BUYOUTS

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In the U.S. buyout market, median EBITDA multiples remain high even though there has been a notable decrease in deal flow. Additionally, the exit market has been slowing even faster than the deal flow market. Despite this, institutional investors continue to be very interested in private equity and, as a result, fundraising remains strong. A major challenge for U.S. buyout fund managers in 2018 will be deploying the abundant capital that they have raised over the past several years without putting additional upward pressure on purchase multiples.

Despite strong public equity markets in 2017, there was a decrease in buyout deal flow compared to the prior three years, with dollar deal flow being reported as $373 billion through the first three quarters of 2017, the lowest amount over the same time period since 2013. In this environment of higher valuation multiples and increased private capital, fund managers have become more cautious with how they deploy capital. Unlike 2005 to 2007, most fund managers are not in a hurry to invest their most recent fund and are using more of the funds' investment period. In 2005 to 2007, there was an increased investment pace, particularly among the larger buyout firms, which then required fund managers to raise their next fund sooner, usually at a larger size. When looking more closely at recent deal flow, there is also less capital flowing to larger deals, defined as those deals valued at more than $2.5 billion. Larger deals received $65 billion through the first three quarters of 2017 compared to $132 billion in all of 2015, and $177 billion in all of 2016. In addition, more capital is going to add-on acquisitions, which are typically smaller companies. Pitchbook reported 64% of U.S.-based activity in 2017 is estimated in add-on acquisitions. This is not surprising given the environment, since the smaller part of the market can be less efficient with lower valuation multiples, less competition, and the potential to add value to larger portfolio holdings by adding a new product, entering a new market, or creating efficiencies internally. By sector, investments in technology have remained strong, driven by private equity managers that have raised larger funds focused on the sector. Two of the largest five funds raised in 2017 are focused on technology (Silver Lake and Vista Equity).

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Similar to private equity deal flow, private equity exit activity has declined to approximately $130 billion through the first three quarters of 2017, which is lower than the three previous years over the same time frame. The decline appears to be driven by a decrease in strategic acquisitions by corporations. In 2017, corporate acquisitions were 46% of exits compared to 50% of exits which were private equity fund to fund transactions; the lowest and highest percentages, respectively, ever recorded in Pitchbook's data set. Although IPO activity increased at the beginning of 2017, this mode of exit is still not a sizeable portion of the market and remains below historic averages. In addition to the dollar amount, the number of exits declined to 755 from 898 through the first three quarters in 2016, resulting in longer average hold periods for investments in funds. Pitchbook reported 38% of private equity-backed companies have hold periods longer than five years, which is the highest percentage recorded in the data set. As a result of longer hold periods, some (or many) fund managers are having to negotiate fund extensions with limited partners. In some cases, fund managers are pursuing restructurings to give limited partners an opportunity to liquidate and, thus, the fund managers a longer runway to continue to hold investments.

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Interest in private equity remains strong as shown by the robust fundraising environment. Approximately $178 billion was raised through the first three quarters of 2017, which is $19 billion greater than 2016 over the same period and larger than any comparable period over the last five years. 2017 saw the largest buyout fund ever raised, with Apollo Global Management closing on $24.7 billion. Large funds continue to capture a high percentage of the capital raised, with funds of at least $5 billion accounting for 54% of all capital raised. The strong fundraising environment has created some challenges for limited partners. Funds raised by high-demand fund managers tend to be in the market for a short period of time. The accelerated schedule precludes extended due diligence and requires limited partners to be more proactive before a fund is officially in the market. In addition, obtaining sizeable allocations to high-demand managers can be difficult as many limited partners are being cut back in oversubscribed funds.

As previously mentioned, EBITDA multiples have remained high in 2017 with a median multiple of 10.5x, similar to 2016. Several surveys have cited high asset prices as the biggest challenge facing private equity fund managers in the coming years. In this environment, many fund managers are underwriting lower exit multiples for new investments, which is putting more emphasis on increasing EBITDA. This can be done through traditional methods such as add-on acquisitions or expanding into new markets. There has also been an increased focus on operational improvements among many buyout firms. Many fund managers have added operational resources to assist with increasing EBITDA, thereby making them less reliant on multiple expansion to generate returns. While this added dimension has the potential to improve returns, it may, in turn, require limited partners to increase the level of their due diligence efforts so that they can fully evaluate these transformative strategies.

Unless otherwise cited, all market information provided by Pitchbook.

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