GLOBAL PRIVATE EQUITY REPORT 2014

BAIN & COMPANY

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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:

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

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Bain & Company, Inc.
131 Dartmouth Street
Boston, Massachusetts 02116 USA
Tel: +1 617 572 2000
www.bain.com

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Change we can believe in?

Dear Colleague:

Looking only at the deal-making statistics for 2013, one might easily conclude that the PE industry is still in the doldrums, with deal value and count little changed from prior years. And while it is true that pricing and competitive conditions make it challenging to get good deals done, other forces are strengthening the PE industry and will help propel winners forward over the coming year.

Exits are increasing, and ubiquitous dividend recapitalizations and a flurry of post-IPO follow-on sales are putting huge amounts of capital back into LP coffers. In fact, many LPs have had net positive cash flow from their PE investments for the past two to three years. This happy result also creates a problem: LPs' PE portfolios are now shrinking in many cases, resulting in a decreasing allocation to their best-returning asset class.

Many LPs were quick to realize this in 2013; they made substantial new commitments to PE funds. Fund-raising continues to be problematic for GPs with poor track records, and the level of LP scrutiny of all GP relationships remains high. But the arrow is pointed decidedly upward to healthier fund-raising levels in 2014. Overall, deal makers will have plenty of dry powder to get those new deals done.

The challenge for GPs will not be deploying capital but making good investments. Competition for deals is unrelenting. Monetary policy in the US and other developed markets continues to force investors to chase yield, and this, in turn, is making plentiful amounts of debt available for any reasonably attractive asset. The resulting effect to push up asset prices exacerbates the difficulty of penciling out winning returns. To make good deals, GPs must truly specialize—both across industries and types of deals—so they can develop distinctive investment angles and have the confidence to bid what is required to win a target asset they can transform into a highly lucrative investment.

We look forward to continuing our dialogue with you as our fascinating industry continues to evolve. Please enjoy Bain's latest Global Private Equity Report with our best wishes.

Hugh H. MacArthur
Head of Global Private Equity
February 2014

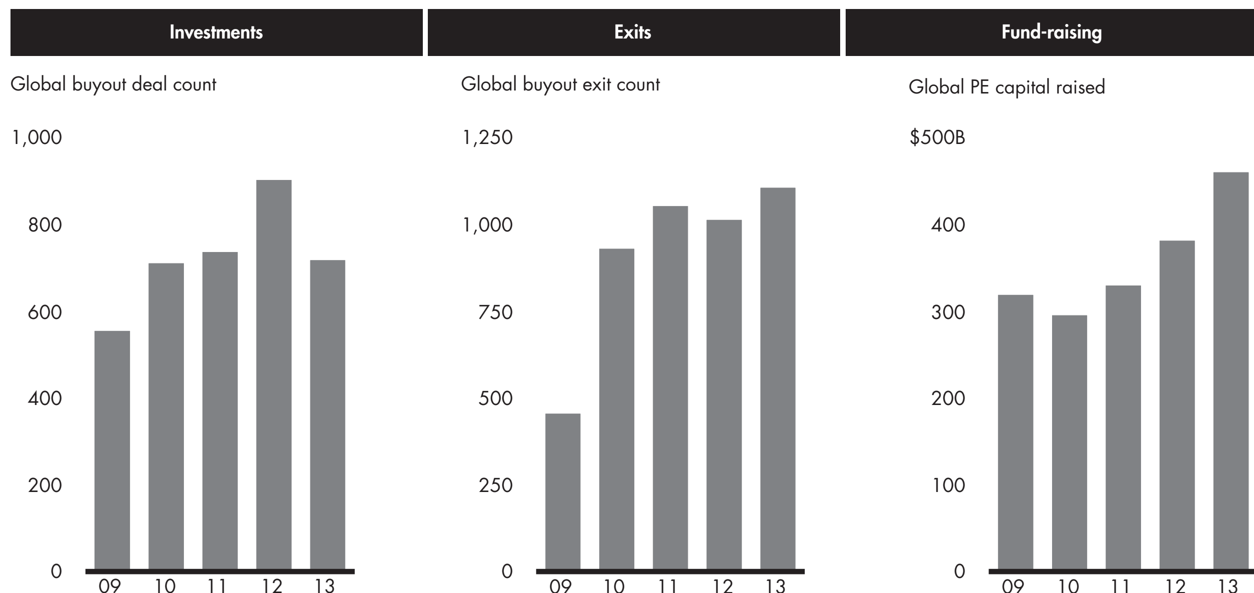
1. The PE market in 2013: What happened

After four frustrating years of false starts, nervous capital markets and deal-dampening volatility, the private equity (PE) industry has taken a sharp turn from uncertainty and worry to enthusiasm about the past year and optimism for the future.

PE investors welcomed the calmer macroeconomic conditions, profited from the stronger public equity markets and enjoyed the persistent low interest rates and accommodating debt markets the central bankers helped engineer. Exit channels opened up. New IPO issuance, follow-on offerings and dividend recapitalizations were robust, enabling general partners (GPs) to increase distributions to limited partners (LPs) as they cashed out a long pipeline of past investments. As new money flowed back into their coffers, LPs were able to refresh their PE commitments, breathing life into GP fund-raising campaigns. With many of the once-troubled deals from the mid-decade boom years profitably sold and the valuations of unsold assets still in GP portfolios climbing, PE returns rebounded. The factors that helped make exits, fund-raising and returns flourish, however, also made 2013 a challenging year for deal making (see Figure 1.1). They raised the floor on sellers' price expectations, making deals that did get completed more costly and pushing some deals out of reach of PE acquirers. The allure of IPOs also siphoned away companies that might have gone to auction, shrinking the pool of potential deals.

The signs of strength we spotted in late 2012 and discussed in Bain's *Global Private Equity Report 2013* fanned an upswing in GP and LP sentiment during the past year. Improving macroeconomic conditions in the developed

Figure 1.1: The PE industry showed long-awaited signs of a return to health in 2013



Notes: 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; Exits: exclude bankruptcies; Fund-raising: includes funds with final close; represents year funds held their final close
Sources: Dealogic; Preqin

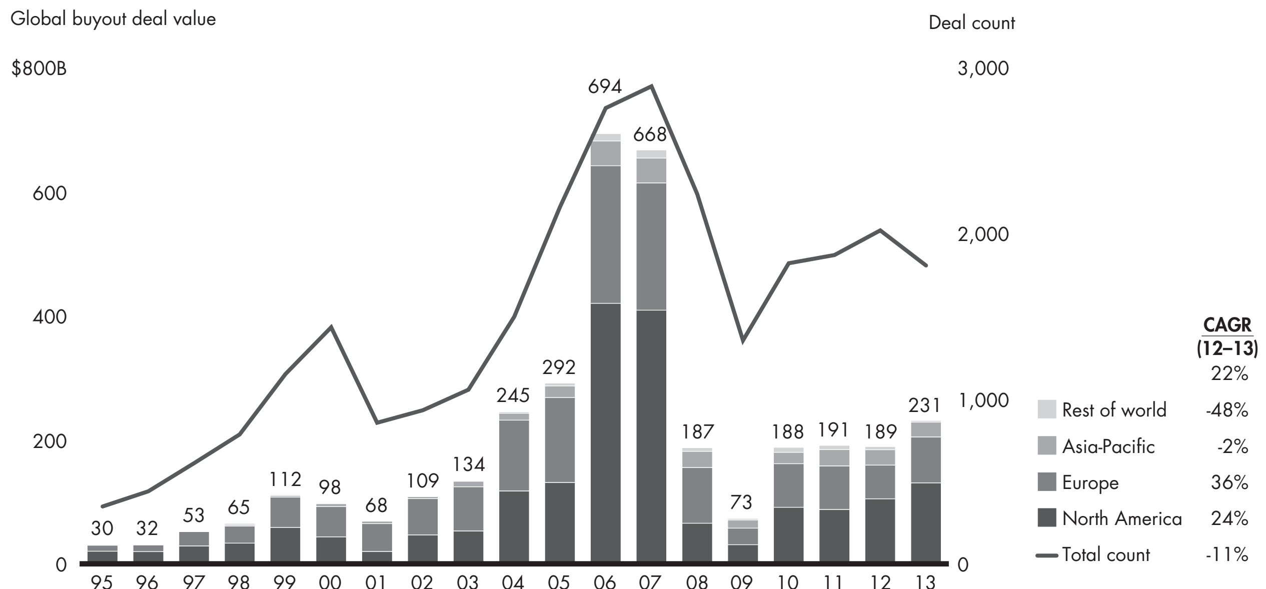
markets and the favorable consequences they had for investors helped boost confidence. But top-performing GPs also added crucial fuel to the fire, as we will see in the following pages, by savvy deal making, well-timed exits, smart fund-raising and continued delivery of solid long-term returns.

Investments: Better economic conditions made deal making harder

Coming into 2013 in the wake of generally flat deal activity between 2010 and 2012, a trifecta of factors suggested that PE investments had nowhere to go but up. Sitting on more than $900 billion in dry powder ($356 billion of it earmarked for buyouts) at the start of the year, GPs were highly motivated to put capital to work. Also weighing in favor of a pickup in deal-making activity was the wide anticipation that one of the big impediments to investment in the aftermath of the downturn—the gap between sellers and prospective buyers on what assets were worth—would close as the economy stabilized and the outlook became clearer. Finally, with interest rates hovering near zero and yield-hungry investors and bankers increasingly eager to lend, GPs could count on being able to use leveraged loans and other debt to help finance new acquisitions. All that was needed was a gust of favorable economic winds at GPs' backs and buyouts should take off, most industry insiders expected.

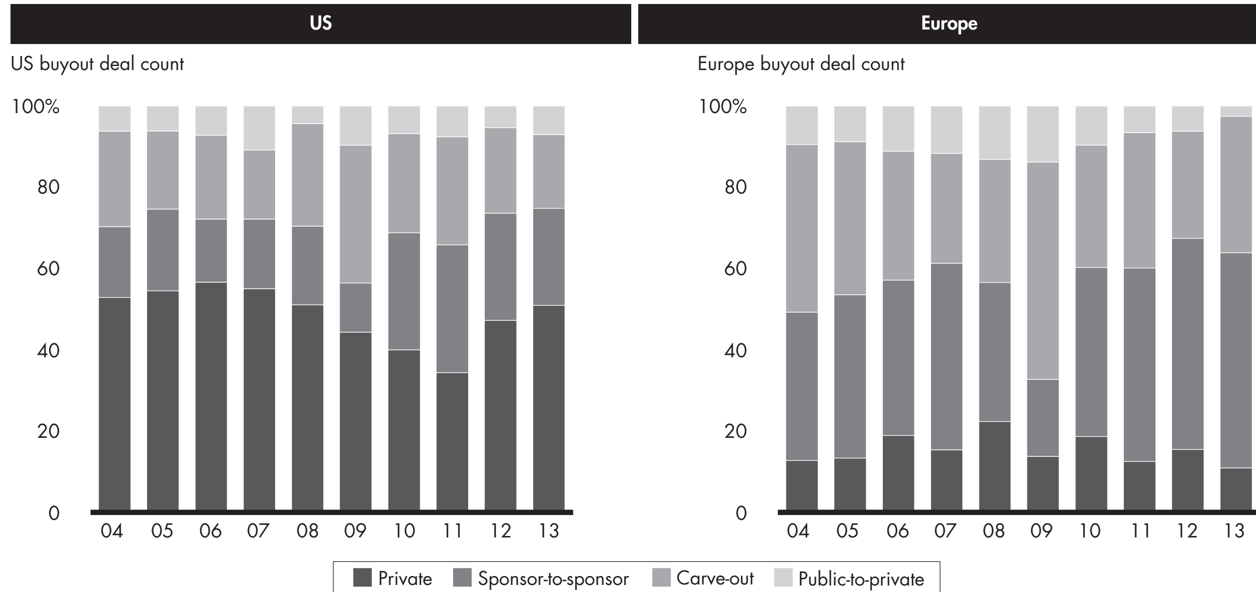
It didn't happen. When the books closed on 2013, the total value of global buyouts was up 22%, yet deal count was down 11% *(see Figure 1.2)*. The increase in total deal value to $231 billion was heavily influenced by two mega-buyouts in 2013—the conversion from publicly traded to private-equity-owned of US-based computer maker Dell and food giant Heinz. Combined, those transactions were valued at $48.6 billion. Setting aside the Dell and Heinz deals, North America buyout activity was down 22% by value and 21% by count. Europe deal making was up 36% by value, but down 6% by count. Buyout activity in Asia held up, posting an 8% gain in deal count and off by just 2% in value. The rest of the world was down in both count and value, by 3% and 48%, respectively.

Figure 1.2: Global buyout activity was up in value but down in count compared to the previous three 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 the location of targets
Source: Dealogic

Figure 1.3: US deal activity was dominated by private company sales; Europe by sponsor-to-sponsor deals



Notes: For US: Represents control buyout transactions by US-based firms; closed deals only; represents year deals were closed; excludes add-on deals. For Europe: Represents buyout transactions ≥$75M where target is based in Europe; represents year deals were announced; excludes add-on deals
Sources: Bain US LBO Deal Database; Bain European LBO Deal Database

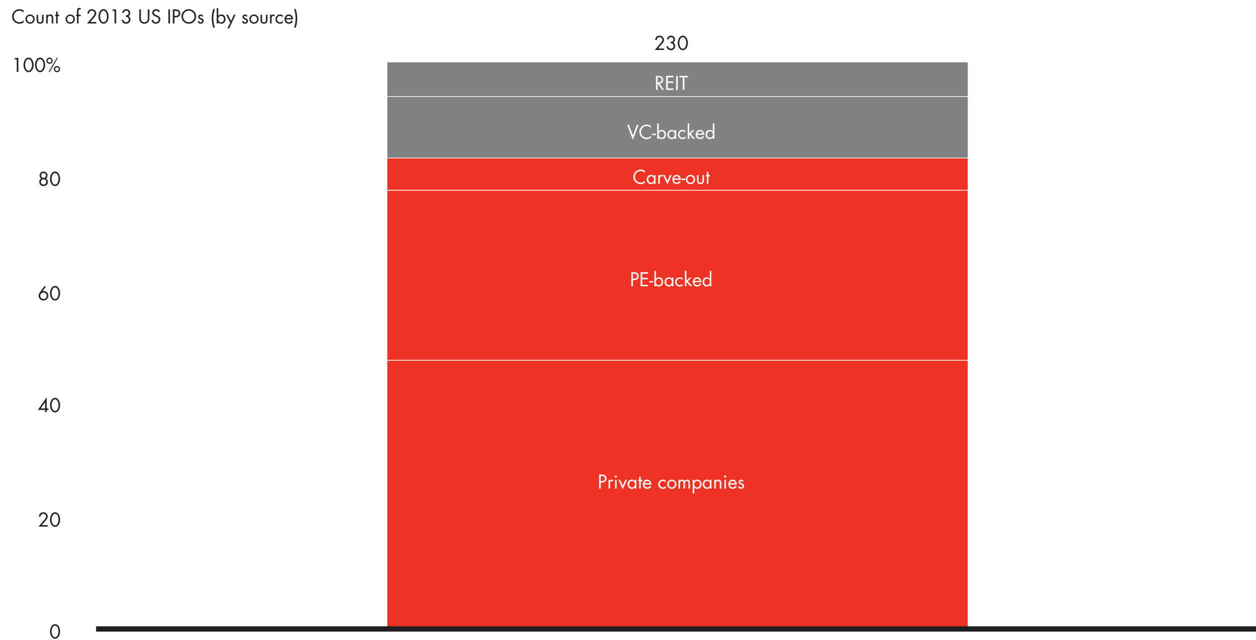
In terms of the types of deals completed in 2013, buyout activity in the US and Europe followed a familiar script (see Figure 1.3). As in past years, PE acquisitions of privately held companies predominated in the US, accounting for nearly half of the total. Fewer US transactions involved the sale of companies by one PE fund to another, as the public markets lured many potential sponsor-to-sponsor sales to IPO instead. By contrast, such sponsor-to-sponsor deals made up the bulk of buyouts in Europe. Purchases of companies carved out of larger corporations continued to be an important source of deals on both sides of the Atlantic. Public-to-private deals took place in both regions, but these were few in count and mostly announced in the first quarter of 2013 before the public equity markets began their stratospheric rise, pushing valuations out of reach of PE investors.

Resilient capital markets drive wedges between buyers and sellers. What accounts for the diminished level of deal activity? Ironically, greater economic stability, buoyant equity markets and the easier availability of low-cost debt that might have been a launching pad for deal making all worked instead to further stretch valuations, in some cases beyond what PE acquirers were willing to pay, or simply limit the supply of deals.

In negotiations with prospective buyers, sellers held out for a high price, and rising public equity markets gave them added reasons to dig in. Elevated stock prices meant that GPs paid dearly for deals they consummated in 2013. In some instances, sellers held out for more than what GPs were willing to pay, and prospective buyers walked away.

In addition to raising the floor on sellers' price expectations, the allure of the public equity markets also drew many companies away from private capital, thereby shrinking the supply of assets. Of the 230 companies that made initial public offerings in the US in 2013, more than 80% were businesses that might have been attractive PE targets (see Figure 1.4). Among several notable companies that ended up opting for an IPO was SeaWorld

Figure 1.4: For "good" companies with scale, there was stiff competition from the public markets in 2013



Sources: Dealogic; Bain analysis

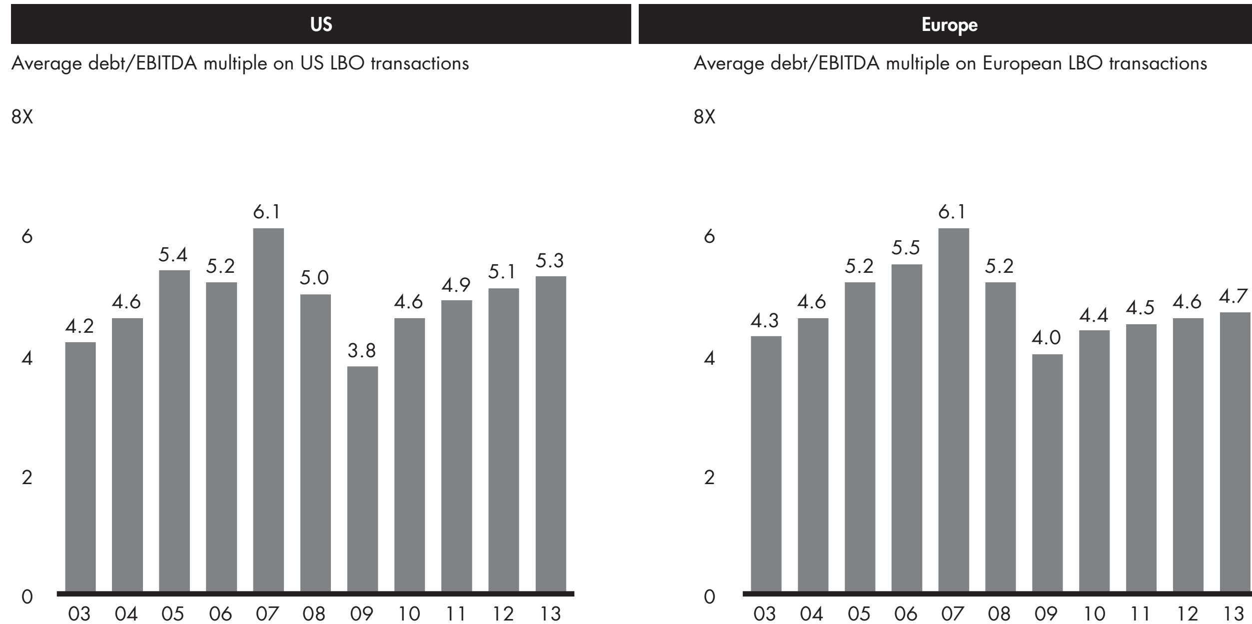
Parks and Entertainment. Its owner, Blackstone Group, pursued parallel talks with both another prospective PE acquirer and a possible strategic buyer before concluding an initial public offering last April that valued the theme parks at about $4 billion. Like SeaWorld Parks and Entertainment, many companies ran dual-track processes in 2013. Often they went straight to IPO.

Together with the public equity markets, the wide-open credit markets that held such promise for PE deal activity at the beginning of 2013 may also have ended up working to the disadvantage of PE buyers by further pushing up prices and limiting the supply of potential deals, as GPs opted to extract equity through dividend recaps rather than sell assets.

The unprecedented supply of cheap credit enabled GPs to pile debt on new deals *(see Figure 1.5)*. The generous use of leverage to structure a deal, of course, helps to turbocharge potential returns on equity. And under normal conditions, readily available debt makes it possible for buyers to bridge their difference with sellers over price. In the easy lending environment of 2013, however, accommodating debt markets served mostly to push prices even higher, further inflating sellers' price expectations beyond what GPs were willing to pay.

In a twist, it was often sellers, not buyers, who made the best use of the debt markets in 2013 and in the process, further limited the supply of potential deals. Instead of putting portfolio companies on the market, many owners availed themselves of rock-bottom interest rates to recapitalize portfolio company balance sheets, issuing dividends to take out equity. For PE funds, dividend recaps became a popular—and profitable—alternative to selling in 2013, enabling GPs to withdraw an average 56 cents for every dollar of equity invested, but leaving the company in their portfolios where they could continue to benefit from future growth. Dividend recaps came in at a record $66.2 billion globally in 2013, according to S&P Capital IQ LCD.

Figure 1.5: Ready supply of cheap debt enabled GPs to increase leverage on new deals



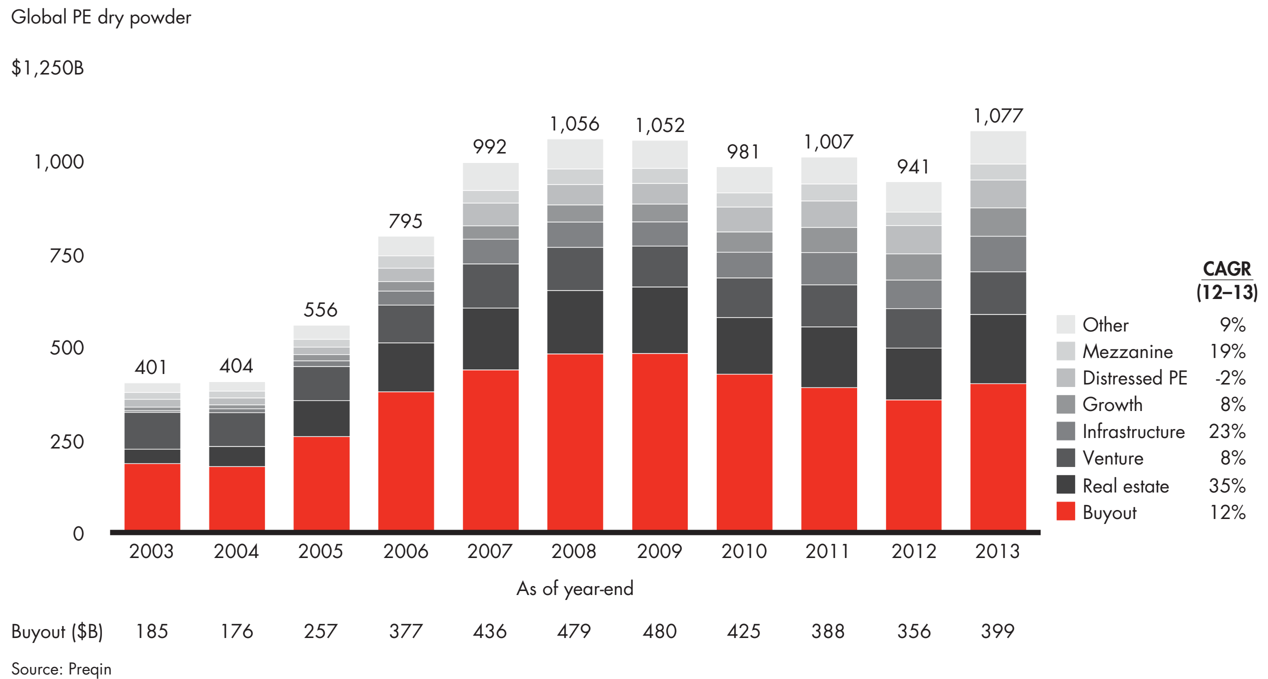
Source: S&P Capital IQ LCD

GPs become more selective. The slowdown in deal making did little to enable GPs to further whittle down the mountain of dry powder. Indeed, the piles of undeployed capital rose even higher throughout 2013, once again piercing $1 trillion by year's end, above its peaks in 2008 and 2009 (see Figure 1.6). Buyout dry powder rose 12% over the course of 2013, climbing to some $400 billion by the end of the year. As in so many other ways that set 2013 apart as a surprising year, the increase in dry powder was yet another sign of improving conditions—this time on the fund-raising front, as we will soon see.

Adding yet more capital to their stores of aging dry powder in 2013, however, did not aggravate a persistent pressure that plagued GPs over the past half-decade: how to put all that idle money from boom-time vintage funds to work before it expired. In fact, many GPs did make considerable progress putting older money to work, and some that were sitting on capital that had aged beyond its expected investment period were able to win extensions from LPs. Last August, for example, Bridgepoint, a pan-European buyout firm that had already called 76% of its €4.8 billion 2008 vintage Europe IV fund that was due to expire in November, negotiated a one-year extension on the balance. For global buyout funds as a whole, aging dry powder became less of a concern in 2013 than it had been in past years as the stock of capital under pressure decreased (see Figure 1.7).

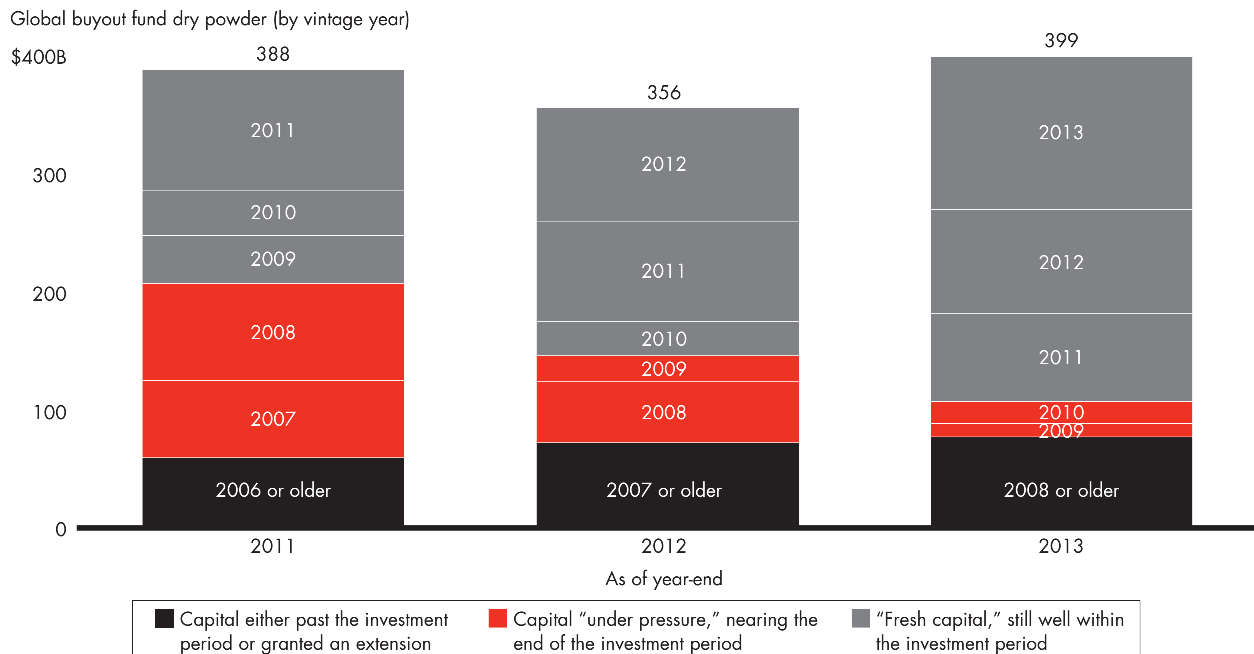
With pressure to put capital to work eased somewhat, GPs had no compunctions about walking away from deals where the target return did not pencil out, reinforcing their already strong propensity to exercise restraint. Beyond steering clear of assets they considered overpriced, some GPs also limited their search only to "safe" investments that could warrant a high price—solid companies with reliable cash flow, a strong management team and a leading market position in their industry. But because the supply of safe assets is limited, those GPs that narrowed their focus to these good companies constricted their deal pipeline and faced rabid competition for these desirable assets.

Figure 1.6: Having been chipped away over the past few years, the mountain of dry powder grew in 2013



Source: Preqin

Figure 1.7: The proportion of buyout capital under pressure to be put to work has declined



Source: Preqin

Emerging market scorecard: Trading places

The swift rise of PE interest in China, India, Southeast Asia and Brazil in recent years was a powerful counterweight to the slump in activity in the mature markets of North America and Europe. In 2013, however, total PE investment (looking more broadly than just buyouts) in the hot Asian economies and Brazil cooled, with deal count up slightly in Asia's emerging markets but deal value off considerably (see Figure 1.8).

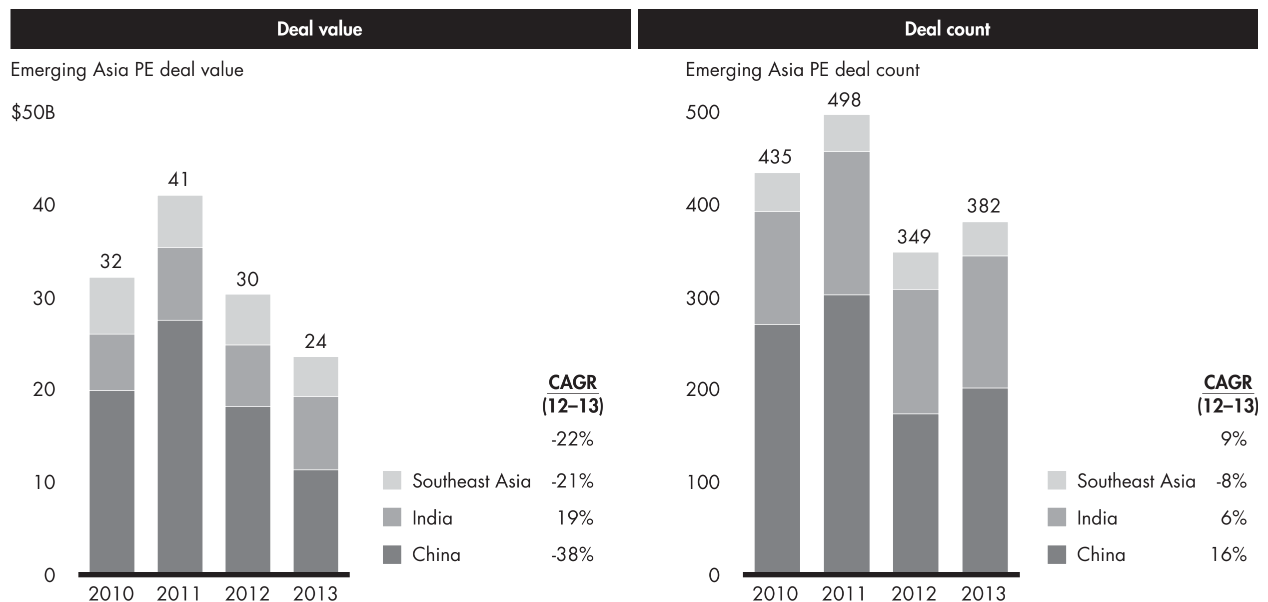
The decline was not the result of GPs turning their backs on these markets, of course. There is more than enough dry powder earmarked specifically for investment in the developing markets to keep deal makers busy for years to come. What have changed are macroeconomic conditions in the rising economies, which have turned from frothy to relatively frosty. Here's an overview:

China

China's economy continues to expand rapidly relative to the developed markets, but the pace has slowed to its lowest rate in more than a decade. GDP growth held steady at 7.7% in 2013, while the underpinnings of China's long expansion shifted. In a year of generational change in China's political leadership, investors have grown cautious as Chinese manufacturers face increased competition from other exporting nations, heavy lending to the real estate sector fuels a housing bubble, urbanization is slowing and income disparities continue to widen.

Investment activity in 2013. PE investment continues to draw on substantial piles of dry powder that grew rapidly between 2009 and 2011 before fund-raising began to taper off last year. At the beginning of 2013, some $36 billion in capital dedicated to growth and buyout investments in Greater China alone sat in GPs' war chests. The number

Figure 1.8: 2013 was a challenging year for deal making in emerging Asia



Notes: Southeast Asia includes Singapore, Indonesia, Malaysia, Philippines, Thailand and Vietnam; includes investments with announced deal value only; excludes deals with value <$10M; does not include real estate, hotels and lodging property deals, infrastructure and large domestic transfers by sovereign wealth funds to government
Source: AVCJ

of deals completed last year in China increased from that of 2012, but total deal value dropped to just $11.4 billion, a decline of 38% from 2012. GPs were eager to put capital to work, but they were wary about overpaying. Because sellers were reluctant to settle for lower prices, deal activity was limited. Last year's biggest PE-financed growth deal was Baring's $1.5 billion acquisition of Giant Interactive Group, an online game developer and operator. Most deals completed in 2013 were small, early-stage investments.

Also dampening deal making in 2013 was the decision by Chinese regulators to close the IPO window for new issues denominated in renminbi and keep it shuttered throughout most of the year. Pre-IPOs for 18 companies worth just $1.3 billion managed to squeeze through in 2013, compared with an annual average of 45 deals worth a total of $3.8 billion between 2009 and 2011. For locally denominated Chinese renminbi funds, which tend to focus on pre-IPO deals, investment activity largely ground to a halt. Looking for a silver lining, PE investors hoped that the closed IPO markets would be a boon for deal flow, as owners looking for an alternative source of capital would turn to PE. Those hopes ended in disappointment. However, by year's end, harbingers began to appear that PE prospects might revive in 2014. There was a noticeable pickup in deal activity in the fourth quarter, as reduced competition from renminbi-denominated funds over the course of the year helped bring down sellers' price expectations and regulators reopened the IPO window.

India

PE investors who had bought heavily into India's recent strong growth story hit a macroeconomic wall in the 2012–2013 fiscal year. GDP clocked in at just 4.9% in 2013, up from 3.3% in 2012 but well below the pace of prior years. Meanwhile, the Indian rupee fell 10% against the US dollar, as inflation remained high at better than 11% last fall. Declining industrial output and political gridlock are also weighing down economic prospects.

Investment activity in 2013. PE deal volume increased to almost 150 in 2013, up slightly from the prior year. The vast majority of these involved infusions of growth capital in exchange for minority stakes or private investments in publicly listed companies. Deal value rose on the back of a $1.26 billion investment in Bharti Airtel, a wireless telecom company, by Qatar Foundation in the year's second quarter. Nevertheless, weakening economic fundamentals have only aggravated challenges PE investors faced even in better times. GPs had waged an uphill battle to win over Indian entrepreneurs, who have been reluctant to cede control of their companies. Although owners of small and midsized businesses have increasingly come to see PE as a credible source of patient capital, their price expectations remain inflated, and the valuations gap between potential sellers and buyers remains wide. Seller skepticism is now being reciprocated on the PE buyer side, as GPs are more cautious about closing deals. Before their confidence in India is restored, GPs will need to see more success engineering profitable exits than they have to date.

Southeast Asia

Stretching from cosmopolitan, prosperous Singapore to bustling, middle-income Indonesia and Thailand to vibrant, lower-income Vietnam, the economies of Southeast Asia cannot be painted with a monochromatic brush. Across the region, GDP growth fell a bit in 2013 to 4.9% compared with 5.5% in 2012, but different countries took diverse paths to that result. In Indonesia, for example, fiscal spending and a current account deficit factored prominently in the year's macroeconomic results. In Vietnam, GDP increased slightly to 5.5% in 2013, as inflation moderated. In the Philippines, GDP expanded at a strong 7.2% rate in 2013, but it is expected to fall in the aftermath of last November's killer typhoon.

Investment activity in 2013. For PE investors, too, Southeast Asia presents a varied profile. In sophisticated Singapore, where the history of PE is long and stable, deal making was brisk in 2013, and average deal size was slightly larger than the average over the last few years. The Philippines showed evidence of more deal activity after many slow years. Deal value picked up in Vietnam, but both deal count and value dropped in Malaysia. For the region overall, deal activity was steady, but deal value fell to $4.3 billion, a drop of about 20% from 2012. However, activity was healthier than these numbers suggest. Traditionally led by sovereign wealth funds, mega-deals valued at more than $1 billion were largely absent from the market in 2013, leaving the total value of core deal making by GPs slightly higher than in 2012. By sector, companies that focus on the fast-rising consumer—from online commerce and healthcare to financial services and logistics—tend to drive both the region's economies and PE investors' interests. PE sentiment toward the region remains quite strong, but a blurry macroeconomic outlook, market volatility and high prices are keeping PE investors on their toes.

Brazil

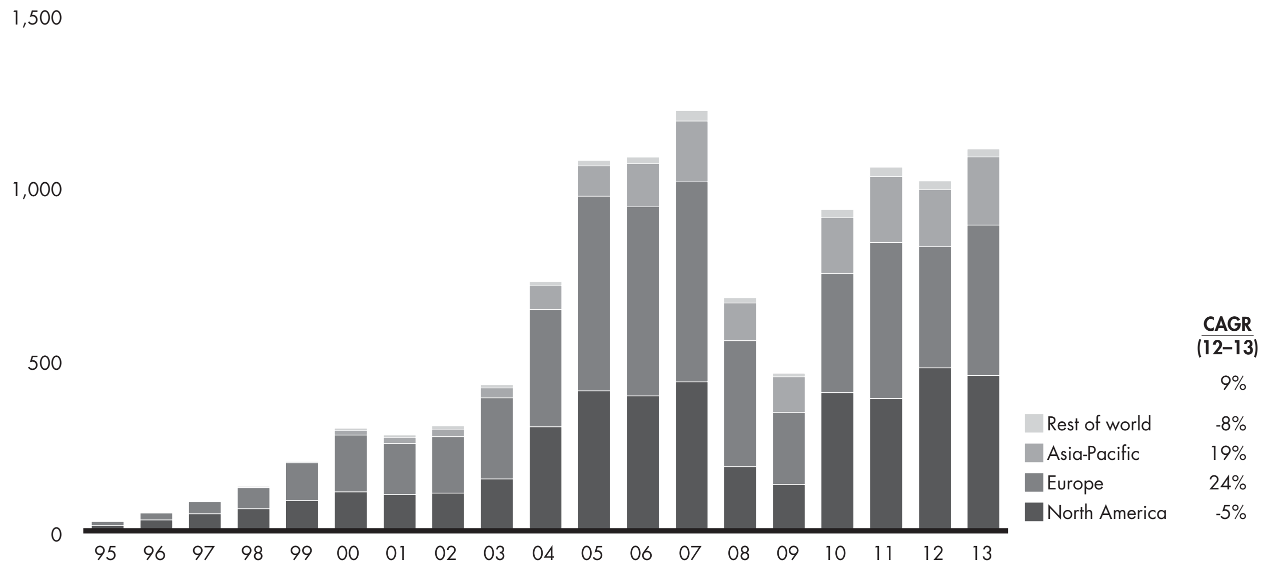
Unlike the economies of China and India, which tend to grow fast and experience occasional slowdowns, Brazil's is basically a modest-growth economy punctuated by occasional periods when it grows rapidly. Over the past few years, Brazil reverted to its modest-growth pattern, with GDP up 2.2% in 2013. The economy faced headwinds from higher inflation and a volatile currency exchange rate.

Investment activity in 2013. Going into 2013, buyout and growth funds sat on $5 billion in dry powder dedicated exclusively to Brazilian investments, with more on the sidelines targeting Latin America as a whole. PE deal activity (excluding venture capital and government-backed investments) was up 43% in 2013, as GPs completed 66 transactions, vs. 46 in 2012. Deal activity was most active in the industrial goods and services, oil and gas, and technology sectors. Yet deal value dropped in 2013. Brazil remains a thin market where a few deals can have a big impact, and big deals were largely absent. The year's two largest deals were in the real estate and infrastructure sectors. Blackstone Group and its local partner Pátria Investimentos Ltda. acquired a 70% stake in Alphaville Urbanismo SA, a real estate developer, for $663 million. EIG Global Energy Partners, an infrastructure investor, acquired a majority stake of LLX Logistica, a port operator, for $567 million. Deal activity might have been higher but for the disappointing macroeconomic environment and the fluctuating value of the Brazilian real that combined to drive a wedge between buyer and seller price expectations. Even though they face increasingly competitive bidding situations, GPs opted to walk away rather than pay a too-high price.

Exits: Firing on all cylinders

It was a great year to be a seller in 2013. Setting aside the likely never-to-be-repeated boom of 2007, global exit activity last year was about as robust as the PE industry had ever seen. Global buyout exit count rose 9% over the prior year, and exit value jumped 14% (see Figure 1.9). By geography, both the number and value of exits in Europe snapped back by 24% and 15%, respectively. A stronger Europe more than made up for a decline in the number of exits in North America, even as the value of exits in the region increased by 14%. Both the number and value of buyout exits in the Asia-Pacific region advanced, although buyouts still account for a small proportion of total deal making in Asia's emerging economies. Beyond just buyouts, total PE exits in the Asia-Pacific region saw a significant decline during 2013, due primarily to a steep falloff in China, where regulators kept the IPO window shut during most of the year.

Figure 1.9: Strong exit activity in Europe made up for weakness in North America



Note: Excludes bankruptcies
Source: Dealogic

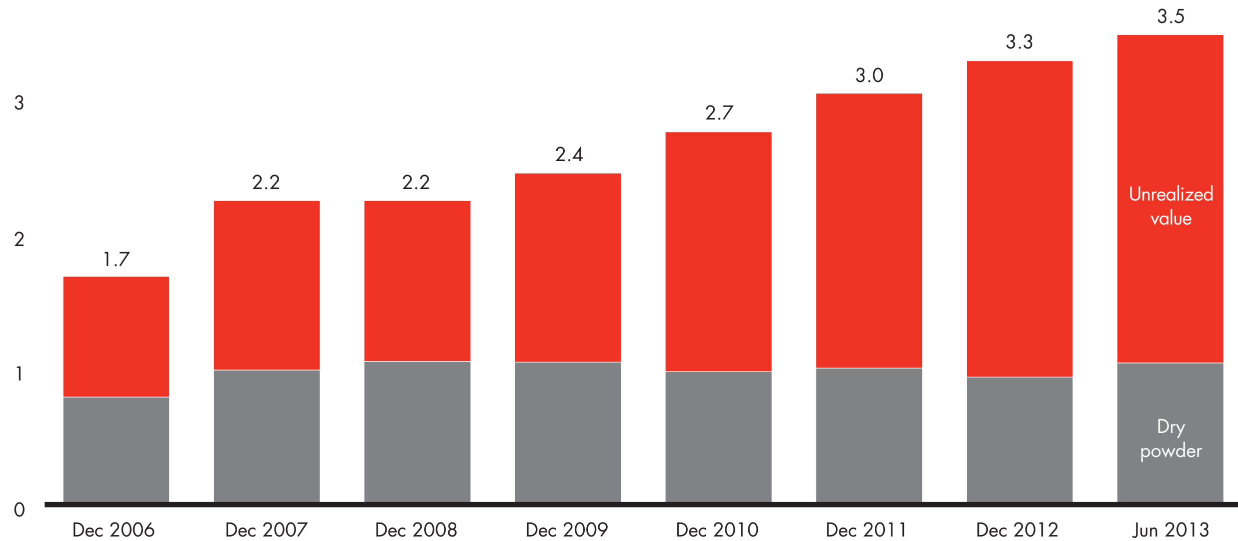
With valuations rich across both private and public markets, GPs were eager to liquidate assets held in the large overhang amassed during the boom years. At the beginning of 2013, GPs were sitting on assets with an unrealized value of nearly $2.3 trillion in their portfolios, of which $930 billion was tied up in buyout funds (see Figure 1.10). GPs with any assets in their portfolios ready to be sold put them on the block. The main constraint they faced was their own unwillingness to part with holdings. A few held back because an asset was still underperforming and needed a bit more ripening in a warming economic climate. More commonly they anticipated even better future gains and were reluctant to cash out too soon.

GPs that were ready to sell tested all of the traditional exit routes, but the mix of exits shifted decidedly in favor of IPOs (see Figure 1.11). Here is how exit activity played out in 2013:

Sponsor-to-sponsor exits: Marriages of convenience. The number and value of exits through sponsor-to-sponsor deals fell considerably in 2013, but the drop was not for a lack of interest by GPs in doing business with each other. PE firms often find sponsor-to-sponsor exits quicker to arrange and more certain to bring to completion than exiting through sales to strategic buyers or navigating the complicated IPO markets. Banks, too, are more willing to lend on favorable terms against the familiar assets and management teams. Those relatively appealing characteristics of sponsor-to-sponsor exits simply did not carry as much weight in 2013 as they have in most years. The declining incidence of sponsor-to-sponsor deals in 2013 was due more to the strength of the strategic and IPO channels than to any inherent unattractiveness of transactions between PE firms.

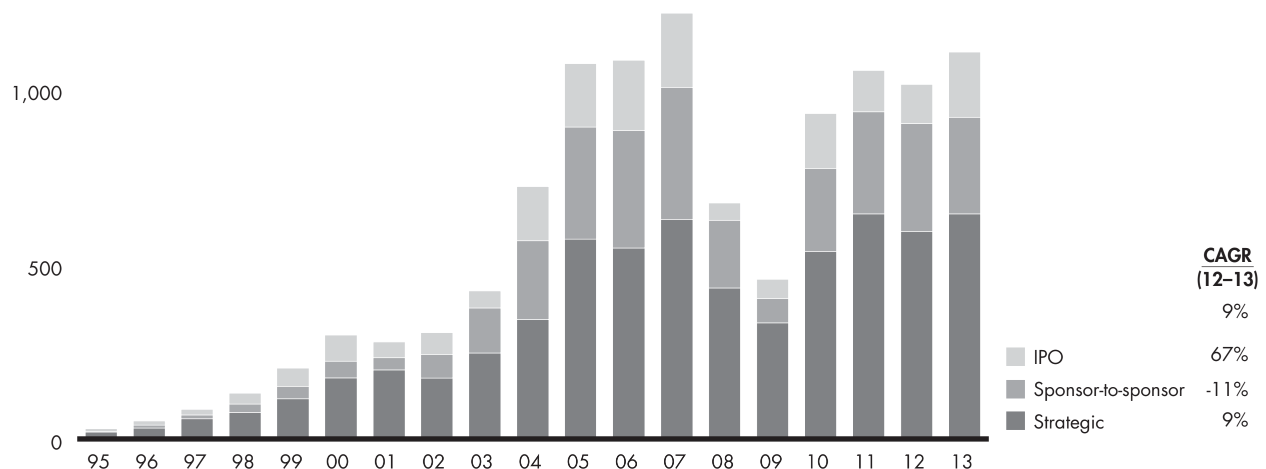
Strategic exits: Searching for synergies. Conditions for sales to strategic buyers—long the biggest exit channel for buyouts across all geographies—remained favorable in 2013. Having spent the slow post-recession recovery years overhauling their income statements and grooming their balance sheets, corporations entered the year

Figure 1.10: Large amounts of unrealized value remained in PE fund portfolios as 2013 began



Source: Preqin

Figure 1.11: Exit activity for buyouts worldwide was up modestly in 2013, chiefly on strength in the IPO channel



Note: Excludes bankruptcies
Source: Dealogic

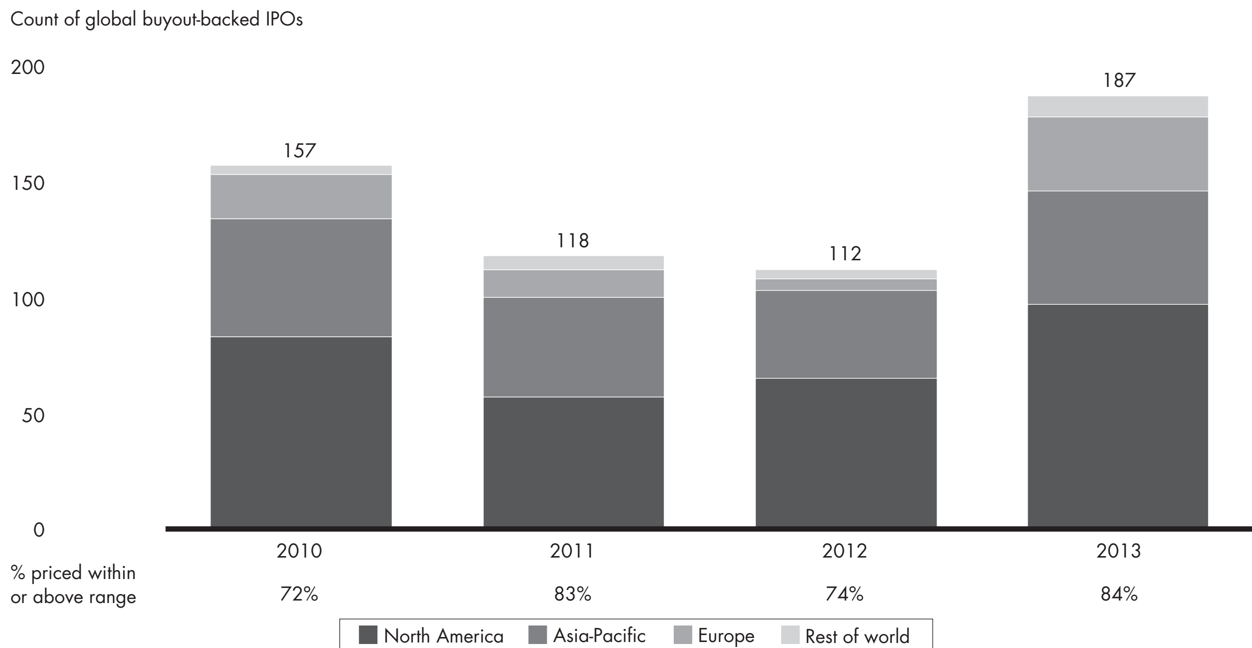
flush with cash and with low levels of debt. The strong equity markets had pumped up stock prices, making their shares a ready currency for takeovers. And because options to grow organically remained few at a time of sluggish demand, mergers and acquisitions had become an attractive alternate path for business expansion.

In the end, global M&A activity came in below what the favorable conditions might have foretold. Although the total value of corporate mergers and takeovers (excluding financial sponsor and government activity) rose 11% over 2012 to reach nearly $2.4 trillion, it advanced on the back of a few big deals and the count was down 14% to the lowest level since 2006. Against that backdrop, buyout exits to strategic acquirers fared well in 2013, equaling 2011 for the most transactions completed within a single year. Year over year, they were up 9% in number to 645 exits and 4% by value to more than $151 billion. Corporations were active shoppers and discerning buyers, snapping up any PE-owned assets that made strategic sense.

Initial public offerings: Riding the wave. For PE sellers, what made a good year for exits the great year it was in 2013 was the strength of the IPO channel. Cruising in the tailwinds of exceptionally strong stock market gains, the number of IPOs for buyouts soared 67% worldwide, from 112 in 2012 to 187 last year. With pricing conditions favorable, fully 84% of buyout-backed IPOs came to market at or above their target range *(see Figure 1.12)*.

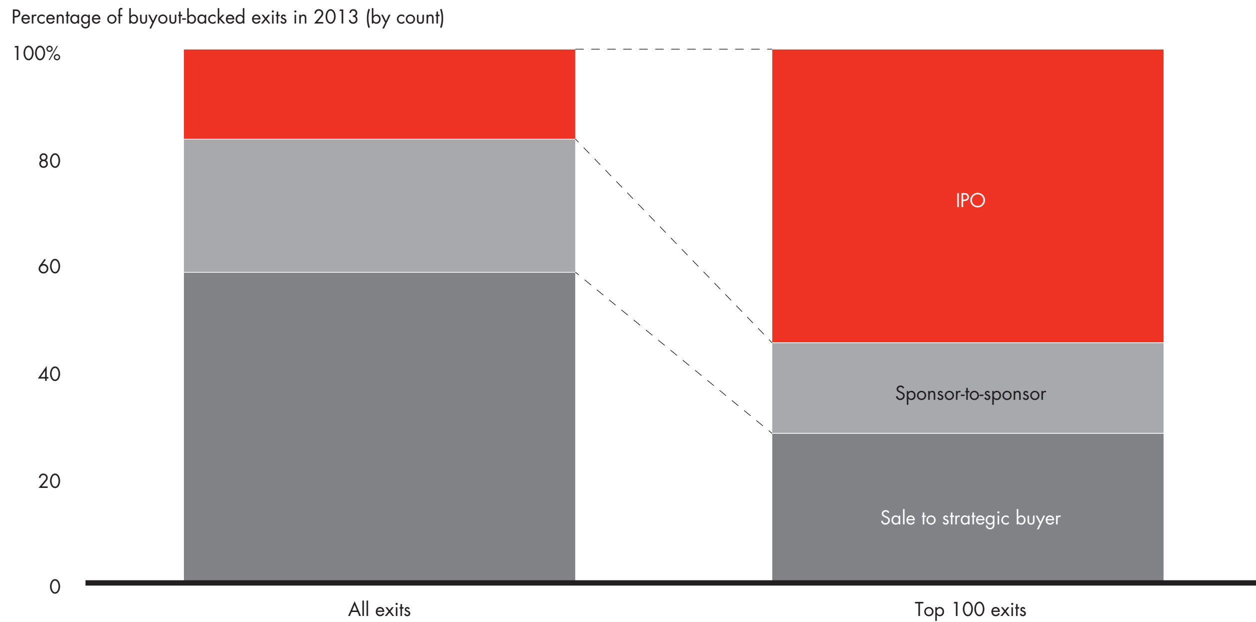
The strong IPO market in 2013 proved a windfall for GPs that participated in the mega-buyout boom at the mid-decade peak of the PE cycle, as it opened the door to begin liquidating these long-held investments. For example, the Container Store, a US retailer of household-organization products that was acquired by Leonard Green & Partners in 2007, made its public-market debut last November. With an initial offering price set at the top of its expected range at $18 a share, Container Store stock climbed 104% to a high of $36.74 during the first trading day.

Figure 1.12: IPOs soared in 2013 on the back of very strong equity markets



Source: Dealogic

Figure 1.13: IPOs represent a disproportionate share of the largest exits



Note: Includes both completed and announced exits
Sources: Dealogic; Preqin; Bain analysis

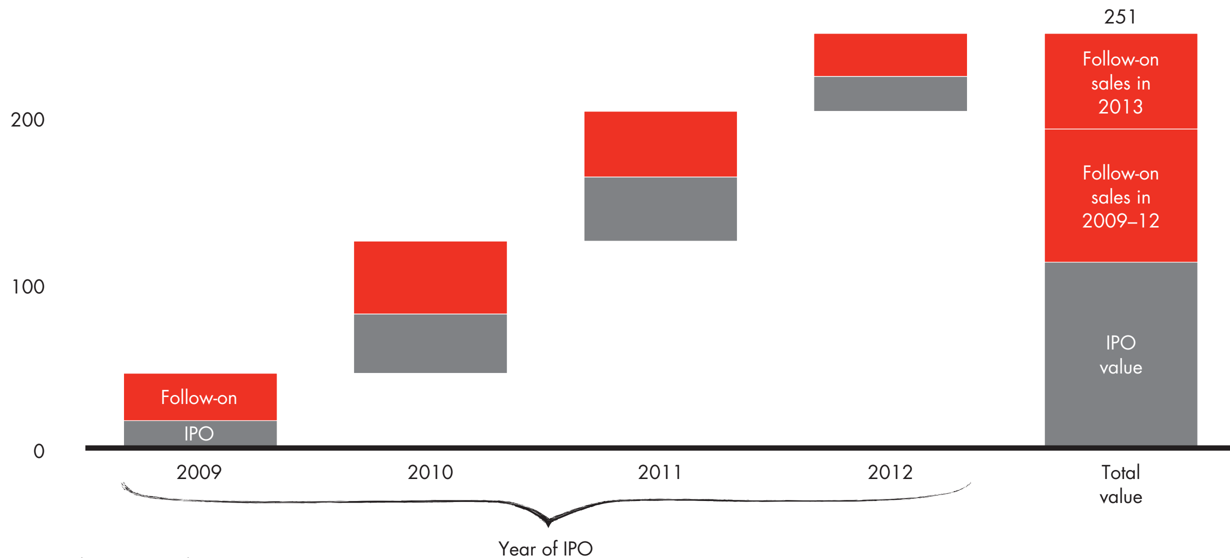
Asset sales through IPOs represented just 17% of buyout exits in 2013 and 15% over the past decade—far fewer than the number of sales to strategic acquirers or exits through sponsor-to-sponsor deals. But IPOs do pack a lot of punch in terms of the value they unlock, since companies that are best suited to an IPO skew larger than most other PE-owned assets. Figure 1.13 suggests just how big. IPOs accounted for more than half of the 100 largest PE exits in 2013.

Follow-on sales and dividend recaps: Lucrative exit alternatives. The global numbers for buyout exits only partially capture how good the pickings were in 2013. In addition to first-time asset sales, GPs took advantage of the favorable debt markets to extract equity they could return to LPs as dividends. They also tapped the healthy public equity markets to execute follow-on sales of shares they still held in companies they had previously taken public. While not "exits" in the conventional sense, they contributed significantly to PE funds' ability to realize value and return capital to LPs last year.

GPs that exit through an IPO typically need years to realize the full value of their investment. For buyout-backed IPOs in 2013 overall, the value of shares sold in the initial offerings represented just 23% of the market value of the assets. Moreover, the GPs seldom tender shares they own. Last year, for example, GPs were not among the selling shareholders in 64% of the 2013 crop of buyout IPOs. Typically, the money raised by the offering flowed back to the portfolio companies to pay down debt or finance capital expenditures.

For GPs, an IPO sets in motion a chain of follow-on sales of shares, enabling them to liquidate their investments over time. In 2013, they took full advantage of record-high public equity markets to execute follow-on sales of

Figure 1.14: The value of follow-on sales now exceeds the initial offerings for recent buyout-backed IPOs



Sources: Dealogic; Bain analysis

shares to profitably whittle away at the exit overhang. Cumulatively, GPs and other shareholders have harvested some $251 billion from buyout-backed assets that first exited as an IPO between 2009 and 2012. More than half of that total, or $138 billion, came as a result of follow-on sales of shares, of which $58 billion was realized in 2013 alone (*see Figure 1.14*).

Another popular way to extract cash from investments in 2013 was through dividend recapitalizations. Recaps enabled GPs to use borrowed funds to restructure the balance sheet of a portfolio company and issue a dividend to LPs, while retaining ownership of the underlying asset. Last year, dividend recaps were especially attractive to European GPs, whose eagerness to return cash to investors coincided with a surprisingly strong credit market in the region. Notable among PE firms taking this route to liquidity last year were Bridgepoint's £150 million dividend recap of sandwich chain Pret A Manger in June, 3i Group's €275 million refinancing for Dutch discount retailer Action and BC Partners' issuance of £200M in payment-in-kind toggle notes for mobile phone retailer Phones4u in September. Globally, GPs made use of the leveraged loan and high-yield bond markets last year to set a new high-water mark for dividend recaps.

Adding post-IPO follow-on sales and dividend recaps to the mix, exit activity gained momentum over the course of the year. Based on data through the first three quarters of 2013, cash distributions to LPs were on track to surpass where they had been in the prior year. As we will see when we turn to fund-raising in the next section, cash returned to LPs through first-time exits and boosted by follow-on sales of shares and dividend recaps created room for LPs to cycle money back into new PE funds.

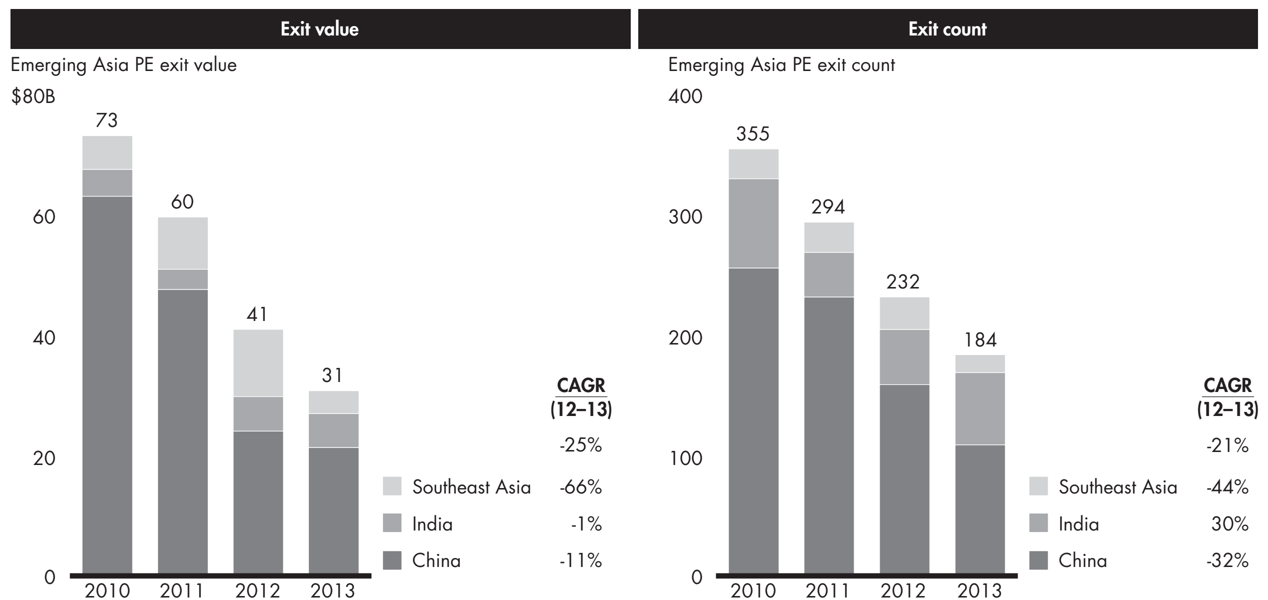
Exit angst in the emerging markets

Buoyant economic growth lifted PE investors' enthusiasm for emerging markets and attracted vast sums of money for investments in China, India, Southeast Asia and Brazil over the past decade. But dodgy exit channels have made it increasingly difficult for GPs to convert these investments into realized gains. In marked contrast to the strong exit activity in Europe and North America, liquidations were off sharply in the big emerging markets during 2013 (see Figure 1.15).

China. Exit activity in the People's Republic has fallen steeply and steadily over the past four years, where economic headwinds and inaccessible public equity markets proved stronger than the pressure GPs have felt to sell assets. From a peak of 256 sales that brought in a total of $63 billion in 2010, exits in China plunged to 109 deals worth just $21 billion last year. Since 2010, the number of exits has dropped at a 25% annual rate compounded, and the value realized tumbled at a 30% yearly rate.

One major challenge PE funds faced was their own reluctance to sell assets they acquired at peak value during the mid-decade investment boom. Lackluster public equity markets and the slower pace of economic growth depressed valuations. Rather than settle for subpar returns, many GPs stretched out holding periods as they waited for more propitious exit conditions to materialize. Trade sales to strategic buyers were the principal exit route for PE sellers in 2013. Chinese corporations looking to expand through acquisition have learned to like businesses that previously had PE owners, seeing their involvement as a stamp of validation on the health of the company they purchase.

Figure 1.15: PE exits in Asia-Pacific continued a sharp multiyear decline



Notes: Southeast Asia includes Singapore, Indonesia, Malaysia, Philippines, Thailand and Vietnam; includes investments with announced deal value only; excludes deals with value <$10M; does not include real estate, hotels and lodging property deals, infrastructure and large domestic transfers by sovereign wealth funds to government
Source: AVCJ

With respect to IPOs, historically China's largest exit channel, GPs had little choice but to sit tight in 2013. There were just 29 Chinese IPOs during all 2013, a drop of 69% from the year prior. For nearly the entire year, financial industry regulators barred new public offerings denominated in renminbi, as they worked to implement new rules that would bring order to an IPO market that had become rife with manipulation and shareholder abuse.

India. PE exits on the subcontinent were a bright spot on the emerging-market exit scene in 2013. The number of exits increased by 30% and value remained stable. However, behind this overall positive story hover shadows of concern about the health of India's exit channels. The public equity markets and corporate M&A activity were both down in 2013, leaving sponsor-to-sponsor exchanges between PE funds as the liveliest exit option. Sales of assets from one sponsor to another reached a record high of $2.3 billion in 2013, a 50% increase over 2012 that lifted them close to the total value of trade sales. Buyers like sponsor-to-sponsor transactions in India because they enable prospective acquirers to dispense with much of the due-diligence risk that burdens Indian primary deals.

Not only did GPs face a range of narrower exit choices, they were feeling pressure to sell. Some of it was self-induced. Following years when they aggressively added to their portfolios but only slowly realized gains through asset sales, PE funds built up a big exit overhang as they stretched out holding periods well beyond the typical five years. Many felt pushed to sell even if that meant not achieving the threshold returns they had looked for. External pressure was also at work from LPs thirsty for liquidity.

Southeast Asia. The most diverse region of the emerging markets experienced some common exit problems in 2013. There were some notable success stories, such as the $1.3 billion flotation of shares last March in Indonesia's Matahari department store chain backed by CVC Capital Partners (CVC) and the Government of Singapore Investment Corporation, a sovereign wealth fund, among other investors. On the whole, however, PE funds faced a very challenging environment for IPOs and a soft corporate M&A market. As a result, both the count and value of exits in the region declined overall, with the number of exits dropping 44% to just 15 and total value off by 66% to only $3.8 billion. With their portfolios heavily stocked with assets purchased at peak prices during 2007 and 2008, PE funds were also hard-pressed to clear their target return hurdles.

Brazil. PE investors in Latin America's largest economy had as little wind to their backs when it came to exits in 2013 as their counterparts in Asia. Increasingly volatile and declining public equity markets over the course of the year chilled the IPO channel. Backed by the Carlyle Group, CVC Brasil Operadora e Agencia de Viagens, SA, a travel operator, did manage to buck difficult conditions and launch an IPO in December.

Sales to strategic buyers remained the readiest exit option, although a cloudy economic outlook and wide currency swings made it difficult for some corporate buyers to commit in 2013. Nevertheless, 2013 did see some notable trade sales. Kinea Investimentos, a Brazilian PE firm linked to the Itaú Group, sold its part ownership in Grupo Multi, an English-language training company, to Pearson PLC, the UK-based publishing and business information services company, for £440 million late last year. In a strategic acquisition involving another prominent global corporation, Mitsubishi Corporation purchased a 60% stake in Los Grobo Ceagro do Brasil, a grain company that had been partially owned by Vinci Partners, a Brazilian PE firm.

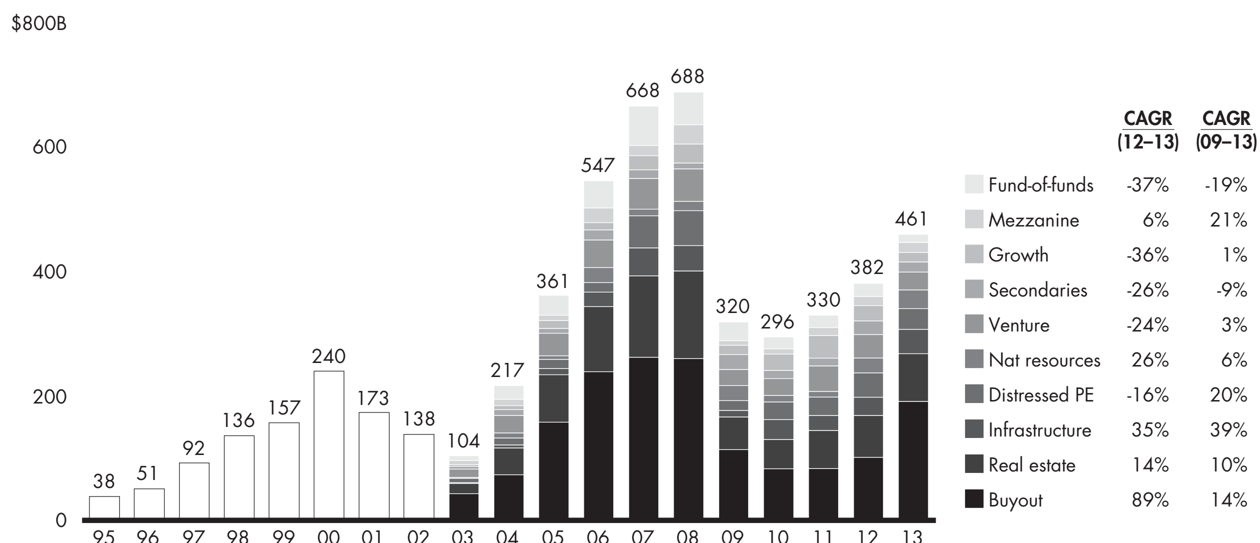
Fund-raising: Loosening the purse strings

PE fund-raising surged in 2013, turning in its best year since the global financial crisis. For the year as a whole, 902 PE funds attracted $461 billion in new capital worldwide, a solid 21% increase over 2012 (*see Figure 1.16*).

The overall fund-raising numbers mask several notable pockets of strength, a few areas of weakness, and some distinct cyclical and geographic shifts. Buyout, infrastructure, natural resources and real estate funds saw the biggest increase in LP commitments last year. New capital flowing to funds that focus on distressed companies, which do well when the economy is struggling, was down in 2013, following several years of growth. GPs that specialize in growth, venture capital, secondaries and fund-of-funds found a chilly reception from LPs since the downturn and were largely frozen out last year.

By region, fund-raising in North America increased at a healthy rate of 33% in 2013. Western Europe returned to LPs' favor, with new commitments from LPs rising 48% year over year, indicating growing investor confidence that the EU has managed to put the worst of its currency woes behind and that Europe's economies have bottomed out. By contrast, Asia-focused funds and others that target opportunities elsewhere around the globe saw a steep falloff in new LP commitments. Part of that pullback likely reflects the revival of LPs' confidence in the prospects of the advanced economies at a time when growth has slowed markedly in China, India and other emerging economies. When the mature economies were on their backs after 2008, LPs placed their bets on the emerging markets' growth story. That enthusiasm has now subsided as LPs near their target allocations to emerging markets, asset prices have climbed dramatically, plenty of dry powder remains to be invested, and GPs struggle to unwind portfolio holdings and return capital to LPs.

Figure 1.16: PE fund-raising was up in 2013; buyout funds were particularly strong



Notes: Includes funds with final close and represents year funds held their final close; only total fund-raising shown for years 1995-2002; distressed PE includes distressed debt, special situation and turnaround funds
Source: Preqin

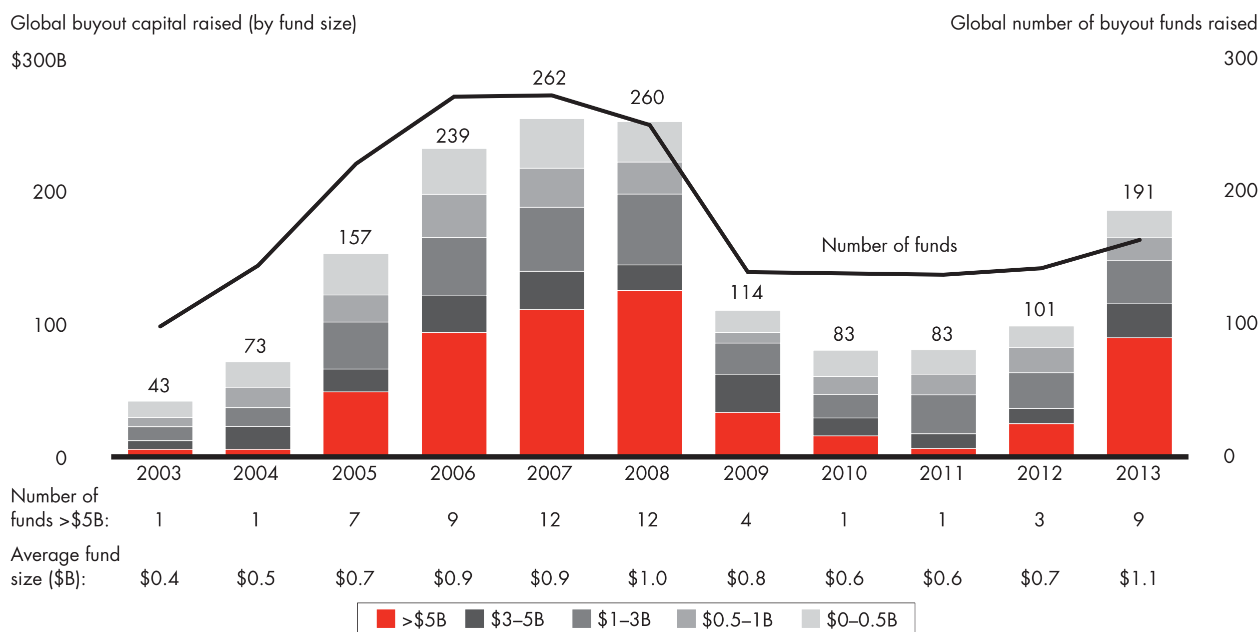
The resurgence of LP interest in buyout funds in 2013 was a marriage of expedience and experience. Although the number of buyout funds that closed last year increased only slightly to 168 (compared with about 140 each year since 2009), the amount of capital raised jumped 89% year over year to $191 billion as money flowed disproportionately to bigger funds (see Figure 1.17). Indeed, nine mega-funds closed in 2013, attracting more than $5 billion each and accounting for 48% of the total capital raised by buyout funds. Among them was the largest buyout fund raised since the financial crisis: The Apollo Investment Fund VIII, Apollo Global Management's flagship PE fund, raised $17.5 billion from outside investors, plus an additional $880 million committed by Apollo and its investment professionals. LPs' appetite for mega-buyout funds demonstrated a hunger to put money to work and to allocate money efficiently by backing bigger GPs with extensive investment platforms and broader capabilities. Said one long-term investor Bain interviewed last fall, "You have to kiss a lot of frogs at the smaller end of the market to get the commitment size you want. In the end, it may be just too much work."

LP demand: Room to grow

The fund-raising surge in 2013 reflected both LPs' abiding faith in PE as an asset class and a confluence of trends enabling them to back their conviction in PE with new capital commitments.

Historically, PE has lifted the returns of most PE portfolios, increasing at a median 12.5% rate over the past 10 years compared with a 7.2% total portfolio return and far outpacing all other asset classes. That consistent outperformance helps explain why LPs have remained remarkably positive about PE in the wake of the financial crisis. In Preqin's latest survey of LPs conducted in the fall of 2013, 90% of respondents said that PE met or exceeded

Figure 1.17: Buyout fund-raising was driven by the closing of mega-buyout funds



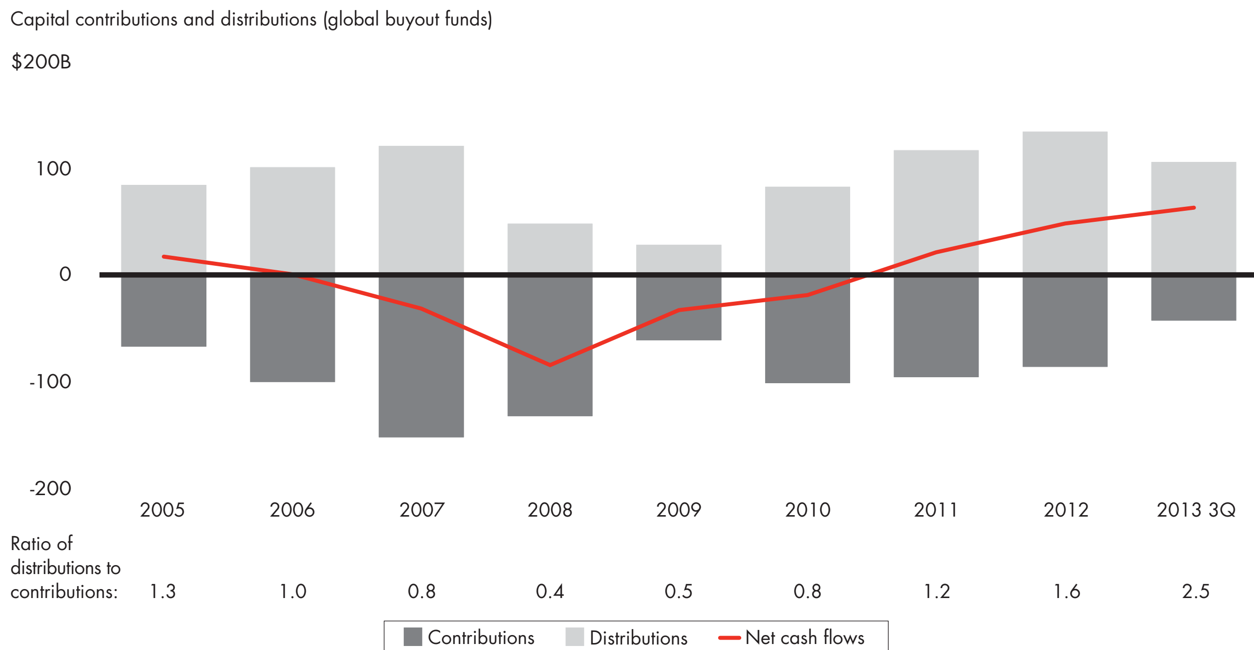
Notes: Includes buyout funds with a final close; represents year funds held their final close
Source: Preqin

their performance expectations, 98% expect PE to continue to outperform the public markets, and 92% plan to maintain or raise their PE allocation in their future investment plans. Particularly in today's low-interest-rate environment, institutional investors continue to believe overwhelmingly that PE remains attractive.

In 2013, LPs were able to put real money behind their convictions. Reflecting the modest investment activity and the more buoyant exit and refinancing opportunities discussed earlier, LPs took in a bounty of distributions from their past investments that far exceeded their capital contributions for a third consecutive year *(see Figure 1.18)*. The flow of distributions relative to contributions accelerated in 2013; GPs of global buyout funds returned $2.50 to LPs for every $1 of commitments they called in the first three quarters of 2013. By contrast, LPs took in just $1.20 from GPs for every $1 invested in 2011 and $1.60 in 2012. The positive cash-flow balance has been most pronounced for buyout funds that focus on investing in the US, which returned $2.90 to LPs for every $1 of commitments they called in the first three quarters of 2013. By comparison, buyout funds focused on Western Europe returned $2.10 per $1 called, while emerging market buyout and growth-equity funds returned $1.20.

The flow of cash has reduced the PE holdings of many LPs, although the full effect of the decline has been mitigated by an increase in the carrying value of the unrealized assets. At the same time, strong returns from 2013's soaring public equity markets greatly increased institutional investors' overall portfolio holdings. As a consequence, many LPs saw PE's share of their total portfolio assets contract in 2013. In a sample of the largest PE investors Bain evaluated, we estimate that two-thirds of them experienced a decline in their current percentage allocation to PE. This situation is a complete reversal from the years immediately following the financial crisis—the denominator effect in reverse. The result was to create room for more LPs to sign up for new PE fund commitments in 2013.

Figure 1.18: LPs have been cash-flow positive for a third year in a row



Source: Cambridge Associates

GP supply: A tale of two markets

Feeling relatively flush with cash and open to making new PE commitments in 2013, LPs had a vast and diversified supply of funds of every type and geography to choose from. Nearly 3,000 PE funds aiming to bring in approximately $1.2 trillion took their fund-raising shows on the road last year.

Among them were funds offered by several top-performing GPs that LPs did not want to miss out on. Because these leaders come to market, on average, only every five years or so, LPs felt compelled to commit when they were available—a significant factor behind 2013's fund-raising tally.

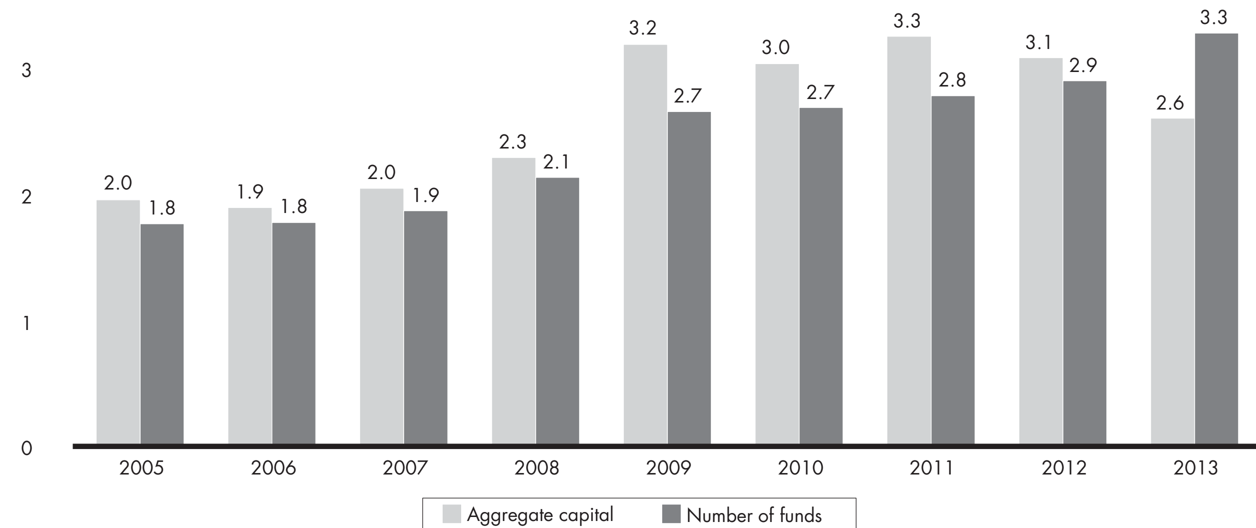
LPs' eagerness to join forces with a top-performing GP was evident in the success and relative ease a few of them had in closing new funds. Coming to market with its CVC European Equity Partners VI fund in January 2013, for example, CVC Capital Partners, the big European buyout firm, announced the fund was closed by July after hitting its hard cap of €10.5 billion within just six months. Fully 90% of the commitments the new fund garnered came from LPs that had backed its previous funds—and for good reason. All five of CVC's earlier funds generated returns that ranked them in the industry's first or second quartile, and its fund immediately prior was a top-quartile performer, with a 15% net IRR at the time fund-raising for the new fund began.

While this crowded and competitive marketplace was a bounty for LPs, it was a headache for the vast majority of GPs that could not show LPs a strong performance track record in their earlier funds, a stable and experienced leadership team, a sound investment strategy, distinctive capabilities and a repeatable model to create value in their portfolio holdings. The number of funds hitting the market in 2013 was 3.3 times greater than the number that closed during the year, and the aggregate dollar value GPs were looking to bring in from LPs was 2.6 times more than LPs anted up in funds that completed their campaigns *(see Figure 1.19)*. Competition for new capital was most intense in the developing markets of Asia and beyond, where the target value of funds looking to raise money was 3.9 times greater than LPs backed in the funds that closed in 2013. By comparison, it was 2.9 times greater in Europe and just 2.2 times greater in North America.

On average, fund-raising campaigns completed in 2013 lasted 18 months, placing an onerous demand on scarce GP partner time and PE firm resources. That's about in line with how long it took funds that closed in 2012 and 2011, when LP purse strings were tighter. Indeed, success was, by far, more the exception than the norm in 2013's sharply bifurcated fund-raising market. Among funds of all types, only one in four (and just one in three buyout funds) that closed in 2013 was able to hit or exceed its fund-raising target value within a year. Forty-seven percent of the total 2013 cohort of funds (37% for buyout funds) threw in the towel short of their targeted fund-raising goal after more than two years on the road *(see Figure 1.20)*.

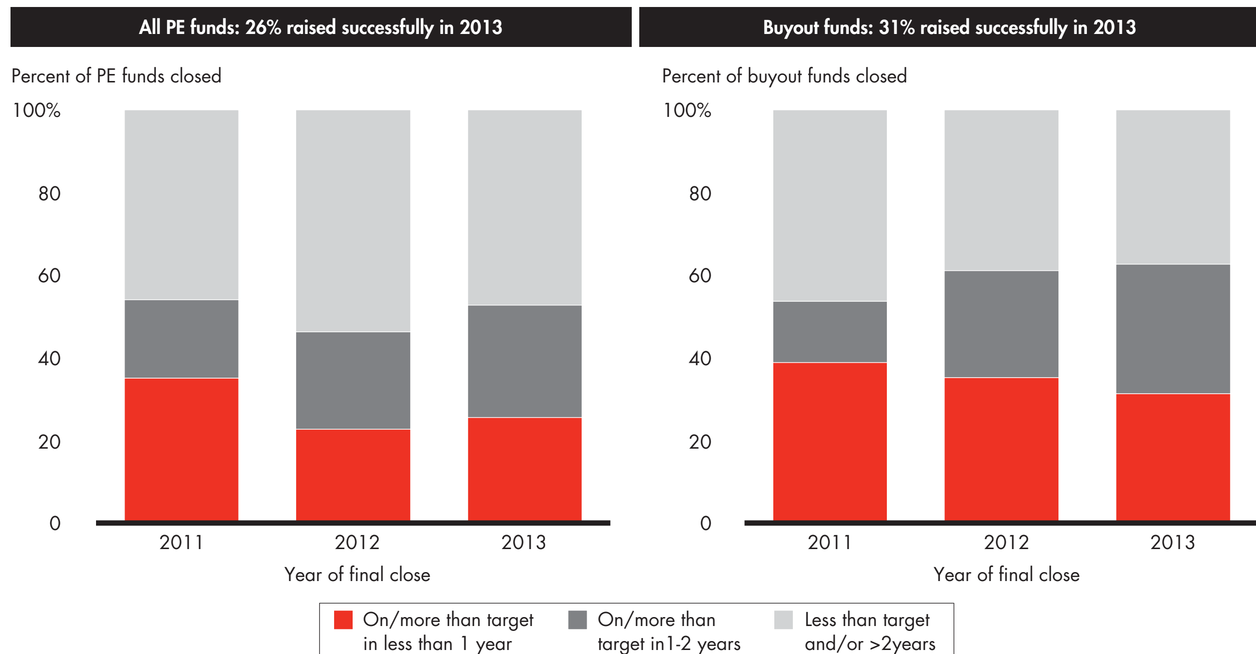
For nearly all but the most in-demand GPs, getting a new fund across the goal line was challenging. LPs have become more discerning about which GPs they will back, and they are more willing to cut ties with GPs they have worked with in the past. For some 45% of the funds that closed in the last pre-crisis years of 2006 and 2007, for example, 70% or more of the LPs from whom they drew commitments had backed their previous funds. The LP re-up rate has slipped steadily since then, with slightly less than 30% of funds that closed in 2012 and 2013 attracting similar support from LP loyalists. There is a silver lining for GPs looking to replace LP defectors, however. Preqin interviews in mid-2013 that asked LPs their intentions about which funds they will commit to over the coming year found that more than 80% were open to working with new GPs, with 20% saying that they expected most of the new commitments will be with GPs they had not worked with in the past.

Figure 1.19: The number of funds and the amount of capital sought far exceeded what was raised in 2013



Source: Preqin

Figure 1.20: In a sharply bifurcated market in 2013, one-quarter of PE funds raised capital quickly and easily



Source: Preqin

Returns: The long and the short of it

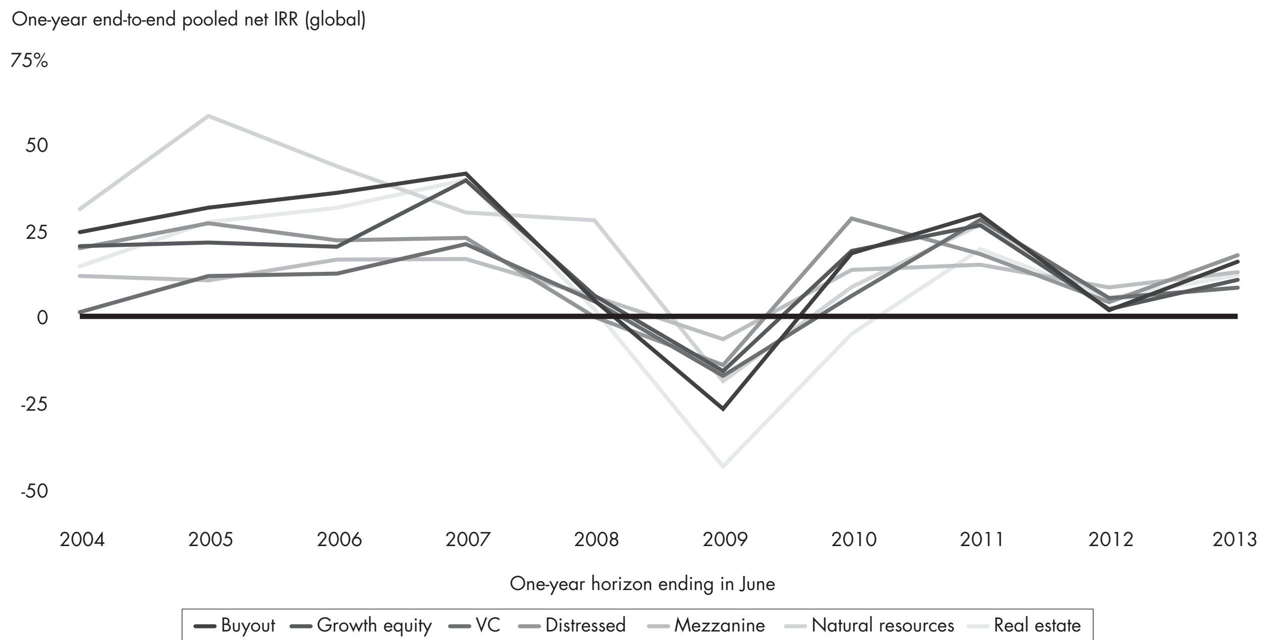
Returns are always top of mind for investors, and PE investors are no exception. They have become even more preoccupied with short-term performance in the slow recovery from the global financial crisis. The sharp downward revisions in valuations on assets that had been acquired at high prices during the boom years and held unsold in fund portfolios since then have led nervous LPs to scrutinize return data for incipient signs of a rebound.

So, how did PE returns fare in 2013? Based on the latest one-year numbers available through last June, compiled by investment consultant Cambridge Associates, PE net internal rates of return posted solid gains across all fund categories and were well above where they had been in 2012 (see Figure 1.21). Funds that focus on investments in distressed assets and buyouts led the pack. Distressed-asset funds were up 18% following a 4% prior-year gain, and buyout funds generated a 16% return, against a 2% gain the year before.

The one-year PE return picture is much the same by geography. Buyout and growth-equity funds were up across all regions, with US-focused funds leading the way, posting an 18% gain through June 2013. Funds that concentrate on opportunities in Western Europe returned 13% last year. Both US- and Europe-focused funds outperformed emerging-market funds, which rose 9%.

Credit the wide-open exit channels and strong public equity markets for PE's strong showing last year. Their positive influence worked to lift both factors that affect PE funds' one-year IRR. First, the sales of portfolio assets triggered lucrative liquidations that significantly pushed up realized gains. Also, the buoyant public equity markets

Figure 1.21: Short-term returns rebounded across all fund types in the year ending June 2013



Source: Cambridge Associates

Figure 1.22: Long-term buyout fund returns have bounced back

Source: Cambridge Associates

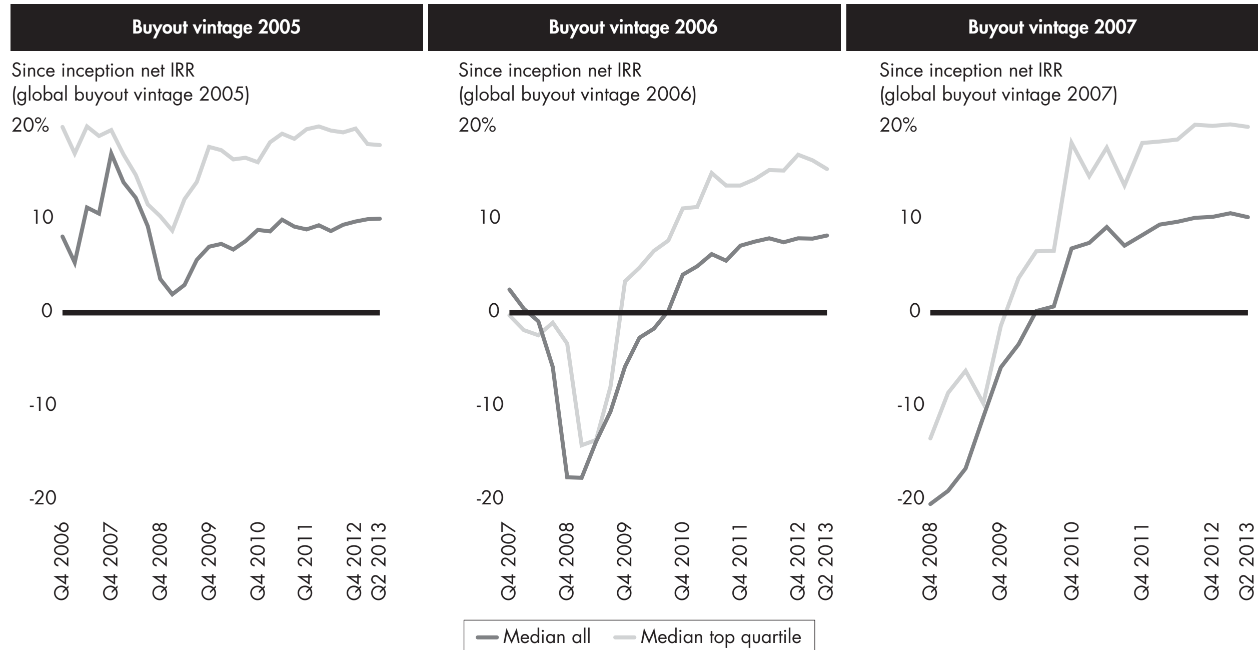
boosted the valuation of unsold PE investments, thanks to mark-to-market accounting rules PE firms have been required to use since the financial meltdown. The surge in exit activity and continued stock market strength during the year's second half will boost full-year returns for 2013.

The longer view. Short-term returns capture the immediacy of the past 12 months, but they are not a meaningful way to measure the performance of an illiquid asset class like PE. A longer-term look better sizes up the influence that passive market beta and the more active alpha components of GP value creation have on returns, as PE funds encounter volatility and GPs maneuver through it to execute their investment plans.

Weighed by that standard, PE is back. The 10-year horizon IRR of buyout funds has rebounded smartly from the lows immediately following the 2008 financial crisis (see Figure 1.22). Long-term returns are now sitting comfortably at 14.4% as of June 2013, having sunk to a low of 8.7% at the bottom of the cycle.

The biggest factor contributing to that strong improvement has been the remarkable recovery in the performance of buyout funds dating back to the big vintage years of 2005 through 2007, the peak of the last PE cycle. Returns from those fund vintages took a big hit when GPs were required to mark down the carry value of assets that they acquired at high, prerecession prices (see Figure 1.23). In the warming business climate after the economy and market bottomed out, however, GPs began to exit a number of the investments made at the height of the last boom, often realizing better-than-expected gains. They also revalued upward their remaining unsold holdings. While market beta played a large role in the recovery, the funds also benefited from the alpha-generating, sheer hard work GPs poured into strengthening and growing their portfolio companies through the downturn.

Figure 1.23: Interim returns for boom-year fund vintages have recovered smartly



Source: Preqin

Listening to what the public markets say. A question on many investors' minds is: How well did PE returns stack up against public market benchmarks? Based on a straightforward, one-year comparison, the answer is: not as good. Through the 12 months ending June 30, 2013, the S&P 500 Index was up 21% and the MSCI Europe Index jumped 19%—above the 18% turned in by US-focused buyout funds and the 13% generated by Europe-focused funds.

Comparing short-term PE returns to a simple snapshot of the public market index, however, presents only a partial and often misleading story, particularly in a great stock market year—as 2013 was in the big developed economies. Because PE is an illiquid asset class, the revaluation of unsold assets plays a large role in determining short-term PE returns. Notwithstanding mark-to-market accounting rules, just how much unsold assets are really worth in volatile capital markets requires a judgment call. Concerned not to confuse LPs with frequent restatements of nominal gains and losses (or worse, deliver bad news to them after having sent them good news), GPs are generally cautious in how they adjust valuations of portfolio holdings. They appraise unsold assets conservatively and smooth out the public equity markets' ups and downs—and, in the process, inevitably play down returns. In a paper published early last year, researchers at the University of Oxford's Saïd Business School found that conservative valuations of unsold PE portfolio holdings understate subsequent distributions buyout funds make by nearly 40%.[1] Recent investigations of samples of investments exited by publicly listed PE firms strongly confirm that the nominal carrying value of PE holdings undershoots the longer-term gains they ultimately generate. These studies conclude that exit values are more than 60% higher than the most recent carrying value of the investments prior to the assets' sale.[2]

1 Tim Jenkinson, Miguel Sousa and Rüdiger Stucke, "How fair are the valuations of private equity funds?" February 2013.

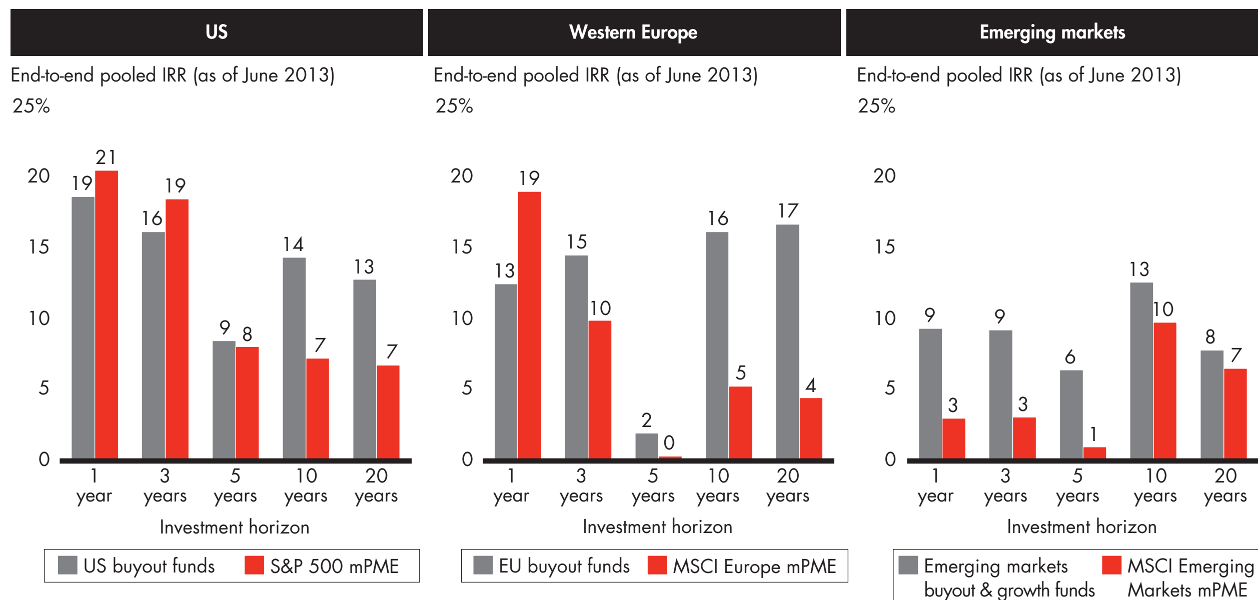
2 Sam Armstrong, "Latent value within LPE portfolios—LPE sectors is set for a re-rating," LPEQ, October 2012, http://www.lpeq.com/AboutLPEQ/LPEBriefings/2012October/InvestorComment.aspx; Red Rocks Capital, "Listed Private Equity: Low Current Valuations and Potential Opportunistic Returns," April 2012.

PE's unfavorable short-term comparison to the results produced by stock indexes flies in the face of the optimism LPs express in poll after poll measuring their faith in PE's outperformance. More to the point, it runs against the eagerness LPs show to back up that conviction with repeated infusions of new capital. The disconnect is understandable; investors recognize that what truly matters is performance over the long term. Particularly since the financial crisis, as PE exits have slowed and investment holding periods have stretched longer, the more appropriate measure of PE performance is a longer time horizon of 10 or even 20 years.

A meaningful comparison of PE's long-term performance to public equity returns should take into account the more irregular timing and size of PE cash flows. Looking to make an apples-to-apples comparison of returns both over the short and longer terms, academic researchers and investment advisory firms have developed the "public market equivalent" (PME) method that replicates PE's cash flows under public market conditions. Investment advisers at Cambridge Associates, for example, designed a modified PME measure, called mPME, which assumes a PE fund invests its cash contributions in a straw public market index and takes out distributions in the same proportion as it withdraws from its fund. It then compares how much a PE fund investor actually earned net of fees to what it would have reaped in the PME.

When viewed through this more common lens, a clear picture of how PE returns stack up comes into focus (see Figure 1.24). In line with the less-precise buy-and-hold measurements described earlier, buyout funds' one-year return underperformed Cambridge Associates' mPME in the US and Western Europe in 2013, but surpassed it in the emerging markets. Even over a three-year return horizon, buyout funds fell short in the US. But looking at returns over a 5-, 10- and 20-year period leads to a reliable and unambiguous conclusion: Buyout funds consistently beat the PME in all regions of the globe. Indeed, in the US, buyout funds' 14% 10-year annual IRR and 13% 20-year IRR exceeded those of the mPME by a margin of about two to one. In Europe, PE's edge over the mPME was closer to four to one.

Figure 1.24: Buyout funds have outperformed the public markets over the long term



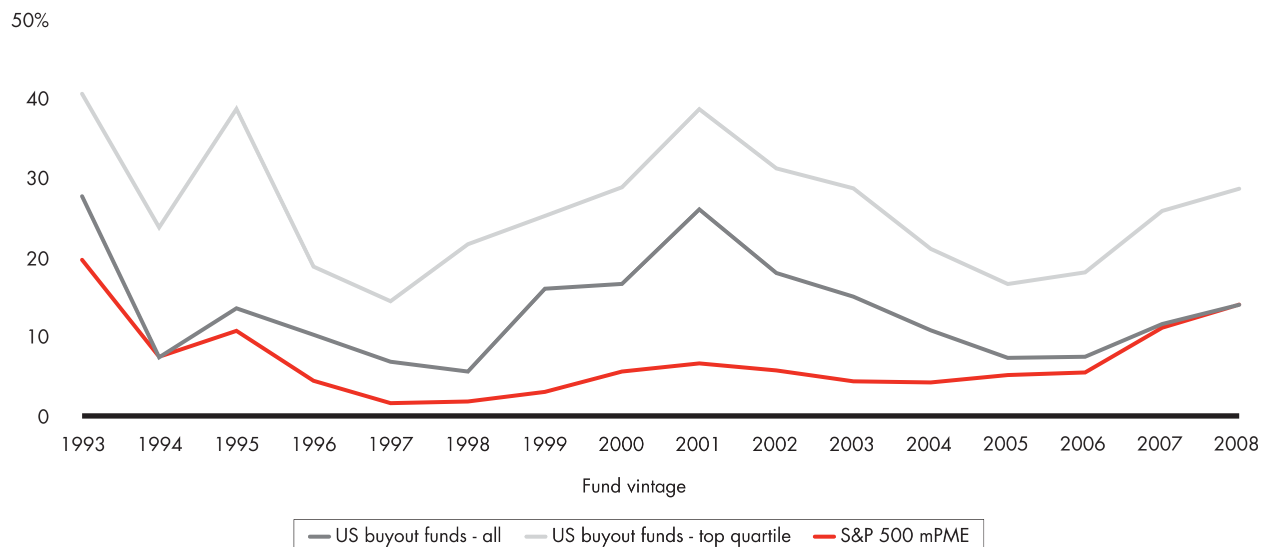
Notes: The Cambridge Associates mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in PE been invested in public markets instead; the public index's shares are purchased and sold according to the PE fund cash-flow schedule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

PE's long-term performance edge also shows up when returns are calculated by vintage. As Figure 1.25 shows, the pooled IRR for all US-focused buyout funds surpassed the S&P 500 mPME for each vintage, with the exception of those for 1994 and 2008, when it equaled the index performance. On average across all vintages, US-focused buyout funds outperformed the mPME by a solid 6.5 percentage points. Buyout funds' superior-performance gap narrowed in the boom-year vintages of 2005 through 2008. But a higher proportion of the assets acquired by these funds still remains in the funds' portfolio, with their gains yet to be realized, where they are held, as previously noted, at valuations that tend to be conservative. When GPs ultimately reap profits from the sale of those assets, the IRR of boom-year vintage funds is apt to rise.

Calculations by vintage-year returns for European buyout funds and emerging market buyout and growth equity funds tell a similar story. In Europe, all buyout-fund vintages topped the mPME based on the MSCI Europe Index by 12 percentage points, on average. The picture is a bit cloudier in the less-mature emerging markets. Emerging markets-focused buyout and growth equity fund vintages prior to 2002 mostly underperformed the mPME for the MSCI Emerging Markets Index. As the PE industry developed over the past decade, fund performance by vintage kicked into high gear and steadily outpaced the public markets.

In all markets, the long-term performance results drive home another crucial insight: Top-quartile funds are durable and significant market beaters, outperforming both the fund averages and the public market returns by wide margins. In the case of US buyout funds, the top-quartile vintages' return edge over the average of all buyout funds was 13 percentage points. Their advantage over the public equity markets averaged a handsome 19 percentage points. Top-quartile European buyout funds outperformed the average of their peers by 14 percentage points and the public markets by 24 percentage points.

Figure 1.25: All US buyout-fund vintages since 1993 have matched or beat public markets



Notes: Vintages after 2005 have limited number of realizations, and returns largely reflect valuations of unrealized assets; vintages after 2008 are excluded because they have few investments and almost no realizations
Source: Cambridge Associates

Key takeaways

- Global buyout deal making in 2013 was up 22% in value, largely attributable to two big public-to-private transactions—Dell and Heinz. Deal count dropped 11% compared to 2012. Buoyant public equity and debt markets pushed valuations up and limited the supply of potential PE deals. Assets that sold in 2013 went for high prices; in some cases, valuations exceeded what GPs were willing to pay. Robust IPO markets drew away from public auction many companies that might otherwise have been PE targets, and dividend recapitalizations enabled GPs to realize gains on an asset without selling it.

- PE deal making across emerging Asia and Brazil held up in terms of deal count but was off in value, with big deals that took place in recent years largely absent in 2013. A slowdown in investment activity mirrored the broad slowdown in economic growth across emerging markets and matched the cooling of investor sentiment for the once-hot BRIC countries (Brazil, Russia, India and China).

- Exit activity was strong in 2013, up 9% by count. The mix of exits across channels shifted in favor of IPOs. Sitting on $2.3 trillion in unrealized value in their portfolios at the start of the year, GPs took advantage of high valuations across public and private markets to sell assets. In addition to first-time asset sales, GPs also extracted equity through dividend recapitalizations and follow-on sales of shares in companies that they had previously taken public.

- Across China, India, Southeast Asia and Brazil, GPs found it challenging to convert investments into realized gains during 2013. Exits in emerging Asia were down sharply, largely due to the shutdown of the mainland China IPO markets. Although just a sliver of all exit activity in these markets, sponsor-to-sponsor transactions increased in popularity. In Brazil, where sales to strategic buyers are the most common exit option, a cloudy economic outlook and wide currency swings made sales difficult.

- Global PE fund-raising climbed 21% in 2013. Due in large part to the closing of nine mega-funds, money flowed disproportionately to buyout funds, which raised 89% more capital last year. An accelerated flow of distributions outpaced capital calls, providing LPs with the liquidity to increase their PE commitments. A vast and diversified supply of funds, including those offered by many top-performing GPs, also gave LPs the motivation to commit.

- Despite their increased liquidity and willingness to make new commitments, LP demand fell short of GP supply. Fund-raising continued to be bifurcated in 2013; just one PE fund out of four that closed in 2013 was able to hit or exceed its fund-raising target value within one year.

- Short- and long-term PE returns rebounded in 2013. They were helped by the profitable sales of many assets, including once-troubled deals from the mid-decade boom years, as well as by the upward revaluation of unsold portfolio holdings. The big boom-year buyout-fund vintages between 2005 and 2008 have staged a remarkable recovery.

- Over the last 5, 10 and 20 years, buyout funds consistently outperformed public equity markets in all regions of the globe. The performance edge achieved by top-quartile funds is both significant and durable.

Emerging markets: Shifting gears

PE investors in emerging markets are only the latest to learn that inflated expectations seldom escape unscathed from encounters with cold reality. But in 2013, as they surveyed the underwhelming results of another in a string of disappointing years, many GPs that had enthusiastically piled into the big developing economies of Brazil, Russia, India and China (the BRICs) are rethinking their emerging market models.

The problem PE faces in emerging markets is stark: GPs are failing to deliver on the job LPs hire them to do—to generate market-beating returns on investment. Indeed, returns of emerging market PE funds have been trending lower for nearly a decade, since they peaked just below the 15% net average IRR of the 2004 vintage. Top-quartile funds held up best, of course, consistently outpacing the emerging market median returns by several percentage points. But even the best performers' results have dropped steadily from their vintage peak. Those in the third performance quartile have either barely broken even or lost money since the 2002 fund vintage.

These are not the results that most LPs signed on for when they enthusiastically shifted their attention to the fast-growing emerging BRIC economies from the deteriorating conditions for PE in the advanced economics after 2008. The initial performance edge that emerging market funds enjoyed over funds that focused on developed markets has largely disappeared. Emerging market funds raised since the financial crisis have underperformed their developed market counterparts. Although these vintages are still very immature and have booked few realizations of gains, their interim results are disappointing.

The emerging market behemoths, China and India, have disappointed most of all. With too much money chasing too few deals and the expectation that double-digit GDP growth rates would endure, some PE firms rushed to close deals without adequately preparing for the risks of a prolonged slow-down. The ebbing tide of growth in India over the past three years has also left many underlying challenges exposed—from a volatile currency and complex regulatory systems to political instability and inadequate infrastructure.

Recent disappointment, however, has not caused PE investors to lose confidence in emerging markets' prospects. Drawn by the allure of diversification, GDP growth and rising middle-class incomes, many LPs are planning to boost their exposure to the emerging markets. In a 2013 global survey of LPs, conducted by EMPEA, the emerging market private equity association, a third of LPs indicated that they plan to increase the share of their PE allocation in emerging markets. However, the pace of new commitments will likely slow in light of the big infusions of capital into emerging market-focused funds from 2010 through 2012, the huge pile of dry powder still waiting to be deployed and the struggle GPs have faced trying to unwind portfolio holdings and return capital to LPs.

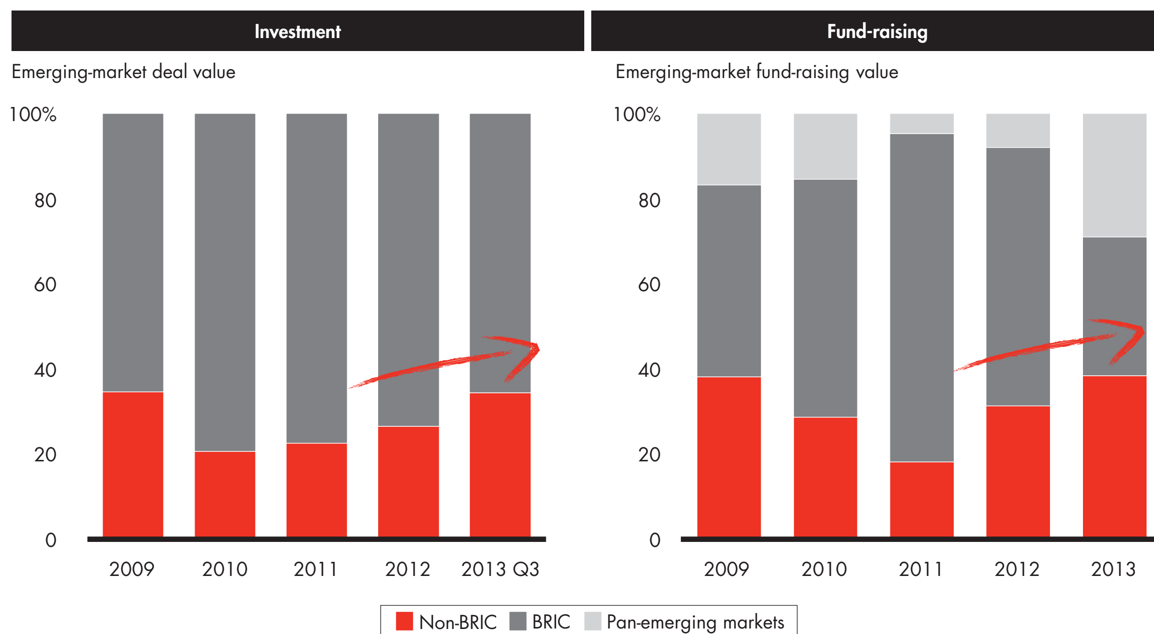
LPs' solid endorsement of PE matches the actions top-tier GPs have taken. In a move to increase its footprint in Southeast Asia, for example, Blackstone Group opened a new office in Singapore last

October, which it expects ultimately to staff with more than 40 employees. Significant new fund-raising campaigns, like The Abraaj Group's recent effort to raise a $1 billion fund to target healthcare investments in Africa, Asia and Latin America, demonstrate the GP's commitment to expand PE to new territories. Finally, Affinity Equity Partners, a large Asia-focused buyout firm, exceeded its $3.5 billion hard cap target for its Asia-Pacific IV fund, ultimately raising $3.8 billion in its final close.

Absorbing the lessons of what has not worked well in China and India, GPs and LPs are broadening their horizons beyond the BRICs to seek diversification in markets that will offer the next wave of growth, including Sub-Saharan Africa, Southeast Asia and Latin America (excluding Brazil). Both investment deal value and targeted new fund-raising reflect the increasing importance of these rising markets (see Figure 1.26).

GPs are also embracing a more hands-on investment model. Most are no longer willing to settle for the purchase of passive minority stakes in companies whose entrepreneur owners, unfamiliar with PE, are reluctant to cede control. Instead, they are increasingly likely to hold out for deals where they can exert effective influence over the assets they acquire. Even when they do end up with a minority position, they insist on having a seat at the table, with involvement in the portfolio company's key hiring and investment decisions.

Figure: 1.26: **PE investors have their eyes on a new tier of emerging markets**



Note: Fund-raising excludes real estate and infrastructure funds
Sources: EMPEA; AVCJ; Preqin

As PE expands its geographic reach and deepens its activist approach to portfolio management, GPs will need to develop distinctive ways to create value in order to succeed. Five skills are paramount:

- First, GPs will need to *build a proprietary deal network* with strong industry sector skill in order to capitalize on deal sourcing and acquisition. Actis, a firm that specializes in emerging market opportunities across Asia, Africa and Latin America, does this by organizing its more than 100 investment professionals in a matrix of countries and sectors, which it applies around the globe.

- Second, the leaders will *overinvest in differentiated due diligence* to surface a potential acquisition target's relevant opportunities and downside risks. They carefully vet the companies they consider buying to ensure that these companies are well within the firm's predetermined "sweet spot" of the businesses they understand well and have succeeded with in the past. They put early warning systems in place to get a fast read on potential problems and deal breakers, and they involve investment committee members early in the purchase decision process, well before a deal is a "done deal."

- Third, operating as owner-activists, top GPs *develop and pressure-test their investment thesis and operating blueprint* that will guide their management teams throughout the time the fund owns an asset. Ethos, the largest PE fund based in South Africa, takes pains to seek out change-oriented management in the deals it decides to pursue and devotes a big part of its due diligence process to exploring opportunities that add value to a potential target company.

- Fourth, they *start thinking about their exit path from day one,* continuously tracking options and identifying potential buyers from the start and preparing the business accordingly. That exit-focused approach was behind CVC Capital Partners' successful sale of $1.3 billion of newly issued shares in the Indonesian department store chain Matahari, a CVC portfolio company since 2010.

- Finally, they *nurture a deep pool of local talent* that possesses the regional and global perspectives needed to build the firm's capabilities. Scarce professional and managerial skills in emerging markets require top GPs to custom-tailor strategies for attracting, retaining and developing their own home-grown talent. They motivate their people by paving career paths that provide opportunities for regional assignments and offer attractive compensation. Top GPs also nurture a local pool of operating managers they can deploy in their operating companies.

Will GPs that adapt their investment models to match today's more tempered realities ultimately be able to crack the code for emerging market success? Certainly, there is a deep need for the role PE firms can play in spurring their growth while rewarding their investors. The demand for private capital in emerging markets is undeniable; thin public markets and weak banking systems in many countries give entrepreneurs few places to go to find patient money that feeds business expansion. What remains to be seen is whether a repeatable model for success in emerging markets can put that capital to work productively.

2. What's happening now: Dynamics for 2014 and beyond

The PE market is primed to continue to expand and prosper in 2014 and beyond. The number of new investments will likely pick up, but absent an unexpected revival in big public-to-private transactions, deal value will probably not increase significantly. As investment activity advances, GPs will profit from what they learned from past successes and failures to make better deals in the years ahead. The hard work they have put into grooming their portfolio companies for profitable exits will pay off as they aggressively harvest the remaining crop of investments made at the height of the last boom. The liquidity and solid gains they reap will, in turn, support stronger fund-raising and fund returns.

This vision of a bright future comes with a few caveats. Modest investment activity in 2013 combined with stronger fund-raising has swollen already vast stores of dry powder to more than $1 trillion. Barring an upsurge in assets coming up for sale, the excess capital will ignite intense competition and keep asset prices high. Volatility in the capital markets could paralyze deal making on both the buy side and sell side. GPs' hunger to raise new funds, meanwhile, continues to exceed the amount of capital LPs are able to feed them. Faced with this unstable situation, many PE firms are making sweeping changes in their strategies, as we discuss in the report's final section, away from a single-minded pursuit of growth to a focus on differentiation.

Investments: Pieces of a new puzzle

Riding the favorable tailwinds of 2013, so many indicators are moving in the right direction on the investment front going into 2014. Stronger fund-raising replenished GP funds with fresh capital to finance new rounds of deal making. Debt markets have rarely been so open and eager to finance new deals. The economic outlook for the year ahead is favorable.

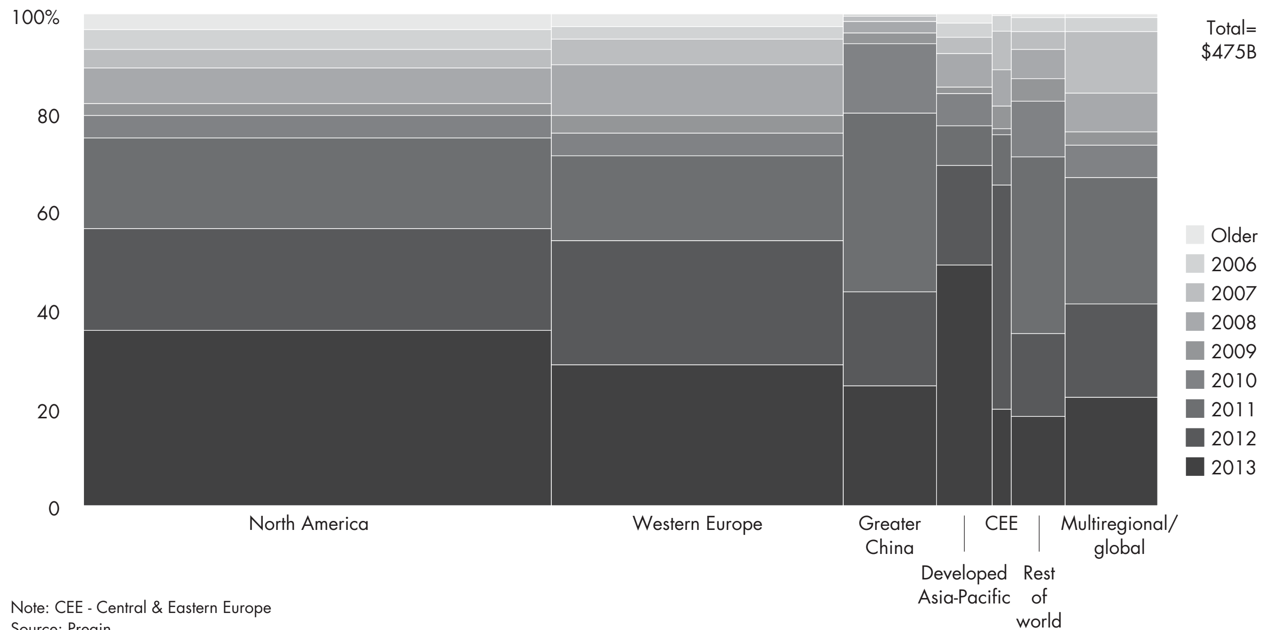
Yet the year will not be all smooth sailing. GPs will find themselves confronting familiar challenges. In combination with robust equity and debt markets, mountains of PE dry powder will keep asset valuations high and competition for deals stiff. GPs will have to dig deeper to ferret out opportunities that can generate the returns they and their LPs expect. They will also need to work harder to add value to the assets they acquire to extract real gains from their ownership.

Still, deal making is the heart of private equity, and there will be plenty to be done in the months ahead. Even in the most mature PE markets, GPs have not fully penetrated the population of companies that are good candidates for PE ownership. A wave of PE-owned assets acquired during the prerecession boom years is slated for sale, setting up opportunities for sponsor-to-sponsor transactions. Deal count could increase this year, but deal value will not move up significantly unless big public-to-private transactions stage an unexpected comeback.

Let's look at the dynamics that will shape the 2014 deal market.

An excess of dry powder: Out with the old, in with the new. Fund-raising success in 2013 was a refreshing change from previous years, giving many GPs an infusion of new money to replenish the older vintages they had finally managed to put to work. Nearly all of the capital from fund vintages dating back to 2007 or earlier has been invested, setting aside a sliver—typically 15% of the fund's capital—to be used in add-on acquisitions, follow-on investments, payment of fees and the like. As 2014 began, global buyout and growth funds were sitting on $427 billion in dry powder from the 2008 vintage or later. Of this, better than 80% was in funds from vintages since 2011—well within their investment period—and more than one-third was in a 2013 vintage fund *(see Figure 2.1)*.

Figure 2.1: Fresh dry powder raised in 2013 replaced older capital that reached its expiration date



Note: CEE - Central & Eastern Europe
Source: Preqin

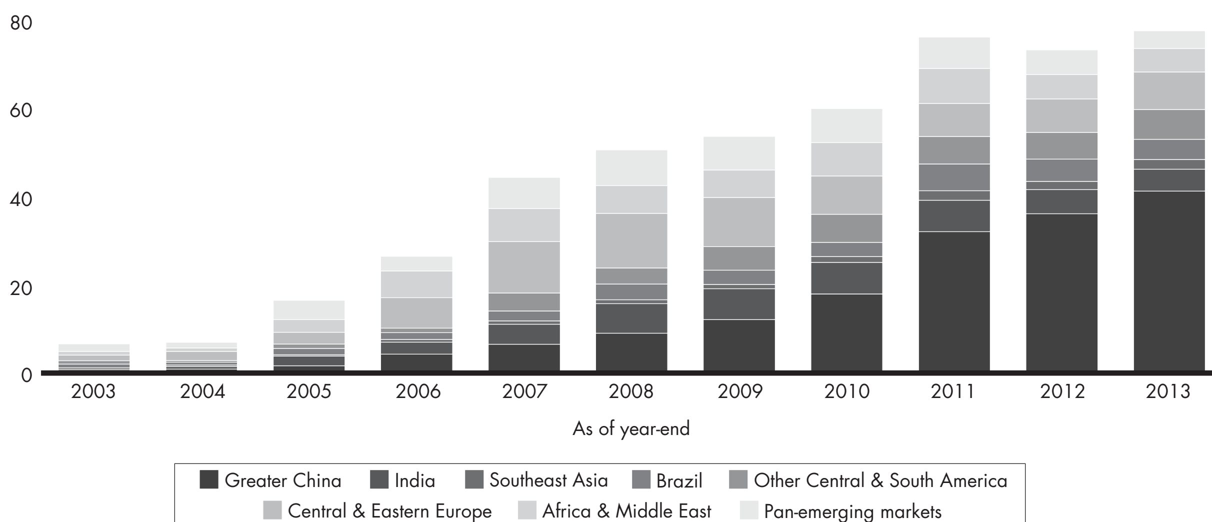
Dry powder for buyout and growth funds combined increased across all regions of the globe in 2013. In Western Europe, North America and other developed markets, the additions of new money were a major reversal of the trend underway since 2009, as GPs in the mature economies steadily chipped away at the wall of capital they struggled to invest. In the emerging markets, the inflow of fresh funds in 2013 piled on top of the dry powder that had rapidly accumulated for more than a decade. By the beginning of 2014, buyout and growth capital in the hands of emerging market funds had increased at a 10% clip compounded annually since 2009, to $77.5 billion (see Figure 2.2).

That fresh capital gives GPs a fresh start. GPs do not feel the acute pressure to invest that hounded them in the years immediately following the financial crisis when the deal market shrank and they were left holding vast sums of dry powder amassed during PE's prerecession boom years. But they cannot afford to wait long to find productive ways to use the new money. The recent large capital infusion ensures competition for deals will remain intense. Assuming no change in buyout deal value from last year's total and that the use of debt to finance new deals remains the same, Bain estimates the $399 billion in dry powder currently in the hands of buyout-fund GPs would be sufficient to cover 3.4 years of new deal making (see Figure 2.3).

More money in the shadows: The new role played by big LPs. The buildup of new dry powder directly under the control of GPs will light a fire under competition for deals in 2014, but another factor could fan the competitive flames even higher—"shadow capital" controlled by big institutional investors. These investors are putting capital to work beyond the traditional LP–GP fund relationship through a wide variety of arrangements, including co-investments, separate managed accounts, co-sponsorships and some direct investments without the involvement of a GP.

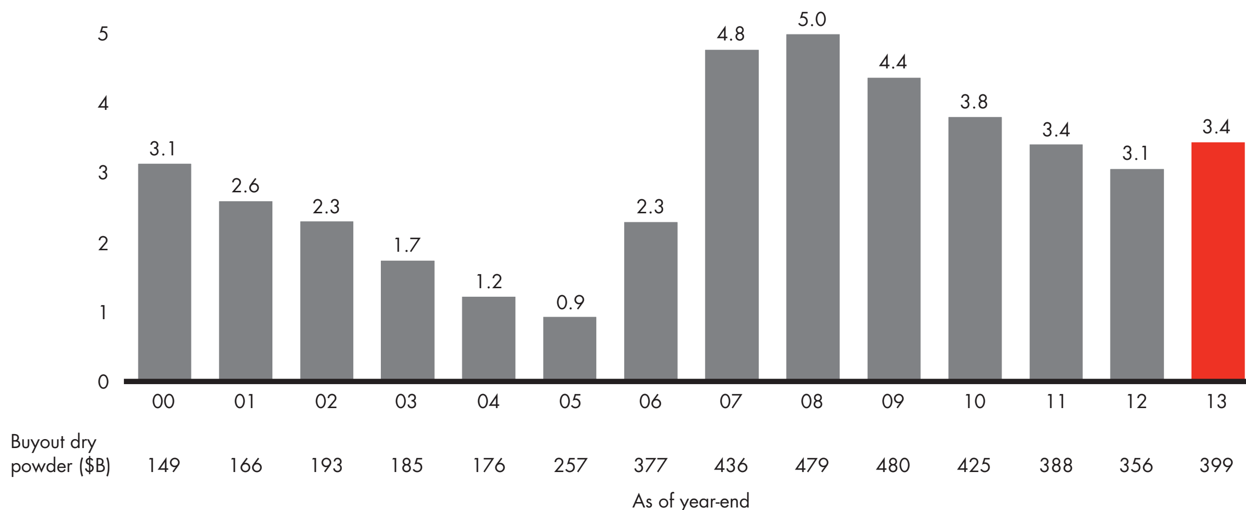
There's a lot to like on both sides of these new relationships. Beyond paying lower fees, which helps boost returns, institutional investors exert more control over the investments they make, enjoy greater exposure to industries

Figure 2.2: Dry powder continues to pile up in emerging markets



Source: Preqin

Figure 2.3: Barring a pickup in deal value, current dry powder could translate into about 3.4 years' worth of investments



Note: Analysis for 2000-2007 calculations based on actual equity value of transactions in future years; 2008-2013 calculations incorporate forecasted projections in base-case scenario
Sources: Preqin; Dealogic; S&P Capital IQ LCD; Bain analysis

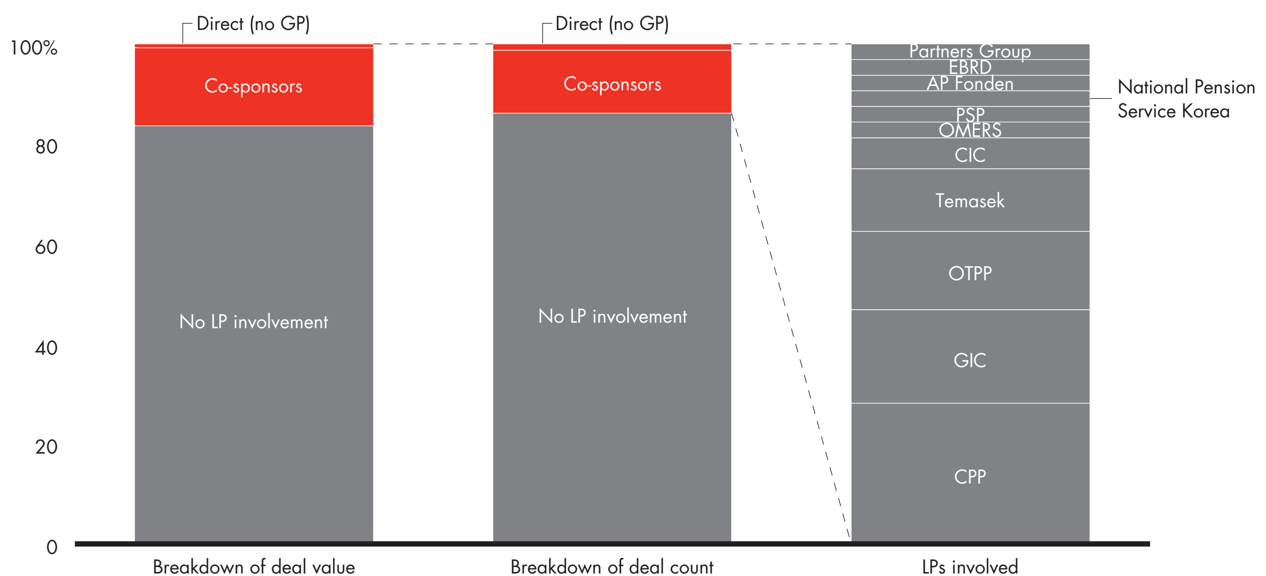
or geographies that appeal to them and can put money to work faster. By working closely with GPs, they get to see their unique capabilities firsthand and learn from them. For their part, GPs are able to offer the opportunity to co-invest as a sweetener to encourage LPs to sign on to a new fund, commit early or increase the size of their investment. Separate accounts give GPs another way to secure capital. And co-investments and co-sponsorships make it possible for GPs to take on bigger deals without having to syndicate a deal with other GPs.

What has yet to be determined is whether the pool of shadow capital might end up being a devil's bargain. It certainly adds to the already high level of dry powder that is bidding for deals. While hard to quantify precisely, shadow capital at its current level is small in comparison with conventional capital amassed by GPs and LPs in comingled funds. Yet, given institutional investors' broad interest in pursuing these new relationships further—sometimes at the expense of their traditional role as LPs—the shade cast by shadow capital will grow larger.

But will shadow capital compete with, or disintermediate, PE firms as institutional investors face off with GPs to buy assets? An analysis by Bain & Company, using Preqin data on 238 global buyouts valued north of $1 billion and closed between 2009 and 2013, found that LPs participated in about 15% of them, as a co-sponsor or directly without GP involvement (see Figure 2.4). Only a handful of institutional investors have the capabilities needed to compete directly with PE firms for buyouts on a standalone basis. Even the biggest, most adept ones tend to partner with PE firms rather than go directly head-to-head against them for deals. The vast amount of capital they control gives them a huge appetite for PE that requires them to maintain a close relationship with GPs in order to participate in their funds, even as they look for ways to invest in PE deals directly.

If not an immediate concern, the role of shadow capital bears watching. In the short run, the threat of competition between GPs and erstwhile LPs will likely show up in four principal areas: "easy" deals with little risk, involving stable companies with reliable cash flows and strong management teams; "local" deals, where a sovereign wealth

Figure 2.4: LPs have penetrated less than 20% of $1B+ buyouts, but almost all in partnership with GPs



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

fund or a large regionally based pension fund enjoy a home-field advantage; deals involving "strategic" assets, such as energy, financial services, telecommunications or media, particularly in sovereign wealth funds' home bases in Asia or the Middle East; and "huge" deals that require the acquirer to write a check bigger than a PE fund can afford.

Strong debt and public equity markets: Able and willing—but not much help to PE buyers. Demand for high-yield debt—both for bonds and leveraged loans—has seldom been greater across the US and Western Europe. Staring at record-low interest rates held down by central banks as far as the eye can see, debt investors are hungry for yield, and PE funds are among the most attractive borrowers in their line of sight.

Certainly, borrowing terms and rates strongly favor debt issuers as demand far exceeds supply. The forward-looking calendar of M&A-related loans in the US was light heading into 2014. On top of this, demand to refinance maturing high-interest debt used in past years' LBOs has virtually dried up. Once a major source of debt issuance by GPs facing a wall of refinancing to restructure the balance sheets of the big buyouts from the boom years, near-term US loan maturities have dropped dramatically over the past three years, from some $380 billion in early 2010 to less than $20 billion by the fall of 2013.

Conditions like those bode well for PE debt issuers going into 2014, but they are likelier to favor GPs that take equity out of their portfolio companies through dividend recapitalizations than potential buyers of new assets. Indeed, by enabling GPs that might otherwise sell a portfolio company to issue a dividend recap instead, the favorable high-yield debt market will likely end up shrinking the supply of attractive companies for other GPs to buy. Instead of a bridge that closes the valuation gap between sellers and buyers, the extra leverage that obliging debt markets are willing to extend will push prices higher.

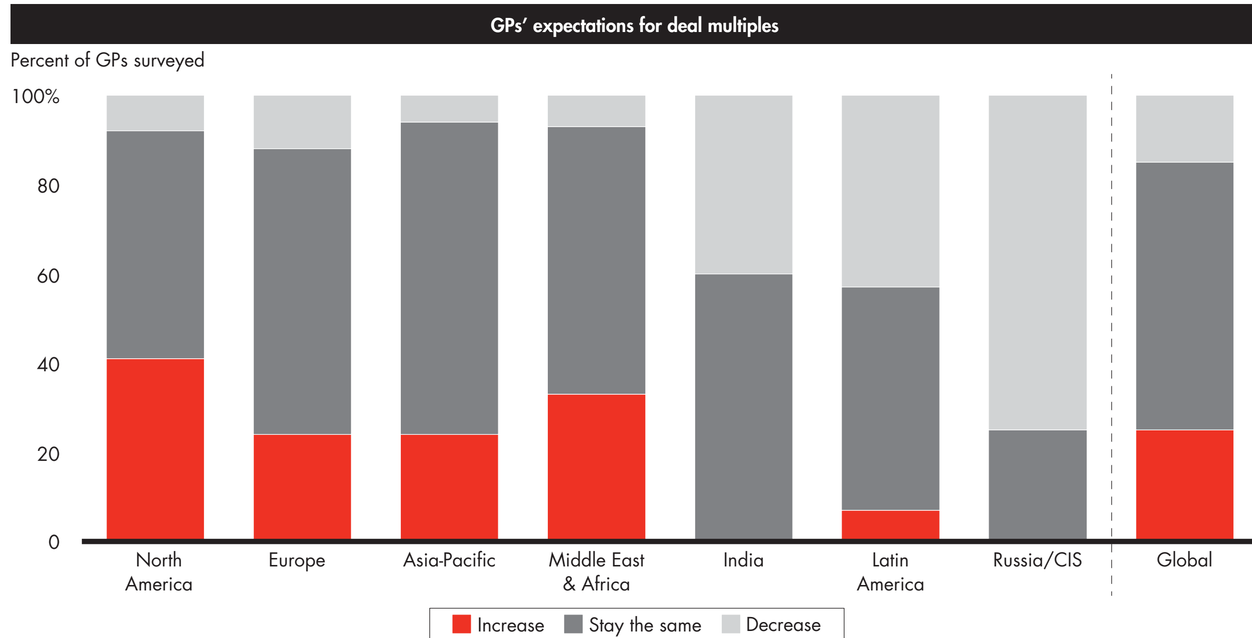
Like the robust debt markets, the buoyant public equity markets will likely depress deal supply and do their part to keep prices high. If public equity markets hold up in 2014, large, well-performing companies will be drawn to the wide-open IPO market rather than put themselves up for sale in an auction. Continued high public equity valuations also mean that fewer public companies will be good candidates for conversion to PE ownership, since acquisition prices will be too high for GPs to pencil out potential returns that justify public-to-private deals. The shrinkage of public-to-private deal activity would have a magnified effect, dragging down total PE deal value. Between 2004 and 2007, the last strong period of public-to-private conversions, 90% of the increase in overall PE deal value was due to the increasing number and size of take-private deals.

For PE deals that do take place, GPs will pay dearly. Strong stock market gains going into 2014 set a firm foundation under sellers' price expectations. Even if stock markets correct in 2014, the impact on deal valuations will not likely be felt right away, since potential sellers are generally slow to adjust their high price expectations to the new reality. As one Latin American investor told Bain in a recent interview, "Sellers' prices go up by the elevator but go down by the stairs." It is little wonder, then, that in a recent survey by Grant Thornton, GPs in nearly all major PE markets said they expect deal multiples to remain at currently high levels or to increase (see Figure 2.5).

The natural response of GPs faced with these deeply entrenched forces holding acquisition prices sky-high has been to accept them as inevitable and organize their investment screening accordingly. Of course, they end up circling many of the same targets—"safe" companies that can support a high bid. But once they pay top dollar and leverage the newly acquired portfolio holding to the hilt, how safe are they, particularly in today's volatile economy? And will returns from safe investments reach the levels LPs have come to expect from private equity?

Expand the PE investment pipeline: Go broader; go deeper. GPs will have their work cut out for themselves in 2014's tough deal-making environment, but there is reason to believe that deal activity will be higher—by count,

Figure 2.5: Around the world, GPs expect upward pressure on deal multiples



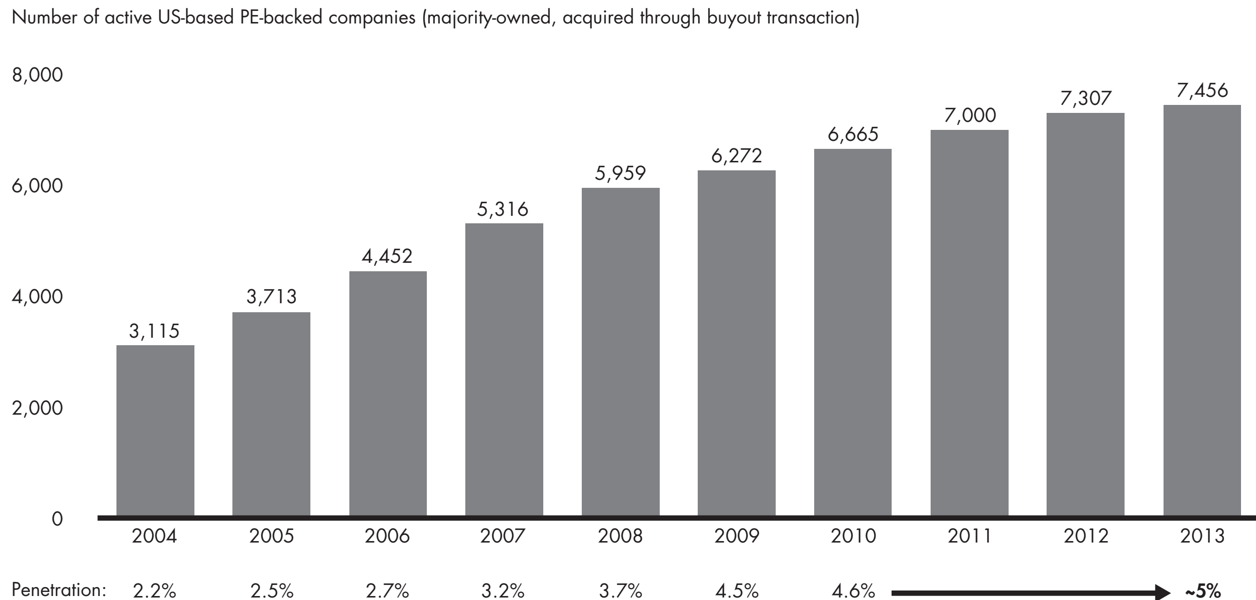
Source: "Global Private Equity Report 2013/14," Grant Thornton [survey conducted July–August 2013 (n=156 GPs)]

if not by value—than last year. The likeliest source of the increase will be sponsor-to-sponsor transactions as the current installed base of PE-fund portfolio companies comes up for sale. Many of these assets are businesses that have been in GPs' hands since the peak of the last PE cycle. Indeed, about half of PE-backed companies in the US were acquired in 2008 or earlier. Many of the PE funds holding these assets are nearing the end of their life and will seek to fully exit these investments as they close out their books.

An emerging new source of deal activity is the product of the creativity of GPs to think outside of the buyout box and consider minority control stakes and partnerships. These less conventional deals can be more lucrative than buyouts, because they are the product of custom-tailored agreements that do not involve auctions. They are also attracting the attention of some of the biggest names in PE. For example, Blackstone Group agreed to invest $200 million to take a minority stake in Crocs, the footwear company, last December. Carlyle Partners put up $500 million for a minority share of Beats Electronics, a marketer of headphones, co-founded by the recording producer, rapper and entrepreneur Dr. Dre. Unconventional investments like Beats are becoming a more common feature in Carlyle portfolios. The Carlyle Partners V fund, raised in 2007, has invested 15% of the $13.7 billion it has under management in less conventional transactions. Its immediate predecessor, the 2005 Carlyle Partners IV fund, had none.

Proactive deal sourcing by GPs holds the key to the third source of new investment opportunities. Even after decades of deal making, GPs have barely scratched the surface in terms of their penetration of the huge number of companies that could benefit from PE ownership. In the mature US market, where PE firms have made the deepest inroads and now own nearly 7,500 companies, that represents only about 5% of all US businesses with revenues exceeding $10 million (see Figure 2.6). PE penetration has tripled since 2000, yet even after approximately 9,800 PE primary buyouts and another 1,000 or so secondary deals, only between 6% and 7% of US companies have been in PE hands at some point during all of that time.

Figure 2.6: PE's penetration of companies in the US has grown over time, but only to about 5% of the total



Note: Penetration calculated as a percent of US companies with more than $10M in revenue
Sources: PitchBook (4Q 2013 PE Company Inventory Report); Internal Revenue Service; Bain analysis

While it is clear the opportunity to do deals is far from exhausted, the most fertile hunting ground will be in small companies. Bain estimates that about 15% of all businesses with an enterprise value of more than $500 million are already owned by PE firms, compared with just 3% of companies valued at less than $100 million. GPs with large funds to invest cannot realistically put the capital to work by targeting $100 million companies. As they continue to focus on deals in the more saturated market for bigger companies, competition will intensify.

Taken together, all three routes to further deal making in 2014—more sponsor-to-sponsor deals, creative new types of deals beyond traditional buyouts and finding deals by more deeply penetrating the universe of companies not yet touched by PE—hold promise. But it is likelier that the total number of deals will increase this year than will the total value of deals that are done. Deal value is driven by big deals. With little prospect that more big deals will take place in 2014—and, in particular, in the absence of big public-to-private transactions—deal value could actually come in lower than it did in 2013.

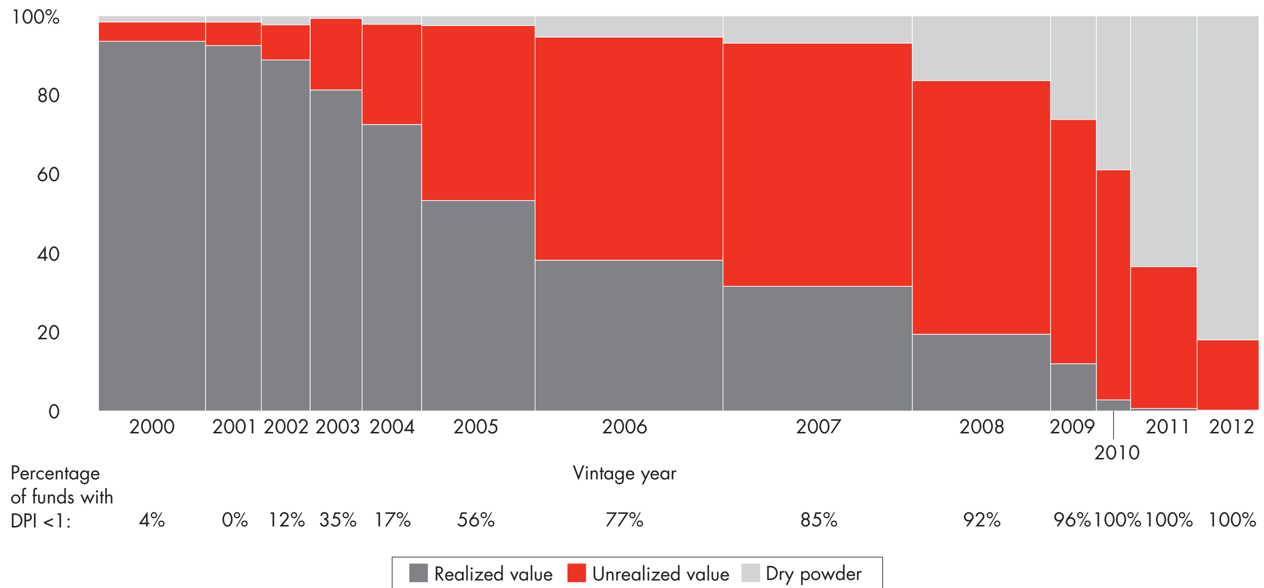
Exits: Releasing the pressure valves

PE exit activity in 2013 started strong and ended even stronger, with global PE-backed buyouts booking the greatest number of sales seen since 2008. Signs point to that momentum continuing, or even accelerating, in 2014: Sales of PE-owned assets to strategic buyers look promising on the back of strong M&A fundamentals, the IPO market is wide open and sponsor-to-sponsor transactions between PE buyers and sellers should be plentiful as funds seek to dispose of a large number of mature portfolio holdings.

All that positive energy could dissipate if the volatility that crept into the equity markets early in the year continues, causing corporate buyers to become skittish and taking the IPO option off the table for some. If capital markets do hold steady, however, there is good reason to be optimistic that 2014 will be at least as good as 2013 for exits.

Figure 2.7: The large exit overhang remains concentrated in the big vintages raised during the peak years of the PE cycle

Realized and unrealized capital and dry powder of global buyout funds by vintage year (as of Q2 2013)

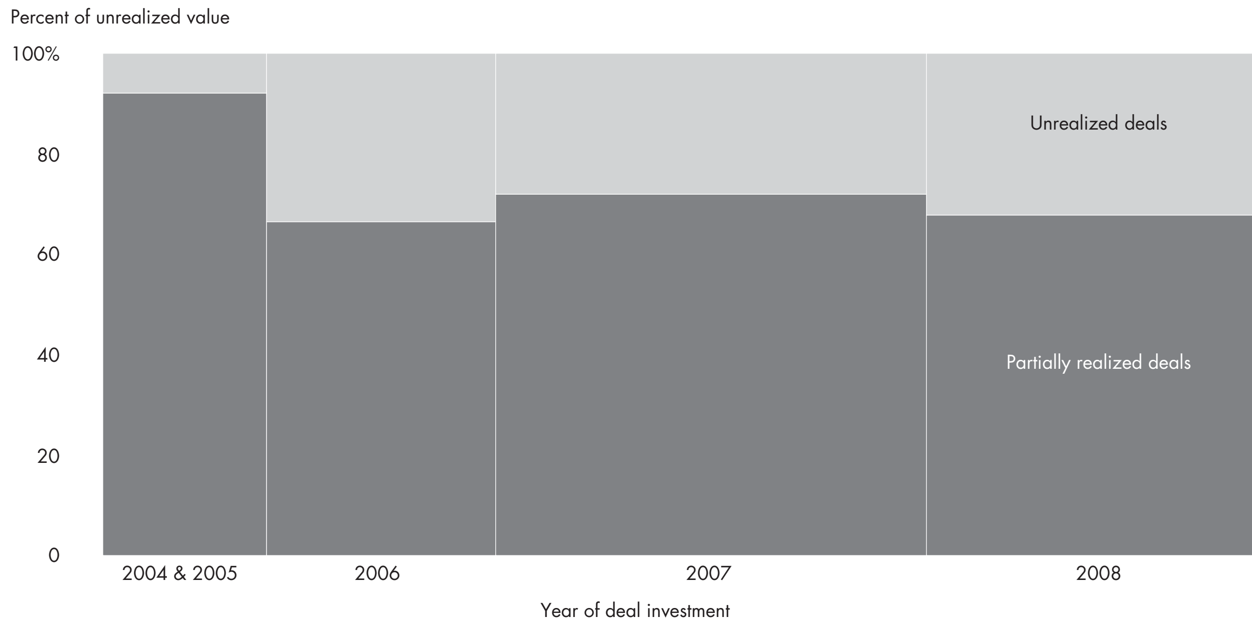


Note: DPI = ratio of distributions to paid-in capital
Source: Preqin

For PE funds, the bright outlook on the exit front is certainly welcome. GPs still had a huge amount of unrealized value tied up in their portfolios: an exit overhang worth $2.4 trillion in all and some $900 billion in buyouts alone as of mid-year 2013 (the most recent data available at the time of publication). The fund vintages from the immediate prerecession PE-cycle peak years of 2005 through 2008 present a special challenge, being far larger than those raised before 2004 or since 2009 *(see Figure 2.7)*. Taken together, the unrealized value tied up in peak-year vintage funds accounted for almost three-quarters of the total. Strong exit activity in the second half of 2013 will make the situation going into 2014 look better; but, without question, there is still a huge amount of capital yet to be exited in this year.

The good news for the industry is that the exit overhang is not as daunting as it may first appear. Bain teamed up with CEPRES, a provider of PE investment-decision products and services, to take a closer look at how the exit overhang really shapes up. Evaluating the overhang by the year when investments were actually made rather than by the fund vintage year reveals how much of the capital is really due for an exit. Indeed, 60% of the $908 billion in unrealized value is bound up in immature investments that are still less than five years old and not expected to be ready for exit. Only 40% is in "old" deals, done in 2008 or earlier, that are past the typical holding period for buyouts. Although higher than the industry norm, there are always some deals—both in good times and bad—that go beyond the five-year holding period. Moreover, as many as three-quarters of these old deals might already have a foot out the door to an exit, having been partially realized through an IPO, a partial sale of the asset or a dividend recap *(see Figure 2.8)*. It is difficult to know how many of these partial realizations represent a true exit (such as an IPO) and how many were simply extractions of equity (such as through a dividend recap). But it is clear that GPs have made considerable progress cashing out of these old investments.

Figure 2.8: Unrealized value tied up in "old" deals is mostly in ones that have been partially exited



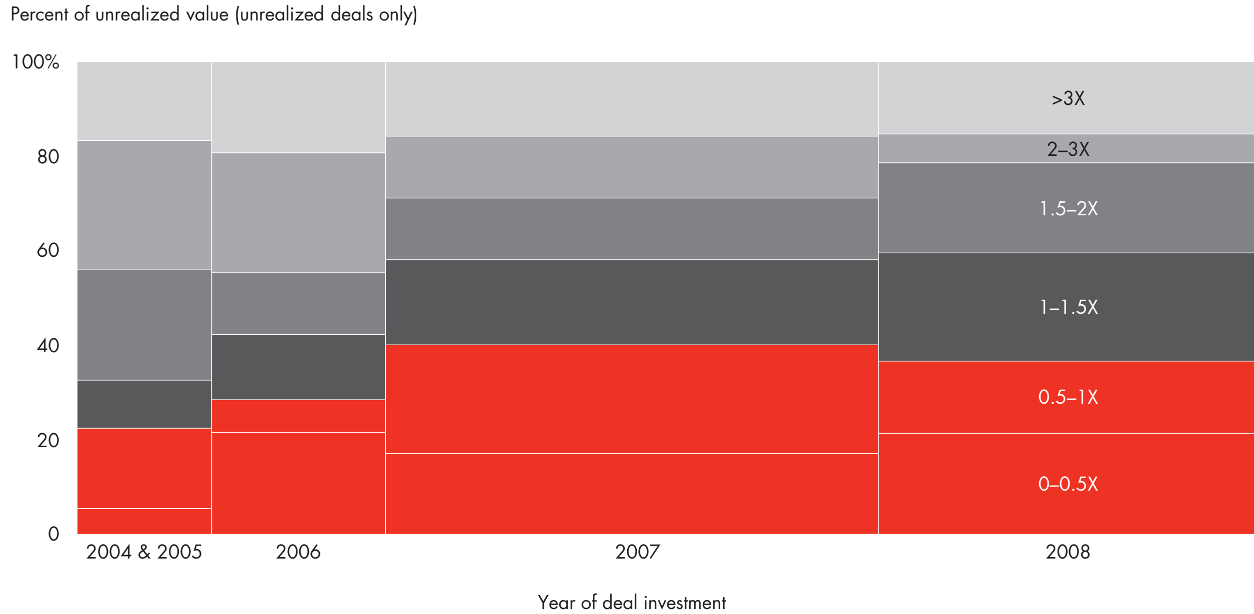
Note: Includes deals made by buyout-fund vintages 2004–2008 only
Sources: CEPRES; Bain analysis

Even old assets may not necessarily be ripe for exit, but GPs that find themselves under the exit overhang have been busy preparing their portfolio companies for eventual sale. A deeper look at investment valuations of assets that had yet to see any realizations shows how far GPs have progressed. By mid-2013, they held the majority of these assets at par value or better—sometimes far better *(see Figure 2.9)*.

Indeed, many investments that were largely written off during the financial crisis have made nice comebacks. Take, for example, KKR's purchase of Alliance Boots, the UK-based pharmacy chain, in Europe's largest-ever buyout back in 2007. When credit markets and economies unraveled in the financial crisis a year later, KKR was obliged to write down the value of Alliance Boots by 40%, and industry watchers predicted the company would be crushed under excessive debt. Buffered by covenant-lite loans that were common when the deal was done, KKR labored to rescue its investment over the next several years. Alliance Boots took advantage of the rebounding debt markets to push out the maturities of its loans. KKR reaped the rewards of its efforts when it agreed to sell a 45% stake in the drug store chain to Walgreens, a US pharmacy company, for $6.7 billion in June 2012—a price that implies a valuation for Alliance Boots 2.2 times what KKR originally paid for the company. By mixing deft portfolio management, improving economic conditions, healthy public equity market gains and the low-interest-rate environment the central banks engineered, GPs came up with a potent elixir that rescued their older investments and set themselves up to realize strong asset liquidations in 2014. As we will see, the exit channels are primed to cooperate.

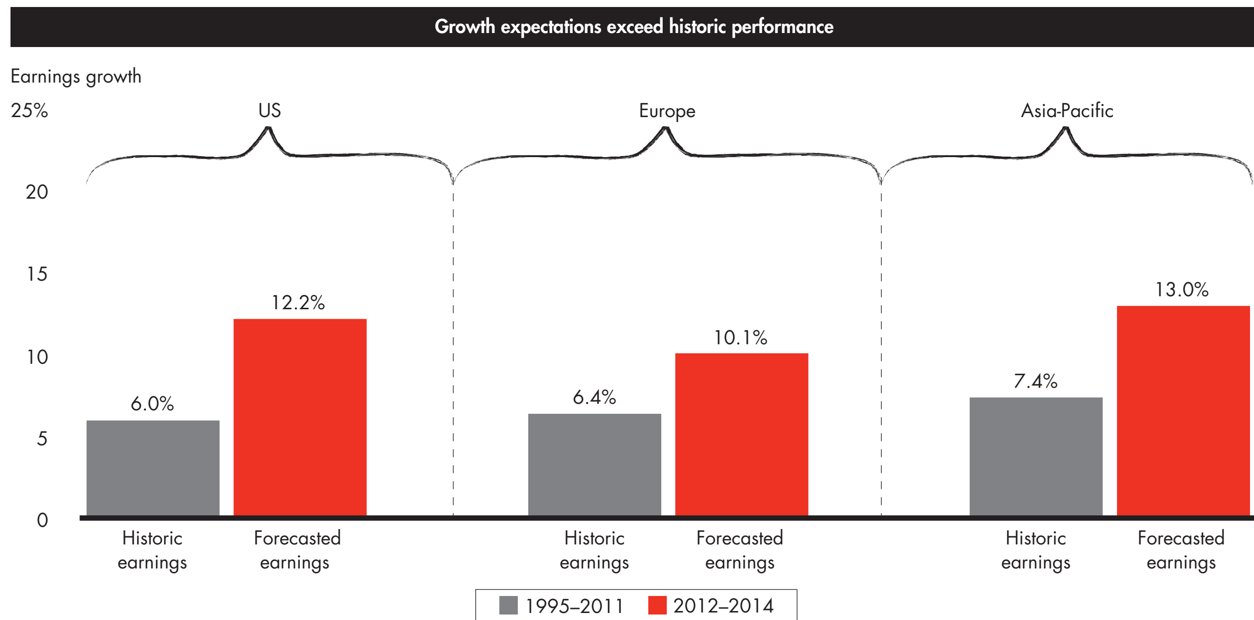
Strategic sales: Living up to expectations. Sales to corporate acquirers have been and will remain PE's most common exit route, and 2014 is shaping up to be a good year for corporate M&A. Optimism about a pickup in strategic sales stands on two solid pillars. First, corporations are feeling intense heat from shareholders to meet their high earnings growth expectations. Across all major regions of the globe, forecast earnings for the two-year period through the end of 2014 exceed by a wide margin what the historic corporate earnings trend has been between 1995 and 2011 *(see Figure 2.10)*. Companies will probe all potential avenues of growth—from new

Figure 2.9: Only 35% of the value of unrealized deals remains underwater



Note: Includes deals made by buyout-fund vintages 2004–2008 only
Sources: CEPRES; Bain analysis

Figure 2.10: Corporate M&A activity will likely increase as investors pressure companies for growth



Note: Based on respective aggregate EPS consensus forecasts for S&P 500 (US), MSCI Europe (Europe) and FTSE Pacific (Asia-Pacific)
Sources: Thomson Financial I/B/E/S; Bain analysis

technologies to new geographies and new businesses. Finding it hard to generate organic growth at a time of slow economic growth, weak aggregate demand and near-zero inflation in the developed regions, corporations will turn to M&A as the best way to act on growth opportunities they spot. As sellers of assets, PE funds stand to be major beneficiaries of corporations' need to satisfy their investors' mandate to grow.

The second pillar supporting an increase in strategic sales in 2014 is that corporate executives have both the means and intention to become more active acquirers. Corporate treasuries are flush with record amounts of cash to do deals. Wide-open credit markets and historically low interest rates enable corporate borrowers to leverage their acquisitions, magnifying their purchasing power. And high share prices have made corporate stock a potent additional currency to support forays into M&A.

Survey findings confirm that corporate leaders' expectations for and confidence in 2014 M&A conditions match their capacity to act on them. In an Ernst & Young poll of 1,600 senior corporate executives, conducted last September, 69% of respondents said that they expected global M&A and deal volumes to increase over the next 12 months. Asked if their company expected to pursue an acquisition in 2014, 35% responded that it would.

Still, corporations are a fickle bunch. An increase in economic uncertainty or jittery equity markets could slam the doors shut on M&A activity as would-be buyers fret about overpaying for assets. But as long as the markets hold up, there are good grounds to be hopeful that corporate M&A could take off.

IPOs: A deep pipeline and more in the shadows. All the elements are in place for 2014 to pick up where the outstanding IPO year of 2013 left off. Benign market conditions are winds to the back of IPO activity, and as the year began, public equity markets in the major developed economies were largely holding on to the strong gains they racked up over the previous 12 months. If the market pullback experienced early in the year turns out to be short-lived and not a harbinger of more turbulence to come, the IPO channel will be strong in 2014.

There is already a healthy lineup of buyout-backed IPOs ready to take off. By late January 2014, 41 buyout-backed companies had filed for exchange listings. Of these, more than half were based in the US, nine were headquartered in Europe and six were companies in the Asia-Pacific region, demonstrating that the IPO opportunity is gaining momentum around the world. At the same point going into 2013, just 12 buyout-backed companies globally had declared their IPO intentions. In the emerging economies of Asia, the long-awaited reopening of the IPO market by regulators on the Chinese mainland will enable PE funds to begin exiting a stockpile of investments.

The already-public announcements by GPs that they intend to undertake an IPO only hint at the potential volume of public offerings that may follow. Regulatory filings typically precede an issue of new shares by between three and six months. They do not yet reflect the many strong potential IPO candidates still tucked in PE fund portfolios. The "shadow" IPO pipeline includes large, big-name companies acquired during the prerecession boom years, which are ready to return to public ownership. Prominent in this group are two companies from among the biggest deals closed in 2007—Biomet, a healthcare equipment and services provider, acquired by a consortium including Blackstone Group, KKR, TPG and Goldman Sachs Capital Partners for $11.4 billion; and Univision, a media company bought by TPG Partners, Madison Dearborn Partners, Thomas H. Lee Partners, Saban Capital and Providence Equity Partners for $13.6 billion. Having sat in PE-fund portfolios for nearly eight years, both companies are due for exit, and their sheer size would make them challenging for a strategic acquirer to absorb or another PE consortium to purchase. But each is a solid candidate to return to public ownership. Since their purchase, the US equity markets (measured by the S&P 500 Index) have now climbed by some 30%—well above the share price at which Biomet and Univision were originally taken private and to a level that would enable their PE owners to recoup the control premium they paid. Industry observers anticipate both companies will make initial offerings this year.

Sponsor-to-sponsor transactions: Eager buyers and sellers of last resort. High-profile IPOs and strategic sales may capture headlines, but bread-and-butter asset sales between PE funds will also grow in importance across all regions in 2014. The sponsor-to-sponsor channel is well suited to accommodate the strong flow of sales by GPs seeking to fully liquidate holdings.

Just how many sponsor-to-sponsor exits there will be in 2014 will depend in large measure on how many exits end up being siphoned off by corporate acquirers and how well the IPO market holds up as the year advances. Corporate buyers are willing to pay up for assets that fit their strategic goals, and GPs will be lured by the higher valuations that large, strong companies fetch on the public markets.

Sponsor-to-sponsor deals will likely see an uptick in emerging markets like India and China. These economies have seen few such exits in the past, but with emerging market PE funds sitting on large piles of dry powder they are eager to put to work, buying assets from other PE funds is becoming both attractive and necessary.

Of course, GPs will continue to execute dividend recapitalizations and follow-on sales of shares to unlock paper portfolio gains and boost distributions to LPs during the coming year. With a large number of deals from the mid-decade boom years now trading on the public markets and more expected to come in 2014, liquidity flowing from follow-on sales of shares will increase. But the prospect of robust, fully functioning exit channels that enable them to clear the big backlog of unsold assets could make 2014 a year to remember.

Fund-raising: The action intensifies

The unmistakable signs of momentum that began to build in PE fund-raising in 2013 look primed to gather force in 2014 as GPs hungry for capital find LPs more open than they have been in years to provide it. Indeed, the dynamics that are coming into focus on the supply-and-demand front suggest that 2014 could be a year of transition, marking the end of one long PE cycle and the start of a new one.

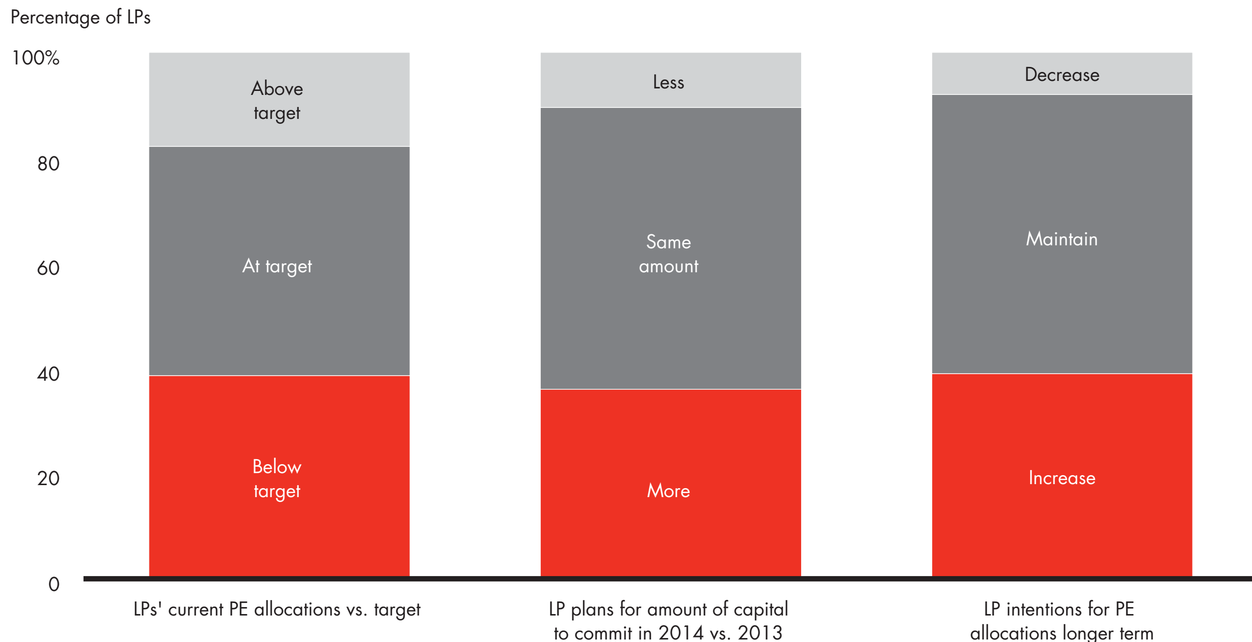
LP demand: Matching appetite and discipline

Following successive lean years when payouts from their PE investments trickled in slowly, LPs now find themselves in an unaccustomed new situation. For a third successive year, the cash returned to LPs in 2013 has well exceeded the amount of capital GPs called from them to fund new acquisitions. Cash distributions are set up for more of the same in 2014 as GPs continue to aggressively harvest the $2.4 trillion worth of unrealized investments in their portfolios. Meanwhile, barring a huge spike in new acquisitions, we expect distributions to continue to outpace capital calls.

More cash flowing in than flowing out will leave an increasing number of LPs short of their target PE allocations. In fact, 39% of LPs surveyed by Preqin last December reported that their PE holdings as a percentage of their total assets under management had fallen below target *(see Figure 2.11)*. Another 44% were at target last December, and based on current trends, more will be likely to slip below.

Many LPs that find themselves short of their target PE allocation will pick up the pace of new fund commitments to close the gap. This is something most LPs are eager to do. As has already been discussed in Section 1 of this report, PE has long been LPs' best-performing asset class over the long term. The rebound in PE returns and the better-than-expected gains on the sale of assets acquired at the height of the last PE expansion helped reinforce PE's performance edge, adding to yield-hungry LPs' inclination to increase their PE exposure. In the same Preqin survey cited above, 36% of responding LPs indicated that they intend to increase their PE commitments in 2014 over 2013, and 39% said that they would increase their PE allocation over the longer term.

Figure 2.11: LPs plan to commit more capital and raise their PE allocation in 2014 and beyond



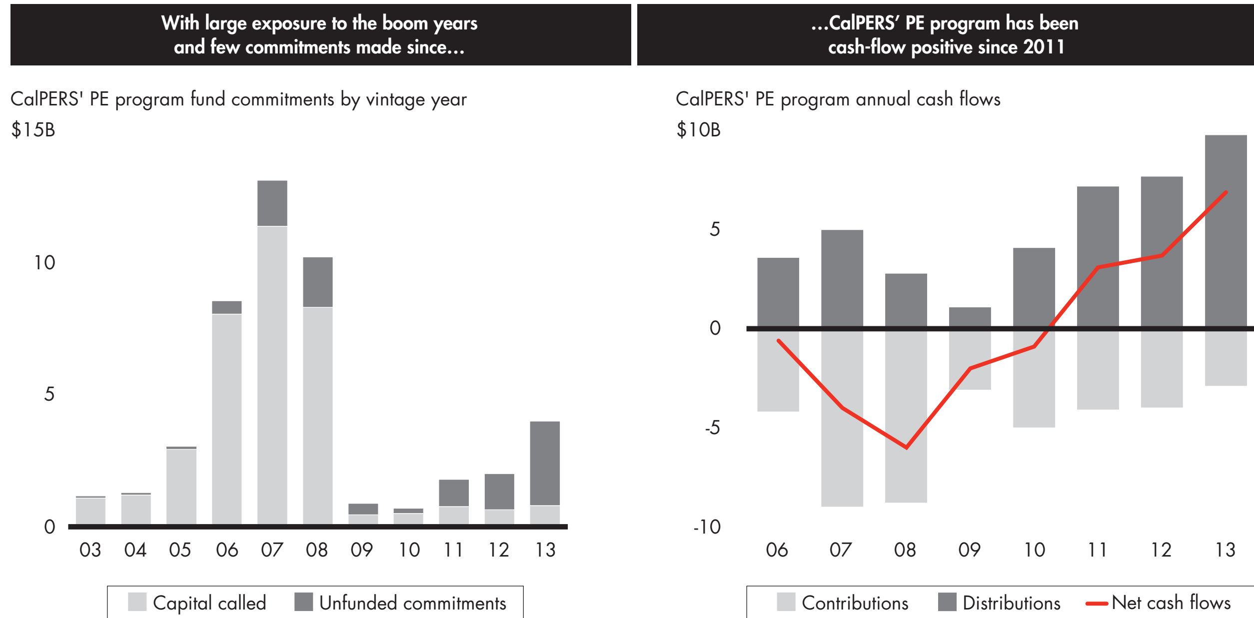
Source: Preqin Investor Survey (December 2013)

What does this bode for PE fund-raising? It is difficult to say precisely, but fund-raising could see a big upswing. Just how much LPs will increase new PE commitments to restore their PE holdings to the balance they aim for, however, will vary widely from investor to investor. That the potential fund-raising sums involved in 2014 and beyond could be considerable can be seen in the situation faced by CalPERS and CalSTRS, the state of California's huge public pension funds covering state employees and teachers, respectively.

Like many big institutional investors with mature PE programs, both CalPERS and CalSTRS ramped up their PE fund commitments during the boom years prior to 2008. In the case of CalPERS, its exposure to the three fund vintages from 2006 through 2008 alone totaled $33 billion, accounting for about three-quarters of the pension's total PE fund commitments made during the decade following 2003. In the aftermath of the 2008 financial market meltdown, however, CalPERS pulled back sharply from making new PE commitments in 2009 and 2010. New capital committed to PE funds during those fallow years totaled just $1.7 billion—and only $3.9 billion more in 2011 and 2012 (see Figure 2.12).

The effect on CalPERS' PE portfolio of three fat years of PE commitments followed by four lean years has been dramatic as big distributions began to pour in from the older fund vintages. Over the last three years, CalPERS received distributions totaling $24.7 billion but anted up just $11 billion to meet capital calls over the same period. With the inflow of cash distributions exceeding new contributions by a ratio of 3.4 to one in 2013, the net asset value (NAV) of CalPERS' PE fund portfolio decreased to $30.6 billion at the end of last year—a 4.4% decline even after adding back the $5.5 billion increase in the valuation of unsold PE assets still on CalPERS' books. With the non-PE portion of CalPERS' assets under management increasing by 16% over that same period, that shrinking PE NAV has pulled CalPERS' PE allocation down by two percentage points, to 11% below its target PE allocation of 14%.

Figure 2.12: CalPERS' PE program has been cash-flow positive since 2011 and will likely remain so for the foreseeable future



Source: CalPERS

CalSTRS followed a similar PE binge-and-purge diet with much the same result. Although it did not pull back as much as CalPERS did in making new PE commitments between 2009 and 2012, the NAV of CalSTRS' PE holdings contracted while that of its non-PE assets under management expanded. As a consequence, PE's share of CalSTRS' portfolio dropped from 15% as of mid-year 2012 to 12.1% through late 2013, below its target allocation of 13%.

Like many other institutional investors whose PE portfolios followed a similar cyclical path and are now below their target PE allocation, both of California's pension fund giants are likely to ramp up new PE commitments in 2014. But GPs with new funds to offer will not find them soft targets. Over the past few years, CalPERS, for one, has instituted measures that will make it a more discerning investor. It has formalized its investment review process and built up its PE team to 52 people, adding 17 in 2013 alone. It will refocus its portfolio on a core set of high-performing GPs. As more big LPs like the California pension fund twins continue to apply the hard lessons learned since the last downturn, Bain expects the PE industry will wring out marginal GPs over the next five to 10 years.

GP supply: A buyers' market as far as the eye can see

The greater inclination of LPs to commit is bringing out a big supply of new funds in 2014. There were already a large number of GPs on the road as the year began, offering some 2,050 funds and seeking to raise $740 billion. More GPs will be sure to join them throughout the year, including many that last raised a fund in 2009 or earlier, and will need to return to the trough for more capital. Among GPs that raised a large buyout fund of $3 billion or more in 2009 or earlier, only one-third have raised a subsequent fund in the past few years. Another third have begun the process and are currently on the road. The remaining third have yet to launch a campaign. They will be joined by a large number of smaller funds in the same situation, along with many new GPs that will be looking to tap the currently receptive market.

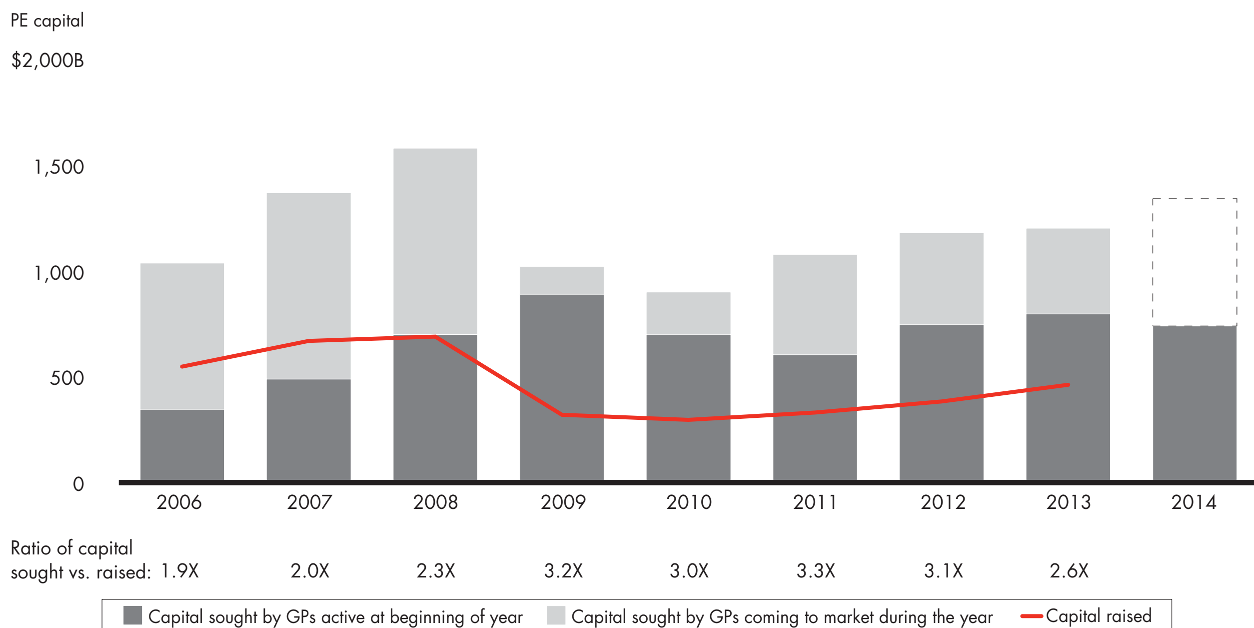
However strong LP demand proves to be in 2014, it surely cannot accommodate this abundant level of supply. To grasp the dimensions of the oversupply, Bain compared the ratio of the amount of capital GPs sought to raise with the amount they actually managed to bring in over the years. Since the financial crisis, that ratio has hovered above three to one, dipping to 2.6 to one in 2013 on the back of strong fund-raising (see Figure 2.13). Looking forward to 2014, even with LP interest in committing to new offerings picking up, the ratio of the amount of capital GPs seek to raise to the amount they will actually manage to bring in during 2014 will be unlikely to fall much below the 2.6 to one it reached last year. The fund-raising trail will be crowded and intensely competitive.

GPs that hope to break through the crowds will need to offer what LPs want, of course. As in past years, mid-market and growth-capital funds in the US and Europe will continue to dominate LP interest. But a recent survey of investor trends in 2013 and 2014 by Probitas Partners, a PE investment advisory firm, pinpointed a shift in the types of funds that are attracting LP interest. Falling out of fashion are pan-European mid-market buyout funds and Asia country-focused funds, but enthusiasm is increasing for energy funds, secondary funds and large US buyout funds (in the range of $2.5 billion to $5 billion).

Bigger buyout funds are returning to popularity for several reasons. First, their recent returns have fared better than expected, lifting LPs' confidence in the big GPs managing them. Second, big LPs like CalPERS plan to reduce the number of GPs they back. Fund managers that survive the cuts—particularly larger, more capable GPs that can offer a broad suite of PE fund types from buyout to real estate and infrastructure—will be the principal beneficiaries. Finally, larger GPs are better able to satisfy LPs that are clamoring to put more capital to work faster by offering alternative investment options, including co-investment opportunities and managed separate accounts.

LPs are also shifting their geographic preferences beyond the North American market. Within Europe, they are flocking to funds in the bastions of safety in the Nordic region, the UK and Germany, where economic fundamentals

Figure 2.13: Many GPs were raising new funds as 2014 began, and many more are likely to join them



Note: Dotted line indicates the additional capital expected to come to market (but not yet announced) in 2014
Source: Preqin

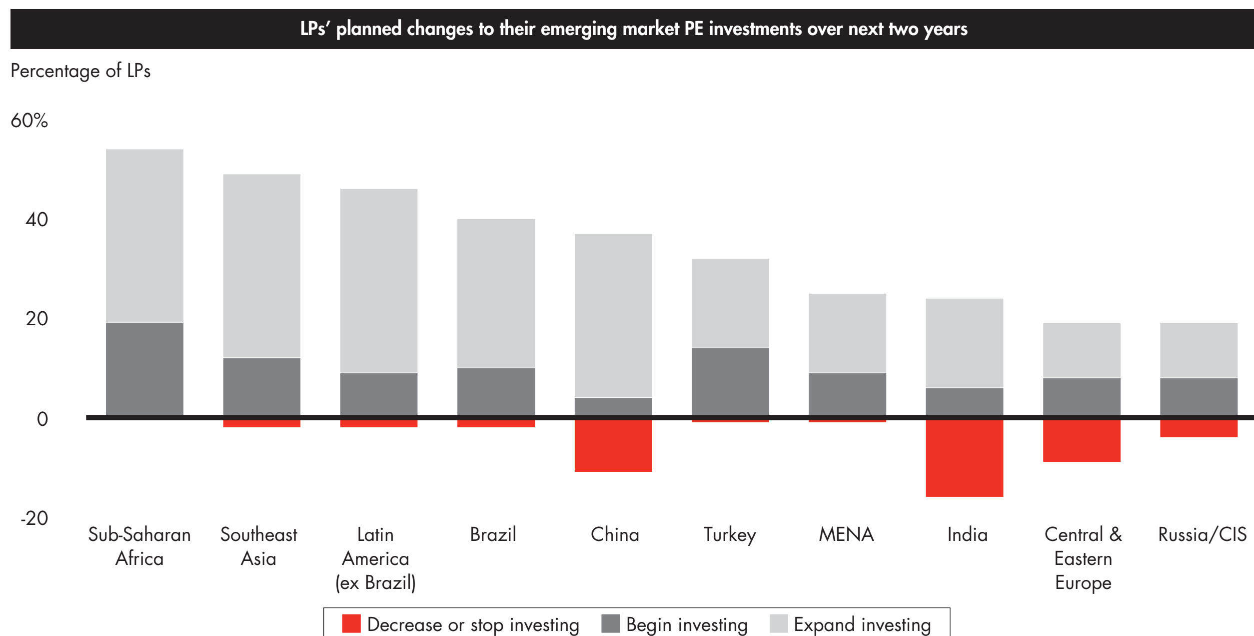
are strong and underlying conditions show signs of improvement. Interest is also picking up in Spain and Italy, where LPs spot an opportunity to buy at the bottom of the cycle as the economy stabilizes. LP interest in Central and Eastern Europe has waned, as signs of recovery elsewhere in Europe and the US have diverted their attention.

In emerging markets, LPs are gradually diversifying their commitments across a broader range of regions and countries (see the sidebar "Emerging markets: Shifting gears," page 28). Annual EMPEA surveys since 2004 capture this shift. For the first time in the nine-year history of the survey, none of the BRIC countries show up among the top three markets LPs find most attractive (see Figure 2.14). Displacing interest in Brazil, Russia, India and China in last year's survey was interest in expanding investments in Sub-Saharan Africa, Southeast Asia and Spanish-speaking Latin America. India and China, which dominated LPs' attention just a few years ago, are likely to see the biggest declines.

GPs under the microscope

The crowded and competitive environment, along with LPs' greater discernment and sophistication in fund selection, will make for tough fund-raising conditions for all but the best GPs. Those that hope to succeed will need to withstand LPs' more exacting winnowing process. The winners in the fund-raising race will be able to demonstrate a solid track record of success based on their ability to create value in their portfolio holdings. They will be led by a stable management team with a history of success working together and a clear succession plan that anticipates changes. They will be able to spot attractive market opportunities and articulate a compelling investment strategy to capitalize on them. They will nurture differentiated strengths that enable them to generate alpha, and they will hone a repeatable model that enables them to create value post-acquisition and demonstrate an ability to execute growth strategies. GPs will need this formidable arsenal of strengths as they come up against LPs' increasingly stringent due diligence processes.

Figure 2.14: LPs plan to increase commitments beyond the BRIC markets over the next two years



Source: EMPEA (Global Limited Partners Survey 2013)

Recognizing that fund-raising is and will remain more competitive, onerous and unpredictable, leading GPs are cranking up their fund-raising game as an expertise that sets them apart from their peers. They are elevating it from a campaign mounted every few years into a set of five integrated core competencies they refine year-round. First, the leaders carefully flesh out their long- and short-term capital needs and organize their fund-raising schedule well in advance. Second, they build an objective fact base of where they stand with LPs, both current ones and those that have turned them down in the past. GPs use the insights derived from this LP due diligence to tweak their strategy. Third, they prequalify their target LPs, work to understand their needs, objectives and vetting procedures, and choreograph their optimal LP-portfolio mix. A deep analysis of what LPs are looking for takes into consideration the maturity of their PE programs, their cash-flow and allocation trends, the types of funds and regions they are targeting for future commitments and their appetite for alternative investment structures, including co-investments. Fourth, they sharpen their sales pitch, making their investment angle clearer, more consistent and more compelling by backing it up with demonstrable facts and results. They tailor their message to each LP, anticipate the LP's questions and concerns, and shape responses that address them. They train their partners and equip them with the material they need to ensure they will be able to deliver the message consistently. Finally, with the boundary blurring between fund-raising and nurturing the relationship after the deal is sealed, they strengthen their investor relations capabilities to become more transparent in their communications and better at reporting on the health of their investments.

PE firms that raise their fund-raising and investor relations game will be better positioned than their rivals to capitalize on the recent revival of LPs' ability to make new fund commitments and to weather the future fund-raising droughts that will inevitably occur.

Returns: It's all about alpha

GPs have worked hard since the 2008 market meltdown to spruce up beaten-down assets they had paid dearly for at the top of the PE cycle and extract far more value than most LPs and outside observers expected. But they also got a big boost from a warming economic climate, strengthening public equity and debt markets, and other favorable external factors beyond their direct control to help push up valuations. In the yin-yang dance between market beta and the unique alpha-generating capabilities of GPs themselves, each played an important part in driving the recovery of short- and long-term returns. But what factors will influence the returns GPs will reap on investments they make in 2014 and beyond? What characteristics will shape funds' return profiles? And, most importantly, what capabilities will top-performing funds need to set them apart from their peers?

It is hard to predict what the return outlook for future investments will be, but it would be imprudent for PE funds to bank on beta forces. Last year's beta boost was largely powered by the easy-money policies of the US and European central banks and is unlikely to last. For the foreseeable future, all three of the major drivers of beta will be slackening in all of the major regions of the world. First, GDP growth will be modest in the US, stagnant in the EU and slower in emerging markets. Second, PE funds will see little if any benefit from expanding valuation multiples. Asset purchase prices remain high everywhere, and abundant dry powder in the hands of GPs eager to put it to work is bound to keep them elevated. Finally, GPs will find little benefit trying to use financial leverage to goose equity returns. The robust low-interest-rate credit markets have pumped up asset prices, leaving no room for buyers to profit by carrying higher levels of debt.

It has been increasingly clear for years as the PE industry matured that GPs will need to rely on the power of alpha to achieve superior returns. Indeed, beta is often erratic and transitory—hardly something PE firms can depend on to build a repeatable model for generating consistent returns and attracting capital from LPs. In fact, major changes in the external environment are making alpha skills more important than ever to the success of PE funds.

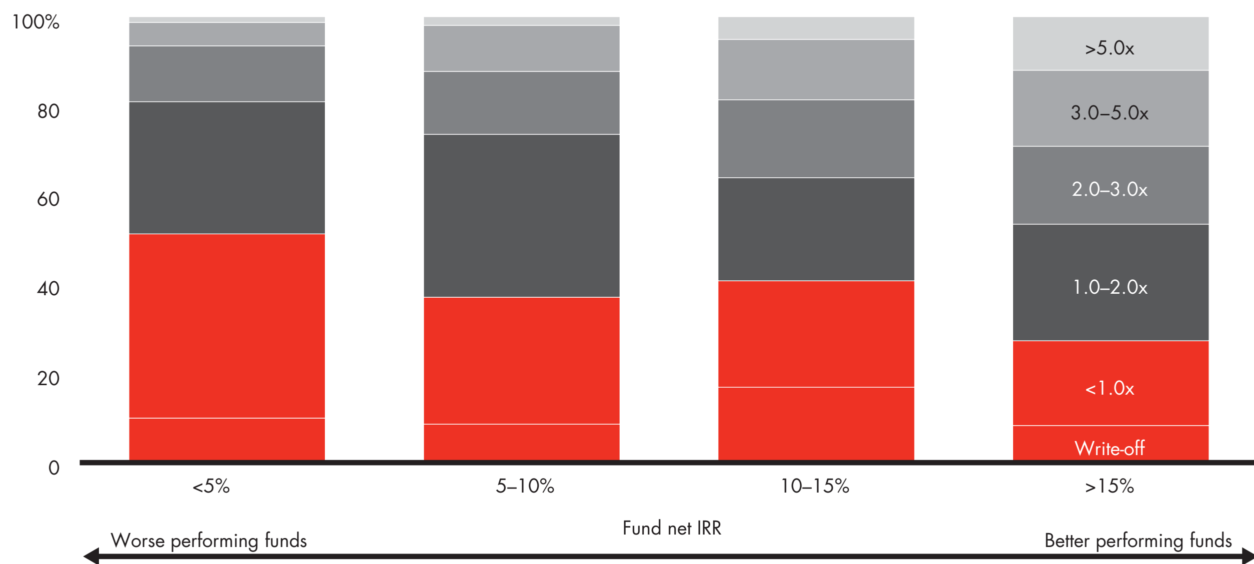
Going forward, GPs will need alpha-generating capabilities to steer their way to winning deals in a more complex and intertwined global economy. The new environment will be characterized by greater volatility and subject to bubble risk, but also riddled with hidden pockets of opportunity that turbulence inevitably creates. PE funds will need alpha skills to read the potentially perilous macro conditions in which deal making takes place and cut through market noise to home in on winning deals (see the sidebar "New macro challenges confront PE," page 53).

Fortunately, alpha comes in many shapes and forms. There are good and bad deals to be found across all segments of the market. The returns GPs earn have less to do with the types of deals they do than with the distinctive capabilities they apply at every link of the value chain, from sourcing and screening to managing and exiting the deals they take on. Building alpha-generating capabilities takes time, draws on the qualities of what it takes for GPs to succeed in their target sweet spot and taps the skills that have served them well historically. Yet while the specific talents for generating alpha may vary from GP to GP, the results do not: Those that can successfully develop and deploy the skills that create alpha consistently do deals that produce more hits and fewer misses.

An in-depth analysis by Bain reveals that the benefits of alpha show up in three ways, and they explain the variance in the returns earned by GPs that can and cannot generate it. The research found that these funds excel in these areas:

Avoiding deals that are losers. Top-performing funds lose money on deals like everyone else, but they are far better able to steer clear of losers than their lower-performing peers. Bain evaluated the return multiple on invested capital of nearly 2,700 deals made by a sample of US, European and Asian buyout funds from the mature 1995 through 2006 vintages and sorted them into four categories by performance, from worst (net fund IRR of less than 5%) to best (net fund IRR of greater than 15%). The weakest-performing funds lost money on better than half of their deals; the top performers, by contrast, booked return multiples below breakeven on just 27% of its deals—a little over half as many *(see Figure 2.15)*. That pattern has proven durable over time, with top-performing funds generating

Figure 2.15: Top-performing funds generate fewer losing deals and more big winners



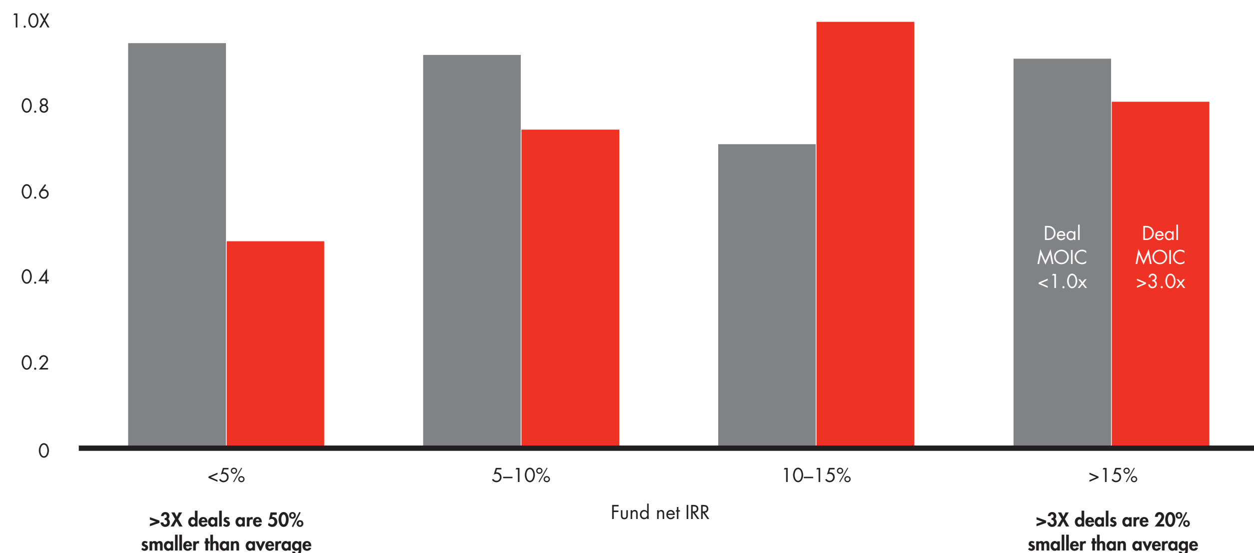
Notes: MOIC = multiple of invested capital; includes US, European and Asian buyout funds of vintage years 1995–2006
Source: Bain analysis

far fewer losing deals and more winners for fund vintages from 1995 through 1998, 1999 through 2002 and 2003 through 2006. The difference in the proportion of money-losing deals explains more than half the variance in the returns between the top-performing and weakest-performing funds.

Finding winning deals that win bigger. A second major performance difference between the top alpha-generating funds and the laggards is the size of their wins. Forty percent of the performance leaders' winners (that is, deals that returned more capital than GPs put into them) earned a multiple that was better than three times the invested capital. Among the weakest performers, just 13% of winning deals earned a multiple that exceeded three times their invested capital. Indeed, among the top-performing funds, one winner in six generated a multiple of better than five times their invested capital; among the weakest performers, just one winner in 40 did that well. The advantage of investing in winning deals that won bigger explained 30% of the performance variance between funds that were leaders and the rest.

Backing winning deals that are bigger deals. Most PE funds have demonstrated a proven ability to convert small deals into winners that return a high multiple on invested capital. It is simply easier to grow a small company into a much larger one than it is to do the same with an enterprise that is already fairly big. But as Bain's analysis discovered, that is just what the high-alpha, top-performing funds do consistently: Their winning deals take bigger companies and make them still bigger. Among the performance leaders, deals that returned a multiple of more than three times their invested capital were 20% smaller than the average deal size in their fund's portfolio. On the other hand, for funds that trailed in performance, the size of their high-performing deals were just half as big as their average deal (see Figure 2.16). This third advantage helps to explain the remaining 15% performance gap between top and bottom performers.

Figure 2.16: High-return deals of top-performing funds are relatively larger than those of lower-performing funds



Notes: MOIC = multiple of invested capital; includes US, European and Asian buyout funds of vintage years 1995–2006
Source: Bain analysis

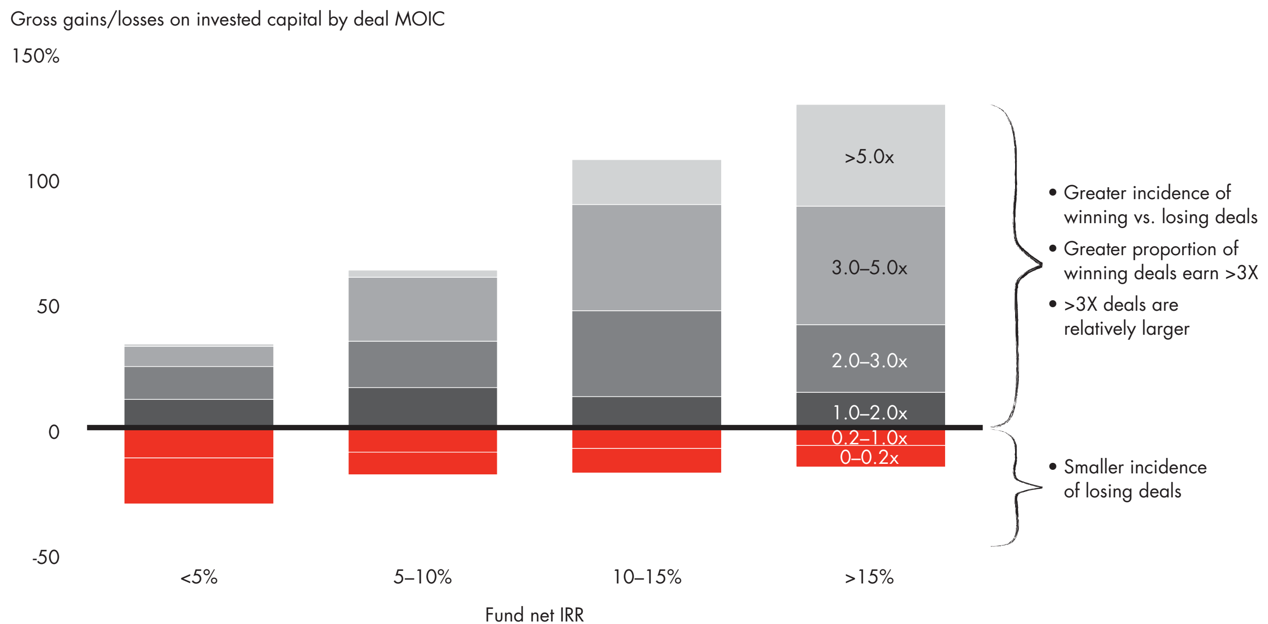
The combined effect of these three performance-enhancing characteristics enables alpha-rich performance leaders to stretch their gains and reduce their losses. The greater incidence of winning deals over losing deals, generating a higher proportion of runaway winners, and converting more large deals into big winners more easily offset their inevitable but far less frequent losing deals (see Figure 2.17).

Bain's analysis of performance-leading PE funds found that there is no one path to top returns. Segmenting the sample of funds we examined that achieved better than 15% net IRR by their pattern of winning and losing deals revealed three distinct routes to success. Funds in the first cluster, representing about 29% of the funds we analyzed, appear to rely on sheer luck, having invested in one or two exceptional deals that more than compensated for many money-losing ones. But GPs managing the funds in the other two clusters followed what appears to be a repeatable process for creating alpha that generated their exceptional results.

The first of these groups—making up 38% of our sample—comprised funds whose hallmark investing style can best be described as consistent. With better than two-thirds of the deals in their portfolios achieving a multiple that ended up being between one and five times their invested capital, they managed to steer clear of deals that end up losing money and were less likely than their high-performing peers to back deals that generate exceptional multiples exceeding five times their invested capital.

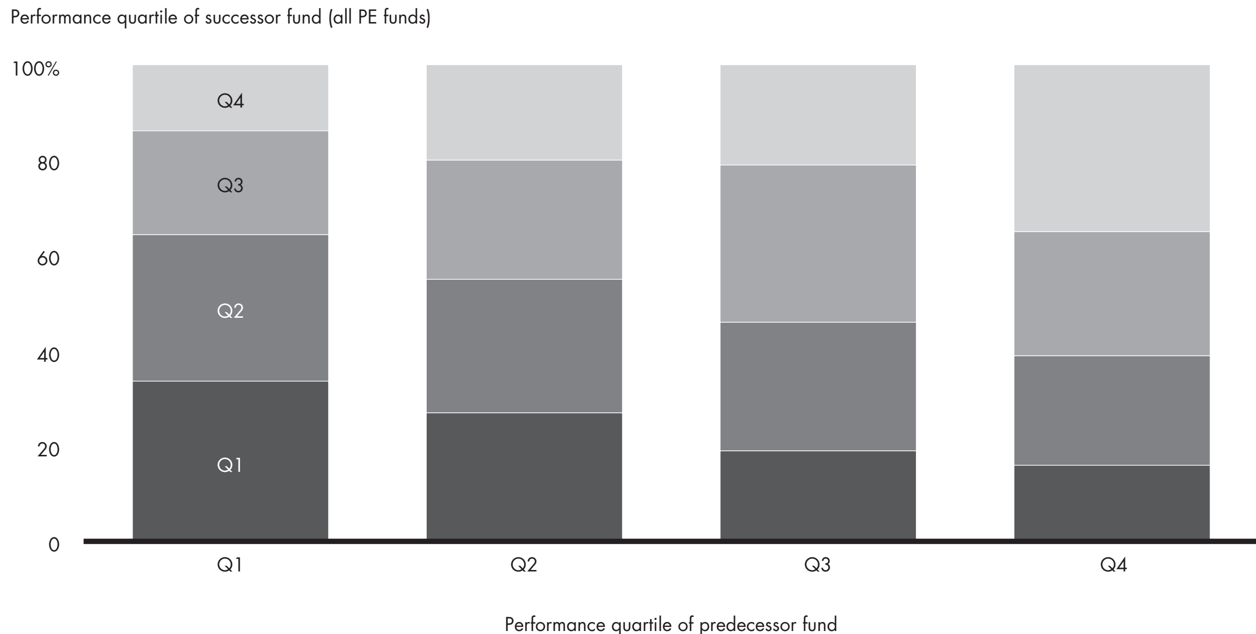
The second cluster of funds that generated industry-leading returns in what looks to be a repeatable way included those that swing for the fences, looking to hit a home run on every deal they do. And like big-league home-run sluggers, they strike out a lot. Comprising one-third of the funds in our sample, these heavy hitters earned multiples exceeding five times their invested capital on 15% of the deals they did, but they ended up with about as many money losers.

Figure 2.17: Top-performing funds offset their smaller loss ratios with far greater gains on more winning deals



Notes: MOIC = multiple of invested capital; includes US, European and Asian buyout funds of vintage years 1995–2006
Source: Bain analysis

Figure 2.18: The performance edge of top-performing funds persists through their successor funds



Note: Based on performance as of Q2 2013
Source: Preqin

PE firms that build a repeatable model for generating alpha are able to sustain their success across successive fund vintages. Using fund performance data through mid-2013, Preqin compared how well a GP's successor fund fared with its predecessor. They found remarkable performance consistency. GPs that managed one top-quartile fund had a probability of some 65% that their next fund would perform above average. Alpha-deficient GPs that managed an initial fund that placed in the bottom quartile faced a 61% probability that their successor fund would also be a subpar performer (see Figure 2.18).

In the brave new world where alpha rules, there are important lessons in these findings for GPs and LPs alike. With asset prices high and showing no signs of coming down, GPs will need to stretch every link of the value chain—from deal sourcing to exit—to steer clear of bad deals and spot deals that have peak-performance potential and to find ways to reap their full value. As we will see in Section 3 of this report, the leaders are building distinctive capabilities to sharpen their focus on where they choose to play and how they will win in a competitive environment that, above all, rewards PE firms that are best able to differentiate themselves. For their part, LPs that want to partner with winning PE firms need to tune up their radar for identifying alpha-generating skills and probing what makes them durable.

Key takeaways

- GPs will pay high prices for assets in 2014, as competition for deals will remain intense. The stockpile of dry powder GPs will be looking to deploy has been replenished, and a growing pool of "shadow capital" from institutional investors adds to the cache. Strong public market valuations and low-cost debt that is readily available to buyers will help keep sellers' price expectations high.

- Buyout deal count could go higher in 2014, but deal value may end up flat. Any new increase in deal opportunities would likely come from three sources: sponsor-to-sponsor transactions as the current installed base of PE-fund portfolio companies comes up for sale, minority-stake and partnership deals as GPs look beyond buyouts, and acquisitions of small and medium-sized businesses as GPs more deeply penetrate this much larger stock of companies. But with big public-to-private transactions unlikely in 2014, total deal value will not go up.

- While the overhang of unsold assets sitting in PE fund portfolios is still large, 40% is in "old" deals done in 2008 or earlier. Many of those earlier deals have had a partial realization or are held at a valuation above par. Strong exit channels will enable the liquidation of these ripe assets, assuming the pullback in the equity markets early in the year is not a sign of more turbulence to come.

- Fund-raising is poised to gather momentum in 2014. The rebound in PE returns has boosted LPs' already deep confidence in PE as their top-performing asset class. The increasing flow of distributions outpacing capital calls will provide LPs with the liquidity to act on that conviction. Many LPs will find themselves in the position of needing to aggressively increase their new commitments to maintain their PE allocation.

- Competition to raise new funds will remain ferocious. GPs on the fund-raising trail will confront the reality of persistent oversupply. Beyond a track record of solid performance, a stable leadership team, a compelling strategy and differentiated capabilities, GPs that hope to break through the crowd will elevate fund-raising and investor relations to a core competence.

- Alpha-generating skills are more important than ever to achieve superior PE returns. For the foreseeable future, the key sources of market beta—GDP growth, multiple expansion and leverage—will not supply the boost they did in the past. The more complex and volatile macro environment will require alpha skills to read the more perilous conditions and uncover the hidden pockets of opportunities turbulence creates.

- While alpha comes in many shapes and forms, the benefits consistently show up in three ways that explain the variance between top-performing funds and their lower-performing peers. Alpha-rich funds have a greater incidence of winning deals over losing deals, they win bigger with their winning deals, and they convert more large deals into big winners.

New macro challenges confront PE

For nearly three decades since the rise of the PE industry, PE firms made money by focusing on the microeconomics of businesses and letting the macro conditions take care of themselves. While investors focused on industry dynamics and company performance, macro factors such as currency movements, monetary policy, banking system trends, global trade trends, technological changes and demographics faded into the background.

The global financial crisis marked an emphatic end to that era. Macro now matters. The economic upheaval of the past several years vividly demonstrated how a PE fund can own a great company in a great industry, but when the macro environment shifts, macro trumps all.

A recent Bain & Company analysis of the factors that spelled success or failure across deals done by a range of PE firms disclosed that firms are vulnerable to two common macro-fundamental errors. First, firms misread the timing or sensitivity of deals to economic cycles. When the US housing market imploded, for example, many retail company owners were slow to realize how much general consumer spending was being supported by a rapidly deteriorating subprime loan market that was worlds away in the financial services industry. Second, firms overlook disruptive competitive, technological or other important shifts affecting their portfolio company's industry. Owners of bookstores, for example, failed to appreciate that consumers did not want books; they wanted to read. The introduction of new low-cost portable readers and better screen technologies quickly shifted consumers' preferences for how they access reading material.

PE firms have undervalued the need for macro analytical capabilities in due diligence and portfolio management, because until recently they were of minor importance. The PE industry came of age during a long period of remarkably stable growth, long economic cycles, and largely stable interest and exchange rates. But conditions have changed. While it is still uncertain how the next global cycle will evolve, key factors that sustained that long period of stable, moderate growth will no longer be in play. The nearly three-decade decline in long-term real interest rates is finding a bottom; rates may not rise much, but there is little room for them to fall further. China's one-time jolt to the global supply of labor dampened inflation and supported corporate profit margins; it is now done. The giant demographic wave of Baby Boomers is now past its peak spending years; their declining consumption will drag on growth for years to come in many markets.

In place of these engines of growth, powerful new forces are shaping the global economy. Large-scale asset purchases by the world's central banks are contributing to the already highly inflationary, bubble-prone environment brought about by decades of financial sector innovation. Global ties of finance and trade that formerly held inflation in check now transmit instability as the effects of national interest rate and foreign exchange management policies ricochet from one region to another.

PE firms cannot play and win in these new arenas by adhering to past decades' practices. In this environment, good macro due diligence is critical. But the art and science of macro-focused diligence is to filter out the distracting and misleading headline information and home in on the short list of factors that truly influence deal theses and returns.

To navigate the macro environment, leading PE investors should, at a minimum, do the following:

- **Identify hidden vulnerabilities—and unseen potential—of the deals they are considering.** Due diligence must go beyond torturing base-case scenarios to surfacing the critical macro factors that could influence an asset's value and the specific circumstances where their disruptive impact could be felt. In some cases, these may be obvious, like the effect a dramatic change in fuel prices would have on the transport industry. In others, they are harder to uncover. For example, a US-based midmarket fund weighed the acquisition of a Canadian company that was well-positioned in the oil and gas market. The fund's conventional due diligence confirmed the attractiveness of the potential deal. However, because the acquisition would be a non-US purchase, the investment team looked beyond company and industry specifics to investigate the deal's wider context. A careful analysis of the Canadian–US dollar exchange rate showed that the Canadian dollar was at the top end of its value range and highly likely to depreciate during the investor's holding period. This macro headwind contributed to the fund's decision not to invest—a decision that proved to be wise in light of the Canadian dollar's drop in value.

  Deals can also benefit from a confluence of macro trends. Shifting macro forces ended up working powerfully to the advantage of a PE fund that purchased a mass-market Indonesian commercial bank in 2008. A slowdown of growth in China led institutional investors to look for opportunities in other markets in the region—including Indonesia—where middle-class incomes were rising. The bank and its PE owners also benefited from a rush of capital unleashed following the quantitative easing of policies in the US and UK. The PE owners ultimately harvested the benefits of their macro bet when Japan gradually and unexpectedly re-emerged as an active investor in the region, reaping a 670% gain on the sale of part of its stake (with more gains to come in the future) to a Japanese financial conglomerate in 2013.

- **Evaluate risk-reward exposure across the entire portfolio.** Most PE firms still run their portfolios within rigid industry silos—consumer durables in one group, industrial services in another. But as they manage their investment portfolio with an eye to macro trends, macro-minded GPs will periodically scrutinize their holdings across industries in search of hidden correlations or common threads of potential vulnerability that may be influencing seemingly disparate businesses. For example, a large US-based PE firm with holdings in seemingly unconnected sectors—US logistics, workplace safety gear and Chinese e-commerce—discovered a strong underlying macro sensitivity to their common exposure to Chinese economic growth. An uptick in Chinese GDP pushes up the price of oil and other commodities, which in turn increases demand for rail and road transport to get around clogged distribution pipelines. Meanwhile, a quickening Chinese economy both increases sales of safety equipment used by factory workers and fuels the growth of e-commerce. The discovery that its highly diversified multinational portfolio actually shared a heavy single-market exposure required the firm to shift its strategy to achieve true diversification.

Macro forces will remain among the most important factors affecting PE returns over the economic cycle. PE firms that can best identify which ones will matter most, monitor them appropriately and understand their potential impact will best be able to achieve market-beating returns.

3. PE's new strategic imperative

PE firms have long prided themselves on their ability to grow and prosper through good times and bad. They have been quick to seize diverse investment opportunities, deft at sizing up the potential of new geographies and canny at managing their portfolio assets to maximize returns.

But the nimble tactical maneuvering that enabled them to surf through PE's cyclical ups and downs will not suffice in the more competitive post–financial crisis environment. As we observed in the preceding pages, the supply-and-demand balance has shifted, and PE firms find themselves caught in a vise. They control more capital but lack enough attractive deal opportunities in which to invest it, limiting the number of ways they can put their dry powder to work profitably. Meanwhile, GPs' appetite to raise new funds exceeds the amount of capital LPs are able to commit, making it hard to keep all GPs running at their current size. To avoid being crushed, successful PE firms will need to ramp up their strategic skills to stand apart from their peers.

Traditionally, the single-minded pursuit of growth has been all the strategy many PE firms felt they needed. PE firms heeded the growth imperative, offering attractive career paths and financial rewards to attract top talent and engaging the best external advisers and expertise. The engine of scale powered a virtuous cycle that enabled them to win more deals, generate superior returns and attract more capital. Their advantages of size enabled them to spread across geographies, broaden industry sectors, expand into new asset classes and participate in deals of every type.

Differentiate to grow. Growth still matters, but Bain believes that hewing to a growth strategy by itself is no longer a path to success open to most firms. PE is not a commodity business, and firms need to accentuate what makes them different and better. Generalists that have hit their benchmark returns in the past will find it hard to win over LPs that want to back firms whose distinctive approach reliably outperforms the average. Without deep specialization, they will also find it hard to muster the confidence to outbid rivals in hotly contested auctions and retool the assets they acquire to earn a good return.

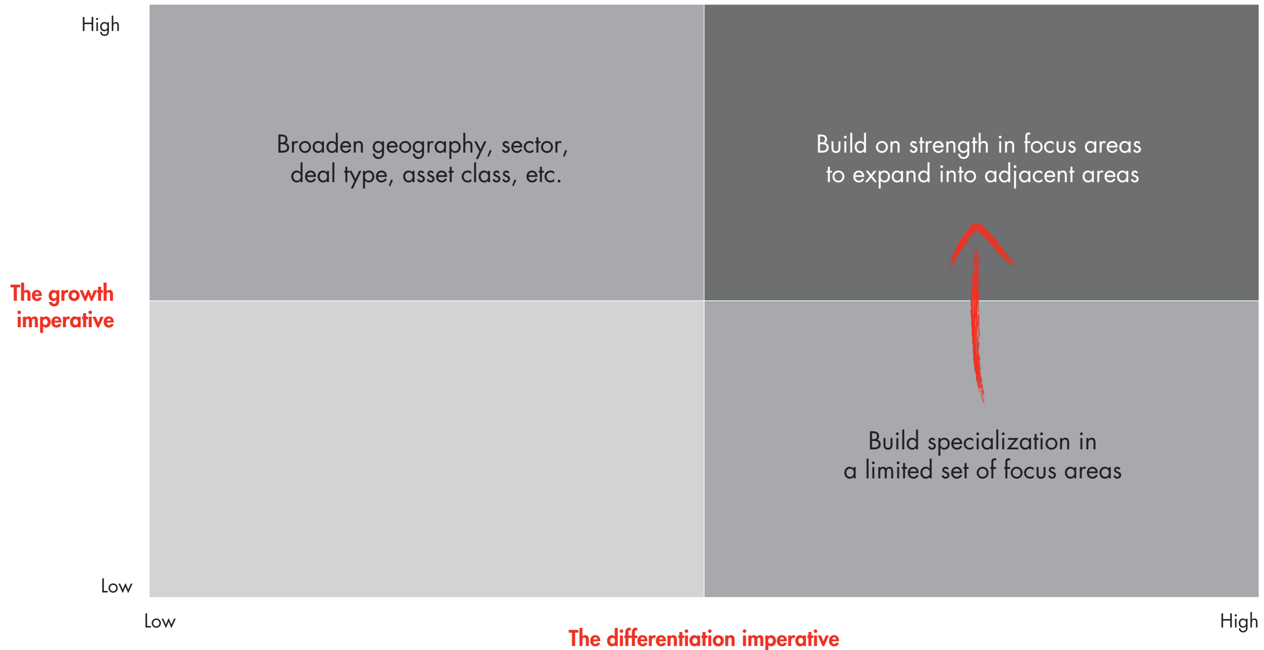
Firms most likely to deliver are those that differentiate themselves not by their raw size but through their relentless focus on being the very best in particular sectors, regions or types of deals. PE firms that march to the differentiation imperative capitalize on the extensive networks they develop in their area of specialization, nurture expertise throughout their talent pool and win recognition as the most respected brand in their niche.

Differentiation does not mean "forever small." A strategy built on differentiation is not in conflict with a growth strategy, but for those that will emerge as PE leaders, it is the most promising route to the same destination *(see Figure 3.1)*.

The surest path to growth for PE firms today is by first strengthening and deepening the capabilities that make them distinctive and building a repeatable model for sourcing deals, applying fresh insights before and after acquisitions, and cultivating superior returns over and over again. Differentiation breeds growth through demonstrated success that attracts more capital from LPs. It also points the way to sustained growth through moves into markets, sectors and deal types adjacent to the firm's core areas of strength.

A small group of firms like Apollo, Blackstone, Carlyle and KKR built global scale when the supply-demand balance tilted in GPs' favor and differentiation was not important. Those days are over (for the foreseeable future, at least),

Figure 3.1: Growth has been a well-worn path to success for years; now differentiation is required, too



Source: Bain & Company

and that path is closed to followers. PE firms in the next wave that follow only the growth imperative and ignore the differentiation imperative run the risk of being stranded in midstream—not yet big enough to enjoy the benefits of scale, on the one hand, and a little good at many things but outstanding at nothing, on the other.

Where to play. Leading PE firms can flesh out their growth-through-differentiation strategy by drawing a tight ring around the investment areas where they will hunt for the vast majority of their deals. The sweet spot for a particular PE firm may lie along any one of several dimensions—from industry sector or deal size, to the degree of control the firm seeks in the deals it does, to whether to focus primarily on growth opportunities, turnarounds or cyclical plays.

Defining the sweet spot is crucial. It spotlights the types of investments the firm's deal teams should pursue. By providing greater focus and knowledge of where to look, it enables deal teams to identify potential investments earlier and evaluate them faster and more thoroughly than other investors. It sharpens the firm's due diligence by highlighting the investment themes and core issues that need to be tested in every deal. It takes advantage of the firm's experience and expertise, enabling deal teams to stretch their bids to win deals they are best qualified to convert into winners. And it guides the firm's multiyear, internal investments to build capabilities it will need to reinforce its distinctiveness or move into attractive adjacencies as the firm grows.

Through our work with leading PE firms, we have found that getting the sweet spot right is one of a PE firm's most consequential decisions. Defining it too narrowly can result in a shortage of deals. Defining it too broadly can undermine clarity, resulting in poor investment decisions and organizational confusion. Combining breadth and specificity, for example, Silver Lake Partners focuses on buyouts in the tech sector, backing businesses it identifies as having huge growth potential. For its part, Triton Partners focuses on Europe's German-speaking and Nordic markets, looking for businesses it can turn around in three core sectors—industrials, business services and consumer.

The rewards reaped by firms that carefully articulate their investing core and stick to it can be profound. Bain's analysis of the portfolio returns of one major PE firm found that when it invested within the boundaries of its sweet spot it generated returns that were 2.2 times invested capital, vs. just 1.3 times when it strayed. Moreover, nearly one-quarter of the GP's sweet-spot deals returned more than three times invested capital compared with just 5% for its opportunistic deals.

How to win. Circumscribing an attractive, target-rich hunting ground alone is not enough. Successful firms not only draw a map around the territory where they will concentrate their fire, they also develop an angle for how they will attack it. Avoiding just a few underperformers can have a dramatic, positive effect on a fund's total returns. Bain estimates that a GP that can convert just one deal out of 10 in its portfolio from a money loser to one that returns more than three times the initial investment would boost its overall fund IRR by a full three to four percentage points.

The angle that will improve a firm's odds needs to be grounded in a deep understanding of what it takes to succeed in the sweet spot and consistent with what the firm has been good at historically. For example, the winning angle for a PE firm that puts companies with strong industry fundamentals in the crosshairs of its sweet spot will be to aggressively play industry cycles, apply rigorous due diligence to weigh industry opportunities and risks, and use capital market conditions to time when to sell. Another firm, by contrast, draws its sweet spot around companies that present cost-cutting opportunities and is willing to do turnarounds. Its angle of attack is to deploy its deep-sector expertise and tap the cost reduction and turnaround skills of its large operations group.

Bain has helped PE firms undertake a comprehensive, 360-degree assessment, both to capture the positive interplay of where-to-play and how-to-win decisions most quickly and to build enduring competitive advantages. Honest and fact-based, the process looks internally at the firm's strengths, weaknesses, opportunities and threats. It probes the team on where they think they stand out, where they see the greatest opportunities in the future and where they have greatest appetite. Then, looking externally, it benchmarks where the firm stands relative to its leading competitors, relying on interviews with LPs and other stakeholders to get a candid, outside-in view.

Some of the sharpest insights come from a detailed, deal-by-deal forensic diagnostic of the sources of the firm's winners and losers. This analysis scours past deals to lay bare the underlying factors that account for the GP's successes and failures. For example, a European PE firm used more than 50 hard and soft metrics it developed from internal data and interviews to appraise outcomes of previous deals. The process unearthed six winning factors common to the best deals and seven warning signs shared by underperformers. The firm added these newly identified "green" and "red" criteria to its due diligence checklist, making it better able to screen for good and bad deals.

As they apply insights they develop from the assessment, leading GPs pinpoint ways to strengthen their investment processes specifically tailored to where they will play and the angle of how they will win across every link of the PE value chain. They can improve deal sourcing by taking advantage of their deep sector expertise and extensive advisory network to pursue targets proactively. They bring rigor and structure to their due diligence and investment committee processes, screening potential acquisitions for the specific markers that characterize good and bad deals within the firm's sweet spot. They elevate their portfolio management by getting a fast start integrating an acquired company's leadership team, executing on their plans to add value and anticipating how to intervene at the first sign of trouble. They build their exit strategy into their ownership plan from the outset, hardwiring exit review into their portfolio management processes, engaging the management team as allies in planning their exit options and developing an actionable plan to realize the assets' full potential. At a time when PE holding periods are stretching longer, nimble GPs that master the exit strategy will have a big advantage reaping top returns.

Most GPs that put themselves through this exercise are able to tighten the alignment between where they play and how they will win by refining their sweet spot and incrementally investing to reinforce their investment disciplines. PE firms that parlay their core capabilities by making them a platform for growth will deliver superior returns and steadily pull away from their rivals. The differential skills a firm brings to bear in its approach to investing through deal after winning deal become baked into its identity, further strengthening its competitive position in the war for talent, the campaigns to raise new funds and the battles to lock in the most promising deals.

Five questions to guide your firm's future strategic path

In Bain's experience, PE firms that undertake the challenge of pursuing growth through differentiation embark on the journey by asking and answering the following questions:

1. What is your desired trajectory along the growth and differentiation dimensions?

2. What common features did your past deal successes and failures share?

3. What is your deal sweet spot, and how attractive are the opportunities it presents for future investments and returns, given market conditions and competitive dynamics?

4. What will be your angle for generating superior returns in your deal sweet spot?

5. What do you need to do to reinforce your firm's distinctive capabilities and address the weak links in your investment processes?

Key contacts in Bain's Global Private Equity practice

Global: Hugh MacArthur *(hugh.macarthur@bain.com)*
Europe, Middle East and Africa: Graham Elton *(graham.elton@bain.com)*
Americas: Bill Halloran *(bill.halloran@bain.com)*
Asia-Pacific: Suvir Varma *(suvir.varma@bain.com)*

Please direct questions and comments about this report via email to *bainPEreport@bain.com*

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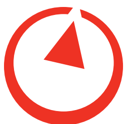

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