Duff & Phelps

Shearman & Sterling LLP

Mergermarket

GLOBAL PRIVATE EQUITY OUTLOOK

CONTENTS

METHODOLOGY

On behalf of Duff & Phelps and Shearman & Sterling LLP, Mergermarket interviewed 75 private equity executives from Europe, North America, and Asia-Pacific regarding their investment strategies over the next 12-24 months. All respondents are anonymous and results are presented in aggregate.

Research notes:

- All data is from Mergermarket.com and as of June 9, 2014
- Average deal size is calculated by dividing the total transaction value by the number of deals that have disclosed value

Breakdown of Respondents' Transaction Sizes

Transaction size	Percentage of respondents
<US$100m	36%
US$100m-US$500m	61%
US$501m-US$1,000m	44%
>US$1,000m	23%

Note: Respondents were able to choose all deal sizes in which they transact

INTRODUCTION

After weathering a long financial storm, private equity firms have entered 2014 with growing boldness and an increased appetite for investment. Industry leaders predict that the coming 12 months will see this confidence level continue, and are forecasting a significant uptick in global private equity activity.

Respondents in the inaugural *Global Private Equity Outlook*, jointly commissioned by Duff & Phelps and Shearman & Sterling LLP in association with Mergermarket, are optimistic about private equity activity over the next 12 months. In fact, a majority of respondents (87%) believe that there will be a near-term increase in buyout activity and 72% expect fundraising prospects to improve in the next year. "Last year's significant level of fundraising, coupled with market strength and an abundance of investment opportunities, suggest that private equity activity is primed to expand over the next year," a Europe-based partner says.

This report reviews the different strategies firms currently employ to stay ahead of the competition and to achieve the desired return from their investments. It also considers the impact of the current and anticipated regulatory environment on the industry. Although private equity has traditionally been lightly regulated, it will likely face increased oversight. The survey results address the various drivers of buyouts and exits in the current market while also exploring regional and industry-specific trends.

"Across geographies and industry sectors, private equity professionals express optimism. Competition is growing, but the industry is confident that strong investment pipelines, financing accessibility, and exit options will all contribute to a vibrant industry in the year ahead and beyond."

Bob Bartell, CFA – Global Head of Corporate Finance, Duff & Phelps

"We expect private equity activity to pick up speed in the next 12 months, with acquisitions making up the lion's share of opportunities. There's no telling what that ceiling might be."

Mark Soundy, Global Co-Head - Private Equity Practice, Shearman & Sterling, London

Highlights from this report include:

- 87% of respondents expect a near-term increase in buyout activity
- The value of year-to-date exits at US$227bn is fast approaching 2013's total of US$282bn
- Private equity respondents expect the consumer and technology, media and telecommunications (TMT) sectors to offer the best opportunities in 2014, followed by the energy, healthcare and industrials sectors
- New entrants are intensifying already fierce competition and co-investments alongside fund managers are becoming more common
- Depth and methodology of due diligence, including attention paid to new regulatory requirements, are increasing the average time to complete a transaction; more than a quarter of respondents (28%) think that regulatory and compliance risks are the top challenges faced by private equity firms
- The value of cross-border buyouts are on the rise; majority of respondents plan to invest in new markets
- On average, cross-border transactions will make up 30% of respondents' acquisitions over the next 12 months; across all regions, near-term exits are predominantly domestic while acquisitions and financing reflect greater international interest
- Nearly 40% of the respondents will raise a new fund in H1 2015 and a majority plan to keep the new funds the same size as their current ones

OVERVIEW

Deal Pursuits

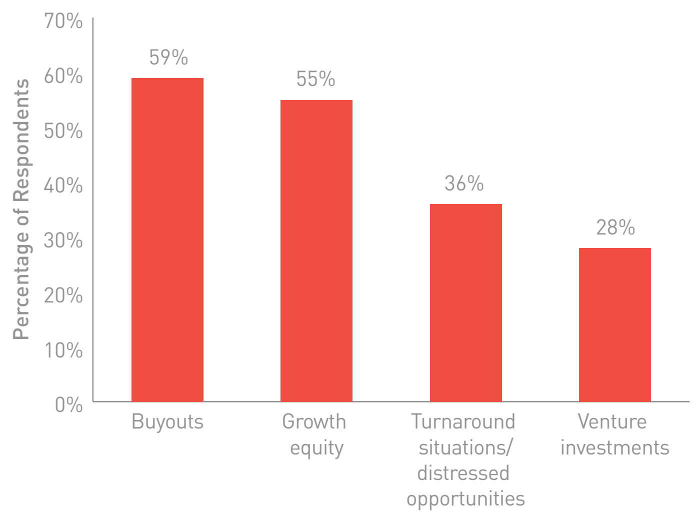
Private equity firms are typically categorized as either a buyout fund or a growth equity fund, but both transaction types can play a key role in a private equity firm's overall strategy. "We are planning to step up our buyout activity and have been able to obtain new capital from our investors to confidently pursue this strategy, although growth equity is what we normally do and excel in," says a US-based managing director.

There are regional differences in respondents' preference for each transaction type. A larger percentage of European respondents plan to focus on growth equity investments compared with North American respondents, who are more inclined toward buyouts. Asia-Pacific respondents plan to make more growth equity investments than any other transaction type in the next 12 months. However, close to half of these respondents also plan to focus on buyout transactions over this time period. This is consistent with the trend of increased buyouts in China and neighboring countries that have historically focused on growth equity. "China is attracting attention as the largely minority-stake market shifts emphasis to buyouts and control acquisitions," says a managing director based in Asia-Pacific.

Private equity firms have traditionally focused on buyouts. But, in recent years, more and more firms have been finding increased investment opportunities in growth equity, which typically involve buying minority stakes in portfolio companies that usually do not have any previous institutional investment. These investments are characterized by very little leverage, if any, and are often made in companies that have tremendous growth prospects and the potential to provide outsized returns. "Our major focus has always been growth equity," says a Europe-based partner. "We look for opportunities and apply our capital and experience to help increase the growth potential of businesses thereby generating superior returns for us and for our investors."

Investors will also focus on turnaround and distressed opportunities (36% of respondents); however, there is a question as to whether supply will meet demand given that distressed private equity fund managers now have record-high levels of dry powder at their disposal. Improving economic conditions across the US and Europe, the increasing availability of cheap debt and the popularity of "amend and extends" will also impact the number of distressed opportunities.

Top Transaction Types Over The Next 12 Months



"Although buyout activity is poised to continue its upward trajectory, growth equity will also be an important strategy for many private equity firms, particularly in Europe."

Scott Petepiece, M&A Head – New York, Shearman & Sterling

Global Buyout Activity

Year	Value (US$bn)	Number of Transactions	Average Deal Size (US$m)
2009	125	1,401	179
2010	249	2,123	255
2011	293	2,287	286
2012	274	2,127	302
2013	288	2,148	304
2014 YTD	162	872	417

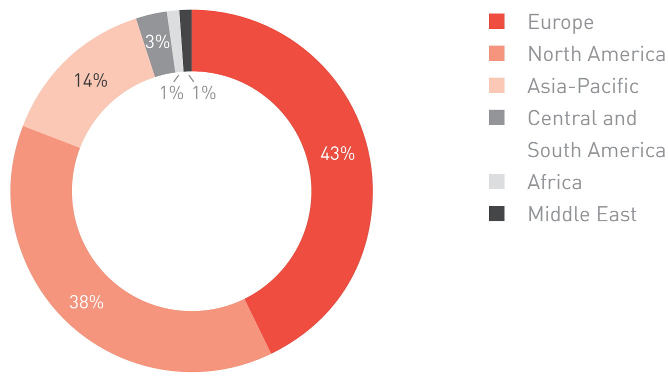
Buyout Activity

Year-to-date buyout activity has reached 872 deals worth US$162bn. Buyout activity in 2013 was flat from the previous year, rising marginally in terms of both volume and value to 2,148 transactions worth US$288bn from 2,127 deals worth US$274bn, according to Mergermarket data. Global buyout volume has generally remained steady since 2010.

In 2013, Europe had the largest share of global buyout activity (43%) by volume with 917 transactions worth US$97bn. North America was second in terms of the number of deals (38%), but had the highest value of transactions with 825 buyouts totaling US$144bn. Europe has traditionally held the largest buyout share among all regions globally in terms of deal volume. The US was the first to witness a recovery in its credit markets, a probable explanation as to why the number of buyouts in North America gained ground versus Europe. There were 751 private equity transactions worth US$139bn in the US and 70 deals worth US$4bn in Canada.

According to Mergermarket data, the bulk of buyouts in 2012 and 2013 were valued less than US$100m, followed by deals valued between US$100m and US$500m. These figures align with the focus of survey respondents: the majority (61%) say that their deals are typically valued between US$100m and US$500m. The average deal size of buyouts (US$303m), which has slightly increased in recent years, is in line with the transaction size range of this survey's respondents.

2013 Regional Breakdown of Buyout Activity By Volume



Deal Size Breakdown of Buyout Activity By Volume

	Percentage of Deals – 2013	Percentage of Deals – 2012
Undisclosed	56%	57%
<US$100m	24%	23%
US$100m-US$500m	15%	12%
US$501m-US$1,000m	3%	3%
>US$1,000m	2%	3%

"The private equity market in the UK and more broadly in Europe is stronger and more active than we've seen for a long time. Driving factors include a massive amount of unspent capital and an increasingly deep and importantly stable debt market with capital providers ever more creative about how they structure deals."

Joel Hope-Bell, Co-Head of M&A – UK, Duff & Phelps

Sectors

A majority of respondents (67%) are optimistic about the quality of the investment opportunity pipeline over the next 12 months. Respondents expect the consumer sector to offer the best opportunities for private equity. "The consumer sector is characterized by its relative stability throughout economic cycles. Private equity firms will be able to find good opportunities to generate attractive investment returns in this sector," says a Europe-based partner. "These companies will be looking to reinvigorate underinvested brands and drive market share through product innovation."

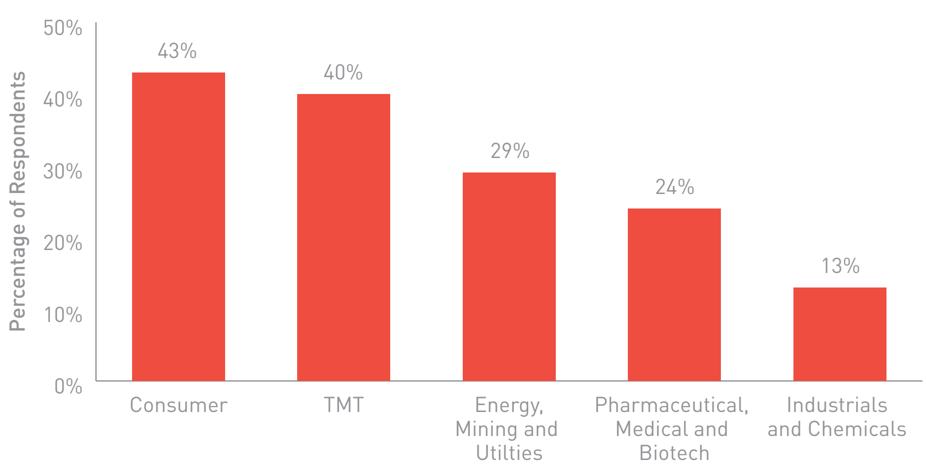
Respondents also view the consumer industry as an area for value creation. "The consumer market is on the rise, providing private equity players with ample investment opportunities," a US-based senior partner says. "Consumer product spending has increased, which gives our firm an obvious platform to grow."

According to year-to-date Mergermarket data, the consumer sector remains in the top two sectors in terms of buyout volume with 128 deals worth US$15bn. In 2013, the consumer sector led the way in terms of aggregate value of buyouts with 318 deals worth US$63bn, including the landmark US$27bn acquisition of ketchup maker H.J. Heinz by Berkshire Hathaway and 3G Capital, and the US$6bn purchase of the Neiman Marcus Group by Ares Management and the Canada Pension Plan Investment Board.

"Some of the segments that are driving activity and interest among private equity investors in the consumer space include organic and better-for-you products, and fast casual, small-box, non-union and convenience-oriented shopping environments."

Josh Benn, Global Head of the Consumer, Retail, Food and Restaurants Practice, Duff & Phelps

Sectors Offering The Best Opportunities



Note: Respondents were able to choose top two

Respondents anticipate that the TMT sector will offer some of the best opportunities for private equity, as well. Private equity interest in the sector is driven by technology investments, which comprise 75% of year-to-date TMT buyouts. There are 149 TMT buyouts worth approximately US$28bn so far this year.

A US-based managing director describes TMT as a high-growth industry that is popular among investors. The influence of TMT also pervades across sectors. "The need for TMT exists in every industry given the increased need for data and mobile devices in sectors that range from financial services to healthcare," a US-based partner says.

A notable number of Asia-Pacific respondents think that the energy, mining and utilities sector offers the most investment opportunities. Increased global demand for energy and other natural resources is creating investment opportunities for private equity in the energy, mining, utilities and industrials and chemicals sectors, says an Asia-Pacific-based vice president. According to Mergermarket data, the industrials and chemicals sector tops all industries in terms of the number of year-to-date buyouts with 194 deals worth US$33bn. Energy, mining and utilities was also one of the top sectors year-to-date with 48 transactions worth US$7bn.

The pharmaceutical, medical and biotech sector is also a top choice for investors in North America. Year-to-date, there are 78 transactions worth US$16bn. As a US-based director explains, "Amid major changes in the industry stemming from the Affordable Care Act, the healthcare and life sciences sector remains attractive to private equity firms as these companies still offer opportunities for growth and strong returns."

"Interestingly, in the technology sector, private equity buyers about four or five years ago used to be 10 to 20 percent of the acquirers. Now that number is up to almost 40 to 50 percent. There's been a lot of capital invested in private equity technology funds."

Kevin Iudicello, Managing Director, Pagemill Partners, a Division of Duff & Phelps

DEAL PROCESS

Challenges

Given the relative imbalance between the record amounts of dry powder held by private equity firms and the number of available investment opportunities, competition is already stiff. Now, this is being amplified by new entrants into the direct private equity investments sector. Many investors, that were traditionally limited partners in private equity funds, are starting to directly compete with private equity firms for assets. "Sovereign wealth and pension funds, which are among the biggest and largest investors in private equity, have started to build direct investment capabilities in recent years in the hope of avoiding private equity management fees, naturally increasing the competition for private equity assets," says a director at a US-based firm.

Pension funds are buying companies directly to avoid the fees and promoted equity paid to private equity firms. "Pension funds are looking to sidestep fees and improve performance to meet obligations for the capital they raised. They are in a better position in terms of capital availability and have increasingly competed with us directly when bidding," a Europe-based partner says.

Increased competition could possibly stretch already high valuations even higher. "Pension funds and other specialist funds that until now have been investing in private equity firms are looking to directly invest in companies and manage their own investment portfolios. If pension funds and specialist funds increase their direct investment activity, then competition for targets will increase together with valuations," says a partner at a Europe-based firm.

Large institutional investors are also deploying capital through co-investments alongside fund managers in transactions. A benefit to this type of investment, aside from lower fees, is that these institutional investors will have increased control over their investments.

Another challenge is that the time required to complete a transaction has become longer, according to 55% of respondents, almost half of whom indicate that the median time to complete a transaction from the start of the sales process is seven to nine months.

The global financial crisis has made investors more risk-averse, respondents say, and are therefore more thorough during the vetting process. "The depth and method of due diligence has changed over the last few years. Since the recession, every investor wants to ensure they have made the right investment decision by collecting and studying all the important information

Longer Transaction Times Due To:

- Thorough due diligence
- Regulatory hurdles
- Compliance risks

"The classical private equity fund is facing stiff competition from a new breed of investors, including sovereign wealth funds, state-owned enterprises, pension plans, specialist funds and large family offices. This has led to fundamental changes in the private equity marketplace."

Jeremy Dickens, Global Co-Head - Private Equity Practice, Shearman & Sterling, New York about the target prior to completing a transaction," says a principal from a US-based firm. For more than half of US and Canada-based respondents, due diligence is the foremost reason for longer transaction times. A third of Europe and Asia-Pacific-based respondents also cite a longer due diligence process as the greatest reason for protracted deal processes. In the US, these longer timelines can also be attributed to inspections by the Security and Exchange Commission (SEC).

Aside from taking longer to assess a target's value through the due diligence process, longer timelines are also a way to make sure that all regulatory hurdles are addressed. More than a quarter of respondents (28%) think that regulatory and compliance risks are the top two challenges faced by private equity firms. "The regulatory requirements have risen significantly, increasing the complexity of the due diligence process and delaying transactions," says a Europe-based director.

Forty-four percent of respondents believe that the inspection by the SEC is the greatest regulatory challenge to private equity investments. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, private equity fund advisers should be registered as investment advisers under the SEC. Having long been exempt from this requirement, private equity advisers now come under the purview of the Investment Advisers Act of 1940 which mandates disclosure and reporting requirement inspections by the SEC.

In a recent speech, the director of the SEC's Office of Compliance, Drew Bowden, said that the SEC is looking closely at the amount of disclosure private equity firms make on the fees and expenses they charge to their funds and portfolio companies. The dearth of support systems and compressed returns, have led these firms to collect added fees and shift expenses to their funds. The SEC has taken issue with this in its inspections. Not only has the intense scrutiny increased compliance costs, particularly for smaller firms, it has also made these firms vulnerable to prosecution by the SEC.

Another challenging part of the deal process occurs when two or more of a private equity sponsor's funds are on opposite sides of an M&A transaction, a situation that crops up fairly regularly. When this occurs, respondents are almost equally split between obtaining a fairness opinion (32%) and letting an investment committee decide on the matter (31%).

Obtaining a fairness opinion, which evaluates facts compiled about an M&A deal to determine whether the offered price for an acquisition is fair, is a way to mitigate future litigation costs. "It is typically much more financially efficient to pay for a fairness opinion upfront rather than have a legal battle with shareholders that are disputing the transaction," says a partner at a Europe-based private equity firm.

> *"Non-traditional fairness opinions, such as those that address whether a deal price is fair to multiple funds sponsored by the same private equity group, pose several analytical challenges. For example, these transactions may lack a typical market-clearing mechanism, such as an auction, and may involve complicated securities with preferred return and convertibility features. Furthermore, traditional fairness opinions employ a threshold concept – the price to a seller must meet or exceed fair value. But an opinion that addresses fairness to both buyer and seller requires a more precise valuation and is open to a greater degree of scrutiny."*
>
> *Chris Janssen, Global Head of Transaction Opinions, Duff & Phelps*

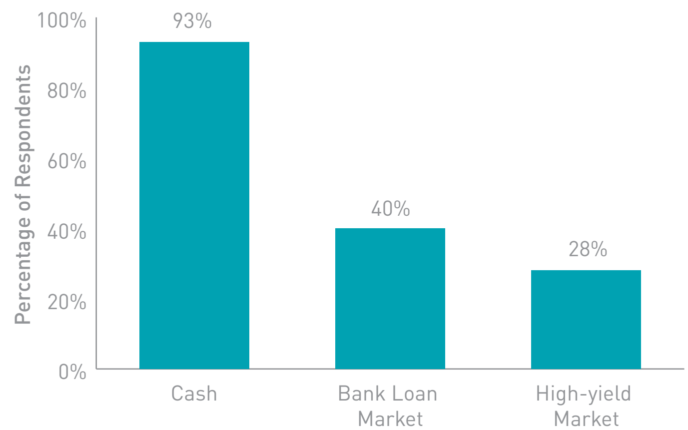
These fairness opinions are non-traditional because they evaluate the fairness of the price to each of the opposite sides of the deal and are seen as providing reassurance to the decision makers (i.e. the private equity sponsors) who have responsibility to protect the interests of multiple stakeholder groups. "Without a fairness opinion, it gets rather tough to handle transactions that involve funds on opposite sides of the deal and to balance the different opinions of partners and founders," says a Europe-based partner.

Financing

Given the near record amounts of dry powder held by private equity firms, the overwhelming majority of respondents (93%) plan to use cash to finance their acquisitions while some respondents (40%) will also access the bank loan market. Twenty-eight percent will tap into the high-yield market, in addition to other financing channels.

Respondents are generally optimistic about the financing environment against the backdrop of an improving global economy. Nearly half of respondents (47%) expect the overall financing environment to loosen in the next 12 months and a quarter of respondents think that it will remain the same. "The improvement in North American debt markets, the signs of positive economic news from Europe, and the sustained growth across the Asia-Pacific region provide supporting evidence for a return of confidence in financing," an Asia-Pacific-based managing director says.

Private Equity Firms Will Finance Their Acquisitions Using:



The vast majority of respondents will primarily obtain financing in local markets, but 66% of North American, 40% of European and 33% of Asia-Pacific respondents will also tap foreign markets for financing, often in conjunction with domestic funding.

There is geographic alignment between private equity's strategy on selecting targets and where these firms choose to finance their acquisitions. Firms are likely to seek financing in the same regions where their targets are located, indicating a focus on cross-border investments, particularly in North America.

Cross-Border Financing

66%

of **North American** respondents will access foreign markets for financing

Most popular markets:
- Europe
- Latin America

40%

of **European** respondents will access foreign markets for financing

Most popular markets:
- North America
- Asia-Pacific

33%

of **Asia-Pacific** respondents will access foreign markets for financing

Most popular markets:
- Europe
- Latin America

PORTFOLIO STRATEGIES

Private equity firms are employing multiple investment strategies to try to maximize returns, including parterning with executives and focusing on operational improvements. Thirty-nine percent of respondents say they expect operational improvements to have the greatest impact on returns on new investments. "We believe in open communication and transparency, aligned financial interests, and a focus on process, people and accountability. Our goal has been to ensure that the people who make success happen are rewarded for their contributions therefore facilitating more operational improvement," a US-based partner says.

On average, respondents recapitalized one in eight of their portfolio companies last year. The expected changes to the US tax code were the main drivers for the rise of dividend recapitalizations in 2012, a motivation that did not exist in 2013. However, the continued favorable debt market environment has motivated many private equity firms to return capital to their investors through these transactions.

More than half (51%) of respondents say they use internal valuation processes to mark their portfolios to market. Private equity firms report values of their portfolio companies regularly to their limited partners, which means quarterly, annually or semi-annually depending on the fund.

General partners (GPs) are beginning to use technology solutions as a way to monitor the performance of their portfolios in constantly changing markets. The private equity marketplace is becoming more complex, making it harder for GPs to analyze and report portfolio performance to their limited partners and stakeholders. GPs are using software solutions that offer standardized portfolio analysis across investments and industry sectors, and that help in pre- and post-acquisition evaluations. They use the technology for fund valuation, to optimize returns and to handle increased regulatory and investor scrutiny.

A number of respondents point to the use of technology as the driver for better investment decisions. "New technology will play an important role in conducting thorough analysis that will help investors determine whether they are on the right track," says a Europe-based partner.

Technology can also help in creating value for investments. "With technology evolving drastically, private equity firms that have a superior ability to source companies with good investment theses as well as the resources and expertise to grow those companies will be able to outperform in the current environment," says a US-based partner.

"2013 exhibited a continuation in the observed increase from 2012 in the number of dividend recapitalizations – this effect was driven by a number of factors – the desire to return capital to investors before commencing fund raising activity, the attractiveness of debt financing compared to other methods of returning capital, and favorable interest rates. We expect dividend recapitalizations to continue to be a frequently used method of obtaining liquidity in 2014."

Jeremy Dickens, Global Co-Head - Private Equity Practice, Shearman & Sterling, New York

CROSS-BORDER DEALMAKING

On average, cross-border transactions are expected to make up 30% of respondents' acquisitions over the next 12 months. The notable proportion of cross-border investments by private equity firms can be attributed to attractive investment opportunities across the globe. "Private equity will continue to grow as global buyout firms increase their presence and smaller firms capitalize on their knowledge of local business environments," says an Asia-Pacific-based managing director.

Year-to-date, there have been 331 cross-border buyouts worth US$101bn and 310 exits worth US$115bn. In 2013, cross-border buyouts increased slightly in terms of volume and value to 815 transactions worth US$135bn from 761 deals worth US$131bn in 2012. Cross-border exits also rose in 2013 to 796 transactions worth US$156bn from 697 deals worth US$176bn in 2012.

A majority of respondents (56%) plan to invest in a new country in the next 12 months, although 44% have no such plans. "International opportunities are vast, so acquisitions will happen more on a global scale," says a Europe-based partner.

> *"Although Europe ranks high on the list for cross-border investments, the emerging markets of India, China and Brazil continue to be attractive regions for private equity activity."*
>
> *Mark Soundy, Global Co-Head - Private Equity Practice, Shearman & Sterling, London*

Cross-Border Buyout Activity

Year	Value (US$bn)	Number of Transactions	Average Deal Size (US$m)
2009	64	542	200
2010	118	760	262
2011	182	842	375
2012	131	761	313
2013	135	815	299
2014 YTD	101	331	519

Cross-Border Exit Activity

Year	Value (US$bn)	Number of Transactions	Average Deal Size (US$m)
2009	54	387	252
2010	149	628	379
2011	191	728	452
2012	176	697	454
2013	156	796	365
2014 YTD	115	310	637

In terms of specific markets, there is still notable interest among respondents in India and China, while Brazil was mentioned by a smaller, but significant, number of respondents.

The increase in potential exit options makes private equity firms more confident in their international investments. "In 2013, investor uncertainty over Asia-Pacific's exit environment hampered dealmaking," a Europe-based investment director says. "However, the re-opening of mainland China's stock market in late 2013 gave us comfort in the region's private equity market."

Higher returns and diversification via an increasing array of investment alternatives are attracting private equity firms to new markets. "There are currently many areas offering attractive opportunities within the emerging markets, including China and Brazil," a US-based partner says. "As the private equity markets evolve, many investors are looking into new ways to access these markets including the opportunity to co-invest alongside fund managers in deals."

"Most of the leading global private equity firms have set up shop and raised dedicated funds for China. As most of them continue to raise more money to invest in the region, we see the market becoming increasingly crowded, and the deal sizes smaller."

David Lu, Head of Corporate Finance in China, Duff & Phelps

Where Will They Acquire?

North American respondents

66% will acquire domestically

50% will acquire in Latin America

40% will acquire in Europe

European respondents

77% will acquire domestically

23% will acquire in North America

17% will acquire in Asia-Pacific

Asia-Pacific respondents

100% will acquire domestically

20% will acquire in Europe

20% will acquire in North America

20% will acquire in Africa

Note: Respondents indicated all regions in which they intend to transact

EXITS

In the midst of a strong IPO market and with both corporate buyers and private equity flush with cash, exit opportunities have risen. The value of year-to-date exits at US$227bn is closing in on 2013's total of US$282bn, according to Mergermarket data. This year's numbers were buoyed by mega deals including Sequoia Capital's US$16bn sale of WhatsApp to Facebook and the US$13bn sale of Biomet to Zimmer Holdings by a private equity consortium that included Blackstone Group and Kohlberg Kravis Roberts Co. The number of global private equity exits increased last year in terms of volume to 1,711 worth US$282bn from 1,544 worth $306bn in 2012. The number of exits began rising in 2010 and has remained within the same range since then. The largest percentage of exits (45%) occurred in North America in 2013 where there were 792 exits worth US$157bn, followed by Europe (41%), where there were 703 exits worth US$87bn.

There are some geographic differences in the average holding periods for private equity transactions in the past five years. Although North America-based portfolio companies had a shorter average holding period in 2009, the length of time has recently increased to match the average holding time in Europe (62 months). Asia-Pacific-based portfolio companies currently have the shortest average holding period of 55 months. However, a majority of Asia-Pacific respondents believe that holding periods for their new investments are bound to get longer, whereas European and North American respondents are split between those that believe these periods will lengthen and shorten.

"While the re-opening of China's stock market in 2013 was certainly a positive development, holding periods for private equity deals may very well increase in Asia due to the continued uncertainty of market conditions and valuations – perhaps even approaching levels currently seen in Europe and North America."

Paul Strecker, Head of M&A - Asia, Shearman & Sterling, Hong Kong

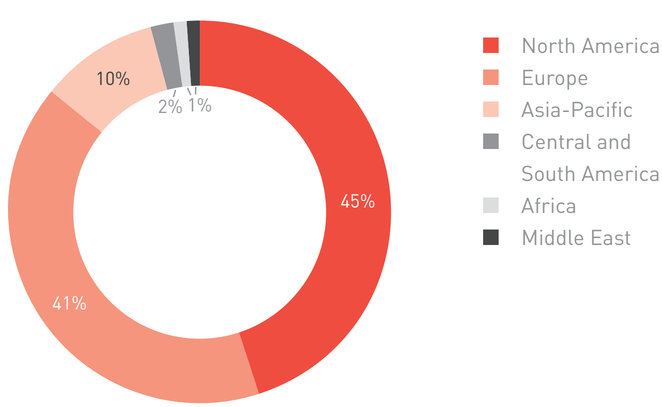
Global Exit Activity

Year	Value (US$bn)	Number of Transactions	Average Deal Size (US$m)
2009	99	806	236
2010	253	1,359	345
2011	326	1,606	386
2012	306	1,544	405
2013	282	1,711	352
2014 YTD	227	739	572

Average Holding Periods (Months)

	2013	2012	2011	2010	2009
North America	61	63	57	56	43
Europe	62	64	57	56	49
Asia	55	60	53	48	44

2013 Regional Breakdown of Exit Activity By Volume



While some respondents see the re-opening of mainland China's stock exchange as positive, others point to continued uncertainty in market conditions and valuations as reasons for holding periods to lengthen. Less than half of respondents (47%) expect the timeframe for exits beginning from the decision to sell to last seven to nine months, while more than a quarter of respondents (27%) say that their exits last 10 to 12 months.

Market conditions often slow the exit process. "Uncertainties in the market usually delay our exits after we make a decision to sell," says a managing director at an Asia-Pacific-based firm. "Now it takes three to four months longer than we want it to, primarily because of market factors."

Price negotiations between sellers and buyers take time. "I agree that 10 to 12 months is long, but we do not have a choice as we cannot force our exit the moment we decide to sell," a US-based partner says. "We have to get the right value for the portfolio we are looking to sell, which is the biggest cause of the delay."

Secondary buyouts are becoming a more common form of private equity exits. Seventy-three percent of respondents either plan to use or think that the industry will more frequently exit investments through secondary buyouts in the next 12 months. More than half (55%) of respondents either plan to or expect the industry to sell to a strategic buyer, with 39% choosing IPOs. "Secondary buyouts provide an alternative way out for private equity firms," says an Asia-Pacific-based managing director. Secondary buyouts also offer an exit strategy for funds that are almost at the end of their investment period and have extra capital to deploy.

Where Will They Exit?

North American respondents

83% will exit domestically

40% will exit in Europe

20% will exit in Latin America

European respondents

86% will exit domestically

17% will exit in North America

Asia-Pacific respondents

100% will exit domestically

27% will exit in Europe

27% will exit in North America

FUNDRAISING

There is optimism about the future private equity fundraising environment. "Private equity, along with every other asset class, has gone through a fair share of changes brought about by the financial crisis and subsequent shifts in regulatory measures and investor sentiment," a Europe-based partner says. "However, I agree with most experts when they predict improvement in the fundraising environment."

In the next 12 months, 72% of respondents believe that fundraising prospects will improve. Most expect to raise a new fund in 2015 with 37% planning to raise a fund in the first half of the year, while 28% expect to raise one in the second half. Preqin data states that there were 199 private equity funds that closed in Q1 2014. These vehicles raised a total of US$102bn, which represents a 19% increase in the capital raised over the same period last year. Fifty-one percent of the funds that closed in the first quarter were above target while 16% reached their fundraising goal.

A majority of respondents (66%) are planning for their next fund to remain the same size as their current one while 20% plan to raise a larger amount. The desire to maintain strategies that are tried and tested is driving many private equity firms to retain their original fund size going forward. "Our funds have done well and the demand for operational effectiveness has made us feel the need to stick to the same competencies," says a Europe-based partner.

When Will They Raise New Funds?

18% will raise new funds in H2 2014

37% will raise new funds in H1 2015

28% will raise new funds in H2 2015

17% will raise new funds in 2016 or later

CONCLUSION

The private equity landscape is evolving with new competition from non-traditional sources for quality assets and increased regulatory and compliance requirements. These challenges have inevitably influenced private equity's playbook. "Growing compliance and due diligence requirements have greatly influenced the valuation processes in private equity firms," says a US-based partner.

Against the backdrop of these changes, private equity firms are still doing what they do best — identifying opportunities and implementing strategies to maximize value. Given the combination of healthy fundraising prospects and record amounts of dry powder, respondents expect to be acquisitive in the next year.

They are exploring both domestic and cross-border avenues to source new assets and find financing. These firms are also taking advantage of the current strong exit market and favorable debt environment to monetize their investments.

Forging ahead, successful private equity firms have to remain agile, diligent and cognizant of the emerging factors that are bound to alter the playing field. The right mix of confidence and pragmatism can lead to successful outcomes as these firms maneuver their way through the ever-changing investment climate.

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PRIVATE EQUITY UNDER THE MICROSCOPE

How Renewed Regulatory Scrutiny will Ultimately Benefit the Industry

By David L. Larsen, Managing Director, Duff & Phelps

Background

The *Global Private Equity Outlook* survey, commissioned by Duff & Phelps and Shearman & Sterling LLP in association with Mergermarket, reveals that the industry's executives across the globe are optimistic about the future of Private Equity. As the research underscores, GPs raised assets in record numbers last year, believe there are new and extended investment opportunities, and remain confident in an expanded set of exit options.

And, yet, the backstory is more nuanced – particularly with respect to regulatory developments and the shifting expectations of limited partners. Recent speeches by Securities and Exchange Commission (SEC) staff members have questioned GPs' transparency, valuation, and disclosure policies and, in the process, validated the independent effort among many LPs to push for change. As was widely-reported in this regard, the SEC recently announced that it has created a new private fund unit dedicated to the examination of private equity and hedge funds.

Media outlets have picked up these developments, running sensational headlines like, "*The SEC Has Revealed Astounding Corruption in Private Equity.*" How can those involved with the industry reconcile the optimism articulated by respondents to this survey with the alternative reality of regulatory developments and media scrutiny? What we do know is that while the private equity industry is the latest sector to undergo increased regulatory scrutiny, it is by no means the first, and will not be the last. Below, we seek to explore the landscape, factors and perspectives currently impacting the industry.

Expanded Regulatory Environment

In the past, the private equity industry operated in an environment with limited regulatory oversight. In the vast majority of cases, the industry established an effective culture of self-policing that often goes unheralded. But those days are passing. As the asset class has grown, market practices have been driven by individual limited partner preferences as articulated through limited partner agreements (LPAs) and advocacy groups such as the Institutional Limited Partner Association (ILPA). Historically, securities laws exempted certain investment vehicles with a limited number of sophisticated investors from registration. However, following the 2008/2009 financial crisis, both the U.S. Congress and the European Union enacted legislation that would directly impact all large alternative investment managers.

In the United States the **Dodd–Frank Wall Street Reform and Consumer Protection Act** (Dodd-Frank), was signed into law in 2010. Dodd-Frank requires certain investment managers to register with the U.S. Securities and Exchange Commission (SEC) resulting in ongoing SEC oversight and inspections. Further, auditors of such regulated entities also face additional scrutiny from the Public Company Accounting Oversight Board (PCAOB) and the SEC.

In Europe, the **Alternative Investment Fund Managers Directive (AIFMD)** entered into force in 2013. AIFMD imposes far reaching rules that will have a profound impact on Alternative Investment Fund Managers' (AIFMs) general operations, and in particular the way they communicate and interact with investors and other stakeholders.

SEC Inspections

In the United States, the SEC is well underway in executing its statutory mandate of inspecting registered private equity fund advisors and managers. The communication of the SEC's initial inspection findings have resulted in the salacious headlines reported above. But what is fact and what is fiction? In a recent speech, Andrew J. Bowden, Director, SEC Office of Compliance Inspections and Examinations, said "When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time."[1] In reality, of the approximately 1,100 registered private equity investment advisors, the 50% figure noted applies to approximately 150 newly registered managers for which initial presence exams have been completed. Inspectors have also subsequently identified weaknesses related to marketing and valuation practices.

[1] May 6, 2014 Speech; Private Equity International (PEI), Private fund Compliance Forum 2014; New York, NY.

Any deviation from legal agreements, agreed upon practices, or established regulations may be considered problematic. The nature of private investing requires the application of informed judgment, the ability to approach situations based on unique facts and circumstances, and the need to demand and be worthy of trust. No bad actors or bad acts should be condoned. Yet is the interpretation of the issues being raised fair to the industry? Clearly, private equity is a highly-functioning, high-growth sector, and could hardly have operated with the trajectory of success it has had if these criticisms were systemic across the industry. The reality is that greater clarity from regulators and a middle-ground must be found.

Private Equity Factors to Remember

Again it should be clearly stated, bad acts and bad actors should not be condoned. Transparency, even expanded transparency, is beneficial to both investors and managers. In this vein, it is prudent to highlight some of the aspects of private equity which could be deemed vigilant, rather than villainous. These factors include:

- The majority of private equity returns benefit the "man on the street" (taxpayers backstop the pension liabilities of public pension funds; private equity returns which pay benefits remove the taxpayer backstop obligation);
- Most GPs work to do the "right thing";
- LPAs are generally thoroughly negotiated by both sides LP/GP;
- All LPAs have some gray area which may be subject to interpretation;
- LPs generally expend less resources to monitor compliance;
- Understood practices, such as the use of "affiliated" consultants or operating partners have not been well documented;
- Reading LPAs with fresh regulatory eyes, without the benefit of years of understood practice, can cause different interpretations;
- LPs generally receive reimbursement of all historical management fees before incentive fees (carried interest) are allocated;
- On a pro-forma basis, fees paid by portfolio companies do not impact the value of the company when sold;
- Valuation processes are becoming increasingly rigorous, with many managers validating their fair value estimates through an independent third party; and
- Some cynically believe that at least in some respects, the SEC needs to demonstrate that their inspections are fruitful to justify the expense involved.

Conclusion

Bruce Karpati, the former head of the SEC Enforcement Division's Asset Management Unit (AMU) stated, "It's not unreasonable to think that the number of cases involving private equity will increase."[2] This is certainly to be expected with a more-focused regulatory oversight program, the role of which is to find deficiencies, not necessarily to highlight strengths. Bad actors should be held accountable. LPs often need support in identifying and dealing with any bad actors that do exist.

Historically, the Private Equity industry has shown itself adept at responding to challenges. Increased regulatory scrutiny will enhance the industry's transparency, reporting and related practices. This improved oversight structure, together with the positive outlook expressed in the *Global Private Equity Outlook*, should benefit all industry participants as well as broader economic and financial markets. As stated by the Private Equity Growth Capital Council, "Private equity investment provides financial security for millions of Americans from all walks of life."[3] And by so doing, private equity helps limit the need for taxpayers to make up the difference between public sector benefits and available retirement assets. Through expanded transparency, more rigorous valuations and clear articulation of expectations, the outlook for private equity truly is optimistic for both managers and investors.

About the Author

David L. Larsen, CPA is a managing director and a leader of the Portfolio Valuation practice in the San Francisco office of Duff & Phelps. He serves a wide variety of investors and managers in focusing on valuation and governance-related questions. Mr. Larsen is a Board Member of the International Private Equity and Venture Capital Valuations Board (IPEV), led the team that drafted the US PEIGG Valuation Guidelines, is a Member of the AICPA Private Equity and Venture Capital Valuation Task Force and was the private equity representative of FASB's Valuation Resource Group.

[2] Bruce Karpati, "Private Equity Enforcement Concerns." Speech delivered at the Private Equity International Conference, New York, NY, January 23, 2013.

[3] Private Equity Growth Capital Council, "Fact and Fiction," available at: http://www.pegcc.org/educationfact-and-fiction/.

THE CHANGED PRIVATE EQUITY LANDSCAPE

Jeremy W. Dickens, Mark Soundy and Paul Strecker

As the survey results and respondent commentary in this inaugural *Global Private Equity Outlook* make clear, the classical private equity fund is no longer the only game in town in the quest to acquire attractive businesses. Sovereign wealth funds, state owned enterprises, pension plans, specialist funds (such as infrastructure funds) and large family offices compete directly for those same desirable assets. As counsel to many of these "private capital" investors, Shearman & Sterling has witnessed firsthand the global impact of these increasingly important direct investors. In our view, the private equity marketplace is in the midst of fundamental change and the importance of this new breed of investor will only grow.

Drivers of Change

Undoubtedly, multiple factors explain the shifts we observe in the market. One is, as noted by a survey respondent, the desire of traditional limited partners to enhance their returns by avoiding (or, through co-investment or via separate accounts, reducing) the management fees and promotes they pay to fund managers. Another, however, is the increasing confidence of private capital investors that they are as capable as traditional sponsors in identifying, evaluating, transacting and overseeing direct investments. Many of these investors have built substantial internal expertise across asset classes, hiring best-in-breed investment professionals, presumably at a lower overall cost compared to the fees and carry they otherwise would pay one or more general partners to achieve the same objectives.

As importantly, many private capital investors have realized their internal investment horizons are not necessarily aligned with those of private equity sponsors. A traditional sponsor, for example, has a fund with a finite life of, generally, 10 years (subject to extensions), with an initial five-year investment period. Typically, once a fund has invested or committed to invest an agreed percentage of its committed capital, the sponsor is free to begin raising its next fund. This explains, in part, why many fund sponsors turn over assets relatively quickly -- it establishes a track record on which to raise a new fund and, not coincidentally, increases the management fee limited partners pay on the invested capital in a closed fund and on committed capital in a fund still in its investment period.

This dynamic for investors such as pension plans can result in administrative headaches. As a pension plan's assets increase (through participant contributions and investment returns), the plan's investment professionals need to redeploy capital in order to meet internal asset allocation guidelines. Comparable dynamics exist for sovereign wealth funds and large family offices, which often prefer to invest for the long term, in part because they value capital appreciation over income production. Similarly, investors in infrastructure assets often have a much longer investment horizon than private equity funds, and those investors often buy infrastructure assets via the acquisition of operating companies.

Consequences of Change

Most obviously, one consequence of the changing landscape is ever increasing direct investment activity by this new breed of investor. As survey respondents from the US and Europe noted, increased competition drives up the prices paid for desirable assets. Moreover, as one respondent noted, pension plans and sovereign wealth funds often have greater capital availability than traditional sponsors. As we analyze the market, however, we believe it is not only capital availability that empowers private capital investors to compete aggressively for assets: it is their willingness to invest for the long term and their lack of reliance on significant financial leverage that gives them an advantage.

Take a simple example. As a rule of thumb, many sponsors would say they target a mid-20s percentage internal rate of return and seek to realize 3x their invested capital upon exit. Assuming a 25% IRR, a sponsor would achieve its 3x multiple of money after four years and often only as the result of applying total leverage of 7-9x trailing EBITDA. However, a pension plan that targets only a 7% IRR would achieve the same multiple of money after 15 years even if it acquired the underlying asset without any long-term debt financing. By using only modest financial leverage, private capital investors often can afford to pay more for the same asset than a sponsor. A lower target IRR, combined with a longer holding period and less financial leverage, also translates to less risk. Simply put, companies owned by private capital investors may be better positioned to weather economic storms than comparable private equity portfolio companies.

*

Examples of Change

There are numerous cases of private capital investors co-sponsoring transactions alongside traditional sponsors. For example, in 2013 Ares Capital Management and the Canadian Pension Plan Investment Board jointly acquired Neiman Marcus Group for $6 billion. Similarly, also in 2013, GIC, a Singaporean sovereign wealth fund, joined Bain Capital, Golden Gate Capital and Insight Venture Partners to acquire BMC Software for $6.9 billion. There are other situations where private capital investors compete directly with private equity funds, such as the 2013 joint acquisition by OMERS (Ontario Municipal Employees Retirement System) and Alberta Investment Management Corporation of VUE Entertainment, one of the largest cinema operators in the world, for £935 million. In asset classes such as real estate and infrastructure, the emergence of private capital investors as competitors for the same assets sought by private equity funds is even more pronounced. Obviously, there is a continuum of activity, ranging from co-investments to co-sponsorships to full blown acquisitions.

Conclusion

It is too early to state with confidence what the long term impact of the changes to the private equity marketplace will be, but change is a certainty. Private capital investors have vast amounts of assets under management. While these investors often rely on the private equity funds in which they invest to bring them large co-sponsorship opportunities, as this new breed of investor acquires confidence and builds internal investment capabilities, there will be further instances of competition between private capital investors and private equity sponsors for the same assets.

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1. Published in Thomson Reuters' Full Year 2013 Mergers and Acquisitions Review. 2. The Deal. Q1 2014 League Table.
3. Thomson Financial Securities Data (U.S. deals < $250 million). Full year 2013 as of January 1, 2014.

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