PitchBook 2018 Private Equity Outlook
Forecasting the primary trends that will shape PE in the year to come

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Note: All data in this analyst note is as of November 30, 2017 unless otherwise noted, with the geographic scope restricted to the US and Europe.
Prediction: Buyout multiples to remain elevated

**Rationale:** Strong corporate balance sheets and elevated dry powder, combined with relatively easy access to financing, will support continued M&A activity from both corporate acquisitions teams and PE firms, which now also face competition from a growing number of LPs executing direct deals.

**Caveat:** Purchase-price multiples tend to be highly correlated with public market valuations; as such, a drawdown in public equity markets could have knock-on effects for PE dealmaking.

We expect buyout multiples to remain elevated as several different groups compete to acquire private companies, which will continue to place upward pressures on valuation. While corporate M&A has declined since the boom years of 2014 and 2015, activity remains strong on a historical basis and corporates have been completing enough deals to prevent an easing in valuation multiples. Most recently, November set the second-highest level of announced M&A deals in two decades.
On the PE front, 2017 has been another strong year for fundraising, with dry powder for US PE firms climbing to $565.9 billion. Given PE firms’ need to put capital to work within a predefined investment period, we expect sustained deal volume and competitive bidding processes for attractive targets to play an active role in keeping valuations elevated. Alongside PE firms in the buyout space, we are seeing rapid growth in the number of direct buyouts by traditional LPs, such as pension funds, family offices and sovereign wealth funds, which should serve to further bolster competition and valuations for private acquisitions.

One development that could change this outlook is a correction in public equity markets, which is not out of the question as the S&P 500 in 2017 is primed to post gains for the ninth consecutive year. If a market correction were to occur, it would provide downward pressure on acquisition multiples, which tend to be highly correlated to movements in public market valuations (even when the acquisition target is a private company).
Prediction: Secondary buyouts continue gaining in stature

**Rationale:** Secondary buyout activity will be supported by the complementary needs of PE buyers and sellers; PE firms have record levels of dry powder to deploy but also need to exit aging portfolio companies.

**Caveat:** While gaining in popularity, secondary buyouts are still stigmatized by some PE professionals, who see limited upside for subsequent financial sponsors. Additionally, PE firms may be able to fetch higher prices for portfolio companies when the acquirer is a strategic.

Secondary buyouts (a PE firm selling to another PE firm) through December 2017 reached 50% of all PE exits, the highest level recorded in PitchBook’s database. At the same time, secondary buyouts have become an integral avenue for deal sourcing, now representing 19% of all buyout activity.

![Secondary buyouts as % of all PE-backed exits](source: PitchBook)

*As of 11/30/2017*
PE sponsorship has exploded since the early 2000s, with a 364% increase in PE-backed companies since 2000. Despite record levels of M&A activity from corporate acquisition teams, the number PE-backed companies as a percentage of company inventory acquired over five years ago is now at record highs (38%). As these companies begin to come to market in the coming years, we expect secondary buyouts to play an even larger role in providing liquidity to PE firms looking to return capital to their LPs.

We expect the increasing prevalence of secondary buyouts to continue in 2018 because PE buyers and sellers have complementary needs. PE firms have record levels of dry powder to put to work, which continues to increase the need for a continuous source of deal flow. Conversely, many PE firms have set lock-up periods established in their LPAs and must either negotiate fund extensions or realize investments in haste—and fellow PE firms provide a relatively quick option. While some investors and managers have been hesitant to pursue secondary buyouts, we think that niche funds will be a major driver of sponsor-to-sponsor activity given their ability to extract value through specific expertise across strategies, industries and geographies.
Prediction: PE investment in software will proliferate further

Rationale: Fast-growing software firms, particularly those with the recurring revenue typical of a SaaS business model, can provide a much-needed source of growth for financial sponsors—both in terms of portfolio company earnings and the pool of investable companies.

Caveat: Given the fast-moving and innovative nature of software companies, operational improvements may prove too difficult, while sky-high valuations may scare away potential suitors.

Information technology is one of the only industries in which PE deal flow has increased in 2017, driven largely by PE’s growing interest in the recurring cash flows provided by SaaS business models. In the coming year, we expect software deals to increase further as a percentage of PE deal flow. This trend is already evident in the increasingly prevalent interactions between PE and venture capital (VC) funds; 18.3% of US VC exits through 3Q 2017 were sold to PE firms—the highest on record. In addition, a maturing ecosystem of tech-focused bankers, lenders, specialized operators and other service providers will grease the wheels for PE firms looking to enter the space.

To employ the saying Marc Andreessen made famous, “software is eating the world,” and PE is no exception. In fact, industry observers are already having to change how they think about software as a sector. S&P Dow Jones Indices recently announced that Alphabet, Facebook, and Netflix—three companies that would have been tracked as software firms earlier in their lifecycles—will now be part of the S&P 500 “communications services” sector. What’s more, there are now private vehicles that tout themselves as specialists in implementing software solutions at non-tech businesses, indicating that software’s impact on PE may be even more significant than the data shows.

Software activity (#) as % of all PE activity

Source: PitchBook
*As of 11/30/2017
Prediction: Niche fundraising will continue its rise

**Rationale:** Due to the rising competition in traditional realms of PE, it will likely be easier for more niche strategies to identify opportunities to deliver alpha.

**Caveat:** Appetite for private market exposure might be so strong that some LPs can only realistically meet their commitment targets by committing large sums to traditional buyout funds.

We expect niche PE strategies—defined here as any vehicles that are not vanilla buyout funds—to become more common in 2018. Fundraising for traditional buyout funds remains robust, with Apollo and CVC in 2017 closing the largest-ever buyout funds in the US and Europe, respectively; however, established GPs are increasingly opening ancillary strategies in areas like credit, growth equity and real estate in an effort to become a one-stop shop for LPs. For example, Bain Capital, which has never before raised a dedicated real estate fund, has acquired Harvard Management Co.’s direct real estate business. What’s more, LPs will realize that **higher risk-adjusted returns are more likely to come through niche strategies**, often in the form of smaller funds that face less competition and are able to buy companies at far lower multiples than their larger counterparts.

### Niche fundraising by strategy

<table>
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<th>Year</th>
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<th>Secondaries ($B)</th>
<th>Fund-of-funds ($B)</th>
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</tr>
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<tr>
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<tr>
<td>2011</td>
<td>$90.0</td>
<td>$60.0</td>
<td>$90.0</td>
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Source: PitchBook  
*As of 10/31/2017
The industry has recently experienced a resurgence in funds raised by first-time managers, as well as the advent of GP stakes’ sales and a proliferation of specialized secondaries funds, underscoring the variety of ways in which investors can gain exposure to the asset class. Additionally, fundraising for funds-of-funds has waned in recent years, further exemplifying the move away from generic, cookie-cutter approaches. Due to concerns about inflated valuations and overexposure to any potential downturn, managers have been experimenting with long-dated funds, which would allow them more flexibility in implementing operations changes as well as properly timing an exit. No matter the timeframe, as the PE industry matures, specialization will become paramount to outperformance.
Prediction: LP net cashflows continue to fall

Rationale: After steadily climbing from 2009 through 2013, LP net cashflows plateaued before dipping in 2016; looking at investment and exit activity year to date in 2017, the data suggests that this downturn is likely to hold throughout 2017, as exit activity remains lackluster and PE firms continue to write bigger equity checks with buyout multiples hovering near all-time highs.

Caveat: PE firms have been utilizing more creative—and harder to track—ways to realize value without fully exiting their investments, which could provide an unanticipated boost to distribution figures.

Private markets have myriad moving parts, all of which feed back into each other in one way or another. But the variable that truly drives the engine is LPs—without their capital, the industry would all but cease to exist. To that end, cashflows to and from LPs are integral in understanding the cycles of private markets. LP net cashflows from PE were negative every year from 2006 to 2010, meaning that investors were pouring more money into funds than they were taking out.

But LP net cashflows improved each year from 2008 to 2013, turning positive in 2011. LPs have now enjoyed six consecutive years of positive cashflows which, combined with rising private market allocations amongst many LPs, have helped to fuel the robust fundraising environment witnessed in recent years.

![Global PE cashflows graph]

Source: PitchBook

*As of 3/31/2017
Since the start of 2016, however, net cashflows have been waning. Fund-level cashflow data is reported on a lag, but our most current dataset through 1Q 2017 shows net cashflows continue to trend downwards. Looking at investment and exit activity YTD in 2017, the data suggest that this deceleration in cashflows should continue throughout 2017. In fact, some LPs have already begun to experience this shift. The Los Angeles City Employees’ Retirement System (LACERS), for example, reported that capital calls outstripped distributions in FY 2017 for the first time since 2012.

This development could have various ramifications for the PE industry, with the biggest potential impact coming in the fundraising market. Dry powder continues to hover near all-time highs, and if LPs begin to see more of their money flowing into PE funds than they see coming back, they may be forced to rethink how much additional capital to lock up in the illiquid asset class.
Prediction: The number of active US PE investors will shrink

Rationale: The number of active firms fell in 2017 for the first time since at least 2000 (and possibly ever) while the number of firms that are at risk of becoming inactive\(^1\) is at the highest point we have ever recorded.

Caveat: LPs are increasingly experimenting with direct deals and represent a potential source of growth in the active firm count while they also maintain a healthy appetite for PE funds, which should continue to support first-time fundraises from established investment professionals.

One of the consistent stories throughout the 2000s has been the unrelenting growth of the PE industry. The growth rate in the number of active PE investors\(^2\) was in mid double-digits each year from 2004 to 2007, in what are colloquially referred to as the “boom years” of PE. Unsurprisingly, the rate of expansion plummeted during the financial crisis, hitting a nadir of 1.8% in 2009. But the industry subsequently rebounded, and the oft-cited dry powder figure continues to climb to new highs.

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1: Firms are “at risk” of becoming inactive if they have neither closed a fund in the last four years nor closed a deal in the last two years.
2: Defined as firms that have closed a fund in the last five years and/or closed a deal in the last three years. This figure includes fund-less sponsors and LPs executing direct deals.

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PE firms (#) by status
What some industry watchers may not realize, however, is that since 2014 the rate of expansion in active PE investors has steadily crept lower. 2017 marked a significant inflection point for the PE industry, as the number of active investors fell for the first time since at least 2000 (and possibly ever).

Through the much-discussed industry consolidation in PE, previously active firms are being absorbed by larger, preeminent firms that are morphing into multi-strategy outfits with fund offerings that span PE, debt, growth, and other strategies. At the same time, the number of newly active funds continues to diminish; while there have been some first-time funds of considerable size in recent years, the number of new firms launched each year has sunk to about 80% below pre-crisis levels.

One reason why the number of active firms has not fallen faster given the lack of first-time funds is the increasing prevalence of fund-less sponsors and direct investments from large LPs, including family offices, sovereign wealth funds and pension plans. While we expect these new entrants to play an increasingly vital role in the coming years, we do not think their presence will be enough to offset the downturn in traditional PE firms. In fact, the number of firms that are at risk of becoming inactive is at the highest point we have ever recorded. As such, we predict that the number of active PE firms will continue to decline in 2018.

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3: See first footnote, above.