2019 Global Private Equity Outlook

Dechert LLP

Mergermarket
An Acuris company

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Methodology

In the second quarter of 2018, Mergermarket, on behalf of Dechert LLP, surveyed 100 senior-level executives within private equity firms based in North America (50%), EMEA (40%), and Asia-Pacific (10%). 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: Succeeding in a crowded market

The global private equity market continues its ascent. Buoyant global buyout activity is being sustained by a combination of historically low interest rates, an extended economic growth run, supportive credit markets supplying cheap deal financing, and bountiful fundraising that is keeping global dry powder stocked up to record levels.

A total of US$528 billion was invested across 3,468 buyouts in 2017, according to Mergermarket data, the highest aggregate value since the global financial crisis a decade ago and the greatest volume of deals in the industry's 40-year history. In what continues to be a clear sellers' market, 1,083 exits valued at US$258.3 billion were recorded last year, an annual uplift of 10% and 8.5% respectively.

There is similar cause for optimism on the fundraising front. Overall, 1,420 funds amassed US$754 billion in investor commitments, Preqin data show, besting the previous record set in 2016 when US$728 billion was raised, albeit across 1,860 funds.

Investors continue to be drawn to the private equity asset class. Central bank policy remains broadly dovish, with interest rates significantly below historical averages. This low-yield environment impacts private equity in two ways. First, it gives investors greater impetus to put capital into private equity funds, which on average have historically delivered higher returns than public markets. Second, it ensures that deal debt financing is cheap and plentiful. The industry has scarcely had it so good.

However, this abundance is not without its drawbacks. In a sense, private equity is bowing under the weight of its own success. An excess of dry powder, which has now surpassed US$1.1 trillion for the first time, means that there has never been greater competition for deals. Further, public equities, a proxy for private market valuations, have largely continued their upward march after shaking off a brief period of volatility at the beginning of 2018.

A total of US$528 billion was invested in buyouts in 2017, the highest aggregate value since the financial crisis.

Key findings

Today's crowded, rising market means that buyout multiples remain stubbornly high, making the deployment of capital at fund managers' disposal a persistent challenge. This is forcing them to think creatively. Never before has it been more necessary to scale up or hone differentiated strategies in order to gain a competitive edge. This includes consolidating with competitors, pursuing uncommon deal structures, and expanding into adjacent markets and new geographies. Firms are also diversifying asset types, adopting new technologies at both the firm and portfolio company levels, and pursuing novel ways of achieving growth to secure future returns for investors.

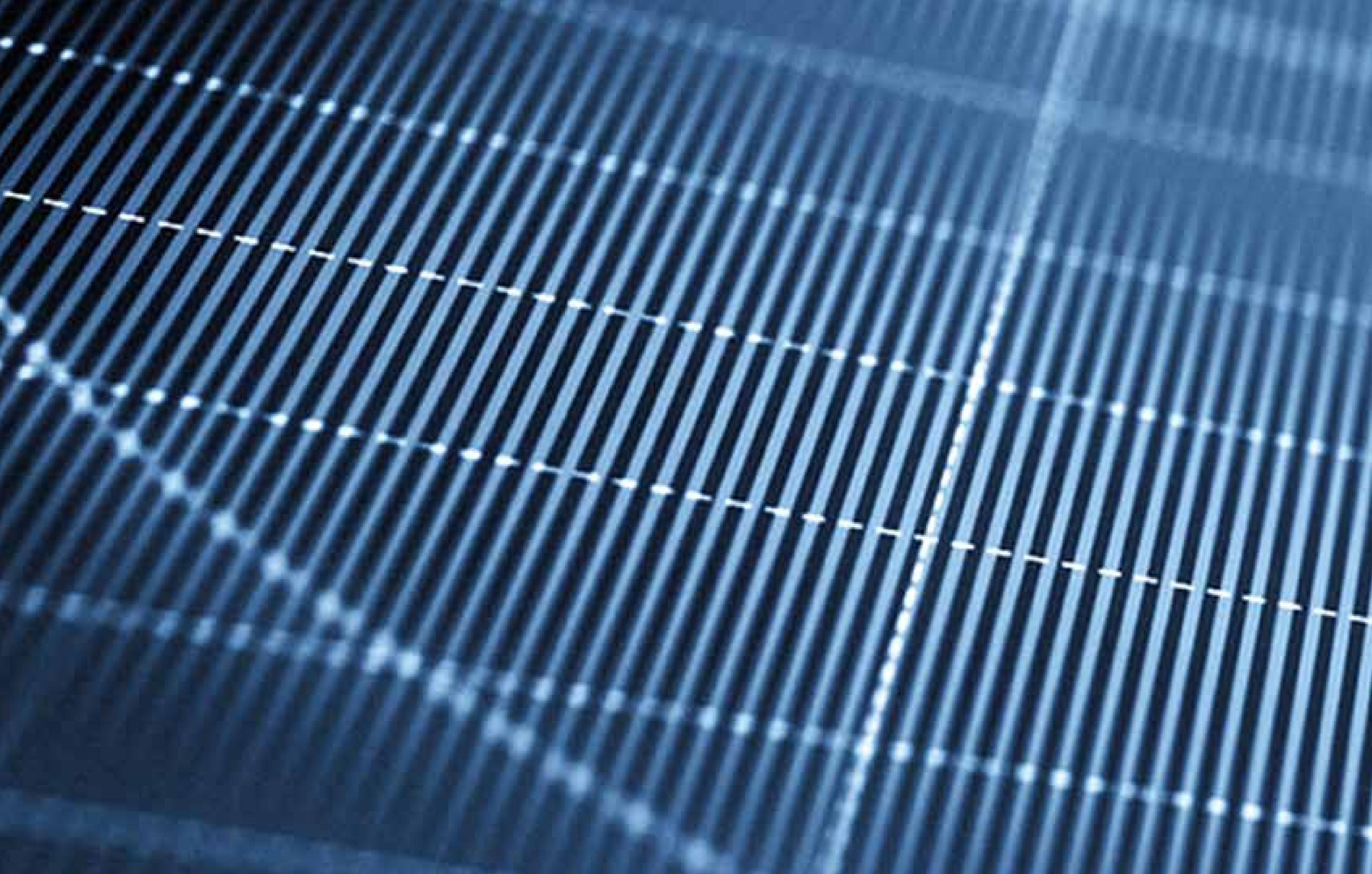
In the following survey, this is precisely what we see: an industry anticipating change and one that is willing and prepared to adapt in order to succeed in today's frenzied pricing environment. Without rising to this challenge, firms are at risk of falling short of their return targets. There has perhaps never been more pressure on the industry to deliver on its promise of public market outperformance.

Finding a niche

Our survey indicates that specialization in PE has become the norm: 88% of respondents said having a niche had become important to their firm, with 53% saying it was very important. The top reason they cited for its significance was the advantage it gave them in winning deals – 48% said it gave them a leg up in convincing companies to sell to them in their areas of specialization.

Getting creative

Creative deal structures are also rising to prominence as a means of coping with competition for deals and the need to pay higher multiples. In particular, respondents are very likely to consider making acquisitions based on industry or market differentials (57%); create vertically integrated portfolio companies instead of horizontal combinations (56%); and build a portfolio company from scratch with a hand-picked management team (51%).



Beyond borders

An overwhelming majority of respondents (93%) said geographic diversification or expansion had become more important to them over the last three years, with 65% saying it had become significantly more so. The main driver of this change has been the desire to gain exposure to faster-growing regions (62%), while the biggest challenge in expanding geographically has been navigating foreign regulatory and tax environments (46%).

Exit environment

Expectations for the exit environment over the coming year are a roughly equal mix of the positive and the negative: 50% think conditions will be favorable, while 43% think they will be neutral or unfavorable. This split in sentiment seems to reflect concern on the part of GPs with their ability to secure desired valuations (55%).

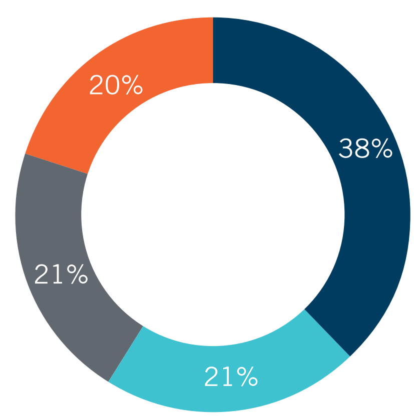
Fund trends: Adapting in a competitive environment

Return expectations: Trending up
In the years following the great financial crisis, private equity's ability to refinance and profitably sell assets acquired at the height of the credit boom was in doubt. However, the market's steep upward trajectory in recent years has been a huge boon for refinancings, exits and returns. When asked how return expectations on deals made 5-7 years ago had changed, well over half of respondents (59%) said expectations now exceeded the initial forecasts they had made.

Whether private equity is capable of repeating this success going forward is open to debate. The surfeit of capital looking to be put to work means that buyers are having to pay exceedingly full prices. Perhaps surprisingly, however, we found that GPs are broadly optimistic about return prospects going forward. Nearly half (48%) anticipate returns on capital invested this year to be higher than on capital invested 5-7 years ago, with only 15% expecting returns to fall.

Whether this confidence is misplaced or not, of course, remains to be seen. One explanation is that, having weathered the worst recession in living memory, and taking lessons from that experience, GPs will be able to withstand any market disruption that may lie ahead, provided they are patient. As one executive of a Germany-based private equity firm says: "Long-term investments are set to provide higher returns as the imbalance in returns only remains temporary, for three

ARE INVESTMENTS YOUR FUND MADE 5-7 YEARS AGO NOW EXPECTED TO ACHIEVE HIGHER RETURNS THAN YOU HAD ORIGINALLY FORECAST AT THE TIME OF INVESTMENT? (SELECT ONE)



- Yes, definitely—our returns on those investments are expected to be higher than we had forecast when we made them
- Yes, most likely they will be higher
- No, not really
- Remains unclear—we are still exiting investments made 5-7 years ago

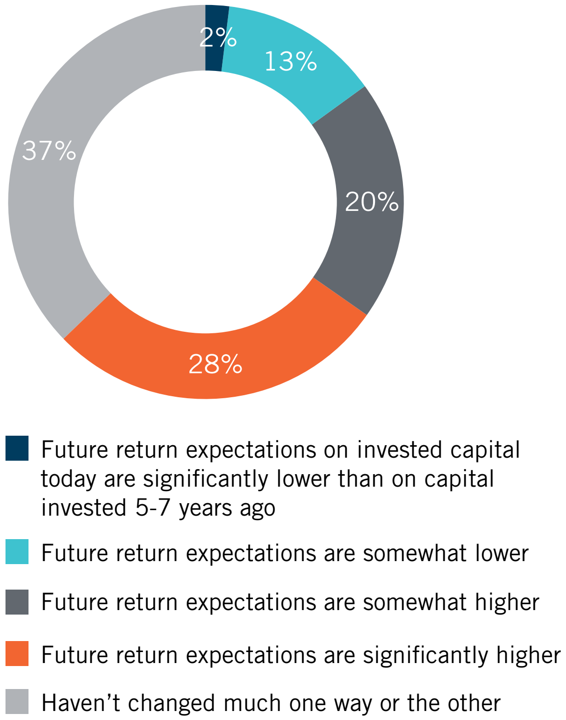
years or so, and improve after that period. By the end of 2025 we are expecting the market to provide valuable returns on all investments."

Consolidation among fund managers: Advantages of scale

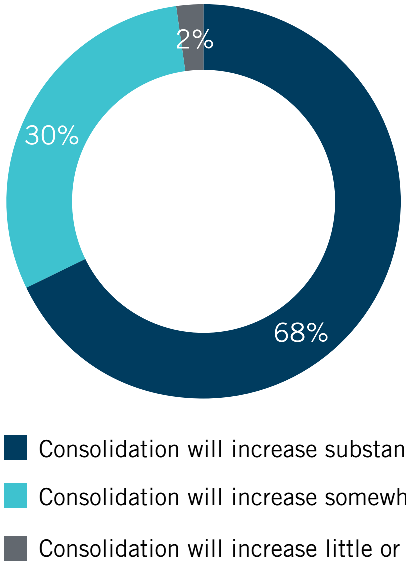
Heavy competition for deals is prompting private equity firms to look to their peers to build scale. Consolidating operations with like-minded firms offers a number of potential benefits, including cost synergies and increasing firepower in a market flooded with capital. Virtually all of our survey respondents (98%) predict that consolidation among fund managers will increase over the next two years, and more than two-thirds (68%) think the increase will be rather substantial.

Notably, in April 2018, KKR, one of the world's largest private capital asset managers, partnered with FS Investments, formerly Franklin Square Capital Partners, to create the largest business development company platform, with US$18 billion in combined assets under management. The deal expanded KKR Credit's assets under management by 33% to US$55 billion and is

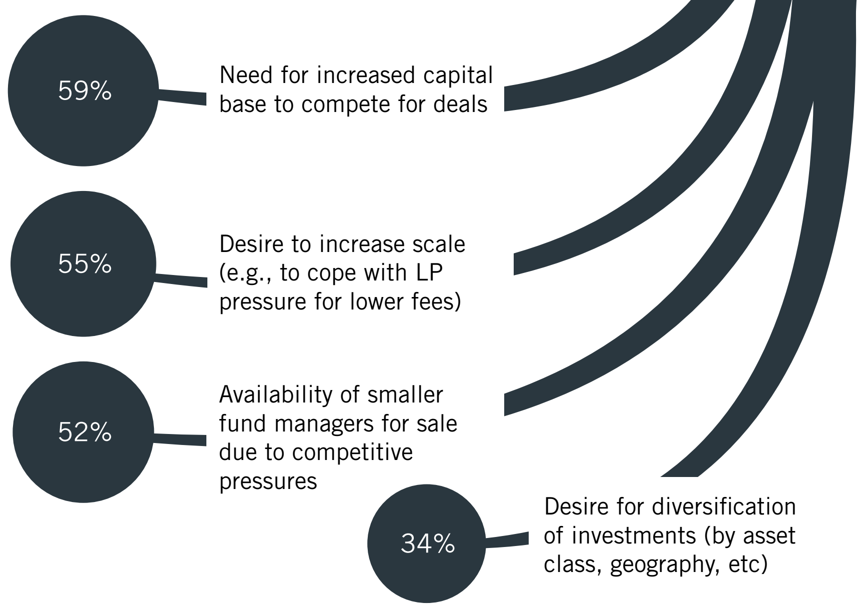
WHAT ARE YOUR EXPECTATIONS FOR FUTURE RETURNS ON CAPITAL INVESTED THIS YEAR COMPARED TO RETURNS ON INVESTMENTS YOUR FIRM MADE 5-7 YEARS AGO (EITHER REALIZED OR EXPECTED)? (SELECT ONE)



WHAT DO YOU EXPECT TO HAPPEN TO CONSOLIDATION ACTIVITY AMONG FUND MANAGERS OVER THE NEXT TWO YEARS? (SELECT ONE)



WHAT WILL BE THE MAIN DRIVERS OF CONSOLIDATION AMONG FUND MANAGERS OVER THE NEXT TWO YEARS? (SELECT TOP TWO)



> "Private equity has always been about operational improvements, and it's just the case that a lot of that is now technology-enabled."
>
> Dr. Markus Bolsinger, Dechert

expected to enable the entity to offer a broader suite of debt financing products.

"The goal is to maximize assets under management," said Dr. Markus Bolsinger, a partner in Dechert's New York and Munich offices. "There are synergies by having that all under one roof. You have a more sophisticated fundraising system, the back office is rationalized and expertise is shared. More assets under management also means more dry powder."

Indeed, respondents in our survey believe the primary motive for firms to consolidate will be to grow their capital base to compete for deals (59%) and increase scale for other advantages (55%), such as coping with LP pressure for lower fees.

Long-hold funds: Planning ahead

Another trend taking hold in the market is the growing popularity of long-hold funds, a strategy employed in recent times by firms including

The technology imperative

Technology will be a key solution to private equity's ongoing competition challenge. Whether applied in the back office or at the portfolio level, digital tools can help to ensure that GPs more effectively compete for deals, meet rising investor demands and deliver operational efficiencies.

The vast majority (92%) of respondents said they will likely or definitely need to adopt technology over the next two years to keep pace with their competitors. The challenge will be in identifying which applications hold the most potential and then being able to effectively exploit them.

"Private equity has always been about operational improvements, and it's just the case that a lot of that is now technology-enabled," said Bolsinger. "Installing customer relationship management (CRM) and point of sales systems, tracking orders, sales inventory, logistics, shipping and those kinds of processes can be made more efficient when technology is applied. There's lots of potential there."

The uses of technology respondents think hold the most potential are for portfolio company analysis, including with the use of machine learning (55%), and performance benchmarking (40%). The third most anticipated use of technology is in performance reporting (31%).

Increasing information demands from investors and compliance obligations mean that streamlining these back-office processes represents significant value. For those LPs who can write the very largest checks, however, a more bespoke approach may be required, said Ross Allardice, a private equity partner in Dechert's London office.

"The general trend is that firms are automating a lot of their general reporting processes. Although, when you come to your hundred-million-dollar investor, they will tell you how they want the reporting to look," he said. "The more capital an investor commits to a manager, the more clout they have and they may require customized service."

OVER THE COMING TWO YEARS, IN WHICH OF THE FOLLOWING AREAS DO YOU EXPECT NEW TECHNOLOGY TO PROVIDE THE LARGEST BENEFITS TO YOUR FIRM? (SELECT TOP TWO)

Blackstone, Carlyle and CVC Capital Partners. Due to the limitations of traditional fund structures, PE managers are often forced to sell well-performing, familiar assets within seven years in order to distribute proceeds to LPs and to raise follow-up funds —only for that money to later be invested into unfamiliar companies. Long-term funds, meanwhile, can hold assets for upwards of 10 years if necessary, and offer more flexibility, as GPs can consider deals that conventional funds may not have the appetite to invest in, particularly where value creation is expected to be protracted. "In many ways, shifts to longer-term holds should allow management teams to focus on absolute growth rather than be distributed by regular changes of ownership," said Allardice.

The managing partner of a US$1bn+ long-hold fund added: "There is a finite pool of assets and there is an ever-increasing amount of capital to buy them. The market is now dominated by companies that have been through multiple buyouts already. If the number of assets available hasn't increased and the money available to buy them has increased, the only way this works is by turning over this inventory of assets faster. So you're seeing a vortex of shorter and shorter holding periods, whereby firms have the incentive and pressure to deploy capital fast so they can raise another fund, and to do so they need to sell assets — and often too early."

More than a quarter of our respondents (27%) said they had already established a long-hold fund and nearly a third (32%) were considering it. Once again, GPs are innovating to increase returns and improve deal flow in the current

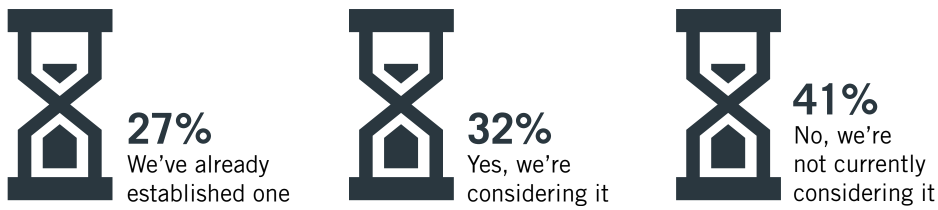
competitive environment: 36% of respondents said a long-hold fund would allow them to hold onto profitable companies for longer, and 31% said it would make their firm more attractive to sellers. At the same time, more than half (52%) of respondents acknowledged that this long-term strategy requires a radically different approach to investment.

"What hits LPs hard is that they make a US$100 million commitment and they need to have that money available, but it doesn't get called for a long time so is not earning a return. Once it is finally invested, it's often returned very quickly and needs to be reinvested," said Bolsinger. "Investors are looking to put more capital into private equity, which plays to the longer-term funds. While many are very IRR-focused, LPs that write hundreds-of-millions to billion-dollar checks are often more focused on the multiple of their investment rather than the IRR, particularly if their liabilities are long term."

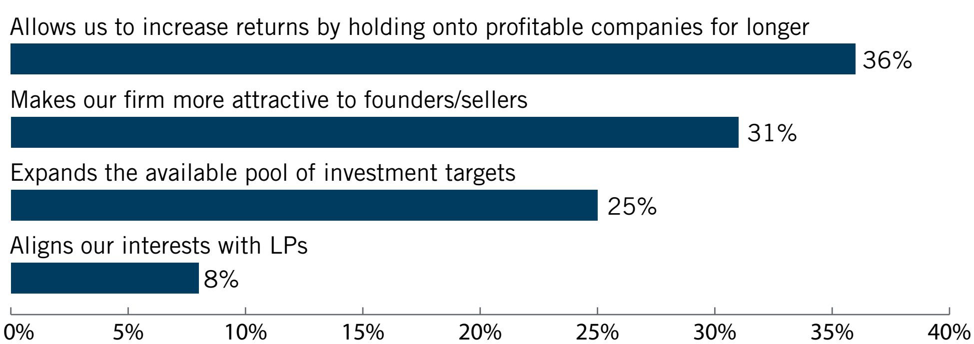
Expansion into new asset classes: Meeting market demand

Unsurprisingly, given the oversupply of capital in the private equity market, more than two-fifths (42%) of respondents say they have

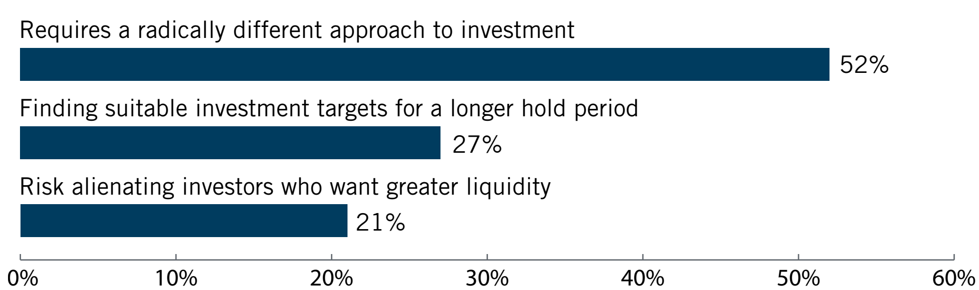
IS YOUR FIRM CONSIDERING RAISING A LONG-HOLD FUND (AROUND 15+ YEARS IN DURATION)?



FOR WHAT REASONS IS YOUR FIRM CONSIDERING OR HAS ALREADY ESTABLISHED A LONG-HOLD FUND? (SELECT THE MOST IMPORTANT)



WHAT ARE THE MAIN CHALLENGES/CONCERNS YOUR FIRM HAS WHEN IT COMES TO LONG-HOLD FUNDS? (SELECT THE MOST IMPORTANT)



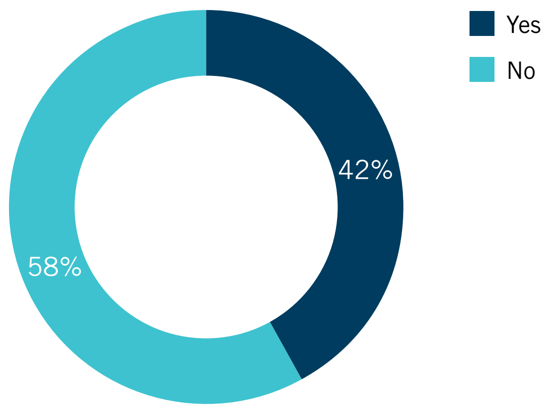
been expanding into new asset classes and more than half (54%) anticipate diversifying their asset class exposure further going forward.

There are various rationales for such diversification. The single biggest driver, cited by 36% of respondents, is to seek higher returns or specific opportunities they have identified. On a cumulative basis, however, 88% said that they saw interest in new asset classes on the part of their LPs as at least one motivator for moving into new areas.

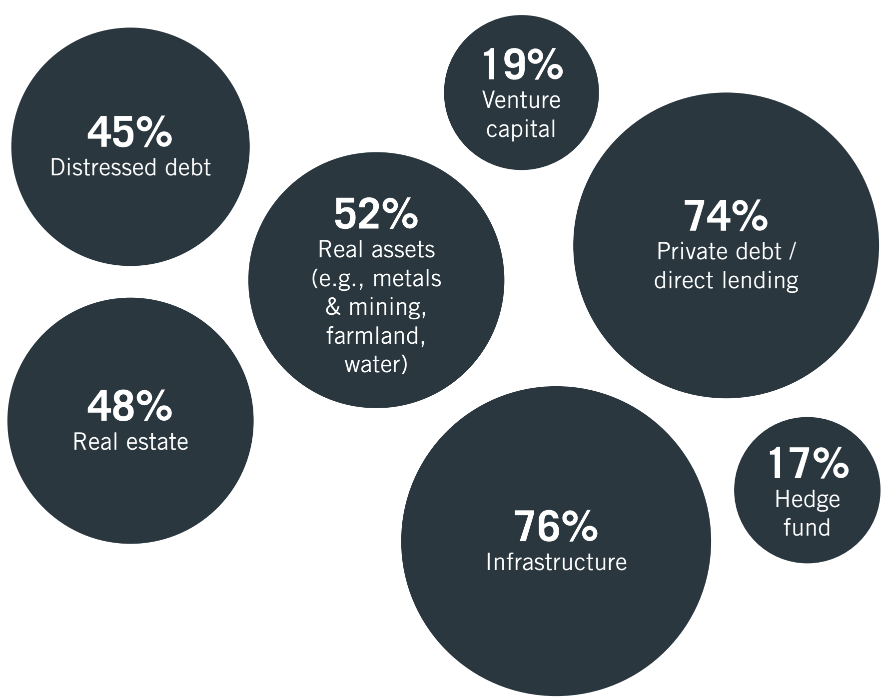
Indeed, the sheer weight of capital that investors are seeking to put to work in private markets means that GPs are having to accommodate with the roll-out of new fund types. This is of particular relevance for large, listed houses, which are incentivized to appease their public shareholders.

"If you look at the multiple that attaches to the fee income versus the multiple that attaches to the carry for those listed firms, there's a huge difference," said Bolsinger. "Public markets reward fee generation over carry earnings. So GPs want to have the maximum amount of assets under management and there are only so many

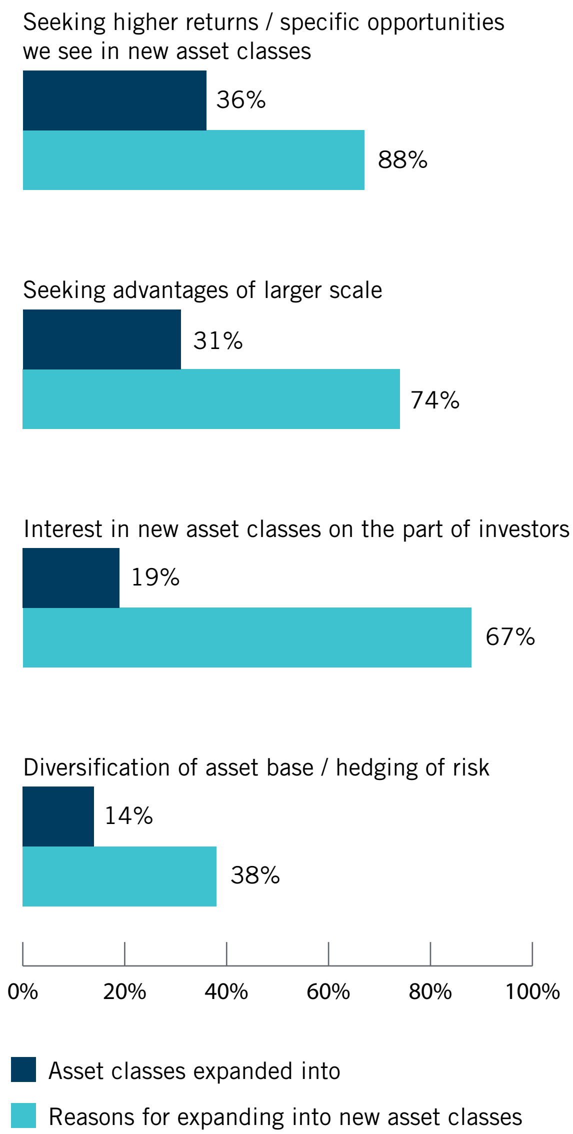
OVER THE LAST FOUR YEARS, HAS YOUR FIRM EXPANDED ITS EXPOSURE TO NEW ASSET CLASSES?



IF YES, WHICH ASSET CLASSES HAS YOUR FIRM EXPANDED INTO? (SELECT ALL THAT APPLY)



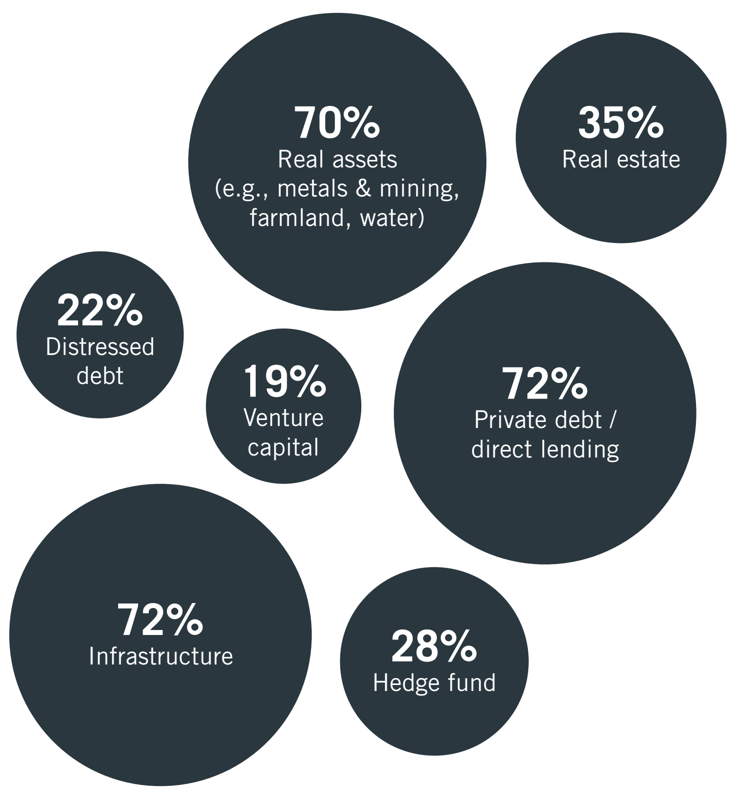
FOR WHAT REASONS DID YOUR FIRM EXPAND INTO NEW ASSET CLASSES? (SELECT THE MOST IMPORTANT)



US$20 billion PE funds they can raise. So, in the U.S. at least, adding infrastructure and private debt strategies is a no-brainer."

The main asset classes that those surveyed have already targeted are infrastructure, cited by 76% of respondents, closely followed by private debt, a strategy pursued by 74% of GPs. The picture is much the same looking ahead, with 72% considering adding both infrastructure and credit going forward, and 70% expecting to move into real assets.

IF YES, WHICH ASSET CLASSES IS YOUR FIRM CONSIDERING EXPANDING INTO? (SELECT ALL THAT APPLY)



Deal targeting: The rise of specialization and creative structures

Domain expertise: The new norm

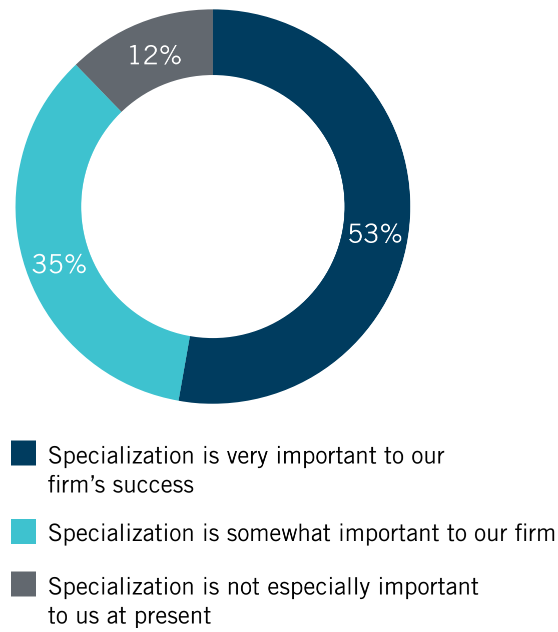
In today's fiercely competitive dealmaking environment, private equity firms recognize the importance of developing domain expertise. Sector specialists can deploy focused and dedicated resources within a sector, drawing them closer to industry participants, trends, and themes that can lead to more attractive and differentiated investment opportunities that generalist firms may overlook. This can afford competitive advantages in deal processes and even result in elusive proprietary transactions.

An abundance of dry powder also means that management teams are no longer simply looking for capital to grow their businesses, but skills, expertise and exemplary investment track records in their given sectors.

As an executive of one U.S. PE firm with more than US$10 billion under management said: "Competition is unforgiving in most cases. With the significant increase in PE firms and capital, we need to utilize our domain knowledge in order to stand out among our competitors. This helps us to succeed in winning deals by convincing companies that we will deliver as promised, and that we are able to execute strategies that will boost their business and revenue."

Our survey indicates that specialization in PE has become the norm: 88% of respondents said having a niche had become important to their firm, with 53% saying it is very important. Further, the leading reason for the significance of domain expertise, cited by 48%, is the leg up it gives firms in

TO WHAT EXTENT IS DOMAIN EXPERTISE IN SPECIFIC SECTORS OR OTHER NICHES IMPORTANT TO YOUR FIRM AT PRESENT? (SELECT ONE)



convincing companies to sell to them in their particular areas of specialization.

Creative structures: Coping with competition

Stiff competition for assets also incentivizes GPs to think more creatively about deal types and structures as a means of expanding their pool of potential targets. The most popular method is to create vertically integrated portfolio companies, as opposed to horizontal combinations, cited as likely (either very likely or somewhat likely) by 97% of our respondents. This was followed by 95% who said they were likely to pursue acquisitions based on industry or market differentials.

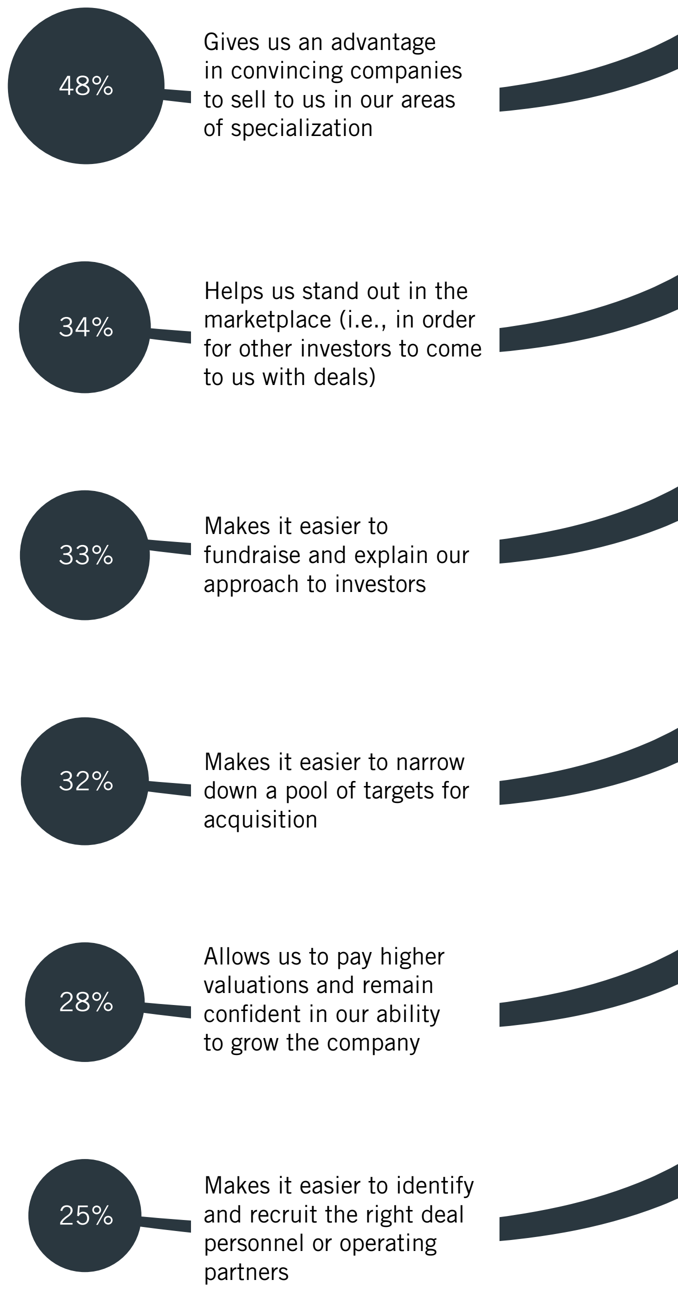
There is a broad spectrum of portfolio integration and synergy available to GPs, whether horizontal or vertical. Commonly, private equity investments in the past have been viewed in isolation, with fund managers focusing on how to improve operations in each individual company. However, there are often opportunities to share capabilities and achieve economies of scale across entire portfolios. For instance, it may be possible to consolidate plants and supply chains, as well as cross-sell products and services between companies' clients and customers.

There may also be opportunities to integrate companies with those owned with competing private equity firms. Last year, J.H. Whitney Capital Partners-sponsored pediatric group PSA Healthcare merged with Epic Health Services, itself owned by Bain Capital, for an undisclosed sum. Rather than exit the business, J.H. Whitney rolled its equity over into the new entity. We found that 66% of respondents said they were likely to consider investing with such an arrangement.

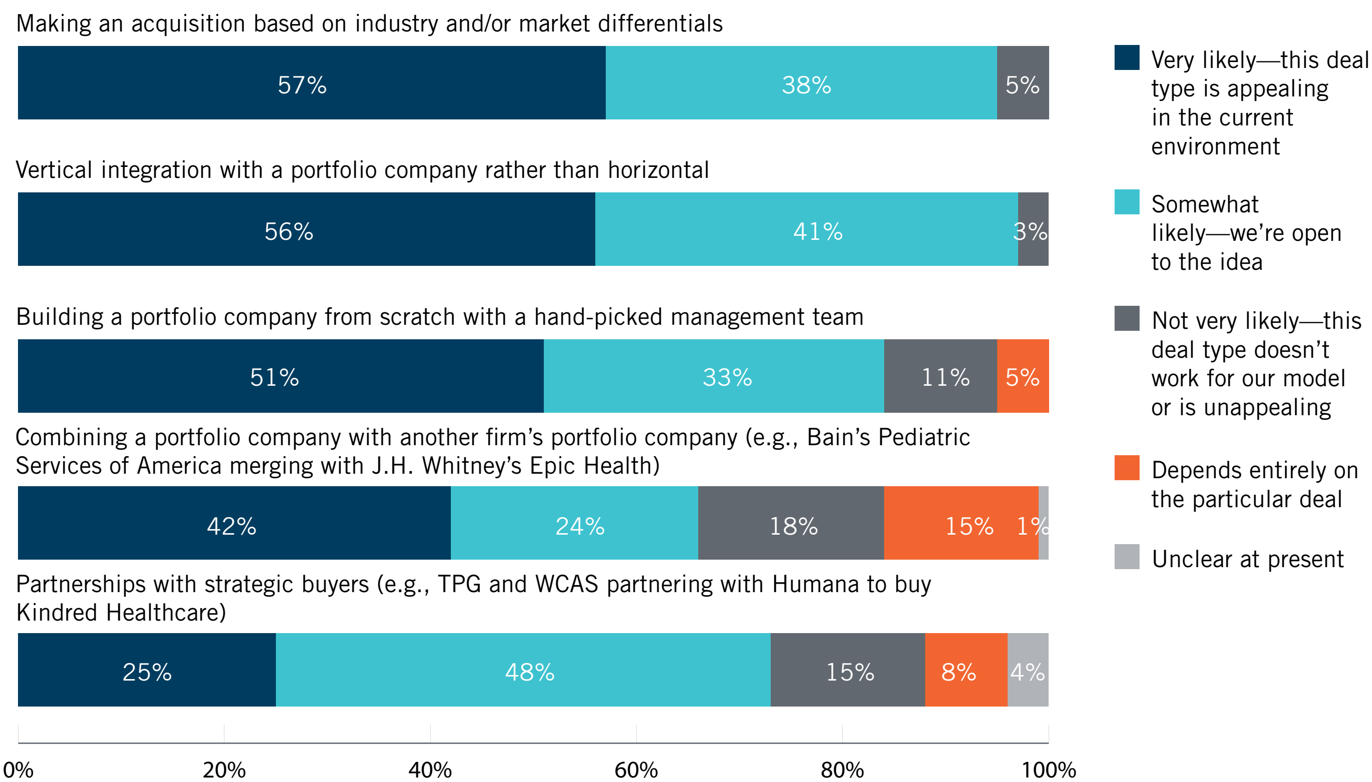
Meanwhile 73% said that partnering with strategic buyers was a likely consideration, although only 25% said this was very likely. While certainly not the norm, there are examples of such strategic partnerships. Earlier this year, TPG Capital and Welsh, Carson, Anderson & Stowe formed a consortium to buy Curo Health Services for US$1.4 billion, alongside New York Stock Exchange-listed Humana Inc as a minority investor.

"These partnerships have been really underdeveloped, not because there is a lack of opportunity to do so but a lack of alignment," said a partner of one private equity firm. "PE's toolkit is valued and

WHAT ADVANTAGES DOES DOMAIN EXPERTISE PROVIDE YOUR FIRM? (SELECT TOP TWO)



HOW LIKELY IS YOUR FIRM TO CONSIDER THE FOLLOWING DEAL TYPES AT PRESENT? (SELECT ONE FOR EACH TYPE)



complementary but then we have to talk about exit, and in the traditional PE fund the need to get out after seven years. That happens early in the discussion and corporates are used to making longer-term decisions."

There are pros and cons to collaborating with strategics. For the corporate, there is the advantage of limiting their equity exposure by bringing in a financial partner, and "intelligent capital," as private equity can bring a unique value-enhancing perspective. For the PE side, they are partnering with a co-investor that has deep sectoral and operational knowledge.

"For private equity there is also a preferred buyer in place when it comes time to exit. The negative is it's much harder for another strategic to buy the entire company, so it shrinks the potential pool of future acquirers. You can't deal with everything upfront. However, you can include put-call options and other mechanics up front into the transaction documents," said Bolsinger. "Those potential issues do not outweigh the benefits. With club deals, you have very similar issues around who can put the company up for sale and when."

Club deals: Back to the future

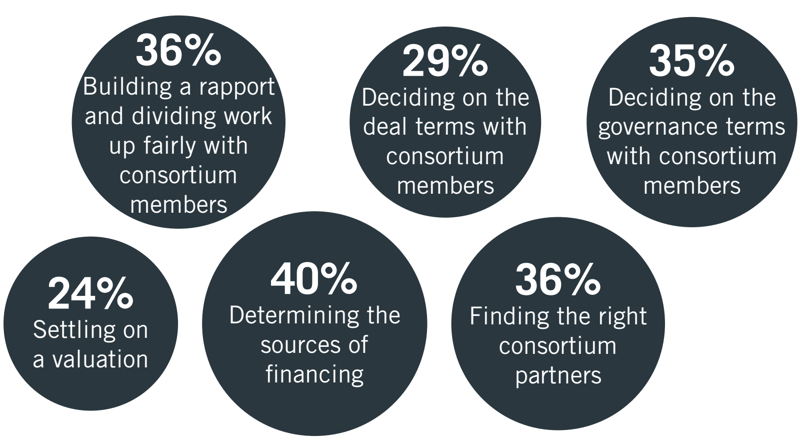
Club deals, whether collaborating with other PE firms, strategics or, as is increasingly common, with a fund's own LPs, are a means of more effectively competing for targets. Pooling equity can allow funds to reduce their exposure to a single deal or increase their firepower for larger transactions. Our survey shows that buyers face a variety of challenges in carrying out such transactions, including determining the sources of financing (40%), finding the right consortium partners (36%), and building a rapport with consortium members (36%).

Many of these challenges can be overcome by pursuing co-investments with LPs. Institutional investors commonly pursue this strategy to reduce management fees and carried interest payments, and the sheer demand for certain funds, which have limited space for capital commitments, makes co-investments a fitting solution. It also means that funds collaborate with their own investors, valuable long-term partners, rather than with competing buyout houses.

However, there are growing examples of former LPs remodeling themselves as conventional buyout houses, in some cases circumventing GPs and representing a new source of competition. For example, Swiss firm Partners Group, historically a fund of funds, directly invested over US$10 billion in May 2018 alone.

"When these major private equity houses miss out on a direct equity investment in an auction scenario, given they have a solid LP position in many plain-vanilla funds, there's often a way for them to get a minority direct co-investment piece," said Allardice. "So there is often an option to go with the winner. They seldom lose out now."

WHAT ARE THE BIGGEST CHALLENGES IN CLUB DEALS (INCLUDING TRANSACTIONS WITH CO-INVESTORS)? (SELECT TOP TWO)



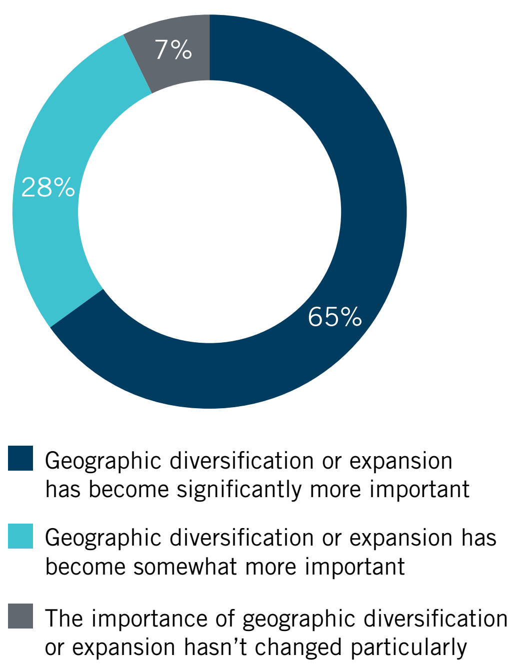
Geographic expansion: Cross-border PE goes mainstream

Private equity firms are placing a greater emphasis on global expansion, for a variety of reasons. Close to two-thirds (65%) of our cohort reported that they have made deals in three or more countries over the last three years. What's more, the same percentage (65%) said that geographic diversification or expansion had become significantly more important to their firms over that same three-year period.

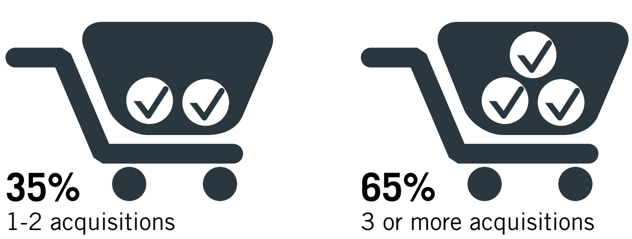
There are numerous motives for enlarging a firm's global footprint, from economic and political risk diversification to currency arbitrage and hedging. We found that the primary motivation, cited by 62% of respondents, is that cross-border deals allow them to gain exposure to a large group of faster-growing regions and economies.

"Expansion is all about moving from our comfort zone to

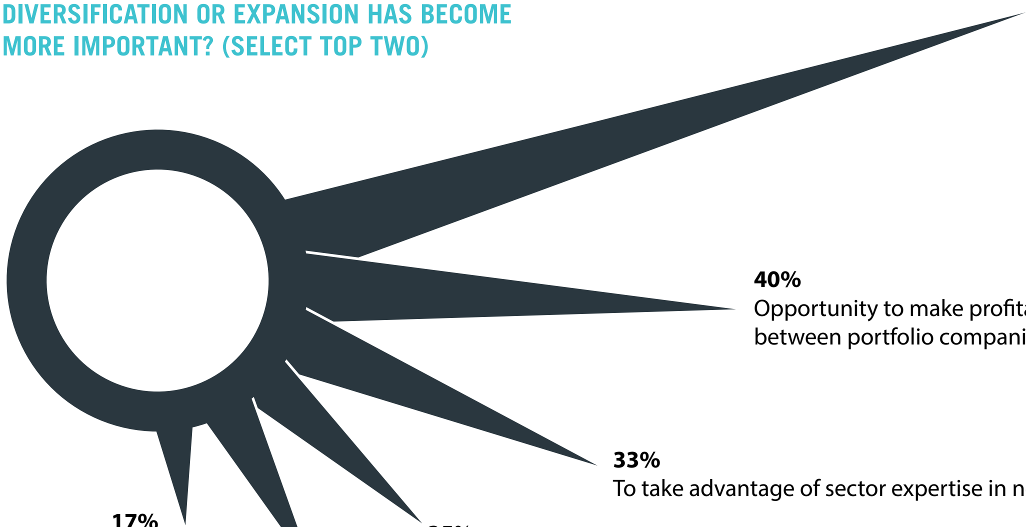
OVER THE LAST THREE YEARS, HOW HAS THE IMPORTANCE OF GEOGRAPHIC DIVERSIFICATION OR EXPANSION CHANGED WHEN IT COMES TO YOUR FIRM'S INVESTMENTS?



OVER THE LAST THREE YEARS, IN HOW MANY COUNTRIES HAS YOUR FIRM MADE ACQUISITIONS?



WHAT ARE THE MAIN REASONS THAT DIVERSIFICATION OR EXPANSION HAS BECOME MORE IMPORTANT? (SELECT TOP TWO)



markets that are differentiated and challenging," said an executive at a Chicago-based PE firm. "Our strategy is to take advantage of currency valuations and invest in fast-growing markets that can provide that extra level of revenue for our targeted portfolios, and in turn provide better returns."

However, in some cases, such growth may already be priced into foreign markets, making value plays elusive.

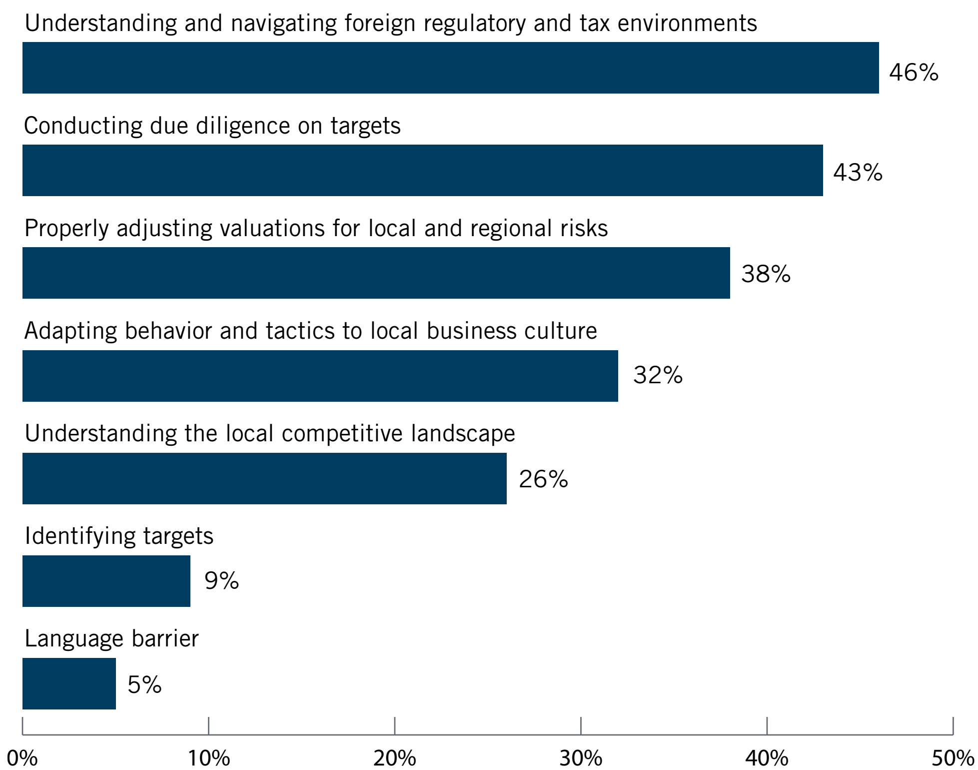
"The growth expectation in the U.S. and Europe is very limited, so finding markets where growth expectations are a lot higher is attractive," said Bolsinger. "Nonetheless, investors will ultimately pay for that growth, so the purchase price multiple differential between the U.S. and other markets may not be as wide as it once was." To this point, the least cited reason (17%) for tapping overseas markets was to find more affordably priced targets.

The number one challenge faced by GPs targeting acquisitions in new geographies is understanding and navigating foreign regulatory environments (46%), with conducting due diligence on targets (43%) a close second. To effectively source deals, the three most popular strategies are working closely with local advisors (57%), partnering with locally established GPs (46%) to assist in this effort, and establishing a local or regional office (42%).

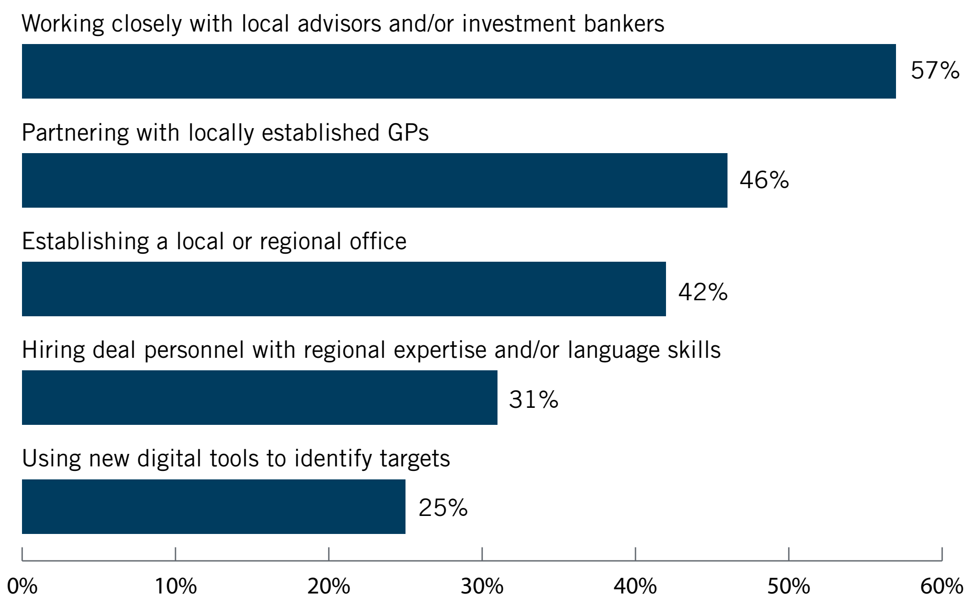
Bulge-bracket PE houses with established global operations and fund strategies will clearly continue to seek foreign deals. The demand from LPs to commit money to these brand name firms means they are forced to look far and wide for opportunities, with markets such as Indonesia and Australia drawing strong interest in recent years.

Looking ahead, however, there may be less impetus for U.S. firms with fewer assets under management to look outside the domestic market. Despite

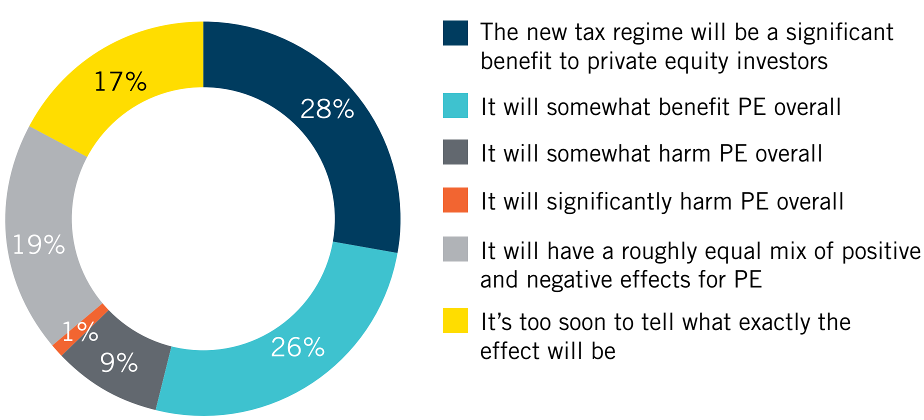
WHAT CHALLENGES DO YOU FACE IN TARGETING ACQUISITIONS IN NEW GEOGRAPHIES? (SELECT TOP TWO)



WHAT STRATEGIES DO YOU USE TO SOURCE TARGETS IN NEW GEOGRAPHIES? (SELECT TOP TWO)



IN YOUR OPINION, WHAT WILL BE THE OVERALL EFFECT OF THE NEW US TAX REGIME ON PRIVATE EQUITY INVESTMENT IN THE COUNTRY? (SELECT ONE)



the higher growth found in Southeast Asia and other frontier territories, a majority of our survey respondents (54%) expect the U.S. tax reform law passed in 2017 to benefit PE investment in the country. The changes mean that American companies now pay less tax owing to the headline corporate-tax rate falling from 35% to 21% (provided that levies are not raised commensurately at the state level). Investment firm Hamilton Lane estimates that this change will increase the value of portfolio companies in the country from between 3% and 17%, making the U.S. a comparatively more attractive market.

Financing: Leverage in flux

The leverage that is available in the lender market and the earnings multiples that we see in the pricing of private equity M&A transactions are closely correlated. A greater availability of debt on attractive borrowing terms creates upward pricing pressure in the buyout market for the simple fact there is more capital, both equity and debt, looking to be put to work. So it is not only the vast reserves of dry powder in private equity funds that is pushing prices higher, but also the demand from banks, bond investors and credit funds to lend on LBOs.

Our respondents indicated that, with multiples continuing to climb, they are facing some challenges when attempting

WHAT ARE THE BIGGEST CHALLENGES AT PRESENT WHEN IT COMES TO FINANCING BUYOUT DEALS? (SELECT TOP TWO)

- **46%** Obtaining sufficient leverage to pay high multiples
- **40%** Securing financing packages quickly enough to win deals
- **40%** Obtaining financing for higher-risk deals
- **33%** Balancing speed with attaining the best terms possible
- **41%** Borrowing terms gradually tightening across the board

> There is more capital, both equity and debt, looking to be put to work

Box-out: Weighing the impact of U.S. tax reform

The Tax Cuts and Jobs Act (TCJA), the biggest overhaul of the U.S. tax code since the Tax Reform Act of 1986, has been embraced by companies in large part because it significantly cut federal corporate tax rates, from 35% to 21%. The private equity industry, meanwhile, has been less welcoming of the changes, as the new rules cap loan interest deductibility at 30% of tax-calculated EBITDA (through 2021, after which it will be further tightened to 30% of tax-calculated EBIT).

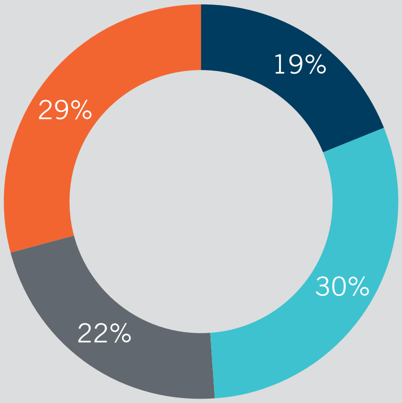
Since leveraged buyouts rely upon debt to maximize returns, it is those companies backed by private equity with their higher levels of debt that are likely to feel the greatest impact from this section of the updated tax code. Nearly half of our respondents said they thought the law's restrictions on interest deductions would cause the use of leverage to drop either significantly (19%) or somewhat (30%) in U.S. buyout deals.

As one executive of a private equity firm said, this is more likely to concern those in the upper end of the market. "The true middle-market rarely gets much more than 6x, whereas on the mega deals you can get more leverage, so the interest deductibility plays a lot more of a factor."

Another point of contention is the restricted availability of carried interest. Prior to the TCJA changes, fund managers received the lower long-term capital gains tax rate through their carried interest on investments held more than one year. The TCJA increases that holding period for carried interest recipients to three years.

The reform is not all bad news, however. Although private equity-backed businesses' taxable earnings may increase on a relative basis with the introduction of the 30% interest deduction cap, they will benefit from the reduced federal corporate tax rate, which may result in a net reduction in their annual payments to the Treasury. In addition, the TCJA included generous expensing provisions for capital investment (which will be phased out beginning in 2023) and significant changes to the taxation of other earnings of non-U.S. subsidiaries. The impact of these new expensing provisions depends on the level of net taxable income of a portfolio company, and PE-backed businesses that have significant tax attributes, especially in the middle and lower markets, may find that these new expensing rules will have little benefit.

WHAT EFFECT DO YOU EXPECT THE NEW US RESTRICTIONS ON INTEREST DEDUCTIONS TO HAVE ON THE USE OF LEVERAGE IN US BUYOUT DEALS?



- The restrictions will cause the use of leverage to drop significantly in US buyout deals
- The use of leverage will drop somewhat in US buyout deals
- The restrictions will have minimal effect on the use of leverage
- It's too soon to tell what exactly the effect will be

to secure financing: 46% said they faced difficulty obtaining sufficient leverage to pay high multiples, and 41% said borrowing terms were gradually tightening across the board. This is consistent with a trend witnessed in recent years: the edging down of debt-to-equity ratios as GPs were required to put up more of their own capital into deals, amid a flight on the part of banks away from lower-grade credits to quality assets. This was largely attributed to the introduction of the Treasury's Leveraged Lending Guidance, which sought to cap regulated banks' lending on buyouts to no more than six times earnings.

More recently this trend appears to be reversing itself, after regulators indicated that they expect banks to use their own discretion in the leveraged finance market. In February this year, Joseph Otting of the Treasury's Office of the Comptroller of the Currency, said: "Institutions should have the right to do the leveraged lending they want, as long as they have the capital and personnel to manage that and it doesn't impact their safety and soundness," adding that he expects leverage ratios to trend upward over the next year.

Data from Standard & Poor's indicates that the share of LBO loans with debt/EBITDA at the closing of the acquisition of at least six times has reached 53%, the highest point since the financial crisis. This is just ahead of the 52% share of such loans recorded in 2014 and behind the 62% recorded in 2007. "For PE, if the debt is available and it's covenant-lite, they can take a lot of comfort from that. The market's telling them that higher valuations can be justified," said Allardice.

And despite increased regulation since the financial crisis, significant and continued demand is fueling borrower-friendly issuance. "There was a softer period during which it became slightly more challenging for funds in the upper market to access the very highest debt multiples, particularly from banks, but that is changing," said Bolsinger. "The signal from regulators that the six-times leverage test is not binding presents a challenge for alternative lenders, which were never subject to the guidance. There is likely to be increased competition from banks going forward."

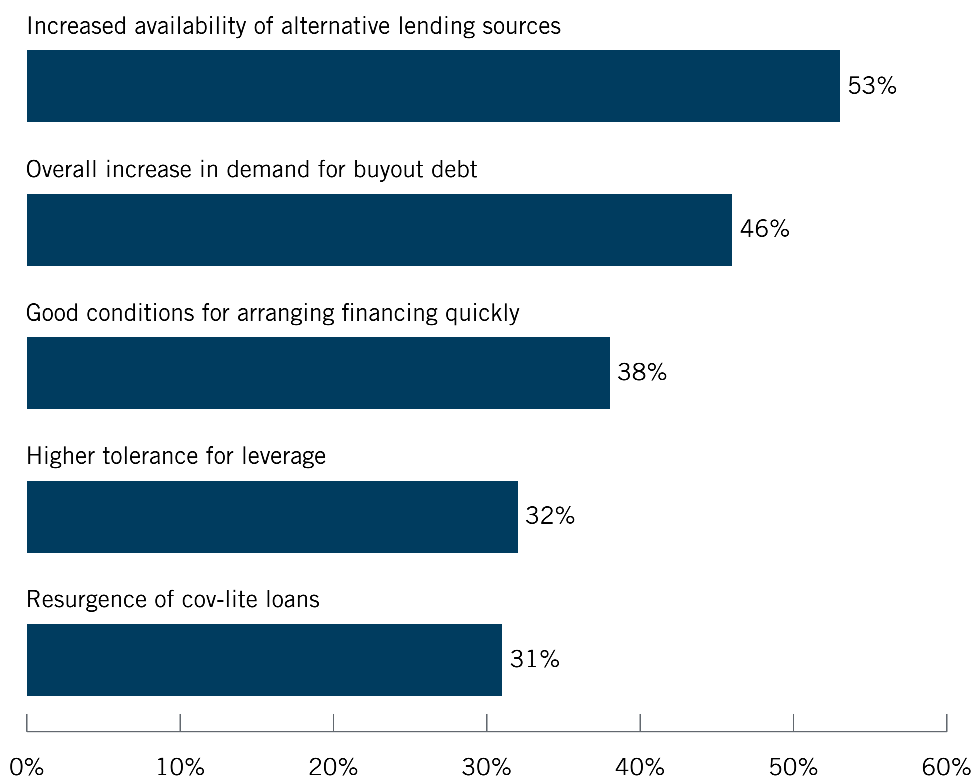
Alternative lending: A new mainstay

One decidedly positive development in the buyout financing sphere is the growth of the alternative lending market. Credit funds typically have a higher cost of capital than banks, which means their loans come at a price. However, this is offset by the advantage that such funds are usually willing to back riskier credits, accept higher leverage ratios and can move quickly.

Just as the low-yield environment incentivizes investors to commit their capital to private equity, an asset class with high returns, there is also an inducement to invest in credit funds that back higher-yielding credits in the leveraged finance space.

"Buyouts have become more and more popular with the availability of investor capital," said an executive at one of the industry's largest private equity groups. "The demand for buyout debt is astonishingly high and is met with an equal supply." A majority of our respondents (53%) said the increased availability of alternative lending sources represented one of the most beneficial recent changes in the financing market, and noted an increase in demand for buyout debt (46%).

WHAT ARE THE MOST BENEFICIAL RECENT DEVELOPMENTS IN THE MARKET WHEN IT COMES TO FINANCING BUYOUTS? (SELECT TOP TWO)



Exit environment: Concerns over hitting valuation targets

The high-multiple climate has been a significant boon for vendors in recent years, allowing them to sell companies acquired at the bottom of the cycle for significant gains, as well as many pre-crisis deals that had to be held for extended periods.

As we have moved through the bull run of the last five years, and funds have continued to deploy capital recycled back into the asset class in a rising market, the prospect of making the same returns looks to be less certain.

Our respondents are clearly concerned about this: 55% said securing a buyer willing to pay the desired valuation for an asset represented one of the biggest challenges they predicted facing when exiting a company in the coming 12 months. Not far behind, 43% said the most significant exit challenge would be determining whether to hold a portfolio company for longer to take advantage of further growth.

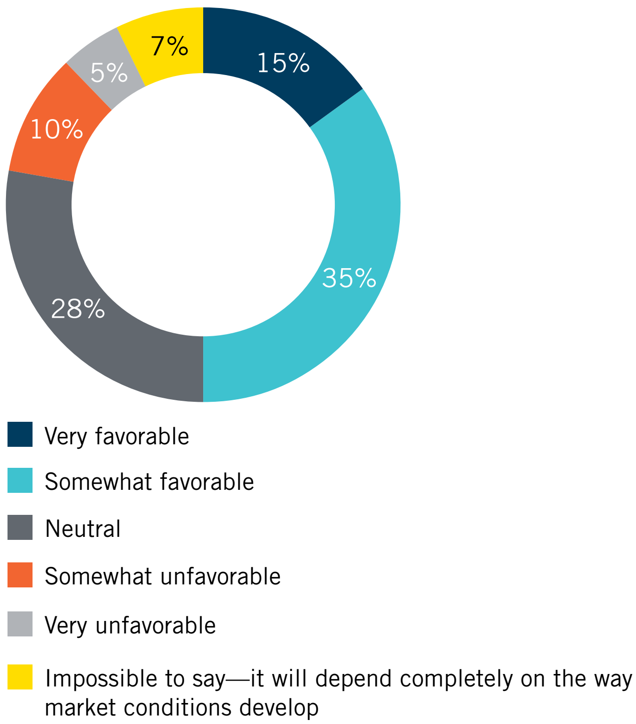
This should be expected given that the economy continues to grow and markets continue to rise. GPs do not want to miss out on future upside.

"Exits are crucial and need to be timed perfectly. It's important to continuously update the target valuation and make sure that it doesn't fall below the desired level, no matter the situation in the market," said an executive at an Italian private equity firm.

One tactic has been to sell minority positions rather than exit companies wholesale. This strategy has been employed in recent months by the likes of U.S. firms Hellman & Friedman and Francisco Partners, to sell fractions of Swedish home alarms firm Verisure and supply chain company BluJay Solutions respectively, and European GP Montagu Partners to partially exit diagnostics company Sebia. All three of these situations featured large sovereign wealth funds or pension funds as buyers.

The rationale for such sales is that fund managers can return a portion of cash to their LPs while remaining invested in a familiar company with growth potential, rather than having to raise a fresh fund that will have to be redeployed in a competitive, high-price market. Allardice points to this as anecdotal evidence that conventional PE funds are now taking a longer-term view when forming an investment strategy.

HOW DO YOU THINK THE MARKET CONDITIONS WILL BE FOR PRIVATE EQUITY EXITS OVER THE COMING 12 MONTHS? (SELECT ONE)



Predictions and preferences

Despite concerns over securing desired valuations, GPs are broadly optimistic about their exit prospects over the next 12 months. Half of our respondents said they thought market conditions would be favorable for exits over the next year, with just 15% predicting they would be unfavorable and 28% expecting there to be neutral conditions.

Less than one-third (32%) expressed a preferred exit route, the majority instead basing the decision on what is best suited to the company and the situation. Of that minority with a preference, negotiated sales to a strategic buyer (81%) or a PE fund

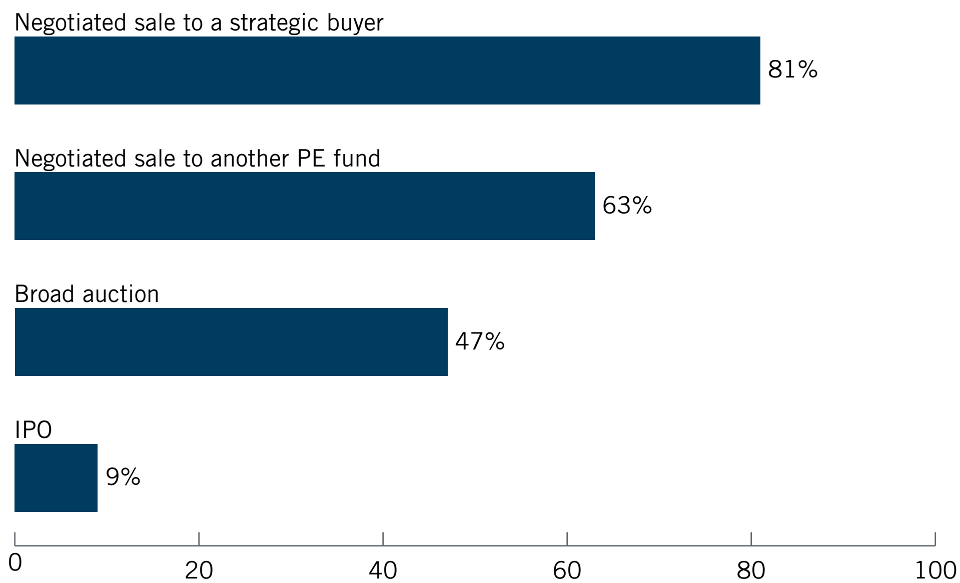
(63%) are more popular than auctions (47%) and considerably more so than IPOs. Only 9% said they anticipated floating a company on the stock market over the next 12 months.

Following a stable run in 2017, stock markets had a volatile start to 2018 precipitated by mounting geopolitical tensions and ongoing trade disagreements between the U.S. and China. That did not, however, slow the IPO market. In the US, 104 companies raised US$28.6bn in aggregate in the first half, the highest sum of proceeds for three years. Demand is squarely aimed at tech, evidenced by the white-hot IPOs of companies like Zscaler, Docusign and Smartsheet, and to a lesser extent Dropbox and Spotify.

Those GPs looking to sell tech assets may choose to consider riding the wave of this demand. However, with attention trained on this sector specifically, the remainder may opt for a private sale to strategics or other PE firms, both of which are heavily equipped with capital.

"We have exit preferences for certain industries that we invest in. For consumer we have negotiated sales, for healthcare we prefer selling to another sector expert, while for smart technology companies we use IPOs," said an executive at a Dutch private equity firm.

WHICH FORMS OF EXIT DO YOU THINK WILL BE MOST FAVORABLE FOR YOUR FIRM'S PORTFOLIO COMPANY SALES OVER THE COMING 12 MONTHS? (SELECT TOP TWO)



Conclusion: The road ahead

Private equity finds itself at a crossroads. The outsized returns it has delivered for decades are under pressure from the sky-high prices that sellers demand today. For most, fundraising is not an issue — rather, putting that capital to work is more challenging than it has ever been. Under such conditions, it is imperative that firms develop new value-enhancement strategies and think carefully about where and how they make their next investments. Looking ahead to 2019, firms should be mindful of the following emerging and maturing trends.

Trump tariffs, retaliation and global trade

The tit-for-tat tariff trade wars have serious implications for investors. Tariffs now impact imports of steel and aluminum (from anywhere in the world). New tariffs targeting industrial goods from China are in effect with more tariffs against China under consideration. An investigation into possible automotive tariffs is ongoing. Any failure of NAFTA negotiations could result in higher tariffs with Canada and Mexico. Trading partners subject to the new tariffs such as the EU and China have retaliated against the United States by imposing their own tariffs on a broad range of U.S. products, with agriculture taking the biggest hit, and initiated cases in the WTO. GPs should familiarize themselves with the tariffs that have been imposed to see how they may impact potential deal targets. Companies that derive a significant proportion of their revenues selling products involved in these trade wars will now be under pressure. Input costs may rise for the same reason. This geopolitical tension has the potential to escalate, so investors should keep a watch on the possible introduction of further tariffs and other trade issues such as threats to the global trading system (under the World Trade Organization).

Heightened scrutiny of foreign buyers

The US has been paying closer attention to foreign direct investment and has grown increasingly willing to block deals on grounds of national security. A record number of Chinese deals were either abandoned or vetoed in 2017 owing to enhanced scrutiny from the Committee on Foreign Investment in the United States (CFIUS), which might be expected given geopolitical tensions between the two countries. A bill to expand CFIUS' jurisdiction, under active Congressional consideration since 2017, is expected to become law

by the time this report is published (or else soon thereafter). The US has been especially protective of so-called "critical technologies" and will now look to protect "emerging and foundational" technologies as well, particularly when investors are from countries of special concern. At the same time, the UK, Germany, France and other EU countries are exploring enhancements to their own foreign investment/national security review procedures. Non-U.S. GPs should therefore be mindful of this heightened oversight before expending time and resources bidding on sensitive assets.

Making the most of technology

GPs anticipate applying technology in a number of ways to keep pace with the competition. Whether for portfolio company analysis, performance benchmarking or reporting to LPs, GPs will benefit from identifying which technologies can be applied to their operations and for what means, and adopting these solutions ahead of their peers.

Long-hold funds and asset diversification

With demand among investors for private capital strategies running high, GPs with the resources and capacity should think carefully about new ways to meet this demand. For example, there are numerous benefits to long-hold fund structures, including the opportunity to increase returns and the attraction to founder vendors of longer-term backing. As well, private debt and infrastructure are expected to increasingly be added to private equity's armory. Is there an opportunity for your firm to diversify and develop its fund structures and asset strategy?

Market impacts of tax reform

Firms should think carefully about what the recent changes to the U.S. tax code mean for them. For one, is the 30% loan interest deductibility

cap liable to impact the way the firm structures debt and models its investments, or shift its attention to less levered sectors? Also, what does the earnings boost from the headline federal tax cut mean for the attractiveness of U.S. deals and the firm's investment strategy, e.g. is the firm taking advantage of this earnings effect before the market prices it in?

Seeking strategics

Private equity is wary of achieving desired valuations at exit on investments made in the sellers' market of recent years. With financial sponsors on both sides of the bid/ask fence understandably price-conscious, GPs would do well to develop their networks and warm strategics up for future exits to capitalize on their ability to pay for cost synergies.

GPs with the resources and capacity should think carefully about how to meet rising demand from investors.

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Dechert is a global law firm and is an active advisor to the private equity industry. As a result of our longstanding roots and diverse client base of more than 200 private equity sponsors, we have a deep understanding of the latest market terms and trends, and provide creative solutions to the most complex issues in evaluating, structuring and negotiating private equity transactions on a global basis. Dechert's integrated global team of more than 250 private equity lawyers advises on a spectrum of funds, transactional and exit matters and has been recognized for its commercial judgment and client focus.

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