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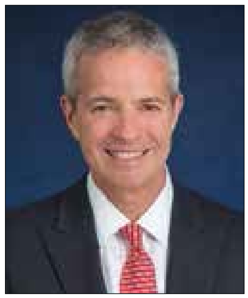
In Their Own Words

Each year, Private Equity Analyst asks senior professionals from different corners of the private-equity industry to share their perspectives on the year that has just passed and the challenges that may lie ahead. This year's contributors represent a cross section of buyout firms, venture capitalists and limited partners.

U.S. Private Equity

Rodney Cohen, Managing Director, Carlyle Group LP



What surprised you most about 2018?

I thought that in the latter part of 2018 we would have seen more of a slowdown in transaction volume and pricing, but that really didn't happen. If anything, the pace and multiples actually continued to pick up. The number of PE firms, family offices, pensions, sovereign funds, etc., and the available capital continued to rise. It's quite a competitive landscape, especially in the middle market. We all understood that we faced a frothy equity market, continued low interest rates and record levels of dry powder, but I'm still surprised to see the frenzy continue as long as it has.

What do you think will be the biggest challenge the industry will face in 2019?

First and foremost: Will there be a recession, or some form of reset or slowdown in overall growth? The credit markets could get tighter, and rates will most likely continue to rise. We've also all been battling political change, which has real economic impact—for example, tax, tariffs and other trade-flow disruptions are hard to predict and, in 2019, we will continue to keep a careful eye out.

José Feliciano, Managing Partner, Clearlake Capital Group

What do you think will be the biggest challenge the industry will face in 2019?

For any private investor, finding interesting investments during a time of increasing volatility in both the debt and equity capital markets, while in the midst of robust public- and private-equity valuations, will be an ongoing challenge. Understanding the potential catalysts, timing and depth of any future downturns or dislocations will also continue to be critical for private investors.

Do you think we'll see volatility impact the private-equity market in 2019?

Yes. Increasing volatility in the public markets, in addition to geopolitical concerns, trade tariffs and volatility in commodity pricing, has started to manifest itself in the credit markets, particularly in the more junior debt tranches. We believe volatility in the credit markets and increasing interest rates may begin to impact private-equity volumes and valuations in 2019, particularly in more cyclical sectors.

What are your biggest lessons learned from 2018?

We are more mindful than ever that we need to remember the lessons of 2008 as we prepare for a world where volatility may impact selected industries and parts of the capital markets. We may see words like "distressed" and "restructuring" re-emerge. During these times, the basics of investing apply: Identify opportunities that provide principal and downside protection, generate cash flow and have unique growth drivers that will deliver attractive equity returns independent of general market conditions.

Stewart Kohl, Co-Chief Executive, Riverside Co.

What surprised you most about 2018?

We didn't see—yet—any softening in this persistent and pervasive seller's market.

What do you think will be the biggest challenge the industry will face in 2019?

To maintain the high level of performance and returns we achieved in 2018. We set a remarkably high bar for expectations from our investors. But we love a challenge, and our team will be focused on the task.

What merger-and-acquisition opportunities are you expecting to see at the midmarket level in 2019?

The rapid advance of technology supercharged through AI, 5G, mobile, IoT, blockchain, social media and the cloud will create opportunity for all middle-market companies, whether technology companies or not, to topple competitors, disrupt industries and change the world. This creates much greater risk but also opportunity for all of us investing during the digital revolution.

Michael Kumin, Managing Partner, Great Hill Partners

What surprised you most about 2018?

The strength of the U.S. economy was a surprise to me in '18. We've been somewhat cautiously waiting for some sort of pullback, but that obviously didn't happen in 2018. Our portfolio has experienced tremendous growth over the past 12 months, which I think is consistent with the overall market environment.

What do you think will be the biggest challenge the industry will face in 2019?

The biggest challenge will be finding the right new investment opportunities to pursue against a likely backdrop of economic headwinds, in combination with a relatively expensive pricing environment. Since Great Hill invests in high-growth businesses that are typically market-share takers or companies creating entirely new industries, some of this economic risk is mitigated, but it's certainly something we'll be focused on in 2019.

What categories within consumer and retail are you the most excited about in 2019?

We remain focused on e-commerce businesses and emerging brands that are leveraging direct-to-consumer marketing strategies. Shopping behavior continues to shift away from traditional brick-and-mortar brands and toward new emerging players, which is a trend we expect to continue for the foreseeable future. Within that ecosystem, we are excited about finding companies with a relentless focus on execution. These DTC business models have proven to be really hard to successfully execute, so talented metrics-driven management teams can make all the difference.

D. Scott Mackesy, Managing Partner, Welsh Carson Anderson & Stowe

What surprised you most about 2018?

I continue to be surprised at the resiliency of the equity markets and the U.S. economy in the face of rising interest rates, trade wars and the aging economic expansion. Every time something takes a whack at S&P 500, it keeps bouncing back. It's like that scene from Monty Python.

What do you think will be the biggest challenge your corner of the industry will face in 2019?

Historically low unemployment. Finding and retaining great talent for our portfolio companies is our top priority and the biggest challenge. I think PE fundraising will be a lot harder. Overall fundraising volume has been strong and may stay strong, but there is a widening divide between the haves and the have-nots.

What is the biggest lesson you learned in 2018, and why?

It's not a new lesson, but we got a good reminder about the importance of relationships. In July, we closed a very complex [joint venture] deal with Humana that took over a year to negotiate. We first met Humana's CEO, Bruce Broussard, when he was treasurer of a Welsh Carson company 30 years ago. He later became CEO of another of our companies, and we've remained close friends. We couldn't have gotten the new deal done without the kind of trust that is built through long-term relationships.

Tricia Patrick, Managing Director, Advent International Corp.

What surprised you most about 2018?

I was surprised that volatility increases came so late in 2018, despite the fact that drivers of increasing volatility—rising rates, geopolitical issues, wage and cost inflation—were present all year. At Advent, we've been anticipating a rise in volatility for some time, and as a result, we've been helping our portfolio companies undergo the necessary preparation to ensure success in more challenging times.

What do you think will be the biggest challenge your industry will face in 2019?

While trade resolution and the strength of the U.S. consumer can't be discounted, the most important questions for consumer investing continue to be, "How do people want to buy?" and "How will they consume information?" I'm also keeping an eye on the multitude of issues around consumer data ownership, which will only rise in importance over the coming years.

If you could change one thing about the past year, what would it be?

Venture-capital valuations continue to impact private equity's ability to play a major role in key disruptive businesses and ideas. We continue to believe there are assets that would benefit from more focused, less distributed ownership and longer-term investment capital, in order to take on the next phase of disruptive growth.

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Béla Szigethy, Co-Chief Executive, Riverside Co.

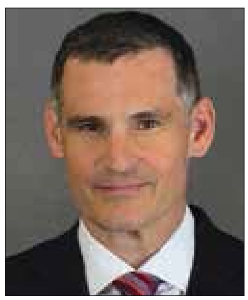
What surprised you most about 2018?

Despite the high-price market, we invested over $900 million into really attractive new investments. And despite the new tax bill, my actual tax rates for 2018 are going up considerably!

What do you think will be the biggest challenge the industry will face in 2019?

I expect the economy will be a bit weaker, perhaps flat to negative GDP for a bit. It could be a challenge for portfolio companies to maintain sales and Ebitda momentum.

David Tayeh, Head of Corporate Investment Private Equity, North America, Investcorp



What surprised you most about 2018?

The resilience of the U.S. public-equity markets. On one hand, it's understandable, given the strong GDP numbers and 20%-plus earnings increase[s] in the S&P 500 in the first three quarters of the year. On the other hand, those results are significantly inflated by the one-time pop from the tax cuts. We face a number of headwinds, some of which include rising interest rates; the rise of populism, nationalism and unrest across the geopolitical landscape; the looming trade war with China; and the large increase in the deficit and likely impact on rates going forward.

What do you think will be the biggest challenge your corner of the industry will face in 2019?

Identifying and investing in companies that strike the right balance between persistently high valuation multiples against a backdrop of increasing interest rates and an economic expansion that's one of the longest on record. Coupled with the record levels of dry powder in PE (and broadly in the market), being appropriately disciplined and pricing across a range of outcomes are more important than ever.

Gene Yoon, Managing Partner, Bregal Sagemount

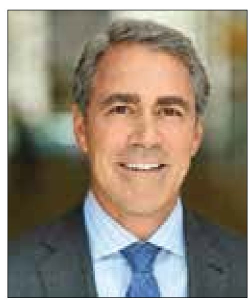
What surprised you most about 2018?

Although having been highly active both investing new capital and exiting several investments, I found two things surprising. First, the extent to which PE buyers are now baking in upside into "base cases" was surprising. Examples would be modeling in tuck-in acquisitions and cost-cutting opportunities into the base case; these used to be held out for upside cases. The second surprise was the extent to which leverage is still being used despite a changing environment. Libor is now above 2.5%, so you are starting to see base borrowing rates into the high-single digits. This, coupled with the pending rules against the deductibility of the interest expense, should have a natural effect on [the] use of leverage. But it didn't in 2018. This may be particularly challenging for lower growth or lower return-on-assets companies going forward.

Richard Zannino, Managing Director and Consumer Practice Co-Head, CCMP Capital Advisors

What surprised you most about 2018?

We've had a much more pro-business economy over the last year or so. That's reflected in business investments; there has been a lot of hiring and higher business activity, including much greater consumer spending. But people are also seeing tremendous pressure on inputs: labor shortages, having to pay higher wages to get that labor, higher commodity prices and higher material costs. It's all making it more difficult to convert the economic growth to robust profit growth.



I was surprised that the economy took off so fast and that there wasn't more slack in the economy to accommodate that growth.

What do you think will be the biggest challenge the industry will face in 2019?

2019 will be another big year for private equity. We're in a good place in terms of interest rates and the economy, and valuations remain high. That works both ways because we're sellers as well as buyers. Not only are valuations at their historical high right now, but pro forma, run-rate adjustments that people are putting on Ebitda are becoming an art form. The combination of high multiples and what adjusted Ebitda people are expecting to get paid on today are making valuations frothy. We're viewing it as "buyer beware." In consumer and retail, we did no incremental deal in 2018 other than bolt-on acquisitions on existing portfolio companies.

In the consumer space, how are you navigating through rising valuations and the flurry of upstarts?

We've built a defensive portfolio over the last couple years. We're looking for companies that in the perfect world would be recession-resistant, but at least would be recession-resilient. I don't think there will be a recession in 2019, but we're building recession into our modeling when we look at our returns over the next three, four, five, six, seven years. We're looking at a recession at some point in that time period.

Joseph Zidle, Managing Director, Blackstone Group LP

What surprised you most about 2018?

That investors could be so bullish on the economy yet so bearish about equity markets. Growth in the U.S. accelerated to rates not seen since the days before the great financial crisis. But U.S. markets still declined by 10% or more twice—in February and again in October [and] November. Unusually, those declines were set against a backdrop of strong economic growth, the best jobs market in almost 50 years and booming corporate profits. That tells me this is an environment to be bullish on equities.

What are the main market trends to watch in 2019, and what effects could they have on private equity?

Expect the biggest trend to be the continued rotation from deflation and quantitative easing to reflation and quantitative tightening. June 2016 was the turning point: the 10-year treasury hit its all-time low yield of 1.35% amid peak central bank purchases. Since then, rates have more than doubled and central banks have all slowed or stopped their purchases while deficit spending threatens to increase the supply of treasury paper. In my view, higher yields are coming, and they could compete against other asset classes for investment dollars.

U.S. Venture Capital

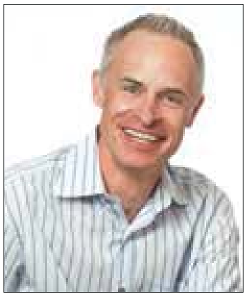
Ambar Bhattacharyya, Managing Director, Maverick Ventures

What surprised you the most about 2018?

The amount of venture, M&A and IPO deals outside the U.S. We will look back at 2018 as the year where China, India, Israel, Korea and Europe were unequivocally recognized as centers of innovation alongside Silicon Valley.

What do you think will be the biggest challenge your industry will face in 2019?

Having portfolio companies continue their strong growth rates in times of a potentially slowing—or at least more uncertain—global economy. The markets are choppier now than ever before, and the IPO landscape will evolve into those with strong and lasting brands.



Bob Kocher, Partner, Venrock

What surprised you most about 2018?

The resiliency of the capital markets. Despite trade wars with China, Canada and Mexico, an unstable geopolitical environment and a White House prone to tweeting out policy, the capital markets embraced the tax cuts and delivered growth. This resiliency extended deep into private markets where any company with product-market fit found low cost equity and debt capital, too.

If you could change one thing about the past year, what would it be?

That our country would make much more progress treating women, immigrants and poor people with respect.

Nicole Quinn, Partner, Lightspeed Venture Partners

What surprised you most about 2018?

How quickly consumer behavior could be changed with the introduction of the electric scooter. In part, scooters tap into an existing behavior of wanting to get somewhere faster. However, our daily commutes, going to see friends on the other side of a city and the way in which we sightsee new cities have been transformed through scooters.

What do you think will be the biggest challenge the industry will face in 2019?

Facebook marketing. 2018 saw the pain that was felt by consumer startups who were reliant on Facebook marketing. Those companies who are nimble on their feet and think outside the box with their marketing approaches will be the 2019 winners.

If you could change one thing about the past year, what would it be?

The prelaunch "seed" companies raising $100 million rounds. 2018 very much showed us that we are 10 years into a bull-market run and valuations are high. That's one thing I would change. But we are all enjoying this strong economy, so be careful what you wish for!

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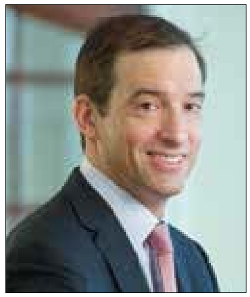
International

Patrice Etlin, Managing Partner, Advent International Corp.



What surprised you most about 2018?

The election of Jair Bolsonaro [in Brazil], an outsider with a military background and a market-friendly agenda, was a big surprise.

What do you think will be the biggest challenge the industry will face in 2019?

The four largest economies in Latin America—Brazil, Mexico, Argentina and Colombia—will all have new political administrations in 2019. This could create distractions for the private-equity industry. It's important not to get sidetracked by these changes and to focus on driving value-creation plans at portfolio companies to ensure continued growth and success.

If you could give Brazil's new president a wish list for 2019, what would be at the top of it?

I would encourage him to focus on enacting reforms that support continued economic growth and political stability.

Raymond Svider, Partner, BC Partners

What surprised you most about 2018?

The continued rise in public-market valuations in the face of increased risks and volatility. Although less surprising, the increased competition from, and determination of, trade buyers is likely an indication that we are at the peak of the market.

What do you think will be the biggest challenge your corner of the industry will face in 2019?

Without any doubt, navigating the increased volatility and continuing to invest if market valuations do not partially correct. A downturn is bound to come our way. Therefore, the longer current valuations persist, the closer we get to a market correction, which makes it more uncertain and riskier to deploy capital.

What do you think will be the best opportunity for your business in 2019?

We seek businesses with defensive growth characteristics. If there is a correction, the opportunity lies in not following the market and buying while others are selling. If not, at current valuation levels, we focus on structurally growing sectors or industry segments which are not yet overly consolidated. We try to buy one of the larger participants with a thesis of organic growth coupled with industry consolidation, to bring down average multiples and benefit from scale and synergies.

Limited Partners & Fundraisers

Antoine Dréan, Chairman, Triago

What surprised you most about 2018?

The incredible growth of the secondary market is one of the most stunning developments of the year, with annual volume on track to hit $70 billion to $80 billion. A key driver

of this growth is the expanding group of nonspecialist LPs...driven on one hand by their increasing sophistication and on the other hand by their increasingly common view of secondaries as an important portfolio-management tool.

What do you think will be the biggest challenge the industry will face in 2019?

For LPs, it will be sifting through the record number of funds seeking commitments. For most GPs, the greatest challenge will be finding investors, ironically, in a boom period for fundraising. With a handful of very large managers raising ever bigger funds, exposure and access to relevant LPs will be key.

How do you think private-equity fundraising will fare in the new year?

Private-equity fundraising will set a new record, or near-record. Fundraising is in the midst of a secular growth trend that should go on for years, with relatively modest dips tied to economic cycles. A bearish public market could trigger a significant shift in asset allocation, namely from large pensions who will invest massively in megafunds. As alpha generation remains a key criterion, niche funds and smaller but more aggressive managers should also stand out.

Steven Nelson, Chief Executive, Institutional Limited Partners Association

What surprised you most about 2018?

While [environmental, social and governance] considerations have become an increasingly important component of investment decision making for a broad base of LPs in Europe and Canada, the weight given to such issues in the U.S.—particularly sustainability—continues to lag. While some in the private-equity industry have moved beyond a check-the-box approach, it is surprising that the U.S. gap persists, especially given growing stakeholder interest and activism, as well as the attention now paid to such issues in the listed equity space. We anticipate greater emphasis going forward—on both sides of the Atlantic and across LP type—and would have expected more progress made in 2018.

What do you think will be the biggest challenge limited partners will face in 2019?

Stakeholder education and management—internally (e.g., trustees) and externally (e.g., beneficiaries)—are critical to the successful execution of a private-equity program. Reputational issues related to diversity and inclusion and the treatment of portfolio-company employees, among others, together with ongoing pressure felt by LPs with regards to fund fees and terms, will continue to challenge allocators.

What will be the most important policy or regulatory issue private equity will have to address in 2019?

The ongoing erosion of fiduciary protections for LPs represents a fundamental issue for private equity to address in 2019. The associated duties of care, loyalty and good faith help form the foundation of a vibrant private market. Unfortunately, LPs are now frequently encountering disclaimers in partnership agreements that place their interests at risk, undermine the GP-LP relationship and, for some institutions, are in direct conflict with their own fiduciary obligations. Restoring these protections is in the best interest of all industry participants.

Jackie Rantanen, Head of Product Management, Hamilton Lane

What surprised you most about 2018?

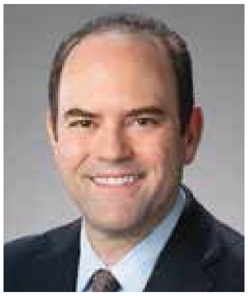
While we expect[ed] overall fundraising dollars to be down, we were surprised to see that the number of [private placement memorandums] we reviewed was at a record level of over 1,000. To us, this is a sign of a growing, diversified market.

What do you think will be the biggest challenge the industry will face in 2019?

The perception that volatility is bad for the private markets. While this is true of the public markets, it hasn't been the case of the private markets. In fact, our analysis shows that buyouts have historically maintained their outperformance across volatile markets, while public equities have underperformed in the wake of high volatility.

If you could change one thing about the past year, what would it be?

The perception that only bad funds get restructured. In fact, we believe that fund restructurings are not necessarily bad for the market. They are a growing part of the current market environment and, as a core component of the fundamental shift in the secondary market, are likely to remain so for a long time.



Christopher Zook, Chairman and Chief Investment Officer, CAZ Investments

What surprised you most about 2018?

In the private markets, we were most surprised by the willingness of many in the private-equity industry to embrace a level of leverage that most everyone knows is unwise. Solid, reputable firms are completing transactions at exceedingly high Ebitda multiples, with extreme levels of debt. They seem to be rationalizing their position that because the loans have little restrictive covenants, which is an entirely different concern, they will be able to muddle through and keep the company afloat if the economy softens. Yet they appear to have sacrificed solid underwriting standards and return expectations in the name of getting deals done. That is very surprising, as they lived through the great recession and are likely doomed to repeat the cycle of having to rescue or write off many of those investments. We would have expected the industry to have learned [its] lesson.

What do you think will be the biggest challenge the industry will face in 2019?

We think the greatest challenge the private-equity industry will face in 2019 will be to properly manage the expectations of investors for both realization timing and returns. If the economy softens, the pace of exits will slow, and some portfolio companies may need to be held until the other side of the cycle. The industry is growing dramatically, and there is an enormous amount of new capital flowing into private equity. That is great for the industry, but many of those investors are newer to the asset class and may not have realistic expectations. ■

—Compiled by Laura Cooper, Chris Cumming, Luis Garcia, Brian Gormley, Jaewon Kang, Laura Kreutzer, William Louch, Heather Mack and Katie Roof. Responses have been edited for clarity.