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Private Market PlayBook

THE EVOLUTION OF LIQUIDITY

Shifting exit strategies for private market investors
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Private Market PlayBook

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A letter from the Editor

Private equity and, to an extent, venture capital can be seen as relatively stagnant industries, utilizing core investing strategies that haven't changed much in decades. But these industries have actually evolved dramatically over the last few years, not just from the perspective of overall market trends but from that of investors. Of course, by "investors" we're referring not only to the general partners (GPs) that make the deals but also to the limited partners (LPs) that fund the GPs, and even the employees who invest years of their life to help grow companies.

Considering PE and VC are highly illiquid asset classes, one of the biggest challenges for fund managers is executing the right strategy to achieve an exit and return capital to themselves and their investors, the LPs. And for LPs, the biggest concern is getting a return on their investment in a reasonable amount of time. The path to liquidity has shifted rather significantly recently. Massive capital availability in the private markets has contributed to lengthening company lifecycles and investment hold times, and sky-high valuations and deal multiples have driven exit volume down, to name a couple factors. Investors have weathered these market shifts and have found new and diverse ways to achieve liquidity.

As companies stay private for longer, activity has grown in direct secondary markets, which has fostered enhanced liquidity for investors and employees in ways we haven't seen before. This has also enabled enhanced price discovery, which in turn has fueled innovation in listing mechanisms, such as Spotify's recent direct public listing. LP secondaries have proliferated and GPs are buying these stakes at an unprecedented clip, no longer seeing these transactions as a red flag. Moreover, there's been a considerable rise in GP stake deals, which provide liquidity to GPs by selling minority positions in their underlying management companies.

The feature article in this issue of our magazine outlines the approach and drivers of some of these shifting strategies, highlighting the evolution of liquidity through the LP, GP and transactional perspectives. This issue's liquidity theme also comes through in the Perspectives section, where we compare the value creation of public and private unicorns to see who's reaping the gains from their rise. Finally, in the Analyst Insights section we dive deeper into Spotify's innovative listing and its potential implications.

George Gaprindashvili
Editorial Director

Perspectives

Private vs. public market investors: Who's reaping the gains from the rise of unicorns?

By Adley Bowden, Andy White

A slow drama is currently playing out that's radically altering the financial market landscape: the number of publicly listed companies in the US is steadily shrinking.

This trend has raised alarm bells across Wall Street and attracted attention from policymakers and capitalists alike. From our vantage point as a data and information provider on the private markets, we believe this is evidence of an ongoing transition into a new capital markets paradigm that includes a significantly more robust institutional private market.

To better understand this change we decided to look at a prominent collision point of this paradigm transition—IPOs and unicorns, which are defined as privately venture-funded companies with valuations of $1 billion or more. That unicorns exist, let alone flourish with 240 globally when this story went to print, is just one of the facts we submit in support of this shift. We'll save the full manifesto on the new paradigm for a future edition of this magazine and, until then, share what we found as we pored over our data on unicorns and IPOs.

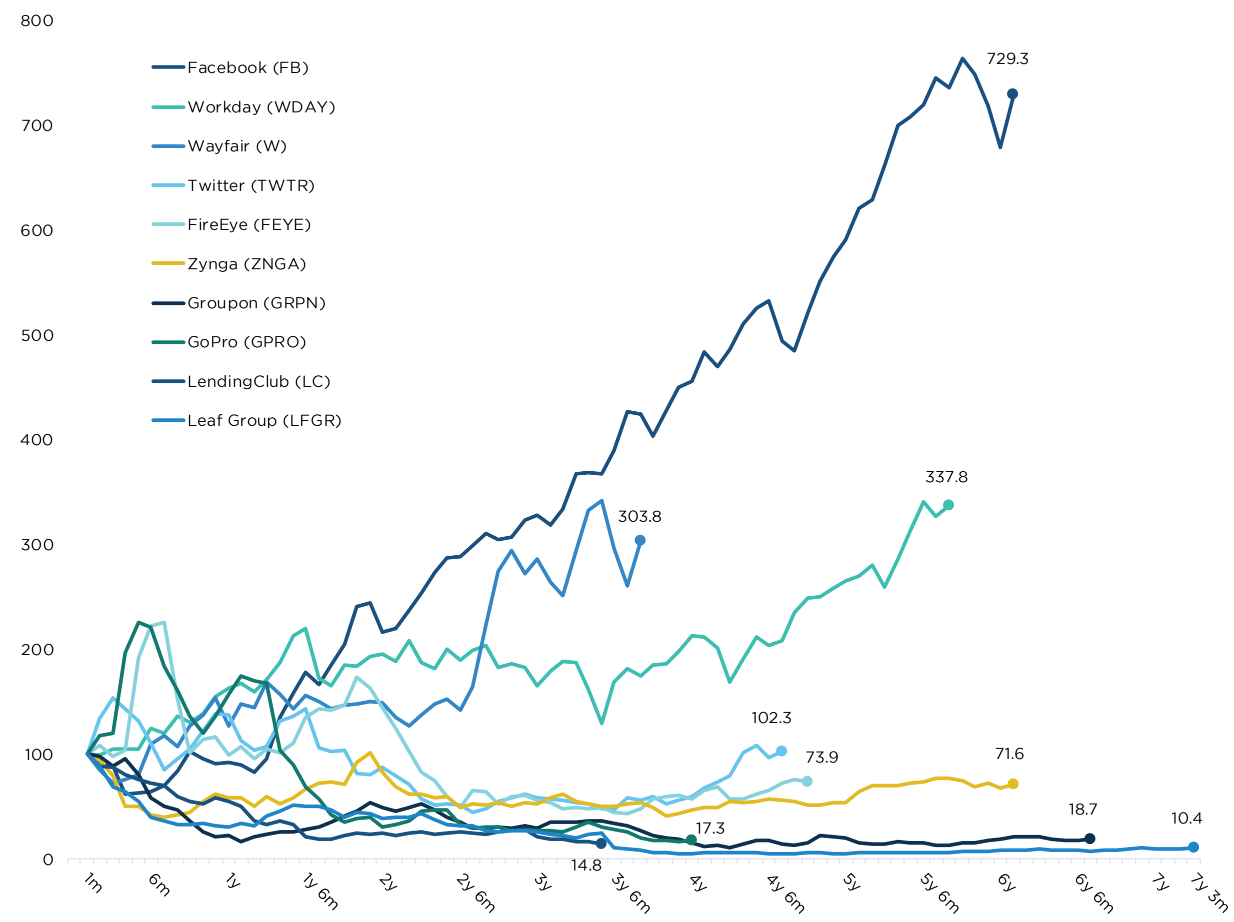
Not your 1990s' IPOs

For ease and consistency of analysis, we focused on US-headquartered, venture-backed technology companies, and what we found confirmed some of our hypotheses, overturned others and opened our eyes to new ideas.

One trend that has been inarguable is venture-backed companies staying private for much longer than ever before. Since 2010, companies have been going public more than nine years after founding, compared to around five years in the mid to late '90s. That increase has meant these companies have gone public at a very different stage in their lifecycles—they're much larger, they're more sophisticated, they have a larger investor base and they're often global in reach. It also means that there are fewer of them, as it's a lot harder to stay in business and/or independent for nine years versus five.

There are several drivers behind the trend of staying private longer, and a few commonly cited causes are the increased cap on investors from the JOBS Act (from 500 to 2,000), new deep-pocketed entrants into the venture market (e.g., SoftBank Vision Fund, PE firms, mutual funds) willing to fund nine-figure investments into these companies, and SOX compliance expenses. Another interesting theory put forth by Dr. Jay Ritter (aka "Mr. IPO" from the University of Florida's department of finance) is that private companies are moving so fast that a better route for them to reach their potential is to be acquired by an incumbent with scale, as opposed to building it themselves. We also believe many founders are intrigued by the relative freedom of the private markets, versus the scrutiny—and quarterly targets—demanded by public markets. As long as these factors stay in place, we don't foresee the current IPO timeline changing.

Average monthly market cap index by time public



Source: PitchBook
*As of May 9, 2018

Which investors see the value?

Some of the world's most highly valued public tech companies entered the public markets with quite modest valuations, at least by today's standards. Microsoft, Amazon, Oracle and Cisco all debuted with market caps south of $1 billion. Of those, only Microsoft topped $500 million. This translated to relatively modest gains for their private market investors, compared to the massive value appreciation they have all experienced post-IPO. By comparison, the current crop of unicorns is creating massive gains for their private market investors.

When we first started compiling data for this article, we had a hypothesis that delayed IPOs meant a greater portion of the financial value that unicorns generate was being captured by private market investors instead of their public market counterparts. That turns out to be mostly the case but isn't exactly the full truth. The reason being that the power law dynamic of venture investing economics carries through into the public markets post-IPO.

For this analysis, we started with 10 tech unicorns in the US that went public between 2009 and 2014 (for at least three years of trading data). We based their market caps at IPO to 100 and then charted their average monthly market caps up to May 9, 2018. We were surprised to see that only four of the 10 are currently valued above what they were at their debut. This means that, to date, six companies reached their peak valuations within the private markets and have only declined in value for any public market IPO investor.

If you had taken $1,000 and invested $100 into each of these companies at its IPO, you would have $1,679.88 today. Not a terrible return, but not great. The interesting reality is that 58% of that gain comes from just Facebook. Then 22% from Workday, 18% from Wayfair and 0.2% from Twitter. If you had instead invested that

$1,000 in just Facebook, it would be worth $7,292 today. A sample size of 10 isn't exactly exhaustive enough to draw solid conclusions from, but it certainly raises some questions about unicorn IPOs and to whom the gains accrue.

How today's unicorns stack up

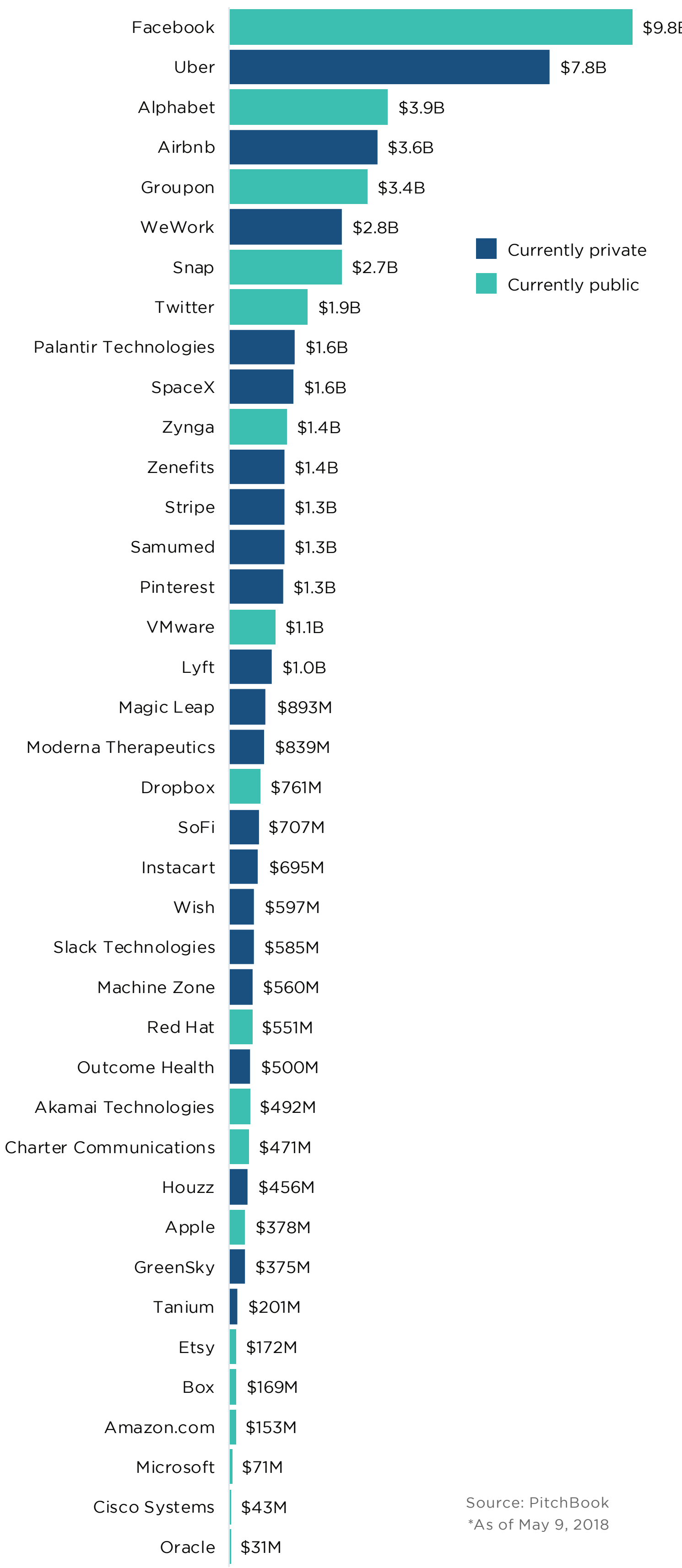
To get a better sense of private market value creation, we took a group of private tech unicorns in the US and divided their most recent private valuation by the number of years from founding to latest financing. This shows us how much value is being created per year private, while accounting for companies that have been private longer, and thus have had more time to accrue value.

We also selected a group of public tech companies and used their market caps on the day of IPO, then dividing that by the time from founding to IPO. Here are the results:

Uber is the only current unicorn that comes close to Facebook's rate of value gain as a private company, possibly boding well for the ridehailing company's planned listing next year (or beyond).

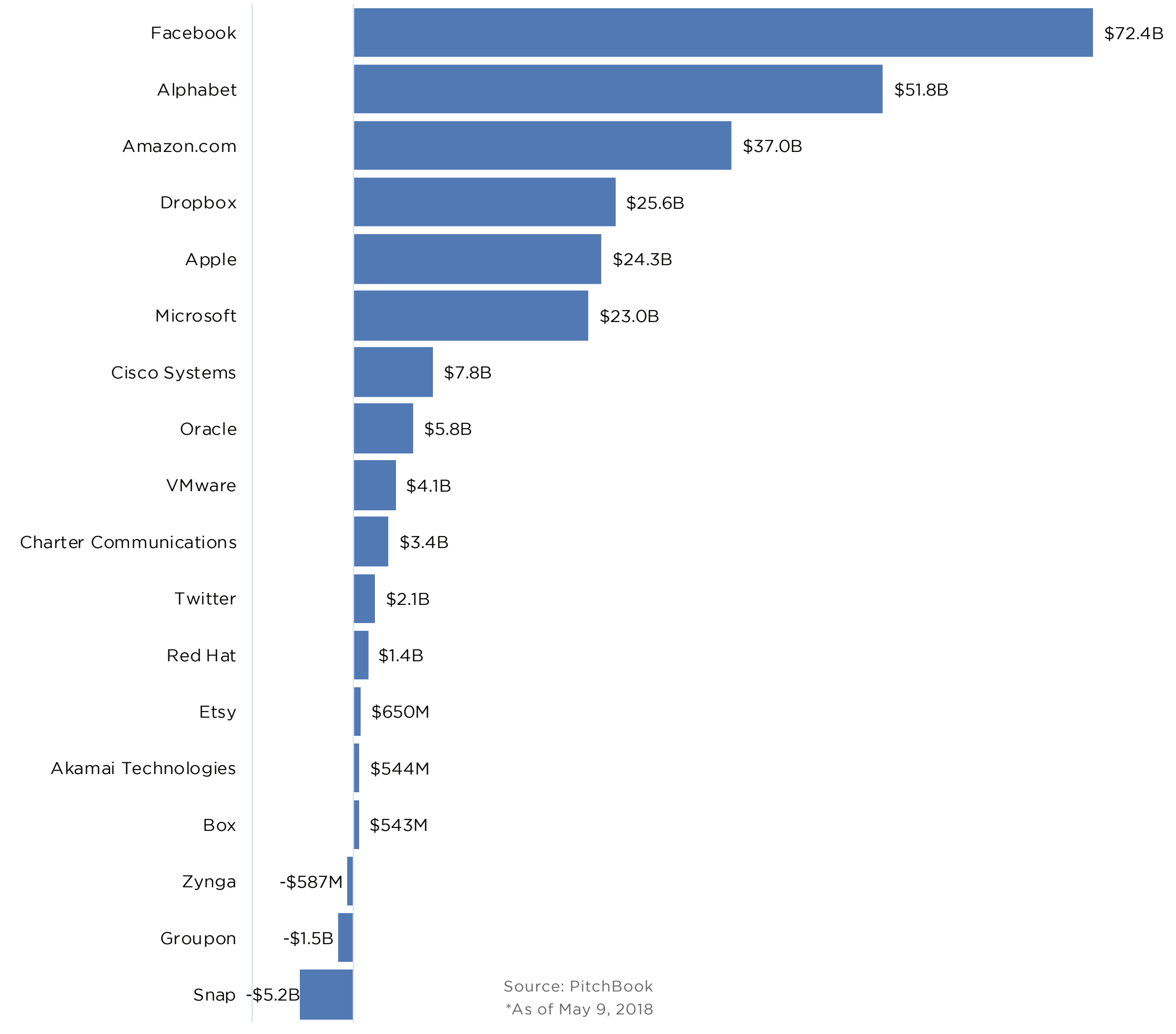
The remainder of the group shows an interesting trend: the companies having accrued private value the quickest tend to be younger companies, while the legacy tech titans accrued relatively little value while private. Amazon, Microsoft, Cisco and Oracle are barely visible at the bottom of the chart, yet all currently have market caps over $150 billion. As a comparison, the billions of dollars in value accruing these days to private investors is staggering. So, clearly the private market investors are profiting significantly more than public investors, right?

Private valuation appreciation by year



Source: PitchBook
*As of May 9, 2018

Market cap appreciation by year



Source: PitchBook
*As of May 9, 2018

Wrong, kind of. Again, a mixed picture emerges where the top companies only accelerate in the public markets, accruing significantly more value to the public markets than the private ones. However, there is a larger number of companies that see marginal or even value destruction while in the public markets.

Clearly, Facebook is in a league of its own, but we also see the true explosion in value that the legacy tech titans have enjoyed since being public, dwarfing even Facebook's value gains while private. We also see that some of the more recent entrants into the public arena have not fared so well. To be sure, it's still far too early to make a definitive judgment on many of these businesses, but it does beg the question: Have some companies exhausted their potential value growth in the private markets?

Our original hypothesis was that the changing paradigm between the public and private markets means that private market investors are capturing a significantly larger chunk of venture-backed companies value creation than in the past, and potentially even more than public market investors. It turns out, like most things in life, it's complicated. For many companies, that looks to be the case—causing us to be suspect of the ultimate performance of many of today's unicorns, should they go public.

There are a select handful of unicorns, however, that will emerge from the private markets with the scale and momentum to only accelerate their growth post-IPO and bring with it majestic returns to their public market investors, as well.

Billionaires, buyouts and basketball: The Gores brothers take on private equity

By Kevin Dowd

Who's the most interesting person in private equity? That's open to debate. Who are the most interesting brothers? To that question, we have an answer.

Alec and Tom Gores are both the founders of their own firms: Alec leads The Gores Group, while Tom is the CEO of Platinum Equity. The pair are also the owners of two of the largest homes in Los Angeles: Alec has an 11-bedroom mansion on 2.2 acres in Beverly Hills, while Tom bought a palatial estate in Holmby Hills in 2016 as part of a reported $100 million deal.

In his spare time, Tom's activity of choice is basketball. He's been the owner of the NBA's Detroit Pistons for the past seven years and has become a major presence within the franchise, often sitting courtside at its shiny new arena in downtown Detroit. Alec, meanwhile, is said to prefer a different game. In 2012, The Daily Beast reported he lost $17.4 million to an Irish gambler in a "serious backgammon match" that spanned three days.

With a net worth of $2.1 billion, per the latest Forbes estimate, he can afford it. Forbes assigns Tom a net worth of $3.9 billion, giving the brothers a combined value of an even $6 billion.

And did we mention the wire-tapping? A dozen years ago, Alec and Tom were at the center of a federal investigation of a private investigator in Hollywood, when reports emerged that Alec had hired the PI in 2000 to determine whether his wife at the time was having an affair with Tom. The detective had proceeded to install listening devices on the pair's phones, and Alec's suspicions were reportedly confirmed.

Neither Gores Group nor Platinum responded to interview requests, and neither brother is known for being an open book with the media when it comes to their private equity activities. But the Alec and Tom still manage to make their share of headlines. And lately, so have their firms.

* * *

The Goreses were born in Israel—Alec in 1953 and Tom in 1964—and moved as kids to Michigan. (A middle brother, Sam, is the chairman of Paradigm Talent Agency. The Gores genes aren't effective only in private equity.)

Growing up in the Rust Belt was a far cry from the brothers' future positions in Hollywood's upper crust. And it wasn't long before they began showing a desire to transcend their humble beginnings. Alec founded his first company in 1978, dealing computers out of their parents' basement, and sold the business eight years later for some $2 million. A career had begun. The next year, in 1987, he founded The Gores Group, making the move from selling products to selling companies.

His younger brother followed suit eight years later, launching Platinum Equity in 1995. These days, Platinum is the larger firm—it boasts $13 billion in AUM compared to about $2 billion for Gores Group—and generally pursues larger deals.

The Gores Group		Platinum Equity
Alec Gores	Founder	Tom Gores
1987	Founded	1995
Los Angeles	HQ	Los Angeles
Boulder, CO	Other offices	Boston, Greenwich, CT, New York, London, Singapore
6	2017 investments*	20
0	1Q 2018 investments*	11
3	2017 exits*	3

*Source: PitchBook

But both firms are operationally focused, seeking out investments that allow in-house teams to use their expertise to create value.

Tom Gores and Platinum completed 20 new investments last year, their most since at least 2006, according to PitchBook data. The firm continued its buyout spree during the early months of 2018, executing 11 transactions during 1Q alone. That ranked in the global top 20 for activity during 1Q and put Platinum on pace to more than double last year's firm record. The biggest price tag from those 2018 deals was the takeover of Husky Injection Molding Systems from Berkshire Partners and OMERS Private Equity in an SBO worth $3.85 billion.

To finance that increase in activity, Platinum is ascending to new fundraising heights. The firm closed its fourth flagship fund on a $6.5 billion hard cap last March, representing a 73% step-up in size from its $3.75 billion predecessor, a rare increase for a firm that's already raising billions.

Things have been a bit slower on the investment front at Gores Group. Alec's shop completed six new deals last year, per PitchBook data, down from a recent high of 14 in 2014.

But the firm has been active in other ways. Reports emerged in February that Gores Group planned to forgo raising a new fund, opting instead to gather cash and invest on a deal-by-deal basis. Not long before that, the firm was involved in an unconventional deal that departed from the normal paradigm of private equity—and that played a role in the revitalization of one of America's most iconic brands.

* * *

In 2012, Hostess Brands was on its death bed. Weighed down by debt from a buyout gone bad, the company shut down its operations entirely and auctioned off its assets. The next year, though, an investor group bought several of the company's major brands—including Twinkies and Ding Dongs—for a reported $410 million. And three years after that, Gores Group lent a hand for the next stage of the rebirth.

Platinum's got company: Other notable recent US buyout fund step-ups

	Year closed	Size	Predecessor size	Step-up%
Thoma Bravo Fund XI	2014	$3.65B	$1.25B	287%
Vista Equity Partners Fund IV	2012	$3.5B	$1.3B	269%
BDT Capital Partners II	2016	$6.2B	$3B	207%
Clearlake Capital Partners II	2018	$3.6B	$1.4B	157%
Marlin Equity Partners IV	2013	$1.6B	$600M	146%
Genstar Capital Partners VII	2017	$4B	$2.1B	90%
Clayton, Dubilier & Rice Fund X	2017	$10B	$6.4B	56%

Source: PitchBook

In November 2016, a special purpose acquisition company sponsored by Gores Group acquired Hostess and took the company public through a reverse merger. Coming with a reported valuation of $2.3 billion, the move allowed Hostess to reap the benefits of being a public company without having to navigate a tough market for IPOs. And in the months since, Hostess' stock price has trended generally up. Gores Group, in any event, seemed pleased with the deal: In January 2017, the company took a second blank-check company public in the hope of pursuing a similar deal in the future.

Other instances of Gores Group's recent activity involve some brotherly love. Back in 2002, a feature in The Wall Street Journal on Alec and Tom Gores highlighted that the two brothers were at the time bidding for the same business, telecom company Global Crossing. In the years since, though, their firms have become less inclined to compete with one another—and more interested in teaming up.

In September 2010, Platinum and Gores Group acquired Alliance Entertainment, a wholesale distributor of music, movies and other media that worked with retail giants like Barnes & Noble and Amazon. The firms exited the business three years later to fellow wholesaler Super D after conducting a pair of add-ons.

Tom and Alec next partnered on a deal in June 2016, when they recapitalized Data Blue, a supplier of various IT services for enterprise clients in North America. Once again they pursued inorganic growth, as Data Blue added on cloud specialists LPS Integration and Williams & Garcia last year.

* * *

Despite all those buyouts for companies in the IT, media and plastics industries, it's possible that Tom Gores and Platinum's best investment this decade involves sneakers and hoops. In 2011, Tom paid a reported $325 million to take a 51% stake in the Detroit Pistons franchise, with Platinum's second flagship fund buying the other 49%. Four years later, Gores bought out the stake owned by his firm to take 100% ownership.

At the time of the original 2011 purchase, an industry source described it as a "shocking" bargain to business publication Crain's. Several years later, it only looks better: Forbes' latest estimate pegs the Pistons' enterprise value at $1.1 billion.

And there are other, indirect benefits. Like the fact that the Platinum Equity logo now occupies a prominent place on the Pistons' home floor, the firm name written in script on either side of midcourt—the kind of prime brand-building real estate most private equity firms could only dream about.

It's the sort of thing that would make an older brother proud. Even, perhaps, if that older brother is also a part-time rival.

Barbarians left behind: How predictive analytics are upgrading PE's playbook

By Alex Lykken

Imagine you're a private equity investor. You focus on the US middle market, with a specialty in food-related sectors.

Your investment team finds a possible target, a trendy ice-cream maker based in California. A big hit with millennials, the brand has a cult-like following in San Francisco and Los Angeles. The company has already tried to expand, with varying results at new retail locations. Restaurant and grocery store sales, however, were up double digits the past three quarters but disguised by low in-store revenues. It turned out that demographics helped explained the discrepancy; younger customers were behind stagnating in-store sales while older customers were fueling grocery sales. To optimize overall growth, the company needed to account for both trends, and reallocate its resources accordingly.

Armed with this insight into consumer behavior, your firm can bid competitively even as others question your team's valuation.

What does this have to do with technology? Not much on the surface—tech poses no immediate threat to the ice cream industry. But technology is playing an increasingly important role when it comes to evaluating a company's growth potential, and it is quickly changing the nature of private equity due diligence.

This is particularly true as it pertains to the use of predictive analytics, which, in PE context, commonly boils down to analyzing how specific clients or users interact with a target company's products or services.

Combining high doses of leverage with cost-cuts is no longer a reliable playbook, and focusing on efficiency measures in a sector like retail, for example, can be like catching a falling knife.

That's where harnessing data and technology comes in.

"Where we've seen a lot of improvement with private equity-backed companies comes back to reporting capabilities," says Chris Stafford, senior manager in West Monroe Partners' Mergers & Acquisitions practice.

Private equity owners are expecting to see value coming from those efforts quickly, he added, in as little as six months. More broadly, PE increasingly emphasizes knowledge sharing among portfolio company leaders with regard to technology capabilities.

"We've seen private equity mature on the operating side," Stafford said. "CIOs are becoming more aware of what their portfolios need within a certain market. Investors and advisors are hosting more conferences where they can share those ideas. And beyond knowledge sharing, we're seeing more centralized services being developed within PE firms. In addition, investors and CIOs are hiring specialists to run portfolio diagnostics and provide recommendations to their CTOs to identify any gaps or opportunities to drive revenue growth."

In some cases, leveraging technology has allowed PE sponsors to better identify add-on targets earlier in the process, and many add-ons today are being negotiated ahead of the platform acquisition itself.

In other cases, it's more about getting answers to more insightful questions, like which customers buy more or more often, and which customers are less active? Which clients or client-types come with higher margins, and which are costlier to serve? Perhaps most important, how are company resources being allocated to those specific products, services or clients?

This line of thinking isn't quite the same as identifying a factory to close or a business line to shut down. Those were blunt instruments that worked effectively in the past, when those situations were more common. But PE has been active for almost 40 years, and after such a long and profitable run, the emphasis on the turnaround play is losing ground to expansion efforts.

Opportunities today are less obvious in a crowded market and more likely to hinge on boosting specific revenues or margins by as little as 10%. That might not seem like much, but knowing that certain resources can be allocated differently can make the difference between bidding confidently for a target versus passing altogether.

Even as buyout multiples won't always be this high and auctions this competitive, predictive analytics are likely here to stay. That would be a good thing for an industry looking to upgrade its image while uncovering even more opportunities in the years ahead.

The evolution of liquidity

Shifting exit strategies for private market investors

By Garrett James Black

Liquidity is the lifeblood of financial markets. For players in private markets, it is perhaps even more so, and yet is much more complicated to achieve. Illiquidity is a hallmark of alternative investments. But it is not just the relative infrequency of liquidity for private funds that complicates matters; rather, even the method of achieving liquidity can be difficult, as there have typically been only so many options for managers to exit holdings. As a result, predicting liquidity trends is complicated, especially considering the protracted lifecycles of private funds.

Over the past several years, however, a handful of key trends have emerged amid the general liquidity landscape that suggest private markets players of all types are opening their minds to new ways of realizing value from their investments.

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These key shifts represent clear signposts of how the current liquidity market is gradually evolving. Not all types of liquidity are equal; the incentives for and routes to liquidity differ for each type of investor. Therefore, taking a snapshot of the current state of liquidity evolution requires considering those signposts from three perspectives: the LP's, the GP's, and the company's.

A quick primer

In the wake of the financial crisis, it took fund managers some time, but eventually they embarked upon a period of massive distributions to their investors, finally realizing the largesse dispensed in the pre-crisis buyout boom era—private equity funds alone distributed well over $300 billion per year between 2013 and 2016. The bull market in financial assets that got well underway in the early 2010s contributed to a spree of M&A as well as initial public offerings (IPOs). But every bull market spawns its own particular issues, and this latest was no different. PE funds sold off their most-valued assets to corporate acquirers hungry for acquisitive growth; venture investors took their hottest software platforms public; and both kept on investing from larger and larger funds, per their mandates, aided by their recent success. Assets became pricier. Competition stiffened. Liquidity became an even more important consideration, relatively speaking; a recent survey of LPs by 17Capital revealed 60% of LPs are dissatisfied with the pace of liquidity from 2007-2009 vintage funds, for example.

Such a sentiment is highly reflective of the impact of cyclical factors, of which two categories primarily affect private markets: macroeconomic and structural, with secular also often playing a significant role. The macroeconomic is straightforward: Since 2016, there has been an oft-challenged narrative of global synchronous growth that, depending on which factors are considered, could be weakening or persisting. Recalling 2007 and 2008, many investors are fearful of missing out on potentially unprecedented rallies in financial markets that could mark their assets even higher, as well as potential collapses if they hold on for too long. Although 2017 marked the fourth consecutive year of at least $2.9 trillion in M&A value across North America and Europe, volume has ceased to increase, either trending downward or at best persisting.

Enter the structural factors: Assets in the private market are inherently illiquid. The trick for investors concerned about liquidity is either creating or finding a market to clear their assets with the participation of all stakeholders. PE and VC managers have traditionally exited their holdings via three main routes: M&A or trade sales, IPOs and buyouts by financial sponsors. The key differing features of each to emphasize from the perspective of private markets investors are speed, scale and time.

IPOs have trended downward in volume among both PE and VC firms, likely due to two secular factors: the gradual disappearance of small-cap companies on public indices as markets have inexorably marched upward and mega-companies have grown via consolidation; and better alternatives for additional funding or liquidity events in private markets in general.

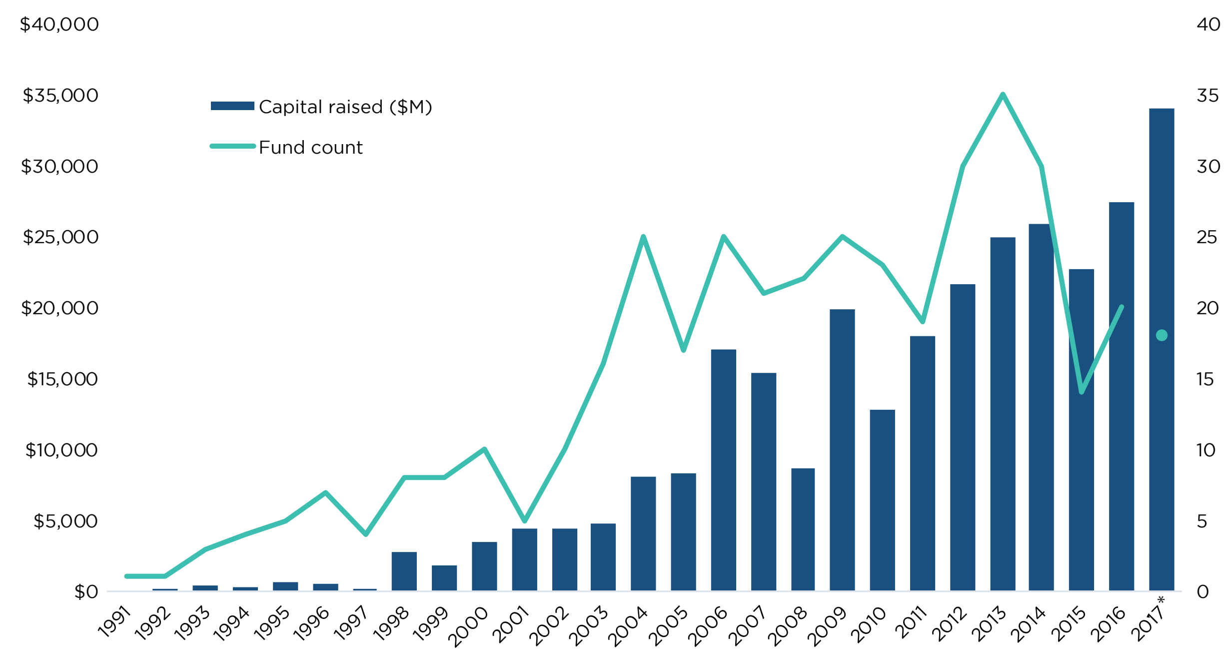
But to reiterate, not all liquidity events are equal. Different investors hold different perspectives, and each major category of player in the private markets has tinkered with their approach to liquidity.

1. The limited partner perspective: Secondary markets as portfolio management

A stake in a fund is a claim to the fund's assets. Liquidity of any stake is simply a matter of finding a market and settling the sale to the satisfaction of all stakeholders. Consequently, it is natural that stakes in PE and VC funds themselves would eventually enter their own marketplace and become bought or sold by LPs. Whatever the motivation, the global secondaries market is growing—the first three quarters of 2017 alone saw over $34 billion raised in such strategies. More recently, New Enterprise Associates made headlines for its plan to sell roughly $1 billion worth of stakes in around 20 startups to a new vehicle, which would then manage those ongoing investments. That last attribute is a departure from the norm but only further emphasizes how such secondary vehicles and markets have become more common. Looking forward, such arrangements are likely to become more popular among a coterie of firms, as only certain large firms like NEA will possess both the means and the incentives.

It is best to view this increased usage of secondaries from a portfolio management perspective.

Global LP secondary fundraising



Source: PitchBook
*As of October 10, 2017

For example, it's difficult enough to craft a compelling investment thesis and find the right portfolio companies, so trying to align incentives by assembling exposure to certain GPs' portfolios can be much more complicated. However, with the burgeoning popularity of the secondaries market, LPs now have an additional tool with which to manage exposure to certain funds, particularly within VC—hence the NEA plan, which would provide liquidity for LPs clamoring for returns while offering stakes to those who desire exposure in more mature tech companies. It should be noted that different fund types currently trade at different discounts to NAV, with buyout vehicles trading flat and VC pools at a discount, down to 80 cents on the dollar in some cases. Such pricing is tied more to the relative risk profiles of funds, hence the disparity in discounts. Those ranges of discounts also evidence the maturation of the market; according to recent PitchBook research, secondary fund stakes typically sold at a 20% discount just a few years ago, when their sale was more stigmatized as a last-ditch effort for distressed sellers. As the market has matured and new buyers have emerged, pricing has risen significantly.

This is perhaps the most momentous of the signposts of evolution. LP liquidity concerns have ebbed and flowed, as they always will, but rendering liquidity options more efficient by using secondary markets will not only aid in price discovery but also, again, overall portfolio management, from an LP's perspective. That could make private funds even more alluring to LPs, helping mute typical concerns around illiquidity and access. In short, this trend retains some of the most substantial, potential implications for players in private markets on the whole.

2. The general partner/owner perspective: Hustle & cash flow

The GP perspective can be viewed as analogous to that of a company founder or owners of significant equity, in some ways. Through this lens, which emphasizes direct ownership, there are two primary trends of innovation: the sale of GP stakes in management companies and the maturation of secondary transactions, as well as secondary sales on private exchanges.

While GPs are typically assessed through the funds they manage, there is also an underlying management company that oversees the investment funds. In its simplest iteration, the sale of minority stakes generates cash to redeem shares in the management company held by founders, many of whom are at or nearing retirement age; such cash can be used in several additional ways, including launching new strategies and helping junior professionals fulfill their obligation to commit capital alongside LPs to funds they manage.

This strategy remains fairly niche, with only the largest, most experienced firms typically embracing the formation of new GP stake-targeted vehicles, such as Goldman Sachs. But, however niche it may appear for now, it does represent yet another incarnation of liquidity options for direct owners of equity in firms themselves. And it is growing in popularity, with the roster of firms that sold stakes expanding to include TPG, Silver Lake, Vista Equity Partners and more. However, it's not just owners of shares in funds that are desirous of additional liquidity options these days; direct equity owners in some of the most prominent private companies that have emerged in the past decade are increasingly in need of alternative liquidity options as well.

Exemplified most notoriously by the unicorn phenomenon, unprecedented capital inflows into mature companies that have elected to grow privately have led to early employees and investors alike requiring liquidity prior to later investors. Accordingly, private exchanges such as those operated by SharesPost or Nasdaq Private Market have evolved to accommodate those who wish to buy or sell exclusive interests to meet their individual needs. Growth has been significant, with Nasdaq Private Market reporting $3.2 billion in private secondary transactions in 2017, a 3x increase from 2016.

Secondary sales can achieve a similar outcome while also qualifying as an additional fundraising round. Uber's recent secondary sale is perhaps the best example of such a deal, with some early employees and investors being able to redeem part of their ownership as SoftBank plied Uber with additional capital.

3. The transactional perspective: Secondhand news

Secondary buyouts, buyouts of VC portfolio companies

Secondary buyouts (SBOs) have become more popular recently, accounting for half of all PE-backed exits in the US in 2017—the highest level we've seen. There are a variety of factors at play here. Record levels of dry powder (unspent capital) have left PE funds with massive sums of capital to deploy. Paired with favorable lending terms, financial sponsors have been able to bid more aggressively to win deals against strategic buyers. PE funds are also facing a particularly competitive dealmaking environment, where quality targets are fewer and deal multiples are sky-high. Pressured by LPs to invest their high levels of capital and facing difficulties in sourcing original, proprietary targets, sponsors have increasingly turned to SBOs. Sellers, on the other hand—who have traditionally preferred selling to strategic buyers—have been happy to offload their holdings at accommodative prices, especially at the prompting of aging inventory needing to be off the books, so to speak.

But these deals aren't last-ditch efforts. Large funds often make a case for purchasing the portfolio companies of smaller firms simply because they can provide better scale than the current owners. On the other hand, large generalist firms may sell to smaller niche firms that have the sector-dedicated resources and growth strategies that can take the portfolio company to the next level. While these transactions can cause potential conflict for LPs who may be exposed to both the selling and buying fund, as long as buyers can continue to deploy effective value creation strategies and sellers can secure the prices and multiples they are content with, all parties can be satisfied.

It's not just buyout GPs that can exit via a sale to a fellow financial sponsor, but also VC fund managers. Much has changed on this front as well recently. 2017 saw a record 20% of exits via buyout relative to all other major types of VC sales, nearly double the levels of the several years prior. This further illustrates how exit strategies are evolving. Much like PE firms turning increasingly to their competitors to sell, VC firms who have seen the IPO option narrow have found diverse exit routes as well.

Alternative routes to public markets: Spotify & SPACs

Due to lengthening exit timelines, investors are finding more creative ways to achieve liquidity through the public markets. Spotify's direct listing and the increasing popularity of special purpose acquisition companies (SPACs) represent prime examples of this evolution.

Rather than undergo a traditional IPO process, Spotify elected to simply list on public exchanges. Such a novel approach led to some head-scratching, as some feared excessive volatility in share price could occur without underwriting support or having a prebuilt book of demand. The twist is that such a change from typical price discovery processes and potential volatility was worth it to Spotify, as all it really sought was liquidity and adherence to its founders' principles of transparency and equality. Mitigating swings in share prices by ramping up private secondary markets trading prior to the listing, Spotify enjoyed an ostensibly cheaper way of going public.

But such a novel form of price discovery and embrace of potential volatility is not necessarily to the liking of all, especially as Spotify had to put in a lot of time and work to pull it off, potentially offsetting IPO commission expenses with internal efforts. More critically, not every company enjoys Spotify's status as the sole significant independent contender in the cutthroat music streaming world, as monoliths Amazon, Google and Apple loom in the offing. So while Spotify's direct listing may not change the traditional IPO process dramatically right away, it does illustrate how other unicorns can find creative avenues to go public, with modifications to typical processes that can suit each to their preferences.

By design, SPACs are intended to purchase one company for one purpose—offer exposure to that particular business for investors in the SPAC. Of course the acquisition of a controlling stake in a private company by a SPAC is also a method to take the company public. Investors want access to companies like Airbnb and Pinterest, which traditionally would have likely been public by now but have been able to scale with massive amounts of capital in the private markets. From a transactional perspective on liquidity, the salient point is reaching an agreement that can satisfy all participants. Accordingly, more bespoke SPACs targeting specific unicorns are likely to ensue.

4. Signposts in a shifting land

Confronted with a challenging, competitive marketplace, as of late, GPs, LPs and even employees have increasingly employed creative methods to get what they want—their money back and then some. Clear signs of change have emerged from the shifting landscape, hinting at which seller preferences are taking priority and the top choices of owners of equity in not only private companies but also investment firms themselves. The upshot is that, promisingly enough, all the ways and means enumerated here aren't likely to be the end-all, be-all of how fund managers get capital back to their investors and employees finally cash out of the companies they've spent years building. Rather, they represent a current snapshot of how the entirety of private markets players are opening their minds to new ways of buying and selling pieces of value in multiple markets, trying to find the right matches for the right assets. The signposts of this snapshot are clear, and yet, it is always worth bearing in mind that the evolution of liquidity in private markets all around them will continue, slowly and gradually.

TwinBrook
CAPITAL PARTNERS
An Angelo, Gordon Company

Hot middle market lending environment comes with competition and new challenges

A Q&A with Twin Brook Capital Partners

Jessica Nels
Director
Twin Brook Capital Partners

Jessica joined Twin Brook Capital Partners in 2015 and is a Director on the Capital Markets team. She is responsible for structuring, underwriting, documenting and syndicating leveraged finance transactions for middle market private equity sponsors.

Previously, Jessica was in the underwriting group at Twin Brook. Prior to joining the firm, Jessica held various roles at BMO Harris Bank, Antares Capital and GE Capital. Jessica earned a B.S. in finance and accounting from the University of Wisconsin-Madison and received an M.B.A. in finance and economics from the University of Chicago Booth School of Business.

2018 has set the economy on a new course. Recent legislative changes lowered corporate taxes; tensions among trade partners have stirred into the possibility of a trade war; and interest rates have risen. These shifts present challenges throughout the financial world, including the debt market, where lenders will have to adapt in order to succeed. Jessica Nels provides thoughts on how recent changes will affect the overall lending marketing, with a special focus on the middle market.

Thus far in 2018, what is your take on lending activity within the US middle market?

2018 has been a busy year. The beginning of the year was marked by deal flow carried over from the fourth quarter of 2017, particularly as the community questioned the impact of tax change. Since then, much of the activity has been driven by repricings, refinancings, and add-on acquisitions. We expect strong M&A activity through the remainder of the year. Senior stretch and unitranche are the favored structures utilized by sponsors given the ease of execution for the original platform and for future acquisitions to support the growth strategy. First-lien/second lien structures provide the most leverage for transactions with higher purchase multiples. However, given the rise in LIBOR rates, fixed-rate mezzanine debt is becoming more cost competitive relative to second lien.

> *You cannot mitigate an economic correction; however, you can back the right company*

Before we get granular, what's your opinion of where we are at in the credit cycle and how that will impact middle market lending? What about broader economic trends?

2018 has been a strong year to date, and we expect positive performance through the course of the year. It seems everyone is on pins and needles waiting for a downturn based on where we are in the current credit cycle along with noise around inflation, interest rates, rising trade tariffs, and a potential trade war. You cannot mitigate an economic correction, however, you can back the right company, management team and sponsor, particularly those that have experience working through (and emerging from) an economic downturn. The senior professionals at Twin Brook have been focused on the middle market for the last 20+ years and have been through multiple cycles. We are not afraid of another downturn because of that experience. Unlike many new entrant middle market firms, we have invested in staff and resources that follow a "credit first" mentality in both a down market as well as a bull market. We are committed to a long-term strategy. We strongly believe that the lower end of the market is in a much better position as it relates to the basic protections that exist in our credit agreements, which makes us far more resilient in the face of a market correction.

> *We strongly believe that the lower end of the market is a much better position*

Given the level of competition in the current environment, particularly with newer entrants into private debt, what do you think will help firms achieve differentiation?

The reality is that most of the new money we see coming into the middle market is directed to the upper end of the market. Why? This is where more syndicated transactions occur that require participants who are happy to play that role. New entrants are not staffed for a direct origination model, nor do they have the depth of sponsor relationships or years of experience in middle market cultivating those relationships. If you review the top 15 lenders in the middle market league tables, you will notice that all of those lenders have been in existence for more than 10 years. There are no new entrants that are taking share in the middle market. To that end, we believe what matters most are reputation, relationships, and the strength of the originations platform. As we continue to grow our portfolio and increase the number of relationships, being the incumbent is also meaningful. Across the Twin Brook platform to date, we are the Administrative Agent/Co-lead Arranger in 89% of our transactions. The incumbent lender has the advantage of knowledge of the business, familiarity with the management team, and speed of execution. In summary, Twin Brook's sponsor relationships and experience in the lower middle market, our role as an administrative agent, and our desire to stay focused on the same strategy that we have pursued for 15+ years differentiates us from a competitive perspective.

> *What matters most is reputation, relationships and the strength of the originations platform.*

TwinBrook
CAPITAL PARTNERS
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Within the middle market, are you seeing increased stratification across structures, terms and the like according to each segment, i.e. lower, core and upper middle market segments? If not, what are your conclusions?

We see the middle market divided up into three categories based on EBITDA size. First, the upper middle market we define as borrowers with greater than $40 million of EBITDA. This segment of the market is effectively a broadly syndicated loan (BSL) market, i.e. cov-lite transactions, very loose structures (negative covenants, EBITDA definitions, etc.), arrangers that negotiate credit agreements but hold less than 10% of the paper, broadly distributed and, in this market, oversubscribed resulting in yield compression. Second, the core middle market, is generally comprised of issuers with EBITDA between $25 million and $40 million. This segment of the market tends to have a single covenant but generally at large (35%-40%) cushions with little to no step-downs (commonly referred to as covenant-wide). The core middle market tends to derive its credit agreements from the BSL market, so the overall protections are weak. Finally, the lower middle market (where Twin Brook focuses) is dramatically different in terms of overall structure and financial covenants (multiple covenants with lower cushions and step-downs). The credit agreements are much tighter than the aforementioned segments of the market and arrangers typically hold 50%-100% of the transaction. The yield on these deals reflects the size of the issuers but more importantly there tends not to be the bake-off or auction-type process that dictates the pricing in the core and upper middle market.

> *Twin Brook maintains its credit discipline and prides itself on being highly selective*

What concerns you the most when you consider what could impact your firm's prospects in the rest of 2018?

The primary challenge that any lending firm has in a "hot" credit environment is that there are far more sub-optimal transactions that come to market. When (i) leverage markets are awash with money, (ii) PE firms are eager to deploy capital, and (iii) purchase price multiples are at an all-time high, these weaker borrowers stand a much better chance of trading and/or getting financed. The outcome of this is that we need to say "no" more often to our sponsors or possibly deploy resources triaging deals that we would not normally spend time on. Twin Brook maintains its credit discipline and prides itself on being highly selective, generally booking less than 4% of the transactions it sees in any given year. The flood of weaker deals can put pressure on resources and underwriting bandwidth.

About Twin Brook Capital Partners

Twin Brook Capital Partners is a finance company focused on providing cash-flow based financing solutions for the middle market private equity community. The firm is managed by highly experienced, dedicated professionals who have successfully worked together throughout their careers at leading middle market lending institutions. Twin Brook's flexible product suite allows for tailored financing solutions for leveraged buyouts, recapitalizations, add-on acquisitions, growth capital and other situations.

Twin Brook focuses on loans to private equity-owned companies with EBITDA between $3 million and $50 million, with an emphasis on companies with $25 million of EBITDA and below. Since inception in the fourth quarter of 2014, Twin Brook has acted as Lead/Co-Lead Arranger on 89% of deals funded (2015-2018), acquired $5.8 billion of committed capital, and closed 195 transactions.

For more information, visit twincp.com

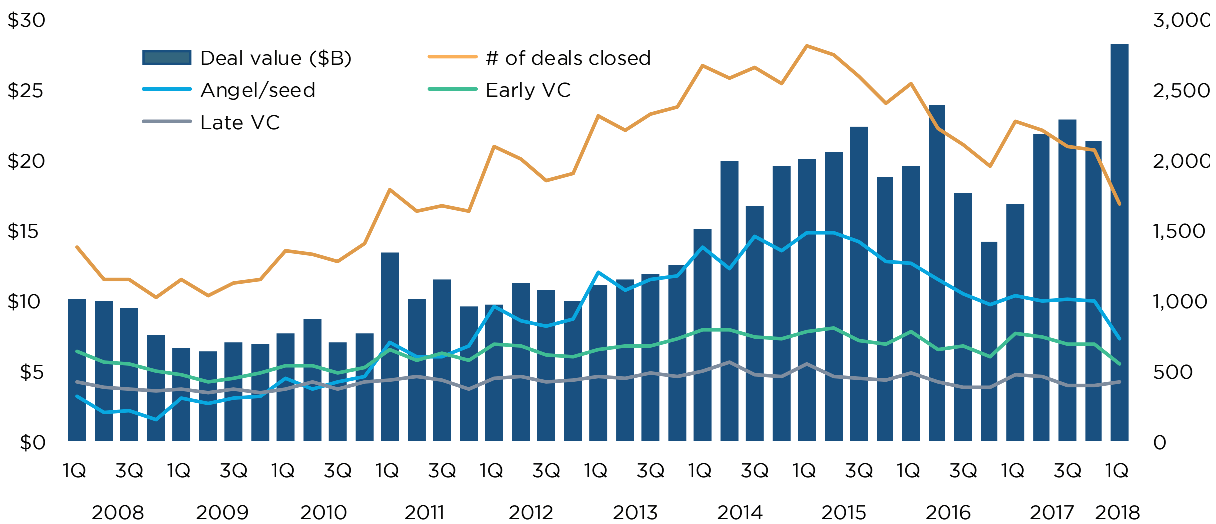
Market Trends

Drawn from our flagship industry reports covering private equity, venture capital and M&A, this section of the PlayBook contains analysis and datasets summarizing the primary trends shaping each market.

Overview

1Q marks fourth consecutive quarter with more than $20B invested

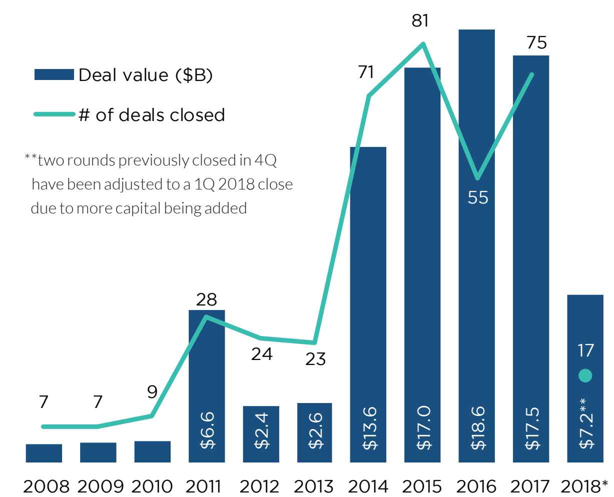
US VC activity



PitchBook-NVCA Venture Monitor

Strong start to year for unicorns

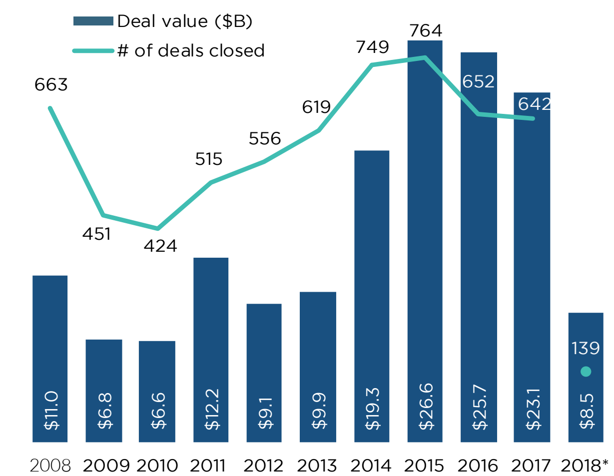
US unicorn activity



PitchBook-NVCA Venture Monitor
*As of March 31, 2018

PE continues to be highly involved

US VC activity with PE participation



PitchBook-NVCA Venture Monitor
*As of March 31, 2018

With over $28 billion invested into the US venture ecosystem, 2018 is pacing to extend the trends we've grown accustomed to over the last few years of total capital invested figures soaring to unprecedented levels. While the top-line count of completed financings declined significantly on a quarterly basis in 1Q, we maintain our conviction around the health of investment activity because of the stability of completed financings at both the early and late stage. The primary driver of the decline in round counts can be attributed to the angel market, which has continued to see the pace of investment decline rapidly since mid-2015. However, we see the proliferation of pre-seed investment activity as a key driver in the market that can be rather elusive from a data perspective as many of these deals happen under the radar. Thus, activity across some of the earliest stages of investment activity may be understood, and we think entrepreneurs are finding novel avenues to finance new ideas and business ventures.

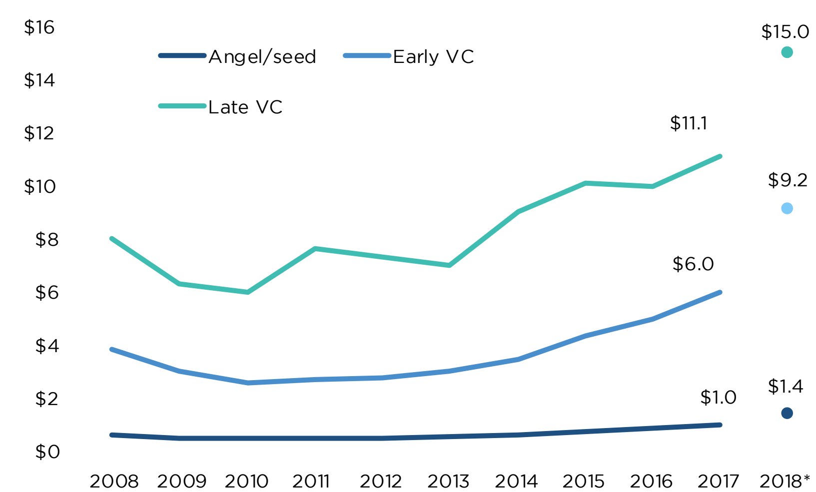
Late-stage activity remains poised for another notable company fundraising year. Unicorn activity represented over 21% of all venture capital invested in the US in 2017, with more than $17.5 billion deployed into companies valued over $1 billion during the period. Through the first quarter of 2018, activity in that subset of the market remains on track to surpass 2017's record total. Investors have piled roughly $5 billion in net new** capital into such companies, accounting for over 18% of all capital invested in the US last quarter.

While late-stage investments in unicorn companies have become more prominent given the growing age of privately held businesses, round sizes of $1 billion+ certainly have not. That said, 1Q alone saw three such transactions close, with both Lyft and Faraday Future holding final closes on rounds launched in 4Q at $1.7 billion and $1.5 billion, respectively, and Uber closing a $1.25 billion round. For comparison, 2017 in its entirety saw just three completed financings of $1 billion or more. Moving forward, we think rounds of this magnitude will still remain outliers. Moreover, as behemoths such as Uber tap investors for massive rounds, one item to note is that not all of that money is primary capital being used to fund operations. Rather, an increased proportion of some of these rounds represents secondary capital where certain investors and employees are finding avenues to generate liquidity as hold periods have lengthened and exit processes have been delayed.

Last, private equity continues to play an increasing role in the venture market. $8.5 billion worth of transactions last quarter involved PE investors, the highest quarterly figure we've tracked since mid-2012, despite these firms participating in just 8% of VC financings. On the exit front, the proportion of completed VC-backed sales to PE declined relative to 2017, during which the highest percentage of PE buyout exits were completed we've ever tracked. Given we are still early in the year, however, we fully expect to see increased activity by PE groups in the venture markets similar to what we saw in 2017 for the following reasons.

Early-stage rounds grow in size by roughly 50%

Median deals size ($M) by stage



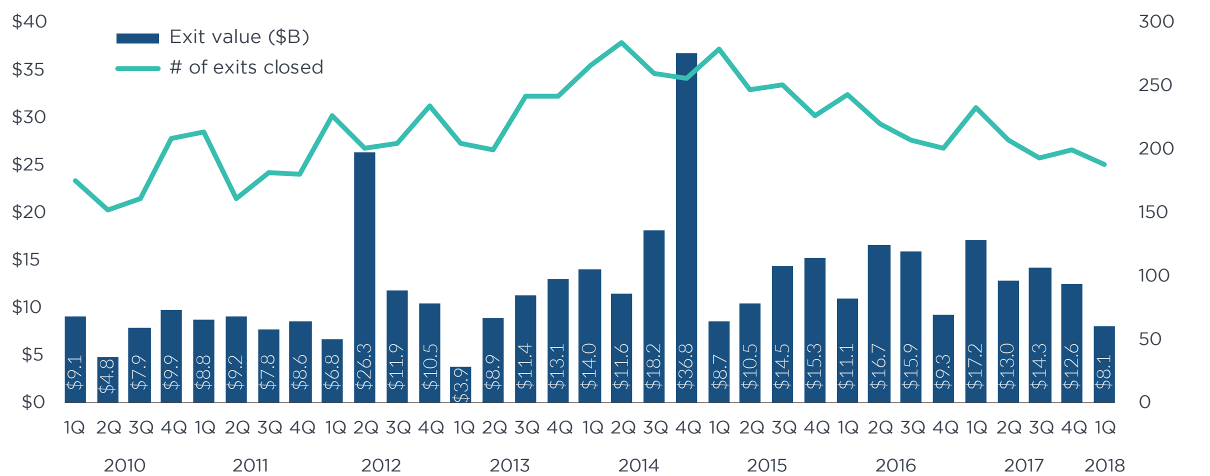
PitchBook-NVCA Venture Monitor
*As of March 31, 2018

Through the first quarter of the year, 15% of all completed PE transactions were done in the software space, which is up relative to the 12% we've seen historically. Further, the PE transaction ecosystem continues to support such deals, particularly as companies have been able to establish recurring revenue, cashflow positive and cash-efficient software businesses that fit nicely with the debt structures PE firms typically utilize to complete leveraged buyouts. As roughly 40% of all venture transactions consistently occur in the software space, the venture markets will continue to provide a fertile sourcing ground for PE firms looking to locate quality software targets.

Exits

Exit slide during three of past four quarters

US VC-backed exit activity



PitchBook-NVCA Venture Monitor

Exit flow in 1Q 2018 came in a bit weaker than the same quarter a year ago, with $8.1 billion exited across 188 deals, representing a 19% decrease year-over-year in deal count. While this is a material drop, it is important to remember that exit timing is largely idiosyncratic and can be delayed for a multitude of reasons. Most recently that reason has been larger VC deals, which supply a longer cash runway for VC-backed companies and can decrease the sense of urgency to exit.

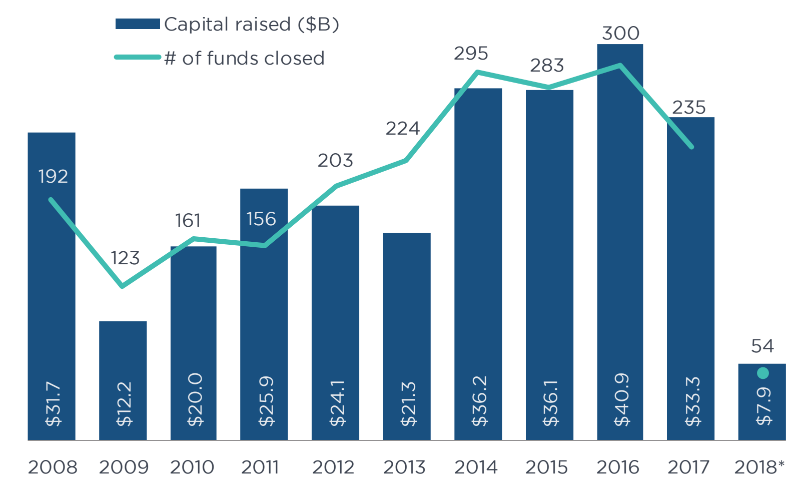
To that point, direct secondary sales of venture shares have become an increasingly popular way to give existing shareholders partial liquidity without a full exit event. Though this volume is not represented in the aggregate exit data, it is becoming a substantial source of alternative liquidity. The monster $8 billion the SoftBank consortium invested in secondary Uber shares in addition to the primary round is an extreme example, but illustrates how such a transaction can provide liquidity for early employees and investors. This capital returned back to VCs is more important now as portfolio company hold periods increase, because these secondary sales will flow through as distributions back to LPs.

Because of these aforementioned shifts in VC toward financing larger companies, it's no surprise that exits over $100 million are driving the aggregate exit market on both a value and count basis. Additionally, due to VC's reliance on "home-runs," these are also the exits that drive the majority of returns back to LPs. While Ring's $1.2 billion acquisition by Amazon was the largest exit in terms of deal size, the most valuable company to exit in the first quarter was Dropbox with its $756 million IPO, which valued the company slightly under their 2014 private valuation of $10 billion. We see the positive early performance from some of the larger VC-backed IPOs, during a more volatile and slightly negative broad stock market during the first quarter, as a potential bellwether of strong demand for these listings throughout the remainder of the year. However, sustained volatility throughout 2018 would likely cause some companies to pull their IPO plans or discourage those companies that are on the fence. That said, Smartsheet and DocuSign have filed for IPOs, which points toward more positivity around highly valued technology firms exiting to the public markets heading into 2Q.

Fundraising

2018 pacing as another $30B year for VC funds

US VC fundraising activity



PitchBook-NVCA Venture Monitor
*As of March 31, 2018

So far in 2018, VC funds have closed on roughly $8 billion in commitments across 54 vehicles, putting both capital raised and fund count on pace to dip slightly from 2017. A strong showing from micro-funds (vehicles smaller than $50 million) has pulled down the median fund size, though we expect a surge of larger funds closing later in the year to provide a boost in fund sizes and total capital raised. With two billion-dollar funds closed already and up to four more in the pipeline, 2018 could still surpass last year in terms of total capital raised.

$45M

median US VC fund size ($M) closed in 1Q 2018

In the first quarter of 2018, micro-funds made up 50% of fund count for the first time since 2015. Driven by seed and early-stage vehicles with niche strategies or regional focuses, the representation of smaller funds speaks to continued development of innovative strategies and emerging venture ecosystems. True Wealth Ventures Fund I, for instance, focuses exclusively on female founders, while Illinois Ventures' Emerging Technologies Fund III seeks to capitalize research spin-outs from the University of Illinois. First-time funds have also made a strong showing with 11 vehicles closed in 1Q 2018, putting this year on track to reach 2014's decade high number of funds closed.

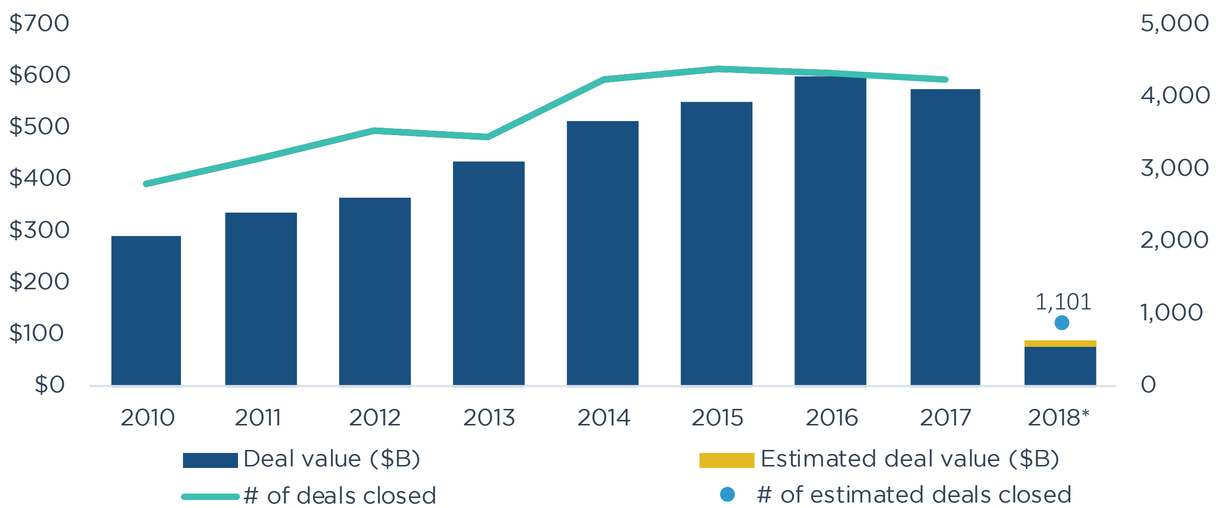
Though capital raised is tracking lower so far, the outsized effects of mega-funds (vehicles $500 million or greater) will likely lift capital raised in the remainder of 2018, as four vehicles including Lightspeed Venture Partners and Social Capital have all announced intentions to raise funds of $1 billion or more in the near future. The impact from mega-funds is clear, as these funds made up 47% of all capital raised by venture funds in 2018, despite representing 5% of all closed vehicles. While three funds of over $1 billion were closed in all of 2017, three strategies have already closed in the beginning of 2018: Norwest Venture Partners' $1.5 billion and General Catalyst Partners' $1.37 billion fund, as well as $1.25 billion raised across two complementary vehicles from Battery Ventures.

VCs have taken to raising larger funds to garner the capital necessary to maintain a competitive stance against deep-pocketed investors, such as SoftBank, as deal sizes and valuations continue to rise. But strong fundraising is only possible if there is sufficient LP demand, and many institutional investors have been looking to allocate more to private market strategies—including VC—while trying to consolidate their allocation to fewer managers, resulting in larger but fewer fund commitments. While these mega-funds may offer GPs competitive advantages, they also bring into question whether their managers can deliver venture-like returns, as GPs run the risks of overpaying in outsized rounds and overcapitalizing startups.

Overview

PE activity likely to be healthier than initial numbers suggest

US PE deal flow



Source: PitchBook
*As of March 31, 2018

US PE activity remained robust, but deal value took a hit through the first quarter of the year, with 1,101 completed transactions totaling $88.8 billion in deal value, 4.0% and 32.8% decreases, respectively, from 1Q 2017. Despite the slowdown, we expect reported deal flow figures to tick upward in the coming months due in part to the 124 deals worth an estimated $94.3 billion that have been announced but not yet closed in 2018. In addition, private market data is often slower to come to market. As such, we suspect there are many deals—particularly secondary buyouts—completed in 1Q that may not appear in this dataset.

Add-ons accounted for 70% of all buyout activity in 1Q 2018, shattering any previous notions that they may have reached a ceiling at two-thirds of all buyouts.

Buy-and-build strategies account for a significant portion of the operational improvements on which managers pride themselves. These strategies have become more common in the last decade as competition has intensified for private assets, rendering the paydown of debt and multiple expansion less useful than they once were. Nearly one-third of PE-backed companies now undertake at least one add-on acquisition, compared to only about 20% in the early 2000s. However, while add-ons have grown more pervasive, a relatively small number of the most prolific buy-and-build investors have increasingly driven activity; roughly one-quarter of the add-on deals completed since 2014 were at least the fifth deal in the platform's buy-and-build strategy.

ADD-ON ACQUISTIONS ON THE RISE

70%

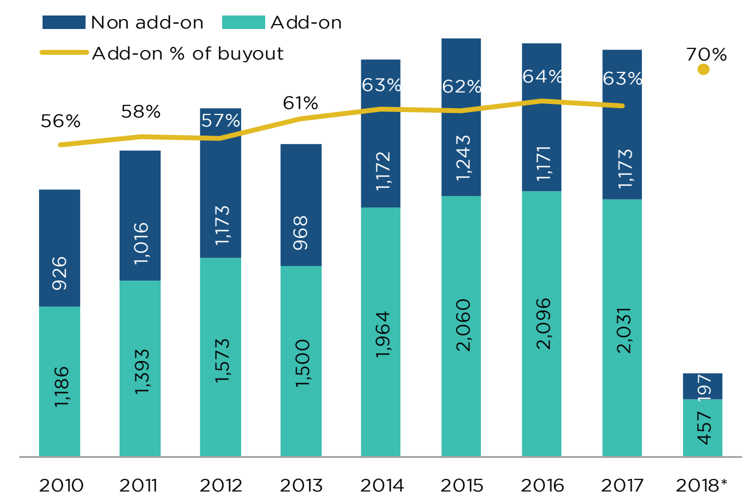
of all buyout activity in 1Q 2018

Growth/expansion deals accounted for 25% of all PE deals in 1Q 2018, a modest uptick from the 22% recorded during the entirety of 2017. Growth equity represents one of the ancillary private capital strategies that have become more common in recent years as both GPs and LPs look to branch out from the traditional buyout model. The ascendance of the growth strategy has been driven in part by PE's heightened interest in the software sector, which has traditionally been an area of relative underinvestment.

Growth deals allow the founder and/or management team to retain some control over the operations—an oft-cited concern of software founders. In 1Q 2018, software deals accounted for 21% of growth equity rounds, but only 13% of buyouts.

Buy-and-build strategies here to stay

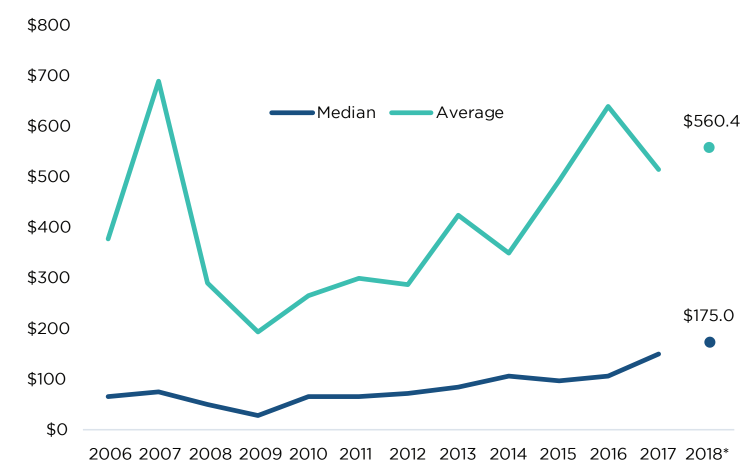
Add-ons (#) as % of US buyouts



Source: PitchBook
*As of March 31, 2018

Median deal size continues to grow

Median and average buyout size ($M) in US



Source: PitchBook
*As of March 31, 2018

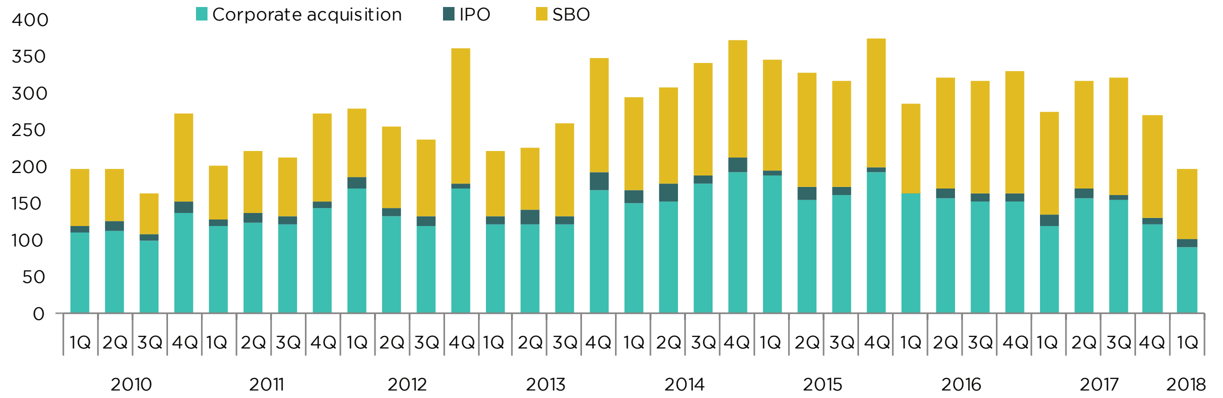
We expect this corner of the market to continue growing over the medium term, particularly as PE and VC investors begin to interact more often. For example, nearly one-fifth of all VC-backed exits in 2017 were via PE firms.

As more competition has moved in and fund sizes have continued ballooning, multiples have expanded and LBO sizes continue to grow. The median buyout size in 1Q 2018 reached $175 million, a 17% increase over the $150 million recorded during the entirety of last year. For further context, the full-year median buyout size has doubled since 2007, when it was just $75 million. We expect this trend to continue for as long as public equities remain in a bull market and PE firms continue to raise larger funds.

These larger funds are also enabling an increase in take-privates, many of which are carveouts and corporate divestitures. Last year saw 382 PE transactions sourced via carveouts, corporate divestitures and asset divestitures, totaling $86.5 billion in deal value—levels not seen since the financial crisis. Carveouts and divestitures often serve as a means of finding companies at lower multiples, with the assumption that the seller parent company underutilizes and/or undervalues some of their assets. This momentum continued into 1Q; of the 13 announced deals of $1 billion or more in 1Q, 10 were either take-privates or some sort of carveout/divestiture.

Exits

US PE-backed exits (#) by type



Source: PitchBook

After a strong back half of 2017, exit activity slowed in 1Q 2018. At the sector level, the proportion of exits coming from the B2C space has been waning. Similar to what we've observed on the dealmaking front, IT is commanding a greater share of the exit market, representing 17% of activity in 1Q 2018, compared to 15% in 2017.

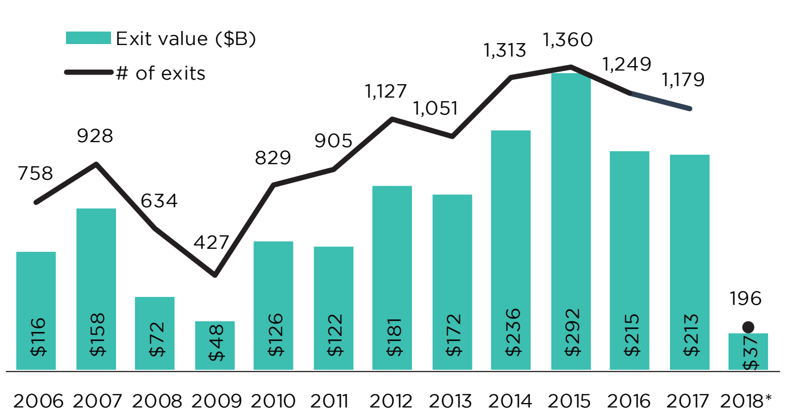
IPOs were a relatively popular exit route for PE-backed companies in 1Q 2018, despite the volatility in equity markets. The 12 offerings in the first quarter marked the third-highest total over the last two years. An IPO is typically viewed as the exit route of choice for large companies, with the assumption being that they are too big for an acquisition, but half of the PE-backed IPOs in 1Q 2018 had valuations of less than $1 billion. Another interesting wrinkle in recent exit activity is that many of the massive club deals from the buyout boom that have plagued investors for years have finally been put to bed. Following its Chapter 11 bankruptcy in 2014, investors in Energy Future Holdings—perhaps the most notorious buyout in history—finally washed their hands clean by selling the remaining assets to Sempra Energy. To be sure, this was unequivocally a poor outcome for investors, but it is preferable to Toys R Us—another cautionary tale of PE exuberance—which filed for Chapter 7 bankruptcy in March. While these high-profile failures have garnered significant attention, we do not think that they should be viewed as a harbinger for the industry going forward.

48%

of PE-backed exits via secondary buyout in 1Q 2018

Exit activity decelerates early in 2018

US PE-backed exits



Source: PitchBook
*As of March 31, 2018

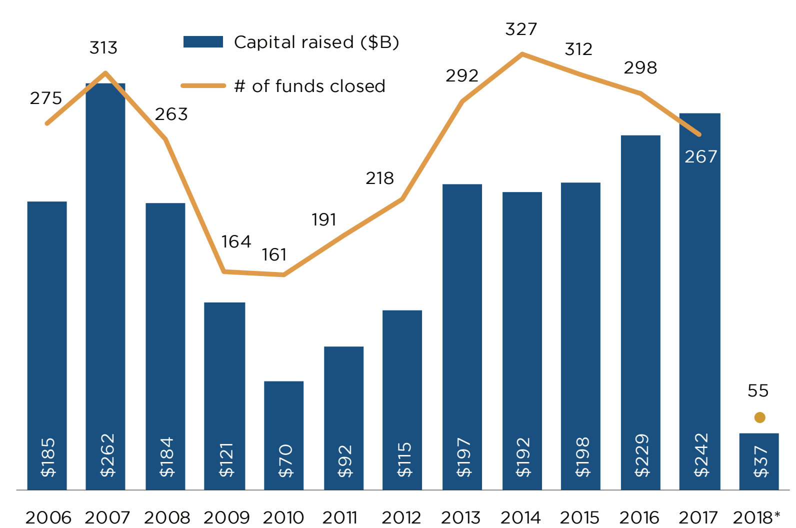
Fundraising

Coming off the strongest year in a decade, PE fundraising decelerated sharply in 1Q 2018, totaling just $36.6 billion raised across 55 vehicles. Bifurcation continues to define the fundraising landscape. On one hand, successful GPs are aggressively raising their target fund sizes and many LPs have upped their allocations to PE while spreading that capital across fewer managers. To that end, large funds remain popular, with vehicles of $1 billion or more taking in more than half of the capital raised in the first quarter. We expect this trend to continue throughout the year, with at least eight open funds targeting $1 billion or more.

While LPs ingratiate themselves with established managers, there is also a desire to tap into the next generation of talent. Indeed, first-time fundraising has enjoyed a resurgence in recent years, with first-time managers accounting for nearly 10% of vehicles in 2017. One hurdle for many LPs considering first-time managers, however, is that the vehicles tend to be small, which can make it difficult for sizable investors to write meaningful checks. A group of investors, including the Alaska Permanent Fund Corporation and Wafra, have combined to create Capital Constellation—a joint venture that will provide capital to new alternative managers. Not only is the group looking to generate financial returns, but the consortium is also seeking insight into direct investing.

Firms raise more capital across fewer funds

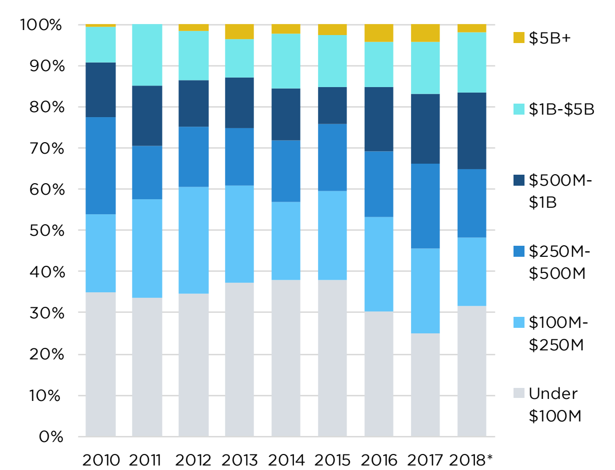
US PE fundraising



Source: PitchBook
*As of March 31, 2018

Small funds gaining share

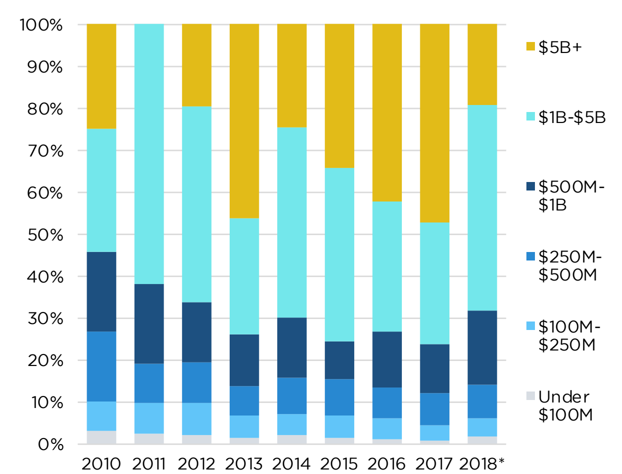
US PE fundraising (#) by size



Source: PitchBook
*As of March 31, 2018

Mega funds see a pullback in 1Q

US PE fundraising ($) by size

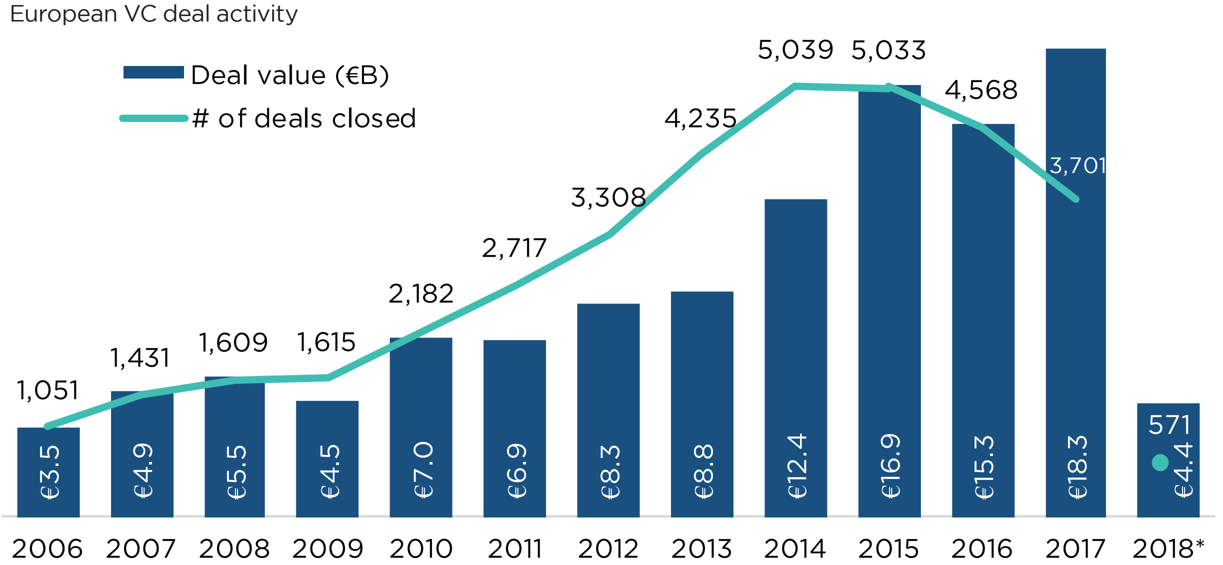


Source: PitchBook
*As of March 31, 2018

Overview

Capital invested is on track to nearly match 2017 total

European VC deal activity



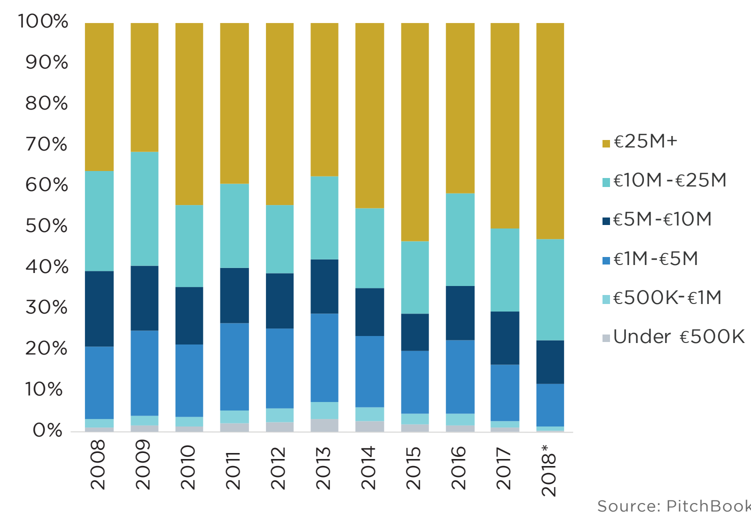
Source: PitchBook
*As of March 31, 2018

Capital invested by European VCs continues to sustain elevated levels despite another quarter of sliding deal count. With €4.4 billion invested across 571 rounds, 2018 is on pace to nearly match last year's aggregate capital investment. However, the first quarter's 49% decrease in closed deals YoY indicates the fifth consecutive quarter deal count has trended downward. We do note that as we continue to collect data after quarter-end, deal count will likely show greater numbers later in the year.

Both first-time financings and rounds closed at the angel & seed level have declined rapidly, accounting for much of the overall decrease in deal count. While some of this decline can be accounted for by under-reporting by investors and startups, the data suggests that capital is being invested in fewer, more mature startups at the angel & seed stage. The number of years from company founding at time of angel & seed round has increased to 1.1 years in 2018, up from just six months in 2014. In the same period, median angel & seed deal size saw a 2.9x increase, reaching €981,000 in the first quarter of 2018, an indication that investors are also cutting larger checks to startups at this stage. The shift toward fewer, larger early financings (as well as the diminishing number of micro-funds raised in recent quarters) appears to be a driving factor in the depressed angel & seed deal count in recent years. This trend is having knock-on effects throughout the VC funding lifecycle, as companies mature at subsequent financing stages. Consequently, larger check sizes have also become prevalent at the late stage, driving elevated levels of capital investment in recent years. The median late-stage deal size for European startups reached €8.1 million in the first quarter of 2018, a 62% jump from 2017. Additionally, the 10 largest deals in 1Q accounted for 34% of capital invested, up from 18% in 2017. German automobile marketplace platform AUTO1 Group raised the largest round in 1Q, receiving a €460 million investment from industry titan SoftBank. With European and global VCs increasingly raising larger funds, we expect to see these trends proliferate throughout the rest of the year.

Larger financings account for a growing share of capital invested

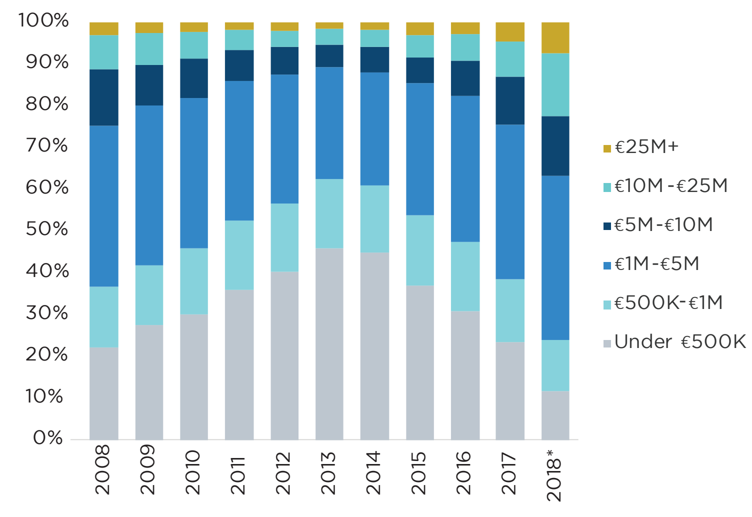
European VC activity by size (€)



Source: PitchBook
*As of March 31, 2018

Deals smaller than €1 million dwindle in 1Q

European VC deal activity by size (#)



Source: PitchBook
*As of March 31, 2018

€4.4B

total amount of VC invested across 571 deals in 1Q 2018

€1.5B

1Q 2018 European VC-backed exit value

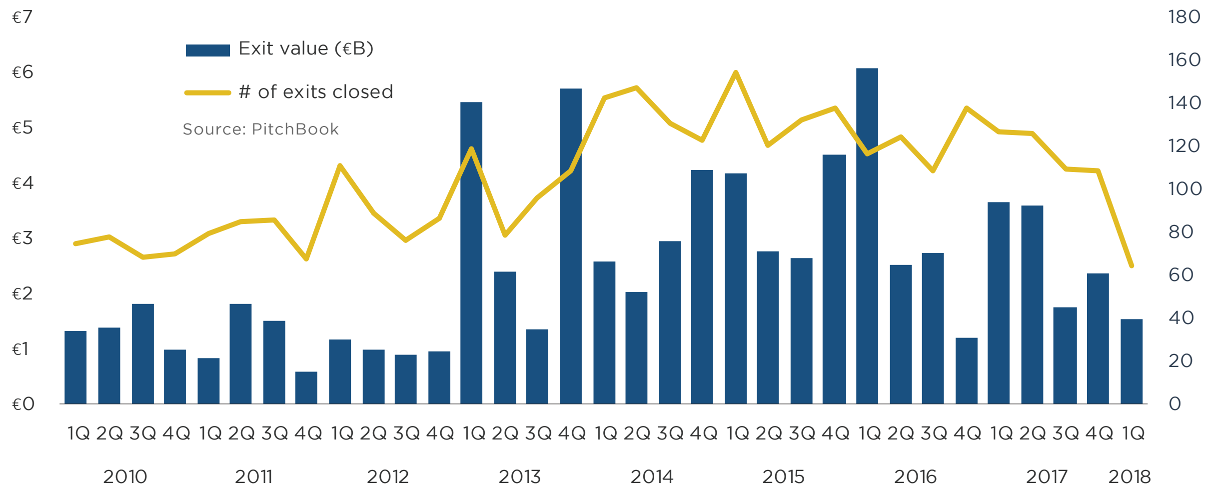
€8.1M

median late-stage deal size during 1Q, the largest figure we have tracked

Exits

Subdued exit totals so far in 2018

European VC-backed exit activity



Just €1.5 billion of value exited across only 64 deals in 1Q 2018. This is a low total for both exit value and count; however, we don't see any immediate source of worry due to the asymmetric timing of VC exits. Because acquisitions and IPOs require a mix of complex transaction structures, reliance on market conditions and long negotiations, these transactions can be prone to delays or long closing processes.

Two of the largest deals completed in the first quarter were the €905 million acquisition of Preston Therapeutics (developer of drugs to treat Parkinson's) by Danish pharma Lundbeck, and Integrated Financial Arrangements exiting via IPO, raising €201 million at a €735 million valuation. These deals illustrate the sustained strength of the exit ecosystem for software and pharmaceutical firms but also the outsized effect on total exit value, as these two deals make up 73% of our current recorded total.

Further depression of exit statistics can be partially attributed to capital availability, which has afforded some VC-backed companies the ability to scale into large multinational corporations without completing a traditional liquidity event.

The Spotify direct listing is a prime, though unconventional, example of this phenomenon. As the company opted to list publicly without raising any new capital, the transaction brought some excitement to the European VC exit environment and has the potential to significantly affect future exits.

From the company's perspective, we categorize the transaction as a success. Though the first trade was delayed due to the scarcity of guidance prior to the price discovery process, Spotify priced 5.6 million shares at $165.90 each, clearing nearly a billion dollars of value at a price 25.7% higher than the reference price of $132 (provided by Morgan Stanley, based on recent private secondary trading).

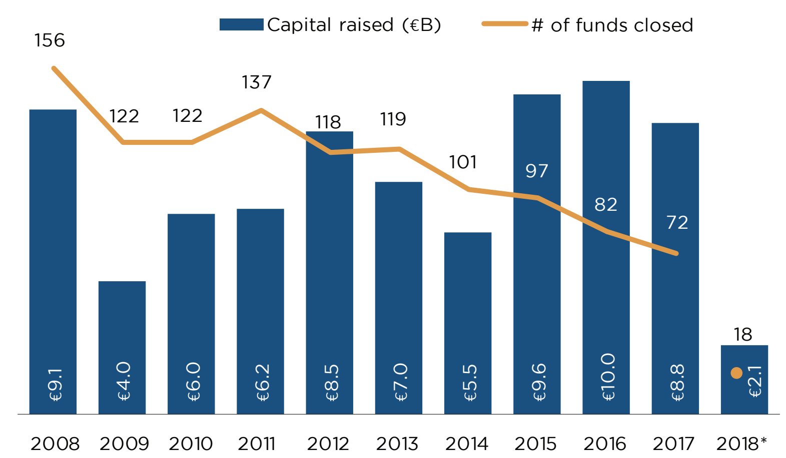
Even though Spotify shares closed lower on both its first and second days of trading, the price has found some stability at around $150, easing worries about initial price volatility. Furthermore, this stability comes in the face of low trading volume relative to the percentage of shares that were eligible to sell immediately. For illustration, more than 90% of Spotify shares were and are eligible to be registered and trade at any time, but on the first day of trading volume representing less than 17% of shares changed hands, much lower than the long-term average first-day IPO turnover of 42%.

Private secondary market trading likely played a substantial role in both the volatility and volume of trading during the first few days, as these private trades allowed insiders with pressing liquidity needs the opportunity to lock in a price and allowed some new investors to begin building a position before the public debut. A direct listing will not be a solution for every company, however, as Spotify's situation was unique with regard to its global reach and financial position.

Fundraising

Capital raised on track for another strong year

European VC fundraising



Source: PitchBook
*As of March 31, 2018

With 18 vehicles closed by European VCs totaling €2.1 billion in commitments, 2018 appears to be on track to fall slightly short of 2017's fundraising metrics. However, should European VCs close larger funds than they have in recent years, capital raised in 2018 could still match or exceed 2017's total. Median fund size has trended up to a decade high of €86 million in the first quarter of 2018, reflecting VCs' shift toward writing larger checks to mature companies. Additionally, a push by the European Commission and the European Investment Fund to seed European fund managers with their fund-of-funds program, VentureEU, will also provide a boost to fundraising. VentureEU estimates that after its aggregate commitment of €410 million, the select funds will aim to raise an additional €1.7 billion, which could boost fundraising by a total of €2.1 billion over the next few years.

The number of larger funds raised by European managers has been low historically, but recent activity suggests this trend is beginning to shift in 2018. Only in the peak fundraising cycle of 2016 have there been at least nine funds closed in the €250 million and €500 million range. This year, however, three funds in this echelon have closed already, almost halfway to 2017's count. These larger vehicles will no doubt be a vital resource for growing the European venture ecosystem. Eight Road Ventures Europe cites the large fundraise of its $375 million (€303 million) growth capital vehicle as necessary for filling the gap in funding to support ever-growing venture-backed startups.

While larger funds will be helpful to mature startups, the dearth of early-stage capital may hinder the development of next-generation entrepreneurs seeking out small funding rounds. In the first quarter of 2015, VCs raised 19 micro-funds (vehicles smaller than €50 million). In 2018, however, only four have been closed, as early-stage investors have continued to raise larger funds. London-based Kindred Capital, for instance, raised a €90 million seed investment vehicle—significantly larger than what traditional seed funds once looked like. While large funds are an important step forward for the maturing European venture ecosystem, a shortage of capital for smaller investments may create an imbalance in available funding sources.

€110M
average European VC fund closed in 1Q 2018

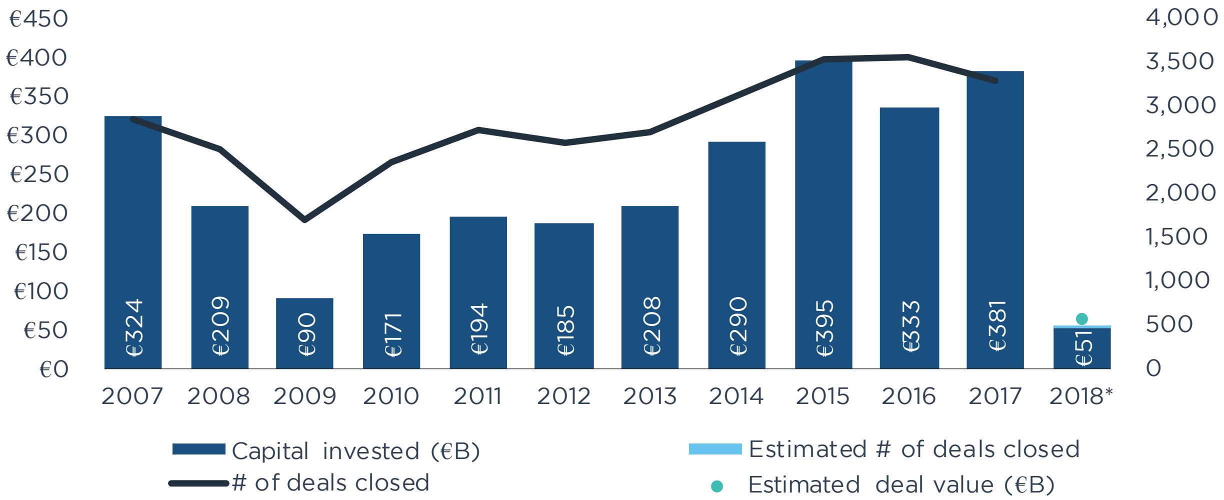
18
total number of fund closings across Europe in 1Q

€345M
size of largest European VC fund closed in 1Q (Edmond de Rothschild Investment Partners)

Overview

Completed deal flow slows in 1Q

European PE deal flow



Source: PitchBook
*As of March 31, 2018

Following three consecutive years of strong activity, European PE deal flow declined substantially in 1Q 2018. Only 690 deals totaling €62.5 billion were completed across the region, representing 7% and 21% quarter-over-quarter decreases, respectively. Though completed deal flow was stagnant, a flurry of deals announced in 4Q 2017 and 1Q 2018 have yet to close, which should aid completed counts through the remainder of the year. Notable announcements include Unilever's planned €11.8 billion divestiture of its spreads business to KKR, as well as Advent International's €1.7 billion take-private of electronics firm Laird.

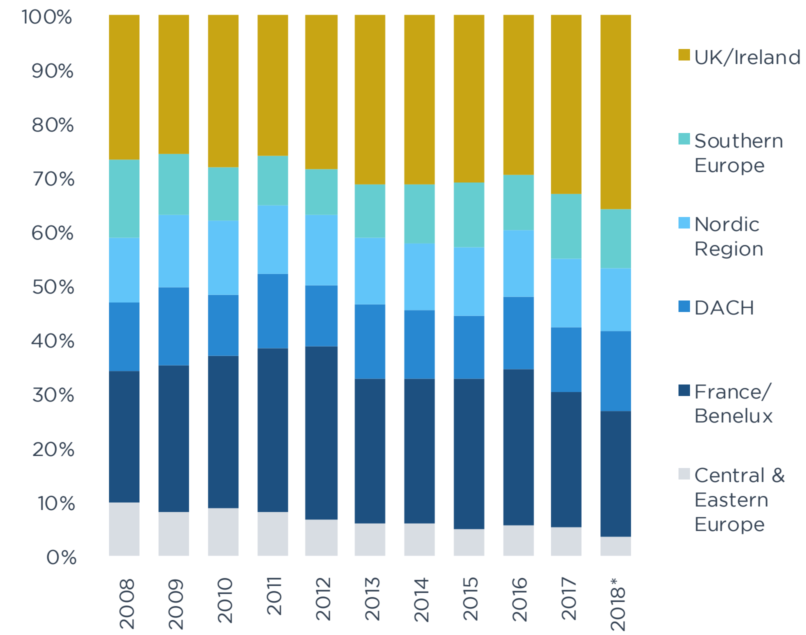
As fundraising and dry powder have grown in recent years, so too has the necessary check size for efficient deployment of capital. The median deal size increased to €33.9 million for deals completed in 1Q 2018, higher than any full-year total since 2006. By comparison, the median size of PE deals completed in the US this quarter clocked in at €175.0 million. Nonetheless, the private capital ecosystem is poised to continue growing, aided by the availability of alternative lenders and a relatively healthy economy. Eurozone GDP grew by 2.4% in 2017—the fastest in the last decade—though early estimates from 2018 point to a modest deceleration in growth.

The UK and Ireland accounted for 36% of completed deals in 1Q 2018, having grown from 33% last year and 30% in 2016. In the UK, Brexit's direct impact is the obvious explanation for the proportionally strong deal flow, with worries about eventual exclusion from the single market leading to carveouts and branch relocations, but Brexit's knock-on effect of GBP depreciation relative to the EUR is also a factor. In the UK, GBP-denominated assets are currently viewed by outside investors as temporarily on sale, with the hope that prices will bounce back once the UK economy re-establishes itself outside the EU. This is especially the case for EUR-denominated investors, while the USD's recent weakening has made this trade less appealing for US-based investors.

On a sector basis, B2B investments still accounted for a plurality (37%) of transactions in 1Q, consistent with trends over the last decade. Meanwhile, IT investments have become more popular, rising from 12% of deals in 2011 to 20% in the most recent quarter. In particular, SaaS businesses have caught the attention of GPs due to their scalability and recurring revenue models. The healthcare sector accounts for 7% to 8% of deal flow over the last decade—about half the 12% to 16% it accounts for in the US—likely due to the prevalence of government-backed healthcare systems in Europe.

Proportion of deal flow increases in UK & Ireland

European PE deal activity (#) by region



Source: PitchBook
*As of March 31, 2018

€33.9M

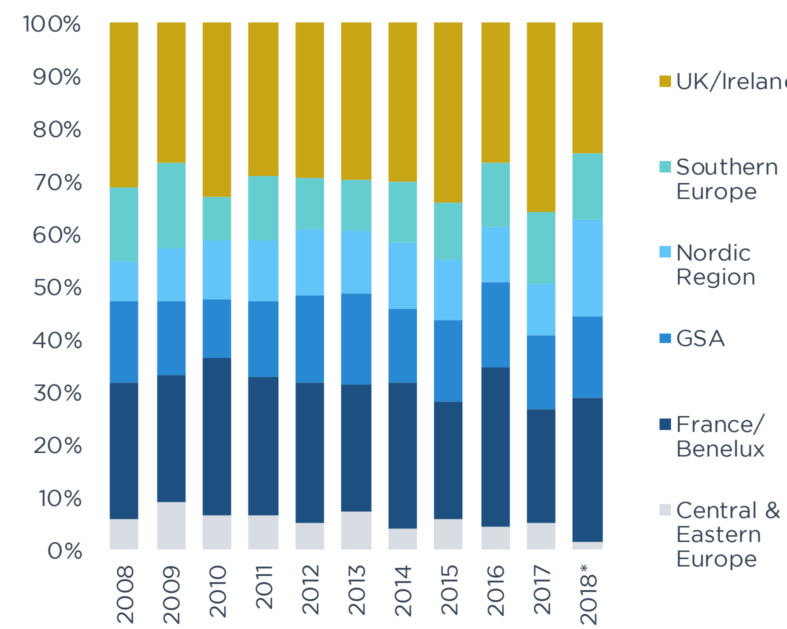
median European PE deal size

€62.5B

total European PE deal value in 1Q 2018

Central & Eastern Europe see a smaller share of deal value

European PE deal activity (€) by region



Source: PitchBook
*As of March 31, 2018

36%

percentage of completed deals located in the UK or Ireland

Exits

Both exit value and exit count in 1Q 2018 fell to the lowest levels in the last four years; however, several signs suggest that activity will accelerate through the rest of the year. First, while just five exits of €1 billion or more were completed in 1Q, there are an additional eight exits of this size that have been announced but not yet closed.

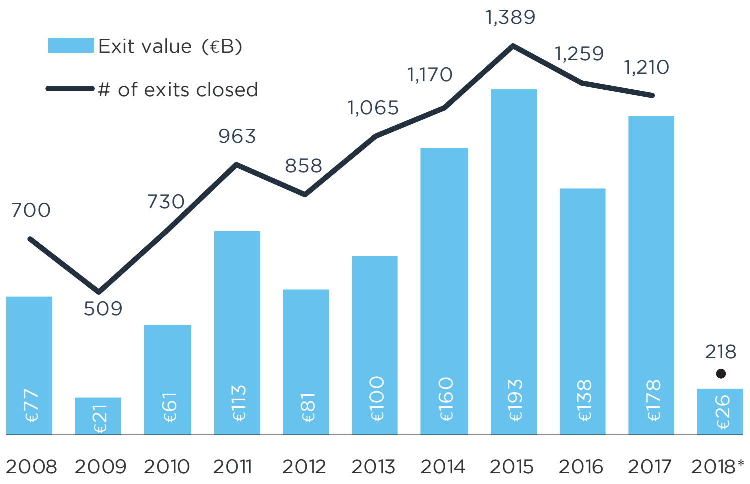
In addition to the drop-off in €1 billion+ exits, we also observed a relative decline in upper-middle-market exits (€500 million to €1 billion) that resulted in a precipitous decline in the median exit size. For exits via corporate M&A, the median exit size plummeted to €47 million in 1Q 2018—the lowest point since 2010. Secondary buyouts in 1Q were smaller, too, while the median PE-backed IPO was only €70 million, down from €120 million in 2017.

SBOs, which represented a plurality of European PE exits for the first time ever in 2017, continued to play a prominent role in 1Q, accounting for 52% of all exits. Their increasing importance is also apparent when looking at capital exited; six of the eight largest exits in 1Q came via SBO, including Scandlines and Albéa.

Though exit activity was down across Europe in 1Q, the steepest declines came from Southern as well as Central and Eastern countries. The UK and Ireland proved most resilient on an exit count basis; however, quarterly exit activity still fell to the lowest point in the last year and a half.

Exit activity decelerates in early 2018

European PE exit activity



Source: PitchBook
*As of March 31, 2018

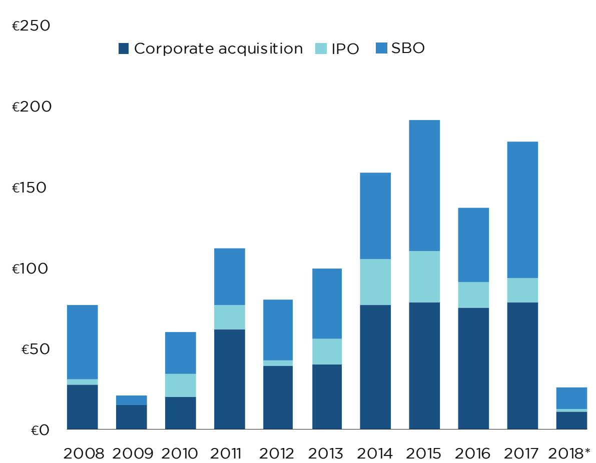
SBOs constitute a growing proportion

European exits (#) by type

Source: PitchBook
*As of March 31, 2018

IPOs off to a slow start this year

European exits (€B) by type

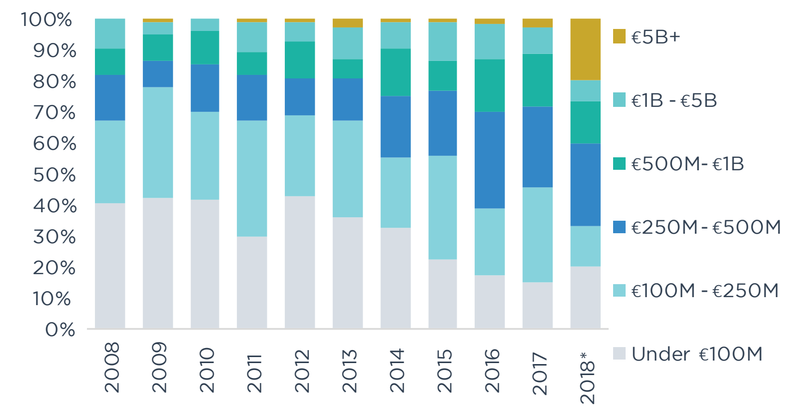


Source: PitchBook
*As of March 31, 2018

Fundraising

Firms close three €5B+ funds in 1Q 2018, tying annual record

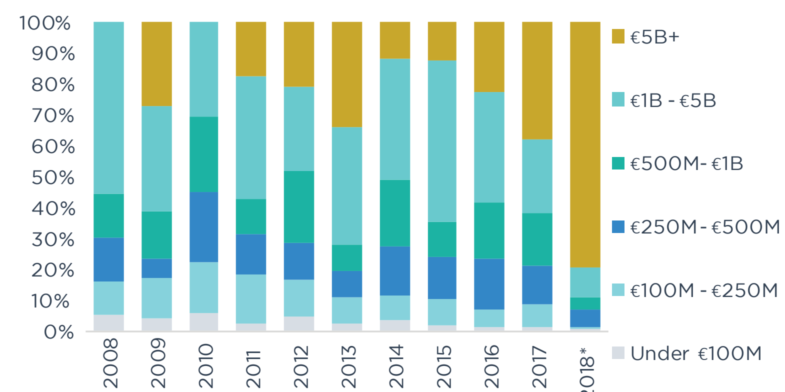
European PE fundraising (#) by size



Source: PitchBook
*As of March 31, 2018

Mega-funds account for majority of capital raised in 1Q 2018

European PE fundraising (€) by size



Source: PitchBook
*As of March 31, 2018

Despite just 15 funds closing in 1Q 2018, total fundraising came in at €28.8 billion as the median fund size leapt to €410.6 million. The migration to larger vehicles is occurring in other regions as well, but the trend is particularly strong in Europe. Funds of €5 billion+ took in a record €29.3 billion in 2017, and with €22.9 billion already closed in 1Q, 2018 is the second-highest annual total ever.

If we assume this pace sustains throughout 2018, it would mark a new European fundraising record and the first time that annual capital raised eclipsed €100 billion; however, we believe that fundraising will decelerate through the rest of the year.

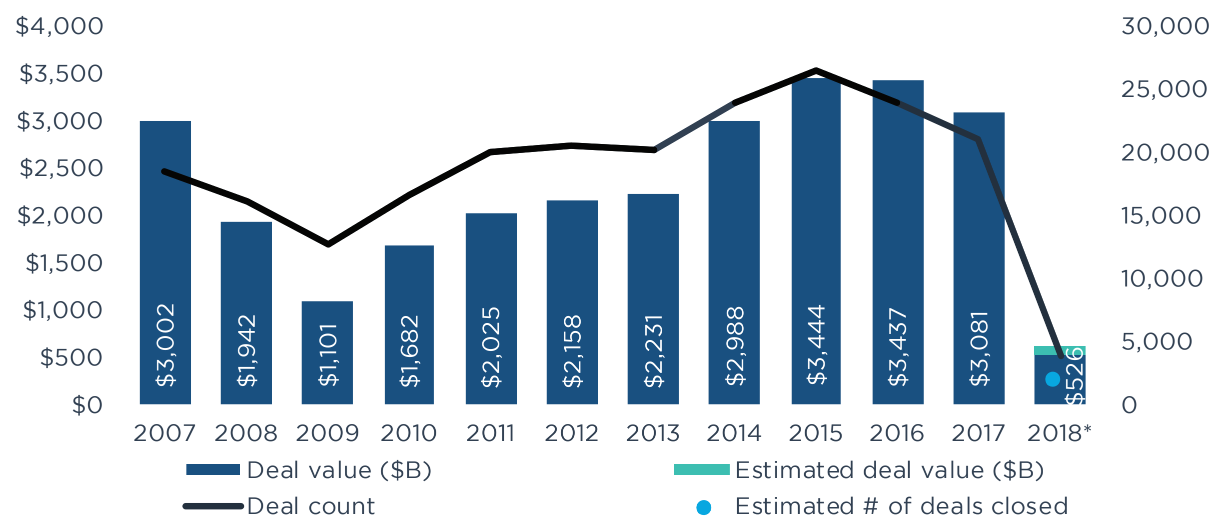
When looking at the 1Q data, it's important to recognize that EQT closed on €10.75 billion for its eighth buyout fund—making it the third-largest European buyout fund in history and only the fifth to surpass the €10 billion mark—but there are no comparable funds on the horizon. Including the EQT vehicle, European PE firms closed on three funds of €5 billion+ in 1Q, which ties the annual record. Of the 10 firms that raised the most capital since 2006, nine have closed a fund of at least €1 billion since the beginning of 2016. The lone exception is Bridgepoint, which is in the market seeking €5.5 billion for a new buyout vehicle.

To that end, we expect some mean reversion in the fundraising data because most of the largest firms are now sitting on large stockpiles of dry powder. That being said, there is evidence that LP appetite for these vehicles remains strong, with The Carlyle Group recently announcing a first close of €3.3 billion for Carlyle Europe Partners V, which has a target of €5 billion. And while there are still 15 open funds seeking €1 billion or more, most of the targets are less than €2 billion.

Overview

Deal count continued to slide in 1Q

M&A activity in North America & Europe



Source: PitchBook
*As of March 31, 2018

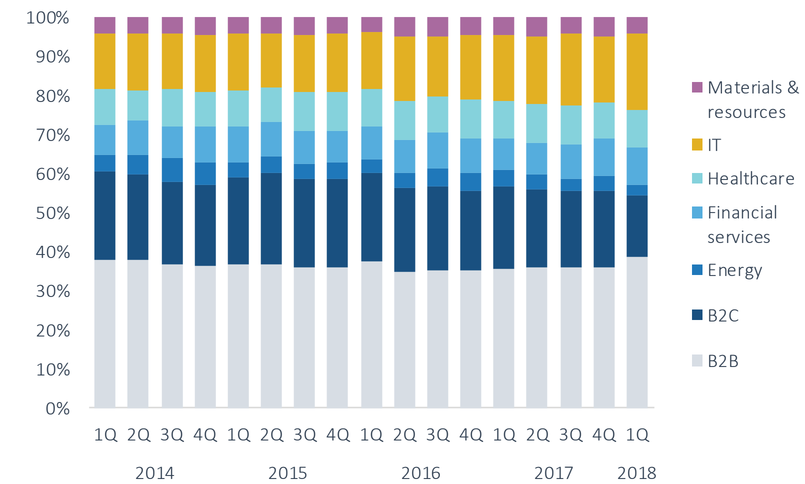
After a strong 2017, M&A activity got off to a sluggish start in the first quarter of this year. Across North America and Europe, 4,867 deals were completed in 1Q 2018, totaling $616.7 billion in value—18% and 25% YoY decreases, respectively. Though completed deal count slid substantially, an additional 973 deals totaling an estimated $451.3 billion have been announced but have yet to close. On that account, combined with the knock-on effects of corporate tax cuts in the US and a relatively stable European economy, we expect completed deal flow to increase through the remainder of the year. Notable transactions announced in the first quarter include Keurig Green Mountain's $23 billion take-private of Dr Pepper Snapple Group and Blackstone's $17 billion carveout of Thomson Reuters' financial and risk business. Both transactions reflect two prominent themes in today's M&A landscape: the growing influence of PE and the interplay between public and private markets.

The IT and B2B sectors saw their shares of M&A activity increase in 1Q, accounting for 19.5% and 38.6% of completed transactions, respectively. The IT sector continues to play a more prominent role for strategic and financial acquirers alike, commanding a greater share of both deal flow and capital invested. Fast-changing technology continues to pose a threat to existing business models, forcing incumbents to either ramp up R&D or to acquire more nimble competitors. In addition, IT companies are increasingly being acquired by businesses in non-tech sectors, accounting for 45.4% of deal flow. Meanwhile, B2C transactions accounted for just 15.9% of deal flow in 1Q 2018. Interest in traditional B2C assets has dwindled as tech-focused firms continue making inroads into consumer-facing segments. Further, businesses that were once thought of as being traditional B2C, such as retail, are now created as tech-focused ecommerce firms.

The number of intercontinental M&A deals has also trended upward in the last decade, particularly in Europe. In 1Q 2018, 13.6% of European M&A transactions involved a non-European buyer—having increased from last decade's nadir of 9.0% in 2009. By contrast, the proportion of North American transactions with an acquirer from another continent has grown more slowly, from 6.4% in 2009 to 8.2% in 1Q 2018. Intercontinental activity in Europe is higher due in part to the prevalence of North American buyers, particularly US-based PE firms and Canadian LPs executing direct investments, with substantial operations across the Atlantic. On the other hand, European investors have traditionally exhibited a propensity to invest close to home. Nonetheless, both regions have seen an increase in activity from foreign buyers, partially driven by the fact that such acquisitions serve as an efficient way to expand a company's footprint in today's global economy.

B2C clout continues to shrink

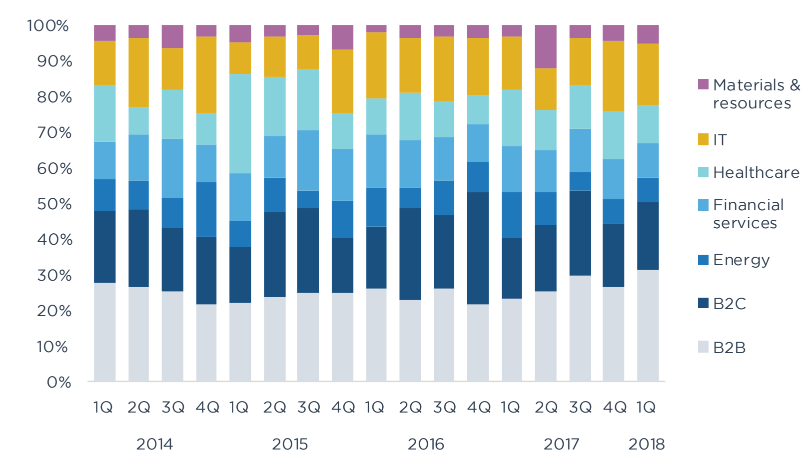
M&A (#) by sector in North America & Europe



Source: PitchBook

B2B commands a growing share of capital

M&A ($) by sector in North America & Europe



Source: PitchBook

$617B

total value across North America and Europe M&A in 1Q 2018

$149B

total value of announced divestitures

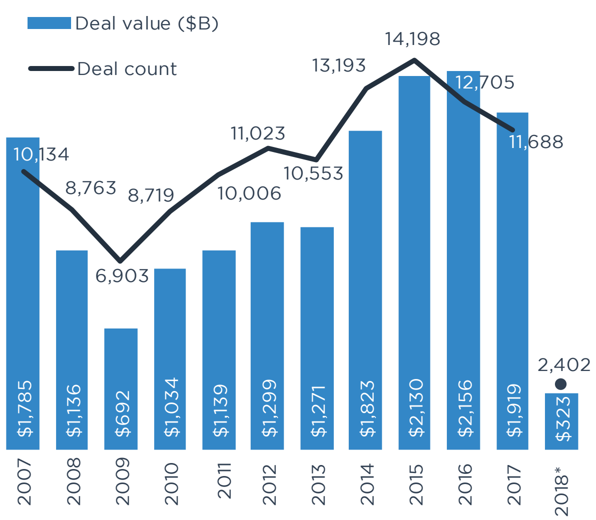
15.9%

proportion of total deal flow attributed to B2C companies in 1Q 2018

Deals by region & size

Off to a slower pace than in past years

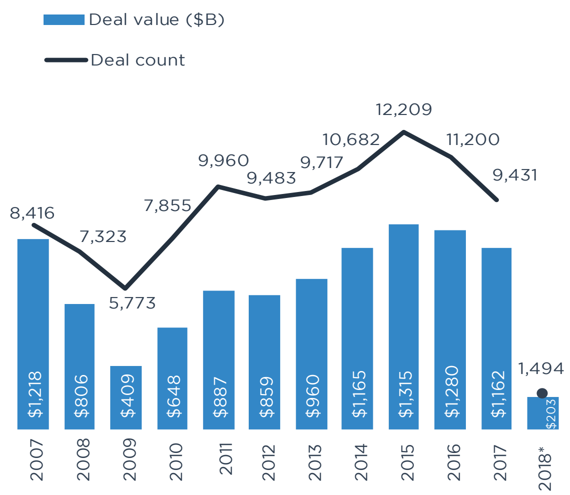
M&A activity in North America



Source: PitchBook
*As of March 31, 2018

European volume at a slow start

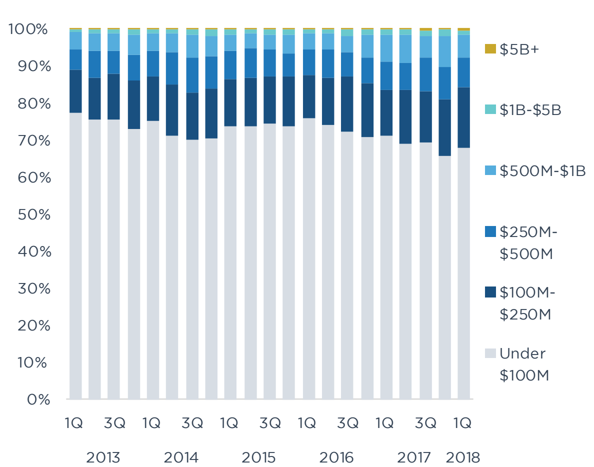
M&A activity in Europe



Source: PitchBook
*As of March 31, 2018

The trend toward larger continues

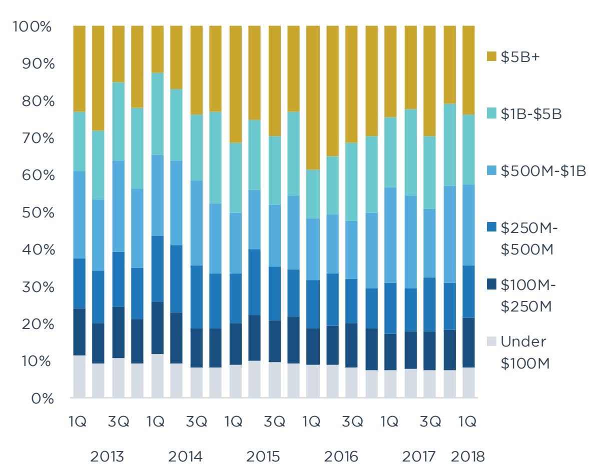
M&A (#) by size



Source: PitchBook

The lower ranges increase deal value

M&A ($) by size



Source: PitchBook

Appendix

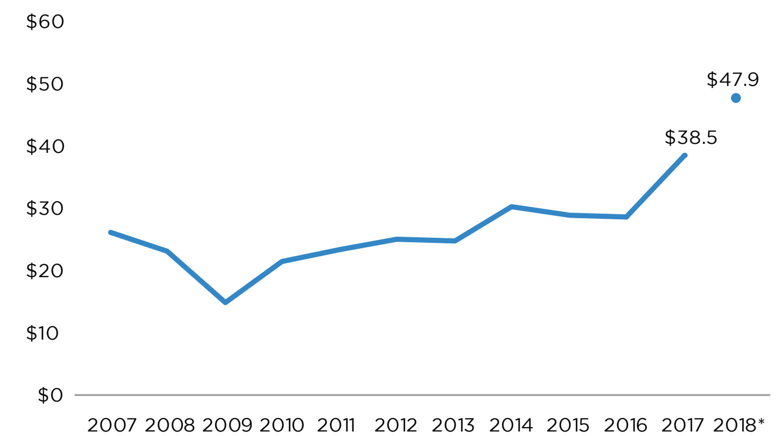
HEALTHCARE DEAL SIZES DECLINE

$37M

median healthcare M&A deal size in 1Q 2018

Median deal size remains historically high

Median M&A deal size ($M) in North America & Europe



Source: PitchBook

Top 5 healthcare deals of 2018

Acquired company	Date	Deal size ($M)	Industry
American Medical Response	March 14, 2018	$2,400	Other healthcare services
U.S. HealthWorks	February 1, 2018	$753	Clinics/outpatient services
Oklahoma University Medical Center	February 1, 2018	$750	Hospitals/Inpatient services
RxCrossroads	January 3, 2018	$735	Other healthcare services
The Medicines Company Infectious Disease Care Group	January 8, 2018	$270	Drug discovery

Source: PitchBook

Top 5 announced carveouts of 2018

Carved-out business	Announced date	Deal size ($M)	Industry
Innogy	March 11, 2018	$53,006	Energy production
Thomson Reuters (Financial and Risk business)	January 30, 2018	$17,000	Financial software
AccorInvest	February 27, 2018	$5,438	Hotels & resorts
Federal-Mogul Holdings	April 10, 2018	$5,400	Automotive
Westinghouse Electric Company	January 4, 2018	$4,800	Alternative energy equipment

Source: PitchBook

Analyst Insights

Sources of impact capital

By Joelle Sostheim

Impact investing has gained traction in recent years as calls to use finance to catalyze social and environmental change have spawned growing demand for sustainably managed assets. With a 2017 study by BNP Paribas suggesting that 20% of institutional investors intend to increase alternative allocations to ESG/impact assets, GPs stand to tap into new pools of capital set aside for impact funds. However, some LPs are hesitant to commit capital without sufficient data about impact funds or insights into other LPs that have committed to the strategy. This note serves as a deeper dive into LPs active in the impact investing space. By profiling different providers of impact capital, we hope to shed light on where funds are currently sourcing commitments and highlight opportunities that may arise in the future.

Development finance institutions

Development finance institution (DFI)[1] is a blanket term to describe varying types of financial institutions (e.g. investment banks, institutional investors, advisors and managers) with mandates to support economic development via investment and financial service provisions. Also referred to as economic development agencies or multilateral development banks, these institutions are owned and backed by one or more governments. DFIs have been established across developed and emerging markets and are structured to last in perpetuity. These institutions make direct debt and equity investments into companies as well as commitments to funds to achieve their development mandates. Because of their long-term financial positions and social and environmental development goals, DFIs are uniquely positioned to commit capital to impact funds. With commitments to over 100 impact funds since 2002, DFIs are among the greatest contributors of capital, per PitchBook data.

DFIs tend to target investments in emerging markets, as their support can catalyze and stimulate economic development in underserved regions. The International Finance Corporation, for instance, has a mandate to support the growth and development of private markets in emerging economies and has backed fund managers from over 35 emerging market countries. Additionally, a select few DFIs make investments in developed regions. The European Investment Fund, for example, seeks to spur entrepreneurship and innovation throughout Europe.

For DFIs, fund commitments are an efficient means to facilitate direct small- and medium-sized enterprise investments, as they can accelerate the capital deployment process and, if operated locally, ensure greater familiarity with a region's market and entrepreneurial ecosystem. Some have specific impact targets, like infrastructure development, or sustainable agriculture and energy, but others concentrate more on macro goals like job creation and economic development. Certain investment strategies are more conducive to specific impact targets. To support small-business development, DFIs will typically seek out early-stage investors; to support growth and scale for established businesses to enter new markets, DFIs look for growth equity funds.

The impact investing ecosystem is still nascent and filled with first-time managers who encounter challenges in fundraising due to a lack of track record or proof of strategy. DFIs are a crucial source of risk capital for these funds, as they are willing to provide catalytic funding to first-time fund managers and encourage impact via private investment.

While they have motivations beyond financial returns, DFIs are still prudent investors that take extensive measures to screen and perform due diligence on fund commitments. Raising capital from DFIs can be a long and strenuous process, as there are considerable bureaucracy and stringent requirements (such as ESG criteria) required for consideration. Funds who do secure DFI funding, then, also procure a signal of credibility, helping to attract further commitments from other LPs.

Foundations

This section is focused on private rather than public foundations. Many private foundations have endowments funded by one or more private sources. In the US, these entities are required to distribute at least 5% of their endowment's corpus annually to charitable purposes to maintain their exemption from income taxes. The remaining 95% may be invested for profit to maintain financial longevity, and net investment income is subject to an excise tax.[2] While private foundations can make concessionary impact investments from that 5% distribution, some foundations have started to tap the remaining 95% of their endowments to make for-profit allocations to impact funds. The Ford Foundation, for example, announced a plan to commit $1 billion of its $12 billion endowment to impact funds in 2017.

Whereas DFIs may accept more macro-level impact targets like job creation or economic development, foundations seek out strategies that adhere closely to their missions, such as access to education, gender equality or affordable housing. Accordingly, the process for fundraising from foundations can also be long-winded and bureaucratic, as investments need to be a strong program- or mission-related fit

1: DFIs in this report include multilateral, bilateral and regional finance institutions.

2: "Private Foundation Excise Taxes." Internal Revenue Service, August 2017.

Select program and mission-related investments

Foundation	AUM ($M)	Select foundation mission themes	Investment example
Bill & Melinda Gates Foundation	$40,413	Polio eradication, HIV treatment, agricultural development, access to financial services, gender equality, US education	CureVac – platform technology to reduce time and costs for developing vaccines against diseases that disproportionately impact developing countries
Ford Foundation	$12,106	Racial justice, equality in cities and geographic regions, climate change	Springboard Community Development Finance Institution – enhancing access to affordable credit in US states
MacArthur Foundation	$6,120	Climate change, criminal justice, economic development, education, affordable housing	Fund to Preserve Affordable Communities – protecting affordable housing for low income individuals across the US
Rockefeller Foundation	$4,107	Healthy communities, sustainable food, clean energy, equity in cities	REDD+ Acceleration Fund – targeting reduced emissions from deforestation in emerging economies
W.K. Kellogg Foundation	$353	Racial justice, children's health, economic equity, healthy communities	Northwest Louisiana Community Development Fund – financing real estate projects to revitalize low income communities

Source: PitchBook, foundation websites

to justify a commitment. The Ford Foundation, for instance, stipulates that it will allocate only to funds addressing affordable housing and financial inclusion. US foundations typically commit capital to impact investments through program-related investments (PRIs) and/or mission-related investments (MRIs).

Program-related investments

According to the IRS, PRIs are investments made by private foundations who's primary goal is to advance the programmatic goals of the organization, where capital appreciation or income production is "not a significant purpose." Though PRIs tend to receive concessionary returns, the IRS also dictates that "a potentially high rate of return does not automatically prevent an investment from qualifying as program-related."[3] PRIs are made from the 5% required distribution typically used for grants or donations and are thus exempt from taxes.

PRIs can be structured as direct debt or equity investments, or fund commitments. One advantage of making direct equity investments as opposed to grants is the long-term strategic relationship formed with the enterprise that foundations hope will deliver a greater scale of impact for their designated programmatic goals. However, given the current "easy money" venture funding environment, foundations can encounter challenges when competing with purely for-profit investors for investment opportunities.

Unless a startup strongly fits a foundation's mission at the onset, a foundation might request it makes operational adjustments to better align with the foundation's programmatic goals. Startups may not encounter the same requirements when fundraising from general venture funds.

With regard to fund commitments, investing in impact funds can make for an agreeable PRI should the fund meet a foundation's criteria. Impact funds are already explicitly committed to delivering and measuring the impact they create and often target thematic areas shared by many foundations, making for a well-aligned investment candidate.

Mission-related investments

MRIs, on the other hand, are made from the other 95% of a foundation's endowment that may be invested for profit, and thus target market-rate returns. Similar to PRIs, foundations can use MRIs to invest directly in companies or commit to funds. MRIs enable foundations to put a greater proportion of their financial assets toward impactful investments, but they are made with more prudent risk and return considerations characteristic of a traditional long-term financial strategy. Foundations must be cautious in making MRIs, as their success or failure will directly impact the financial longevity of a foundation. Additionally, if the investment is considered by the IRS to jeopardize the foundation's financial needs, a foundation can be subjected to a sizable penalty tax.

Unlike the smaller base of capital available from PRIs, tapping the larger for-profit portion of foundation endowments via MRIs can be a significant source of capital for impact funds.

HNWIs & family offices

More than 90% of HNWIs globally, particularly those under 40, believe that driving social impact is important.[4] Many philanthropically motivated, wealthy investors choose to act on this conviction through their investment choices, and asset managers have increasingly adopted impact asset offerings to serve this demand. A 2017 family office survey reports that 28.3% of family offices utilized impact investing as a strategy, and 40% of surveyed investors expect to increase commitments to impact and ESG investments in 2018.[5] Similar to those made by foundations, these commitments tend to be thematic, allocated according to the desired impact theme of the capital provider.

Unlike both foundations and DFIs, LPs in this category can allocate capital to funds on a faster timeline, as they have fewer bureaucratic limitations; it should be noted the relative base of capital may not be as large as other sources. However, HNWIs can be secretive about their investment preferences (typically to maintain privacy about their actions) and thus are difficult to access from a fundraising standpoint. Additionally, because family offices do not share the same non-financial motivations as DFIs, they may be less inclined to place bets on sometimes riskier first-time managers. However, the smaller check sizes most family offices or HNWIs target might make them ideal prospects for emerging managers raising smaller funds.

Pension funds & insurance companies

Pension funds and insurance companies constitute the primary institutional base of for-profit LPs that commit to impact funds. Participation in impact investing by these institutional investors has been a product of two factors: demand by their plan holders and the larger movement toward ESG investing by European LPs. Switzerland-based Zurich Insurance Group, for instance, announced in 2017 it would expand its target allocation to impact investing to $5 billion in the coming years, aiming to obtain market-rate returns while still "doing something good."

These entities exclusively target market-rate impact fund investments because, as part of their fiduciary duty, they are legally held accountable by measures such as the Employee Retirement Income Security Act (ERISA) in the United States. ERISA requires fiduciaries to prioritize financial obligations to plan participants, which has brought into question whether impact or ESG assets are an appropriate allocation if they prioritize non-economic factors.

However, in 2015 the US Department of Labor posted an interpretive bulletin clarifying that it "does not believe ERISA prohibits a fiduciary from addressing ETIs [economically targeted investments] or incorporating ESG factors in investment policy statements or integrating ESG-related tools."

The bulletin adds that if impact and ESG criteria are appropriate components of financial analysis and contribute to an asset's value, an investment may be made "without regard to any collateral benefits the investment may also promote." This clarification has aided pensions in justifying allocations to impact assets, allowing them to join the ranks of social minded European institutional investors that consider ESG criteria to be both a risk mitigant and value-add. Accordingly, for-profit LPs allocate to impact funds as they would to regular private investment funds, where GPs will only be considered if their approach meets the institution's financial goals and strategic allocations.

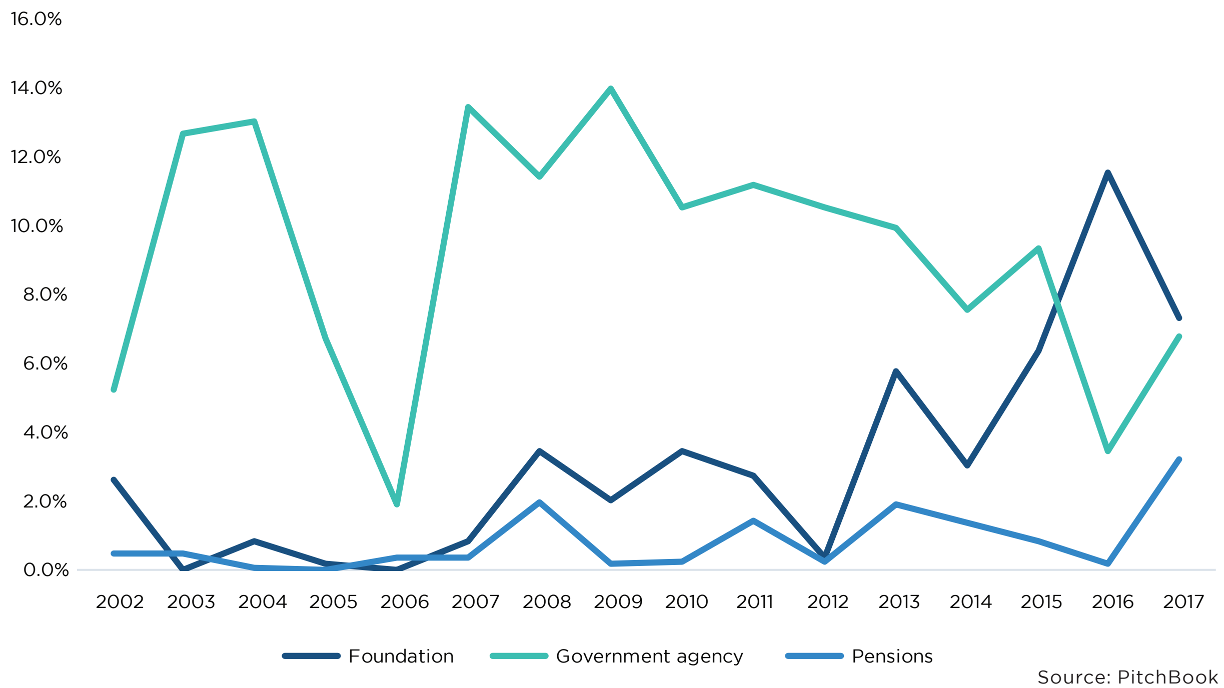
Because pension funds and insurance companies are generally larger than foundations or family offices, smaller impact funds have weaker chances of raising funds from such entities, as their required check sizes would be too small to be a reasonable allocation. Even so, pension funds and insurance companies have the potential to catalyze impact funding should they find a sufficient pipeline of investable funds. The risk considerations for these investors are significant, however, as they cannot compromise their financial obligations by committing to unproven managers.

3: "Program-Related Investments." IRS, September 2017.

4: World Wealth Report 2014, Capgemini and RBC Wealth Management

5: Global Family Office Report 2017, UBS

Commitments (#) to impact funds as a percentage of all PE & VC commitments



Source: PitchBook

Analysis

DFIs as a group have maintained a steady and robust allocation to impact funds over time. This is likely a product of their mandates to encourage private investment. Of all LP types, DFIs also show the strongest aggregate commitment to impact funds, with almost 9% of all commitments to PE and VC funds being impact funds. Even dating back to 2004, over 10% of all PE and VC fund commitments made by DFIs were to impact funds.

This data point suggests this type of institution has been an active participant and financial driver of impact investing for an extended period. PitchBook data suggests that foundations were not active contributors of impact capital before the financial crisis, but their activity in the space has multiplied in recent years. Though the proportion of all commitments made to impact funds by foundations sat below 4% 10 years ago, activity has trended strongly upward in the last five years, with commitments at around 11% as of 2016. Large commitments and capacity-building efforts from leaders in the space, like the Bill & Melinda Gates Foundation and the Ford Foundation, have paved the way for other nonprofit organizations to explore implementing impact investing in their portfolios. Additionally, an increase of offerings by mainstream fund managers may have served to provide less risky products to which foundations can justify making commitments.

Finally, the portion of commitments by pension funds has been low for the last 15 years, remaining near or under 2%. Of all LP types, pensions show one of the lowest values when it comes to percentage of total allocations that are made to impact funds. This is likely a reflection of pension fund managers' explicit fiduciary duty, particularly with many schemes facing underfunding issues. With concerns about fund manager experience and profitable investment opportunities, this class of LPs may be waiting until impact funds can provide evidence their strategies can deliver sufficient returns.

New horizons for PE

By James Gelfer

While Ares and KKR have both taken the plunge of converting from a partnership to a C-Corp, other firms are adopting a wait-and-see approach to gauge whether the move is actually worth it. The common hypothesis is that with a C-Corp conversion PE firms could become eligible for inclusion in indices and therefore gain exposure to new investors by being included in retail products, potentially leading to higher valuations; however, this has yet to be proven. Additionally, to be successful, it's likely that firms must resemble Ares and KKR in that they have a relatively higher proportion of management fees compared to performance fees. Apollo is the firm that most closely matches the profile, but CEO Leon Black has recently downplayed the possibility, unimpressed with Ares' stock performance following its conversion. Until the hypothesis is proven, it could be awhile until we see another firm become a C-Corp conversion.

Newly enacted US tax legislation has seemingly provided a long-awaited catalyst for the first major publicly traded alternative asset manager to transition from a partnership to a C-Corp. The prospect of publicly traded PE firms converting from partnerships to corporate structures has been discussed for some time, with the tactic viewed as a solution to the common belief that PE firms' shares are perpetually undervalued.

Firms have been locked in a proverbial game of chicken, however, with no one daring to act first. The quotable Leon Black, CEO of Apollo, has gone as far as to describe the current situation as "classic game theory." The topic began to pick up steam throughout 2017, though. One sign that the tide was turning came when the activist hedge fund ValueAct Capital Partners took a stake in KKR. While not explicitly advocating for KKR to adopt a C-Corp structure, ValueAct did present the idea as an option to boost KKR's share price.

In February, Ares became the first firm to blink and officially announce its conversion to a C-Corp. On its recent earnings call, Ares COO and CFO Michael McFerran succinctly summed up the rationale for the switch: "We believe [this] will simplify our structure, broaden our potential investor base, improve our liquidity and trading volume, and provide a more attractive currency for strategic acquisitions."

Now that Ares has played its hand, the question is, Who will be next to follow suit?

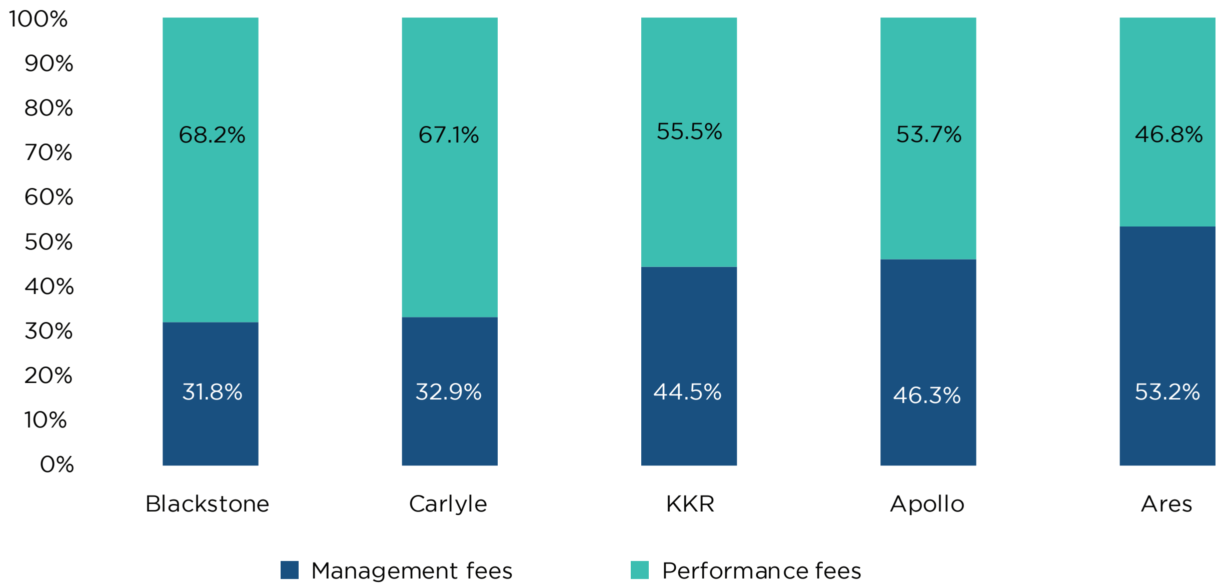
Not all firms are created equal

Several variables need to be considered prior to converting, as some firms are better suited for the corporate structure. When organized as partnerships, as is the case with most public PE firms, companies can funnel performance-related income (e.g. carried interest) directly to shareholders, where it is taxed as capital gains. Under the corporate structure, however, that performance income first will be taxed at the corporate rate. As such, how the firm generates revenue is perhaps the most important consideration.

The business mix of Ares, for example, lends itself particularly well to the C-Corp model. Ares' relatively low proportion of income from performance fees is one reason why it was the first to make the switch. According to the firm, management fee revenue has averaged 80% of total fee income since it went public. In Ares' case, the heavy skew toward management fees comes almost entirely from the firm's credit business, which is relatively large in relation to other firms, with the firm delivering fee-related earnings that were roughly 8x performance-related earnings. As part of the move, Ares is aligning its equity shares more with its core business and will "begin paying a steady, quarterly dividend for each calendar year based on the growth in our after-tax core fee-related earnings," McFerran said, adding that "this dividend policy should reduce the historical volatility of our distributions." While Ares is reserving the right to declare special dividends, the firm "intends to retain performance fee earnings to fund future growth and for potential share repurchases." This means that investors will receive a lower dividend than they could potentially, but that capital will be reinvested without incurring the individual tax rate, mitigating some of the downside of the new structure.

Reducing the volatility of distributions makes sense for Ares, but what about firms that have revenue more skewed toward traditional closed-end funds? In these instances, the firm's performance relies more heavily on performance fees, which translates to more volatility in returns and makes a steady dividend more difficult to achieve. The Carlyle Group provides a good case in point: While the firm generates significantly less revenue than most of its peers, it historically earns roughly 10 percentage points more of its income via performance fees. As such, switching to a C-Corp structure would be particularly costly when returning capital to shareholders. Because of this reality, we think converting to a corporate structure is likely untenable for firms like Carlyle and Blackstone, which rely heavily on performance fees.

Fee breakdown (FY 2017)



Source: PitchBook, company filings

Value in the eye of the shareholder

But dividends are only one component to consider. Alleged misvaluation of its shares has been a persistent gripe among public PE firms, with one explanation being that the partnership structure makes PE firms ineligible for many institutional investors and investment products. So perhaps the biggest motivating factor for switching from a partnership to a corporation is that it could lead to higher valuations by opening the door to previously untapped investor bases, particularly in the realm of passive investments.

The methodology of many index creators explicitly excludes partnerships, meaning that shares of public PE firms often don't find their way into index-based retail products. By simply changing their structure, PE firms could facilitate the inclusion of their shares into products like ETFs and defined contribution plan offerings, as well as other passive instruments increasingly used by even the most sophisticated investors.

However, simply changing the corporate structure may not be enough to attract new investors. To that end, another investor relations issue for PE firms is the outsized control of many founders and insiders; Blackstone's common shares, for example, have no voting rights. Unless PE firms are willing to cede some of this power, they could continue to be excluded from certain designations (like some tech companies with dual-class shares).

When discussing the decision-making process behind its potential change, KKR has claimed that its "institutional ownership is lower than most traditional corporations," implying that this is weighing on the share price. Even when an institution is not explicitly restricted from investing in partnerships, many choose to avoid them due to the additional tax and legal costs associated with preparing Schedule K-1s (the unique tax docs used by partnerships).

To be sure, for firms that do make the switch, the decision will be predicated on the belief that it will be accretive for shareholders. KKR CFO Williams J. Janetschek estimated that the firm's after-tax ENI in 2017 would have been 17% lower if it were restructured as a corporation, with other firms reporting similar analyses. As for the implications on share prices, KKR would need "to see approximately two turns of multiple expansion, all else being equal, for a breakeven stock price." Some think that may be doable—a recent report by Morgan Stanley asserted that converting to a C-Corp could propel share prices as much as 26% higher.

But other analysts assert that a portion of the upside of the corporate structure may already be baked into the share prices of some public PE firms. Prior to its formal announcement, Ares was long-rumored to be the lead contender to make the switch. And while the stock saw a pop of 8% following the news, the gains were smaller than previously predicted and shares traded down in subsequent days. Rival firms undoubtedly will be looking at price movements over the next several quarters to judge the efficacy of the move.

Even corporate PE firms have partners

Analysts covering public PE firms naturally default to the shareholders' point of view, but these firms have fiduciary duties to a host of other investors too. To that end, one constituency that is overlooked in this debate is limited partners—the investors who commit capital to private market funds and without whom this industry would cease to exist. The most straightforward concern is that all of this is a distraction. With seemingly every public PE firm being explicit about the time and resources being poured into analyzing the decision to convert to a C-Corp, we think public PE firms run the risk of shifting their focus from their core business (i.e. managing investment funds) toward managing their public company personas.

Alignment of interests is also a potential issue. Before committing to a PE fund, LPs want to ensure the general partners have "skin in the game" and generate the bulk of their remuneration through performance fees. All else being equal, the fact that a firm relies more heavily on performance fees is a positive from the LP perspective, indicating a tight alignment of interests with the GP; however, this mix of income is a headwind for firms that might adopt a corporate structure. Particularly with the recent consolidation happening in the industry, LPs have been leery of so-called "asset gatherers," which are GPs that may unduly expand their strategy offering to bolster management fees.

Second-mover advantage?

In this context, should LPs be skeptical of PE firms that shift to a corporate structure? Are PE firms prioritizing stock price and management fees over performance-related income and the taxability of earnings? Seth Bernstein, CEO and president of AllianceBernstein, has shot down the C-corp structure for that very reason: "I'd rather have our unitholders paying the lowest level of taxes at the greatest defensible position that we can." But the C-Corp structure is not one-size-fits-all, and no one yet understands the full long-term effects the change will have. Recent changes to the US tax code—namely the slashing of the corporate rate from 35% to 21%—have lessened some of this impact. Still, the consequences of shedding the partnership structure will be real.

Ares will certainly provide a helpful data point for others considering the move. KKR is widely assumed to be the next to make the leap, with Credit Suisse positing the move as a foregone conclusion in a recent research piece. Apollo is another likely candidate given its reliance on management fees. But with the decision to convert to a C-Corp being irreversible, as the tax costs and structural complexity are prohibitive, we expect to see most firms adopt a wait-and-see approach to see how the first mover fairs.

A SPOT of secondary activity

By Cameron Stanfill

Direct listing success:

As expected, shares experienced low volatility while closing share price comes in 13% above last private trade.

Spotify's public debut wasn't without its hiccups; however, based on early indications, we would count the company's direct listing experiment as a success. The initial premium of $10 billion over Spotify's most recent private valuation was much greater than we expected, and while shares traded down steadily from the highs of the day, existing shareholders who didn't sell are still sitting on significant gains from where shares were trading in the private markets just a few weeks ago.

One of the most common worries with the Spotify direct listing revolved around the volatility of initial trading without formal underwriting support. Interestingly, the ~$20 intraday price fluctuation—which calculates to 12% variation from the initial price of $165.90—is fairly low volatility for the first day of trading for a technology IPO.

Spotify made an effort to smooth the transition to public markets by promoting increased volume in the private secondary market over the last few quarters. The ability for existing shareholders to achieve liquidity before the direct listing may have caused more subdued volume than a traditional IPO, and a less volatile public debut was a welcome effect. After the delayed start due to the price discovery process, it took over two hours to trade 10% of the total shares outstanding with less than 17% changing hands as of market close (compared to long-term average first-day turnover of 42%). With no lock-up period, it seems many existing shareholders may be biding their time before making any final decisions.

Analysis

While the direct listing is a decision to list on a public exchange, Spotify's choice is really an early litmus test of the maturity of private secondary markets. So, while much of the focus will be on Spotify's post-listing price activity, we see an equally interesting and overlooked scene currently taking place in the private secondary markets.

Over the last few quarters, Spotify waived its right of first refusal on company share sales to promote increased secondary volume in the private markets. From the beginning of 4Q 2017 to March 9, 2018, 13,403,720 shares have changed hands, with prices varying 170%. While this price action in less than two quarters may be concerning to some investors, we think these trades serve as a form of price discovery and may help to contain some of the expected volatility of the direct listing.

Additionally, we believe the secondary sales are providing the company and its advisors vital information about investor sentiment, in addition to providing a more robust market valuation. In essence, the secondary transactions provide a sneak peek of the demand for Spotify shares from potential new investors and a more real-time gauge of the valuation investors are willing to accept. Because of the enlarged role the secondary market is playing in this scenario, the success of this direct listing could now provide a boon for the overall trading volume of venture shares in the direct secondary market. If the valuations implied by the private sales turn out to give an accurate prediction of the initial public pricing and more companies are persuaded to pursue a direct listing, direct secondaries pre-listing should become more common.

IPO advisory investment banks are one segment of the financial services industry that may be most impacted by direct listings. Spotify has shirked the need for the full-service IPO package and opted for an à-la-carte approach to pay solely for what they need. While the three advisors on the Spotify deal are still receiving a fee, it is almost assuredly less than a traditional IPO percentage fee—and a much smaller syndicate of banks are benefiting from the deal.

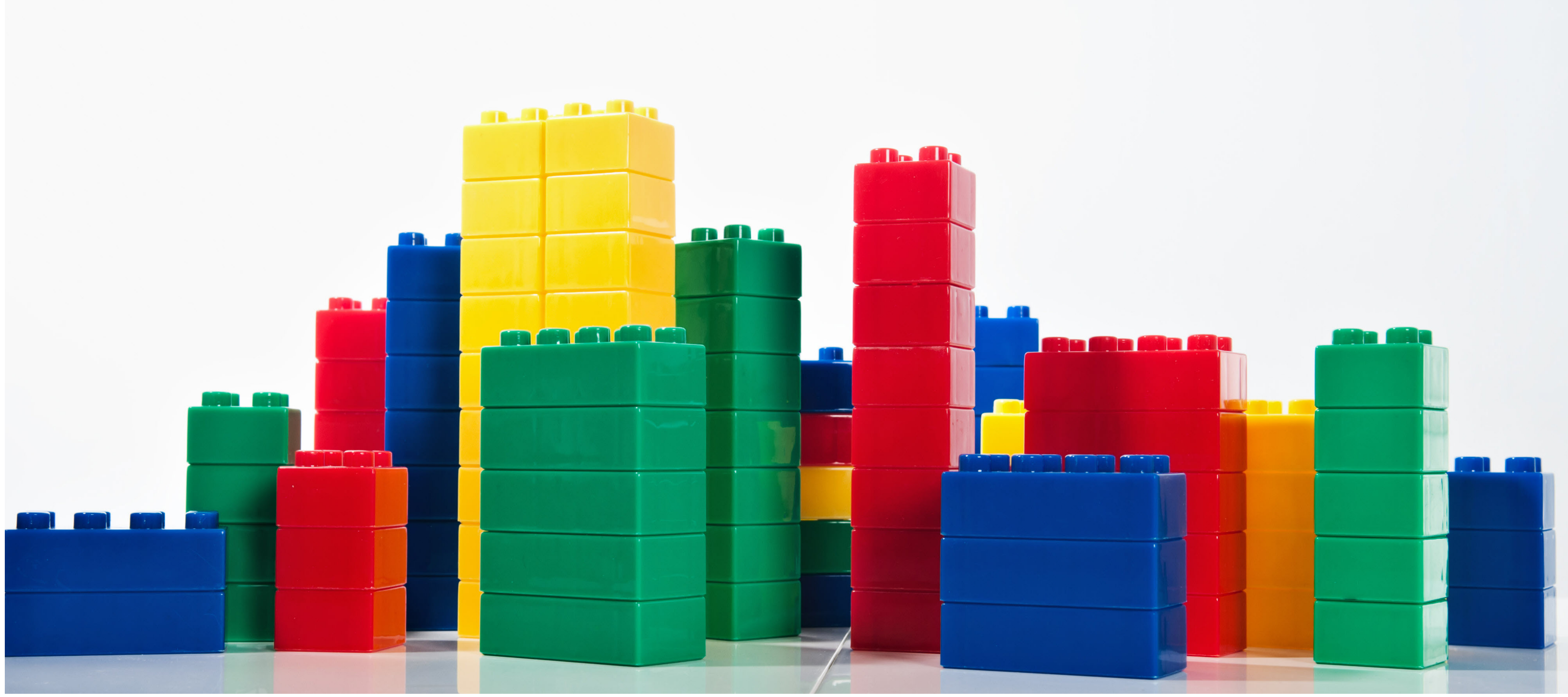
This really becomes a factor only if Spotify is successful in proving that private market secondary activity, in addition to the public reputation and excitement large private firms can garner without a traditional roadshow, is enough to transition to the public market. Nonetheless, the potential of this transaction to cause substantial shifts in bargaining power between companies and banks is a highly intriguing side effect.

Lastly, it is important to consider valuations—an increasingly important topic in venture capital as they have extended to decade-high levels. Using information from the F-1, we've estimated Spotify's market capitalization will fall between $17 billion and $23 billion. We came to this conclusion based on the range of share prices of Spotify's private sales and calculating the company's fully diluted shares using the treasury stock method for the options and warrants (see summary table below for detail). The company also uses a probability-weighted expected return method to calculate a fair value for the business based on five scenarios. As of December 2017, this method valued the company at $120.50 per share, which falls near the top of our estimated valuation range. With our estimated range, some uncertainty lingers around whether Spotify's initial market capitalization will exceed its most recent private valuation of $19 billion. Pricing above the company's latest private valuation has become an even more important achievement as some sky-high VC valuations have been slashed by leery public market investors.

In theory, any investor in Spotify will be able to sell as many shares as they choose at the publicly determined valuation, another departure from the classic IPO structure where many large investors and employees agree to lock-up periods or to not sell directly into the IPO. From this standpoint, the direct listing should prove a truer liquidity event than a traditional IPO for current Spotify shareholders, given enough outside demand.

Additive dealmaking

By James Gelfer



As PE investors have come to terms with the stark reality that the use of leverage, financial engineering and multiple expansion are no longer adequate to deliver strong returns, they have become more willing to pursue value creation initiatives that are more capital- and labor-intensive—and that take longer to bear fruit. Perhaps the most tangible example of this willingness is the explosive growth in add-ons, which now account for roughly half of all buyouts globally and more than two-thirds in the US.

Add-ons have been a fundamental component of the PE playbook for some time, but over the last decade the "buy-and-build" strategy has morphed from a common tactic into a cornerstone of PE value creation. Less than 20% of PE-backed companies acquired in the early 2000s undertook an add-on deal, but that rose sharply to nearly 30% for platforms acquired in the mid- to late 2000s. More recently, however, the percentage of platform companies undertaking add-ons has stabilized while overall add-on activity has continued to climb.

Buy, build, repeat

Interestingly, both the median and average number of add-ons per platform company haven't changed very much. As such, while add-ons have grown more pervasive, a relatively small number of the most prolific buy-and-build investors have increasingly driven activity.

The accompanying charts show add-on activity by year, categorized by the order in which the add-on was acquired by the platform (i.e. the first add-on is "1," the second add-on is "2," etc.). Roughly one-quarter of the add-on deals completed since 2014 were at least the fifth deal in the platform's buy-and-build strategy. Conversely, only about one-third of the add-ons executed in recent years have been the first acquisition for the platform, compared to more than half in the early 2000s. As such, it has been a relatively concentrated group of platform companies that have been the driving force behind the rise in add-ons; more than 10% of add-ons are at least the 10th add-on for the respective platform.

This development is particularly evident in the financial services sector, especially insurance. Hub International—an insurance brokerage now under its second regime of PE ownership—has completed more than 200 add-ons and shows no sign of stopping, with 10 deals closed YTD through the first week of April. It's a similar story for many other PE-backed companies in the space, including Assured Partners, USI Insurance Services and Confie Seguros.

Buy-and-build is used differently depending on the sector, but the strategy naturally tends to be most prevalent in areas of the market that are highly fragmented. Healthcare—a sector in which add-ons have represented more than half of buyout activity every year since 2011—is a prime example, particularly when it comes to patient care. A popular strategy has been for PE firms to roll up dozens of small, regional diagnostic centers and specialty care facilities, allowing them to achieve scale and expand their geographic footprint. Some notable examples include Advanced Dermatology & Cosmetic Surgery, Aurora Diagnostics and Team Olivia. The targets for these add-ons often have fewer than a dozen employees, making them unsuitable for platform deals and leading to less competition for the acquirer.

Construction delays

Many PE textbooks claim that PE-backed companies are held for three to five years, but that has become the exception rather than the rule. Add-ons are one factor contributing to the extended timelines; the median time between platform and add-on spiked to nearly three years in the wake of the financial crisis, although there has been some mean reversion.

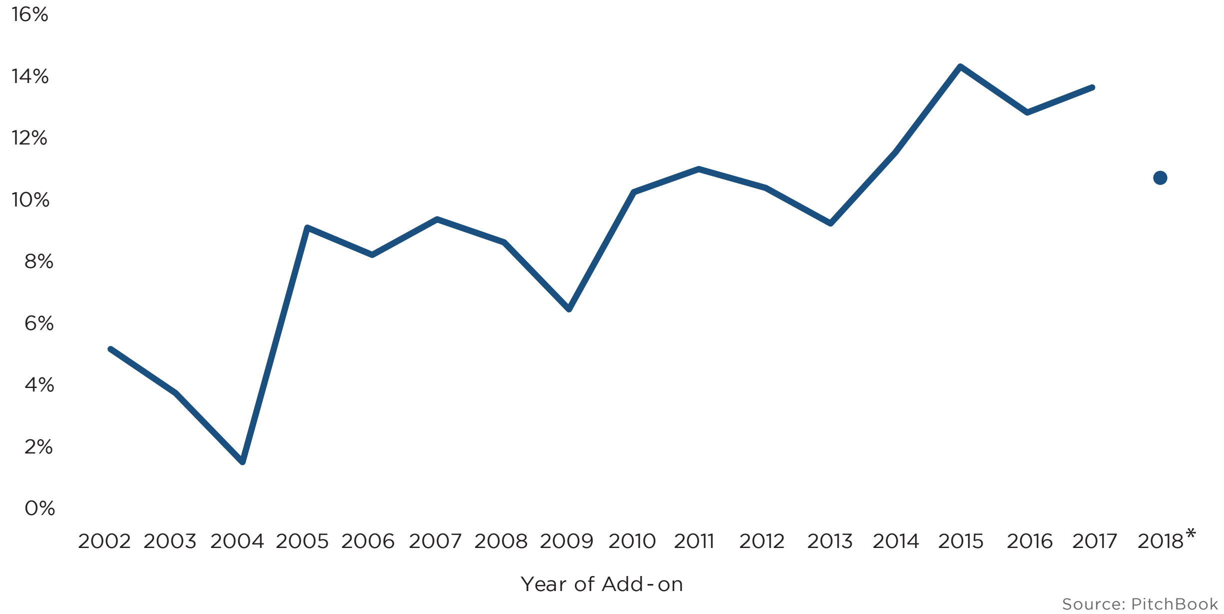
One reason add-ons boomed during this period was that platform companies were facing macroeconomic headwinds and performance issues, making it difficult to spur organic growth. We posit that add-ons executed later into the platform company's hold period were used as a means of boosting revenue in a struggling post-crisis environment, while averaging down the acquisition multiple (as purchase-price multiples were at record levels in the run-up to the crisis).

To that end, platforms acquired in 2006 and 2007 have the highest level of add-ons acquired more than five years after the initial platform, on both an absolute and relative basis. The proportion of add-ons executed more than five years after the initial platform acquisition is naturally lower in more recently; however, given the prevailing trends, we expect to see a substantial uptick in the coming years.

The sum of the parts

Enhancing operations at a single portfolio company is difficult, and combining multiple businesses only complicates the matter. Inking the deal is just the

Global % of add-ons (#) that were at least the 10th add-on for the platform



Source: PitchBook
*As of March 31, 2018

beginning of the process—once the transaction is finalized, work must be done to integrate the companies and realize the benefits for the merger. Historically, it has taken about one year longer to exit a PE-backed company with add-ons compared with one that does not, though that margin has shrunk in recent years. Predictably, the average hold time lengthens as a platform company's number of add-ons increases.

With buy-and-build strategies becoming more prevalent and longer hold times now the norm, how should limited partners (LPs) respond? We think that the PE industry in general will benefit from general partners (GPs) spending more time and resources on operational improvements, but LPs need to be cognizant that this shift will impact fund timelines. For their part, many GPs are launching funds with extended lives and adopting a "Buffett-like" approach to long-term value creation. Many LPs, particularly endowments and sovereign wealth funds that have indefinite investment horizons, are warming to this idea and are now locking up capital with coveted managers for two decades or more.

But for other LPs, extended fund timelines remain a concern. When committing to closed-end PE funds, it's important to have a deep understanding of how the GP plans to drive performance. If add-ons are a key component in that strategy—as is increasingly the case—the GP should contemplate potential targets as they conduct due diligence on platform companies. Not only will this help to streamline the buy-and-build process, it may also allow the GP to formulate a more competitive bid for the platform company.