



GLOBAL PRIVATE EQUITY REPORT 2015

About Bain & Company's Private Equity business

Bain & Company is the leading consulting partner to the private equity (PE) industry and its stakeholders. PE consulting at Bain has grown fivefold 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 1,000 experienced professionals serving PE clients. Our practice is more than triple the size of the next largest consulting company serving PE firms.

Bain's work with PE firms spans fund types, including buyout, infrastructure, real estate and debt. We also work with hedge funds, as well as many of the most prominent institutional investors, including sovereign wealth funds, pension funds, endowments and family investment offices. We support our clients across a broad range of objectives:

Deal generation. We help develop differentiated investment theses and enhance deal flow by profiling industries, screening companies and devising a plan to approach targets.

Due diligence. We help support better deal decisions by performing due 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.

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Finding meaning in the year of the exit

Dear Colleague:

We've been waiting for big news from the PE industry for almost five years, and 2014 delivered. Exits from buyouts exceeded \$450 billion, surpassing the all-time high by a wide margin. The flow of so much capital came as a welcome relief to LPs and GPs alike and has infused the industry with new confidence that returns from holdings acquired during the peak investment years will end up better than most industry pundits feared. However, this flood of capital will have knock-on effects that raise new challenges for investors in 2015 and beyond.

The dramatic increase in exits marks the fourth consecutive year distributions have outpaced capital calls for the LP community. As a result, LPs looking to maintain or increase their exposure to their highest returning asset class made 2014 another strong year for fund-raising. Top funds attracted fresh capital very rapidly, as huge amounts of money chased the same top-quartile performers. Most were oversubscribed and hit hard caps. So, where is the extra capital going? Some of the overflow is cascading into other funds, and some is even going into LPs' own direct investment programs. By the end of last year, freshly committed dry powder hit a global record of \$1.2 trillion, including \$452 billion earmarked for buyouts alone.

One thing that did not change very much in 2014 was the always limited supply of companies to buy; it has remained relatively constant as the mountain of capital pursuing these companies has grown. Supported by a continued abundance of low-cost debt and high valuations for comparable public companies in most markets, more PE money chasing the same assets has led to stubbornly high pricing. The forces that are driving up valuations are structural and very difficult to change. The challenge of how to make money investing in PE has never been greater.

Our industry continues to evolve in interesting ways. Please read on to learn about the full impact of super-abundant capital and why it will not ensure that PE rebounds from future downturns as well as it has from this past one. See how "shadow capital" is reshaping the GP-LP relationship and risks shaking up the industry's economics. Discover the challenges of investing in the resurgent US market, why it has become so difficult to spot winning funds and how to continue to invest for success as a GP.

We hope you will enjoy Bain's latest *Global Private Equity Report*, and we look forward to continuing our dialogue with you in the year ahead.



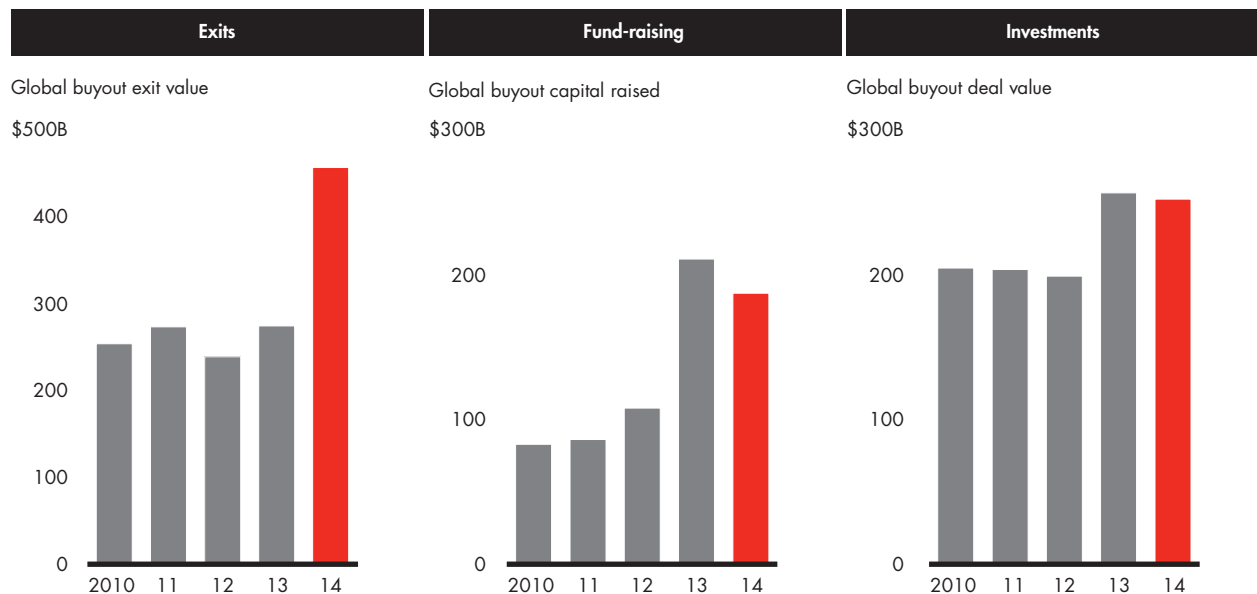
Hugh H. MacArthur
Head of Global Private Equity
February 2015

1. The PE market in 2014: What happened

With the results in for 2014, the characteristics of this remarkably durable private equity (PE) rebound have come into sharper focus. It is now clear that PE has been riding the waves of a world awash in capital that show no signs of breaking anytime soon. Worldwide, the number and value of buyout exits climbed to an industry record last year. Strong distributions of capital flowed back to LPs, helping to make 2014 another solid year for raising new funds. But while it has been a great time to be a seller in the current cycle, it has been challenging to be a buyer. The combination of a surge in global liquidity and near-zero interest rates has inflated asset valuations, lifting acquisition multiples on PE investment targets. Global buyout investment activity has remained steady since the recovery got under way (see Figure 1.1).

As 2015 unfolds, will the PE industry continue to display the resilience that has served it so well in a time characterized by capital superabundance and torpid global growth? The industry's near-term prospects will be influenced by whether ongoing structural problems in the eurozone and slowing GDP growth in the Asia-Pacific region outweigh the gathering momentum of North America's cyclical expansion, tipping the global economy into recession. PE's potential will also be shaped by whether the actions of central banks—in particular, a long-anticipated interest rate hike by the US Federal Reserve Board—choke off the ready availability of cheap high-yield debt or curb the animal spirits of the public equity markets.

Figure 1.1: It was a standout year for exits, while fund-raising and investments held steady



Notes: Exits: exclude bankruptcies; Fund-raising: includes funds with final close; represents year funds held their final close; Investments: exclude add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; include announced deals that are completed or pending, with data subject to change
Sources: Dealogic; Preqin

What will not change in the year ahead, however, are the forces unleashed by superabundant global capital. As we will explain in Section 2 of this report, asset prices will remain chronically high as dry powder continues to pile up and competition for deals remains feverish—including competition from large pools of “shadow capital” in the hands of big institutional investors and sovereign wealth funds looking to co-invest, or even bypass PE funds entirely. Those factors will turn up the heat on general partners (GPs) to demonstrate new resourcefulness by digging deeper into the pool of companies that could benefit from PE ownership or by discovering untapped opportunities, particularly in the relatively attractive US market. Whether the economic expansion keeps grinding along or ends in a downturn in 2015, PE firms will need to become authors of their own success by grooming their portfolio companies to prosper in any business climate. In Section 3, we identify the barriers that would-be PE portfolio activists face and describe the building blocks for engaging early and effectively with portfolio company management.

Exits: A year for the record books

Optimism was high on the exit front going into 2014. Public equity markets in Europe and North America had registered strong gains in the preceding year, laying a solid foundation for lucrative initial public offerings. Cash-rich corporate acquirers, feeling pressure to meet shareholder demands for growth, were poised to open their wallets for PE-owned companies that fit their strategic goals. And deal-hungry PE funds, eager to put capital to work, were ready buyers-in-waiting of assets groomed by PE owners inclined to sell in sponsor-to-sponsor transactions.

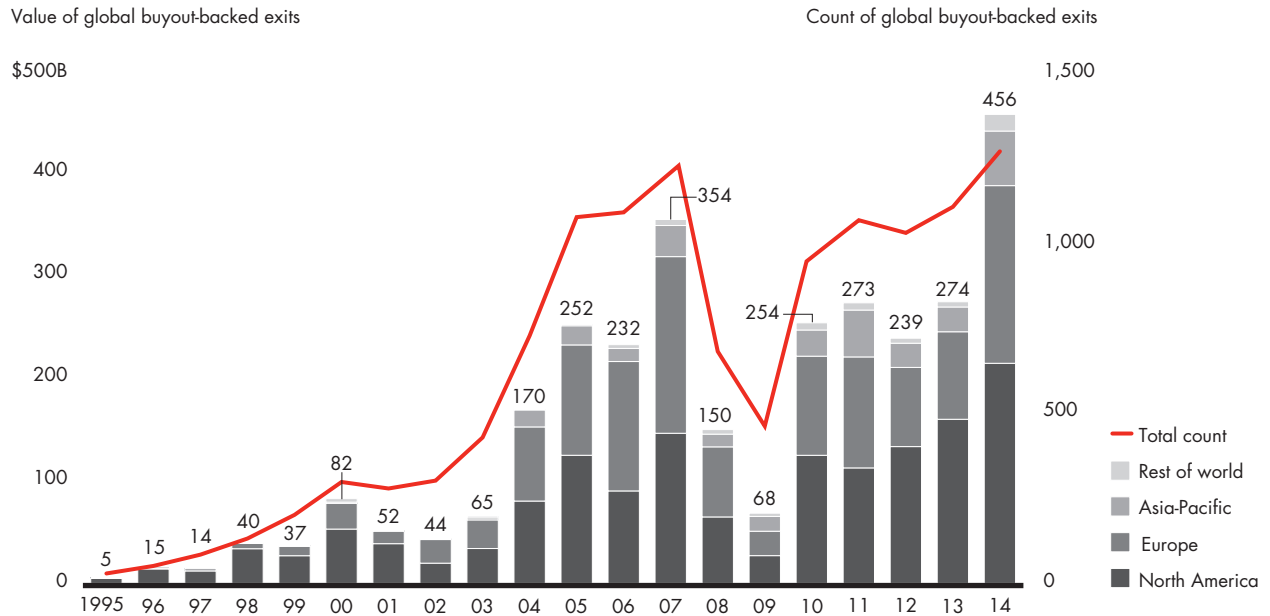
In the end, exits in 2014 shattered even the lofty expectations of an industry primed for a good year. Worldwide, the numbers and value of buyout-backed exits reached new records (*see Figure 1.2*). At better than 1,250 sales, last year’s exit count surpassed its previous peak of 1,219 transactions in 2007. And total exit value, at \$456 billion, also blew past its previous record of \$354 billion in 2007 and was 67% higher than it was in 2013.

A superabundance of global capital and sustained high asset valuations powered these dramatic gains in most regions of the world, making sellers rejoice and buyers cautious. There were healthy double-digit increases in the number of buyout exits from the year before: 22% in North America and 16% in Europe. In the Asia-Pacific region, which is typically not a buyout market, the number of buyout-backed exits dropped 12%, but overall, PE exits, including sales of minority stakes in private companies and shares of publicly traded enterprises, jumped 22%, to 476 sales—well above the previous year.

A world awash in capital more dramatically affected deal values across the major regions. Notably, buyout-backed exits in Asia-Pacific markets shot up to nearly \$53 billion, a 120% increase. In all, Asia-Pacific exits topped \$105 billion. Europe saw the biggest jump in the value of buyout-backed exits, increasing to \$173 billion from just \$85 billion in 2013. Buyout sales in North America rose a solid 34%, to more than \$214 billion.

As PE funds continued to harvest the unrealized value in their portfolios, the average holding period has lengthened—and will continue to stretch because so many holdings acquired during the boom years have yet to be fully exited. For buyouts exited in 2014, the median holding period had extended to a record-long 5.7 years, up from just 3.4 in 2008. Many investments made before the global financial crisis simply required more time to be made ready for exit. Also, it takes longer to groom assets acquired at high purchase multiples after the crisis to yield acceptable returns. Indeed, 60% of assets sold in 2014 had been in PE portfolios for more than five years; in comparison, only 11% had been held less than three years—so-called “quick flips” (*see Figure 1.3*).

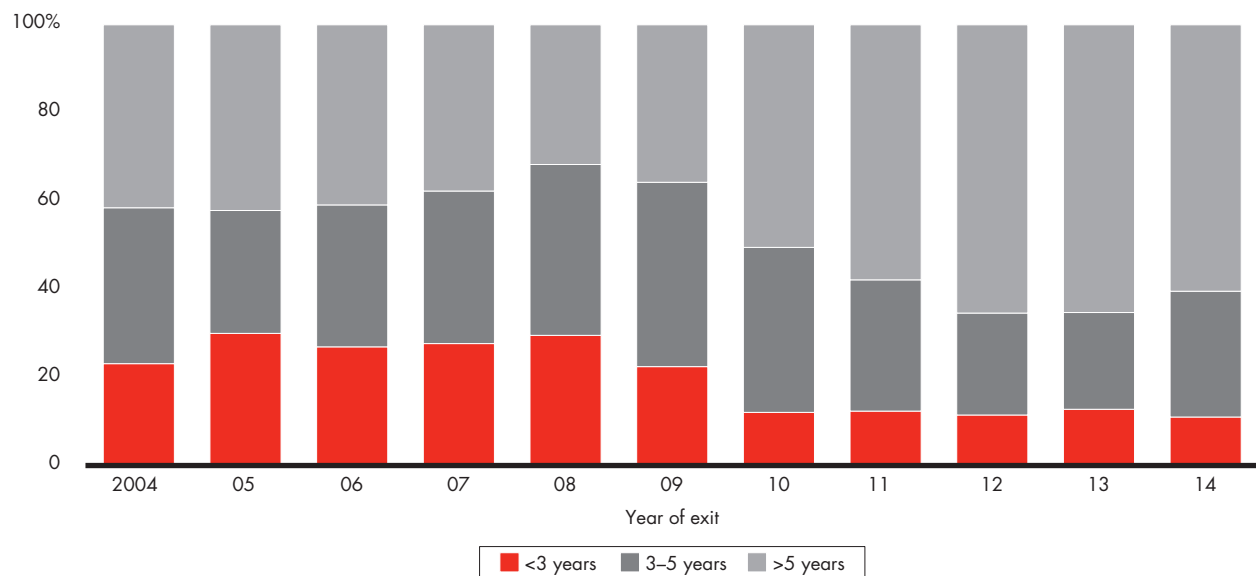
Figure 1.2: The number and value of buyout-backed exits hit new records in all regions in 2014



Notes: Bankruptcies excluded; IPO value represents offer amount and not market value of company
Source: Dealogic

Figure 1.3: In 2014, fewer than 10% of exits were "quick flips" of assets held less than three years

Percentage of global buyout-backed investments exited (by length of time investment was held in fund portfolio)



Source: Preqin

Exit channels were deep and broad

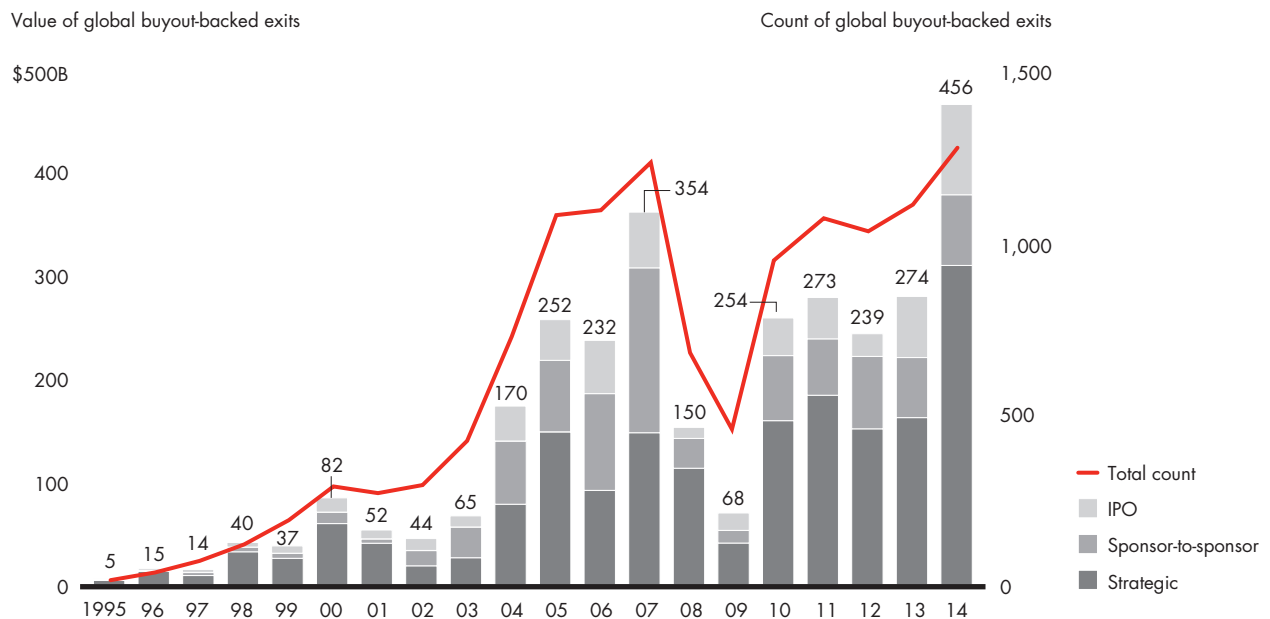
Exits through all channels increased significantly last year, with sales to strategic buyers and IPOs dominating (see Figure 1.4).

Sales to strategic buyers have traditionally been the biggest channel for buyout-backed exits, and corporations saw their purchasing power turbocharged in 2014. With capital spending restrained in a hesitant global expansion, corporations sat on unprecedented cash reserves, and the steep climb in public equity markets made their shares a valuable supplemental currency they could use for acquisitions. Historically low interest rates and wide-open debt markets added further rocket fuel to boost corporations' ability to buy.

Along with this increased wherewithal came a much greater willingness to put it to work. Shareholders demanded that corporations boost growth and earnings in order to warrant sharply higher share prices. But organic growth was hard to come by in a competitive, low-inflation economy, making mergers and acquisitions an attractive path forward.

Corporate acquirers were discerning shoppers for assets that fit their strategic goals, buying 715 PE portfolio companies in 2014—13% more than the year before. And deal sizes were also much larger than in 2013: By value, total exits to strategic acquirers topped \$303 billion—a 91% jump. Three buyout-backed exits came in at valuations exceeding \$10 billion, led by KKR's completion of the \$25.1 billion sale of UK-based drugstore chain Alliance Boots to Walgreen Company, the largest US drug retailer (see Figure 1.5).

Figure 1.4: Buyout-backed exits increased across all channels in 2014; IPOs and strategic sales dominated



Notes: Bankruptcies excluded; IPO value represents offer amount and not market value of company
Source: Dealogic

Figure 1.5: Exits to strategic buyers were up sharply in 2014 and included three valued at \$10 billion or more

Target name	Target country	Target industry	Seller	Initial entry year	Strategic acquirer	Deal value (\$B)	Quarter announced
Alliance Boots	UK	Retail	KKR	2007	Walgreen Company	25.1	Q3
Biomet	US	Healthcare	Blackstone; Goldman Sachs; KKR; TPG	2007	Zimmer Holdings	13.4	Q2
Grupo Corporativo Ono	Spain	Telecom	CCMP; Providence Equity; Quadrangle Group; Thomas H. Lee Partners	2003	Vodafone Group	10.0	Q1
Athlon Energy	US	Oil and gas	Apollo	2010	Encana	6.8	Q3
Nuveen Investments	US	Finance	Madison Dearborn	2007	TIAA-CREF	6.3	Q2
Oriental Brewery	South Korea	Food and beverage	Affinity Equity; KKR	2009	Anheuser-Busch InBev	5.8	Q1
Numericable Group	France	Telecom	Carlyle; Cinven	2005	Altice Group	5.7	Q2
Omega Pharma	Belgium	Healthcare	Waterland	2012	Perrigo	4.5	Q4
Arysta LifeScience	US	Agriculture	Permira	2008	Platform Specialty Products	3.5	Q4
OneWest Bank	US	Financial services	Dune Capital Management; J.C. Flowers; MSD Capital; Paulson & Company; Silar Advisors; Soros Fund Management; Stone Point Capital	2009	CIT Group	3.4	Q3

Notes: Initial entry year is based on deal's close date; deal value includes debt and is as reported by Dealogic as of January 2015
Sources: Dealogic; Preqin

Robust equity markets underpinned the success PE sellers enjoyed in strategic exits and served as a potent exit channel in its own right through IPOs. Globally, buyout-backed IPOs numbered 210, an increase of 20% over 2013, and their value jumped 48%, to \$86 billion. Even though IPO activity weakened in the second half of the year due to greater market volatility, nearly three-quarters of public offerings floated by PE firms sold within or above their target range. Indeed, because valuations in the public markets were often higher than those of privately held assets, PE firms often pursued dual-track sales processes to maximize the value of their holdings.

Exits via IPOs were strong, particularly in Europe and the Asia-Pacific region. Buyout-backed IPOs doubled both in number and value in Europe. In the Asia-Pacific markets, their value almost quintupled, and the \$63 billion value of new share offerings exceeded the value of strategic sales and sponsor-to-sponsor exits combined. Accounting for the big increase in the Asia-Pacific region was the reopening of China's IPO market, a critical venue for IPOs across the Asia-Pacific region, which regulators had shut amid accounting scandals in late 2012. Even excluding the \$21.8 billion public debut of Alibaba, China's biggest e-commerce company, the value of PE-backed IPOs in the Asia-Pacific region in 2014 was still three times what it had been a year earlier.

The big official numbers posted in 2014 do not fully reflect how important the healthy IPO market has been to PE firms, because they reflect only the value based on the issuing price for the shares offered. What they fail to capture is the imputed full market value of the portfolio company, including shares that remain to be sold in future offerings. Examining the 100 biggest PE exits worldwide, a Bain & Company analysis found that 49 were IPOs carrying a market value of \$184 billion, which nearly matched the \$188 billion disclosed value of the 38 largest strategic sales and the 13 biggest sponsor-to-sponsor deals combined.

The new IPOs also understate in other ways the importance of public equity markets as an exit venue for private equity. PE funds, for example, tapped the strong stock markets in 2014 to issue \$103 billion worth of follow-on shares for portfolio companies that had previously held an IPO. In all, the combined value of new buyout-backed IPOs and follow-on issuances from “old exits” totaled \$189 billion last year and was a critical source of capital that PE firms could distribute to their LPs.

Any year that boasts solid double-digit gains both in the number and value of exited deals has got to be counted as a strong one. By that standard, sponsor-to-sponsor transactions certainly qualified in 2014. By count, sales to PE buyers were up 15%, and by value, they increased a solid 18% over the previous year. Only in a great year for exits would numbers like these look modest, but such were the conditions PE sellers faced in sales opportunities to corporate acquirers and in the hot IPO markets that sponsor-to-sponsor deals trafficked mainly in leftover holdings.

Fund-raising: Recycling the gains

GPs that hit the trail to raise capital for new funds in 2014 encountered the same forces at work as they did in 2013, a strong year for fund-raising. Flush with cash distributions from an exceptional year of exits, LPs were eager to top up their allocations to PE, their best performing asset class. But they remained highly selective in the commitments they were prepared to make and the firms with which they were willing to invest. The road warriors also ran into a record number of like-minded GPs competing fiercely for the same goal. The result: Highly discriminating LP investors and hungry fund sponsors racked up another solid year on the fund-raising front.

Worldwide, 1,001 PE funds—200 fewer than in 2013—landed \$499 billion in new capital commitments last year. This value was 6% less than the year before, but funds raised over the past two years exceeded that in all but the boom years between 2006 and 2008. Capital raised for buyout funds dropped 11%, but growth funds, secondaries and venture funds all scored impressive gains (*see Figure 1.6*).

The drop in buyout fund-raising from a year earlier was more a consequence of the idiosyncrasies of the funds that happened to be in the market than a sign of weakness. In 2013, buyout firms recorded the close of five mega-funds exceeding \$10 billion, including the \$18.4 billion Apollo Investment Fund VIII. Last year saw the close of just one such fund, the \$10.9 billion Hellman & Friedman VIII, but it came in at 22% above target within six months. Although many LPs remain averse to mega-buyout funds, larger LPs with a lot of capital to invest have little choice other than to sign on if they are going to meet their PE asset-allocation goal. Indeed, the best of the mega-buyout funds turned away LPs looking to make new commitments. For example, Hellman & Friedman VIII was reportedly oversubscribed by several billion dollars. In the end, seven of the year’s biggest buyout funds brought in more than \$5 billion each, and all of them met or exceeded their targeted fund-raising goal.

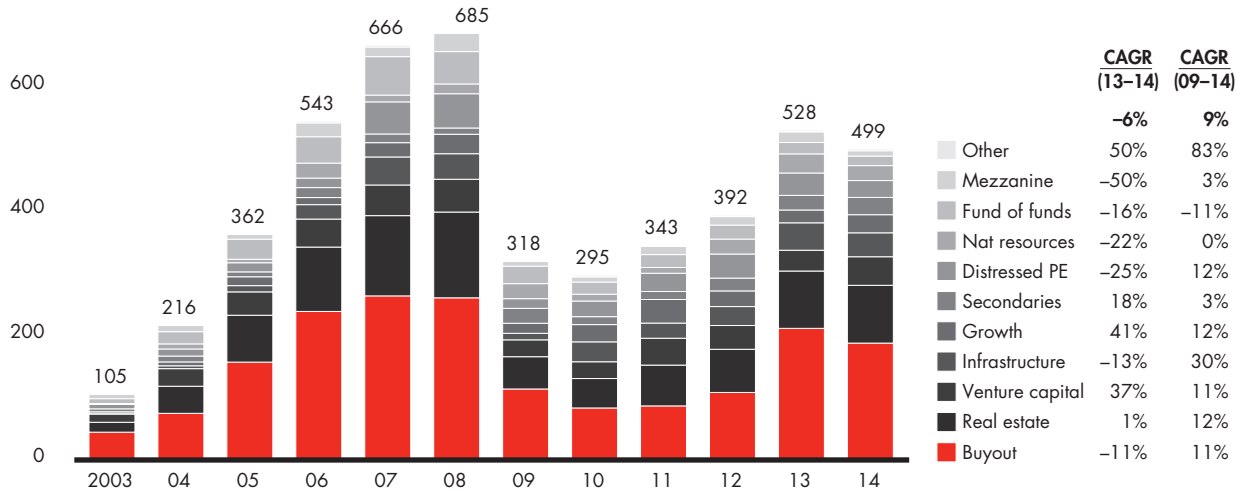
If the bigger buyout funds were able to win over reluctant LPs, mid-market funds looking to raise between \$500 million and \$3 billion faced no such reticence. GPs shopping these funds won commitments totaling \$68 billion in 2014, and competition among LPs to get an allocation with the better performing GPs was fierce.

By region, fund-raising increased for Europe-focused PE funds in 2014, despite current economic weakness and stubborn structural challenges that will hang over the eurozone in coming years. Fund-raising also rose in the Asia-Pacific region, where patient institutional investors finally saw distributions pick up since 2013. In North America, fund-raising settled below the high level achieved in the previous year, which had been inflated by the closing of a large number of US mega-buyout funds.

Figure 1.6: In 2014, PE fund-raising slipped 6%, to \$499 billion, but the year still ended strong

Global PE capital raised (by fund type)

\$800B



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

LP demand: Ready, willing and able

LPs had both the confidence and capacity to commit fresh capital to new PE funds in 2014. Over the longer term, gains from PE investments towered above those of all other major asset classes in LPs' portfolios. As of midyear, the median return of PE holdings in public pension fund portfolios over a 10-year time horizon was 10.8% vs. 8.2% for public equities, 6.4% for real estate investments and 5.4% for fixed income.

Both the magnitude and consistency of those returns have reinforced LPs' conviction that their PE investments were meeting or exceeding their expectations. A recent survey by Preqin, the alternative assets data provider, found that just 8% of LPs felt PE had fallen short, compared with 19% that had expressed some disappointment just three years ago. And with near unanimity, LPs believe that PE markets will continue to outperform public markets in the future, even as they anticipate that the performance gap will narrow in the wake of five years of steady stock market gains. With that faith in PE, it is little wonder that 84% of LPs responding to the Preqin survey said they planned to maintain or increase their PE allocation. As one LP we interviewed last fall put it, "I don't know where else you would put capital."

LPs have lots of room—and plenty of capital—to back new PE funds. They have seen a bounty of cash flow their way over the past four years as distributions from GPs exiting mature investments have outpaced capital calls in a slower-paced deal-making environment. This recycling of capital is one important pillar supporting PE fund-raising, and it has been gaining strength in all major regions of the world. In the US and Europe, distributions have exceeded new cash calls every year since 2011. In 2014, LPs invested in US buyout funds got back \$2.40 for each dollar called; in Europe, LPs received \$2 for every dollar they were expected

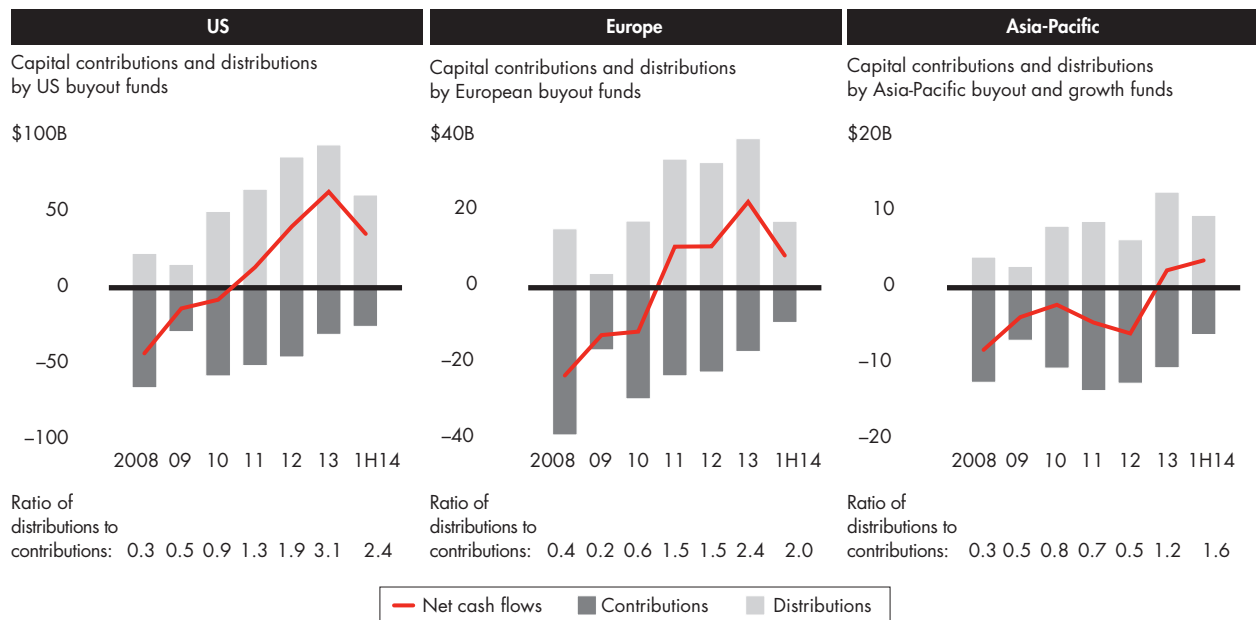
to ante up. LPs that invested in Asia-Pacific growth and buyout funds, too, have been cash-flow positive in 2013 and 2014, following a seven-year drought. The turnabout may mark a turning point for LPs in the Asia-Pacific region, sparking their renewed interest in making new commitments to Asia-Pacific-focused funds (see Figure 1.7).

Another crucial support holding up fund-raising over the past two years has been the strong returns generated by the bullish public equity markets. Rising stock prices have inflated the unrealized value of institutional investors' overall portfolio holdings, requiring them to boost their new commitments to PE funds simply to maintain their target allocation for the asset category. Based on Preqin data, nearly half of all LPs were tracking below their target PE allocation by the end of 2014, compared with just shy of 30% that were underweighted at the end of 2012. The bottom line: Fund-raising has plenty of room to grow on the demand side.

GP supply: It's crowded out there

LPs looking for PE funds to back had an abundance of choices. GPs shopping more than 2,000 funds of every description and across all geographies were on the road as 2014 began, looking to raise approximately \$740 billion, with nearly one-half of that amount targeting investments in North America. Europe-focused funds aimed to bring in \$196 billion, or about one-quarter of the total, and funds earmarked for the PE markets in the Asia-Pacific region and the rest of the world accounted for the balance. By fund type, sponsors of buyout funds were looking to raise more than one-quarter of capital sought worldwide.

Figure 1.7: Positive cash flow from distributions supported new PE fund commitments



Note: Europe includes developed economies only
Source: Cambridge Associates

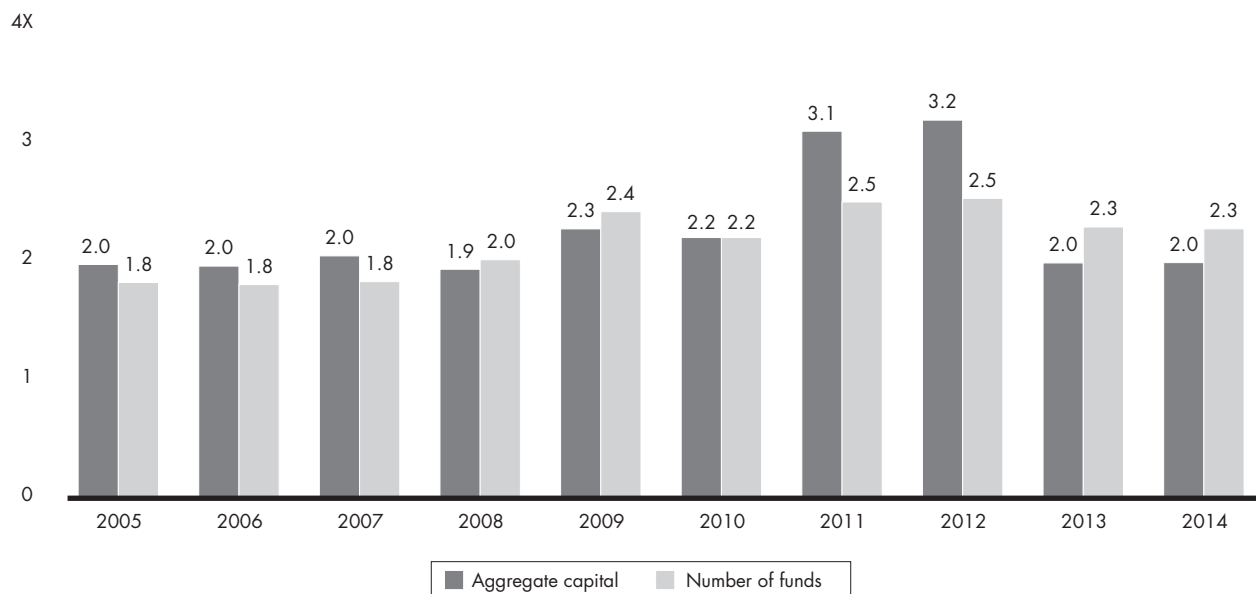
The key to GPs' prospects for fund-raising success, of course, was to hit the sweet spot of what LPs were looking to buy. Mid-market buyout funds targeting the US and Europe remained in high demand, capturing the top two spots in Probitas Partners's 2014 and 2015 institutional investor trend surveys of LPs' fund preferences. Similarly, growth-capital funds continued to rank high on LPs' lists. Big buyout funds again had a low ranking, but they managed to attract a lot of capital from major institutional investors with large sums of capital to put to work.

The pace and intensity of fund-raising remain hot and are markedly improved over what they had been earlier in this PE cycle. In 2009 and 2010, fund-raising was largely on pause as LPs' willingness and capacity to take on new commitments were weak. In 2011, when LPs started to enjoy positive cash flows that enabled them to reinvest in PE, GPs surged to capitalize on the green shoots of a recovery by mounting new fund-raising campaigns. Competition intensified as GPs' eagerness to raise new funds far outstripped LPs' ability to commit. With demand from LPs finally coming into full bloom, the fund-raising market in 2013 and 2014 has settled into a more normal equilibrium. More than twice as many buyout funds came to market last year as closed during the year, with GPs looking to raise two times more capital than LPs ended up committing (see Figure 1.8).

The persistent imbalance between GP supply and LP demand continues to make fund-raising challenging. The average amount of time GPs needed to raise a new PE fund still hovers at nearly 17 months—little changed since the global financial crisis. Buyout funds appear to be having more success, with the average time to raise

Figure 1.8: The wide gap has narrowed between GPs' supply of buyout funds and LPs' demand for them

The number or value of buyout funds on the road during the year divided by the number or value of buyout funds closed that year



Source: Preqin

a fund down to around 14 months for funds closed in 2014. Of course, averages obscure the reality that the most successful and sought-after GPs have been able to raise new capital quickly and easily, while others have struggled. Among the PE funds that closed in 2014, 30% met or exceeded their fund-raising target within 12 months, a meaningful improvement from two years ago. Buyout fund-raisers were more successful, with nearly half raising the capital they sought within a year (see Figure 1.9).

With so much money in the hands of LPs looking to reinvest in PE, the improved fund-raising results enjoyed by top-performing firms is spilling over to other GPs more broadly. Money that could not find a home in a new fund of a top-performing GP is cascading down to GPs with weaker or shorter track records, enabling more funds to successfully raise capital.

LPs are still shying away from recommitting to GPs with whom they have had a bad experience. But in a recent Preqin survey, four out of five LPs said they were open to investing with a GP with whom they had not previously worked. It takes significant investment for PE firms to cultivate relations with new LPs that may eventually result in a commitment of capital to a new fund, but the evidence shows it is paying off. Among funds that had their final close between 2012 and 2014, 64% of funds were able to replace 30% or more of the LPs that had invested in a predecessor fund with new investors.

Figure 1.9: Fund-raising remained bifurcated in 2014, but more GPs had success raising capital than in prior years



Source: Preqin

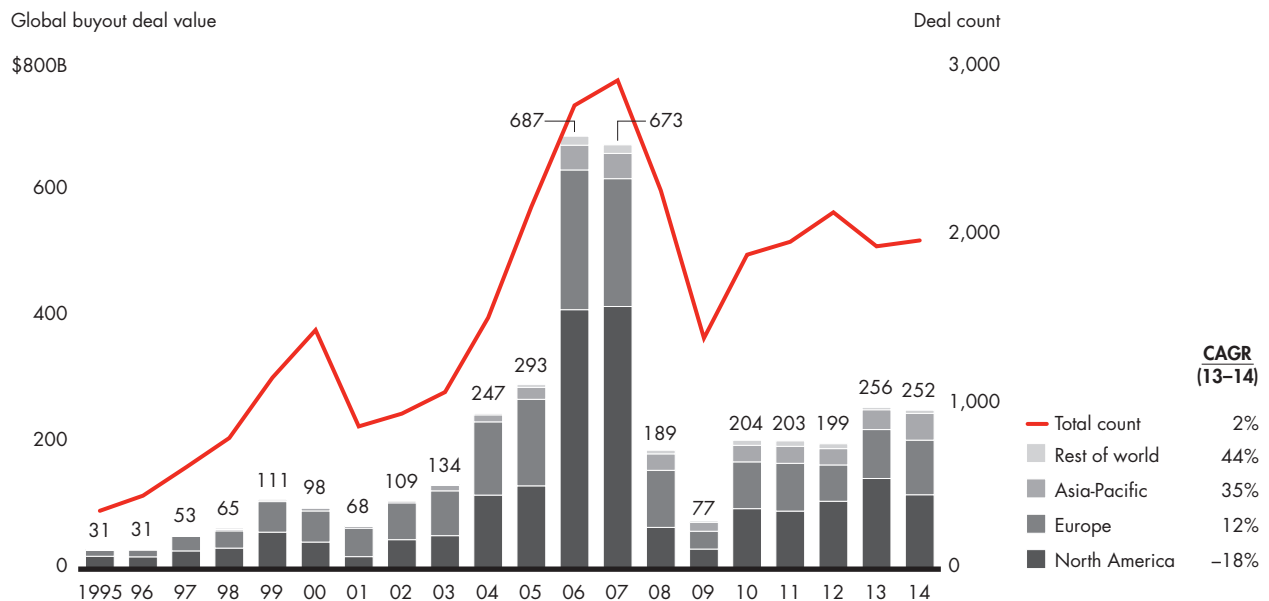
Investments: Turbulence beneath a calm surface

PE buyout activity has been remarkably flat since the latest expansion cycle kicked into gear back in 2010, and 2014 marked a continuation of that trend. Unlike in past cycles, when deal making steadily gained momentum as confidence in the upswing solidified, recent buyout activity has barely budged since snapping back from 2009’s recessionary levels (see Figure 1.10). In fact, buyout firms announced 1,955 transactions in 2014—only 85 more than in 2010—with a total deal value of nearly \$252 billion. Minor year-to-year fluctuations in the deal totals over the current cycle reflect more the idiosyncrasies of the specific transactions completed in a given 12-month period than a shift in trend.

Yet the apparent calm on the new-investment front masks intense—and growing—deal-making pressures just beneath the surface. The forces at work cut two ways. First, PE funds’ keen hunger to buy in an environment of intense competition, on the one hand, did battle with GPs’ self-imposed restraint not to overpay. Second, the continued rise of the public equity markets has lifted the floor on valuations that prospective PE buyers face, increasing acquisition multiples to levels that price many deals out of reach.

Vast sums of undeployed capital in the hands of a record number of PE firms has been the biggest factor propelling deal making forward in 2014. Nearly 6,000 active PE firms (more than 1,000 of them buyout firms), wielding \$1.1 trillion in dry powder (\$408 billion of it earmarked for buyouts), were in the hunt for

Figure 1.10: Global buyout activity changed little over the past four years



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 target’s location
Source: Dealogic

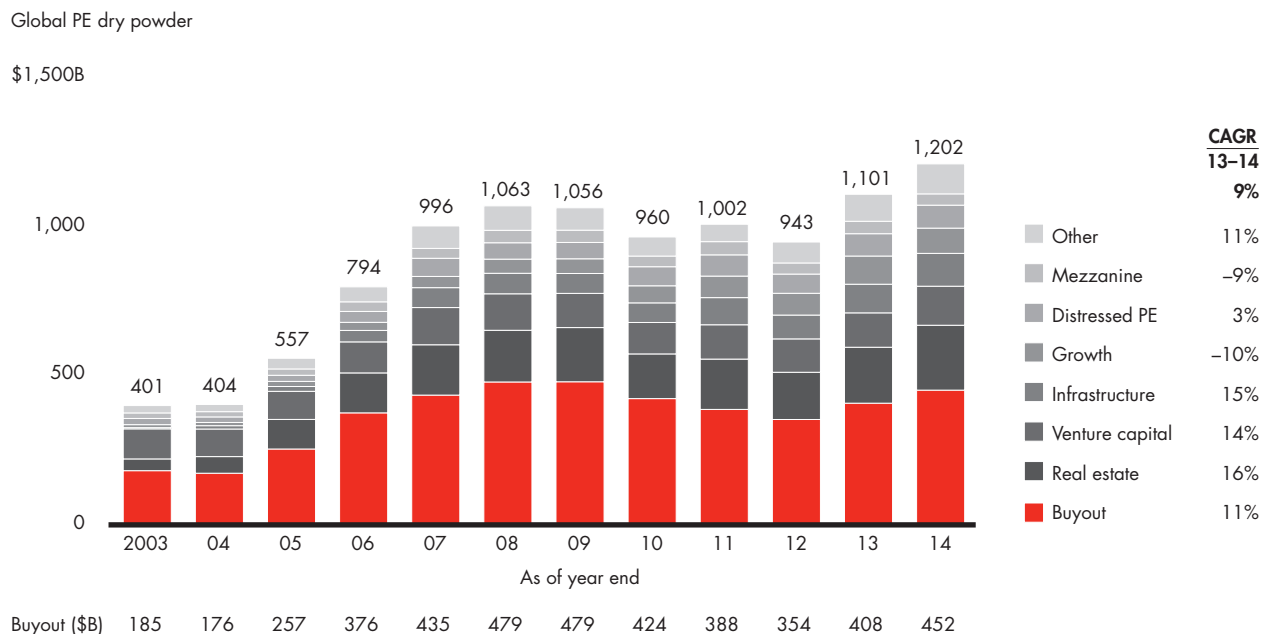
acquisitions as 2014 began. As the year unfolded, PE firms refilled their coffers faster than they could put capital to work; by year end, their mountain of dry powder topped out at a shade above \$1.2 trillion—\$452 billion of it for buyouts (see Figure 1.11).

Lenders desperate for yield flocked to PE, holding down the cost of debt for buyouts and offering favorable terms to issuers as the supply of credit far outpaced demand. Average multiples of debt used in leveraged buyouts in 2014 continued to climb in the US and Europe, inching back up to levels last seen during the prerecession years of 2006 and 2007.

Abundant dry powder and credit were not just characteristics of the mature US and European markets; steadily rising stores of capital overhung PE funds across the Asia-Pacific region as well, pressuring GPs to put money to work and cranking up competition for deals. In all, dry powder in the hands of Asia-Pacific-focused buyout and growth funds totaled \$87 billion at the end of 2014, an increase of 64% from the end of 2008.

Instead of greasing the skids of global deal making, however, these vast sums of dry powder, supplemented by abundant cheap debt in the hands of eager PE buyers, pushed up prices in a capital-saturated market where attractive assets were in limited supply. Courted on all sides, would-be sellers in every major market could hold out for top dollar for assets they controlled. PE buyers ran into stiff competition from familiar deal-making rivals. Flush with record-high levels of cash, corporations remained active acquirers, as they have been since the start of the economic recovery. Continued buoyant public equity markets also set a firm floor under asset valuations. Despite short-lived bumps that gave sellers no reason to recalibrate their price expectations, the FTSE 100 and DAX indexes ended 2014 up 8% and

Figure 1.11: PE funds held record amounts of dry powder in 2014, including \$452 billion for buyouts



Source: Preqin

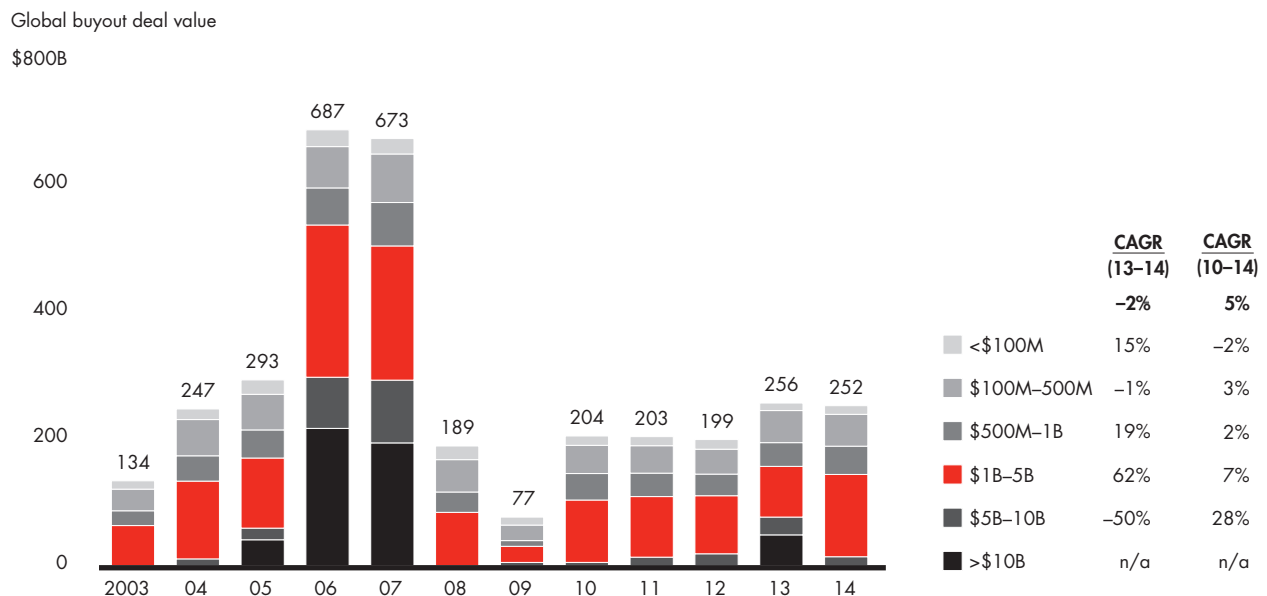
26%, respectively, and the S&P 500 soared 40% since the start of 2013, moving into record territory. According to data analyzed by S&P Capital IQ through the middle of 2014, purchase-price multiples for leveraged buyouts in the US averaged 9.6 times earnings before interest, taxes, depreciation and amortization (EBITDA) and 10 times EBITDA in Europe—highs the market had not seen since the peak of the last cycle.

Finally, self-imposed and externally applied restraints also reined in PE deal making. Coming out of the global financial crisis, PE funds have avoided joining forces with one another in the big club deals that were so popular in 2006 and 2007; as a result, the equity check size for any deal has been limited to what a single fund can write (fund mandates typically cap a fund from investing more than 15% of the fund size in a single portfolio company) along with co-investors. Squeezing PE deal size from the debt side, regulators are trying to limit the amount of leverage on deals. In the US, for example, regulators have issued guidance to banks not to finance takeovers where debt exceeds six times EBITDA.

Taken together, the caps on the amounts of equity and debt that can be marshaled to conduct a transaction keep a fairly tight lid on deal size. Limitations like those take potential deals off the table—not just big public-to-private conversions but also large sponsor-to-sponsor deals and carve-outs. The buyout market today is composed almost exclusively of deals valued at less than \$5 billion (see Figure 1.12).

Given the public equity markets' rise, it is no surprise that few public-to-private transactions took place in 2014; only three of the 10 largest buyout deals around the world were public-to-private conversions. Yet one benefit of the high valuations was the incentive they gave corporations to sell noncore assets. Many of these carve-outs ended

Figure 1.12: An increase in deals valued at \$1 billion to \$5 billion made up for the lack of mega-deals in 2014



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

up in PE portfolios, including four on the top 10 list. Sponsor-to-sponsor transactions rounded out the list of the biggest deals announced in 2014. Meanwhile, sales of privately held companies, typically smaller transactions, remain a mainstay of the industry.

As in Europe and North America, Asia-Pacific-focused PE funds labored hard to put capital to work in 2014. At \$81 billion invested in more than 700 deals, the topline number on the total value of completed transactions in the region set a record for the industry. But a more nuanced picture emerges if you look just beneath the surface: A handful of mega-growth deals, each valued in excess of \$1 billion and most originating in Greater China, accounted for one-third of the year's total deal valuation.

Traditionally and overwhelmingly, PE deals in Asia-Pacific markets have been limited to purchases of minority positions through private investments in public equities (PIPEs). Reflecting both the markets' increasing maturity as well as investors' sense that they need to take measures to protect themselves in today's pricey deal market, however, more PE funds are looking to acquire sufficiently large stakes in the companies in which they invest to gain some degree of operating control or, at least, to put themselves on a path to control. Although minority stakes still dominate PE deal making in the Asia-Pacific region, GPs appear to be increasingly successful in their efforts to gain board representation, decision rights in the hiring or firing of key managers and a say in the company's large capital investment decisions.

The fierce competition for deals has led PE firms around the world to roam beyond their normal hunting grounds in search of new investments. Big buyout funds, for example, are pushing into the middle market. Worldwide in 2014, one out of every five buyouts valued at between \$250 million and \$500 million involved at least one of the 15 largest GPs. In comparison, only one out of every eight middle-market deals attracted the biggest players at the height of the previous PE cycle.

Hunger for deals has led PE firms to get creative. Some buyout funds appear to be increasingly open to purchasing minority stakes, even when that means sacrificing the control buyout GPs usually insist on having to build value in their portfolio holdings. In October 2014, for example, TPG purchased a minority stake in GreenSky Trade Credit, a US-based home improvement financing company, for about \$150 million. Other funds are investing in convertible securities. Aeropostale, the struggling teen-clothing retailer, issued \$150 million in convertible preferred stock in 2014 to Sycamore Partners, a New York-based PE firm specializing in consumer and retail investments. The investment gives Sycamore the right to increase its existing 8% stake in Aeropostale by an additional 5% and moves the firm closer to its rumored ultimate goal of a takeover of the business. PE firms are even creating their own businesses in order to put capital to work. Partnering with other investors early last year, for example, Goldman Sachs provided start-up capital to launch Global Beverages & Foods in India. A. Mahendran, a serial entrepreneur with deep experience in building consumer brands, will lead the new consumer products company. PE investors are also showing a renewed interest in the "buy and build" strategy of making add-on investments to complement a company they already own.

With heightened competition for assets raising multiples paid on new deals to record levels, PE firms are challenged more than ever to generate outsized returns. GPs will need to earn their success by controlling what they can. This includes becoming more creative in sourcing attractive transactions that offer unpriced value. GPs will also need to take on risks that they are comfortable underwriting in their search for great performance.

PE funds learn to dance to a slower Brazilian beat

In a world overflowing with capital to invest and cutthroat competition for deals in the aftermath of the global financial crisis, Brazil beckoned PE firms as a land of opportunity. The biggest market in Latin America and the gateway to that still largely untapped region, Brazil boasted healthy GDP expansion and rapidly rising household wealth, which enticed more than a dozen prominent global buyout firms—among them, Actis, Carlyle Group, General Atlantic, TPG and Warburg Pincus—to plant a flag there since 2007.

PE has sunk solid roots in Brazilian soil, but as has been the case in most dynamic young markets, investors have had to adapt to fast-changing conditions. Brazil's economy has slowed dramatically since 2010 and flirted with recession last year. Consumer income growth stalled and investor confidence sank amid the political uncertainty that surrounded the presidential election and large government deficits. The Bovespa stock index slid more than 20% over the past four years.

Meanwhile, dry powder continued to pile up. As 2014 began, PE funds were sitting on \$4.7 billion in capital commitments earmarked specifically for investment in Brazil, with a portion of another \$6.6 billion that had been targeted at South America likely ending up in Brazil. Three notable new fund-raising that closed during the course of the year—Advent International's \$2.1 billion, Pátria Investimentos's \$1.8 billion and Gávea Investimentos's \$1.1 billion—dramatically increased Brazilian PE's capital overhang. Canada Pension Plan Investment Board, a major institutional investor; GIC, Singapore's sovereign wealth fund; and Tiger Global Management, the big hedge fund, also revved up their search for PE deals in recent years.

Against that challenging backdrop, however, new PE deal activity held up surprisingly well. PE's continued strength stems from the bifurcated nature of the Brazilian market, which gives PE a seat at the table in both good and bad economic times. Brazil's economy is split between a relatively small number of big, state-owned businesses and large, often public, companies, on the one hand, and the vast majority of small, midsize and privately held companies, on the other. When looking for growth capital, Brazil's smaller businesses have few options. The public equity markets are unreceptive to new offerings, and bank lending is either unavailable or very expensive. Private equity is often the best source of new funding for these entrepreneurs.

In 2014, PE funds tacked to the shifting economic winds. In all, PE investors closed 56 deals last year—fewer than the 66 transacted in 2013 but more than the 46 completed in 2012. Indeed, successful PE deal makers managed to leverage the sluggish economy to their advantage. The persistent gap in asset valuations between buyers and sellers, which had been a challenge to PE deal making, narrowed considerably.

Successful deal makers are looking for potential deals outside of Brazil's major urban centers and capitalizing on their deep networks of local relationships to turn up proprietary opportunities. For example, managing directors at Actis, a seasoned leader among PE firms that focus on emerging

markets, patiently courted the owners of Genesis Group—a major provider of inspection, certification and compliance services to the Brazilian agribusiness sector—after extensive research put the company, located in the interior of the state of Paraná, on its radar.

Applying the same lessons for deal making in a slow Brazilian economy should serve PE funds well in 2015, when GDP growth is forecast to be no better than it was last year and a further devaluation of the real is anticipated. Companies suffering from financial distress could generate refinancing and consolidation opportunities for PE. A dormant IPO market may incline entrepreneurs who are looking to raise new capital to turn to PE for bridge investments that will tide them over until conditions for new public offerings improve. And the currently low value of the public equity markets may present opportunities for PE funds investing in public company shares to pick up bargains. PE investors should continue to find deals in sectors that are less tied to the growth themes that first attracted them to Brazil, such as rising consumer spending, by targeting assets that are more insulated from the business cycle—like education, agribusiness, infrastructure and healthcare.

The major shadow hanging over Brazilian PE in 2014 has been constricted exit channels. With IPOs off the table and just a few sponsor-to-sponsor transactions taking place last year, purchases made by corporate acquirers presented the rare bright spot for PE exits. Though there were not many sales to strategic buyers, those that occurred commanded strong valuations and produced sizable returns. For example, GP Investments's sale of Sascar, a leading fleet management and cargo tracking company, to tire company Michelin in 2014 generated a return of 2.6 times equity within three years.

Unlike in other emerging markets, where PE money goes in but rarely comes out, Brazilian PE funds have been able to sell assets and return capital to LPs even under difficult economic and market conditions. PE firms' continued ability to do so in what is shaping up to be another challenging exit environment in 2015 will be an important test of their future fund-raising prowess.

Returns: Mind the gap

The bar is always set high for PE returns. Long experience has accustomed LPs to expect that PE will remain their best performing asset class. But as recently as just a few years ago, their confidence that GPs could deliver on those high expectations was badly shaken. PE returns lagged the public equity markets through 2009 and 2010, and worries mounted that PE investments made during the boom years would end up being a disaster.

Today, however, PE is back. Riding the tailwinds of sharply higher public equity markets, PE returns roared ahead in 2013 and had another strong showing through midyear 2014, according to the latest data available at the time of publication. A cascade of capital is flowing to PE investors. A recent survey by Preqin found that just one out of every 12 LPs felt that PE failed to meet its expectations compared with one in four surveyed in July 2009. A wave of market beta—a heady mix of GDP growth, near-zero interest rates and covenant-lite loans, and rising mark-to-market valuations—helped power PE's rebound. GPs also had a starring role in the recovery,

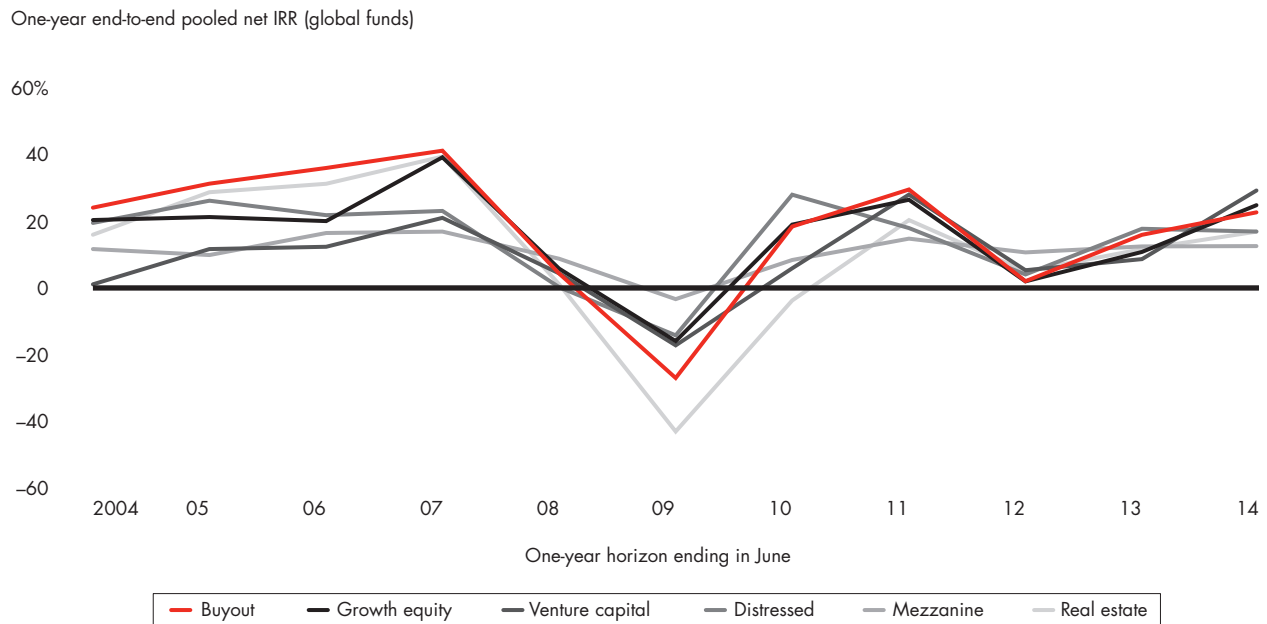
through smart financial and operational restructuring of assets that fortified them against the economic storm and positioned them to benefit from the recovery. Together, the combination of market beta and the alpha of active value creation engineered PE’s resurgence. PE returns are up both in the short run and over the longer term.

The strong returns story reflects solid fundamentals of robust exit markets and valuation gains on PE funds’ portfolio holdings. But as we shall soon discuss, a disquieting concern lurks just beneath this shining surface. PE’s long-term performance edge over investments in the public equity markets appears to be diminishing in recent fund vintages. A gradual erosion in PE’s overall competitive advantage has important implications for PE investors.

LPs had good reason to cheer PE’s performance through the first half of 2014, the latest results available at the time of publication. According to data compiled by Cambridge Associates, an investment consulting firm, nearly every major category of PE matched or exceeded the strong double-digit one-year gains racked up in 2013 (see Figure 1.13). Buyout funds climbed 23%; growth-equity funds were up 25%; and venture capital funds came in 30% above the previous year. Across the major geographic regions, buyout and growth-equity funds gained 24% in both the US and in the developed economies of Europe over 2014 through midyear; emerging-market-focused funds posted a modest 5% uptick.

The strong short-term fund returns flowed from two powerful streams: from the healthy gains funds realized through asset sales in a buoyant year for exits, as well as from the appreciation in the carrying value of assets that remained unsold in PE portfolios. The unrealized gains, the result of mark-to-market accounting adjustments, have been an especially important contributor to the solid one-year results. Despite robust exit activity in

Figure 1.13: Short-term returns continued to climb through mid-2014



Source: Cambridge Associates

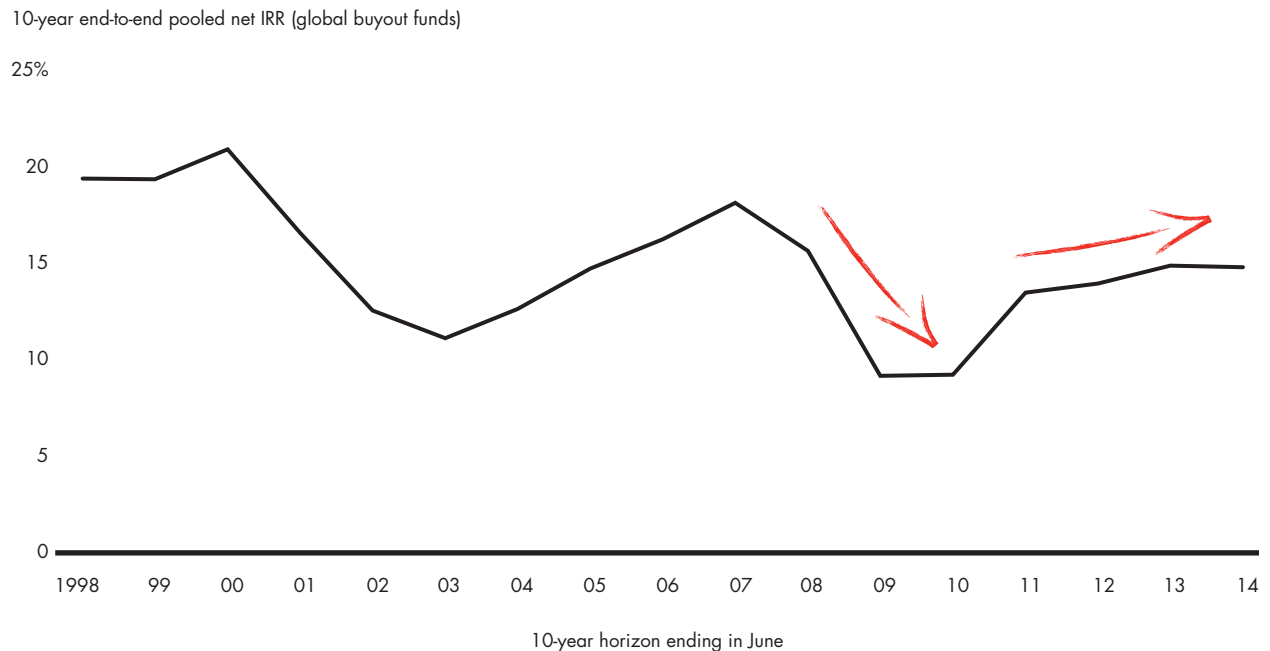
recent years that has shrunk the once-long overhang of unrealized PE portfolio holdings acquired during the boom years from 2005 through 2008, the value of all unrealized PE assets currently stands at a record \$2.6 trillion through June 2014, 50% more than at year-end 2010. The value of unrealized assets held in buyout funds now stands at \$942 billion.

Indeed, notwithstanding short-term swings in the public equity indexes, portfolio valuations for nearly every type of PE holding have increased each quarter since September 2011. Only mezzanine funds and venture capital funds experienced brief write-downs before rebounding.

A healthy recovery in longer-term PE returns mirrored the good short-run gains. Having hit a low of an 8.8% return at the bottom of the PE cycle in 2009 and 2010, the return for global buyout funds over a 10-year time horizon has trended gradually upward over the past four years, standing at 14.4% as of midyear 2014 (see Figure 1.14).

Stronger-than-expected returns from the big buyout fund vintages of 2005 through 2008 have contributed to the recovery. Acquired at high prices in the years immediately preceding the global financial crisis, asset valuations of these large fund vintages took a huge hit when the public equity markets tumbled. GPs were obliged to stretch out holding periods as they nursed assets back to health and gradually harvested gains. That work is well under way for the oldest boom-year vintage: The 2005 funds have now remitted back to LPs 99 cents for each dollar of original equity capital invested.

Figure 1.14: Long-term buyout-fund returns remain strong, at better than 14% annualized over 10 years



Source: Cambridge Associates

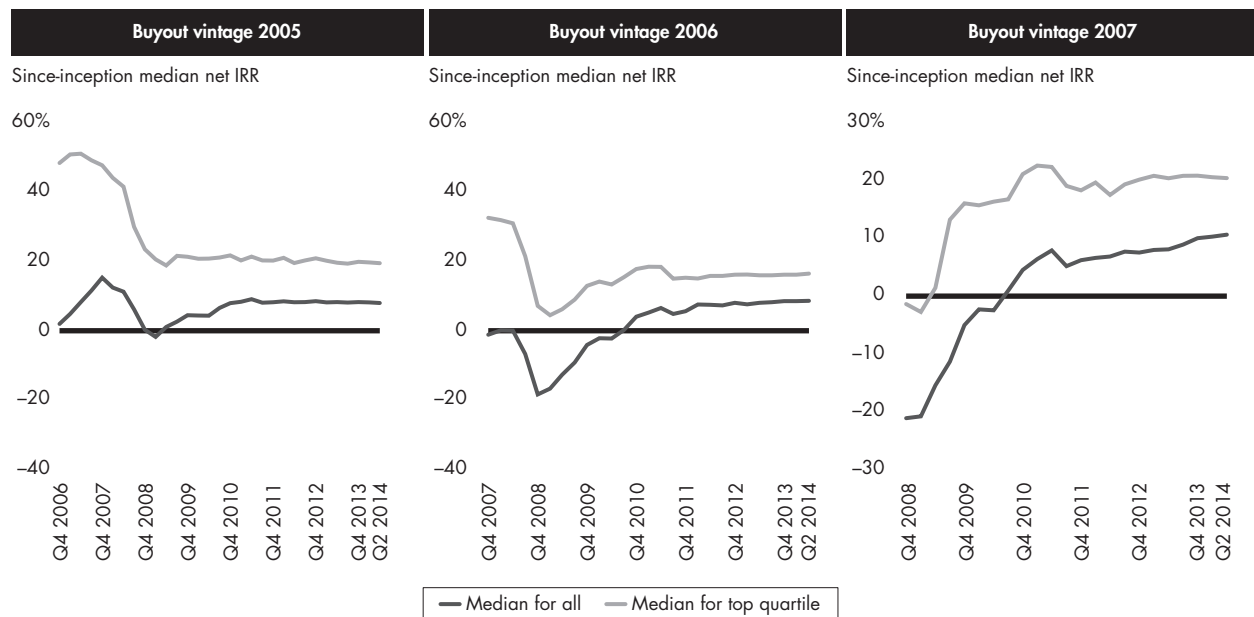
The recovery of the public equity markets has further helped the healing process, enabling GPs to mark up the boom-year vintage holdings that remain in their portfolios to reflect their regained value. Because GPs are generally conservative in their mark-to-market revaluations (they don't want to surprise LPs with bad news in the event they may later be required to discount some of the accounting gains they previously booked), these portfolio gains likely understate what the boom-year vintage funds will ultimately yield.

The big boom-year vintages are back on track to deliver solid results (see Figure 1.15). Including both realized and unrealized gains, the pooled returns of the median 2005 vintage buyout funds rebounded from minus 1.8%, where they bottomed out by the end of the first quarter of 2009, to 8% by the middle of 2014. The story for the big 2006 and 2007 vintage buyout funds is much the same. Median returns for the 2006 buyout funds have recovered from minus 18% at year-end 2008 to 8.6% in mid-2014; for the 2007 vintage, median returns snapped back from minus 21.1% at year-end 2008 to 10.6% in the most recent accounting.

The public market benchmark: Good compared to what?

The truest test of PE performance is how returns—net of fees and carry—compare with those of the best alternatives available. Indexes of publicly traded equities make reasonable benchmarks, but for the comparisons of returns to be meaningful, they must explicitly acknowledge that PE investments are, by and large, lumpy and illiquid. Any comparison must also recognize that PE is a long-term investment and the revaluation of portfolio holdings plays a large role in determining short-term PE returns. Fortunately, independent researchers and investment advisory firms have made such apples-to-apples comparisons possible, in recent years, through the development of a

Figure 1.15: The big boom-year vintages are on track to deliver solid gains



Notes: Vintage year is determined by year of fund's first cash flow; return data for all vintages is global
Source: Cambridge Associates

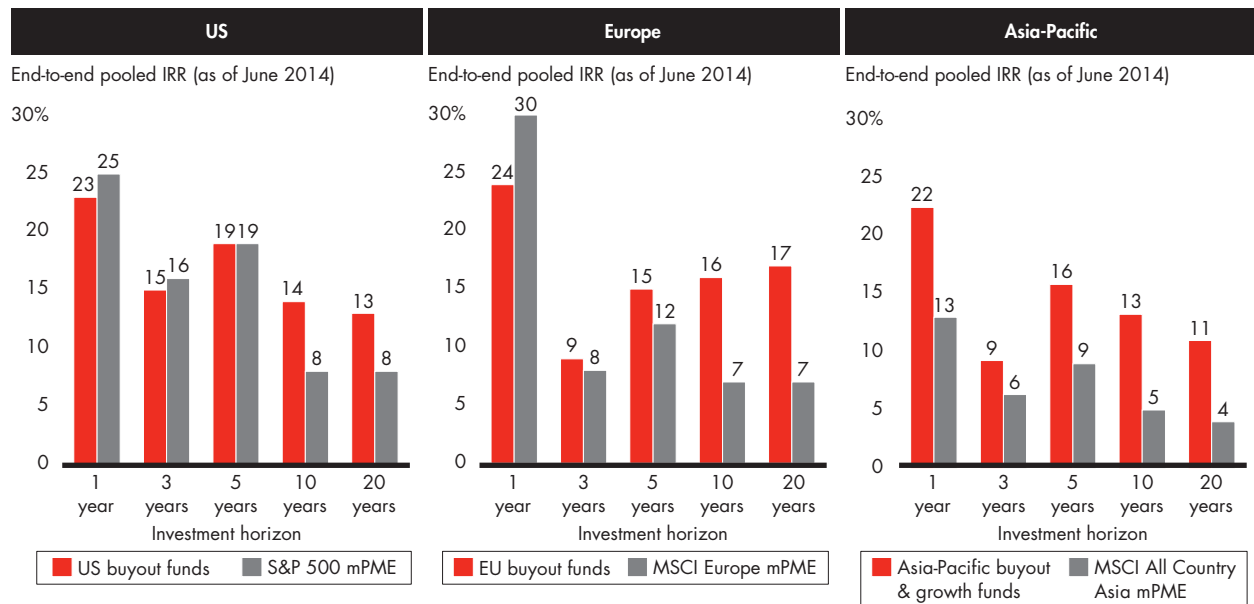
measurement standard called the public market equivalent (PME). Cambridge Associates has refined one such proprietary measure, called modified PME (mPME), to replicate the timing and size of PE investment flows—including both purchases and sales—as if they had been invested, instead, in a basket of publicly traded stocks.

When stacked up against this benchmark, US-focused buyout funds underperformed the S&P 500 mPME over a one- and a three-year holding period, equaled the mPME over five years and then surpassed the index returns over a 10- and a 20-year time horizon (see Figure 1.16). Europe-focused buyout-fund returns badly lagged those of the European stock index mPME after just one year, but they began to overtake them by the third year and continued to outpace the benchmark by widening margins over a five-, a 10- and a 20-year investment horizon. In the Asia-Pacific region, the combined returns for buyout and growth funds surpassed public market gains over all investment periods.

PE’s continued ability to outpace public market gains over the long term can no longer be taken for granted. That performance edge has narrowed considerably for more recent vintage funds (see Figure 1.17). Among most US- and Europe-focused buyout funds raised between 2006 and 2008—a cohort that has had sufficient time to invest capital and harvest realized gains—returns merely track those of the S&P 500 mPME and MSCI Europe mPME, respectively.

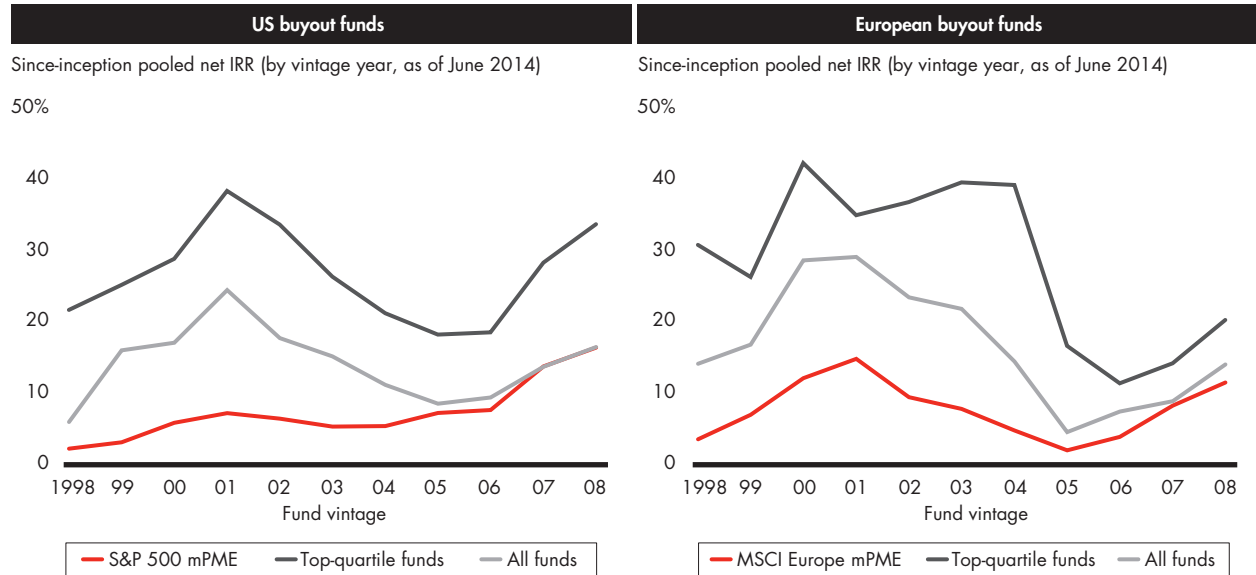
At this point, no one can know whether the more recent vintage funds will see their returns accelerate as they mature and realize more of their gains through exits rather than mark-to-market revaluations. But as Figure 1.17 shows unambiguously, top-quartile buyout funds continue to maintain a sizable performance lead over the benchmarks, as they have for all fund vintages virtually since the PE industry’s inception. There is more pressure than ever on LPs to sort out who those top-performing GPs will be going forward.

Figure 1.16: Buyout funds have outperformed public markets in all major regions over longer time horizons



Notes: Europe includes developed economies only; Cambridge Associates’ mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in PE been invested in public markets instead; the public index’s shares are purchased and sold according to the PE fund cash-flow schedule
Source: Cambridge Associates

Figure 1.17: Top-quartile funds continue to outperform, but for average funds the gap has narrowed



Notes: Europe includes developed economies only; vintage year is determined by year of fund's first cash flow; vintages after 2008 were excluded because they have relatively few investments and realizations; Cambridge Associates' mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in PE been invested in public markets instead; the public index's shares are purchased and sold according to the PE fund cash-flow schedule
Source: Cambridge Associates

Key takeaways

- PE continued to ride the waves of a world awash in capital in 2014, making it a great time to be a seller, as investors looking to put capital to work were eager acquirers of PE-owned assets. But it was a difficult time to be a buyer, as a superabundance of capital in the hands of GPs and other investors—along with strong public market valuations—stirred intense competition and inflated asset prices.
- Buyout-backed exit activity hit record highs worldwide for both deal count and value. In 2014, sales to corporate strategic buyers were up 13% by count and much more in value than in 2013, as several very large assets traded. PE sellers took advantage of accommodating public equity markets to launch IPOs, which increased in number by 20% over the past year, and to execute follow-on sales of shares by companies that had previously held an initial offering. Sponsor-to-sponsor sales were up as well, but the strength of the strategic-buyer and IPO channels limited how good a year it was for this exit channel.
- Global PE fund-raising was down 6% in 2014, but the drop was due more to the idiosyncrasies of the funds that happened to be in the market than a sign of weakness. Just one mega-buyout fund exceeding \$10 billion closed in 2014, compared with five in the previous year. LPs were flush with cash from increasing distributions and continued to recycle capital into new PE funds. Although GPs' supply of new fund offerings continued to outstrip LPs' demand by about two to one last year, more funds managed to reach their goals. Indeed, with so much money in the hands of LPs, capital that could not find a place in a fund offered by top-performing firms spilled over into other GPs' funds.
- Buyout investment activity barely budged in 2014—up just 2% by count and down by the same percentage in value. An increase in deals valued between \$1 billion and \$5 billion made up for the lack of mega-deals last year. Low-cost debt financing was readily available, and GPs were sitting on a mountain of dry powder they were eager to put to work—more than \$400 billion earmarked for buyouts at the start of 2014. But PE firms faced stiff competition for assets that came up for sale, and record-high valuations they were obliged to pay left little room for GPs to hit their targeted returns.
- Buyout-fund returns increased through the first half of 2014, boosted both by the profitable sales of many assets as well as by the higher mark-to-market valuations of unsold assets in PE portfolios. However, buyout funds have underperformed the recent strong run-ups in the public equity markets. Only over longer 10- and 15-year investment horizons has PE outperformed public equities.
- PE's performance edge vs. public market benchmarks has narrowed considerably for more recent vintage funds. It remains to be seen whether the returns of funds from more recent vintages will accelerate as they mature and realize more of their gains through exits rather than through mark-to-market revaluations. But currently, only the top-quartile buyout funds continue to enjoy a sizable performance lead over the public market benchmarks.

2. What's happening now: Dynamics that will shape PE in 2015 and beyond

Viewed from the safe shores of 2015, it is easy to forget how dire the prospects for the PE industry looked seven tumultuous years ago as investors stared into the abyss of an imploding economy. The global financial crisis brought a screeching halt to the PE boom years—the unprecedented three-year run from 2005 to 2007 that was characterized by mega-buyouts at record-high prices and sky-high multiples of EBITDA. The boom-year deals were not only bigger, they also were more heavily leveraged. When the downturn hit, the industry was primed for the calamitous fall that ensued, and few observers at the time expected anything less than widespread disruption for nearly all PE funds' portfolio companies and defaults for many.

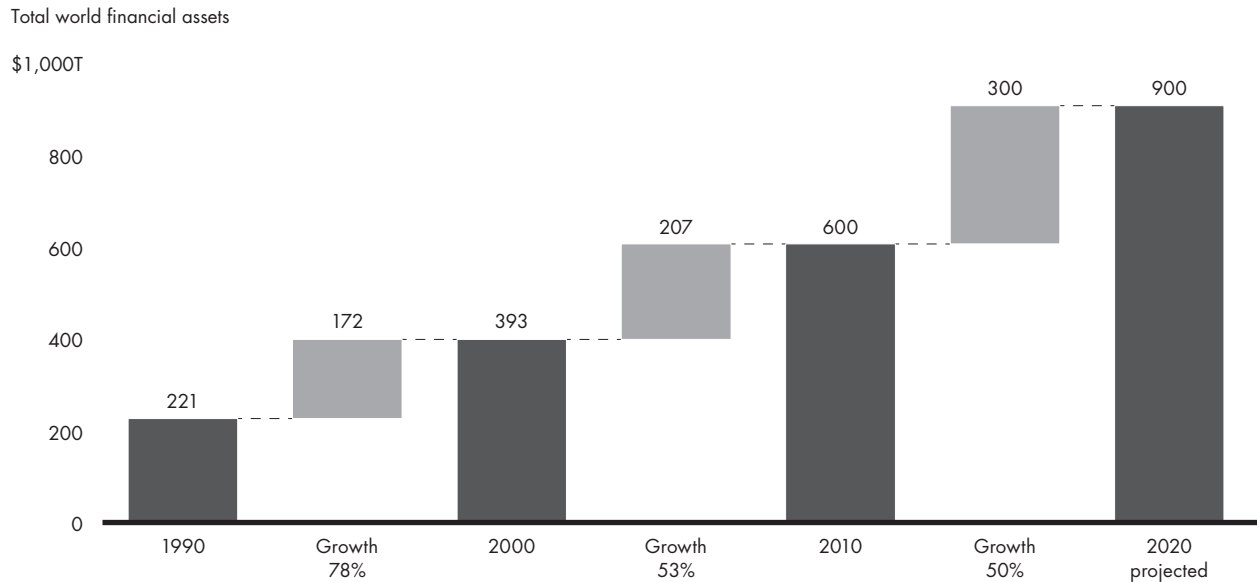
How differently events have turned out. Successive years of near-zero interest rates and favorable credit conditions enabled PE borrowers to refinance their debt. Strong public equity market gains lifted the value of marked-down PE assets. Robust corporate profits and accommodating IPO conditions paved the way for profitable exits. And with waves of distributions resulting from profitable portfolio realizations flowing their way over the past few years, LPs have restored their confidence in PE and increased their capacity to commit to new PE funds.

Where does that leave PE today? Clearly, when well-founded expectations of an industry in trouble are so strongly at odds with the ultimate reality of renewed vigor and health, there must be forces at work that have yet to receive their full due. In this section, we highlight four forces that have exerted increasing influence over PE in recent years and will likely weigh heavily in the industry's evolution in ways that every PE investor will need to be aware of in 2015 and beyond.

The first of these is the vast global expansion of investors' balance sheets, leading to capital superabundance and total financial assets of more than 10 times global real GDP. Totaling some \$600 trillion in 2010, financial assets will increase by another 50% by the end of the decade, according to Bain's Macro Trends Group projections (*see Figure 2.1*). We will explain the role that capital superabundance played in boosting PE's recovery following the recession and how the continued swelling of financial assets threatens to distort PE investment decisions and magnify risks in the period ahead.

Next, we consider the challenge posed by "shadow capital" in the hands of LPs, the role it is playing in PE deal making and how it is altering the characteristics and economics of the LP-GP relationship. Shadow capital is enabling LPs to tailor PE investment programs to match their unique preferences—often looking to GPs with whom they partner to provide active asset management, other times investing alongside GPs as co-sponsors and occasionally investing independently of, and potentially in competition with, them.

We then size up the opportunities that PE firms will find as they refocus on the US, the industry's biggest and most mature market. Currently, a rare oasis of improved GDP growth in an otherwise struggling global economy, the US economy is benefiting from unique sources of strength in its consumer, energy and technology sectors that could provide a solid foundation for sustained expansion. But as we will see, the US is also PE's most competitive and expensive market for finding attractive investment opportunities. For PE firms to thrive on American soil in coming years, they will require exceptional value-creation skills.

Figure 2.1: The rapid growth of financial capital has shaped the global economy—and PE—since the 1990s

Note: All figures are in real 2010 US dollars at 2010 exchange rates
Sources: International Monetary Fund, *World Economic Outlook: Slowing Growth, Rising Risks*, September 2011; Organisation for Economic Co-operation and Development; national statistics; Bain Macro Trends Group analysis

Finally, we take up the challenges that LPs face today in identifying the most successful GPs to invest behind. PE fund returns have become more compressed than ever before, the steady outperformance of leading PE firms is less consistent than in the past and longer holding periods are making it harder for LPs to rely on the performance of a GP's current fund as a guide for determining whether or not to commit to the firm's next one. The constellation of issues influencing PE at this crucial juncture in the industry's development will exert its pull throughout the year ahead and likely for years to come.

For better and worse, capital superabundance is here to stay

PE's impressive rebound from the downturn subsequent to the 2008 global financial crisis—along with the factors that created the buyout boom and brought PE to the precipice in the first place—has been a manifestation of the enormous expansion of financial assets that have been building up in the global economy for more than 25 years. The confluence of several powerful trends, this capital superabundance is the product of financial engineering, high-speed computing and a loosening of financial services regulations that supplanted the post-World War II fixed exchange-rate system with a system allowing rapid expansion of capital around the globe. The resulting growth of financial assets has been prodigious and relentless: Global financial capital increased 53% from 2000 to 2010, reaching some \$600 trillion, and Bain's Macro Trends Group projects that it will swell by half again, to approximately \$900 trillion, by year-end 2020.

The power of capital superabundance has roiled markets everywhere over the past two decades: It figured prominently in emerging Asia's growth and subsequent financial crisis in the late 1990s. It helped inflate the

tech bubble in the US that evaporated in the subsequent crash that wiped out \$5 trillion in market value. It expanded the US housing bubble that peaked in 2006. And it played a lead role in PE firms' ability to mobilize large pools of capital, fueling the buyout boom years between 2005 and 2007.

As it approached a cyclical peak, global buyout deal value spiked from \$293 billion in 2005 to \$687 billion and \$673 billion in 2006 and 2007, respectively. Headline-grabbing mega-buyouts that exceeded \$10 billion led deal making at the apex of the expansion. Often takeovers of large publicly traded corporations, mega-deals accounted for more than one-quarter of the boom-year totals in terms of value. PE buyers were willing to pay high prices to win intensely competitive auctions, as average deal multiples climbed to 9.7 times EBITDA on US and European leveraged buyouts in 2007. Lots of readily available debt capital helped pay for the takeovers, as buyers in the US and Europe financed leveraged buyouts using an average of 6.1 times EBITDA for their deals. But instead of being set up for the success they worked so hard and paid so dearly to pursue, PE funds quickly discovered they were poised for disaster when they were blindsided by the 2008 financial crash.

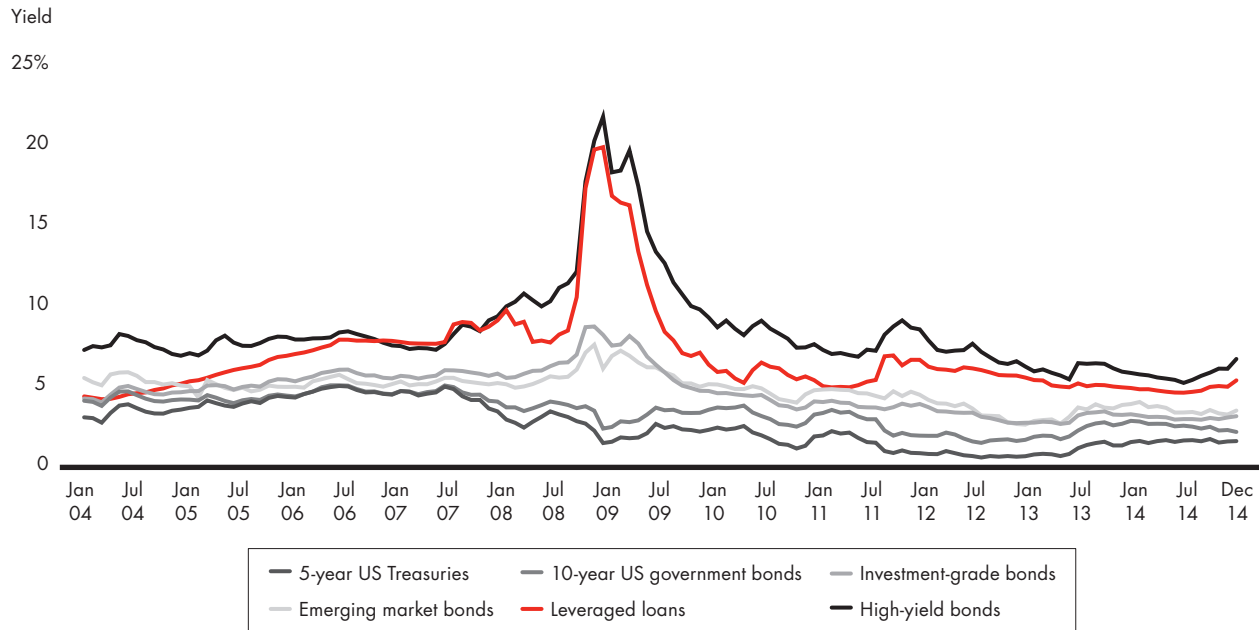
How capital superabundance helped rescue PE following the downturn. As they surveyed the wreckage of the global market meltdown and took stock of what lay ahead, PE investors found little cause for optimism. A trio of formidable challenges loomed: massive asset write-downs mandated by mark-to-market accounting regulations, seemingly impassable roadblocks at every exit channel and a towering wall of portfolio company debt refinancings needed to avoid defaults.

Each threat was potentially an existential one, and mega-buyout funds—those greater than \$4.5 billion—were the hardest hit. Write-downs on these big funds stripped an average 22% off their assets' book value in the fourth quarter of 2008 alone. Meanwhile, interest rates on the high-yield bonds and leveraged loans issued to finance the purchase of these suddenly depreciated assets rocketed toward 20% and triggered covenants on some of that debt. Any hope that GPs of these funds may have held for a profitable exit from their beaten-down assets dwindled away.

In the end, none of these challenges led to the industry's downfall, thanks to the heretofore underappreciated role of superabundant capital. Central bank programs unleashed a flood of liquidity that quickly brought rates on high-yield bonds and leveraged loans back to prerecession levels. By July 2009, average rates on leveraged loans fell to 8.4%—a drop of nearly 12 percentage points from their peak just seven months prior and about where they had been before the crash. High-yield bond rates, which topped out at 22% in December 2008, dropped by nearly half, to 11.5%, by August 2009. With debt investors desperately scouring for yield wherever they could find it, rates on leveraged loans and high-yield bonds issued by PE borrowers kept falling—to just 5.4% and 6.8%, respectively, by the end of 2014 (see *Figure 2.2*).

The benign interest-rate environment worked wonders in razing the wall of refinancings that PE borrowers faced. From where they stood at the beginning of 2009, when rates were near their peak and showed little likelihood of coming down anytime soon, GPs were looking at the prospect of having to roll over ever-steeper amounts of maturing high-yield bonds and leveraged loans through year-end 2014—if creditors were still willing to lend, of course. Obligated to replace \$13 billion in maturing US leveraged loans in 2010, GPs would face a daunting sixteenfold increase in loans coming due in 2014, totaling some \$513 billion over the five-year period. Scaling that steep wall of debt refinancings would have been painful for most PE portfolio companies and perhaps ruinous for many.

Figure 2.2: The rapid drop in interest rates since 2009 and yield-hungry creditors helped portfolio companies skirt default



Sources: Merrill Lynch; PIMCO; Bloomberg; S&P Capital IQ

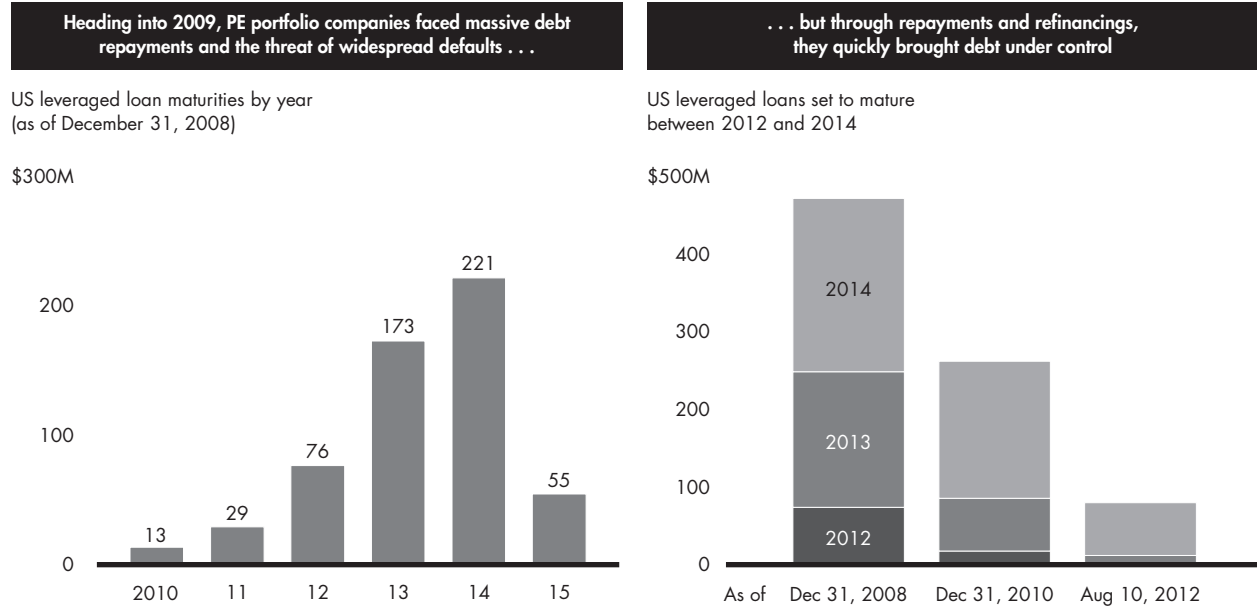
Eager lenders and accommodating debt markets spared them that fate. As business conditions began to stabilize by mid-2009 and creditors regained confidence that the threat of widespread portfolio company defaults was retreating, creditors' hunger for yields outstripped their worries of default risk. By 2012, borrowers had managed to level the wall of refinancing down to a small fraction of its original size (see Figure 2.3). Rather than having to worry about a potential credit crunch as they struggled to restructure debt, PE funds were buoyed by a flood of liquidity.

Capital superabundance also quickly helped revive the valuations of PE funds' portfolio holdings by lifting public equity prices. As buyout-fund GPs revalued their portfolios to reflect stock market gains, net asset valuations climbed nearly every quarter since the financial crisis hit with the brief exception of the third quarter of 2011, when Europe's sovereign debt crisis ignited fears that the eurozone would slide back into recession (see Figure 2.4).

With rising valuations powered by broad market beta, worries of massive PE defaults soon subsided. Examining 337 companies owned by the 14 largest PE sponsors, Moody's, the credit-rating agency, discovered that the annualized 6% default rate between 2008 and 2013 of the PE-backed companies in the sample was a shade lower than that of similarly rated companies that were not in PE hands.

The period following the downturn had its share of notable multibillion-dollar PE defaults. However, failures had little to do with the size of the portfolio company or how much leverage the buyout fund GPs used to finance it. The chief reason for many of the PE defaults associated with the financial crisis was the fact that the companies that stumbled were not well positioned for success from the start. The downturn did not cause these deals to fail; it merely hastened their downfall.

Figure 2.3: The “wall of refinancing” worries that once looked insurmountable have been overcome



Source: S&P Capital IQ LCD

Figure 2.4: Steadily increasing asset valuations have boosted PE buyout portfolios since the financial crisis



Source: Preqin

The experience of the past several years confirms patterns about deal success and failure that Bain & Company has seen developing for a long time. Bain has been co-investing alongside clients in deals for more than 20 years. Combing through this extensive set of deals with which Bain is intimately familiar, we have identified a set of winning factors that correlate with deal success. Winning factors include characteristics such as a high market growth rate for the relevant sector in which a target company competes and opportunities to expand into an obvious product or geographic adjacency. Bain has found few deals that achieved unambiguous success in the absence of at least one winning factor—and the more of these factors there are, the more potential ways for a deal to win. Bain has also documented several “warning beacons” that are highly likely to undermine a deal’s success, even if only one is present. One such indicator of trouble is to underestimate the impact of competitive challenges that disrupt a target company’s business model. That is what scuttled Apollo Global Management’s \$1.3 billion buyout of Linens ‘n Things in 2006. The big-box housewares chain failed to adjust to the rapid shift in consumer spending to e-commerce and away from brick-and-mortar stores, leading the company to file for bankruptcy in 2008.

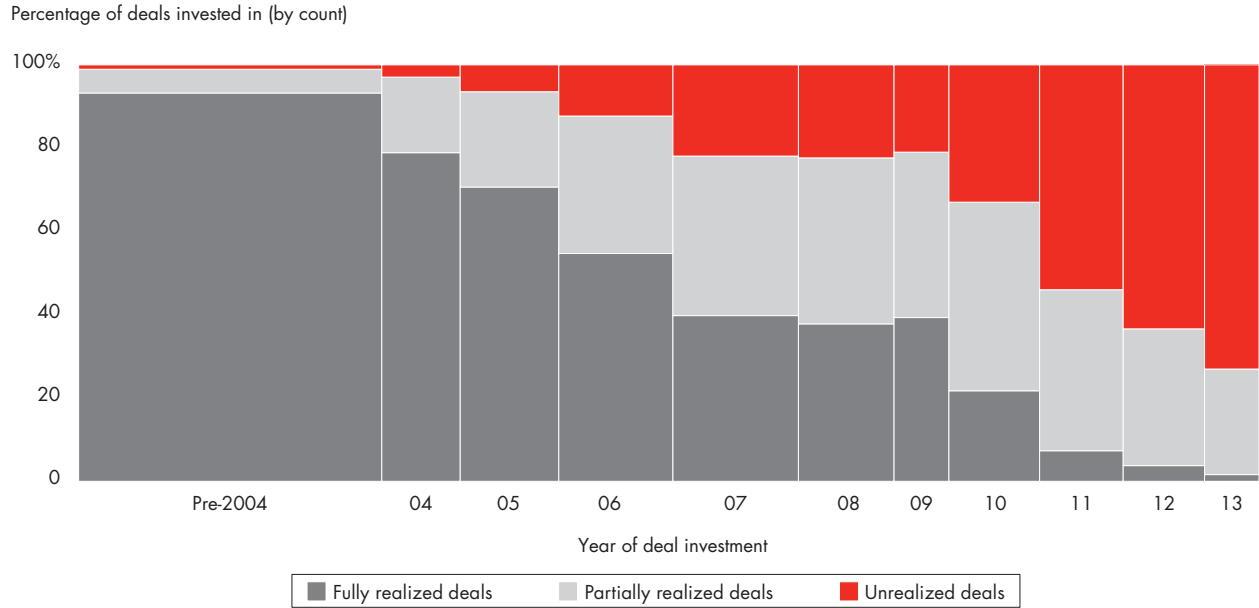
Ultimately, buyouts from the boom years preceding the market crash fell into three distinct groups. The obvious winners were deals that had one or more winning factors and no warning beacons; barring unforeseen shocks, such as terrorism or natural disasters, these assets were highly likely to be successful from the outset. Clear losers lacked winning factors and had at least one glaring warning beacon; they were unlikely to succeed, irrespective of business-cycle or financial market conditions. The third category of deals had characteristics that made them neither especially good nor particularly bad, and this group benefited most from the helpful effects of capital superabundance. Bought for high prices at the cyclical peak, these companies could easily have tipped into losing territory had it not been for the surge of market beta that ultimately bailed them out.

PE funds husbanded their buyout assets through the downturn and rode a wave of market beta to successful exits that, while taking longer than the three- to five-year holding periods envisioned at their time of purchase, were unanticipated just a few bleak years before. As public markets recovered, the door for IPOs reopened and the confidence of strategic corporate buyers rebounded. The overhang of exits from boom-year holdings gradually began to recede. By the middle of 2014, PE funds had at least partially realized gains from the vast majority of buyouts they had made during the boom years (*see Figure 2.5*). The small numbers of unrealized investments made in 2008 or earlier that still populate their portfolios are not in great shape. Fewer than half of these deals are valued at more than the original equity invested (*see Figure 2.6*). But even in the best of times, there are losing deals in PE.

How capital superabundance could burn PE investors going forward. The continued expansion of financial assets looks to be an enduring feature of the investment environment that PE firms will need to reckon with for a long time to come. However, the force that they exerted to propel the PE industry to new heights since the downturn will not be tugging so favorably in PE investors’ direction as the current expansion ages—or as future ones unfold.

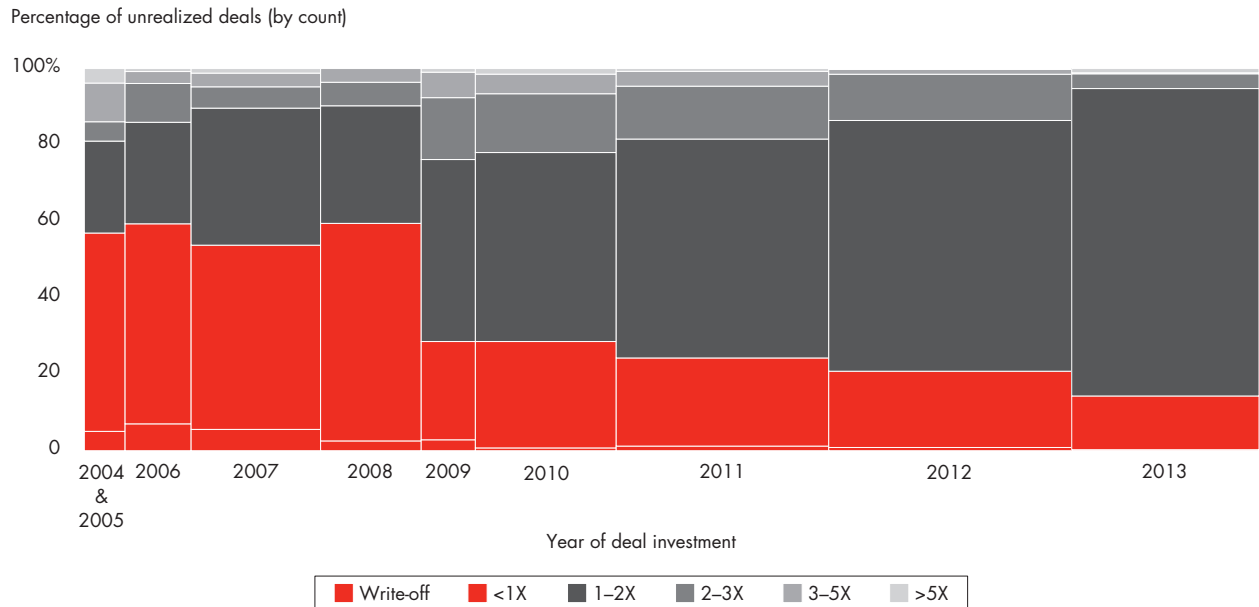
In fact, the very forces that rescued the boom-year investments—record low interest rates and plentiful capital—are magnifying two issues that are making it more challenging for GPs to profit from investments they make today. First, asset prices are and will remain high as investors of all types wielding record amounts of capital, including GPs sitting atop mountains of dry powder, are willing to bid up acquisition multiples to acquire assets. The plentiful low-cost debt thanks to capital superabundance in the hands of yield-hungry creditors merely adds upward pressure on prices and ensures they will stay high.

Figure 2.5: Wide-open exit channels enabled buyout funds to escape the shadow of the exit overhang



Notes: Includes deals made globally by buyout funds between 2000 and 2013; data as of Q2 2014
Source: Cambridge Associates

Figure 2.6: There are plenty of unrealized gains still locked up in PE portfolios, particularly from recent years' investments



Notes: Includes unrealized deals made globally by buyout funds between 2000 and 2013; data as of Q2 2014
Source: Cambridge Associates

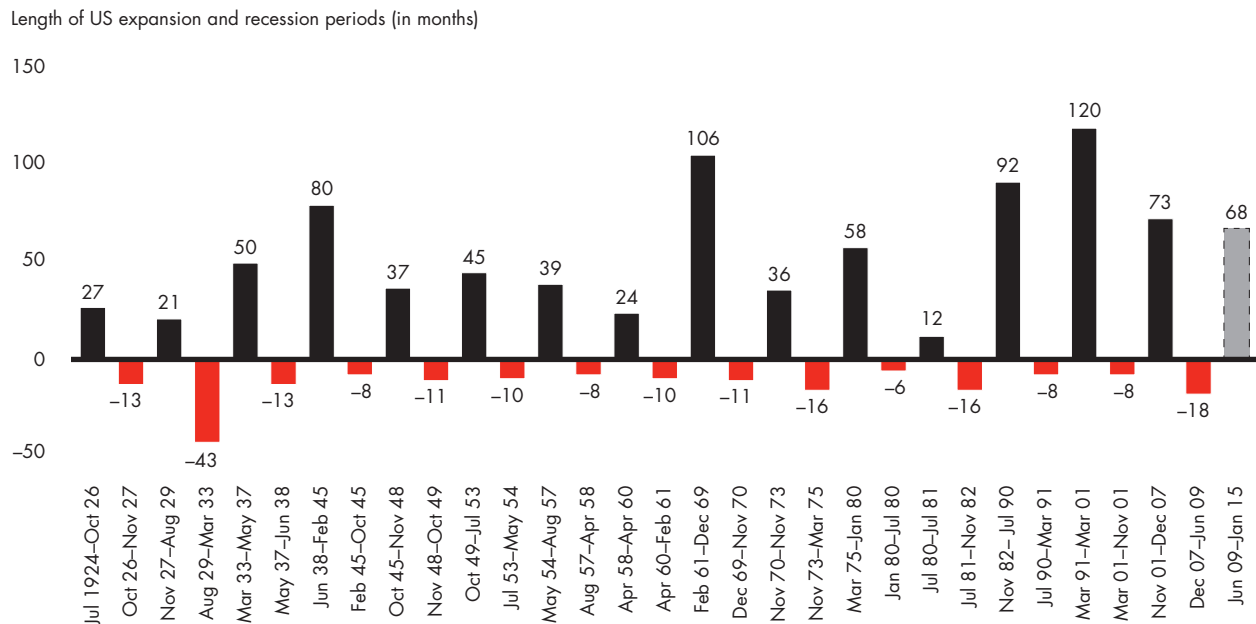
The second area where capital superabundance pinches is the longer holding periods that will be needed to prepare fully priced assets for exits that can command decent returns. With GDP growth slower nearly everywhere and further beta-driven multiple expansion from the public equity markets limited, the era of three-year holding periods is not likely to come back. PE funds have little incentive to sell an asset until they have at least doubled the equity they invested. Thus, simple mathematics suggest that holding periods of five years or more look to be the new norm; it takes at least that long to achieve a twofold return on invested capital at IRRs trending toward the mid-teens that we are currently seeing prospective acquirers use as their underwriting target.

Further complicating the superheated PE investment climate at a time of capital superabundance is the increased likelihood that the deals GPs undertake today will experience a turn in the business cycle during their hold period. Nearly six years have passed since the US economy hit the bottom of the last recession (*see Figure 2.7*). Given an expected five-year holding period for a majority of assets, GPs contemplating an investment should consider that they may need to ride out a downturn that could persist for a year or more. There is no guarantee that the monetary and fiscal medicines that worked in the last downturn will be as effective next time around.

Getting right with capital superabundance: A GP’s guide

Since the financial crisis hit in late 2007, the big role played by the global expansion of financial assets has cut in important—but opposite—directions. In the immediate aftermath of the downturn, superabundant capital helped keep interest rates low, which aided PE funds as they restructured their debt and surmounted the wall of refinancing.

Figure 2.7: With holding periods stretching out to five years or longer, GPs must weigh future recession risks



Note: Current expansion period is still in progress
Sources: National Bureau of Economic Research; Bain analysis

Valuations recovered as plentiful capital pushed asset prices higher on a swell of market beta. Now, however, capital superabundance and low-cost leverage have pushed asset prices to new heights, extending holding periods and stripping away the opportunities for GPs to expect market beta to boost returns.

The lesson successful GPs are drawing from this pattern of “same causes–different results” is that capital superabundance is here to stay and they can no longer rely on beta to do the heavy lifting. Instead of waiting for beta to do their work for them, they are stacking the odds in their own favor. Leading GPs are stepping up their due diligence to ensure that they can identify the winning factors in a target company that can become the basis for a value-creation plan that can withstand any economic or market climate. Bain research has found that for companies acquired in deals where the acquisition price was high, the presence of more than one winning factor was critical to their ultimate success. Indeed, in transactions where the price paid exceeded 10 times EBITDA, Bain analysis found that the winners had an average of more than three winning factors.

Although GPs face a tough challenge, they can find much to emulate in the experience of Hellman & Friedman, a leading San Francisco–based buyout firm, and JMI Equity, a growth equity firm based in Baltimore. These firms partnered to acquire Kronos in a public-to-private transaction in mid-2007. Paying \$1.8 billion—some 17 times EBITDA—for the business software developer, the partners identified potential for continued growth beyond Kronos’s core strength in workforce management software deeper into the adjacent area of talent management that warranted the high price. The GPs backed up their conviction by supporting Kronos’s acquisition, in late 2007, of Deploy Solutions, a provider of software used in the selection and hiring of job candidates. The move enabled Kronos to broaden its portfolio of services and gain access to Deploy Solutions’s high-profile client base. By May 2014, Kronos became the first vendor in its field to surpass \$1 billion in revenue. At the same time, its PE owners recapitalized the business through a \$750 million equity investment by Blackstone Group and GIC, the Singaporean sovereign wealth fund, and arranged for Kronos to use part of the proceeds to pay Hellman & Friedman and JMI Equity a special dividend. This transaction, combined with earlier dividend payments, has netted investors more than five times their initial equity investment. Today Kronos has an enterprise value of \$4.5 billion, and Hellman & Friedman and JMI Equity still own a majority stake in the company.

The power of capital superabundance over the fate of PE firms’ success reinforces the importance of exercising due diligence that can quickly spot winning factors and warning beacons and having the capability to execute a repeatable value-creation plan that can transform assets into top performers over and over again.

Shadow capital looms over PE

Institutional investors have been spreading their wings in recent years, experimenting with new ways to participate in PE deals beyond the conventional constraints of being passive partners in PE funds. It’s a development that is generating a lot of buzz in the PE community—and raising a host of sensitive issues for GPs. At the heart of the discussion is the emergence of so-called “shadow capital”—the vast sums of money that institutional investors are putting to work in new ways apart from their traditional role as limited partners in a PE fund—and the potentially large part it will play in the evolving GP-LP relationship in the future.

Shadow capital is not a new phenomenon. LPs have been passively co-investing alongside GPs in deals for years. But its gradual buildup over the past decade has gained momentum during the current PE cycle, and now in a wider variety of forms, it is beginning to reshape the industry. Across all regions of the globe, several leading endowments, public pension systems and sovereign wealth funds have stepped up their PE holdings

as a percentage of total assets under management, from a weighted average of 6% in 2006 to 12%, according to the most recent data available (*see Figure 2.8*). Many have had to look beyond the traditional limits of investing in a PE fund in order to satisfy their bigger appetites for PE.

Shadow capital's allure lies in the myriad ways it serves the long-term interests of LPs and GPs alike. For LPs, investing outside of the conventional PE fund structure improves their prospects for boosting returns at lower costs. A recent survey by Preqin, the PE data provider, found that 85% of LPs have realized bigger gains on their co-investments than on their fund portfolios. Investing shadow capital also gives LPs greater control over where they put their money to work. They are better able to time the market or gain greater exposure to specific industries and geographies they like. LPs investing actively alongside GPs have opportunities to develop closer relationships with them and to gain a deeper understanding of their operating style and strengths. It also enables LPs to develop their own internal capabilities, gain experience in direct investment disciplines and acquire valuable knowledge about industries to which they may not otherwise have access. With all of these positives to recommend it, it is little surprise that LPs expect shadow capital to play an increasingly prominent role in their future investment plans (*see Figure 2.9*).

There is also a lot for GPs to like about how shadow capital investments complement their traditional relationships with LPs. In a tough fund-raising environment, GPs can offer the opportunity to co-invest as a sweetener to encourage a current LP to re-enlist in a new fund, sign on earlier or commit larger amounts. They can also use co-investment as a lure to entice new LPs to make a first-time commitment to their funds. The large checks they accept to establish separate accounts deepen both GPs' assets under management and their relationships with LPs. Accepting shadow capital from LPs enables GPs to take on bigger deals without having to form hard-to-manage syndicates with other PE firms that have fallen out of favor.

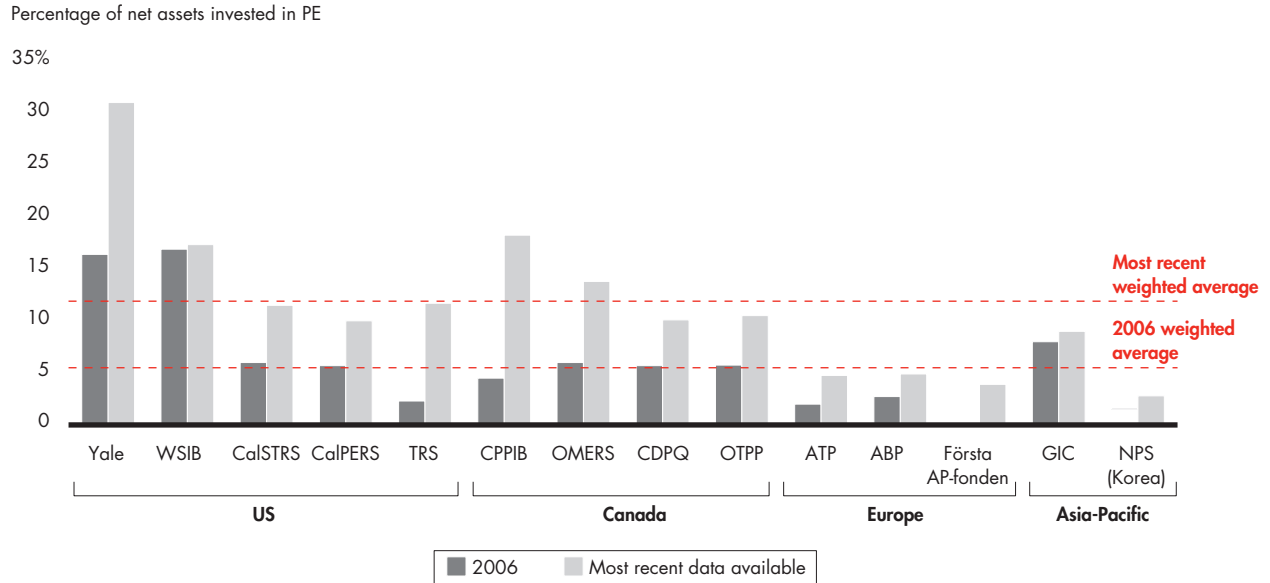
Despite the undeniable benefits that it offers both LPs and GPs, shadow capital also has the potential to shake up the PE industry. To begin with, shadow capital injects even more money into the already saturated deal market, increasing competitive intensity. The focus of much discussion today is the risk that more and more shadow capital will end up competing directly against GPs for deals—disintermediating PE firms by making investments that bypass them entirely. Yet, as we will discuss, a more likely outcome is shadow capital's potential to chip away at the PE industry's economics at the margins.

LPs are exploring four principal alternatives for deploying shadow capital that run along a spectrum from investments they depend on GPs to actively manage for them to those where they exercise greater independence.

Separate accounts. As they look for efficient ways to rationalize their PE exposure while managing larger investment portfolios, sophisticated LPs are turning to PE firms for help. They are increasingly entrusting firms to oversee the investment of additional assets held in customized accounts that have been set up on their behalf. According to a survey by Preqin, 18% of LP respondents reported that they actively invest in PE via separate accounts. Another 25% of those surveyed expressed interest in moving in this direction. Altogether, GPs have raised some \$128 billion through more than 400 separate accounts over the past five years, still a relatively small total compared with the more than \$2 trillion raised in PE funds over the same time period.

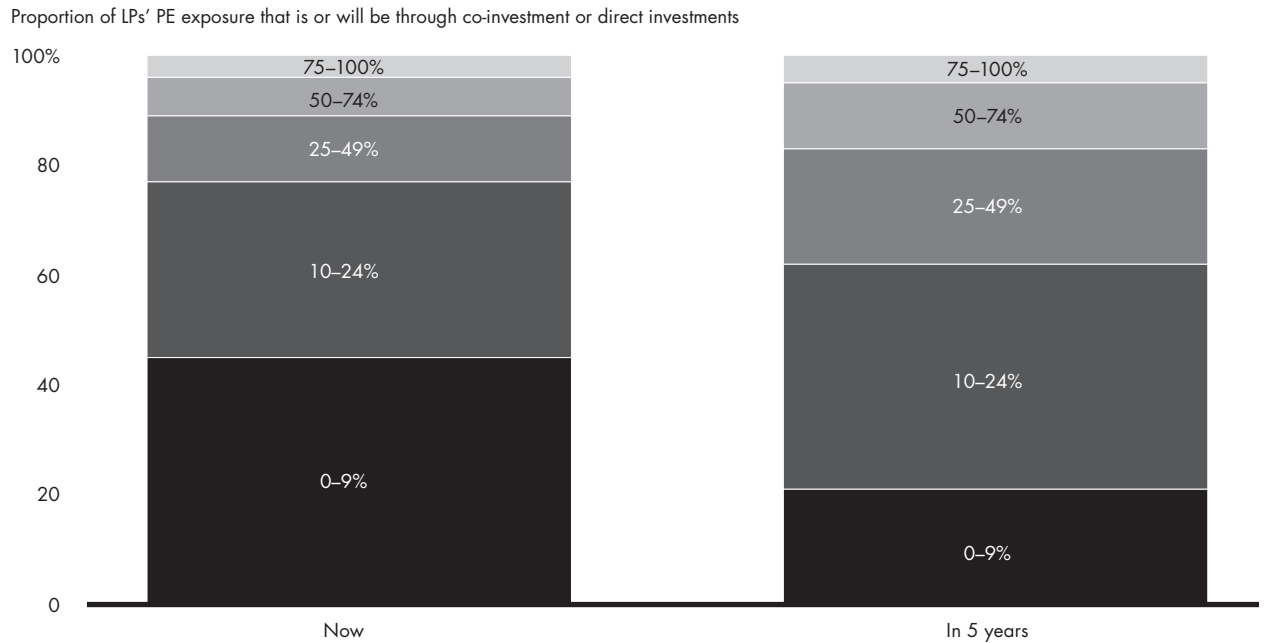
Rather than competing with GPs in their role as PE fund specialists, separate accounts enlarge their responsibility to that of a more general asset manager. Under typical terms of the arrangement, the PE firm is able to tap money it manages in these accounts to invest in buyouts or other predetermined PE categories as opportunities arise.

Figure 2.8: Growing demand for PE has LPs looking at all options for putting capital to work in the asset class



Notes: Most recent reported data is from 2013 to 2015; Yale's most recent data is its target for 2015, not actual; CPPIB includes all private equities (vs. public equities); 2006 data for GIC is unavailable, so 2008 data is shown instead; GIC percentage includes PE, venture capital and infrastructure
Sources: Annual reports; Sovereign Wealth Fund Institute

Figure 2.9: LPs expect shadow capital to play a bigger role in their portfolios over the next five years



Source: Collier Capital, *Global Private Equity Barometer*, Winter 2014-15

LPs and GPs have tailored some large and interesting relationships around separate accounts in recent years. For example, the Teacher Retirement System of Texas (TRS) partnered in 2011 with Kohlberg Kravis Roberts (KKR) and Apollo Global Management to set up a separate \$3 billion account with each that aims to steer TRS's capital into buyouts, real estate and debt investments. In 2012, CalPERS, the pension plan covering California state workers, placed \$500 million in a Blackstone Tactical Opportunities account with a flexible mandate to invest across a wide range of asset classes. In Europe, Germany's largest pension fund, Bayerische Versorgungskammer (BVK), cemented its seven-year relationship with the UK-based PE firm Pantheon last year. The fund, which invests on behalf of public-sector employees in the state of Bavaria, set up a €500 million dedicated account that will seek out, among other things, buyout, growth and venture capital investment opportunities. This arrangement, which will extend to 2017, will allow BVK to consolidate its holdings around a select core group of asset managers.

But for all of their many benefits to GPs, separately managed accounts present some risks. To attract that new money, GPs are discounting the prices they charge for their services, reducing fees and carry from the standard "two and twenty." For many GPs, the trade-off of lower fees in exchange for a larger, steadier volume of assets under management can look appealing, but accepting it can put GPs in a bind. By charging less, GPs can justify holding assets longer and settling for lower returns, but if they fall too far short, they risk jeopardizing their relationships with LPs. There is also potentially a price to pay for success. GPs that deliver performance in discounted, separate accounts that meet or beat the returns they generate in standard funds risk cannibalizing their premium-priced products. Why pay full price when there is little or no difference in results?

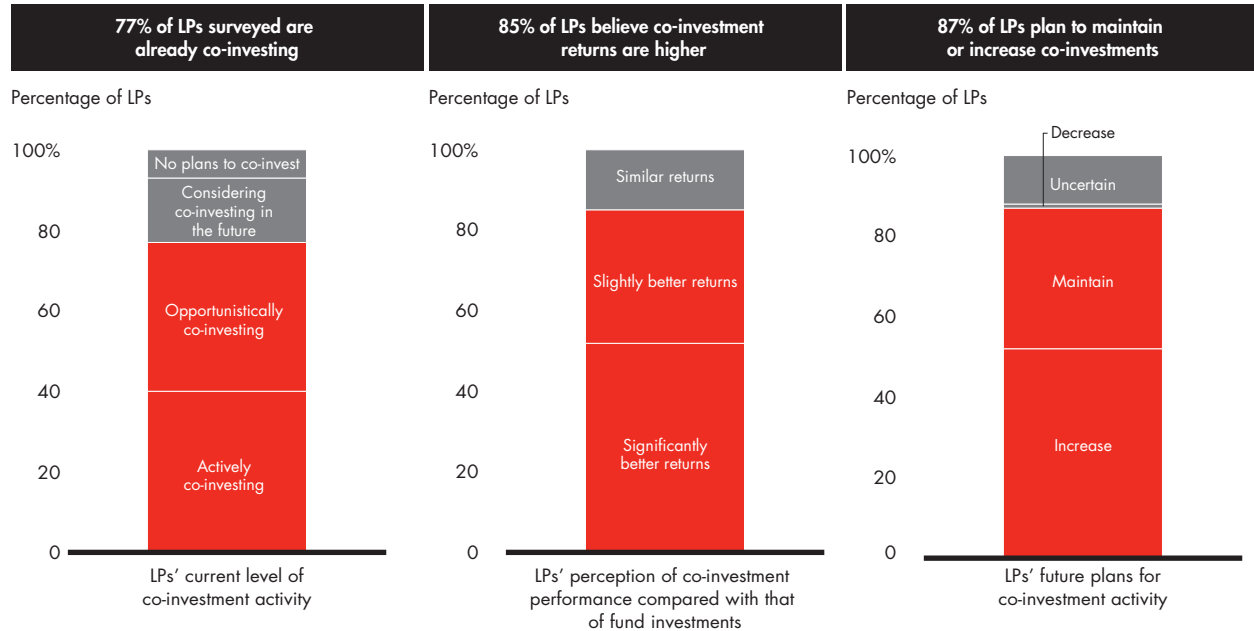
Co-investments. Accounting for roughly 10% of PE assets under management, co-investing is currently the most common way for LPs to put shadow capital to work. Co-investing appeals to LPs that want to exercise more discretion over where and how their money is deployed, without requiring the deal sourcing, due diligence and portfolio management skills that a seasoned GP would be expected to possess. They also like the no-fee or lower-fee structure that co-investing offers.

Increasingly, when GPs approach LPs to get them to sign on to a new fund, LPs are making the opportunity to participate as co-investors a condition of their agreement. In a typical arrangement, a GP pitches opportunities to LPs to put up money on a deal-by-deal basis. Co-investors can choose to actively select the deals in which they will participate or simply agree to join forces with the PE firm in all of its deals. When it comes to selecting the investment target or actually managing assets after they are acquired, however, the co-investor's role remains a passive one: It is the PE firm functioning as a conventional GP that sits in the driver's seat.

Co-investing has attracted increased attention in recent years as LPs have gained confidence in the higher returns it can yield. As recently as 2012, of the LPs that Prequin interviewed, only 13% believed that returns from co-investment were significantly better than those of a typical PE fund. In Prequin's latest round of interviews in March 2014, 52% of LPs reported that their co-investment returns were far higher than the returns their funds generated and none said that they were lower. With that proven track record, 77% of the LPs said they are now co-investing and more than half said they planned to do more of it in the future (*see Figure 2.10*).

With experiences like that, it is easy to understand why co-investing has gained popularity. But as promising as it looks, co-investing programs have difficulty accommodating everyone's goals. For their part, GPs cannot make co-investment an option available on every deal or for every LP. To keep the trust of their LPs, they must set transparent and clear rules for offering co-investment opportunities, but that is difficult to do since co-investment

Figure 2.10: LPs' search for better net returns has buoyed their interest in co-investing



Source: Preqin, "The State of Co-Investments," *Private Equity Spotlight*, March 2014

may not be practical for some deals. Co-investing today is full of gray areas in terms of the promises GPs are prepared to make to LPs. Many are willing to offer it, but the specifics for how or under what circumstances they will be able to follow through are not fully fleshed out.

As for LPs, many that are drawn to the idea of co-investing as a good way to proceed lack capabilities needed to process what GPs are offering and end up taking a pass. Sometimes the pro rata allocation in the co-investment opportunity may simply be too small to warrant their participation. Other times, LPs need to be able to react to an offer more quickly than their investment committee cycles permit. Still, co-investment seems to be here to stay, because it is yet another way to align the interests of GPs and LPs, even though this application of shadow capital, too, lowers prices and dilutes GPs' economics.

Co-sponsorships. A transition to more active investing, co-sponsorships enable institutional investors to put capital to work directly in businesses as equal partners with PE firms. In much the same way that PE firms joined forces in club deals prior to the 2008 financial crisis, large, independent-minded institutional investors with an appetite for more direct participation in PE deal making are partnering with GPs to co-sponsor deals of all types and sizes.

Recent co-sponsored transactions illustrate the range and breadth of this trend. In May 2014, for example, Ontario Teachers' Pension Plan, the large Canadian pension fund, teamed up with PE firms AEA Investors and Fitness Capital Partners to acquire 24 Hour Fitness, a US-based chain of health clubs, from Forstmann Little. Last June, Temasek, also a Singapore-based investment fund, co-sponsored a Warburg Pincus-led acquisition of 50% of Santander Group's custody business in Spain, Brazil and Mexico.

Rather than a rivalry, co-sponsored investments that pair GPs and LPs can be a mutually beneficial division of labor, serving both parties' interests. GPs gain access to deep pools of cash from sophisticated investors. A deep-pocketed pension fund or a sovereign wealth fund willing to put serious money behind an asset purchase can add the critical capital to make it possible for a PE fund to win a hotly contested auction. The LP partner gets to leverage, and also learn from, the expert guidance of a GP partner seasoned in the disciplines of PE due diligence, negotiation and post-acquisition value creation. Many institutional investors that participate in co-sponsorships are using the experience to develop their own in-house PE deal-making capabilities.

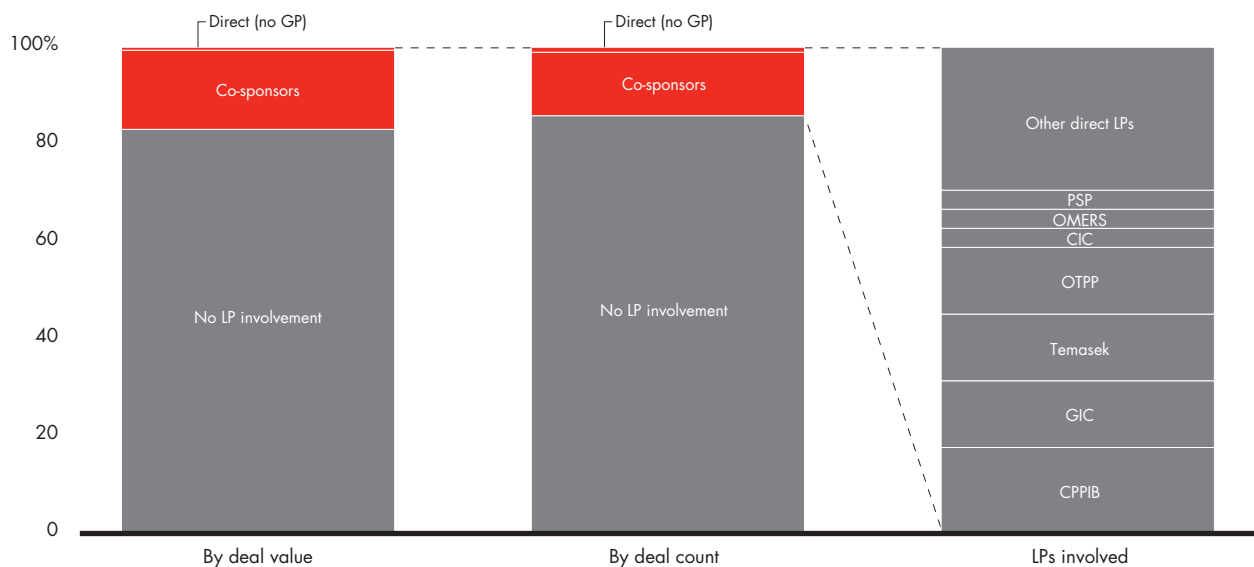
As crucial as an LP's capital can be to making an acquisition possible, co-sponsorship is still limited to a relatively small number of institutions that have the scale and capabilities to take the leap into more active investing. Co-sponsorships between GPs and LPs during the period between 2009 and 2014 accounted for less than 15% of all deals with a price tag of more than \$1 billion (see Figure 2.11). About 60% of these co-sponsorship deals involved just four institutional investors.

As the GP typically takes the clear lead managing the co-sponsored asset post acquisition, this new type of club investing is better positioned to create value than were the often rancorous GP-only consortium deals of the recent past. But it is still far too early to determine how well co-sponsorships will work out. Just how good the returns are will largely depend on the types of deals the co-sponsors do.

Solo direct investments. The shadow capital that is most apt to cause GPs to lose sleep is the money in the hands of big LPs investing entirely on their own, independent of PE firms and potentially in direct competition with them.

Figure 2.11: Co-sponsorship is the leading form of LPs' direct investment, particularly for larger deals

Percentage of buyout deals with disclosed values of \$1 billion or more (2009–2014)



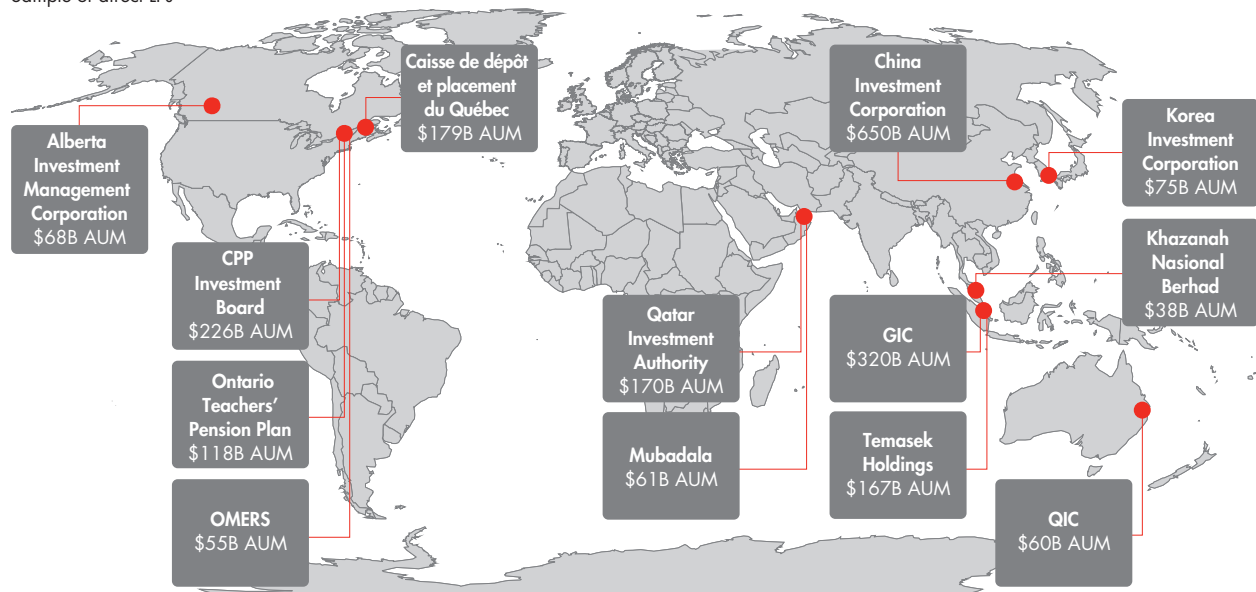
Notes: Includes deals with disclosed value; excludes real estate and infrastructure, PIPEs and add-on transactions
Sources: Preqin; Bain analysis

Looking just at the vast resources the biggest institutional investors and sovereign wealth funds can mobilize, it is easy to understand GPs' concerns. Bain & Company estimates that there may be no more than 100 institutional investors—less than 2% of the overall LP base for PE—that have the heft and the ability to mount direct investment programs, but they command considerable resources. Among leading organizations that have demonstrated an interest in direct investing are big pension funds in Canada and sovereign wealth funds across the Middle East and Asia (see Figure 2.12). Yet, while it is evident that these and other LPs' interest in solo direct investing is growing, the competitive threat this presents to GPs is limited.

There are real risks and challenges that any LP contemplating a direct investment program needs to reckon with. To begin with, they need to recreate all of the capabilities and processes a PE firm possesses—from sourcing their own deals and conducting rigorous due diligence to leading robust post-acquisition value-creation plans and managing successful exits. Developing these skills, much less matching the experience that world-class PE firms have attained over years in applying them, takes time and dedication. Above all, it takes top talent to generate the returns that direct investing LPs aim for—even when they set their underwriting target return at a relatively modest level of, say, 15%. LPs that go solo may be able to lure talented investors with the attractions of a more sustainable lifestyle and perhaps an attractive location. However, they face challenges holding onto star PE investment professionals because the compensation they offer does not match what their GP competitors pay. Finally, direct investing offers less diversification than committing capital to several PE funds and far more accountability if a direct investment does not pan out, with no GPs to blame for unsatisfactory results.

Figure 2.12: Big Canadian pension funds and SWFs dominate among LPs with direct-investment capabilities

Sample of direct LPs



Notes: This is not an exhaustive list; values are assets under management in US dollars based on Preqin data as of January 2015; SWF stands for sovereign wealth fund
Source: Preqin

LPs that are currently undertaking direct investment programs recognize the need to proceed with caution. The evolution of the direct program under development by the Toronto-based Canada Pension Plan Investment Board (CPPIB) illustrates the deliberate approach these careful investors are taking. CPPIB began investing in PE in 2001, focusing on building its relationships with GPs as a “preferred investor.” By 2004, its overseers set their sights on increasing its participation on co-investing and direct investing, primarily as co-sponsors partnering with fund managers to help them. By 2007, CPPIB created a dedicated “principal investment” (PI) team—an in-house group to manage its direct investments in PE and natural resources, which then totaled about C\$1 billion. Since 2008, CPPIB has aggressively scaled up its direct investment efforts, staffing its increasingly expert in-house group with 35 senior PI professionals and adding offices in London, Hong Kong and São Paulo. By the end of last year, its direct PE portfolio had grown to 31 investments valued at C\$11.6 billion, or 59% of its PI program. Despite opportunistically taking the lead role in transactions, however, CPPIB continues to execute direct investments primarily through co-sponsorships.

The caution practiced by LPs investing directly on their own is also evident in the types and sizes of deals they have made to date. The LPs have concentrated their investments in four areas. First, they are cutting their teeth on smaller deals, seldom exceeding \$1 billion, and tilting toward growth investments, minority stakes or private investments in public equities rather than buyouts. Second, they have been inclined to target low-risk investments in stable companies that have reliable cash flows and strong management teams. Third, they favor deals where they enjoy a home-field advantage, using their information edge to partner with local companies, often in pursuit of regional development programs. Finally, some institutional direct investors, particularly sovereign wealth funds in Asia and the Middle East, pursue deals that are influenced as much by the strategic goals of the sovereign entity on whose behalf they invest—in such areas as financial services, energy, telecom and infrastructure—as by financial outcomes. Within each of these four core direct investment areas, institutional LPs may enjoy unique competitive advantages over GPs.

Learning to live in the shadow: Lessons for GPs

The global superabundance of capital—and the influence of shadow capital on PE investing to which it has given rise—are realities that PE firms will need to accommodate for the foreseeable future. Their ongoing challenge will be to fend off pressure to reduce prices for their services and to find new ways to partner with LPs, which benefit both parties. Their best defense in this battle will be to mount a great offense—simply generate high returns. Top-performing GPs will be able to command the prices they deserve and capture the assets under management they desire. Others will find that these new forms of partnering generally require them to concede to LPs on price while doing the same work they did in the past. For the bottom performers that struggle to raise capital, shadow capital offers no salvation. Poor results are not worth having at any price.

For LPs, shadow capital does not substitute for fund investing but augments it. The incentives for both sides to collaborate rather than compete are powerful. Even as they spread their wings and begin to invest more independently, LPs need GPs to help them put capital to work and demonstrate the disciplines for success. As LPs that mount direct investment programs learn from first-hand experience what it takes to succeed as value creators, they are likely to develop renewed respect for the PE professionals who can generate winning returns over and over again.

Refocusing on America

Discriminating PE investors have a long list of attributes they look for when deciding where they will put money to work. Their preference to invest where legal protections are strong, capital markets are liquid and corporate governance is transparent has long attracted them to the developed economies of Europe and North America. When the global financial crisis chilled the economies of the West, PE investors' appetites for novelty, an entrepreneurial culture and vast growth potential lured them to seek out opportunities in the emerging markets of Asia-Pacific, Latin America and Africa.

But at a time when political, economic and social uncertainties are running high—as they are in most markets around the world today—PE investors are reflexively taking steps to reduce their risk exposure. Most European economies are slumping, as sovereign debt woes, deflation pressures, currency instability and near-zero GDP growth threaten to break up the eurozone. China's growth is highly volatile as it attempts to manage the difficult transition from the rapid expansion and investment that characterized its boom years to a more balanced growth model. War, social upheaval and tumbling oil prices have sent economies across Russia, Central Asia and the Middle East into free fall.

A flight to quality has made the US a renewed focus of investors' interest, with PE investors prominent among them. In striking contrast to trends elsewhere, macroeconomic signals are flashing green across North America. After years of sluggish recovery since the 2008 recession, US job growth rebounded strongly in 2014. Consumer confidence and capital spending are turning up. Unemployment and government budget deficits shrank, and the US dollar is trading near its highs against other major currencies. The combination of an already strong dollar and sustained low inflation in the US, and the pursuit of expansionary monetary policies by central banks in Europe, Japan and China, will likely hold any interest rate increases by the Federal Reserve in check. Against that backdrop, the outlook for credit conditions remains auspicious for financing PE buyouts.

It is not only the customary business cycle indicators that point to a revival of the US economy. Analysis by Bain & Company's Macro Trends Group shows four durable sources of growth that could help power the US economic expansion deep into the rest of this decade and potentially beyond—engines that could help keep the economy humming for an entire PE buyout cycle. The first is the rebound of the US consumer, particularly middle-income households that benefited from the Fed's low interest rate policies, which helped reflate housing prices, the principal source of middle-class wealth. Hit hard by the recession, these consumers are opening their wallets again. The second source of growth is demographics, specifically the coming of age of the vast population of younger adults born after 1980, who are entering their prime household- and family-formation years. Some 81 million strong, this generation is bigger than the baby boomer generation, with 76 million Americans who have largely passed their peak earning years or are entering retirement. The third force powering the economy is the juice provided by the energy sector. Now one of the world's top oil and natural gas producers, thanks to the shale drilling revolution, much of the US energy industry can operate profitably even at today's prices. Meanwhile, US energy consumers will see savings from lower fuel costs flow straight into their pockets and to their bottom lines—a spur to consumption and investment. The final growth factor is the emerging advances in robotics, nanotechnology, genomics, artificial intelligence and ubiquitous connectivity, which are just hitting the new product lines of big corporations and the radar screens of venture capitalists.

As a new high tide of global capital starts to flow to US shores in search of promising opportunities, PE investors will find a market that is not only deep and welcoming but also mature and intensely competitive. As PE's home turf dating back to the leveraged buyout days of the 1980s, the US has long attracted the lion's share of capital

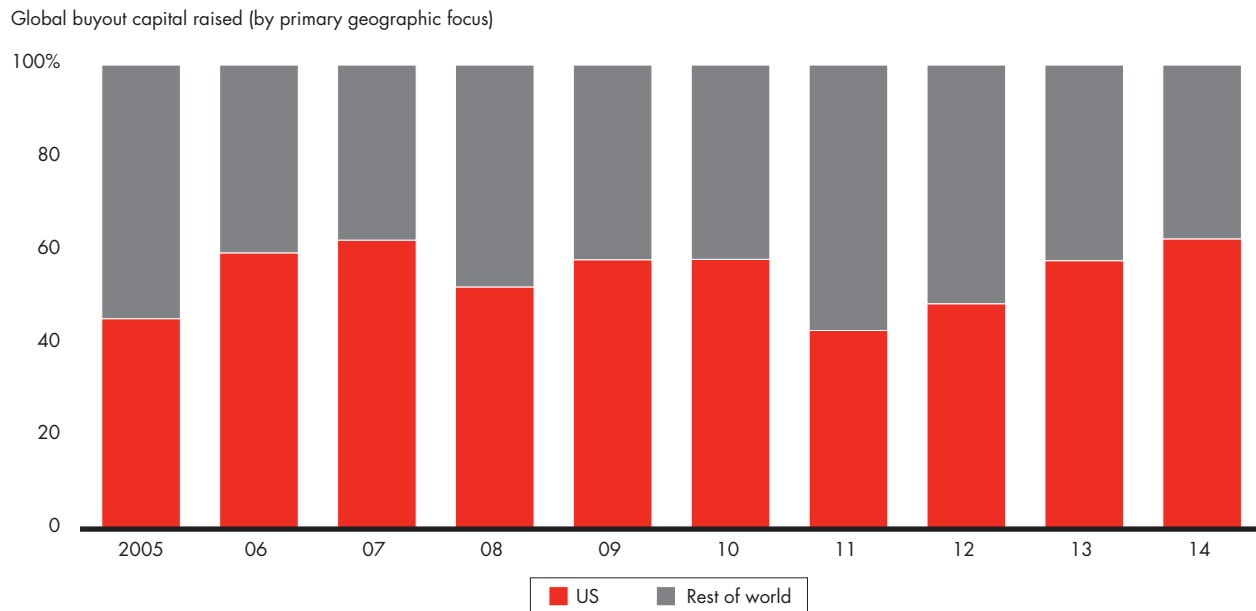
raised for buyouts and continues to do so. Over the past decade, money pouring into US-focused buyout funds has accounted for 56% of the world’s total (see Figure 2.13). Indeed, as buyout fund-raising began to recover from the depths of the global financial downturn, US-focused funds have seen their share steadily climb—to 63% of the total in 2014.

The magnet for that capital is the vast pool of sizable companies operating in the world’s most open economy (see Figure 2.14). The capacity of the US economy to absorb capital is another of its many attractions to PE investors.

Having exposure to the US market has been crucial for LPs that aspire to build a top-tier PE program. Even as PE has spread beyond the US and Europe to other regions around the world since the late 1990s, US-oriented buyout funds have led the elite list of funds, generating a net annual return of 15% or more (see Figure 2.15). Recent vintage buyout funds targeted at US investments have continued to punch well above their weight. US-focused funds from the 2007, 2008 and 2009 vintage years made up less than half of their peer global buyout funds worldwide, but they comprised 70%, 75% and 55%, respectively, of the world’s top-performers within their vintages. It is little wonder, then, that the US tops the rankings of attractive PE markets in surveys of LPs.

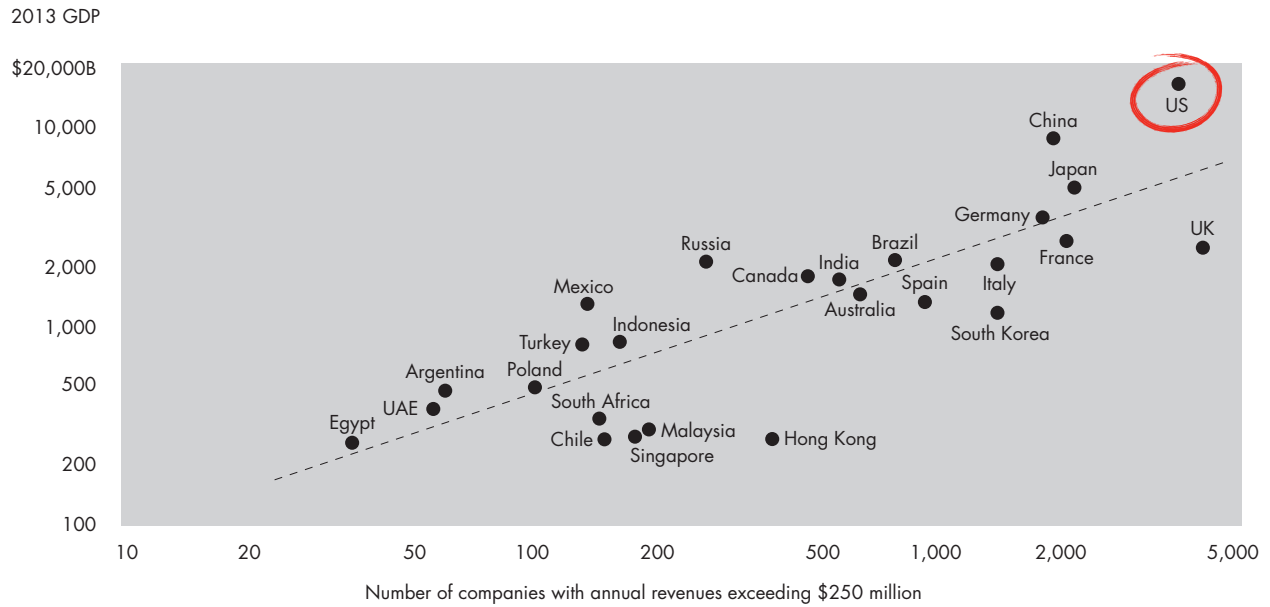
Yet, even with the economic winds expected to be at GPs’ backs in the period ahead, finding compelling deal opportunities at valuations that work and converting them to top-quartile winners will require extraordinary investment discipline. PE has already penetrated deep into the available pool of companies. Among middle-market businesses with an enterprise value of between \$100 million and \$500 million, for example, Bain & Company found that PE ownership increased from 8% of companies in 2000 to 23% in 2013—nearly one company out of

Figure 2.13: The majority of buyout capital raised globally has been targeted at investments in the US



Notes: Includes buyout funds with a final close; represents year funds held their final close
Source: Preqin

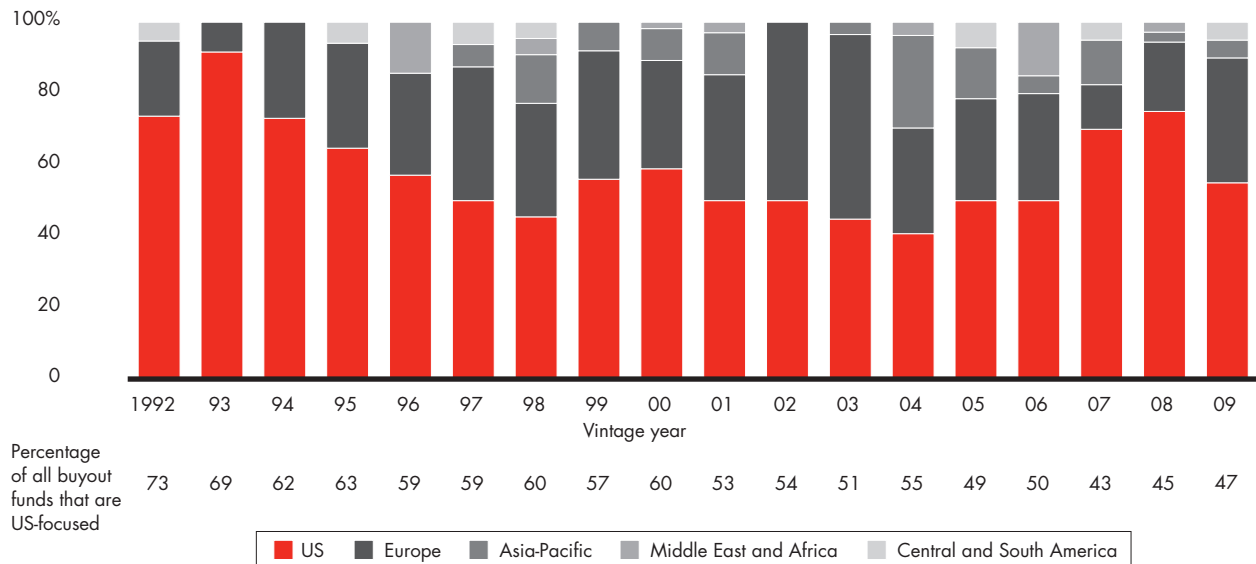
Figure 2.14: The US has a deep pool of companies



Notes: Based on FY '13 revenues; includes public companies and private companies for which revenue data is available
Sources: IMF; Capital IQ; Bain analysis

Figure 2.15: The US has generated the majority of the top-performing buyout funds

Count of buyout funds with net IRR greater than 15% (by investment region focus)



Note: Excludes funds with multiregion investment focus
Source: Preqin

four (*see Figure 2.16*). The PE penetration rate is lower among companies with an enterprise value of greater than \$500 million, simply because those bigger businesses can more easily tap the public equity and corporate debt markets for capital and, thus, are less reliant on PE than their mid-market counterparts. Penetration is also very small among companies valued below \$100 million—just 3% of this large group of businesses are in PE's hands—because many of these enterprises lack the scale or the growth potential to attract the interest of investors.

If too much capital in the hands of a growing number of PE funds chasing too few good assets is a classic prescription for inflated acquisition prices, then the US is ground zero for asset-bidding wars. So thick are the ranks of prospective buyers that a PE firm's ability to quietly line up a proprietary deal has all but disappeared. Nearly every company that puts itself up for sale is the object of a hotly contested auction.

More than ever, for successful PE investment in the competitive market for US assets in the years ahead, the prerequisites will be getting an early edge in the auction process, doing great diligence to home in on winning deals and determining with confidence what price to pay. Although the US is PE's most mature market, it is not a fully efficient one. To test that proposition, CEPRES, a provider of products and services to support PE investment decisions, undertook an analysis of buyouts completed since the downturn in order to probe just how efficient or inefficient the US market is. The results show that for any EBITDA multiple a GP may pay for assets, there is a wide range of outcomes for earnings growth (*see Figure 2.17*). The conclusion: GPs can still find businesses with value-creation opportunities that others don't see—and buy them for less than full price.

The rewards available to PE firms that can spot seams of opportunity that enable them to buy growth potential at a favorable price are evident in Advent International's 2011 acquisition of Bojangles', a regional quick-service restaurant chain based in North Carolina. With a decades-long focus on investing in the retail, consumer and leisure sectors, Advent drew on its depth of experience and its plugged-in adviser network to quickly size up Bojangles' as a likely leader in its category. What its deal team saw in Bojangles' was a business with a healthy core, a solid management team, strong franchisees and a loyal customer base. Working with company management, Advent added new Bojangles' stores within its existing territory and expanded into adjacent markets and introduced a wider range of menu options to appeal to its broadening customer base. By 2013, Bojangles' boasted the fastest growth rate in its industry and built on that success with sales increasing 7% in 2014. With the quick, efficient execution of its value-creation plan achieved, Advent is readying Bojangles' for an early-2015 IPO.

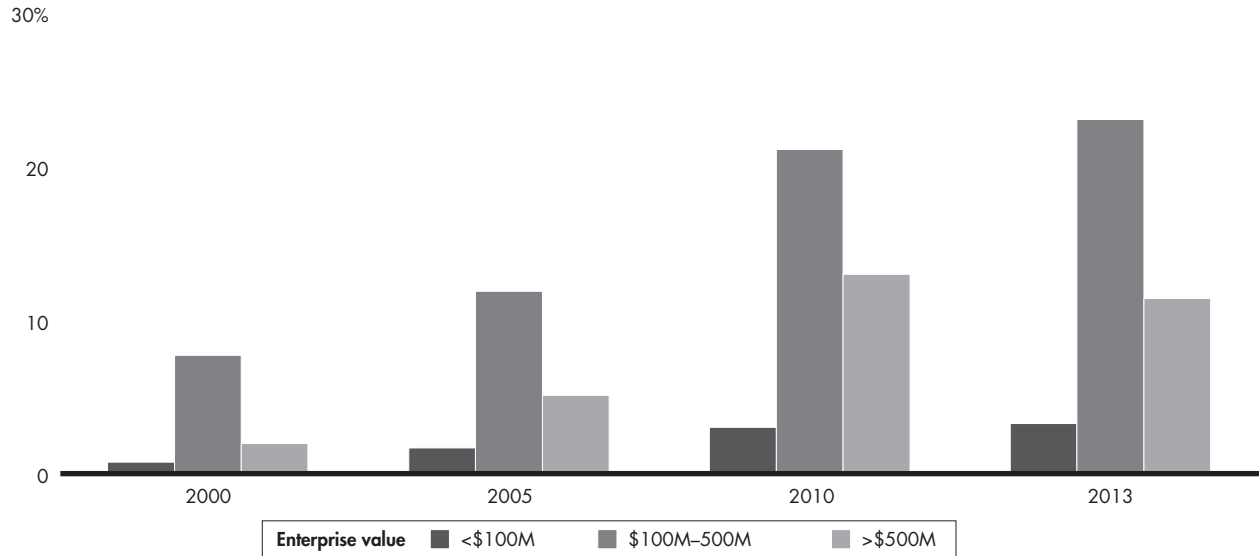
Making it in America: Precautions for GPs

As more and more global capital seeks refuge in a resurgent US economy, PE investors will need to be on their guard against ever-present bubble risk. Asset prices, already high, will likely go higher. Particularly as new technologies spawn new industries or reshape existing ones, compelling business-growth stories and seductive investment theses will be plentiful and, more often than not, illusory. As every seasoned GP knows, the supply of truly great ideas is limited, and few withstand rigorous scrutiny.

A high priority for PE firms aiming to invest in the already deeply penetrated and hyper-competitive US market is the heightened focus they bring to deal sourcing. Bain has worked with leading firms that are developing repeatable sourcing models to separate themselves from the pack of rivals showing up at auctions ready to pay full price. Some firms are seeking contrarian plays on assets that are out of favor but where they see hidden value. Others are digging into macro themes to anticipate trends the market has yet to spot but avoid chasing headlines. For instance, news stories in the early part of the decade speculated that millennials were different from older generations in their housing preferences; they would want to live in cities and not in suburbs. In

Figure 2.16: PE ownership of US companies has increased over time, particularly among middle-market businesses

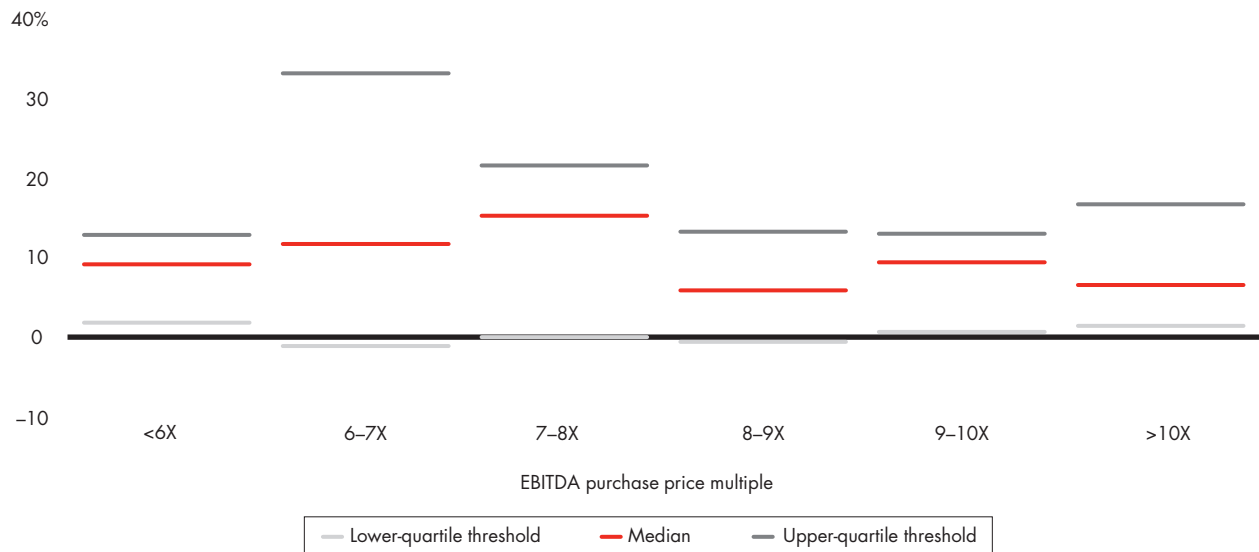
PE-backed companies as a percentage of all US companies (by enterprise value category)



Notes: All values are estimated; calculations are based on data only for companies with more than \$10 million in revenues
Sources: PitchBook; Internal Revenue Service; Bain analysis

Figure 2.17: Even in the mature PE market in the US, investors can still spot good opportunities and not pay full price

EBITDA CAGR, post acquisition



Notes: Includes 845 US buyouts invested in 2009 or later; EBITDA stands for earnings before interest, taxes, depreciation and amortization
Source: CEPRES PE Analyzer

fact, millennials are becoming suburbanites, after all, having simply delayed their move due to the recession. Probing deeper in order to separate insight from conventional wisdom and to understand second- and third-order consequences of a macro theme can unveil investment opportunities the market may not have, as yet, fully priced.

Once GPs have honed the investment themes they will pursue and confirmed that they are aligned with the core elements of their fund's investment sweet spot—such as the size of the equity commitment they are prepared to make, their geographic preferences and the degree of control they will exercise—they develop a list of potential targets and a plan to approach them.

With the prospects for most buyouts balanced on a razor's edge between a target company's high valuation and a precise calculation of its return potential in any economic climate, fortune will favor only the well prepared. Top-performing PE firms understand that the ultimate returns they achieve will reflect the “quality of the buy”—how well they size up the potential of the assets they acquire during sourcing and due diligence and how much they ultimately pay.

New macro risks challenge Europe's PE investors

Following years of persistent near-zero GDP growth and a steady drumbeat of bad news from the eurozone, European PE investors could breathe a sigh of relief in 2014. The financial turmoil that threatened to undermine the euro and plunge the continent's weaker economies into deep recessions had abated. Yield spreads on euro-denominated sovereign debt had stabilized and, apart from Greece, the air of crisis hanging over the smaller eurozone periphery economies had begun to lift.

With the recent Greek elections once again throwing open the heated debate between austerity and growth, however, it would be a mistake for Europe-focused PE firms to confuse a respite with a recovery. As 2015 began, the European Central Bank (ECB) launched a €1.1 trillion quantitative easing program in an urgent bid to reignite growth. But banks' business lending remains weak amid gathering signs of a recession in the major European economies. Beyond the near-term economic indicators, Bain & Company's Macro Trends Group sees powerful structural tensions that threaten to pull the eurozone apart in the not-too-distant future. Differences in the age structure of eurozone member states' populations—in particular, in the size of the cohort between the ages of 45 and 60—are an important but too-little-appreciated source of Europe's unresolved problems.

The number of these thrifty and highly productive mature households, which are past their biggest consumption years, is currently near its peak in Germany, where their frugal spending patterns risk aggravating deflationary pressures. As Europe's leading exporter, however, Germany has been able to ship goods and capital to its younger, more consumption-oriented neighbors on the eurozone periphery, boosting its GDP and keeping a floor under prices—all without having to worry about exchange rate adjustments to the common currency. The consequences for Germany's eurozone trading partners have been profound: Inflation has heated up and their economic competitiveness has eroded—conditions exacerbated by the ECB's loose monetary policies.

By the end of the decade, as Germany's bulge of 45- to 60-year-olds ease into retirement and begin to consume their savings (pushing up prices), the periphery countries will see that age cohort swell (kindling deflationary tendencies). If the ECB's monetary policies hike interest rates to keep inflation in check in Germany, they will risk worsening deflation in the periphery countries, which will need a weaker euro to stimulate demand and to repay their large overhang of sovereign debt. Thus, the eurozone is poised for another crisis: It remains weakened by years of economic stagnation, increasing debt burdens, the rise of nationalist parties and a loss of competitiveness and deflation on the periphery, on the one hand, and the constraints of the euro pact, on the other. Certainly one scenario every investor should weigh is a partial breakup of the eurozone toward the end of the decade.

Prudent Europe-focused PE firms will use the current interlude between crises as a window of opportunity and fortify their current holdings against looming macro risks. They will also want to scan the economic horizon to recalibrate their investment theses over the next PE cycle to identify potential opportunities to profit as the EU restructures.

Storm-proof the portfolio. Vigilant PE funds will use today's hiatus of relative calm to work through a long checklist of potential financial and operational vulnerabilities, beginning with shoring up their portfolio companies' balance sheets. They will take advantage of the currently favorable debt markets to lower borrowing costs, lighten covenants or pull equity out of assets that may need more time to ripen in Europe's slow-growth environment.

Every EU-based PE fund will also want to comb through its supply chain to evaluate how a potential euro breakup might impact their input costs. PE funds whose portfolio businesses are net recipients of euros today should protect themselves against currency risk over the medium and long term. For example, energy-intensive manufacturers, particularly those operating in the struggling economies on the eurozone periphery, will want to hedge against a possible rise in energy prices from today's low levels and a further drop in the euro-US dollar exchange rate. Likewise, PE owners of luxury goods businesses or other high value-added product or service providers will want to evaluate how they might take advantage of a weakening euro by increasing domestically sourced raw materials while boosting exports to markets outside of the eurozone.

Pressure test new investment theses. Facing the significant risk that the eurozone will need to restructure within the next few years, any Europe-focused buyout fund looking to deploy new capital needs to add that scenario to how it sources deals and evaluates potential acquisitions. Independent of the inherent attractiveness of the asset they are thinking to buy, fund managers will want to weigh the possibility that a euro crisis could see the temporary reinstatement of barriers that impede the free movement of capital and inflate borrowing costs or consider how a return of exchange-rate differentials across eurozone markets might affect debt repayment costs and operating margins.

As PE funds armed with vast reserves of dry powder scour Europe's markets for a diminishing supply of crisis-resistant acquisition opportunities, they will need to be on guard against the risk of investment bubbles. In France and Germany, for example, where the real estate sector may already be overheated, trapped assets present a particular danger.

Successful PE-fund investors will sharpen their sector focus and deepen their geographic and industry expertise as they target resilient investments in selective pockets with upside opportunity. For example, the healthcare sector will expand and diversify to serve Europe's growing aging populations. Toward the end of the decade, the substantial pool of retiree savings will present opportunities in wealth management. In Germany, an increasing population of pensioners will spend more on leisure activities.

PE funds will also be able to help portfolio companies adapt to the eurozone's smaller and increasingly expensive workforces by substituting capital for labor, particularly as sophisticated robotics penetrates traditional service businesses like food, hospitality and healthcare. Using advanced telecommunications and information technology to ship services outside of the eurozone presents other opportunities to invest in businesses that specialize in, for example, remotely performed diagnostic analysis or Web-based training.

Finally, Europe's crisis-weakened and gun-shy banking sector presents flush PE funds with investment opportunities to fill a lending gap for capital-starved small and midsize enterprises. Blackstone Group seized this chance last July, when it prevailed over a consortium led by Oaktree in an auction to purchase a portfolio of home loans for €3.6 billion from a bailed-out Spanish bank.

With the world's second-largest economy and a large population of affluent consumers, the eurozone has long been a powerful magnet for PE investors. Beset with macro challenges that threaten the heart of the continent's decades-long program to broaden and deepen its integration, the eurozone will remain a risky attraction over the medium term and potentially for years to come. PE firms will need all of the foresight, flexibility and creativity they can muster in order to survive and thrive in today's Europe.

It's getting harder to spot the winners

In sharp contrast to the boilerplate disclaimer that every stock market investment fund is required to make, the notion that past performance is a reliable indicator of future returns has been a proud hallmark of PE investing since the industry's earliest days. For LPs, the task of separating the top-performing GPs from the laggards was a pretty straightforward business. The best guide for institutional investors selecting GPs to invest behind? Look at how previous funds fared.

No longer. In today's world of superabundant capital, the conditions that made it possible for top GPs to cruise from success to success have washed away in a flood of money chasing assets. With so much capital in the hands of so many GPs, opportunities to quietly ferret out proprietary deals at cheap prices are gone. Record low interest rates on high-yield debt and covenant-lite loan terms have opened the spigots of leverage to PE borrowers, broadening the pool of potential buyers. Today, nearly every GP has the means—and incentive—to hire consultants and other outside advisers to reduce the likelihood of big mistakes.

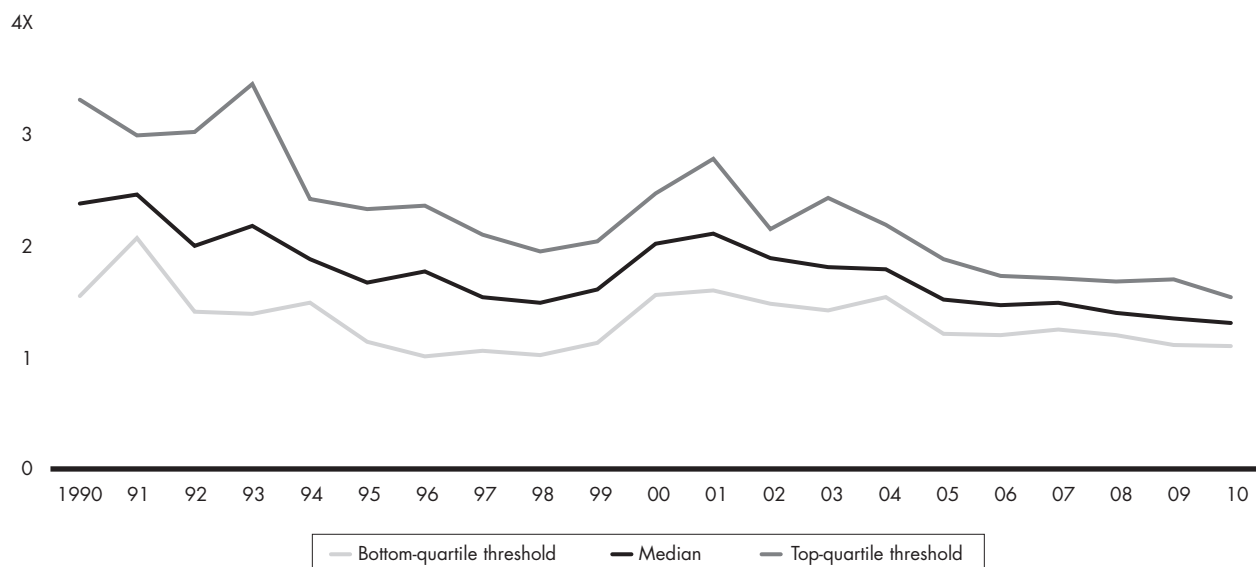
The democratizing influence of plenty of money in the hands of many has had a leveling effect on PE returns. Transparent auctions guarantee hot competition for assets, and GPs that prevail in them pay top dollar. The combination of high acquisition prices and longer hold periods is eroding returns. Meanwhile, slow but steady economic growth in major developed markets has put a temporary floor beneath the returns of the weaker PE performers.

The cumulative result of these shifts has been to compress industry returns. As recently as a decade ago, top-quartile buyout funds generated between \$2 and \$3 or more for each dollar of capital invested—nearly a full turn higher than the best of the bottom-quartile funds whose ratio of returns per invested dollar hovered between 1-to-1 and 1.5-to-1 (see *Figure 2.18*). The picture is very different today. Among recent-vintage funds launched between 2006 and 2010, the gap separating the top-quartile GPs from their bottom-quartile peers has narrowed to less than 50 cents—\$1.54 per dollar invested for the best 2010-vintage buyout funds vs. \$1.10 per dollar invested for the laggards. The extent of the compression that we are seeing in recent vintage funds may be temporary. As these funds exit investments and realize gains, the gap between the top- and bottom-performing funds could widen some. Nevertheless, the increasing competitiveness of the markets means that there will be some lasting compression of returns.

The squeeze on fund performance. The compression in return multiples between the top- and bottom-quartile funds is mirrored in a narrower distribution of returns overall for recent-vintage funds (see *Figure 2.19*). Whereas during the 1990s, when 52% of US focused buyout funds generated returns that clustered between

Figure 2.18: Buyout-fund performance has become compressed for recent fund vintages

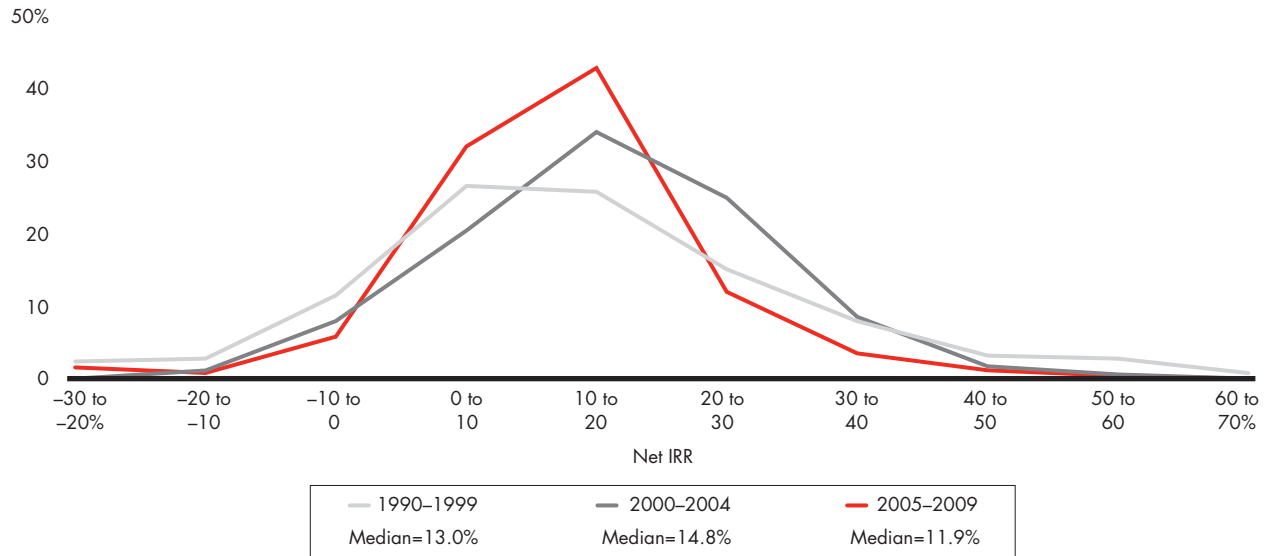
Global buyout fund vintage-year benchmark returns (TVPI, as of Q2 2014)



Note: TVPI is total value to paid-in ratio
Source: Preqin

Figure 2.19: Funds now cluster in a very narrow band of returns, as the long tail of outperformers has shrunk

Distribution of US-focused buyout funds (grouped by vintage year, percentage of funds in sample)



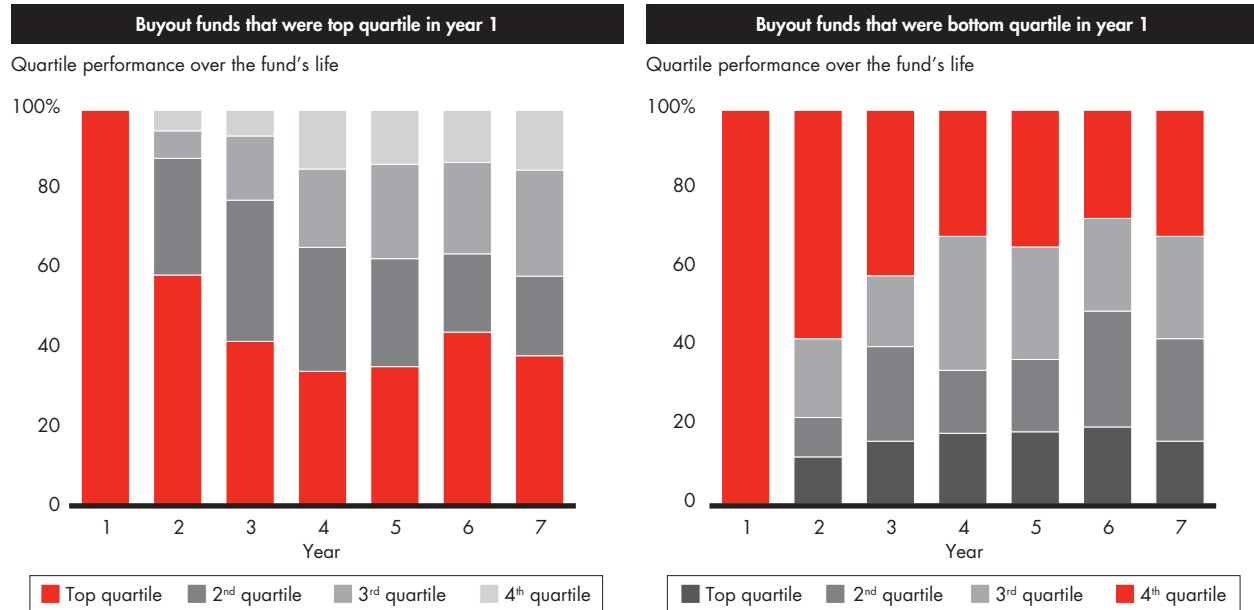
Note: Includes buyout funds with 1990-2009 vintages for which IRR data is available
Sources: Preqin; Bain analysis

zero and 20%, fully 75% of the 2005 through 2009 vintage funds have produced gains that fall within that range. With so many recent-vintage funds bunched within that narrow band, many fewer GPs show up in the distribution tail with funds that produced superstar returns. Just over 15% of the US-focused buyout funds from the 2005-2009 vintages are on track to yield outsized IRRs that exceed 20%; in comparison, nearly 30% of 1990s-vintage funds and fully 35% of funds in the 2000-2004 vintages produced IRRs over 20%. The narrow range of returns among the vast majority of GPs grouped in the middle makes it very challenging to distinguish which is truly good from which is weak—and which is just lucky.

Trying to hit a moving target. For LPs, the task of separating the strong from the weak performers for purposes of deciding which GPs to back with future capital commitments has become that much harder as PE funds have stretched out holding periods for investments.

LPs do get interim readings on the status of their unrealized holdings, of course, when GPs revalue assets still held in the portfolio to reflect market-equivalent gains or losses. But those mark-to-market updates have been of little help as forward-looking assessments about where their funds will ultimately end up and, hence, of little value in guiding their future capital commitments. For example, when Bain & Company analyzed a sample of buyout funds whose valuations put them in the top quartile after their first year, we discovered that just 40% of them ended up as top-quartile funds by the end of year seven. In fact, they were just as likely to have closed out their seventh year as underperforming third- or fourth-quartile funds. Likewise, 40% of the funds that were in the bottom quartile after their first year ended up in the top two quartiles after seven years (see *Figure 2.20*).

Figure 2.20: With a lot of unsold assets sitting in fund portfolios, performance can shift dramatically over a fund's life

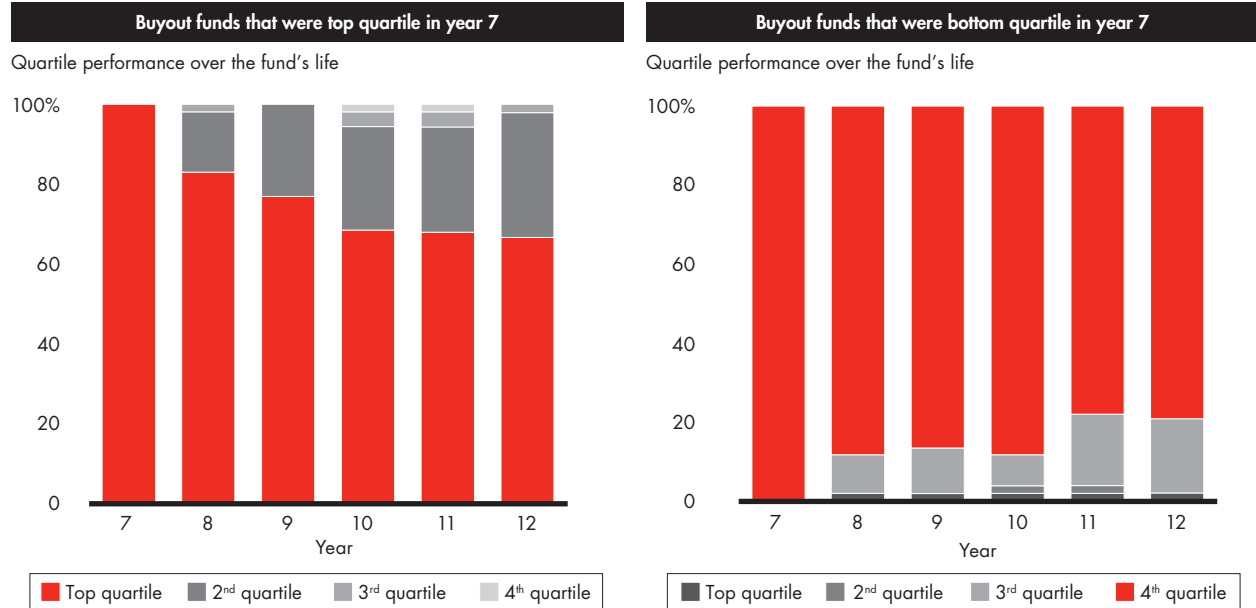


Notes: Year 1 is the fund's vintage year plus one; includes buyout and balanced funds across all vintage years
Sources: Preqin; Bain analysis

That high degree of uncertainty as to whether a fund will end up a winner or a loser based on its initially reported gains poses a real challenge for LPs needing to make a call whether to re-up with GPs when they come knocking with new fund offerings. Typically, GPs look to raise new capital around four years following the close of their previous fund. Based on interim returns at that point in the predecessor fund's life, LPs trying to decide if they will commit to the new fund lack sufficient clarity to make a truly informed decision. And with such a narrow spread between top- and bottom-quartile fund performances for recent vintages, a dramatic swing in the outcome of just one deal can move a fund out of one quartile and into another. Further Bain analysis found that it is only after around year seven in a fund's life that its ultimate return profile begins to stabilize. Buyout funds that were top-quartile performers by the end of the seventh year had a two-in-three probability of ending up a top-quartile fund, and they were virtually certain to end up in the top half of funds. A bottom-quartile fund in year seven had a four-in-five chance of finishing as a bottom-quartile performer (see *Figure 2.21*).

Are you smart or just lucky? Even when it becomes clear that a GP's predecessor fund has been a top performer, one can no longer presume that success will inevitably follow success. A Bain analysis of how likely a GP was to follow up a top-quartile fund with a top-quartile successor found that performance persistence has slipped badly in recent years. Specifically, Bain discovered that the persistence of returns broke down coming out of the last investment cycle: Nearly 40% of the successor funds to top-quartile funds from a vintage of 2000 or prior turned out to be top-quartile performers themselves; this compares with just 30% among successors to the top performers of more recent vintages, 2001 and on (see *Figure 2.22*). Clearly, some good firms let down their guard during the boom, committed to deals they should have avoided and paid the price in terms of a poor-performing fund. Similarly, other firms with a poor track record parlayed lucky timing of investments made during the downturn into a good fund.

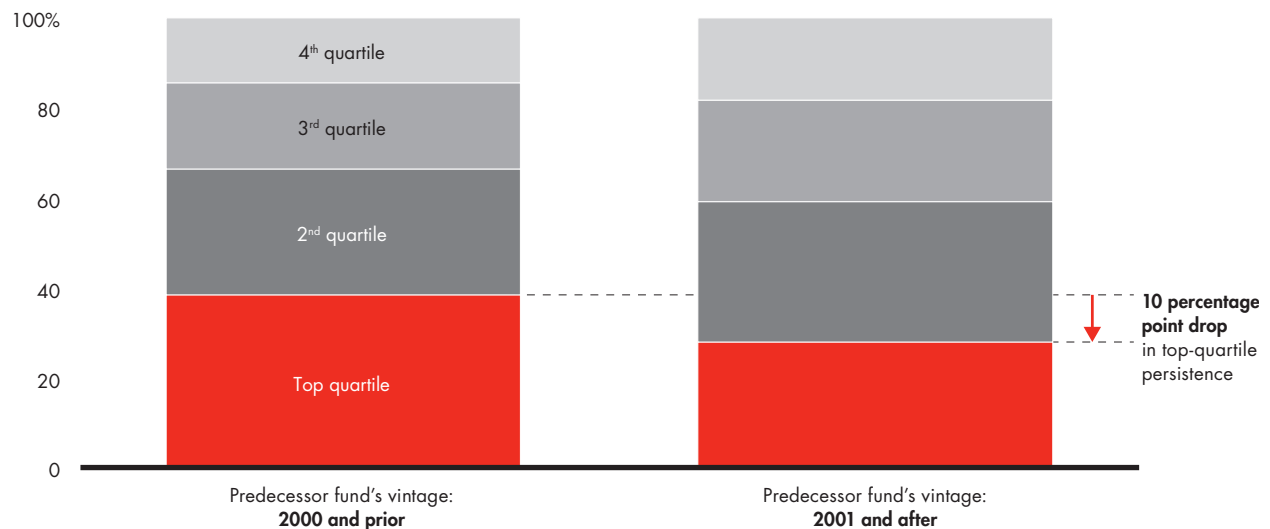
Figure 2.21: How well a fund will ultimately perform is not clear until around the seventh year of its life



Notes: Year 7 is the fund vintage year plus seven; includes buyout and balanced funds across all vintage years
Sources: Preqin; Bain analysis

Figure 2.22: The persistence of fund performance appears to be slipping

Performance quartile distribution of successor funds to top-quartile funds



Notes: Analysis includes buyout funds with investment region focus of North America, Central and South America, Western Europe, and Central and Eastern Europe; includes 125 fund pairings with the "predecessor fund's vintage: 2000 and prior" and 93 fund pairings with the "predecessor fund's vintage: 2001 and after"
Sources: Preqin; Bain analysis

The break in performance persistence has further complicated LPs' task of determining whether a fund's performance was the result of canny investment prowess or blind luck. Persistence still matters, but LPs can no longer rely on it as they have in the past and must look beyond a GP's past track record when making investment decisions. Investors have become keenly aware that beta, the passive outcome of market forces, is no longer likely to produce consistently strong returns from one fund to the next. But alpha—the value addition that skillful GPs manage to generate—is repeatable, as suggested by recent research from Oliver Gottschalg, a professor at the École des Hautes Études Commerciales in Paris, in collaboration with Golding Capital Partners. Their study found a statistically significant correlation between the evidence of alpha present in one fund and its successor. By identifying funds that have a demonstrated model for generating alpha, LPs can differentiate successful funds that will likely win again from those that are not apt to repeat their past success—though this is easier said than done. An even bigger challenge for LPs is to identify which firms have a repeatable model in place for generating alpha from the start. If they wait until the firm has demonstrated success in several earlier funds, they will likely find that they are too late to get in as an investor with that GP in its latest offering.

GPs' mandate to differentiate

When they sit across from skeptical LPs to pitch their latest fund, many GPs recognize that they have some explaining to do. If your most recent fund faltered, how can LPs tell whether the misfire was a one-off anomaly or a sign that your firm has lost its mojo? If your most recent fund's results fall within the narrow range of so-so performance turned in by the majority of GPs, what will persuade LPs that your next will be a breakaway winner? If your funds have done well in the past, how can they remain confident that you still have the skills needed to repeat that success?

Some PE firms that hit a bump during the downturn assuage questioning LPs by candidly acknowledging past mistakes and then quickly assuring them that these are unlikely to recur. Others that may have outperformed trumpet their success, while quietly anguishing over whether good fortune may deserve more credit than deft investment or portfolio management skills for their recent fund's strong performance. But candor and luck go only so far. Forward-looking GPs—the kind that LPs want to invest behind—understand they must demonstrate that they can tap clear and enduring sources of competitive advantage, an alpha model that enables them to transform the assets they acquire to generate top-quartile returns.

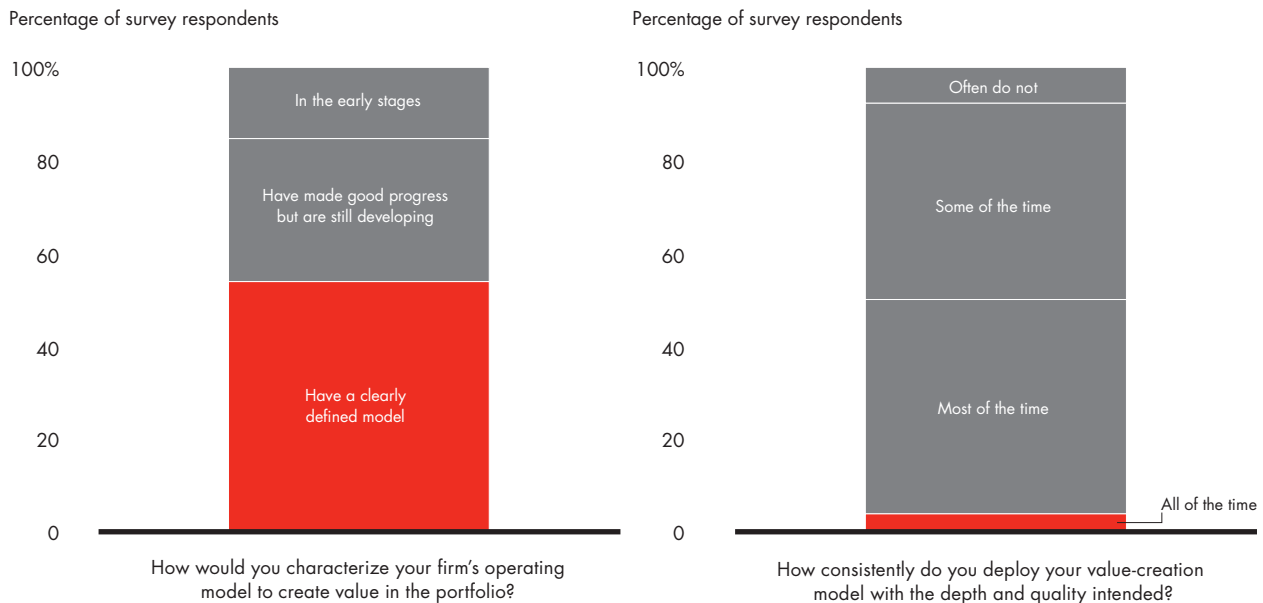
At the core of a well-tuned alpha model is a PE firm's clear articulation of where it will play and how it will win. It draws a tight ring around the investment areas where it is confident it will find success and where it will hunt for the majority of its deals. It determines how it will win by looking across the entire investment value chain to map out an angle of attack that makes the most of the firm's unique strengths—from sourcing deals and conducting enhanced due diligence to applying a robust portfolio value-creation model and nimbly managing the exit process. In today's investing environment, those firms that hone a repeatable model for value creation in their portfolio companies will outpace the rest.

3. Back to basics: Portfolio building blocks for market-beating returns

Today's tough deal-making environment has drummed home one truth, perhaps above all others, to buyout firms: To generate the outsized returns of the past requires sustained active engagement with portfolio companies. PE fund managers have become painfully aware that today's high prices for new acquisitions mean they can no longer count on external market forces to boost the value of their holdings. An activist approach is just one element of the investment value chain—stretching from proactive deal sourcing, a structured due diligence that thoroughly vets the quality of the proposed buy and on through a well-managed exit process—on which the fund's deal success depends. But it is a critical step for unlocking alpha in a PE fund portfolio.

Many buyout firms have made solid progress since the 2008 market meltdown in marshaling resources to actively create value in their portfolios. They are engaging earlier with the management of portfolio companies, dedicating more time and resources to identify potential sources of value and refining their value-creation models to help extract it. Yet, PE firms still struggle with execution: Few systematically engage with each company in their portfolio, and still fewer do it consistently well. According to a survey that Bain & Company conducted through the Private Equity Operating Partner Executive Network (PE OPEN), a global network of more than 400 partners responsible for portfolio company oversight, more than 50% of respondents reported that their firm has a clearly defined operating model to create value in their portfolio, but fewer than 5% apply the model consistently—and with the depth and quality intended—with each portfolio company they own (see Figure 3.1).

Figure 3.1: Half of PE firms claim to have a well-defined operating model, but less than 5% consistently deploy it



Note: PE OPEN members are full-time operating partners of major PE funds with assets under management exceeding \$500 million
 Source: PE OPEN member survey, conducted by Bain & Company, 2014

It is not hard to understand why PE firms have difficulty. Following the energy-draining intensity of completing a deal, a quick pivot to hands-on engagement that will flesh out and maximize potential sources of value-generating alpha is hard—and in many respects antithetical to PE's transactional mindset. Five major barriers inhibit the shift from deal making to value creation. The first is complacency on the part of the target company's management and the PE firm itself. With both sides feeling vindication and relief that the deal has been successfully consummated, neither is eager to revisit management's pitch or the fund's investment thesis and turn them into an integrated, actionable roadmap for creating new value. Second, during the honeymoon period following a deal's completion, neither side is eager to tackle difficult issues in the initial months under new ownership. The third impediment is simple confusion over roles. PE firms wrestle with how to balance the backing of strong management teams, which PE firms pride themselves on nurturing, with helping those teams achieve more than they might have with the next highest bidder. Fourth, would-be PE activists come up against internal cultural norms. Typically, what a PE fund buys merits the best thinking of both a managing director team and the firm's investment committee, yet the challenge of how to maximize value is left to the judgment of one or two managing directors and junior team members. Finally, PE firms labor to develop repeatable processes that impose the right amount of structure to accommodate both the variety of deal situations they encounter and the individual managing directors' personal operating styles.

As is common in situations where organizations confront challenges that cannot be surmounted easily, they default to doing too little, too late. But with the stakes so high and the alpha-generating imperative more important than ever, delay and half-measures are prescriptions for missed opportunities and underperformance. There is no single template for activist value creation, and there is much debate about the size, structure and assigned roles of the portfolio team and the nature, extent and timing of its engagement with portfolio-company management. Yet as Bain & Company has found through years of experience working with PE firms, all effective activist value-creation programs are built on the five interlocking building blocks described below. None is sufficient by itself, and each needs to be addressed early and repeatedly throughout the asset's holding period.

1 **Capture the “quick hits.”** Every deal presents immediate opportunities to make tactical operational improvements to boost revenue (by tweaking pricing, for example), shrink costs (through smarter procurement or by squeezing out excess inventories, perhaps) and pocket money left on the table. Engaging quickly with management to tackle these as soon as the deal closes builds momentum and reduces risk in the investment in year one. Although it is important to harvest low-hanging fruit and put out fires, these actions are simply the start of a value-creation program. In fact, the quick gains captured by fine-tuning performance can breed complacency, and they can absorb resources and energy that distract the portfolio team's attention or may be more profitably invested in higher value activities with a larger long-term payoff.

In late 2009, CVC Capital Partners, a leading global PE firm, paid around \$2.2 billion for a string of central European breweries spun off by AB InBev, the multinational beverage and brewing company. Operating across nine countries, the new company, renamed StarBev, faced declining beer consumption and falling market share in key countries. CVC's operations team became involved during due diligence to scrutinize StarBev for potential cost savings that could yield quick wins. They discovered that even as a smaller, standalone company, StarBev could reduce ancillary costs in procurement and manufacturing by, among other things, pooling indirect expenditures across facilities and switching to energy cogeneration. Within six months the new procurement initiatives and manufacturing improvements were well under way, and StarBev was able to plow cash back into its brands, improve product quality and pay down debt.

- 2 Develop strategies to transform the businesses.** A long-term strategy that identifies and creates real competitive advantage for portfolio companies is the surest way to move the needle on portfolio returns. Portfolio activists need to formulate and quickly deploy a multiyear strategic transformation—a major product-line extension, say, or a push into a new adjacency or a channel expansion. Strategies designed to move a company onto a new trajectory need time to implement and mature if they are going to yield their expected results within the portfolio company’s typical five-year holding period.

Implementing a transformational change requires deep foundational understanding about the business and the competitive dynamics of its industry. The PE firms that are best able to do this are ones that stick to their deal sweet spot and have applied their change model over and over again with portfolio companies that share a similar profile. That focus enables them to bring to bear the unique capabilities for identifying where and how they can create untapped value and mobilize them effectively.

Supported by CVC’s operations team, the country-management teams at StarBev set out to transform the organization into a growth business. The major priorities of the transformation strategy would be to reinvest in StarBev’s core lager brands and strengthen the salesforce and account management to recapture market share. And they would make a major push behind Staropramen, a premium Czech beer that market analysis showed to have untapped export potential. Beyond its focus on growth through brand building and exports, CVC would continue to take steps to boost margins as sales volume increased over the long term, consolidating StarBev’s manufacturing footprint and exiting the malting process.

- 3 Roll out a robust value-creation plan in year one.** Jointly formulated by the portfolio company’s senior management team and the PE fund, the value-creation plan builds alignment around the three to five highest priority short-term actions and the longer range transformational initiatives that will achieve target equity value over the holding period. Strategy is about choices and resource allocation; the value-creation plan pares down the laundry list of potential opportunities to the short list that really matters. It assigns accountability, details an actionable implementation roadmap, lays out key internal and external metrics to track performance, charges a program management office to oversee execution and provides the resources it will need to succeed. Far from being a static document, leading PE firms routinely refresh their value-creation plans at predetermined intervals or following a significant trigger event, such as an acquisition or a change in top management, to ensure the plan is moving toward its expected goals and making necessary course corrections. Prior to exit, the team updates the value-creation plan to build the economic case for the asset’s sale and to identify future growth opportunities for the next owner.

When done well and early in the PE ownership cycle, value-creation plans have a huge impact on deal success. Analyzing 128 exited deals in which Bain was retained to work with management post acquisition, we found that when the PE fund and management team rolled out a plan and operational blueprint within the first year of ownership, the fund realized a multiple of 3.6 times invested capital, twice the industry average.

With the help of CVC’s operations team, management fleshed out its strategic transformation plan by developing a detailed program to guide implementation of each country’s set of value-creation initiatives. Working with local managers in each market, the operations team assigned ownership for each initiative, established clear goals and key milestones and marshaled the resources needed to meet them. StarBev kept close tabs on key performance indicators to measure progress against each project and take corrective action where required. A program management office at StarBev’s headquarters consolidated reporting across the business. Monthly management and executive committee meetings reviewed execution, identified performance gaps and opportunities to close them and kept on top of all time-sensitive decisions that had to be made.

- 4 Focus on talent and build high-performing organizations.** The quality of portfolio company management teams and their ability to drive change is perhaps the most critical—and sensitive—factor influencing a deal's ultimate success. In a recent survey by accounting firm Grant Thornton, PE executives ranked having a strong management team in place ahead of strategy, operational improvements or macroeconomic factors as the most important factor influencing their portfolio companies' results.

Setting up the top management team to succeed and providing powerful incentives for them to deliver from the outset is essential. PE activists must strike a delicate balance between supporting a portfolio company CEO and being prepared to put someone new in the job early on. A delay in replacing an underperforming or ill-equipped CEO can significantly undermine even the best formulated value-creation plan. Bain found that among the portfolio companies it examined, slightly fewer than half of PE owners replaced a CEO at some point during the period they owned the business. In three out of five of those instances, the decision to fire the CEO was not an action the PE firm had planned to take at the outset. And in the overwhelming majority of those cases where an unplanned replacement was made, the PE owners did not act until after the all-important first year of ownership—after the honeymoon period had ended and the opportunity to build early forward momentum had passed.

Experienced activist firms anticipate the potential need to take decisive and quick action. They maintain a stable of seasoned senior executives on call who can be parachuted in to fill key senior management roles. They undertake an early, clear-eyed evaluation of the CEO and his or her chief lieutenants against the most important criteria of the value-creation plan, and they make necessary changes soon after the deal closes.

A virtue of the fact that StarBev had begun its life under their ownership as a carve-out was that it lacked a top-heavy centralized senior management. Rather than build one, CVC instead worked to develop strong country-operations teams with local talent that would lead and implement the market-specific transformation plans. The single-minded pursuit for these teams was to deliver on the value-creation plans' objectives and build local capabilities to support the key initiatives within their countries. StarBev's lean corporate leadership team focused on human resources, marketing and sales playbooks, procurement, manufacturing and export expansion.

- 5 Convert good deals into great ones.** Successful portfolio activists take pains to avoid a costly asset-management pitfall—the temptation to double down and try to put a troubled company back on track at the expense of nurturing their winners. Of course, it is essential that GPs apply a consistent value-creation model to each portfolio company as it comes on board, but inevitably some deals will show far more promise than others. But it is also true that top-performing funds consistently generate fewer losing deals and more winning deals than their less successful peers. For the average fund, there is much more to gain by dedicating resources and management time to deals that are already performing well than trying to salvage those that are failing. Notably, a Bain analysis that simulated alternative outcomes for a sample of funds that turned in a net IRR of between 5% and 15% during the vintage years from 1995 to 2007 found that the payoff from investing to go from good to great by replicating the success of top-performing funds' higher frequency of winners has three times greater impact than trying to lift a money-losing investment marginally above breakeven.

Many PE firms struggle to find the time and resources to do value creation right. On average, PE-fund operating partners responding to the PE OPEN survey reported that they devote some 40% of portfolio resources to deals on track to deliver less than two times their invested capital. Some said that their firms are expending as much as 60% to turn around deals that will likely return less than the equity capital they committed. Funds whose mix of portfolio companies is apt to produce just so-so results must pick their battles. By starving their losers and redirecting resources to nurture their winners, they can boost their overall portfolio performance.

From the day CVC took control of the StarBev assets in late 2009 until the day it exited the investment less than two-and-a-half years later, the operations team worked alongside management to maintain a disciplined cadence of implementing the value-creation strategy. The \$3.5 billion sale of StarBev to Molson Coors in early 2012 capped a winning deal for CVC.


Portfolio value creation is not a one-and-done proposition. Working from these building blocks, PE activists implant a whole new set of disciplines and capabilities into the daily rhythms and cultural norms of their firms, turning value creation into a repeatable process they hone over time and draw on over and over again.

CVC is now executing a nearly identical playbook at Continental Foods, a carve-out of leading European consumer brands, purchased for €400 million from Campbell Soup Company in October 2013. Less than a year into CVC's ownership, Continental Foods returned to growth after four years of declining revenues, and it improved its run-rate EBITDA by more than 20%—all while elevating the quality of its products and increasing marketing investments by 40%. Having already refinanced the business and taken equity off the table, early indicators suggest that this, too, will end up as a very successful deal.

Identifying barriers to value creation: A self-assessment

Successful portfolio activism prizes two qualities above all others: a sense of urgency and focused intention. Only PE firms that can quickly transition from thinking as acquirers to acting like value creators will be able to unleash the alpha that will increasingly separate the winners from the losers. With no time to lose, these firms are primed to mobilize the entire organization around the five interlocking building blocks of portfolio activism before the ink is dry on a deal's closing documents. To test whether your firm will be able to do the same, your deal teams, operations teams and managing partners can evaluate their value-creation readiness by answering the following questions:

- Has your firm developed a repeatable model for creating value in its portfolio companies, and does it have a high degree of buy-in from the deal partners?
- Does your firm have formal processes in place—endorsed by senior partners—that enable it to pivot quickly from deal making to value creation as soon as a deal closes?
- At each of your portfolio companies, are management and operating partners aligned on the short list of priority initiatives that will really move the needle on equity value creation?

- Has your firm built a network of C-level executives it can call on to manage a portfolio company as the need arises?
- Is there consensus among your deal and operating partners about which portfolio companies have the potential to go from good to great, and does your firm back those companies with sufficient resources to help them become big winners?
- Does your firm conduct periodic reviews of each portfolio company and adjust both near-term and long-term objectives to accommodate changing macroeconomic conditions, new portfolio company challenges and opportunities or shifting industry dynamics? 

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