GLOBAL PRIVATE EQUITY REPORT 2019

BAIN & COMPANY

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 eightfold 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 integrated due diligence to assess the market dynamics, a target's competitive position and margin expansion opportunities, and by providing a post-acquisition agenda.

Immediate post-acquisition. We support the pursuit of rapid returns by developing a strategic value-creation plan for the acquired company, leading workshops that align management with strategic priorities, and directing focused initiatives or wholesale transformations.

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

Exit. We help ensure that 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 private equity, 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 private equity, including through coinvestment and direct investing opportunities.

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The beginning of the rest of the story?

Dear Colleague:

The past five years have been ones of unprecedented success for the private equity industry. During that span, more money has been raised, invested and distributed back to investors than in any other period in the industry's history. Private investment in general, and private equity in particular, seems to be on a secular penetration curve that has no end in sight. Yet, there are also some cautionary notes to sound.

Returns, while still strong relative to other asset classes, have slowly declined toward public market averages during the period. Persistent high prices, volatile capital markets, US–China trade arguments, Brexit worries and, of course, the ever-present threat of recession have injected a sense of uncertainty that dealmakers dislike. The pace of technological change is also increasing in almost every industry, making it harder to forecast winners and losers. So, while the good times are rolling, some bells of worry are tolling.

In this, Bain's 10th-anniversary Global Private Equity Report, we look fearlessly at the industry's strengths, its challenges and the evolutionary path that lies ahead. In addition to the critical statistics that characterize PE industry performance, you'll find our assessment of how to do "buy-and-builds" properly and why this tactic is increasing in popularity. Building on last year's assertion that PE firms need to increase their 10% share of the approximately 40,000 M&A deals done globally each year, we discuss how firms are building merger integration muscles to better compete with corporate buyers, and why the integration process should begin during due diligence. We also take a hard look at adjacency strategy 2.0 and the new wave of equity products that many PE firms are moving into aggressively, hoping to find higher returns and more productive ways to invest capital at scale.

In addition, we zero in on exciting topics such as advanced analytics, which speeds insight in both diligence and post-close value addition; liquidity solutions for general partners; and the Chinese PE market, which is on the leading edge in areas like technology.

We close our 2019 review of important trends in private equity by getting out our crystal ball. It's a bit cloudy (as is everyone's), but we see fundamental shifts happening in capital markets that are likely to drive a long-term trend toward much larger private capital (and private equity) opportunities vs. traditional public equity models. This ongoing movement will have seismic impacts for providers of capital, investors of that capital and for the companies owned by a widening variety of private models. It portends a future in which a much larger share of capital flows into private markets. Perhaps this is indeed the beginning of "the rest of the story" for the PE industry.

Hugh MacArthur
Head of Global Private Equity

1. The private equity market in 2018: What happened?

As the current economic expansion chugged into its ninth full year in 2018, the global private equity (PE) industry continued to make deals, find exits and raise capital at a historic five-year pace. Limited partners (LPs) remain highly enthusiastic and have continued to flood the market with fresh capital. Keeping the momentum going, however, has hardly been easy.

Chronically heavy competition has driven deal multiples to historic highs, and growing jitters about an eventual economic downturn are affecting decision making, from diligence to exit planning. For general partners (GPs), putting record amounts of capital to work means getting comfortable with a certain level of discomfort when investing. They are paying prices they swore they would never pay and looking to capture value that may prove elusive post-close. The most effective GPs are stepping up their game to identify targets and sharpen diligence, while simultaneously planning for the worst. In Sections 2 and 3, we'll explore several strategies firms are using to make the most of an increasingly difficult market. In the meantime, here's what happened in 2018.

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Investments: More strength, same challenges

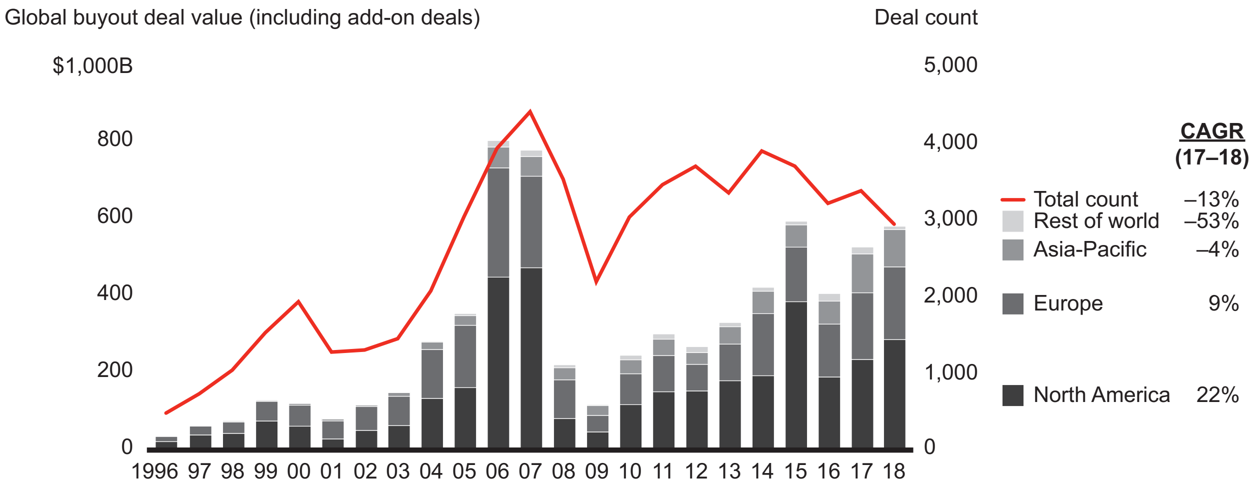
Amid heavy pressure to do deals, the PE industry saw another impressive surge in investment value in 2018. Fierce competition and rising asset prices continued to constrain deal count—pushing down the number of individual transactions by 13%, to 2,936 worldwide—but total buyout value jumped 10% to $582 billion (including add-on deals), capping the strongest five-year run in the industry's history *(see Figure 1.1)*.

While the current investment cycle hasn't been a steady upward march, especially in terms of deal count, it has shown great resilience and overall strength. Every year since 2014 has produced higher deal value than any year in the previous cycle, with the exception of the peak in 2006 and 2007. Over this period, the industry has benefited from an unprecedented wave of investor interest, buttressed by ebullient equity markets, low interest rates and steady GDP growth in the US and Europe. For GPs, it has been a remarkable run.

Predictably, experts are debating how long the good times can last. Only one other US recovery on record (from 1991 to 2001) has extended as long as this one. While GDP growth in the West remains strong, US interest rates are rising as inflation picks up in the US and Europe. Slowing growth in China, global trade tensions, ongoing uncertainty about Brexit and year-end market volatility are all fueling concern that this cycle may be running its course.

For PE firms, however, the question isn't so much when the next downturn will appear as how to negotiate it successfully when it does. With record amounts of capital to invest, it doesn't pay to sit idle trying to time the downturn. Instead, GPs are finding ways to cope with a growing level of macro uncertainty

Figure 1.1: Rising deal value in 2018 capped the strongest five-year stretch in history, while deal count reflected stiff competition and rising asset prices



Add-on count percentage	9	17	25	25	27	33	29	27	28	29	29	33	36	36	37	41	40	40	45	48	48	49	42
Add-on value percentage	14	16	16	15	20	16	8	11	12	17	10	11	13	21	12	25	21	14	31	43	21	24	23

Notes: Excludes 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 target's location
Source: Dealogic

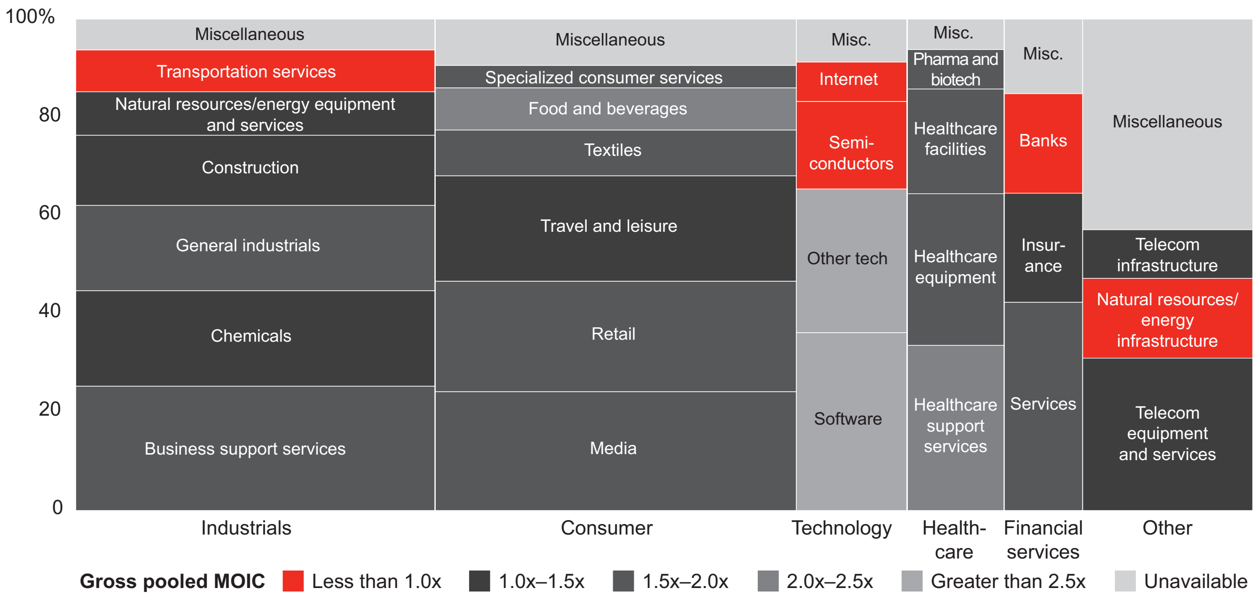
and planning carefully for how they can profit from the downturn. With the global financial crisis fresh in their memories, firms are focusing their diligence much more intently on downside scenarios this time around. They learned valuable lessons during the crisis about what holds up well through the cycle—or not—and are adjusting accordingly. Even within a sector like healthcare, widely viewed as recession-resistant, there were subsector differences in performance worth noting. Healthcare support services, for instance, produced multiples of better than two times invested capital, while healthcare equipment and pharmaceuticals fared less well, according to CEPRES, a digital investment platform and transactional network for the private capital markets *(see Figure 1.2)*.

Spotting pockets of opportunity has been a challenge even in the up-cycle. For GPs, finding the right asset at the right price was the biggest constraint on doing deals in 2018. That helps explain why the number of transactions has remained stubbornly flat, bouncing around between 3,000 and 4,000 buyouts per year since 2010. Indeed, despite the industry's impressive showing over the last five years, it has failed to carve out a larger share of the global market for mergers and acquisitions, which has hovered around 40,000 transactions per year for a decade *(see Figure 1.3)*.

When asked what most gets in the way of closing more deals, GPs cite the same challenges they have faced for years: high deal multiples, a dearth of attractive targets and stiff competition *(see Figure 1.4)*. GPs are clearly hungry to do more deals, but when they find attractive assets, they consistently encounter aggressive corporate buyers willing to push up auction prices. These buyers are strategic,

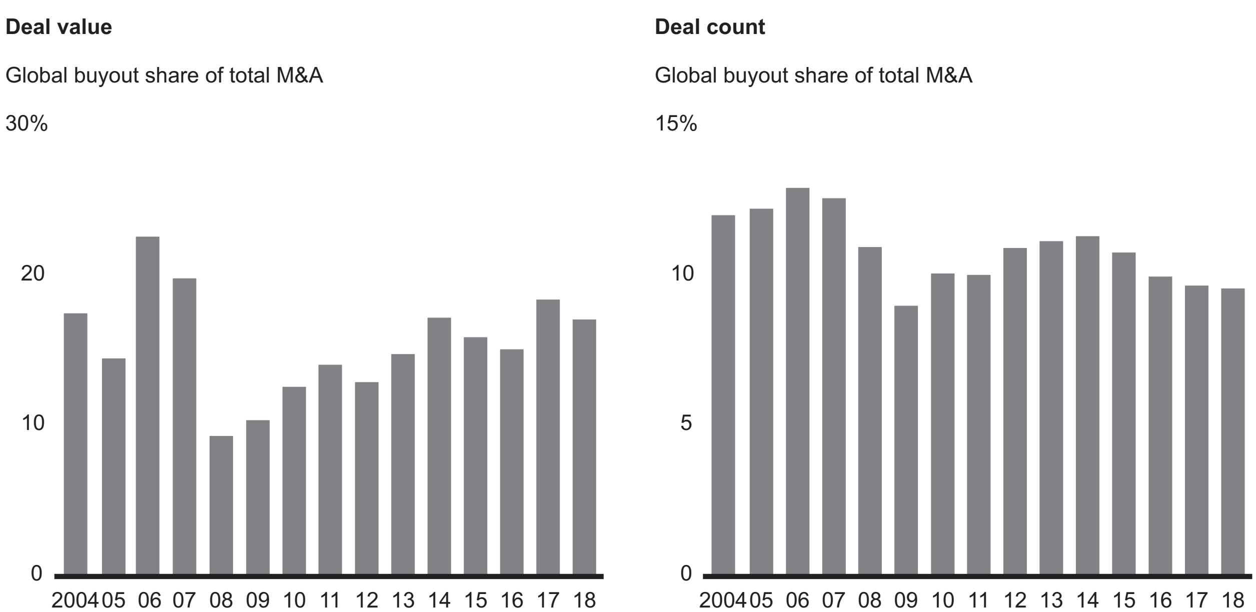
Figure 1.2: Returns during the global financial crisis were all over the map—between sectors and within sectors

Global buyout equity capital invested, by sector and subsector (2006–08)



Notes: Includes realized and unrealized buyout deals with invested equity capital of $50 million or more and initial investment between January 1, 2006, and December 31, 2008; MOIC stands for multiple of invested capital
Source: CEPRES PE.Analyzer

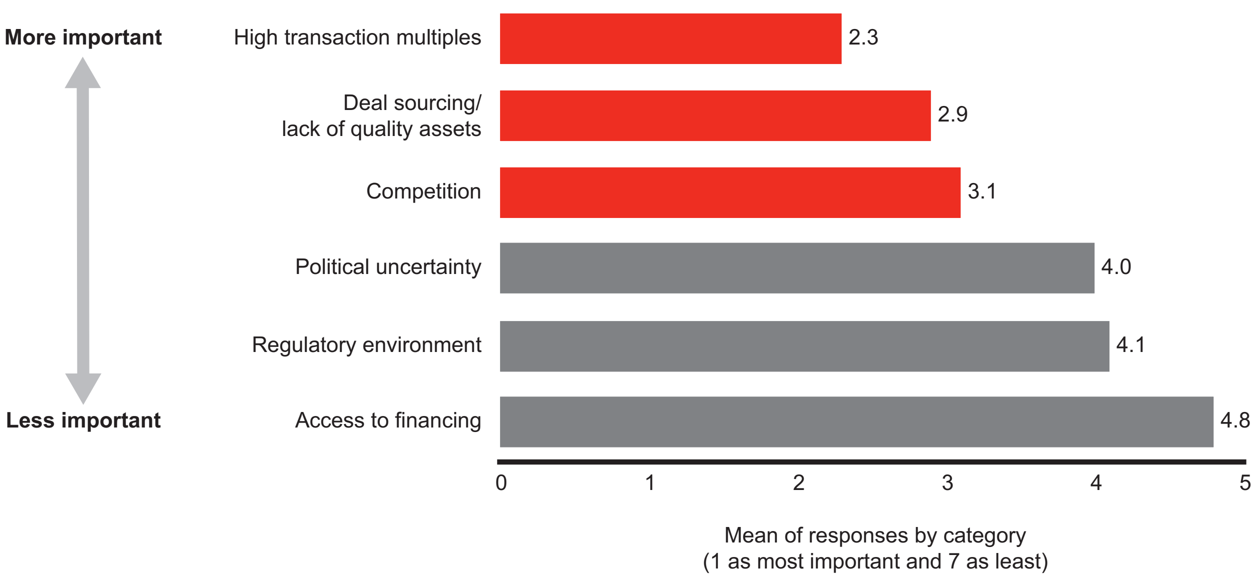
Figure 1.3: Private equity is not increasing its share of the total market for mergers and acquisitions



Notes: Total M&A is the sum of corporate M&A and buyouts, including add-ons; corporate M&A excludes transactions in which the acquirer is a government entity; based on announcement date; includes announced deals that are completed or pending, with data subject to change
Source: Dealogic

Figure 1.4: High multiples, a dearth of targets and stiff competition continue to be the biggest challenges for PE firms looking to close deals

What do you anticipate to be the biggest challenges for PE dealmakers in 2018?



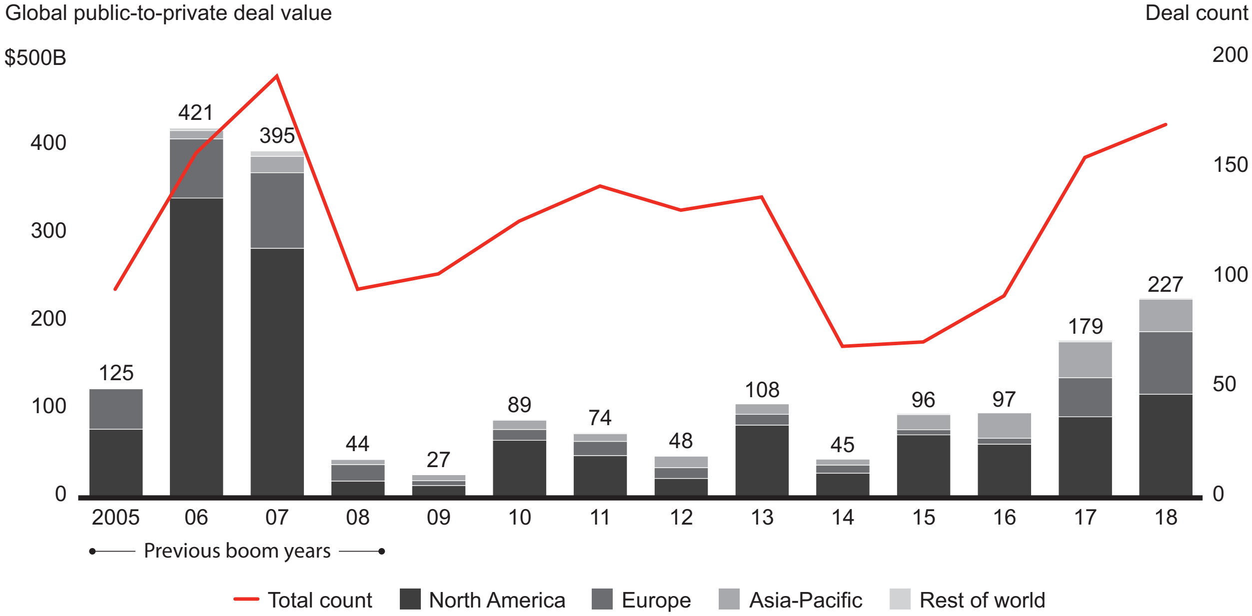
Source: Crystal Ball Report 2018, PitchBook Data, Inc.

meaning they will pay more to advance corporate objectives and capture synergies. Increasingly, they are showing up at all ends of the market as they search for ways to spur new growth through acquisition.

Large deals, especially a spate of very large carve-out transactions, helped boost deal value in North America by 22% in 2018. The year's largest buyout was the $17 billion carve-out of Thomson Reuters' Financial & Risk unit, led by Blackstone and the Canada Pension Plan Investment Board. Large public-to-private (P2P) deals, such as KKR's $9.6 billion leveraged buyout (LBO) of Envision Healthcare, also contributed to the bump in value. The strong P2P activity in the US pushed the value of these deals globally to its highest level since the previous take-private boom in 2006–07 *(see Figure 1.5)*. The reason: Despite the run-up in equity prices, public investors often undervalue companies they don't understand. "If you have a complicated story, you're not really welcomed so much in the public market," said Josh Harris, the cofounder of Apollo Global Management, which took LifePoint Health private in 2018. "That is creating a very fertile hunting ground for private equity, and we do see more opportunities here."

Sponsor-to-sponsor deals also provided a rich vein of opportunity in 2018. That was especially true in Europe, where deals between PE funds dominated in terms of both value and deal count, as they have since 2010. Partners Group led a consortium including CDPQ and the Ontario Teachers' Pension Plan in the $5.4 billion acquisition of Techem, a global leader in heat and water submetering services, from Macquarie. EQT acquired Azelis from Apax Partners for $2.3 billion. It was the fourth consecutive sponsor-to-sponsor transaction for Azelis, a global distributor of specialty chemicals and food ingredients.

Figure 1.5: Public-to-private deals reached their highest level since the previous boom years, in terms of both value and count



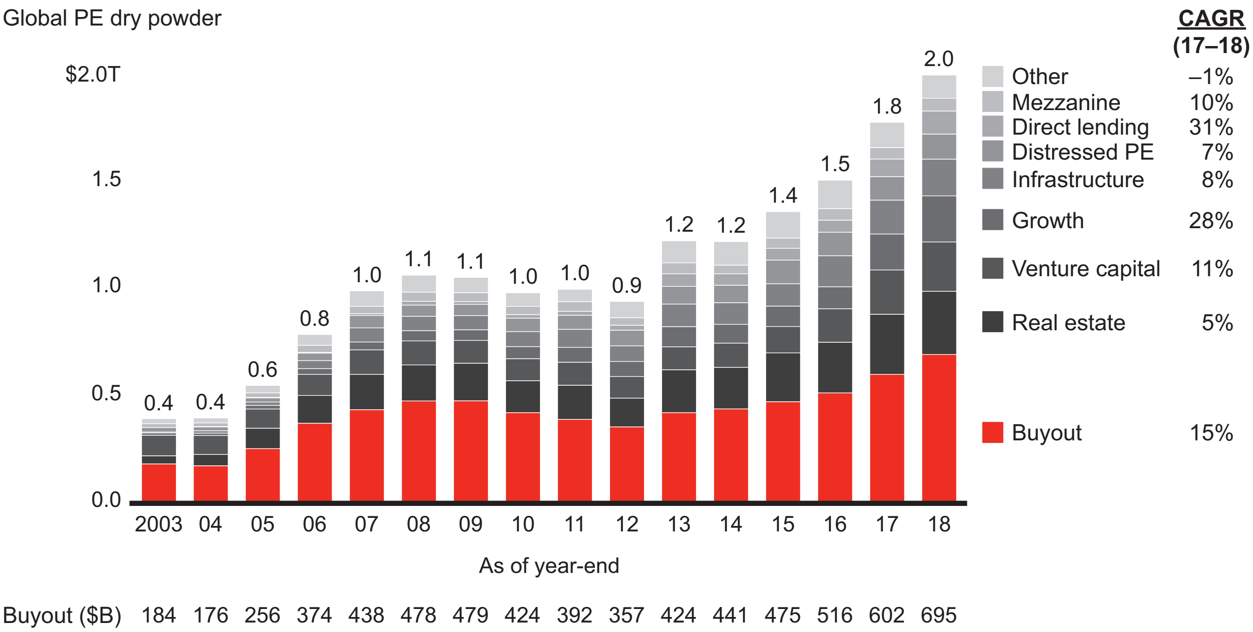
Notes: Includes add-ons; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location
Source: Bain global public-to-private deal database

Sponsor-to-sponsor deals get a bad rap because they can be inefficient in terms of repeated transaction fees, and the paths to value creation may be less obvious. Yet PE firms continue to see value in them. Indeed, Apax Partners netted a 3.5 times return when it sold Azelis. Working with another firm on the sell side can make deals significantly easier by speeding up both diligence and the transaction process. Previous PE ownership also generates a reliable track record and reassures buyers that any time bombs have likely been found and defused. Research consistently shows that sponsor-to-sponsor deals have performed at least as well as primary buyouts over time, often with less risk. When deals have gone bust, failure was frequently the result of factors that could affect any business, whether or not it was previously owned by a PE firm.

What's clear is that GPs are hard at work searching out value wherever they can find it. After years of record-level fund-raising, PE funds are awash in capital and face a growing need to put large amounts of money to work. Despite the strong pace of investment since 2014, PE dry powder, or uncalled capital, has been on the rise since 2012 and hit a record high of $2 trillion in December 2018 across all fund types *(see Figure 1.6)*. That stockpile raises concerns that the industry may be getting ahead of itself, much as it did in 2007 and 2008, when the global financial crisis slammed the brakes on deal-making, leaving GPs holding years' worth of uncalled capital and seeking extensions.

While the level of dry powder bears watching, a closer analysis of the dynamics at work today suggests there's little danger of the buyout industry falling too far out of balance. Based on current deal

Figure 1.6: Dry powder continues to pile up globally, setting a new record in 2018

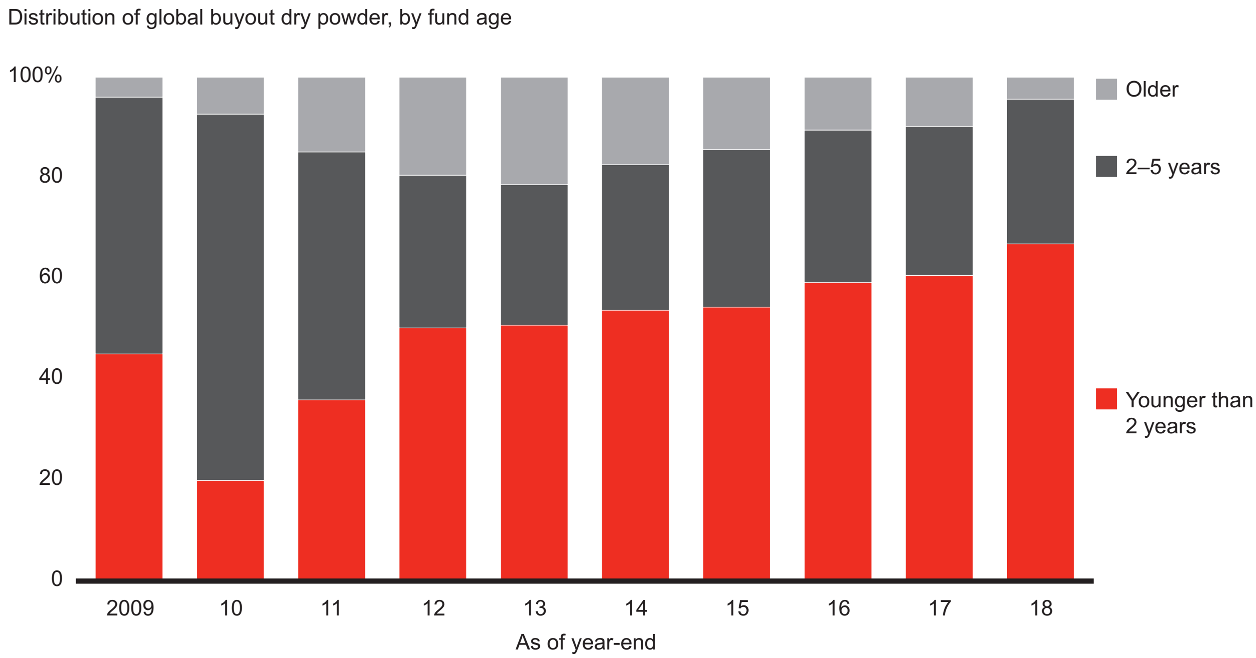


Note: Discrepancies in bar heights displaying the same value are due to rounding
Source: Preqin

values, the dry powder held in buyout funds today represents 3.0 years of investment, vs. 4.6 years in 2007 and 2008. That duration is well below the buyout industry's typical five-year investment time frame, suggesting that GPs have time to get unspent capital into the market. Of course, duration would rise if a recession developed over the next couple of years, but it would take a major downturn to produce a significant spike. Dealmaking would have to drop to the 2010–12 average for a sustained period of time—an unlikely scenario—for duration to push back above the five-year mark. It helps that PE funds are accumulating mostly "young" capital, raised by funds with recent vintages. Buyout firms hold 67% of their dry powder in funds raised in the last two years *(see Figure 1.7)*. That means the recent deal cycle is clearing out the older capital and replacing it with new.

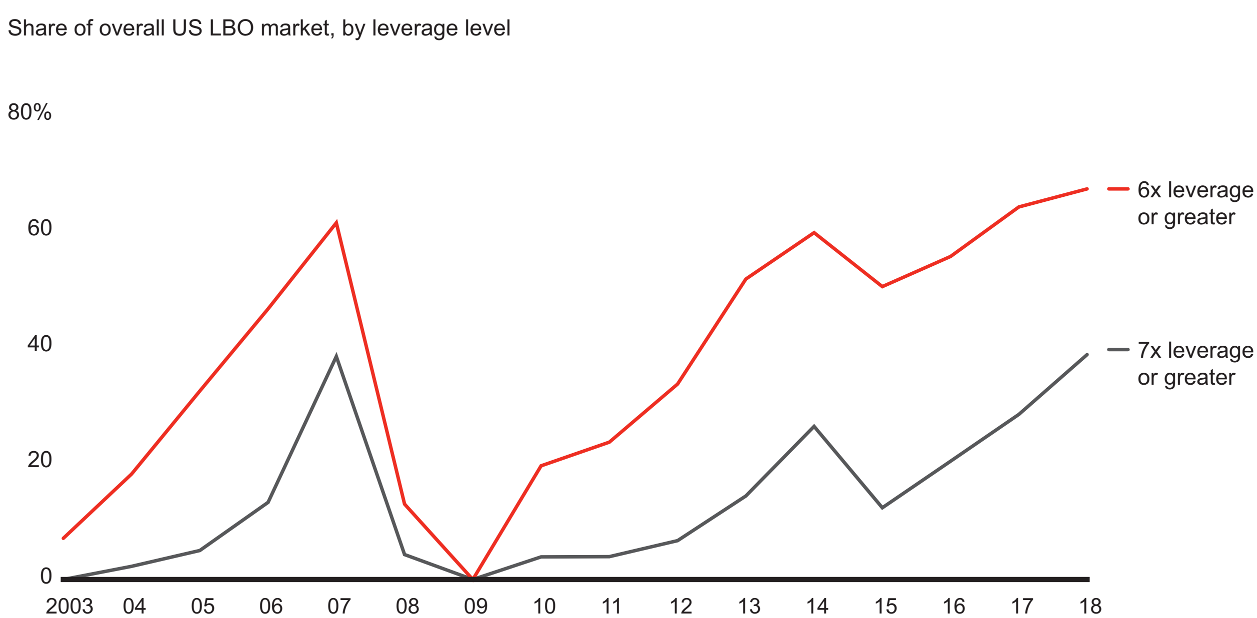
The debt markets encouraged GPs to keep doing deals through much of 2018. Despite the rise in US interest rates, the updraft was slow to be felt in loan pricing. Lenders, meanwhile, were competing aggressively to extend credit on easy terms. So-called covenant-lite loans have become increasingly common in lending markets in the second half of this cycle, and debt multiples have entered territory not seen since the peak of the last cycle. In the years following the global financial crisis, regulators discouraged multiples of six times earnings before interest, taxes, depreciation and amortization (EBITDA). Yet in the Trump era's more relaxed regulatory environment, the share of deals with multiples of greater than seven times EBITDA rose to almost 40% of the total, according to Loan Pricing Corp. (LPC), which tracks the syndicated loan market *(see Figure 1.8)*. The true leverage deployed in many deals may also have been understated: As is often the case in times of high risk tolerance, banks have allowed borrowers

Figure 1.7: Firms are holding the majority of their dry powder in their youngest-vintage funds



Source: Preqin

Figure 1.8: Highly leveraged buyouts have become increasingly common



Source: LPC

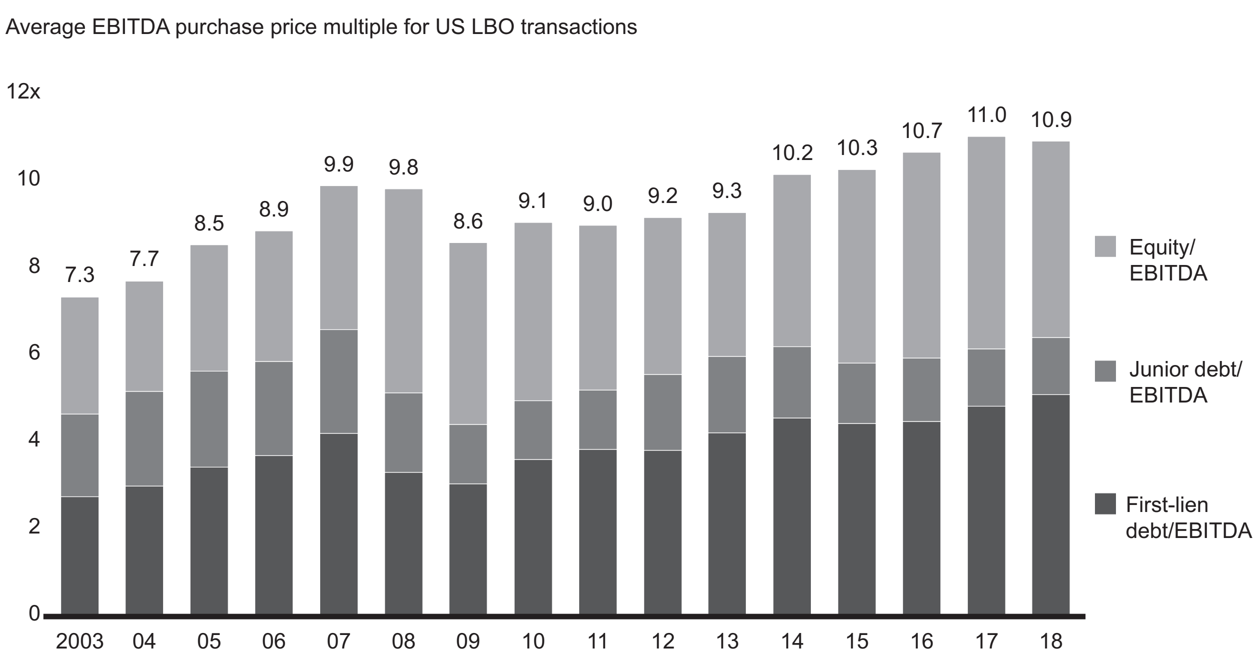
to calculate multiples based on projected earnings instead of actual results. Such calculations tend to bake in expectations for cost cutting, synergies and revenue increases that may or may not materialize.

As hot as the debt markets were for most of 2018, there were signs near year-end that things were cooling off. Amid heavy market volatility, Bloomberg reported that US leveraged loan funds saw $15.7 billion in outflows from November 21 to January 2, a seven-week rout that included the worst week on record. The news service also reported that Wells Fargo and Barclays had failed to sell a $415 million leveraged loan related to Blackstone's $700 million purchase of oil services firm Ulterra Drilling Technologies. Bloomberg said the banks reportedly planned to hold the loan on their books until they could once again try to unload it in January.

The heavy competition for assets and the flood of capital—both debt and equity—into the market since 2014 has had the inevitable effect of raising asset prices to all-time highs. The average multiple for leveraged buyouts in the US and Europe has hovered around 11 times EBITDA in recent years, above levels leading up to the global financial crisis *(see Figure 1.9)*.

These dynamics—abundant capital on easy terms, pressure to do deals, rising asset prices and an uncertain economic outlook—raise all the usual end-of-cycle red flags. The best-positioned firms are adjusting their approach in several ways, both to win more auctions without overpaying and to hedge against the risk of a downturn.

Figure 1.9: The average multiple for US leveraged buyouts continues to hover near record-high levels



Source: LPC

- With asset prices high and competition fierce, the most effective firms aren't pulling back. Rather, they are preparing themselves to either go big or go home. They are dialing in on the sweet spots and sectors where they are most confident, making clear calls on which auctions to show up for and which to avoid, as well as which teams to deploy. By starting diligence earlier and bringing in performance improvement experts, firms are working to build greater conviction about assets so they can bid more intelligently.

- Firms are also taking steps to get better access to target company management and data. That can strengthen the relationship and improve insights, giving the firm an edge against less-prepared bidders. In Europe, firms are taking it a step further: They are increasingly launching preemptive bids in an attempt to win an auction process before it starts.

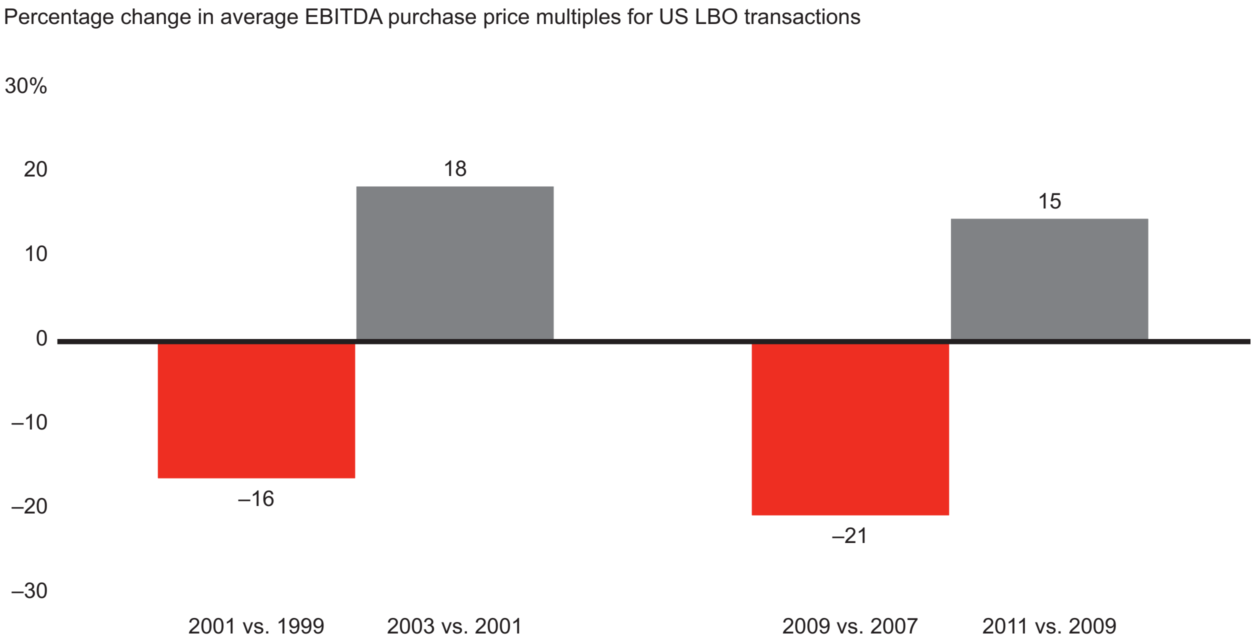
- As we mentioned earlier, firms are paying much closer attention to what might disrupt their carefully prepared value-creation plans and looking to avoid blind spots. Not only are they running through more robust downside scenarios to pressure test investments, but they're also anticipating other challenges—how to cope proactively with digital disruption, for instance, or how to negotiate issues like consolidation in the supply base.

- Downturns inevitably create opportunities as markets stall and target company performance weakens. Historically, this brings valuations down—but not for long. In the past two downturns, the average LBO purchase price multiple dropped about 20% from its high but then recovered most of that within two years *(see Figure 1.10)*. It pays to be ready to pounce when the downturn arrives, developing a clear understanding of where the most attractive targets are in a given asset class or sector and striking aggressively as the cycle plays out.

- That also applies to distressed situations. Recognizing that downturns create real opportunity for those prepared to invest across the capital structure, firms like Apollo and Centerbridge Partners have developed the capabilities to pivot quickly to buying debt or other distressed credits. In Apollo's 2008 fund, for example, distressed debt and other credits made up 60% of total assets, reflecting the firm's confidence in acquiring the debt of companies in trouble. By the 2013 fund, however, distressed investments comprised only 4% of assets as the economy improved and the firm shifted back to traditional equity investments *(see Figure 1.11)*. "We traverse downturns," Apollo cofounder Leon Black told the *Financial Times*. "Forty percent of all our money has been invested in down-cycles, when everybody else shuts down."

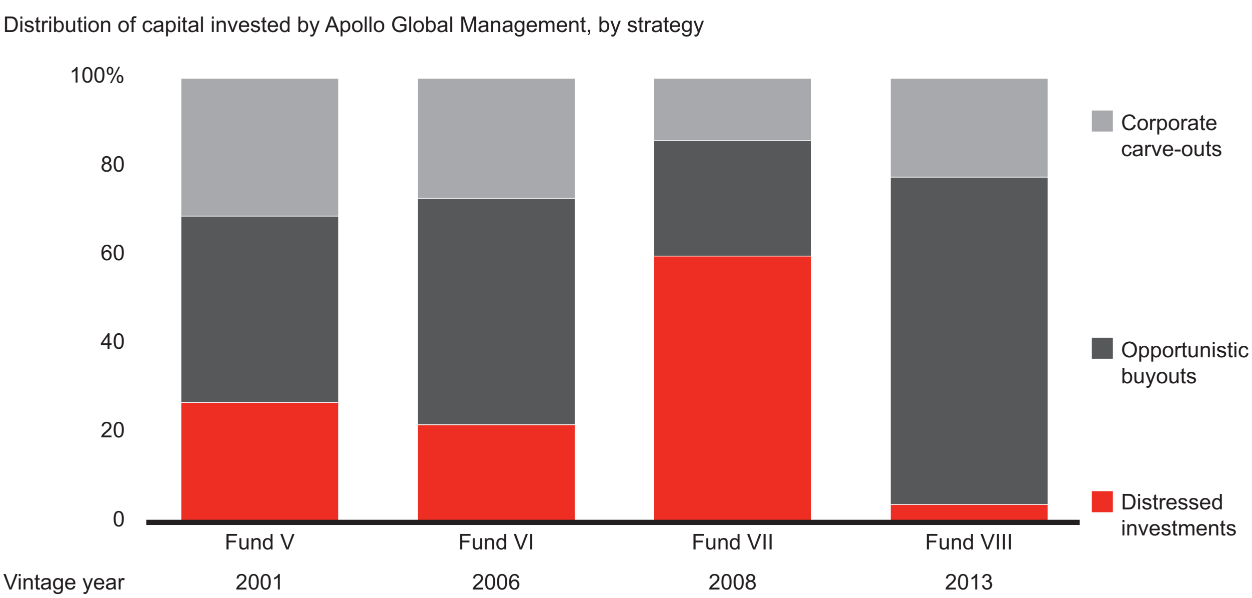
The industry's structural challenges—high prices and fierce competition—are combining with macro uncertainty and accelerating digital innovation across sectors to force behavior change among PE firms. As we'll explore in Section 2, the most effective are building new capabilities, like advanced analytics, or reinforcing existing ones, like merger integration. They are also underwriting new and different kinds of risk than in the past. Firms continue to put money to work, but they are working harder to get it done.

Figure 1.10: Purchase price multiples tend to bounce back quickly after downturns



Source: S&P Capital IQ LCD

Figure 1.11: The distressed portion of Apollo's funds follows the ups and downs of the economic cycle



Notes: Funds shown are part of the Apollo Investment Fund series; vintage year as stated by Apollo; data as of December 31, 2016; based on total invested capital as per the fund's initial investment strategy at time of acquisition, except for Fund VIII, which is based on committed capital; distressed investments include credit and distressed buyouts
Source: Apollo investor presentation, February 2017

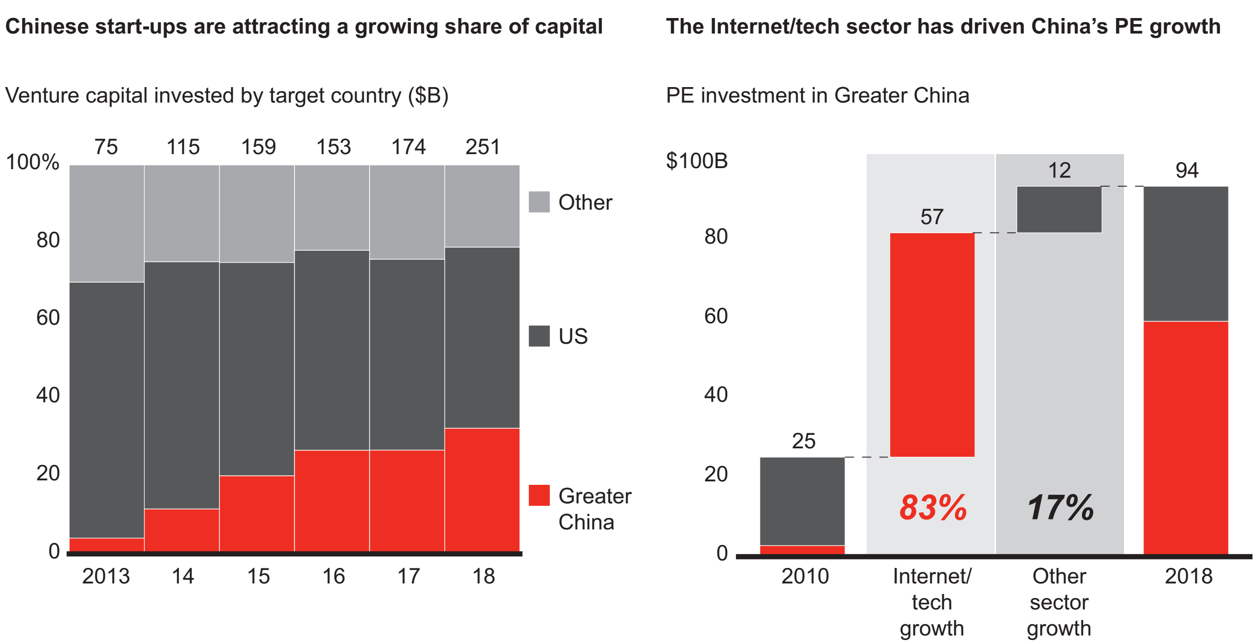
Spotlight on China: Navigating the new economy

Despite the overall slowing of China's GDP growth, its new-economy sector has expanded dramatically over the past five years. Chinese Internet and technology firms are capturing a growing share of global private equity and venture investment, a signal of just how much has changed. In 2018, global investors poured an estimated $81 billion into Chinese start-ups—32% of invested global venture capital, up from 4% five years ago and creeping up on the 47% received by US start-ups *(see Figure 1.12)*.

The US still produces more unicorns—start-ups valued at $1 billion or more—but Greater China is now producing them at a faster pace than the US. Internet and technology deals have accounted for roughly 85% of Greater China's PE investment growth over the past eight years, and they represented fully half of all Asia-Pacific deal value in 2018.

As investors flock into the market, however, there are clear signs that China's new economy may be overheating. With asset values soaring, we see potential for the speculative bubble to burst sooner rather than later. Fund managers who continue investing in Chinese Internet and tech companies do so now at considerable risk. Some may have the expertise to navigate the risks successfully, but for most investors, particularly those that haven't yet entered the market, staying on the sidelines is likely the smartest short-term approach. Now's the time to develop a clear strategy for the future by identifying

Figure 1.12: Greater China's new economy is moving at astonishing speed



Note: PE investment excludes deals with a value less than $10 million
Sources: PitchBook Data, Inc.; AVCJ

where to strike opportunistically when valuations become more attractive. Given its long-term potential, China's new economy will almost certainly bounce back from any crash.

A different world

By many measures, China's new economy is in a class of its own. China's consumers behave differently than Western consumers. Obsessed with technology and convenience, they snap up new products and online services quickly. Chinese Internet users surpass US users, for example, in adopting new apps for online entertainment, payments, and education and travel services. In the mobile payments industry, China racked up $9 trillion in transactions in 2016, 80 times the US level of $112 billion.

Cutthroat competition among the country's burgeoning Internet and tech companies has shaped a Darwinian corporate culture. Managers expect their teams to deliver the rapid growth needed to survive. Employees in China's tech sector work a grueling 72 hours per week on average—12 hours a day, six days a week. The pool of skilled labor is also deeper—China has almost six times more computer science graduates than the US. Overall, US computer scientists may be more skilled, but the profusion of engineering talent in China accelerates development.

Fueled by intense, open-source competition, Chinese tech companies also grow faster. While Silicon Valley companies have tended to steer clear of copycat products and services, Chinese managers consider it good corporate practice to copy the competition. Unlike their US counterparts, Chinese Internet and tech companies expand outside their core product or service in every direction. China's Internet giants, for example, have acquired companies in financial services, gaming, education, healthcare and artificial intelligence.

Unsurprisingly, this dynamism has attracted a stampede of investors keen to tap into this large and growing market. According to Bain's 2019 Asia-Pacific private equity survey, 80% of Greater China–focused funds are considering or actively pursuing new-economy deals. In 2017–18, more than 800 PE investors had a stake in an Internet or technology deal in China with a value greater than $10 million, up from about 170 in 2009–10. China's new economy, once dominated by venture capitalists, now includes traditional private equity houses, LPs, sovereign wealth funds, and Internet giants such as Alibaba, Tencent and Baidu. The influx of investors has saturated the market for smaller deals and prompted many to focus on larger investments: Average deal size rose to $213 million in 2018, up from $30 million in 2013.

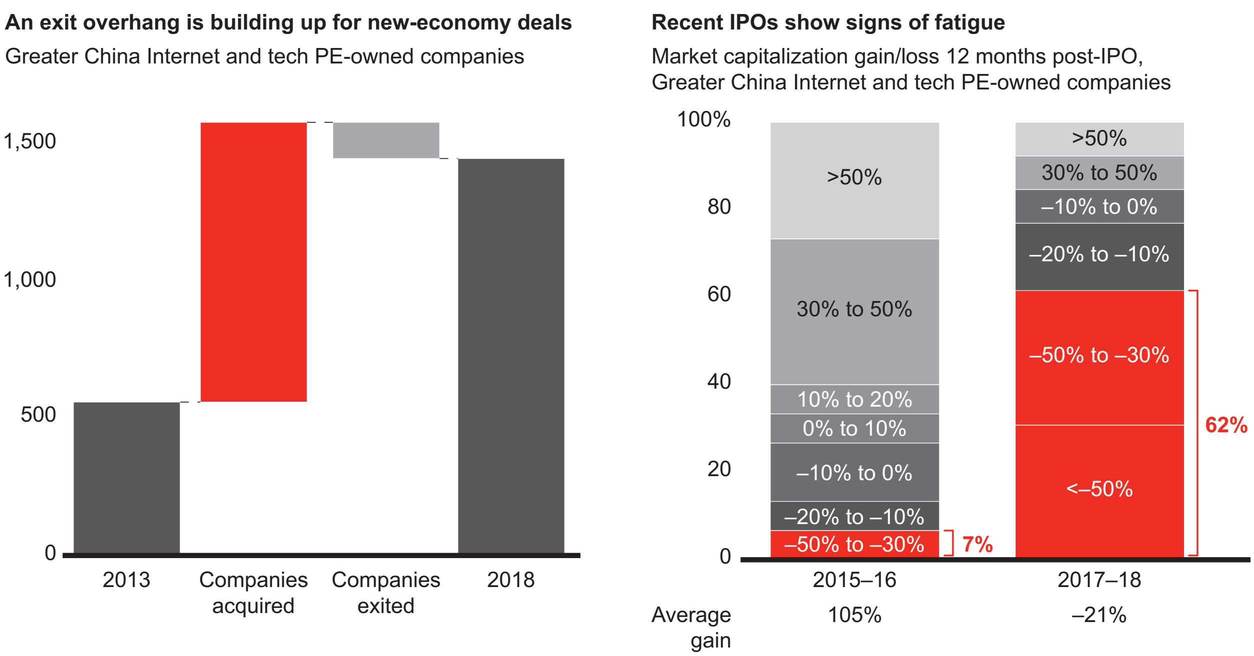
Early warning signs

For traditional PE investors, China's new economy can be particularly challenging. Our research shows that 85% of PE investors focused on Greater China consider it difficult to evaluate new-economy companies, mainly because traditional PE valuation techniques don't work in that market and because it's difficult to justify investing in loss-making businesses.

At the moment, those risks are magnified by inflated expectations. Internet and technology deals already are wildly overpriced compared with other sectors. At 31 times EBITDA, median M&A deal multiples for Chinese Internet and tech companies are twice as high as those for other industries in Greater China, and 2.4 times greater than the median multiple for Asia-Pacific deals in 2016–18. That's a warning signal for investors, and funds' recent performance underscores the danger. China's new-economy returns are in free fall: Median return multiples dropped to less than 2.0 times in 2016–18, from 4.7 times in 2014–15.

Another ominous sign: the sizable and expanding exit overhang of Internet and tech assets. Over the past five years, PE funds acquired more than 1,000 Internet and technology companies in Greater China with a value of $10 million or more, but they divested only about 130 in the same time frame. That trend means viable exit opportunities are scarce. Recent initial public offerings (IPOs) are a case in point. Companies that went public between 2017 and 2018 had lost, on average, 21% of their initial market capitalization 12 months post-IPO. And the losers lost big: 62% of companies that went public shed more than 30% of their value. By contrast, companies that went public between 2015 and 2016 gained an average of 105% in value in the first 12 months after the IPO. Only 7% lost more than 30% of their value. As the IPO market softens and return multiples drop, funds that overpaid for companies in their portfolios see no alternative but to hold onto assets *(see Figure 1.13)*.

Figure 1.13: There are warning signs that China's new-economy bubble may burst



Notes: Excludes deals with a value less than $10 million; based on number of unique companies; IPO sample size was 15 for 2015–16 and 13 for 2017–18
Sources: AVCJ; Bloomberg

Given those challenges, it's no surprise that GPs focused on Greater China are wary. A full 65% of those we surveyed see a high to very high risk of a bubble bursting in the coming years. Meanwhile, only 6% of them believe they are operating at full potential when it comes to establishing partnerships to help source new-economy deals. The same small proportion say they have a proven model to evaluate risks or add value in this sector.

Strategies for the future

Given the degree of uncertainty, the best strategy is likely to hold fire. There are plenty of solid investment opportunities outside China's new economy, in markets that are not so overpriced. What is risky today, however, could well become attractive in the future, when soaring valuations retreat to a normal range. China's new economy is moving at astonishing speed. Its entrepreneurs are creating a new paradigm for growth and value creation. That's a wake-up call that fund managers should not ignore. Those who focus on defining a strategy now will be well positioned to seize opportunities, especially in a post-bubble market.

A few questions can help fund managers map out a clear approach for the future:

- What are the distinct capabilities that helped us win in the past, and which ones are transferable to new-economy markets in China?
- Under what conditions might it make sense to invest in Chinese tech or Internet companies in the future?
- If we decide to enter this market, where should we play first, and why?
- What are the capabilities or partnerships we would need? Which ones can be built or bought now?

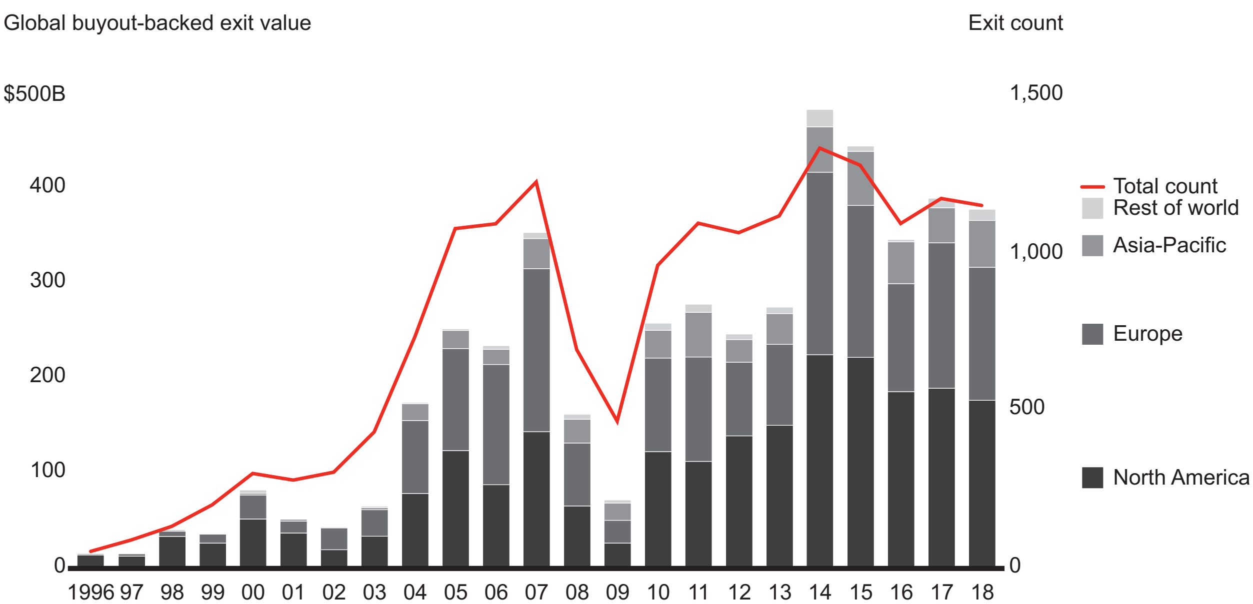
Exits: Strategic buyers keep the party going

Although exit activity in 2018 came in a smidgen lower than the previous year, it was still a strong contributor to a historic five-year stretch that has produced unprecedented distributions for investors. Last year's 1,146 exits, valued at $378 billion, were on par with 2017 *(see Figure 1.14)*. The robust performance brought total exit value since 2014 to $2 trillion, by far the largest five-year total on record.

Activity over that period has bounced around somewhat, but the overall trend in exits has been strong and steady, generating an equally steady flow of capital back to LPs. Investors were cash flow positive for the eighth year running, meaning distributions have outstripped contributions each year—a virtuous cycle that has encouraged LPs to continue pumping capital back into the industry *(see Figure 1.15)*.

Exit value has been steady across regions, with the Asia-Pacific market producing the only real spike in 2018. Asia-Pacific exit count actually dropped during the year, but the average transaction size more than doubled due to a number of large exits in China and India. The US and Europe also benefited from a stream of big deals. Golden Gate Capital and Bain Capital, together with GIC, Insight Venture Partners and Elliott Management, produced the biggest exit in the US when they sold BMC Software to KKR for $8.3 billion. Europe's largest exit was Macquarie's $5.4 billion sale of Techem to Partners Group, CDPQ and the Ontario Teachers' Pension Plan.

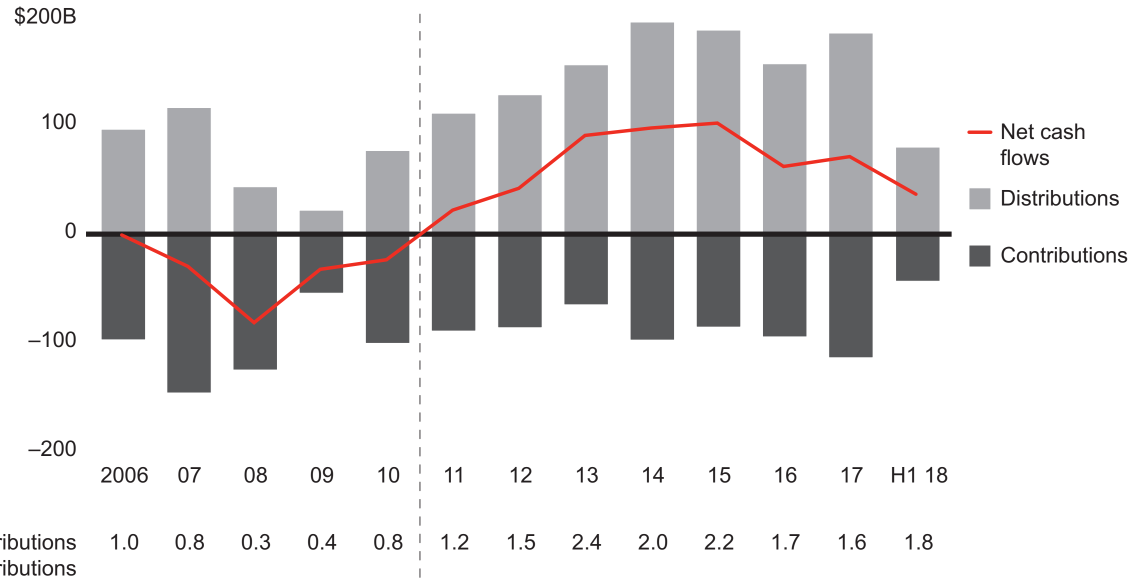
Figure 1.14: Buyout-backed exits continued strong in 2018



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

Figure 1.15: LPs have been cash flow positive on their PE investments for eight years running

Capital contributions and distributions, global buyout funds



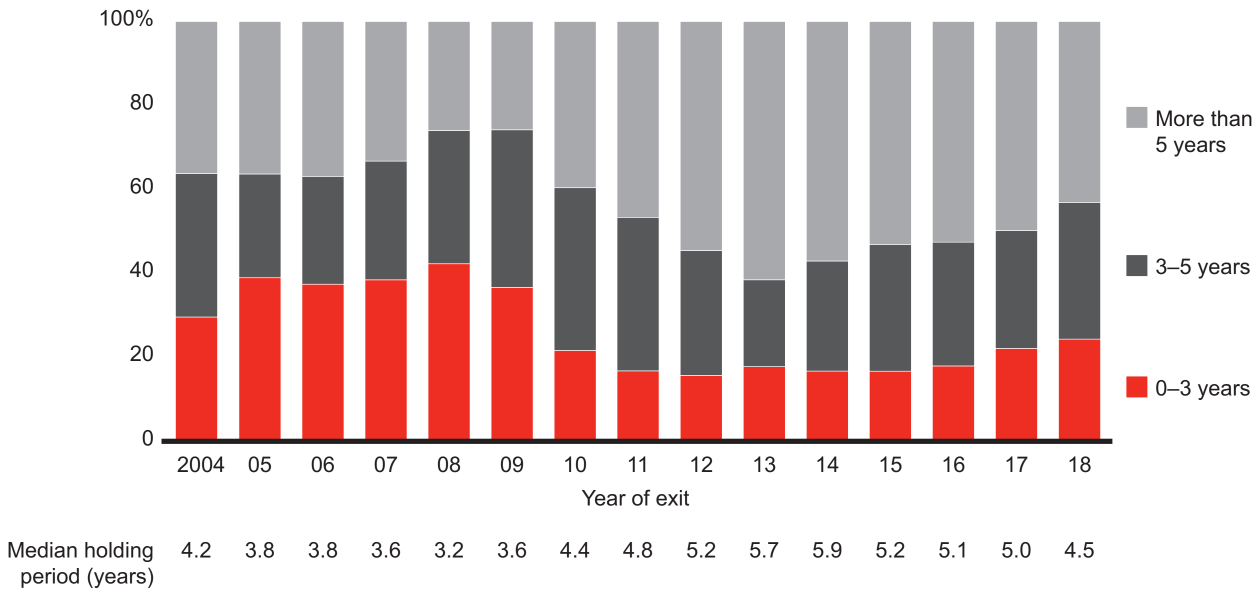
Source: Cambridge Associates Private Investments Database

With some exceptions, such as partial exits, GPs are clearly in no mood to hang onto assets any longer than they have to. The median holding period (how long funds are holding onto portfolio companies before exiting) fell 10% last year to 4.5 years, after edging down slowly from a peak of 5.9 years in 2014. "Quick flips," or assets held for less than three years, are still well below levels seen at the exuberant end of the last cycle, but they've crept up to 24% of the total *(see Figure 1.16)*. Changes in the US tax treatment of carried interest were expected to discourage quick flips, but they ticked up last year anyway.

The urgency to sell reflects a number of factors. First, demand for assets among both corporate and PE buyers is ravenous. The same rise in competition and deal multiples that frustrates GPs on the buy side provides a rich opportunity to sell assets for premium prices. Second, as signs of economic weakness pile up, firms are also looking to sell anything that isn't tied down, knowing that a recession could make it harder to sell later. Similarly, firms know that the robust fund-raising environment won't last forever, meaning it pays to get back on the road as soon as possible. Many are willing to trade a little bit of IRR on current exits so they can turn to raising a new (and hopefully bigger) fund, which can provide fee income and fresh capital to invest for the next five-plus years. Decisions like those are made easier by the proliferation of exit committees charged with moving assets out of the portfolio most opportunistically. Taking the decision away from the managing director who "owns" the deal tends to avoid the trap of missing opportunities while trying to squeeze every last dollar from every last deal.

Figure 1.16: The median holding period is falling as GPs exit an increasing percentage of companies in less than five years

Distribution of global buyout-backed investments exited, by length of time held in fund portfolio



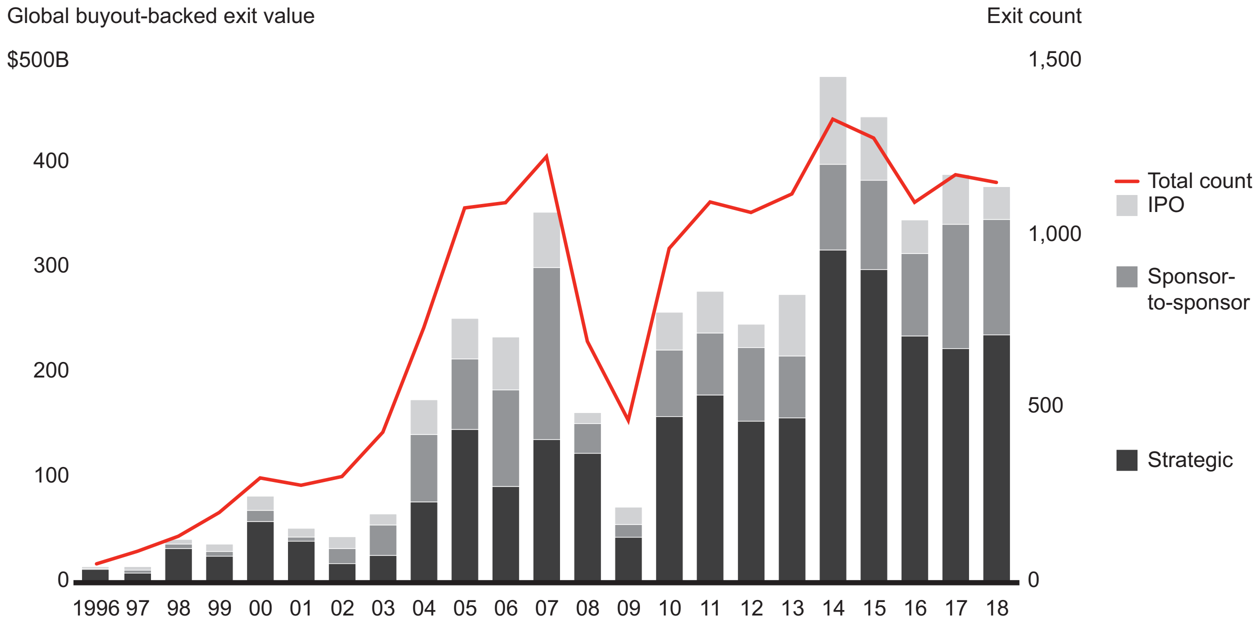
Source: Preqin

Where the activity was

Strategic deals. Cash-rich corporate buyers looking to build scale and scope through acquisition continue to pace the market. Sales to these strategic buyers represented 2018's most vibrant exit channel *(see Figure 1.17)*. At a time when organic growth is hard to come by, corporations see real advantage in acquiring companies that have been pre-scrubbed during PE ownership. When The Stars Group bought Sky Betting & Gaming from CVC Capital Partners for $5 billion, for instance, the goal was to add sports betting to Stars' dominant position in online poker. By the same token, Adobe hopes its $4.8 billion acquisition of Marketo from Vista Equity Partners will help accelerate expansion of its cloud-based marketing platform in the business-to-business space.

Sponsor-to-sponsor deals and IPOs. Sponsor-to-sponsor deals remained an important exit channel globally. While off slightly in terms of value, sponsor-to-sponsor exits turned in their third-strongest year ever for the industry in 2018. The value of IPOs, meanwhile, fell 34% globally as market uncertainty and higher volatility curtailed activity, especially in Europe and Asia-Pacific. As GPs grapple with an uncertain economic outlook, IPOs can be less attractive than onetime sales. Public offerings are essentially slow-motion exits, since mandated holding periods and market timing considerations force a firm to hold onto a large share of its investment for a period of years. That can allow a GP to continue to profit from the upside in good times, but if the economy falters, so might the value of the investment. It's notable that, in December, CVC launched a bid to take private Sweden's Ahlsell, a construction prod-

Figure 1.17: Sales to strategic buyers and other sponsors kept up a brisk pace in 2018, while IPO exits weakened



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

ucts company it had listed on the public markets only two years earlier. CVC still held a 25% stake in Ahlsell, but the company's stock was trading below the IPO price. IPO data doesn't account for follow-on sales—the sale of stakes left over from previous years' IPOs—which have provided a significant source of liquidity in recent years. In 2018, however, increased volatility in the global equity markets suppressed follow-on activity, as GPs saw fewer chances to exit positions.

Dividend recapitalizations. Despite the upward trend in US interest rates, GPs have continued to take money off the table and de-risk investments by recapitalizing debt. Dividend recaps, in fact, have held up better than anyone expected. Tightening credit markets are starting to take a toll, however. Given the favorable debt environment of the past two or three years, it's becoming harder to find a new credit agreement with better terms than the old one. In Europe, dividend recaps were down meaningfully from a spike in 2017, crowded out by demand for loans from the broader M&A market.

Partial exits. Last year, we talked about the increasing popularity of partial exits, deals in which a firm sells part of a portfolio company but holds onto the rest. Despite the seller's market for assets described earlier, the trend continued in 2018. Given how hard it is to find deals and redeploy capital, GPs are increasingly reluctant to sell a company they believe has more room to run. Faced with the traditional three- to five-year timeline for buying and selling assets, a firm may feel the need to sell a partial stake to lock in gains or return capital to investors. Occasionally, the goal is to pass the asset from one fund to another, and selling a stake establishes the necessary arm's-length valuation. In any of those cases, though, retaining a position keeps the firm involved in the company's upside, often as majority shareholder.

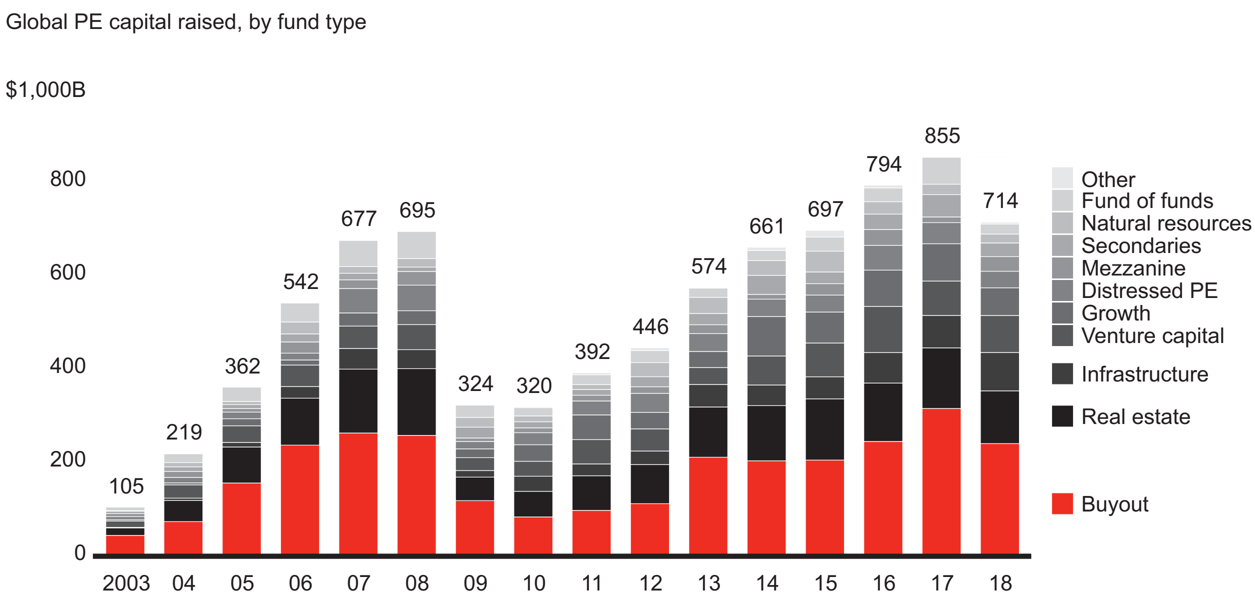
That was the strategy when Carlyle and Paris-based Montefiore Investment sold a 40% stake in European Camping Group (ECG) to the Ontario Teachers' Pension Plan in April 2018. The PE owners had spent several years assembling ECG through a buy-and-build strategy and had faith that more time would allow them to unlock additional value. Selling a minority stake to a patient, long-term investor like Ontario Teachers' monetized a significant portion of the investment. It also allowed Carlyle and Montefiore to retain majority control over ECG's future. Following a similar logic, Hellman & Friedman sold a partial stake in insurance brokerage Hub International to Altas Partners in October 2018. After the minority investment, H&F remained Hub's largest shareholder. Altas, a Toronto-based fund manager with a long-term orientation, said it plans to support the current strategy and management, which also invested in the deal. Selling a partial stake obviously doesn't make sense for all assets. But when a portfolio company's potential extends well beyond the five-year timeline, more firms are taking steps to ensure they aren't bailing out too soon.

• • •

Fund-raising: The capital continues to flow

By historical standards, PE funds attracted an impressive amount of capital in 2018, although the pace slackened from 2017's record-breaking performance. GPs raised $714 billion from investors during the year—the third-largest amount on record—bringing the total since 2014 to $3.7 trillion *(see Figure 1.18)*.

Figure 1.18: While PE fund-raising fell off slightly in 2018, GPs have attracted more capital since 2014 than during any previous five-year stretch



Notes: Includes funds with final close and represents the year in which funds held their final close; buyout includes buyout and balanced funds; distressed PE includes distressed debt, special situation and turnaround funds; other includes private investment in public equity and hybrid funds
Source: Preqin

Buyout funds continued to draw the biggest share of capital, but investor interest during this record stretch has been broad and deep, benefiting all variety of funds.

The fund-raising peak in 2017 owed much to the closing of several of the largest buyout funds ever—the top three funds alone collected a staggering $57 billion in capital. Last year's megafunds weren't quite that big, but it would be hard to describe them as anything but massive. Carlyle Partners VII led the pack with $18.5 billion, followed closely by Hellman & Friedman Capital Partners IX with $16.0 billion and EQT VIII with $13.2 billion. Investors surveyed by Probitas Partners insisted they are turning their attention to smaller US buyout funds, US growth equity funds and European funds. Yet the strong performance by trusted managers continues to attract large flows of capital to megafunds, those raising $5 billion or more. Indeed, 2019 started off with a bang when Thoma Bravo closed its latest flagship fund at $12.6 billion, a big leap from the $7.6 billion it had raised for its previous flagship.

Emerging markets and the Asia-Pacific region were global fund-raising's lone soft spots last year. Investors looking for diversification continue to be drawn to Asia-Pacific's relatively strong long-term growth profile. But Greater China saw a massive decline in RMB fund-raising amid the central government's decision to tighten rules on PE investment, part of an effort to rein in debt and reduce financial risk. Only 14% of funds raised globally in 2018 were focused on the Asia-Pacific region, down from 23% the year before.

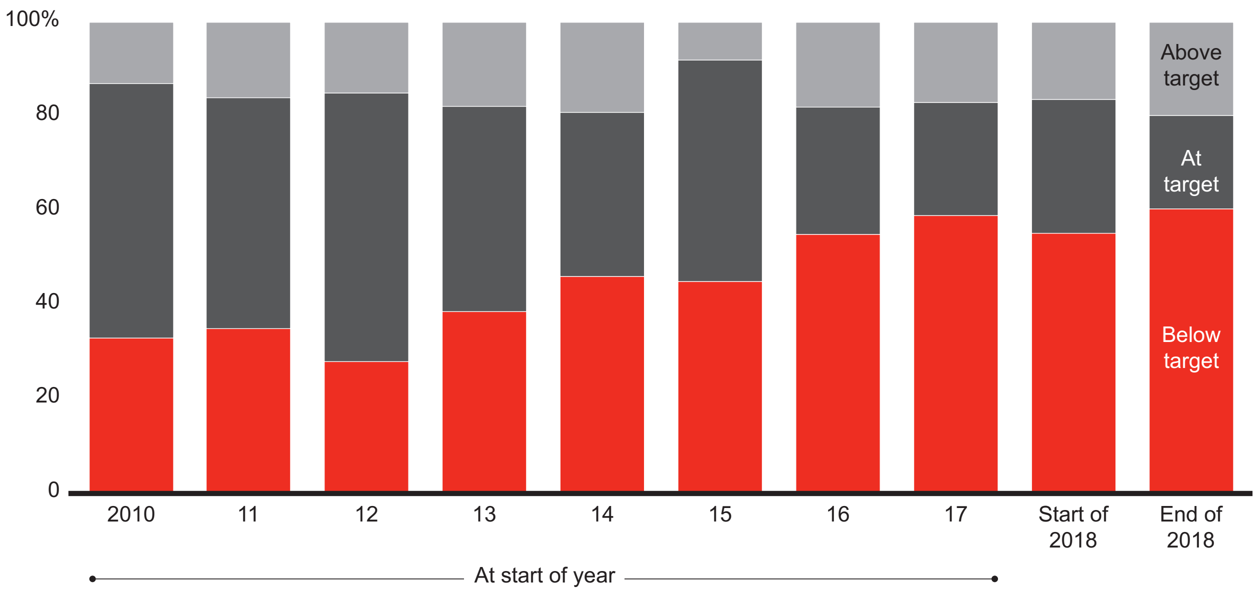
Emerging markets and the Asia-Pacific region were global fund-raising's lone soft spots last year. Overall, though, investor enthusiasm for private equity remains vibrant.

Overall, though, investor enthusiasm for private equity remains vibrant, and it's easy to understand why. As we noted earlier, LPs have been cash flow positive on their PE positions for the past eight years. The asset class has outperformed others historically, and market analysts are almost unanimous in their opinion that private equity's track record will continue. For LPs, the major challenge is keeping up with their gains. More than 90% of those surveyed by Preqin said they want to maintain or increase their capital contributions to private equity in coming years, and intend to maintain or increase their percentage allocations. Yet because distributions have been so robust and competition for new allocations is fierce, LPs have been unable to recycle gains fast enough to maintain their targets *(see Figure 1.19)*.

Strong investor demand led to continued success on the fund-raising trail. Although the total number of PE funds closed during the year dropped in 2018, 56% of those seeking capital reached their goals (or were oversubscribed) within two years. For buyout funds, the pace was even faster—60% reached their goals within a year *(see Figure 1.20)*. The average time on the road for all PE funds stayed the same at 16 months. Buyout funds are getting to close within 12 months on average.

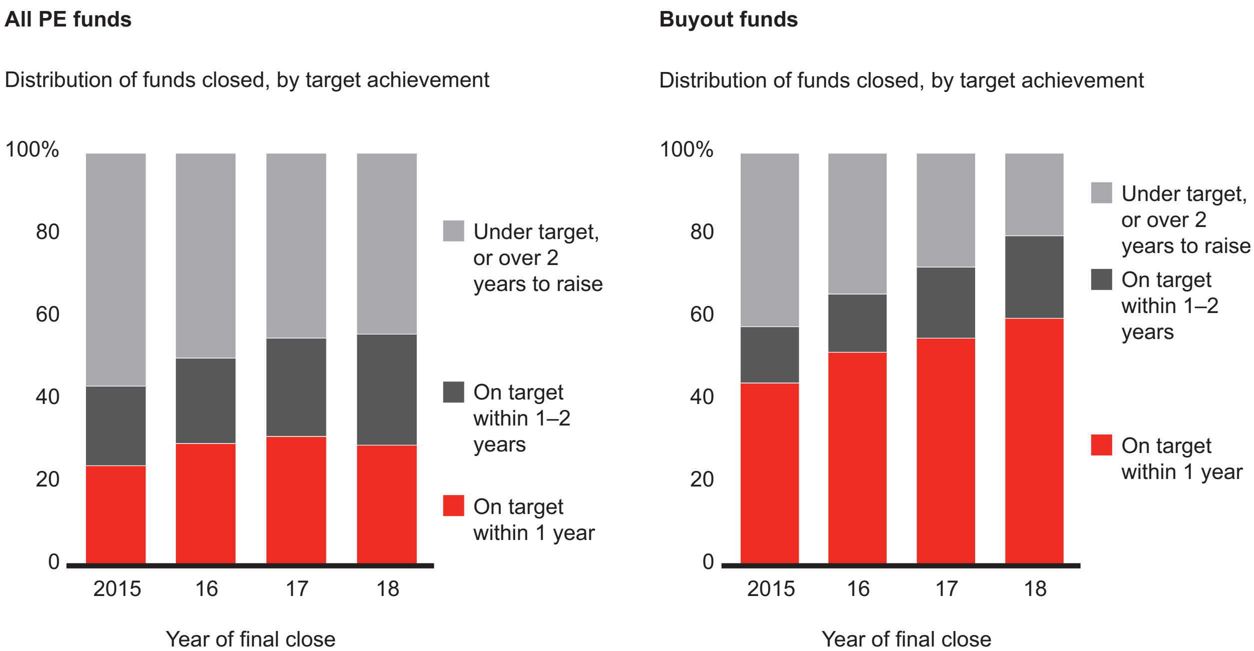
Figure 1.19: Institutional investors cannot pump their PE gains back into the industry fast enough to maintain their target allocations

Distribution of LPs, by fund-raising status



Source: Preqin

Figure 1.20: Buyout funds are reaching their targets faster than the overall industry



Source: Preqin

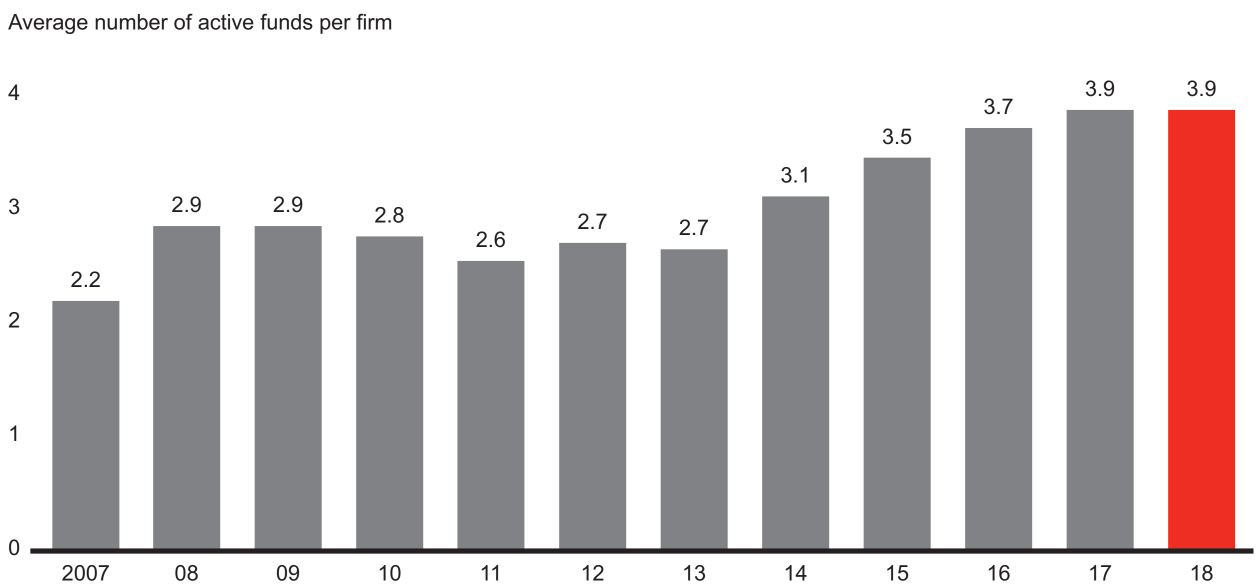
Moving beyond the core

Because LPs are constantly looking for new ways to invest with the firms they favor, GPs are expanding their menu of offerings. The number of funds per firm has increased steadily since the beginning of the current cycle, as GPs take careful steps to stretch beyond their core *(see Figure 1.21)*. While these menu expansions typically depend on where the firm thinks it can best take advantage of its unique capabilities, we've seen heavy activity in three areas: sector-focused pools of capital, growth equity funds and long-duration funds. (For more on adjacency expansion, see page 58.)

The number of sector-focused funds in the market has grown sharply since the economy began its climb out of the global financial crisis in 2010. GPs have also raised pools of capital dedicated to specific sectors that can fly under the radar, such as sidecar funds or sleeves within funds. Specialization has become increasingly attractive as the market for deals has gotten more competitive. Specialized funds allow a GP and its investors to double down on areas in which the firm has deep expertise, strong conviction about assets and an extensive network that can surface attractive targets.

About half of the sector-specific funds on the market are dedicated to healthcare and technology investments. The superior growth characteristics of these two broad sectors have attracted PE investors for years, but they've become even more popular among LPs at a time when fears of an economic down-

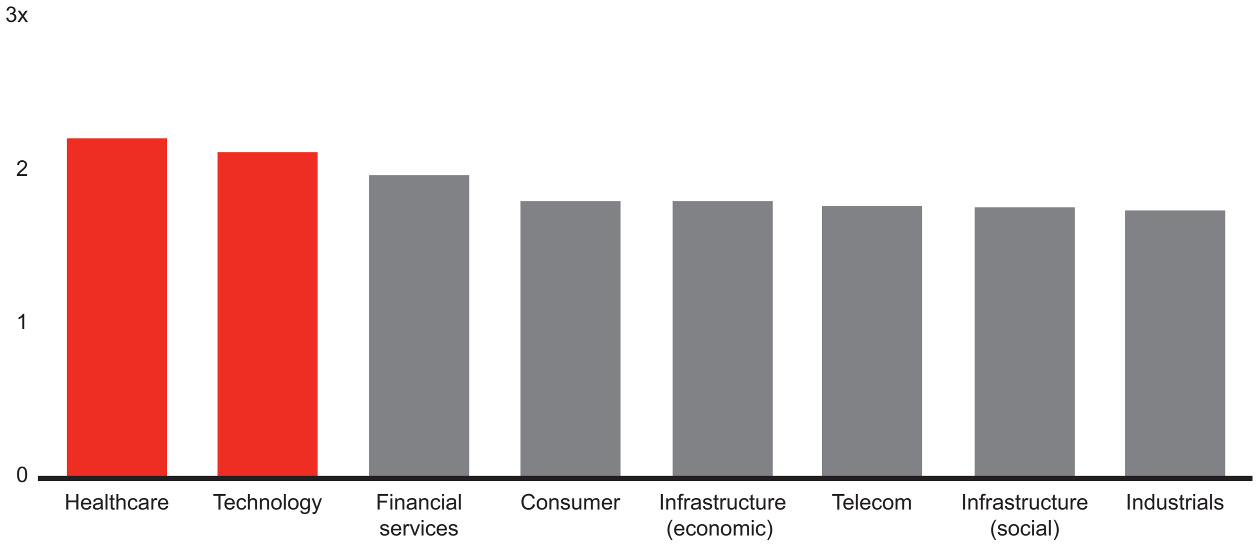
Figure 1.21: Responding to market demand, buyout firms continue to add products to their slate of fund offerings



Notes: Analysis includes 88 buyout firms that have closed more than $2 billion in buyout capital funds in the last five years; active funds defined as those having held a final close in the five years preceding each year; discrepancies in bar heights displaying the same value are due to rounding
Source: Preqin

Figure 1.22: Strong returns and shelter against recession are attracting investors to healthcare and technology funds

Gross pooled MOIC, by sector, for global buyouts invested 2009–15



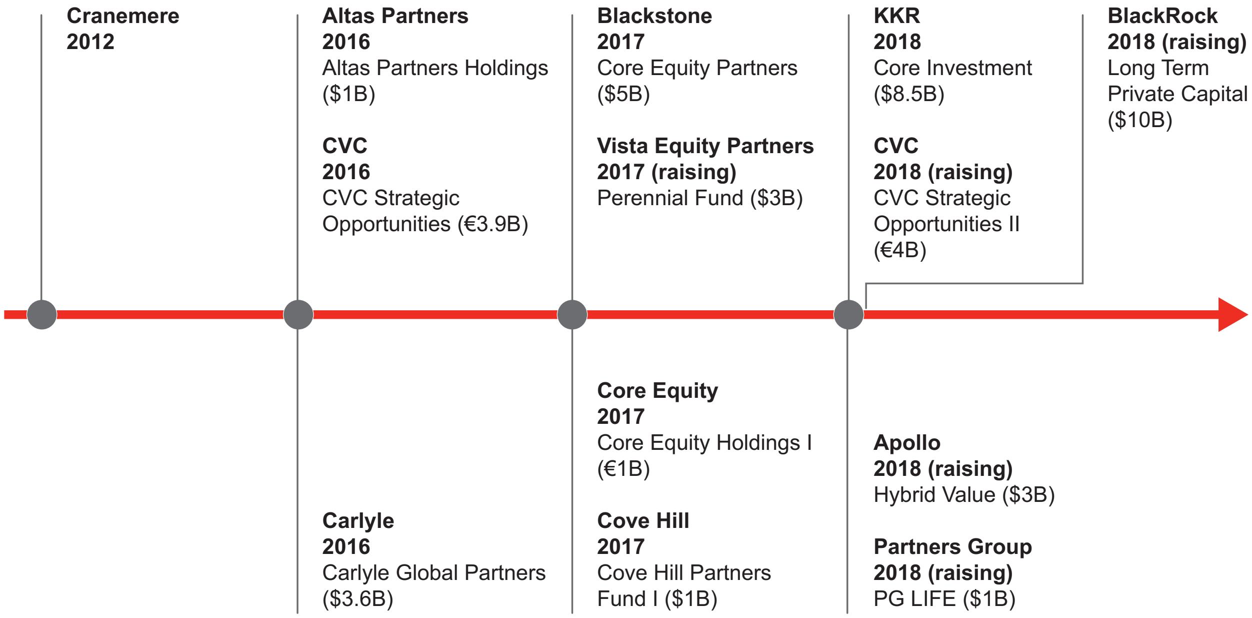
Notes: Includes realized and unrealized buyout deals with invested equity capital of $50 million or more and initial investment between January 1, 2009, and December 31, 2015; MOIC stands for multiple of invested capital
Source: CEPRES PE.Analyzer

turn are prompting investors to look for cover. Healthcare and technology offer the holy trinity of strong growth, recession resistance and superior historical returns. In the current cycle, healthcare deals have returned $2.2 for every $1 of invested capital on a gross pooled basis, while technology deals have returned $2.1, according to CEPRES. Those multiples outshine valuations in every other sector *(see Figure 1.22)*.

GPs catered to the high level of investor demand by launching a number of large sector-specific funds in 2018, including Thoma Bravo's $2.4 billion Discover Fund II, focused on technology, and Linden Capital Partners' $1.5 billion Fund IV, dedicated to healthcare. Healthcare and technology investments also figure prominently in another vibrant area for fund-raising—growth equity funds. Since 2014, GPs have raised $367 billion for these funds, which invest in companies that lie between venture-backed firms and traditional buyout targets in terms of business maturity. (For more, see "Growth equity: Buyout-like returns with less leverage" on page 66.)

As we discussed in last year's report, longer-duration funds are another way that PE firms are broadening their offerings. With attractive new targets harder and harder to find, more GPs are seeing the value of holding onto high-quality companies for as long as they keep generating value. Traditional buyout firms, of course, typically aim to acquire companies and sell them within three to five years. Not all assets, however, have reached their full potential within that time frame. Many are held by a

Figure 1.23: Firms continue to experiment with fund duration and risk/return profile



Notes: Year represents year of final close for closed funds and year of formal announcement or first public reporting for raising funds; Blackstone Core Equity Partners has not held a final close but reportedly reached its target of $5 billion in 2017; for raising funds, value listed is the reported target amount
Sources: Preqin; literature search

succession of PE owners over a 15- or 20-year period, generating value all along the way. For the original owner, that amounts to leaving money on the table.

Consequently, GPs are launching funds with longer investment time frames, a trend that accelerated in 2018 with large long-duration funds from firms like KKR, Partners Group and CVC *(see Figure 1.23)*. This corner of the PE universe is still relatively small and untested. But it is growing steadily as investors come to appreciate its virtues—lower transaction costs, advantaged tax treatment, more flexibility to sell when the time is right, and capital that is fully invested over longer periods.

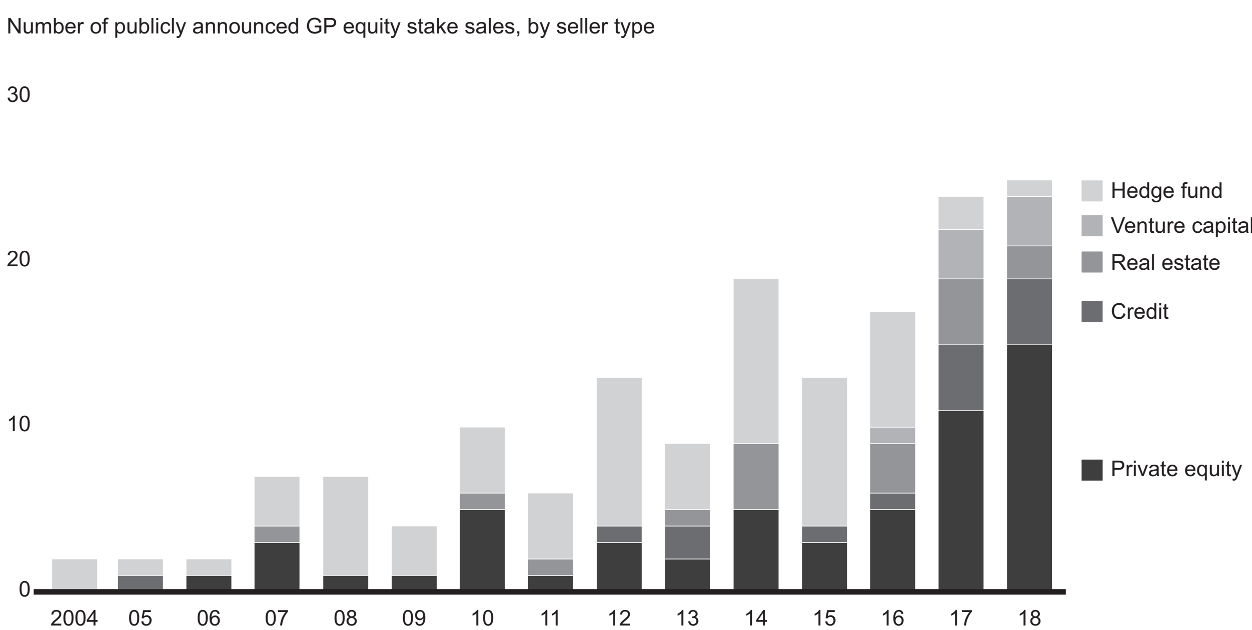
Spotlight on GP equity stakes: Will the bonanza continue?

While the buying and selling of minority stakes in PE firms isn't exactly new, a once-infrequent practice has exploded into a full-blown market over the past several years. Since 2014, 119 firms have sold off pieces of themselves to raise capital—more than double the number over the previous five years. Until recently, hedge funds had dominated the relatively short list of firms seeking to raise capital this way, but that's changed. Now, traditional, privately held PE firms like American Securities and Bridgepoint are the ones selling the most minority stakes *(see Figure 1.24)*.

The emergence of bulk buyers like Dyal Capital Partners (a division of Neuberger Berman) and Blackstone's Strategic Capital Holdings has accelerated the trend. While the space was once the domain of institutional investors buying individual stakes, these firms are raising billions in capital for "fund of firms" vehicles that are dedicated to buying portfolios of GP minority stakes. Including players like Goldman Sachs' Petershill fund and AlpInvest Partners, this group has raised more than $17 billion since 2012 to pursue the market *(see Figure 1.25)*. They are clearly addressing hungry demand: A recent Coller Capital survey indicated that one in six LPs already invest in funds pursuing GP stakes, while another one in five are considering such investments.

The expanding market for GP minority stakes is a natural outgrowth of a maturing PE market. It's easy to forget that private equity was a cottage industry 30 years ago, dominated by a relatively small

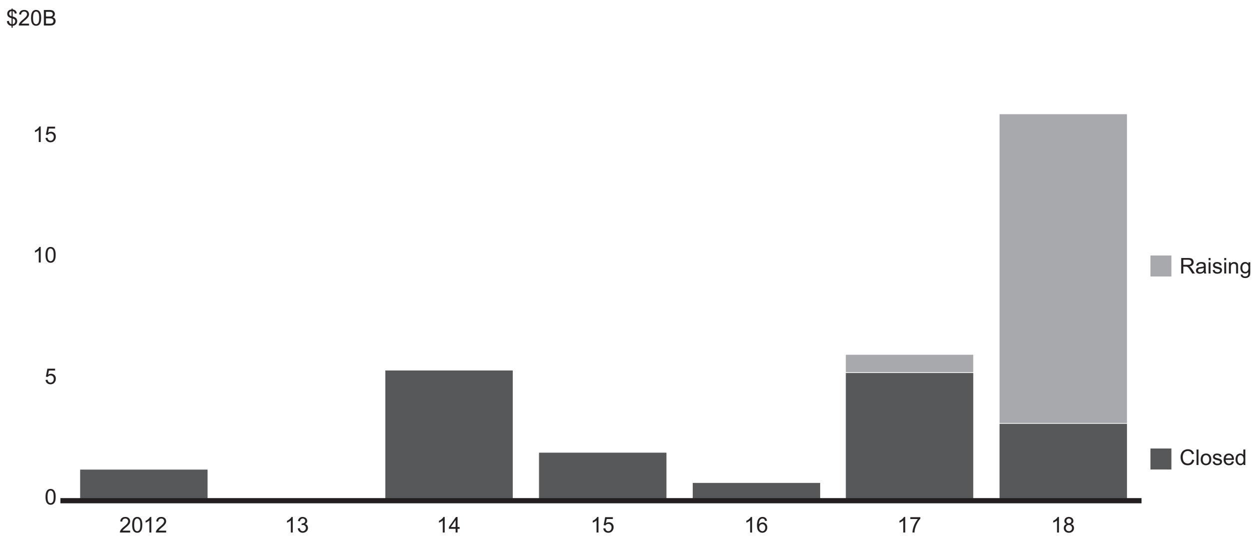
Figure 1.24: Sales of GP equity stakes have increased in recent years



Notes: Excludes secondary transactions of GP equity stakes; in case of multiple equity stake sales by one fund manager, each stake sale is counted
Source: Bain GP equity stake sale database

Figure 1.25: Funds targeting GP equity stakes have raised $17 billion so far and are currently on the road looking to raise $14 billion more

Global PE fund-raising exclusively targeting GP equity stakes



Notes: Closed represents the year in which funds held their final close and the final amount; raising represents the year in which fund-raising was announced and the target amount
Sources: Preqin; literature search

club of scrappy founder-led firms courting a similarly narrow set of LPs. Having grown significantly faster than anyone anticipated, today's PE marketplace raises issues and opportunities—for both GPs and LPs—that didn't exist in the early days. The market for GP equity can support objectives on both sides of the transaction.

Funding succession and growth

For GPs, the need to manage generational change within the firm has been the primary motivation for selling minority stakes to date. This often isn't the publicly stated reason, since firms are careful to avoid the appearance that they are cashing out the team responsible for historical performance. Yet the truth is that a growing number of firms face the challenge of succession planning as their founding partners approach retirement age and seek ways to monetize substantial ownership and carry stakes. Going public is one option, but that raises its own set of headaches and is not a viable path for most firms, given the scale and fee streams public markets demand. Selling a minority stake, on the other hand, is proving to be an efficient means of generating liquidity for many firms.

Increasingly, sellers are motivated by the operational and financial challenges that come with growth. Up to a point, firms can use lines of credit to fund their needs. But as they become larger and more sophisticated, many are looking to build their own balance sheets. They require capital to support acquisitions or expand into new geographies and sub-asset classes. They also need to beef up talent, add capabilities or fund internal investments in areas like digital technology and IT. H.I.G. Capital, for instance, sold a stake of less than 15% to Dyal in 2016; the firm plans to use the raised capital to invest in its own funds and to finance growth initiatives. And Vector Capital sold an unspecified stake to Dyal in 2018 to help build out its credit business.

Tapping cash flows

For investors, buying a minority stake offers the chance to boost performance by participating in a firm's cash flows, not just the returns of an individual fund. The income stream from management fees and carried interest can be both steady and substantial. What drives disproportionate investor returns for this strategy is strong growth in assets under management (AUM). A firm capable of expanding AUM in both its core and newer products will generate a predictable fee income that increases into the future. Investors that buy well can make a lot of money from fees, with the additional prospect of strong carry income. At a time when LPs are clamoring to get into the best-performing funds, owning a stake may also offer another benefit. Striking a closer relationship with a GP can result in preferred allocations in a firm's primary fund, as well as opportunities to coinvest alongside the firm.

Investing in minority stakes, of course, carries its own set of risks. While simply allocating capital to a PE fund has a time limit, taking an equity stake is a long-term bet on the firm's success. The buyer is putting enormous faith in the firm's ability to maintain performance over time, to continue to differentiate itself, to understand market changes, and to adjust strategy accordingly by choosing the right adjacencies and executing within them. Buyers are also betting that the leadership team will remain aligned over the years and renew itself with new talent as necessary.

Investing in minority stakes carries its own set of risks. While simply allocating capital to a PE fund has a time limit, taking an equity stake is a long-term bet on the firm's success.

History has shown, however, that a track record of poor performance can impair a firm's equity or wipe it out completely by making it harder for the GP to raise new capital or causing the firm to wind down. There's also the threat that selling equity in the firm will shrink the pot for existing partners, increasing the risk that top talent might leave. Even if firm leadership proves worthy of trust, negative macro trends can disrupt growth in AUM, crimping cash flow. These risks raise the bar for the buyer to do its due diligence, structure the deal thoughtfully and invest in firms that have earned its trust already.

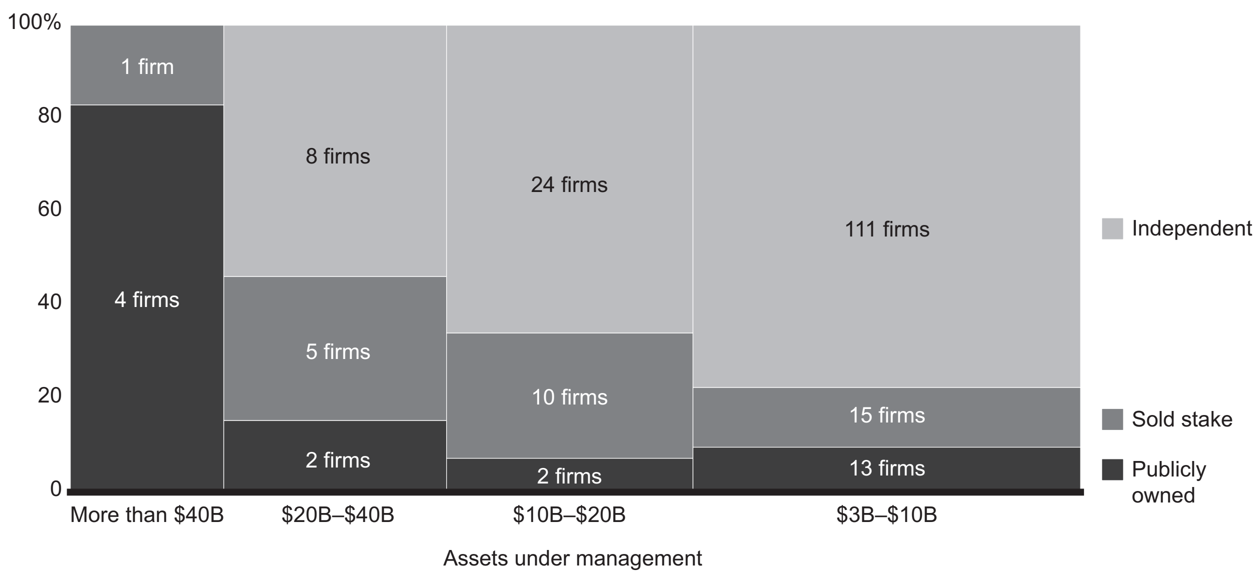
Is the peak past?

A critical question is how much opportunity remains. Already, the pool of the most obvious candidates is shrinking. Many of the buyout, growth equity, infrastructure and natural resources firms with AUM of $3 billion or more have sold a minority stake or are publicly traded *(see Figure 1.26)*. These "off the market" firms represent around 40% of the AUM for this group. Firms can sell additional stakes, but when buyers raise capital to fund acquisitions, the agreements tend to cap sales at 20% of a given firm's equity, so as not to disrupt its incentive programs and provoke defections. That leaves buyers to scour the market for targets among other PE subcategories or among small GPs that might need capital to grow. Some are even trying to seed new firms. Three large institutional investors—the Alaska Permanent Fund Corporation, RPMI Railpen and Wafra, on behalf of Kuwait's Public Institution for Social Security—have formed a coalition called Capital Constellation to fund promising start-up funds and spin-offs.

At the same time, the pools of capital dedicated to buying GP minority stakes are proliferating. As competition for their equity increases, sellers are likely to drive harder bargains for a stake, preserving more value for themselves. Although public data is scarce, anecdotal evidence suggests that returns for those who invested early in this cycle have been sensational. One example: Dyal Capital Partners III, launched in 2015, is reporting a net internal rate of return (IRR) of 26%. Clearly, however, the early buys were done at attractive prices, as industry AUM expanded beyond what anyone would reasonably

Figure 1.26: Because many large firms are either public or have already sold equity stakes, investor focus has shifted to midsize firms that promise future growth

Global PE firm assets under management, by GP equity ownership status



Notes: Assets under management approximated as sum of capital raised between 2009 and 2018; includes only buyout, growth equity, natural resources and infrastructure funds; GP equity ownership status reflects announced transactions and publicly stated intentions to IPO
Sources: Preqin; literature search

have expected. Now, with more savvy sellers and increased competition among buyers, returns for this strategy will likely come down. Publicly traded PE firms like Apollo, KKR and Blackstone, which together averaged an IRR in the mid to high single digits over the past five years, provide a good benchmark. It is reasonable to expect returns for private and publicly traded equity to converge over time.

As the opportunity set for primary equity stake sales is exhausted, it is almost certain that a secondary market for the stakes will develop. This would act as a relief valve for the capital raised for this strategy, as well as provide a path to liquidity for existing stake owners. In 2016, Goldman Sachs sold five stakes in hedge funds invested by Petershill Fund I to Affiliated Managers Group, a holding company for money management firms. While transactions like this have been few and far between to date, they are likely a harbinger of more to come.

Maximizing value

With so much capital chasing firm equity, GPs have a prime opportunity to tap the market. To make the most of it, they'll need to develop a clear understanding of the firm's full potential and build a convincing story around that vision. Otherwise, the firm risks doing what many did in the early days—giving away value. Maximizing the upside is no different from readying a portfolio company for sale. Leaders need to start with questions in a few key areas:

- What is our growth ambition for both our core business and adjacent products? Have we mapped out with confidence what the firm's future cash flows will look like over the next 5 to 10 years?
- Do we really know what has driven historical performance in our core, and are we confident we can replicate that success in the future? Are we still focusing on the same kinds of deals, and if not, why not? How should our sweet spot expand, and why do we believe we will be successful doing so?
- For adjacencies, do the anticipated new product offerings take advantage of existing assets and capabilities? What will it cost to build new ones?
- Do we have a comprehensive plan for scaling our management platform to achieve expansion ambitions?
- Have we quantified the opportunity to maximize our cash flows by taking cost out of the business and becoming more efficient?

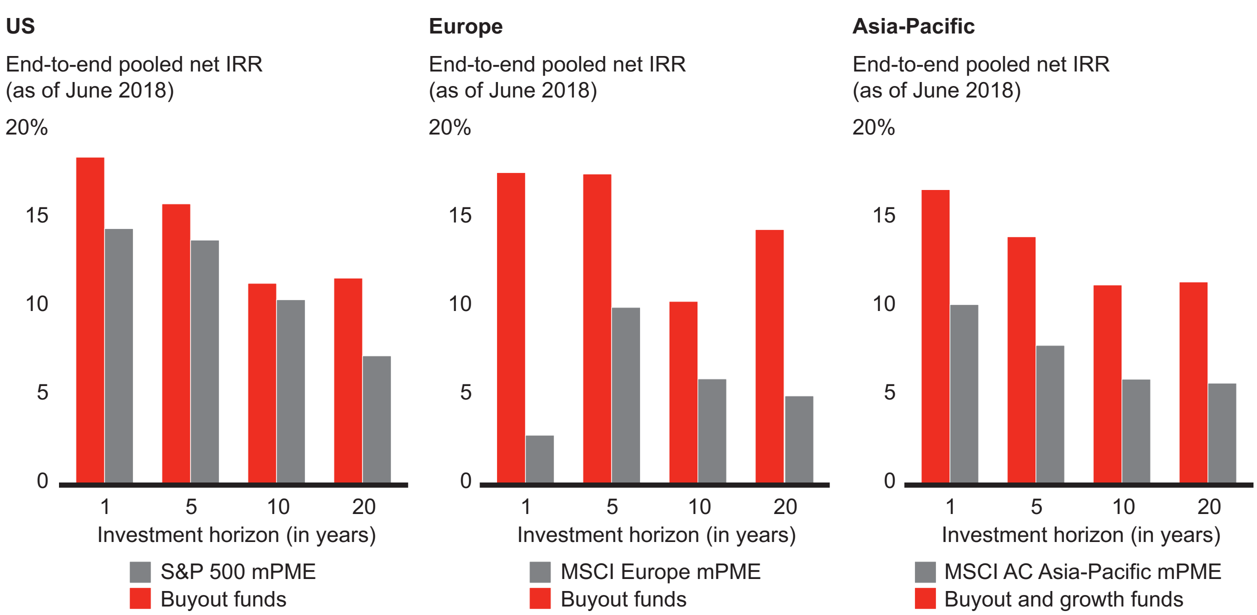
Returns: Despite a drop, PE still outperforms

If private equity has demonstrated anything over the past several years, it's that the asset class produces steadier, more reliable returns than public equities. After a period of heavy stock market volatility around the world, buyout funds have continued to outperform public equity markets in all major regions, over both short and long time horizons.

Consider how wildly public equity valuations have swung in recent years. In 2016, European stock markets tanked on the Brexit vote, while Asian markets declined due to a correction of the bubble in China's stock market. In 2017, markets turned around as a synchronized global economic expansion resulted in gains across regions. In 2018, European public market performance was anemic, while Asia was weighed down by trade tensions and slowing growth in China. In the US, a torrid, multiyear bull run came to an abrupt halt at the end of 2018 as an array of concerns began to spook investors.

Private equity, meanwhile, kept outperforming. Using the modified public market equivalent (mPME) metric developed by Cambridge Associates, which replicates the timing and size of PE cash flows as if they had been invested in public equities, it is possible to make an apples-to-apples comparison of PE returns with public equity returns. By this measure, which looks at end-to-end pooled net IRR, buyout funds outperformed the public markets across all regions for a variety of periods ending June 2018, the most recent data available from Cambridge Associates *(see Figure 1.27)*.

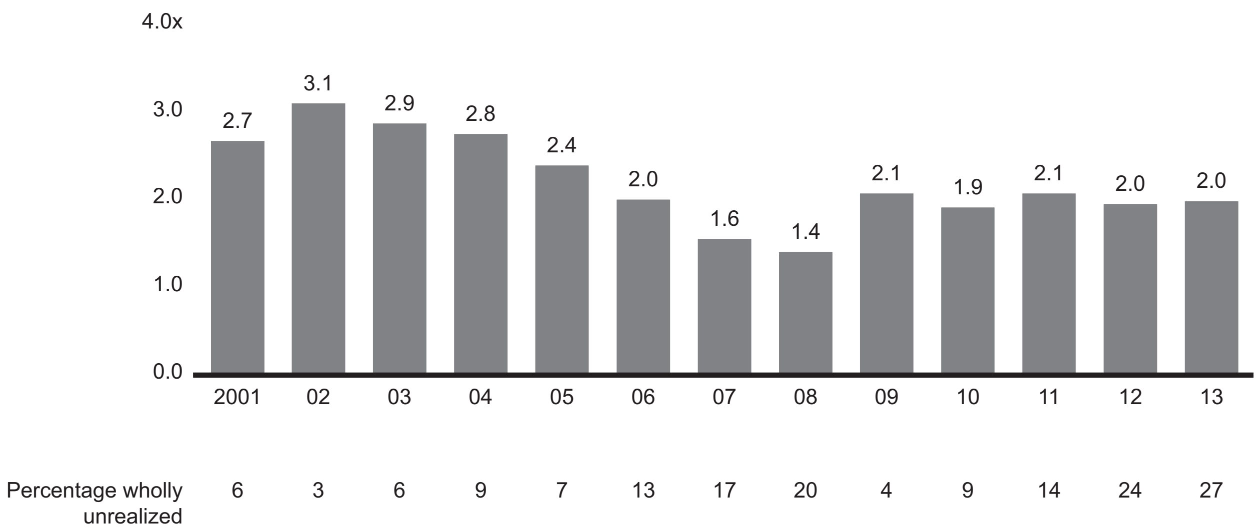
Figure 1.27: Buyout funds have outperformed public markets in all major regions



Notes: Data for US and Asia-Pacific calculated in US dollars; data for Europe calculated in euros; Europe includes developed economies only; Cambridge Associates' mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in private equity 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 Private Investments Database

Figure 1.28: Buyout returns in the current cycle have fallen from levels recorded before the global financial crisis

Gross pooled MOIC for global buyouts, by investment year



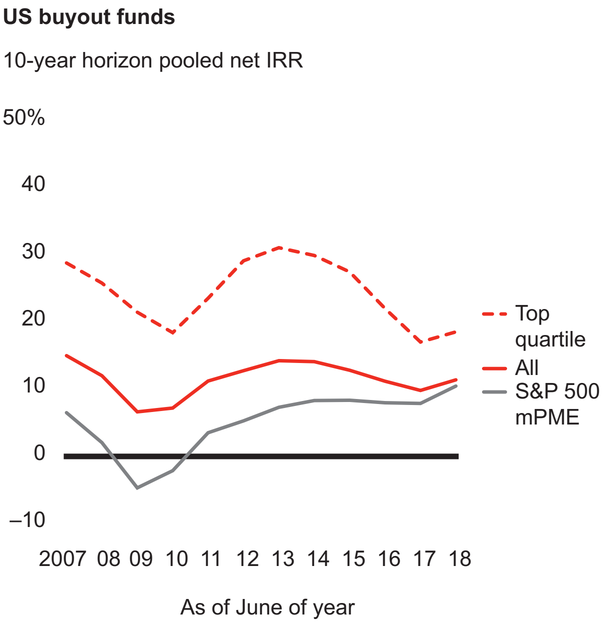
Notes: Includes realized and unrealized buyout deals with invested equity capital of $50 million or more; represents year of initial investment; MOIC stands for multiple of invested capital; discrepancies in bar heights displaying the same value are due to rounding
Source: CEPRES PE.Analyzer

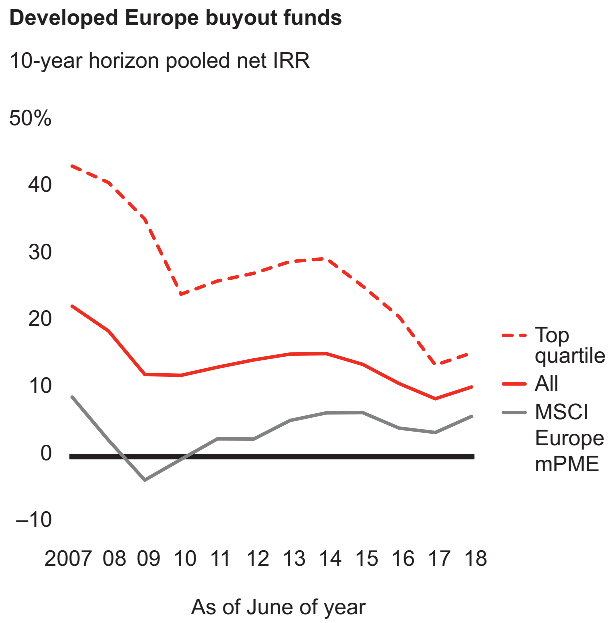
At the same time, it's important to highlight another fundamental trend: While private equity is still beating the public markets, buyout returns in the current cycle are not as robust as they were in the cycle before the global financial crisis. Using CEPRES data, we examined buyout deal-level returns as measured by the gross pooled multiple of invested capital (MOIC). Returns for deals done after the financial crisis are down, on average, compared with precrisis investments *(see Figure 1.28)*. The PE industry has matured and become more competitive, with many more participants and massive amounts of capital vying for a limited set of deals. The outsize returns that GPs once could earn on a large pool of undervalued assets are harder to find today.

Why is this decline less evident when looking at net IRR? The effect is masked by several factors. First, PE funds have taken advantage of low interest rates in this cycle and increasingly used lines of credit, which pushes back the timing of investment. Second, advantageous credit markets also enabled the liberal use of dividend recaps to cash out early in the deal life cycle. Third, after the financial crisis, LPs negotiated more favorable terms for fees and carry, which pushed up net returns.

While average industry returns have declined, it is important to recognize that top-performing funds still exceed the average by a relatively wide margin *(see Figure 1.29)*. Moreover, private equity has demonstrated an unusual persistence of performance, as measured by the likelihood of successor funds to deliver the same quartile of performance as their predecessors. LPs can trust that a PE firm

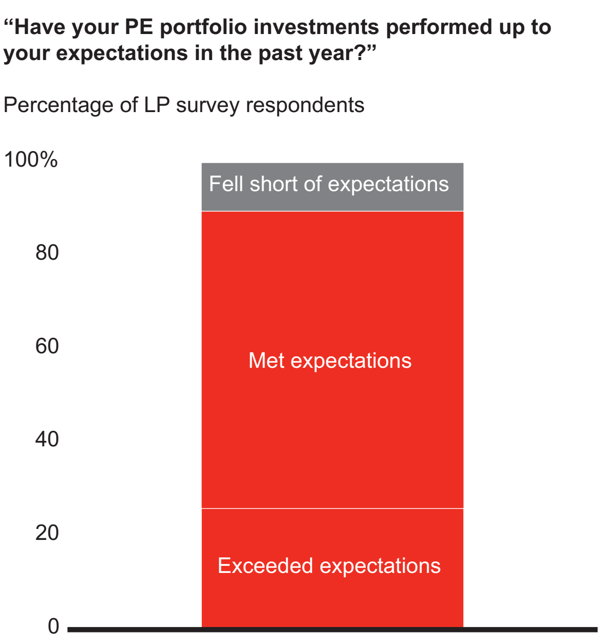
Figure 1.29: Top-quartile funds still outperform the average by a wide margin

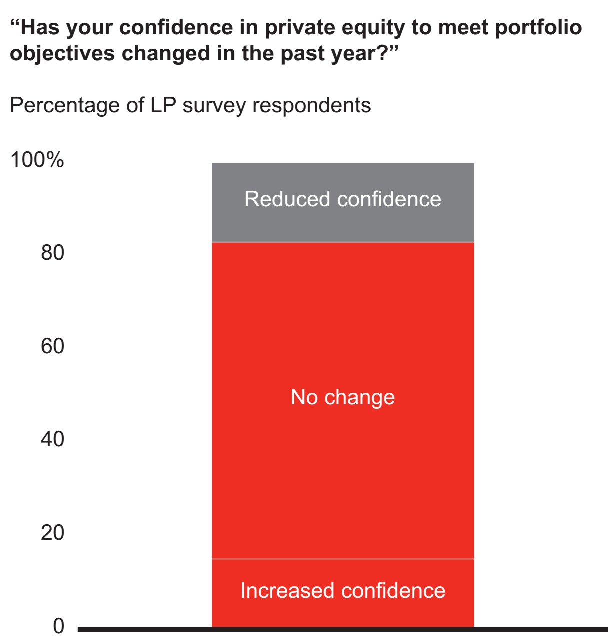




Note: Data calculated in dollars for US funds and in euros for European funds
Source: Cambridge Associates Private Investments Database

Figure 1.30: Private equity continues to meet investors' expectations





Source: Preqin survey, 2018

that excels with its first fund has a greater chance of replicating that success with the next fund. For GPs that have managed a top-quartile fund, there's a better than 6-in-10 probability that their successor fund will also be an above-average performer. A case in point is Hellman & Friedman, which since 1995 has had five consecutive funds that rank in the first quartile of IRR performance.

Looking ahead to the likelihood of more volatility in public markets, investors remain focused on the relative outperformance of private equity. In a recent global survey of LPs by Preqin, 90% of respondents said that their PE investments met or exceeded their expectations over the past year. And 83% said that their confidence in fund performance has either not changed or increased *(see Figure 1.30)*. Through economic thick and thin, private equity has delivered remarkably stable returns.

Key takeaways

- PE funds produced another impressive surge in investment value in 2018, capping the strongest five-year stretch in the industry's history. Fierce competition and rising asset prices continued to constrain deal count—the number of individual transactions dropped by 13%, to 2,936 worldwide—but total buyout value jumped 10% to $582 billion (including add-on deals). The performance owed much to an upswing in public-to-private transactions. Globally, P2P deals reached their highest value since the previous take-private boom in 2006–07.

- Despite the steady pace of investment, PE dry powder has been on the rise since 2012 and hit a record high of $2 trillion at year-end 2018 across all fund types ($695 billion for buyouts alone). The buildup of excess capital is putting pressure on PE firms to find deals, but the good news is that buyout firms hold 67% of their dry powder in funds raised over the last two years. That means the recent deal cycle is clearing out the older capital and replacing it with new.

- The stiff competition and high multiples that made it challenging to find deals in 2018 also made it a great time to exit. With 1,146 transactions valued at $378 billion, exit activity came in a smidgen lower than in 2017, but the total was still a strong contributor to a historic five-year stretch that has produced unprecedented distributions for investors. There was clearly some urgency on the part of GPs to sell assets, as signs of economic weakness pile up. The median holding period for buyouts fell last year to 4.5 years, after edging down slowly from a peak of 5.9 years in 2014.

- PE funds continued to attract an impressive amount of capital in 2018, although the pace fell off from 2017's record-breaking performance. GPs raised $714 billion from investors during the year—the third-largest amount ever—bringing the total since 2014 to $3.7 trillion. LPs remain committed to what has been their best-performing asset class. A full 90% say they intend to maintain or increase their PE allocations.

- After several years of heavy stock market volatility around the world, buyout funds continued to outperform public equity markets in all major regions, over both short and long time horizons. At the same time, buyout returns in the current cycle have not been as robust as they were in the previous cycle. As the overall PE industry has matured and become more competitive, the outsize returns that GPs could once earn on a large pool of undervalued assets are harder to find. Yet, top-performing funds still exceed the industry average by a relatively wide margin.

2. What's happening now: The strategies shaping private equity in 2019 and beyond

For the past several years, fund managers have faced virtually the same challenge: how to put record amounts of raised capital to work productively amid heavy competition for assets and soaring purchase price multiples. Top performers recognize that the only effective response is to get better—and smarter. We've identified four ways leading firms are doing so.

A growing number of GPs are facing down rising deal multiples by using buy-and-build strategies as a form of multiple arbitrage—essentially scaling up valuable new companies by acquiring smaller, cheaper ones. The biggest firms, meanwhile, are beating corporate competitors at their own game by executing large-scale strategic mergers that create value out of synergies and combined operational strength. GPs are also discovering the power of advanced analytics to shed light on both value and risks in ways never before possible. And they are once again exploring adjacent investment strategies that take advantage of existing capabilities, while resisting the temptation to stray too far afield. Each of these approaches will require an investment in new skills and capabilities for most firms. Increasingly, however, continuous improvement is what separates the top-tier firms from the rest.

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Buy-and-build: Powerful strategy, hard to pull off

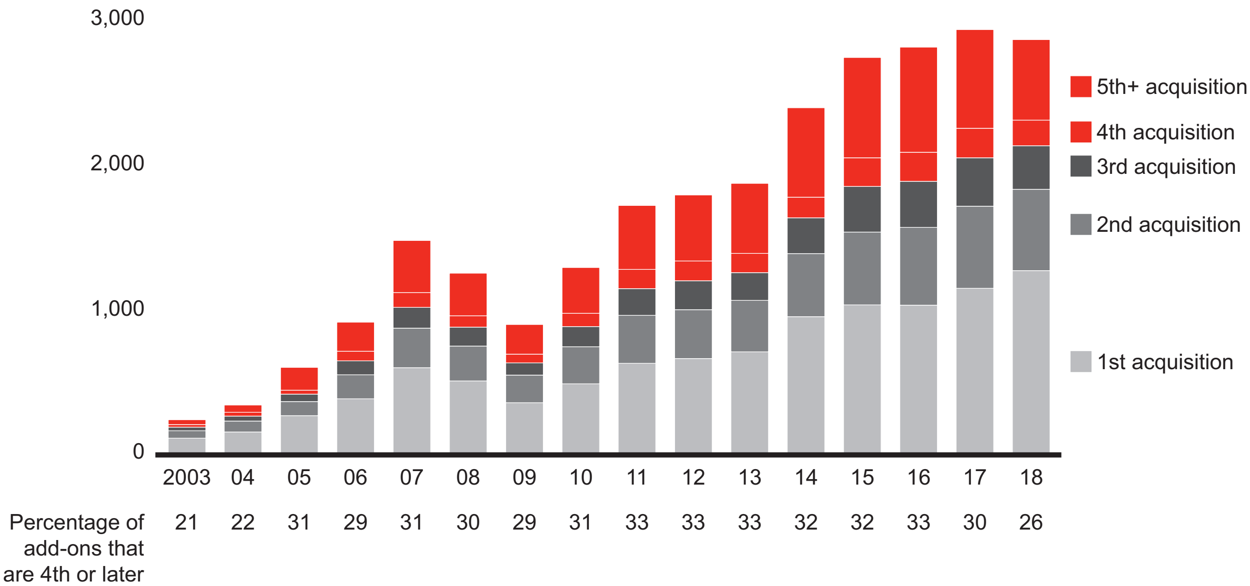
When Investcorp acquired Chicago's Berlin Packaging for around $410 million in 2007, it was already a strong player in the container business. Yet seven years and four strategic acquisitions later, Investcorp sold out to Oak Hill Capital Partners for $1.43 billion, creating a better than three times return. Since then, Oak Hill and Andrew Berlin, the company's well-regarded CEO, have doubled down on the buy-and-build strategy with four more major acquisitions and a scattering of smaller ones. In November 2018, they attracted $500 million in new capital from the Canada Pension Plan Investment Board. The objective: more acquisitions in North America and Europe.

While buy-and-build strategies like this one have been around as long as private equity has, they've never been as popular as they are right now. The reason is simple: Buy-and-build can offer a clear path to value at a time when deal multiples are at record levels and GPs are under heavy pressure to find strategies that don't rely on traditional tailwinds like falling interest rates and stable GDP growth. Buying a strong platform company like Berlin Packaging and building value rapidly through well-executed add-ons can generate impressive returns. As the strategy becomes more and more popular, however, GPs are discovering that doing it well is not as easy as it looks.

When we talk about buy-and-build, we don't mean portfolio companies that pick up one or two acquisitions over the course of a holding period. We also aren't referring to onetime mergers meant to build scale or scope in a single stroke. We define buy-and-build as an explicit strategy for building value by using a well-positioned platform company to make at least four sequential add-on acquisitions of

Figure 2.1: Around 30% of the time, add-on transactions are part of a broader buy-and-build strategy

Total global add-on deals, by sequence for platform company



Note: Represents the year in which add-on was acquired
Source: PitchBook Data, Inc.

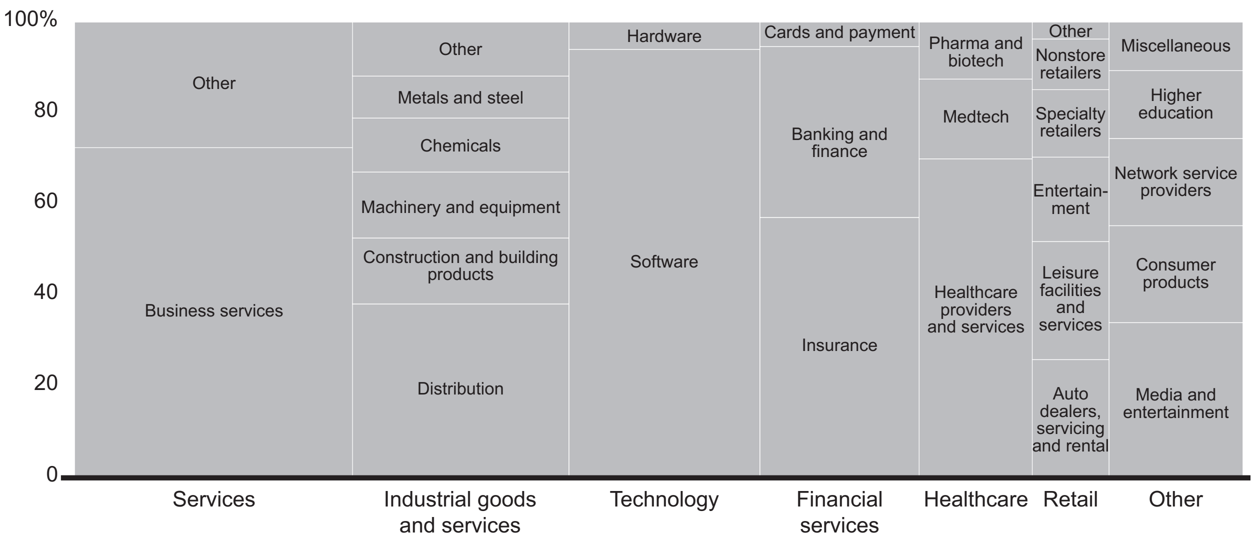
smaller companies. Measuring this activity with the data available isn't easy. But you can get a sense of its growth by looking at add-on transactions. In 2003, just 21% of all add-on deals represented at least the fourth acquisition by a single platform company. That number is closer to 30% in recent years, and in 10% of the cases, the add-on was at least the 10th sequential acquisition *(see Figure 2.1)*.

Buy-and-build strategies are showing up across a wide swath of industries *(see Figure 2.2)*. They are also moving out of the small- to middle-market range as larger firms target larger platform companies *(see Figure 2.3)*. KKR is a good example. It has been pursuing a buy-and-build strategy in the cybersecurity business through Optiv, a Denver-based company with $2.25 billion in revenue. In early 2018, Optiv hired a European general manager with extensive rollup experience in the security industry and began pursuing acquisitions of independent security firms in Britain and Europe.

Buy-and-build strategies are popular because they offer a powerful antidote to soaring deal multiples. They give GPs a way to take advantage of the market's tendency to assign big companies higher valuations than smaller ones *(see Figure 2.4)*. A buy-and-build strategy allows a GP to justify the initial acquisition of a relatively expensive platform company by offering the opportunity to tuck in smaller add-ons that can be acquired for lower multiples later on. This multiple arbitrage brings down the firm's average cost of acquisition, while putting capital to work and building additional asset value through scale and scope. At the same time, serial acquisitions allow GPs to build value through syn-

Figure 2.2: Platform companies pursuing buy-and-build strategies have become common across sectors

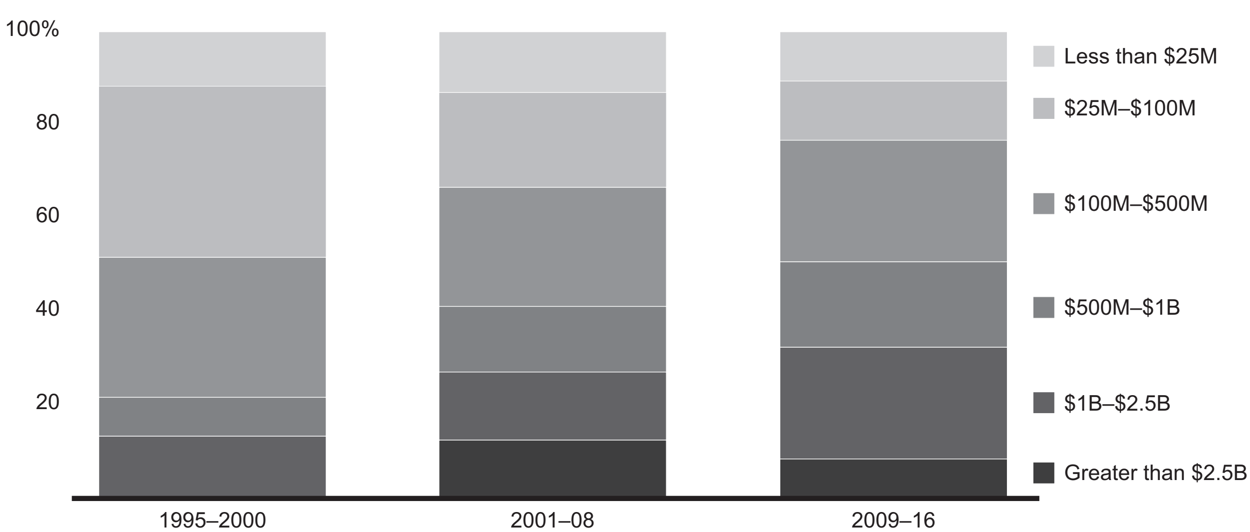
Distribution of US and European platform companies, by sector and subsector (2007–16)



Notes: Geography based on headquarters location of platform company; represents the year in which the deal to buy the platform company closed; platform companies defined as companies acquired in a buyout transaction that subsequently acquired at least four more businesses under the same PE ownership
Sources: Dealogic; Bain analysis

Figure 2.3: Platform companies are also getting bigger as larger firms enter the fray

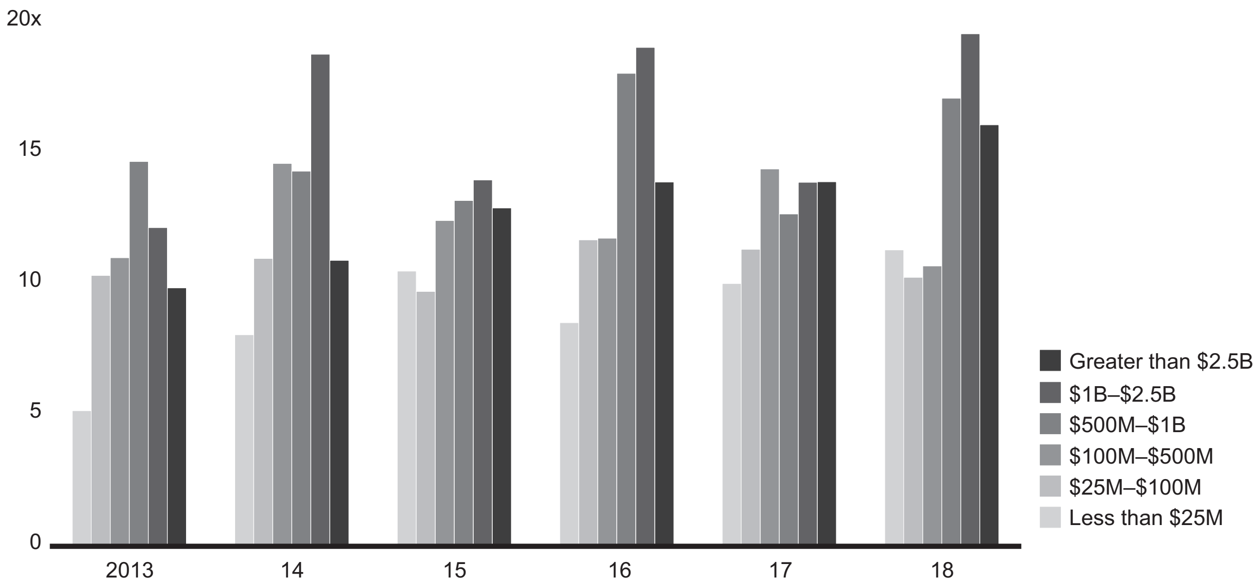
Distribution of US and European platform companies, by deal value



Notes: Represents the year in which the deal to buy the platform company closed; platform companies defined as companies acquired in a buyout transaction that subsequently acquired at least four more businesses under the same PE ownership
Sources: Dealogic; Bain analysis

Figure 2.4: Smaller companies consistently trade for lower multiples than bigger ones, offering an opportunity for multiple arbitrage

Median EBITDA purchase price multiple for global buyout transactions, by deal size



Source: PitchBook Data, Inc.

ergies that reduce costs or add to the top line. The objective is to assemble a powerful new business such that the whole is worth significantly more than the parts.

Having coinvested in or advised on hundreds of buy-and-build deals over the past 20 years, we've learned that sponsors tend to underestimate what it takes to win. We've seen buy-and-build strategies offer firms a number of compelling paths to value creation, but we've also seen these approaches badly underperform other strategies. Every deal is different, of course, but there are patterns to success. The most effective buy-and-build strategies share several important characteristics.

A sector with room to run

Sector dynamics can have a huge impact on the success or failure of a given buy-and-build strategy. Value creation depends on a steady cadence of acquisitions, which means a sector has to provide an ample supply of targets and a stable environment in which to pursue them. Importantly, the platform company usually makes the add-on acquisitions—not the PE fund—so it's critical that the company generates consistent free cash flow to finance deals in succession.

Sector issues can disrupt cash flow in a number of ways—cyclicality being the most obvious. In an industry like oil and gas, for instance, ping-ponging demand can wreak havoc on free cash flow, crimping a platform's ability to do deals. The potential for large-scale technological disruption is another factor. Buy-and-build was a brilliant strategy in the magazine business until the Internet plundered print advertising and completely changed the industry's economics. Supplier or customer consolidation can also upset the best-laid plans. Buy-and-build depends in part on creating scale advantages. But if suppliers or customers are combining in parallel, a business plan that relies on increased purchasing leverage or pricing power can fall apart quickly.

Following the stability imperative, the most effective buy-and-build strategies target sectors with predictable secular growth and a low risk of disruption (unless, of course, the platform company is the disrupter). They also target fragmented industries with sufficient acquisition targets of the right size. This raises two questions in diligence: First, will potential add-ons have lower valuations than the platform company, so that buying them presents a true multiple-arbitrage opportunity? Second, will potential add-ons be meaningfully accretive? In other words, does the sector offer plenty of targets that are smaller than the platform company, but not so small that acquiring them doesn't add value?

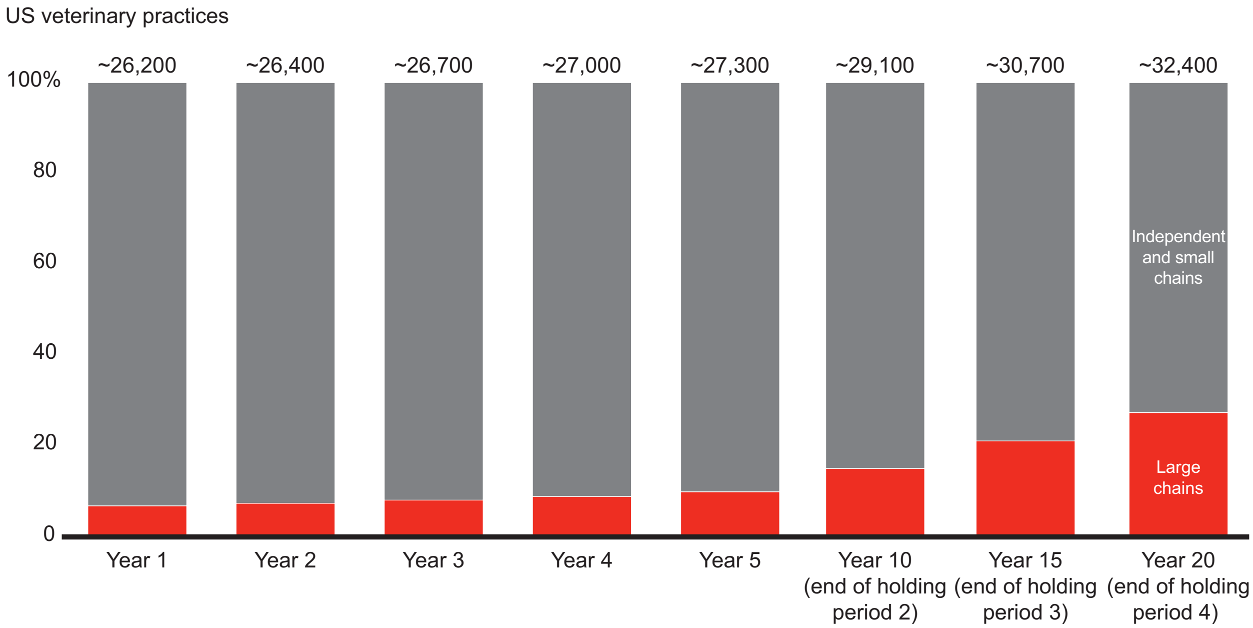
Plenty of white space

The sector's "white space" is a function of supply and demand. On the supply side, how many businesses are there in the sector that might naturally transact? Are a lot of founders reaching retirement age, or are macro pressures making it difficult to remain independent? On the demand side, how many other consolidators or strategic buyers are already at work in the industry picking off the ripest fruit, and what are their cumulative plans? These questions add up to a bigger one that guides due diligence: Does the potential for acquisitions in this sector provide enough runway for the buy-and-build strategy to create meaningful value? Too much demand for too few targets will drive up prices and compete away the multiple-arbitrage opportunity.

When Cressey & Company acquired control of VetCor Professional Practices in 2010, the company already had 41 veterinary practices. Yet the industry was growing steadily and remained highly fragmented. The vast majority of practices were independent, and many practice owners were nearing retirement age. These smaller businesses could be acquired for a mid-single-digit EBITDA multiple (vs. a mid-teens multiple for the platform), making for an attractive multiple-arbitrage opportunity. Pet ownership, meanwhile, was on the rise, and veterinary practices generated steady, recession-proof cash flow since owners care for their pets in good times and bad. VetCor could create efficiencies by offering a standardized package of management, training and administrative support. Individual clinics could keep their local identities, and resident veterinarians would remain in control of medical decisions.

Control of VetCor shifted from Cressey to Harvest Partners in 2015 and then to Oak Hill Capital in 2018 (all three firms remain investors). VetCor now has more than 300 practices and adds 2 or 3 each month. With other consolidators jumping into the veterinary sector, it has become critical to understand how quickly the remaining consolidation opportunity is being eaten away. A recent analysis shows that, given the current state of play, the veterinary space still offers plenty of runway for current and future investors to execute on buy-and-build *(see Figure 2.5)*. But dynamics can change quickly as capital and consolidators pile in. For anyone getting in now, a fresh look at the white space will be essential.

Figure 2.5: A white-space analysis of the US veterinary business indicates plenty of runway for future consolidators



Notes: Linear growth rate assumed when data not available; excludes specialty veterinary practices; large chains include those with 50 or more clinics in year 5
Sources: Bain veterinary clinic database; company websites and public filings; expert interviews; Bain analysis

Coming in late or following the herd can spell trouble. A good example is the funeral home industry. As macabre as it sounds, PE-backed buy-and-build strategies thrived in the US death business for years. Eventually, a crowd of consolidators picked off all the attractive midsize targets, bid up asset prices and eroded the multiple-arbitrage opportunity. In essence, the sector had "barbelled," meaning companies were either too big or too small, with nothing left in the middle to support a buy-and-build strategy.

GPs can avoid getting caught by focusing on their exit strategy from day one. If the sector continues to offer buy-and-build opportunity, it leaves runway for the next buyer to continue the consolidation, which should improve exit value. If buy-and-build is largely exhausted, the exit story needs to reflect a clear shift in strategy. Often the opportunity graduates from buy-and-build to scale M&A, where a consolidator starts buying up other consolidators. Alternatively, the most logical next owner might be a strategic buyer that is looking to expand in the sector and sees value in a newly scaled-up platform company.

Building on a solid platform

As we noted earlier, the most effective buy-and-build strategies assume that the platform company's free cash flow will fuel acquisitions. The PE fund is theoretically a backstop if the platform asset starts to sputter, but few GPs are willing to throw good money after bad if the well runs dry at the platform level. It's also critical to determine if the platform is stable enough to support what the fund wants to do with it. To pursue an efficient acquisition strategy, the buyer needs the right foundational infrastructure—robust IT systems, a strong balance sheet, repeatable financial and operational models, and assets like distribution and sales networks that are set up for expansion.

It's an enormous benefit to start with a strong existing management team that has already demonstrated its ability to pull off acquisitions. That's what Investcorp saw in Andrew Berlin, who, at 27, joined the 1988 leveraged buyout of the former Alco packaging company in Chicago. Through acquisitions, Berlin Packaging grew into an industry leader with a history of strong margins and free cash flow. Its innovation and design capabilities were top notch, and it developed a loyal customer base. Andrew Berlin expanded the business at double the market rate and quickly integrated newly bought companies. The CEO was—and still is, under new owner Oak Hill—integral to implementing the growth strategy.

It's not always that easy. When Advent International took over Morrison Supply Company in 2011, the distributor of HVAC, plumbing and oil pipeline–related products was still recovering from the global financial crisis. Advent saw a clear opportunity to buy and build within the sector, but it knew that Morrison would need some shoring up first. Advent brought in a CEO with 20 years of experience in the building supply industry, and he recruited a new executive team. The CEO rebranded the company as MORSCO and set it up as a holding company that could easily absorb newly acquired distributors. MORSCO opened a 128,000-square-foot shared distribution center, rationalized the supply chain by switching to a vendor-managed inventory system, and revamped back-office operations to centralize many aspects of purchasing and operations. The new, more efficient holding company structure accelerated the M&A cadence and transformed MORSCO into one of the fastest-growing companies in the industry. After six large acquisitions and a slew of smaller tuck-ins, in 2018 Advent sold the company for $1.44 billion to an enthusiastic corporate buyer, Reece Group. A leading Australian distributor of plumbing, waterworks and HVAC products, Reece sees MORSCO as its ticket to expand in a US market that is growing twice as fast as Australia's.

A central question in diligence is how much work the platform company needs in order to spearhead the strategy. If the answer is a lot, it can drastically affect the timing of value creation.

A central question in diligence is how much work the platform company needs in order to spearhead the strategy. If the answer is a lot, it can drastically affect the timing of value creation. PE firms are often buying someone else's starting point. The company might already have made acquisitions that are poorly integrated. IT systems may look like spaghetti, go-to-market strategies may be at odds, one unit's delivery trucks might be driving past another's distribution centers. Fixing issues like these takes both time and investment, which may pay off if the opportunity is big enough. The key, however, is going in with eyes wide open as to what the up-front costs really are. A years-long reclamation process can cut deeply into ROI.

Targets that add value

While vetting the right targets for buy-and-build involves all the normal M&A diligence questions, the key factors are strategic: How does an add-on or group of add-ons increase value? More is not simply better; an acquisition has to fit into a strategic logic that assumes the whole is worth more than the sum of its parts.

More is not simply better; an acquisition has to fit into a strategic logic that assumes the whole is worth more than the sum of its parts.

For this reason, successful buy-and-build strategies target acquisitions that are close to the core, rolling up a set of highly related companies to achieve the benefits of scale. VetCor, for instance, is a classic like-meets-like rollup, where the value comes from taking advantage of synergies and increasing market power. Moving into adjacencies can make sense, but it is critical to understand the risk. The further a company strays from its core, the greater the chance that something goes wrong.

Bain defines a company's core as the clients, products and services that a) drive the majority of its profits and profitable growth, and b) provide its key competitive advantage. Defining a company's core is the heart of strategic planning and an essential element in ensuring that each acquisition adds value to the platform. Each step away from the core creates distance between the acquisition and what the company does best. The question becomes, how much overlap is there between the two companies' customers, costs, channels, capabilities and competition? A rollup strategy assumes significant, if not total, overlap. Close-in adjacencies have less overlap, and two-step adjacencies have significant differences. Looking at potential acquisitions—or the entire strategy—through this lens prevents firms from trying to knit together related businesses that are further from the core than they seem.

A company's core and adjacencies aren't always obvious. Ascend Learning, for instance, looks like a hodgepodge of training businesses and brands. In fact, since it was acquired by Providence Equity Partners in 2007, the company has grown into a global leader in online learning. Providence sold a partial stake to the Ontario Teachers' Pension Plan in 2014, and after more than a dozen acquisitions, they sold Ascend in 2017 to Blackstone and the Canada Pension Plan Investment Board for over $2 billion. Its acquisition strategy pushed Ascend into a diverse array of industries with vastly different training and certification needs—physician, nurse and EMT training; construction safety training; fitness professional training; insurance training; auto mechanic training; etc. In defining its core, however, Ascend wasn't focused so much on what its businesses were teaching or who the students were. The glue holding everything together was the company's ability to combine content, assessment analytics and software, using shared platforms. That amounts to an asset that can be used for, and adapted to, different industries, tests and customer needs, allowing the company to reliably accelerate the growth of nascent e-learning businesses, while quickly monetizing new product development and distribution partnerships. By looking at the e-learning industry through a nontraditional lens, Ascend has been able to build tremendous value.

The same can't be said for Aurora Foods. An early example of a PE-driven buy-and-build strategy, Aurora started buying up "orphaned" premium brands like Mrs. Butterworth's and Log Cabin syrups in 1996 under the ownership of Dartford Partnership, Fenway Partners and McCown De Leeuw. Two years later, the company bought budget brand Duncan Hines and merged with Van de Kamp's, which specialized in frozen foods—seafood, pizza and breakfast foods. The combined company went public in 1999 but ultimately filed for bankruptcy in 2003. A major problem: Aurora had strayed too far from its core and wasn't able to create value out of its combination of assets. From the outside, each of its acquisitions said "food," but it turned out that premium foods on shelves and budget foods in the freezer aisles are actually very different businesses, with little overlap in terms of costs and capabilities. What looked like a chance to create scope and take advantage of synergies never materialized as Aurora had hoped.

Each step away from the core creates distance between the acquisition and what the company does best. The question becomes, how much overlap is there between the two companies' customers, costs, channels, capabilities and competition?

The buy-and-build strategies that outperform typically rely on multiple paths to value creation. They take full advantage of multiple arbitrage, they identify and capture synergies and operational improvements, and they generate top-line growth by improving commercial capabilities and implementing smarter go-to-market strategies at each company acquired. Spotting these opportunities has to be the explicit target of due diligence, so that the fund can begin pulling each of these levers from day one of ownership. Interface Security Systems, for instance, looked like a straight-ahead rollup play. SunTx Capital Partners bought it in 2001 and has since recapitalized several times to fund more than 10 acquisitions in the security space. Each add-on offered the usual opportunities to capture synergies by consolidating branches and reducing overhead in the back office. But SunTx has also used each one to build a more valuable whole. Instead of a collection of standalone monitored security services, Interface offers a bundle of cloud-based services for companies tired of purchasing them individually and having to integrate them on premise. The company's tagline—"simplify to the power of one"—describes this value proposition, but it might just as well be applied to the logic of SunTx's long-term buy-and-build strategy.

A winning approach

Too many attempts at creating value through buy-and-build founder on the shoals of bad planning. What looks like a slam-dunk strategy rarely is. Winning involves assessing the dynamics at work in a given sector and using those insights to weave together the right set of assets. The firms that get it right understand three things going in:

- **Deep, holistic diligence is critical.** In buy-and-build, due diligence doesn't start with the first acquisition. The most effective practitioners diligence the whole opportunity, not just the component parts. That means understanding how the strategy will create value in a given sector using a specific platform company to acquire a well-defined type of add-on. Are there enough targets in the sector, and is it stable enough to support growth? Does the platform already have the right infrastructure to make acquisitions, or will you need to build those capabilities? Who are the potential targets, and what do they add? Deep answers to questions like these are a necessary prerequisite to evaluating the real potential of a buy-and-build thesis.

- **Execution is as important as the investment.** Great diligence leads to a great playbook. The best firms have a clear plan for what to buy, how to integrate it, and what roles fund management and platform company leadership will play. This starts with building a leadership team that is fit for purpose. It also means identifying bottlenecks (e.g., IT systems, integration team) and addressing them quickly. There are multiple models that can work—some rely on extensive involvement from deal teams, while others assume strong platform management will take the wheel. But given the PE time frame, the imperative is to have a clear plan up front and to accelerate acquisition activity during what inevitably feels like a very short holding period.

- **Pattern recognition counts.** Being able to see what works comes with time and experience. Learning, however, relies on a conscious effort to diagnose what worked well (or didn't) with past deals. This forensic analysis should include the choice of targets, as well as how decisions along each link of the investment value chain (either by fund management or platform company management) created or destroyed value. Outcomes improve only when leaders use insights from past deals to make better choices the next time.

At a time when soaring asset prices are dialing up the need for GPs to create value any way they can, an increasing number of firms are turning to buy-and-build strategies. The potential for value creation is there; capturing it requires sophisticated due diligence, a clear playbook, and strong, experienced leadership.

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Merger integration: Stepping up to the challenge

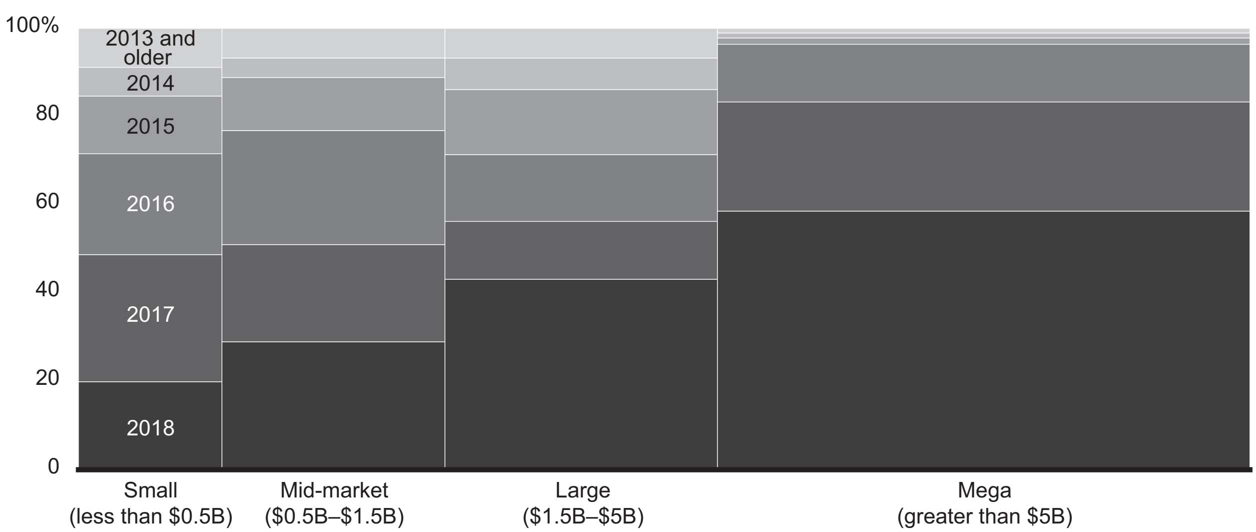
If deals like LifePoint Health's $5.6 billion merger with RCCH HealthCare Partners or RCN's $2.4 billion takeover of Wave Broadband look and feel like straight-ahead corporate M&A transactions, then ... mission accomplished. For Apollo and TPG, the owners of LifePoint and RCN, respectively, executing corporate-style M&A was all part of the plan.

PE funds are increasingly turning to large-scale M&A to solve what has become one of the industry's most intractable problems—record amounts of money to spend and too few targets. GPs have put more money to work over the past five years than during any five-year period in the buyout industry's history. Still, dry powder, or uncalled capital, has soared 64% over the same period, setting new records annually and ramping up pressure on PE firms to accelerate the pace of dealmaking. One reason for the imbalance is hardly a bad problem: Beginning in 2014, enthusiastic investors have flooded buyout funds with more than $1 trillion in fresh capital. Another issue, however, poses a significant conundrum: PE firms are too often having to withdraw from auctions amid fierce competition from strategic corporate buyers, many of which have a decided advantage in bidding.

Given that large and megabuyout funds of $1.5 billion or more hold two-thirds of the uncalled capital, chipping away at the mountain of dry powder will require more and bigger deals by the industry's largest players *(see Figure 2.6)*. Very large public-to-private transactions are on the rise for precisely this reason. But increasingly, large funds are looking to win M&A deals by recreating the economics that corporate buyers enjoy. This involves using a platform company to hunt for large-scale merger partners that add strategic value through scale, scope or both.

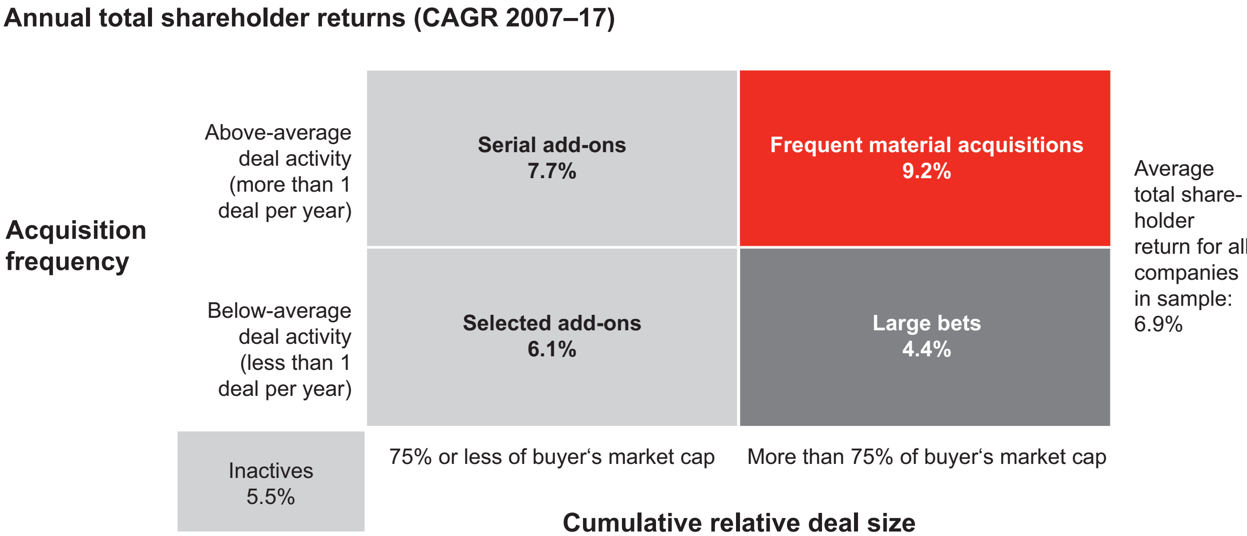
Figure 2.6: Megafunds hold by far the largest share of dry powder, dialing up the pressure to do more multibillion-dollar deals

Distribution of global buyout dry powder, by fund vintage year



Notes: Vintage year represents the year of initial investment/drawdown from the fund; excludes vintages older than 2008
Source: Preqin

Figure 2.7: Merger integration experience pays off in rapid growth and strong shareholder returns



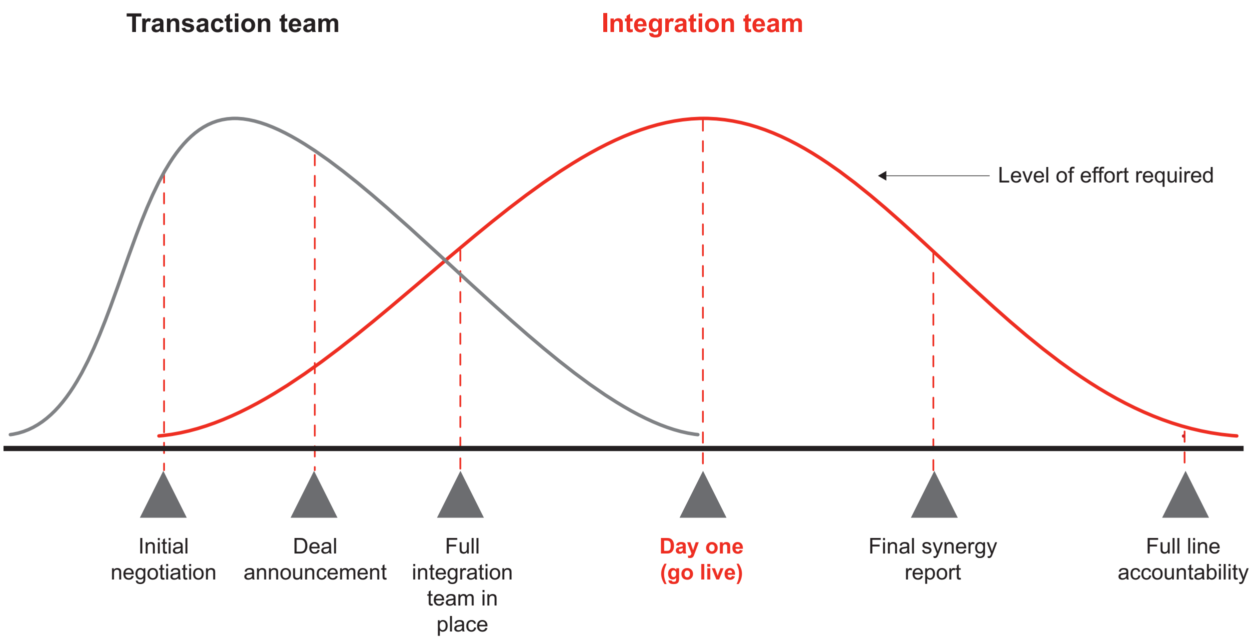
Notes: Sample includes 1,729 companies; natural resources sector excluded; cumulative relative deal size is the sum of relative deal size (deal value divided by market capitalization three months prior to announcement) across all deals from 2007 to 2017; deal size for deals with undisclosed value is estimated using median deal value benchmark, calculated for each sector from disclosed deal values as a percentage of acquirer market capitalization; deals involving partial-stake acquisitions, increase in controlling interest and remaining interest acquisitions are excluded; multistep deals have been consolidated into single deals; consortium, intracompany and property portfolio deals excluded
Sources: Dealogic; Bain M&A deal database

Apollo saw the opportunity last year to take its 2015 acquisition of RCCH to another level by merging it with LifePoint Health. The firm bought LifePoint for $5.6 billion in July and then combined the two companies to create a much larger player in the healthcare industry. The merger produced a national operator of 84 nonurban hospitals in 30 states, with 7,000 affiliated physicians and approximately 60,000 employees. The strategic imperative is to improve the economics of providing local hospital care in less populous areas, while generating new opportunities for growth and partnerships as the healthcare industry evolves.

Making it all work, of course, is another matter. Large-scale, strategic M&A solves one problem for large PE firms by putting a lot of capital to work at once, but it also creates a major challenge: capturing value by integrating two or more complex organizations into a bigger one that makes strategic and operational sense. Bain research shows that, while there is clear value in making acquisitions large enough to have material impact on the acquirer, the success rate is uneven and correlates closely to buyer experience *(see Figure 2.7)*. The winners do this sort of deal relatively frequently and turn large-scale M&A into a repeatable model. The laggards make infrequent big bets, often in an attempt to swing for the fences strategically.

Broken deals tend to fail because firms stumble over merger integration. They enter the deal without an integration thesis or try to do everything at once. They don't identify synergies with any precision,

Figure 2.8: Successful merger integration begins with strong due diligence and stretches well into the ownership period



Source: Bain & Company

or fail to capture the ones they have identified. GPs neglect to sort out leadership issues soon enough, or they underestimate the challenge of merging systems and processes. For many firms, large-scale merger integration presents a steep learning curve.

In our experience, success in a PE context requires a different way of approaching three key phases of the value-creation cycle: due diligence, the post-announcement period and the post-close integration period *(see Figure 2.8)*. In many ways, what happens before the deal closes is almost as important as what happens after a firm assumes ownership. Top firms invest in deep thinking about integration from the outset of due diligence. And they bring a sharp focus to how the firm can move quickly and decisively during the holding period to maximize time to value.

Due diligence: Building a foundation

In a standalone due diligence process, deal teams focus on a target's market potential, its competitiveness, and opportunities to cut costs or improve performance. In a merger situation, those things still matter, but since the firm's portfolio company should have a good understanding of the market already, the diligence imperative switches to a bottom-up assessment of the potential synergies.

Measuring synergies. Synergies typically represent most of a merger deal's value, so precision in underwriting them is critical. High-level benchmarks aren't sufficient; strong diligence demands rigorous quantification. The firm has to decide which synergies are most important, how much value they represent and how likely they are to be captured within the deal's time frame. When Blackstone's Graham Packaging acquired Liquid Container for $568 million in 2010, for instance, the deal had elements of both scale and scope. Liquid Container, which specialized in food-grade blow-molded plastic containers, offered Graham the chance to expand for the first time into the high-margin food segment. The deal also promised to add scale in Graham's household container business. Diligence uncovered $25 million in cost synergies from sharing the procurement of plastic resin, rationalizing the manufacturing footprint and eliminating duplicative G&A expenses. Blackstone identified significant revenue synergies as well.

A full understanding of the synergies available in a deal allows a firm to bid as aggressively as possible.

A full understanding of the synergies available in a deal like this allows a firm to bid as aggressively as possible. It often gives the deal team the option to share the value of synergies with the seller in the form of a higher acquisition price. On the other hand, the team also needs to account for dis-synergies—the kinds of negative outcomes that can easily lead to value destruction. When AEA Investors merged TimberTech with CPG International, for instance, it saw a chance to generate savings by consolidating the two companies' manufacturing footprints and reducing capacity. But such a move would also generate new costs—standing up new production lines, moving down the new production learning curve, closing existing facilities and so on. Netted out, the synergies still produced substantial savings. But in formulating a bid, it was critical for AEA to anticipate both the positive and negative implications.

Tapping the balance sheet. One area of potential synergies often underappreciated by corporate buyers is the balance sheet. Because companies in the same industry frequently share suppliers and customers, combining them presents opportunities to negotiate better contracts and improve working capital. There might also be a chance to reduce inventory costs by pooling inventory, consolidating warehouses or rationalizing distribution centers. At many target companies, these opportunities represent low-hanging fruit, especially at corporate spin-offs, since parent companies rarely manage the working capital of individual units aggressively. Combined businesses can also trim capital expenditures. Merging the operations of Graham Packaging and Liquid Container, for example, made it possible for the combined company to cut back on procured molds and spare machinery parts.

Managing the "soft" stuff. While these balance sheet issues play to a GP's strong suit, people and culture issues usually don't. PE firms aren't known for their skill in diagnosing culture conflicts, retaining talent or working through the inevitable HR crises raised by integration. Firms often view these so-called soft issues as secondary to the things they can really measure. Yet people problems can quickly undermine synergies and other sources of value, not to mention overall performance of the combined company.

To avoid these problems, it helps to focus on two things in due diligence. First, which of the target company's core capabilities need to be preserved, and what will it take to retain the top 10 people who deliver them? Second, does the existing leadership team—on either side of the transaction—understand how to integrate a business? The firm needs to know whether those responsible for leading the integration have done it before, whether they've been successful and whether the firm can trust them to do it successfully in this situation. PE owners are often more involved in integration than the board of a typical corporation. It's important not to overstep, however. Bigfooting the management team is a sure way to spur a talent exodus.

For PE firms eager to put money to work, great diligence in a merger context is critical. It should not only answer questions such as "How much value can we underwrite?" but also evaluate whether to do the deal at all. Deal teams have to resist the urge to make an acquisition simply because the clock is ticking. Corporate buyers often take years to identify and court the right target. While it's true that PE firms rarely have that luxury, no amount of merger integration prowess can make up for acquiring a company that just doesn't fit.

Key questions: Due diligence

- What is our bottom-up estimate of cost, cash and revenue synergies, accounting for potential dis-synergies? Which are we willing to underwrite and share with the seller?
- How long will the integration take? How quickly will value be realized?
- How efficient is each of the organizations today? Is there room for improvement?
- Does the acquiring company have a good "chassis"—that is, scalable IT systems and sound infrastructure—for adding on new assets? If not, what investment is required to get there?
- Have we identified the combined firm's critical capabilities and the key individuals who deliver them? Do we have a plan to retain them?
- Do we understand the cultures of the two companies and how potential discord might affect time to value?
- Has the leadership team successfully managed a merger in the past? How much help will they need?
- Have we negotiated some level of pre-close access to the acquired company's systems and management team?
- What else is going on in these companies—previous merger integrations, cost initiatives, new business plans—that will consume management attention? Do they have enough bandwidth to manage a complex integration?

Mobilizing the integration

Even the best due diligence is limited by the fact that it is largely an outside-in process. That begins to change once an offer is accepted. The period between deal announcement and close is vital to filling in knowledge gaps and turning a deal thesis into a formal plan for integrating the two organizations. It starts with creating a shared vision for the combined company and beginning to communicate it to the companies' various stakeholders. The buyer has to map out which parts of the organization should be integrated to unlock scale economics and which parts should be kept separate to preserve differentiated capabilities. The integration thesis should set priorities, lay out implementation steps and estimate how long it will take to capture value. One of the most important steps GPs can take during the pre-close period is to sort out governance issues for the merged entities. Who reports to whom in the interim, and what activities is each side responsible for? After clinking glasses at the merger announcement party, the two management teams staring at each other across the room need to know who will be running things and what their roles are ahead of the deal close.

The integration thesis should set priorities, lay out implementation steps and estimate how long it will take to capture value.

Light touch or heavy touch? When Graham Packaging began thinking through the best way to bring Liquid Container into the fold, it became clear early on that integrating strategically would add the most value. As we noted earlier, the deal offered substantial cost synergies from combining procurement and rationalizing aspects of production. The merger's true promise, however, involved scope—giving Graham access to a lucrative new market that was growing. Liquid Container's food-grade blow-molded containers had little customer or market crossover with Graham. The company had developed market-leading technology to serve these sectors and had a strong portfolio of patents pending. If Graham could manage the integration, it would increase both its scale and scope.

A key to success was retaining Liquid Container's top talent. Blackstone and Graham Packaging were confident that Graham could capture the synergies between the two companies, but Graham needed to rely on Liquid Container's management team to make the most of the opportunity. Graham decided to operate Liquid Container as a freestanding unit and made it abundantly clear to the people it wanted to retain that they would be free to run their own show, subject to the new strategic plan. The integration was by no means easy. To capture the synergies and work through the hundreds of issues any merger raises, Graham formed a steering committee led by the CEO, which managed 13 integration teams charged with finding cost savings and rationalizing the business where it did intersect. But Graham's light touch with the Liquid Container team was central to the deal's success.

Setting up an IMO. The sheer complexity of integrating any two large organizations frequently calls for a dedicated integration management office (IMO). There's usually no other way to manage the daily barrage of complicated, high-stakes decisions. Integration planning demands rapid, cross-functional decision making among stakeholders who haven't worked together before. There are countless interdependencies and issues that require continuous prioritization. An IMO run by smart, dynamic executives serves as an air traffic control tower—anticipating risks, mitigating them and making real-time decisions. The office focuses teams on the most important elements of value and develops tools to measure progress.

Managing communications is an often-overlooked priority. Companies are limited in what they can say during the pre-close period, but it is critical to get the story straight and issue consistent messages from both companies. Leadership needs to reach out to stakeholders and let them know when more information will be available. Indeed, a major element of integration preplanning is forging the mission statements and day-one communiqués that will ensure business continuity and project decisiveness once the new owner takes control.

Enlisting a "clean team." No matter how close the two companies have become through the courtship period and deal negotiations, there is always certain information, contracts and data that the seller must withhold from the buyer in case the deal falls apart. One way around that is to set up a clean team—a third party that can begin the time-consuming work of sorting through proprietary information. This protects each company's confidentiality but allows them to get a jump on validating synergies prior to close.

Setting up a clean team isn't simple. There has to be significant value at stake and time to implement one. But in a PE context, where speed to value is paramount, it can be a highly effective tool. Being able to capture, codify and analyze proprietary information pre-close can save a firm valuable time later.

Key questions: Mobilizing the integration

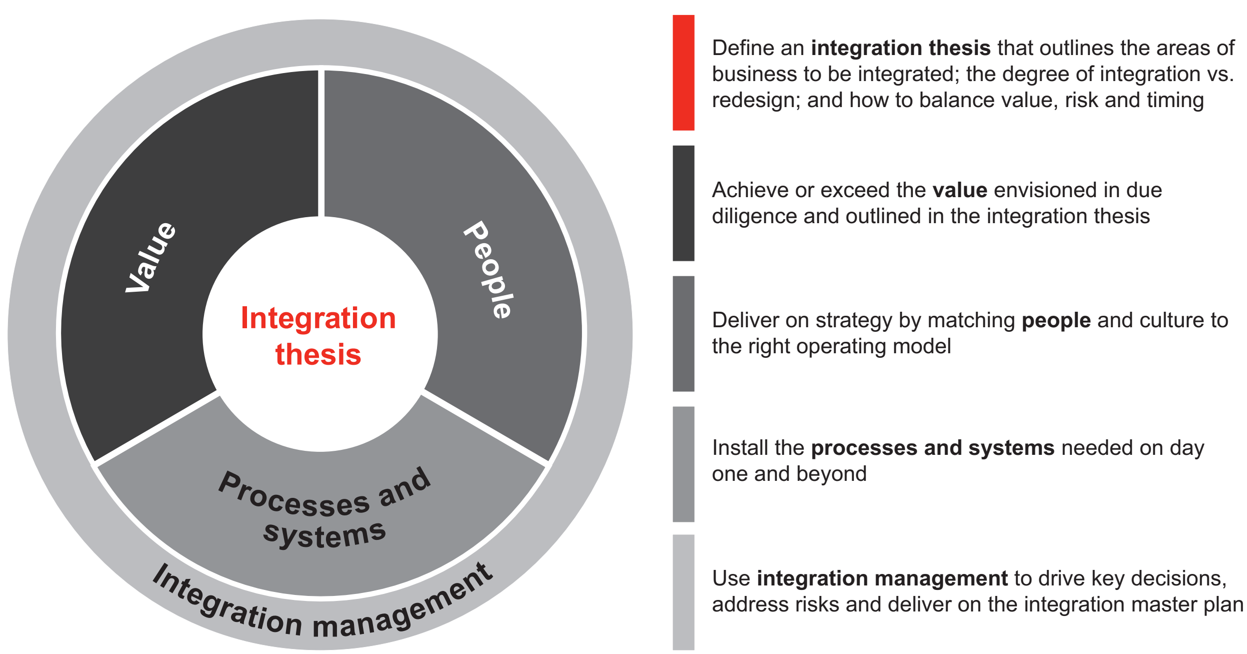
- Have we effectively translated the deal thesis into a comprehensive integration thesis?
- Have we established an integration structure and team aligned to the integration thesis, headed by an effective integration leader?
- Have we defined the right operating model and governance scheme for the merged company, and do we know who reports to whom in the short term?
- Is there a plan to communicate the value created in this deal and what the future holds for employees, customers and sourcing partners?
- Do we need a clean team to help capture the value at stake quickly?
- Have we established an overall integration timeline, including what's "in scope" for day one?

Integration planning and execution

Once the hard work of underwriting value and generating a robust integration thesis is complete, integration planning begins in earnest. A successful integration has three major objectives: capturing the identified value, managing the people issues, and integrating processes and systems *(see Figure 2.9)*. This is where the IMO needs to shine. As the central leadership office, its role is to keep the integration effort on track and to hit the ground running on day one. Pre- and post-close, the IMO monitors risks (including interdependences), tracks and reports on team progress, resolves conflicts, and works to achieve a consistent drumbeat of decisions and outcomes. It manages dozens of integration teams, each with its own detailed work plan, key performance indicators and milestones. It also communicates effectively to all stakeholders.

Cinven and Warburg Pincus took on the full scope of this integration management challenge when, in 2005–06, they bought three Dutch cable providers to create Ziggo, the largest cable operator in the Netherlands. The combination was purely a scale play, a three-way merger of equal-sized rivals with complementary strengths. It offered more than €100 million in synergies (around 20% of the cost base) related to operating expenses, cost of goods and capital expenditures. Capturing that value, however, meant rapidly transforming three disparate companies into a single organization with a unified brand, technology platform and go-to-market strategy. The complex deal offered a significant

Figure 2.9: Generating results from a comprehensive integration thesis requires sharp execution to capture value, align people and install systems



Source: Bain & Company

opportunity to combine the best practices developed at each firm, creating a leading "cable operator of the future" that could entice customers with a triple-play bundle of cable, high-speed Internet and telephone. It helped that the deal was a true merger of equals. And it helped the integration effort that there was no dominant acquirer. Each of the three management teams had equal representation and an equal say in decisions.

Cinven and Warburg Pincus formed a centralized IMO led by a single strong executive and a deputy. These two executives were 100% dedicated to the integration effort and quickly laid out a detailed plan to stand up the new company. They deployed 35 integration teams and a set of task forces to tackle specific initiatives. That focused energy on everything from building a new data warehouse and creating a single service-platform architecture, to optimizing the business model and developing a new brand for the consolidated company. The results were impressive. The combined company exceeded its synergy targets, while producing strong growth in revenue and EBITDA over the three years following the merger. Cinven and Warburg Pincus exited the public company in tranches, realizing a 2.8 times return on invested capital.

Realizing synergies is essential, but value can be lost quickly if a chaotic integration process gets in the way of running the core.

Capturing value. An often-underappreciated aspect of the early merger integration process is the art of maintaining continuity in the base business. Knitting together the two organizations and realizing synergies is essential, but value can be lost quickly if a chaotic integration process gets in the way of running the core. Management needs to reserve focus for day-to-day operations, keeping close tabs on customers and vendors, and intervening quickly if problems crop up.

At the same time, it is important to validate and resize the value-creation initiatives and synergies identified in diligence. The team has to create a new value roadmap that articulates in detail the value available and how to capture it. This document redefines the size of the prize based on real data. It should be cascaded down through the organization to inform detailed team-level work plans.

Tackling the people challenge. Integrating large groups of people is very often the most challenging—and overlooked—aspect of bringing two companies together. Mergers are emotionally charged events that take employees out of their comfort zone. While top leadership may be thinking about pulling the team together to find value, the people on the ground, understandably, are focused on what it means for them. The change disrupts everybody; nobody knows what's coming, and human nature being what it is, people often shut down. Getting ahead of potential disaster involves three critical areas of focus: retaining key talent, devising a clear operating model and solving any culture issues.

Figure 2.10: PE firms need to be decisive and fair in selecting and retaining talent

Minimize uncertainty	• Make decisions and communicate on established timelines; don't delay or push back decisions • Design the operating structure before making talent decisions • Assign employees to roles as early as possible
Pick the best people	• Combine the best of both organizations; aim to populate the new company with the best people regardless of their company of origin • Make sure to find a home for the top performers; don't be afraid to exclude bad apples from the selection process • Seek to cross-pollinate the new organization
Use a structured and fair process	• Follow a systematic and objective evaluation process to give equal opportunity to the most qualified employees and get buy-in – Have functional leaders interview and select the candidates – Take a team approach to avoid bias – Get HR involved to support and legitimize the process
Overinvest in the transition experience	• Communicate termination decisions face to face; also provide printed material • With severance, be fair, not generous; provide outplacement and counseling services • Remember that effective migration requires detailed planning

Source: Bain & Company

Talent retention boils down to identifying who creates the most value at the company and understanding what motivates them. Firms need to isolate the top 50 to 100 individuals most responsible for the combined company's value and devise a retention plan tailored to each one. Keeping these people on board will likely involve financial incentives, but it may be more important to present these stars with a clear vision for the future and how they can bring it to life by excelling in mission-critical roles. It is also essential to be decisive and fair in making talent decisions *(see Figure 2.10)*.

Assigning these roles is an outgrowth of a larger challenge: devising a fit-for-purpose operating model that aligns with the overall vision for the company. This is the set of organizational elements that helps translate business strategy into action. It defines roles, reporting relationships and decision rights, as well as accountabilities.

Whether this new model works will have a lot to do with how well leadership manages the cultural integration challenge. Nothing can destroy value faster than internal dysfunction, but getting it right can be a delicate exercise. When AEA was merging CPG and TimberTech, for instance, it recognized that TimberTech had a distinct position in the marketplace that partly reflected its unique company culture. TimberTech maintained strong personal relationships with its channel partners and had a reputation for warm and fuzzy customer service. In thinking about how to integrate the two companies, CPG saw value in preserving that culture and the TimberTech brand vs. trying to integrate everything rapidly at the risk of customer attrition or talent loss.

Processes and systems. The final integration imperative—designing and implementing the new company's processes and systems—is all about anticipating how things will get done in the new company and building the right infrastructure to support that activity. PE firms must consider which processes to integrate and which to leave alone. The north star on these decisions is which efforts will directly accrue to value within the deal time frame and which can wait. Often, this means designing an interim and an end-state solution, ensuring delivery of critical functionality now while laying the foundation for the optimal long-term solution.

Integrating IT systems requires a similar decision-making process, focused on what will create the most value. If capturing synergies in the finance department involves cutting headcount within several financial planning and analysis teams, that might only happen when they are on a single system. Likewise, if the optimal operating model calls for a fully integrated sales and marketing team, then working from a single CRM system makes sense. Most PE firms are hyperfocused on the expense involved in these sorts of decisions. They weigh the onetime costs of integration against a sometimes-vague potential return and ultimately decide not to push forward. This may be a mistake. Taking a more expansive view of potential value often pays off. Early investments in IT, for instance, may look expensive in the short run. But to the extent that they make possible future investments in better capabilities or continued acquisitions, they can be invaluable.

Key questions: Integration planning and execution

- Now that we have all of the data, what did we get right in the diligence phase, and what did we miss?
- Do we have a credible plan (and the needed resources) to achieve the synergies we've identified?
- What are the risks and downsides to achieving these synergies, and how do we manage them?
- Who are the influencers, critical contributors and integration enablers in the new organization, and how do we retain them?
- Where are the interdependencies between people, systems or processes, and how are we managing them?
- What did we learn through the creation of this new company, and how should that inform the future strategy?

There's a reason so many large mergers go awry—successfully combining large, complex organizations is exceptionally hard to do. It is even more difficult in the PE context, thanks to shortened time frames and most firms' relative inexperience in many aspects of merger integration. The firms that do it right raise the odds of success by identifying as much value as possible in due diligence, translating that work into a detailed integration thesis and being fully prepared to implement it methodically once the deal is closed *(see Figure 2.11)*. PE firms are finding there's money to be made in beating corporate competitors at their own game. They're also discovering that it's a lot harder than it looks.

Figure 2.11: Successful mergers follow a methodical path from integration thesis to integration management

Integration thesis	**Tailor the integration approach to the nature of the deal:** Watch out for "this is how we did it last time" **Use the "unlocking moment" to capture value beyond the deal thesis:** Seize the opportunity to selectively optimize or redesign parts of the business
Value	**Follow the money:** Focus the integration on the few critical issues that represent the value **Safeguard your customer assets:** Competitors strike and customers depart during times of uncertainty
People	**Resolve power and people issues quickly:** Get the senior team in place soon after the announcement **Proactively wrestle culture issues to the ground:** Win the hearts and minds of both companies' employees
Processes and systems	**Secure critical systems, and pace the changes:** Focus on base business and day-one requirements before adding new capabilities **Manage cost-to-achieve with the same rigor as synergies:** Monitor and challenge investment costs to preserve net value
Integration management	**Ensure 90% of the organization is focused on the base business:** If everyone does both things, no one does anything **Call out and resolve day-one issues:** Don't try to do everything on day one—focus on what's critical

Source: Bain & Company

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Adjacency strategy: Taking another shot at diversification

Given the amount of capital gushing into private equity, it's not surprising that PE firms are diversifying their fund offerings by launching new strategies. The question is whether this wave of diversification can produce better results than the last one. History has shown that expanding thoughtfully into the right adjacencies can deliver great results. But devoting time, capital and talent to strategies that stray too far afield can quickly sap performance.

The first wave: A step too far

In the mid-1990s, the industry faced a similar challenge in putting excess capital to work. As institutions and other large investors scoured the investment landscape for returns, they increased allocations to alternative investments, including private equity. Larger PE funds eagerly took advantage of the situation by branching into different geographies and asset classes. This opened up new fee and revenue streams, and allowed the funds to offer talented associates new opportunities.

Funds first expanded geographically, typically by crossing the Atlantic from the US to Europe, then extending into Asia and other regions by the early 2000s *(see Figure 2.12)*. Larger firms next began to experiment with asset class diversification, creating growth and venture capital funds, real estate funds, mezzanine financing and distressed debt vehicles.

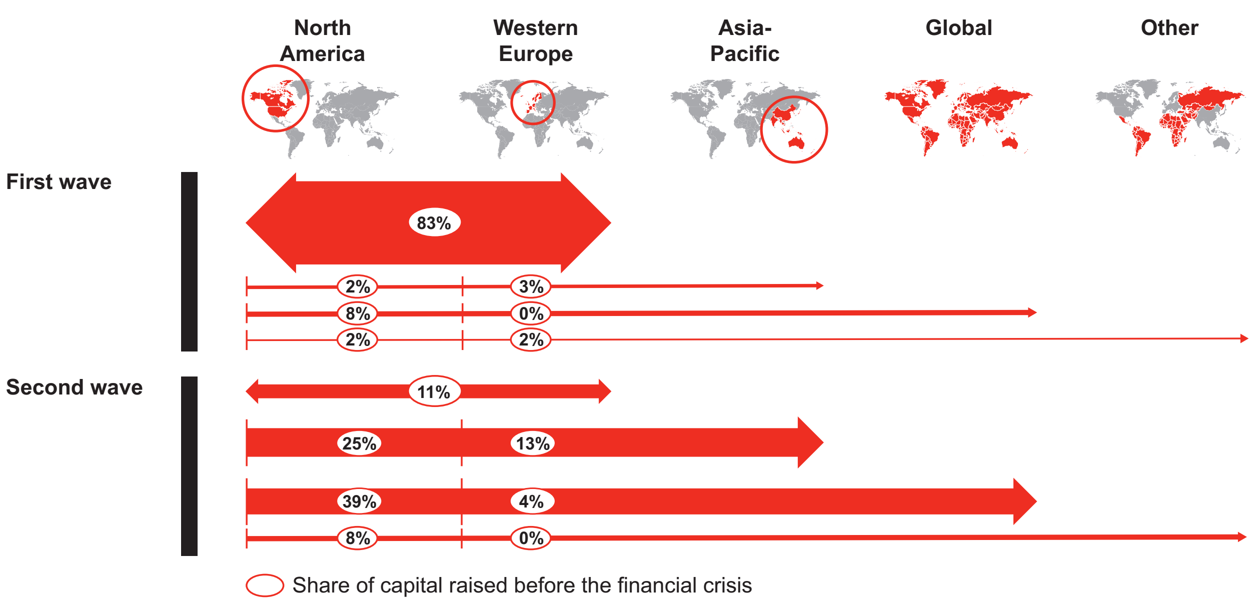
The Carlyle Group exemplified these ambitious expansions. From its core investing in heavily regulated sectors, such as the defense industry, Carlyle diversified geographically and then across asset classes, including venture capital, real estate, leveraged finance, high-yield debt, infrastructure and a hedge fund. The financial crisis took a toll on parts of Carlyle (as it did on most PE firms), but the firm remains one of the industry's largest, with more than $210 billion under management today.

Many other PE firms found it more challenging to succeed in new geographies and especially in different asset classes. Credit, infrastructure, real estate and hedge funds held much appeal, in part because they were less correlated with equity markets and offered new pools of opportunity. But critically, most of these asset classes also required buyout investors to get up to speed on very different capabilities, and they offered few synergies. Compared with buyouts, most of these adjacent asset classes had a different investment thesis, virtually no deal-sourcing overlap, little staff or support-function cost sharing, and a different LP risk profile.

To complicate matters, PE firms found that many of these adjacencies offered lower margins than their core buyout business. Some came with lower fees, and others did not live up to performance

Figure 2.12: Geographic adjacencies started with transatlantic expansions, followed by Asian and global targets

Buyout funds with home market in North America or Europe



Note: Based on a sample of 171 buyout funds, raised between 1998 and 2008, that expanded geographically
Source: Preqin

targets. Inherently lower returns for LPs made it difficult to apply the same fee structures as for traditional buyouts. To create attractive total economics and pay for investment teams, PE firms needed to scale up some of these new products well beyond what they might do in buyouts. That, in turn, threatened to change the nature of the firm.

For large firms that ultimately went public, like KKR, Blackstone and Apollo, the shift in ownership intensified the need to produce recurring, predictable streams of fees and capital gains. Expanding at scale in different asset classes became an imperative. And today, buyouts represent a minority of their assets under management.

Diversification, it became clear, was trickier to navigate than anticipated. Succeeding in any business that's far from a company's core capabilities presents a stiff challenge—and private equity is no different.

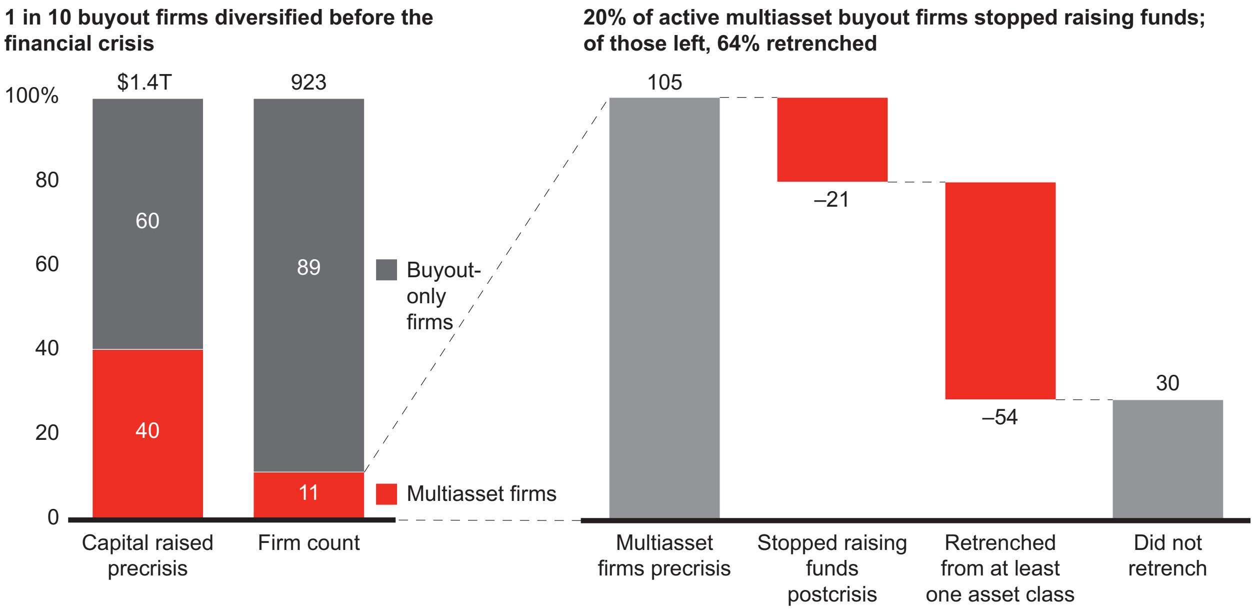
As other firms pursued diversification, however, the combination of different capabilities and lower returns wasn't always worth the trade-off. When the global financial crisis hit, money dried up, causing funds to retrench from adjacencies that did not work well—either because of a lack of strategic rationale or because an asset class struggled overall. Of the 100 buyout firms that added adjacencies before 2008 (roughly 1 in 10 firms active then), 20% stopped raising capital after the crisis, and nearly 65% of those left had to pull out from at least one of their asset classes *(see Figure 2.13)*.

Diversification, it became clear, was trickier to navigate than anticipated. Succeeding in any business that's far from a company's core capabilities presents a stiff challenge—and private equity is no different.

To test this point, we looked at a sample of funds launched between 1998 and 2013 by 184 buyout firms for which we had performance data, each of which had raised at least $1.5 billion during that period. We found that, when it comes to maintaining a high level of returns, staying close to the core definitely matters. Our study defined "core/near-in" firms as those that dedicated at least 90% of their raised capital to buyouts and less than 5% to adjacencies (including infrastructure, real estate and debt). We compared them to firms that moved further away from the core (dedicating more than 5% to adjacencies). The results: On average, 28% of core/near-in firms' buyout funds generated top-quartile IRR performance, vs. 21% for firms that moved further afield *(see Figure 2.14)*.

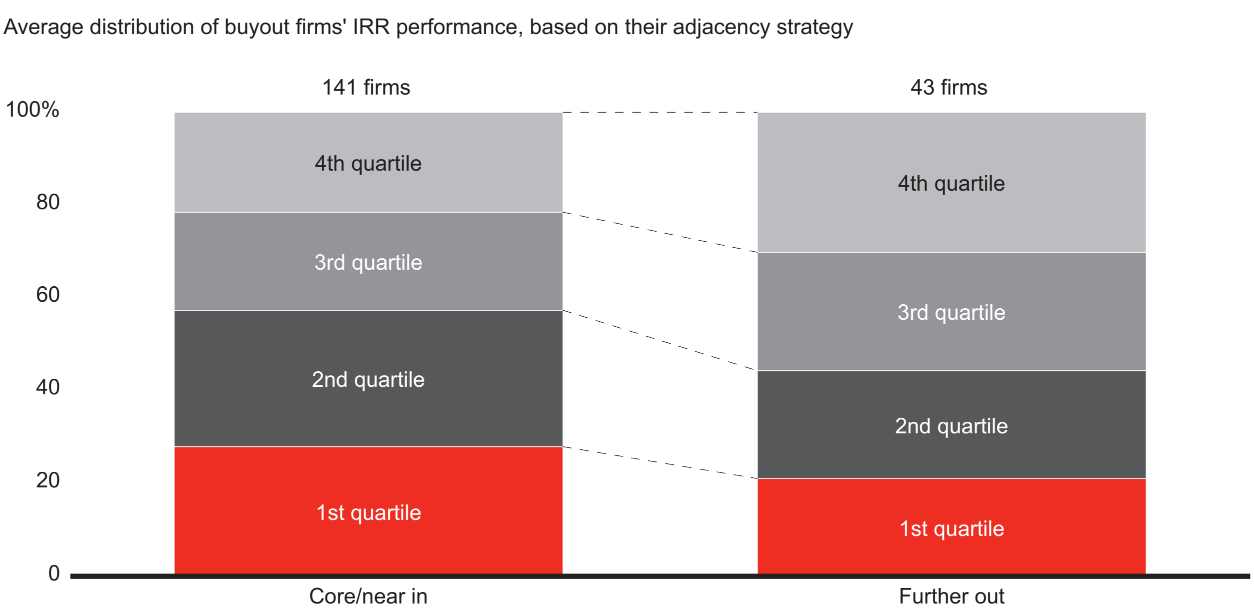
The IRR gap for geographic diversification is more muted, because making such moves is generally easier than crossing asset types. But expanding into a new country or region does require developing or acquiring a local network, as well as transferring certain capabilities. And the mixed IRR record that we identified still serves as a caution: Firms need to be clear on what they excel at and exactly how their strengths could transfer to adjacent spaces.

Figure 2.13: The financial crisis caused many failures and retrenchments in private equity



Notes: Includes all buyout firms that were active before the financial crisis (having raised a fund in the previous 10 years); multiasset firms are those that expanded in another asset class precrisis; funds considered closed if they stopped raising funds postcrisis; firms considered retrenched if they stopped raising funds for at least one asset class
Source: Preqin

Figure 2.14: Strategies close to the core yield higher performance



Notes: Analysis includes funds raised by 184 buyout firms between 1998 and 2013; excludes firms that raised less than $1.5 billion during the same period; core/near in defined as firms with 90% of their capital dedicated to buyouts and less than 5% to adjacencies like real estate, infrastructure or debt; further out represents the other firms
Source: Preqin (as of January 1, 2019)

The new wave: Closer to the core

With a record amount of capital flowing into private equity in recent years, GPs again face the question of how to deploy more capital through diversification. While a few firms, such as Hellman & Friedman, remain fully committed to funding their core buyout strategy, not many can achieve such massive scale in one asset class. As a result, a new wave of PE products is finding favor with both GPs and LPs.

Top performers are considering adjacencies that are one step removed from the core, rather than two or three steps removed. The best options take advantage of existing platforms, investment themes and expertise. They're more closely related to what PE buyout firms know how to do, and they also hold the prospect of higher margins for the GP and better net returns for LPs. In other words, these new products are a different way to play a familiar song.

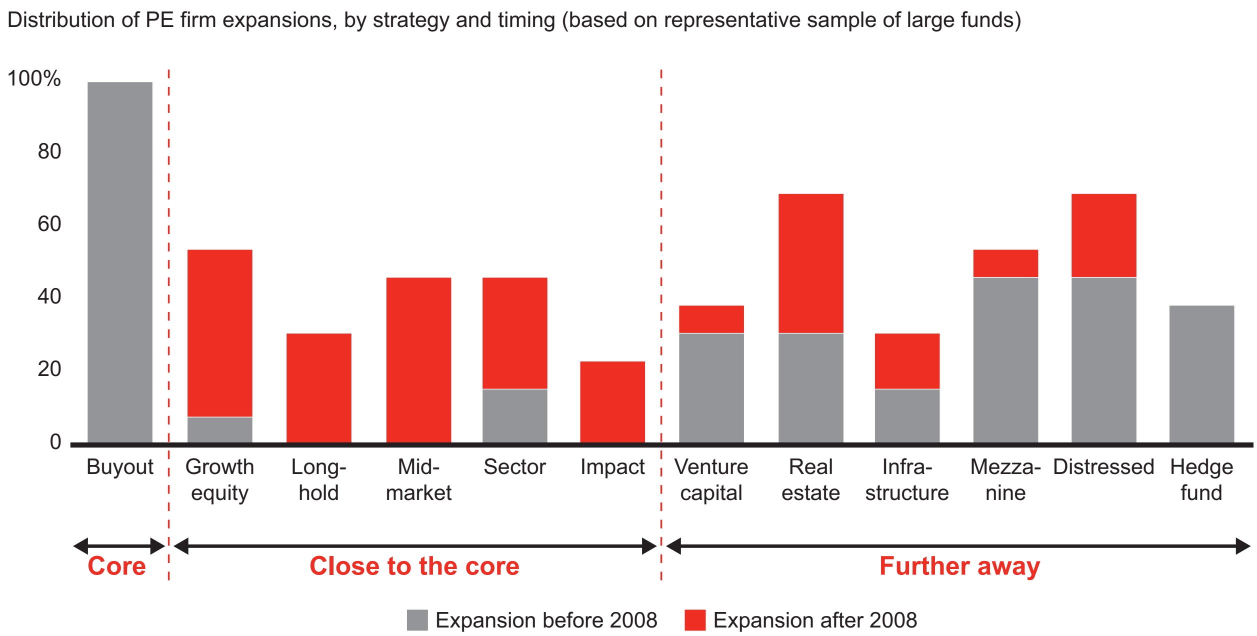
Top performers are considering adjacencies that are one step removed from the core, rather than two or three steps removed. The best options take advantage of existing platforms, investment themes and expertise.

The experience of Vista Equity Partners illustrates successful diversification close to the core business. Founded in 2000, Vista invests almost exclusively in software, data and technology-enabled enterprises. In 2017, it closed an $11 billion core fund, which was oversubscribed by almost 40%, and is currently targeting $16 billion for its successor. Along the way, Vista added several adjacencies that were slight variations on its core business model. In 2009, it founded a small- and midcap fund to tap into the North American middle market. In 2013, the firm raised a direct-lending fund to invest in the debt of the companies it buys, and it is now reportedly raising a $3 billion long-hold equity fund.

There are any number of ways for firms to diversify, but several stand out in today's market *(see Figure 2.15)*:

- **Long-hold funds** have a life span of up to 15 years or so, offering a number of benefits. Extending a fund's holding period allows PE firms to better align with the longer investment horizon of sovereign wealth funds and pension funds. It also provides access to a larger pool of target companies and allows for flexibility on exit timing with fewer distractions. These funds represent a small but growing share of total capital. CVC Capital Partners, for example, is raising its second long-hold fund with a hard cap of €5 billion, aiming for a 12% to 14% IRR, compared with the 20% target of its mainstream fund.

Figure 2.15: The new wave of adjacencies aim to stay closer to the core



Note: Sample includes 13 multiasset PE firms based in the US and Europe
Sources: Preqin; firm websites; literature search

- **Growth equity funds** target minority stakes in growing companies, usually in a specific sector such as technology or healthcare. Though the field is getting more crowded, growth equity has been attractive given buyout-like returns, strong deal flow and less competition than for other types of assets. Here, a traditional buyout firm can transfer many of its core capabilities. Most common in Asia, growth equity has been making inroads in the US and Europe of late. (See the sidebar, "Growth equity: Buyout-like returns with less leverage.")

- **Sector funds** focus exclusively on one sector in which the PE firm has notable strengths. These funds allow firms to take advantage of their expertise and network in a defined part of the investing landscape. TPG, for instance, is currently raising $2.5 billion for a healthcare sidecar fund after completing multiple deals in that space. This move should allow TPG to focus on the full healthcare value chain while giving it the flexibility to write smaller checks, which is not always possible with large buyout funds.

- **Mid-market funds** target companies whose enterprise value typically ranges between $50 million and $500 million, allowing the firm to tap opportunities that would be out of scope for a large buyout fund. For instance, the EQT Mid Market fund invests in middle-market buyouts and growth equity investments.

All of the options described here have implications for a PE firm's operating model, especially in terms of retaining talent, communicating an adjacency play to LPs, avoiding cannibalization of the firm's traditional buyout funds and sorting out which deal belongs in which bucket.

Key questions for GPs

It is too early to tell how much capital these vehicles will attract, or the level of returns they will generate. Still, for PE funds aiming to expand their hunting ground without straying too far from their core, they are viable options worth considering. Success will likely flow from careful assessment of three factors: Does the opportunity leverage existing capabilities? Can these adjacencies deliver good returns? And can we scale up the platform or product?

It is too early to tell how much capital these vehicles will attract, or the level of returns they will generate. Still, for PE funds aiming to expand their hunting ground without straying too far from their core, they are viable options worth considering.

The first wave of adjacencies worked for a subset of investors that figured out how to overcome the challenges of new asset classes, but many firms proved less successful. Learning from this experience, GPs need to thoroughly assess not only the attractiveness of the opportunity but also their ability to compete. And there must be a strong strategic rationale for expansion, convincingly communicated to LPs so that they don't perceive expansion as drifting strategy. Only a rigorous review of a GP's strengths from a strategy perspective can unlock the right moves. This second wave of adjacencies is a more disciplined attempt to stay closer to core capabilities, creating products that LPs want and GPs can execute on with higher odds of success.

With this in mind, GPs committed to adjacency expansion should ask themselves a few key questions:

- Do we have the resident capabilities to execute well on this product today, or can we add them easily?
- Does the asset class leverage our cost structure?
- Do our customers—our LPs—want these new products?
- Can we provide the products through the same channels?
- Have we set appropriate expectations for the expansion, both for returns and for investments?

Figure 2.16: PE funds with successful expansions have identified the unique assets, expertise and capabilities they can leverage

Investment sweet spot	Risk appetite (turnaround, high growth)	Degree of thematic investment	Depth of sector model	Geographic footprint and focus	Participation across the balance sheet
Investment value chain execution	Sourcing approach and networking strategy	Investment thesis definition and due diligence execution	Portfolio value-creation model	Exit management	
Proprietary firm assets	Brand and reputation	External network (advisers, management teams, technical specialists)	Scale and assets under management	Team (quality, accumulated experience, performance)	
Management capabilities	Investment committee and governance	Limited partner relationship management and fund-raising capabilities	Talent management and incentive structure	Firm culture	

Source: Bain & Company

Clear-eyed answers to these questions will determine whether, and which, adjacencies make sense. The past failures and retrenchments serve as a reminder that investing too far afield risks distracting GPs from their core buyout funds. Instead, a repeatable model consists of understanding which strengths a fund can export and thoughtfully mapping those strengths to the right opportunities *(see Figure 2.16)*. Adjacency expansion will remain a popular tack among funds looking for alternative routes to put their capital to work. Funds that leverage their strengths in a disciplined, structured way stand the best chance of reaping healthy profits from expansion.

Growth equity: Buyout-like returns with less leverage

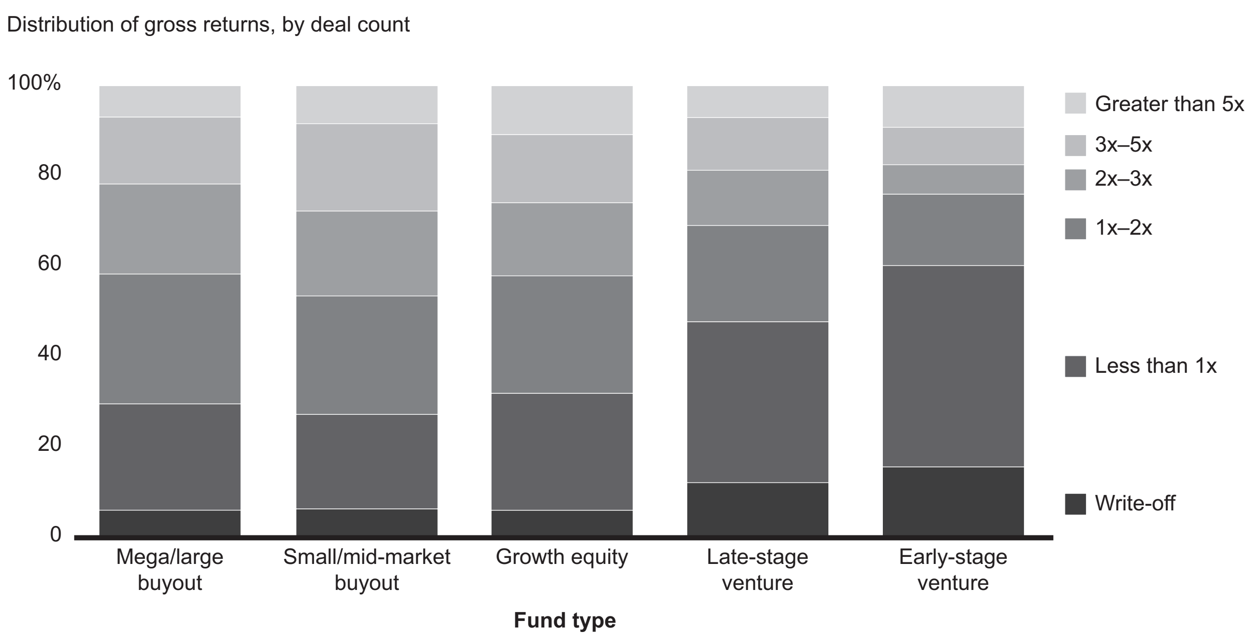
Growth equity is on a tear. Since 2014, $367 billion has been raised globally for the strategy, much of it by traditional buyout firms. For some firms, this is a return to their roots. While they started out raising funds that felt much closer to growth equity, they grew through the current cycle to find themselves concentrated mostly in the big buyout space. Raising a fund focused on fast-growing companies takes them back to where they started. For other buyout firms, growth equity represents a true adjacency expansion. They recognize that these funds aren't much of a stretch from their core capabilities and strengths.

The investment straddles the space between buyout, which focuses on companies with years of proven cash flow and profitability, and venture capital, which invests in start-ups that are still developing products and persuading early adopters. The target companies have typically reached an inflection point and need capital to scale an already proven business model.

The appeal for investors is the risk/return profile, which is closer to buyout than to venture. While venture capital holds the potential for huge wins, it also risks big losses for investors that make the gamble. Growth equity, on the other hand, is less risky and offers buyout-like performance, without the need for heavy leverage to magnify returns.

A look at the distribution of deal returns, as tracked by the State Street Global Exchange Private Equity Index, shows that growth equity performance is very close to that of buyout funds, with much lower rates of capital impairment than venture capital *(see figure)*.

Growth equity's distribution of returns is similar to that of buyouts



Notes: Analysis includes 28,000 fully realized deals invested globally; gross returns are returns before fees, expenses and carried interest; data as of June 30, 2018
Source: State Street Global Exchange Private Equity Index

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Advanced analytics: Delivering quicker and better insights

At a time when PE firms face soaring asset prices and heavy competition for deals, advanced analytics can help them derive the kinds of proprietary insights that give them an essential edge against rivals. These emerging technologies can offer fund managers rapid access to deep information about a target company and its competitive position, significantly improving the firm's ability to assess opportunities and threats. That improves the firm's confidence in bidding aggressively for companies it believes in—or walking away from a target with underlying issues.

At a time when PE firms face soaring asset prices and heavy competition for deals, advanced analytics can help them gain an essential edge against rivals.

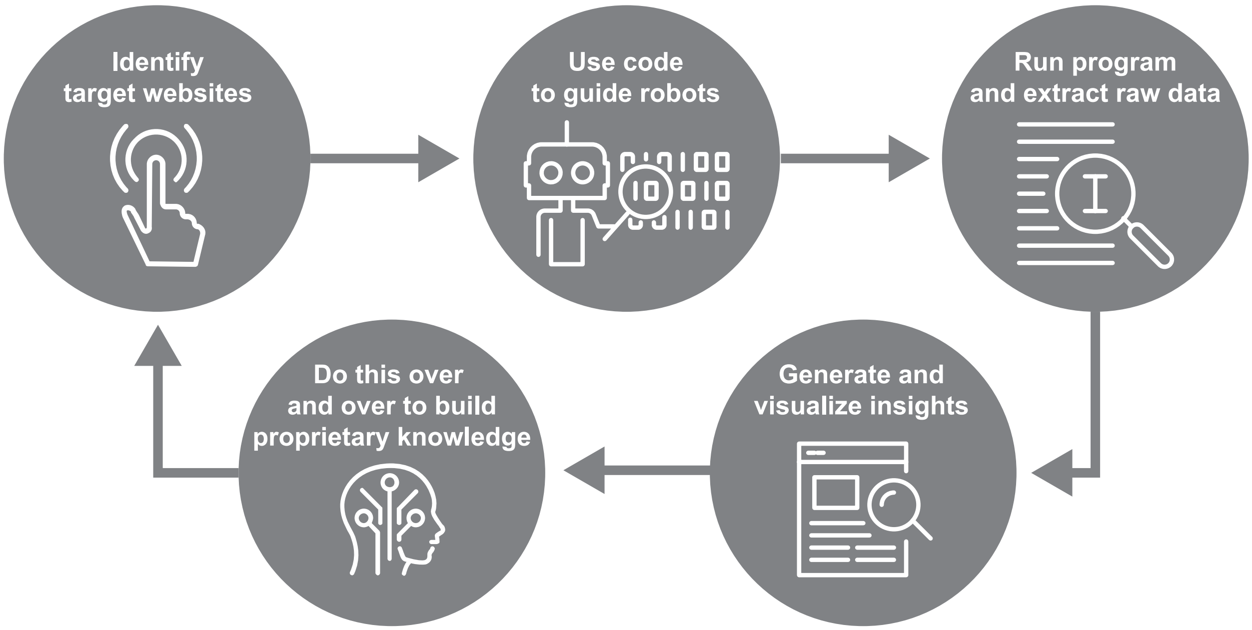
What's clear, however, is that advanced analytics isn't for novices. Funds need help in taking advantage of these powerful new tools. The technology is evolving rapidly, and steady innovation creates a perplexing array of options. Using analytics to full advantage requires staying on top of emerging trends, building relationships with the right vendors, and knowing when it makes sense to unleash teams of data scientists, coders and statisticians on a given problem. Bain works with leading PE firms to sort through these issues, evaluate opportunities and build effective solutions. We see firms taking advantage of analytics in several key areas.

Scraping the web 2.0

Many PE funds already use scraping tools to extract and analyze data from the web. Often, the goal is to evaluate customer sentiment or to obtain competitive data on product pricing or assortment. New tools make it possible to scrape the web much more efficiently, while gaining significantly deeper insights. Deployed properly, they can also give GPs the option to build proprietary databases over time by gathering information daily, weekly or at other intervals.

Using a programming language such as Python, data scientists can direct web robots to search for and extract specific data much more quickly than in the past *(see Figure 2.17)*. When one global PE fund was evaluating a delivery service company, for instance, it needed to create a list of all the stores the service worked with to estimate its market penetration. Traditional web scraping would have required several days. But the new technology produced a complete list of stores in a few hours. The same quick results helped another PE fund evaluate a wellness chain. Overnight, data scientists com-

Figure 2.17: Web scraping 2.0 uses programming language to produce more powerful insights, faster



Source: Bain & Company

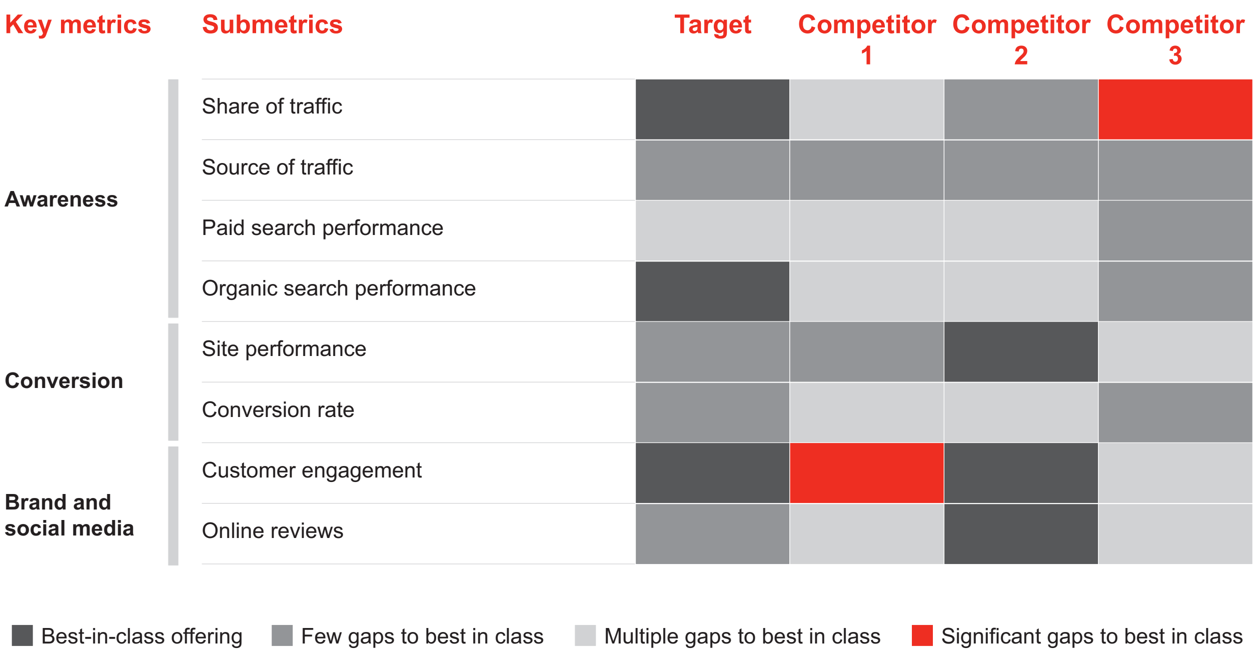
piled reviews and scores available on the web for the company and all of its competitors. That data allowed the firm to understand the target's market penetration by location and compare customer scores, including negative and positive comments. With the right code and the right set of target websites, new tools can also allow firms to assemble proprietary databases of historical information on pricing, assortment, geographic footprint, employee count or organizational structure. Analytics tools can access and extract visible and hidden data (metadata) as frequently as fund managers find useful.

Taking a digital X-ray

Most target companies these days sell through online channels and rely heavily on digital marketing. Fewer do it well. The challenge for GPs during due diligence is to understand quickly if a target company could use digital technology more effectively to create new growth opportunities. Post-acquisition, firms often need similar insights to help a portfolio company extract more value from its digital marketing strategy.

Assessing a company's digital positioning—call it a digital X-ray—is a fast and effective way to gain these insights. For well-trained teams, it requires a few hours to build the assessment, and it can be done from the outside in—before a fund even bids. It is also relatively easy to ask for access to a target company's Google AdWords and Google Analytics platforms. That can produce a raft of digital metrics and further information on the target's market position.

Figure 2.18: A digital X-ray showed a PE firm in half a day that its target had little digital marketing upside



Source: Bain & Company

Data scientists working for an international PE firm used digital X-ray tools to glean important insights when the firm evaluated a leading online real estate business based in the US. The deal thesis focused on the opportunity to increase revenues significantly by improving traffic to the target's website. In less than a day, the team tapped multiple data sources to measure the target's performance using key digital metrics, including awareness, conversion, brand performance and social media effectiveness *(see Figure 2.18)*.

The firm found that the target already ranked as a leader digitally, offering little opportunity to increase web traffic. Although the company had the potential to improve its margin on paid search, there was limited upside there, too; the sector was highly competitive, so absolute margins would still be low. User testing identified something even more troublesome: Customers who visited the target's website questioned the basic value proposition. The combined insights from the digital X-ray helped convince the PE firm not to make a bid.

Using the power of the masses

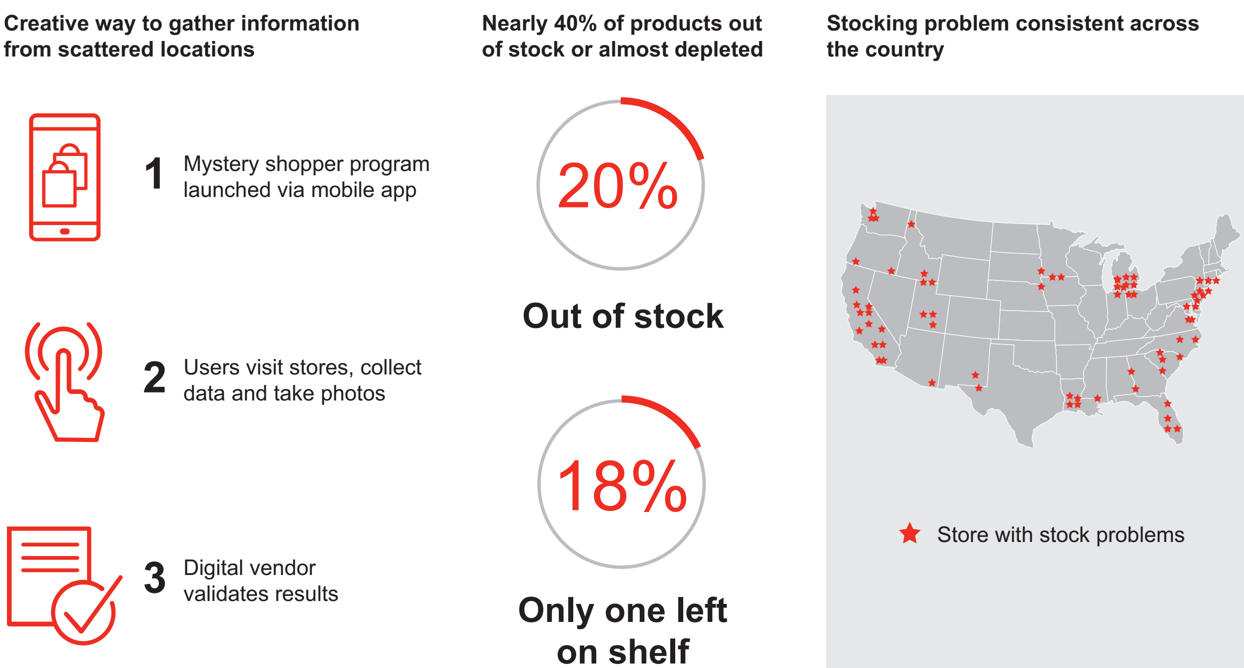
One challenge for PE funds historically has been accessing data from large networks or from scattered and remote locations. But new tools let deal teams complete such efforts in a fraction of the time and cost. Take the case of a US portfolio company that believed one of the retail chains carrying its products was not stocking them appropriately, leading many stores to run out of stock. With more than 700 store locations nationwide, it would have been time consuming and expensive to send a mystery shopper to visit each store and collect data.

Instead, the company's management turned to a digital vendor that mobilized a large group of consumers to do the spy work. After registering through a mobile application, the consumers earned small incentives for visiting the retailer's stores, spending 15 to 20 minutes collecting information and taking photos, and then supplying key data points via the app. In essence, the digital vendor's program launched an invisible army of mystery shoppers to all of the stores simultaneously. The flood of data confirmed that about 40% of the brand's products were either out of stock or the store had only one unit left on the shelf *(see Figure 2.19)*. Armed with real data, the portfolio company's management convinced its retail partner to take immediate action.

Understanding traffic data

One issue that PE deal teams often ponder in evaluating companies is traffic patterns around retail networks, manufacturing facilities and transport hubs. Is traffic rising or declining? What's the potential to increase it? In some industries, it's difficult to track such data, especially for competitors. But high-definition satellite images or drones can glean insights from traffic flows over time. Take the case of a global PE investor in the midst of due diligence on a retail target. The target company's financial performance had improved significantly over the previous five years, but it still lagged its

Figure 2.19: A portfolio company used an invisible army of shoppers to rapidly see where its products were out of stock

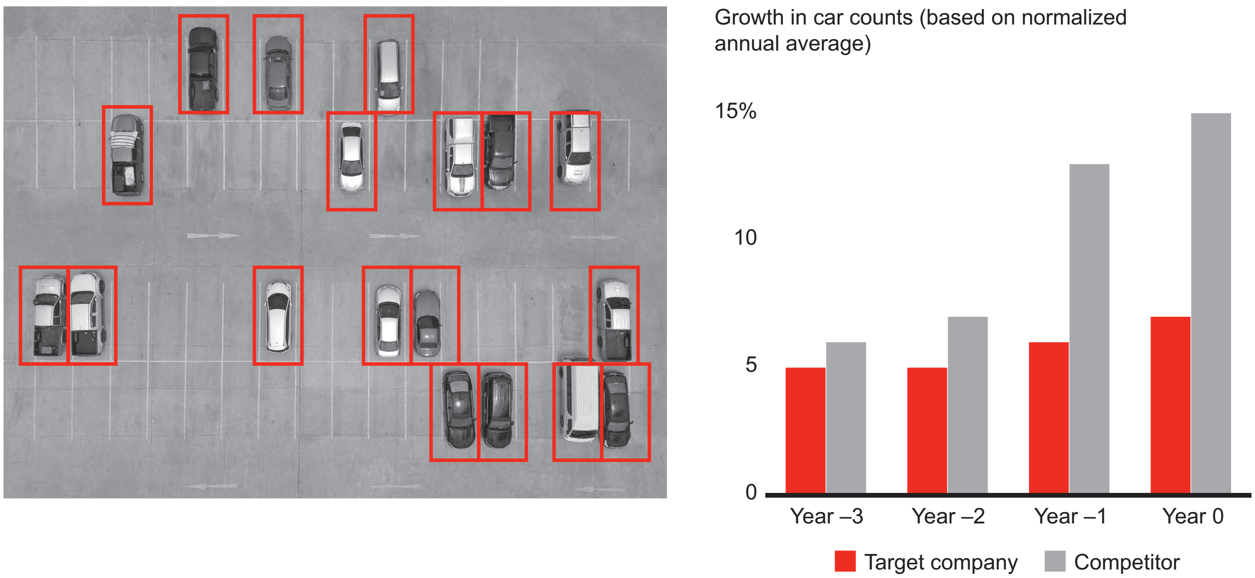


Source: Bain & Company

Figure 2.20: A PE firm harnessed satellite technology to gain insight into a target's performance

Satellite images used to analyze daily car counts

Competitor's car count grew faster than the target's



Source: Bain & Company

major competitor in revenue per store—and the gap was growing. While differences in customer and channel mix could explain part of the gap, the deal team suspected lower traffic and poor store execution were the main factors.

The fund enlisted a data science team to tap satellite observations and estimate the number of cars parked at the target's stores vs. the competitor's stores over the previous four years *(see Figure 2.20)*. Using a geoanalytics platform, the team obtained a series of high-definition satellite images of the two parking lots and analyzed changes in normalized daily car counts. The data demonstrated that the competitor's average car counts had been increasing steadily over the past three years, while the target company's stores showed limited traffic growth. The findings also pinpointed when the traffic counts started to diverge, allowing the deal team to check whether the competitor's increasing traffic was linked to marketing campaigns or supply-chain improvement initiatives. Through these insights, the fund could fully diagnose the main reasons for the target's lagging performance and zoom in on locations where the gaps were biggest. The traffic data also gave the deal team a head start designing growth initiatives for the target during due diligence.

Identifying disruption

Another advantage of analytics tools is the ability to see around corners, helping fund managers anticipate how disruptive new technologies or business models may change the market. Early signs of disruption are notoriously hard to quantify. Traditional measures such as client satisfaction or profitability won't ring the warning bells soon enough. Even those who know the industry best often fail to anticipate technological disruptions. With access to huge volumes of data, however, it's easier to track possible warning signs, such as the level of innovation or venture capital investment in a sector. That's paved the way for advanced analytics tools that allow PE funds to spot early signals of industry disruption, understand the level of risk and devise effective responses. These insights can be invaluable, enabling firms to account for disruption as they formulate bidding strategies and value-creation plans.

These are just a few of the ways that PE firms can apply advanced analytics to improve deal analysis and portfolio company performance. We believe that the burst of innovation in this area will have profound implications for how PE funds go about due diligence and manage their portfolio companies. But most funds will need to tap external expertise to stay on top of what's possible. A team-based approach that assembles the right expertise for a given problem helps ensure that advanced analytics tools deliver on their promise.

3. Private multiples are ascendant: Is this the new normal?

Valuation multiples, or the price paid per dollar of EBITDA, move up and down. Yet for the past 30 years, the average multiples investors have paid for public assets have almost always topped those paid for private assets, usually by as much as one to two times EBITDA. There have been periods when the gap has widened out in favor of public assets—the best example being the late-1990s tech boom, when everybody and their brother was piling into the stock market, driving up public valuations and making IPOs the easy exit for PE investors. As for periods when private multiples generally exceed the public average, there have been exactly three: during the "Barbarians at the Gate" era of the mid-1980s, during the exuberant run-up to the recent global financial crisis, and now.

The Barbarians era and the precrisis boom were short lived. There's no single reason why multiples quickly reverted to normal, but one contributor was that the arbitrage opportunity dried up quickly. Both eras were marked by heavy activity in public-to-private deals, driven by investors' belief that companies would be worth more in private hands than the public markets were giving them credit for. Heavy P2P activity, though, ends up being a backstop. The rush for public assets eventually buttresses public multiples and helps restore the usual balance.

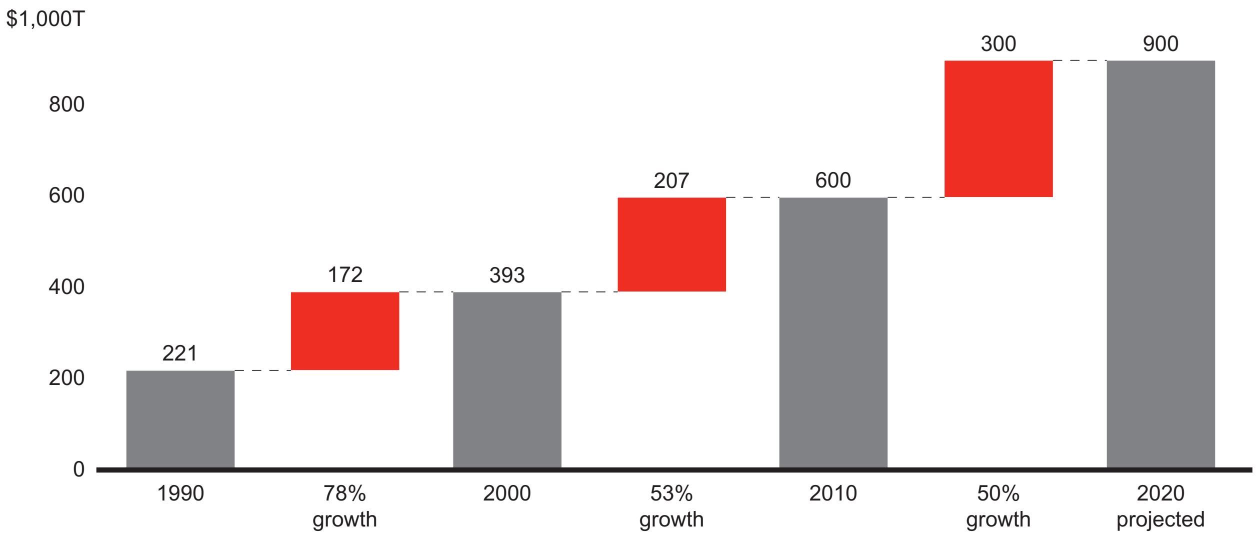
Is there something fundamentally different in the way investors view the public and private markets that is leading to a long-term reversal in how those markets value assets? There are signs that the ground is shifting under the old order.

A question worth asking this time around is whether this dynamic has changed. Is there something fundamentally different in the way investors view the public and private markets that is leading to a long-term reversal in how those markets value assets? Obviously, there's no way of predicting the future, but there are signs that the ground is shifting under the old order. And if the markets are, in fact, undergoing long-term change, it will have clear implications for PE firms navigating a hotly competitive environment.

Public assets have historically commanded higher average valuations for a number of reasons, including the fact that investors are willing to pay a premium for more liquidity and transparency. The universe of investors is also much broader, enabling the public markets to attract truly massive flows of capital. Nothing has really changed in that regard. But a lot has changed on the private side of the ledger. Investors have never been more drawn to the private markets than they are today, and it's plausible this abiding enthusiasm is leading to long-term change in how markets value assets.

Figure 3.1: The rapid growth of financial capital has shaped the global economy—and private equity—since the 1990s

Total world financial assets



Note: All figures are in real 2010 US dollars at 2010 exchange rates
Sources: International Monetary Fund, *World Economic Outlook: Slowing Growth, Rising Risks,* September 2011; Organisation for Economic Co-operation and Development; national statistics; Bain Macro Trends Group analysis

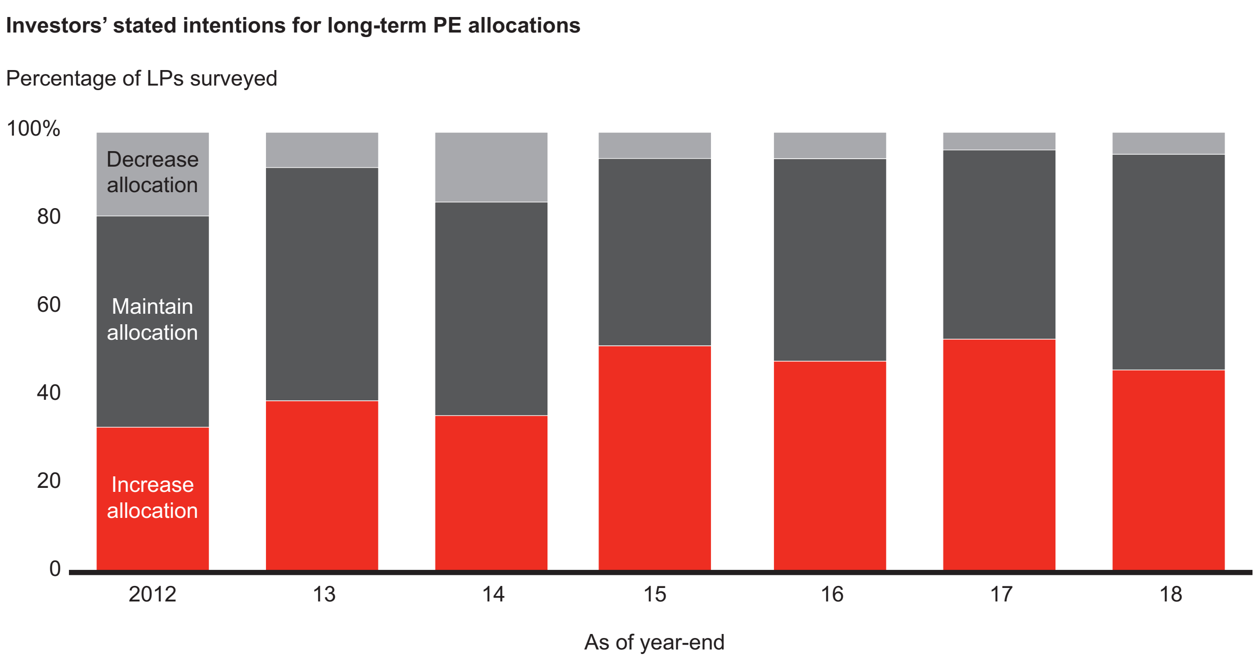
The flow of capital into the private markets is unprecedented. Partly, that's because investors simply have more money to put to work than they've ever had in the past. Financial engineering, high-speed computing and the loosening of financial regulations have unleashed a superabundance of financial assets over the past 25 years, which has transformed how both the equity and debt markets behave. Global financial capital increased 53% from 2000 to 2010, reaching some $600 trillion, or 10 times real global GDP. Bain's Macro Trends Group projects that it is swelling by half again and will reach approximately $900 trillion by the end of 2020 *(see Figure 3.1)*.

This age of superabundance has had both negative and positive effects. The flood of capital led to the housing and buyout booms that imploded so spectacularly during the global financial crisis. Yet the ready liquidity in the aftermath of the crisis also powered the rebound in public and private markets, allowing private equity to recover, regain its momentum and accelerate out of the gloom. Since then, investors hungry for yield have flocked to private equity, enticed by its superior returns relative to other asset classes. Since the start of the current economic cycle in 2009, investors have allocated a staggering $5.8 trillion globally to private equity, and the debt markets have been eager to finance transactions. LPs have also been steadily increasing their overall PE allocations, a sign that they are confident in private capital's long-term ability to deliver strong performance *(see Figure 3.2)*. Over the past 20 years, private-market capital has grown at more than double the rate of public capital globally, and, at the moment, there's no slowdown in sight. Indeed, a number of firms are experimenting with ways to make PE investments available to retail investors. If these innovative new vehicles take off, it could open the floodgates to a massive new investor channel.

As we explained earlier in this report, the unprecedented amount of capital chasing a limited number of assets has driven average buyout purchase price multiples to record highs in recent years. It has also given companies financing choices they've never had before. During the late-'90s tech boom, riding the surge in public equities to a blockbuster IPO was the obvious choice for any company looking to finance growth. Today, that's no longer true. Companies can now tap private equity or institutional capital with relative ease and borrow at historically low rates. That means they can avoid the myriad costs and hassles of going public. Uber, which has ridden almost $21 billion in venture capital to a private valuation of around $72 billion, is the poster child for this new reality. The company has filed to launch a public offering in 2019, but that's because it has grown to the point that the public markets are now its only option to gain wide-scale liquidity (a real exit) for investors and shareholders.

What's clear is that the advantages of going public no longer outweigh the considerable disadvantages. First of all, it's expensive. Initiating a public offering is an exercise in writing checks to investment bankers and lawyers. Being public then adds several million to a company's cost structure in the form of higher compensation and the many costs associated with financial reporting. For many leadership teams, managing in a fishbowl is also enervating. Relentless scrutiny from Wall Street, quarterly re-

Figure 3.2: Institutional investors are steadily increasing their exposure to private equity



Source: Preqin surveys

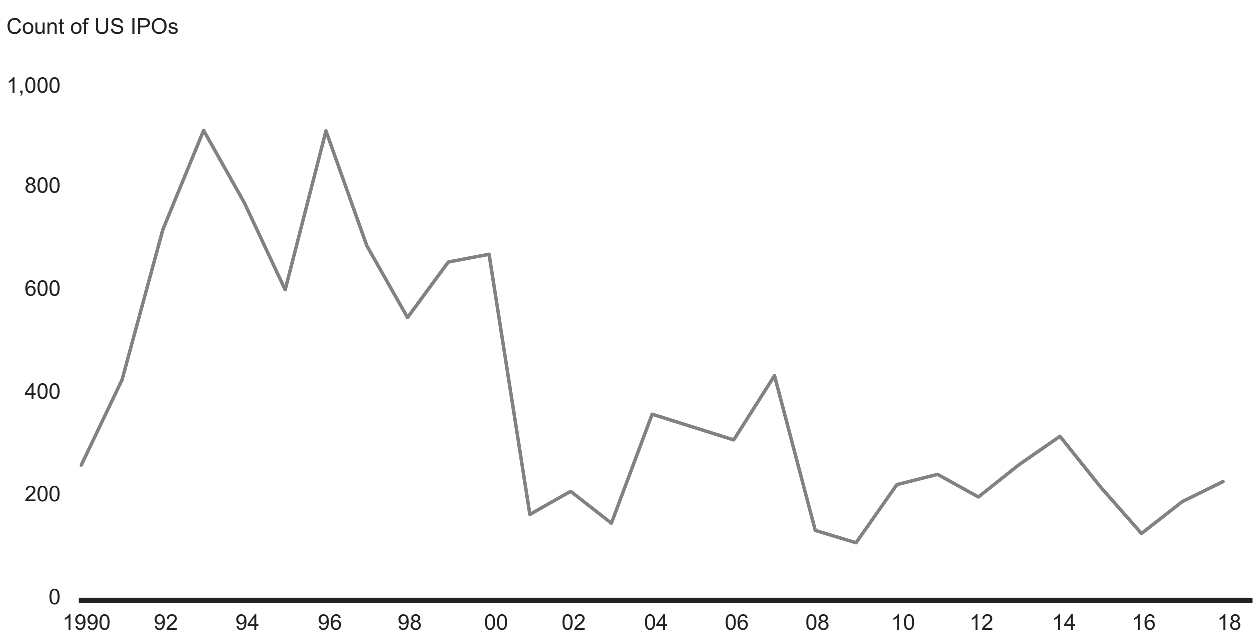
porting requirements and the linkage of corporate incentives with short-term performance goals all discourage a long-term perspective on value creation. If the stock price suffers, any number of hostile entities will be ready to swoop in with a massively disruptive takeover bid.

Leaders who have experienced both the public and private arenas rarely equivocate about which they prefer. Michael Dell, who teamed with Silver Lake Partners to take his eponymous PC company private for $24 billion in 2013, put it this way: "Privatization has unleashed the passion of our team members, who have the freedom to focus first on innovating for customers in a way that was not always possible when striving to meet the quarterly demands of Wall Street. As a private company, Dell now has the freedom to take a long-term view." Dell reemerged as a public company in December to simplify its capital structure. But it did so through a complex cash-and-equity deal that avoided the hassles of an IPO.

Given the choice, more and more companies are choosing to stay or go private. The number of US public companies has declined approximately 45% since its peak 20 years ago, despite a rise in the total number of companies. At the same time, the number of IPOs has plummeted. During the 1990s, the US market averaged 652 public offerings a year. Last year, the total was around one-third of that *(see Figure 3.3)*.

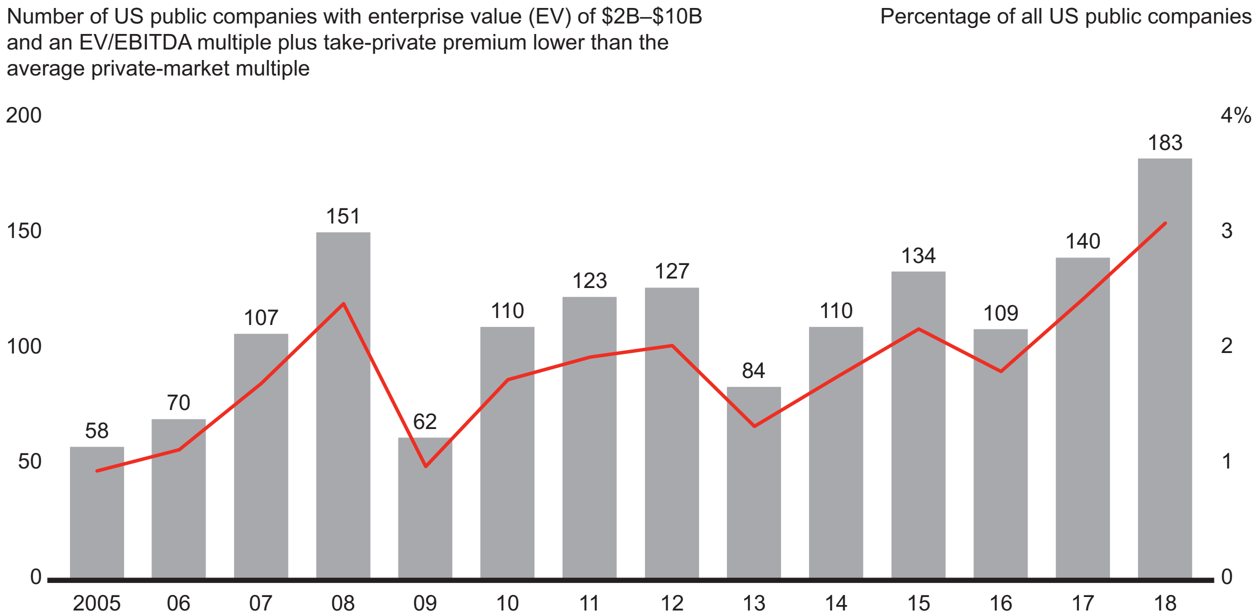
Meanwhile, the pool of companies ripe for take-private transactions is growing. As private multiples have surged and public multiples begin to price in the threat of a recession, a record number of com-

Figure 3.3: The number of US IPOs has dropped substantially since the mid-1990s



Note: Includes only US-based issuers listing on US exchanges
Source: Thomson Reuters

Figure 3.4: The pool of potential take-private targets is growing, as public companies trade at lower valuations relative to private multiples



Notes: Public company enterprise value calculated as average over four quarters of each year; analysis assumes a 20% take-private premium; 2018 company EBITDA based on last 12 months from previous quarter close; companies with negative EBITDA excluded from analysis
Sources: S&P Capital IQ LCD; Bain analysis

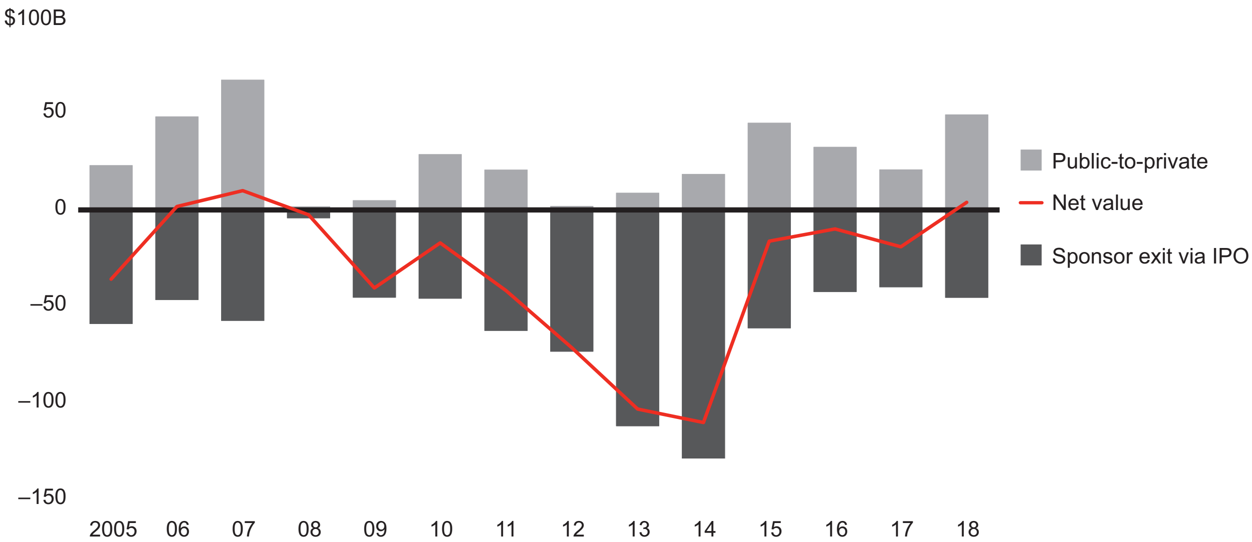
panies are drifting into private equity's P2P sweet spot. These are companies with an enterprise value between $2 billion and $10 billion that could be purchased for a multiple plus take-private premium that is still below the average private-market multiple *(see Figure 3.4)*.

It's unsurprising, then, that P2P activity has been robust in the latter part of this cycle. For the first time since 2006–07, the value of US companies going private in 2018 exceeded the value of those going public, causing a net outflow from public markets *(see Figure 3.5)*. It is noteworthy that, in the US and Western Europe, one in five companies taken private in 2017 and 2018 had earlier been taken public via a sponsor-backed IPO. The market, in other words, has decided that these companies are clearly more valuable under private ownership than they were in the public realm.

Taken to the extreme, this pattern would end up placing most cash-generating companies in private hands. Public ownership in that case would be reserved for companies that must exist in the public realm for regulatory reasons (banks, insurance companies, utilities) or because they can't carry leverage (non-cash-generating early-stage investments in sectors like biotech or technology). That seems far-fetched, but from where we sit, the superabundance of capital shows no signs of ebbing. And it is likely to affect how investors and companies think about financing growth and long-term strategy for years to come. Again, there is no way to accurately predict whether the current multiple reversal will last any longer than the last two brief periods of inversion did. We are, however, noticing some real

Figure 3.5: Total enterprise value of US take-private deals exceeded that of sponsor-backed IPOs for the first time since 2007

Enterprise value (EV) of US public-to-private deals and sponsor-backed IPOs (for companies with EV of $2B–$10B)



Notes: Public-to-private year categorized by announcement date; IPO year categorized by pricing date
Sources: Bain global public-to-private deal database; Dealogic

trends that haven't been a factor until now. That suggests it's worth considering what it would mean for PE firms and their investors if private multiples remain elevated over the long term. We see several implications.

Goodbye, IPO exits. If private multiples remain high relative to public valuations, it becomes less attractive to exit via an IPO. For GPs, the best prices for assets will come from selling a company to a strategic buyer, like a large corporation looking to acquire growth, or to another PE firm willing to shepherd the company to a new level of performance. Maximizing value has always meant thinking about the right exit strategy from day one and building value accordingly. For GPs, focusing on strategic and sponsor-to-sponsor exits may become the new normal. And for LPs, it means getting comfortable with the idea that sponsor-to-sponsor transactions may become an even bigger part of the deal market.

Public company targets. The growth in public-to-private transactions we have seen in the latter part of this cycle could be just getting started. Faced with the challenge of putting record amounts of capital to work, private equity is already targeting bigger and bigger companies. One obvious place to look for big companies is the public markets. For many large firms, this will likely become an increasingly important hunting ground, requiring a shift in their approach to deal sourcing, screening and due diligence.

Even bigger megafunds. The past several years have seen the return in earnest of the megabuyout fund. Witness recent fund launches by Apollo, Hellman & Friedman and Carlyle of $24.7 billion,

$16 billion and $18.5 billion, respectively. Funds are growing in size, and the take-private opportunity in the public markets makes a case for even bigger funds capable of transacting ever-larger P2P deals. It is conceivable that we will see funds hit the $30 billion, $40 billion or even $50 billion mark as more companies cross over from public to private.

Democratization of private equity. Given the growth of the private markets and their higher return potential vs. public markets, making private equity more accessible to retail investors is gaining importance. Already, retail investors are struggling to gain exposure to the small and middle-market companies that have been the bread and butter of private equity. These companies are increasingly turning to private financing to avoid the cost and hassle of being publicly traded. Individuals are missing out on the opportunity to invest in fast-growing start-ups with potential to generate big returns (like Uber) as companies stay private longer. Now, as a growing number of traditionally public companies go private, it makes more sense than ever to push the door open for retail PE investors. Around 15% to 20% of Blackstone's annual fund-raising already comes from retail investors, and this is likely just the start.

A playbook for a $20 billion acquisition is not a simple "scale up" of the playbook firms use to unlock value at a $2 billion company. Mega-deals require a mega-investment in due diligence and the skills needed to choreograph change on a massive scale.

The trend toward bigger and bigger deals—whether they be large take-private transactions or buyouts of fast-growing private companies that never went public—will require significant changes in how most PE firms operate. We know from the P2P boom a decade ago that, for many PE firms, the experience of buying and trying to add value to truly large enterprises was disappointing. Too many deals went sideways or blew up, either because the firm didn't do a thorough enough job in due diligence to really understand the risks and opportunities involved in these complex businesses, or because it didn't have a value-creation process that could work on a much larger business. A playbook for a $20 billion acquisition is not a simple "scale up" of the playbook firms use to unlock value at a $2 billion company. Megadeals require a mega-investment in due diligence and the skills needed to choreograph change on a massive scale, to affect the financial, operational or strategic trajectory of the business. As we discussed in Section 2, that could mean developing the capabilities to pursue corporate-style M&A strategies. It could also require becoming more adept at deploying tools like zero-based redesign to achieve rapid cost reduction on a large scale, or developing the kind of human resources capabilities to manage enterprise-wide cultural change. The bottom line is that firms need to adjust their investment and capabilities to the task at hand. Tackling larger deals successfully means matching due diligence and resources post-close to the increased scale of the investment.

One more point: It is notable that after the previous two periods when private multiples exceeded public valuations, the economy headed for a downturn. As we mentioned in Section 1, that risk exists this time around as well. There is, of course, no way of predicting a downturn, either in terms of timing or severity. But hunkering down and not investing through the storm isn't an option for most firms; they need to put money to work. It's critical, however, to enter into any new deals with eyes wide open. We disagree with the notion that firms should completely avoid anything with a whiff of cyclicality at times like these. As long as a company is fundamentally sound and isn't carrying too much leverage, it can still perform through a downturn. Many PE-owned cyclical companies bought before the global financial crisis rode through the storm and emerged as winners on the other side. The 2007 carve-out of Allison Transmission from General Motors by Carlyle and Onex is a good example. Allison's EBITDA declined to $501 million from $544 million between 2008 and 2009, but leadership managed expenses aggressively to improve margins and generated cash by finding working capital and capital expenditure efficiencies. The company not only survived the downturn but was well positioned to benefit from the recovery.

The key imperative in cyclical deals is a deep understanding of how well a company is positioned financially and competitively.

The key imperative in cyclical deals is a deep understanding of how well a company is positioned financially and competitively. It isn't enough to know the industry well; in diligence, firms need to test the business against robust downturn scenarios. This means having a firm grasp of how far earnings can fall and for how long, and exactly what levers an owner can pull to minimize the damage. It is essential to build a balance sheet that can withstand a period of economic weakness. It is also critical to understand the company's core strengths and how the value-creation plan will take advantage of them.

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