Q4 2016 GLOBAL PRIVATE EQUITY UPDATE

Private Equity Trends

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Introduction

Reflecting the overall deal market in 2016, private equity also had some ups and downs. But generally the market remained strong, with some outlets reporting that the number of private equity deals in 2016 was at an all time high. As 2017 begins, across multiple jurisdictions we see the combination of significant undeployed capital, a limited supply of quality targets and an increasing number of participants supporting a continuing seller-favorable environment. The table below summarizes some of the key practice trends in sponsor acquisitions of private companies across the U.S., Europe and Asia.

U.S.	Europe	Asia
Deal Landscape		
As a result of the seller-friendly market, many traditional large and middle market buyout firms are executing alternative strategies to deploy capital. A number of these firms have announced dedicated growth equity funds (ABRY Partners, CVC Capital Partners, KKR, Providence Equity Partners and others) leading to increased competition in the growth equity space. Correspondingly, there has been an increased focus by many sponsors on "buy and build" strategies where the sponsor targets smaller value deals with the express goal of executing multiple add-ons. U.S. sponsors have seen increased participation from non-U.S. buyers, especially Asian investors, including Asian PE funds which have recently raised large funds. Large institutional LPs also continue notably to actively co-invest with their GPs, allowing the LPs to avoid extra fees and providing the GP with	Brexit was the single most influential factor in the European private equity markets last year. The shock outcome of the referendum shaped European investor sentiments, dampening sponsor appetite for larger buyouts. However, middle market deal volume remained comparatively buoyant as the market saw both traditional mid cap players and larger fund participants refocus attention on smaller transactions. There has been an increase in extremely competitive auctions compared to previous years. While historically common in the U.S., in Europe it became increasingly popular to see auction processes run down to the wire with multiple bidders required to deliver fully executed transaction documents and winning bidders chosen on a final sealed envelope basis. European sponsors responded to the competitive environment, in part, by increasing exposure to	For cultural, regulatory and other reasons, Asia has historically been a growth equity market with relatively few change of control transactions. The competition for quality targets has risen to record levels. In a crowded market, a typical auction may involve strategic companies competing with international, regional and "local" private equity funds for the same asset. Even larger transactions are now becoming more and more competitive as many Asia-based PE firms have successfully raised funds in excess of $3 billion (PAG, Baring Private Equity Asia, MBK Partners and others) and are now able to compete in much larger LBOs or investment opportunities traditionally reserved for international PE funds with greater capital. An example of this phenomenon is the acquisition by MBK Partners of Tesco PLC's South Korean operations for $6.1 billion in

U.S.

additional equity firepower and diversification of risk, but also deciding to invest directly with more frequency.

There has been an uptick in sponsors trying to preempt the auction process in an attempt to reduce a time-consuming and costly process that ultimately may not result in an acquisition. While price is always king, a preemptive bid can be attractive to a target that is concerned with disclosing competitively sensitive information to competitors or avoiding a lengthy bid process.

Finally, there has been a rise in private equity-sponsored SPACs. SPACs are publicly-listed special purpose acquisition companies that raise funds in order to acquire unspecified future targets. Several successful private equity firms have raised SPACs, including TPG, The Gores Group, WL Ross, Avista and others. This strategy allows traditional PE sponsors more flexibility, whether it is using public stock as consideration, allowing the sponsor to invest in industries otherwise prohibited by fund documents or being freed from specific return pressures.

Europe

consortium arrangements, or "club deals", as a method of reducing competition and spreading capital risk and also by looking to LP co-investor syndication with more regularity.

Brexit's impact on currency value was particularly acute in the U.K. The depressed sterling created an attractive market for U.S. dollar-denominated sponsors operating in Europe, who were more active than usual. Chinese demand for investments in Europe also remained strong in 2016 with Chinese wealth funds and private investors becoming staple features on auction contact lists.

Asia

cash in 2015.

In addition to raising larger funds, Asia-based GPs are taking a cue from their U.S. and EU counterparts and increasingly offering co-investment opportunities to their LPs.

As the level of competition increases, a number of Asia-focused PE firms are also seeking to differentiate themselves by focusing on specific sectors/strategies (e.g., real estate or special situations) or countries.

Finally, there have been increased investments in emerging Asian markets such as Vietnam, where investment more than doubled in 2016 when compared to 2015. This is a combination of the differentiation strategy described above and more relaxed foreign ownership restrictions and policy reform in those regions.

Key Deal Terms

U.S.

Sellers continue to enjoy seller-favorable deal terms, with more risk being shifted to buyers. Most non-strategic sales continue to be done as "public-style" deals where there is no (or limited) post-closing seller indemnification. Over the years, the valuation point at which deals are done on this basis has continually decreased. In even small and lower middle market deals we are seeing sellers requiring buyers to purchase representation and warranty insurance and capping seller's indemnity at half the retention amount of the insurance policy. As the use of such policies expands to a broader spectrum of deals, sellers have been increasingly willing to share the cost of such policy. In addition, with the increasing prevalence of representation and warranty policies, the number of insurers entering the field is on the rise. As a result, some new entrants are starting to offer (i) marginally better policy terms (premiums, deductibles and exclusions) and (ii) shorter underwriter periods.

Some other terms sponsors are increasingly willing to provide are full equity backstops (versus reverse termination fees) and fixed time periods for closing (versus marketing periods).

Europe

As in the U.S., deal terms continue to be influenced by a seller-favorable market. As a result, buyers accepted comparatively aggressive seller positions with greater consistency, including shorter claim periods, reduced scope of warranty cover and more extensive warranty limitations (for example all business warranties being given on a knowledge qualified basis).

Traditional buyer protections such as key manager non-solicits were also less common and buyers were increasingly prepared to pay for certain seller transaction costs (such as the cost of vendor due diligence reports prepared for the benefit of bidders) and accept reverse break fees, which were traditionally rare in Europe.

Regulatory risk sensitivity was a key theme in 2016 and despite the seller market, sponsor buyers were relatively successful in moving away from hell or high water obligations in relation to regulatory conditions.

Representation and warranty insurance (called "warranty and indemnity" insurance in Europe) continued to be an important feature of European sponsor transactions, often appearing in auction sales as a standard to justify lower aggregate seller liability caps. Synthetic warranty and indemnity insurance policies (with £1 seller liability

Asia

The deal terms in Asia, particularly for quality assets, reflect the seller-friendly environment.

Deal terms in Asia also reflect the confluence of law firms from other markets (New York, London, etc.) and the importation of deal technology from those markets into Asia. For example, locked box mechanisms were typically used in European deals, and rarely seen on Asian deals (where buyers favored a cash-free, debt-free, target working capital mechanism). Locked box mechanisms are becoming more common in Asia.

As in the U.S., private equity sellers are increasingly seeking a "public-style" or "walkaway" deal where there is no (or limited) post-closing seller indemnification.

As in the U.S. and EU, private equity sellers are also increasingly asking for, and private equity buyers are increasingly pre-emptively offering, representation and warranty insurance.

It still remains the case that the terms of the insurance (including pricing) can differ materially between jurisdictions, with such insurance being more attractive in certain Asian jurisdictions (e.g., Hong Kong, and

U.S.	Europe	Asia
	caps as opposed to the more traditional warranty and indemnity insurance policies with higher seller liability thresholds) were also used with more frequency, particularly on smaller transactions.	Singapore) than in others (e.g., China). A very large majority of the insurance policies are buy-side policies, and it is rare to see sell-side policies in the Asian market. Full equity backstops remain rare in Asia private equity transactions, although we do see them in certain situations (such as very competitive auctions).
Financing Terms		
As a result of increased competition to finance middle market acquisitions, large cap terms are being increasingly adopted in middle market transactions, including additional carveouts from the “MFN” on issuances of new debt and a shortening of the “MFN sunset” provision. The increased competition has also led to reduced pricing, resulting in sponsors frequently refinancing existing debt with less expensive debt. In response to increased enforcement of the leveraged lending guidelines, direct lenders and other non-regulated lenders have been competing for an increased portion of market share versus traditional banks. Additionally, there has been a recent trend away from a traditional marketing period and toward a fixed minimum period from signing to closing. The length of the fixed period varies depending on the dynamics of each deal, but 30 or 45 days is common.	As a result of the shortage of supply in the 2016 European financing market, borrowers have received increasingly friendly terms. This has led to downward pricing with sponsors regularly repricing/recapping existing deals. Given the borrower-favorable market, in 2016 there remained limited opportunities for high yield debt. However, “high yield in disguise” has become increasingly popular in large cap financing structures with loan form and pricing but with high yield bond covenants, that are characterized by having fewer restrictions on borrowers but with higher yields. Additionally, an expansion of investor appetite for yield in 2016 led to a return of PIK facilities above highly levered operating groups.	An increasing number of deals in Asia involve leverage and this trend is expected to continue in 2017. In Asia, financing terms can vary significantly from deal to deal, making it difficult to establish a “market standard”. It continues to be the case that local deals are being principally financed by local banks.

U.S.	Europe	Asia
Exits		
Partially as a result of 2016's volatile IPO market conditions and partially a result of the competitive sale auction climate, private equity firms have increasingly sold their portfolio companies to strategic buyers or private equity investors, rather than taking these companies public. However, IPO activity increased in the last half of 2016, and we are seeing signs that this trend will continue. Given the continued low interest environment, sponsors' extensive dry powder power and the willingness to adopt some of the pro-seller deal terms described above, sponsors effectively competed with strategics in 2016 and we'd expect this trend to continue.	Given volatile public markets and a number of aborted IPO launches in 2016, IPOs and dual track processes have been less popular. Exit activity was down by around 14% as compared to 2015, partially as a result of longer hold periods and increased focus on add-on/bolt-on transactions and operational improvement. Similar to the U.S., European exits were predominantly driven by strategic investors and the secondary buyout market. The secondary buyout market was particularly buoyant, also fueled by significant levels of dry powder and attractive access to leverage and debt capital markets. Lack of quality asset availability contributed to a rollover trend in 2016 exits, where existing sponsors looked to retain a minority stake alongside the buyer.	Volatility in the IPO markets in China and Hong Kong has recently lessened their attractiveness as an exit mechanism. In 2016, trade sales were the preferred exit mechanism for sponsors, but we are also seeing an increasing number of secondary transactions.
Fund Raising		
North America-focused fundraising was strong again in 2016 – more than 450 funds reached final close, raising a combined $188 billion. 2016 marked the fourth consecutive year in which aggregate fundraising exceeded $175 billion. Given the significant amount of capital currently available to fund managers, GPs are aggressively searching to deploy their capital over the next 12 months.	European-focused fundraising in 2016 was strong, exceeding levels raised in 2015 at €100bn. Over 40% of this amount can be attributed to five Europe focused mega funds, which closed funding in the aggregate for €44bn of capital and as a result, the market is entering 2017 against a backdrop of ever increasing dry powder from previously capital raises. LP investment activity continued to be driven by rising demands for exposure to higher yield opportunities in growth equity and venture capital markets. Since sovereign wealth funds have greater tolerance to illiquidity than other investor types and are focused on absolute returns, there has been a notable increase in the overall appetite of sovereign wealth funds for private equity. GP's pricing discipline continued to be a key theme in 2016 and will remain such in 2017, especially for larger deals in an environment where purchase multiples continue to rise. Given increased competition amongst private equity firms, GP's face sustained downward pressure on manager fees and increased scrutiny on ensuring proper alignment of GPs' and LPs' interests. While political uncertainty in Europe has caused some GPs to defer fund launches and/or consider changing fund jurisdictions, funds representing €80bn of capital are currently in the market echoing the fundraising momentum of 2016.	In Asia, the fundraising market continues to be highly competitive for Asia-focused private equity managers and investors looking to invest in the leading Asia-focused funds. In Asia, top tier regional sponsors compete on an equal footing with global sponsors for capital and targets. Asian LPs continue to invest aggressively in "best of class" funds, which raise large amounts of capital quickly, sharply differentiating them from the rest of the market. Fund growth continues to be mostly in country-focused and, increasingly, sector-focused funds.

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