Perspectives

JAN
2019

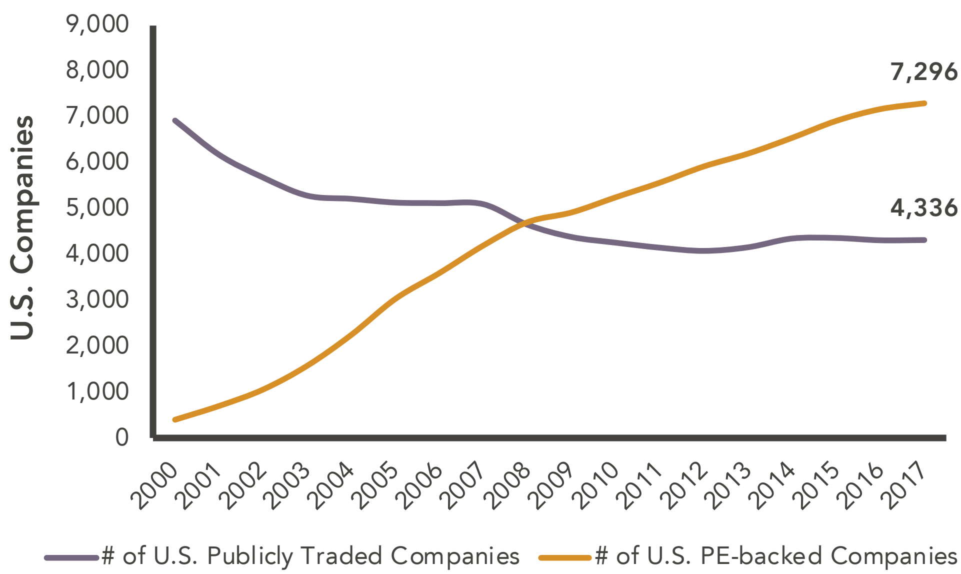
2019 Market Preview: Private Equity

POISED FOR ROBUST DEPLOYMENT

Derek Schmidt, CFA, CAIA
Senior Research Analyst,
Private Equity

Private equity investors in 2018 benefited from strong overall industry performance, with U.S. funds up 8.3% YTD.[1] U.S.-focused funds returned to their typical position of relative outperformance with U.S. buyout funds up 7.9% YTD[2] while international buyout funds were up 4.3%.[3] Growth equity funds collectively produced the strongest industry performance, up 10.6% YTD.[4] Global private equity fundraising remained strong in 2018, but down 25% from the record level raised in 2017 with much of the difference attributable to the raise of SoftBank's $100 billion Vison Fund.

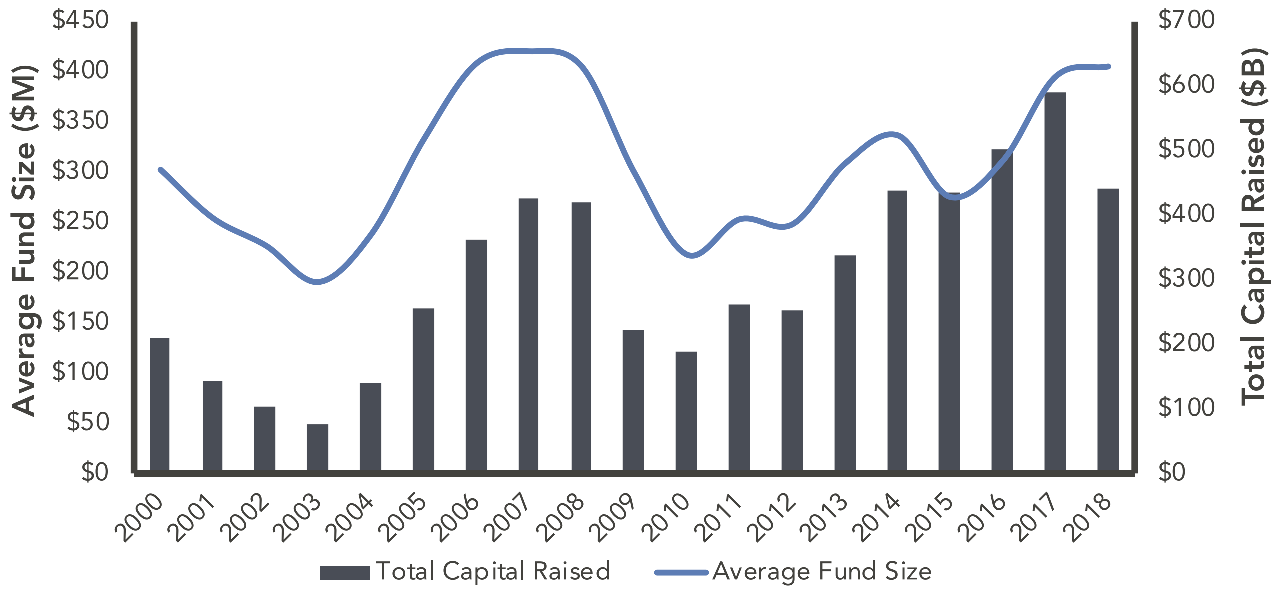
Exhibit 1: Public Equity vs. Private Equity Company Supply



Sources: Pitchbook, Worldbank.org

The private equity industry continues to expand as new investors and managers are attracted to the broader investable opportunity set within private markets. Uber and Lyft have both filed to go public in 2019, and many more private businesses may follow. These exits are likely to provide a tremendous return of capital to investors and will likely be redeployed into many more private businesses. Significant capital remains available for investment in 2019 and beyond, which should further the growing divergence between the number of private equity-backed companies and the number of publicly traded companies. *(See Exhibit 1, previous page)*

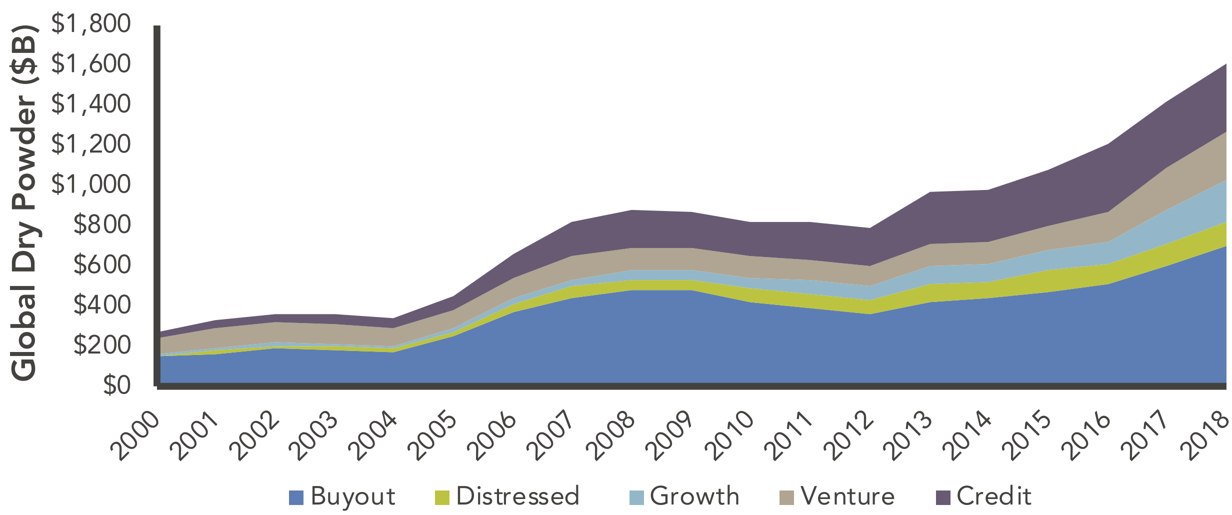
Exhibit 2: Global Private Equity Annual Fundraising and Average Fund Size



Source: Preqin

Private equity managers raised $441 billion in 2018, down 25% from the $589 billion raised in 2017. However, the average fund size in 2018 was $404 million, up 3% from 2017, rising for the 3rd consecutive year and well above the 10-year average of $300 million. Average industry fund size in 2019 is likely to eclipse the peak of $419 million reached in 2007.

Exhibit 3: Global Dry Powder

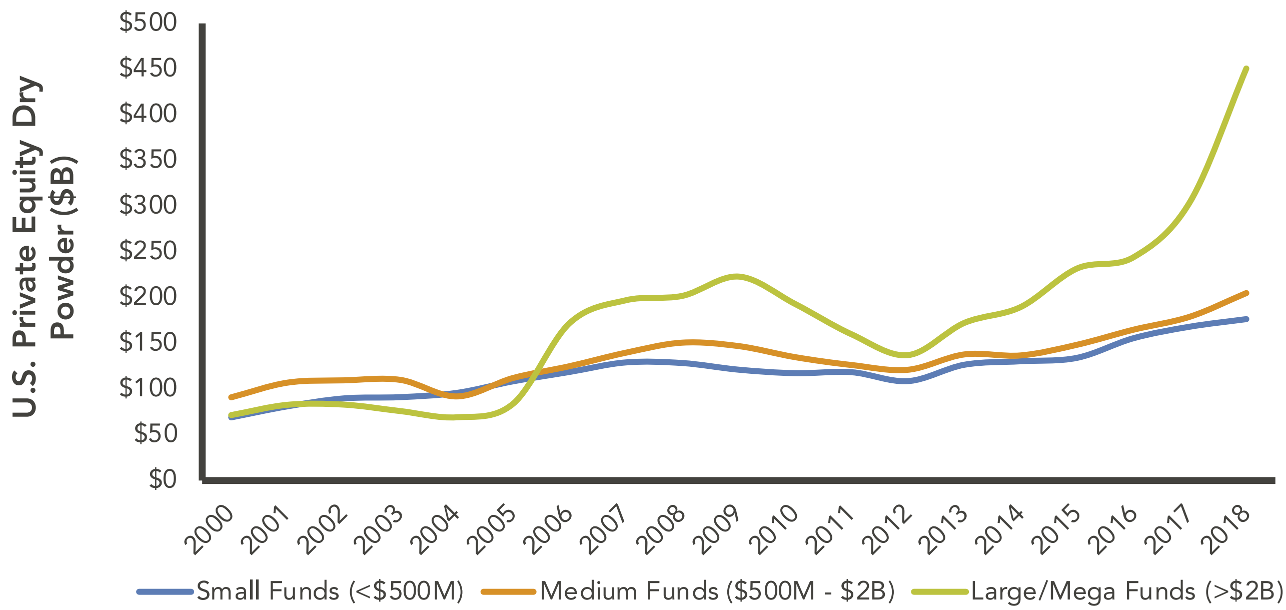


Source: Preqin

Successful fundraising continues to drive industry dry powder to record levels with nearly $1.6 trillion globally awaiting deployment, which remains the largest concern for investors. However, a closer look at the underlying components of this dry powder helps to partially ease investor concerns and support further capital growth. Throughout this extended growth market companies have grown larger — in all global markets — and are increasingly choosing to access private markets for more capital to remain private longer.

Much of the increased capital raised — and subsequent rise in dry powder — has been driven by industry expansion. The private equity industry continues to grow as managers expand into international markets, larger buyouts, private credit, and growth equity. Dry powder within international funds was up 12% in 2018 and now collectively makes up 45% of the industry's dry powder. Investors have increasingly sought international exposure in an effort to globally diversify their private equity portfolios. Many industry leading U.S. managers have capitalized on this demand by raising international focused funds. Additionally, the evolution of the private credit industry has been a great source of growth for private markets. Private credit and mezzanine funds constitute 22% of the industry's dry powder, and is an area poised for considerable growth as an estimated $1.1 trillion of credit is required to support the current level of buyout dry powder.

Exhibit 4: U.S. Private Equity Dry Powder By Fund Size

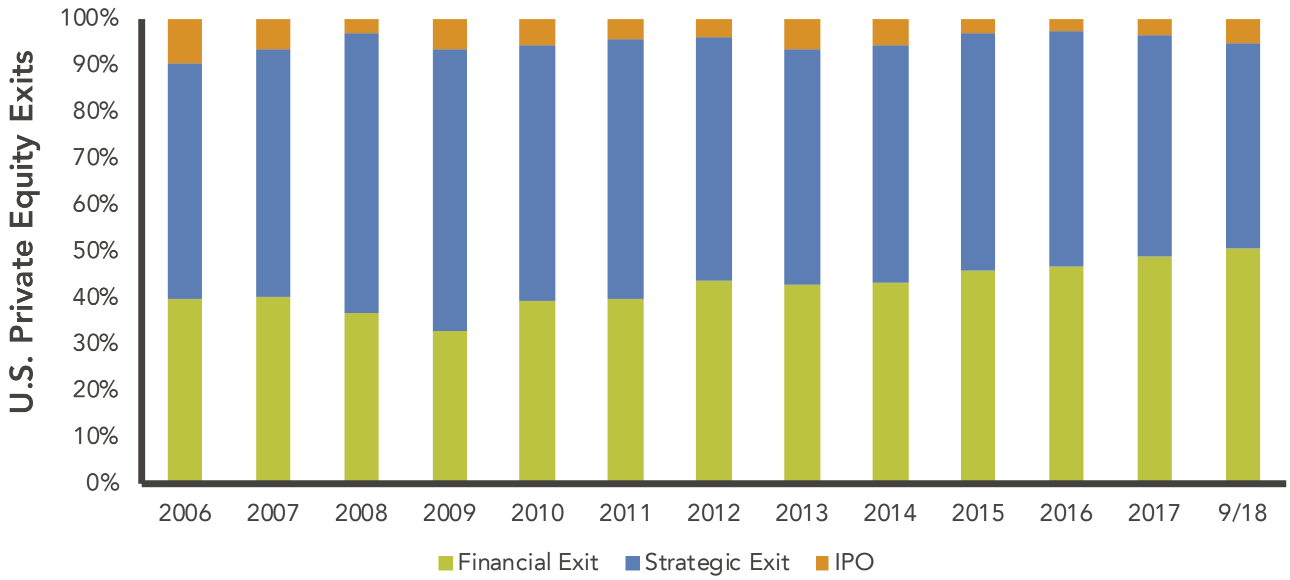


Source: Preqin

Many private equity managers continue to respond to increased investor demand by raising larger funds. We have seen the average private equity fund size grow over the last three years due in large part to a growing number of large (>$2 billion) and mega funds (>$10 billion). Over just the last three years, 33 mega funds have been raised globally with 20 of those being raised in 2018. However, this market dynamic has translated to a growing level of dry powder within these funds as they seek opportunities to deploy the capital. The large and mega funds are competing in a fiercely competitive market for deals. These funds are targeting larger transactions that have historically been relatively rare over the last three years, with only 200 transactions over $1 billion, or 2% of total private equity deals. Furthermore, elevated public company multiples have remained too high (14x EBITDA for the Russell 3000 as of September 30th) and created too large a spread from private market transactions (10x EBITDA for transactions $500 million to $1 billion) to bring together transactions. However, as these managers with large and mega funds face growing pressure to deploy capital and greater public market volatility drives valuations lower, it is likely we will see private equity managers ready to buy declining public companies in 2019.

This evolution of larger funds has been beneficial to the maturation of private equity as an asset class. Increasing investor demand would have likely resulted in a capacity bottleneck had managers not elevated their fund sizes. However, these larger funds and subsequent larger transactions are likely to boost the average private equity deal value, transaction multiple, and financial leverage for the industry in 2019 and beyond. Additionally, large and mega funds have historically provided lower returns to investors with less risk as performance dispersion has been tighter in this peer group. If this performance trend persists, the growing amount of capital being deployed by these large and mega funds is likely to weigh down overall industry returns in the upcoming years. This will require improved benchmarking metrics, better industry transparency, and private equity investors to truly understand the exposures and risk/return expectations within their portfolios.

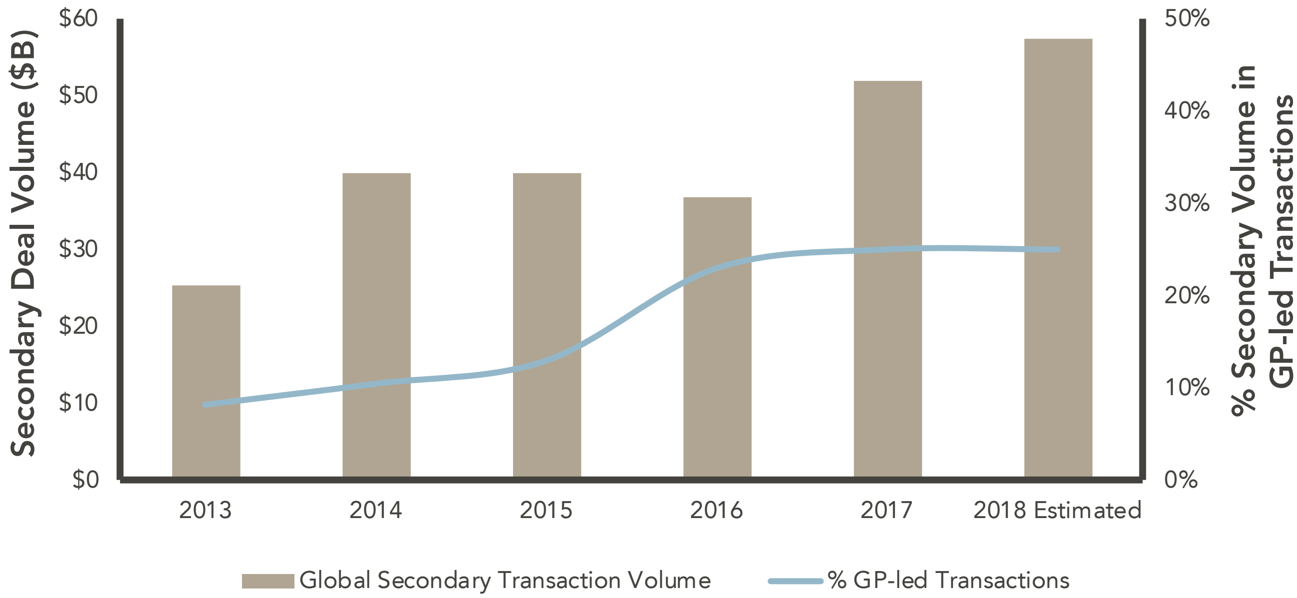
Exhibit 5: Transaction Volumes and Size



Source: Pitchbook

The exit market in 2018 is likely to end at a similar level in overall value, but lower in deal counts, with the median exit size up 37% to $274 million in 2018 from $200 million in 2017. Financial exits — typically exits to private equity buyers — currently comprise 51% of all U.S. private equity exits for the industry, rising each of the last nine years from 33% of exits in 2009. Financial exits are likely to be increasingly prevalent in the market as considerable amounts of industry dry powder are deployed over the next few years.

Exhibit 6: Secondary Market Volume

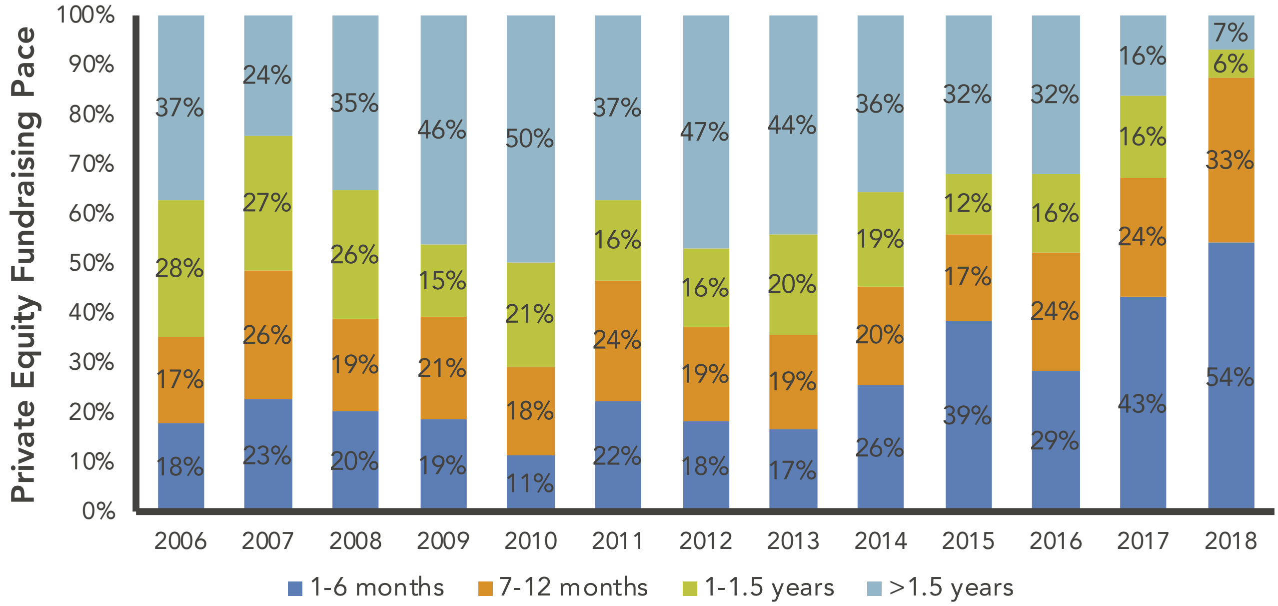


Sources: Greenhill, Collier Capital, and Evercore

Secondary transaction volume is estimated in 2018 to have reached between $55–$60 billion, up from $52 billion in 2017, as the secondary market continues to provide an additional source of liquidity for private equity investors. Secondary funds have been successful fundraising in recent years, accumulating $99 billion of dry powder awaiting deployment. This market continues to evolve as the mix of sellers has shifted away from distressed investors requiring liquidity a decade ago to more sophisticated large sellers looking to access the market to better manage the risk and exposures within their portfolios. This lack of distressed sellers and growth of secondary capital has increased the level of competition for assets, resulting in lower NAV discounts or in some cases, premiums for quality assets.

Many secondary funds have shifted their focus to acquiring tail-end funds, or older funds in the market, which is a substantial emerging opportunity. Currently, over $500 billion of investor capital remains in private funds ten years and older. Secondary interest in these funds is particularly evident in recent years as GP-led transactions have grown from zero to an estimated 25% of secondary volume. Secondary funds will likely continue to target tail-end funds in 2019, providing potentially attractive returns and continued liquidity for investors seeking exits from their longer dated, closed-end investments.

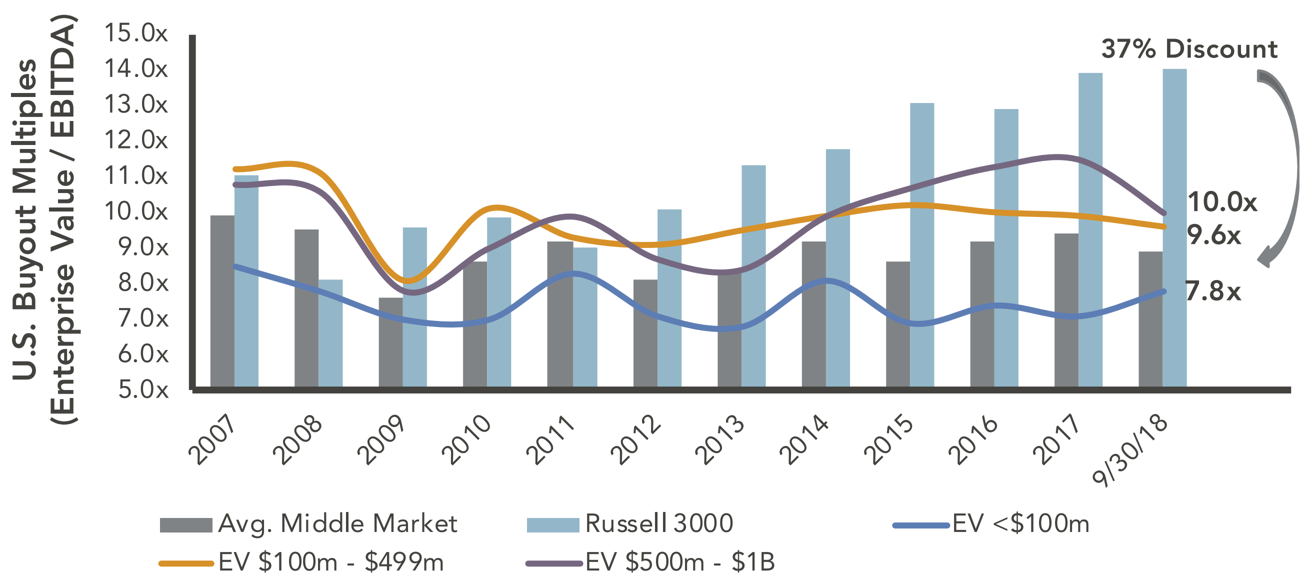
Exhibit 7: Private Equity Fundraising Timelines



Sources: Greenhill, Collier Capital, and Evercore

Demand for high quality managers is likely to remain intense, forcing quick commitment decisions from investors in 2019. Over the past five years the number of funds holding quick closes (< 6 months in the market fundraising) has steadily risen with growing investor demand. Fundraising in 2018 accelerated to an even faster pace as 54% of funds closed to investors within 6 months. A significant number of funds are only holding a first and final close given the strong existing demand from their limited partners. This elevated demand requires private equity investors, with both new and established programs, to make quick decisions. We encourage investors interested in making private equity commitments to have a strong understanding of their annual commitment needs as well as a plan to either continue with existing partners or explore new managers with an understanding of the opportunities and timing of funds that will be coming to market.

Exhibit 8: U.S. Equity vs. Private Equity Valuations



Sources: Bloomberg; Global M&A Monthly - Robert W. Baird & Co.

MarquetteAssociates

Looking to 2019, private equity fundamentals continue to remain attractive in a competitive environment as significant levels of dry powder and cash built up by strategic acquirers is likely to support the current valuation multiples. However, these competitive conditions require investors to focus their investments within high quality managers capable of navigating this market and driving attractive outcomes for investors. We believe investors should continue to overweight allocations towards the small buyout market. This area remains the most attractive to investors due to persistent inefficiencies both operationally within these small businesses as well as the transaction process. The smaller end of the private market is also the most insulated from significant industry risks, which remain elevated dry powder, geopolitical risk, foreign trade negotiations, excessive leverage, and rising interest rates. While 2019 may be an unpredictable year for public equities, we expect private equity to again provide satisfying relative returns to investors.

[1] Based on preliminary performance of the Cambridge Associates LLC U.S. Private Equity Index through June 30, 2018

[2] Based on preliminary performance of the Cambridge Associates LLC U.S. Buyout Index through June 30, 2018

[3] Based on preliminary performance of the Cambridge Associates LLC Ex-U.S. Buyout Index through June 30, 2018

[4] Based on preliminary performance of the Cambridge Associates LLC U.S. Growth Equity Index through June 30, 2018

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO I BALTIMORE I PHILADELPHIA I ST. LOUIS

PHONE 312-527-5500
WEB marquetteassociates.com

About Marquette Associates

Marquette Associates is an independent investment consulting firm that guides institutional investment programs with a focused client service approach and careful research. Marquette has served a single mission since 1986 – enable institutions to become more effective investment stewards. Marquette is a completely independent and 100% employee-owned consultancy founded with the sole purpose of advising institutions. For more information, please visit www.marquetteassociates.com.