PitchBook

2018 Private Equity Outlook: 1Q 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.

Credits & Contact

Analysts

JAMES GELFER Senior Analyst
james.gelfer@pitchbook.com
DYLAN COX Analyst II
dylan.cox@pitchbook.com

Contact PitchBook
pitchbook.com

RESEARCH
reports@pitchbook.com

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In late 2017, PitchBook's private equity research analysts provided our outlook for development in the year. Here we take a look at how four of our themes have played out early in 2018.

Predictions

- Secondary buyouts will continue gaining in stature
- Software investing to proliferate further
- Niche fundraising will continue its rise
- Limited partner (LP) net cashflows will subside

Prediction: Secondary buyouts will 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.*

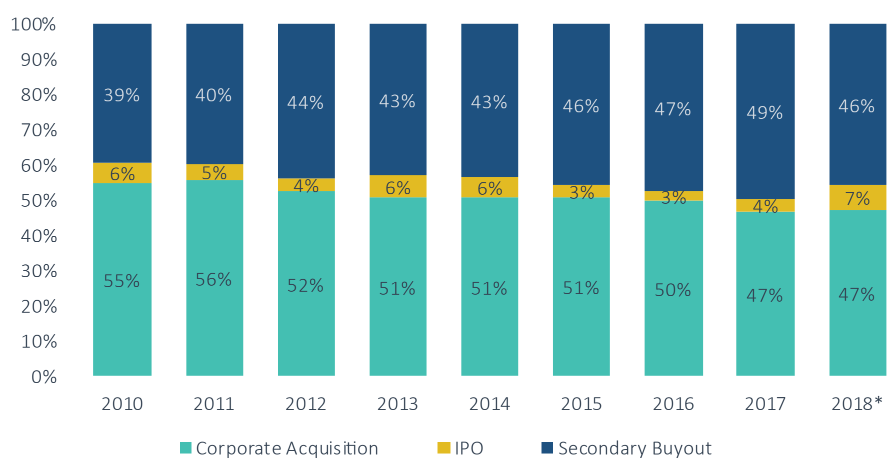
Caveat: *While gaining in popularity, secondary buyouts are still stigmatized by some PE professionals, who see limited upside for subsequent financial sponsors. Additionally, PE firms may be able to fetch higher prices for portfolio companies when the acquirer is a strategic.*

Update: 2017 marked the first time that secondary buyouts were the primary exit route for PE-backed companies, but that supremacy was short-lived, as secondary buyouts slightly trail corporate acquisitions early in 2018. However, the long-term trend toward more secondary buyouts remains intact, and current market dynamics should continue to encourage these deals. On the dealmaking front, 13% of US buyouts in early 2018 were secondary buyouts, down from the 15%-17% seen in recent years.

We expect secondary buyouts to see their share of PE activity trend higher throughout the year, particularly as these transactions often take longer to track due to the relatively secretive nature of PE dealmaking.

Secondary buyouts slipped slightly in early 2018

Exit activity (#) in US by type



Source: PitchBook
*As of 3/21/2018

Prediction: PE investment in software will proliferate further

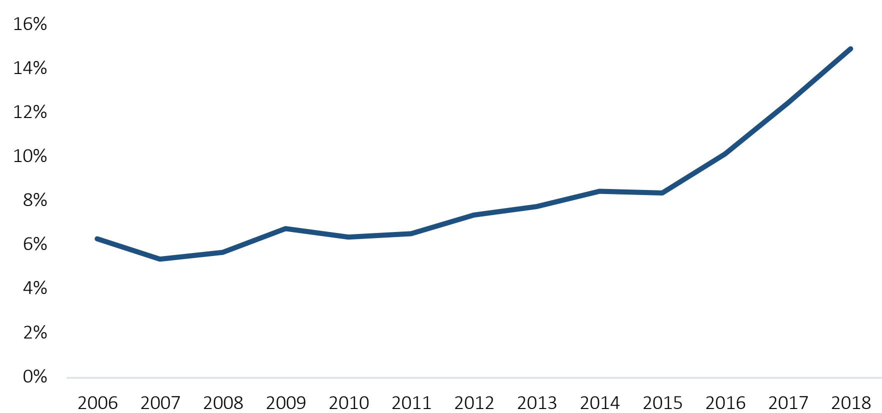
Rationale: *Fast-growing software firms, particularly those with the recurring revenue typical of a SaaS business model, can provide a much-needed source of growth for financial sponsors—both in terms of portfolio company earnings and the pool of investable companies.*

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: Software has been a focal point of the PE market early in 2018, representing 15% of deal flow—up from an all-time high of 12% in 2017. Software's clout is also growing in terms of capital invested, currently accounting for 12% of deal value in 2018, thanks in part to the $1.6 billion take-private deal for Barracuda Networks that closed February. Additionally, a handful of notable deals have been announced in 1Q, including the $17 billion carveout of Thomson Reuters' financial and risk business. Several prominent fundraises, including $10-billion-plus funds for Silver Lake and Vista Equity, suggest that software deals will remain popular for some time.

Software continues to attract dealmakers

Software activity (#) as % of all US PE activity



Source: PitchBook
*As of 3/21/2018

One additional development that may be facilitating more deal flow in the software space is PE firms' adoption of growth equity deals, whereby they acquire a minority stake in the company while allowing the founder and/or management team to retain some control over the operations—an oft-cited concern of software founders. Since 2010, we've seen growth deals expand from about 25% of software PE deal flow a decade ago to 35% early in 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 only realistically meet their commitment targets by committing large sums to traditional buyout funds.*

Update: Results for this prediction have been mixed early in 2018. Fundraising has been muted for certain niche strategies, such as private debt, but secondaries funds have maintained their momentum following a record-breaking year in 2017, with nine funds having already closed on more than $6 billion. Real estate has been another bright spot, with 10 funds closing with more than $500 million so far in 2018, including a $9 billion vehicle from Brookfield Asset Management.

Meanwhile, major players in the FoF space—which in many ways epitomizes a generalist, one-size-fits-all approach—have continued to adapt to investors' waning interest in their traditional offering. A recent article from PEI suggested that Ardian has been shifting its model away from traditional FoF vehicles and toward more customized LP mandates.

Select niche funds closed in 1Q 2018 to date

Investor Name	Fund Name	Fund Type	Fund Size ($B)
Brookfield Asset Management	Brookfield Strategic Real Estate Partners III	Real Estate	$9.0
Goldman Sachs	Broad Street Real Estate Credit Partners III	Real Estate Distressed	$6.7
Apollo Global Management	Apollo European Principal Finance Fund III	Distressed Debt	$4.0
Partners Group	Partners Group Direct Infrastructure 2016	Infrastructure	$3.7
EnCap Flatrock Midstream	EnCap Flatrock Midstream Fund IV	Energy - Oil & Gas	$3.3
Goldman Sachs - AIMS	Petershill Private Equity	GP Stakes	$2.5
Kohlberg Kravis Roberts	KKR Private Credit Opportunities Partners II	Mezzanine	$2.2
Orion Mine Finance	Orion Mine Finance Fund II	Mining	$2.1
Kohlberg Kravis Roberts	KKR Real Estate Partners Americas II	Real Estate Opportunistic	$2.0
Guggenheim Partners	Guggenheim Private Debt Fund II	Direct Lending	$2.0

Source: PitchBook
*As of 3/21/2018

Prediction: Limited partner (LP) net cashflows will 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.*

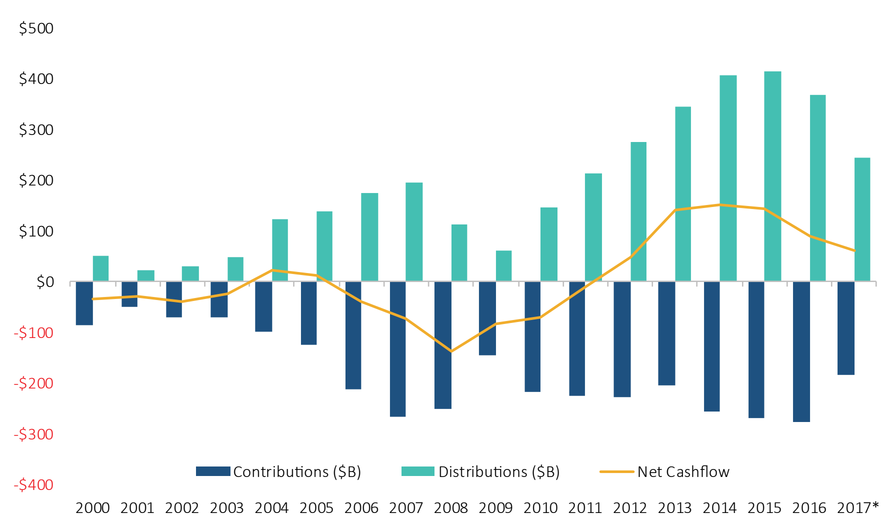
Caveat: *PE firms have been utilizing more creative—and harder to track— ways to realize value without fully exiting their investments, which could provide an unanticipated boost to distribution figures.*

Update: PE net cashflows through 1H 2017[1] came in at just over $60 billion. If this pace were to hold through the entire year, it would represent an increase over 2016 figures and fail to fulfill our prediction. However, 2017 net cashflows are on pace to fall short of the annual totals from 2013 to 2015, suggesting we may still be in the midst of a longer-term downtrend.

Indeed, our recent analysis in the PitchBook Benchmarks showed that the average PE fund raised in the early 2000s generated a DPI of 1.0x before its seventh year, but the story has shifted profoundly; it now takes more than nine years for the average fund to make investors whole. And while the pace of capital calls has also slowed as well, it has not been nearly to the extent of distributions.

1: 2Q 2017 is the timeframe of the most recently available data, as fund cashflows are reported on a lag.

PE firms continue to return more capital than they deploy
Global PE cashflows



Source: PitchBook
*As of 6/30/2017