Global Private Equity Report 2011

BAIN & COMPANY

Content: Lou Richman, Elaine Cummings
Layout: Global Design

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Private equity in 2011: A new beginning?

Dear Colleague:

Welcome to Bain & Company's Global Private Equity Report for 2011. Building on the extraordinary success of our 2010 report, we have worked hard to sift through the complicated forces that buffeted PE markets in 2010 and will continue to shape them in 2011. This report is our interim analysis of what lies ahead.

We begin with a review of 2010, a mixed year in many respects. Deal making began to recover from 2009 lows, with plenty of dry powder, good-quality assets and available credit laying a foundation for higher levels of investment. At the same time, inflated asset prices driven by high public-market comparables, intense competition and sellers' sticky price expectations prevented many transactions from reaching conclusion. In fund-raising, the news was almost universally poor, as new capital raised hit a cyclical low. While this was not unexpected given the lag effect of limited partners' (LPs) funding commitments, the weak exit market during the first three quarters of 2010 continued to bode ill for fund-raising in 2011. Hope for a fund-raising recovery arrived in the fourth quarter as exit markets opened up—perhaps a harbinger of better conditions ahead. Returns also rebounded, but the lack of liquidity overall for 2010 left many LPs scratching their heads about the true value of their PE holdings.

Our view of the 2011 global PE markets must take into account not only the conflicting forces at work in 2010, but also the continued fragility of the global economic recovery and credit markets. Market indicators clearly point to stronger PE activity across the board in 2011: More deals will be consummated, more deals exited, returns will be higher, LPs will commit more funds for future transactions. However, stronger PE markets remain just one major geopolitical problem or sovereign debt crisis away from being derailed. When assessing the world of PE over the coming year, our watchwords of the day are "cautious optimism."

Bain also firmly believes that the credit crunch of 2008 and the Great Recession have unleashed forces that will fundamentally change the PE industry over the next decade. General partners (GPs) and limited partners alike are both reexamining enduring strategies and long-held beliefs about PE as an asset class and how to play to win. Private equity has long been a cyclical business—whether driven by conglomerate breakup values and junk bonds in the 1980s, expanding multiples on the back of strong equity markets in the 1990s or credit market-enabled multiple expansion in the early 2000s. Whatever the cause, there has always been a healthy market beta driving returns along. Not seeing much evidence of market beta today, Bain believes future PE returns will be shaped more by alpha, that is, the actions taken by GPs themselves. Bain's research shows that most of what can be called alpha will be created by four interrelated factors: (1) having a well-defined PE strategy; (2) professionalizing organizations and positioning them to win; (3) creating truly proprietary investment theses supported by rigorous due diligence; and, very critically, (4) building real, repeatable value-creation processes that run through the life cycle of an investment partnership.

We hope you enjoy Bain's private equity report. As always, we look forward to continuing our dialogue and our work with private equity stakeholders around the world.

Hugh H. MacArthur
Head of Global Private Equity

1. The PE market in 2010: What happened

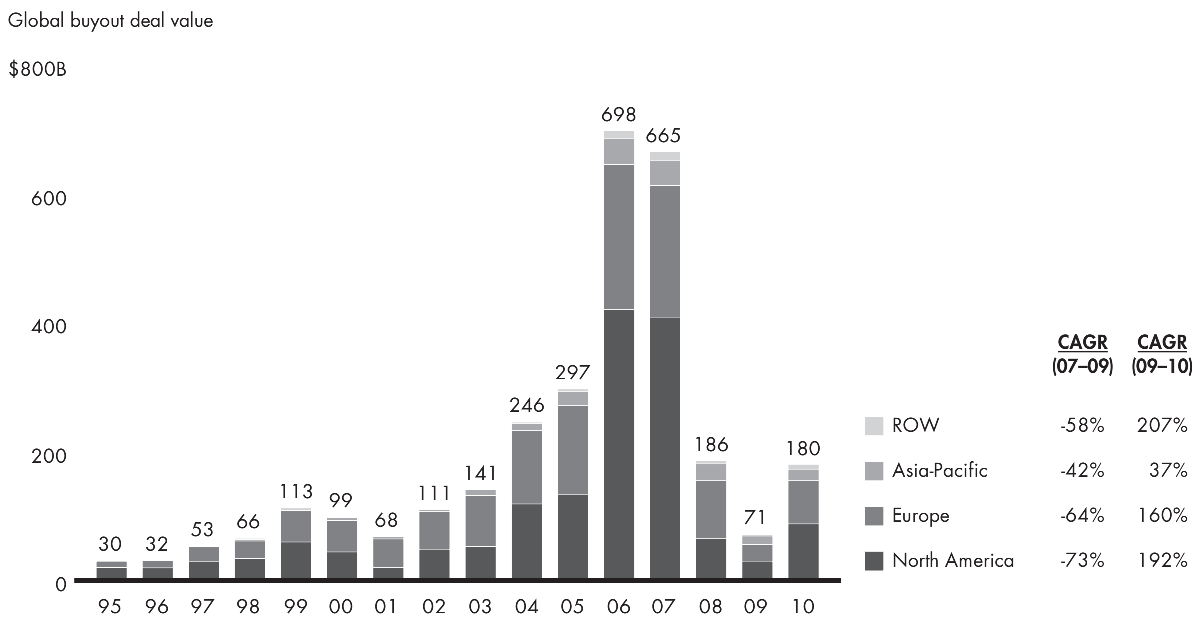
Private equity emerged in 2010 from the steep decline that followed the global financial meltdown and economic recession, looking very much like the kind of recovery that characterized rebounds from the industry's past cyclical downturns. According to data provider Dealogic, announced buyout deal value totaled $180 billion for the year worldwide, with big gains in deal activity in all major markets. In North America and Europe, the epicenter of the global credit crisis, deal values were up 192 percent and 160 percent, respectively, from the cyclical trough. Deal making in the Asia-Pacific region, too, resumed its strong growth as PE firms and their investors continued to lavish attention on that hot growth market (see Figure 1.1).

But beneath these signs of renewed strength are powerful cross-currents that mark an industry in the throes of profound changes, which, as we will see in the pages of this report, will shape what happens in 2011 and beyond. In nearly every aspect of the PE deal life cycle—from the kinds of transactions being done and the timing and nature of exit activity to the changes limited partners (LPs) are making to the ways they invest in PE and their commitments for future rounds of fund-raising—we see new forces at work that will challenge PE firms and the LPs that invest with them for years to come.

Investments: A healthy recovery

Indeed, there are few familiar landmarks on the changed landscape of the industry's past year—beginning with that healthy-looking pickup in deal activity. When viewed in the context of PE's size and scope, the

Figure 1.1: Strong recovery in global buyout deal activity



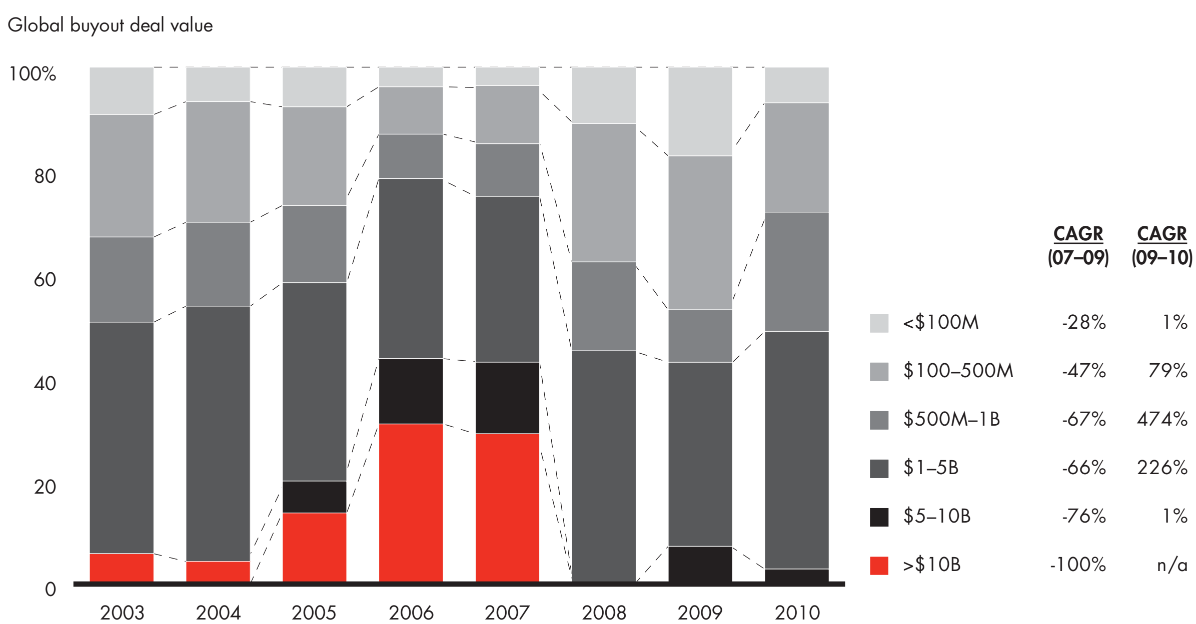
Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on the location of targets
Source: Dealogic

past year's solid rebound could have been more robust. Heading into 2010, PE firms were sitting on approximately $500 billion in capital earmarked for buyouts worldwide—a keg of "dry powder" that would suggest a far higher level of investment than we saw. Coming out of the previous cyclical downturn in 2003, in contrast, the industry posted announced deals totaling $141 billion generated on a far smaller base of dry powder totaling just $193 billion.

Given the uncertain outlook for the economic recovery and weak consumer balance sheets, PE funds were inclined to favor industries that are less exposed to cyclical swings and have brighter longer-term prospects. Thus, in a survey undertaken in early 2010, PE fund general partners (GPs) and advisers were looking to see significant increases in investment opportunities in healthcare and the energy sector. As the year unfolded and confidence in the durability of the recovery firmed up, however, PE investments touched all sectors of the economy from industrial goods and retail to financial services and technology.

Bigger deals also began to show signs of returning to fashion in 2010, with buyouts in the $500 million to $5 billion range bouncing back the fastest. After dropping by nearly 90 percent in total transaction value between 2007 and 2009, deals valued between $500 million and $1 billion rebounded nearly sixfold in 2010 from their 2009 cyclical floor. Deals in the range between $1 billion and $5 billion more than tripled over the same period. These buyouts clustered in the upper end of the mid-market accounted for nearly three-quarters of total global deal value in 2010. Continuing to reflect more sober times, however, 2010 saw only one of the multibillion-dollar megadeals valued above $5 billion that seemed to grab headlines weekly during the peak of the PE cycle between 2005 and 2007 (see Figure 1.2).

Figure 1.2: Deals in the $500 million–$5 billion range bounced back



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

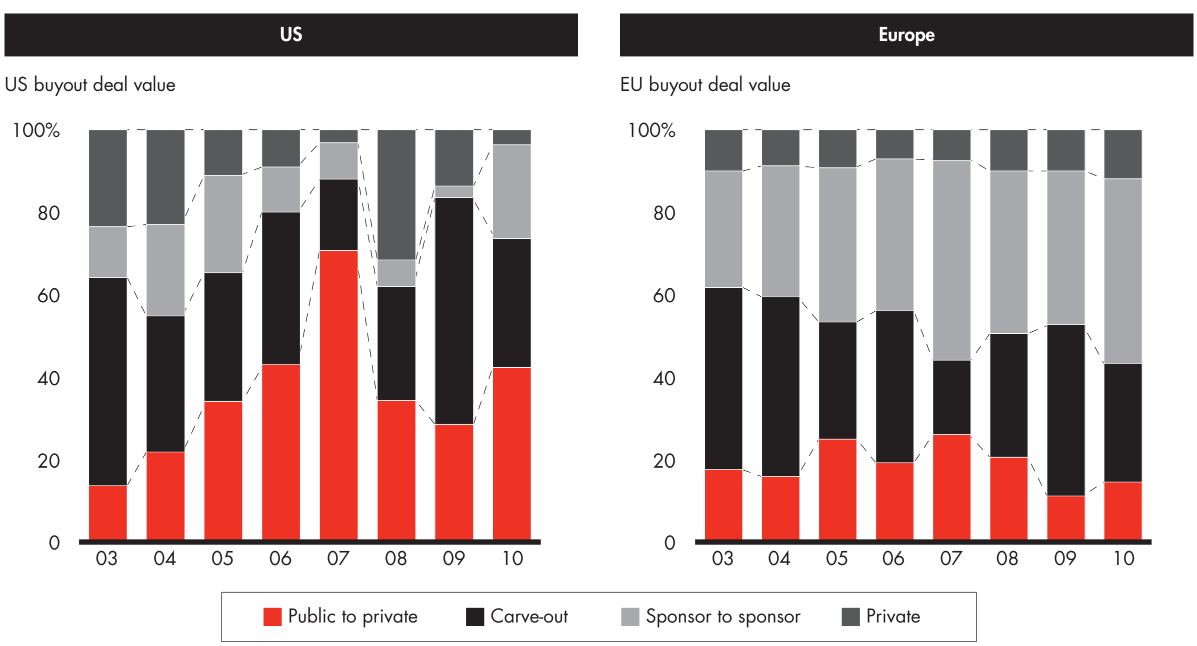
There was also a shift in the kinds of deals that closed in 2010, particularly in the US. Taking public companies private and acquiring assets from other PE funds in sponsor-to-sponsor deals (also commonly referred to as secondary buyouts) were back in vogue in 2010, displacing carve-outs and private-company deals, which were more prevalent in 2009 (see Figure 1.3). Public-to-private (P2P) buyouts dominated the year's list of biggest PE deals. Biggest among them: the pending acquisition for $5.3 billion of Del Monte, the iconic food and pet products company, by KKR, Vestar and Centerview.

In Europe, sponsor-to-sponsor deal activity, traditionally strong, also accelerated. The shift has attracted considerable media attention—and controversy. We will explore the debate about whether a pickup in sponsor-to-sponsor deals represents a healthy industry trend later in this report. But for now it is worth pointing out that the increase has not been exceptional. Sponsor-to-sponsor buyouts accounted for 45 percent of total European buyout value in 2010, up marginally from an average of 39 percent between 2004 and 2007.

Private equity deal making in 2010 was shaped by the interplay of three major forces, often working at cross-purposes, both to push deal activity aggressively forward and to rein it back in. Let's examine each of these factors and the dynamics they unleashed during this past year:

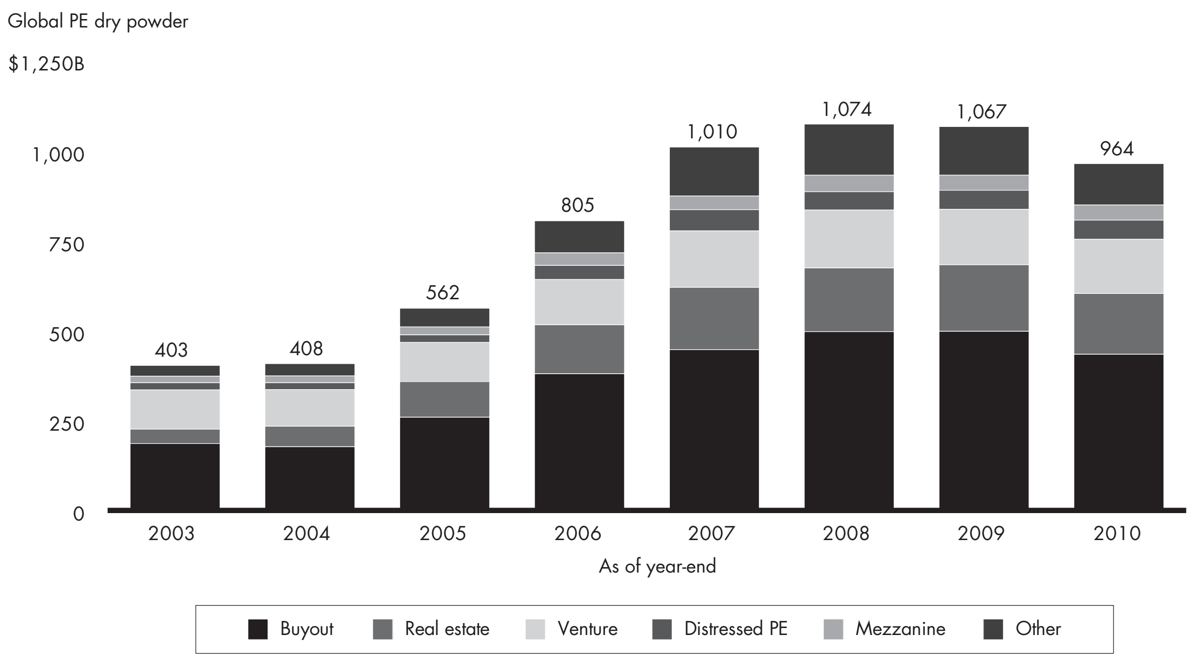
Motivated general partners . . . and reluctant ones. Capital is the fuel that powers deal making, and PE funds in 2010 were topped up. Going into 2010, PE firms wielded more than $1 trillion in dry powder—about half of it slated for buyouts. By itself, this vast sum was a powerful driver of deal activity (see Figure 1.4).

Figure 1.3: Carve-outs gave way to public-to-private and sponsor-to-sponsor deals



Notes: For US: Represents control buyout transactions by US-based firms; closed deals only; represents year deals were closed.
For Europe: Represents buyout transactions where target is based in Europe; represents year deals were announced
Sources: Bain US LBO deal database; Bain European LBO deal database

Figure 1.4: PE firms wielded $1 trillion of dry powder



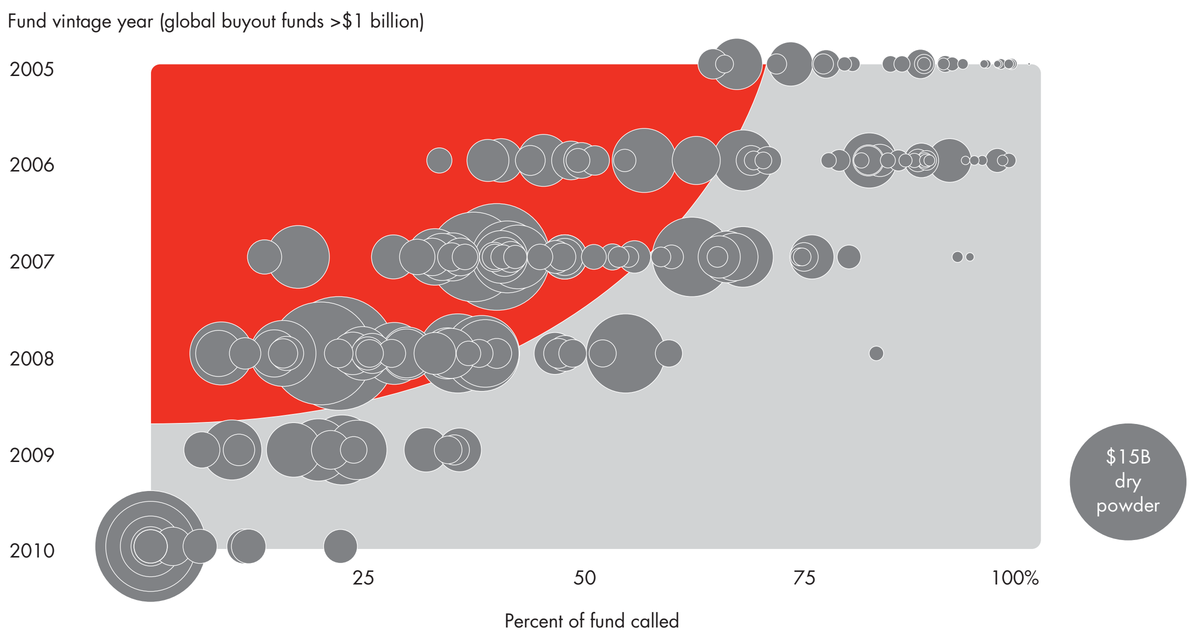
Note: Distressed PE includes distressed debt, special situation and turnaround funds
Source: Preqin

Adding to its force was the ever-increasing number of active PE firms scouting for investment opportunities. Now numbering more than 4,100 and joined by several hundred new entrants each year, the industry has more than doubled in size over the past decade. For many in that crowd, the need to put their capital to work is becoming urgent: Their dry powder is aging. Because PE funds typically have an investment period of between four to six years, the large amount of capital committed in the boom years of 2005 through 2007, but not yet invested, will expire over the next 12 to 24 months. GPs that fail to put that capital to work could end up paying a price in terms of lost management fees on invested capital they would typically collect when the investment period expires.

Because of that aging dry powder, the clock was ticking at many PE firms in 2010. Indeed, Bain & Company's analysis reveals that more than 40 percent of buyout funds larger than $1 billion, representing 55 percent of dry powder for these funds, were likely under significant pressure to put capital to work over the course of 2010. These included 2005–2007 vintage funds that had called less than two-thirds of their committed capital and 2008 vintage funds that had called less than one-third (see Figure 1.5).

With that pressure weighing on them, GPs jumped at the signs of an improving PE climate to seek out investment opportunities, dramatically intensifying competition for deals. In a survey done in the first quarter of 2010 of 120 PE executives by the accounting firm EisnerAmper LLP, more than 60 percent of respondents said they saw a marked increase in competitive bidding over the previous year. Competition has been especially strong in the middle market, as large funds also went shopping in this space. Bain analysis finds that large buyout funds accounted for a growing share of the deals valued between $100 million and $500 million in 2009 and 2010.

Figure 1.5: Buyout funds felt pressure to put capital to work



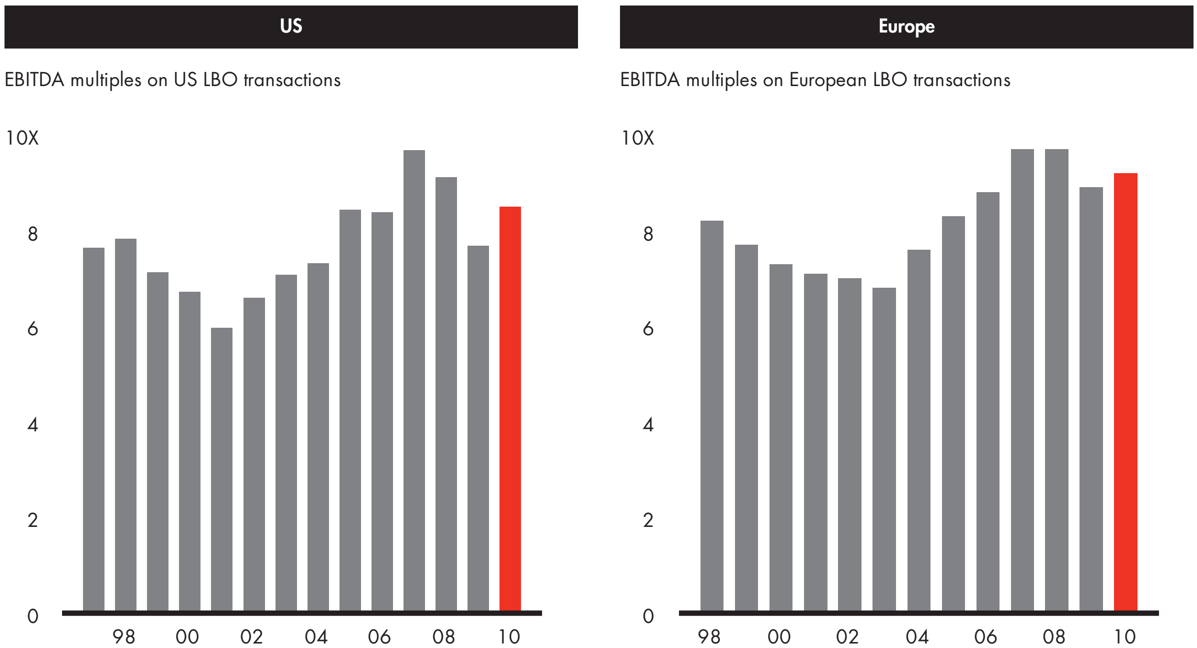
Notes: Includes buyout funds vintage 2005 and later that have held a final close; excludes funds with insufficient data; vintage year refers to year of initial investment; based on most recent performance data available, primarily as of Q2 2010
Sources: Preqin; Bain analysis

Stiff competition for leveraged buyouts (LBOs) made acquisitions pricey—one of the biggest issues defining the PE industry in 2010. At 8.5 times earnings before interest, taxes, depreciation and amortization (EBITDA) in the US and 9.2 times in Europe, purchase multiples on LBOs completed during the past year were back up to levels not far below where they had been at the cyclical peak in 2007 (see Figure 1.6). Although accurate data are hard to come by, we hear from GPs active in Asia that purchase multiples have become very rich, too. The escalation in prices came off an already surprisingly high level during the depths of the credit crisis and economic slowdown in 2009. (Price multiples were still running at 7.7 times EBITDA in the US and 8.9 times in Europe in 2009, well above the low of between six to seven times EBITDA they tumbled to during the last downturn.)

The rapid recovery in public market valuations in 2009 and their continued momentum in 2010 triggered two dynamics that affected pricing: First, it set the base on which acquisitions are priced at a higher level than it had been coming out of prior recessions. Also, it did not allow sellers' price expectations to reset. Along with so many potential acquirers eager to do deals, these factors drove prices to unexpected heights.

As they watched acquisition values being bid up all around them, both leading GPs and LPs that Bain interviewed were openly dubious whether buyers would be able to reap returns that justified what they were required to pay. "I haven't met anyone who can explain why prices are so high from an economic point of view," said a European private pension fund manager. "A lot of deals are so brutally competitive that unless you have real insight into the company before it comes to market, you haven't got a prayer," said the CEO of a major global PE firm. "And if you do win it, you had better worry."

Figure 1.6: LBO purchase multiples climbed back up in 2010



Note: Based on pro forma trailing EBITDA
Source: S&P LCD

That skepticism bred healthy caution on the part of many PE funds in 2010. For one thing, they focused on buying high-quality assets—companies that weathered the economic downturn well, had promising growth prospects and faced limited market and operating risk. Ongoing economic uncertainty, successive downward revisions to gross domestic product (GDP) and the sovereign debt crisis made it difficult for would-be acquirers to get comfortable with the downside risks or have much confidence in the upside potential of lower-quality assets. PE firms also needed to look no farther than their own portfolios to find reasons to temper their willingness to take risks. Having nursed many of their portfolio companies through the economic turbulence—and likely needing to continue to do so going forward given the tepid recovery and lengthening investment holding periods—many firms were reluctant to tax their stretched portfolio resources further by adding assets of more questionable quality to the mix.

In a year of high prices, smart investors were also cautious not to overpay. PE firms brought a higher level of scrutiny to potential deals they were offered, conducting very thorough due diligence to develop the proprietary insights required to identify the upside opportunities in any target company that would warrant their stretching to win an auction.

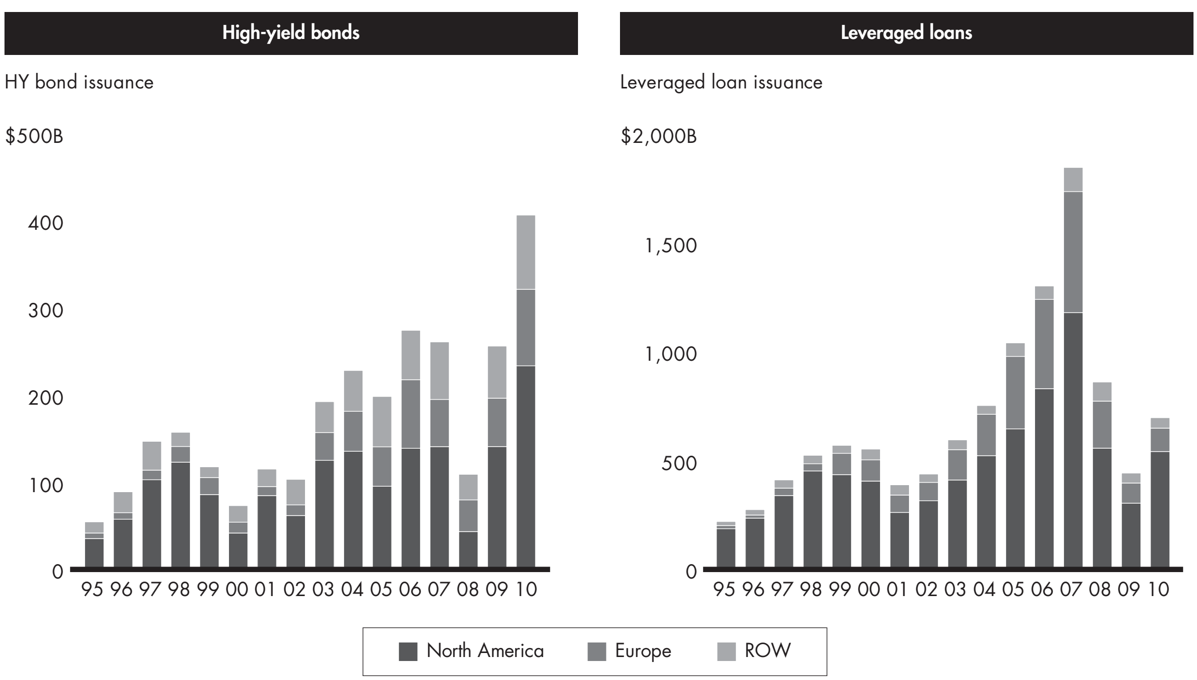
While many PE firms were cautious, others held back altogether. Feeling less pressure to deploy capital in the high-priced market, funds with dwindling dry powder chose to keep some in reserve to finance portfolio company needs through the recovery and avoid having to raise new capital under difficult fund-raising conditions.

Stronger debt market . . . but picky lenders. Freer-flowing speculative-grade debt was another lubricant for PE deal making and an enabler for PE firms to refinance their portfolio companies in 2010. Building on momentum that began in late 2009, the issuance of high-yield bonds started the year strong and ended at a record level. Riding in the slipstream of the strong bond market, leveraged loans also rebounded, especially in the US (see Figure 1.7). But the year was not uninterrupted smooth sailing. Demand for speculative-grade debt slumped sharply last spring as banks and debt investors were whipsawed by credit-market volatility, sovereign debt problems in the euro zone, geopolitical tensions and fears of a double-dip recession. The market made a strong comeback in the summer and fall once investors regained their footing.

Strong demand for speculative-grade debt was buoyed by investors looking for yield in a declining interest-rate environment. Thanks to central bank quantitative easing, yields on lower-risk debt instruments like US Treasuries, longer-duration US government bonds and even emerging-market bonds fell to record lows in 2010. Returns on equities, meanwhile, remained problematic in a sluggish economy. To boost returns, investors were forced to extend duration or move up the risk curve (see Figure 1.8).

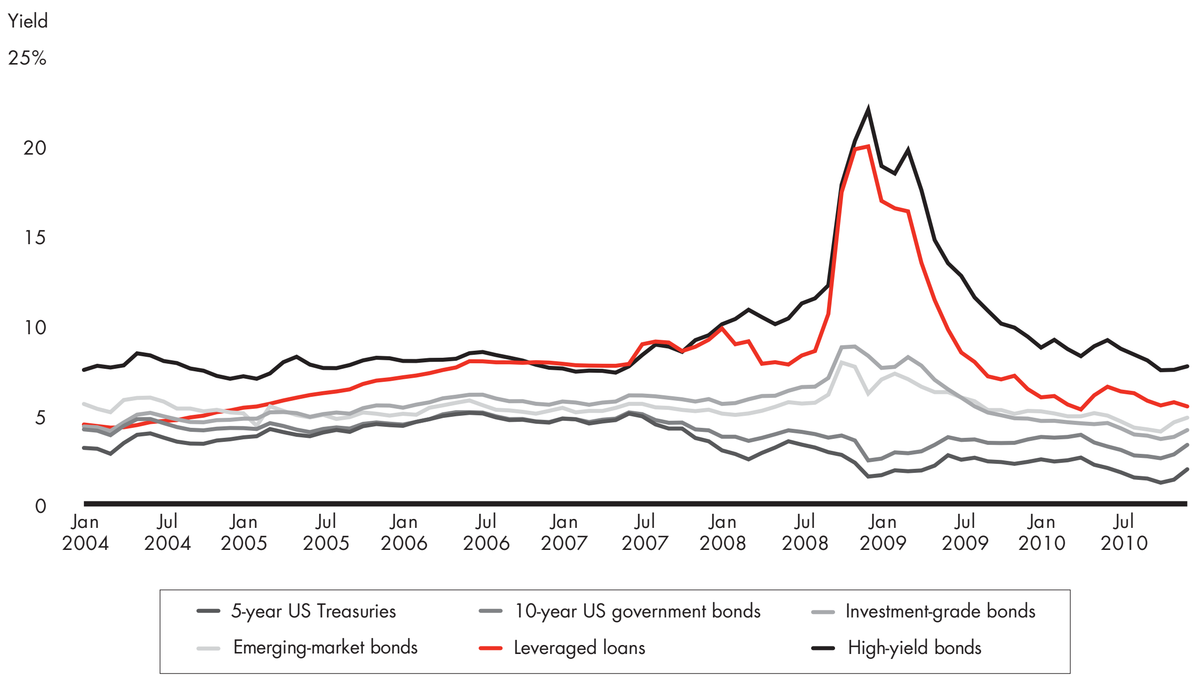
Collateralized loan obligations (CLOs) continued to play a major role in fueling institutional leveraged-loan demand over the past year, capturing nearly 45 percent of new issuances in 2010. One important driver was the recycling back into the primary loan market of repayments that legacy CLOs still in their reinvestment period received. Those repayments came from two primary sources: The first was a rise in bond-for-loan takeouts as the high-yield bond market rallied and issuers moved to secure the refinancing of their debt. A second source was an increase in partial or full pay-downs of loans as companies sought to reduce leverage. Other big yield-hungry investors, such as hedge funds and high-yield and loan mutual funds, also fueled demand for leveraged loans, together snapping up another 47 percent of available supply. Overall, demand was so strong that many of the new loan issues were oversubscribed.

Figure 1.7: Primary market for speculative-grade debt was unexpectedly robust



Source: Dealogic

Figure 1.8: Investors' search for yield buoyed strong demand



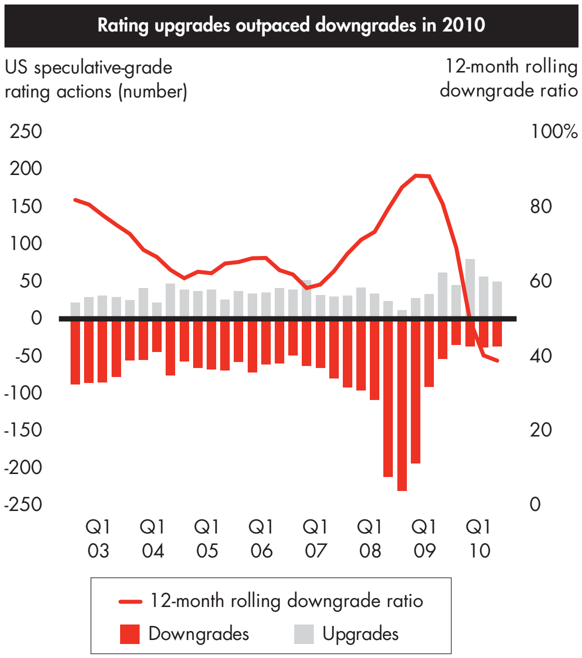
Sources: Haver Analytics; Bank of America; Merrill Lynch; PIMCO; S&P; LSTA

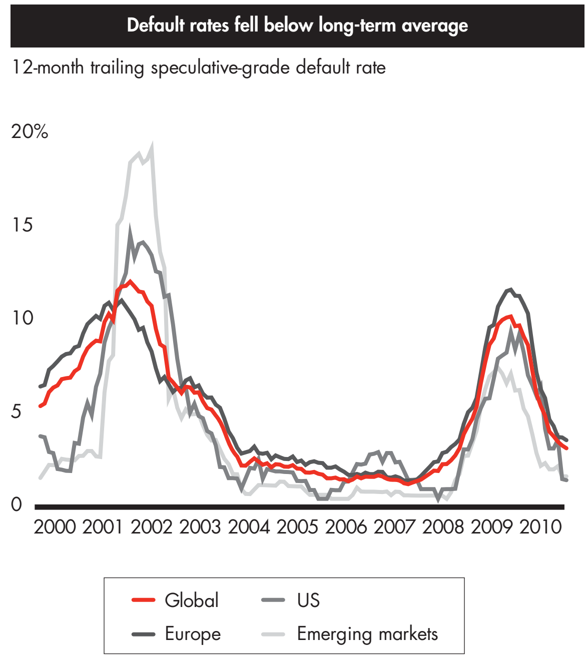
The resurgence in demand for high-yield bonds and leveraged loans was a boon for issuers, as the debt market opened up to riskier deals. Indeed, as investors pursued greater yields, they gravitated toward ever more speculative-grade securities. More risk-tolerant investors were willing to pour money into lower-quality companies. Credit was also more available for LBO deals looking to finance with a higher proportion of leverage. The loan markets were even willing to tolerate less prudent uses for borrowings such as dividend recapitalizations. The market also saw the re-emergence of covenant-"lite" and second-lien loan structures, enabling borrowers to ease balance sheet pressures.

Investors' increasing appetite for risk came during a time of overall improvement in credit-quality trends. The number of ratings upgrades of speculative-grade debt by Standard & Poor's significantly exceeded the number of downward revisions since the final quarter of 2009, leading to a steep drop in the 12-month rolling downgrade ratio to less than 40 percent in the latter part of 2010. The stronger ratings mirrored a steep and speedy decrease in default rates on the speculative-grade debt held by corporations. During this cycle, it took less than two years for defaults to rise from the baseline 5 percent level to the cyclical peak and then return to 5 percent in the US. Over past cycles between 1989 to 1992 and 2000 to 2004, that default round-trip lasted 3.3 years, on average (see Figure 1.9).

These remarkably healthier credit conditions gave PE borrowers readier access to more generous levels of debt to finance LBOs in 2010. Debt multiples on LBO transactions concluded in 2010 edged back up to 4.6 times EBITDA in the US, from a cyclical low of 3.8 times in 2009. In Europe, transactions reached debt multiples of 4.4 times EBITDA, on average, up from four times in 2009. Equity contribution (including rollover equity) in the US, meanwhile, retreated to an average 44 percent (from a cyclical peak of 51 percent

Figure 1.9: Increasing appetite for risk came during a time of improving credit-quality trends





Note: The downgrade ratio represents the number of downgrades as a proportion of total number of rating actions
Source: S&P

in 2009) and fell back to 51 percent on European LBOs (from their peak of 53 percent in 2009). While markedly higher, these leverage levels remain conservative compared with boom-time highs—reassuring to market observers worried that conditions have become too frothy.

The all-in cost of LBO loans dropped significantly in 2010 as risk spreads dropped from their post-Lehman crisis levels in 2008 and 2009. Furthermore, with the London Interbank Offered Rate (LIBOR) falling to historic lows following the financial crisis, LBO debt financing in 2010 cost less, albeit only marginally, than it did at the height of the boom times.

Despite some easing in lending, banks remained cautious and picked their bets carefully. Their eagerness to extend credit was reined in by the uncertain impact of looming new regulations. A survey of lenders by Thomson Reuters in September found that only about one-quarter were unconstrained in their ability to provide financing for new deals. A large majority—some 60 percent—responded that constraints remain, although they were lending selectively.

In the US, ambiguity surrounding the newly passed Dodd-Frank Wall Street Reform and Consumer Financial Protection Act left banks apprehensive about having to retain on their balance sheets a larger stake of the loans they originated. In both the US and Europe, concerns over increased capital and liquidity requirements under the Basel III framework made banks more circumspect about lending. Therefore, only high-quality assets could secure financing from banks that were comfortable with the operating performance of the businesses they were backing.

Attractive assets to acquire . . . but deals have been hard to close. With PE funds flush with dry powder, corporate balance sheets carrying record levels of cash and credit markets obliging, conditions could hardly have been more propitious for motivated sellers of choice assets. Valuations on potential target companies were relatively rich coming out of the recession, and volatile public equity markets gave sellers every reason for wanting to act while prices remained high. Uncertainty about the pace and durability of the economic expansion and fears of a double dip also added to sellers' eagerness to lock in gains while they could. PE funds added to the supply of deals by harvesting their so-called pregnant exits, or assets that had gestated through the downturn and were ready to be sold for a good profit.

Meanwhile, would-be sellers of less attractive assets chose to wait on the sidelines, tightening the supply of potential deals. Some were still adjusting to the new economic reality or were waiting for the economy to pick up to get back on the growth track. Others were not yet able to demonstrate that they had stabilized their performance and hoped to book a few more good earnings quarters before coming to market.

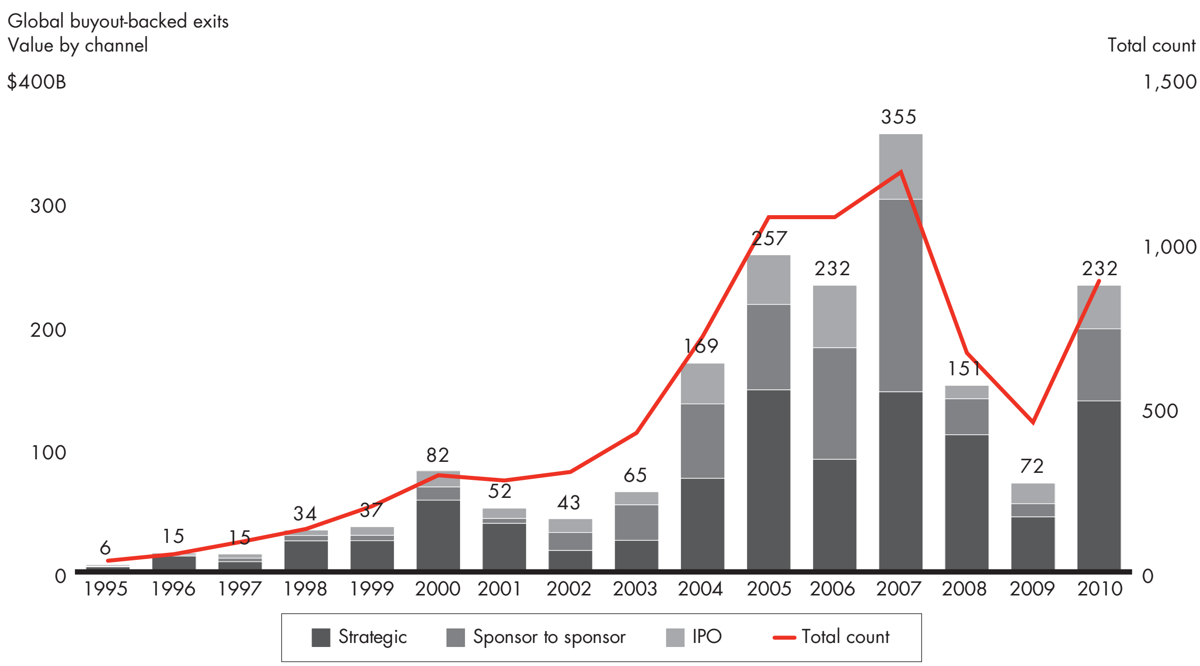
Still, with so many motivated buyers and sellers, why did not many more deals come to fruition? Banks played a gatekeeper role, preventing all but the highest-quality assets from securing financing. In many instances, lower-performing companies that could not get an "indication of interest" from the banks were not put up for sale at all. But a bigger fact was simply that many sellers' price expectations were high and inflexible. Fueled by strong market valuations and the rich premiums buyers were willing to pay, they drove hard bargains and were backed by their shareholders who rebelled against conceding on price. A survey of 75 PE firm general partners in early 2010 found that acquisition prices that ultimately did clear the market in 2010 were far higher than GPs' expectations, with multiples stretching to 8.5 times EBITDA last year compared with 7.7 times in 2009. For their part, nearly three-quarters of the GPs said they were looking to pay multiples in the range of five to seven times EBITDA. The GPs do not expect that price stickiness to change much going forward. Survey respondents cited sellers' "unrealistic" valuation expectations as the biggest challenge for 2010 and 2011.

Exits: A solid pickup in activity

As with deal making, exit activity rebounded strongly from depressed 2009 levels. Both in terms of the number of sales completed and the total value realized worldwide, exits in 2010 showed signs of a solid recovery (see Figure 1.10). Even better, GPs saw opportunities to sell their previous investments improve markedly throughout the year. As concerns over a double-dip recession or a collapse of the European banking system ebbed, buyers of PE assets—corporations, public market investors and other PE firms—grew more confident and found common ground with PE sellers' price expectations (see Figure 1.11).

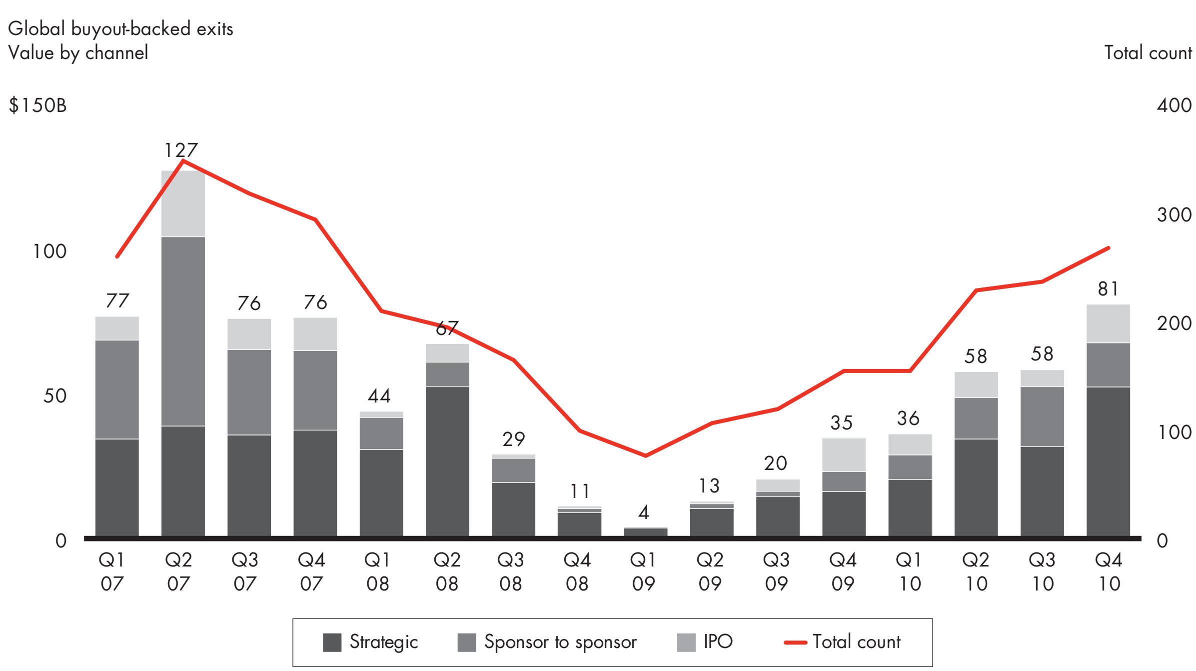
Certainly, GPs were highly motivated to close out their ripe portfolio holdings and burn through their large unrealized portfolios. Many felt pressure to score some "wins" and bank returns before taking to the road with their next fund-raising effort. They also needed to provide liquidity to their distribution-starved LPs, enabling them to meet capital calls and reignite the fund-raising cycle. Some felt obliged to get money back into the hands of the more junior investment professionals within their firms, many of whom joined at the height of the PE boom and have yet to earn any carry throughout the exit drought that followed the boom. Further, with expectations high throughout most of the year that taxes on dividends and capital gains in the US would be raised, PE firms were eager to lock in returns at the lower rates. Finally, and perhaps most important, market valuations on high-quality assets were robust.

Figure 1.10: Exit activity picked up significantly



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

Figure 1.11: Exit activity gained momentum throughout the year



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

But tempering those strong reasons to sell, GPs were anxious not to dispose of portfolio companies in haste—certainly not below their carry hurdle rate. Most GPs preferred to wait for the economy, valuations or their companies' performance to improve—and a chance to generate even better value for their LPs and more carry for themselves.

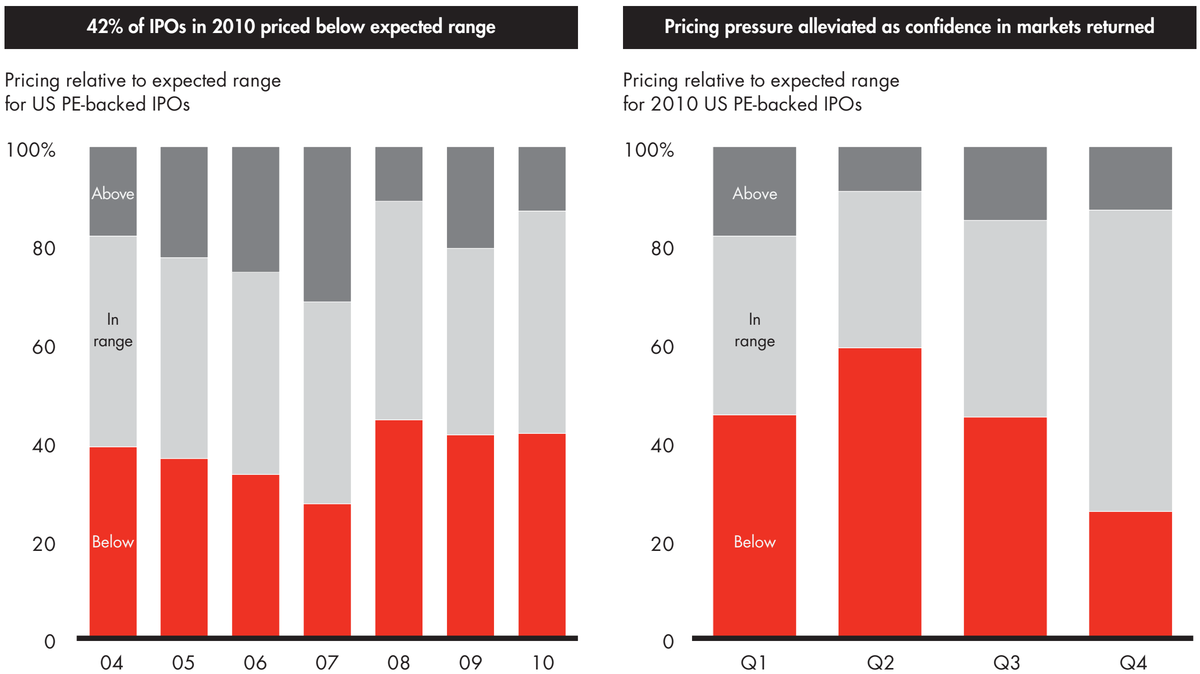
Those that tested the exit market in 2010 also encountered conditions both welcoming and challenging. Of the three major routes to the exits—strategic sales to corporate acquirers, initial public offerings (IPOs) and sponsor-to-sponsor transactions, only sponsor to sponsor proved to be a consistently attractive option. Looking first at sales to corporate buyers, the conditions in place for corporate mergers and acquisitions (M&A) were favorable. Improving macroeconomic conditions put growth back on the corporate agenda following two years of risk avoidance and hunkering down to survive the downturn. To fuel that growth, CEOs were looking to expand into new adjacencies or strengthen their core businesses, objectives often best accomplished through M&A, particularly at a time when consolidation was a major theme across several industries. Finally, corporate cash flows had been strong, companies were sitting on piles of cash reserves accumulated through the downturn and were looking to put that money to work.

But despite these factors pushing M&A forward, corporate M&A activity worldwide was modest in 2010. Announced deal value (excluding PE targets) did rise by 20 percent in Asia-Pacific and grew even faster off a small base in Latin America and the rest of the world over the year, but it increased by just 2 percent in the big North American market and grew just 10 percent in Europe. Overall, corporate M&A was up only 18 percent from the depressed conditions of 2009, during a year when buyout deal activity jumped 152 percent.

Why were corporations so gun shy? Their principal worry was the lingering economic uncertainty that led companies to continue to hoard cash. As that concern dissipated over the course of the year, corporations' appetite for M&A started to revive, and, as can be seen in Figure 1.11, strategic acquisitions of PE assets increased substantially in the last quarter of 2010. But several other concerns weighed against more corporate purchases of PE and other assets. Some companies were distracted from taking on new acquisitions at a time when they had a good deal of housecleaning to do in their current holdings. Many others were less willing to do deals simply to buy growth, but were more preoccupied with the strategic fit of assets they acquire and concentrated on matching their top priorities with the best-quality targets. Finally, many were wary about paying high prices for acquisitions where cost synergies were fully priced—and risk just becoming bigger and slower growing.

The IPO route to the exits was much improved in 2010, but it was still choppy. Worldwide, there were 154 PE-backed IPOs during the year—60 of them in the final quarter alone, as confidence in the durability of the global expansion and equity markets took hold—compared with just 55 in 2009. IPO pricing conditions were difficult: More than 40 percent of US IPOs ended up being priced below their target range. The pricing pressure was more pronounced in the first half of the year and among issuers with weak growth prospects and levered balance sheets (see Figure 1.12). Largely as a result, 33 IPOs ended up being withdrawn—among them, prominent companies including New Look, a UK-based fashion retailer owned by Apax and Permira, and Merlin Entertainments Group, Europe's largest amusement park company. On the other hand, that pricing pressure helped assure that most companies that came to market through IPOs performed well. Seventy-one percent of all the 2010 PE-backed IPOs ended the year trading above their offering prices. The largest 10 IPOs globally generated an excess return of nearly 30 percentage points on average over the market benchmarks from the initial offering date to year-end 2010.

Figure 1.12: IPO pricing conditions were difficult but improved as the year progressed



Source: Dealogic

With corporate acquirers holding back and IPO markets volatile, the one unambiguous bright spot in the 2010 PE-exit market was sponsor-to-sponsor activity, which accounted for 25 percent of the year's sales value. The matching of PE sellers hungry to cash out with PE acquirers eager to put some of their un-deployed capital to work was in many respects an ideal fit. Banks and other lenders were accommodating, too, since the transactions repaid some of their debt at par and allowed them to refinance the companies with less leverage. Over the course of the year, sponsor-to-sponsor activity heated up as high prices realized on some deals lured more PE firms to look to this exit route with increased enthusiasm. Said the managing director of a major European PE firm, "Right now anything that is private equity owned is viewed with skepticism by the public markets, so why bother trying to do an IPO, especially when there is a wall of private equity money chasing deals?"

Disposals of PE assets through sales to strategic acquirers, IPOs and sponsor-to-sponsor transactions were not the only ways for PE firms to turn appreciated portfolio holdings into cash they could redistribute to LPs. The year also saw a strong revival in dividend recapitalizations—$31 billion worth in US loans. Credit the easing debt markets, strong investor demand and concerns about a future tax hike for the recap rebound. The 2010 recaps were more prudent than those in the boom period between 2005 and 2007. Most deals relied on moderate amounts of leverage at less than five times EBITDA compared with between seven and eight times during the market peak.

Fund-raising: A pause in the action

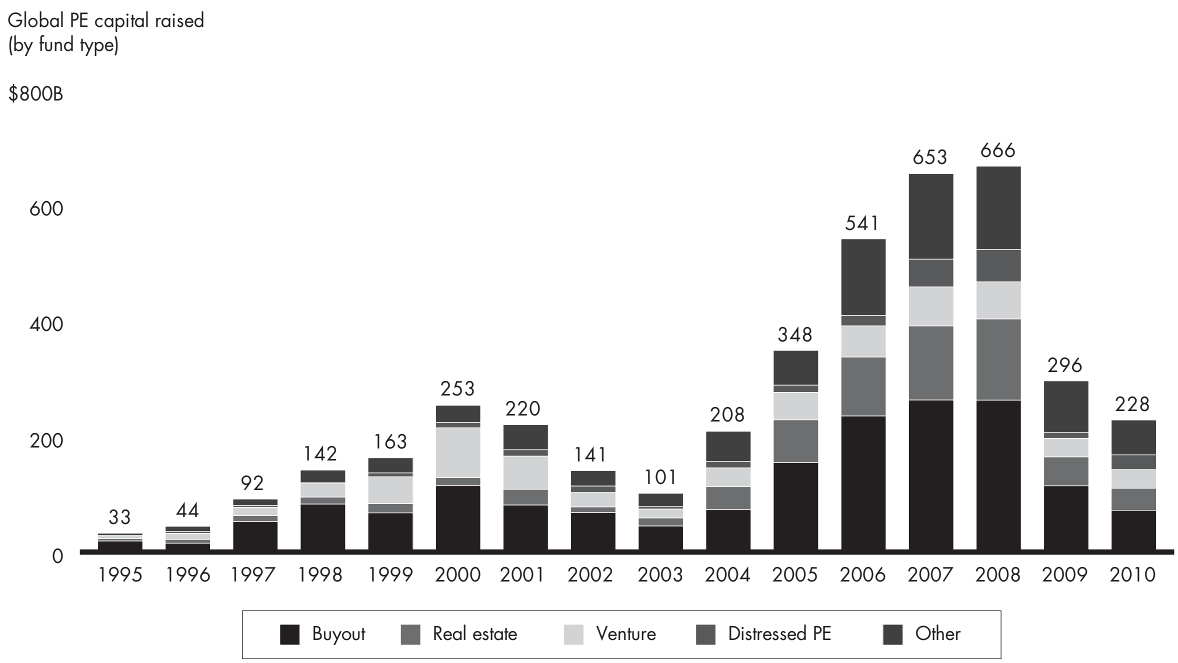
PE fund-raising conditions continued to deteriorate throughout 2010. Worldwide, PE firms managed to raise just $228 billion last year according to Preqin, the private equity research firm. That was 23 percent less than they took in during 2009, itself a depressed year. Perhaps befitting economic conditions, only funds that invest in distressed assets saw a small fund-raising pickup during this otherwise bleak time (see Figure 1.13). Europe took the biggest hit while Asia and a handful of countries in smaller PE markets around the world saw a positive uptick (see Figure 1.14).

In all, new buyout capital raised totaled $71 billion, just one-quarter of what firms were able to round up prior to the 2008 credit crisis. While buyout funds of all sizes were off sharply in terms of the capital they raised, only seven large funds above $2 billion reached a final close.

These figures clearly indicate that LPs' willingness—and capacity—to take on new commitments remained weak in 2010. At the same time, the total number of funds on the road and the target amounts of capital they were attempting to raise did not drop in similar proportions (see Figure 1.15). To put this demand-supply imbalance in perspective, the $700 billion of capital that GPs set out to raise as 2010 began represented an unprecedented two-and-a-half times what LPs committed in 2009. Not surprisingly, GPs ratcheted back their aspirations throughout 2010, reducing the total capital sought to approximately $600 billion by year's end. Nevertheless, LP demand fell even more precipitously, making for very challenging conditions for GPs on the road.

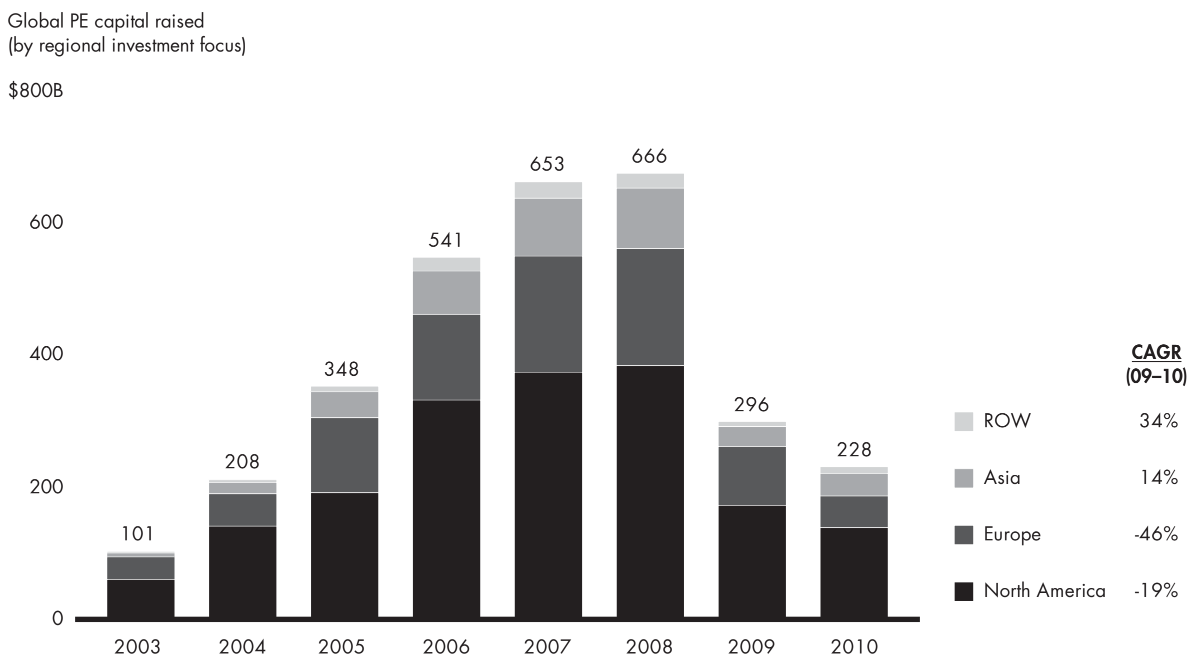
In the end, GP fund-raising efforts came in lower than even these diminished expectations foretold. Half of all PE funds closed in 2010 fell below their target fund size, with more than a quarter of funds raising less than 75 percent of the targeted amount. While this was an improvement over 2009, when two-thirds of funds closed were below target, it likely reflects GPs setting more realistic size targets for their new funds rather than improved fund-raising conditions (see Figure 1.16).

Figure 1.13: Fund-raising activity continued to deteriorate



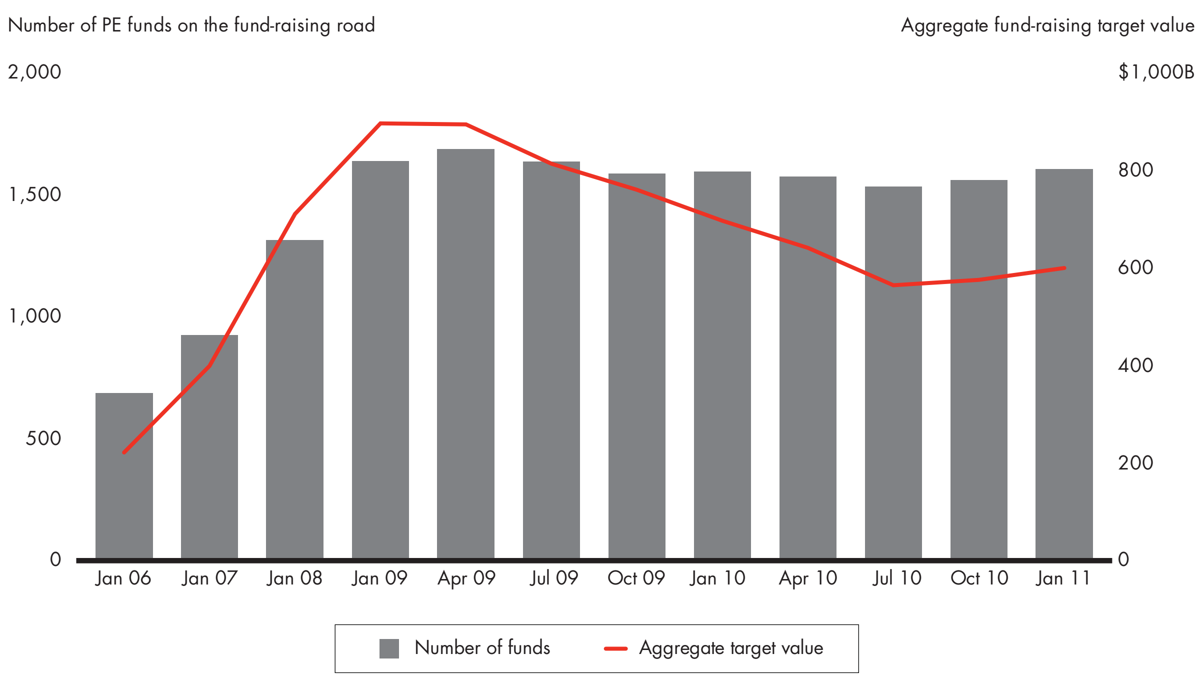
Notes: Includes funds with final close; represents year funds held their final close
Source: Preqin

Figure 1.14: No region was spared



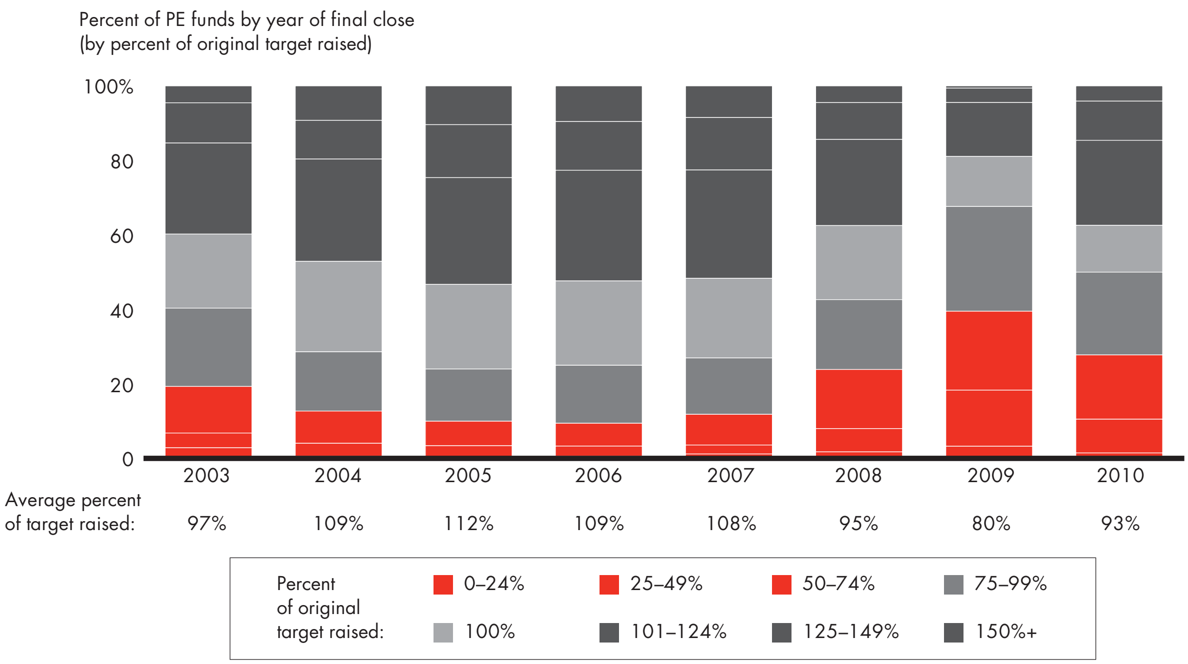
Notes: Includes funds with final close; represents year funds held their final close
Source: Preqin

Figure 1.15: Fund-raising was crowded on the supply side



Source: Preqin

Figure 1.16: Funds struggled to reach their target



Note: Year represents year of final close
Source: Preqin

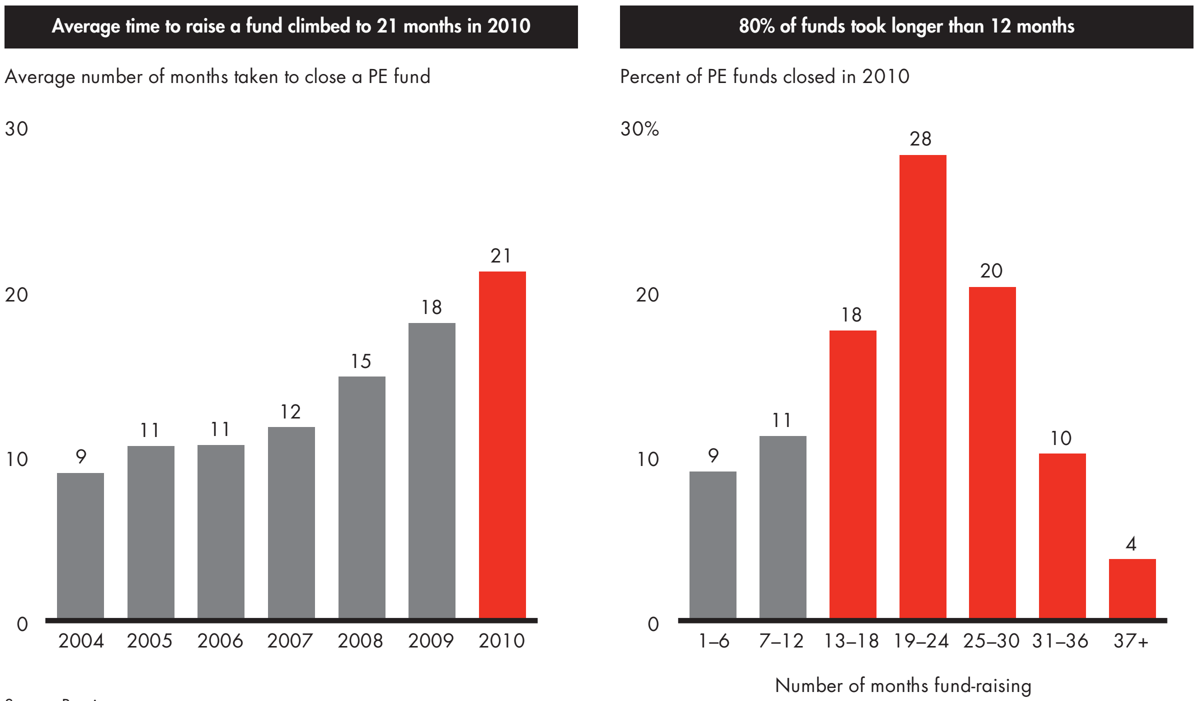
GPs also needed more time to close their scaled-down funds. At the peak of the PE boom in 2007, the average fund closed within a year of its launch. By 2010, funds were taking nine months longer to close, on average; fully 80 percent needed more than a year (see Figure 1.17).

Many factors weighed against new fund-raising efforts in 2010. On the demand side, LP budgets for new PE commitments in 2010 were conservative. Most drew up their 2010 budgets in 2009 when the market conditions they faced were grim. At the time, most LPs were pushed to the limit of their PE target allocations by the so-called denominator effect, as write-downs in the valuation of their PE holdings lagged those of their portfolio as a whole. Also, with PE exit activity blocked and little in the way of cash distributions they could count on, they were caught in a liquidity squeeze. Finally, they faced a huge overhang of obligations to meet capital calls on $1 trillion of commitments they had previously made.

As the year unfolded, many LPs ended up deploying even less capital than they had budgeted, choosing to be prudent and turning down marginal opportunities. Three main factors restrained the deployment of their already conservative budgets. First, for most LPs, the spread between their actual and target PE allocations improved throughout 2010, but only modestly. According to ongoing surveys by Preqin, one-half of all LPs remained at or above their target allocations at midyear (see Figure 1.18).

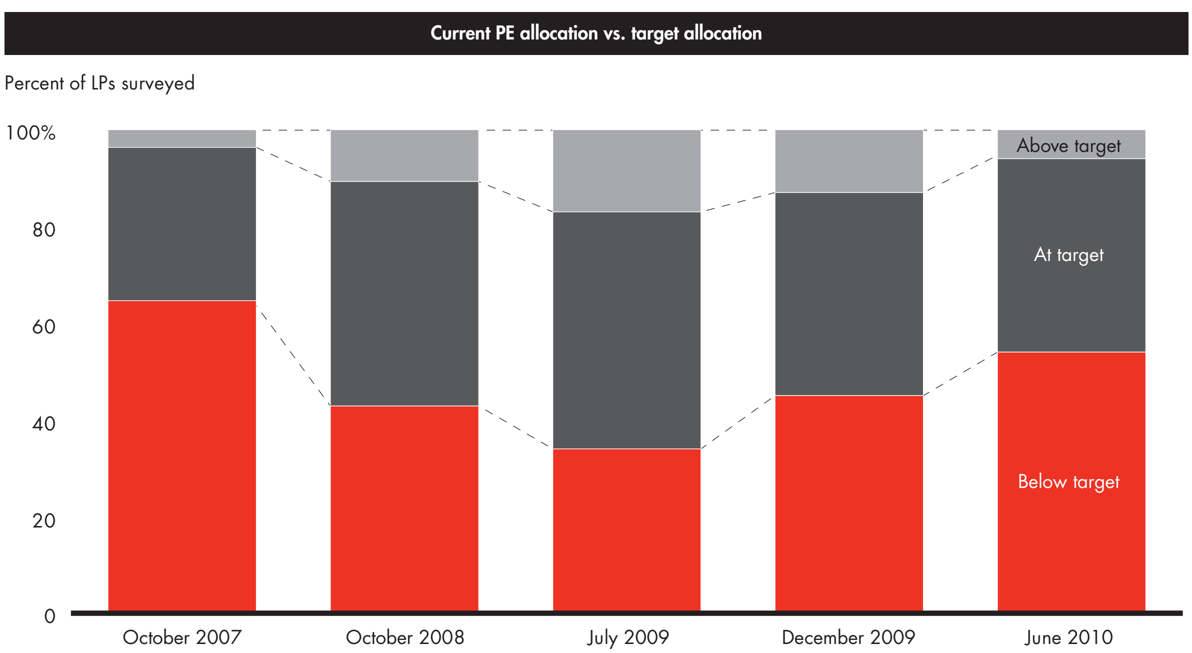
Several forces at play throughout the year kept PE allocations tight. The denominator effect eased somewhat over the course of the year as the public markets rallied, but PE valuations rose as well. Continuing to put upward pressure on allocations, capital calls outpaced distributions in the first half of 2010, although exit

Figure 1.17: Funds took longer to reach a final close



Source: Preqin

Figure 1.18: Headroom in LPs' PE allocations improved modestly



Source: Preqin Investor Surveys

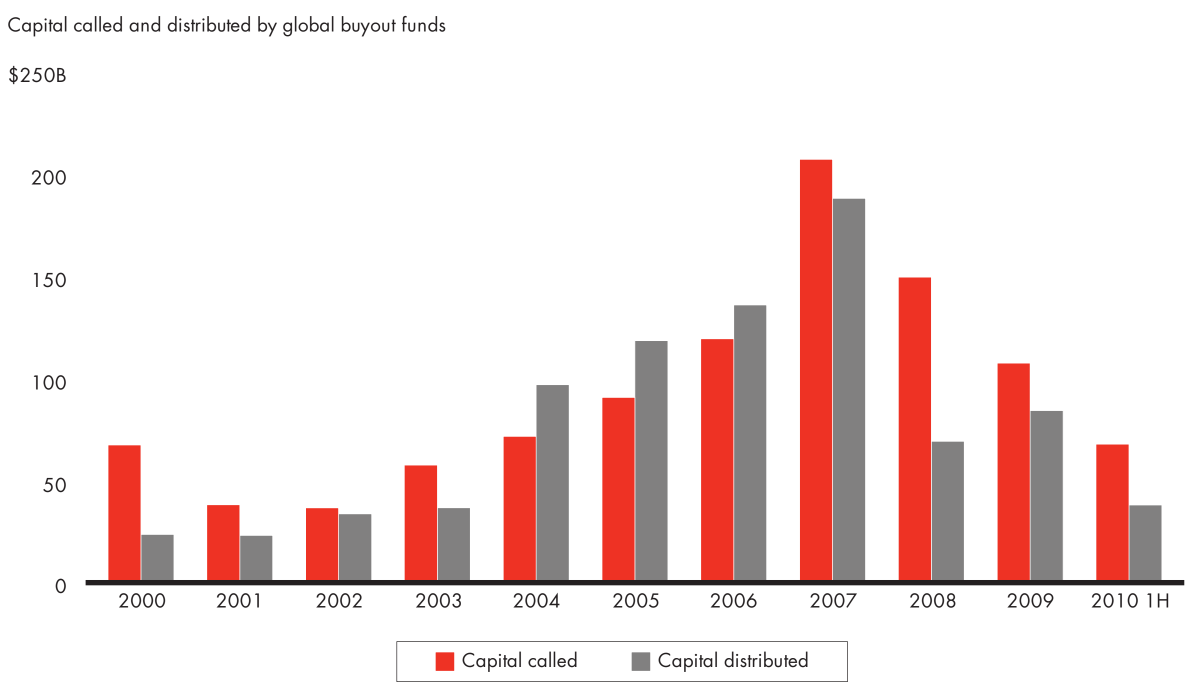
activity and Bain's interviews with LPs point to a surge in distributions in the latter part of the year (see Figure 1.19). This cash-flow imbalance also hindered LPs' ability to recycle capital into new PE commitments, a challenge that particularly affected the more cash-strapped LPs.

It is worth noting that the mismatch between capital calls and distributions affected LPs differently, influenced mainly by the maturity of the PE holdings in their portfolios. LPs overseeing more mature programs with PE investment vintages that stretched back to before the boom period that started in 2005 benefited from a steadier flow of distributions. Newer programs holding PE investments made since 2005 did not enjoy a similarly favorable distribution stream.

Further keeping allocations tight was the large amount of unfunded commitments. These shrank only by 10 percent during 2010, making LPs wary of committing yet more capital and risking an over-allocation or liquidity squeeze if capital calls surged. Of course, LPs could relieve these pressures by increasing their target PE allocations, giving them more headroom to take on new commitments, but few were willing to take that step, at least in the short term.

The second main factor that constrained LPs' budgeted outlays was their still-wavering confidence in the asset class. Nearly all LPs were rattled by the sharp devaluation of their PE portfolios during the crisis. Many LPs' PE holdings are weighted toward boom-time vintages, whose interim valuations were most affected by the downturn. Seeing their PE returns decline significantly knocked LPs' confidence in PE's ability to continue to meet their absolute and relative return expectations. LPs' confidence also took a hit from the low level of investment activity during 2010 relative to the large unfunded commitments LPs were facing, which combined with the high prices PE funds paid, raised doubts about the opportunity set for PE investments

Figure 1.19: Capital calls continued to outpace distributions in the first half of 2010



Source: Preqin

going forward. Finally, limited exit activity throughout the downturn and into the early part of 2010 relative to the value of unrealized investments in LPs' portfolios raised LPs' concerns about GPs' ability to lock in gains. Such exit activity as they did see—many sponsor-to-sponsor transactions—further heightened LPs' skepticism and generally rubbed them the wrong way. Taken together, the pressure of continued tight PE allocations and their wavering confidence in the asset class made LPs a hard sell in 2010.

The third critical factor that made it difficult for LPs to spend their budgets was the dearth of compelling investment opportunities. The LPs we spoke to told us bluntly they could not find the quality they expected. "There haven't been a lot of attractive investment opportunities. The people who are forced to raise funds now might not be the ones that you want to be with," said a senior manager at a leading US foundation.

LPs pointed to the fact that many GPs, including some of the industry's brand names and historically top performers, simply put fund-raising on the back burner in 2010. They believe that those GPs were hoping for improved fund-raising conditions in 2011 and for a chance to bank successful exits that would allow them to boost their track records and demonstrate their ability to generate returns from deals made at the peak.

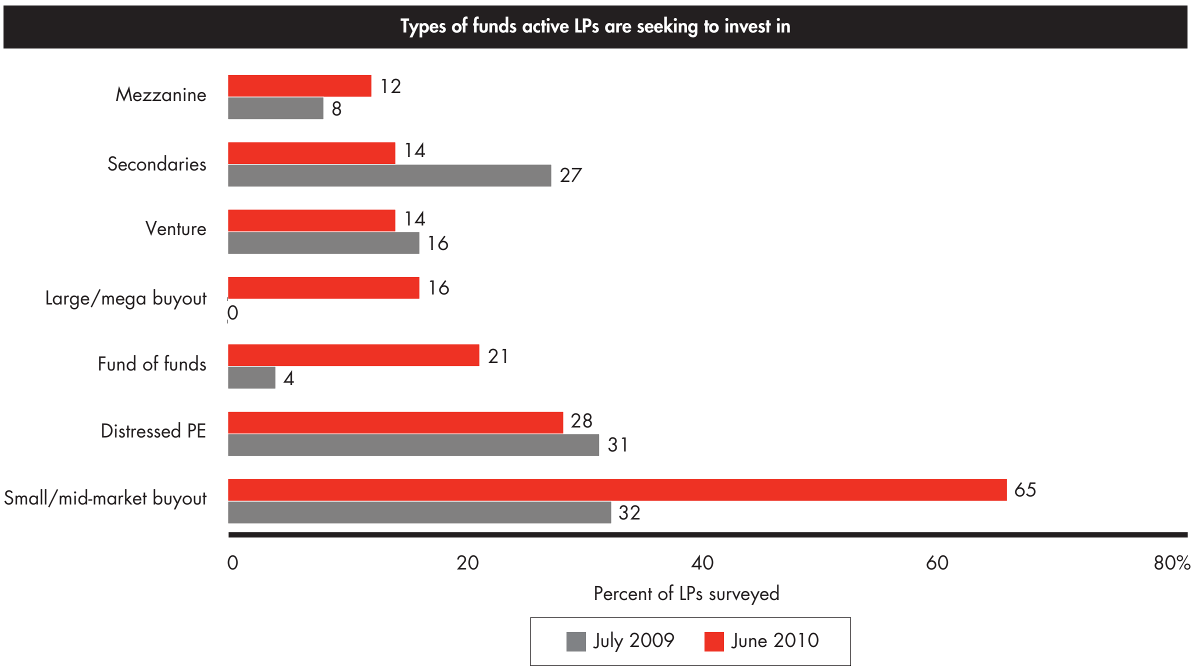
LPs also were troubled by the limited visibility they could get into the track records of GPs seeking their commitments. Holding GPs' evidence of performance to close scrutiny, they wanted to see a proven ability to generate cash-on-cash returns. But because of the exit drought, many GPs that hit the road in 2010 had only largely unrealized portfolios to present. This required LPs to form judgments based on interim valuations, which they view with skepticism. Lacking a high degree of conviction in a GP, LPs either spurned the opportunity outright or felt no urgency to jump in on the fund's first close. Instead, they preferred to watch from the sidelines until they got a clearer insight into the GP's track record and ability to line up commitments from other LPs to amass a fund of sufficient size to achieve its objectives. Describing the higher standards he was applying, a university endowment manager told Bain: "We're delaying having to make a decision for as long as we can. We know that we have limited bullets to use up and we're asking ourselves, are these guys really worth using a bullet for?"

Further diminishing LPs' interest was the fact that their investment preferences had shifted away from what many funds on the road had to offer. Over the past few years, LPs have refocused their attention from mature US and European markets in favor of emerging markets. They have also shied away from the large and mega-buyout funds and are concentrating instead on middle-market funds (see Figure 1.20). These shifts show up clearly in the characteristics of funds that have successfully raised capital since 2009 by landing commitments that meet or exceed the target goal and reaching their final close within less than a year. All offered something that squarely hit the LP "sweet spot," being relatively small, having a sector focus or targeting an attractive emerging region.

Returns: The valuation rebound continued

Private equity fund returns in 2010 continued to climb out of the deep hole they had been knocked into by the 2008 financial crisis, recession and steep valuation write-downs required under mark-to-market accounting rules. The recovery in portfolio valuations, which got under way in mid-2009 and gathered momentum through 2010, was, with the exception of real estate, healthy and broad based across the asset class (see Figure 1.21).

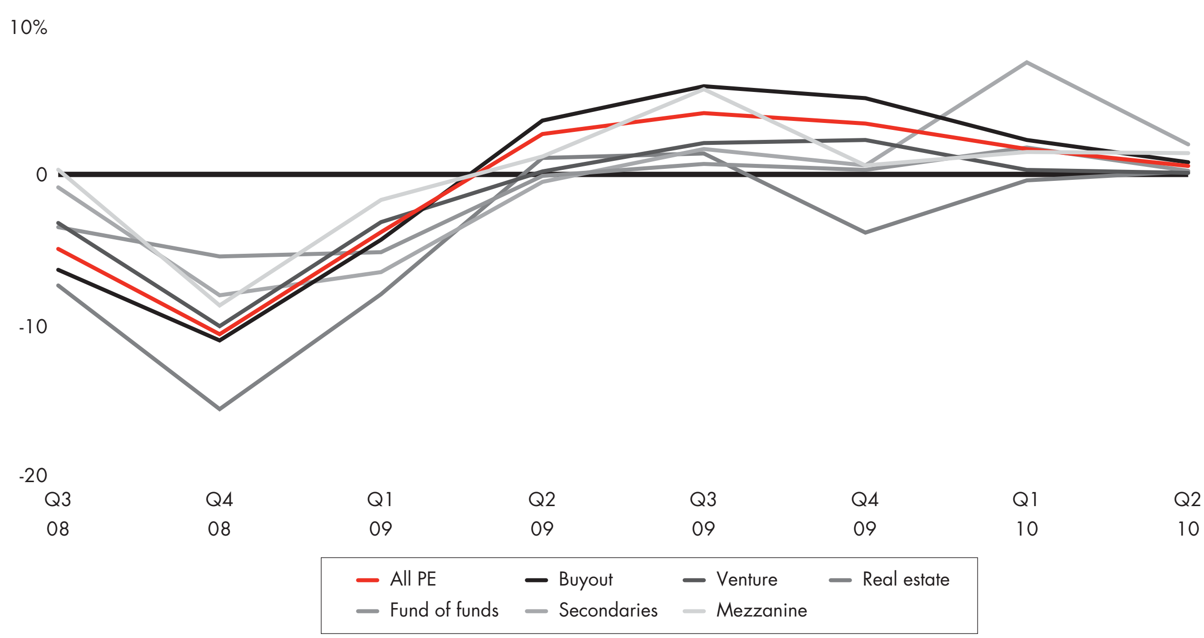
Figure 1.20: LP investment preferences shifted



Source: Preqin Investor Surveys

Figure 1.21: Portfolio valuations continued to recover

Average change in NAV from previous quarter (global, unweighted)



Source: Preqin

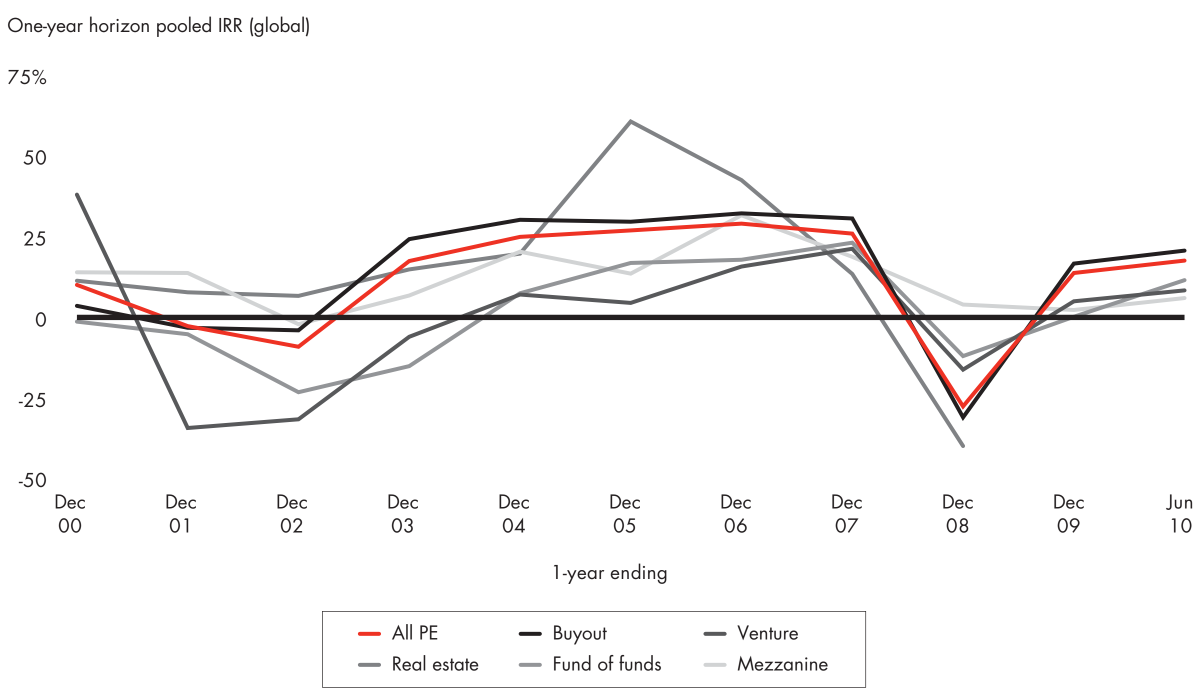
Strengthening valuations powered much more positive PE returns over the short term. For almost all PE fund types, returns climbed to double-digit rates for the one-year period ending in the second quarter of 2010 (see Figure 1.22). For many LPs, the higher returns from PE helped lift their overall portfolio performance, outpacing their public equity and fixed-income holdings by a substantial margin.

Having taken the biggest hit within the buyout-fund category during the downturn, the largest funds recorded the sharpest upward revaluations over the past year. Again, improved valuations flowed into sharply higher short-term returns for this fund group, with the mega-buyout funds outpacing smaller ones with a one-year return of 24 percent through the end of the second quarter of 2010.

Returns have climbed most dramatically among buyout funds of more recent vintages (see Figure 1.23). Because a larger proportion of their portfolios are unrealized, these funds are more sensitive to rising valuations. For example, 75 percent of the portfolio value of more mature 2002 buyout funds resulted from locked-in investments as of the second quarter of 2010. By contrast, close to 80 percent of the portfolio value of funds formed in 2005 came from the interim value of unrealized investments.

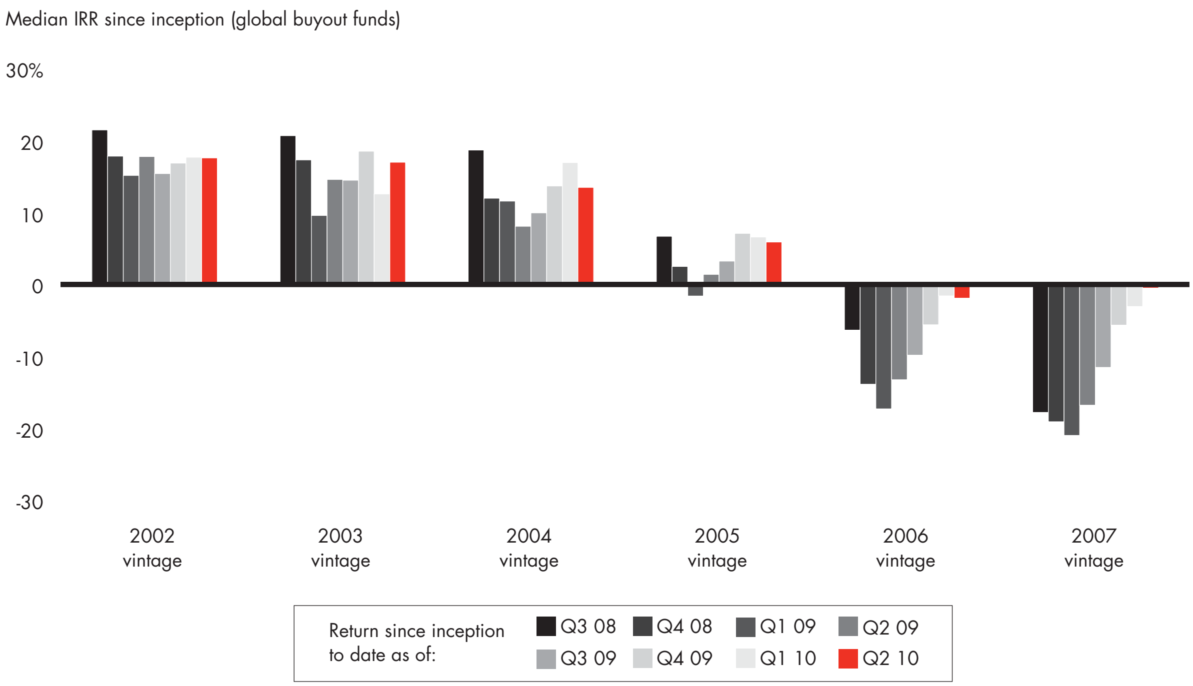
The swings in valuations and returns through the past downturn have been far from typical. They have departed from the traditional "J-curve" pattern of negative returns in the first few years of a fund's life, followed by increasing gains over time as PE firms add value to their portfolio companies and reap the benefits when they liquidate their investments. Since the financial crisis, however, returns have traced more of a "W-curve." An initial decline in value is followed by a brief recovery and then succeeded by a second dip before ultimately climbing back into stronger positive territory. The erratic look of the performance curves adds complexity to the story firms currently trying to raise new funds have to tell in order to sway skeptical LPs to invest with them (see Figure 1.24).

Figure 1.22: Recovery in portfolio valuations powered short-term PE returns



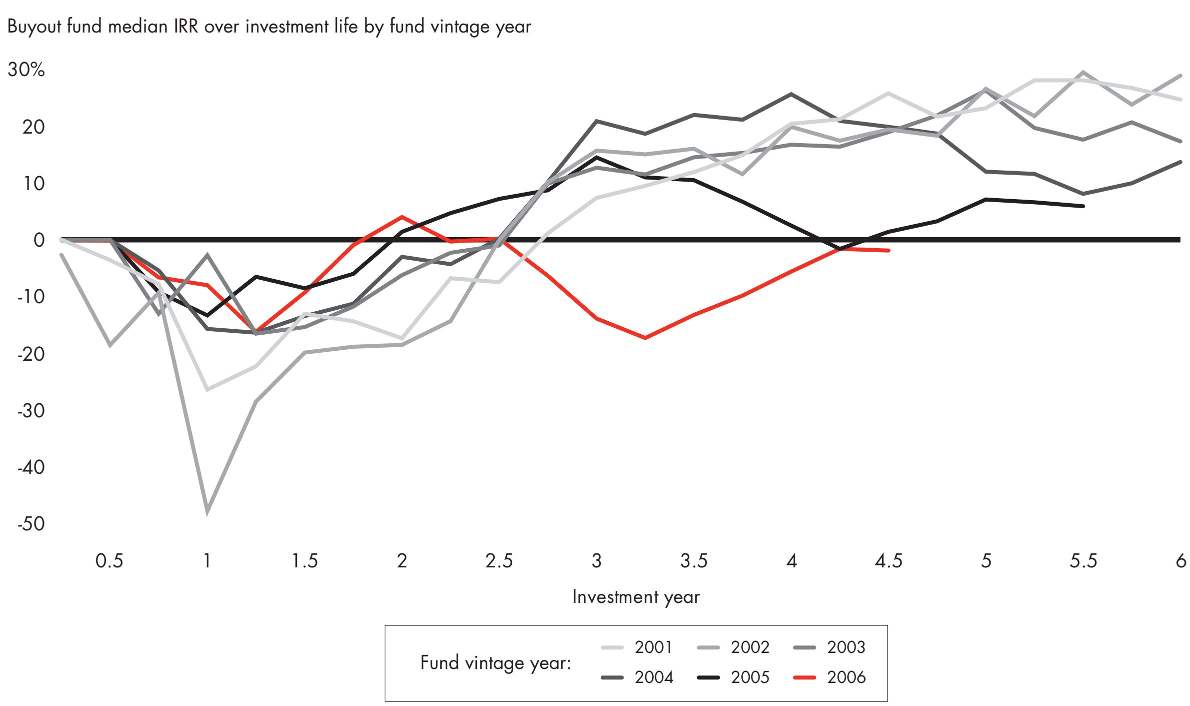
Source: Preqin

Figure 1.23: Returns of recent buyout fund vintages also recovered dramatically



Source: Preqin

Figure 1.24: "J-curves" have turned into "W-curves"



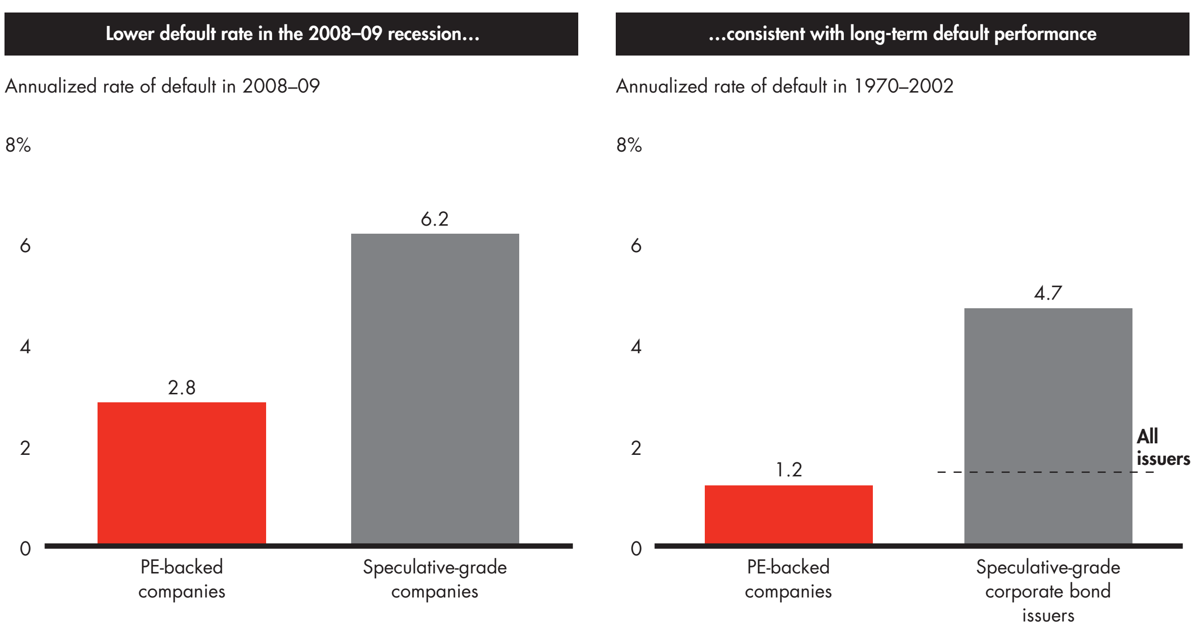
Source: Preqin

A compelling picture of PE's strength shows up in the far fewer incidences of default among PE-backed companies throughout the turbulence of 2008 and 2009. During the worst of the economic and credit storm, the annual default rate of PE-backed companies was less than half that of speculative-grade companies that lacked PE sponsors—just 2.8 percent versus 6.2 percent, according to calculations published by the Private Equity Council in March 2010 (see Figure 1.25, left-hand panel).

The better performance of PE-backed companies during the recent downturn is very much in line with longer-term trends. Their annualized default rate between 1970 and 2002 was a low 1.2 percent compared with the 4.7 percent annual rate for speculative-grade corporate-bond issuers over that 32-year period and the 1.6 percent rate for corporate-bond issuers of all grades (see Figure 1.25, right-hand panel). That significantly lower number of portfolio-company collapses proved to be an important factor that helped raise PE valuations and returns during the past year.

The higher survival rates of companies in PE portfolios largely reflect the greater foresight exercised by owners. In a survey published in early 2009, more than three-quarters of PE respondents said their firms had increased their involvement in the management of their portfolio companies in response to deteriorating market conditions. Indeed, the most seasoned PE firms took measures well ahead of the downturn, knowing that it would be only a matter of time before lenders would tighten up on issuing less restrictive, low-cost loans. Many sold holdings or arranged dividend recapitalizations while they could. Others refinanced debt obligations to insulate their holdings further against harsh credit conditions and structured new deals with flexible debt packages. Seeing the handwriting on the wall as early as September 2007, one senior director at a leading global PE firm said at the time: "We went to all our portfolio companies and told them to take advantage of these debt markets [while they could]. . .. We virtually de-risked every company in our portfolio."

Figure 1.25: PE-backed companies weathered the 2008–2009 storm



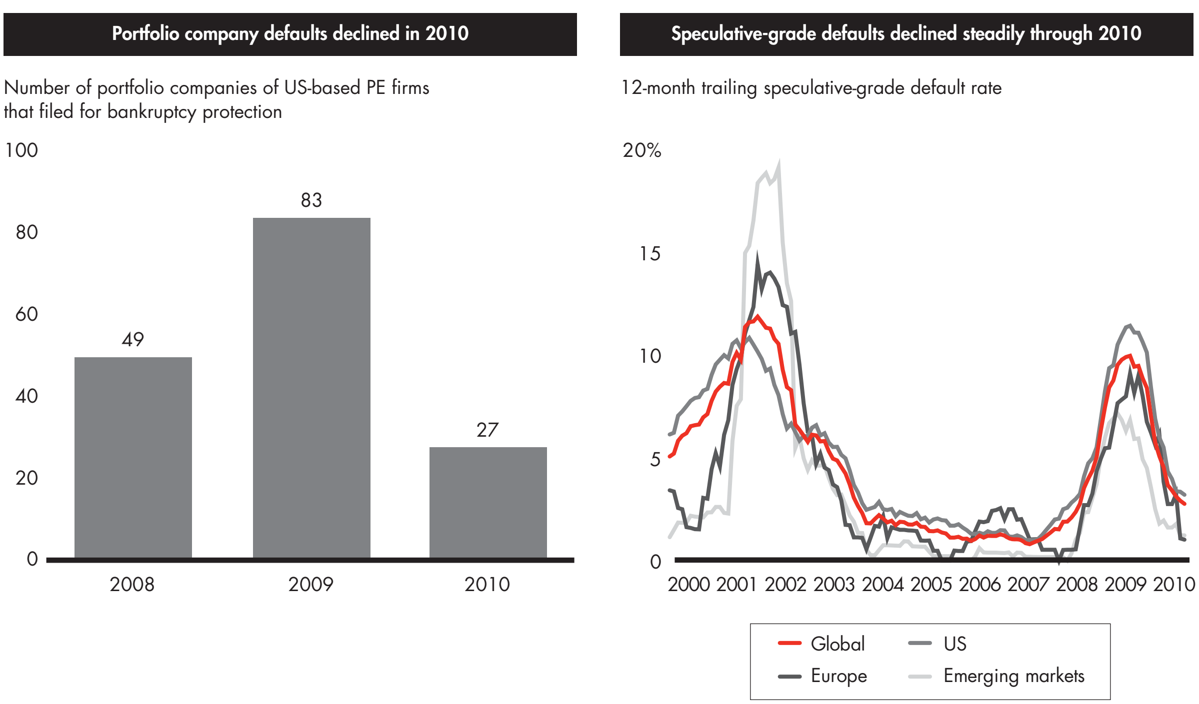
Note: Default defined as missed payment or bankruptcy filing (excludes distressed exchanges)
Sources: "The Credit Performance of Private Equity-Backed Companies in the 'Great Recession' of 2008–09," Jason M. Thomas, Private Equity Council, March 2010; "Leveraged Buyouts and Private Equity," Steven N. Kaplan and Per Stromberg, *Journal of Economic Perspectives,* Winter 2009

Those anticipatory measures taken ahead of the downturn along with prudent management of their portfolio companies during it continued to benefit PE firms and their investors over the past year. The number of portfolio companies filing for bankruptcy protection fell sharply in 2010—a trend that is consistent with the experience of speculative-grade companies in every major region of the world (see Figure 1.26).

Helping to reduce bankruptcy filings was the flexibility shown by debt providers that were willing to stretch out debt maturities and amend covenants, making them less likely to be breached. Companies also benefited from greater access to high-yield bond and leveraged-loan markets to refinance their debt. Finally, and significantly, the disciplined cost-cutting PE owners required of their portfolio company management teams over the past few years bolstered cash flow and earnings as the recovery kicked in, improving companies' abilities to meet their debt obligations or more easily persuade creditors to refinance them.

For creditors of PE-backed companies that did seek court protection since the downturn, moreover, past experience strongly suggests that they are likelier to recover what they are owed than creditors in other liquidations. Based on a sample of UK companies that went into receivership or court-supervised administration between 1997 and 2009, recent research sponsored by the British Venture Capital Association found that PE-backed companies have twice the recovery rate of secured debt than do publicly owned companies that default. Again, the superior alertness, decisiveness and more hands-on approach of PE owners in the face of distressed conditions largely explains the difference in outcomes.

Figure 1.26: Portfolio company defaults declined significantly in 2010



Sources: *Buyouts*; S&P

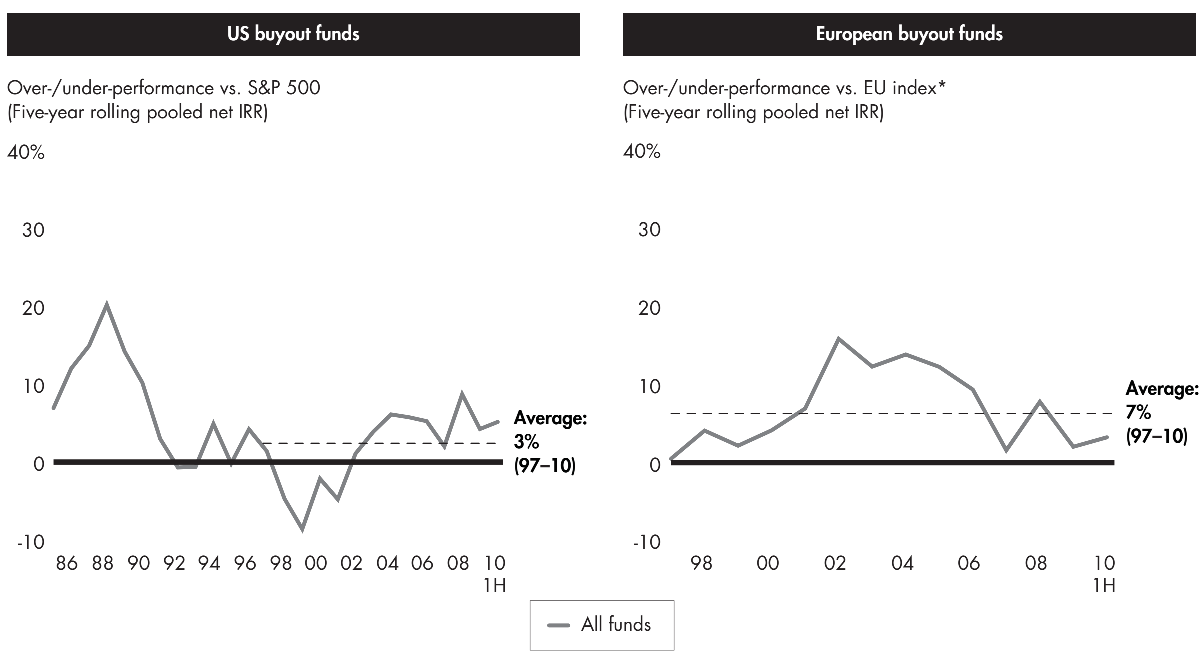
The debate about PE returns flares up

Even as PE returns improved in 2010, the roller-coaster returns of the past few years have revived a chorus of critiques charging that PE funds are failing to produce the market-beating returns GPs promise. The debate heated up last year with the release of a report in July by the Centre for the Study of Financial Innovation, a UK industry think tank, taking issue with PE firms' returns record and heaping criticism on the industry's fee structure, lack of transparency, misaligned incentives and unsophisticated limited partners.

Long before this latest revival of the issue, efforts to get to the bottom of the controversy about whether PE truly outperformed other investments had attracted considerable analysis. Over the past decade, academic and industry researchers have sought to refine methods used to measure and compare PE performance. For example, some researchers have adopted a modified-IRR calculation method to remove distortions created by the financing and reinvestment rate of cash flows, and they have adjusted for PE's streams of irregular cash flows. Others have attempted to ascribe PE's performance to a host of specific factors such as financial leverage, expansion of valuation multiples during the holding period, the underlying performance of portfolio companies and PE firms' governance practices.

From this research emerges a fairly strong case for PE. A simple comparison of PE fund returns with public equity indexes shows that, over time, buyout funds have outperformed public equities by between 300 and 700 basis points, on average, over a five-year rolling time horizon (see Figure 1.27).

Figure 1.27: Buyout funds outperform public equities by 300–700 basis points



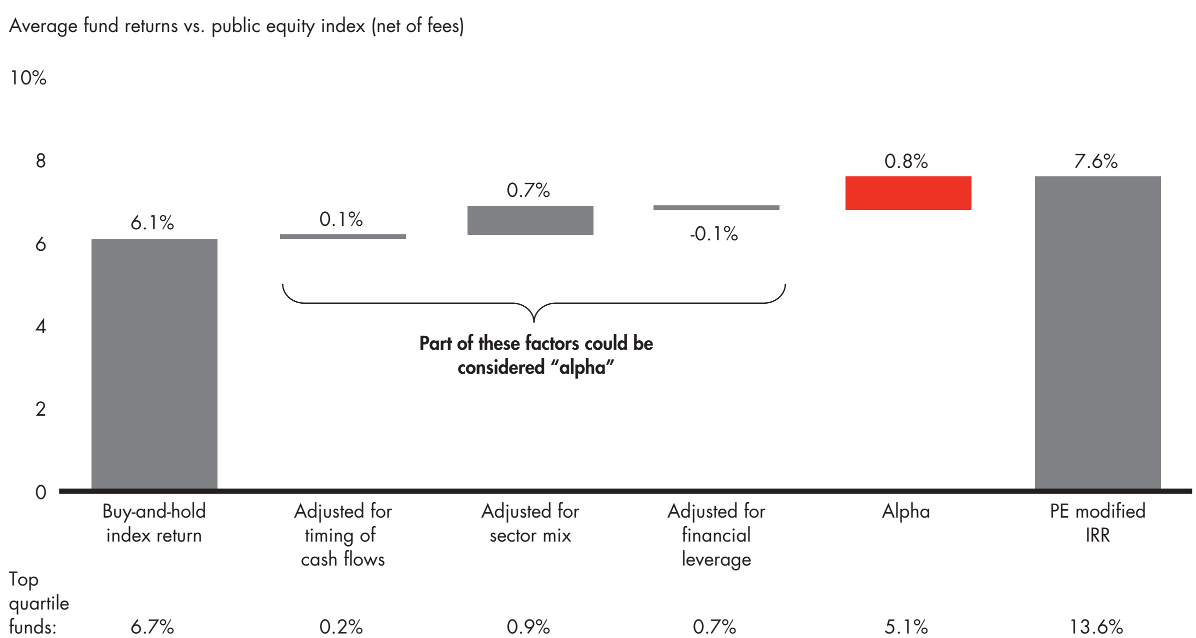
*Composite of FTSE, CAC and DAX (equally weighted)
Note: Quartile position assigned based on ranking within region, fund type and vintage year
Source: Thomson Reuters

Just how much of this outperformance can be truly credited to the active involvement of PE managers is largely a matter of how much of the difference in performance a researcher attributes to alpha versus passive, market-related factors. One of the more conservative attempts to get to the bottom of the issue is a study by Oliver Gottschalg, a professor at the École des Hautes Études Commerciales (HEC) in Paris. Gottschalg suggests that average PE returns marginally surpass those of public equities. He accounts for the irregular timing of cash flows from PE fund investments, captures the operating risk of PE fund investments by adjusting for differences in sector mix between PE fund investments and public equity indexes, and corrects for differences in financial leverage (see Figure 1.28). However, there are arguably alpha skills in choosing the best time to invest and selecting the best sectors to focus on. Thus, even from a conservative perspective, PE funds perform better, albeit only slightly, than public equities.

More impressive still is the solid outperformance turned in by true top-quartile funds. They beat both the average PE fund and public equities returns by a substantial margin (see Figure 1.29). In the US, for example, the five-year net returns generated by top-quartile buyout funds beat the market index by 19 percentage points since 1997. In Europe, the first-quartile funds outperformed public equities by 27 percentage points since 1997.

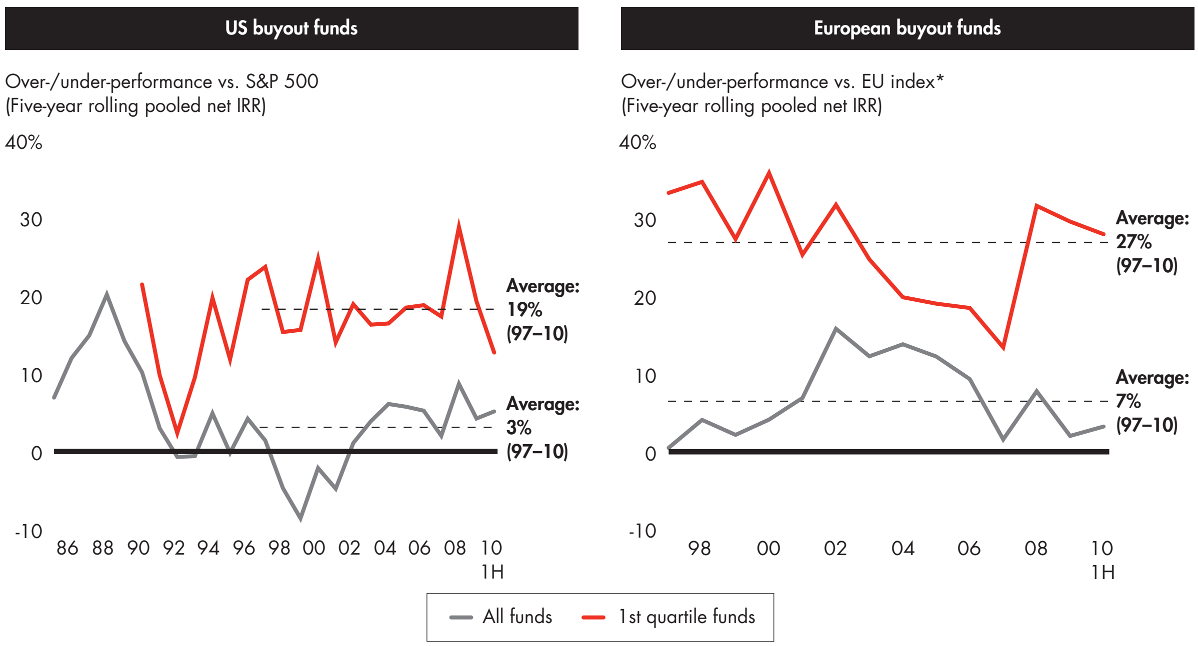
The evidence also shows that there is nothing accidental about this superior result. Unlike public equities, the returns of PE funds do not follow a normal distribution curve. In fact, the distribution of PE fund returns has a bigger and longer tail of strong performers that earn outsized gains (see Figure 1.30). An analysis by Professor Gottschalg of the alpha generated by a sample of 701 US and European buyouts funds raised between 1972 and 2003 confirmed that the distribution of fund performance is skewed toward outperformers.

Figure 1.28: Conservative analysis suggests average PE returns are in line with public equities



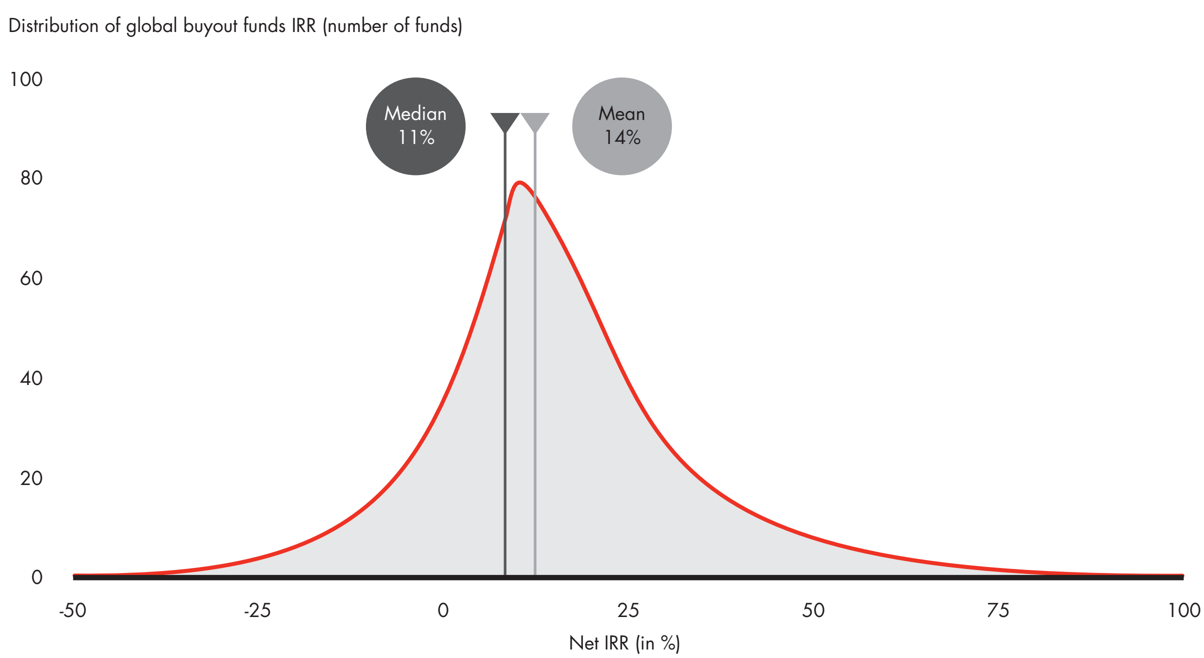
Note: Based on 701 mature buyout funds in the US and Europe
Source: "The Real Reasons to Invest in Private Equity," Oliver Gottschalg, HEC Paris, August 2010

Figure 1.29: Top quartile funds outperform significantly



*Composite of FTSE, CAC and DAX (equally weighted)
Note: Quartile position assigned based on ranking within region, fund type and vintage year
Source: Thomson Reuters

Figure 1.30: Distribution of PE fund returns is skewed toward outperformers



Notes: Only mature vintages considered (1996–2005); n=435 buyout funds (one fund with IRR of 147% excluded); performance data as of December 2009
Sources: Preqin; Bain analysis

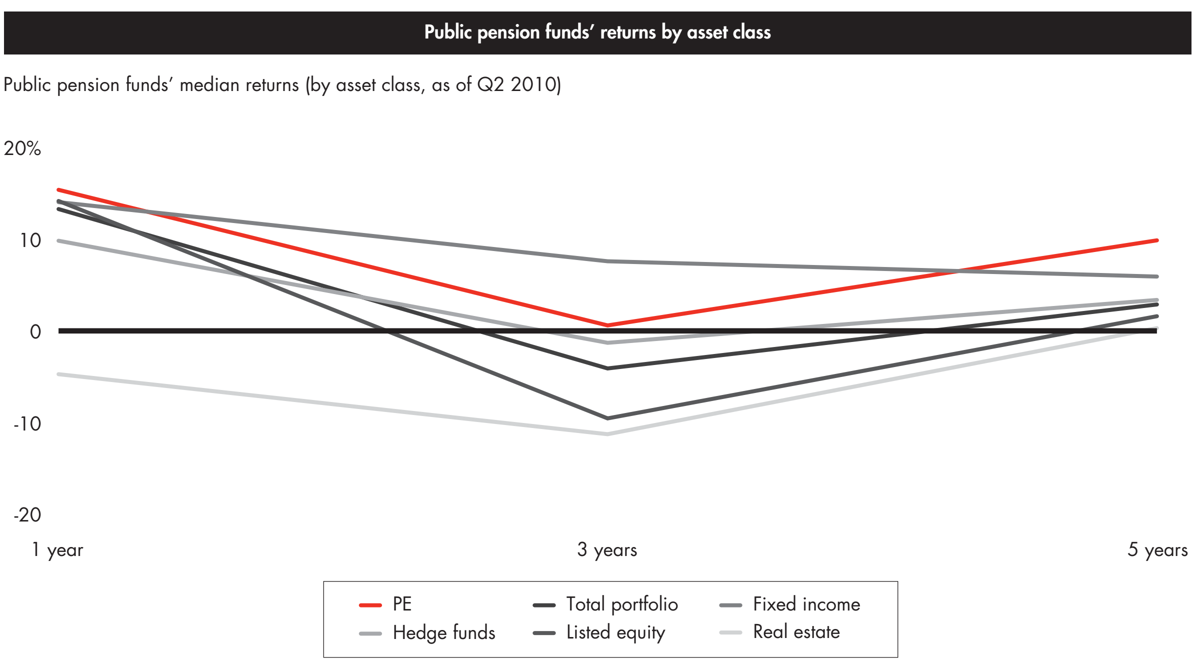
These data and others show that the case for investing in private equity remains compelling, especially when evaluated from LPs' perspectives. On average, PE holdings have been one of the better-performing asset classes in LPs' portfolios. Over the five-year period ending in mid-2010, the median return earned by public pension funds in PE beat that of both their portfolios taken as a whole, as well as every other major asset class they owned (see Figure 1.31). Leading LPs demonstrate that it is possible to construct PE programs that beat average PE returns by a wide margin.

A year marking a return to deal making

If it is possible to sum up the complex, competitive and challenging year of 2010 in a single phrase, the most succinct label might be that PE firms got back to deal making. They devoted considerable energy scouring the sectors they decided to focus on for deals, working their networks for opportunities and screening them thoroughly. In a period of high valuations, many firms fine-tuned—and some thoroughly overhauled—their due diligence practices. They put their freshly honed deal appraisal skills to work canvasing for upside potential to stretch for winners and plumbing the downside to avoid losers.

PE firms also continued to keep a tight grip on their portfolio companies throughout the year. As the economy backed away from the edge of recessionary relapse, they shifted their focus from cost reduction to revenue growth to position themselves for profitable exits. They recognized that securing these would require convincing growth stories and demonstrated momentum. PE firms also took advantage of improving debt markets to refinance capital structures of portfolio companies most at risk.

Figure 1.31: For average LP, PE is one of the better-performing asset classes



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

Anticipating formidable challenges in 2011, PE firms also devoted 2010 to fortifying themselves internally. Most of the biggest PE firms had deepened and strengthened their portfolio management capabilities in 2009. During this past year, the next tier of firms tackled that task by building internal portfolio groups and creating or strengthening networks of industry and operational advisers. Finally, anticipating pressures from more assertive LPs on future fund-raising rounds, some firms took steps to right-size their own organizations—particularly on the deal-making side—to be in line with future management fees and carry revenue streams.

Key takeaways

- PE deal activity rebounded in 2010 but not nearly enough to alleviate the pressure PE funds were under to invest, stemming from their nearly $1 trillion mountain of dry powder and expiring investment periods. Stiff competition made acquisitions pricey.

- Deal making was whipsawed by favorable credit conditions, attractive assets to acquire and high prices that made potential PE acquirers active shoppers but reluctant to close deals.

- Exit activity rebounded significantly from depressed 2009 levels, with sponsor-to-sponsor transactions playing a significant role. Exits gained momentum in the fourth quarter as worries over a possible European banking crisis eased, confidence in the durability of the economic expansion strengthened, and strong equity markets created more inviting conditions for corporate acquirers, financial sponsors and IPOs.

- Fund-raising conditions remained challenging throughout 2010. Tight PE allocations, ongoing liquidity issues (as exit activity picked up only late in the year), and the lack of compelling opportunities to invest all played a role in constraining LPs' outlays. Many LPs reevaluated their PE investment preferences in 2010, shifting from mega-buyout funds and mature economies toward midsize, sector-focused funds and emerging markets.

- PE returns strengthened in 2010, as portfolio valuations recovered smartly from depressed levels during the downturn. The significantly lower incidence of portfolio-company collapses during the downturn and into 2010 proved to be an important factor that helped raise PE valuations and returns during the past year.

2. What is happening now: Dynamics for 2011 and beyond

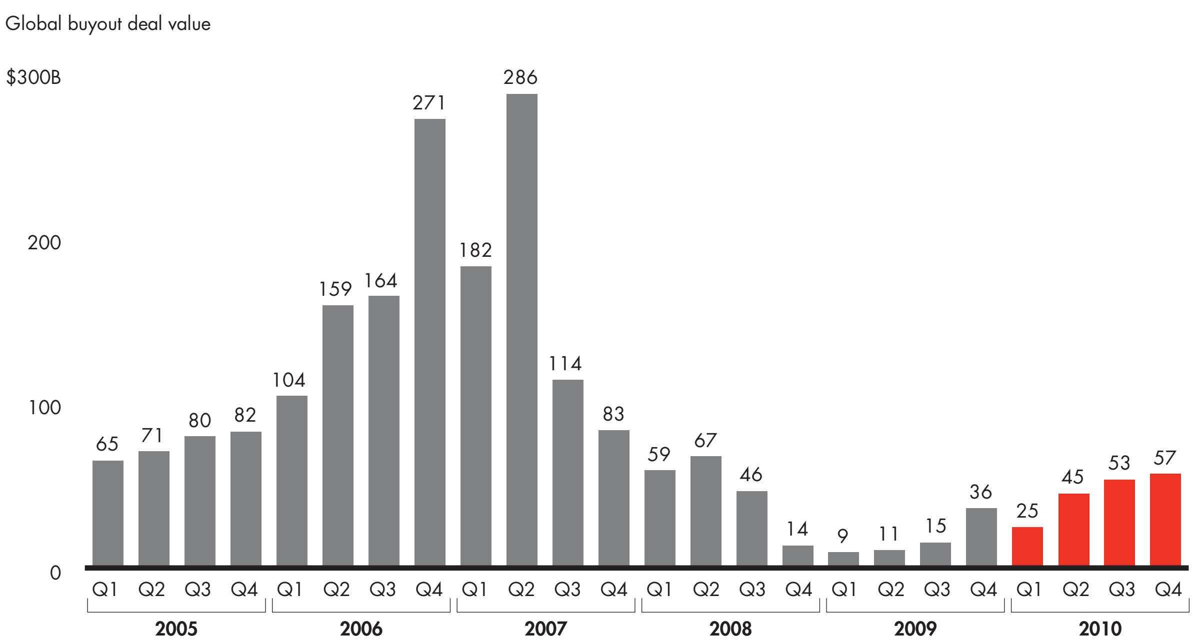
Private equity began 2011 still in the grip of the powerful forces unleashed by the global credit crisis, reinforced by recession and cemented in place through last year's uneven recovery. How the year plays out will be determined by whether PE is weighed down by macroeconomic and financial market uncertainties or builds upon the signs of renewed strength that appeared late in 2010, and achieves escape velocity that will propel the industry back toward the heights of the pre-Lehman Brothers cyclical boom.

Investments: Cautious optimism amid a fragile recovery

There are clear signs that the "animal spirits" are beginning to return to PE firms. The new year got under way on the heels of a continuing pickup in deal activity that accelerated through 2010 (see Figure 2.1). Quarter over quarter throughout the year, global announced buyout deal value increased, although it remained well off pre-crisis levels.

PE firms express optimism for further increases in deal activity in 2011. In a recent survey of sentiment at 50 PE houses by BDO, the financial advisory firm, respondents overwhelmingly described deal activity in 2010 as "low" or "too low." Looking ahead, however, 80 percent said they expected it will increase over the next 12 months, with one-third of the optimists saying they looked for activity to "increase significantly."

Figure 2.1: PE deal activity gathered momentum in the second half of 2010



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

This more positive outlook comes in the face of significant pressures that could easily derail PE's deal recovery. To begin with, the strength and sustainability of economic recoveries in the US and EU remain far from certain, and such rebounds as the big developed economies have seen to date may lack the durability of those in recent business cycles.

In the US, household balance sheets remain under pressure and real estate markets continue to be weak, weighing against the economy broadly and posing challenges for banks' ability to assess loan quality specifically. Looking ahead into 2011 and 2012, the deflation of the commercial mortgage-backed securities bubble and scheduled resets of option adjustable-rate home mortgages (option ARMs) will add strain to bank balance sheets and hold down lending.

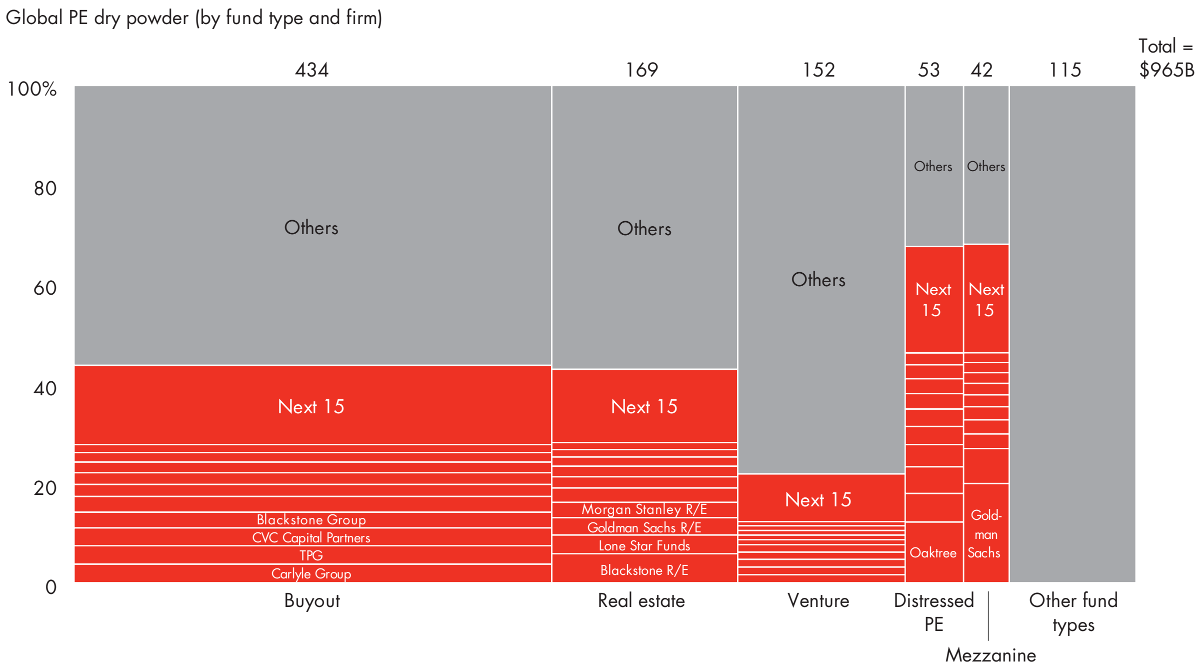
In Europe, confidence has yet to be restored fully to fiscal and financial systems vulnerable to sovereign debt risks. Those risks remain strong, particularly in the developed economies hobbled by high debt levels and persistent structural deficits as governments struggle to support aging populations against a background of slow GDP growth. Over the coming year and beyond, EU governments will be treading a fine line between getting their fiscal houses in order while at the same time ensuring sufficient economic growth to be able to service their debt loads. With many banks large holders of cross-border sovereign debt, a flare-up of a public finances crisis in one country could quickly spread across the region.

Even the developing economies of Asia face macroeconomic pressures that could hobble PE activity in the region. Since the downturn, Asia's leading economies parted ways with the developed economies of the West and continue to grow at a fast pace, led by economic powerhouses China and India. However, worries about inflation and the risk that policy makers may be a tad slow in responding to the threat of asset bubbles forming could increase volatility and undermine the profitability of PE investments.

PE fundamentals look positive: Demand is picking up. Although economic disruption or debt market problems could cut short PE's nascent recovery, the fundamentals of supply and demand that drive PE deal activity now point in the right direction. Starting on the demand side, three factors will drive PE deal making going forward.

The number of active PE firms loaded with dry powder is large—and they are hungry to do deals. The capital overhang from fund-raising rounds during the boom that persisted throughout the downturn shrank by only 10 percent last year and still totals nearly $1 trillion worldwide. The capital is available for investment across all PE fund types: $434 billion waiting to be used in buyouts, $169 billion in real estate, $152 billion in venture capital, $53 billion in distressed assets (including distressed debt, special situation and turnaround funds) and $42 billion in mezzanine finance. Not only are the stockpiles of dry powder large, they are widely dispersed among funds. The 10 largest funds command less than 30 percent of the global buyout dry powder, while the largest 25 funds account for 44 percent. Capital targeted for investment in real estate and venture capital is similarly fragmented. Only in the smaller and more specialized categories of funds that invest in distressed situations and mezzanine financings is the dry powder more concentrated: In both fund categories, the largest 25 funds control two-thirds of the capital available for investment (see Figure 2.2).

Figure 2.2: There is still a huge amount of dry powder spread among a large number of firms



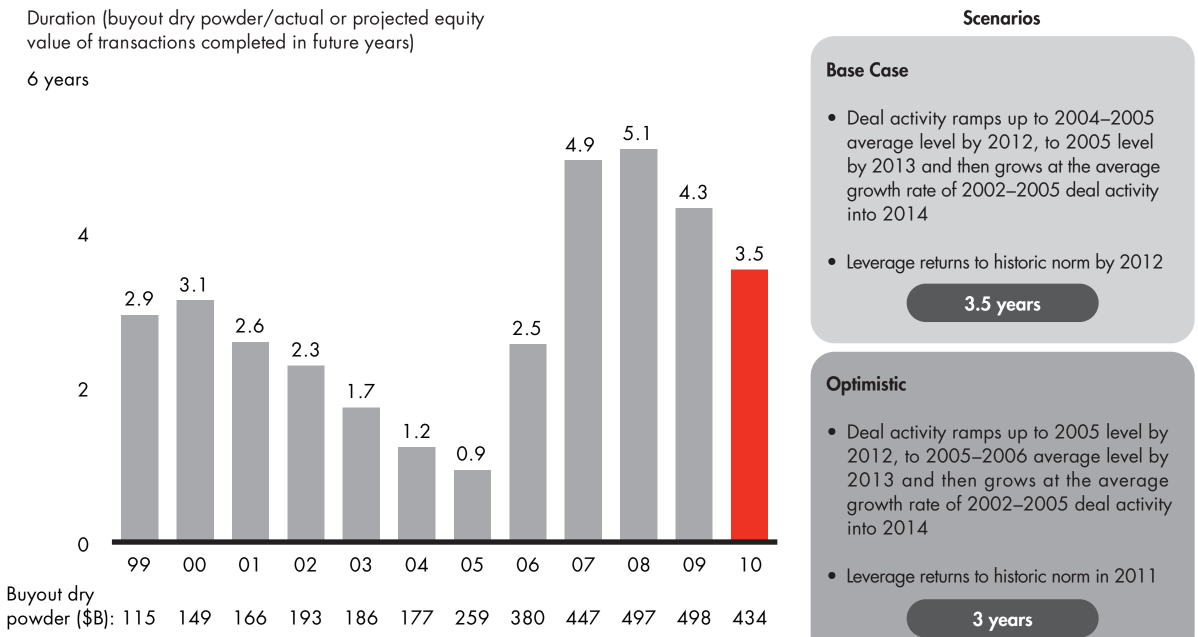
Notes: Data as of December 2010; distressed PE includes distressed debt, special situation and turnaround funds
Source: Preqin

The uninvested capital looking to be put to work is sufficient to fuel deal activity for some years to come. According to Bain analysis, it could take three-and-a-half years to burn through the current volume of dry powder targeted for buyouts. That projection assumes that deal activity ramps back up to the average levels of 2004 and 2005 by 2012 and then continues on a strong upward trajectory into 2014, and that the amount of leverage investors use returns to historic norms by 2012 (see Figure 2.3). Our estimate of how long it will take to put the backlog of dry powder to work is significantly lower today than in 2009, given expectations for a steep recovery in deal making. The pattern in this recovery is similar to the previous rebound in the PE cycle. Yet the years of supply are higher this time around because the volume of dry powder is markedly larger.

With the pace of PE deal activity gaining momentum over the past year, the sheer volume of uninvested capital is not the foremost concern to the PE industry. The bigger worry is that much of the dry powder is in the hands of GPs that, facing increasing pressure to invest, may not do so in a disciplined way. "The ultimate danger to returns for investors is not that GPs will not spend the money, it is that they do bad deals," said a managing director at a PE firm.

How worrisome is the issue? As reported in Section 1, Bain's segmentation of PE funds and dry powder targeted for buyouts found that 55 percent of it is parked as significant reserves with GPs whose funds are nearing the end of their investment periods. Of particular concern are the GPs with weak performance in their current fund. Staring at limited prospects of raising future funds, they have a powerful incentive to invest their remaining committed capital to extend the life of their firm and maximize their revenue streams. Nearly half of the pressured capital—more than $110 billion, or about one-quarter of all dry powder slated for buyouts, by Bain's estimate—is held by GPs with below-average performance track records and at risk of overreaching to close deals.

Figure 2.3: The buyout dry powder could translate into 3.5 years' worth of investment



Note: Analysis for 1999–2006 calculations based on actual equity value of transactions in future years, 2007–2010 calculations incorporate forecasted projections in base-case scenario
Sources: Preqin; Dealogic; Bain analysis

Large amounts of capital in the hands of pressured GPs willing to take big risks could have spillover effects on the broader PE market, as these GPs compete fiercely for deals and drive up prices in the process. The actions of these GPs should give GPs at funds that do not feel the same urgency to invest further reason to remain on the deal sidelines—as many have done in 2010. However, there is a risk that the fierce competition could undermine the investment discipline of a broader group.

There is a way out of the cul-de-sac for pressured GPs—go to their LPs and seek fund extensions to draw out the investment period. Much to LPs' surprise, however, few GPs have approached them with this request. "It's the number one topic in the private equity industry today for LPs," said an investment executive at a US insurance company. "[But] I haven't seen a single manager, certainly in our portfolio, come up with an innovative, LP-friendly approach to this problem . . . I think those that don't are going to feel great pain three years from now."

Why haven't more GPs asked for extensions? Winning approval for an extension typically requires agreement from the entire LP base. With some LPs still experiencing tight allocations and feeling squeezed for liquidity, many GPs know they will not likely get all their LPs on-board. Clearly, GPs that seek an extension should expect that it will come at a price—likely in the form of fee rebates, term adjustments or both. However, what they lose in dollars they will more than recoup in LPs' goodwill.

PE confidence rises as economic uncertainties dissipate. The torpid pace of the macroeconomic recovery in the major developed markets has not given PE firms much to be excited about over the past two years, but the brightening outlook is strengthening confidence that the risk of a double-dip recession has abated.

Adding to the more positive outlook are the continued robust GDP growth rates in emerging and developing economies. Overall, world GDP is forecast to grow at a fairly steady 4.4 percent rate in 2011 and 4.5 percent in 2012 (see Figure 2.4).

The higher degree of visibility into a future of sustained economic growth is a tonic for PE deal activity. It bolsters the confidence of GPs bidding for deals in the reliability of the forecasts built into their valuation models. As a managing director of a global PE firm put it: "It reduces the discount you have to apply for general uncertainty." It may also have a salubrious effect on sellers' expectations, leading them to bring their price expectations in line with more certain and realistic growth projections—and in line with buyers' valuations.

PE will continue to benefit from more stable debt markets. With the economic uplift comes improving debt market conditions that should help put wind into the sails of more PE deals. Debt will continue to be available to finance new LBOs in amounts sufficient to support both riskier and bigger deals. Let us consider first the dynamics in the debt markets, and then weigh the implications for PE financing.

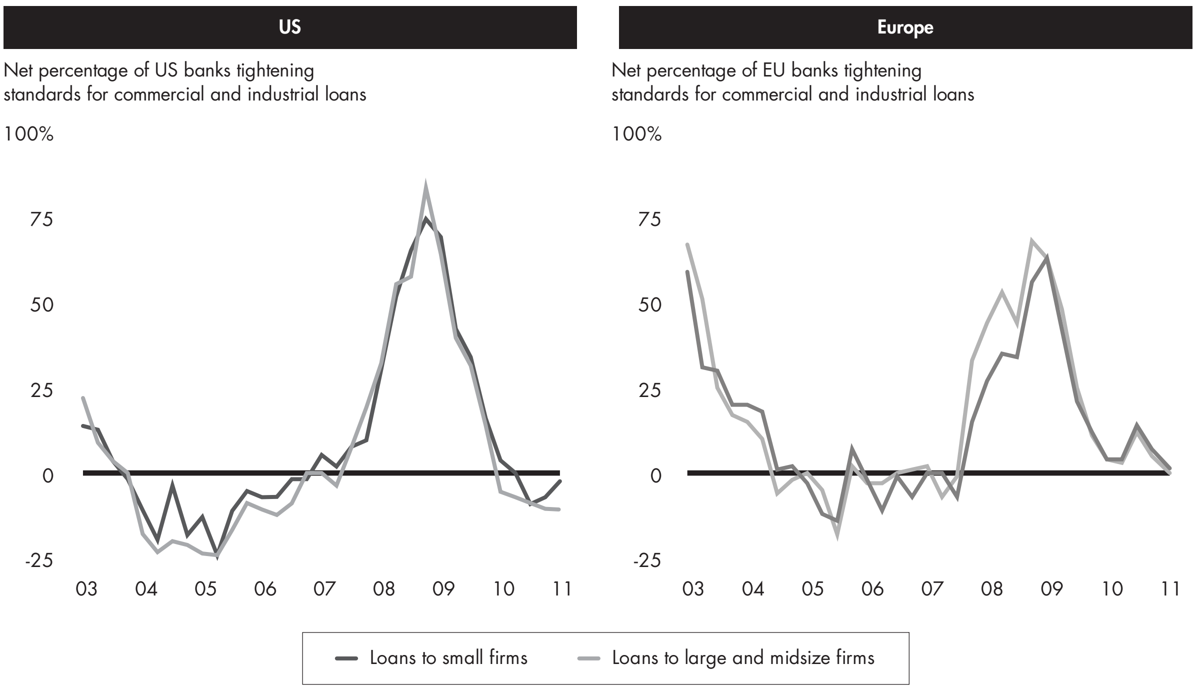
The loosening of lending standards across the US and Europe provides evidence that banks are showing signs that they will be willing to lend for larger, higher-risk issuers, including PE deals (see Figure 2.5).

Banks will be able to syndicate larger, riskier loans to institutional investors. With interest rates at record lows and expected to remain there well into 2011, demand for leveraged loans from yield-hungry institutional investors will continue to be strong. Legacy CLOs will continue to recycle the cash they receive in the form of repayments. Since the large majority of CLOs have yet to reach the end of their reinvestment periods, this stream of capital should continue to irrigate the leveraged loan market throughout the year. Meanwhile, 2011 may also see the reopening of the market for new-issue CLOs, replenishing the loan demand.

Figure 2.4: Confidence is rising as the economic recovery takes hold

Source: IMF World Economic Outlook (October 2010, January 2011)

Figure 2.5: Bank lending standards are loosening in the US and Europe



Sources: US Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices; ECB Euro Area Bank Lending Survey

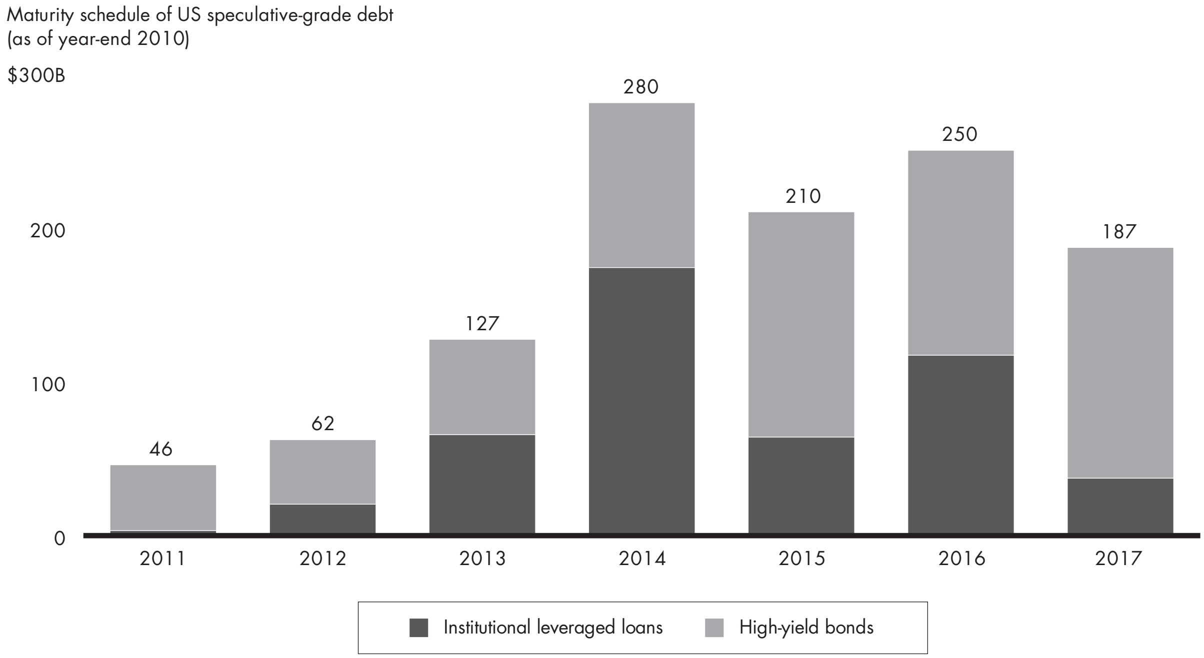
One vibrant source of demand in 2011 is likely to be loan mutual funds. Loan mutual funds took in a record $16 billion in the US during 2010, according to Lipper FMI, driving their share of the institutional demand for new leveraged loans to 14 percent—a five-year high. Industry observers expect the flow of capital into them will continue to expand this year. They also expect to see a pickup in buying from pension funds and endowments, as well as from relative-value investors such as hedge funds, high-yield accounts and multi-strategy credit investors. These investors are eyeing leveraged loans not only because they offer relatively attractive yields compared with other fixed-income instruments. These floating-rate instruments also offer some protection against the possibility that inflation worries will lead to higher interest rates, and they provide seniority and insulation of collateral in the event of an economic downturn.

One big barrier looming over the market for speculative-grade debt is the cliff of institutional leveraged loans and high-yield bonds coming due for refinancing over the next several years. Will banks' and investors' capacity to absorb a growing supply of refinancings leave enough room to supply companies with net new capital, including the financing of new PE deals?

In the US alone, some $515 billion in speculative-grade debt ($265 billion of leveraged loans and $250 billion of high-yield bonds) will come to maturity over the next several years. Beginning modestly in 2011, when $46 billion in mostly high-yield bonds will mature, the refinancing cliff face rises steeply in 2013 and 2014, casting a shadow over the debt markets through 2017 (see Figure 2.6).

Borrowers have made considerable progress chipping away at the refinancing cliff over the past two years, reducing the volume of institutional leveraged loans (the steepest face of the cliff and the one most relevant to PE) due through year-end 2014 by nearly 20 percent (or some $100 billion) in 2009 and knocking off

Figure 2.6: The refinancing cliff stands at $515 billion in the US



Notes: Loan data as of December 31, 2010; bond data as of November 19, 2010
Sources: Bank of America Merrill Lynch; S&P LCD

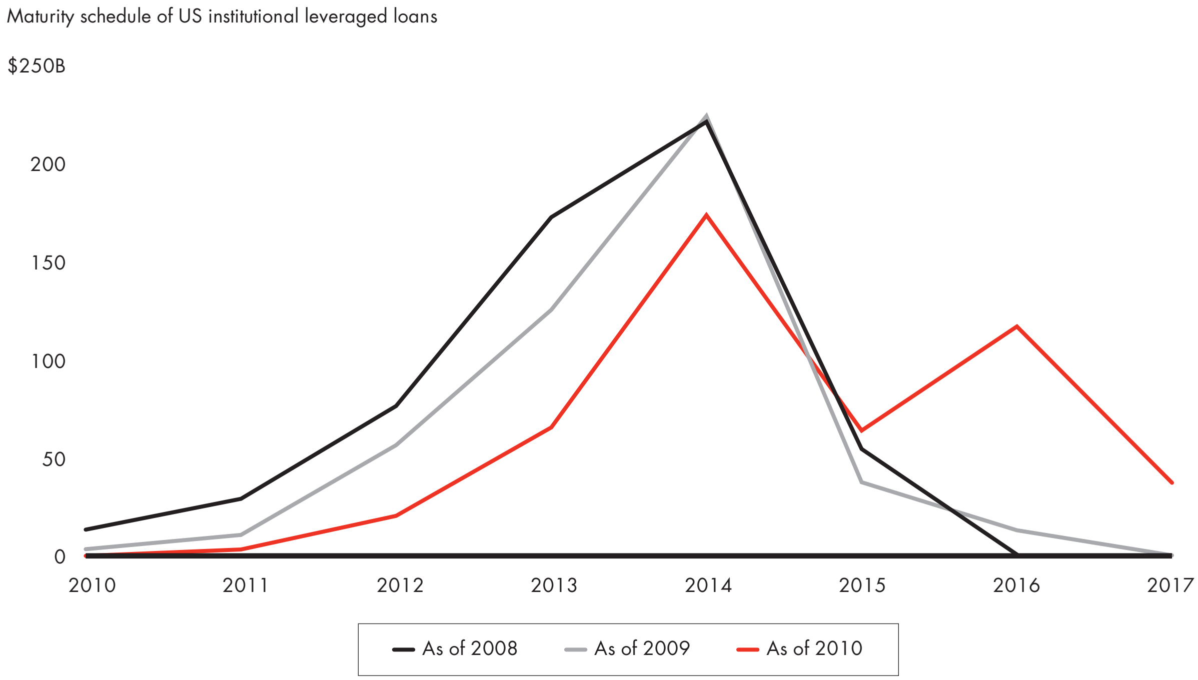
another 37 percent (or $160 billion) through the end of 2010 (see Figure 2.7). The effect has been to make the cliff flatter and push more of the obligations that will come due farther out into the future. Europe has seen a similar pushing out of maturities, albeit on a more modest scale.

Several factors played a part in reducing the leveraged-loan cliff in 2010, with the stabilization in credit quality and improvements in the high-yield bond and leveraged-loan markets playing a crucial role. A rally in the high-yield bond market made it possible for borrowers to swap leveraged loans coming due for newly issued bonds. Such bond-for-loan takeouts accounted for some 40 percent of high-yield bond issuances in 2010. Similarly, the increasing appetite of banks and investors for leveraged loans supported strong debt refinancing activity, which absorbed about 75 percent of all leveraged-loan issuances last year. Lenders also continued to be willing to amend and extend terms on maturing debt. Average amend-and-extend transactions pushed out maturities to nearly three years in 2010, up from an average of two in 2009.

Aided by a strengthening economy, borrowers were able to pay down loans using cash generated internally through a surge in profitability. Initial public offerings and secondary equity offerings also made minor contributions to reducing leveraged loans outstanding in 2010. Helping to keep confidence in the debt markets high going into 2011, write-offs through defaults played only a small role last year, accounting for about 6 percent of last year's debt reduction.

The net effect of the combination of improving debt-market conditions and company-level progress in leveling the refinancing cliff has been to lift confidence among debt-market participants and observers. Surveys indicate that the mood about refinancing has brightened considerably from daunting worries of a little more than a year ago that there will be a refinancing shortfall followed by a wave of defaults. For example,

Figure 2.7: Good progress has been made so far in tackling the loan refinancing cliff



Sources: Bank of America Merrill Lynch; S&P LCD

nearly three-quarters of the attendees polled at the annual conference of the Loan Syndication and Trading Association, a creditor trade group, in the fall of 2010 said they thought the refinancing cliff in North America was now manageable. However, progress in tackling the refinancing cliff in Europe has been weaker; the maturity schedule of leveraged loans and high-yield bonds remains more front-loaded.

Significant risks that could temper the revived optimism still lurk. Top among these is continued concerns that the economy may weaken or fall victim to an exogenous shock. Economic growth that falls below expectations would undermine credit quality, cause defaults to rise and quench demand for speculative-grade debt. A shock to the system such as sovereign debt crises or systemic weakness crippling European banks would shut down debt markets.

Banks' reluctance to keep their lending windows open is a second risk with disruptive potential. Banks have eased lending standards at a very slow pace since the debt crisis, and they are holding their purse strings very tight on higher-risk debt issuers. Rising interest rates and tightening profit margins on loans could further reduce banks' appetite for lending.

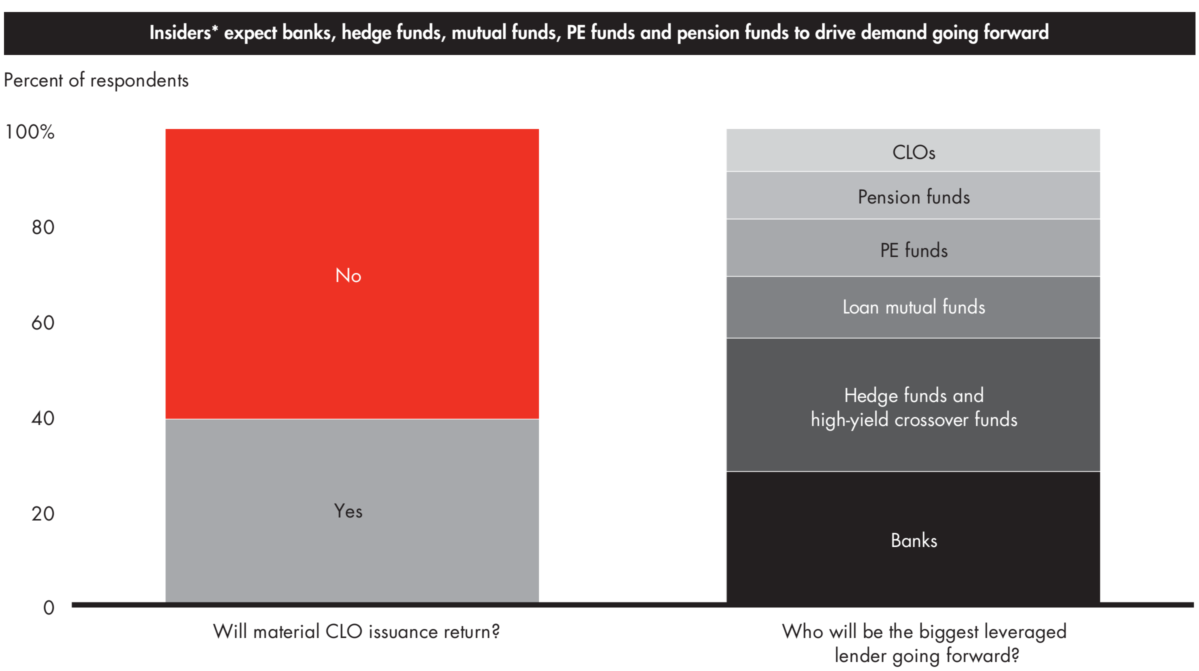
A final risk hovers around the tepid demand for collateralized loan obligations, a major source of growth in the leveraged-loan market. CLOs accounted for between 60 percent and 75 percent of institutional demand from 2001 to 2007. At year-end 2010, legacy CLOs held more than half of all leveraged loans outstanding and made up nearly 45 percent of institutional demand for new-issue leveraged loans last year. However, demand will begin to wane as legacy CLOs' reinvestment periods start to expire in 2012—just as the refinancing cliff begins its steep ascent. Without a corresponding revival in new CLO creation, the ending of CLO reinvestments could leave a large hole in the leveraged-loan market going forward. A survey of industry insiders judges prospects for new CLO issuance as moderate. Respondents see their revival contingent upon the emergence of a new investor base for structured products such as CLOs, the economics of less-levered CLO structures, and how new rules affecting CLOs are interpreted and adopted by regulators and by both parties structuring and executing CLOs (see Figure 2.8).

Coming in the wake of the biggest credit crisis in nearly a century, the major improvements we are beginning to see in the dynamics of the debt markets have major implications for the financing of PE deals. Here is how they are likely to play out in 2011.

More leverage and easier terms for LBOs. The increase in the amount of leverage that PE investors were able to bring to the financing of LBOs and the softer covenants attached to it in 2010 should continue into 2011, provided investor demand remains buoyant. Thanks to banks' easing of lending standards and investors' strong appetite, leverage levels for large LBOs in the US have been gradually trending upwards throughout 2010, reaching a leverage ratio of five times EBITDA by the end of 2010; the average for the year was 4.6 times EBITDA (see Figure 2.9). The greater availability of debt has enabled PE funds to reduce their average equity contribution for buyouts to 41 percent in late 2010 from a post-Lehman Brothers' peak of 51 percent a year earlier.

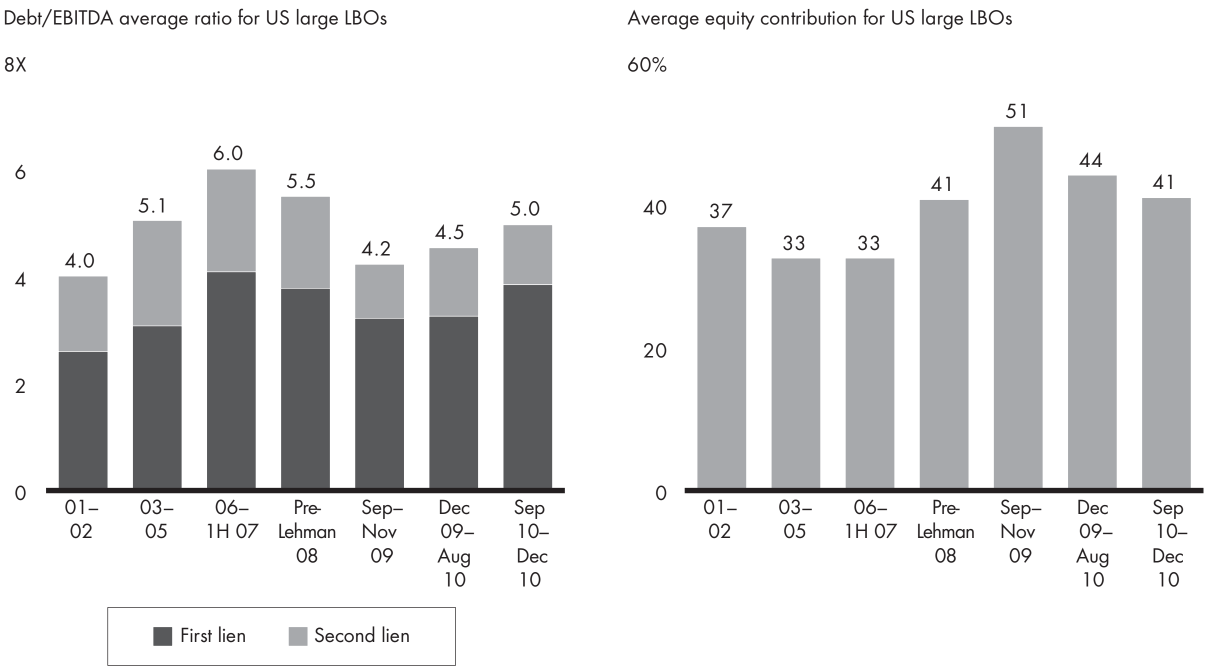
Lenders' greater willingness to make more leverage available has been accompanied by signs that lenders are also easing up on loan terms. Covenant-"lite" loans increased to nearly 10 percent of total leveraged loans issued in the US in the latter part of 2010. In January of this year, their share swelled to 26 percent, on par with what it had been during the 2007 PE boom when fully a quarter of leveraged loans carried

Figure 2.8: Who will fill the void left by CLOs?



*Poll of LSTA conference attendees in October 2010
Source: LSTA

Figure 2.9: LBO leverage levels are rising



Note: Equity contribution includes both rollover and contributed equity
Source: S&P LCD

less-restrictive covenants. Loans that give borrowers the option to make payments in kind in lieu of interest payments—so-called PIK-toggles—have yet to make a comeback, but they too may start to reappear on a limited scale. Representing more than 10.5 percent of the market in the first half of 2007, PIK-toggles fell to just 0.2 percent in 2010. There is nowhere to go but up from that low base in a more risk-tolerant lending environment. Indeed, lending terms will only grow more aggressive if strong investor demand continues to swamp supply.

Cost of debt should remain relatively flat but could face upward pressure. LIBOR, one of the components in debt costs, is at historic lows and continued loosening of monetary policy by the US Federal Reserve and other central banks in developed economies is expected to hold it there. However, investors will continue to write LIBOR floors into the loans they buy to compensate them for low lending benchmarks.

Risk spreads, the other major component of debt costs, did widen some during 2010 but erased part of those gains in the last quarter of 2010 as surging demand gave issuers more power to demand better terms. Spreads could expand in 2011 as more new issues come to market and the imbalance between already strong demand and increasing supply narrows.

Taken together, the improving dynamics of the debt markets will make the economics for LBOs more attractive, which will support increased deal activity in 2011. It will also help portfolio companies of PE firms refinance and restructure their balance sheets.

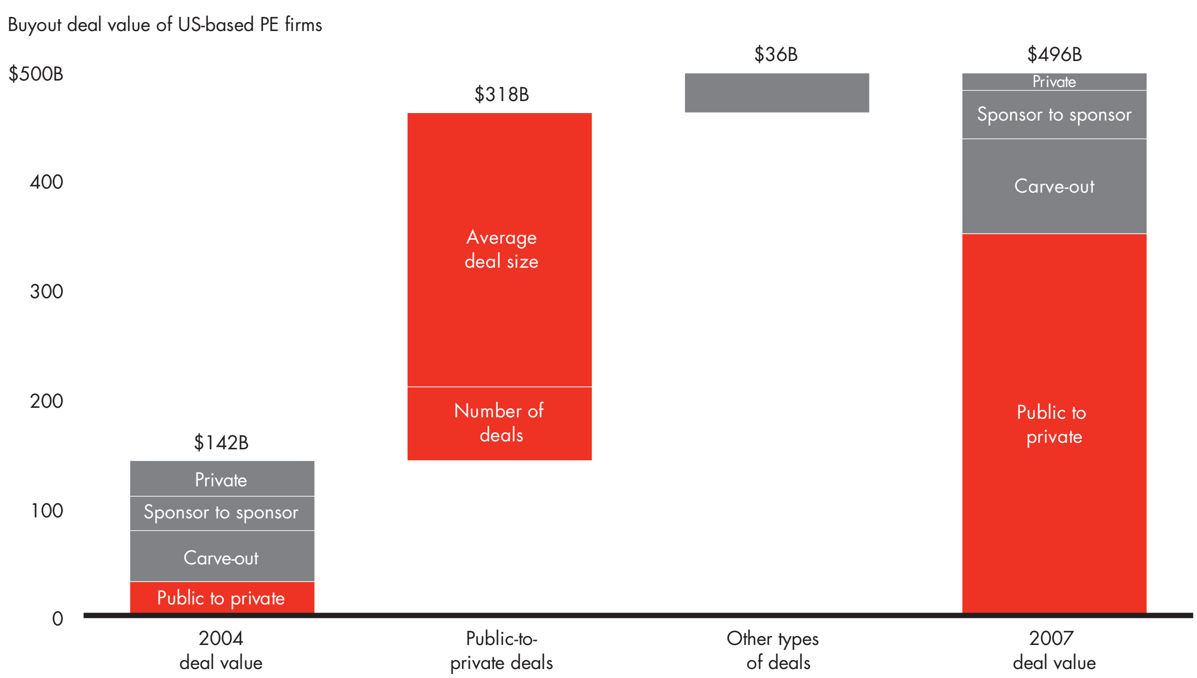
PE fundamentals look positive: The supply—and range—of deals will increase. Strong public valuations and buyers' willingness to pay healthy premiums on acquisitions during 2010 will continue to draw sellers of high-quality assets into the market over the coming year. The two-year extension of the lower tax rates in the US may spur some sellers looking to lock in profits at lower capital gain tax rates.

The supply of potential PE targets will increase as the opportunity set broadens. Let us consider three other supply-side factors that may drive deal activity in 2011.

A thaw in public-to-private deals. Robust public-to-private deal-making activity drove the last PE boom and will be essential for powering a healthy recovery going forward (see Figure 2.10). Yet, as we saw in Section 1, while P2P deals came back into vogue during the gradual pickup in transactions during 2010, both their number and size fell short of potential. Banks were hesitant to back bigger deals with large debt packages, and only a very few were able to secure more than \$2 billion to \$3 billion of debt. For their part, PE firms lacked the confidence to pull the trigger on large deals in light of target public companies' high price expectations.

Taking current equity and debt market conditions as a starting point, Bain investigated the universe of approximately 1,400 US public nonfinancial companies with more than \$500 million in annual revenues and having an enterprise value in excess of \$50 million. Our model's base case targeted a 20 percent gross internal rate of return (IRR) over a five-year holding period. We further assumed that the acquirer would pay a premium of 30 percent over the public valuation to purchase the asset and would finance the deal with debt at 4.75 times EBITDA and priced at about 8 percent.

Figure 2.10: Public-to-private deals largely drove the last boom



Note: Other types of deals include sponsor to sponsor, carve-out and private targets
Source: Bain US LBO deal database

When we ran the numbers, we found that more than 400 companies having a combined market capitalization in excess of $1 trillion appeared to have valuation and cash-flow characteristics that could support a P2P transaction. (This estimate, of course, is very sensitive to changes in market valuations.)

The window of opportunity for these transactions to materialize is not substantially wider than in 2010. But several factors at play in 2011 suggest that more of those potential deals could end up being realized. For one thing, banks and other lenders are increasingly open to writing larger checks, reopening the market for larger P2P transactions. The market already saw deal size move up considerably in the final months of 2010, including the pending $5.3 billion buyout of Del Monte Foods. “Debt markets have rallied to a higher point than I would have predicted,” said the North American co-head of a leading global PE firm. “It is possible we will see [buyouts worth more than $10 billion] being done over the next six months.”

Also pointing to a rise in P2P deals is the attraction of PE funds to the large number of public companies carrying record amounts of cash on their balance sheets. Given today’s historically low interest rates, that cash is generating virtually no return. Yet shareholders do not place a premium on the cash target companies hold. By taking on additional leverage in an LBO, a PE fund could unleash value and make the capital structure of the company they take private more efficient.

A continued bull market for secondary buyouts. The overhang of dry powder and the uncertain prospects for PE funds to engineer IPOs in a choppy market or arrange sales to strategic acquirers conspired to make sponsor-to-sponsor deals popular in 2010. Those transient conditions will still be in place in 2011, but there are more fundamental reasons why these deals make sense and are likely to remain a staple of the deal supply.

One factor favoring sponsor-to-sponsor deals is that they can be completed more expeditiously than an IPO or a sale to a strategic buyer can. Regulatory filings for an IPO typically require a lead time of eight or nine months. When equity markets are volatile, waiting for optimal pricing conditions and receptive market conditions can postpone an IPO indefinitely. Sales to strategic buyers are not much easier, requiring approval by the acquirer’s shareholders and often involving drawn-out closing periods.

Second, the number of PE-owned companies has increased dramatically following 30 years of deal making. Because the business model of PE firms is to sell their portfolio companies after a holding period of typically three to five years, PE-owned companies represent a significant share of businesses that come up for sale.

Those limited holding periods, moreover, can trigger the sale of a PE-backed company while there remains significant upside gains to be realized. That makes them highly attractive to other PE firms that can bring their unique capabilities to bear to realize that yet-untapped potential. Different stages of a company’s development may best be supported by new PE owners with different, more appropriate skill sets.

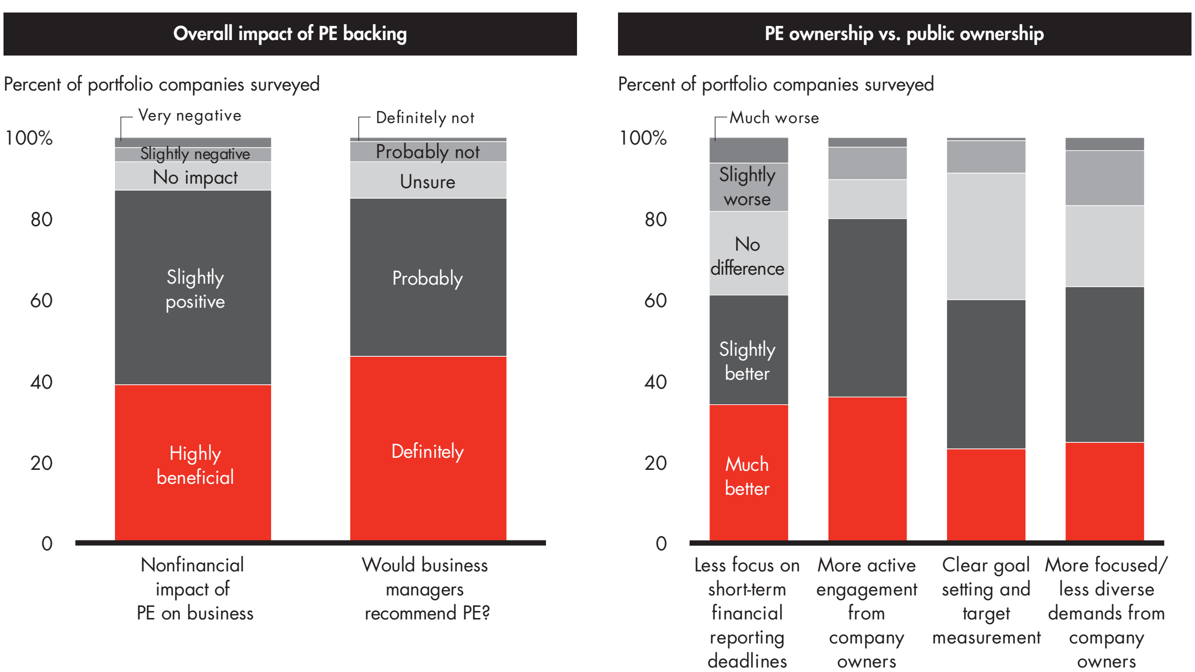
Also, secondary buyouts are becoming prevalent because some companies are simply better suited for private ownership. Typical characteristics of these businesses are that they are stable, enjoy predictable cash flows, require low capital expenditures and need limited working capital. They also tend to compete in a defined and consolidated market and have no obvious strategic buyer. A significant share of these “PE suitable” companies have already been acquired by a PE firm, and having found their way into PE hands are likely to find their way back.

Many management teams, too, that have worked with PE owners have enjoyed the experience, and many prefer it to operating under public ownership. A 2010 survey of managers who have worked at PE portfolio companies asked how they would describe the nonfinancial impact of PE on the business. Nearly 90 percent said it was positive, and 40 percent described it as highly beneficial. Similar proportions said they would recommend working under PE ownership to their colleagues who have not had the experience. A majority of managers who had worked both under public and PE ownership also responded that they found PE superior for a variety of reasons from more hands-on engagement from the company owners to clearer goal setting (see Figure 2.11).

Experience in the European markets where 30 to 40 percent of PE investments have been secondary buyouts demonstrates that these deals make good money for LPs. There's every reason to believe that same potential exists for secondary deals to rise to that level in the US.

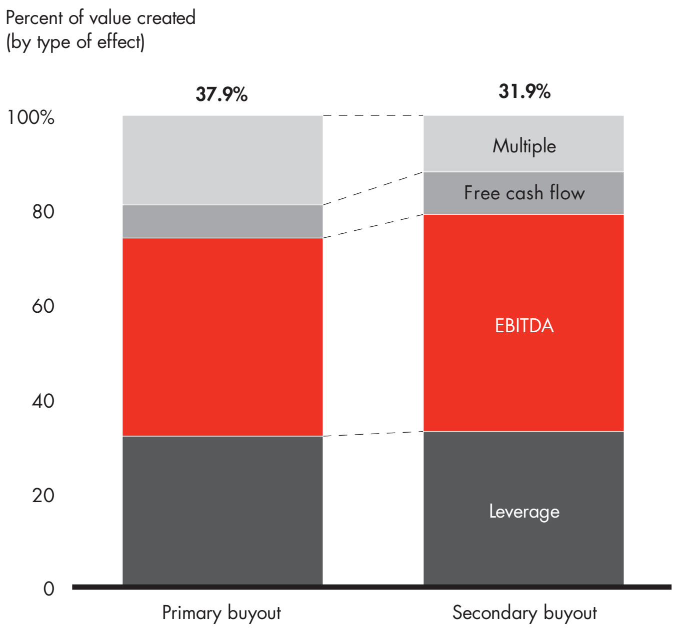
Perhaps the most compelling reason why secondary buyouts make sense and are likely to remain a staple of the deal supply is their performance. Recent research suggests that secondary buyouts offer attractive returns. A study by Golding Capital Partners together with the Center for Entrepreneurial and Financial Studies at the Technische Universität München of 236 primary buyouts and 50 secondary buyouts in Europe from 1989 to 2006 found that the median IRR of the secondary buyouts was a very respectable 32 percent compared with 38 percent for the primary buyouts (see Figure 2.12). That somewhat lower return for secondary buyouts can be explained by the fact that they tend to be larger than primary buyouts, with returns generally being negatively correlated with size. Accepting a somewhat lower IRR may be a small trade-off to make for a lower-risk investment. An investor in a secondary buyout benefits from groundwork done by the initial owner, who will have identified—and resolved—management weaknesses, hidden traps in the company's balance sheet and financial-reporting problems.

Figure 2.11: Research suggests that management teams' satisfaction with PE ownership is high



Source: "What Do Business Managers Think about Private Equity and Venture Capital," BVCA, September 2010 (n=208 managers at PE and VC-backed companies)

Figure 2.12: Research suggests similar value-creation potential between primary and secondary buyouts



- **Overall return:** Lower median IRR, but can be explained by secondary buyouts' larger size (negatively correlated with returns)
- **Multiple effect:** Lower, offering less potential for multiple expansion as negotiation skills of PE funds on buy and sell sides neutralize each other
- **EBITDA and free cash-flow effect:** Similar, offering the same operational value-creation potential
- **Leverage effect:** Similar, given only slightly higher debt-to-equity ratio (2.1:1 for secondary buyouts vs. 1.9:1 for primary buyouts)

Notes: Based on 236 primary buyouts and 50 secondary buyouts from 1989–2006 in Europe; free-cash-flow effect refers to the impact of debt repayment and dividend payment on returns
Source: "Private Equity Study: Secondary Buyouts Offer Attractive Potential for Value Creation," Golding Capital Partners and CEFS, November 2010

Examining the components of returns more closely, the study found that the proportion of overall returns achieved by increasing EBITDA and free cash flow was similar between secondary and primary buyouts, showing that both enjoyed the same potential to create operating value. Stating the case for secondary buyouts, a managing partner with a major European PE firm said, "People have made good money out of our secondaries and there's definitely a place for them. [Secondaries] need to be part of the market because there are companies that are better suited for private ownership than public."

Despite the many compelling reasons why secondary buyouts make sense, LPs have mixed feelings about them. In a survey conducted by Coller Capital last summer, 70 percent of LP respondents said secondary buyouts are fine with them in principle—although LPs Bain interviewed said that was the case so long as they are on the sell side.

The major concern they voice is over the frictional costs in the form of transaction fees and carry that reduce the returns of LPs that are in both the selling and buying of funds. "Investors don't . . . like being on both sides of those deals because we pay fees and carried interest, and we still own the asset," said the European head of an investment management firm, expressing a view shared by many LPs Bain interviewed.

But LPs also highlighted other issues that go to the heart of their relationship with GPs and how well their interests are aligned. "To me, this isn't a sign of strength in the private equity business, but more a sign that firms must commit their capital before their investment period runs out," said the chief investment officer of a major public pension fund.

LPs also expressed doubt about whether portfolio companies sold by one fund to another—quite possibly three or even four times—present true opportunities for the new PE owners to bring new skills to bear that can add value. "We tend to scratch our heads when a company is passed between two large firms with similar characteristics and skill sets. You have to ask, what performance improvements will the new owners be able to make to the company that the previous owners already haven't made?" said a director with a public pension fund.

Emerging-market opportunities. As developed markets remain ensnared by public-debt worries and modest prospects for GDP growth coming into 2011, the sustained robust expansion in the major emerging markets around the world stands out in dramatic contrast. The opportunities they present have not escaped the notice of PE investors—GPs and LPs alike—that have created and poured capital into the growing number of funds that target regions and specific countries outside of North America and Europe.

China, India and the other hot-growth economies of Southeast Asia continue to top the list of markets where PE firms and LPs see the most promising PE opportunities. We described major issues international PE firms are confronting in the region in last year's global private equity report. For all the attractive growth potential these markets represent, GPs must reckon with a host of regulatory, cultural and corporate governance challenges that enormously complicate PE deal making and can compromise returns.

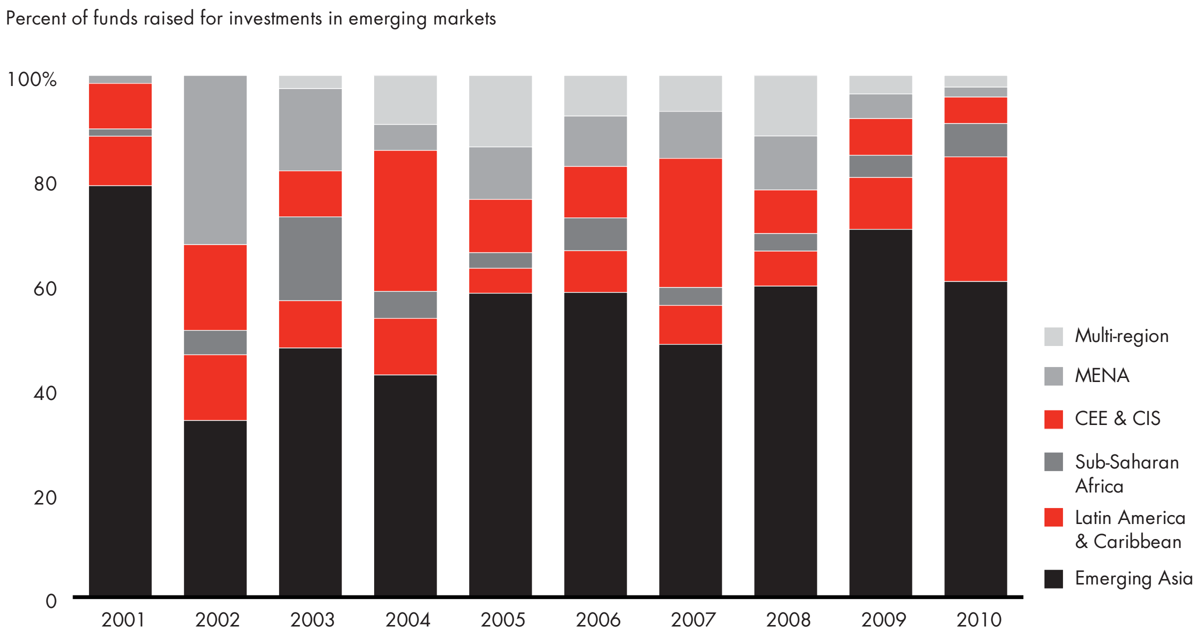
These are not conditions unique to the Asia-Pacific region, but apply broadly across emerging and developing markets, albeit with crucial differences that characterize each. This year, we turn our spotlight on two other markets attracting increased PE attention—Brazil and Central and Eastern Europe.

Brazil. After Asia-Pacific, Latin America is today the second most-attractive emerging region, attracting nearly 25 percent of the PE funds raised for investment in emerging markets in 2010. Brazil, the region's largest economy, has been at the center of PE investors' interest (see Figure 2.13).

Largely skirting the global downturn, Brazil's economy has grown at an average rate of nearly 4 percent over the last four years and is forecast to grow at a better than 5 percent annual rate over the next several years, according to LCA, a Brazilian economic consultancy. Inflation is in the single digits, concerns over unemployment have eased, middle-class consumption is rising, exports to China are booming and infrastructure improvements are multiplying. This macroeconomic environment has attracted the attention of large international PE firms, and some local firms with longer performance track records celebrated record fund-raising in 2010.

The competitive dynamics of Brazilian PE are in the throes of change. Through the 1990s and into the 2000s, the industry was dominated by local firms, which focused mainly on professionalizing the management of the nation's midsize family-owned businesses. Lacking a clear IPO exit route or fully developed debt market, the environment was neither conducive to larger-scale deals nor inviting to bigger PE firms. Now, however, Brazil's economic momentum combined with greater development of the capital markets—including an active IPO market and an increasingly sophisticated debt market—are attracting global attention. The increasing presence of international PE firms is encroaching on local competitors by bringing new expertise and more dry powder to the country. PE deals are increasing in size, and international firms are behind more of the largest deals.

Figure 2.13: After Asia, Latin America and CEE attract the most capital for investment



Notes: Include capital raised for EM-specific funds, whether a pan-EM fund, an EM-focused regional fund or an EM-focused country-specific fund; represents year of incremental closes
Source: EMPEA

Although investors will find opportunities across all industries, companies that benefit from rising middle-class consumption and infrastructure investment are likely to continue to be attractive targets for PE funds. Housing, consumer products, retail and financial services are sectors that will benefit from rising consumption trends and offer opportunities for profitable PE plays. Brazil is midway through a major infrastructure investment cycle to remedy years of underinvestment, support the growing oil and gas and renewable-energy industry, and develop the installations and systems for the FIFA World Cup and the summer Olympic games, which Brazil will host in 2014 and 2016, respectively. The infrastructure investment cycle will create opportunities in transportation, logistics, energy, sanitation, education and healthcare, among other sectors.

Although it has been through a great cycle of growth, Brazil still presents many challenges found in other emerging markets. PE investors in Brazil must navigate a deal environment where potential target companies may lack professional management expertise and externally audited financial records. They also face complex and sometimes changing legal, tax, environmental and regulatory frameworks in many sectors. Regional differences are still important and difficult to accommodate. Gaps in workforce talent and education could jeopardize growth plans in some sectors and prevent companies from achieving operational full potential. Debt markets, while developing, are burdened by relatively high interest rates to contain inflation. These are obstacles that local PE firms are accustomed to but may be new to outsiders. Lately, international firms have sought partnership deals with local firms in part to serve as guides through these thickets, a trend that may continue.

PE interest in the Brazilian market should remain high over the coming years. Whether returns will be as great as the interest is still an open question.

Central and Eastern Europe. A diverse region made up of former Soviet satellite states from Poland to the Balkans and including Turkey, Central and Eastern Europe (CEE) is drawing increased interest from PE investors. Recent rapid economic growth will continue to benefit from closer integration with the EU, favorable demographics, and rising consumer and retail demand. As countries across the region continue to harmonize their economic and legal systems with those of the EU, business and consumer confidence is improving. A growing population of younger, more affluent urban residents across CEE are propelling consumer spending. Over the past five years, consumer expenditures across most of the region have grown at an annual rate of between 5 and 11 percent versus just 2 percent for the EU, according to Euromonitor. This solid growth has helped make CEE economies less reliant on EU exports and more resilient during the downturn. Overall, GDP in CEE countries and Turkey grew at nearly double the annual pace of the EU15 average since 2004, and that is forecast to continue in the coming years, according to the Economist Intelligence Unit, an economic and business research firm.

These attractive fundamentals have drawn a growing number of local and international PE firms to the region. Both PE fund-raising and deal making in CEE accelerated going into the 2008 global credit crisis. In 2007 alone, CEE attracted nearly one-quarter of all funds targeted for emerging markets. Although PE fund-raising and investment activity declined sharply across the region since the global financial crisis, anecdotal evidence points to a growing number of PE firms scouting the region, with many leveraging the capital in their funds with broader geographic mandates.

PE deals in the region have hewed closely to the macro trends, with many investments focused on domestic consumer goods and retailing, as well as in industries with "easy" access to the developed European countries. In Poland, Turkey and the Czech Republic, investments in communications and consumer goods are riding the consumer spending wave while increased investments in energy, healthcare and transportation capitalize on infrastructure improvements as the region develops.

Across industries, major investment themes in the region include the privatization of formerly state-owned industries, consolidation by small and medium-sized enterprises (SME) and carve-outs. Another potential investment is following the increased presence of PE firms' non-CEE portfolio companies in the region. Especially with regional governments more open to foreign ownership, privatization opportunities are likely to continue, albeit at a slower rate, and could provide scale investment opportunities. Ongoing SME consolidation provides PE firms the opportunity to build scale and add management capabilities. Finally, as many conglomerates across the region move to streamline their portfolios and divest businesses, carve-outs become an attractive investment opportunity for PE investors going forward. Many of the trends unfolding in CEE are reminiscent of the early days of PE activity in the West. As such, lessons learned two decades ago in the US and Western Europe are relevant to investing in the region today.

Not surprisingly, the promising macro view of CEE and Turkey is complicated by several challenges. The business environment still lags EU standards. Investment protection, regulatory red tape, and political and economic volatility remain persistent problems. Also, competition for the larger acquisitions will be fierce, as corporations trying to penetrate these fast-growing markets will be drawn to these large companies as platforms for expansion. Most PE deals will likely involve midsize and smaller companies. Another bottleneck for PE deals in the region is the lack of availability of deal exits through IPOs. Most exits occur through sponsor-to-sponsor deals or sales to strategic buyers, requiring careful planning from the outset.

Finally, with their different languages, currencies, and political and economic dynamics, CEE and Turkey are by no means homogeneous markets. Thus, PE firms will need to develop localized playbooks to increase the odds of success. Building a network of local advisers and industry experts, as well as having knowledgeable people on the ground, will be critical for getting into the deal flow and successfully managing portfolio companies.

Exits: Pressures are building

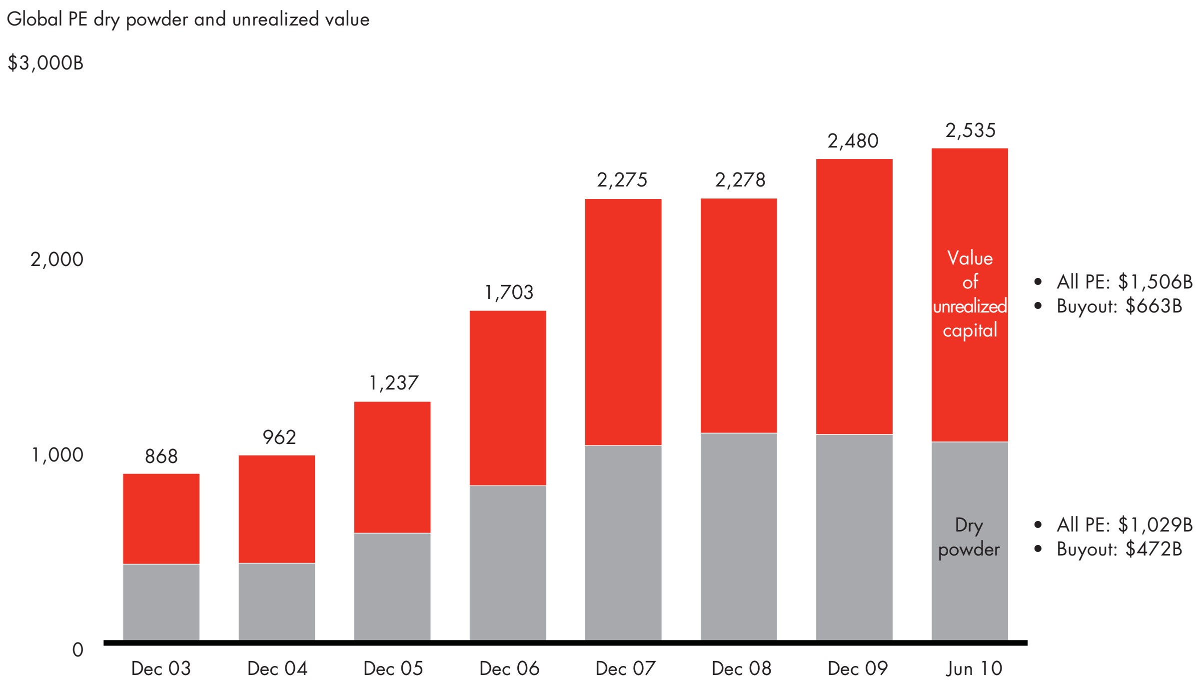
Private equity funds saw opportunities to sell portfolio companies improve markedly since the last quarter of 2009, and that momentum continued throughout 2010. But challenging exit conditions following the downturn and lasting until the latter part of 2010 have added to PE funds' huge pool of unrealized investments. Indeed, the value of this pool for all PE funds swelled to $1.5 trillion by the end of the second quarter of 2010—$663 billion for buyout funds alone (see Figure 2.14). To put that figure in perspective, the unrealized value of assets managed by PE firms is now nearly 50 percent more than their holdings of dry powder and approaching 60 percent of total capital under PE-fund management, the highest ratio in years.

The pool of unrealized buyout investments is concentrated in the big vintages raised and invested during PE's cyclical peak. Some 70 percent of that value is tied up in buyout funds of vintages between 2005 and 2008. Virtually no buyout fund with a vintage after 2004 has yet to return paid-in capital to its LPs (as measured by a distributed to paid-in-capital ratio of less than 100 percent—see Figure 2.15).

These portfolio structures will spur GPs to be even more motivated to look for ways to exit in 2011 than they were in 2010. The pressure will be most intense on those funds that have largely invested their commitments but have distributed little capital back to LPs. Specifically, only about one-third of large buyout funds with vintages between 2005 and 2007 have called more than two-thirds of their LPs' commitments. But virtually none of these funds have yet returned LPs' money (see the red shaded area in Figure 2.16). These GPs will likely need to hit the fund-raising trail again soon and will be motivated to realize investments—to feed capital through the PE cash cycle but, more importantly, to show potential LPs a *real* picture of the performance track record of their previous fund.

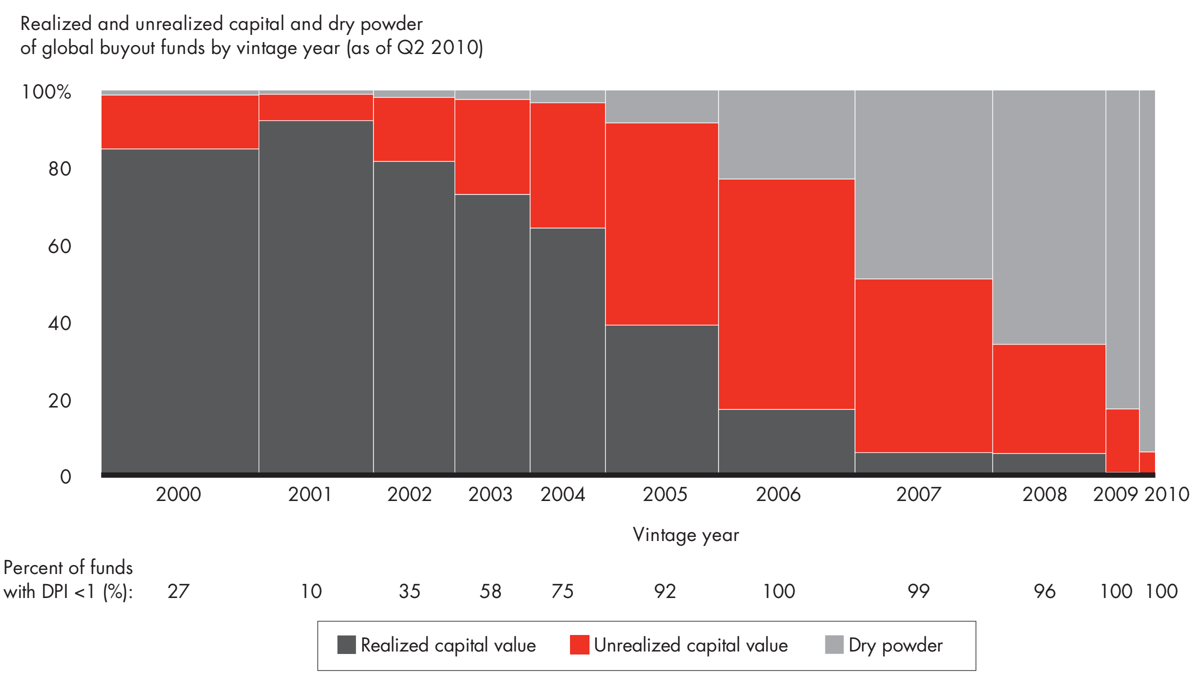
The composition of unrealized portfolios, however, will make it difficult to burn through the exit backlog. Some holdings may not be ripe for sale in 2011, or possibly for some time to come. PE funds made many of these investments at peak prices during the height of the PE boom. According to Bain analysis, more than 80 percent of the unrealized investments in a sample of buyout funds we examined were completed between 2005 and 2008 (see Figure 2.17). These unrealized investments were either purchased at high multiples, were in sectors sensitive to the business cycle that have yet to recover, or were in larger companies that have more limited exit options. Many of these unrealized investments are still underwater. As Figure 2.17 shows, the value of 40 percent of PE portfolio holdings is currently worth less than the equity invested. A further 33 percent of unrealized investments are currently valued between one and one and one-half times the equity invested (before payment of fees). When translated into net IRR, this is likely below the hurdle GPs need to earn their carry, depending, of course, on the age of these investments. GPs will be unwilling to rush to sell those investments at a loss or below their carry hurdle rate.

Figure 2.14: Challenging exit conditions have left the PE industry with a large pool of unrealized capital



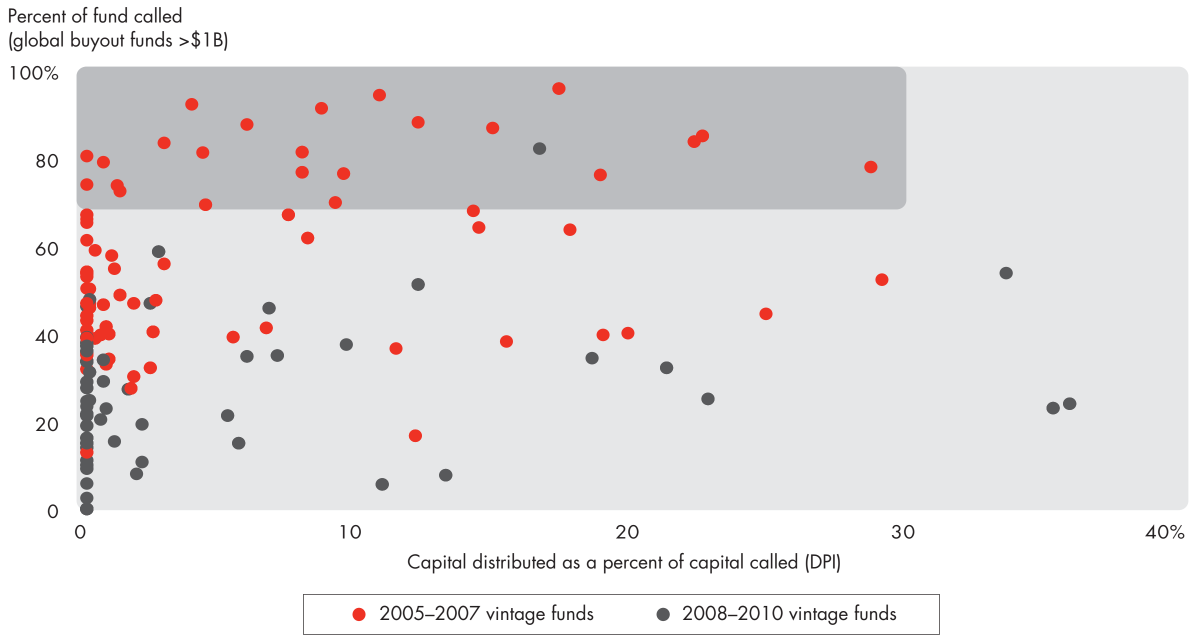
Source: Preqin

Figure 2.15: The pool of unrealized capital is concentrated in large vintages raised during the peak



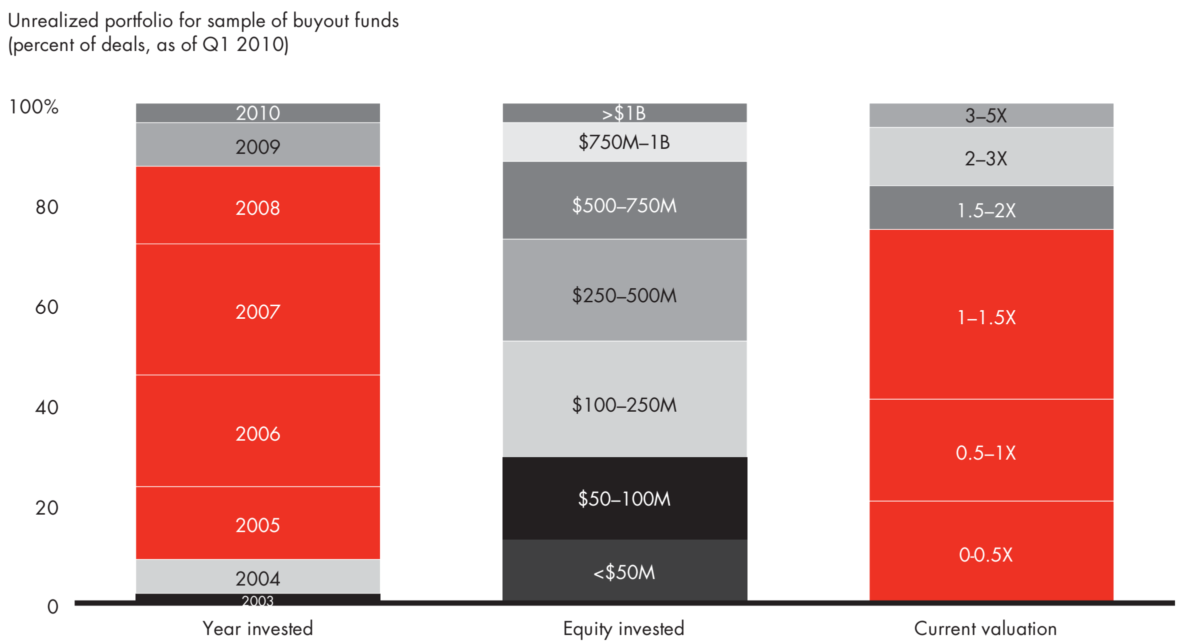
Note: DPI = ratio of distributions to paid-in capital
Source: Preqin

Figure 2.16: GPs will be motivated to exit



Notes: Includes most recent closed buyout fund for each geography for each GP; vintage 2005 and later ≥$1B; funds with insufficient data excluded; vintage year refers to year of initial investment; based on most recent performance data available, primarily as of Q2 2010
Sources: Preqin; Bain analysis

Figure 2.17: Many of the unrealized investments may not be ripe for sale for a while



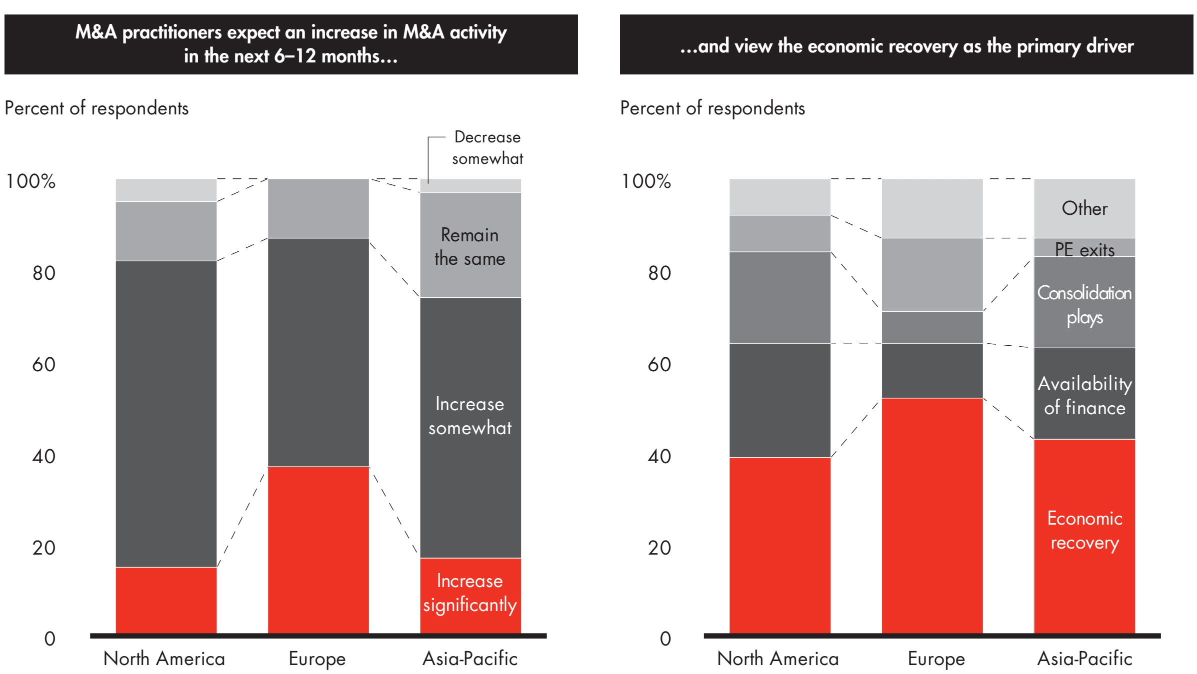
Notes: Fund vintages in sample range from 2002–2008; analysis includes unrealized investments and partially realized investments for which <90% of the total value of the investment is still unrealized; valuation multiples are before payment of fees
Source: Bain analysis

The good news is that for those investments ripe for sale, GPs are likely to find the three major PE exit channels—sales to strategic acquirers, IPOs and sponsor-to-sponsor transactions—more welcoming in 2011.

PE sellers will likely see more activity from strategic buyers in 2011. The somewhat better macroeconomic environment along with continued low interest rates, less volatile equity markets and stocks trading at low forward-looking multiples improve the outlook for an uptick in corporate mergers and acquisitions. Flush with record cash reserves, companies certainly have the resources to do transactions. Following years of cost cutting during the downturn, growth is firmly back on corporate agendas; and M&A will be a likelier route to achieve it in a slowly expanding economy that is not conducive to growing organically. A survey last fall of experts involved with corporate M&A found that they expect to see at least a modest increase in activity across North America, Europe and the Asia-Pacific region over the coming six to 12 months (see Figure 2.18). But their optimism could quickly fade if the economy stumbles. More than two-thirds of the survey respondents said that M&A activity would be cut short if the economic recovery weakens. Among those, half suggested that a double-dip recession is the most significant threat.

IPOs will continue to be a viable exit channel for high-quality companies with strong growth prospects, and GPs are lining up portfolio companies for sale in the hopes of improved IPO conditions in 2011. As of January 2011, 35 PE-backed IPOs were on file in the US, representing $16 billion in potential proceeds. Among them were such notable names as HCA, the world's largest operator of healthcare facilities that is held by Bain Capital, KKR and Merrill Lynch Global Private Equity, and Skype, the Internet communications company sponsored by a consortium that includes Silver Lake Partners and the Canada Pension Plan Investment Board. Beyond the active IPO backlog is a significantly bigger "shadow pipeline" of potential deals ready to come to market at any time.

Figure 2.18: Some optimism about corporate M&A in 2011



Source: "Driving the Comeback of M&A," Mergermarket/Merrill Datasite (n=125 corporate executives, PE practitioners, legal and financial advisers; Q3 2010)

IPO market observers believe that portfolio companies are apt to face some of the same headwinds in 2011 as blew throughout 2010. Investors are longing for growth stories, so they will push back on pricing when portfolio companies with weak balance sheets try to tap equity markets in order to de-leverage. However, the successful debut of Nielsen Holdings, the audience rating company owned by KKR, Thomas H. Lee Partners, Blackstone Group, Carlyle and others, looks like a promising sign of things to come. After pricing above range, Nielsen shares rose 20 percent in the first weeks after trading began.

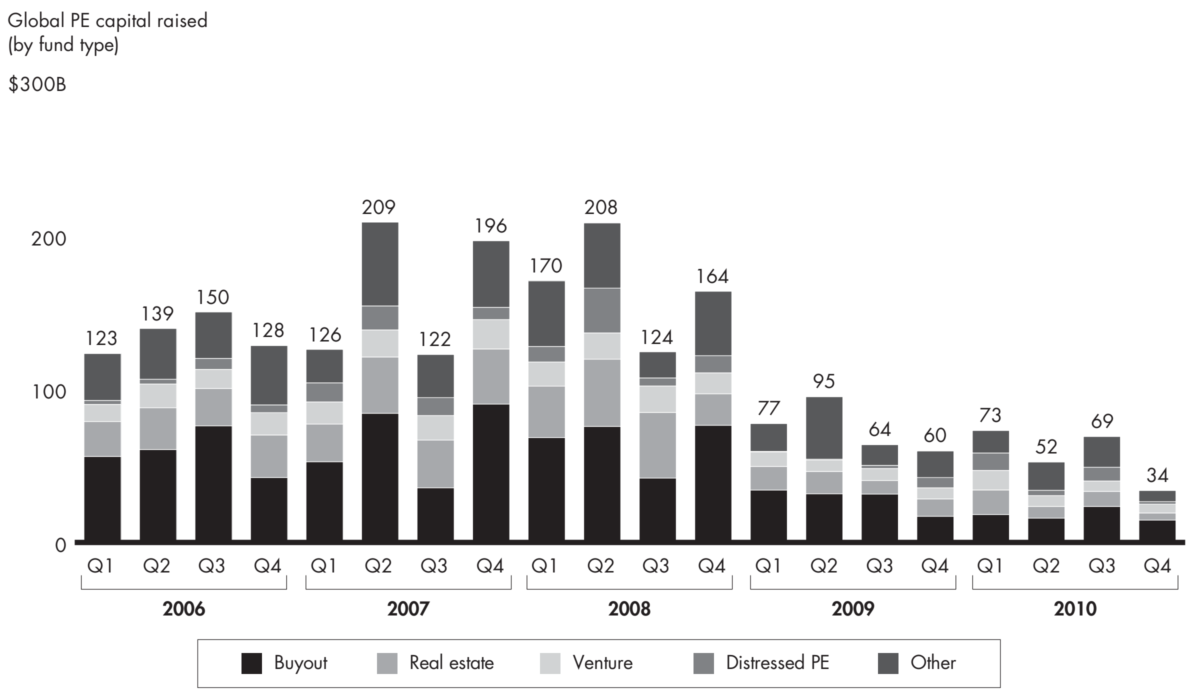
Finally, sponsor-to-sponsor transactions will stay strong for all the compelling reasons discussed earlier in this report, although PE firms may encounter stiffer competition from strategic acquirers.

Following its big improvement throughout 2010, can the exit market continue its recovery? Certainly, any number of exogenous shocks could derail it, and many companies that remain underwater in GP portfolios will not come to market for years. But for many players, the exit market is better right now than at any time since 2007.

Fund-raising: Signs point to a rebound

New private equity fund-raising was all but dormant in 2010 and was weaker even than in 2009, itself an inauspicious year. Global PE capital raised during 2010 continued to trend generally lower as the year wore on (see Figure 2.19).

Figure 2.19: PE fund-raising has not shown signs of recovery yet



Source: Preqin

If past patterns remain a reliable guide, it appears that, coming into 2011, fund-raising has reached a cyclical low and is poised for a recovery. Fund-raising typically lags investing activity on the way down and, again, as the industry enters a new up cycle. Fund-raising remains high as deal activity plunges because many commitments are signed months before the market tumbles. And fund-raising does not pick up again until allocation pressures and liquidity constraints ease, and LPs regain their footing.

That pattern was in evidence during the past PE cycle, as fund-raising followed a recovery in deal making between 2002 and 2004 and trailed off as deal activity slumped in 2007 and 2008 (see Figure 2.20). A similar lag effect appears to be at work now. The year-over-year percentage increase in new investment activity over the past year is being trailed by a continued decline in fund-raising activity.

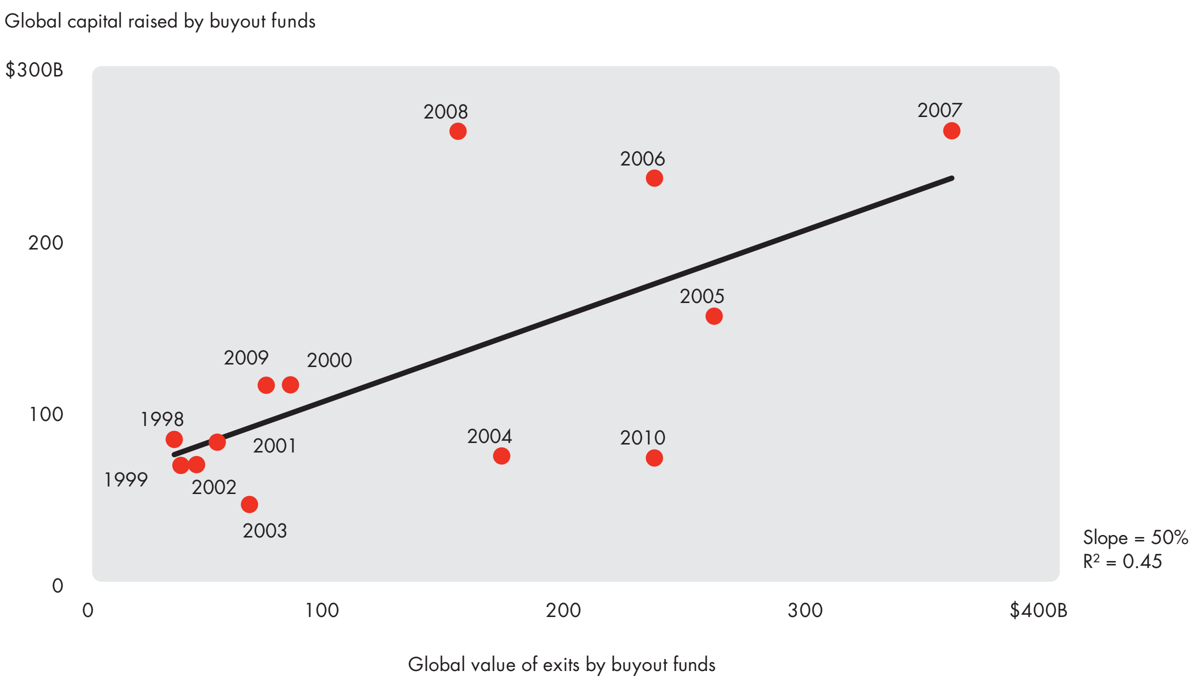
Another leading indicator of a fund-raising recovery is the pace of exits. The correlation between the value of buyout exits and new buyout funds raised over the past decade is significant—again, with a bit of a lag—as the distributions that flowed to LPs provided the lubricant to get the fund-raising cogs turning (see Figure 2.21). If exit activity continues to outpace investment activity, as it did in the latter half of 2010, there is no doubt that fund-raising will get back on the recovery path.

A likely increase in LP demand. Anticipating that high-quality GPs will be coming to market with new funds, many LPs are penciling into their 2011 budgets higher commitments than they did a year ago. Expressing the intentions of many LPs, one insurance company executive told Bain, "We want to be back in when our best managers are raising capital." Indeed, in a Preqin survey of 100 LPs last December, 54 percent said they would be committing more capital to PE this year (see Figure 2.22). Specifically, 15 percent

Figure 2.20: Fund-raising is lagging the recovery in investment activity

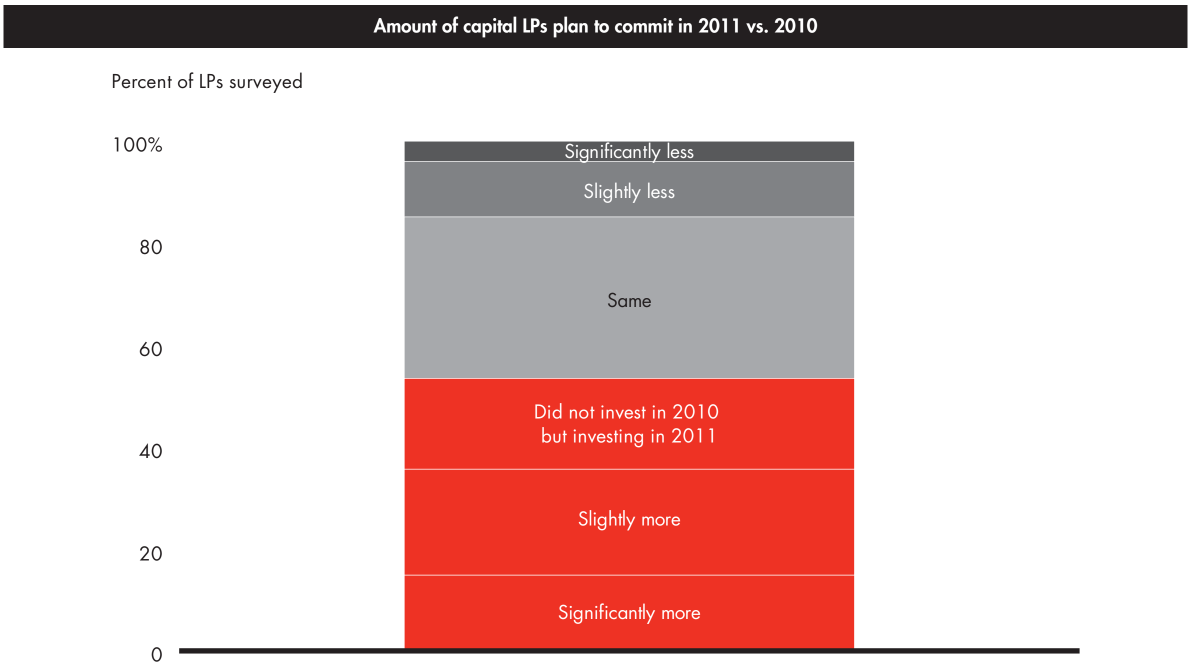
Sources: Preqin; Dealogic

Figure 2.21: Fund-raising is correlated with exit activity



Sources: Preqin; Dealogic; Bain analysis

Figure 2.22: LPs' 2011 budgets for new PE commitments are set higher than in 2010



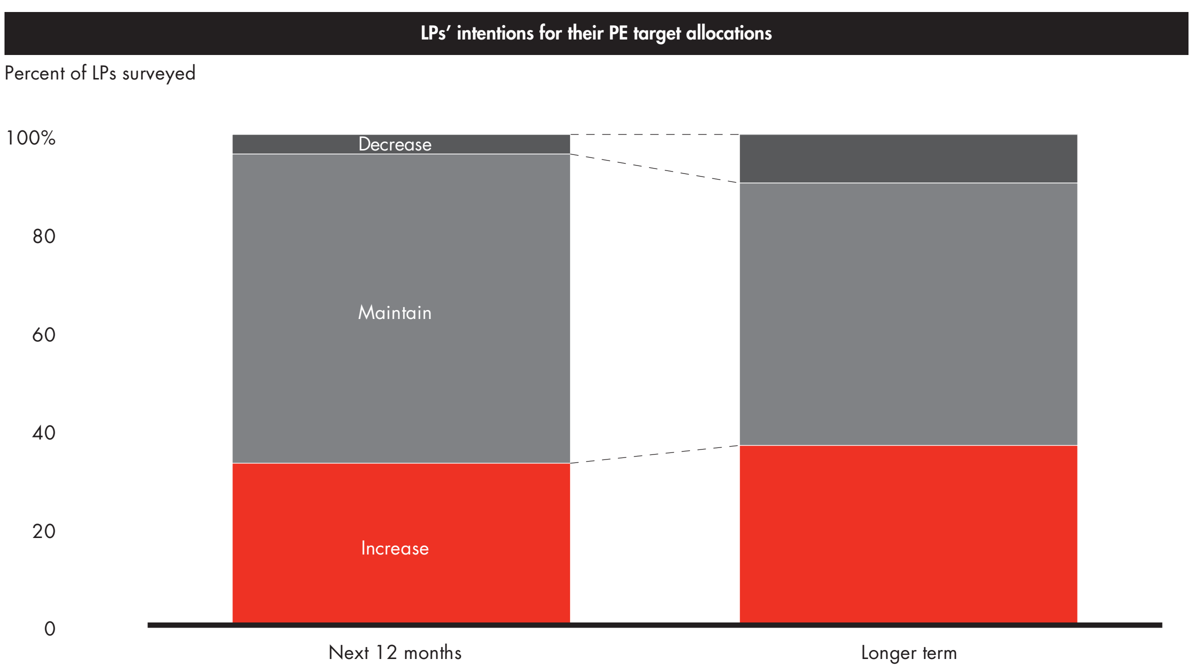
Source: Preqin Investor Survey (December 2010) asserted they would commit significantly more, 21 percent said they would increase their commitments slightly and 18 percent that made no commitments in 2010 said they were looking to get back into the game in 2011. Only 15 percent said they would commit less.

For many LPs, budgets for new commitments this year—and how they get deployed—continue to be governed by their still-tight allocations to PE. Of course, where LPs stand with respect to their target allocation varies considerably by investor type and by the maturity of their PE program. Family offices, foundations and endowments are most frequently at or over their target allocation, while pension funds and insurance companies have more headroom, on average.

Of course, LPs do have the option to lift their allocation ceilings to make room for new PE commitments, and available survey evidence suggests a minority may do so. In a survey of 100 LP investors by Preqin last December one-third of respondents said they planned to increase their PE target allocations in 2011, and slightly more said they would bump it up over the longer term (see Figure 2.23).

PE firms may also be able to expand fund-raising potential by attracting new investors to the asset class. For all the success PE has had winning over big institutional investors over the past two decades, there is still plenty of room to grow. According to *Pensions & Investments*, the industry trade publication, only about half of the 200 largest public and private pension funds in the US currently invest in PE. Sovereign wealth funds (SWFs) are another potential new source of growth. Preqin estimates that only some 45 percent of SWFs currently invest in PE funds and that another 16 percent could begin investing soon.

Figure 2.23: One-third of existing LPs are planning to increase their target allocations



Source: Preqin Investor Survey (December 2010)

As they maneuver to attract LP capital, PE firms still have work to fix another problem tempering LP demand—restoring the confidence of their current stable of LP relationships bruised during the downturn. Several LPs Bain interviewed raised a number of persisting concerns. They said that some GPs took advantage of the flexibility permitted in their agreements with LPs to stray from their core. "Everything from private investments in public equities [PIPES], buying up debt positions and similar moves may turn out to be decent investments at the end of the day,'" said one European pension fund investor. "But GPs have done things that LPs . . . didn't find appropriate."

Other LPs said that many GPs did not meet their expectations for transparency and frequency and quality of communications. They also complained that some GPs behaved in ways that suggested they did not have their LP partners' best interests at heart. "There is a lot of bridge building to be done," an executive from a major private US foundation told Bain.

Despite the rebound in portfolio valuations, some LPs harbor doubts whether PE can continue to generate attractive long-term returns given the high prices paid for assets acquired in the early stages of the recovery. They wonder particularly how well assets acquired during the boom years will ultimately perform. "If the capital structures in those deals hold together, the returns will be good and demand will be strong. [However,] if the economic scenario worsens and returns are poor, investors will turn away from private equity," said the chief investment officer at a major US public pension fund.

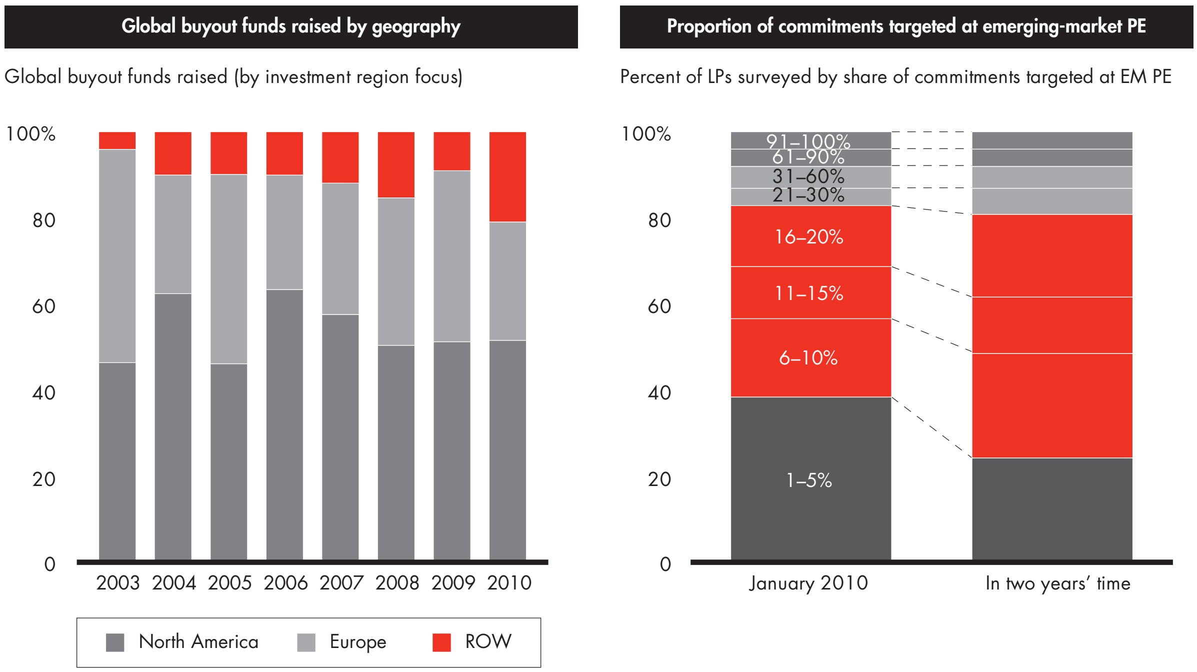
Still, for all the short-term strains, the foundations of PE's relationship with LPs are strong. Even after a few challenging years, LPs' conviction in PE remains solid. LPs continue to believe that PE offers an attractive risk/reward profile and has a place in their portfolios. They express confidence in the ability of the PE owner-operator model to generate superior returns. "The top-quartile performers, the better players in the space, will continue to generate significant alpha," said a US-based fund-of-funds investor.

Many LPs also see evidence that GPs are strengthening their operational expertise, and they are confident they will find attractive new segments within the PE asset class, including new geographies, sectors or fund types. Finally, they praise GPs for the efforts they have made to improve their communications and transparency and to achieve a better alignment of interests. "I think firms are doing a dramatically better job of having formal meetings . . . being more productive and providing better information, [and] more disclosure to their advisory board," said a US insurance company investor.

Where will LPs deploy their 2011 budgets? The ones Bain interviewed emphasize that they will not be looking simply to add to their PE exposure broadly but will be targeting new PE segments. One university endowment investor told Bain that his new PE commitments will not go to "general plain-vanilla buyout funds." Indeed, some LPs told Bain that they will be spurning large buyout funds, in particular, and will instead be looking to invest with GPs that target a specific sector, geography, deal stage or fund type. For example, a US insurance company investor said that his new commitments will be steered to venture capital, distressed, mezzanine, and power and energy funds.

The LP capital shift to emerging markets that gathered momentum in 2010 will also continue into 2011, making investments in these economies a bigger proportion of their PE holdings (see Figure 2.24). "We will invest where we can see strong underlying economic fundamentals and good growth prospects, so that's going to drive us toward China, India, Brazil and a few other notable parts of the world," said a private foundation executive.

Figure 2.24: LPs shifted capital to developing and emerging markets



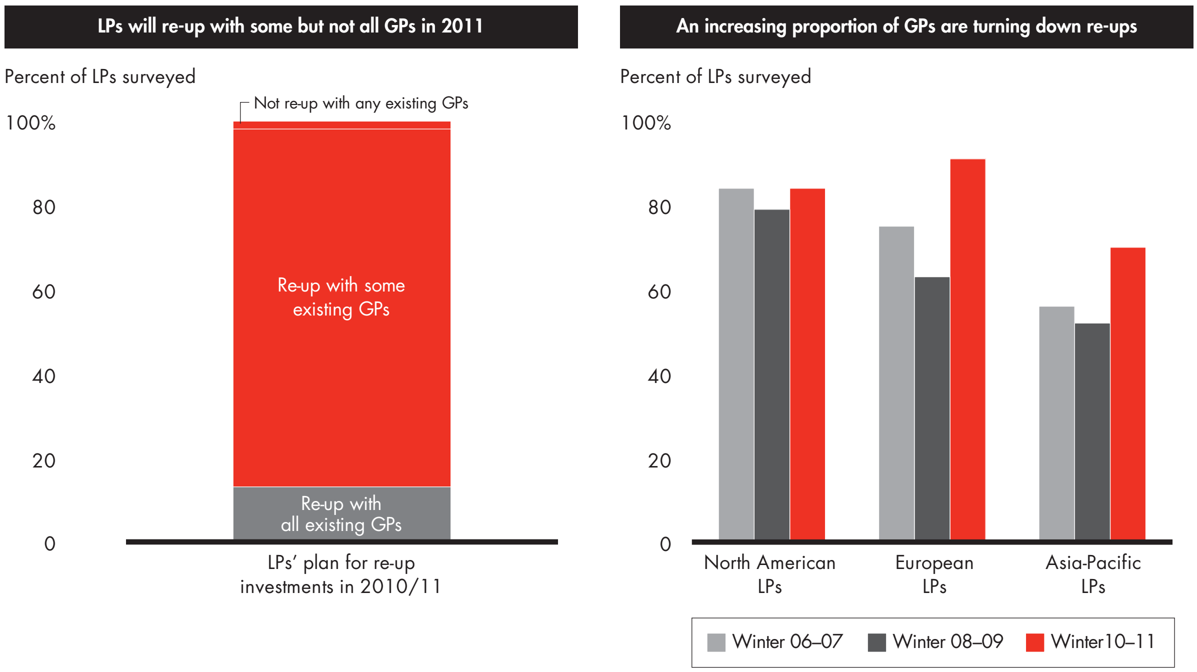
Sources: Preqin; EMPEA-Coller Capital Emerging Markets Private Equity Survey 2010

A challenging supply-demand imbalance. Even as LPs increase their budgets for new PE commitments in 2011, the number of new PE fund opportunities will continue to outpace LP demand. If anything, the imbalance between supply and demand could widen in 2011 as GPs that put off fund-raising in 2009 and 2010 reenter the market. "The next 18 to 24 months are going to be a very crowded fund-raising environment for private equity. The supply-demand equation is going to make it very hard for GPs to raise money," said a fund-of-funds investor.

Further compounding GPs' fund-raising challenge in 2011 are two factors that will also be working against many of them. First, because a disproportionate number of GPs expected to come to market this year are historically top performers, marginal or poor-performing GPs will not compare well in the eyes of increasingly discerning LPs. Second, LPs they have worked with in the past may be less likely to sign on for another fund. Nearly 90 percent of LPs surveyed by Preqin in mid-2010 said they anticipated reenlisting with only some of their existing GPs. A survey by Coller Capital in late 2010 confirmed that re-ups were down: 84 percent of LPs in North America declined to reinvest with one or more GPs in the prior 12 months. In Europe, the proportion of LPs passing on reinvestment opportunities increased to 91 percent, from a low of 63 percent in the fall of 2008. Similarly, in Asia, 70 percent of LPs declined to re-up in 2010 (see Figure 2.25).

Indeed, re-up rates by returning LPs for funds raised in 2009 and 2010 have slipped to just 62 percent. According to Preqin, 35 percent of the funds closed during that period pulled in less than half of their commitments from LPs that had been with them for earlier funds. With LPs making fewer new commitments overall and smaller commitments to individual funds, re-up rates in terms of the dollars they bring in will likely be much lower if GPs seek to raise new funds of comparable size to their prior ones. For example, the CEO of a leading placement agency has pegged the re-up rates for mega-funds at 70 percent in terms of number of LPs signing on and just 40 percent in terms of the dollars they commit.

Figure 2.25: LPs will be selective with re-ups in 2011



Sources: Preqin Investor Survey (June 2010); Coller Capital Global Private Equity Barometer (Winter 2010–2011)

The lower rate of re-ups by GPs over the past two years reflects LPs' ongoing flight to quality. Looking to reduce their stable of managers to a smaller core, LPs are subjecting their GP relationships to harsh scrutiny and culling those that do not measure up. GPs on the losing end of the winnowing process will need to turn to new LPs to source the capital they hope to raise. But because LPs have earmarked a large proportion of their 2011 new commitment budgets for GPs they believe in, they may have little room to take on new GP relationships or consider first-time funds. "I would say that 90 percent of our money is earmarked for our best-performing managers that we expect will be in the market," said a US insurance company executive. "The chance of our doing something that comes in over the transom is highly, highly unlikely." The result of this Darwinian process will be to put a lid on fund sizes and wring out weak and marginal players.

Experienced GPs that do go knocking on new LPs' doors will not find them shut entirely. Surveys find that LPs are, if anything, more inclined to consider taking on new GP relationships going forward. More than 70 percent of LPs that Preqin surveyed in December 2010 said they would consider investing with some new GPs not currently in their portfolios, up from 54 percent at the end of the previous year. And 81 percent of the LPs Coller Capital surveyed last fall reported they intend to make commitments with new GP relationships in the next two to three years.

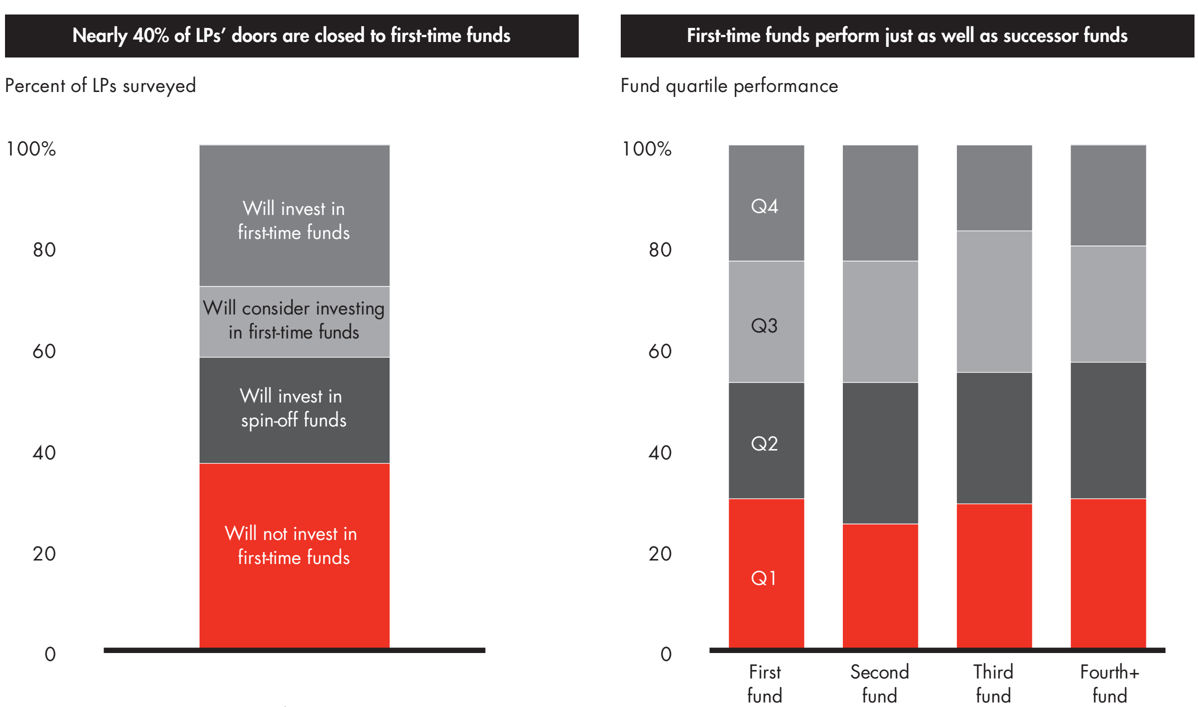
What might convince an LP to partner with a new GP? To begin with, the large majority of LPs make it a policy to scan the horizon in search of promising new GP relationships. Also, some LPs looking to expand into new PE segments where they have little exposure or few existing partnerships will naturally consider new relationships. Furthermore, most LPs that consider re-upping with a current GP will conduct thorough due diligence, and in the process may discover another GP offering a similar fund that compares favorably. Finally, many LPs in Europe and Asia-Pacific have less mature PE programs and will be looking to add new GPs as they build.

GPs looking to raise their inaugural fund will face a harder time wooing LPs. Nearly 40 percent of LPs surveyed by Preqin in late 2010 said flatly that they will not invest in first-time funds. For those that do not rule those out entirely, the hurdle will be set much higher than in the past. Many LPs know that first-time funds perform as well as follow-on funds do, but the key attributes they will look for in the absence of a demonstrated track record are, among other things, a history of having worked successfully with the fund's principals and whether the fund possesses a distinctive investment strategy (see Figure 2.26).

Both first-time and experienced GPs can fortify themselves against a chilly reception from LPs by taking several steps to improve their odds before taking to the fund-raising trail. Apart from notching some good exits, they can manage their LP relationships proactively by improving their transparency and the quality and frequency of communication. "Job one is generate returns, job two is be transparent and communicative while doing job one. Job three is read jobs one and two and make sure you balance them appropriately," said an investment executive at a private foundation. Also, GPs need to communicate their fund-raising plans with LPs before they officially launch to ensure that LPs will earmark money for their new fund. "We really stay on top of the folks we invest with and track pretty closely when they're going to be in the market," said a university endowment investor.

Several GPs are looking to make themselves more attractive to LPs by using sweeteners to lure them aboard. They are offering incentives to LPs willing to sign on early to a new fund ahead of the first close and to LPs willing to sign larger checks. They are sprinkling sugar on terms, such as making concessions that reduce management fees, increasing transaction fee offsets or offering preferential access to co-investment.

Figure 2.26: Fund-raising will be difficult for first-time GPs



Sources: Preqin Investor Survey (December 2010); Preqin

Of course, there is nothing new in the use of incentives, but they are becoming more common as the supply-and-demand balance has shifted to LPs—at least for now. GPs that resort to them need to be aware that a sweetener strategy is not without risks. For one thing, most LPs do not like favoritism. Sweeteners risk alienating LPs that don't qualify and might open the door for all LPs to insist on getting the "special deal." Still, a minority of LPs strongly believe they should be compensated for moving quickly or signing a bigger check. "If you don't want to come to us with a deal, then we'll do whatever we need to do and we may never get around to looking at your fund—whoever it might be," said a European pension fund investor. A second sour note is that many LPs doubt that sweeteners will have their desired effect. Said a European public pension fund executive, "The type of sweeteners that I've seen are very limited in their scope. They're not going to drive any decision." Finally, incentives risk sending the wrong signal, making GPs that offer them look desperate or having LPs perceive them as lower quality. "If you're competing on price, I guess I wonder why you feel that's the best way to compete. Great performance is going to overwhelm [incentives you can offer]," said a US private foundation investor.

Limited partners: More discriminating than ever

As we observed in last year's *Global Private Equity Report 2010*, the long downturn has subjected LPs to a baptism of fire. Lackluster performance of PE portfolios and tight funding for new commitments have made them more discerning about how they go about investing in PE, far more selective in their choice of GPs with which they invest and increasingly assertive about the terms and conditions on which they are prepared to do business.

It is anyone's guess how long the new rigor will hold. The PE industry saw many of the same dynamics at work coming out of the 2001 downturn. However, when the PE market swung back into a recovery, LPs loosened their purse strings.

Still, coming into 2011, many of the LPs Bain spoke to said they continue to put all of their recently acquired disciplines to work with added resolve—and perhaps none with more energy than the expertise they have built subjecting GPs to more rigorous due diligence. LPs have doubled-down on their determination not to make mistakes. Taking no GP's performance claims at face value, they are investing more time and resources to vetting current GPs and qualifying new ones. Referring to the private-placement memoranda produced by GPs that pitch their funds to his organization, an investment officer at a private US foundation said, "We throw away the PPM and do our own due diligence."

Doing more with due diligence. As LPs continued to refine their approach, their experience in 2010 brought four due diligence issues to the forefront:

Verifiable returns. The first is to deepen their analysis to ensure that they could verify true PE returns. Some LPs have learned from hard experience that most PE funds can lay claim to top-quartile performance by selecting the benchmark that makes them look best. A study by Professor Oliver Gottschalg scrutinized the returns of 500 buyout funds raised between 1985 and 2005 and found that more than three-quarters could stake a claim to producing top-quartile results by selecting the most favorable comparison benchmark.

Not content to take GPs' return claims at face value, many LPs now perform an independent review that involves a bottom-up quantitative analysis of how returns were generated, deal by deal. They know that the high returns generated during PE's boom years rode a tailwind of expanding equity and debt markets.

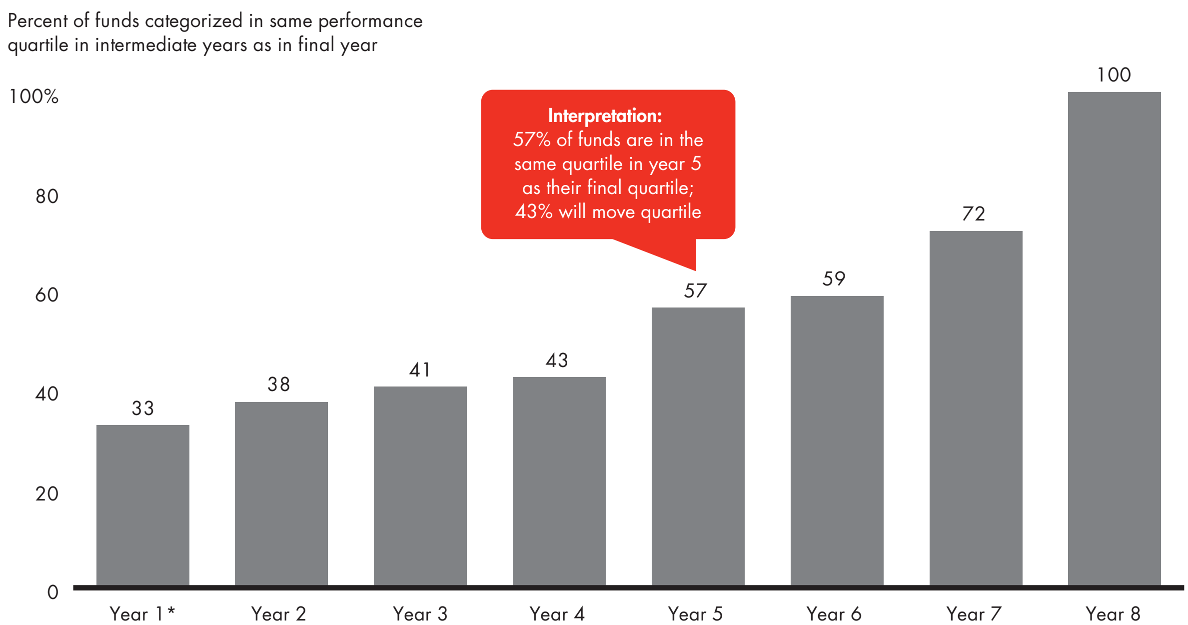
Going forward, only GPs that can add value with the market winds blowing against them will prove to be winners. What role did leverage play? How much of the gains can they attribute to the alpha a GP brings through its investment and operational skills? A European public pension fund investor says his team's diligence process involves "getting down to the nitty-gritty to understand what has been driving returns and whether [the GP] has truly been adding value or just adding leverage."

Many LPs are heightening their investigation of fund-raising GPs that pitch their new fund based on the unrealized performance of their previous one. The exit overhang that has built up over the past couple of years has made these circumstances more common. Despite the implementation of mark-to-market accounting rules, LPs are understandably skeptical of interim valuations, which they believe leave GPs a fair amount of room for subjective judgment.

They also recognize—with good reason—that interim, largely unrealized performance is not a reliable indicator of the returns a fund will ultimately generate. Indeed, Bain analyzed the reported interim returns over the holding periods of scores of funds. We found that particularly in a fund's early and intermediate years, the reported returns are unreliable predictors of where the fund ends up once all investments have matured and been realized (see Figure 2.27). For example, only 57 percent of funds in a given performance quartile in year five will end up in that same quartile when the holdings are liquidated at the end of the funds' life. More than two out of five will have moved at least one quartile higher or lower.

Finally, many LPs are putting less credence in GPs' performance track records as indicative of what to expect in their next fund. Although it is still too early to tell how recent funds active during the peak of the PE boom will ultimately fare, anecdotal evidence suggests that the widely acknowledged persistence of GP performance

Figure 2.27: Interim performance cannot be trusted



Note: Includes only buyout funds
*Year 1 = vintage + 1 year; vintage defined as year of first investment
Sources: Preqin; Bain analysis

across funds may have weakened in recent years. There is sufficient uncertainty surrounding this issue for LPs to know that they cannot rely solely on track record to guide their GP selection. They need to take a 360-degree look at every GP that comes back to the market to raise a new fund—even those whose past funds have been stellar performers.

GP investment discipline. LPs are examining one aspect of GPs' past behavior, in particular, for hints of what they can expect to happen in the future, namely the actions a GP took in the boom times, through the downturn and during the past year's recovery to get a sense of how disciplined it is. One key indicator of discipline, of course, is a GP's consistent adherence to its investment strategy. In a recent survey, this variable ranked as the most important factor to LPs when conducting due diligence.

Increasingly, in light of the flow and ebb of the PE cycle in recent years, LPs think it is critical that GPs stick to what they know best. The LPs Bain interviewed suggested that GPs should avoid growing too quickly outside of their areas of expertise as occurred during the boom years or avoid chasing hot segments of the market as they did during the downturn. "We always tell GPs, 'How do you ensure that somebody like us doesn't want to work with you anymore? Go off the reservation and do things that you said you wouldn't do or behave in an un-partnership-like way,'" said a university endowment investment officer.

LPs are also looking to confirm that GPs take a disciplined approach to deal pricing. Many now believe that high prices GPs paid during the PE boom and continued to pay through the downturn and recovery have brought this once underestimated issue to the forefront. Many LPs now recognize that the biggest danger to returns is not that GPs end up not investing the capital but that they overpay for what they buy with it. "We like GPs that show great discipline on both the buy and the sell side," said a US foundation investment executive. "Some of the best-performing funds we had in the last three years were ones where we gladly paid [the GP] the management fee because they did nothing else with the money when they just couldn't make the deals they examined pencil out."

Finally, LPs are taking a closer look at how GPs source their deals, and especially whether they relied too much on secondary buyouts over the past two years. Secondary buyouts were heavily auctioned in 2009 and 2010 and fetched rich prices. LPs value GPs that are able to source deals proactively. They see proactive sourcing as an outgrowth of GPs' sector specialization that endows them with heightened capabilities for spotting opportunity, and using systematic screening processes and networks of well-connected expert advisers. LPs are unlikely to flatly reject a fund for over-reliance on secondary deal flow, but it can be one more nail in the coffin.

GPs' operational skills. With more LPs training their due diligence sights for GPs that can generate alpha, GPs that can demonstrate successful value-creating partnerships with the management teams of their portfolio companies will increasingly win favorable attention. GPs clearly recognize this new reality, and many have stepped up their involvement in the operations of their portfolio companies since the onset of the economic downturn. They are touting operational expertise as a strength that differentiates them from other GPs and have made these claims a staple of the private-placement memoranda pitching new funds. But as with GPs' claims of superior returns, LPs are taking nothing at face value. In Coller Capital's recent survey that asked LPs to assess the ability of GPs to turn around struggling portfolio companies, one-third of LPs responded that the majority of GPs do not have sufficient operational skills. It is also worth noting, however, that two-thirds of LPs do believe that GPs' operating skills are "adequate"—a marked improvement over prior years.

LPs are probing deeper to identify GPs with *true* operational expertise, the area where their due diligence processes have made the most progress in recent years. A European public pension fund, for example, has added two professionals over the past two years whose exclusive role is to do due diligence on GPs' operating skills. What the LPs are looking for is evidence that those skills produce real results. At the very least, LPs interview management teams at GPs' portfolio companies and may widen their investigation to include interviews with GPs' past employees and former portfolio company executives.

Some LPs also bring analytical rigor to bear on GPs' past deals in an effort to tease out how much of their returns they can attribute to alpha versus other factors. LPs that Bain interviewed believe that the downturn helps them distinguish GPs whose true operational capability enabled them to manage the crisis well from those that are mere "window dressers." "The tide did go out over the last couple of years and you saw which GPs could defend their portfolio, roll up their sleeves and create operating efficiencies and improved margins, maintained EBITDA and preserved value," said an executive with a private US foundation. "Those are the firms we respect and are more likely to continue to be partners with."

GPs' organizational dynamics and risks. Ensuring that the interests of the GPs with which they work are aligned with their own has become a crucial issue for LPs. Until recently, most LPs contented themselves to judge how well their interests were aligned by focusing on a fund's terms and conditions that are meant to foster it—things like the GP's own equity interest in the fund, management-fee offsets and the carry hurdle rate. But for many LPs those contractual arrangements no longer go far enough to ease their concerns. Indeed, a survey by Preqin in May 2010 found that 40 percent of LPs feel that GP and LP interests are not properly aligned. Again, it is worth noting that this is a significant improvement since Preqin's December 2009 survey when nearly 60 percent of LPs felt that GP and LP interests were not properly aligned.

Most sophisticated LPs are becoming more vigilant, analyzing the internal organizational dynamics of the GP as a whole. One top-of-mind concern for LPs is the motivation level of the younger partners at some PE firms, particularly partners whose first fund may have been from a peak market vintage. Because of the high prices paid to build their portfolios and the slow rate of realizations to date, these partners have not yet made much money and may not earn a carry. Nor do they have money of their own to commit to the next fund. Yet they are locked in because they may have borrowed from their firm in order to commit to their first fund. "What you don't want are people tied in [to the GP] who are not motivated but can't leave so they're stuck with a GP," said a university endowment executive.

Other organizational risks and legacy issues raise LPs' concerns, as well. For instance, they know that GPs invest in firm infrastructure and personnel based on the projected size of their next fund and the management fees they can be expected to generate. But if the GP is unable to realize those projections in a tough fund-raising environment, they may be saddled with too much overhead and weak staff morale. Also, LPs worry that the burden of GPs' large legacy portfolios may overly tax their deal and operations partners.

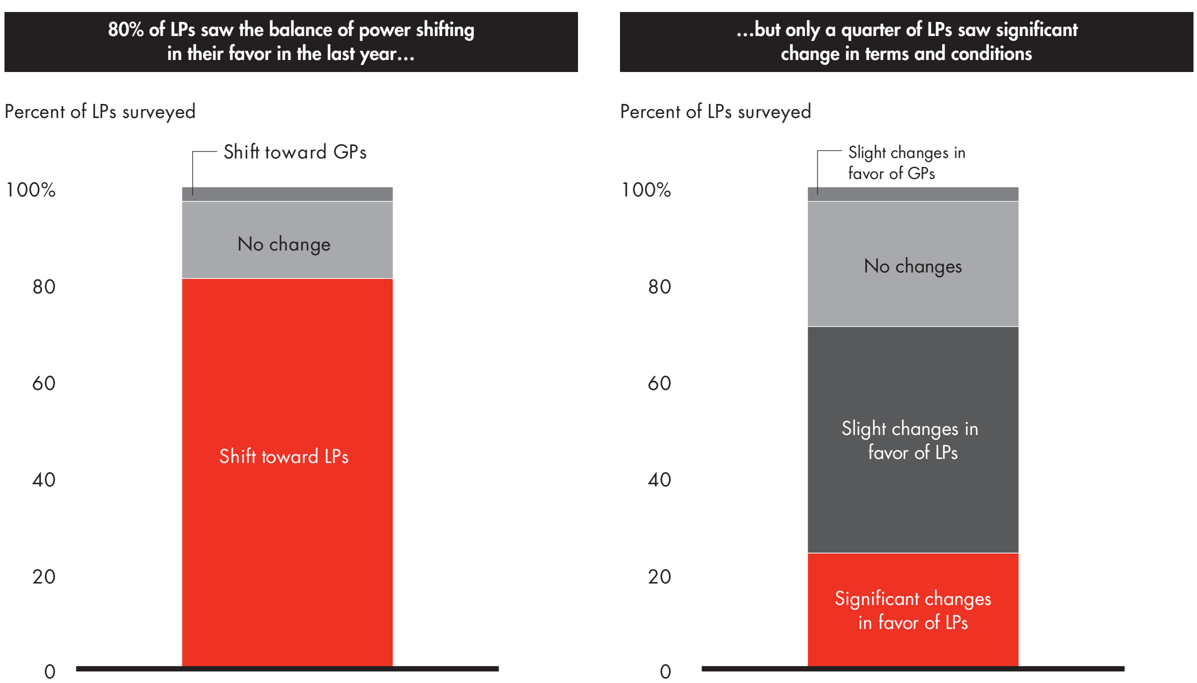
LPs keep up the pressure on GPs for more favorable terms and conditions. Long unable to do much individually to alter the rules of the road set by GPs for how their funds will be compensated and their contractual relationships defined, LPs continue to push back with increased determination—and some signs of success. Indeed, GPs and LPs are beginning to pursue a closer alignment of their interests by modifying fund terms and conditions.

To a large degree, the conversation, which has gathered momentum since late 2009 with the launch by the Institutional Limited Partners Association (ILPA) manifesto calling for terms and conditions more favorable to LP interests, reflects a shift in the relative power of LPs to be more assertive. In Preqin's mid-2010 survey, 80 percent of responding LPs said they saw the balance of power tilt in their favor during the past year (see Figure 2.28). The practical effect of that realignment, however, has been modest so far. Only a quarter of LPs surveyed by Coller Capital in mid-2010 said they witnessed significant changes in terms and conditions by last summer; another 50 percent responded that there had been slight changes to LPs' advantage.

Change will not come easily for LPs hoping to negotiate more favorable terms and conditions. Chief among the challenges they face is the simple fact that with the exception of a few large ones, LPs individually are not that powerful. Large LPs may extract concessions from a GP, but their sweeter deal often does not flow to other LPs in the fund. Moreover, LPs are a diverse and disparate group, and their opinions of which terms and conditions are the most urgent priorities for reform—and what changes are acceptable—differ dramatically. "Trying to get LPs to behave collectively is like trying to herd cats," said a university endowment officer. "Just because I feel strongly about the way a waterfall should be structured in a fund, there can be four or five other strong opinions of how it should be done differently." Especially when it is difficult gaining access to a top-performing fund or to get in on an investment strategy where LP demand outpaces supply, the GP still has the edge in negotiations.

Still, LPs are beginning to see the majority of GPs willing to adjust some terms and conditions. Slightly more than half told the Coller Capital survey last summer that a majority of GPs were making a satisfactory effort to adopt the ILPA guidelines for financial terms. Areas where LPs say they have witnessed changes

Figure 2.28: Shift in balance of power has not yet translated into significant change in terms and conditions



Sources: Preqin Survey of Investors on Fund Terms & Conditions (May 2010); Coller Capital Global Private Equity Barometer (Summer 2010) in the past year include adjustments to management fees, rebates on deal-related fees and to a lesser extent reductions in the hurdle rate and changes to the carry structure. An executive at a major US public pension fund told Bain that he expects to see much more of this going forward. "I don't think there's any big fund that's going to be able to come back to market and expect to raise money without having addressed the economics," he said.

Nearly three-quarters of the LPs in the Coller Capital survey reported seeing more willingness to adjust nonfinancial terms and conditions. LPs that Bain interviewed think it is simple common sense that the two sides should be able to rally around the ILPA position. "You read through those principles and it's like okay, what part of motherhood and apple pie are you against?" said a private foundation executive.

Returns: Battling a downward trend

Following the boom years of the PE cycle that peaked in early 2008, PE firms and their limited partners have faced a post-downturn "new normal" of returns that are both lower and harder to earn. But as they recalibrate their return expectations in light of the past few years' experience, it is important to keep in mind two longer-term realities that have characterized how PE has made money.

First, private equity has always been a cyclical industry, with each cycle driven by a shifting set of factors. During the 1980s, buyouts flourished in an environment of conglomerate breakups, low valuations and heavy reliance on leverage made available by an accommodating junk bond market. The 1990s were fueled by the expansion of multiples on invested capital during an equity-market boom. And through much of this decade, returns were held high by the easy availability of debt financing that lifted multiples. The second, and harsher, reality is that despite persistent market beta and GP alpha, returns have been in a long-term secular decline as the PE industry has matured and competition has intensified.

Of course, each successive period of economic expansion on which PE returns depended ended in recession. But our analysis has found that PE fund vintages caught in a cyclical downturn recovered smartly with the economy. For example, the IRR of the median global buyout fund in the year 2000 vintage fell to a negative 13 percent by 2002 as the economy was just beginning to emerge from the 2001 recession. However, IRRs soon regained positive momentum and climbed to 20 percent by the time the economy was beginning to fire on all cylinders, in 2005, and stabilized at around 18 percent, as the 2000 vintage funds approached the end of their lives.

Those pre-recession fund vintages of 1999 through 2001 benefited from near-perfect conditions for recovery. GDP growth in the US and EU was running at an annual rate of 5.9 percent and 4.7 percent, respectively, as the expansion neared its apogee between 2005 and 2007. Returns were also turbocharged by rising LBO multiples, increasing in the US from a low of six times EBITDA in 2001 to 9.7 times in 2007, and in Europe from 7.1 times to 9.7 times. Returns were also boosted by generous levels of leverage and easing borrowing terms.

Now two years into a stunted economic recovery characterized by limited availability of credit and uncertain equity markets, what do conditions bode for returns in 2011 and beyond? The conventional market forces PE investors relied on earlier in the decade will not provide much boost. GDP growth will be a limited factor. Most economies appear to have skirted the risk of falling back into recession, but the recovery is forecast to be tepid in the developed markets, although stronger in China, India, Brazil and other emerging markets. Multiple expansion likely will not offer a significant lift. Multiples on recent purchases remain high, and they have little room to move up from current levels. Leverage will not be much help, either. Debt markets have become friendlier to LBO financing, leverage levels have increased, the cost of debt has trended down and credit terms have loosened. Still, conditions are unlikely to see significant additional easing.

Combined, these external conditions point to more modest PE-industry returns. New buyout-fund vintages and new investments in the next few years will likely generate gross returns in the low to mid-teens, on average. These projected returns are several percentage points below returns achieved during the 2002 to 2007 boom years. This should come as no surprise to GPs; competitive dynamics are driving some of them to structure their bids on the basis of target returns in the mid-teens compared with the mid-20s as in earlier years. Over the short term, however, buyout returns could outpace those of today's unpredictable public equities or the rock-bottom yields on fixed-income securities—with little additional risk as deals are likely to continue to involve high-quality assets financed prudently. Furthermore, GPs that bring something distinctive to their investments will continue to outperform PE-return averages, perhaps by even more than in the past.

The performance of existing funds with investments already in the ground, particularly buyout fund vintages between 2005 and 2007, should continue to recover. These vintages are no longer deep underwater. However, their recoveries will ultimately be more modest than the rebounds of vintages caught in earlier downturns and they are unlikely to close with strong returns. Unlike 2003 and 2004 fund vintages, which had time to exit several investments before the downturn hit, the 2005–2007 vintages do not enjoy this performance cushion. Also, many of the funds in those vintages have a large portion of their holdings tied up in deals made at the cyclical peak. As noted earlier, it will be difficult to work through and realize those investments; the stretched-out holding periods will hold down time-sensitive IRRs. These funds' best opportunities to boost returns are likely to come in future years as they make promising new investments with the remaining uncalled capital in their funds.

The outlook for returns has major implications for GPs and LPs alike. GPs will need to bring to bear all the tools in their control to produce outsized returns. There are two major areas where they can improve their return prospects. First, to achieve GDP-beating top-line and bottom-line growth, they must buy into the right sectors. This entails increasing their sector focus and expertise. They must also invest to improve their operational capabilities. They need to bring those new strengths to bear early in their ownership of a portfolio company to pursue top-line growth both through organic means and via mergers and acquisitions, as well as to introduce improvements to internal operations. "On larger deals, operational improvement is not the icing on the cake; it's the entire cake, if you are going to buy businesses at high prices with low levels of debt," said a director at a major global PE firm.

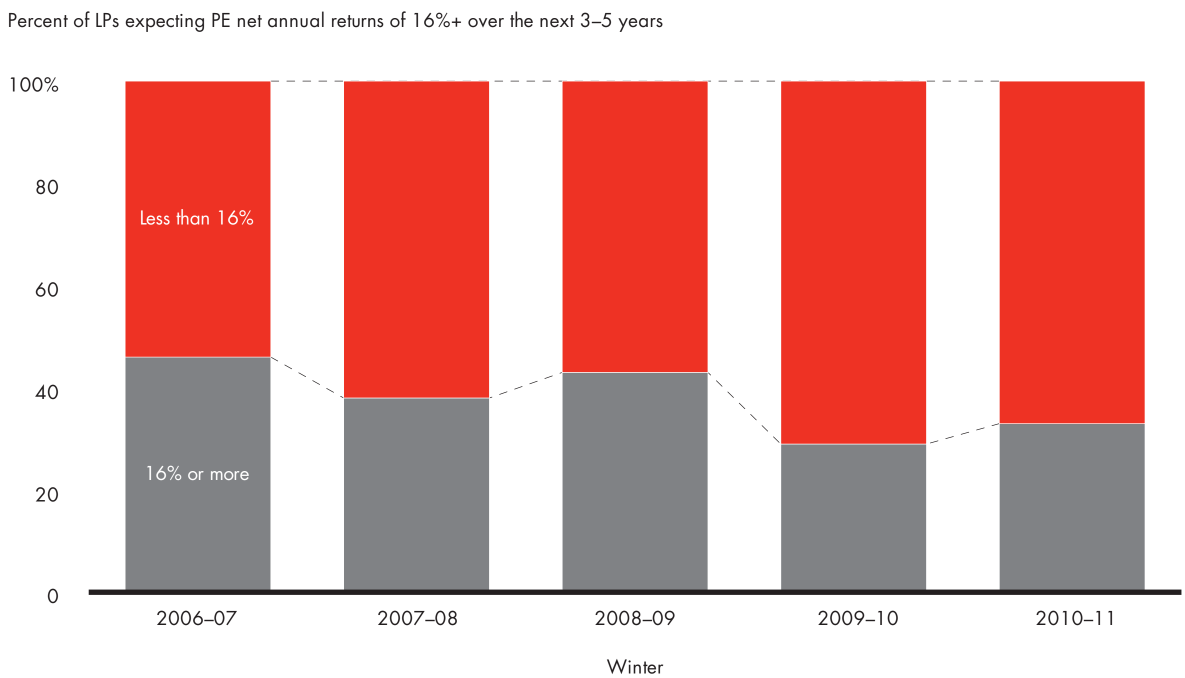
Second, GPs can boost their funds' returns by ensuring that their portfolio yields more investments that turn into "home runs" and fewer that end up as "zeroes." Funds that excel in converting more winners and avoiding the losers use an enhanced due diligence process to dig deeper into a potential target's operations before they commit to an investment.

For their part, LPs that want to elevate their PE returns will need to dial up their ability to select top-performing GPs. All of the LPs Bain interviewed look for average industry returns to come in below historic levels over the next few years. A recent survey reinforced their opinion. Two-thirds of LP respondents said they expect that annual returns from PE will fall below 16 percent over the next three to five years (see Figure 2.29). "Returns will depend a lot on who we partner with, but broadly speaking, given that the leverage inside of most deals has come down . . . it means that the return to the [larger] equity piece is going to be lower," said an executive at a US private foundation.

However, in this environment, LPs believe that skilled GPs will continue to outperform their PE peers and the equity markets by a wide margin. Most LPs also believe that GPs that have earned top returns in the past will be able to maintain, or widen, their performance gap, and they are counting on the continued discrepancy between returns generated by GP leaders and the rest of the pack to build high-performance PE programs. "The divergence of returns of managers and individual deals is enormous. I think there is scope still for a well-targeted program to produce good returns," said a European pension fund executive.

LPs are gearing up to meet the challenge of building high-performance portfolios by focusing on the most critical step, selecting the right managers to work with. "If you are not adding any value in terms of manager selection you have to really think about why you're in the asset class," said an investment manager at a US insurance company.

Figure 2.29: LPs expect returns over the next 3–5 years will be below historic levels



Source: Coller Capital Global Private Equity Barometer (Winter 2010–2011)

Key takeaways

- Confidence that the still-fragile economic recovery will gain momentum in 2011 is fueling optimism that conditions are in place for the revival in PE deal volume to continue. PE firms wielding vast sums of dry powder are eager to put capital to work, the supply and range of deals will increase and more stable debt markets are better able to provide financing than they have been since 2007.

- Slow economic growth in the developed economies of North America and the EU continue to push GPs and LPs to look to new geographies and sectors for promising growth opportunities. Attractive emerging markets like Brazil and Central and Eastern Europe will continue to draw interest and will see outsize activity.

- PE firms have seen exit opportunities improve over the past year; and public-equity markets, sponsor-to-sponsor transactions and corporate M&A all continue to show signs of strength pointing to a continued pickup in exit activity in 2011. The pace of exits will be a major factor influencing new PE fund-raising in the year ahead, as GPs distribute realized returns to LPs and provide the lubricant to get the fund-raising cogs turning.

- GPs and LPs will continue their dance around terms and conditions in search of a new alignment of interests. Although most LPs report seeing greater willingness on the part of GPs to modify nonfinancial terms, changes over hurdle rates and carry structures will not come easily.

- Without market beta in the form of strong GDP growth, expanding multiples and abundant leverage to drive returns, both GPs and LPs recognize that only the alpha that PE firms can provide through proprietary investment theses, enhanced due diligence and post-acquisition value-creation skills will lead their portfolio to outperform.

3. Hot topics for 2011

As we have seen throughout this report, trading conditions for private equity have improved and may strengthen further in 2011. But if they did not recognize it before, investors should now be fully aware that the forces unleashed since the 2008 slump will continue to make generating attractive returns very challenging.

PE firms must adapt and evolve. They need to reassess how they can continue to deliver superior returns when the traditional drivers they looked to in past years—GDP growth, multiple expansion and friendly debt markets—no longer provide the lift they once did. Going forward, PE firms will need to demonstrate to discriminating LPs that they have a well-defined investment strategy, a fully professionalized organization, rigorous due diligence processes and especially the distinctive value-creation capabilities needed to excel in the changed environment.

Develop an adaptive investment strategy built on core strengths. To keep in step with LPs' changing tastes, many PE firms have expanded their geographic footprint across borders, and many have moved into new fund types. But PE firms cannot simply pursue diversification for diversification's sake and expect either to remain credible with LPs or have serious prospects for success in new areas. Bain analysis has found little correlation between the number of fund types or geographies in which a firm invests and its overall performance. Moreover, our interviews with LPs reveal that many do not place a premium on firms that bridge several fund types or geographies. Rather, these LPs evaluate each fund opportunity on its own merits.

Before venturing outside their core, the best PE firms start by looking objectively in the mirror and asking themselves: "What do we do best?" PE firms that have enjoyed the greatest success typically follow five steps: First, they weigh not just the attractiveness of the opportunity but carefully vet it against their own strengths to assess their firm's ability to compete. Second, they ensure that the opportunity will be big enough to support an investment team and related infrastructure needed to succeed. Third, they carefully define their investment "sweet spot," that is, the deals they prefer to do based on such factors as industry sector, size, degree of control and investment thesis. Fourth, and often in parallel with the previous steps, they gauge interest of LPs and get their support before committing to the opportunity. Finally, after they proceed, they communicate their diversification plans clearly to LPs, leaving no opportunity that their well-thought-out investment strategy can be confused for style drift.

Strengthen and professionalize the organization. PE firms need to attend to their organizational health and continually seek ways to professionalize, with a focus on four key areas. The first is talent management, with programs to attract, retain and motivate the best people. Of particular concern are the morale and incentives of PE firms' junior partners and analysts, many of whom joined at the height of the PE boom and have yet to earn any carry. PE firms will want to address these motivation issues, possibly rebase profit-sharing policies to improve incentives and strengthen the firm's overall culture.

The second organizational area needing attention is investor relations. Most PE firms can no longer afford to cling to the old part-time model of fund-raising, having their best deal makers hit the road for a period of intensive interaction with LPs. They need to raise funds and manage investor relationships every day, year-round.

That requires them to devote more full-time and senior talent to the task. They also need to create a strategic plan for mapping and segmenting the LP universe—staying connected to old LP relationships and developing new ones. Knowing more PE investors and getting better acquainted with the ones they already know is a much surer path to continued success.

Building resources to support repeatable value-creation processes is the third organizational area PE firms need to address. With portfolio companies potentially needing more time to find their way to profitable exits, PE firms are left managing larger—and in many respects, more challenging—legacy portfolios. Nurturing these companies consumes precious partner energy, time and resources. Portfolio management can also be a distraction from the equally urgent business of scouting out and closing on new deals. Both activities need to be appropriately resourced and cordoned off to ensure they are done well. (We highlight some best industry value-creation practices below.)

Because the business of running a PE firm has never been more complex, the firm's general management needs to be professionalized—the fourth organizational issue needing attention. Investment teams that operate across asset classes, regions and sectors need support that imposes new dimensions of responsibility for strategic planning and for managing the firm's brand, knowledge and talent. New regulatory requirements and compliance issues are making administrative roles more demanding. The most forward-looking PE firms have developed an integrative senior-executive-level set of functions that set the firm's direction, facilitate the sharing of insights across investment teams, develop the programs to recruit and motivate top talent, and take the lead in fund-raising and managing investor relations. Many PE firms are exploring whether their business would benefit by establishing an office of the CEO rather than continuing to be managed by committees, as many are today.

Have truly proprietary investment theses and beef up due diligence. Given the higher-than-ever competitive intensity GPs face and the elevated prices they are required to pay for assets they acquire, PE firms need to dig deeper to ferret out how they can make money on deals. As important as it is for PE firms to be masters at adding value post-acquisition, that counts for little if a firm does not close the right deals, at the right price, in the first place. Firms that are best in class recognize that strengthening their due diligence and investment-committee processes helps them avoid losers and develop the proprietary insights required to stretch for winners.

Build repeatable value-creation processes. Even in the heady days when PE returns were propelled by leverage, strong economic growth and buoyant equity markets, the top GPs set themselves apart by their ability to add alpha to their portfolio returns through their distinctive portfolio-management strengths. Today, however, with those traditional external sources of returns not expected to provide as much uplift, value-creation skills need to be in the tool kit of every PE firm.

Many PE firms have already taken the first crucial step: They know they must become portfolio activists. In recent surveys, respondents from nearly four out of five firms agreed that helping their portfolio companies achieve operational improvements will be the key source of value creation over the next five years. More than 75 percent said they have begun to increase their involvement in portfolio company management, typically by beefing up standard financial and operating performance reporting.

Some PE firms have gone further, assembling dedicated internal portfolio teams to unearth new operating efficiencies or growth potential in their portfolio companies and helping their managers to achieve them. But bringing talent and resources together to unlock value in their portfolio companies has led many PE firms into one or more of these common pitfalls:

- *Throw people at the challenge without resolving how best to deploy them.* Having a disciplined process is far more important than the volume of resources it consumes.

- *With a focus on people over process, the squeaking wheel always gets the grease.* It is easier, and certainly more valuable, to help a good company on a path to three times cash-on-cash return boost its performance to five times than it is to help a struggling company get from 0.5 times back to par or above. Achieving this calls for a process that reaches out to every portfolio company.

- *One size fits all.* The complexities of dealing with different businesses and management-team personalities are immense. A process that is both disciplined and flexible enough to partner with management teams to create value is crucial.

- *Paralysis by analysis.* Not knowing how to get started and struggling to change deeply entrenched operating norms, some PE firms wind up doing nothing. That is the worst pitfall of all.

Our experience working with a wide range of PE firms around the world has shown that there is no single "killer app" that is right for all circumstances. Rather than try to do everything at once, PE firms that set out to become portfolio company value creators can begin by adopting a prevalent process that best suits their unique combination of firm and portfolio company characteristics. A prevalent process is a starting point and a guide for action, not the ultimate destination. Because it captures the most common situations a firm and its portfolio will likely face, the model a PE firm chooses becomes the foundation for developing the disciplines of a repeatable model. As their competence grows, PE firms can shift to a second phase—customizing their process and resources to the unique needs of each portfolio company. Ultimately, PE firms evolve into a third phase when they are able to flex their model dynamically to suit portfolio company needs at any stage in the ownership life cycle—from creating a post-acquisition blueprint to paving the path to an exit three to five years later. PE firms that reach this stage are able to combine fact-based insights about the business with the emotional intelligence required to read the needs of their portfolio company management teams in order to achieve a great plan within a performance culture that delivers over the entire life of the deal.

More a précis than a full argument, the hot topics for 2011 we discuss above are certainly not exhaustive. Rather, they are a tip sheet of critical issues that we believe every PE firm needs to work on to be positioned successfully to earn outsized returns for its stakeholders in the years ahead.

About Bain & Company's private equity business

Bain & Company is the leading consulting partner to the private equity industry and its stakeholders. Private equity consulting at Bain has grown 11-fold since 1997 and now represents about 25 percent of the firm's global business. We maintain a global network of more than 400 experienced professionals serving private equity clients. In the past decade, we estimate that Bain & Company has advised on half of all buyout transactions valued at more than $500 million globally. Our work with buyout funds represents 75 percent of global equity capital. Our practice is more than three times larger than the next-largest consulting firm serving private equity funds.

Bain's work with private equity does not stop with buyouts. We work across fund types, including infrastructure, real estate, debt and hedge funds. We also work for many of the most prominent limited partners to private equity firms, including sovereign wealth funds, pension funds, financial institutions, endowments and family investment offices.

We have deep experience working in all regions of the world across all major sectors—from consumer products and financial services to technology and industrial goods. We support our clients across a broad range of objectives:

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

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

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

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

Exit: We help ensure funds consummate deals with a maximum return by preparing for exits, identifying the optimal exit strategy, preparing the selling documents and pre-qualifying buyers.

Firm strategy and operations: We work with private equity firms to develop their own strategy for continued excellence. Topics include asset-class and geographic diversification, sector specialization, fund-raising, organizational design and decision making, winning the war for talent and maximizing investment capabilities.

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

Bain & Company Global Public Relations

Media contacts:

Cheryl Krauss
Phone: 646-562-7863
cheryl.krauss@bain.com

Frank Pinto
Phone: 917-309-1065
frank.pinto@bain.com

Bain's business is helping make companies more valuable.

Founded in 1973 on the principle that consultants must measure their success in terms of their clients' financial results, Bain works with top management teams to beat competitors and generate substantial, lasting financial impact. Our clients have historically outperformed the stock market by 4:1.

Who we work with

Our clients are typically bold, ambitious business leaders. They have the talent, the will and the open-mindedness required to succeed. They are not satisfied with the status quo.

What we do

We help companies find where to make their money, make more of it faster and sustain its growth longer. We help management make the big decisions: on strategy, operations, technology, mergers and acquisitions and organization. Where appropriate, we work with them to make it happen.

How we do it

We realize that helping an organization change requires more than just a recommendation. So we try to put ourselves in our clients' shoes and focus on practical actions.

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