Paul|Weiss

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A Review of 2018 U.S. Private Equity Trends and Expectations for 2019

In this issue of the Private Equity Digest, we take a look at private equity trends in 2018 and possible developments for 2019.

Fundraising

Fundraising in 2018 retreated from 2017 numbers. U.S. PE funds raised $184.9 billion in 2018, falling well short of the all-time record of $244.3 billion raised in 2017.[1] Due to a relative decline in mega-fund activity in 2018, middle market fundraising accounted for 67% of capital raised, up from 52% in 2017. The overall fundraising slowdown may be a sign of both the high levels of dry powder in the market and overall regression to the mean from the record levels experienced in 2017.

Both the total number of U.S. PE funds that closed and the average fund size dropped during the year. 219 funds closed in 2018 – the lowest level since 2012 (with 182 funds closed) and well below the 278 funds closed in 2017. The average fund size in 2018 was approximately $849 million, down from roughly $895 million in 2017. 2018 was the first down year for fund size since 2015, when the average fund size was $613 million.

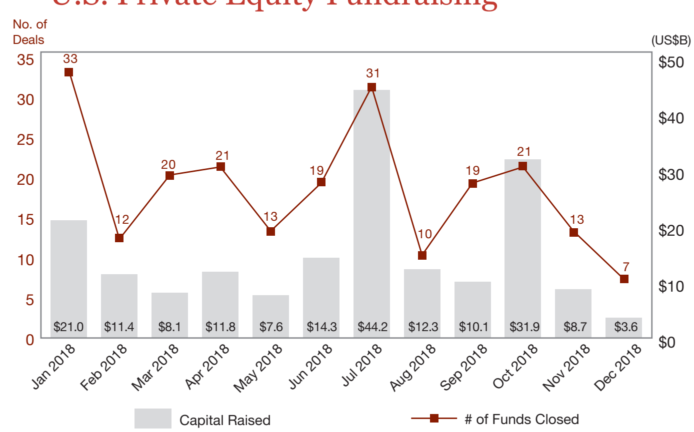
The decline in the number of $10 billion-plus mega-funds raised in 2018 was a significant factor in the average fund size decrease. Contributing to 2017's record-setting fundraising totals were five different U.S. firms with fund raises of $10 billion or more, including the largest buyout fund ever raised at $24.7 billion.[2] In comparison, only two firms raised funds of $10 billion or more in 2018.

Exits

After peaking in 2015, U.S. PE exits continued to slide in 2018. There were 1,052 exits in 2018, a 10.2% decrease from the 1,171 exits in 2017, and a 24.8% decline from 2015 exits. However, the average holding period for U.S.-based companies by U.S. PE funds remained steady at 5.83 years in 2018 compared to 5.92 years in 2017, in part due to headwinds facing exits, as discussed below.

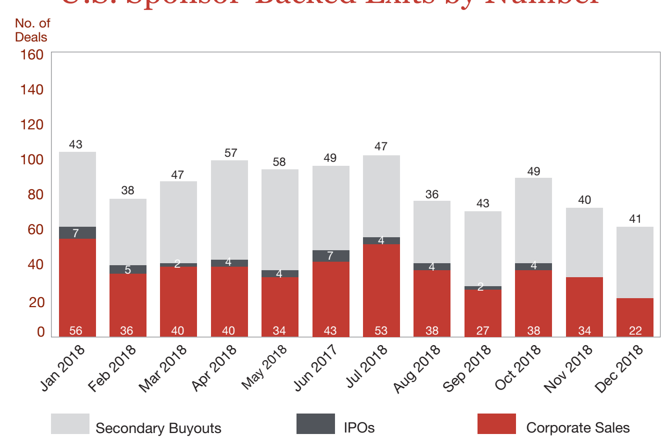
The U.S. PE-backed IPO market remained relatively flat year-over-year with 43 offerings in 2018, nearly matching the 45 offerings in 2017. Similarly, the $13.3 billion in 2018 IPO proceeds lines up closely with the $13.8 billion from 2017. The broader IPO market started strong in the first three quarters of 2018, but cooled off in the last quarter due to equity market volatility and the associated challenges of pricing an IPO under those conditions. As for 2019, the government shutdown and the associated partial closure of the Securities and Exchange Commission is forcing companies to shelve IPO plans. Historically, years in which an IPO drought occurred in January went on to be among the weakest years for IPOs overall.[3]

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits by Number



Source: Pitchbook

There were 461 PE exits via sale to corporate buyers in 2018, accounting for 44% of total exits. The number of sales to corporate buyers declined by almost 18% compared to the 559 such sales in 2017 (which represented 48% of all exits). Sales to corporate buyers in 2018 were, to some extent, supported by cash-rich corporate balance sheets which had benefited from recent U.S. tax reforms.

On the other hand, 548 secondary buyouts took place in 2018, comprising the bulk of PE-backed exits at 52%. The 2018 numbers showed continued strength from the 566 secondary buyouts accounting for 48% of exits in 2017.

Deal-making

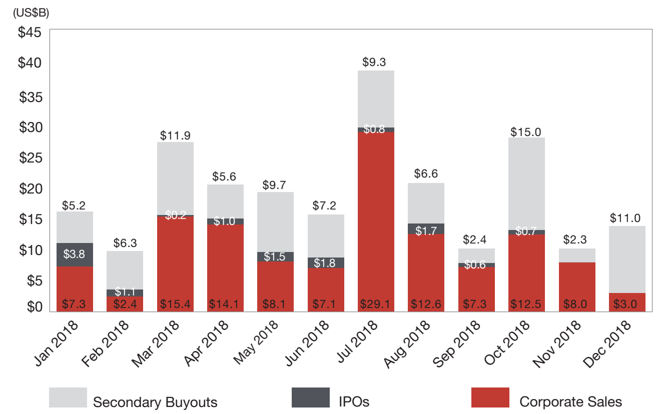
U.S. sponsor-related M&A activity in 2018 saw a slight uptick in total dollar volume from $429.6 billion in 2017 to $435.2 billion in 2018. However, U.S. PE M&A activity as measured by deal count waned from 2,104 in 2017 to 1,765 in 2018. In comparison to the average PE deal size of $204.2 million in 2017, the average PE deal size rose to $246.6 million in 2018.[4]

In 2018, the most active industries for U.S. PE M&A activity, by deal count, were Computers & Electronics (444), Professional Services (231) and Healthcare (178). However, dollars were focused on Computers & Electronics ($117.0 billion), Oil & Gas ($52.7 billion) and Healthcare ($44.7 billion).[5] Computers & Electronics has likely remained popular as technological advancements have both driven efficiencies within the sector, and enabled funds to utilize such advancements in other portfolio companies or more broadly throughout the respective funds. Meanwhile, Healthcare has maintained momentum due to robust demand. Furthermore, the fragmented nature of the market makes Healthcare attractive for PE firms pursuing consolidation strategies.

The jump in average PE deal size was, in part, attributable to the return of more mega-deals in the U.S. in 2018. Capitalizing on affordable, "covenant-lite" debt, PE firms led four leveraged buyouts worth $10 billion or more in 2018 – the most announced since pre-financial crisis levels in 2007. "Covenant-lite" loans, which give borrowers greater financial and operational flexibility with respect to the purchased asset, have become the norm. In 2007, roughly 20% of financing deals were written with loose covenants; in 2018, close to 80% of all deal financing was covenant-lite.[6]

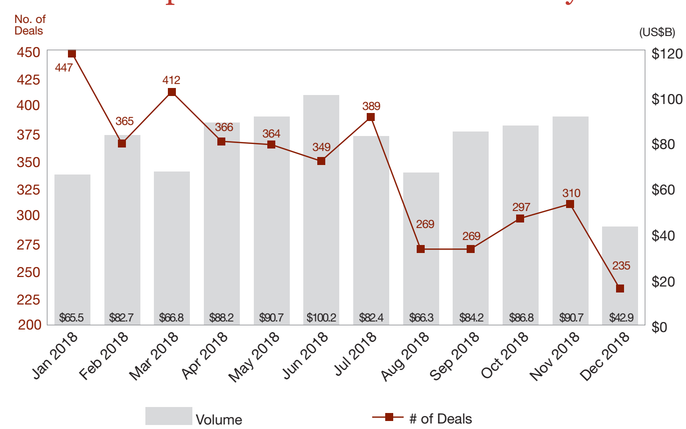
Regulatory developments may also be responsible for increasing the appeal of mega-buyouts. Clarification by Trump Administration officials that the Obama-era guidance limiting leveraged buyout debt to six times a company's EBITDA is not a strict cap provided banks with greater flexibility and discretion with respect to leveraged lending.[7] U.S. PE funds have capitalized on this favorable credit environment by more than doubling, from 6.0% in 2017 to 13.1% in 2018, the proportion of leveraged buyouts done with leverage of 7x or greater.[8]

U.S. Sponsor-Backed Exits by Dollar Volume



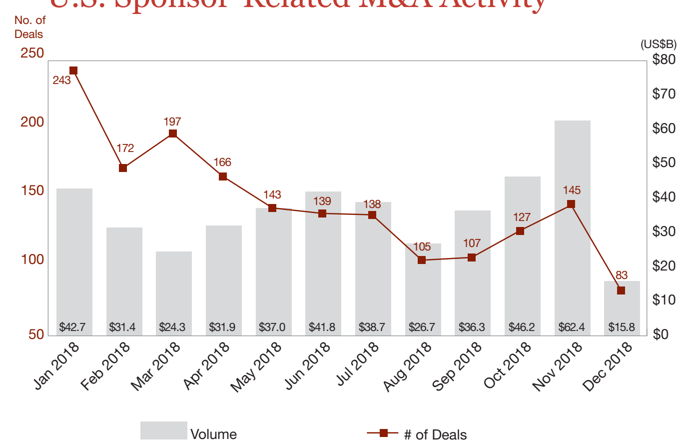
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Cortex

U.S. Sponsor-Related M&A Activity



Source: Cortex

Each metric in this publication that references deal volume by dollar value is calculated from the subset of the total number of deals that includes a disclosed deal value.

This robust credit market tightened at the end of 2018 as rising interest rates and market volatility weighed on high-yield demand. December 2018 was the first month since 2008 in which not a single company borrowed money through the U.S. high-yield corporate bond market.[9] Furthermore, there were several instances in 2018 where banks struggled to find investors to support highly leveraged buyouts.[10] These year-end credit market developments could cause problems for financing in 2019, and therefore negatively impact sponsor-backed M&A activity.

Observations for 2019

Fundraising

Despite the slowdown in fundraising from the record-breaking amounts raised in 2017, investors continue to show appetite for PE as an asset class. A recently released BlackRock survey of its global institutional clients found that 47% expect to increase allocations to PE in 2019, versus only 11% planning a decrease.[11] This is in part due to concerns about the economic cycle and a potential decline in equity values, which has created a greater desire for PE funds as representing uncorrelated sources of returns. Therefore, the fundraising outlook remains positive in the near-term.

We also observe that many of the established PE shops have been raising long-dated funds intended to last 15 years or longer. Several of the benefits derived from the long-term nature of such funds include triggering fewer taxable events, lower transaction costs and additional time to make return-maximizing operational improvements. Considered against the cons of less liquidity and key person risk, long-dated funds are expected to continue among the largest buyout shops because these firms' reputations and process-driven nature – as opposed to reliance on a handful of star managers – are likely to mitigate those downsides.[12]

Finally, we expect to see fund specialization strategies continue into 2019. Fueled by significant competition for buyout targets, fund managers are increasingly fundraising along regional and industry lines and forming multi-strategy, retail and other bespoke products. Selectively investing in targets exhibiting a narrow band of EBITDA, focusing on companies looking to expand to international markets and adopting regional strategies are all examples of such activity. This offers investors opportunities to invest with funds in very particular niches and allows managers to create focused products.

Deal Sourcing and Investment Strategies

Creative deal-making strategies are expected to continue into 2019 as $1.2 trillion in dry powder globally remains to be deployed, and the acquisition market remains competitive for the time being. Buy-and-build, add-on transactions and early stage investing (discussed in our prior article) are the types of investment strategies we expect to see. Further, secondary buyouts will likely continue to be popular into 2019.

An important factor will be whether further pullbacks occur in the stock market. All else being equal, this could make public-market valuations more palatable for buyers and weaken strategic buyer competition for assets. Moreover, this would make IPO exits tougher, potentially driving more firms into sale exits or forcing longer holding periods in hopes of multiple recovery.

Continued Appetite for Investment Management M&A

U.S. investment management M&A is expected to remain strong in 2019. The 2018 deal count of 210 and the $15.8 billion in dollar volume of activity were both all-time highs for U.S. investment management M&A.[13] Coming off a strong performance in 2018, we expect this trend to continue as managers seek new product offerings, broader geographic reach and cost savings, all in an effort to navigate an increasingly competitive environment. Finally, as the ownership base of asset managers ages and investors pull money from underperformers, managers may seek an exit from the business, which would further support U.S. investment management M&A activity in 2019.

Especially notable is the increase in GP stakes investing, which set an annual record in 2018 with 18 closed-end fund GP stakes deals, which is more than 2015, 2016 and 2017 combined. Recognized players in the space, such as Dyal, remain active. Yet, with new firms like AlpInvest Partners (an arm of The Carlyle Group), Landmark Partners, Aberdeen Asset Management and Magnetar Capital launching GP stakes strategies,[14] it is likely that this trend will continue into 2019.

Macroeconomic and Political Effects

General political uncertainty and changes to the global trading system, including new trade barriers, may continue to cause concerns for investors in 2019. U.S. tariffs now impact imports of steel and aluminum, and tariffs aimed at Chinese industrial goods are either already in effect or under consideration. Our trading partners have been retaliating with similar tactics.

PE funds tend not to like investing into an uncertain environment. However, changes to the global trading system may create new investment opportunities, either in the U.S. or internationally. Investments in companies that benefit from tariffs may be positively impacted and/or assets may become more realistically valued in companies facing risks from trade or other geopolitical instability.

Market instability in the second half of 2018 resulted in a slower year-end close to M&A activity generally. Further, the federal market shutdown has forced a slow start to 2019, as many deal-related governmental functions are shuttered. It remains to be seen whether 2019 U.S. M&A activity will break free from its year-end 2018 slowdown.

1 Unless stated otherwise, all referenced statistics in this issue were obtained from PitchBook.

2 Kevin Dowd, July 16, 2018, "The US PE fundraising correction has begun," PitchBook.

3 Corrie Driebusch, Maureen Farrell and Dave Michaels, January 9, 2019, "U.S. Government Shutdown Freezes IPO Market, Imperiling Expectations for 2019," *The Wall Street Journal*.

4 All statistics in this paragraph were sourced from Cortex.

5 All statistics in this paragraph were sourced from Dealogic.

6 Eric Platt and Mark Vandevelde, November 16, 2018, "Credit boom: Private equity bounces back on cheap debt bubble," *The Financial Times*.

7 Jonathan Schwarzberg, May 24, 2018, "OCC head says leveraged lending guidance needs no revisions," *Reuters*; Eleanor Duncan, February 27, 2018, "Banks can 'do what they want' in leveraged lending: Otting," *Reuters*.

8 LCD/S&P Global Market Intelligence.

9 Dealogic.

10 Eric Platt, Colby Smith and Joe Rennison, December 16, 2018, "US credit markets dry up as volatility rattles investors," *The Financial Times*.

11 BlackRock, January 7, 2019, "Global institutional investors shifting risks from public to private markets - BlackRock study."

12 Alex Lykken, June 18, 2018, "The pros & cons of long-dated funds," PitchBook.

13 Bloomberg.

14 James Gelfer, Jordan Beck, and Darren Klees, August 27, 2018, "How GP Stakes Investing Is Becoming Less Rare: A review of the uptick in GP stakes investing," PitchBook.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content.
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