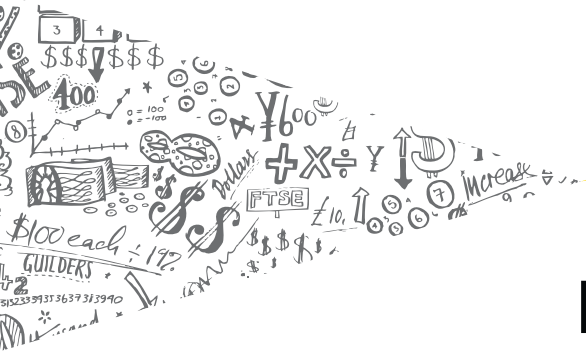
Issue 4
Outlook May 2013–October 2013

Private Equity

Global Capital Confidence Barometer



Determined to diversify

While private equity (PE) investors remain confident about the global economy in our latest survey, they are diversifying their investment and exit activity in response to muted corporate M&A levels.

There is continued confidence regarding the global economy. This optimism is driven by improved prospects for economic growth (albeit at low rates), corporate earnings and availability of credit. GPs say that the fund-raising environment is more positive, with LPs keen to diversify their investments across different funds and geographies. PE firms are positioned to make more investments in emerging markets and are expanding their focus outside the BRIC countries. There are plans for PE portfolio companies to create new jobs over the coming year and to increase acquisition activity.

However, concerns remain about slowing growth in emerging markets, stagnant growth in the Eurozone, increasing M&A valuations and future central bank actions. The impact can be seen in a reduced level of M&A activity. Among corporations in particular there appears to be a confidence paradox – the rebound in economic sentiment globally is not coupled with an increased appetite for capital investment, most notably among companies in Europe that remain very cautious. This reluctance to invest could be linked to the persistent low-growth environment in the global economy, creating little urgency to make investments.

Subdued M&A activity will restrict deal flow for PE firms and continue to challenge a key exit route for portfolio companies. This will be offset slightly by the reopening of IPO markets, which is bringing welcome relief to PE firms as there remains an estimated 1,400 companies* to be divested in the US and Europe over the next five years.

Jeff Bunder, Global Private Equity Leader

About this survey

The *Global Capital Confidence Barometer* is a regular survey of senior executives from large companies around the world conducted by the Economist Intelligence Unit (EIU). For the eighth *Global Capital Confidence Barometer*, we once again polled PE participants using a separate, but related, survey.

This PE subset of our findings gauges PE investors' confidence in the economic outlook and identifies key trends and practices in the way PE firms manage their capital agendas.

Profile of respondents:

- Panel of over 100 PE investors surveyed February through March 2013, in addition to our overall sample of almost 1,600 corporate executives from 50 countries and more than 20 sectors
- 44% respondents from firms with more than US$5 billion in assets under management

The Capital Agenda

Based around four dimensions, it helps companies consider their concerns and challenges, understand their options and make more informed capital decisions.

1. **Preserving capital:** managing portfolio and investee risk and effective financial reporting
2. **Optimizing capital:** driving exits and returns and managing the performance improvement of the portfolio
3. **Raising capital:** assessing fund diversification needs and managing interactions with investors
4. **Investing capital:** sourcing new deals and strengthening transaction execution

Key findings

- **55% of PE investors believe the global economy is improving, albeit slowly.**
- **85% of GPs think that fund-raising conditions will be positive or stable over the coming year.**
- **44% of PE firms say that slowing growth in emerging markets is the biggest risk to portfolio companies in the coming year.**
- **78% of PE firms are spending at least six months preparing portfolio companies for exit.**
- **24% of GPs expect the number of IPOs to increase over the coming year. Just 15% thought the same in October.**

*With an entry enterprise value of more than US$/€150m

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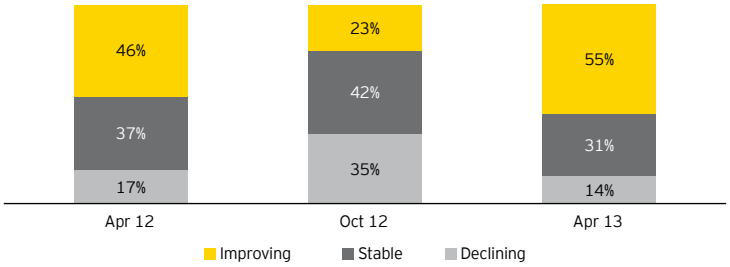
Economic outlook

Confidence in global economy returns

PE investors and companies are more optimistic about the global economy than they were six months ago. Over half of respondents – 55% of PE firms and 51% of corporations – believe that the global economy is improving, up from 23% and 22%, respectively, in October. However, this appears to be a regular pattern we have seen before, with sentiment more positive in our April reports but declining in October.

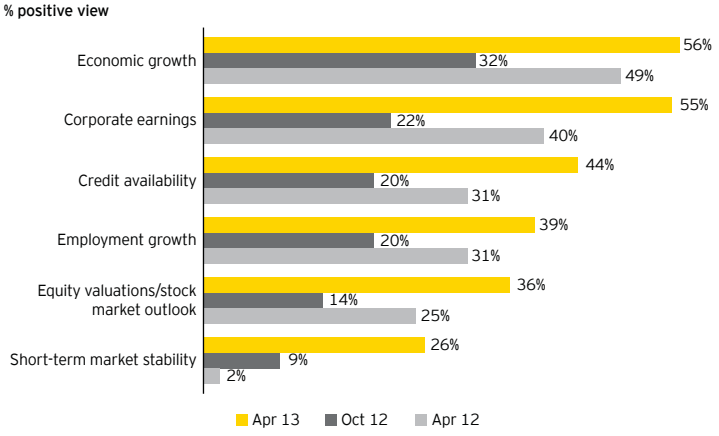
Figure 1. What is your perspective on the state of the global economy today? (PE firms)



55% of PE investors say the global economy is improving.

The increase in confidence about the global economy is linked to better prospects for economic growth, corporate earnings and credit availability.

Figure 2. Please indicate your level of confidence in the following at the global level (PE firms)



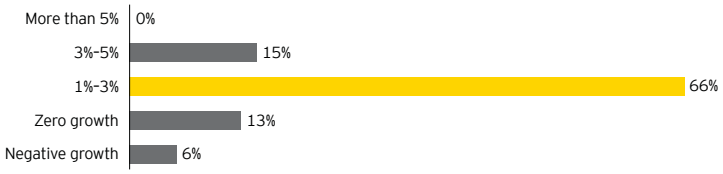
Global economic growth expected to be low

Although respondents think the global economy is improving, growth rates are expected to be at the lower end of the range. Two-thirds of PE firms (66%) and companies (65%) expect the global economy to grow by 1%–3% over the next 12 months.

This is currently the biggest driver – or constraint – on investment activity. Confidence has returned as the financial crisis has ebbed, but in a low-growth environment there is no urgency to act.

A minority of PE firms (15%) expect growth of 3%–5%. Companies in the mining and metals, consumer products, power and utilities, and oil and gas sectors – sectors that may benefit from growth in emerging markets – are more likely than companies in other sectors to expect global economic growth of 3% or more.

Figure 3. By how much do you think or expect the global economy to grow in the next 12 months? (PE firms)



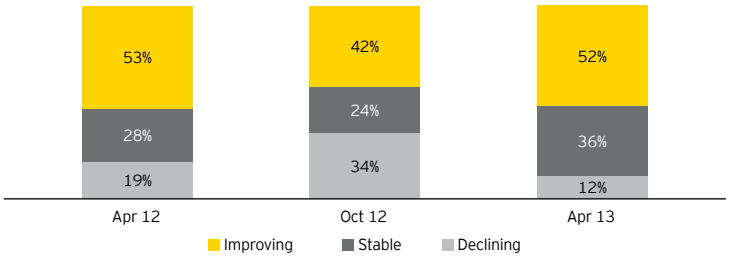
81% of PE firms expect global economy to grow by 1%–5% over the next year.

Confidence in local economies also grows

The prospects for local economies have strengthened in line with global expectations. Half of PE firms (52%) report that their local economies are improving, up from 42% in October. Just 12% expect their local economies to decline, down from 34% six months ago.

GPs based in the United States, Southeast Asia and Australia are more positive about their local economies, while those in the India, China and Eastern Europe are less so.

Figure 4. What is your perspective on the state of the local economy today?

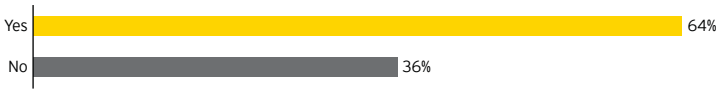


Regulatory environment supportive of business growth

A majority of companies (80%) and PE respondents (64%) believe the current regulatory environment is conducive to business growth initiatives at a global level. Two-thirds of PE firms (65%) also believe the same is true at a local level.

There are pending issues for the industry such as the Alternative Investment Fund Managers Directive in Europe and Dodd-Frank and FATCA in the US, which may impact PE firms' views on the regulatory environment in the future.

Figure 5. Do you think the current regulatory environment is supportive of business growth initiatives at the global level? (PE firms)



64% believe the current regulatory environment is supportive of business growth initiatives at a global level.

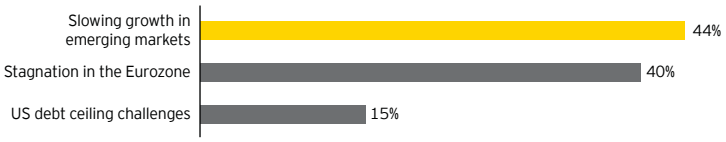
Risks to PE portfolio company growth persist

Slowing growth in emerging markets is cited as the biggest risk to PE portfolio companies over the next 6–12 months, followed by stagnation in the Eurozone area.

These issues are also cited by corporations as economic risks to their businesses. Many corporations expanded into emerging markets because of higher relative growth rates compared with developed markets. They are therefore concerned that these growth rates will decrease and slow down consumer spending, which will impact revenues.

Many companies are adjusting their strategies to compensate — for example, by putting M&A plans on hold over the coming year — while others view it as an opportunity for their businesses.

Figure 6. What do you believe to be the greatest economic risk to your companies over the next 6–12 months? (PE firms)



44% of PE firms believe that slowing growth in emerging markets is the biggest risk to portfolio companies in the coming year.

Viewpoint

PE firms increase their focus on non-BRIC countries

The extent of the slowdown in economic growth in emerging markets, especially the larger countries like Brazil, China and India in 2012, seems to have caught commentators by surprise. China grew by 7.8% in 2012, its slowest growth in 13 years, and growth in the first three months of 2013 was disappointing at 7.7%, albeit above the Government's 7.5% target for the year. India grew at around 5% in 2012, its slowest pace since 2002, and although it seems to be showing early signs of recovery in 2013, there is still uncertainty about its growth prospects. Brazil is also experiencing relatively low growth by emerging market standards (2.1% in 2012) and inflationary pressures.

Low growth in emerging markets translates into lower consumer spending, which in turn impacts corporate revenues. This is why in our survey, corporations identify slow growth in emerging markets as the biggest risk to their businesses in the next 6–12 months, and it could be the reason behind their cautious stance on M&A in the coming year. PE firms are also concerned about the impact of the slowdown on their portfolio companies.

However, PE is a long-term asset class, and investors' appetite for emerging markets seems strong. In 2012, emerging markets continued to grab an increasing share of PE activity, accounting for 20% of the total funds raised globally and 12.5% of total PE investments.

The focus of global PE investors is increasingly pan-emerging markets and moving beyond the BRIC countries. Markets such as Turkey, Southeast Asia and Sub-Saharan Africa with relatively strong demographic and economic fundamentals are being targeted by investors. According to EMPEA, emerging market PE funds outside of BRIC countries raised US$8.3 billion and saw 297 deals being completed in 2012. This was a significant increase from 2011, when US$6.1 billion was raised and 255 deals were completed, especially in light of the global economic uncertainties that persisted over this period.

PE investors remain concerned about exit options for their investments in emerging markets, especially outside of the more established BRIC markets. Recent research by Ernst & Young and AVCA* suggests that a vibrant PE exit market has developed in Africa over the last six years that has returned almost double to investors what they could have obtained from investing in public markets. Similar research in Latin America** shows that exits are successfully taking place outside Brazil. This broader pan-emerging market approach by investors is good news for emerging markets and good news for PE.

*Ernst & Young and AVCA, *Harvesting growth: how do private equity investors create value in Africa*, 2013.
**Ernst & Young and EMPEA, *Building vital partnerships: how do private equity investors create value in Latin America*, 2013.

Fund-raising

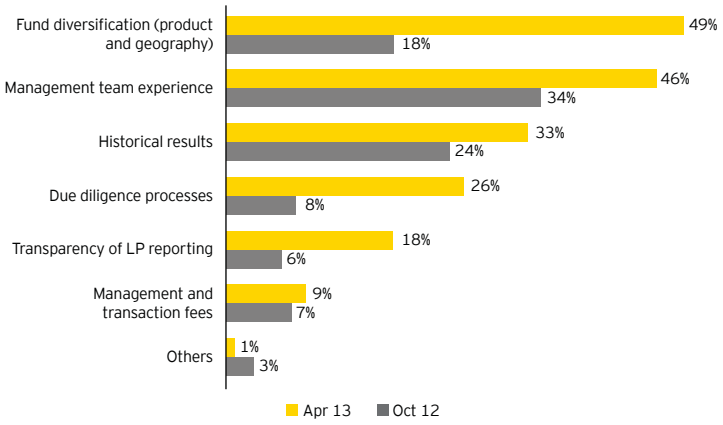
GPs remain optimistic about fund-raising

PE firms are even more optimistic about fund-raising than they were six months ago. Eighty-five percent of PE firms say that the fund-raising environment is positive or stable, compared with 75% last October. GPs' sentiment about fund-raising is likely to be linked to increasing global economic confidence.

Limited partners focusing on fund diversification

Fund diversification (by product/geography) is top of mind for LPs when selecting GP funds — 49% of respondents cited this versus 18% in October. This may be contributing to PE firms increasingly diversifying outside the traditional buyout model and into areas such as debt funds and funds-of-funds.

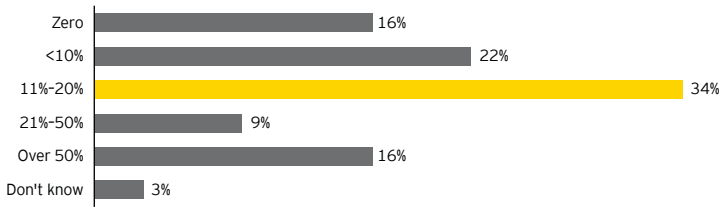
Figure 7. Over the next 12 months, what will be the most important issue for institutional investors (limited partners) when making new allocations? (Select two)



GPs plan more exposure to emerging markets

A large majority of GPs (81%) plan to allocate some of the funds they raise over the next 12 months to emerging markets, with a quarter of the respondents planning to allocate 20% or more to emerging markets.

Figure 8. What percentage of funds raised by your firm over the next 12 months will be allocated to investments in the emerging markets?



85% of PE firms believe fund-raising conditions will be positive or stable over the next 12 months.

Viewpoint

The institutionalization of PE funds

In order to grow their firms, PE firms have been adapting to the changing economic and regulatory landscape in recent years by diversifying into new investment strategies and geographies and exploring different avenues of fund-raising from institutional and global investors.

The changes PE firms have been making to their businesses often require them to have a more robust and comprehensive operational infrastructure — one that resembles institutional asset managers — for reporting, technology and treasury services and other middle- and back-office functions. As such, there has been increasing emphasis on the roles of chief financial officer (CFO) and chief operating officer (COO) to build the infrastructure to support an expanding footprint and asset classes, manage investor demands and meet regulatory compliance standards in ways that are cost-effective and scalable.

The operational transformations that PE firms are undertaking usually require recruiting appropriately skilled and experienced new staff to work with the CFO and COO — for example, for in-house portfolio management or investor relations — and making sure that they have the tools they need to assist them in their responsibilities. A cottage industry is therefore emerging in private equity technology and data services, but the solutions are often not mature or complete. Service providers and consultants are looking to plug these gaps by providing solutions that focus on process efficiency, data management and technology integration. Additionally, as PE firms build out their internal infrastructures, elements of their operating models may become candidates for outsourcing to third-party administrators.

PE executives that are either well down this road, or just now embarking on this journey, need to keep in mind an important facet: the transformation of an organization's operating model is not a one-off "project" but rather an ongoing process that will evolve over the coming years.

Further information is available from Ernst & Young's publication *Positioning for an upturn: the institutionalization of private equity operations.*

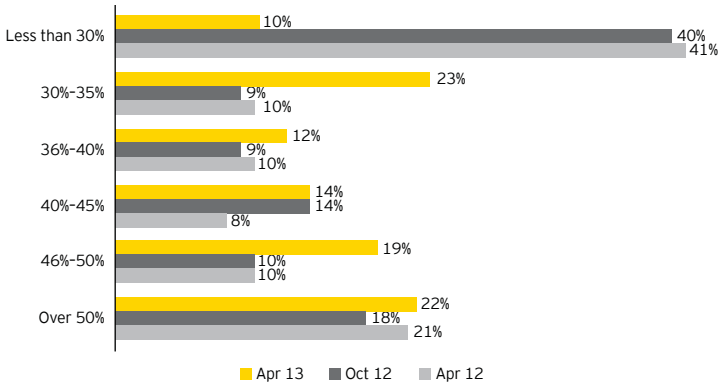
Mergers and acquisitions outlook

GPs more positive about credit availability

Nearly half of PE firms (44%) believe that there is credit available for deals, up from just 20% of PE firms in October (see Figure 2).

In spite of the availability of credit, a majority of PE firms (67%) intend to finance transactions with more than 35% of equity over the next 12 months, compared with 51% in the October results. This could indicate that although leveraged lending is improving, PE firms intend to do more deals in emerging markets where transactions are not typically financed with debt.

Figure 9. On average, what percentage of your acquisition funding in the next 12 months will be in the form of equity?



M&A activity remains relatively subdued

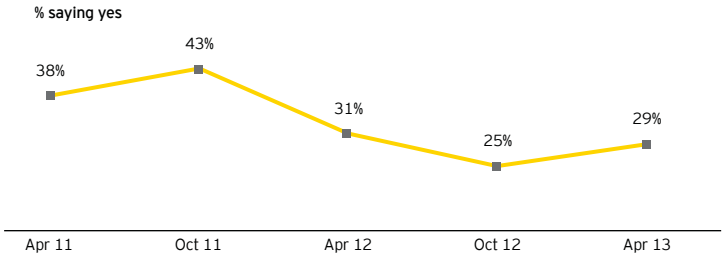
Half of the corporate respondents (49%) are also positive about the availability of credit for transactions. This view has not translated itself into significantly increased planned M&A activity by companies – 29% have acquisition plans, up from 25% in October, but this is still low compared with 43% in October 2011.

The decline in respondents planning to make acquisitions in 2012 was partly related to the impact of austerity measures in Europe and the uncertainty over elections and sequester in the US. In 2013, although respondents are more confident that the worst is over, they are all too aware that the fundamentals for growth are not consistently strong in any market. Slowing growth in emerging markets and stagnation in the Eurozone area are currently a cause for concern.

Nevertheless, the slight rise in planned acquisition activity will be good news for PE as trade buyers are a key exit route. Among companies planning to make acquisitions, 88% expect the deals to be US$500 million or less, and this should therefore benefit mid-market PE players more than large buyout players.

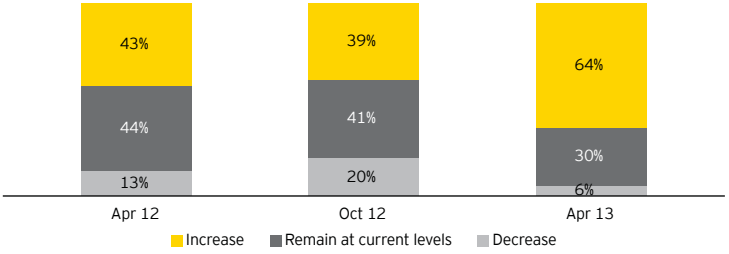
29% of corporations plan to make an acquisition over the coming year.

Figure 10. Do you expect your company to pursue acquisitions in the next 12 months? (Corporations)



M&A valuations remain high, and this could also be impacting acquisition sentiment. Two-thirds of PE firms (64%) expect M&A valuations to increase over the coming year. Fewer than half (43%) had this view a year ago.

Figure 11. What do you expect the price/valuation of M&A assets to do over the next 12 months? (PE firms)



Results from a separate Ernst & Young survey on divestments* provide some positive news for PE. Nearly one-third of respondents from that survey were planning a divestiture in the coming year; nearly half expected to divest within the next two years, which could reopen an important source of deal flow for PE.

Table 1. Top sectors planning to divest (Corporations)

1. Power and utilities
2. Diversified industrial products
3. Consumer products
4. Financial services
5. Oil and gas

*Ernst & Young global corporate divestment study, 2013.

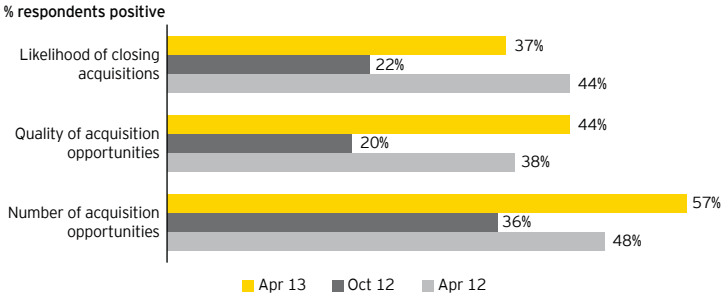
PE firms and companies see improvement in number and quality of deals

Both PE firms and companies think that the number and quality of acquisition opportunities has improved since October.

Fifty-seven percent of PE investors, and half of companies, believe that the number of deals has improved, compared with 36% and 37%, respectively, six months ago. In terms of quality of deal flow, 44% of GPs and 39% of companies say that the deals available are of a higher quality. Overall, respondents are also slightly more positive than they were six months ago about the likelihood of closing deals.

This rise in confidence in the number and quality of deals, and in the likelihood of closing acquisitions, is reflected in companies' view that there will be a slight rise in acquisition activity over the coming year.

Figure 12. PE firms indicating a positive level of confidence in the current deal environment

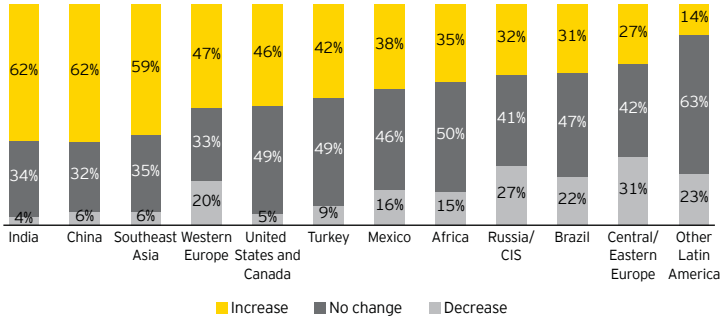


57% of PE firms are positive about the number of acquisition opportunities.

Turkey and Mexico join top five emerging market destinations for PE investment

A majority of PE firms are looking to increase their investment activity in India, China and Southeast Asia over the next 12 months. Investment activity in Africa, Brazil and Latin America (excluding Brazil) will remain, on balance, relatively stable.

Figure 13. In which of the following selected mature and emerging markets will your PE firm increase or decrease acquisition activity in the next 12 months?



Turkey and Mexico join the top five emerging market destinations for PE investment activity over the next 12 months. India, China and Southeast Asia make up the remainder.

Interestingly, three of the top five emerging market destinations are outside the BRIC countries, unlike in October 2012, when all four BRIC countries were represented in the top five. This could be further indication of GPs increasingly focusing on non-BRIC countries (see Viewpoint on page 7).

Table 2. Top five emerging market destinations for PE investment over the next 12 months

April 2013	October 2012
India	Emerging Asia
China	China
Southeast Asia	India
Turkey	Latin America (including Brazil)
Mexico	Russia/CIS

42% of PE firms plan to increase their investment in Turkey over the coming year.

Barriers remain to PE investment in emerging markets

In spite of PE firms' increasing focus on emerging markets, there remain significant challenges. GPs believe that the barriers for doing deals in emerging markets include a lack of attractive targets, local business governance practices and regulatory risk (which includes tax-related issues).

The reliability of financial information is also a challenge – albeit further down the list of current concerns for GPs – because many companies often lack sophisticated reporting systems and accounting controls.

An important barrier to investing in emerging markets, which will become increasingly significant, is a scarcity of talent to drive the businesses forward, especially at the management and senior management level.

Figure 14. What is the primary barrier to doing deals in emerging markets?

22% of PE firms see a lack of attractive targets as one of the key barriers to invest in emerging markets.

Viewpoint

Spotlight on Turkey

Turkey has risen up the list of attractive emerging market destinations for PE investment and now ranks fourth in our survey.

A number of factors are driving PE's interest Turkey. The country has relatively strong economic growth compared with Europe, growing by around 3% in 2012 and forecast to reach 3.5% in 2013. This is after notching up growth rates of 9% and 8.5% in 2010 and 2011, respectively. Growth is underpinned by strong consumer spending from the emerging middle class and a large, young and skilled population. The tax, legal and regulatory framework is PE-friendly, and Turkey has an advantageous geographic location that is well-placed to serve Europe, the Middle East and Central Asia.

Turkey's PE industry is relatively nascent in comparison with India and China. According to data from Dealogic, a total of US$2.4 billion PE deals were done in Turkey from 2010 to Q1 2013, while China and India saw more than 10 times as much investment over the same period.

PE investors face a number of challenges in Turkey. A major source of potential PE deal flow is from family-owned businesses that are reluctant to sell to PE. For those that do want to sell, there is often a valuation gap between sellers and buyers. There is also a shortage of good-quality large assets, which is resulting in fairly stiff competition for the few large transactions that do reach the market. Additionally, there are issues related to lack of transparency and recordkeeping in companies.

Recent Ernst & Young research* identified Turkey as a high-potential economy, alongside Indonesia, Vietnam, China and India, and changes are taking place at all levels that should support PE. The Government recently introduced a revised commercial code that aims to bring corporate governance and accounting rules in line with practices in the rest of Europe. Entrepreneurs and family owners are gradually coming around to the concept of PE investment. With GPs proactively engaging with local families to create deal opportunities, and with strong underlying growth fundamentals, the PE market in Turkey should be set for a period of growth.

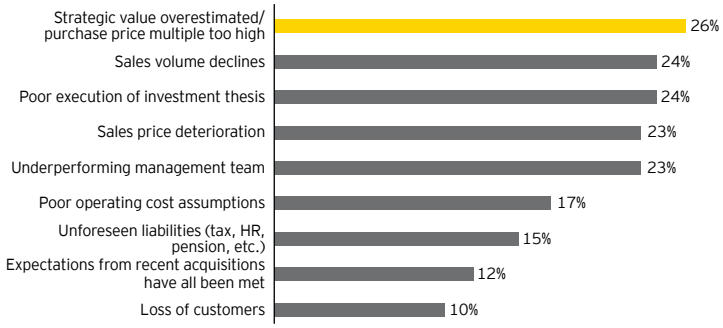
*Ernst & Young, *Rapid-growth markets forecast: Autumn 2012; High-potential economies: Indonesia, Turkey and Vietnam.*

Value creation and growth

Acquisitions continue to carry risks

Over half of PE firms (59%) plan acquisitions for their portfolio companies in the coming year. It is well-known that acquisition strategies come with inherent risks. PE firms say that some of the risks related to recent transactions include overestimating the strategic value of companies or paying too high a price multiple, and subsequent declines in sales volumes. A quarter (24%) believe that poor execution of the investment thesis was to blame for portfolio companies not meeting expectations.

Figure 15. For transactions completed recently, what was the most significant issue that contributed to portfolio companies not meeting expectations?

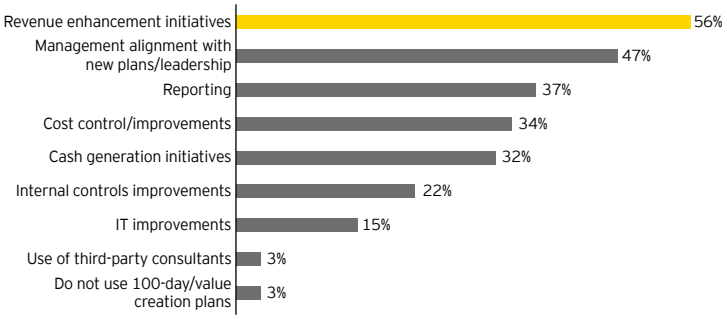


24% of PE firms believe poor execution of investment thesis was to blame for portfolio companies not meeting expectations.

100-day plans help execution of investment thesis

To avoid poor execution of the investment thesis, GPs are building 100-day plans to map out key activities for management. These plans focus on a range of value creation strategies, with a majority focused on including initiatives to enhance revenues, followed by aligning the management team with the new plans or leadership. The programs also help protect companies from sales volume declines in the post-closing phase, which is critical for the success of the investment.

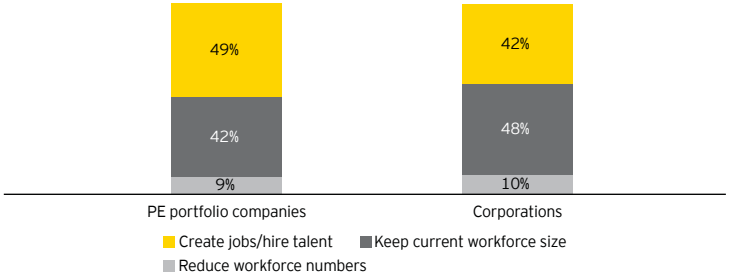
Figure 16. Which of the following items are typically the most important in your first 100-day/value creation plans for new investments? (Select three)



Portfolio company growth leads to job creation

As part of value creation strategies in portfolio companies, half of GPs (49%) expect to create jobs in their portfolio companies over the next 12 months; just 9% plan a reduction. Corporations have similar plans. Last October, 42% of PE firms intended to create jobs in their portfolio companies, while just 28% of corporations planned to do so.

Figure 17. With regards to employment, which of the following does your organization expect to do in the next 12 months? (April 2013 responses)



49% of PE firms plan to create jobs in their portfolio companies in the next 12 months.

Viewpoint

100-day plans — supporting the execution of the investment thesis

A vast majority of PE firms today consider 100-day plans for management teams as a "must-have" rather than a "nice-to-have." A 100-day plan typically focuses on maximizing value, executing on growth opportunities and optimizing control and efficiency during ownership, transforming the business in order to drive efficient growth.

A clear set of responsibilities, timings and measurements is key to a successful 100-day plan. Advisors are typically involved in the creation and execution of the plan in tandem with the PE investors and management.

The purpose of a 100-day plan is threefold:

- Developing the value creation plan during the ownership period. This is how a PE firm puts its investment thesis into action.
- Implementing initiatives that allow the company to realize its full potential. A rule of thumb is to get as much implemented in the first year and to start with "quick wins" to create a successful partnership between the management team and PE firm.
- Achieving alignment on execution of priorities.

Research by Ernst & Young* supports the view that deals with 100-day plans have better returns than those without.

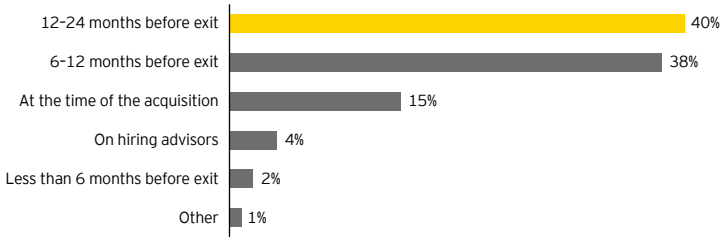
*Ernst & Young, *How do private equity investors create value? 2010 European Study.*

PE exits

Exit preparation begins at least six months before exit

GPs are spending time preparing for exit months, and even years, before exit. Overall, 78% of PE firms are spending at least six months preparing for exit, with a significant number (40%) spending up to two years.

Figure 18. When do you typically begin planning and preparing for an exit?



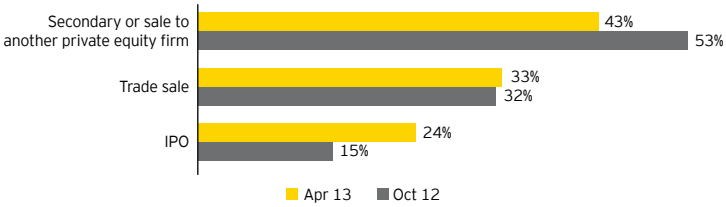
78% of PE firms are spending at least six months preparing for exit.

GPs expect more IPOs

Overall, PE firms expect an increase in exit activity over the coming year. Three-quarters (72%) expect an increase in the value of assets they are looking to exit in the next 12 months (compared with 43% in our last survey).

One-quarter (24%) of GPs expect an increase in IPOs over the coming year. Just 15% thought the same in October. The first five months of 2013 have witnessed buoyant stock markets, driven somewhat by investors seeking better returns in the face of governments' zero interest rate policies. As long as stock market valuations remain high, this should support GPs' optimism about IPOs.

Figure 19. Which exit route do you expect to see the largest increase in activity in the next 12 months?



24% of GPs expect the number of IPOs to increase over the coming year. Just 15% thought the same in October.

Viewpoint

Will 2013 turn out to be a good year for PE-backed IPOs?

Our survey suggests that PE firms are more optimistic about IPO markets than they were six months ago. There may be good reasons why. Although IPO markets were relatively quiet in 2012, and political risks persist, IPO activity has had a promising start in the first quarter of 2013. There are a number of underlying factors that should continue to drive IPO activity over the coming months:

- **Zero interest rate policies of Western governments**
  Low interest rates on traditional savings instruments are driving investors toward stock markets, real estate and riskier assets in a bid to improve their returns.
- **Buoyant stock markets driving increased investor confidence**
  Investor confidence improved in the first quarter of 2013 on the back of strong performance of major equity market indices and data, which suggested a reduction in global macroeconomic risk.
- **US IPOs to continue to lift on improving economic momentum**
  Positive employment data in the US, a recovery in US housing, as well as possible divestments in financial services, which aim to take advantage of higher stock markets, should contribute to a relatively high number of US IPOs over the coming months. PE funds are reacting to the receptive market by filing registration statements in preparation of future IPOs.
- **Asia IPO recovery expected; China regulatory developments are critical**
  Construction, finance, transport and consumer products IPOs are in the pipeline for Asia in the second quarter of 2013. And as stock markets in the region strengthen, state-owned companies may also begin to issue new offerings. In China, domestic exchanges stopped approval of IPO registrations in the second half of 2012. The resumption of approvals later in 2013 should boost IPOs in China, but there will be an adverse effect on IPO activity in Asia if the resumption of approvals is delayed.

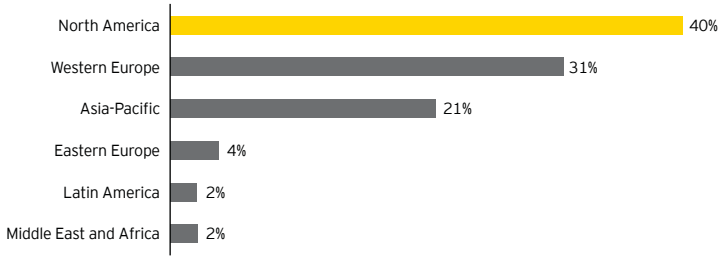
Regulatory developments in China are not the only potential obstacles to IPO markets. Turmoil over elections in Italy and the banking crisis in Cyprus reignited sovereign debt concerns in Europe, while in the US, sequestration and the looming debt ceiling continue to represent economic uncertainty.

In view of these risks, PE firms will be keeping a watchful eye on IPO markets to identify opportune timing for a listing. As long as stock markets remain buoyant, PE firms should be able to benefit from the reopening of IPO markets.

Survey demographics

Figure 20. What are your firm's global assets under management in US$?

Figure 21. PE respondents by region



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