



GLOBAL PRIVATE EQUITY REPORT 2013

About Bain & Company's Private Equity business

Bain & Company is the leading consulting partner to the private equity (PE) industry and its stakeholders. Private equity consulting at Bain has grown 13-fold over the past 15 years and now represents about one-quarter of the firm's global business. We maintain a global network of more than 400 experienced professionals serving PE clients. Our practice is more than three times larger than that of the next-largest consulting firm serving private equity funds.

Bain's work with PE spans fund types, including buyout, infrastructure, real estate, debt and hedge funds. We also work with many of the most prominent limited partners (LPs) to PE firms, including sovereign wealth funds, pension funds, financial institutions, endowments and family investment offices. We support our clients across a broad range of objectives:

Deal generation: We help PE funds develop the right investment thesis and enhance deal flow, profiling industries, screening companies and devising a plan to approach targets.

Due diligence: We help funds make better deal decisions by performing diligence, assessing performance improvement opportunities and providing a post-acquisition agenda.

Immediate post-acquisition: We support the pursuit of rapid returns by developing a strategic blueprint for the acquired company, leading workshops that align management with strategic priorities and directing focused initiatives.

Ongoing value addition: We help increase company value by supporting revenue enhancement and cost reduction and by refreshing strategy.

Exit: We help ensure funds maximize returns by identifying the optimal exit strategy, preparing the selling documents and pre-qualifying buyers.

Firm strategy and operations: We help PE firms develop their own strategy for continued excellence, focusing on asset-class and geographic diversification, sector specialization, fund-raising, organizational design and decision making, enlisting top talent and maximizing investment capabilities.

LP and institutional investor strategy: We work with private equity LPs to develop best-in-class PE programs and with institutional investors to achieve optimal performance of their overall investment portfolio. Topics we address cover asset-class allocation, governance and risk management, organizational design and decision making, PE portfolio construction and fund manager selection. We also help LPs expand their participation in PE, including through co-investment and direct investing opportunities.

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Turning the corner?

Dear Colleague:

Most of the data describing global private equity markets in 2012 suggests barely any improvement over the tepid conditions of 2010 and 2011. On the whole, global deal making was flat, exits were flat, fund-raising was flat and returns were up a bit, but only on paper. Has private equity's growth as an asset class stalled? In a word, no.

Our crystal ball is as cloudy as the next expert's, but as we detail in Bain & Company's *Global Private Equity Report 2013*, we do see harbingers of better times ahead for both GPs and LPs. The hunger for yield and the rapid erosion of the "refinancing cliff" have made the debt markets more buoyant than they have been in many years. Current leverage multiples rival those at the peak of 2007, and the cost of debt is near record lows. Clearly, GPs have the wherewithal to get deals done. Rising public equity markets and corporate cash stockpiles make exits look more attractive than they did in 2012. A robust secondary market continues to provide liquidity and eats into the global pile of dry powder. Prospects for fund-raising, while specific to the unique circumstances of individual GPs and LPs, may be slowly improving. Increased liquidity and new deal making are giving a boost to future capital commitments and enabling LPs to discriminate more confidently about which potential investment partners to back. Returns are clearly on the rise again, but only the realization of gains through exits and actual cash-on-cash returns will tell that story.

Could things go wrong? Of course. The past few years have shown all too well how macroeconomic surprises can throw the entire private equity industry into a tailspin. However, we at Bain believe several things to be demonstrably true: 1) Private equity is the best-performing asset class for most LPs over any long-term horizon; 2) LPs will want—and need—to continue to make a long-term commitment to private equity; 3) Many established GPs have proven themselves to be winners that deserve to attract additional capital, and new GPs will provide appealing options that will merit backing as well; 4) GPs and LPs will find creative new ways to work together for their mutual success; and 5) Private equity investors—GPs and LPs alike—that devote their attention to developing their own distinctive strategy will ultimately be the biggest winners.

Please enjoy this year's report as we continue to participate in the global dialogue about our fascinating industry.



Hugh H. MacArthur
Head of Global Private Equity
February 2013

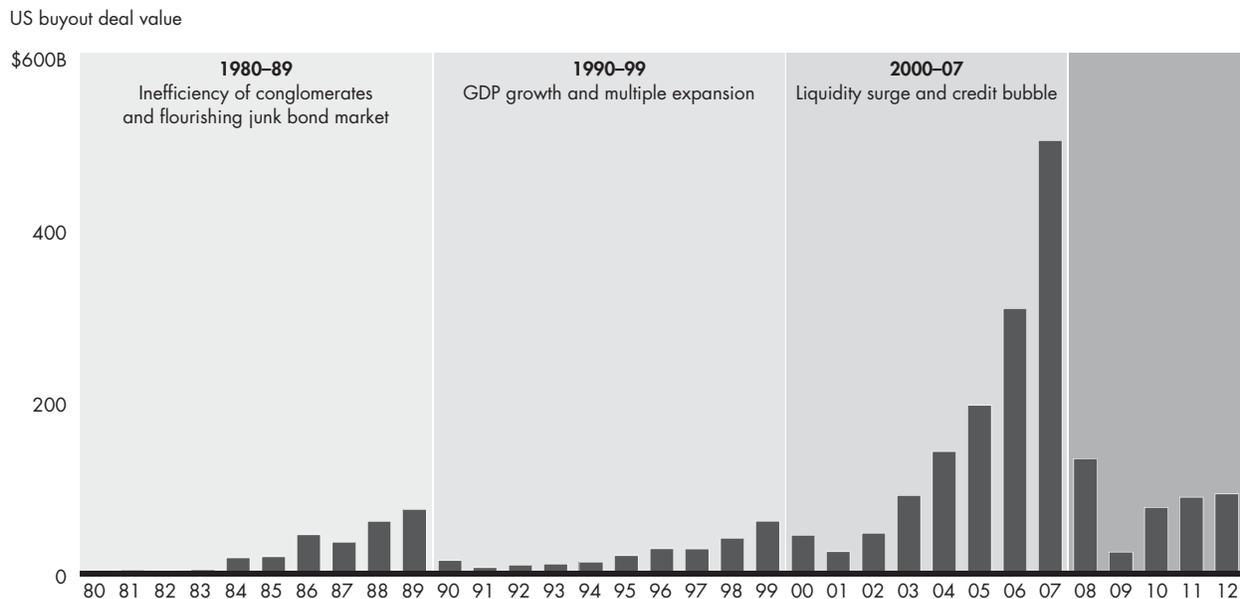
1. The PE market in 2012: What happened

More than three years have passed since the bottom fell out of global credit markets, and the private equity (PE) industry has yet to show signs of clear momentum that characterized past PE cycles. Following PE's takeoff in the mid-1980s, each successive upswing was propelled forward by a powerful dynamic—from the breakup of conglomerates and the vibrant junk bond market in the 1980s, to the buoyant economic growth and rising valuation multiples in the 1990s, to the flood of liquidity and credit of recent past years (see *Figure 1.1*).

Based solely on the top-line numbers for the past year, the PE industry looked to be stuck in a rudderless recovery through the end of 2012. The global buyout market has remained flat since 2010. Sales of mature portfolio holdings were below 2011 levels. And new fund-raising improved only marginally as pension funds, foundations, endowments and other limited partners (LPs) found it difficult to commit additional capital to PE fund general partners (GPs) following years without a pickup in investments and exits. When the final numbers were totaled, buyout deal value came in at \$186 billion (see *Figure 1.2*). A disheartening figure considering that over the past decade both the number of active PE firms and the amount of dry powder committed for investment had more than doubled.

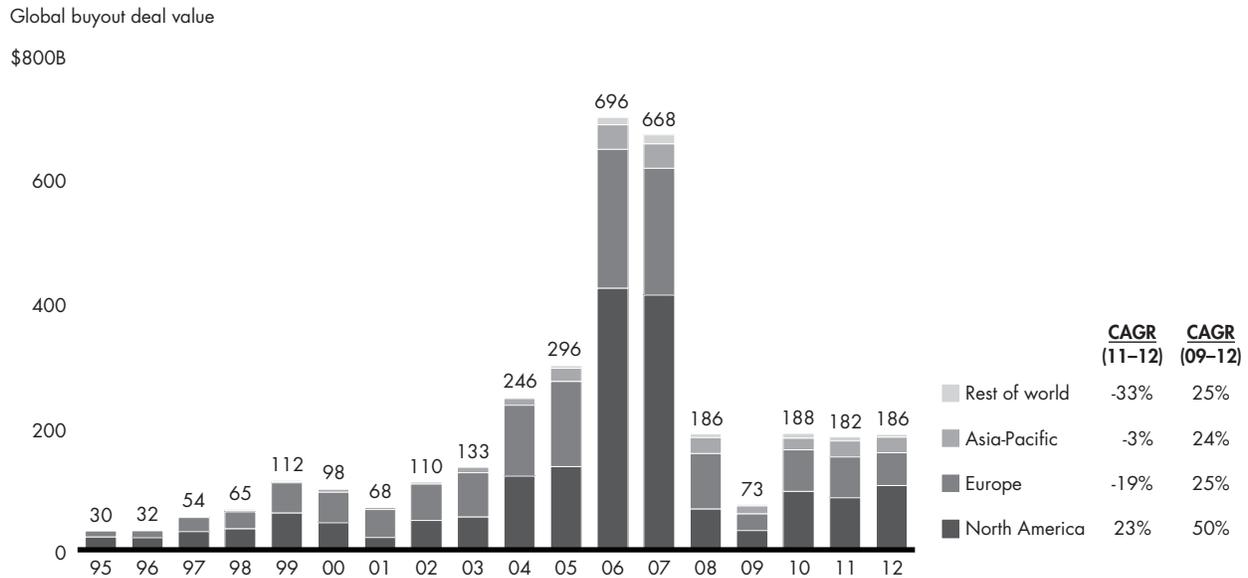
But 2012 was not a year that could be easily summed up in a few headline statistics. Just how the year played out for good or for ill depended on where in the world you looked. Private equity is increasingly becoming a regional, or even a national, market story. As we will see, PE conditions in North America were reasonably strong. PE in

Figure 1.1: The private equity business is cyclical, but it is unclear what will propel the industry forward in the next cycle



Notes: Represents control buyout transactions by US-based firms; includes closed deals only; represents year deals were closed
 Source: Bain US LBO deal database

Figure 1.2: Global investment activity in 2012 was flat for the third year in a row



Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on the location of targets
Source: Dealogic

Europe, by contrast, disappointed, although across the continent conditions varied between generally satisfactory in the North and abysmal in the South. Among the emerging economies, the PE darlings of China and India, which captured so much investor enthusiasm in recent years, both hit a rough patch in 2012. Latin America held up well.

Digging still deeper, the contours of trends that foreshadow improving prospects for the industry come into view. The once-vast supply of dry powder earmarked for buyouts has shrunk steadily from its peak in 2009 as GPs labored diligently to uncover investment opportunities. Exit activity over the past three years has held fairly steady at the healthy levels of 2005 and 2006, as GPs battled economic and market headwinds to ready their portfolio companies for exit. By tapping the substantial value they were able to build in their portfolio companies, GPs strengthened LPs' confidence that PE will remain their best bet to deliver superior returns. Increasingly, GPs and LPs have been fine-tuning the PE operating model by collaborating on new and mutually advantageous ways to work together.

As PE enters 2013, the industry is poised to benefit from strengthening fundamentals. Credit markets are very healthy and open for business to finance new leveraged buyouts (LBOs). The clouds of uncertainty about the economic prospects for the key economies where PE is active have begun to lift. One harbinger of better things to come was the announcement in early February that Michael Dell would pair up with Silver Lake Partners to take Dell Computer private in a \$24.4 billion buyout, the largest LBO since the boom years.

Looking ahead, PE will continue to be saddled with many of the accumulated burdens from the downturn. Too much dry powder is still chasing too few attractive investment opportunities, keeping deal multiples high. GPs

continue to sit on a backlog of aging portfolio assets they are eager to sell, forcing them to stretch out holding periods and pushing down returns. GPs hoping to raise new funds from tapped-out LPs must devote more precious resources and partner time to the task. These persistent challenges are leading GPs and LPs to fundamentally reassess their ongoing relationship. As LPs recommit themselves to PE as an asset class, some are turning to creative solutions for engaging with GPs by launching separate accounts and even direct investment programs (see sidebar, “GPs and LPs: Where is this relationship going?” on page 61). Look for that search for new directions to gain momentum in 2013.

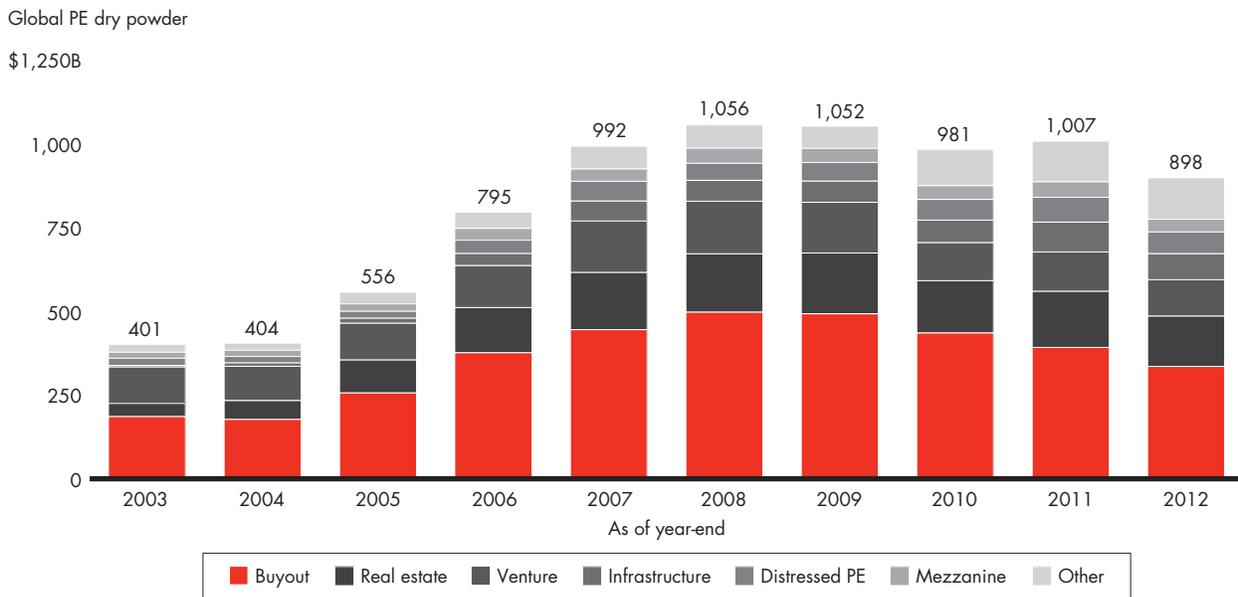
The global deal market has snapped back to a size not seen before 2004. But successive years of flat growth have PE insiders wondering if annual deal activity below \$200 billion will be the industry’s size going forward. As we shall see, the outlook for the coming year shows some surprising signs of strength that could spark an upswing.

Investments: Trading water

While there was no masking the fact that 2012 remained flat overall, there was plenty of energy to propel deal making forward as the year began, with more than 4,800 active PE firms looking to invest \$1 trillion in dry powder. Some \$392 billion of that total was earmarked for buyouts, and half of it was from commitments LPs had made during the pre-crash vintage years of 2007 and 2008 and earlier (see Figure 1.3).

With aging dry powder burning a hole in their pockets, GPs from these older-vintage funds were in a race to put capital to work. Bain & Company analysis found that one-quarter of older-vintage buyout funds larger than \$1 billion—a group that together held more than a third of the dry powder—were under considerable pressure

Figure 1.3: GPs were stockpiled with dry powder, fueling demand for deals



Note: Distressed PE includes distressed debt, special situation and turnaround funds
Source: Preqin

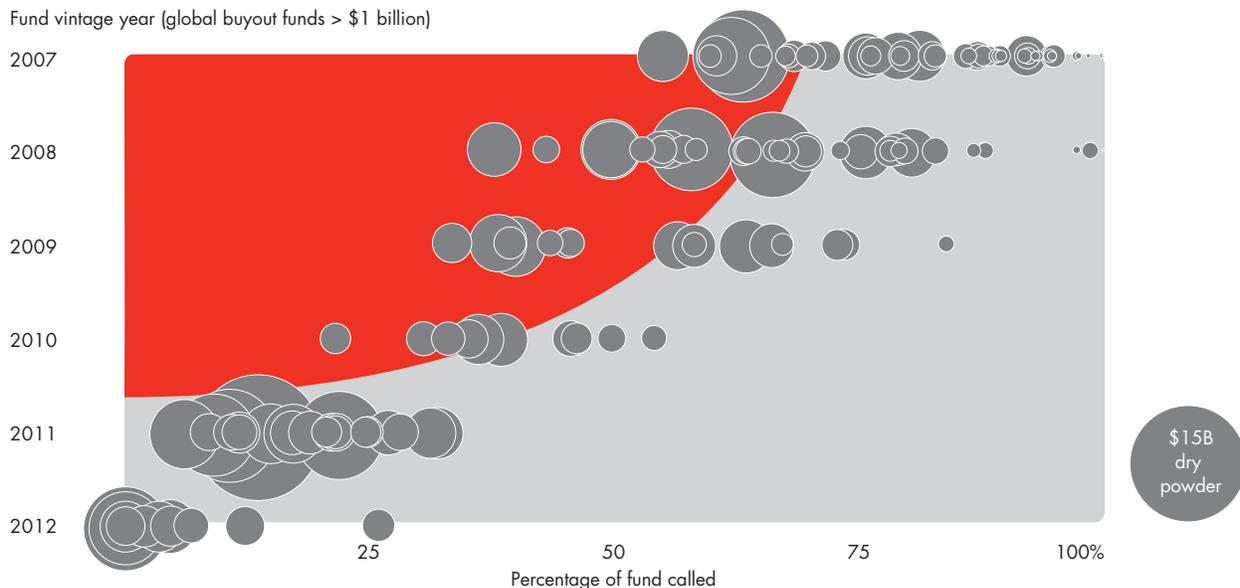
to close deals in 2012. These included funds from the 2007–2009 vintages that had called less than two-thirds of their committed capital and from the 2010 vintage funds that had called less than one-third. Although the proportion of funds and capital under pressure was somewhat less than in 2011, GPs holding aging dry powder faced fierce competition from more recent vintage funds that were themselves hungry to invest (see Figure 1.4).

GPs' urge to do deals was met by an eagerness that strengthened over the course of the year on the part of debt markets to finance them. For yield-hungry creditors, funding buyouts was one of the few options for earning high returns in a low-interest rate environment (see Figure 1.5).

Against the backdrop of accommodating lenders and a continued fall in interest rates, the cost of debt for LBOs dropped significantly over the course of the year. By the third quarter of 2012, the rate on leveraged loans to finance large US corporate LBOs was just 6.4%, well below the average rate of 7% between 2006 and 2010. Favorable conditions on the demand side for debt caused the issuance of high-yield bonds and leveraged loans to bounce back in 2012 (see Figure 1.6). Led mostly by credit markets in North America, total issuance of high-yield bonds and leveraged loans topped \$462 billion and nearly \$1.4 trillion, respectively, for the year, according to data supplied by Dealogic.

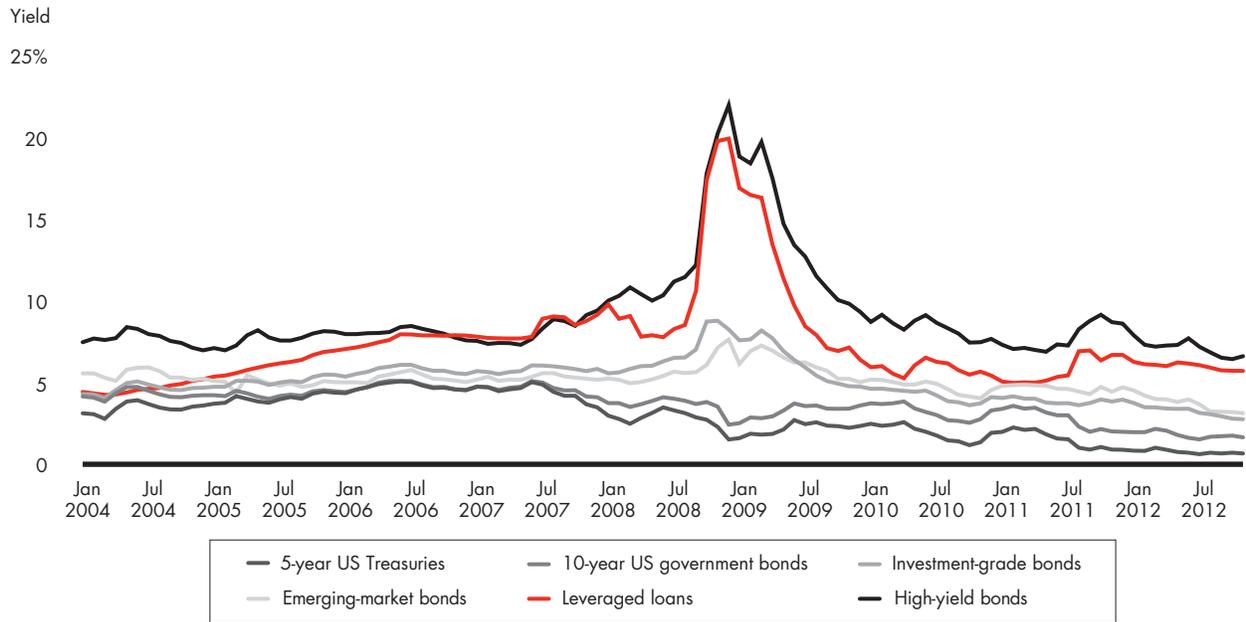
Benign credit conditions enabled buyout funds to increase the amount of debt they used to finance deals as they stretched their bids to win auctions. Leverage levels jumped from an average multiple of 4.9 times EBITDA on large US corporate LBOs to 5.7 times between the second and third quarters of the year. GPs were happy to take advantage of creditors' eagerness to lend. But it was the declining cost of debt and not a loosening in lending

Figure 1.4: The last of the boom-era funds were looking to invest their remaining dry powder



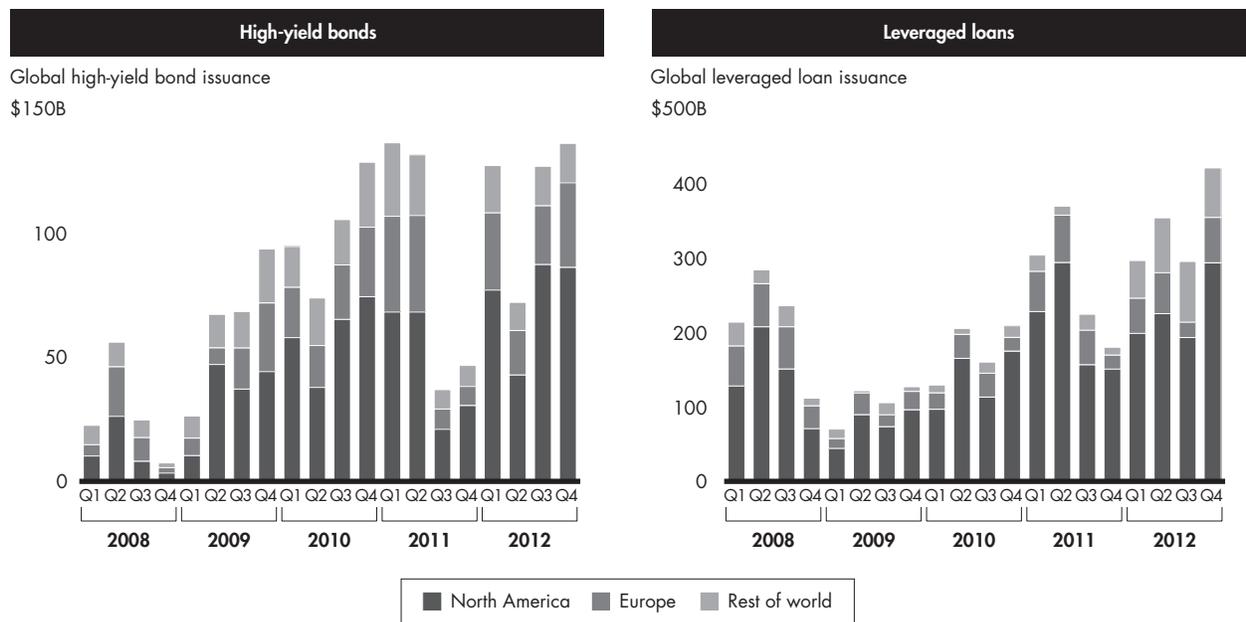
Notes: Includes buyout funds vintage 2007 and later that have held a final close; excludes funds with insufficient data; based on most recent performance data available, primarily as of Q2 2012
Sources: Preqin; Bain analysis

Figure 1.5: Strong debt demand continued to be fueled by investors' search for yield



Sources: Haver Analytics; Merrill Lynch; PIMCO; S&P; LSTA

Figure 1.6: The primary market for speculative-grade debt was robust



Source: Dealogic

standards that allowed GPs to structure deals with higher levels of debt. Interest coverage ratios on deals completed in the year's second half dipped only slightly.

Buoyed by these favorable conditions, managers of PE funds from the boom-year vintages pushed hard to put capital to work. Our close examination of ten 2007 vintage buyout funds found that they increased the amount of capital called by 27%, on average, between mid-year 2011 and mid-year 2012. Among the bigger funds, the Carlyle Group lifted the percentage called from its \$13.7 billion Carlyle Partners V fund from 59% to 77% over that period, investing about \$2.5 billion.

Many PE industry observers worried that some funds reaching the expiration date on committed capital would succumb to deadline pressure by investing as much as they could, with an eye less on the quality of the assets they were buying than with an aim to continue to pull in management fees. For funds that were weak performers and had poor prospects of raising a future fund, there would presumably be little downside to doing this. To test for that possibility, we compared the investment behavior of buyout funds that were below-average performers and likely experienced pressure to invest with their peers that generated above-average returns. We found neither group deployed a disproportionate share of their dry powder in the marketplace. While not conclusive, this is one indication that GPs did not behave recklessly to win auctions at any price.

By the end of 2012, some \$100 billion in aging dry powder remained committed to boom-year vintage funds. The clock has yet to run out on some of those commitments, and no doubt LPs that have patiently paid management fees for years will be willing to extend the investment period on some. However, there is still a sizable supply of dry powder for which commitments will expire in the coming years. What fund managers ultimately do with it will bear watching.

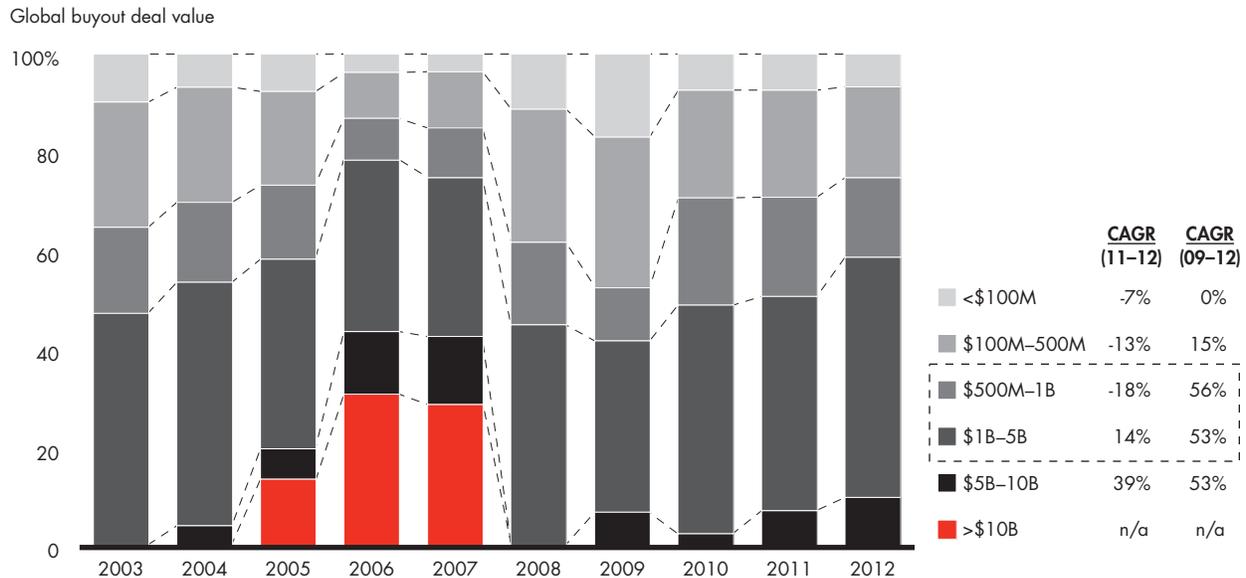
What kinds of deals did GPs conclude in 2012?

As in past years, PE deal makers were active across all sectors—from high-tech and industrials, to financials and media, to retail and real estate. Within the sectors, GPs focused on two themes that have been in precious short supply: growth and certainty. But with competition fierce and asset prices high, GPs needed to exercise penetrating due diligence to zero in on the fundamentals that set apart companies in the veins of opportunity that merited paying top value to acquire. Conditions in the energy and healthcare sectors, two favorites of prospective PE buyers in 2012, reveal the challenges of what it took to identify the winners (see sidebar, “Hot sectors in 2012: Healthcare and energy,” on page 31).

Continuing a pattern that has prevailed since the global financial crisis brought down the curtain on mega-buyouts, the size of deals consummated in 2012 remained concentrated in middle-market investments valued at between \$500 million and \$5 billion. More deals were done at the higher end of the mid-market range last year than the year before, with 56 buyouts valued at more than \$1 billion announced in 2012 compared with 44 in 2011 (see *Figure 1.7*).

Why didn't more and bigger deals get done in 2012? In short, because pervasive macroeconomic uncertainties weighed heavily on GPs' animal spirits throughout the year and in all major regions around the globe. But just how subdued moods were depended upon where in the world investors sat.

Figure 1.7: Deal size remained concentrated in the middle market



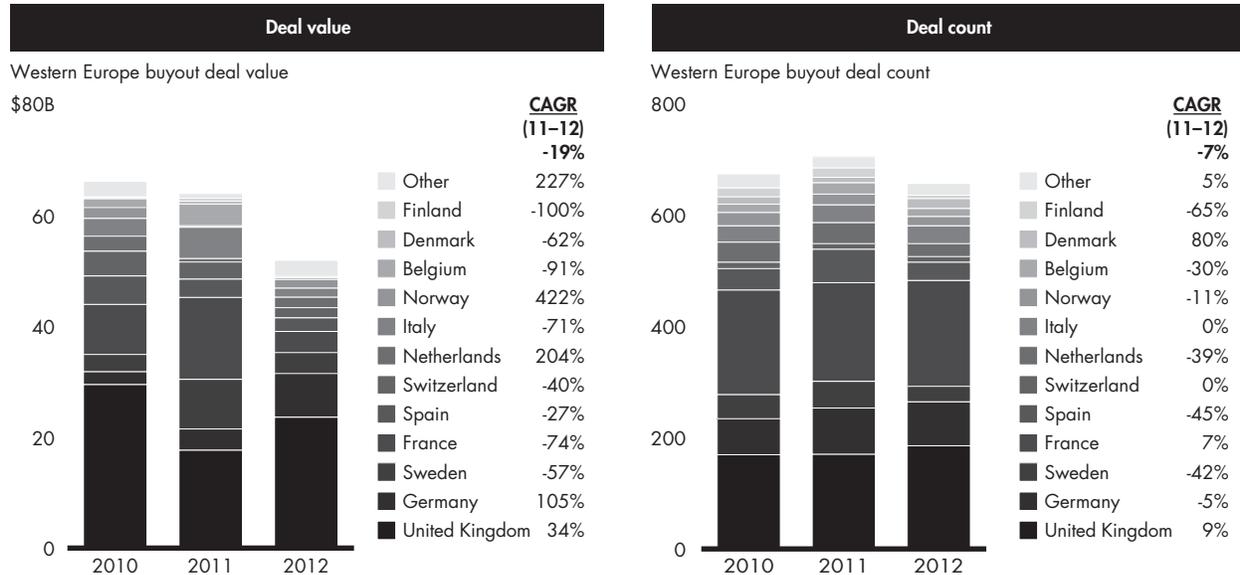
Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change
Source: Dealogic

Europe: Austerity bites. PE’s top story in 2012 was the weakness of deal making in what has traditionally been one of the industry’s strongest markets. PE in Europe moved in lockstep with North America in recent years, but that pattern broke last year under the weight of euro-zone sovereign-debt crises, unsustainable deficits and budget austerity that shut down growth. Although these conditions were evident at the start of the year, many PE investors anticipated that adversity might generate deal flow. Troubled European banks looking to deleverage their balance sheets would need to sell off assets that deal-hungry PE funds would stand ready to buy. But that did not come to pass. Instead, asset prices remained high even as economic conditions deteriorated in many markets, making it hard for potential acquirers and sellers to reach agreement over valuations.

The European PE market in 2012 was anything but unified. For the region overall, PE deal count was off by 7% from 2011 levels; deal value declined by 19% (see Figure 1.8). But those averages masked a sharply divergent experience between a reasonably healthy North and a moribund South. Like all industries, PE was drawn deeper into the vortex of sovereign-debt woes, rising taxes and budget austerity that crippled deal-making activity in Italy, Spain and France. However, deal activity did hold up well in Germany, where the economy remained strong, and in the UK, where the reign of the pound has largely kept investors above the euro-zone fray.

Nervousness and faltering confidence dampened PE deal making across the EU as economic conditions deteriorated and analysts steadily revised their forecasts downward over the course of the year. The flow of potential deals slowed to a trickle as would-be sellers moved to the sidelines waiting for market conditions to improve. Among deals in the pipeline, fewer closed as the valuation gap between buyer and seller expectations widened. Sellers that had repaired their balance sheets following the 2009 downturn were in no hurry to drop their price in the

Figure 1.8: Within Europe, the South suffered while the North held up better



Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on the location of targets
Source: Dealogic

face of buyers’ reluctance to place a big wager on growth that looked less and less likely to materialize. For example, Blackstone Group and BC Partners declined to increase their bid for Iglo Foods Group, Europe’s leading branded frozen foods business, from €2.5 billion to meet the €2.8 billion to €3.0 billion price that Permira, the PE owner, was asking.

That stickiness on valuations ensured that prices would be high on the smaller number of deals that were done. On average, European LBO acquirers paid 9.6 times EBITDA in 2012—up from 8.8 times in 2011 and very near the all-time high of 9.7 times EBITDA at the 2007 buyout market peak. High multiples also heavily influenced the kinds of deals PE funds completed. The most motivated parties on each side of the transactions that closed in 2012 were generally PE funds themselves—the sellers eager to take advantage of premium prices in order to return capital and the buyers looking to put dry powder to work. When the books closed on 2012, therefore, a record 61% of European buyout deal value was in sponsor-to-sponsor deals.

In their search for a ray of sunshine amid all the gloom, Europe-oriented LPs increasingly turned their gaze to the land of the midnight sun—the Nordic countries of Sweden, Norway, Finland and Denmark. For the fifth consecutive year, institutional investors named the Nordic PE market Europe’s most attractive, as found in a survey by Probitas Partners, a private markets investment advisory firm.

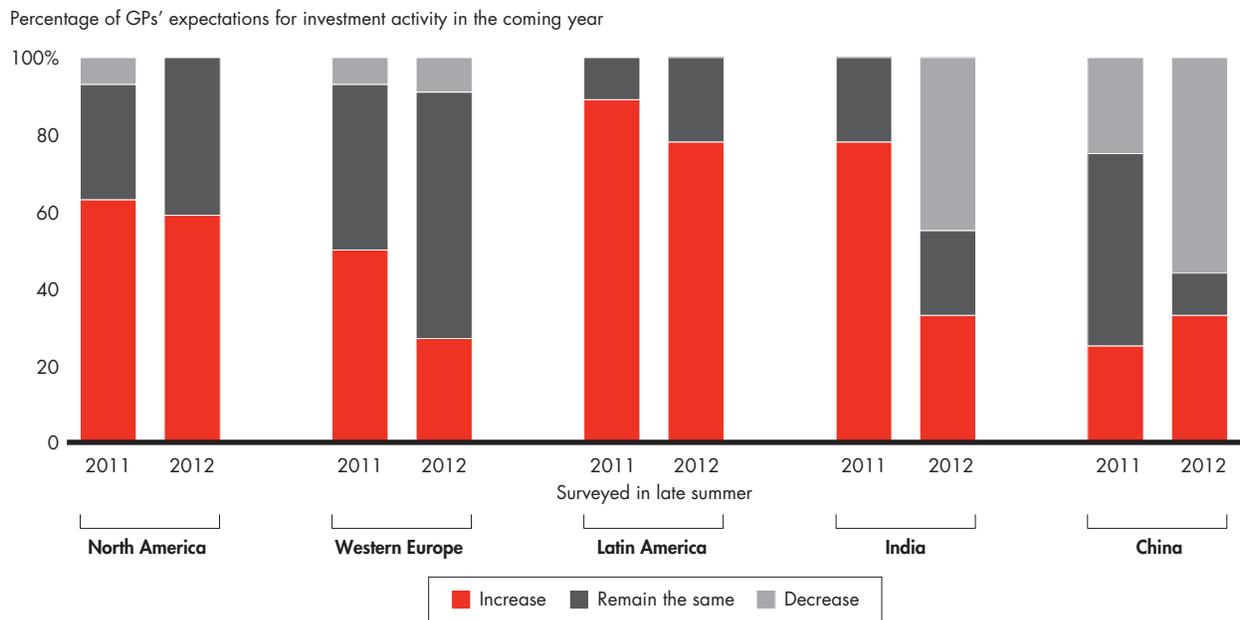
There was a lot to like in the Nordics’ economic fundamentals. The region largely avoided the global financial meltdown. GDP growth remained strong and is forecast to lead Europe through 2014, and solvent banks continued to lend. Investors also like the Nordic countries’ institutional transparency, their globally oriented companies and their skilled, well-educated workforces.

Were the Nordics truly the happy exception to Europe’s PE malaise? Sadly, they were not. From 2011 to 2012, the changes in both the region’s deal value and deal count came in below those for the continent overall. What is striking about the Nordic PE market is not its differences from PE elsewhere in Europe (or the rest of the world, for that matter), but its similarities. As has been the case in nearly all markets over the past few years, competition has driven up multiples for Nordic-region PE acquirers, including for the local firms. The combination of high prices and low market beta from subdued GDP growth and weak multiple expansion means that GPs in the Nordic region, like their counterparts everywhere else, must learn to be consummate value creators if they aim to generate top-quartile results.

North America: The tallest dwarf. By far the strongest region for PE activity, deal making in North America was up 23% over 2011.¹ Despite uncertainties early in the year surrounding the US federal debt-ceiling standoff and edginess that the economy could slip back into recession, GPs gained confidence as the year wore on that they could count on continued growth—slow and unspectacular though it may be. In a wider world beset by deeper woes, they saw the US as a bastion of safety and security. Surveyed by the accounting firm Grant Thornton in mid-2011 and again in mid-2012 about their evolving outlook for PE in North America for the coming year, GPs expressed more optimism about the region’s investment climate than for that of any other major PE market apart from still-small Latin America (see Figure 1.9).

The growing sense of stability in the US markets had practical implications for deal making. GPs could take heart in the reliability of the forecasts they built into their valuation models and, armed with low-cost debt, they could stretch to meet sellers’ prices. The average purchase price multiple of large US corporate LBOs rose to 9.1 times

Figure 1.9: GP confidence in North America returned and remained high throughout 2012



Source: Grant Thornton Global Private Equity Reports 2011 and 2012 (n=144 and 143 executives from PE firms, respectively)

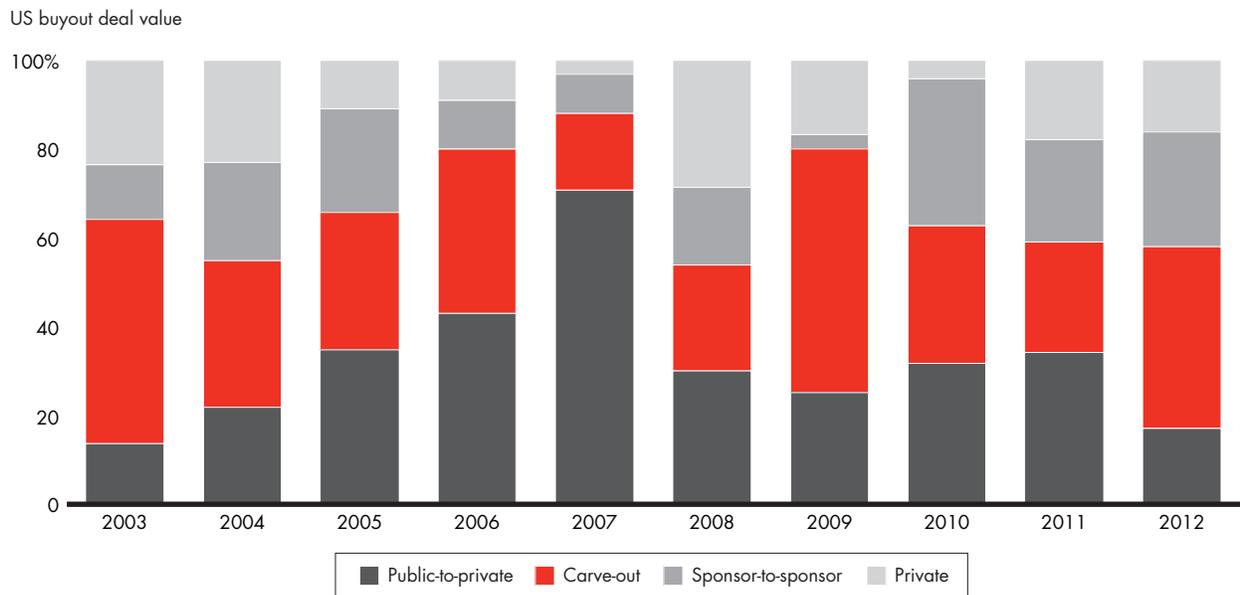
EBITDA by the third quarter of 2012, compared with 8.6 times and 7.9 times EBITDA in the first and second quarters, respectively. High prices lured more sellers into the market, and a narrowing mismatch between buyers and sellers over what assets were actually worth expanded the pool of deals on which the two sides could agree. However, GPs remained cautious not to pay too large a premium for the assets they acquired as some had done at the peak of the past PE cycle.

US-focused PE funds were active acquirers of non-core businesses spun off by large public companies looking to consolidate without diluting shareholder value. Carve-outs were popular with acquirers because, unlike purchases of privately held companies or public-to-private conversions, which commanded steep control premiums, they could be purchased at a price very near what the former parent company traded for. They accounted for 41% of total buyout deal value in 2012—up from just 25% in 2011 (see Figure 1.10).

Sponsor-to-sponsor sales of companies from one PE fund’s portfolio to another’s also picked up in the year’s second half. They proved to be a marriage of convenience, ideally suiting the needs of sellers who were eager to liquidate their mature holdings and buyers who were yearning to put money to work. Taken together, carve-outs and sponsor-to-sponsor deals accounted for nine of the year’s 10 largest deals in 2012—all of them in North America.

Asia: Growth chills. Following a remarkable burst of deal making by global PE firms over the past several years, investment activity slowed across most of the Asia-Pacific region in 2012, reflecting a stunning turnaround in investor sentiment. When surveyed in mid-2011, GPs were bullish on investment prospects in India and reasonably optimistic about China. One year later, they expected both markets to cool considerably. By year’s end, total deal value across the Asia-Pacific region dropped to \$47 billion, off 22% from the previous year. The decline

Figure 1.10: Carve-outs were popular in the US



Notes: Represents control buyout transactions by US-based firms; includes closed deals only; represents year deals were closed
 Source: Bain US LBO deal database

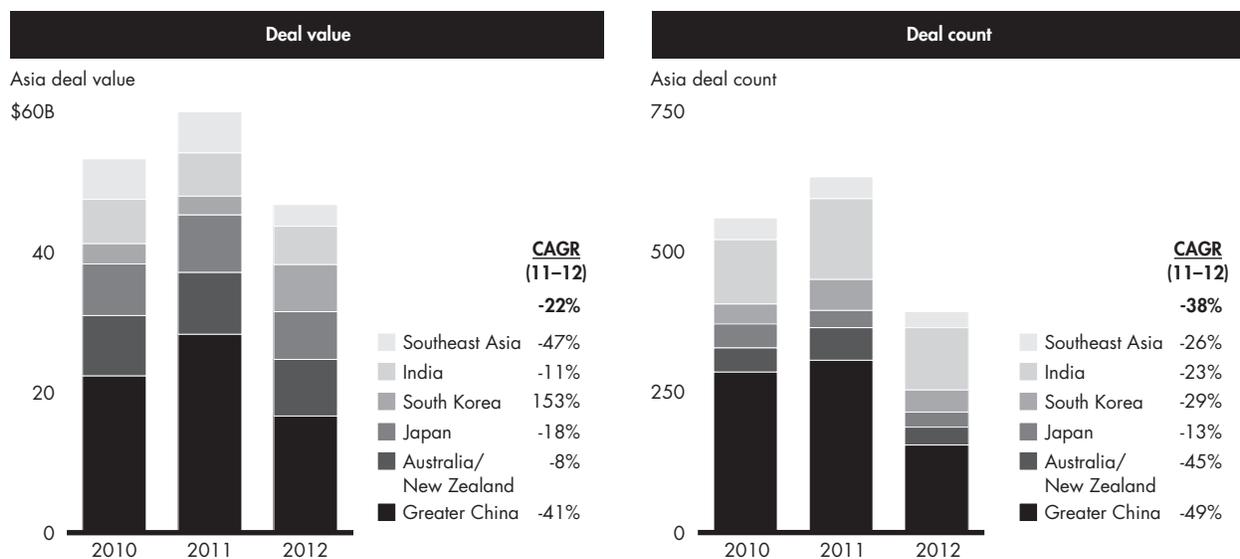
was pronounced in the big emerging markets of greater China, India and Southeast Asia, which tumbled 41%, 11% and 47%, respectively (see Figure 1.11).

Since it first swung into high gear about a decade ago, PE's Asian emerging market boom was predicated on a simple, but powerful, investment thesis: Strong, steady GDP growth pushes asset values higher. Thus, GPs could justify paying high multiples to acquire Chinese, Indian and Indonesian companies as long as the economies of those markets kept chugging along. Throw sand in the gears of reliable GDP growth and the PE investment engine would seize up because GPs would no longer be able to trust their valuation models.

That's precisely what happened in 2012. The sharp falloff in deal activity reflects an immediate recalibration on the part of GPs that only a continuation of torrid GDP growth warranted paying the high prices sellers commanded for minority stakes in their companies. Thus, even though GDP in China expanded at a 7.8% annual rate in 2012 and is forecast to grow at a rate of 8.4% in 2013, GPs remain dubious about forward-looking forecasts, anticipate that growth will remain slower than in the past and worry about overpaying for deals. With some \$56 billion in dry powder earmarked specifically for investment in China at the outset of 2012, and more capital in the hands of regional or global funds that could be put to work there, PE funds faced challenges deploying capital. Foreign PE funds continued to face regulatory obstacles to investment despite some recent easing of restrictions.

PE funds did find pockets of opportunity in China's more volatile economic climate. For example, a sluggish market for initial public offerings (IPOs) inclined Chinese entrepreneurs to look to PE for growth capital. The past year also marked what appears to be the beginning of a shift to a market more open to buyouts, as some owners were even willing to cede control to secure PE investment and the benefits that PE stewardship could

Figure 1.11: Investment activity in Asia-Pacific countries trended down in 2012



Notes: Asia includes China, Taiwan, Macau, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam, Australia, New Zealand, India, South Korea and Japan; includes investments with announced deal value only; excludes deals with value <\$10M; does not include bridge loans, franchise funding seed/R&D, concept funding deals and distressed; excludes infrastructure, real estate, real estate investment trust, hotels and lodging property deals and domestic transfer by sovereign wealth funds to governments
Source: AVCJ

bring. For their part, GPs are beginning to realize that their deal thesis needs to shift to more active management of assets. These conditions should play to the strengths of seasoned foreign GPs familiar with operating in more hands-on markets.

Conditions faced by PE funds in India last year were very much like those in China, only more so. As in China, Indian GDP growth slowed—to some 5.5% in 2012, down from 7.6% in 2011 and well below what economists had forecast. Further dampening PE prospects, India's currency tumbled sharply and regulatory and tax changes spooked PE investors early in the year. GPs were sitting on some \$16 billion in dry powder targeted specifically at India as 2012 began, but Indian entrepreneurs continued to hold out for higher prices and remained disinclined to cede management control.

PE deal making in India did pick up as the year unfolded. Equity markets rebounded, the rupee strengthened, and surer economic growth prospects restored investor confidence. Deal prices remained high although they showed some signs of tempering. With plenty of PE capital still in the ground and a long pipeline of deals seeking to exit, the sense is growing that GPs will soon need to demonstrate that they can deliver results for LPs.

Deal activity in Asia-Pacific's mature developed markets in 2012 lacked the drama of the region's emerging ones, but each presented its unique challenges. In the thin Australian PE market, buyout deal count was essentially flat last year, but deal value tumbled more than 47%, to about \$2.7 billion. Buyouts were flat in Japan as well, with deal value off by about one-third to some \$3.5 billion. Among developed Asia's big three economies, only South Korea saw a spike in buyout value—largely on the strength of a single transaction. MBK Partners' purchase of a 31% stake in Woongjin Coway, a maker of water purifiers, for \$1 billion late in the year accounted for more than a quarter of the total value of all 16 South Korean deals last year.

Brazil: Dancing to its own beat. GDP growth in 2012 slowed to just 1% from 7.5% two years earlier, but that didn't dissuade PE funds eyeing opportunities in Latin America's largest economy. For PE, Brazil was the industry's rising star last year. With activity across more and bigger deals led by the Carlyle Group's \$347 million buyout of furniture maker Tok&Stok, investments were up 78% over the \$2.5 billion of 2011, according to the Emerging Markets Private Equity Association (EMPEA). Still below the peak year in 2010, but a healthy rebound for sure.

An environment conducive for deal making with a growing number of scale companies, stronger management teams and increasingly sophisticated capital markets, Brazil attracted country-specific PE funds armed with more than \$12 billion in dry powder by early 2012—nearly twice as much as in 2010. The rapid increase in capital and GPs on the prowl for investment opportunities did not irrationally inflate asset prices, however. Although banks and other intermediaries tend to get involved in the bigger transactions and extract full value, many smaller proprietary deals are still closing at lower prices. The growing abundance of dry powder and presence of GPs willing to pay higher prices are just two of several factors that have lured sellers into the market. A still difficult IPO market is prompting companies in need of growth capital to tap alternative sources, and the presence of a big population of family-owned businesses in search of liquidity and succession planning solutions has also led to many deals.

Optimism for PE's future in Brazil remains high. Investment in badly needed infrastructure is robust. Recent discoveries of offshore oil and gas reserves have PE funds circling Brazil's booming energy sector. Consumer spending is growing as the middle class expands and becomes more prosperous. And major world events Brazil will soon host, particularly the 2014 football World Cup and 2016 Olympics, are spurring both public and private capital investment. Nevertheless, significant challenges, including real interest rates that are among the highest

in the world, will require PE funds to strengthen their due diligence and risk management skills, build local expertise and focus on post-deal value addition.

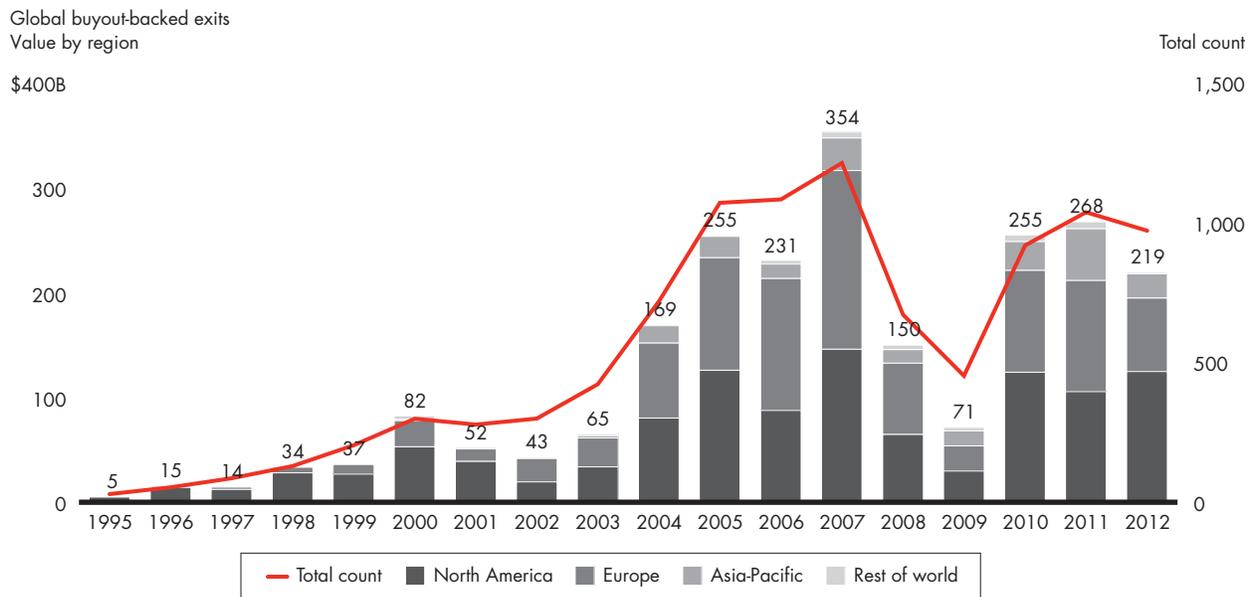
Exits: The gridlock continues

For GPs looking to cash out of portfolio holdings, 2012 did not live up to their hopes. Coming off a weak second half of 2011, exits failed to gain traction last year in any of PE’s major markets beyond North America (see Figure 1.12). Worldwide, the number of buyout-backed exits was down 6% from 2011’s total, and their value was off by 18%, to just \$219 billion. Exit activity in Europe and Asia-Pacific slowed sharply. European funds sold 25% fewer assets with a total value that was 34% below the previous year. GPs in the Asia-Pacific region exited from 11% fewer holdings, and deal value plunged 53% to \$23 billion. Only in North America did exits hold their own, up 18% in both count and value. The region accounted for nearly half of total global buyout exits by count and a little less than 60% by value.

GPs encountered obstacles at most exit channels, including most prominently PE sales to corporate acquirers (see Figure 1.13). Long the dominant way for funds to dispose of mature holdings, sales to strategic buyers remained the biggest exit channel in 2012, accounting for 62% of the total value of buyout-backed exits globally. But they were far below their full potential. Although would-be acquirers’ coffers remained flush with cash and other liquid assets, global corporate M&A deal value came in at \$2.3 trillion—about what it had been in 2011.

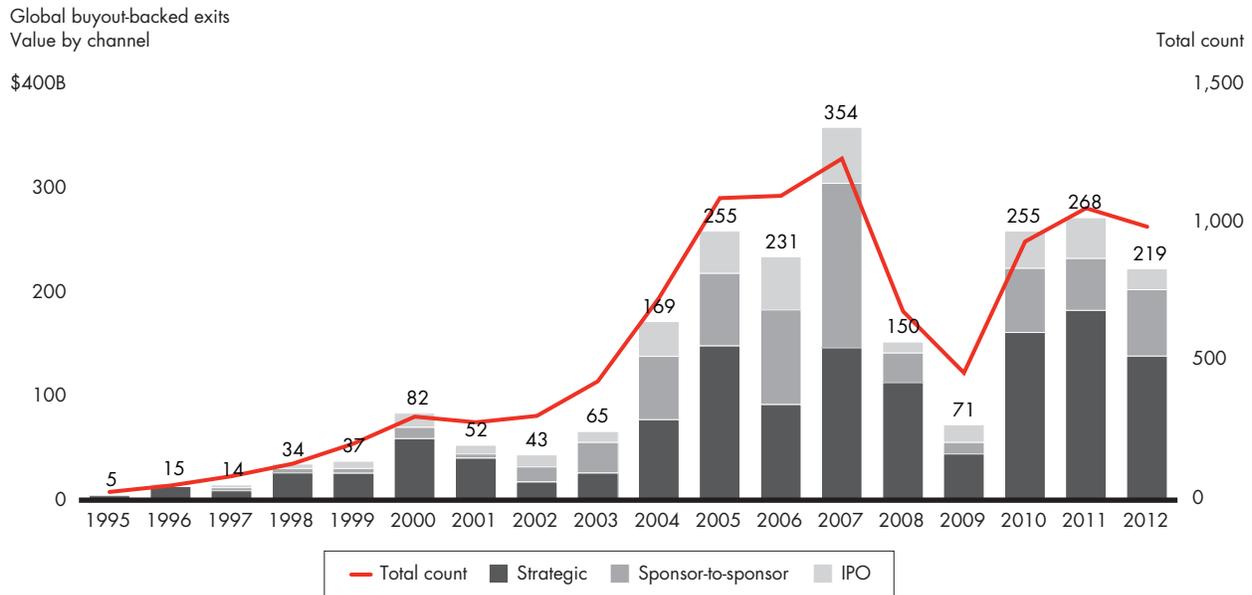
Macroeconomic uncertainty in Europe and Asia dampened corporate M&A activity, with the total value of buyout-backed sales down by 32% and 58%, respectively. Corporate acquisitions of PE-owned companies in North America

Figure 1.12: Exit value moved up in North America, in 2012, but struggled in Europe and Asia



Notes: Excludes bankruptcies; IPO value represents offer amount
Source: Dealogic

Figure 1.13: Sponsor-to-sponsor exits increased in 2012; IPOs and sales to strategic acquirers tumbled



were stronger, up 9% in value and 13% in count in 2012. In all, the number of strategic exits for PE-owned companies worldwide dropped to 582 in 2012 from 643 the previous year.

Corporations needed a compelling strategic rationale to pull the trigger last year, but once they saw one, they were fierce competitors for assets. Last July, for example, Campbell Soup Company squeezed out Blackstone Group, Ares Management and other PE bidders to buy Bolthouse Farms, a natural food company, from Madison Dearborn Partners. Campbell found the acquisition attractive because it would be able to improve its revenue and cost position by increasing the scale of its beverages business at a time when sales in its core soup business are sluggish.

The value of IPOs, too, was well below what that exit channel had permitted over the previous two years. The number of buyout-backed IPOs globally fell to just 110 for the year, slightly below 2011 offerings. Their total value sank by 49%, to just \$19.7 billion worldwide. IPO markets were especially inhospitable in Europe, where troubled equity markets could muster only four buyout-backed public offerings, bringing in a total value of just \$1.4 billion in 2012.

IPO activity in Asia-Pacific was lower than in 2011 and far off the high point in 2010. Given their vital importance for PE exits in past years, the drying up of Asia's IPO markets in 2012—particularly those in China, India and other emerging Asia economies—can only be seen as a disappointment for GPs. All PE-backed IPO exits in Asia's emerging economies, not limited to buyouts, brought in \$76 billion in 2010 but just \$25 billion last year.

Even in North America, where public equity markets turned in a good year overall and long-awaited initial offerings by Facebook and the Carlyle Group made their debut in 2012, the appetite for buyout-backed IPOs was lackluster. Sixty-six PE portfolio companies exited through this channel, raising just \$13.6 billion compared with \$27.7 billion in 2011, but only companies with the very best growth stories found the IPO door open to them. Among the leading PE-backed IPOs in the US was Apollo Global Management's \$1.2 billion flotation, last October, of Realogy Holdings, a real estate brokerage company, which found buyers looking to profit from the recovery of the beaten-down housing market. With continued strength in the public equity markets, successful IPOs like Realogy's, one of the big buyouts from the boom years, may become more frequent.

If PE asset sales were harder to realize in the weak corporate M&A and IPO markets in 2012, GPs did find willing buyers at the third major exit ramp—sales to other PE funds. Accounting for 29% of all buyout-backed exits both by count and value last year, sponsor-to-sponsor sales continued to pick up as a share of exit activity as they had over the prior three years, although they remained well below the share they commanded between 2003 and 2007. So-called secondary sales from one PE fund to another were an important feature of the exit market in all major regions of the world. Even in Europe, where the number of sponsor-to-sponsor sales was 21% below 2011 activity, this channel held up well in comparison to IPOs and sales to strategic buyers, which were down even more. Sponsor-to-sponsor sales increased in North America over 2011, modestly by count but substantially by value as several big assets traded from one PE firm to another. And with public equity markets flat in the Far East, they emerged for the first time as a viable exit option in emerging Asian economies.

Lacking much support from the conventional exit channels in 2012, GPs took advantage of near-zero interest rates and obliging credit markets to improvise one suitable for the times—cashing out by recapitalizing a portfolio company and returning capital to LPs through a special dividend. By borrowing at attractive prevailing rates to extract equity, a PE fund could book a solid gain, make LPs happy and continue to own a large stake in the asset with potential for further value appreciation. In all, debt sales to finance PE dividends soared to \$54 billion last year—their highest level in years. As has been the case historically, the bulk of dividend recap activity took place in the US.

Lingering headaches. The ongoing weakness of the exit market in 2012 magnified three big challenges GPs have faced since the 2008 downturn—an ever-increasing overhang of assets waiting to be sold, the continued pressures GPs felt to return capital to LPs and the diminishing chances to profitably exit from big holdings from the boom-year vintages that continue to languish in their portfolios.

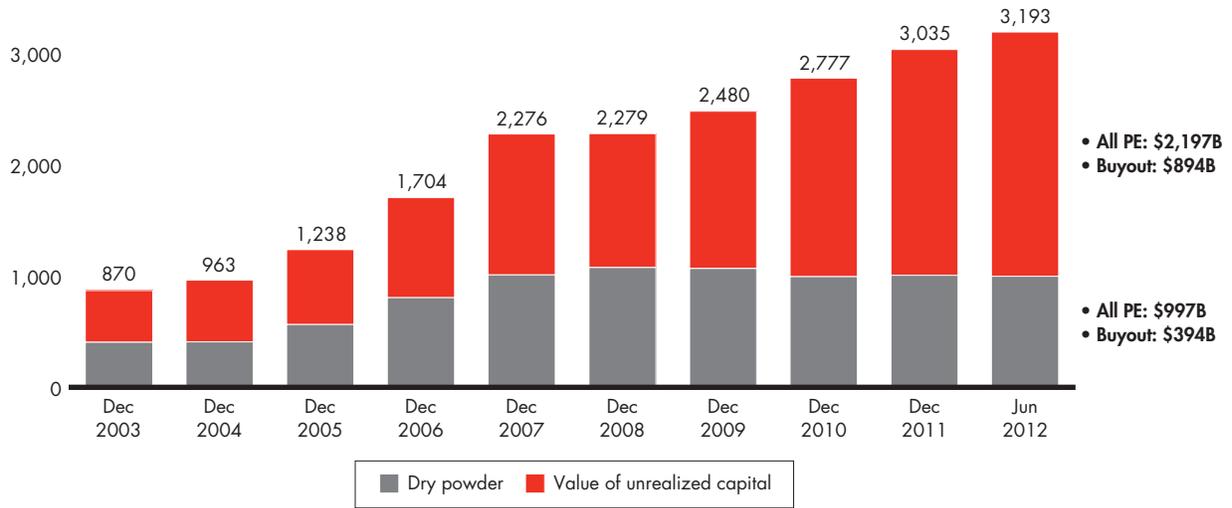
First, the large pool of unsold assets that had accumulated in PE portfolios since the peak investment years of 2006 and 2007 has only gotten larger as GPs added more holdings since then. As 2012 began, unrealized holdings totaled more than \$2 trillion—up nearly 14% from the previous year and more than double what they had been in 2006 (*see Figure 1.14*). To put that growing problem into perspective, GPs globally had completed 10,260 buyout deals between 2003 and 2007, yet there have been fewer than half as many exits between 2008 and 2012—just 4,057 in all, according to Dealogic data.

The exit overhang was becoming an especially acute problem for buyout funds, which collectively were sitting on more than \$800 billion in unrealized capital at the beginning of 2012. Fund vintages from the boom years of the past decade especially were far behind the curve in returning much capital to LPs (*see Figure 1.15*). Two-thirds of the funds that closed between 2006 and 2008 have distributed less than 40% of LPs' paid-in capital. Fewer than 5% of funds from the 2006 through 2008 vintages have returned all of or more than the capital LPs entrusted to them.

Figure 1.14: The “exit overhang” loomed large going into 2012

Global PE dry powder and unrealized value

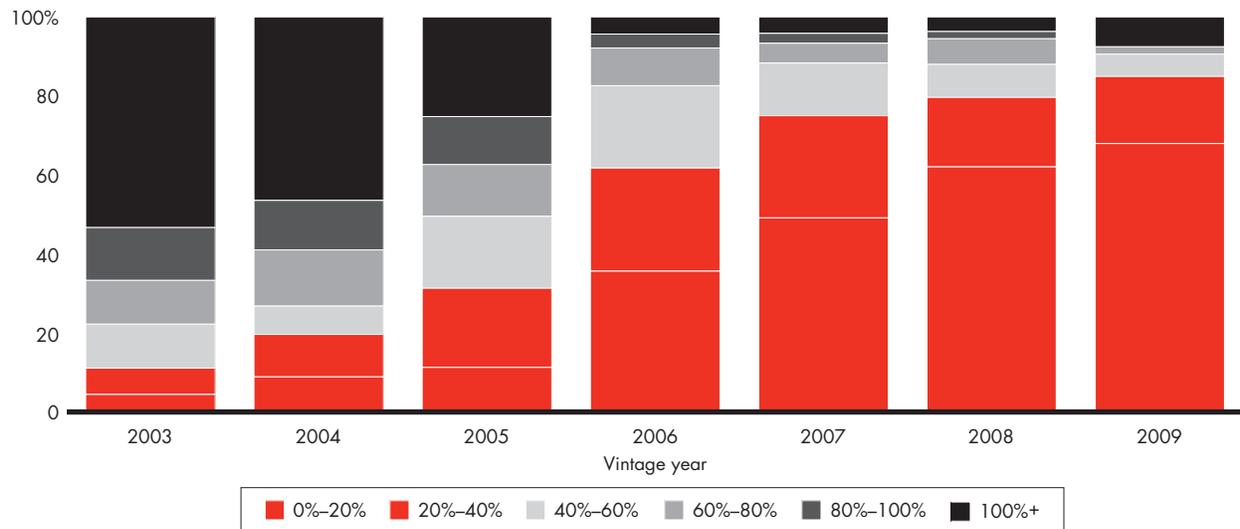
\$4,000B



Source: Preqin

Figure 1.15: Boom-year vintage funds have yet to return significant capital to their LPs

Proportion of distributed to paid-in capital (DPI) by number of buyout funds



Notes: Includes all buyout funds globally of any size that have held a final close; excludes funds with insufficient data; based on most recent performance data available, primarily as of Q2 2012

Sources: Preqin; Bain analysis

The backlog of exits waiting in the wings is playing havoc with GPs' planned holding periods. Most funds aim to sell assets within three to five years, but recent experience has stretched that out well beyond that industry norm. For investments exited in 2012, the median PE asset holding period had risen to 5.1 years—a year and a half longer than it had been at the PE cycle peak in 2007. Expect this figure to rise as the clock continues to tick on companies still held.

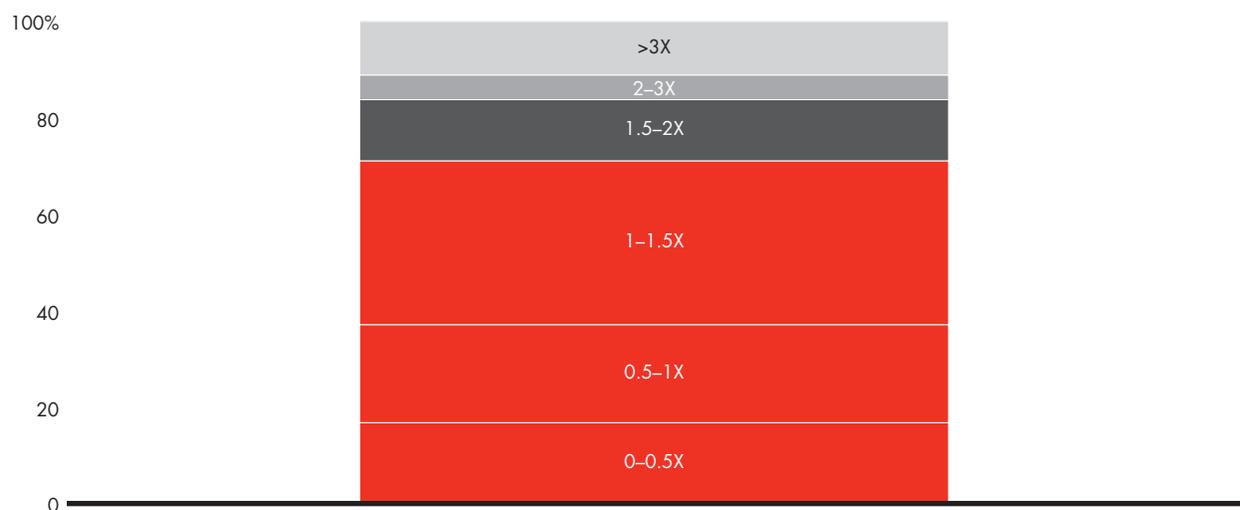
The second big challenge resulting from slow exit activity has been to stymie GPs that wanted to provide LPs with liquidity to make them more receptive to their next fund-raising efforts. LPs are rightly skeptical of committing new capital to GPs that have little to show beyond unrealized returns on their earlier investments. GPs hitting the fund-raising trail needed to unwind some mature holdings to get some “wins” under their belts.

The final challenge of continued slow exit activity has been to delay a profitable payday for GPs whose holdings were not yet ripe for sale. Many unrealized investments languishing in fund portfolios had been purchased at peak prices during the mid-decade buyout boom. Their PE owners were successful in nurturing them through the downturn but still held four out of five of them at valuations below what they required to earn their carry (see Figure 1.16).

A high percentage of these assets are large companies that, because of their size, face a narrower range of exit options—particularly in a struggling IPO environment. With little GDP growth, multiple expansion or other sources of market beta to count on to lift the value of these holdings, GP owners continue to look for ways to boost growth by generating alpha. Yet, the more time that goes by before the aging assets ripen for sale, the higher the valuation will need to be for GPs to achieve their time-sensitive internal rate of return target.

Figure 1.16: PE funds continued to hold most portfolio assets at values below what they needed to earn carry

Valuation multiples for the unrealized portfolio of a sample of buyout funds (as of Q2 2012)

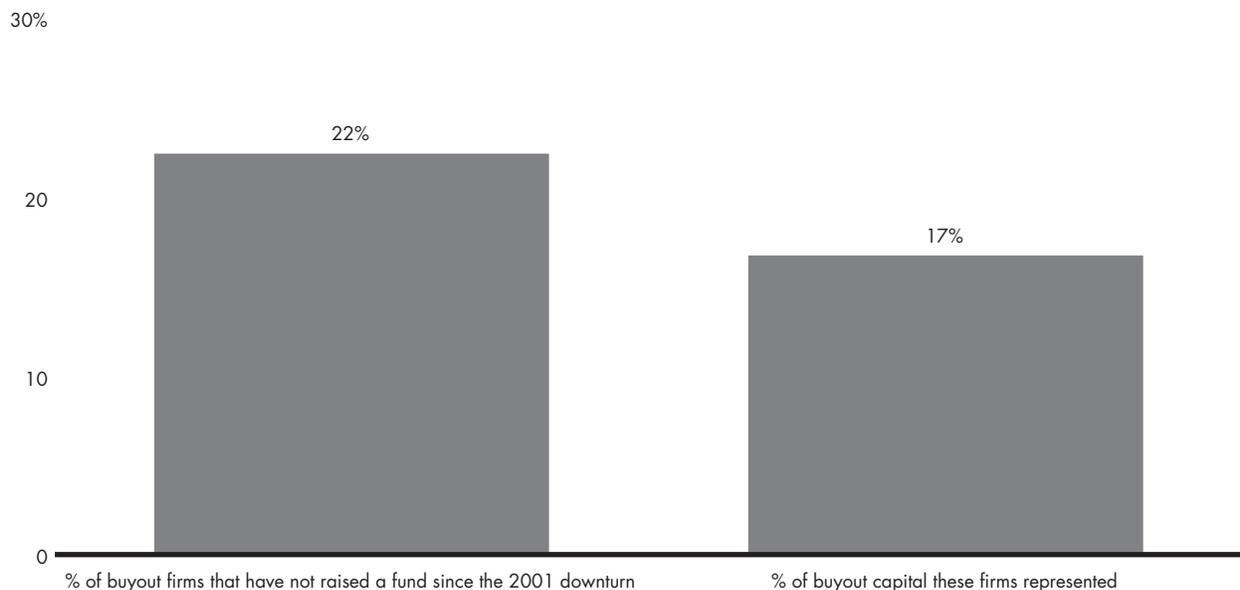


Notes: Fund vintages in sample range from 2004-08; analysis includes unrealized investments and partially realized investments; valuation multiples are before payment of fees; PE firms have different policies regarding how they report the value of portfolio investments
Source: Bain analysis

Powerful motivations to sell required many GPs to intensify their efforts in laying the groundwork for exits and to divert considerable resources to the task. Many pursued multiple exit strategies, testing several potential exit routes simultaneously in search of a timely sale at the best price. GPs were also formally setting aside time quarterly or even monthly to review the exit strategies for each portfolio company. In some cases, they called in independent advisers to conduct third-party due diligence on their own portfolio companies in an effort to uncover potential issues they needed to resolve in order to facilitate sales. Others went a step further, refreshing the value-creation blueprints for portfolio companies nearing sale in order to identify and plot out new initiatives they or a new owner could pursue to boost performance.

A growing concern among LPs is that some GPs might not be motivated to exit at all. Sitting on underperforming portfolios of unsold assets, some GPs recognize that they will be unlikely to generate carry on their current funds and face poor prospects for raising a new fund in the future. Our analysis found that about one GP in five failed to raise a new fund of any kind in the years following the 2001 downturn. These firms accounted for 17% of assets under management at the time (see Figure 1.17). Most GPs that find themselves in this position continue to perform their fiduciary duties. They owe it to their LPs to keep the lines of communication open and demonstrate by their responsible actions that they have their LPs' best interests in mind.

Figure 1.17: Following the 2001 downturn, one PE firm in five—a group that controlled a lot of capital—failed to raise another fund



Note: Buyout capital for firms calculated as the sum of capital raised in 1992–2001 vintage buyout funds
Sources: Preqin; Bain analysis

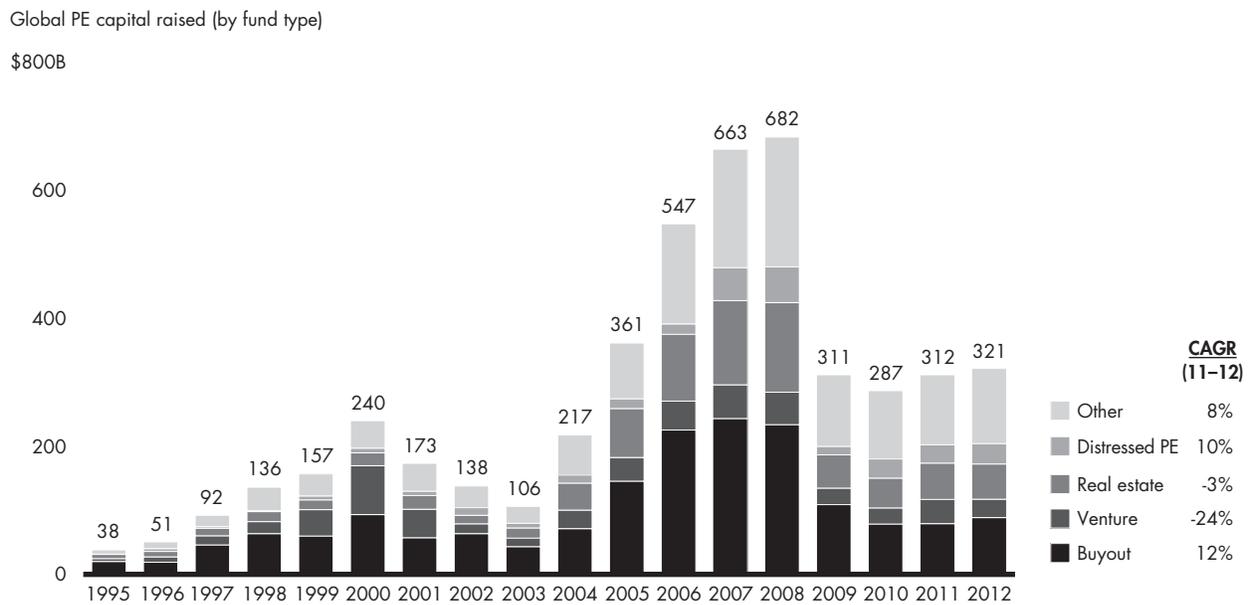
Fund-raising: Change is roiling beneath the surface

New fund-raising did live up to expectations in 2012—it was as flat as close industry observers anticipated. When surveyed by Preqin at the end of 2011, nearly half of the LP respondents said their planned commitments of new funds for PE would be unchanged from 2011, with 21% saying they planned to increase their allocations slightly and 10% planning to slightly decrease them. And when the final fund-raising numbers were tallied, the LPs proved to be as good as their word. Total PE capital raised for the year came in at \$321 billion—little changed from the previous three years (see Figure 1.18).

Buyout funds remained the top draw, attracting more than one-quarter of the total as they had over the past several years. Perhaps fittingly during a time of economic weakness, the relatively small category of funds that invest in distressed assets increased by 10% over 2011 to \$31.6 billion worldwide. A handful of large funds, including a \$5 billion fund raised by Oaktree Capital Management, helped drive up the distressed PE totals. As we shall see, the overall steadiness in funds raised in 2012 masked some important shifts that are under way in how LPs are equipped to respond to PE fund-raising campaigns and how GPs are adapting to changing conditions.

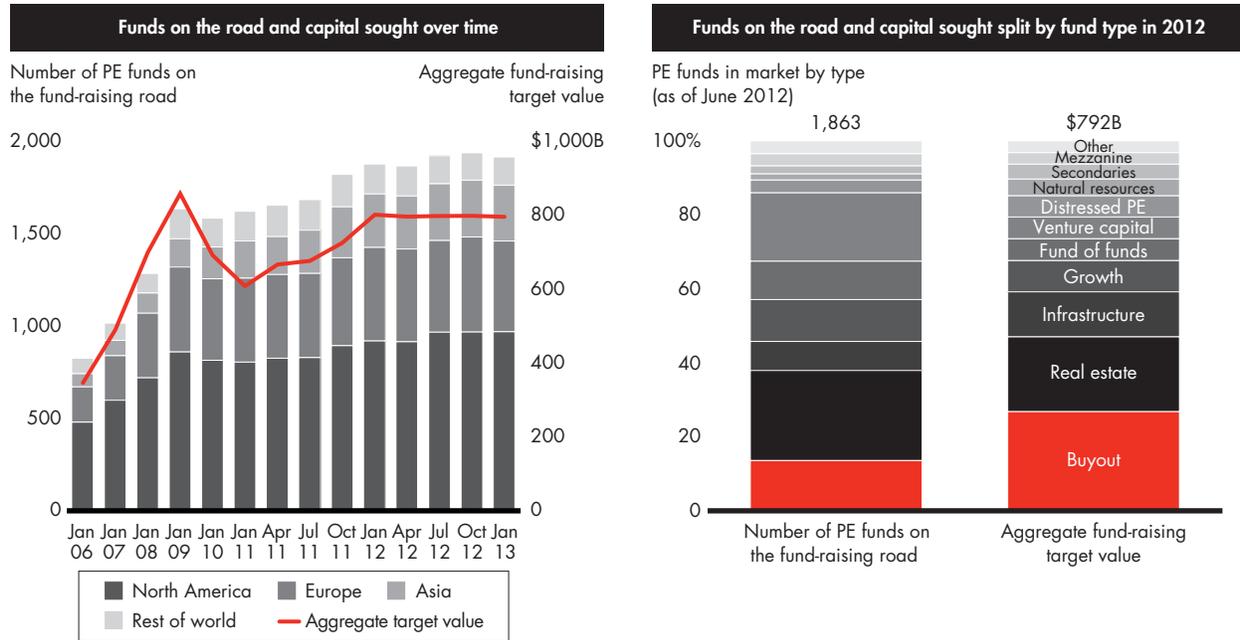
But first consider the factors that did *not* account for last year’s lukewarm fund-raising activity. They certainly did not reflect a lack of eagerness on the part of GPs to replenish their fund coffers. More than 1,800 funds were on the road at the start of the year, seeking to raise more than three-quarters of a trillion dollars—the highest level on both counts since the PE downturn hit in late 2008 (see Figure 1.19).

Figure 1.18: Fund-raising failed to stage a recovery in 2012



Notes: Includes funds with final close; represents year funds held their final close; distressed PE includes distressed debt, special situation and turnaround funds
Source: Preqin

Figure 1.19: The number and target value of funds on the road remained high



GPs began 2012 beating the bushes looking to raise 2.4 times as much capital as they brought in during all of 2011, and they were eager to line up commitments to funds of every type. In terms of the number of funds in the market, real estate, venture and buyout funds predominated, accounting for 56% of the total. But buyout-fund GPs aspired to raise the most capital, targeting an aggregate value of more than \$212 billion—or more than one-quarter of the total—as of mid-year.

Neither did the overall flat year for fund-raising reflect any diminution in LPs’ enthusiasm for PE as an asset class. Quite to the contrary, interviews conducted by Bain with a wide range of LPs confirm what the data clearly show: LPs’ confidence that PE will continue to generate superior returns going forward remains unabated. Indeed, when compared with the long-term performance of other asset classes in public pension funds’ portfolios, for example, PE outpaced them all over both a five-year and 10-year time horizon (see Figure 1.20).

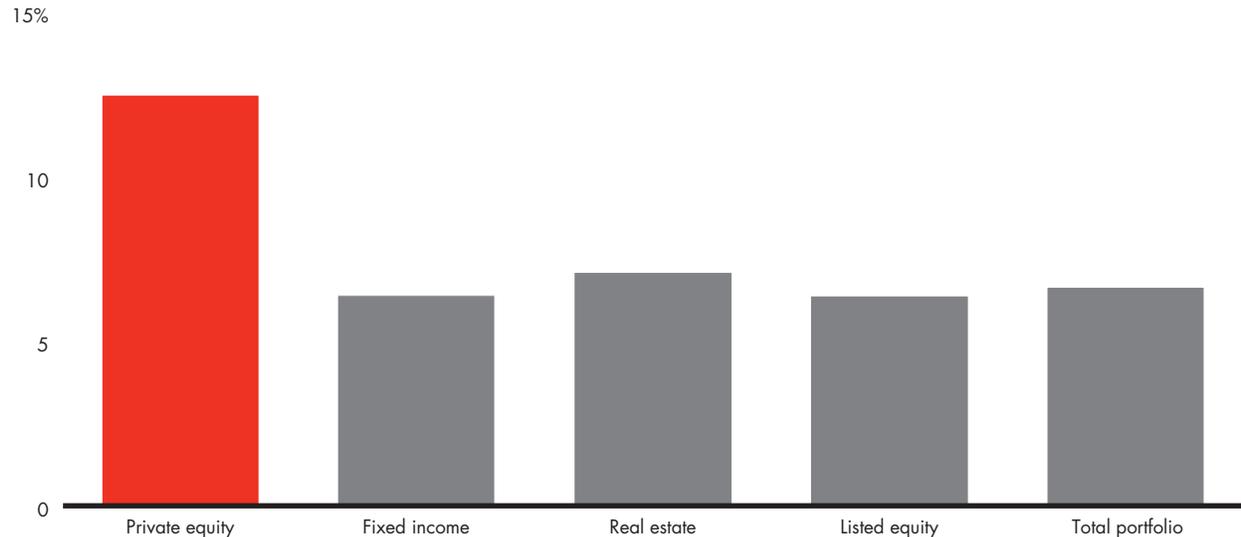
Looking ahead at an extended period of historic low interest rates and weakening prospects for listed equities to generate returns comparable to their past performance, LPs see a favorable spread for expected PE returns. Although PE industry returns have been declining over time, LPs still expect their spread over other asset classes to be as wide as it has ever been. That optimistic outlook for PE had the large majority of LPs willing to maintain or increase their PE allocations in the hope that PE would continue to boost the returns of their portfolios overall.

GPs: Riding a two-speed market

Fund-raising in 2012 was sharply bifurcated, with a very small minority of GPs reaching their targets quickly and with seeming ease, while the vast majority of PE firms were forced to work harder than ever to achieve their

Figure 1.20: For public pension funds, PE has outperformed other asset classes over the long term

Median returns for public pension funds
(by asset class, 10-year horizon IRR, as of June 2012)

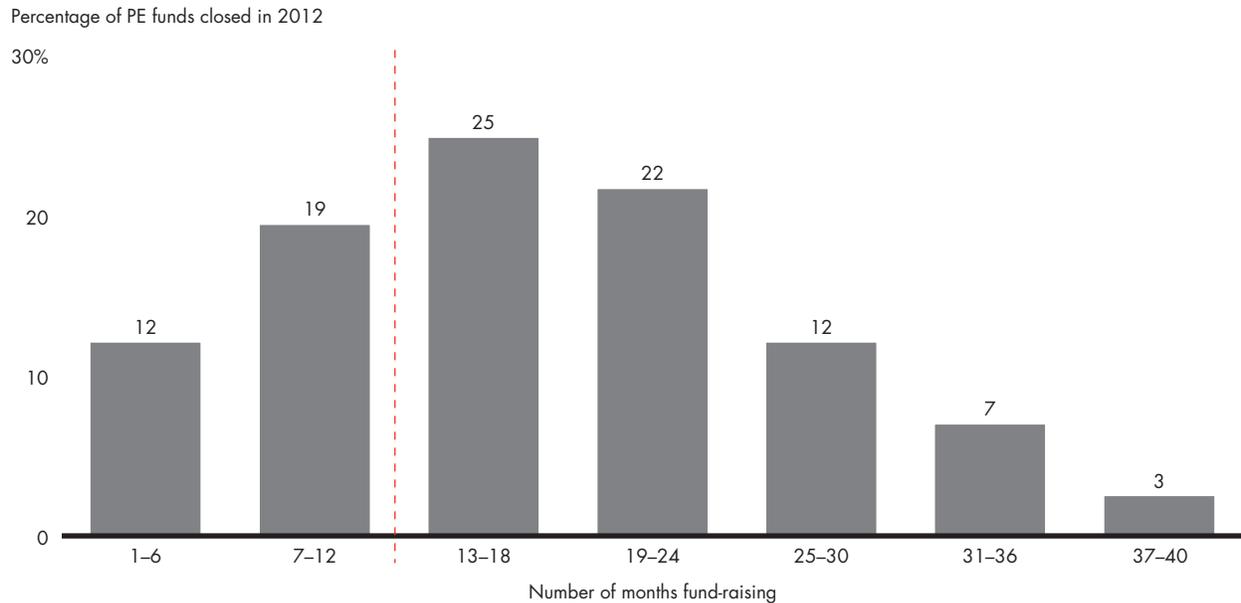


Note: Data based on review of public pension funds in North America and Europe
Source: Preqin

goals. For example, Advent International, a US-based firm with worldwide reach, set out to raise €7 billion for its Advent International GPE VII fund, but within less than nine months ended up oversubscribed, closing with €8.5 billion in new capital. Overall, nearly one-third of funds on the road were able to close within 12 months or less (see *Figure 1.21*). However, the average time GPs spent bringing a new fund to close in 2012 was approximately a year and a half—about in line with what it has been since 2009, and at least six months longer than it took funds to close during the mid-decade cyclical peak.

Three criteria separated the GPs that found themselves on the fund-raising fast track from those that found it hard to get up to speed. Not surprisingly, a GP's past performance was the most important factor, with those whose earlier funds ranked, on average, in the top two quartiles facing a warmer reception than their less successful peers. That was certainly the case with Advent International, as it was, too, with Leonard Green & Partners and Ares Management, all strong performers that were not only able to exceed their target new-fund size quickly but managed to raise larger funds in 2012 than their prior funds.

The second quality that gave leading GPs an edge in the fund-raising marathon was stable teams and experienced leadership. In a survey conducted by Preqin at mid-year, LPs ranked team stability and experience the second-most important factor they were looking for in GPs behind performance track record. Indeed, Bain analysis found that among GPs with below-average performance track records, those that could point to a longer history of having sponsored more funds were likelier than their less experienced peers to have had fund-raising success within the past five years.

Figure 1.21: One-third of GPs closed new funds within a year; most took longer

Note: Excludes funds raised in less than one month and more than 40 months
Source: Preqin

This does not suggest that new and smaller funds were frozen out of the fund-raising race in 2012. In fact, our investigation found that there was a willingness on the part of LPs to take a chance on younger PE firms that was not in evidence just a few years ago. However, the successful new funds shared the common trait that they were run by seasoned investors who had built strong personal relationships and individually had proven their stripes. For example, Searchlight Capital, a new firm headed by a trio of senior professionals from KKR, Apollo and Teachers' Private Capital, raised \$860 million for its debut fund last year. What appealed to LPs willing to take a risk on a young firm were the traits that have won favor with investors since PE's early years—closely aligned incentives, evidence that the team that would run it had a differentiated strategy and the right “fire in the belly” to make it work.

Finally, GPs that could demonstrate they were able to deliver strong cash-on-cash returns and return a meaningful portion of the previous funds' capital to investors found favor on the fund-raising trail. Others faced deep LP skepticism. “Private equity firms are supposed to buy companies and sell them. When we see someone serially not selling, it's not a positive for us,” said a senior executive at a US endowment fund. “You can only blame the market so much for not getting stuff out the door.”

For GPs that were unable to show themselves to be fleet of foot on the performance, stability and cash return tracks, 2012 was a tough slog. Among six of the largest Europe-focused buyout funds that closed last year, for example, three were between just 70% and 80% of the size of the firm's prior fund. Rather than struggle to meet an ambitious target that would consume valuable partner time, some GPs threw in the towel early. They declared their fund closed, acted swiftly to get investments in the ground and planned to return to the fund-raising trails within two or three years instead of waiting the more conventional five years or more between fund-raising forays.

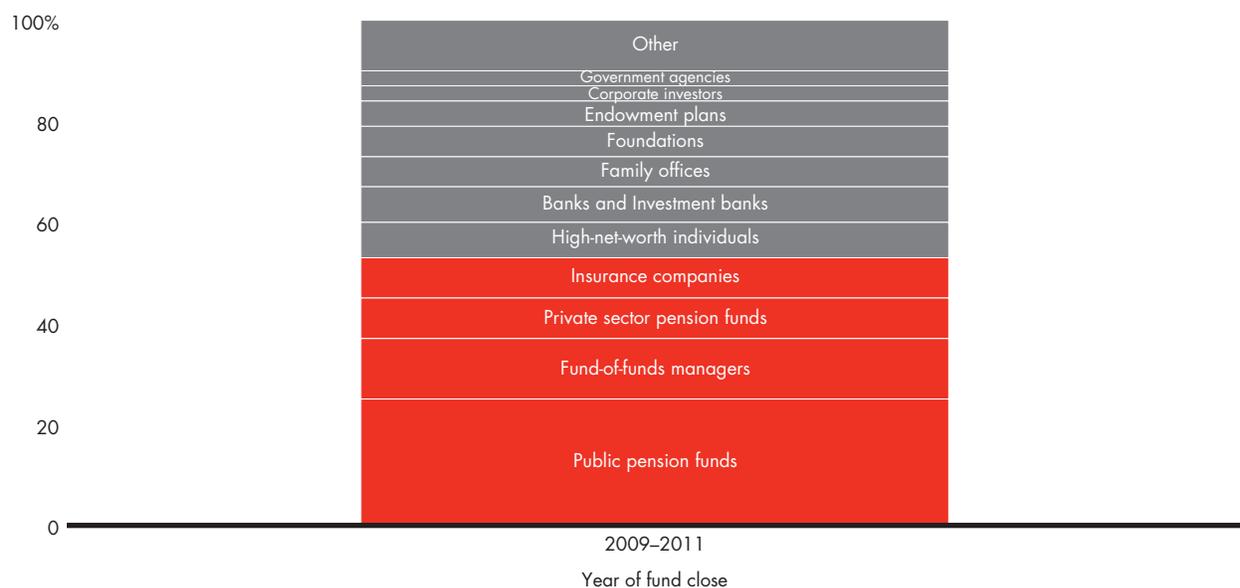
LPs: A changing of the guard

The major constraint preventing many LPs from making commitments to new funds commensurate with their conviction that PE would continue to outperform other investments was that most had little headroom to allocate more capital to PE. Indeed, as of mid-2012, two-thirds of LPs were bumping up against the ceiling of their target PE allocations as a percentage of their total asset base or had broken through it, according to Preqin surveys. Further tying LPs' hands were the large commitments they had previously made during the aggressive fund-raising of the boom years before the 2008 financial crisis. The steep drop in deal activity since then left LPs with a big pile of unfunded commitments, making them hesitant to add much more in the event that deal activity might pick up and capital calls surge.

LPs that have long been the major sources of capital feeding PE—large public sector pension funds, most notably—were simply tapped out (*see Figure 1.22*). Many lacked the capacity to add to their PE holdings. For one thing, traditional LPs with mature PE programs depend heavily on receiving distributions of previously invested capital they can recycle into new commitments. The slow pace of exits going into 2012 gave LPs little reason to expect that they could count on seeing distributions increase sufficiently to warrant adding to their budgets for new PE commitments. Distributions were especially slow to flow back to LPs that had heavily backed the mega-buyout funds of the 2005 through 2007 vintages. GPs that managed those funds had acquired the big companies in their portfolios at peak prices and were finding it difficult to unwind those positions. Of course, LPs could increase their headroom for new commitments by raising their target PE allocations. But 75% of LPs responding to a survey conducted by Preqin in late 2011 said that they had no plans to do so in 2012. Any additional amounts

Figure 1.22: Most of the capital committed to PE has come from traditional sources

Percentage of capital committed to PE funds, by LP type



Source: Preqin

committed by the minority who lifted their allocation ceilings did not appear to have a meaningful impact on 2012 fund-raising.

Representative of the challenges even the biggest LPs confronted in making new commitments in 2012 are two of the largest public pension funds in the US, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). With total assets under management of \$243 billion and \$158 billion, respectively, they have been major pillars of PE investment for decades, but both are now straining to plow more capital into their PE holdings. Because they face increasing obligations to pay out benefits to the public employees and beneficiaries they represent, pension funds like CalPERS and CalSTRS are judicious about how much capital they tie up in illiquid assets. Pension funds typically use the recent flow of distributions they have received from GPs as a guide to gauge how much capital they can prudently invest in PE. But those distributions have diminished in recent years, making it hard to justify increasing their PE exposure. For example, CalPERS and CalSTRS had between 1.3 and 1.5 times their paid-in capital returned to them from the PE fund investments they made prior to 2005. But the two have only gotten back less than 0.4 times the capital they paid into the big fund vintages of 2005 through 2007. Neither CalPERS nor CalSTRS have increased their target PE allocations since 2009.

Those shrinking distributions give the California pension systems virtually no room to add to their PE holdings. Both are at or above their targeted PE allocations of 14% of total assets in the case of CalPERS and 12% for CalSTRS. Add in the prior commitments each has made to funds that have yet to be called for investment (another 6% for CalPERS and 5% for CalSTRS), and both organizations are above their self-imposed PE allocation ceilings. The squeeze shows up clearly in the far smaller new capital commitments both pension systems have made to the most recent vintage PE funds. Since 2009, CalPERS has committed a total of \$4 billion to new funds. CalSTRS's commitments over the same four-year period have totaled \$4.2 billion. By contrast, they had committed \$13.5 billion and \$6.4 billion, respectively, to the peak-year vintage of 2007 alone.

The limited capacity of LPs like CalPERS and CalSTRS to add to their PE commitments signals a major shift in the PE investor base that has been building for several years. Whole categories of LPs that have been the major traditional sources of PE capital—from public and private pension funds to fund-of-funds and insurance companies—are finding it a strain to increase the pace of commitments. The fund-of-funds model, which provided access to top-tier PE funds for LPs that were too small to command the attention of GPs that were in high demand, is less relevant in today's tough fund-raising environment, when it is GPs that are struggling to line up any LP commitments they can get. For their part, insurance companies face stricter regulations that limit their exposure to risky assets, including PE.

The inability of traditional LPs to write as many large checks to fill new PE fund coffers has been partially offset by LPs that are able to make new commitments, including those whose asset bases have continued to grow or face lower liquidity demands. Most prominent among this group are sovereign wealth funds (SWFs), which have seen their total assets under management expand by some 60% over the past five years, to some \$5.2 trillion today. Their swelling base means SWFs must continue to increase the size of their PE programs simply to hold their PE allocations constant as a proportion of their total portfolio.

GPs that have been quick to identify these potential new funding sources and win them over with appealing pitches have gotten a boost to their capital campaigns. For example, EQT Partners, the Nordic buyout firm, brought its latest fund to a successful final close in late 2011, raising €4.75 billion—in part, because EQT was able to

diversify its investment base, including tripling the size of the commitments it received from Asian sovereign wealth funds.

The emergence of these new sources of LP capital, however, offered only modest comfort for most GPs on the road in search of new-fund commitments. They are neither large enough to compensate for the diminished appetite of the far larger traditional PE-investor groups for new funds, nor are they likely to displace them. For example, SWFs control huge amounts of capital, but many are constrained by regulations and by policy and strategic considerations that limit their allocations to PE to only single-digit percentages of their total assets.

With bargaining power tilted decisively in their favor, LPs were pickier about the kinds of funds they would favor and on what terms. Two strong preferences LPs displayed in the funds and GP teams they chose to invest in gave 2012 its distinct flavor and hinted at themes that will influence fund-raising in the coming year. First, in surveys and interviews, LPs continued to express a strong shift in favor of smaller and mid-market buyout funds. For example, 60% of the institutional investor respondents to a survey conducted by Probitas Partners said they were seeking to invest in US funds targeting buyouts in the range of \$500 million to \$2.5 billion. Among LPs looking to invest in Europe, mid-market buyout funds that focus on the stronger northern countries garnered favorable mentions by 40% of respondents. Growth capital funds and US-focused smaller-company buyout funds were also among respondents' top picks for 2012.

A second significant shift in LP sentiment in 2012 showed up in their attitude toward emerging markets. PE capital raised for emerging market investments in 2012 fell overall—from \$76 billion in 2011 to \$63 billion during the past year—and declined in all major regions with the exception of the still-small Central and Eastern Europe markets. The 21% drop in funds targeting the emerging economies of Asia in 2012 is somewhat overstated by the close of two large Asia-focused funds in the final weeks of 2011. LPs remain committed to emerging markets, overall. They are maintaining their target allocations; according to a recent survey by EMPEA, they indicate that they will execute on their previously planned increases in new commitments (*see Figure 1.23*).

Nevertheless, survey findings from EMPEA confirm that LPs have altered their thinking about the markets they view as most attractive (*see Figure 1.24*). Ranked on a scale of 1 to 10 (with 10 being most attractive), China slipped from a top score of 10 in 2010 to a score of 8 in 2012. India has fallen three notches to a lukewarm 5, putting emerging Asia's second-largest economy behind Sub-Saharan Africa in attractiveness. Meanwhile, Latin America and Brazil have usurped both of emerging Asia's behemoths.

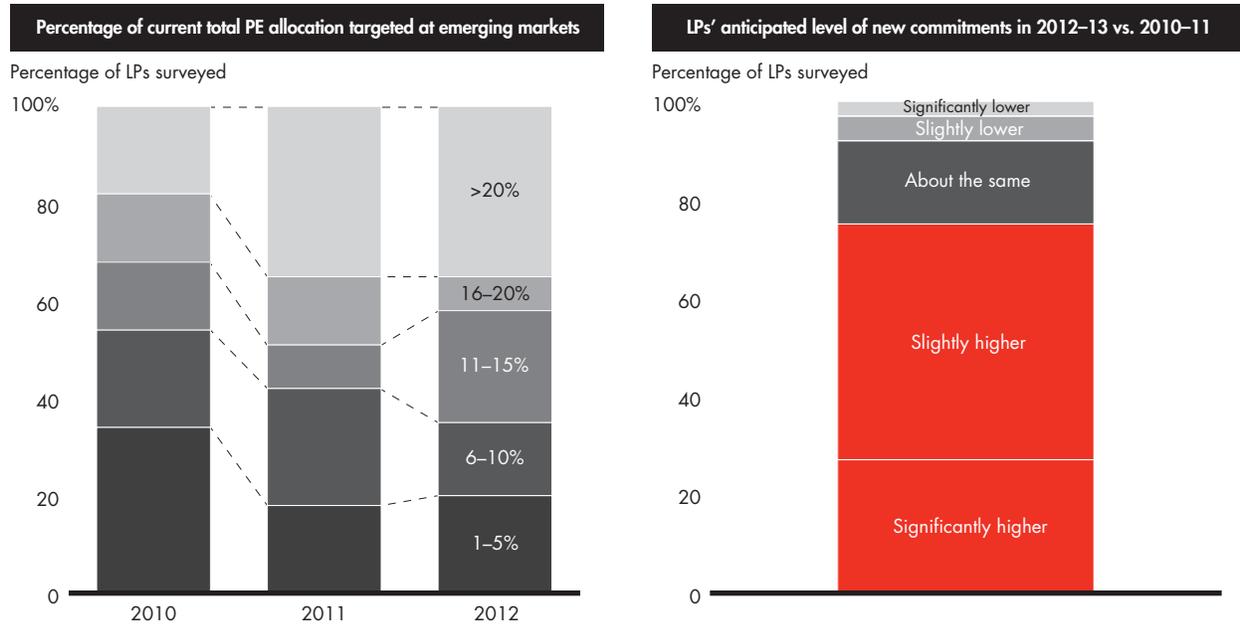
The bifurcated fund-raising market of 2012 underscored that GPs needed a bullet-proof track record and a compelling investment strategy to win over LPs that had the capacity to make new PE commitments. This is a lesson that is also apt to apply in 2013 and beyond.

Returns: Gaining an alpha edge

The bottom line for GPs and LPs in any year—and particularly in a hard-to-read year like 2012—is “how much money did we make?” Based on the latest one-year horizon fund return data available through last June, the answer is not reassuring. Overall PE internal rates of return averaged just 5.5%, the weakest performance since 2008 (*see Figure 1.25*).

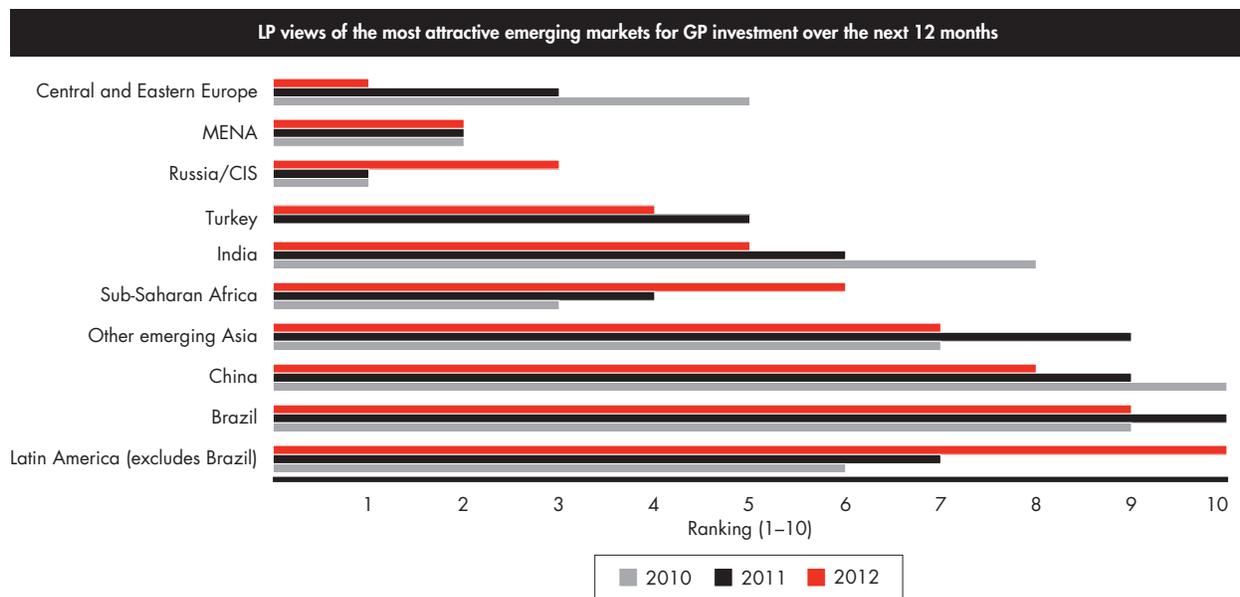
Given the large overhang of unrealized assets, last year's PE returns largely reflected changes in portfolio valuations of investments that GPs had yet to sell. Valuations, in turn, tracked swings in public equity markets, thanks

Figure 1.23: LPs maintained their target allocations to emerging markets and continue to increase their exposure



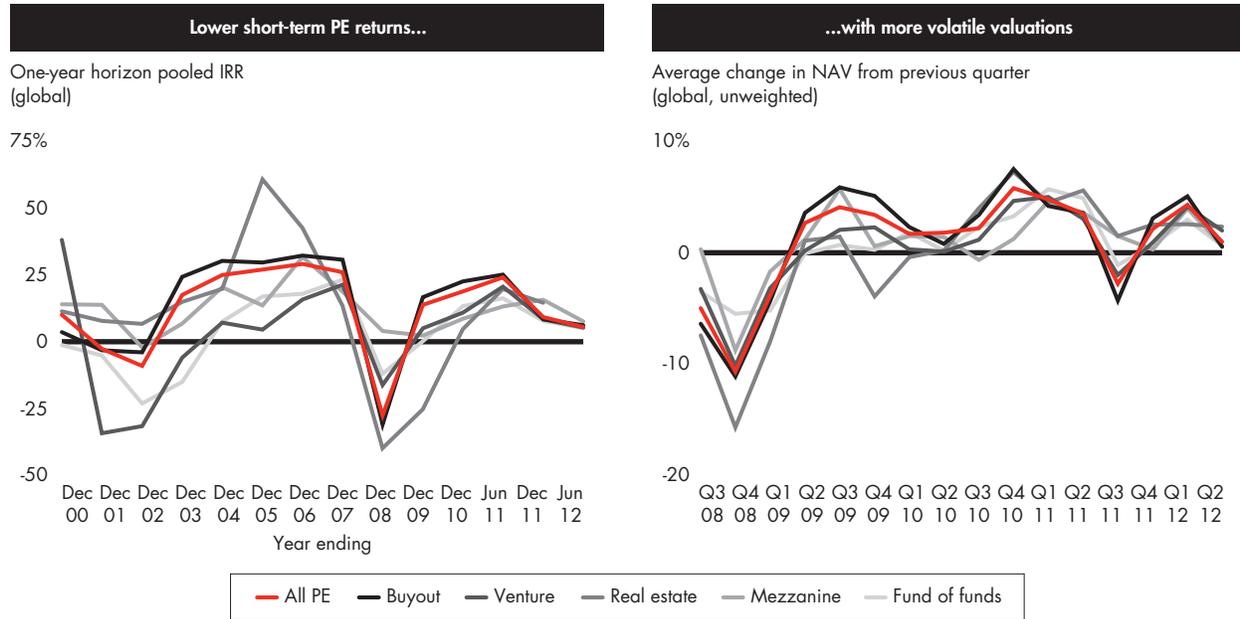
Source: EMPEA Global Limited Partners Survey 2012 (n=106 PE limited partners; survey conducted between December 2011 and February 2012)

Figure 1.24: Brazil and the rest of Latin America have emerging markets for PE



Notes: Emerging markets ranked on a scale of 1 to 10 (with 10 being most attractive); Turkey was not included in the 2010 survey
 Source: EMPEA Global Limited Partners Survey 2012 (n=106 PE limited partners; survey conducted between December 2011 and February 2012)

Figure 1.25: Short-term PE returns have slowed down



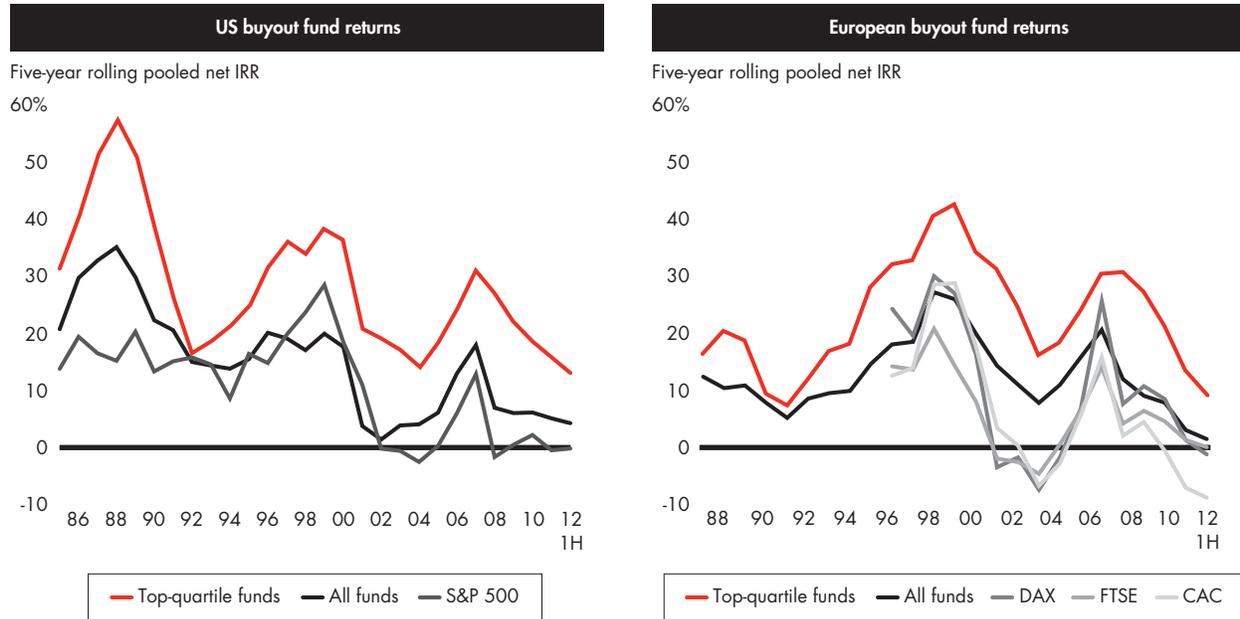
Source: Preqin

to mark-to-market accounting implemented during the crisis. In the 12-month period through June 2012, stock markets were prone to jitters about possible sovereign-debt default and a potential double-dip recession. That volatility took a toll on PE valuations, affecting PE fund returns in all major geographies and all size categories. Funds that focused on the European and Asian markets experienced more volatility in their valuations and suffered the steepest declines in their short-term returns. The swings were also more pronounced for the biggest buyout funds, in part because they typically use more leverage than the smaller funds do.

But what the most recent PE industry data do not show is the boost in valuations and returns that resulted from strengthening public equity markets in the year's second half. The gains posted by publicly traded investment firms hint at how much better the full-year returns for PE in 2012 will turn out to be. For example, the carrying value of KKR's PE portfolio appreciated 24% in 2012. For Apollo and Blackstone the same figure rose 25% and 14%, respectively.

If short-term returns looked shaky in 2012, GPs and LPs can take heart in PE's more relevant longer-term return profile. PE funds continued to outperform US and European public equity markets by a healthy margin over both the past five and 10 years (see Figure 1.26). Returns posted by US-focused buyout funds beat the S&P 500 index by 5 percentage points, on average, since 2003. European funds topped a mix of the leading public equity indexes by 7 percentage points over the same period. The performance of the top-quartile US and European funds was even more impressive, besting their respective market index averages by 19 percentage points.

Across the PE industry's history, returns have benefited from GDP growth, expanding multiples and the power of leverage—all sources of what is sometimes called beta. But the impact of beta has varied over time. The past

Figure 1.26: PE funds continue to outperform public markets over a five-year horizon

Source: Thomson Reuters

few years have made it crystal clear that GPs investing today can no longer count on substantial beta to lift returns but instead will need to apply the power of alpha, or active value creation, to achieve superior returns in the future. Although generating alpha has become more important than ever, it has also become more challenging. Coming out of the downturn, most portfolio companies are already running lean from cost-cutting. Going forward, alpha will need to come mainly from profitable revenue growth, which can do more than just squeezing out more costs to improve exit multiples.²

Bain has worked with portfolio companies on a wide variety of growth initiatives. Two that are especially well-suited for PE-owned companies, because they can generate a lot of value quickly are programs that sharpen the company's pricing capabilities and those that enhance the effectiveness of its salesforce.

The potency of pricing. No capability has a bigger effect on profit growth than pricing. Bain estimates that a 1% increase in the realized price a company commands for its goods and services results in a 15% boost to pretax profits. By contrast, a 1% increase in sales volume has just half as much impact on the bottom line. Yet pricing capabilities are underdeveloped in many companies.

There are many reasons why companies shy away from building pricing capabilities. Hundreds of factors affect the pricing environment and the analytics required to understand them can be daunting. Pricing is also highly dynamic, reflecting continuous changes among competitors, the customer base, the product mix and the interplay among them. And pricing touches every part of the business, requiring input from sales, marketing, finance, suppliers, lawyers and others.

Yet, for all of pricing's complexity, PE-backed companies can pocket many readily available "quick wins" that put money in the bank and help create an appetite for tackling the bigger issues involved in building a longer-term pricing capability. In PE-ownership situations, portfolio companies can spring into action on pricing following a four- to six-week diagnostic and see dramatic results within a year. For example, when a European manufacturer of specialized pipes and fittings used by customers in the construction industry was acquired by a European PE fund, the new owners and management recognized that despite strong sales that brought in some €1 billion annually, the unsophisticated cost-plus pricing system applied to the company's tens of thousands of products was leaking a lot of potential profits. The company worked with its sales reps to identify factors that affect customers' price sensitivity, and then combined the insights it gleaned with actual sales data to estimate customers' price elasticity for each product category. Armed with this information the company was able to raise prices on products its investigation confirmed that its customers most valued. The company also identified and plugged a major source of price leakage, reduced the amount of time it took to pass through price adjustments, introduced tools and procedures to monitor realized prices and provided the salesforce with targeted training and proper incentives. Together, the pricing initiatives enabled the company to increase earnings by some 20%—most of them captured by the end of the first year and all of them in the bank within 18 months.

Supercharging the salesforce. Making a salesforce more productive is a powerful engine for increasing revenues in nearly all companies, and when done right those gains fall directly to the bottom line. Bain estimates that the gains that flow from a focused and effective salesforce can boost pretax earnings by between 20% and 25%, with many of those results delivered within the first year.

Again, most sales organizations fall far short of their full potential. The most visible symptom of underlying problems is the high variability between the productivity of the top-performing sales reps and their less successful peers. But it does not take much deep digging to uncover many indicators as to why the organization is falling behind. Signs of trouble include: falling revenue due to a loss of market share; a sales win-loss rate that is deteriorating or compares poorly with benchmark competitors; an increasing rate of defections by customers in the top accounts; sales reps who spend too much time on the least-profitable accounts; and a customer pipeline that is thin or drying up. That list of deficiencies is also a road map for priority actions for improving salesforce effectiveness.

Portfolio companies can diagnose their salesforce shortcomings and begin addressing them within three months; they will see impressive results within the first year, Bain's experience has found. For example, a US-based payments-processing company recently acquired by a PE fund made improving the effectiveness of its salesforce a centerpiece for meeting its aggressive goal to boost EBITDA by 80% by the middle of the decade. The company began by upgrading its salesforce talent with new recruitment, onboarding and training processes that sought to test for, replicate and track the attributes possessed by its strongest sales reps. In parallel, the company deployed cross-functional "SWAT" teams to build targeted action plans and provide tailored training to boost sales performance in regions that had been perennial laggards. In the third leg of its sales effectiveness overhaul, the company bolstered its new-sales lead generation capabilities. Productivity in 2012 was already 28% higher than in 2011, and the company stands to reap even bigger gains as it continues to strengthen its salesforce effectiveness.

Beyond the striking improvements the growth-oriented alpha-generating techniques like sharper pricing skills and enhanced salesforce effectiveness bring about, these profit and revenue enhancers deliver two more undeniable benefits. For one thing, they open up positive channels of engagement between the PE fund and a portfolio company's top-management team. Just as important (and unlike high-anxiety cost-cutting programs), they and the success they help breed can be highly motivating to portfolio company employees.

Key takeaways

- Two-thousand twelve was a flat year for PE globally, as recoveries in deal activity, exits and fund-raising did not gain momentum. From region to region, GPs' ability to put capital to work depended on how firm the economic outlook was. Where there were doubts about what the future would bring, buyers and sellers found it difficult to close deals.
- Wielding some \$1 trillion in dry powder as the year began, and taking advantage of increasingly favorable credit conditions as it unfolded, GPs pushed deal making forward in 2012. Asset prices remained high in all markets and competition for deals was fierce.
- Deal making increased in North America as GPs gained confidence in the region's continued growth and debt markets strengthened over the course of the year. Europe remained hobbled by deteriorating economic conditions that widened the gap in price expectations between buyers and sellers. In China and India, uncertainty over future growth pushed buyers to the sidelines in the year's first half. Deal activity in these markets picked up in the year's second half as growth expectations firmed up. Latin America continued to beckon PE investors.
- Worldwide exit activity in 2012 fell below the pace of the previous two years. Exit conditions were inhospitable in Europe and Asia; North America gained some traction. Unrealized holdings in GPs' portfolios increased to more than \$2 trillion, an all-time high. Sales to strategic buyers were off as corporations hoarded cash in the face of macroeconomic uncertainty. Volatile equity markets stifled IPOs in Europe and Asia, but the IPO market held up better in North America. Only sponsor-to-sponsor exits were up in 2012.
- Global PE fund-raising increased marginally in 2012, despite the large number of funds on the road and LPs' enthusiasm for PE's continued outperformance. Fund-raising was sharply bifurcated: A favored few GPs were able to reach their targets quickly while the large majority struggled. Many LPs were constrained by their PE allocation ceilings, a slow pace of PE distributions they could recycle into new commitments and large amounts of unfunded commitments from the boom years.
- Short-term PE returns in 2012 largely reflected changes in portfolio valuations of unrealized investments. Full-year returns for 2012 are expected to be higher, boosted by strengthening public equity markets in the year's second half. Over the long term, PE funds continued to outperform public equity markets by a healthy margin on average, with top-quartile PE funds performing significantly better.
- Leverage will continue to provide a lift for returns going forward, but other key sources of beta—GDP growth and multiple expansion—will not supply the boost they did in the past. GPs investing today will need to apply the power of alpha, or active value creation, to achieve superior returns in the future.

¹ North America includes the US, Canada and Bermuda, but excludes Mexico; discussion focuses on the US, as Canada accounts for less than 5% of both buyout deal value and deal count in the region, and deal activity in Bermuda is negligible.

² This excludes, of course, some PE investors that specialize in acquiring distressed assets.

Hot sectors in 2012: Healthcare and energy

PE thrives in those pockets of the economy that are spawning attractive growth opportunities, experiencing rapid technological change, facing a dramatic regulatory shift or feeling pressure to boost efficiency and cut costs. For PE investors who know where, what and how to hunt, the healthcare and energy sectors are target-rich environments on all counts.

Healthcare: Applying PE prescriptions. With its continued steady growth, the healthcare sector has all of the symptoms of an attractive PE play. Patient demand is robust worldwide. In emerging economies, broad populations are gaining access to modern healthcare for the first time. And in the advanced economies, where healthcare cost inflation is far outpacing the general price index, governments, health insurers, employers and other private payers are overhauling reimbursement formulas and restructuring healthcare delivery systems to rein in costs.

This combination of healthy vital signs is luring PE investors around the globe. The number and value of PE buyouts in healthcare accounted for roughly 11% of all deals consummated worldwide in 2012. The majority of deal activity focused on providers (such as free-standing urgent-care clinics and physical therapy centers) and services (from physician practice management to healthcare information technology). Globally, the providers and services segment accounted for 53% of total deal value in healthcare PE in 2012, about in line with its average over the past decade.

From region to region, the healthcare deal activity reflected differences in the regulatory environment and health insurance coverage models. In Europe, PE acquirers looked for assets like nursing homes and medical laboratories that would enable them to take advantage of more efficient purchasing of supplies across country borders. Across Asia, PE investors in the providers and services segment are branching out to fund labs and specialty medical centers and explore concepts in retail healthcare delivery.

In the US, where healthcare faces sweeping changes accelerated by the Affordable Care Act, two hot themes in particular sparked PE interest in 2012. In the first, PE investors targeted physician management organizations, making serial acquisitions of smaller medical practices that they roll up into larger, more efficient groups. GPs are finding two major areas to play within this space. In the first, they are assembling groups of practitioners, both in traditional hospital-centered specialties in such areas as radiology and neonatology as well as in emerging fields of hospital-focused specialization like neurology and general surgery. Investments in physician practice management (PPM)

companies—such as the agreement last December by Welsh, Carson, Anderson & Stowe, a leading GP in healthcare, to back a management team that will pursue assets in anesthesiology—saw increased interest from PE investors in 2012. PE investors are building independent practice associations (IPAs), or groups of doctors with a diverse range of capabilities who together can provide the all-encompassing patient care and case management services that recent health reform measures try to promote. (We will have much more to say about opportunities for PE in physician management organizations in Bain & Company's forthcoming *Global Healthcare Private Equity Report 2013*, due out this spring.)

The second major target of opportunity in 2012 was the retail health category, spanning traditional specialties like dental clinics and urgent-care facilities, as well as emerging areas from fertility to cosmetic surgery. Two features of retail health appeal particularly to PE funds. First, reimbursement terms in many of the health retail categories are attractive, because they are affordable to payers and patients who pay out of pocket for some services. Second, most segments within retail health are highly fragmented and underpenetrated, presenting opportunities for both growth through merger and acquisition, as well as organic expansion. Physiotherapy Associates, a leading provider of outpatient rehabilitation, capitalized on the opportunity to roll up clinics and practitioners in the physical therapy field. Under PE ownership, the company grew to 700 locations across 35 states. Court Square Capital Partners, a New York-based firm, bought the company last year and has continued the expansion, having acquired one clinic and opened four new ones since the deal closed.

Not surprising, the sector's appeal has raised competition for assets to a fever pitch. And because there are so many sensitive moving parts to a retail health enterprise, shaping a value-creation plan begins with a thorough due diligence process that explores four critical areas. The checkup begins with a detailed evaluation of the underlying market dynamics, including the target company's mix of patient vs. third-party payment and how much reimbursement pressure the business faces from payers. Second, successful acquirers take the temperature of how key stakeholders—particularly patients and clinicians—assess the value proposition the target company offers. The third area to probe is the relative scale the target company enjoys in its local market and its ability to win additional market share. Finally, a prospective acquirer needs to weigh the target's potential to expand—either by opening new clinics or through further acquisitions.

Energy: Riding double-barreled growth. The global economy's insatiable demand for energy in all its forms, from power plants and utilities to oil and gas, has made the energy sector a magnet

for capital, innovation—and high-wattage PE interest. Strong recent fund-raising activity by GPs targeting the industry suggests that PE investments in the energy space will be plentiful over the coming years. Big energy-focused investors that are raising capital include Denham Capital, which closed a \$3 billion fund last April; Riverstone Holdings, which recently lifted the hard cap from \$6 billion to \$7.5 billion on its current fund-raising in the face of keen investor interest; and First Reserve, which aims to raise a \$6 billion fund.

Accounting for 10% of all buyout deal value worldwide in 2012, PE investment activity in energy has held steady over the past four years, but the deal mix has shifted. In the years preceding the global downturn in 2008, power and utilities attracted the bulk of PE investment. Last year, however, 83% of energy-related buyout deal value was for oil and gas properties—nearly half of them in the North American market, including 2012's biggest buyout, the \$7.2 billion acquisition of EP Energy Corp. by Apollo Global Management and Riverstone Holdings.

Recent PE deal making in the power and utilities space has focused primarily on emerging markets where rapid economic growth is boosting demand for energy generation and distribution infrastructure. Through its portfolio company Globeleq, for example, Actis, a leading PE firm focused on emerging markets, is developing and acquiring power generation facilities across Africa and Central and South America. The power and utility subsector is also attracting PE interest in Western Europe, where government incentives have encouraged investments in wind, solar, waste-to-energy conversion and other renewables. In both Western Europe and the US, where aging infrastructure requires replacement or reinvestment, PE investors are scouting opportunities in equipment and service companies that supply the components required to keep plants running.

By far the hottest draw for PE investors in energy lately, however, is the oil and gas sector. Here, discoveries of vast new extractable hydrocarbon deposits once locked up in shale rock or in deep-water seabeds have combined to ignite wildcatter fever. In the North American market, the epicenter of the shale revolution, hydraulic fracturing (“fracking”) and new horizontal drilling techniques have unleashed opportunities across the entire oil and gas value chain. Many PE acquirers are staking out claims in oilfield equipment and services, which accounted for 45% of deals in 2012, and will likely remain a mainstay of oil patch deal making going forward.

The appeal of the equipment and services segment to PE investors is easy to understand. Because it resembles investments in traditional industries, it is by far the most approachable way for the majority of PE funds to play in the oil and gas sector, from drilling-rig leasing and seismic testing

to maintenance and transportation contracting. Outside of North America where big state-owned national oil companies (NOCs) and integrated oil companies (IOCs) dominate exploration and production, PE-owned equipment and services suppliers are looking to gain share as the NOCs and IOCs work to replace their resource asset base while outsourcing non-core activities. In any geography, it is critical that prospective PE acquirers develop a clear and compelling value proposition—an offering that is in sync with how oil companies are bundling their needs for contractor services. This means deciding whether to operate at the low-cost end of the business, master complex new energy extraction methods or work in frontier regions of the globe, such as Iraq or in the deep waters off West Africa.

PE funds that invest in equipment and services stand to benefit from the double-barreled growth of the industry's more than \$1 trillion in annual capital and operating expenditures worldwide. Opportunities abound to expand organically (by adding customers or by enlarging the suite of products and services on offer), or through acquisitions (by rolling up competitors in fragmented segments of the industry or by branching out into a new geography).

Like discovering elusive oil and gas deposits, the challenge for PE funds investing in the equipment and services sector lies in ferreting out rich pockets of opportunity. A thorough due diligence process should focus on four key areas: First, a PE acquirer needs to drill into how many different businesses the target company participates in and what its revenue profile is. Second, successful PE acquirers are careful to identify the target business's most important risk exposures, particularly its vulnerability to cyclical swings—and the buffers it has against them. The third priority for effective due diligence in equipment and services is to evaluate the target's position with its customers; companies with strongly differentiated technical expertise whose products and services are mission critical are better positioned to profit from their customers' success. Fourth, successful acquirers carefully size up the target's growth opportunities. At a time of high asset values generally, prices for equipment and services companies fully capture the growth tailwind of the industry, so future growth will need to be created by the new PE owner.

Finally, no due diligence of a target company, whether in healthcare, energy or any other sector, would be complete until the potential PE acquirer sizes up the management team's capabilities. Ensuring that the people who will run the business have the skills and experience needed to realize the company's growth potential is critical for the success of a PE investment in every business.

2. What's happening now: Dynamics for 2013 and beyond

As 2013 got under way, many PE investors likely had a gnawing feeling that they were reliving Groundhog Day. The calendar may have turned but key industry conditions appeared to be fundamentally unchanged for a fourth consecutive year. Blinking under the harsh light of a global economy seemingly frozen in slow-growth mode and vulnerable to any number of macroeconomic shocks, the PE groundhogs were apt to see their shadows in 2013 and return to their long hibernation.

The early harbingers of a PE revival, however, are more in evidence this year than they have been since the global financial crisis. And, indeed, it would not take much to rouse PE activity out of its slumber. Continued record-low interest rates and creditors' yearning for yield coming off a strong debt market in the second half of 2012 make lending conditions for leveraged buyouts and other debt-financed deal making as attractive as they have ever been. Signs of a renaissance in corporate M&A activity bode well for a stronger market for PE-backed exits. Looking to invest their extensive cash reserves into financing their future growth, deep-pocketed corporate acquirers have traditionally been the biggest buyers of PE assets. On the stalled fund-raising front, some large LPs are raising their target PE allocations in their quest to boost overall portfolio returns. An increase in exit activity would allow GPs to provide LPs with long-awaited liquidity, enabling them to recycle capital back into new PE funds.

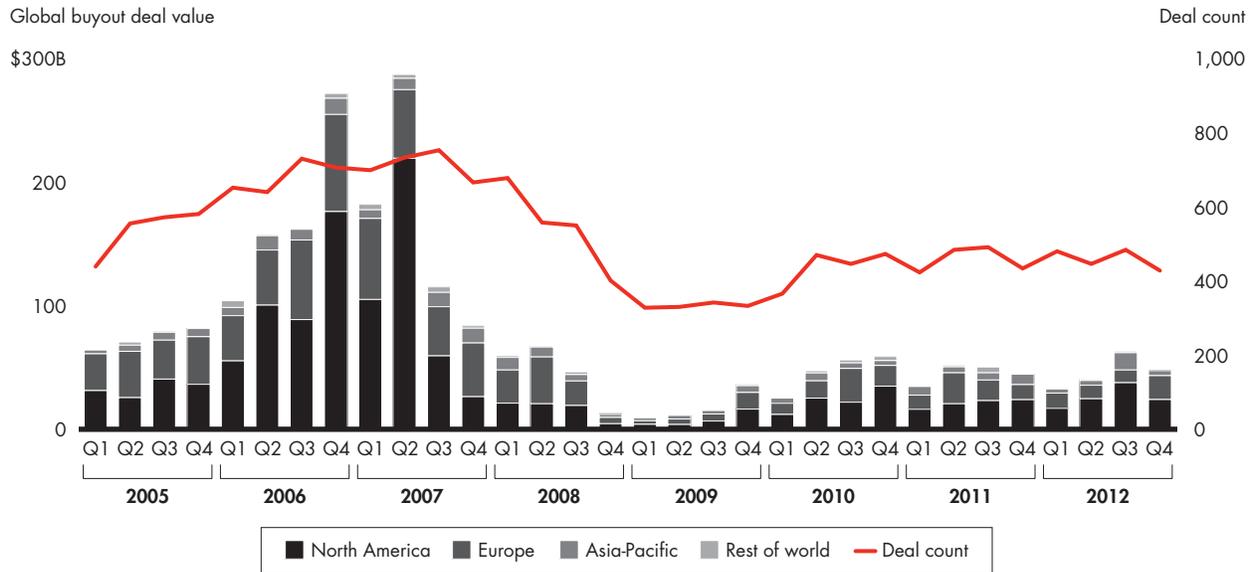
Will a thousand flowers bloom for PE in 2013? Expectations have been beaten down so long that it's hard to find fault with those who argue that the current state of PE markets defines a slower-paced "new normal." There is still enough frost in global economic conditions to nip an incipient recovery in the bud. Until the market for mega-buyouts begins to revive, for example, there will be no going back to the mid-decade go-go years. But stasis is not the normal condition of this creative and resourceful industry. As we will see in this section of the 2013 edition of the *Global Private Equity Report*, leading GPs and forward-thinking LPs are making adjustments that will position them to thrive in a warmer PE climate whether it arrives this year or not.

Investments: Straws in the wind

On the deal-making front, 2013 began much as 2012 ended—directionless and lacking any clear sense of forward momentum. Despite fits and starts, total global buyout deal value in 2012 bounced around in a relatively narrow range from \$33 billion in the year's first quarter to \$48 billion in the fourth (see *Figure 2.1*). Hitting a quarterly peak of \$63 billion in cumulative deal value, buyout activity in the third quarter of 2012 was briefly back to about where it had been in late 2010, its post-recession high-water mark, before edging back down again. Deal count, too, has been flat since early 2010, fluctuating in a range from just above 400 to just below 500 buyouts per quarter.

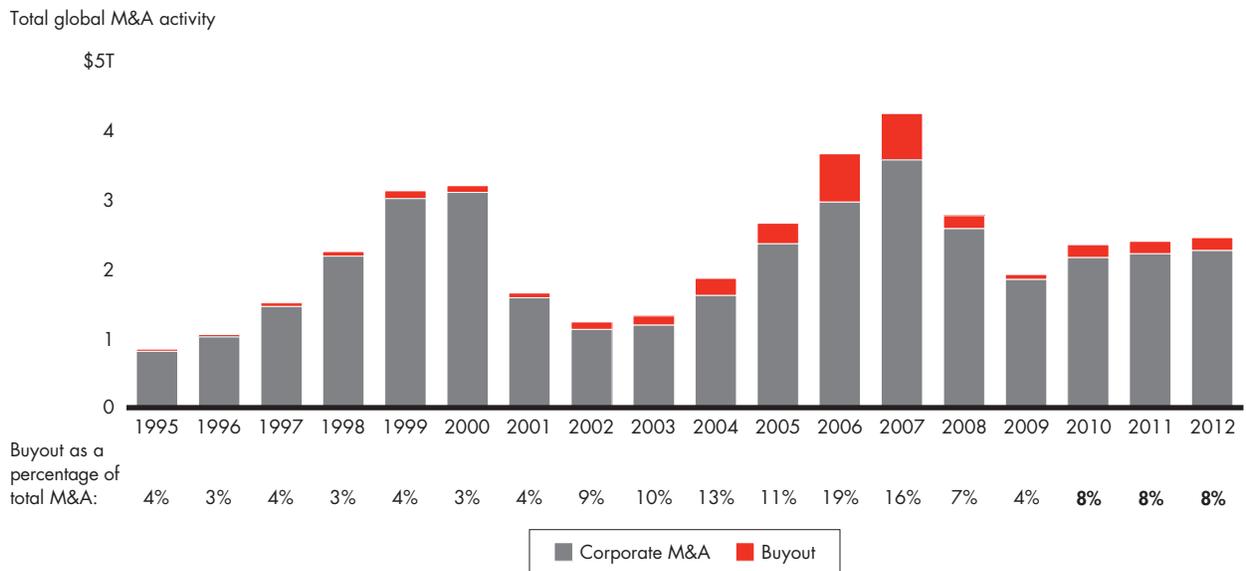
The failure of deal activity to gain traction globally since the financial crisis has raised concerns among many industry observers that PE may be suffering from more than a cyclical slide. To gauge the underlying health of the PE buyout market, Bain looked at how acquisitions by buyout funds compared with the far bigger number and value of corporate M&A activity in recent years. The data clearly show that the LBO market has held its own and do not suggest that there is anything structurally wrong with PE (see *Figure 2.2*). Accounting for a steady 8% of total M&A over the past three years, buyouts enjoy a higher market share post-downturn than they did prior to the last upswing, when the mega-deals of 2006 and 2007 drove up PE's share to as high as 20% of all global mergers and acquisitions. The past few years have simply been a challenging time to do deals, regardless of who the acquirer is.

Figure 2.1: As 2013 began, the PE industry appeared directionless and lacked momentum



Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on the location of targets
Source: Dealogic

Figure 2.2: Buyouts have kept pace with corporate M&A; doing deals has been challenging for everybody



Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; corporate M&A also excludes transactions for which the acquirer is a government entity; based on announcement date; includes announced deals that are completed or pending, with data subject to change
Source: Dealogic

Probing deeper into whether PE might expect to see an increase in buyout activity going forward, we uncovered tantalizing possibilities. Buyouts have failed to keep pace with M&A activity in industry sectors that have been fertile hunting grounds for corporate acquirers but where PE looks poised to make gains. One of these is the energy and power sector, which has accounted for around 20% of all M&A over the past three years. As we described earlier in the report, the energy sector's growth opportunities have drawn increased PE interest lately and attracted substantial new fund-raising commitments. Other sectors where buyout activity could increase include financial services and industrial goods, both big areas for M&A where PE penetration has been low but where restructuring and business-cycle plays could rekindle opportunity.

Those who assert that the experience of recent years defines a scaled-down "new normal" for the PE industry need to contend with several inconvenient facts. For one thing, industry growth would have been far higher overall across the period had major economic upheavals not disrupted PE deal making. In the US and Europe in 2011, the resurfacing of sovereign-debt problems disrupted credit markets, making it difficult to finance deals. Then in 2012, the euro zone's slide back into recession scrambled expectations of buyers (who were reluctant to over-pay) and sellers (who were loath to settle for a lower price) across Europe, making it even harder for the two sides to come to terms.

Furthermore, superficially flat buyout activity between 2010 and 2012 masks shifting regional undercurrents. Despite choppy economic conditions over the past three years, the trend line of buyouts in both North America and Asia-Pacific has increased overall—by 5% and 8% compounded annually, respectively. By contrast, Europe—the epicenter of global economic woes—saw buyout activity shrink by 11% annually over the three-year period through 2012. Indeed, Europe's troubles and the consequent decline in deal making in that region obscured gains elsewhere in the world.

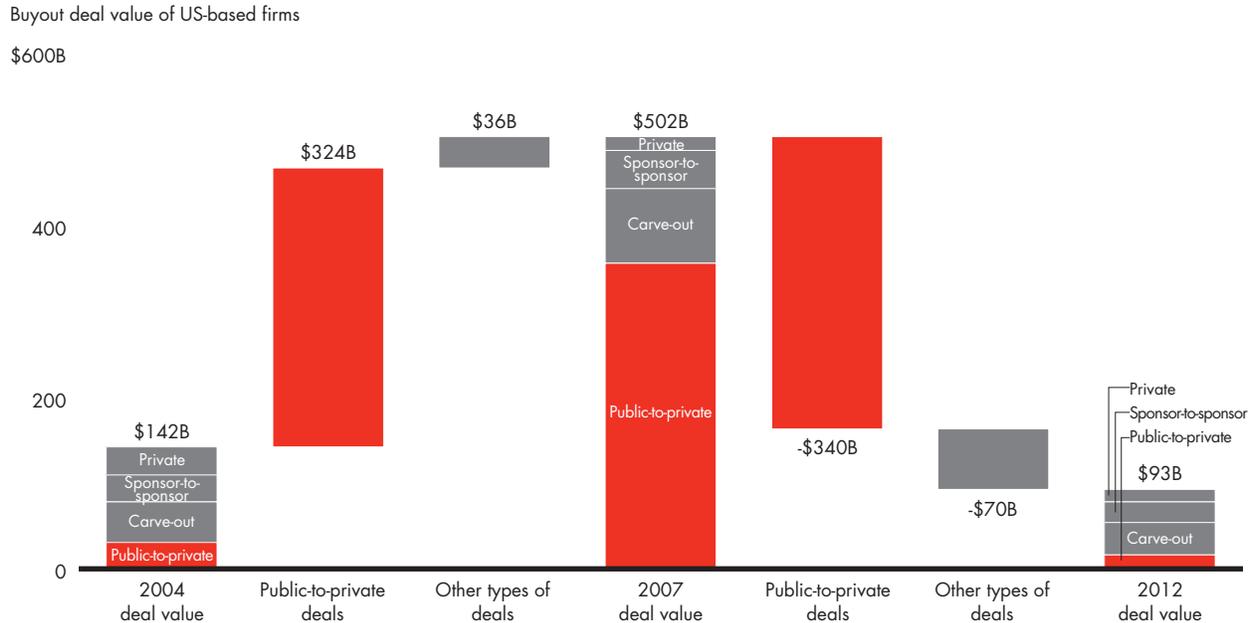
Finally, in the absence of a major economic shock, prospects are good that 2013 will be a better year than preceding ones. Beyond struggling Europe, market conditions for PE are solid. GPs are armed with plenty of dry powder that they are eager to put to work. Debt markets began 2013 far stronger than they had going into 2012, with both the cost and availability of borrowing for LBOs very favorable. And some high-profile macro concerns have lifted with the resolution of the US presidential contest, the avoidance (for now, at least) of the fiscal cliff, and the increased likelihood that China's economy is headed for a soft landing.

The PE industry's growth since 2009, however, does not suggest that the industry will become much bigger anytime soon. Based on current trends, with European PE remaining at its 2012 level of activity and the North American and Asian PE markets continuing to grow at the same rate as they did between 2010 and 2012, the industry would expand from last year's disclosed deal value of \$186 billion to about \$195 billion. But such strengthening as the PE market has seen over the past few years only hints at what 2013 could bring.

A public-to-private comeback?

To push the amount of PE capital invested into a higher orbit would require a major revival of public-to-private deals that dominated PE's last cyclical peak and have been so notably absent since then. Between 2004 and 2007, public-to-private buyouts accounted for 90% of the increase in total buyout deal value. Since 2007, the end of "take private" deals contributed to 83% of the drop in deal value (*see Figure 2.3*).

Figure 2.3: Public-to-private deals powered the last boom, and their absence since has driven the market down



Source: Bain US LBO deal database

Recent industry and market changes are making public-to-private deals harder to pull off today. Because PE fund sizes are smaller than they were in the boom years, fewer funds have the wherewithal to absorb a mega-deal on their own. PE deal makers will need to join forces with other funds or seek partnerships with large LPs to do big deals. Rising public equity markets make it more difficult for PE funds to identify good companies they can buy at a low enough price to make the math work.

What would it take to power a revival of public-to-private deal making? The basic formula is simple: Buy a public company at a “reasonable” price (generally less than eight times EBITDA); add a lot of debt (ideally in the range of six to seven times EBITDA); then through a mix of industry growth and by taking actions that create value, achieve about 5% top- and bottom-line growth. The challenge for PE funds, of course, is identifying publicly traded companies that meet those criteria. Indeed, the problem with the mega-deals made during the mid-decade boom years was that too many PE funds paid too much (in the range of 12 times EBITDA or higher) for businesses they ultimately discovered did not have strong growth potential and are now suffering from multiple compression as the value of the asset they purchased has declined. PE firms that paid less for a mediocre or cyclical business have not fared any better, as absent earnings growth the returns are just not there.

For a public-to-private deal to be attractive, would-be PE acquirers need to be satisfied that a transaction they may be contemplating meets three criteria before they proceed. Let’s consider how conditions line up in the current climate and examine how they compare with those that prevailed in the boom years, when KKR, Bain Capital and Merrill Lynch teamed up to acquire HCA, the US’s largest publicly traded hospital company, for \$32.7 billion in one of the biggest mega-buyouts of all time.

The first criterion: Is the target company a good business, that is, can it profitably increase revenues and generate returns that exceed the cost of capital? The due diligence process needs to confirm that the target has a strong market position, share trend, market growth and return on capital. It also needs to weigh the company's business-cycle risk and how much free cash flow it generates. In the case of HCA, due diligence confirmed that the hospital chain was the leader in its industry, gaining share in a stable market that was growing at between 4% and 6% annually. In its last year as a public company, HCA generated \$2.1 billion in pretax earnings and was achieving a return on capital expenditures in the range of 10% to 12%, easily covering the cost of capital at that time.

The second criterion for public-to-private acquirers to evaluate: Is the acquisition price attractive relative to the company's growth prospects? There is not enough magic in leverage or growth to generate attractive returns if the price paid for the company is too high. At HCA, KKR and Bain Capital saw that revenue growth was already strong and that there was sufficient room to improve profit margins, making the company a good deal at the price they paid. As owners, they improved margins by investing strategically to expand offerings in profitable services like cardiac care and orthopedics, controlling costs through improved data and management processes and taking advantage of HCA's national and regional scale to improve back-office efficiency.

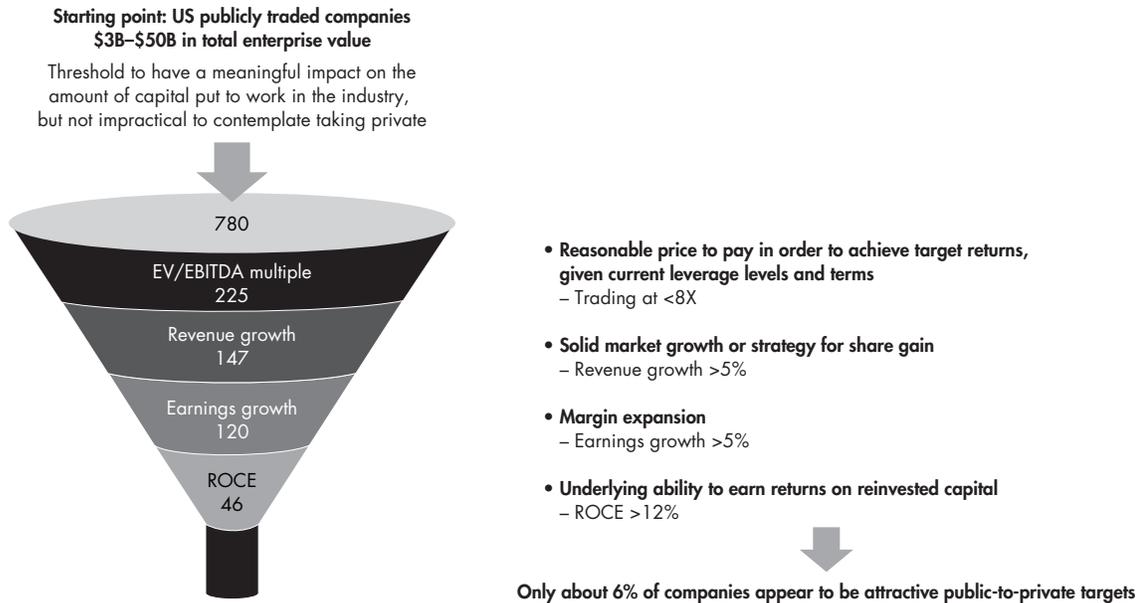
Criterion No. 3: Is sufficient leverage available at low interest rates to allow for a good return? Debt multiples for large US buyouts of companies with pretax earnings above \$50 million were 5.5 times EBITDA in the fourth quarter of 2012—high by historical standards. Indeed, with the debt markets as strong as they are going into 2013, it is conceivable that they will close in on 2007's record-high average of 6.2 times EBITDA for similar deals. Interest rates today are far more favorable than in 2006 and 2007, with the cost of debt currently around 6% vs. nearly 8% in the boom years. And the desire for yield is leading creditors to arrange large debt packages able to support big deals. Today's debt markets are about as robust as they were when the HCA deal was done. The buyout firms and their partners together chipped in total equity of just \$5.5 billion for HCA, or less than one-fifth the company's acquisition price.

The strides that HCA made while in the hands of private equity owners paid off when KKR and Bain Capital decided to exit, more than tripling their original investment. Like most very large public-to-private deals, the PE owners had no real alternative for selling HCA other than to return to the public markets. The company's size and market position ruled out a sale to strategic buyers or other PE sponsors. GPs that take a business private need to pay a control premium, making it essential that they add a lot of value in order to generate returns when they return to the public markets.

Faced with those stringent criteria and 2013 market realities, how many companies pass the sniff test as potential "take private" candidates today? To find out we screened all 780 publicly traded US companies with a total enterprise value between \$3 billion (a proxy for the threshold size a deal would need to reach to have a meaningful impact on the amount of capital put to work in the industry) and \$50 billion (the largest practicable deal size). Just 46 companies—only about 6% of the initial candidates—satisfied the reasonable assumptions we applied to qualify as attractive targets (*see Figure 2.4*).

Although this analysis does not lead us to anticipate a large number of big public-to-private deals in 2013, it would not take many to move the needle on deal value. Even if the North American buyout market were to otherwise remain flat in 2013 compared with 2012, the \$24.4 billion Dell deal alone would push up total disclosed deal value in the region by 24%.

Figure 2.4: How many companies today might be attractive public-to-private targets?



Note: ROCE is return on capital employed
Sources: Capital IQ; Bain analysis

With or without a return of take-private deals, the investment picture for 2013 is brighter than it was a year ago, setting the stage for a bigger result. Continuing to fuel PE investment activity, dry powder at the beginning of 2013 totaling nearly \$900 billion globally (\$335 billion of it for buyouts alone) is already in the hands of GPs eager to do deals. Capital commitments from buyout fund vintages dating back to 2008 or earlier account for 29% of the total and are still waiting to be put to work. Estimating the amount of buyout equity capital put to work at the pace of deal making over the past few years, that money alone would be sufficient to fuel deal making in 2013. Moreover, money is poised to flow to where the deals are. North America remains by far the biggest market of interest to PE investors. Total dry powder looking to be invested in emerging markets has surpassed the amount targeting Western Europe (see Figure 2.5).

GPs have drawn down their stockpiles of dry powder some in recent years, and new fund-raising has slowed. Nevertheless, Bain estimates that assuming North American and Asian deal making continues to grow at its recent pace and Europe remains flat, uncalled capital commitments could be sufficient to finance buyout activity for the next 3.1 years (see Figure 2.6). This ensures that competition for deals will continue to be intense in 2013.

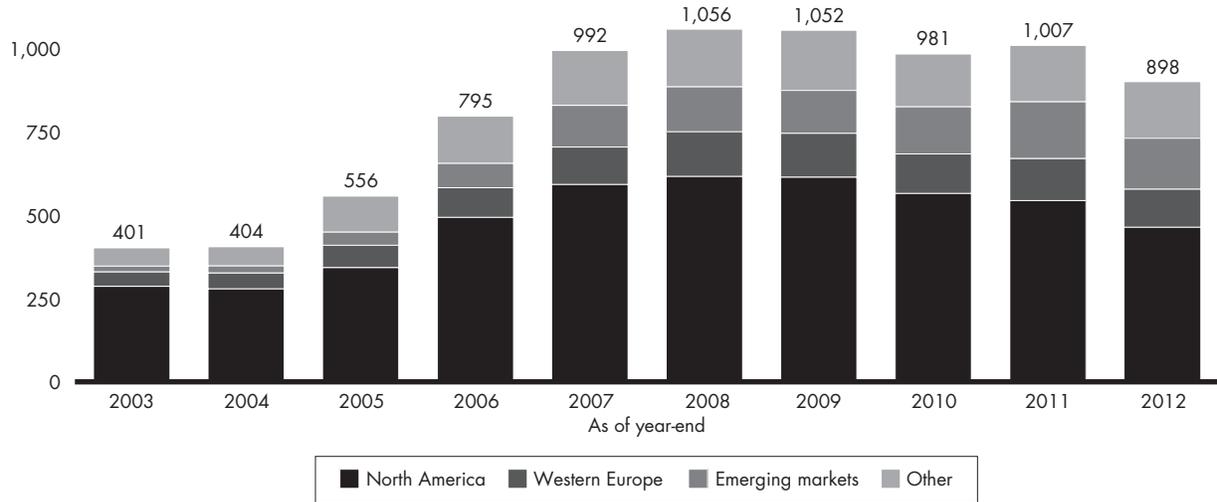
The big borrowing rebound

The biggest factor favoring a pickup in PE investment activity in 2013 is the big “open for business” sign hanging over the global debt markets. Unlike last year, when lenders remained sidelined by a host of worries, beginning with the sovereign-debt crisis, financing conditions going into 2013 are robust from the outset. Investors of all sorts, from those interested in hedge funds to loan mutual funds, are hungry for yield wherever they can find it in today’s climate of sustained near-zero interest rates, and they are flocking to buy new debt issuances from PE borrowers.

Figure 2.5: Capital is poised to flow where the deals are; emerging markets have surpassed Europe

Global PE dry powder (by investment region focus)

\$1,250B

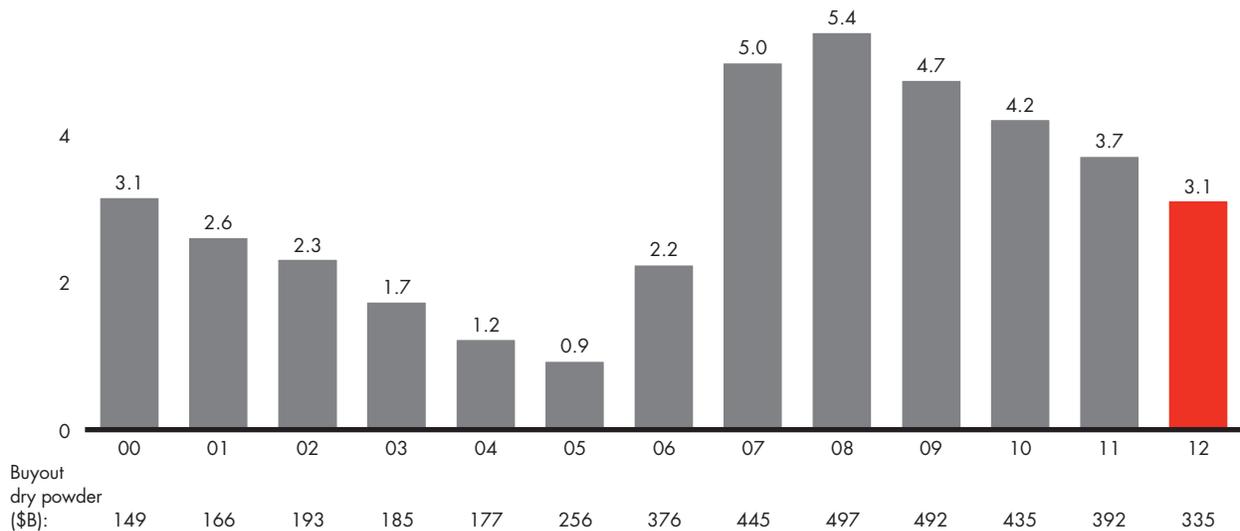


Note: Other includes developed countries outside of North America and Western Europe, global funds and funds that invest in both emerging and developed markets
Source: Preqin

Figure 2.6: Current stockpiles of dry powder could finance all buyouts for the next 3.1 years

Duration (buyout dry powder/actual or projected equity value of transactions completed in future years)

6 years



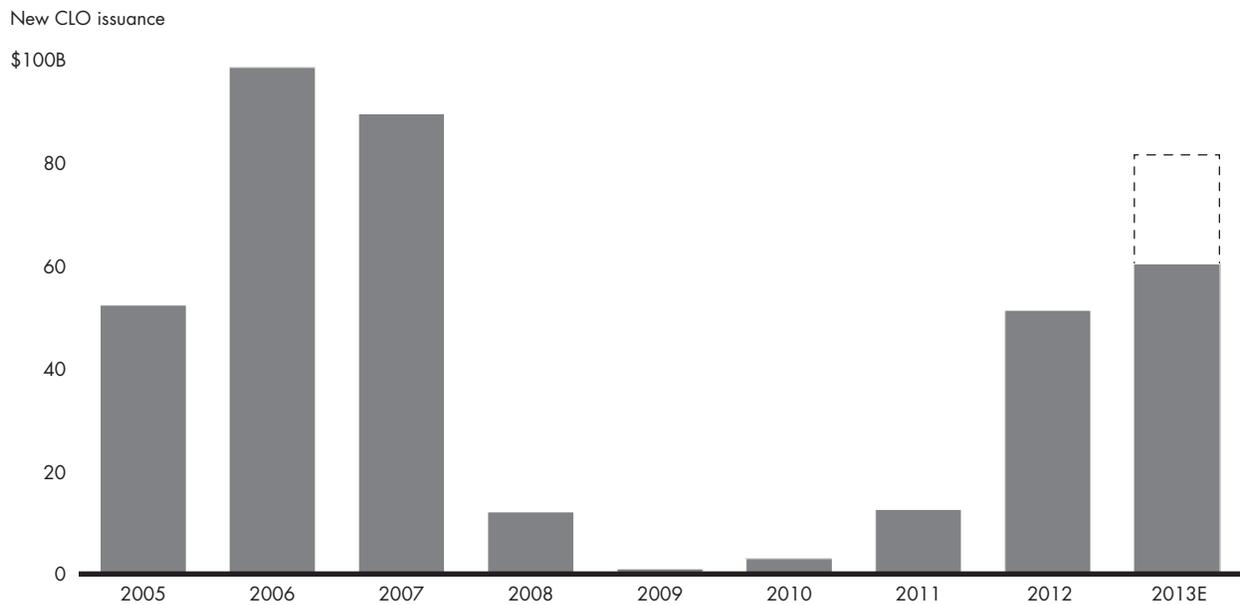
Note: Analysis for 2000–08 calculations based on actual equity value of transactions in future years, 2009–12 calculations incorporate forecasted projections
Sources: Preqin; Dealogic; Bain analysis

The recent surge in demand for PE debt with few or no covenants is a major shift. Coming out of the downturn, debt markets were fixated on the looming wall of refinancing of hundreds of billions of dollars in leveraged loans issued to pay for the big buyouts done at the peak of the PE cycle. Over the past few years, companies have leveled the refinancing wall through bond-for-loan take-outs, amend-and-extend transactions and by paying down loans.

Meanwhile, new collateralized loan obligation (CLO) issuances revived. By the end of this year, some 80% of the CLOs issued between 2004 and 2008 will have passed their reinvestment end date, nearly closing the books on the debt wall of the boom years. But as this legacy debt expires, new CLO issuances will more than replace it, resulting in CLOs continuing to increase their overall share of the leveraged loan market. CLO issuance, meanwhile, hit a post-downturn peak of some \$50 billion in 2012—approximately four times the total volume for 2011—and appears to be headed far higher in 2013 (*see Figure 2.7*). Targeting returns ranging from the low to mid-teens, forecasters estimate CLO issuances could increase to between \$60 billion and \$84 billion this year. Barring an economic shock that causes investors to retreat to the sidelines, the biggest shadow overhanging new CLO issuance is whether there will be a sufficient loan supply to gird up risk spreads (and with them, CLO returns) enough to continue to attract investors.

As capital poured into the debt market from investors seeking yield, assets under management for another key investor in the loan market, loan mutual funds, rose to an all-time high of more than \$90 billion by December 2012. Indeed, there seems to be no limit to the capital pouring into the high-yield debt markets, which means plenty of debt will be available for LBOs and at a low cost that will make more deals possible.

Figure 2.7: Resurgence of new CLO issuances indicates strong leveraged-loan demand as investors hunt for yield



Notes: Nearly all CLOs are issued in the US; dashed segment at top of 2013E bar represents upper range of expected issuances
 Source: S&P Capital IQ LCD

The changing contours of deal making

PE investors are bracing for the familiar combustible effects that invariably follow when a plentiful supply of dry powder mixes with record levels of available debt: hot competition to land deals and higher acquisition prices. But two factors—sharply divergent growth prospects in different regions of the world and a pickup in sponsor-to-sponsor transactions—will give deal making in 2013 a distinctive character.

The regional growth factor. Differences in economic outlook across the globe will sharpen the regional flavor of investment activity. In North America, continued confidence that the US economy will stay on its recovery course in 2013 will be essential for buyer and seller price expectations to remain aligned. However, lingering doubts persist as to whether the economy will strengthen or stall. The economy is rolling along on its slow-growth track coming into 2013, but question marks hanging over whether festering fiscal problems will be resolved this year make it impossible to rule out the risk that GDP growth could flatten. Other indicators, such as weakening industrial production and stagnant personal incomes, are also flashing mixed signals. One overarching positive is monetary policy, which will remain loose throughout the year, giving room for the debt markets to increase the number of deals that will get done in 2013. Other signs of strength include the housing market recovery, which looks to be stabilizing and helping households repair their balance sheets, and a gradual uptick in employment.

What kinds of deals are we likely to see in North America in 2013? As explained earlier, there may be more public-to-private deals done on the back of accommodating debt markets willing to finance bigger transactions. Also, look for sponsor-to-sponsor deals to continue to gain momentum, as GPs look to exit aging portfolio companies on the sell side and put aging dry powder to work on the buy side. The deal market is less likely to see a wave of private-company acquisitions or carve-outs coming on the heels of a good year to sell in 2012. Few sellers were holding out for better times ahead.

The deal environment in Europe will be more problematic. For activity to pick up this year, PE funds would need to see stronger economic growth ahead. Buyers and sellers also need to coalesce around a common and realistic view about the region's longer-term growth prospects in order to bring prices down to levels that are more likely to clear the market. On both scores, Europe continues to look like a dicey proposition for deal making in 2013. Despite significant progress building a framework for resolving the currency and sovereign-debt crises, the euro zone remains in a soft recession as fiscal austerity measures stifle growth. Even in this generally inhospitable environment, there are sellers waiting in the wings, but few are willing to concede on price in order to close a deal. That leaves sponsor-to-sponsor transactions between motivated PE buyers and sellers as the likeliest source of deal activity for the foreseeable future.

PE's prospects in the rest of the world remain largely tied to macroeconomic conditions in the big emerging markets of Asia and Latin America. More certain GDP growth going into 2013 could be strong enough to support more deal activity, but the specifics of how that will play out will vary from country to country.

Conditions are likely to remain volatile. China's economy looks poised to accelerate in the near term following a period of volatility as the government goosed spending to spur growth following the global financial crises, then tightened credit to curb a spike in inflation, followed by yet more stimulus to prevent the economy from stalling out. Longer term, however, China's growth potential will slow sharply as factors that acted as a tailwind for GDP—strong capital flows, favorable export conditions and a growing labor force—are now reversing and beginning to weigh the economy down. GPs are holding on to a large amount of dry powder they are trying to put to work.

But the PE industry has not experienced an economic cycle like China's current one, and the lack of clarity will make it difficult for the gap between buyers' and sellers' value expectations to close. In this environment, sponsor-to-sponsor activity could pick up since PE funds may be some of the most motivated sellers and other exit channels will likely remain relatively weak.

India remains the most insulated of the major emerging markets in 2013, but its economy has recently hit a weak patch and will not provide much lift for PE investments. The industry is laboring under the burdens of high asset prices, the reluctance of Indian business owners to sell controlling stakes in their companies and virtually no viable exit options to provide liquidity. Until these structural barriers are addressed, India will continue to be a challenging deal-making environment for PE. Meanwhile, as China slows and India looks for a path forward, the emerging economies of Southeast Asia continue to enjoy strong GDP growth that is attracting the increased attention of PE investors looking for greenfield opportunities. Their exposure to China as commodity exporters, however, may create some bumpiness along the way.

PE investors looking to the Asia-Pacific region's developed markets will face a unique set of issues in each. Australia has weathered the past few years remarkably well, but it is entering a period of heightened risk and vulnerability as global commodity demand wanes. The devaluation of the yen may add some buoyancy to conditions in Japan in the very near term, but investors will be battling the powerful headwinds of an aging population and high government debt. South Korea is facing severe economic challenges in the short run, in particular an overleveraged household sector and stiff competition from neighboring exporters China and Japan, although public stimulus spending will likely cushion the downward pressures over the course of the year.

The PE investment outlook for Brazil is in many respects the opposite of India's—a reasonably good climate for PE but an uncertain economy. PE funds that target Brazil continue to attract dry powder, ensuring that deal making will remain active. There are good deals to be done at reasonable prices, but they are becoming harder to find as competition heats up. PE investors are not getting much help from Brazil's economy, which is slowing. As a major commodity exporter, Brazil's economy faces significant near-term risks and longer-term volatility as it rides out the dips and surges in demand for raw inputs, particularly from China. Some of the near-term drag on Brazil's growth, however, has been self-inflicted by heavy-handed government tax, export and interest-rate policies.

The sponsor-to-sponsor conundrum. The second big feature that will dominate deal making in 2013 will be the continued popularity of sponsor-to-sponsor transactions, which is sure to reignite the controversy over whether sales of assets from one PE fund to another are good or bad for investors. There is plenty for GPs to like about sponsor-to-sponsor deals, which is why they will continue to be a rich source in 2013. On the selling side, GPs find it easy to do business with other GPs. Because GPs speak the same language and follow many of the same disciplines, the deals tend to be quick and efficient. On the buying side, GPs are eager to put capital to work, and sponsor-to-sponsor deals are filling their pipeline as other sources of deals have slowed. This has been particularly the case in Europe but increasingly in North America and Asia as well. Market conditions in all three regions in 2013 virtually assure that transactions between PE funds will continue to gain in importance.

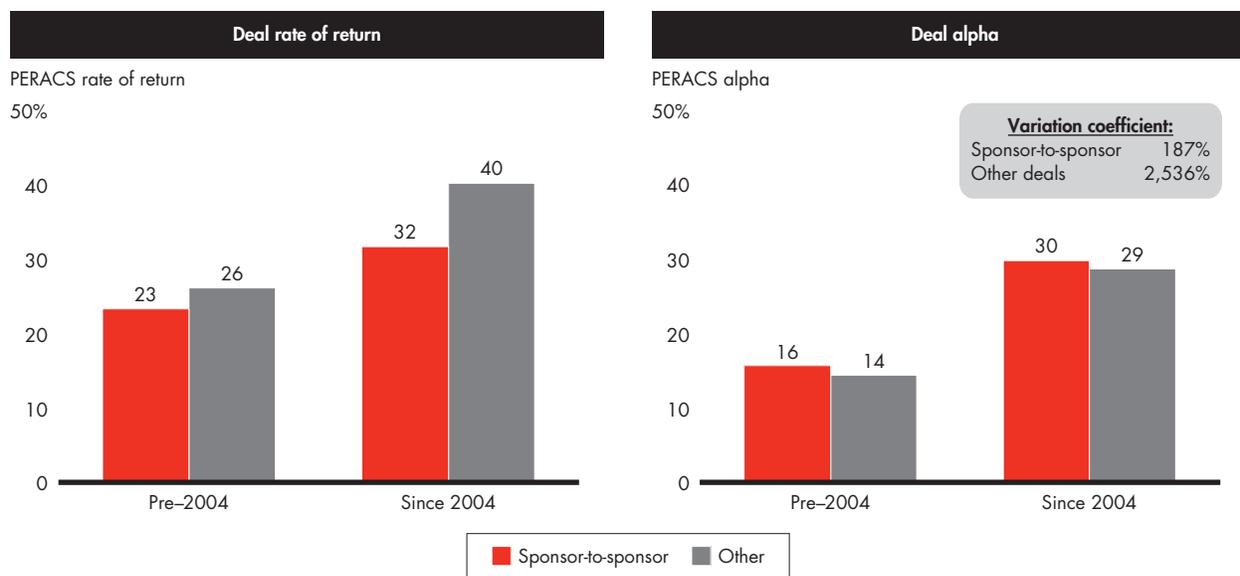
Sponsor-to-sponsor deals have long raised the hackles of LPs, who have been inclined to see them as a triumph of expedience for GPs at the cost of their own returns. The most common criticism LPs express is “frictional costs”—the double-barreled transaction fees that cut into returns for LPs that are both in the selling and buying of funds. They are also skeptical that the new PE owners of the companies at the center of the transaction have truly distinct skill sets that will enable them to find ways to create value that the original PE owner did not already

extract. This is becoming a more widely heard concern among LPs now that some PE portfolio companies have been passed from GP to GP multiple times. How, LPs ask, can a third- or fourth-round sponsor-to-sponsor buy-out possibly produce PE-style returns several times in succession?

That question and many others have attracted recent academic scrutiny. Performance data show that sponsor-to-sponsor deals did underperform other types of deals slightly on an absolute return basis—by 3 percentage points, on average, in the years prior to 2004, and by 8 percentage points since then, according to PERACS, a PE performance analytics company (see Figure 2.8). Yet by the measure of whether successive PE owners are able to generate alpha, PERACS’s analysis reveals that sponsor-to-sponsor deals have consistently performed on par with other types of transactions. Intriguingly, sponsor-to-sponsor deals show a significantly lower variation in the returns they generate, as measured by the variation coefficient in alpha. In other words, sponsor-to-sponsor deals are a lot less risky.

It is understandable why these deals have a lower risk profile than their counterparts. Companies that have been owned by a GP tend to be better known and more readily understood entities, with a capable management team already in place that is accustomed to working with PE owners. It also helps explain why banks are willing to extend more credit, often on more advantageous terms, to companies that have already demonstrated that they can thrive under PE ownership. As awareness of these results spreads, LPs should come to look more favorably upon sponsor-to-sponsor deals.

Figure 2.8: Sponsor-to-sponsor deals perform well compared with other deal types and are significantly less risky



Notes: Averages for each category weighted by deal equity value; alpha takes into account opportunity cost, approximated using the MSCI World Index over the time that corresponds to the deal cash flows; analysis includes 101 sponsor-to-sponsor deals and 660 other deals, all fully realized
 Sources: Data from HEC Paris; analysis by PERACS PE Analytics and Track Record Certification

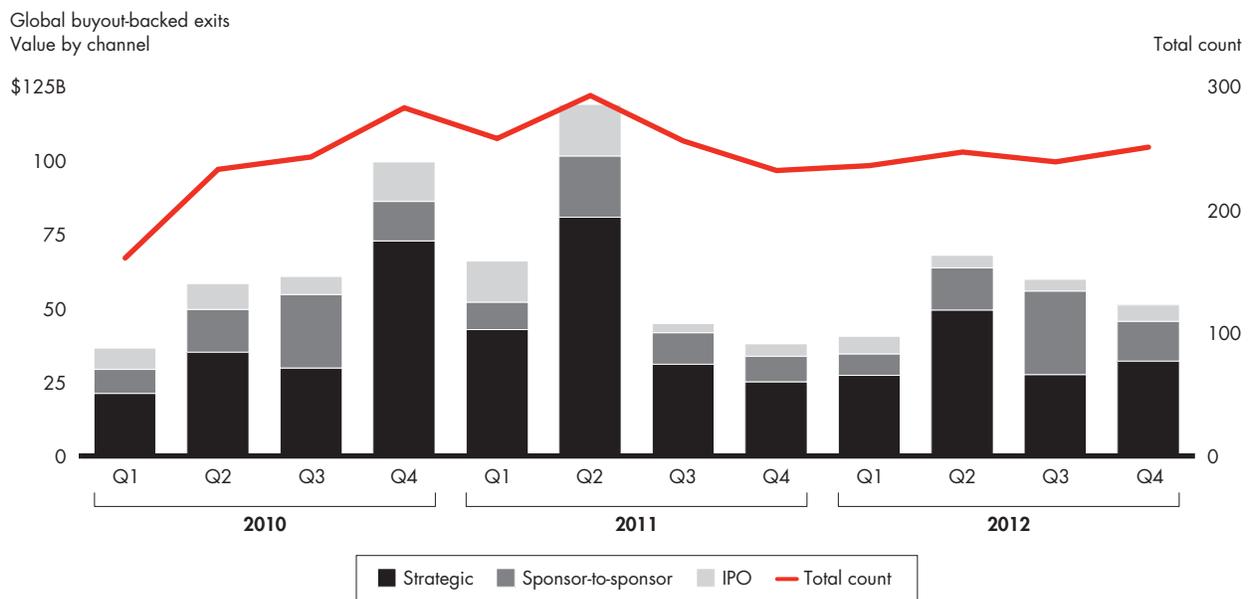
Exits: Moments of truth

On the exit front, 2013 is shaping up as a year of peril and promise. With exit activity sputtering over the past three years, PE funds are increasingly eager to sell the aging assets locked up in their portfolios and return capital to LPs. The internal rates of return for many of those investments are coming under downward pressure as holding periods stretch into the sixth or seventh year since their original purchase. But as the squeeze tightens, there are unmistakable signs that exit opportunities might finally move into higher gear. Corporate M&A is poised to accelerate, bringing critical strategic buyers of PE-owned companies back into the markets. Meanwhile, strengthening public equity markets have rebounded to pre-downturn valuations, a crucial precondition for the possible long-awaited sale of the mega-buyouts through IPOs.

Welcome as the brighter prospects appear, exit conditions in 2013 will come face-to-face with one of the industry's most stubborn and as yet unresolved issues: Much of the unrealized capital in GPs' portfolios is tied up in the big public-to-private deals done during the boom years. Efforts to sell them will test the capacity of exit channels to liquidate these mega-sized buyouts.

Certainly, it was hard to discern many hopeful signs as the year began. Indeed, there was virtually no clear evidence of growth in exit activity since the global financial crisis either by channel or by geographic region (see Figure 2.9). Between 2010 and 2012, only sponsor-to-sponsor sales showed a faint spark of life. Strategic sales fell as corporate buyers hoarded cash and kept their well-stocked wallets in their pockets as they waited for market volatility to ease and for economic growth to pick up. IPOs virtually shut down.

Figure 2.9: As with investments, exits do not appear to be building momentum



Notes: Excludes bankruptcies; IPO value represents offer amount
Source: Dealogic

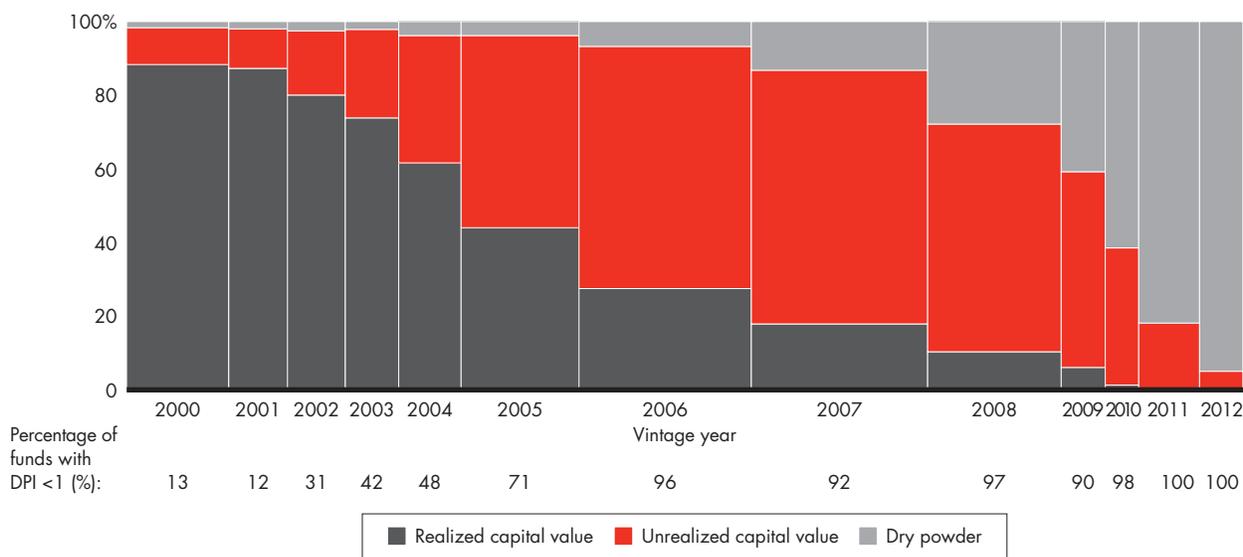
While economic and market uncertainty threw a wet blanket over exits, the backlog of assets PE funds were looking to sell has only grown larger. The exit overhang is heavily concentrated among the big buyout vintages between 2005 and 2008, which account for three-quarters of the unrealized capital (see Figure 2.10). More than two-thirds of 2005 vintage buyout funds have yet to return paid-in capital to LPs, and that figure jumps to over 90% for funds from the 2006–2008 vintages.

The slow pace of exits by the boom-era vintage funds has tightened the screws on GPs. In PE’s largest markets, North America and Europe, the median ratio of buyout fund distributions to LPs’ paid-in capital (DPI) continued to lag in comparison to earlier vintages as the amount of time GPs were keeping LPs’ money tied up stretched longer and longer (see Figure 2.11). For example, five and a half years into the life of the median 2001- and 2002-vintage North America-focused buyout fund, GPs had sent back to LPs two-thirds of the money they had invested. However, the buyout funds from the 2006 and 2007 vintages had returned just 15% and 26%, respectively, of LPs’ paid-in capital by mid-2012. Among Europe-focused buyout funds, the spread between strong capital distributions for earlier vintages and meager distributions relative to paid-in capital for the more recent vintages is even wider—108% and 117% for the 2001 and 2002 funds, respectively, vs. 15% and 14% for the 2006 and 2007 funds five and a half years in.

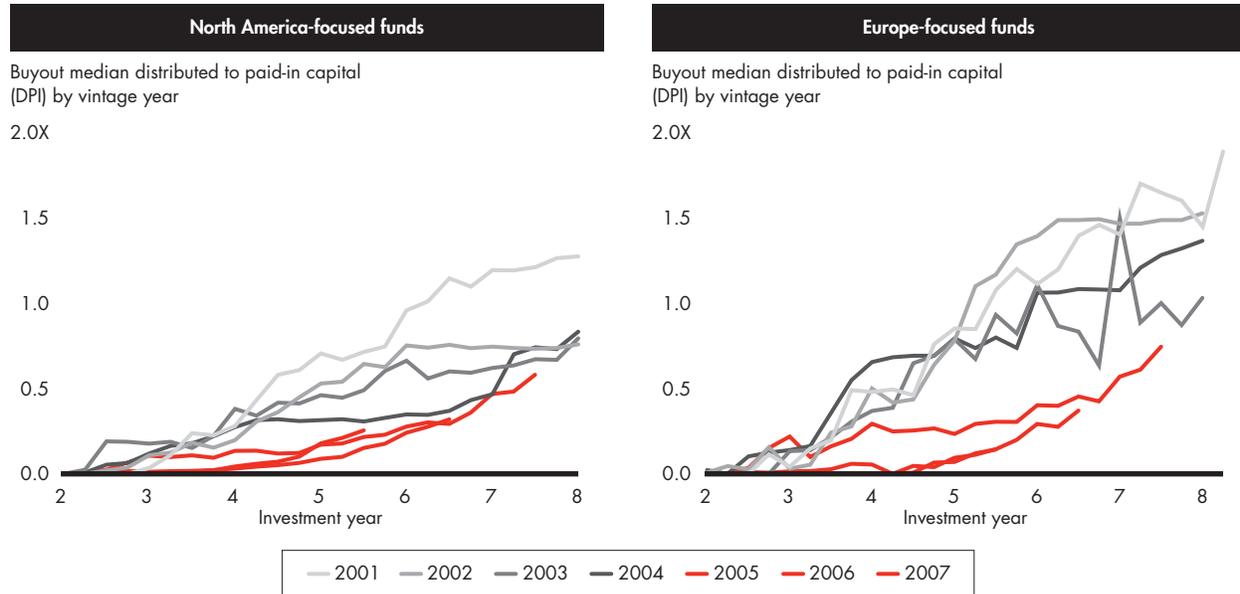
The buildup of an exit overhang is a relatively new phenomenon for funds that focus on the emerging markets of Asia, but it is fast becoming an existential problem for many GPs that are looking to sell a slew of investments they made when the markets started to get hot in 2006 and 2007. In China, local-currency renminbi funds, which took off post-crisis but have much shorter holding periods—typically between two and three years vs.

Figure 2.10: The exit overhang remains large, concentrated in the big vintages raised at the peak of the business cycle

Realized and unrealized capital and dry powder of global buyout funds by vintage year (as of Q2 2012)



Note: DPI is the ratio of distributed to paid-in capital
Source: Preqin

Figure 2.11: Funds in North America and Europe have been slow to return capital

Note: Data as of Q2 2012
Source: Preqin

five years or longer for the foreign-currency funds—are also trying to exit mature deals. The falloff of the IPO market in 2012, long the favored way to exit in China, has created a backlog of companies seeking to exit and has made GPs and LPs anxious about the prospects for liquidity in 2013.

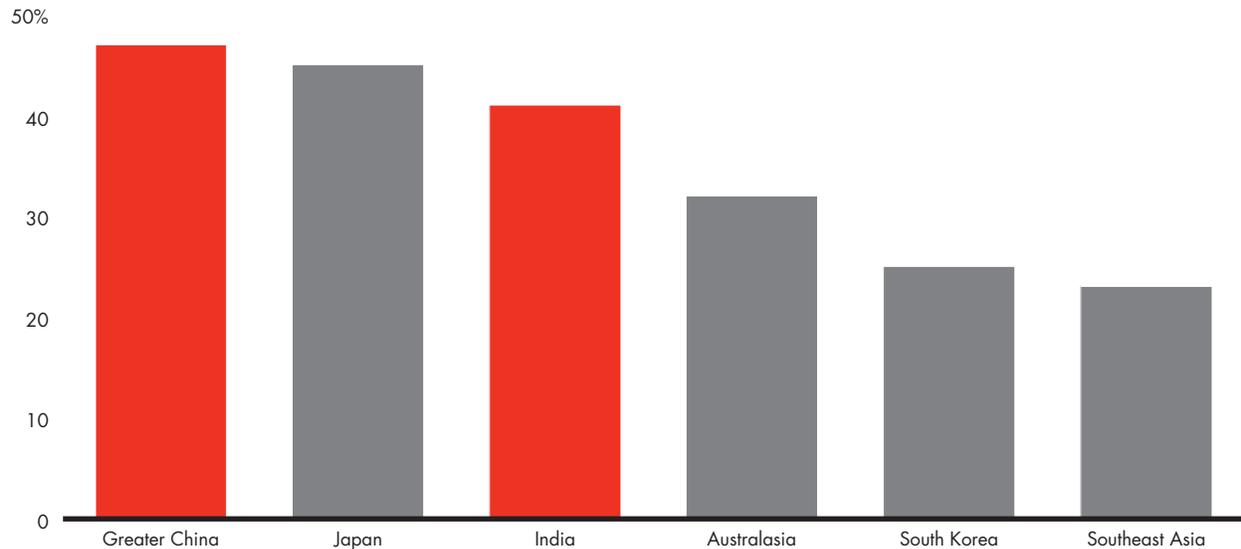
The jam-up at the exits has raised the stakes for GPs that aggressively sold emerging Asia's growth prospects to LPs to demonstrate they are able to cash out of these markets successfully. Harvesting investments is particularly important for GPs that are trying to exit from their first funds in these countries and do not have an established track record of success. But the ability to show realized gains is important even for established GPs that aspire to go back to LPs for new rounds of fund-raising. Those that cannot demonstrate an ability to profitably exit their investments will call into question whether they have a future in these markets. It is little wonder, then, that in a recent survey of Asia PE professionals conducted by Ernst & Young, nearly half of the respondents focused on the China and India markets said that exiting current investments will be a top priority in 2013 (see *Figure 2.12*).

With exit pressures reaching critical mass, prospects for a break in the logjam this year look better than they have for a long time. The outlook is by no means uniformly bright and there are many stubborn problems that will not be solved anytime soon. But from strategic sales, to sponsor-to-sponsor deals, to IPOs, there are enough new sources of strength coalescing to push exit activity to a significantly higher level over the next 12 months—although perhaps not of sufficient strength to meet LPs' liquidity needs.

Strategic sales are poised to ride a renaissance in M&A activity. Corporate buyers have long been the mainstay of PE exits, accounting for the largest proportion of exit activity both by value and count. Even over the past three years while corporations husbanded their cash, waiting out economic uncertainty and market volatility, strategic

Figure 2.12: In Asia, exiting current investments is the top priority for nearly half of GPs in China and India

Percentage of PE professionals that expect exiting current investments will be a primary goal for GPs in 2013 (by region of focus)



Source: Ernst & Young Asia-Pacific Private Equity Outlook 2013 (n=100 PE professionals: GPs, LPs and private equity investment bankers; survey conducted between July and August 2012)

exits made up a higher proportion of all buyout-backed exits than they did during the mid-decade boom years. Measured in terms of absolute value, annual strategic purchases of PE assets were greater in 2010 and 2011 than in any previous year.

Because even a modest increase in strategic acquisitions would make a material difference to PE exits, it is highly significant that nearly 40% of corporate M&A experts surveyed in late 2012 by the accounting firm KPMG described themselves as “more optimistic” or “significantly more optimistic” about the outlook for corporate acquisitions going into 2013. Indeed, all indicators point to an upsurge in corporate M&A activity—from rising public equity markets and low interest rates to strong corporate balance sheets and readily available debt. Measured as a percentage of equity, corporate debt levels have declined since 2008. Meanwhile, corporate cash and cash equivalents have hit record levels, with the S&P 500 companies now holding some \$800 billion on their balance sheets.

Perhaps the overriding mandate for M&A to rise is the pressure corporate executives are feeling from shareholders to put cash to work to fuel their next wave of growth. With GDP of the advanced economies forecast to increase only marginally if at all and even growth in China and India down markedly, organic growth is proving to be elusive. Growth through acquisitions looks to be an attractive option. Bain analysis has found that companies that were active acquirers achieved consistently higher growth in revenues, profits and total shareholder return over the past decade than did those that relied on organic growth.¹

With the M&A stars aligned, 2013 is off to a strong start, with some large PE sales to strategic buyers announced or in the works across the globe. In late January, for example, Starwood Capital Group, a holding company for the international hotel chain, announced a \$1.1 billion acquisition of LNR Property LLC from a PE group led by

Cerberus Capital Management, Oaktree Capital Management, Vornado Realty Trust and iStar Financial. Also announced early this year, Praxair, one of the world's largest industrial gases companies, will acquire NuCO₂, a company that supplies liquid carbon dioxide to retailers, from Aurora Capital Group in a \$1.1 billion deal. Other strategic sales also appear to be in the works. In December, the *Financial Times* reported that US-based Wal-Mart was in talks to purchase Migros Ticaret A.S., the Turkish supermarket and retail affiliate of the big Migros superstore chain, from BC Partners, a Europe-focused buyout firm.

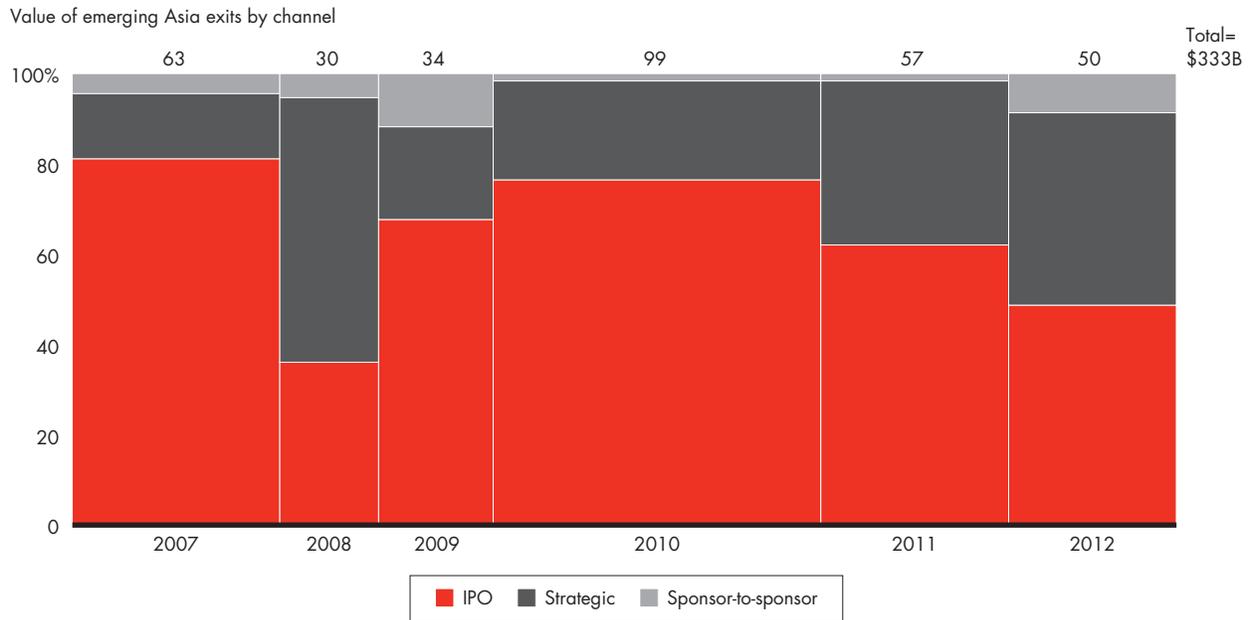
As the size of the recent and pending exits to strategic acquirers suggest, a pickup in corporate M&A will be a boon in sales of smaller and mid-size deals. But given the size and strategic position of some of the biggest companies in GPs' portfolios, the M&A gate is not likely to be open for them. Of the largest 25 buyouts closed between 2005 and 2007, only one has been able to liquidate completely through a sale to a strategic buyer. Alltel Wireless, the mobile telecom services provider taken private in 2007 by TPG and GS Capital Partners in a deal worth \$27.9 billion, was quickly turned around and sold to Verizon Wireless in 2009.

Sponsor-to-sponsor transactions will broaden and deepen. Transactions between PE sponsors have become an increasingly important route to exit over the past three years in Europe and North America. With abundant supplies of dry powder still waiting to be put to work, there is every reason to expect that they will only gain in frequency. But look for sponsor-to-sponsor deals to increase even in India, China and other emerging economies, where they have been relatively uncommon to date. The slowdown in IPOs, long the favored exit option in these fast-growing markets, makes secondary transactions a viable backstop. Sponsor-to-sponsor deals are attractive to buyers in emerging markets because they can dispense with much of the due diligence risk that plagues primary deals. Companies that are at the center of the deals in countries such as China and India are becoming more receptive to secondary transactions. They offer the opportunity to structure the transaction to include a new round of financing that provides a fresh injection of growth capital into the business.

IPOs will face challenges in Europe and Asia, but are ripe for a rebound in North America. One of the most intriguing trends to watch for in 2013 will be the pace of initial public offerings. The pipeline of filings for new buyout-backed listings worldwide was not robust as the year began, and half of the pending buyout-backed IPOs were filed on US exchanges. IPOs were moribund in Europe and look to remain troubled throughout the year. GPs that did the biggest deals in Europe during the boom years will likely continue to have to sit on these companies. In the Asia-Pacific region, the uncharacteristically weak IPO channel heading into 2013 poses significant challenges in a region where IPOs accounted for some 70% of all exits by value between 2007 and 2011 (see *Figure 2.13*). In a survey conducted by Ernst & Young, PE professionals in Greater China, India and Southeast Asia all expected that IPOs will be less viable as an exit strategy in 2013 than they had been in 2012.

China, emerging Asia's largest IPO market, will likely remain in lockdown this year in the wake of a government-imposed suspension of new issues in 2012. A wave of accounting scandals involving audits that misstated the value of newly listed shares of Chinese companies on US exchanges in late 2011, coupled with concern that a flood of new issuances would weigh too heavily on an already slumping stock market, led Chinese regulators last October to impose a moratorium on further IPO approvals until at least March 2013. In addition, the China Securities Regulatory Commission recently introduced stringent new financial requirements for IPOs to restore investor confidence that shares in Chinese companies are not merely a speculative gamble. In the meantime, a bulging backlog of companies has filed their intentions to go public when the ban is lifted. As of the beginning of the year, 900 companies are waiting in the IPO queue, according to Ernst & Young, significantly more than the 362 IPOs completed in 2011 and the 214 done in 2012.

Figure 2.13: The exit stakes are high in Asia, where IPOs have traditionally been the primary channel



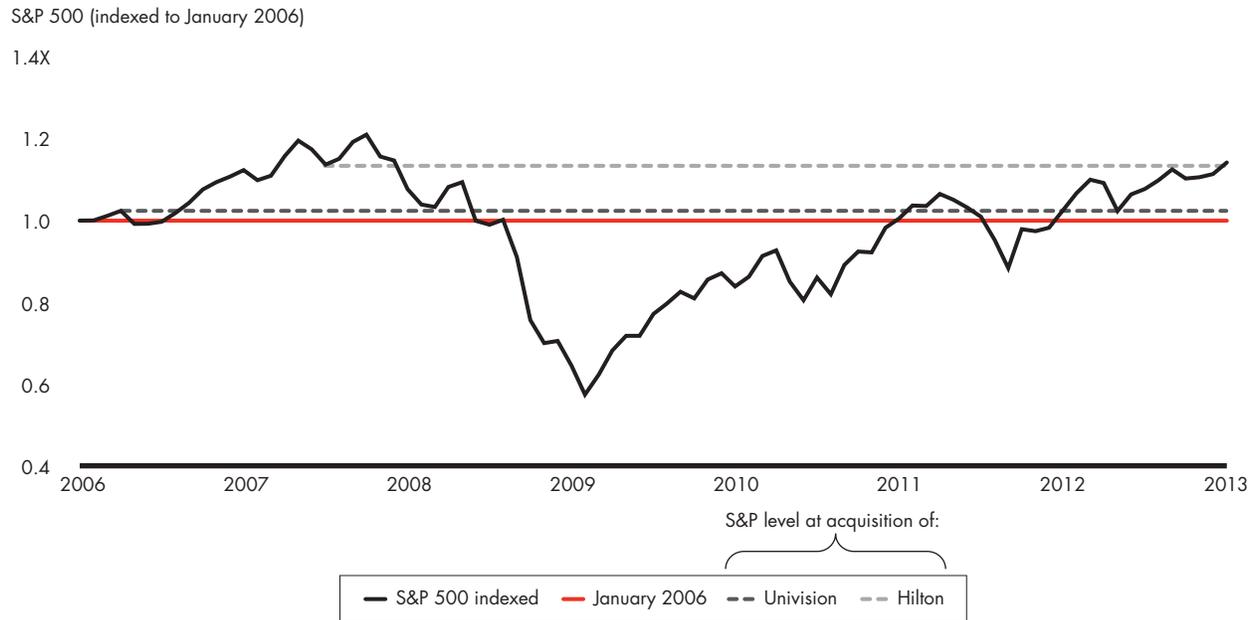
Source: AVCJ

The brightest signs of life on the IPO front are in the US, where the strong run-up in the public equity indexes in 2012 has lifted stock prices back to near their peak prior to the financial crisis (*see Figure 2.14*). If sustained, the gains bode well for long-awaited exits from the frozen boom-era mega-buyouts, potentially allowing liquidity to begin to flow to LPs and providing a major lift for the industry's prospects overall.

To gauge how significant a rebound in US IPOs would be, consider the impact that just two long-held companies would have if the buzz about their possibility of public offerings comes to pass this year. Univision, the Spanish-language media company, was acquired in 2007 by Madison Dearborn Partners, Providence Equity Partners, TPG, Thomas H. Lee Partners and Saban Capital Group. Hilton, the international hotel chain, is a Blackstone portfolio company. Both companies have shown strengthening business fundamentals under their PE owners, who would be in line to reap the gains should they decide to cash out while the S&P index continues to trade at values above the acquisition prices of each. Together, these two companies represent nearly \$10 billion in equity capital invested.

Still, if an uptick in IPOs would be a healthy first step, it is by no means a panacea. Some of the IPO proceeds would be directed to pay down debt rather than for LP distributions, and mandatory lock-up periods following the initial offering would stretch out the time to fully cash out to approximately three years. However, it will take a more robust IPO market to put the wind back into the sails of fund-raising and propel PE back into cruising speed. Will it happen in 2013? Stay tuned.

Figure 2.14: Cracks in the dam have opened for liquidity to flow through IPOs from the mega-buyouts of 2006–2008



Sources: Dealogic; Yahoo! Finance

Fund-raising: Finding equilibrium

There is a hint of something new and unfamiliar in the air on the fund-raising front this year. It's a scent of optimism, and it's coming not just from hopeful GPs that have taken their fund-raising shows on the road. LPs were lifting their sights as 2013 got under way, giving off signals that they may be ready to increase new PE commitments enough to jolt fund-raising out of the flat trend it has been in since 2009 (see Figure 2.15). Among LPs surveyed by Preqin last December, 86% of respondents said they planned to commit as much as or more capital this year than they did in 2012.

Much of that larger appetite for PE, of course, reflects LPs' desperate hunger for yield that will help boost their overall portfolio returns at a time when the bond markets have not been providing much nourishment and the public equity market returns have recently been spicy but erratic. Facing rising obligations to the retirees and institutions they were formed to help support, LPs are increasing their diet of PE as the asset class that will remain the likeliest to serve up supersized returns going forward.

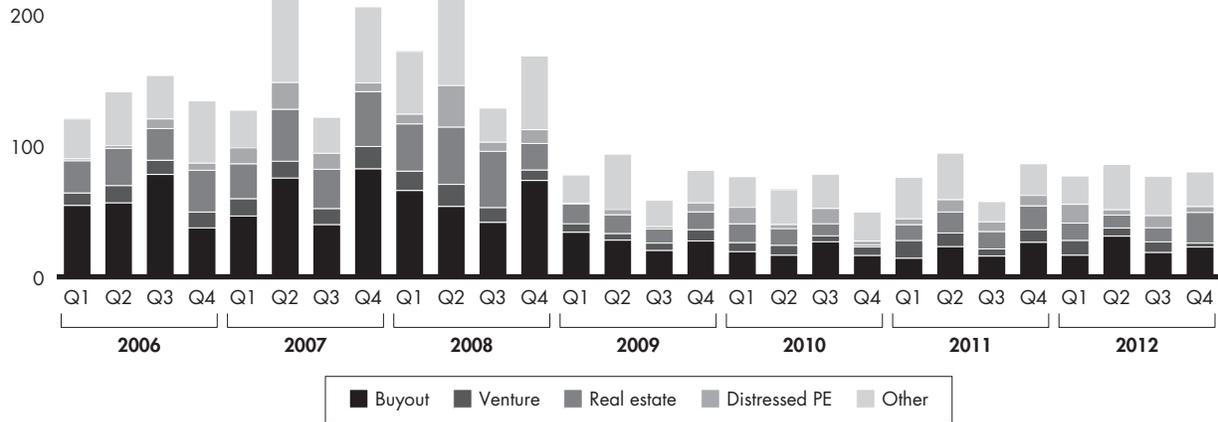
For many LPs, this will mean bumping up against their target PE allocations. Among all US public pension funds, for example, average target allocations to PE increased to 8.3% in January from 7.5% at the beginning of 2012 (see Figure 2.16). The increase was even larger among the biggest pension funds with total assets over \$5 billion. Since last year, their PE allocations have gone up by nearly 1.5 percentage points, to 9.7%.

The Los Angeles County Employees Retirement Association (LACERA) is one public pension fund that has recently lifted its target, which for years had been set at 7% of portfolio assets. But while LACERA's PE holdings

Figure 2.15: Fund-raising has been slow to gain momentum

Global PE capital raised (by fund type)

\$300B

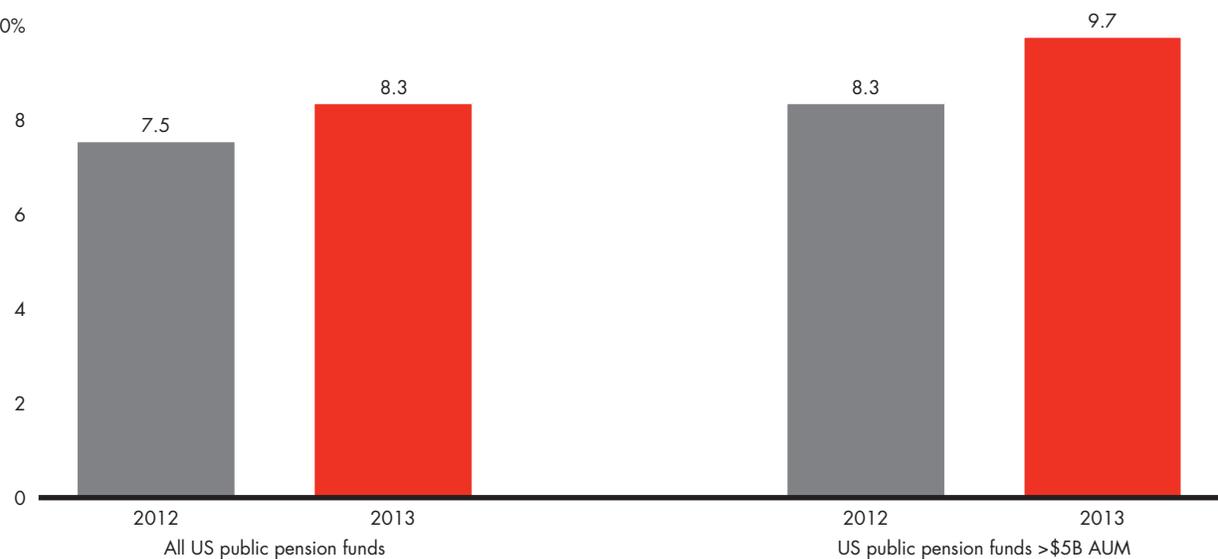


Notes: Includes funds with final close; represents year funds held their final close; distressed PE includes distressed debt, special situation and turnaround funds
Source: Preqin

Figure 2.16: Some LPs are lifting their target PE allocations to make room for new commitments

Average target allocation to private equity

10%



Notes: Data as of January for both 2012 and 2013; AUM is assets under management
Source: Preqin

had flourished, rising at an annual rate of 19.8% over the three years through 2012, its other investments did less well, and LACERA's actual PE allocation had risen to over 10% of its \$38.6 billion portfolio. In order to formally recognize what markets had already done to scramble its asset holdings and provide scope to increase its PE exposure, LACERA bumped up its target PE allocation to 11%. With more room to maneuver, LACERA has already added new PE fund commitments to Lightyear Capital and Europa Capital in 2013.

Other LPs are doubling down on their bet that PE will generate superior returns going forward and making the most of their existing PE target allocations. The Washington State Investment Board (WSIB), which manages \$87.2 billion on behalf of public employees and public trust funds, is doing exactly that. This public pension fund has its PE allocation set at 25% of its overall portfolio but is authorized to move higher or lower within a range of 4 percentage points. In mid-2012, WSIB was already over the target threshold, with PE investments making up 26% of WSIB's total assets under management, but that did not inhibit it from continuing to make big PE bets. Throughout 2012, for example, WSIB committed \$400 million each to Advent International, Oaktree Capital and First Reserve. WSIB and other LPs will continue to stretch toward the upper limits of their allowable PE allocations in 2013.

Recently rising public equity market valuations have also lifted the lid on PE allocations for many LPs. As assets in their overall portfolio expand, LPs can take advantage of the so-called denominator effect and increase their PE numerator to keep it at the same proportion of the total asset base. Just for the 10 biggest US public pension funds, the combination of higher PE allocations and expanding asset bases over the past year represents an additional \$12 billion that could potentially find its way into GPs' hands over the next several years.

That LPs will be loosening their purse strings some this year is encouraging news for GPs that are currently on the road trying to raise new capital. But do not look for fund-raising to pick up significantly until PE markets see an upswing in exits and deal activity. One repeating long-term pattern has been that new fund-raising tends to lag a pickup in exit and investment activity. As buyout deal value rose with the economy's climb out of the 2001 recession, new buyout capital raised trailed by about a year.

The logic behind that pattern is compelling. As an upswing in deal making begins to get under way, LPs' PE allocations are tight as capital calls increase. Their PE capital invested in earlier funds remains tied up but distributions from GPs have yet to flow back to them. Meanwhile, the overhang of dry powder committed to GPs before the dry spell began remains large as they struggled to put capital to work. It is only after GPs can convincingly demonstrate their capacity to whittle down the piles of dry powder and begin to send LPs reliable streams of returns as they cash out of earlier investments that the fund-raising party will really swing into high gear.

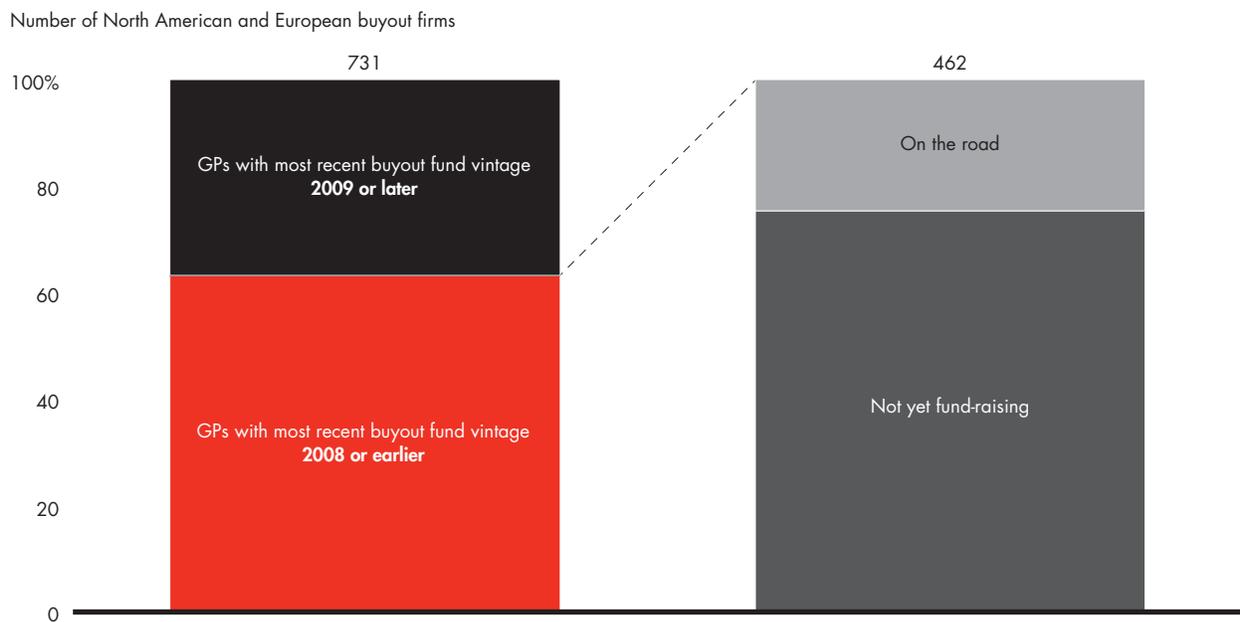
Curb your enthusiasm. How high is "up" given prevailing conditions, and what are the implications for fund-raising in 2013 and beyond? According to Bain's analysis, unless there is a major increase in deal value (such as the potential revival of the big public-to-private deals discussed earlier), it is not clear that the PE industry needs more capital. Taking a holistic view of the current level of deal making we estimate that the PE industry today is putting to work approximately \$100 billion in buyout equity capital around the world.² That amount will rise, of course, as buyout deal making expands. But based on its recent growth path of 5% annual growth in North America, 8% in Asia and remaining flat in Europe, new investment activity will not be a great deal higher in coming years than it was in 2012.

New fund-raising, meanwhile, has accommodated a high proportion of new deal making since the economic downturn. Globally, GPs raised \$78 billion, \$79 billion and \$88 billion in buyout capital in 2010, 2011 and 2012, respectively. They have covered the difference between what they have invested and what they are bringing in by chipping away at the still-large mountain of dry powder already committed to them. At current levels, total buyout dry powder is sufficient to support approximately 3.1 years' worth of investment activity. Thus, if fund-raising accelerates a bit, the PE industry would be at equilibrium, with money coming in about equal to money going out.

Overall, it's a picture of good health—except for the many GPs that will not be likely to meet their aggressive fund-raising goals. They will continue to face a crowded and ferociously competitive environment for bringing in new capital. To get our arms around the dimensions of the challenge they will face, Bain segmented all 731 buyout GPs based in North America and Europe into two groups—one constituting about 60% of the total that successfully closed on its most recent buyout fund in 2008 or earlier; the remaining 40% have closed their last fund in 2009 or later (see Figure 2.17).

The group with the older fund vintages has reached the point when they will need to hit the road to raise their next fund, as about 25% of them have already done. But that implies that, just in North America and Europe, some 350 GPs needing to refresh their capital have yet to come into the market. Many GPs are already on the fund-raising trail in these two regions trying to raise capital for 228 buyout funds that collectively aspire to bring in \$212 billion, or more than twice as much equity capital as the entire industry is putting to work annually in buyouts at its current pace. When the other 350 or so GPs that have yet to get started on their fund-raising journeys eventually join them, the sums they will seek will far exceed the industry's capacity to accommodate them all.

Figure 2.17: Fund-raising will remain competitive as many more funds looking to raise capital join those that are already on the road



Sources: Preqin; Bain analysis

The final fund? Clearly, not all of the buyout firms that have not closed a new fund since 2008 are going to succeed in raising another fund in 2013—or any time thereafter. Attempting to understand which ones are apt to have trouble, Bain sorted all 462 firms that have not closed a new fund since 2008 by the two broad criteria that we have found have the biggest influence with LPs. First, we separated them by the depth of their fund-management experience. How many funds had they run prior to their latest effort to raise capital for their new one? Second, we grouped them by whether their earlier funds were of above- or below-average performance. Then combining the length of the GPs' fund history with the firms' performance track record for all GPs for which information was available, we determined that at least 13% of the 462 GPs will likely face stiff resistance raising a new fund.

It is important to keep in mind that these findings are only suggestive of what could happen; they are not a prediction of what will happen. Which and how many firms will fail to raise a new fund or be required to settle for less capital than they hoped? Nobody knows. However, it is also well worth noting that these results are consistent with the finding we reported in Section 1 of this report that coming out of the last industry downturn, about one firm in five with similar characteristics failed ever to raise a successor fund.

Eternal rules for successful fund-raising. In addition to those with a long fund-management experience and a great performance track record, GPs that will be most likely to find an open door when they come knocking will be those that are raising capital for funds that hit LPs' "sweet spot." According to a recent institutional investor survey by Probitas Partners, LPs will continue to strongly favor mid-market and growth capital funds. Topping the list of types of funds where respondents said they would be looking to invest in 2013 are US-focused mid-market buyout funds that target acquisitions in the range of \$500 million to \$2.5 billion, but pan-European and European mid-market country-focused funds also rank high in LP preferences.

Selling what buyers are interested in is important, of course, but that alone will not seal the deal for fund-raising GPs in the fiercely competitive environment that lies ahead. LPs will be open to committing capital to GPs that are active across a wide spectrum of fund types, but the PE firms that succeed will be able to demonstrate that they possess four essential qualities LPs increasingly insist upon. First, obviously, are a demonstrated track record of success and a deep understanding of its sources. The second key attribute is a stable core team that has achieved a shared history of success together and has a clear plan for succession if circumstances change. Third, a GP needs to be able to describe how its investment model differentiates itself from the competition and demonstrate that it has a well-developed and repeatable model for creating value post-acquisition—including a proven ability to execute growth strategies. Finally, GPs need to have a financial commitment to the fund themselves and other clear incentives that are closely aligned with LPs' interests and codified in the fund terms.

Even with LPs penciling in more PE commitments in 2013, GPs will need to bring their "A game" with them on their fund-raising road shows. Anything less than that will likely result in a shutout.

Returns: Going to the source

Through good times and bad, PE returns have consistently topped those generated by public equities. But within PE an elite minority of deals, funds and firms has stood out from the pack. Clearly, the performance edge that shows up over and over again in the long narrow tail of strong performers is not going away, and more than ever it bears close examination.

PE firms that have bottled the secret sauce that adds spice to their returns deal after deal do more than ride favorable market currents, of course. They buy right. They manage their portfolios and motivate management teams with skill. Their timing and choice of exit channel are handled with precision. But in today's ferociously competitive deal environment and at a time of economic uncertainty, what can we learn about the deals that outperform? What can PE firms do to improve their hit rate?

To get to the source of the mystery, Bain teamed up with Oliver Gottschalg, a professor at the École des Hautes Études Commerciales in Paris, and PERACS, a leading provider of quantitative analytics for the PE industry, to investigate the performance of more than 8,000 realized buyout deals that have passed through PE funds, dating back to before 1995.

We began by investigating whether certain broad characteristics of deals—time period, region, deal size and industry sector—yielded better returns on average, but our analysis found only weak patterns of over- or under-performance across deal segments through time. Probing deeper, we considered whether some categories of deals were inherently less risky than others, yielding more consistent returns. Looking across the entire sample, we found a wide variation in deal returns. When we ranked the deals by their return multiple from lowest to highest, we discovered that the bottom 25% of deals lost money or broke even.³ The next quartile produced sufficient returns to recoup the losses incurred by the bottom quartile, but overall the bottom half of the deals generated no return. The real gains showed up only among the top one-third of the deals in our sample, each of them contributing returns that cumulatively accounted for 80% of the total return in our broad portfolio.

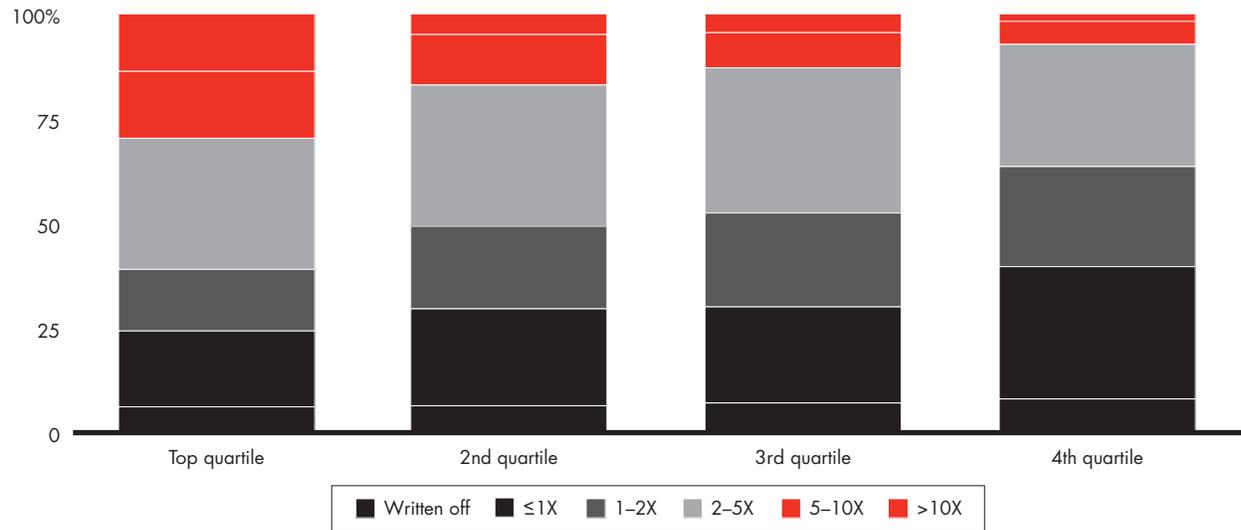
Segmenting the deals by the time period when they were completed, the region where they were done and their size, we again found overall consistency. Most segments showed a similar dispersion of deal returns, with 20% to 25% of the deals in each segment losing money or breaking even and the top 30% to 35% cumulatively contributing 80% of the segment's total return. A few segments strayed from this pattern: Deals made in the less-mature PE markets outside of North America and Europe generated a wider distribution of returns. So, too, did deals made during the boom periods between 1995 and 1999 and from 2005 through 2007. However, deals that were realized before 1995 displayed a narrower distribution of returns.

Our findings also corroborated an earlier analysis by Professor Gottschalg that discovered that most buyout funds—including the top-quartile performers—produce a mix of deals that are big winners and money losers. Indeed, Gottschalg's investigation of 117 mature buyout funds globally found that, on average, 17% of the deals the funds completed returned at least five times their original investment, and 30% did not earn back their investors' money. Top-quartile funds also had hits and misses, but were able to raise the proportion of winners to 30% and shrink the number of losers to just 23% (*see Figure 2.18*). Clearly, the top funds do a better job of steering clear of investments that result in write-downs or write-offs. And the discipline they exercise for spotting great opportunities and developing value-creation plans that they and their management teams implement help them convert a higher proportion of their investments into runaway winners.

With good and bad deals found across all segments of the market and among all rankings of PE funds, it is safe to conclude that fund performance hinges less on the specific types of deals a fund targets than on the alpha-generating capabilities of the GPs that manage them. For LPs the message in our analysis is loud and clear: They are far better off working to find the best-performing GPs, irrespective of the region, deal size or industry, than they would be trying to sort out which areas of the deal market might produce the best returns.

Figure 2.18: All funds generated both good deals and bad, but the top performers produced more winners and fewer losers

Distribution of gross deal returns for a sample of buyout funds by quartile



Notes: Analysis based on 117 mature buyout funds globally (≥ 9 years old with at least 10 investments made); funds were classified into performance quartiles based on fund total value to paid-in ratio (TVPI); total of 2,973 investments, realized and unrealized
Source: PERACS-HEC Report on Risk Profile of PE Funds

Forensics for funds and profits

There is also a powerful lesson for PE firms in these results. The findings underscore relevant questions they need to ask themselves: “How have we made or lost money on our past deals, and what do we need to do to hard-wire those alpha-generating capabilities into our organization and investment processes going forward?” Leading firms have dug into precisely those issues by subjecting their past deals to a detailed forensic examination.

A deep and candid exploration of the sources of success or failure in every deal a firm has completed helps a PE firm to define its deal “sweet spot” and mobilize its resources and processes around the factors that made it successful. A forensic investigation can serve a multitude of purposes. It can help lay a strong foundation for the launch of a new fund or set the right course for investing an immature fund. For example, a major global PE firm wanting to set up its new fund for success analyzed nearly 100 past deals by looking at scores of variables that influenced each. It evaluated hard measures that influenced returns, such as leverage, multiple expansion, revenue growth and margins. The forensic team also probed a range of softer factors, such as the target company’s market growth, its leadership position against competitors, trends in its EBITDA, the characteristics of the management team, the PE firm’s experience with similar deals and the degree of influence it had over the company after its acquisition.

The exercise yielded several powerful insights. It revealed which industry sectors had presented the biggest challenges, but it found few differences in the return profile across deal sizes and geographies. It also helped uncover 10 specific investment themes that were common to the successful deals but missing from the underperformers.

Putting those findings to work, the firm formalized guidelines for deals it would target and those it would avoid, and it improved how the firm operated to ensure that it would adhere to these guidelines. For example, management fortified its due diligence procedures to screen each prospective investment against the 10 investment themes, include a clear description of the key sources of value, and cover must-have analyses that test the prospective deal's thesis. The firm also required deal teams to quantify factors that would be deal breakers and specify scenarios where they would be likely to occur. Management also implemented new investment-committee processes it would follow before signing off on deals and active ownership practices it would adhere to once a new company became part of the fund.

A detailed forensic self-assessment can also guide a PE firm's move into new sectors, regions or deal types by exploiting successful formulas that worked in the past. Last year, a leading US-based sector-focused firm used deal diagnostics to sharpen the definition of its investment core and assess opportunities to grow beyond it. The self-assessment team tested more than 35 factors that may have influenced its past track record, including how the deal was sourced, the investment size, the sector and region in which the company operated and the maturity of the company's operations. It also evaluated the influence of more subjective factors, including the firm's own expertise in the sector, the competitive position of the company in its industry and the strengths of both the company's management team and the PE firm's internal deal team.

The investigation confirmed that deals the firm made in its core area of strength significantly outperformed those that strayed wide of its expertise. Of the nearly three dozen deal characteristics the team examined individually, only a few made a material difference to a deal's success. But when the team looked at different combinations of factors, it discovered that three combinations were present in deals that had realized outstanding returns—in short, a road map to where the firm would find its deal “sweet spot.” Based on these discoveries, the team sized up how much room it had left to grow in its core market based on its competitive dynamics, and it set about improving how it would go about sourcing future deals. Recognizing that it would need to look beyond its core in order to continue its growth, the firm identified the most attractive adjacencies that would allow it to build on its strengths and past success.

The experience of the pioneers of detailed deal forensics showed that GPs need resolve—and not a little courage—to plumb the depths of their firm's strengths and weaknesses. Self-assessments tend to be highly politicized undertakings that often involve individuals who have contributed to some of the firm's best- and worst-performing deals. For deal forensics to work, there is no alternative to tackling the process openly and objectively, making realistic judgments based on prevailing market conditions but with an eye to future industry and competitive dynamics.

Key takeaways

- Across the globe, GPs are eager to put capital to work, motivated to exit and ambitious to lock in fresh funds. But how PE unfolds in 2013 will again vary by market.
- In North America, continued confidence in the economic recovery, rising equity markets and robust debt markets bode well for PE deal making. Europe will be held back by economic uncertainty, which will continue to drive a wedge between buyers and sellers. The Asian market is adjusting to the reality of slower growth, a transition that could put a damper on deal activity.
- GPs feel pressure to exit in 2013, as the overhang of unsold assets in the developed markets is magnified by an overhang in the emerging markets, which resulted from a depressed IPO market in 2012. Exit activity could pick up in 2013 as corporations, the largest buyers of PE assets, become more active acquirers. Everywhere, sales to other PE sponsors are likely to increase. PE in North America may also benefit from a re-opening of the IPO window. The IPO channel will remain dormant in Europe and challenging in Asia.
- Fund-raising is poised to strengthen somewhat in 2013. Confident that PE will continue to boost their overall portfolio returns, many LPs are planning to commit more capital than in 2012. Some LPs are increasing their target PE allocations, and rising public equity markets are also making room for increased commitments. Yet even if deal making and exit activity pick up substantially in 2013, fund-raising will rise meaningfully only after a typical lag. With the oversupply of funds seeking capital, raising a new fund will remain intensely competitive.
- The performance edge of the PE industry's strongest funds hinges less on the specific size and types of deals a fund targets than on the alpha-generating capabilities of the GPs that manage them. Leading GPs are performing detailed forensic diagnostics on their own deals to understand how they have made money in the past and position themselves for future success.

¹ See David Harding, Satish Shankar and Richard Jackson, "The renaissance in mergers and acquisitions: The surprising lessons of the 2000s," Bain & Company, 2013.

² We arrived at this estimate by adding to the publicly disclosed value of all buyout deals completed in the past year our most realistic estimation of the value of deals that were done but not disclosed and multiplying that total by recent equity contribution percentages.

³ We ranked deals from lowest to highest based on their ratio of distributed to paid-in capital (DPI). We used the DPI ratio to remove the influence of deal size on the analysis of deal-return distribution. We then plotted the cumulative proportion of deals in the sample against the cumulative proportion of the sample's combined return.

GPs and LPs: Where is this relationship going?

Throughout PE's long and dynamic history, the industry has added thousands of firms, attracted tens of thousands of investors and weathered booms and busts as it spread around the globe. Yet for all the fads and fashions that have shaped the relationship between GPs and LPs, the basic terms on which they do business with each other have remained remarkably stable. LPs entrusted their capital to GPs, typically paid them a 2% annual fee to manage the fund portfolio, and customarily agreed to share 20% of the profits when assets were sold.

Recently, GPs and LPs have begun to experiment with a wide range of new models. The harsher realities of raising new funds and the downward pressure on returns have given both GPs and LPs powerful incentives to try new things. Forced to devote more time and resources lining up LPs' commitments for new capital, GPs are hungry to build longer-term strategic partnerships with LPs that are willing to write bigger checks. At KKR, for example, the investor relations that were managed by just a handful of individuals a decade ago now require the full-time efforts of a staff of 50 globally.

For their part, many LPs recognize that PE has been the best-performing asset class in their portfolios over the long term. LPs remain as committed as ever to PE, but some are seeking new arrangements that will enable them to work around industry challenges and improve the economics of their PE investments. The search for continued attractive returns has resulted in several novel experiments and business model variations.

GPs sell LPs a stake in their firm. If it's a struggle signing up LPs to make a major commitment of capital to a new fund, why not simply offer to sell them a piece of the PE firm itself? This can be a first step for a GP to redefine its relationship with an LP and move toward a more permanent capital base. While not a new phenomenon, there are several recent instances of GPs selling a stake in their firm to an LP. Last September, for example, CVC Capital Partners, the UK-based global PE firm, sold a 10% stake in itself to three deep-pocketed sovereign wealth funds, including the Government of Singapore Investment Corporation and the Kuwait Investment Authority. For LPs, the attraction of becoming a minority owner of a PE firm is the opportunity to participate in the same economic benefits the GP enjoys, including a share of the fee flow it receives on the funds it manages and a proportionate slice of the carry it earns.

Separate LP accounts. GPs have hit upon a promising way to win big, multiyear commitments from larger LPs by setting up side accounts they will manage, often for a reduced fee. In the biggest such deals last year, KKR and Apollo Global Management each landed \$3 billion in commitments from Teacher Retirement System of Texas (TRS). The GPs retain wide latitude in terms of the investments they can pursue, including buyouts, real estate and debt. In exchange, the TRS special accounts will pay substantially lower fees than a typical fund LP, and they will be offered a first opportunity to participate on many deals. The capital returned to the accounts can be reinvested at TRS's discretion, with the understanding that it will be committed for longer than the typical five- to seven-year time frame.

In addition to more favorable economics, some LPs like the separate-account approach because it enables them to make a significant commitment to a set of investment strategies they find compelling, while avoiding having to make and manage many small fund investments. LPs also gain greater access to the GP specialists they work with. The clear upside for GPs, of course, is the opportunity to land larger, more permanent capital commitments.

Buying out a GP's assets. Perhaps 2012's most intriguing new collaboration has been an outright purchase of an entire fund's assets led primarily by one LP. The LP in this instance was the Canadian Pension Plan Investment Board (CPPIB), and the fund in question was Behrman Capital III LP, an 11-year-old fund originally valued at \$1.2 billion that was created by Behrman Capital, a New York-based buyout firm with a total of some \$3 billion under management. Working with Behrman and other LPs, CPPIB committed up to \$654 million to form a new \$1 billion, six-year fund called Behrman Capital PEP LP. Around three-quarters of the new fund's capital was tendered to buy five businesses still held in Behrman Capital III LP; the balance could be used to make add-on acquisitions to the existing portfolio companies or for new platform investments. By accepting the option to sell, the legacy LPs were able to cash out of their aging asset. The new LPs in Behrman Capital PEP were able to buy five businesses at what they believed to be attractive valuations, while at the same time investing in a fund with a lower fee structure. The arrangement gave Behrman Capital a new lease on life. In addition to securing fresh capital that allowed it to continue investing, the transaction reset the clock on the portfolio investments, enabling Behrman to patiently nurture the companies and improve the prospects of generating a solid IRR and carried interest when it came time to exit.

Nontraditional fund models. Some newer GPs were among the innovators of fresh approaches for winning LP commitments in 2012 by tailoring their funds to LPs' unique preferences. One such newcomer was Altas Partners, launched by Andrew Sheiner, a former key player at Onex, the venerable North American buyout firm. To break through the fund-raising clutter most new firms

confront and to secure long-term funding that is not often available to them, Sheiner presented potential LPs a unique value proposition he calls “core private equity investing.” Altas plans to target companies with a hard-to-replicate business model that gives them a highly defensible market position and offers the potential for a longer holding period than traditional private equity. And because the fund will rely on less leverage to finance deals and charge more modest fees than are standard in the industry, the LPs that commit capital to the new fund stand to earn net returns that are consistent with traditional PE investing but with less risk.

Another firm that is bending the traditional PE investment model is Dyal Capital Partners, a 2010 offshoot of Neuberger Berman, the global asset management company. Successfully raising \$1.3 billion in 2012 (well above the \$1 billion it had originally targeted), the new GP plans to blur the line between PE and hedge fund investing by buying minority stakes in high-performing hedge funds.

Direct-sponsorship programs. Direct investing is nothing new for LPs. Many have co-invested alongside their GP partners for years. Likewise, some pioneering LPs have had direct sponsorship programs for much of their history. There is no doubt, however, that among some LPs, including Canadian public pension systems and sovereign wealth funds, interest in expanding programs that make sponsorship investments directly has taken on a new life. For example, Teachers’ Private Capital, the PE arm of Ontario Teachers’ Pension Plan, has completed 13 direct investments since 2010, including six during the past year. The Ontario Municipal Employees Retirement System, another large Canadian LP, has also launched a direct program.

Early analysis suggests that direct programs do have the potential to generate attractive returns. Harvard Business School Professor Josh Lerner and his colleagues recently reported that the internal rate of return for seven direct programs he examined beat the benchmark average for 873 LPs he compared them with by a margin of 15.5% to just 8.4%. It is worth noting that all the direct programs in Lerner’s study were large, experienced PE investors that enjoyed strong local connections for industry intelligence and deal sourcing¹. But even for large LPs, direct investing is a big leap from conventional fund investing or active co-investing. To build a credible program requires end-to-end investment capabilities that take a lot of time and money to build.

The ultimate success of each of these arrangements will not be known for years, but one thing is already clear: More experimentation is on the way.

¹ See Lily Fang, Victoria Ivashina and Josh Lerner, “The disintermediation of financial markets: Direct investing in private equity,” (INSEAD and Harvard Business School), October 2012.

3. Facing the future: Four questions GPs and LPs each need to ask

Two-thousand thirteen is shaping up as a major year of transition for the private equity industry. As we've seen in the preceding pages, PE still faces a perplexing near-term future. Will credit markets remain as accommodating to new deal making as they currently are? Will LPs be able to fuel GPs' prodigious fund-raising goals? Can exit channels absorb all the aging assets funds are eager to sell? Will PE continue to deliver returns that maintain its sizable performance edge over other asset classes?

Clearly, facing questions like these makes it risky for GPs and LPs to simply stand pat when the landscape around them is shifting. The PE industry is maturing, yet some GPs and LPs retain the reflexes and outlook that served them well in PE's start-up years but may be ill-suited for what lies ahead. Both GPs and LPs will need to engage in deep introspection about what it will take to thrive in years to come. Following are key questions Bain thinks all investors would do well to ask themselves.

GPs: Institutionalizing success

Facing a prolonged period ahead of high acquisition prices and weak market beta to push up the valuation of assets they control, PE firms will need to institutionalize the value-generating capabilities that will be the hallmark of top-quartile performers. Here is what tomorrow's leaders will need to know:

1 How have we made money on past deals?

This is becoming the first thing discriminating LPs want to know. Providing a compelling answer requires GPs to tease apart what proportion of the returns they reaped from their past investments have come from growth, leverage, multiple expansion, operational improvement and sheer serendipity. A detailed, dispassionate, data-driven investigation will enable the firm to identify the profile of deals that constitute its money-making "sweet spot." It will also be the starting point for understanding how well the firm's capabilities and processes are aligned with the deal opportunities that have yielded their top returns.

2 Are our past sources of success still relevant, and will they continue to serve us over the next five years?

Anyone who has lived through the most recent PE boom and bust knows that the climate PE firms are investing in today is vastly different from what it was five years ago. That makes it essential to respond to three challenging questions: First, do the deal profiles, investment theses and value-creation approaches that worked then remain applicable in the face of today's new realities? Second, will there be a sufficient flow of attractive deal opportunities to fill the firm's investment pipeline? Third, if we have raised a larger or smaller fund, can we put the capital to work profitably following the same playbook we used in our previous one? Probing the answers to these questions will spark discussion of whether the firm needs to adjust its deal "sweet spot" or find attractive adjacencies that will enable it to deploy capital profitably.

3 Are we developing and retaining the top talent we will need to succeed over the long haul?

PE has long been an industry of maverick “rainmakers”—the firms’ senior partners who land the biggest deals, persuade LPs to make the largest commitments or have the financial acumen or operational chops to turn around a troubled portfolio company. But while individual charisma and reputation will always have a prized place in industry lore, leading PE firms today are finding ways to bottle the “secret sauce” behind the firm’s success and sprinkle it liberally across the organization. They place a premium on recruiting, training and retaining young talent, nurturing in them the strengths that differentiate the firm from its competitors. They surround their home-grown talent with tailored investment and operational processes that maximize the firm’s distinctive strengths and mobilize its resources to make them repeatable.

4 Are we effective at evaluating portfolio company management teams, and do we have a robust talent pipeline to tap for C-suite executives when needed?

One troubling statistic in the PE industry is the high rate of turnover in top management. Many PE firms find that about half of the CEOs across their portfolio companies will depart during the period of their ownership. Given the high prices funds must pay to buy attractive assets, there is much less room for error in the execution of an investment thesis than in the past. Leading firms are working to improve their ability to evaluate a portfolio-company management’s ability to execute on future plans at every stage of the deal—pre-close, post-close and for the duration of the fund’s ownership. Top PE firms are scouting out and deepening the talent pool they can draw from to add needed capabilities to management teams and boards, and figuring out how to deploy this talent more rapidly when required.

LPs: Broadening and deepening the PE playing field

Because it has consistently delivered outsized returns, PE has come to occupy a prized place in the portfolios of LPs of every stripe. But looking ahead, investing in PE for its own sake does not assure LPs that they will achieve better returns from their PE holdings than they would by putting their money in the public equity markets. It will be more critical than ever for LPs to carefully scrutinize which GPs they choose to invest with and how they choose to collaborate. Here are the questions discriminating LPs are asking themselves:

1 Are we selecting the best GPs with whom to invest?

The process of selecting a fund manager is the most critical factor influencing an LP’s future returns. But finding the best has never been harder. Nearly three-quarters of all the capital invested since 2005 has yet to be realized, making GPs’ performance track records more difficult to assess. LPs need to consider that one-time top-quartile GPs may be less likely to remain top quartile over time. The persistence of returns appears to have faded since the industry’s boom years. LPs now must weigh whether a GP that had a stellar record in the past still has the capabilities to generate outside returns in the future. Those that learn how to do this well will be well rewarded for their effort. LPs that are able to identify just 10% more top-quartile managers and avoid 10% fewer bottom-quartile managers stand to increase their overall PE portfolio performance by 400 basis points.

2 Is our co-investment program successful and are we getting the most out of it?

At a time when secular PE returns are trending lower, more and more LPs are jumping at opportunities to co-invest alongside the GP in specific PE deals. Unlike their more common participation in PE as investors in broad funds, LPs with co-investment programs enjoy more concentrated exposure to deals that most appeal to them, with the added sweetener that they pay no carry or management fees. But the purported appeal of co-investing often fails to materialize. Indeed, recent academic research has found that co-investment programs have consistently underperformed ordinary fund investments.¹ LPs that passively manage their co-investments are more prone to fall victim to adverse selection. Putting a co-investment program on the right footing requires LPs to carefully analyze co-investment opportunities rather than react only to what is presented to them.

3 Are we open to new ways of playing in the PE space to create value for the future?

The next few years will be a fertile period for LPs to explore a wider variety of new ways to partner with GPs and strike some creative deals. With GPs facing unprecedented fund-raising pressures and LPs in a commanding position to influence terms and conditions as they never have before, both sides have strong incentives to experiment. The innovation has already begun. Some larger LPs are expanding direct-sponsorship programs or creating joint ventures with GPs. Others are buying equity stakes in PE firms. And some are considering more permanent capital models that do away with the time restrictions limiting the life of a fund.

4 Are we building an adaptable organization that attracts and retains top talent?

With their involvement in PE spreading across a wider front of geographies, relationships and investment structures, each requiring its own probing and continuous scrutiny, LPs need to build organizational capabilities that are up to the task. Just as they are evaluating GP teams for their skills and resourcefulness, they need to ensure that they are attracting, retaining and providing appropriate incentives for top talent that possess the same qualities. ↻

¹ See Lily Fang, Victoria Ivashina and Josh Lerner, "The disintermediation of financial markets: Direct investing in private equity," (INSEAD and Harvard Business School), October 2012.

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