

# Global Private Equity Report 2010

BAIN & COMPANY





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## Taking stock of private equity

Dear Colleague,

Welcome to Bain & Company's first private equity report. Bain is the global leader consulting to all players related to private equity. Addressing areas such as private equity firm strategy and operations, deal generation, due diligence and post-close portfolio company value creation, Bain has led the industry for more than 25 years working with the world's most sophisticated investors. Combining world-class capabilities with dynamic industry expertise, our unique business model delivers customized insights to more private equity investors than any other firm in the world. We estimate that Bain has advised on half of all buyout transactions valued at more than \$500 million over the past decade. We work with funds ranging in size from \$150 million to more than \$20 billion in all geographic regions. Bain partners also align their incentives with their clients', having invested alongside them in scores of individual deals at time of close. We put our money where our mouth is, and that's the way our clients like it.

In the following pages, you will find several integrated topics that describe what is happening today in the world of private equity, with a particular focus on buyouts. We begin with a brief review of 2009—examining what happened and, equally important, explaining what didn't. From there, we quickly shift to assess the environment the global private equity industry faces in 2010, and what opportunities and headwinds the industry will encounter during the next 12 months and beyond. We make no claims to be seers; our crystal ball is as cloudy as yours in many respects. We do bring the facts to the table in classic Bain fashion and integrate them with our decades of expertise working in the private equity space to characterize the environment all firms must navigate—not just to survive, but to thrive.

We conclude by offering some insights into what leading-edge private equity investors will be doing better and differently in 2010. It's often said that where you stand depends upon where you sit. If nothing else, it is quite clear that almost all private equity firms sit in different places today than they did five years ago. The processes, organizations and rules of the past may no longer apply to building a successful investment business for the future.

We hope you enjoy Bain's private equity report. We look forward to having you join us and many hundreds of private equity stakeholders around the world in a continued dialogue on these and other topics.



Hugh H. MacArthur  
Head of Global Private Equity



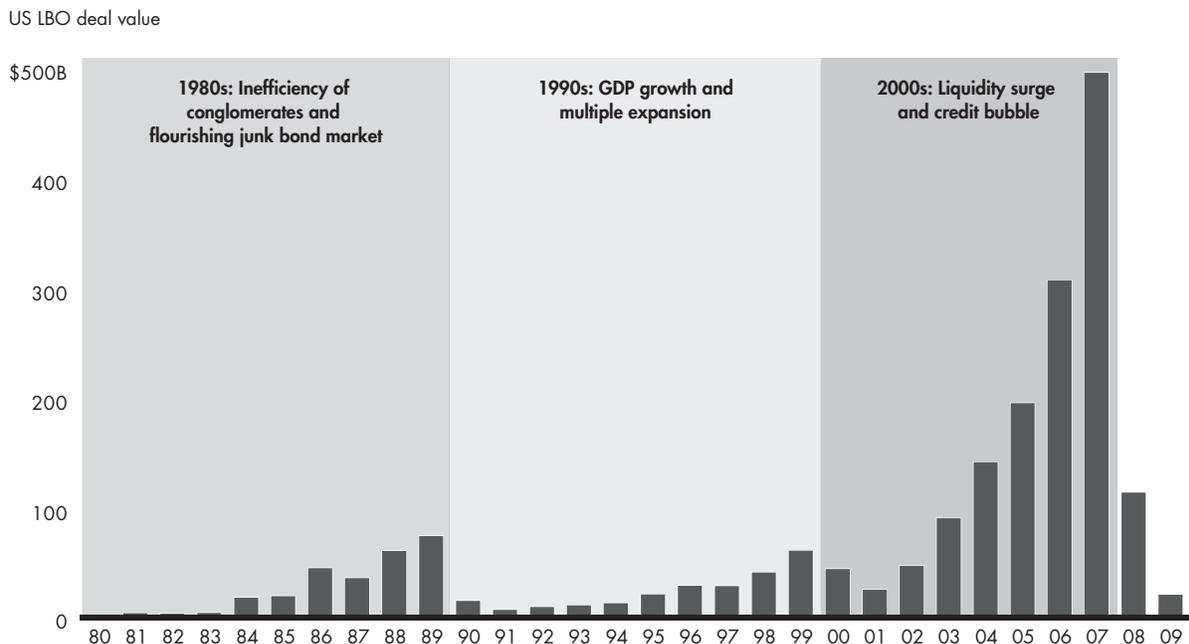
# 1. Introduction: A turn in the cycle for a cyclical industry

From private equity’s heyday a few years ago when deal makers were riding high, to the gut-wrenching drop in deal making through last year’s recession, this industry knows what it’s like to ride the roller coaster. PE has always been a cyclical industry, and signs of a nascent rebound in 2010 underscore that fact (see Figure 1.1).

Since it emerged as a major asset class in the 1980s, PE has experienced three major booms. Each time, the expansion was a direct result of the industry’s resourcefulness, adaptability and capacity for innovation in the face of fast-changing market realities. Each upswing ended in precipitous downturns before PE firms rallied around new growth themes.

In the 1980s, the PE industry capitalized on the sale of many poorly run public companies and corporate divestitures available at low cost and largely financed with junk bonds. That expansion ended abruptly with the collapse of the high-yield bond market, the savings-and-loan crisis that crippled consumer confidence and the 1990–91 recession. The bond market was slow to recover, as spreads on high-yield debt increased and the mandated withdrawal of savings and loans from the high-yield market created a glut of low-priced assets that froze new bond issuance. PE activity remained in hibernation for nearly five years.

**Figure 1.1:** Private equity is a cyclical business



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

During the 1990s, debt financing played a less prominent role. PE industry returns were driven mainly by gross domestic product (GDP) growth and expanding price-to-earnings multiples during the long economic expansion. PE firms went on to raise ever-deeper pools of capital to finance larger deals at more aggressive valuations. Frothy markets for mergers and acquisitions and initial public offerings locked in big gains for PE investors. This time, the boom ended when the technology bubble burst and debt markets tightened, followed by the relatively short and shallow recession of 2001. But PE was quick to recover: By 2003, deal activity exceeded the pre-recession peak.

Over the past decade, PE rode a credit bubble inflated by low interest rates to record deal values. A global liquidity surge from investors hungry for returns fueled PE's "golden era." Leveraged lending grew larger and more complex than ever before, and investor demand for structured finance vehicles such as collateralized loan obligations (CLOs) powered the market for leveraged loans to new heights. Favorable debt-market and fund-raising conditions provided the capital to finance multibillion-dollar buyouts. That boom, of course, came to an abrupt end with the mortgage-led debt crisis that froze credit markets in 2008 and triggered a global recession affecting nearly every industry.

### **Charting a new course**

What new direction will the industry take this time around? Deal making is beginning to recover, but critical credit markets remain an uncertain source of leveraged lending. Fund-raising is struggling to revive from a state of suspended animation, while investors wrestle with over-allocation to PE and liquidity problems. Impatient with high fees and feeling that their interests are misaligned with those of PE fund managers, limited partners (LPs) are exercising newfound power. And PE fund returns are languishing in negative territory, hit by tumbling valuations on investments made at the cyclical peak. This report, Bain & Company's update on issues and trends facing the PE industry in 2010 and beyond, will explain how the downturn rearranged established rules, reset expectations and planted the seeds of PE's next phase. In it, we draw on Bain's research and long experience in the industry, data culled from the most reliable industry sources and extensive interviews with LPs to take the pulse of the industry's new direction.

## 2. The PE market in 2009: What happened

PE firms entered 2010 as the grip of the industry’s most severe downturn in more than a decade was beginning to loosen. By every indicator—from investment activity to exit level, and from new fund-raising volume to fund returns—the PE market in 2009 approached or hit deep lows from its 2007 peak.

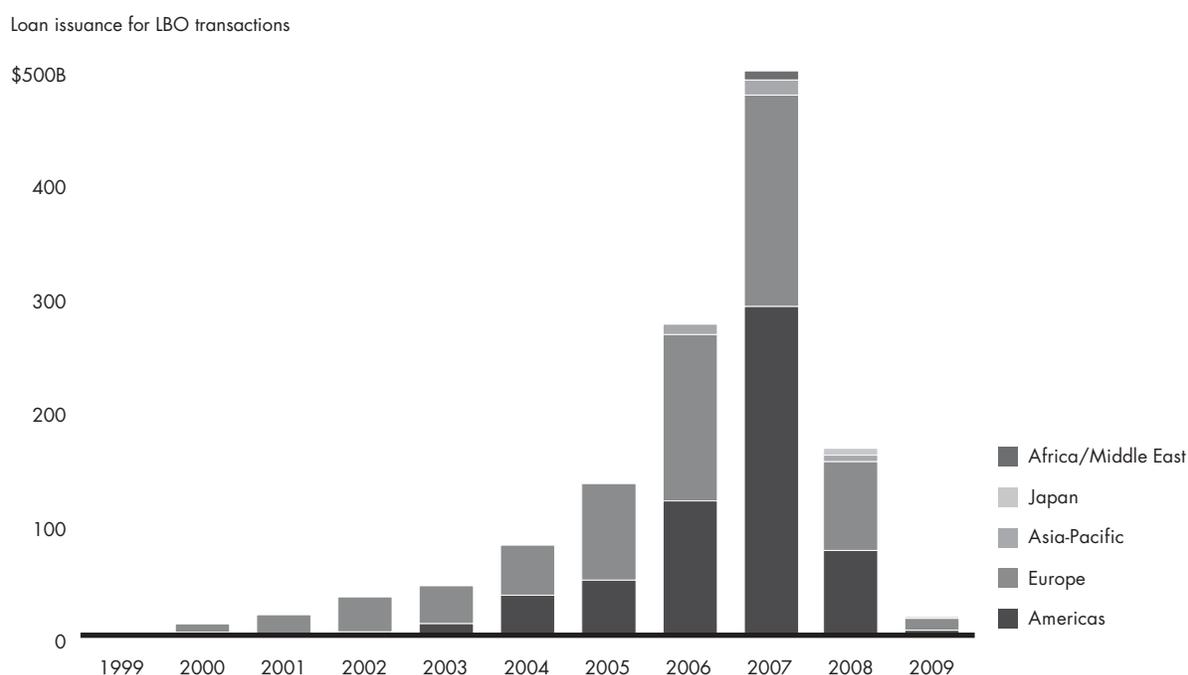
Let’s begin by reviewing how conditions affecting PE played out in 2009, exploring the impact they had on industry activity, and putting the past tumultuous year in context.

### A massive falloff in deal activity

The headline event for PE in 2009—as for so much of the world’s economy—was the global credit crisis and the chilling effect it had on the number, size and types of PE deals concluded. The most immediate impact of tightening credit markets since the summer of 2007 was to cut off the financial fuel that powered leveraged lending—particularly in North America and Europe, where credit markets were hit hardest.

The impact on PE’s access to leverage was quick and dramatic. Following a steep increase from virtually nothing in 1999, global loan issuances for leveraged buyout (LBO) transactions swiftly climbed to nearly \$500 billion at the business cycle peak in 2007. But by 2009, total loans extended virtually disappeared, falling to less than \$20 billion at year’s end. Loan issuance suffered from banks’ reduced appetite for risk, anemic institutional investor interest and a dearth of CLO activity. Only a handful of quality LBOs were able to tap the leveraged loan market in 2009 (see Figure 2.1).

**Figure 2.1: Financing for LBOs evaporated**



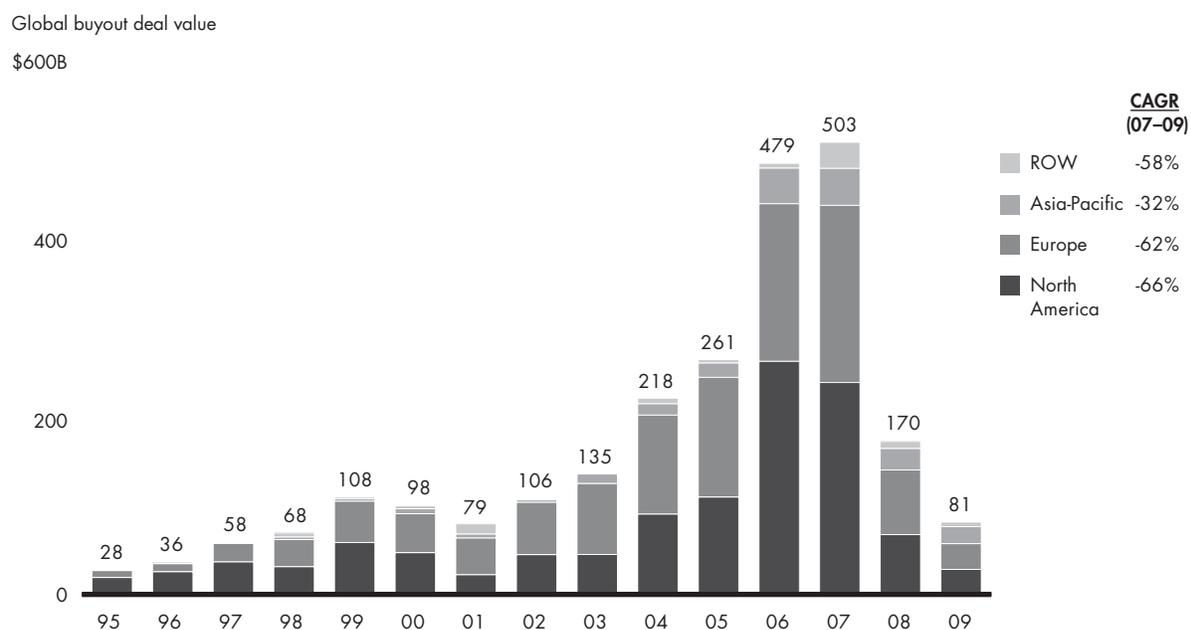
Source: Thomson Reuters

With credit scarce, the LBO deals struck in 2009 were structured with modest amounts of debt, well below peak levels. In the US, the average amount of debt dropped to 3.8 times earnings before interest, taxes, depreciation and amortization (EBITDA), from five times EBITDA in 2008 and from the record six times EBITDA in 2007, according to Standard & Poor’s Leveraged Commentary and Data. But total purchase multiples declined more modestly to 7.7 times in 2009, from 9.7 times at the peak in 2007. Thus, LBO deals required far bigger infusions of equity—52 percent of the total purchase price on average in 2009, up from 33 percent in 2007 and the highest level since at least 1997. In Europe, too, the average debt multiple dropped to 4.1 times EBITDA, from a peak of 6.1 times in 2007. The average equity contribution increased from a low of 34 percent in 2007 to 56 percent last year.

Equally dramatic was the impact on PE’s cost of debt: Heading into 2009, the spread on term loans and revolving credit had more than doubled from mid-decade levels. In the first half of 2009, the average spread on US LBO loans reached 650 basis points (BPS) above the London Interbank Offered Rate (LIBOR), before declining to the 500 basis-point range in the final quarter of the year.

A direct consequence of the scarcity and higher cost of debt was a massive falloff of buyout deal activity—some \$500 billion worth of deals (with disclosed values) annually during the cyclical peak in 2006 and 2007 to just \$81 billion worldwide in 2009, according to Thomson Reuters. The decline brought buyout activity to its lowest level since 2001, when the industry was just a fraction of its current size. The precipitous drop in deal value was most dramatic in PE’s traditionally strong North American and European markets, where activity plunged at a compound annual rate of 66 percent and 62 percent, respectively, from 2007 peak levels. But the contraction was felt in every region, including the fast-growing Asia-Pacific markets where deal value decreased at a rate of 32 percent (see Figure 2.2).

**Figure 2.2: Global buyout deal activity sank; all regions suffered**



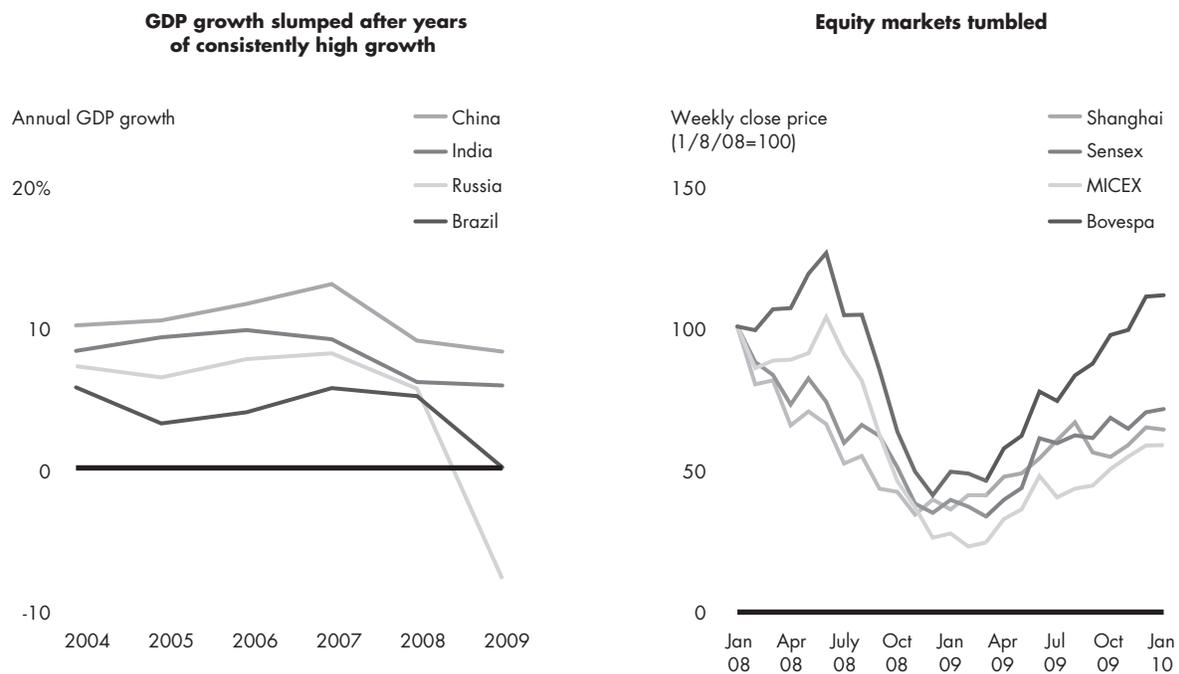
Notes: Includes activity by buyout funds and their majority-owned portfolio companies; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on the location of targets  
Source: Thomson Reuters

**Different regions, different dynamics:** The dynamics underlying the decline differed by region. In the developed markets of North America and Europe, the credit crisis severely crimped buyers' ability to finance transactions. Also, with economies in a slump of unknowable depth and severity, buyers in the mature markets were reluctant to trust their valuation models at a time tinged with so much cyclical uncertainty.

A somewhat different—but from the perspective of PE deal making, no less chilling—dynamic was at work in the major emerging markets last year. After years of consistently high growth, GDP growth slumped in China, India, Russia and Brazil into 2009, casting a shadow on prospects for corporate growth. Equity markets in those countries also fell sharply; and with the exception of Brazil, they remained well off their pre-downturn peaks at year's end. Nevertheless, entrepreneurs in the fast-growing emerging economies were accustomed to uninterrupted business expansion and still skeptical about accepting PE investments. They were even more unwilling to take on PE partners, particularly as notions of value differed dramatically. For their part, PE buyers were unwilling to ante up the premiums sellers demanded. This mismatch between buyers and sellers held PE transactions in check (see Figure 2.3).

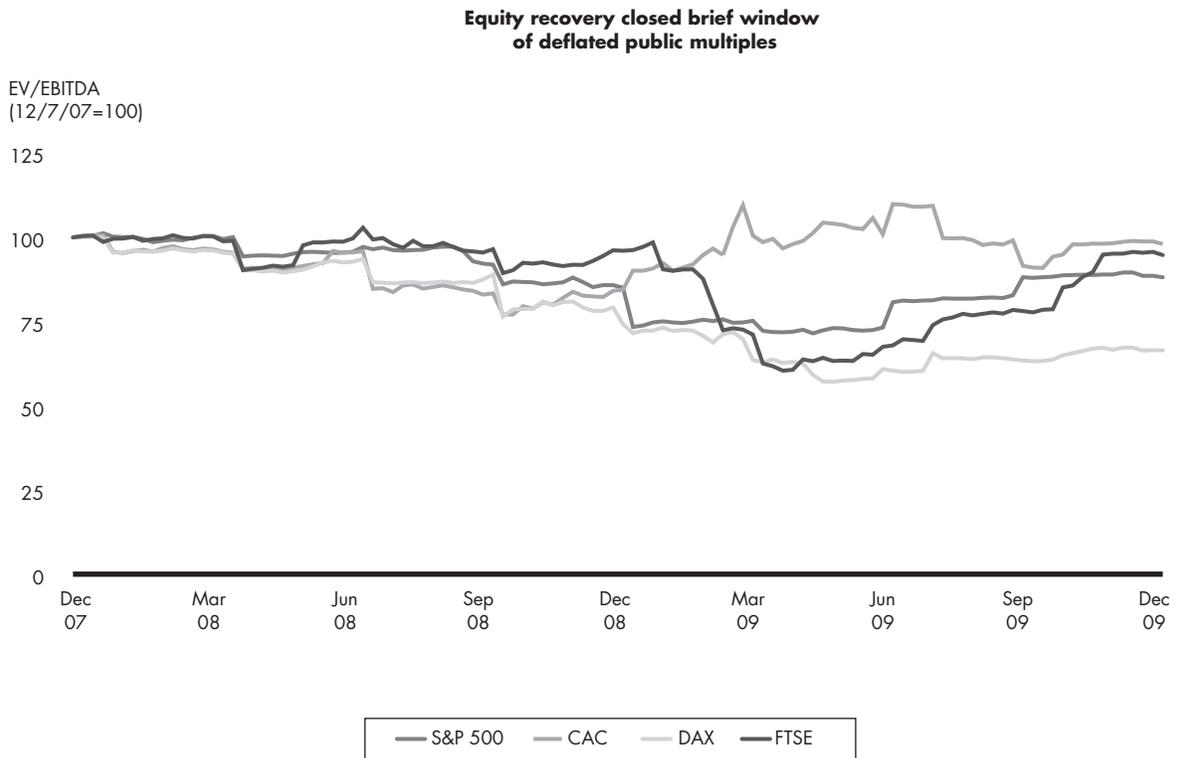
**Rebounding equity markets, sticky deal valuations:** As the global economy began to stabilize in the second quarter of 2009, PE deal making was hampered by a new constraint in both the developed and emerging economies. Major equity market indexes around the world, which had fallen steeply through early 2009, began strong recoveries that lasted through the balance of the year. The quick drop-off in equity prices and their equally rapid rebound within the space of just a few months did not allow valuation multiples, the basis on which PE buyers calculate what they are willing to pay for an acquisition, sufficient time to reset. (Seller price expectations are always stickiest on the way down.) By mid-2009, the brief window when potential targets of PE interest began to look less expensive (as measured by the ratio of enterprise value to EBITDA) started to close. EBITDA multiples on almost all major exchanges recovered to near their 2007 highs by year's end (see Figure 2.4).

**Figure 2.3: Massive dislocation of value across the emerging markets**



Sources: Bloomberg; Economist Intelligence Unit

**Figure 2.4:** Rapid decline and rebound of equity markets



Source: Bloomberg

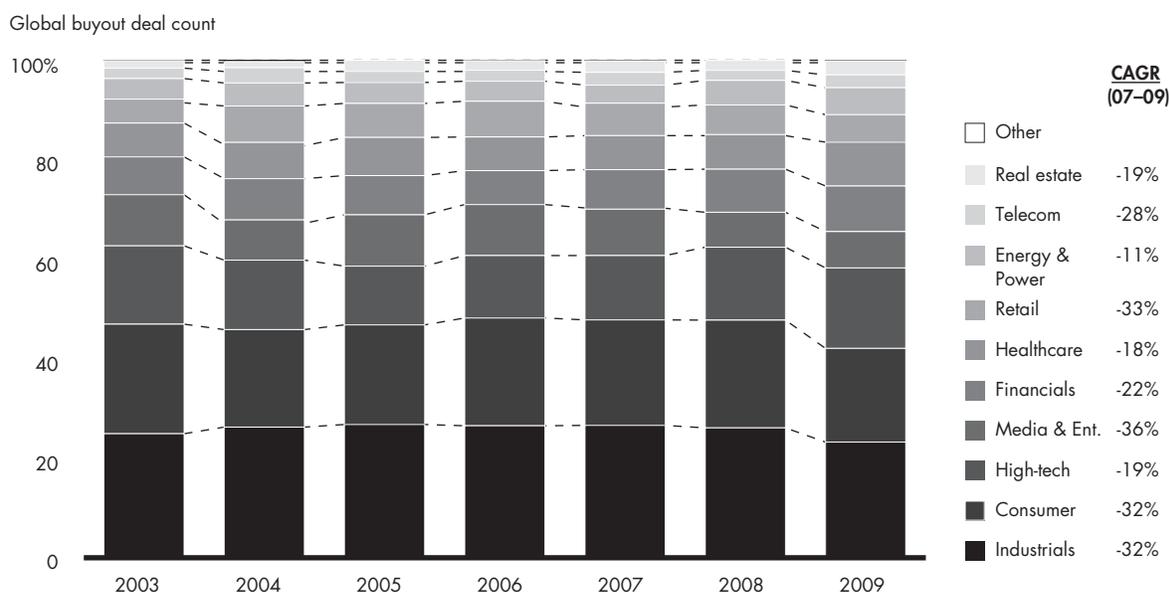
The net result was that confusion about growth prospects, reduced levels of more expensive debt and the valuations gap between buyers and sellers made it very hard to complete deals. At the outset of the crisis, many PE industry insiders were counting on opportunities for mid-market buyouts, growth-equity investments and deals in China and India (which are much less reliant on debt) to provide reasonable deal flow and carry them through the downturn. However, those areas provided much less activity than hoped for. Both buyers and sellers stayed on the sidelines.

The contraction in deal activity was felt across all industry sectors. Reflecting the broader business cycle downturn, buyout deal count dropped most in the industrial goods and services sector, consumer products, media and entertainment, and retail. But activity in sectors less sensitive to business cycle gyrations—for instance, healthcare, and energy and power—also fared poorly (see Figure 2.5).

**New directions in deal making as deal values drop:** The past year marked an end to the blockbuster transactions that dominated headlines between 2005 and 2008. Buyout deals valued at \$10 billion or more accounted for nearly one-quarter of the total value of buyout transactions at the peak in 2006, but last year there was no deal that large. The total value of deals priced between \$1 billion and \$10 billion tumbled at a compound annual rate of 64 percent between the 2007 peak and 2009. Even mid-market and smaller deals, which many investors anticipated would fill the gap, were hit hard (see Figure 2.6).

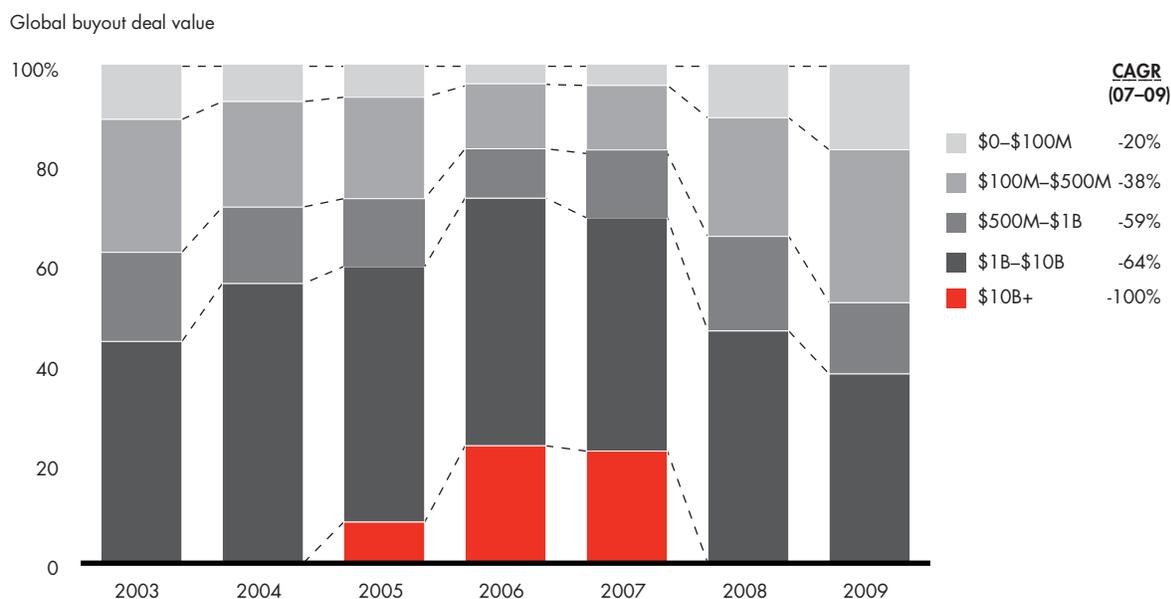
In parallel with the shift to smaller deals was a rotation in the types of investments PE firms made. In the US, the once dominant trend that saw PE buyers convert public companies into private businesses reversed as the proportion of public-to-private deals declined to its lowest level in more than five years. In Europe, the proportion of public-to-private deals did not increase as substantially as in the US during the 2006 and

**Figure 2.5: Deal activity was down across all sectors**



Notes: Includes activity by buyout funds and their majority-owned portfolio companies; based on announcement date; includes announced deals that are completed or pending, with data subject to change  
Source: Thomson Reuters

**Figure 2.6: The size of deals shrank dramatically**



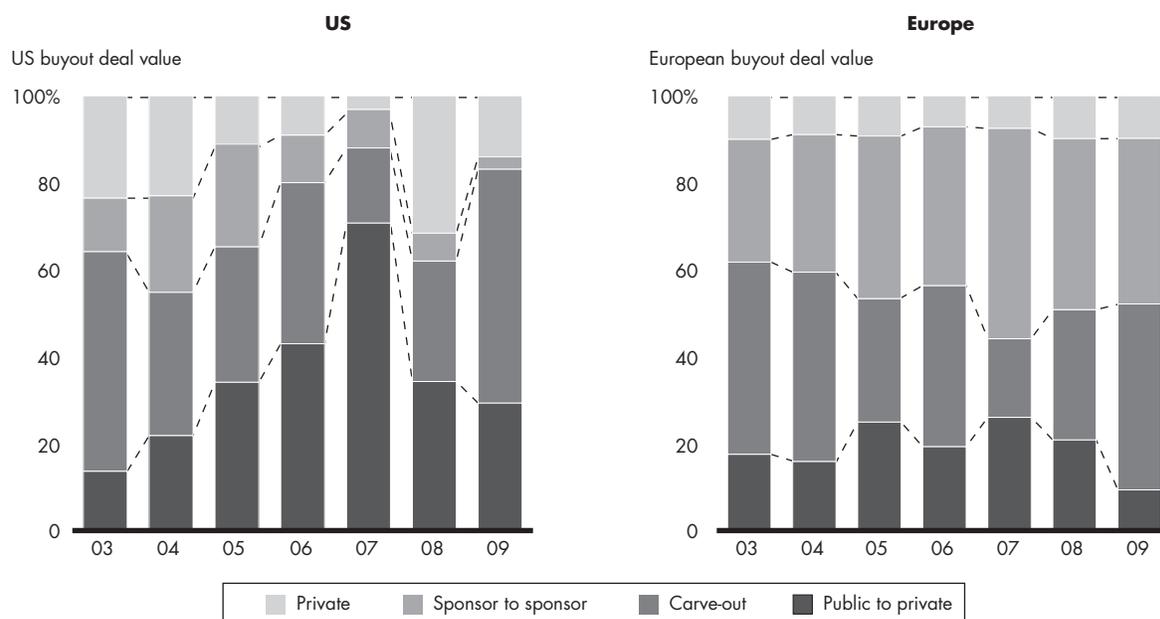
Notes: Includes activity by buyout funds and their majority-owned portfolio companies; based on announcement date; includes announced deals that are completed or pending, with data subject to change  
 Source: Thomson Reuters

2007 boom years. Nonetheless, public-to-private deals declined to a seven-year low in European markets during 2009. Also decreasing as a percentage of total deal value were sponsor-to-sponsor transactions, hurt by tight credit and high borrowing costs. Though sponsor-to-sponsor deals still accounted for some 30 percent of total buyout value in the EU (due mainly to a handful of large deals motivated by debt issues), they all but dried up in the US (see Figure 2.7).

As PE firms readjusted their investment focus to the opportunities 2009 presented, they came to favor five types of deals. PE funds flowed into *carve-outs*, sales of non-core assets by cash-strapped parent companies. Carve-outs garnered the lion’s share of deal value both in the US and Europe in 2009, just as they had earlier in the past decade. As suppliers of *growth equity*, PE investors supplied healthy companies that had limited access to public markets with capital needed to finance their expansion. As providers of *acquisition finance*, PE funds invested alongside strategic buyers looking to fund mergers and acquisitions—chiefly through minority-stake investments. PE investors also provided capital to finance add-on acquisitions for their portfolio companies. Through *balance-sheet restructurings*, PE firms made structured equity investments to reduce debt or to buy out equity positions. Finally, *debt* and *distressed debt* investments offered PE investors opportunities to buy the debt of their own portfolio companies or to trade in troubled loans, potentially enabling PE investors to convert debt positions they acquired into ownership stakes.

The shift in PE investor deal-making preferences shows up in the composition of 2009’s 10 largest transactions. While the \$5.1 billion leveraged buyout of IMS Health by TPG and Canada Pension Plan topped the list as a conventional public-to-private conversion, carve-outs accounted for five of the remaining nine deals. In Europe, CVC Capital Partners added to its portfolio the Central and Eastern European subsidiary spun off

**Figure 2.7: Public-to-private and sponsor-to-sponsor deals gave way to carve-outs and private buyouts**



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

from AB InBev, the global brewing company, paying more than \$2 billion for the acquisition. Meanwhile, the big US-based buyout firms KKR, Blackstone and Silver Lake each added a carve-out to their holdings (see Figure 2.8).

### A pause in fund-raising

PE’s popularity with investors is reflected in the increasing flows of capital they have entrusted to PE fund managers over the past five years. Indeed, the \$1.8 trillion PE funds raised globally between 2006 and 2008 alone exceeded the total funds the industry attracted over the entire previous decade. That run came to an abrupt halt in 2009, when new funds raised worldwide tumbled to just \$248 billion—less than 40 percent of what the industry brought in during 2008. Fund-raising declined across all major asset classes. Funds focused on buyouts and real estate, the industry’s two largest investment categories, saw the biggest declines (see Figure 2.9).

Fund-raising was weak in every region. New funds also took longer to close, stretching out to an average of 18.4 months from just 12 months in 2007, and only 9.5 months as the industry emerged from the last downturn in 2004, according to research firm Preqin. With funds taking longer to close, many firms scaled back new fund-raising efforts or abandoned them entirely. In the 18 months leading up to the end of 2009, firms gave up on efforts to raise 92 funds targeting \$48 billion in capital.

Fund-raising weakness was not uniform across the industry. Performance and pedigree continued to draw investor interest. For instance, some of the biggest firms in the EU and North America, such as CVC Capital

Figure 2.8: Top 10 buyout deals announced in 2009

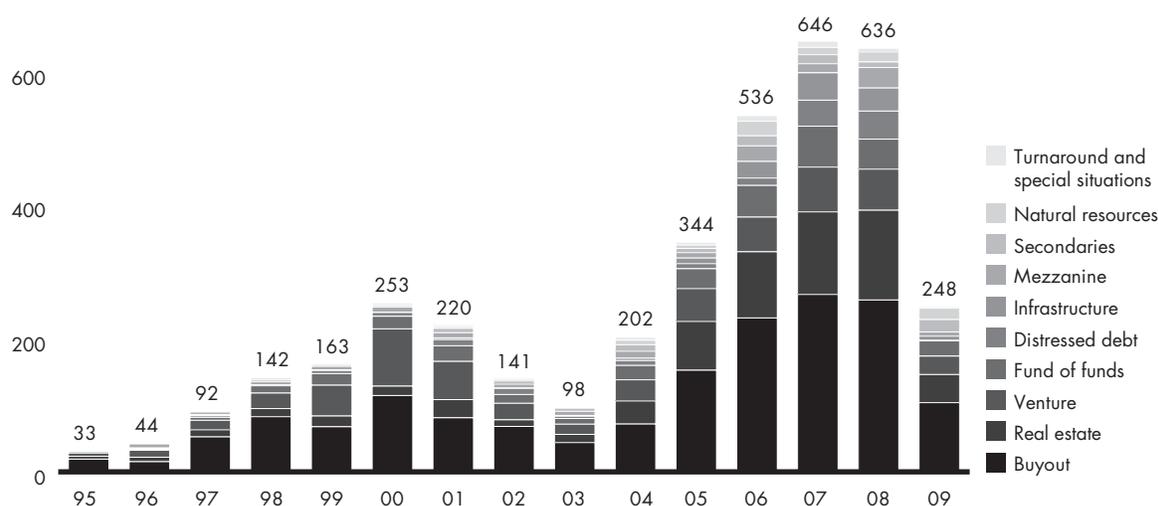
Target	Acquirer(s)	Target industry	Deal size	EV/EBITDA	Debt financing	Deal type
IMS Health	TPG, Canada Pension Plan	Healthcare providers and services	\$5.1B	10.4X	\$3.3B (65%)	Public to private
Springer Science	EQT, GIC Singapore	Publishing	\$3.4B	8.2X	\$2.5B (74%)	Sponsor to sponsor
Busch Entertainment	Blackstone	Recreation & Leisure	\$2.7B	7X	\$1.6B (59%)	Carve-out
AB InBev CEE (Central Europe)	CVC	Food & Beverage	\$2.2B <sup>1</sup>	8X <sup>2</sup>	\$1B (45%)	Carve-out
Skype	Silver Lake, Andreessen	Telecom services	\$2.0B	12X <sup>3</sup>	Undisclosed	Carve-out
Oriental Brewery	KKR	Food & Beverage	\$1.8B	8–9X <sup>4</sup>	\$1B (56%)	Carve-out
TASC	KKR, General Atlantic	IT consulting and services	\$1.7B	5X	\$850M (50%)	Carve-out
Bird's Eye Foods	Blackstone	Food & Beverage	\$1.3B	9.2X	\$1B (77%)	Sponsor to sponsor/add-on
Bellsystem24	Bain Capital	Business services	\$1.3B	5.9X	\$880M (66%)	Sponsor to sponsor
Wood Mackenzie	Charterhouse	Research and consulting services	\$0.9B	14.6X	\$405M (45%)	Sponsor to sponsor

Notes: <sup>1</sup>Potential for additional \$800M future payment contingent on CVC Funds' return on initial investment; <sup>2</sup>not including \$800M contingent payment (if included, would imply 10.8X multiple); <sup>3</sup>based on 2009 estimated earnings; <sup>4</sup>rumored to be between 8X and 9X EBITDA  
Sources: Thomson Reuters; Capital IQ; literature search

Figure 2.9: Fund-raising fell off sharply

Global PE capital raised

\$800B



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

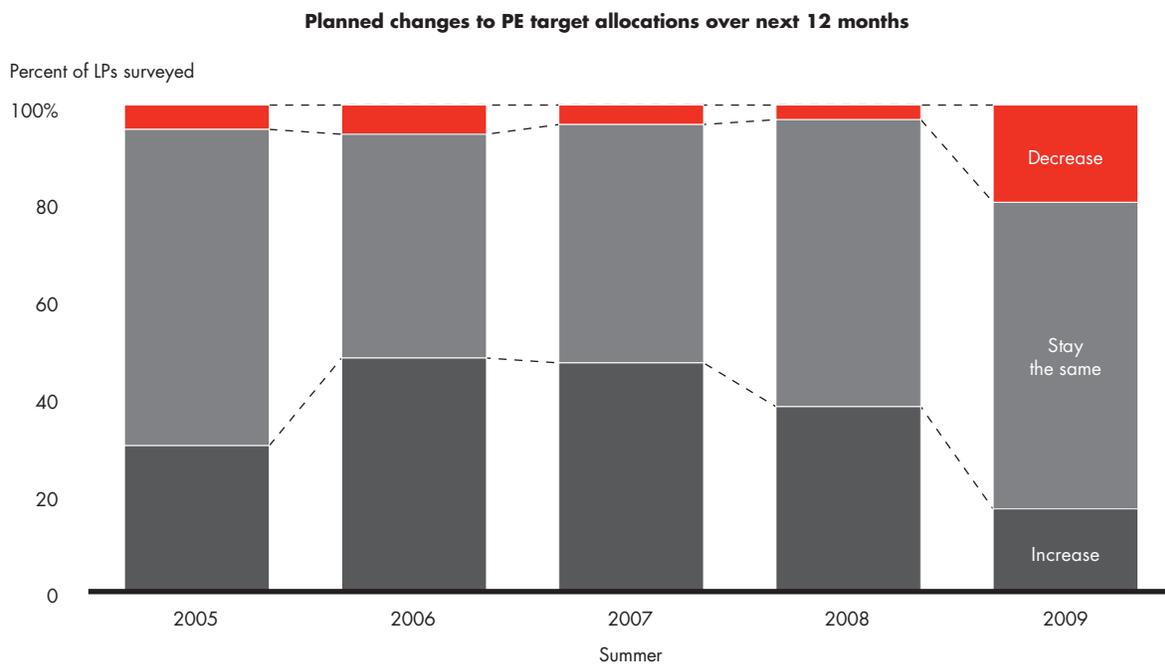
Partners, Charterhouse Group and KKR in Europe and First Reserve, Hellman & Friedman and Clayton Dubilier & Rice in the US, managed to raise larger funds in 2009 than in their previous vintage.

**Committed but constrained LPs:** The slowdown in fund-raising did not reflect a major diminution of interest on the part of LPs in PE as an asset class. Indeed, annual surveys of LPs’ intentions reveal that, at midyear 2009, 80 percent of LPs indicated their target allocation to PE would remain the same or increase during the next 12 months. Just 20 percent of those surveyed said they would decrease their commitment to PE, up from pre-crisis levels of about 5 percent (see Figure 2.10).

Notwithstanding LPs’ continued interest in PE, their ability to act on it was impaired by the so-called denominator effect, causing more and more LPs to bump up against—or exceed—their target allocations for PE. With public equity and fixed-income markets falling throughout 2008 and into the first quarter of 2009, LPs saw the value of publicly traded assets in their portfolios drop immediately and dramatically. Yet, most PE firms did not begin to revalue the illiquid assets in their portfolios using new “fair-value” (or “mark-to-market”) accounting rules until the last quarter of 2008. As result, the value of LPs’ PE holdings as a proportion of their total holdings rose. And, because there is typically a one-quarter lag in reporting, LPs did not get relief from this situation until after the first quarter of 2009. As public equities and fixed income subsequently rebounded and GPs marked down their portfolios, the denominator effect moderated substantially for LPs during the second half of 2009 (see Figure 2.11).

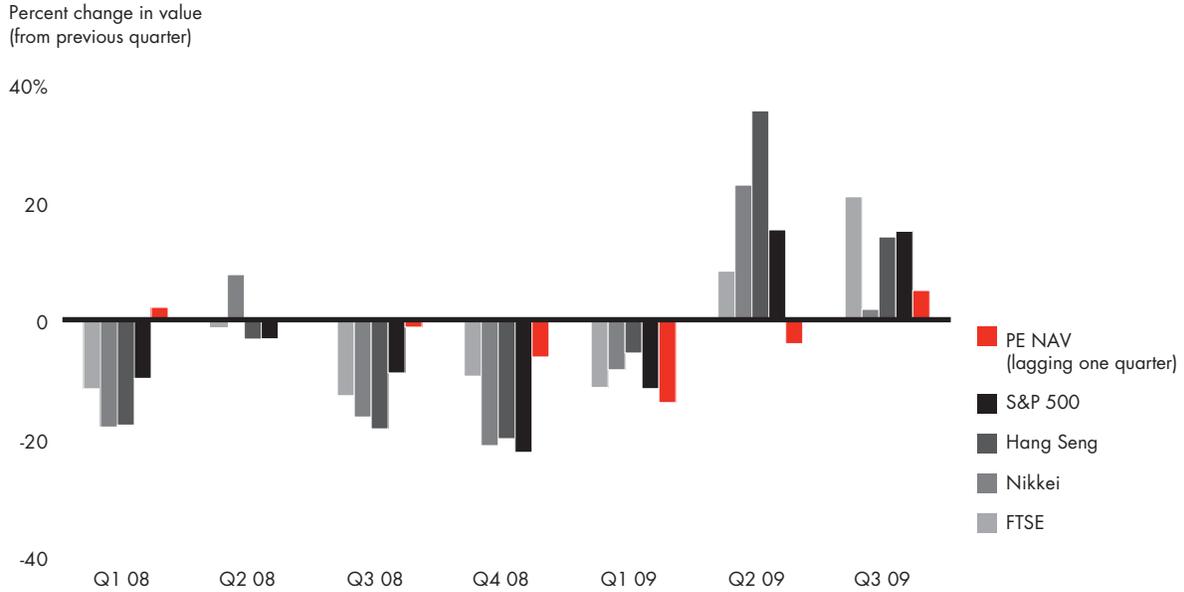
Through the first half of 2009, fewer and fewer LPs had headroom in their PE target allocations to steer capital to new rounds of fund-raising. A survey conducted by Prequin last August found that two-thirds of LPs were at or above their target PE allocations compared with about one-third in the fall of 2007 (see Figure 2.12).

**Figure 2.10:** LPs remained committed to PE through the downturn



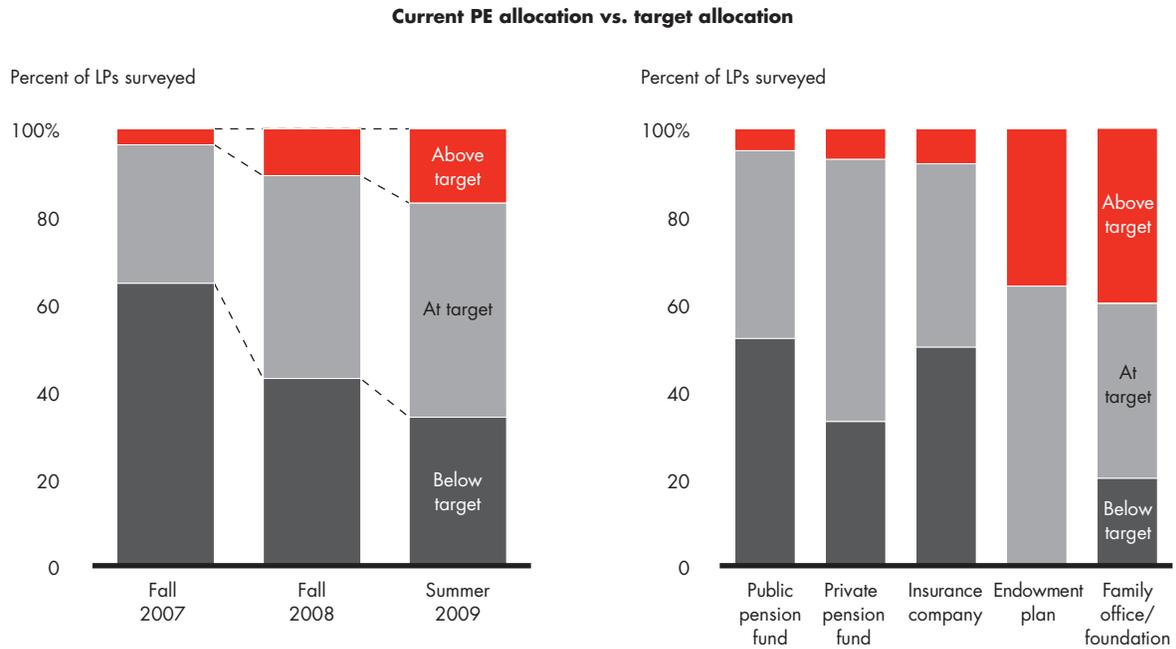
Source: Collier Capital Global Private Equity Barometer (summer 2009)

**Figure 2.11: PE revaluations lagged the sharp fall in public securities**



Notes: PE includes all fund types and represents weighted NAV; assumes a one-quarter lag in PE reporting revised valuations to LPs (for instance, change in PE NAV in Q1 09 on chart reflects actual change in NAV for Q4 08)  
Sources: Preqin; Bloomberg; Bain analysis

**Figure 2.12: The denominator effect reduced LPs' headroom in their PE allocation**



Source: Preqin (Private Equity Investor Survey, August 2009)

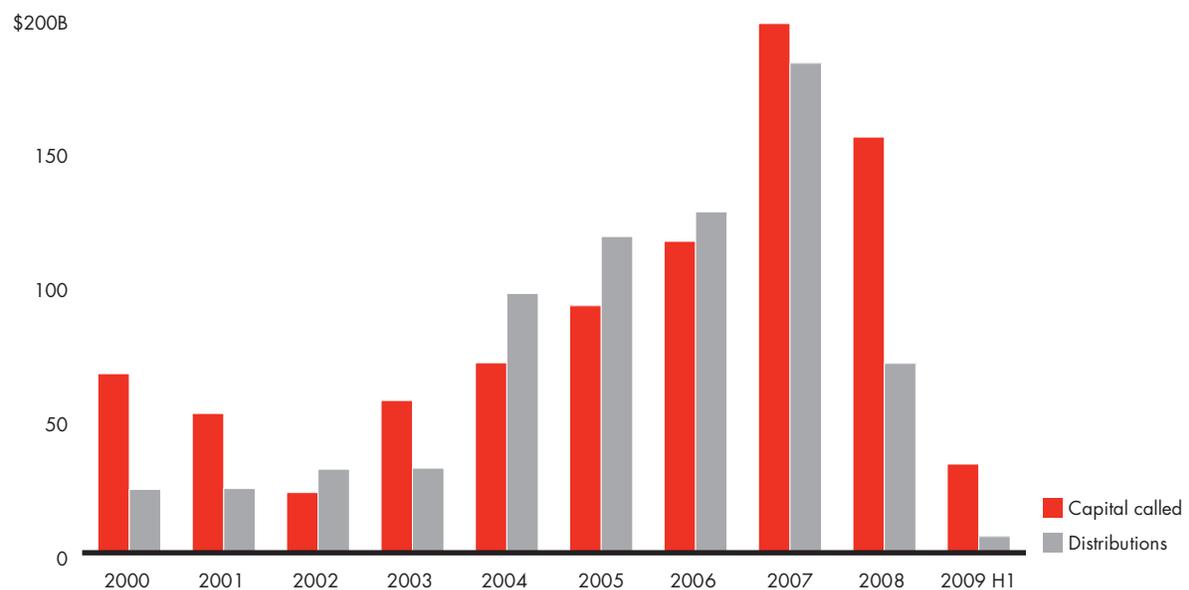
Some types of LPs were affected more than others. About 50 percent of public pension funds and insurance companies were at or above their target PE allocations. On the other hand, nearly two-thirds of private pension fund investors, 80 percent of family office or foundation investors, and all endowment plans were at or above their target PE allocations.

LPs' ability to ante up for new fund-raising was also constrained by a tightening liquidity squeeze. Declines in the value of liquid investments put pressure on cash reserves. A cash-flow imbalance between PE capital calls and distributions further contributed to the squeeze. This reduction in cash flow particularly affected LPs that fund their capital calls with distributions (see Figure 2.13).

Some PE firms responded proactively to LPs' allocation and liquidity challenges by easing up on fund commitments and terms. For example, Bain Capital offered LPs the opportunity to reduce their pledges to a \$1.8 billion co-investment fund by up to 50 percent. Permira gave LPs the flexibility to reduce their commitments to its fourth €11.1 billion buyout fund by 40 percent. Other PE firms reduced or refunded management fees, increased sharing of transaction fees or cut the carry rate on their most recent funds. For example, TA Associates cut the carried interest on its latest fund, TA XI, from 25 percent to 20 percent. TPG trimmed its management fees by 10 percent and also refunded \$20 million in fees paid on its \$18.8 billion flagship buyout fund. (Only a few embattled firms were forced by LPs to slash the size of their funds.)

**Figure 2.13: Capital calls exceed distributions, creating a cash-flow imbalance**

Capital called and distributed by global buyout funds



Source: Preqin

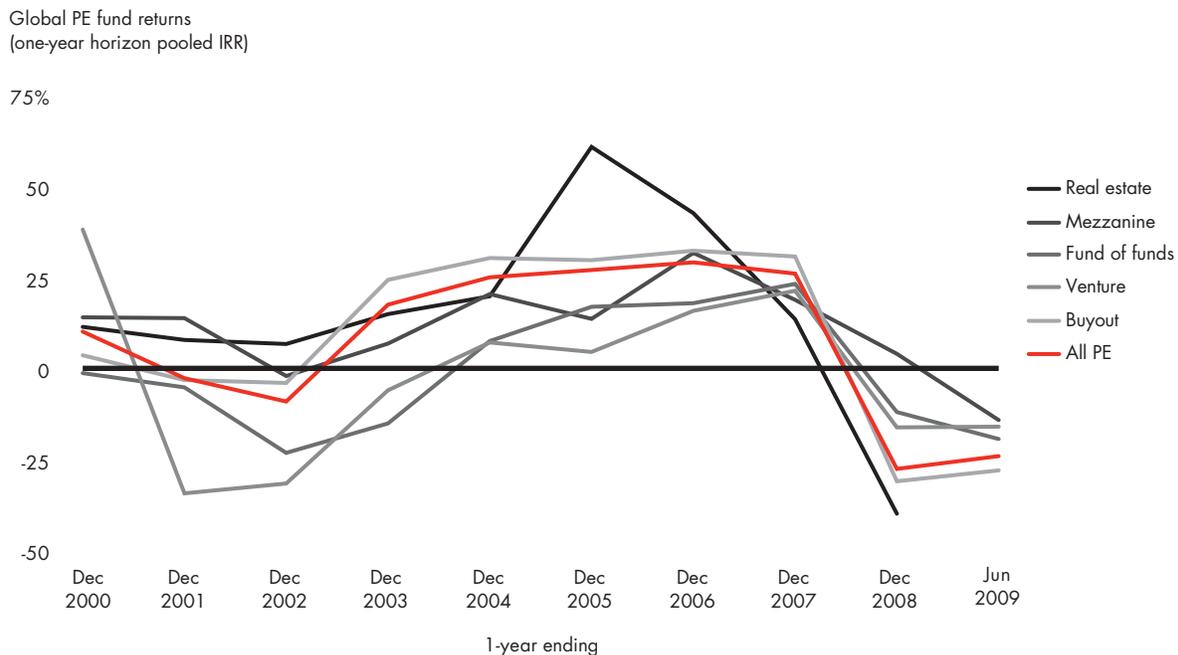
## Fund performance suffered but the asset class still demonstrated superior relative performance

PE fund returns took a major hit in the downturn. By late 2008, the one-year returns on global PE funds were in steep decline, leveling off deep in double-digit negative territory in early 2009. In contrast to the previous recession, when mezzanine funds and real estate continued to show gains, funds of every stripe generated losses. Within the buyout fund category, the larger end of the fund scale was hit hardest (see Figure 2.14).

However, it is important to understand what these big nominal declines represent. In fact, it is hard to evaluate short-term returns for illiquid assets like PE investments. There were very few exits, and therefore distributions, in the last year. As a result, the “losses” reflect markdowns in portfolio valuation PE fund managers were mandated by mark-to-market regulations to report and were not realized returns. Regardless of regulations, PE firms do not manage their portfolio businesses for quarterly earnings. When an investment is made, their objective is to create value over years, not quarters. Quarterly valuations provide a very limited snapshot of what is truly happening in an illiquid portfolio.

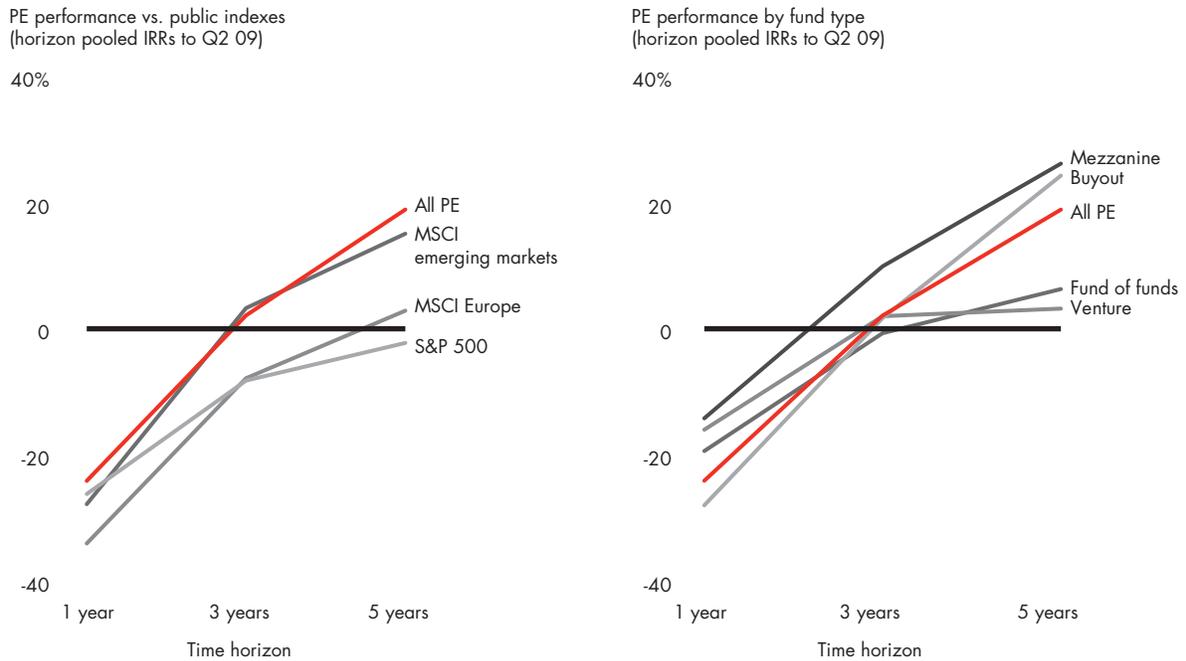
What the decline in short-term PE returns should not obscure is the fact that PE investments consistently outperformed the public equity markets, both in the short and long term. Whether over a one-, three- or five-year time horizon, the internal rates of return for all PE funds beat the performance of stock market indexes for the US, EU and emerging markets through mid-2009. (It is worth noting that this comparison is based on actual returns, not returns that are adjusted for risk or leverage. Many studies have analyzed the performance of PE funds compared with public market investments—adjusting for such factors as timing of cash flows, leverage risk, operating risk, illiquidity premium and fees. While results vary, several studies provide evidence of outperformance of the buyout asset class.) (See Figure 2.15.)

**Figure 2.14:** Short-term PE fund returns took a hit



Source: Preqin

**Figure 2.15: Compared with public equities, PE outperformed**



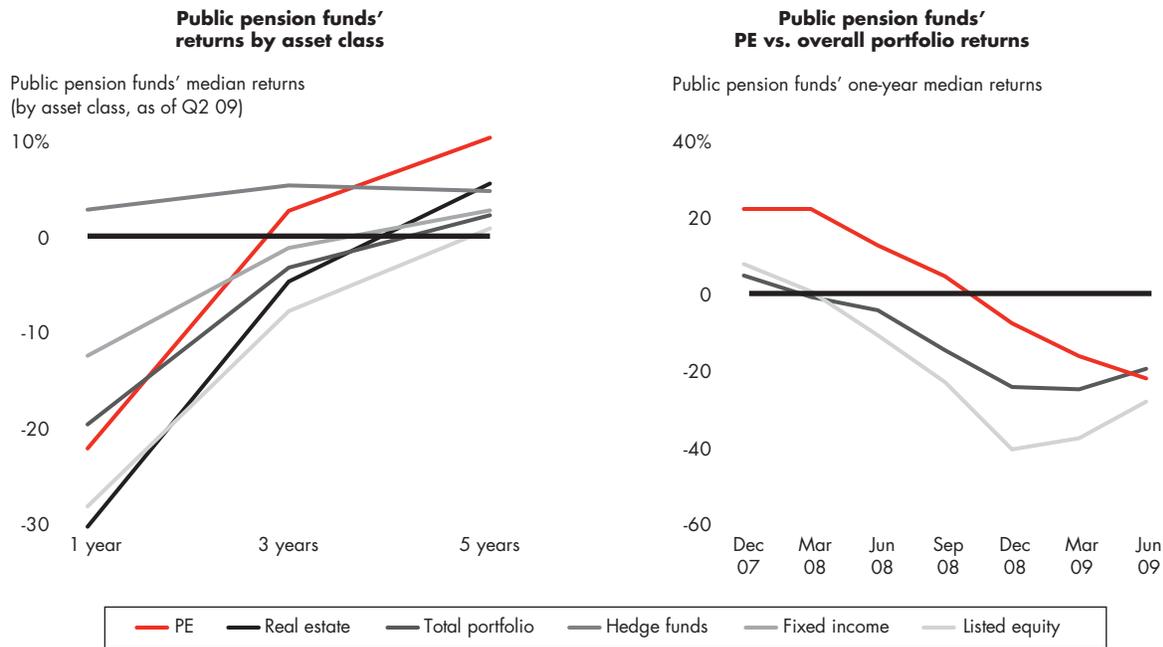
Sources: Preqin, Bloomberg

Among fund types, mezzanine and buyout funds were top performers, while fund of funds and venture capital funds underperformed PE as a whole. Nevertheless, all four fund categories showed positive returns over the three- and five-year time horizons. Indeed, over the five-year investment time horizon, PE funds as a whole posted an annual internal rate of return (IRR) of 19 percent, while returns on the S&P 500 and the MSCI Europe indexes hovered near zero.

PE’s superior performance helped shore up the portfolios of LPs. Public pension funds’ median returns on PE investments over a five-year period, for example, produced a 10 percent annual return through mid-2009, compared with 2 percent for their portfolio as a whole. Tracing one-year median returns from the onset of the recession in late 2007 reveals that PE’s fall lagged that of publicly listed equities and total portfolio performance at pension funds overall. Again, the delay reflects the lag in revaluations of PE assets and represents unrealized declines, not locked-in losses (see Figure 2.16).

**Funds keep a lid on defaults:** Looking inside PE portfolios, it appears that fund managers worked hard to avoid portfolio company collapses during the downturn. Moody’s evaluated a sample of 186 portfolio companies sponsored by 14 of the largest buyout firms. The analysis found that PE-backed companies experienced rates of default comparable to similarly rated non-PE companies between the January 2008 and September 2009 period—19.4 percent for PE-backed companies versus 18.6 percent for non-PE companies. (Here “default” includes distressed exchanges, payment defaults, restructurings and bankruptcies). However, “minor” distressed exchanges—those made for less than 15 percent of a given company’s total debt at distressed prices—accounted for 70 percent of all the distressed exchanges of PE-backed companies versus only

**Figure 2.16:** For LPs, PE outperformed their overall portfolios



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

38 percent for non-PE companies. These companies could purchase or exchange debt largely because of the lax terms in their secured-credit facilities or by using additional liquidity provided by the PE firm. When these “minor” defaults are excluded, the PE-backed companies’ default rate drops to 12 percent versus 16 percent for the non-PE companies over the 21-month period. The annualized default rate for PE-backed companies comes in at about 7 percent, significantly better than the most bearish predictions made at the beginning of the year.

### PE firms raised their game

Deal making may have been quiet during the turbulent past year, but leading PE firms certainly did not sit idle. Leading firms were quick to take five bold actions to elevate their game during the downturn. First, they pressed both healthy and distressed companies in their portfolio to reduce costs and squeeze working capital. Second, they refinanced portfolio companies, if possible, to give them more headroom. Third, as they groomed the companies in their portfolios to withstand the downturn better, they also deepened and strengthened their own portfolio-management capabilities, and they augmented internal and external resources required to sustain returns. Fourth, they sharpened their sector focus and laid the groundwork for where to invest as conditions improve. Finally, they undertook a review of their own strategy—from asset and geographic diversification and fund-raising to investment capabilities, operations and talent management—in order to become nimbler and execute more crisply.

As we will see, the leaders that laid this important groundwork during the downturn should be positioned well for market conditions in 2010 and beyond, when mastering these initiatives will become critical for achieving and sustaining top performance.

## Key takeaways

- Private equity's "golden age" of low interest rates, abundant leverage, mega-deal making and effort-less returns is over, and will not soon return.
- Global PE investments sank to a level not seen since the last downturn. All regions and industry sectors suffered.
- The dynamics underlying the decline differed by region. In North America and Europe, economic uncertainty and frosty debt conditions constrained deal making. In emerging markets, the massive dislocation of value brought about by declining economic growth and tumbling equity markets led to a mismatch of buyer and seller expectations. In both regions, the rapid rebound of equity markets did not give valuation and deal multiples a chance to reset.
- PE firms readjusted their investment focus to the opportunities 2009 presented, favoring carve-outs, growth equity, acquisition finance, balance-sheet restructurings and distressed debt investments.
- Fund-raising declined across all major PE asset classes and was weak in every region.
- Despite their continued commitment to PE, the "denominator effect" and the paucity of PE distributions squeezed LPs' liquidity and impaired their ability to commit to new funds.
- The downturn forced significant markdowns in portfolio valuations, causing short-term PE returns to decline by double digits; recent vintages were hit hardest.
- Still, PE funds continued to outperform all major stock market indexes, helping to shore up LPs' portfolios.
- Leading PE firms that laid the groundwork during the downturn should be positioned well for market conditions in 2010 and beyond.



### 3. What is happening now: Dynamics for 2010 and beyond

As the new decade begins, it is increasingly evident that the worst of the economic downturn has ended. But for PE investors it is far from clear how the recovery will play out. Will it be robust like the rebound following the 2001 recession, when the PE market bounced quickly back to life? Or will it more closely resemble the sluggish recovery that followed the early 1990s slump, when PE markets languished for years before returning to pre-downturn levels?

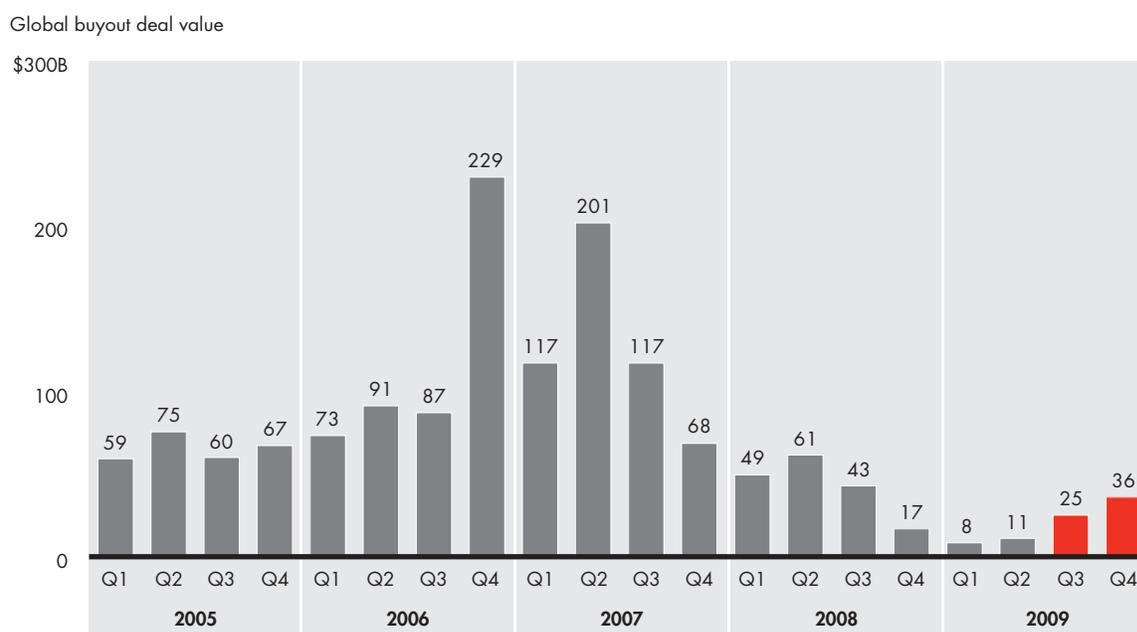
One thing few PE insiders—even the most optimistic ones—expect is for the industry to return to the “golden age” of bounteous fund-raising, easy credit and mega-deal making of 2006 and 2007. More likely, in the consensus view, will be a reprise of the more sedate growth of the period between 2003 and 2005, although it is still anyone’s guess how quickly the PE market will recapture those levels.

As we will see, the evidence suggests that the obstacles the industry must first overcome point to a protracted period of sluggishness.

#### Budding signs of recovery in deal activity

As PE enters the new decade, investment activity has revived modestly. Buyout investments grew from an all-time low of \$8 billion in the first quarter of 2009 to \$36 billion in the last quarter of 2009 globally. But deal making remains far below the levels of spring 2007 (see Figure 3.1).

**Figure 3.1:** PE investment activity has picked up in recent months



Notes: Includes activity by buyout funds and their majority-owned portfolio companies; based on announcement date; includes announced deals that are completed or pending, with data subject to change  
Source: Thomson Reuters

How will the coming cycle unfold? In the wake of the credit meltdown and the recession of 2007 to 2009, powerful countervailing forces are at work that will both help fuel PE's recovery and constrain it.

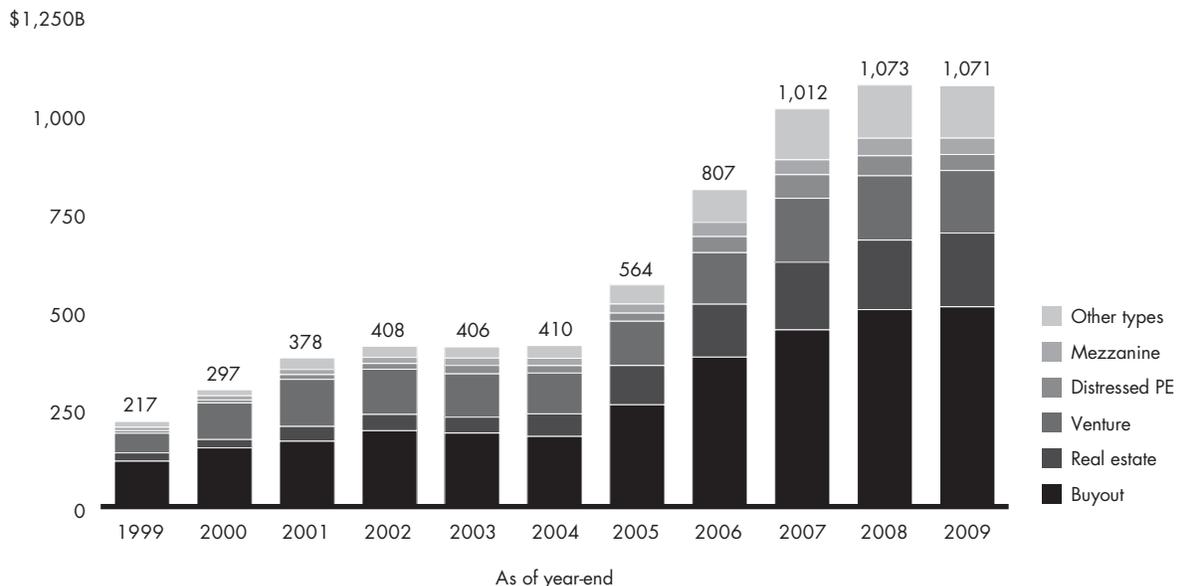
Two factors will drive a rebound. First, a large number of active PE firms wield an unprecedented amount of "dry powder"—capital committed by LPs but not yet invested—looking to invest. Second, PE firms are active across an ever-broadening playing field, with more asset classes, geographies and sectors relevant for investment. Let's explore these issues in greater depth.

**More private equity firms:** The number of PE firms looking to invest increased to an all-time high of 4,270 in 2009, according to Preqin—more than three times as many as there were a decade earlier. Broadening the PE universe to include firms that do not manage or invest out of distinct PE funds, the total rises to approximately 6,000 firms, which employed some 69,000 people last year. The industry remains fragmented: The 10 largest firms account for roughly 15 percent of all funds raised in the last 10 years; the top 100 account for about 45 percent.

**More capital to invest:** Capital, of course, is PE's great enabler, and the amount of capital the industry currently has available to deploy is prodigious. Estimates of capital that was committed but not yet invested at year-end 2009 totaled more than \$1 trillion—about three times the amount available at the end of the 2001 recession. That capital is available for investment across asset classes: \$508 billion waiting to be used in buyouts, \$159 billion earmarked for venture capital. In a year that witnessed the near collapse of the real estate market, another \$188 billion is slated for use to acquire real estate assets (see Figure 3.2).

**Figure 3.2: Unprecedented level of "dry powder"**

Committed, uncalled PE capital



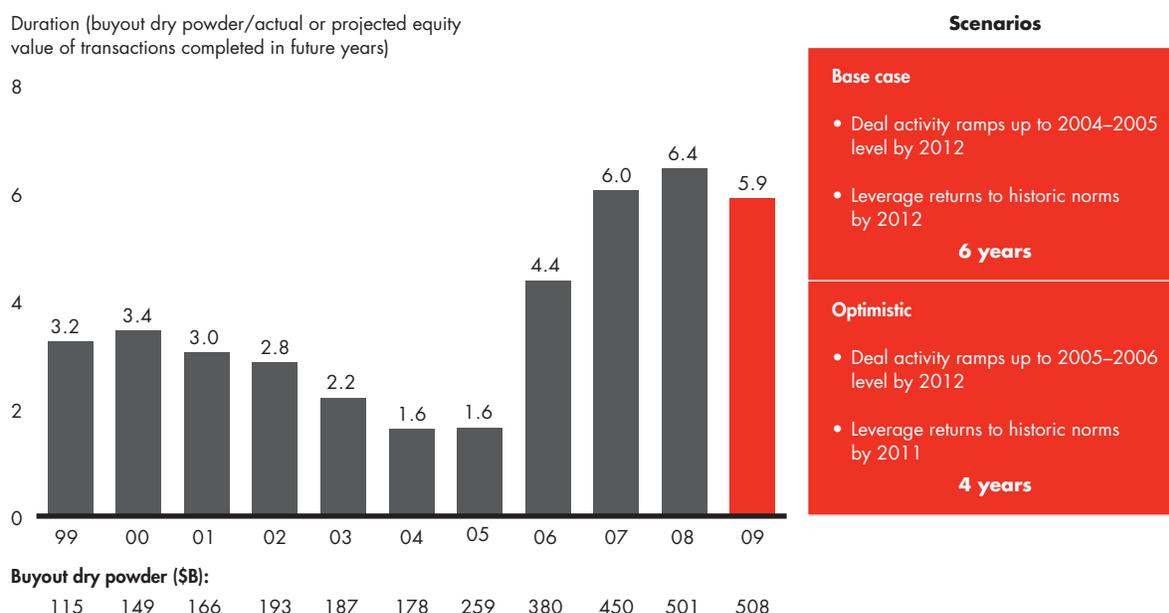
Note: Distressed PE includes distressed debt, special situation and turnaround funds  
Source: Preqin

Uncalled capital is widely dispersed among funds. Globally, the 10 largest funds command less than 30 percent of the buyout dry powder, while the largest 25 funds account for 45 percent. Among funds that focus on real estate, the largest 25 account for just 40 percent of uninvested capital. Only in the smaller categories of funds that invest in distressed situations and mezzanine financings is the dry powder more concentrated. In both asset categories, the largest 25 funds control almost 75 percent of the capital available for investment.

According to our base-case projection, it will take a lot of time to put that money to work. If we assume that it will take until 2012 for buyout activity to regain the level it last reached in 2004 and 2005 and that the proportion of leverage used to finance transactions will return to its historic norm about the same time, the current supply of buyout dry powder will take six years to be put to work fully. With more optimistic assumptions that deal activity ramps up to the higher levels of 2005 and 2006 by 2012, and that leverage bounces back to its historic norm by 2011, it will take four years to deploy the capital that has already been committed fully (see Figure 3.3).

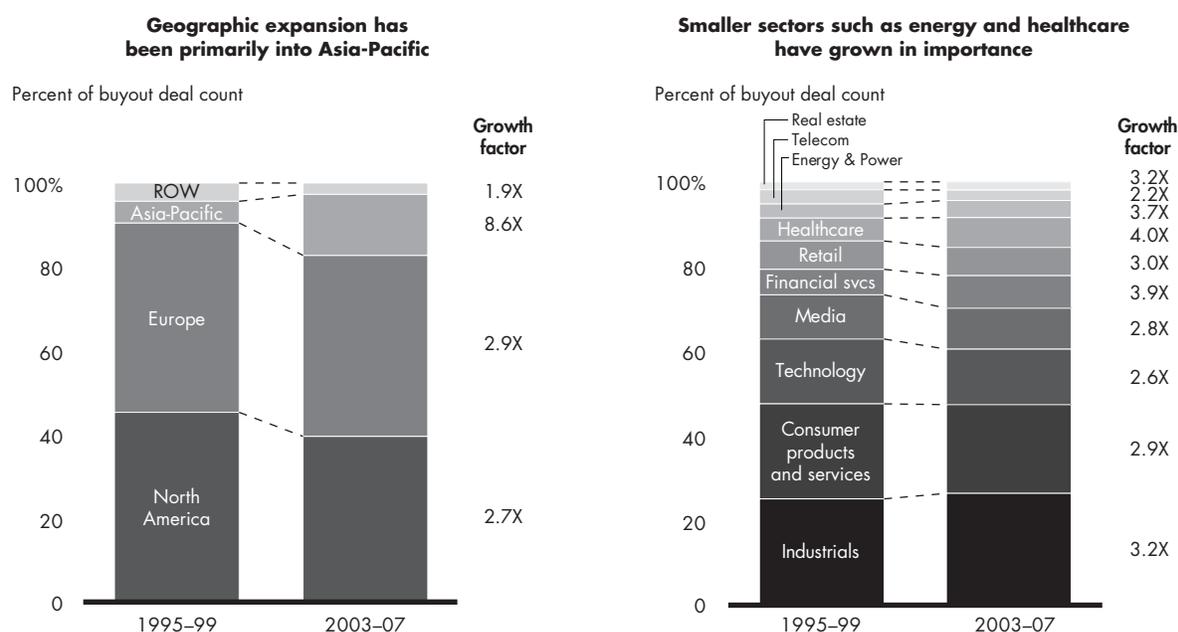
**More investment options:** Increasingly, PE capital is finding its way to new geographic regions and a broader array of industry sectors. The emergence of Asia as a target of PE interest beyond the industry’s core North American and European markets has been a notable trend of the past 15 years. In the period from 2003 through 2007, PE deal activity in Asia-Pacific had grown to 8.6 times the level of deal activity compared with the corresponding period in the last cycle of 1995 to 1999. In North America and Europe, in contrast, deal activity was just three times greater. Investment in Asia, and in other emerging markets, such as Brazil, is poised for further rapid expansion (see Figure 3.4).

**Figure 3.3:** Buyout “dry powder” could take years to deploy



Notes: Analysis for 2001–05 calculations based on actual equity value of transactions in future years, 2006–09 calculations incorporate forecasted projections in base-case scenario  
Sources: Preqin, Thomson Reuters, Bain analysis

Figure 3.4: PE activity has broadened across geographies and sectors



Notes: 1995-99 and 2003-07 represent the five-year period up to and including peak of PE cycle; includes activity by buyout funds and their majority-owned portfolio companies; based on announcement date  
Source: Thomson Reuters

PE investors have also broadened their focus beyond the industrial, consumer products and services, and tech sectors that have long been areas of PE interest. Comparing the distribution of deal making by industry sector between 2003 and 2007 with the period between 1995 and 1999, the number of deals across 10 major sectors tripled. But deal activity in the relatively underpenetrated financial services, healthcare and energy and power sectors has expanded even faster.

While these factors bode well for PE's renewed growth, three other circumstances will act to hold a robust recovery in check. First, credit-market conditions are improving, but they remain strained; and as we will explain in the following section, they are severely encumbered by future debt refinancing obligations. According to a recent survey of financial sponsors by *Private Equity News*, only 21 percent of respondents believe that the effects of the credit crunch will be minimal in 2010, and that the industry will be back to normal within 12 months. Seventy percent think the repercussions will linger for years, perhaps changing the industry forever.

Second, sensitivities about PE ownership could reduce the availability of target companies, particularly in regions where the media have vilified PE and governments are attempting to regulate the industry. There is little doubt that the industry will face new scrutiny going forward, and regulators in different markets are debating a patchwork of rule changes. But it is still too early to tell what impact the imposition of any new rules will have on deal activity or how changes in the tax treatment of gains could alter general partners' incentives.

Finally, bargains will be hard to find. As mentioned earlier, the rapid decline and recovery of the major stock-market indexes off their cyclical lows in early 2009 and the accompanying rebound in valuation multiples did not allow sufficient time for sellers' expectations to reset. As a point of reference, US and European equity markets coming out of this downturn recovered between 40 percent and 50 percent of the value lost from their peaks in less than a year. In the previous downturn, equity markets needed more than two years to recover the same proportion of value. High asset prices combined with relatively tepid GDP growth forecast for many markets are likely to hold down deal activity, at least over the near term (see Figure 3.5).

This dynamic affects all potential takeover candidates, especially public companies. The continued ability of PE investors to find attractive opportunities in public-to-private (P2P) deals is essential to a strong recovery of overall deal activity. A Bain analysis found that P2P conversions represented 90 percent of the growth in the value of US buyout deals consummated between 2004 and 2007, totaling 70 percent of the total value of buyouts closed in 2007. But these transactions will be difficult to pull off at a time when valuation multiples are high and debt is in short supply.

### A thaw in the debt markets

Viewed against the backdrop of 18 months ago, conditions in the credit markets are much improved, but they are still far from normal. With credit markets flush with central bank liquidity infusions, interbank short-term lending rates are at a record low.

Restored confidence in the credit markets is a necessary precondition for the next wave of PE growth, and evidence of some credit easing has begun to appear. Lower perceived credit risk in the general economy

**Figure 3.5:** Equity markets rebounded rapidly



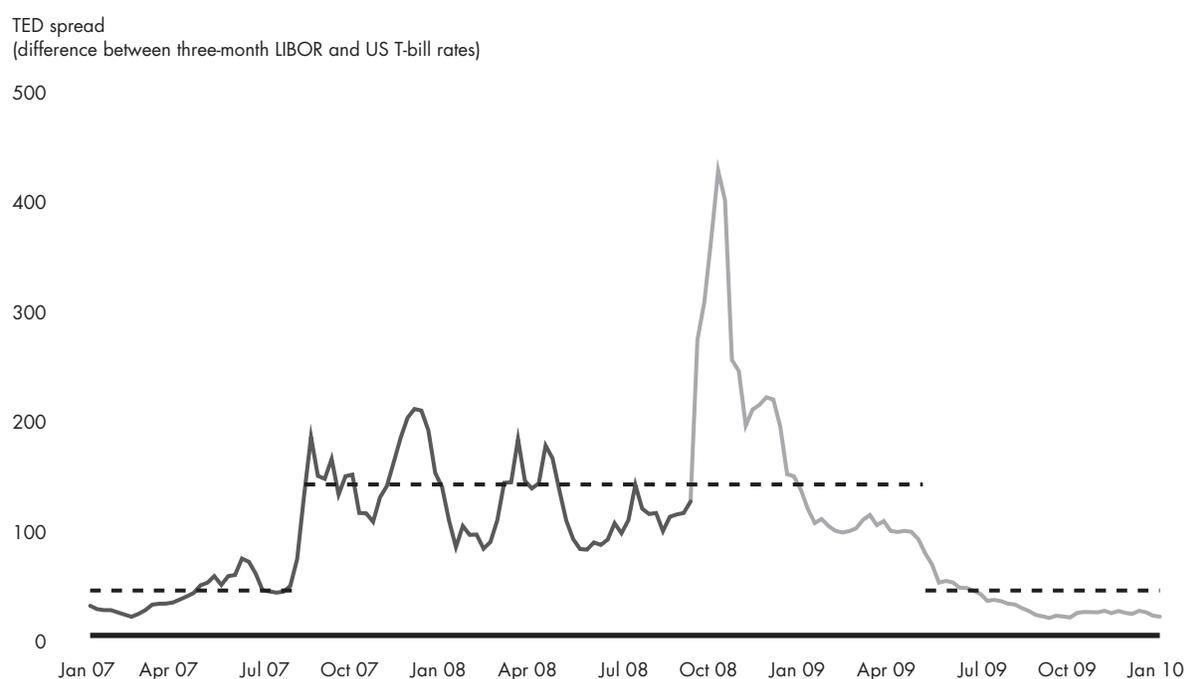
Source: Bloomberg

shows up clearly in a dramatic narrowing in recent months of the TED spread, a key benchmark that measures the difference between the three-month Treasury-bill rate and the three-month LIBOR. As credit market conditions deteriorated through the summer of 2008, the spread oscillated between 100 and 200 basis points—far above the long-term average of 30 basis points—before spiking at more than 450 basis points when the credit markets cratered in October 2008. Coordinated action by the Federal Reserve and other central banks, since then, helped restore calm, and by last summer rates settled back to pre-crisis levels, signaling a credit-market revival (see Figure 3.6).

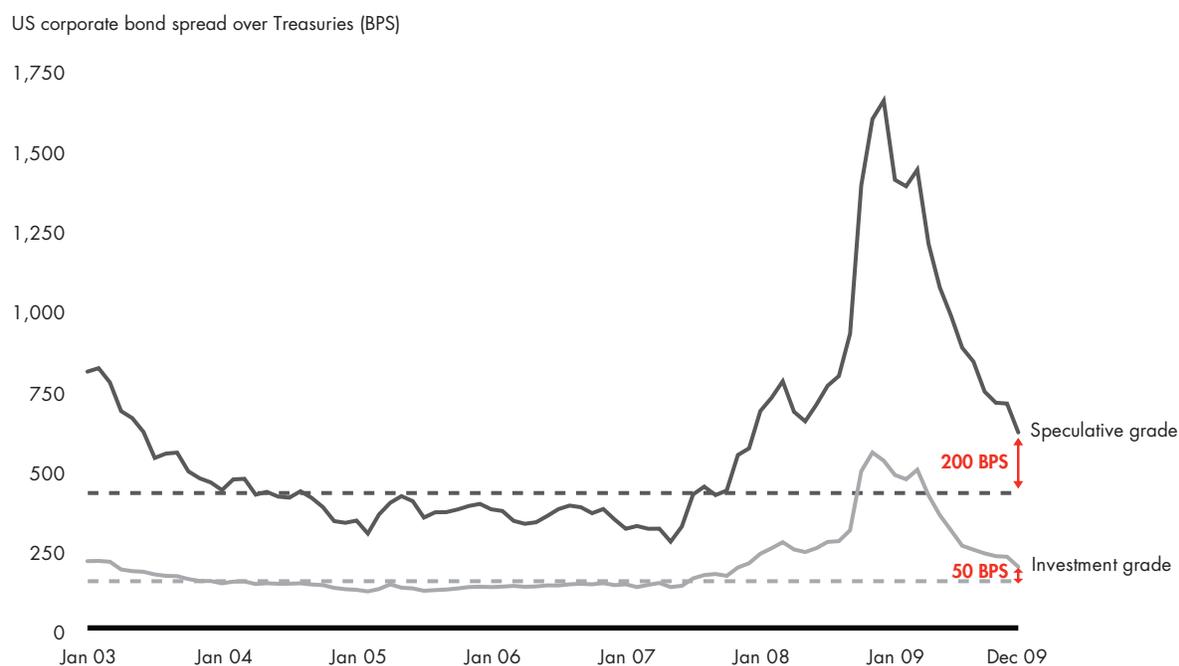
But even as interbank lending rates and TED spreads have eased, actual bank lending is and will remain tight. Banks are still hampered by distressed assets on their balance sheets, fears of additional loan losses and uncertainty over capital requirements and accounting rules for off-balance-sheet assets. Surveys of bank lending practices conducted by central banks reported in January 2010 that a net percentage of banks continued to increase spreads on loan rates over their cost of funds and tighten non-price terms. In general, these ratios continued to decline from the peaks reached in the last quarter of 2008, though the net fraction of banks that reported further increases in loan rate premiums for risky borrowers remained somewhat elevated.

Indeed, despite having come down significantly, risk spreads remain elevated. The spread on US investment-grade corporate bonds (measured as the difference in yield between bonds and US Treasuries), for example, has narrowed to 191 basis points at the end of 2009, down from a high of more than 500 basis points at the end of 2008. Still, the investment-grade spread is some 50 basis points above the long-term trend. For speculative-grade bonds, risk spreads have tightened to 611 basis points, down from a peak of more than 1,600 basis points in December 2008. Like investment-grade bonds, the spreads on speculative-grade bonds remain elevated at 200 basis points above the long-term average (see Figure 3.7).

**Figure 3.6:** Interbank confidence has returned



Source: Bloomberg

**Figure 3.7:** Risk spreads have come down, but are still elevated

Sources: S&P Composite Credit Spreads; S&P Global Fixed Income Research

Mirroring the improved conditions in the overall debt markets, the speculative-grade debt markets—the fuel that powers PE transactions—have thawed. While leveraged lending continued to plunge in 2009, the issuance of high-yield bonds rallied in one of their best years on record (see Figure 3.8).

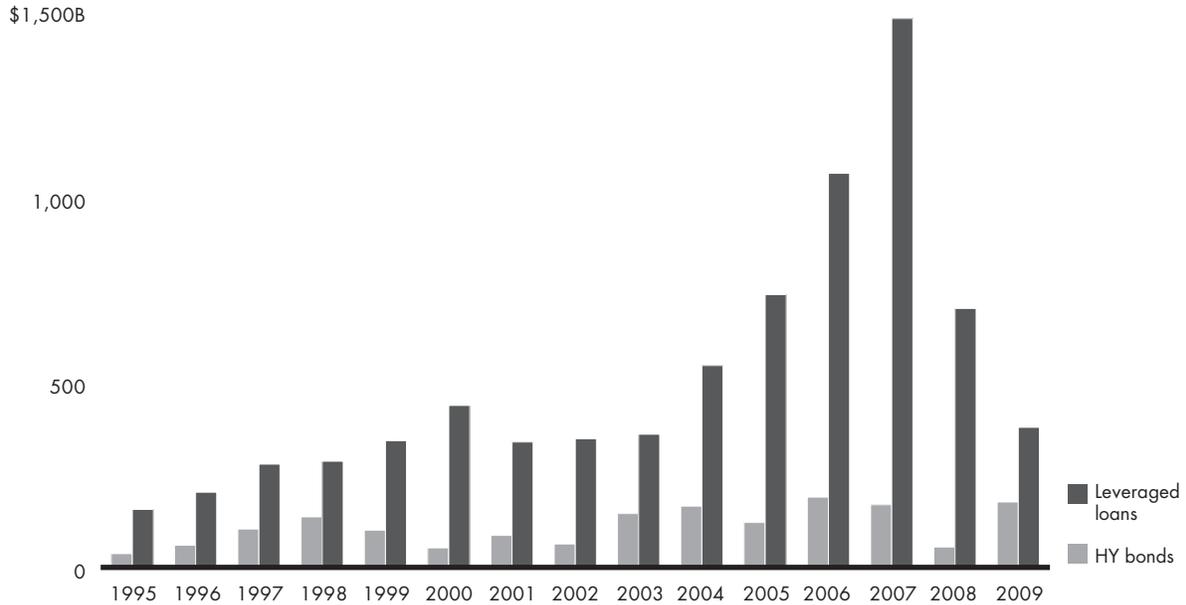
Notwithstanding the high-yield bond rally, borrowers still face major, unfamiliar challenges both in the near term and over the next several years that raise questions about how much leverage will be available for new PE transactions and on what terms. PE firms will be particularly sensitive to the conditions in the leveraged loan market. Bigger than the market for junk bonds, leveraged loans have historically made up half or more of the total value of LBOs.

Let us delve deeper into the factors influencing the high-yield bond and leveraged loan markets. Many of the factors at work in 2009 will continue to exert influence in 2010. And as we will soon explain, a glut in the supply of speculative-grade debt that buyers of high-yield bonds and leveraged lenders will struggle to absorb will leave less credit available to support new PE activity.

**High-yield bonds:** On the demand side, high-yield bonds appealed to investors who were hungry for yield in the low-interest-rate environment and willing to take on increased risk as their fears of large defaults and poor prospects for recoveries receded. The deep dislocation in the leveraged loan market offered debt investors few alternatives. The issuance of senior secured bonds helped broaden the investor base, bringing in institutional investors, mutual funds and others attracted by greater security. In 2009, senior-secured high yields made up 40 percent of the bonds issued—a far higher proportion than the historical average of just 7 percent (see Figure 3.9).

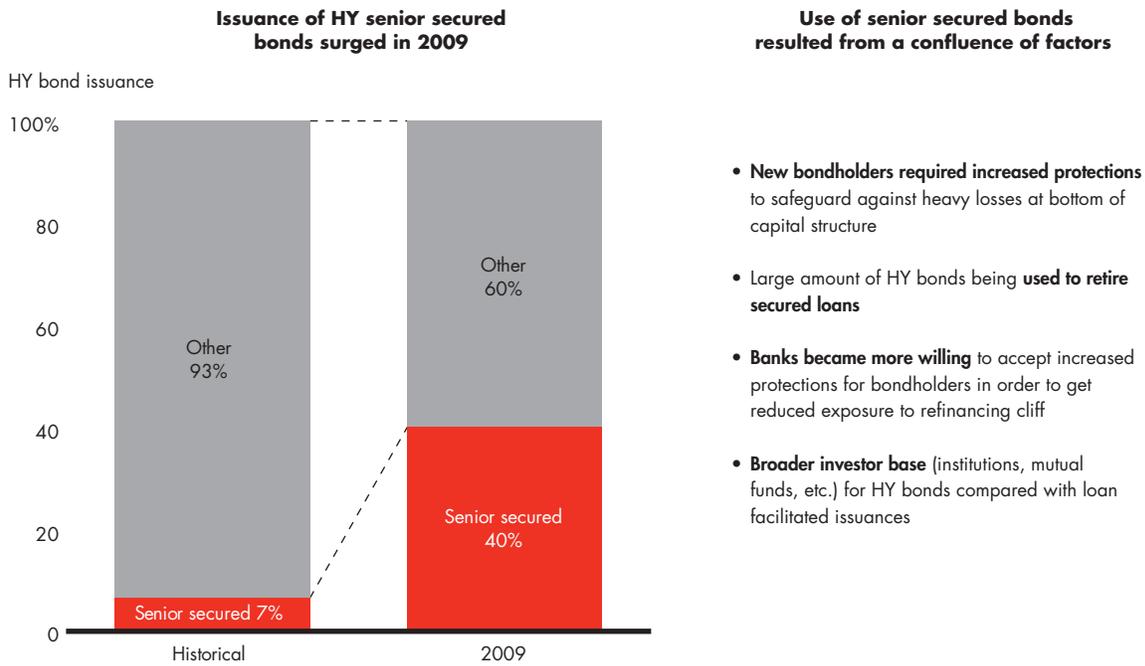
**Figure 3.8: Leveraged loan issuance declined, while high-yield bonds rallied**

Global issuance of high-yield bonds and leveraged loans



Source: Thomson Reuters

**Figure 3.9: High-yield bonds attract a broader investor base**



Sources: Fitch, literature search

**Use of senior secured bonds resulted from a confluence of factors**

- **New bondholders required increased protections** to safeguard against heavy losses at bottom of capital structure
- Large amount of HY bonds being **used to retire secured loans**
- **Banks became more willing** to accept increased protections for bondholders in order to get reduced exposure to refinancing cliff
- **Broader investor base** (institutions, mutual funds, etc.) for HY bonds compared with loan facilitated issuances

Borrowers also found a lot to like in high-yield bonds. They saw in them the opportunity to refinance earlier borrowings—typically leveraged loans—by issuing bonds with longer maturities that gave them more breathing room. Buyers of high yields also required fewer protections, mitigating borrowers' downside risk. Furthermore, fixed-rate bonds helped safeguard them better against future interest-rate hikes than leveraged loans that would be tied to benchmark rates. In any case, access to the leveraged loan market was severely constrained for most borrowers.

Strong demand for high-yield bonds is expected to persist well into 2010's low-interest-rate environment as investors continue to move to riskier asset classes in search of yield. But the pace of fund flows into high-yield bonds is likely to slow as the big contraction in bond spreads has eroded the return potential of this asset class. Thus, investors will likely become more selective, favoring cyclical-growth companies with strong balance sheets. Stable, highly leveraged ones will have to accept higher spreads if they want to tap the market.

On the supply side, the continued need to refinance high-yield bonds and leveraged loans will satisfy some investor demand, although the rate of loan displacement will slow as leveraged loan issuance recovers. An expected increase in M&As, LBOs, acquisition lines and dividend recapitalizations will provide additional supply outlets for high-yield bond investors to channel their funds.

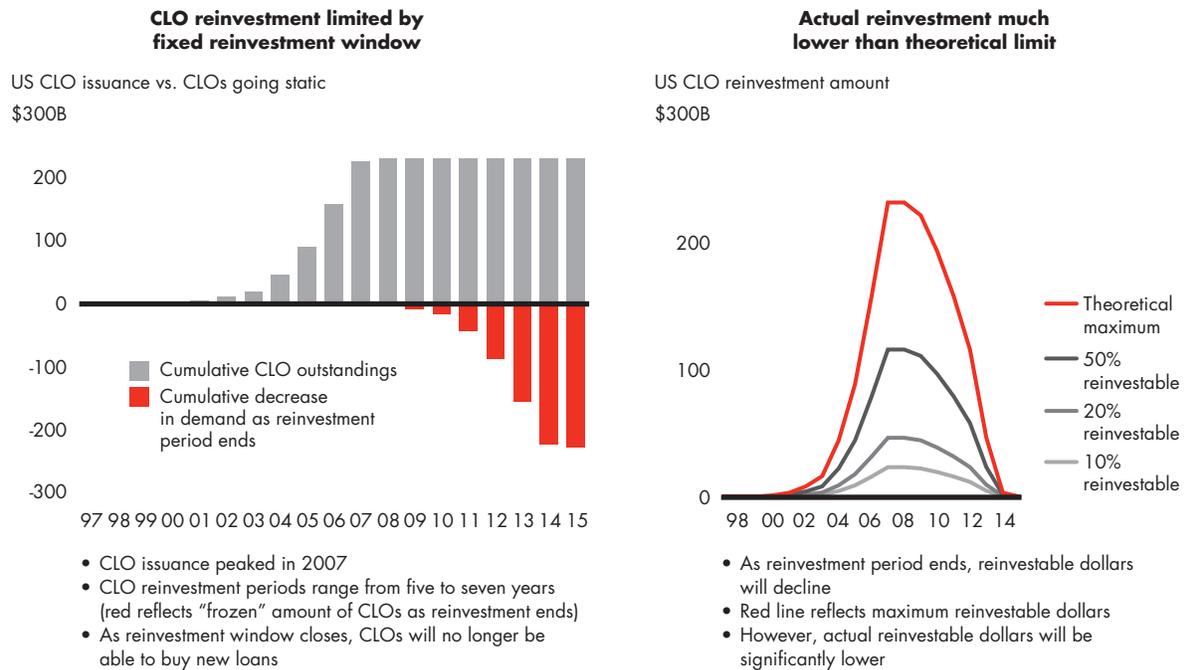
**Leveraged loans:** In 2009, leveraged loan demand dried up as troubled banks struggled with liquidity and capital adequacy problems that reduced their appetite for risk, both as underwriters and lenders. Absent, too, were collateralized loan obligations—the “natural buyers” of these loans. Between 2000 and 2007, CLOs accounted for between 60 percent and 75 percent of the demand for institutional leveraged loans, enabling the phenomenal growth of the leveraged loan market overall. With the collapse of credit markets, the creation of new CLOs stopped abruptly, and demand from existing CLOs in the form of reinvestments was limited by liquidity and regulatory constraints.

On the supply side, new LBO deals were difficult to pull off, as only modest amounts of expensive leverage were available to high-quality companies. Dividend recaps, which consumed a large share of loans in the buyout glory days, were out of favor.

Throughout 2010, loan repayments through bond or equity exchanges will continue to trigger new investment demand. Also, the narrowing of spreads in the secondary market should drive lenders back to the primary market, where new issues offer pricing and terms that are at least as attractive as secondary-market loans. With the economy on the mend, lenders are becoming more comfortable with borrowers' earning prospects and are more willing to make money available. But efforts by banks to pay back Troubled Asset Relief Program (TARP) funds and shore up their weak balance sheets will continue to suppress their willingness to engage in leveraged lending. Banks that remain open for business will lend on more conservative terms to high-quality names only. On top of that, doubts over the underlying riskiness of CLOs have driven away buyers of these bundled leveraged loans. Thus, new CLO issues have all but disappeared, and future issuance will be muted until the dormant market for arbitrage CLOs recovers.

Existing CLOs also face many reinvestment constraints. Outstanding CLO issues have a limited reinvestment period of between five and seven years, and demand will drop off quickly through 2014 as the reinvestment periods expire. Furthermore, liquidity pressures and regulatory constraints will limit how much managers of CLOs can reinvest. Industry watchers at the Loan Syndication and Trading Association (LSTA) posit that actual reinvestable dollars will run between just 10 percent and 50 percent of the theoretical maximum available for reinvestment (see Figure 3.10).

**Figure 3.10: Existing CLO reinvestment demand will fall**



Sources: LSTA, Bain analysis

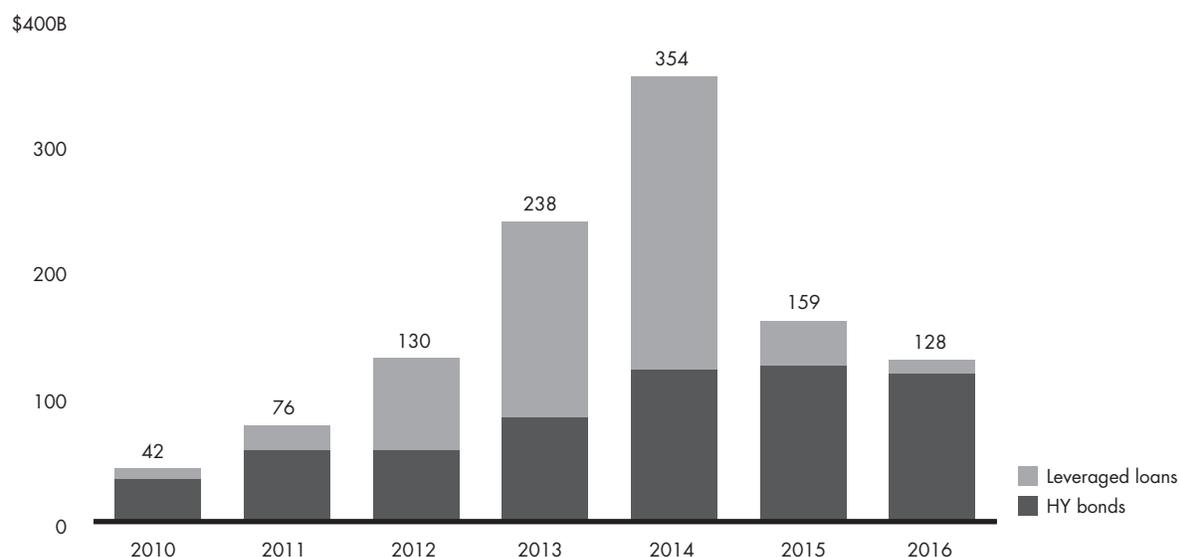
**Refinancing challenges:** The biggest challenge for the high-yield bond and leveraged loan markets—and consequently for the PE market—is the looming refinancing cliff (also commonly referred to as the refinancing wall). Investors’ limited capacity to absorb a growing supply of refinancings may severely crimp the borrowing needed to finance new PE deals—and the shortfall will begin to show up in 2010, when the market starts to climb the base of the cliff.

Over the next five years, issuers of speculative-grade debt (including PE-backed borrowers) will need to refinance roughly \$850 billion in maturing debt denominated in US dollars—\$500 billion of it in the form of leveraged loans and \$350 billion in high-yield bonds. The refinancing obligations will start off slowly in 2010, amounting to less than \$50 billion; but they will rise steeply through 2014, when some \$355 billion will come due. The steepest cliff wall will be in the leveraged loan market between 2012 and 2014, when more than 85 percent of loans outstanding mature. Most of that debt is owed by PE-sponsored companies (see Figure 3.11).

What to do about the looming loan cliff? Borrowers can pursue a variety of techniques to level out some of their big refinancing needs, but each has only limited ability to ameliorate the problem. For example, they can pay lenders to amend terms, extend maturities or do both on existing loans. But the higher interest costs on so-called amend-and-extend agreements could strain cash flows. Others might tap the bond market, exchanging high yields with longer maturities for loans coming due. But even though the exchanges carry fewer covenants, they are often pricier than the existing loans. Borrowers can resort to the equity markets, using a stock initial public offering (IPO) to pay off debt; but that option is available only to companies with good balance sheets.

**Figure 3.11: Borrowers face a refinancing cliff**

Maturity schedule of US high-yield debt  
(as of November 26, 2009)



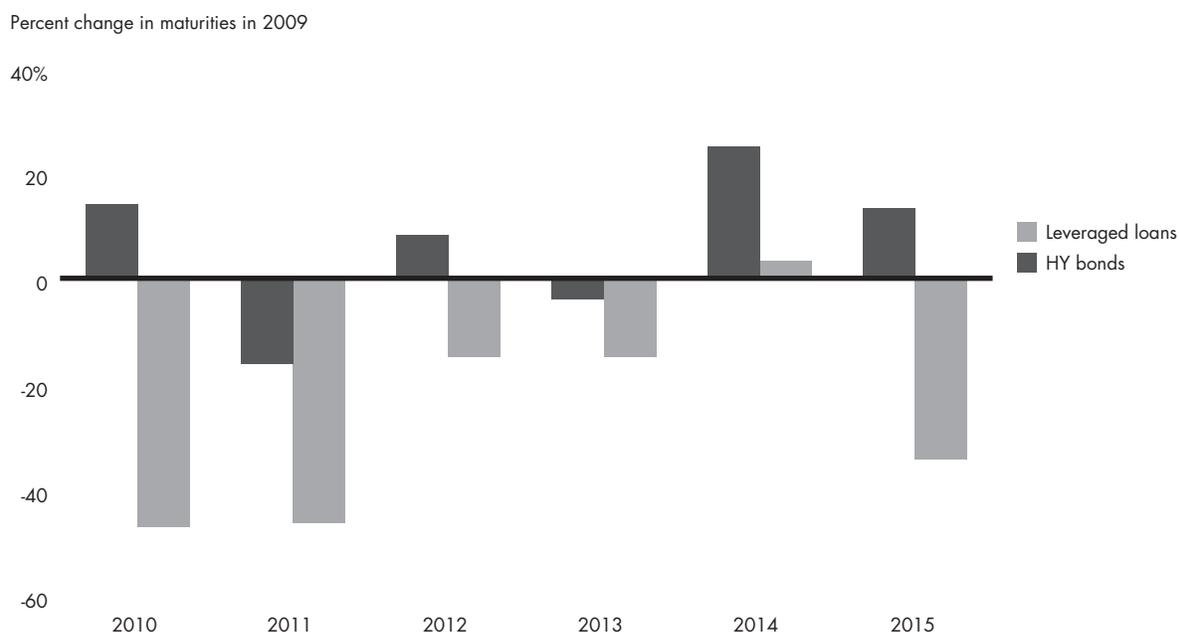
Notes: Based on high-yield bond and leveraged loan (institutional and pro-rata) maturities; includes all USD-denominated debt  
Source: Bank of America Merrill Lynch

Other companies needing to refinance may look to organic solutions, such as buying back their loans through open-market operations or by using their free cash flow to repay loans on, or ahead of, schedule. But rebounding bond prices are making buybacks less attractive, and the ability to tap free cash presumes that top-line growth will be strong in a still-tough economy. Borrowers may also be able to sell assets or divisions to strategic buyers, as merger and acquisition activity picks up, and use the proceeds to repay debt. Or they could sell the entire business to an investment-grade company that can refinance the existing high-cost debt through new borrowing at a much lower interest rate. Finally, there will inevitably be defaults that will clear the system of some debt entirely. Of course, that could result in a major credit market disruption that leaves investors with less money to invest and more wary about putting additional money into loans.

Taken together, all of these techniques suggest that both issuers and investors will respond dynamically to scale the refinancing cliff. Indeed, by taking such measures in 2009, borrowers have already reduced the total debt maturing in 2010 and 2011 by about 20 percent, mainly by pushing repayment obligations out to later years (see Figure 3.12).

Looking specifically at leveraged loans—the steepest face of the cliff wall and the one most relevant to PE—much progress was made in 2009. To date, borrowers have decreased the loans maturing in 2010 and 2011 by 47 percent. However, their real test will be refinancing ahead of schedule the \$460 billion of loans maturing in 2012–2014. Only 7 percent of these maturities were refinanced during the past year.

Under scenarios developed by LSTA, if half of all leveraged loans rated B- and all loans rated CCC+ or below were to go into default, loan refinancing needs between 2010 and 2014 would fall by some 25 percent. Affirmative steps by borrowers could lower the refinancing cliff by another 15 percent, for a total of 40 percent.

**Figure 3.12: Good progress was made in 2009, tackling near-term maturities**

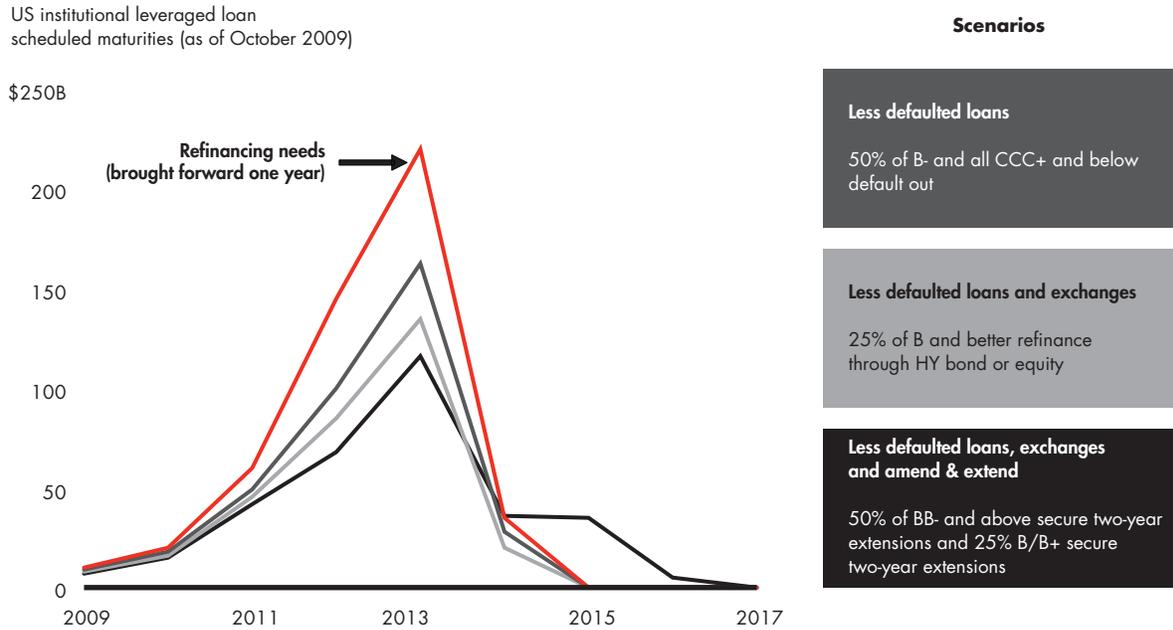
Notes: Based on high-yield bond and leveraged loan (institutional and pro-rata) maturities; includes all USD-denominated debt  
Source: Bank of America Merrill Lynch

Borrowers could do that by working out exchanges of half of all maturing leveraged loans rated BB- or above for high-yield bonds or new equity and by arranging two-year extensions on 25 percent of the B/B+ loans (see Figure 3.13).

The cumulative effect of the measures borrowers take to level the refinancing cliff could have a dramatic impact on the ability of loan investors to absorb the remaining refinancing supply. Plotting LSTA's optimistic scenario against average loan issuance levels that prevailed between 1998 and 2005, the refinancing picture brightens considerably. Only in 2013, when borrowers are rolling over loans that mature at the refinancing cliff's peak a year later, do refinancing needs rise above the trend line. Plotted against average loan issuance levels between 2002 and 2005, the cliff appears quite manageable (see Figure 3.14). Borrowers in Europe, where the high-yield bond market is smaller and that are more dependent on banks to underwrite loans, may face a bigger challenge.

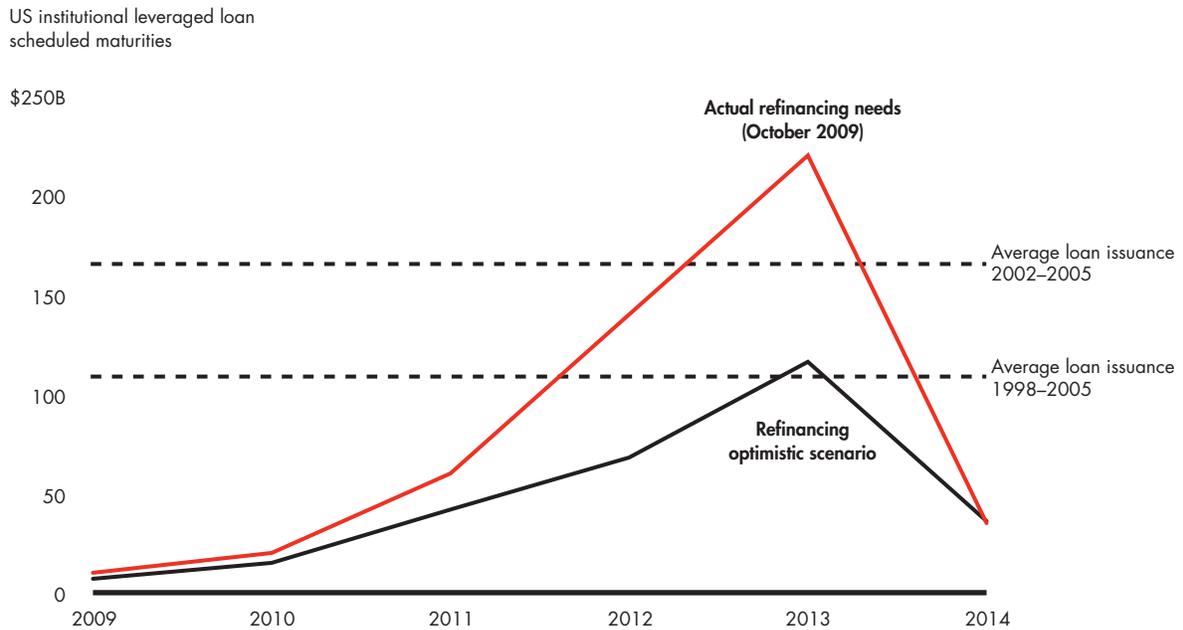
Even if that more favorable set of circumstances comes to pass, the danger remains that the loan market is no longer deep enough to meet the refinancing challenge and still leave enough room to finance new LBOs. With bank lending and CLOs still dormant, roughly two-thirds of the demand for leveraged loans is still not in the game. As pointed out earlier, reinvestment demand from existing CLOs will decline steadily over the next five years, on its way toward zero when refinancing reaches its peak in 2013, under LSTA's optimistic scenario. Industry insiders are divided over whether significant new CLO issuance will materialize to take up some of the slack. If CLO issuance does not bounce back, they look for institutional managed funds to be the principal loan buyers in 2010 and beyond (see Figure 3.15).

**Figure 3.13: Optimistic scenario could reduce loan refinancing cliff by 40 percent...**



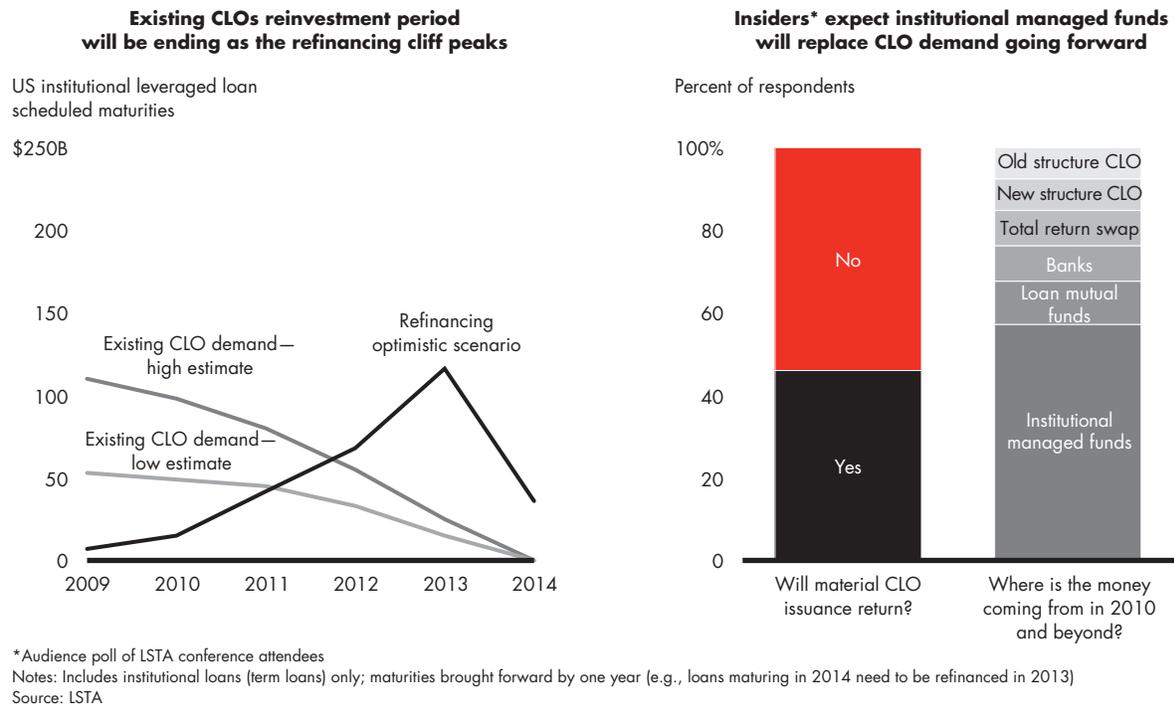
Notes: Includes institutional loans (term loans) only; maturities brought forward by one year (e.g., loans maturing in 2014 need to be refinanced in 2013)  
Source: LSTA

**Figure 3.14: ...to levels in line with historical loan issuances**



Notes: Includes institutional loans (term loans) only; maturities brought forward by one year (e.g., loans maturing in 2014 need to be refinanced in 2013)  
Source: LSTA

Figure 3.15: Where will investor demand come from?



**PE firms need to be proactive:** If leveraged loan demand continues to be muted, PE firms looking to finance new transactions may need to tap alternative sources, such as high-yield bonds, mezzanine, debt funds and vendor notes. There has been evidence in recent months that the high-yield bond market may be opening up to borrowers to finance PE transactions. However, these alternative funding sources are likely to be more expensive than loans, putting pressure on the deal models PE firms use to evaluate potential investments. Having virtually no margin for error, PE firms that are inclined to rely on new capital outlets will need to step up their due diligence and flex their operational muscles to create value following the acquisition.

It is certainly clear that many PE firms will face refinancing challenges. Many of the LBO deals struck between 2005 and 2007 were financed with excessive leverage and optimistic assumptions about cash flows to service that debt. However, many of these companies have fallen short of their EBITDA projections, and consequently they face even higher leverage ratios. Some will have a hard time tapping the debt and equity markets to ease their debt loads. Inevitably, some will go bankrupt or end up in an out-of-court restructuring. Others will need to complete a distressed exchange (whereby some of the debt is canceled) to lure new debt or equity investors into reinforcing their rickety capital structures.

With the overall economy on the mend and debt and equity markets improving, PE-sponsored companies may be tempted to take a wait-and-see approach, hoping to get a better deal down the road. But they also need to recognize that the future also holds a few “known unknowns” that could end up making conditions significantly worse. Predicting the context they would face by waiting to refinance debt at maturity is a nearly impossible exercise. For one thing, the eventual tightening of monetary policy could leave PE-sponsored companies struggling in a slow-growth economy, facing even higher interest costs and adding downward pressure on

earnings. Refinancing companies with deteriorating fundamentals in weaker market conditions will be a bigger challenge than confronting the issue today, difficult as that may be. Second, the winding down of central banks' monetary stimulus could coincide with the loan-refinancing bulge that looms between 2012 and 2014. That supply glut would only compound companies' troubles. The real credit crunch may be ahead.

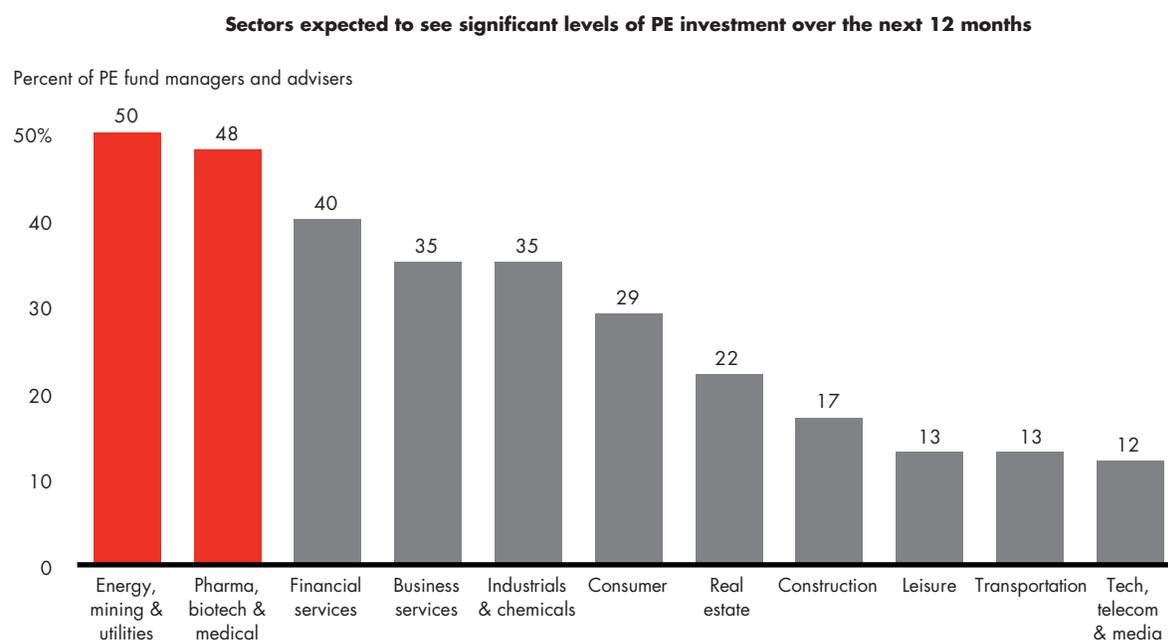
Passivity and wishful thinking are not options for PE firms and their sponsored companies, especially the weaker, most highly leveraged ones. They should aggressively whittle down their debt now while the markets are more accommodating. In addition to shoring up their balance sheets, PE firms should continue to take steps to strengthen operations that will improve their portfolio companies' top and bottom lines, better positioning them for refinancing when the time comes.

In a similar vein, it would not be surprising to see a wave of "add-on" deals, whereby a PE firm merges a newly acquired company with an existing portfolio company. An add-on acquisition that is largely financed with equity can rebalance a portfolio company's capital structure and provide additional cash flow to service existing and future debt obligations. It may even allow the merged company to recapitalize as part of the transaction. Steps like these would surely put PE firms and their portfolio companies in a more comfortable position when negotiating refinancing terms.

### Hot areas to put money to work

As PE fund managers scan the expanding range of sectors and geographies that now comprise the PE universe of promising places to invest, several areas that drew interest in 2009 continue to offer hot prospects in 2010 (see Figure 3.16).

**Figure 3.16: Where to put money to work: Hot sectors**



Notes: Respondents include PE houses, financial advisers and legal advisers; n=125; survey conducted August 2009  
 Source: Mergermarket/Merrill Datasite "Future of Global Private Equity"

Energy and healthcare topped a recent poll of sectors where PE fund managers and their advisers expect to see significant levels of investment over the coming year. Both had been among industries that increased their share of total PE deal making during the rising PE market of 2003 to 2007, and they look poised to continue their ascent.

**Hot sectors: Energy.** Already a rare bright spot in 2009, energy-sector plays last year capitalized on the turbulence created by declining oil and natural gas prices, limited alternative sources of capital and highly leveraged balance sheets. Affecting all major energy sectors—upstream, midstream, downstream, power and services—these factors created unique situations for PE firms to recapitalize weak balance sheets and to fund longer-term growth opportunities. PE investors in environmentally friendly “clean-tech” also sought to ride the slipstream of the Obama administration’s economic stimulus package. (The American Recovery and Reinvestment Act of 2009 calls for the US government to invest \$69 billion in projects that will create jobs and, among other things, result in a doubling of US renewable energy output.)

There were several high-profile transactions in 2009. On the acquisition front, for example, Charterhouse acquired Wood Mackenzie, a leading provider of information and services to the energy sector. PE investors also funded wave after wave of investment in Silver Springs, a supplier of smart-grid technology. As for notable exits, Warburg Pincus and Blackstone Group’s pending sale of Kosmos Energy’s deep-water oil field located off the coast of Ghana garnered some \$4 billion, representing a fourfold return on their 2004 investment.

The energy sector has continued to draw PE interest, as a number of PE firms have added resources and dedicated teams to pursue opportunities in the space. The fundamentals powering the energy sector’s rise last year will shift in 2010, but energy’s potential appeal to PE investors should only grow. For one thing, increases in the cost of oil and natural gas extraction through deepwater drilling and in other challenging environments will propel growth across the oil and gas value chain, particularly in oil-field services. The sector is also poised for a surge in global infrastructure spending on new capacity in developing markets and on replacement and upgrades in developed ones. These requirements, combined with the emergence of new technologies, will drive up demand for PE capital and trigger greater interest among limited partners, sovereign wealth funds and other capital providers.

PE investors that venture into energy will need to develop distinctive capabilities to ride out the cyclicity of the end markets. Firms that approach the sector as if it were simply an extension of services or another area of their competency will quickly be displaced by more focused teams with clear mandates to invest in energy. The attractions of the sector and increasing competition among firms scouting for opportunities in it will require investors to stretch to acquire the choicest assets. Some of the traditional energy players will find themselves needing to upgrade their capabilities to generate returns in a market where the best assets are heavily competed for, and the balance sheets of cyclical assets can tolerate only moderate amounts of leverage.

**Hot sectors: Healthcare.** Although action has centered on health reform in the US over the past year, major dislocations in the sector focused on two major themes—cost containment and the demonstration of health economic value creation—that are shaking up the healthcare industry across all major economies. Remedies for both of these major priorities have coalesced into a new concentration on four key issues: First, there is an increased focus on quality of care and the development of performance metrics for physicians and other care providers. Second, there has been a shift to link reimbursements for care rendered to

concrete health economic outcomes. Third, the industry is beginning to outsource non-core services, including an increasing shift of some activities offshore. Finally, electronic medical records and healthcare information technology (IT) are playing a larger role in all aspects of the industry.

Sectors in upheaval are inherently attractive to PE investors, but what concretely should they be looking for? Near-term opportunities abound in key segments across the healthcare value chain—from payers and providers to IT services and manufacturers of medical equipment and supplies. Those activities with the most manageable regulatory and reimbursement risks will be the most attractive.

Many businesses address the key healthcare issues in play. Among these are companies that handle billings and collections, firms that manage physician practices, contract researchers and manufacturers, distributors, healthcare IT companies and developers of clinical decision-support systems. These businesses do not always have obvious strategic acquirers, making them attractive to PE investors.

The sector's dynamism presents a host of investment theses for PE funds to pursue. Some may consider "riding the outsourcing wave," for example, by targeting investment toward pharma contract research services. Others might want to look for opportunities in undermanaged specialties, like orthopedics or ophthalmology, and help them achieve their full potential. There are profitable niches to pursue in sleep disorders, dental, neurology and bariatrics. Promising potential will be found through a greater focus on wellness programs, delivered through workplace health programs, for example. Finally, a major theme going forward will be the rise of healthcare consumerism through home healthcare and as providers of mail-order supplies.

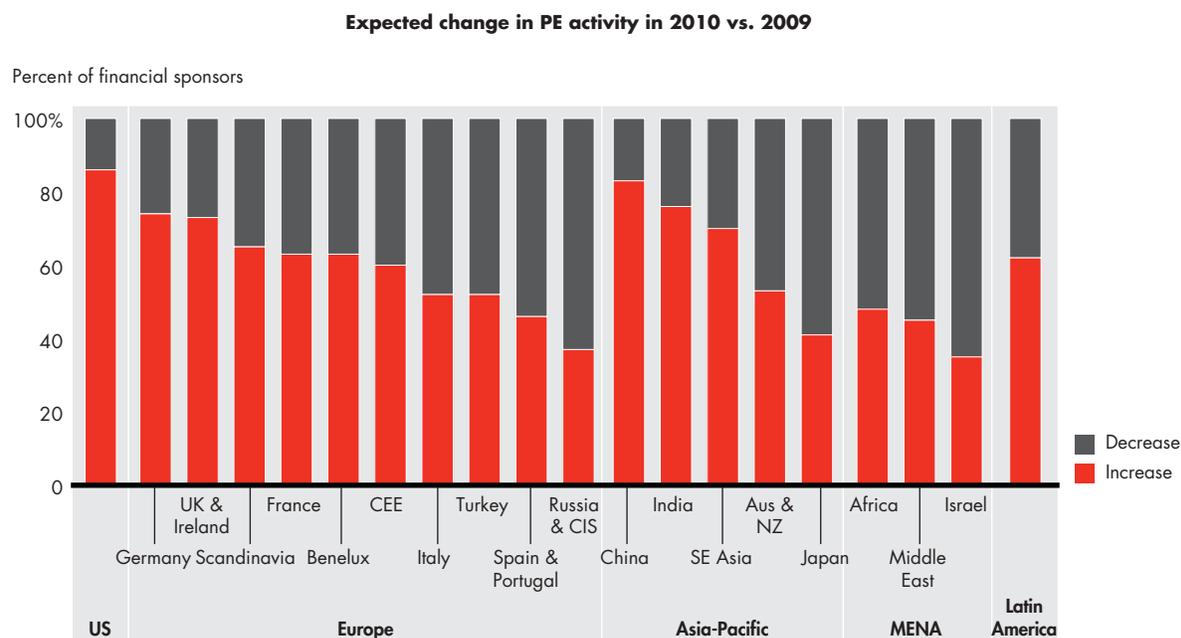
The ferment in healthcare is spawning intense competition as many PE firms target the sector as a strategic priority. Those that hope to succeed will need to decide where and how to focus their efforts. The winners will be firms with healthcare expertise that master the fast-changing reimbursement landscape and the increasingly complex interactions among patients, payers, providers and other stakeholders. They will bring that expertise to bear to create value in their portfolio companies post-acquisition.

**Hot geography: Asia-Pacific.** The smaller impact of the credit crisis on Asia-Pacific's markets and the better prospects for economic growth continued to make the region attractive to PE investors during the downturn. Even as PE contracted globally from 2007 to 2009, Asia-Pacific's share of investment nearly tripled from about 8 percent to 23 percent.

Across much of Asia-Pacific, the fundamentals are in place for continued buoyant growth. A substantial share of global growth in sectors like energy and healthcare, in greenfield infrastructure development and in commodities demand will likely come in Asia. Those opportunities have not escaped the notice of institutional investors, which are keen on investing a greater share of their global PE pools in the region.

Different factors will drive PE activity across developed and developing Asia-Pacific. In China, India and other developing markets, rapid domestic expansion in many sectors will provide ample opportunities for growth-capital investing. Many entrepreneur-led companies are looking for capital to finance their growth and to help them access overseas markets. More-established family-owned businesses are turning to outside investors to ease succession issues and ownership transitions. Private equity is emerging as an attractive alternative funding source in these markets where public equity exchanges and debt-capital markets are not as deep as those in the more developed parts of Asia-Pacific (see Figure 3.17).

Figure 3.17: Where to put money to work: Hot geographies



Notes: Survey conducted between November 2009 and January 2010; more than 500 respondents  
 Source: Private Equity News (5th Annual Survey of Financial Sponsors, 2010)

Even in the region’s more mature economies, like Japan, South Korea and Australia, PE investors should see continued opportunities for buyouts and turnarounds. Corporations are spinning off non-core assets to raise cash. In some sectors, consolidation trends are creating roll-up opportunities; and distressed companies hammered by the economic slowdown are in need of investors that can help engineer turnarounds. As the Japanese economy struggles to recover from its two-decades-long underperformance, look for more buyouts like Bain Capital’s purchase, in December 2009, of Bellsystem24, a call center operator. In Australia, the existence of many large PE-owned companies, such as PBL Media sponsored by CVC Capital Partners and Coates Hire backed by The Carlyle Group, creates opportunities for sponsor-to-sponsor transactions.

Private equity’s race to Asia-Pacific has covered the region with a large overhang of capital. Funds have raised more than \$300 billion earmarked for deployment across the region since 2003, of which nearly \$200 billion still remains uninvested. Adding to the potential PE capital horde are sovereign wealth funds (SWF), which have emerged as a key investor class. Recently created SWFs in China and Korea are adding to the capital of regionally based funds. Meanwhile, increasing numbers of global SWFs, such as the Abu Dhabi Investment Council and Mubadala, have developed an appetite to increase their Asian positions.

**Hot asset class: Distressed investing.** The tough economy and challenging debt conditions of 2008 and 2009 created some of the most favorable investment opportunities in the distressed debt market, including debt trading, loans-to-own and restructurings. The economic downturn pushed many highly leveraged but high-quality companies into distressed territory. The biggest bargains were to be found in late 2008 and early 2009, as companies’ debt prices were in near freefall and the face value of their debts exceeded market value. And with credit markets paralyzed, companies hitting covenants had limited options

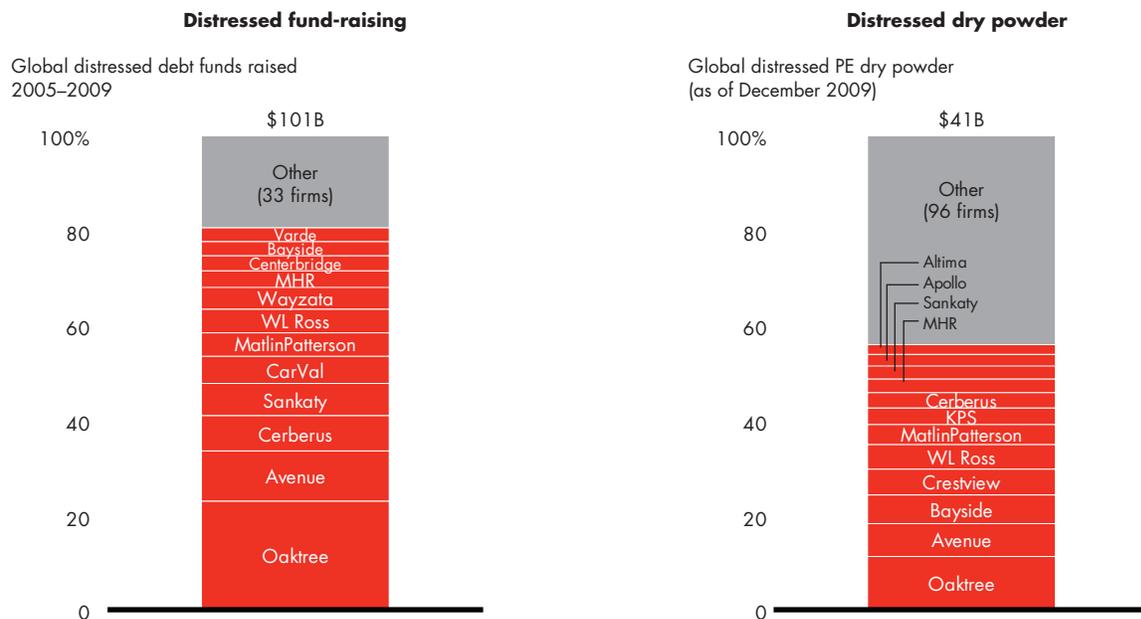
to restructure. Distressed investors had a choice array of companies in which to invest. Unlike past downturns when a relative handful of industries like telecom, infrastructure and automotive were hard hit, nearly every industry offered debt plays over the past two years.

These near-perfect conditions provided plenty of opportunities for non-control debt investors—collecting steady cash flow from coupons and holding until the value appreciated—and for loan-to-own and restructuring deals. Well-publicized restructuring examples included Masonite, a construction materials supplier, which filed for bankruptcy and landed in the hands of its debt holders led by Oaktree Capital and Centerbridge Partners. Simmons, the mattress manufacturer, emerged from bankruptcy protection under the ownership of Ares Management and Teachers’ Private Capital (which also own rival Serta).

But while the demand for financing was strong, few PE firms on the supply side had either the expertise or charter to invest in distressed debt situations. Just 12 firms accounted for some 80 percent of the \$101 billion in distressed debt funds raised over the past five years. Having gained the required capabilities and wisdom from accumulated experience of past downturns, distressed PE funds were sitting on \$50 billion in dry powder going into 2009; and by year end, capital earmarked for distressed PE investments had shrunk to \$41 billion, the greatest decline of all PE asset classes (see Figure 3.18).

Industry insiders think distressed investors should still be able to find ways to put that money to use in control and non-control situations that will continue to abound in 2010. The economy remains fragile, market disruptions are likely to recur and debt prices will continue to fluctuate, though are not likely to repeat the steep downward pitch they took in the recent past. Credit markets remain tight, especially for lower-grade companies; and their current dynamics suggest they will not be able to meet all refinancing demand.

**Figure 3.18: Distressed debt capital is concentrated**



Notes: Distressed PE includes distressed debt, special situation and turnaround funds; excludes other funds that have the ability to divert substantial capital to distressed investing; includes funds with final close and represents year funds held their final close  
Source: Preqin

The most fertile targets for distressed investing will likely be in those hard-hit sectors such as discretionary spending on consumer goods, like luxury products, and media and entertainment. Companies in these areas will continue to need substantially more outside funding over the next two to three years or risk greater probability of default.

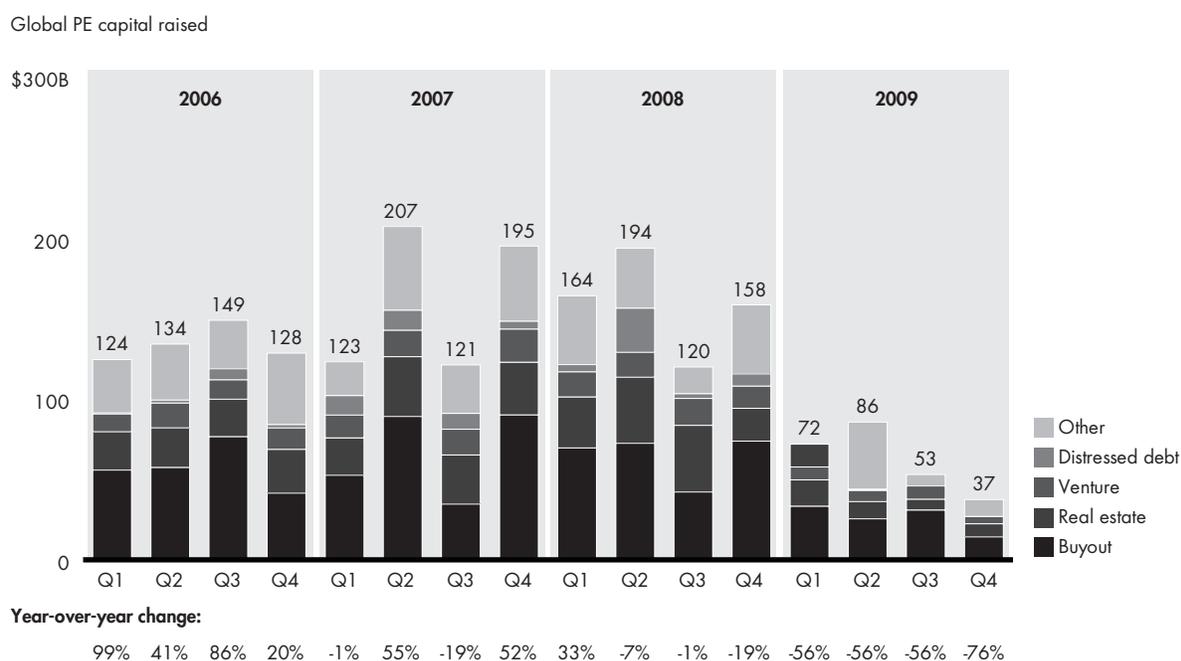
### Fund-raising conditions will be challenging over the short term

Fund-raising ended 2009 at its lowest ebb in five years, a harbinger of sluggishness that will likely continue well into 2010 and possibly longer. The economic slowdown is one major factor suppressing new efforts to raise capital, of course. But structural issues are at work, as well. PE firms are flush with committed but uncalled capital that will take years to deploy. Even some firms short on dry powder may hold back on new fund-raising until conditions improve. As for LPs, much as they remain committed to PE as an asset class, they lack the capacity to commit significant amounts of new capital. Until more distributions flow in, many LPs will hold the purse strings tight.

Unlike the modest pickup in the pace of PE investment and exit activity in the last quarter of 2009, fund-raising has been lackluster. Through each quarter of 2009, fund-raising dropped by better than 50 percent from the prior-year period, culminating in a 76 percent decline in the final quarter—the lowest level since the third quarter of 2004. The numbers were down across all asset classes—from buyout and real estate to venture capital and distressed debt (see Figure 3.19).

What will bring fund-raising back? The barrier is clearly not a lack of support for PE (broadly defined to include buyout, venture and distressed, among other fund types). A survey conducted last December by Preqin found that nearly 90 percent of current LPs say they will maintain or increase their PE target allocation in both the short and long term.

**Figure 3.19: PE fund-raising has not shown signs of recovery**



In interviews Bain conducted in late 2009, LPs expressed considerable optimism toward PE. While LPs' perceptions of PE took a hit during the downturn, most remain confident in and committed to it. As an interviewee representing a major foundation told us: "It's like having a fight with your mate. You're not happy about it when it happens, but you are going to stick it out."

Many LPs Bain interviewed said they believe PE is undergoing a cyclical adjustment, although they expect to see profound change in some parts of the market, such as for large and very large buyouts. Most LPs expect PE, broadly defined, to continue to generate excess returns, but they look for the gap between PE and public equity returns to narrow. They anticipate that certain types of funds will do better than others. And not surprisingly, their expectations for returns on investments already made are much lower. They believe in PE's post-acquisition formula for generating excess returns by creating value in portfolio companies, although they concede that many GPs have few operating value-creation capabilities.

As for their own portfolios, many LPs see the current crisis as a wake-up call, an opportunity to take a fresh look at PE's true risks—liquidity, volatility and leverage—and to reevaluate the risk-return role PE plays in a multi-asset portfolio. As already noted, this reevaluation will not affect most LPs' target allocation to PE. However, it will influence the composition of their PE portfolio as they shift capital more actively among fund types to manage risks and maximize returns. Said one pension fund manager, "Because of the turmoil, we have to decide what [PE fund types] we will not continue to invest with."

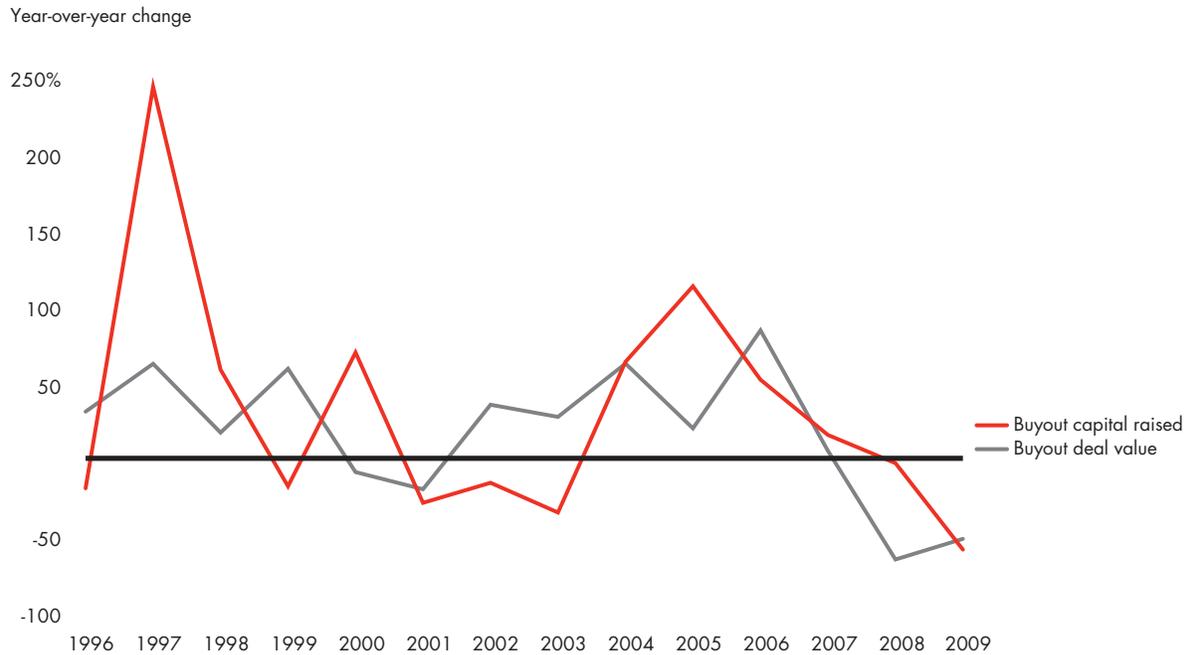
The optimism LPs express toward PE generally is more guarded when it comes to PE's fund-raising prospects in 2010. The experience of previous PE cycles shows that an important precursor to fund-raising's revival will be a pickup in new investment activity. Fund-raising tends to lag new investments both on the way up and on the way down. Investment activity has recently shown signs of picking up; but again, expect a delayed recovery in fund-raising (see Figure 3.20).

The next fund-raising cycle will be held in check over the short term by three mutually reinforcing factors affecting LPs' capacity to make new commitments: Most LPs are scraping against target allocations, there is huge overhang of capital commitments already made and LPs face a continued liquidity squeeze. Let's explore each of them in depth:

**Over-allocation:** With the ongoing recovery of the public equity and fixed-income markets, the denominator effect that made PE holdings a disproportionately large part of LPs' portfolios in 2009 has begun to subside. But most LPs still have little headroom left in their target PE allocations, and only 20 to 25 percent are planning to increase them in both the short and long term. At year-end 2009, 55 percent of LPs remained at or above their target allocations, a marked relaxation of pressure since the middle of the year, but leaving little room to add new PE commitments. Among traditional PE investors, private pension funds and endowments had the least headroom (see Figure 3.21).

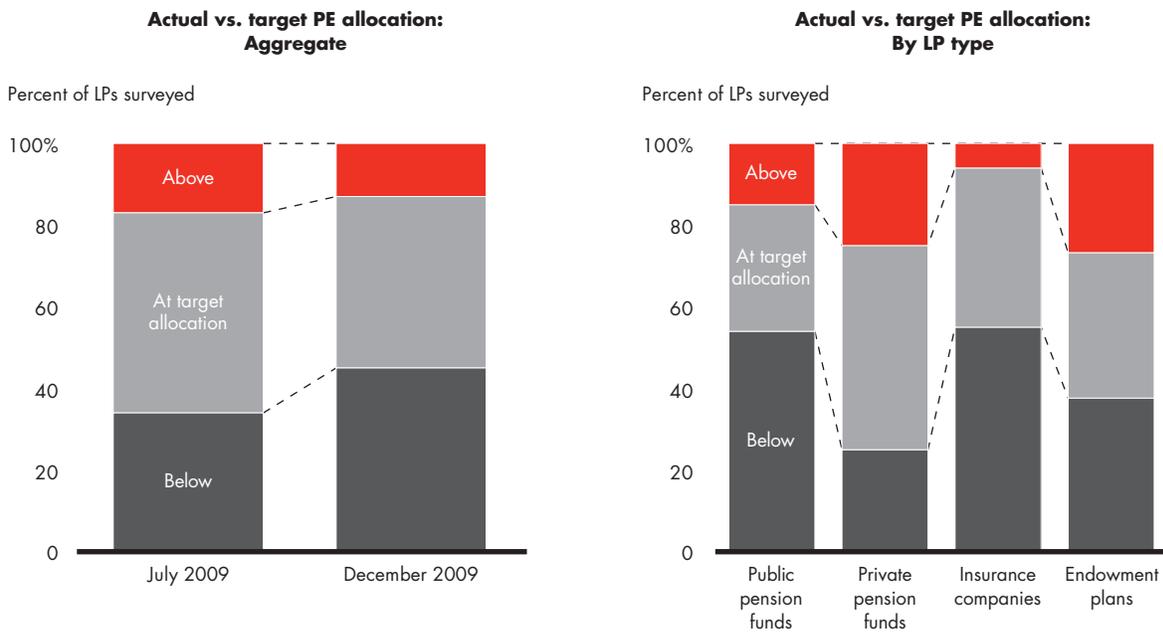
Even with tight headroom and liquidity pressures, some LPs told us they are continuing to make new commitments. However, they are working with smaller amounts and are sprinkling those among fewer GPs. "We have to plant seeds if we want to have a harvest later on," said one pension fund investor.

**Figure 3.20:** As in the past, fund-raising will lag the recovery in investment activity



Sources: Preqin, Thomson Reuters

**Figure 3.21:** Many LPs remain at or above their target allocation



Sources: Preqin (Private Equity Investor Survey, July 2009 and December 2009; Endowment Plan Survey August–October 2009; Insurance Company Survey August–September 2009)

As they screen new fund-raising invitations, other LPs told us they plan to use the period ahead to make opportunistic commitments to areas that are in favor, like distressed assets or secondaries. Some also said they will commit in order to maintain a valued GP relationship, or to secure a new one that had been out of reach in the past. “We have a lot of outstanding commitments, and we are not using this period to get more generic exposure, because we don’t need it,” said a private pension fund manager. His fund is looking to shore up positions in secondaries and distressed and to gain “access to managers where two years ago we wouldn’t even have gotten through the door.”

**Capital overhang:** LPs need not participate in new fund-raising rounds to position themselves firmly to benefit from an uptick in deal making. They have already pledged more than \$1 trillion in commitments to earlier funds and sitting as capital that has yet to be called. As deal making picks up and PE funds activate capital calls, LPs will be in the favorable position of being able to put their money to work at what historically has been the most advantageous time in the deal cycle—when acquisition prices are most attractive and growth prospects brightest coming out of a downturn. Indeed, LPs believe that this huge commitment backlog, and the opportunity it provides to be in the deal market early in the cycle, relieves them of the need to be quick to sign up for new fund-raising commitments as they had to in the past.

The capital overhang will put further pressure on PE allocations. To understand the magnitude of the impact, we looked at the current PE allocations of three big US endowments and evaluated what would happen if they were to fund all of their uncalled commitments: By doing so, their PE allocations would double, blowing through their targets.

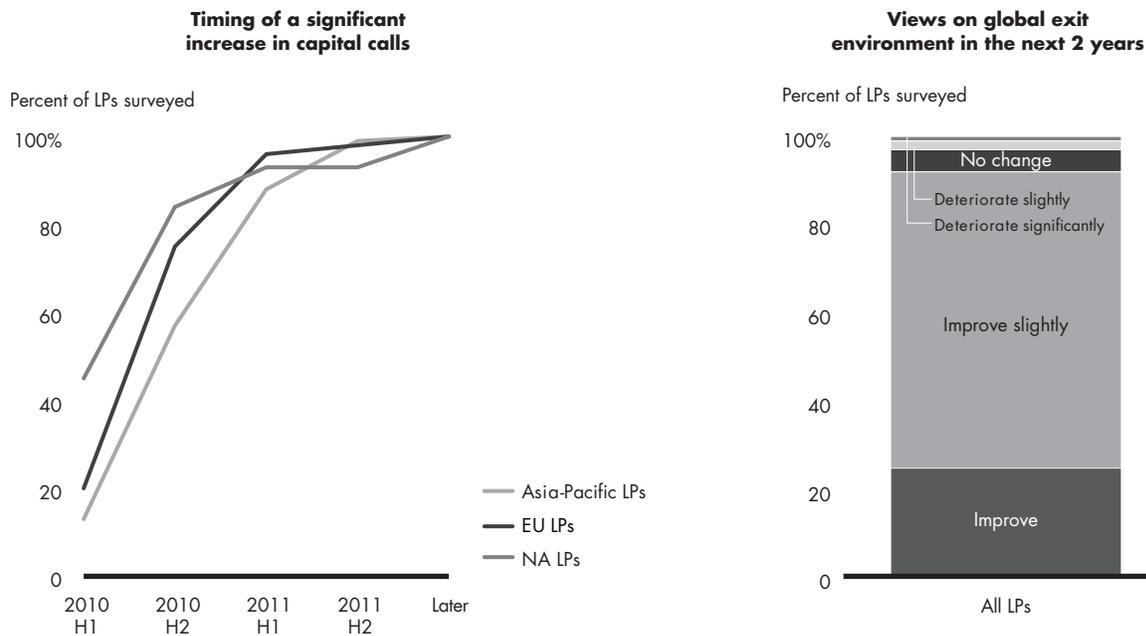
**Liquidity squeeze:** LPs are anticipating that capital calls will become more frequent as deal activity revives from its hiatus. Collier Capital’s Global Private Equity Barometer Winter 2009–2010 found that 84 percent of LPs in North America, 75 percent in Europe and 57 percent in Asia expect calls to increase significantly by year end (see Figure 3.22).

More capital calls will bring into play another timing imbalance related to the PE deal cycle: PE funds will continue to find the environment to sell assets already in their portfolios challenging until earnings improve as the recovery gathers momentum. Thus, distributions could well lag capital calls through 2010, as they did both in 2008 and 2009, further squeezing LPs’ liquidity and impairing their ability to make new commitments.

Every LP we interviewed said they expect capital calls to outpace distributions over the coming year. However, they also told us they expect distributions to be higher in 2010 than they were last year, as PE managers feel obligated to recycle money back into the system. In other words, GPs will feel under pressure to provide distribution-starved LPs some of the liquidity they need to meet capital calls and make new commitments. “We have [PE fund] managers who are going to have to reload and raise a fund again 12 to 18 months from now,” said an endowment manager LP. “Unless they start to send money back, trying to raise a new fund is going to be like trying to sell a bag of air; nobody’s going to want in.”

This uncertainty over how much they will realize in net cash flows in 2010 has many LPs managing to a downside scenario and keeping a close eye on liquidity. As one explained, “Our working assumption is that we are not getting any money back for two years. When we plan, we ask ourselves, if everything gets shut off, are we doing the right thing?”

**Figure 3.22: LPs expect capital calls to ramp up, but see only a slight improvement in exits**



Source: Collier Capital Global Private Equity Barometer (winter 2009–10)

Historically, it has taken a pickup in exit activity—and the distributions it triggers—to loosen the grip of a liquidity squeeze on LPs and open up space for new rounds of fund-raising. The correlation between the value of buyout exits and new buyout funds raised over the past decade is significant. As 2010 begins, the industry is clearly at a nadir with respect to exits and fund-raising comparable with where PE was at the depths of the cyclical downturn at the beginning of the decade (see Figure 3.23).

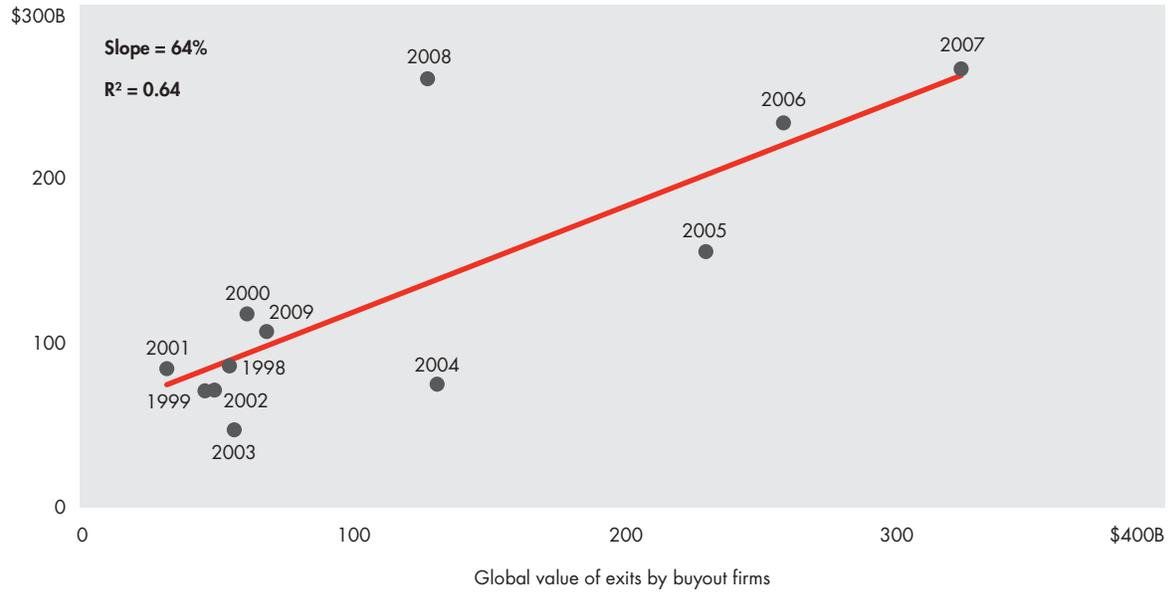
With that relationship in mind, what does recent exit activity portend for fund-raising in 2010? Exits did begin to recover late last year. Sales to strategic buyers, sponsor-to-sponsor (or secondary) transactions and initial public offerings showed momentum in the fourth quarter of 2009 (see Figure 3.24). US buyout-backed IPOs performed well, outpacing the Standard & Poor’s stock index by more than 500 basis points, on average, from their initial listing to mid-February this year.

But PE funds cannot count on IPOs to loosen the liquidity squeeze anytime soon. With a large backlog of PE-backed portfolio companies looking to go public, the markets will be unlikely to absorb a glut of offerings. The volatility of the stock markets so far in 2010 has not made things easier. Also, discriminating investors are looking to buy businesses with healthy balance sheets and stable or improving earnings, which is not the profile of many companies in PE funds’ portfolios.

Moreover, those companies that do successfully navigate the IPO route will yield only minimal cash distributions to the LPs in the near term. Equity investors expect a portion of IPO proceeds to be used to pay down debt. They also expect PE firms to continue to align their interests with theirs by retaining a significant equity stake in the newly listed company.

**Figure 3.23: Until exit activity picks up, fund-raising will be on hold**

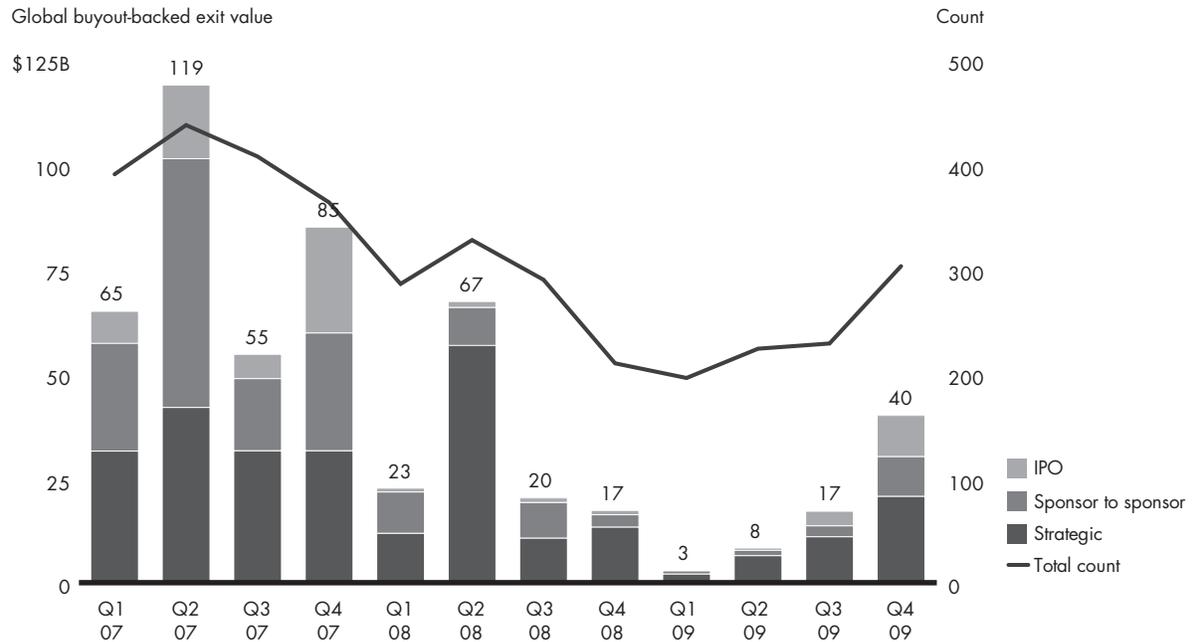
Global buyout funds raised



Sources: Preqin; Thomson Reuters

**Figure 3.24: Exit activity has just begun a modest recovery**

Global buyout-backed exit value



Note: IPO value represents offer amount  
Sources: Thomson Reuters; Buyouts News

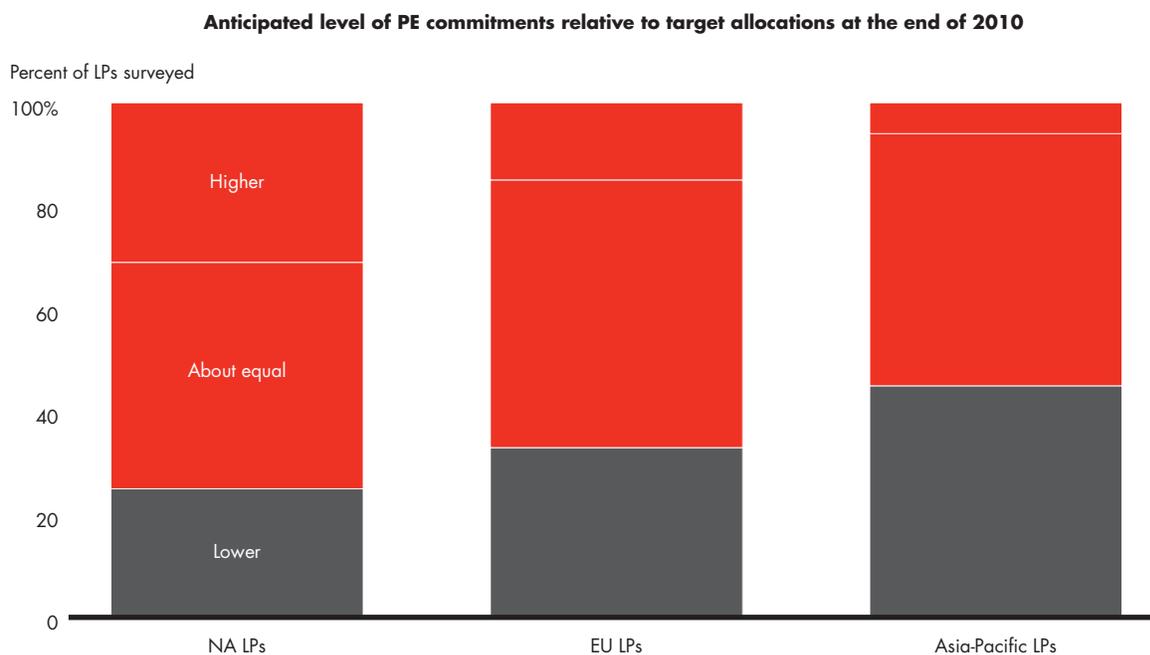
PE firms may face better chances exiting through sales to strategic buyers. More potential acquirers have balance sheets flush with cash reserves, and they are more confident in the economic recovery and their industries' growth prospects. The viability of exits through sponsor-to-sponsor sales will depend heavily on conditions in the credit markets, as these transactions often require large amounts of debt to be rolled over. (Sponsor-to-sponsor exits may aggravate the liquidity squeeze if they come to dominate exit activity: For large LPs, that may be money that goes into one pocket and out the other.)

Needless to say, GPs' motivations to head for the exits abound: In addition to returning money to LPs, GPs are eager to bolster their time-sensitive internal rates of return. However, the large concentration of big, expensive deals made at the cyclical peak will cool their enthusiasm. These deals will inevitably take longer to mature. Their performance has been hit hard by the downturn and expectations of a modest economic recovery will make returning them to historical earning levels, let alone to the level of earnings projected in their deal models, challenging. PE funds will need the luxury of time to effect significant improvements. Furthermore, these deals have fewer exit options, as a limited number of strategic buyers can digest these behemoths.

Together, over-allocation, the capital overhang and the liquidity squeeze will further cause LPs to bump up against target allocations by year's end. In Collier Capital's latest survey, 75 percent of North American LPs, 67 percent of European LPs and 55 percent of Asia-Pacific LPs anticipate their actual allocations to match or exceed their target allocations at the end of 2010. New fund-raising commitments will suffer as a result (see Figure 3.25).

With nearly 1,600 PE funds on the road at the beginning of 2010 looking to raise more than \$700 billion globally, competition for the few new dollars available will be intense.

**Figure 3.25: Many LPs expect to bump up against their target allocations by the end of 2010**



Source: Collier Capital Global Private Equity Barometer (winter 2009–10)

## Limited partners are becoming more discerning investors

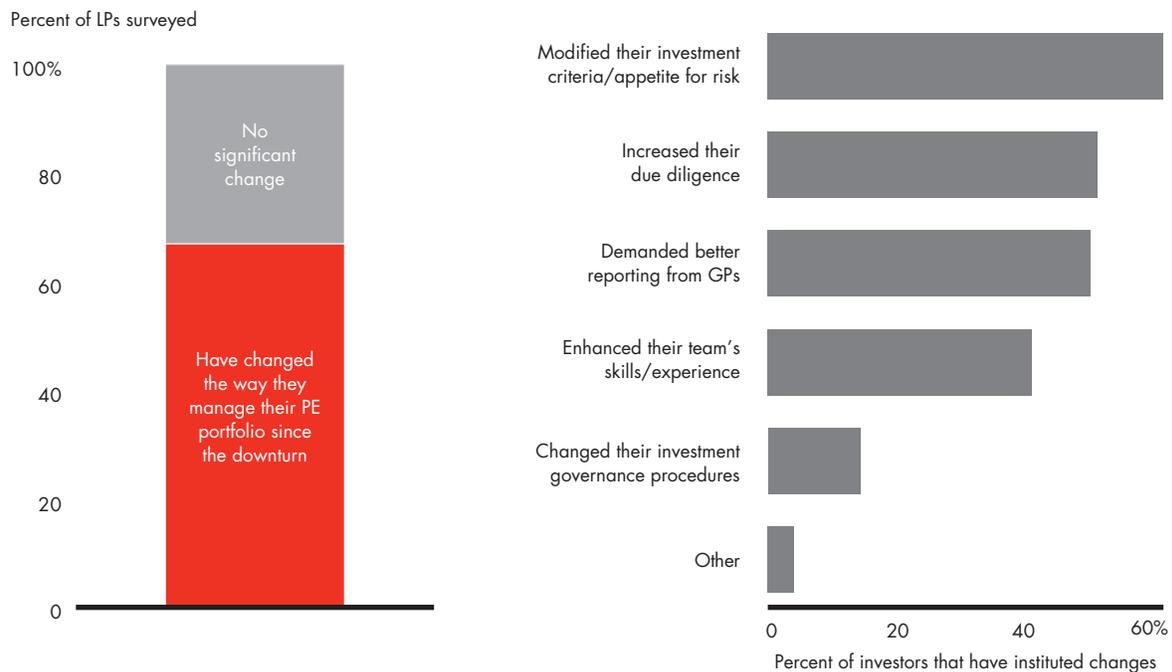
One notable shift that is beginning to emerge with the latest turn of the PE cycle—one that is likely to redefine relationships between LPs and GPs going forward—is a determination by LPs to invest more selectively and on terms more to their liking than they have until now. In part, this newfound assertiveness has been a natural by-product of the deep downturn and the surprises and disappointments it revealed. Having watched the valuations of their PE investments drop and feeling no hurry to commit new funds, LPs have had the time to reassess their investment goals and where PE fits within them. But the attitudinal sea change is also a reflection of the maturing of PE as an asset class. And as in many industries, the greater maturity of PE is being accompanied by the beginnings of a tilt in the balance of power to the customer.

LPs have begun to change the way they are investing in private equity. Two-thirds of LPs polled in a recent survey reported that they have modified how they manage their PE portfolio since the downturn. Of that group, a majority have changed their investment criteria and reevaluated their risk appetite, increased their due diligence and insisted that GPs provide better reporting of their activities. Many have enhanced their in-house skills and team experience, and about one-fifth have altered their investment governance procedures (see Figure 3.26).

Our interviews with institutional investors probed the changes many LPs are instituting and found that they are modifying their approaches in five key areas:

**LPs are giving more thought to portfolio construction.** The downturn has raised LPs’ sensitivity to the illiquidity of PE investments, the risk associated with volatility and the risk arising from leverage.

**Figure 3.26:** LPs have changed the way they invest in PE



Source: Collier Capital Global Private Equity Barometer (winter 2009–10)

The volatility of PE valuations has recently become an especially thorny issue. Prior to 2008, PE funds carried illiquid companies in their portfolio at cost for at least a year, and often longer, unless an intervening financial transaction warranted a different valuation. In some cases, cost-basis valuations continued until exit. That approach, often justified as conservative, had the benefit of smoothing out returns.

Although generally accepted accounting principles (GAAP) require that investments be carried at “fair value,” it was not until September 2006 when the US Financial Accounting Standards Board issued FAS #157, which specified how illiquid investments should be valued and spelled out required disclosures, that PE firms were obligated to alter their valuation practices. (Compliance with FAS #157 was generally in effect for financial statements issued for fiscal years beginning after November 2007.) Most PE firms in the US adopted the new valuation method in the latter part of 2008, resulting in much greater volatility in fund valuations and returns, with meaningful impact on LPs’ portfolios.

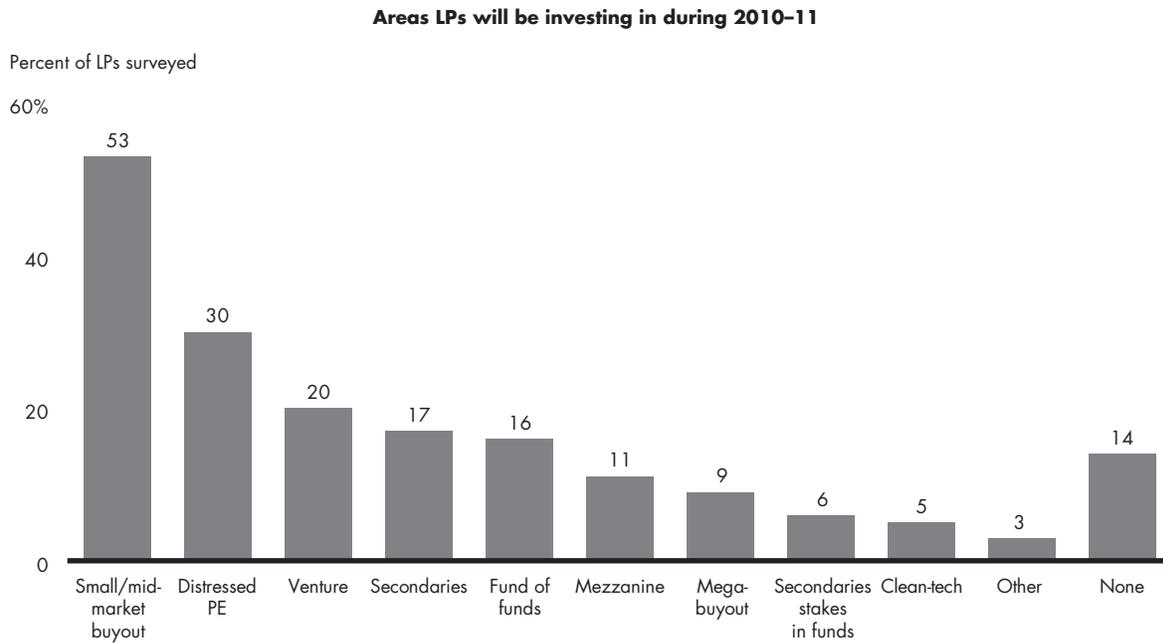
As a result of the changes, LPs are now undertaking formal and thorough assessments of risks and giving more thought to how they construct their portfolio. As one insurance company LP told us: “The big increase in volatility [has led us] to take a fresh look at our long-term views on the asset class and alter our investment plans. It was more about portfolio management and risk management than about saying that we fundamentally think opportunities in PE no longer exist.”

**LPs are diversifying across fund types and geographies.** One consequence of differences in performance and volatility across the various types of PE funds has been to reorient and broaden LPs’ preferences for the kinds of fund investments they will be inclined to make at different points within economic and PE cycles. Historically, many LPs’ fund investments were concentrated in US and European buyout and venture capital funds. Our interviews confirmed that this definition has expanded to cover mezzanine, distressed debt, turnaround, infrastructure and real estate, among others. Even as most LPs maintain their PE target allocation overall, they will diversify their capital among fund types to maximize returns and manage risks.

In the Preqin survey conducted last December, more than half of the LP respondents said they would be looking to invest in small and mid-sized buyouts over the coming two years. Interest in funds that invest in distressed assets also runs high for 2010 and 2011. LPs say they will be steering clear of the mega-sized buyouts that were so much in favor in recent years. Investor interest also continues to run high for opportunities in Asia among the fast-growing emerging markets, particularly in China and India (see Figures 3.27 and 3.28).

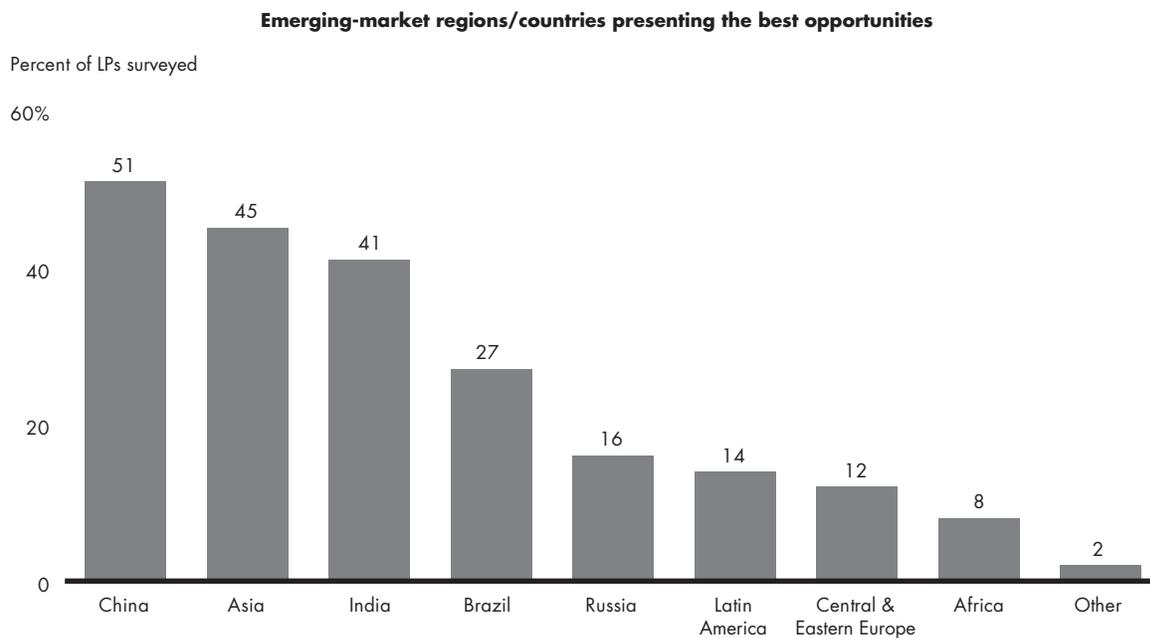
Even as they move to diversify, none of the LPs Bain interviewed placed value on investing with PE firms that offer one-stop shopping, preferring instead to work with focused GPs that stick to their knitting. Said one foundation executive: “We prefer to find people who can do one thing really well and build our own portfolio rather than assume that one firm can do everything well.” Most LPs we interviewed believe they have the resources to undertake due diligence and the sophistication to determine which GPs are best in class as they construct their holdings on their own and try to diversify. LPs evaluate each PE fund offered by one-stop-shop firms on its own merits, insisting that it perform at least as well as similar funds offered by more focused GPs. As one LP explained, “We have investments with firms that offer a multitude of offerings. We won’t consider other things on the platform unless we believe that they are superior performers to funds that we can get elsewhere.”

**Figure 3.27: LPs will invest in smaller buyout funds**



Note: Respondents could pick more than one area  
 Source: Preqin (Private Equity Investor Survey, December 2009)

**Figure 3.28: LPs believe Asia presents the best emerging-market opportunities**



Note: Respondents could pick more than one area  
 Source: Preqin (Private Equity Investor Survey, December 2009)

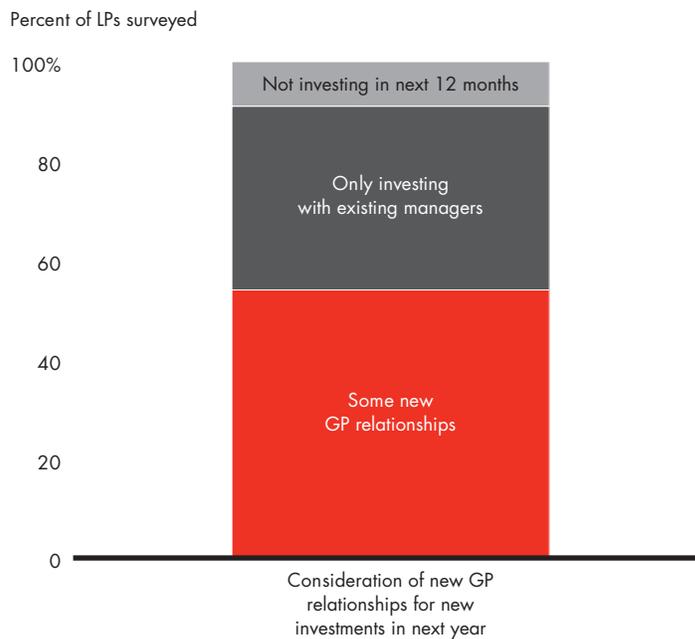
**LPs are culling their portfolios in a flight to quality.** Many surveys indicate that, on average, LPs expect to maintain about the same number of GP relationships over the next two years. But Bain’s interviews with LPs uncovered a greater degree of consolidation and churn within LPs’ GP base. A large majority of the LPs we spoke with reported that they are actively reevaluating their GP relationships, maintaining a stable of core GPs and aggressively weeding out the poor performers. In several instances, LPs we interviewed said they would be reducing the number of GPs they work with by more than 50 percent.

For many LPs, the culling process began before the financial crisis, but the downturn has served as a catalyst that motivated LPs to move more forcefully. The consolidation process is being done principally by LPs declining to participate in new funding rounds (“re-up”). Some have been considering opportunistic secondary sales as a way to sever relationships they no longer want to maintain, but those have been hard to pull off at a time when the gap between seller and buyer expectations has been so wide.

As they build their stable of core managers, will LPs be disinclined to form new GP relationships? In a survey, about 30 percent of LPs said they will be investing only with their current managers, while 55 percent said they will consider new GP relationships for the new investments they make in the coming year (see Figure 3.29).

However, our interviews suggest that LPs will be very selective and opportunistic when adding new fund managers. LPs we spoke with emphasized that adding a new fund manager would be considered in the context of replacing an existing GP as they look to reduce their number of relationships overall.

**Figure 3.29: LPs will consider new GP relationships selectively**



Source: Preqin (Private Equity Investor Survey, December 2009)

Paradoxically, LPs may end up becoming more exposed to, and perhaps tempted by, new GP relationships than before. As they scrutinize their current GPs relative to their peers, they will come across ones they like and may seek them out. Said one, “As we look at particular sectors and how our managers are performing, we will [discover] managers with whom we are not invested and who are performing better.”

But if LPs are open to adding new GP relationships, few are ready to consider investing with first-time funds. “We never want to see a first-time fund ever again,” said a public pension fund LP bluntly. Newcomer funds typically account for about 15 percent of capital raised, but they garner less at the bottom of the cycle. The hurdle will be much higher coming out of this downturn. A private foundation LP described the criteria for his organization to invest with a new fund: “If someone can come out with a compelling idea, has an angle and has a verifiable track record, I’d look at that pretty hard.”

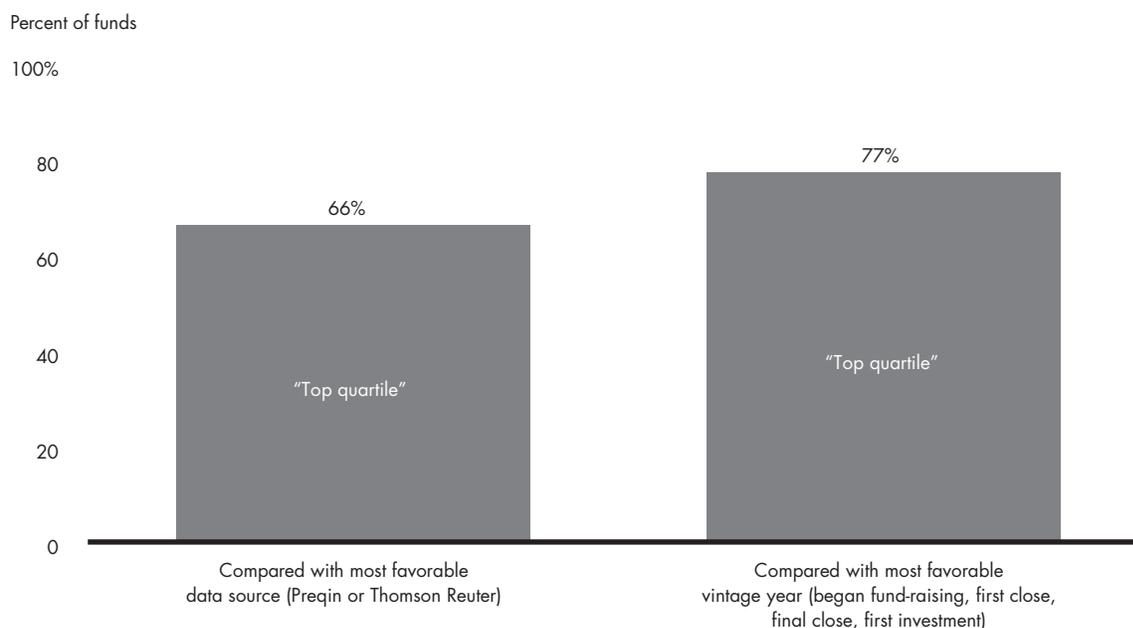
For PE firms, LPs’ greater selectivity will wring out marginal players and could trigger a broad shakeout. Many firms will contract, others will be unable to raise new funds and some will disappear entirely. That is nothing new; PE cycles have always taken their toll of victims.

**LPs are subjecting both existing and new GP relationships to closer scrutiny.** As they decide where and with whom to invest, LPs are stepping up the rigor, discipline and objectivity of their due-diligence process. Drawn-out fund-raising periods have freed up time for LPs to exercise increased scrutiny. In interviews, LPs told us that they are more sensitive to GPs’ true performance track record. They are taking a closer look at how the GPs generate their returns and how much their performance is the result of leverage or whether returns are achieved by adding operating value to their portfolio companies.

Another factor weighing more heavily in LPs’ decisions is a GP’s firm and team dynamics. Priorities topping the list of what LPs are looking for are: how the firm is managed, team stability, how succession is determined, the firm’s incentive structure, how it funds its own commitments and how key decisions are made. LPs are also more concerned with investment terms and conditions; and they are paying closer attention to such issues as alignment of interest, transparency and how forthcoming GPs are with information.

LPs we interviewed insisted that they will scrutinize every GP, new or current, by a common set of standards. As one put it, “Even if we have a long-term relationship, every time a GP comes in, it’s a whole new process. We need to evaluate whether this is really the best opportunity for us given the current environment. There is some sort of strength in relationships that perhaps allows subpar performance to continue to be supported. Private equity firms are not going to get away with leaning on the relationships to overcome performance shortcomings.”

When it comes to sizing up fund performance, LPs will take a harder look at some GPs’ creative math. A recent investigation of performance claims made by 500 buyout funds raised between 1985 and 2005 has found that fully two-thirds of the funds claimed they turned in “top-quartile” results by comparing their returns with the most favorable data source. More than three-quarters said they achieved “top-quartile” performance by comparing the returns they generated with the most favorable vintage year, be it the year when fund-raising began, or the anniversary of the fund’s first close, its final close or its first investment. Instead of trusting in such dubious self-reporting, many LPs will be evaluating performance using a common set of verifiable metrics (see Figure 3.30).

**Figure 3.30: Skeptical LPs will scrutinize GPs' benchmarks**

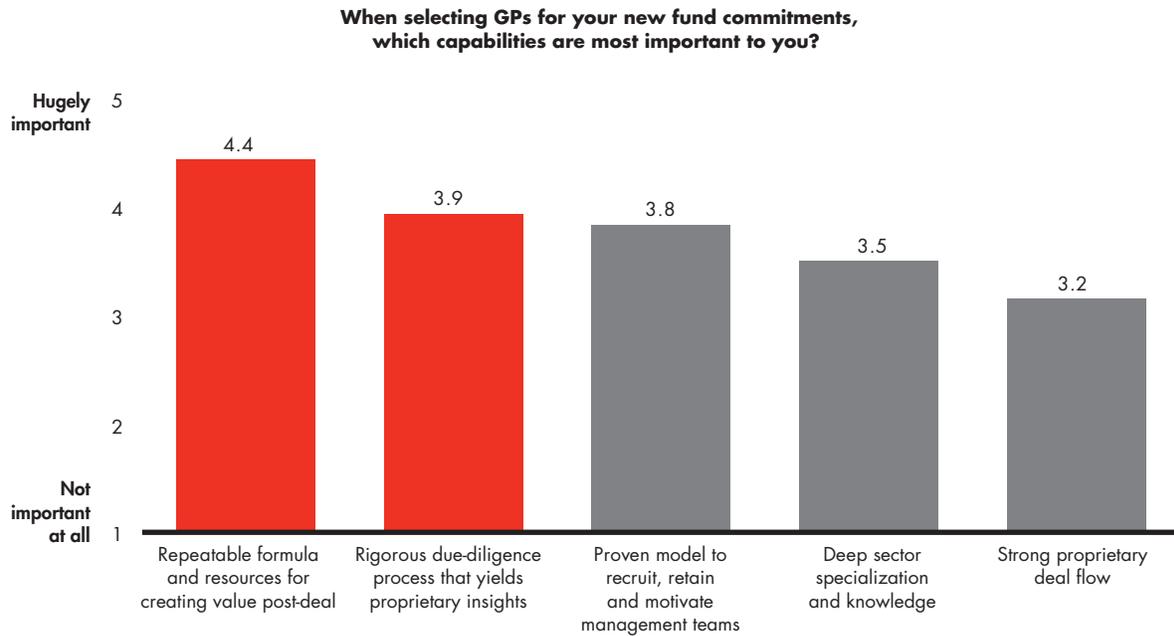
Note: Based on sample of 500 buyout funds raised between 1985 and 2005  
 Source: Buyout Research Program Research Brief, Oliver Gottschalg (February 2009)

Beyond demanding a provable performance record, LPs are looking to work with GPs that have demonstrable capabilities. When we asked LPs to rate the importance of various capabilities they look for when selecting GPs for their new fund commitments, having a repeatable formula and resources a PE firm can call on to create value post-acquisition came in at the top. Close behind were a rigorous due-diligence process that yields proprietary insights and a proven model for recruiting, retaining and motivating strong management teams. These are all qualities that will be paramount for success in an environment where leverage alone cannot be counted on to work its magic (see Figure 3.31).

Most PE firms believe they have capabilities that differentiate them from their peers. In a survey, 69 percent of respondents say they possess distinctive operational skills and 55 percent believe that their industry expertise sets them apart from their peers. But LPs are skeptical; only 40 percent are satisfied that GPs' portfolio management abilities are adequate to meet the challenges of the current economy (see Figure 3.32).

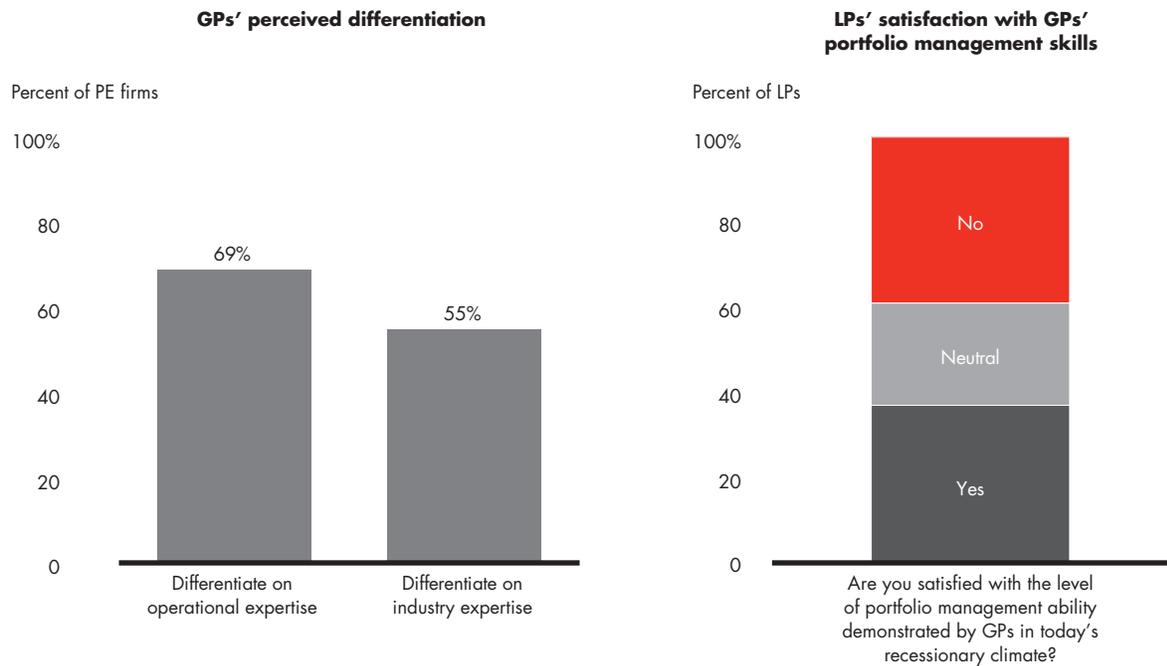
How will LPs scrutinize GPs' post-deal value-creation capabilities—the most important criterion for LPs? Most LPs confess that it is difficult to evaluate who does it well. But that challenge will not deter them from examining the question from many angles, bringing to bear as much independent validation as possible. Many LPs have started to perform a systematic quantitative review of past deals that dissects returns into its key factors. “You need to do the work, deal by deal, to get a better sense of the quality of the returns, and you have to do it yourself,” said an endowment LP. “The GP is always going to show returns that are all based on operational improvement.”

**Figure 3.31: LPs view post-deal value creation as the most important capability**



Source: Bain interviews with LPs (September 2009, December 2009)

**Figure 3.32: LPs are lukewarm about GPs' post-deal value-creation capabilities**



Sources: Gotham Consulting Partners (4th Annual PE Survey, March 2009); Private Equity International (LP Survey 2009, conducted March–April 2009)

GPs should not be surprised if they find prospective investors interviewing the senior and mid-level managers of their portfolio companies, talking to their former employees and former portfolio company employees, questioning operating executives that have worked with their firm or even talking to companies whose transaction with their firm failed to pan out.

**LPs believe passionately that GPs need to be more closely aligned to their interests.** For the many years over the past two decades when PE thrived, GPs were free to set fees and dictate terms and conditions. LPs had little choice but to accept. However, the adverse climate of the past two years—along with some pent-up frustration on the part of LPs—is shifting the balance of power back to limited partners.

Recent moves at the industry level reflect this shift. Last September, the Institutional Limited Partnership Association (ILPA) issued a manifesto intended to restore and strengthen the alignment of interests between PE fund managers and their investors. The timely release of the ILPA principles and their broad endorsement (as of January, more than 90 institutional investors had signed on) may help level the playing field.

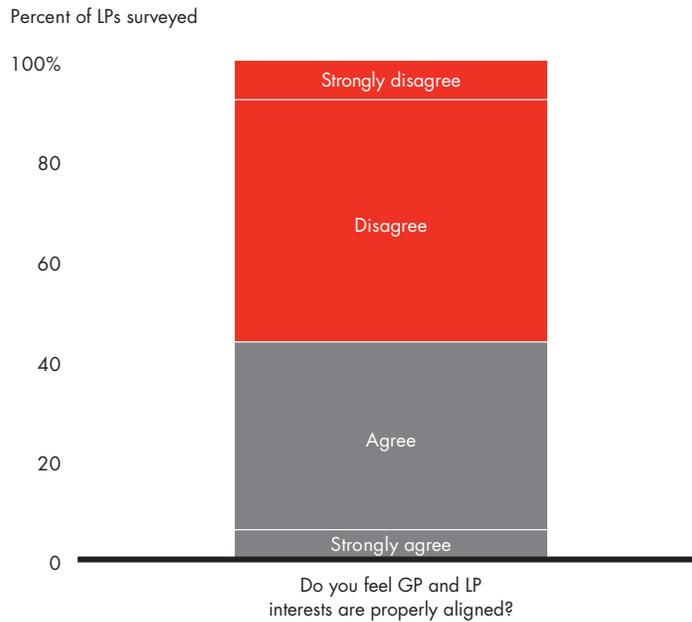
Certainly, survey data are unambiguous that LPs feel that their interests are not properly aligned with those of the PE fund managers with whom they work. The list of grievances is long and includes both economic and noneconomic aspects of the relationship such as transparency and governance (see Figure 3.33).

In our interviews with LPs, it was apparent that they recognize that the swing of the power pendulum in their favor may be short lived, lasting only until the fund-raising environment improves. Said one foundation manager: “LPs need to strike while the iron is hot. It is very important that [steps be taken] to rebalance the relationship.” Tempering the impatience for realignment, however, most LPs are realistic about what they can achieve and aware that taking a punitive approach would be counterproductive. “We don’t want to starve these guys,” said a university endowment manager speaking of GPs. “We hire these people, we partner with them to generate good returns for us. We want to make sure they have the resources and manpower to do that job on our behalf.”

In what areas do LPs look to win concessions? On the economic side of the relationship, LPs see room to secure more favorable terms and conditions when they negotiate new fund commitments over the coming year or two. LPs told us that, by far, the biggest opportunity for bargaining will be over the sharing or elimination of transaction and monitoring fees. As one insurance company LP put it: “It’s the most abused area within PE, an absolute misalignment of interests. Investors have accepted that sharing of those fees is appropriate, and it’s not.” The next opportunity for bargaining LPs see will be to trim management fees, especially those charged by the larger funds. LPs are less confident that they can extract significant concessions to lower carried interest or raise the hurdle rate for GP profit participation. “For carry, 20 percent is stable, but those at 30 percent might fall,” said an investment management company executive. “The hurdle rate will probably not rise past 8 percent, but GPs that do not currently have one will incorporate one.” Although they are not expecting meaningful changes in the level of carried interest, LPs we interviewed did emphasize that they are looking for tighter carry distribution provisions to avoid clawback situations (see Figure 3.34).

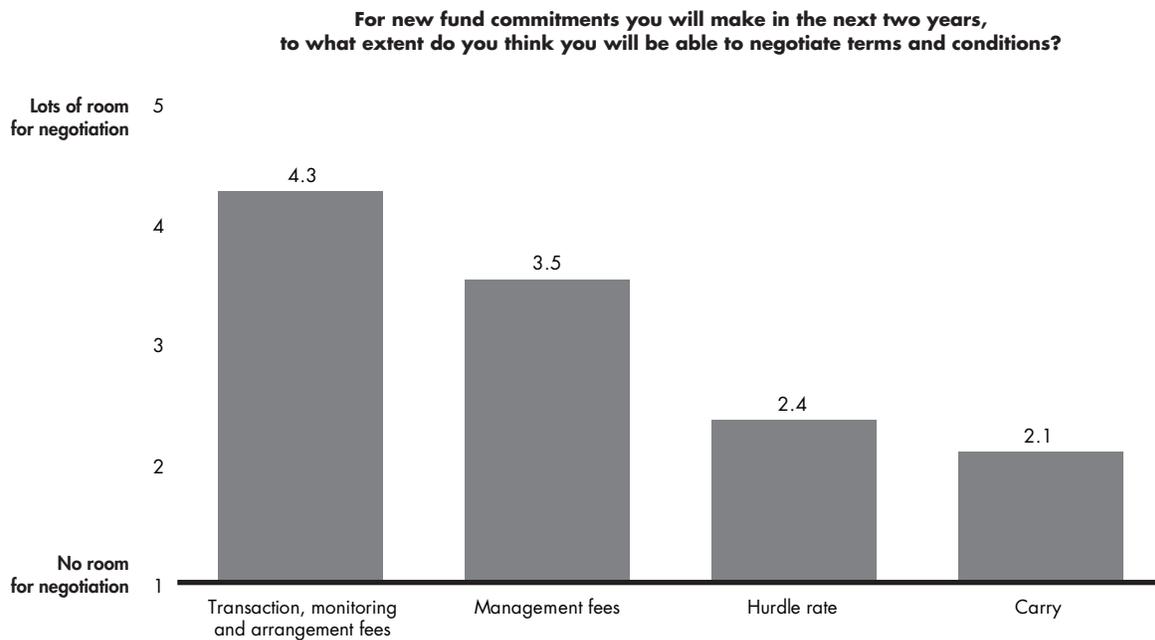
Early indicators suggest that terms and conditions have begun to shift modestly in LPs’ favor. The Prequin survey, last December, found that about half of LPs polled had seen changes in prevailing terms and conditions in their favor in the previous six months—mainly with respect to lower management fees and rebates of deal-related charges (see Figure 3.35).

**Figure 3.33:** Interests of LPs and GPs are not properly aligned



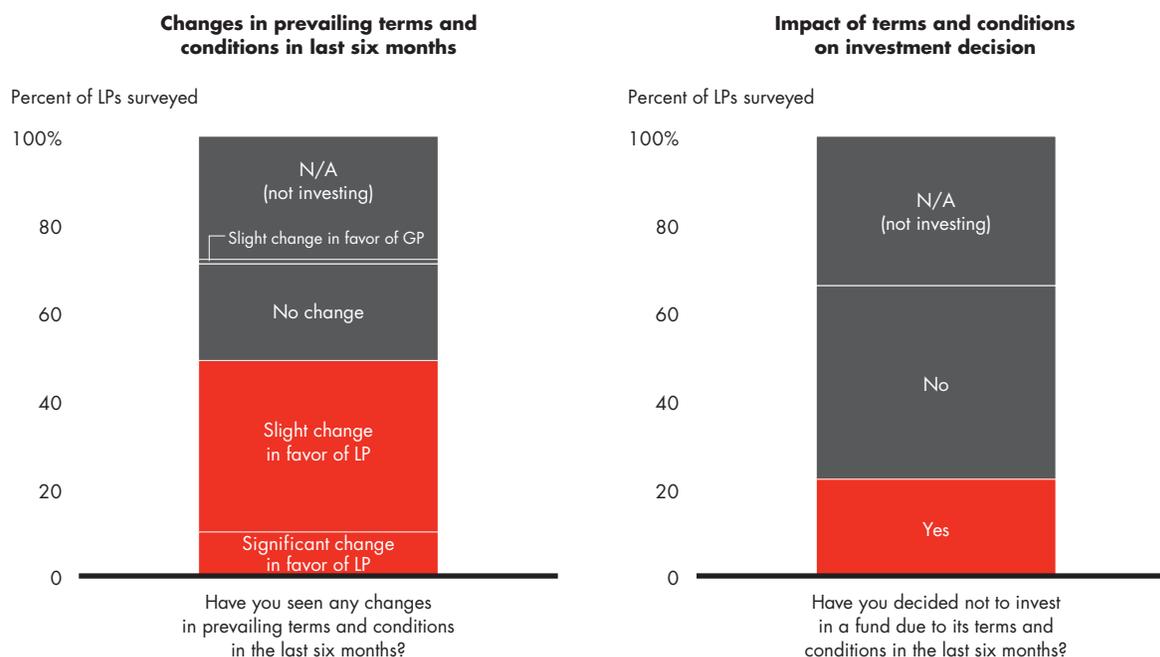
Source: Preqin (Private Equity Investor Survey, December 2009)

**Figure 3.34:** LPs expect concessions on fees



Source: Bain interviews with LPs (September 2009, December 2009)

**Figure 3.35: Shift in fee terms is already evident**



Source: Preqin (Private Equity Investor Survey, December 2009)

It is too soon to say, however, whether these initial reports mark the beginning of a trend. Only slightly more than one LP in five surveyed reported that they had declined to invest in a fund in the prior six months because they could not accept the terms and conditions GPs sought to impose.

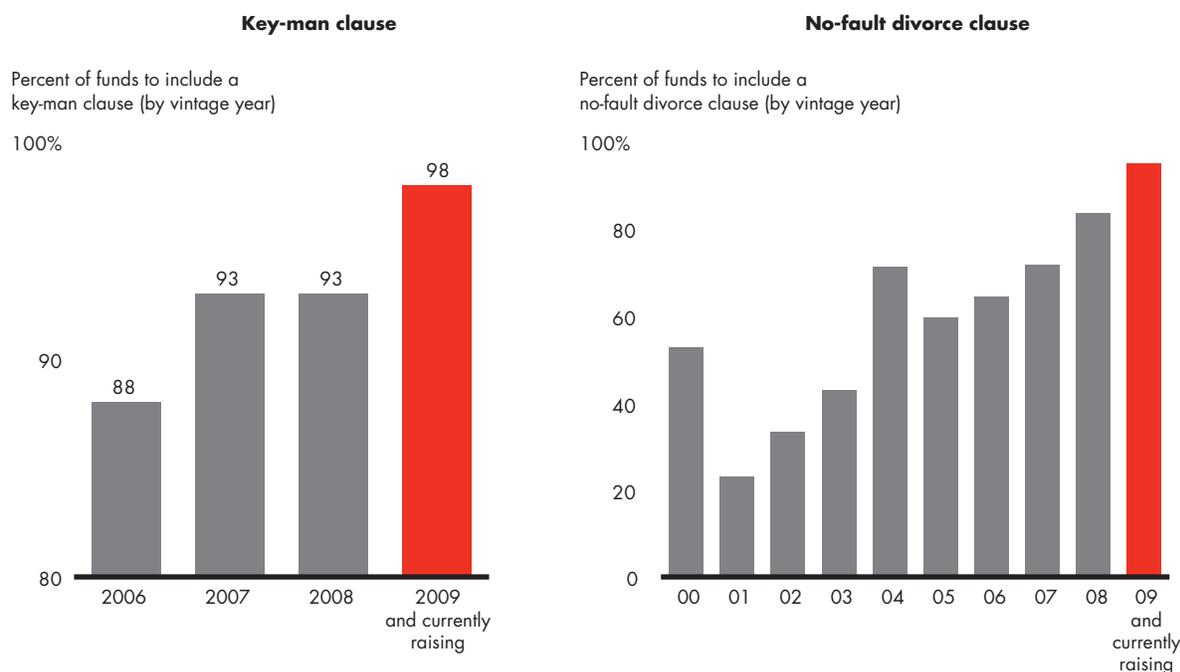
GPs appear more willing to grant concessions to LPs over some noneconomic contractual issues. Nearly all funds that have recently closed or are still on the road have been amenable to adding key-man clauses to their contracts, a significant increase over recent years. LPs have also been able to extract more flexible “no-fault divorce” clauses that make it easier for them to part company with GPs when circumstances dictate they should. Present in just over 20 percent of contracts in 2001, they are becoming ubiquitous (see Figure 3.36).

Going forward, it is clear that LPs will be more assertive in their future negotiations with GPs. Most affected will be poor performers, of course, but also GPs that, in the past, resisted making changes that have been widely adopted by other firms in the industry. As one foundation LP put it, “If anything, we are starting to believe that you are better off with an A- manager that is completely aligned with you than an A+ manager that is not.”

### Returns will be modest over the next three to five years

When PE fund managers look back over the past private equity cycle, they will marvel at how seemingly effortless it was to make money. Market conditions could hardly have been more favorable for generating returns, a far cry from what lies ahead.

**Figure 3.36: Shift in non-economic terms is also starting to occur**



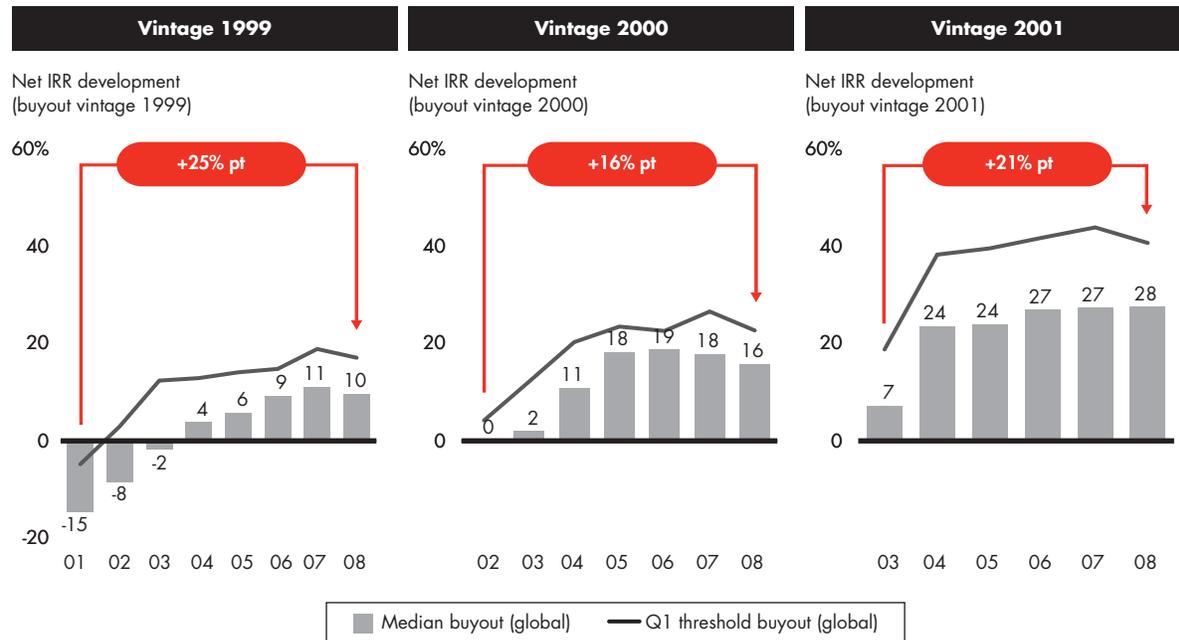
Source: Preqin (2009 Fund Terms Advisor)

PE investments benefited from steady economic growth. Between 2002 and 2004, nominal GDP in the US and EU averaged a healthy 4.9 percent and 3.3 percent, respectively, accelerating to 5.9 percent and 4.7 percent between 2005 and 2007. PE firms could finance their deals with generous helpings of inexpensive leverage, thanks to a global surge of liquidity from investors hungry for returns in an environment of cyclically low interest rates, declining corporate defaults and falling yields. By 2005, the spread for US LBO term loans had dropped to less than 300 points over LIBOR and deals could be financed with equity contributions averaging just 33 percent in both the US and Europe, according to Standard & Poor’s Leveraged Commentary and Data.

Fierce competition among PE investors in this benign climate pushed up transaction multiples to record highs. That generously inflated the prices PE firms could realize when they exited after shorter holding periods. (It also inflated the purchase prices firms paid for new investments, a factor that, as we discuss below, will hurt future returns.) By 2007, LBOs in the US and Europe were closing out at 9.7 times EBITDA, on average. Without having to put much muscle behind the effort, firms surfing the growth wave could generate gross internal rates of return of between 30 percent and 50 percent on deals made during this “golden age.”

The recovery that followed the 2001 recession helped turbocharge the performance of buyout funds raised and partly invested at the peak of the prior boom. After absorbing the recession headwinds in 2001, for example, the performance of fund vintage 1999 recovered smartly, from a net loss of 15 percent in 2001 to a net gain of about 10 percent by the time it reached maturity in 2006—a positive 25 percentage point swing, as Figure 3.37 shows. The 2000 buyout fund vintage also rebounded; but with fewer investments made

Figure 3.37: Returns for fund vintages 1999–2000 recovered after the 2001 downturn



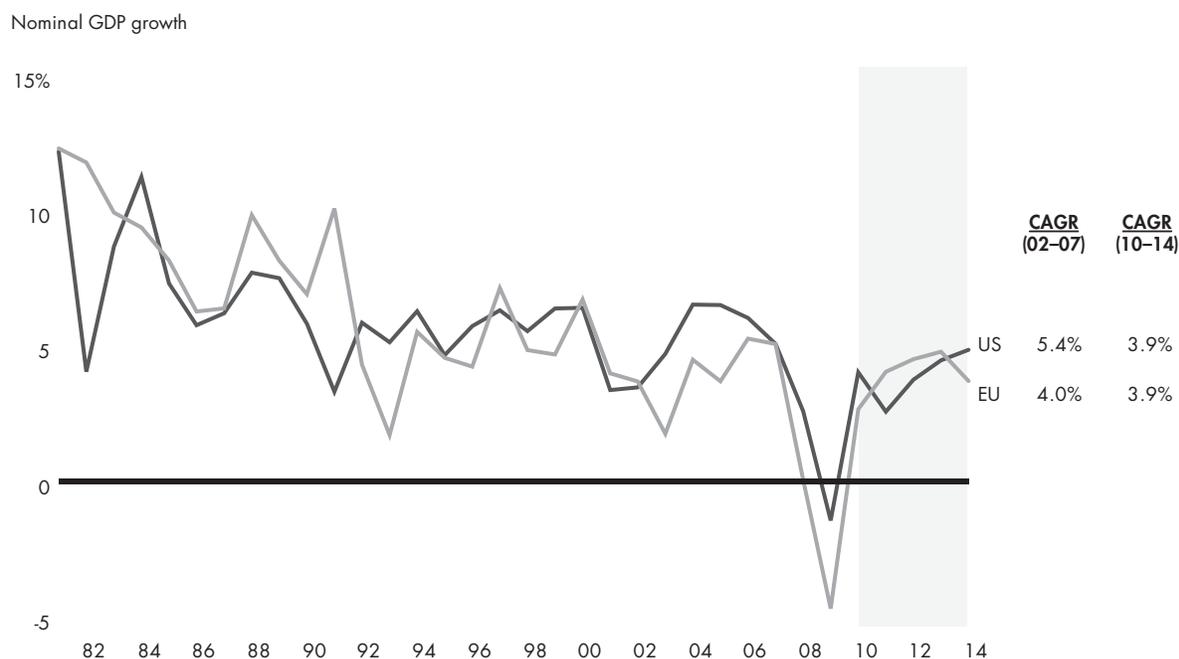
Sources: Preqin; Bain analysis

at the market peak, it performed even better, climbing into the mid to high teens by 2006. With the foresight—or luck—to start investing at the bottom of the PE cycle, buyout fund vintage 2001 posted the best net IRR, returning from 25 to 30 percent, on average.

**Harsh conditions will mark this recovery.** Market forces that are not remotely similar to those of the last PE cycle will be at work in the coming year or over the medium term. Nominal GDP growth is forecast to be lackluster through 2014, at an annual rate of just 3.9 percent compounded in the US and in Europe (see Figure 3.38).

As previously noted, debt availability and pricing will improve slowly from current levels but they are unlikely to return to anything like the conditions of 2006 and 2007. PE investors will be forced to put more equity into transactions.

Finally, deal multiples have little room to expand—mainly because they have not come down as far or as fast as in previous downturns. Through year-end 2009, multiples were still running at 7.7 times EBITDA for US buyout transactions (7.9 times in the busier final quarter of 2009), well above the low of six times EBITDA they tumbled to during the last downturn. Anecdotal evidence suggests that true deal multiples may have been even higher: A significant number of transactions that closed last year involved desperate sellers willing to accept the lower multiples that PE firms could afford to pay given the debt terms banks were offering. The fact that very few deals cleared the market at this level suggests that sellers' expectations were higher. From this level, there is little upside potential for deal multiples even as debt conditions ameliorate.

**Figure 3.38: GDP growth forecasts are tepid**

Sources: US Bureau of Economic Analysis (as of January 2010); HIS Global Insight (as of February 2010)

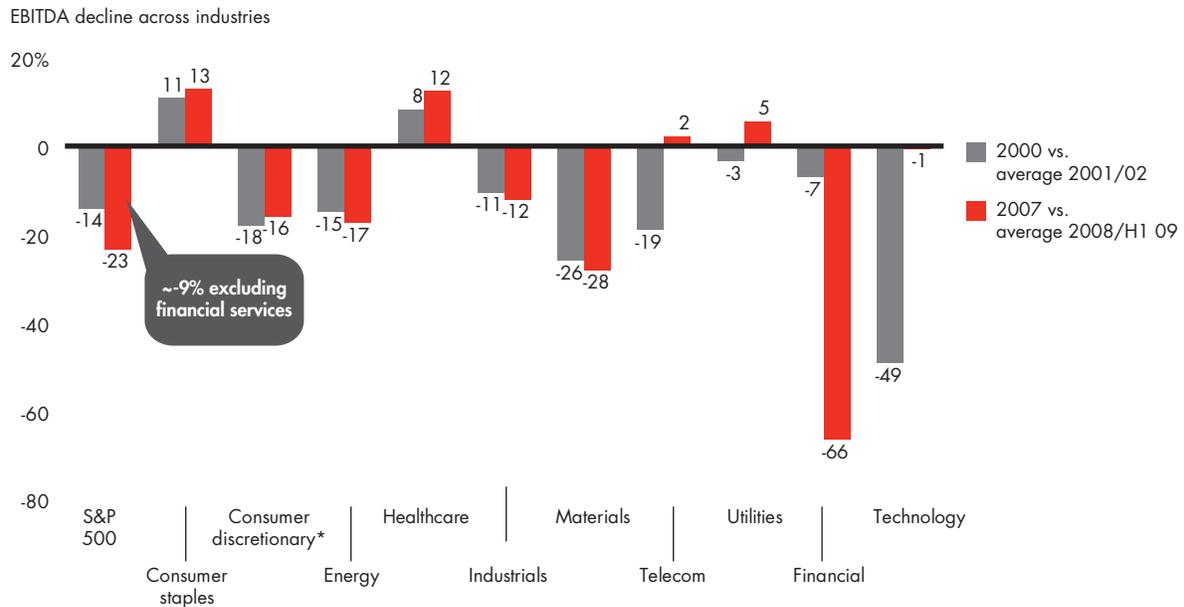
Several factors appear to be at work holding multiples aloft. For one thing, valuations in public equity markets fell sharply—but briefly—over the first half of 2009 before recovering briskly in the year's second half. As we have already noted, the bear market's short duration did not allow sufficient time for public and private sellers' expectations to reset in the form of lower transaction prices.

Earnings, too, remained relatively strong, justifying higher deal multiples. EBITDA for nonfinancial corporations were off only slightly from their 2008 peak and remained near historic levels in 2009. Indeed, by stripping financial services results out of the S&P 500 earnings aggregate, we found that EBITDA held up better during the most recent recession for most companies than it did in the recession of 2001. In several sectors, including healthcare, telecom and utilities, earnings were higher in the year following the cyclical peak of 2007 than they had been for the corresponding period in 2000 (see Figure 3.39).

Finally, competitive dynamics among buyout funds are helping to keep multiples high. With more than \$500 billion buyout dry powder available to be put to work (\$1 trillion in all PE fund types), many firms are bidding up prices and settling for a lower target internal rate of return in order to win investments.

**Returns will be under pressure.** For new fund vintages and new investments, the tepid economic growth, weaker debt markets and stickiness of higher deal prices that awaits them over the near and medium term will combine to hold down returns. We estimate that new funds formed and new investments made over the next three to five years will likely generate gross returns in the low to mid-teens on average, several percentage points below their historic levels. Recent surveys and Bain's interviews with LPs confirm that

Figure 3.39: Earnings have held up well in the recent downturn

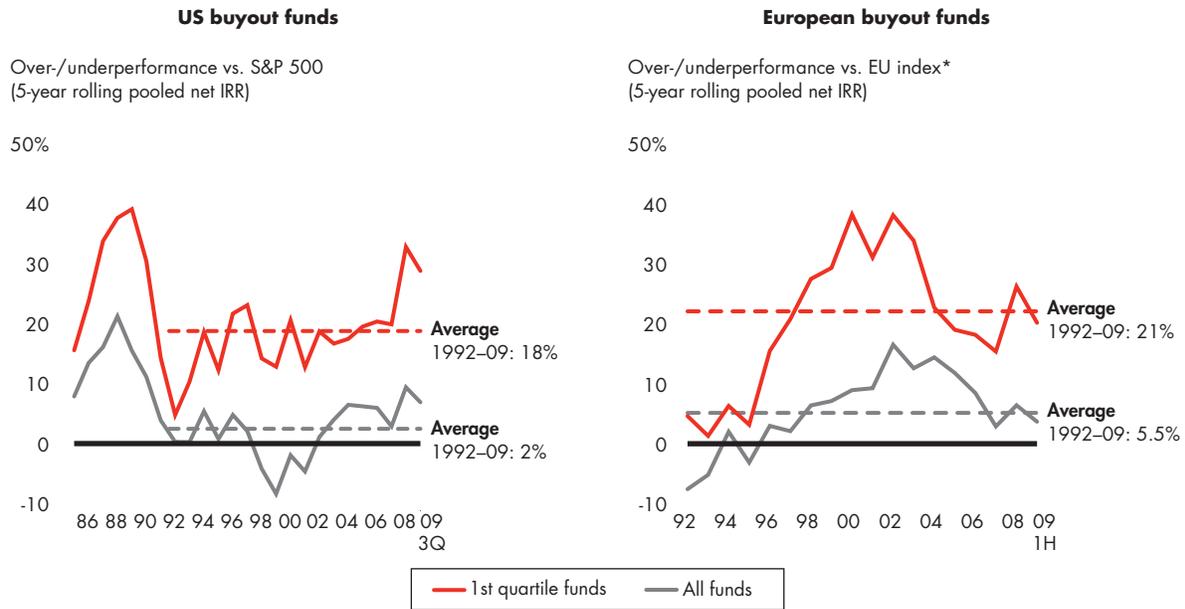


LPs share the expectation that returns will lag some going forward and may closely track returns on public equities, on average. Still, top-quartile US and EU buyout funds and their LPs should continue to expect their PE investments to outperform public equities by between 1,000 and 1,500 basis points, on average, as they have for better than a decade. Achieving differentiated returns will require PE firms to flex their muscles with smart buying and selling, and post-acquisition activism, which we will describe in greater depth in the next section (see Figure 3.40).

Pressure on returns is being felt most by vintage buyout funds from 2005 to 2007. With half or more of their called capital tied up in deals made at the peak of the past cycle, their holdings have suffered major paper losses that will take them years, if ever, to recoup. Unlike 2003–2004 fund vintages, which had time to exit several of their investments before the downturn hit, the 2005–2007 vintages do not benefit from this performance cushion. The IRR of the later-vintage funds, whether measured as the median for all funds of this vintage or weighted by the funds’ size, are currently deep underwater (see Figure 3.41).

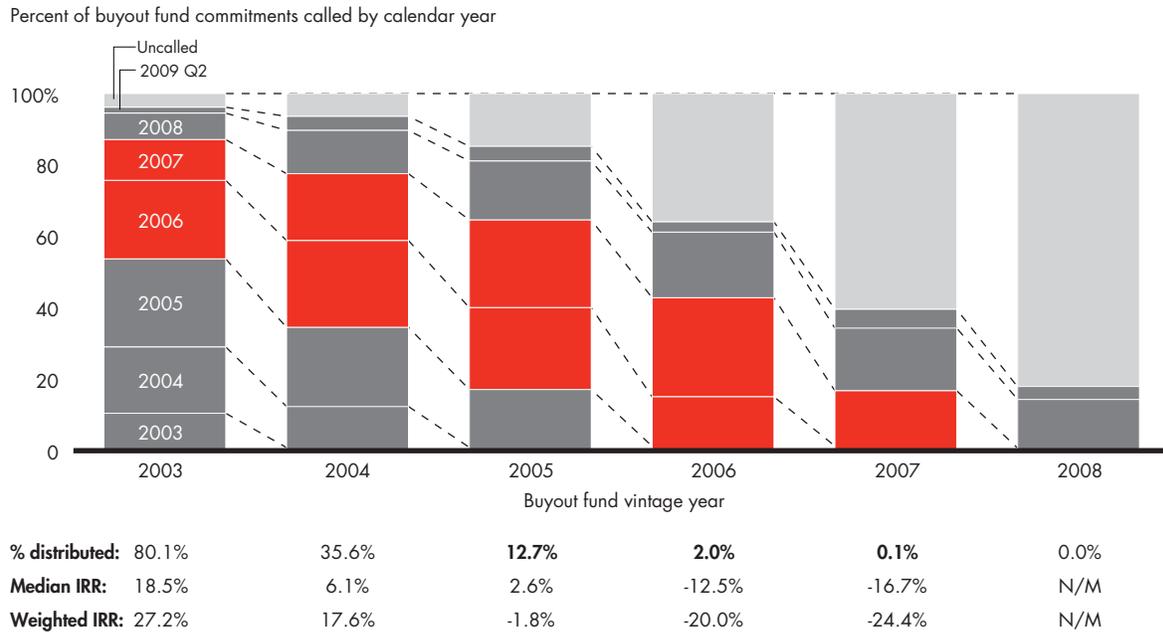
Just how challenging the prospects are for these vintage funds is revealed in the special report issued by Moody’s in late 2009. Moody’s examined the portfolio company performance of the 14 largest PE firms and found that 12 percent of the deals made prior to 2008 had defaulted and another 21 percent were in distress as of September 2009. The number of bankruptcies and restructurings has been limited to date, thanks mainly to the relatively lenient covenant terms that would trigger them. Going forward, however, avoiding bankruptcy or restructuring could become more difficult if the economy recovers slowly and holds down earnings and free cash flow. Troubled companies could also run head-on into the 2011 to 2014 refinancing cliff that will make debt refinancing far pricier than today—if they can borrow at all.

Figure 3.40: Expect top buyout firms to outperform



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

Figure 3.41: Returns for fund vintages 2005-07 will suffer the most



Notes: Fund vintage year represents year of first investment; percent distributed based on median fund; data as of Q2 2009  
Source: Preqin

## Key takeaways

- Harsh conditions will mark this recovery. Credit markets remain strained; sensitivities about PE ownership could reduce the availability of target companies; bargains will be hard to find.
- The debt markets' limited capacity to absorb a growing supply of refinancings may crimp the borrowing needed to finance new PE deals. The shortfall will begin to show up in 2010.
- Fund-raising will be anemic. Many LPs are scraping against target allocations, there is a huge overhang of capital commitments already made and LPs face an ongoing liquidity squeeze.
- LPs are becoming more assertive, but the best investors will still be rewarded. Both LPs and GPs recognize they don't want to ruin what historically has been a good partnership.
- Returns on new funds formed and new investments made over the next three to five years will be several percentage points below their historic levels.

## IV. High-stakes implications for private equity firms

Every private equity cycle calls for creative solutions to new challenges that will separate not just PE firm winners from laggards, but can spell the difference between firms that will thrive and those that may not survive. The phase of the cycle the industry is about to enter will, if anything, magnify these risks and opportunities.

As we have seen, fund-raising conditions will be anemic as LPs wrestle with allocation and liquidity constraints. Firms that need to go back on the road to replenish their fund coffers will face a hard slog, particularly if their recent fund performance has been subpar. Deal making will be fraught with perils. Tight credit conditions will make leverage less readily available and more expensive, and the large overhang of dry powder risks unleashing a competitive frenzy to win auctions, pushing up acquisition prices and compromising future returns. For their part, LPs have become more discriminating about terms and conditions; they will be looking to work with GPs that possess truly differentiated capabilities that enable them to deliver superior returns.

Leading PE firms have not been waiting to equip themselves to compete and win in the face of these challenges. They used the downturn to shore up their portfolio companies and sharpen their portfolio management skills. Now, firms that aspire to winning results in the lower-return period ahead will need to apply to themselves the same techniques they use to build value in their portfolio companies—namely, a clear strategy for competing effectively in their markets and a focused blueprint for delivering their investments' full potential.

### **As they position themselves for the next PE cycle upswing, PE firms need to raise their game across these five areas:**

- **Investment strategy:** The PE universe has expanded over the past decade, and PE firms face a complex new set of investment decisions. Beyond traditional buyouts, opportunities now extend to a wide range of asset classes—from distressed, mezzanine, debt and bridge financing to real estate, infrastructure and natural resources—with broader geographic reach. As the climate for buyouts chilled heading into this downturn and LPs' preferences broadened, diversification into new asset classes and geographies, which was already under way, became an even greater focus for many PE firms. Today, more than half of the biggest PE firms are now active across multiple asset classes and more than 80 percent invest in regions beyond their home base.

But diversification alone is not a winning strategy. Our analysis has found little correlation between the number of asset classes or geographies in which a firm invests and its overall performance. Successful firms take a disciplined approach. They evaluate each opportunity's economic attractiveness and competitive intensity. In parallel, they assess their firm's ability to leverage its strengths, such as an in-depth knowledge of select industry sectors, a network of relationships or distinctive investment capabilities. Then, for each asset class and region they choose, they carefully define their investment "sweet spot"—preferred deals based on factors such as industry sector, size, degree of control and investment thesis.

- **Fund-raising:** With LPs pinched in a liquidity squeeze and facing the big overhang of uncalled capital commitments, PE firms need to sharpen their differentiation from their competitors. Successful ones will not rely on exaggerated claims of fund and deal performance to attract LPs but, instead, will display

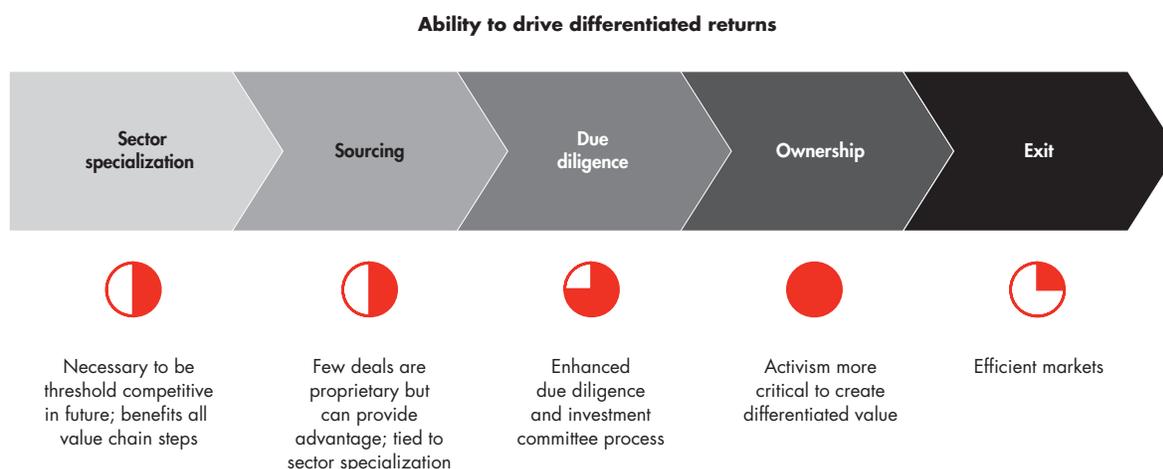
a well-honed strategy and provide solid evidence that it works. Firms will also need to be more cognizant of LPs' greater willingness to challenge GPs' terms and conditions by carefully spelling out their economic offering as well as the noneconomic aspects of the relationship. As one LP put it: "The industry could do itself a favor and change, ahead of people trying to beat them over the head to do so." These imperatives have ramped up the need for a more professional approach to fund-raising. Many leading-edge PE firms have started to institutionalize this "365-days-a-year" activity.

- **Center and enablers:** Running a PE firm that embraces more asset classes, geographies and sectors has never been more demanding. It requires a greater degree of integration in the management of the firm's brand, talent, knowledge, business processes and investors. Thoughtful firms are recasting their central functions to perform a role we call "strategic architect." They coordinate overall direction setting, recruit and train top talent, foster the sharing of insights across investment teams and take the lead in fund-raising and managing investor relations. At the same time, strategic architects build the investment processes so that sourcing, due diligence, post-close value creation and exit are all conducted the same way across geographies and asset classes and are performed to a high standard. Lastly, the most effective firms are careful to take on only support services they can perform efficiently. They periodically reassess whether the activities the center performs would be better delegated to an investment business, reengineered or outsourced.
- **Organization and decisions:** PE firms have long fixated on hiring top talent and building strong organizations in their portfolio companies. But too often they seemed willing to tolerate convoluted reporting structures, ambiguous career paths and ad hoc decision-making processes in their own operations. Today, however, PE firms' senior partners are too stretched to micromanage teams deployed across many more asset classes, regions and sectors. In the challenging period ahead, inattention to strengthening the firm's organization and culture can be a fatal shortcoming. LPs told us that, second only to a firm's performance, their most important criterion in selecting a firm with which they will invest is the cohesiveness of its teams.

The turmoil of the past two years has exposed deep flaws in firms' decision-making processes. Many firms discovered that their ad hoc decision-making processes and confusion about accountabilities led to bad decisions in boom times. And, once the downturn hit, it did not allow them to respond quickly to fast-changing circumstances. Others found that they were overly reliant on one or two individuals to make highly complex decisions that called for the talents and inputs of many. Crisp decision-making skills will be more important than ever in the ambiguous period ahead. The firms that will be best equipped to adapt will be those that sharpen their sense of which decisions should command the most energy, clarify responsibilities and assign key roles in the process.

- **Investment capabilities:** The cornerstone of a PE firm's success, of course, is and will remain its ability to develop differentiated capabilities that enable it to add value across the entire investment life cycle from deal sourcing to exit. Indeed, the competencies that PE firms will need to outperform in the coming PE cycle are an order of magnitude higher than they were when a robust economy and rising markets did most of the work of generating good returns for them. As mentioned earlier, the top two capabilities LPs will look for are a repeatable formula with quality resources a PE firm can call on to create value post-acquisition and a rigorous due-diligence process that yields proprietary insights (see Figure 4.1).

Figure 4.1: Winning PE firms need differentiated investment capabilities



**Pick your industry battles:** Recognizing this challenge, many leading firms are raising their game by specializing in just a handful of industry sectors. Sector specialization enables PE firms to mobilize proprietary insights about sector trends and tap networks of industry insiders to give them an edge in sourcing and screening good deals and winning the best ones. Following an acquisition, it helps PE firms quickly set the right strategic direction to improve performance and build value, recruit seasoned professionals and challenge management to hit operational targets. But as important as exercising sector expertise can be to every step in the value chain of a winning deal, it is fast becoming a capability firms need simply to be threshold competitive.

**Give due diligence its due:** Increasingly, the capability that is emerging as essential coming out of the downturn is enhanced due diligence. Of course, nearly every PE firm has an established due-diligence process, but firms that are best in class elevate their due-diligence model several notches. Having a superior due-diligence process is important because PE firms are targeting smaller companies—often private ones or carve-outs of larger companies—where information is often less transparent. Also, competition against other trade and financial bidders is fierce. With less accommodating debt terms, it is harder for PE firms to compete against trade buyers’ ability to generate synergies. And, valuations have not come down significantly. It takes strong due diligence to avoid losers and to develop the proprietary insights required to stretch for winners.

As important as it is for PE firms to be masters at adding value post-acquisition, that counts for little if a firm does not close the right deals, at the right price, in the first place. Enhanced due diligence helps assure that the firm makes a good purchase that can be propelled into a “home run” when it brings to bear its superior post-deal value-creation skills. Bain’s analysis of buyout fund performance has found that the “quality of the buy” drives top returns. Buyout funds that generate the best returns have fewer deals that end up as “zeros”—just 8 percent versus 14 percent for the average fund. They also hit a lot more “home runs” (defined in the analysis as five times return on equity investment)—23 percent of deals versus 7 percent for average performers. Firms that have more zeros and fewer home runs than their peers can find there is significant value to be gained by reviewing their due-diligence and investment committee processes.

What should they look for? To begin, they do not wait for the auction process to start before launching their due diligence. Instead, they conduct an external assessment pre-auction to winnow deals and get a head start. Second, they do not follow a rigid three-to-four-week process. They tailor the length of their due diligence to the complexity of the asset being evaluated and remain flexible based on their findings along the way. They tend to engage in extended due diligence to deepen and refine insights beyond what their competitors develop. Third, they don't limit the scope of their due diligence to testing the management plan and establishing the base case, as most PE firms do. Instead, best-in-class PE firms augment their base case by testing for factors that can potentially boost the upside or increase risks. They also focus their resources on exploring potential "answer-changing" issues (those details that can make or break a deal) to develop a strong investment thesis. Finally, they do not rely on management plans or third-party research reports. They follow an institutionalized data-driven approach that is geared toward building proprietary insights on the target and its industry from the bottom up and outside in.

Top-tier firms not only have more horsepower in the due-diligence engine room, but they bring better processes to bear in the investment committee boardroom as well. They formulate clear investment strategies and criteria that govern their decisions and are consistent with their investment sweet spot. They have learned through experience that diverging from the types of investments they are experienced and organizationally equipped to do best compromises their ability to judge risk and add value post-acquisition. The best investors also follow a structured evaluation process, whereby each successive round focuses on different decision criteria that give them an effective 360-degree look at a potential deal. For instance, early rounds might focus on the industry, company position and deal economics. Later rounds might focus on value-creation opportunities and downside exposure. Finally, top firms zero in on key analytics that facilitate consistent value-added discussions. Specifically, the investment committee examines a "must-have" set of analyses that ties to the firm's investment strategy—for example, evaluation of cyclical, pricing trends and customer concentration. The committee also adheres to specific, nonnegotiable "deal breakers," such as never paying more than seven times EBITDA, or refusing to buy unless management of the acquired company rolls at least two-thirds of its existing stake into the deal.

**Create value through activist ownership:** The fruit of enhanced due diligence shows up most clearly in the head start it gives leading PE firms to deliver on what has become their most important differentiating capability—their talent for creating value in portfolio companies post-acquisition. Even before the ink is dry on a deal, top PE firms pivot from deal making to active engagement that accelerates performance in their new portfolio company to achieve aggressive goals quickly. Results speak for themselves: In an analysis of its clients' performance on deals closed and exited between 1993 and 2009, Bain has found that deal returns were 3.6 times the original investment, on average, in situations where early post-acquisition work was undertaken—well above the industry average of 1.4 times original investment.

The new owners begin with a systematic on-boarding process to engage senior management at their new holding to zero in on a handful of high-value initiatives that can yield outsize gains within the three-to-five-year PE ownership period. Tapping their network of external advisers and seasoned industry insiders, they put the right people in the right jobs, and they work with these key players to develop a blueprint for choreographing the steps that need to be taken to convert the core initiatives into results.

They mobilize common functions and resources—such as purchasing, payroll management and the like—across their portfolio companies to help hold down costs and bring scale efficiencies to bear. To monitor performance, they identify and track a few key metrics that provide an early-warning system to alert management to take fast corrective action if the program begins to drift off course.

Activist PE owners cultivate a results-oriented mind-set in their portfolio companies by putting in place an incentive system that holds management accountable and amply rewards key players for hitting ambitious targets. And, even as PE owners implement the actions prescribed by the blueprint, they continuously scan the marketplace, taking a fresh look for shifting signals that can influence when and how they exit. Adding power to this style of ownership, leading PE firms create repeatable processes that enable them to spur performance improvements again and again.

Going forward, LPs will be more sensitive to PE firms' ability to manage risk. Building sector specialization and an enhanced due-diligence process can help win LPs' confidence. Steering portfolio companies as hands-on owners that consistently hit ambitious targets ensures that this confidence is warranted. Sector specialization gives PE firms a comprehensive understanding of the risks intrinsic to the industries they invest in and that are associated with the economy more broadly. Enhanced due diligence gives them a more robust approach to stress-testing the impact of macroeconomic forces and industry-specific risk factors on companies they target for investment. Value-creating ownership enables PE leaders to absorb shocks the economy throws at them. As the economy recovers gradually from the recession, PE firms that will fare best are the ones that can demonstrate an ability to manage their portfolios through future downturns or other industry turbulence.

## Key takeaways

- PE firms that aspire to winning results need a clearly differentiated strategy and a focused blueprint for delivering their investments' full potential.
- Diversification alone is not a winning investment strategy. There is little correlation between the number of asset classes or geographies in which a firm invests and its overall performance.
- Inattention to strengthening the firm's organization and culture can be a fatal shortcoming. Second only to a firm's performance, the most important criterion for LPs in selecting a firm with which they will invest is the cohesiveness of its teams.
- Creating value through activist ownership is becoming the most important differentiating capability. Deal returns were 3.6 times the original investment in situations where early post-acquisition work was undertaken—well above the industry average of 1.4 times.
- The “quality of the buy” drives top returns. Enhanced due diligence helps assure that the firm makes a good purchase that can be propelled into a “home run” when it brings to bear its superior post-deal value-creation skills.

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