SPRING 2014
www.bdo.com

BDO PERSPECTIVE

FIFTH ANNUAL PRIVATE EQUITY STUDY

GENERAL PARTNERS ANTICIPATE ANOTHER YEAR OF MODERATE DEAL FLOW

Manufacturing and Asia are Expected to Provide Compelling Opportunities for Investment but Pricing and Quality Targets Remain a Hurdle

Despite a strong fourth quarter and a record setting year for private equity returns, private equity deal flow has yet to take off in early 2014. Deploying capital has proven to be more challenging for general partners who are competing for a smaller pool of quality assets and increased competition by financial and strategic buyers.

At the same time, investor appetite for the asset class continues to grow. According to a recent study by *Preqin*, institutional investors are predicting private equity will produce the best opportunities among the alternative asset classes in the coming year.

To take the pulse of the industry and identify the key challenges and opportunities that will impact private equity in 2014, the Private Equity practice at BDO USA, LLP, conducted its fifth annual ***PErspective Private Equity Study*** from November through December 2013. This year's study, which examined the opinions of more than 100 senior professionals at private equity firms throughout the U.S., found that despite a robust year of returns in 2013, fund managers anticipate they will face a year of moderate deal activity, marked by challenges in terms of pricing and identifying quality targets, as well as an unfavorable investment environment.

▶ Read more

BDO USA, LLP'S PRIVATE EQUITY PRACTICE

Strategically-focused and remarkably responsive, the experienced, multi-disciplinary partners and directors of BDO's Private Equity Practice provide value-added assurance, tax and consulting services for all aspects of a fund's cycle, wherever private equity firms are investing.

CONTACT:

LEE DURAN, San Diego
858-431-3410 / lduran@bdo.com

JOE BURKE, McLean, VA
703-770-6323 / jburke@bdo.com

SCOTT CACURAK, San Francisco
415-490-3232 / scacurak@bdo.com

JERRY DENTINGER, Chicago
312-239-9191 / jdentinger@bdo.com

MARK ELLENBOGEN, Washington, DC
301-634-4975 / mellenbogen@bdo.com

RYAN GUTHRIE, Costa Mesa
714-668-7385 / rguthrie@bdo.com

SCOTT HENDON, Dallas
214-665-0750 / shendon@bdo.com

KEVIN KADEN, New York
212-885-8000 / kkaden@bdo.com

TODD KINNEY, New York
212-885-7485 / tkinney@bdo.com

MATT SEGAL, Chicago
312-616-4630 / msegal@bdo.com

DAN SHEA, Los Angeles
310-557-8205 / dshea@bdocap.com

MICHAEL WHITACRE, Atlanta
404-979-7116 / mwhiteacre@bdo.com

In fact, only 15 percent of private equity fund managers – regardless of fund size – predict they will close more than five deals in 2014, a marked dip from 2013, when 22 percent of fund managers anticipated closing more than five deals.

While anticipating fewer deals, fund managers are simultaneously hopeful that they will have opportunities to deploy more capital in the deals that close during the coming year. Thirty-six percent of fund managers expect to invest more than $100 million in new deals or add-on acquisitions in 2014, a significant uptick from 2013, when only 23 percent projected this level of investment. In terms of where this capital is heading, 97 percent of private equity fund managers plan to grow existing portfolio companies by seeking add-on acquisitions in the coming year (up from 87 percent in last year's forecast).

"With highly sought-after new deals in short supply and the total volume of dry powder creeping back up, private equity fund managers are eager to put their capital to work and drive private equity purchases." – Lee Duran, Partner & Private Equity Practice Leader at BDO

2013: A YEAR OF SOLID PRIVATE EQUITY PERFORMANCE

Private equity firms enjoyed a robust 2013 with record-making returns for investors. Three-in-four survey respondents report that the value of their entire portfolio increased during the past 12 months, an 11 percent uptick from the year prior. Only 12 percent of fund managers report a decrease in the value of their overall portfolio (down slightly from 15 percent last year), and 13 percent of respondents indicate that the value of their portfolio stayed the same in 2013 (down from 21 percent last year).

Of the 75 percent of fund managers who saw the value of their portfolio increase during the past year, the largest group (49 percent) report increases of between 6-15 percent, followed by increases of 16-25 percent, reported by 31 percent of fund managers. Another 11 percent saw increases of between 26-35 percent, and five percent of respondents report increases of more than 35 percent.

For fund managers who saw their portfolio decrease, the largest percentage (44 percent) indicate that the fund's value decreased between 6-15 percent. Another 33 percent indicate their fund's value decreased less than six percent, and 11 percent of fund managers report the value of their current portfolio decreased between 26-35 percent and 46-50 percent, each.

"2013 was a good year for private equity investors, who profited greatly from private equity funds taking advantage of a seller's market. Strong exits led to private equity sponsors returning a record amount of cash." – Dan Shea, Managing Director with BDO Capital Advisors, LLC and a Member of the Private Equity Practice at BDO

PRICING, IDENTIFYING QUALITY TARGETS PRESENT BIGGEST CHALLENGES

Thirty-nine percent of fund managers cite pricing as their most significant obstacle in the coming year, a marked uptick from just 15 percent of respondents who said the same in last year's study. With a smaller pool of quality assets, competition is pushing valuations higher with cash-rich strategic buyers going head-to-head with traditional private equity funds. Such competition is resulting in rising purchase price multiples, which increased to approximately 9.8 times EBITDA in 2013, up from 8.3 times in 2012, according to *Preqin*.

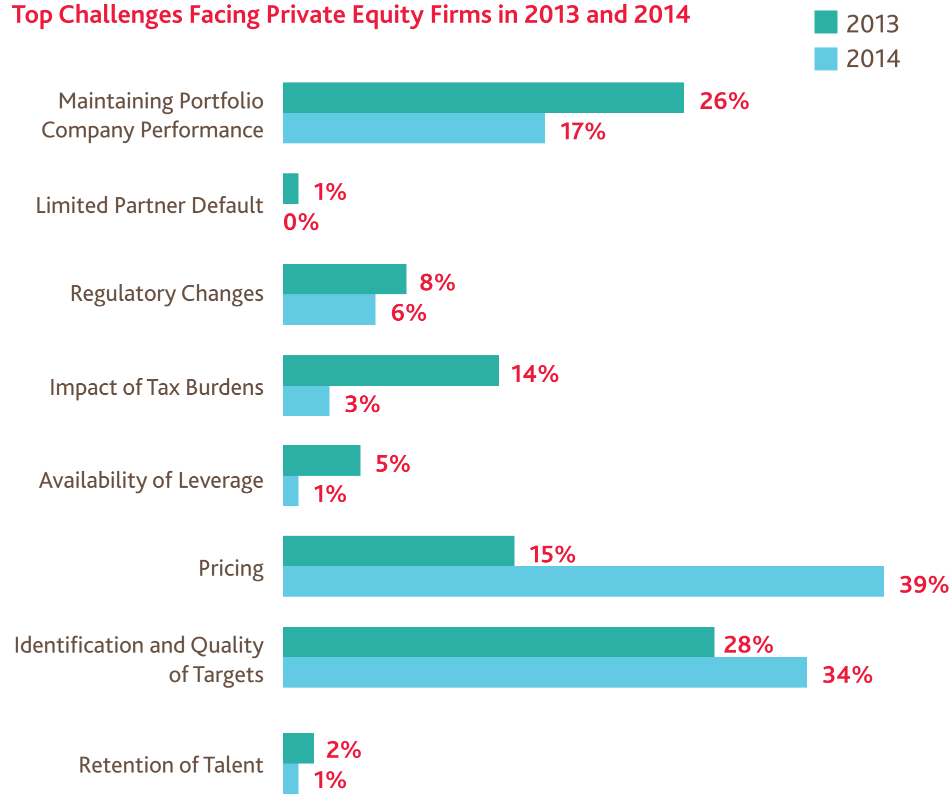
The second largest percentage of fund managers (34 percent) say the identification of quality targets will be their number one challenge in the coming year, up from 28 percent in 2013. This points to ongoing concerns about deal flow in the wake of a slow year for private equity deal making, and a rising mountain of dry powder.

"We're seeing an increased number of financial and strategic buyers competing for deals, as well as increased access to debt, leaving many fund managers concerned about their ability to source and close quality deals in the year ahead. While compelling investment opportunities do exist, private equity firms will need to be extra diligent as they work to find quality companies that are priced right in today's frothy market." – Scott Cacurak, Partner & National Dirctor of Transaction Advisory Services at BDO

Read more

"We are continuing to see longer holding periods with little to suggest that the duration will decline. In order to add value, private equity funds are finding the need to hold businesses longer. Money-on-money returns may be larger, but funds' IRR will naturally decline given the increased holding period."
– Doron Grosman, Operating Partner with Court Square

Top Challenges Facing Private Equity Firms in 2013 and 2014



Source: BDO PErspective Private Equity Study

▶LONGER HOLDING PERIODS EXPECTED, ALONG WITH SHIFT IN POTENTIAL BUYERS

When it comes to exit activity, 70 percent of fund managers expect to see longer holding periods in the coming year, which is similar to the fund manager expectations in 2013. Of those fund managers, 53 percent expect holding periods that will last 7-12 months longer, and 30 percent expect holding periods that will last 13-24 months longer.

Fund managers are also anticipating a shift in potential buyers. More than half of private equity fund managers (54 percent) indicate that their exit assumptions have changed, with 25 percent reporting an increased focus on sales to strategic buyers (down from 35 percent), followed by 15 percent reporting an increased focus on sales to financial buyers (up from 11 percent). Initial public offerings (IPOs) continue to be a less favorable exit plan as only eight percent of fund managers say they are increasing their focus on the IPO market, up from just four percent in 2013.

Anticipated changes to exit assumptions align with fund managers' expectations that the greatest returns will be generated from sales to strategic buyers. In the coming year, 72 percent of fund managers say sales to strategic buyers will generate the greatest returns, up from 64 percent the year prior. Another nine percent indicate sales to financial buyers will be most lucrative, down from 11 percent; and seven percent predict that the IPO market will generate the greatest returns on their investments, down from 15 percent. Eleven percent of fund managers say they are focusing on long-term holds, as exits will not generate a return in the current market, up from nine percent in 2013.

Because of pent-up demand to liquidate investments resulting from longer average holding periods, the majority of fund managers (77 percent) expect that secondary offerings are going to be a key driver of private equity deal flow in 2014, followed by private equity funds investing in distressed businesses and corporates divesting to raise cash (seven percent each).

"Given the strong public equity markets and the significant amount of cash that is sitting on U.S. corporations' balance sheets, strategic buyers, which have been very busy acquirers over the past few years, are likely to remain active." – Ryan Guthrie, Partner in the Private Equity Practice at BDO

▶Read more

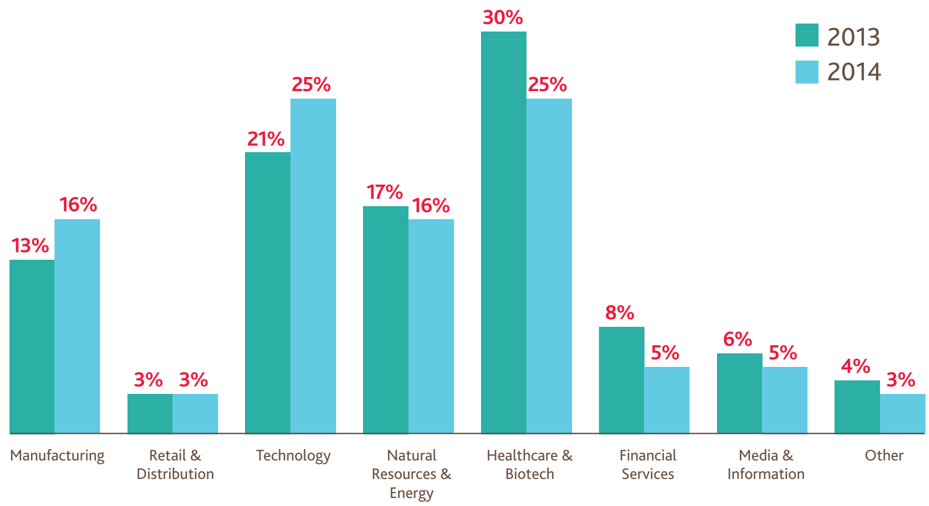
▶MANUFACTURING IDENTIFIED AS THE GREATEST OPPORTUNITY FOR NEW INVESTMENT; TECHNOLOGY, HEALTHCARE & BIOTECH EXPECTED TO EXPERIENCE INCREASING VALUATIONS

Private equity interest in manufacturing is on the upswing with 32 percent of respondents identifying manufacturing as the industry most likely to see the greatest opportunity for new investment in the coming year, up from 25 percent last year. According to *Privcap*, given the recent wage inflation in China and the increasing costs of outsourcing, the U.S. has become a competitive manufacturing destination.

Technology, healthcare & biotech are also deemed attractive industries for new investment in 2014, with 17 percent of respondents equally indicating that both of these sectors will provide the greatest opportunity, followed by natural resources & energy (15 percent), retail (eight percent) and media & information (six percent). Another five percent of fund managers believe financial services will provide the greatest opportunities for new investments in 2014.

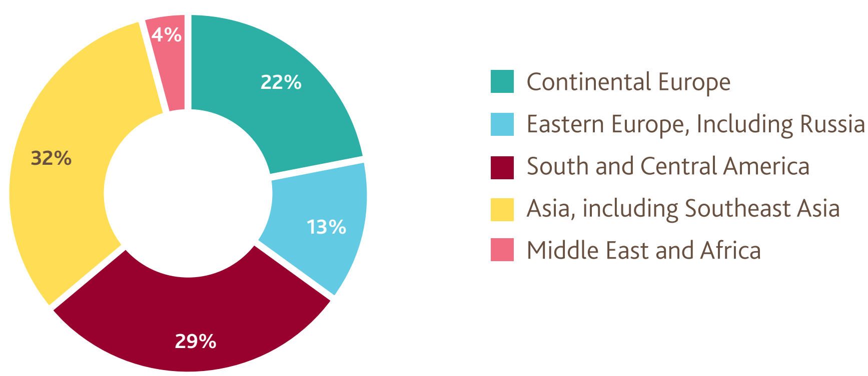
Fund managers anticipate sellers will have high pricing expectations in the year ahead. Twenty-five percent of fund managers believe the technology and healthcare & biotech sectors are the most likely to experience increasing valuations in 2014. For technology, this is a slight increase from 21 percent last year, while healthcare & biotech report a slight decline from 30 percent last year.

Industries Anticipated For Increased Valuations in 2014 by Percentage of Fund Managers



Source: BDO PErspective Private Equity Study

Geographic Areas that Present the Greatest Opportunity for Investment, Outside of North America



Source: BDO PErspective Private Equity Study

▶FUND MANAGERS ARE POISED TO TAP ASIA'S POTENTIAL

As the number of wealthy investors in Asia increases, private equity managers are progressively looking to increase their allocations to the region. As such, 32 percent of fund manager respondents – regardless of fund size – report that, other than North America, Asia (including Southeast Asia) will present the greatest opportunities for new investments in 2014. That's up from only 22 percent of fund managers who identified Asia as the market with the greatest opportunities looking into 2013.

"Up until recently, Asia hasn't been a core focus of capital due to complex market dynamics, but that seems likely to change. While Asia is certainly a diverse market and its private equity footprint is relatively small compared to other regions, we're seeing that U.S. private equity firms are increasingly looking to Asia for opportunities."
– Lee Duran, Partner & Private Equity Practice Leader at BDO

South and Central America, an area that was considered the hottest area for investment looking into 2013 (as identified by 42 percent of fund managers last year), dropped to second place this year, with 29 percent of respondents identifying this region as having the greatest opportunities for new investments in the year ahead.

Diverging slightly from the pack, large funds – those with more than $1 billion in assets under management (AUM) – indicate that Continental Europe (32 percent) and South and Central America (32 percent) will provide the greatest opportunities for new investments in the coming year, followed by Asia (18 percent).

▶ Read more

▶FUNDS FOCUS ON GROWING AND ACTIVELY MANAGING PORTFOLIO COMPANIES

Fund managers are also looking to enhance their existing investments through add-on acquisitions. Ninety-three percent of fund managers indicate that they sought add-on acquisitions in 2013, and 97 percent say they plan to do so in the coming year (up from 87 percent in last year's forecast). As mentioned earlier, 75 percent of survey respondents report that the value of their entire portfolio increased during the past 12 months, an 11 percent uptick from the year prior. The ability to enhance portfolio valuations through add-on acquisitions was important to this growth. And 19 percent of respondents report that they directed the most capital toward add-on acquisitions in 2013, up from 14 percent in 2012.

Although the private equity industry overall enjoyed robust performance in 2013, some individual portfolio companies continue to struggle, requiring fund managers to place greater emphasis on actively managing their investments. In fact, one-in-five fund managers report more than 20 percent of their sponsored companies are performing below forecasts or expectations, and another 20 percent are seeing 6-10 percent of their portfolio companies underperform. Only 14 percent of fund managers say none of their portfolio companies are performing below forecasts or expectations.

While only 17 percent of fund managers ranked maintaining portfolio company performance as their most significant challenge (down from 26 percent last year), private equity firms say they are continuing to actively manage portfolio company operations to mitigate losses. Overall, funds report that they are taking the following actions when it comes to managing portfolio companies:

- Sixty-five percent of fund managers report that they reduced headcount for portfolio companies that are performing below forecasts or expectations, up from 58 percent last year.
- To manage costs, 61 percent of fund managers are scaling back operations, 63 percent are renegotiating debt for poorly performing portfolio companies and 70 percent are monitoring portfolio company cash flow on a weekly basis.
- The majority of fund managers (80 percent) indicate that they are reassessing the market strategy for portfolio companies that performed below forecasts or expectations, up from 72 percent last year.
- Private equity fund managers are also increasingly hiring turnaround professionals, with one-quarter of fund managers indicating they did so in the past year, up 39 percent since last year.

Despite portfolio companies' losses in the past year, bankruptcy filings remain low, with only eight percent of fund managers indicating that they declared bankruptcy for one or more portfolio companies in 2013. The outlook is even brighter for 2014, with only six percent of fund managers anticipating they will have to file for bankruptcy for one or more portfolio companies.

▶OPERATING COMPANY HIRING TO INCREASE; HIRING TO REMAIN FLAT AT THE FUND LEVEL

When it comes to hiring at the operating company level, nearly three-in-four (72 percent) fund managers plan to increase professional staff headcount at the operating company level in the coming year, up from 63 percent who say they increased professional staff headcount in 2013.

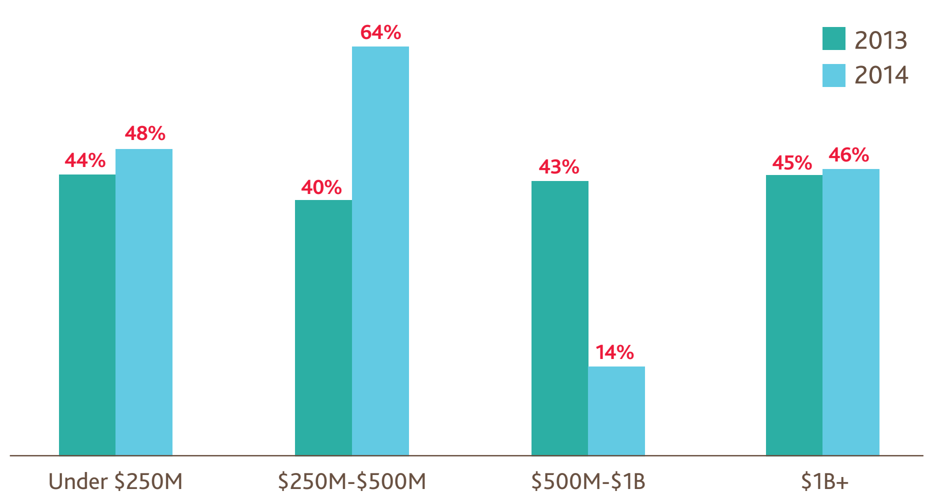
The hiring landscape at the fund level is less aggressive. The majority (54 percent) of fund managers did not increase fund employee headcount in 2013, and 56 percent of fund managers plan to keep hiring at bay in the coming year.

Breaking the data down by fund size, while 64 percent of respondents managing between $250 million and $500 million in assets anticipate increasing staff in 2014, only 14 percent of funds that manage between $500 million and $1 billion in assets plan to hire new staff in the coming year.

Other major findings from the *BDO PErspective Private Equity Study* include:

- **Limited Partners Still Hold Track Records in High Regard:** Reinforcing concerns about succession plans for large funds, the majority (62 percent) of survey respondents believe that a fund's track record is the most important factor for limited partners (LPs) when evaluating general partners (GPs), down slightly from 67 percent last year. Operating experience was the second most popular choice, with 19 percent of fund managers viewing it as the most important factor (up from 12

Percentage of Fund Managers Who Plan to Increase Headcount at the Fund Level by Fund Size in 2013 and 2014



Source: BDO PErspective Private Equity Study

▶Read more

percent last year), followed by 13 percent of fund managers who believe LPs prioritize a fund's management team.

- **Funds Consider Changes to Fee Structure, Transparency to Attract LPs:** When it comes to making funds more attractive to LPs, 22 percent of private equity fund managers are considering changing fee structures (i.e., decreasing management fees, introducing new fee structures), followed by 14 percent who are increasing disclosures and transparency to LPs, 13 percent who are changing philosophy with regard to investment type (i.e. mezzanine, equity) and 13 percent who are not making any changes to their strategy.

- **Fund Managers Continue to Invest from Pre-2007 Vintage:** Sixteen percent of fund managers – regardless of fund size – indicate that they are still investing from vintage funds, with two-in-five mid-size fund managers (those with $500 million to $1 billion in assets under management) reporting that they are still investing in funds that closed prior to 2007.

- **Funds Take a Wait-and-See Approach to the JOBS Act:** The majority of private equity fund managers (71 percent) remain reluctant to change their plans or policies regarding general solicitations in response to the JOBS Act. Only 10 percent of fund managers plan to update their procedures to verify investor accreditation and a mere four percent plan to publicize past performance or hire an in-house marketing or media professional. Diverging slightly from the majority, 13 percent of fund managers with AUM between $250 million to $500 million are more likely to opt-in via Form D filed with the SEC to begin solicitation, and 13 percent plan to hire an in-house marketing or media professional.

- **Fund Managers Remain Lukewarm about the Current Investment Environment:** Sixty percent of fund managers say that the current environment is "somewhat favorable" for private equity firms looking to invest, and 29 percent of fund managers report that it is either "somewhat unfavorable" or "very unfavorable" at the moment. This is along the same script as last year's findings when 64 percent of fund managers said the environment was somewhat favorable and 25 percent said it was either "somewhat unfavorable" or "very unfavorable."

THE BDO USA, LLP PERSPECTIVE PRIVATE EQUITY STUDY is a national survey conducted by PitchBook, an independent and impartial research firm dedicated to providing premium data, news and analysis to the private equity industry. More than 100 senior executives at private equity firms throughout the U.S. with $30 million to $70 billion in AUM responded to BDO's latest study, which was conducted from November through December 2013.

Court Square did not participate in The BDO Perspective Private Equity Study; opinions expressed herein do not directly correspond with survey input or results.