



GLOBAL PRIVATE EQUITY REPORT 2012

## About Bain & Company's Private Equity business

Bain & Company is the leading adviser to the private equity (PE) industry and its stakeholders. Most people in the industry recognize that Bain & Company and Bain Capital are separate companies, with no shared ownership or governance. However, in light of the heightened media attention we have received in this US election year, it may be worth setting the record straight: Bain & Company is not a private equity firm.

Bain & Company maintains a global network of more than 400 experienced professionals serving PE 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.

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

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

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

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

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

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

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

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

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## Searching for bedrock

Dear Colleague:

A year ago, the signs looked promising. Deal making in most private equity markets was reviving, fostered by a more positive economic outlook and surging debt markets. Exit activity in the fourth quarter of 2010 was the highest it had been in years. With liquidity flowing back to limited partners, new fund-raising appeared poised for a rebound. Returns looked ready to continue their upward climb.

And so it was, at least for a while. Activity in the first half of 2011 built on these auspicious harbingers. But then in the summer, a cavalcade of bad news in Western Europe and the United States threw PE activity into reverse. Fears of recession and credit defaults slammed the brakes on new deal making and exits, while foreshadowing tougher times for fund-raising and returns. By year's end, 2011 had morphed from Dr. Jekyll into Mr. Hyde.

What does this bode for 2012? As we enter the new year, the trends at play more closely bear an uncomfortable similarity to those prevalent two years ago than to a return to boom times. There are many deal discussions taking place but less confidence that buyers and sellers will agree on value given the current macroeconomic uncertainties. Exit markets remain anemic. The portents for fund-raising are ominous. The economic engines that power returns seem to be idling.

Meanwhile, the industry remains awash in commitments, with nearly \$1 trillion in dry powder still waiting to be put to work. Almost \$2 trillion worth of assets remain on general partners' books, and more than 75% of them are currently valued at below carry hurdle rates. There are clear forces pushing for a resumption of more robust deal making, but PE firms must address problems in their portfolios more systematically and forcefully for this to happen.

As you will read in Bain & Company's Global Private Equity Report 2012, these issues and forces are taking center stage in all PE markets. For all of their differences, developed and emerging economies share more traits than is commonly assumed. Yes, there are buyouts and buy-ins. There are exciting growth trajectories to follow. But everywhere there are high prices to underwrite, too much capital chasing too few deals and worries about returns and liquidity.

So is it time for the PE industry to cash in its chips? Certainly not. For one thing, the best investors continue to dramatically outperform their benchmarks and other asset classes. Pension funds, endowments, foundations and many other limited partners need this type of investment return to meet liquidity demands on their portfolios. Furthermore, the need for private capital is not going away—and for many sectors and markets, it is increasing. Inhospitable capital markets make it difficult for entrepreneurs to find capital and for management teams and their boards to fix underperforming businesses. There are many places in the world where PE is needed that more traditional sources of funding dare not tread.

What are investors doing as they adapt to these forces? Whether one believes the current market is still “on pause” from the levels of activity we saw five years ago or whether conditions of the past two years augur the arrival of a “new normal,” the evidence is compelling: PE firms can no longer rely on market beta to lift returns but must assertively mobilize themselves to generate alpha that feeds business growth well beyond normative expectations—both in the companies that PE firms own today and the ones they buy tomorrow. The firms that build rigorous repeatable models for partnering with portfolio company management teams and climb the growth curve will be the long-term winners. For many firms, doing this will require dramatic changes in how they organize themselves and go to market. For the PE industry as a whole, 2012 will be a year of watchful waiting to see who is clearly on the right path and who is not.



Hugh H. MacArthur  
Head of Global Private Equity  
February 2012

## 1. The PE market in 2011: What happened

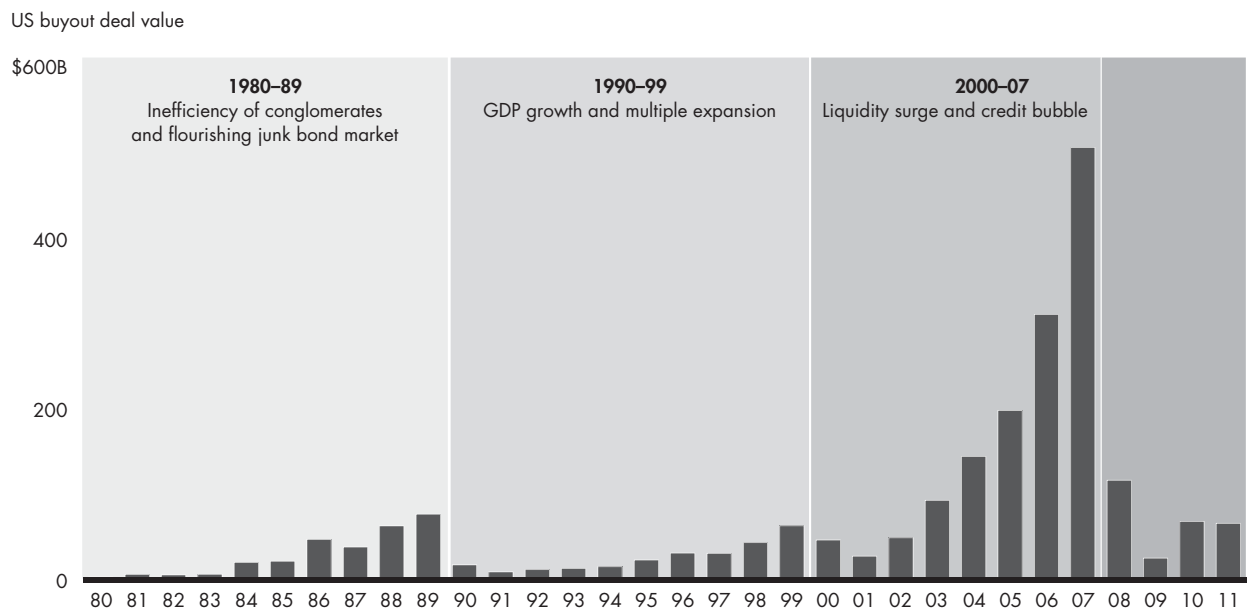
Like any industry sensitive to macroeconomic shifts, credit-market turmoil and volatile equity values, global private equity (PE) has had to navigate through booms and busts over the decades. From the rise and fall of the junk bond market in the 1980s through the climb and collapse of the dotcom craze in the 1990s and on to the swelling and bursting of the subprime credit bubble in the past decade, PE activity in the US, the industry's largest market, has ridden the ups and downs of long cyclical waves. While each PE cycle has had its distinctive characteristics, the industry remains a captive of broad macroeconomic forces (see *Figure 1.1*).

At first glance, the past year appears to have been a continuation of that broad trend. With global buyout activity of \$184 billion, according to data provider Dealogic, the total announced deal value for 2011 was essentially flat from a year earlier, but it continued its recovery from 2009's cyclical trough. Buyouts remain solidly higher in all regions from where they were two years ago—increasing at a compound annual growth rate of 67% in North America, 58% in Europe and 41% in Asia-Pacific since 2009 (see *Figure 1.2*).

Continuing, if unspectacular, GDP growth in both developed and developing markets—along with record low interest rates by central banks in the US and Europe—helped fuel PE investor confidence. And accommodating lenders, solid equity market gains and robust corporate profit growth helped propel deal making.

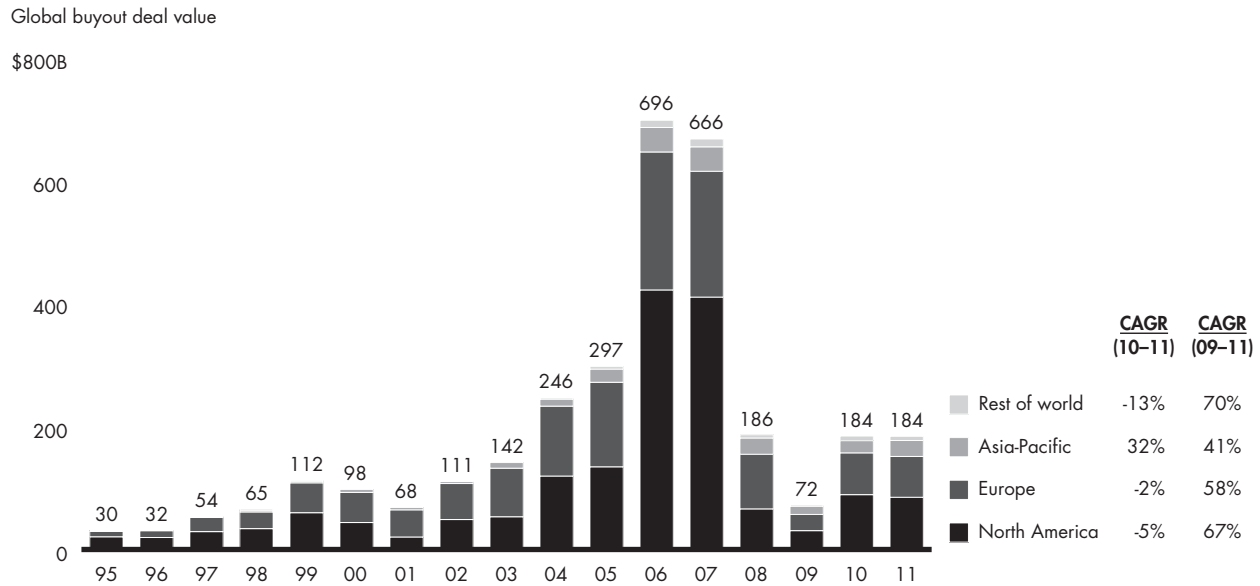
Those benign conditions deteriorated sharply in the year's second half, as buyout deal value plunged to less than \$11 billion by December. The suddenness of the reversal coincided with the full-blown emergence of the EU sov-

*Figure 1.1:* Private equity is a cyclical business



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

Figure 1.2: Global investment activity in 2011 matched 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; geography based on the location of targets  
Source: Dealogic

foreign debt crisis last summer and credible fears that developed market economies would slide back into recession. For PE funds, mounting fears of government defaults turned debt markets less favorable. Meanwhile, economic uncertainty triggered stock market gyrations that threw off PE valuation models and widened a mismatch between buyers’ and sellers’ expectations, which had no chance to reset in the volatile environment. By late 2011, the PE recovery had petered out and conditions largely reverted to what they had been in early 2010. The continued rebound of the PE industry had become hostage to the stabilization and recovery of the global capital markets—a theme that has carried over into 2012.

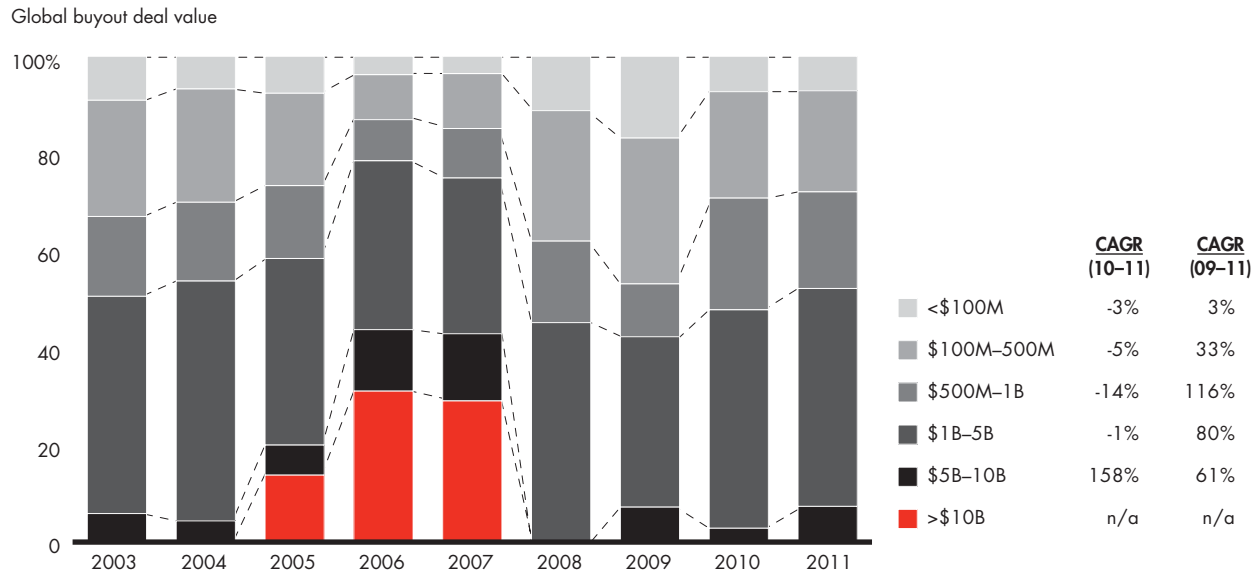
### Investments: Coping with climate change

Taking the year as a whole, PE investments in 2011 displayed many continuities with 2010. Not only did total deal value come in the same, but investment targets remained remarkably consistent, as well. Multibillion dollar, mega-sized buyouts that captured headlines during the peak of the mid-decade credit bubble did not reappear last year and are unlikely to recur in the foreseeable future. Since hitting bottom in 2009, investment activity has settled into a “new normal” that harkens back to pre-boom years, with buyouts concentrated in mid-market deals valued between \$500 million and \$5 billion (see Figure 1.3).

Also consistent throughout the year—but perhaps less expected given the reprise of recession worries in 2011—was PE funds’ appetites for deals spanning all sectors. Sectors that saw the biggest increases in buyout activity as measured by the number of completed deals included retail, technology and media and entertainment. Seeing less activity in 2011 compared with 2010 were financial services, consumer products and healthcare.



Figure 7.3: Deal size remained concentrated in the middle market



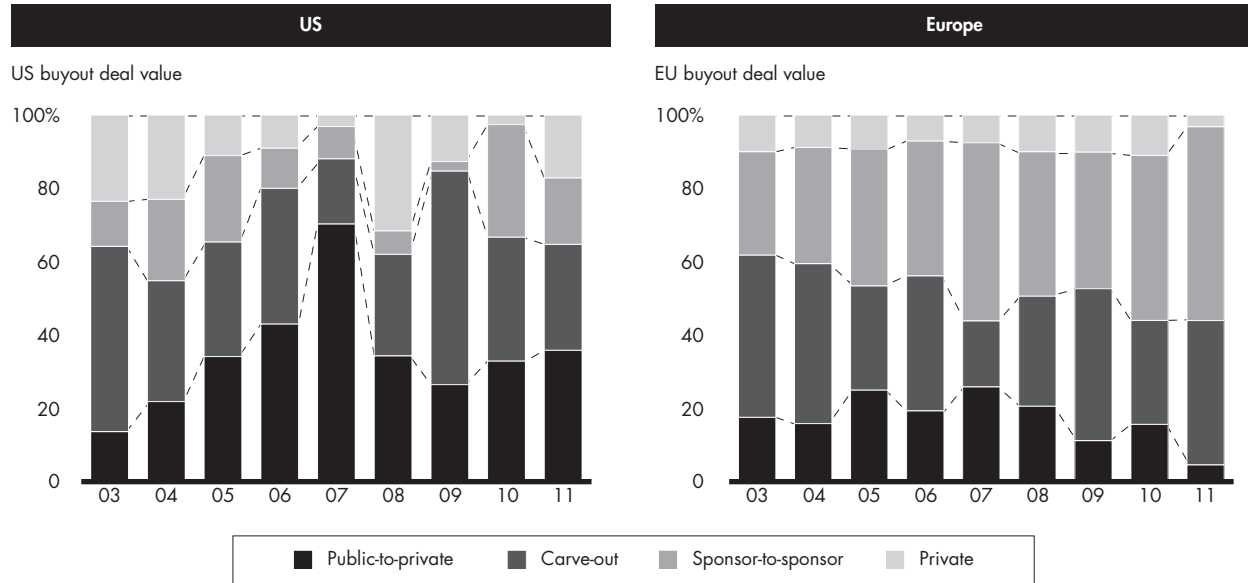
Notes: Excludes add-ons, loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change  
Source: Dealogic

Where PE investment activity in 2011 parted ways with the prior year was in the types of deals they consummated (see Figure 7.4). In the US, for example, public-to-private deals increased in popularity, accounting for just more than 35% of all transactions completed, as measured by deal value. Two of the year’s three largest deals—the \$6.3 billion acquisition of Kinetic Concepts by Apax Partners, Canada Pension Plan and PSP Investments and the \$3.9 billion purchase of Pharmaceutical Product Development by Carlyle Group and Hellman & Friedman—were public-to-private transactions. Sponsor-to-sponsor deals also remained popular with PE investors in the US. Although they fell to just under one-fifth of the year’s total deal value compared with nearly one-third in 2010, sponsor-to-sponsor transactions held steady at one-quarter of total deal count.

In Europe, the proportion of sponsor-to-sponsor transactions, long a preferred form of deal making, increased, accounting for more than half of all buyouts, as measured by deal value. Four of the year’s 10 biggest deals were Europe-based sales from one sponsor to another. Public-to-private transactions slipped to just about 5% of buyouts by value. Regulation in the region always makes these transactions difficult to pull off, and a tightening of debt availability in the euro zone during the latter part of the year made it more challenging to finance large deals.

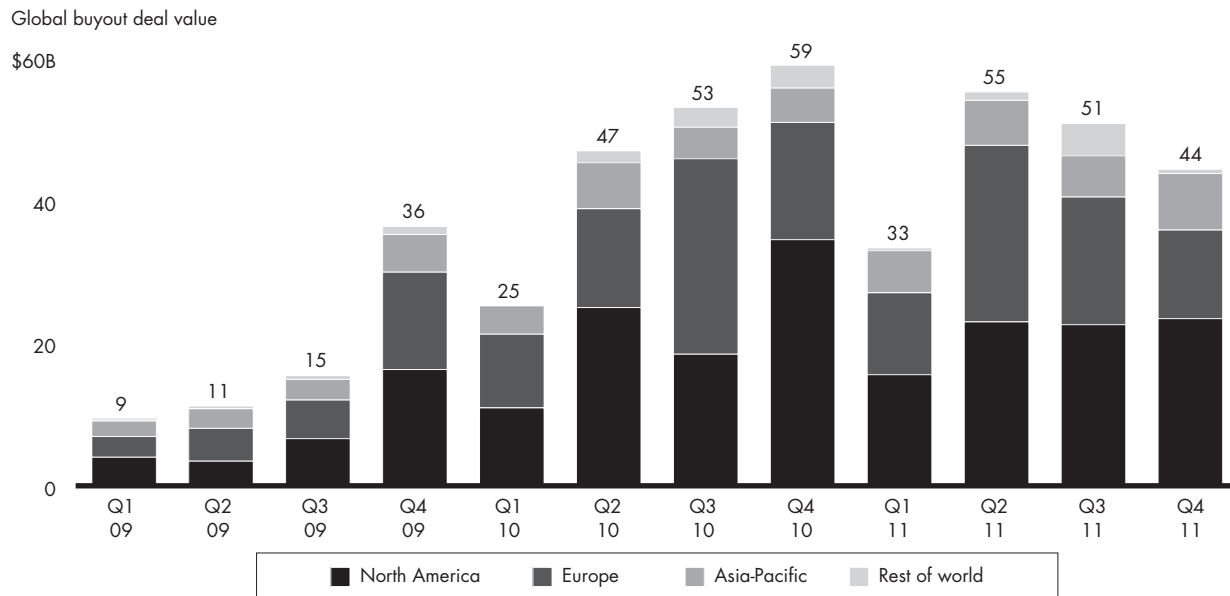
Overall, 2011’s “split personality” turned what had started out as a healthy year for PE investments into an unexceptional one. The year’s overall flat performance was a direct consequence of the dramatic falloff in deal activity in the year’s second half (see Figure 7.5). After climbing to a year high of \$55 billion in the second quarter, global buyout activity fell by 20% to just \$44 billion by the fourth quarter. The decline was especially dramatic in debt-plagued Europe, where buyouts were off by 50%. Only the Asia-Pacific region, where buyout activity continued apace, remained immune from the drop. One indication of 2011’s subpar performance: Had investments

**Figure 7.4:** Sponsor-to-sponsor deals continued to be popular; in US, buyouts of private companies and public-to-private deals increased



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 7.5:** Full-year investment data mask a pivotal turn in the PE market recovery in the second half of 2011



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

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stayed on the same trajectory they had been on through mid-year, full-year activity would have been in the range of \$230 billion, 20% more than where it ended up.

**A false spring.** Although PE deals completed in the strong first half of 2011 were similar to those concluded in the year's weak second half with respect to deal size, the distribution across a broad range of industry sectors and the deal source, the underlying forces propelling deal activity—particularly in the US, EU and other developed PE markets—were dramatically different. Conditions through mid-year could hardly have been more auspicious for motivated PE acquirers to find eager yield-hungry lenders to help them bring deals to fruition from an ample supply of companies available to be acquired.

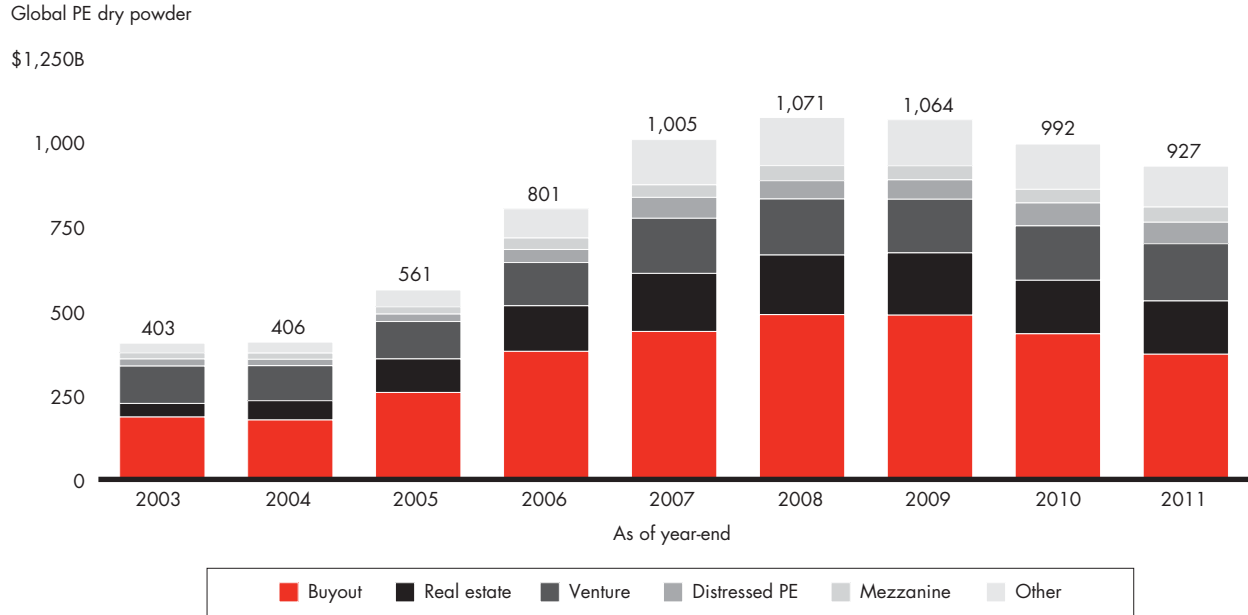
As the year began, more than 4,500 PE firms armed with nearly \$1 trillion in dry powder—more than \$400 billion of it for buyouts alone—were eager to put capital to work (*see Figure 1.6*). Pressure to invest continued as PE firms' dry powder aged. General partners (GPs) faced the increasingly urgent need either to find productive investments to absorb the capital or risk sacrificing management fees, not to mention the missed opportunity to earn carry on an investment as the clock ran out. Bain & Company's analysis reveals that roughly 36% of buyout funds larger than \$1 billion, representing 60% of dry powder for these funds, were likely under pressure to put capital to work over the course of 2011 (*see Figure 1.7*). These included funds from the 2006 through 2008 vintages, which had called less than two-thirds of their committed capital, and the 2009 vintage funds, which had called less than one-third. In short, GPs were under much the same pressure to put capital to work throughout 2011 as they had been in 2010.

With so much buyout capital to deploy, competition for attractive assets would be intense. But buyout funds were not the only shoppers in the market. Corporate acquirers, their coffers also flush with cash, were on the lookout for strategic acquisitions that would help fuel their growth or give them a competitive edge. Excluding financial companies, the 1,500 US corporations that comprise the S&P large-cap, mid-cap and small-cap indexes held more than \$1 trillion in cash or cash equivalents. The inevitable effect of the competition from both PE firms and corporates to land attractive assets was higher transaction prices. On leveraged buyouts concluded in the US during the first half of 2011, acquirers paid 8.5 times EBITDA, in line with deal multiples paid in 2010. Multiples on European deals came in lower in 2011 at 8.6 times EBITDA, versus 9.2 times in 2010. But in both markets purchase multiples remained well above the 6 to 7 times EBITDA coming out of the last downturn.

Did the pressure many funds felt to complete deals in 2011 distort market prices? Certainly the danger was real. About one-quarter of all aging dry powder was in the hands of PE funds with below-average performance track records, which might have had an incentive to recklessly bid up acquisition prices. Having only limited prospects to raise future funds, they have a powerful motivation to invest their remaining committed capital to extend the life of their firms and maximize their revenue streams. However, Bain analysis suggests reckless behavior by some GPs likely did not have a distorting effect. We found that underperforming funds that might have behaved imprudently did not put disproportionately more capital to work in 2011 than either their better-performing peers or funds that were not facing use-it-or-lose-it investment deadlines. The fact that these GPs did not win more auctions does not prove that their behavior did not drive prices up. However, it was far likelier that the sheer amount of capital bidding for deals, not reckless behavior on the part of pressured GPs, kept deal multiples high.

Competition, however, required GPs to stretch to win deals. Many GPs placed heightened focus on deal origination, working hard to uncover proprietary opportunities. They sharpened their investment strategies, more clearly defined their "sweet spot" for deals and built out their networks in target sectors to ensure they would be

**Figure 1.6:** PE firms still had over \$900 billion in dry powder—more than \$400 billion for buyouts alone—at the start of the 2011



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

**Figure 1.7:** Many older funds had substantial dry powder in 2011



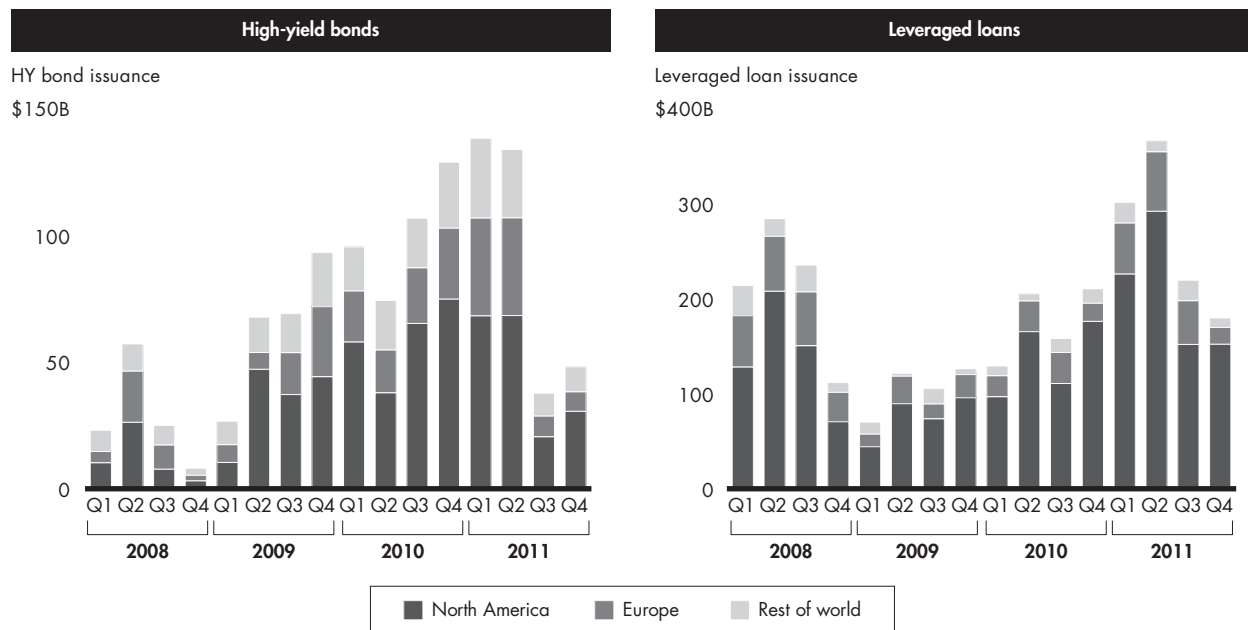
Notes: Includes buyout funds vintage 2006 and later that have held a final close; excludes funds with insufficient data; based on most recent performance data available, primarily as of Q2 2011  
Sources: Preqin; Bain analysis

in the early deal flow. They worked to strengthen their relationships with company owners and intermediaries, such as banks and advisers. And they took steps to solidify their reputation as the “go to” firm for deals that played to their strengths.

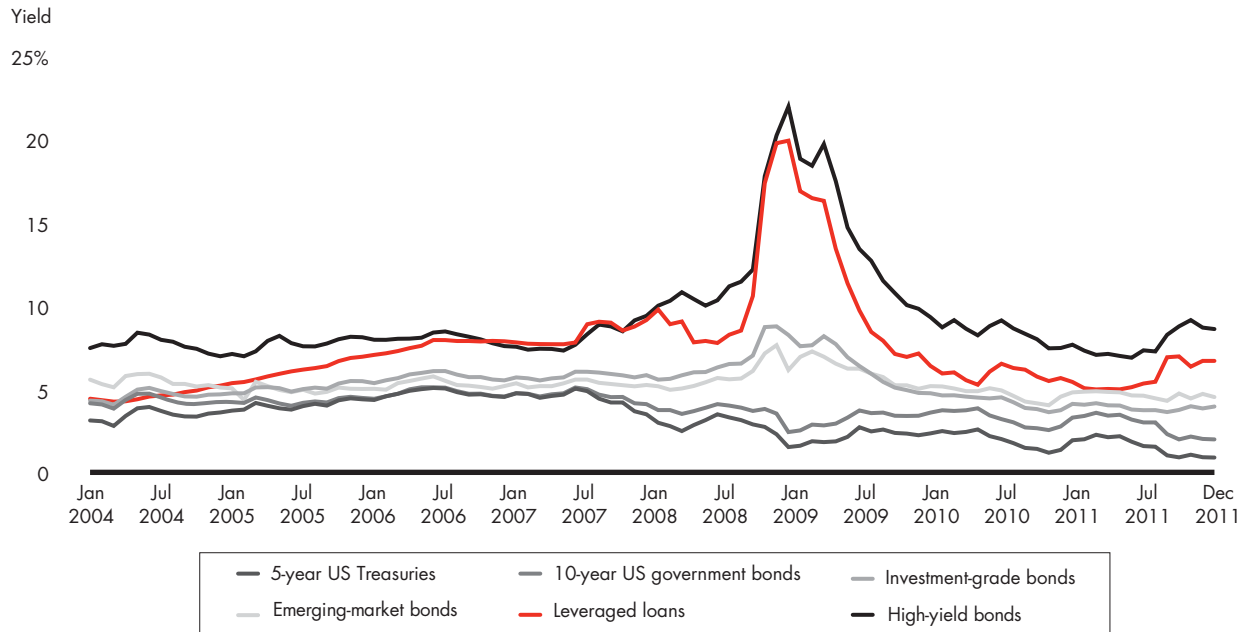
For deals that were not proprietary, GPs maneuvered to get a foot in the door early and gain a winning edge. Getting a head start would give them more time to uncover value-creation opportunities and develop a proprietary investment thesis, using an enhanced due diligence process in order to flesh out the potential upside for gains and, if necessary, bake a portion of it into the price. Again, they cultivated relationships with management to increase their likelihood of being selected as the winner, while also taking advantage of the opportunity to assess the executive team’s strengths. With leading GPs taking proactive steps like these, many public-to-private transactions in 2011 ended up as “semi-proprietary,” having the contours of the deal in place before the go-shop period. As a result, the go-shop period was often mere formality, as other buyers had little time to get comfortable submitting a competing bid.

GPs had a powerful ally in the favorable debt markets during the year’s first half. Coming off a strong year in 2010, the market for speculative-grade debt clearly signaled to PE deal makers that it was open for business. According to data supplied by Dealogic, high-yield bond issuance hit a high of \$138.3 billion in the year’s first quarter and leveraged loans surged to \$366.3 billion in the second quarter, the highest levels since the subprime credit meltdown (see Figure 1.8). The strong demand for speculative-grade debt was buoyed by investors’ hunger for yield and their willingness to move up the risk curve to find it (see Figure 1.9).

Figure 1.8: The primary market for speculative-grade debt was robust through the first half of 2011



Source: Dealogic

*Figure 7.9:* Strong demand was buoyed by investors' search for yield

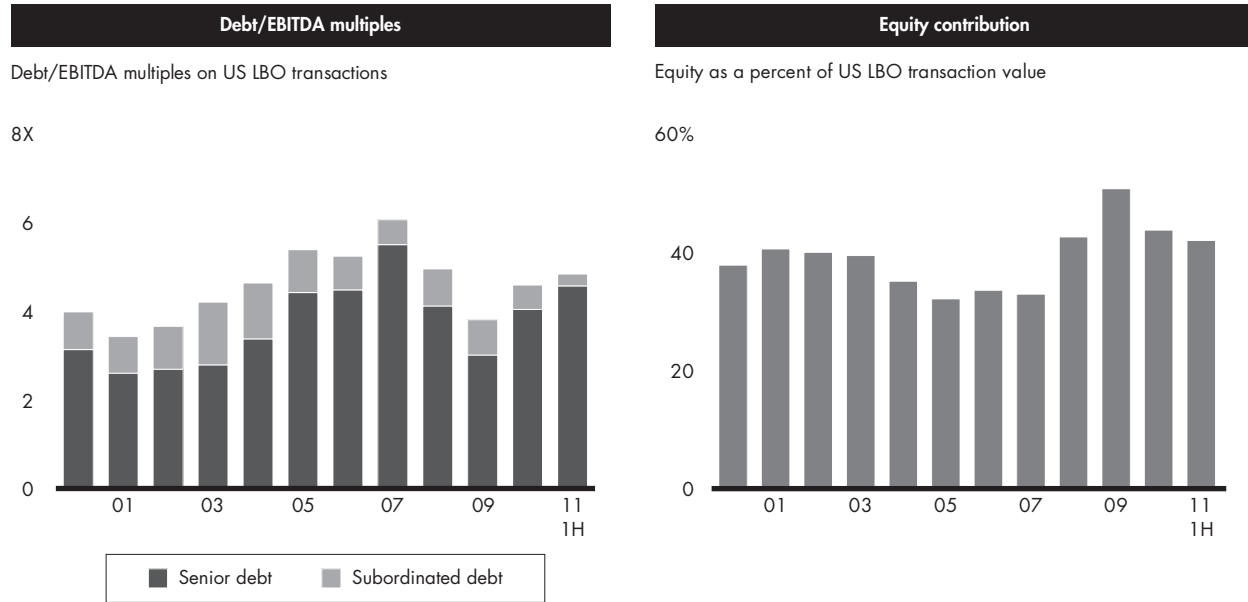
Sources: Haver Analytics; Merrill Lynch; PIMCO; S&P; LSTA

The ready availability of relatively low-cost credit made it possible for PE funds to secure financing on favorable terms for a far more diverse range of deals, including riskier ones, than in 2010, when generally only high-quality transactions got financed. Tolerant lenders enabled them to use more leverage and less equity to structure the buyouts they transacted through mid-year. In the US, for example, leverage levels on new LBOs increased during the first half of 2011, as debt multiples rose to 4.8 times EBITDA from 4.6 times in 2010. PE funds' equity contribution, meanwhile, inched down in the first half of 2011 to 42% of transaction value from 44% in 2010 and was far below the 51% PE funds were required to put into buyouts during the 2009 credit drought (*see Figure 7.10*). Not only was there more lending for buyouts, it came with fewer strings attached. Harkening back to the credit boom of the mid-decade, many loans imposed fewer covenant restrictions, and creditors were more willing to take a second-lien position.

The combination of highly motivated PE buyers, cash-rich corporate acquirers and yield-hungry lenders ensured that deal valuations would remain rich. Favorable circumstances on the "buy side" were a powerful draw, pumping up the supply of companies available for sale. Indeed, about half of GPs surveyed by Preqin and LexisNexis at mid-year reported that they had seen an increase in the pipeline of deals they were weighing (*see Figure 7.11*).

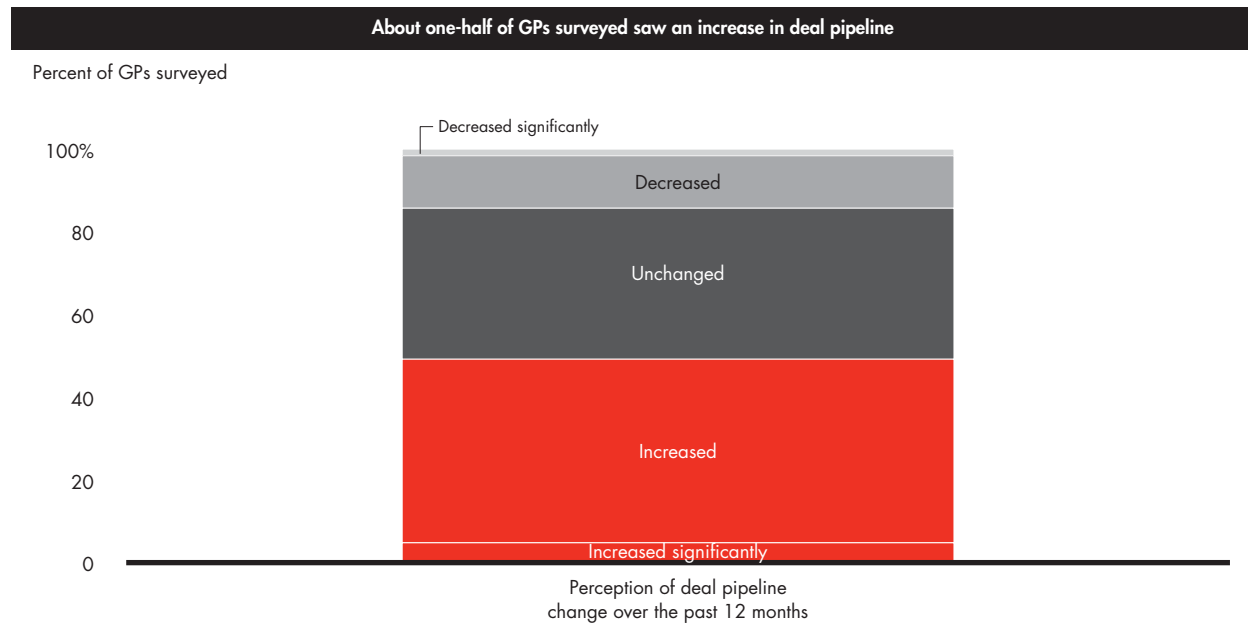
Business conditions also made the first half of 2011 an opportune time for sellers to test the market. Companies acquired by PE funds prior to the downturn and held in their portfolios until the economy recovered were ripe for sale. They and other companies that had hunkered down to take out costs and strengthen operations during the recession were now able to demonstrate the payoff. With several quarters of stable or improving performance to show potential acquirers, they were in a strong position to seek top value. Because they had achieved much of their recent success boosting their cash positions and profitability through temporary expedients like inventory

Figure 1.10: Leverage levels for new LBOs increased in the first half of 2011 in the US



Notes: Based on pro forma trailing EBITDA; equity contribution includes contributed equity and rollover equity  
Source: S&P LCD

Figure 1.11: Supply of companies was robust and more deals were consummated



Source: "CRM Systems and Deal Sourcing," Preqin/LexisNexis, September 2011 (n=63 GPs)

restocking, they had incentives to pursue their sale and return capital to their LPs, rather than run the risk that the expansion might stall. Meanwhile, on the buyer side, GPs' belief that the economic expansion would continue gave them the confidence to bid more aggressively for deals.

**A late-summer frost.** By early in the third quarter, market conditions in Europe and the US turned dramatically less hospitable to PE investments. A sharp and sudden rise in the cost of debt and the tightening of debt availability in the euro zone cooled LBO financing. Renewed signs of economic weakness and increased market volatility widened the mismatch between buyer and seller expectations, resulting in fewer deals agreed to in the year's second half.

Debt-market troubles resurfaced in June as worries intensified that a looming Greek sovereign-debt default increased chances that other euro-zone economies might soon follow. Investors pulled back sharply in a flight from risk. Sensitive to every headline that the crisis would or would not be resolved and what that implied for the continued health of the global economy, high-yield investors remained fickle throughout the balance of the year. By early autumn, the falloff in investor demand and a weakening economic outlook led to a widening in risk spreads on high-yield bonds and leveraged loans. With few alternative investment options offering attractive yields, investors did not give up on speculative-grade debt altogether, and flows into and out of high-yield securities continued to be erratic. But the unsettled markets caused the all-in cost of LBO debt to jump significantly, limiting the amount of leverage PE funds could use to finance deals and consequently reducing what they were willing to pay.

Debt-market turbulence during the second half of 2011 took its toll in both the US and the EU, but it affected PE investment differently on opposite sides of the Atlantic. In the US, GPs were still able to arrange financing for deals, but debt came at a higher cost. For example, the \$5.3 billion buyout of Del Monte Foods by KKR, Centerview Capital and Vestar Capital Partners had an all-in cost of debt of 5.5% when it closed in March. In July, when it closed on its \$2.4 billion carve-out of Capsugel, a unit of drug maker Pfizer, KKR faced a 6.88% cost of debt and cut back on its use of leverage. As KKR co-founder Henry Kravis told *Forbes* in July 2011, had the same deal closed just two months later, its capital cost would have risen closer to 9%.

In the euro zone, the epicenter of the sovereign-debt crisis, LBO financing became difficult to arrange at any price, as even high-quality assets faced debt rationing. The debt situation was more favorable in the European countries and regions that ring the euro zone. Although PE deal makers in the UK felt the effects of the euro-zone troubles, debt conditions in the Nordic countries, Central and Eastern Europe and Turkey were reasonably good.

Costlier, and for some GPs scarcer, leverage combined with volatile equity markets inevitably drove a wedge between buyers and sellers. Growing uncertainty about the outlook for the economy left GPs unsure whether they could trust the forecasts built into their valuation models. When researchers at Preqin and LexisNexis surveyed GPs on their opinion of asset values in late summer, nearly 70% responded that they were "overpriced" or "very overpriced." But sellers were reluctant to accept lower valuations as the new reality. Accustomed to the stiff competition during the year's first half that kept transaction multiples high, sellers were slow to recalibrate their expectations when equity markets turned volatile in the second half of 2011.

The result was deal gridlock, with transactions stalling, offers being withdrawn or sellers deciding to wait out the volatility. In September, for example, Permira, the UK-based buyout firm, put a halt to the sale of its portfolio company All3Media, the UK television production company, when the five bidders failed to meet the company's asking price. The following month, Dollar Thrifty, the US-based auto rental company, ended its effort to attract buyers after receiving no "acceptable offer."



**Some warmth in emerging markets.** Somewhat insulated from the recession anxieties and fears of sovereign-debt defaults that gripped the developed markets, fast-growing emerging market economies from Asia to Latin America continued to beckon global PE investors. GPs continued to flock to healthier macroeconomic climates and booming regions, like Greater China, Southeast Asia and the Indian subcontinent, seeking investment opportunities (see Figure 1.12).

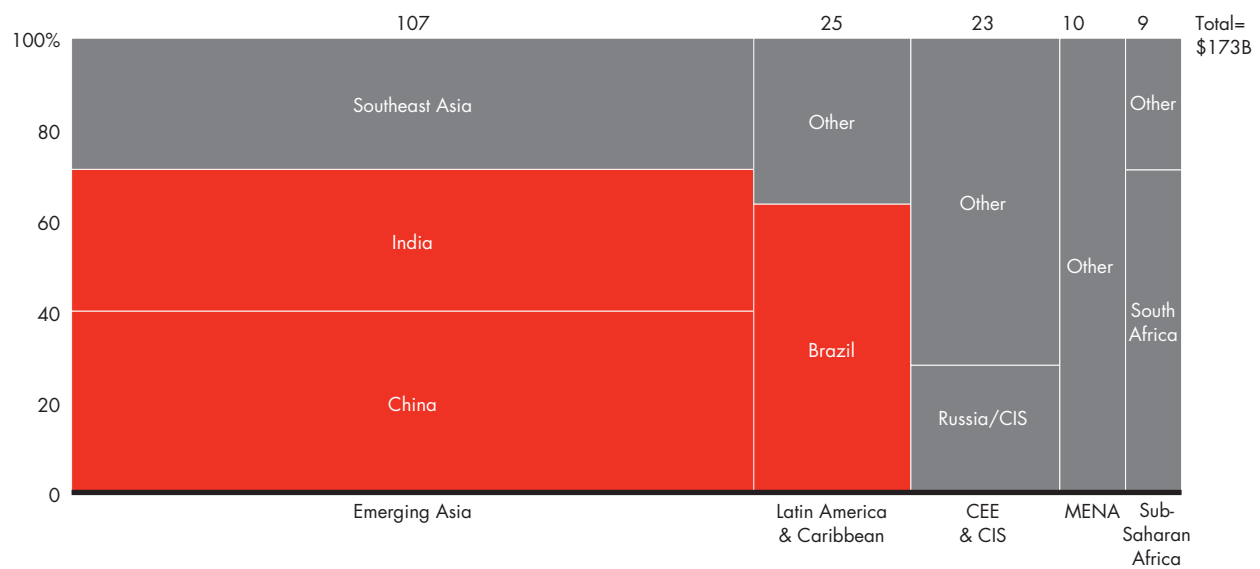
Overall, however, PE emerging market investment volume was flat in 2011—about half what it was at the peak of the PE boom in 2007. The year played out differently in each country, with PE investment volumes up in the two biggest markets, China and India. Meanwhile, investment activity stalled in Brazil, the third-largest emerging-market destination for PE capital.

**China:** PE firms deployed \$43 billion in China over the past five years, the most for any developing country. China is now the world’s second-biggest economy, and its GDP growth of 9.2% continued to far outpace developed countries and other emerging markets last year. Down just slightly from 2010, China’s economy is expected to sustain annual growth in the range of 8% to 9% in coming years.

International PE funds were drawn by more than China’s macroeconomic growth. There was also an expanding supply of potential target companies to attract PE attention through the privatization of inefficient state-owned enterprises, fiscal tightening by Chinese authorities that restricted access to bank lending, and volatile equity markets that limited companies’ ability to float public stock offerings. With \$43 billion in dry powder targeted for investments in China alone at mid-year and additional capital held by pan-Asian or global funds that could be put to use there, PE funds were more than ready to accommodate demand.

*Figure 1.12:* Emerging-market PE investment is dominated by China and India, followed by Brazil

Emerging-market PE capital investment by region 2007–Q3 2011



Notes: Includes equity capital invested (excludes debt); excludes real estate, infrastructure and secondary transactions; excludes activity by hedge funds, captive funds and government-backed funds; Emerging Asia excludes Australia, New Zealand and Japan  
Source: EMPEA

Total 2011 PE investments in China ended up higher than in 2010 and even surpassed the boom years of 2007 and 2008. Yet investment activity did not live up to its full potential. One major factor hindering GPs' efforts to put more capital to work was a valuation mismatch between buyers and sellers. Despite lower and more volatile public equity markets, sellers held out for the lofty trading multiples high-quality assets commanded at the market peaks. For their part, PE firms struggled to get comfortable paying high prices for minority investment positions that offered limited ability to influence the direction of the company. In addition, with mounting uncertainty about the sustainability of global demand for goods from China's export-driven economy, potential buyers were reluctant to stretch to meet sellers' high price expectations.

**India:** Second only to China as the emerging-market destination of choice for global PE, India saw PE investments grow substantially in 2011. Sectors seeing the biggest uptick in activity were real estate, information technology and information technology-enabled services, and manufacturing. As in previous years, deal volume skewed toward smaller transactions. Larger global funds continued to be challenged putting capital to work in a market dominated by minority-stake deals and with limited availability of sizeable potential targets in need of capital infusions. Yet, as in other fast-growing emerging markets, India's strong economic fundamentals in a year, when weakness and uncertainty were the norm in the developed markets, were the lure that attracted PE funds to India. Solid GDP growth of some 7% in 2011 far outpaced faltering expansions in the US and EU, and forecasters expect growth to remain in the range of 8% in coming years. With some \$17 billion in dry powder targeted for investment in India alone at the end of 2010, plus more on tap from pan-Asian and global funds, GPs have plenty of capital to expand their holdings.

GPs also found much to like about Indian companies and business conditions. India boasts a deep pool of talented managers with strong operational skills. Indian companies also showed an increased appetite for PE capital in 2011 as more conventional financing sources became harder to find. Borrowing costs rose as India's central bank raised interest rates to combat inflation and a volatile stock market discouraged public offerings. Partially offsetting the factors advantageous for deal making, GPs eager to put capital to work had to contend with high asset prices, which have lately shown signs they may be moderating. One question mark on the horizon is the potential impact of new draft regulations proposed by the Securities and Exchange Board of India last August. Under the new rules, international PE and venture capital funds could face more onerous registration and reporting requirements that would increase the costs and risks for PE firms.

**Brazil:** GDP growth slowed to less than 4% in 2011 from the 7.5% pace of a year earlier and PE investment activity largely followed the macroeconomic trend. New investments were off nearly 50% in 2011, according the Emerging Markets Private Equity Association, an industry trade group. But the dramatic decline overstates the actual falloff in deal making. Investments in 2010 spiked due to a handful of large buyouts. Remove these and the drop in deal activity was closer to 13%.

The fact that the data is sensitive to the impact of a few big deals reveals an important characteristic of PE in Brazil: Brazil remains a thin market, dominated by small and midsize investments, chiefly in family-owned businesses. Moreover, the process of matching PE buyers and sellers increasingly involves intermediaries, driving a wedge in prices. The valuations sellers seek are generally higher than the growth assumptions in PE buyers' models warrant them paying—a mismatch that has held PE investments well below their full potential in 2011.

Despite the recent slowdown, investment opportunities remain plentiful. The nation is in the midst of a major infrastructure investment cycle to support a major expansion of the oil and gas and renewable-energy industry;

build facilities ahead of the World Cup and the summer Olympic Games, which Brazil will host in 2014 and 2016, respectively; and continue to expand its long-neglected education, sanitation and healthcare sectors. And although private wealth remains highly concentrated, discretionary spending by a growing consumer class is on the increase. The emergence of a larger, stable and more confident middle class is transforming many industries, including apparel, real estate and travel, which are benefitting from increased spending and growing far faster than overall GDP. With interest rates dropping, consumer spending is unlikely to slow any time soon.

Brazil is clearly becoming more hospitable to PE. Its capital markets are growing more sophisticated, and the country boasts one of the most active public equity markets in the world, making IPOs a realistic exit option. Yet, significant hurdles remain. Government regulation, tax policy and economic uncertainty add complexity and risk to PE deals, making local expertise, enhanced due diligence, strong risk-management capabilities and attention to post-deal value creation imperatives for GPs operating there.

Looking ahead, GPs in all emerging markets will need to work hard to bridge the price-expectations gap. Successful PE funds will work to educate company management about the contributions that PE owners can bring to a company. They will build stronger relationships with owners prior to acquisition to align interests and make it possible to influence the company post-close. Finally, they will collaborate with their target-company partners during ownership to create value.

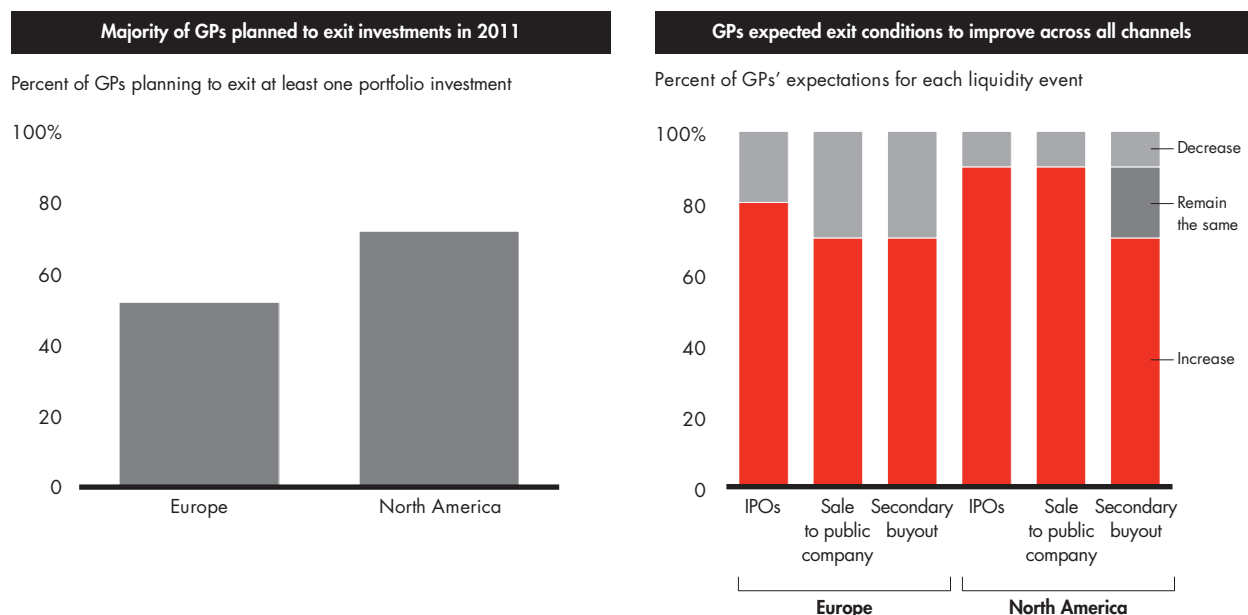
## **Exits: The recovery stalls**

Exit activity stormed into 2011 on a wave of momentum and GPs' optimism. The majority of GPs on both sides of the Atlantic told survey researchers in late 2010 that they were planning to divest at least one portfolio investment in 2011, and they were overwhelmingly bullish on the conditions they expected would await sellers in all three major exit channels (see *Figure 1.13*). Equity markets were highly receptive to IPOs by high-quality PE-backed companies with strong growth stories to sell. Interest in sponsor-to-sponsor transactions, which had been a notable part of 2010's exit activity, remained robust, as motivated PE sellers eager to off-load assets found eager PE buyers with plenty of dry powder to deploy. And with corporate acquirers sitting on deep cash reserves and refocused on growth in an improved macroeconomic environment, asset sales to strategic buyers looked promising.

Sales got off to an apparent slow start during the first quarter, as typically happens at the beginning of each PE calendar year. This was exacerbated in 2011 as exits that naturally would have occurred early in 2011 were pulled forward into the fourth quarter of 2010 by GPs eager to lock in returns before anticipated higher tax rates on carry, capital gains and dividends went into effect. Measured by total deal value, global buyout-backed exits through March came in well below the \$99 billion during the strong fourth quarter of 2010. However, exit count had dipped only slightly from 281, the highest level since the peak of the last PE boom in mid-2007, to a still-robust 254 exits. By the second quarter, exit activity was hitting on all cylinders. The value of IPOs and sponsor-to-sponsor exits hit levels not seen since before the market meltdown, and sales of buyout-backed assets to strategic acquirers soared to record heights, totaling more than \$75 billion.

The continuation of favorable exit conditions into 2011 gave PE firms a welcome opportunity to convert unsold portfolio holdings into realized gains. PE funds were sitting on a large pool of unrealized capital that had increased to \$1.8 trillion by the end of 2010—nearly four times more than they had in their portfolios at the end of 2003. One benchmark of how big the exit overhang had grown: The value of unrealized capital had swollen to more than one and a half times the amount of dry powder in PE fund coffers. Some of those unrealized investments

Figure 7.13: GPs were optimistic about exits going into 2011



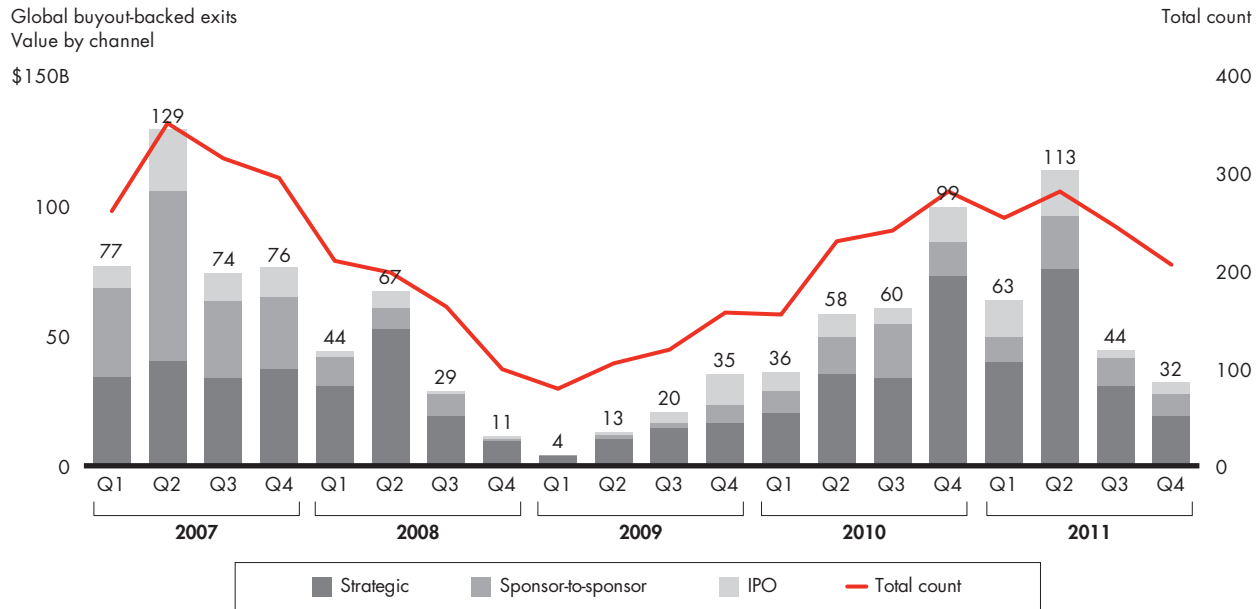
Source: "Transatlantic Private Equity," mergermarket/Duff & Phelps, May 2011 (n=50 GPs; survey conducted late 2010)

were still valued either below cost or below the carry hurdle rate, particularly larger companies acquired at high multiples during the cyclical peak years of 2005 through 2007 that had yet to mature. But many assets were ripe for sale, having stabilized or improved their performance since the depths of the downturn.

It was a great time to sell. With valuations high, GPs who were eager to get "wins" under their belt before hitting the road to raise their next fund capitalized on the market opening. Virtually none of the large buyout funds from the vintage year of 2005 or later had yet returned capital paid in by their limited partners. Asset sales during the first half of 2011 enabled them to put cash into the hands of distribution-starved LPs, who would need the liquidity to meet capital calls on previous fund commitments and to sign on for new funds. They would also enable firms to make payouts to their own junior investment professionals who had yet to realize any carry since they signed on.

Yet, as on the investment front, what started so promisingly in the first half of the year fizzled out amid recession fears, sovereign-debt woes and market volatility in the year's second half (see Figure 7.14). Activity retreated across all channels, and exit value dropped some 57%. The global market for PE-backed IPOs cratered from 45 offerings in the second quarter to just 27 by the fourth quarter, and total IPO value sank from some \$17 billion to \$4 billion. According to data provider Dealogic, some 55% of the year's initial filings were postponed or withdrawn. Meanwhile, global corporate M&A activity decreased steadily throughout the year, with the value of acquisitions by strategic buyers dropping approximately 15% from the first half of the year to the second half. Sponsor-to-sponsor sales suffered as the year drew to a close as the price-expectations wedge widened between what sellers were looking to get and what buyers were willing to pay. Whether measured by deal count or deal value,

**Figure 7.14:** Exit activity in the first half of 2011 was very strong, but declined severely in the second half of the year



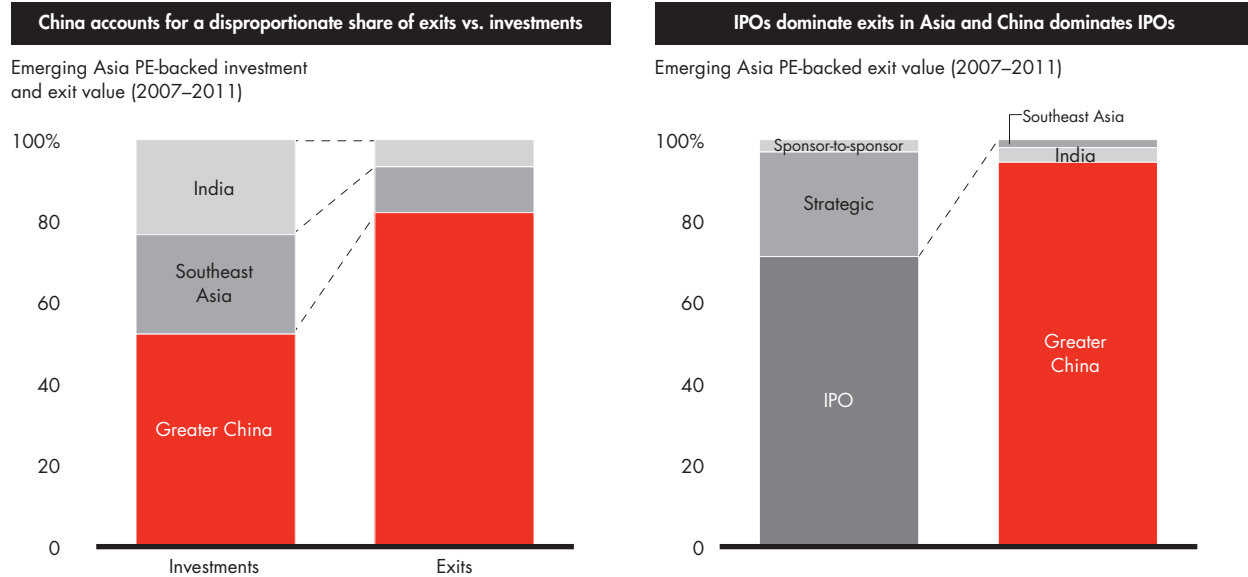
Notes: Excludes bankruptcies; IPO value represents offer amount  
Source: Dealogic

total buyout-backed exits ended the year flat from full-year 2010 levels. Clearly the buoyant mood that greeted the start of the year had soured by year’s end.

Exit opportunities remain nascent in emerging markets. Valuations fell in 2011, making IPOs and sales to strategic buyers less attractive. Realizations from asset sales continued to trail the pace of new investments, as they have throughout the past decade. Again, this reflects structural realities of PE in emerging markets. Although the slow pace of exits to date has raised skepticism about the attractiveness of emerging markets for PE investments, the simple fact is that a large proportion of the investments made to date simply has not yet had time to ripen for sale. PE investors have principally provided their target companies with infusions of growth capital, which require far longer holding periods than the buyout investments more typical of PE in developed markets. Because PE funds only began in earnest to pour capital into the developing economies in 2005, relatively few growth capital investments had sufficient time to reach a threshold size that made them attractive candidates for IPO or sale to strategic acquirers.

Indeed, among emerging markets broadly, only China has provided PE funds meaningful liquidity. Greater China accounted for less than half of PE-backed investments in Asia’s emerging economies between 2007 and 2011, yet it generated about 80% of all exit activity and 90% of the region’s IPOs (see Figure 7.15). Although initial offerings of shares in state-owned banks with PE sponsorship have inflated PE-backed IPO exit volume in recent years, China is undeniably a robust IPO market. Because China’s regulatory environment is not very conducive to trade sales, particularly those involving foreigners, IPOs continue to be the preferred exit route for PE-backed companies. Further boosting the volume of PE-backed IPOs in China is the large number of companies seeking

**Fig 1.15:** China is the only country in emerging Asia providing meaningful liquidity, largely driven by IPOs



Notes: Includes only investments with disclosed deal value >\$10M; does not include bridge loans, franchise funding and seed/R&D deals; excludes infrastructure project finance deals, real estate, real estate investment trust and hotels and lodging property deals  
Sources: AVCJ; Bain analysis

to list on a Chinese exchange. Chinese entrepreneurs look to PE investors to help smooth their path to going public, since having a reputable PE firm on board as an investor can enable a company to jump the queue.

In India, by contrast, capital markets are not as deep and trade sales are the most popular path to exit. Because many PE firms in India acquired stakes at peak valuations between 2005 and 2007, PE funds have been left holding on to unrealized investments in companies for which they had paid dearly. In Southeast Asia, as well, capital markets are shallow, and many PE-backed investments are simply still too recent to have reached maturity.

### Fund-raising: The rebound falls flat

As 2011 began, PE fund-raising looked to be poised for a modest recovery after hitting what many thought to be the cyclical bottom in 2010. LPs that had dramatically scaled back their commitments to new funds since the downturn were ready and able to get back into the action. Many had used the period since the 2009 market crash to fundamentally reassess their PE exposure, having recognized, for instance, that during the mid-decade boom years their PE portfolios had become too heavily concentrated in big buyout funds from the 2005 through 2008 vintages. LPs were taking a more thoughtful approach to how they would construct their PE portfolios going forward. Rather than simply add broadly to their PE holdings, many were determined to seek out pockets of opportunity more selectively. As they waited for the markets to recover through 2009 and 2010, LPs also resolved to be much more discerning in their selection of GPs with whom they would invest.

Anticipating that top-performing GPs would soon be hitting the road to line up commitments for new funds, LPs were primed to put their new insights and disciplines to work. Flush with distributions from the pickup in exit

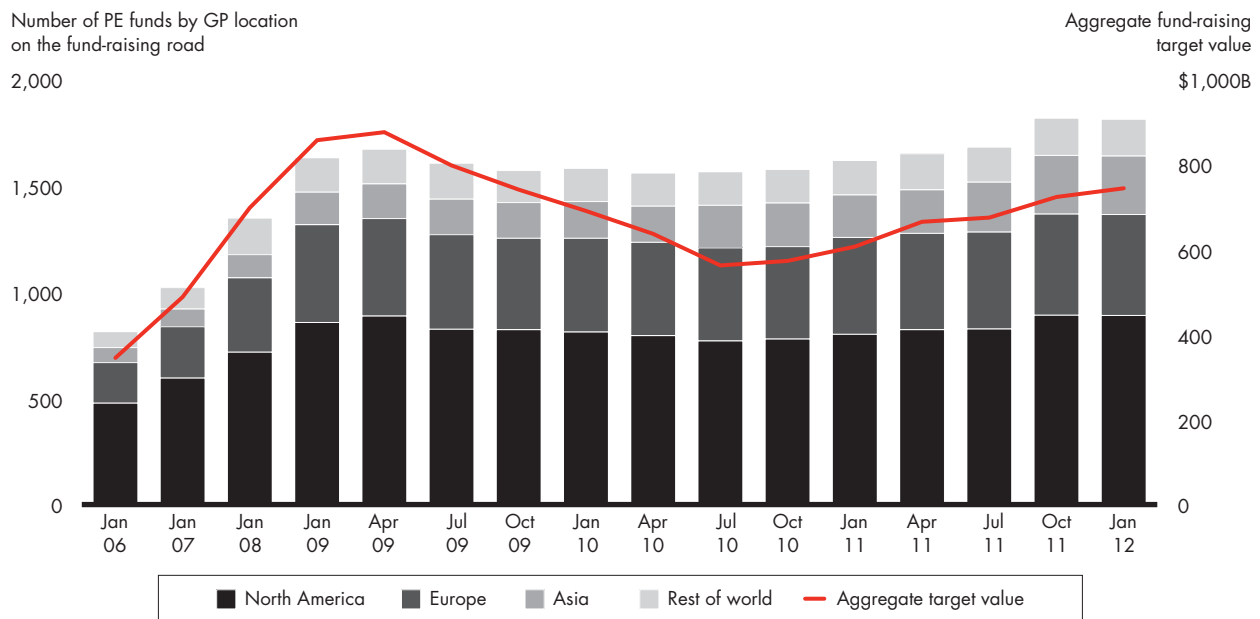
activity during the second half of 2010, they penciled in modest increases to their budgets. More than half of the LPs surveyed by Preqin in late 2010 said they would be increasing their PE commitments in 2011.

GPs were also reawakening from their bear-market hibernation. Most had been subsisting on their stores of dry powder accumulated during the boom years, which the drop-off in new investment opportunities since the downturn enabled them to stretch out. With time passing and investment activity beginning to revive by late 2010, many GPs found themselves at a natural point in their fund cycle to refocus attention once again on fund-raising. Those whose most recent fund dated from the boom years or had called the bulk of the capital committed by LPs were making plans to get back on the fund-raising road.

They found plenty of company. In January of 2011, more than 1,600 PE funds were pitching new funds with an aggregate target value of more than \$600 billion, and the count continued to climb throughout the year (see Figure 7.16). The addition of so many new fund-raising campaigns on top of the already large number of funds worsened the global oversupply, greatly intensifying competition as the year began. At the start of 2011, GPs sought to raise 2.2 times as much capital as they had brought in during all of 2010 (see Figure 7.17).

Still, fund-raising conditions remained auspicious through the year's first half. With major international equity indexes rising, PE made up a shrinking proportion of LPs' total assets under management, creating headroom for LPs to increase their PE commitments. Meanwhile, the strong market for PE exits kept LPs who were sitting on mature PE portfolios awash in liquidity (see Figure 7.18). For many LPs, distributions through June were the best six months on record. The liquidity wave added to LPs' confidence that they could make new fund commitments while continuing to meet capital calls on past pledges. In light of the favorable circumstances, LPs did

Figure 7.16: The number and target value of funds on the road remained high



Source: Preqin

Figure 1.17: Oversupply made fund-raising conditions challenging

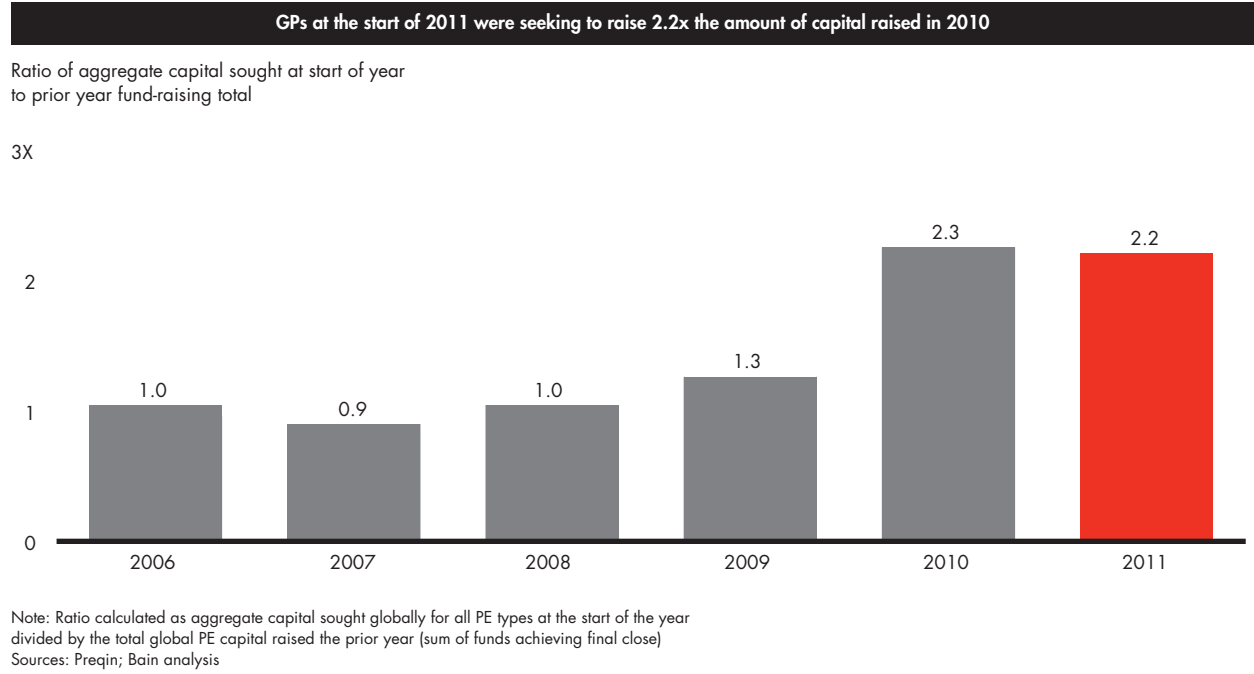
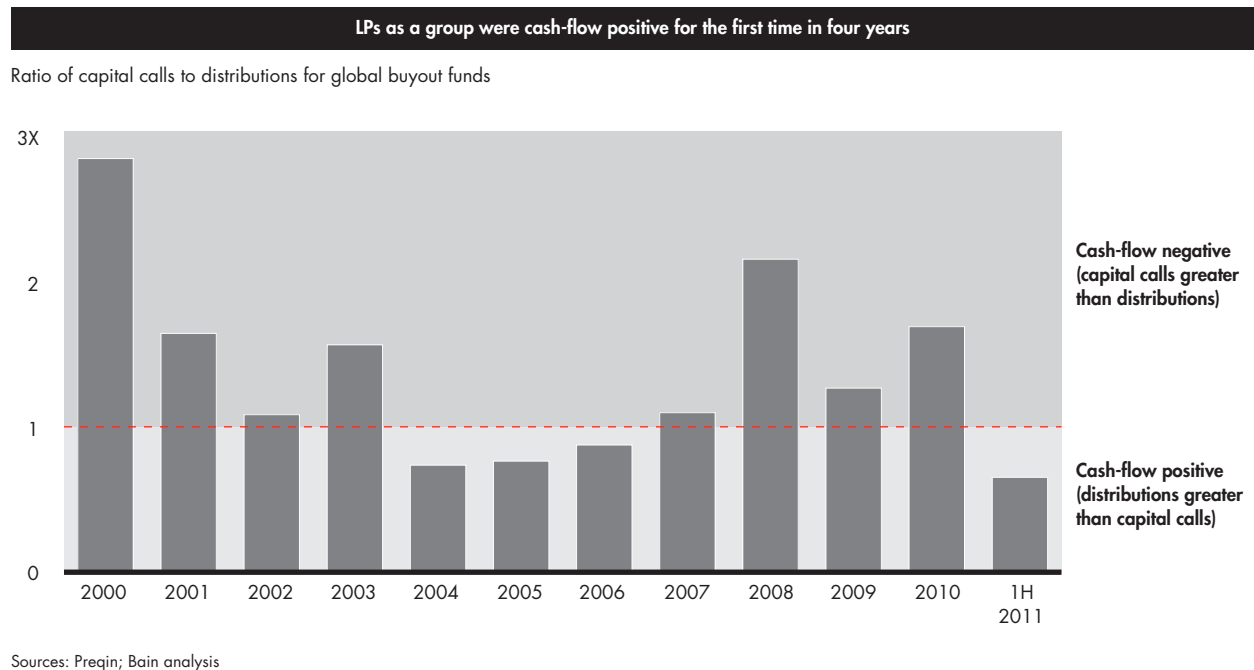


Figure 1.18: Distributions surged and LPs were cash-flow positive for the first time in four years





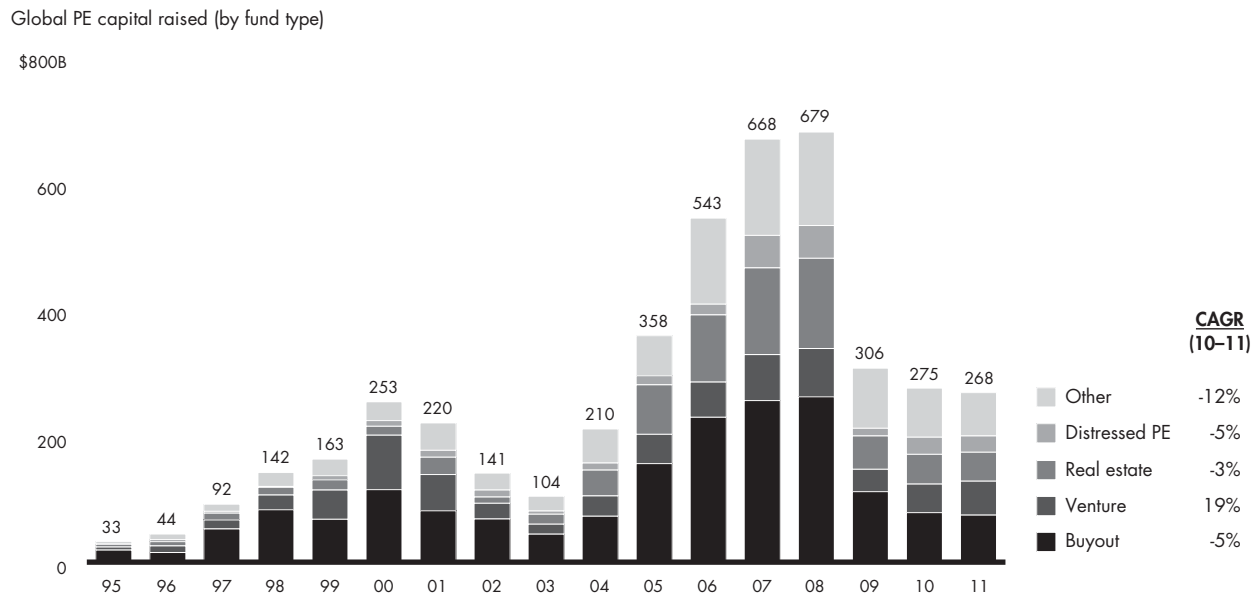
not want to miss out on an opportunity to re-sign with a GP in whom their confidence was high or start a new relationship with a promising one they had been tracking.

Countering LPs' openness to making new fund commitments were forces that curbed their enthusiasm. For one thing, many LPs' PE allocations, although easing some, were still tight. At mid-year, more than 60% of LP respondents to a survey conducted by Preqin reported that they were at or above their target allocation. In addition, LPs throughout the world were still on the hook for more than \$900 billion in previously committed capital that had yet to be called, making them wary of committing yet more capital and risking an over-allocation or liquidity squeeze if capital calls surged. In a mid-year survey for Collier Capital's Global Private Equity Barometer, fewer than 30% of LPs said they intended to lift their ceiling in order to take on new commitments.

What began so promisingly unraveled in the year's second half, and PE fund-raising for the full-year ended no higher than it had been in 2010 (see Figure 7.19). Every category was down, with the exception of venture capital, which increased modestly. Fund-raising was flat or down in North America and Asia, with Europe the only major region where fund-raising increased by year-end 2011.

Clearly, the macroeconomic headwinds and turbulent equity markets played a part, but it did not take much to push new fund-raising off the rails. The sudden decline in exit activity turned off the distributions tap that had made new fund-raising possible. Deteriorating equity markets pushed more LPs up against their PE allocation ceilings as the denominator effect reemerged. Some LPs hit the brakes on new commitments entirely. Others turned their backs on marginal opportunities. And some LPs stretched out investment decisions in

Figure 7.19: Fund-raising failed to stage a recovery in 2011



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

the hope that markets would soon regain their legs. The net result was a significant drop in new commitments in the second half of the year.

For GPs, the heightened selectivity by LPs in 2011 created a bifurcated market, with an elite group of GPs having very successful campaigns while fund-raising languished for the large majority. Even as the year began, many LPs had already earmarked capital they were prepared to commit to a narrow set of managers they anticipated would soon be coming back into the market. In an ongoing flight to quality, LPs were very discriminating in their choice of funds as they concentrated commitments with the GPs that had their very highest confidence.

Making the LPs' short list was a distinct advantage. GPs with a record of above-average fund performance needed to spend less time on the road in order to hit their fund-raising target. Moreover, for PE funds that closed in 2011, nearly three-quarters of the top-ranking GPs met or exceeded their goal, compared with a little more than half of their less well-performing peers. In spite of the overall lackluster year, buyout funds sponsored by successful PE firms with a distinctive, sharply focused approach that was in favor with LPs were generally able to attract significantly more capital to their latest fund than they had to their previous fund. In Europe, for example, Waterland's 2011 vintage fund closed with 30% more capital than its predecessor. In the US, Berkshire's most recent fund attracted 50% more capital than the firm's previous fund-raising foray had. For the chance to participate in funds offered by the best managers, LPs often needed to elbow their way in and were willing to accept terms and conditions the GPs dictated.

Because LPs were not looking for more generic exposure to PE, however, even some GPs with demonstrated records of success faced a challenging fund-raising market. When deciding if they would be open to increasing their PE holdings, LPs weighed whether the funds the GPs were promoting offered access to specific investment strategies, sectors or geographies of interest. What investment themes won favor in 2011? According to a survey of institutional PE investor trends conducted by Probitas Partners, a private markets investment advisory firm, US mid-market buyout funds and growth capital funds topped the list. Large US buyout funds and global mega-buyout funds remained out of vogue with LPs last year.

The winnowing process did not favor only a narrow set of well-established incumbents. LPs were willing to make the difficult decision to say "no" to an existing GP relationship in order to sign on with a new GP they felt offered better prospects for returns. In a survey of LPs conducted at mid-year, more than 85% of the respondents said they were willing to consider forging new relationships with GPs that inspired their confidence, but they rarely opted to pursue a fund opportunity that came over the transom during the year. New relationships that won LP commitments in 2011 were often the result of a courtship lasting months or years. "We have a good list of managers we want to do business with, and we've mapped that out for the next two or three years," a US endowment executive told Bain in an interview.

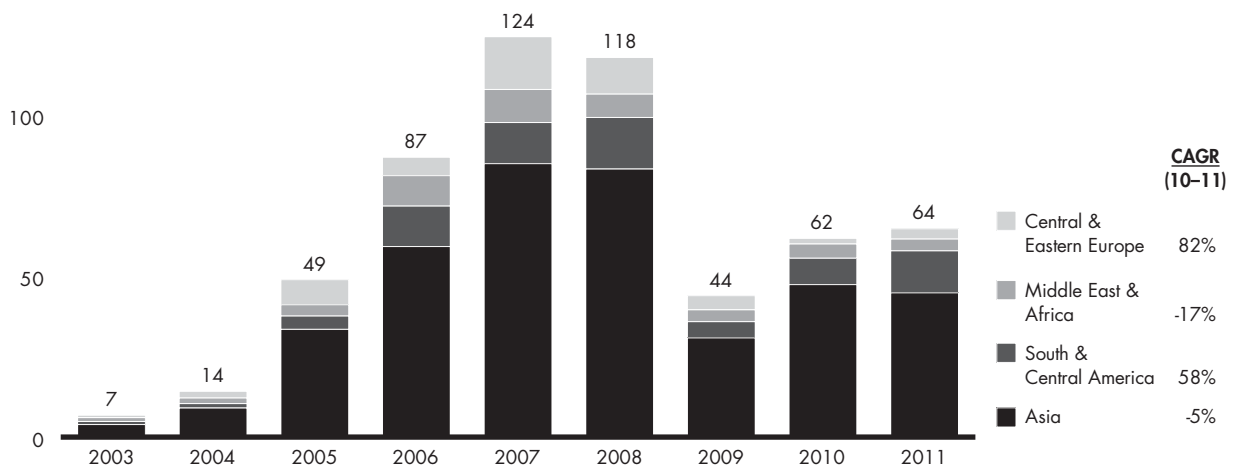
Emerging-markets funds—particularly ones that target Latin America and Central and Eastern Europe—held up well in 2011 (see *Figure 1.20*). In the latest EMPEA/Collier Capital Emerging Markets Private Equity Survey, nearly all LPs responded that their new commitments to emerging markets PE would be the same or higher in 2011 and 2012 than they had been in 2009 and 2010—nearly 25% of them indicating that their planned commitments would be significantly higher. Underlying LPs' increasing allocations to emerging markets is their expectation that investments in these economies will generate superior returns over the coming three to five years.

Recent years' experience has increased LPs' sophistication about emerging markets, and GPs' emerging market fund-raising efforts reflect that greater maturity. In Asia-Pacific, the past year has seen a continuation of the trend

*Figure 7.20:* Emerging markets fund-raising held up in 2011, largely influenced by growth in South America

Global PE capital raised (by investment region focus)

\$150B



Notes: Includes funds with final close; represents year funds held their final close; excludes developed Asia (Australia, New Zealand, Japan) and Israel-focused funds  
Source: Preqin

away from pan-regional fund-raising and toward more country-focused funds. PE markets in individual Asian countries are gaining sufficient depth to support their own full-scale funds. That movement has been especially strong in China, where country-specific funds accounted for more than nearly half of all capital raised by PE funds that invest in Asia. One powerful factor contributing to the flow of capital to China has been an increase in funds denominated in local currency, which represents an increasing share of the new capital raised. Government policies to boost domestic investment activity have made it easier to raise renminbi funds from deep-pocketed Chinese institutional investors, which in turn enjoy advantages over foreign-currency funds in terms of stronger deal sourcing, greater liquidity and fewer regulatory obstacles.

## Returns: Facing a moment of truth

Year by year, PE investors have ridden a roller-coaster of returns over the decades, magnified by PE's use of leverage and by the expansion and contraction of purchase multiples. But less visible among the upward and downward gyrations has been a longer-term secular decline in returns, as the industry has matured and competition intensified.

Despite the volatility, PE remains one of the top-performing asset classes for LPs. The rise in the stock markets during the first half of 2011 made short-term returns from public equities jump. But taking a longer-term perspective, PE has consistently generated better returns than listed equities, hedge funds and real estate, on average (see *Figure 7.21*). By the middle of 2011, PE fund portfolios had finally recovered ground lost following the equities market crash in late 2008. Indeed, all categories of PE—buyout, mezzanine, venture capital and fund of funds—have produced positive returns over the short, medium and longer term, with buyouts leading the pack.

Figure 1.21: PE is one of the better-performing asset classes for the average LP

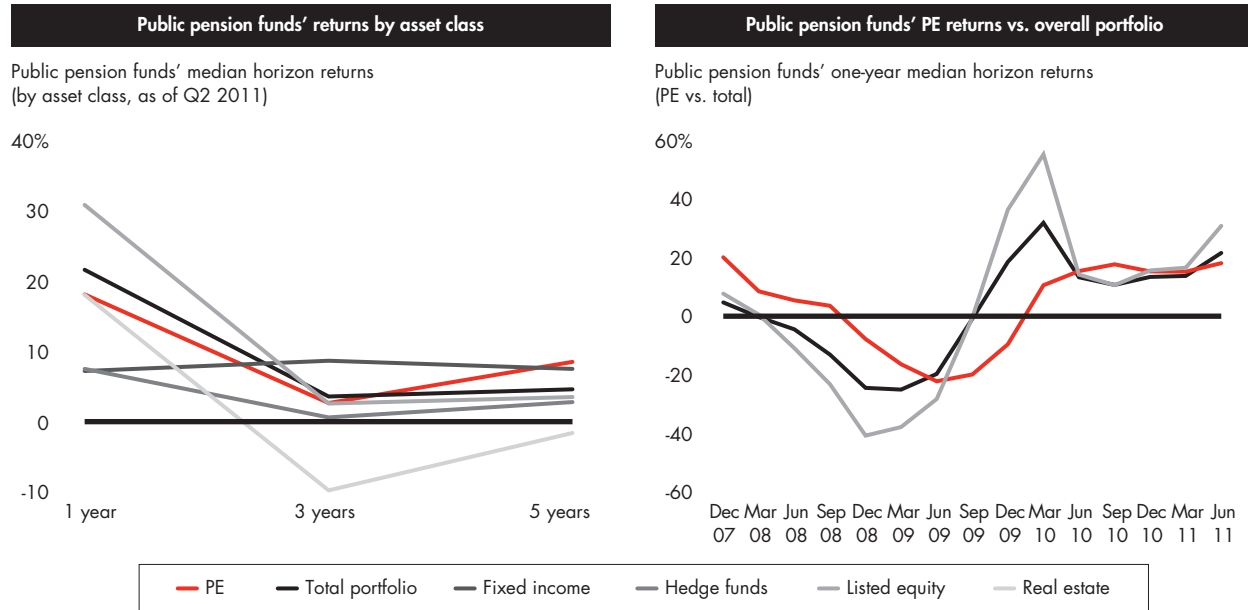
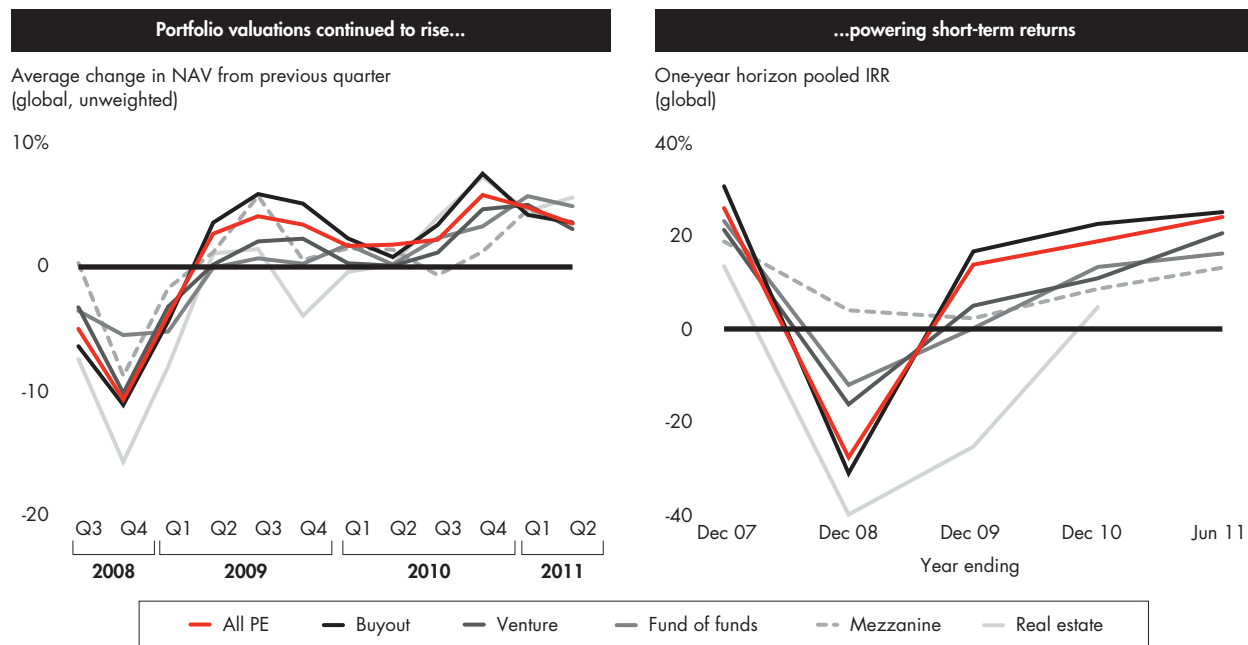


Figure 1.22: Portfolio valuations continued to increase through the first half of 2011



Viewed against that overall positive background, PE returns through the first half of 2011 were strong as portfolio valuations continued to rise, powering short-term gains (*see Figure 7.22*). But while a healthy pop in returns is always welcome, the conditions that have steadily driven up returns over the past two years are now coming to an end and are not likely to be repeated. The consistent quarter-by-quarter gains PE investors have seen were the by-product of the confluence of the equity market implosion following the 2008 financial crisis and the PE industry's transition to mark-to-market accounting rules set out under FASB 157. When equities took their hard hit that autumn, PE firms acted cautiously and promptly and sharply wrote down their portfolio company net asset valuations (NAVs). Not knowing where the markets would ultimately bottom out, GPs wanted to get the bad news out to their LPs all at once rather than through a series of successive restatements that would require repeated, confidence-sapping explanations.

As economic conditions improved and the public markets recovered, GPs continued to value companies conservatively with a result that private valuations have lagged the recovery of public valuations. Subsequent restatements since the second quarter of 2009 have gradually and smoothly lifted the depressed PE NAVs out of their deep hole.

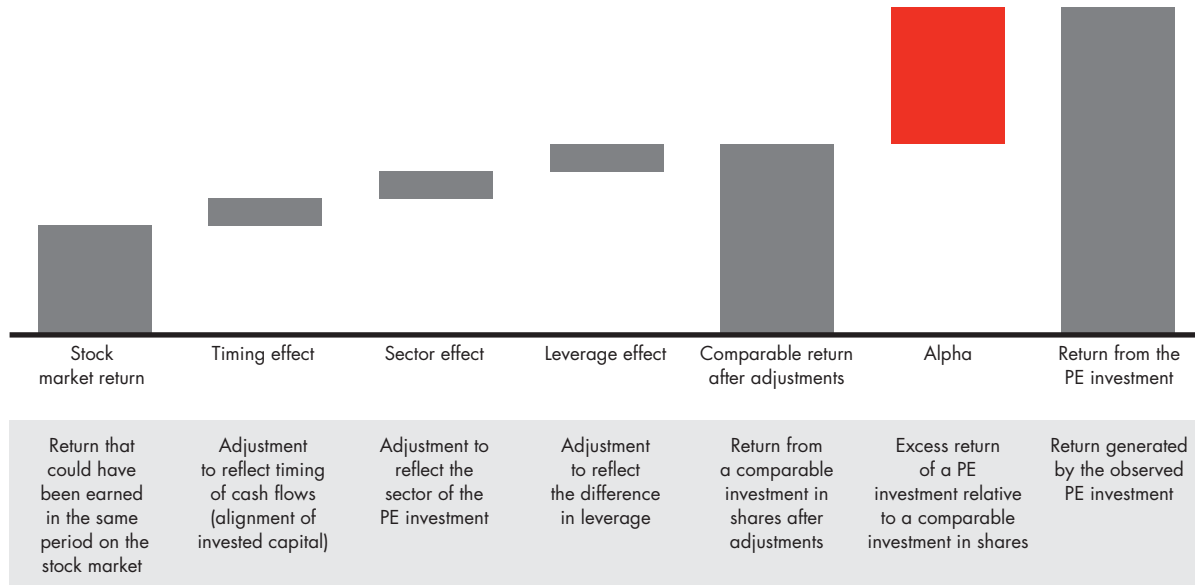
With PE assets now appraised close to their intrinsic value, returns going forward will become more volatile as they more closely track the ups and downs of the public markets. But it is far from clear what external market forces, or “beta,” will power the next wave of PE returns. Certainly, the familiar combination of factors that PE funds relied on in the past—GDP growth, multiple expansion and leverage—do not look nearly as favorable in the current recovery as they had in past ones, and particularly not in the developed markets where fragile economies teeter on the edge of falling back into recession. Recent valuation multiples and purchase prices remain high, making the likelihood of their further expansion limited at best. The LBO-friendly debt markets of early 2011 have given way to conditions of costlier and less available debt that are more akin to the less favorable environment of 2010.

While weakness appears likely to continue in the traditional sources of market beta, returns that depend on them do not look poised for a great leap forward. To continue to produce returns that will sustain PE's edge over other asset classes, GPs will need to dig deeper to generate alpha, the returns that rely on the superior management talent of PE firms to lift the performance of the assets they control above that of comparable public companies.

Evidence of the power of alpha in PE is compelling. Oliver Gottschalg, a professor at the École des Hautes Études Commerciales (HEC) in Paris, demonstrates the alpha effect by comparing actual PE returns with stock market returns of similar investments in company shares (*see Figure 7.23*). To put the investments on an equivalent basis, he adjusted the stock market return by taking into account the timing of cash flows, the industrial sector in which the PE investment was made, and the use of leverage. Based on a sample of deals' gross returns, Gottschalg ascribes the difference between the adjusted market returns and the observed PE returns to the alpha the PE owners provided. In his most recent research undertaken with Golding Capital Partners, he estimates that return margin to be worth an additional 5 percentage points. Impressive as the alpha advantage appears, it likely understates its full value, since it takes at least some skill on GPs' part to choose the best time to invest and pick the sectors to focus on. The PE alpha effect has been exceptionally strong in times of economic turbulence. Indeed, by Gottschalg's calculation, PE returns generated through alpha added 18 percentage points to PE performance during periods of economic recession.

**Figure 1.23:** Alpha is calculated as the excess return of PE above a comparable investment in public shares

Calculation of alpha for PE (illustrative)

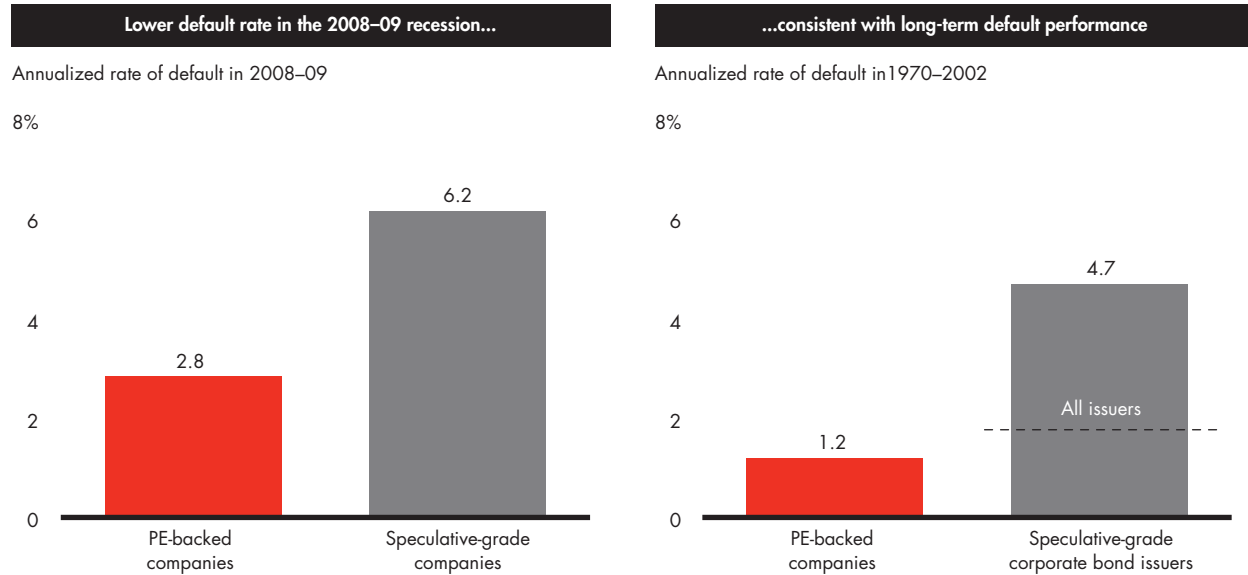


Source: "Private Equity Study: Finding Alpha 2.0," Oliver Gottschalg, HEC-Paris; Golding Capital Partners, November 2011

PE funds generated a massive wave of alpha during the most recent downturn in assets they had acquired at the height of the boom. From their peak in 2007, public equity markets tumbled and have yet to recover. The S&P 500 Index, for example, topped out at about 1550 pre-crisis but traded at just over 1250 at the end of 2011. Yet, over the same period PE portfolio company valuations have risen, almost entirely because PE firms were quick to take aggressive actions to rein in costs, which helped the companies they backed to successfully navigate the depths of the recession. The PE alpha effect shows up clearly in the far lower default rate of PE-backed companies both during the most recent downturn and over the longer term (see Figure 1.24).

**Unlocking the alchemy of alpha.** Having worked these heroics, PE firms now find themselves in a box. The power of alpha that helped PE firms stabilize their portfolio companies over the past three years has yet to be converted into realized gains. Those companies were acquired at high earnings multiples during the cyclical peak of 2005 through 2008; but since the downturn, multiples have been compressed. Despite the performance improvements PE owners made, many of those companies are still valued below the threshold return needed to put cash into LP coffers or earn carry, making GPs reluctant to sell. As a result, many high alpha holdings still languish in GPs' portfolios, where they represent a sizable portion of the "exit overhang."

**Figure 7.24:** Alpha in action: PE-backed companies suffered a lower rate of defaults through the economic crisis



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

In 2011, the best GPs doubled down on the measures that generate alpha by building four mutually reinforcing capabilities. First, to ensure that they end up closing the right deals at the right price, they worked to refine truly proprietary investment theses and beef up their due diligence. Second, they tweaked their investment strategies to adapt to the new market reality, weighing each new opportunity not only for its inherent attractiveness but vetting it objectively against their own core strengths and ability to compete. Third, they strengthened and professionalized their organization, working continuously to augment the team through recruitment, training and retention of top talent to ensure they have the right people in place. Finally, they acted to build a repeatable value-creation model for generating alpha over and over again by marshaling the firm's resources to meet their most common portfolio company needs across all stages of the ownership cycle.

By 2011, GPs had begun to realize that value creation through cost reductions alone would not be enough. Many now recognize that both companies currently in their portfolio and ones they acquire in today's high-multiple, slow-growth environment are already running lean. Understanding that the future will belong to those that are able to spot growth opportunities and capitalize on them, the best GPs are working to adapt their portfolio engagement model to successfully pursue growth.

## Key takeaways

- For PE, 2011 was a tale of two halves. During the year's first half, deal activity, exits, fund-raising and returns all continued the healthy recovery that had begun in late 2010. However, they all stalled in mid-year with the emergence of the EU sovereign debt crisis and fears that developed market economies would slide back into recession.
- Deal making was propelled early in the year by PE funds under pressure to invest. Wielding more than \$900 billion in dry powder and facing expiring investment periods, GPs sought to take advantage of favorable credit conditions and a growing supply of assets for sale. Fierce competition kept prices high. But economic weakness, market volatility and deteriorating debt-market conditions in the year's second half drove a wedge between buyers and sellers that made closing deals difficult.
- Fast-growing emerging markets across Asia and Latin America continued to beckon PE investors. But investment volume in 2011 overall was flat chiefly because volatile public equities markets widened the "price-expectations gap" between buyers and sellers. In countries such as China and India where minority investment positions are prevalent, GPs struggled to get comfortable paying high prices for stakes in companies whose direction they would have only limited ability to influence.
- Exit activity stormed into 2011 on a wave of momentum, reaching near-record levels. Conditions were favorable across all exit channels, valuations were high and GPs were eager to sell. Exit options vanished abruptly by mid-year as activity retreated across all channels: IPOs fell victim to volatile equity markets, corporate buyers hoarded cash in the face of economic uncertainty and sponsor-to-sponsor sales floundered over an inability of buyers and sellers to agree on price.
- Fund-raising was poised for a modest recovery heading into 2011. With rising equity markets easing pressure on PE allocations, LPs awash in liquidity and an increased number of GPs on the road, the first half of the year looked auspicious. The promising start unraveled in the year's second half, as falling public equity markets tightened LPs' PE allocations and distributions dried up. LPs' intense scrutiny of GPs created a bifurcated fund-raising market of haves and have-nots.
- PE returns continued their steady recovery during the first half of 2011, from depressed levels following the economic downturn. However, with PE assets now appraised close to their intrinsic value, returns will become more volatile as they more closely track the ups and downs of the public markets. In the absence of market beta and with companies already running lean, GPs will need to pursue growth opportunities aggressively for both their current and new portfolio companies to generate alpha that will be the key to earning superior returns going forward.



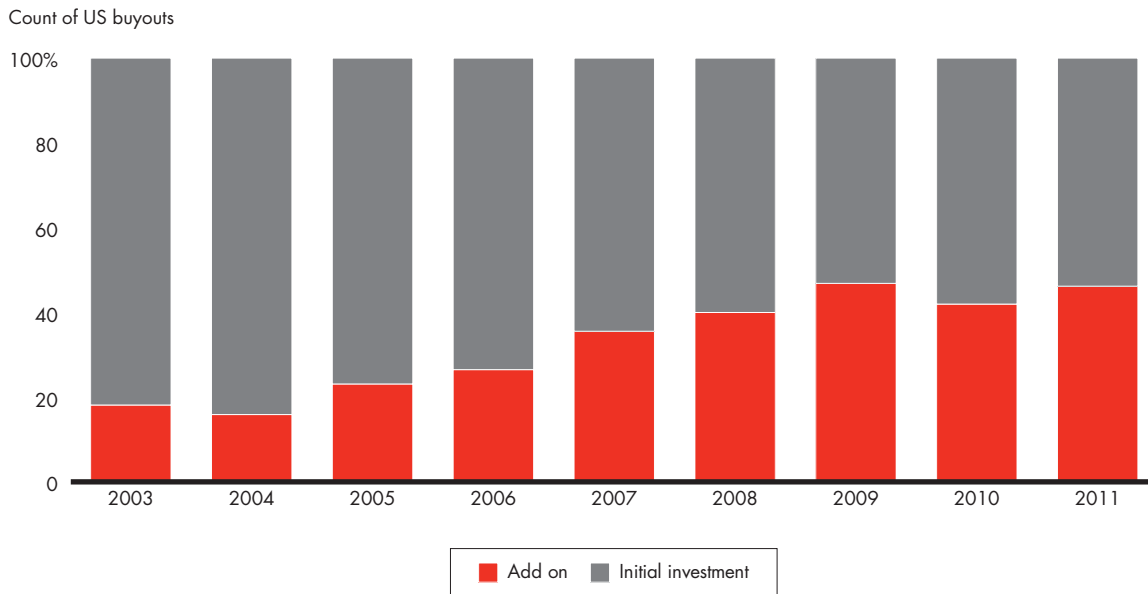
## Buy-and-build: An investment theme for challenging times

Fashion has a way of following necessity in private equity. Certainly, in the period of weak economic growth and volatile capital markets since 2008, GPs have faced no shortage of needs. They need to put vast sums of dry powder to work at a time when opportunities to do multibillion-dollar mega-buyouts are scarce. They need to avoid overpaying for assets while deal multiples remain high. And they need to find ways to realize top returns when the market winds are not at their backs and they are holding aging assets in their portfolios at little more than book value. Those circumstances have combined to bring “buy and build” strategies into vogue.

Based on the proven logic that the whole can be worth more than the sum of its parts, buy-and-build investors acquire a platform company that occupies an attractive niche in a fragmented market, and then carefully add on several other closely related businesses. Collaborating with a core management team to integrate the holdings, PE owners aim to capture the advantages of scale and improve performance to add value.

Indirect evidence of buy-and-build’s recent popularity emerges from the big pickup in the number of add-on deals as a proportion of total US buyout activity since 2004 (*see Exhibit A*). Over the past three years, nearly 45% of all buyouts have been add-ons to existing portfolio companies. The buy-and-build bug has struck PE firms in just about every industrial sector and region of the world in 2011. High-profile transactions last year include KKR’s \$428 million acquisition of Bond Air Services to complement its platform company Grupo Inaer, a Spanish-based helicopter fleet operator, in the aerospace industry. In the US, Blackstone Group continued to add to its platform holding in Summit Materials, a building supplies outfit. In Asia-Pacific, TPG Capital picked up a \$170 million stake in Emir Oil, an oil exploration enterprise based in Kazakhstan, through its platform company MIE Holdings, a Chinese oil and gas company. In BDO’s Private Equity Survey 2011/2012, nearly half of participating GPs said that more than 75% of the add-ons in which they had experience added value, and some 95% expect buy-and-build acquisitions to increase or stay at their current high level over the coming 12 months.

It’s not hard to understand the many apparent advantages of buy-and-build. Because acquisition multiples are lower, buying smaller companies and merging them is often less costly than buying scale businesses. It is also an effective path to achieving scale, particularly in markets like China where scale companies are rare. Third, GPs that buy and build typically find it easier to line up debt financing from creditors who see add-on deals as less risky than new-money ones. GPs also perceive there to be lower risk in adding companies to a portfolio company whose business they understand and management team they know and trust. Fourth, pursuing buy-and-build usually increases flexibility when the time comes to exit. By integrating several companies into a larger one, GPs can end up with an asset that is big enough for an IPO or to attract the interest of a strategic buyer. Finally, buy-and-build

*Exhibit A:* Add-on acquisitions have seen a big pickup in recent years

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

increases the possibility that, by bolting on additional assets, GPs could alter the profile of a business languishing in their portfolio and dramatically improve its prospects for a more profitable sale.

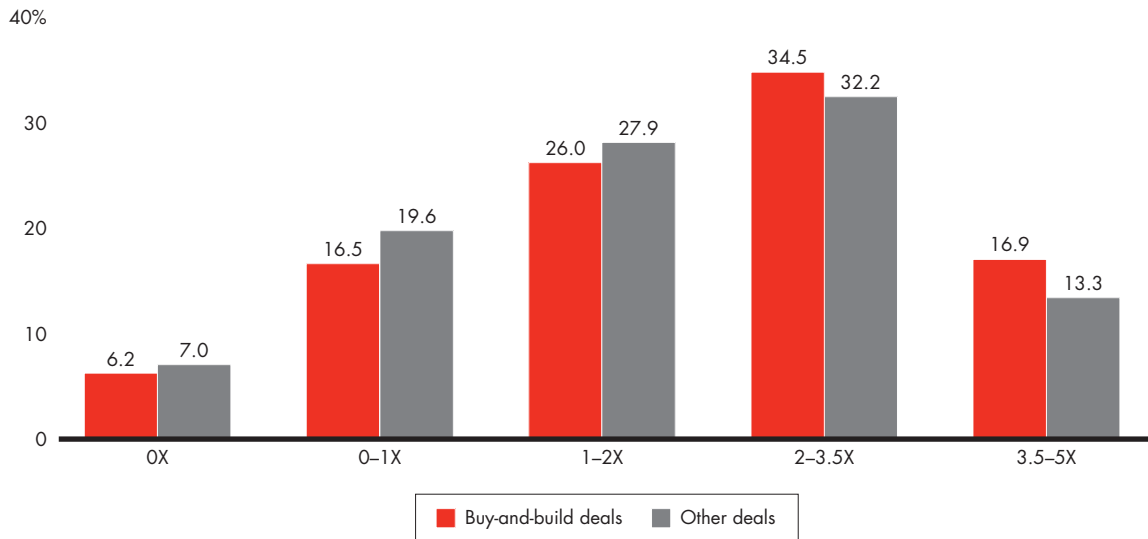
Do PE firms that pursue buy-and-build reap the purported rewards? Recent academic research suggests that PE buy-and-build deals do perform marginally better than other types of PE transactions (*see Exhibit B*). An analysis by Oliver Gottschalg, a professor at the École des Hautes Études Commerciales in Paris, that compared the return multiples of 1,905 European buyouts found that those identified as buy-and-build generated lower rates of total losses or capital impairment and a higher proportion of successes. Indeed, more than three-quarters of PE buy-and-builds generate benefits for investors. By comparison, numerous studies have found that corporate mergers and acquisitions are more likely to destroy value than create it.

Why would that be the case? Unlike with occasional corporate acquirers, deal making is a core competency of GPs. Moreover, in buy-and-build situations, PE firms bring that well-honed capability to bear on a business they already know very well through the platform company, further reducing risks and increasing the odds of success.

Executing a successful buy-and-build strategy, however, requires discipline, planning and patience. Bain & Company's work with scores of clients that have embraced buy-and-build for more than two

*Exhibit B*: Buy-and-build deals marginally outperform other deals

Percent of deals by gross deal multiple



Note: Based on a sample of 1,905 deals in Europe, 504 of which were identified as “acquisitive” with at least one add-on and the sum of all add-ons at least 50% of the transaction value of the initial investment  
 Source: HEC/Industries & Finances research, January 2012

decades has revealed that adherence to six key success factors separates the winners from the losers.

1. **Harness top talent.** The common attribute contributing to a successful buy-and-build program is the strength and leadership of the senior management team charged with spearheading it. Leading GPs take pains to recruit seasoned executives with proven track records in M&As and post-merger integration, and they put in place an incentive system—typically involving a significant equity stake—that rewards exceptional performance. For example, when SunTx Capital Partners invested in Construction Partners (CPI), a small asphalt paving manufacturer and installer, in 2002, the Dallas-based PE firm hired Charles Owens as CEO to build out the new platform company from its small base in Florida and Alabama. A recent veteran of a successful consolidation of 32 companies also in the road construction industry, Owens was eager to parlay his experience into another winning buy-and-build program in which he and his team could be equity owners. Recruiting key members of his former company’s management team to help, Owens hit the ground running.
2. **Buy small; buy often.** One of the most frequent pitfalls of buy-and-build programs—as with M&As generally—is the propensity of acquirers to bet the ranch on a single, large acquisition. Distracting complexities of integrating two nearly equal-sized companies proliferate, absorbing precious

resources and management time. Successful GPs focus on assembling a “string of pearls”—many smaller businesses, each of which tucks seamlessly into the platform company. They take time to assess the strategic rationale for each add-on, recognizing that achieving the program’s full scale can take years.

3. **Stick to the core.** Building a business to scale succeeds far more frequently than attempts to expand its scope. Each add-on should strengthen the platform company’s core and complement its strengths. The dangers of even modest-seeming deviations can be profound, as partners at McCown De Leeuw & Co. and other investors learned with their failed effort to build Aurora Foods into a leading grocery brand in the late 1990s. Beginning in 1996 with an acquisition of Mrs. Butterworth’s, the syrup producer, Aurora’s management soon added Log Cabin syrup, a close competitor. But the PE owners’ later acquisitions of other food-related business in frozen fish, cake mixes, bagels and pizza proved hard to integrate into the platform. Within three years, the program ended up as a write-off for the investors.
4. **Know the true synergies of scale.** Clearly, the opportunities to find significant cost savings or revenue enhancements are among the chief rationales for buy-and-build, but these are seldom achieved without a careful analysis of how and where they can be found. GPs and company management need to understand in detail how scale economics works in the target industry, including how costs can come out and how much margins can expand as the company moves up the scale curve.
5. **Plan for the exit from the start.** Even as they embark on their buy-and-build venture, GPs need to develop a clear view of their point of arrival for the combined business. The plan for the exit—whether to sell to a strategic buyer, aim for an IPO or prepare for a secondary sale to another PE fund—informs decisions the PE owners and managers will make along the way.
6. **Hone a repeatable model.** The true benefits of buy-and-build compound with experience. Frequent acquirers that have a repeatable formula for integrating add-on companies usually enjoy bigger and more frequent successes. For example, Construction Partners, the asphalt paving consolidation sponsored by SunTx, fine tuned a repeatable process for integrating 57 companies acquired since 2002. Over the program’s nine-year life, CPI has expanded from revenues of \$60 million from three asphalt plants in one state to \$500 million in revenues generated by 23 plants in four states. By 2011, the PE owners expanded CPI’s multiple nearly eightfold.

When done right, buy-and-build can be a portfolio management strategy ideally suited for markets like today’s, when PE firms can no longer ride in the tailwinds of multiple expansion and leverage but need to generate alpha to earn their carry.

## 2. What is happening now: Dynamics for 2012 and beyond

The global PE industry edged into the new year trailing heavy baggage from 2011 and surrounded by a dense fog of potentially destabilizing uncertainties. The US economy remains weak, hobbled by stagnant household incomes, anemic spending by overleveraged consumers, fiscal policy gridlock heading into an election year and hesitancy on the part of businesses to invest until the growth outlook clears. In the euro zone, policy makers have managed to improvise patchwork solutions that have held the currency union together, but the risk is real that a misstep could cause the fragile stability to unravel, with potentially catastrophic consequences for the banking sector and the global economy.

Emerging markets and other major economies face uncertain prospects in 2012. China, an engine of global expansion throughout the downturn and since, is early in what could prove to be an unsettling transition as the economy, built around export growth, adjusts to reduced global demand for its goods and services. Meanwhile, natural resources-rich Brazil, Australia and Canada will ride the waves of volatility emanating from the US, Europe and China that consume their energy, minerals and other primary inputs. In short, PE investors will need to navigate a sea of global macroeconomic and geopolitical worries in a year characterized by choppy equity markets and nervous debt markets that could be capsized by any number of policy miscalculations or exogenous shocks.

### Investments: Rewinding the clock

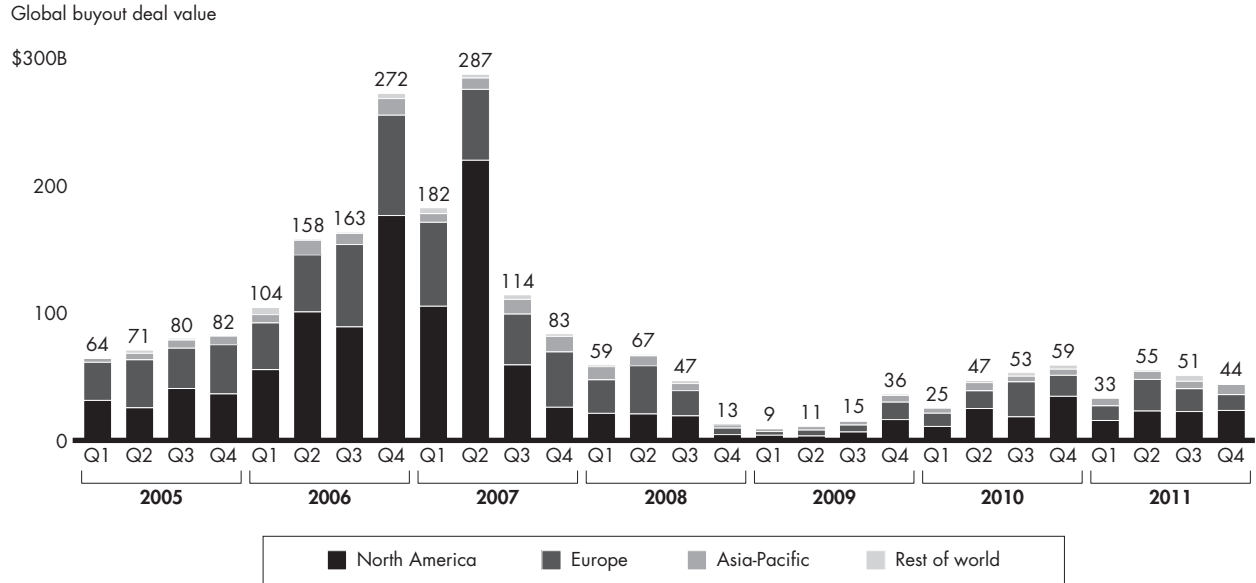
If the broad economic prospects for the year ahead are cloudy, the PE investment picture as 2012 begins looks very much like the one that prevailed at the beginning of 2010. Having traced a rising and falling arc of deal activity through 2011, global buyout deal value at the start this year is about back to where it was in early 2010 (see *Figure 2.1*). As in 2010, GPs are motivated to put their aging dry powder to work. Today, like then, debt markets to finance deals are open for business in an environment of low interest rates. And in 2012, like in 2010, volatile equity markets have widened the mismatch in expectations between buyers (who are concerned not to overpay) and sellers (who are holding out for top value) that makes it challenging for deals to close.

In important ways, however, conditions today are more favorable for PE deal making. Unlike in 2010 when picky lenders were typically willing to underwrite loans only for high-quality assets, debt is available to finance a wider spectrum of deals. There are also more companies suitable for PE acquisition. The supply of companies for sale in 2010 was constrained as many potential PE targets were struggling to absorb the shock of the credit crisis and subsequent recession. Today, with their finances righted and costs under control, more companies are ripe for sale.

There is plenty of momentum to drive deal making forward in 2012. Nearly \$1 trillion in dry powder—almost 40% of it slated for buyouts—remains widely dispersed among PE firms of all sizes and types worldwide. In the biggest PE fund categories—buyouts, real estate and venture—only around 25% or less of capital raised and available to be deployed is concentrated in the 10 biggest firms, ensuring that competition for deals will be broad and intense (see *Figure 2.2*).

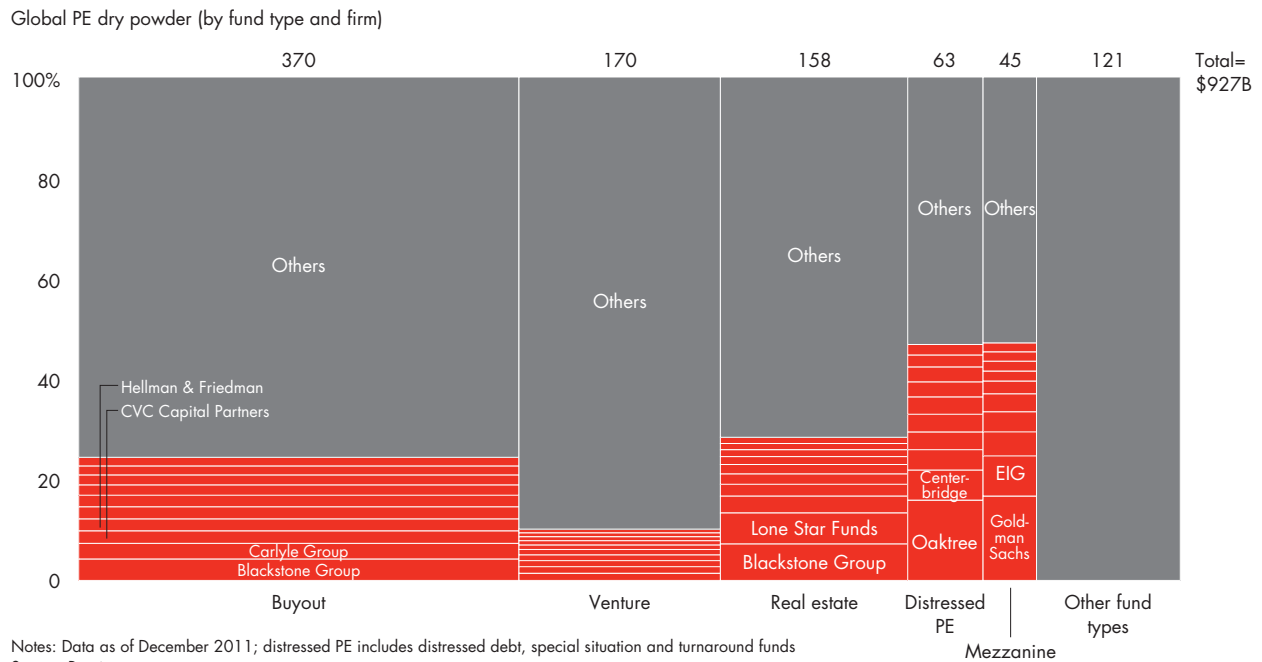
Adding to the pressure to do deals is the fact that a sizable portion of the dry powder earmarked for buyouts—48% of the total—is held in funds raised during the big 2007 and 2008 vintage years. The clock is ticking loudly for these funds. Unless that capital is invested by the end of 2013, GPs may need to release LPs from their commit-

Figure 2.1: As 2012 began, the PE market felt very much like the early part 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; geography based on the location of targets  
Source: Dealogic

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



Notes: Data as of December 2011; distressed PE includes distressed debt, special situation and turnaround funds  
Source: Preqin

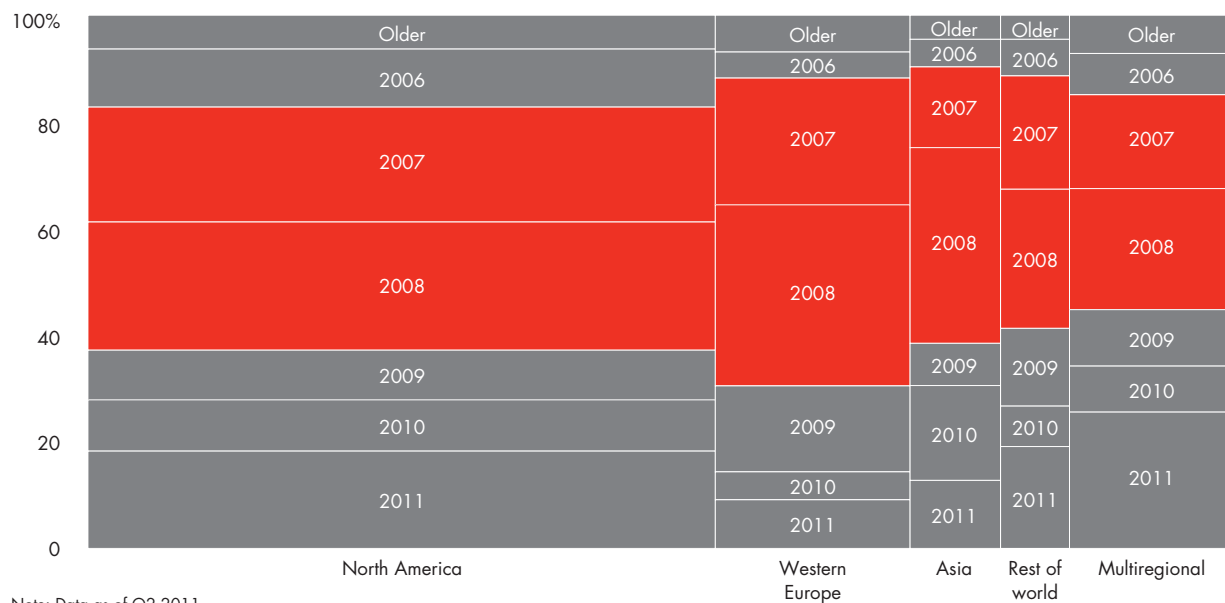
ments and forego the management fees and potential carry it could generate. Burning off the aging dry powder will likely result in too much capital chasing too few deals throughout 2012, as GPs that manage the older vintages compete with one another and with GPs of more recent vintage funds to close deals. Indeed, if buyout activity remains at the modest levels of 2010 and 2011, the dry powder from the 2007 and 2008 vintages alone could fuel the deal market for 1.8 years. That pressure will be even greater in Western Europe, where funds are sitting on an even larger proportion of dry powder nearing its “use by” date (see Figure 2.3).

**A question of supply and demand.** Just how many buyouts ultimately end up closing, of course, depends in large measure on the conditions of the debt markets, and here the outlook heading into 2012 is stable but not robust (see Figure 2.4). Following a steep drop-off in the second half of 2011, new loan issuances are down, as both the supply of loans from PE and corporate acquirers and the demand for debt by hedge funds, loan mutual funds and other institutional lenders pulled back in the face of mounting economic uncertainty and increased market volatility. And even as some central banks hold interest rates near zero, the heightened perception of macroeconomic risk has been keeping the cost of debt to finance PE deals high as yield spreads widened. Still, as the year began demand and supply were roughly in balance, albeit at a subdued level of activity.

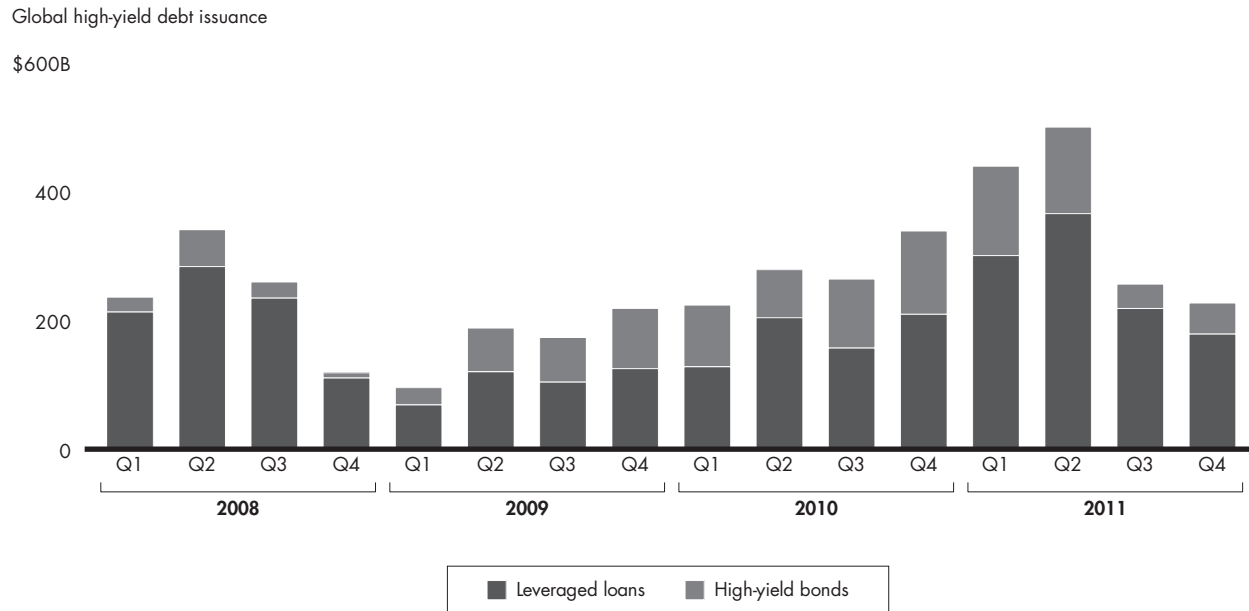
Whether the delicate balance between debt supply and demand will remain will depend on whether capital markets stabilize and the economic outlook firms up, unleashing a burst of pent-up M&A activity. On the supply side, corporations looking for growth and an outlet for the cash they had been hoarding since the downturn will be in the market for acquisitions. PE investments will also surge, as GPs look to deploy their aging dry powder. With debt investors hungry for yield in the low interest rate environment, demand will chase the pickup in deal supply.

Figure 2.3: Funds in Europe could feel pressure to invest most acutely

Global buyout dry powder (by investment region focus and fund vintage year)



Note: Data as of Q2 2011  
Source: Preqin

*Figure 2.4:* Heading into 2012, debt markets were stable but not robust

Source: Dealogic

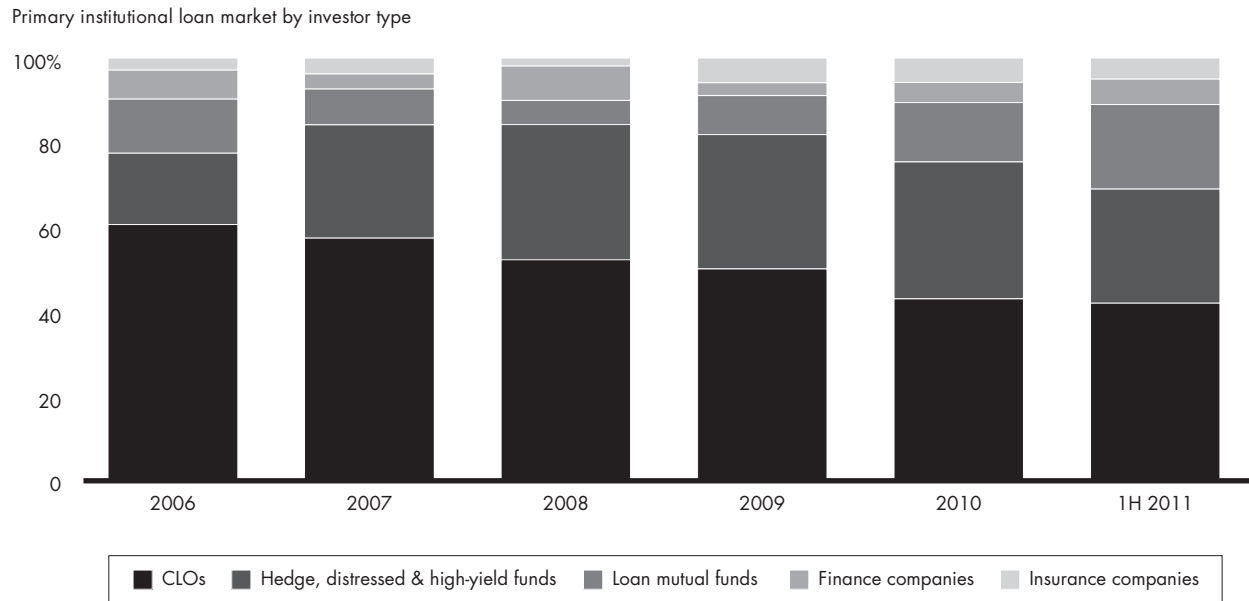
The critical question is whether demand will be able to keep up with an increase in deal making, and the answer needs to take into account how the investor base for leveraged loans to finance those deals is shifting. There are five principal institutional sources of leveraged loan demand: collateralized loan obligations (CLOs); loan mutual funds; finance companies; insurance companies; and assorted hedge funds, distressed debt funds and high-yield funds.

CLOs have been the go-to source of debt financing for most of the past decade, accounting for between 60% and 75% of the total institutional demand for leveraged loans between 2001 and 2007. Demand from CLOs has continued to provide crucial support to the debt markets since the downturn, as capital returned to them when their loans were refinanced into high-yield bonds was reinvested (*see Figure 2.5*). But demand from this source will begin to wane in 2012, when the reinvestment period for about half of all legacy CLOs expires. By the end of 2011, CLO demand had already fallen to only about 40% of the total institutional loan market.

Who will fill the void? Over past year, the window for new CLO issues has reopened. It is reasonable to expect they will match the more than \$12 billion raised globally in 2011, but newly minted CLOs will not come close to the some \$100 billion issued at the market peak in 2007 nor will there be nearly enough to replace the amounts recycled by legacy CLOs. Yield-hungry loan mutual funds have been an increasingly important source of capital since 2009 and have taken up some of the slack left by expiring CLOs. Whether they will continue to plug the gap depends critically on the stability in the euro zone. Flighty loan mutual funds were quick to pull out of the market last summer when the EU sovereign debt crisis hit the headlines. Other institutional investors will continue to be drawn to the relatively high yields that leveraged loans offer compared with returns from other fixed-income



**Figure 2.5:** The investor base for leveraged loans is shifting as reinvestment periods for legacy CLOs expire



Sources: S&P LCD; LSTA

instruments. However, if the US economy averts recession, the trend in flows out of equities and into leveraged loans from this source could moderate in 2012.

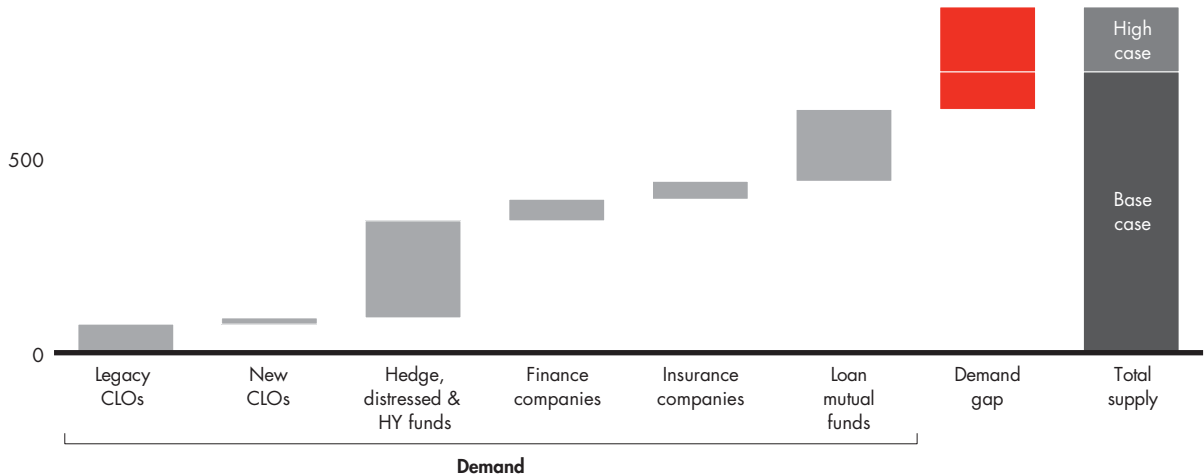
Looking at the cumulative leveraged-loan demand from all sources and based on past experience, Bain estimates that it could fall short of the projected loan supply by a sizable margin (see Figure 2.6). As levels of loan supply and debt demand fluctuate throughout the year, what remains harder to predict is whether that gap will ultimately be closed by a ratcheting down of supply as loan arrangers limit volumes and the cost of debt increases or by a surge in leveraged-loan debt demand from yield-hungry investors. What we do know is that the credit markets over the past several years have been surprisingly resilient and have responded nimbly to fill gaps in demand. Take for instance the dreaded “wall of refinancing,” which two years ago threatened to engulf any number of companies in financial distress. The near-term need for loan refinancing is now largely gone. Issuers diligently reduced the size of their obligations, extended their maturities or both; lenders were accommodating; and investor demand for high-yield bonds stayed strong. If the past is a predictor of the future, credit markets will be accommodating for M&A activity in 2012, barring a blow-up of the euro zone. For LBOs that means spreads will stay in check and debt will continue to be available for new deals.

Prospects are different for the euro zone, where speculative-grade debt issuances are stalled and financing for any M&A activity is hard to come by. An increasing proportion of EU banks have been tightening standards for commercial and industrial loans throughout 2011. Even if the region’s sovereign debt problems do stabilize, debt rationing in the euro zone will likely continue, making it difficult to finance acquisitions even of high-quality assets.

*Figure 2.6:* There could be a gap between supply and demand at some point in 2012

Global projected demand for and supply of leveraged loans in 2012

\$1,000B



Notes: Legacy CLO demand based on 50% reinvestment rate; new CLO issuance assumed to be \$16B (average of high and low expert projections); demand reflects estimated 2011 levels for other investors; supply base case assumes continuation throughout 2012 of Q4 2011 leveraged loan issuance level; supply high case based on average of 2010–2011 leveraged loan issuances  
Sources: S&P LCD; LSTA; Dealogic; Bain analysis

Problematic debt markets are not the only potential barrier to PE deal making in 2012. Lingering uncertainty about the durability of economic growth in Europe and the US continues to make it challenging to close deals. And doubt as to whether the euro zone sovereign debt situation will stabilize is feeding market volatility, which in turn sustains a mismatch in price expectations between buyers and sellers. Deal activity will not come close to reaching its full potential in 2012 unless the valuation expectations gap narrows.

In this cloud of uncertainty, deal activity will likely concentrate on “trophy assets,” the most attractive properties in any industry and those in sectors characterized by strong secular growth trends that will hold up even if the economy slows. Hesitancy about the direction of the economy has not stopped eager PE funds from actively scrutinizing companies across a wide swath of industry sectors across both Europe and North America. Due diligence activity has been strong as PE firms test investment themes and jockey to position themselves to move quickly on acquisitions when conditions stabilize. Analyzing hundreds of due diligence exercises Bain performed in 2011, (including both deals that were announced and ones that were not) shines a light on where GPs were focusing their attention (*see Figures 2.7 and 2.8*).

What trends are attracting GPs’ interest? Within the industrials sector, a consensus is emerging that the US real estate market has finally hit bottom, drawing GP attention to construction and building products. In this segment, timing and geography are critical. GPs are taking care to understand where in the building cycle the products made by the companies they are evaluating fit. For example, in commercial construction, where it can take 18 months to erect buildings, they want to be able to move quickly to acquire producers of building materials that are in demand early in the cycle. In Europe, GPs are also playing the business cycle, looking broadly within the

Figure 2.7: Where GPs are looking to put capital to work in North America...

Americas PE due diligences (count by sector; 2011)

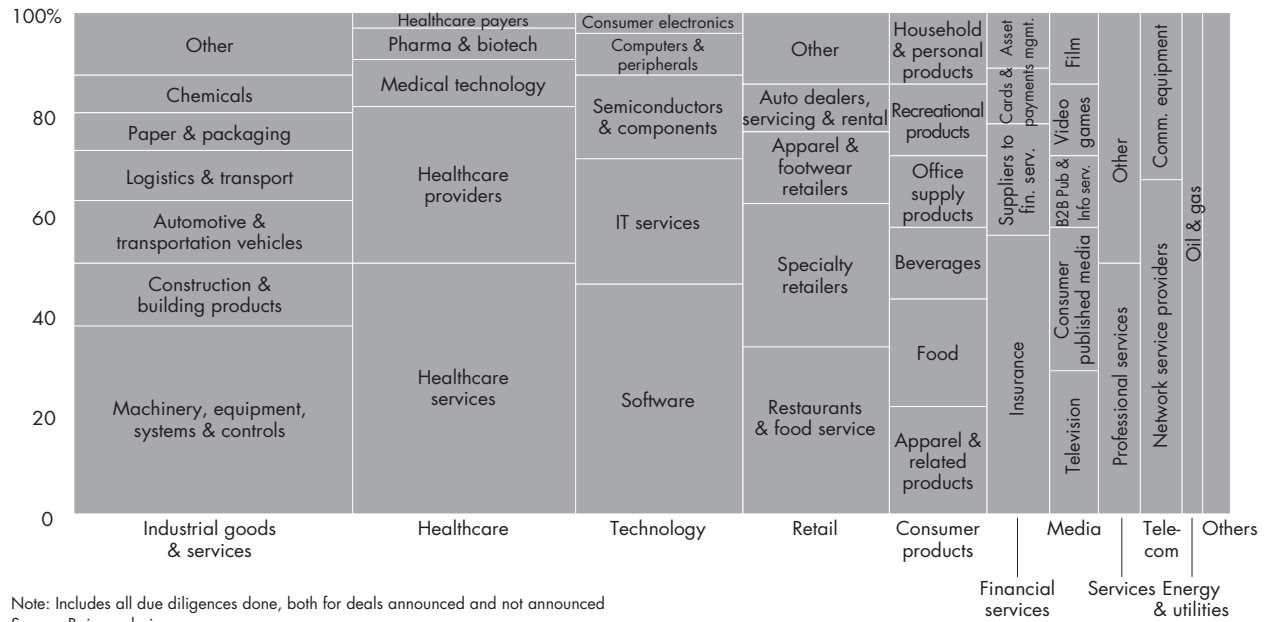
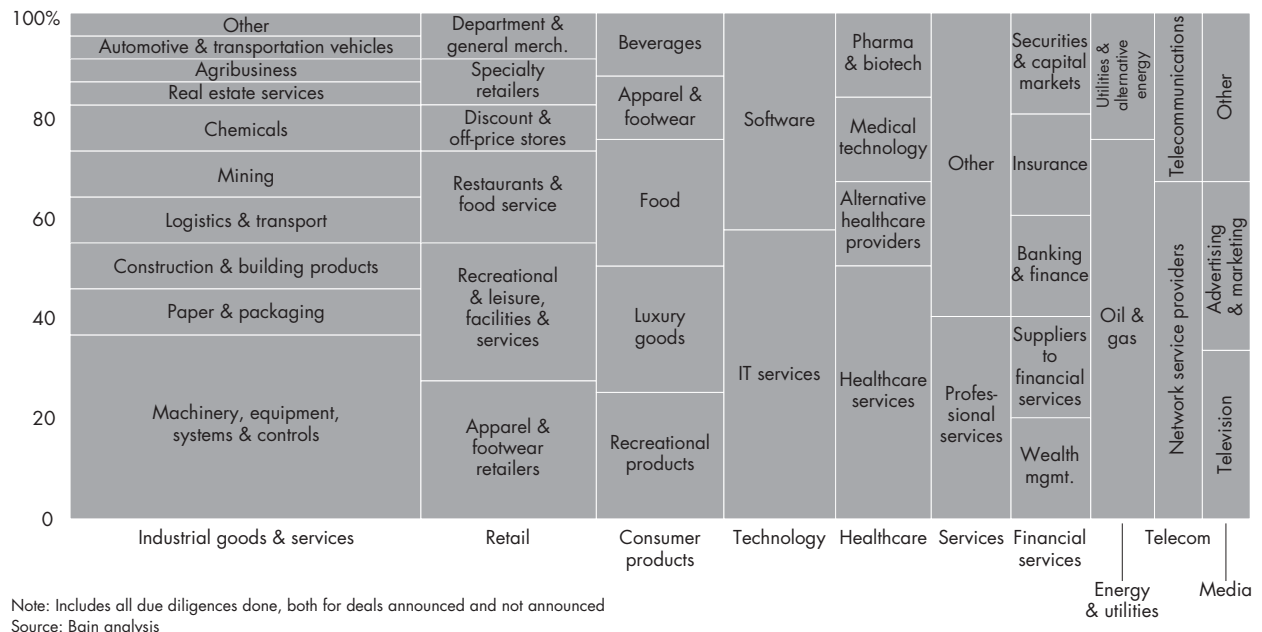


Figure 2.8: ...and in Europe

Europe, Middle East and Africa PE due diligences (count by sector; 2011)



industrial sector at everything from automotive to chemicals that they might be able to buy at low valuations relative to recent highs.

In the US healthcare space, GPs are scouting for opportunities in a sector that is being reshaped by recent legislation and efforts to rein in costs. Companies that offer practice management and information technology services are promising targets that are attracting PE scrutiny. PE funds are also looking to capitalize on the growing trend of retail clinics that are able to provide consumers quick, effective, high-quality care. In Europe, healthcare providers are attracting a lot of attention as government cost-reduction programs open opportunities for more efficient suppliers to fill the gap. The medical technology industry is also drawing investor interest in both the US and Europe, where investors are navigating shifting profit pools as manufacturers of mature medtech products face pricing pressures from budget-minded hospital purchasers and fast-growing new technologies emerge.

In a time of slow growth and economic uncertainty, GPs are also testing themes that have momentum to propel them forward. For example, in technology, interest is high in data centers and cloud computing, both of which are riding strong growth tailwinds. Enterprise software, in particular developers of vertical applications, is another tech subsector that has demonstrated stability.

**Looking for a breakthrough in emerging markets.** With developed economies stuck in the doldrums, PE's fascination with the fast-growing emerging markets continues to intensify. Captivated by robust emerging market GDP growth, increasingly sophisticated companies and managers, and their seeming exemption from the debt-market woes that beset Europe and North America, LPs continue to pour money into funds that target emerging market opportunities. Eventually, hopeful investors seem to believe, those vast sums of capital will surely find abundant productive investment outlets in these underpenetrated economies.

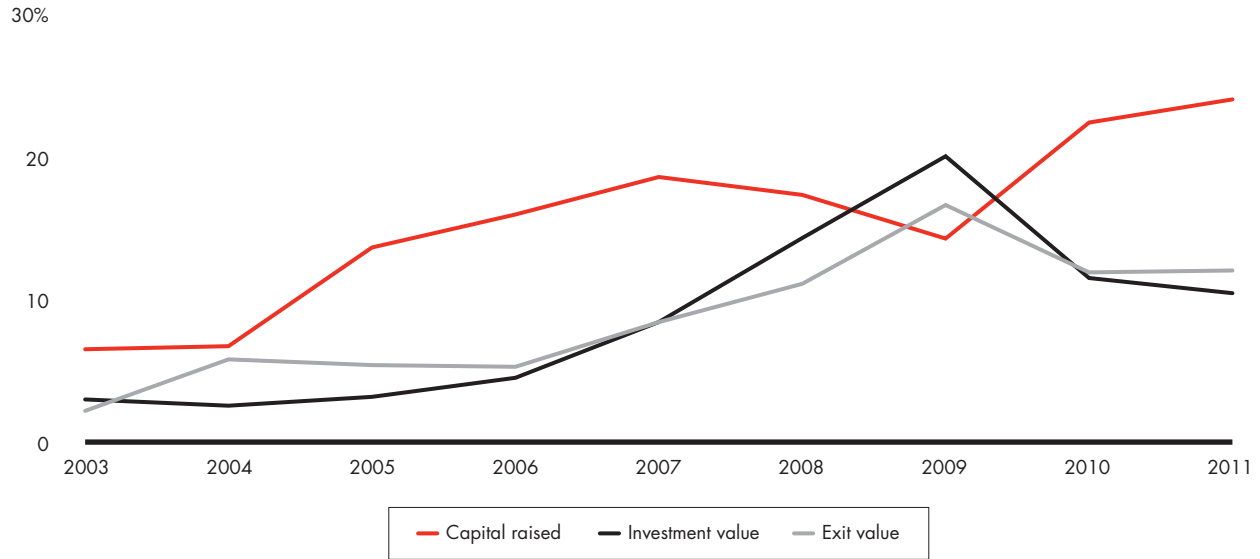
To date, however, that long-anticipated potential has failed to materialize to the extent investors had hoped. While emerging market fund-raising has garnered an increasing share of global PE capital raised over the past decade, PE deal value and exits have not kept pace. Both remain stuck at only slightly more than 10% of global activity (compared with nearly 25% for PE capital raised), despite the much faster pace of relative and absolute emerging market GDP growth (*see Figure 2.9*). As a result, dry powder continues to pile up at a faster rate in the emerging markets—growing at a 32% annual rate compounded since 2005 compared with 8% and 7% in Western Europe and North America, respectively (*see Figure 2.10*).

What will cause PE investment in emerging markets to take off? Supporting the idea that PE could grow substantially is the sheer growth and increasing size of their economies. Accounting for just over one-third of total global GDP of \$70 trillion in 2011, according to the International Monetary Fund (IMF), the emerging economies' share is forecast to expand to nearly one-half of the \$100 trillion global economy by 2020. By then, the IMF projects, China and India alone will account for about one-half of the \$32 trillion GDP of the major developing countries.

With the emerging economies still on the lower slopes of all of that anticipated growth, the theory holds, they will surely soak up all of the PE dry powder currently earmarked for investment, and much more, as their GDP expands. But Bain analysis found that an economy's size is not a reliable indicator of its capacity to absorb PE capital. A far more important determinant of an economy's attractiveness to PE investors and capacity is its number of scale companies. For example, South Africa, with a GDP of \$400 billion, enjoys a PE penetration of 0.3% (measured as PE deal value since 2007 divided by total GDP in 2011). By contrast, PE penetration in

Figure 2.9: Emerging markets' share of capital raised has surpassed their share of investment activity

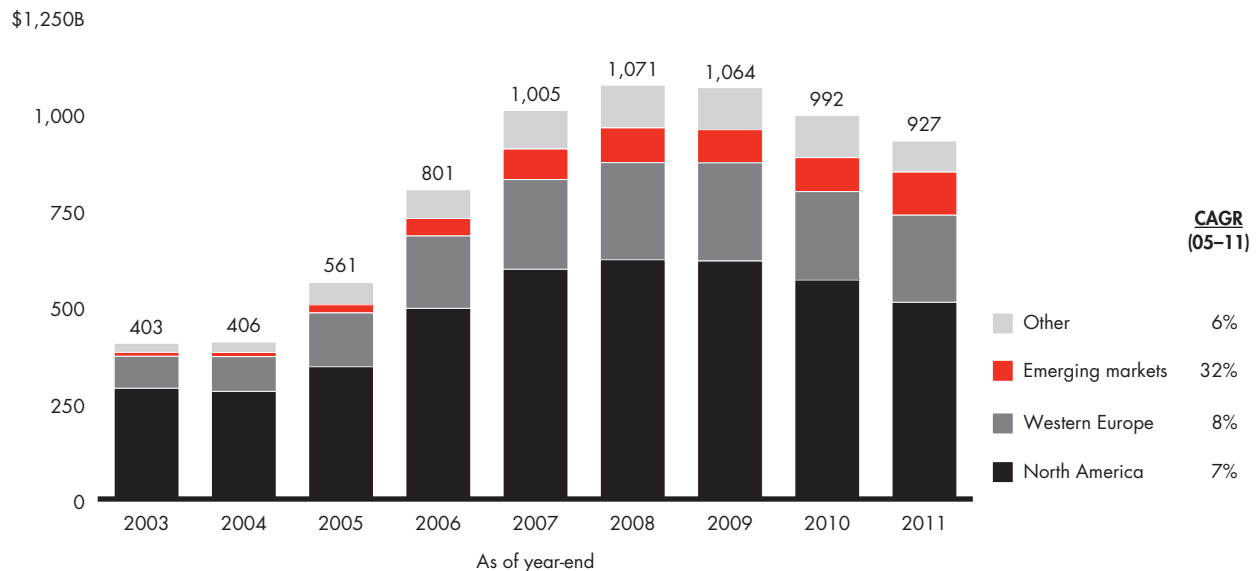
Emerging markets' share of global PE activity



Note: Emerging markets excludes Japan, Australia, New Zealand, Israel, Hong Kong and Singapore  
Source: Dealogic

Figure 2.10: As a result, dry powder has increased at a faster pace in emerging markets

Global PE dry powder (by investment region focus)



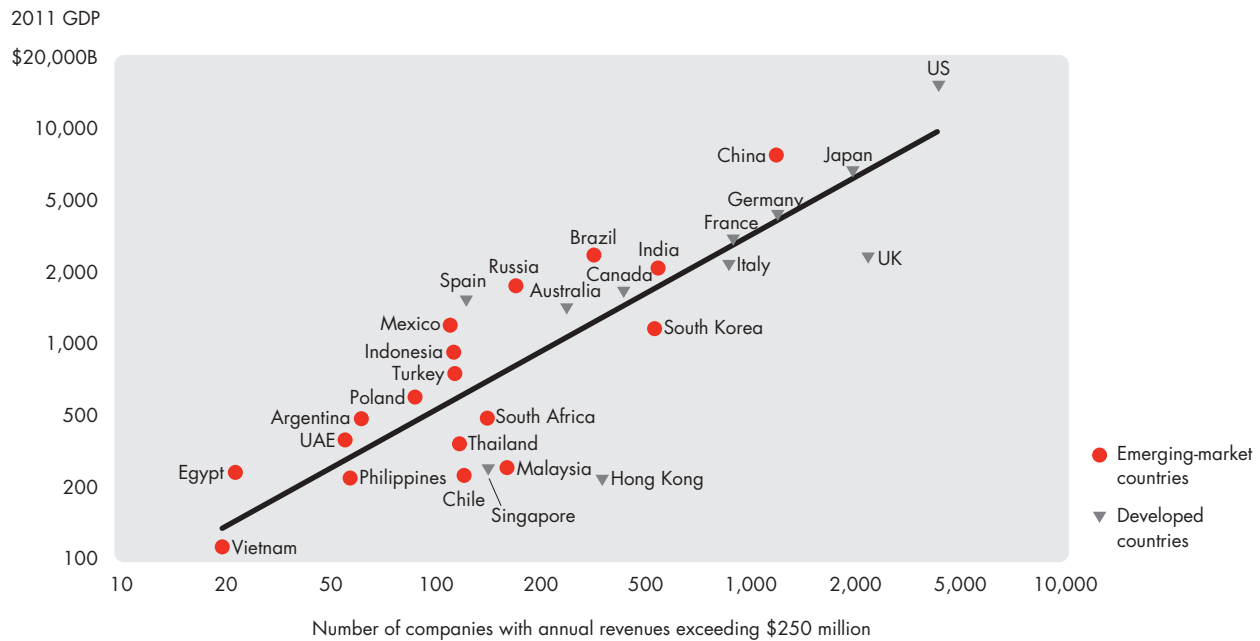
Note: "Other" includes developed countries outside of North America and Western Europe  
Source: Preqin

Russia, with a GDP nearly four times larger than South Africa's, has been negligible. Yet, holding other factors constant, both countries have roughly the same capacity to absorb PE investment. Despite Russia's far larger GDP, South Africa has almost as many companies with annual revenues that exceed \$250 million (see Figure 2.17).

The number of scale companies an economy boasts is itself evidence of the presence of a host of other critical factors that increase a market's ability to absorb PE capital. Some of these, such as the depth and liquidity of the country's capital markets, its legal system and protection of investor rights and the availability of debt financing, reflect underlying economic and policy foundations. Other variables, including corporate governance and transparency, the depth of management talent, a creative entrepreneurial culture and investors' ability to influence companies' direction, reflect a nation's commercial maturation. Taken together, these qualities are the signposts of a market's—or region's—receptivity for PE investment.

**The Southeast Asia opportunity.** When weighed against these broader indicators of PE readiness, some of the most attractive potential markets for investment are not necessarily the ones that have been the principal focus of GP and LP attention. Indeed, according to the widely used IESE Business School's Global Venture Capital and Private Equity Country Attractiveness Index, Southeast Asian economies now rank among the leaders. Singapore, the region's hub, ranks just behind the US, UK and Canada. Malaysia scores higher than China. Thailand comes in just a few slots below India, and Indonesia also makes the top 50 list, not far below Brazil, a recent favorite target of PE interest.

Figure 2.17: Countries attractive to PE have a greater number of larger-scale companies



Sources: Dealogic; Economist Intelligence Unit; Capital IQ; Bain analysis

Although it is economically, ethnically and culturally diverse, there is much that makes Southeast Asia appealing for PE investment. Spanning a territory from the Philippines in the east to Thailand in the west, the region's economies rebounded smartly from the global financial crisis, outperforming both China and India in recent years. Its GDP last year totaled \$1.9 trillion, fueled by its population of 600 million young and increasingly affluent consumers. Through the 10-member Association of Southeast Asian Nations (ASEAN), the region is forging a more tightly integrated platform for trade and commerce.

From the perspective of PE investors specifically, Southeast Asia is attractive for many reasons. It is relatively well endowed with scale companies, particularly in Singapore, Malaysia and to a lesser extent, Indonesia. Unlike China and India, where PE funds have typically been able to take minority stakes in smaller companies or limit themselves to private investments in public equities, Southeast Asia has traditionally been a buyout market, offering GPs more opportunities to create value.

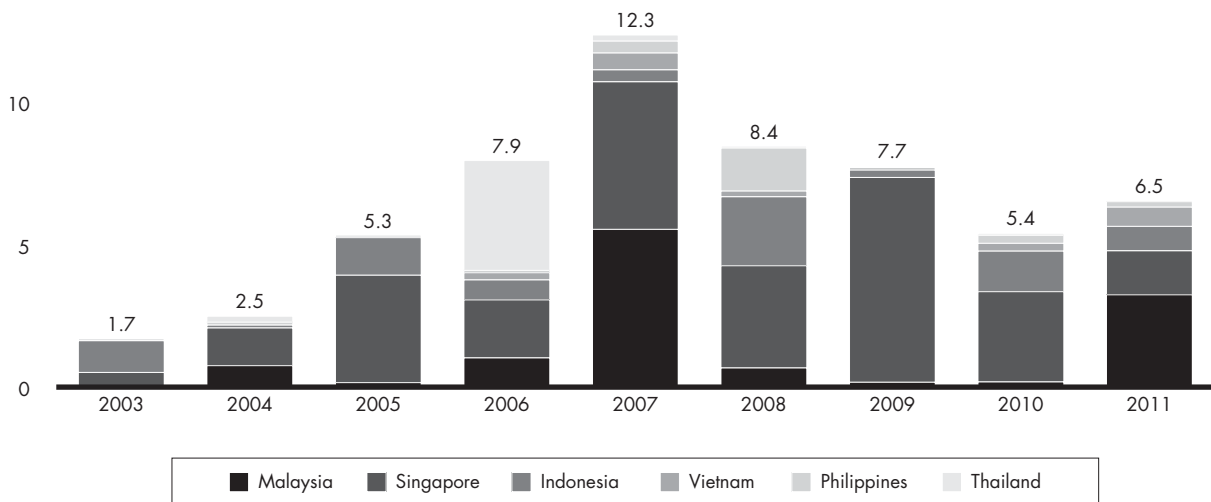
Despite these undeniable attractions, PE investment activity in the region to date has been relatively subdued. Following a brief upsurge in 2007, when it peaked at \$12.3 billion, total deal value has since dropped back to just \$6.5 billion last year (see Figure 2.72). Relative to deal activity in Asia overall, Southeast Asia's share of total deal value—at about 10%—is no higher than it was in 2003 and far below the spike of 25% it briefly reached in 2009.

That could soon begin to increase—perhaps as early as this year. Recent fund-raising has tended to favor regionally focused funds, and the sums being committed have increased sharply. Funds focused on Southeast Asia reaching their final close took in commitments totaling nearly \$4 billion in 2010 and 2011 combined, better than 40% more than what they had amassed on average in the prior two years. There is much more potential capital

**Figure 2.72:** Singapore is Southeast Asia's largest PE market, but activity is increasing in Indonesia and Malaysia

Southeast Asia's PE deal value by country

\$15B



Sources: Asia Venture Capital Journal; Bain analysis

in the pipeline. Currently, GPs on the road are seeking commitments totaling nearly \$6.5 billion, with eight funds specifically earmarked for investments in Indonesia and Vietnam looking to raise more than \$1.5 billion and \$850 million, respectively. As those funds begin to be deployed, Southeast Asia could soon begin to realize its vast potential.

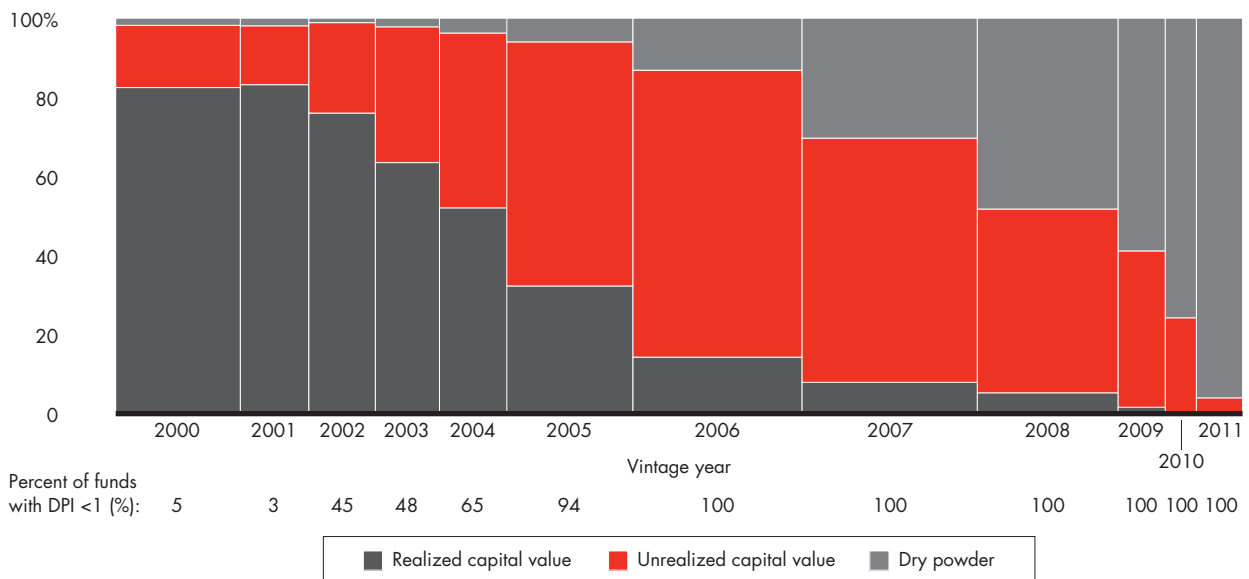
### Exits: Animal spirits are dormant

PE exit activity began 2012 just as it ended 2011—dead in the water. PE-backed sales to strategic buyers, normally the mainstay of global buyout exits, plunged late last year as fears that the fragile US recovery could unravel and worries that euro-zone problems might spill over to the global economy led potential corporate acquirers to sit on their cash hoards. IPOs could not get out of the gates, and sponsor-to-sponsor deals stalled. Conditions conducive for GPs to sell portfolio assets—clarity about the direction of the economy and a reasonably close match in valuation expectations between buyers and sellers—have been elusive since mid 2011, and they look to remain so. Until uncertainty lifts, it is difficult to see how exit opportunities will improve.

The exit bottleneck continues to aggravate a problem that has plagued PE firms since the 2008 downturn: the increasing amount of unrealized capital frozen in their portfolios, and the stubborn dilemma of when and how it can be monetized. The value of unsold assets swelled to nearly \$2 trillion, two times more than all of the dry powder GPs were looking to invest and up from one-and-a-half times just a year earlier. Working through the backlog will not be easy. The vast bulk of the unrealized capital stems from huge buyout fund vintages that closed from 2006 through 2008 and is tied up in investments made at peak value before the downturn (see Figure 2.13).

*Figure 2.13:* The capital overhang is concentrated in the large vintages raised and invested during the peak of the PE cycle

Realized and unrealized capital and dry powder of global buyout funds by vintage year (as of Q2 2011)



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



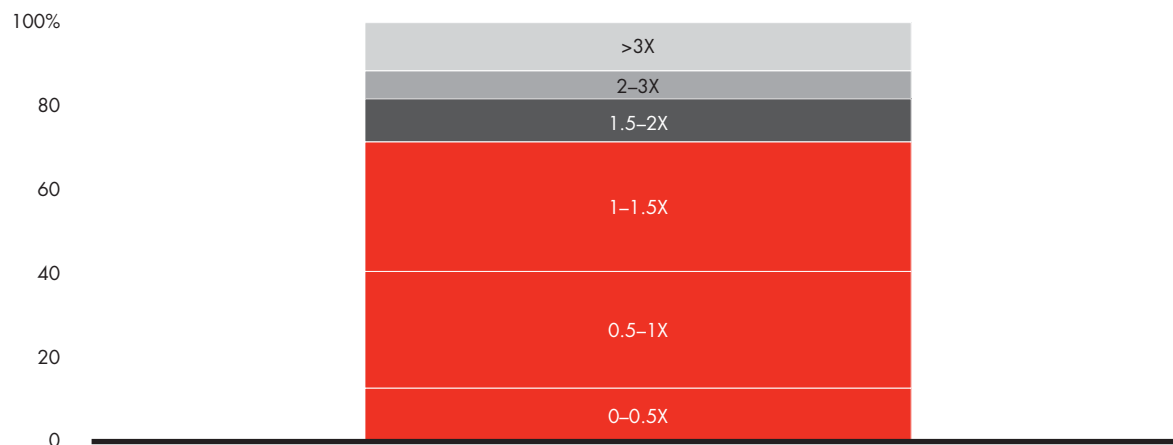
That puts GPs in a bind. They cannot return cash to LPs and their investment professionals until they liquidate these frozen holdings, but the assets are not ripe for sale in today’s market on terms that are attractive to GPs. PE fund managers have successfully nursed their high-priced portfolio companies through the downturn, but GPs still hold the overwhelming majority of them at valuation multiples below what they need to reap in order to earn their carry (see Figure 2.14). They will need to continue to work with their portfolio company managers to prepare them for eventual sale by creating additional value.

Meanwhile, the pressure to return capital to LPs increases. The pace of distributions from recent fund vintages has been glacial (see Figure 2.15). For example, five years into the lifecycle of 2005 vintage funds, the median buyout fund had returned only about 20% of their LPs’ paid-in capital. At an equivalent point in the lifecycle of the 2001 vintage funds, GPs had distributed more than 70% to their LPs. The distribution tempo for the 2006 and 2007 vintages has been even slower, with less than 10% of paid-in capital returned to LPs. At this pace, it could be quite awhile before cash-starved LPs begin to see any appreciable capital return.

What could cause exit activity to perk up in 2012? Certainly there is considerable pent-up interest on the part of buyers to purchase PE assets as there is on the part of GPs to sell them. Growth is high on the agendas of corporations that are looking to put their deep cash reserves to productive use in M&A activity at a time when slow GDP growth makes it difficult to grow organically. More than half of the North American respondents to the Intra-Links and mergermarket Global M&A Survey late last year said they expected M&A activity to increase in 2012. Even larger majorities anticipated an M&A revival in Latin America and the Asia-Pacific region, although only

Figure 2.14: Some unrealized investments may still not be ripe for sale

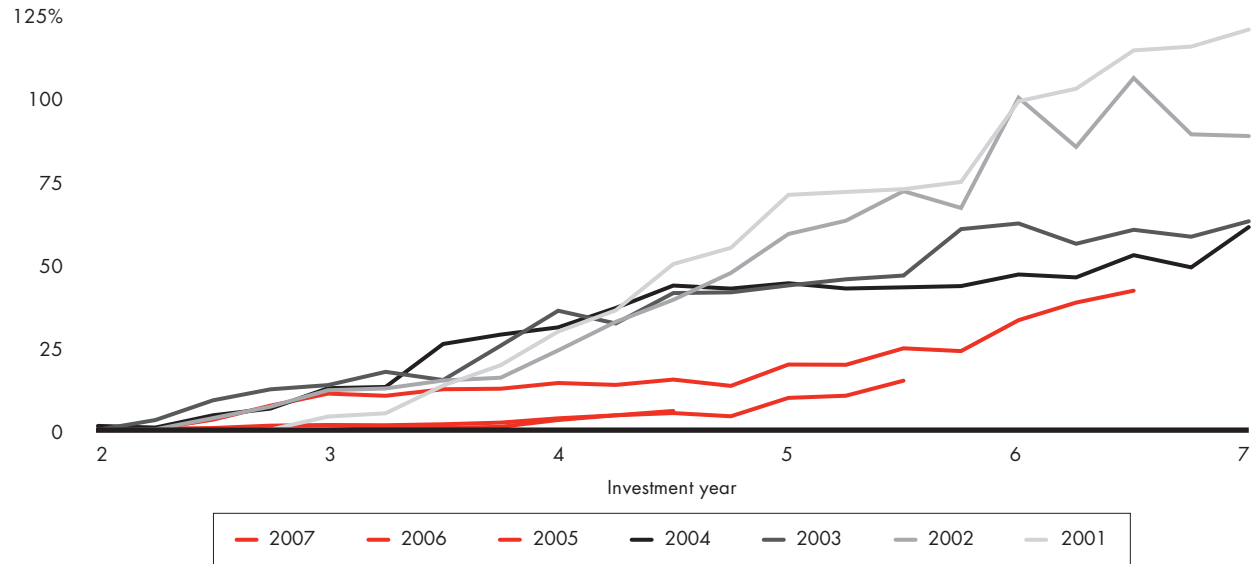
Valuation multiples for the unrealized portfolio of a sample of buyout funds  
(as of Q2 2011)



Notes: Fund vintages in sample range from 2004-2008; analysis includes unrealized investments and partially realized investments; valuation multiples are before payment of fees; PE firms have different policies regarding how they report the value of portfolio investments  
Source: Bain analysis

**Figure 2.15:** More recent vintage funds have been slow to return capital to investors, and no doubt GPs feel pressure to exit

Buyout median distribution to paid-in capital (DPI) by vintage year



Note: Data as of Q2 2011  
Source: Preqin

about one-quarter said they thought M&A would pick up in the EMEA region. However, until they gain confidence that the economy is firming up, strategic acquirers will remain on the sidelines. Even with a more certain economic outlook, continued market volatility could foil corporations' best efforts to deploy their war chests.

Likewise, there is no reason to believe that interest in sponsor-to-sponsor deals will fade. GPs on both sides of these transactions are keenly interested in putting money to work as investors, and returning capital to LPs as sellers. But until there is a sustained period of lower volatility in the equity markets and a brighter economic outlook, buyers and sellers will struggle to agree on price.

The global IPO pipeline is also filled with filings for new PE-backed listings, with more than 80 portfolio companies biding their time until market conditions stabilize. Some bigger ones, like Warburg Pincus and Cinven's filing to raise \$2.1 billion in an IPO of their portfolio company Ziggo, the big Dutch cable operator, and Silver Lake and TPG Capital's plan to raise \$1 billion through an initial offering of Avaya Holdings, the telecom equipment maker, have been waiting since last spring. Most IPO hopefuls will continue to battle market headwinds as they wait for volatility to subside, but high-quality companies with compelling growth stories could break through.

Exit pressures will remain strong in the major emerging markets where funds have flowed in heavily over the past five years but have yet to flow back out as steady investor returns. In Greater China, IPOs will continue to be the principal exit route as investments made during the boom years of 2006 through 2008 ripen for sale. Hony Capital, one of the largest domestic PE funds, has announced that it plans to list 10 of its portfolio companies in 2012. Sponsor-to-sponsor deal volume also looks set to rise as new funds armed with fresh dry powder enter the market. Political factors may also influence exit volume this year, as PE funds maneuver to close out

investments ahead of the ascension of a new premier and the potential tightening of controls over the financial industry that could follow.

Exit pressures will also be strong in India in 2012, due to the slow pace of exits over the past decade. PE industry insiders anticipate that IPOs will be the preferred exit option. However, LPs' nervousness about market stability and weak investor confidence amid corruption scandals and political gridlock could derail IPOs and boost interest in sponsor-to-sponsor sales or sales to strategic buyers.

Sponsor-to-sponsor sales and sales to strategic buyers will remain the primary exit routes in Southeast Asia. Chinese and Japanese corporate acquirers, among others, are scouting the region for growth opportunities. Successful deals such as Honeywell's 2011 acquisition of King's Safetywear, a manufacturer of industrial safety footwear that is a portfolio company of Navis Capital Partners, have bolstered buyer confidence. Although IPO volume in Southeast Asia remains low, the example of the recent successful initial listing—the largest even for Indonesia's capital markets—of the coal mining and processing company Adaro Energy, a portfolio company of Saratoga Capital, could give exits via IPOs a boost.

As they weigh the exit prospects for 2012, what PE funds in both mature and emerging markets need more than anything else to awaken their animal spirits is confidence that global economic growth is firmly on track. Lacking that elusive ingredient, the exit outlook will likely be lackluster.

## **Fund-raising: Knocking on a locked door**

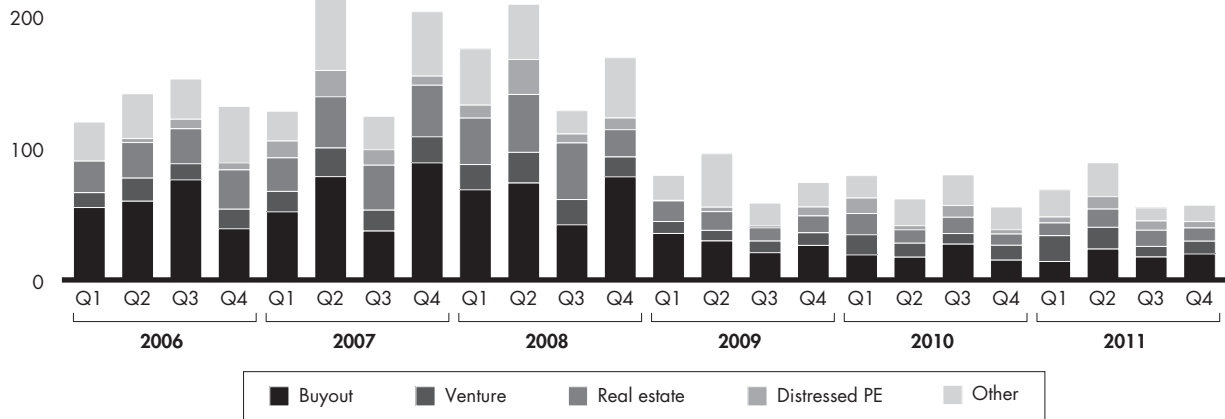
Fund-raising is always the last piece to fall in place when the PE cycle enters an upswing. Judging from the torpid pace and perilous outlook for the current recovery, 2012 is shaping up as an inauspicious year for eager GPs that have taken to the road to line up commitments from LPs for new funding rounds. Having failed to stage a hoped-for rebound in 2011, fund-raising activity has remained mired in a cyclical slump for the past three years (*see Figure 2.16*).

Absent a clear and sustained increase in investment and exit activity, GPs will not see a revival this year. Fund-raising tends to lag a pickup in investments, as LPs scramble to meet capital calls on prior commitments and have little headroom to take on new ones. But it also trails investments on the way down because LPs typically sign on to new commitments months before deal activity plunges. The steep year-over-year climb in buyout deal making in 2010 followed by a flat 2011 has resulted in no net growth in buyout capital raised last year (*see Figure 2.17*). Fund-raising also strongly correlates with exit activity and will not rebound unless exits do. Particularly in times like today, when LP allocations for PE are tight, many LPs depend on receiving distributions in order to recycle capital into new fund commitments. With all exit channels blocked going into 2012, LPs will be cut off from that critical flow of cash.

Sluggish fund-raising conditions in no way suggest a weakening of LPs' commitment to the asset class—at least not any time soon. For many LPs, their PE programs remain the top performers in their portfolios. They look to PE to boost their overall portfolio returns, particularly since it is one of the few asset classes that has proven its ability to generate alpha in a general market environment that has been devoid of beta. “There is no doubt that PE is an alpha engine for the overall fund,” said a US public pension fund manager. In a year-end 2011 survey conducted by Preqin, LPs overwhelmingly responded that they planned at least to maintain their target PE allocation over the coming year.

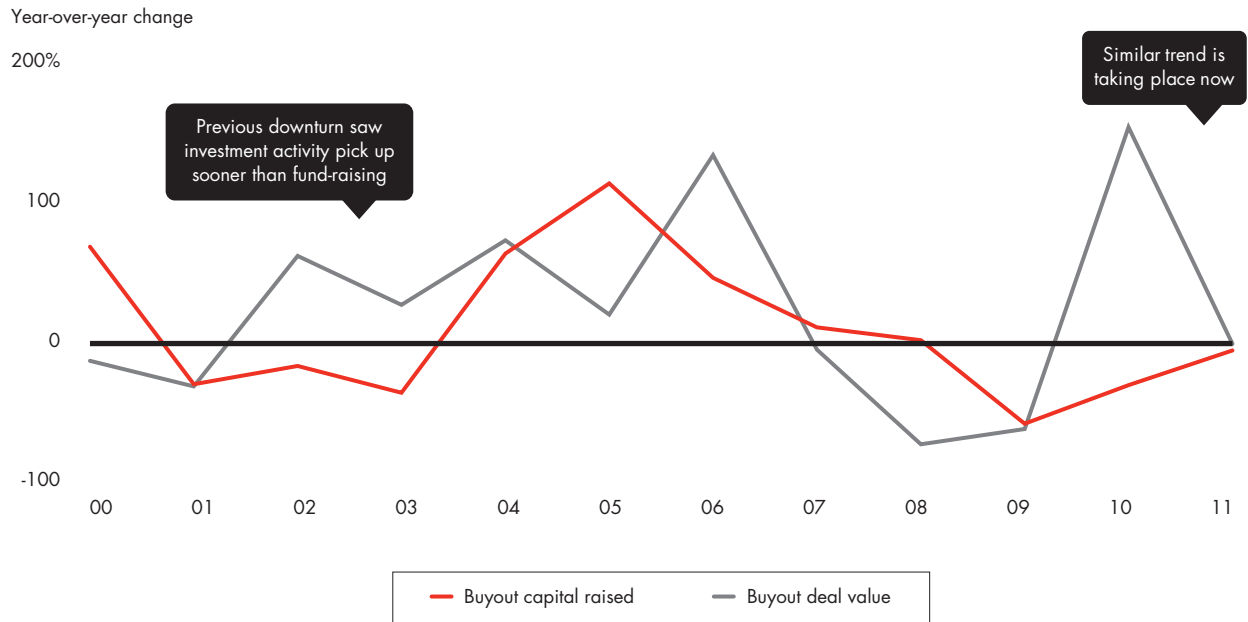
**Figure 2.16:** Fund-raising failed to stage a recovery in 2011, bumping along at a cyclical low since 2009

Global PE capital raised (by fund type)  
\$300B



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

**Figure 2.17:** As in the past, fund-raising is lagging the recovery in investment activity



Sources: Preqin, Dealogic

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Yet, most LPs will be hunkering down in the coming year. In surveys, nearly two-thirds of LPs report that they are currently at or above their target PE allocation, which will remain tight with little relief in sight. Their net cash flows will likely be negative as GPs call capital, and weak performance of the public equity markets will continue to hold down the value of their total assets under management, further tightening the lid on allocations. Nor are LPs inclined to make additional room for PE in their portfolios. More than 60% of those that Preqin surveyed as 2011 ended said they planned to commit no more in 2012 than in 2011.

With little wiggle room in their budgets, most LPs will be operating in “execution mode,” fulfilling planned commitments already on their calendars to known GPs they anticipated would be raising new funds. They are unlikely to be responsive to private placement memoranda that come in over the transom. Thus, GPs looking to forge new relationships with LPs or raise a first-time fund will find it difficult to garner commitments.

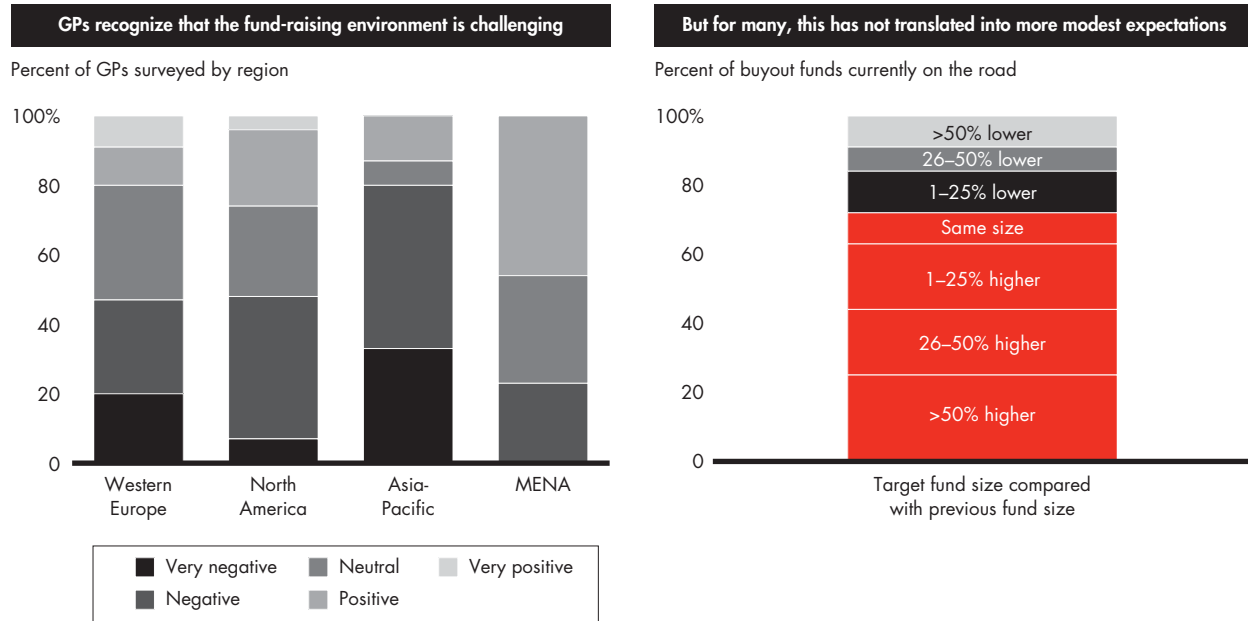
GPs that plan to go to the well to fill up new funds in 2012 know they will be facing a wall of LP skepticism. The exit overhang that has built up from the unrealized investments of funds from the 2005 through 2007 vintages has not only deprived LPs of critical cash flow to support new commitments; it has deprived LPs of recent insight into GPs’ realized returns. “LPs are edgy about whether to commit and [how much to] commit. They just need more time to see performance,” a US public pension fund executive told Bain in an interview. Many LPs are also doubtful about GPs’ ability to invest the dry powder they already are sitting on and find it hard to understand how they would productively put to work even more capital they are now trying to raise.

Although about half of GPs in North America and Western Europe rated fund-raising prospects as “negative” or “very negative” in a late-2011 survey, that pessimism has not caused GPs to reduce their fund-raising targets (see *Figure 2.18*). Approximately three-quarters of buyout funds currently on the road aim to raise the same or larger fund than their previous one, and nearly one-quarter set the goal for their new fund to raise 50% more. In aggregate, more than 1,800 GPs looking to bring in \$744 billion (230 of them buyout funds seeking \$177 billion) have taken their fund-raising show on the road.

Many of them are likely to be disappointed. Despite a huge backlog of dry powder they are already struggling to put to work, and deteriorating fund-raising conditions going in to 2012, GPs are looking to raise 2.8 times as much capital globally this year as they were able to raise in all of 2011 (see *Figure 2.19*). Where will they find all of that capital? Challenging times call for resourcefulness on the part of GPs. With pension funds, endowments, foundations, big institutional investors and many other usual LP candidates for fund-raising solicitations tapped out, GPs are turning over rocks in search of new investors. Some are eyeing ultra-high-net-worth individuals as prospective targets. But because courting them requires the careful nurturing of personal relationships and trust, this will be a very difficult group of investors to land. Other GPs are pinning their fund-raising hopes on deep-pocketed sovereign wealth funds, an undeniably huge cache of capital that offers intriguing potential for GPs that properly size up the opportunity (see “Will sovereign wealth funds be PE’s ‘white knight?’” on page 56).

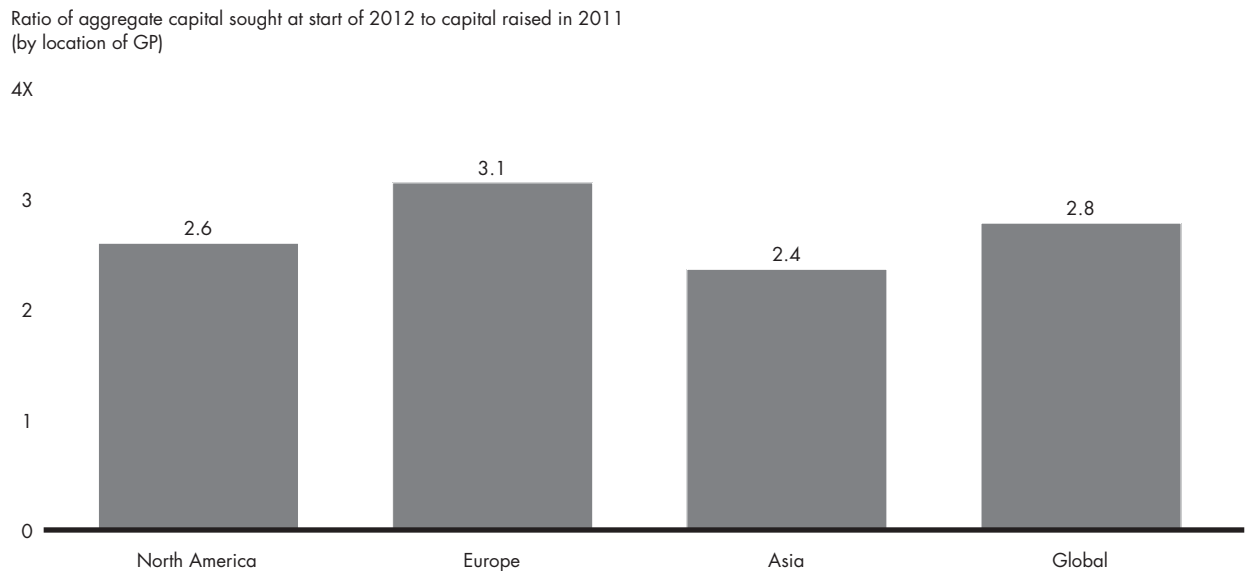
It is premature to predict that there will be a shakeout among PE firms. More than half of the 181 buyout funds that were on the road at the beginning of 2011 managed to reach a final close by year-end. Of these, almost 90% of the new funds were larger than their immediate predecessor (see *Figure 2.20*). However, these successful funds share a telling characteristic. Overwhelmingly, they were sponsored by veteran GPs that had raised at least three prior funds, strongly suggesting that LPs were drawn to GPs that had an established fund series with a performance track record to show.

**Figure 2.78:** Although they recognize that the fund-raising market is bad, many GPs have set high expectations

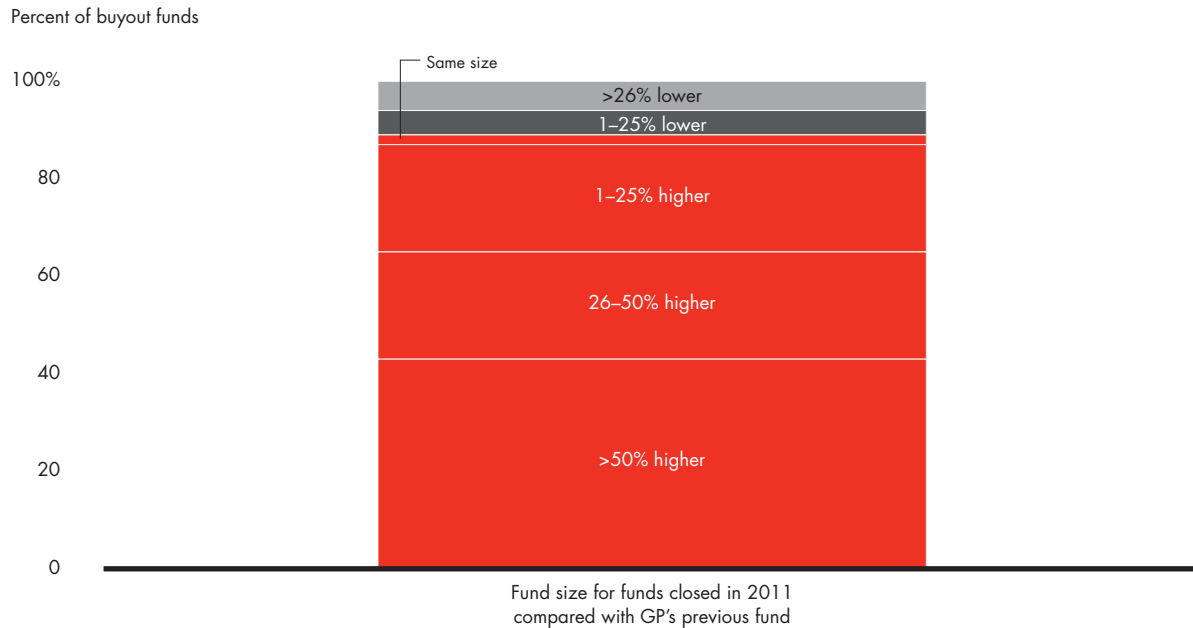


Sources: Grant Thornton Global Private Equity Report 2011 (n=144 executives from PE firms; survey conducted Autumn 2011); Preqin

**Figure 2.79:** Fund-raising will be very competitive in 2012, and many GPs could be disappointed



Note: Ratio calculated as aggregate capital sought for all PE types at the start of the year divided by the total PE capital raised the prior year (sum of funds achieving final close)  
Sources: Preqin; Bain analysis

*Figure 2.20:* Yet buyout funds that closed in 2011 managed to raise capital successfully

Source: Preqin

At some point, however, the math may no longer work. With so many funds vying for LPs' attention and aggregate fund-raising goals so much higher in 2012, GPs will need to mount long campaigns to achieve their target size and many may be required to reset their expectations. For PE firms that are forced to retrench, the implications will be severe. Many are counting on using the fees they collect from managing more capital to hire the top talent and build organizational capabilities they will need to strengthen their portfolio management skills. With the PE industry increasingly reliant on firms' ability to generate market-beating alpha going forward, second-tier funds will fall farther behind the leaders.

Will this happen in 2012? Perhaps not, but if investment and exit activity remain suppressed over a sustained period of economic weakness, a thinning of the PE-firm ranks cannot be ruled out.

## Returns: Making an alpha bet

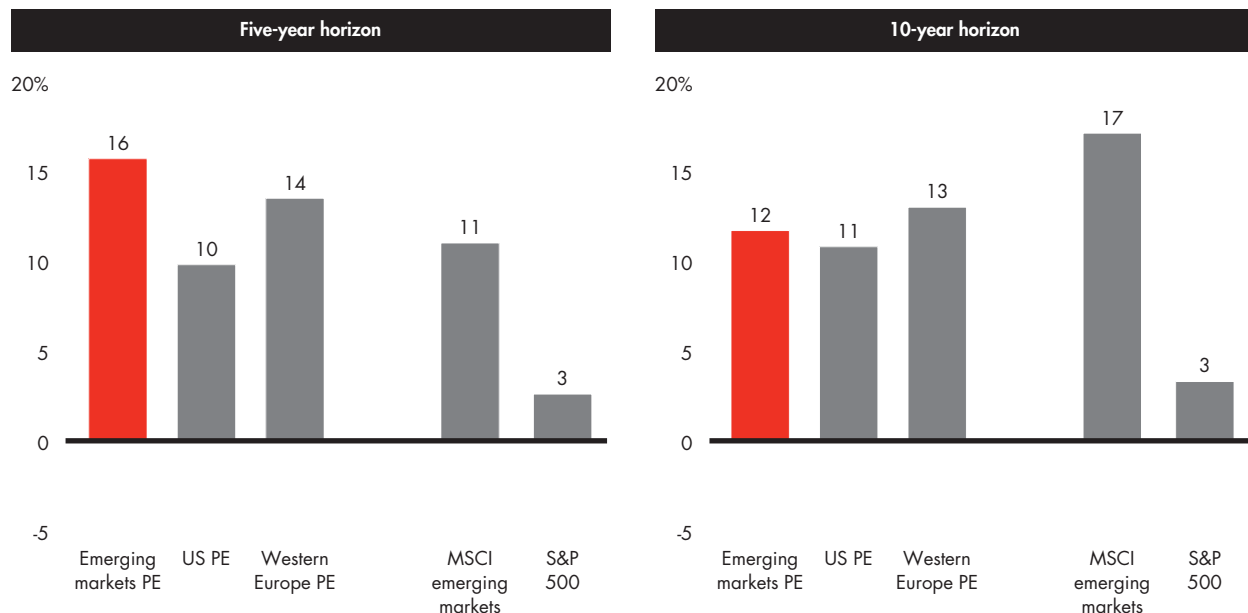
The acid test for private equity has always been whether it could continue to generate the premium returns that PE firms promised their LPs. The industry generally made good on that pledge, usually outperforming all other asset classes, on average, across the ups and downs of the business cycles. However, returns since the 2008 market meltdown have gotten little support from the tepid economic recovery or volatile debt and equity markets. Now with the markets showing little sign that they will generate beta to power further gains, GPs that aspire to achieve attractive returns in a much more competitive environment will need to redouble their focus on the elements of alpha generation, such as proactive deal sourcing, enhanced due diligence and post-close value creation.

The dynamics influencing PE returns suggest that the industry has become trapped by its own success. An ever-increasing number of PE firms able to raise deep reserves of dry powder compete fiercely for deals, keeping asset prices high and leaving little or no room for return multiples to expand at a time of sluggish GDP growth, higher-cost debt and lower levels of leverage. A combination of variables would need to change for the pressure on returns to ease. Most important of these would be a lessening of competition among GPs for assets and a lessening of pressure to invest. That might come to pass if new fund-raising slows down allowing the current capital overhang to be absorbed, if some funds decline to raise another fund and withdraw from the market, or if LPs permit GPs to stretch out their fund investment periods. As these conditions play out, deal valuations could come down as markets more realistically price low growth into earnings. This, however, will take time.

If returns have reached an impasse in the mature markets of North America and Europe, it is not clear that they have done much better in emerging markets. Net returns for emerging-market PE funds over the past five years did outperform publically listed stocks and their US and Western Europe counterparts. But longer term, they were only on par with the developed-market PE funds and significantly below the emerging-market public equities index (see Figure 2.27).

The challenges besetting PE returns in emerging markets reflect many of the same circumstances influencing developed-market returns. LPs' expectations that PE will outperform are sky-high. In a recent survey, more than 70% of LPs said they expected emerging market funds to generate superior returns on a sustained basis, with about one-half looking for net returns to exceed 16%. They continue to pour a lot of capital into emerging markets based on those expectations. But as in the developed markets, GPs have accumulated vast piles of dry powder and

*Figure 2.27:* Despite hopes pinned on emerging markets, it is unclear that they have outperformed to date



Note: Data as of Q1 2011  
Source: Cambridge Associates

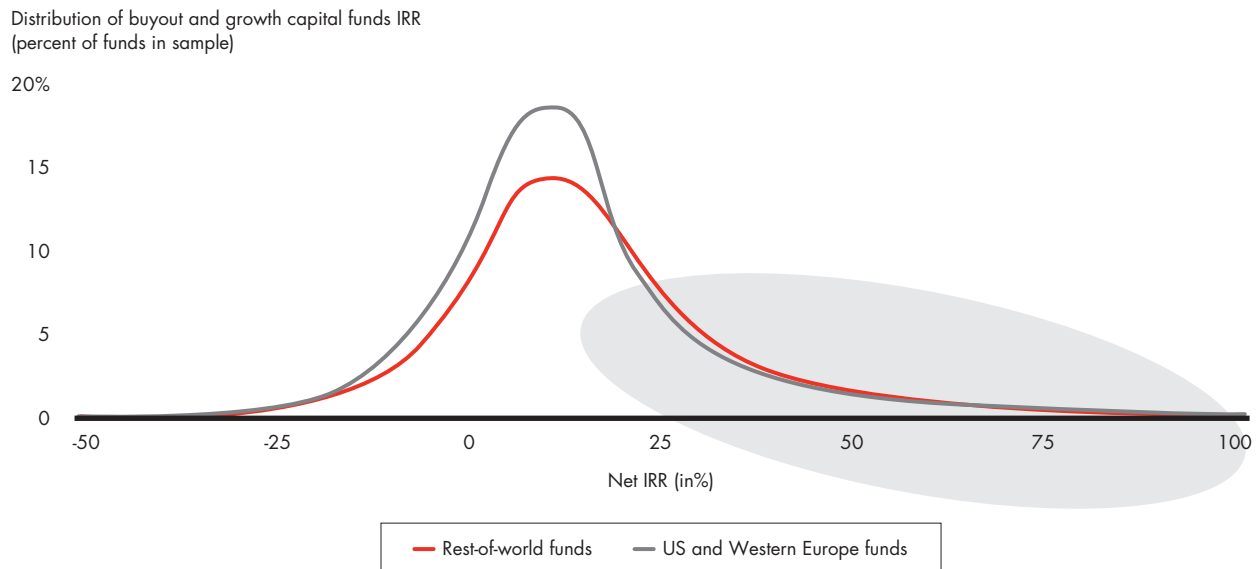


bid up valuations of target companies as they have tried to put it to work, particularly in China and India. With emerging-market economies now entering a period of slower growth and increased volatility, that high price of entry will make it difficult for GPs to generate outsized returns going forward.

Several conditions unique to the emerging markets also add pressure that push down returns. GPs are commonly acquirers of minority stakes in the companies they target, and they have limited ability to generate alpha by influencing their direction. Furthermore, it remains to be seen whether exit channels in emerging markets will develop sufficiently to provide reliable ways for GPs to monetize their unrealized investment gains. Finally, the emerging markets' rapid growth has attracted a large number of neophyte GPs who are struggling to find their legs and will pull down the return averages. In fact, the highest emerging-market returns were earned by smaller country-focused funds that were pioneers in the markets they targeted. Since those early days, these funds have scaled up and will be unlikely to match their superior past performance on the larger-sized deals they are now bidding for against other big regional and global PE funds.

The challenging overall outlook for returns means that, more than ever before, LPs need to be able to identify and work with top-quartile GPs that are not dependent on market beta to boost their results. The PE performance gap between the best and the rest is huge (see Figure 2.22). Bain analyzed the distribution of returns produced by more than 850 buyout, growth-capital and late-stage venture capital vintages in both the mature markets of the US and Western Europe and the rest of the world from 1995 through 2009. Although the results clustered around the median as expected, we also found a long tail of strong performers—with an elite group of outliers producing spectacular gains.

**Figure 2.22:** PE investing is not about building an average PE portfolio; it is about selecting top-quartile GPs



Notes: Includes mature buyout, growth capital and late-stage VC fund vintages (1995–2009) for which IRR data is available; geography based on investment region focus of funds  
Sources: Preqin; Bain analysis

Indeed, the performance leaders generate a disproportionately large share of the value-creating alpha that accounts for PE's superior returns. Recall that the recent analysis by HEC professor Oliver Gottschalg described earlier in the report, found that, on average, 5 percentage points of PE fund managers' returns could be attributed to alpha. But when Gottschalg and his collaborators at Golding Capital Partners grouped fund managers by their overall performance relative to their peers, they found the bulk of the alpha was concentrated among the top performers (*see Figure 2.23*). Indeed, fund managers in the top half of the rankings generated 18% of alpha, and an elite group of performance superstars—GPs whose returns rank in the top 5% relative to the peer group—generated alpha worth an impressive 40 percentage points in returns.

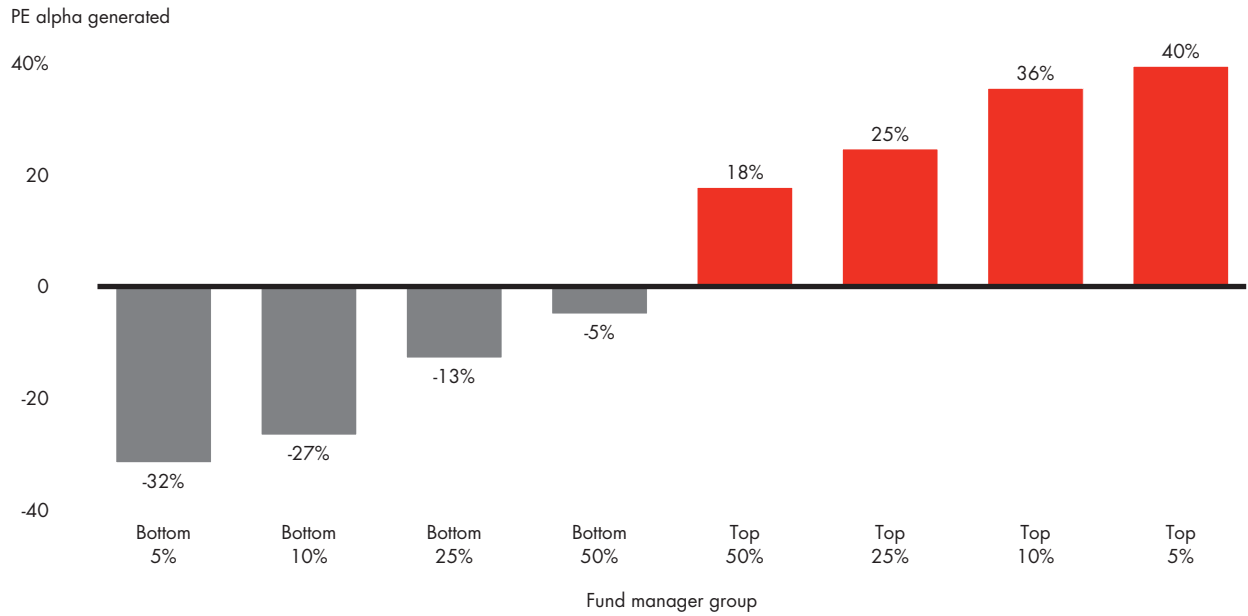
Consistency is the hallmark of GPs that generate best-in-class returns. Honing a sharp investment thesis and undertaking deep due diligence enable them to steer clear of investments that result in write-offs and write-downs. Their disciplines for spotting great opportunities and developing value-creation plans they and the management teams they hire then implement help them convert a higher proportion of their portfolio companies into run-away winners. It is a model the leading GPs draw upon—and improve—again and again. Relying on market beta does not yield realized gains that are between five and 10 or more times their initial investments, yet the alpha-generating capabilities of top-quartile funds achieve this repeatedly (*see Figure 2.24*).

How can LPs separate the few true winners from the pack of followers? A successful track record is one important guidepost. Unlike for most other investment managers, past performance is an indicator of likely future results in PE. GPs that have managed a top-quartile fund have a better than six-in-ten probability that their successor fund will also be an above average-performer. Likewise, for a GP whose last fund ended up in the bottom quartile. Their next fund will be nearly 60% as likely to underperform the industry average (*see Figure 2.25*).

But a record of past success is only a partial guide to continued premium performance—and perhaps one that is weakening over time. A recent Bain analysis, which compared the performance of pairs of successive buyout funds from vintages of 2000 and earlier with fund pairings from vintages of 2001 and later, found that the persistence of GPs' ability to produce top-quartile returns may have faded over the last PE cycle. Whereas 37% of successor funds from the pre-2000 pairings were able to repeat their predecessor's top-quartile performance, only about 27% of the successor funds of the post-2001 pairings did as well (*see Figure 2.26*). It is too early to determine whether the drop-off in top-quartile consistency is a one-time blip or a longer-term trend. It is possible that some strong performers, who ended up overexposed to hard-hit sectors in the 2008-2009 crash, will regain their footing. But they and other GPs will also need to be open to the possibility that the rules of the game have changed and that they have not kept pace by changing their business models quickly enough to get in front of the new wave that generates alpha.

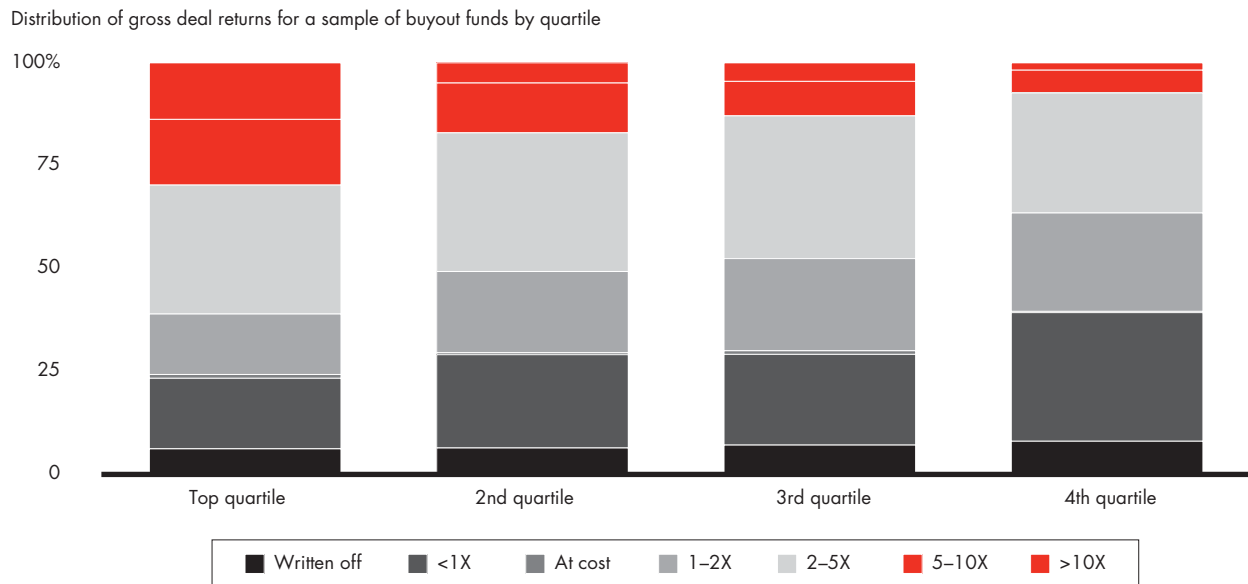
LPs need to subject even the best-performing GPs to a deeper level of scrutiny each time they come back to the market. Their probe should assess whether the GP continues to have the strong foundation of underlying operational and organizational skills on which continued premium performance can be built. What specific traits should they be looking for? First, winning GPs should be able to demonstrate that they have forged durable partnerships with strong portfolio-company management teams that possess distinctive operational expertise and have incentives in place that motivate them to succeed. Do the operating managers have skin in the game that makes them think like owners? Does the GP back them up with outside experts and advisers whom they can call on to solve technical problems or help break through strategic bottlenecks? Second, LPs need to weigh the internal organizational dynamics of the PE firm as a whole. Does the fund have a depth of seasoned leadership or is its

*Figure 2.23:* Selecting the right fund managers is vital for generating alpha



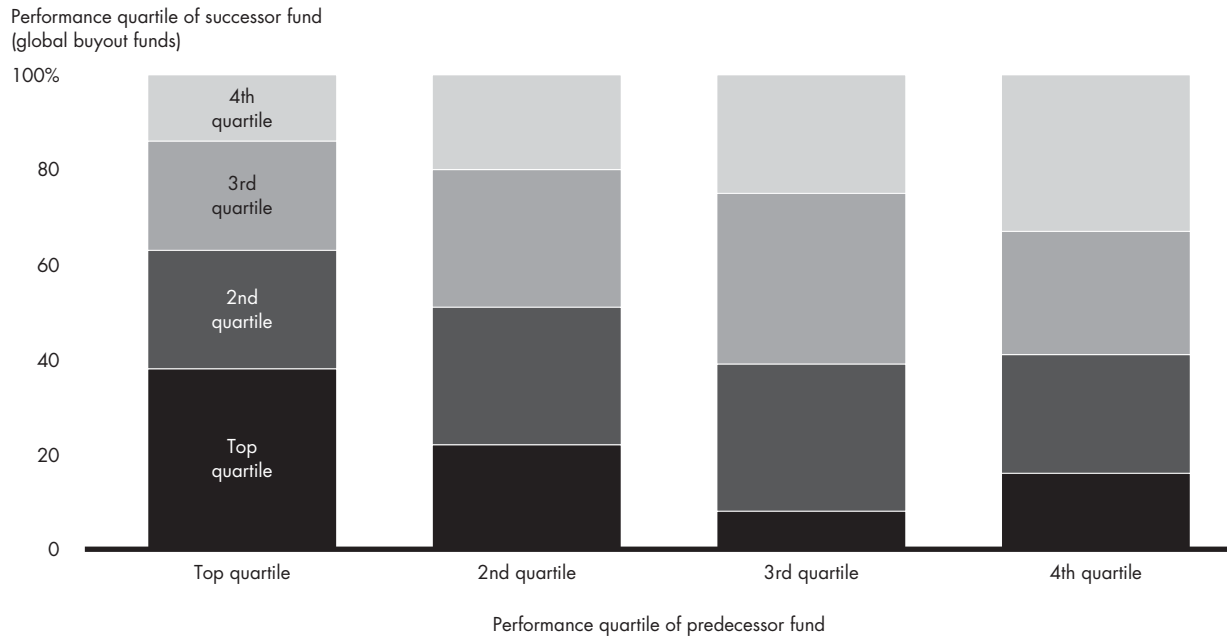
Notes: Analysis includes only fund managers with at least 10 realized transactions; analysis based on gross deal returns, not net of fees to LPs  
 Source: "Private Equity Study: Finding Alpha 2.0," Oliver Gottschalg, HEC-Paris; Golding Capital Partners, November 2011

*Figure 2.24:* The best GPs will continue to deliver outsized returns, not by relying on beta but by generating alpha

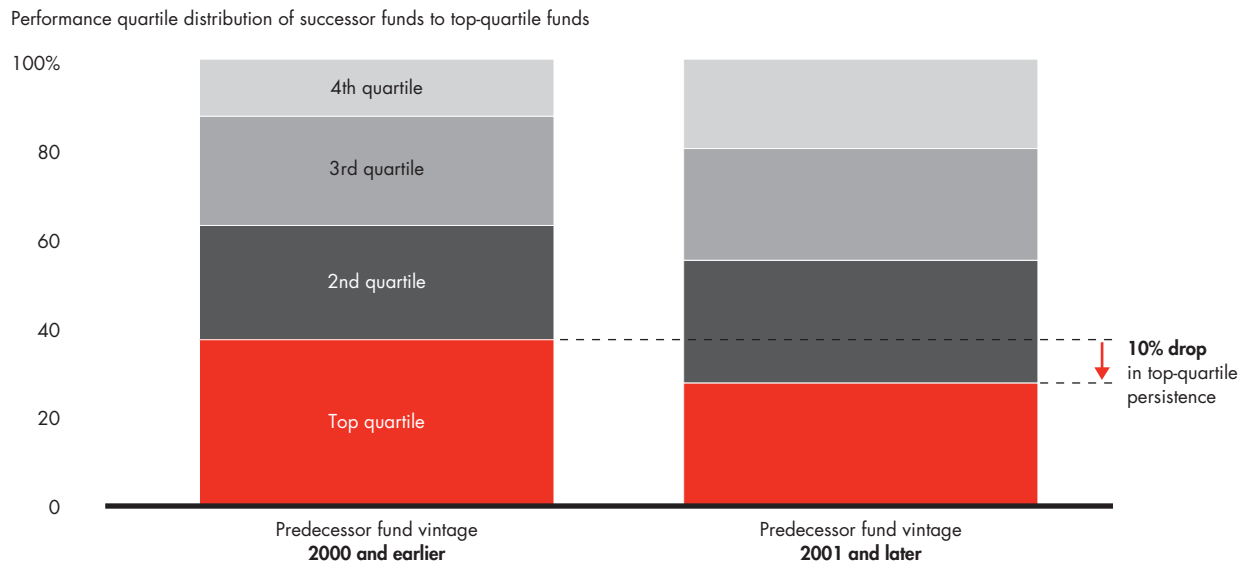


Notes: Analysis based on 117 mature buyout funds globally (≥9 years old with at least 10 investments made); funds were classified into performance quartiles based on fund-TVPI; total of 2,973 investments (realized and unrealized)  
 Source: Peracs-HEC Report on Risk-Profile of PE Funds (forthcoming)

*Figure 2.25:* For LPs, picking the winners will be challenging, and a GP’s track record continues to be an important consideration...



*Figure 2.26:* ... but track record alone does not provide LPs with enough certainty about future performance, especially as it appears that performance persistence is fading



Notes: Analysis includes buyout funds of US-based GPs; includes 271 fund pairings with the predecessor fund, vintage 2000 and earlier, and 119 fund pairings with the predecessor fund, vintage 2001 and later  
Sources: Preqin; Bain analysis

future performance overly dependent on the continued services and insights of a single key partner? Has the GP shown a continued commitment to invest in building a talented team that is dedicated to strengthening performance across the portfolio and to equip them with the infrastructure and resources to succeed? Finally, they need to look beyond the superficial results of past deals and rigorously analyze how the GP brought its capabilities to bear to generate alpha.

In the challenging three years since the currently sputtering PE recovery has tried to assert itself, both GPs and LPs have come to recognize that they can no longer count on market beta to be a wind at their backs. The lesson now seems to be sinking in that value-creation skills will be the only reliable source of strong future returns. For LPs, that means they will need to shift their focus from engaging GPs to be investment overseers to hiring great managers. For GPs that aspire to be performance leaders, it is time to roll up their sleeves and demonstrate that they can build great companies.

## Key takeaways

- PE firms will propel deal making forward in 2012 as they race to put vast sums of aging dry powder to work before investment periods expire. But GPs face strong headwinds. Uncertainties in the economic outlook and volatile equity markets will make it difficult for buyers and sellers to agree on price. Debt-market conditions were less favorable at the start of this year than in 2011. One major concern: Will the supply of debt be able to keep pace with demand if deal making picks up in earnest? It is likely that credit markets will remain accommodating as long as the hunt for yield in a low interest rate environment continues to draw investors in.
- Fast-growing emerging markets continue to attract both LPs and GPs, but most will be challenged to meet their high expectations. The principal factor influencing an economy's ability to absorb PE capital is the number of larger-scale companies available for acquisition. With many emerging markets falling short on this dimension, dry powder will continue to pile up.
- GPs will feel pressure to unload assets in 2012. They have been slow to return capital to LPs since the downturn, and the exit overhang has grown to nearly \$2 trillion globally. But do not look for exit activity to perk up in 2012. Weakness persists across all exit channels, and many companies in PE fund portfolios are still not ripe for sale, being held at valuations below what GPs need to earn carry.
- Fund-raising is not poised for a recovery in 2012. The slower pace of exit activity is leaving liquidity-strapped LPs strained to meet capital calls for past commitments, and volatile equity markets are pressing them against their PE allocation ceilings. Meanwhile, an oversupply of funds seeking capital could force GPs to scale back lofty expectations.
- The ingredients of market beta—strong GDP growth, expanding multiples and abundant leverage to power returns—are gone and they are not coming back any time soon. The focus of both GPs and LPs now needs to be on generating alpha to earn market-beating returns by boosting growth in their portfolio companies. For GPs, that means honing new disciplines for vetting deals, adding organizational capabilities to accelerate growth and building a repeatable model for value creation. For LPs, the challenge will be to identify GPs that can deliver alpha going forward. They will need to look beyond a GP's performance track record in light of recent evidence that the persistence of superior performance could be fading.

## Will sovereign wealth funds be PE's "white knight"?

With GPs testing the limits of LPs' ability and willingness to fill their new-fund coffers, sovereign wealth funds (SWFs) are emerging as a potential source of capital to help bridge the fund-raising gap. Contrary to conventional industry thinking, SWFs are eager to partner with a wide range of PE firms—provided GPs understand how to work with them.

Managers of investible assets of some of the world's richest nations, SWFs command enormous resources, which have quadrupled over the past decade to some \$4.7 trillion in 2011. Two powerful trends make SWFs attractive to GPs. First, they receive a steady inflow of capital from mighty rivers of cash—the proceeds from energy sales across the Middle East and other oil-rich countries and the recycling of surplus foreign currency reserves amassed by the fast-growing economies of Asia. Second, SWFs are increasingly looking to deploy assets in higher-earning alternative investments, of which PE is a prime candidate.

As SWFs ramp up their PE programs, their near-term capital injections into the industry could rival PE commitments from conventional public and private sources. Bain analysis conservatively estimates that, taken together, the 10 largest SWFs investing in PE could channel an additional \$30 billion to \$60 billion into PE over the next several years, and potentially far more if they or other big SWFs significantly step up their PE participation.

SWFs enjoy enormous flexibility as PE investors. Unlike conventional LPs, which try to match the duration of assets and liabilities in order to meet their need for liquidity, SWFs can patiently commit capital over long time horizons. They are also able to participate in PE in a variety of ways—as traditional LPs or, as is the case for more mature programs, as co-investors or direct investors that can maintain a position in an investment even after the PE fund exits.

For all the traits they share, SWFs are by no means monolithic, and it behooves GPs to understand how they differ and tailor their pitches accordingly. Their investment objectives can vary greatly. For example, government-linked investors such as the Abu Dhabi Investment Authority and the Kuwait Investment Authority, take a global perspective on the allocations they make with a goal of safeguarding reserves while maximizing risk-adjusted returns. By contrast, directed SWFs, such as Temasek Holdings in Singapore and the Mubadala Development Company in Abu Dhabi, focus on both the development objectives of their home economies and on achieving high total shareholder returns.

GPs that aspire to win capital commitments from SWFs need to be prepared for intense scrutiny. Like many other investors that invested proportionately more capital as fund sizes grew, some SWFs are now overexposed to the mega funds of the 2006 to 2008 vintages, which are underperforming return expectations for this asset class. That experience has redoubled their determination to work only with great managers who have proven track records and are likely to achieve superlative results going forward.

SWFs are eager to learn more about GPs that clear the initial performance hurdle. Newer SWFs and those that are scaling up their PE allocations are looking to make targeted investments that round out their portfolios. They are open to establishing ties with funds from across a broad spectrum of investment styles, including funds that offer geographic and sector diversification opportunities. They are also willing to consider investing in smaller funds that many might assume to be below the threshold size a large SWF would look at.

Far from being remote and requiring endless cultivation, SWF managers are quick to make investment decisions once they have completed their due diligence. What they want to determine above all is that the GPs with whom they work can demonstrate that they will add value by bringing to bear a depth of expertise, strong network relationships and solid performance improvement skills. Because of their size and sophistication, SWFs with more mature programs do not need help from PE firms to offer diversification they can easily provide for themselves. They are cautious about working with funds that could end up being a direct competitor. But for GPs that develop a good relationship with a big SWF, having a mutual interest in a target company can work to the benefit of both parties as the ultimate winner of the deal brings the other in as a co-investor.

GPs that make the SWF short-list need to be prepared for a tough negotiation to seal the deal. Like any large investor in PE, SWFs are devoting increased attention to terms and conditions and can drive a hard bargain. Mid-market-sized PE funds in the range of \$250 million or less also need to get comfortable with the idea of having a single behemoth as a partner that can exert disproportionately large influence in how the fund operates. Nevertheless, as they begin to get acquainted with sovereign wealth funds, PE firms of all sizes may be surprised to discover that they can be the best allies to have in today's tough fund-raising environment.



### 3. PE hits a new inflection point

Three years after the global economic downturn, the contours of a new future for PE are finally coming into sharp focus. Through the bumpy recovery of the developed markets and the prospective growth of untested emerging markets, many GPs and LPs seem to have been treading water, waiting for familiar forces to reassert themselves and allowing the industry to find traction for the next long-awaited upswing. When stronger GDP growth eventually resumes, debt markets thaw, equity market volatility subsides and exit channels unclog, surely GPs would be able to get back to putting their masses of dry powder to work in profitable high-volume deal making.

It has not happened, and as we have seen in the pages of this report, the PE industry has begun to recognize the need to adapt to the new normal. Having guided their portfolio companies through the cyclical upheaval, GPs worth their carry now know how to cut costs. The skills of managing a balance sheet and keeping costs under control are now basic industry table stakes. In the present highly competitive deal environment, opportunities for cost reduction and capital management are built into every GP's bid model. They are part of the price any deal-hungry GP must pay to have any chance of acquiring an asset, and they no longer figure in the deal's excess return.

For the foreseeable future, GPs' ability to partner effectively with management and create growth will be the primary factor that will differentiate top performers from the rest. With no market beta in sight, generating returns both in their current portfolio companies and in new investments hinges on GPs helping managers grow their businesses' top line.

Succeeding in these times requires new skills across every dimension of how PE firms source deals, vet their growth potential, partner with portfolio management teams to achieve supercharged results and, perhaps most challenging of all, reorganize themselves to develop a repeatable model for success. Let's explore what it takes to win.

**Identify growth opportunities others don't see.** In the new world of premium-priced assets, GPs need to dig deep to win auctions or seal proprietary deals—without overpaying. Walking the fine line between paying the premium that markets require and ensuring that there is still room to earn a solid return begins with true sector expertise. Having a deeply informed view into the specific industry in which they are investing is crucial to ensuring there is headroom for growth that can yield an attractive potential return despite a steep initial acquisition price. Too many folks have erred in the past by paying up for assets that were solid companies and leaders in their markets but lacked substantial incremental growth potential.

Leading PE firms parlay their sector expertise to enrich the mix of prospective candidates for their deal pipelines, probing deeply into specific subsectors in their deal "sweet spots" where growth opportunities are likely to be more abundant. To help expand and refine the target list, they engage a network of advisers that includes senior industry executives and operating partners to bring in more potential deals and conduct an early triage to determine which growth prospects have merit and are worth pursuing further. Knowing that their most precious resource is the time and energy of their people, leading PE firms actively manage each step of the deal pipeline—from origination through due diligence—to ensure that they invest only in the highest-potential opportunities at each step of the process.

**Vigorously test the investment thesis.** With a focus on uncovering the true growth potential of the survivors of the initial vetting, the due-diligence process takes on a new importance and intensity. Whether the acquisition objective is a part of a buy-and-build program, the pursuit of organic market share gain, a channel or geographic expansion or the launch of new products and services, every investment thesis needs to be investigated. Working in collaboration with an outside due-diligence team or relying on internal resources, an enhanced due-diligence process thoroughly examines each opportunity for hidden traps and buried treasure by taking four distinct steps:

1. *Develop an exhaustive list of questions for the diligence team to explore.* That is what Berkshire Partners did when it launched its investigation into whether to pursue the acquisition of Bare Escentuals, an up-and-coming retailer of mineral cosmetics, a niche segment in an industry dependent on discretionary purchases and shrouded in mystique. The list of unknowns the deal team would need to investigate—from the size of the potential customer base to the mysteries of pricing in an intensely competitive environment—was extensive, and each item was sharply articulated for examination.
2. *Flesh out the priority issues that demand attention and carefully scope the diligence process to focus on them.* For Berkshire, the critical factors surrounding its decision to buy Bare Escentuals were to determine the growth rate of the various cosmetic sales channels and product categories, how much headroom there was to expand them and how well the company was positioned to compete. However, an overarching question that needed an answer before the investment team could confidently stretch to win the deal: How loyal was Bare Escentuals' customer base to the company and its products? A detailed investigation revealed that a high proportion of customers were passionate fans, implying that the company would be able to command premium prices and implement major expansion initiatives to boost profitable growth without risking major defections.
3. *Eliminate the blind side.* Smart acquirers probe the answers the diligence process surfaces against a range of scenarios the target company could face. What factors could upset the deal's calculations and what probabilities should be assigned to them? Even the best investors will lose money from time to time, but what separates them from their less successful peers is that they are never taken by surprise.
4. *Make a go or no-go decision and determine a firm price.* The Berkshire deal team knew it would be facing a competitive auction that would require it to pay top dollar. But based on the comfort it had established with the company's potential—and the analysis it had undertaken to size up what that was—the fund determined it would dig deep on valuation to prevail in the auction process. The bold decision was ultimately vindicated. Working with the retailer's management team, Berkshire implemented its aggressive growth plan, generating a return of better than 15 times the invested capital.

**Make sure management is on board from the start.** More than ever, forging a strong and early partnership with a company's management team on a value-creation plan for a new portfolio company is essential for achieving today's supercharged growth expectations. Today, many PE firms cobble together 100-day plans, but often they are unfortunately just long lists of activities that amount to little more than having many hammers banging on lots of nails. GPs that want to ensure that they are truly aligned with company management about what really matters for creating value need to ask themselves three key questions. First, does the management team understand from the outset the priority initiatives for reaching the company's full potential? Second, do the management and the sponsor both agree on the sequence of actions they need to take in pursuit of meaningful growth, what it will take to achieve it and the timetable for producing projected results? Finally, do management

and the organization they oversee have the right talents, capabilities and sufficient resources to reliably deliver the required results?

If the answer to any of those questions is no or maybe, the portfolio team needs to candidly address the shortcomings to ensure the company can come charging out of the gates with everyone pulling in the right direction from day one. Ignoring potential problems or letting them fester can fatally compromise a value-creation plan. Bain's experience working with portfolio teams and operating managers around the world has confirmed that companies that fail to hit their first-year targets rarely capture the mojo needed to hit ambitious growth targets.

**Retool the firm with a repeatable model for success.** PE firms have long recognized the importance of adding value to their portfolio companies, but few have yet to organize themselves around a consistent approach for doing it. Markets and competitive dynamics may have fundamentally changed in recent years, yet many PE firms retain the “cottage industry” practices from the industry's early years, when individual deal makers took complete responsibility for all decisions related to portfolio companies from deal close to exit.

This “cradle to grave” mind-set on the part of the deal partner—often a senior managing director or even one of the firm's founders—remains important for providing valuable experience, continuity and a unified perspective to the needs of each asset. But the best investors are bottling that genius and sprinkling it generously around their firm by building institutional capabilities and processes to give their senior deal makers the support they need to bring out the full potential of the companies with which they work.


What are leading PE firms doing to institutionalize repeatable success? First, they are recruiting top talent beyond the financial wizards that have traditionally populated their managing director ranks. They are adding seasoned operating executives and former management consultants, who bring not only a trained eye to uncover and implement value-creation opportunities but also the experience of working with company management teams to achieve transformational change.

Second, they are broadening the role of their investment committees beyond giving a thumbs up or down on the decision to acquire. Among their expanded responsibilities, they must explicitly sign off on an overall value-creation plan and specific first-year initiatives for a newly acquired company at the time of investment. Endowing the people who decide on investments with oversight of the value-creation process puts the weight of the entire firm behind a bias for portfolio activism.

Third, to ensure that they are able to take the right consultative role with portfolio company management teams, the leaders are refining value-creation processes and beefing up the resources available to back them up. The precise form these take will differ from firm to firm depending on its size, sector focus and distinctive investment style, but what the top firms have in common is a focus on identifying the two or three highest-priority value-creation measures rather than small-bore improvements. To support management teams in the execution of their growth agendas, they enlist internal and external experts with functional expertise in such areas as pricing strategy or boosting sales force effectiveness.

Finally, an idea that is gaining momentum among some forward-looking firms is to make portfolio committees a formal part of their governance model. These entities actively monitor the progress of each investment on a

quarterly basis, identifying which ones may need hands-on intervention, which may require a refresh of their full-potential plan and which may be near-term candidates for exit.

The need for PE firms to shift their focus and energies to value creation arises at a major moment of transition for the industry, as the generation of pioneers who shaped PE's early decades reaches retirement age. What characterized the approach these great investors brought to the table was a remarkable ability to earn market-beating results for their firms by nimbly adapting to changing conditions. The test for the firms they created—and for the new generations of GPs who will succeed them—will be whether they can prove as adaptable by marshaling the resources of their firms to collectively earn superlative returns that no individual can earn on his own any longer. 

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