Global Private Equity Report

Idea In Short

Private equity performed strongly in 2016: fundraising hit $589 billion, exits remained robust, and top-quartile buyout firms returned 20 to 30 percent annually. The key concerns are rising asset prices and declining net asset values, signaling that the cycle may be peaking.

Exits and the Snake Digesting the Elephant

Exits, meaning private equity firms selling their investments, fell from the 2014 and 2015 highs, but times remained good. Investors continued looking for those returns. Approximately 1,000 exits occurred in 2016, down from 2015 with the biggest drop in Europe. This is no surprise given bad loans, Brexit, and protectionist rhetoric from European leaders. Still, 2016 was better than 17 of the last 20 years 1.

Bain describes the glut of deals unable to exit after the financial crisis as an elephant working its way through the private equity snake. Only 10 percent of pre-crisis deals had yet to exit, meaning most current deals are post-crisis. The snake has digested the elephant. The median holding period is now five to six years, reflecting a new normal in portfolio company tenure.

Strategic Buyers and IPOs

Strategic buyers have the cash, stock valuation, and motivation to buy. Bain notes that organic growth is tough to find in developed markets, and high stock valuations give strategics good currency to buy from private equity firms. The 10 largest exits to strategic buyers all occurred in the United States and Western Europe, led by CVC Capital Partners with the top two deals: the sale of Formula One World Championship in the United Kingdom to Liberty Media for $7.9 billion and Spain's IDCSalud Holding to Fresenius for $6.4 billion.

Initial public offerings dropped by 40 percent in volume and 48 percent in value in 2016. The

largest IPO was a Chinese company, ZTO Express, backed by Warburg Pincus. Follow-on sales, which are the post-IPO selling down of private equity holdings, generated $79 billion in exits. This was more than 2.5 times the amount originally raised through IPOs, meaning that for every $1 of IPO exit, firms sold $2.50 of shares after the IPO.

Dividend Recaps and Fundraising

A dividend recapitalization is when private equity firms take on debt to pay dividends out to their investors. This improves liquidity but makes the underlying asset more risky. Creditors were eager to lend, and private equity firms were smart to take advantage, provided it did not sink the asset itself 2. In 2016, there was $7 billion in dividend recaps.

Fundraising was going well. $589 billion was raised in 2016, almost flat versus 2015. There were 11 megafunds, defined as more than $5 billion, in 2016. Advent was looking for $12 billion, attracted $20 billion, and settled on $13 billion. Thoma Bravo raised $7.6 billion at its hard cap and was oversubscribed. Cinven raised $8 billion at its hard cap in four months, two times oversubscribed. The capital is flowing freely into private equity, and limited partners want to put more money to work.

Institutional Investors Cannot Get Enough

Institutional investors want to put more money to work in private equity, but times are so good that they are having difficulty maintaining enough invested. Bain explained the story of one pension fund: the Washington State Investment Board experienced a steady decline from a 26 percent actual allocation in mid-2012 to 21 percent in mid-2016. Over the same period, unfunded private equity commitments rose from $8.2 billion to $12.7 billion.

They are not invested enough in private equity, even though the money they want to put to work continues to pile up. This dynamic creates pressure on general partners to deploy capital, which in turn drives up asset prices. The tension between limited partner expectations and available deal flow is one of the defining features of the current private equity landscape.

Lowering Hurdle Rates

With times so good for private equity, some general partners are renegotiating the terms of

their funds. CVC negotiated down the customary 7 to 8 percent hurdle rate, which is the minimum annual return for limited partners before the general partner gets paid, to 6 percent. Advent removed the hurdle rate entirely and adopted a different payment schema. This is not true for middle performers, but everyone is looking to raise funds while times are good.

The willingness of limited partners to accept lower hurdles signals confidence in the asset class but also raises questions about whether returns will hold. If general partners are conceding on terms, it suggests they hold the negotiating power. That power tends to correlate with market peaks, when capital is abundant and competition for deals is fierce.

Rising Prices and Impressive Returns

There are plenty of assets for sale, including carve-outs and public-to-private transactions. There is plenty of debt to help fund deals and lots of private equity capital ready to invest, totaling $1.4 trillion. The problem is prices. More people are hunting for the same assets, which creates price inflation 3. The business cycle reminds us that good times do not always last, and a recession could be around the corner.

Private equity returns are impressive. The asset class has outperformed broader markets in the United States, Europe, and Asia. This is notable considering Warren Buffett's recent $1 million wager that hedge funds would underperform the S&P 500 over 10 years. The top quartile of United States buyout firms returned 20 to 30 percent annually. Those are the numbers that get people retired.

Many Flavors of Private Equity

For those new to the asset class, private equity offers an entirely new world of fund types and strategies. Bain provides a rundown of different approaches including contrarian, playbook value, macro-trend, and cross-pollination strategies. The second half of the report covers specific industries, geographies, and strategies for those who want to go deeper.

The diversity of strategies means that private equity is not a monolith. Different funds pursue different value creation models, from operational improvement to financial engineering to sector consolidation. Understanding these distinctions matters for consultants, lawyers, bankers, and other professionals who advise or compete with private

equity firms.

Building a Network and Web Intelligence

The most fascinating part of the report is the process of becoming an effective private equity investor. How do you cultivate and manage a network of people who can give you specialized insight into a deal? For consultants, lawyers, bankers, and other professionals, this section offers insider perspective on how to win at private equity. Building a network starts now and develops across deal sourcing, due diligence, and portfolio management.

The report also covers how up-and-coming private equity associates can add value by gathering industry insight and competitive intelligence legally from the web. This is a practical how-to for associates who want to differentiate themselves through research rigor rather than relying solely on paid databases and traditional sources.

Vision, Where to Play, How to Win

Bain breaks down the key questions executives need to answer in simple terms: What is the vision? Where to play? How to win? These three questions make the heart sing. You have to make choices and set up the activities which self-reinforce your strategy and make it hard to imitate. The framework applies equally to private equity portfolio companies and to the funds themselves.

Figure out how you are adding value, then do it. The report provides tables and frameworks that consultants naturally gravitate toward, but the underlying message is clear. Strategy is about choices, and private equity at its best is a disciplined application of strategic thinking to capital allocation. The firms that answer these three questions most rigorously are the ones that generate top-quartile returns.

- 1Global Private Equity Report 2017
- 2Dividend Recapitalization: Definition, Process, And Example
- 3Private Equity Holding Period Statistics

Summary

Private equity had a banner year in 2016. Fundraising reached $589 billion, exits held strong, and top-quartile firms returned 20 to 30 percent annually. However, rising prices, lowering hurdle rates, and $1.4 trillion in dry powder suggest the cycle may be peaking. Strategic buyers and dividend recaps added complexity. Read the full Bain report for detail.