

US PE Breakdown

1Q 2019

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Introduction

After 2018's blistering pace of dealmaking, 2019 has gotten off to a sluggish start. Poor performance in leveraged loan and high-yield markets during 4Q 2018 had an adverse impact on the cost of deal financing, causing many GPs to hold off on finalizing deals. These deals often take months to close, and difficulty securing financing is often evident in lower deal flow the following quarter. The deals that did close, however, were at elevated multiples similar to what we have witnessed in recent years. Pricing ought to remain competitive because GPs have record dry powder waiting to be invested, pressuring PE firms to act.

Exits experienced an even greater downturn than deals. Public equity price decreases in 4Q 2018 likely led to GPs marking down portfolio companies, though to a lesser extent than seen in public indices. GPs instead held portfolio companies and awaited a friendlier selling environment. 1Q 2019 saw just one PE-backed IPO as GPs instead opted to sell portfolio companies to other financial sponsors or strategic acquirers, continuing recent trends.

Market tranquility was sustained throughout the end of the quarter, so we expect the 1Q lull in exit activity to be short-lived.

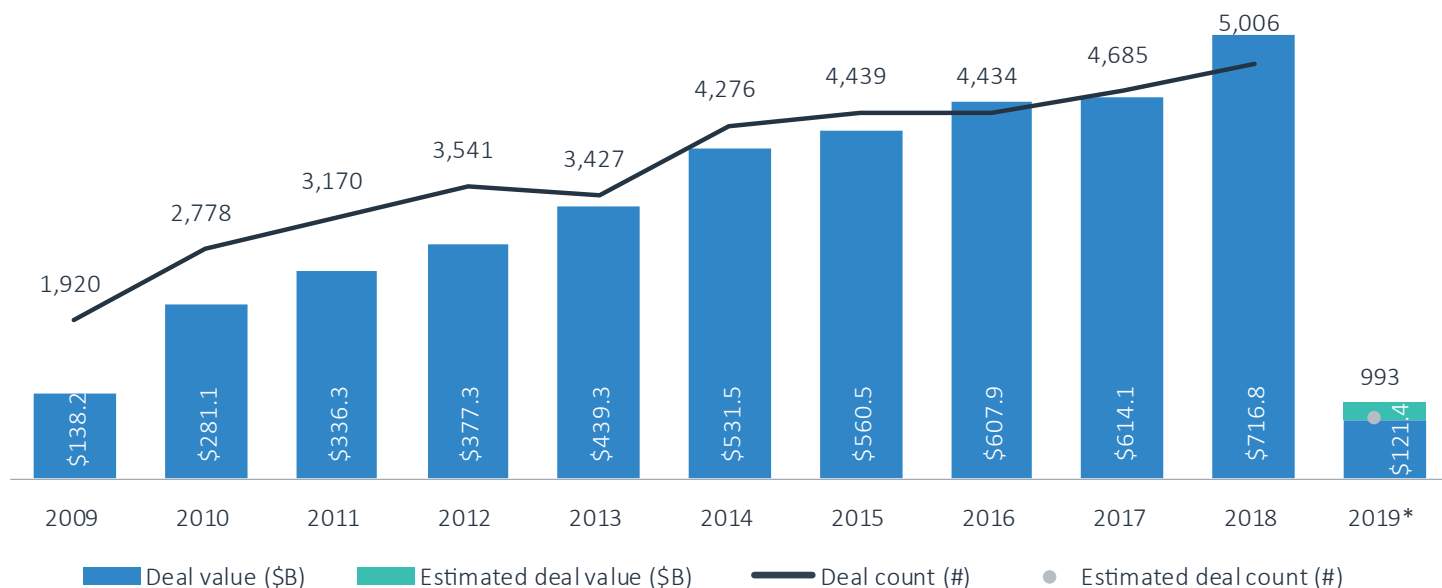
Fundraising—unlike deals and exits—is on pace to match 2018's annual total with over \$40 billion raised in the first quarter. Fewer but larger funds are closing, pushing median and average fund sizes even higher. Strategies beyond the vanilla buyout continue to proliferate, with technology-focused and growth equity funds witnessing massive closes. The recent figures also speak to a longer-term change whereby GPs headquartered in the Bay Area and Chicago accounting for a swelling portion of capital raised.



Wylie Fernyhough
Analyst, PE

Overview

US PE deal activity



Source: PitchBook
*As of March 31, 2019

US PE deal activity is off to a slow start through 1Q 2019, with reported figures falling well below those of any quarter in 2018. Through the first three months of the year, GPs closed on 993 deals totaling \$121.4 billion—declines of 27.9% and 26.7% from 1Q 2018, respectively. Markets—including leveraged loan and public equities—returned to stability in 1Q. However, as deals typically take 12-16 weeks to close, many of the deals that closed were being negotiated in the last quarter of 2018 when those markets were much more volatile. This is likely a reason for the decline in exit activity, because this volatile time caused many GPs to hold onto investments and ride out the negative valuation pressures until the pricing landscape is more advantageous and deal financing costs are more reasonable. Crag Larson, head of IR for KKR, echoed this strategy in the firm’s 4Q conference call: “The beauty of our model is that we get to time our entries and exits. We’re not forced sellers during these periods.” As such, it is likely that following quarters will experience higher levels of deal and exit activity. Even though deal flow was down, the quarter saw the continuation of several key trends we have discussed in recent quarters.

The largest deal to close in the quarter was the \$6.9 billion take-private of Dun & Bradstreet, a data and risk management company. The acquiring consortium, including CC Capital and Thomas H. Lee Partners, involved

Black Knight Holdings (a public company that offers complementary services), which invested \$375 million alongside the PE firms. Interestingly, Anthony Jabbour, the CEO of Black Knight, became the CEO of Dun & Bradstreet, leading both entities. Another notable deal was the \$5.2 billion leveraged buyout (LBO) of Sears Holdings by ESL Investments, a hedge fund that had previously invested in Sears. The retail giant filed for bankruptcy after being led by the head of ESL, Eddie Lampert, for several years.

Despite a volatile pricing environment and a steep slide in energy prices during the fourth quarter of 2018, energy deal activity held steadfast. The largest and most significant deal to close in the sector was Blackstone’s acquisition of Tallgrass Energy’s GP (Tallgrass is structured as an MLP) for \$3.2 billion. Interestingly, the consortium will also purchase approximately 44% of the economic interest in Tallgrass Energy.¹ One reason this deal was so monumental is that it was one of the first announced deals to come from Blackstone’s infrastructure fund. The behemoth—which is targeting \$40 billion and received a contribution from Saudi Arabia’s Public Investment Fund that could total \$20 billion—has had a difficult time raising capital. Looking at energy investing more broadly, the sector saw \$8.1 billion invested across 25 deals. This accounted for 8.4% of PE deal flow, below where the sector has performed in recent years.

1: Master limited partnerships (MLPs) are divided into two entities, the GP and the LP.

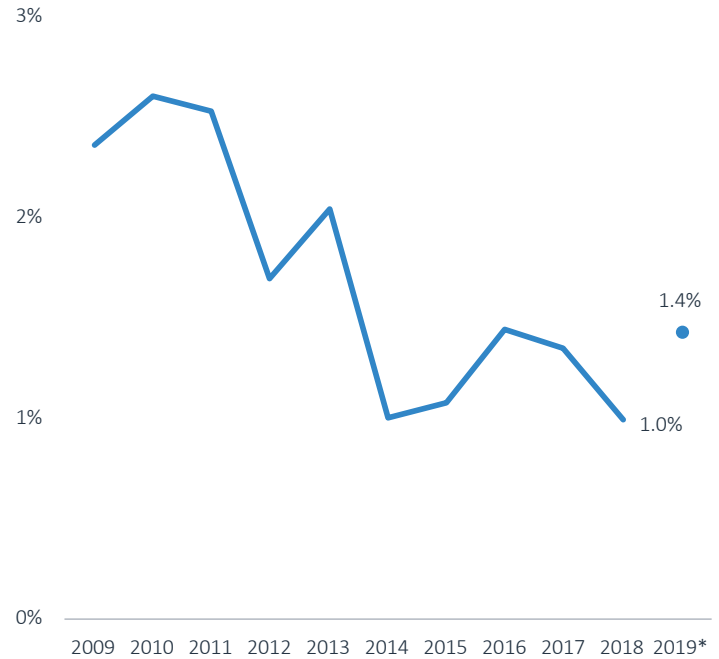
Overview

The past decade has seen relatively flat take-private activity, but an increase in take-privates in 1Q 2019 appears to have snapped the trendline. There are several reasons beyond pricing for this upswing in [take-privates](#). One is that mega-funds (\$5 billion+) have become a regular part of the fundraising environment; these massive funds tend to hunt for big game, often taking aim at public companies, and EV/EBITDA multiples in public markets have nearly traded at parity with private markets in recent years. Additionally, downward volatility in the public equity markets during the last quarter of 2018 made take-privates more attractively priced.

The three deals mentioned earlier—Dun & Bradstreet, Sears Holdings and Tallgrass Energy Partners—were take-privates. Those were also the three largest deals to close in the quarter. In fact, the six largest deals to close in 1Q 2019 were take-privates. These buyouts oftentimes exceed \$1 billion but have been accounting for a reduced portion of deals in recent years as GPs have moved toward smaller, add-on transactions to build portfolio companies through acquisitions. Take-privates comprised 1.4% of all US PE deals in 1Q 2019. While this figure still sits below the levels achieved over a decade ago, a sustained increase in take-private activity throughout 2019 looks likely.

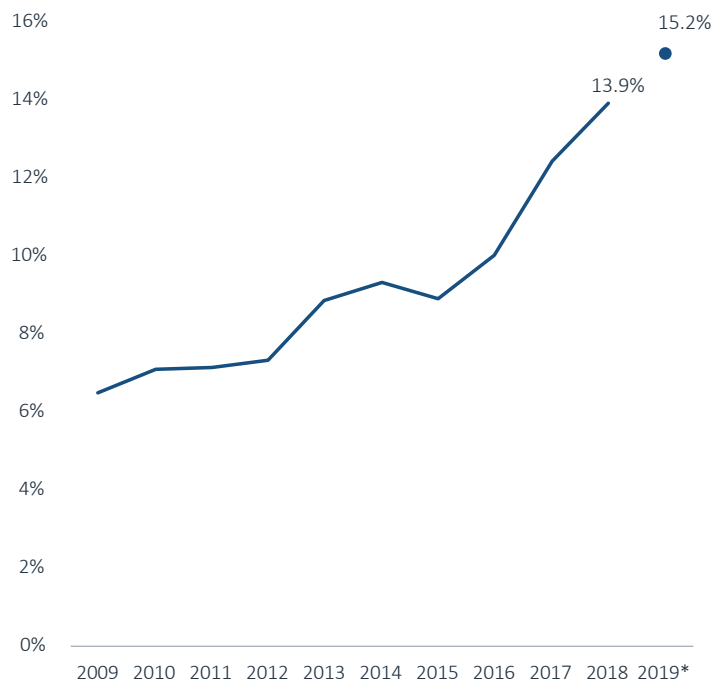
Software—which has proliferated throughout PE dealmaking in recent years and was highlighted in our [PE outlooks from 2018](#)—saw multiple billion-dollar-plus take-privates close during the quarter. The elevated rates of organic revenue growth, sticky products—especially those using the SaaS model—and capital-light structure are highly sought-after business traits by PE firms. During the quarter, 15.2% of deals were sourced from software, and 20.6% were sourced from IT more broadly. The \$11.0 billion LBO of Ultimate Software Group, one of the largest announced deals during the quarter, shows that GPs are willing to take big risks on technology buyouts. The consortium investing in the deal includes several high-profile investors, including Hellman & Friedman, Blackstone, and CPP Investment Board. Further contributing to overall software deal activity figures were two of the most prolific investors in the US PE technology space, Vista Equity Partners and Thoma Bravo, each of which closed multiple deals in the quarter. Vista closed on its \$1.9 billion LBO of Apttio as well as its \$1.9 billion LBO of Mindbody—both deals were take-privates. Thoma Brovo, meanwhile, closed on a \$950 million LBO of Veracode. The cybersecurity company was divested from CA Technologies as it was being purchased by Broadcom. This flood of technology buyouts is something we believe will have a lasting impact on PE dealmaking.

Proportion of US PE buyouts targeting public companies (#)



Source: PitchBook
*As of March 31, 2019

Proportion of US PE deals targeting software companies (#)



Source: PitchBook
*As of March 31, 2019

Overview

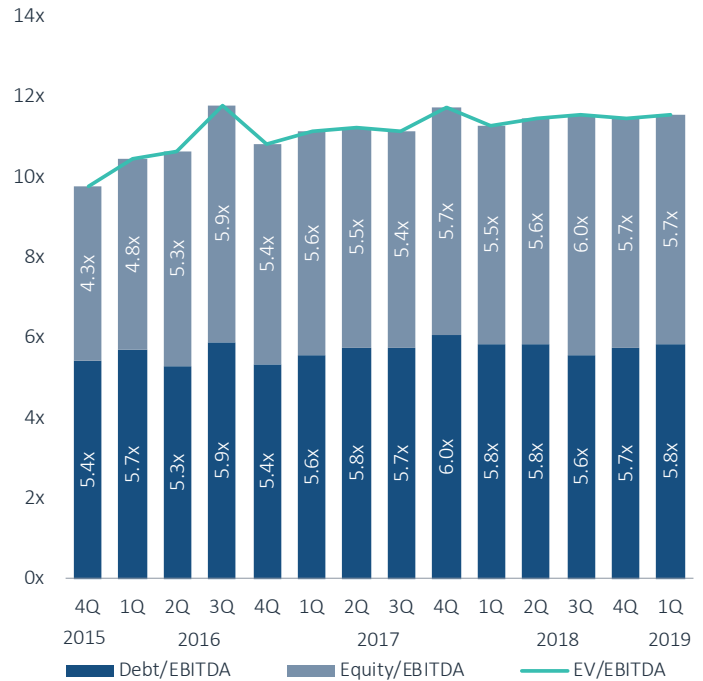
Deal pricing remains elevated, though there has not been much movement over the past couple of years. These lofty levels are in part due to the hundreds of billions of dollars in dry powder for buyout funds and to private debt funds seeking deals. Some industry experts are calling attention to the elevated debt levels. “Private equity groups are taking on too much debt in the competition to win deals,” according to Jonathan Lavine, co-managing partner at Bain Capital.² It is also due to the changing composition of deals as PE firms pursue higher growth sectors like technology. In a recent example from 1Q, CVC took ConvergeOne—a data storage and networking company—private, paying \$1.8 billion at an EV/EBITDA multiple of 12.5x. This **take-private** also exemplifies converging multiples between public and private markets, because even with a premium paid, the figure is just one turn above the median PE buyout multiple. That said, we present a median, and many deals in the industrial sector happen at high single-digit multiples while multiples for tech deals may be higher multiples.

Partially due to the current high-multiple environment, the buy-and-build strategy continues to proliferate because the strategy allows the buyer to average down the blended multiple. 1Q 2019 saw add-ons account for 71.0% of deals. While this is a record proportion, the year is just beginning. Overall, the approach has become so commonplace, it is now the sole strategy for some firms, such as Audax Group. Certain industries are more conducive to the add-on strategy than others. Healthcare—for reasons including fragmented sub-industries and technological changes—has been a prime sector for the strategy. In 1Q 2019, add-ons represented 72.6% of all deals in the sector. Patient services, physical therapy and elderly care facilities are just a few of myriad sectors where consolidation offers financial gains to the player(s) that can scale quickly. A recent example of this is TrialCard, a patient support services company acquired by Audax Group for \$400.0 million in 2017, which completed an add-on of RxSolutions in 1Q 2019.

Another sector rife with add-ons is financial services, where insurance brokerage firms represent an outsized portion of add-on activity. With reasonably stable cash flows, attractive margins and a high level of fragmentation, it is no surprise that PE firms are chasing these deals. One example of this is Edgewood Partners Insurance Center (EPIC)—acquired by Oak Hill Capital Partners from The Carlyle Group in September 2017 for \$977.0 million—which has completed five add-ons during its most recent round of PE ownership. In the first quarter of 2019, EPIC inked another add-on, closing on Integro Insurance Brokers for \$200.0 million. We believe insurance brokerage will be an area to watch in 2019 for platform buyouts and subsequent add-on activity.

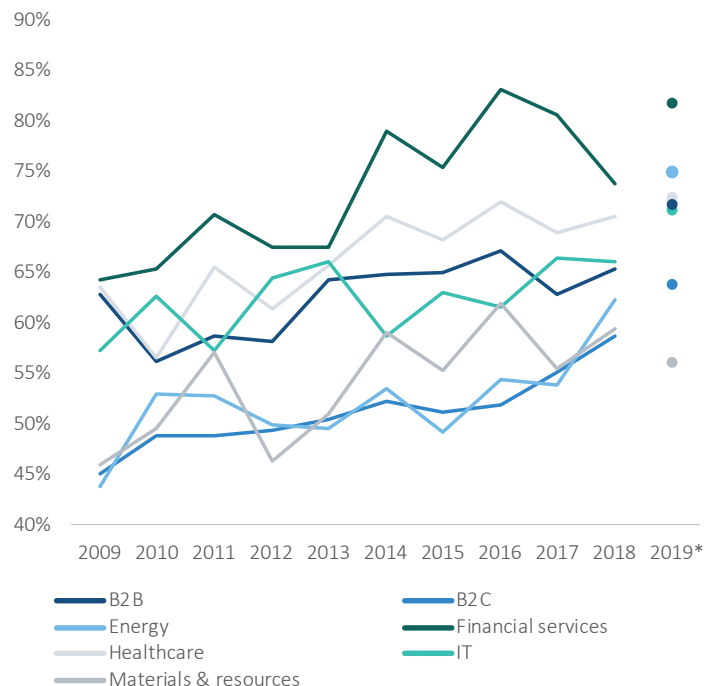
2: “Bain boss warns over private equity debt levels,” Financial Times, Javier Espinoza & Patrick Jenkins, March 29, 2019

US PE buyout EV/EBITDA multiples (four-quarter rolling median)



Source: PitchBook
*As of March 31, 2019

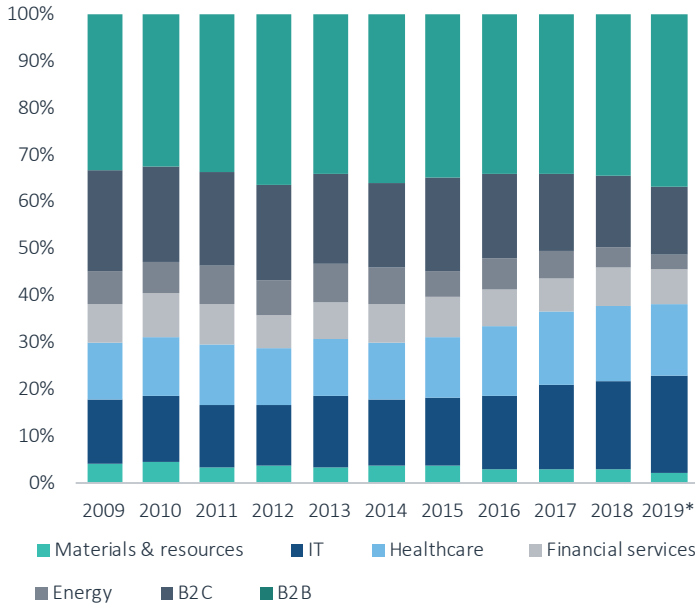
Add-ons as proportion of total US PE deals (#) by sector



Source: PitchBook
*As of March 31, 2019

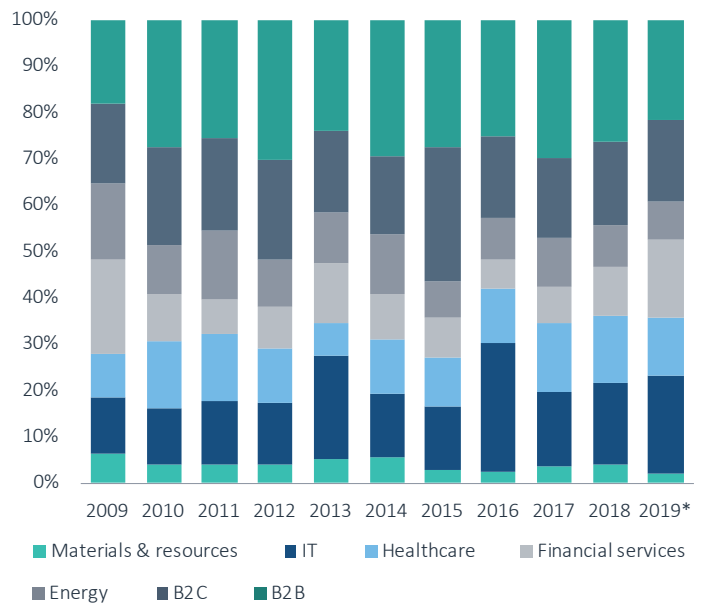
Deals by size and sector

US PE deals (#) by sector



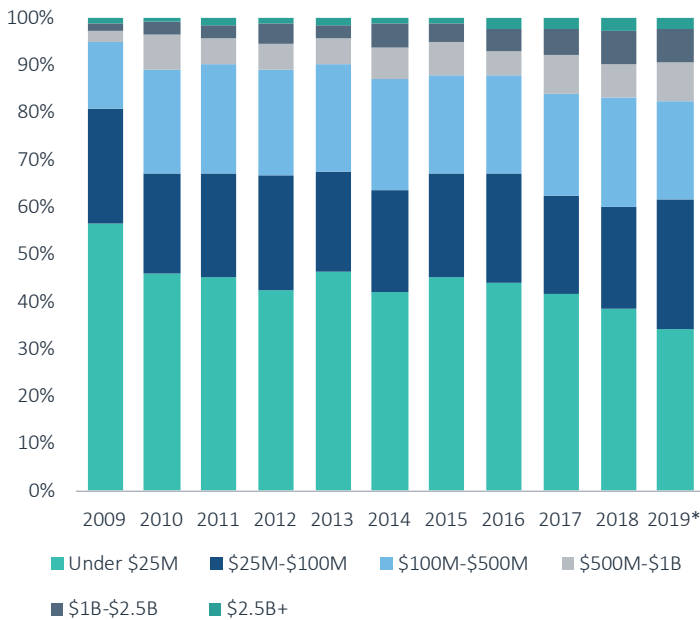
Source: PitchBook
*As of March 31, 2019

US PE deals (\$) by sector



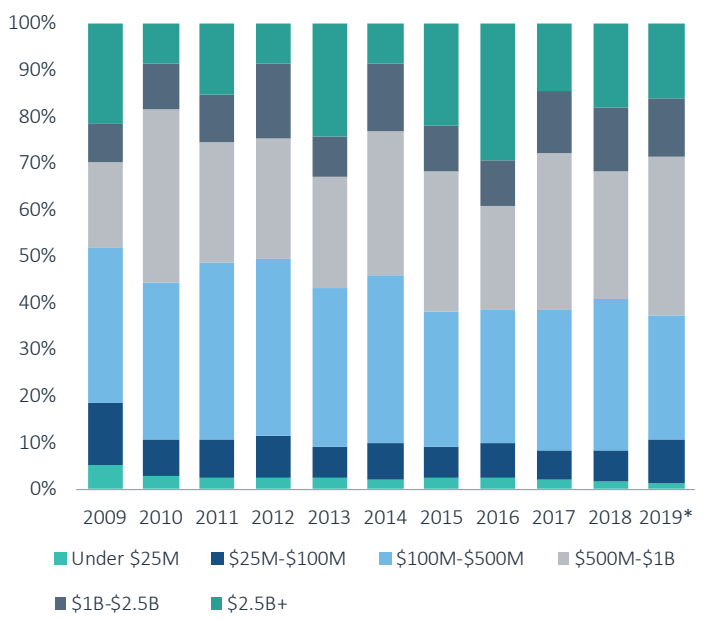
Source: PitchBook
*As of March 31, 2019

US PE deals (#) by size



Source: PitchBook
*As of March 31, 2019

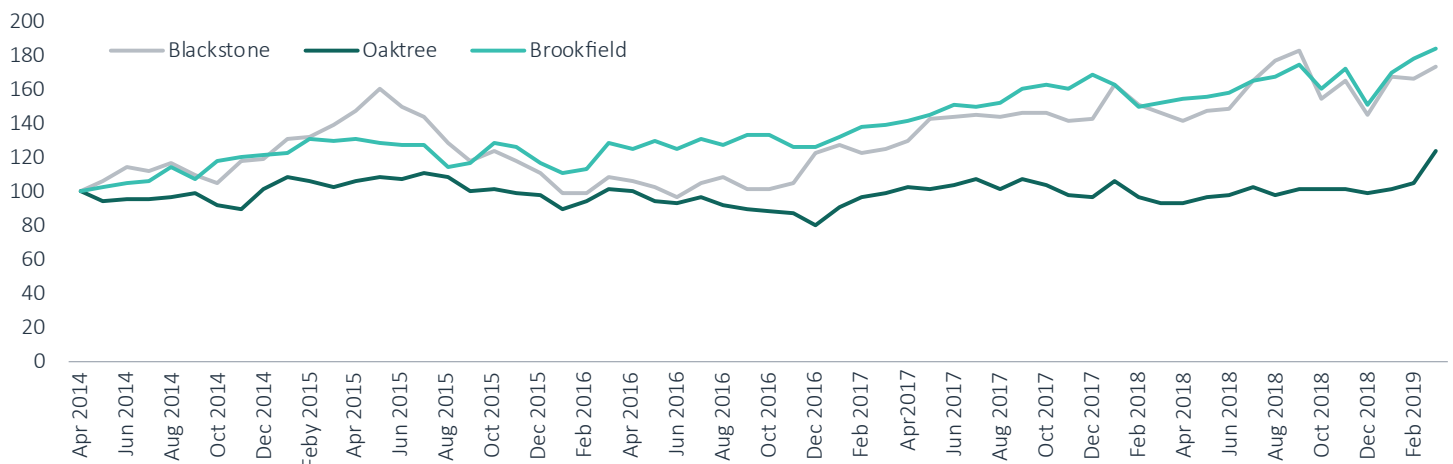
US PE deals (\$) by size



Source: PitchBook
*As of March 31, 2019

Spotlight: Brookfield's acquisition of Oaktree

US stock prices rebased to 100



Source: Morningstar
*As of March 31, 2019

In a deal heard around the world—the alternative investment world, at least—Brookfield Asset Management announced that it was acquiring 62% of Oaktree Capital for \$4.7 billion in cash and stock. While Howard Marks will join the Brookfield board, the companies will continue to operate independently for the time being. Under the deal's terms, Brookfield could own 100% of Oaktree by 2029. Overall, this acquisition seems to make sense for both entities because there is little overlap in offerings.

This mega-deal combines two well-known private asset managers into a powerhouse with complementary offerings. Brookfield, known for its real estate, infrastructure and PE investments, is seeking to benefit from adding Oaktree's credit operations. The importance that asset managers place on private credit has become evident in other recent acquisitions as well. The past two years saw several nontraditional private asset managers purchase credit managers, including SoftBank (purchased Fortress Investment Group), BlackRock (purchased Tennenbaum Capital Partners), and Franklin Templeton (purchased Benefit Street Partners). And Blackstone—one of the world's largest alternative asset managers that Brookfield is positioning to better compete against—purchased the foundation for its credit arm (GSO) in 2010.

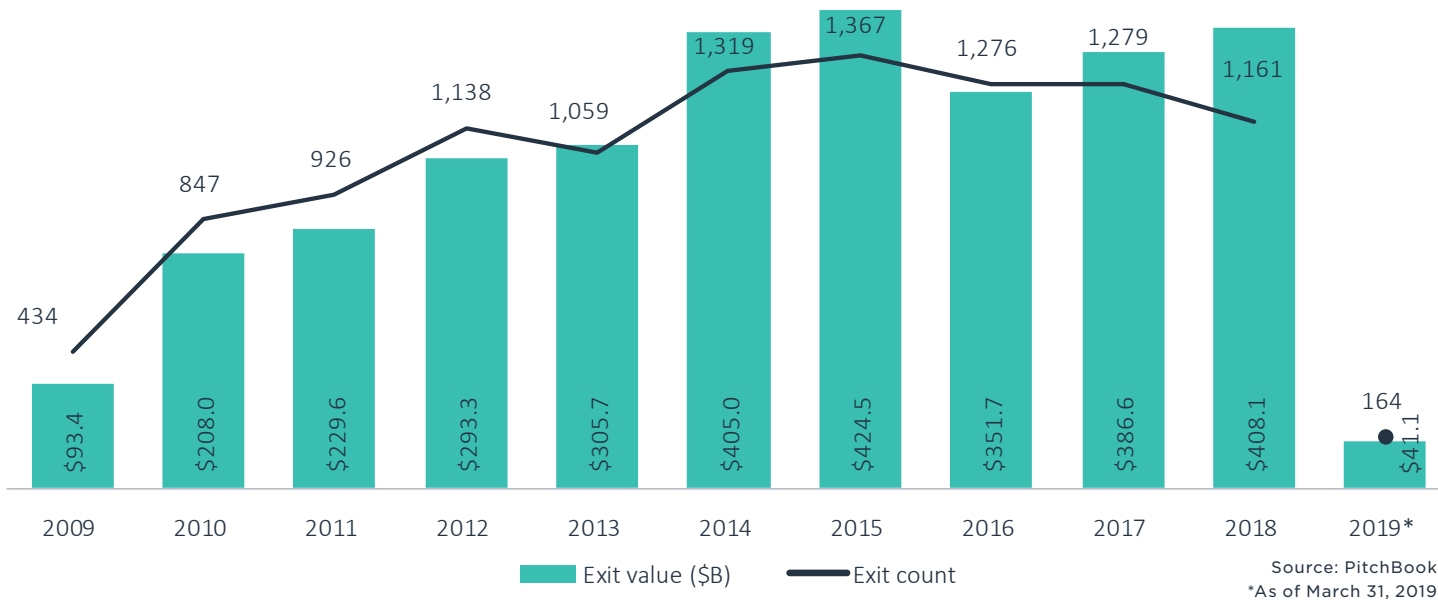
Brookfield's acquisition of Oaktree may set the stage for strategic M&A in future years for other GPs seeking to tack on

specialists and build out strategy offerings as well as provide full liquidity for aging founders. There is a growing count of founders that have sought out liquidity options in recent years. Rather than publicly listing, as Oaktree did, most are opting for GP stakes transactions whereby founders will sell minority stakes in the management company. A question around this had been how GPs will exit these investments, and perhaps Brookfield's acquisition gives us a roadmap for future transactions of private debt managers. To note, several private credit firms, including Golub, have received GP stakes investments and may become M&A targets down the road.

A growing number of credit arms coexisting with buyout groups will have a lasting effect in private markets. When these groups comingle within one GP, they can glean insight from each other as well as use established networks for deal sourcing. Credit divisions can be useful for underwriting the GPs' buyouts, but also allow GPs to present a more well-rounded strategy offering to LPs. Furthermore, credit operations entice a new breed of investors. BDCs can attract retail investors, which is prohibited for most private capital. Alternatively, the high-yielding, fixed-income investments that credit divisions offer are sought after by insurance companies. Investment funds from retail investors and insurance companies could radically alter fundraising and the LP/GP relationship going forward.

Exits

US PE exit activity



After a strong second half in 2018, PE exit activity in 1Q 2019 has slowed down with GPs exiting 164 companies for a total value of \$41.1 billion—QoQ decreases of 41.2% and 57.3%. Although exit count and value have fallen, median exit size remains elevated at \$287.5 million. Secondary buyouts (SBOs) continue to account for a majority of exits, a milestone that was achieved in 2018, when they became more frequent than corporate acquisitions.

The first quarter saw just one PE-backed IPO, the lowest figure since 1Q 2009. This is in part due to the volatility in and lackluster performance of public equities in 4Q of 2018, as well as the longest US government shutdown in history, which delayed some offerings. One notable example is PE-backed firm Ardent Health Services, which initially filed in December of 2018 but refiled its registration in March 2019. Though Ardent didn't give an explicit reason for its delay, other companies, such as Gossamer Bio Inc., were unambiguously forced to defer their plans due to the government shutdown; this leads us to believe that some other companies may have planned to announce or register for their own public offerings in 1Q but had to push those announcements to a later date. In another example of skittishness around this exit path, Blackstone-backed Alight Solutions postponed its own IPO in March, which was expected to raise over half a billion dollars and potentially value the company at more than \$7 billion. Due to these delays, it would not be surprising to see an

increase in the number of IPOs in the coming quarters. In addition to public market volatility and potential delays, ample corporate cash on hand and vast reserves of PE dry powder have made IPOs a relatively less-attractive liquidity option.

One way GPs are coping with a tepid IPO environment is by taking advantage of currently low interest rates through dividend recapitalizations (though recaps are common even in strong IPO environments). This allows the GP to achieve partial liquidity and moves the timing of cash flows forward, boosting IRRs early in the fund life. On the other hand, this type of financing diminishes the credit quality of the company; thus, it is looked upon unfavorably by creditors and other stakeholders. In a recent example of this, Sycamore Partners is currently gearing Staples up for a \$1 billion dividend recap to recoup the majority of its initial \$1.6 billion equity investment during the 2017 buyout. This will raise Staples' debt to \$5.3 billion or 4.7x adjusted EBITDA.³

While SBOs didn't constitute the majority of all PE-backed exits until 2018, they have represented the bulk of healthcare exits since 2016, in part due to the prevalence of the buy-and-build strategy within healthcare. Of the 11 healthcare SBOs in 1Q 2019, five were add-ons. One example is the SBO of BrightSpring Health Services. Onex originally acquired BrightSpring in a \$292.0 million

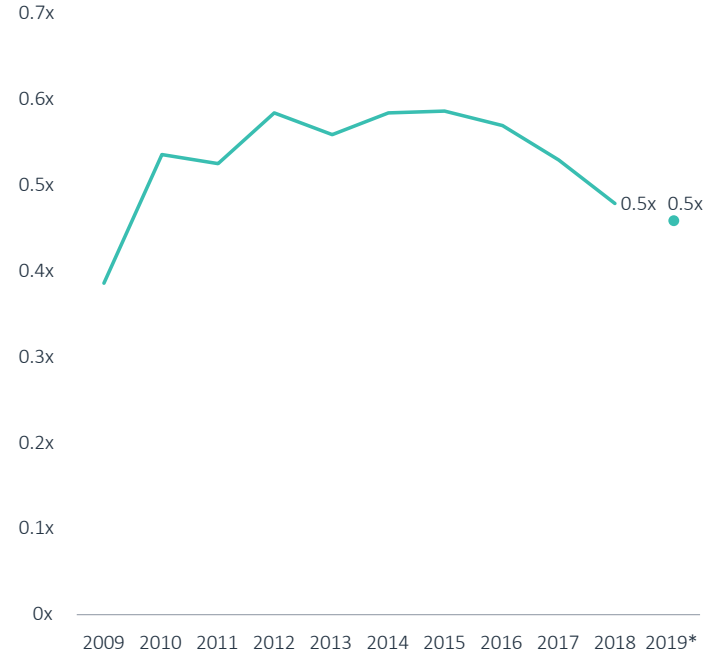
3: Notably, this is still less than the 5.7x debt/EBITDA median buyout multiple seen in 2018.

Exits

buyout in December 2010 (undergoing multiple rounds of dividend recaps during its tenure), before selling it to KKR portfolio company PharMerica for \$1.3 billion. Onex generated a sizable 5.7x return on the sale. These types of healthy returns are one reason so many GPs are investing in healthcare. We believe ongoing consolidation in the industry with myriad GPs seeking to grow portfolio companies inorganically augurs well for the frequency of healthcare exits via SBO in coming years.

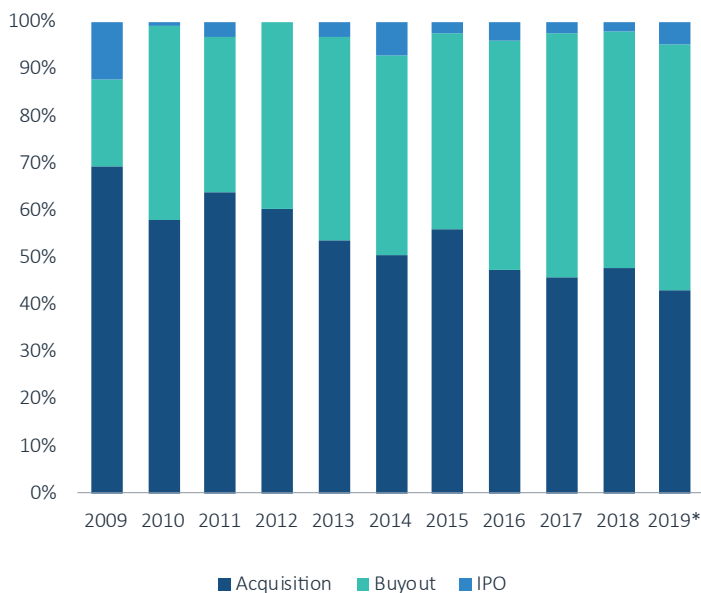
PE firms are exiting fewer companies than they are buying. In fact, there were only half as many exits as there were platform buyouts in 1Q 2019, due in part to steadily increasing deal flow and continually strong demand for private market assets. On the other side of the equation, exit count has been decreasing marginally, though the declines pale in comparison to the gains on the investment side. GPs have tended to “hold onto their winners,” resulting in increased holding times and fewer exits. We expect this ratio to remain depressed in the coming quarters as companies work to accumulate portfolio companies to put their record levels of dry powder to work.

Ratio of US PE exits to investments (excluding add-ons)



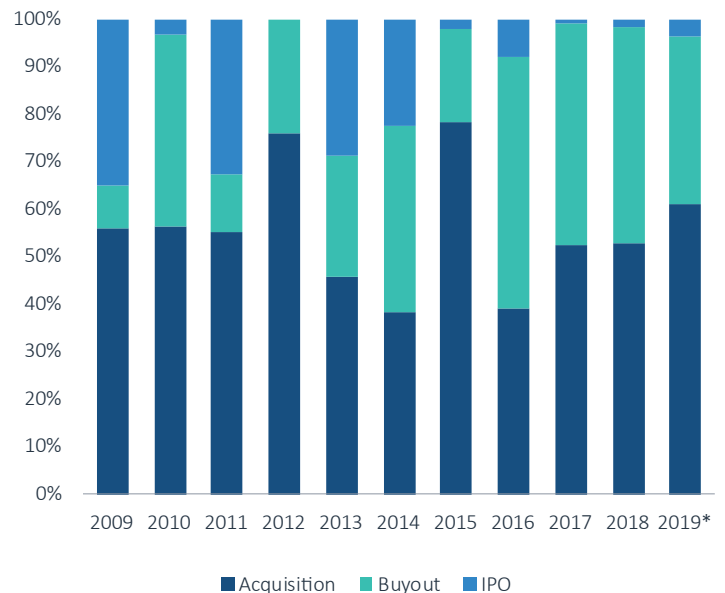
Source: PitchBook
*As of March 31, 2019

US healthcare PE exits (#) by type



Source: PitchBook
*As of March 31, 2019

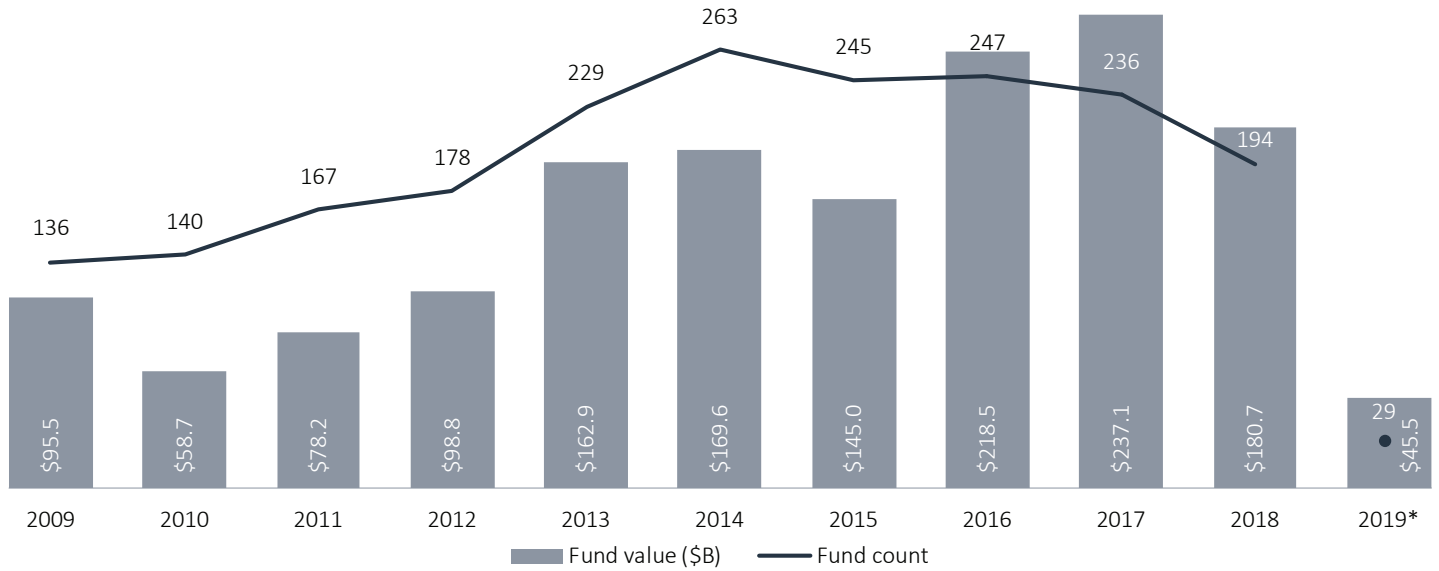
US healthcare PE exits (\$) by type



Source: PitchBook
*As of March 31, 2019

Fundraising

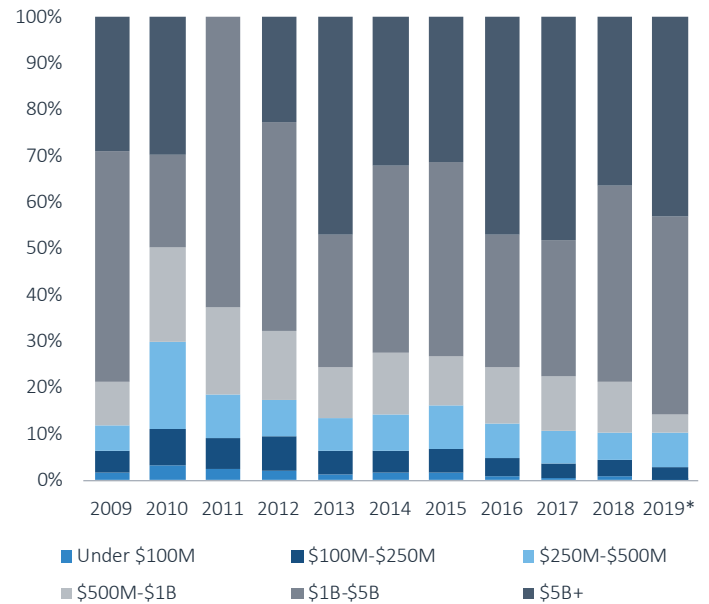
US PE fundraising activity



Source: PitchBook
*As of March 31, 2019

Fundraising activity for US PE funds continued apace from 2018’s strong showing. In the quarter, \$45.5 billion was raised across 29 funds. Mega-funds drove much of the quarter’s total; these funds are garnering a rising share of the total capital raised. YTD, 1Q figures were pushed upward by the largest fund to close in the quarter, Thoma Bravo Fund XIII, which closed on \$12.6 billion. After splitting off from GTCR in 1998, the firm that would later become Thoma Bravo has exhibited top-tier performance, with five of six flagship funds for vintage years between 1998 and 2014 (we exclude the 2016 vintage fund because its performance is not yet meaningful) currently maintaining top-quartile status. The hefty \$12.6 billion fund is exactly \$5 billion larger than its 2016 vintage fund, representing a 65.8% step-up. While step-ups have been climbing recently, a step-up of this magnitude for such a massive fund is noteworthy. The success of this tech-focused firm is not a one-off; Vista Equity Partners, perhaps the most-prolific PE technology investor, is currently fundraising for a vehicle seeking \$16 billion—also \$5 billion larger than its previous flagship fund.

US PE fundraising (\$) by size



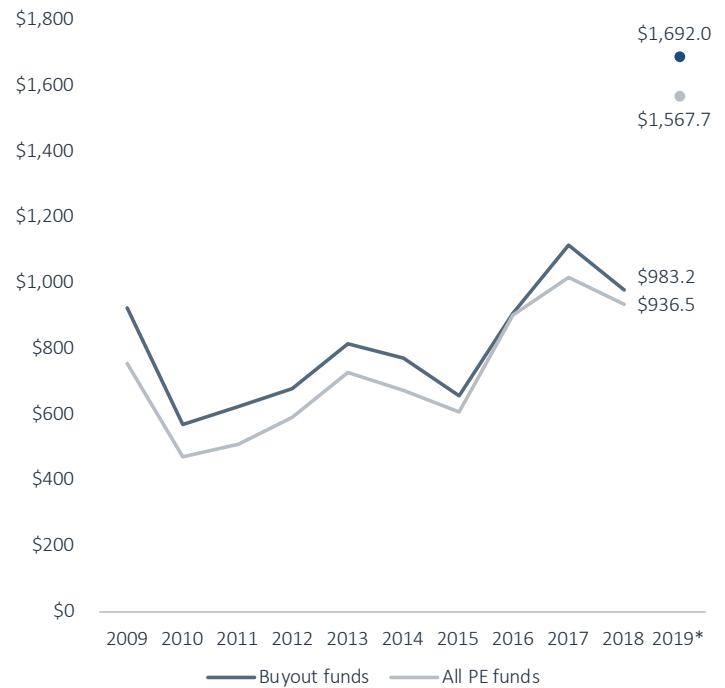
Source: PitchBook
*As of March 31, 2019

Genstar Capital Partners also closed on a mega-fund in 1Q 2019. The firm's ninth flagship fund, Genstar Capital Partners IX, raised \$7.0 billion. With high-profile exits, such as the \$2.0 billion sale of Accruent to Fortive in September 2011, this firm is capitalizing on a rising reputation and has closed on \$11.0 billion across two buyout funds over the past two years. The climb to **mega-fund status** has been quick for Genstar, which has seen step-ups of at least 75% on each of their past three fundraises. Their 2012 vintage fund Genstar Capital Partners VI closed on just \$912.0 million. This San Francisco-based shop speaks to more than just the growing count of mega-funds in the PE landscape; it also shows the Bay Area's growing prominence in the fundraising landscape.

Recent years have seen multiple other GPs based in the Bay Area raise mega-funds, including Silver Lake Management and Hellman & Friedman. On top of this, several other Bay Area managers—such as Francisco Partners, GI Partners, and TSG Consumer Partners—have raised multi-billion-dollar funds in recent years. Chicago has also seen its share of fundraising swell due to the ascension of Thoma Bravo and GTCR, each raising funds of \$5 billion or larger in the past 18 months. None of this is to say that New York is no longer the preeminent city for PE fundraising; however, some capital seems to be clustering in a second tier of cities, including Chicago, the Bay Area and Boston, which may lead to deepening talent pools in these cities and specific regions specializing in unique investment types—e.g. technology in the Bay Area, biotech in Boston, etc.

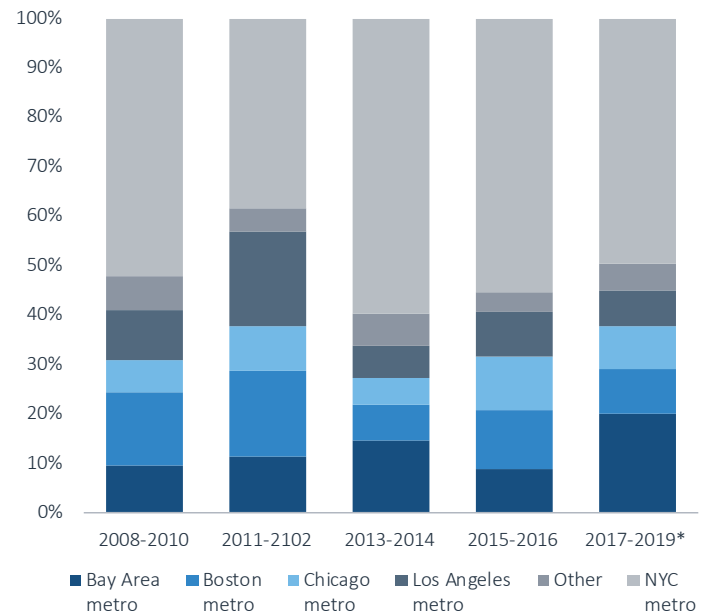
Perhaps the rise in fundraising in the Bay Area is also correlated with the increase in growth equity deal activity and fundraising. Growth equity—which typically makes investments earlier in a company's life cycle, at a point when they are approaching or have just reached positive EBITDA margins—only pursues minority investments, often in technology companies. They also tend to use lower levels of leverage—if any at all—compared to the debt-intensive LBO. Additionally, this strategy has produced similar performance to buyout funds while maintaining a differentiated risk/return profile. 1Q 2019 saw one of the largest growth equity funds to close on record when Summit Partners Growth Equity Fund X closed on \$4.9 billion in March.

Average US PE fund size (\$M)



Source: PitchBook
*As of March 31, 2019

US PE fundraising (\$) by metro



Source: PitchBook
*As of March 31, 2019

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