BDO

ABOUT THE STUDY

The ***BDO Ninth Annual Private Equity PErspective Survey*** is an international survey of more than 230 senior executives at private equity firms in the U.S. and internationally. The survey is administered by PitchBook, an independent and impartial research firm dedicated to providing premium data, news and analysis to the private equity industry.

Private Equity Firms Continue Hunting for Quality Deal Flow in 2018

Record-breaking amounts of capital and cheap, easily accessible debt have driven valuations to sky-high levels. But as the amount of capital available for investments far outpaces the acquisition opportunities that exist, deal activity is slowing down.

Further constraining the deal making environment is the Trump administration's decision to tackle tax reform, leading many private equity firms to take a wait and see position.

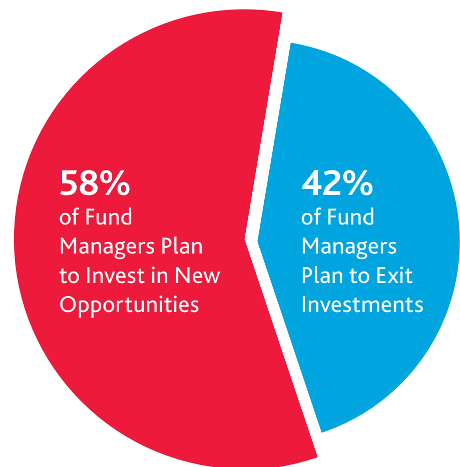
Despite these factors, 58 percent of private equity fund managers intend to continue seeking acquisition opportunities over the next 12 months, according to ***BDO's Ninth Annual Private Equity PErspective Survey***. After all, firms must put their dry powder to work if they're ever going to be able to distribute capital back to their investors.

Still, institutional investors continue betting on private equity as a provider of good returns. In fact, 37 percent of fund managers point to institutional interest in the asset class as the main driver of dry powder accumulation, followed by competition for deals (31 percent), and high valuations (24 percent).

Respondents identify family offices as the main source of commitments (37 percent), followed by pension funds (22 percent). Last year, 46 percent said family offices were their main source of commitments while 20 percent pointed to pension funds.

According to private equity fund managers, these institutional investors are mostly looking for firms with solid track records (55 percent), strong management teams (10 percent) and ability to source deals (nine percent).

PLANS FOR 2018: ACQUISITIONS VS. EXITS



"Private equity firms are up against very tough competition. That could tempt some firms to pay up for less-than-ideal targets, but if they can instead find those few diamonds in the rough that no one else has thought to look at, they will do very well by avoiding the high valuations and intense competition."

Scott Hendon, BDO's National Leader of Private Equity

The Trump Administration & Tax Reform Bring Hopes and Challenges

Overall, private equity firm partners surveyed expect the Trump administration to have a favorable effect on the environment for private equity, with 42 percent saying the new government could increase investor interest in the asset class and only nine percent believing the contrary.

However, tax reform proposals bring a major caveat, with 57 percent of private equity fund managers describing them as the national policy issue that is having the greatest impact on their firm's investment strategy.

As expected, when asked about the tax reform proposals anticipated to have the greatest negative effects on private equity, fund managers point to carried interest being taxed as ordinary income rather than as capital gains (48 percent) and the elimination of interest rate deductibility (44 percent). Versions of both these provisions are included in the tax reform bills that was signed into law on December 22.

Regarding interest rate deductibility, until now, private equity firms were able to deduct 100 percent of their interest payments on corporate debt. The new tax regime caps interest deduction to the sum of business interest income plus 30 percent of the

IF PRIVATE EQUITY COULD VOTE ON TAX REFORM PROPOSALS:

YEA:

- ☑ **Corporate tax cuts**

NAY:

- ☒ **Elimination of Interest rate deductibility**
- ☒ **Carried interest being taxed as ordinary income**

adjusted taxable income of the taxpayer for the taxable year. Adjusted taxable income is defined similar to EBITDA for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2022, and is defined similar to EBIT for taxable years beginning after Dec. 31, 2021. Limitation applies to both related party and unrelated party debt. Disallowed interest is carried forward indefinitely. For a highly-levered industry like private equity, limiting interest rate deductibility could lead firms to reduce their issuance of debt and change the way they finance acquisitions.

This is likely to encourage firms to shift towards using more equity to finance deals, exacerbating the decrease in returns on investment, which is already being hurt by high acquisition multiples.

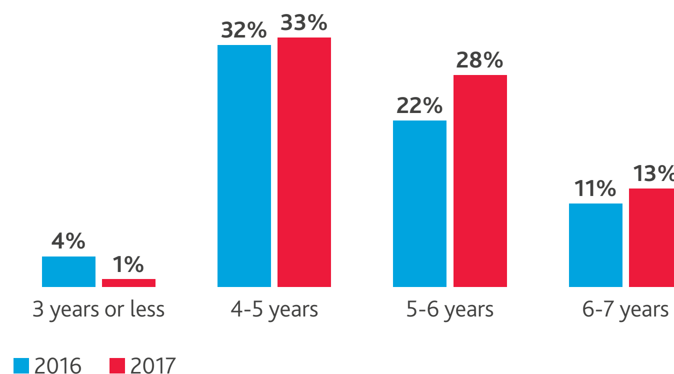
As for carried interest, the "carry," or profit gained from investments, was previously taxed at 20 percent if the underlying investments are held for over one year. The new tax reform law proposes that any gains from investments held for under three years should be taxed as ordinary income. This shouldn't have much of an impact on private equity's tax bill, as investments are usually held for more than three years. Hedge fund managers, however, could be adversely impacted by the jump in holding periods from one to three years as their holding periods tend to be shorter.

But private equity holding periods are getting longer. The percentage of fund managers holding on to investments for an average of four to five years has grown from 32 percent in 2016 to 33 percent in 2017; those with hold periods averaging five to six years has gone from 22 percent to 28 percent; and those with hold periods of six to seven years have grown from 11 percent to 13 percent.

The trend should continue in 2018, with 51 percent of fund managers expecting to extend holding periods.

If private equity firms could write up a tax reform wish list, the first items on their list would be income tax simplification and a lower corporate income tax, with 32 percent of respondents

AVERAGE HOLDING PERIODS IN EXPANSION MODE



choosing both. Meanwhile, 26 percent would add lower tax rates for partnerships and seven percent would ask for lower capital repatriation rates.

Private equity firms did end up getting some of the items on their wish lists.

For instance, the corporate tax rate—was cut from 35 percent to 21 percent, effective for taxable years after Dec. 31, 2017.

U.S. shareholders of certain foreign corporations are also allowed to include into taxable income their pro rata share of such foreign corporations' undistributed earnings. Such earnings held in cash and cash equivalents are subject to a 15.5 percent rate and an 8 percent rate applies to all other earnings..

In addition,the bill that was signed into law includes a dividend exemption system in which certain U.S. corporate shareholders would be entitled to a 100% dividends-received deduction for dividends received from certain foreign corporations, essentially exempting such dividend from U.S. tax. Non-corporate taxpayers however would not be entitled to such an exemption.

"With a lower repatriation rate, strategics should have an incentive to pull cash from foreign subsidiaries and pay higher multiples for deals in the U.S., leaving private equity firms at a disadvantage."

Keith Mannor, Tax Partner at BDO

European PE Shops Face the Same Challenges as U.S. Peers

European private equity trends are increasingly mirroring those seen in the U.S., including the extreme competition for deals and the mismatch in buyers' and sellers' price expectations.

The vast majority of non U.S.-based fund managers[1] who participated in ***BDO's Ninth Annual Private Equity PErspective Survey*** are based in Europe. And just like their U.S.-based peers, most of which are based in the Northeast and especially in New York, they are concerned about the gap between buyer and seller price expectations, with 42 percent of survey respondents deeming it the main challenge to getting deals done.

Also, 32 percent of international fund managers point to increased competition from private equity peers, just like in the U.S.

It's the same story repeating itself on both sides of the Atlantic: a strong fundraising environment and easy access to leveraged loans with loose covenants is driving up both asset valuations and competition for quality deals.

Fundraising in Europe hit €74.5 billion in 2016, a 37 percent increase over the previous year and the largest amount since 2008, according to **Invest Europe**. That amount was collected by 74 funds, also the highest number since 2008.

Meanwhile, the use of covenant-lite leveraged loans, once rare in Europe, has skyrocketed. As of May 2017, cov-lite loans, which offer little protection to lenders, made up almost 73 percent of all European loan supply, according to data compiled by **Standard & Poor's LCD**. This is well above the 55 percent share seen at the same point last year. The year's European cov-lite share is nearing the U.S. record set in 2016, when such deals accounted for 75 percent of all volume, LCD notes.

These factors, in turn, are driving up valuations. According to **Fitch Ratings**, buyout firms in Europe paid an average of 11.6 times EBITDA for targets in the first half of 2017, up from an average of 10 times EBITDA seen the previous year.

But the show must go on, so just like their U.S. peers, international fund managers intend to continue seeking acquisition opportunities, with 79 percent of respondents already directing most of their capital toward new deals. About 82 percent of them plan to make between one and four new platform deals in the next 12 months.

Whatever number of acquisitions they do manage to close, one thing is certain: they will likely have to hold on to these investments longer than usual, with 58 percent of international respondents expecting investment periods to increase.

1 International fund managers comprised about 35% of the respondents.

Deregulation and Protectionist Measures on the Horizon

There are other policy issues that are keeping some private equity firms from getting deals done. For 27 percent of private equity fund managers, international tensions such as the rhetoric between the U.S. and North Korea and turmoil in the Middle East are causes for concern. NAFTA renegotiations, and talk of protectionist measures, also bring pause to 23 percent of respondents.

Regulations continue impacting private equity funds. Respondents say they have been mostly affected by Dodd-Frank, including fund registration requirements (28 percent), the Alternative Investment Fund Managers Directive (22 percent), the possible repeal of the Affordable Care Act (15 percent), the Foreign Account Tax Compliance Act (15 percent), the Jumpstart our Business Startups or JOBS Act (four percent) and the new partnership audit rules under the Bipartisan Budget Act (four percent).

"Heading into 2018 the new centralized partnership regime rules under the Bipartisan Budget Act open the door for substantial risk for private equity firms as they could unknowingly take on the exposure for imputed tax liabilities of companies they acquire."

Jeffrey N. Bilsky, Technical Practice Leader, BDO National Tax Office Partnership Taxation group

Deploying Capital is Tough, But It Must Be Done

Fifty-eight percent of private equity fund managers are more interested in making acquisitions rather than selling, while 42 percent noted they would rather focus on exiting investments.

Moreover, 64 percent of respondents indicated they intend to increase the amount of capital they deploy, while 31 percent plan to invest the same as usual, with only five percent expecting to decrease the amount of capital they will invest.

That capital will likely go to finance between one and four platform deals, with the plurality—33 percent— of respondents specifically expecting to make two platform deals over the next 12 months.

While private equity firms may express an interest in making more acquisitions, they will have to overcome a few roadblocks to bring those deals to fruition. When asked about the top challenges to making investments, 39 percent of survey respondents point to the gap between buyer and seller price expectations.

To wit, during the third quarter of 2017, median enterprise value-to-EBITDA multiples reached 10 times, well above the five-year median multiple of 7.6 times, according to PitchBook. This is certainly bringing pause to potential buyers.

The gap in price expectations may widen even more over the next year in some industries. For instance, when asked which three industries could see valuations increase over the next 12 months, 67 percent of respondents point to technology, 59 percent mention healthcare & biotech, and 37 percent choose financial services.

Additionally, private equity firms seek to embrace disruptive technologies that will transform the way different industries operate. About one quarter of fund managers (26 percent) see retail and distribution as the sector that is bound to undergo the most transformation, closely followed by technology (25 percent), and healthcare & biotech (12 percent).

Intense competition is another challenge to getting deals done. While 71 percent of fund managers say other private equity firms are their main competition, strategic acquirers are also getting in their way. Because strategics can extract synergies by acquiring companies and merging them into their operations, they are able to pay higher multiples in an already frothy environment.

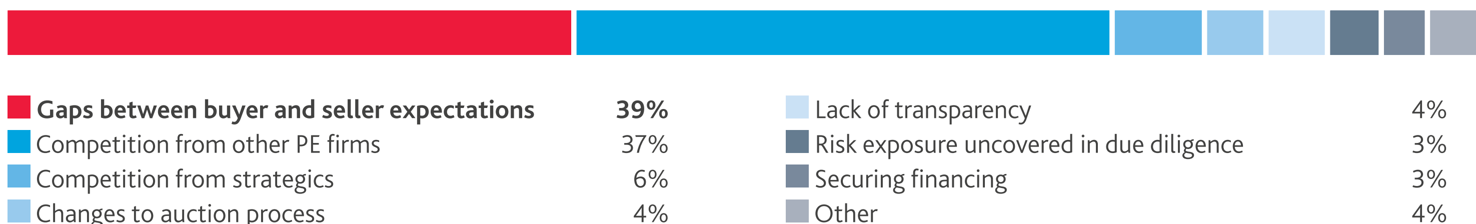
Despite reports of institutional investors such as family offices and pension funds increasingly looking to make direct investments, thus bypassing the private equity middleman, only about seven percent of respondents see these investors as competitors.

Then of course, there are only so many potential acquisition targets for private equity buyers to pursue. And out of the finite amount of companies that do exist, not all of them are necessarily worthy targets. Given that valuations are so high, and are expected to remain high over the near future, private equity firms are being very careful and trying not to overpay.

That explains why private equity firms have focused mostly on acquiring high-growth companies. According to PitchBook survey data from the third quarter of 2017, 61 percent of deals executed by survey respondents involved target companies with over 10 percent revenue growth in the trailing 12 months.

That said, more than eight in 10 fund managers (85 percent) expect the value of their portfolio to increase in the next year, with just three percent forecasting a decrease. Of respondents that are banking on an increase, 50 percent believe the value of their portfolios will increase between 11 and 25 percent over the next 12 months, while 25 percent expect the increase to be between zero and 10 percent. An additional 16 percent expect to see gains of more than 25 percent.

TOP CHALLENGES TO GETTING DEALS DONE



Are Sovereign Wealth Funds Gearing Up to Steal Private Equity's Thunder in Tech?

Sovereign wealth funds, state-owned investment vehicles, are not the principal institutional investors in tech-focused middle-market private equity funds. But this could change soon.

Tech-focused fund managers surveyed in ***BDO's Ninth Annual Private Equity PErspective Survey***, about 18 percent of all respondents, note that the financial commitments they receive come mostly from pension funds (41 percent) and family offices (36 percent), with about 24 percent coming from a mix of high net-worth individuals, fund of funds, banks, strategics, endowment funds and insurance companies.

However, sovereign wealth funds have been increasingly investing in private equity funds overall, with Carlyle Group co-founder and co-CEO David Rubenstein recently predicting that these investors will replace pension funds as the largest source of capital commitments.

So why haven't sovereign wealth funds marched en masse to tech funds yet? The answer could be that they are opting to invest directly in tech companies rather than getting that exposure via private equity funds.

In the year up to November 22, 2017, Asian sovereign wealth funds alone invested more than $6 billion directly into tech, $1 billion more than they did during the same period in 2016, according to the **Sovereign Wealth Fund Institute's SWF Transaction Database**.

And they invested all over the world, with some of their targets being Chinese internet company Meituang Dianping, Germany-based audio distribution platform Soundcloud, Denmark payment service provider Nets A/S, Norwegian software provider Visma, California-based advertising technology provider Turn Inc., and Ohio-based Vantiv, another payments processing provider.

It will be interesting to see how sovereign wealth funds, which have historically been passive investors, will fare in competing for deals as well as in the managing those investments without the assistance of a private equity middleman. After all, even highly-experienced private equity fund managers with strong track records of acquiring and managing technology companies have seen their own sets of challenges.

For instance, survey respondents say that directly managing tech companies entails challenges such as identifying growth opportunities (42 percent), and finding and retaining management teams (33 percent).

Among the tactics they plan to use to drive valuations upwards are to diversify products and services (96 percent), evaluate cybersecurity risks (95 percent) and implement digital transformation strategies (91 percent).

Still, an overwhelming majority, or 92 percent, of fund managers in private equity firms that invest mostly in the tech space expect the value of their portfolios to increase over the next 12 years.

It remains to be seen if sovereign wealth funds can efficiently switch gears from finding the best funds to identifying optimal acquisition opportunities, managing portfolio companies directly and then exiting them for a private equity-like return.

The other question is: will the investment in ramping up the infrastructure necessary to invest directly be less expensive than paying fees to a fund manager?

Planting the Seeds for Portfolio Growth

Portfolio management brings a whole other set of challenges to contend with. For instance, 37 percent of fund managers note that identifying and retaining skilled management teams is the top challenge, followed by finding growth opportunities (28 percent), changing outdated processes (23 percent) and dealing with a poor economic environment (nine percent).

To ensure portfolio company growth amid an environment of uncertainty, 94 percent of fund managers expect to invest in human capital, 90 percent will diversify products and offerings, 82 percent will implement digital transformation initiatives, 81 percent plan to cut costs, 77 percent will evaluate cybersecurity risks, and another 77 percent will adjust geographic footprints.

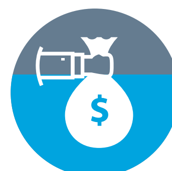
As firms evaluate their geographic footprints, the majority appear poised to remain stateside. Only 26 percent of fund managers plan to increase cross-border deals in 2018–down from 38 percent from what was expected in 2017—and 69 percent foresee that less than 10 percent of their funds will invest internationally. Those that do plan on investing outside of North America are most likely to look for deals in Western Europe (37 percent), followed by Asia and Southeast Asia (30 percent), South and Central America (17 percent), the Middle East and Africa (11 percent) and Eastern Europe and Russia (five percent).

Private equity firms are also willing to take on more leverage, or at least they were before the tax reform bill was signed into law. While 44 percent of fund managers were not planning on raising more debt, the remaining 56 percent did plan to raise debt over the next 12 months to refinance portfolio companies' existing debt, take dividend recaps and finance operational improvements.

LENDING TO PRIVATE EQUITY-BACKED COMPANIES HITS NEW RECORD

Previous record:

$530.2B



2013

New record:

$588B

2017

(as of Nov. 30)

Source: Thomson Reuters LPC

Manufacturing-Focused Private Equity Firms Eye NAFTA Reforms and Digitization

Among private equity firms with a majority of their investments in the manufacturing & distribution industry—comprising 37 percent of participants in *BDO's Ninth Annual Private Equity PErspective Survey*—the North American Trade Agreement (NAFTA) reform and digitization arise as the key issues.

Nearly one-quarter (24 percent) identify trade issues, including ongoing NAFTA renegotiations, as the most concerning global political issue. With the potential for more protectionist language to enter the agreement, fund managers with a stake in the manufacturing industry are acutely aware that their portfolio companies could incur a sharp increase in the cost of doing business.

Given the uncertainty surrounding NAFTA, it is no surprise these fund managers don't plan to venture outside of the U.S. much for acquisition targets. The clear majority (81 percent) plan to dedicate less than 10 percent of their fund to deals outside of the U.S. and about three-quarters (73 percent) will not pursue cross-border deals in 2018.

To continue growing despite the headwinds, the manufacturing & distribution industry is in the early stages of the fourth industrial revolution, or Industry 4.0, in which plants, processes, products and people come together in an entirely new way, blurring the line between the digital and physical. Borne out of a confluence of technology disruptions—from Big Data and analytics to the Internet of Things to artificial intelligence—Industry 4.0 ultimately hinges on the ability to integrate data with physical processes.

Private equity firms recognize the opportunity to scale up their portfolio companies' technology. Nearly nine in 10 (87 percent) plan to implement digital transformation initiatives at the portfolio company level in the next 12 months.

As manufacturing companies increasingly seek to become digital, cybersecurity is becoming a top priority, with eighty percent of fund managers surveyed planning to evaluate their current portfolio companies' cybersecurity risks.

Still, not all fund managers are considering acquisition targets' cybersecurity vulnerabilities prior to closing a deal. Fifteen percent report that cybersecurity due diligence is not at all important, nearly double the fund managers that say the same across all industries.

"We have heard that institutional investors plan to continue allocating capital to private equity, even if holding periods are getting longer and returns could see somewhat of a dip. That really speaks to the strength of the asset class, especially as it enters a maturity phase."

Lee Duran, BDO National Private Equity Partner

It's a Sellers' Market, but Where Are the Buyers?

A high-valuation environment would automatically be expected to drive sellers to the market. But the gap between buyers' and sellers' price expectations is putting a bit of a damper on hopes for abundant exit opportunities, according to 77 percent of private equity fund managers.

Exits are on a declining trend. According to **PitchBook** data, private equity exits continued their downward trend with $40.8 billion in value exited across 224 companies during the third quarter of 2017—a 20 percent drop in deal volume from the previous quarter.

This trend is likely to continue. In fact, only 13 percent of respondents expect deal flow over the next 12 months to be related to exits—likely because buyers are wary of overpaying.

But if sellers were to have their way, they would prefer to sell to strategics. The survey showed that respondents believe the exit types that will provide the best returns in the next 12 months will be sales to strategics (68 percent), followed by sales to private equity peers (19 percent), with initial public offerings (IPOs) coming in last with only two percent of respondents favoring them in the current environment.

When private equity firms are preparing to exit an investment, they are increasingly employing sell-side due diligence to proactively uncover and address any surprises that could impede the sale. Nearly half of fund managers (49 percent) say they employ a third party to perform sell-side due diligence on a "moderate" basis, while 24 percent do their own due diligence and do not hire outside vendors.

When a firm has an exit opportunity, other obstacles can pop up in the middle of the due diligence process. At the top of that list are cybersecurity vulnerabilities, according to the survey.

But being that data breaches at large companies make headlines more and more often, companies of all sizes are now aware of the importance of defending against possible hacks.

In fact, only eight percent of fund managers say cybersecurity due diligence is not important to them, while the remaining 92 percent say the opposite.

To prepare for a data breach, respondents say they are offering employee training (29 percent), testing for attacks (17 percent), assessing vendors' cyber risk (17 percent) and purchasing or maintaining cybersecurity insurance (eight percent), among other measures.

Overall, the private equity industry has continued growing despite the headwinds. A scenario of potentially softer returns will likely push firms to come up with innovative ways to make their portfolio companies' operations more agile and efficient.

At the onset of 2018, the influx of capital into private equity shows little signs of slowing, and it looks like firms' will continue to have the blessing of institutional investors. The fund managers that keep their sights on achieving steady returns in an overheated market are the players that will, in the long run, eclipse their peers paying inflated prices just to put cash to work.

Private Equity-Backed Retailers Seek to Stage a Comeback via E-Commerce

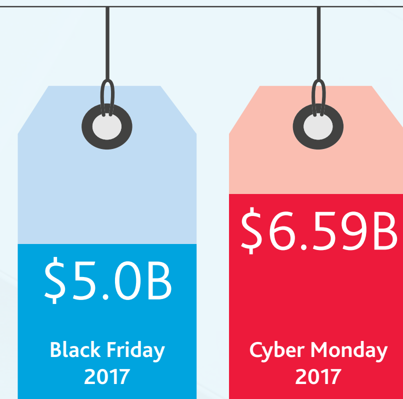
The retail industry has seen its fair share of turmoil in the past year, with the bankruptcies of well-known private equity-backed chains making headlines. Indeed, the world of retailing faces a do-or-die moment: Figure out how to compete against fast-moving internet-based megacompanies like Amazon, or perish.

As a result, retailers and their private equity owners are in pursuit of strategies to bring luster back to the industry. Fund managers at retail-focused funds who participated in ***BDO's Ninth Annual Private Equity PErspective Survey***, about 14 percent of all respondents, say they plan to have their portfolio companies invest in human capital (95 percent), diversify products and service offerings (88 percent), implement digital transformation initiatives (83 percent), employ cost cutting measures and adjust their geographic footprint (tied at 72 percent) and evaluate cybersecurity risks (67 percent).

In practice, some of those initiatives entail bolting on e-commerce providers. For example, in April, PetSmart, backed by a consortium led by private equity firm BC Partners, acquired pet food e-retailer Chewy.com for about $3.4 billion. Previously, it had acquired online pet adoption company AllPaws.

That type of activity is likely to continue, with 42 percent of respondents expecting to significantly increase (more than 25 percent) the amount of capital they invest in new and add-on deals in the next 12 months. Another 31 percent expect a moderate increase (less than 25 percent) in capital deployed for this purpose.

CYBER MONDAY SALES BEAT BLACK FRIDAY'S



Source: Adobe

But it's not only private equity-backed retailers adding on online targets to their companies. Walmart, for instance, acquired online menswear company Bonobos for about $310 million in June. Previously, it had acquired Jet.com for more than $3 billion. Jet.com, in turn, acquired online women's clothes retailer ModCloth.

After all, online retailing is enjoying record breaking year-over-year sales, according to a Reuters report. One indicator of this is the growth in so-called "Cyber Monday" holiday sales, which reached $6.6 billion in sales in 2017, up from $5.6 billion in 2016. Meanwhile, in-store traffic was hurt by online discounts.

This does not mean that physical stores are about to go the way of the dinosaurs. In a recent study by Market Track, 80 percent of respondents said they compare prices online before ultimately making a purchase in a brick and mortar store, especially when it comes to higher-priced items such as electronics and major appliances.

ABOUT BDO'S PRIVATE EQUITY PRACTICE

Strategically-focused and remarkably responsive, the experienced, multi-disciplinary partners and directors of BDO's Private Equity practice provide value-added assurance, tax and consulting services for all aspects of a fund's cycle, wherever private equity firms are investing.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, and advisory services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 60 offices and over 550 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 73,800 people working out of 1,500 offices across 162 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2018 BDO USA, LLP. All rights reserved.

People who know Private Equity, know BDO.

For more information on BDO USA's service offerings to this industry, please contact one of the following regional practice leaders:

KAREN BAUM, DALLAS
214-969-7007 / kbaum@bdo.com

JOE BURKE, MCLEAN, VA
703-770-6323 / jburke@bdo.com

LENNY DACANAY, CHICAGO
312-730-1305 / ldacanay@bdo.com

JERRY DENTINGER, CHICAGO
312-239-9191 / jdentinger@bdo.com

JAMES DUFFY, MIAMI
305-420-8051 / jduffy@bdo.com

LEE DURAN, SAN DIEGO
858-431-3410 / lduran@bdo.com

BRYAN FISCHER, DALLAS
214-243-2934 / bfischer@bdo.com

RYAN GUTHRIE, COSTA MESA
714-668-7385 / rguthrie@bdo.com

SCOTT HENDON, DALLAS
214-665-0750 / shendon@bdo.com

TUAN HOANG, LOS ANGELES
310-557-8233 / tmhoang@bdo.com

KEVIN KADEN, NEW YORK
212-885-8000 / kkaden@bdo.com

TODD KINNEY, NEW YORK
212-885-7485 / tkinney@bdo.com

MATT SEGAL, CHICAGO
312-616-4630 / msegal@bdo.com

DAN SHEA, LOS ANGELES
310-557-8205 / dshea@bdocap.com

CONTACT US:

FIRST NAME

LAST NAME

EMAIL

PHONE

SUBJECT

MESSAGE

SUBMIT