PAVILION

PRIVATE EQUITY OUTLOOK FOR 2016

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Overview

Our philosophy and approach to private equity investing, which has been consistent over the last decade, is rooted in developing a highly selective portfolio diversified by investment stage, type, vintage year and geography. While we place a significant amount of importance on diversification, we believe manager selection should be the primary focus as each sub-strategy will have managers with demonstrated ability to generate value across multiple economic cycles.

With that approach in mind, we find it is useful to look back at the prior year's market trends to identify potential opportunities and assess potential risks that may be on the horizon. Given the longer term and illiquid nature of private equity, it is difficult to react quickly and capitalize on temporary market dislocations, so our outlook is focused more on longer-term issues and structural market changes.

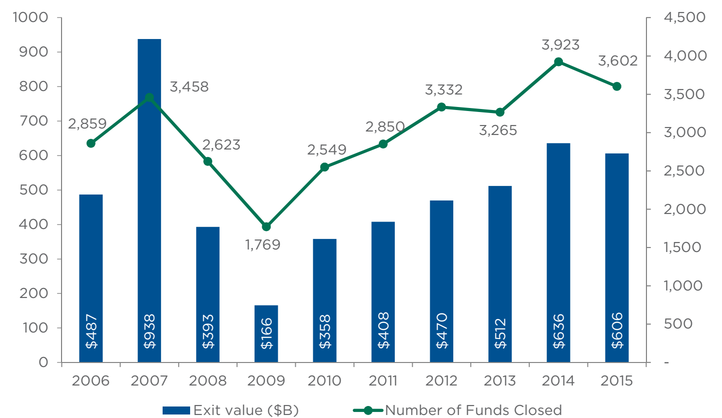
Broad Market Dynamics

When trying to assess the private equity market, always be conscious of what is happening in the capital markets, broadly, as these forces help create the opportunities for investment, impact holding periods and drive the liquidation process. High levels of volatility in the public markets can cause uncertainty, which drives buyers and sellers to different sides of the playing field. Tight credit markets can limit the ability of firms to borrow the money needed to fund leveraged buyouts. Lower valuations can restrict the desire of business owners to sell. On the flip side, these forces also can drive businesses into the arms of private equity owners when other capital sources disappear as the need for liquidity increases, or when slowing growth drives the need for restructuring or asset sales.

Investment Activity

While U.S. private equity activity marched steadily upward from 2009 through 2014, that trend appears to have reversed with a decline in both the number of deals and total transaction value in 2015.

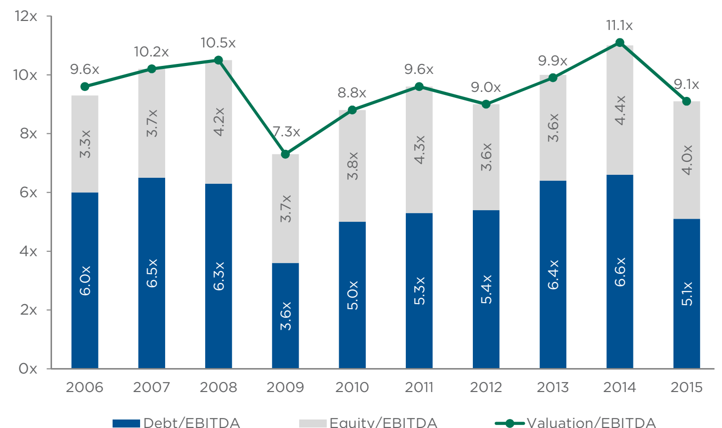
U.S. Private Equity activity by year



However, it is important to look at the longer-term trends, which show that while 2015 slowed relative to 2014, it remains the third highest level of activity in the last decade.

Average purchase multiples also declined significantly in 2015 from 11.1x to 9.1x, which is more in line with the levels seen in 2010 to 2012. However, be cautious in drawing conclusions as a portion of the multiple compression relates to plunging values in the Energy sector. Through our client portfolios, we have seen continued high purchase (and exit) multiples across a broad range of sectors, particularly in Information Technology and Healthcare.

Median EBITDA multiples for U.S. buyouts



Leverage multiples also have declined, contributing to the decline in overall purchase multiples, due to a number of factors including increased scrutiny on leveraged loans by financial regulators and a massive decline in high yield market activity in the second half of 2015.

Exit Activity

Not surprisingly, the robust pace of investment from private equity firms over the last five years has driven a similar increase in private equity exits over the same time period.

U.S. Private Equity exits by year

Adding to this trend was the backlog of deals executed in 2006, 2007 and early 2008 that suffered through extended holding periods. Many of these deals were "left for dead" in 2009 and 2010, but have since recovered and were exited to return invested capital or a profit in some cases.

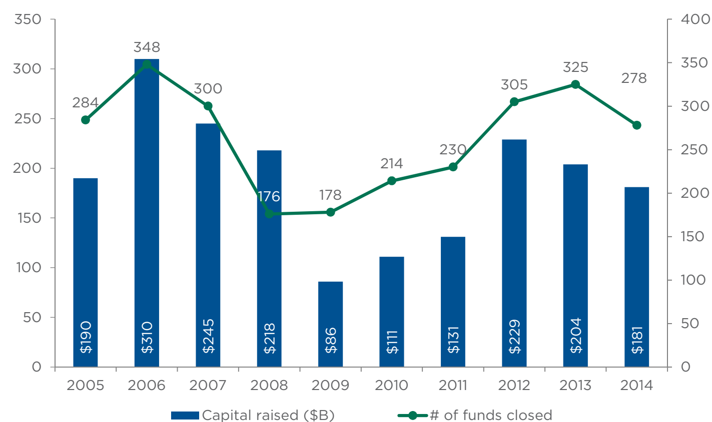
Given the volatility in the equity and high yield markets from the end of 2015 through early 2016, we expect the pace of exits to decline in the near term. However, with tremendous uncertainty around a potential U.S. recession, instability in Europe and the upcoming Presidential election, the annual figures for 2016 may be comparable to 2015 as managers look to de-risk their portfolios.

Because of their structure, private equity firms will continue to buy and sell assets at a regular pace over time as they seek to deploy the capital raised from investors. They will attempt to optimize these decisions by doing so at the most opportune times. The market can influence investment pace on the buy side as private companies may not be for sale.

Fundraising and Capital Flows

The private equity market has seen strong tailwinds over the last five years with regard to capital flows driven by the significant recovery in overall asset levels, an increase in private equity target allocations as a percentage of total assets and increased distributions flowing back to investors. As a result, approximately 52% of limited partners are below their private equity allocation targets according to a recent survey from Preqin[1].

U.S. Private Equity fundraising by year



However, at the same time that investors have an increasing amount of capital deploy, the amount of capital raised by private equity funds has declined over the last several years.

The result is that manager selection and access have become more difficult for investors seeking to deploy capital into private equity. We have not only seen this trend first hand in working with our clients, but also it has been seen across the market. Pitchbook reported that the period from launch to final close reached its shortest span since 2008 at 15 months and 88% of funds hit their fundraising targets, the highest ratio in a decade.

Opportunities

As we look forward into 2016, opportunities we see across the market are summarized below.

Venture Capital / Growth Equity

Depending on the nature of the client, we have tended to be highly selective regarding venture capital as returns in this sub-asset class are driven by a small number of top performing groups that may not accept capital from new limited partners or may be too small to accommodate commitments at scale. Given that venture capital tends to be more cyclical than other asset classes, we recommend investors focus on funds that have more of a multi-stage approach and / or the ability to invest across different sectors in order to provide the flexibility needed to adapt to a changing valuation environment.

We have found that growth equity serves as a good substitute for large investors unable to deploy sizeable capital or investors concerned about the risk of venture capital, as it tends to generate strong absolute returns with a lower level of volatility.

1 - Preqin Investor Interviews, June 2015

Buyout

With regard to buyout, investors can commit to a range of groups that have different strategies and target different segments of the market such as traditional buyouts, turnaround / restructuring and distressed for control. Within these categories, we prefer having groups that target the small, middle and large ends of the market along with different levels of industry focus ranging from generalist firms that cover multiple industries to specialist firms that focus on one or two sectors such as IT, Healthcare, Consumer (staples and discretionary), Financial Services or Energy.

This approach should be employed on a concentrated basis, meaning that clients should focus their commitments on those managers they view as the strongest in the market rather than over-diversify a portfolio, which can lead to median returns. This approach also will result in a portfolio where the managers can capitalize on opportunities in a variety of economic and capital markets environments.

Credit / Secondaries

The opportunities available to investors in private equity have evolved significantly over the last decade, particularly in areas we consider in our "special situations" category such as credit and secondaries. This area used to be mainly focused on mezzanine and non-control distressed debt opportunities and thus had a lower weight in many investors' portfolios given the relatively lower returns. However, we have observed increased allocations more recently with the advent of additional credit products, including opportunistic credit, rescue financing, direct lending and a wider range of secondary fund opportunities. In the current market, we are seeing increased interest in distressed debt opportunities as the downturn in energy spreads into other sectors.

With regards to secondaries, while nominal pricing as a percent of NAV fluctuates, the net returns on secondary funds tend to cluster tightly around net multiples of 1.4x to 1.6x and net IRRs 18% to 20%, making them appealing across a broad range of market environments. These special situation opportunities likely would be made earlier in the portfolio's life as they tend to have a shorter term, accelerated drawn down pace and return capital more quickly than other strategies. Thus, they will mitigate the "J-Curve" and drive more efficient capital management. These strategies also work well in an established portfolio for those investors seeking higher yield.

Energy

Within both the buyout and special situations categories, we see interesting opportunities in the energy space given the rapid decline in commodity prices. Opportunities exist to invest in existing companies or in backing management teams in businesses whose models are better suited to a lower commodity price environment, as well as in capitalizing on the distress of companies whose capital structure or business model is being challenged by the current environment.

However, investors should exercise patience in the space as commodity prices may continue to fall and remain low for an extended period of time and the most attractive distressed opportunities may be another six to 12 months out. However, timing the bottom of the current commodity price cycle should not keep an investor from investing in a high quality manager currently in the market.

Geographies

North America is the largest and deepest private equity market and thus affords the most opportunities to invest capital across all subcategories. Europe is fairly developed and generally has a similar return profile as North America, but tends to be more concentrated around buyout opportunities.

Asia and Emerging Markets offer interesting opportunities in buyout and growth equity, but proceed with caution as these markets tend to be more volatile and the overall industry is not as mature as the more developed markets. As a result, investors may want to focus on more established managers who have invested over one or two cycles in these regions versus newer, less proven managers.

When investing internationally, investors should consider the impact of currency fluctuations in their analysis of a manager's track record as well as the expected movements over the life of the fund under consideration.

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