



GLOBAL PRIVATE EQUITY REPORT 2016

## About Bain & Company's Private Equity business

Bain & Company is the leading consulting partner to the private equity (PE) industry and its stakeholders. PE consulting at Bain has grown fivefold over the past 15 years and now represents about one-quarter of the firm's global business. We maintain a global network of more than 1,000 experienced professionals serving PE clients. Our practice is more than triple the size of the next largest consulting company serving PE firms.

Bain's work with PE firms spans fund types, including buyout, infrastructure, real estate and debt. We also work with hedge funds, as well as many of the most prominent institutional investors, including sovereign wealth funds, pension funds, endowments and family investment offices. We support our clients across a broad range of objectives:

**Deal generation.** We help develop differentiated investment theses and enhance deal flow by profiling industries, screening companies and devising a plan to approach targets.

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

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

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

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

**Firm strategy and operations.** We help PE firms develop distinctive ways to achieve continued excellence by devising differentiated strategies, maximizing investment capabilities, developing sector specialization and intelligence, enhancing fund-raising, improving organizational design and decision making and enlisting top talent.

**Institutional investor strategy.** We help institutional investors develop best-in-class investment programs across asset classes, including PE, infrastructure and real estate. Topics we address cover asset-class allocation, portfolio construction and manager selection, governance and risk management and organizational design and decision making. We also help institutional investors expand their participation in PE, including through coinvestment and direct investing opportunities.

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## Heading toward a new normal?

Dear Colleague:

Over the past decade, the private equity industry has been through the throes of volatility and change. It began, in 2006, with the largest deal-making boom in the history of the industry. This boom was followed, two years later, by the financial crisis and the worst recession in 70 years. By 2010, there were real concerns that many portfolio companies—and, indeed, PE firms themselves—would go bust as a mountain of debt requiring refinancing seemed insurmountable. Fund-raising dried up and times looked dire.

But a funny thing happened on the way to perdition. The PE industry proved itself to be remarkably resilient over the decade's second half. The debt mountain was refinanced and paid down, aided by the US Federal Reserve and European Central Bank reducing interest rates to near zero. Deals done at the peak of the boom that appeared wobbly suddenly looked much sounder with revised capital structures and better growth prospects. A period of relative economic stability brought rising global equity markets, large corporate cash balances and, eventually, a flood of exits at better than expected rates of return.

By 2015, LPs enjoyed a fifth consecutive year when distributions outpaced capital calls, generating strong net positive cash flows. Their response: substantial increases in allocations and a renewed push to cycle money back into PE, historically the best-performing asset class in most LP portfolios. Since 2013, PE funds raised \$500 billion annually worldwide, and uninvested dry powder today stands at a record \$1.3 trillion. The past year saw the best environment for fund-raising since the precrash boom.

With generally benign debt markets continuing to finance most deals, this confluence of favorable conditions has created attractive industry economics for every constituency save one: current buyers. Asset prices remain near record highs in most markets. Unable to keep pace with the tide of money chasing these investments, deal count and values are up only modestly from what they had been several years ago. For GPs, sharpening their focus on deal sourcing, investment thesis articulation and post-close value addition have never been more important, and they are hurrying to raise their games on these and many other fronts.

As PE entered 2016, the shadow of interest-rate increases in some markets and the risk of recession loom as tricky prospects that investors need to include in their deal-making calculus. More than ever, PE firms with finely tuned strategies and repeatable value-creation models will prosper. As we have seen over the past dramatic decade, smart investors find ways to overcome problems, make money for their constituents and earn the right to raise more money to fuel their continued growth.

We hope you will enjoy Bain's latest *Global Private Equity Report*, and we look forward to continuing our dialogue with you in the year ahead.



Hugh H. MacArthur  
Head of Global Private Equity



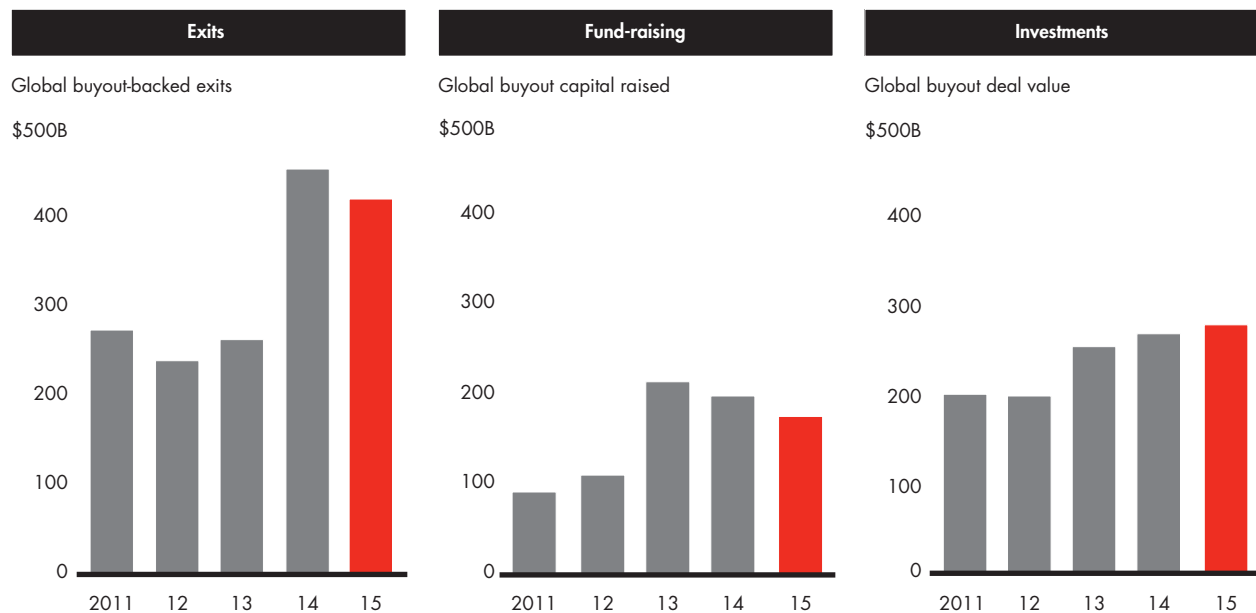
## I. The private equity market in 2015: What happened

With its complex interplay of fund-raising, investments, exits and returns carried out on a global scale against kaleidoscopic shifts in the business cycle, credit conditions and regulatory environment, a year in private equity (PE) is a lifetime in most other industries. As the global economic expansion showed signs of strain amid continued record-low interest rates, feverish competition that had investment multiples skirting record highs and increased volatility in public equity markets, 2015 presented many challenges. Yet, PE turned in another surprisingly solid year.

PE's vital signs remained healthy in 2015, although the aggregate figures retreated somewhat from the highs in 2013 and 2014 (see Figure 1.1). Exits in 2015 rode a tsunami of corporate merger and acquisition (M&A) activity as cash-rich strategic acquirers set out to buy growth. PE returns once again began to widen their performance edge over the public markets, reinforcing investor confidence. The eagerness of limited partners (LPs) to recycle a flood of cash distributions back into their best-performing asset class enabled PE firms of just about all sizes, areas of focus and performance track records to hit or exceed their targets. New investments by PE funds remained robust despite sky-high asset valuations and growing uncertainty in the debt markets as general partners (GPs) discovered new ways to deploy capital.

As we will see in Section 2 of this report, the disciplines and resourcefulness that served PE so well last year will be even more important in the year ahead as the competitive intensity for deals reaches new highs, recession risks mount and the maturing PE industry wrestles with generational change. Leading PE firms are arming themselves for future turbulence by probing deeply to understand the unique sources of their past successes, investing in skills that will enable them to create value across their portfolios and learning how to anticipate—

Figure 1.1: 2015 was another strong year for private equity



Sources: Preqin; Dealogic

and invest behind—the new macro forces that will disrupt industries and reshape economies. There are lessons in these novel approaches that no PE firm or LP can afford to ignore, because if there is one constant amid the PE industry’s kaleidoscope of challenges it is the need to embrace change.

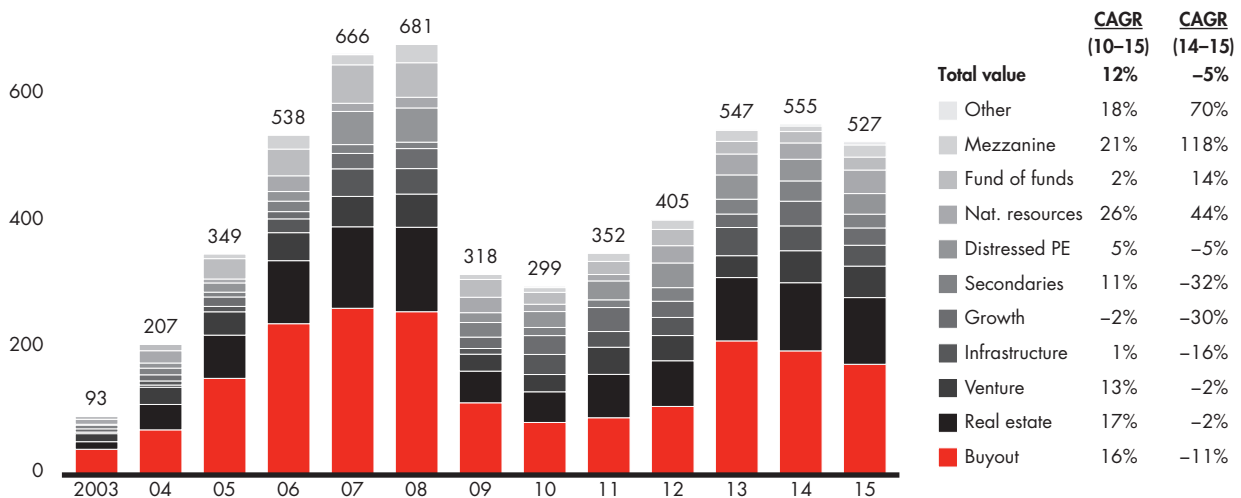
## Fund-raising: Bigger, better, faster

GPs setting out to raise new funds in 2015 encountered some of the best conditions they had seen in years. With cash distributions from exits continuing to run well ahead of calls on previous commitments LPs had made for a fifth consecutive year, abundant fresh capital enabled most GPs to hit or exceed their fund-raising targets. Funds are also raising capital more quickly, on average, than in any year since the height of the last PE cycle nearly a decade ago.

Indeed, with memories of the global financial crisis still fresh in the minds of GPs and LPs alike, it is remarkable how far fund-raising has rebounded. With all exit channels blocked in the period immediately following the crisis as GPs gradually nursed their troubled holdings back to health—and because LPs were overweighted in PE as the value of non-PE assets tumbled—most shelved new fund-raising plans, and many looked as if they might never be able to raise another fund. As economies and markets around the world slowly recovered, PE fund-raising began to climb out of its trough. (For Bain’s analysis on how surprisingly well PE industry fund-raising weathered that last downturn, see “The shakeout that didn’t happen” on page 3.) Fund-raising in 2015 built on recent years’ strengths as cresting cash distributions lifted across-the-board demand from LPs. The strength was not evident in the year’s headline numbers. As recently as mid-December, total capital raised globally in 2015, at \$527 billion, was slightly less than the \$555 billion raised in 2014 (see Figure 1.2). Most fund categories dipped below the previous year’s level, with growth funds slipping 30%, infrastructure funds off by 16% and buyout funds

Figure 1.2: PE capital raised globally in 2015 came in less than the previous year’s high

Global PE capital raised (by fund type)  
\$800B

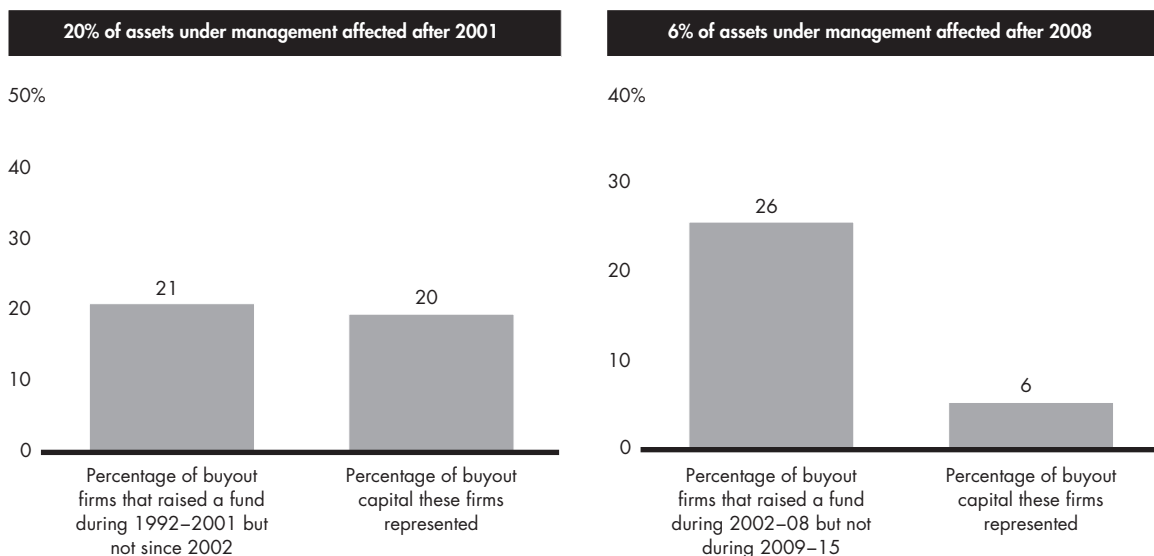


Notes: Includes funds with final close and represents year funds held their final close; distressed PE includes distressed debt, special situation and turnaround funds; other includes PIPE and hybrid funds  
Source: Preqin

## The shakeout that didn't happen

The global financial meltdown was a disaster for banks, brokerages, insurers and investors, as credit seized up and equity markets tanked. However, in one surprising respect, the PE industry withstood the maelstrom far better than commonly expected. Sure, the downturn claimed PE firms by the hundreds: 26% of the 4,019 buyout firms that had raised a new fund between 2002 and 2008 went dark after the crisis hit, not raising another fund since 2009 and appearing unlikely to do so ever again. An in-depth Bain analysis of the downturn's impact on the PE industry found that the casualty rate of buyout firms was somewhat higher than that triggered by the bursting of the tech bubble in 2001, but off a much larger base. Then, 21% of the 196 firms that had been active new fund-raisers between 1992 and 2001 failed to raise a subsequent fund after 2002. But by one crucial measure—the proportion of total assets under management (AUM) of buyout funds—the effects of the 2008 downturn were far milder. The AUM represented by the firms that did not raise new funds after 2002 were 20% of the industry total raised in the prior period. By sharp contrast, firms that failed to raise a new fund after 2009 represented just 6% of total buyout fund AUM raised between 2002 and 2008 (*see figure*). One big reason why the cessation of so many mattered so little is that most of the 2008 firm casualties were small shops; more than half of them had raised just one fund before their demise. The financial crisis and downturn that followed culled the young and weak, as recessions are wont to do, but barely put a dent in the health of the PE industry overall.

## The global financial crisis claimed many victims but barely put a dent in PE assets under management



Note: "Dead" firms do not include investment banks forced to terminate PE activities due to regulatory changes; Bain determines a PE firm dead if it has not raised a buyout fund since 2008 and Preqin lists the firm as no longer active or as not currently investing; Bain also considers the firm dead if it has stated that it will not raise another fund or the firm meets two of these four criteria: has less than \$50 million in dry powder, has not made an investment in two years, its last fund was in fourth quartile, or had a major SEC lawsuit  
 Source: Preqin

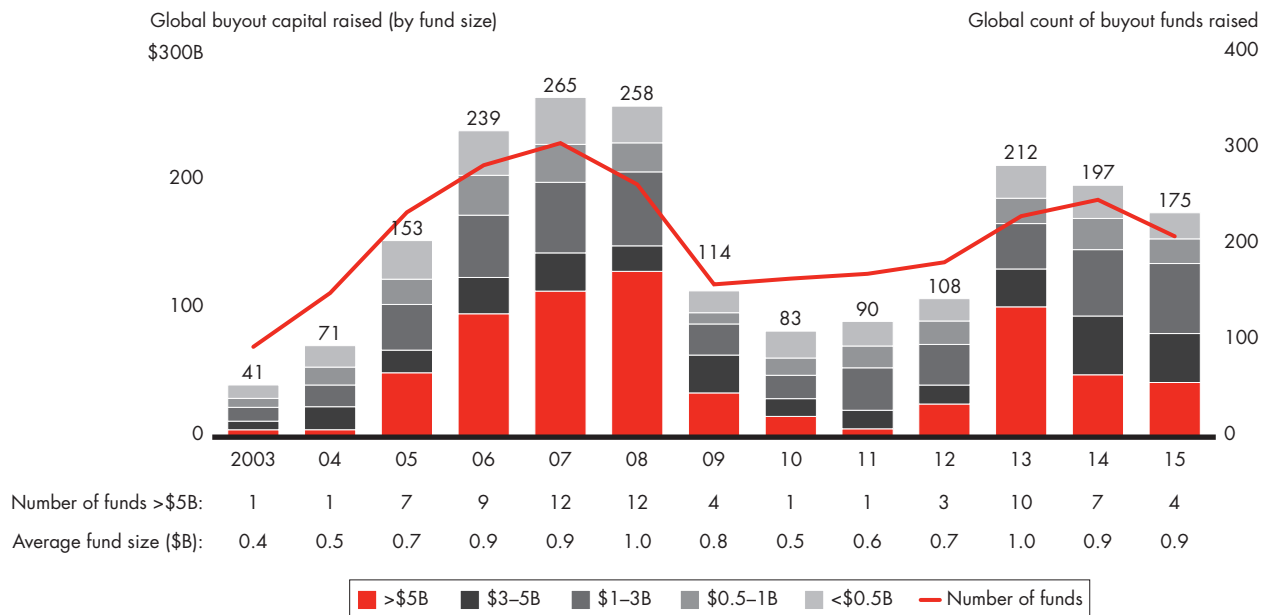
down by 11%. Funds based in North America posted a down year, but funds headquartered in Asia-Pacific increased modestly. Europe proved surprisingly strong given the EU’s currency and debt crises that kept the continent teetering on the edge of recession. Indeed, European PE’s dollar-denominated fund-raising success understates its true value due to the euro’s steep depreciation in 2015. When restated in euros, the value of new capital commitments to European buyout-backed funds increased by 15%.

The modest overall numbers reflected quirks of the calendar as much as anything else and failed to capture the strength of the fund-raising environment. Fund-raising activity gained momentum, resulting in scores of new fund offerings that were close to completion by year-end. At the start of 2016, 12 large buyout funds, each of them targeting \$5 billion or more, were still on the road, looking to raise an aggregate \$86 billion. That total was slightly less than one-third of the \$256 billion that GPs sought for buyout funds of all sizes but had not yet closed, highlighting the preponderance of megafunds in the market in 2015. Based on data available at the time of publication, global buyout funds that closed in 2015 brought in a healthy total of \$175 billion, but it was below the preceding year’s total of \$197 billion (see Figure 1.3).

### LP demand: Hungrier than ever

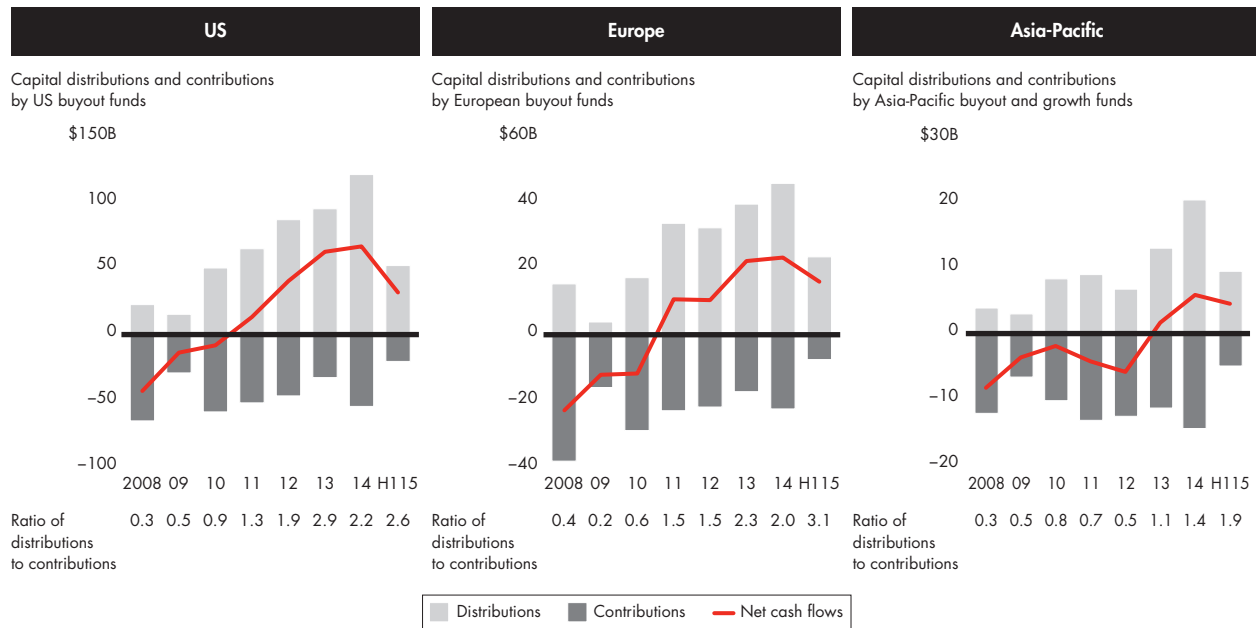
Successive years of strong cash distributions supported LPs’ capacity to plow capital back into PE across every region of the world in 2015 (see Figure 1.4). Total distributions have exceeded contributions each year since 2011, rising to a peak surplus in 2014 of \$66.3 billion and \$23.6 billion in the US and Europe, respectively. In the smaller Asia-Pacific market, net cash flow first turned positive in 2013, returning \$1.7 billion to LPs, and in 2014, it more than tripled, to \$5.9 billion. The ratio of distributions to calls widened across the globe in 2015.

**Figure 1.3:** Buyout funds raised in 2015 came in less than in recent years, but many more big funds still on the road were near closing



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

Figure 1.4: Positive cash flow from distributions supported new PE buyout fund commitments in all major regions



Note: Europe includes developed economies only  
Source: Cambridge Associates

Since distributions of cash returns first surpassed calls on prior LP commitments in 2011, PE funds funneled more than \$650 billion to LPs through mid-2015—nearly \$300 billion more than LPs sent back to meet call obligations, leaving a sizable amount available to back new funds just to replenish PE allocations. Fewer than 10% of the LPs surveyed by Preqin, the PE data firm, were running above their targeted PE allocations through the end of 2015—the lowest proportion since late 2007 (see Figure 1.5).

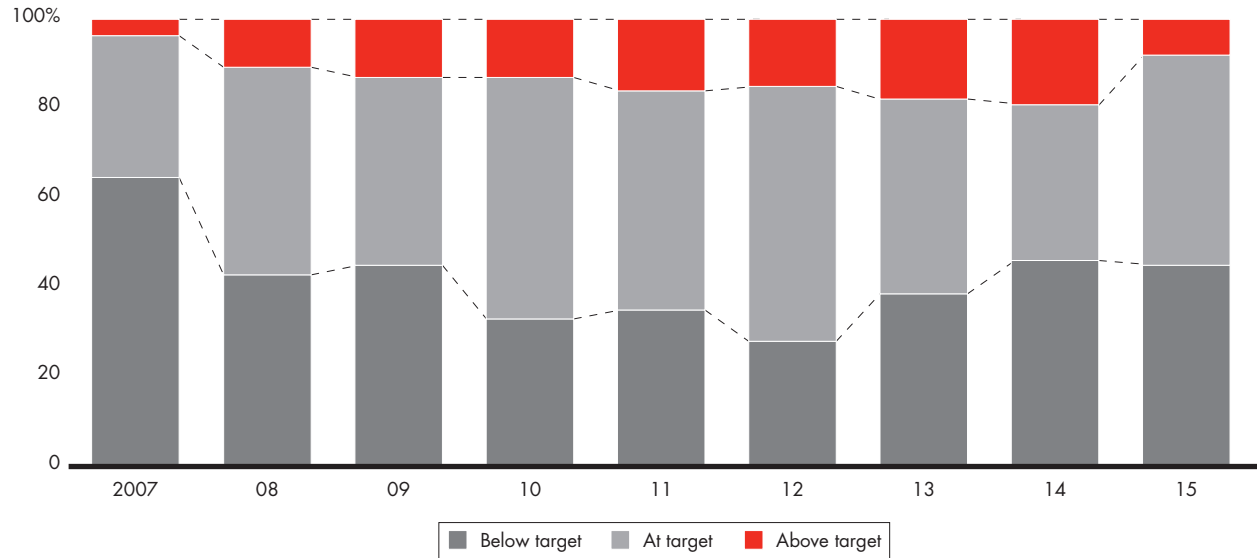
The strong exit markets since 2010 and the torrent of returns they have generated at a time of flattening yields have only whetted LPs’ appetites for more PE. Nearly one-half of LPs expect PE will continue to exceed public market returns by more than 4 percentage points, and nearly 90% anticipate PE returns will outperform by at least 2 percentage points. They are willing to back up that confidence with capital, both over the short and longer term. In a Preqin survey conducted last June, 42% of LPs said they planned to increase their PE commitments over the coming year, and 51% would raise their PE allocations over the long term.

**GP supply: Riding the liquidity wave**

The attraction of all of the capital LPs have been eager to recycle kept 318 global buyout funds alone on the road at the end of the year, aiming to raise \$247 billion—the largest amount of buyout capital sought since 2008 and the greatest number of fund sponsors ever (see Figure 1.6). Following their ambition, heightened by the promising prospects they perceive, GPs sponsoring these funds are lifting their sights. GPs offering funds of all types and across all regions shared broadly in fund-raising success. Funds are closing faster, and the share of those that hit or exceeded their goal was higher in 2015 than at any time since the precrisis boom of 2007 (see Figure 1.7). Among buyout funds, fully 40% closed in six months or less. On average, funds won commitments from LPs

Figure 1.5: Fewer LPs were tracking above their target PE allocation in 2015

Percentage of LPs reporting themselves as below, at or above target PE allocations

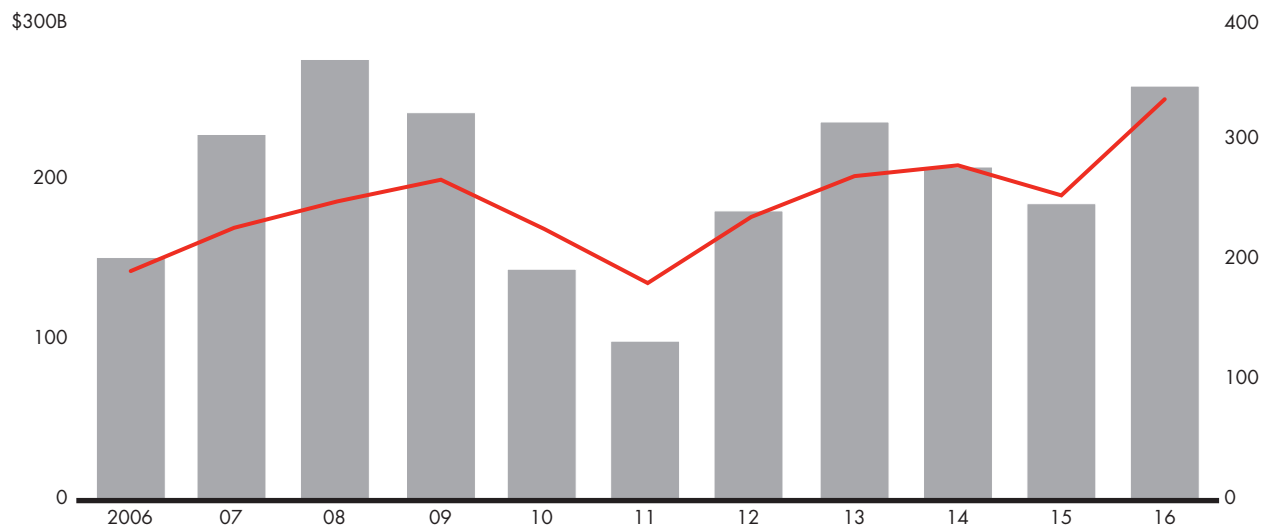


Note: 2007–08 results were from September of their respective years, and 2009–15 results were from December of their respective years  
Source: Preqin

Figure 1.6: Both the number of buyout funds and the value of buyout capital sought were up in 2015

Value of global buyout funds on the road at the start of the year (bars)

Count of global buyout funds on the road at the start of the year (line)



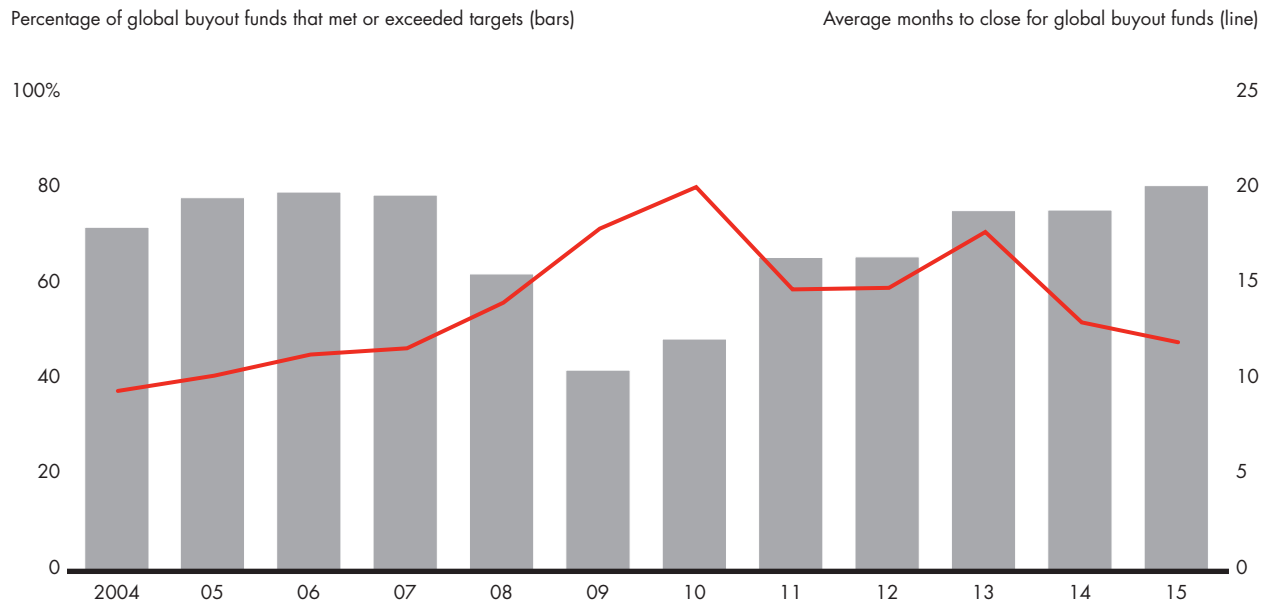
Source: Preqin

that were well above the targets they set out to raise: 112% for US-sponsored funds and 110% for funds sponsored by GPs based outside the US. Of buyout funds, 25% brought in at least 125% of their targeted goals, and none closed having raised less than half of the amount they had aimed to raise.

Of the five largest buyout funds to close last year, all hit or exceeded their goals, and each was substantially larger than the fund that preceded it. Three of these funds achieved their final close within eight months of their launch date. The largest of the group, Blackstone Capital Partners VII, raised \$18 billion and was the second-biggest buyout fund raised since 2008. Launched in November 2014, the fund closed last December having raised 111% of The Blackstone Group’s predecessor fund. The runner-up, Warburg Pincus Private Equity XII, hit its \$12 billion target in a quick six months. Among the dozen top buyout funds to close in 2015, seven were offered by a GP based in North America, three by GPs in Europe and two by GPs in Asia. Much of the capital raised in North America is also slated for investments across the globe, including funds sponsored by KKR and The Carlyle Group that are earmarked for Europe, and others that plan to invest across several regions. Among the 12 largest buyout funds still on the road at year-end, all aimed to raise \$5 billion or more, and two, Advent Global Private Equity VIII and KKR Americas Fund XII, were shooting to bring in \$12 billion and \$10 billion, respectively.

So strongly has the supply-demand balance for new funds tipped in favor of GPs that PE firms are testing ways to reinforce fund fees and terms that had softened to the advantage of LPs in the wake of the global downturn. For example, *The Wall Street Journal* reported that Boston-headquartered global buyout firm Advent International dropped the preferred hurdle rate that it would need to clear before it begins collecting carried interest on the \$12 billion fund that it is currently shopping to LPs. In Europe, Valedo Partners, a middle-market firm based in

Figure 1.7: Funds closed faster and more hit their targets in 2015 than at any time since 2007



Note: Average months to close excludes funds closed in less than one month or more than 40 months  
Source: Preqin

Sweden, hiked its carried interest levy from 20% to 25% on the €210 million fund it recently closed. Valedo succeeded in closing its Partners Fund II, which was twice the size of its predecessor fund, in less than six months.

### **New PE plays for putting money to work**

With so much capital vying to win a place in the new fund of a successful GP, many LPs are weighing new options for filling or increasing their PE allocations. Some are looking for ways to gain a coveted new-fund allocation while streamlining their portfolio management costs by agreeing to write bigger checks backing fewer GPs in exchange for more favorable fees and terms. That tactic is fine as far as it goes, which is too often not far enough in today's high-demand environment. That is why these LPs and many others are also turning to novel ways to invest in the PE space, beyond just signing on to a GP's new fund.

**The expanding penumbra of shadow capital.** Coinvesting alongside a GP is continuing to grow in popularity with LPs. This shadow capital does not figure in the totals raised by PE funds, but it is having a big influence on GP-LP relations and the evolution of the industry overall. LPs like coinvesting because anteing up additional capital can buy them access to an elite GP—or squeeze concessions from one with middling performance—by putting money in its new fund and then writing another check that lets the LP ride shotgun with the fund while paying a far lower fee to the GP, taking a smaller bite out of returns.

Alongside those undeniable benefits of being able to deploy more capital in PE at lower cost, however, come some real concerns. For instance, when a big chunk of nontraditional money from LPs is hidden in the shadows of a GP's new fund, other LP participants, typically smaller or midsize institutions, can be left wondering just how much capital the GP will ultimately need to put to work—and precisely whose interests the GP will end up representing. Yet, despite those potential frictions, coinvestments took a big step forward last year. On an annualized basis, shadow capital invested in PE during 2015 totaled an estimated \$161 billion, or the equivalent of 26% of the year's traditional capital raised, according to a 2015 report by Triago, a leading PE industry fund-raising adviser.

**Secondaries get a new look.** Another novel way LPs are choosing to participate in PE is through their increasing use of the secondary market to deploy capital by actively trading shares in existing PE funds. Traditionally, the buying and selling of secondary interests has been the narrow domain of specialist funds created solely for that purpose. The extent to which LPs were active directly in secondaries had been to liquidate a stake in an established fund, either because they needed the cash or because they lost confidence that the GP would generate a hoped-for return. For their part, conventional LPs who bought secondaries often sought to take advantage of the steep discounts they could command, but when doing so they knew they had to take care to check under the hood of a fund that another LP was eager to sell.

Over the past few years, secondaries have almost entirely lost that stigma. In a recent report on PE liquidity, SEI, a US asset-management advisory firm, reported that 58% of LPs acknowledged having bought or sold assets on the secondary market. Indeed, trading in secondaries has become a potent portfolio management tool. In addition to allowing LPs to use uninvested capital to increase their exposure to PE, secondaries also enable them to better diversify their holdings across several fund vintages. The number of nontraditional buyers in the secondary market—a group that includes regular LPs looking to firm up their PE allocations—nearly doubled since 2013, to 485 last year. The increased use of the secondary market is helping to create additional liquidity in this traditionally illiquid asset class, and if the trend continues, could lead to a reduction in the “illiquidity premium” LPs have long expected in returns.

LPs are willing to broaden their exposure to PE coinvesting, trade in secondaries and resort to other novel approaches because they know that the disciplines of PE value creation are well suited for today’s market turmoil and will likely better withstand the headwinds of an uncertain economy ahead. PE has served LPs well in good and bad times in the past, and confidence is strong that it will continue to do so going forward.

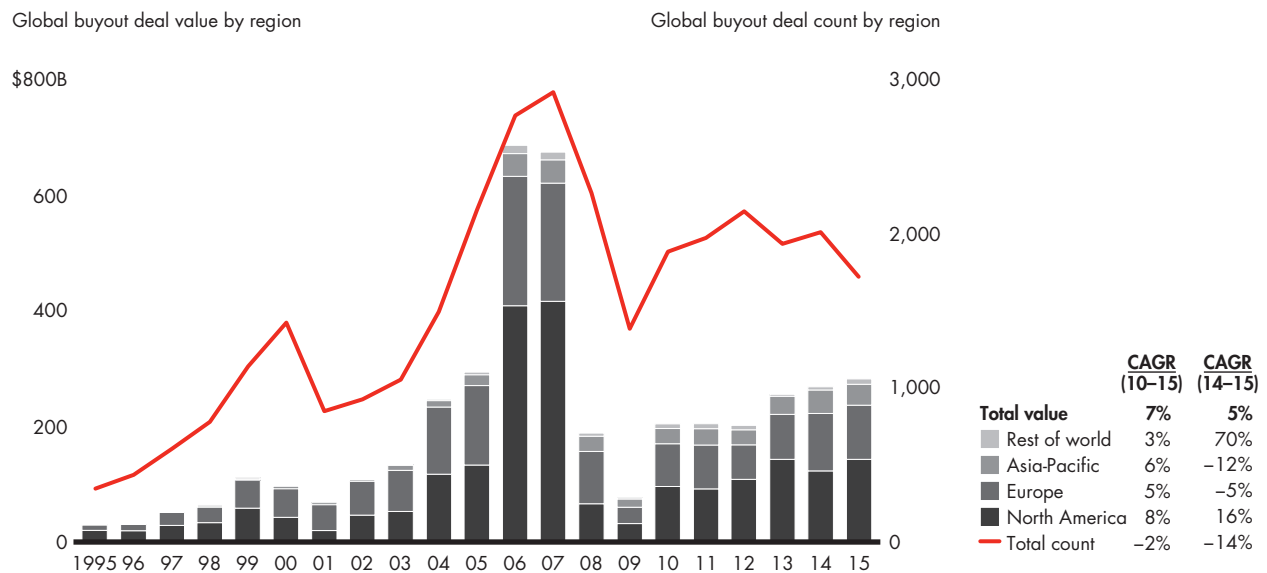
### Investments: Pressures mount on every side

New PE deal making ground on steadily in 2015, as it has every year since 2010, the start of this remarkably durable PE cycle. When the final reported numbers were toted up, deal value for announced global buyouts totaled \$282 billion, a shade more than in 2014, and deal count came in a tad lower (see Figure 1.8).

By region, 2015 buyout activity was proportionately higher in North America than in Europe or the Asia-Pacific region, largely reflecting stronger economic fundamentals in the US. Including growth investments and other minority deals, however, Asia-Pacific deals dwarfed those in 2014, climbing to \$129 billion in reported deal value. (See “Private equity foreshadows China in transition” on page 19.) The past year also saw an uptick in deals worth more than \$5 billion, further suggesting a firming of investor confidence. But bigger deals valued at \$10 billion or more proved elusive. Although still far short of the megadeals common during the 2006–2007 boom years, GPs anted up more than \$58 billion in all for these larger transactions, nearly tripling 2014’s total for deals of that size (see Figure 1.9).

But the superficial stability on the PE investment front has been an artifact of related and powerful counter-currents tugging on GPs since late 2009, when the recovery from the global financial meltdown first got under

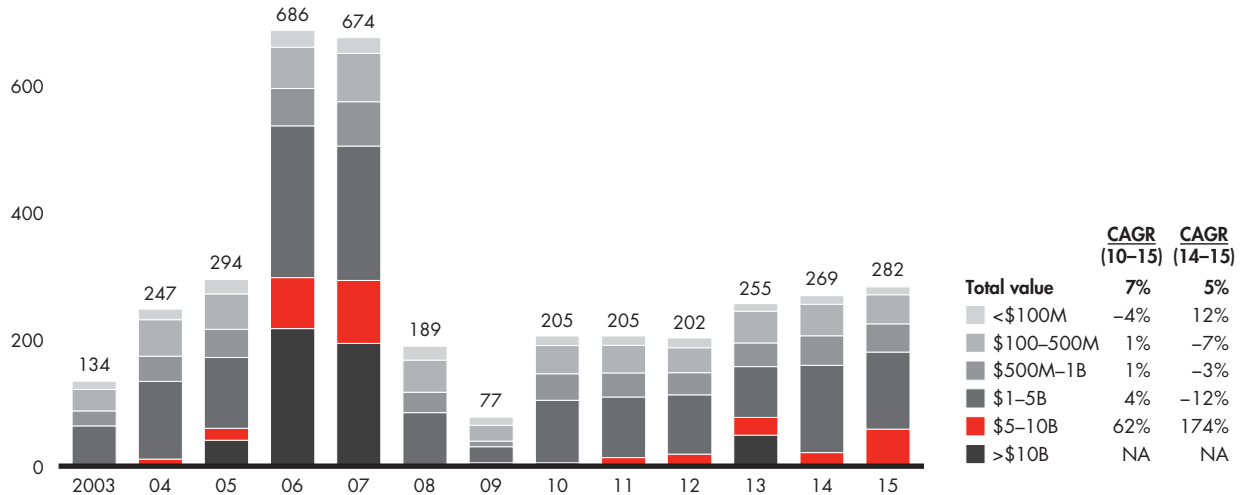
Figure 1.8: Global buyout activity in 2015 was on par with that of the past five years



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

Figure 1.9: Deals valued between \$5 billion and \$10 billion saw an uptick in 2015

Global buyout deal value by size of transaction  
\$800B



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

way. The first and most forceful of these has been the towering mountain of dry powder—the massive amounts of capital now standing at a record \$1.31 trillion, as the pace of investment has lagged fund-raising activity (see Figure 1.10). The pile of dry powder added in 2015 was roughly equal to about one-quarter of all new capital raised during the year, increasing the already sizable backlog of investible money waiting to be put to work. Undeployed capital earmarked to finance real estate, venture capital and growth funds has seen the lion’s share of the growth, but all major PE categories saw a pickup in interest in 2015. At \$460 billion, the total capital targeted for buyouts alone reached its highest level since 2009 and was sufficient to fuel global buyout activity at recent levels for more than two and a half years.

For GPs, the torrent of recycled capital directed their way by LPs eager to replenish or increase their PE allocations has increased pressure to channel idle dry powder into new deals. Not putting that money to work risks alienating LPs and jeopardizing GPs’ chances of raising new funds in the future. But as GPs weigh the investment options they face in today’s deal markets and contemplate how the money they invest now will fare over the life of their fund, they find themselves caught in another bind.

The dry powder available for productive investments has further stoked already intense bidding battles among GPs. Indeed, with more competition on every deal and shorter time limits imposed by the banks that bring deals to market, today’s auctions often leave potential buyers with little alternative but to “bid the book”—that is, to accept on good faith the seller’s assertions about a target company’s market position and growth potential. Small and middle-market PE firms, in particular, often lack the resources and depth to compete for deals, and even many of the best-qualified firms need to exercise the necessary self-restraint to avoid being drawn into bidding wars they may ultimately regret having won.

Beyond head-to-head battles against other GPs, PE firms face a surge in competition from other formidable rivals—deep-pocketed strategic acquirers that are fueling a historic corporate M&A boom. The announced value of global corporate M&A transactions topped \$4 trillion in 2015, a more than 40% increase, surpassing the 2007 peak and dwarfing total PE deal activity (see Figure 1.11).

In the battle for the choicest assets, the advantages that corporations have over PE funds are considerable—the consequence of the lower cost of capital that strategic acquirers enjoy. Powered by the stock market gains of recent years, corporations are able to use the elevated value of their shares as currency to make strategic acquisitions. Corporate acquirers can also use their investment-grade credit ratings to help finance their acquisitions with lower-cost debt. These financial strengths enable them to take time to patiently nurture the assets they buy, allowing them to bid more and accept lower rates of return than PE funds intending to exit investments within five years. Because M&A enables them to buy future growth that has proven elusive through organic means in a sluggish global economy, the public equity markets are rewarding these deals. Unlike past M&A booms, when investors bid up share prices of acquisition targets while selling acquirers’ stock, both acquirers and target companies have seen their share prices spike this time around. In all but four years between 1995 and 2011, M&A deal announcements triggered a fall in stock prices of acquiring companies, according to Dealogic, a firm that tracks transaction data. Stock price increases in other years during this span topped out in 2010 at 1.4%, on average. Since 2012, however, acquirers’ share prices have risen upon deal announcements, with average gains of 3.2%, 2.1% and 2.8% in 2013, 2014 and 2015, respectively.

The crowding of GPs and corporations into the same space has resulted in a big run-up in asset valuations, which were already hovering near record highs (see Figure 1.12). By early 2015, buyout funds were paying more than

Figure 1.10: Uninvested dry powder hit record levels in 2015

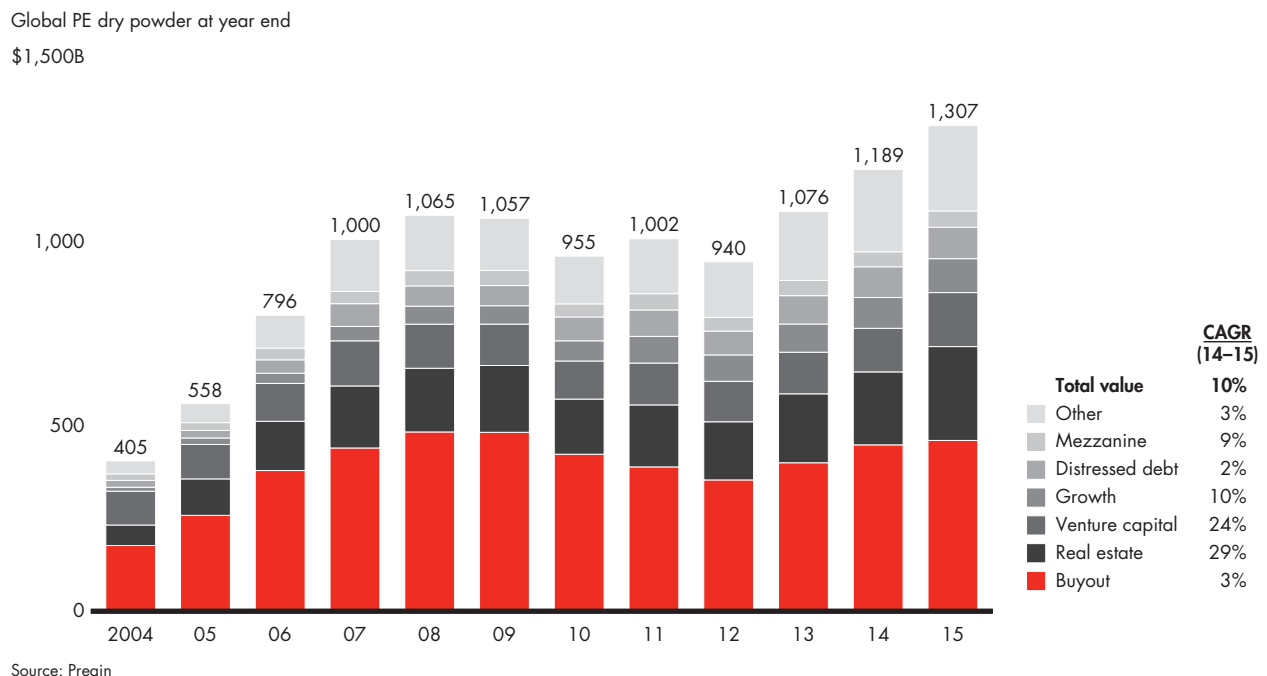
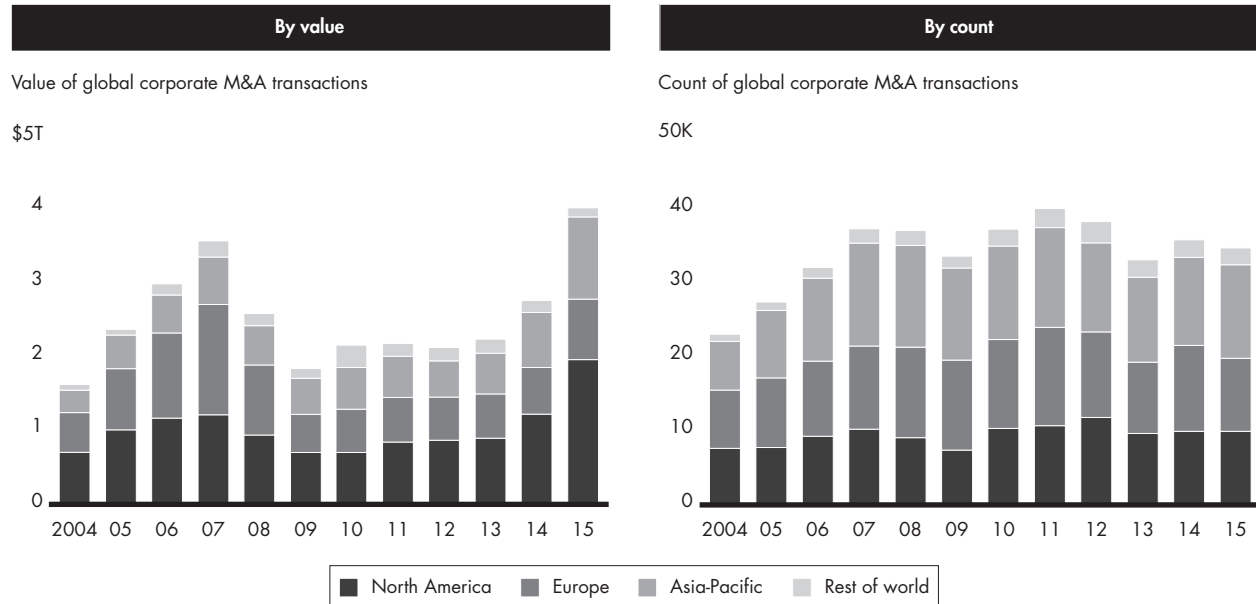


Figure 1.11: Corporations were active acquirers in big North American and Asia-Pacific deals in 2015



Note: Excludes government acquisitions and acquisitions by buyout funds  
Source: Dealogic

10 times earnings before interest, taxes, depreciation and amortization (EBITDA), on average, to land deals in the US—surpassing even the elevated multiples of 2007, the peak year of the go-go era of megadeals. In Europe, buyout multiples dipped a fraction below 10 times EBITDA, which they hit in 2014, but remained near all-time highs even as EU economies teetered on the edge of recession. Indeed, so relentless has the steady climb of multiples become that PE industry insiders have come to refer to today’s multiple of 10 as “the new 7”—the cost of doing deals in a high-priced environment.

But the average multiple may even understate the actual run-up in valuations. In last year’s vibrant deal-making environment, many assets that would not have been viable targets for PE acquisition two or three years earlier came up for sale at lower multiples, diluting price increases for higher-end investment targets. Facing sky-high acquisition prices, increased market volatility and stiffening economic headwinds, GPs know that the prudent course would be to wait for deal multiples to ease. And despite their desire to satisfy LPs’ expectations for them to commit to new investments, GPs also recognize that the surest way to set up LPs for disappointment is to succumb to the pressure to overpay in haste for assets that could then gather dust in their portfolios, waiting for returns they might never see.

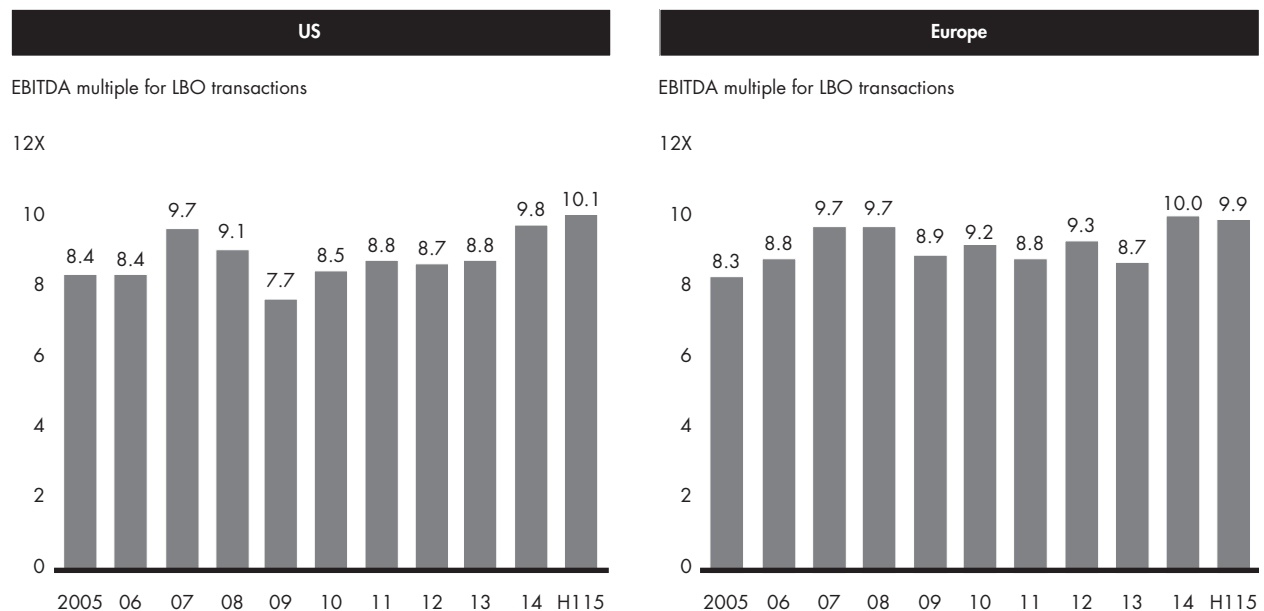
Reluctant to accept either of those unappealing choices, most GPs have tried to weave a cautious path to put capital to work while maintaining strong investment discipline. But their attempts to do so have come up against a third crosscurrent that stirred up the 2015 deal market: deteriorating credit conditions. Although central banks held interest rates close to zero, debt markets have turned choppy over the past year, particularly for the high-yield bonds and leveraged loans that help grease the skids of PE transactions. After falling steeply from their peak at the end of 2008, yields on both have trended higher since the middle of 2014, picking up the pace in mid-2015 and looking likely to continue upward in the year ahead.

Facing these more uncertain conditions, banks—the critical intermediaries that PE firms count on to advance the leverage needed to bankroll a deal—increasingly have become reluctant underwriters. Worried that they could be left holding risky debt that they cannot syndicate to other investors, they are backing out of PE deals or shunning them altogether. Under the tougher regulatory regime created by the Dodd-Frank banking reform law, US banks are determined to avoid carrying unsold high-yield debt on their balance sheets lest they trigger steep capital charges regulators now impose.

The tumult in credit markets roiled PE deal making in 2015 and, to the disadvantage of PE acquirers, significantly altered terms of deals that did reach completion. Met with resistance from investors, for example, a syndicate of big banks led by Bank of America and Morgan Stanley was forced to postpone the marketing of \$5.5 billion in leveraged loans and high-yield bonds it had underwritten to finance The Carlyle Group’s proposed \$8 billion buyout of Veritas Technologies, a data storage business owned by Symantec, last August. Even after sweetening the yield offered to investors who would buy the debt—to between 11.5% and 12.5%, the highest level in more than three years—and finding few takers, the banks stopped marketing the loan in mid-November. At the time, the Veritas deal was the 24th buyout-backed deal facing trouble with financing in 2015, according to Bloomberg, and by far the biggest. The Carlyle acquisition ultimately prevailed in early 2016 after a deal structure more amenable to the banks, coupled with a lower asking price, helped secure financing.

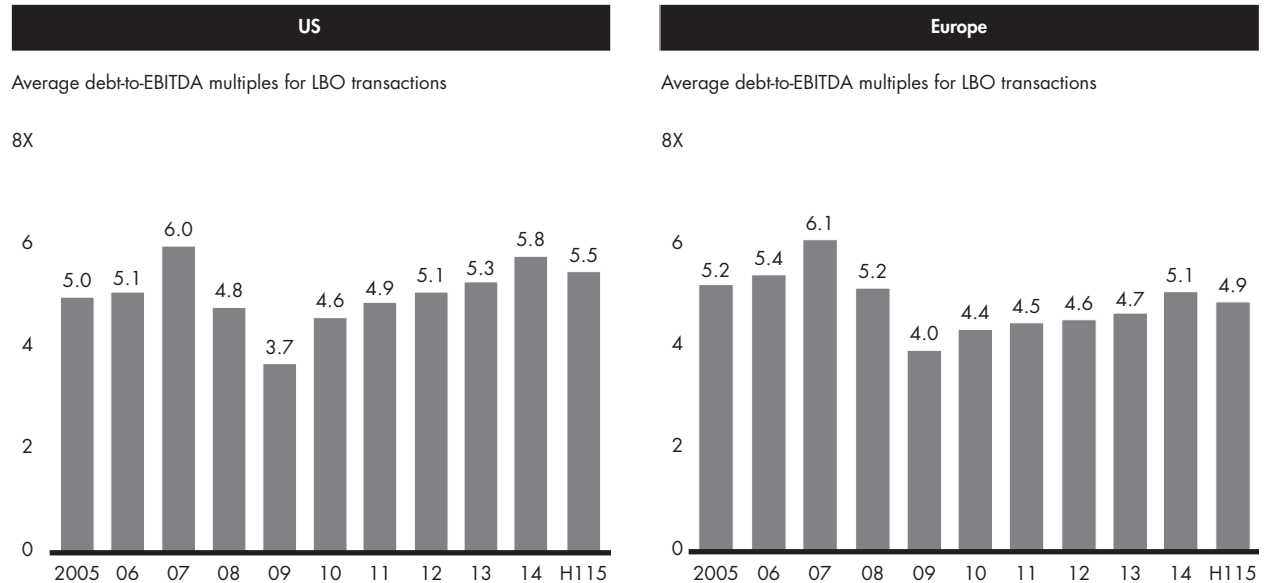
The gradual drying up of cheap credit, combined with higher purchase multiples, is scrambling the calculus of deal making. Even as acquisition multiples on US leveraged buyouts (LBOs) inched up from 9.8 times EBITDA to 10.1 times EBITDA between late 2014 and the first half of 2015, the multiples of debt used to finance new

*Figure 1.12:* In 2015, average LBO purchase price multiples hit record highs in the US



Source: S&P Capital IQ LCD

**Figure 1.13:** The ready supply of cheap debt that enables GPs to increase leverage on new deals may be tapering off



Source: S&P Capital IQ LCD

buyouts dropped from 5.8 times EBITDA to 5.5 times EBITDA (see Figure 1.13). The result has been to force buyout funds to put more equity capital at risk to close deals or to render some potential acquisitions unaffordable at today's high prices. Finding debt to fund bigger buyouts has become particularly problematic. "[Any deal] above \$5 billion is more challenging for most private equity firms to do on their own," Harry Hampson, a managing director at JPMorgan Chase, told *The Wall Street Journal*. At \$133 billion in 2015, the value of debt financing for buyouts fell for the first time in the six-year run of the current PE cycle as the cost of debt on high-yield bonds and leveraged loans increased steeply during the second half of the year (see Figure 1.14).

While the debt market likely will continue to be choppy into 2016, the market will be buoyed somewhat by new sources of debt outside of the traditional bank-led syndication rounds. New loan instruments are gaining in popularity, including such novelties as unitranche financing, which are loans issued by a single underwriter that takes both senior and subordinated debt positions, and stretch senior loans, which combine elements of both asset-based and cash-flow lending. Further supplementing capital that banks are more reluctant to provide are direct-lending funds. In 2015, mezzanine funds raised more than \$19 billion in capital, more than twice the amount raised in 2014 and the highest total since 2008.

### GPs get creative: The deal-making landscape in 2015

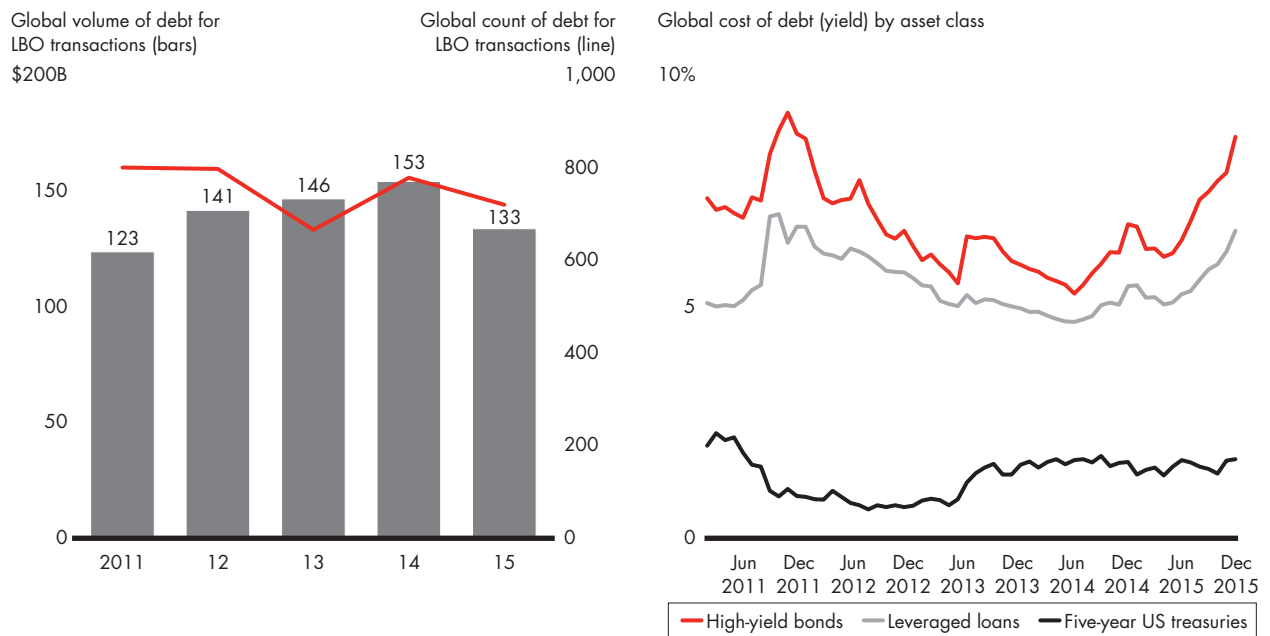
The map of last year's PE investments shows GPs venturing in many directions to get around the obstacles of ferocious competition, high multiples and skittish lenders in order to put dry powder to work. Of the year's ten biggest deals, nine topped \$5 billion in value, including Blackstone's \$7.9 billion acquisition of BioMed Realty

Trust, a California-headquartered developer and manager of real estate for the life science industry in the US and the UK, in a public-to-private conversion late last year. Real estate plays and buyouts in the computer and electronics industries dominated this list, accounting for seven of the top ten deals. Among the big buyouts, eight targeted US companies. Significantly, four of the nine deals exceeding \$5 billion were buyouts in which LPs joined forces with GPs as coinvestors. Such partnerships mobilizing shadow capital from LPs are emerging as alternatives to the all-GP club deals of the past, a new way to bring big buyouts to fruition. More broadly, PE deal making in 2015 was an eclectic mix, reflecting the whims of opportunity and timing. Yet four distinct themes emerged that capture the year’s unique combination of competitive pressures as GPs sought to find ways to deploy dry powder.

**Buy-and-build strategies gain in popularity.** Under pressure to make high-stakes decisions about whether to ante up steep acquisition multiples for assets sold through intensely competitive auctions, more and more GPs are looking into buying businesses they know well—similar to companies already in their portfolios. PE firms have long resorted to buy-and-build strategies, using established portfolio companies as platforms to accelerate growth. Adding bolt-on acquisitions gives PE owners a lot of flexibility to steer their platform portfolio companies in promising new directions, enabling them to grow their core businesses or opening doors to new adjacencies.

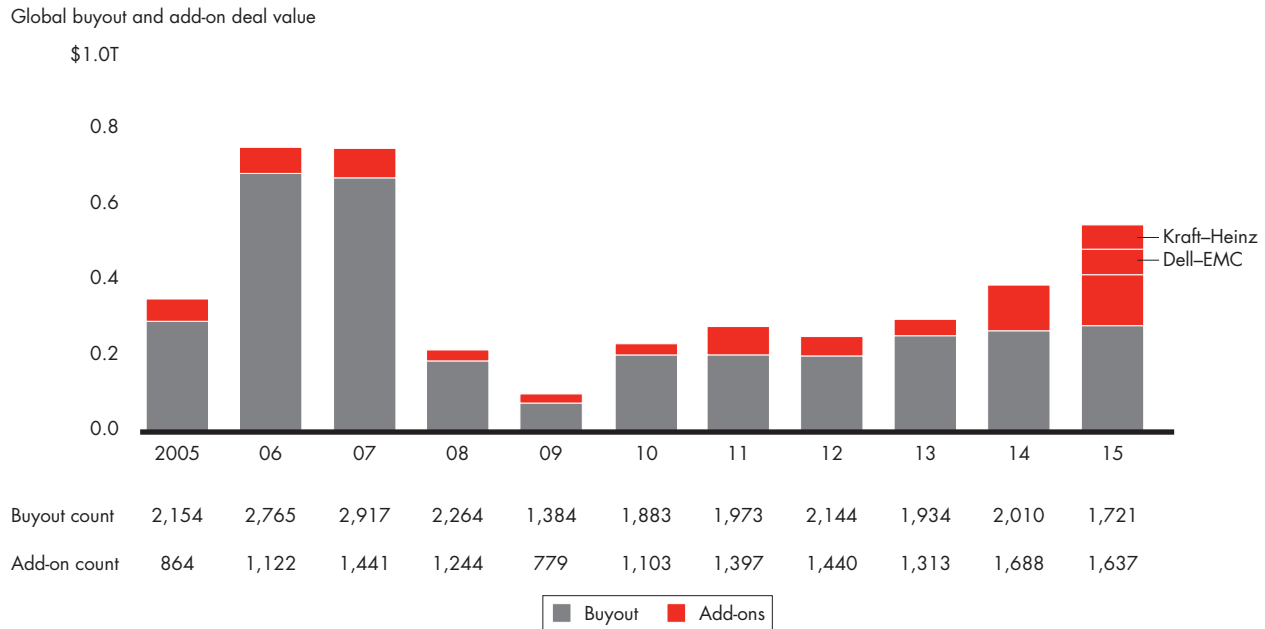
Buy-and-build is especially well suited to today’s PE environment, and the numbers from 2015 reflect this. Globally, the value of add-on acquisitions by PE-backed companies more than doubled to a record \$267 billion in 2015, nearly matching the \$282 billion invested in all buyouts during the year. Sizable acquisitions, such as Kraft’s acquisition of Heinz in the food industry and Dell’s acquisition of EMC in computing, dominated the buyout scene (see Figure 1.15). Business-cycle dynamics are an important factor, raising the popularity of buy-and-

Figure 1.14: Debt financing for LBO transactions has slowed as spreads increased in the second half of 2015



Note: On left-panel chart, x-axis is year of credit issuance  
 Sources: Dealogic; PIMCO; Bloomberg; Merrill Lynch; S&P LSTA; S&P Capital IQ LCD; KPMG

*Figure 1.15:* Add-on deals have increased as funds resort to buy-and-build strategies to boost returns



builds. London-based PE firm Cinven, a seasoned practitioner of buy-and-build, is pursuing this strategy to roll up medical laboratories, a fragmented sector that the firm sees as ripe for consolidation. Over the past year, Cinven acquired French medical diagnostics company Labco for €1.2 billion and just weeks later bolted on German company Synlab, giving the combined business a respectable enterprise value of €2.9 billion.

By adding on enterprises in the same or related business to a portfolio holding, GPs can target companies that often are too small to attract the attention of big corporate acquirers and can be bought at reduced prices. Particularly as economies slow, owners of smaller companies will be increasingly motivated to sell at lower prices. Indeed, by bolting on several low-cost businesses, GPs can lower the multiples of their initial platform companies while enhancing their growth prospects. Buy-and-builds also give PE funds more options when it comes time to exit, enabling GPs to sell their holdings in part or in their entirety as exit channel conditions dictate.

**Public-to-private deals make a comeback.** Competitive intensity and deal prices for private companies heated up in 2015 as the public equity markets cooled, causing PE firms to view publicly held companies as attractive investment targets again. Examining a subset of deals for which transaction details were available, Bain found that public-to-private conversions accounted for nearly 60% of the value of US buyouts (see Figure 1.16). That large sum put into take-private transactions was spread over relatively few deals—just 14 companies, or a little less than 5% of all tracked US buyouts for the period. Public-to-private conversions were not nearly as popular in Europe, where they accounted for just 2% of the total tracked buyout deal value and only 3% of deals by count.

The logic behind GPs' stepped-up interest in taking pricey public companies private can be explained by the tightening convergence of average LBO multiples and the average enterprise value to EBITDA for US publicly

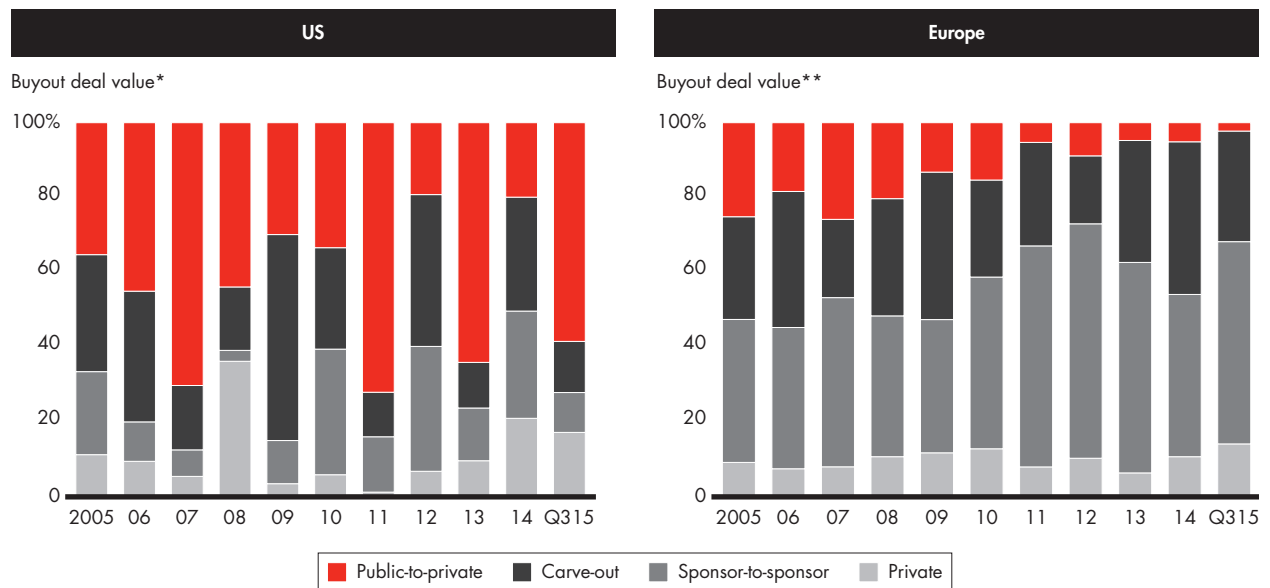
traded companies (see Figure 1.17). As the mean LBO multiple edged up to 10.1 times EBITDA in late 2015 from 9.8 times EBITDA a year earlier, the average multiple for public companies fell from 12.6 in 2014 to 12.2 last year. The pickup in public-to-private conversions has been sensitive to this narrowing spread between multiples in past years, including in 2007 and in 2011.

PE acquirers paid up to own the former public assets. Of the top ten buyout deals worth more than \$5 billion in all categories, five were public-to-private conversions in 2015. Multiples on three of these deals exceeded 12 times EBITDA, topped by the \$5.3 billion acquisition of Informatica at 29 times EBITDA, led by London-based PE firm Permira.

**Finding bargains in the middle market.** As every successful angler knows, the surest way to bag a good catch is to fish where others are not. GPs are taking that wisdom to heart by targeting acquisitions in the less crowded waters of small and midsize companies. Even larger PE firms are stalking opportunities among smaller enterprises valued at \$250 million or less.

At the lower end of the middle market, GPs like the relative bargains that are available, because their small size puts them off the radar of corporate acquirers. Buying these lower-cost assets also affords GPs opportunities to pursue buy-and-build strategies, enabling them to assemble several low-multiple companies into a larger entity that can command a far higher multiple upon exiting. For companies valued at less than \$250 million, the median multiple, measured as the ratio of enterprise value to EBITDA on LBOs, was about half that of companies valued at more than \$250 million. As these lower multiples are likely to persist, look for PE funds to continue fishing in middle-market waters in 2016 (see Figure 1.18).

Figure 1.16: In the US, large public-to-private conversions account for the bulk of total buyout deal value

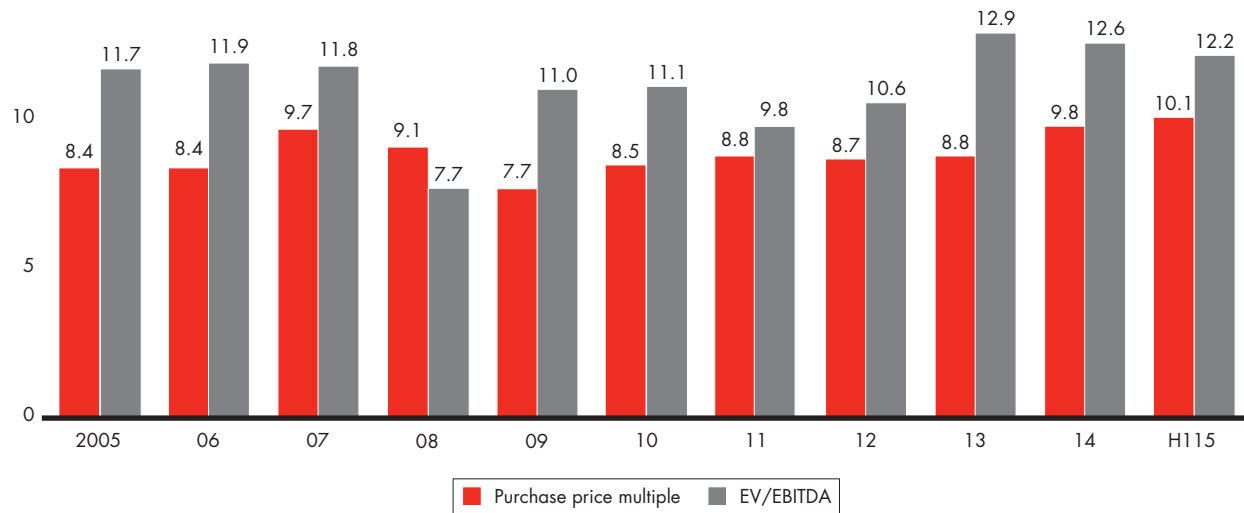


\*Represents control buyout transactions between US-based firms and US-based target companies; closed deals only; represents year deals were closed; excludes add-on deals  
 \*\*Represents buyout transactions worth \$75 million or more in which target companies are based in Europe; represents year deals were announced; excludes add-on deals  
 Sources: Bain US LBO deal database; Bain European LBO deal database

*Figure 1.17:* Public-to-private deals have become more common as valuations of public and private companies converge

Average LBO purchase price and average EV/EBITDA ratio for US publicly traded issuers with EBITDA of \$50M–\$2B

15X



Notes: EV is enterprise value; 2015 EV/EBITDA multiple is last 12 months' EBITDA with EV as of midyear 2015  
Sources: S&P Capital IQ LCD; S&P Capital IQ

**Teaming up with strategic buyers to mitigate risk.** Recognizing the futility of winning bidding wars against deep-pocketed strategic acquirers caught up in the frenzy of the corporate M&A boom, many GPs have adopted the mantra “If you can’t beat ’em, join ’em.” They are finding ways to partner with big companies in buyouts that suit the needs of both. For PE funds, having a strategic coinvestor provides a built-in exit strategy, enabling them to sell their stakes to the corporate partner when the timing is right.

Corporations also find much to like about joining forces with buyout funds. Some are tapping their PE partners for capital to share the risk of acquiring new assets they are not yet ready to integrate into their balance sheets and for expertise to help boost performance. In one of the year’s biggest buyouts, Permira and strategic partners Microsoft and Salesforce.com bought Informatica, a once-troubled data integration software provider, for \$5.3 billion. The deal will enable Informatica to reorganize as a privately held company outside the scrutiny of public markets. For the new owners, this partnership will bring potential financial returns as well as competitive advantages.

Other corporations also are teaming up with PE firms to off-load business units, making their PE partners owners of the new subsidiary and retaining a significant minority position in the spun-off enterprise. That is what Walgreens Boots Alliance, the global pharmacy and retail drug chain, did by selling a majority stake in its infusion services business to Madison Dearborn, the US-based PE firm.

Creative approaches like these will become more common and evolve in the quick-paced, high-stakes deal-making environment that lies ahead. To succeed, PE firms will need to be nimble in their ability to size up opportunities and be prepared to seize upon novel ways to put capital to work.

## Private equity foreshadows China in transition

The GDP slowdown in China and the turbulence that has jolted its stock exchanges since mid-2015 have dominated worries about the country's outlook. The world's second-largest economy entered 2016 struggling to make a momentous transition from hothouse, export-led growth to somewhat more sedate and sustainable consumer-led growth. Everyone with a stake in China's future is poring over the numbers to divine what will happen as the economy lurches into this new phase.

The PE industry is no stranger to the need to adapt to large ambiguous forces that could bring existential threats or point the way to new prosperity for the markets where it operates. PE is certainly facing those circumstances in China today, and based on the latest evidence, the industry is showing signs that bode well for its future, as well as for China's.

Despite the gathering economic clouds, 2015 was a surprisingly strong year for PE in China. Coming off record activity in 2014, reported PE deal value and deal count were remarkably robust last year—up by more than 50% and 25%, respectively. Exit activity, too, held up well, about in line with the average over the previous five years. Despite volatility in public equity markets, the IPO channel was a productive source of exits.

Beneath the bright surface of China's PE numbers last year, the market is going through a major transformation. Surfing on a digital wave, Internet deals accounted for some 40% of total deal value—more than a sixfold increase from the average over the previous five years. By contrast, deal values in most traditional industries were down, leaving many long-established PE firms floundering. Some firms joined forces, forming consortia of buyers for bigger deals—typically worth more than \$500 million—as they sought attractive investment opportunities. Three public-to-private conversions of US-listed Chinese companies topped the year's roster of the largest deals.

Between today's old-economy slowdown and China's brighter new economic future, of course, lies a difficult market transformation, as yet of unknown magnitude and duration. The uncertainty on the path to a new normal will present PE investors in Greater China with challenges that will test them. PE returns will come under pressure as corporate profits shrink and as further depreciation of the renminbi hangs over balance sheets. After two great years of buoyant asset sales, an exit backlog could build up again if the IPO market remains volatile or weakens and as potential corporate acquirers turn inward to focus on their core businesses.

Last year was a breakout year for deals that gave their PE acquirers effective control over the assets they bought—a promising sign of PE's new strength in a deal market that had long limited owners to minority stakes in growth companies. The value of buyouts was five times higher than their annual averages from 2010 to 2014, and for the first time, it was on a par with the value of growth deals. Also, more deals in which PE acquirers bought minority stakes paved a path to control by allowing the new owners to share an active role in the target company's most consequential decisions.

By adapting nimbly to the new conditions they face, leading China-focused PE firms will capitalize on their increased control by doing what they do best. They will focus on promising sectors offering

### Private equity foreshadows China in transition (continued)

future-oriented investments, finding opportunities in China's next-generation "Made in China 2025" manufacturing sector, profiting from Chinese consumers' increasing wealth and leading the convergence of online and offline sales channels—all while steering clear of bubble risks. They will shift their investment theses from the pursuit of growth to a focus on business renewal and performance improvement. They will hone a differentiated strategy, moving away from a broad sector focus and emphasizing, instead, strong due diligence and portfolio management skills. And they will invest in building their firms' organizations and capabilities to support their adjustment to China's unprecedented economic transformation.

### Exits: A great year to be a seller

The stars remained aligned in 2015, making it another strong year on the PE exit front. Investors' risk appetite was keen. Corporate profit margins to support M&A activity were robust. Asset valuations were near all-time highs. GPs wanting to liquidate portfolio holdings found buyers eager to oblige.

The aggregate value of buyout-backed exits came in slightly below the record \$456 billion posted in 2014. But with \$422 billion in realizations and 1,166 deals reported at year-end, asset sales were just shy of their all-time peak (see *Figure 1.19*). Exit activity was vibrant in all regions around the world, led by a healthy North American market, where buyout-backed exits hit \$223 billion. In Asia-Pacific, a region that continues to rely more and more on growth investments and private investments in public equities, sellers took in nearly \$51 billion on buyout-backed deals—a record. Overall, exits in the Asia-Pacific region came in at \$85 billion, in line with the region's performance over the past five years. Even in Europe, beset by sovereign debt and currency woes, GPs pulled in \$143 billion in asset sales—an amount surpassed only twice over the past 20 years, in 2014 and in 2007, the peak of the last PE cycle.

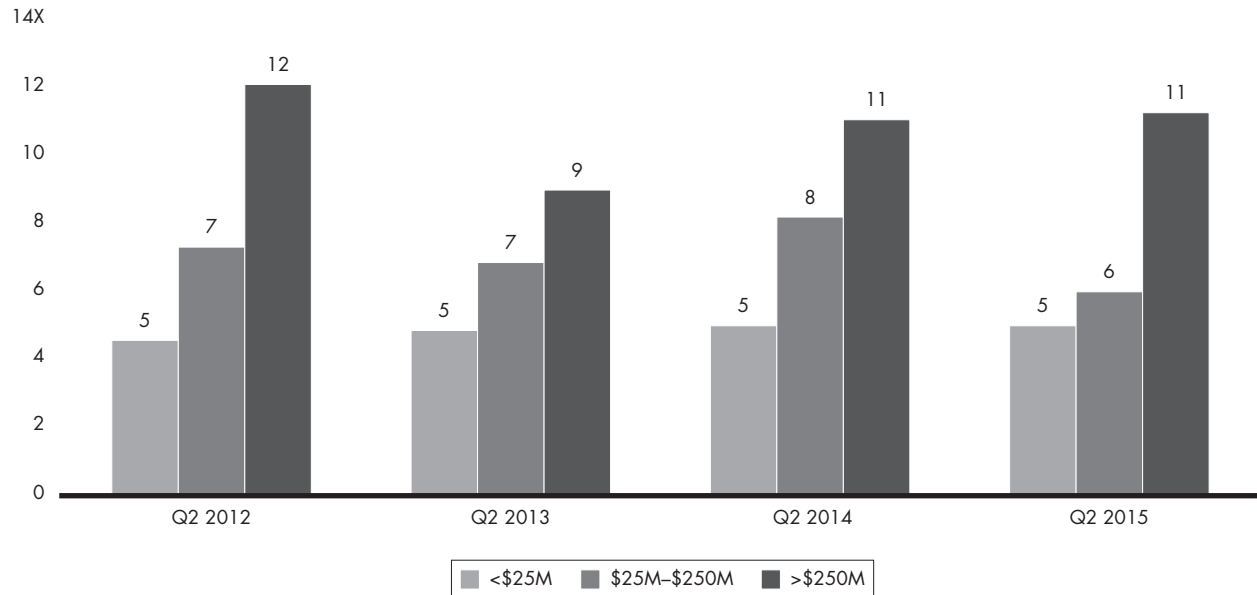
Underlying 2015's impressive exit totals were several notable signs of health. Many GPs took advantage of favorable exit conditions to complete the years-long process of selling off their large inventories of unrealized assets acquired before the global financial crisis. Purchased at peak prices before 2008 and sharply devalued following the market meltdown, these holdings sat in their fund portfolios as GPs patiently rehabilitated them and waited out the recovery.

Robust exit channels over the past three years provided the opening GPs were looking for to sell. Of the exits completed in 2013, 87% were assets purchased in 2010 or earlier. In 2014, 76% of exits were assets belonging to those older vintages. Last year, the backlog of older holdings made up just 57% of exits. In fact, sales of holdings acquired since 2011 nearly equaled those purchased during the peak years of the previous PE cycle for the first time (see *Figure 1.20*).

As GPs cleared out their inventory of older assets, they reduced the median holding period for the properties they own—from a peak of 5.8 years in 2014 to 4.9 years in 2015—for the first time since 2007. An uptick in the number of

Figure 1.18: Smaller middle-market deals are available at more reasonable purchase prices

Median EV/EBITDA LBO multiples (by enterprise value, global data)



Source: Pitchbook

Figure 1.19: Exit activity was strong globally in 2015



Notes: Bankruptcies excluded; IPO value represents offer amount and not market value of company  
Source: Dealogic

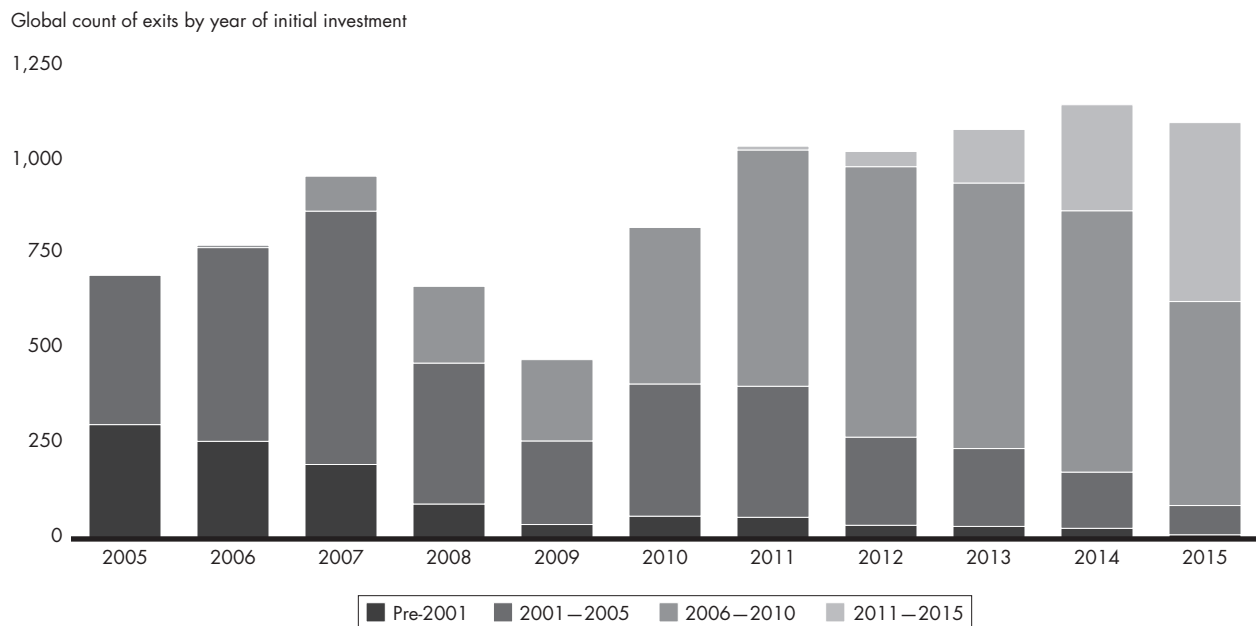
investments owned for less than three years helped to bring the amount of time that GPs held on to assets closer to the five-year goal for buyouts. Quick flips of assets held for three years or less edged up to 20% of all exits last year.

These gains were not simply the passive result of PE funds aging out of the problem of long-held unrealized assets by waiting for exit channels to open up. GPs actively cultivated this success by taking steps that maximized both their exit options and realized returns. They tested several exit strategies in search of the one that would yield a timely sale at the best price. Many conducted quarterly or even monthly reviews of exit scenarios for portfolio companies primed for sale. In some cases, GPs hired experts to conduct due diligence on portfolio companies slated for sale to uncover and resolve any issues that could complicate a planned exit. And some GPs even went an extra step to identify and pursue initiatives that have the potential to burnish a portfolio company's performance and further set the stage for a successful exit.

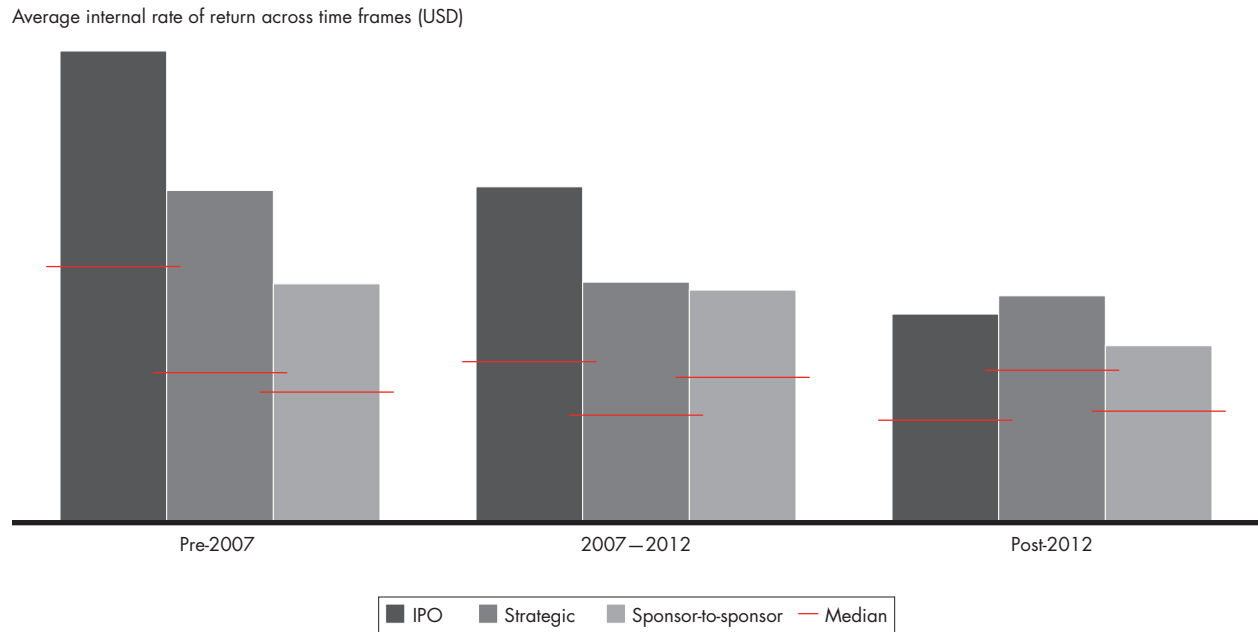
### Exit channels: Finding a path to the winning door

The hard lessons learned since the recent downturn and the increasing sophistication of exit management skills that PE funds are applying to their soon-to-be-sold portfolio companies have changed how GPs think about exit channels. They are approaching exit channels with an open mind to weigh all of the factors influencing their channel choice and with nimble reflexes to adapt to quickly shifting constraints and opportunities. Often they will pursue several channels in parallel, continuing to ready initial public offerings (IPOs) even as they negotiate terms for a direct sale to a corporate buyer or for a secondary sale to another PE fund. Over the past two decades, across channels, average internal rates of return (IRR) have begun to converge as GPs have learned to bob and weave across exit channels in order to optimize asset sales (see Figure 1.21).

Figure 1.20: Wide-open exit channels have helped clear the backlog of precrisis investments



Note: Exits exclude partial exits  
Source: Preqin

*Figure 1.21:* Returns have fallen since the boom-year exits and have begun to converge across exit channels

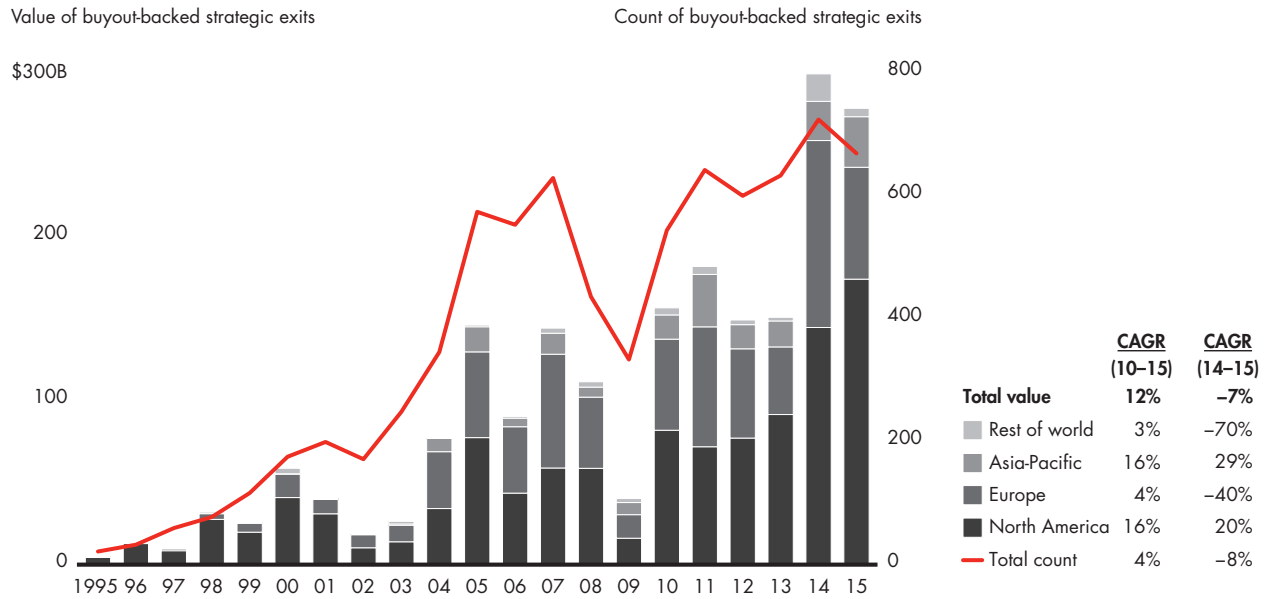
Source: CEPRES

Let's examine how exit-channel dynamics played out across the globe last year.

**Sales to strategic acquirers.** Cash-rich corporations accounted for the lion's share of buyout-backed exits in 2015 as they have done consistently since 2008 (*see Figure 1.22*). These corporations were ferocious competitors to GPs on the investment side but some of GPs' best friends on the sales side. Exits to strategic acquirers dominated activity in North America, where the value of these deals rose by more than \$29 billion from the previous year, to \$173.5 billion, during a year when total exits in North America increased by only \$2 billion. With plenty of deal-ready cash sitting on the balance sheets of nonfinancial corporations in the US and with strategic acquirers shopping aggressively to fuel their growth, these buyers were best positioned to pay the high multiples sellers demanded. In Europe, economic uncertainty and weak profits suppressed strategic sales, which fell 40% from 2014's total, to \$68 billion, last year. But 2015 still ended up as one of the strongest years for strategic sales in this market. Across the Asia-Pacific region, although the number of buyout-backed strategic exits dipped for the second year in a row, to 96, deal value jumped by \$7 billion, to \$30.8 billion, last year.

PE-backed asset sales to strategic acquirers in North America not only led global exit activity in total value and deal count; they accounted for seven of the year's ten biggest exits in this channel. Topping the list was Blackstone and Permira's \$16.8 billion sale of Freescale Semiconductor, a Texas-based computer chip design and manufacturing firm (originally spun off from Motorola in 2004), to Dutch chip maker NXP Semiconductors in a deal completed last December. Rounding out the top ten strategic sales were a \$4.8 billion Japanese sale and two UK deals valued at \$3.8 billion and \$3.7 billion, respectively.

Figure 1.22: Sales to strategic acquirers remained strong in 2015



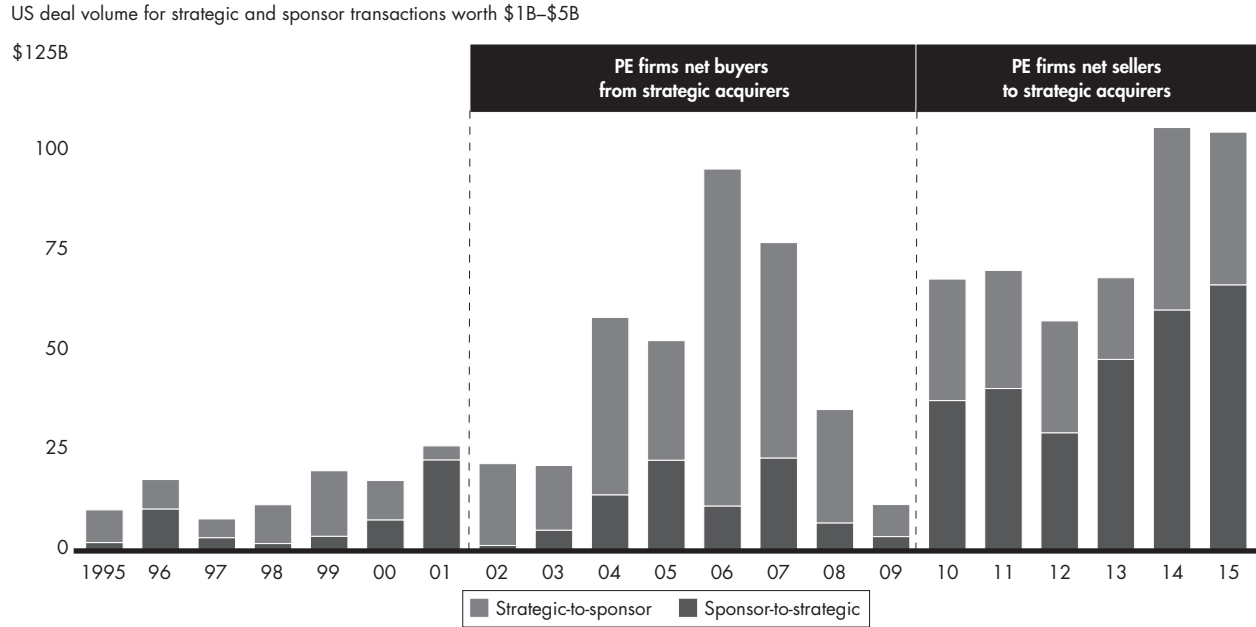
Note: Excludes bankruptcies  
Source: Dealogic

The dominance of corporations as buyers of PE-backed assets in the US is a trend of rather recent vintage. Particularly for deals valued between \$1 billion and \$5 billion, prior to 2010, corporations were more commonly sellers of assets to PE funds through spin-offs and carve-outs than acquirers. That has flipped over the current PE cycle as purchases by corporations from PE funds outpaced corporate asset sales to PE buyers by a substantial margin (see Figure 1.23). At more than \$66 billion, the value of US strategic acquisitions of that size category topped sales to PE funds by nearly two-to-one.

**Sponsor-to-sponsor exits.** At \$84.5 billion, global exit activity through the sponsor-to-sponsor channel in 2015 was higher than in 2014 and easily surpassed totals going back to the beginning of the recovery in 2010 (see Figure 1.24). By region, the picture is more mixed: Sponsor-to-sponsor sales were up strongly in Europe, off sharply in North America and solid in the Asia-Pacific region. Despite the wide variation, however, the same set of fundamentals influenced exit activity in this channel.

The strength of sponsor-to-sponsor deals in Europe, for example, reflected the greater caution of corporate acquirers faced with a weakening economy, a softer euro and an uncertain profit outlook. In this environment, GPs seeking to liquidate holdings found receptive buyers among other GPs wanting to deploy their large stockpiles of dry powder. For the year, Europe's 152 sponsor-to-sponsor exits brought in a record \$44.7 billion, easily surpassing 2014's \$28 billion. Two sponsor-to-sponsor transactions in Germany and one in the UK ranked among the year's biggest exits through this channel.

**Figure 1.23:** In the US middle market, corporations have been more active buyers from PE funds than sellers to PE funds since 2010

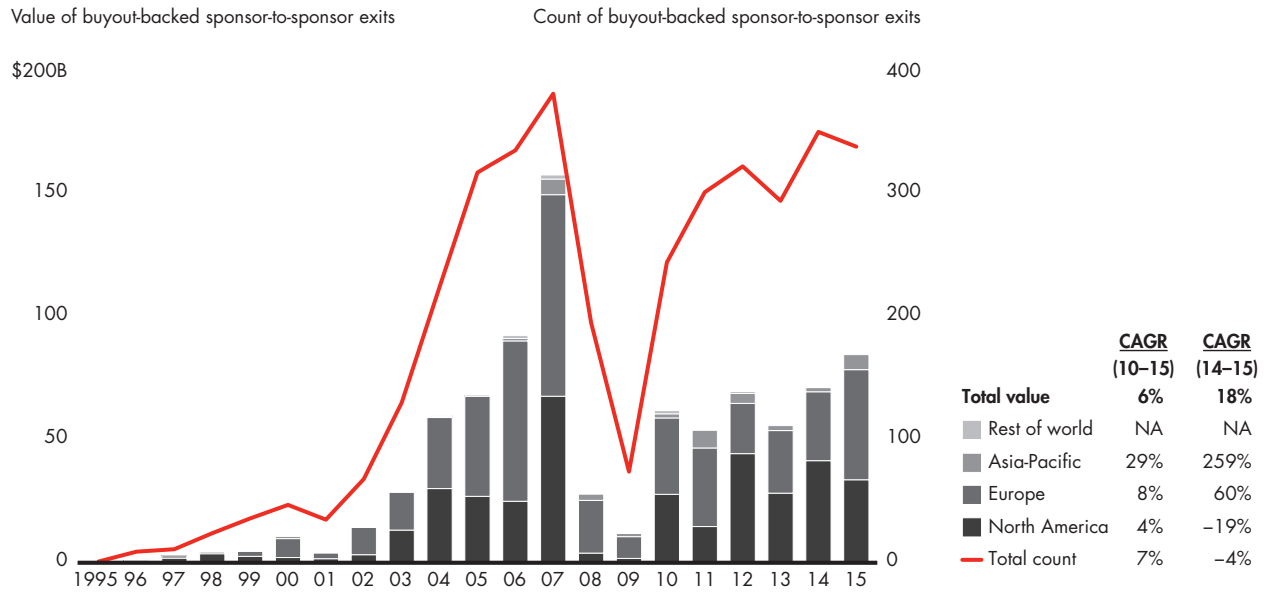


In North America, where the underlying dynamics were much the same as in Europe, sponsor-to-sponsor exits decreased by more than 19% from 2014, to just \$33.7 billion. Valuations explain this difference. In a face-off to win deals against hungry corporate acquirers that are able to pay higher multiples, wait longer to see payoffs from assets they buy and settle for lower rates of return, value-conscious GPs were in a weaker position to buy and sell one another’s assets. When sponsor-to-sponsor exits did take place, the mechanics and rationale followed the European pattern. In the year’s second-biggest sponsor-to-sponsor deal, for example, CVC Capital and the Canada Pension Plan Investment Board agreed to pay \$4.6 billion to acquire US pet supply retailer Petco, owned by a consortium of investors led by Leonard Green & Partners and TPG.

**The IPO portal.** PE-backed IPOs last year dipped well below their remarkable 2014 peak, yet global IPO activity ended 2015 by posting its second-strongest year ever. The \$60 billion that GPs took in through the IPO channel worldwide fell 30% short of 2014’s \$86 billion, and the total of 161 companies that GPs brought to market was well shy of 2013 and 2014 totals. But measured by valuation and count, the global IPO channel remained a productive source of exits in 2015 (see Figure 1.25).

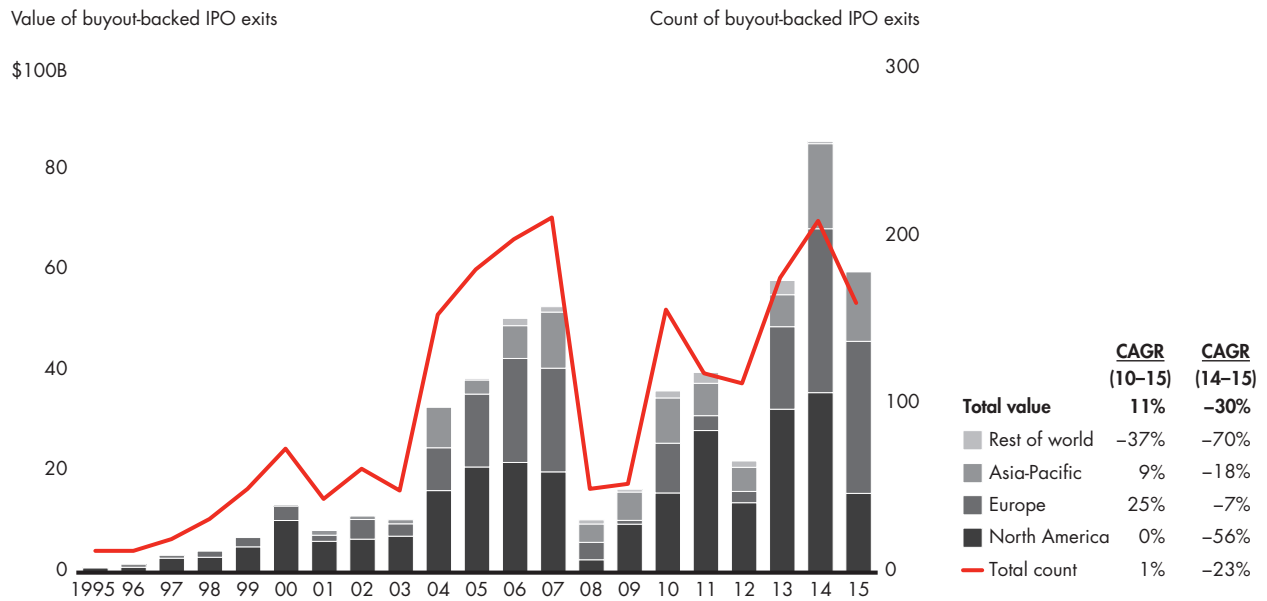
Regarding the route that offered the best exit prospects, the aggregate numbers mask how sensitive GPs were to market conditions in different parts of the world. The IPO channel held up well in Europe and in the Asia-Pacific region, where sales to corporations were less robust, and dropped sharply in North America, where strategic exits were strong. Although global public equity markets turned more volatile in 2015, GPs in Europe navigated through the chop-

Figure 1.24: Sponsor-to-sponsor sales spiked in Europe



Note: Excludes bankruptcies  
Source: Dealogic

Figure 1.25: IPOs remain strong



Note: Excludes bankruptcies  
Source: Dealogic

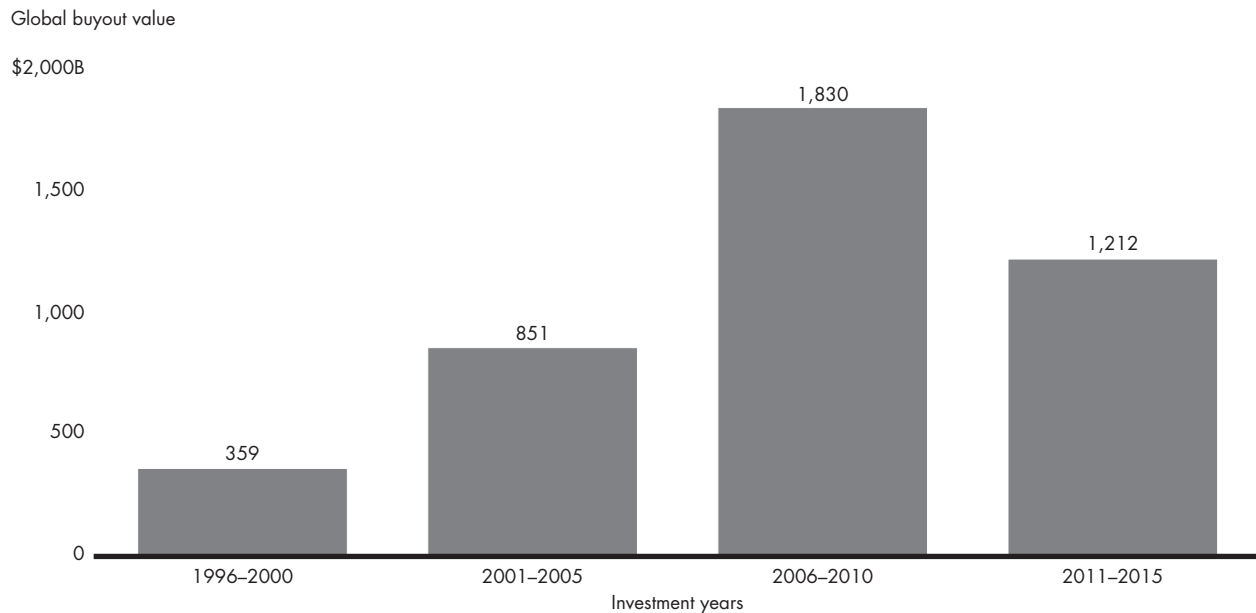
pinness to take 65 portfolio companies public in deals worth more than \$30 billion—just shy of IPO totals in any year prior to 2014. In the year’s biggest European PE-backed IPO, Advent International and Bain Capital offered shares for one-half of their stake in Worldpay, the UK-based payments processing firm, valuing the company at \$7.4 billion.

In the Asia-Pacific region, GPs looking to exit through IPOs weathered the summer market swoon and a five-month suspension in China of new share issuances to end the year strong. Total buyout-backed IPOs brought in nearly \$14 billion in 2015, including a pair of fourth-quarter Chinese exits that ranked among the world’s 10 biggest exits. In October, Warburg Pincus’ issuance of \$2.3 billion in shares of China Huarong Asset Management valued Huarong, which manages underwater bank debt, at \$15.3 billion. Then last November, CDH Investments, a Chinese PE firm, sold a \$1.1 billion stake in the Dali Foods Group through a share offering that valued the snack food and beverage company at \$9.3 billion.

**Looking ahead: An exit slowdown**

Past investments are the fuel that stokes the fire of future exits. Recent investment activity—which is far less than that from 2005 to 2010—portends a coming falloff in exits over the next five years (see *Figure 1.26*). As the slower pace of investments feeds through to fewer exits and smaller cash distributions flowing back to LPs, the PE industry should settle into a more sedate new normal next year and beyond.

*Figure 1.26:* Slower investment activity over the past five years will feed through to fewer exits in the years ahead



Notes: Bankruptcies excluded; IPO value represents offer amount and not market value of company  
Source: Dealogic

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## Returns: Confidence regained

The period immediately following the 2008 global financial meltdown was a time of anxiety about PE's ability to deliver market-beating returns. GPs had paid peak prices prior to the crash to acquire the assets held in their portfolios and rushed to mark them down sharply to their much lower prevailing market value. They put exit plans for their mature assets on ice and stretched out holding periods as they waited for the crisis to pass. Even top-performing GPs were not spared as first-quartile fund returns converged dangerously close to those of the public markets. Stunned by the deep and prolonged downturn and fixated on subpar short-term performance, worried LPs wondered when, if ever, they would see gains from their expensive PE investments.

Even as the recovery slowly gained traction after 2010, doubts about PE returns persisted—for perfectly understandable reasons. Deferred asset sales had created a huge exit overhang that would take years to clear, adding to the pressures that would dampen returns. Market beta, the benign passive forces of economic growth, rising equity values and readily available low-cost debt had melted away, but many GPs had yet to demonstrate that they possessed the strategic and operational skills needed to generate alpha in its place. The lingering uncertainty hammered home the recognition that PE is an illiquid, long-term investment and that the PE industry had matured. The outsize returns GPs could earn on once-abundant undervalued assets had dried up. Leveraging their buyouts to boost equity returns was no longer working its magic. The industry was feeling the tugs of economic gravity that appeared to be pulling it down to earth.

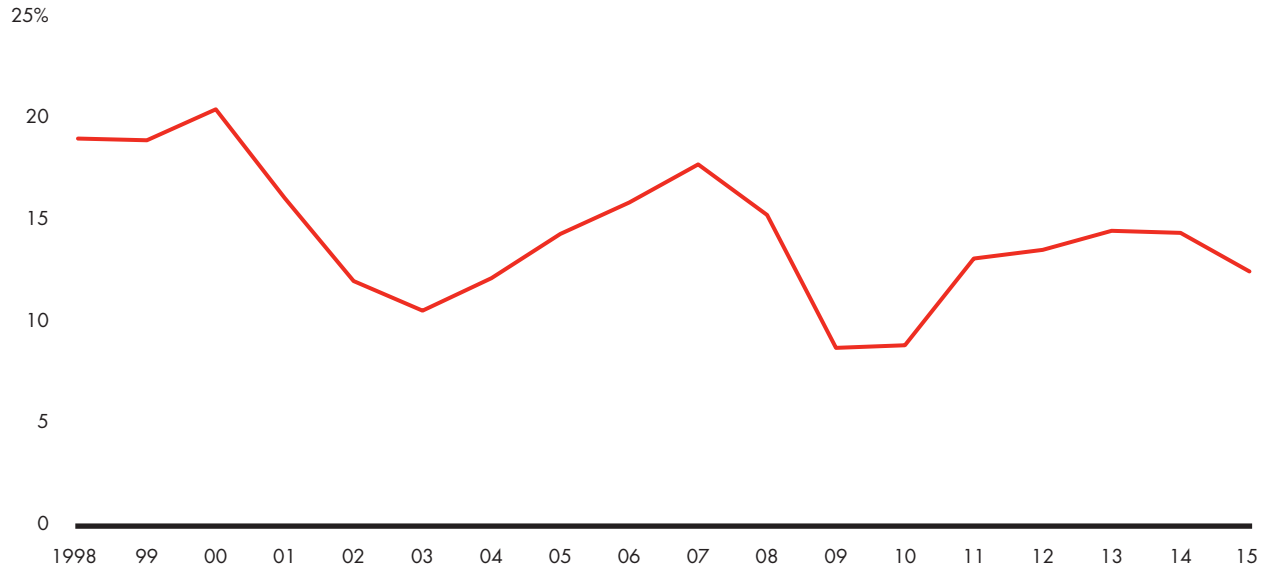
Now, however, following a succession of four strong years, PE returns have recovered their footing, and GPs and LPs have regained both confidence and a fresh perspective. Both short- and long-term results reflect PE's restored luster and GPs' justifiable claims to have been prudent stewards of their investors' capital. In all major markets during 2015, public equity markets were volatile and returns were flat or down, but PE returns cruised through the turbulence. Using the modified public market equivalent (mPME), a metric developed by investment advisory firm Cambridge Associates, it is possible to make an apples-to-apples comparison of PE returns with public equity returns by replicating the timing and size of PE investment flows—both purchases and sales—as if they had been invested in a basket of public equities. PE buyout funds outperformed the mPME tracking the S&P 500, the MSCI Europe and the MSCI All Country Asia indexes on a one-year basis last year: In the US and Europe, they were higher by 5 percentage points and in the Asia-Pacific region, by 6 percentage points.

Short-term performance has received disproportionate attention since the downturn because PE's year-to-year gains or losses provide the first signals of economic recovery or setback. However, it has been PE's proven capacity to outperform over the long term that has made it the preferred destination for investment capital from LPs. The drop in public equity markets did put a dent in the longer-term performance of global buyout funds in 2015. Ten-year pooled IRR dipped slightly from 2013 and 2014 levels, and they trailed the S&P 500 mPME over three- and five-year time horizons. But returns remained attractive over a 10-year time horizon (*see Figure 1.27*), and their performance edge over the mPME index returns widens further over 15-, 20- and 25-year periods.

According to the most recent data, PE's 10-year returns to large public pension funds outpaced the S&P 500 by 3.7% net of fees. And as the legacy effects of the financial crisis retreat further into the past, PE should consistently perform at a level close to or above public equities over one-, three- and five-year time horizons as well—as buyout funds are currently doing in all major regions of the world (*see Figure 1.28*).

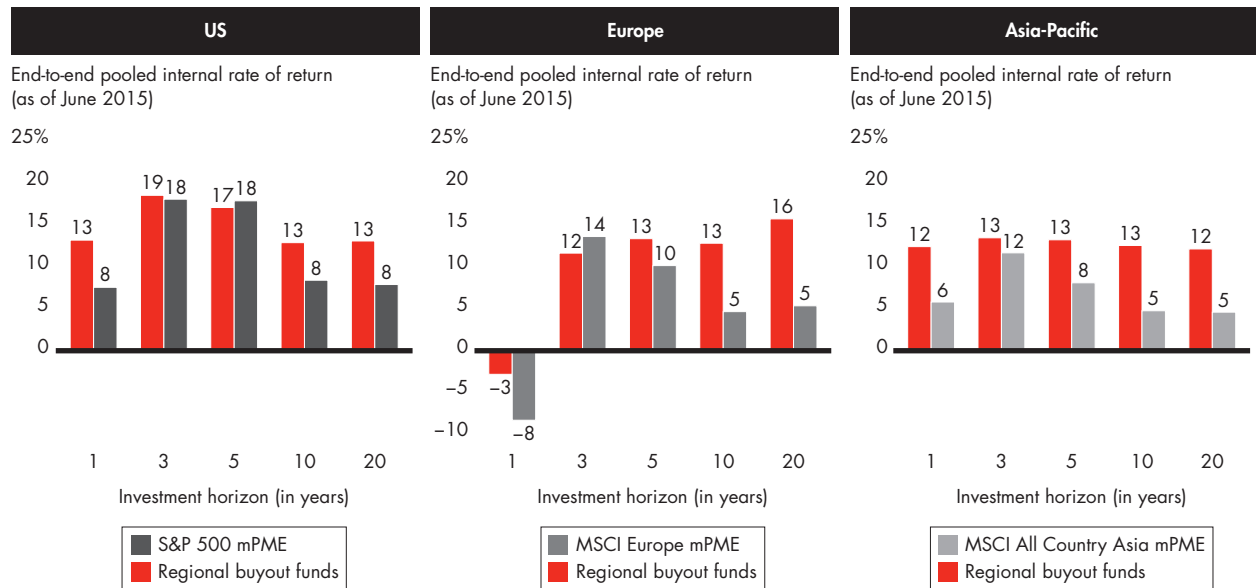
**Figure 1.27:** Long-term buyout fund returns dropped slightly from 2014, but remained attractive over a 10-year time horizon

10-year end-to-end pooled net internal rate of return for global buyout funds (end of June)



Source: Cambridge Associates

**Figure 1.28:** Buyout funds outperformed public markets in all major regions over longer time horizons



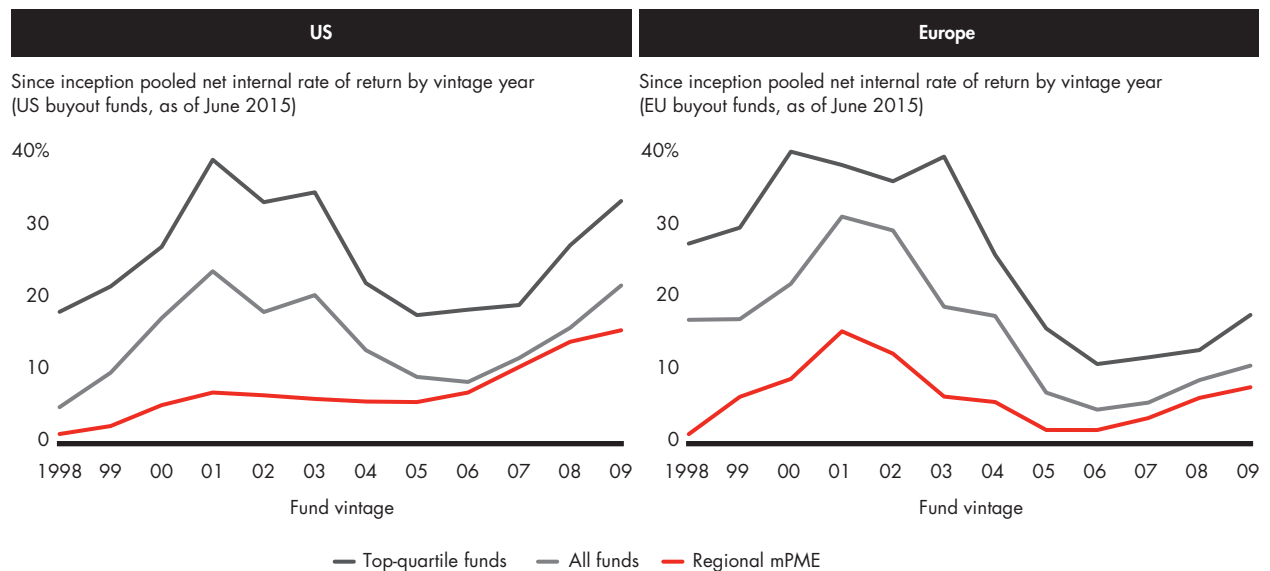
Notes: Europe includes developed economies only; the Cambridge Associates mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in PE been invested in public markets instead; the public index's shares are purchased and sold according to the PE fund cash-flow schedule  
Source: Cambridge Associates

While market recovery has led to a general uptick in returns of funds since the 2005 and 2006 vintages that bore the brunt of the economic downturn, returns data for the 2008 and 2009 vintages now coming to fruition suggests that PE performance is again beginning to pull away from the performance of public markets. Top-quartile funds have widened their lead in returns by an even greater margin (see Figure 1.29).

Comparing successive buyout vintages between 2006 and 2008 reinforces the conclusion that fund returns are trending higher over time. The median IRR, both realized and unrealized, of all three fund vintages took a big hit when the markets tanked from late 2007 through the end of 2008, as GPs wrote down the net asset values of holdings in their portfolios. And all have recovered with the strengthening of public equities markets by the end of 2010. Yet the strength of their rebound followed different trajectories. The median IRR of the 2006 vintage buyout funds was up to 9% by the middle of 2015, while the 2007 funds rose to 10%. Meanwhile, the median IRR of the 2008 funds climbed to 12%. Median top-quartile fund returns followed much the same track—up to 17% for the 2006 vintage, 20% for the 2007 vintage and 24% for the 2008 vintage.

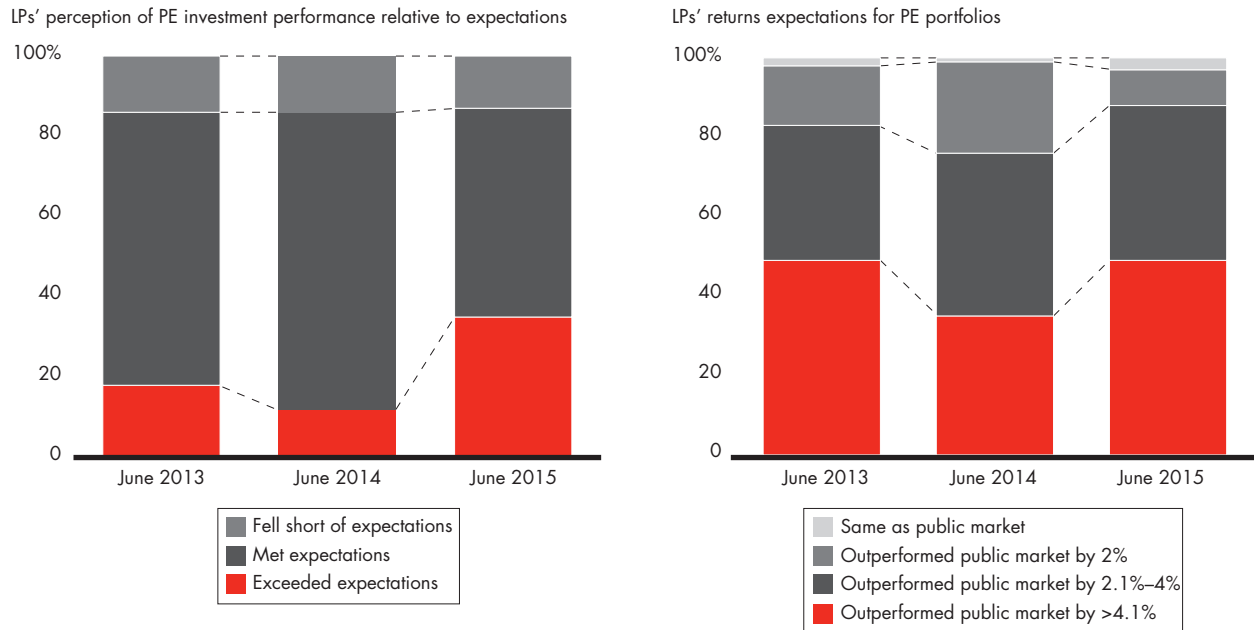
The rebound in returns has been met with LPs' renewed enthusiasm and belief in PE. In a recent poll by Preqin, LPs overwhelmingly said that PE had met or exceeded their expectations and that positive sentiment for this asset class has been strengthening in recent years (see Figure 1.30). In mid-2014, for example, just 12% of surveyed LPs reported that PE had exceeded their expectations—about the same percentage as those who said PE had disappointed. A year later, 35% of LPs said that PE had exceeded expectations, nearly triple the number who said PE had fallen short. That bullishness for PE also shows up in LPs' expectations for future performance. Just more

**Figure 1.29:** The returns of post-crisis fund vintages are beginning to pull away from the public markets' performance



Notes: Europe includes developed economies only; vintage year is determined by year of fund's first cash flow; vintages after 2008 are excluded because they have relatively few investments and realizations; the Cambridge Associates mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in PE been invested in public markets instead; the public index's shares are purchased and sold according to the PE fund cash-flow schedule  
Source: Cambridge Associates

Figure 1.30: LPs' satisfaction with and expectations for PE returns improved markedly



Source: Preqin

than one-third of LPs surveyed in 2014 anticipated that PE would outperform the public market benchmark by more than 4 percentage points. By mid-2015, nearly one-half of LP respondents held that view.

With renewed confidence in PE returns comes a heightened awareness of PE's cyclicity and a magnified sensitivity to the economy's vicissitudes. As healthy as PE returns were over the past three years, those vulnerabilities and the simple fact that the PE industry has matured should temper investors' expectations that returns will remain as strong as they have been. With GPs now paying premium prices for assets and the chance of recession looming on the horizon, the risk remains that PE investors will see future waves of downward revaluations and a convergence of PE and public market returns.

Future returns will depend, of course, on the severity of the cyclical market and economic shifts. But they will also depend on the skills and foresight of GPs to manage their portfolios proactively in order to withstand future turmoil. Every crest of every wave in the PE cycle is an opportunity for GPs to demonstrate their ability to outperform. GPs have embedded many lessons they learned from the past downturn into their new investment discipline. They are exercising caution when paying high multiples for acquisitions and taking care in their use of debt, which can just as easily eat into returns as enhance them. For now and over the next year or two, GPs and LPs should continue to enjoy the fruits of that dearly acquired wisdom. But as we will see in Sections 2 and 3 of this report, prudence dictates that even in a time of newfound confidence, success will come only to those who are ready for adversity.

## Key takeaways

- In 2015, private equity turned in a solid year against the backdrop of a slowing global economy, increasing volatility in public equity markets and feverish competition that drove investment multiples to new highs.
- The \$175 billion that GPs attracted for commitments in new buyout funds came in 11% below the amount GPs had raised in 2014. Despite this, new PE fund-raising encountered the best conditions in years. PE funds are closing faster, and the percentage of funds that hit or exceeded their fund-raising targets was higher in 2015 than at any time since the precrisis boom of 2007.
- LPs continue to turn to new ways to put capital to work within the PE space by using shadow capital to coinvest alongside GPs and by looking increasingly to the secondaries market to meet their target allocations.
- On the investment front, reported buyout deal value totaled \$282 billion globally—the strongest year since the global financial crisis—as dry powder increased to a near-record \$460 billion. Asset valuations, already high as 2015 began, rose to 10.1 times EBITDA in the US. Multiples in Europe dipped slightly but remained near all-time highs. The second half of the year brought increased turmoil to the debt markets, as spreads on leveraged loans increased.
- At \$422 billion, buyout-backed exits were just shy of their all-time peak, as GPs completed sales of older vintage fund holdings. Exit activity was robust across all major channels, led by sales to corporate buyers, who accounted for more than \$275 billion in asset sales last year. Recent investment activity, far below that of the peak period between 2005 and 2010, portends a falloff in exit activity over the coming five years.
- Despite turbulent public markets, private equity continued to post strong returns relative to alternative asset classes. Top-quartile funds are widening their lead over median fund returns for the 2008 and 2009 vintages now coming to realization.

## 2. Private equity firms face a mandate to differentiate

Six years into a PE cycle that has seen strong buyout activity, wide-open exit channels, prodigious fund-raising and solid returns coming out of the global financial crisis, there has never been a better time to be a GP. Yet, the characteristic that dominates private equity more than any other today is the industry's continuing competitive ferocity in deal making. GPs are working harder—and paying more—to source, vet and land deals in every market around the world. Deal teams and operating partners are rolling up their sleeves and lavishing precious time as they stretched out holding periods to groom their portfolio companies for successful sales and to optimize their own returns.

Business conditions have remained generally healthy during the latest upswing, and PE returns continue to outpace those of all other asset classes over the medium and longer terms. But the shifting contours of the competitive landscape have forward-looking PE firms fundamentally reevaluating every facet of their businesses. Clearly, there is more to do than simply adapt to the challenging new realities of the current investment cycle. The maturing PE industry finds itself in the throes of ongoing generational change as PE firms evolve from the charismatic leadership style of their founding partners, who are now aging into retirement, into the dynamic institutions that they will need to become to carry on their legacy. The two dozen or so elite PE firms that dominate the industry are well under way with this shift, but the great bulk of middle-market firms that account for a large proportion of deployed PE capital are only beginning the journey. They are now looking to recast themselves into organizations with the people, systems and disciplines that can surmount formidable new challenges in order to become enduring institutions.

As PE firms wrestle with new competitive threats, they need to reckon with institutional investors' shifting priorities as well. The LP community has always been a diverse group, representing many investment styles, behaviors and objectives. That heterogeneity has never been as prominent as it is today and will almost surely become even more so over time. Big LPs with large specialized teams and long PE investment experience have been eyeing new ways to streamline their relationships with GPs. Others are coinvesting alongside GPs or even building and managing their own PE portfolios. Still others are relying on their research skills to home in on novel investment themes, ferret out GPs that share their outlook and back those who they are convinced can deliver the goods.

For all of their diversity, however, LPs remain deeply committed to PE as their top-performing asset class. In a survey conducted by Preqin in late 2015, 35% of the LPs who participated said the performance of their PE portfolios that year had surpassed their expectations. More than 90% said they intend to maintain or increase their allocations to PE in the coming year and over the long term.

As they weigh the implications of the environment they face, however, many LPs worry that average PE returns might again converge toward those generated by the public market indexes. It is little wonder, then, that many LPs have been hunkering down as they contemplate their new rounds of PE commitments, prizing safety, reliability and efficiency over flash and dazzle.

**LPs streamline and concentrate their PE holdings.** One manifestation of LPs' reactions has been a flight to quality: There is a growing inclination among many investors to shrink the number of PE funds in which they invest, writing bigger checks to fewer GPs. For large LPs like CalPERS, California's huge public employee pension fund, paring back the number of their relationships with GPs significantly reduces their administrative burden and presents an opportunity to negotiate more favorable management fees. "By having fewer managers, at larger scale,

we will be able to reduce our overall costs,” Ted Eliopoulos, CalPERS’ chief investment officer, told the *Financial Times*. “We are looking at every possible lever to use to lessen the cost, but [making] sure we still have access to the talent that we need.”

For other LPs, such as Nebraska’s public pension system, concentrating more capital commitments into fewer PE funds helps bolster the vetting process for GPs. Directing larger commitments to a smaller group of managers will create “a higher conviction portfolio than we [had] in the past,” Michael Walden-Newman, who oversees the Nebraska Investment Council’s \$21.7 billion portfolio, told *Buyouts* magazine. This frees up time for due diligence and fund tracking. “The more time you can take on the front end, the more you get on the hind end,” he said.

Both the logic and mathematics behind this strategy give a powerful edge to the largest and best-performing GPs, magnifying the chasm between big, well-performing GPs (the haves) and less prominent GPs (the have-nots) in a deeply bifurcated market. Bigger brand-name GPs have far greater marketing heft than their smaller rivals and bring to bear their substantial economies of scale, offering a broader array of funds to absorb more capital from LPs looking to pool their commitments with fewer PE firms. LPs also know that they can more easily eliminate smaller GPs from their commitment allocations without putting a dent in their portfolios’ overall returns.

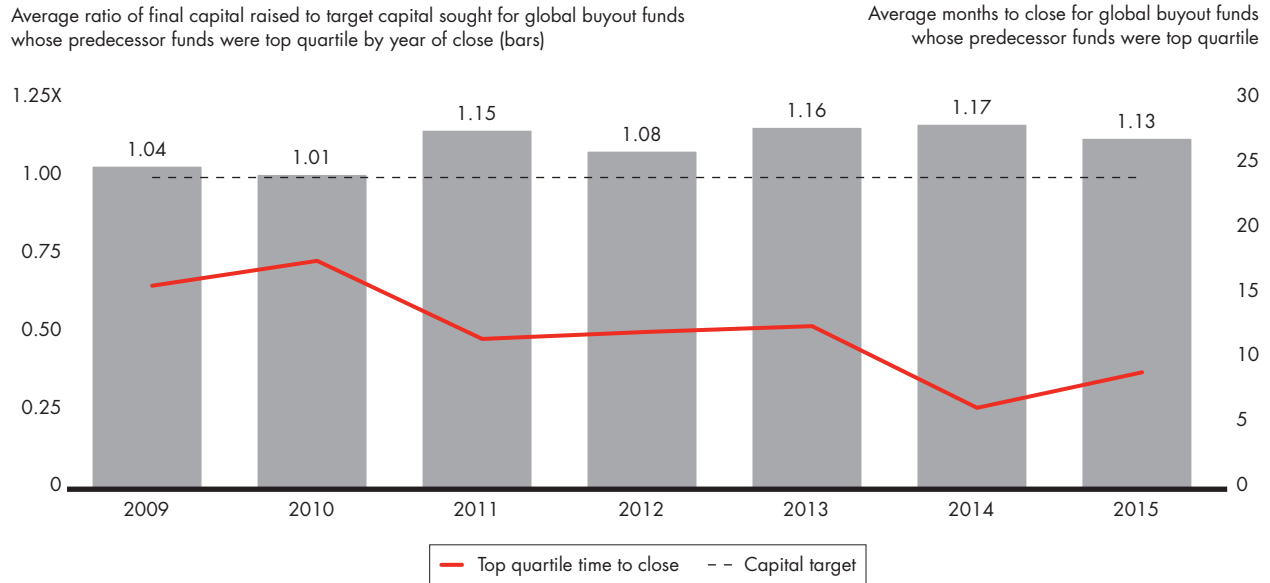
LPs’ preference in investing with bigger, tried-and-true funds has been gaining momentum over the recent PE cycle. Contrary to the conventional wisdom in public equities investing, past performance is widely taken to be a reliable predictor of future returns in PE. Examining a select group of big institutional investors, Bain found that, between 2009 and 2014, these prominent LPs increasingly concentrated their commitments to bigger funds marketed by firms in the first or second quartile based on the returns of their predecessor funds. They also decreased by 19% the number of funds in their portfolios from the 2005–2009 PE investment cycle. The funds they backed were larger by \$500 million, on average, than their counterparts in earlier-year vintages and more than twice the size of funds they invested in between 2000 and 2004.

**Top-performing GPs reap a fund-raising bonanza.** With LPs flocking to them in droves, high-flying GPs whose predecessor funds performed in the top quartile have been beating their fund-raising targets by a wider margin and in less time over the past six years. In 2009 and 2010, for example, the best-performing GPs hit their goals and were able to complete new fund-raising activities within 16 months, on average. By 2013, the most sought-after GPs were exceeding their capital targets by 16% and closing in just over a year. In 2015, they continued to be oversubscribed, at 13%, and were wrapping up within 9 months (*see Figure 2.1*).

LPs’ appetites for big, top-performing funds vastly exceed the supply of PE funds available to absorb all the capital LPs need to deploy. LPs have been on the receiving end of a tsunami of cash that is effectively bankrolling anew the entire PE industry. In 2015, for the fifth consecutive year, LPs as a whole reaped far more from the distributions that GPs channeled back to them than they poured into new PE funds to which they had committed. The net cash flowing to LPs over that period exceeded \$300 billion—equal to more than one and a half years’ worth of fund-raising.

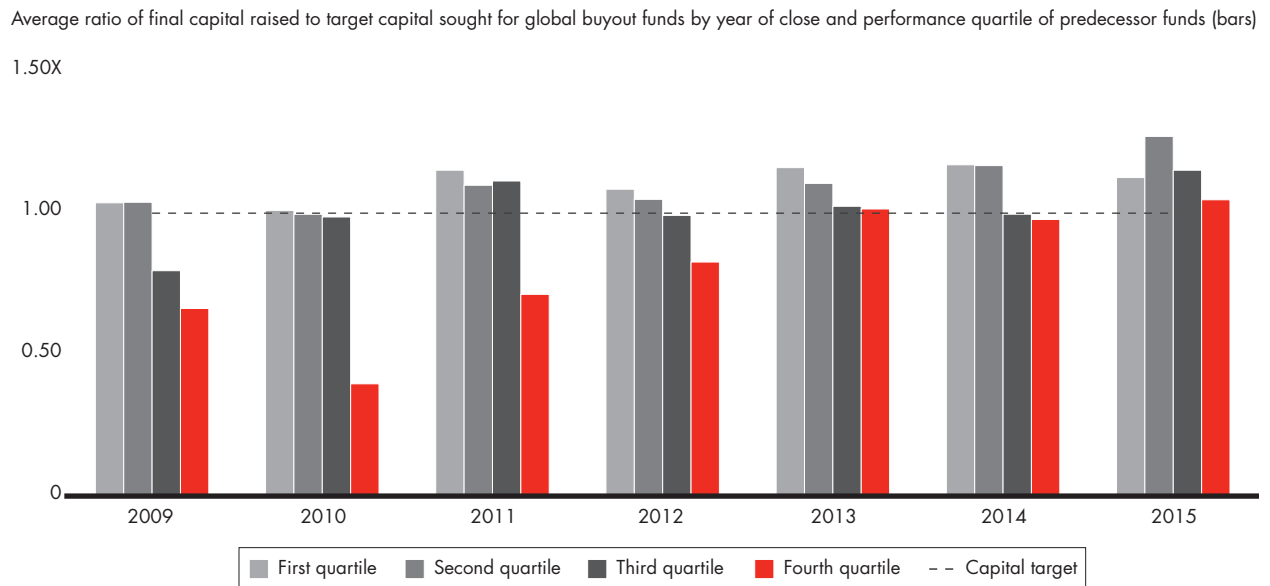
**The spillover effect floats all GPs’ fund-raising boats.** The effect of so much capital looking to be put to work is distorting the overall fund-raising environment, and its benefits are flowing well beyond the big, favored GPs. New PE fund offerings of all sizes are absorbing the spillover of LPs’ capital allocations that are unable to find a home with a top performer (*see Figure 2.2*). Even GPs whose prior funds were third- or fourth-quartile performers exceeded or came close to hitting their fund-raising targets. In 2009, sponsors of fourth-quartile funds were able to bring in just two-thirds of their new fund-raising targets; in 2015, they surpassed their goals.

Figure 2.1: Top-performing PE firms are exceeding capital targets at an accelerating pace



Notes: Data effective December 21, 2015; predecessor fund is defined as a fund with the same manager and geographic focus and having a vintage year at least five years earlier than the new fund at the date of close  
Source: Preqin

Figure 2.2: Top-performing PE firms are maxing out capital in fund-raising, creating spillover to bottom-quartile funds



Notes: Data effective December 21, 2015; predecessor fund is defined as a fund with the same manager and geographic focus and having a vintage year at least five years earlier than the new fund at the date of close  
Source: Preqin

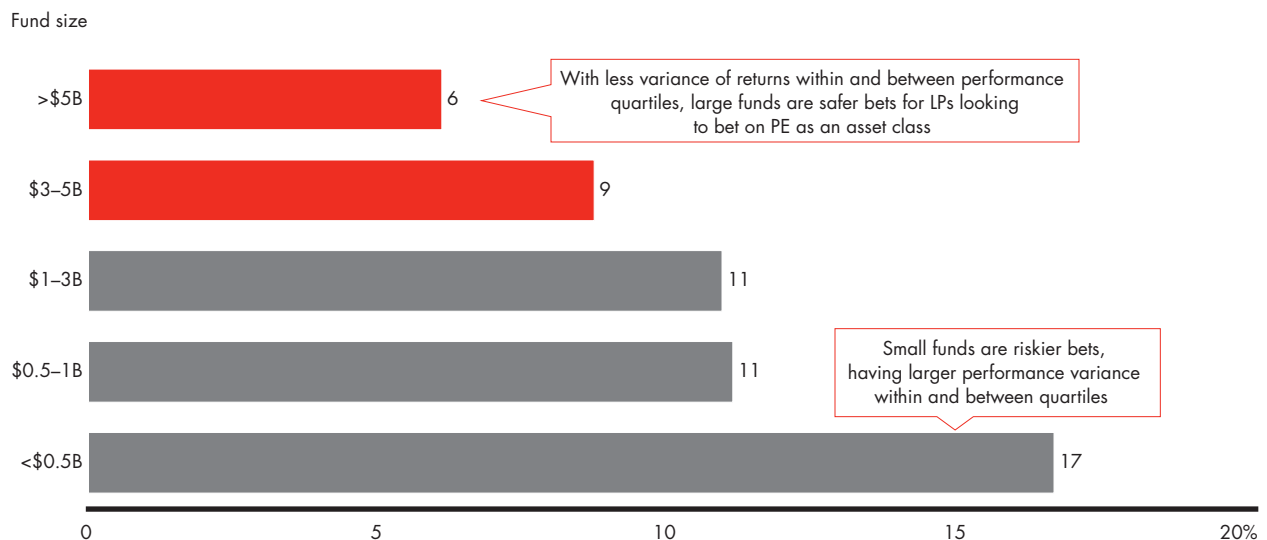
**Big GPs enjoy natural advantages.** The biggest and best-performing funds clearly enjoy the pole position in the race for a large tranche of this capital. Bigger is better when it comes to producing steadier results, because the variation in returns between the top and bottom performers is reduced (see Figure 2.3). PE funds exceeding \$3 billion are apt to hold more and larger companies, so they are more likely to produce steadier results than their smaller counterparts. For the large number of LPs increasingly looking for low-cost access to PE-level returns, these larger funds provide the best option.

With LPs so flush with capital to reinvest, fund size even favors big PE firms whose predecessor funds have underperformed in the past (see Figure 2.4). While the firms with first- or second-quartile predecessor funds easily met or exceeded their fund-raising targets when they brought new funds (of every size) to market, so did the largest new funds marketed by firms whose prior funds fell into the bottom quartile. By contrast, smaller funds that were successors to bottom-quartile funds and aiming to raise less than \$1 billion fell short of their targets, even after logging 20 months on the fund-raising trail.

Undeniably, the bigger and more successful GPs are reaping a windfall in the current fund-raising environment, but there appear to be clear limits on how far they can press their advantage, suggesting the PE industry will remain highly fragmented in the years ahead. Even as the largest PE firms lift their fund-raising targets and roll out new offerings to accommodate the surge in LP allocations, Bain experience suggests that, absent an unlikely return to the megadeals of the precrash PE cycle, there may be a ceiling on just how big individual funds can become—capped somewhere between \$16 billion and \$18 billion in the years since 2009. LPs may want GPs to grant them larger allocations to invest in attractive funds, but they also want the GPs they work with to keep the size of their fund to a manageable limit.

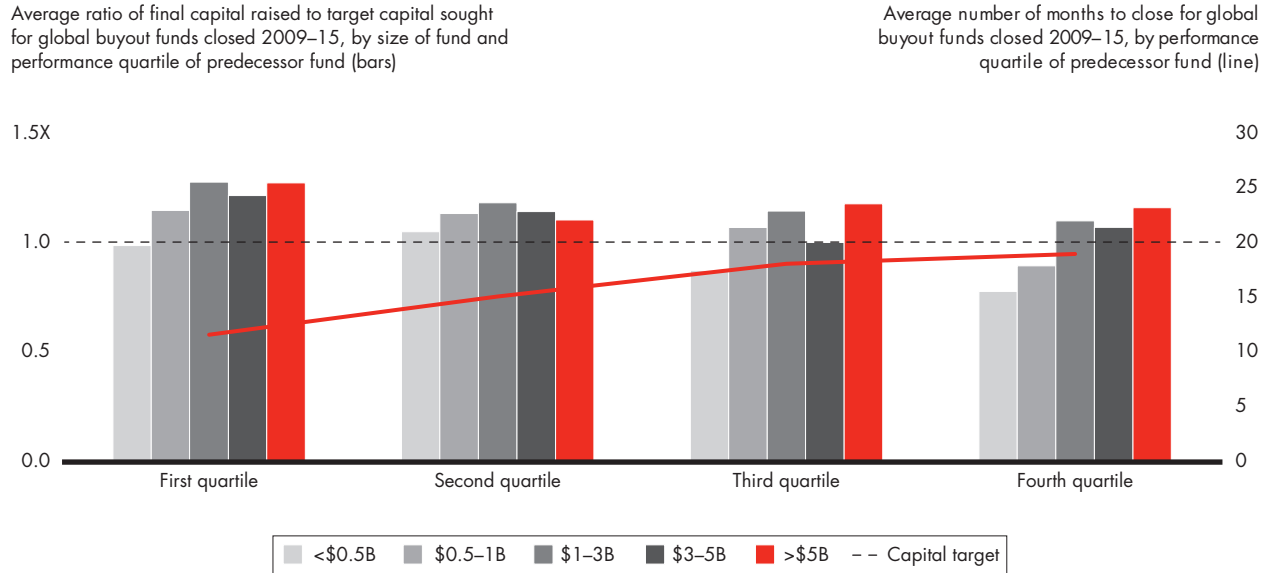
*Figure 2.3:* Especially for funds larger than \$3 billion, there is less variance between top and bottom performers

Standard deviation of net internal rate of return by fund size (vintage years 2007–12)



Note: Data effective December 21, 2015  
Source: Preqin

**Figure 2.4:** Top funds win easier and faster access to capital; large funds benefit from marketing and operational scale to exceed their fund-raising targets



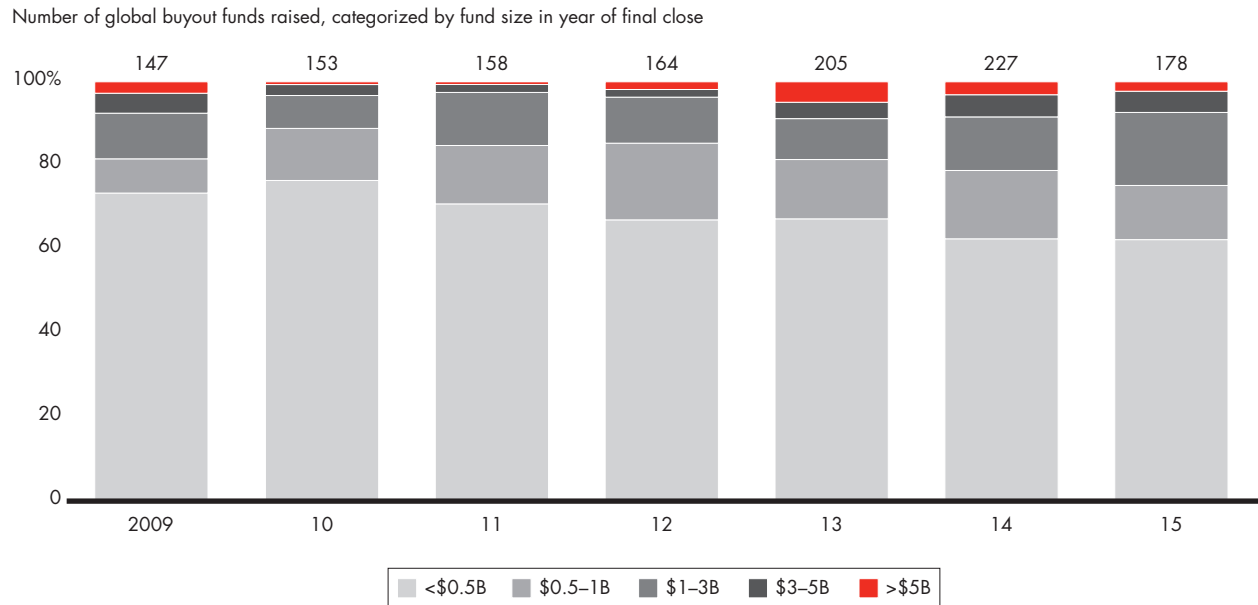
Notes: Data effective December 21, 2015; predecessor fund is defined as a fund with the same manager and geographic focus with vintage year at least five years older than the fund at the date of close  
Source: Preqin

**LPs still see a lot to like in smaller PE funds.** That fund-size ceiling helps explain why small PE funds have continued to garner a large proportion of new funds raised globally in recent years. Since 2009, new funds looking to raise up to \$1 billion accounted for 75% or more of all funds raised (see Figure 2.5). Smaller funds remain popular in large measure because PE fundamentally remains an entrepreneurial business. More than ever, a sizable subset of LPs want to sign up with GPs that can identify promising pockets of opportunity and demonstrate that they can deliver top-quartile results. Many of these focused LP investors have clear targets for how they want to allocate their money, and they are willing to back smaller or new GPs that offer funds matching the specific risk and sector exposure they are looking for.

### The primacy of strategy

As LPs survey the global macroeconomic landscape, their high expectations for PE will likely be put to a severe test. Over the next investment horizon, they see slowing GDP growth nearly everywhere they look. And while they expect that PE will continue to outperform public equity markets on a relative basis, they recognize that returns on all asset classes are unlikely to continue posting the strong double-digit gains racked up over the past four years.

In due course, and almost certainly over the next year or two, the extraordinary fund-raising conditions, which have produced a high tide of capital from LPs to float nearly all new funds introduced by GPs, will give way to a more competitive scramble to win the backing of LPs. GPs have largely cleared out the overhang of assets that had sat in their fund portfolios since the last financial downturn, awaiting improved exit conditions. As exits from investments the industry made in the peak period of 2006 to 2007 wind down, the net distributions LPs

*Figure 2.5:* Smaller funds continue to make up a significant portion of funds raised globally each year

Note: Data effective December 21, 2015  
Source: Preqin

receive will drop significantly. As LPs' allocations to PE begin to stabilize, the industry will reach a new normal of positive cash flow, with the ratio of distributions to contributions well below their peak of recent years.

A tighter balance between GPs' supply of new funds and LPs' demand will continue to favor the largest and best-performing GPs. Large GPs that have a less impressive track record and mid-market PE firms hoping to grow to megafund status will encounter more resistance from LPs when the current excess of capital subsides. They will no longer be able to siphon off some of the spillover LPs have been willing to send their way, as they currently are doing. Sponsors of smaller and mid-market funds that have underperformed in the past may still be able to garner some capital, but they will be at a distinct disadvantage compared with their more sharply focused peers as fund-raising conditions slightly soften.

A past history of success will always be crucial, but the ability of GPs to clearly communicate how their investment approach differentiates them from their peers has become table stakes for winning investor confidence and financial backing. Indeed, a sound, differentiated strategy is increasingly viewed as the platform on which successful and durable future performance can be built. It will be the centerpiece of the once-in-a-generation transition that many PE firms are now wrestling with as they set their sights on rising to the industry's top tier.

The fundamentals of a good strategy cannot be put in place overnight. GPs need to begin today and commit themselves to continually refining their strategy as a crucial part of doing business. Sound strategy begins with senior members clearly articulating their ambitions for sustained wealth creation (*see Figure 2.6*). It is, in essence, a statement of the character of the firm, aligned with its broader team of investment professionals and shared with its investors. Not a mere overlay of committee-generated objectives, a firm's ambition is the capstone of its

organic structure, built from the bottom up on a sound organizational foundation, supported by fund-raising capabilities and support services that enable strategy to succeed. It is informed by an ongoing deliberative process between the firm’s leadership and its deal teams to assess which investment areas to pursue and, within those areas, what specific strengths it will bring to bear to ensure that it can compete and win.

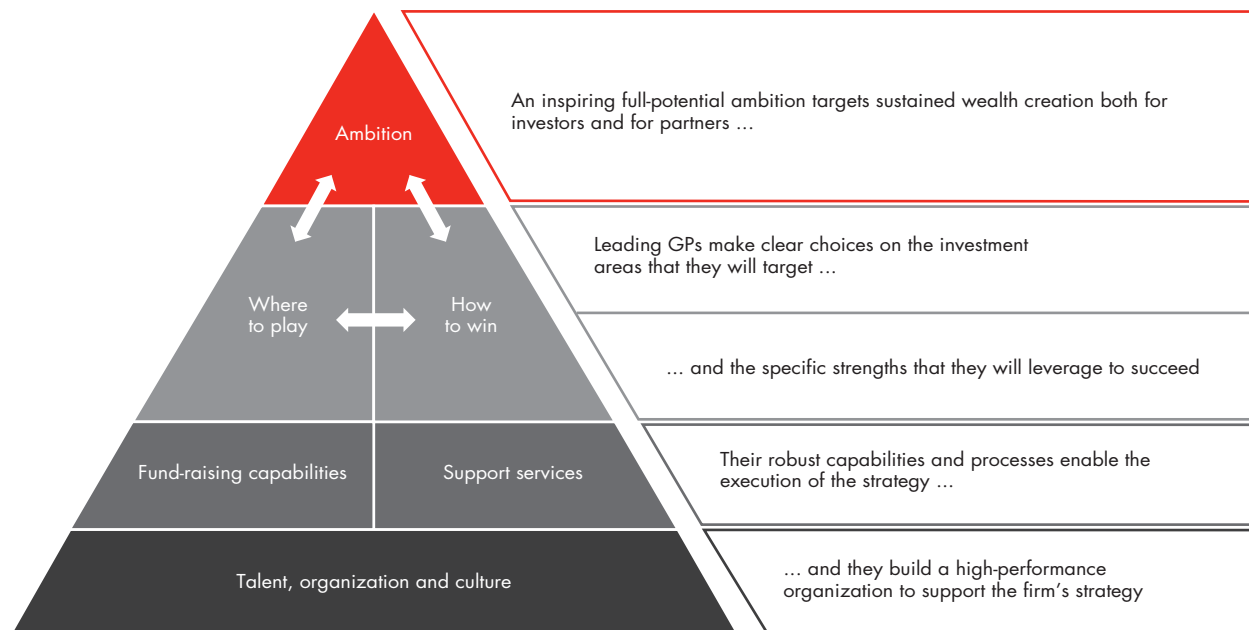
From this overarching ambition-inspired vision, built on capabilities and a high-performance organization, the strategy-driven firm derives concrete goals, for example, to be the preferred technology partner for leading LPs and to develop a suite of investment vehicles that fully exploit the firm’s talents and insights. The goals, then, guide the firm to a statement of concrete performance targets.

As we will see in the sections that follow, leading GPs—whether they are large global players across many asset classes or tightly focused specialist boutiques—are deepening their strategies to sharpen their competitive edge. Bain has identified 17 distinct ways PE firms can define their future sources of differentiation and strength—from risk appetite and geographic footprint to company culture, talent management and incentive structure (see Figure 2.7).

While all of these are important and each element of differentiation needs attention, PE firms must actively prioritize those that will truly set them apart and then invest behind them. The goal: to create a repeatable model that provides a real basis for competitive advantage and is consistent with the firm’s history and capabilities.

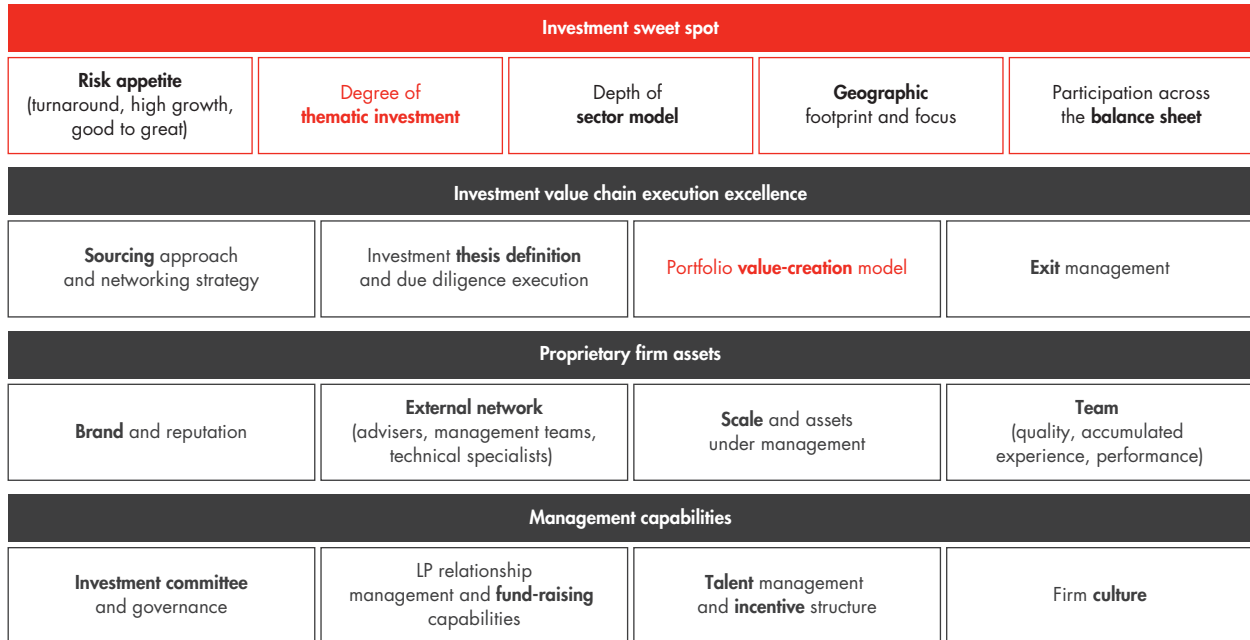
In the balance of Section 2, we highlight three ways leading PE firms are honing their strategic edge to improve returns and garner investors’ attention. First, we examine how they identify and refine their investment “sweet

Figure 2.6: Ambition should be the capstone of a private equity firm’s strategy



Source: Bain & Company

*Figure 2.7:* Private equity firms need to mine their current sources of strength and differentiation and cultivate their future ones



Source: Bain & Company

spot,” then focus on it to articulate and invest around the characteristics of deals that are most likely to deliver the returns they seek. Second, we shine a spotlight on one critical element of sweet-spot discipline that has become an increasingly important way PE firms are gaining a distinctive edge: spotting and applying thematic investing insights that enable them to capitalize on broad macro trends. Finally, we focus on how leading firms are mobilizing their talent and resources to win by adopting firm-wide models for creating value across their fund portfolios.

Challenging new times for PE call for bold new ways to organize for investing success. PE firms that have been industry trailblazers in the past and want to remain leaders in the future cannot afford to be complacent. Smaller, newer or less successful PE firms will need to sharpen their profiles in the eyes of LPs by demonstrating they possess distinctive qualities that will make them repeatable winners in the tough new environment ahead of them.

### Mine your investment sweet spot

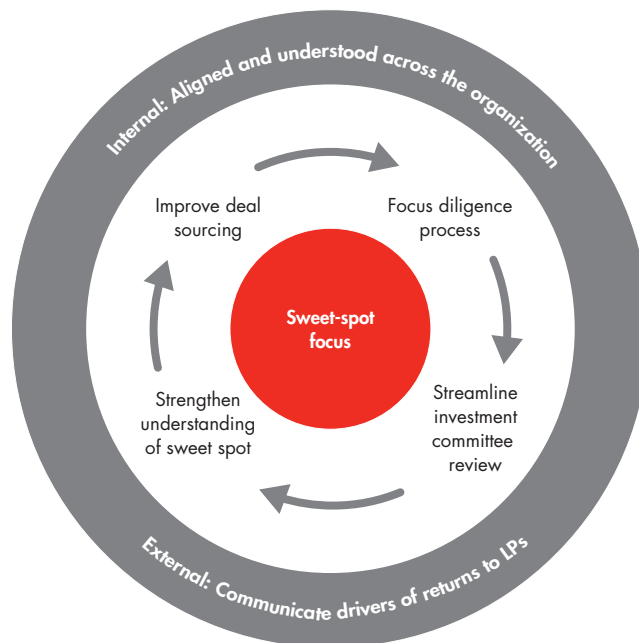
In private equity, as in most high-stakes business pursuits, sticking to what you’re good at is a surefire way to achieve real success. But in an industry in transition from its early buccaneering days, the thrill of pursuing attractive novelties can often result in a scattershot approach to finding new deals. Many longtime industry-leading PE firms know that the true sources of their repeatable successes are encoded in their DNA—the combination of unique qualities deeply ingrained over time in the firms’ experience, ambition, talent and expertise. Many firms stray from their investment sweet spot because they fail to fully define what it is they know how to do best. It is a problem that has been magnified in recent years as the growth of the PE industry has filled the deal pipeline with investment opportunities that can be very different from those in which a firm knows how to make money.

Finding, and sticking to, the firm’s investment sweet spot is critical because it provides a roadmap, showing deal teams the types of investments they should pursue, and gives LPs compelling reasons to back them (see Figure 2.8). It sharpens the deal-vetting process by highlighting the critical issues to be tested during due diligence for every deal. It brings the firm’s expertise to bear in the bidding process by enabling the firm to make its best case with target-company management that, as owners, they would be the business’ best stewards. It increases the effectiveness of the firm’s investment committee by enabling the GPs to recognize patterns that foretell success across deals. And it guides the firm’s multiyear investments to hire the right talent and build the right capabilities to ensure that success will continue to build upon success. For a maturing PE industry in the midst of a generational shift from the charismatic rainmaker–founders to today’s more buttoned-down deal teams, it is that disciplined approach that best suits a time of record-high asset prices and cutthroat competition.

Bain’s analysis has found that deals that fall within the firm’s sweet spot consistently and significantly outperform those opportunistic deals that stray from it. In one instance, 45% of a fund’s sweet-spot deals generated at least twice the return on capital invested vs. just 25% of its opportunistic deals (see Figure 2.9). On average, the multiple earned on all sweet-spot deals was a handsome 2.2 times invested capital vs. 1.3 times invested capital on the deals that deviated from the firm’s sweet spot.

What makes a sweet spot such an effective guide to PE investment success is the comprehensive way it captures so many factors that can influence investment outcomes. It helps a PE firm to define the contours of where its strengths lie and the types of deals it seeks to do across dozens of investment variables along at least eight vectors—from the firm’s strategy (the sectors in which it has seen its greatest deal successes and the size of the target

Figure 2.8: Sweet-spot investing can help focus a PE firm both internally and externally



Source: Bain & Company

companies that best match its capabilities) to its geographic footprint, target ownership, the type of control it seeks to exert, the primary investment thesis (whether growth-oriented, turnaround or contrarian) and the partners with which the firm is willing to work (see Figure 2.10).

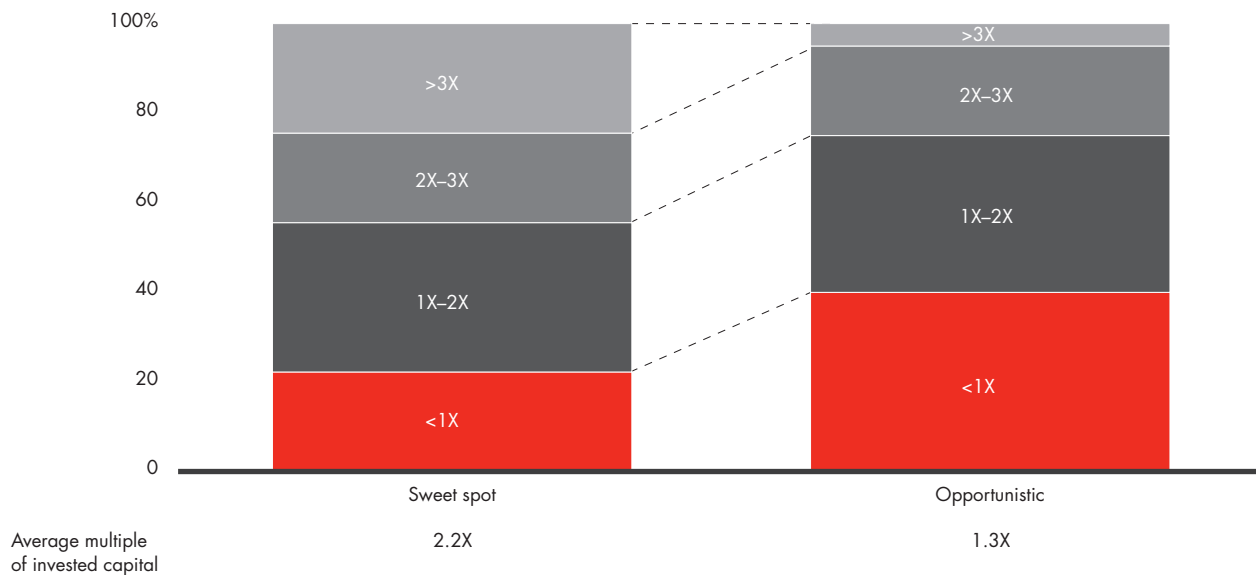
The process of drawing a sweet spot’s boundaries is a detailed and painstaking one. The characteristics that an investment sweet spot reveal do not emerge from guesswork or intuition but from deep probing of data. While many firms believe that they instinctively know where their sweet spot is, Bain’s analysis of prior deals’ successes has consistently found fallacies in this perceived wisdom. When done right, the end result should circumscribe a precisely drawn investment space that encompasses the majority of the deals that a PE firm will undertake. That space should be at once broad enough so as not to limit the firm to just a narrow set of deal options but tight enough to focus the firm on areas in which it is most likely to see success.

There are no shortcuts, but the payoff from a rigorous sweet-spot analysis can be huge. To understand what the exercise of defining an actionable sweet spot entails, let’s consider what the process might reveal for a midsize Europe-based PE firm that traditionally focuses on buyouts of industrial enterprises.

**Begin with a deal postmortem.** The first step is to undertake a deep dive into the firm’s own experience with deals, including those currently in its portfolio as well as those it has exited, by selecting a sample of investments that is broadly representative of its successes, so-so performers and failures across all the funds it has managed. For our European PE firm, that process yielded 44 companies, representing 65% of deal count and 55% of deal value distributed across the five funds the firm has managed since its inception. Engaging outside advisers to help with the detailed analysis and mediate the process, the firm sorted the sample by the deals’ outcomes, mea-

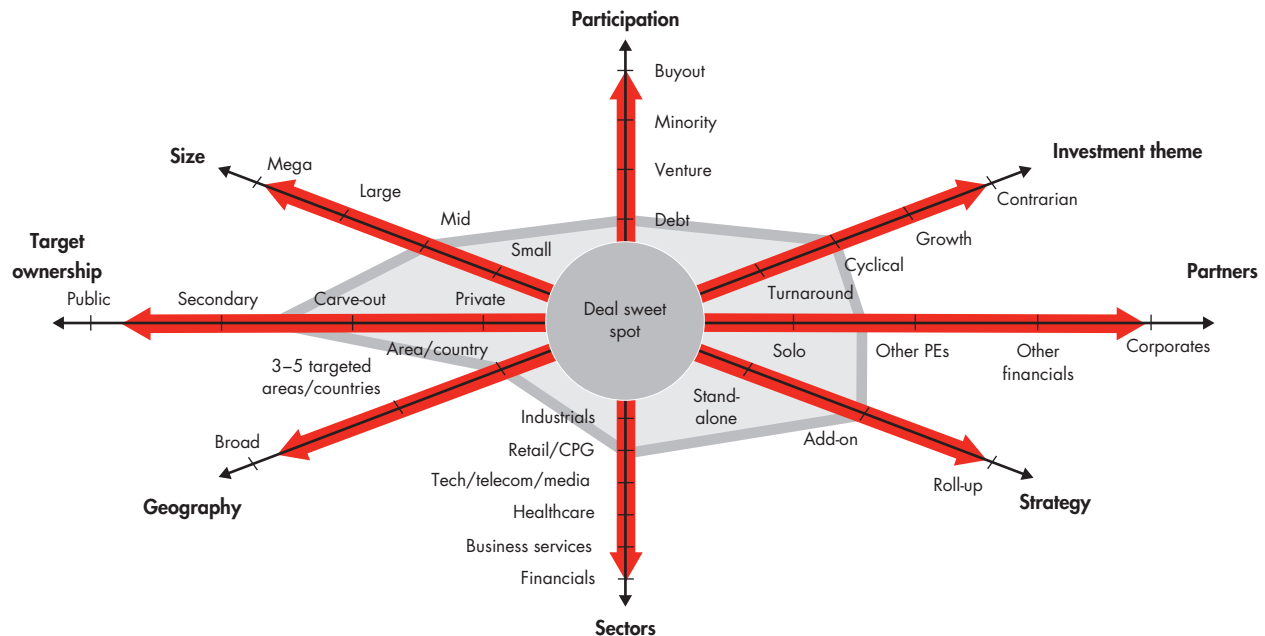
*Figure 2.9:* Deals that strayed from PE firms’ sweet spot consistently underperformed those that did not

Percentage of deals, by multiple on invested capital at exit



Source: Bain analysis

Figure 2.10: A sweet spot cuts across many different dimensions that influence investment choices



Source: Bain & Company

measured by return on invested capital, into three clusters—those that lost money, satisfactory performers that earned between 1 and 2.5 times invested capital and winning deals that returned at least 2.5 times the equity put into them. The ranges can vary, but it is important for the fund to define what constitutes a winning deal and what makes a losing one. That culling of winners from losers created two pools of companies that the firm could probe for sources of deal success and reasons for their failure.

**Interview the experts.** Step two of the sweet-spot investigation is to conduct structured interviews with the deal teams that managed a subset of the investments to explore the specific characteristics, value-creation initiatives, management team dynamics and external factors that influenced the deal outcomes. For the European PE firm, the objective of this exercise was twofold. First, the discussions zeroed in on the common features that the firm’s most (and least) successful deals shared to get a deeper understanding of how the firm made (or lost) money for its LPs. The second objective was to explore how the firm’s processes—from deal sourcing, due diligence and investment committee engagement to post-close value-creation plans to exit planning and execution—correlated with a deal’s success or failure. Understanding how deals succeed and why they succeed is essential for designing a repeatable model the firm can implement.

**Weave the “red threads” together.** By collating the data on deal performance with the insights derived from the deal team interviews, the PE firm’s sweet-spot steering committee was able to see the breakthrough features that its successful deals shared. The commonalities spanned geographic markets, industry sectors, deal size and the types of companies in which the firm invested. For example, the team discovered that many of its top performers had been midsize carve-outs of investment-starved divisions of multinational conglomerates that had tended to lag market growth under their previous owners. Most of these acquisitions were companies that had strong senior

management teams in place with whom the PE fund had a strong relationship. The best companies were market leaders or had a clear path to become one in their niche and had room to boost sales further. The potential to consolidate market share through add-on acquisitions within their own country or across borders in a play to develop a continental presence was another big plus.

**Discover your “ahas!”** The bull’s-eye of a well-defined investment sweet spot is the recognition of the winning factors that set a fund’s strong performers apart from its great ones. These are seldom the obvious criteria that investors usually look for such as a strong balance sheet or a patented process. Far more often, the unique competencies that a firm brings to bear are the ones that have a disproportionate impact on the deal’s success. In the case of the mid-market European PE firm, for example, the sweet-spot identification exercise found that it was the firm’s talent for strengthening the effectiveness of its companies’ sales organizations that paid the largest dividends.

PE firms that recognize the total impact that the presence of winning factors has on the returns of deals across their portfolio and that adhere to the disciplines of their sweet spot typically see a strong correlation—more winning factors typically bring higher returns. At the European PE firm, for example, none or just one of the factors were present in the five money-losing deals that had generated a weighted average return of 0.5 times invested capital. However, there were three factors present in seven deals that returned an average of 2.5 times invested capital, and six of the factors showed up in the four best deals generating a return of four or more times invested capital.

**Mind the warning signals.** Often dampening the success or undermining the performance of deals that otherwise look so promising is the presence of common factors that nudge them off track. In some PE portfolio companies one of these warning signals might be a disruptive new technology, for example, or some other adverse shift in the competitive dynamics affecting the core business. For the European PE firm, a common signal of trouble ahead for its underperforming deals was situations in which the key thesis for growth was incompatible with the competencies of existing management teams; yet the firm relied on those teams to develop skills that they had not previously demonstrated. Steering clear of these characteristics can spell the critical difference between a winning deal and a losing deal.

**Beyond the sweet spot?** Because business conditions always change and PE firms evolve over time, an investment sweet spot must be inherently elastic. A periodic reevaluation of whether the factors that helped create success in the past will continue to do so in the present or future is essential. So, too, is it crucial for a PE firm that aspires to grow into new adjacencies or expand into new regions to undertake a disciplined refresh of its sweet-spot analysis before making these moves. For our European PE fund, one way to test its desire to foray into new territories would be to look for deals that incrementally stretch its sweet spot by, for example, finding a target company that otherwise has the characteristics that led to success in the past but that happens to be based in a different part of the world. By narrowing the number of variables that deviate from its proven path to success and monitoring their impacts closely, the firm can expand its appeal to new LPs or satisfy the appetite of its deal teams to stretch their wings with greater confidence that it will continue to hit its performance benchmarks.

Of course, in today’s tough, competitive deal-making environment, it will be challenging for any PE firm to live within its sweet spot alone. Potential target companies that most closely conform to a firm’s sweet-spot criteria will naturally become top priorities for deal-team and investment-committee engagement. But faced with today’s high prices and fast-paced competitive deal making, sticking to sweet-spot criteria can be the only way to maintain investment discipline. Knowing and adhering to its sweet spot gives a PE firm the confidence to be much more aggressive when sourcing and paying up for deals that it knows it can do well. Some openness to opportunistic investments

should always remain but needs to be weighed cautiously and with a clear understanding of their limits and the risks they present. Confident restraint is the new order of the day in the challenging markets that GPs now face. The simple recipe for consistently earning winning returns is to do more of what works and avoid what does not. Being proactive within its sweet spot helps ensure that the firm wins the deals it should and that the deals it wins will be big ones.

## **Mobilize around big investment themes**

As they scour the globe for their next round of investments, PE firms find themselves facing a shifting and perilously uncertain landscape. The forces that drove business expansion and underpinned investment returns since the PE industry's earliest years are winding down, bringing the global economy to a major inflection point. China's three-decade-long surge of economic growth is over, but the transition path that China's economy will take and where it will end up remain unclear. The US baby boomer generation's consumption patterns are evolving as its peak period of earnings and savings ebbs and its sizable cohort ages into retirement. Meanwhile, how vibrant and different demand will be as the "echo boomer" millennials reach their consumption peak will not be apparent for another decade. The breakthroughs in computing and telecommunications that powered the decades-long information technology revolution have matured, but the advances in robotics, genomics, artificial intelligence and nanotechnology that will give rise to the next wave of commercial development are only just beginning to emerge from the labs.

Many leading PE firms are getting ahead in this challenging environment by taking a thematic approach to investing that enables them to get an early read on emerging macro forces, organize around them and incorporate a deep understanding of their potential impacts on the deals they choose to make (or walk away from). The themes that firms adopting this approach embrace are big ideas that will unfold over a decade or longer. Thematic investors take a top-down view of one or more of the macro forces they focus on and anticipate how they will play out across sectors, industries and geographies. They bring their deep analytical skills to bear, quantifying how an overarching investment theme will, for example, influence consumption patterns and capital flows, reconfigure supply chains and affect frontline results at the individual business level. (For a discussion of themes Bain sees coming to the fore over the coming decade, see the sidebar "Five for 2025" starting on page 49.)

The practical benefits that thematically oriented PE firms can capture are considerable. First, by sizing up macro forces that will shape the investment landscape, they build a more confident understanding of the types of opportunities they want to pursue and assemble a network of contacts and industry relationships that will help them find suitable deals. Second, a thematic approach helps streamline due diligence, enabling firms that apply it to quickly size up whether possible deal opportunities satisfy the macro criteria they have prioritized, double down on the few that pass the macro screens and dismiss the many that fall short. Third, having a well-developed view on priority investment themes gives PE deal makers greater confidence in selecting when to lean in and bid aggressively to acquire an asset with a favorable macro profile and when to hold back. Finally, as its understanding of macro investment trends broadens and deepens, the thematically oriented firm can align its entire organization around a common macro thesis and develop distinctive areas of competence that cut across conventional geographic and business sector boundaries.

### **From concept to checklist: How PE firms put investment themes to work**

All successful thematic investors follow sequential steps for converting themes into actionable investment criteria. In the discussion below, we describe how two representative PE firms—one a US-focused mid-cap buyout firm; the other a large, global multi-asset investor—have used these building blocks to develop a distinctive thematic investment approach.

**Identify and analyze.** Thematic investors cast a wide net to pick up the early threads of an emerging macro force that will move the economy in new directions over the next 10 to 15 years, taking care not to confuse a high-impact theme with a passing trend that can quickly unravel. They look for bold, counterintuitive investment opportunities frequently built on second- and even third-order impacts of well-understood themes, recognizing that to settle for obvious approaches risks generating obvious answers that are already fully priced.

As firms select from among the ideas that they weigh, they look for ones that best fit their expertise and prior investment successes. They focus on themes whose impacts they can quantify and whose likely evolution they can chart over time. They convince themselves that the themes they commit to will have clear impact across several business sectors, geographies or both, pointing the way to specific classes of asset targets.

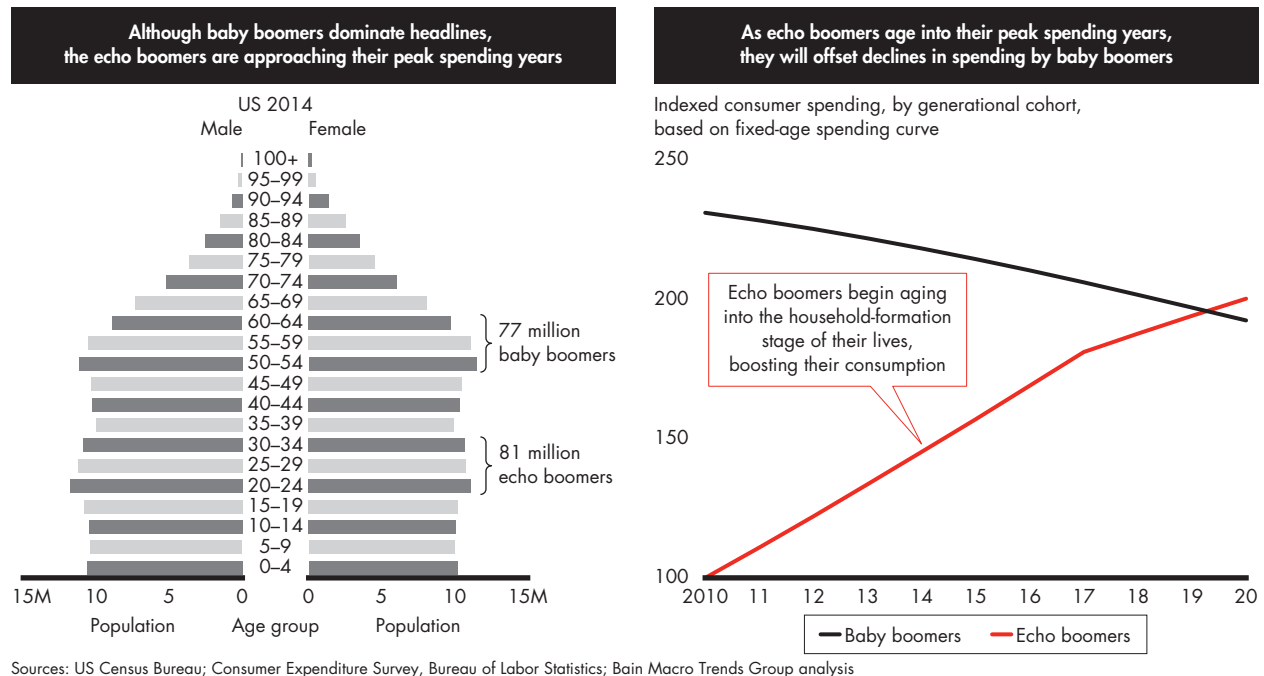
Sizing up the demographic transition that will shift the weight, tastes and spending patterns of the US population from the dominance of the aging baby boomer generation to that of the rising echo boomers reveals how consequential a macro theme can be for PE investors (*see Figure 2.11*). With a population totaling 81 million in 2014, the echo boomers, who were born after the early 1980s, comprise a larger age cohort than the 77 million baby boomers born between 1946 and 1964 that have dominated the American consumer economy for so long. The aging of both cohorts over the coming decade will generate an economic tailwind that will lift consumer spending overall but vastly alter its composition. As they complete their child-rearing years and gradually retire, the older boomers will have more discretionary income to indulge their personal tastes even as they downsize. Meanwhile, the echo boomers, already in their early family-formation years, will advance through the life-cycle corridor, increasing their household spending as their incomes rise. Toward the end of the decade, total echo boomer spending will outstrip declining baby boomer outlays, bringing with it all of the repercussions for investors that such a major generational change suggests.

**Drill down and codify.** Exploring high-level themes is a crucial first step, but only by diving deeper can GPs marry the top-down pockets of opportunities to specific areas where the fund can find investing success. This deeper analysis of how the fund's specific capabilities can make the themes actionable enables GPs to sort out what truly suits them from what is merely interesting.

Probing beneath the surface of the powerful demographic transition unfolding in the US, for example, enables a PE firm to track its concrete impact down to specific business sectors. Although small in percentage terms, life-cycle spending patterns represent billions of dollars in business opportunities, with major implications for companies and industries as the baby boomers and echo boomers move through their life stages (*see Figure 2.12*). Shifts in aggregate spending between baby boomers and echo boomers are amplified by how spending varies by category across the consumer life cycle. Education outlays, for example, drop significantly in early adulthood but then spike as consumers reach their peak parenting and mid-career years. Spending on entertainment, by contrast, remains strong across adulthood, climbing through age 35, dipping a bit in later middle age, recovering as consumers reach their peak years of discretionary income, and then trailing off again in old age. The tastes of the consumers making up each age cohort, too, will put their stamp on what people buy—fewer burgers for the older boomers, more Thai food for the younger ones.

Deeper investigation can also help turn up intriguing second- and third-order effects of a macro trend beyond the most obvious opportunities. For example, the larger population of older drivers that the demographic changes will bring means more safe drivers on the roads. The result: fewer accidents and lower auto insurance premiums. The effects of this trend will compound with the addition of more passive-safety technology in the fleet of passenger cars cruising the highways. For owners of chains of automotive shops, the consequences flow in both directions—

Figure 2.11: Mapping the timing and scale of a demographic shift can open up consequential investment theses



fewer repairs overall but higher-value ones. PE investors who are early to size up a promising macro theme and its foreseeable effects will be well-positioned to reap superior returns.

The disciplines of thematic investing are beginning to be rolled out by GPs around the world. The clarity and confidence that PE firms are gaining by taking a thematic approach to building their portfolios will help power superior performance for years to come.

### How to begin embedding theme-spotting capabilities in your firm

Going forward, every PE firm will need to fine-tune its radar for divining where markets are heading and zero in on the disruptions and discontinuities that will spell future investment success or failure. But there is no single template for doing this that will work for all. Here is how two very different PE firms developed thematic investment programs and built them into their investment-sourcing and deal-vetting processes.

**Capitalizing on rented expertise.** The managing directors at a midsize PE firm that focuses exclusively on growth-oriented middle-market investments in the US took a tack suited to its size and market niche. Lacking the resources to build a dedicated team to sort through the vast array of social, technological, economic and geopolitical trends that will unfold over the coming decade, the firm called in outside experts to help structure its investigation. Through an iterative process, the consultants helped identify eight themes that they and the firm believed would influence the global economy going forward. The firm dug into the themes, breaking them down into trends that would be likely to play out at a country level and the impact that they would have (both positive and negative) on

specific industries and subsectors. Capitalizing on these insights, the firm redirected its sector focus, concentrating on those sectors that it believed would benefit the most from the new trends and where it was confident that it had an ability to invest.

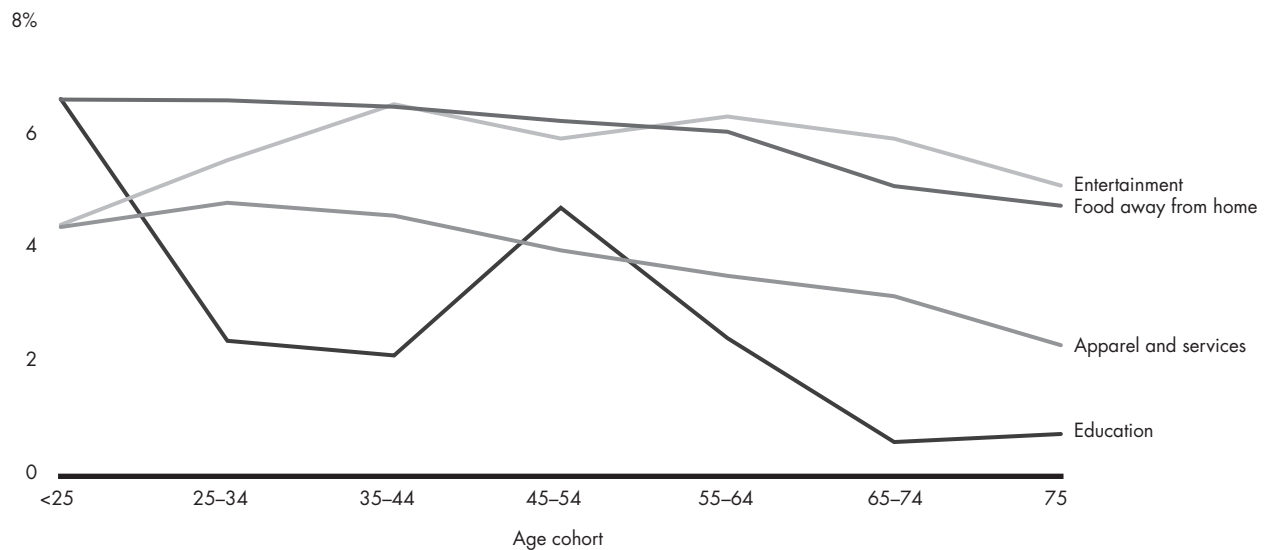
The next step was to embed the macro perspectives that the exercise developed in the firm’s culture and deal processes. Armed with the list of sectors that the firm decided it would focus on, deal specialists communicated them to the financial intermediaries with which they worked and broadcast them to the world by featuring them on the firm’s website. The firm redesigned its deal scorecard to ensure that it would explicitly assess the fit between the deals that it saw and the subsectors that the firm determined it would target. Finally, the firm fine-tuned its due diligence process, developing expertise specific to the thematic subsectors of interest in order to strengthen the quality and speed with which it would be able to determine whether to pull the trigger on a prospective deal and how much to pay. Now sizing up all of its prospective deals for their fit with its core investment themes, the firm has boosted its win rate on auctions for companies in its areas of focus.

**Grooming in-house specialists.** When a large investment firm set out to develop its thematic approach, it entrusted its macro idea exploration to a newly formed team dedicated specifically to that task. With investments spanning many asset classes and geographic markets, it needed broad in-house expertise across a wide front to investigate thematic concepts for its far-flung deal teams, and it worked with them to convert the macro themes into concrete investment theses.

Based on its initial assessment of the firm’s strengths and its internal evaluation of deal teams’ interests and past successes, the team identified six themes that it would focus on in depth. As it took its evaluation of the specific

*Figure 2.12:* Spending patterns vary across life stages, magnifying the impact of demographic shifts

Percentage of total household spending on various consumption categories in the US (by age cohort)



Sources: Bureau of Labor Statistics, Consumer Expenditure Survey, 2012; Bain Macro Trends Group analysis, April 2014

effects of each of the themes to a deeper level of analysis, the trends team undertook a comprehensive market-by-market investigation of spending patterns, supply chain implications, competitive dynamics and business cycle sensitivity on sectors representing a wide range of goods and services that fit with the firm's experience.

Applying the guidelines that the in-house analysts developed to codify each theme, the deal teams concentrate their hunt among companies and sectors poised to benefit from opportunities that track the macro theme's trajectory. Meanwhile, the analysts continue to track the macro themes' emerging impact as well as investigate potential new ones to feed fresh insights to the investment teams. The firm is now deploying its macro insights as a central part of a fairly sizable portfolio, with its teams aligned around its investment themes across all geographies and asset classes.

### **Five for 2025: Transformational themes for the decade ahead**

Bain & Company's Macro Trends Group expects that the following five high-level themes will help shape the global economy over the next 10 years and beyond. They will present new investment opportunities for PE investors who understand and embrace the big changes that they will bring—or risk disruption for those who ignore them.

#### **The shrinking cost of distance**

Spatial economics, the cost of distance, has been one of the most basic determinants of business location decisions, individual choices about where to work and live, the growth of cities and the flow of trade since the dawn of the industrial age. Spatial economics is now in the throes of a fundamental change. The catalyst for this historic shift is an array of new platform technologies that have pushed the cost of distance to a tipping point. Robotics, 3-D printing, delivery drones, logistics technology, autonomous vehicles and ubiquitous connectivity are giving rise to new products and services that sharply reduce the cost of moving people, goods and information. As these technologies combine and converge, change will accelerate, leading many industries to discover over the next decade that they are able to operate on a smaller scale and across a broader geographic scope, both of which were previously unprofitable.

With the cost of distance receding to an ever-diminishing constraint as sophisticated logistics bridge the last-mile cost of delivery of goods and services, new business models will emerge to reap the benefits. Mobility and new divisions of work, made possible by cloud-based collaboration and telecommuting, will raise the productivity of working at a distance. This combination will give rise to a broader scope of services available in remote locations. In an exurb of Dallas-Fort Worth, for example, Blackstone Group invested in Solana, a landmark office development that will be bordered by a new complex with a hotel, shopping village, fitness center and eight office buildings.

As the very nature of growth shifts, the foundations of some existing business models may turn out to be flawed, leaving many companies with stranded assets physically tied to the wrong locations or with businesses predicated on size, scale and density assumptions that have become obsolete.

## Five for 2025 (continued)

### The lengthening of longevity

An aging population, commonly thought to be one of the greatest long-term threats to continued economic growth and prosperity, may instead be a force for renewal. In advanced economies, where lifespans have been increasing by five years every two decades since 1970, the pace of increase may even accelerate with new advances in biotechnology and genomics as well as the emergence of a new medical paradigm that treats aging itself as a disease. The lengthening of healthy longevity will neutralize the economic drag of a shrinking working-age population as the definition of working age encompasses older workers who choose to remain employed. Indeed, Bain Macro Trends Group's analysis of OECD data found that a three-decade-long decline in retirement ages in the advanced economies has reversed and, on average, has risen modestly over the past decade. Advances in medicine and technology are also extending fertility, pushing out families' peak spending years well into late middle age.

For businesses, the impacts of this trend will be a more flexible and experienced workforce and a broader population of consumer households with more discretionary income. One example of a play on longer longevity is H.I.G. Growth Partners' investment in Integrity Nutraceuticals, a developer and manufacturer of supplements. The PE owners engineered Integrity's merger with Cornerstone Research and Development, a pharmaceutical-grade nutrients manufacturer, to broaden its product lines as demand for supplements from an aging but active population ramps up. In a similar vein, American Securities, a New York-based middle-market PE firm, acquired Learning Care Group, which operates networks of private, high-quality, for-profit preschools and should benefit as older couples with greater discretionary income have children later in life.

### From bell curve to barbell

The emergence of a new breed of scale technology providers is enabling small businesses to harness business capabilities that can match or beat those of far bigger rivals. Renting front-end logistics from Amazon, for example, or subscribing to information management services through Salesforce.com or relying on social media as their marketing platform, these nimble operators can conserve capital as they attack the most profitable pieces of the market, capitalizing on their low-cost advantages to focus only on niche segments that are challenging for larger players to target. The trend is shifting the distribution of competitive advantage. Instead of a bell curve distribution of small, midsize and large businesses across an industrial or service subsector, the shape of the competitive battlefield is changing and forming the shape of a barbell, with very large and very small enterprises thriving at the expense of less nimble and less endowed midsize enterprises. Innovative companies—from logistics giant UPS to Instacart, the start-up urban delivery service—are working to crack the challenge of bridging the final distance between sellers of these niche products and their customers.

Bain Capital recently placed a big bet on a nimble, entrepreneurial start-up called TOMS, prevailing over other PE firms in an auction for a 50% stake, which valued the business at \$625 million. Starting

### **Five for 2025 (continued)**

as a maker of specialized casual footwear, TOMS has branched out into apparel, eyewear and accessories, sourcing its products in Latin America, Asia and East Africa. The company sells its wares through major retailers like Nordstrom and directly through five of its own retail outlets and has a strong online business. TOMS has not only developed a solid, low-cost and fashion-forward business, its founder also runs the company as a philanthropic enterprise, donating its products or providing services to those in need for each item sold. Even with its charitable mission, the company's growth prospects are appealing, enough so that its founder was able to sell half of TOMS to a discerning PE fund.

### **Asia-Pacific ascendant**

Within the coming decade, the dynamic Asia-Pacific region will likely account for more than one-third of total global output, approaching that of Western Europe and North America combined. But the pattern of economic development across the region will look strikingly different. Improvements in economic output and rising household incomes will largely result from the climb of the population out of poverty and into the lowest rungs of the global middle class. Despite the region's rapid rise in living standards, however, per capita output will still be only about 15% that of the advanced economies. Sizable pockets of affluence will continue to expand across the region, but the bulk of Asia-Pacific's economic heft will come from its large population of more than 4 billion people—nearly six times that of North America and Western Europe combined.

To date, Asia has meant China with a dash of India for most investors. But China's region-dominating size does not reduce the riskiness of its market; it amplifies it, both within China and throughout the region. Indeed, no market within the Asia-Pacific region will provide outsized returns. Investing in a region with countries as diverse as Japan and Myanmar requires a thoughtful weighting of different markets. Portfolios will need to take into account the very different macroeconomic risks of the countries where they deploy capital—from lower-risk growth plays in Japan to higher-risk, higher-return bets in India and defensive positions in slowing markets such as China. Infrastructure and commodity-oriented investments, which once worked well as proxies for participating in rapid Chinese GDP growth, are giving way to more targeted plays that focus on narrow themes such as the growth of Chinese online retail. From a growth perspective, Asia-Pacific will provide the best global opportunities, but success will depend crucially on having an investment thesis that matches the opportunity (whether to capitalize on local growth or serve global markets) and an investment strategy to manage risk (by taking on a local partner or building long-term relationships). CVC Capital Partners' acquisition of a stake in PT Softex Indonesia, a top producer of infant-, adult- and feminine-care products serving Asia's fourth-largest market, portends vast growth potential in Indonesia's swelling and increasingly urban middle-class population. By combining its financial strength and long-term success in building household brands with PT Softex's position among the domestic leaders in its core segments, CVC expects to ride Indonesia's demographic and economic growth wave.

## Five for 2025 (continued)

### Capital superabundance

As PE investors try to work through the implications of the big new technological, geopolitical and demographic forces that they will face in the decade ahead, they will need to be prepared for the bracing challenges that global capital markets will present. The world is awash in financial capital and will remain in a state of capital superabundance through 2020 and beyond. Indeed, a new breed of nonbank financial companies has emerged to facilitate the flow of that plentiful capital to smaller businesses looking to tap lines of credit in the private debt markets. One of these, Kabbage, a 2009 venture-backed start-up that initially focused on helping to capitalize online businesses, rocketed to \$1 billion in working capital by late 2015.

Bain's macro trends analysis projects that by 2020, total financial assets will increase by 50% over 2010, to some \$900 trillion, or about 10 times the total output of the real global economy. The forces that created capital superabundance will remain in place beyond the end of the decade, continuing to swell the pool of global financial capital. So much money in the hands of investors hungry for ways to put it to work productively will consequently keep interest rates under pressure. Average returns on capital invested will continue to appear low by historical standards, but volatility and the formation of investment bubbles will remain as threats.

## Build a repeatable model for creating value across your portfolio

The turbulent investment climate of recent years has impressed upon nearly every PE firm worth its carry how important strong value-creation skills have become for grooming portfolios that can earn top-quartile returns. Sky-high asset valuations and acquisition multiples, sluggish macroeconomic growth and topped-out public equity indexes have dampened the passive market beta that GPs have long relied upon to push up portfolio returns. Today, many leading PE investors recognize that only by generating alpha through active portfolio management can they deliver results that LPs look for and markets will reward.

The challenge and the efforts to address it are not new. Some PE firms have recognized the need to develop portfolio-wide value-creation capabilities since the industry's earliest days, and many more have experimented with a variety of approaches to boost fund returns in the ever-more competitive landscape of the past decade. Indeed, longtime readers of Bain's Global Private Equity reports will recognize that portfolio value creation is a theme we've harped on consistently over the past seven years.

Yet, attempts to implant portfolio value-creation capabilities have too often been halting, scattershot and, in some cases, ineffective—and, even as 2016 began, too often nonexistent. A Bain analysis of the size and composition of resources committed to portfolio value creation at 40 major PE firms found that fully one-quarter of the firms had no dedicated internal portfolio resources at all.

PE professionals have been candid in recognizing their shortcomings. A recent Bain survey of operating partners hired to head up portfolio value-creation initiatives found that only half of the respondents said that their firm had developed a clearly defined model for how to proceed (*see Figure 2.13*). Just 40% report that their portfolio management teams are fully staffed and focused on the right priorities. One-third of the respondents said their portfolio value-creation programs had not won the full backing of their firm's deal partners.

There is no one winning formula for getting this right, but the inconsistencies do share many of the same characteristics. Survey respondents report that their value-creation plans fall short because their portfolio management teams do not have the requisite skills to pull them off, and the plans are too ambitious, lack sufficient resources to achieve their goals, fail to win buy-in from management or do not receive adequate board oversight (*see Figure 2.14*). Even circumstances that derail value-creation programs that are ostensibly beyond the control of a PE portfolio management team, such as unforeseen competitive challenges or a business cycle downturn, would be within the scope of value-creation efforts that begin early and are considered during due diligence.

The shortcomings of some PE firms' portfolio value-creation plans stem from the fact that they often originate not as efforts to take an integrated view of the portfolio but are organized instead as solutions seeking problems rather than the other way around. One manifestation of this could be called the "fireman approach" that was popular in the immediate aftermath of the 2008 financial crisis. Seeing that some of their portfolio holdings were going up in flames, PE firms rushed to hire a handful of seasoned experts, often former management consultants, to help douse their problems. However, lacking a comprehensive understanding of how to proceed, the new hires more often than not found themselves battling for relevance by trying to rescue a small number of broken deals rather than driving value across the portfolio.

Another common value-creation misfire might be called the "hammers seeking nails" approach. Recognizing that many of their portfolio companies shared common problems, PE firms hired technical specialists to fix them. Too often, however, the experts lacked the proper oversight to ensure that they focused on the right issues.

Having achieved the predictable results from flawed approaches, some PE firms are beginning to recognize that a solid portfolio value-creation program needs to flow organically from a firm's unique strategy and values. Bain believes that any properly structured approach should be consistent in the way it acts across companies and address three interlinked issues: the firm's philosophy, or its guiding objectives for value creation; its engagement model, or when, on what issues, how and with what resources it will intervene in its portfolio companies; and its organization, or what talent it needs (both internal and external) to execute the model and their roles and responsibilities for achieving success. In the following section, we examine each in turn and look at four archetypal portfolio value-creation program approaches that leading PE firms have implemented in ways that best suit them.

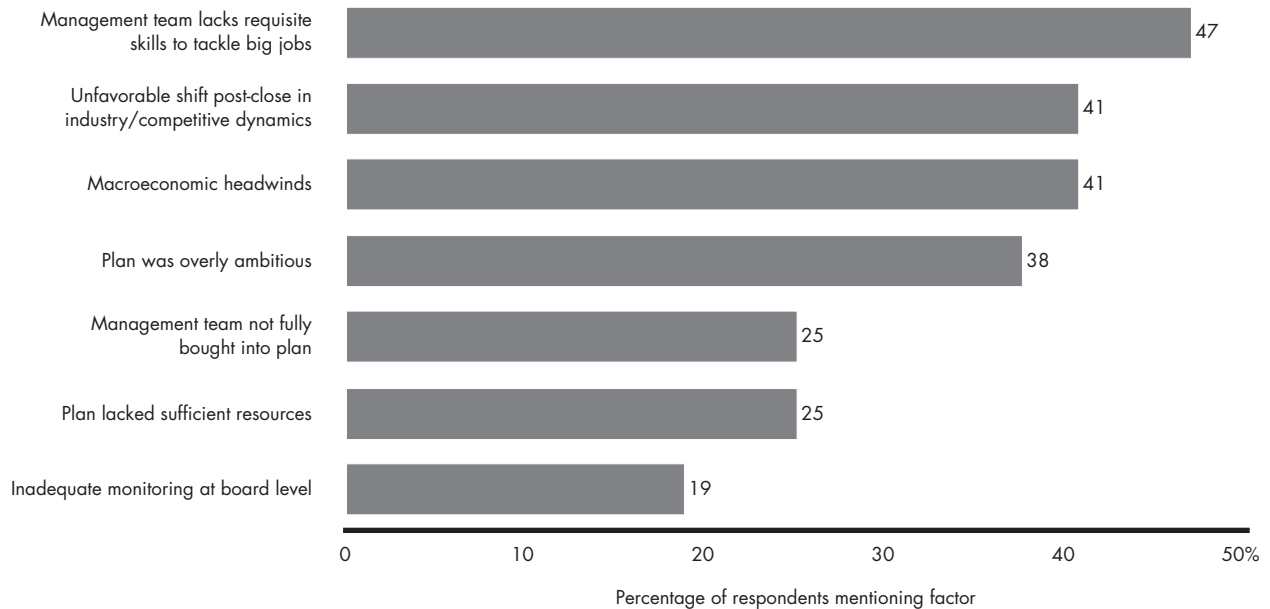
**The general activist model.** Many large, well-capitalized PE firms build portfolio activism into their DNA. Their multidisciplinary operating teams bring a high level of engagement to each deal they do across the broad range of industries and sectors in which the firm invests. For example, with its globe-spanning portfolio holdings, Bain Capital tackles value creation with a portfolio group structure comprising a sizable number of dedicated full-time employees, most of whom are former management consultants. A firm-wide resource, the portfolio teams work closely with the newly acquired companies in the year after deals close, providing deep strategic analysis, supporting the development of value-creation blueprints and helping management teams put them into operation.

**Figure 2.13:** Most private equity firms are building portfolio value-creation capabilities, but only half say they have a clearly defined model



Note: Respondents are operating partners of US private equity firms  
Source: Bain survey (n=34)

**Figure 2.14:** Why value-creation plans fail



Note: Respondents are operating partners of US private equity firms  
Source: Bain survey (n=34)

Similar to other general activists, Bain Capital engages with portfolio companies by placing a consistent emphasis on immediate post-acquisition collaboration with management, particularly during the first and second years of ownership. Together, they set out to create detailed, actionable blueprints and help launch and support a set of high-priority initiatives. The principal focus is on achieving significant top-line growth. In-house Bain Capital teams typically initiate the blueprint process, put resources behind it and work day to day, and use an appropriate dashboard of key metrics to monitor the results, but portfolio company management owns the initiatives and is accountable for the outcomes.

**The maestro model.** A variant of the general activist approach, this model places the same emphasis on early, high-level and continuous engagement with management of the firm's holdings across the entire portfolio, but it is well suited for PE firms that lack the resources or desire to staff expensive in-house operating teams. Instead, the firm designates a senior managing director, working with a small internal staff and the firm's individual deal teams, to coordinate and bring harmony to a pickup ensemble of external experts who help develop and implement value-creation plans. In this model, the maestro-led team adopts a collaborative approach with newly acquired companies to shape a value-creation blueprint immediately post-close, support management on special projects, serve on portfolio company boards and monitor exit options continuously. Once the value-creation plan is agreed to and adopted, the firm delegates implementation to its portfolio company managers, who are accountable for results.

**The adviser-led model.** With an orientation to provide less interventionist support to portfolio company executive teams on a deal-by-deal basis, PE firms that adopt an adviser-led approach actively lean in on selected investments to help shape the management team's goals and supply resources to enable it to achieve them. Adviser-led value creators typically eschew hiring dedicated portfolio operations teams and instead assemble a large network of outside experts who can parachute in to address focused needs or take on discrete technical roles.

Investing across a broad spectrum of sectors and geographies, Sweden-based EQT Partners begins tendering advice to senior management of its new portfolio companies early in their relationship. The principal focus of EQT's value-creation model is to enhance long-term growth through market and product expansion and strategic repositioning. The advisory roles that EQT's model puts in place span both financial and operational strategies. EQT advisers counsel management teams on how to optimize their capital structure and help them evaluate what bolt-on acquisitions can best enhance their strategic growth objectives. EQT deal teams take a lead role in monitoring the value-creation agenda that the firm sets while portfolio company management teams, acting as partners and co-owners, implement the action initiatives day to day, calling in support from EQT advisory teams (or from the stable of approximately 90 external advisers that the firm maintains) as conditions warrant.

**The functional-playbook model.** Some activists take a more hands-on prescriptive approach for creating value in their portfolio companies. For example, Vista Equity Partners, a US-based firm that focuses on acquiring software and technology-enabled businesses, has refined a proprietary playbook it calls "Vista standard operating procedures" (VSOP) that it applies to each of its portfolio holdings. Highly selective in choosing to invest in just a few best-in-class companies each year, Vista engages early to impose VSOP as its proven formula for adding value, and it sticks with the script throughout the duration of its ownership.

PE firms that take a specialized functional approach to value creation need seasoned, full-time experts who can lead a cost-reduction program, achieve far-reaching operational improvements or implement other focused initiatives that make up their value-creation playbook. At Vista, six operations professionals, supported by members of the Vista consulting group with functional expertise in areas such as cost optimization and sales management, provide

heavy support. However, Vista's deal team directors remain on point for maintaining relationships with portfolio companies' senior leaders and are accountable with them for implementation of the value-creation plan.

As different as they are, these models do share some common best practices. For one thing, the leaders staff their portfolio teams with the right experience and motivate their talent with the right incentives to achieve value-creation results. They ensure that there is clear buy-in across their organization about who has ownership of and accountability for value creation. They draw clear boundaries between the roles and responsibilities of deal teams, portfolio teams and external adviser networks. And they set firm decision rules for assigning their functional experts to initiatives that present the maximum value-creation opportunities.

### **Consistency is critical**

Top PE value creators are learning where and how to achieve the highest returns on their costly investment in portfolio management resources. The leaders apply a consistent process across all deals, using their value-creation plans to zero in on initiatives that offer the best opportunity to improve a portfolio company's performance. The high performers put resources on those that will yield the best overall return.

Ongoing changes in the PE investment climate will continue to favor the activist portfolio value creators over the longer term. Since 2008, the median length of time that assets sit in PE portfolios has stretched from less than 3.5 years to more than 5.5 years, yet only about a third of the PE firm managing directors that Bain surveyed reported that their firms refreshed value-creation plans for a majority of their funds' assets held for more than three years. This presents an opportunity for the activists. PE firms that nurture strong portfolio value-creation capabilities and apply them consistently will almost certainly see their performance advantage increase over their more passive rivals.

## Key takeaways

- Record-level cash distributions to LPs over the past two years resulted in a huge influx of capital seeking to be redeployed into private equity. With top-performing PE funds oversubscribed, this surplus capital is spilling over to funds whose predecessors were only third- or fourth-quartile performers. On average, these funds exceeded their target fund-raising in 2015.
- The flood of new fund-raising capital masks a shifting landscape as many LPs aim to streamline their PE holdings, reducing their administrative costs and negotiating more favorable fees and terms by writing bigger checks to fewer GPs.
- As today's favorable fund-raising conditions slow over the coming year or two, GPs will need to be able to demonstrate to LPs that they have a sharply honed and differentiated strategy for achieving superior performance.
- There are many ways to do this, and no firm can excel at all of them. Successful firms will identify and focus on areas in which they have a natural advantage and build their strategies around them. Many PE firms are testing novel pathways to differentiation that show promise and will become increasingly important in the years ahead.
- First, some firms are sharpening their focus on their investment sweet spots, enabling them to zero in on deals with characteristics that best match the firm's unique strengths, capabilities and past patterns of success. This is allowing them to effectively communicate both internally and with LPs the types of deals they will target and to build their expertise to capitalize on these deals.
- Second, other PE firms are developing thematic investment insights to capitalize on broad macro trends and gain an investment edge. They are applying their in-depth understanding of key trends to identify and evaluate businesses and sectors that will see long-term sustainable growth.
- Finally, more PE firms are mobilizing their talent and resources to develop repeatable approaches for creating value across their fund portfolios. They are adopting value-creation models that reflect their firms' unique philosophy and distinctive investment preferences while ensuring that their methods for enhancing the value of their portfolio companies are consistent and focused.



### 3. Paying for growth while waiting for the recession

As every PE investor who has weathered past turns of the business cycle knows, recessions have a powerful way of concentrating the mind. For most, an economic downturn derails business plans, curtails access to credit needed for financing new acquisitions and freezes exit channels, cutting deeply into returns. For those nimble and adaptable enough to fortify themselves against inevitable economic headwinds, a recession can be a time to shore up portfolios and seize new opportunities.

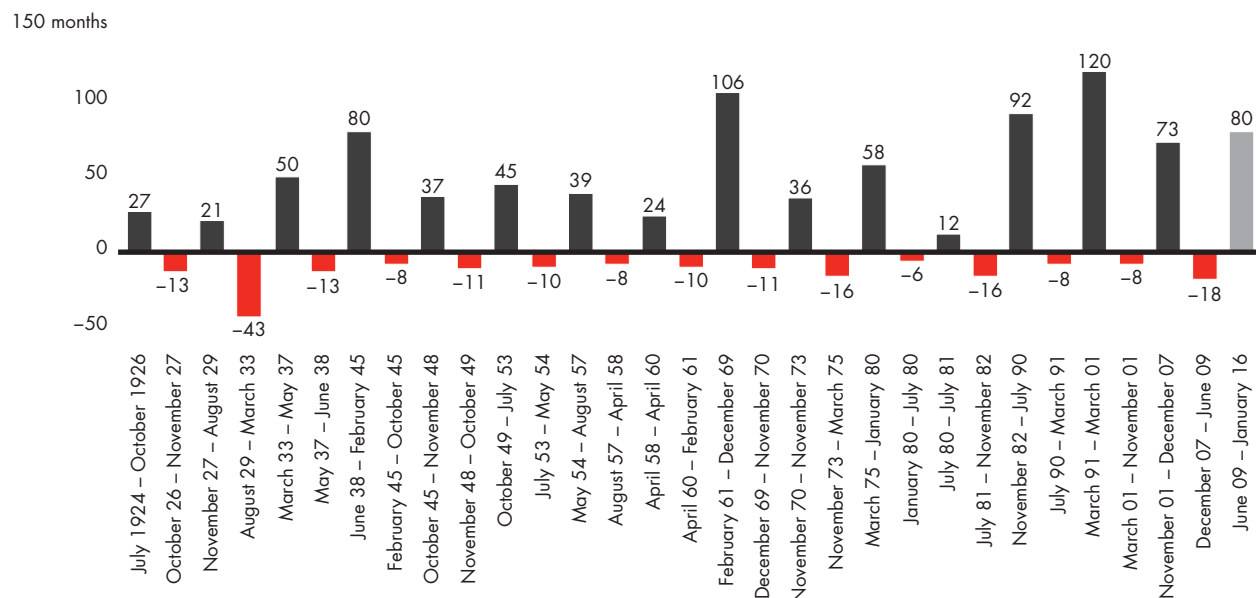
GPs may soon find themselves facing the test. With the economies of most developed countries struggling, China in the grips of a major slowdown and the aging US expansion staggering toward its seventh anniversary, the period ahead could see the stalling of global growth (see Figure 3.1). A recession, or even continued near-zero growth, could wreak havoc on the holdings currently in PE portfolios and on investments GPs will make over the coming year.

#### Have you stormproofed your portfolio?

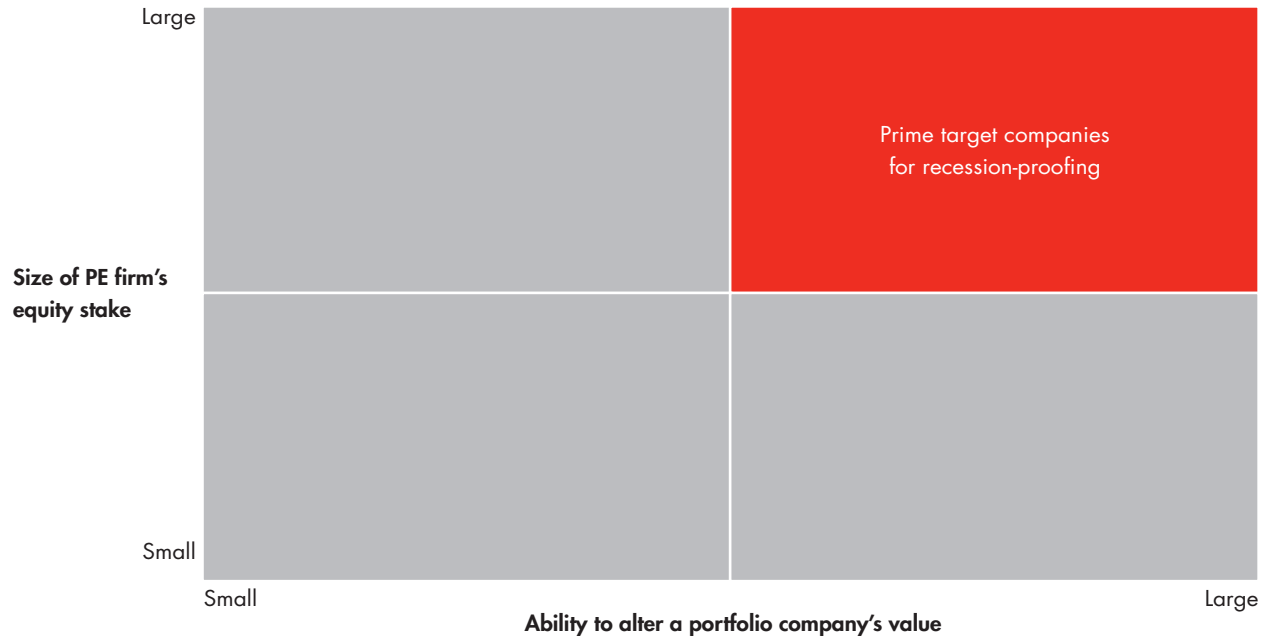
The timing of recessions is hard to predict, but just as no one wants to have to fix the roof during a hurricane, the time for PE firms to prepare for a downturn is before the storm hits. Portfolio assets acquired within the past two or three years are particularly susceptible to buffeting by economic turbulence. Purchased at prevailing high multiples and under sunny economic skies, many of these holdings were set up for exit sooner rather than later.

Figure 3.1: As the current expansion nears its seventh anniversary, GPs must weigh future recession risks

Length of US expansion and recession periods



Source: Bain analysis

*Figure 3.2:* Where to invest resources when recession-proofing your portfolio

Source: Bain &amp; Company

But as recession clouds gather, GPs are likely to end up keeping many of these holdings until exit channels open up with a recovery.

GPs that remain stewards of their assets for longer than they had expected will want to weigh how best to insulate them from economic headwinds and to set them up to prosper when conditions improve. Since it is difficult to devote adequate resources to recession-proof every asset in their portfolio, GPs will need to do some basic triage as a first step in determining where and how to intervene. One effective way to identify which holdings should be the focus of their efforts is to sort a fund's deals by the size of the fund's equity investment and by the GP's ability to enhance the value of a given asset. Assets that cluster in the upper right-hand quadrant should be the prime candidates for funds' recession-proofing efforts (*see Figure 3.2*).

**Refresh your due diligence.** To size up the vulnerabilities a holding may face in a weaker economy, it pays to revisit two issues: whether the potential that originally made it an attractive investment still prevails and what course corrections to the value-creation plan may be needed to position the asset to ride out a downturn. GPs that do this well examine the cost reductions and the revenue-enhancing adjustments that their portfolio companies can make now to squeeze everything they can out of their top and bottom lines. Putting every aspect of operations under a cost X-ray, they look for ways to work with suppliers and cut overhead to maximize savings, which will reduce pressure on EBITDA growth. They then look for opportunities to strengthen EBITDA and cushion their portfolio company's bottom line against slower demand by undertaking a revenue hunt to turn up ways to boost topline growth, for example, by identifying low-cost service enhancements or reexamining pricing and discount policies.

**Tighten up the balance sheet.** The period heading into an economic slowdown is also a crucial time for GPs to scrutinize the balance sheets of their priority portfolio companies, with the principal goal of optimizing their capital structure. Smart GPs will explore ways to tap still-accommodating credit markets to refinance portfolio-company debt with covenant-lite loans or bonds that will pinch less if a recession hits. Recognizing that exit conditions may deteriorate in the period ahead, they also look for opportunities to de-risk their investments by freeing up cash from the balance sheet and using it to pay down debt.

## How will you put capital to work ahead of a slowing economy?

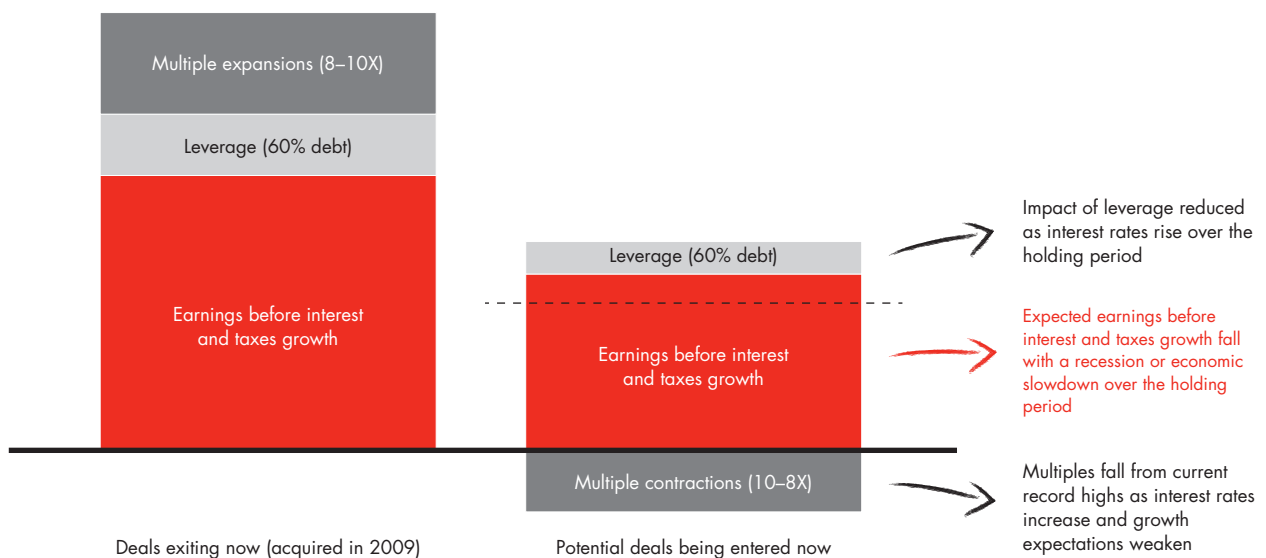
With record amounts of dry powder in GPs' hands waiting to be deployed, PE funds must put capital to work notwithstanding uncertain conditions. But investing at today's high acquisition multiples while facing the mounting prospect of a downturn requires special care and discernment. Three common features of a recession—declining EBITDA, a tougher credit environment and shrinking deal multiples—point to the potential for major compression of returns on PE transactions made today (see Figure 3.3). Even modest changes in the underlying economic environment could have a dramatic effect on the multiple on invested capital earned.

### 1. Look for businesses that can shift their growth trajectory.

The growth that many PE firms covet in the companies they acquire can come in various forms. The most conventional—and simplest—is to rev up the company's core business by increasing its market share or by taking other steps that enable it to outpace its competitors in order to beat priced-in expectations and generate higher EBITDA. This has been a familiar path some GPs have long followed to great effect. According to Bain research,

*Figure 3.3:* Potential future returns will be unlikely to match those of recent exits

Theoretical multiple on invested capital on leveraged buyout deal



Source: Bain LBO model

conducted with PE investment advisory firm CEPRES, PE-owned companies have significantly outperformed their underlying industries' boom and bust periods over the past 15 years (see Figure 3.4).

As growth stalls across the economy during a downturn, GPs will need to broaden the growth potential of their portfolio companies by seeking out ways to expand the markets in which they compete. That is what Bain Capital, The Carlyle Group and Thomas H. Lee Partners did with Dunkin' Brands Group, the quick-service restaurant chain they co-owned, following the 2008 recession. Although Dunkin' Donuts outlets were plentiful and strong across New England, the PE owners recognized that the brand was underrepresented across the rest of the country, where Starbucks dominated. Seeing an opportunity for Dunkin' Donuts to occupy a strong No. 2 position as a national brand, they took advantage of the business' limited cyclical— that people continue to buy their morning coffee, recession or not—and aggressively expanded Dunkin' stores. The strategy worked, and the owners took the business public in 2011 at a valuation of \$2.4 billion—some 60% more than its enterprise value at acquisition.

**2. Use your due diligence to ferret out operational improvements that can generate a significant earnings boost.**

PE firms commonly rely on commercial due diligence to understand a potential acquisition's competitive market position and to investigate how their ownership can help the target company boost its revenue and growth potential. But anticipating stronger economic headwinds, forward-looking GPs are deepening their operational due diligence to bring rigor to their evaluation of a target's cost structure and cash position.

Figure 3.4: PE-backed companies typically outgrow their underlying markets



Note: Based on a blended average of 4,800 PE-owned companies compared with an identically weighted basket of market growth rates for their respective industries and regions  
Sources: CEPRES, IHS, Bain analysis


Rather than impose simple across-the-board cost reductions and working capital goals, these GPs sniff out potential ways to beat industry benchmarks, capturing margin improvements that rely on prudent management in any growth environment. For example, a leading European buyout firm deepened its due diligence for a contemplated acquisition of a consumer products company, investigating ways to reduce costs across procurement, administrative overhead and factory operations. Digging into procurement, the diligence process examined the company's spending for each category of purchases the company had made, compared them with external benchmarks and mapped out potential savings. In the end, the PE firm identified potential cost savings in the range of 8% to 13% over three years—solid evidence that the deal would work.

When managing assets in recessionary times, the best of all possible outcomes is to capture the benefits of both cost reductions and growth. That's what Montagu Private Equity, a London-based European buyout firm, did during the last recession with its portfolio company BSN Medical, a specialist in the low-growth businesses of compression therapy, wound care and orthopedics products. Montagu bought BSN in 2006. Seeing the 2008 downturn as an opportunity to roll up smaller competitors in these markets and also move into new territories, Montagu helped BSN buy growth, making a series of acquisitions in the space while cutting costs. When Montagu sold BSN in 2012 to the Stockholm-based PE firm EQT Partners, BSN's revenue had increased by 40%—but EBITDA on the back of cost reductions had grown by 80%.

### **3. Seek out companies in sectors well positioned to ride out a downturn.**

When recession risks hover over the horizon, prudent GPs need to assess how well sectors are apt to perform during a period of economic slowdown. Some industries—like pharmaceuticals, education services and utilities—are resistant to cyclical downturns, and some even prosper. An economically grounded due diligence will surface these assets, of course, and competition for them will keep their acquisition prices high. But a deeper dive can also uncover countercyclical pockets of opportunity for companies that normally feel the effects of a business contraction. Industrial equipment manufacturers, for example, typically see their new sales drop during a recession as their customers curtail capital investments. Some, however, can offset those losses by beefing up service offerings that can extend the life of their installed base of equipment. Both cyclical and countercyclical business dynamics need to be key parts of any due diligence and major factors in determining the multiple a PE fund is willing to pay and in structuring the financing of a new acquisition.

CVC Capital made a smart countercyclical play ahead of the last recession when it bought 206 outlets of Matas, a Danish health and beauty aids retailer, in early 2007. People get sick during good and bad economic times, of course, keeping a solid countercyclical floor under the healthcare lines. Beauty aids also are a product category that people continue to indulge in during recessions. Thus Matas benefited from very little downside exposure when a recession hit later in the year and rode out the downturn with its core business intact. CVC consolidated sourcing and purchasing to gain operating efficiencies that helped boost margins. As the economy recovered, Matas built on the advantages it had nurtured through the downturn, raising sales of its popular store-brand cosmetics lines by developing the largest customer loyalty program in Denmark and by selling online. Under CVC's ownership, Matas strengthened its leadership position as Denmark's largest health and beauty aids retailer.

Turns in the economic cycle are inevitable. PE firms that have felt recession's bite have learned from hard experience that, during economic expansions, it is wise to be a bit paranoid about how long good times will last. The cost of spending a little time bolstering current holdings and getting new deals right is not nearly as high as trying to rescue investments when it may be too late. 

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