Can private markets boom if public markets bust?

EY Global PE Watch 2018
Introduction

Markets are cyclical, and let’s face it, they can’t inflate forever. Since the last economic downturn, private equity (PE) has seen record-setting growth. The industry’s assets under management (AUM), which include unspent “dry powder” and the unrealized value of current investments, have grown more than 80% over this time period, reaching roughly $2.7t. Throughout, the industry has become increasingly resilient to challenges in the macroeconomic environment (indeed, thriving despite a global financial crisis).

So, is PE more or less prepared for a public market collapse this time around?

In the following pages, we outline the fundraising, investment and exit imperatives for PE. We also provide a comparison of the 2007 and 2017 data and an analysis of the trends that inform this guidance. While there are some similarities to 2007, PE as a sector has undergone a significant transformation. This evolutionary tale might not reveal when the peak of the present cycle will be reached, but it provides important perspectives about where it might be headed and how firms can remain relevant in an increasingly complex and competitive environment.

Herb Engert
EY Global Private Equity Leader
The power of (positive) equity

PE’s role in the broader economy continues to grow. PE firms now own stakes in more than 13,000 companies across the globe. They employ more than 20m people, and for each additional $1m they invest, they’re estimated to create an additional 10 jobs.1

Despite PE’s growth, substantial headroom remains

Spoiler alert: while the PE industry has changed and evolved in many dramatic ways, fundamentally it remains the same. At the root of PE’s unprecedented record of growth, value creation, continual innovation and sustained outperformance is its superior governance structure. This is achieved through a concentration of ownership and the alignment of limited partner (LP) and general partner (GP) interests. Structurally, the engine that powers PE and its ability to transform companies has not changed over the past 10 years. Indeed, the two key metrics of alignment – profit sharing (which has been holding steady at around 20%) and GP commitments to funds (which have slowly risen from an average of 2% in 2007 to 4% in 2016)2 – show that PE is as engaged as ever.

The value of PE portfolio companies is estimated to be equivalent to less than 3% of the US$81t in publicly traded shareholder value.

The growth of the global PE portfolio

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>2,453</td>
</tr>
<tr>
<td>2001</td>
<td>2,834</td>
</tr>
<tr>
<td>2002</td>
<td>3,305</td>
</tr>
<tr>
<td>2003</td>
<td>3,875</td>
</tr>
<tr>
<td>2004</td>
<td>4,532</td>
</tr>
<tr>
<td>2005</td>
<td>5,321</td>
</tr>
<tr>
<td>2006</td>
<td>6,262</td>
</tr>
<tr>
<td>2007</td>
<td>7,442</td>
</tr>
<tr>
<td>2008</td>
<td>8,447</td>
</tr>
<tr>
<td>2009</td>
<td>8,856</td>
</tr>
<tr>
<td>2010</td>
<td>9,501</td>
</tr>
<tr>
<td>2011</td>
<td>10,090</td>
</tr>
<tr>
<td>2012</td>
<td>10,716</td>
</tr>
<tr>
<td>2013</td>
<td>11,190</td>
</tr>
<tr>
<td>2014</td>
<td>12,005</td>
</tr>
<tr>
<td>2015</td>
<td>12,959</td>
</tr>
<tr>
<td>2016</td>
<td>13,587</td>
</tr>
<tr>
<td>2017</td>
<td>13,741</td>
</tr>
</tbody>
</table>

1 Joshua Cox and Bronwyn Bailey, Private Equity Investment and Local Employment Growth: A County-Level Analysis, September 2016.
2 Arleen Jacobius, General Partners putting money where investments are, Pensions and Investments, March 20, 2017.
Today’s fundraising imperatives for PE – redefine the relationship

Today’s fundraising environment is poised to eclipse the prior peak, putting PE into uncharted waters. The industry’s ability to successfully fundraise over multiple economic cycles, and across an environment that is continually changing is now well established, firms are facing a far more complex landscape. The line between customer and competitor increasingly is blurred and requires new ways of doing business. In short, it’s time to redefine the relationship.

Here are some things PE firms should be doing in today’s market.
1. Work the channels to access new sources of capital

The last decade has seen a marked expansion of the LP universe. Ten years ago, PE’s investor base was dominated by developed market pension funds, endowments and foundations. Today, LPs that are largely new to PE are increasingly accessing the asset class, including Sovereign Wealth Funds (SWFs), which, collectively, control more than US$6.6t in assets; family offices, which control more than US$4.7t in assets; and pension funds across the emerging markets, wherein regulations are adapting to allow for increased exposure to PE.

The most successful accumulators of AUM are those that are most aggressively pursuing these new sources of capital. Blackstone said in its third-quarter earnings call that 18% of its AUM was from retail and other high net worth investors. Other large firms report similar trends. The Carlyle Group said on a recent earnings call that 22% of its capital is coming from retail sources. KKR reports that 10% to 15% of investments are from retail investors.

Firms continue to push deeper into the space. Blackstone, for example, has been active in raising capital from investors in the US$5m to US$10m segment for several years. It is now seeking to penetrate further, by launching vehicles designed for investors with US$1m to US$5m in investable assets. Indeed, the trends are clear: firms that fail to pursue these new sources of capital risk being left behind in a widening gulf between PE’s “super accumulators” and the rest of the industry.

2. Embrace the dynamism of the GP and LP relationship

Ultimately, relationships are what drive the industry. They drive commitments and they drive returns by ensuring that all parties are properly aligned. Firms can be responsive to evolving investor needs by providing increased transparency, fee option arrangements or partnering on co-investment opportunities.

The asset class’s growing maturity, combined with LPs’ greater sensitivity to fees initiated during the financial crisis, helped spark an increasing interest in participating in private market investments outside of the traditional commingled fund structures. As a result, possible approaches for today’s investors include:

1. Allocating capital toward separately managed accounts (SMAs) to gain customized exposures and reduce program outlays
2. Increasing co-investment capabilities, investing alongside managers to receive more favorable terms and gain more dealmaking insight
3. Investing directly in private companies

During the last several years, the term “shadow capital” has emerged to define these types of activities. While precise figures about shadow capital remain difficult to determine, estimates suggest that such activity represents somewhere between 10% and 20% of the aggregate fundraising, a figure that is poised to grow as LPs rapidly increase their capabilities to effect such investments.

---

2 Miriam Gottfried, Blackstone Targets Millionaire Next Door; Blackstone is aiming to attract more investors with $1 million to $5 million to spare by offering them direct access, The Wall Street Journal, Oct 15, 2017.
Number of separate account mandates

Source: Preqin, as of Nov 20, 2017
“LPs are looking for a range of differentiated offerings that satisfy an LP’s demands for value, transparency and, most importantly, a well-defined strategy or competitive advantage that can enable GPs to excel despite high valuations and otherwise challenging conditions.”

Bridget Walsh
EY Global Head of Transaction Tax

3. Treat innovation as an imperative

As the industry has navigated through the cyclical downturn and grown, so too has its menu of product offerings to investors. This has been driven in large part by PE’s growing ability to add value throughout the life cycle of companies and the evolution of their capital structures. For example, PE firms are increasingly moving down-market into the growth capital space. At the opposite end of the spectrum, some have developed “core” PE funds, with lifespans anywhere from 5 to 10 years longer than a typical PE vehicle, enabling long-term holding periods for attractive mature companies.

One of the fastest growing strategies since the last peak is private debt, which provides a good example of how PE can quickly fill gaps in the market. After the onset of the financial crisis, authorities imposed stricter regulation and capital requirements on banks, creating an opening for non bank entities. At the same time, income-producing strategies became especially attractive to investors looking for downside protection. Private debt investing is a good complement to equity in terms of analyzing firms’ balance sheets and providing investors with different levels of yield, return and J-curve mitigation. Today, private debt AUM stands at nearly $600b, which is about a fourfold increase from where it stood in 2006.

For investors, this has meant that they now have access to a broader array of products that can help them better achieve their targeted outcomes. For GPs, it underscores the need to be responsive to investors and attentive to market opportunities. Key to this is being mindful about the possibility of new product offerings and the potential to realize synergies in related asset classes. While there are – and will remain – many successful single-strategy firms and “pure play” PE shops, the market is increasingly moving toward firms that can build on their expertise in one area and apply it to another.

Fundraising

AUMs over time – PE now a minority of assets across larger firms

Source: based on analysis of S-1s from top five publicly traded PE firms between March 22, 2007 and May 14, 2012 and Q3 2017
4. Capitalize on the open window for fundraising

In the wake of the 2008-09 downturn, PE fundraising declined dramatically like that of all asset classes. Not only did investors of all stripes favor face serious demands for liquidity amid the uncertainty of the markets, but structural issues prevented even those that would be otherwise willing from increasing their allocations. For example, the denominator effect (whereby LPs were overallocated to PE simply by virtue of the steep declines in their public equity portfolios) prevented others from capitalizing on the abundant opportunities.

While valuations and reporting methodologies have improved since then, there’s no guarantee similar issues wouldn’t arise in another broad market decline, even for LPs with sufficient fortitude to get more aggressive as others are pulling back on their exposures. With uncalled commitments at an all-time high, the effect may in fact be even more pronounced this time around. This points to an imperative that firms must raise capital now before eventual inflection point in the cycle because it may very well not be available then.
Fundraising then and now – twin peaks

PE has a strong element of cyclicality, which is tied to the credit and broader economic cycles. Boom years often are followed by bust years. During the last cycle, the fundraising peak was reached in 2008, when funds closed with a record US$634b in commitments from LPs (the majority of this fundraising occurred during the prior two years). Ten years later, and having weathered a severe global financial crisis, the industry is finally nearing this milestone once again. PE firms are expected to raise more than US$680b by the close of 2017.
One defining characteristic of the 2007–08 time period was the number of mega (US$5b and or more) buyout funds raised. Between 2007 and 2008, 25 such funds closed, with an aggregate of US$249b in commitments. This figure hasn't been approached until the last two years, when 24 mega funds raised an aggregate of US$251.4b in assets. With each year in the present cycle, like the last, funds are growing in size. In both instances, PE firms have responded to excess investor demands by raising larger funds. While not necessarily a consensus point of view, some LPs increasingly are looking to funds that can deploy large amounts of capital, even if it means that there is a return trade-off.
Two favorable environments for raising capital

Both the 2007 and 2017 environments have been shaped by strong cyclical and secular forces that, together, were highly conducive for fundraising. In particular, easing monetary policies and highly accommodative debt markets helped strengthen investor confidence. Responding to the global financial crisis that began in 2008, central bankers launched an unprecedented, decade-long battle to stimulate economic activity through ultralow interest rates. However, beyond the cyclical forces driving capital toward the asset class, the era of superabundant capital that followed was also noteworthy for a number of secular tail winds that accelerated the allocation trend to PE and other private capital vehicles. These include:

1. A wider appreciation for PE’s risk-and-return profile and diversification benefits

The financial crisis crystallized for many investors the need to push further into private markets. Among state-funded pensions in the US, for example, lower-than-expected investment returns and declining contributions from plan sponsors led to a dramatic widening of shortfalls. According to the Pew Charitable Trusts, between 2007 and 2015 (the latest year for which data is available), shortfalls increased threefold, from US$362b to nearly US$1.1t. Not coincidentally, allocations to alternatives went from 9.7% to 17.1% during the same period. Other trends, including the need for diversification among oil-sensitive SWFs and the increasing sophistication of family offices, drove additional capital into PE. By 2017, PE’s track record of consistently outperforming public market benchmarks was longer and more widely known across the institutional investor base, as were the diversification benefits, leading existing investors to reinvest and bringing new investors into the fold.

2. An unprecedented wave of distributions to LPs

In the gigantic wave of capital that accumulated prior to the 2007 peak, net distributions to LPs were negative or roughly equal to contributions, as investors put billions of dollars of new (i.e., not recycled) capital to work. These commitments played an important role in delivering investors steadily greater net cash flows from 2011 and onward.

3. The evolution of a broader array of private market strategies

Finally, the last 10 years have seen a dramatic broadening of PE’s purview and the widespread adoption of private market strategies designed to address specific investor needs, running the gamut from steady and early income, inflation protection, and increased and decreased liquidity to geographic diversification.
Strong fundraising in the years leading up to both the 2007 and 2017 peaks is reflected in the levels of dry powder. PE firms currently hold a record US$628b in capital available for new deals.

While these increasing levels of dry powder have been a source of generalized anxiety for some industry watchers, when viewed across time, the picture looks less worrisome. In fact, the speed at which the industry has added assets in recent years is far more constrained than during the last peak. In 2007, dry powder was ballooning at a three-year growth rate of 35% per year; in 2017, PE added dry powder at a rate of just 12.1% per year.
Today’s investment imperatives for PE – evolve the model

Prepare for the PE model to come into scrutiny again. The 2008 credit crisis wasn’t the first time the PE model has been questioned, and it probably won’t be the last. In the 1980s, the implosion of the junk bond market seemed to signal the end of the relatively nascent industry. Ten years later, widespread market excess, especially in tech, brought similar doubts. But throughout, PE firms employed the same transformational skills they apply every day to portfolio companies in their own business – adaptability to market conditions, nimbleness despite growing scale and a constant willingness to reinvent themselves. Today’s firms are challenged to exhibit these traits more intensely than ever across nearly all aspects of the enterprise. This includes innovation in:

- Sourcing
- Diligence
- Monitoring
- Back-office operations
- Portfolio value creation

All of this must be taken into account if PEs remain true to their unique identity and the differentiators that enable them to excel in an increasingly challenging environment.

Here are the keys to optimizing investments in today’s market.
1. Get the origination process right

Now more than ever, deal origination is where value creation begins. In today’s environment of high valuations and increasing competition from corporate acquirers and others, identifying attractively priced targets with transformational potential is one of the most significant challenges for firms. PE remains a high-cost asset class for LPs. Although it’s a challenge, given the degree to which intermediation is permeating more broadly and deeply into the market, when all is said and done, they’re not paying their firms to simply line up for the latest Wall Street auction.

GPs must be more focused than ever on optimizing their deal sourcing and origination efforts by:

- Casting wider nets in the search for opportunities and expanding their networks in the search for new deals (While relationships with industry execs and bankers remain critical, PE firms are increasingly looking to intermediaries and others that are well positioned to identify high-quality deal flow.)
- Getting increasingly creative about uncovering pockets of value, whether in carve-out opportunities, buy-and-build or consolidation plays, or new geographies
- Leveraging core competencies, such as those unique skills or value-added services that differentiate a firm from its competitors, whether it’s sector expertise, a global reach, partnership opportunities or specific value-creation skills

In short, align the origination process in a way that can identify hidden value that other market participants often overlook, which can deliver a unique angle or an “edge” for a PE investor.

2. Be creative to cope with high valuations

Focusing on mega and public-to-private deals, in which generally there was less competition, was an attractive strategy to escape the bidding wars, auctions and high valuations in the run up to the 2007 peak in prices. Moreover, in the case of supersized deals, risk was mitigated by the use of club structures that spread risk across two or more sponsors.

However, in today’s more evolved marketplace, PE firms are finding a number of creative ways to cope with higher valuations. Instead of trying to cover the entire universe of opportunities, they’re increasingly using sector specialization as a value driver. Many are avoiding paying control premiums by moving down-market into the growth capital space and looking at other minority stake deals. They’re launching long-life funds to invest in longer-term opportunities that might not make sense in a traditional 10-year structure. In certain sectors, they’re increasingly funding greenfield investments — starting with a proven management team and building a company around them. They also are using deal-by-deal structures and pledge funds, which provide increased flexibility in deploying capital, and increasing their use of add-on strategies. For larger firms, some of which have gained permanent capital through the sale of minority stakes in the GP, they’re using a reinforced balance sheet to seed new strategies or break into new regions.

3. Capital is a commodity – articulate the value-added

Market distortion from a decade’s worth of zero-interest-rate policies means that capital is much more readily available than it was in the run up to the prior boom (and, even then, by historical standards, capital was largely accessible for most companies). Increasingly, PE firms must be able to articulate a differentiated source of value-added above and beyond their ability to invest capital. This
includes operational expertise; the ability to help firms access new markets or open doors to new customers; access to a firm’s network of relationships; or a vision for the company that aligns with a founder, owner or management team.

In competitive situations, firms can position themselves as the buyer of choice by spending time with management and demonstrating that they understand the asset and the nuances of its operating environment.

4. Develop new ways of partnering with competitors and customers

Ten years ago, the universe of potential deal partners was far smaller than it is today; hence, the large number of PE consortium deals. However, with the increasing interest and involvement of many institutional investors in exposure to co-invest and direct investment, firms now have a lot more choices than they used to.

Partner with your competitors, in this case, strategics

PE firms also have the potential to increase their partnerships with strategic investors. These investors sometimes can provide firms with the ability to leverage synergies to justify higher multiples and achieve an edge versus pure financial buyers. They also have an ability to achieve larger deal sizes without formation of a PE consortium in which alignments may be more difficult. At the end of the natural holding period, firms may even have a locked-in buyer for the asset. LPs benefit too, by reducing the amount of overlap in their portfolios versus a consortium deal, where they might be invested in two or more funds committing capital to the same asset.

For strategic investors, there exist significant benefits to partnering with PE. Corporates can see deal flow they might not otherwise have access to, and can take on deals they might be priced out of on their own. At the end of PE’s holding period, corporates can own an option on an asset that has been through PE’s rigorous playbook of operational transformation and capital structuring optimization.

5. Intense competition drives the evolution of operating resources

The continual evolution of PE’s value creation model is perhaps the most important reason why the industry has been so successful in delivering attractive returns to investors over the past 40 years. In its early stages, with less competition, PE was able to rely on financial and governance levers to achieve alpha status. The use of leverage to concentrate equity and stronger oversight that comes with a board that has “skin in the game” went a long way toward generating superior returns. Leading up to the 2007 peak, with competitive pressures increasing, PE groups began to turn to sharpening their operational expertise by bringing onboard executives with operational backgrounds from well-known companies, such as GE and IBM.

“As a PE firm in today’s market, you have to distinguish yourself as to why someone would take your money, whether it’s the ability to take a company into new markets, the ability to open doors to new customers or something else.”

Amitava Guharoy
EY Asia-Pacific TAS Markets Leader
PE firms are pursuing a wide range of sectors, both cyclical and countercyclical. The emphasis is on those undergoing significant digital disruption where PE firms can add operational value and help reposition companies for the future – companies or industries in which costs are more highly variable or in sectors where powerful secular growth trends have the potential to drive growth regardless of the macro backdrop.

We invited EY leaders to provide insight about the investment trends in their sectors.

Oil and gas

Adi Karev  
EY Global Oil & Gas Leader

What is the deal landscape in O&G?
Investor interest has slowly returned, the result of improved fundamentals and a measure of stabilization in the industry relative to two years ago. This is likely to spur a return of deal-making that could approach levels last seen in 2013 and early 2014, when oil prices were at their peak.

What will drive this activity?
Deep-pocketed investors with patient capital. Major producers are reshaping their portfolios in response to changing industry dynamics. PE firms have nearly US$143b of dry powder capital dedicated to investments in the space. With a relatively well-defined crude price range and a reduction in volatility, the ability for PE firms to cherry-pick assets is increasing.

What role has technology played in PE investments in the sector?
Technology-driven efficiency gains have reduced the amount of capital required on a per barrel basis, but the industry as a whole remains very capital intensive. PE firms can fund the consolidation of smaller parcels and create value by employing new technologies and operating practices.

Where are you seeing opportunity for PE in 2018?
There is significant overcapacity in oilfield services and greater consolidation looks inevitable. This will be driven by competitor acquisitions with strategic technological advantages such as AI or well-developed data analytics capabilities. Finally, there are a number of companies that are overleveraged, and PE firms are helping them to “right-size” their balance sheets.

In the upstream space, portfolio rebalancing by publicly traded companies has the potential to drive PE activity across the globe. Opportunities are expected to arise from strategic players looking to monetize mature and marginal assets in Southeast Asia and the North Sea. Notwithstanding questions about returns, unconventional drilling in North America continues to attract private capital, primarily because of the short cycle times and project scalability.

Health

Jim Costanzo  
EY Global Health Leader

What is driving investments in the health care industry?
Megatrends, such as regulatory change, aging populations, a shift toward value-driven care and the rise of technologies designed to meet the growing demand for consumer-centric services are driving investments. Deal activity is being driven by the continuing consolidation and disruption in the health care industry, and the growing reach of technology, especially in the biotech space.

What is the 2018 outlook?
PE firms announced US$30b in deals in 2017, up 21% from a year ago. We expect elevated activity to continue despite high valuations, given the unchanged nature of the fundamental business drivers transforming the industry.

How are health care companies containing costs and driving efficiencies?
The next disruptive change is the shift from treatment to prevention, which is being enabled and fueled by the integration of technology and analytics. The current imperative for PE is to find companies with the necessary infrastructure to support
growth and with management teams sophisticated enough to build scalable, sustainable enterprises. Companies are doing this through acquisitions, partnerships and alliances. Behavioral health management, which historically has been a highly fragmented industry, is also ripe with opportunities to effect roll-up transactions.

What are other interesting areas for PE?

- "Payvider" – the provider-payer blend, which is driving efficient, sustainable health care delivery
- Specialty pharmacy
- Lower-cost settings, especially in post-acute care, home health and inpatient rehabilitation
- Roll-up opportunities, especially in dermatology and optometry
- Health information services, telemedicine and digital health

**Consumer products and retail**

**Kristina Rogers**
EY Global Consumer Products and Retail Leader

**Why do PE firms gravitate toward the consumer products and retail space?**

Businesses tend to be lightly regulated and fairly predictable, often with strong cash flows, a clear path to growth, and a clear thesis around cost reduction.

**What drove deal activity in 2017?**

PE activity in the consumer goods space increased 37% in 2017, to US$41b in total activity, driven by deals like PAI Partners’ US$3.9b acquisition of Refresco Group NV and Bain’s US$3.2b acquisition of Diversey. Despite the “death of retail” headlines in mainstream news outlets throughout the year, PE investment in the space climbed 10% on the back of deals like Sycamore Partners’ US$6.8b acquisition of Staples, Inc.

**Technology**

**Greg Cudahy**
EY Global Technology Leader

**How have technology investments fared recently?**

Technology has been one of the most active sectors for PE over the last two years. PE firms announced deals valued at US$67.5b in tech in 2017. While down 9% from the year prior, it still represents more than 20% of total PE activity.

**What’s hot in technology?**

A handful of deals have been inked in the semiconductor or hardware spaces, but the vast majority of PE firms’ focus remains on software, which represented nearly two-thirds of PE’s investment in the technology sector in 2017. Other areas of interest to PE firms include companies providing network security, cybersecurity and disaster recovery services. The segment is mature enough for PE firms to acquire companies of increasing size, particularly with a number of VC firms looking to exit from their investments.
Today, the levers have expanded as firms look to more systematically and comprehensively create operational value-added. They can employ a range of different approaches, such as:

- Working with senior industry executives on a full-time or part-time basis, or developing their own internal operating teams
- Hiring outside functional experts with deep expertise across a range of competencies, including finance, human resources, supply chain, pricing and other areas

Just a few years ago, most operational resources comprised full-time employees. But the market is now shifting, with many firms increasingly using contractors in their place or using hybrid models that utilize both, allowing firms to bring leading resources to bear and quickly pivot, when needed. A decade ago, operating resources were concentrated at larger shops. During the past four or five years, we’ve seen smaller and mid-market firms increasingly catch up.

<table>
<thead>
<tr>
<th>Variations of the operating partner model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level</strong></td>
</tr>
<tr>
<td>Retired CEO</td>
</tr>
<tr>
<td>Peer-level resource</td>
</tr>
<tr>
<td>Junior analyst</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Background</strong></th>
<th><strong>Working style</strong></th>
<th><strong>Purpose</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operator</td>
<td>Mentor</td>
<td>Strategic</td>
</tr>
<tr>
<td>Consultant</td>
<td>Doer</td>
<td>Tactical</td>
</tr>
</tbody>
</table>

6. Get granular: codify and institutionalize your playbook

One of the industry’s greatest challenges has been the replication of value creation results and achieving persistently top quartile returns. PE historically has been a largely bespoke process of identifying very specific value creation levers for each company with teams working in a siloed manner. Increasingly, however, firms are looking to break down these silos. Their goal? To fully codify and institutionalize their value creation playbook and apply certain leading practices systematically across the entire portfolio, whether it’s salesforce effectiveness, supply chain management, pricing, cost rationalization or myriad other levers. While value creation indeed will never be a wholly systematic exercise, firms can absolutely reduce the need to reinvent the wheel with each new deal.

The essential precondition to this level of institutionalization is access to high-quality data. To remain competitive, firms must invest in their ability to collect data from within and across the portfolio – financial performance, operating metrics, customer data, supplier information and more. Many of these efforts remain in the early stages, given the level of sophistication and data standardization required. This represents a significant opportunity for middle-market firms. Those that recognize this as an area of focus can harness a critical value creation driver over the coming years.

“Success is defined by how well a private equity firm aligns its operating model with its investment strategy. Ultimately, there is no one-size-fits-all solution.”

Jay Bartlett  
Managing Director, Co-head of Private Equity, EY-Parthenon
7. Embrace the dramatically increasing role of digital

The advent and implementation of digital technologies are dramatically impacting the ways that PE firms organize and execute — not only at the firm level, but in the way they drive value across their portfolios. Helping their investees fully embrace a digital mindset that permeates all aspects of their business is increasingly one of the most significant value drivers for PE firms of all types, regardless of their sector specialization, geography, strategy or size.

Investee companies are continually entering the PE ecosystem with varying levels of sophistication. For PE firms, the first step is a full assessment to understand where companies fall within the spectrum and what resources they’ll need to collect, harness and utilize their data. Involving operating resources and advisors well versed in digital during the diligence phase is increasingly essential.

Some of the ways PE firms are helping companies navigate today’s rapidly changing landscape include:

- Defining and articulating a digital strategy
- Developing an enhanced customer experience
- Revamping and digitally enabling supply chains
- Integrating their front-office systems with back-office IT framework
- Putting into place robust cybersecurity measures
- Digitally enabling the finance function
- Acquiring and implementing new technologies

While data analytics is at the center of this, it’s important to note that it’s just one component, with robotic process automation (RPA), artificial intelligence (AI), the Internet of Things (IoT) and other emergent technologies all making their way into the PE ecosystem. One company in the waste management space, for example, identified new value creation opportunities by using sensors in its equipment to increase operational effectiveness and better route trucks and identified new business growth in adjacent market categories.

8. Remain disciplined

PE’s ability to rebound after the 2007 financial crisis is a tribute to the PE model’s resilience. Its recent performance to date is evidence of its investment discipline. It is hard to say when today’s immutable confidence and steep valuations will finally give way to a more rational paradigm. In the meantime, GPs remain under increasing pressure to deploy capital and face the ever-greater temptation to nod yes to another quarter turn of purchase multiples. How closely the asset class keeps to its model of concentrated ownership and its signature governance structure, and how well it maintains its discipline will, go a long way in determining its ability to ride out future challenges and take advantage of market dislocations.

“*If you’re going to take risks on valuations, you have to have a very clear vision about how you’re going to grow into them and eventually buy down your multiple.*”

Bill Stoffel
EY Americas Private Equity Leader

What can PE firms offer companies that already are digitally savvy?

Companies already adept in the digital space are looking to PE to help them build out the other pieces of their infrastructure. In consumer products, for example, barriers to entry have been knocked down dramatically because consumer access to social media decreases the capital required to build brands. Companies are able to grow very quickly in a short period of time through their digital savvy. While such firms might find revenues quickly growing, they might also be absent the benefit of an established infrastructure that incumbents have built over the course of decades. PE firms can play a critical role in helping them more quickly scale by building financial controls, supply chains, distribution channels and human resources functions — all of the essential elements of a sustainable enterprise.
Investments then and now

A maturing, more disciplined asset class

Closely tracking fundraising trends, PE investment in recent years has been steadily increasing, but still hasn’t approached the tsunami of deals that occurred in 2006 and 2007. PE firms are on track to announce deals valued at more than US$350b, slightly above 2016, but just a fraction of the nearly US$1.5t that was deployed between 2006 and 2007. This is despite an investment environment that was similar to today’s in terms of highly accommodative debt markets, record-high stock market activity and relatively strong global economic growth.
2007 peak: a more exuberant market drives larger deal sizes

One important difference between the earlier peak and today is the overall higher levels of exuberance experienced in 2007 across the economy from commodities, stocks and housing. In PE, this exuberance manifested itself in ever-increasing deal sizes. The combined value of the top 10 buy-out deals between 2005 and 2007 was US$375b – nearly US$25b per deal, on average. Nine of these deals involved multiple PE buyers (i.e., club or consortium deals). The megadeal era reached its pinnacle in 2007 with the US$44b buyout of TXU Corp.

Source: Dealogic, accessed Dec 1, 2017
### The top deals – 2005-07 and 2015-17

**Top LBOs 2005-17: the era of the club deal**

<table>
<thead>
<tr>
<th>Announcement date</th>
<th>Target</th>
<th>Acquirer</th>
<th>Deal value US$b</th>
</tr>
</thead>
<tbody>
<tr>
<td>26-Feb-07</td>
<td>TXU Corp.</td>
<td>Goldman Sachs Capital Partners TPG Capital LP, KKR &amp; Co. LP</td>
<td>$43.8</td>
</tr>
<tr>
<td>20-Nov-06</td>
<td>Equity Office Properties</td>
<td>Blackstone Group LP</td>
<td>$38.9</td>
</tr>
<tr>
<td>24-Jul-06</td>
<td>HCA Inc.</td>
<td>Bain Capital LLC North Cove Partners KKR &amp; Co. LP</td>
<td>$32.7</td>
</tr>
<tr>
<td>21-May-07</td>
<td>ALLTEL Corp.</td>
<td>Goldman Sachs Capital Partners TPG Capital LP</td>
<td>$27.9</td>
</tr>
<tr>
<td>2-Apr-07</td>
<td>First Data Corp.</td>
<td>KKR &amp; Co. LP</td>
<td>$27.7</td>
</tr>
<tr>
<td>2-Oct-06</td>
<td>Harrah’s Entertainment Inc.</td>
<td>TPG Capital LP Apollo Global Management LLC</td>
<td>$27.4</td>
</tr>
<tr>
<td>3-Jul-07</td>
<td>Hilton Hotels Corp.</td>
<td>Blackstone Group LP</td>
<td>$25.8</td>
</tr>
<tr>
<td>16-Nov-06</td>
<td>Clear Channel Communications Inc.</td>
<td>Thomas H. Lee Partners LP Bain Capital LLC</td>
<td>$24.9</td>
</tr>
<tr>
<td>29-May-07</td>
<td>Archstone-Smith Trust</td>
<td>Lehman Brothers Private Equity</td>
<td>$20.6</td>
</tr>
<tr>
<td>30-Mar-07</td>
<td>Alliance Boots plc</td>
<td>KKR &amp; Co. LP</td>
<td>$20.6</td>
</tr>
<tr>
<td>15-Sep-06</td>
<td>Freescale Semiconductor Inc.</td>
<td>Carlyle Group LP, Blackstone Group LP Permira Ltd. TPG Capital LP</td>
<td>$17.6</td>
</tr>
<tr>
<td>23-Jan-06</td>
<td>Albertson’s Inc.</td>
<td>Cerberus Capital Management LP, SuperValu Inc, Klaff Realty LP, Lubert-Adler Real Estate Funds, Schottenstein Stores Corp, Kimco Realty Corp, CVS Corp</td>
<td>$17.4</td>
</tr>
<tr>
<td>30-Nov-05</td>
<td>TDC A/S</td>
<td>Blackstone Group LP Providence Equity Partners LLC Permira Ltd. Apax Partners LLP KKR &amp; Co. LP</td>
<td>$14.1</td>
</tr>
<tr>
<td>27-Jun-06</td>
<td>Univision Communications Inc.</td>
<td>Saban Capital Group Inc. Thomas H. Lee Partners LP Madison Dearborn Partners LLC Providence Equity Partners LLC TPG Capital LP</td>
<td>$13.6</td>
</tr>
<tr>
<td>Announcement date</td>
<td>Target</td>
<td>Acquirer</td>
<td>Deal value US$b</td>
</tr>
<tr>
<td>-------------------</td>
<td>--------</td>
<td>----------</td>
<td>-----------------</td>
</tr>
<tr>
<td>20-Sep-17</td>
<td>Toshiba Memory Corp</td>
<td>Bain Capital LLC, SK Hynix Inc, Hoya Corp, Seagate Technology plc, Apple Inc, Dell Technologies Capital, Kingston Technology Corp</td>
<td>$17.9</td>
</tr>
<tr>
<td>18-Aug-17</td>
<td>Calpine Corp</td>
<td>Energy Capital Partners LLC; Access Industries Inc; Canada Pension Plan Investment Board</td>
<td>$17.4</td>
</tr>
<tr>
<td>7-Dec-15</td>
<td>Keurig Green Mountain Inc</td>
<td>JAB Holdings, BDT Capital Partners LLC, Mondelez International Inc</td>
<td>$14.3</td>
</tr>
<tr>
<td>8-Oct-15</td>
<td>BioMed Realty Trust Inc</td>
<td>Blackstone Group LP</td>
<td>$7.9</td>
</tr>
<tr>
<td>5-May-16</td>
<td>MultiPlan Inc</td>
<td>Hellman &amp; Friedman LLC, GIC Pte Ltd, Leonard Green &amp; Partners LP</td>
<td>$7.5</td>
</tr>
<tr>
<td>22-Jun-15</td>
<td>Home Properties Inc</td>
<td>Lone Star Global Acquisitions Ltd</td>
<td>$6.9</td>
</tr>
<tr>
<td>28-Jun-17</td>
<td>Staples Inc</td>
<td>Sycamore Partners LP</td>
<td>$6.8</td>
</tr>
<tr>
<td>11-Aug-15</td>
<td>Veritas Technologies LLC (94.5946%)</td>
<td>Carlyle Group LP, GIC Pte Ltd</td>
<td>$6.6</td>
</tr>
<tr>
<td>7-Sep-15</td>
<td>Homeplus Co Ltd</td>
<td>MBK Partners Ltd, Public Sector Pension Investment Board, National Pension Service, Canada Pension Plan Investment Board, Temasek Holdings (Pte) Ltd</td>
<td>$6.5</td>
</tr>
<tr>
<td>25-Sep-17</td>
<td>Nets A/S</td>
<td>Hellman &amp; Friedman LLC, Bain Capital LLC, Advent International Corp, StepStone Group LP, GIC Special Investments Pte Ltd, Fisher Lynch Capital LLC, Sampo Oyj</td>
<td>$6.4</td>
</tr>
<tr>
<td>8-Aug-17</td>
<td>Banco Popular Espanol SA (Real estate business)</td>
<td>Blackstone Group LP</td>
<td>$6.0</td>
</tr>
<tr>
<td>7-Apr-15</td>
<td>Informatica Corp</td>
<td>Permira Ltd, Canada Pension Plan Investment Board, Microsoft Corp, Salesforce Ventures LLC</td>
<td>$5.3</td>
</tr>
<tr>
<td>5-Nov-15</td>
<td>Stuyvesant Town-Peter Cooper Village, NY</td>
<td>Blackstone Group LP, Caisse de Depot et Placement du Quebec</td>
<td>$5.3</td>
</tr>
</tbody>
</table>

Source: Dealogic, accessed Dec 1, 2017
Investment

“The days when PE could make returns through just financial engineering and market growth are gone for awhile – maybe for good.”

John van Rossen
EY United Kingdom and Ireland Private Equity Leader

PE groups today, by contrast, are more disciplined in deploying capital. Instead of club deals, which raise complexities around governance and decision-making, GPs are turning to their own investors and to strategics to co-invest in larger deals when additional capital is needed, or where sector experience or operational expertise can add value. Between 2005 and 2007, club deals accounted for two-thirds of all PE megadeals (US$5b and more). Over the last three years, however, the proportion has flipped – just 33% of such deals were put together by a consortium of competing PE funds. More common today are deals involving family offices, corporates and pension funds. Take, for example, Bain Capital’s recent collaboration with a number of corporate investors for the carve-out of Toshiba’s memory chip unit.

Acquisition multiples are another clear linkage between the 2007 and 2017 peaks. With valuations high, most firms are underwriting limited or negative margin expansion. Acquisitions made now will likely need to be held through a prolonged market downturn. As a result, PE firms must look to operational value creation more than ever to ensure “PE-like” returns for their investors over the coming decade. Market-wide M&A multiples remain near the same steep levels reached a decade ago. In 2007, M&A multiples averaged 12 times the earnings before interest, taxes, depreciation and appreciation (EBITDA), compared with 11.8 times the EBITDA in 2017.

M&A valuations are in line with the last peak

Source: Dealogic, accessed Dec 1 2017
Another way of highlighting PE’s discipline is to look at the industry’s share of M&A over time. At 9%, PE’s share of the total M&A value is relatively low and remains less than half the level it reached at the peak in 2007. This suggests that firms are much more content to let other actors do the overbidding this time around. After all, PE is a long-term investing business.

**Resiliency: Proven post-financial crisis, and stronger today**

While it’s perhaps not surprising to anyone within the industry, PE’s resiliency in the wake of the global financial crisis was an unanticipated outcome for many outside observers. Many speculated that the financial crisis would see a number of PE-backed companies default (especially, some of the mega buy-out deals that were significantly leveraged). The real story, however, is that there were fewer defaults by PE-backed companies than there were by non PE-backed peers. Only 2.8% of PE-backed companies defaulted during the financial crisis, compared with 6.2 % of comparable non-PE businesses.4

Why so resilient? PE’s superior governance structure comes through the concentration of ownership and the alignment of interest. This puts it in a better position to build sustainable companies, and when challenges do occur, move quickly to address them. Hence, at the onset of the 2008 financial crisis, PE firms moved quickly to renegotiate loan amendments to increase financial flexibility, push back maturity dates, de-leverage and inject equity, and cut costs dramatically. During the 2008 financial crisis, while most companies were consolidating their position and pulling back on investments, PE-backed companies actually increased their investments, a testament to PE’s unique governance model and longer-term time horizon relative to publicly traded counterparts.5

---

Today’s exit imperatives for PE — nail the landing

Few firms believe that the hard work of increasing market share, growing revenues, improving margins and keeping a close eye on costs automatically will be appreciated and understood by a wide pool of potential buyers. That said, the exit process has historically taken a backseat to other priorities — namely, working with operations teams and management to execute growth initiatives and planning for new deals. However, in the same way that a well-defined playbook can add value to the buy and build during the holding period, so too can a codified set of leading practices help firms realize full value.

Here’s how you can get the most from an exit.
1. Expand the buyer pool – disruption as an opportunity

PE firms have become adept at multi-tracking in recent years, and should continue to bake this into their exit strategy, where appropriate. The traditional liquidity options of sales to strategics, IPOs and secondary buy-outs have proven successful at ensuring timely exits. The industry’s experience digesting the 2007 peak point to the value of its long-term investment horizon and hands-on governance and operational business strengths. PE firms should identify a ready pool of potential buyers as part of their initial diligence. Then they can pursue value-creation opportunities through the buyer’s eyes. A “buyer’s mindset” helps focus efforts on those initiatives that can create the most value.

Moreover, today’s M&A landscape is increasingly defined by cross-sector convergence. Ten years ago, who would have considered that Amazon would someday have an interest in Whole Foods, or that Walmart would acquire Bonobos? Strategic acquirers are casting wider nets as they look to remain relevant in a world of increasing disruption and uncertainty. Viewing disruptive forces as a chance to market to a wider array of buyers is a significant opportunity.

2. Slow is smooth, and smooth is fast

Like fundraising and acquisition activity, a number of both cyclical and secular drivers have influenced holding periods for PE-backed portfolio companies. The low point in the average holding periods was 2008, just past the top of the last cycle. Since then, holding periods have risen significantly, hitting a high of 5.8 years in 2014, and averaging 5.5 years in 2017. By shutting down M&A activity and the IPO market, the global financial crisis required fund managers to stabilize assets purchased before the crisis and hold onto them longer. Perhaps, more importantly, longer holds have also coincided with the greater push to add operational teams to create value. This takes more time, and suggests that at least part of the increase is secular in nature and here to stay.

Average global buy-out holding periods from 2006-17 (in years)

Source: Preqin, as of 15 November 2017
While longer hold periods might distress certain stakeholders, PE firms should, nonetheless, resist the pressure to exit quickly. Instead, firms can establish a number of protocols to ensure that the timing is optimal, including:

- An independent committee can guide the timing of the sale, taking into account the exit environment, company prospects and opportunity costs.
- Dedicated firm resources can work with deal professionals and management teams to articulate the story in a way that resonates with buyers and ensures that the company is ready for the exposure.
- A range of supportive analytics can help determine when to sell, how to sell and to whom.

3. Secondaries: not just for LPs

New liquidity structures are also providing a healthy channel for new investors to enter the asset class and capture the unique benefits associated with purchasing more stable, mature assets. The secondary PE market for LP interests in primary funds has a long history, mostly as a niche focused on distressed sellers. Over the past 10 years, it has significantly grown and evolved, with approximately US$37b in partnership interests changing hands in 2016. The market gives investors the ability to rebalance their portfolios, address unanticipated capital needs as was common in 2009 and 2010, or exit investments in older funds that have run past their original lives. Investors in secondary funds that purchase existing LP positions can achieve accelerated returns by investing in more mature, cash-flow-positive assets and, thus, mitigate the J-curve effect and gain downside protection by having visibility into the underlying assets.

GPs are another beneficiary of the increasing sophistication of these markets. Rather than taking a passive role, they can initiate transactions that enable new fund-level equity and debt structures. According to an analysis by Evercore, nearly one-third of PE secondaries were GP-led in the first half of 2017. This potentially cleans up older legacy investments, while at the same time offering investors liquidity options. For GPs concerned that alignments have deteriorated as holding periods lengthen on a particular asset or set of assets, such transactions can be creatively structured to offer all parties an effective “reset” that restores alignment and provides each party with an outcome attuned to their economic interests and liquidity preferences.

---

6 Rod James, Evercore: GP-led deals and directs take a record share in H1, Secondaries Investor, July 27, 2017.
Exits then and now

Exits continue to power fundraising and evolve

Today, few investments from the 2007 deal wave remain unrealized. PE firms are currently on track to announce deals valued at more than US$350b in 2017 across sales to strategics, IPOs and other PE firms. However, the peak of the exit supercycle occurred between 2013 and 2014, when firms exited companies valued at US$482b and US$429b, respectively. As a cyclical industry, healthy exit years are a function of investment booms and the broader M&A and IPO environment. While exit activity in 2007 benefited from sponsors’ ability to effect a quick turnover of investments, the high-water mark of the exit super cycle can be clearly attributed to the 2006 and 2007 deal frenzy.
Strategics remain reliable liquidity providers

Strategic acquirers have historically played an important role in providing liquidity to PE sponsors. Over the past 10 years, on average, they’ve accounted for just more than 60% of the activity by value. However, the two endpoints offer a study in contrast. In 2007, secondary buy-outs accounted for 46% of exits by value as PE firms traded companies among each other in an effort to deploy rapidly accumulating assets. In 2017, strategics accounted for 65% of the value, and secondary buy-outs represented just 24%, as corporate acquirers aggressively pursued inorganic growth strategies and PE firms remained far more subdued in competitive bidding situations. Across both time periods, the IPO market has remained a distant third exit channel. In 2014 and 2015, PE-backed deals hit a two-year-in-a-row high, representing more than 20% of exits by value. This dynamic was also reflected in PE's record-high share of the overall IPO market during this time.
PE exits by channel – then and now

Source: Dealogic, accessed Dec 1, 2017

PE-backed IPOs as a percentage of the overall IPO market (by value)

Source: Dealogic, accessed Dec 1, 2017
Conclusion

Have we been here before? Do years of high valuations and record levels of dry powder mean the bubble is ready to pop?

There are indeed many uncertainties about the present environment. The global economy is large and complex and PE is a highly dynamic asset class. However, comparing the industry of today to its less mature counterpart during the last peak is a worthwhile and revealing exercise.

There are a number of important similarities, for example, with respect to fundraising levels, deal multiples and the reliance on strategics for exits. More fundamentally, the industry during the past 10 years has been dramatically transformed in terms of AUM, the breadth of strategies, value creation capabilities and its integration into the broader economy. Today’s PE industry is considerably more transparent, liquid and diversified than it was a decade ago.

Perhaps one of the most important least appreciated insights is that while the global financial crisis significantly impacted private capital, by a number of metrics, including default rates and performance relative to its public counterparts, it weathered the sharp downturn remarkably well. While excesses certainly existed, the industry’s overall resiliency and agility are testimony to the PE engine’s twin drivers: its highly disciplined and aligned governance structure and the long-term investment horizon.

Going forward, PE must ensure that the discipline remains, and that the lessons from overpriced and overleveraged deals done at the peak of the last cycle are kept in the forefront. We are confident that, assuming there are no structural changes to the engine, the asset class will continue to evolve, remain resilient, and discover new ways to transform companies and create value for investors across the economic cycles.
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

How EY's Global Private Equity Sector can help your business

Private equity firms, portfolio companies and investment funds face complex challenges. They are under pressure to deploy capital amid geopolitical uncertainty, increased competition, higher valuations and rising stakeholder expectations. Successful deals depend on the ability to move faster, drive rapid and strategic growth and create greater value throughout the transaction lifecycle. EY taps its global network to help source deal opportunities and combines deep sector insights with the proven, innovative strategies that have guided the world’s fastest growing companies. Our clients discover powerful new ways to create unexpected paths to value generating positive economic benefits for both investors and society. That’s the power of positive equity.

© 2018 EYGM Limited.
All Rights Reserved.

SCORE EYG no. 07222-174Gbl
1712-2506751 US CSG
ED None

ey.com