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# US PE Breakdown

2017 Annual

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# Contents



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# Key takeaways from the analyst

- PE firms saw an 11% year-over-year (YoY) decrease in exit volume, with both exit value and volume falling below the 5-year average.
- PE firms closed on $232.7 billion across 247 funds during 2017. Capital continues to accrue to fewer yet larger funds, evidenced by the 8% YoY increase in committed capital despite a 15% decrease in volume.
- GPs are capitalizing on the current fundraising market; a full 75% of follow-on funds raised in 2017 were larger than their predecessors, as the median time between funds fell to 2.8 years.

**$538.2B**
US PE deal value
8.9% YoY

**10.5x**
2017 median
US M&A (including PE buyouts) multiple

**75%**
of follow-on funds in 2017 were larger than their predecessors

Nico Cordeiro, Analyst

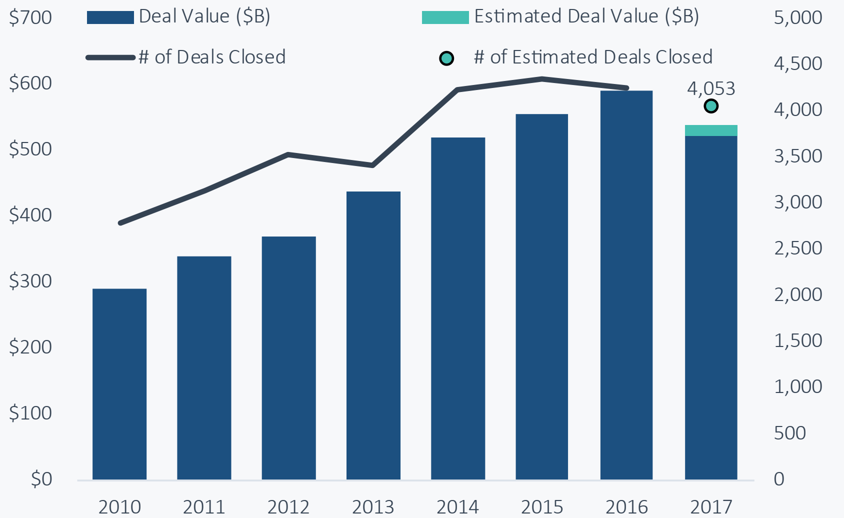
# Overview

## Past fundraising success is contributing to an even more competitive landscape

PE deal activity during 2017 was roughly on par with 2016, as dealmakers put $538.2 billion to work across 4,053 deals. After spiking in 3Q, deal activity decelerated in 4Q, which accounted for 24.6% of 2017 deal volume with 999 deals completed to close out the year. The flat activity year-to-year is surprising, as dry powder has continued to build as a result of the record-breaking fundraising environment we've seen over the last few years. Somewhat counterintuitively, this excess availability of capital may be hindering dealmaking. Our recent 2018 Crystal Ball Survey report found that the

### 2017 PE activity concluded at par with 2016

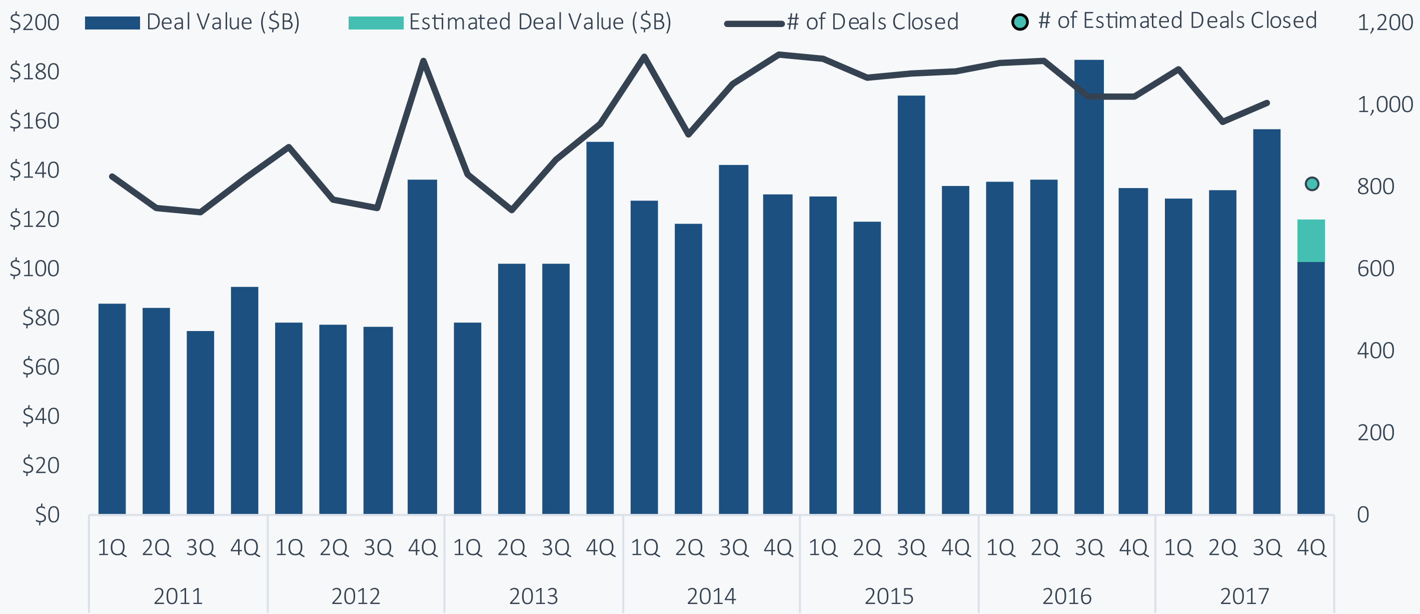
US PE activity




Source: PitchBook

# Activity slowly cycled down throughout 2017, culminating in a quieter 4Q

US PE activity



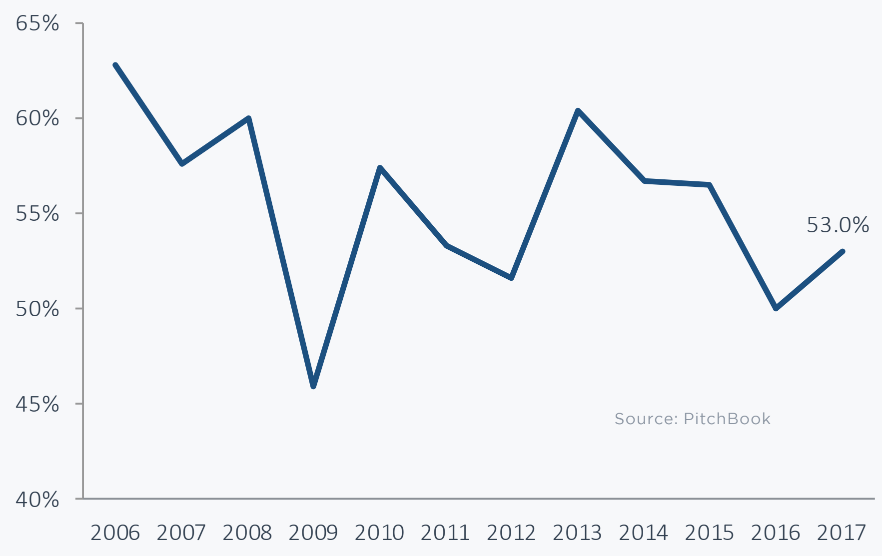

Source: PitchBook

two biggest concerns for dealmakers were the high-priced environment and the lack of quality targets—two factors influenced by competition. The ever-growing amount of dry-powder is certainly contributing to these concerns, as PE fund managers struggle to place a greater amount of capital to work.

These competitive pressures do not appear to be abating anytime soon. While no year has surpassed the amount of capital raised in 2007, recent annual US fundraising has consistently approached record levels, with at least $200 billion raised every year since 2014. Furthermore, a total of $648.4 billion was raised from 2015 through 2017, which is the most raised over any three-year period in our sample. Moreover, anecdotes

# Debt percentages climb, but remain within historical bounds

Median debt percentages in US PE buyouts




Source: PitchBook

from various LPs suggest that the fundraising trail is unlikely to lose steam in the near term. Given the broad-based strength in fundraising, the median fund size climbed from $225.0 million in 2016 to $292.5 million in 2017—another record high in the database.

Despite growing fund sizes, the proportion of deals in various size buckets remains relatively unchanged, with 89% of deal volume in the sub-$500 million deal range. However, the competitive nature of the private markets kept acquisition multiples elevated, with a median EV/EBITDA multiple of 10.5x. While median acquisition multiples remained unchanged from 2016, dealmakers used higher levels of leverage, with the median debt percentage in overall M&A climbing from 50% to 54.3%. These higher proportions of debt usage are not unprecedented, however, as debt usage in 2017 is in line with the 10-year average debt percentage of 55%. That said, the median debt/EBITDA multiple climbed from 5.2x to 5.7x, which is the highest debt/EBITDA multiple recorded in the dataset.

Elevated valuations have done little to deter PE acquisitions; the number of US PE-backed companies continued to climb in 2017, reaching a total of 7,250. Not only is the company inventory (PE-sponsored companies excluding add-ons) growing, but the companies that comprise it are getting older. As of 2017, 34% of PE-sponsored companies were acquired more than five years ago. We continue to find it surprising that more long-held portfolio companies have not been exited given favorable market conditions, but this seems likely to change. A previous build-up in aging inventory, which peaked in 2013, was followed by a boom in exit activity that coincided with the record-setting M&A years between 2014 and 2015.

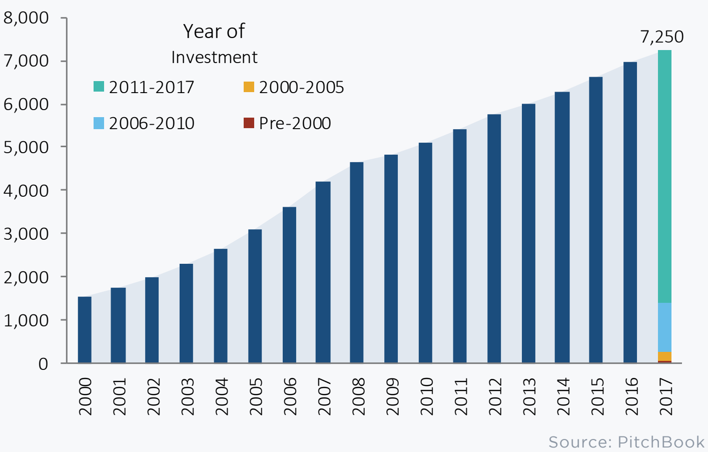
### The highest yet recorded

**5.7x**

median debt/EBITDA multiple

## As inventory ages, does it portend more exits?

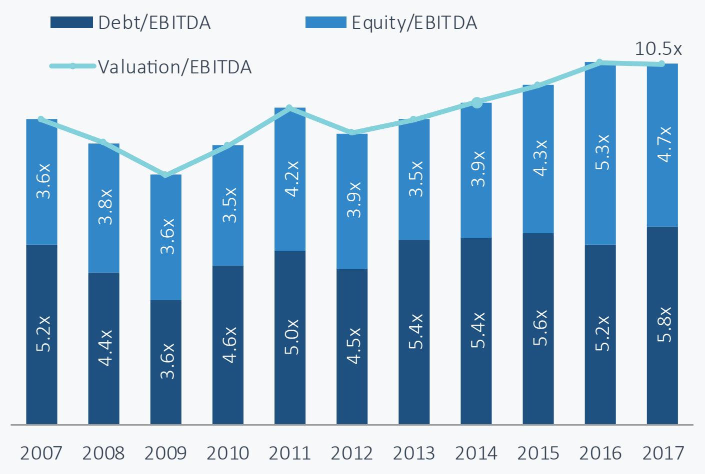
US PE-backed company inventory




Source: PitchBook

## Multiples persist at elevated levels

US M&A (including PE buyouts) multiples

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# Merrill Q&A: 2018 PE Outlook


## Dan Hostetter
## Global Head of Strategic Advisors
## Merrill Corporation


*Dan Hostetter is Global Head of Strategic Advisor Accounts at Merrill Corporation, responsible for leading the company's private equity accounts team. Dan successfully founded and grew Merrill's European and Asia business, and is a trusted SaaS-based transaction services advisor to financial professionals throughout the M&A and capital markets industry. His worldwide network and 23 years of deep M&A and Capital Markets expertise provides a unique outlook on today's market.*

**1. What does the PE pipeline look like for next year?**

Generally, very robust. There is a lot of activity across all sectors including both traditional auction processes and one to one situations with PE firms very active on the buy side and the sell side.. We've been out talking to clients about our new dataroom platform for PE and M&A deals, and they're signing up because it lets them manage exits and acquisitions from the same place. That kind of fast adoption is a strong indicator PE is getting ready for an action-packed year, and the advisor community is busier than ever.

**2. What are hot PE sectors or trends?**

Technology has been very hot recently, and software M&A continues to be particularly strong. Vista Equity Partners closed an $11 billion buyout fund last year just focused on software, for example. We're also really seeing PE firms jump on the bandwagon of chasing 'disruptive technologies', as PE loves anything that will upset mainstream sectors. As we've seen oil prices edge up closer to $70, that's brought lots of PE buyers into the energy space.

**3. Any headwinds?**

One of the biggest issues is the disconnect between buyers and sellers on price. Because asset prices are high, private equity buyers need to be more careful about picking the right companies that will continue to grow through any potential market downturns. While this disconnect has slowed down some processes, deals continue to close at a steady rate as buyers have a lot of capital to put to work.

**4. How are PE fund managers tackling high deal prices?**

Many firms are focusing on opportunities where they can do "add-on" transactions to scale their businesses. Some are focusing on niche segments in more fragmented markets, or trying to bargain shop in more obscure sectors. The fact of the matter is high price tags can't be avoided these days, so the question becomes one of relative value.

**5. What else is on PE managers' minds?**

One key issue is cybersecurity. Potentially leaking sensitive data remains a huge concern, and a big reason why PE firms are talking to us about using our new platform not just for M&A transactions but ongoing file storage and sharing. In general, PE firms are investing heavily in cybersecurity best practices and technologies. It's really top of mind for them and their legal counsel.

**6. How else do PE firms differentiate themselves in such a crowded environment?**

Operating partners will become even more of a differentiating factor than they have in the past, as dealmakers source acquisitions from increasingly niche areas in terms of both size and sector. There will be auctions where one team's expertise may help it win over other buyers who don't have the same depth of sector-specific knowledge.

**7. How do PE fund managers mitigate LPs' concerns about high valuations' impact on ROI?**

For some time now, there's been concern around whether the robust returns enjoyed by PE funds in the past will be as easily achievable or even replicable given recent high valuations. While investors can see returns are not at historic levels, they may have concluded that returns are still strong and compare favorably to other asset classes.

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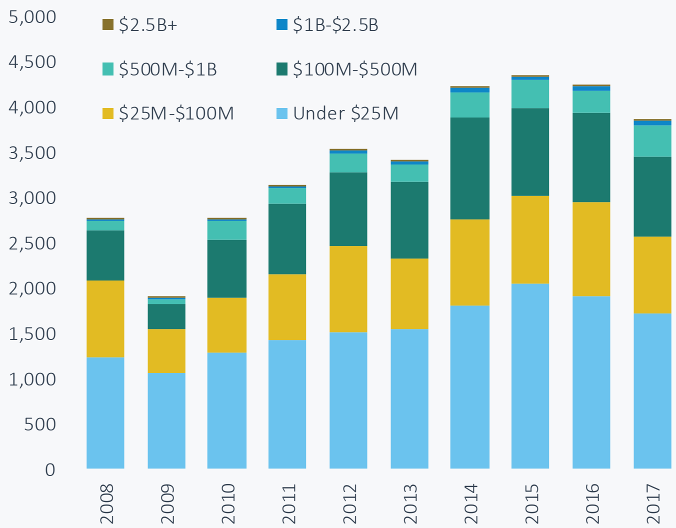
# Deals by Sector & Size

## Size trends hold steady

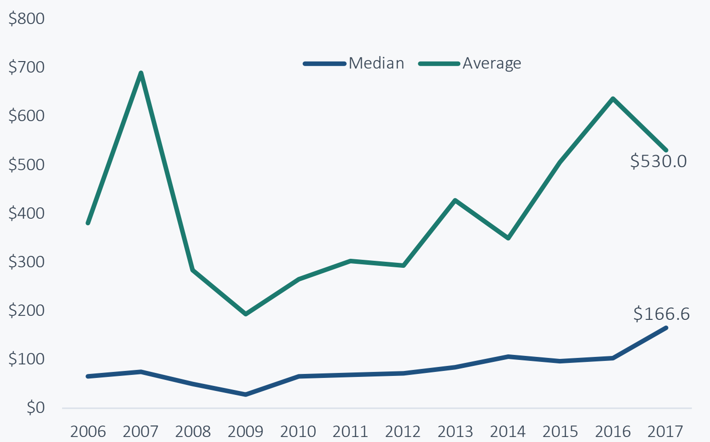
US PE activity (#) by size




Source: PitchBook

## Deal sizes remain elevated

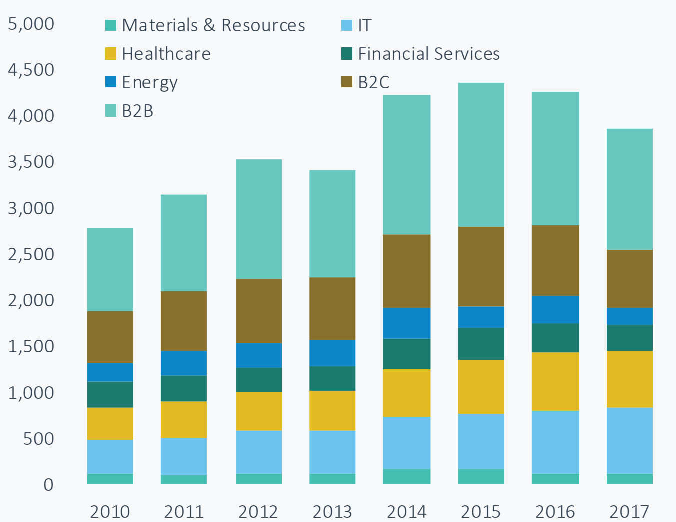
Median buyout size ($M) in US




Source: PitchBook

## Tech is en vogue

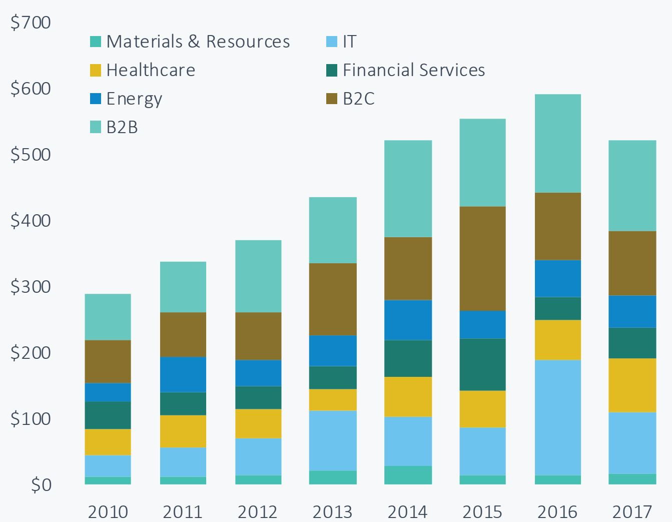
US PE activity (#) by sector




Source: PitchBook

## B2B & IT predominate

US PE activity ($) by sector

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# Spotlight

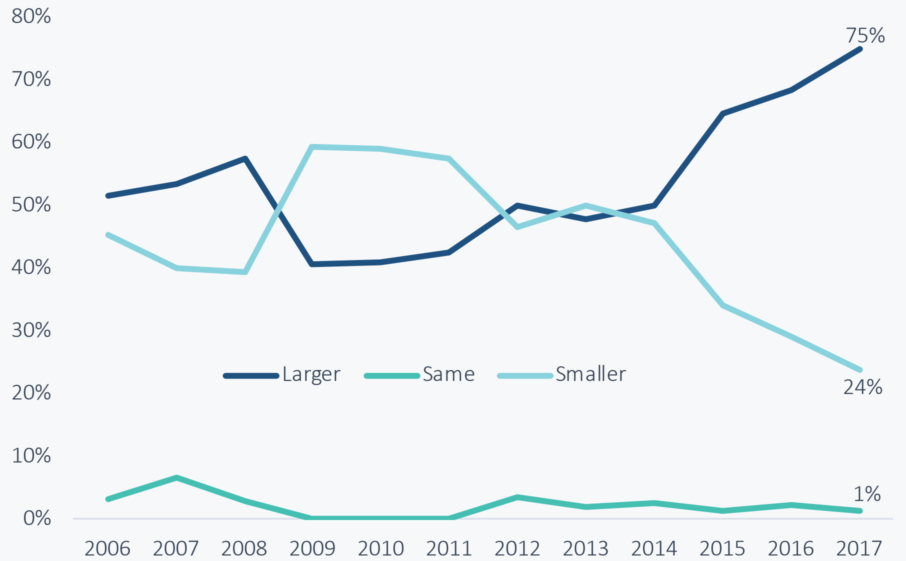
## Fund managers are hitting the trail again while conditions remain prime

As LPs search for yield in a low-growth environment, PE firms are pressing their advantage when launching new funds, as a full 75% of follow-on funds raised by GPs in 2017 were larger than their predecessor. Presumably, a firm raising a follow-on fund was successful with their first fund, enabling the firm to raise more capital; however, the quickness with which PE firms are raising follow-on funds means that LPs making commitments must deal with significant uncertainty surrounding the performance of the prior fund. To that end, the median time between funds has fallen from a high of 4.3 years in 2012 to 2.8 years in 2017.

Following the last financial crisis, PE firms were much more likely to raise a smaller follow-on fund. But that trend began reversing in 2014, coinciding with the fundraising boom that began around that timeframe. While deal flow in this competitive environment is a primary concern for PE investors, that hasn't stopped GPs from raising additional capital. While it is difficult to know the exact effect these trends will have on returns, LPs are certainly unable to evaluate the success of previous funds before re-investing in a GP with such a short timeline.

### Funds are raising not only more capital, but also closing faster

US PE follow-on fund size compared to predecessor




Source: PitchBook

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# Exits

## Secondary buyouts to become more the norm

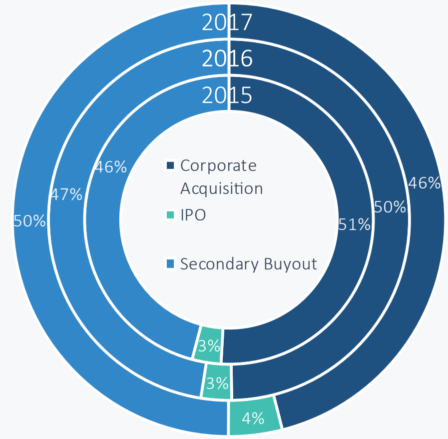
PE firms saw an 11% YoY decrease in exit volume, with exit value and volume falling below both five-year averages for the first time since at least 2010. A total of $184.8 billion in value was realized over 1,097 exits during 2017. The technology sector saw a 2% increase in exit volume and is the only sector that did not seen a decline in exit volume, with all other sectors trailing their five-year average in exit activity.

The downward trend in exits is largely driven by a strong pullback in strategic activity, with $95.45 billion in exit value across 505 strategic acquisitions of US-based portfolio companies in 2017. While exit value via strategic acquisition remains above pre-crisis levels, it fell below both the five- and 10-year averages in 2017, which saw the lowest amount of strategic activity since 2011. Despite several corporate mega-deals, which represented much of the industry commentary in 2017, it was secondary buyouts (SBOs) that drove the median exit size to a new all-time high of $221.5 million.

As discussed last quarter, SBOs, in which a PE-backed company is sold to another PE fund, are becoming the go-to exit option for PE firms in the middle-market. PE firms exited $77.6 billion of value through 548 SBOs in 2017, with a median exit size of $400 million. As the saturation of PE-sponsorship grows in the US, it is likely PE-to-PE transactions will become more of an industry norm as firms look for both liquidity and deal flow in the current market environment.

### The primary decline in exits is due to diminishing M&A

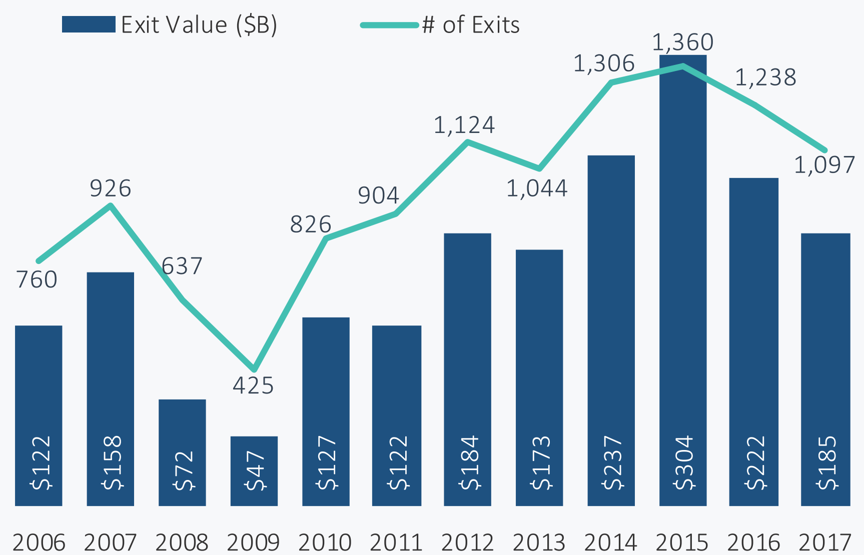
US PE-backed exits (#) by type




Source: PitchBook

### Exits decline below long-term trends

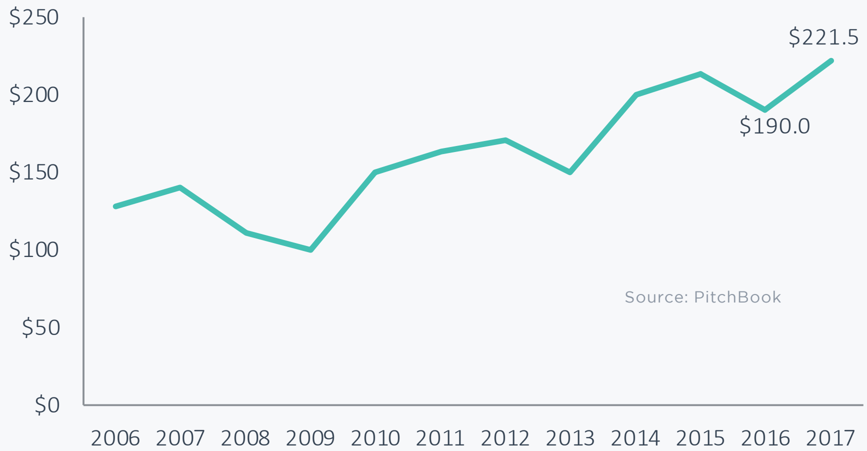
US PE-backed exits




Source: PitchBook

## A new all-time high

Median US PE-backed exit size ($M)




**Exits have been falling across all sectors save tech:**

**2%**

increase in exit volume of PE-held technology portfolio companies

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# Three Valuation Considerations for GPs Seeking Outside Capital

***As alternative fund managers institutionalize their business and processes, many are seeking minority-stake investments***


## Daniel DiDomenico III
## Senior Managing Director
## Murray Devine


*Dan DiDomenico, a Senior Managing Director, joined Murray Devine in 1995 and his responsibilities include the day-to-day management of valuation and financial opinion engagements. Prior to joining Murray Devine, Dan was a Senior Financial and Operations Auditor with United Technologies Corporation, and was also a member of the internal audit staffs of Bethlehem Steel Corporation and Foster Wheeler Corporation. Dan received a Bachelor of Science degree in Business Administration and a Masters in Business Administration from Drexel University's Bennett S. LeBow School of Business. Dan is also a Certified Public Accountant (CPA) with an Accreditation in Business Valuation (ABV) and holds the designation of Chartered Financial Analyst (CFA).*

When investment pros look back at 2017, many will probably recognize it as a defining year for PE. As PE deal multiples reached unprecedented heights, no longer is it enough for sponsors to rely purely on leverage and multiple expansion to generate returns. Rather, the ongoing maturation of the asset class is driving GPs to institutionalize both their business and processes. And it's against this backdrop that several top names have either already taken on outside capital or are considering minority investments that can position their business for this evolving era.

Over the past 18 months, middle-market stalwarts such as Riverside Company, Arclight Capital, TSG Consumer Partners and several others have each sold minority stakes in their respective management companies. In the case of Riverside, for instance, the investment seemed to coincide with the strategic expansion of the firm's product set into complementary strategies such as non-control capital. For Arclight, the investment reportedly was not only to fund future growth, but also helped to effect a succession plan in which certain founders monetized their ownership interests. Others, meanwhile, have used these transactions to fund executive distributions, which can ease the burden for junior partners to commit to new funds.

What many fund managers are discovering, however, is that selling a stake in their partnership can be far more challenging than merely exiting a portfolio company. For one, these transactions have ramifications that can be felt throughout the partnership for years to come, potentially influencing future fundraising efforts, recruiting and succession planning and, often, the overall direction of the firm as smaller partnerships evolve into larger institutions with hardened processes and protocols. The other challenge is that while these deals are becoming more popular, each one often differs in scope and objective. But given the growing propensity of these transactions, we've outlined three considerations around valuation for GPs considering such a transaction.

**Consideration One: A Market-based Approach**

In traditional M&A, the process of finding relevant comparables is fairly cut and dried. For alternative fund managers, though, not only are relevant comps few and far between, but the valuations can fluctuate based on several variables. The forward P/E ratios of several publicly held alternative managers, for instance, range from approximately 8x estimated earnings to more than 12x. This reflects the incongruities that exist between even the largest and most diversified firms. But when one considers the illiquidity discount for private partnerships and, then, the differences in the maturity, scale and investment strategies of most mid-market firms, it becomes that much harder to reach a consensus around an agreed-upon multiple.

**Consideration Two: The Income Approach**

Given the challenges of finding apples-to-apples comps, most management company valuations will apply an income approach to assess fee-related earnings that are then used to support a sum-of-the-parts valuation. In this scenario, cash flows are adjusted for systematic or market risk, using discount rates determined via pricing models (such as CAPM). This provides an anticipated rate of return for traditional management fee income streams. Evaluations around carry, however, remain quite subjective since it is contingent on the performance and exit timing of the underlying portfolio companies. Discount rates applied to these performance-related earnings, as a result, tend to be higher based on several factors ranging from the target rates of return identified in LP offering documents to industry benchmarks that factor in the size, focus-area and vintage year of the funds.

**Consideration Three: Understanding How the Objective Informs the Valuation**

In most cases, the minority stakes being acquired are non-voting, passively held positions. But whether the investment is premised on seeding new strategies to grow the business or designed to effect a possible succession plan, the investments can draw scrutiny from existing and prospective LPs. Within the partnership these deals can also be a source of internal dissension if the economics of the partnership change significantly. Junior partners, for instance, will want to understand the extent to which the investments dilute future carry. While these questions can be easy to resolve, the sensitivities often influence the deal terms and, ultimately, the price.

In light of the industry's ongoing maturation, it's likely that 2018 will only see more GPs pursue these types of transactions. Indeed, the recent activity would suggest that it is a sellers' market, particularly as portfolios further strengthen, AUM growth accelerates, and as demand from institutional investors percolates. But whatever the goal, the scrutiny these deals often receive underscores the need for experienced and objective oversight to realize both the existing and future value of the partnership and ensure the firm is positioned well for the evolving landscape.

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# Fundraising

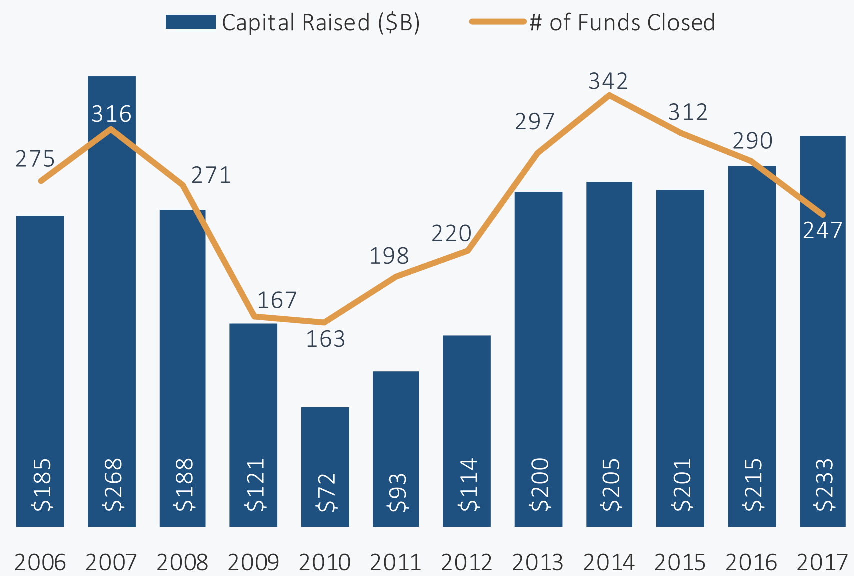
## Consolidation among LPs in mega-funds

PE firms closed on $232.7 billion in capital commitments across 247 funds during 2017. Capital continues to accrue to fewer yet larger funds, evident in the 8% year-over-year (YoY) increase in committed capital despite a 15% decrease in the number of funds over the same period. The proportion of funds under $100 million in committed capital fell to 25%, which is well below both the 5- and 10-year averages of 33%. This is in line with industry commentary surrounding some LPs' desire to consolidate around fewer and more-established GPs in order to negotiate a better fee structure, gain access to co-investment opportunities, and reduce the due diligence costs of managing a large number of fund managers.

The unfortunate second-order effect of saving money by consolidating to fewer, larger funds is that these larger vehicles are less likely to deliver top-quartile returns. In previous research, we found that sub-$100 million funds outperformed all other fund-size buckets by a wide margin, with a median IRR of 32.3%.

## Capital accrued increases 8% YoY even as volume drops 15%

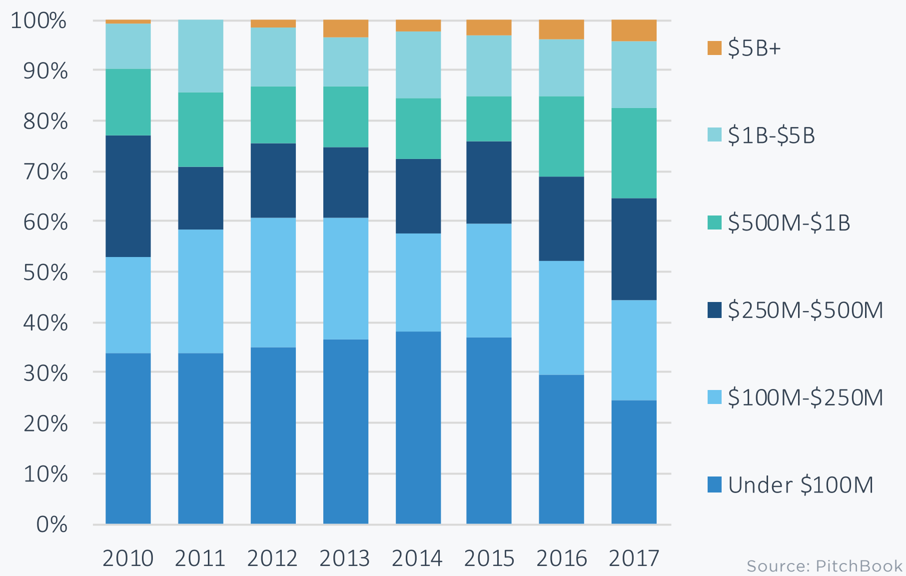
US PE fundraising




Source: PitchBook

### Mega-funds primarily drive aggregate commitments

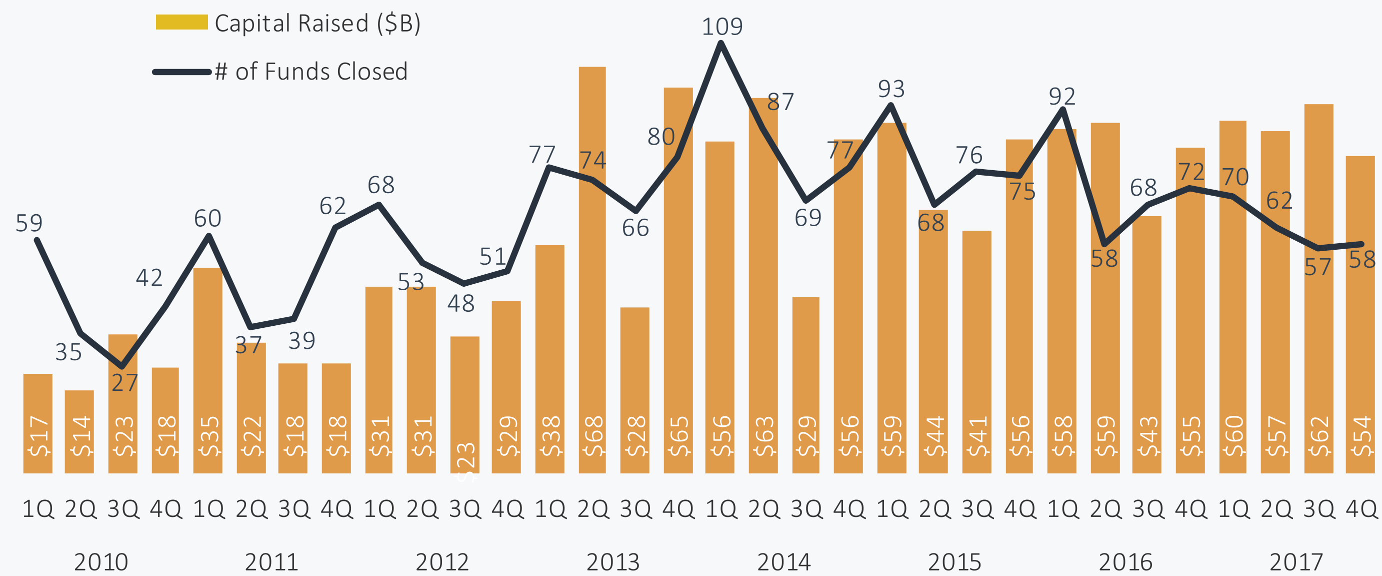
US PE fundraising (#) by size




Source: PitchBook

# 2017 was robust in terms of capital raised, yet the back half of the year saw lowest total in years

US PE fundraising

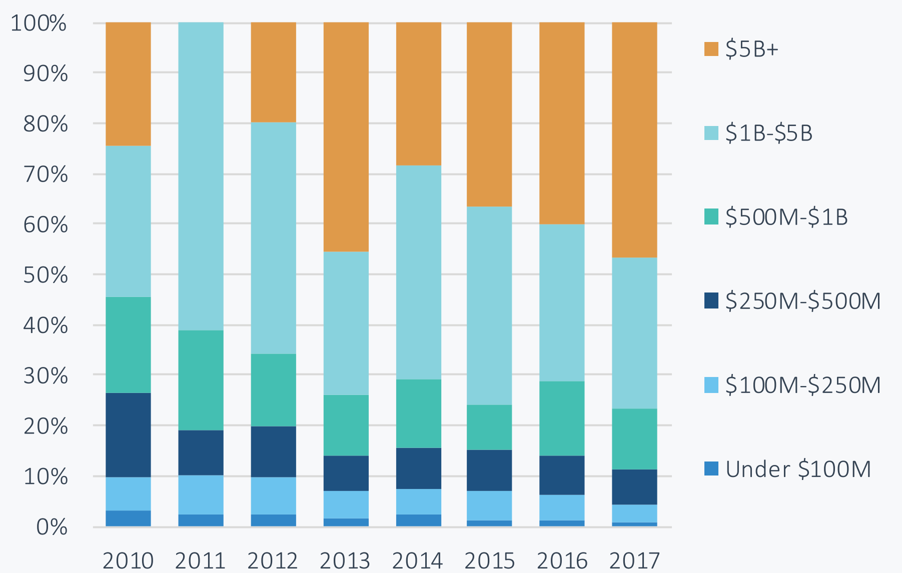



Source: PitchBook

Of course, the dispersion of returns for smaller funds are certainly higher as well, driven by a variety of factors at the operational level. While the ability to effectively allocate relatively small sums of capital will vary depending on the LPs' unique situation, LPs who consolidate their commitments generally should expect lower returns relative to historical performance, albeit with less variance.

## Capital flows are becoming increasingly concentrated

US PE fundraising ($) by size




Source: PitchBook