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Private equity (PE) remains an industry still in the early stages of its evolution. Large firms continue to diversify, smaller firms continue to develop and pursue niche strategies and limited partners (LPs) are allocating ever-increasing amounts to the asset class. The result is an industry which looks very different today than it did ten years ago, and which will see even greater change over the next decade.

Firms that remain successful through this evolutionary period will be those that can stay disciplined in their investment philosophies and thorough in their diligence, yet flexible enough to seize new opportunities and address new markets.

The 2017 Global PE Watch articulates some of the key trends that defined PE in 2016, including trends in fundraising, acquisitions, financing and exits. More importantly, the report breaks down some of the key emerging issues and opportunities that are poised to define the industry as it continues to grow over the next 5-10 years and beyond.

We hope you’ll find this report illuminating and insightful, and encourage you to reach out to any of our PE professionals listed on the back of this report in order to arrange a more in-depth conversation.

Join the conversation! For the latest trends and insights, follow EY PE on Twitter, at @EYPrivateEquity.

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It’s no secret that the world is changing faster than ever before. The forces of globalization, technological advancement and demographics are powering dramatic changes to the ways that we work, the places we live, the ways we get around and the people with whom we interact. The Digital Revolution, the Fourth Industrial Revolution – whatever we choose to call it, the bottom line is that outside periods of global conflict, there is no time in human history where so much about the way that we experience and interact with the world has changed so quickly.

Amidst this rapid change, global governments are struggling to respond and adapt. Many of the old-line policy options for stimulating investment, managing currencies and spurring economic growth are experiencing sharply reduced effectiveness. Central bank-induced distortions continue to permeate the market. Indeed, negative interest rates – once unthinkable – are now a reality for a quarter of the world’s economy.

Throughout this time, PE firms have continued to grow and evolve, expanding beyond their roots in financial engineering, to creating value through operational transformation. After several years of elevated exit activity, PE firms, against long odds, have now ushered the vast majority of their portfolio companies acquired during the last buyout boom to a successful resolution. Waves of distributions to LPs have affirmed their faith in the asset class, precipitating new investment and leading to record levels of unspent commitments of commingled funds, or dry powder.

Which brings them to their current dilemma. With anemic gross domestic product (GDP) growth throughout the developed economies, and slowing in many of the emerging markets, companies throughout the world have gone all-in on growth through M&A. Facilitated by a low interest rate environment of unprecedented length, companies pushed M&A activity to record levels in 2015, and valuations moved higher in lockstep. While 2016 has seen some respite on the valuations front, valuations remain high, and PE firms are challenged to underwrite deals for attractive targets at prices that leave headroom for growth.

Firms thus find themselves in a liminal space, having completed the last cycle, while waiting for the next to begin. While firms are pursuing a number of strategies in order to remain active in the current environment – among them, distressed and opportunistic investment, and moves downmarket into growth capital and mid-market – the next deployment cycle for PE has yet to really get underway. The hesitation is reflected in the figures – PE activity totaled US$319b in 2016, down 4% from 2015, and miles away from the US$740b recorded in 2007. This is despite the industry having a war chest of more than US$525b, well above what the industry held in ’07. Firms are challenged in putting these assets to work in an environment that allows no room for error, while keeping watch for a widespread repricing that may or may not be imminent.

Nonetheless, we remain optimistic. Private equity firms are used to dealing with challenging environments. Indeed, they thrive on them. Throughout its history, the industry has optimized itself and its model to the operating environment, and the present period will be no exception. Success will depend on firms’ ability to remain patient, disciplined, innovative and opportunistic as they look for the right entry points and the upswing of the next investment cycle.

Herb Engert
EY Global Private Equity Leader
## Key stats at a glance

<table>
<thead>
<tr>
<th>Year</th>
<th>PE funds closed</th>
<th>Total commitments (US$b)</th>
<th>Announced PE deals</th>
<th>Total deal value (US$b)</th>
<th>M&amp;A exits (US$b)</th>
<th>PE IPOs (US$b)</th>
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<td>1,117</td>
<td>$616.7</td>
<td>3,413</td>
<td>$748.4</td>
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<td>2,763</td>
<td>$222.4</td>
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<td>$9.9</td>
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<td>2009</td>
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<td>1,914</td>
<td>$142.5</td>
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<td>2,149</td>
<td>$238.6</td>
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<td>2011</td>
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<td>$305.6</td>
<td>2,210</td>
<td>$230.2</td>
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<td>2012</td>
<td>882</td>
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<td>2,388</td>
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<td>$219.9</td>
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<tr>
<td>2013</td>
<td>959</td>
<td>$501.4</td>
<td>2,163</td>
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<td>$208.9</td>
<td>$22.0</td>
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<td>2014</td>
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<td>2,198</td>
<td>$288.1</td>
<td>$365.7</td>
<td>$58.5</td>
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<tr>
<td>2015</td>
<td>958</td>
<td>$534.1</td>
<td>1,907</td>
<td>$332.0</td>
<td>$365.4</td>
<td>$58.2</td>
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<tr>
<td>2016</td>
<td>826</td>
<td>$530.7</td>
<td>1,563</td>
<td>$318.8</td>
<td>$298.5</td>
<td>$32.1</td>
</tr>
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</table>

### Fundraising in line with 2015

- **US$534b** in 2015
- **US$531b** in 2016

- **16 Months** for the average fund to close in 2016, down from **17**

### Dry powder is at a record high

- **US$480b** in 2007
- **US$525b** in 2016

- **Shadow capital** in 2009-14: **US$63b**
- **Shadow capital** in 2016: **~US$180b**

- **Dry powder** is growing the fastest among funds with US$1b-3b in assets:
  - Small funds: 0.7%
  - Mid-size funds: 6.0%
  - Large funds: 8.6%
  - Megafunds: 7.0%
Key stats at a glance

The regional view

US
Fundraising down 4%
Deals down 17%

Europe
Fundraising up 28%
Deals up 7%

Asia-Pac
Fundraising down 22%
Deals up 26%

Acquisitions down 4% in 2016

M&A valuations are declining, but slowly:
2014 – 12.3x
2015 – 12.0x
2016 – 11.5x

Add-ons 29% versus 2015
(excludes Kraft and EMC acquisitions in 2015, inclusive of which add-on acquisitions are down 66%)

The exit cycle is winding down

Top sectors
by % of all PE investments

- Technology: 16% 20%
- Utilities: 1% 16%
- Health care: 5% 10%
Introduction

With record amounts of dry powder in hand, PE firms look for their opening

PE firms are looking for their opening. After having spent the last three years exiting companies at a brisk pace and distributing massive amounts of capital back to their LPs, fundraising remained strong in 2016, with more than US$530b in new commitments closed across over 800 separate funds.

As a result, firms now have record amounts of dry powder to put to work on new deals – indeed, more than they did in 2007. 2016 saw buyout firms sitting on more than US$525b in available capital. Adding in other fund types such as mezzanine, growth capital and real estate brings the figure to a staggering US$1.5t in available capital that is slated to be invested over the next several years.

While PE firms have an excess of capital at the ready, putting those assets to effective use has been far more challenging. After a record year for M&A in 2015, overall merger activity (by both strategic investors and PE firms) declined 15% in 2016. And while valuations have trended lower in recent quarters, they remain elevated relative both to historical norms and to PE’s comfort zone for most deals.

This was most evident by a decline in PE megadeals, deals valued at more than US$3b, which declined 6% year-over-year, as continued competition from corporate acquirors and a challenging financing market in the first half of the year saw many firms move downmarket for targets. Indeed, conditions led firms to become increasingly opportunistic in a number of ways, as they sought to creatively deploy capital as they waited for broad-based market adjustment.

When that adjustment might materialize is anyone’s guess. In the meantime, with expectations for multiple expansion largely off the table, firms will look to deploy assets across a range of companies and industries in transition, where they can add value through operational improvement and industry expertise to uncover hidden value.
Fundraising in line with 2015, despite secular growth in the asset class

The last four years have seen a marked uptick in PE fundraising, driven by two factors: 1) record levels of exit activity and distributions back to LPs, and 2) secular growth in the asset class, as more LPs allocate capital to alternative investments, and to PE in particular. In total, PE firms have raised more than US$2t for commingled funds since the beginning of 2013, making it one of the most active periods for commitment-gathering in the industry’s history.

Global PE firms have raised US$490b–US$535b for each of the last four years. While not quite the highs seen in 2007–08, it represents a marked uptick from the years immediately following the global financial crisis. In 2016, PE firms raised US$531b, in line with 2015.

Many LPs were driven by an increased sense of urgency resulting from massive waves of distributions received over the last three to four years. Indeed, over the last three years, PE firms have exited companies valued at more than US$1.2t, with exits outpacing new acquisitions by a ratio of 1.3 to 1. However, 2016 saw a marked decline in the value of exit deals; firms have largely completed the sell-down of boom-era assets, and are now looking forward to a new deployment phase. As such, with the exit cycle now winding down and global powder at record highs, it is reasonable to expect that some LPs may seek to slow the pace of re-ups over the near term.

However, beyond the cyclical drivers, PE continues to see secular growth, with many existing LPs increasing their target allocations to PE, and many new investors investing in the asset class for the first time. A recent survey by Preqin, for example, found that 56% of institutional investors planned to increase their allocations to PE over the long term (just behind private debt, which saw more than two-thirds looking to increase exposure).

At the same time, PE is attracting investors that are new to the asset class, driven by the continued low interest rate environment and middling returns in public equities. Family offices, for example, have been increasingly moving assets into PE; a report from iCapital found that more than half of family offices surveyed were invested in PE, with the majority expected to increase their allocations over the next two years. And while estimates vary as to the number of family offices worldwide, conservative assessments of their total assets exceed US$2.4t.

Similarly, pension funds, insurance companies and other institutional investors across many of the emerging markets (EMs) are raising their allocations to PE, increasing the global pool of assets available to general partners (GPs). LPs in the emerging markets currently have more than US$116b invested in PE vehicles, with an average target allocation of 6.8% versus a current allocation of 6.1%. The last decade has seen regulators become increasingly comfortable with the asset class, and in many cases they have amended regulations to allow for greater investment in PE by local investors. As the trend continues, EMs will become an even greater source of capital for PE investors across the globe.

Longer term, some firms are looking to retail investors as a significant source of potential capital for the industry. Already, several vehicles have been introduced in order to facilitate investment by high-net-worth investors, and many firms are working on solutions which would open up the asset class to everyday investors, even those in defined contribution vehicles, such as 401(k)s.

Figure 1. Global PE fundraising by year
Europe sees fundraising gains, while US and Asia see declines

While the top-line number for global fundraising in 2016 remained largely unchanged versus 2015, there were significant differences across the regions.

Firms focused on the US saw a modest decline of 5% from 2015, with US$306.3 in total assets raised across 449 different vehicles. In the buyout space, megafunds (more than US$5b) and large (US$3b–US$5b) buyout funds saw the most activity, accounting for more than half of total closings, as funds sponsored by Advent, Ares, TPG, Cinven, Thoma Bravo and others all held final closes during the year.

In Europe, uncertainty stemming from the UK’s vote to leave the EU was a contributing factor to a marked uptick in funds raised by European managers, as investors sought to back managers poised to capitalize on the potential dislocations. In total, firms based in the region took in US$159b, an increase of 28% over 2015.

Asia-Pac saw a marked decline in activity, with just US$49b raised, representing a 25% year-over-year decline. Macro uncertainty in China was a prime driver of the downturn, as was recent fundraising activity, which has left managers in the region with high amounts of dry powder.

Other emerging markets outside of Asia saw similar declines, as macro concerns kept many new investors at bay, while those already invested in the EMs took a wait-and-see approach pending the outcome of existing investments.

Funds focused on Latin America, for example, raised just US$5.1b in 2016, a 22% decline from 2015, and a significant decline from the more than US$14b that was raised in 2011. However, in Brazil (and indeed, in any of the emerging markets where macro concerns have dominated), any sense that a bottom has been reached or that stabilization is imminent could quickly precipitate a new round of funding from investors anxious to capitalize on buying opportunities.

Figure 2. Global PE fundraising by region

Figure 3. Top buyout funds raised

<table>
<thead>
<tr>
<th>Fund</th>
<th>Target size (US$b)</th>
<th>Close size (US$b)</th>
<th>Close date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advent Global Private Equity VIII</td>
<td>12.0</td>
<td>13.0</td>
<td>21 Mar 16</td>
</tr>
<tr>
<td>TPG Partners VII</td>
<td>9.0</td>
<td>10.5</td>
<td>6 May 16</td>
</tr>
<tr>
<td>Green Equity Investors VII</td>
<td>8.5</td>
<td>9.6</td>
<td>3 Jun 16</td>
</tr>
<tr>
<td>Apax IX</td>
<td>7.5</td>
<td>9.0</td>
<td>20 Dec 16</td>
</tr>
<tr>
<td>Permira VI</td>
<td>7.2</td>
<td>7.9</td>
<td>14 Dec 16</td>
</tr>
<tr>
<td>Ares Corporate Opportunities Fund V</td>
<td>6.5</td>
<td>7.9</td>
<td>22 Apr 16</td>
</tr>
<tr>
<td>Cinven VI</td>
<td>5.9</td>
<td>7.7</td>
<td>29-Jun-16</td>
</tr>
<tr>
<td>Thoma Bravo Fund XII</td>
<td>7.0</td>
<td>7.6</td>
<td>13-Sep-16</td>
</tr>
<tr>
<td>BDT Capital Partners Fund II</td>
<td>5.2</td>
<td>6.2</td>
<td>19-Feb-16</td>
</tr>
<tr>
<td>Berkshire Fund IX</td>
<td>5.5</td>
<td>5.5</td>
<td>31-Mar-16</td>
</tr>
</tbody>
</table>

Source: Preqin
Dry powder reaches historic levels

One of the most important stories of 2016 has been the growth of the industry’s dry powder. PE firms have seen several years of strong fundraising, with more than US$2t raised for commingled funds since the beginning of 2013. At the same time, the environment for putting those assets to work is among the most challenging we’ve ever seen. High valuations, competition from corporate acquirors, and increased macro and geopolitical uncertainty have led to a flat market for new acquisitions. PE firms announced just 1,536 deals valued at US$319b in 2016, a 4% decline from 2015.

The result is that PE now has a massive war chest with which to pursue new deals. PE firms currently hold more than US$525b in dry powder in buyout funds alone, representing a roughly 11% increase over 2015, and significantly exceeding the US$480b that firms held in 2007. While the bulk of this remains focused on the North American market (up 16% in 2016), all major regions have seen dry powder increase, with dry powder up 21% in Europe, to US$173b, and 12% in Asia-Pac, to US$41b. Asia, in particular, has seen the most dramatic growth over the last decade; while dry powder has increased 19% in North America versus 2006, and 17% in Europe, assets focused on the rapidly growing Asian market have more than doubled over the same period.

Including all fund types (buyout, venture, growth, real estate, distressed, etc.), dry powder has grown to more than US$1.4t.

Figure 4. Global PE dry powder by year (in US$b)

Large funds (US$3b–US$5b) shine as LPs consolidate and GPs diversify

The last several years have seen large funds, sized US$3b-US$5b, emerge as most effective for fundraising, the result of several factors. With increased volatility in many of the EMs, and bull markets in the US and Europe approaching the eight-year mark, investors have increasingly flocked toward the stability of large funds from established managers. Moreover, LPs continue to seek opportunities to consolidate the number of relationships they manage. The purpose of this consolidation is twofold, as investors 1) are seeking to streamline the selection and oversight process as programs get bigger and demands on staff increase; and 2) more importantly, earn fee discounts and reduce overall program expenses. Another factor in favor of large funds is the relative decline of megafunds (US$5b and above). The last several years have seen many of the largest fund managers offer a wider array of funds to their investors — instead of raising a single megafund, fundraising is thus split over several smaller funds. As a result, over the last five years, dry powder has grown at an annualized rate of 6.3%. Large funds, however, with commitments between US$3b-US$5b, have grown the fastest, with a compound annual growth rate (CAGR) of 8.6%.

Interest in smaller funds remains robust

While the bulk of this remains focused on the North American market (up 7% in 2016), all major regions have seen dry powder increase, with dry powder up 20% in Europe, to US$165b, and 12% in Asia-Pac, to US$45b. Asia in particular has seen the most dramatic growth over the last decade; while dry powder has to date increased 17% in North America since 2006, and 13% in Europe, assets focused on the rapidly growing Asian market have more than doubled over the same period.

First-time funds tend to outperform more established vehicles for a number of reasons — among them, a more rigorous selection process, lower target sizes and highly motivated GPs. According to a Privcap study published in 2015, funds raised by first-time managers since 2000 have averaged an annual median internal rate of return (IRR) of 14.1% versus more established managers, which have averaged a median IRR of 10.2%.
Despite a continued robust market for PE fundraising, LPs’ standards haven’t softened. As the market and its participants continue to mature and increase in sophistication and ability, GPs must contend with an increasing array of considerations when promoting their next fund.

**Consider new sources of capital**

Assets are flowing into PE from sources beyond the traditional triad of pensions, endowments and foundations. PE firms are now receiving commitments from investors that are new to the asset class – institutional investors in the emerging markets, family offices, sovereign wealth funds and high-net-worth retail.

**Be responsive to LPs’ increasing data and reporting requirements**

As PE becomes an increasingly important part of investors’ portfolio, the demands for transparency and more comprehensive reporting have increased as well. Successful GPs are using best-in-class access to information as a competitive edge in raising new assets.

**Fee transparency**

Fees and everything fee-related have taken center stage as a hot topic with regulators and LPs. A robust disclosure of fee arrangements and discussion of potential conflicts is a prerequisite to earning LPs’ trust and their commitments.

**Track records still key**

For many LPs, track records remain the single most important consideration when deciding whether to invest. GPs raising capital should have a clear and detailed summary of past performance, and be able to articulate how those results were achieved, as well as be able to explain any missteps or periods of underperformance. Many LPs will immediately and forever discount firms they perceive as seeking to present anything other than the unvarnished truth.

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**Figure 5. Five-year compound annual growth rates**

- Small funds, 0.7%
- Mid-size funds, 6.0%
- Large funds, 8.6%
- Megafunds, 7.0%

*Source: Preqin*

**Figure 6. Time to close (in months)**

Firms are raising capital faster than almost any time since 2006-07. Funds that closed in 2016 spent an average of 16 months between launch and final close, in line with 2014, and down significantly from 2012-13, when the average fund took 18 months to close. Moreover, some large funds have experienced markedly shorter times to final close – Advent VIII, for example, closed after just six months.

Funds in 2016 were also, on average, oversubscribed. The average fund closed with 103% of its target commitments.

**Figure 7. Percentage of target raised**

Buyout funds and infrastructure funds were among the fund types seeing the strongest demand, closing, on average, in 12 months and 15 months, respectively.

**Figure 8. Time to close by fund type**

- Buyout
- Growth
- Real estate
- Infra
- Distressed

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**The new imperatives for PE fundraising**

Despite a continued robust market for PE fundraising, LPs’ standards haven’t softened. As the market and its participants continue to mature and increase in sophistication and ability, GPs must contend with an increasing array of considerations when promoting their next fund.
Uncalled commitments only a part of the story — shadow capital increasing at a rapid rate

Unspent commitments from commingled funds (dry powder) only tell part of the story – an increasingly smaller part. Shadow capital, which includes co-investment activity, direct investments and commitments to separate accounts, is accounting for an increasing share of total investment in the asset class.

According to London-based consultancy Triago, in the five years preceding 2015, shadow capital averaged approximately US$63b per year. In 2015, however, such fundraising totaled more than US$160b, and as of midyear, 2016 was on track for more than US$170b in total shadow fundraising. As such, traditional estimates of the industry’s size are increasingly likely to underestimate the total amount of capital that is flowing into PE.

Behind the rise is a greater focus on fees. With LPs increasingly looking to reduce the costs of their alternatives programs, shadow capital commitments – whatever the form – can offer increased exposure while averaging down aggregate fee outlays. Presently, the largest LPs are the most active in the shadow capital market, given their ability to effectively manage co-investment deal flow, make the sizeable single-manager commitments required for separate accounts and invest in directs. However, mid-size LPs are increasingly looking to scale their activities, especially with co-investments, and are building the processes and infrastructure to manage the increased monitoring and oversight requirements. As a result, it’s reasonable to expect that shadow capital will only increase in importance to PE in the coming years.

Fundraising outlook

A number of competing dynamics will define the health of the fundraising market over the coming year.

With many public market indexes at or near record highs, and valuations exceeding 25 times earnings in the US, many economists and market observers are forecasting limited growth for public equities in the coming years. As a result, investors are expected to look increasingly to alternatives in order to reach their portfolio objectives. Public pensions in particular are looking at PE as a way to increase plan returns and mitigate the need for massive hikes in contributions from sponsoring entities. For example, in the US, pensions are facing a funding gap which, by some estimates, has reached US$3.4t, making PE’s risk/return profile extremely attractive.

At the same time, however, exits and distributions are slowing. With firms already sitting on record levels of dry powder and the industry already largely in possession of the capital it needs to fund the next cycle of deals, many firms have limited need to return to the market with new funds. As such, the outlook for fundraising, particularly in the large buyout space, could be constrained over the near term until firms are able to deploy a meaningful percentage of their existing commitments. While the next year will see continued offerings from mid-market firms and smaller niche funds, along with large firms continuing to roll out new strategies, aggregate commitments could level off, or even fall, and average fund sizes could decline.
Deal activity declines amid continued high valuations, competition from corporates and a challenging financing environment

After a record year for global M&A activity in 2015, 2016 saw a measure of deceleration, as prospective acquirors grappled with the potential implications of Brexit, the outcome of the US presidential election and increasing macro volatility in the emerging markets. Global M&A activity totaled US$3.7t in 2016, down 15% from 2015, when free-spending corporate acquirors with M&A-driven growth agendas pushed aggregate deal values past US$4.3t for the first time ever.

PE activity saw similar, albeit less dramatic, declines, as firms found themselves in a liminal space; while valuations have declined markedly from two years ago, they nonetheless remain elevated relative to historical averages, and after three years of exceedingly strong M&A activity, firms have a somewhat diminished ability to find attractive targets that they can aggressively underwrite. As such, PE firms announced just 1,536 deals valued at US$319b in 2016, a 4% decline from 2015.

However, as with fundraising, the top-line numbers tell only part of the story. Activity has slowed in the megadeal space; while the number of deals valued above US$3b increased, from 21 to 24, the aggregate value dropped 6%, to US$121b. Continued competition from corporate acquirors amid a low organic growth environment was a primary culprit, a trend which could continue well into 2017 in the absence of a widespread market reversal prompting corporates to become more cautious.

Another factor in the activity decline was a challenging market for financing, especially in the early part of the year, as buyers stepped away from the market. While lending recovered in the second part of the year, levels remain lower than in 2015. In aggregate, leveraged finance (including loans and high yield (HY)) totaled US$706b in 2016, in line with 2015. The softness was driven in particular by weakness in high yield, which was down 10% from 2015. European Central Bank (ECB) is now considering leverage limits for Europe similar to those being implemented in the US; the trend could spread across the Atlantic.

Indeed, analysts at Fitch recently warned that if implemented, such measures could have an even more profound impact on the financing markets in Europe than they have in the US.

Activity in the size band one step lower – deals valued between US$1b-US$3b – has remained robust, with 65 deals announced valued at US$103b, a 14% increase over the same period last year. A marked increase in tech-related deals was the key driver of activity in the segment, as PE firms looked to acquire high-growth companies with stable revenues, in some cases partnering with activist investors to effect deals.

Figure 9. Global PE activity by size – year-over-year change, 2015 versus 2016 (by value)

Activity in the sub-US$1b space saw a decline of 16% through the end of the year, where the increasing role of intermediaries made the segment increasingly efficient and reduced the ability of sponsors to find proprietary deal flow at more modest valuations. This was especially true in the upper middle market (deals valued at US$250m–US$1b), where deal value fell 13% versus last year. Activity at the lower end (US$100m–US$250m) declined 4% during the year.

Figure 10. Global PE deal activity by year
Acquisitions

Valuations moderate, yet remain high; add-on deals decline after a record 2015

While PE firms have more dry powder than at any time in their history, activity remains muted, the result of persistently high valuations. After hitting a peak of 12.3x in 2014, marketwide M&A valuations have trended lower in the period since, as volatility in the public equities markets and concerns around global growth have trickled to private market valuations – to an average of 11.5x earnings before interest, tax, depreciation and amortization (EBITDA) in 2016. While the decline has allowed some firms pursuing attractive assets with solid growth prospects the ability to underwrite aggressively, most firms have remained disciplined in their approach to investment. Indeed, given the length of the current economic expansion, many fully expect that companies purchased today may need to be held through an economic downturn, and are thus wary of overpaying.

In 2014 and 2015, PE firms sought to mitigate higher entry multiples on platform investments through buy-and-build strategies. Typically, smaller companies will trade for lower multiples, allowing firms to reduce their cost basis, and allowing firms to stay active amid a high-price environment. Add-ons hit a record high in 2015, with US$263b in announced deals. While a significant percentage of total value was attributable to just two deals – Dell’s acquisition of EMC software for US$65.7b, and Heinz’s acquisition of Kraft Foods for US$62.6b – add-ons hit a record, even excluding those deals.

2016, however, saw a moderation of buy and build activity, suggesting that deals for many of the most immediately synergistic assets have already been consummated. Overall, add-on activity (excluding Dell and Heinz) was down 29% this year, with 1,142 deals announced valued at US$94.9b. Some of the most significant declines were seen in the consumer products/retail space, which saw the value of add-ons fall from more than US$33b in 2015 to US$9b in 2016. Conversely, activity remained strong in the health care space, as firms continued to consolidate the highly fragmented sector. Firms announced deals valued at more than US$23b in the space, up from just US$3b in 2015.

Figure 11. Global M&A EBITDA/EV multiples

![Graph showing global M&A EBITDA/EV multiples from 2000 to 2016]

Source: Dealogic

Figure 12. PE add-on activity

![Graph showing PE add-on activity from 2000 to 2016]

Source: Dealogic

Table: Top PE deals announced in 2016

<table>
<thead>
<tr>
<th>Announced</th>
<th>Company</th>
<th>Value (US$b)</th>
<th>Sponsor</th>
<th>Sector</th>
<th>Deal type</th>
</tr>
</thead>
<tbody>
<tr>
<td>08-Dec-16</td>
<td>National Grid plc (Gas distribution business)</td>
<td>$14.5</td>
<td>Allianz Capital Partners GmbH; Macquarie Infrastructure &amp; Real Assets Pty Ltd</td>
<td>Utility &amp; Energy</td>
<td>Strategic</td>
</tr>
<tr>
<td>20-Oct-16</td>
<td>Ausgrid Pty Ltd</td>
<td>$12.4</td>
<td>IFM Investors Pty Ltd</td>
<td>Utility &amp; Energy</td>
<td>Strategic</td>
</tr>
<tr>
<td>05-May-16</td>
<td>MultiPlan Inc</td>
<td>$7.5</td>
<td>Leonard Green &amp; Partners LP; Hellman &amp; Friedman LLC</td>
<td>Healthcare</td>
<td>Secondary buyout</td>
</tr>
<tr>
<td>31-Oct-16</td>
<td>Team Health Holdings Inc</td>
<td>$6.0</td>
<td>Blackstone Group LP</td>
<td>Healthcare</td>
<td>Strategic</td>
</tr>
<tr>
<td>23-Jun-16</td>
<td>GE Money Bank SCA</td>
<td>$4.6</td>
<td>Cerberus Capital Management LP</td>
<td>Finance</td>
<td>Strategic</td>
</tr>
<tr>
<td>22-Nov-16</td>
<td>Calsonic Kansei Corp</td>
<td>$4.5</td>
<td>KKR &amp; Co LP</td>
<td>Auto/Truck</td>
<td>Strategic</td>
</tr>
<tr>
<td>26-Aug-16</td>
<td>Rackspace Hosting Inc</td>
<td>$4.4</td>
<td>Apollo Global Management LLC</td>
<td>Computers &amp; Electronics</td>
<td>Strategic</td>
</tr>
<tr>
<td>14-Dec-16</td>
<td>Tatts Group Ltd (Lottery business)</td>
<td>$4.2</td>
<td>KKR &amp; Co LP</td>
<td>Leisure &amp; Recreation</td>
<td>Strategic</td>
</tr>
<tr>
<td>11-Jul-16</td>
<td>Ultimate Fighting Championship</td>
<td>$4.0</td>
<td>MSD Capital LP; KKR &amp; Co LP; Silver Lake Group LLC</td>
<td>Leisure &amp; Recreation</td>
<td>Strategic</td>
</tr>
<tr>
<td>02-Aug-16</td>
<td>Vertiv Co</td>
<td>$4.0</td>
<td>Platinum Equity LLC</td>
<td>Computers &amp; Electronics</td>
<td>Strategic</td>
</tr>
</tbody>
</table>

Source: Dealogic
Acquisitions – the regional picture

US

PE activity in the US has historically accounted for approximately one-half of global PE investment; in the years immediately following the last recession, however, the percentage declined to a low of just 33% in 2008, as the industry increasingly focused its attention on opportunities in Asia and the rest of the emerging markets. The last two years though have seen a marked shift back to the US, as economic uncertainty across Asia and the EMs, combined with positive (albeit anemic) growth in the US led firms to refocus their efforts on the world's largest economy. In 2015, US targets represented 53% of aggregate PE investment, and in 2016, such investments accounted for 45%.

Despite the increased focus, it remained challenging to put assets to work in a constructive way, given persistently high valuations, rising US wages and tepid growth. As a result, aggregate investment fell 17% from 2015, to US$145b. While megadeals (US$3b+) fell significantly, platform deals valued at US$1b–US$3b saw significant increases, up 48% by value versus 2015.

Firms responded to these challenges by looking for pockets of opportunity and special situations where they could add value via operational improvement or balance sheet transformation. Many firms found such opportunities in the take-private space, particularly in the tech sector; sponsors announced 29 deals for publicly listed targets during the year, up 41% from the year prior. While technology accounted for roughly half (by both number of deals and value), the trend saw traction across a range of industries. Apollo, for example, was particularly active in acquiring a number of public companies throughout the year, each with varying degrees of complexity. In February, the company announced a US$1.1b deal for Apollo Education Group in the for-profit education space, a sector which has come under significant scrutiny from regulators. In June, the firm inked a buyout of timeshare operator Diamond Resorts for US$3.2b, a company which has, in the past, come under fire for its aggressive sales practices; and in March, the firm led a US$1.2b take-private for Fresh Market, which has seen slowing growth in recent years amid increasing competition from mainstream operators such as Wal-Mart and Kroger.

Firms also remained busy deploying assets outside of the traditional buyout/growth capital space. Recent years have seen US-based firms in particular continue to expand their platforms and move into a wider range of alternative asset classes. While the buyout model remains an important part of the market, firms are increasingly deriving revenue from a range of alternative asset classes – hedge funds, credit, real estate, fund-of-funds, advisory, capital markets underwriting – all under one roof. Indeed, among the top five largest US publicly traded alternative managers, buyout/traditional PE investment is an increasingly smaller percentage of the business, with just 30% of total assets dedicated to PE.

Figure 15. Top five publicly traded alternative asset managers – assets under management by type

<table>
<thead>
<tr>
<th>PE</th>
<th>Real estate</th>
<th>Hedge funds</th>
<th>Credit</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>15%</td>
<td>10%</td>
<td>36%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Source: 10-ks, EY research

The credit space in particular has seen a great deal of attention from PE investors in recent quarters. Firms continued to invest across the energy space, as access to traditional sources of capital remained on the sidelines amid continued low oil prices. Firms were also active in the distressed space, mid-market lending and structured products.

The year also saw firms seeking opportunities by redefining the PE model itself, as a handful of US and European firms closed funds that sought to replicate the longer-term hold periods of a Berkshire Hathaway. In June, reports surfaced that Blackstone was close to finishing fundraising on Blackstone Core Equity Partners LP, a buyout fund with a 20-year time frame focused on opportunities with decreased risk profiles, more established revenue streams and lower return expectations than traditional buyout investments. In May, Carlyle announced that it had raised US$3.3b for a similar fund; CVC is reportedly making investments out of a similar US$5b pool.

Figure 14. US PE deal activity by year

Source: Preqin
Brexit injects uncertainty, and for some, opportunity

Britain’s historic vote for independence from the EU in late June led Europe and the rest of the world into uncharted territory. Indeed, the next several years promise to be a period of significant uncertainty as the terms of Britain’s exit from the EU are negotiated.

While the near-term impacts – widespread volatility and market disruption – have died down in the months following the referendum, the long-term impacts of the vote could yield significant disruption versus the status quo of the last 40 years. PE firms find themselves challenged on several fronts. At the firm level, significant changes are likely in store for the ways PE firms structure and market their funds. At the portfolio level, firms will face a wide array of changes across a range of industries.

Already, M&A and buyout activity has seen marked disruption in the days leading up to and after the vote, as potential acquirors and PE firms reassessed opportunities and the impacts of the vote. PE acquisitions of UK-based targets dropped from an average of US$9.6b/quarter in 2015 to US$2.0b/quarter in the first three quarters of 2016, before rebounding in Q4, largely on the strength of the Macquarie/CIC Capital Corporation/Qatar Investment Authority investment in National Grid (the largest deal of 2016).

Perhaps the most significant long-term effects from the vote are the eventual changes to fundraising and marketing processes for UK and EU funds. Currently operating under the Alternative Investment Fund Managers Directive (AIFMD) and other passporting frameworks, it remains to be seen what will ultimately be negotiated as Britain exits the EU. There are several potential scenarios, including the creation of a new UK-specific passporting mechanism, the ability to market under some broader umbrella legislation (similar to Norway) or some type of continued application/grandfathering for the existing AIFMD framework.

Beyond the challenges, however, firms will also find new opportunities. PE is an industry which thrives on volatility and ambiguity, and Britain’s exit from the EU could beget a wide variety of attractive investments for firms that can successfully navigate the new landscape. Already, anecdotal evidence exists of an increased interest in inbound activity as dollar-denominated firms seek to take advantage of the Euro’s weakness and generalized market uncertainty.

Figure 16. UK PE activity pre- and post-Brexit

<table>
<thead>
<tr>
<th>Quarter</th>
<th>US$b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q115</td>
<td>9.3</td>
</tr>
<tr>
<td>Q215</td>
<td>11.7</td>
</tr>
<tr>
<td>Q315</td>
<td>8.1</td>
</tr>
<tr>
<td>Q415</td>
<td>9.3</td>
</tr>
<tr>
<td>Q116</td>
<td>0.4</td>
</tr>
<tr>
<td>Q216</td>
<td>2.7</td>
</tr>
<tr>
<td>Q316</td>
<td>2.9</td>
</tr>
<tr>
<td>Q416</td>
<td>19.3</td>
</tr>
</tbody>
</table>

Source: Dealogic

Some of the most attractive sectors include those with strong secular growth trends that are poised to remain intact, even if UK domestic growth slows: technology, health care, telecoms and certain consumer products among them.
Figure 17. Key implications of Brexit for PE funds and their portfolios

<table>
<thead>
<tr>
<th>Concern</th>
<th>Recommended actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency</td>
<td>Continued volatility of sterling, with likely weaker sterling vs. USD and Euro over the medium-term</td>
</tr>
<tr>
<td></td>
<td>Review foreign exchange (FX) strategy and capacity of treasury function in portfolio trade and fund denomination context</td>
</tr>
<tr>
<td>Trade</td>
<td>Loss of access to the internal EU market and the consequent loss of free movement of goods, services, workers and capital</td>
</tr>
<tr>
<td></td>
<td>Management teams to develop detailed impact assessments based on a range of potential scenarios, including implications for supply chain</td>
</tr>
<tr>
<td>Operations</td>
<td>If UK exits the European Economic Area (EEA), UK firms would lose automatic rights to operate in EU markets.</td>
</tr>
<tr>
<td></td>
<td>Identify and review key legislation at EU level and where changes to these rules might impact your business</td>
</tr>
<tr>
<td>Structuring</td>
<td>Entities situated in the UK and other EU jurisdictions rely on passporting rights to operate across borders, which could be called into question.</td>
</tr>
<tr>
<td></td>
<td>Review locations of operational and back-office functions and consider creating a new corporate structure</td>
</tr>
<tr>
<td>Contracts</td>
<td>EU exit is a potential trigger for a breach in company contracts and/or financing agreements.</td>
</tr>
<tr>
<td></td>
<td>Identify contracts that contain geographical definitions referencing the EU, force majeure clauses, material adverse change clauses or other related terms</td>
</tr>
<tr>
<td>Employment</td>
<td>The right to travel and work within the EU/UK; rights with third nations agreed at an EU level</td>
</tr>
<tr>
<td></td>
<td>Monitor EU staff in UK and vice versa, and immediately review hiring and retention strategy</td>
</tr>
<tr>
<td>Data</td>
<td>If UK exits the EU, storage and processing of UK personal data in the EU will stop.</td>
</tr>
<tr>
<td></td>
<td>Plan for data storage capacity in UK (unless EU-UK Safe Harbour Privacy Laws to be created)</td>
</tr>
<tr>
<td>Tax</td>
<td>Indirect taxes, particularly Customs Duty and value-added tax (VAT) and the reclaiming of VAT on transaction costs</td>
</tr>
<tr>
<td></td>
<td>Assess business taxed under numerous jurisdictions, both corporate and client services</td>
</tr>
<tr>
<td>Transactions</td>
<td>Uncertainty during the period of renegotiation of trade deals and legislation will cause challenges for investors assessing investment opportunities.</td>
</tr>
<tr>
<td></td>
<td>Management teams and fund will need to revisit their exit strategies and timelines, and funds may consider reallocating capital or returning it to investors</td>
</tr>
</tbody>
</table>
Acquisitions – the sector view

Technology, health care and utilities move to the forefront as retail fades

Technology saw continued interest from PE investors in 2016 across a range of subsectors, including software, hardware, internet and semiconductors. Firms announced US$65b in tech-related deals during the year, representing more than a fifth of the industry’s total.

Beyond tech, PE firms spent much of the year looking at opportunities with non-cyclical or countercyclical components – for example, pursuing investments in industries such as power & utilities, which saw a marked uptick in PE investment. Industries in the midst of significant transformation, such as health care, also saw significant investment throughout the year, while sectors with notable potential exposure to deteriorating macro conditions, such as retail, industrials, financials and real estate, saw comparatively less interest from investors.

<table>
<thead>
<tr>
<th>Sector</th>
<th>2015 value and percentage of deals</th>
<th>2016 value and percentage of deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utilities</td>
<td>$4.5b 1.4%</td>
<td>$50.6b 15.9%</td>
</tr>
<tr>
<td>Health care</td>
<td>$16.3b 4.9%</td>
<td>$31.4b 9.8%</td>
</tr>
<tr>
<td>Technology</td>
<td>$54.0b 16.3%</td>
<td>$64.9b 20.4%</td>
</tr>
<tr>
<td>Materials</td>
<td>$15.8b 4.8%</td>
<td>$23.0b 7.2%</td>
</tr>
<tr>
<td>Consumer goods</td>
<td>$32.4b 9.8%</td>
<td>$23.8b 11%</td>
</tr>
<tr>
<td>Consumer services</td>
<td>$19.0b 5.7%</td>
<td>$20.9b 6.6%</td>
</tr>
<tr>
<td>Oil &amp; gas</td>
<td>$8.4b 2.5%</td>
<td>$7.6b 2.4%</td>
</tr>
<tr>
<td>Industrials</td>
<td>$31.7b 9.6%</td>
<td>$22.5b 7.0%</td>
</tr>
<tr>
<td>Telecom</td>
<td>$23.6b 7.1%</td>
<td>$9.0b 2.8%</td>
</tr>
<tr>
<td>Retail</td>
<td>$21.4b 6.5%</td>
<td>$5.4b 1.7%</td>
</tr>
</tbody>
</table>
Technology

Tech deals increased significantly in 2016, as companies pursued take-private strategies alongside PE firms attracted to the potential for stable growth. PE firms announced 19 tech deals valued at US$1b or greater across a range of industry subsectors, including IT services, hardware, internet and especially enterprise software, a segment which accounted for nearly 70% of aggregate investment. Firms took particular interest in incumbent players that may have lost market share to cloud-based solution providers, but retain a strong brand and customer relationships, and have the potential for competitive transformation. Going private allows these companies to undertake comprehensive and difficult transformations away from the glare of the public eye and the burden of analysts’ quarterly expectations.

In many cases, PE firms partnered with activist investors in order to identify and acquire targets in the space. Firms including Elliot Management and Starboard have become increasingly active in “old-line” tech, and several firms, including Vista Equity Partners and Apollo Management, have executed buyouts of companies under activist scrutiny.

There is good reason to believe that such deals will continue. PE firms are just scratching the surface of potential targets in the space, and have ample dry powder available for pursuits. Chicago-based Thoma Bravo, one of the most active investors, recently raised US$7.6b of additional commitments after a year which saw the firm involved in the take-privates of Qlik Technologies, TRADER Corp., SolarWinds, Imprivata and others.

Health care

Health care was another sector that saw a significant increase in PE activity, with 147 deals announced, valued at US$31b; this is nearly twice the value of 2015 and represents 10% of the industry’s aggregate deal value, up from just 5% in 2015.

With a worldwide spend of US$6.5t (representing more than 10% of global GDP) growing at roughly two to three times the rate of inflation, an aging global population and the rise of chronic disease are likely to drive steady cost increases in the future, making it an attractive space for PE investment. Increased regulatory activity in the US around the Affordable Care Act and its implications provided additional context for deals.

While the sector saw fewer large deals than tech – just seven deals valued at US$1b or more – health care saw one of the largest deals announced in 2016, when Leonard Green and Hellman & Friedman announced a US$7.5b acquisition of MultiPlan from Partners Group AG and Starr Investment Holdings. It was the third-largest secondary buyout in history, and the largest in the health care space.

Like technology, the outlook for continued investment in the sector is bullish. Although valuations remain high while asset quality has grown increasingly mixed, continued secular growth, ongoing policy reforms and the potential for roll-ups in a highly fragmented space will continue to provide attractive opportunities.
Power & utilities

While deals in the oil & gas (O&G) space stagnated as buyers and sellers worked to bridge the valuation disconnect, lower energy prices led to a wave of PE-backed deals in the P&U space. In total, firms announced 34 deals valued at US$51b, the highest for the sector since 2007.

With electric producers under pressure from lower natural gas prices, increased production from renewables facilities and lower demand, PE firms inked a number of deals for electrical generation facilities in both the US and Europe. In the US, Riverstone acquired Talen Energy, and Blackstone and ArcLight Capital Partners acquired four facilities from AEP. In Europe, Czech-based PPF teamed up with strategic investor Energeticky a prumyslovy holding, a.s (EPH) to acquire Vattenfall AB’s lignite business for US$3.8b.

Two of the year’s largest deals also occurred in the space: the US$14.5b sale of National Grid’s gas distribution business to a consortium that included Macquarie, China Investment Corporation and Qatar Investment Authority; and the US$12.4b sale of Ausgrid to IFM Investors Pty Ltd.

Oil & gas

Since oil prices began dropping midway through 2014, the O&G sector has been at the top of many firms’ watchlists. To date, however, comparatively little of the capital that has been raised for the sector has been deployed. With companies initially able to access traditional sources of financing up through mid-late 2015, many industry players are holding on, not wanting to sell out at lows.

2016 saw firms announce 27 M&A deals in the space valued at US$7.6b, down 9% from 2015. Many were in the upstream and midstream spaces. In upstream, firms are looking for distressed transactions of higher-quality assets, as hedges begin to expire and lender covenants can no longer be stretched. In the midstream space, firms are seeking opportunities from upstream sellers seeking to monetize their midstream assets in order to deleverage balance sheets.

With a recent bounce in oil prices, few assets for sale at fire-sale prices and significant competition from both strategics and PE, many PE firms are hesitant to invest until they feel the bottom of the cycle has been reached.

Consumer products and retail

After a period of elevated activity in the CPR space, precipitated by a wave of CPR companies selling off non-core assets, 2016 saw a softening of M&A activity as the cycle wound down, and PE investors remained sidelined by high valuations and significant competition for prime assets.

PE firms announced deals valued at US$65b in the space in 2016, down 11% from the prior year. Retail, in particular, saw a significant drop, with just US$5b in announced deals, down from more than US$20b in 2015.

While finding quality assets at reasonable valuations will remain challenging, firms will remain interested in the sector for a number of reasons — the space is lightly regulated, and companies often have strong cash flows and an open path to growth. There’s also a clear emerging markets component, and for many companies, a cogent thesis that can be developed around cost reduction.
Exit activity slows as firms shift to deployment

In the years immediately following the financial crisis, one of the industry’s biggest concerns was whether exit activity would be sufficient to effectively, and in an orderly way, exit the huge inventory of companies that had been acquired during the 2006-07 period.

Activity over the past three years has definitively put those concerns to rest. In 2014, exit activity increased dramatically, rising nearly 80% versus the year prior, as market conditions became favorable for exits. PE firms exited a record 1,292 companies valued at US$475b during the year. 2015 saw significant declines, but was nonetheless robust, with an additional US$424b in companies that were exited.

Having sold many of the assets acquired during the boom years, activity has since moderated significantly. PE firms are generally far more comfortable with the size and age of their portfolios than they were just two-three years ago, and presently have a reduced imperative to exit. Many have thus turned their focus to deployment of the record US$525b in dry powder raised by buyout funds over the last several years. PE firms exited 998 companies in 2016, with an aggregate value of US$331b, down 22% by value and down 17% by volume versus 2015.

Strategics drove much of the activity in 2014 and 2015, fueled by significant amounts of corporate cash reserves, elevated stock prices and readily available financing, a trend which continued in 2016. Overall, strategics drove 70% of PE exit activity by value, up from 66% in 2015, with US$231b in aggregate activity.

Sales to other PE firms have seen a marked decline in recent years, as cautious buyers stepped back in response to aggressive strategics. In 2007, sales to PE were nearly one-half of PE exits by value; by 2014, they had dropped to just 15% of exit value, after rebounding modestly in 2016 to roughly 20% of aggregate exit value.

Figure 18. Global PE deal exit by year (in US$b)

While 2016 saw a marked decline in the number and value of exits, future years should see activity continue at a more normal pace. Although the growth of the PE portfolio (representing all companies in which PE has an investment) has moderated in recent years – from a CAGR of 21% per year between 2005-10, to just 8% per year in the period since – PE firms nonetheless hold stakes in more than 16,000 companies across the globe, according to Pitchbook. As such, firms will continue to actively pursue buyers among both strategic and financial investors, as well as the public markets.

Figure 19. Top PE exits announced in 2016

<table>
<thead>
<tr>
<th>Announced</th>
<th>Company</th>
<th>Value (US$b)</th>
<th>Sponsor</th>
<th>Deal type</th>
</tr>
</thead>
<tbody>
<tr>
<td>9 Jun 2016</td>
<td>DONG Energy A/S</td>
<td>$15.0</td>
<td>Goldman Sachs Capital Partners</td>
<td>IPO</td>
</tr>
<tr>
<td>25 Feb 2016</td>
<td>Sharp Corp (66.06%)</td>
<td>$8.0</td>
<td>Japan Industrial Solutions Co Ltd</td>
<td>Strategic</td>
</tr>
<tr>
<td>7 Sep 2016</td>
<td>Formula One World Championship Ltd</td>
<td>$7.9</td>
<td>CVC Capital Partners Ltd</td>
<td>Strategic</td>
</tr>
<tr>
<td>5 May 2016</td>
<td>MultiPlan Inc</td>
<td>$7.5</td>
<td>Partners Group Holding AG, Starr Investment Holdings LLC</td>
<td>Secondary</td>
</tr>
<tr>
<td>5 Sep 2016</td>
<td>IDCsalud Holding SLU-Quironsalud</td>
<td>$6.4</td>
<td>CVC Capital Partners Ltd</td>
<td>Strategic</td>
</tr>
<tr>
<td>25 May 2016</td>
<td>US Foods Holding Corp</td>
<td>$5.1</td>
<td>KKR &amp; Co LP, Clayton Dubilier &amp; Rice LLC</td>
<td>IPO</td>
</tr>
<tr>
<td>12 Jun 2016</td>
<td>Blue Coat Systems</td>
<td>$4.7</td>
<td>Bain Capital LLC</td>
<td>Strategic</td>
</tr>
<tr>
<td>23 Sep 2016</td>
<td>Nets A/S</td>
<td>$4.5</td>
<td>Advent International Corp., Bain Capital LLC, ATP Private Equity Partners</td>
<td>IPO</td>
</tr>
<tr>
<td>28 Jun 2016</td>
<td>Change Healthcare</td>
<td>$4.0</td>
<td>Blackstone Group LP, Hellman &amp; Friedman LLC</td>
<td>Strategic</td>
</tr>
<tr>
<td>7 Aug 2016</td>
<td>Mattress Firm Holding Corp</td>
<td>$3.9</td>
<td>JW Childs Associates LP</td>
<td>Strategic</td>
</tr>
</tbody>
</table>

Source: Dealogic
IPOs decline significantly in 2016 amid global macro volatility

Among exit routes, IPOs saw the most dramatic decline in 2016, as global macro volatility – most notably Britain’s vote to leave the EU, and the slowdown in China’s growth rate and other emerging markets – led to increased risk aversion, particularly in the early part of the year. As a result, global IPO issuance (including PE-backed and non-PE-backed) saw its slowest start to the year since the recession, with just 452 deals priced in the first half of the year, raising US$43.9b, a decline of 60% from the first half of 2015. Activity picked up markedly in the second half of the year, however, with nearly $90b in proceeds. PE-backed deals experienced a similar trend, off 45% by value and 38% by volume versus 2015, with 96 deals valued at $32b reaching the public markets.

The Americas region, in particular the US, has seen the most dramatic decline in IPO activity over the last two years, falling 81%, from US$61b in 2014 to just US$12b in 2016. Asia-Pac saw similar declines, the result of a renewed IPO moratorium in China for most of 2015 and subsequent economic slowdown that capped IPO activity. By contrast, EMEA was the most active region by far with respect to PE-backed deals – largely the result of a deeper and longer recession in Europe – such that exit activity trailed the US by two-three years. Thus, where exit activity peaked in the US in 2014, exits have remained strong in Europe, as the industry continues to work to sell down the bulk of its portfolio.

While part of the decline in PE-backed IPOs is clearly correlated to the volatility in the broader new issuance market, PE-backed deals have also fallen as a result of lower inventories of PE-backed companies and overall reduced imperatives to exit relative to two-three years ago, when inventories were high. Sponsors are presently much more able to wait out periods of excess volatility than they were just a few years ago.

Figure 20. PE IPOs by region (in US$b)

<table>
<thead>
<tr>
<th>Year</th>
<th>Americas</th>
<th>EMEA</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>61</td>
<td>32</td>
<td>14.1</td>
</tr>
<tr>
<td>2015</td>
<td>15</td>
<td>8.4</td>
<td>8.4</td>
</tr>
<tr>
<td>2016</td>
<td>4</td>
<td>6.1</td>
<td>6.1</td>
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</tbody>
</table>

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Figure 21. Global IPO activity by year

Nonetheless, while exits are winding down from their record highs of the last few years, IPOs will remain an important part of the market. In 2007, PE-backed deals accounted for just 17% of global IPO proceeds. By 2014, as the wave of exits hit its peak, PE had accounted for more than 40% of the total market, and have since declined to 23% of the market in 2016. Currently, there are more than 60 PE-backed companies in registration; in the aggregate, they could raise nearly US$10b in total proceeds. Moreover, despite the fact that exits are seeing a cyclical decline as the industry works through many of the last of the large companies acquired during the 2006-07 period, there continues to exist a substantial number of companies in the shadow pipeline – companies interested in pursuing an IPO, or pursuing multi-track agendas as they await the optimal time to sell.

Source: Dealogic
Emerging markets

Emerging market headwinds beginning to abate

Emerging markets have seen an unprecedented amount of interest in the last several years, as low growth and low interest rates in the developed markets, coupled with favorable demographics, a rapidly growing middle class and increasingly favorable regulatory environments, pushed many GPs and LPs toward investments in emerging Asia, Latin America, Central Europe, Africa and other EMs. Since 2008, PE firms have raised more than US$300b for investment in these regions.

Recent quarters, however, have seen rough winds for many emerging economies, as the slowdown in China, volatile commodities prices, and an imminent rise in rates in the developed markets took a toll on growth prospects. Both Brazil and Russia remain in recession, and there continues to exist significant uncertainty around where China’s growth rates will ultimately settle.

The macro environment has had an impact on PE. Fundraising activity has moderated, and deal activity has slowed as some firms adopt a wait-and-see approach to the macro situation. Through the end of the third quarter, the most recent for which figures are available, PE firms had raised US$17.9b for investment in the emerging markets, on track for a 35% decline over 2015. Similarly, investment activity declined from US$27.2b to a projected US$22.8b, a fall of 16%.

The downturn in fundraising, while dramatic, was not wholly unexpected. While some is almost certainly due to macro pressures, firms have also raised significant amounts of capital for the EMs in recent years, much of which has yet to be invested. Moreover, exits to date have been limited in many EMs — in part by the youth of the many investments themselves (investments made in the last three to five years) and in part from externalities, such as China’s moratorium on IPOs, which has closed off a favored exit route in the region.

While investment activity has also seen declines, the magnitude is consistent with the decline in PE investment across the globe; moreover, the reasons for the dropoff are not dissimilar. Despite deteriorating macro situations in many EMs, valuations in many industries remain stubbornly high, challenging PE firms to invest opportunistically and in a way that preserves the potential for upside amid scaled-back growth expectations.

Despite the downturn, the long-term outlook for PE across the EMs remains optimistic. EM equities were among the best-performing asset classes in 2016, the result of rising sentiment for domestic growth, limited contagion from Brexit and the US Fed’s decision to delay further interest rate increases. According to Morgan Stanley estimates, all four of the BRIC economies (Brazil, Russia, India and China) are forecast to see positive economic growth by mid-year 2017. Further, many countries will continue to see elevated growth relative to the developed markets; after all, there are still millions of people entering the middle class, consumerism continues to rise and the demographic trends that have attracted many to the EMs will continue to play out over the next decade. In aggregate, economists forecast EM growth of 4.7% next year, versus just 1.5% for the developed economies of the G10 countries.

Figure 23. Emerging markets fundraising by year (in US$b)

Source: EMPEA. 2016 figures through Q3 2016, annualized

Perhaps most importantly from a PE perspective, penetration (measured as a percentage of aggregate PE investment relative to GDP) remains extremely low across the EMs. Where PE represents 1% of GDP in the US and Europe, the economies of China, Latin America and Sub-Saharan Africa represent less than one-fifth of that. As a result, despite the waves of private capital entering the markets over the last several years, there still exists significant headroom for growth, and significant opportunities remain to opportunistically identify and invest in these regions’ inefficiencies.

LPs seem to agree. EMPEA’s annual survey of more than 100 investors in the emerging markets found that 40% intend to increase their allocation to EM PE funds over the next two years, and another 38% intend to maintain their current allocations. Sectors of particular interest include those that will benefit from rising ME incomes and the expansion of the middle class — consumer products, telecom, health care, education and others.

Figure 24. Emerging markets investment by year (in US$b)

Source: EMPEA. 2016 figures through Q3 2016, annualized
China

Activity in China was impacted by the continued slowing of the economy. Domestic PE investment totaled just US$5.1b through the end of the third quarter, on track for a roughly 45% decline versus 2015. However, fundraising remained resilient, totaling US$10.8b, on track for a 47% increase versus 2015.

Asia-Pac investment activity as a whole climbed 26% by value in 2016, largely on the strength of a couple of large deals announced in Australia – the US$8.6b acquisition of rail operator Asciano by the Canada Pension Plan Investment Board, and the US$12.0 and the US$12.4b investment in Ausgrid by Westscheme Pty Ltd and IFM Investors Pty Ltd, respectively.

In many ways, however, the figures belie the strength of China’s PE industry, which has grown rapidly in both scale and sophistication. 2016, for example, saw the aggressive pursuit of targets outside of the region. Large China-based firms, including CDH, Legend Capital, Golden Brick Capital, Hony Capital and others, have recently increased their pursuit of large cross-border deals.

In many instances, strategic investors are partnering with PE firms to execute on such deals; this was the case with two of the largest cross-border deals. In August, Caesars Interactive Entertainment announced that it had sold its social gaming platform Playtika to a China-based consortium, including Shanghai Giant Network Technology, an affiliate of one of China’s largest online gaming companies, as well as several PE investors, including CDH China Holdings Management, Hony Capital and Yunfeng Capital, for US$4.4b. An announcement earlier in the year for printer maker Lexmark saw a similar dynamic. The buyers in the US$3.6b deal included ink-cartridge maker Apex Technology, PAG Asia Capital and Legend Capital. PE’s involvement has followed a larger M&A trend which has seen Chinese companies invest in foreign targets at a record rate. For targets, these deals can offer entry into the often-lucrative Chinese markets; for buyers, they represent an opportunity to diversify beyond their home markets and, in some cases, acquire companies at more attractive valuations than the elevated Chinese market. As PE firms in the region continue to grow and expand, they will increasingly challenge the large US and European incumbents for access to top opportunities.

Latin America

Latin America has been one of the most compelling destinations for EM PE in recent years. While much of the industry’s initial focus was on Brazil, the last several years have seen a significant expansion of activity in countries including Colombia, Peru, Chile and Mexico. 2016, however, saw a challenging environment for many of the region’s economies. Already facing a macro slowdown from declining demand in the commodities space, political upheaval in several countries – especially Colombia and Brazil – compounded the economic malaise and contributed to a pullback in investment.

Overall, PE investment in Latin America reached US$1.4b through the end of Q3 according to EMPEA, on track for a 24% decline versus 2015. Much of the drop-off was attributable to a slowdown in Brazil, which has accounted for more than 70% of aggregate PE investment since 2008. In 2016, investments worth just US$940m announced were in Brazil, on track for a 29% decline versus 2015, and a marked decrease from the US$4.3b announced at the region’s peak in 2012.

Activity in Mexico, by contrast, has continued to grow, with investment on track for a 27% increase versus 2015. Mexico’s economy, which is more closely tied to the US than many other Latin American, or LatAm, economies, has accelerated in line with the continued US expansion and led to increased interest from both domestic and global PE investors. Moreover, the last several years have seen regulators shape an increasingly accommodative environment for private capital: first, with the 2009 decision to allow local pensions to invest in the asset class; and more recently, with the creation of the Fibra E and CerPis frameworks to facilitate additional investment.

Activity was also strong across many of the other economies in LatAm, with Peru, Chile and Argentina all seeing year-over-year increases in PE investment.

Moreover, investments of other types – beyond traditional PE investment – increased, albeit from a low base. PE-backed infrastructure and real estate deals increased from US$187m in 2015 to more than US$252m through the third quarter of 2016, on track for a nearly 80% increase; and PE involvement in private credit, which has grown dramatically in the US and Europe, is seeing similar increases in LatAm. Such investments totaled US$52m through 3Q16, on track for a 52% increase versus 2015.
Latin America will clearly remain a compelling destination for capital over the long term, spurred by the ongoing growth of the region’s middle class and favorable demographic trends. Over the near term, however, things are more uncertain. While Brazil is expected to emerge from recession by the end of 2016, which should precipitate renewed confidence among dealmakers, looming questions over potential shifts in US trade policy could see some investors sidelined. For Mexico, in particular, the effects could be profound; concerns around the fate of the North American Free Trade Agreement (NAFTA) and a crackdown on Mexican workers in the US have already led to a sell-off in the equities markets and a decline in the peso. Conversely, should those fears turn out to be unfounded, PE firms could find bargains amid the uncertainty. Opportunities may also arise if US policy changes precipitate closer ties between the economies of LatAm and Asia. Investors in the region will be keeping a close eye on geopolitical developments and weighing the potential impacts as 2017 progresses.

India

PE activity has been undergoing a renaissance over the last two years as rising GDP growth and a reform-minded government provide investors with increasing confidence in the country. After falling out of favor among EMs in the years immediately following the financial crisis in favor of up-and-comers, including Africa and Latin America, India is once again toward the top of investors’ lists. The recent EMPEA LP survey found that India was LPs’ second-most-favorite destination in 2016, after suffering for several years in the bottom half of the rankings.

In 2016, fundraising totaled US$2.6b through the end of the third quarter, a decline from the US$4.2b raised in 2015, but well above both 2013 and 2014. The increased pace of investment over the last two years has necessitated many funds’ return to the market; furthermore, elevated exit activity, which has allowed many funds to exit investments made from earlier waves of Indian investment, have precipitated renewed confidence among both global and local LPs.

PE interest in sectors including technology, infrastructure, education and others propelled PE investment to US$4.6b, on track for an 11% increase over 2015.

In line with global trends, credit investments are also on the rise, with many global investors preferring the credit market in India to equities, given the solid macro environment, which is being supported by Prime Minister Narendra Modi’s policies. Through the end of the third quarter, private credit investment in India was on track to exceed half a billion US$. While this is a modest amount relative to the US and European market, the figure nonetheless represents a record for the region.

While interest in India is expected to remain high in 2017, the country will continue to grapple with challenges in the coming year. Among them, increased regulatory scrutiny: the Securities and Exchange Board of India (SEBI) has proposed tighter regulations for compensation agreements between PE firms and the key management of listed firms in which they invest. Moreover, several PE-backed companies have struggled in recent months to launch their initial share sales despite a booming primary market. Investors will want to continue to see strong evidence of public appetite for PE-backed floats before committing additional capital to the country.
Outlook for 2017 and beyond

Firms to remain disciplined and patient as they await the right opportunities

Private equity is presently in one of its most challenging periods in its history. Having ushered thousands of companies through the depths of the Great Recession to successful exits, PE firms now find themselves in a liminal space. Exits are winding down and firms have distributed record amounts of cash back to investors, an action that has precipitated additional investment in the asset class and led to record amounts of dry powder.

However, with valuations remaining stubbornly high, and severe central bank-induced distortions permeating nearly all aspects of the market, firms are in the unusual position of having more capital than they can effectively invest. In many ways, it’s an attractive problem to have.

Although “when” is anyone’s guess, the environment will almost certainly change — possibly sooner than later, and potentially in dramatic fashion; valuations will eventually come down from their lofty highs; and PE firms will be able to underwrite deals at levels that leave headroom for a continuation of the types of returns that have cemented LPs’ trust in the asset class.

In the meantime, firms will remain patient, opportunistically investing in deals where they can offer a unique perspective and a differentiated value-add. Although the degree of difficulty has increased, PE firms have spent the last decade moving beyond the outdated financial engineering model, building the skill sets required to succeed in a market that is priced to perfection.
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