PitchBook

# U.S. PE BREAKDOWN

1Q 2016

IN PARTNERSHIP WITH

## 1Q 2016 SEES 23% DECLINE IN ACTIVITY FROM 4Q

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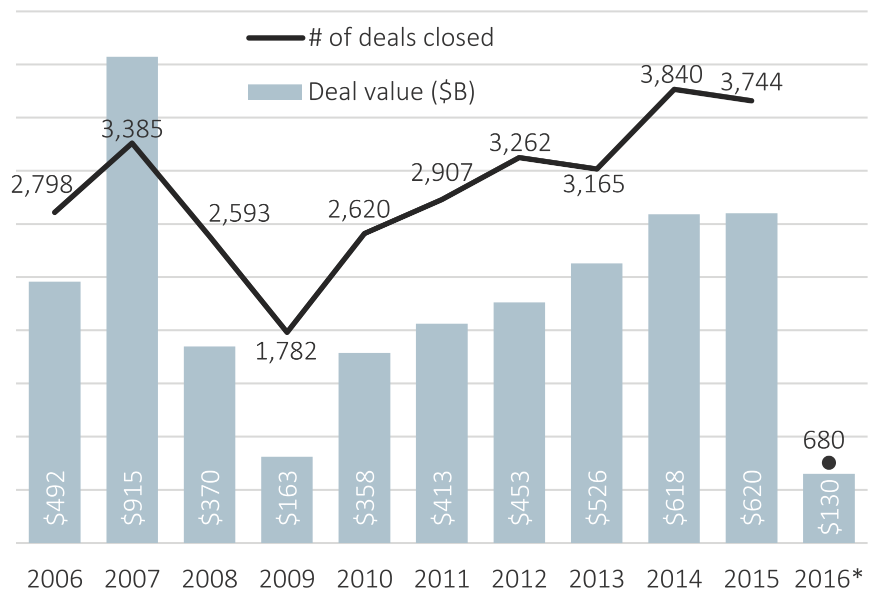
# 1Q activity remains subdued

## Overview

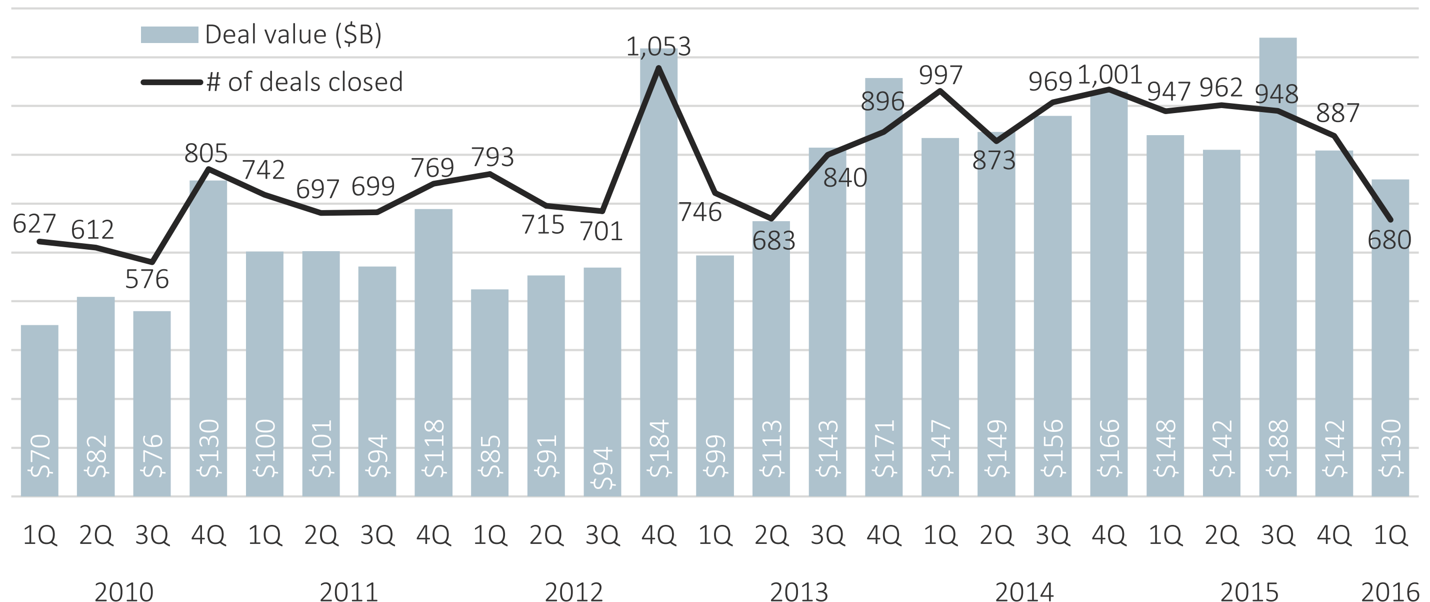
After seeing PE deal activity endure an inflection point and trend lower in 2015, activity in 2016 to date has experienced quite the hangover. The first quarter of the year saw $130 billion invested across 680 transactions, representing quarterly declines of 8.4% and 23.3%, respectively. On a yearly basis, 1Q deal value was down just over 12% with counts down more than 28%. Retrospectively, we saw the macro clearly move lower in 2H 2015, yet gauging where the U.S. and global economy will go in 2016 has become a rather impossible task. The S&P 500 index began the year in the red before rebounding some 11% since February. The U.S. dollar, which has served as a headwind for companies selling outside of the U.S. due to its increasing strength, recently declined against a basket of currencies, highlighted by the 5% YTD decline we've seen in the DXY index. Interestingly, however, U.S. treasury bonds have continued to receive significant capital flows, with yields on the 10-year declining from over 2.2% to around 1.7% thus far in 2016. Further, noninvestment-grade corporate debt rebounded a bit last quarter. In a positive light, the rebound in high-yield debt has incentivized some buyers to re-enter the market, subsequently lowering the required

**2016 off to slow start**
U.S PE activity




Source: PitchBook
*As of 3/31/2016

**Volume continues to leg lower**
U.S. PE activity by quarter




Source: PitchBook

yield of new issuances, which can open up a window for PE to better price debt packages at the higher end. That said, we don't view the high-yield bounce as a signal of a sustained recovery, but what appears to be more of a "buy-the-dip" trade.

What the above examples highlight is a seesawing external environment that makes modeling out the various post-acquisition scenarios a fairly strenuous task. Nailing the macro thesis before completing a deal is never a simple task, yet today, managers will either have to pay a hefty multiple to win quality assets, or devote a significant amount of time and effort to help rebuild and grow distressed or tier-2 assets acquired at lower valuations. So, although a tremendous amount of capital remains to be deployed, and firms are typically incorporating the probability of a black swan event manifesting during a hold period, dealmakers are forced to move more carefully before pulling the trigger.

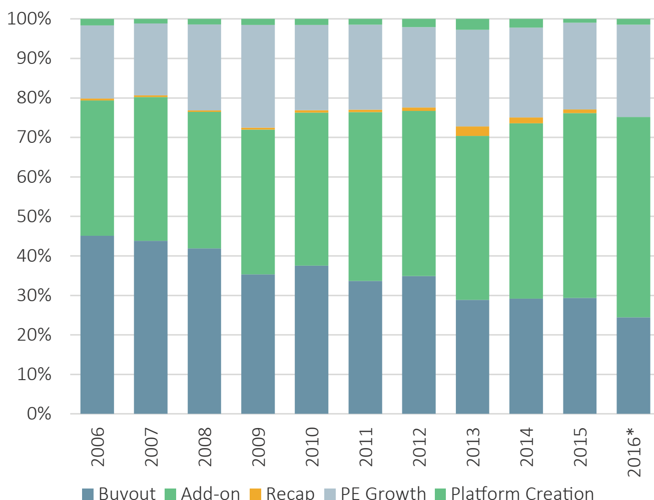
If you survey a group of dealmakers, you'll likely encounter a split in sentiment, with some claiming to have remained busy through 1Q, and others acknowledging the rather slow environment the numbers show. However, being busy doesn't necessarily translate into a plethora of announced or closed transactions. Deals in the upper size buckets and those of the highest quality are likely in auction processes with multiple strategic and financial bidders. To gain advantages in an auction and offer incentives to selling companies such as the ability to close quickly or secure lending packages sooner, bidding firms need to be able to complete various types of diligence earlier. This keeps PE shops busy, especially if this is occurring in multiple processes, yet diving into diligence early and assuming the costs without the certainty of winning the transaction can keep many PE firms on the sidelines.

Moving through the remainder of 2016, GPs will need to be creative throughout the entire deal process, from sourcing to closing to, ultimately, portfolio management. We've certainly harped on the quality of supply currently coming to market and the justifiability of the multiples asked for, and thus, sourcing will remain pivotal for GPs to find both quality and affordable prices. Deal flow could stay subdued through the year, yet older firms with more robust networks may well be able to mine out cleaner middle-market transactions as they arise.

Being able and willing to deploy an operational strategy will also be important for both sourcing and post-closing performance. Lower-middle-market deals, that, in many cases can be done amid less competition, can help GPs locate more attractive valuations, yet there is also the potential that such deals will require more time and hands-on work from the fund. With that in mind, transactions closing between $25 million and $100 million represented 26% of all 1Q deals. We still have plenty of room to run in the year, yet 2015 as a whole saw transactions in this size bucket represent just 22.5% of all activity. Deals in this range also continue to be a haven for add-on acquisitions, which accounted for 68% of all 1Q buyout volume, more than any other year we've tracked to date. The buy-and-build strategy will continue to be essential for PE buyers as they look to position portfolio companies to endure any dip in the economic and business cycle.

**Add-ons continue to grow their proportion of activity**

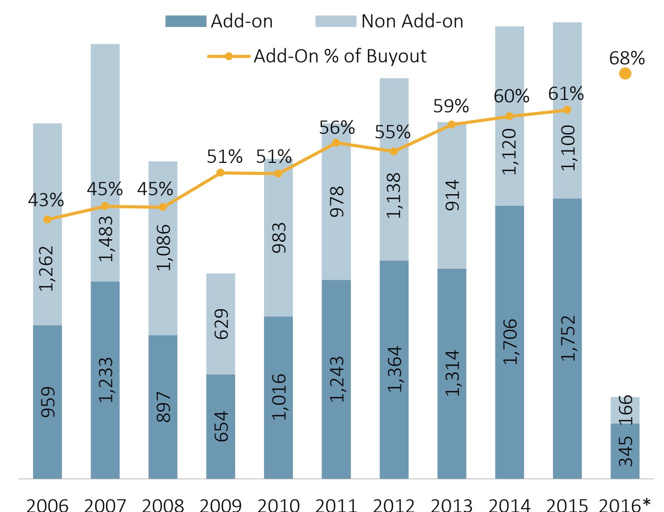
U.S. PE deal flow by type




Source: PitchBook
*As of 3/31/2016

**Add-ons represent nearly 70% of all buyouts**

U.S. add-on % of buyout activity




Source: PitchBook
*As of 3/31/2016

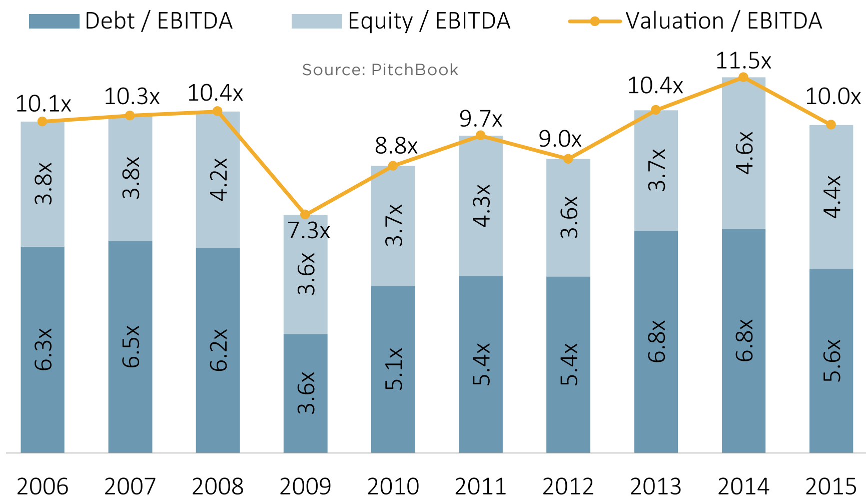
# New normal for multiples

## Deal multiples & debt levels

While deal multiples subsided a bit in 2015, the 10x valuation-to-EBITDA figure recorded last year still holds at pre-recession levels, while the median debt percentage used in transactions has edged below. With deal flow as low as it is thus far into the year, it's difficult to gauge where valuations will ultimately end up, but we think we'll continue to experience a new normal where cleaner business coming to market will garner outsized multiples similar to the 11.5x we saw in 2014. Businesses marketed with any type of "hair" or concerns around the quality of their current and future earnings, among other metrics, will garner significantly lower prices.

As sellers have been able to take advantage of hungry, acquisitive buyers, the best assets have likely been sold and thus anything a bit more speculative will also face difficulties from the debt side. Everyone is certainly aware of the difficulty banks have had pushing debt to institutional investors, yet a competitive deal environment has forced middle-market lenders to accept much lower rates of returns, a risk they'll be forced to more closely scrutinize in the near future. Keeping this in mind, 2015 saw the median deal debt percentage move lower to 56%—preliminary 1Q numbers have it at roughly 54%. Nonetheless, a large amount of capital remains available for lenders to deploy, and while they may be more careful given the quality of companies in the market, we've seen a few special-situation vehicles come to market and fare well. LPs have also opened up space within their credit portfolio for similar opportunities. PineBridge Investments recently closed its Structured Capital Partners III fund at $600 million, surpassing its initial $500 million target. The fund will look to target junior capital securities including mezzanine debt and structured equity issued by middle-market businesses. KKR, Carlyle and Oaktree have also raised oversubscribed multibillion-dollar vehicles to invest in the debt or equity of distressed businesses as we've moved to the later stages of the credit cycle. While this may not lift the debt percentages of completed deals, it does highlight the ability of savvy investors to step up and help support lower tier-businesses in a period where traditional capital may not.

Median EBITDA multiples of U.S. buyouts



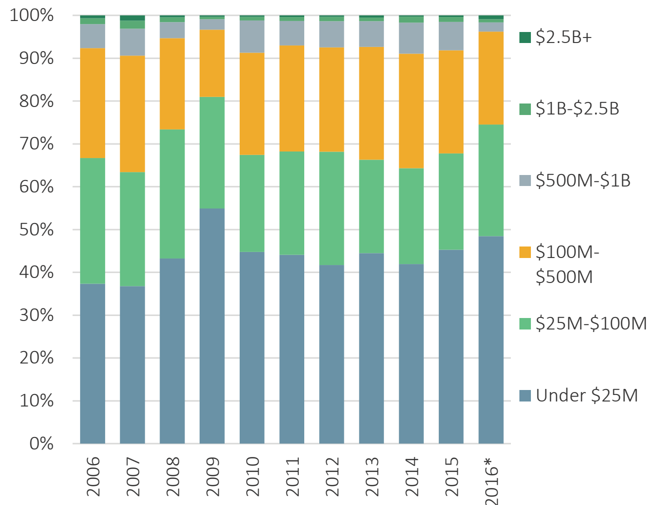

**Debt usage slides amid macro uncertainty and competitive middle-market lending environment**
Median debt percentages for U.S. buyouts

Source: PitchBook
*As of 3/31/2016. Figures are preliminary and are likely to adjust as more data is collected.

# Deals by size and sector

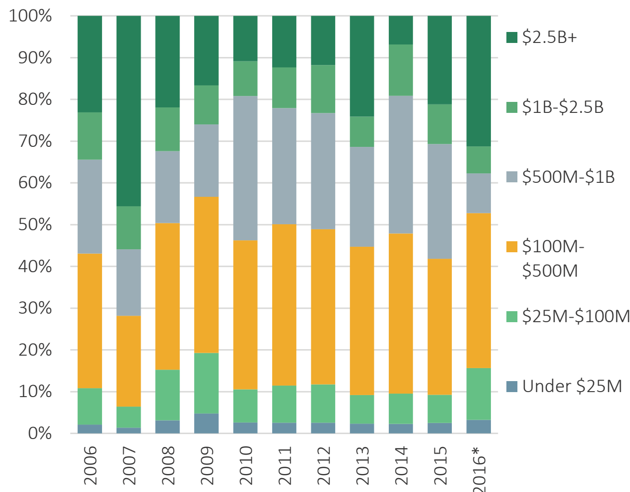
**1Q 2016 LMM activity sees jump in percentage of activity**

U.S. PE deals (#) by deal size




Source: PitchBook
*As of 3/31/2016

U.S. PE deals ($B) by deal size

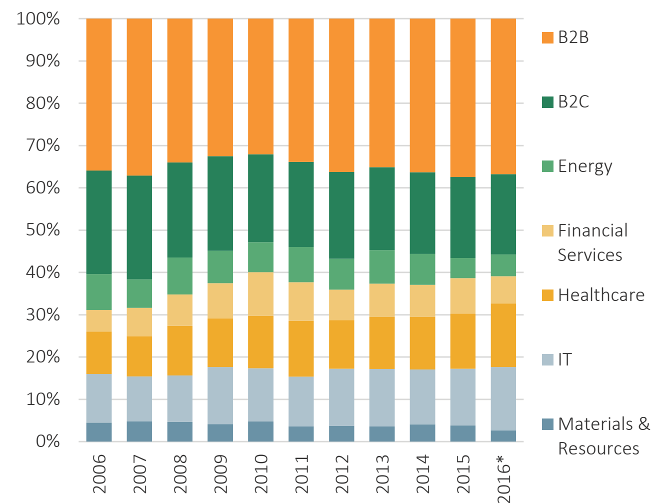



Source: PitchBook
*As of 3/31/2016

> The relative portion of total deal value in the IT space stands at the highest percentage yet recorded.

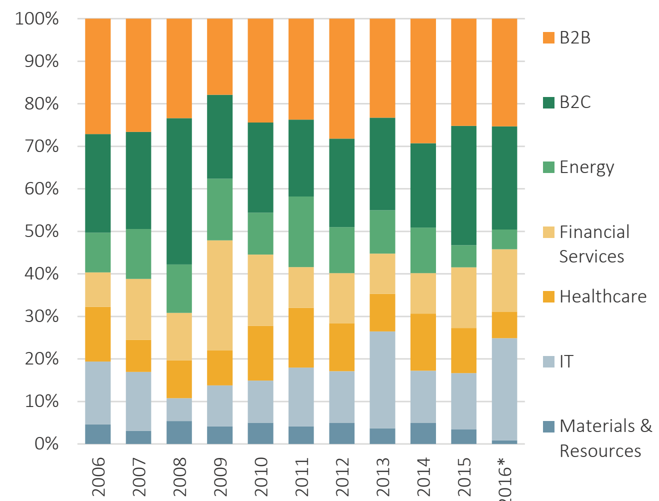
> $2.5B+ deals represented 31% of all 1Q transaction value; no previous year has finished with a similar proportion.

U.S. PE deals (#) by sector




Source: PitchBook
*As of 3/31/2016

U.S. PE deals ($B) by sector




Source: PitchBook
*As of 3/31/2016

## Daniel DiDomenico

**Senior Managing Director, CPA/ABV, CFA**
**Murray Devine**



*Dan DiDomenico joined Murray Devine in 1995 and his responsibilities include the day-to-day management of valuation and financial opinion engagements.*

*With over 25 years of accounting and valuation experience, Dan has prepared valuations of business enterprises, debt and equity securities, and intangible assets for tax and financial reporting purposes. In addition, he has been involved with numerous financial opinions related to solvency, capital adequacy and fairness. Dan services clients across varied industries and also has significant experience in portfolio valuation services.*

*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).*

**What accounts for the drop off in 1Q 2016 PE deal activity?**

PE deal activity lives and dies with lender appetite, and the uncertainty in the market—reflected in the volatility witnessed in both the equity and high yield markets—has led many mid-market lenders to tap the brakes. There were a number of macro hiccups toward the end of 2015: China slowdown, lower U.S. corporate profits, Brexit discussions, U.S. election tumult, and the stock market slowdown, among others. All of this affected sentiment among buyers across markets.

These concerns were coupled with seller asking prices that still reflected the optimism going into 2015, when purchase price multiples were elevated. With the pullback in the debt markets and heightened economic concerns, GPs are reluctant to pay overly aggressive multiples. While quality deals are getting done at higher multiples, there are fewer quality targets on the market and weaker targets are struggling to get a deal done at what they consider acceptable multiples. When you factor in the fact that the Federal Reserve is now embarking on a rising interest rate cycle, you have a recipe for the kind of pause in activity that we witnessed in the first quarter.

**Are buyer-to-seller discrepancies prolonging negotiating periods, and if so, how can that best be avoided?**

Absolutely. There is a misalignment in buyer/seller expectations and this was particularly pronounced in the lower middle market. This is especially true with weaker targets that are struggling to get deals done because they are expecting higher multiples, but buyers are not willing to pay up and lenders are leery to provide too much leverage. There is not so much misalignment in the quality targets where sponsors are willing to pay and lenders willing to lend.

We're seeing sellers pursue deeper sell-side due diligence to identify any issues and correct them prior to a sale. Among buyers, they're also doubling down on due diligence given all of the concerns out there today. In these markets with misaligned expectations, you also see increased usage of earnouts, which only extends negotiating periods. For the PE firms that are sellers in today's market, they've been focused on selling assets that may appeal to strategics, versus sponsor-to-sponsor deals, as corporate buyers, less reliant on financing, and driven by strategy, are providing a higher certainty of close.

**How active have clients been in requesting solvency opinions connected to dividend recapitalizations?**

Dividend recapitalizations are generally the product of an enthusiastic lending market. We are still seeing a fair amount of dividend recapitalizations, but they're more about right-sizing the balance sheet following a period of strong earnings growth and providing some liquidity to limited partners. Dividend recapitalizations can be attractive, particularly for sellers who don't think their assets are being valued appropriately by the market. However, the process of re-leveraging a business in an uncertain economic cycle can have severe adverse consequences if the business goes sideways.

The Q&A is continued on the next page.

**What other trends are you seeing in the market?**

We view the first quarter slowdown as a blip, as there was a perfect storm of factors that led to near-term uncertainty. We anticipate dealmaking will pick up again this year if the economy remains solid and there are no major political events. We think you will see the presidential election have an effect on some sectors within the market. Pfizer's failed merger with Allergan, for instance, fell apart after the White House took steps to alter the tax laws in response to the inversion transactions that had been so popular last year. In general, the election will hopefully lift some of the uncertainty that the business community has been dealing with over the past seven years which has limited investment by businesses in the U.S. Hillary Clinton has also fired a shot across the bow of the pharmaceutical sector regarding drug prices, which could certainly affect M&A in the sector, while Donald Trump's views on climate change wouldn't bode well for green energy.

Each sector will be affected in its own way based on the election, so this is something dealmakers are watching. That being said, we do anticipate dealmaking will pick up pace throughout the year. Equity contributions may rise, there will be lots of competition for quality companies, and we expect there will be continued LP interest in co-investments. We also expect to see more add-on investments to enhance valuations of platform deals and help position these companies for both EBITDA growth and multiple expansion upon exit. In certain sectors, including energy, you will see more investments in distressed companies, especially after the first wave of Chapter 11 filings when the better assets start to become available. You saw a very healthy fundraising market last year, so there is a record amount of dry powder that needs to be put to work. We expect institutions to continue to see PE as an attractive asset class and family offices are only showing more interest as a way to diversify and find alpha in an otherwise low-return environment. The only thing standing in their way is the potential "denominator effect," from a volatile market, which could provide opportunities for secondary investors.

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# PE-backed sales plunge

## PE-backed exits

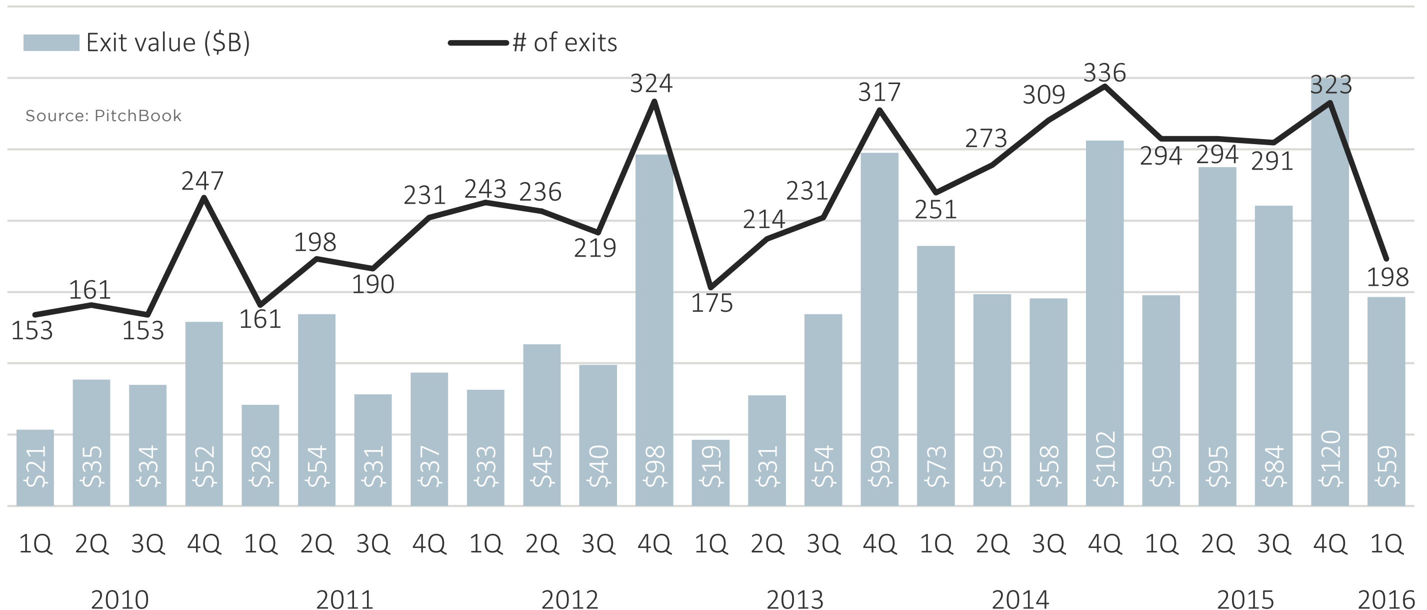
After a record-setting year for exits in 2015, 1Q 2016 saw PE-backed sales plunge. $58.5 billion was exited across 198 completed sales, equating to a QoQ decline of 51% and 39%, respectively. While the QoQ decline was rather dramatic, it should be noted that historically the first quarter of the year has been slow for PE sales relative to its predecessor.

Exits were down across the board, regardless the type, yet corporate acquisitions experienced the lowest QoQ decline in terms of volume. 118 strategic sales were completed during the period, and while that figure represents a near 32% decline over 4Q activity, the exit ramp still accounted for nearly 60% of all PE-backed exits last quarter. From a total exit value perspective, $49.5 billion was exited to corporate acquirers, which is half the amount registered in 4Q 2015, yet up nearly 25% on a YoY basis, highlighting the continued trend of corporate acquirers willing to shell out large sums of capital to win deals that can help drive efficiencies and ultimately top and bottom-line growth.

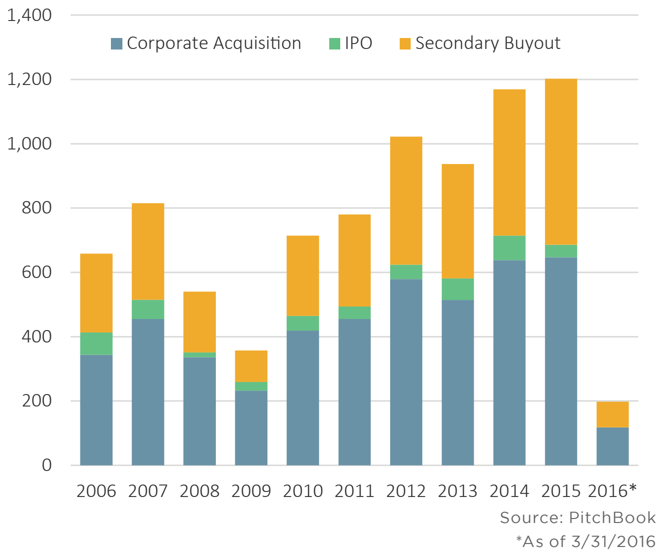
Secondary buyouts declined over 44% compared to the last quarter of 2015, with capital exited via PE-to-PE sales down roughly 48%. While volume clearly was the major determining factor for the drop in SBOs, the median exit size on this front came in at $253 million during 1Q 2016, a sum considerably lower than what we've experienced the previous couple of years. As GPs have penetrated the lower buckets of the middle market to win deals, this figure makes a bit more sense, and will likely stay within a reasonable range of the reported number through the year.

Moving through the remainder of 2016, we think we'll see exits rise a bit due to the historical, seasonal trend of lower volume during the first quarter of a year, however, we most likely won't experience the record-setting numbers recently witnessed. Lastly, the fact that deal volume has slipped, and much of the inventory in PE portfolios is either relatively fresh or of lesser quality, we also do not expect to encounter a significant uptick in secondary buyouts.

**QoQ capital exited drops by half**
U.S. PE-backed exit activity



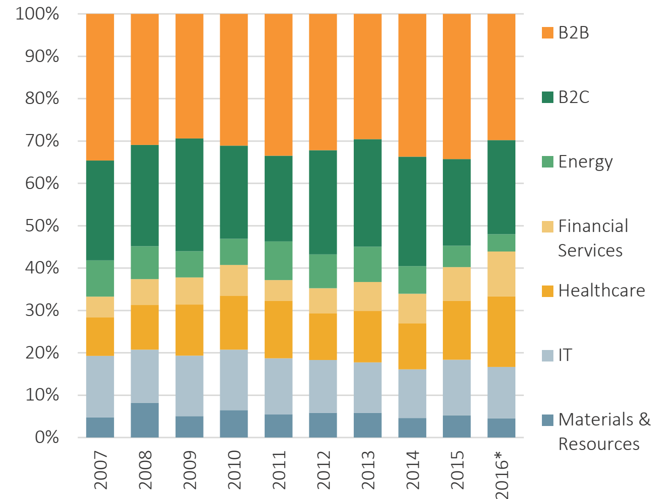
**Not a single PE-backed IPO happened in 1Q**
U.S. PE-backed exits (#) by type




Source: PitchBook
*As of 3/31/2016

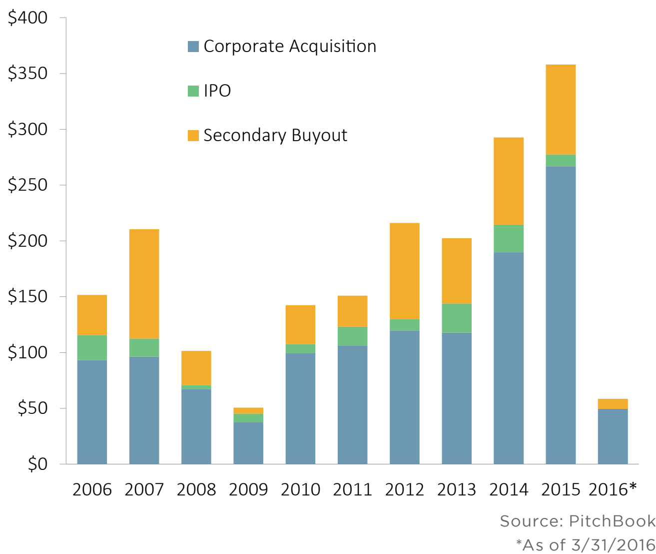
> SBOs look set to remain at lower levels in terms of total exit value.

**Selling in healthcare remains relatively considerable**
U.S. PE-backed exits (#) by sector



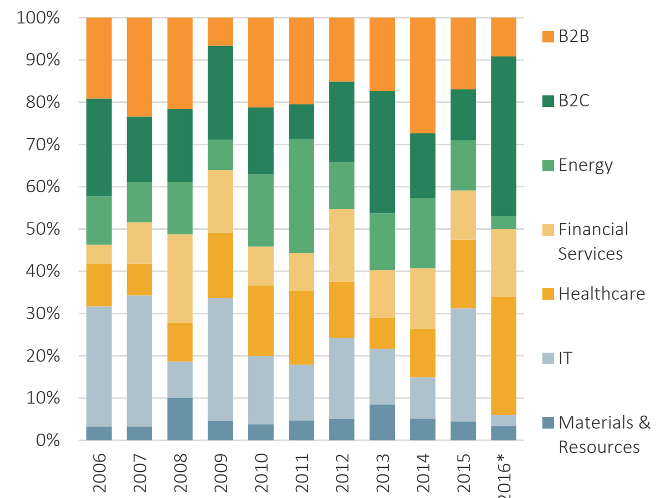

Source: PitchBook
*As of 3/31/2016

**GPs are more active in lower reaches of the market**
U.S. PE-backed exits ($B) by type




Source: PitchBook
*As of 3/31/2016

**Select huge exits skew sector totals**
U.S. PE-backed exits ($B) by sector




Source: PitchBook
*As of 3/31/2016

> B2C dominated 1Q in terms of exit value, with $22.1B already amassed.

# LPs continue to trust in PE

## Fundraising

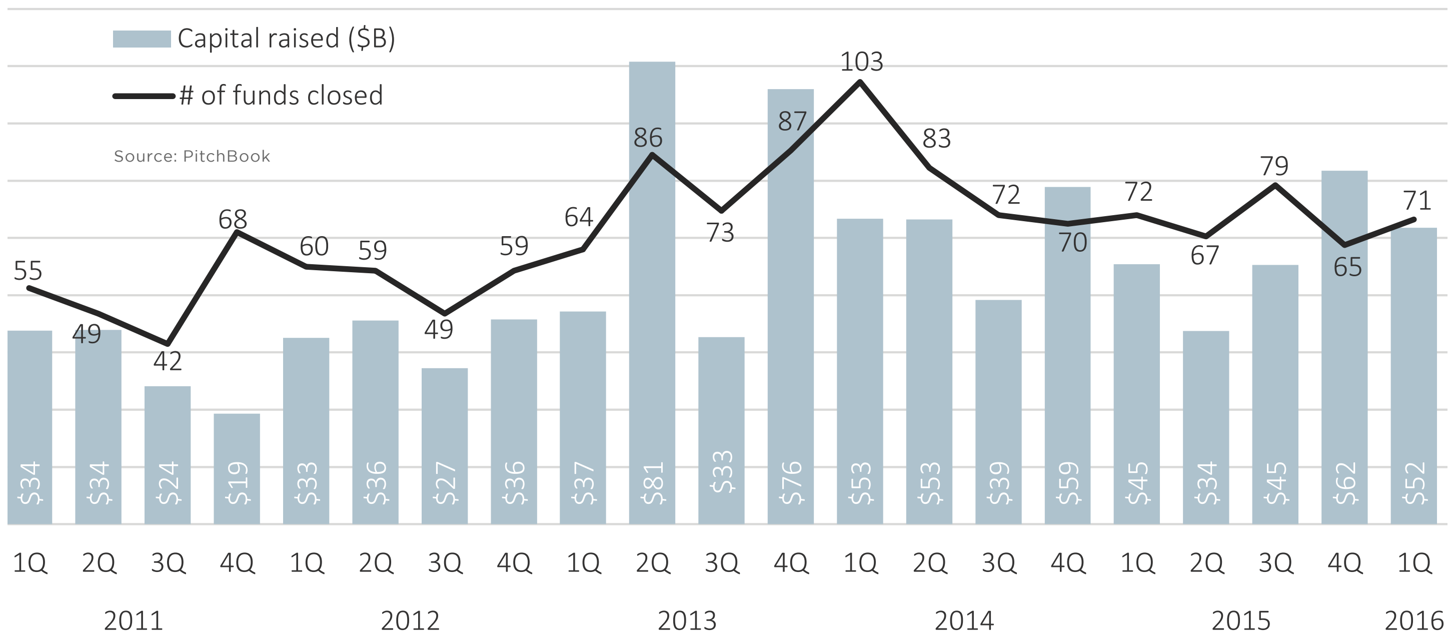
Despite a lagging deal environment, fundraising during the first quarter continued to perform very well on a historical basis. $51.8 billion was raised across 71 vehicles in 1Q, and while that capital raised figure was down 16% compared to what we saw in 4Q 2015, the number of vehicles closed were up over 9% during the same period. On a yearly basis, capital raised was actually up 14% over what was raised in 1Q 2015, with the number of completed fundraises just about flat. We saw an uptick in the number of funds closing with between $250 million and $500 million in capital committed, which continues to support the trend we've seen of managers coming to market with smaller targets, yet more focused and niche strategies. Mega funds also performed exceptionally well in 1Q. Three vehicles closed with over $5 billion in commitments, raising an aggregate of $24.7 billion. Benchmarking this against all of last year, which saw $57.7 billion raised across seven mega-funds, 1Q 2016's numbers already equate to nearly 43% of all capital raised for comparably sized funds in 2015.

With companies looking to restructure and optimize operations to maximize earnings potential in a more uncertain future, growth capital can be an essential need. Participating in growth rounds in addition to the typical buyout also allows GPs to put some of their dry powder to work at reasonable valuations, rather than sitting on the sidelines in a high-price environment. Consequently, growth vehicles that closed in 1Q accounted for 15% of all PE funds closed during the period. Although this trend may not hold true as the year plays out, that 1Q statistic matches the second-highest percentage we've ever tracked in any previous year.

Out of all funds closing in 1Q, more than 98% of those vehicles either hit or exceeded their targets. Again, whether this percentage will hold through for the remainder of the year remains to be seen, but the highest annual figure we've ever tracked is 88%, which we saw last year. Despite volatility across multiple asset classes, LPs have remained confident in PE. The average time to close for all funds in the quarter came in rather low at 13.6 months; 2015 in its entirety saw funds close at an average of 14.5 months. GPs with deeper LP relationships have been and will continue to attract LPs willing to re-up into new vehicles, especially as they've received ample distributions.

**Capital raised slows, but number of closings inches higher**

U.S. PE fundraising

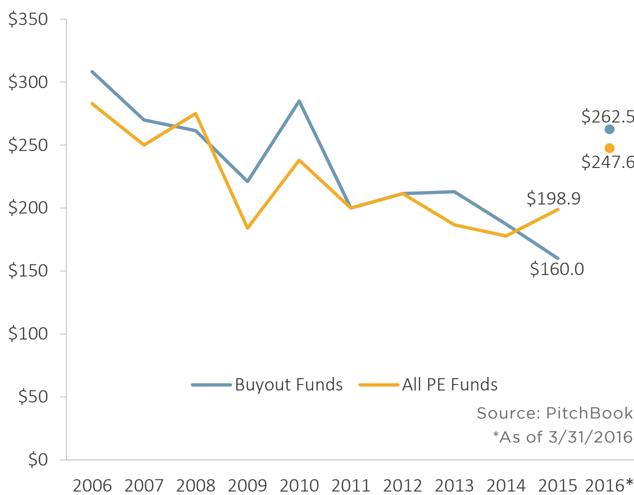


Currently, mega-funds are able to attract hefty amounts of commitments from LPs looking to write bigger checks to fewer managers. LPs have also shown increased interest in new managers able to offer more unique strategies that can help them diversify amongst their alternative investment allocations. Thus, the high success rate for fundraisers in 1Q doesn't come as much of a surprise.

> "The stellar success rate of funds hitting their target may become more aligned with historical norms as 2016 goes on.

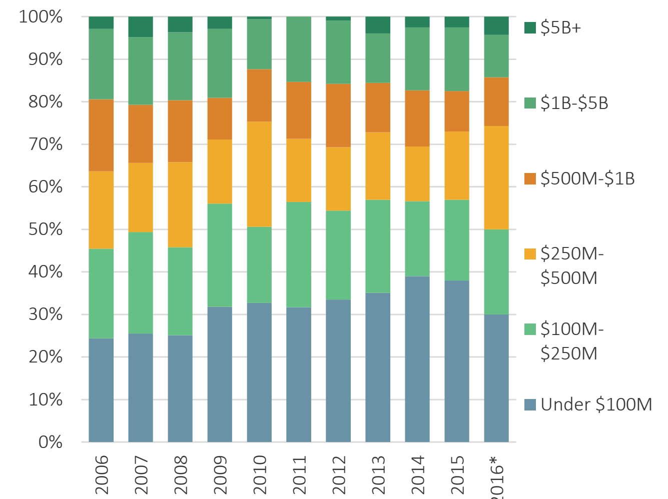
**At $248M, vehicles closed in 1Q were rather large, relative to prior years**

Median U.S. PE fund size ($M)




**24% of all vehicles raised in 1Q were sized between $250 million and $500 million**

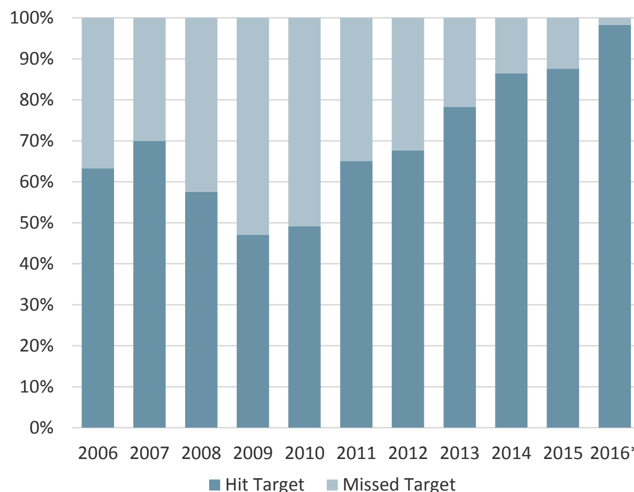
U.S. PE funds (#) by size




Source: PitchBook
*As of 3/31/2016

**A staggering 98% of all funds closed in 1Q either hit or exceeded their target**

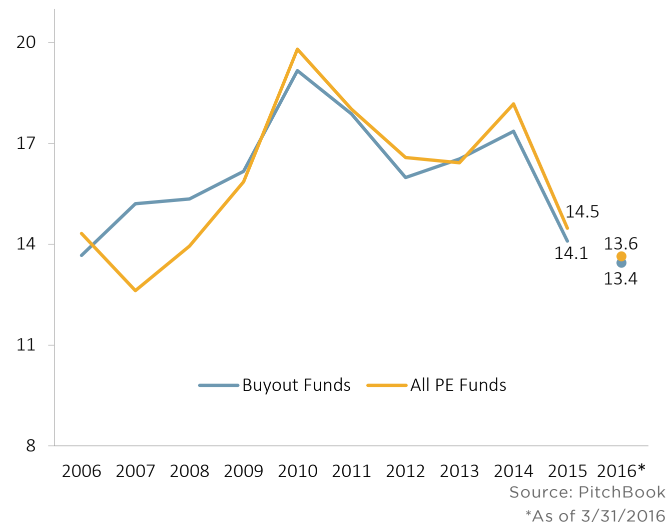
U.S. PE funds (#) to hit target




Source: PitchBook
*As of 3/31/2016

**The proportion of funds hitting their targets and the low closing times indicate very targeted strategies**

U.S. PE fund closing times (months)




Source: PitchBook
*As of 3/31/2016

# League tables

1Q 2016

## Most active investors by deal count

| Investor | Deal count |
|---|---|
| Audax Group | 19 |
| ABRY Partners | 15 |
| The Carlyle Group | 11 |
| Summit Partners | 9 |
| Apax Partners | 8 |
| HarbourVest Partners | 8 |
| Kohlberg Kravis Roberts | 8 |
| AEA Investors | 7 |
| Hellman & Friedman | 7 |
| The Blackstone Group | 7 |
| Providence Equity Partners | 6 |
| Tailwind Capital | 6 |
| Arsenal Capital Partners | 5 |
| CI Capital Partners | 5 |
| H.I.G. Capital | 5 |
| Kayne Anderson Capital Advisors | 5 |
| Natural Gas Partners | 5 |
| Nautic Partners | 5 |
| Oaktree Capital Management | 5 |
| Vista Equity Partners | 5 |

Source: PitchBook

## Most active lenders by deal count

| Lender | Deal count |
|---|---|
| Antares Holdings | 20 |
| BMO Harris Bank | 19 |
| Madison Capital Funding | 10 |
| Wells Fargo | 4 |
| MUFG Union Bank | 4 |
| NXT Capital | 4 |
| SunTrust Banks | 3 |
| The Goldman Sachs Group | 3 |
| Abacus Finance Group | 3 |

## Most active lenders continued

| Lender | Deal count |
|---|---|
| PNC Financial Services Group | 3 |
| Fifth Third Bank | 3 |
| Fifth Street | 3 |
| Cadence Bank | 3 |
| Bank of America | 2 |
| Barclays | 2 |
| BBVA | 2 |
| CIT Group | 2 |
| Comerica Bank | 2 |
| Credit Suisse | 2 |
| KeyCorp (Cleveland) | 2 |
| Golub Capital | 2 |
| LStar Capital | 2 |
| Northstar Capital | 2 |
| Northcreek Mezzanine | 2 |
| Nomura International | 2 |
| Penfund | 2 |
| Patriot Capital | 2 |
| PrivateBancorp | 2 |
| RBC Capital Markets | 2 |
| Texas Capital Bank | 2 |
| Tenth Street Capital | 2 |
| TCF Capital Funding | 2 |
| U.S. Bancorp Investments, Inc. | 2 |
| Zions Bank | 2 |
| Yukon Partners | 2 |

Source: PitchBook

## Most active law firms by deal count

| Law firm | Deal count |
|---|---|
| Kirkland & Ellis | 40 |
| DLA Piper | 22 |
| Latham & Watkins | 16 |
| Jones Day | 16 |
| Goodwin Procter | 14 |
| Ropes & Gray | 13 |
| Weil, Gotshal & Manges | 11 |
| Paul, Weiss, Rifkind, Wharton & Garrison | 11 |
| Paul Hastings | 10 |
| Greenberg Traurig | 8 |
| Sidley Austin | 7 |
| McDermott Will & Emery | 7 |

Source: PitchBook

## Most active advisors by deal count

| Advisor | Deal count |
|---|---|
| Robert W. Baird & Co. | 12 |
| Piper Jaffray | 10 |
| TM Capital | 8 |
| Moelis & Company | 7 |
| The Goldman Sachs Group | 7 |
| William Blair & Company | 7 |
| Cascadia Capital | 6 |
| Cain Brothers | 6 |
| Marlin & Associates | 6 |
| Lincoln International | 5 |
| KeyCorp (Cleveland) | 5 |
| J.P. Morgan | 5 |
| Morgan Stanley | 5 |

Source: PitchBook