Paul | Weiss

Private Equity Digest

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A Review of 2017 U.S. Private Equity Trends and Expectations for 2018

In this issue of the Private Equity Digest, we take a look back at private equity trends in 2017 and possible developments for 2018.

Fundraising

Fundraising in 2017 was robust. Over $231 billion was raised in the U.S., surpassing the previous record of $211.4 billion raised in 2016 (Pitchbook). 2017 also saw many PE funds close well above their initial target size in short timeframes.

Despite record fundraising, there are signs of a bifurcation in the market between larger, more established firms and others. Only 236 U.S. PE funds held final closings in 2017, the lowest number since 2012 (Pitchbook). However, the average size of U.S. PE funds hit a high of $988 million this year (Pitchbook). This indicates that more capital was raised in 2017 by fewer funds, with larger funds generally being the drivers and beneficiaries of the record fundraising, as they rely on their brand equity and as investors look to consolidate their dollars in fewer funds to increase efficiencies.

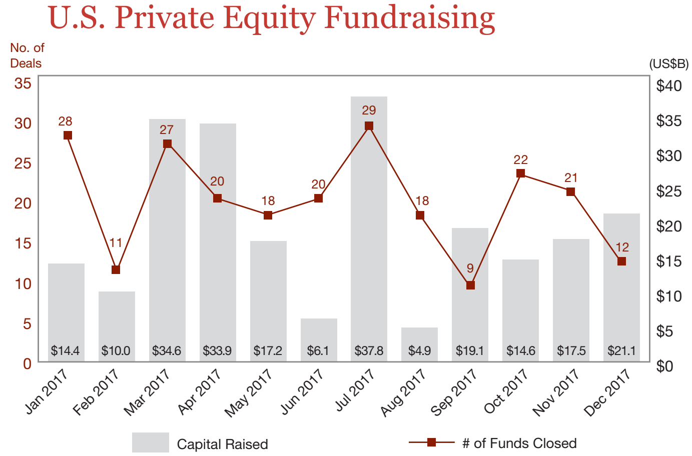
The flurry of fundraising activity plus other factors (such as a more targeted, and hence slower, deployment of capital due to higher target valuations) has resulted in unprecedented dry powder among U.S. firms, reaching a record high of $565.91 billion as of December 31, 2017 (Pitchbook).

Exits and Dealmaking

In contrast to the torrid fundraising market, the pace of U.S. exits has continued to slow after peaking in 2015. There were 1,171 exits in 2017, a 9.6% decrease compared to 2016 and a 16.3% decrease compared to 2015. Of all exits, there were 15.5% fewer secondary sales and 5.5% fewer corporate sales in 2017 than in 2016. Total capital invested in U.S. public-to-private deals was also down 38.9% from the previous year (Pitchbook).

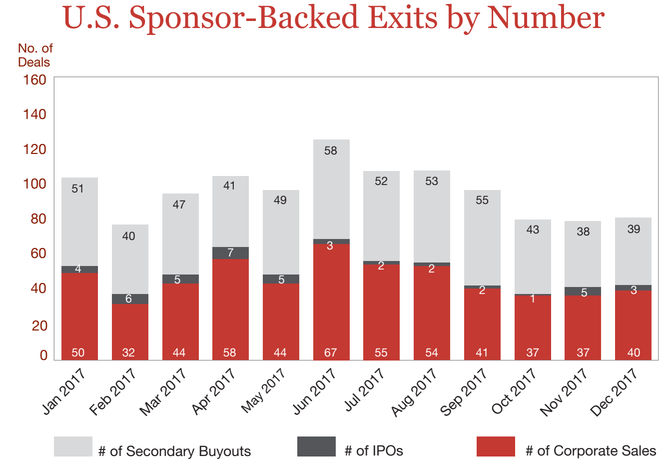
The IPO market rebounded somewhat compared to 2016, although IPO activity has generally slowed since the high in 2014. In 2017, the number of sponsor-related U.S. IPOs increased by about a third compared to 2016, returning to 2015 levels. The total value of IPOs also rose about 45% compared to 2016, going from $9.6 billion in 2016 to $14 billion in 2017 (Pitchbook).

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits by Number



Source: Pitchbook

Larger limited partners (LPs) are increasingly making direct investments in PE fund assets, for example, by co-investing in deals with PE firms or by acquiring minority ownership of existing portfolio assets. Co-investments are attractive to LPs because they offer transparency into the funds in which they invest, and because they often include lower or no fees, although they do put LPs at higher risk if the investments fail. To a lesser extent, some LPs have bought minority stakes in existing portfolio companies. PE funds may agree to these types of transactions because they deliver higher returns to investors and it creates additional goodwill between the sponsor and the LP.

Target valuations continue to be high, leading to fewer traditional investment opportunities, and thus intense competition. The S&P 500 hit a record closing high on January 17, 2018, with its best performance since 2013. At over 3,234 days (as of January 17, 2018), this bull market is one of the longest on record. Further, the U.S. economy has been strong and the credit market accessible. The result is that target valuations continue to be high, and the average multiple required to win a target in the U.S. is now generally reported to be 10x or above.

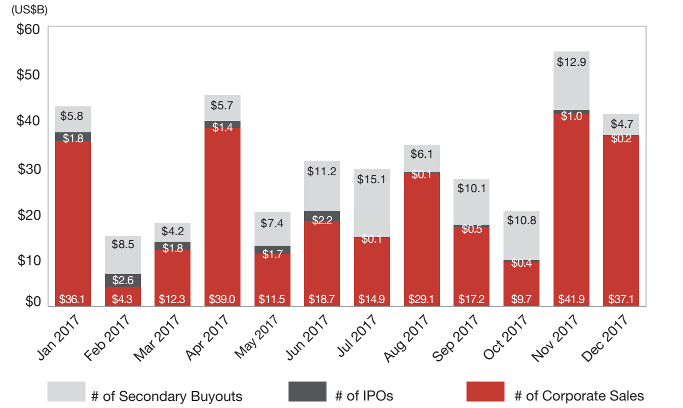
This tightening target market has had ripple effects, including the following:

- Firms attempt to distinguish themselves at auction by highlighting their specific sector focus or demonstrated operational expertise, or they may attempt to front-run full auctions by leveraging relationships to submit bids ahead of time, by asking for "VIP auctions," in which a select group of parties access management and the data room ahead of a formal auction, or by completing due diligence earlier in the process or by the final bid date.

- PE-strategic partnerships and club deals continue to be viable options. Rather than lose out to well-heeled strategic buyers, some PE firms are teaming up to bid on assets together. Recent examples of PE fund/strategic partnerships include the $782 million acquisition of Kindred Healthcare by Humana, TPG and other PE funds and the $900 million acquisition of PharMerica Corporation by KKR and Walgreens Boots Alliance. Recent club deals include the $5.6 billion acquisition of Calpine by Energy Capital Partners and other funds and the $934 million acquisition of Albany Molecular Research by Carlyle and GTCR.

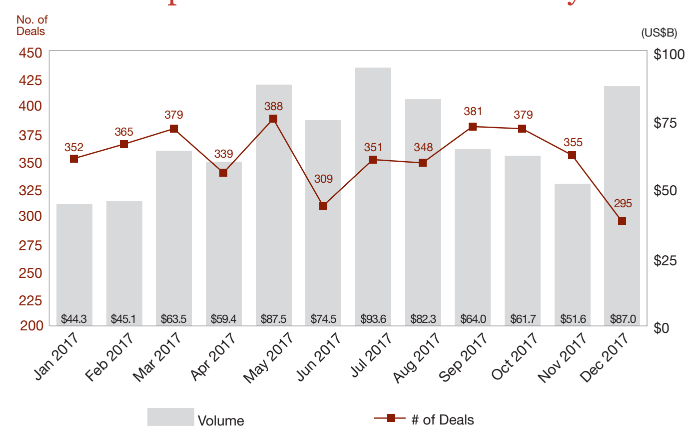
- Buy-and-build strategies remain a popular way to create growth by acquisition in an otherwise low-organic-growth environment. PE firms are merging their existing portfolio companies with smaller companies from outside of their portfolios in similar industries. This strategy has several advantages: it accelerates portfolio companies' growth by acquisition, enables PE firms to realize strategic synergies similar to corporate investors, reduces the original purchase price multiple and therefore increases return and enables PE firms to secure higher exit prices by creating larger targets that become interesting for large corporations who would otherwise ignore smaller players.

U.S. Sponsor-Backed Exits by Dollar Volume



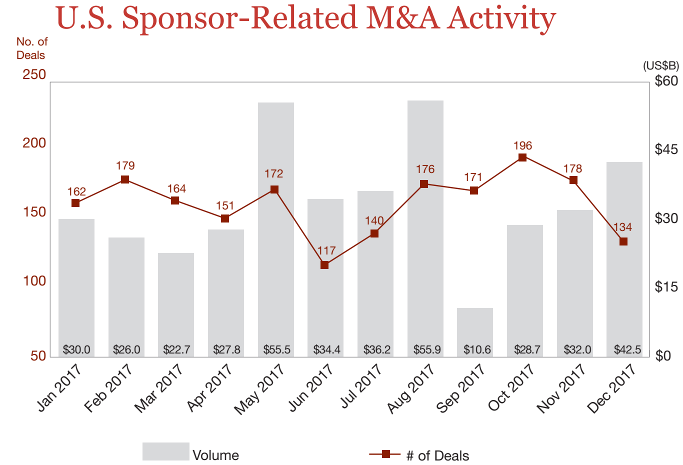
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

Expectations for 2018

Fundraising is expected to remain robust in the foreseeable future, and trends of upward pressure on multiples and elevated valuations are expected to persist. The increased competition on the buy side looks to continue for the foreseeable future.

The impact of tax and other regulatory and political changes is likely to be the big wild card for 2018. The reduction in the corporate tax rate from 35% to 21% and the non-U.S. profit repatriation changes will likely give corporations more free cash flow on hand to fund acquisitions. This and a continued healthy U.S. economy, among other things, are likely to spur M&A activity, although this is a double-edged sword for PE funds as this means more buyers for their assets but also more competition at the auction block. New limits on deductibility of interest payments exceeding 30% of adjusted taxable income and less favorable treatment of carried interest are among the tax changes that may affect the PE industry negatively. The impact of these changes remains to be seen.

This publication is not intended to provide legal advice, and no legal or business decisions should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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