



2020

# Global Private Equity Outlook

Dechert  
LLP

 Mergermarket  
An Acuris company



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## **Methodology**

In the second quarter of 2019, Mergermarket, on behalf of Dechert LLP, surveyed 100 senior-level executives within private equity firms based in North America (45%), EMEA (35%) and Asia-Pacific (20%). In order to qualify for inclusion, the firms all needed to have US\$500m or more in assets under management and could not be first-time funds. The survey included a combination of qualitative and quantitative questions, and all interviews were conducted over the telephone by appointment. Results were analyzed and collated by Mergermarket, and all responses are anonymized and presented in aggregate.

# Introduction: A critical juncture

Two themes dominate this year's *Private Equity Outlook*. From a macro perspective, the inextricable link between today's tense geopolitics and the global economy is playing on the minds of investors. The year-long-and-counting trade war between the U.S. and China has seen tariffs imposed on at least US\$360bn worth of goods on both sides of the divide, and the OECD revised down worldwide GDP growth as a direct response. This has, at least in part, prompted the U.S. Federal Reserve to loosen its monetary policy, with the European Central Bank following suit.

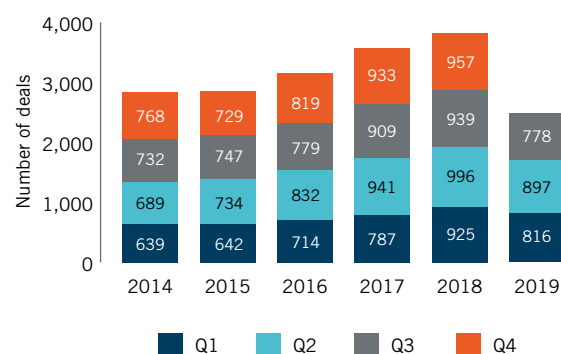
Equity market volatility, meanwhile, has intensified in the last 12 months, which could spell opportunity. Private valuations have now virtually reached their pre-crisis peak. On a relative pricing basis,

public markets are becoming more attractive as they lose their liquidity premium over private assets. Equity markets witnessed a new bout of volatility in summer 2019, and any severe drop – such as that seen in Q4 2018 – would make this even more pronounced, particularly in the short term.

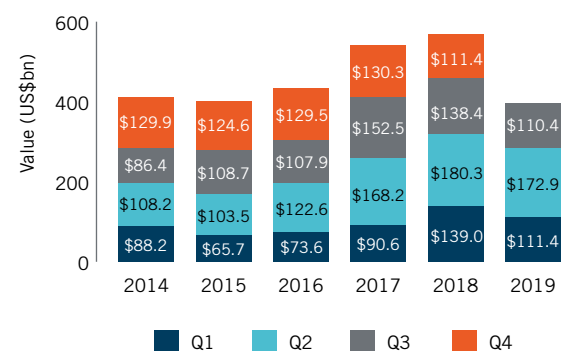
Taking a micro, industry-specific view, PE houses are faced with a US\$1trn-plus conundrum. Innovative strategies are becoming commonplace as the industry is being forced to adapt to an overabundance of capital, with buyout practitioners moving into growth capital and minority stake investing, and raising long-hold funds.

And deploying it they are. In 2018, US\$569bn was invested globally across

**NUMBER OF GLOBAL BUYOUT DEALS, 2014 – Q3 2019**



**VALUE OF GLOBAL BUYOUT DEALS, 2014 – Q3 2019**





# Key Findings

3,817 buyouts, according to Mergermarket data, a post-crisis value record and the highest volume of deals in history. Whether that momentum can be sustained through the end of 2019 is another matter. Results from the three quarters of the year (US\$394.7bn deployed across 2,491 deals) indicate a deceleration. However, the fact remains that PE fund managers have US\$1.5trn at their disposal and this will need to be invested somehow.

Exits and fundraising may be a more relevant area of attention as we approach the top of the economic cycle. Last year, global buyout fundraising fell by 23% to US\$426bn, Preqin data show. There are likely numerous reasons for this, not least the fact that the three previous years were record-setting. Annual fundraising figures can also be skewed by which players happen to be in the market raising funds. However, there is reason to believe that

LPs may be tempering their allocations. As concerns mount over a possible recession, it would be understandable that investors may choose to rein in PE allocations to pre-empt any forthcoming denominator effect from falling stock prices.

We also see that optimism among GPs regarding short-term exit prospects is low, and indeed exit value declined 18% in the first three quarters of 2019 (compared to the same period last year) to US\$367.3bn and volume fell by 223 deals to 1,727 exits. PE has made hay while the sun has shone in the last five years, rewarding investors with strong returns and raising even larger funds. The question now is: how can funds prepare themselves for the storm clouds on the horizon?

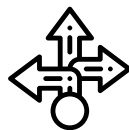
PE fund managers have US\$1.7trn at their disposal and this will need to be invested one way or another.

## Big picture concerns (and opportunities)



The biggest challenges currently facing the PE industry, according to our respondents, are region-specific factors such as geopolitical and macroeconomic issues. This reflects growing concerns about the state of politics in major markets, as well as apprehensions over a looming recession. When asked about specific regional issues that concerned them most, GPs called out the 2020 U.S. elections; the U.S.-China trade conflict; Brexit; and China's economic slowdown. One positive from all of this is that equity market volatility is presenting deal opportunities. Public-to-private transactions are accounting for a larger share of deal activity in certain markets, and funds are identifying arbitrage opportunities as valuation multiples in public and private markets diverge.

### Diverse specialization: From growth equity to long-hold funds



Our survey indicates that PE firms are diversifying their strategies through specialization, homing in on corners of the market where there may be less competition as they seek to put record sums of dry powder in the ground. A majority of GPs said they make minority stake investments, for instance; nearly half said they have increased their targeting of growth equity investments in the last 12-24 months; more than half are planning to raise a long-hold fund; and more than half said they are very likely to consider partnerships with strategic buyers. All of this clearly shows that formerly niche strategies have become mainstream.

### Carving out deals



There are high expectations for carve-outs, with the majority of respondents expecting an increase in such deals. The primary driver, GPs said, will be the need to spin off business units in order to pay down debt. After a decade of the loosest monetary policy in history, which corporates capitalized on by taking on record levels of cheap financing, this cycle could potentially come to fruition – although not as quickly as first envisaged. As corporates look to deleverage, PE is the natural owner of non-core corporate orphans that are locking up cash.

### LPs flex their muscles



With more active PE funds than ever before competing to attract LP capital, institutional investors are adjusting their strategies when it comes to their PE commitments, our respondents said. In the area of fundraising, GPs said that large LPs are concentrating their investment relationships on a smaller number of funds and urging firms to put their capital to work quickly. Interest in co-investment and joint ventures is rising as well, as LPs not only seek lower fees but greater control over the management of their portfolios.

# Fund trends: A natural evolution

Private equity continues to be a high-demand asset class, for obvious reasons. The alpha delivered by GPs keeps investors returning for more, which is undoubtedly a blessing for fund managers – but is not without its challenges. Preqin data show that up to H1 2019, more than US\$200bn was raised globally across private equity funds, a year-over-year increase compared to H1 2018. And while 2018 saw an annual decline of 23%, this must be viewed in context: 2015 through 2017 were the three most abundant fundraising years since private equity's inception.

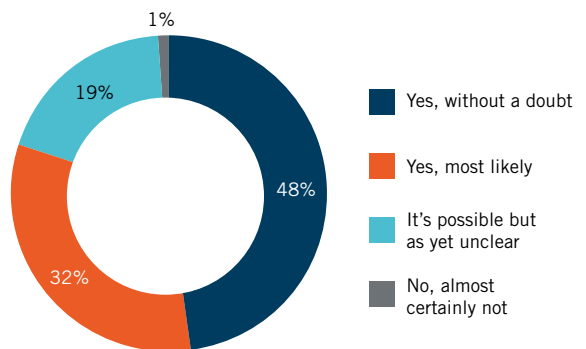
The long-term trend seems clear. Dry powder in the PE ecosystem continues to accumulate – the total currently stands at US\$1.7trn. The conundrum for GPs is how to invest this capital overhang and continue to deliver public-

market-beating returns in the face of unrelenting competition for private assets.

Managers have been adding new strategic strings to their bows by diversifying into adjacent asset classes, and our survey indicates that this trend will only strengthen in the years ahead. Nearly half of respondents (48%) said they plan to diversify their asset class exposure without a doubt over the next 12-24 months, and another third (32%) said they will most likely do so. With 19% saying such diversification is a possibility, that leaves just 1% who are firmly sticking with their tried-and-true buyout strategy.

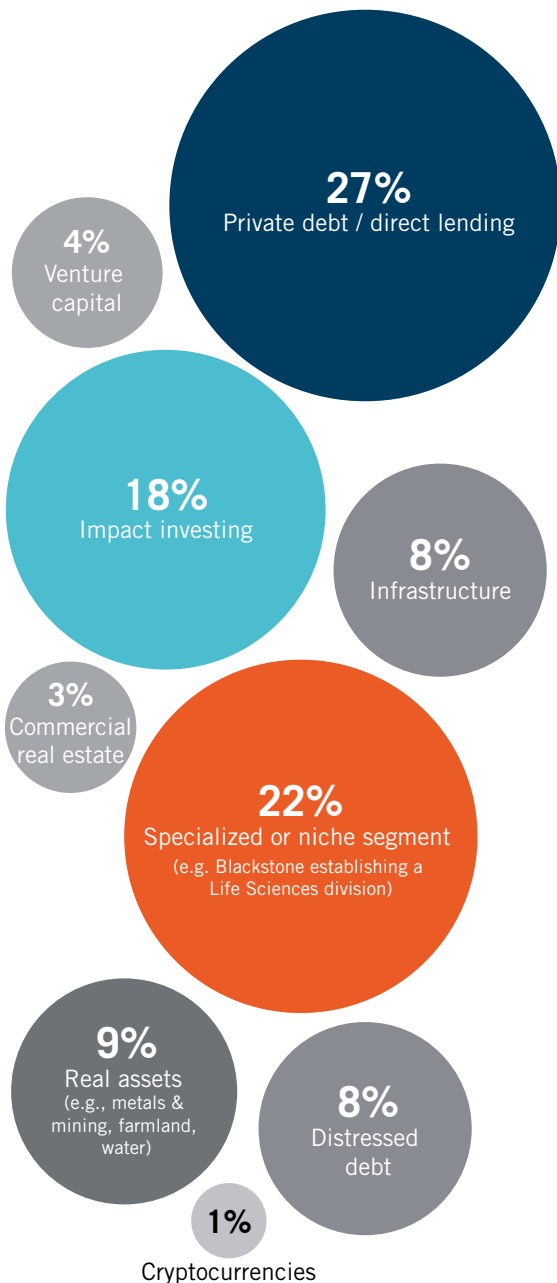
The three most popular asset types, claiming more than two-thirds (67%) of the vote between them, are private debt (27%); specialized niche

## OVER THE NEXT 12-24 MONTHS, DO YOU PLAN TO DIVERSIFY YOUR ASSET CLASS EXPOSURE?

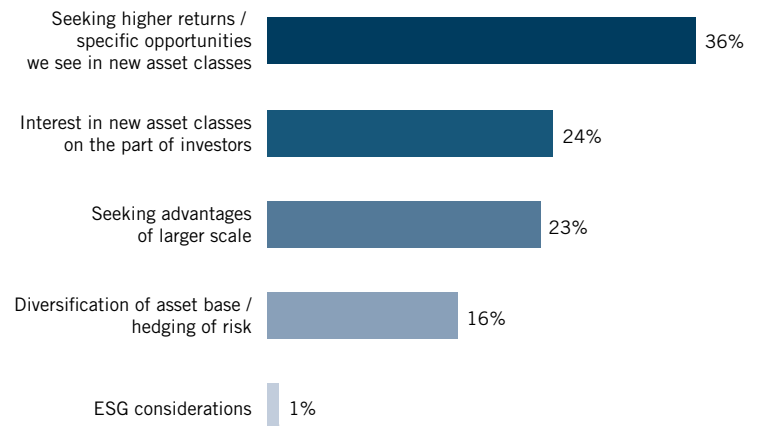


The persistently high demand for leveraged financing makes private debt an obvious choice to offer LPs.

**IF YES, WHICH ASSET CLASS IS YOUR FIRM'S TOP PRIORITY FOR EXPANSION?**



**WHAT IS THE MAIN REASON YOUR FIRM IS CONSIDERING EXPANSION INTO NEW ASSET CLASSES?**



segments (22%) along the lines of the life sciences division launched by Blackstone Group, after it acquired Clarus in October 2018 and renamed it Blackstone Life Sciences; and impact investing (18%), a new focus for KKR after it launched a dedicated fund in April 2019.

The persistently high demand for leveraged financing makes private debt an obvious choice to offer LPs, a fact that managers have successfully capitalized on. “There’s a huge appetite for privately financed deals,” said Dr. Markus Bolsinger, a partner in Dechert’s New York and Munich offices. “If you do the math, that makes it a product that LPs want. There are a lot of risk-averse investors out there, the returns on private

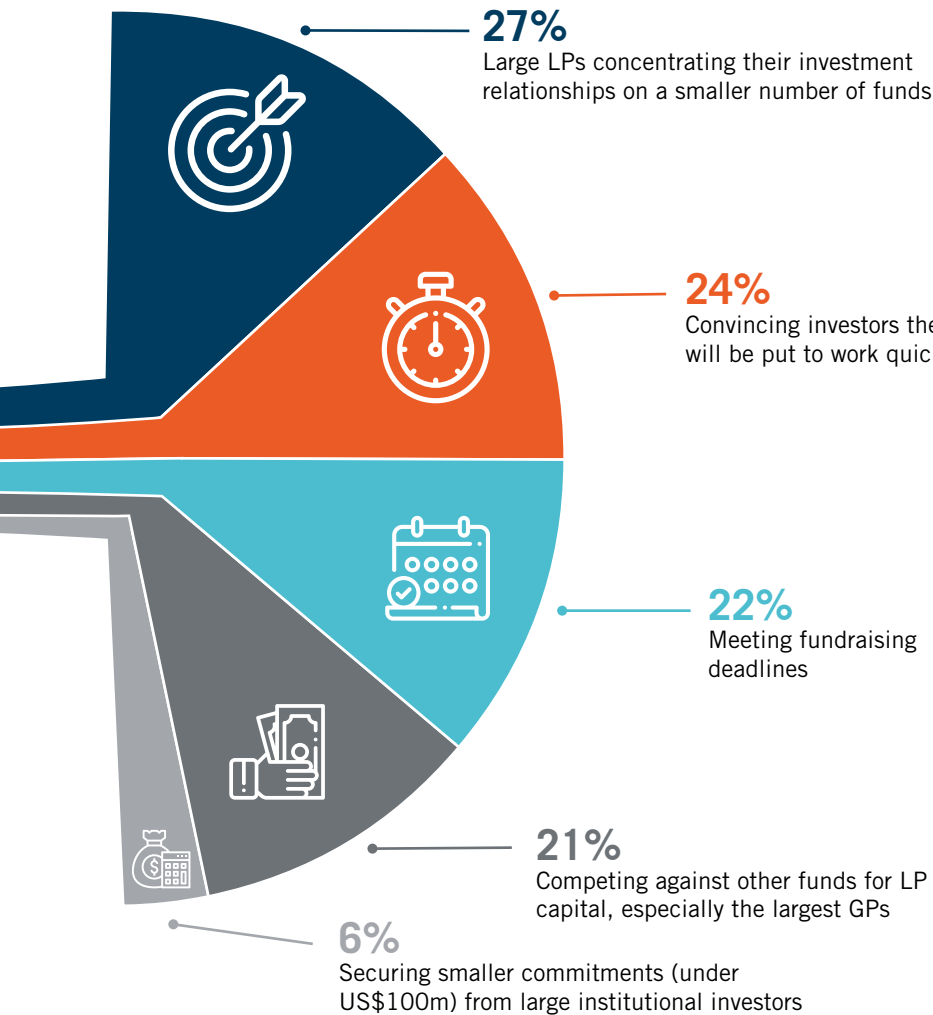
debt are still way above the public markets and the risk profile is totally different because as an investor you’re in a different spot in the capital structure. So the investment appetite for private debt is very large.”

Areas such as life sciences and impact investing, meanwhile, have been less fully explored by mainstream private equity. Blackstone’s and KKR’s foray into these less charted territories is, among other things, a symptom of private equity’s need to develop creative methods for capital deployment. The traditional buyout market has limited capacity and is struggling to absorb the quantum of equity capital that the PE industry has and continues to raise.

**HAS YOUR FIRM RAISED A FUND IN THE LAST 12 MONTHS, OR IS IT CURRENTLY RAISING A NEW FUND?**



**IF YES, WHAT IS THE BIGGEST FUNDRAISING CHALLENGE YOUR FIRM HAS FACED?**



**The rise of mega-funds**

Not all GPs are benefitting from the LP gold rush, however. The top-cited fundraising challenge in our survey was the trend of large LPs concentrating their investment relationships to a smaller number of funds (27%), reflecting in part the rise of mega-funds and the dominance of top firms when securing new investments.

Commensurate with this finding, 21% of GPs reported that their biggest fundraising obstacle is competing with other managers to secure LP commitments, especially the largest GPs around which investor capital is concentrating.

Further, in a sign of the times, 24% said that convincing investors their capital will be put to work quickly is proving to be difficult. This should come as little surprise. The primary downside of the industry nursing record stockpiles of private capital is that finding fairly priced assets is proving to be an uphill battle. The median price-to-EBITDA multiple for deals globally has risen steadily after formerly peaking in 2007, reaching a level of 11.5x by the start of 2019, according to Mergermarket data. GPs are therefore having to exercise caution in their deal sourcing and auction bidding, or spend more time seeking out unilateral deal opportunities. All of this may result in delayed drawdowns, until a turn in the economy precipitates lower valuation multiples.



## Co-investment and JVs gain momentum

More than three-quarters (78%) of our survey pool said the level of interest in co-investment and JVs on the part of their LPs has increased, and not a single respondent reported that interest has decreased.

Appetite for co-investing is one of the more notable LP trends of recent years. There are a number of reasons why LPs might want greater direct exposure to assets by circumventing funds.

Investing outside of the typical 2-and-20 LP structure is a way to improve returns by reducing management fees and carried interest. Such arrangements vary from heavily reduced economic terms to no fee, no carry at all, depending on the nature of the relationship between the LP and GP. Although it is worth noting that, in almost all instances, monitoring fees will still apply in such situations.

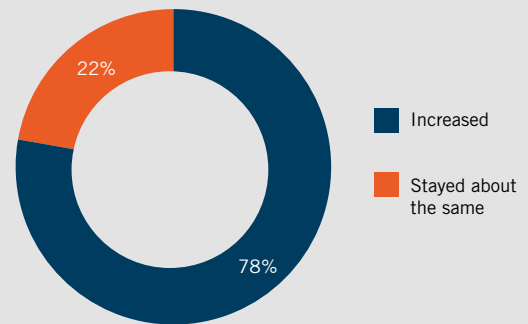
While we found that nearly a quarter (24%) said LPs were primarily seeking lower fees, nearly double this proportion (42%) said that LPs are seeking greater control over the management of their portfolios. PE funds

are essentially black boxes – LPs don't know what they will end up invested in. However, if they can invest a portion of their PE allocation in co-investments or JVs, they're able to structure their portfolios more precisely.

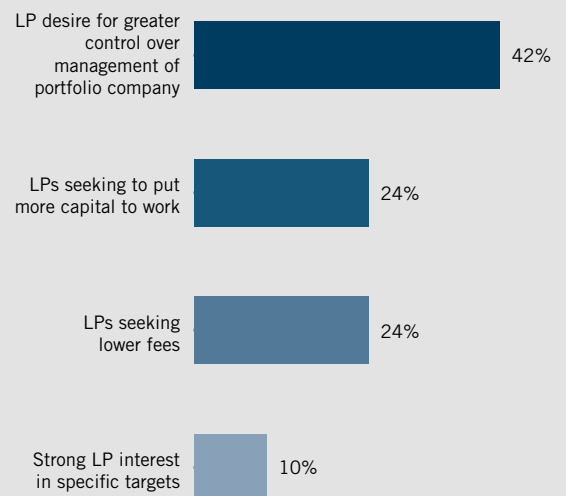
Likely investors will continue to seek improved returns through direct investing methods, in collaboration with their GPs. But GPs should also anticipate an increasingly discerning investor base as LPs look to more actively manage their portfolios. Co-investing and JVs have become commonplace as investors seek to deploy additional capital, in excess of their fund commitment allotments, into select deal opportunities.

“There is a further reason for the growing co-investment or JV trend. Given the amount of competition for good assets, LPs and GPs are co-investing and entering into JVs to combine efforts and distinguish themselves from other GPs by leveraging the LP's industry expertise, networks and/or reputation to provide value added benefits to the portfolio,” said Dechert's Siew Kam Boon.

## OVER THE LAST 12-24 MONTHS, HOW HAS THE LEVEL OF INTEREST IN CO-INVESTMENT AND JOINT VENTURES ON THE PART OF YOUR LPs CHANGED, IF AT ALL?



## IN YOUR EXPERIENCE, WHAT IS THE PRIMARY DRIVER OF LP INTEREST IN CO-INVESTMENT OR JVs CURRENTLY?



## Go long or go home

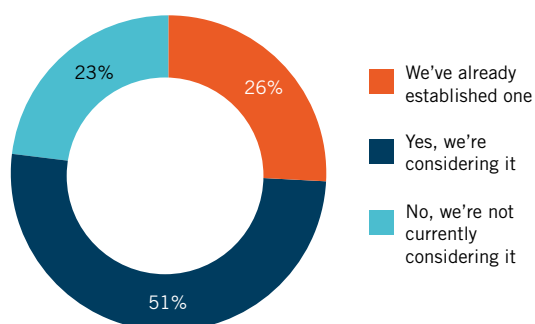
A number of PE firms have launched vehicles or managed accounts in recent times that can own companies for 15 years or longer, and it seems that long-hold funds have quickly become a firm fixture on the GP agenda. We found that 26% of respondents said they had already established one, in line with the 27% who said the same in our *2019 Global PE Outlook*. More strikingly, last year 32% said they were considering launching such a vehicle and this has now risen to more than half (51%) who have designs on a long-term fund.

Once again, this speaks to the way in which stiff competition for assets is prompting GPs to devise new means and methods of putting capital to work. The reasons for pursuing long-hold strategies appear to be shifting somewhat – the top drivers this year were expanding the available pool of investment targets (30%) and aligning interests with LPs (27%), while last year the priorities were increasing returns by holding onto profitable companies for longer and making the firm more attractive to founders/sellers. Another possible motivating factor at this latter

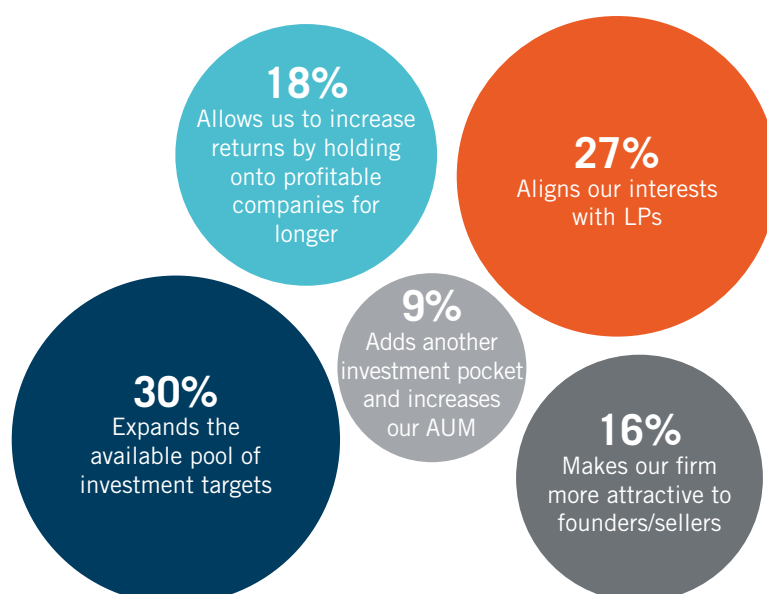
stage in the business cycle is that, with mounting concerns of a recession in the next 12 to 24 months, such funds buy managers extra time to hold assets through any forthcoming downturn – and out the other side.

“It’s a constant theme across all different kinds of funds now. People see the merit in holding assets for longer in certain instances and if you have one single vehicle that can do that, it makes things a lot easier from a logistics and process standpoint,” said Bolsinger.

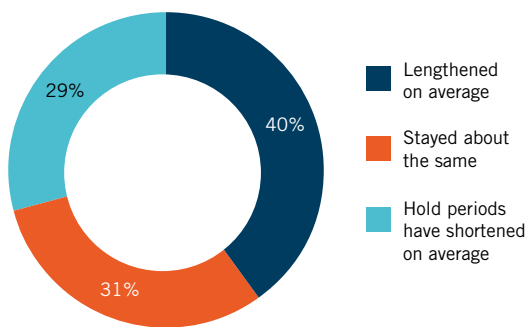
### IS YOUR FIRM CONSIDERING RAISING A LONG-HOLD FUND (AROUND 15+ YEARS IN DURATION)?



### FOR WHAT REASONS IS YOUR FIRM CONSIDERING OR HAS ALREADY ESTABLISHED A LONG-HOLD FUND?



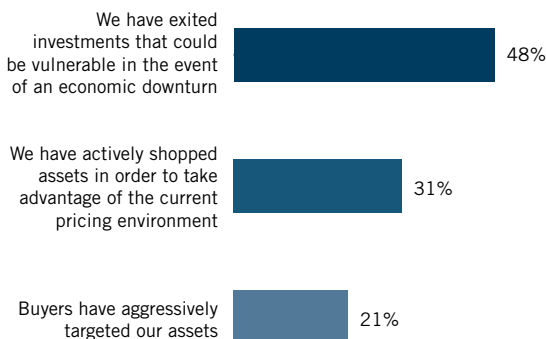
**OVER THE LAST 12-24 MONTHS, HOW HAVE THE HOLD PERIODS FOR YOUR FIRM'S PORTFOLIO COMPANIES CHANGED ON AVERAGE COMPARED TO THE PREVIOUS FIVE YEARS, IF AT ALL?**



“People see the merit in holding assets for longer in certain instances and if you have one single vehicle that can do that, it makes things easier from a logistics and process standpoint.”

Dr. Markus Bolsinger, Dechert

**IF HOLD PERIODS FOR YOUR FIRM HAVE SHORTENED, IN YOUR OPINION WHAT HAS BEEN THE STRONGEST DRIVER OF THIS TREND?**



The emergence of long-hold funds is not yet influencing average holding periods, however. Prequin data show that in 2018, the most recent period for which data are available, the median hold fell by 10% to 4.5 years. This is the first time that hold periods have slipped below five years since 2011, and is the fourth consecutive year that holds have shortened since a peak of 5.9 years in 2014. This trend is indicative of the voracious demand for assets. Fierce competition makes securing new buyouts immensely challenging, but has created a sellers’ market that has allowed fund managers to more quickly achieve sales at desired returns. At the same time, recessionary signals are mounting, such as the inversion of the yield curve on U.S. treasuries and weakening manufacturing output. This

is giving increased impetus to sell sooner rather than later in order to return cash to investors and get the next fundraising in train before the market retreats.

Our survey findings do not show a clear trend with regard to hold periods, however. We found a marginally higher percentage of respondents (40%) said that hold periods have lengthened on average compared with five years ago, 31% said they have stayed about the same, and 29% said they have shortened on average. For those who said they have shortened, the primary reason behind this contraction was funds exiting investments that could be vulnerable in a downturn (48%), followed by funds actively seeking to take advantage of current prices (31%).



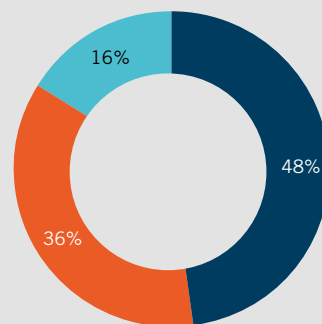
### U.S. capital gains: Much ado about nothing

Following the change in tax rules for capital gains, nearly half of our U.S.-based respondents (48%) said they have soft-circled a hold period of at least three years across the board. It should be noted, however, that more than a third (36%) said they take the new policy into account when considering an exit but have no strict rule, and the remaining 16% said it has had no impact. The intention of the tax change was partly to narrow the gap between the tax rates applied to investment professionals and wage-earners, by taxing some carried interest returns for investments held less than three years at the same rate as wages.

The change may have the ancillary effect of discouraging PE from the short-termist quick flipping of companies. And indeed, the

median PE hold period in 2018, according to Preqin data, was 4.5 years, a 10% reduction from 2017 and yet still well above the U.S. tax rule threshold. Therefore, it might be expected that the tax update would have a limited impact in the majority of cases, as quick flips are the exception rather than the rule. However, as we move through the latter stages of the sellers' market, there is intense pressure to sell, meaning GPs may suffer a personal tax disadvantage as they seek to maximize LP returns.

### WITH CAPITAL GAINS NOW BEING TAXED AT A HIGHER RATE ON SALES OF ASSETS HELD FOR LESS THAN THREE YEARS, HAS YOUR FIRM SOFT-CIRCLED A HOLD PERIOD OF AT LEAST THREE YEARS?



- Yes, across the board
- We take this into account when considering an exit, but we have no strict rule
- No

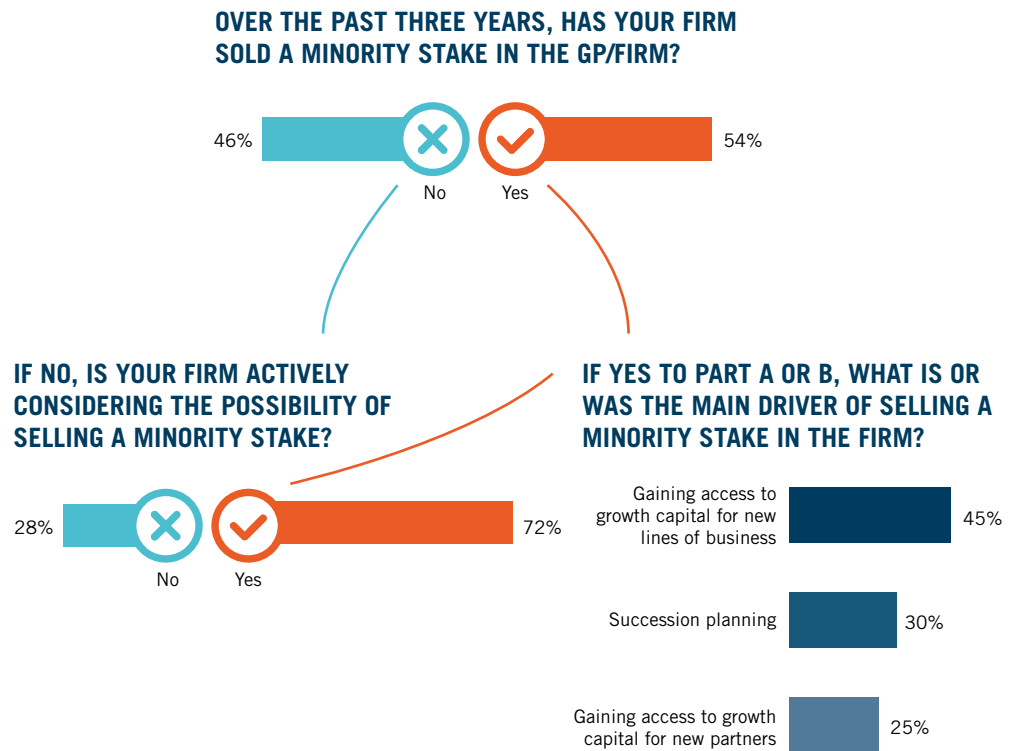
(FOR RESPONDENTS ONLY)



## Raising the stakes

Another trend that has emerged in recent years is the trade in stakes in PE management firms themselves. A number of high-profile purchases have been made since the global financial crisis – marquee names such as Apax Partners, BC Partners, Blackstone, Carlyle, CVC Capital Partners, Lexington Partners, Rhone Capital, TowerBrook Capital and Providence Equity Partners have sold off slivers of the GP management firm to core investors, in most cases pension funds and sovereign wealth funds with deep pockets and long-term perspectives. This is increasingly becoming a mainstream phenomenon, with institutional funds specialized in buying such stakes.

So-called “funds of firms” have been operating in this area of the secondary market for at least a decade, one example being Neuberger Berman’s Dyal Capital Partners. While this activity has historically targeted managers with more than US\$10bn under management, the bar is lowering. For instance, London’s Goodhart Partners has launched Volunteer Park Capital to acquire strategic minority stakes in mid-market GPs in North America and Europe; the platform is raising a fund with a US\$200m target. Similarly, Stonyrock Partners has teamed up with



Leucadia Asset Management to raise a US\$1bn permanent capital fund aimed at mid-cap GP stakes.

Our survey shows just how common these kinds of trades are: A majority (54%) of respondents said their firm had sold a minority stake over the past three years, and of those that have yet to do so, 72% are considering it. Given the maturity of the private equity asset class, it might be expected that the primary motivator for such activity would be succession. This is undoubtedly a strong

driver, with 30% of the cohort reporting this as the main reason for such a decision; however, 45% of GPs said their rationale was gaining access to growth capital for new lines of business. Once again, this speaks to the pressure within the industry to diversify amid heavy competition in the buyout market. Raising ancillary capital in this way can provide the wherewithal to test new investment strategies than can be opened to LPs at a later date, or can be used to cover the GP commitments required to seed new fund types.

# Spotlight on APAC

Deal activity for targets in the Asia-Pacific region held up relatively well last year: The 608 transactions represented a five-year high, and the US\$131bn deployed was the second-highest figure over the same period, despite constituting an annual fall of 10%. There appears to have been something of a pullback more recently, however. In the first three quarters of 2019 just 320 deals were tallied, with only US\$62.7bn invested.

Local fundraising in China, meanwhile, has all but evaporated, amid the ongoing trade war with the U.S. and escalating political protests in Hong Kong. An analysis by Bain & Co shows that domestic private equity houses raised about US\$13bn in renminbi-denominated

funds in 2018, down about 86% on the US\$93bn raised a year prior. Similarly, Dutch fund services group Intertrust also observed that the number of China-focused private equity and venture capital fund launches it handles dropped from about 10 per month in 2018 to just two or three in the first months of 2019.

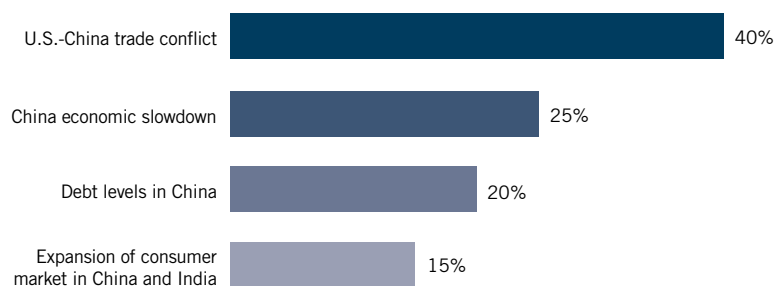
At the same time, a significant portion of the capital raised for private equity in China comes through offshore funds, and there is still some successful fundraising in the offshore fund space. For instance, in August 2019 CITIC Capital announced it had raised US\$2.8bn for its fourth buyout fund, making it the fourth-largest fund ever raised by a Chinese manager. Offshore money has

predominantly been funnelled to larger, blue-chip PE houses with APAC strategies and to larger local heavyweights.

Without a doubt, the Chinese private equity market — just like its economy — is feeling the effects of the ongoing U.S.-China trade war. Two out of five APAC GPs in our survey said they expect this conflict will have the largest impact on the deal environment in the region over the coming 12–18 months, while 25% think the economic deceleration in China, which itself has in part been linked to trade tensions, will be the most significant variable.

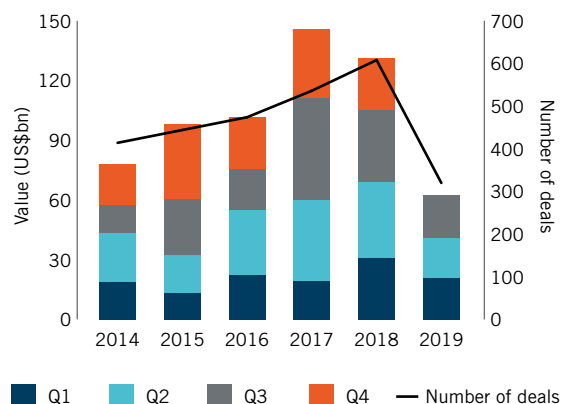
But how exactly might these factors impact dealmaking in the region? Chinese activity is likely to remain subdued,

## IN YOUR ESTIMATION, WHICH CURRENT OR UPCOMING DEVELOPMENTS IN ASIA-PACIFIC WILL HAVE THE BIGGEST EFFECT ON THE DEAL ENVIRONMENT OVER THE COMING 12–18 MONTHS?



(APAC RESPONDENTS ONLY)

## NUMBER AND VALUE (IN US\$BN) OF PE BUYOUT DEALS IN APAC, 2014 – Q3 2019





at least until the country reaches an accord with the U.S. This may be to the benefit of countries to the south. In particular, China's loss has been Vietnam's gain. In recent times the country has opened its borders to foreign investors and is now a regional manufacturing hub. Its proximity to China and low-cost labor makes it an attractive destination, especially as salaries in Asia's largest economy reach closer parity with those in the U.S. and Europe. As the trade war has rolled on, Chinese businesses themselves have relocated manufacturing capacity to Vietnam to sidestep U.S. tariffs.

"Thailand, the Philippines and Vietnam are all beneficiaries of the current situation," said Siew Kam Boon, a partner in Dechert's Singapore office. "There is also a new level of interest in other frontier markets. Southeast Asia seems to be gaining a lot of attention."

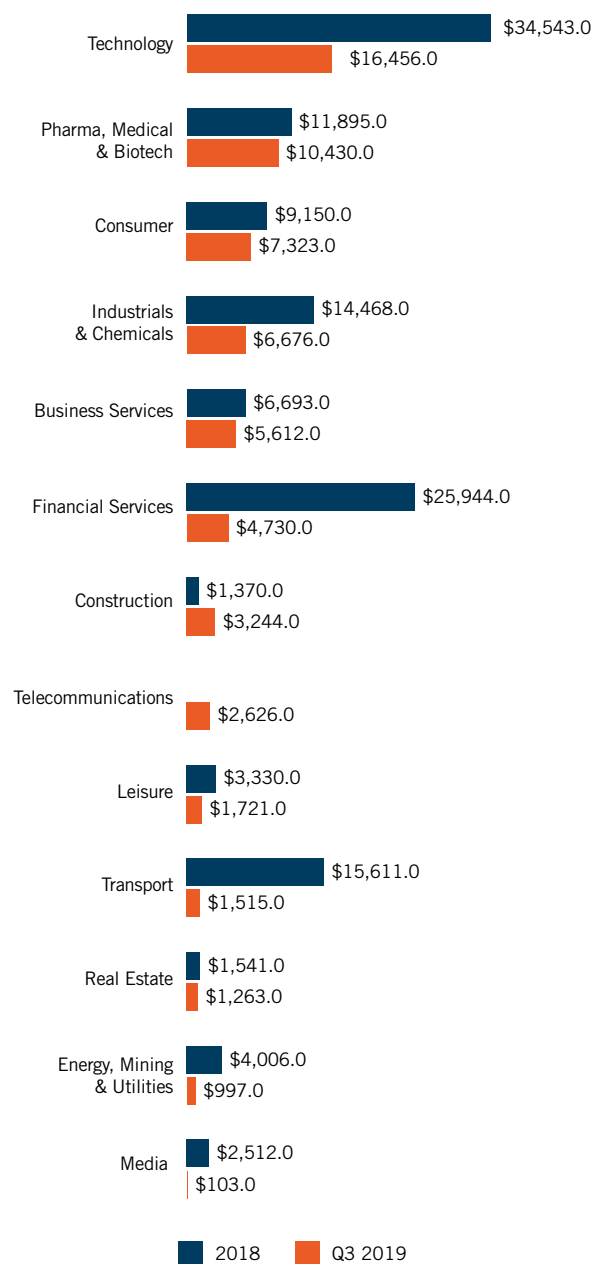
General Atlantic for one is looking to capitalize on this proxy war. The firm has said it is looking to invest more in Southeast Asia as a direct consequence of the trade dispute, and the firm's head of India and Southeast Asia, Sandeep Naik, said that he

anticipates opportunities to arise as companies remodel their supply chains. "We're looking at Vietnam as a very interesting destination at this point," he said in August 2019.<sup>1</sup>

Partners Group has also made inroads to emerging markets in Asia. The Swiss private equity giant established a Manila office in 2016 and acquired Philippines-based business outsourcing company SPi Global Holdings for US\$330m a year later.

But the fact remains, China is the world's second-largest economy and so will remain the regional leader in buyout activity. Taking a leaf out of Tencent Holdings' playbook, GPs in the country have identified an opportunity to form creative, diversified platform companies. This conglomerate approach is seeing funds combine assets in various domains. "Companies have been creating these super-agile platforms, broadening into areas where they might consolidate a finance company with a transportation company, for example, or a social media company," said Boon. "They're looking at the so-called 'super apps' such as Tencent's WeChat, where the more you're in people's lives, the more success you will have."

### PE BUYOUT VALUE BY SECTOR IN APAC (US\$M), 2018 - Q3 2019



<sup>1</sup> <https://www.cnbc.com/2019/08/29/vietnam-ripe-for-private-equity-investors-as-us-china-trade-war-drags.html>







# Deal targeting: No stone unturned

With dry powder at an all-time high, targeting deals has become one of the PE industry's greatest challenges. Further complicating matters is the current global economic and political environment, which is among the most complex dealmakers have faced over the last decade.

Macroeconomic and geopolitical developments have dominated the last year's news flow, with trade tensions between the U.S. and China, the world's largest and second-largest economies, being a particular focal point. The strain of this ongoing conflict is already dragging on the global economy.

The OECD estimates that GDP growth will slow to 3.2% in 2019, from 3.5% in 2018, with the think tank singling out trade tensions as the principal factor weighing on the world

economy. A slowdown in China is also a key factor – China's statistics bureau reported that the economy grew 6.2% on a pro-rated basis in Q2 2019, the slowest pace of growth since records began in 1992.

In September 2019, the Federal Reserve cut the interest rate for the second quarter in a row. The decision to cut was justified by trade-war risks and lower-than-targeted inflation.

When asked about the biggest challenges the PE industry currently faces, 32% cited region-specific factors such as macroeconomic and geopolitical issues. "Prevailing economic and political challenges hinder the private equity industry, because they result in an unstable and risky environment," said a managing director at an Australian private equity firm.

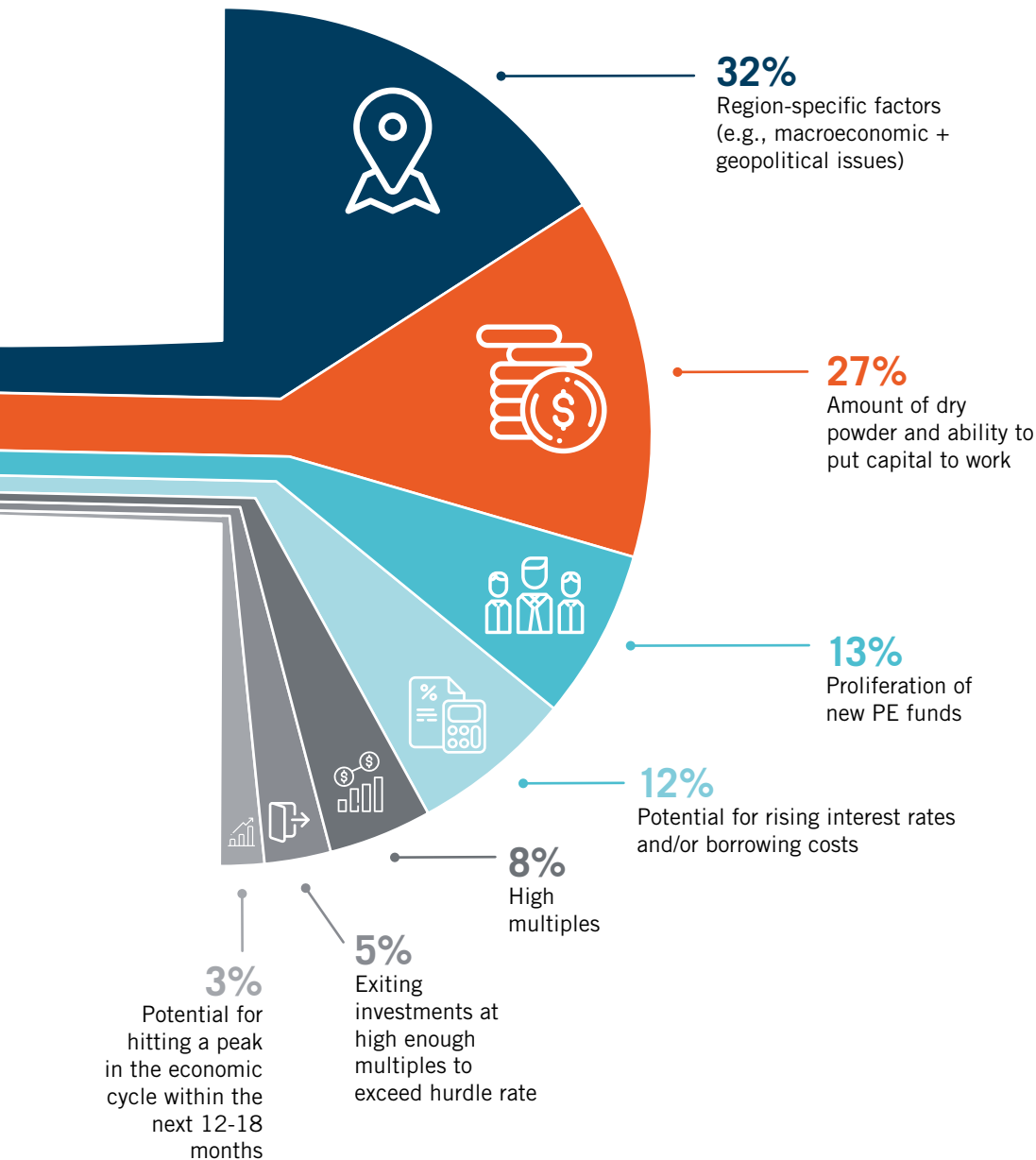
**“Prevailing economic and political challenges ... result in an unstable and risky environment.”**

**Managing director at an Australian PE firm**

“Even if opportunities are perceived to be available, only the more established companies are able to pursue and complete deals effectively.” Second to this, 27% of respondents said the amount of dry powder held by funds and their ability to put it to work was a top challenge. On a related note, 13% pointed to the proliferation of new PE funds, itself a contributing factor to the mountain of dry powder and, ultimately, heavy competition for assets.



**WHAT DO YOU SEE AS THE BIGGEST CHALLENGE CURRENTLY FACING THE PRIVATE EQUITY INDUSTRY?**



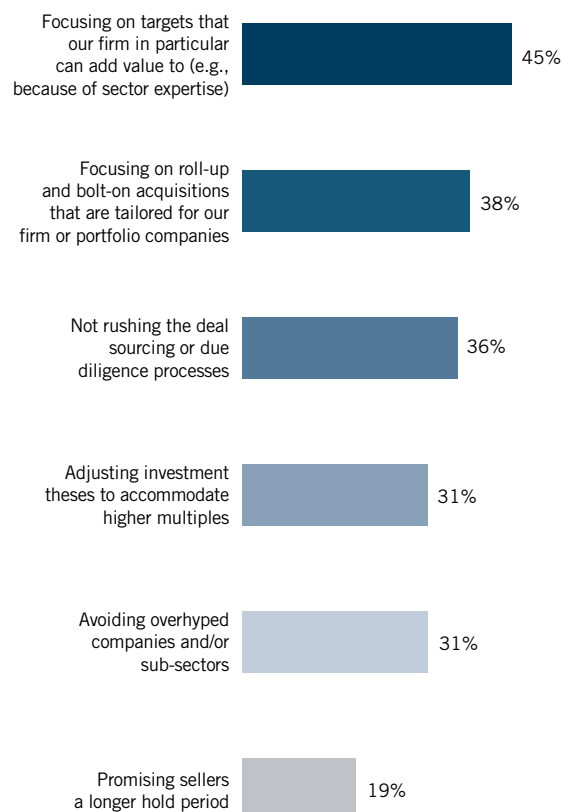
**P2P opportunities**

This elevated competition over the past three or four years has pushed pricing multiples ever higher, up to 11.5x at the start of 2019. Consequently, one of the key challenges that firms face in the deal sourcing process is finding assets with an acceptable price tag.

It is worth noting that while private market valuations have climbed to almost unprecedented heights, volatility in public markets is presenting opportunities. The first half of 2019 saw a surge in European public-to-private (P2P) transactions – takeovers of listed companies accounted for 21% of total deal value, compared with 16% over the same period last year. For example, in July, the UK’s largest pub chain Ei Group was taken private in a US\$3bn deal by Stonegate, backed by TDR Capital.

European take-privates have become attractive, especially for foreign PE funds, owing to a weak euro and pound. In a more PE-specific trend, valuation multiples in public markets have begun to trend lower than private market multiples, even with a take-private premium factored in. An analysis by Bain & Co shows that in 2005, there were just 58 U.S. public companies with an enterprise value between US\$2bn and US\$10bn that could be

## WHAT ARE THE MAIN STRATEGIES YOUR FIRM USES TO JUSTIFY PAYING ELEVATED MULTIPLES FOR TARGETS?



purchased for a multiple plus a take-private premium that was lower than the average private-market multiple, representing little more than 1% of the stock market. By 2018, that figure had surged to 183 such take-private prospects, nearly 4% of the U.S. stock market. A natural consequence of this divergence, combined with increased shareholder activism, will be more take-private activity.

### Dealing with high multiples

Aside from P2P transactions, when respondents were asked about their strategies for justifying today's elevated multiples, they cited two approaches that both involve taking advantage of specialization: Focusing on targets to which they can add value to, either because of sector expertise (45%); and focusing on roll-up and bolt-on acquisitions tailored to their firm or portfolio companies (38%). Bolt-ons are an effective way of giving

PE houses greater bidding headroom. Like corporates, which can justify paying higher prices owing to cost synergies, PEs can benefit from this same effect in bolt-on situations, as they can realize the same cost synergies between two portfolio companies that a strategic buyer can.

Further, more than one-third (36%) said they avoid overpaying by taking their time and not rushing the sourcing or due diligence process. Another 31% sidestepping high multiples by avoiding overhyped companies and sub-sectors.

“We can justify paying elevated multiples for targets if we see commensurate potential in those companies and their products and services,” said one GP. “Adjusting investment ideas to a certain extent helps in expanding businesses and realizing objectives. Target values are not ignored, but additional details such as performance and potential are acquired so that we can rightsize our bids.”

“Corporates are focusing on their core business and deleveraging — and often it’s a combination of both.”

Ross Allardice, Dechert

## High expectations for carve-outs

Carve-outs are on the menu for the majority of PE firms, and for good reason. Corporates are under increasing pressure from shareholder activists. Such investors have never been more influential and are pouring more capital than ever into their hands-on public market strategies. Roused by recent successes, names such as Elliott Management, Third Point, Starboard Value, Triun Partners and ValueAct have ensured that H1 2019 saw a continued trend of activism, with 107 new campaigns, after last year when more companies were targeted, capital deployed and board seats won than in any prior year, according to an analysis by investment bank Lazard.

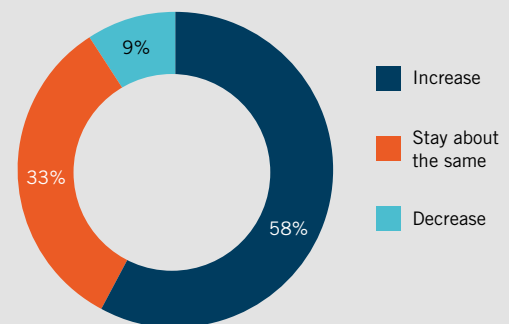
This trend is conducive to greater carve-out activity. Unimpressed by past returns, activists often push quoted firms to dispose of non-core assets in a bid to refine their corporate strategies and free up cash for share buy-backs and dividends. Private equity will be waiting with open arms. We found that well over half of respondents (58%) believe the number of carve-outs targeted by their firm

will increase over the next 12-18 months, and another third (33%) think it will stay the same; just 9% predict the number will decline.

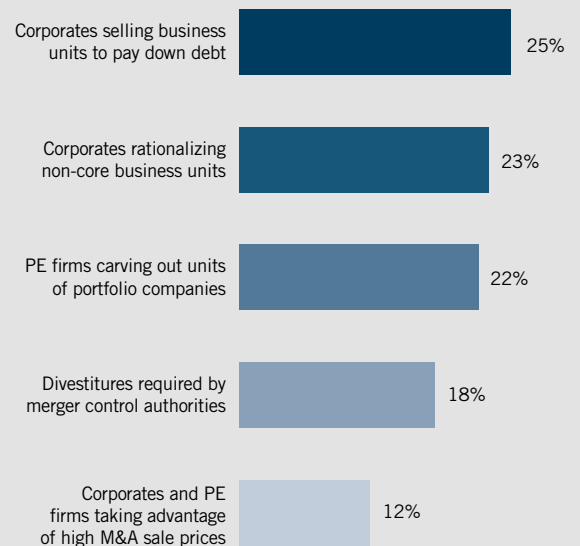
Another contributing factor is leverage. After 10 years of cheap financing, corporate debt has climbed to an all-time high. In a report released in early 2019, the OECD estimated that there was nearly US\$13trn of non-financial corporate debt globally. We found that the most important drivers of carve-out activity, according to our respondents, are corporates selling business units to pay down this debt (25%) and corporates rationalizing non-core business units (23%).

“Corporates are focusing on their core business and deleveraging — and often it’s a combination of both,” said Ross Allardice, a partner in Dechert’s London office. “Companies are concerned about the next recession and some of them have taken on significant debt for future acquisitions and expansion. They are looking at how to de-leverage what is non-core and taking advantage of high valuations for divestments.”

## OVER THE NEXT 12-18 MONTHS, WHAT DO YOU EXPECT TO HAPPEN TO THE NUMBER OF CARVE-OUTS TARGETED BY YOUR FIRM?



## IN YOUR OPINION, WHAT IS THE MOST IMPORTANT CURRENT DRIVER OF CARVE-OUT ACTIVITY?



### Growth equity makes gains

As already mentioned, GPs are having to think more creatively in order to put record sums of dry powder to work. As part of these efforts to broaden into new strategy types, many PE firms are expanding deeper into areas such as growth equity – the intersecting territory between venture capital and buyouts that was historically occupied by specialist funds. According to our survey, nearly half (48%) of GPs have increased their targeting of growth equity deals versus just 12% who said they have decreased, and 39% who said the level has stayed about the same.

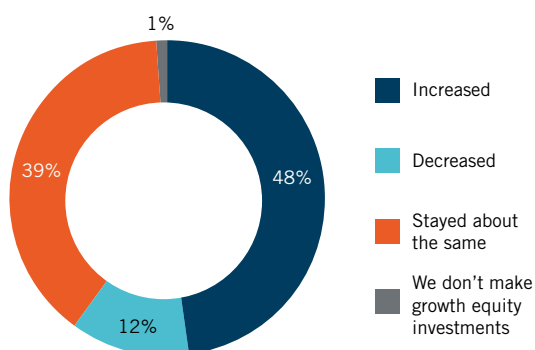
The primary motivator for pursuing growth equity deals was, as might be expected, expanding and differentiating the pool of deal targets, said 41% of the survey pool. This was followed by 37% who said the rationale was the potential for higher returns. “In comparison to traditional buyouts, growth equity investments help to modulate returns and risk patterns to an optimum level,” said a managing partner at a U.S. PE firm. “Since growth equity complements our other strategies, we are better able to guarantee returns through this diversification.” The target area also permits equity

investing in high growth early stage companies that are not yet interested in pursuing a control transaction.

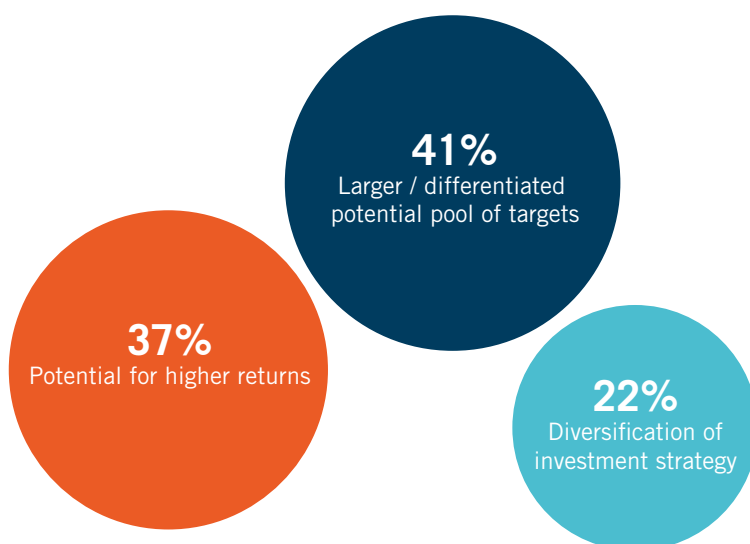
It is worth noting that in recent times there has been a concentration of venture capital at the later end of the funding spectrum, some of which is likely to spill over into the growth equity domain. As well, blue chip buyout houses have steadily moved into this area. This may serve to dampen any differentiating advantage that early movers may have benefitted from.

“Several PE firms now have a pool of capital set aside

### OVER THE LAST 12-24 MONTHS, HOW HAS YOUR FIRM'S TARGETING OF GROWTH EQUITY INVESTMENTS CHANGED, IF AT ALL?



### IN YOUR OPINION, WHAT IS THE MOST ATTRACTIVE ASPECT OF GROWTH EQUITY INVESTMENTS CURRENTLY AS COMPARED TO TRADITIONAL BUYOUTS?





### DOES YOUR FIRM MAKE MINORITY STAKE INVESTMENTS?



### DOES YOUR FIRM EVER RETAIN A MINORITY STAKE WHEN EXITING A PORTFOLIO COMPANY?



“Since growth equity complements our other strategies, we are better able to guarantee returns through this diversification.”

Managing partner at a U.S.-based PE firm

for growth equity deals,” said Allardice. “There is an opportunity where you need to back these businesses early in the life cycle.”

### Taking a smaller slice of the pie

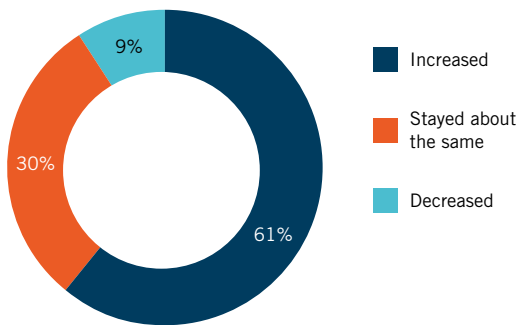
Further to this, minority stake investing in general is proving popular. Nearly three-quarters of our respondents (72%) said they make minority stake investments; 56% said they sometimes retain a minority stake when exiting a portfolio company; and

61% said their targeting or retaining of minority stakes had increased in the last 12-24 months. Respondents said the main drivers of minority stake purchases include the opportunity for diversification of risk (25%) and an attractive proposition to founders resisting a control investment (23%).

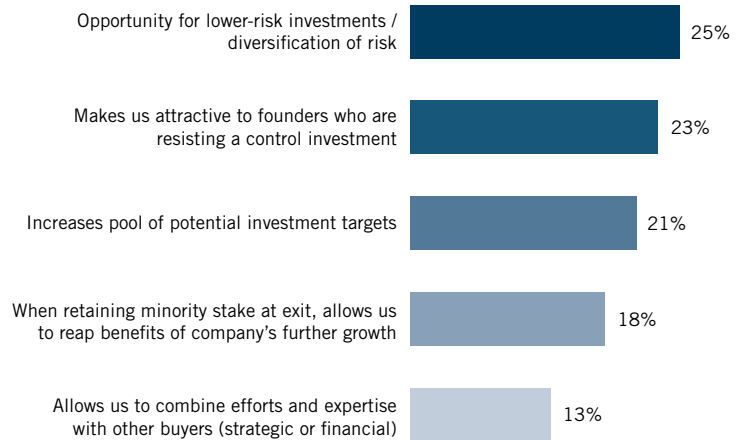
This risk-spread approach is especially relevant in today’s elevated multiple environment. “The contractual arrangement between parties and what the



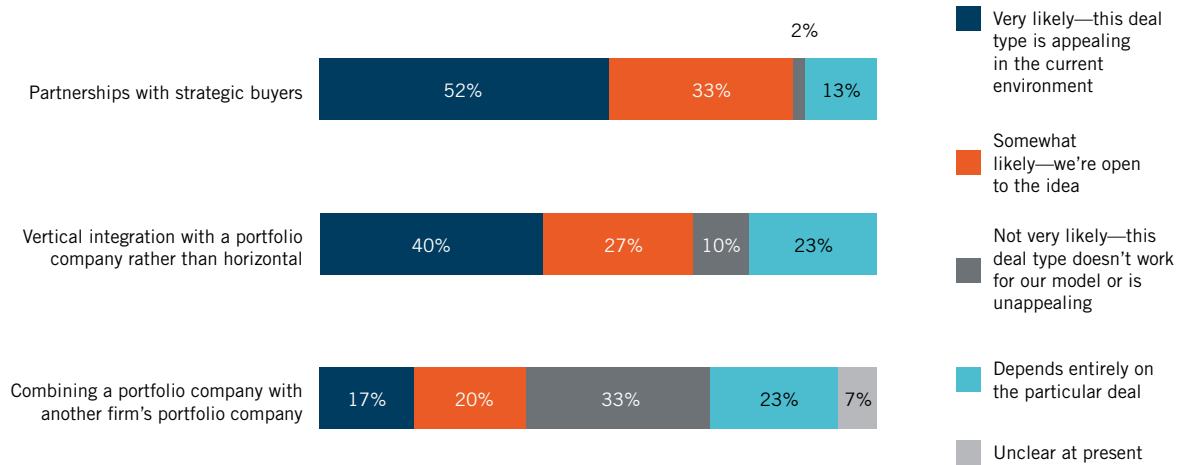
**OVER THE LAST 12-24 MONTHS, HOW HAS YOUR FIRM'S TARGETING OF MINORITY STAKE INVESTMENTS (OR THE RETAINING OF A MINORITY STAKE WHEN EXITING A PORTFOLIO COMPANY) CHANGED, IF AT ALL?**



**WHAT IS THE MOST IMPORTANT DRIVER OF MINORITY STAKE PURCHASES OR RETENTIONS BY YOUR FIRM?**



## HOW LIKELY IS YOUR FIRM TO CONSIDER THE FOLLOWING DEAL TYPES AT PRESENT?



exit will look like, who can buy, who can sell, who can push at what time — all of that obviously makes minority deals more complicated,” said Bolsinger. “At the same time, by diversifying in this way, funds do not have as much money tied up in any single deal, which is advantageous at this stage of the cycle.”

Another strategy that has its advantages is pursuing unorthodox deal types that might be off-limits or out of the comfort zone of other funds. One such unconventional transaction sees buyout shops partnering with strategic buyers, a tactic that has gained significantly in popularity. We found that

more than half (52%) of GPs said they were very likely to consider this deal type at present; this compares with just 25% who said the same last year. Once again, venturing into this less charted territory can be a means for navigating today’s high multiple environment, said Bolsinger.

“When a PE shop partners with a strategic who knows the market inside-out, that is a way of de-risking the deal and, as a result, that can help to justify some of the higher multiples that funds are having to pay.”

Forty percent of respondents also said they were very likely to consider vertical integration deals, whereby a portfolio

company is combined with another in the value chain. Combining a portfolio company with another firm’s portfolio company has apparently become less appealing, with only 17% saying they were very likely to consider such a deal compared with 42% who said so last year.

# Spotlight on North America

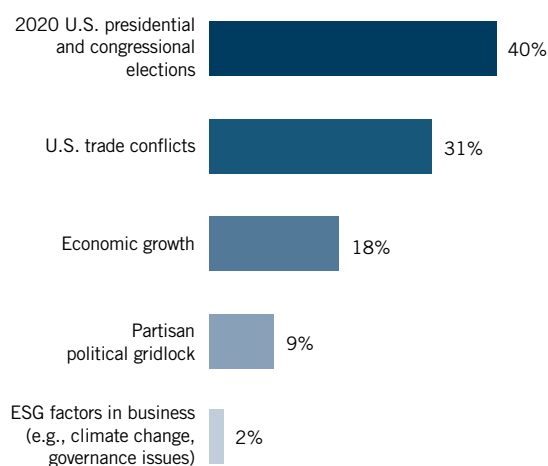
The private equity market in North America has been on a hot streak in recent years and 2019 has mostly seen a continuation of that trend. A total of US\$187.8bn was invested in 1,048 buyouts in the first three quarters of 2019, setting a pace for the highest value since 2007. Gargantuan deals such as the US\$13.4 billion buyout of logistics company GLP Pte. by Blackstone Group in May 2019 and the US\$20bn purchase of 55% of the equity in a new corporation created to hold the financial and risk business of Thomson Reuters, renamed Refinitiv, in 2018 have helped to push total buyout value to new heights. (In August 2019, the owners

of Refinitiv agreed to sell a 37% stake in the business to the London Stock Exchange in a deal valued at US\$27bn.)

Another massive deal from last year, the US\$21bn acquisition of Dr Pepper Snapple by BDT Capital Partners and JAB Holding, knocked KKR's US\$19.6bn takeover of Alliance Boots in 2007 out of the top ten largest buyouts in history, without adjusting for inflation. Peak dry powder is ensuring that the very largest megadeals are firmly on private equity's radar.

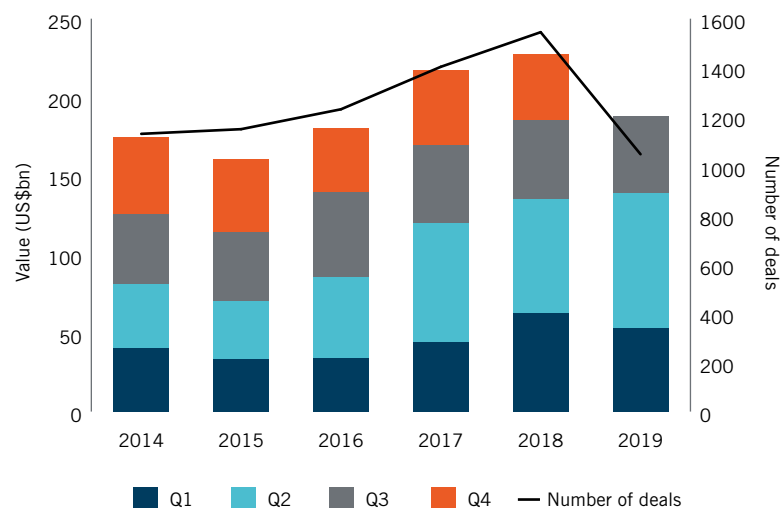
Technology was the most dominant sector in Q1 – Q3 2019, claiming US\$37.8bn worth of deals, followed

## IN YOUR ESTIMATION, WHICH CURRENT OR UPCOMING DEVELOPMENT IN NORTH AMERICA WILL HAVE THE BIGGEST EFFECT ON THE DEAL ENVIRONMENT OVER THE COMING 12–18 MONTHS?



(NORTH AMERICA RESPONDENTS ONLY)

## NUMBER AND VALUE (IN US\$BN) OF PE BUYOUT DEALS IN NORTH AMERICA, 2014 – Q3 2019



“Combining healthcare with tech has seen a lot of activity there, in the medtech vertical”

Dr. Markus Bolsinger,  
Dechert



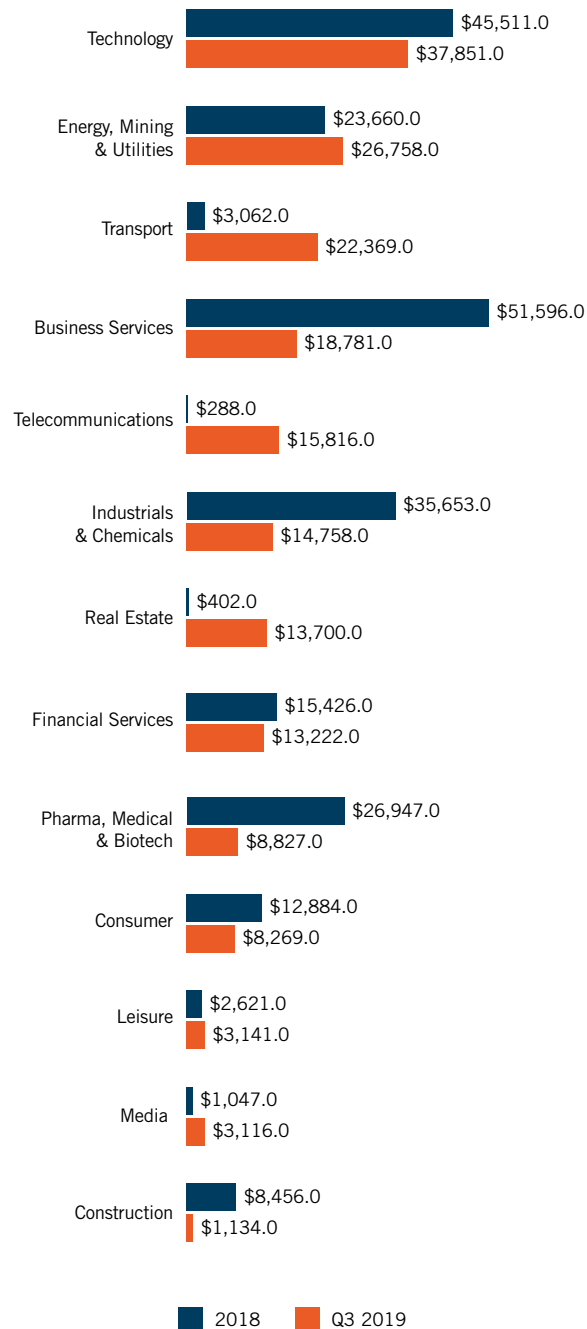
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closely by energy, mining & utilities at US\$26.8bn in buyout value. While the IPOs of Uber and Lyft did not live up to their hype – a result seen by some as confirmation of the widely debated tech bubble finally deflating – PE is likely to remain keen on the tech sector. This is especially true given that technology continues to permeate just about every other industry in some way.

“Combining healthcare with tech has seen a lot of activity there, in the medtech vertical,” said Bolsinger. “We expect to see a lot of PE houses wanting to get involved in that. With medtech, PE firms are beginning to move into the start-up territory.”

With deal activity running so high in North America, the question surrounding PE’s biggest, most dynamic market is: How long can activity continue to build, and what is likely to derail it? For 40% of our respondents, the 2020 presidential and congressional elections is the development most likely to impact dealmaking, while 31% point to U.S. trade conflicts, the ongoing rift with China being the most obvious example. The next few months will reveal whether 2018 will be reflected on as a market peak.

### PE BUYOUT VALUE IN NORTH AMERICA BY SECTOR, 2018 – Q3 2019



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# Private debt: Credit where it's due

Private debt has become fully embedded in the PE financing ecosystem. Investors have taken to debt funds like never before in the last four years, in part a function of the low-yield environment prompting them to seek credit at the riskier, higher-returning end of the spectrum. Preqin data show that a total of 61 funds raised just under US\$50bn in H1 2019, representing year-over-year declines both in terms of value and volume. However, last year saw 163 funds secure US\$110bn, making 2018 the fourth consecutive year that investors committed more than US\$100bn.

More than two-thirds (69%) of our GP pool reported that their use of private debt has stayed the same over the past three years, 30% saying it has increased and just 1% reporting that it has decreased.

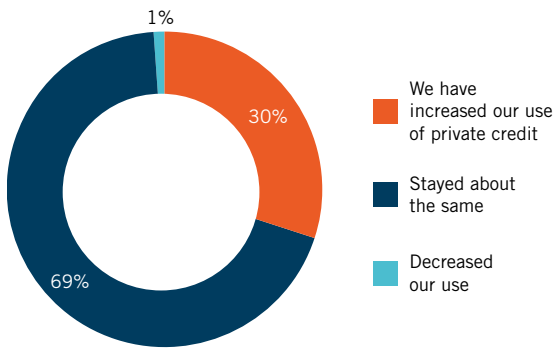
While on first glance this may appear as if the market has stagnated somewhat, that is far from the case. Instead, these 69% of GPs had likely already ramped up their use of such debt more than three years ago.

This is evidenced by the small minority of respondents who remain pure bank financing users; only 11% say that they prefer traditional lending, leaving 89% who either use private credit more than bank financing (40%) or use roughly equal amounts of both (49%). In other words, the private debt market has already fully established itself.

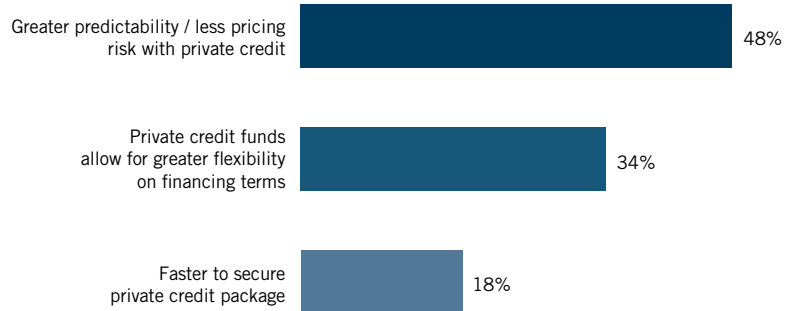
All private debt is not created equal, however. For instance, Preqin found that in addition to declines in distressed debt fundraising (a product that is not used by GPs to finance buyouts),

Direct lending is here to stay, not least because it offers dealmakers specific advantages over bank financing. GPs can typically push harder on covenants and secure higher leverage ratios.

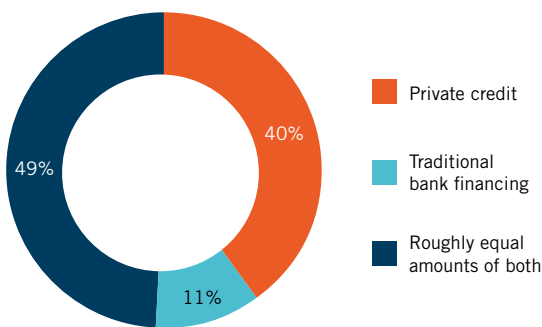
**OVER THE LAST THREE YEARS, HOW HAS YOUR FIRM'S USE OF PRIVATE CREDIT FINANCING IN BUYOUTS CHANGED, IF AT ALL?**



**IN YOUR OPINION, WHAT IS THE GREATEST ADVANTAGE OF USING PRIVATE CREDIT AS COMPARED TO TRADITIONAL BANK FINANCING CURRENTLY?**



**DOES YOUR FIRM USE PRIVATE CREDIT OR TRADITIONAL BANK FINANCING MORE OFTEN IN ITS BUYOUT DEALS?**



direct lending fundraising dropped significantly in 2018, from US\$68bn in 2017 to US\$45bn. It is not clear what is behind this fall. It could be a symptom of the swathes of fundraisings in the prior three years absorbing LPs' capital capacity.

Looking at the current situation, 2019 already has all the makings of a record year for direct lending. According to figures from research service Creditflux, a total of US\$18.6bn was raised across 14 funds in the second quarter, pushing half-year figures to US\$40.5 billion over 23 final fund closes. This year a number of sizable vehicles have capitalized on high investor demand and the European market continues to cement its position, with BlueBay Asset Management and Alcentra raising €6bn and

€5.5bn respectively in the first half.

Direct lending is here to stay, not least because it offers dealmakers specific advantages over bank financing. For one, such funds are not susceptible to the vagaries of the loan syndication market as, unlike banks, they tend to hold loans rather than sell them down. GPs can also typically push harder on covenants and secure higher leverage ratios than they can from financial institutions, which are regulated and therefore have a higher risk aversion. For the GP cohort surveyed, the primary benefits that make private debt the favored option are its greater predictability and lower pricing risk, cited by 48%, and the improved flexibility in financing terms, the main attraction of such loans for 34% of PE fund managers.

# Spotlight on EMEA

The EMEA region held up well in the first three quarters of 2019. A total of US\$140.7bn was invested across 1,085 buyouts in the first nine months of the year, according to Mergermarket data. Pro-rated, this would put full-year 2019 activity at US\$187.6bn over 1,446 deals, an 8% annual drop in value terms and a 10% fall on a volume basis.

There are a number of reasons to believe that deal activity will persist into 2020, a major macroeconomic downswing from Brexit notwithstanding. CVC Capital Partners is expected to return to market with an €18bn fund early next year, its largest to date. EQT is believed to be eyeing a new fund for 2020 worth €14bn, and BC Partners is planning a return to market. Cinven, meanwhile, has

already successfully closed on €10bn earlier this year, capitalizing on the healthy fundraising environment before sentiment changes.

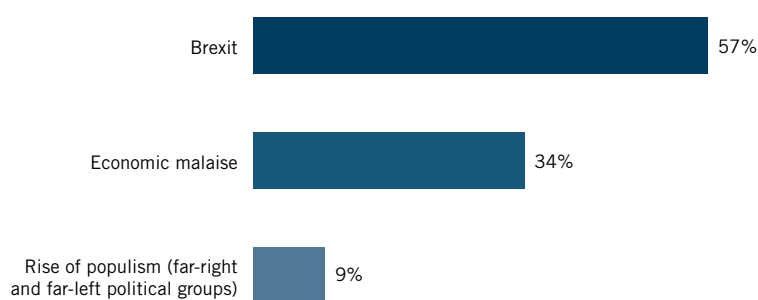
Recent deal activity has been remarkably robust across the region considering the prospect of Brexit and what the UK's departure from the EU means for the future unity of Europe. Nevertheless, Brexit remains the biggest potential barrier to investment for PE firms in EMEA over the coming 12 – 18 months, as cited by 57% of respondents investing in the region. This was followed by 34% who said the territory's economic malaise would hamper activity.

And despite deal activity remaining strong, a closer look indicates that the prospect of Brexit – the March 29

deadline for which came and went, postponed until October 31 – appears to be having an effect. In H1 2019, UK buyout value actually increased 62% year-over-year to US\$24.7bn, though volume declined to 112 deals from 140 in the year-earlier period. After UK deals made up nearly 25% of 2017 deal value in Europe, they represented just 18% in 2018.

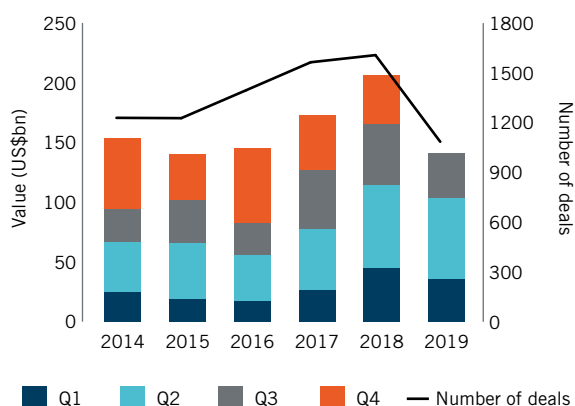
It is not just Brexit that appears to be influencing GP behavior. With sub-2% growth in Europe's largest economies and the specter of a global recession beginning to loom, PE houses have turned their attention to industrials and healthcare-related sectors. Industrials & Chemicals was the top performing sector across the first nine months of the year, accounting for US\$25.8bn in deals in Q1-Q3 2019.

## IN YOUR ESTIMATION, WHICH CURRENT OR UPCOMING DEVELOPMENT IN EMEA WILL HAVE THE BIGGEST EFFECT ON THE DEAL ENVIRONMENT OVER THE COMING 12 – 18 MONTHS?



(FOR EMEA RESPONDENTS ONLY)

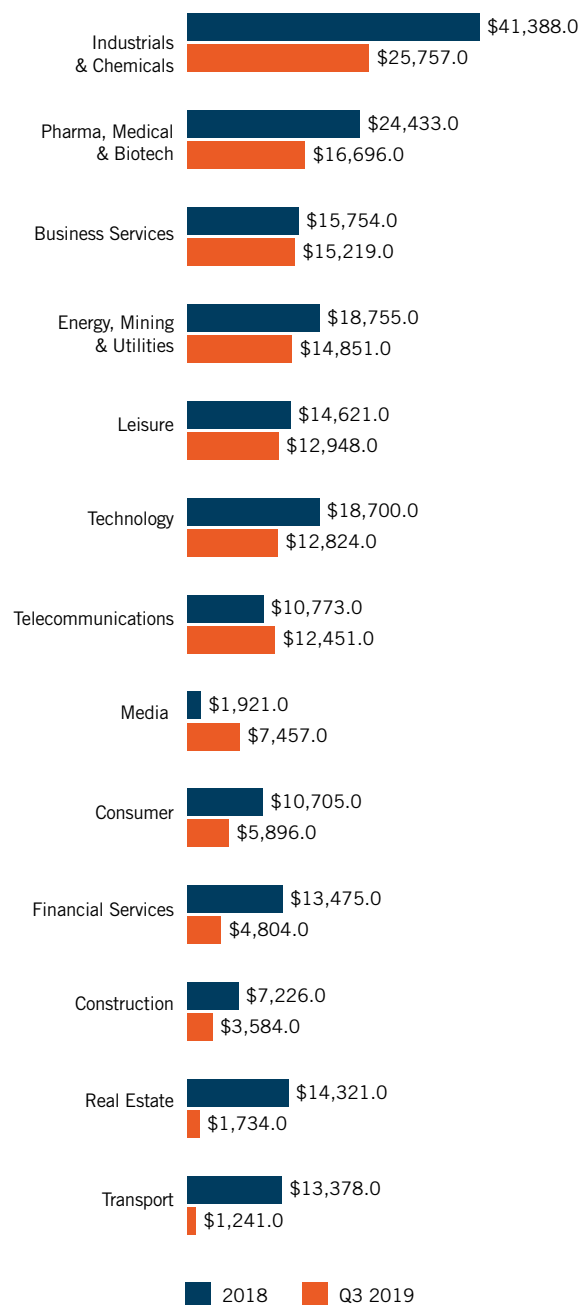
## NUMBER AND VALUE (IN US\$BN) OF PE BUYOUT DEALS IN EMEA, 2014 – Q3 2019





The picture in the Middle East, meanwhile, is far from positive — and for industry-specific reasons. Following an 18-month investigation, in July 2019 the Dubai Financial Services Authority imposed a US\$315m fine on the Abraaj Group, a record penalty in the emirate. The fine, leveled as the result of the DFSA's determination that the firm misused its LP's funds, and Abraaj's demise are significant because the firm was one of the largest emerging markets PE houses not just in the Middle East but the world. This has served to undermine investors' confidence in the region, and it may be some time before fundraising activity and dealmaking levels recover. However, the story is not entirely doom and gloom, and as well as continued deployment of capital across the region from leading private equity firms such as Gulf Capital and Amanat, there continues to be certain confidence and interest in the Middle East from international private equity players, as illustrated by KKR and Blackrock's US\$4bn investment in ADNOC's oil pipelines and CVC's acquisition of a 30% stake in GEMS Education.

### PE BUYOUT VALUE IN EMEA BY SECTOR, 2018 – Q3 2019





# Exits: Less haste, more speed

As mentioned earlier, GPs are paying close attention to macroeconomic fundamentals as they seek new deals — and the same is true for exits. Fund managers are cognizant that these warning signs are emerging after 11 straight years of economic expansion. We are now in the longest bull run in history, depending on whose definition you adhere to. Naturally this is feeding into the urgency with which GPs pursue exits.

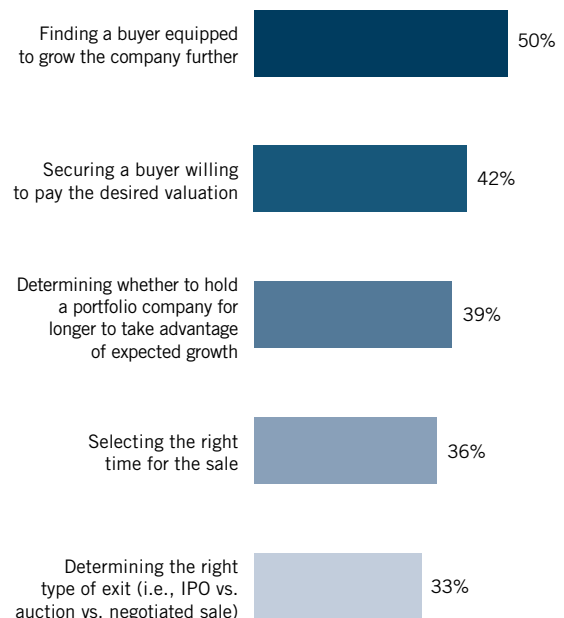
In correlation with this, median holding periods are trending downward, falling 10% in 2018 to 4.5 years. This means that the proportion of assets exited after five years or more is now at its lowest point since 2010. Aside from the fact the persistent sellers' market makes light work of offloading assets, there are macro-

related motivations for this hold-period downtrend.

GPs are asking themselves what the world will look like a year from now when maturing assets require selling. Increasing recessionary signals are prompting GPs to sell today rather than hold and have to see out a downturn, exiting on the other side, or sell at the bottom.

Another motivating factor is that any downturn will not be conducive to fundraising. As public markets fall, private equity allocations in investors' portfolios will increase overnight — the so-called denominator effect — which will put the brakes on fund launches. GPs are therefore mindful that they need to sell sooner rather than later in order to get their next fundraisings in line.

## WHAT ARE THE BIGGEST CHALLENGES YOU EXPECT TO FACE WHEN IT COMES TO EXITING INVESTMENTS OVER THE COMING 12 MONTHS?



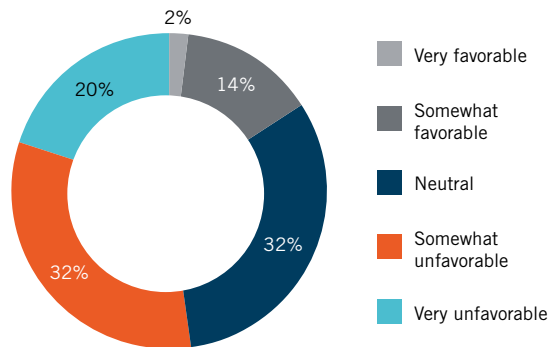
“Everyone is selling everything that’s not nailed down,” said Bolsinger. “Notwithstanding the introduction of the capital gains tax change in the U.S., anything that’s right for sale is definitely being looked at and prepared for exit.”

In our survey, only 16% of respondents said they thought market conditions for PE exits would be favorable over the coming 12 months, while 32% said they thought conditions would be neutral and a majority (52%) believe they will be unfavorable. The biggest challenges GPs expect to face include finding a buyer equipped to grow a portfolio company further (50%) and securing a buyer willing to pay the desired valuation (42%). Perhaps more telling, 39% of respondents think determining whether to hold a portfolio company for longer to take advantage of expected growth will be the biggest exit challenge of the next year, while 36% pointed to the difficulty of selecting the right time for a sale.

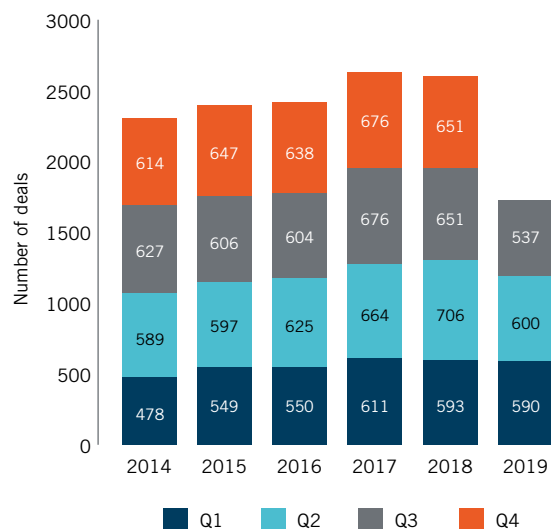
We can see, then, that a significant proportion of PE houses are concerned about timing exits as we approach the top of the economic cycle. This is likely to have an impact on GP behavior in the coming months, said Bolsinger. “What will be coming, not this year but next year, is a lot of trades

GPs are asking themselves what the world will look like a year from now when maturing assets require selling. Increasing recessionary signals are prompting GPs to sell today rather than hold and have to see out a downturn.

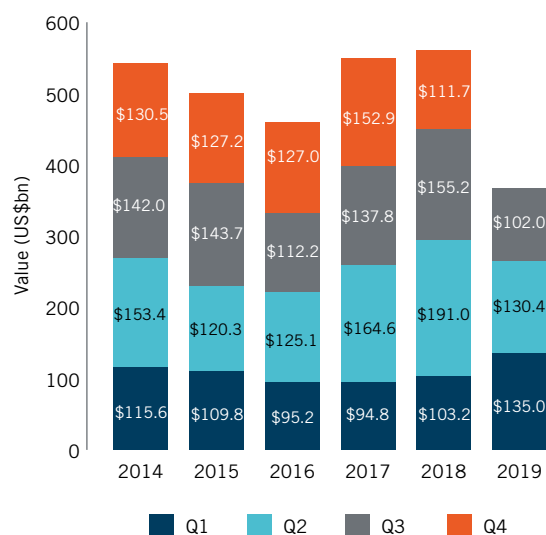
**HOW DO YOU THINK THE MARKET CONDITIONS WILL BE FOR PRIVATE EQUITY EXITS OVER THE COMING 12 MONTHS?**



**NUMBER OF GLOBAL PE EXITS, 2014 – Q3 2019**



**VALUE OF GLOBAL PE EXITS, 2014 – Q3 2019**



from the predecessor fund to the current fund. A GP likes the company, it understands the business and the risks associated with it, and with the appropriate approvals, ensuring that the transaction will occur at market price, will flip the company to the next fund.”

One of the most notable examples of this secondary market rollover activity involved Nordic Capital successfully establishing a €2.5bn continuation vehicle, Nordic Capital CV1, that fully acquired the assets of its 2008 vintage Nordic Capital Fund VII. LPs were given the option of selling to incoming investors Coller Capital and Goldman

Sachs Asset Management, or participating in the new fund as the GP seeks to create more value from its nine portfolio companies, in essence extending the life of the fund rather than liquidating it and starting afresh.

“We expect more of this kind of activity, but more generally GPs are preparing for what might be next to come,” said Allardice. “As a PE fund manager, today you need to be thinking very carefully about what you can sell, how and to whom.”

“What will be coming, not this year but next year, is a lot of trades from the predecessor fund to the current fund.”

Dr. Markus Bolsinger, Dechert







# Conclusion: Times they are a-changing

Private equity has never had more capital at its disposal, and it will take years for dry powder reserves to be processed. This may be the industry's new normal. Deal activity, meanwhile, has never been higher, at least in the core North American market. But there is no guarantee that dealmaking activity will sustain such levels in the short to medium term. In spite of having the wherewithal to transact, all GPs are focused

on the geopolitical climate, and time is ticking on this historical period of business expansion. Fund managers have no choice but to continue being creative making deals and seeking profitable exits, regardless of forces in the outside world.

**Recessionary signals are mounting. What does the maturity of the economic cycle mean for your portfolio and your firm?**

## **Timing is everything**

Hold periods are trending down and more than half of GPs are pessimistic about the short-term exit environment. Calling market peaks is all but impossible, but fund managers should be mindful of the maturity of their individual portfolio companies, these companies' growth prospects and cyclical nature, the timing of forthcoming exits and their imminent fundraising schedules. Recessionary signals are mounting and the state of the economy will impact upon private market activity. What does the maturity of the economic cycle mean for your portfolio and your firm?



### Preparing for spin-offs

A confluence of record levels of debt on corporate balance sheets and heightened shareholder activism indicate that spin-off opportunities will be abundant in the short to medium term. Our survey findings also show that GPs anticipate such an uptick. Firms with a demonstrable track record of carving out assets from corporate sellers should communicate this to the adviser community now in order to be front of mind and first in line when such deal opportunities arise.



### Think big, search wide

Demand for the asset class is such that private equity is having to evolve and expand to get this capital invested. Whether long-hold funds or moving into private debt, growth capital or minority investing more generally, it is worth bearing in mind that your competitors are traversing into adjacent investment territory. This is compounded by the fact that capital is increasingly concentrated around fewer managers, who are expanding their menu of fund offerings. In order to keep pace, it is imperative that firms with the requisite resources expand their horizons and think creatively about their strategies and how to go beyond the standard buyout template.



### Market volatility and the take-private opportunity

Shareholder activism is also conducive to P2P activity. As private market valuations continue to tick upwards, public markets are becoming comparatively attractive, even when accounting for take-private premiums. This will become even more evident in the event of a major stock market correction. Given sustained competition in the traditional private buyout market, GPs should consider looking to the public sphere for unilateral, off-market deal opportunities.



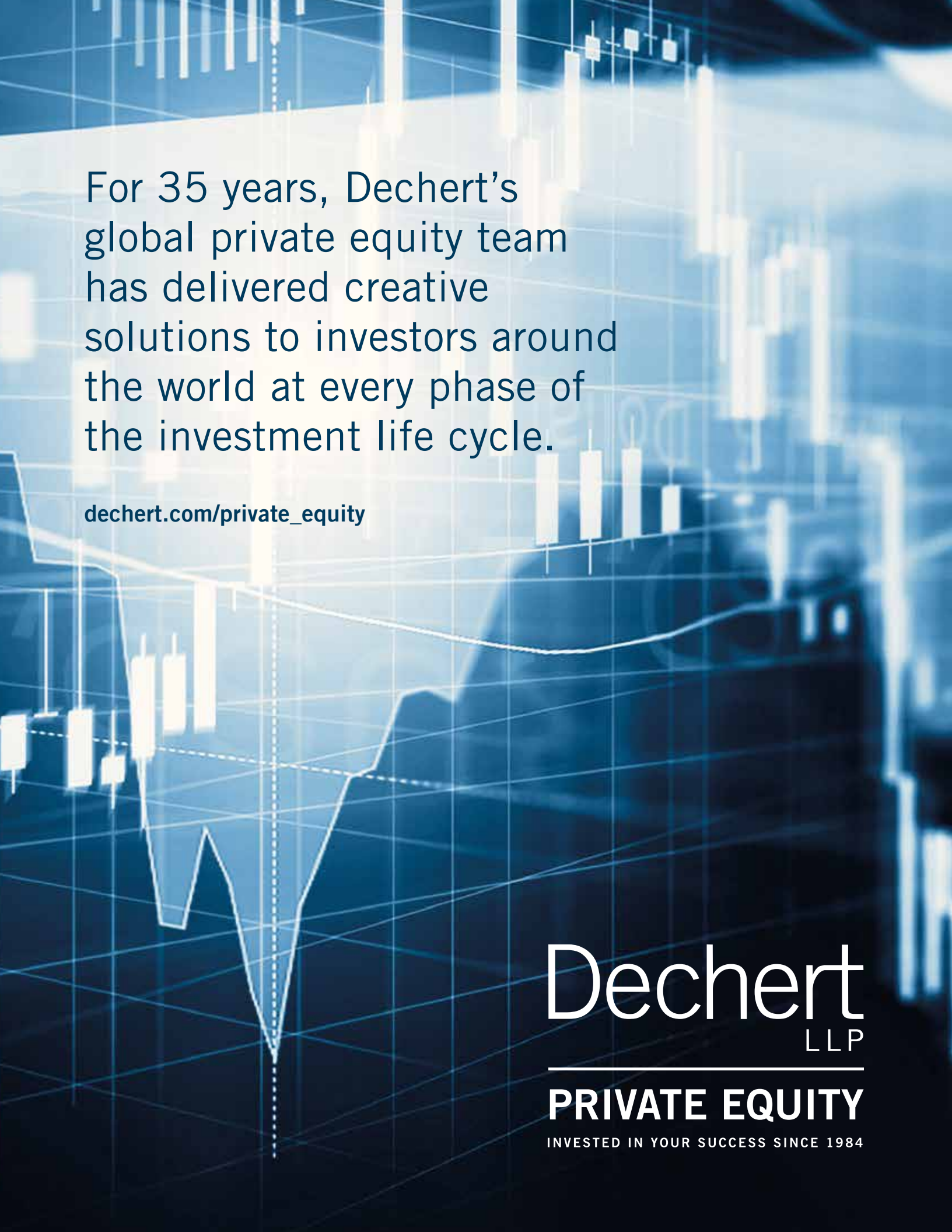
### APAC: Southeast meets West

APAC PE deal activity weakened in the first half of 2019, owing to a pullback in China. The trade war with the U.S. is hampering Asia's largest economy, which is proving to be a boon for Southeast Asian countries. In the last year Vietnam has been a prime beneficiary of Chinese manufacturers seeking to circumvent trade tariffs by relocating operations, while other countries in the region are expected to benefit. What were once frontier markets in Southeast Asia are beginning to be seen as true emerging markets, like the BRICS a decade ago. GPs with global remits should consider investing in these markets now if they are prepared to face the risks associated with the potential outsized rewards.



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The background of the entire page is a complex, semi-transparent overlay of financial data. It includes a candlestick chart at the top, a line graph with a shaded area below it in the middle, and another candlestick chart at the bottom left. A grid of thin white lines is superimposed over the entire scene, creating a technical, analytical feel. The overall color palette is a range of blues, from light sky blue to deep navy blue.

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For more information, please contact:  
**Alissa Rozen**  
Head of Sales, Acuris Studios  
Tel: +1 212 500 1394





[www.mergermarket.com](http://www.mergermarket.com)

1501 Broadway, FL 8  
New York, NY 10036

t: +1 212.686.5606  
f: +1 212.686.2664

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