

PRIVATE EQUITY  
2016 FORECAST  
AND DESKBOOK

On an ongoing basis, Probitas Partners offers research and investment tools for the alternative investment market to aid its institutional investor and general partner clients. Probitas Partners compiles data from various trade and other sources and then vets and enhances that data via its team's broad knowledge of the market.

**probity** (prō' bī· tē)

*n. [from Latin probitas: good, proper, honest.] adherence to the highest principles, ideals and character.*

Probitas Partners is pleased to present its *Private Equity 2016 Forecast and Deskbook*. The purpose of this paper is to offer our forward view of likely trends for 2016 and beyond based on our review of 2015 and our ongoing dialog with (and surveys of) the global institutional investor marketplace. The paper starts with our forecast for this year, then presents a summary review of the dominant trends that shaped 2015 and the details behind those trends.

We encourage you to obtain copies of our research reports, surveys, and deskbooks from our firm's library at [www.probitaspartners.com](http://www.probitaspartners.com).

# CONTENTS

<b>Private Equity Outlook</b> .....	2
<b>Private Equity Deskbook</b> .....	5
<b>Deal Volume and Capital Overhang</b> .....	9
<b>The Buyout Market: Investor Focus and Concerns</b> .....	12
<b>U.S. Venture Capital</b> .....	18
<b>Distressed Private Equity</b> .....	21
<b>Asia</b> .....	26
<b>Europe</b> .....	30
<b>Emerging Markets</b> .....	32
<b>Private Debt Markets</b> .....	34
<b>Energy and Private Equity</b> .....	36
<b>The Secondary Market</b> .....	39

## Private Equity Outlook

### *Increasing Focus on Risk – and Opportunity – in the Buyout Market*

- High purchase price multiples, relatively high leverage, the return of covenant-lite debt and increasing dry powder – these attributes have some limited partners that invest in developed market buyout funds worried that we are reaching or have reached a new market peak. As a result, concern is increasing that there is more downside risk than upside opportunity, especially in recently made investments. However, investors are not worried about a market meltdown similar to 2008; most expect a more normal market down-cycle.
- Increasingly, these investors are more focused during due diligence on managers with experience across cycles and who maintain pricing discipline in expensive markets.
- A few investors are beginning to slow their commitment pace to buyout funds to limit their exposure even as maintaining allocation targets becomes increasingly difficult as private equity distributions remain relatively high and public market valuations on the rest of their portfolios have been volatile.
- A number of investors are also focused on the fact that market down-cycles put downward pressure on purchase price multiples, creating a more attractive environment for acquiring companies likely to generate strong returns in the long run, and are interested in backing disciplined fund managers to provide them with dry powder when prices fall.

---

*“Market down-cycles put downward pressure on purchase price multiples, creating a more attractive environment for acquiring companies”*

---

### *Distressed Private Equity*

- There are signs in the market that corporate debt defaults are at the beginning a cyclical increase, driven at this point by the Oil and Gas and Metals and Mining sectors, but also with increasing weakness in the retail sector and the beginning of concern in hospitality.
- Over the last couple of months, there have been early signs of liquidity issues in the market, with buyout general partners reporting some difficulty raising debt to support their transactions and certain banks reportedly having difficulty syndicating high-yield loans issued in support of buyouts.
- In addition to the market stresses noted above, central banks in the developed markets, that limited the impact of the last distressed cycle by pumping massive amounts of liquidity into the system, have a much more limited toolkit; most have already driven interest rates to near zero – or in certain cases, below zero. This limits their ability to impact an upcoming cycle.

## Energy Sector: Risks and Opportunities

- The dramatic decline in oil prices since the summer of 2014 has already shaken a number of funds with significant exposure to the oil sector, especially those with portfolio companies that are highly leveraged.
- A number of fund managers rushed funds to market targeting distressed energy investments both in equity and debt plays, seeking to raise money quickly at what they perceive to be the bottom of an oil pricing cycle. The further declines, beginning in the summer of 2015 after a rebound in the late spring, caught a number of these investors short.
- The key question for both stressed legacy portfolio companies and new distressed opportunities is *“At what price level will oil prices stabilize and how long will it take to reach that point?”* – a question for which there is no consensus, especially because, for a number of oil producers, the question of production is one heavily dependent upon political considerations.
- Some investors are predicting that the sharp drop in oil prices will have significant negative impact on the renewable energy market. However, the renewable sector is heavily focused on electricity generation with a somewhat different pricing dynamic and, though natural gas fired plants are a significant factor in the production of electricity, oil is not.

---

*“At what price level will oil prices stabilize and how long will it take to reach that point?”*

---

## Venture Capital: Rebound or Bubble – or Deflation?

- Interest in venture capital remained steady in 2015. The market continued to shift towards a barbell approach quite different from the late 1990s which was dominated by early-stage funds.
  - *Growth capital.* Many of the largest funds have shifted to a growth capital/late stage focus taking advantage of a larger number of successful companies – the Unicorns – that seek to delay going public for various reasons.
  - *Seed stage and angel investing.* Capital efficiency, in part driven by cloud outsourcing, is making seed-stage and angel investing a more viable option for launching internet-focused companies with minimal capital needs, though seed-stage vehicles are often too small to attract institutional investor interest.
- Early-stage funds are still of interest to investors, but the dynamics of the market make them difficult to scale, a constraint not limiting growth capital funds.
- In the second half of 2015, there was increasing talk of a venture capital bubble building. This came along with an increasing focus on the value of Unicorns – venture capital-backed companies that were valued at \$1 billion or more and privately held. Valuations of these companies have come under increasing pressure. In addition, volatility in the public markets over the last six months has limited the ability of companies to go public – highlighted by the fact that not a single venture capital-backed company was able to IPO in the United States in January 2016.

## Private Debt

- Private debt continues to gain in importance as a dedicated sector of alternatives, especially as banks continue to struggle with portfolio and regulatory issues. This area now includes a broad array of debt, expanding beyond mezzanine debt funds, long considered part of private equity allocations. The rise of direct lending funds as a partial replacement for bank lending is directly related to these issues, and direct lending fundraising has continued to soar, especially for funds targeting Europe.
- A number of investors are also interested in pursuing alternative debt strategies — such as funds investing in royalty streams — that they feel will be less affected by a market down-cycle.
- Because many direct lending fund managers were launched since the Great Financial Crisis (“GFC”), they often lack track records that stretch over a market cycle. The next two years are likely to reveal how their portfolios perform under stress.
- An often open question in private debt investments is *“Where will these investments reside in investors’ portfolios?”* The answer depends partly on a fund’s particular strategy, but there is still no universal consensus.

## Regulatory Issues: The SEC — Co-Investment and Structured Secondaries

- The U.S. Securities and Exchange Commission (SEC), recently put in charge of reviewing most U.S.-based private equity firms as part of Dodd-Frank, has recently begun to turn its attention from fees at private equity funds to structured secondaries and co-investments.
- As far as structured secondaries are concerned, where a fund, usually under some stress, is restructured in an arrangement that involves the general partner, the SEC is concerned that there are potential conflicts of interest between the general partner, the limited partners and potential new investors in pricing such a transaction. The SEC is still investigating the issue, and has not yet provided definitive guidance.
- For co-investments, the SEC is looking into the issue of access to co-investments and the disclosure of how general partners allocate co-investments. This not only has ramifications for general partners, but also for limited partners with active co-investment programs that are satisfied with the way the system works now. Again, there is no definitive guidance from the SEC on the topic.

# Private Equity Deskbook

## Fundraising

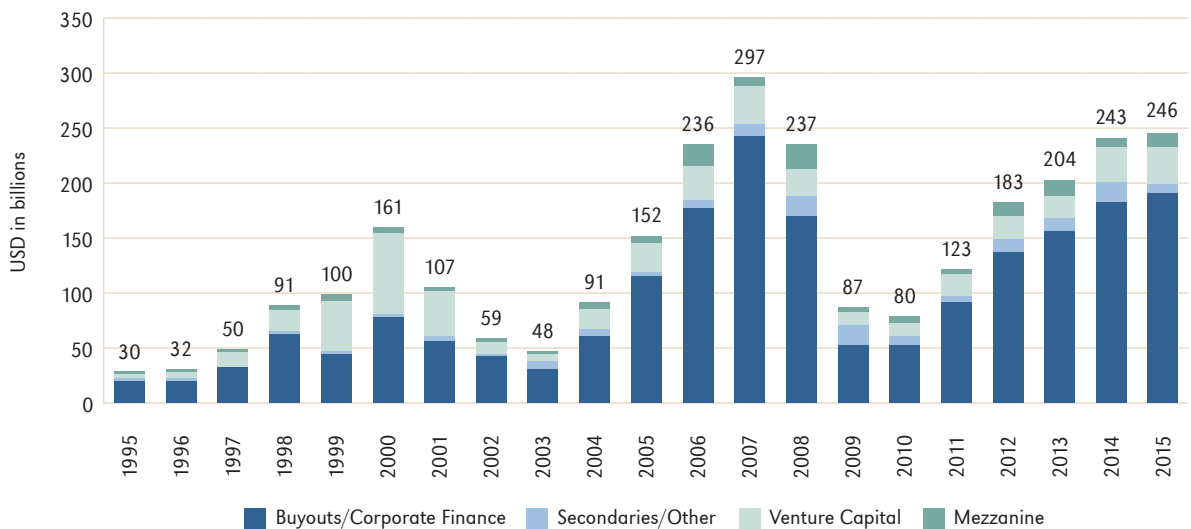
Private equity fundraising was basically flat during 2015, driven by increases in Europe that offset a slight decline in Asia and a flat market in North America. Established private equity investors' portfolios saw significant cash returned during the year and downward pressure on publicly-traded portions of their portfolios began to raise some concern about allocations as 2016 began.

### North America

- Private equity fundraising nudged upwards by 1% over 2014's total (Chart I), with buyout funds reaming the largest sector of the market.
- Venture capital fundraising inched up by 4% during the year after surging by nearly 70% during 2014, though still considerably below its 2000 peak.
- The North American private equity market is the most developed and data in Chart I clearly shows the three major market cycles over the last 20 years – the first cycle driven by the Internet Bubble and its bursting, the second cycle driven by debt pouring into the corporate and asset backed securities markets that ended with the GFC and the third cycle surge over the last four years.
- Notably, over the last decade co-investments and separate accounts investing alongside buyout funds have surged both in North America and Europe, and allocations to these are not included in the fundraising totals in Chart I as they are very difficult to track accurately. However, strictly as far as co-investments are concerned, it is not unusual for 20% to 30% of the capital deployed on a buyout fund to be matched with co-investments.

*“The North American private equity market is the most developed and data in Chart I clearly shows the three major market cycles over the last 20 years”*

**Chart I Commitments to U.S. Private Equity Partnerships by Sector**

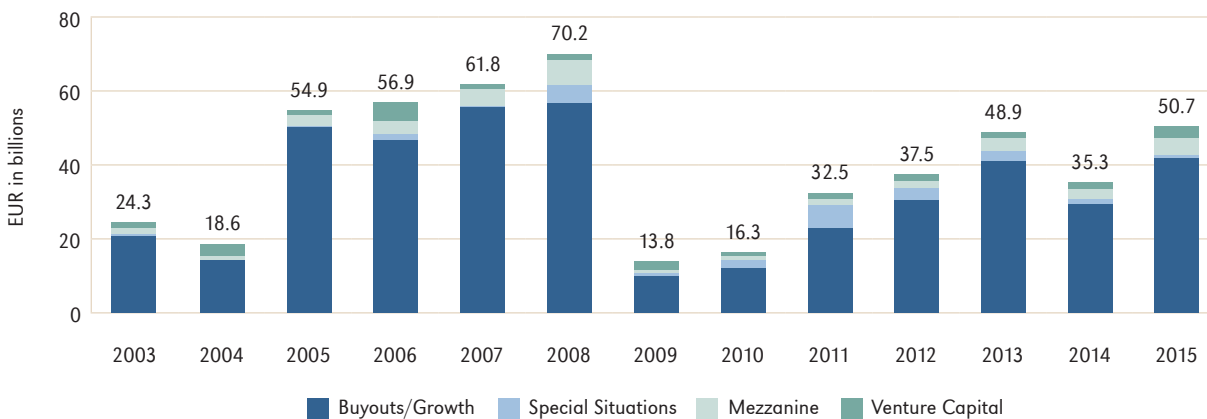


Source: Private Equity Analyst  
 Note: Does not include fund-of-funds, infrastructure funds

## Europe

- European-focused fundraising increased by nearly 45% during the year, as several large Pan-European funds were in market, led by EQT which by itself raised €6.5 billion (Chart II).
- Middle-market country-focused funds remain a mainstay of the European market in terms of the number of funds offered. Investors were focused on the stronger economies of Northern Europe, with the Nordic countries, the UK, and Germany leading investor interest.
- Not included in the private equity totals in this chart is the full range of private debt funds, which had increased fundraising success in Europe in 2015 after a strong 2014.

**Chart II Commitments to European Private Equity Partnerships by Sector**



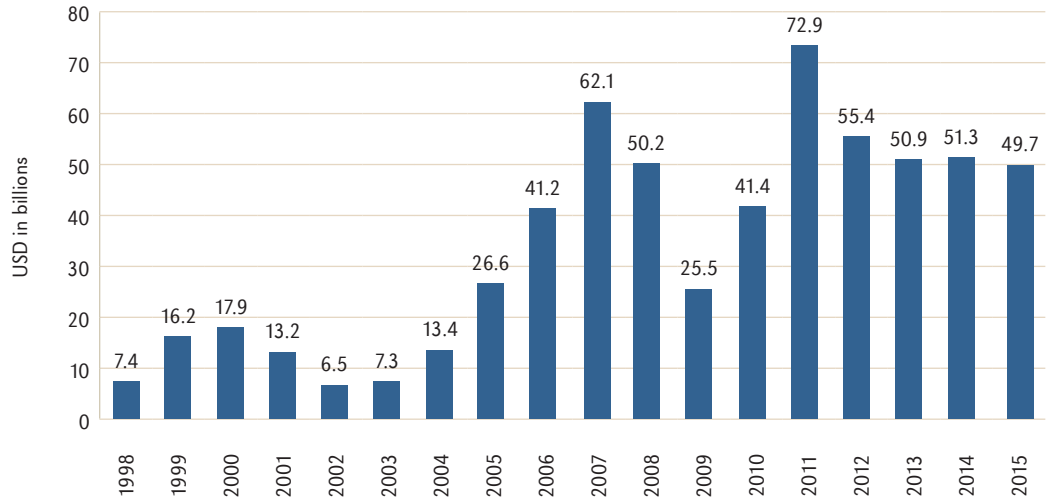
Source: Probitas Partners



## Asia

- Asian fundraising remained fairly flat during the year and is still noticeably below 2011's market peak, driven by ongoing concerns about the slowing of the Chinese economy (Chart III).
- Though interest in funds strictly focused on greater China has declined recently, interest in Pan-Asian funds has increased.

**Chart III Commitments to Asian Private Equity Partnerships**



Source: Asian Venture Capital Journal; 2015 number is preliminary

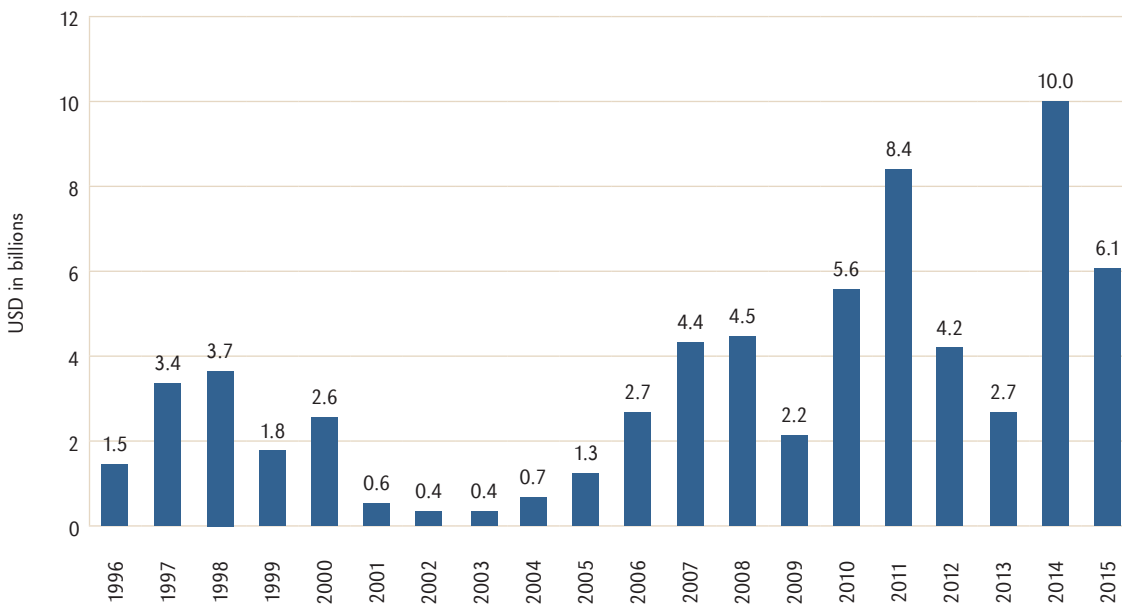
## Latin America

- Latin American fundraising fell noticeably during the year, impacted both by turmoil in Brazil and the technical fact that three of the five largest Latin American-focused funds raised their latest funds in 2014 and were out of the market in 2015 (Chart IV).

## Other Emerging Markets

- Fundraising for other emerging markets is not detailed in a chart; these niche markets are fairly volatile and long-term trend lines are less meaningful. It was notable, however, that funds targeting Sub-Saharan Africa followed the \$4 billion raised in 2014 with another strong year of \$3.4 billion raised in 2015.

Chart IV Capital Raised for Latin American Private Equity Partnerships



Source: EMPEA, LAVCA

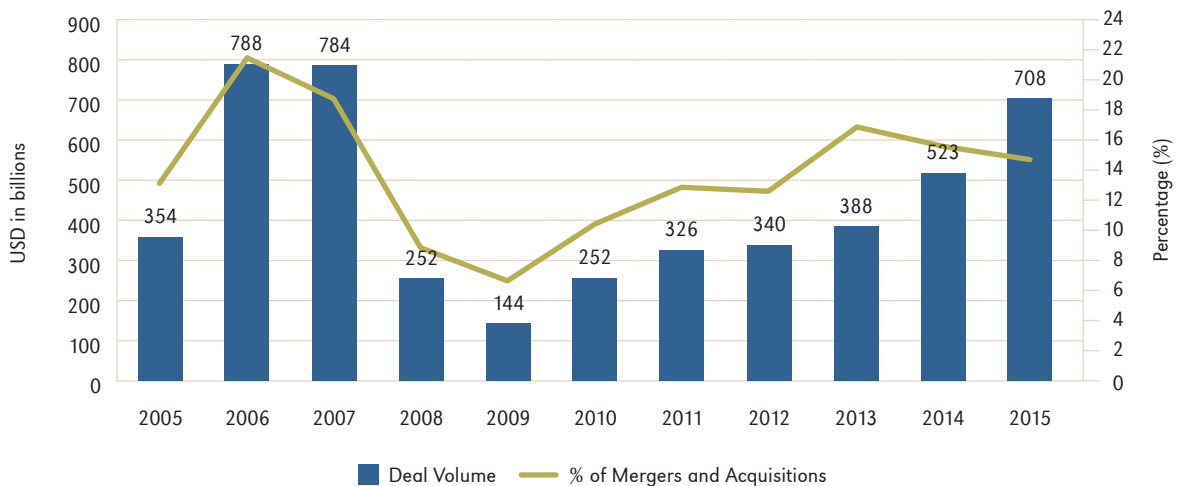
## Deal Volume and Capital Overhang

Funds are raised to be profitably deployed during their investment periods. At a high level, deal volume and capital overhang statistics offer some insight into that dynamic and where we are in the cycle.

### Global Deal Making

- Global private equity deal volumes increased significantly again in 2015 and began to approach the peak years of 2006 and 2007 (Chart V).
- However, private equity activity as a percentage of all mergers and acquisitions activity fell in 2015 to 14.9% as mergers and acquisitions driven by strategic investors surged even higher. The \$4.7 trillion in overall global mergers and acquisitions activity during the year set a new record, exceeding the \$4.3 trillion of activity in 2007.
- 2015's dollar deal volume was driven by a few very large complex transactions such as Pfizer's \$160 billion purchase of Allergan.

**Chart V Global Private Equity Deal Volume and Percentage of Mergers and Acquisitions Activity**



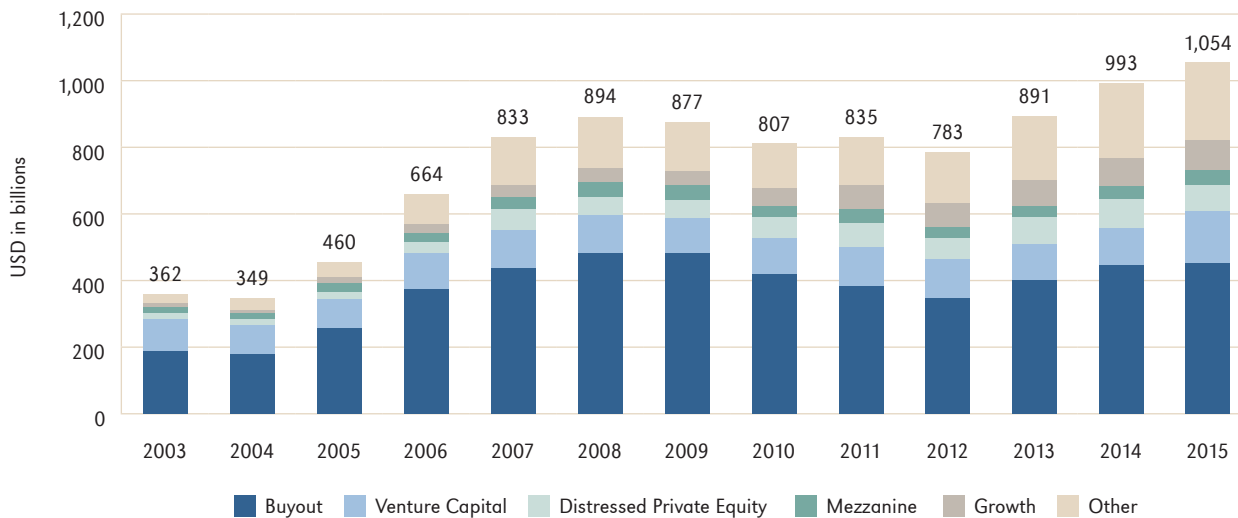
Source: Thomas Reuters

## Capital Overhang or Dry Powder

- Dry powder or capital available for deployment continued to increase in 2015, setting a new record of over \$1 trillion (Chart VI). The high level of capital waiting to be deployed is likely to put pressure on prices, increasing competition among fund managers when buying or investing in companies.
- Buyout funds drive the capital overhang numbers as they make up 44% of the overall total; buyouts remain the largest sector of the global private equity market.

*“Dry powder...  
[set] a new  
record of over  
\$1 trillion”*

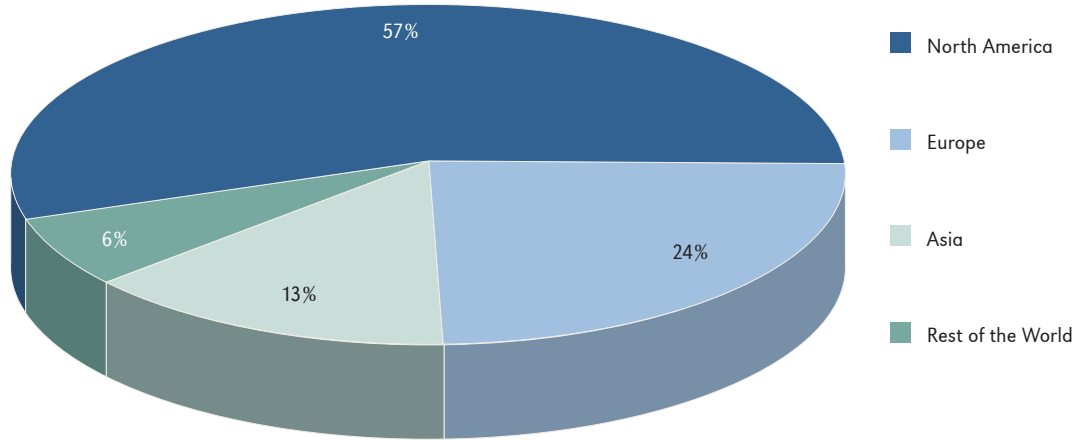
**Chart VI Private Equity Dry Powder by Investment Strategy**



Source: PREQIN, as of February 2016

- North America is the largest private equity market and has the largest capital overhang with 57% of global dry powder (Chart VII), but these totals include a number of U.S. headquartered mega buyout funds that invest globally.
- The dry powder numbers are understated because they do not include allocations to co-investments which are substantial at a number of large limited partners but are not easily tracked.

**Chart VII Private Equity Dry Powder by Geography, December 2015**



Source: PREQIN

## The Buyout Market: Investor Focus and Concerns

Buyouts are the largest segment of the North American and European private equity markets. Consequently, the key factors impacting buyout investments significantly impact the performance of most institutional private equity portfolios. This section covers a number of key factors that impact the buyout markets, many of which point to increasing stress in the sector.

### *Purchase Price Multiples*

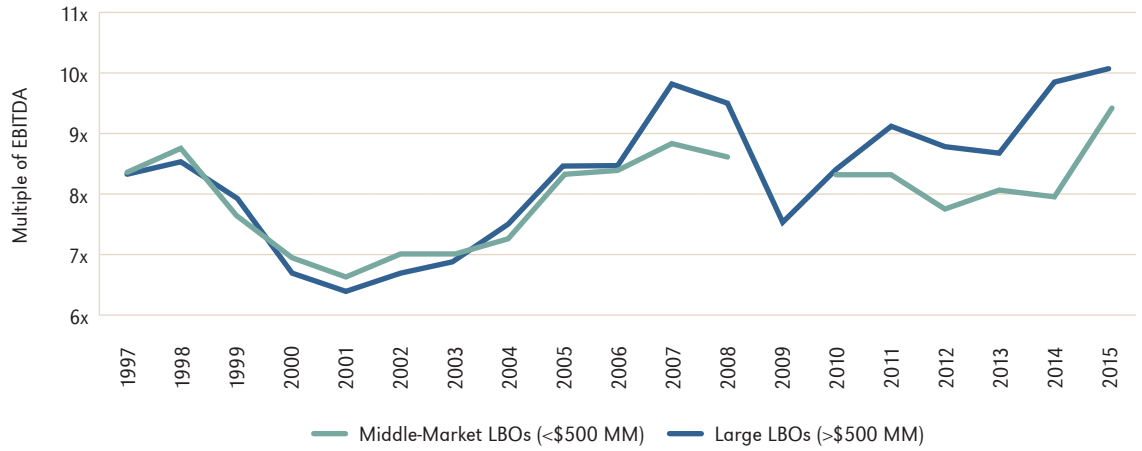
- Purchase price multiples at the large end of the market increased sharply in the United States last year, while prices at the large end of the European market remained flat (Charts VIII and IX). At the large end of the market in the United States, average purchase price multiples exceeded that of the 2007 market peak.
- The pattern for middle-market buyouts, however, was more mixed; multiples shot up in the United States and decreased significantly in Europe.
- The premium paid for large buyout deals compared to middle-market buyout deals has increased during this cycle in the United States and remains wide in Europe, causing increased interest in middle-market buyouts as investors search for more attractive deal entry prices.
- The current high purchase price multiples offer an excellent opportunity to exit investments already in portfolio but make it more difficult to purchase new companies at attractive prices.

---

*“At the large end of the market in the United States, average purchase price multiples exceeded that of the 2007 market peak”*

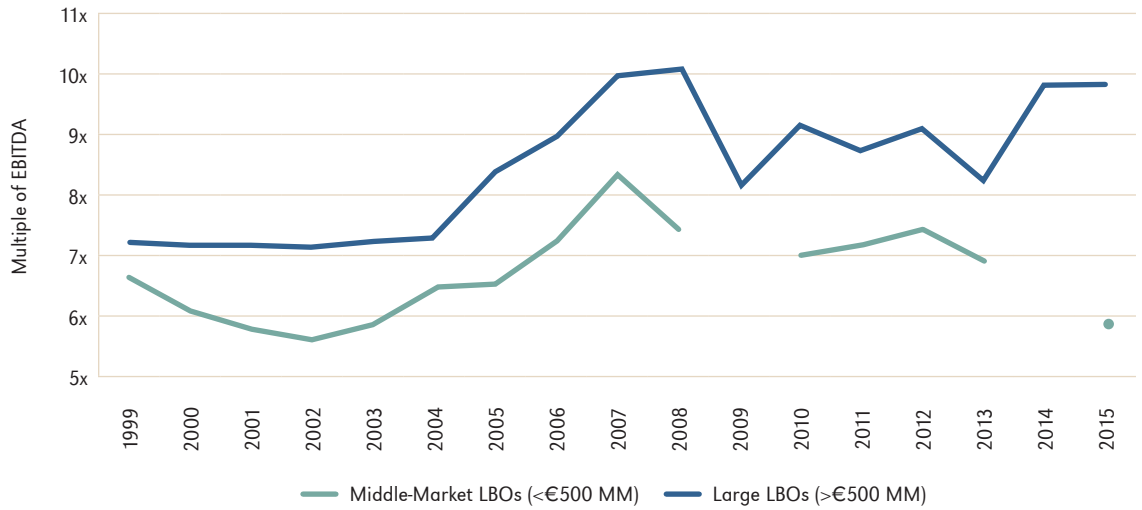
---

**Chart VIII Average U.S. LBO Purchase Price/Adjusted EBITDA Multiples**



Source: Standard & Poor's LCD; for middle-market LBOs, data from 2009 not statistically significant

**Chart IX Average European LBO Purchase Price/Adjusted EBITDA Multiples**



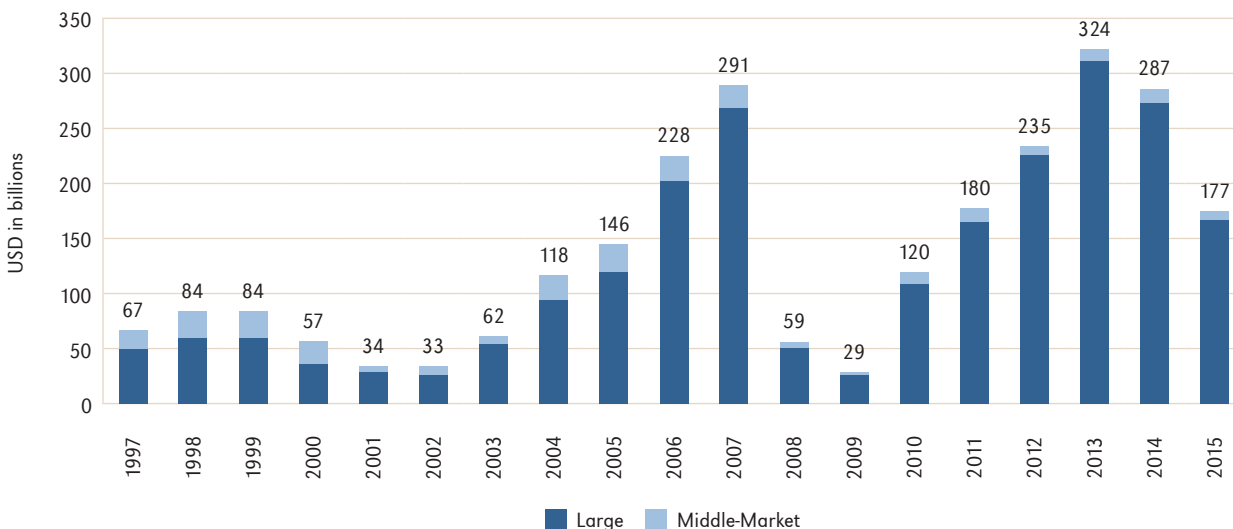
Source: Standard & Poor's LCD; for middle-market LBOs, data from 2009 and 2014 not statistically significant

## Buyout Loan Volumes

- U.S. loan volumes for sponsored transactions fell significantly in 2015, well below 2013's all-time peak (Chart X) as bank regulators increased pressure on banks to limit their exposure to riskier high-yield loans. Notably, though sponsored loan volumes for large transactions have rebounded since the GFC, the middle market has not come back nearly as much.
- Much of the loan issuance between 2010 and 2013 was used to refinance loans used to buy companies during the market peak. In 2015, as deal volumes continued to increase, 38% of loans issued were to finance new leveraged buyouts, up from 24% in 2013, with another 19% used to finance add-on acquisitions made by portfolio companies, up from 9% in 2013 (Chart XI). Loans used to refinance debt fell from 41% in 2013 to 20% in 2015.
- Over the last three years, investors hungry for yield have demonstrated increasing willingness to take on "covenant-lite" structures in volumes not seen since the market peak.
- However, the appetite for high-yield/high-risk buyout linked loans has slowed noticeably over the past four months as debt has been more difficult to secure and certain banks are reporting difficulty selling bridge loans they issued to support transactions.
- European buyout loan activity has not rebounded nearly in the same manner as the United States post-GFC (Chart XII). The Eurozone continued its slow economic recovery with many European banks still under stress — a scenario that led to the creation of a number of private funds that provide senior debt in support of buyouts or other corporate purposes.

*"The appetite for high-yield/high-risk buyout linked loans has slowed noticeably"*

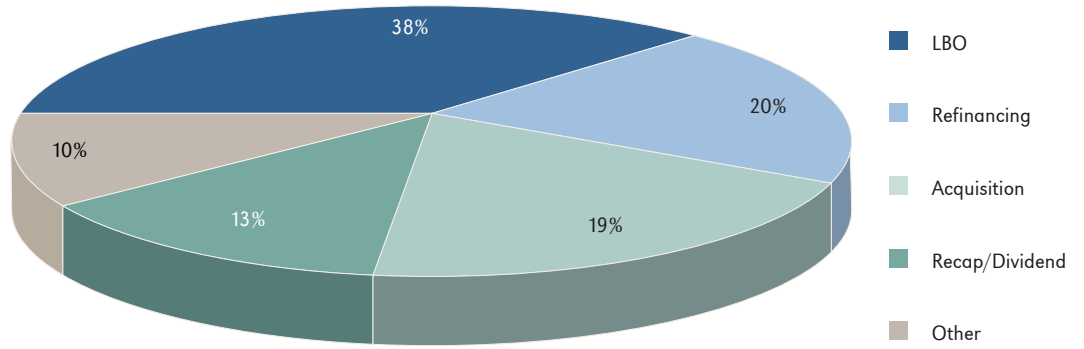
**Chart X U.S. Leveraged Sponsored Loan Volume**



Source: Standard & Poor's LCD, as of February 2016

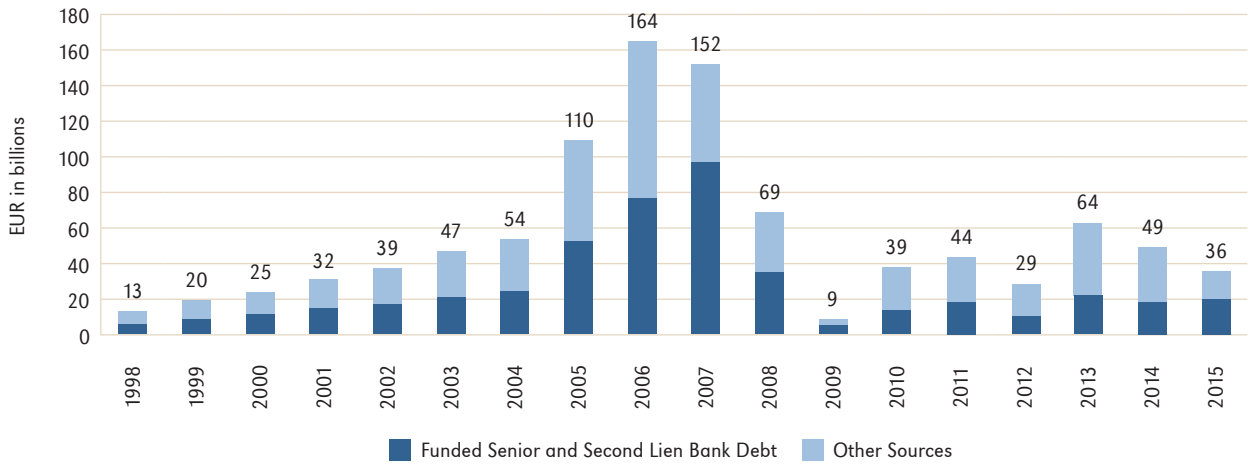


**Chart XI U.S. Leveraged Sponsored Loan by Purpose, 2015**



Source: Standard & Poor's LCD

**Chart XII European Buyout Loan Volume**



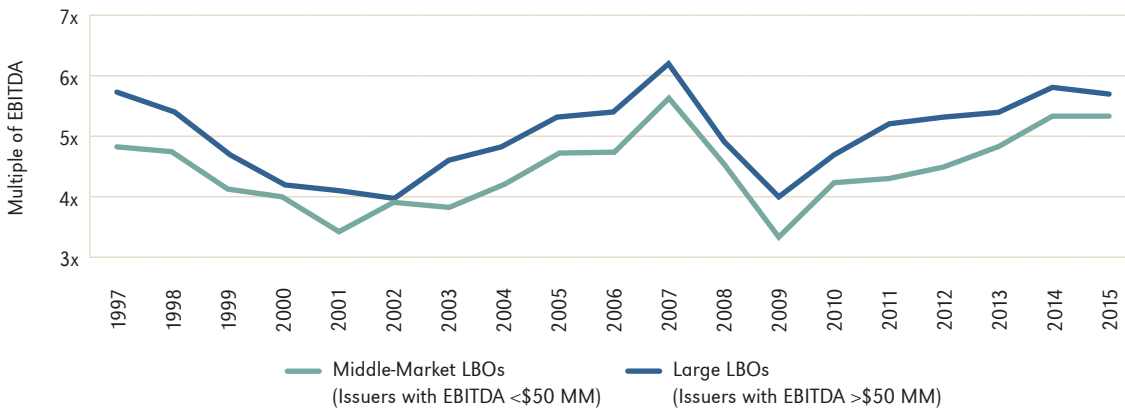
Source: Standard & Poor's LCD

Note: Reflects total sources of funding of initial and secondary buyouts by a private equity firm — excludes recaps, refinancing, etc.

## Debt Multiples

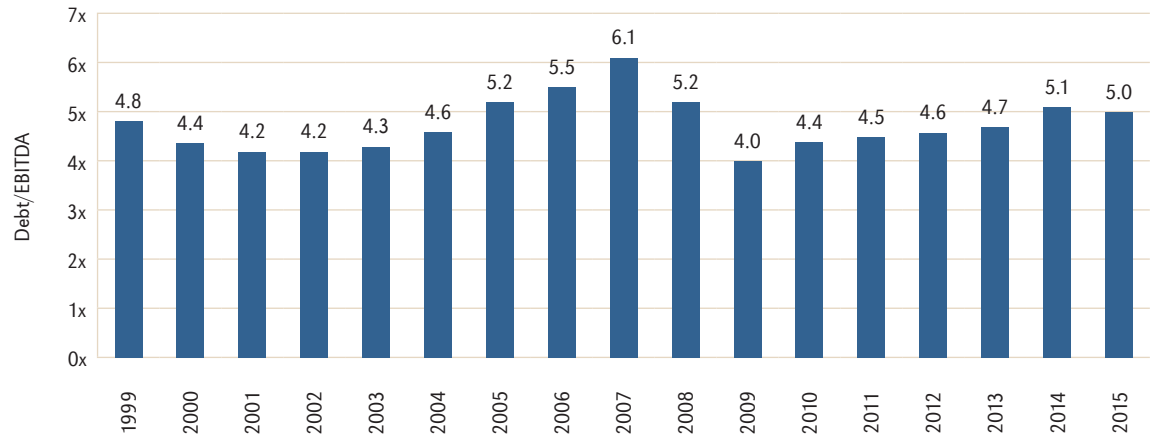
- Debt multiples on new corporate LBO loans in the United States and Europe fell slightly in 2015 (Charts XIII and XIV), even as deal volume decreased.
- In the United States, debt multiples hovered slightly below their pre-GFC peak, while a noticeable gap remained between middle-market and large buyout multiples.
- In Europe, debt multiples remain more than a full turn below their pre-GFC levels and have been relatively flat for the last two years.

**Chart XIII Average Debt Multiples of U.S. Corporate LBO Loans**



Source: Standard & Poor's LCD

Chart XIV Average Debt Multiples of European Corporate LBO Loans



Source: Standard & Poor's LCD

---

*“In Europe, debt multiples remain more than a full turn below their pre-GFC levels, and have been relatively flat for the last two years.”*

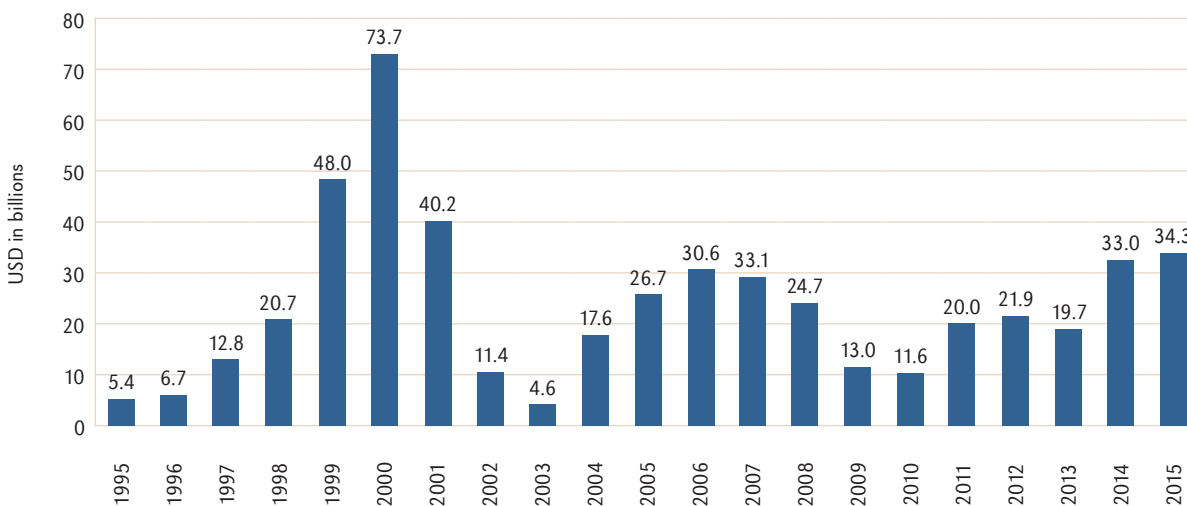
---

## U.S. Venture Capital

The U.S. venture capital market remains the largest, deepest and longest-lived sector for venture investing, and consequently sets the patterns for much of that market globally.

- After three years of flat fundraising at around the \$20 billion level, venture fundraising increased significantly in 2014 and increased again slightly from that level in 2015 (Chart XV). However, this surge is still significantly below the amounts raised at the peak of the Internet Bubble in a fundraising trend line totally different from the buyout markets.
- U.S. venture returns (Table I) offer further insight. 10-year horizon returns for venture capital have been weak since the bursting of the Internet Bubble in 2000, punctuated by negative 10-year horizon returns in 2010, though they have been steadily clawing their way back since then. Strong IPO markets at particular points in time make the 1-year returns volatile and the weakness in the value of both publicly-traded and privately held venture capital positions (especially in Unicorns) over the last six months are not reflected in the table.
- A look at the ten largest funds raised in 2014 and 2015 (Table II) highlights other trends. The fundraising market has become increasingly concentrated, with the ten largest funds of 2014 making up roughly 40% of fundraising, rising to 46% in 2015. In both these years the funds skew much more towards late stage and growth capital investing than they did in 2000.

Chart XV Commitments to U.S. Venture Capital



Source: Private Equity Analyst

**Table I U.S. Venture Capital Index Returns: IRR**

For the Period Ending	Quarter	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year
June 30, 2015	6.7	24.9	20.3	18.2	11.3	3.4	35.5
June 30, 2014	3.0	29.2	13.8	14.8	10.3	13.1	34.0
June 30, 2013	4.3	8.9	13.5	5.7	7.8	22.8	30.1
June 30, 2012	0.6	6.0	12.7	4.9	5.3	27.5	27.9
June 30, 2011	7.0	26.3	4.3	7.4	1.3	30.9	27.4
June 30, 2010	0.4	6.4	-2.7	4.4	-4.2	38.1	24.3
June 30, 2009	0.2	-17.1	1.3	5.7	14.3	36.3	22.7

Source: NVCA, Cambridge Associates

**Table II U.S. Venture Capital Concentrations**

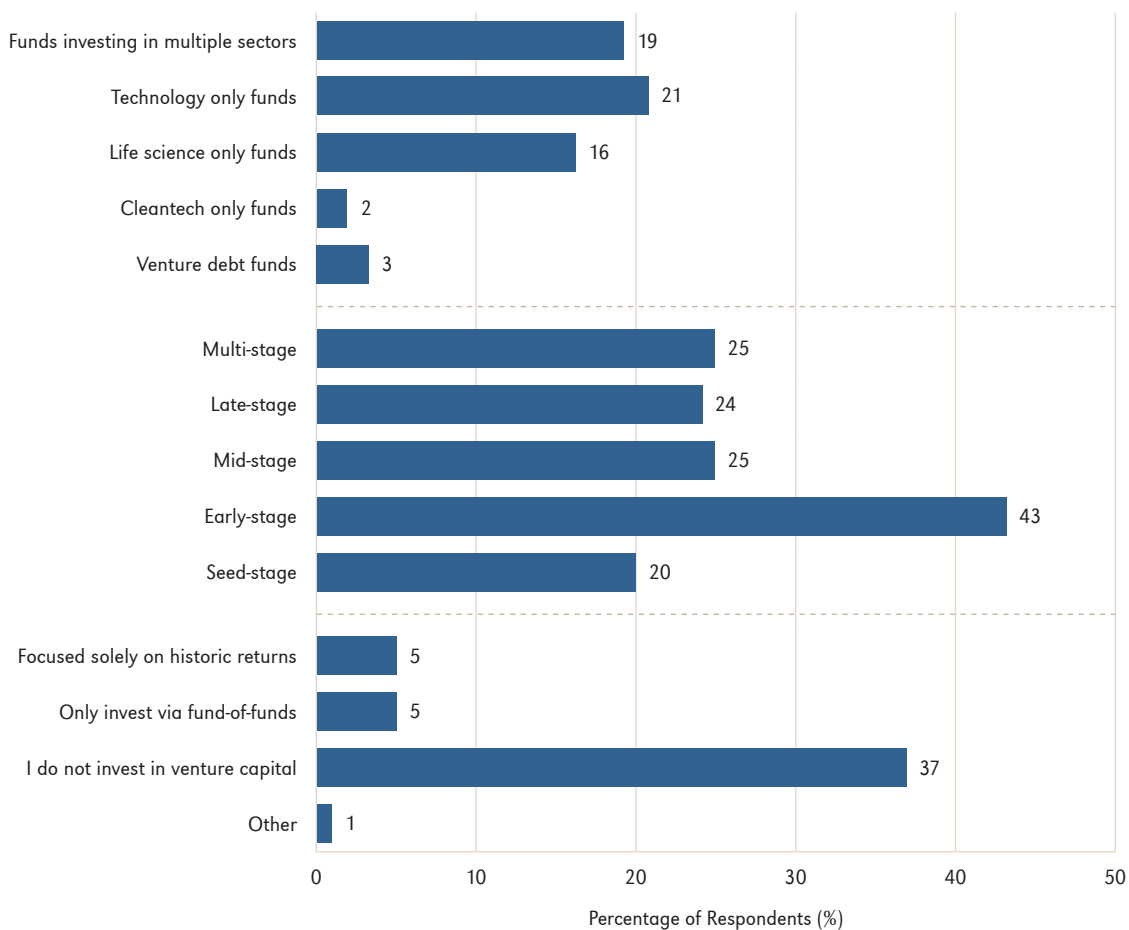
Ten Largest U.S. VC Fundraises of 2014		Ten Largest U.S. VC Fundraises of 2015	
Fund	Capital Raised USD MM	Fund	Capital Raised USD MM
Tiger Global Private Investment Partners IX	\$2,500	Insight Venture Partners IX	\$3,446
Technology Crossover Ventures VIII	\$2,230	New Enterprise Associates 15	\$2,800
Andreessen Horowitz Fund IV	\$1,500	Tiger Global Private Investment Partners X	\$2,500
Tiger Global Private Investment Partners VIII	\$1,500	Bessemer Venture Partners IX	\$1,600
J.P. Morgan Digital Growth Fund II	\$1,184	Institutional Venture Partners XV	\$1,400
Accel Growth Fund III	\$1,000	Athyrium Opportunities Fund II	\$1,227
Founders Fund V	\$1,000	OrbiMed Private Investments VI	\$950
KPCB Digital Growth Fund II	\$750	Vivo Capital Fund VIII	\$750
Bain Capital Venture Partners 2014	\$718	YC Continuity Fund	\$700
Canaan X	\$675	Deerfield Healthcare Innovations Fund	\$550
<b>Total Top Ten</b>	<b>\$13,057</b>	<b>Total Top Ten</b>	<b>\$15,923</b>
<b>Total Number of Funds That Raised Capital</b>	<b>317</b>	<b>Total Number of Funds That Raised Capital</b>	<b>337</b>
<b>Ten as Percent of Total Fundraising</b>	<b>40%</b>	<b>Ten as Percent of Total Fundraising</b>	<b>46%</b>

Source: PREQIN, Probitas Partners

- Probitas Partners' recent private equity survey highlights investor interest in venture capital sectors going into 2016 (Chart XVI). Notable is the lack of interest in pure cleantech funds. Further, 37% of respondents say they do not invest in venture capital, though that number has receded from 44% two years ago.
- Interest in venture debt remains quite low even, while interest in private debt remains strong and growing in other markets.

**Chart XVI Most Attractive Venture Capital Sectors**

In venture capital, I focus on funds active in the following sectors or stages (choose all that apply):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2016 Survey

## Distressed Private Equity

Investor activity at the large end of distressed private equity tends to be cyclical, surging as recessions roll through different economies or industry sectors. However, the GFC and its long aftermath have been anything but normal.

- The risks presented by the GFC were so intense that central banks worldwide pumped unprecedented levels of liquidity into the system, strongly tilting the market towards refinancings rather than bankruptcies.
- Banking regulators globally eased pressure on banks' distressed loan portfolios in the face of the GFC, granting them more leeway to "amend, extend and pretend" rather than deal proactively with troubled assets.
- As a result, the "wall of debt maturities," that has frequently been cited, has been continually pushed back and moderated by ongoing waves of government created liquidity.

### *Where do we stand now?*

- The pattern of strongly increasing high-yield bond issuance followed by a sharp increase in default rates (Chart XVII provides the U.S. example) may be reasserting itself. After the GFC, the spike in default rates was very sharp, but very short. The past four years have seen a high level of issuance, and 2015 saw a significant increase in defaults driven by trouble in both the Oil and Gas and Metals and Mining sectors.
- Given that interest rates in most developed markets remain low – or indeed, negative – central banks’ “toolkit” for dealing with increasing market stress and defaults is much more limited than it was going into the GFC.
- Fundraising remained steady for distressed private equity funds over the last three years (Chart XVIII) as the market has continued to expand beyond classic distressed debt funds into special situations and opportunistic credit funds.

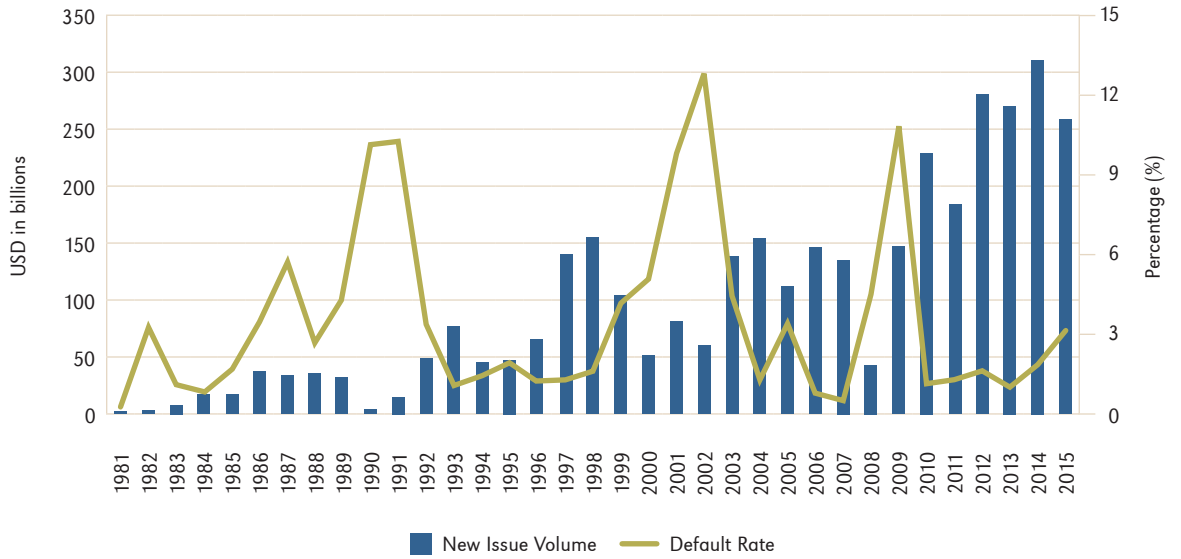
---

*“The pattern of strongly increasing high-yield bond issuance followed by a sharp increase in default may be reasserting itself.”*

---

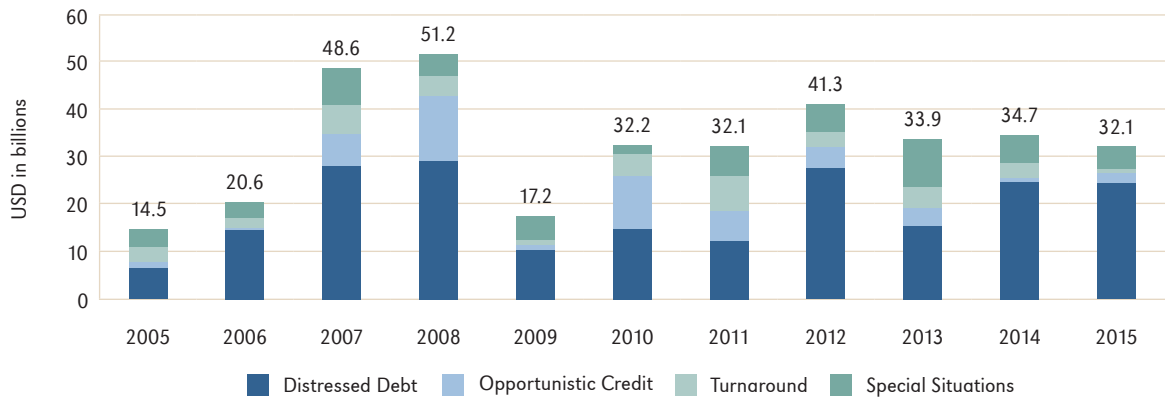


**Chart XVII High-Yield Bond Issuance and Annual Default Rates: 1981–2015**



Source: NYU Stern School, Moody's, Standard & Poor's

**Chart XVIII Global Distressed Private Equity Fundraising**

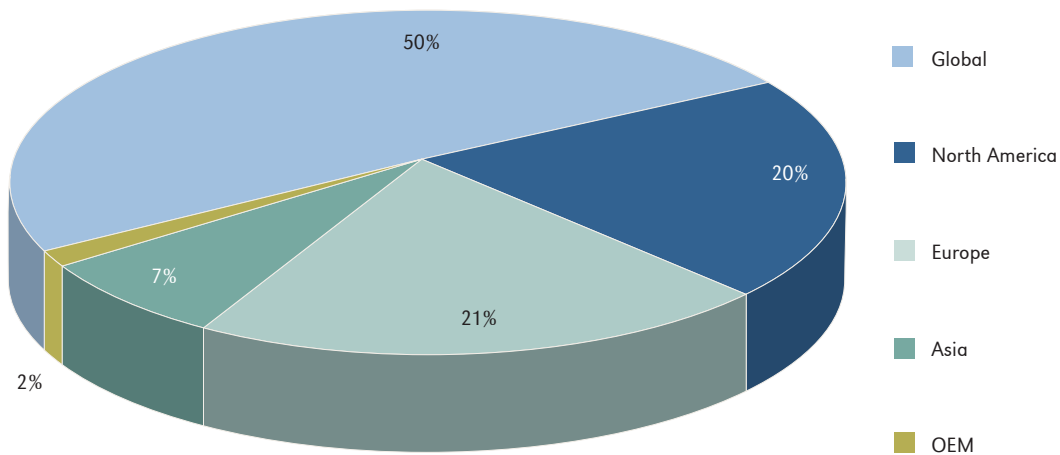


Source: Probitas Partners

- The largest funds tend to have global mandates with the ability to shift resources depending upon where opportunities present themselves. Funds focused on Europe, however, have continued to expand as investors view this market as particularly attractive (Charts XIX and XX). Asia is a newer geography for distressed investing, and most funds focused on Asia are special situations vehicles that take advantage of opportunities with companies under stress as opposed to those likely to go bankrupt.

**Chart XIX Capital Raised for Distressed Private Equity Funds, 2015 by Geography**

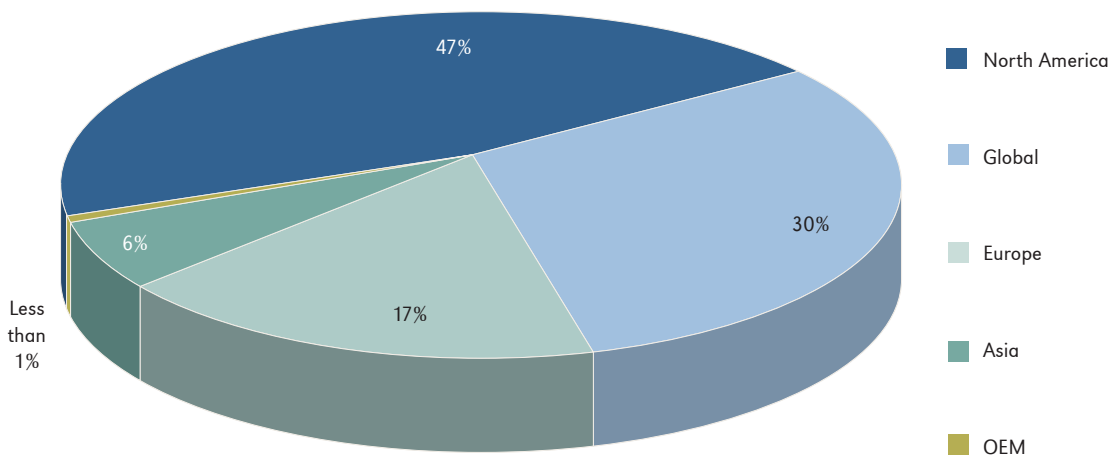
(In terms of USD raised)



Source: Probitas Partners, PREQIN, Private Equity Analyst

**Chart XX Capital Raised for Distressed Private Equity Funds, 2014 by Geography**

(In terms of USD raised)

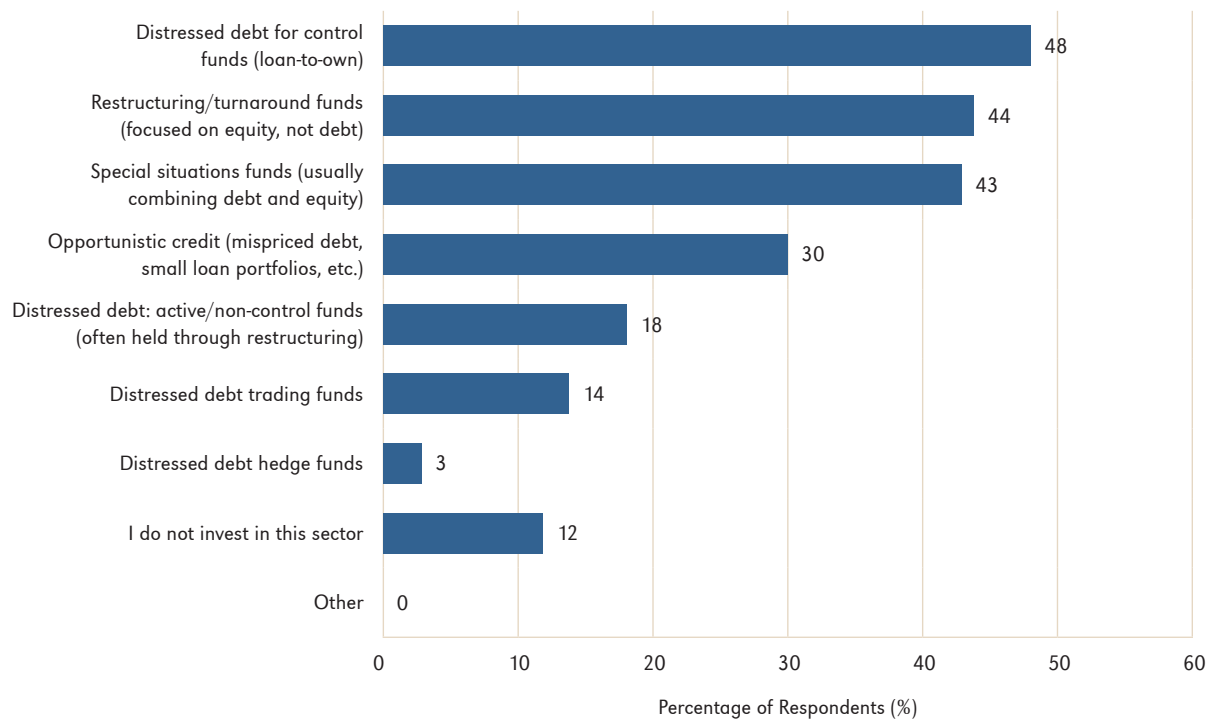


Source: Probitas Partners, PREQIN, Private Equity Analyst

- Many funds in the distressed sector run hybrid strategies that combine various skill sets to address different sectors. Going into 2016, investors seeking exposure in “pure play” distressed strategies remained most focused on value-added approaches that can generate attractive multiples in “loan-to-own,” turnaround and special situations strategies (Chart XXI). Distressed debt for control strategies, though popular with investors, are becoming more difficult to execute as increased competition makes it more difficult for fund managers to build positions that will give them a controlling stake in a company at an attractive valuation.
- Additionally, there has been increased interest in opportunistic credit funds that pursue potential investments outside of corporate debt in stressed or distressed whole loan portfolios and asset backed securities.

**Chart XXI Distressed Investments**

Within the distressed debt/restructuring sector, I am most interested in (choose no more than two):



Source: Probitas Partners’ Private Equity Institutional Investor Trends for 2016 Survey

## Asia

Asia is distinctively split between the developed economies of Australia and Japan, and the emerging markets of China, India, and Southeast Asia. In the emerging markets, growth capital – not control buyouts – continues to drive overall activity, though buyouts are beginning to be more important as the emerging economies continue to develop.

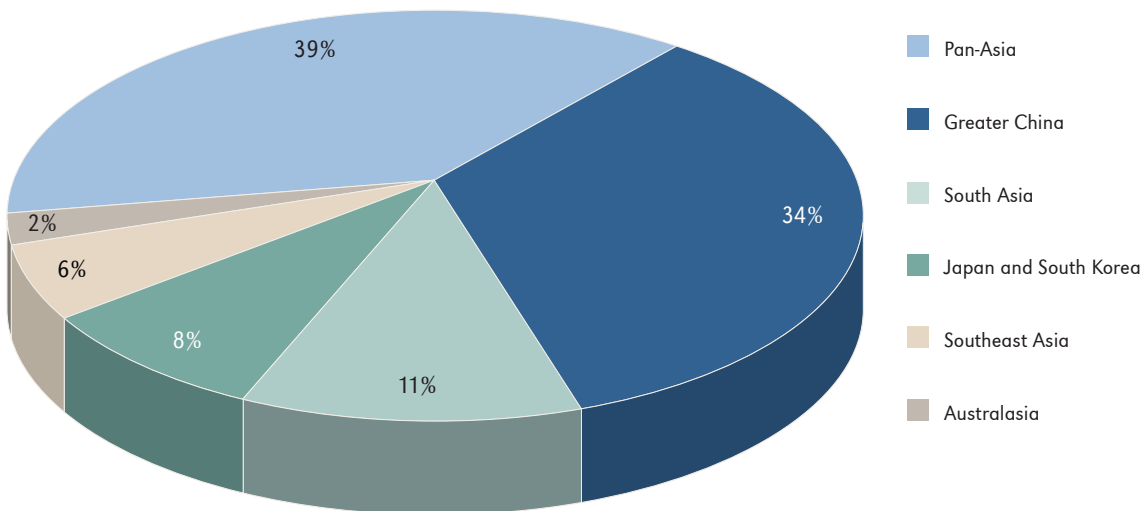
- As noted in Chart III, fundraising for Asia-focused funds has remained fairly flat over the last three years, but these annual totals are still roughly 30% less than 2011 peak.
- There was a marked shift in geographic focus between 2011 and 2015 (Charts XXII and XXIII) from Greater China's funds to Pan-Asian funds, driven both by concerns about the China market and increased interest in Pan-Asian buyouts. In 2015, buyout funds overtook growth capital funds as the most popular fund strategy by a small margin (Chart XXIV), while interest in mezzanine funds, never particularly strong in Asia, fell to a fraction of a percent.

---

*“There was a marked shift in geographic focus between 2011 and 2015 from Greater China's funds to Pan-Asian funds”*

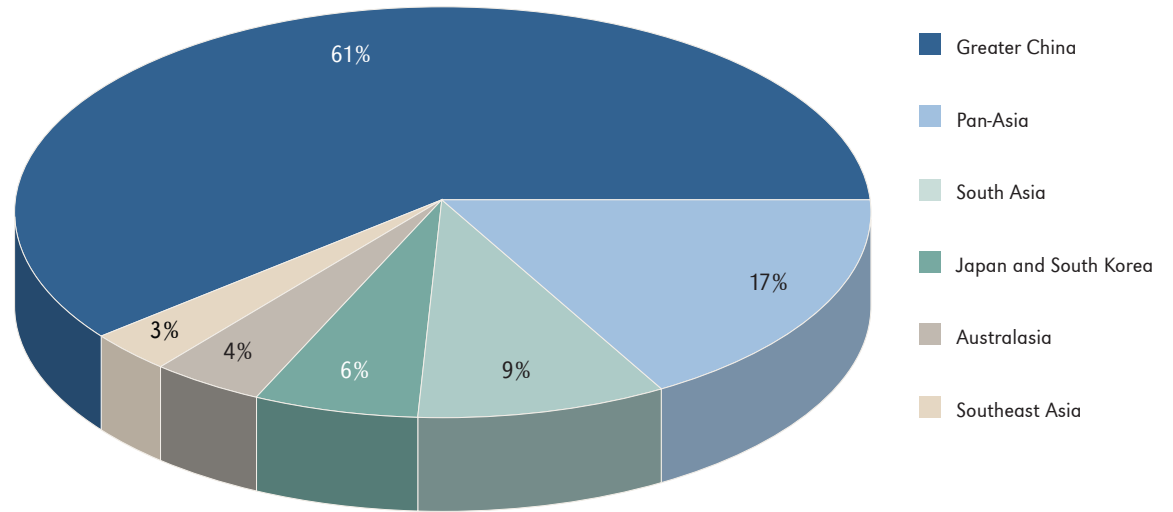
---

**Chart XXII Asian Fund Commitments by Geography, 2015**



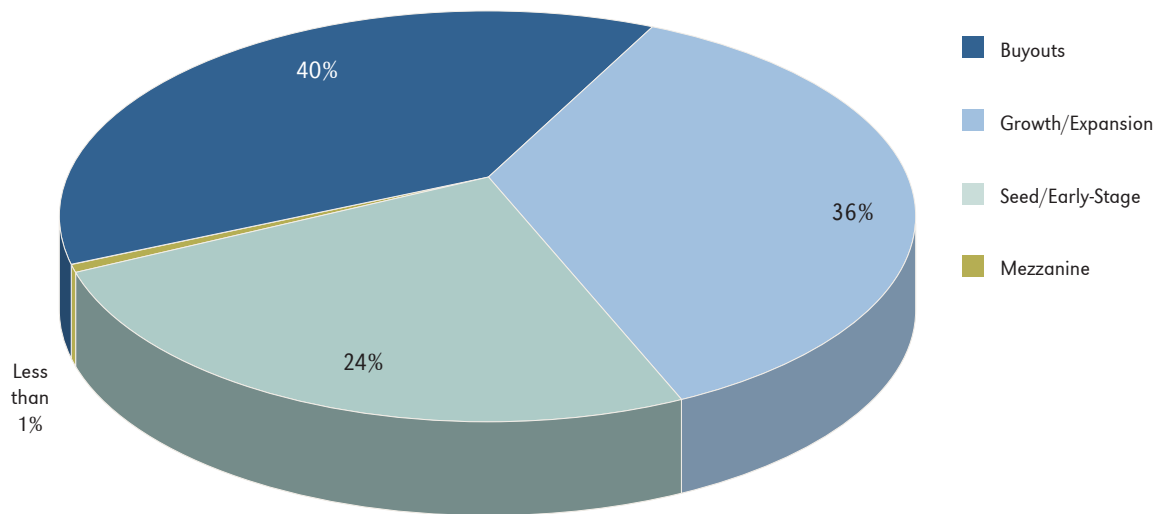
Source: Asia Private Equity Research

**Chart XXIII Asian Fund Commitments by Geography, 2011**



Source: Asia Private Equity Research

**Chart XXIV Fund Strategies for Asia-Focused Funds, 2015**



Source: Asia Private Equity Research

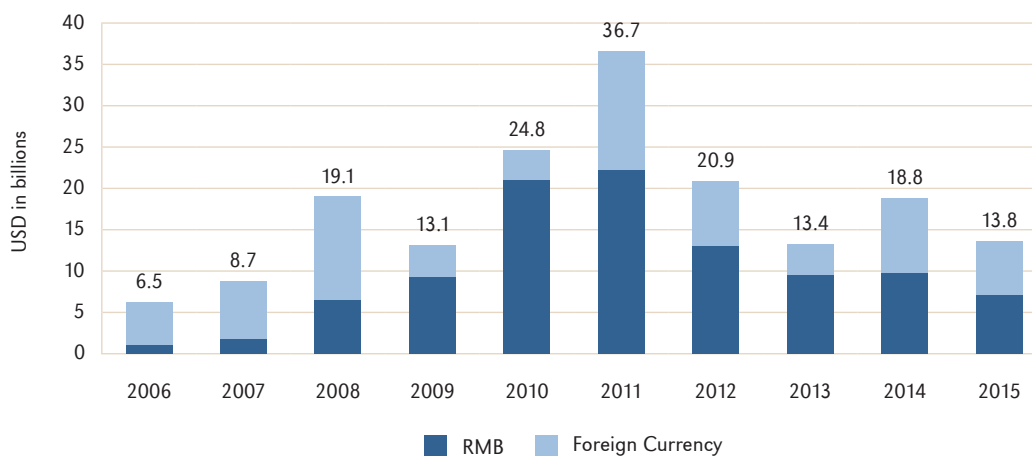
- Fundraising for China-focused funds denominated in both U.S. dollars and RMB fell in 2015 due to continued concerns over the Chinese economy (Chart XXV). Fundraising focused on China was over 60% off its 2011 peak in 2015 as both dollar denominated funds attractive to international investors and RMB funds attractive to local investors fell in interest.
- Even with these declines, China is still the primary focus for investors targeting Asia (Chart XXVI).
- Pan-Asian funds continue to be of significant interest to investors and, because these funds tend to be very large, they have an outsized impact on fundraising totals.
- Interest in Japan in the Probitas Partners' survey is overstated due to the fact that there were a large number of Japanese investors who participated in the survey and they strongly supported their home market.
- India, on the other hand, is a country that has more support as an investment target outside Asia than within Asia.

---

*“Fundraising focused on China was over 60% off its 2011 peak in 2015”*

---

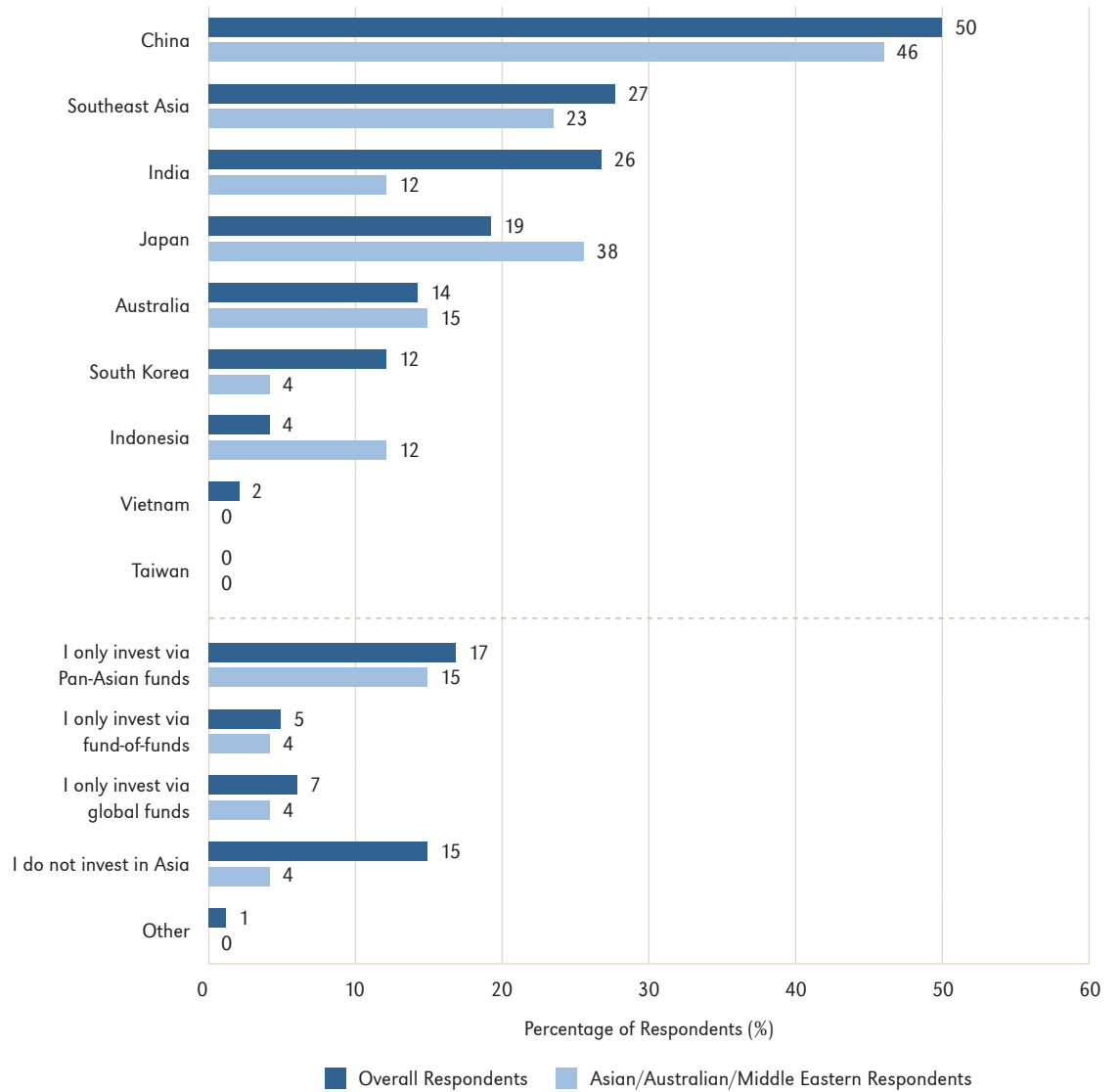
**Chart XXV Commitments to China-Focused Funds by Fund Denomination**



Source: Asia Private Equity Research, as of February 2016

### Chart XXVI Most Attractive Asian Markets

For Asia-focused funds, I find the most attractive markets to be (choose no more than three):



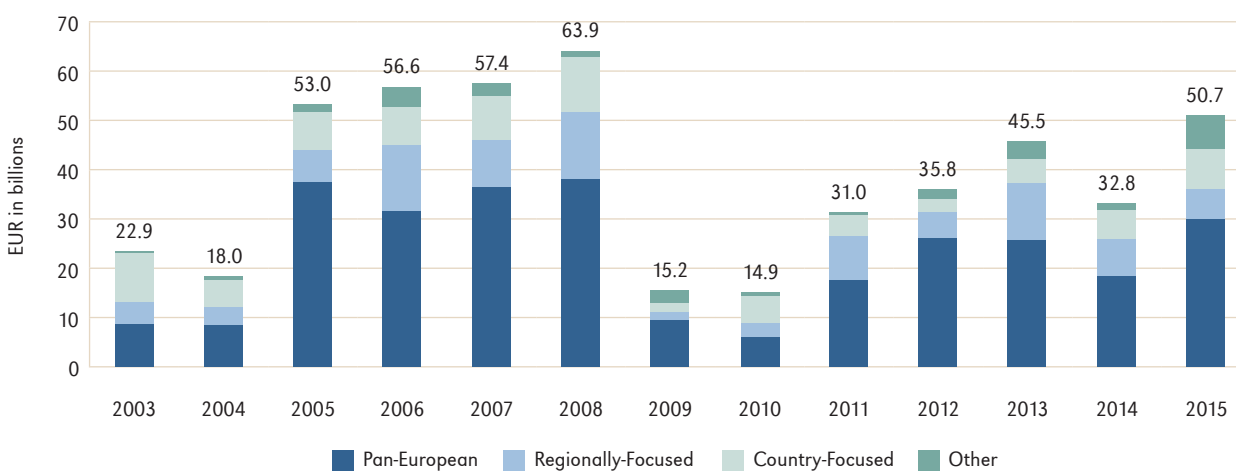
Source: Probitas Partners' Private Equity Institutional Investor Trends for 2016 Survey

## Europe

Europe is the most developed private equity market with the longest history after the United States and is dominated by buyout funds. It is also a market under lingering pressure from a slow recovery after the GFC.

- As detailed in Chart II, buyout/growth capital fundraising increased over 50% in 2015, triggering a steep increase in overall European fundraising. As Chart XXVII shows, the reason for that was a significant increase in both Pan-European and country-focused funds. Though country-focused funds dominate the market in Europe in terms of number of funds, each individual fund tends to be much smaller than its Pan-European brethren.
- Looking forward, our recent survey indicated strong interest in middle-market country-focused funds, especially those targeting the stronger economies of Northern Europe (Chart XXVIII) – with interest in Southern Europe and Eastern Europe being notably weak.
- The most noticeable shift in interest between 2015 and 2016 was an increase in those targeting Italy, a trend that is even more marked among European respondents to our survey. It reflects the feeling that Italy has bottomed out and attractive private equity opportunities are increasing – though the absolute level of interest is still rather small.
- Venture capital fundraising in Europe rose in 2015, helped by a €650 million close from Index Ventures' latest growth fund (Chart XXIX). However, European venture capital is still a fraction of the U.S. venture capital market as, especially in technology, the best European fund managers continue to struggle to achieve comparable returns to top tier U.S. managers.

**Chart XXVII Commitments to European Corporate Finance Funds by Geography**



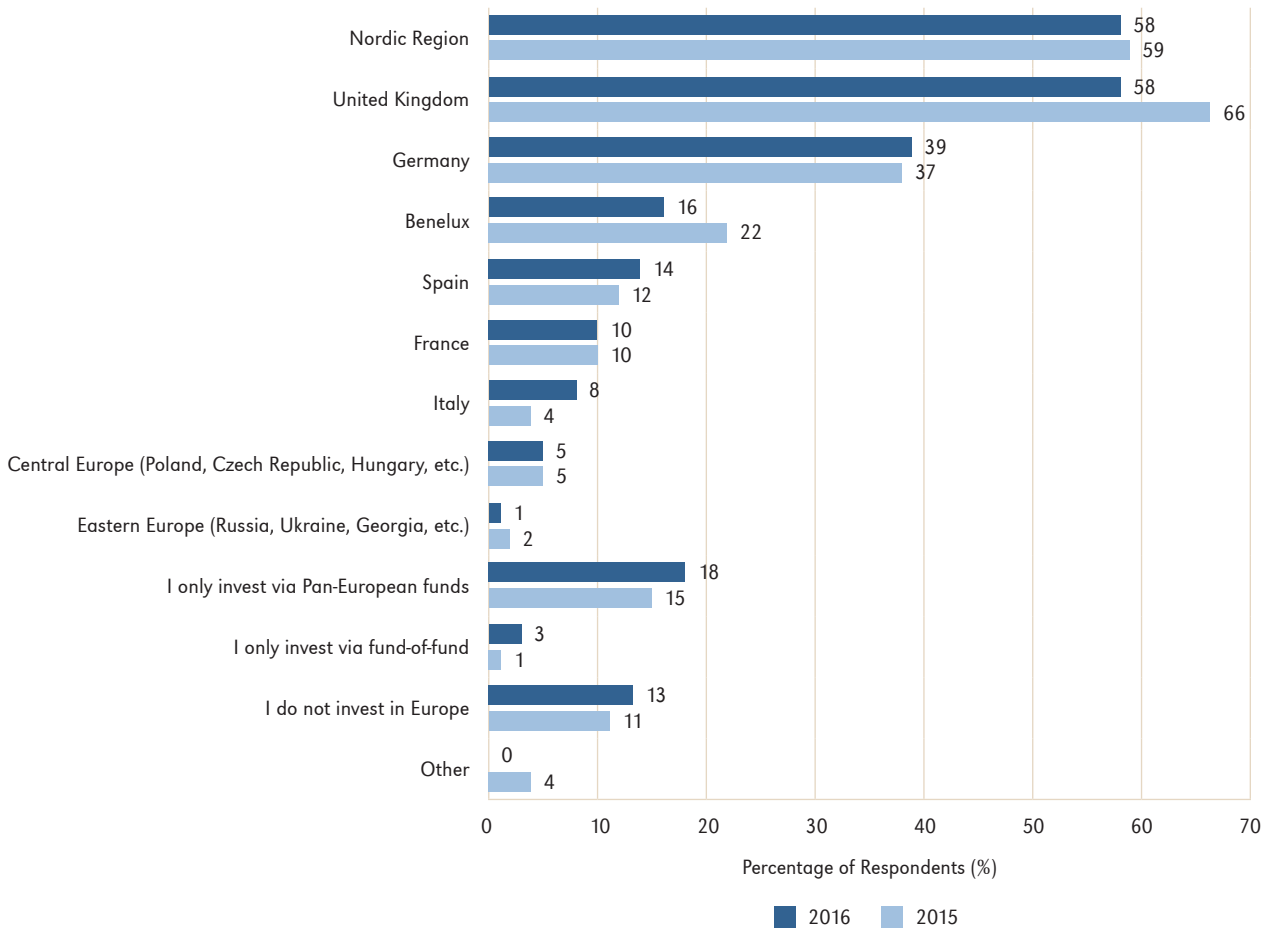
Source: Probitas Partners

Note: "Other" includes commitments to funds with a geographical focus on Eastern Europe, Cyprus, Greece, and Turkey



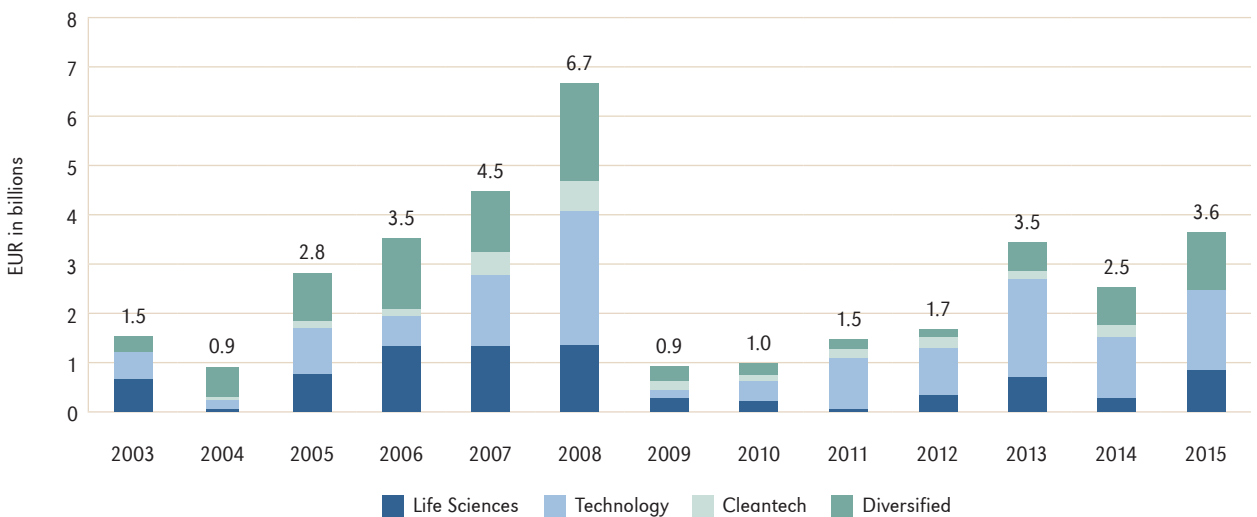
### Chart XXVIII Most Attractive European Markets

For European country/regionally-focused funds, I find the most attractive markets to be (choose no more than three):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2016 Survey

### Chart XXIX Commitments to European Venture Capital Partnerships



Source: Probitas Partners

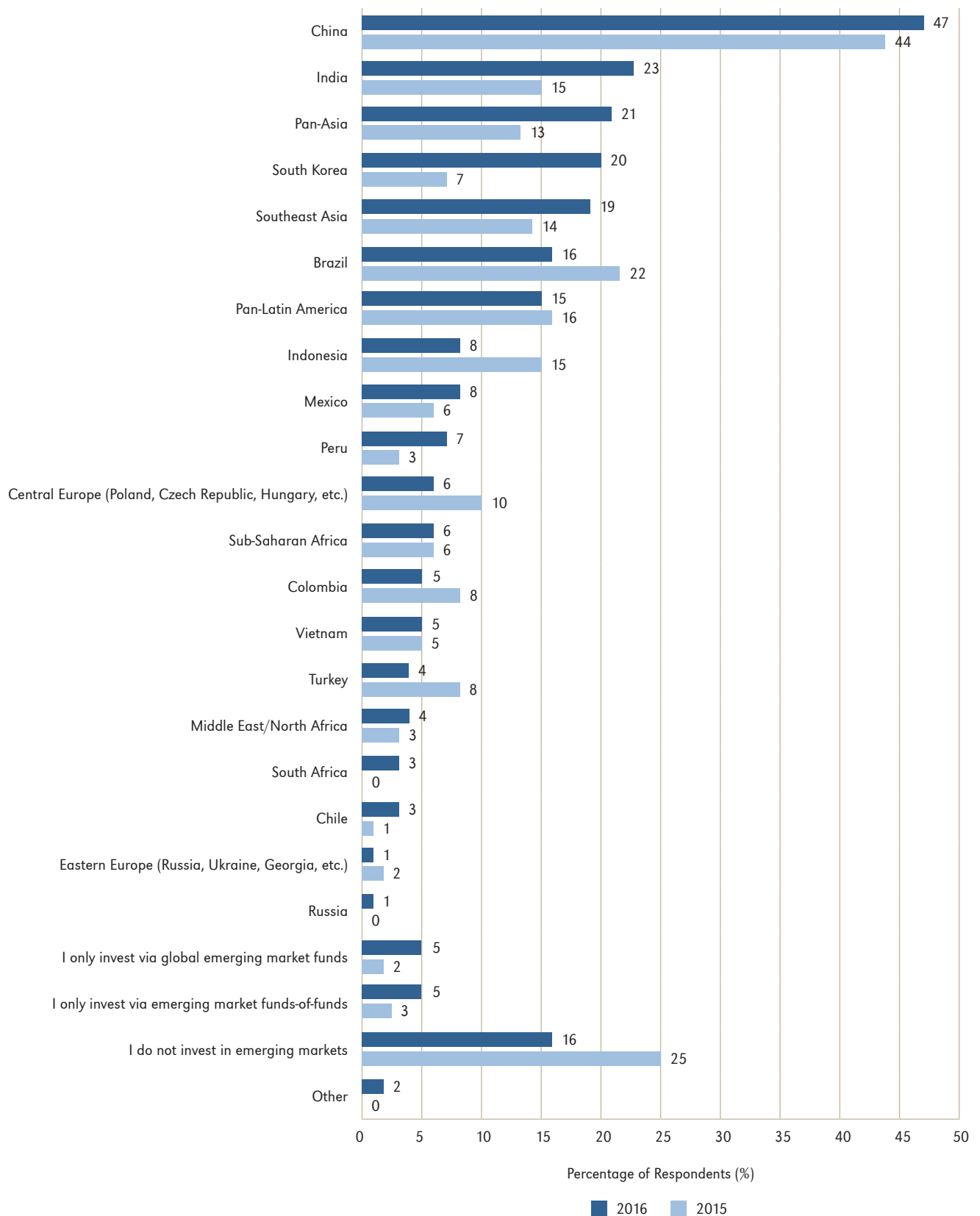
## Emerging Markets

Private equity fundraising for emerging markets in its various country or regional sectors represent a series of niche markets for which investor interest can vary significantly year-to-year based upon economic, political, regulatory, or technical factors. Sanctions against Russia over the Ukraine and the closure of the IPO market in China in 2013 provide some recent negative examples. 2014's surge of Latin American fundraising, driven in large part by the fact that three of the five largest managers in Latin America all closed substantial funds that year that accounted for more than 60% of total Latin American fundraising, is a positive example.

- Though a number of investors still have concerns about China's economy, interest in China increased slightly going into 2016 (Chart XXX). China is by far the most developed private equity sector in the emerging markets; funds targeting China raised \$13.8 billion last year, twice the amount that was raised for all of Latin America.
- At the other end of the BRICs scale is Russia. It has never been a major target for private equity investors, and in this year's survey only 1% of respondents were targeting it. Notably, interest in Brazil, one of the other major BRICs, dropped significantly to 16% from 22% on the back of increasing economic and political difficulties.
- 16% of the respondents to the survey were not interested at all in investing in the emerging markets — though that is a marked improvement on the 32% who had no interest in emerging markets in 2014's survey. This was helped by increasing interest in a number of Asian geographies, including India, South Korea, Southeast Asia, and Pan-Asian funds.
- The Emerging Market Private Equity Association has reported that 2014 was the largest year ever for commitments raised for funds focused on Sub-Saharan Africa, with \$4 billion raised, followed by an additional \$3.4 billion raised in 2015.

### Chart XXX Most Attractive Emerging Markets

Which emerging markets do you find most attractive (choose no more than four):



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2016 Survey  
 Note: South Africa was added for the first time to the survey this year, we have no data for 2015

## Private Debt Markets

Private debt markets are going through a period of turmoil and expansion that is creating new opportunities. In response to stresses at banks in North America and especially Europe, a number of new private vehicles continue to be launched targeting direct lending/senior debt while other sub-sectors have gained in importance as well.

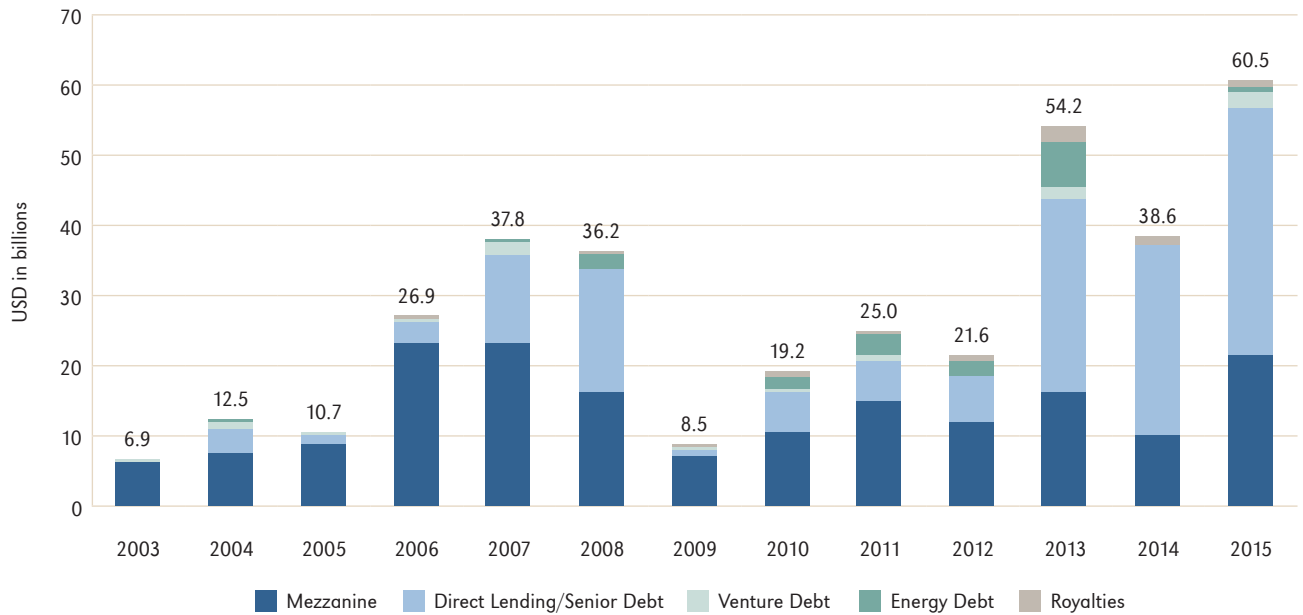
- Probitas Partners tracks fundraising in five different private debt sectors:
  - *Mezzanine*, targeting subordinated debt, often alongside equity co-investments or with equity kickers.
  - *Direct lending*, targeting senior debt or unitranche investments made either directly or, less frequently, through secondary markets.
  - *Venture debt*, usually targeting early-stage venture capital backed companies with a focus on generating returns through equity warrants.
  - *Energy debt*, funds focused on energy sector debt investments (unusual because most debt funds are diversified by industry).
  - *Royalty funds*, which invest in royalty income streams from patented products, mainly in the life sciences sector, which often have bond-like characteristics.
- Fundraising for these sectors was strong in 2015, hitting an all-time peak (Chart XXXI) driven by direct lending — though mezzanine fundraising was also bolstered by an \$8 billion close for Goldman Sachs’s latest mezzanine fund.
- Energy debt had by far its largest fundraising year in 2013 — but interest plunged substantially with the oil price fall in 2015. Energy-focused debt funds raised in 2015 were mainly focused on purchasing distressed debt and not on making new loans.
- As far as geography is concerned, funds focused on North America and funds with a global mandate have tended to lead the market, but interest in Europe has surged over the last three years led by direct lending funds (Chart XXXII). Asia and other emerging markets remain a small part of the market.
- Investor allocations to private debt vary tremendously, with certain investors placing investments into specific allocations to illiquid credit, others making commitments from special situations or tactical allocation buckets, while others make investments from private equity allocations — at least for certain higher return strategies.
- There are a few investors who include distressed debt, real estate debt, and infrastructure debt into overall credit allocations, though many more investors consider these as part of distressed private equity, real estate, or infrastructure allocations, respectively.

---

*“Funds focused on North America and funds with a global mandate have tended to lead the market, but interest in Europe has surged over the last three years led by direct lending funds”*

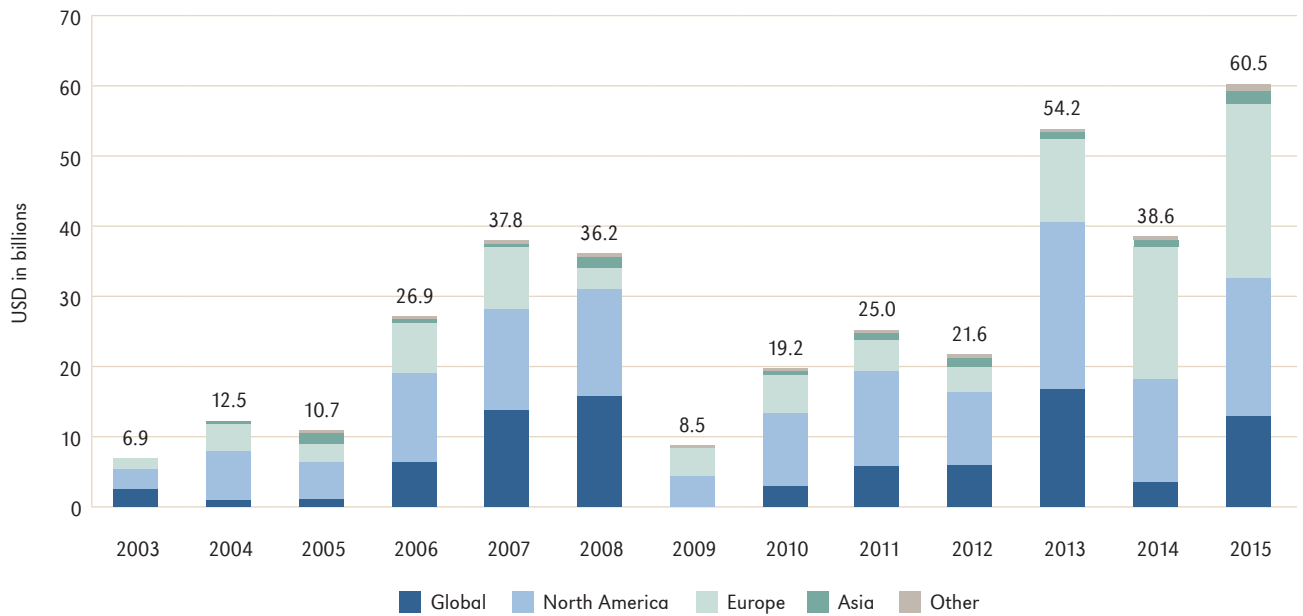
---

**Chart XXXI Global Private Debt Fundraising by Strategy**



Source: Probitas Partners, as of February 2016

**Chart XXXII Global Private Debt Fundraising by Geography**



Source: Probitas Partners, as of February 2016

## Energy and Private Equity

Over the past decade investing in the energy sector had been of increasing interest to private equity investors, especially vehicles targeting fracking and other alternative production strategies in North America. As detailed in the previous section on private debt, there was also strong interest in energy debt during 2012 and 2013. The dramatic drop in oil prices that began in the summer of 2014 has upset those trends.

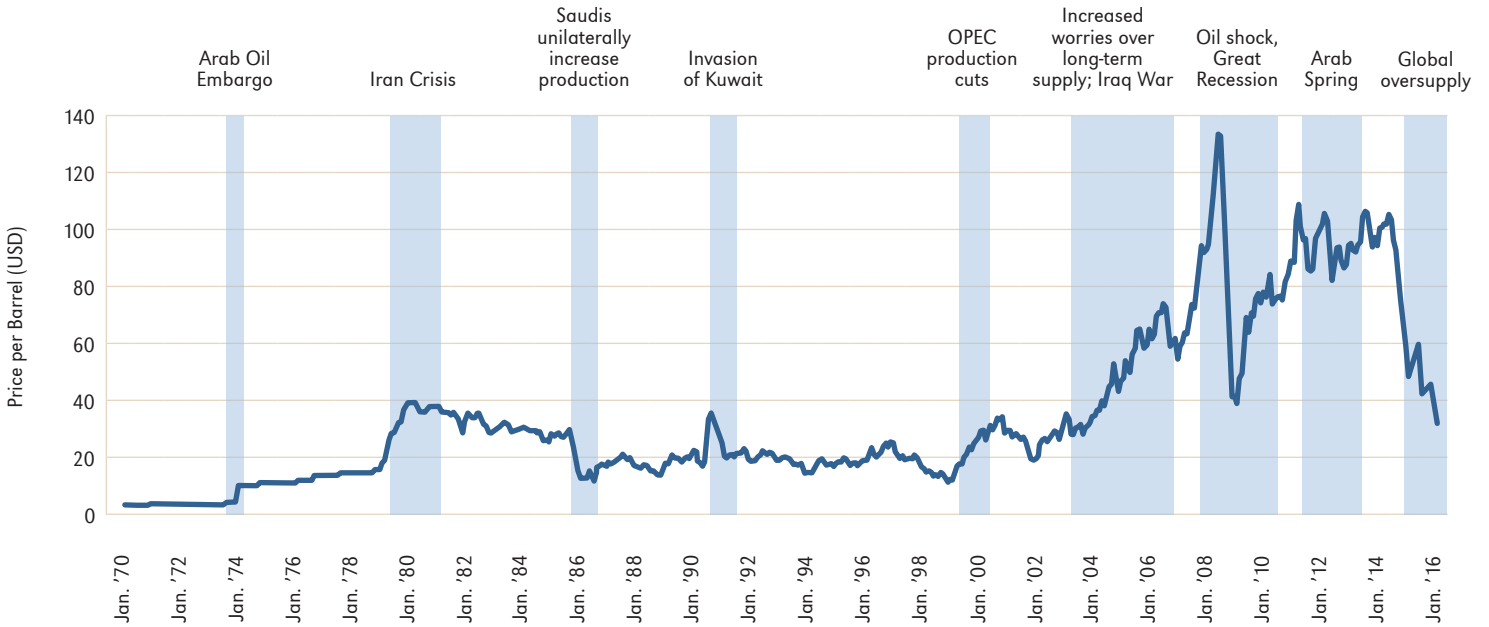
- The price of oil has a history of being stable for long periods interspersed with periods of extreme volatility and sharp price movements (Chart XXXIII). Many of the sharpest movements have been driven by political issues, and though over the long run the trend has been towards increasing prices, many dramatic changes have reversed price gains before settling in at a new equilibrium.
- The current fall in oil prices has been caused by dramatically increased production in the United States driven by alternative methods of production (much of it supported by private equity) coupled with political decisions made to maintain production levels even as prices have fallen. In addition, demand for oil has also slackened — though it has not plunged — due to various issues in a number of markets.
- Natural gas production and pricing in the United States tells a different story driven by similar factors. Chart XXXIV details U.S. natural gas prices over the last 20 years. Because natural gas is more difficult to transport overseas, its pricing is more dominated by local factors. Alternative production technologies and dramatically increased natural gas supply had a more immediate impact on U.S. natural gas prices, which have been relatively low over the last seven years and have now been driven to a nearly 20-year low.
- The current steep decrease in oil prices is having a significant impact on a number of companies in private equity portfolios, dragging down reported performance. At the same time, it is also presenting new investment opportunities in energy companies under stress.

---

*“The price of oil has a history of being stable for long periods interspersed with periods of extreme volatility and sharp price movements”*

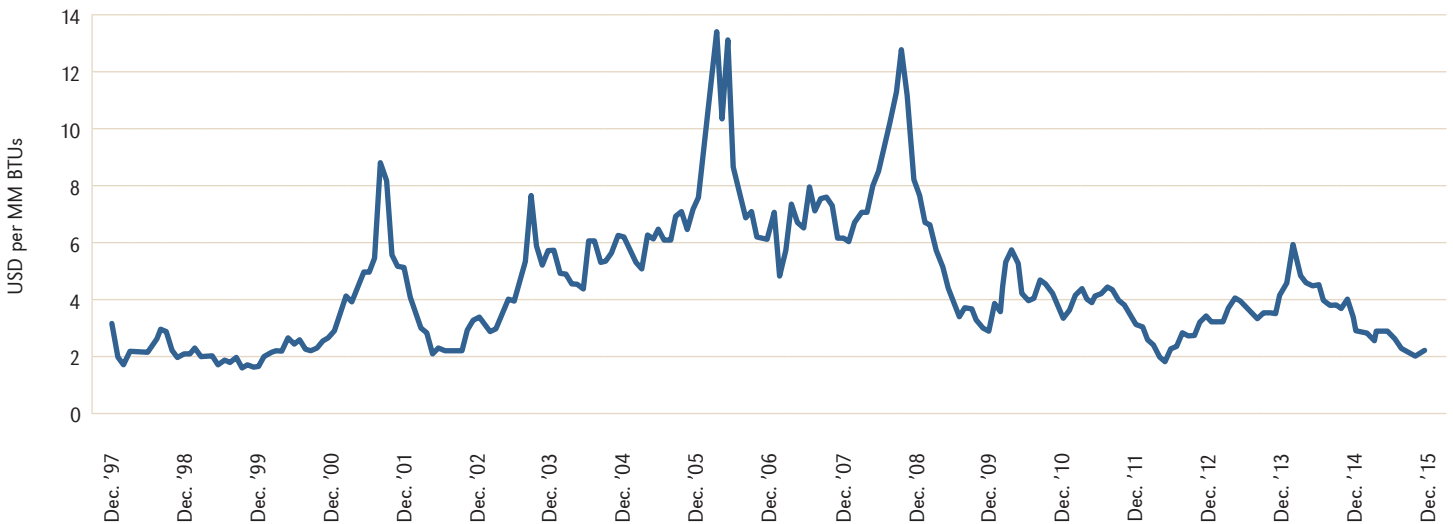
---

**Chart XXXIII Crude Oil Prices, West Texas Intermediate, 1970–2016**



Source: Federal Reserve Bank of St. Louis, current dollar basis

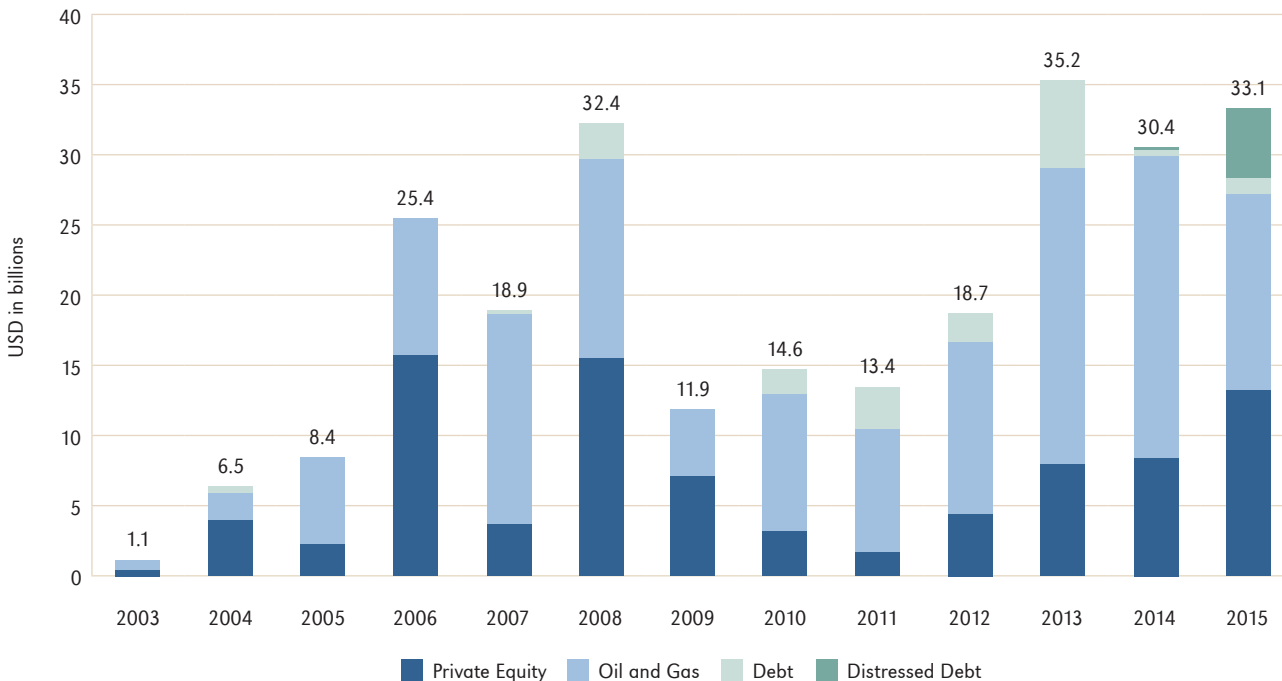
**Chart XXXIV Natural Gas Prices (Henry Hub), 1997–2015**



Source: Energy Information Administration (EIA)

- Chart XXXV details historic fundraising in the sector. The chart tracks four different categories:
  - *Private Equity*. Diversified strategies, with a significant focus on midstream and services companies.
  - *Oil and Gas*. Heavily focused on exploration and production of oil and gas, over the last six to seven years, often with a focus on alternative methods of production.
  - *Debt*. Though most private debt funds are diversified by industry, there are a few firms that are focused on debt investments in energy.
  - *Distressed Debt*. This sector did not even exist as a separate fund focus until 2014, and in 2015 nearly \$5 billion was raised by funds focused on this sector.

**Chart XXXV Capital Raised for Energy-Focused Funds, 2003–2015**



Source: Probitas Partners



---

*“The high transaction levels over the last three years compared to specialist secondary fundraising highlights the fact that large, sophisticated investors are increasingly buying positions directly, instead of investing through specialized secondary funds”*

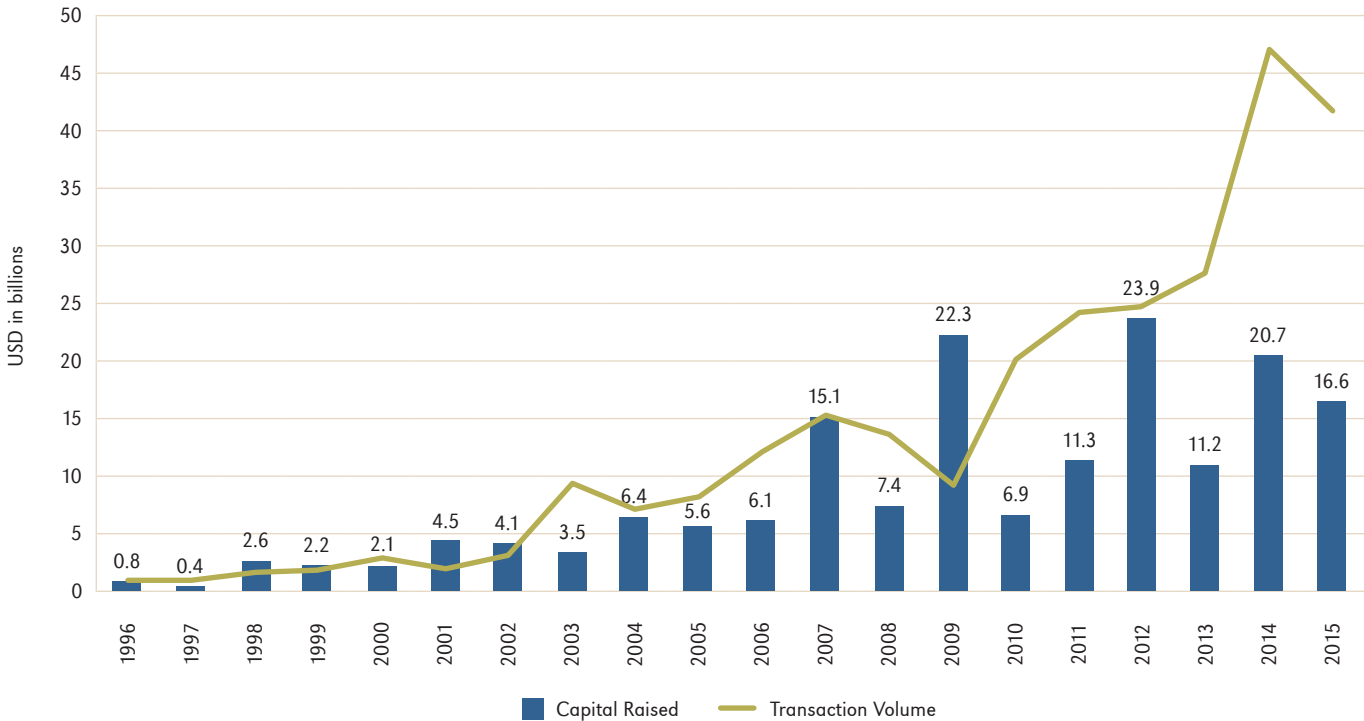
---

## The Secondary Market

The secondary market for private equity has expanded rapidly over the last decade as more sophisticated investors have turned to secondaries as an investment management tool.

- Fundraising for secondary fund specialists declined slightly in 2015 (Chart XXXVI). Historically, fundraising in the sector has been volatile year-to-year driven more by the timing of a few large funds coming to market rather than any sharp change in investor interest.
- Secondary market transaction volume, a surer measure of activity, also declined in 2015, though it was still substantially above specialist secondary fundraising. Volatility in the publicly-traded markets at the end of the year began to impact secondary pricing, increasing the average discount to net asset value (NAV).
- The high transaction levels over the last three years compared to specialist secondary fundraising highlights the fact that large, sophisticated investors are increasingly buying positions directly, instead of investing through specialized secondary funds (Chart XXXVII). When combined with amounts targeting secondaries through primary funds-of-funds, the amount of capital focused on secondaries in Chart XXXVI is understated substantially.
- Chart XXXVII also details that a number of investors both buy and sell positions in the secondary market, using that market as a tool to actively rebalance their portfolios.
- Over the last few months the SEC, responsible for overseeing a majority of private equity funds in the United States, has stated that it will increasingly focus its attention on the potential for conflicts of interest on structured secondaries used to restructure funds, usually those having difficulties, with the involvement of the general partner of the fund. It is uncertain how any decisions announced by the SEC might impact the market.

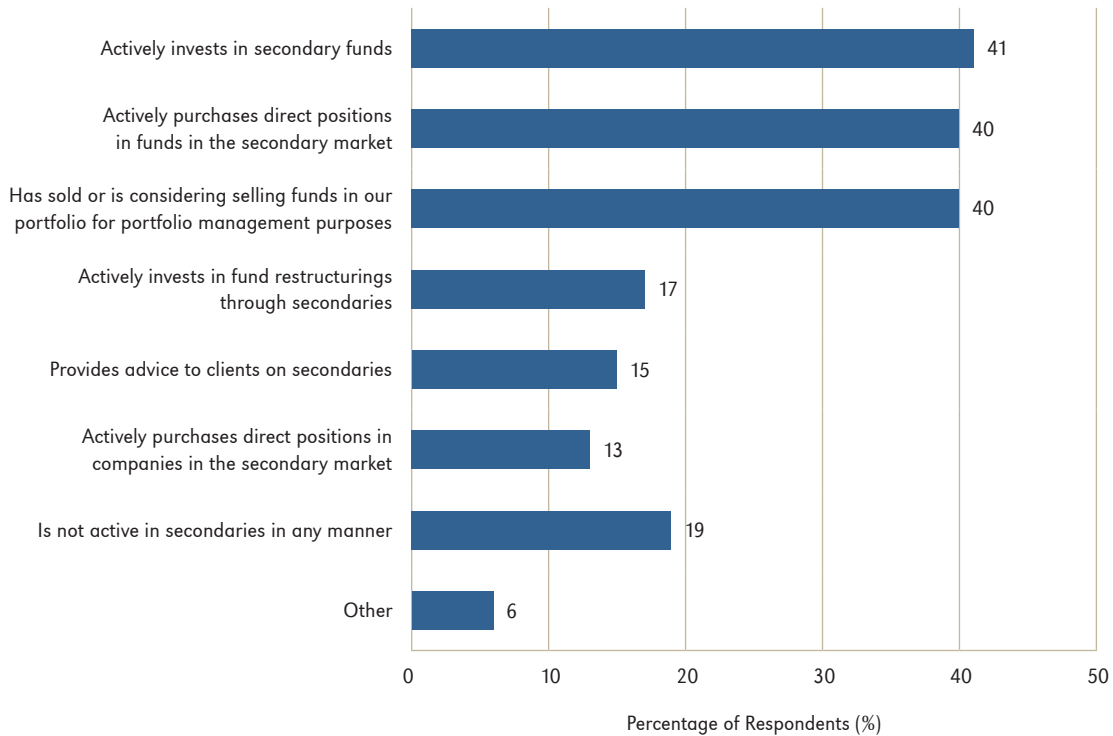
**Chart XXXVI Secondary Market Transaction Volume and Capital Raised by Secondary Fund Specialists**



Source: Probitas Partners

**Chart XXXVII Secondary Market Investments**

*In the secondary market, my firm (choose all that apply):*



Source: Probitas Partners' Private Equity Institutional Investor Trends for 2016 Survey





# PRIVATE EQUITY 2016 FORECAST & DESKBOOK

## **Probitas Funds Group, LLC**

425 California Street  
Suite 2300  
San Francisco, CA 94104  
USA  
Tel: +1 415 402 0700

## **Probitas Funds Group, LLC**

1120 Ave. of the Americas  
Suite 1802  
New York, NY 10036  
USA  
Tel: +1 212 403 3662

## **PFG-UK Ltd.**

1 Stanhope Gate, 4th Floor  
London  
W1K 1AN  
UK  
Tel: +44 20 3829 4330

## **Probitas Hong Kong Limited**

Nexus Building  
Level 15  
41 Connaught Road  
Central, Hong Kong  
Tel: +852 3757 9727