PRIVATE EQUITY OUTLOOK

June 2014

SEATTLE | 206.622.3700
LOS ANGELES | 310.297.1777
www.wurts.com

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EXECUTIVE SUMMARY: STRATEGY RECOMMENDATIONS

For those with a strategic allocation requirement, select opportunities include

- Opportunities to participate in the apparent dislocation in European markets, including direct lending
- Smaller, niche sectors or companies that are overlooked by mega-funds
- Special vehicles, timely opportunities and other unique offerings

Buyout	Outlook: Negative (US Large/Emerging markets)/ Neutral (U.S. Middle Market, Europe) ▪ New commitments face higher than average purchase prices which reduces expected returns ▪ U.S. middle market, European buyout more attractive than U.S. large and mega deals or Emerging Markets
Venture/ Growth	Outlook: Neutral ▪ Market dynamics improving, but the majority of capital is allocated to larger funds
Secondary Markets	Outlook: Neutral ▪ Rising asset values, growing dry powder and rising transaction prices limit expected returns
Private Credit	Outlook: Neutral (U.S.)/ Positive (Europe) ▪ Premiums for direct lending appear more attractive in Europe than in the U.S
Manager Selection	▪ Skilled GPs have delivered attractive returns in most market environments through superior company selection and ability to lead portfolio companies to greater than market driven growth

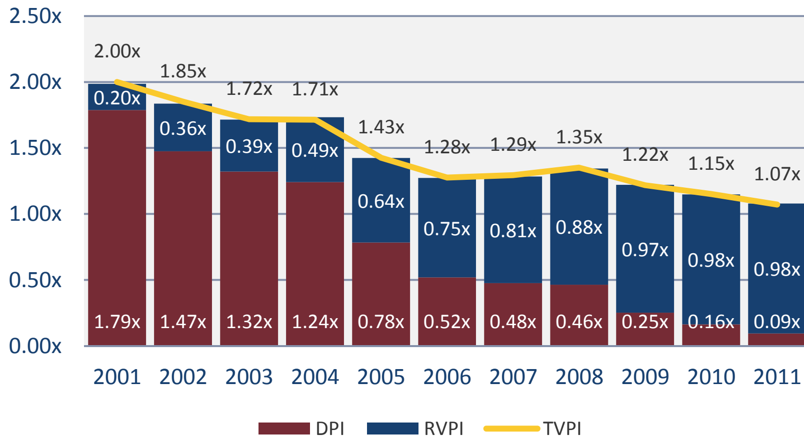
- Today's environment for new commitments to private equity is not broadly favorable for generating attractive long-term expected returns, and is characterized by headwinds to new investments that have negative implications for future performance.

Valuation	**Unattractive** ▪ Purchase price multiples are near historical highs, driven in part by easy access to inexpensive credit. ▪ Rising distributions have been a tailwind to increased fund raising, leading to record amounts of dry powder that has negative implications for future purchase price multiples, expected IRRs and the composition of future private investments.
EBITDA Growth	**Neutral** ▪ In a period of slow expected economic growth it will be more difficult for companies to grow EBITDA. ▪ Five years into the US economic recovery, it is likely that growth will slow sometime in the next five years, hurting EBITDA growth, while growth in Europe and the emerging markets should improve over that period. ▪ Facing slow growth, General Partners must find other ways to grow portfolio company revenues and earnings to support exit values. " Buy and Build" strategies reflect an attempt by General Partners to create value by "bolting" portfolio companies onto one another.
Exit Environment	**Neutral/Unattractive** ▪ While it is impossible to know what the exit environment will be in 7 to 10 years, the possibility of longer holding periods for portfolio companies, and the expected large number of portfolio companies needing exists (based on record levels of buyouts taking place today) are headwinds to attractive exit prices.

- 2013 was a good year for distributions, but 2005 to 2008 vintage funds have yet to return all of their investors' capital.

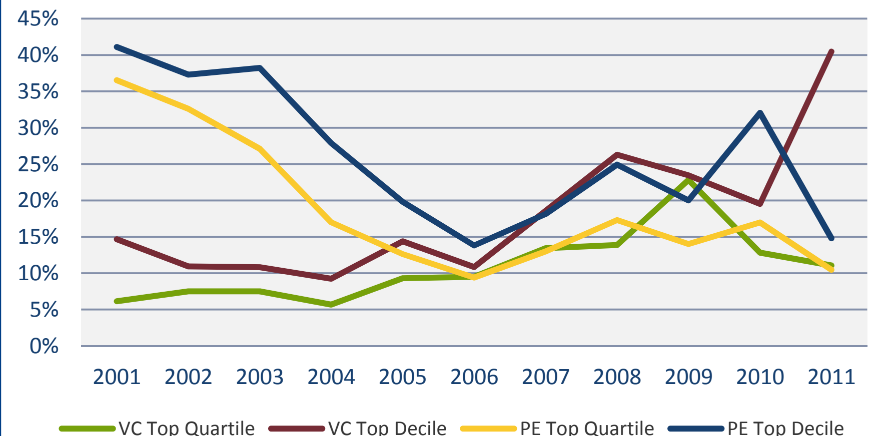
- Evaluated as a whole, private equity returns have been average for some time, but skilled managers have delivered attractive risk-adjusted returns over time.

While investors in early vintage funds (pre-2004) have been made whole (their DPI: Distributions to-Paid-in-Capital are greater than one) they still have significant amounts of unrealized value (RVPI: Remaining Value to Paid-in).



Source: Pitchbook

During most vintage years since 2001, top quartile buyout managers have outperformed top quartile venture capital funds.

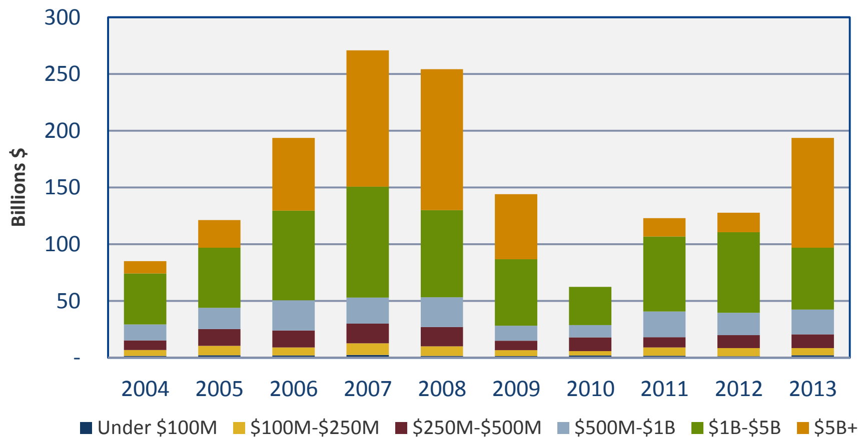


Source: Pitchbook

- Positive net-cash flows to limited partners helped fund raising, but 2013 also saw the return of "mega" funds-those that closed with more than $5 billion of committed capital.

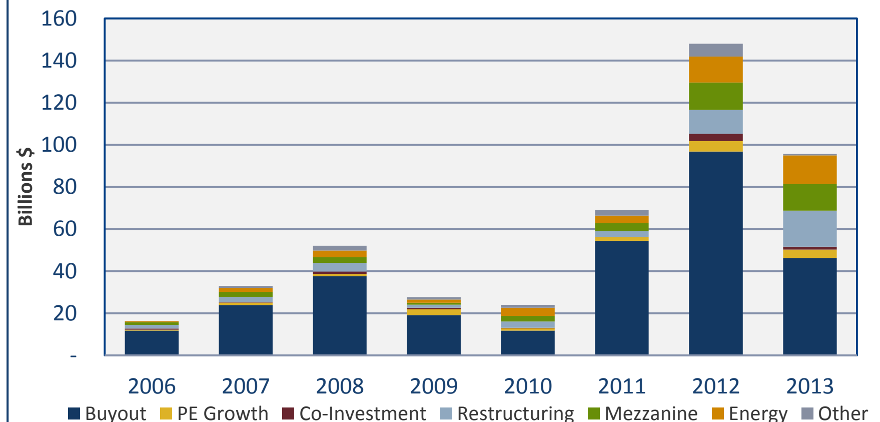
- Dry powder continues to grow and has negative implications for purchase price multiples, expected IRRs and the composition of future private investments.

2013 fund raising not only saw its best year since 2008, but the return of "mega" funds. Nearly half of committed capital went to funds that raised more than $5 billion.



Source: Pitchbook

The majority of dry powder in US focused funds is held by buyout funds ($400b), and the majority of that in recent vintage funds with several years left in their investment periods.

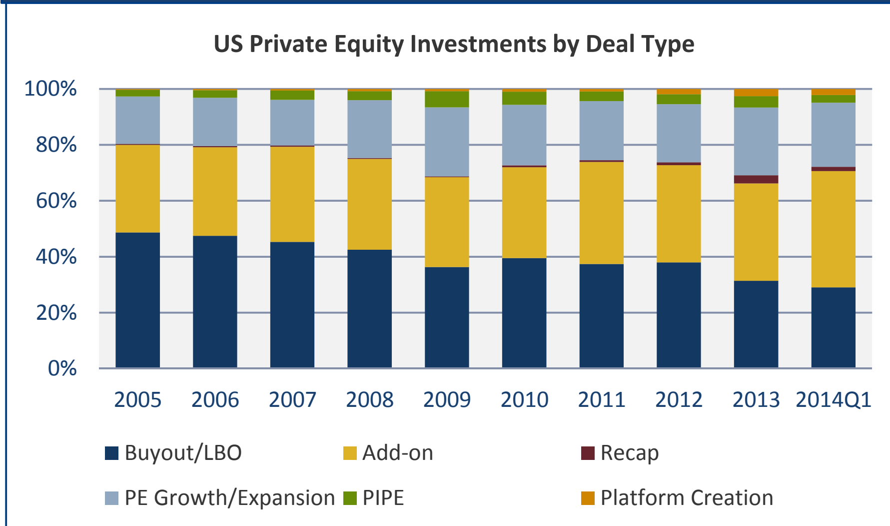


Source: Pitchbook

- Leveraged buyouts continue to drop as a share of total private equity deals, reflecting a change in how general partners believe they can best create value. Sponsor-to-sponsor transactions ("Direct Secondaries"), "buy and build" strategies and taking minority positions in growth/expansion deals have grown in importance.

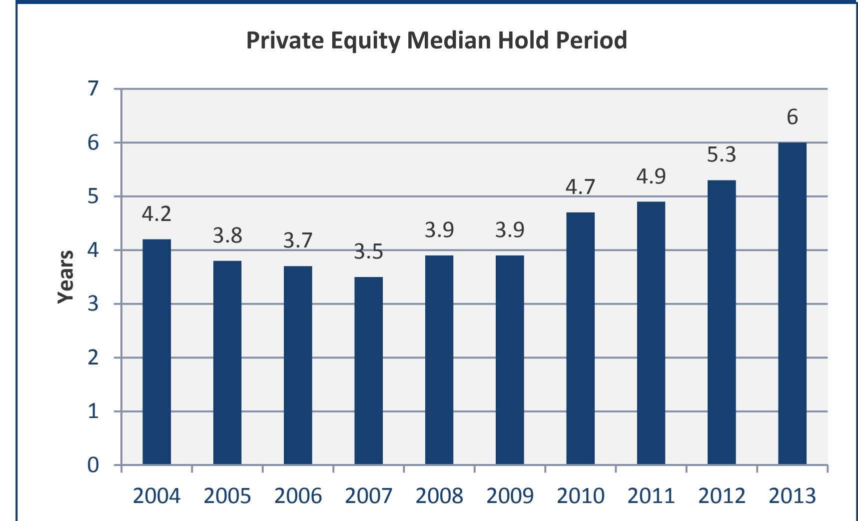
- The growth in sponsor-owned portfolio companies is leading to rising holding periods for portfolio companies, and has negative implications for returns to future investments in private equity.

Buyouts represent a declining portion of private equity deals as GPs see greater opportunity to add value through add-ons and in the growth/expansion stage of venture.



Source: Pitchbook

2012 and 2013 were good years for portfolio liquidations and distributions to limited partners, but holding periods continue to rise.



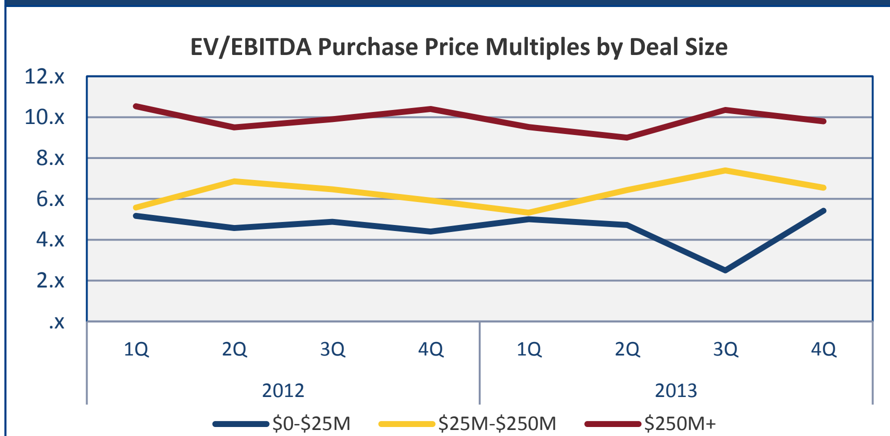
Source: Preqin, Landmark

BUYOUT

Rising public equity markets, growing dry powder and easy access to credit drove U.S. buyout purchase price multiples higher, creating headwinds to future performance

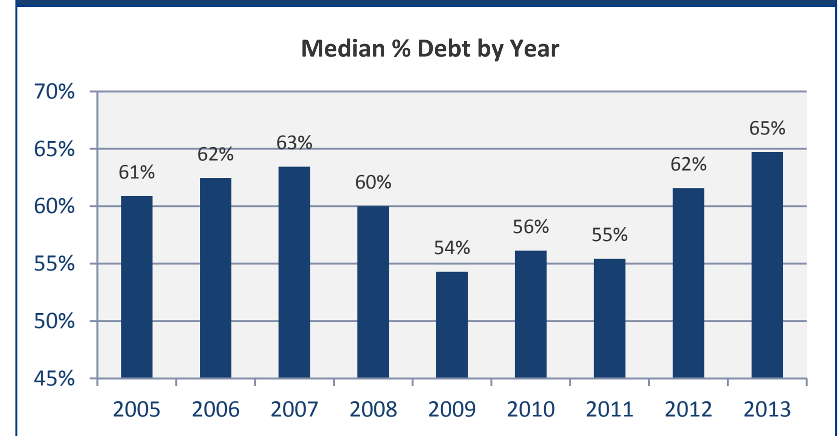
- Buyout deals completed at today's purchase price multiples face a number of headwinds to expected performance:
  - In a period of slow expected economic growth it will be more difficult for companies to grow EBITDA, forcing general partners to hold portfolio companies longer in order to generate enough earnings to justify the necessary sale prices. This brings IRRs down.
  - Five years into the US economic recovery, it is likely that growth will slow sometime in the next five years, challenging EBITDA growth. The increased use of leverage to finance deals is a drag on performance in a weakening economic environment.
  - Growth in the number and value of portfolio companies needing liquidation will increase the supply of companies being auctioned, a headwind to exit prices.
- **Outlook: Large (Negative); Small/Mid (Neutral):** Fund raising and dry powder will keep purchase price multiples high for large deals. Prices and leverage are more attractive for Small/Mid size deals, but trends seem to support higher prices ahead.

Rising stock prices, aging dry powder and inexpensive debt is a tailwind to purchase price multiples. Smaller LBOs face less competition and require greater equity and less leverage, helping hold down prices.



Source: Pitchbook

The use of debt to finance LBOs fell dramatically following the financial crisis. As credit markets have opened up, the use of debt has increased to pre-crisis levels.



Source: Pitchbook

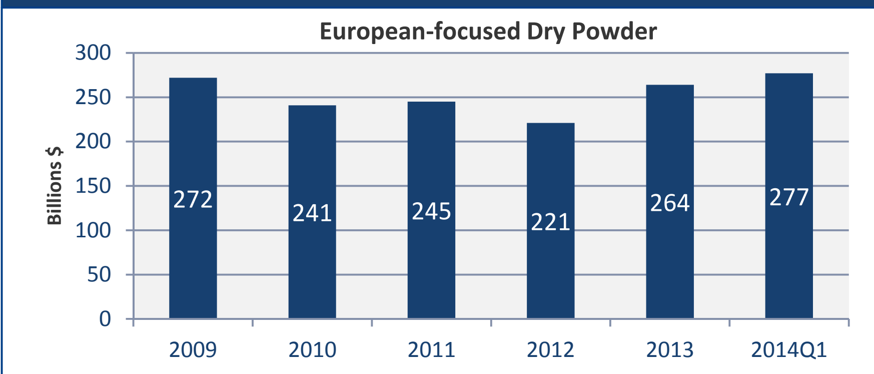
Growing confidence in economic reform and recovery is leading to renewed activity and opportunity in European leveraged buyouts, but slow growth may limit returns

- A review of 2013 fund raising, deal flow, exit activity and purchase price multiples reveals a return to more normalized levels of activity. This appears to reflect investors' growing confidence in the effects of economic reforms and recovery on earnings and valuations.

- Purchase price multiples have nearly recovered to pre-crisis levels, but reflect:
  - cyclically-low/depressed EBITDA: as EBITDA recovers with growth, price multiples will decline.
  - a limited supply of available companies as sellers seek to avoid selling at depressed EBITDA levels and buyers seek only high quality, low risk assets.

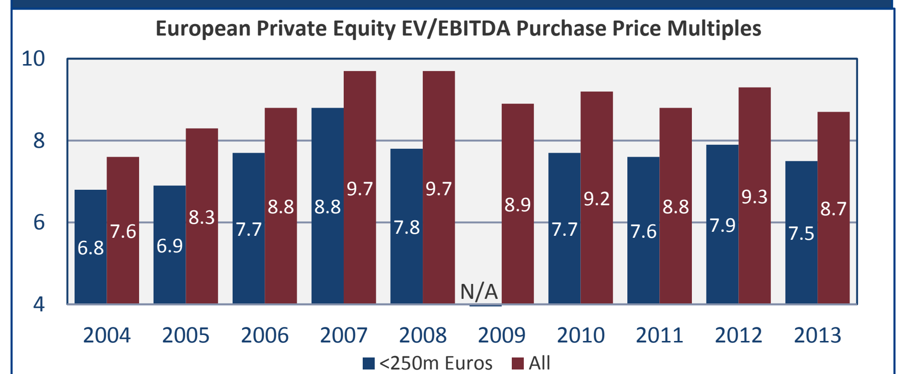
- **Outlook: Neutral**
  - Europe's economy has turned, but investor sentiment appears ahead of fundamentals as reflected by rising dry powder. Slow growth will limit returns.
  - European recovery is expected to be uneven and slow, favoring northern over southern Europe. Successful General Partners will be those that recognize these risks and identify high quality, global companies with limited exposure to on-going risks.
  - While economic growth is slower, European buyouts are more attractive than U.S. given their valuations are lower and based on cyclically depressed EBITDA.

Investors' growing confidence in European reforms and economic growth has led to record levels of dry powder as fund raising appears ahead of deal-making.



Source: Preqin

Purchase price multiples for smaller deals are generally more attractive, reflecting less competition and more difficulty in obtaining financing.



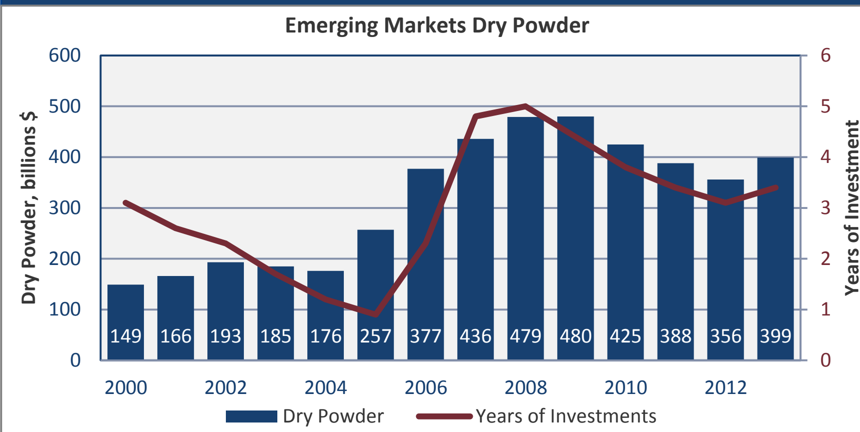
Source: LCD European Leveraged Buyout Review

Emerging markets remain an attractive long-term opportunity, but over the next year the dynamics and fundamentals associated with private equity investing are poor

- As a whole, emerging markets private equity investing is characterized by:
  - A decade of successful fund-raising that has led to significant dry powder, placing upward pressure on purchase price multiples.
  - A weak exit environment (including the closure of the Chinese IPO market) has increased holding periods and hurting exit prices.
  - Poor performance on the part of general partners in managing and creating value in their portfolio companies.
  - Macroeconomic conditions (weak economic growth, market and exchange rate volatility), that negatively impacts company competitiveness, revenue and earnings growth.

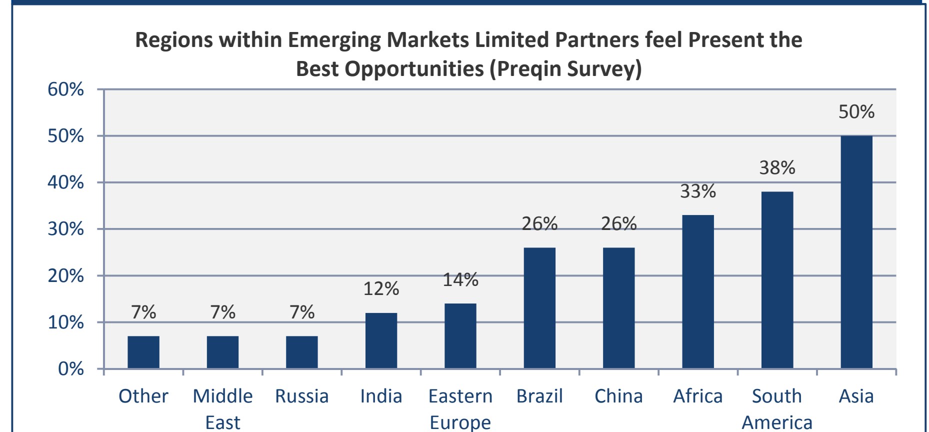
- **Outlook: Neutral**
  - Demographic trends favor a growing allocation to emerging markets, but in the next year private equity faces many of the same headwinds that developed markets struggle with: an overhang of capital, slowing growth and challenging exits, and managers challenged to create value.
  - For those with capital to put to work, manager selection, skillful country selection and access to attractive deal flow matters; managers are looking to a new set of countries today including Mexico and South East Asia.

Emerging market deal flow declined from 2009 until 2012 before starting to grow. Dry powder, measured in terms of years-of-investment has begun to rise again.



Source: *Bain Capital*

For all of its potential, less than half of private equity investors find any region within emerging markets attractive investments today.



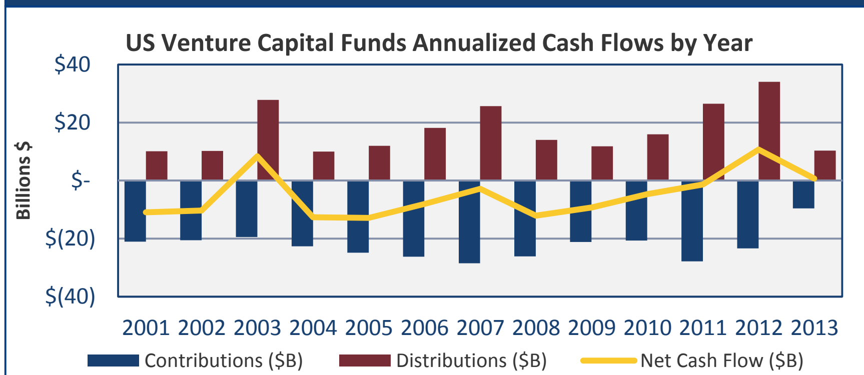
Source: *Preqin*

VENTURE CAPITAL & GROWTH

The changing dynamics of the venture capital industry as well as innovation in technology is altering the ways in which limited partners should approach venture and growth capital

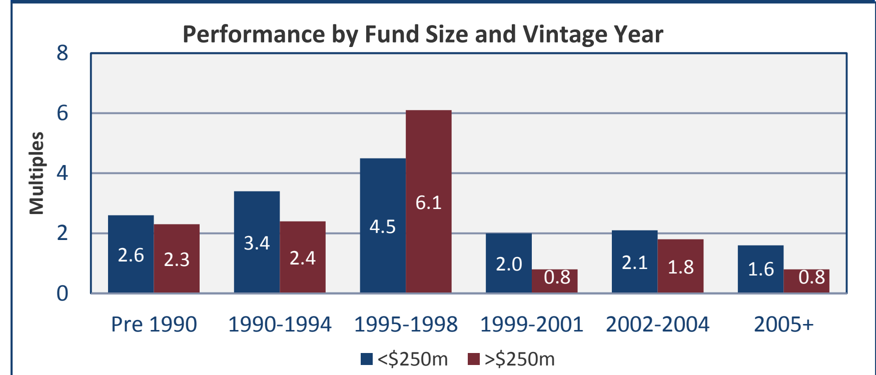
- Trends in Venture Capital
  - The difficulty in returning investors' capital has led to less capital raised and a rationalization of the industry; the number of active venture capital (VC) funds is half that of 2000.
  - Successful VC firms are capturing a larger proportion of limited partners' capital, leading to bigger funds; in 2012 over 50% of the $21 billion raised went to 11 of the 182 VC funds raised.
  - Developments in IT (the growth of open source software, the "cloud" and leverageable distribution platforms) have reduced the amount of seed and early stage capital needed to see a company through to its growth stage. As a result, smaller funds taking smaller positions are better positioned to exploit these opportunities than larger funds.
- The intersection of these trends suggests that smaller funds are more likely to outperform, and thus many limited partners in larger funds will be disappointed. The evidence of fund performance by size tends to confirm this hypothesis.
- **Outlook: Neutral.** The supply/demand dynamics of VC is improving, but the majority of capital allocated to larger funds suggests that the average limited partner will underperform, making manager selection critical.

Distributions continue to exceed new commitments, leading to a net outflow of assets, letting the asset class downsize to a sustainable level given opportunities.



Source: Pitchbook

Small Venture Capital funds have outperformed the large end of the market.



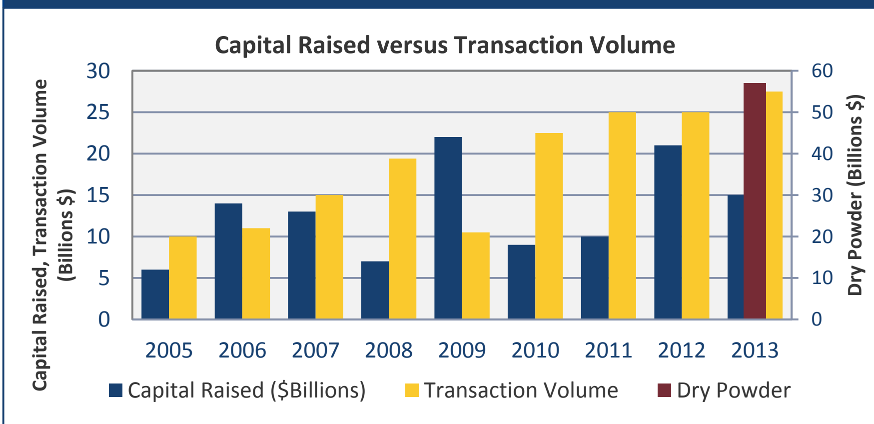
Source: StepStone

SECONDARY MARKETS

Secondary market offerings continue to rise, but rising public equity markets have driven up seller's expectations, hurting expected returns

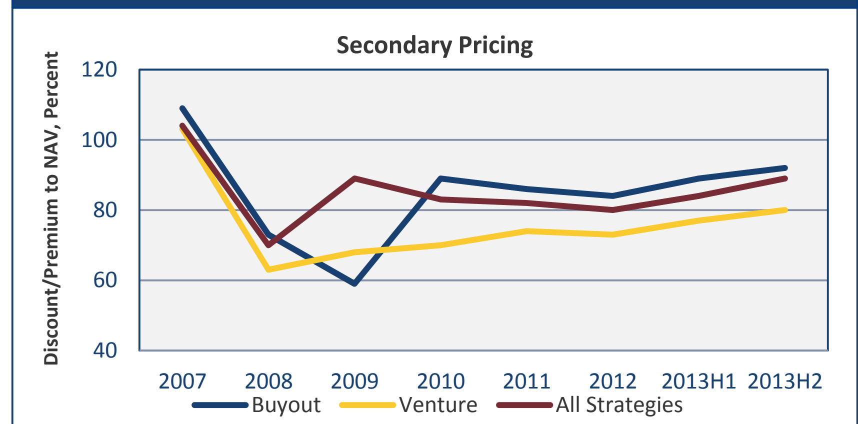
- Supply continues to grow, the result of regulatory driven selling and the recent attractiveness of "fund restructuring" opportunities.
  - Over $125 billion of funds coming to the end of their life are not in a position to provide liquidity (zombie funds).
  - With visibility to the underlying portfolio companies, secondary buyers are restructuring these portfolios, providing liquidity to LPs and giving GPs additional time to realize value.
- Secondary pricing has climbed, in part due to higher seller expectations following rising public equities.
  - Buyers suggest that these prices can be misleading, pointing to the rise in "structured transactions". Buyers will pay par in a structured transaction for assets about to be written up in value and with payment to be deferred, effectively reducing the purchase price to below par.
- **Outlook: Neutral.** Regulatory driven selling will increase the supply of secondary portfolios, but the write-up of NAV due to rising equity markets, rising transaction prices and growing dry powder should limit returns compared to recent history.

Transaction volume continues to rise, but so does fund raising. Existing dry powder of $24.5b is about one-year of volume, while 2013 fund raising has created another $33b of dry powder yet to be called.



Source: Preqin

Venture capital portfolios trade more cheaply than buyout portfolios, reflecting greater uncertainty about expected IRRs, and making the points that portfolios selling at large discounts to NAV are not necessarily attractive.



Source: Cogent

PRIVATE CREDIT

Returns to U.S. focused private lending appear attractive but risks are likely to rise as the economic recovery matures

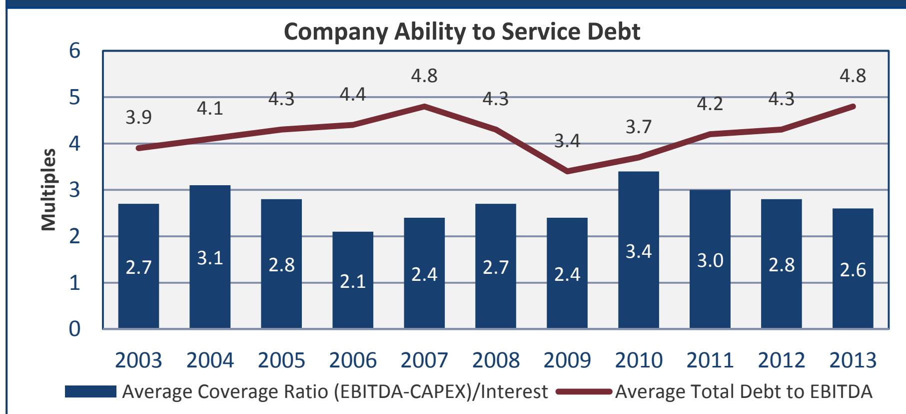
- Understanding the role of private credit (first & second lien loans, mezzanine debt) is important to understanding its relative attractiveness. It is most often used by middle market companies to finance growth, leveraged buyouts, and refinance existing debt.

- Private equity sponsors have (1) large pools of dry powder that need to be put to work; and (2) a need to refinance and recapitalize their large portfolio of companies in order to provide liquidity to limited partners.
  - The large demand for private debt is being rewarded with attractive premiums relative to public market credit.

- Risk to private lending appears low today; default rates are low and companies as a whole are well prepared to service debt.

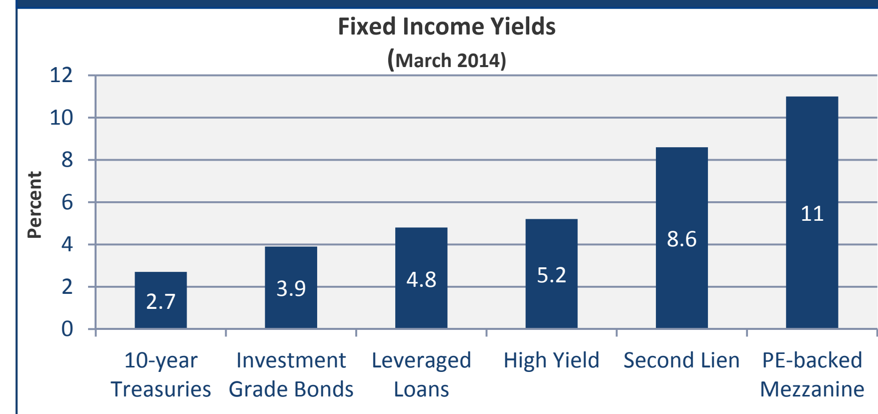
- **Outlook: Neutral.** High demand for financing and strong corporate balance sheets are providing attractive premiums for private lending over public market credit, but default rates are low relative to history and likely to rise over time. Prospective investors must consider that the US economic recovery is five-years old; the average business cycle has lasted about six years since WWII.

The ability of companies to service their debt remains high, but is less attractive than in the last couple of years. As credit markets ease, companies have taken on more debt, reducing their interest coverage.



Source: Standard & Poor's LCD

The premium for investing in private credit strategies above public credit remains high relative to history.

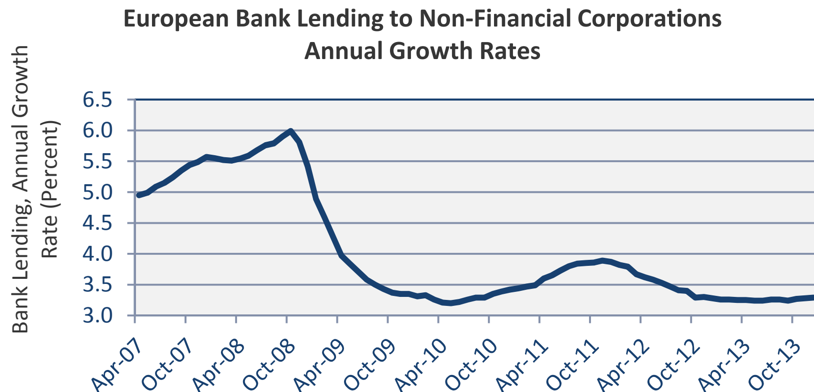


Source: Bloomberg, Credit Suisse, Barclays, S&P LCD

Declining bank lending to companies and a slowly recovering economy is creating an opportunity for direct lending strategies focused on Europe

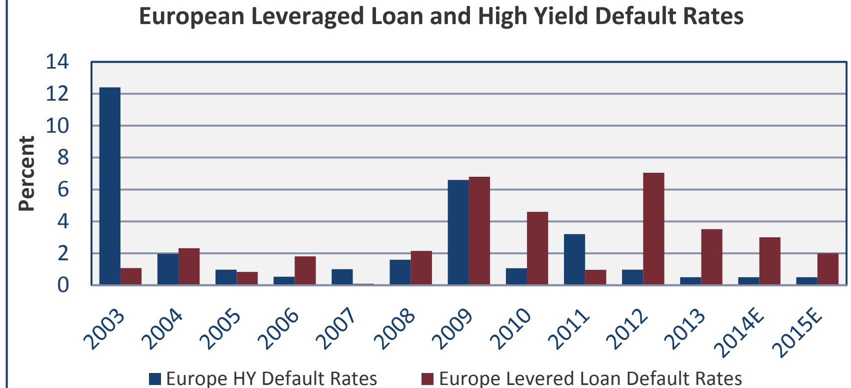
- An opportunity exists for direct lenders because European banks, the traditional suppliers of debt, are constrained while demand for loans is recovering.
  - Banks, under pressure to meet higher capital ratios, are reducing risk by not only reducing their lending, but shifting their lending to larger, publically traded companies.
  - As Europe recovers, so does the demand for loans: midsize European businesses will need to raise 3.5 trillion euro in debt funding over the next five years; in addition over 250 billion euros of debt will mature over the next five years.
- There are risks to lending in Europe. While Europe's recession has technically ended, no one expects its economy to recovery quickly, and in fact there are threats to its recovery. Some EU nations are still in recession; European inflation is falling and its money supply is falling, measures that hint at slowing growth.
- **Outlook: Positive.** With declining access to bank credit for smaller borrowers, pricing appears most favorable for non-traditional lenders to small and lower middle-market companies.

Historically, European companies have relied on bank financing, but banks' need to delever is limiting their creation of new loans.



Source: Europe MFI

As the European economy recovers, default rates continue to come down. Its recovery is a year old, suggesting default rates will remain low for some time.



Source: Credit Suisse

RECOMMENDATIONS

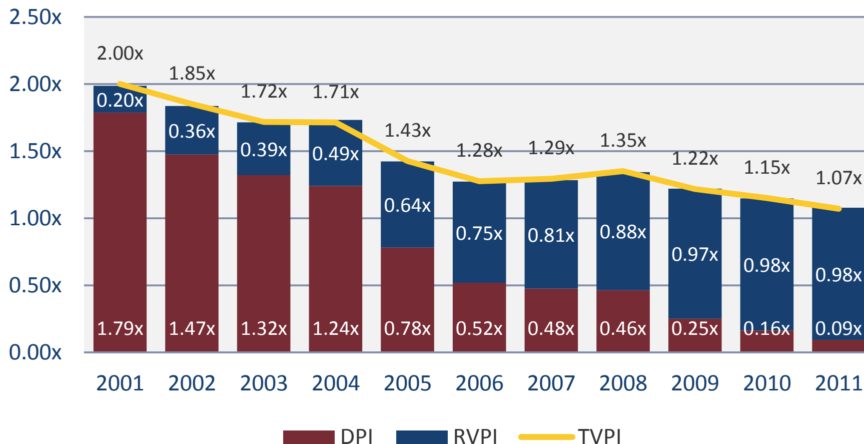
	U.S. Buyout	European Buyout	Emerging Markets Buyout	Secondary Market	Venture	Private Credit
Pricing Conditions	Prices for large and middle-market LBOs are high relative to their history, though more attractive for middle market deals than than for large deals.	Purchase price multiples are high, but in part because earnings are cyclically depressed. As growth and earnings recover, purchases over the next several years will appear more attractive.	Conditions remain similar to a year ago. Strong fundraising relative to opportunity set is leading to large capital overhang and rich pricing.	Strong equity markets and increased distributions to LPs have pushed purchase prices up. General Partners suggest that "structured" transactions that delay payment to sellers effectively reduces the purchase price.	Fundraising appears to have settled at a more sustainable level. Decreasing commitments and improved industry dynamics are producing more favorable pricing.	The premium for investing in private credit over public credit is wide relative to historical averages, in both the U.S. and Europe, but the risks associated with these premiums are different and changing.
Macro Environment (Beta)	Conditions are similar to a year ago. Rising public equity markets, inexpensive financing and dry powder is putting upward pressure on price multiples. Slower than average economic growth will contribute to longer holding periods, effectively reducing expected returns.	European recovery is expected to be uneven and slow, favoring northern over southern Europe.	Over the intermediate-term, faster economic growth is a tailwind to value creation, but in the near term markets are recognizing differences in macro conditions across countries that have implications for expected returns. In the near-term, private equity faces the same headwinds that developed markets struggle with: an overhang of capital, slowing growth and challenging exits.	Fundraising and strong public equity markets have in the short-run made the market less attractive, but changing market dynamics (regulatory driven selling) will, in the medium-term, favor buyers of secondary portfolios..	Developments in information technology have reduced the amount of seed and early stage capital needed to see a company through to its growth stage. As a result, smaller funds taking smaller positions are better positioned to exploit these opportunities than larger funds. .	Its relative attractiveness varies with where credit is in its market cycle. Five years into its recovery, U.S. credit markets are late in their cycle, while European credit cycle is in its earlier stages. In addition, European banks, are under pressure to raise capital ratios, leading them to lending to companies.
Manager Environment	High purchase prices and low economic growth means manager driven value creation will be key to strong returns; favoring small and middle-market deals where managers have more levers to create value and exit options	A bifurcated economic recovery suggests that successful General Partners will be those that identify high quality, global companies with limited exposure to on-going European risks.	Successful managers will be those that recognize differences in country risk and that are skillful in country selection and company selection. Managers are looking to a new set of countries today including Mexico and South East Asia.	As the market matures, LP interests will be more efficiently priced. Managers with access to proprietary deal flow and strong underwriting efforts will outperform. .	Managers that have demonstrated earlier success are raising larger funds at a time when small allocations are needed by technology firms.	The absolute returns to private credit appear attractive, but today, as the credit cycle reaches its top, the risk return profile is less attractive. With many "new" managers raising funds, the challenge for investors is to identify managers with the skill set and experience to implement the strategy in a manner that reflects the desired risk-return profile they seek.
Outlook	**Negative (Large) Neutral (Mid-market)**	**Neutral**	**Neutral**	**Neutral**	**Neutral**	**Neutral (U.S.)/Positive (Europe)**

MARKET ENVIRONMENT

2013 was a good year for distributions, but 2005 to 2008 vintage funds have yet to return all of their investors' capital

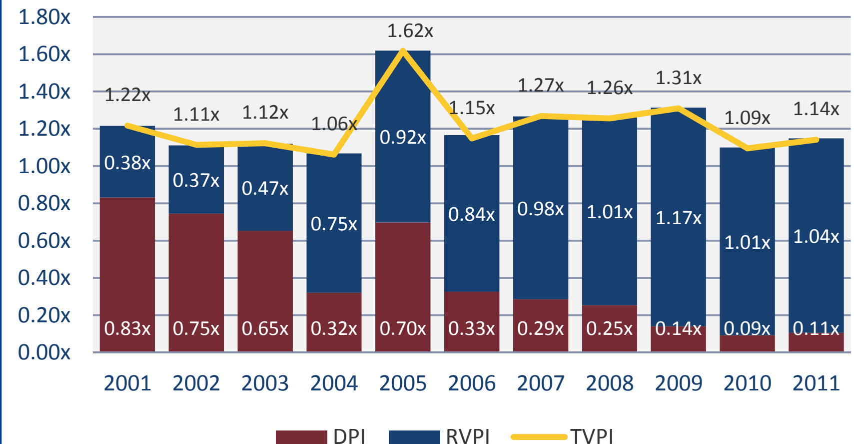
- Funds raised during the years leading up to the Great Financial Crisis paid high prices for portfolio companies that lost value during the downturn. As a group, these funds have struggled to return capital.
- Many are starting to see a recovery in the value of their portfolio companies but as their life-spans are winding down, limited partners are seeking liquidity and the funds' ability to generate "carry" for their general partners is limited. These have become known as "zombie funds".
- Zombie funds have become targets of secondary funds. The secondary funds provide liquidity to limited partners while creating new economics for general partners to actively manage the portfolios to their conclusion.

While investors in early vintage funds (pre-2004) have been made whole (their DPI: Distributions to-Paid-in-Capital are greater than one) they still have significant amounts of unrealized value (RVPI: Remaining Value to Paid-in).



Source: Pitchbook

As a group, no vintage year funds since 2001 have yet to make limited partners whole. All DPI's are less then one. Potential returns, as measured by TVPI (realized and unrealized value) are also low across all vintages.



Source: Pitchbook

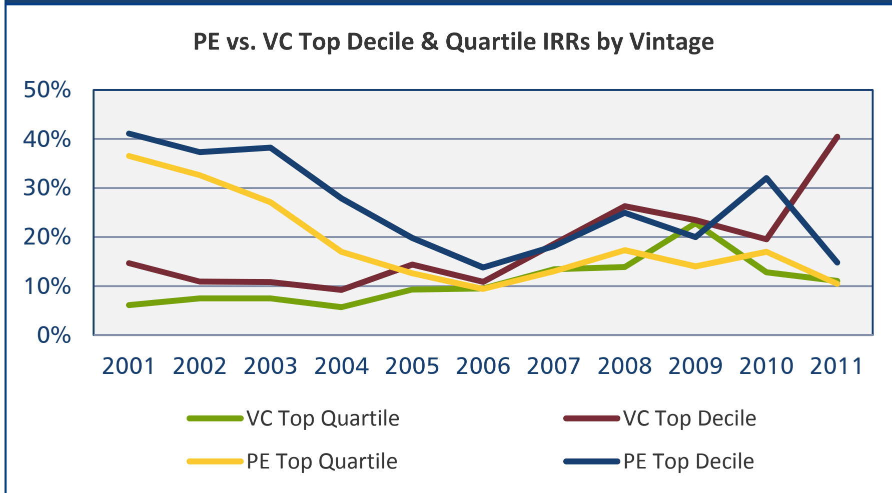
Evaluated as a whole, private equity returns have been average for some time, but skilled managers have delivered attractive risk-adjusted returns over time.

- Academic research suggests there is persistence in general partner performance over time, and thus manager selection matters. A review of performance by quartile reveals double digit differences in performance between the top and bottom quartile funds in both buyout and venture capital.

- A review of fund performance by quartile reveals that:
  - Bottom quartile buyout funds have consistently delivered superior absolute performance relative to bottom quartile venture capital funds.
  - Top quartile buyout funds have generally outperformed top quartile venture funds.

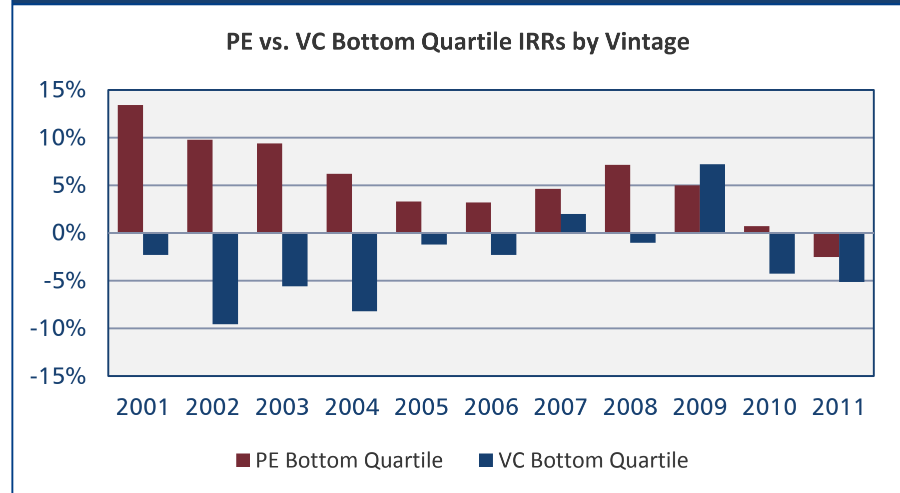
- These results raise a question about the role of venture capital in a client's portfolio in the absence of skill in fund selection; should limited partners ignore venture and invest only in buyout?

During most vintage years since 2001, top quartile buyout managers have outperformed top quartile venture capital funds.



Source: Pitchbook

Bottom quartile PE (Buyout) funds have consistently outperformed bottom quartile venture capital funds.

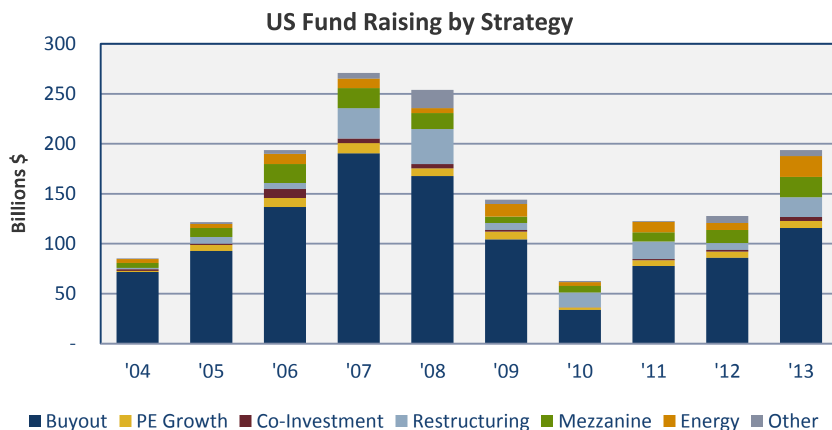


Source: Pitchbook

Positive net-cash flows to limited partners helped fund raising in 2013, but it also saw the return of "mega" funds-those that closed with more than $5 billion of committed capital

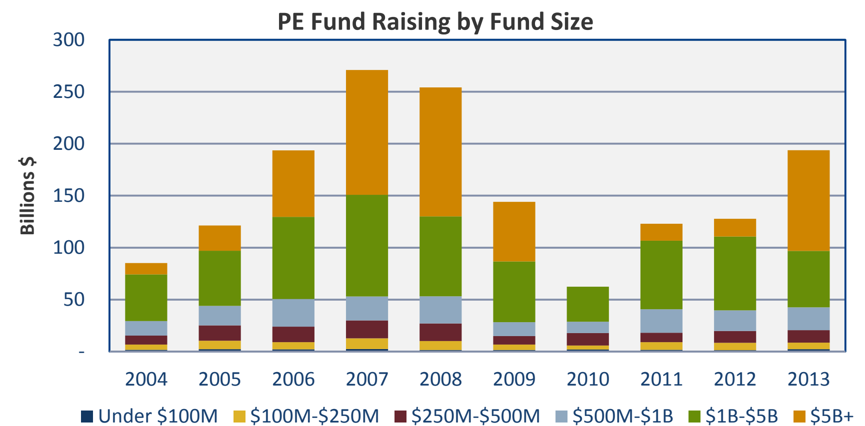
- After four years of weak fund raising, the amount of capital raised and the number of funds closed reached post-financial crisis highs.
- The primary explanation for a recovery in fund raising is an increase in distributions to limited partners, giving them new capital to commit to private equity. Other explanations include an under allocation to private equity relative to investors' policy statements given the outperformance of public market equities since 2009.
- The increase in fund raising was accompanied by a rise in the proportion of assets committed to "mega" funds (those with more than $5b of committed capital). One explanation is that limited partners are reducing the number of managers they invest with to those that have been the most successful in the past.
- One implication of more capital being allocated to mega funds is the likelihood of more "larger" deals being done than in the last five years.

The increase in fund raising was driven by an increase in commitments to buyout funds as well as to energy and mezzanine focused funds.



Source: Pitchbook

2013 fund raising not only saw its best year since 2008, but the return of "mega" funds. Nearly half of committed capital went to funds that raised more than $5 billion.

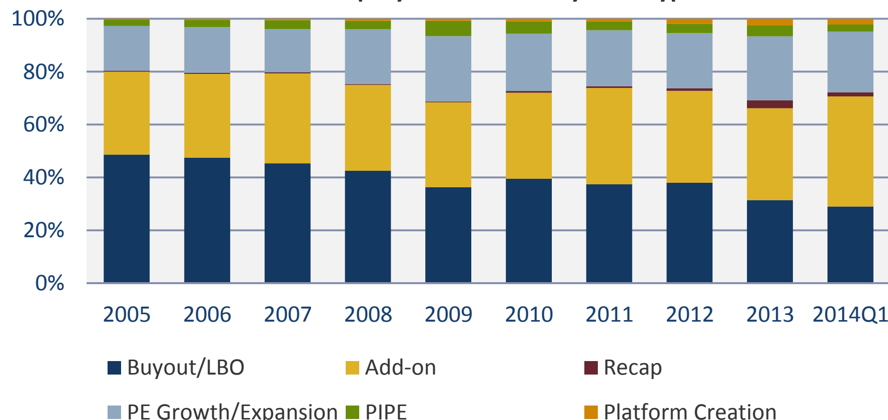


Source: Pitchbook

Changes in the make-up of completed private equity transactions suggests General Partners are finding new ways to generate value for their limited partners

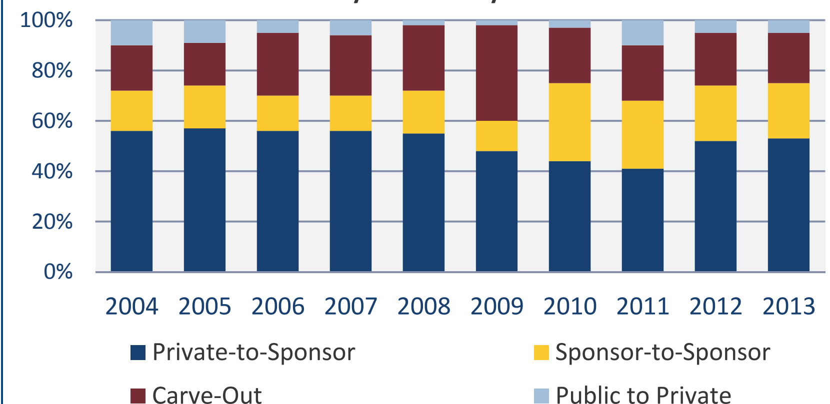
- PE-acquisition of privately held companies continues to dominate deal making. Sponsor-to-sponsor transactions which grew significantly following the financial crisis have stabilized as sponsors turn to a recovering IPO market for better exit values.
- Leveraged buyouts continue to drop as a share of total private equity deals, reflecting a change in how general partners believe they can best create value.
- "Buy and build" strategies and taking minority positions in growth/expansion deals have grown in importance.
- An increase in capital allocated to growth/expansion deals reflect a change in the nature of venture capital funding. Early round funding needs to develop new technology have got smaller but more capital is necessary to see those companies to profitability.

Buyouts represent a declining portion of private equity deals as GPs see greater opportunity to add value through add-ons and in the growth/expansion stage of venture.



Source: *Pitchbook*

Within US buyout, acquisition of private companies remains the biggest portion of deals. Sponsor-to-sponsor transactions have stabilized with recovery of the IPO market.

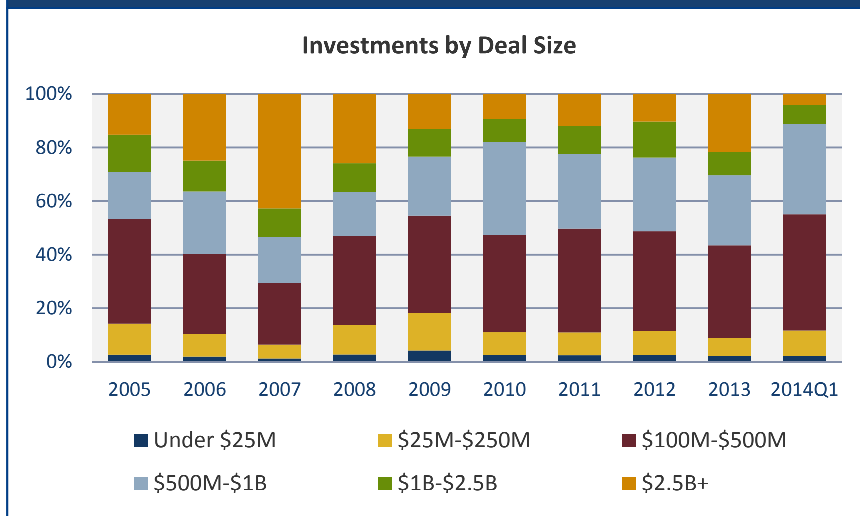


Source: *Pitchbook*

The changing economics of private equity deals is forcing General Partners to look for new ways to create value, leading to changes in the composition of completed private equity deals

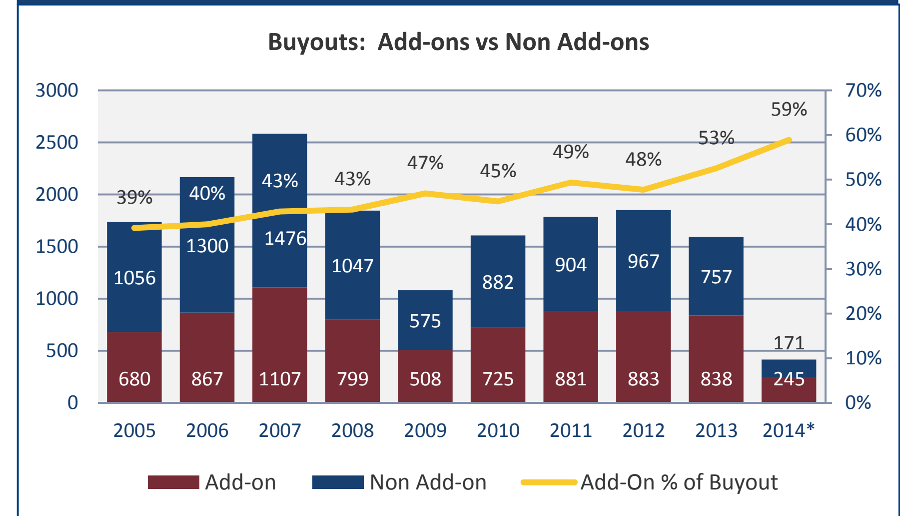
- The share of smaller deals, specifically under a billion dollars, has grown the last couple of years, reflecting changing private equity economics.
- The increase in capital raised, dry powder waiting to be put to work, and recovery in public equity markets has put upward pressure on purchase price multiples. In an environment of slow economic growth, General Partners must find other ways to grow portfolio company revenues and earnings to support exit values.
- "Add-ons" , typically smaller deals, reflect an attempt by General Partners to create value by "bolting" portfolio companies onto one another in "buy and build" strategies. They believe that synergies arising from putting companies together will create value.

The share of deals under a billion dollars has risen in importance as GPs engage in buy and build strategies within buyout, and minority growth/expansion deals.



Source: *Pitchbook*

Add-on deals continue to grow in importance as GPs seek to create value through buy and build strategies.

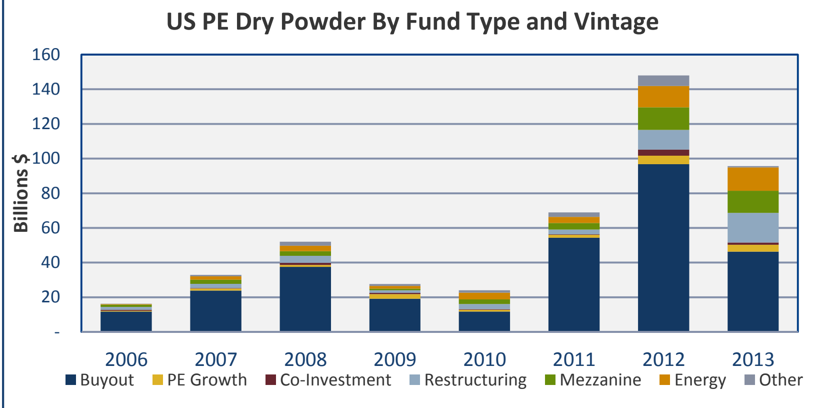


Source: *Pitchbook*

Growth in dry powder has negative implications for purchase price multiples, expected IRRs and the composition of future private investments

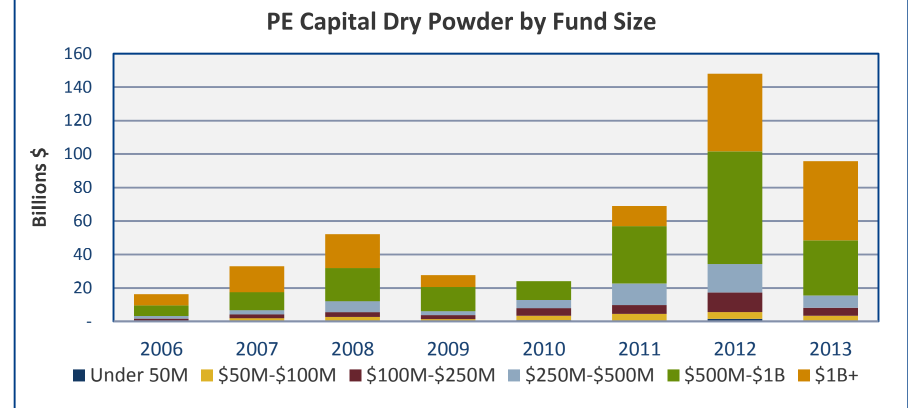
- In the competition between fund raising and new deal flow, fund raising continues to win. The result is a rise in the dry powder General Partners have to put to work.
- A more granular look reveals that General Partners are sitting on nearly a trillion dollar in global dry powder, over $600 billion of it dedicated to US-focused funds and over $400 billion of that dedicated to US buyout funds (nearly 5-years of deal flow).
- A legitimate concern is that General Partners, anxious to put that capital to work before their investment period ends, will bid up purchase price multiples. Others suggest that the composition of dry powder makes its potential impact on purchase price multiples less serious. Specifically, that within the pool of buy-out focused dry powder, only approximately $100 billion is in funds whose investment period is nearing an end. More than half of dry powder has been raised in the last two years.
- Three-quarters of the dry powder is held by funds with more than a billion dollars. As there are generally not enough large buyout deals to put this much dry powder to work, it is likely these larger funds will seek out other types of transactions including add-ons and minority growth expansion deals.

The majority of dry powder in US focused funds is held by buyout funds ($400b), and the majority of that in recent vintage funds with several years left in their investment periods.



Source: Pitchbook

The majority of US dry powder dedicated to buyout is held by funds with greater than $1 billion, The limited number of mega buyout deals in which to put capital to work suggests General Partners will seek out new investment strategies.

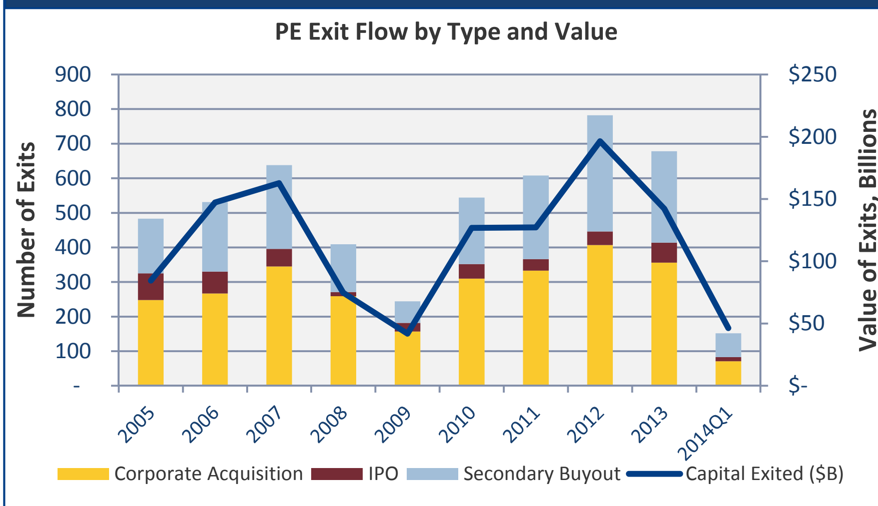


Source: Pitchbook

Rising public equity markets, lots of dry powder and aging sponsor-owned companies contributed to a strong exit market

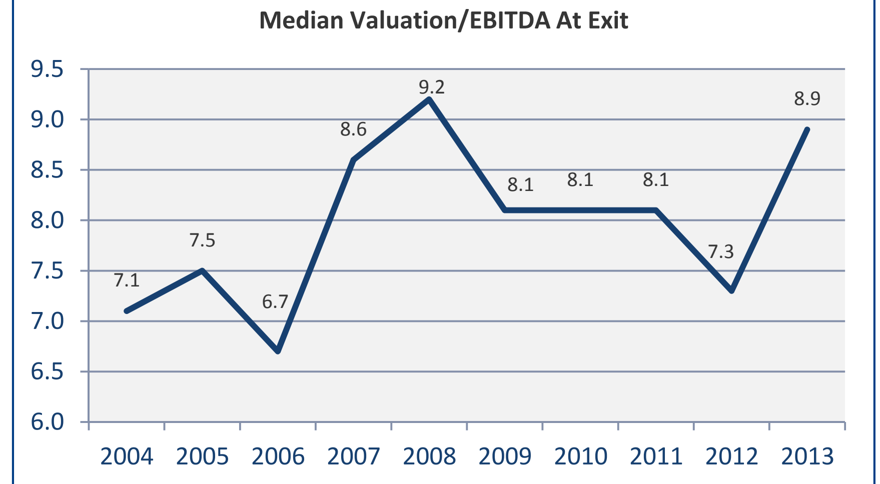
- Corporate acquisitions continue to provide the majority of exits for private equity owned companies, but 2013 saw a small decline in its overall contribution to exits, the result of a recovery in the IPO market.
- With general partners holding lots of dry powder on one hand and an aging portfolio of companies on the other, the growth in secondary buyout (also known as sponsor-to-sponsor transactions) exits is not surprising. They have grown from 25% of all exits in 2009 to 39% in 2013; and the average median secondary buyout size has increased from $150m in 2011 to $379m in 2013.
- The increase in 2012 and 2013 exits has reduced the ratio of new privately held companies-to -exits, but it is still greater than one, meaning the number of privately held companies continues to grow.
- The combination of high purchase price multiple in a low growth environment and lots of companies needing to be sold will lead to longer holding periods for companies, hurting expected returns.

After two strong years of exit activity, 2014 is off to a slower start.



Source: Pitchbook

A recovery in exit price multiples has rewarded partners in earlier vintage funds but those high prices are an impediment to returns for new buyers.



Source: Pitchbook

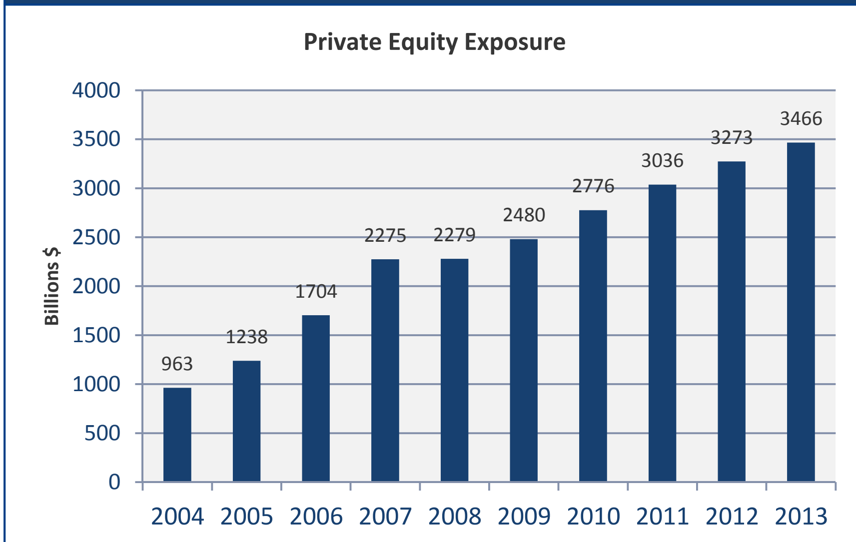
The growth in sponsor owned portfolio companies has negative implications for returns to future investments in private equity

- Ten years ago, private equity firms controlled nearly 2300 companies worth about $960 billion. Today, private equity controls over 7000 companies worth nearly $3.5 trillion.

- The rate at which private equity sponsors are acquiring portfolio companies is faster than the rate at which they are being liquidated. Historically, private equity owned portfolio companies are held for around four years before they are turned over and liquidity provided to limited partners. Today, the average holding period exceeds 6-years.

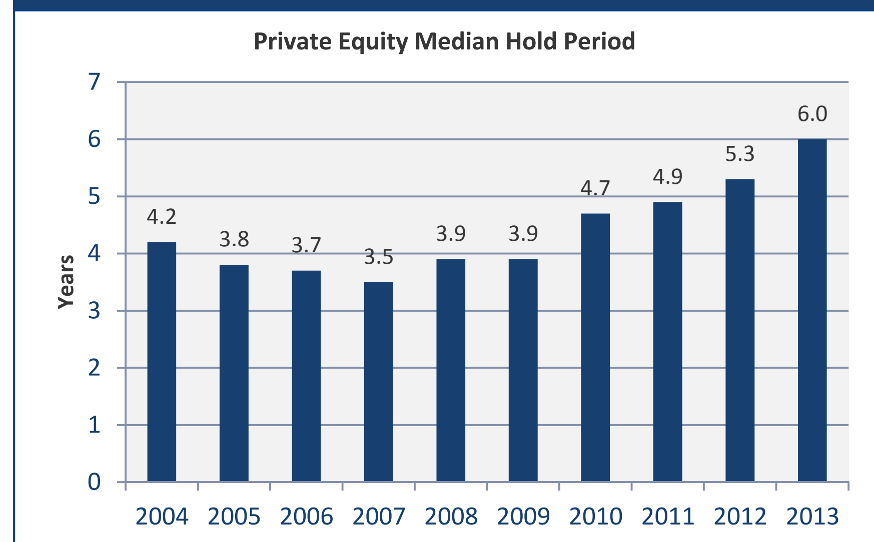
- Rising holding periods in the absence of above average revenue and earnings growth, leads to smaller distributions (TVPI) and lowering realized IRRs.

The value of private equity controlled companies now exceeds the market cap of the Russell 2000.



Source: Pitchbook

2012 and 2013 were good years for portfolio liquidations and distributions to limited partners, buy holding periods continued to rise.



Source: Pitchbook