Private Equity Activity Maintains Holding Pattern as Investors Await Economic Clarity

February 2016

After private equity activity leveled off in 2015, industry leaders have moderated their expectations for the coming year, according to the seventh annual ***PErspective Private Equity Study*** Urish Popeck's Alliance partner BDO USA, LLP. Ninety-five percent of firms plan to close five deals or less within the coming year, a slightly higher projection than last year's survey, when 87 percent of respondents said they would close no more than five deals. Overall, the study found that firms are largely planning to replicate 2015 investment levels and priorities in 2016 as they wait out current economic fluctuations.

Investment levels are also more conservative, with 93 percent of managers expecting to invest $250 million or less in the coming year, up from 88 percent in 2015. Further, approximately 66 percent of firms highlight investments in new platform deals as their chief deployment of capital over the past 12 months, compared with 67 percent in 2015. Last year, add-on deals were the second-most cited use of capital, with 24 percent of fund managers seeking out this type of investment.

Private equity leaders also believe the challenges they faced in 2015 will hold steady in the coming year. As in our 2015 study, pricing remains the top challenge respondents expect PE firms to face this year, cited by over a third of those surveyed. At the same time, 64 percent of fund managers cite gaps between buyer and seller pricing expectations as their top obstacle when it comes to closing deals, up from 48 percent in 2015. With the past few years largely favoring the sell-side, many sellers may still be trying to command high prices despite economic realities beginning to favor buyers.

"After the successes private equity experienced in 2014, market unevenness and a sluggish deal landscape led to a plateau in 2015. As we kick off 2016, fund managers are being prudent about deploying their dry powder as they wait to see how the economy continues to recover and consider industry shake-out of weaker players," says Lee Duran, partner and Private Equity practice leader at BDO.

Despite fund managers' conservative 2016 planning, 70 percent of respondents still feel optimistic about the investment environment for the year ahead, up from just over half of respondents (56 percent) in 2015. Forty-one percent of respondents believe that private equity raises will be a primary factor in driving deal flow, while 43 percent cite private company capital raises and sales.

Fund Managers Expect Increasing Valuations to Continue for Technology & Healthcare Companies

Fund managers cite the technology (65 percent) and healthcare/biotech (63 percent) sectors as the industries most likely to experience rising valuations throughout the coming year, consistent with their sentiments in 2015. Sixty-eight percent of respondents believe valuations for tech are likely to grow in the next 12 months, likely owing to the sector's continued advancements in scalable IT services and cloud computing, as well as the proliferation of founder-owned startups.

Private equity firms were extremely active in the robust healthcare/biotech M&A environment last year, and that trend is expected to continue in 2016 with the ongoing consolidation of service providers and increasing investment in healthcare technologies like mobile and telehealth. Sixty-three percent of fund managers surveyed believe it will be a key sector for increasing valuations in the upcoming year. Conversely, 59 percent of those surveyed deem the retail & distribution sector the most likely to see declining valuations this year as growth in the industry continues to stagnate and consumer confidence remains volatile.

"While PE interest in some healthcare segments, such as hospital and inpatient services, has been tempered up to this point, PE funds continue to be active in specialty areas such as behavioral health, dermatology and pain management, where they can leverage their operational expertise through a buy-and-build strategy and scale," says Patrick Pilch, managing director and Healthcare Advisory practice leader with The BDO Center for Healthcare Excellence & Innovation.

Close to one-third of those surveyed said the manufacturing sector will generate the greatest opportunity for investment in the next 12 months. Though the manufacturing sector in the U.S. has suffered from lagging exports due to a strong U.S. dollar and weak demand for durable goods, investors see opportunity thanks to the low cost of energy in the United States.

"Manufacturers are taking advantage of current conditions to set themselves up for future success," says Dan Shea, Managing Director with BDO Capital Advisors, LLC and a member of BDO's Private Equity practice. "The U.S. has a sustainable energy cost advantage thereby making U.S. manufacturers more competitive globally. As such, the appeal of the manufacturing industry for private equity investment may continue for years to come."

After a tumultuous year in the sector, fund managers are somewhat polarized in their expectations for natural resources & energy companies, who have seen valuations steadily fall alongside oil prices. While 57 percent of those surveyed believe the industry will continue to experience decreasing valuations over the next 12 months, over a third believe valuations will increase, and 15 percent believe natural resources & energy will offer the greatest opportunity for investment. This disparity is likely driven by uncertainty about how natural resource and energy companies will weather the continued lower prices and fallout of weaker companies.

Investment in Emerging Markets Tepid as Economic Woes Persist Globally

Despite the decrease in deal flow in the latter half of last year, fund managers have a generally optimistic view of the international investment environment, with a majority (65 percent) believing it will be favorable for PE firms looking to invest. However, 65 percent of respondents do not anticipate doing any additional activity, on top of what they are currently doing.

The number of firms saying they plan to pursue more cross-border deals has grown this year, suggesting that some funds may be increasingly willing to expand their geographic focus in order to find good deals. However, they are still in the minority of respondents, with 65 percent of fund managers not anticipating any additional international activity in the coming year.

While attitudes surrounding international investment have largely remained the same, there have been significant shifts in where fund managers believe opportunities lie. Only 14 percent of PE managers believe Asia will present the greatest opportunity for new investment outside North America, versus 41 percent in 2015. Though China's economic growth remains strong relative to other countries, its perceived slowdown has resulted in concerns that a depreciation of wealth and investor jitters may create fewer investment opportunities in the region. Similarly, just 14 percent cite Latin America—which is facing its own economic hardships—as a top investment opportunity, down from 45 percent last year. Survey respondents perceived Europe as the best for new opportunities in 2016. Respondents may be viewing Europe as a more stable and predictable market compared with some of the uncertainty in other regions.

The challenges funds face in pursuing international activity, however, remain largely the same. Fund managers point to local resources (31 percent), cultural nuances (30 percent) and regulations impacting cross-border acquisitions (23 percent) as the top challenges investors expect to face when evaluating or engaging in international transactions, consistent with 2015 results.

These findings are from the seventh annual *BDO PErspective Private Equity Study*, which was conducted from October through December 2015 and examined the opinions of more than 140 senior executives at private equity firms throughout the United States and Western Europe.

Other major findings from the ***BDO PErspective Private Equity Study*** include:

- **Industry specialization and personal relationships are integral to deal sourcing:** A majority of PE leaders (57 percent) say they specialize in an industry or region in order to identify and successfully execute deals, using their capital to focus on key industries and markets, especially in less traditional areas where capital may be lacking. Fifty percent work with buy-side intermediaries, such as bankers, as a sourcing strategy. This suggests that PE sponsors continue to rely on direct networking and relationships with intermediaries in order to target potential investment opportunities.
- **As deal volumes stagnate, funds are looking for add-ons to cushion low valuations:** An overwhelming majority (88 percent) of fund managers sought add-on acquisitions last year in response to current market conditions, and the same percentage plan to use this strategy in 2016. Competition for sizeable deals is fierce in the current marketplace, and with deal volume languishing, tuck-in deals offer a relatively low cost and low stakes way to add value to an existing portfolio.

The BDO PErspective Private Equity Study is a national survey conducted by PitchBook, an independent and impartial research firm dedicated to providing premium data, news and analysis to the private equity industry.