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A Macroeconomic Overview

In 2015, global economic activity remained subdued. Growth in emerging market and developing economies – while still accounting for 70% of global growth – declined for the fifth consecutive year, whereas a modest recovery continued in advanced economies. Global manufacturing activity and trade remained weak in 2015 reflecting restrained global demand and a decline in investment in extractive industries. Oil prices fell significantly throughout the latter half of the year, in response to expectations of sustained production increases by OPEC members amid a global surplus. In regard to global equity markets, returns remained fairly tepid or fell during the year. In the US, the S&P 500 and Russell 3000® returned -0.7% and -1.5% for the year, respectively. European equity markets were mixed, as the FTSE 100 fell 4.9% and the DAX 30 gained 9.6%. As for emerging markets, geopolitical uncertainty prevailed, as evidenced by a 17.0% drop in the MSCI Emerging Markets Index. Overall, the gradual slowing and rebalancing activity in China, falling energy and commodities prices, and the tightening of monetary policy in the US should continue to be the primary drivers of global economic affairs in 2016.
Economic Growth

According to early estimates from the Bureau of Economic Analysis, US real GDP increased at an annualized rate of 0.7% in the fourth quarter of 2015, following a moderate third quarter in which growth was up 2.0%. The increase in real GDP in the fourth quarter primarily reflected positive contributions from personal consumption expenditures, residential fixed investment, and federal government spending, which was partially offset by negative contributions from private inventory investment, exports, and nonresidential fixed investment. On an annual basis, US real GDP increased 2.4% year-over-year in 2015, representing the same rate as 2014.

The euro area continued its recovery with the help of lower oil prices, monetary easing, and the euro depreciation. Conversely, potential growth remains weak as a result of lingering crisis legacies along with the slowdown in total factor productivity which predates the financial crisis. For countries such as France, Italy, Spain, and Germany, early estimates suggest an annual growth rate of 1.2%, 0.8%, 3.1%, and 1.5%, respectively. Overall, the International Monetary Fund (“IMF”) expects real GDP in the euro area to reach 1.5% in 2015, a notable increase from 0.9% in 2014.

In China, the economy grew at an annual rate of 6.8% in the fourth quarter of 2015, slightly down from the 6.9% in the previous quarter and the weakest since the first quarter of 2009. This figure was in line with market expectations as strength in services and consumption offset weaker manufacturing.
and exports. For the full year of 2015, China’s GDP growth missed the 7.0% government target by 0.1 percentage point, lower than the 7.3% in 2014 and the weakest growth in 25 years.

**Unemployment**

The US unemployment rate decreased from 5.6% in December 2014 to 5.0% in December 2015, representing the lowest level since April 2008 for the third month in a row. On an absolute basis, the number of unemployed persons was 7.9 million, a 0.8 million decrease from 2014, and the number of long term unemployed persons fell by 0.7 million over the year to 2.1 million.

The seasonally adjusted unemployment rate in the eurozone decreased slightly to 10.5% in November 2015 when compared to the previous month of 10.6% and prior year of 11.5%, representing the lowest rate recorded since October 2011. Among the member states, the lowest unemployment rates were recorded in Germany (4.5%), the Czech Republic (4.6%), and Malta (5.1%), whereas the highest were registered in Greece (24.6% in September 2015) and Spain (21.4%).

According to early estimates from the IMF, Southeast Asian countries continued to observe low levels of unemployment. The lowest levels were in Thailand (0.8%), Singapore (2.0%), and Vietnam (2.5%) followed by Malaysia (3.0%), Japan (3.5%), and South Korea (3.7%). The unemployment rate in China remained unchanged from the prior quarter at 4.05%, which is slightly lower than the 4.1% unemployment rate at the end of 2014.

**Inflation**

Consumer prices in the US increased to 0.7% year-over-year in December 2015, higher than 0.5% in the previous month, but below market expectations of 0.8%. Upward price pressure was driven by services (less energy), medical care, and transportation services. Food inflation fell to 0.8% from 1.3% in November, and energy costs fell 12.6%, representing a slower decline than the 14.7% drop recorded in the previous month.

Consumer prices in the eurozone edged up 0.2% year-over-year in December 2015, in line with the previous month and preliminary figures. The largest upward impacts to annual inflation came from restaurants and cafés, tobacco, and vegetables, whereas fuels for transport, heating oil, and gas had the biggest
downward impacts. In December 2015, negative annual rates were observed in 12 member states, the lowest of which were registered in Bulgaria (-0.9%), Romania (-0.7%), Cyprus (-0.6%), and Slovenia (-0.6%).

China’s annual inflation rate matched consensus estimates at 1.6% in December 2015, slightly higher than the 1.5% rise in the previous month. The politically sensitive food prices increased by 2.7% on the back of upward price pressure from fresh vegetables and meat & poultry, which were partially offset by downward pressure from eggs, fresh fruits, and dairy products. Non-food costs rose at a slower pace of 1.1%, which were primarily driven by tobacco & liquor, clothing, household equipment and maintenance services, and were partially offset by declines in transport and communication.

Sovereign Banks

According to the Fed’s December press release, US economic activity has been expanding at a moderate pace in the second half of 2015. Household spending, business fixed investment, and the housing sector continued to grow at a solid pace, and ongoing job gains and declining unemployment confirmed that underutilization of labor resources has diminished appreciably over the year. As a result, the Federal Open Market Committee (“FOMC”) elected to raise the target range for the federal funds rate to 0.25% to 0.5% in December, despite missing the long-term inflation objective of 2.0%. In an attempt to mitigate the issue, the FOMC stated, “Inflation is expected to rise to 2.0% over the medium term as the transitory
effects of declines in energy and import prices dissipate and the labor market strengthens further. The Committee continues to monitor the inflation developments closely.”

In Europe, the European Central Bank (“ECB”) maintained its benchmark refinancing rate at a record low of 0.05% and extended its €60 billion per month quantitative easing program to March 2017, which has boosted confidence and eased financial conditions. According to the IMF, these monetary policy efforts should be supported by measures to strengthen bank balance sheets, which would help improve monetary policy transmission and credit market conditions. As such, stricter supervision of nonperforming loans and measures to improve insolvency and foreclosure procedures continue to be a priority moving forward. As for the European escapades over summer, Greece remained in the spotlight after Greek voters rejected the terms of a financial bailout package, which called into question the stability of the monetary union and the possible expulsion of the delinquent member. Ultimately, a compromise was reached and European lenders approved an €86 billion bailout package that imposed austerity measures, but only after Greece defaulted on a $1.7 billion loan payment to the IMF.

One of the most noteworthy events circling Asia in 2015 revolved around the increased flexibility of the yuan. On August 11, the People’s Bank of China (“PBOC”) unexpectedly devalued its currency midpoint to 6.2298 per US dollar, the lowest point in nearly three years. China manages the exchange rate through an official midpoint, or daily fixing, and is permitted to adjust the yuan 2.0% above or below the midpoint in daily trading. According to a statement released by the PBOC, the move was to better align the

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**Central Bank Rates**

![Central Bank Rates Chart](source: Trading Economics)
currency with market forces and promote growth by giving domestic exporters an edge in global markets. This whirlwind of monetary action was coupled with six interest rate cuts since November 2014 that resulted in an overall drop of 1.65 percentage points for the benchmark lending rate.

The Outlook for 2016

Global growth, currently estimated at 3.1% in 2015, is projected at 3.4% in 2016 and 3.6% in 2017, according to the IMF. A modest and uneven recovery is expected to continue in advanced economies, whereas emerging and developing economies will continue to witness diverse and challenging conditions. The projected growth over the next two years primarily reflects forecasts of a gradual improvement of growth rates in countries currently in economic distress, notably Brazil, Russia, and some countries in the Middle East. Risks to the global outlook relate to ongoing adjustments in the global economy such as the slowing in emerging market economies, rebalancing in China, dwindling commodity prices, and the gradual exit from accommodating monetary conditions in the US.

Growth in the US is expected to reach 2.6% for both 2016 and 2017, which is primarily driven by continually easy financial conditions and gains in the housing and labor markets. This growth is partially offset by a strengthening dollar and its pressure on manufacturing activity, along with lower oil prices curtailing investment in mining structures and equipment. Longer-term growth is expected to weaken, however, as the result of an aging population and low total factor productivity growth.
In the euro area, stronger private consumption supported by lower oil prices and easy financial conditions outweighs the expected weakening in net exports. As a result, year-over-year growth in the euro area is expected to reach 1.7% through 2017. Emerging Europe is projected to continue growing at a steady pace, albeit with some slowing in 2016. Russia, which continues to adjust to low oil prices and Western sanctions, is expected to remain in recession during 2016. Other economies of the Commonwealth of Independent States are caught in the slipstream of Russia’s recession and geopolitical tensions, and are projected to expand only modestly in 2016, but gain traction in 2017.

In Asia, the IMF projects that growth in China is expected to slow to 6.3% in 2016 and 6.0% in 2017, primarily reflecting weaker investment growth as the economy continues to rebalance. India and the rest of emerging Asia are generally projected to continue growing at a robust pace, although some countries may face strong headwinds from China’s economic rebalance and manufacturing weakness.
Tactical Summary

North America Buyouts > page 11

**SMALL ($500 Million and Below) and MIDDLE MARKET ($500 Million to $5 Billion)**
- **Favorable:** Continued strong exit interest from strategic purchasers and larger buyout funds, strong deal flow, continued monetary accommodation, US economic growth acceleration
- **Unfavorable:** US public market volatility, high level of dry powder in upper middle market, extended debt and purchase price multiples in upper middle market

**LARGE ($5 Billion and Over)**
- **Favorable:** Continued strong exit interest from strategic purchasers, strong deal flow, continued monetary accommodation, US economic growth acceleration
- **Unfavorable:** US public market volatility, high level of dry powder, extended debt and purchase price multiples

Europe Buyouts > page 17

**SMALL (€500 Million and Below) and MIDDLE MARKET (€500 Million to €5 Billion)**
- **Favorable:** Boost from quantitative easing, beginnings of expanded credit flow from banks, acceleration of GDP growth in euro area, somewhat more moderate purchase price and debt multiples in small middle market, more stable exit routes for smaller deals
- **Unfavorable:** Deflation risk persists, emerging market slowdown threatens export sector, high purchase price and debt multiples in larger end of middle market

**LARGE (€5 Billion and Over)**
- **Favorable:** Boost from quantitative easing, beginnings of expanded credit flow from banks, acceleration of GDP growth in euro area
- **Unfavorable:** Deflation risk persists, near-record purchase price and debt multiples, emerging market slowdown threatens export sector

Special Situations Distressed Debt, Mezzanine, Secondaries > page 26

**DISTRESSED DEBT** > page 26
- **Favorable:** Investor repricing of credit risk, major deterioration of US energy sector HY debt, large quantity of lower quality debt issuance since 2011, Fed rate hike, European NPL sales
- **Unfavorable:** Continued accommodative central bank postures, lack of breadth in US HY market decline

**MEZZANINE** > page 34
- **Favorable:** Buyout deal flow remains at reasonable levels, beginning of Fed rate hike cycle, disruption of high yield markets
- **Unfavorable:** Excess dry powder, high leverage multiples in buyout sector, interest rates still highly accommodative

**SECONDARIES** > page 38
- **Favorable:** Public equity market decline and volatility, slightly moderating NAVs and transaction pricing, potential for opportunistic environment within next 12 to 18 months has increased
- **Unfavorable:** Continued absence of liquidity pressure on sellers, extension of Volcker Rule compliance, substantial overhang of dry powder devoted to strategy, high pricing persists for better quality assets

**Venture Capital** > page 44
- **Favorable:** Pace of innovation, inventory of attractive enterprises, momentum from past two years
- **Unfavorable:** Valuations across all major stages at or near peak levels for this cycle, shortening window for exit in bull equity market, attractive deals remain highly competitive, exit markets are volatile and currently underperforming

Ratings are tactical recommendations and assume a portfolio with a stable strategic allocation.

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It should be noted that TorreyCove’s private equity portfolio management methodology emphasizes the equal or greater importance of manager selection in relation to other elements of the portfolio management process, such as regional or sector weightings. For this reason, a client may pursue an investment with a top-performing investment manager even when a region, sector, or strategy is deemed less attractive on a relative basis. These are guidelines; an institution’s weightings may differ based on their current portfolio composition and overall goals, objectives, and risk tolerance.
Buyouts > North America

2015 Recap

The past year was another of steady performance on the fundraising trail for North American buyout funds, which gathered approximately $106 billion in fresh commitments for the year, a level that is essentially flat in comparison to both the 2013 and 2014 levels. Taken together, fundraising for the last three years marks a full recovery from the post-crisis doldrums experienced by the buyout sector. For each of those years, the amount raised was at or near 3x the amount raised at the 2010 nadir and well above the average of $58 billion set in the 2009 – 2012 period. That being said, last year’s fundraising figure represents a drop of over 40% from the peak year of 2007, which should be reckoned a positive.

The see-saw battle between mega and large funds for primacy continued, with mega funds gaining the upper hand in the past year, in part due to the closing of the $17.5 billion Blackstone VII vehicle. Buyout investment flow was solid in 2015, turning in the best post-crisis performance to date, as buyout shops looked to deploy a large amount of dry powder while market psychology was favorable and debt remained plentiful and low-cost. Investment of $292 billion more than doubled 2014’s $124 billion, or any year since 2007 for that matter. The exit environment for sponsor-backed deals remained strong for much of 2015, and would likely have exceeded what was a standout year in 2014, if markets had not deteriorated in the latter part of the year. M&A flow for buyout-backed firms totaled approximately $153 billion, over 16% higher than 2014’s amount. The IPO side of the equation was a very different story, with 2014’s IPO proceeds of over $60 billion substantially outperforming 2015’s $18 billion, which more than explains the relative decline in total exit value for 2015.

North American Buyout Deals - Cambridge ($ billions)

![Graph showing North American Buyout Deals from 2006 to 2015](chart.png)

Source: Cambridge
Buyouts > North America

**Outlook**

The past few years have seen North American buyout shops execute an impressive run, including a full recovery of fundraising and strong exit performance, particularly in 2014 and 2015. Capital deployment has been less outstanding over this timeframe, but has shown steady growth and remained at a healthy level in 2015. While we expect this momentum to carry into 2016, the coming year is expected to be a more challenging one for the buyout space as the US market moves into the later innings of the current cycle. As it enters 2016, the North American buyout sector appears to be facing more headwinds than it has been accustomed to in recent years.

For one thing, it looks like the cheap debt party is at the beginning of the end, barring another recession. With the Fed finally engineering “lift-off” in December 2015, the stage is set for modest increases throughout 2016, though the timing and magnitude are a source of debate. Though the actual minor rate increase the Fed undertook in December is of little consequence to any particular existing or proposed buyout deal, the signaling of a rising rate environment may have a modest dampening effect on credit flows in the near term, with a growing impact later this year and into the next as rate increases proceed. Overall, this is a bearish sign for buyout deal making, especially as it regards the most highly levered and marginal deals.

**Credit Market Disruption**

There are also indications that the credit environment in the US is entering a tighter phase, although it is still highly accommodative. One exhibit in this respect is the high yield market, which was under heavy stress in the last quarter of 2015 and posted a loss of over 5% for the year, its first since the financial crisis. Estimates for 2016 are generally not optimistic, typically ranging from a negative 2% to 3% to a positive...
1% or 2% total return for the year. Of course, the obvious culprit for the decline is the energy sector, which had been issuing high yield debt in massive quantities for the past few years, and which currently accounts for about 11% of the high yield market. While there is no doubt that the energy sector is most highly implicated in the high yield decline, market fears over the other 89% of the high yield market, particularly the lower-rated issues, present the prospect of a contagion beyond energy names and appear to discount an expected higher default rate within the junk universe. While the credit markets remain open and accommodative (as noted above), the signs are now pointing to further tightening and increasing lending standards rather than more easing. All in all, this should begin to present a challenge to buyout deals, particularly within the mega, large, and middle markets where leverage is more aggressively utilized and where the bulk of buyout dollars are deployed.

**Competition Remains Intense**

The deal environment in 2015 was as competitive as nearly any on record, primarily driven by a banner year for strategic M&A activity. US corporate acquirers finally began to deploy their cash hoards - which totaled over $1.5 trillion at the beginning of the year - aggressively in 2015, pumping approximately $2.3 trillion into nearly 11,000 transactions, an eye-popping increase of 55% over the 2014 level ($1.5 trillion). According to Ernst & Young, the pace is not expected to slacken considerably in 2016, as 57% of US corporations report at least three deals in their active pipeline at the onset of 2016 and nearly three-quarters of US executives anticipate doing M&A deals in the coming year. And the demand is not just coming from the domestic side, as strong foreign interest in acquiring US assets materialized into $408 billion in deals in 2015 – in spite of dollar strengthening - making the US the most targeted country for the year.
As if this does not make things competitive enough, the US buyout sector has made its own contribution to heated deal valuations, in large part due to its own pile of cash awaiting deployment. Recently, Preqin reported $480 billion in dry powder sitting in the coffers of buyout funds globally (third quarter of 2015), of which over half resided with US buyout shops (about $275 billion), figures that rival or exceed the most exuberant years leading up to the financial crisis.

It is no surprise then that deal values remain highly elevated. Both 2014 and 2015 saw purchase price multiples for all LBO transactions break 10.0x (10.3x for 2015), a level not seen even in the bubble years of 2006 and 2007. This pattern held for both large cap and middle market transactions, which posted multiples of 10.1x and an impressive 10.7x, respectively, for the year. Leverage levels essentially held even for the year, at 5.7x for large deals and 5.3x for the middle market. In both cases, these are the highest levels seen in the past 15 years, barring the peak year of 2007 (6.2x and 5.6x, respectively).

**Challenging Investment Environment**

Given that limited partners remain relatively bullish on the private equity asset class as a result of strong distributions in recent years and outperformance versus US equity and bond markets in the past year, we anticipate another solid fundraising year in 2016, though it may be tempered somewhat by easing allocation pressures and probable lower distribution levels in the coming year. Capital deployment is likely to be a challenge for the North American buyout sector in 2016, due to the continuation of aggressive competition for deals by both strategic and private equity houses, as well as the marginally less accommodative credit environment. Purchase price multiples are expected to remain high, while debt
multiples may moderate slightly as credit becomes a bit more tight, though levels should remain well at the high end of the range set over the past ten years since debt is still freely available for good quality private equity LBO deals. Even though the flat equity market of 2015 might be expected to temper seller valuation expectations somewhat, the public markets remain at reasonably high valuation levels and there is typically a significant lag between public market pricing and adjustment of expectations on the private side; therefore, very little relief in terms of pricing is expected from this dynamic in 2016. Somewhat surprisingly, private equity shops have exhibited reasonable discipline in deploying capital over the past few years, with certain signs of excess – club deals and multiple mega deals – not in evidence. Apparently institutional memories of the financial crisis still pack some punch, though it cannot have hurt the cause of discipline to be outbid by aggressive corporates during the past year. Nevertheless, with another year past the financial crisis and a moderately well-performing US economy in the balance, memory can be expected to fade and the pressure to deploy capital to take control, with a resultant slippage in pricing discipline. We expect North American buyout players to face a rather stark choice this year: lose discipline or lose deals. Firms that do not want to simply pay up will have to be especially creative in 2016 and work in the niches. We expect add-on acquisitions to have a good year and specialist firms to outperform the general buyout universe in terms of capital deployment.

Exit Picture Less Clear

The return of volatility to US equity markets in 2015, combined with the disappointing returns for the year have muddied the exit picture for North American buyouts going into 2016. Initial public offerings for private equity-backed companies were already down significantly in 2015 and it is doubtful that 2016 will be a solid year in this respect, though there will be windows of opportunity for this exit route. Secondary sales, coming off a down year (42% decline), are also not expected to be a robust exit route in the coming year.

The bright spot on the exit horizon is the same thing that is making deployment difficult for private equity firms: strategic M&A. With corporates still aggressive, trade sales should be particularly dominant this year. While a poor year on the exit front is not expected, the upward momentum looks to have broken and a relatively flat year in comparison to 2015 seems likely.

Our tactical rating for the small and middle market buyout sector is moving from “Moderate Overweight” to “Neutral.” The middle market sector, particularly its high end, is impacted by the same factors as the large buyout sector, and if anything, appears to be more competitively heated, if purchase price multiples are to be trusted. Only the lower reaches of the middle market sector appear to have avoided some of the pricing pressure and should still have a relatively attractive exit route with regard to secondary sales.
Our tactical rating for the large buyout sector is moving from “Neutral” to “Moderate Underweight.” The risk presented by the continued intense competitive pressures of the market, as evidenced by excessive purchase price and debt multiples, now outweigh the constructive factors for the sector, namely a growing US economy, continued ease of obtaining low-cost credit, and a robust M&A exit market. Moreover, recent events have lessened the strength of these latter positive factors. In particular, the Fed’s signal of a rising interest rate environment and the deterioration of the high yield market point to a somewhat tougher credit environment, while US equity market volatility and underperformance suggest a more difficult year for exits is in the offing, meaning the pressure on limited partners to deploy recently distributed capital is likely to lessen. Even US economic prospects are under some threat from uncertainty regarding China and the effects of a stronger dollar.
2015 Recap

The European buyout sector made a solid showing in 2015, as signs of life on the macroeconomic front appeared to quell the fears of private equity investors, GPs and LPs alike, and induced them to open their pockets to deploy capital into the European theater. Fundraising came in at a respectable pace, with 2015’s €45 billion over 45% ahead of a somewhat modest figure from 2014 (€31 billion) and only about 10% off a relatively strong 2013. It should be noted that each of the years 2013 through 2015 have had stronger fundraising than any year since 2008. European buyout funds had a good year in terms of capital deployments in 2015, with €81 billion in investment marking the fourth straight year of increase (€76 billion for 2014) and the best year since the euro crisis reared its head. The volume of deals was relatively steady at 1,094, a dip of about 5% from the prior year, while deal size appears to be reasonable, as indicated by a drop in the average size from €101 billion to €90 billion. Both of these numbers, while at the higher end of the post-crisis range, are less than half of the peak average deal size seen in 2007. In our 2015 Outlook, we voiced an expectation that European buyouts would have another solid year of exits, coming off a breakout year in 2014, and this came to pass. For 2015, European buyout-backed companies generated about €130 billion in exit value, effectively flat with the prior year. Both years were an approximate 46% improvement over the 2013 figure, better than any year during or since the financial crisis (including 2006 and 2007), and over 5x the post-crisis low in 2009.

Source: Preqin
At the beginning of 2015, an investor had some right to feel a (very) modest sense of optimism regarding the prospects of the European Union (“EU”) and the eurozone in particular. While the latest installment of the Greek debt crisis – which was finally resolved in cliffhanger fashion in June - did its best to derail those prospects, European economies generally justified this optimism, albeit in an unspectacular and incremental fashion. With the rather large exception of the sovereign debt/currency crises, most economic factors were in the tailwind category for the region in 2015. For one thing, the ECB maintained a highly accommodative monetary policy stance and continued robust implementation of its version of quantitative easing. Though this was apparently not enough for the markets, as indicated by the selloff in December triggered by the Bank’s failure to expand the program as expected. External factors also played a role, most notably the massive decline in energy prices, an economic shot in the arm for a net energy importer such as the EU. Further, a weakening of the euro provided a boost to the export sector, with eurozone states, Germany in particular, benefitting in terms of trade with external partners, including non-eurozone states within the EU.

Recovery Is Underway, but Precarious

As was the case a year ago, the high level data remain somewhat mixed, but the trend is unmistakably positive and momentum appeared to pick up in 2015. In response to the aforementioned tailwinds, the EU economies posted the strongest growth seen since 2011, with real GDP expected to come in at approximately 1.6% for the euro area (1.9% for the EU) for 2015. Moderate increases are projected for the euro area in 2016 (1.8%) and 2017 (1.9%), with slightly better growth expected in the EU. In spite of the ECB’s loose monetary policy, neither the EU nor euro area (“EA”) could muster any inflation in 2015. After 2014, a year in which there was essentially zero inflation, the region once again flirted with deflation, with
2015 projections indicating inflation of 0.1% for the EA (0.0% for the EU). These figures are expected to rebound next year and breach the 1.0% level. However, since energy prices are the primary factor putting downward pressure on prices, the projected rebound relies in large part on a rebound and stabilization in energy prices, which looks less and less likely as 2016 kicks off, suggesting continued downward pressure on price inflation in 2016. The unemployment picture for the region remains rather gloomy, with EA unemployment, currently at about 11.0%, not expected to get out of double digits until possibly 2018. The EU is only marginally better at 9.5% (projected) in 2015 and dropping below 9.0% only by 2017.

Credit Is Slowly Returning

The credit picture in Europe improved in slow and steady fashion in 2015. Though senior loan sponsored volume was down slightly in 2015 (around €85 billion) in relation to a relatively strong year in 2014, LBO loan volume of just over €40 billion in 2015 posted a slightly better year than 2014. The more important story however, is the continuing recovery of bank lending, which began to show signs of life in 2014. The October 2015 Bank Lending Survey highlighted upturns in demand for credit from both the business and household sectors, along with an easing of credit standards for all major loan categories with the exception of home purchase debt to households. Lending to both sectors posted gains in 2015, with the uptick in household lending being primarily a 2015 phenomenon, while the growth in lending to non-financial companies extended a trend that began in 2013. The reasons for increased loan demand likely lie with the increased consumer confidence and the growth in industrial production/PMI that emerged in 2015. On the supply side, European banks, though far from completely healthy, made some progress over the past year, most notably in increasing Tier I capital by 40 bps, to 12.5% (Q2 2015).

GDP Growth and its Components, Eurozone

Further, impaired and past due (over 90 days) loans to total loans declined marginally (6.6% to 6.4%) but remain at higher than normal levels.

**2016: Still on Track, but Outside Pressures Build**

At the beginning of 2016, it is clear that Europe is in a much better place, from a macroeconomic perspective, than it was at the beginning of either of the previous two years. For one thing, the threat of crisis that seemed to hang over the region from 2012 through mid-2015 has finally been dispelled, at least for a time. Several imperfect compromises with respect to the Greek debt problem, along with a good deal of help from the ECB, have enabled the EU to generate modest positive economic momentum. Former train wrecks like Spain and Ireland are now leading growth, with Germany continuing to carry the bulk of the load in terms of expansion. Improved economic performance buys the region more time to continue the process of deleveraging, repairing its financial sector, and getting people back to work. A sharp downturn or catastrophic crisis no longer seems likely, but the region remains in a convalescent mode and continues to be vulnerable to a variety of shocks, both internal and external. On the internal side, the key risk is still the ongoing debt crisis, although it is quiescent for the time being. The brinkmanship of last year was highly damaging, especially to Greece; however, it did not inspire confidence in either side of the table. Neither did the 11th-hour agreement that finally resolved the dispute, as it was more of a statement of intentions than a thoughtful roadmap and looked very much like another exercise in kicking the can down the road. That can has now landed in 2016 in the form of large debt service payments due to the bailout consortium (including the ECB and IMF). If the negotiations around these payments follow the pattern of last year’s, we will likely see the same disruption that gripped the Continent.
in 2015. Closing the gap between the expectations of Greece and its creditors will not be an easy task. Already, an opening salvo has been launched, as Greek Labor Minister George Katrougalos made statements in early January suggesting that Greece should be allowed to meet its fiscal targets via growth rather than austerity. His comments relating to the pension reform he is charged with implementing also suggest that there may be a dispute over the adequacy of the proposed reforms. The tensions relating to bailout-related austerity have never been confined to Greece, as demonstrated by the elections in Portugal last year that threw out the center-right government that had backed austerity in favor of a socialist government that is not likely to be as supportive of some of the key terms of Portugal’s debt agreement with its European creditors. The Portuguese election results have reawakened fears that a similar dynamic might play out in another, larger country such as Spain.

Another concern for the European market relates to the stimulus program initiated by the ECB about one year ago. After riding the boost from the program through December, markets were disappointed when the ECB failed to expand the program. Without additional pump priming, the expectation was that 2016 would see the ECB’s QE program begin to lose steam, thereby reducing the power of one of the major tailwinds to the euro area economies in recent years. While this is still a possibility, a recent statement by Mario Draghi that the ECB would “review and therefore possibly reconsider” its monetary policy at its next meeting in March, suggested that there may be more monetary stimulus on the way, thus lowering the risk of trouble coming from the monetary policy front.

The relative weight of internal versus external risk to the EU economies has shifted to the latter over the past year as European economies have dug their way back to a growth posture. Key amongst these external risks are the overall global growth slowdown engendered by the weakness of emerging market economies (“EME”) and the currency dynamic introduced by the rising US dollar. In fact, these two factors are closely-related and mutually reinforcing in the present environment. Concerns about the magnitude and pace of China’s growth deceleration are well-known and well-founded; however, the secondary impacts on key commodity-exporting countries that have depended on China for growth are likely to be nearly as important to European growth prospects as the course of events in China. Complicating matters is the Fed’s recent embarking on a rate-hiking cycle, which has contributed to a stronger dollar and the related weakening of many emerging market currencies and put pressure on EMEs with current account deficits, though some of the pain has been relieved by the collapse in oil/gas prices for net energy importers. Further, global markets are also concerned about the expected unwind of the carry trade, which involves an estimated $11 trillion of US dollar-denominated debt that has been deployed into emerging markets over the past several years. If the unwind occurs in dramatic fashion, the strain on EME
currencies and liquidity could push some countries into recession or even crisis, while global EME economic growth could be dampened materially. The current EME weakness poses a significant threat to the EU, as it impacts the important export sector, which remains a major growth driver for the region, particularly its leading economy Germany, which derives 50% of its GDP from exports.

**Robust Buyout Activity, Expensive Deals**

From a macroeconomic perspective, Europe is clearly on a recovery path, though the pace differs, sometimes considerably, from country to country. The question is: Does this positive trend in macroeconomic growth translate into a positive trend with regard to the attractiveness of private equity investment in the region? There, the picture is more mixed. On the positive side are increasing consumer confidence and demand, a highly accommodative monetary environment, increasing availability of credit, and a higher level of confidence within the corporate sector as various crises abate and the GDP growth trend picks up some steam. On the downside, the primary concern relates to purchase price multiples, which remain elevated. In fact, multiples for European deals were never really all that cheap in the post-crisis period, having ranged between 8.4x and 10.1x in each year since their peak in 2008 of nearly 10.1x (transactions of €1 billion or greater). The last two years indicate multiples that are virtually indistinguishable from that 2008 peak, at 10.1x and 10.0x, respectively. The story does not get much better in the upper end of the middle market either, where PPMs for 2014 and 2015 stand at approximately 9.8x for transactions exceeding €500 million. Only when transaction sizes down to €250 million are included does the multiple drop meaningfully – to around 8.4x. Like their US counterparts, European LBO-backed companies have borrowed heavily, with overall leverage ramping up steadily since 2009 to today’s level of 5.0x EBITDA.

**Average LBO PPM of Pro Forma Trailing EBITDA by Transaction Size: €500M or More**

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<thead>
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<th>Year</th>
<th>Fees/Expenses</th>
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</thead>
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</tr>
<tr>
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</tr>
<tr>
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<td>2015</td>
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</tbody>
</table>


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Buyouts > Europe

At the beginning of 2015, we expected an upturn in the activity level of the European buyout sector in all three phases of the game – fundraising, investment, and exits. The year delivered on all three, in particular putting together another solid year of exits, despite a more volatile public market environment; and on the fundraising side, as limited partners delivered the second best year of the post crisis era after overcoming their fears regarding Europe once the Greek crisis was resolved (deferred?) and the ECB rolled out an aggressive stimulus proposal. With even more economic momentum going into 2016, along with the possibility of expanded stimulus, the power behind these trends should remain in place, suggesting another good year on all fronts. While it is possible the fundraising figure will slip somewhat due to the base effect of a strong 2015, the current and upcoming fundraises of several large buyout shops (Cinven, Apax, BC, Permira) may very well push 2016 aggregate fundraising past last year’s level. At the other end of the spectrum, continuing market volatility may cause exits to come in a little short of last year. Investment flow should be strong as buyout shops look to aggressively deploy the large amount of fresh capital just handed to them by limited partners looking for yield in a low-return environment.

Changing Times, Shifting Strategies

The European buyout sector faces the same problem as its US counterpart: too much money chasing expensive deals. This will make it difficult for buyout shops to deploy capital without letting underwriting standards slip or taking on excessive portfolio company leverage to try to juice acceptable returns from pricey assets. However, there will still be strategies that are likely to outperform, though the mix has changed somewhat from last year. At that time, investment in the core EU countries looked most attractive, with forays into the periphery on an opportunistic basis. Further, non-euro area countries looked more attractive than those employing the euro. As EU growth accelerates, the performance gap between core and peripheral countries can be expected to narrow (and has already done so to some extent), meaning that investment opportunity in the latter should increase, particularly with regard to more attractively priced deals. Further, the euro area’s highly accommodative monetary policy and the currency’s depreciation have given it a boost in relation to its competitors (such as the UK), some of whom may be shifting policy to a less supportive monetary stance in the next year. Therefore, the performance gap between core/peripheral and euro area/non-euro area should abate further in 2016, and the weight of the opportunity set of attractive investments should shift accordingly.

Export-oriented industries were identified as attractive last year, but have lost much of their shine this year. With global trade growth declining from 3.4% in 2014 to 2.6% in 2015 and the continuing uncertainty and slower growth associated with emerging markets, exporters are likely to come under considerable pressure in the coming year, meaning buyout investors will have to be more selective in how
Buyouts > Europe

they play the space. Companies with export flows to the US and the EU should perform well, while those with a large percentage of EME exposure may struggle. The slow recovery of the European banking system will eventually erode the competitive position of credit-oriented strategies over time; however, these strategies remain attractive on a risk-adjusted basis, as bank lending remains in the early stages of recovery. At least as regards strategies that focus on less senior debt, the European high yield bond market is a more formidable competitor. However, recent activity in that sector works to the favor of credit strategies, as it experienced a rough final quarter of last year (in line with, but not as severely as, its US counterpart) and saw default rates rise in 2015, with a further rise anticipated in 2016. Given the high levels of debt currently on corporate balance sheets and what looks to be a turn in the default rate, distressed strategies may be at the beginning of the best potential investment environment they have seen since 2009, though it must be stressed that the game has not yet begun and some catalytic event will have to occur to create a major distressed opportunity. Finally, for the first time in years, consumer sentiment, and spending, appear to be on the upswing in Europe in a sustained way, meaning that consumer-facing companies, and buyout shops that invest in them, should fare better in the coming year or so, especially on the exit front. While this should be an attractive sector from an investor standpoint, deal pricing may limit the ability to profitably take advantage of improvements in company performance.

Our 2016 tactical rating for the European small and middle market buyout sector is “Neutral,” one step above the large and mega segments of the market. As with its US counterpart, the upper half of the European middle market is more or less indistinguishable from the large and mega spaces when it comes to purchase price multiples and leverage levels. However, deal pricing does appear to moderate, if only slightly, in the lower reaches of the market, particularly under the €250 million threshold. European buyout funds have typically made considerable use of the secondary buyout avenue for exit, more so than their North American counterparts. This route should continue to be open to the smaller European buyout space as a reliable exit route, and with larger funds aggressively seeking to put capital to work, exit pricing should continue to be strong. For these reasons, a slightly better outlook and rating are justified for the European middle market buyout space, particularly as it regards the smaller segment of that category.

Our tactical ranking for the European large market buyout sector will move from “Neutral” to “Moderate Underweight.” We expect the trend in European buyout investment to exceed the 2015 level, while exits remain at or moderately below the past year’s level, due to market volatility. 2016 should see a respectable fundraising year, with a fair chance of beating 2015’s level. A higher rating is not warranted due to the ongoing major challenges the EU faces with regard to growth and the stability of the euro.
As of the end of 2015, the trends in Europe had shifted noticeably in favor of the buyout strategy, with the biggest positives being the materialization of a significant economic boost from QE, a modest but meaningful acceleration in GDPs across the EU, and the beginnings of a recovery in bank lending. On the negative side, deflation remains a threat and unemployment continues to be a drag on the economy; however, the most important risk for the buyout sector is the peak purchase price and leverage multiples in the current environment. The sovereign debt crisis appears to be contained for now, but there will be opportunity for that problem to break its bonds in 2016. If the negotiations turn out like a rerun of 2015’s, the progress the euro area has made to date could be derailed. The European economy has doubtlessly improved, but the prospects for buyout capital deployed in the current market have not improved commensurately, in most part due to near-record high deal pricing and the large quantity of fresh buyout capital waiting to be deployed in the European region.
2015 Recap

Global distressed strategies posted a fairly decent year in terms of fundraising, even though 2015 marked the third straight decline since the recent peak of $39 billion in 2012. The past year saw $33 billion raised by 37 funds, less than 10% off the $35 billion raised by 51 funds in 2014. Assuming some upward revision as year-end information flows in, it appears that the year will come in roughly in line with the prior year in terms of fundraising. Last year’s fundraising performance still puts the year squarely in the middle of the pack for the post-crisis years 2009 through 2015, though all are well off the levels seen in 2007 and 2008 (over $50 billion in each year). Distressed strategies held their share of the fundraising pie vis-à-vis other private equity strategies, accounting for around 6% of total private equity commitments, considerably down from the 2012 high (over 9%), but consistent with 2014. The geographic breakdown was relatively unchanged, with Europe-focused funds pulling in about 20% of the haul, while North American funds accounted for about 66%. Perhaps unsurprisingly, the investment side sprang to life in 2015, with global distressed deals of $53 billion up about 35% from 2014 levels, by far the best showing in terms of capital deployment since 2008. Driven by the increasing pace of Non-Performing Loan (NPL) sales by financial institutions (with Spain, Ireland, Italy, and the UK leading the way), Europe stole the show on the investment front in 2015, breaking a three-year streak in which the US saw more deployments. It did so in dramatic fashion, with a more than 3x increase over 2014’s sub-$10 billion showing (over $31 billion). Meanwhile, the US posted a very respectable increase for the year, with about $20 billion in outlays representing an approximate 45% year-over-year increase.
Outlook

At the beginning of last year we noted that, due to continuing monetary accommodation and yield-seeking by investors that kept debt default rates at or near record lows, the environment for distressed strategies remained relatively unfavorable. However, we also noted that the stage was being set for a compelling distressed opportunity at some point in the medium term, as the forgiving credit environment allowed a massive build-up of debt, some of it of questionable quality. Further, we cited several factors - namely a shift in US interest rate policy, increased market volatility, continued economic underperformance, European bank deleveraging, and sustained weakness in the US energy space - which would be important drivers of the next major distressed opportunity. Further, we moved our tactical rating up one notch in recognition of the nearing turn of the credit cycle from benign to stressed. As it turned out, most of these factors shifted in distressed strategies’ favor during 2015.

Energy Woes

One factor that was not expected at the outset of last year was the magnitude of the deterioration in the US credit markets that began in the summer and picked up steam throughout the latter half of the year, eventually turning ugly in the month of December. Led by the increasingly dicey US energy sector, the high yield bond market ended 2015 with its first year in the red since 2008, dropping approximately 5% for the year, with about half of that decline occurring in the month of December. The estimates for next year’s return in the high yield space range from -3% to 6%. Of course, the pain is concentrated predominantly in the energy patch, which lost all hope of a quick rebound in oil pricing by the end of the year. Through the first three quarters of 2015 just over 50% of the amount of corporate bond defaults (over $18 billion) related to energy and mining companies. Large defaults from this sector included Alpha Natural Resources ($2.3 billion), Samson Resources ($2.3 billion), and Walter Energy ($2.1 billion). Overall, the default rate within the energy sector through the third quarter of 2015 came in above 5%. The situation worsened in the fourth quarter of the year, leading to an estimated final default rate for the entire US high yield universe of over 5%. Further, things are going to get much worse for the energy/mining sector in 2016. Fitch projects an 11% default rate for the sector this year, which would exceed the industry’s worst year to date, 1999, which came in just under 10%. As a result of this performance, the agency is projecting an
overall corporate high yield default rate of 4.5% for 2016. For now, the damage has been contained, as the non-energy/mining issuers are actually projected to have another below average year for defaults, with Fitch indicating a rate of 1.5%, under its long term non-recessionary average rate of 2.1%. However, the markets fear a potential contagion spreading from the energy sector to related sectors like services, pipelines, equipment, construction, etc.; and from there igniting a more general deterioration in the credit markets. This is a real possibility, barring relief from the commodity price collapse. With oil plummeting below $30/barrel in the last quarter of 2015 and the market currently scrambling to adjust expectations downward from too-rosy predictions just a few months ago, relief on this front does not look likely.

In response to the increased pressure on US high yield debt, spreads have pushed out across the board; however, most of the adjustment has so far been confined to the lowest quality segments. In January 2016, spreads on the CCC Index had blown out to over 1,800 bps, nearly double the average of the last six years of 981 bps. The BB Index was much less impacted, with spreads widening out from 388 bps (average over last six years) to a level of 497 bps in January.

Leveraged loan markets are also showing some signs of increased investor caution. Fitch reported an 82 bps widening of pricing on “B” credits, to an average of 487 bps, during the second half of 2015. For the year, leveraged loans posted a minor loss (total return basis) of less than 0.5%. As was the case with high yield bonds, this was the first loss for the leveraged loan segment since 2008. Total volume of new issuance came in low for December, at less than $7 billion, while 2015 saw a decline of about 20% year-over-year in new issuance. Fitch reports that a relatively high number of deals were withdrawn in the fourth quarter, suggesting that investors are demanding richer terms to reflect a higher perceived risk for this paper.

Source: Guggenheim Investments, Federal Reserve Bank of St. Louis

According to The Credit Suisse Leveraged Loan Index.
Macroeconomic and Policy Shifts

A number of macroeconomic and policy factors have also converged to create a higher level of stress in credit markets than was present just one year ago. For one thing, at long last the Fed got interest rates off of zero in December. Markets, which had widely anticipated this move, were largely unfazed, and the size of the hike was quite small, meaning its direct impact was relatively immaterial. However, as a signal of the initiation of a rate-hiking regime, the move has a wider impact, as it will cause investors to discount higher rates in the next year or two, along with a corresponding repricing of risk in financial instruments, particularly as it relates to longer term credit instruments. Global economic performance has also shifted into a negative factor relating to credit markets. While the US appears to be performing decently for now, global growth has been in a decided downward trend for much of the last couple of years, as indicated by the IMF’s recent adjustment of its global growth estimates from 3.6% to 3.4%. The fear of this global slowdown feeding back from emerging markets to developed markets has already caused investors to reassess the risk of their debt holdings, especially in corporations with a high level of exposure to the emerging markets. In the US, the impact of the strengthening dollar has already been felt via a significant decline in the industrial sector and pressure on corporate profits more generally, both of which can be expected to unleash some pain on the most heavily-indebted corporations. In Europe, the state of the banking system continues to exhibit a slow improving trend in terms of capitalization and asset quality.

However, the European Banking Authority’s Risk Dashboard Q3 2015 noted that impaired and past due (over 90 days) loans totaled 6.4% during the second quarter, down from the previous quarter (6.6%) but still high. Further, major European banks are estimated to house approximately €800 billion of non-performing

Historical Default Rates ($ millions)

Note: Straight bonds only, not including defaulted issues in par value outstanding.
Source: NYU Salomon Center (10/2015) Altman & Kuehne High-Yield Bond Default and Return Report
loans according to Deloitte Deleveraging Europe Market Update H1 2015. Prompted by market and regulatory pressures, European banks have ramped up the sale of these assets in recent years, with a sharp increase in transactions completed, from €30 billion in 2013 to €93 billion in 2014. Estimates for last year anticipate another meaningful jump in that number (€152 billion) and a strong market for such sales going into 2016. The most active sellers to date have been institutions within the UK and Ireland, with the lead expected to shift to Italy, Spain, and countries within the CEE region in the coming years. Europe appears to be in better shape than the US in at least one area: high yield markets. For 2015, European high yield markets returned approximately 1.4% for the year and had an estimated default rate (TTM) of just under 1% (Western European bonds). Both figures easily beat their US counterparts, which were weighted down by the energy sector.

**Metrics Turn Negative**

In general, most of the measures of credit quality and overall health within the US debt markets declined during 2015. A summary of some notable metrics is as follows:

- After exceeding $300 billion of new issuance from 2012 through 2014, the US high yield markets issued $260 billion in 2015, certainly not a bad year in relation to most of the last ten, but still off about 18% from 2014’s $318 billion. Perhaps more important is the direction of the market, as indicated by the collapse in volume in December, when only $3.8 billion priced. Leveraged loan volumes were also off significantly: after peaking at $605 billion in 2013, volumes declined in both of the next two years, with 2015’s $422 billion over 20% off the 2014 pace of $530 billion.

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**European Bank Loan Sale Activity by Year**

<table>
<thead>
<tr>
<th>Year</th>
<th>Rumored</th>
<th>Ongoing</th>
<th>Completed</th>
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<tr>
<td>2015</td>
<td></td>
<td></td>
<td>€152bn</td>
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*Note: As of June 2015
Source: Deloitte (H1 2015) Deleveraging Europe Market Update*
The distress ratio for high yield bonds (proportion selling at 1,000 basis points over comparable US Treasury maturities) exploded during the latter half of 2015. As of the end of the third quarter, this figure stood at 19.1%, compared to 12.3% just three months prior. More notably, the ratio stood at just 5.3% one year prior. The collapse of pricing within the energy component is the overwhelming cause of this deterioration, which has now pushed the ratio beyond its historical mean of 18.1% (2000 – 2014).

Due primarily to this massive increase in the distress ratio, the face value of defaulted and distressed debt pushed up to over $1.4 trillion as of the third quarter of 2015, a major increase (22%) from the second quarter of 2015.

The quantity of issuance of high yield issuance rated B- or lower over the past few years will provide ample ammunition for a distressed debt cycle, whenever it happens to occur. Each year of the period 2012 through 2014 saw high yield issuance in the lower quality categories of over 25% of the entire issuance (2011 was the peak post-crisis year at 31%). 2014 saw strong issuance for the first three quarters, with the third coming in just under 32%, before a steep decline in the fourth quarter to 12%.

The market resumed at a lowered pace (20% to 25%) in 2015, posting three strong quarters before the high yield markets came apart in the fourth quarter. It remains to be seen whether the pace of issuance will pick back up once a repricing has been established, or if this is the beginning of a cyclical decline in high yield issuance.

Source: Guggenheim Investments, Federal Reserve Bank of St. Louis
Last year we suggested that the state of the credit markets continued to be quite forgiving and suggested a continued benign environment for 2015. There were two potential spoilers to this scenario: stress within the energy industry and its effect on high yield debt and the initiation of an interest rate increasing cycle by the Fed. The 2015 environment for distressed strategies turned out to be pretty much as expected for the first half of the year, as short term interest rates stayed at zero, the economy picked up steam, and the willingness to stretch for yield on the part of investors remained the dominant theme. The second half of the year saw both of the aforementioned factors shift in favor of the distressed asset class. Most importantly, the energy sector slid precipitously as the hoped-for rebound in oil prices never materialized, instead giving way to the plumbing of new recent lows. As hedges have run off and the cold realization that this is likely to be a longer bear market than expected has set in, fear has gripped the US energy production sector. As a result, several large independent production companies have already defaulted, with many more under stress, pushing spreads out and leading to a substantial increase in the high yield default rate in the fourth quarter of the year. So far the damage has not spread to the non-energy sectors, where default rates have remained below average. As for the Fed’s interest rate increase, as noted elsewhere, the direct effect on credit provision has been minimal.

However, the shift of Fed policy in the direction of a more neutral stance, along with the slowing global economy and the stress in the US high yield sector, have combined to effect a repricing of risk within the credit markets more generally, as evidenced by the widening spreads across the board. Further, to the extent it supports dollar strength, the Fed move has contributed to pressure on the US manufacturing sector and increased pressure on the overseas earnings of the larger US corporate sector, both of which
may contribute to growing stress in the credit markets over the next one to two years. We do not anticipate a large scale meltdown in the credit markets in the next 12 months, as there does not appear to be a major contagion spreading from the energy sector to the larger corporate sector as of yet. However, it does appear that most of the important factors impacting stress in the credit markets have now moved in the direction of the distressed asset class; and therefore risk of a major distressed event occurring in the next 12 to 24 months has increased. Further, the timing of such an event appears to have moved up. Last year, we suggested a likely window of two to four years. Given today’s markets, the timing looks to have shifted closer to the lower end of that range. 2016 is still likely to feature defined, opportunistic investment possibilities (energy sector debt in the US, NPLs in Europe, etc.), but the time to position portfolios to take advantage of a more general decline is within the next 6 to 12 months. Based on these factors, we are moving our tactical rating for 2016 for distressed strategies from “Moderate Overweight” to “Strong Overweight.”
2015 Recap

At first glance it appears that the US mezzanine sector experienced a major bounce in year-over-year fundraising in 2015, with 20 funds raising just over $13 billion in fresh commitments. This more than doubles the amount of $5 billion raised by 19 funds in 2014 and exceeds all but one of the post crisis years (2013 - $14 billion), none of which managed to break through $10 billion. A closer look suggests that the fundraising bounce is more likely due to a timing effect and the usual lumpiness that affects the mezzanine asset class fundraising statistics due to the small size of the universe. The culprit here is the $8 billion GS Mezzanine fund (Goldman Sachs), which began fundraising in 2014, but held its final close in 2015. So it appears that mezzanine fundraising continues to clock in at around the $9 billion mark if the past two years are averaged, which is very much in line with the amounts seen since 2010. On the investment side, US mezzanine has never fully recovered from the crisis. Since the peak year of 2008, when over $50 billion was deployed, the deployment pace has been quite depressed, with five of the past seven years at, or below, the $5 billion mark. This trend continued in 2015, as mezzanine funds were hard-pressed for most of the year by continuing competition from various alternative sources of capital and found it difficult to close deals on attractive terms and pricing, despite the recovery of buyout deal flow.

Source: Preqin
Special Situations > Mezzanine

Outlook

Last year we mentioned that the mezzanine asset class got a boost in 2014 with the recovery of buyout deal making that year, but that the competitive dynamic within its sector remained very much to its disadvantage. In 2015, the market finally began to break, albeit slightly, in favor of mezzanine funds, though it didn’t become completely clear until the last month of the year. First, The Federal Reserve (the Fed) finally got the up leg of the interest rate cycle off the ground with its admittedly modest hike of the target Fed Funds rate off of zero (target range of 0.25% to 0.50%) at its December Federal Open Market Committee (“FOMC”) meeting. The magnitude of the hike and the Fed’s stated conservative view on the pace of future hikes mean that the near term effect of the hike on credit markets should not be too significant. However, with the direction of Fed policy now formally shifted toward tightening, lenders and the credit markets can be expected to follow suit and tighten terms over the next 12 to 24 months as the cycle develops (unless the global economy continues to slow, in which case all bets are off as to Fed policy).

High Yield Trouble Spells Less Competition?

Another indicator of potential credit market tightening comes from the US high yield markets, which deteriorated significantly in the latter half of 2015, ending the year at a loss of about 5% in 2015, the first such since the ugly days at the beginning of the crisis in 2008 (loss of over 20%). The last quarter of the year, especially December, was particularly bad, as the US Fitch Fundamentals Index for the fourth quarter came in at -2%. This is no surprise, as the US HY default rate, after years of below-average numbers, pushed out to around 3.4% (issuer-weighted basis) by the end of 2015, more in line with long term averages and a substantial increase from where it ended 2014, at just over 1%. Much of the pain has emanated from the energy sector, which makes up over 10% of high yield issuance and has recently moved into double digit default territory. Fitch estimates a default rate of about 4.5% for 2016, with the energy sector continuing to be the main culprit; however, there is concern that the energy meltdown could spread to related industries (pipelines, services, etc.). Further, the stress in the HY market has already caused lenders to take a harder look at new deals and caused debt holders to question the value of their existing holdings. This can be seen in the market skittishness surrounding new issues in the first
couple of weeks of January, including large offerings from Petco and 1-800-Contacts, which both opted for private placements rather than risking the HY market at this time. The picture does not look much better in the leveraged loan markets, as yields blew out over the latter half of 2015, leading the S&P/LSTA Index to give back just over 3% during the period. Though default rates remain at reasonably low levels, a sharp decline in issuance that began in the summer and continued through the year end snapped a reasonably strong uptrend in volume since the end of 2014.

An Opening, but Loads of Dry Powder

Given the continued provision of a reasonable quantity of deal flow from the buyout sector, combined with the recent weakness in the US credit markets, the stage is set for at least a modest amount of tailwind at the back of US mezzanine strategies during the next 12 to 24 months. One potential false note relates to the supply of capital within the mezzanine space. The twin factors of reasonably steady and modestly growing capital raises by North American mezzanine funds and the restrained level of deployment over the past few years have allowed a substantial amount of dry powder to build up over the period. According to Preqin, dry powder associated with North American-based mezzanine funds reached a ten-year peak in 2015, at around $31 billion. Further, dry powder has not fallen below $25 billion over the past five years. Therefore, while the mezzanine strategies’ main competition on the public side is working through its problems, the level of internecine competition between funds may intensify as buyout shops look once more to the private side for junior capital.

Our tactical weighting for mezzanine strategies is moving from “Moderate Underweight” to “Neutral.”

North American Mezzanine Fundraising vs. Dry Powder ($ billions)
Special Situations  >  Mezzanine

With buyout deal making in North America at least holding steady, there promises to be sufficient potential deal flow for mezzanine funds in 2016. The key factor that has broken in favor of the mezzanine asset class in recent months is the relative competitiveness of alternative sources of debt. Since the end of the financial crisis the Fed’s Zero Interest Rate Policy (“ZIRP”) has supported aggressive lending at low rates by these alternatives (high yield, leveraged loans, BDCs), thereby putting severe pressure on the profitability of mezzanine lenders and forcing them to accept lower returns and weak terms or walk away from deals. As of December 2015, this dynamic has shifted, albeit only marginally, from headwind to tailwind. The disruption and increased risk sensitivity impacting the public credit markets, in conjunction with the Fed’s signal of the start of an interest hiking cycle, have provided a small opening for mezzanine funds to get back in the game. On the negative side of the ledger are the substantial amount of dry powder that has accumulated at mezzanine shops over the post-crisis years and the heated purchase price and leverage multiples that have been a feature of the buyout universe for years. It is here that the structure of most mezzanine funds works as a disadvantage. With multi-year investment periods that tend to be more in line with buyout funds and typical fund terms of up to ten years, mezzanine funds lack the flexibility often required to be a truly opportunistic asset class, as they must deploy capital across the buyout cycle rather than only in a counter cyclical manner, when potential returns are highest. That being said, a tactical rating for mezzanine strategies that is one notch higher than our rating for buyouts is justified due to the former’s higher position in the capital structure, better terms, and current income component, even though both strategies are vulnerable (to different extents) to many of the same risk factors.
2015 Recap

Secondaries strategies turned in a solid year on the fundraising front in 2015, though they came up short in comparison to 2014’s record year. After three years of steady increases that culminated in nearly $30 billion raised by secondary funds in 2014, the market appeared to take a breath in 2015, as investors committed approximately $20 billion of fresh capital to the space. It appears that an additional explanation for the fundraising slowdown may be found in the number of large funds that closed in the prior year, in whole or part. In spite of being off by one-third on a year-over-year basis, 2015 was still a better year than all but four of the past 13 years on this metric. Deployments were exceptionally strong for the second year in a row. 2014 was a landmark year for secondary fund investment - approximately $42 billion was put to work, an over 50% surge over the 2013 figure, which was the second best showing of all time at that point. 2015 investment appears to have slipped only slightly, with total deployments for the year estimated at $40 billion, less than 5% off the breakneck pace set in 2014.

The purchases were broadly diversified by seller type, with public and private pensions representing the largest cohort, at just under one-quarter of capital invested. Secondary funds remained the dominant players in the market, with 99% of deals completed by pure secondary or primary/secondary investors, which suggests that non-traditional, opportunistic players are behind the curve in terms of establishing themselves as a meaningful force in the market. The “mega secondary” funds continued to dominate the

Secondary Pricing Over Time

Source: Greenhill Cogent (01.2016) Secondary Market Trends & Outlook
market, accounting for over 60% of the transaction volume last year. Pricing remained strong throughout the first half of the year; however, the second half of 2015 presented a somewhat different picture, as market participants noticing softer pricing in the face of equity market weakness and increased volatility. Greenhill Cogent reports that first half pricing generally held up well, with an average bid of 92% of NAV (all strategies), while the second half saw a noticeable slip in pricing, to 88% of NAV.

Most likely as a way to juice lower return expectations due to high pricing, secondary players amped up their use of leverage. For 2015, approximately one-quarter of deals employed leverage, a fair-sized increase over the 17% seen in 2014. Further, the amount of leverage employed grew, to an average of 40% last year from 30% in 2014.

**Outlook**

The shift of the public markets from very bullish in 2014 to flat in 2015 was the single most important favorable factor to impact the secondary investment strategies in the last 12 months. The positive effects should manifest in a variety of ways as 2016 plays out. For one thing, seller psychology should eventually lead to lower expectations of the growth in private equity portfolio value, which may lead to somewhat greater flexibility on pricing. Net asset values for private equity interests have halted their relentless upward swing, begun in 2013, and may even adjust downward somewhat if the poor performance of equity markets persists throughout the year.

Last year, we surmised that the investment pace of secondary funds was likely to moderate in 2015, based on a number of dynamics, including the base effect of a very strong 2014; the solid performance of the private equity asset class over the prior two years in terms of NAV expansion, exits, and distributions to limited partners; and the lack of any serious liquidity pressure on institutional portfolios as a result of strong distribution flows and the reversal of the denominator effect. It appears that we were correct, but only marginally so, as 2015 investment flows just missed the 2014 flows by a relatively minor margin, and apparently due to a second half slump to boot. Given the proven ability of secondary funds to deploy
large amounts of capital in a rather difficult pricing environment, the prognosis for 2016 investment flows is highly favorable, as pricing has improved slightly and the confluence of factors working against LPs’ propensity to sell have lessened somewhat. It is likely that a new structural level of secondary fund activity has developed over the past few years, suggesting annual investment at, or north of, $30 billion rather than the sub-$15 billion levels seen as recently as 2009. We expect investment flows in 2016 are likely to go well over the $30 billion threshold, perhaps coming within striking distance of the levels seen in the past two years.

**Secondaries: Less Opportunistic, More Routine**

As noted in our last Outlook, the secondary asset class appears to have arrived as a fixture in the private equity landscape. The increasing acceptance of secondary sales on the part of both limited and general partners means the strategy has evolved from its small, opportunistic roots in the 1990s to a structural, even routine, element of the private equity investment universe. This means higher fundraising, larger volumes of capital deployed, a more or less permanent shift to higher pricing (with some variation in severe downturns), and most likely higher leverage as a usual business practice for many transactions. In other words, pretty much exactly what we have seen over the past four to five years. Limited partners’ regular management of their private equity portfolios throughout their life cycles has now become, and should remain, the dominant provider of deal flow to the secondary markets. This is not to say that there will not be occasional opportunistic drivers of deal flow. In fact, the continuing spinoff of assets by European financial institutions and their US counterparts is one such opportunity that continues to play out in the current private equity cycle. However, this source of deals, at least in the US, took a break in

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**Historical Secondary Market Volume ($ billions)**

<table>
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<tr>
<th>Year</th>
<th>Volume ($)</th>
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<tr>
<td>2011</td>
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<td>2012</td>
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<td>2015</td>
<td>$40.0</td>
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*Source: Greenhill Cogent (01.2016) Secondary Market Trends & Outlook*
2015 as the Volcker Rule implementation was pushed out to 2017. According to Greenhill Cogent, financial institutions accounted for 25% or more of transactions (by number and volume) in 2014, but slipped to around 10% last year. Though momentum in 2016 is not likely to approach the levels of 2014 again, sale activity within this sector should pick up as the year winds along, as institutions position themselves for full implementation of the Volcker Rule next year. Another important source of deals in 2016 and beyond will be transactions initiated by GPs, which serve as another proof point relating to the institutionalization of the secondary asset class. 2015 saw approximately 15% of deals (20% by amount) originate from this source, a number that is expected to increase to one-quarter of deals for 2016 (Greenhill Cogent).

A Little More Caution, but Pricing Will Remain Firm

The 2015 market decline has caused secondary investors to rediscover a sense of caution, meaning that assessments of fund NAVs—along with assumptions about their growth—are now being recalibrated. Also, increasing risk aversion is likely to result in a bias toward quality on the part of purchasers, which will worsen the bid spread between higher and lower quality assets. As noted above, secondary deal pricing already appears to be in the process of softening. However, the magnitude of this should not be overestimated. Given the strong performance of the portfolios (private and public) of the vast majority of LPs in 2013 and 2014, liquidity pressure or allocation concerns are still non-factors in terms of seller motivation. Barring a major market dislocation, most major limited partners (with the possible exception of some financial institutions) will continue to be able to choose the timing and manner of their portfolio dispositions, which will effectively put a floor on deal pricing. As a result of the increased preference for quality, it is unlikely that the pricing of interests in the best assets will slip much at all, though less desirable assets should experience meaningful downward pressure on value. Therefore, blended portfolios may see some modest downward adjustment in pricing, though the more likely outcome is for a relatively flat environment in terms of deal valuations. Interestingly, while we expect deal volumes to be strong this year, it is possible that the aforementioned buyer caution, combined with seller expectations that have not yet fully adjusted to current realities in terms of net asset values, will create a chill on many new deals until both sides of the table can have more confidence in their asset valuations.

Dry Powder Keeps a Floor on Pricing

One factor that promises to keep a solid floor under transaction pricing is the high level of dry powder that currently exists within the secondary space. According to a survey by Evercore, approximately $65 billion in commitments available for investment are held by various secondary players, of which nearly
$53 billion is dedicated to private equity assets. With over $40 billion in fundraising interest reported for 2016, the amount of available capital does not look set for a decline within the next 12 to 24 months. Secondary funds have shown that they can be quite creative in terms of getting deals done over the past few years. With this much capital sitting on the sidelines, there will be a powerful incentive to put it to work, all of which translates into a continuing aggressive pricing environment, in spite of equity market troubles.

Another Strong Year Ahead

As we anticipated in last year’s Outlook, secondary strategies posted another impressive year in 2015 in both fundraising and investment activity, though falling just short of reaching the peaks of 2014. In spite of market disruption, we expect another solid year – more in line with 2014/2015 performance than prior years - for secondary strategies on both fronts, as limited partners continue to take advantage of what is still an attractive selling environment, in spite of the 2015 market weakness. In keeping with its relatively recent status as an integral part of the private equity ecosystem, most of the investment activity should once again derive from ongoing, “business as usual” portfolio management transactions. Though their portion of the pie declined considerably last year, there is an outside possibility that there will be a resurgence of deal flow from financial institutions, as European banks continue to reduce risk assets and US banks look to get in conformity with the Volcker Rule.

Last year, we also expected that pricing would remain elevated and increasing levels of leverage would be employed by secondary purchasers in order to get deals done and juice profits to acceptable levels. Both of these expectations turned out to be correct. For 2016, we anticipate that the use of leverage will most likely increase, as competition for deals between secondary funds is likely to maintain at intense levels.

Dry Powder as of December 31, 2015 - Concentration

Source: Evercore (01.2016) 2015 Secondary Market Survey Results
and force would-be purchasers to use debt creatively to structure deals that are acceptable to both the seller in terms of headline price and their own limited partners in terms of return. With regard to pricing, a different story is likely to develop. The flat performance of equity markets in 2015 and the poor performance to date in 2016, along with increased volatility, have definitely taken some of the steam out of the secondary markets, and some adjustment in NAVs and pricing is to be expected. Indeed, there are indications that pricing has already begun to soften in the latter half of 2015.

A shift in favor of secondary purchasers appears to have taken place in the past several months, and at least some of the upward pressure on secondary pricing has been relieved, albeit moderately. However, the magnitude of softening pressure should not be overestimated - consistent with the last few years, the secondary market remains a seller’s market. For reasons noted earlier, there is no foreseeable triggering event on the horizon to put pressure on portfolio liquidity and push limited partners to sell. The shift to quality with regard to private equity assets should keep the pricing of the most desirable assets reasonably high and the copious amount of dry powder should keep the pressure on the buy-side to deploy capital.

For 2016, we expect the secondary asset class to continue its emerging role as a liquidity provider to limited partners in exchange for reasonable investment returns. A much more substantial decline in the equity markets, something close to a meltdown, will need to occur before the strategy can shift from this ongoing, all-weather role to an opportunistic stance that would be reminiscent of its earlier history. It appears that the recent equity market disruption and lagging performance is not sufficient to bring this about; however, the risk of a major market decline has increased substantially since the beginning of last year. In spite of the increasing efficiency of secondary markets and the maturation of the asset class, secondary strategies are still capable of operating opportunistically when the environment is conducive, thereby providing a strong countercyclical balance to the private equity asset class as a whole, and buyouts in particular. Secondaries should be able to gain not only from the repricing of existing assets, but by purchasing future exposure to more attractively priced assets via the investment of primary commitments by fund managers in the aftermath of a market downturn. Given poor equity market performance and the elevated pricing within the buyout and venture sectors, the prospect of a dislocation within the next 12 to 24 months has increased in likelihood compared to the last few years. For this reason, we are recommending an overweight rating to secondary strategies as a countercyclical hedge to existing private equity investments and as a way to gain exposure to opportunistic investments in the case of a major downturn in private equity markets. Thus, our tactical rating for 2016 is moving from “Strong Underweight” to “Moderate Overweight.”
2015 Recap

As anticipated last year, US venture capital strategies put together another solid year on the back of a standout year in 2014, marking three consecutive years wherein VCs led the private equity pack in terms of performance. Investors continued to open their pocketbooks to gain exposure to the sector, which showed up in another successful fundraising year. US VCs gathered $28.1 billion in fresh capital in 2015, just under 10% off 2014’s $31 billion. However, to add some perspective to this number, it should be noted that 2014 is essentially tied with 2007 as the best fundraising year of the last ten, while the 2015 figure is more than double the 2010 fundraising low and a nearly 60% improvement over the 2013 take. Clearly, the venture capital strategy has left the fundraising doldrums of 2009 through 2013 behind, at least for the time being. After blowing the doors out of the investment numbers in 2014, VC went a notch further in 2015. The past year saw US VC funds deploy approximately $58.8 billion, a healthy increase over the $50.8 billion deployed in 2014. This is all the more impressive considering that 2015 and 2014 were the number one and number two years of the last ten in terms of investment. Actually, it’s not even close: the next best year after the last two was 2007 at $32.1 billion. 2015 was another good year for cashing in on investments, as VCs completed 622 exits for about $74 billion in proceeds, making this the third best year of the past decade by value. However, the reemergence of volatility and generally flat performance of equity markets in 2015 certainly took some of the verve out of both the IPO and M&A markets last year, causing the year to fall short of 2014 in both number of deals (797) and total exit value ($85 billion), by 22% and 13%, respectively.

US VC Exits

Source: Cambridge
Venture Capital

Outlook

Last year we suggested that the venture capital space felt very similar to the years leading up to the peak and crash of the Internet Bubble, with ever-increasing valuations, high confidence on the part of fund managers, limited partner eagerness to gain exposure to the asset class, and robust equity markets providing fuel to the fire. For much of 2015, the same aura prevailed and momentum continued to build. However, the flat performance and volatility of public equity markets eventually caught up with the venture capital asset class and by the fourth quarter of the year, some of the air looked to be coming out of the sector. One indication of this is the material dip in investment activity in the fourth quarter, with 2015’s $11.3 billion – though a good showing by the standards of the past several years - comparing unfavorably with 2014’s $15.7 billion. The fourth quarter total is particularly notable in that it is the first quarter-over-quarter decline since mid-2013.

As a result, heading into 2016, venture capital investors appear to be taking a more cautious bent, muting the enthusiasm that was seen in 2014 and 2015. There have been several well publicized “down rounds” and lower-than-expected IPOs of the so-called unicorn companies in 2015. Whether this is a result of the public market slowdown experienced in 2015 or whether venture investors are finally taking time to digest the gargantuan amount of capital spent in 2014 remains to be seen. As a result, many have tempered their expectations of some

US VC up, Flat or Down Rounds by year

Venture Capital

colossal exits. Square, Box, and Hortonworks all held their initial public offerings at lower valuations than the prior private financing rounds. This is causing companies to stay private longer, delaying the exits for many venture funds. And while the IPO window is not exactly closed, the public futures of Palantir and Uber remain the large tech elephants in the room, with Square as a cautionary tale.

That being said, many of these companies are experiencing strong growth rates, even if they are not yet profitable. As we stated last year at this time, the fundamentals for many of these businesses remain relatively strong, and we are likely a far cry from the Bubble days of the early 2000s.

For much of 2014, venture investors noted that entrepreneurs and management teams were able to dictate the terms of the investments. Now, this trend appears to be reversing. And while there is still ample demand to fund the strongest companies, the pace of consumption is somewhat less frenzied than what it was in 2014.

More Selectivity and a Higher Price for Quality

Venture investors appear to be looking for more mature companies, and are willing to pay higher prices for them. The average deal size has steadily increased, particularly since 2013. Ever more capital is flowing into venture, but according to the National Venture Capital Association (NVCA), fewer companies are receiving that capital. In 2014, 4,441 deals were completed. This fell to 4,380 in 2015, the first drop in volume since 2009. Capital invested continued to rise; however, moving from $50.8 billion last year to $58.8 billion in 2015, which has in turn pushed up average deal size from less than $12 million to nearly $14 million, more than twice the level seen as recently as 2013. Unsurprisingly, given the large quantities of capital raised over the past few years, deployments have been strongly up since 2013, with early,

Average Deal Size by Stage of Development ($ millions)

Source: PWC & National Venture Capital Association
expansion, and later stage deals all registering significant year-over-year increases during that time. In particular, early and expansion stage deals have exploded (on a relative basis), with the latter posting more than double the amount of 2013 deployments in each of the next two years.

**Flattening Pricing on the Way?**

Despite a narrowing IPO window, valuations remained rich across the board in 2015, especially within the expansion and late stage rounds. The venture sector saw its best year of the past ten in terms of percentage of up rounds compared to down or flat rounds, marking a third annual increase in this metric. There is some expectation that this trend will flatten or even decline somewhat in 2016, and there appears to be some mild evidence of just that occurring in the fourth quarter. However, it is not clear yet whether this will be a short term blip or is the beginning of a flattening trend. What appears likely is that, in terms of valuation, the venture capital market will lose some breadth, but the top tier of companies will continue to command high prices and attract a larger percentage of the capital, as VCs shift to a more selective stance in deploying capital. Regarding the sector mix of investment, it was relatively unchanged from 2014, with software dominating and pharmaceutical/biotech logging another solid year.

**Momentum Should Carry to 2016**

In spite of the recent concerns that have begun to enter the picture in the VC space, there remains solid fundraising momentum going into 2016, as limited partners continue to chase return in a difficult market. If the markets remain volatile and down rounds begin to accumulate, limited partner interest can be expected
to wane; however, there will be a considerable lag before this decline in interest shows up in the fundraising figures, as limited partners catch-up with where general partners already seem to be in the current environment.

As for investments, we expect another strong year, though, as noted earlier, 2016 is likely to see a culling of the herd as venture capitalists concentrate their bets on the best companies. This year promises to be a bad one for “me-too” companies and will put pressure on the valuations and funding resources of those companies that are not already at or near critical mass in terms of revenue and profitability. Even though VC funds have been on a fundraising tear over the last few years, excessive dry powder does not seem to be a problem, as the strong fundraising coincided with a robust investment environment. According to Preqin, the amount of dry powder on hand (global basis) within the venture space has not changed appreciably in the last several years. Exit activity will of course be the wild card for the VC sector this year, as the IPO market does not appear too promising at the outset of 2016 and the relative weight of exit activity appears set to shift to the M&A channel. While this points to fewer blockbuster exits and overall lower returns for VCs, it does not exclude the possibility of another solid year on the exit front, though we expect 2016 to modestly underperform the last two years in this activity.

Our tactical rating for venture capital strategies will move from “Neutral” to “Moderate Underweight.” The venture capital strategy stuck to the script we outlined last year: strong fundraising, heavy capital deployment, rising deal valuations, and robust exit performance. As noted earlier, even though valuations are stretched, the market does not appear to be veering into excess, at least not on the level seen during the last great venture heyday at the turn of the millennium. Nevertheless, valuations have been on a sharp rise over the past two to three years, especially in the later funding rounds, as VCs have counted on a continuing accommodative exit environment. The performance of equity markets in 2015, especially in the latter portion of the year, have certainly called the validity of that assumption into question. The good news is that it appears that VCs have noted this shift and are taking action to restrict investment into only the most promising deals. The bad news is that this means competition for these deals will intensify even further. Last year, we suggested a neutral stance on venture capital strategies due primarily to concerns relating to valuations and the longevity of the current bull market in equities. Both of these factors have noticeably turned more negative over the past 12 months. Venture capital valuations appear to be at or near a peak, while the downside risk in the equity market considerably outweighs the potential upside at this time and the bull market looks to be running out of steam, with perhaps one to two more years left to run. The interplay between these two factors has clouded the exit picture for VC-backed deals in 2016 and cast a pall over the potential investment performance of the asset class for the medium term; therefore, an even more measured approach to venture capital is justified going into 2016.