2015 Year-End Private Equity
Market Review and 2016 Outlook

Overview

Private equity investors in 2015 enjoyed another strong year of capital distributions with $392 billion in realized investments and dividend recapitalizations through the first three quarters of 2015, adding to the over $800 billion distributed to investors in 2013 and 2014. Investors received this capital at a time of public market volatility and increasing economic uncertainty. In this way, the private equity industry in 2015 highlighted the difficult question investors in all global financial markets have faced this past year: how does one prudently deploy capital in such an unclear market?

The distributed capital, plus a solid year of fundraising with another $291 billion of new capital raised in 2015, have combined to bolster the private equity market and reward those disciplined and patient investors that allocated to private equity during and after the global financial crisis. In contrast, investors in public financial and commodity markets in 2015 were dramatically affected by complicated macroeconomic events, particularly the steep decline in the price of oil. Exit activity in 2015 for private equity and venture capital managers was led by strategic mergers and acquisitions as well as secondary buyouts, while IPOs were a less active source of liquidity than prior years. In fact, 2015 IPO activity was marked by a more than 40% drop in transaction proceeds as compared to the average annual proceeds between 2011 and 2014, and poor post-offering share performance.

Although flush with cash, the private equity industry faces headwinds as it moves into 2016. Abundant capital and a reduction in the overall level of corporate valuations may have joined to affect the level of investment activity in buyouts, special situations, and venture capital. General partners of buyout and special situations funds have faced somewhat tighter borrowing conditions in 2015 than in the recent past, with the cost of financing rising for heavily indebted companies, notably within the energy and retail sectors. Although the cost of debt affected general partners’ views of the attractiveness of certain investments, macroeconomic factors including the fall in the price of oil were considerations as well. As a result, a smaller amount of investment capital was put to work in the buyout and special situations segment in 2015 than in 2014, as firms scrutinized global market volatility and some held on to their capital to await more attractively priced opportunities.

In contrast, venture capital investment activity grew by nearly 20% over the prior year as investments in software, bio-technology, and industrial and energy companies were sought by venture capital funds and corporate buyers alike. Venture capital investors, having raised nearly $125 billion in new funds over the last three years, were compelled to invest their ample dry powder, despite facing a period of seemingly-high valuations. The valuations of “unicorns” (meaning those portfolio companies valued at $1 billion or more) and other price-elevated, venture-backed investments began to normalize in 2015, which will most likely and directly affect those venture capital managers that have invested in these companies. Such an adjustment may create disconnects between return expectations at the point of investment and actual realization results. While the potential degradation of portfolio company valuations is important to monitor, Abbott has found that general partners are generally sensible about the timing of their exits, as unrealized valuation changes are not tantamount to realized outcomes.
Outlook for 2016

The U.S. Federal Reserve in December raised its benchmark interest rate, finally breaking out of the near-zero-rate policy it had followed since 2009. While this move had been telegraphed by the Fed for most of 2015, it came just before a time of significant global equity market volatility caused by economic weakness in Asia and other regions. While the U.S. economy is not widely expected to follow those regions into stagnant growth or recession, domestic industrial production and corporate profits sagged in 2015, falling 2% and 5%, respectively, although the decreases have been driven mainly by a collapse in the oil industry. As such, the future health of the U.S. economy rests on businesses’ abilities to navigate an instable global market. The Fed’s path for future interest rate rises in 2016 has become more uncertain given these global macroeconomic issues and lower-than-expected domestic unemployment and inflation measures. If the Fed sticks to its articulated plan, Abbott does not expect interest rate increases will have much effect on private equity deal volume, although CLO formation and syndicated debt issuance may slow further.

Abbott expects that fundraising for private equity and venture capital strategies will likely remain high as long as distributions remain elevated, and provided that any downturn in the public equity markets is not severe enough to trigger a “denominator effect” among private equity investors. Given the dormant state of the IPO exit market, and the recent volatility of equity prices, it appears likely that distributions will moderate from their current annual levels if M&A activity reverts to its long-term mean.

There are weak spots in the financial markets, though, that could cause the private equity markets to deteriorate in 2016. The market to syndicate loans for larger buyout deals (meaning, $50 million EBITDA companies and larger) are at a standstill, according to several managers in Abbott’s network. Although it is not a certainty, continuance of this trend in 2016 could lead to asset re-pricing and a subsequent drop in transaction volume as seller expectations of prices, and buyers’ willingness-to-pay, adjust to one another. The ensuing decreased transaction activity could be expected to result in declining distributions and a muted investment pace. The slower pace of investments would, in turn, likely result in decreased fundraising activity as GPs would be focused on deploying their existing dry powder more selectively.

Within venture capital, a swing in momentum has begun with a retrenching of the valuations of a number of late-stage venture-backed companies. The potential downdraft in valuations could ripple through the industry much as it has in past cycles, and optimism may shift to pessimism. In such a situation, unicorn portfolio companies suffering write-downs would likely garner the most press, publicly illustrating how even multi-billion enterprises can suffer. Companies with truly disruptive business models could be expected to continue as going concerns, riding out the storm, but others could be at risk of failure if capital becomes scarce. While history is often a guide, the potential fallout in the venture capital space may be different this time due to the more mature profile of venture-backed companies than firms that faced difficulty or failure in the post-2000 decline.

The strong state of the private equity market over the last few years has given rise to an active secondary market, and Abbott expects this to continue in 2016. Transaction volume is likely to be near the historically high levels set in 2014 and 2015, as limited partners continue to use the secondary market to actively manage their existing private equity portfolios. Prices in the secondary market appear to be moderating, which may present opportunities for secondary investors in the future.

Some scenarios and trends that Abbott believes could affect the private equity and venture capital markets in 2016, and possible near-term effects, are identified below:
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Buyout & Special Situations in 2015

Distribution activity was again the headline from 2015 within this segment, continuing a trend that has been in place since 2013. Portfolio liquidity was brought about by a strong year for mergers and acquisitions, dominated by strategic purchases by corporate buyers. Buyout IPO activity was particularly weak, falling to roughly 30% of 2014’s elevated transaction value. Market volatility continued to make IPOs difficult to execute, as evidenced by private-equity-backed firms like Neiman Marcus Group and Albertsons Cos. postponing their public offerings in 2015. Still, investors were in the fortunate position of having record amounts of capital returned to them, even if they were then required to make the difficult decision as to what to do with it. Global buyout firms raised more than $240 billion in 2015, of which approximately $40 billion went to small-and-medium buyout funds globally. Interestingly, $73 billion was raised for funds seeking more than $5 billion in committed capital, 16% more than in 2014. Despite the influx of capital, global investment activity within buyouts fell nearly 20% from 2014, with European buyouts experiencing a 43% decline in capital invested due to concerns about macroeconomic conditions.

Leverage became more difficult to obtain for larger transactions, as banks have seemingly stepped away from financing deals that require more than 6x EBITDA of debt. CLOs had another strong year in 2015 overall, but slowed their purchase activity by over 36% in the second half of 2015 compared the first half, and declined approximately 20% year-over-year. According to managers in Abbott’s network, leverage seems to be still available through middle-market and mezzanine loans.

Buyout & Special Situations Fundraising

- Buyout and special situations firms globally raised $245.6 billion, a 12% decrease from 2014. In this healthy fundraising environment, the average time for a U.S. buyout fund to close was 13.9 months.
- U.S.-based firms raised 8% less capital compared to 2014, accumulating $162.1 billion. European-domiciled firms raised $62.1 billion in 2015, roughly flat compared to the prior year.
- Asian fundraising fell over 50% from 2014 levels, raising only $12.1 billion. The annual fundraising level for Asian buyout funds peaked in 2008 at $38.6 billion, and since that time the annual amount raised has only come within 10% of that peak once in 2011.
**Buyout & Special Situations Investments**

- Buyout and special situations firms globally invested $83.8 billion in nearly 4,000 companies, representing decreases of 19% in value and 3% in number, respectively, over 2014 totals.
- While U.S. buyout and special situations firms invested approximately 16% less than they had in 2014, European investing fell by 43% from its total in 2014.
- Asian investing increased modestly to a new high. 2015 was the second year in a row that Asian buyout investment activity remained at elevated levels from its 2000 – 2013 average annual investment pace of $6.0 billion per year.

**Credit**

- Median debt percentages used for U.S. buyouts eased below 60%, reflecting regulators’ efforts to reduce the level of debt in buyout transactions.
- Plenty of debt remained available at favorable rates for quality targets. Companies coming to market with financial weaknesses received greater scrutiny, leading to delays in the debt portion of certain deals. Lenders sought to remain higher in the capital structure to mitigate the effects of any potential default.
- Sources in Abbott’s network indicate that for companies with less than $50 million in EBITDA, mezzanine and other sources of debt are still available, with debt financing at around 5.0 – 5.5x EBITDA. For companies with more than $75 million in EBITDA, financing is now more difficult because such debt is typically syndicated.
- 2015 high yield new issuance began the year strongly, but then moderated due to weak commodity prices, stress in the energy and retail sectors, and market volatility.
- The CLO market in 2015 experienced its second highest volume year on record, lower only than 2014. Despite this continued strength, issuance declined from 2014 by 21.6% to $97.3 billion in 2015.
Buyout & Special Situations Exits

- Buyout-backed IPOs fell precipitously from elevated 2014 levels to $28.8 billion, a 68% decrease in transaction value. By transaction amount, 2014 was a historic outlier with IPOs, including Alibaba Group’s $25 billion offering, as well as Ally Financial, The Automobile Association, NN Group NV, Healthscope, and Santander Consumer USA whose listings each raised more than $2 billion.

- The total value of U.S. Buyout M&A deal activity was the highest since 2007, at $174.1 billion, on the back of the second-highest number of deals done in any one year, a count of 581. European M&A deal value fell from 2014 by 34% to $60.9 billion.

- Asia M&A deal value fell 4% from 2014 to $28.7 billion, although this deal value level remains elevated from the average M&A per year of $6.5 billion from 2001 – 2013.

Small and Medium Buyouts

- Global M&A activity for SMBO funds by transaction value fell slightly by 6% to $58.7 billion. Notably, SMBO M&A activity in Asia increased eight-fold from 2014, rising to $9.2 billion from $1.1 billion in the prior year. In contrast, European M&A activity for SMBO funds fell by nearly 50% year-over-year to $5.5 billion.

- SMBO fundraising globally was broadly lower in 2015. SMBO funds globally raised $41.9 billion, 45% less than in 2014. In a similar vein, U.S. SMBO funds collected $26.7 billion in 2015, a sum falling nearly 70% short of the SMBO capital raised a year earlier. European SMBO funds raised $7.7 billion in 2015, nearly 60% less than funds of this size collected in 2014. In all regions, fewer SMBO funds were in the market in 2015, with the number of funds globally falling by 41%, and by 44% and 33% in the U.S. and Europe, respectively.

- Global investment by SMBO funds fell by 32% to $8.4 billion, largely driven by European SMBO funds’ 71% decline in investments to $881 million in 2015. U.S. SMBO funds invested $3.9 billion, 28% less than in 2014. In contrast, Asian SMBO investment increased 36% from the prior year, to $2.9 billion.
Venture Capital and Growth Equity in 2015

Investment activity within venture capital and growth equity approached the peak level reached in 2000, with $131.0 billion invested globally in 2015 versus the $153.5 billion in 2000. Last year’s transactions included some of the best-known venture-backed names, such as Airbnb, Social Finance, and Uber Technologies. Corporate investors, benefitting from strong balance sheets, accounted for more than 10% of all venture capital deals in the U.S. last year, investing $2.5 billion and $1.2 billion in the software and biotechnology sectors, respectively. Global venture capital fundraising remained healthy, with many cycle-tested general partners raising capital for new funds, and investors willing and able to redeploy capital. Demonstrating the region’s increasing influence in the global venture capital industry, European venture funds raised $7.7 billion in 2015, representing 17% of the global total.

Trade sales, long considered an exit channel for more mature private equity-owned businesses, have become more frequent in venture capital. Strategic acquirers such as EMC, Pandora Media, and Blackberry helped to make 2015 the biggest year ever for mergers and acquisitions, including all regions, transaction types, and sizes. Corporations have taken advantage of financial sponsors’ hesitancy to tap the volatile and uncertain public equity markets through IPOs. Venture capital public offerings produced $10.9 billion of total transaction value in 2015, including the disappointing Square and Box transactions that priced their IPOs below their peak private values.

While strategic activity increased, corporations remained selective in their purchases, exercising caution as the market began to question valuations of many unicorn portfolio companies. Non-traditional investors, such as mutual funds and hedge funds, have contributed to the overall valuation decline because of their need to mark their assets to market more frequently. Dropbox and Snapchat, for example, were marked down by more than 20% last year by mutual funds holding their shares, while Fidelity marked down its investment in Blue Bottle more than 60% after its purchase. A continued drift in valuations may force private firms to raise capital through “down-rounds,” or valuations below their earlier billion-dollar-plus levels.

Venture Capital & Growth Equity Fundraising

- Globally, capital raised in venture capital and growth equity funds fell 6% from 2014 to $45.6 billion. Notably, 2015’s fundraising total is still more than the average annual capital raised between 2001 and 2014 of $40.4 billion per annum. At a total of 402 funds seeking capital, there were 15% fewer funds in the market than in 2014.
- U.S. funds raised $28.3 billion in capital, approximately 10% less than in 2014. Capital raised for Asian funds was also lower, falling by nearly 25% from 2014 to $7.8 billion. In stark contrast to these two regions, European funds raised $7.7 billion in 2015, up 83% from their 2014 total.
- The number of U.S. and Asian funds seeking capital both fell by 18% from 2014. In contrast, there were 20% more European funds in the market this year than last.

Global Venture Fundraising

Source: Thomson Reuters / Thomson ONE database
Venture Capital & Growth Equity Investments

- Global venture capital and growth equity investments increased 19% over 2014’s measure, to $131.0 billion. The number of transactions remained essentially flat.
- European venture and growth investors were particularly active in 2015, investing 64% more than the region had the prior year. Asian and U.S. investors also increased their activity, with investment transaction amounts increasing by 38% and 31%, respectively, over 2014’s measure.
- The number of transactions in Asia increased by nearly 30% over 2014. Demonstrating a more static picture in the U.S. and Europe, the number of transactions in each of these regions was roughly the same across the years.

Venture Capital & Growth Equity Exits

- M&A activity fell 28% to $51.9 billion, dramatically lower than the prior year which included the multi-billion-dollar sales of WhatsApp, Nest Labs, and Oculus VR. Even after removing those three acquisitions, the combined value of deals in 2014 still outpaced 2015.
- VC-backed IPOs in 2015 that generated more than $200 million in proceeds included Fitbit, Pure Storage, Etsy, Square, SunRun, and Box.
- “The bar for new IPOs is higher now due to general market volatility, expectations of higher interest rates, anticipation of a stronger dollar, and perceptions that the U.S. is late in its economic cycle.” — Samuel Wilson, Head of IR at MobileIron (Venture Capital Journal).
Secondary in 2015

Secondary transaction volume remained elevated, reaching $40 billion and nearly matching the record $42 billion set in 2014. While the trade of limited partner positions still dominates the type of secondary sales at 78% of all volume, direct equity deals and general partner liquidity solutions have expanded, comprising 22% of activity versus 19% in 2014. The secondary market continues to be highly concentrated, with the top 15 buyers accounting for approximately 80% of transaction volume in 2015, up from 75% in 2014.

The estimated level of dry powder for secondaries rose to a record high of $65 billion at year-end 2015, up from $56 billion at the midpoint of 2015. Secondary fund managers hope to raise an additional $40 billion of capital in 2016. If transactions volume remains at similar a similar level for 2016, dry powder may end the year at similar levels. The price of secondary deals remains competitive given sustained buy-side demand, although prices appear to have moderated slightly in late 2015 due to public market volatility.

- Active portfolio management and regulatory pressure remain the two main reasons for the sale of interests, at 66% and 14%, respectively.
- Public and private pensions were the most active seller type in 2015 at 24% of transaction volume, followed by financial institutions at 18%, which dropped steeply from 41% of transaction volume in 2014.
- Leverage played an increasingly important role in secondary transactions. 25% of deal volume was leveraged at the special-purpose-vehicle level in 2015, up from 17% in 2014. Average loan-to-value levels were 40%, versus 30% in 2014.
- Buyout and growth equity funds still represent the bulk (71%) of the interests that trade on the secondary market.
End Notes

The information and charts presented in this document were generally sourced from the following materials.

Adviser Perspectives, January 26th, 2016. “Consumer Confidence Improved in January.”
AltAssets, January 21st, 2016. “Corporate Venture Investment in Early Stage VC Rising.”
The Triago Quarterly, November 2015.
Thomson Reuters/Thomson ONE database (Fundraising, Investments, M&A, IPOs). Data retrieved from Thomson Reuters is continuously updated and is therefore subject to change. All data in Thomson One derived from either Thomson Financial sources or public filings.
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