PRIVATE EQUITY FORECAST

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Private equity deal flow slowed down in 2015. U.S. and global markets were volatile. Interest rates finally increased. The SEC turned its attention to private equity firms. Despite these challenges, the private equity forecast provides reason for optimism. Forbes reports that in a recent survey of 142 professionals conducted by the Association for Corporate Growth (ACG) New York (which is the largest association of middle market deal making professionals in New York), the results indicate that 83 percent of these professionals expect private equity investments to outperform the S&P 500 in 2016. Private equity buyers offer unique advantages to sellers, which can be marketed to potential sellers to increase the likelihood of success with targets.

ANTICIPATED DEAL VOLUME

In the ACG New York survey, 66 percent of the respondents indicated that they believe that their firm's overall deal volume will increase in 2016. Private equity firms have high levels of capital on their books to invest. The middle market continues to account for the majority of private equity buyouts. Many private equity firms see value in the buy-and-build model, meaning that these investors are acquiring lower middle market and core middle market companies to grow themselves, focusing on value creation strategies. Another positive factor is that valuation-to-EBITDA multiples are down from last year. Opportunities are available; an increasing number of baby boomers are looking to sell their businesses and retire. Private equity firms need to source new deals due to median hold times falling for the first time in six years and their continued success in fundraising. Private equity firms can harness these positives and take advantage of a market where, for the first time in two years, target opportunities may be increasing, the need to source new deals is also increasing, and the difference between seller and buyer expectations regarding the valuation of a business does not seem to be so far apart.

CHALLENGES

To successfully navigate the deal landscape, private equity firms need to be prepared to meet current challenges. Regulatory hurdles continue to be one of the biggest challenges that private equity firms will face. During the past year, the SEC focused on transparency issues, particularly spotlighting transaction fees and expenses. The likely outcome of this scrutiny will be increased disclosure obligations. Unfortunately, the SEC's lack of understanding of private equity causes them to try to use rules not tailored to the manner in which private equity operates. And, while better transparency may mean better investor confidence, increased disclosure also means increased costs; and that means decreased profits. Another challenge that private equity firms need to prepare themselves for are cybersecurity threats. To beef up cybersecurity, private equity needs to be investing in better security measures, which will also affect profits. Finally, interest rate hikes have finally started occurring, meaning profits will be further impacted as financing availability decreases and the cost of financing increases. In addition to the effect felt from an interest rate hike, market volatility, such as that recently occurring in both the U.S. and global markets, tends to cause money to move from middle-market loan funds to broadly syndicated loan funds, which usually causes loans to become more expensive.

INVESTOR TRENDS

Investors continue to hold high expectations for the returns from private equity investing, and as a result, private equity fundraising continues to be strong. Private equity funds have offered better relative value in the middle market. Private equity firms have generally outperformed the asset class. As mentioned previously, median hold times have fallen for the first time in six years. Given the strong fundraising year that private equity experienced in 2015, private equity funds have significant cash on their balance sheets to spend and they are looking for ways to effectively deploy these funds.

Institutional investors and pension funds continue to be aggressive investors in private equity funds, making up 12 percent of the equity, but there are noteworthy new trends in the composition of investors and how they are investing. Limited partners have shown an increasing interest in actively participating in deals as co-investors. Also, due to the increasing concentration of wealth, there has been a rise in the number of family offices actively managing investment portfolios of companies and investing in private equity funds. This increased activism by family offices brings certain advantages to private equity investors: (1) flexibility in sourcing of deal funds; (2) willingness to hold the company for longer periods of time due to tax advantages used in wealth succession planning (thereby providing management with lengthier growth trajectories); and (3) continuity, industry experience, and numerous industry relationships in the industry in which they invest due to low turnover internally. Another interesting new development is in how deals are being sourced. Rather than the traditional reliance on investment bankers to source potential deals, there has also been an increase in independent sponsors bringing deals to private equity firms. These independent sponsors frequently have strong relationships of trust with sellers and are able to source deals that might not come to the attention of private equity firms otherwise.

COMPETITION FROM STRATEGIC ACQUIRERS

2015 was the year of high value strategic tie-ups. In fact, it was a record-breaking year. Dealogic reported $4.87 trillion worth of deals were completed in 2015, far exceeding 2007's record. However, strategic acquirers are facing many of the same headwinds as private equity buyers are facing. In addition, antitrust regulation is playing a more important role in deterring completion of high-value deals by public company strategic acquirers. The record deal value of 2015 is a reflection of the mega-deals that were completed. In reality, deal making slowed down from 2014, if measured by the number of deals completed. In 2014, 41,241 deals were completed but as of December 16, 2015, only 38,033 deals had been completed in 2015. Activist shareholders continue to push for more deal making, so although the pace of deal making may not be record breaking in 2016, it is expected to remain strong. If strategic acquirers begin hesitating due to more difficulty in financing deals with debt, due to the global unrest, and due to increased antitrust scrutiny, private equity may actually be the answer. Many private equity firms have growing platform companies and they are a viable alternative to the large strategic acquirers; they represent potential buyers who are unlikely to face the same economic and antitrust challenges.

INDUSTRIES TO WATCH

The healthcare and pharmaceutical industry set new records in 2015 for the number of deals completed. This area shows no signs of slowing. Technology companies appear to be moving in the direction of increasing merger and acquisition activity. The opportunities for technology companies to exit through an IPO have decreased, with that market showing a great deal of softening and volatility. As a result, more technology companies will exit through mergers and acquisitions. This trend started in 2015, with deals more than doubling in 2015 over 2014. This trend is expected to continue. Finally, the energy industry is expected to be active, although many of those deals will be distressed asset sales, due to lagging oil and gas prices.

PITCHING THE ADVANTAGES OF A PRIVATE EQUITY BUYER

Although much of the attention in deal-making last year focused on what a blockbuster year it was for mega-mergers and acquisitions in the public sector, private equity buyers have strengths that they offer to sellers. Private equity acquirers have money to deploy and their funds are accessible. To compete effectively, private equity firms need to be prepared to market their advantages to potential targets. One advantage of selling to a private equity buyer is the decreased likelihood of antitrust roadblocks. Also, during due diligence, the seller probably will not have to struggle with disclosing sensitive information to a competitor. A private equity buyer can be more creative with deal structure and has the ability to retain current management, which may be important to a baby boomer who has nurtured the current team and may want to retain some interest in the company's continued success.

As confidence wanes in the strength of the market, private equity may not continue its current growth pattern. However, significant deceleration also seems unlikely. Private equity has capital to invest and the target pool appears to be improving in the middle market. By harnessing the strengths of new investors and new investment patterns from existing investors, private equity firms can take advantage of this market with creative deal structures.

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