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What's in Store for PE in 2017, Trends and Practices

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After a deal-rich 2015, 2016 saw a decline in PE activity. Both PE deal volume and deal count fell approximately 20% year on year. Target valuations remained high. Relatively high purchase price multiples, combined with increased competition from strategic buyers rife with cash and seeking external growth, made for a challenging environment. PE exits also declined by approximately 25% as capital markets continued to struggle and PE firms postponed sales to avoid price cuts that would erode overall returns. On the bright side, fund raising only dropped marginally and for the fourth consecutive year, private capital raised globally exceeded $300 billion.

Deals have become more difficult to source and more expensive to complete since financial buyers may be forced to invest a greater proportion of equity to avoid overleveraging investments. Moreover, holding periods have become longer as PE firms have chased suitable but often fleeting exit windows to maximise returns. These factors are coming together to drive changes in the duration of funds and their return profile, as well as a greater number of deals where PE firms team up with family offices to make up the additional equity required. At the same time, family offices are emerging as yet another alternative to, and therefore competition for, PE investments.

The amount of time PE firms hold on to buyout investments has increased steadily − from 4.1 years in 2008 to almost 6 years in 2014.[1] Europe had the longest average holding period, having increased from 4.1 years in 2008 to 6.2 years in 2014. This increase was most pronounced in deals worth $1 billion or more, where the average holding period increased from just 3 years in 2008 to 7 years in 2014.[2] The average holding period decreased in 2015 to approximately 5.5 years, likely as a result of the record number (1,700) and value ($442 billion) of private equity-backed exits in the relevant period. Investment holding period is a crucial factor to PE firms as it is generally more challenging to generate a high return over a longer investment holding periods. While longer holding periods may affect PE firms' ability to meet investors' return expectations, faced with the alternative of selling within a given timeframe, but making little profit (or even a loss) or holding onto the investment with a view to selling at a better time, PE firms naturally lean towards the latter. On the other hand, PE investors may grow impatient if they perceive investments are being held on to for longer than anticipated while continuing to pay high fees. This dynamic is driving a structural change.

PE firms such as Blackstone and Carlyle are developing funds with longer investment hold periods, potentially twice as long as a traditional fund. Carlyle has already raised $3 billion and invested $500 million in one of these funds, which will invest in technology start-ups,[3] and Blackstone has raised $670 million of their target $5 billion for a long-term fund with a lower risk profile.[4] This shift will require an investor base willing to invest patient capital, such as pension or sovereign wealth funds, and a different fee schedule as the return (IRR) would be lower. This change will allow PE firms to target businesses that need long-term capital and do not intend to go public in a 3–5 year period. A longer time horizon will also allow PE to address the ever increasing cost of sourcing deals in a market that becomes more competitive every day.

As PE firms readjust to new market conditions, family offices have emerged as a player to reckon with. Single-family offices manage about $1.2 trillion in assets, and multi-family offices manage approximately $550 billion.[5] Family offices have come about as an alternative way to put private capital/wealth at work, but have gained momentum as a valid means to address some of the perceived PE pitfalls. Direct investment allows family offices to avoid PE fees, obtain greater control over the investment and determine the holding period themselves, in the hope of realising higher returns. On the other hand, family offices are also an equity ally to PE firms that seek additional capital at a time when the traditional investors base may not be as willing to open their coffers.

Family offices have been poaching private equity experts to manage their direct investments, and we see this as a trend that will continue. On the investment side, they have until recently mostly purchased minority interests in target companies, but as they grow more confident in their direct investing abilities and their structure develops, we see them beginning to purchase controlling interests, which will pitch them against, and in direct competition with, PE firms. On the fund raising side, the larger family offices have begun to attract funds from investors that are external to members of the family. As the wall of secrecy surrounding family offices subsides somewhat, they have also started teaming up to compete with other players by pooling capital together to generate scale as well as sourcing deals.

Family offices can be attractive bidders because of their willingness to invest patient capital and be flexible. On the other hand, family offices are unlikely to engage in bidding wars and are wary of high valuations, mainly as a result of their using 50% or less debt capital when funding deals. Low bids are the most common reason investment bankers cite when family offices fail to win auctions.

The increase in direct investments, however, has not been matched by a decrease in investment in PE funds. Large majorities of single-family offices believe both private equity and direct investments outperform traditional portfolios. The majority of single-family offices invest in PE funds and are likely to increase their allocation to PE funds in the next few years. Numerous sponsors/GPs indicate that family offices have an increasing desire to invest in PE, which is supported by the fact that family offices increased from 7% to 11% of LPs in PE funds between 2010- 2015.[6]

PE firms are today more willing to offer co-investment rights, and we see that family offices that are LPs are eager to take up the offer. Co-investment is attractive in many ways, it can improve the LP's return profile on the one hand (by improving the net (after fees) returns), and keeps a potential competitor close on the other hand. One survey of GPs found that 69% offered co-investment rights to investors, with an additional 18% considering doing so in the future. These advantages measure against the impact to the relationships between GPs and LPs. In return for additional capital, LPs may gain preferential/elite rights that sometimes create friction with the GP itself or other LPs that enjoy no such rights.

We think PE will continue to evolve and change to address these challenges. Industry-specific funds with tailored holding periods and fee schedules will become more common. At the same time, we see the potential for large family offices to develop into quasi PE structures, adding to the arena of competitors. Increasing competition is likely to drive more positive changes (more efficient management, greater cost control), but will also continue to fuel high valuations at a time when it is not unthinkable economic growth may slow down and the opportunities for investment shrink.

Endnotes

1. *Private Equity Spotlight*, Preqin, p. 7 (May 2015).
2. *Id.* at 8–9.
3. *Carlyle Said to Raise More Than $3 Billion for Long-Term Fund*, Bloomberg Technology (Feb. 9, 2016), available at http://www.bloomberg.com/news/articles/2016-02-09/carlyle-said-to-raise-more-than-3-billion-for-long-term-fund.
4. *Blackstone Core Equity Partners Raises Almost $670M*, Pitchbook (Apr. 25, 2016), available at http://pitchbook.com/newsletter/blackstone-core-equity-partners-raises-almost-670m.
5. *Family Offices Team Up Taking Page from Private Equity*, Bloomberg (May 28, 2014), available at http://www.bloomberg.com/news/articles/2014-05-28/family-offices-team-up-taking-page-from-private-equity.
6. *Private Equity Fund Manager Outlook for 2016*, Preqin, p. 5, 12 (February 2016).

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