Grant Thornton

An instinct for growth™

Creating growth:

the challenge of buying well in today's market

Global private equity report 2014/15

Foreword

Private equity has always focused on creating value and helping promote growth in portfolio companies. Since the industry began, private equity firms have tried many ways to meet this ultimate objective – and with varying success. Now, post the global financial crisis, the question being asked more than ever is: how can private equity deliver its value-added promises?

Whilst the market has benefitted from wider exit options and an improvement in the fundraising climate, at the same time as debt finance markets have eased, finding good quality deals at good prices is proving a real challenge for many private equity buyers. There is so much more competition both in developed and emerging markets.

In addition to the private equity cycle adding to the pot of money looking for a home, LPs themselves are increasingly seeking to put funds to work directly, representing another source of competition for the best deals.

Then there are corporate buyers and such is their hunger in certain sectors right now that, even with favourable debt markets, it is tough for private equity to compete.

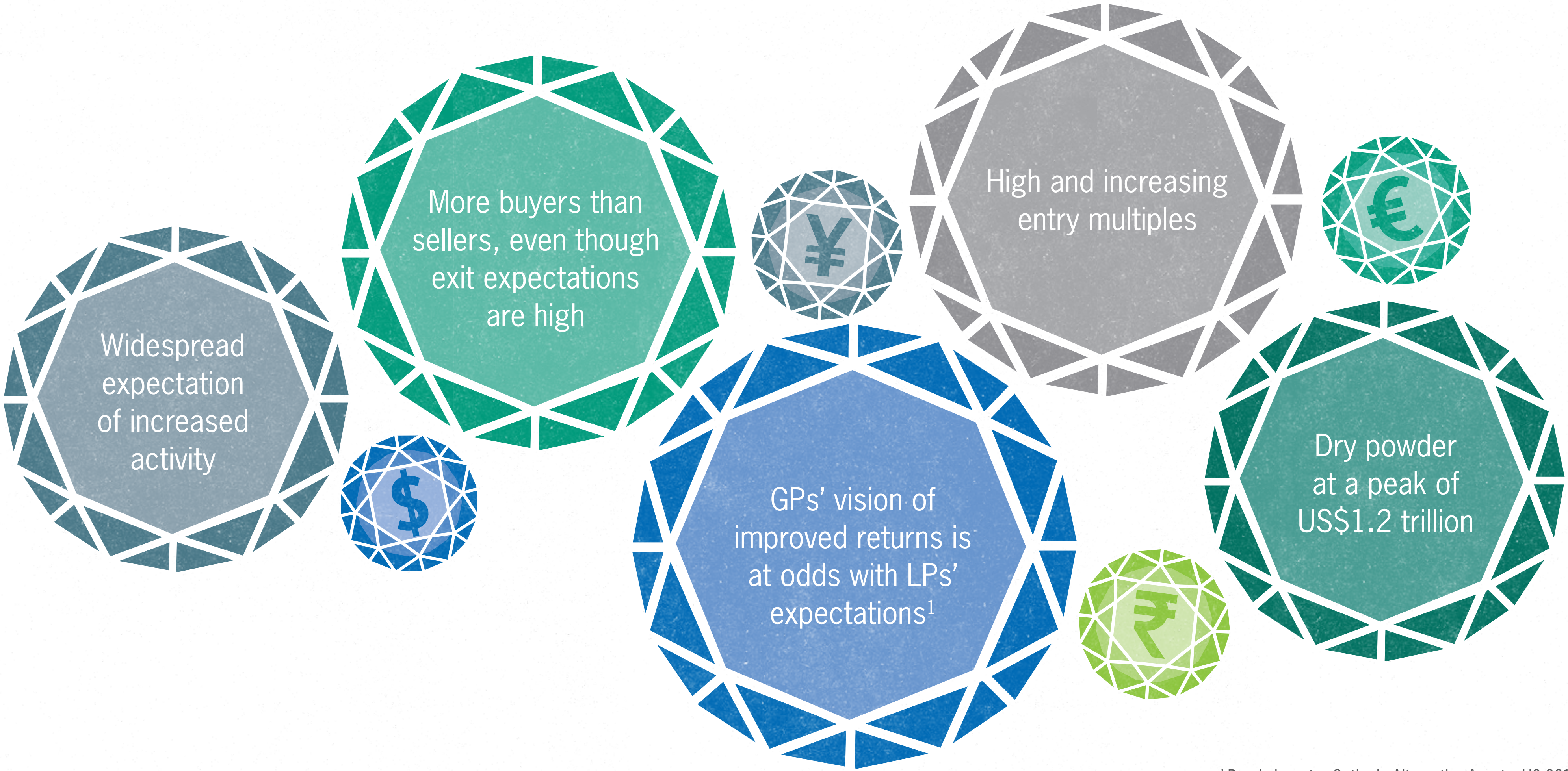
More competition means one thing: higher prices. And higher prices at entry make it harder to achieve attractive returns at exit. This means there is a growing and clear emphasis on how to generate the value needed to justify the commitment of further capital and costs to private equity.

Put simply, the responsibility is with private equity firms to identify and pull the most important levers in the value generation machine that most now either have, or at least recognise, they need to build.

This is the fourth annual Grant Thornton global private equity survey and we interviewed **175** private equity firms from across the globe. This year we focus on the themes of 'buying well' in today's market, and the role that secondary buyouts are playing in this challenging but fast-moving environment.

Contents

1 Private equity dashboard:
looking at the current environment



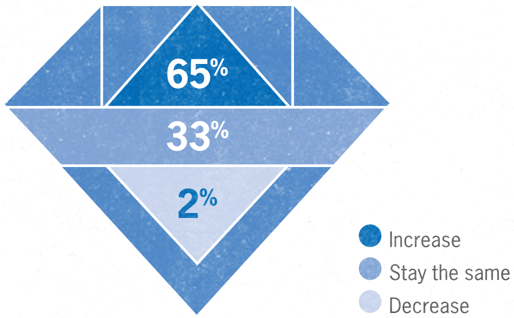
[1] Preqin Investor Outlook: Alternative Assets, H2 2014

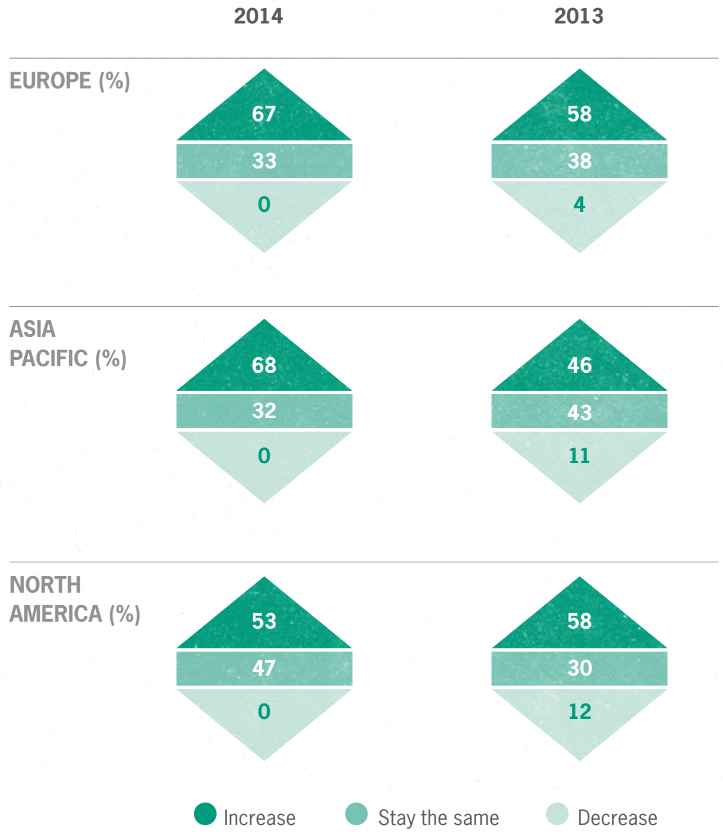
Great expectations: predicted increase in private equity investment activity

Headlines

- 65% foresee an increase in deal volumes over the next 12 months.
- Expectations for an increase in deal activity have risen year-on-year in both Europe and Asia Pacific.
- North America shows a small year on year decline, which we attribute to:
  - high levels of competition for deals and pricing
  - a rapid recovery in credit markets following the global financial crisis, stimulating an earlier turnaround in activity levels in this region.

DO YOU EXPECT PRIVATE EQUITY INVESTMENT ACTIVITY IN YOUR COUNTRY TO INCREASE, DECREASE, OR STAY THE SAME OVER THE NEXT 12 MONTHS?





"It's hard to see activity increasing given present competition and multiples."

USA

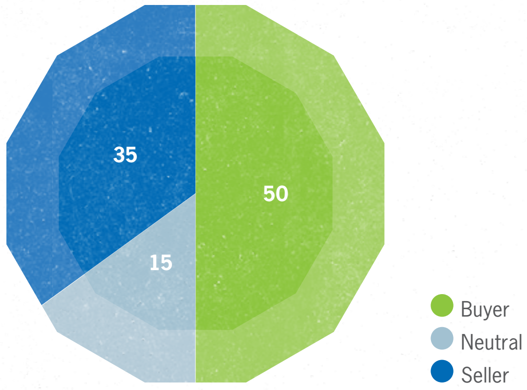
Exit activity expectations remain high

Headlines

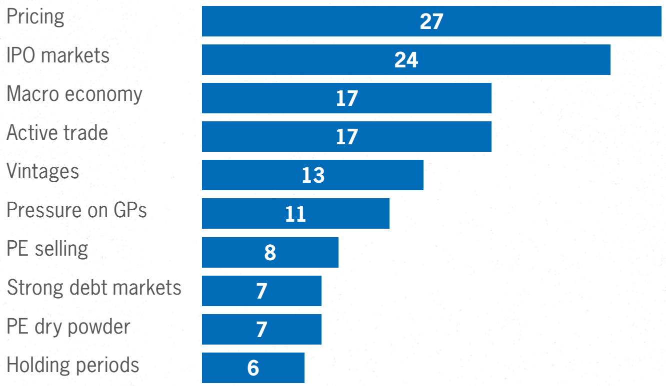
- Expectations for an increase in exit activity remain high.
- Strong valuations, improving IPO markets and a positive macro environment are seen as key drivers, as are the stage in the cycle of many PE funds and the associated pressure to generate liquidity.
- Despite this, GPs foresee more buying than selling in the year ahead. This reflects the predicted increase in deal volumes as GPs seek to find a home for the dry powder built up through fundraising campaigns.

DO YOU EXPECT LEVELS OF EXIT ACTIVITY ACROSS THE MARKET TO INCREASE, DECREASE OR STAY THE SAME OVER THE NEXT 12 MONTHS? (%)

DO YOU EXPECT TO BE A NET BUYER OR SELLER OF ASSETS OVER THE NEXT YEAR? (%)



WHAT DO YOU SEE AS THE KEY DRIVERS OF THIS? (% OF PE FIRMS SURVEYED REFERENCING THIS CRITERIA)

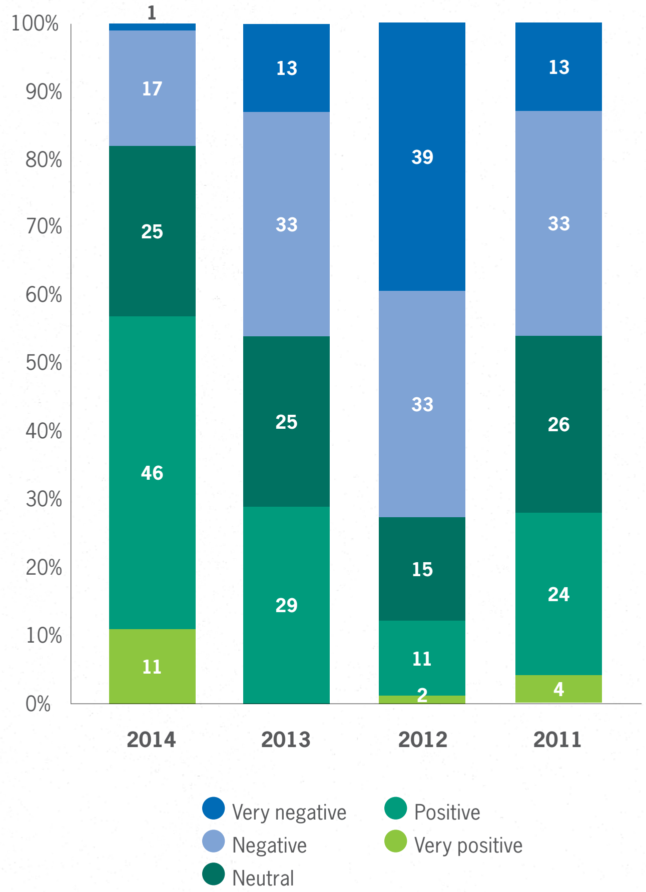


A peak in dry powder

Headlines

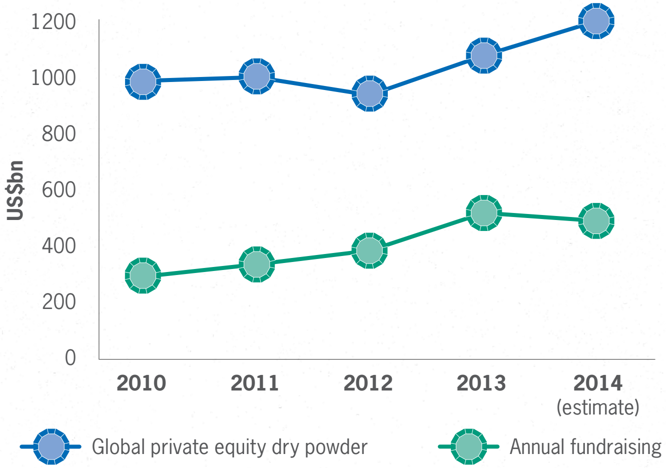
- The volume of dry powder looking for a home is US$1.2 trillion.
- This liquidity makes it unsurprising that the proportion of GPs expecting a rise in entry multiples continues to grow, rising to 42% of firms surveyed in 2014.
- In recent times, dry powder levels have been driven by an up-tick in fundraising. However, this has yet to work its way through the system in terms of increased investment levels, which inevitably lag behind.

HOW DO YOU VIEW THE CURRENT FUNDRAISING ENVIRONMENT? (%)



DO YOU FORESEE ENTRY MULTIPLES INCREASING, DECREASING OR STAYING THE SAME IN YOUR MARKET OVER THE NEXT 12 MONTHS? (%)

DRY POWDER/FUNDRAISING ($)



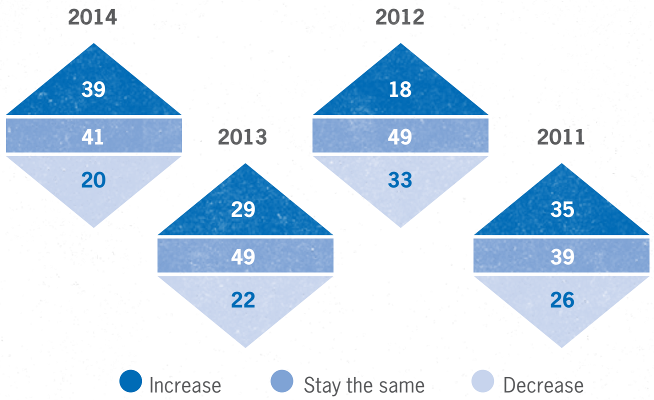
Source: Prequin: Q3 2014, Private Equity Funding

GPs positive about increase in average returns

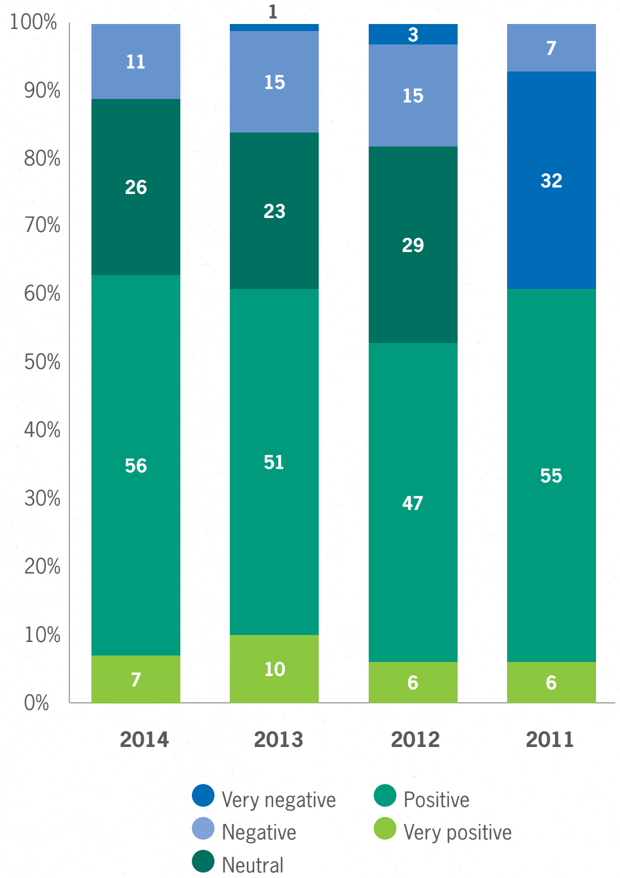
Headlines

- The number of GPs expecting average returns to increase continues its upward trend. With increasing entry multiples the challenge on delivering against this expectation is heightened.
- GPs remain broadly optimistic in respect of the economic outlook for their portfolio companies, which further supports the assertion of improved returns.

DO YOU EXPECT AVERAGE RETURNS TO INCREASE, DECREASE OR STAY THE SAME OVER THE NEXT 12 MONTHS? (%)



HOW POSITIVE DO YOU FEEL ABOUT THE ECONOMIC OUTLOOK OVER THE NEXT 12 MONTHS IN YOUR REGION FOR YOUR PORTFOLIO BUSINESSES? (%)

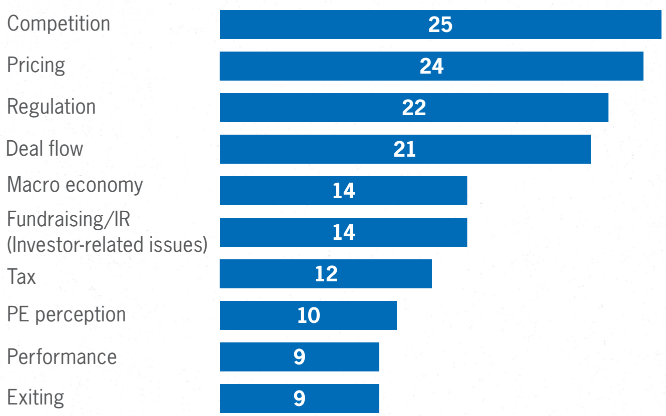


Competition challenges and sector specific opportunities

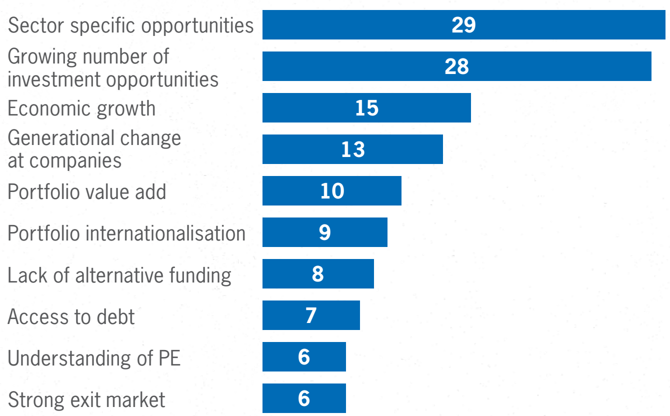
Headlines

- Private equity firms are faced with increased competition, pricing and dealflow issues.
- GPs believe that good deals can be found when they use sector specific insight. There is a real need to find an 'angle' which can be translated into a tailored plan for generating value with a particular asset.

WHAT DO YOU BELIEVE ARE THE KEY CHALLENGES FACING PRIVATE EQUITY AT THIS POINT IN TIME? (%)



WHAT DO YOU BELIEVE ARE THE GREATEST OPPORTUNITIES FOR PE IN YOUR HOME MARKET? (%)



"The main challenge is competition. There are too many GPs around, and too much capital to chase only a thin layer of deals."

CHINA

"Big changes in energy, healthcare and manufacturing will create big opportunities for private equity."

USA

2 Buying well

Old fashioned multiple arbitrage is not enough

It's never been more important to have a robust plan to create value

GPs must do more to get to know management pre-deal and really understand their ability to deliver the plan

Deal origination networks have never been more critical to buying well

Some evidence that driving returns is an increasing priority over entry price

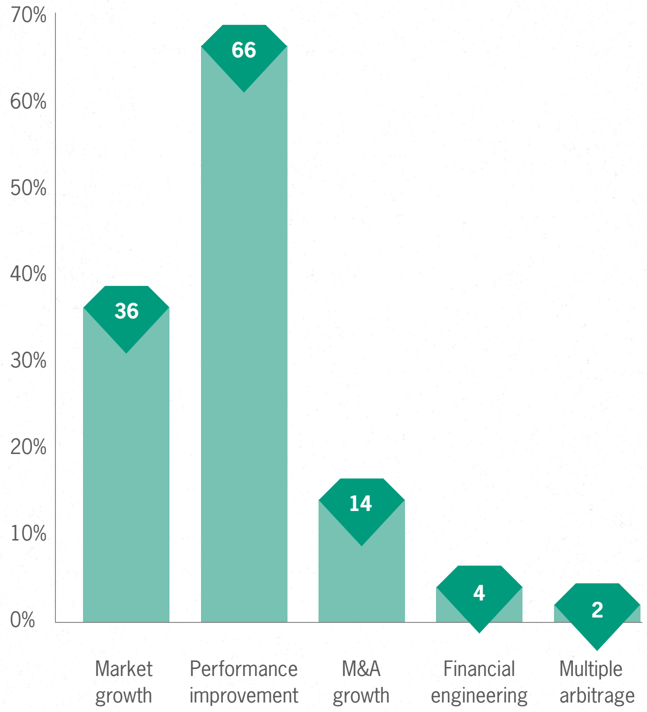
Management issues are the biggest reason deals collapse

Old fashioned multiple arbitrage is not enough

Headlines

- Performance improvement in portfolio businesses is the key driver of returns.
- The perceived significance of M&A as a growth driver has fallen this year, perhaps reflecting a focus on organic growth and the reality of current high purchase prices.
- Market growth is the second most significant driver of returns (most important in Latin America, and a close second in India).

WHAT DO YOU SEE AS THE MAIN PORTFOLIO VALUE DRIVER OVER THE NEXT 12 MONTHS? (%)



"The question is: how good is your thinking on what you are going to do with the business before you buy it?"

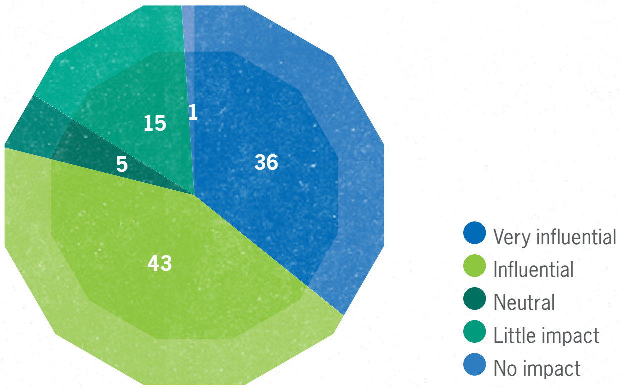
UK

What is the ‘right’ price?

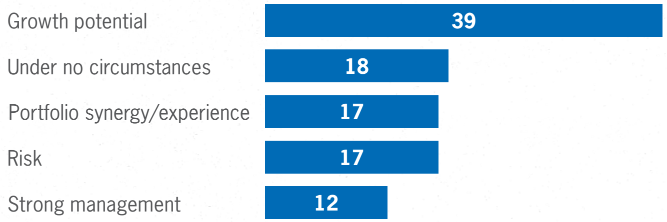
Headlines

- Only **36%** of GPs felt deal performance was ‘very influenced’ by the entry price.
- GPs indicate that they are prepared to pay a premium in certain circumstances, particularly if the company shows strong growth potential or operates in an area in which the GP has specific knowledge and experience.
- Unsurprisingly GPs are prepared to pay more to secure deals if they have clarity on the growth potential of the business.

TO WHAT EXTENT DO YOU BELIEVE THAT YOU CAN INFLUENCE THE ULTIMATE PERFORMANCE OF A DEAL AT THE INITIAL PRICE NEGOTIATION STAGE? (%)



REASONS FOR PAYING A PREMIUM (%)

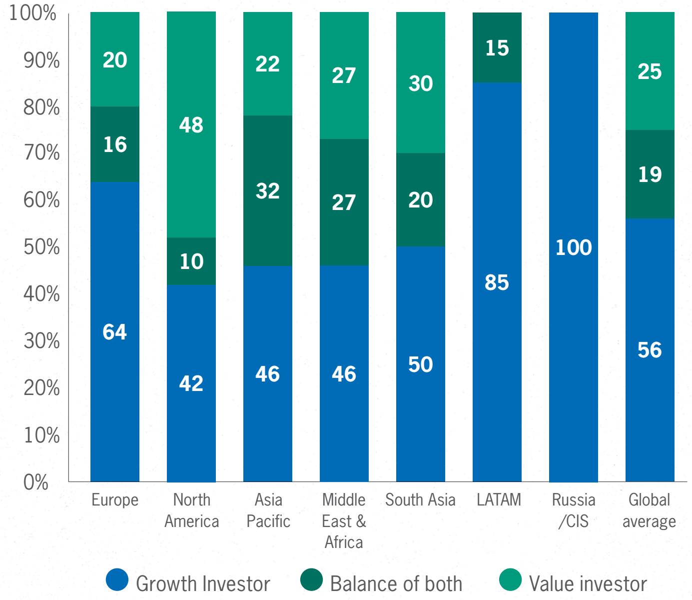


The company is more important than the market

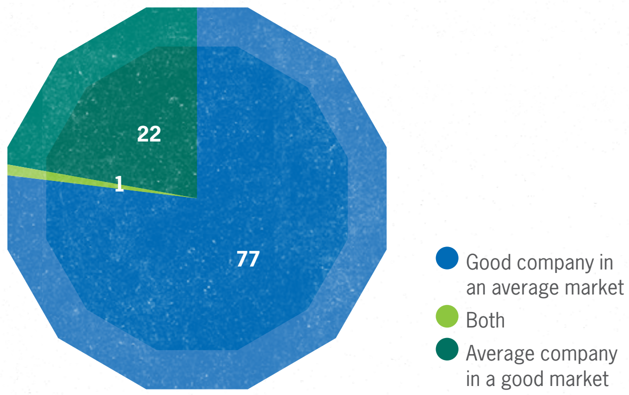
Headlines

- Given that exceptional growth potential can provide justification for paying a premium, it is not surprising that more GPs see themselves as 'growth' rather than 'value' investors. This is reflected in the competitive and pricing market pressures.
- Interestingly, in the highly competitive North American market, views are more even. Slightly more GPs describe themselves as value investors as they seek opportunities at lower multiples, rather than growth investors.
- While a growing market will always be attractive, GPs place more emphasis on finding good companies. Over three-quarters of respondents claim that finding a good company in an average market is better than identifying an average company in a good market.

DO YOU CONSIDER YOURSELF A GROWTH INVESTOR, A VALUE INVESTOR, OR SOMETHING ELSE? (%)



IS A GOOD COMPANY IN AN AVERAGE MARKET MORE ATTRACTIVE THAN AN AVERAGE COMPANY IN A GOOD MARKET? (%)



"I would always go for a good company. Usually a good company means good management. We've always made more money with good management than with anything else."

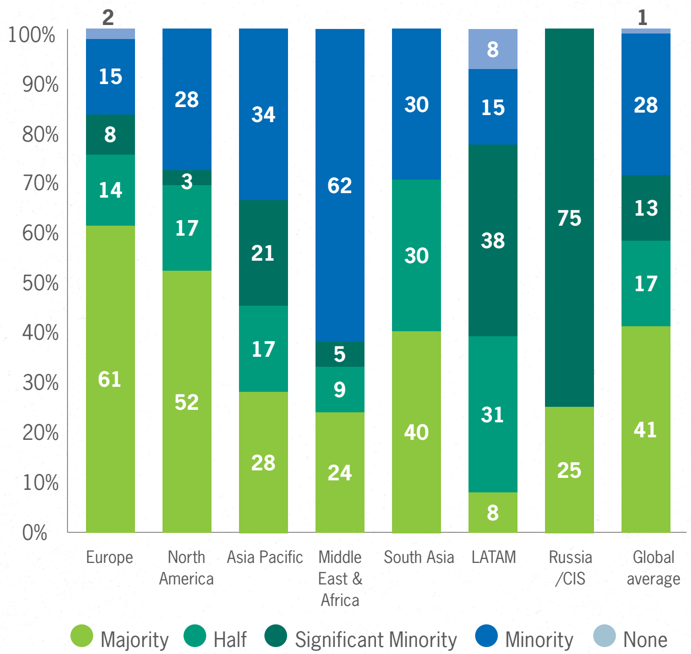
CANADA

A highly competitive market

Headlines

- Today's new deal market is very competitive. Over half of all respondents compete with other PE firms on at least half of the deals they evaluate.
- PE competition is reported to be highest in Europe and North America, but typically lower in the more emerging markets.

ON WHAT PROPORTION OF DEALS ARE YOU COMPETING AGAINST OTHER PE FIRMS? (%)



	Europe	North America	Asia Pacific	Middle East & Africa	South Asia	LATAM	Russia /CIS	Global average
Majority	61	52	28	24	40	8	25	41
Half	14	17	17	9	30	31		17
Significant Minority	8	3	21	5		38	75	13
Minority	15	28	34	62	30	15		28
None	2					8		1

"Many large and mega-cap firms can't find suitable deals of the required size in Turkey in the current environment. So they make mid-market investments and add to the competition."

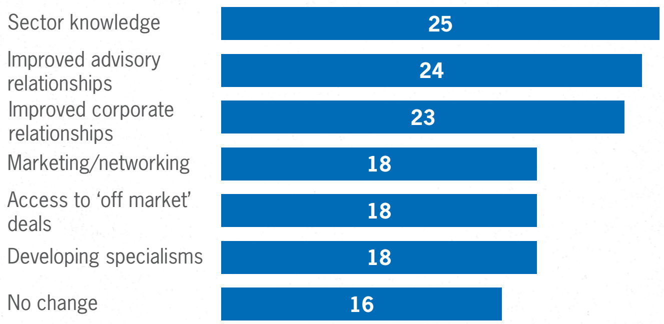
TURKEY

Increased emphasis on origination

Headlines

- Given the highly competitive market conditions, GPs are focusing more on deal origination.
- GPs see it as vital to build closer relationships with advisory and corporate communities. Sector expertise tops the rankings – noting the need to develop specialisms and angles.

IN WHAT WAYS ARE PE FIRMS HAVING TO DEVELOP AND ADAPT THEIR APPROACH TO DEAL ORIGINATION IN ORDER TO IDENTIFY DEALS IN TODAY'S MARKET? (%)



"We focus on building relationships early; finding businesses by reviewing subsectors; and building on our own existing network or knowledge from previous portfolio experience."

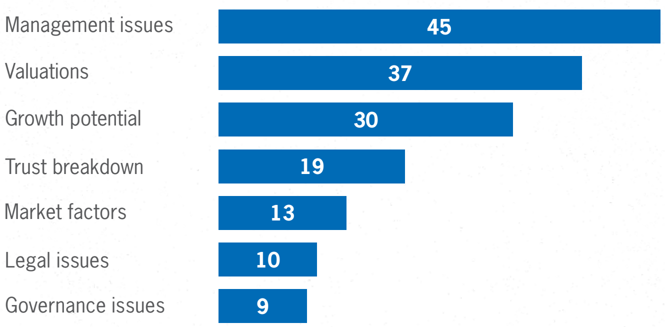
UK

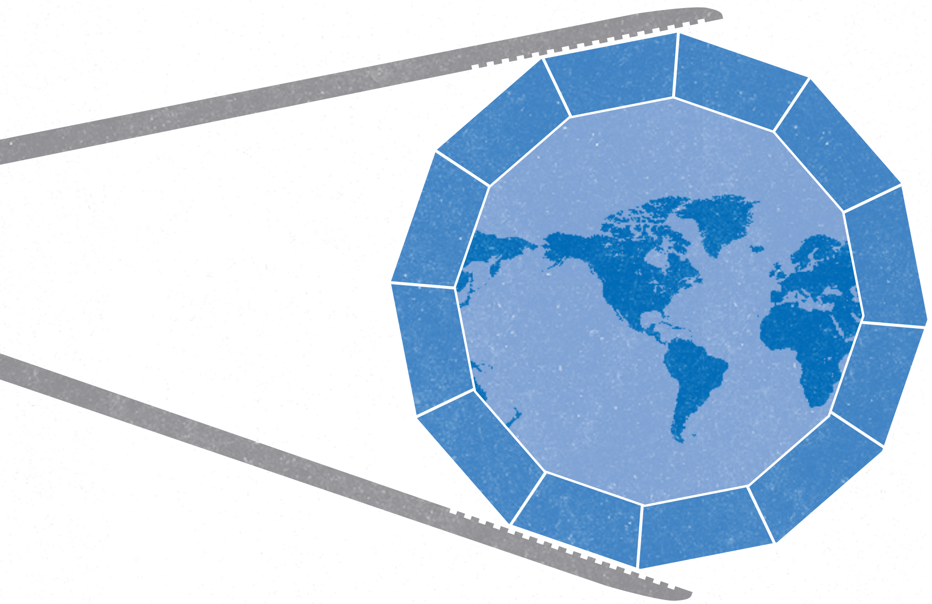
Management issues are a primary cause of deal failure

Headlines

- GPs are most likely to walk away from a deal after due diligence because of management issues, valuations and a lower than expected growth outlook.

REASONS FOR WALKING AWAY FROM A TRANSACTION POST DUE DILIGENCE (%)





"It doesn't tend to be financial. If anything, it's a combination of the commercial and financial work not supporting the original thesis and not being able to work with management."

AUSTRALIA

Entry multiples

"It's less about entry multiples and more about returns"

The Grant Thornton view

- Does greater portfolio engagement imply longer hold periods? What implications could this have on fundraising strategy and liquidity realisation?
- Is there a need for greater investment in sector and business skills to drive value creation in the portfolio businesses?
- For each investment is there a credible thesis which is supported by robust commercial/strategic evidence?

Getting to know the owners and managers

"You can never spend too much time evaluating management"

The Grant Thornton view

- In assessing management, what more could be done to mitigate deal execution risk?
- The investment plan will inevitably require change – can the present management team deliver a plan that may be very different to its current one?
- Are management relationships sufficiently broad or are they restricted to a narrow senior team?

3 The role of secondary transactions

There are more sellers than buyers in this space

Secondary deals can help develop a portfolio company which outgrows its existing PE investors

The challenge for buyers is generating sufficient return when paying full price

Perceived to provide safer, more consistent returns as quality of assets considered to be higher

Secondary market is driven by pressures on GPs

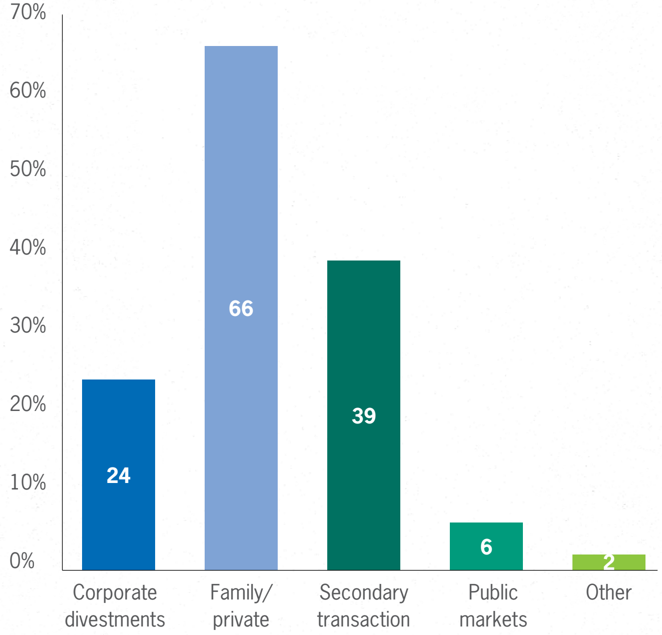
The secondary market is here to stay

Secondary deals on the increase

Headlines

- For four years in a row, secondary deals are viewed as the second most important source of PE transactions. Privately owned businesses have been the most significant source of deals this year.
- The level of secondary deals is not likely to decline any time soon, with over two-thirds of respondents expecting the number of such deals to increase over the coming year. Only 3% of GPs expect a decrease.
- The expected increase is being driven by pressure on GPs to both buy and sell. There is also a general improved appetite for secondaries.
- Increasing PE market maturity in countries such as India and China have stimulated further secondary deals.

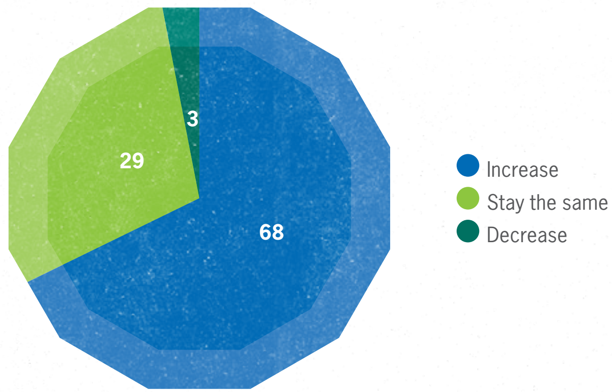
WHAT DO YOU EXPECT TO BE THE MOST SIGNIFICANT SOURCE OF DEALS OVER THE NEXT 12 MONTHS? (%)



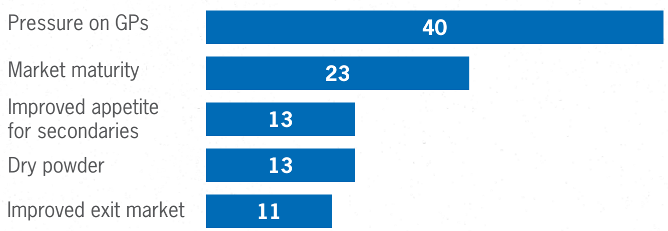
"This increase is driven by late vintage PE funds coming to the end of the fund period and having to exit. There are also new funds which need to find deals."

SOUTH AFRICA

DO YOU EXPECT THE NUMBER OF SECONDARY TRANSACTIONS IN YOUR MARKET TO INCREASE, STAY THE SAME, OR DECREASE OVER THE NEXT 12 MONTHS? (%)



WHY DO YOU EXPECT THE LEVEL OF SECONDARY DEALS TO INCREASE/STAY THE SAME? (%)

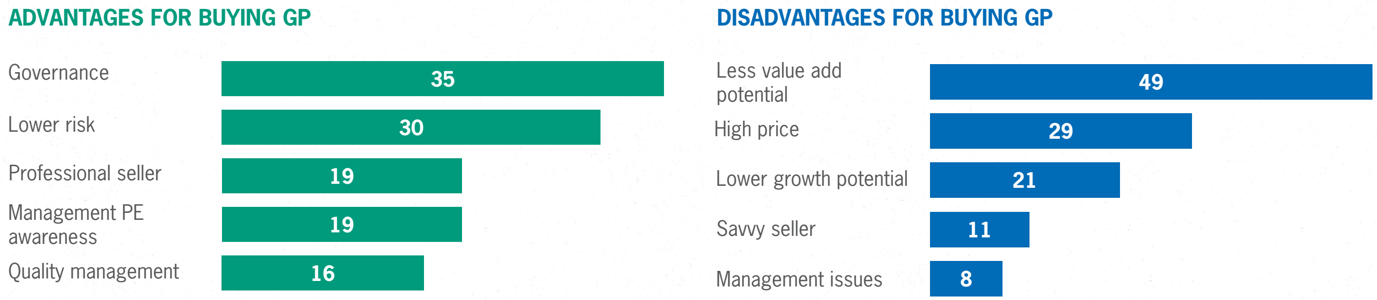


Secondary transactions have pros and cons for buying GPs

Headlines

- Businesses bought via secondaries are seen as lower risk assets with better governance, usually with quality management teams that understand how PE works; working with professional sellers can also smooth the due diligence process and result in a higher chance of deal closure.
- However, GPs caution that acquirers of secondaries need to be comfortable that the assets have adequate remaining growth and value-add potential. There are also concerns that 'savvy' PE sellers may demand higher prices than other types of vendor.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF SECONDARY TRANSACTIONS FROM THE PERSPECTIVE OF A BUYING GP? (%)



"The advantages are that you typically find that the company is already used to PE ownership – it is 'cleaned up', so due diligence is easier. The disadvantages are there is a price concern because you buy from PE with certain return expectations. You will pay a full price."

SOUTH AFRICA

"The business should be in good shape having been run by another PE firm. The main disadvantage is the management team will usually be taking some money off the table and that can have an effect on their motivation."

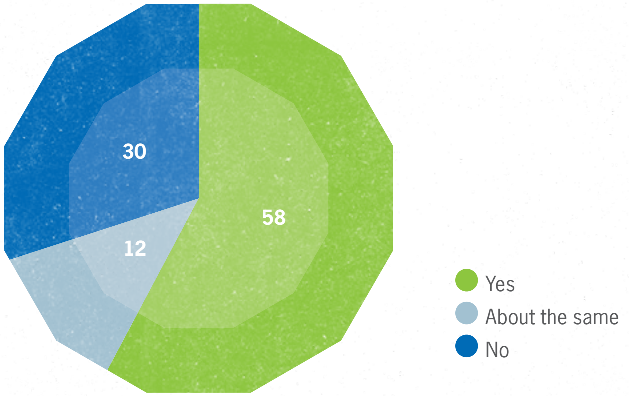
UK

Secondary deals tend to be pricey

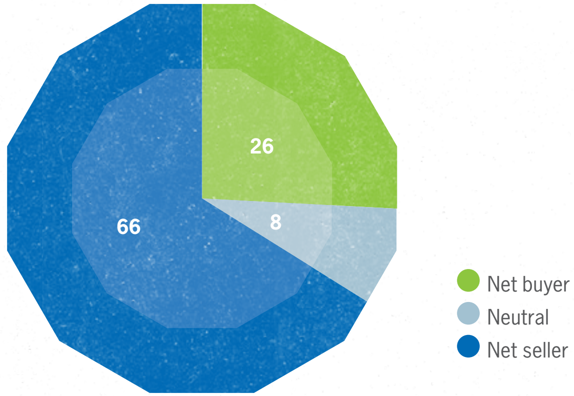
Headlines

- Well over half of respondents believe that PE buyers pay higher prices for companies acquired via secondaries. A third don't believe that secondary deals command a premium.
- Unsurprisingly, PE firms prefer to be on the sell side of the secondary deal with over two thirds of GPs claiming to be net sellers. Just over a quarter are secondary buyers.

ON AVERAGE, DO YOU PERCEIVE THAT PE FIRMS PAY HIGHER MULTIPLES FOR BUSINESSES ACQUIRED VIA SECONDARY TRANSACTIONS THAN THROUGH OTHER ROUTES? (%)



ARE YOU A NET BUYER OR NET SELLER WITHIN SECONDARY TRANSACTIONS? (%)



"In a secondary you will be paying a higher price than in a primary private equity deal – which is as it should be."

SOUTH AFRICA

"I would agree that PE firms pay higher multiples for businesses acquired via secondaries. It's a natural assumption given the work the PE firm will have done to refine the business."

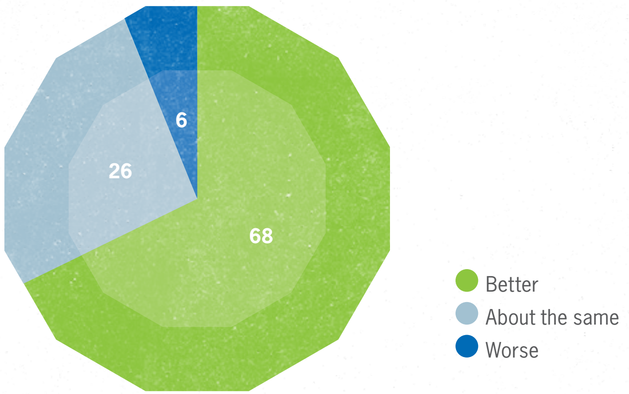
CHINA

Secondary transactions require a trade off between quality and future return potential

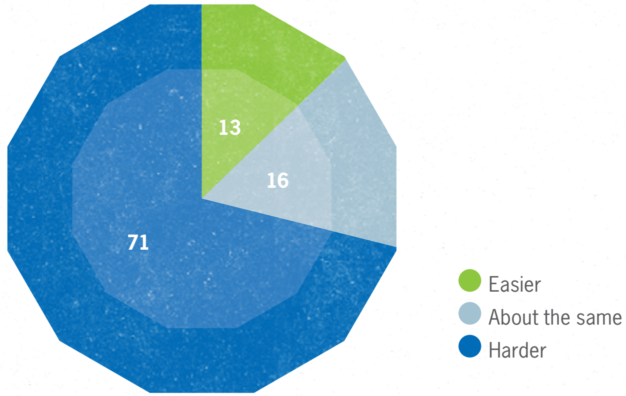
Headlines

- For the buying GP, secondary deals often involve a trade off between the benefits of purchasing a better quality asset and the risk that all the 'juice has already been squeezed' from that asset.
- Just over two thirds of GPs believe that the average quality of companies acquired via secondaries is better than for primary deals. This is typically due to the professionalisation process that the asset has been through during its previous PE ownership.
- However, almost three quarters of GPs believe it is harder to generate value in assets acquired via a secondary process than in a primary situation. Many believe there are fewer value-add levers to pull in a business that has already been through a cycle of PE ownership.
- That said, a number of GPs point to the case-by-case nature of the situation, suggesting that it really comes down to the specialist knowledge, expertise and investment thesis of the buying GP.

SECONDARY TRANSACTIONS COMPARED TO PRIMARY DEALS (QUALITY) (%)



SECONDARY TRANSACTIONS COMPARED TO PRIMARY DEALS (VALUE GENERATION) (%)



"It is harder to generate value. But it's perhaps more reliable. The returns are not necessarily as high compared with if you got a trade buyer. They are stable. You are unlikely to face major shocks."

SCANDINAVIA

"Secondaries are expensive and will stay expensive."

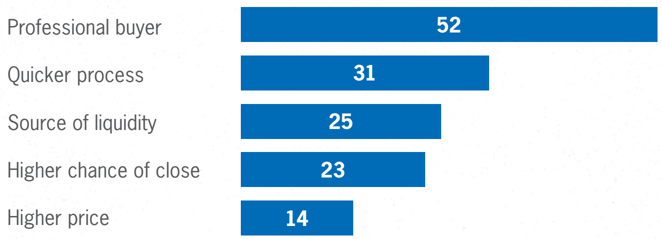
FRANCE

Secondary transactions have pros and cons for selling GPs

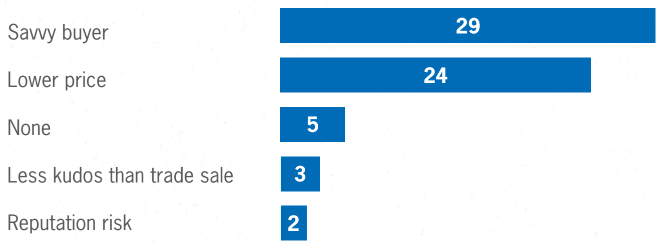
Headlines

- In recent years, secondaries have become an important additional source of liquidity in an environment in which returning cash to investors ahead of fundraising has been essential.
- On the flip side, a professional buyer is often viewed as a savvy buyer. This can lead to tougher negotiations and a lower price for an asset.
- A relatively small number of GPs note the potential reputational risk associated with selling a company to another GP only to see them generate a high return two or three years later.

ADVANTAGES FOR SELLING GP (%)



DISADVANTAGES FOR SELLING GP (%)



"In terms of advantages, you are dealing with a more sophisticated and seasoned investor; negotiations are fluid and efficient. The disadvantages: are they are savvy buyers and PE experts too?"

AUSTRALIA

"The advantage is a generally smoother process. But there's the reputation issue if the PE buyer turns around and sells for more."

USA

Secondary buyouts

"Secondary buyouts are a serious buy side option, not just an exit makeweight"

The Grant Thornton view

- Could an appropriate weighting in the portfolio towards more secondary investments lead to average portfolio returns being substantially the same as a traditional portfolio mix where a few 'high performing' investments balance out a number of 'poor performing' investments?
- The need to motivate a management team which will be taking money off the table?

Grant Thornton and the private equity industry

This report highlights a number of opportunities for those within private equity. At Grant Thornton our network of professionals can provide support in realising and taking advantage of these opportunities. We have in-depth experience working with private equity firms around the globe, bringing together international teams from corporate finance, restructuring and performance improvement, taxation and assurance services that provide bespoke solutions – from investment, through the growth phase to exit.

As well as acting for private equity firms, we also advise many private equity-backed companies, and management teams seeking private equity investment.

If you have any questions about the findings in our report or would like to discuss how these results may affect you and your business, we would be more than happy to discuss further.

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A truly global organisation

Grant Thornton is a leading business adviser that helps dynamic organisations to unlock their potential for growth. Our brand is respected as one of the major global accounting organisations, recognised by capital markets, regulators and international standards setting bodies worldwide.

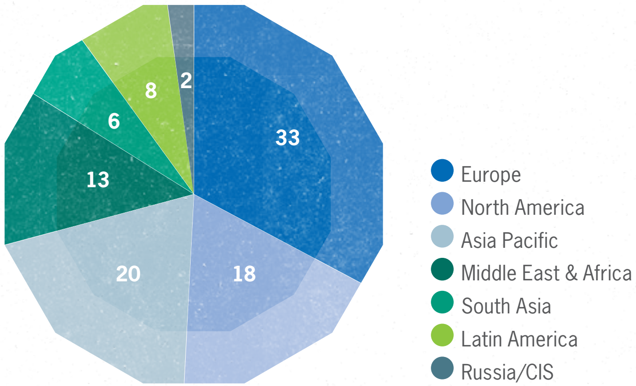
- $4.5 billion turnover
- 2,800+ member firm partners with 38,500 people
- More than 700 offices in 130 countries

Methodology

This document presents the findings of the fourth annual Grant Thornton Global Private Equity Study. The findings are based on data gathered from 175 interviews with GPs. Respondents are spread across the seven regions covered by the study: Europe, North America, Asia Pacific, Middle East & Africa, South Asia, Latin America and Russia/CIS (see pie chart).

In addition to our regular 'barometer' questions which provide insight into expected key trends throughout the private equity cycle, this year's study also explores the significance of buying well in generating value, as well as GPs' latest views on secondary buyouts.

REGIONAL BREAKDOWN OF RESPONDENTS (%)



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