BDO PERSPECTIVE EIGHTH ANNUAL PRIVATE EQUITY STUDY

"2016 served as something of a reset for the private equity industry, which experienced a rocky 2015. But as we look ahead to 2017, there is plenty of reason for optimism: The economy is on the upswing, deal flow is loosening, and fund managers are eager to deploy uninvested capital in the year to come."

Scott Hendon, partner and Private Equity practice leader at BDO

Private Equity Fund Managers Expect a Sunnier 2017 after Volatile 2016

2016 proved to be a challenging year for the private equity (PE) industry as market instability and political uncertainty took hold worldwide. According to PitchBook, total global PE deal value fell by 12 percent from 2015 levels, while deal volume declined 14 percent—a result of stiff competition from strategic buyers, ballooning valuations and a lack of promising targets as PE dry powder continued to amass.

But 2017 is poised to bring brighter days for the PE industry. According to BDO's ***Eighth Annual PErspective Private Equity Study***, a survey of more than 200 fund managers across North America and Western Europe, fund managers are optimistic for the year ahead. When the initial survey was conducted in October 2016, more than half (56 percent) of fund managers characterized the investment environment as favorable, while 44 percent said it was unfavorable—the highest proportion since 2014. In a follow-up poll conducted in early January, however, the number of fund managers reporting optimism jumped to 71 percent.[1]

Underlying this substantial growth in optimism may be easing economic uncertainty across the business landscape. The 2016 general election cycle—in conjunction with other major developments, including the shockwaves of Brexit, the contraction of the Chinese economy early in the year and continued volatility in commodity prices—created significant market fluctuations throughout the year. In October, 45 percent of fund managers said a transition in the presidential administration was their top global political concern, followed by Brexit (19 percent) and sovereign debt crises (14 percent).

1 The initial ***PErspective Private Equity Study*** survey was conducted in October 2016. To gauge how respondent sentiments may have changed over the course of Q4 2016, respondents were contacted again in late December 2016 and early January 2017 to provide follow-up responses to the following questions:

- In your view, is the current environment favorable for private equity funds looking to invest?
- What do you think will be the key drivers of private equity deal flow in the next 12 months?
- Which of the following exit options do you expect to generate the greatest returns during the next 12 months?
- Are you raising new funds from Limited Partners?

Sixty-eight fund managers responded to this follow-up survey. Unless otherwise specified, data in this report has been pulled from the October 2016 poll.

ABOUT BDO'S PRIVATE EQUITY PRACTICE

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

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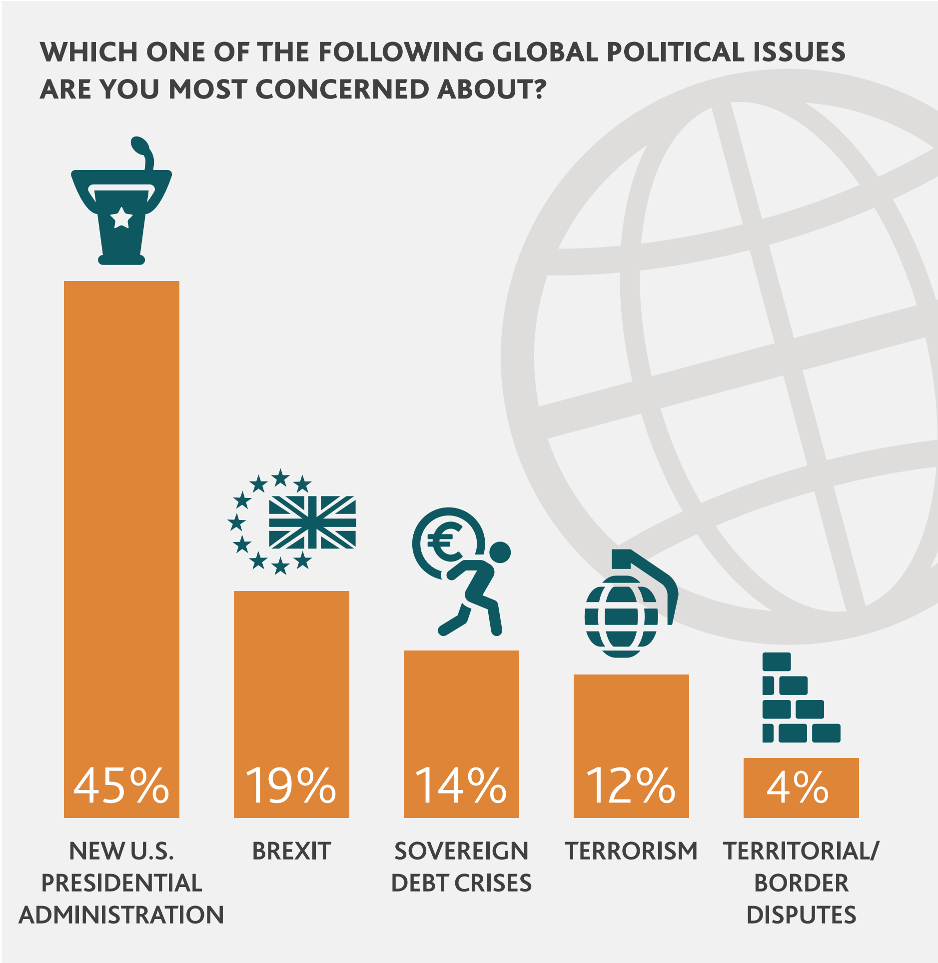
However, in the days following the election, markets began to stabilize: According to the *Wall Street Journal*, the week ending Nov. 11 was the Dow's best since 2011. Meanwhile, the Bureau of Labor Statistics' December jobs report indicated that the economy added about 156,000 jobs that month, while average hourly wages grew by nearly 3 percent from December 2015. In response to these positive movements, the Fed raised interest rates in December for only the second time since June 2006, and in mid-January, Fed Chair Janet Yellen indicated that she expected interest rates to continue to increase at a steady pace.

With the election over, PE fund managers appear to be mirroring the optimism reflected in the equity and labor markets.



"Election years always carry some degree of uncertainty for the PE community, but 2016 was a particularly contentious and volatile year. However, improving fund manager sentiment likely has less to do with who won the election—many market analysts expected a small, brief downturn in the event of a Trump win, which ultimately did not materialize—and more with the fact that it's over. It's easier for fund managers to plot their strategy with such a huge unknown out of the mix."

Dan Shea, managing director with BDO Capital Advisors, LLC

"I believe 2017 will see a strong push to reduce corporate taxes, create jobs through infrastructure development and spending, free up capital through tax reform and bolster American manufacturing and business in general. This should lead to a fertile deal-making environment."

Ted Beneski, CEO and managing partner, Insight Equity

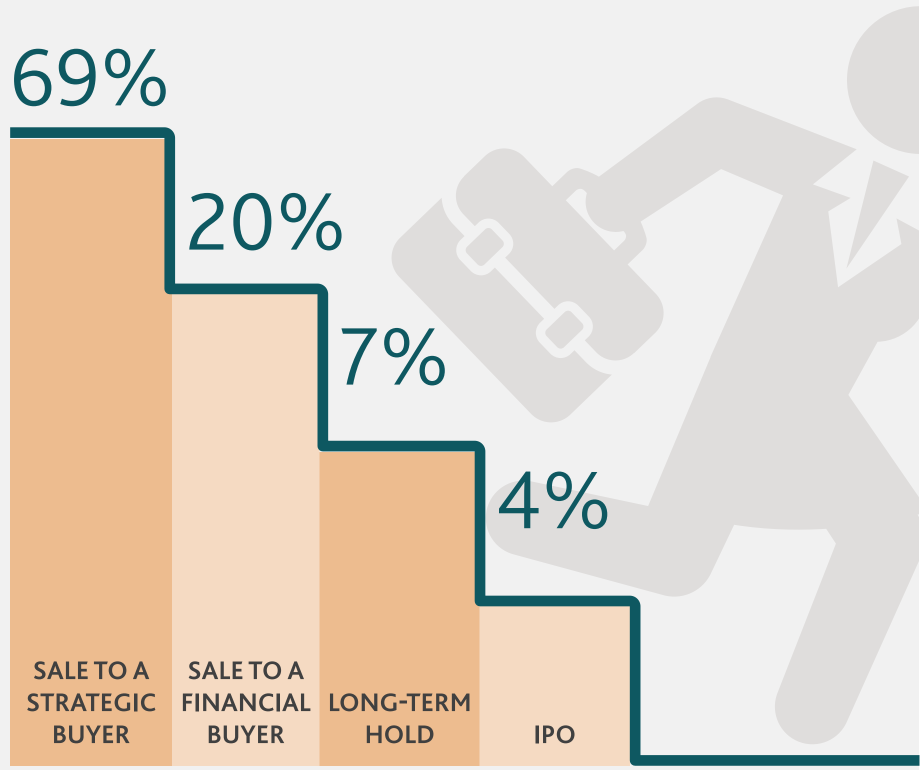
IPOs Poised to Make a Comeback

Reflecting the PE industry's renewed optimism is improved sentiment toward the IPO market, which experienced a painful 2016. When asked which factor most contributed to 2016's disappointing IPO environment a plurality (31 percent) point to high volumes of M&A activity, followed by poor IPO performance (28 percent) and a slowing global economy (24 percent).

Amid this uncertainty and pessimism, in October, just 4 percent of fund managers surveyed said an IPO was likely to be the most lucrative exit option in 2017. By January, that proportion had doubled to 8 percent, suggesting that the IPO market may be heating up as 2017 gains momentum.

Sales to strategic buyers remained the top-ranked exit option both in October and January, however, suggesting that even as conditions for IPOs improve, strategics will remain dominant players in the transactions space.

WHICH OF THE FOLLOWING EXIT OPTIONS DO YOU EXPECT TO GENERATE THE GREATEST RETURNS DURING THE NEXT 12 MONTHS?



Examining exits and holding periods more broadly, many of the trends observed in last year's PErspective Study hold true again for 2017: Holding periods are set to remain relatively consistent, with 61 percent of respondents saying their average holding period is between four and six years, and 84 percent of fund managers saying mismatched buyer and seller pricing expectations remain the primary obstacle to exit. In a more notable departure from the 2016 study, the number of fund managers reporting long-term holds (more than seven years) decreased from 16 percent to 9 percent.

"There are several short-term factors helping to influence the decision to IPO or not—stocks trading at all-time highs, lower market volatility and pent-up sell-side demand for IPOs due to a less favorable environment in 2016. But there are also a number of longer-term factors impacting how firms are looking at the option and some common goals in what they aim to achieve with the capital secured through an IPO. These longer-term goals are telling a positive story about the state of the private equity industry, specifically, and about the rising optimism around economic growth in general."

Lee Duran, partner, BDO's Private Equity practice

"The deal-making environment continues to favor sellers as markets remain rife with lofty valuations, leaving PE firms and significant stores of investment dollars on the sidelines. In such a competitive environment, firms taking innovative approaches to deal-sourcing—perhaps drilling deep into a niche industry or targeting older, 'forgotten' deals—will be best positioned to pull out ahead of the pack."

Karen Baum, national partner, BDO Transaction Advisory Services

"With the market rallying and share prices surging, concerns over the disparity between private and public market valuations have eased, which is good news for the industry. If the post-election rally and pro-growth environment persist, we're going to see that valuation gap shrink even further."

Anthony Alfonso, BDO Valuation & Business Analytics national leader

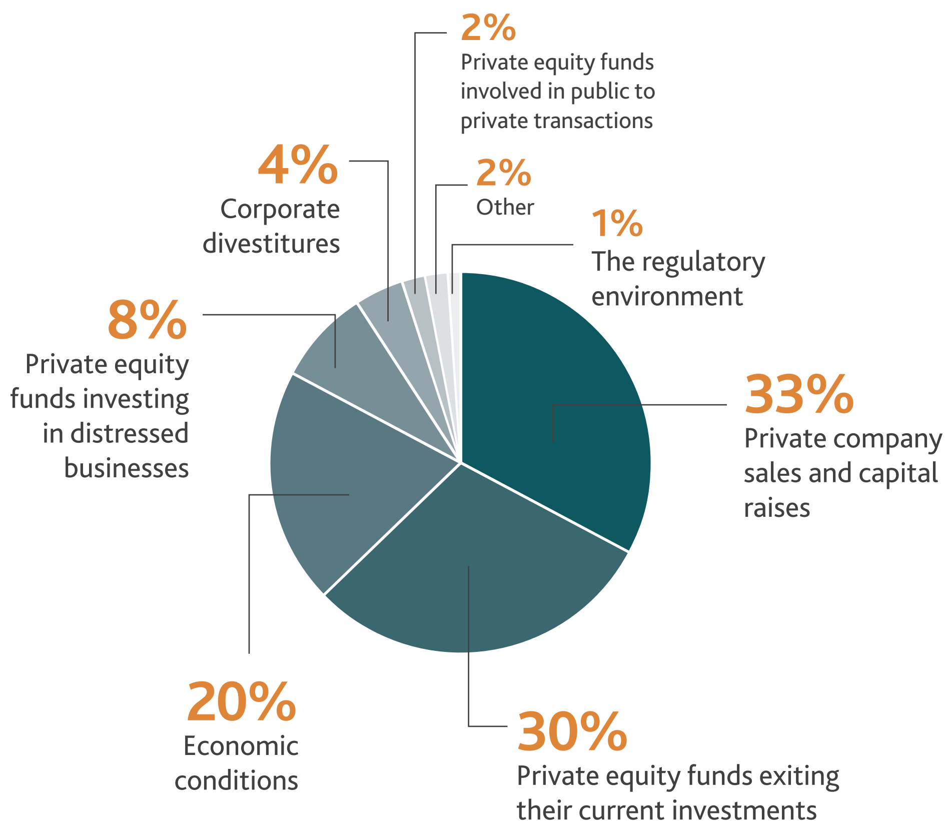
Fund Managers Expect to See Improved Deal Flow Overall

Similar to IPOs, 2016 was a difficult year for overall deal flow. In our 2016 PErspective Study, one-quarter of fund managers anticipated investing $10 to $29 million in new deals and add-on acquisitions; however, this year's data finds that 26 percent of respondents invested less than $10 million last year.

Looking ahead to 2017, though, fund managers are realigning their expectations. Consistent with prior years, the largest proportion of respondents (28 percent) say they plan to close two new platform deals in the coming year, and 25 percent are looking to invest $10 to $29 million once again. The overall optimism generally fluctuates based on fund managers' self-reported assets under management (AUM). Firms with AUM totaling $501 million to $1 billion appear the most aggressive, with about one-third expecting to close three deals. Meanwhile, nearly half (48 percent) of firms with more than $1 billion in AUM plan on closing four or more deals in the coming year; this is down from 56 percent last year.

When asked about the key drivers of PE deal flow in the coming year, private company sales and capital raises are most frequently cited (33 percent), and PE exits are the second-most-cited at 30 percent. From a deal-sourcing perspective, industry or market specialization remains the most popular strategy, cited by 62 percent of fund respondents (up slightly from 57 percent last year). While most of the AUM brackets analyzed generally aligned with the overall trend, the number of fund managers reporting more than $1 billion in AUM and who are planning to leverage buy-side intermediaries nearly doubled this year.

WHAT DO YOU THINK WILL BE THE KEY DRIVER OF PE DEAL FLOW IN 2017?



Fund managers also expect to encounter similar challenges in 2017 that they experienced in the past. Forty-one percent of fund managers rank pricing as the top challenge facing PE firms, followed by maintaining portfolio company performance (23 percent), and the identification and quality of targets (22 percent). Despite continued public scrutiny of the private equity industry—in particular, continued debate surrounding the taxation of carried interest—just 1 percent of respondents say public perceptions of private equity is their top challenge.

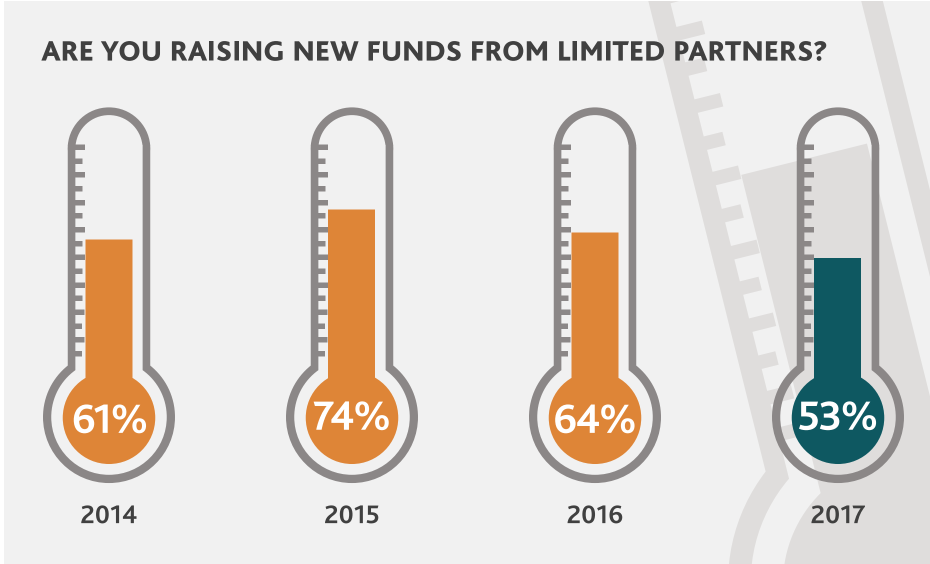
Consistent with both the 2016 and 2015 editions of the PErspective Study, a majority (53 percent) of fund managers cite gaps between buyer and seller pricing expectations as the top hurdle they face when closing deals. Competition from financial buyers (25 percent) and strategic buyers (10 percent) are also frequently cited as leading challenges.

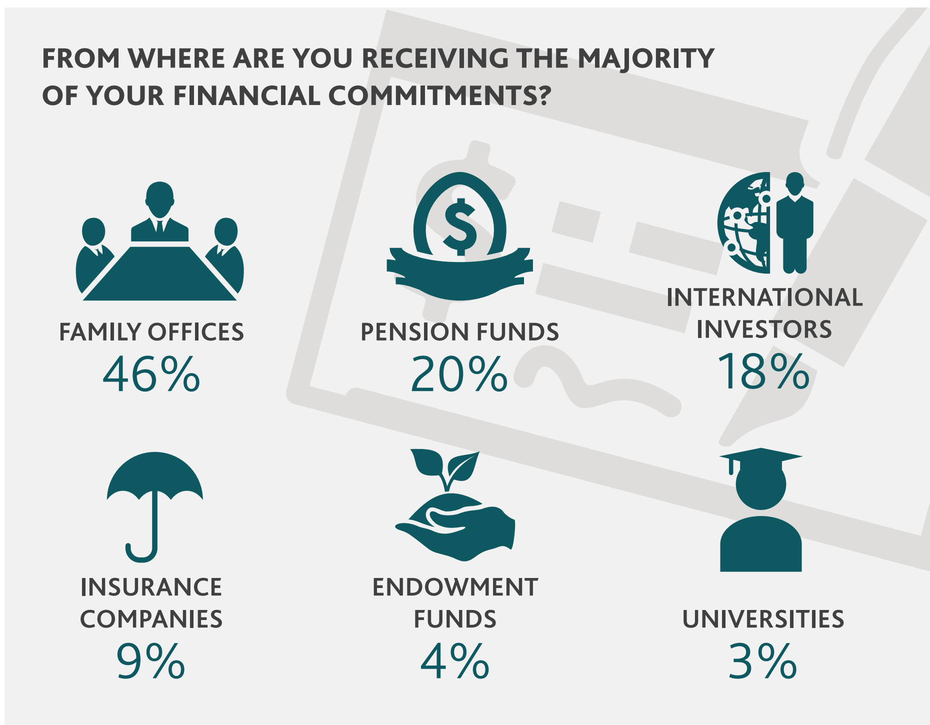
Fundraising May Taper

This year's survey marks the least optimistic year for fundraising since 2014, with just 53 percent of fund managers saying they are raising new funds from limited partners (LPs). This is down from 64 percent last year, 74 percent in 2015 and 61 percent in 2014.

Family offices remain the most common source of funds, with 46 percent of fund managers saying they provide the majority of their financial commitments. Larger firms ($501M in AUM and up) tend to skew more heavily toward pension funds, which is consistent with last year.

Fund managers also expect potential LPs to evaluate them on similar criteria to years past. Sixty percent of fund managers say track record is the most important factor LPs consider when assessing general partners, followed by management team (cited by 33 percent), as well as operating experience and investment focus (both cited by 19 percent of fund managers).





"Traditional markets continue to generate low returns for family offices, driving them to the higher returns of private equity. But this is a mutually beneficial relationship—these single and multifamily offices are helping PE firms maintain a robust rate of fundraising as institutional investors, such as pension funds, continue to pull back from these alternative investments."

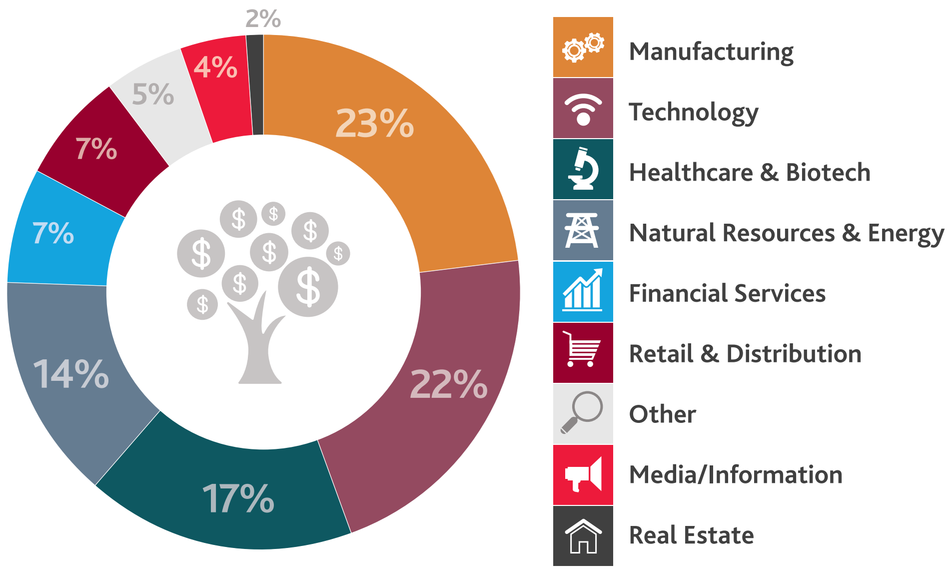
Kevin Kaden, partner, BDO Transaction Advisory Services

Technology and Energy Sectors Grow Riper for Investment

In 2016, many market analysts expected to see investor appetite for technology companies right-size after years of skyrocketing valuations. However, despite some significant sector setbacks—such as the downfall of laboratory testing company Theranos—PE fund managers remain bullish on the industry, with two-thirds expecting to see increased valuations in the year ahead. At the same time, 70 percent expect to see valuations grow in the healthcare and biotech industry in the year ahead.

In a reflection of growing stability in the energy space, 44 percent of fund managers say the natural resources industry will see increasing valuations in the coming year, up from 36 percent last year and 34 percent in 2015. With OPEC reaching the first agreement to cut production in eight years—and some non-OPEC members, such as Russia, making similar promises—prices are back on the upswing. This spells good news for buyers and sellers alike: On the cusp of a new upswing, PE dollars may start to flow back into the industry, while sellers may be more willing to come to the table if they believe the worst has passed.

WHICH OF THE FOLLOWING SECTORS PRESENTS THE GREATEST OPPORTUNITY FOR NEW INVESTMENT?



On the other hand, fund managers expect to see decreasing valuations in the retail and distribution (67 percent), real estate (49 percent) and manufacturing sectors (48 percent), pointing to continued volatility in these industries. Nevertheless, nearly one-quarter of fund managers say the manufacturing sector poses the greatest opportunity for new investment in the coming year as the Trump administration signals a renewed commitment to infrastructure improvements and domestic industry growth.

Meanwhile, 22 percent see promise in the technology industry, up slightly from 17 percent last year. This may be a reflection of the comparative bullishness of European respondents versus their North American counterparts: 27 percent of European fund managers say the technology space offers the greatest investment opportunity, compared with 19 percent of North American fund managers.

"The savviest health data and technology companies are finding new ways to monetize advances in telehealth, data sharing among clinicians, and diagnostic and treatment innovation. These rapid advances are coming at a time that patients, providers and payers alike are extremely hungry for products and services that lead to demonstrably better outcomes and lower overall healthcare costs. For the investor, the challenge is in assessing valuations in the context of an unknown future. Shifts in the industry could pull some valuations down, but those same shifts could help accelerate some of the disruptive efforts that are now redefining where, how and by whom healthcare is delivered."

Patrick Pilch, managing director and Healthcare Advisory practice leader, The BDO Center for Healthcare Excellence & Innovation

PE Firms Remain Tepid on International Investment

Consistent with results from 2015 and 2016, fund managers are generally cool toward international investment, with just 38 percent saying they plan to increase cross-border transactions in the year ahead. It is unsurprising, then, that North America and Continental Europe are ranked the most attractive regions for new investments, cited by 53 percent and 23 percent of respondents, respectively.

Latin America continues to decline in appeal, with just 6 percent of respondents citing it as a key investment region for 2017. Coming off a year of significant instability, and with the Trans-Pacific Partnership in legislative limbo, Asia also grew less attractive, with 12 percent of fund managers saying it presents the greatest opportunity for new investments—down from 15 percent last year. The Middle East has also reached a nadir in investor interest, cited by only 2 percent of respondents.

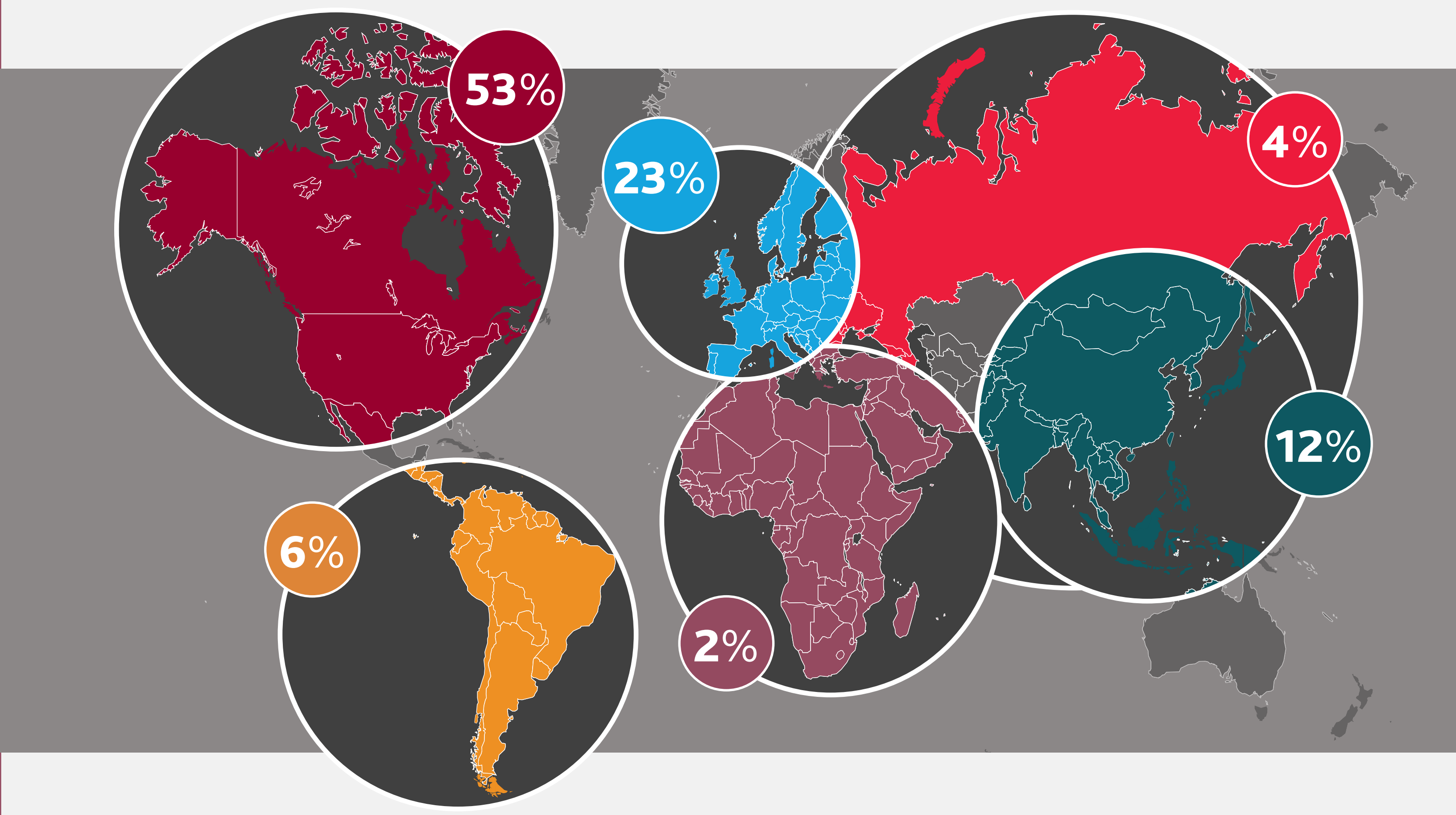
Examining how North American and European respondents diverged in their responses, fund managers prefer investment opportunities in their own backyards: 46 percent of European respondents say Continental Europe presents the best investment opportunity, while 78 percent of North American respondents point to North America. European fund managers, however, are more optimistic about cross-border transactions, with a majority (58 percent) saying they plan to pursue more. European fund managers are also far more bullish on investment in Asia than their North American counterparts, with 17 percent citing it as a top region (versus 6 percent in North America).

In addition, Brexit looms large for European respondents. While just 5 percent of North American fund managers rate it as a top political concern this year, 46 percent of European fund managers express worry about its impact on PE investment.

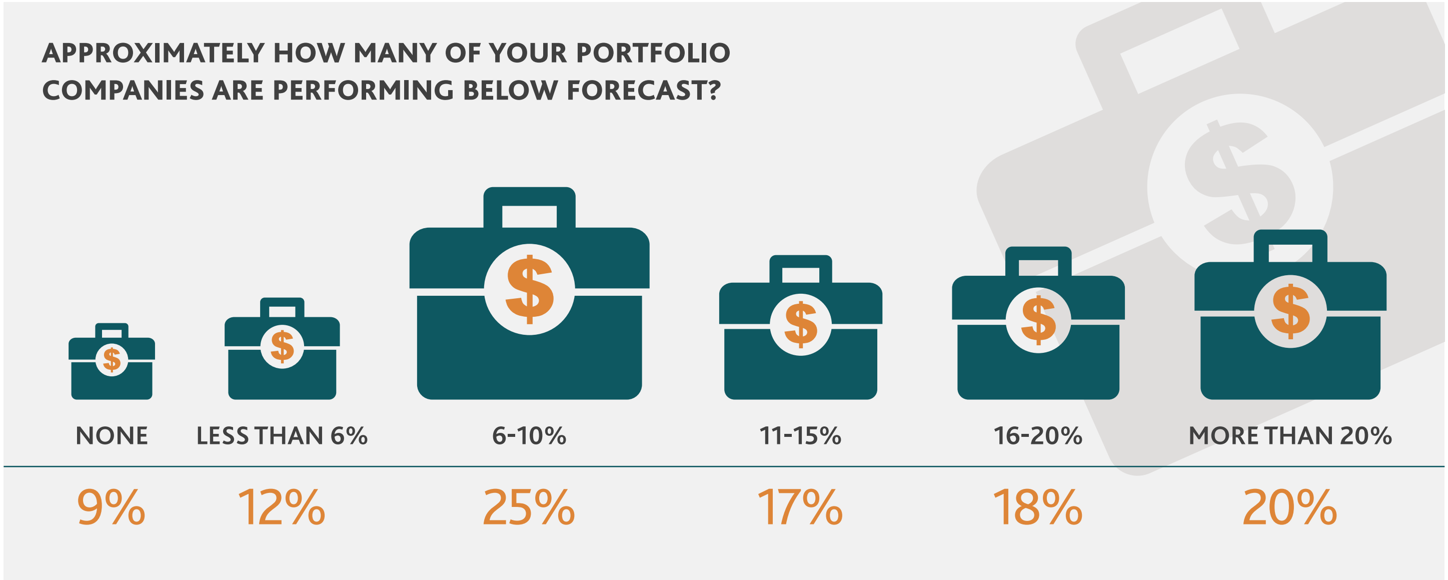
"Cross-border investment will always carry unique risks and challenges. Brexit, however, has further muddied the waters for PE firms exploring opportunities across Europe. Potential acquisition targets could redomicile, the U.K. could lose access to the broader market and investors will need to navigate an even more complex regulatory environment."

Ryan Guthrie, partner, BDO Transaction Advisory Services

During the NEXT 12 months, which ONE of the following geographic areas do you think presents the greatest opportunity for new investments?



- North America
- Continental Europe
- Eastern Europe, including Russia
- South and Central America
- Middle East and Africa
- Asia, including Southeast Asia



Portfolio Performance Strengthens

After a soft 2015, portfolio performance seems to be regaining momentum. Nearly three-quarters of fund managers say the value of their current portfolio, including all funds, has increased in the past year. Firms with more than $1 billion in AUM reported the most robust performance, with 86 percent saying their portfolio value increased in 2016. Of those fund managers reporting portfolio value increases, 75 percent cite growth of 6 to 25 percent, which is consistent with what respondents reported in prior years. Meanwhile, the proportion of respondents saying their portfolio decreased—10 percent—reached a four-year low. Almost all (90 percent) respondents reporting portfolio value decreases say those declines totaled 25 percent or less—the most modest decreases seen since 2014.

Looking specifically at portfolio companies, a plurality (25 percent) of fund managers say just 6 to 10 percent of their portfolio companies are performing below forecast, while 62 percent say that 15 percent or fewer of their portfolio companies are underperforming, representing the best year for performance since 2014.

When it comes to managing their portfolio companies, fund managers rank identifying and retaining skilled management personnel as their top challenge (43 percent), followed by identifying and executing on growth opportunities (28 percent). From a staffing perspective, hiring patterns are expected to remain consistent with prior years. Fund managers plan to continue to grow professional headcount at the portfolio company level—67 percent say they have done so in the past year, and 65 percent say they will do so in 2017. Funds, however, have generally not increased administrative staff headcount. Sixty-five percent say they did not last year, and 64 percent say they will not this year. Meanwhile, at the fund level, 42 percent say they increased fund headcount last year, and another 42 percent say they will do so in the coming year.

"The talent at our portfolio companies is of paramount importance to our investment strategy. We look at three primary factors when it comes to investing: asset valuation, cash flow and people. Of the investments we have pursued and ultimately passed on this year, the majority have been due to concerns regarding people."

Thomas Schmidt, partner and COO, Lantern Capital Partners


Revenues
Africa
Asia
5000
4000
3500
3000
2500
2000
1500
1000
500
0

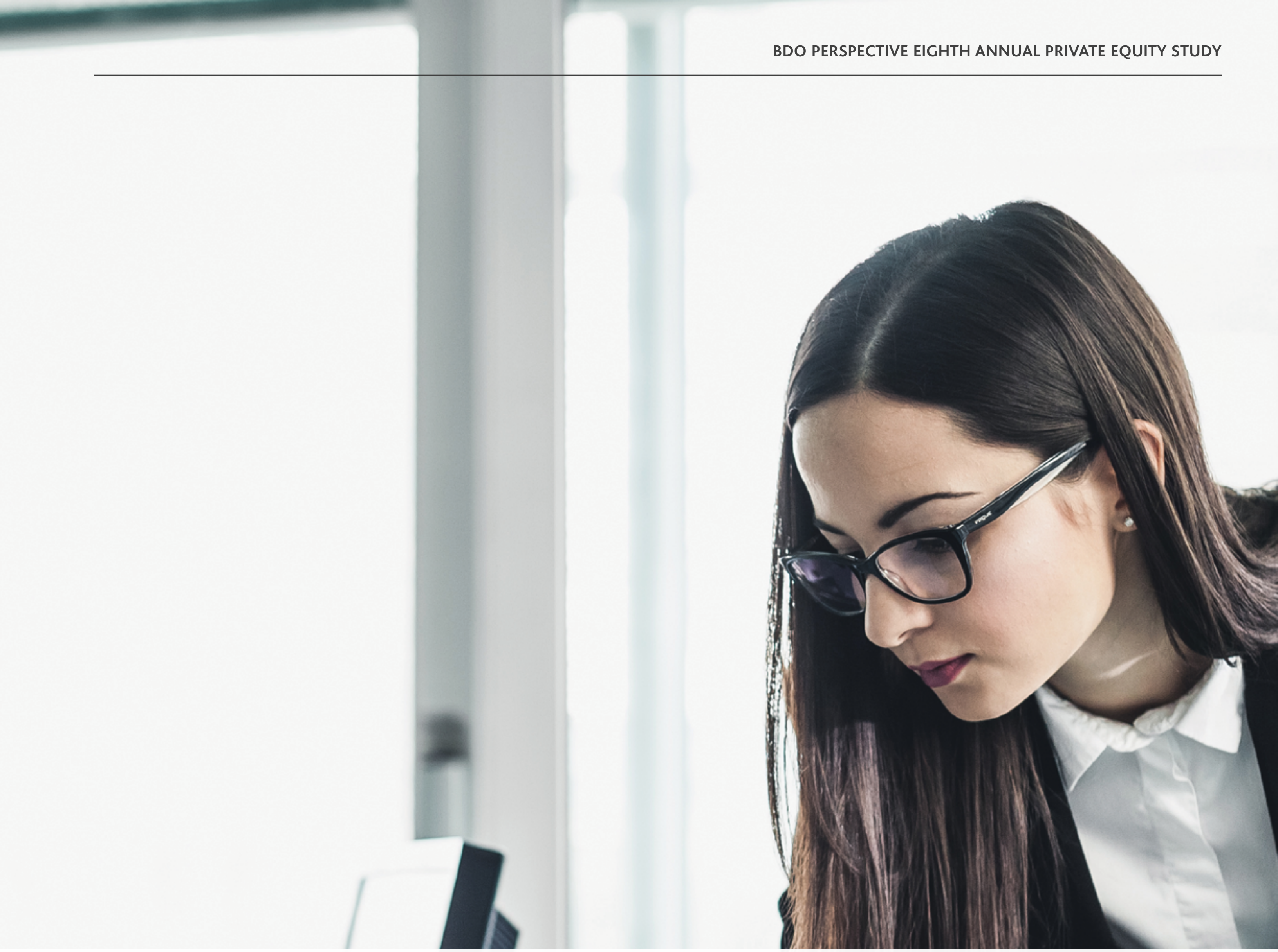
Regulation Tightens Its Grip, but PE Firms Are Prepared

Regulators in both the United States and abroad continue to crack down on private equity firms, increasing oversight and looking to rein in an industry subject to fewer regulations than public companies. It appears, though, that many PE firms have already begun the work of enhancing compliance and staying up to date on the latest regulatory developments: Despite major headlines surrounding SEC enforcement actions, just 13 percent of fund managers say they've experienced increased scrutiny from the SEC.

It appears that PE firms' 2017 regulatory priorities will likely look similar to 2016. When asked which steps they have taken in response to increased SEC oversight, 68 percent of fund managers point to enhancing internal controls, a slight uptick from 63 percent in 2016.

In addition, 36 percent say they have focused on improving fee transparency, 28 percent say they have updated LP agreements to further enhance fee clarity, and 23 percent say they are focused on monitoring agreements. Dodd-Frank remains the most impactful regulation PE firms face, ranked as a top concern by 39 percent of respondents.

Overall, the private equity industry has experienced a tumultuous two years, with economic headwinds in 2016 proving particularly challenging. It appears, however, that 2017 is set to usher in renewed prosperity as the economy improves, the political dust settles and private equity continues to grow in prominence as the alternative asset class of choice. As we look ahead to the next 12 months, we may expect to see private equity remain a key player in global transactions—including IPOs—as well as a highly sought capital solution for companies across industries looking to seize emerging growth opportunities.



The BDO ***Eighth Annual PErspective Private Equity Study*** is an international survey of more than 200 senior executives at private equity firms throughout the U.S. and Western Europe. The survey is administered by PitchBook, an independent and impartial research firm dedicated to providing premium data, news and analysis to the private equity industry.

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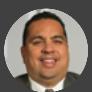
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