PitchBook

2018 Private Equity Outlook: 1H Follow-Up

Assessing our PE predictions

PitchBook is a Morningstar company. Comprehensive, accurate and hard-to-find data for professionals doing business in the private markets.

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In late 2017, PitchBook's PE research analysts provided our outlook for development in the year. In this note, we look at how five of our themes have played out half-way through 2018.

Predictions

- Secondary buyouts (SBOs) will continue gaining in stature.
- PE investment in software will proliferate further.
- Niche fundraising will continue its rise.
- Limited partner (LP) net cash flows will subside.
- The number of active US PE investors will shrink.

Published on August 21, 2018

Prediction: SBOs will continue gaining in stature

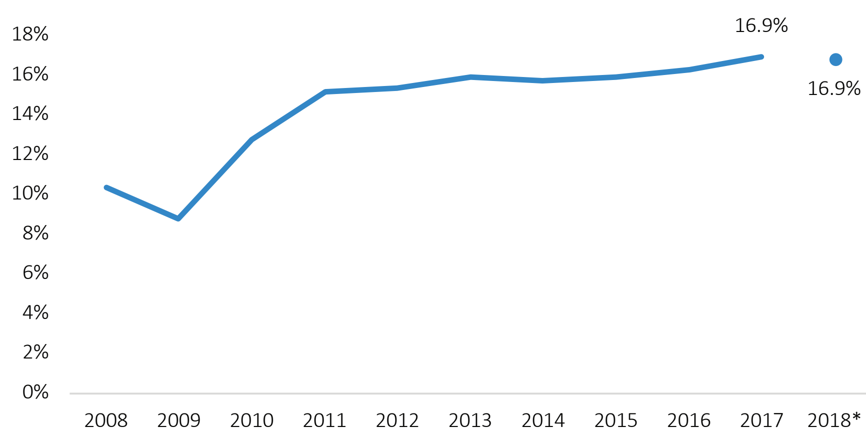
Rationale: *SBO activity will be supported by the complementary needs of PE buyers and sellers; PE firms have record levels of dry powder to deploy but also need to exit aging portfolio companies.*

Caveat: *While gaining in popularity, SBOs 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.*

Update: 2018 has marked a landmark point in the maturation of PE as SBOs have accounted for over half of all exits in North America and Europe. The dealmaking end still has room to run as PE firms have shown a developing aptitude for sourcing deals from other financial sponsors. To note, SBOs now account for 16.9% of all non-add-on buyouts, compared with 10.3% in 2008.

Our previous research shows that PE firms are able to extract value from SBOs at a rate competitive with that achieved via primary buyouts (PBOs). In fact, PE firms are becoming savvy enough to buyout companies that have already undergone at least one SBO—a term we've deemed the "echo buyout." As the number of PE-backed companies escalates further and PE firms sit on record levels of dry powder, SBOs will be utilized more frequently in exits and dealmaking.

SBOs expand prevalence in dealmaking
North America and Europe SBOs as a proportion of non-add-on LBOs



Source: PitchBook
*As of June 30, 2018

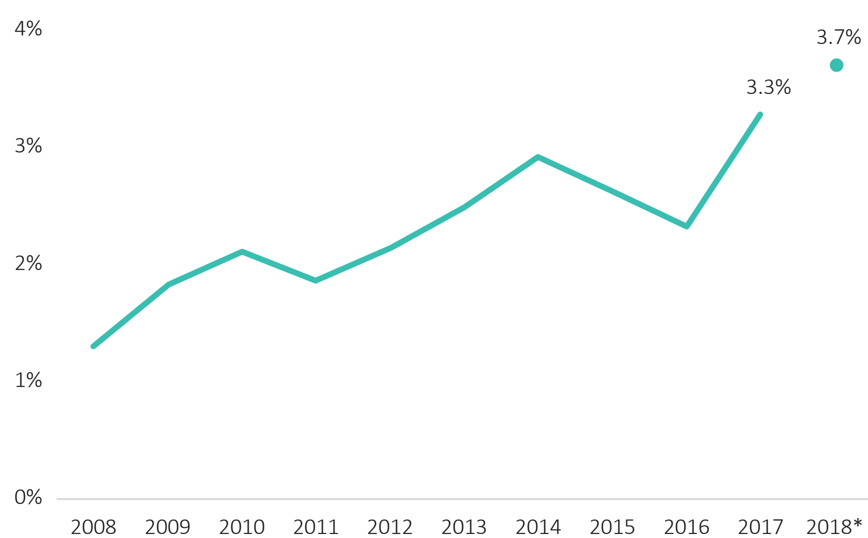
Prediction: PE investment in software will proliferate further

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.*

Update: The momentous rise in software's proportion of dealmaking is altering the PE landscape. The trend of PE firms buying more VC-backed companies is amplifying software's growth in dealmaking. As these two private market practitioners interact more, software is poised to further lift its share of buyouts. VC-backed companies have accounted for 3.7% of PE buyouts at the midway point in 2018. Within VC, software represents 43.0% of the number of deals through the first half of 2018. Within PE, software represented 11.9% of buyouts in 1H 2018 compared to just 10.2% in 2017, 8.3% in 2016 and 7.0% in 2015. PE will look to more VC-backed companies as they seek to deploy record levels of capital through buyouts and growth rounds, such as KKR's recent announcement to provide $400.0 million in growth equity to VC-backed AppLovin.

The proportion of PE deals sourced from VC portfolios swells
VC-backed companies (#) as a proportion of US PE buyouts



Source: PitchBook
*As of June 30, 2018

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 realistically meet their commitment targets only by committing large sums to traditional buyout funds.*

Update: Through the first half of the year, activity and fundraising within niche PE spaces has remained resilient. In particular, fundraising and deal activity within the general partner (GP) stakes category is flourishing, with dealmaking in 2018 already matching annual recordsf Vigorous fundraising for the GP stakes strategy illustrates the success these niche players are having. To note, Dyal is raising its fourth fund and AlpInvest is in the market for its first fund—attempting to raise $500.0 million.

As LPs get more comfortable with PE and increase allocations—such as The University of Texas/Texas A&M Investment Management Company (UTIMCO), which recently elevated its PE allocation from 17.5% to 25.0%, a 43.0% increase—they often want exposure to the more niche areas within PE, offering comparable risk-reward but not just the plain vanilla leveraged buyout. Along with GP stakes, the fundraising environment within real estate and secondaries is rapidly developing.

Fundraising in GP stakes burgeons
Open GP stakes first-time-funds

Fund name	Target amount ($M)
Alpinvest GP Stake Fund	$500.0
Bonaccord Capital Partners I	$1,000.0
GP Interests Fund	$750.0
Hycroft Capital Fund	$750.0

Source: PitchBook
*As of June 30, 2018

Prediction: LP net cash flows continue to fall

Rationale: *After steadily climbing from 2009 through 2013, LP net cash flows 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.*

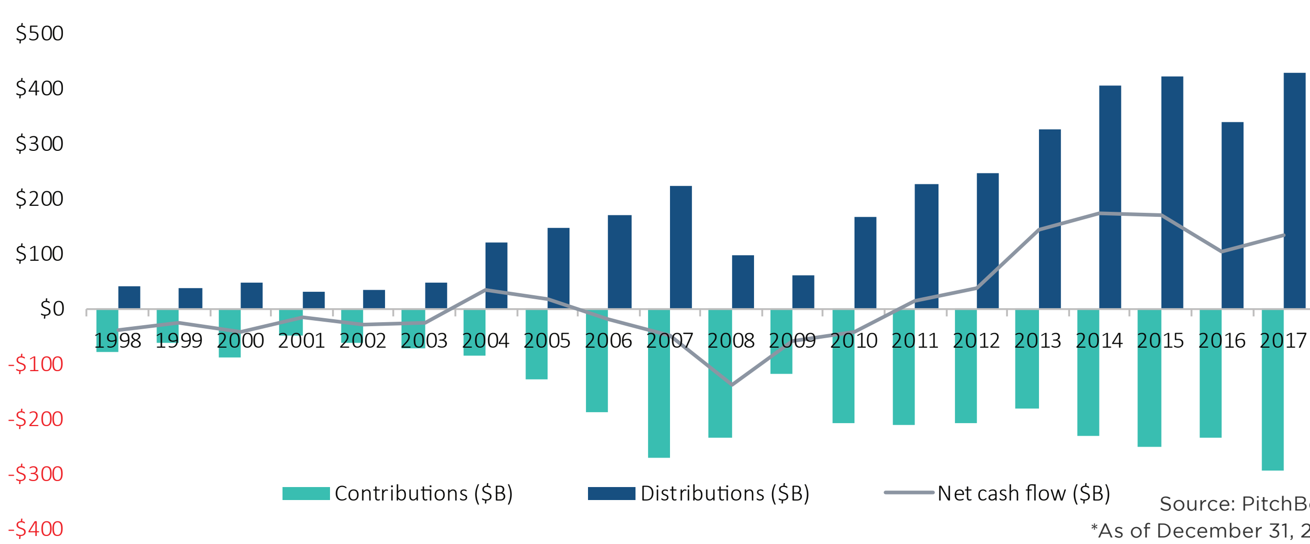
Caveat: *PE firms have been utilizing more creative—and harder to track—ways to realize value without fully exiting their investments, which could provide an unanticipated boost to distribution figures.*

Update: PE net cash flows through 2017 came in at $132.7 billion, increasing for the first time since 2014. The downward trend—which began after the 2014 peak in net cash flows—has been broken. Distributions from PE firms hit a record $426.6 billion, eclipsing the previous peak in 2015 of $421.0 billion. To note, even though the exit activity has been less vivacious than the peak years, PE firms are using recaps and other means to distribute LP capital without the need for a full exit.

Cash flows are cyclical. This environment of continued heightened exit activity—as PE firms sell to capture high multiples at a time that many feel is "late in the cycle"—has caused distributions to swell. In addition, capital calls reached record levels in 2017. We will need to watch the trend unfold over the next couple of years before determining whether this is a shorter-term blip in the downtrend or a true reversal; however, at this point it looks as though our original prediction has not held up.

The downward sloping trend in PE net cash flow stabilizes

Global PE cash flows



Source: PitchBook
*As of December 31, 2017

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 is at the highest point we have ever recorded.*

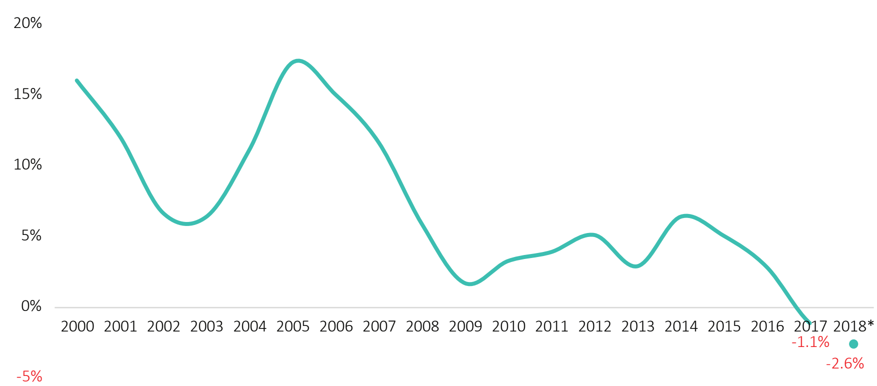
Caveat: *LPs are increasingly experimenting with direct deals and represent a potential source of growth in the active firm count while they also maintain a healthy appetite for PE funds, which should continue to support first-time fundraises from established investment professionals.*

Update: The trend of LPs adjusting portfolios to lessen the number of GP relationships endures. The diligence process takes vital resources, and since most LPs allocate across numerous asset classes, they cannot devote the required resources to apportion calculated bets spanning several dozen PE managers. This means the gargantuan asset managers are consolidating capital at a clip far outpacing the median PE firm. GPs understand this and are expanding their offerings to be a one-stop-shop, spanning buyouts, growth, real estate, credit and more. To that end, Thoma Bravo—a PE firm with several successful buyout funds raised—announced that it has raised nearly $500.0 million for its debut credit fund.

Larger GPs are also using M&A to expand their offerings instead of building new strategies in-house; however, this trend is not new. For example, Blackstone acquired GSO Capital Partners, its lending business, in 2008. As larger managers expand their core offerings, many first-time fund managers have been forced to differentiate through niche offerings. The number of active managers fell in 2017 and looks to do so again in 2018.

The number of active PE firms shrinks

YoY % change in the number of active PE firms (#)



Source: PitchBook
*As of June 30, 2018