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As 2018 opens, the private equity space in most major markets, especially North America and Europe, has an aura not unlike that which existed leading up to the financial crisis. The pace of economic growth is accelerating, monetary policy is favorable, consumer confidence is increasing, credit is plentiful and relatively inexpensive, corporate earnings are sound, and most economic indicators, like unemployment, are moving in the right direction. Investor demand for exposure to the asset class is strong. On the other hand, the heat associated with the late-cycle period just before the crash is not yet evidenced. Megadeals do not dominate the headlines, credit quality has not yet shown signs of major deterioration (spreads remain within reason) as lenders throw caution to the wind, and investor optimism and exuberance are within bounds (though the beginnings of a shift here are underway). We are in the midst of a synchronized global growth trend, conditions are generally benign, and most everyone expects another year or three of good times. Think circa 2004-2005, the time before the time that everything got crazy. What this means for the core private equity asset groups, mainly buyouts and, to a lesser degree, venture capital, is that recent past vintages should perform well, as already-planted investments that are perhaps halfway through their life will be able to take advantage of the current tailwinds to build value and get to an exit while markets are strong. However, the picture is likely to be considerably different for vintages of the next two years. Peak valuations, a large buildup of debt, and an economic cycle that is quite long in the tooth are likely to make their weight felt before many of the current and upcoming late-cycle investments can make it to harvest time. It should also be noted that there are some important differences between today and the last “pre-peak” period. For one thing, equity contributions for buyout deals are substantially higher, at about 43% compared to 34-35% in both the US and Europe. Also, covenant-lite structures have consistently gained ground since the financial crisis (accounted for over 70% of leveraged loan outstanding issuance as of mid-2017). Both of these factors suggest that the fallout from any future credit deterioration should be more contained than in comparison to the prior bust. Timing the end of the cycle is not an option – it could last another year or another five. However, at this time it is prudent to avoid a general increase in exposure to the pro-cyclical private equity strategies, namely buyouts and venture capital, as the risks of being caught in an
underperforming vintage have been growing for the past few years and there are some signs that we are entering the late stage of the cycle. Returns to beta have compressed considerably in the private equity world since at least 2013, so in the next two or three vintage years investors will have to seek out alpha even more conscientiously than in recent years past. This means going smaller in the buyout segment and focusing on more specialist and/or off-the-run strategies. It also means focusing even more intently on manager discipline, which will be at a premium in the next part of the cycle, and committing to managers who have demonstrated ability to succeed through both the up and down legs of the market. Increasing allocations to counter- or less-cyclical strategies, including distressed/turnaround and certain types of credit, should also serve investors well in the coming environment.
## Tactical Summary

### North America Buyouts

<table>
<thead>
<tr>
<th>SMALL ($500 Million and Below) and MIDDLE MARKET ($500 Million to $5 Billion)</th>
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</thead>
<tbody>
<tr>
<td><strong>Favorable:</strong> Accelerating US GDP growth expectations, sound buyout investment flows, expected earnings boost from US tax reform, more pro-business political environment, continued strong interest in add-on acquisitions from large buyout players, somewhat more attractive pricing in smaller end of market</td>
</tr>
<tr>
<td><strong>Unfavorable:</strong> High levels of dry powder, rising interest rates, persistent high debt and purchase price multiples in the upper half of the middle market</td>
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<tr>
<th>LARGE ($5 Billion and Over)</th>
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<tr>
<td><strong>Favorable:</strong> Accelerating US GDP growth expectations, sound buyout investment flows, expected earnings boost from US tax reform, robust supply of low-cost credit (especially at the larger end of the market), strong US equity markets to support exit flows, more pro-business political environment</td>
</tr>
<tr>
<td><strong>Unfavorable:</strong> High levels of dry powder, rising interest rates, stretched debt and purchase multiples</td>
</tr>
</tbody>
</table>

### Europe Buyouts

<table>
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<tr>
<th>SMALL ($500 Million and Below) and MIDDLE MARKET ($500 Million to $5 Billion)</th>
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<tbody>
<tr>
<td><strong>Favorable:</strong> Relatively more accommodative monetary stance of ECB, improved GDP growth trajectory for EU and Eurozone, more attractive pricing in the lower middle market space, recovery of growth within EU Peripheral countries, add-on appetite of larger European buyout players</td>
</tr>
<tr>
<td><strong>Unfavorable:</strong> Purchase price and debt multiples remain at or near record levels across much of the middle market, credit availability at smaller end of market is less robust, political risk from Brexit or populist movement may disrupt EU economies (though they have not really done so yet)</td>
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<td><strong>Favorable:</strong> Relatively more accommodative monetary stance of ECB, improved GDP growth trajectory for EU and Eurozone, recovery of growth within EU Peripheral countries, strong credit availability and pricing in upper half of buyout market</td>
</tr>
<tr>
<td><strong>Unfavorable:</strong> Peak pricing and near-peak debt levels for larger European buyout deals, political risk from Brexit or populist movement may disrupt EU economies (though they have not really done so yet)</td>
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### Special Situations

- **Distressed Debt, Mezzanine, Secondaries**

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

- **12- to 18-month commitment outlook**
  - **MODERATE OVERWEIGHT**
  - **NEUTRAL**

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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.
The North American buyout sector had a blowout year on the fundraising front in 2017, as limited partner demand remained strong and institutions scrambled to fill private equity allocations, many of which have been increased in recent years, either by choice or necessity (due to rising assets resulting from strong public markets). Year-over-year, buyout shops gathered about 38% more capital commitments last year than they had in 2016, which was itself a pretty good year. Moreover, 2017 now holds the title for the best year ever in this category, having edged out the prior peak year of 2007. The investment side was a bit more restrained in 2017, with approximately $163 billion in reported deployments, a slide of just under one-quarter from the prior year (for perspective, 2016 was the best year on record in this regard, and 2017 turns out to be the third-best, right after 2008). The exit picture was relatively disappointing for the year, with 2017 figures off by about 25% from the prior year and even more so compared to 2014 and 2015, both of which came in well over $200 billion. Overall, North American buyout funds did a great job of raising capital last year, a decent job of deploying it (especially in a tough market to find value), but came up short in returning the capital, as evidenced by the declining trend in distribution flows over the past couple of years.

In what is becoming an old story, purchase price multiples across the buyout spectrum remain elevated, coming in at over 10x every year since 2014, which itself was just a tick or two below
at 9.7x EBITDA. Unsurprisingly, most of the inflation is coming from the larger end of the market, with deals over $500 million showing an average PPM just shy of 11.0x. The middle and smaller market segments have shown more stability, and pricing in the middle cohort ($250 million to $499 million) has actually moderated somewhat year-over-year (9.0x to 8.3x), though it remains to be seen whether this is a blip or a sustained trend.

Looking forward, what can we expect from North American buyouts over the next two to three years? For the current crop of buyout-backed companies, the tailwinds have picked up from this time last year. For one thing, US economic growth looks to be accelerating, in part due to higher animal spirits, as well as investment (more recently) in the corporate world resulting from a more pro-business agenda from DC. On the consumer side, wages appear to finally be moving up as unemployment sits not far from record lows, both of which have been a tonic to consumer confidence and retail sales. The recently passed tax reform promises to provide a boost to the economy via higher net earnings for corporations and expanded deductions and lower effective taxes for the vast majority of individuals. How long the bump lasts and how strong it is will depend on how much of the tax savings translates into investment from the corporate sector and consumption from the individual sector.

While these tailwinds should aid the performance of buyout funds’ existing portfolio companies, what they portend for investments planted over the next one to three years is

Source: M&A Stats 2017
a more complex question. One thing that seems clear is that a meaningful softening of purchase price multiples does not look to be in the cards. Several factors are set to maintain upward pressure on multiples, including: a more ebullient US economy, continued strong corporate M&A interest fueled by flush balance sheets and generally rich equity valuations (especially in the tech sector), record levels of dry powder within the buyout space on the heels of a stellar fundraising year, and the potential for repatriation of dollars from overseas by US corporations as a result of incentives and lower overall tax rates included in the tax reform package. Perhaps the only major factor working against this floor on purchase multiples is the continuing increase in interest rates in the US; however, this is not likely to provide enough counterweight to the numerous factors mentioned above to make a material difference in valuations, at least for the next year.

Add-on acquisitions should continue to be a major source of investment and divestment activity for North American buyouts in 2018. According to PitchBook, secondary buyouts of private equity-backed companies (not only buyouts) accounted for about one-half of all exits for 2017 (the highest level it has ever recorded) and about 19% of new buyout investments for the year. This data is supportive of our expectation, stated in last year’s Outlook, that this avenue of investment would be increasingly important for buyout shops, as it allows them to deploy capital in accretive fashion in a challenging valuation environment by taking advantage of synergies and cost savings from the combined entities, thus lowering the effective purchase multiple associated
Buyouts > North America

Another good year, or two, looks likely…

Another good year, or two, looks likely…

with an acquisition.

2018 should turn out to be another good year for North American buyout fundraising, as most of the factors that feed high investor interest in the strategy remain in force and in many cases, have intensified. The two exceptions to this are rising interest rates and sky-high multiples, but investors have shrugged any concerns about these off in recent years and are likely to do so again in 2018. The total haul is likely to fall a bit short of 2017 due to fewer mega funds in the market in the coming 12 months. Investment by buyout shops should be robust next year, as they seize the moment afforded by a propitious confluence of factors, including renewed optimism and confidence in the US economy, strong equity markets, continued availability of low-cost debt, and the expected growth of corporate earnings, both organically and as a result of lower tax rates. Somewhere in this calculation must be the thought that, coming up on nine years, the post-crisis economic recovery is getting long in the tooth and there may not be more than one or two years to run before the next downturn. Further, on current course, interest rates should begin to bite in 2019 and take some air out of hot credit markets. Exits are more of a wildcard for 2018, with an expected increase in equity market volatility potentially throwing some cold water on the outlook for a receptive IPO market. However, 2018 M&A flows, both from buyout shops looking for bolt-on acquisitions and from strategic players with major expansion plans, should outpace last year’s levels. If the IPO market can surprise just a little on the upside, the base provided by M&A should allow 2018 to turn in a better exit performance than the past year. Buyout shops should do their part by aggressively seeking liquidity before the cycle turns or higher interest rates make financing more difficult.
Across the Atlantic, European buyout funds put up another good year, much like their North American counterparts. On the fundraising front, 2017 edged out 2016 by less than 5%, with both years (over €65 billion in each year) easily surpassing the rest of the post-crisis field and demonstrating solid investor interest in the region. European buyout managers were active in deploying capital, with the €90 billion invested in the space making 2017 the second-best year since the financial crisis and about one-third better than the average level for that period. Also in common with their North American brethren, European managers put more money to work in fewer companies, as evidenced by the surge in average deal value to over €1 billion, or about 30% higher than the average just seen in 2015. Exits slumped heavily. After three good years on this front, 2017 came in nearly 40% off the 2016 figure and worse than that when compared to the three-year average. Investors will find no relief from rich valuations in European buyouts. At 10.5x and 9.7x, purchase price multiples for the large and medium-size deal cohorts, respectively, European deals essentially mirror their North American counterparts. If anything, the upper reaches of the European market may be slightly more expensive, with PPMs for deals over €1 billion well over the 11.0x mark.

For the past several years, Europe has been bouncing from one “crisis” to another: Greek debt, the euro’s viability, Cyprus, and deflation fears in the earlier years, followed by the Italian banking sector insolvency, Catalan separatism, and of course Brexit more recently.
Throughout, there have been a number of political flashpoints or pivotal elections that have grabbed the headlines, including last year’s historic French Presidential election in which the candidate of a brand new political party upended the long-time order by besting both traditional parties of the center-right and center-left, as well as the (somewhat) surprisingly inconclusive German election which set Angela Merkel frantically trying to cobble together a governing coalition after her party lost a significant number of seats in national elections (all in the midst of a booming economy). Given the whack-a-mole nature of these crises, big and small, the relatively uninspiring economic performance (ex-Germany and the UK) of the Eurozone since at least 2012, the political and economic challenges that remained in front of the region (Brexit negotiation, the aforementioned French and German elections), and the waning impact of extensive monetary easing, 2017 was looking to be another relatively uneventful year for Europe in the economic growth department. Not bad, not declining, but basically another muddle-through year, the region’s dubious specialty. On this count it must be said that Europe exceeded expectations in 2017, as the region continues to brush off one challenge after another. As in prior years, the recovery has been led by Germany, but the difference-maker in the last two years has been the acceleration of growth in the region’s other economies, particularly within the formerly moribund Periphery (Spain has been performing well and even Italy and Greece put up some growth last year). In its Autumn 2017 Economic Forecast, Eurostat projected 2017 real GDP growth of 2.2% and 2.3% for the Euro Area and EU, respectively, which represented a material upgrade from its estimates of only
Buyouts > Europe

several months earlier in its Spring report (1.7% for Euro Area and 1.9% for EU). For 2018, the organization is projecting GDP growth of over 2% for the EA and EU, with a slip to just under that level for 2019. There’s good reason to think that the EU can maintain this course, at least for another year or two, as labor market conditions still have some slack, inflation is quite moderate, and the ECB continues to maintain a highly accommodative stance. Also of importance, consumer confidence has recovered, and credit demand has picked up. The political equation is still a bit of a mess, with Brexit negotiations looming, uncertainty in the region’s largest economy as Merkel works to put together a government, and the ups and downs of the experiment that is Emmanuel Macron in France. However, Europe has shown an uncanny ability to push past such issues over the last several years (remember the Greek Debt Crisis?) and it is likely that it will do so for a least another two or three. In short, Europe is starting to make muddling-through look respectable these days.

Due in part to the aforementioned labor market slack, which should keep wage pressure and inflation low, and the fact that the ECB is a year or two behind the Fed in terms of monetary tightening, we expect that the European economies may have more room to run in comparison to the US economy, and so do not count out another positive surprise in macroeconomic growth. The Continental economies are likely to outperform the UK in the coming year, as the latter is likely to feel some impact from Brexit, and the former benefits from the continued economic recovery of the periphery countries. With regard to Brexit, the latest prognostications suggest a very “soft” exit, but this issue remains one of the top risk factors for the region in the next year.

Our expectations for the European buyout sector are very much in line with those for North American buyouts. A robust fundraising year is in order, as investor interest in Europe remains firm in light of high US equity valuations (even though private equity valuations are more or less at parity), the ECB’s relatively easier policy regime, and the perception that Europe is an inning or two earlier in the cycle than the US. Investment flows should maintain the momentum that was generated in 2017, as accelerating economic activity provides increasing deal flow to European buyout managers. Just as in North America, the exit picture is relatively murky. Our expectation is that this number will rebound meaningfully, but not back to the levels seen in 2014 through 2016. This is in part due to the sense that European buyout shops are not under the same pressures to exit at this stage as their North American counterparts. Also, the expected repatriation of overseas profits by US corporations and foreign M&A interest due to a weaker dollar should contribute to a more active exit market
in North America. Purchase price multiples will stay high, for essentially the same reasons as noted earlier for North American deals, with the added factor that the ECB has not yet initiated an interest rate hiking cycle. Secondary buyouts, which are a more common feature of the European buyout environment, should prove to be consequential on both sides of the table – acquisitions and exits – in 2018.

**Buyouts as a Whole: Tactical Summary**

Our tactical recommendation for North American large buyouts will remain at “neutral,” while the smaller end of the market will remain at “moderate overweight” due to somewhat lower entry pricing and the expectation of strong secondary sale demand for middle market companies as add-on acquisitions over the remainder of this cycle. Our ratings for European buyouts mirror the North American ratings. Aside from a tactical lowering of exposure to the buyout strategy in the current environment, one of the better ways to reduce risk is therefore to go smaller, by shifting commitments to the lower half of the middle market in both North America and Europe. Admittedly, this is more difficult to accomplish in Europe, where, despite much harmonization by the EU, regional differences in law, language, regulation, and the like make it more difficult to efficiently deploy capital at scale across a broad territory in the middle market.
Within the special situations strategies, distressed debt looks to be one of the more attractive relative opportunities. This may sound surprising, as the strategy has had a rough go of it for most of the post-crisis period. With the Fed holding interest rates down for nearly a decade and providing massive liquidity to the longer end of the bond markets for a good portion of that time, the writing was more or less on the wall for distressed strategies. Most of the factors that contribute to success for distressed investors remain decidedly negative in the current environment. After being well below their long-term historical averages from 2010 through 2015, high yield default rates finally found a reason to rise as the energy sector crisis hit in 2014. Even so, by 2016 the rate had only risen to around 3.7%, which was more or less in line with the long-term annual average. At the time, there were concerns that the contagion may spread from the oil and gas sector to other high yield sectors, but this scenario failed to materialize, and by the end of 2017 the high yield default rate had settled in to around 1.5% (and failed to break 3% for the year). High yield flows remain quite strong going into 2018, with JP Morgan predicting over $300 billion in new issuance in the coming year on the back of 2017, which saw around $280 billion in new issuance. Also, despite rising US interest rates, high yield pricing remains quite low by historical standards with effective yields averaging around 6%. Finally, global economic growth and corporate profitability are on the upswing both in the US and Europe, with the former getting an added boost to the bottom line from the tax reform package just passed. Demand for high yield debt remains strong, as investors continue to stretch for yield, which should keep a floor under pricing, barring an economic

BofA Merrill Lynch US High Yield Master II

![Chart of BofA Merrill Lynch US High Yield Option-Adjusted Spread and BofA Merrill Lynch US High Yield Effective Yield from January 2014 to January 2018. The option-adjusted spread peaks in January 2016, while the effective yield peaks in July 2015.](chart_image)

Source: Federal Reserve Economic Data
downturn or major market correction. Even the one glimmer of opportunity that rose in the energy patch after the oil price meltdown did not fully realize as expected, as more companies than expected were able to hold on until prices recovered somewhat. Of those that did need some version of rescue capital, many turned to specialist investors in the private equity energy sector for financing, leaving less for the traditional distressed investors to grab. Certainly, by the latter half of 2017 the worst of the crisis had passed, and now the commodity sectors look to be poised to stage some sort of comeback. Overall, the picture is one of low defaults, ample low-cost high yield debt, strengthening economies, and greater corporate profitability. As we said, it’s not been an easy time to be an investor in distress.

Despite this, we contend that this is the right time to increase exposure to distressed strategies. Certainly, the argument is not made on the basis of current expectations or even those for the next 12 months (or most of the post-crisis period for that matter), but on the expectation of a solid investing environment for the strategy sometime in the next two to four years, well within the investment period of the typical distressed fund. In this regard, the strategy has a couple of things going for it:

- Rising interest rates in the US should eventually put more pressure on corporate balance sheets, particularly those with outstanding CCC-rated debt. The key word is “eventually,” as current interest rate levels, even with Fed tightening, are still accommodative by historical standards, and not yet high enough to put the bite on most borrowers’ cash flows. It will take another year or two at the current pace of rate increases for this to be felt in the US. Distressed investors will have to wait a while longer for opportunity in Europe, due to the ECB being behind the Fed in the tightening cycle.

- Though the US economy appears to have shifted to a slightly higher gear in the latter half of 2017 and Europe appears to have finally managed some real growth on a synchronized basis, it is reasonable to presume that we are in the fourth quarter of the current credit cycle. At nine years and running, one wonders how much gas is left in this recovery, even though it appears to have gotten a shot in the arm recently. Calling a recession is not something that can be done with any accuracy and we will not try. However, as we head into year ten, we think the chance of a downturn in the next two to three years now has a material probability.

These are cyclical factors, but there is one potential “bright” spot for distressed funds in the near term: disruption caused by US tax reform. The key catalyst relates to the limitation placed
on interest expense deductibility, which in most cases will amount to 30% of EBITDA. While this is not expected to have a meaningful impact for most companies (and will also be partially or fully offset by other beneficial portions of the new code), it is expected to hit highly-leveraged, lower-profitability companies squarely. A reliable figure for the size of this universe is tough to pin down, but one recent estimate, by Mercer, suggested that about one-third of companies in the high yield market (mostly CCC and B-rated issuers) fit into this category. In another take, Morgan Stanley estimates that approximately 28% of high yield companies will see any tax benefit from lower rates eaten up by the reduced interest expense deductibility. And these estimates are at the current low interest rates, so more companies can be expected to bump up against this limit as rates rise. This means that about $350 billion to $400 billion of debt issues could come under varying degrees of pressure as the new tax code takes effect.

Distressed strategies do not look too promising in the current environment, but this is to be expected from an opportunistic asset class. What is important for investors is to increase exposure now, while the bull market in credit is running, because the investment window for distressed strategies will open and close quickly, and capital must be at the ready to take full advantage of the opportunity for outsized returns. And the explicit cost (fees, not opportunity) to having capital “on the sidelines” in such strategies waiting for the cycle to turn is coming down in many cases, as many distressed funds’ terms continue to shift toward only charging fees on invested capital or using flexible start dates that can be activated when the cycle turns. Increased
allocations to distressed strategies should be an effective way to hedge some of the pro-cyclical portfolio exposure from buyouts and venture capital as the environment becomes more heated and we run longer into the cycle. For this reason, our tactical rating will remain at “moderate overweight” for 2018. We expect that if current trends remain intact or strengthen, we will consider increasing next year’s rating to “strong overweight.”
North American mezzanine strategies saw their fundraising slump in 2017, but that came on the heels of two reasonably solid years on the fundraising front, which pushed dry powder to just under $40 billion as of the end of both 2016 and 2017, the highest levels seen in this space going back to at least 2000. Investment flows in recent years have been moderate and somewhat volatile. As would be expected, the asset class has never recovered to the levels seen in its glory days prior to the financial crisis. The current environment for mezzanine strategies is a bit of a mixed bag. On the positive side, buyout deal flow is moving at a brisk pace, a trend that is expected to remain in place in the coming year. The prospects for a good year on the M&A front also work in favor of mezzanine funds. The interest rate hiking cycle in the US should eventually narrow the pricing gap between mezzanine and competitive sources of capital, thereby reducing the significant cost of capital advantage that these competitors wield. Default rates remain very low, so the quality of existing mezzanine debt portfolios, and hence performance, remains intact. On the negative side are the factors that have been in place more or less since the end of the crisis. With the US 10-Year Treasury yielding around 2.8%, rates still have a long way to go before they start to make mezzanine look particularly attractive as a source of financing for any borrower that has other options. Further, high yield markets in both the US and Europe continue to be one of those options for a broad segment of the mezzanine funds’ potential borrower universe. With yields still close to 6% and solid issuance in recent years, the high yield markets remain a formidable competitor. Put all this together and the conclusion is that mezzanine funds are still in the position of being price-takers. And by the looks of it, the price is not often right, as mezzanine tranches
have accounted for a smaller and smaller slice of buyout cap structures over the last several years (see graph). On the risk side of the equation, persistent high debt multiples for sponsored buyout deals, which are still the mainstay of the mezzanine universe, continue to expose mezzanine tranches to higher potential default risk and loss in the event of a downturn, which are real risks given the late stage of the economic and credit cycles in which we find ourselves. One wildcard for the mezzanine asset class relates to the interest expense deductibility limitations that were mentioned earlier (30% of EBITDA). Given that mezzanine funds provide relatively high cost credit to more highly-levered companies, it stands to reason that many of their borrower companies will be impacted by this new rule. This is a story that bears watching as the year unfolds. Our expectation is that this will not be a devastating blow to the mezzanine space; however, we do expect that some significant restructuring (shifting to PIK, warrants, etc.) will occur in existing portfolios and that the mix of deal flow deemed attractive will shift meaningfully as mezzanine providers adjust their loan offerings and structures to accommodate the new tax regime.

We are moving our tactical rating for mezzanine debt strategies to “moderate underweight” from a “neutral” rating last year. This move is based primarily on the high availability of alternative, and lower cost, sources of debt that compete with mezzanine, and secondarily on the high debt multiples maintained by buyout funds, which expose mezzanine to increased risk. The potential disruption that may arise from the interest expense deductibility issue is another factor that suggests a lower tactical rating.
Secondary investment strategies have been on a roll since 2013. After putting up three solid years in terms of investment volume, ranging from $37 billion to $42 billion, secondaries are set to log another blowout year on this front, with first half 2017 volume of $22 billion setting a pace for a record year. Concurrent strong fundraising and ample dry powder suggest that the party will continue through the rest of the current cycle. Unsurprisingly, pricing remains rich. For the first half of 2017, average pricing for buyout funds came in at 98%, a tick upward from 95% in the prior year. Of course, the average conceals a meaningful variance in pricing between high-quality funds (mid-90s to over par) and low-quality funds (80s) as well as buyout and venture, with the latter pricing in the low 80s. Clearly, the secondary space continues to be a sellers’ market. The vast majority of deals - and nearly all transactions of size - are pursued by choice, not necessity, as neither performance nor liquidity-related pressures are weighing on limited partners’ portfolios in the current environment. Though the pace has slowed, distributions from private equity funds in recent years have been robust and underperforming managers have been slowly rationalized. This means that most transactions will be related to more mundane portfolio rebalancing considerations, as they have been for much of the post-crisis period. We expect these dynamics to persist over the next year or two, unless an economic downturn comes into play. Pricing will remain at or near the current peaks and volumes will settle in a range of $35 billion to $40 billion per year².

At the turn of the millennium, the secondary space still resembled a niche strategy, with a few funds providing liquidity to limited partners that were under pressure to sell. This imbalance led to meaningful discounts. Since the financial crisis the strategy has fully matured, with more and larger players on the buy-side, more extensive use of leverage, higher volumes, and much more efficient pricing. Given the higher level of sophistication on the sell-side, more effective intermediation, and more robust information flow available today as compared to the earlier days, this dynamic is unlikely to change. Therefore, secondary strategies are more appropriately viewed as vehicles by which investors can gain access to a lower-risk, diversified pool of private equity exposure that mirrors the overall performance of the private equity universe. However, the opportunistic element of the strategy has waned over the years as market efficiency took hold. That being said, the secondary strategy does retain some value from a defensive perspective, due primarily to its lagging orientation to the cycle and the fact that there is a comparatively (in relation to, say, distressed strategies) consistent opportunity

²) Greenhill Secondary Market Trends Outlook July 2017
to deploy capital to managers in the space year-in and year-out. Therefore, investors can afford to get some visibility on the cycle’s turn before deploying to secondary managers without sacrificing too much exposure to the upside that can come from having secondary investments when the post-boom repricing of assets occurs.

Our tactical rating for secondary strategies will drop to “moderate underweight” for 2018 from “neutral” last year. The key factors contributing to this rating are the rich pricing associated with peak-level NAVs, lack of pricing power, and effectively pro-cyclical nature of the strategy in the existing market environment.
In 2017, the venture capital strategy logged another impressive year on the fundraising and investment fronts, while putting up relatively uninspiring numbers on the exit side. VC funds continue to be quite attractive to limited partners. While it does not appear that 2017 fundraising will surpass 2016’s record year ($40 billion), VC funds should end up with over $30 billion in new commitments, putting them well in line with the mini-boom fundraising years that took off in 2014, as well as above all post-crisis years. Deal-making rolled ahead at the torrid pace set in the past few years: 2017 VC investment of approximately $84 billion blew past the 2016 level and topped the previous post-millennial record of $79 billion set in 2015. While that is impressive enough in its own right, the real story is in the deal count. After consistently increasing year-over-year since the end of the crisis, the number of companies receiving venture funding topped-out in 2014-2015, with each year coming in at over 10,400; after which a steep decline occurred in 2016, when only about 8,600 deals were done. The past year saw just over 8,000 deals, but with around 17% more capital deployed in comparison to 2016. To see what is happening in the venture capital world today, look no further than the $4.4 billion late-stage round closed by WeWork last year, $3 billion of which was provided by VC mega-investor Softbank Vision Fund. WeWork and over 70 of its fellow unicorns accounted for about 23% of total VC investment last year, strongly continuing the trend of the past few years in which

![Median Pre-Money Valuation ($M) by Series](image)
later-stage investors pour larger amounts of capital into fewer, more established companies. This has had the effect of pushing average exit timeframes into the 6+ year territory, compared to 5 years in 2008. Unsurprisingly, the exit picture has suffered due to this dynamic: through the third quarter of 2017, venture capital exits totaled about $36 billion for over 500 companies – at that pace, the year is set to come up short by about one-third compared to 2016 exits (by value)\(^3\).

What is in store for venture capital in 2018-2019? Investors can expect most of the dominant trends of the past few years to prevail, as there are few visible factors that are likely to derail them, barring a recession and/or market crash. Here are some things to expect:

- Fundraising by venture capital shops should more than hold its own this year, as investor interest has not waned, and has likely increased due to a more optimistic outlook on the world economy and equity markets. Also, with most US financial assets being fully-priced, venture capital is one of the only areas (at least theoretically) in which investors can access above-market returns. We anticipate another fundraising haul in excess of $30 billion for the year, but short of a record.

- The investment pace will remain robust, though it may not hit last year’s high. The supply side in the venture space is well-capitalized, with dry powder of over $90 billion held by traditional VCs alone, after a string of solid fundraising years. But this is only half of the story: non-traditional players, including corporate investors, sovereign wealth funds, crossovers from the public side, and even hedge funds (and we should not forget about the Softbank behemoth) remain active and willing to provide later-stage funding at rich prices, at least for now.

- The impressive amount of capital in reserve, plus the large stable of unicorns that still need to be fed will keep intense upward pressure on later-stage valuations, which are not expected to moderate and may even increase substantially. After a slight pause in 2016, median pre-money valuations for Series D+ surged upward once again in 2017 on the back of numerous large unicorn funding rounds\(^3\). A similar dynamic is likely to play out in 2018.

- There is room for some optimism on the exit front in the coming year. While the immediate IPO picture is not entirely clear, there are several unicorn companies that are mentioned as possible contenders for a public offering in the next 12 months. If even half

\(^3\) Pitchbook NVCA Venture Monitor as of 9/30/2017
of them make it to IPO, they will be big enough to move the needle well past last year’s relatively unimpressive totals. Further, the M&A side, which has been carrying the weight for exits over the past two to three years, should remain as a solid route to liquidity for venture-backed companies. In all likelihood, M&A exits should pick up the pace from the last couple of years, due in part to intensifying acquisitiveness of corporates in both the tech and life sciences sectors that are rich in both cash and equity valuations. Further, there may be some boost to these companies’ acquisition war-chests resulting from repatriation of overseas capital as a result of US tax reform. Finally, buyout shops, also flush with cash to invest, have in recent years become keener on acquiring larger venture-backed companies, a trend that is expected to continue. Market volatility in 2018 could put a damper on this more optimistic exit scenario. However, the momentum over the next two years should be considerable. The reason: simple necessity. While investors have so far been patient with extended times to exit and have provided relatively low cost capital to ever-larger late-stage funding rounds, it is reasonable to conclude that at some point the pressure to exit will increase, especially before the market begins to lose confidence and down rounds kick in. The non-traditional investors in the mix are particularly likely to begin seeking a return on their sizable investments in unicorn deals of the past few years. Add to this the increasing probability that we are in the later innings of the economic and market cycles, with a shortening time left to get to the doors before the turn, and there is a good deal of incentive for VCs to generate liquidity over the next two years.

In last year’s Outlook we had a tactical rating of “moderate underweight” for venture capital strategies. We expect the asset class to perform well this year, assuming that the exit door can be cracked wider, which bodes well for existing venture capital investments from the 2012 and later vintage years. However, given that later-stage valuations remain quite high (and have moved even higher in the past year) and we are late in the equity market cycle, the value proposition of capital planted in the space over the next 12 to 18 months is much less obvious. For these reasons, we are keeping our tactical rating of last year in place.