. Just 41% of survey respondents plan on embarking on a new fundraising process in 2017, compared to 87% last year—a major shift. Dry powder stashes, currently totaling $852 billion globally, will keep PE funds from needing to fundraise next year. 53% of survey respondents who said they do not expect to raise a new fund next year cite the reason as “still investing from a current fund.” What’s more, many of the 25% of respondents who answered “other” (Q17 on page 11) cited having just raised a fund when asked to elaborate on why they had decided not to raise funds next year.

Additionally, the multiple expansion seen over the last year may dissuade some managers from raising a new fund if they believe they can’t reasonably expect to earn the promote portion of their compensation given the high prices in the market. 2017 will see managers focus more on operating in this new environment, rather than planning and fundraising for it, as they seek to earn the carry on all of the capital deployed in the last few years.

**Q12: Is your firm currently raising a fund?**
- No: 76.7%
- Yes: 23.3%

**Q13: Does your firm have plans to embark on a new fundraising process in 2017?**
- No: 59.2%
- Yes: 40.8%

**Global PE fundraising**

![Graph showing capital raised and number of funds closed from 2010 to 2016*](source: PitchBook)

*As of 12/13/2016*
Larger funds will have their pick of the best deals, as they often receive offerings that no one else does.

Notably, very few respondents (7%) cited being unsure of the market as a reason for not raising funds. This is similar to respondents rating political uncertainty as relatively unimportant when it comes to investment decisions. The relatively long investment timeframe of PE means that decisions are made largely on company fundamentals and financing availability, not short-term fluctuations.

Q16: Will your firm employ a new strategy with this fund?

Q14: Which strategies will your firm use to find limited partners to raise funds in 2017? (Please select all that apply.)

Q17: Why has your firm decided not to raise funds in 2017?

Q15: What type of fund will your firm be raising? (If your firm is raising more than one fund, please select all that apply.)
Deal terms

Contrary to what we often hear anecdotally from industry professionals, about the same percentage of PE investors (41%) as last year say they will use traditional banks as a source of debt financing. Even though the survey data doesn’t show it, we still believe that nontraditional lenders will make up a bigger portion of the market in the future—particularly in the US.

Access to financing was rated by our survey respondents as being one of the least significant challenges for dealmakers in 2017. That is, dealmakers don’t expect securing appropriate financing to be a big issue going into next year. Not surprisingly, 85% of respondents expect interest rates to rise next year. In addition, 60% expect a rise in interest rates to impact deal markets—an interesting figure given that dealmakers told us that they don’t expect access to financing to be an impediment. Because leverage ratios have come down this year, PEGs already expect to contribute higher equity amounts and so can easily find financing for a smaller portion of the deal size.

Further rate hikes by the Fed, however, could create opportunities for the 18% of our survey population that identify as mezzanine, general debt, or restructuring/distressed investors. Particularly for distressed investors, rising rates could create an opening by forcing companies with already burdensome capital structures and floating rate loans to trigger covenant defaults if the cost of servicing debt increases.

Another interesting result of our survey is that a significant percentage of GPs (18%) say they feel pressure from LPs to exit investments early. We don’t have an accurate benchmark for this question from the past, but
we view this figure as correlating with the increase in SBO activity we’ve seen this year. As PEGs feel pressure to exit investments early, portfolio companies may not be ready for an IPO or strategic acquisition, thereby necessitating another financial buyer which can help the portfolio company the rest of the way. We believe pressure from LPs to exit investments early is also contributing to the longer fund lifecycles that are coming to market. Carlyle recently closed a $3.6 billion buyout fund with a stated lifespan of up to 20 years. This will give them the opportunity to hold investments until they feel they can exit at a more opportune time, producing a higher money multiple, if not IRR. The longer lifecycle also allows for more patience and timely capital deployment during the earlier years of the fund.

Q21: If you ranked the importance as > 6, are you willing or able to close a deal without a debt package already lined up, in anticipation of refinancing later?

<table>
<thead>
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<th>Response</th>
<th>Percentage</th>
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<tbody>
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<td>51.4%</td>
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<td>48.6%</td>
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Source: PitchBook

Q22: Do you expect interest rates to rise in 2017?

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<tr>
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<td>84.7%</td>
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<tr>
<td>No</td>
<td>15.3%</td>
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Source: PitchBook

Q23: If so, do you expect a rise in interest rates to impact deal markets at all?

<table>
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<tr>
<th>Response</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>39.8%</td>
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<tr>
<td>Yes</td>
<td>60.2%</td>
</tr>
</tbody>
</table>

Source: PitchBook

Global PE-backed exit flow

Source: PitchBook

*As of 12/13/2016
We do contact information, LP investment preferences, custom benchmarking, mandates, fund performance data.

You focus on building relationships.

See how the PitchBook Platform can help your private equity firm close your next deal.

demo@pitchbook.com

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