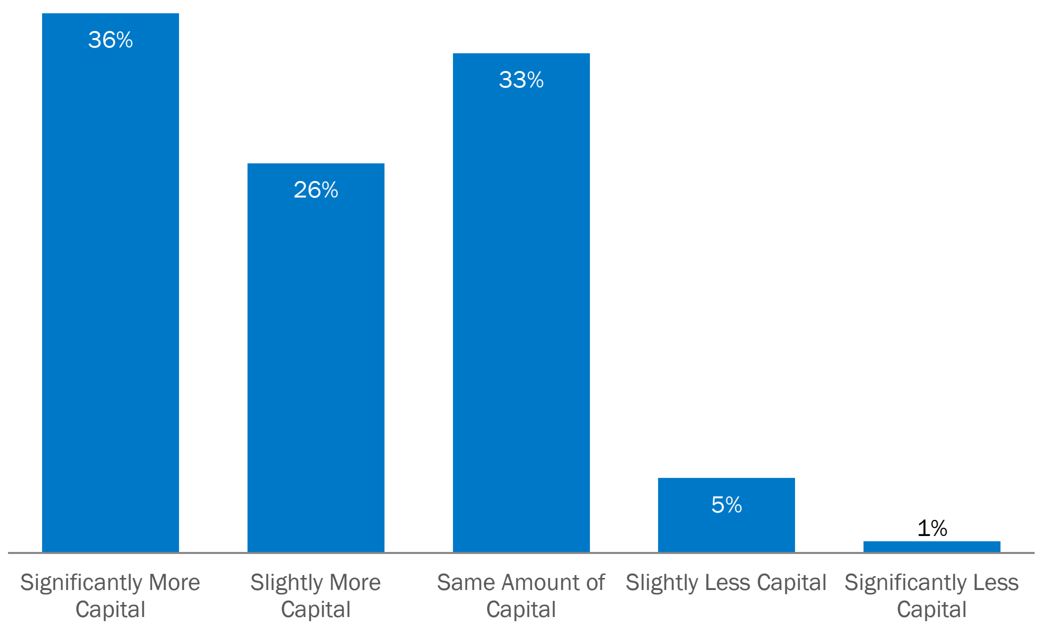
Valitas Insights: Adapting to a Challenging Environment: The Outlook for Private Equity

Are we in a private equity bubble that is about to burst? A recent Wall Street Journal article considers this question in light of increased stake sales, bigger funds, and record levels of investment capital. “Is it a bubble? My answer is no,” says one fund manager, whose view is shared by many of his peers. In fact, despite some challenging industry dynamics, PE fund managers interviewed in the WSJ article and for a recent Prequin report share an optimistic outlook for investment activity.

Amount of Capital Fund Managers Expect to Deploy in the Next 12 Months Compared to Past 12 Months



Source: Prequin

We were curious about the Canadian PE viewpoint, so we spoke with Michael Wagman, a Managing Director at Clairvest, James Merkur, President of Intercap, and Darrell Pinto, Research Director of the Canadian Venture Capital and Private Equity Association (CVCA), to get their insights. Like many of those interviewed for the WSJ article and Prequin report, all three held cautiously optimistic views.

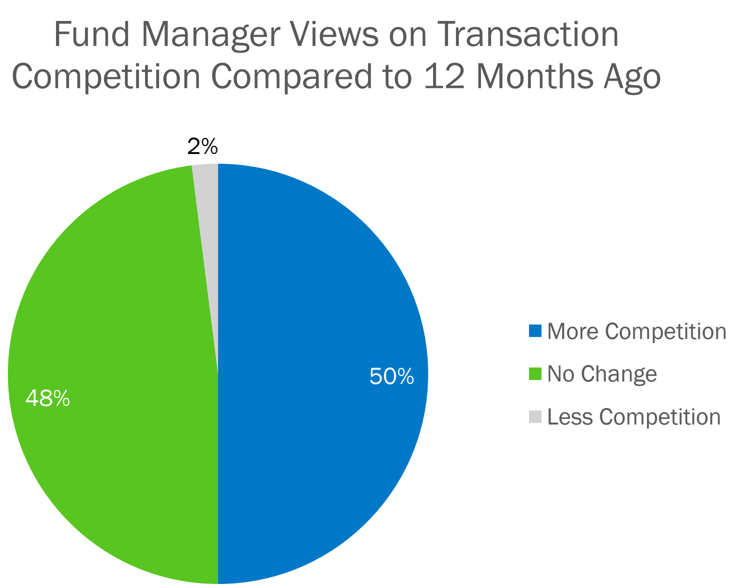
In his role as Research Director, Darrell Pinto interacts with a broad subset of the Canadian PE community. He told us that there is a general air of optimism, attributable to significant levels of dry powder, as well as the potential returns delta offered by the asset class relative to the public markets. The CVCA’s recent H1/2017 review reported accelerating PE activity in the lower and mid market, as well as in the megadeal transaction range, with heightened cross-border activity in larger transactions ($500 million+). Mr. Pinto believes this is likely to be sustained through the second half of the year.

Michael Wagman agrees that investor activity is unlikely to slow, given the extensive access to capital and the increasing number of buyers, including U.S. PE shops. These dynamics are driving increased competition and higher valuations, pushing PE fund managers to adapt their strategies accordingly. Mr. Wagman points to domain expertise as one effective strategy in this competitive, high valuation environment.

The themes of increased competition and high valuations are recurrent. James Merkur puts it this way: "With these dynamics, our biggest challenge is deploying meaningful capital in an intelligent way." This is particularly true of the technology sector, where there is growiing competition from U.S. PE investors. But despite the challenges, and like his counter-parts, Mr. Merkur believes that higher levels of activity will be sustained, supported by easy access to capital and the promise of strong returns,

These reflections on the Canadian PE landscape are consistent with the findings of the recent Prequin report which surveyed 153 U.S. fund managers on their views of the current PE environment and their outlook for the upcoming year. Respondents reflected on issues including deal flow and investor appetite, and shared their viewpoints on the increased levels of competition relative to 12 months ago.

Half of respondents reported an increase in competition while only 2% reported a decrease. For buyout situations specifically, this increase was between 41-53% depending on the size of the transaction.



Source: Prequin

With these dynamics at play, it's no surprise that fund managers regard deal pricing as the biggest challenge of the next 12 months. As Michael Wagman points out, this is creating an impetus for many firms to broaden their horizons in their quest to find quality targets at reasonable valuations. From our perspective at Valitas, we expect that to translate into plenty of cross-border activity and healthy investment in the mid and lower mid-market range, as PE investors pursue that increasingly elusive objective: deploying their capital on quality targets with reasonable valuations.