Each New Year delivers a mixture of ongoing and new challenges and opportunities for the financial services industry. Global private equity, along with every other asset class, has seen its fair share of changes brought about by the financial crisis and subsequent shifts in regulatory measures and investor sentiment. This year is no different; as 2013 starts, Altius Associates professionals offer up their view on the top investment, regulatory and client service challenges facing the private equity industry.

1. US Buyouts

One of the top challenges facing the US buyout market is the rise in purchase price multiples being paid for high quality companies. Over the last year this hovered at around 9x ebitda and sometimes more, primarily due to the increased number of private equity firms competing for high quality deals, the efficiency of a more intermediated market, and the improvement in accessing debt for leveraged buyouts. Improvements in bank financing and capital markets in 2012 have allowed debt multiples to increase from an average of 3.0x in 2009 to 5.0x in 2012. There still remains the opportunity for managers to pay reasonable multiples, which depending on the company size, range between 7.0 and 8.0x ebitda, especially at the less intermediated smaller end of the market. Private equity groups with a certain “edge”, such as experience with a similar company, a well-developed relationship with management, or an expertise in a particular sector, may also be able to “win” deals on factors other than paying the highest purchase price; however, the overall trend towards higher purchase multiples is clear.

The result is that private equity firms can no longer rely on multiple arbitrage to drive returns. Fund managers must be sure their investment thesis is solid; there is less room for mistakes when higher prices are paid. Higher purchase multiples can be justified by finding high-growth companies that can grow even faster with the help of a private equity sponsor. A good fund manager must be able to make meaningful improvements to portfolio companies and use leverage effectively to balance risk and return. Private equity firms that have a superior ability to source companies with a good investment thesis and the resources and expertise to grow those companies will be able to outperform in this environment. The challenge for limited partners will be identifying those private equity firms that are best poised to outperform in a more expensive and more competitive environment.

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2. European Buyouts

One of the main challenges for European Buyout Managers is finding a profitable way to exit the boom year deals. With the IPO markets closed and a number of very large companies (think Intelsat, Formula One, Kion, Acromas, Abertis, GHG, Evonik, ISS) under private equity ownership, just how are the sponsors who own these businesses going to realise them and return cash to investors? In many cases the clock has reached the five year mark and is very definitely ticking.

There are difficulties surrounding all three of the established exit routes: the public markets, the trade sale and the secondary sale. The IPO market is largely closed, financing is almost certainly not available to allow financial sponsors to be realistic buyers in a secondary transaction (given the macro uncertainties in Europe, leverage for buyout deals has been harder to secure compared to the US), and a full trade sale of one
10 CHALLENGES FACING THE PRIVATE EQUITY INDUSTRY IN 2013

of these large businesses is theoretically possible but problematic, given the current economic environment in Europe and a desire for the vendor to receive cash rather than paper.

GPs have therefore been forced to become increasingly innovative in seeking liquidity and, thankfully for the asset class, have been successful in this regard in a number of cases. They have looked for ready sources of capital and found them amongst sovereign wealth funds, public market fund managers willing to bridge the pre-IPO gap, and corporates, often (but by no means exclusively) of Asian origin. KKR has been notably successful in persuading corporates to take stakes in two of its businesses: China’s Shandong Industries acquired a 25% stake in German forklift manufacturer Kion, and Walgreens has agreed to buy Alliance Boots, a 2007 FTSE 100 take private that really called the peak of the market, in a two-stage transaction. Other potential buyers include sovereign wealth funds and those institutions, in particular a number of the Canadian institutions, with the appetite and capability to make direct investments. CVC’s partial sale of a stake in Formula One to three asset management firms, one of which is effectively a sovereign fund, shows an encouraging interest from what are effectively public market investors in private equity owned assets. The Singapore IPO is pencilled in for 2013 and should herald the final liquidity event for one of Europe’s most successful private equity investments.

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There remain assets that, for a variety of reasons, have either not found the right buyer or are not yet ready to be moved on, perhaps needing time for further deleveraging. There is also talk that some need to be reduced in size to be made more palatable, and speculation continues that Acromas may be broken back up into its two constituent parts: Saga and The AA. Overall, however, it appears that high quality and strategic businesses are saleable, even in an environment where the public markets are effectively closed. We applaud GPs for their ingenuity in tapping these alternative buyers and believe that, just as the secondary market has improved the exit options for the lower mid-market, so this development will open up a broader range of strategic options at the larger end of the buyout market for the years to come.

3. Asia Private Equity

As financial markets in China are slowly liberalizing, China has emerged as the largest private equity market in Asia during the last couple of years. Whereas, for a long time, foreign investors have only had access to the Chinese market by off-shore constructions, private equity investment by local investors became possible in 2005 when new legislation was implemented to facilitate this. The RMB market includes industries and industry sectors not accessible for foreign investors and offshore funds. Conversely for local investors, it is difficult to make commitments to offshore funds. Private equity has, therefore, become increasingly popular with local fund raisers as well as with local investors, mostly large and cash-rich sovereign funds. Initially, RMB fund managers were generalists; however, in a later stage, provinces, municipalities and other local authorities have discovered the private equity phenomenon as a way to attract capital and have funds raised to make investments in their own regions.

During the last few years, some foreign private equity groups, such as Blackstone have received a license to raise RMB funds and have done so successfully. Simultaneously, a number of local Chinese private equity managers, such as New Horizon, Orchid and CDH, have raised RMB funds. There are a number of reasons to enter the RMB market. Foremost, it is much easier to receive an investment permit for an onshore investment, thus creating an advantage when a RMB Fund is competing against an off-shore fund for a specific deal.

The rise of the RMB funds has been so steep that since 2009, RMB fundraising has surpassed fundraising
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by offshore funds. The challenge will be managing the potential market disturbance created by the combination of three factors: (i) not all RMB private equity firms have experienced and professional teams, (ii) the risk that funds are raised by government bodies for political motives and (iii) the large scale in which RMB fund raising has occurred.

USD versus RMB Fundraising in China by Vintage Year USD in Billions

Source: Asia Private Equity Review

The chart above compares the amount raised in China for RMB and USD denominated funds for the past five years.

4. Emerging Markets

In the private equity universe, emerging markets are generally grouped into one of two markets, frontier markets (e.g. Nigeria), or emerging markets (e.g. Poland). Regionally, these markets have different groupings:

- Asia, (which is typically partitioned into North, South, and Southeast Asia);
- Latin America, (which is generally treated as one entity, typically disregarding most frontier countries in Central America);
- Africa, (which is divided into Sub-Saharan Africa and North Africa);
- MENA (a region which may also include North Africa as well as the Middle East);
- Eastern Europe, containing countries in varying stages of development from Poland to Romania.

Each region has unique, softer distinguishing attributes such as culture, regional language barriers, and sophistication of trade, but the overarching demographics are more or less similar. Nearly all emerging markets have a need for healthcare, infrastructure, education, and basic technology that facilitates business. The more attractive regions, such as Southeast Asia, politically stable countries in Latin America such as Peru and Colombia, and emerging African countries like Kenya and Nigeria have increasingly younger populations with increasing levels of disposable income, helping drive consumerism. Foreign direct investments in emerging markets tend to flow quickly in and out of the regions and it is important for all investors, including private equity investors, to avoid the “herd mentality” flow of capital.

The one challenge that affects all of these regions despite the differences in demographics, proximity to developed markets, and abundance of natural resources, is fundraising.

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Turkey, and Southeast Asia (mainly Indonesia). In these regions large funds were raised by global investment firms as well as several regional asset managers, and now they are having difficulty deploying this capital. The funds that raised over USD1.0 billion in Latin America have either been solely dedicated to Brazil, or virtually dedicated to Brazil, since few other Latin American countries offer large market investment opportunities. Investors are now turning to countries such as Peru and Colombia, which have been private equity capital starved until the past 12 months, and it appears several funds will be raised at record sizes in those markets in 2013. Turkey and Indonesia have raised record amounts of capital in the past two years (Turkey raised USD2209 million, Indonesia raised USD1577 million), but most of these funds are very young. On the contrary, countries such as Mexico and virtually all large countries in Africa, excluding South Africa, have had extreme difficulty raising capital.

Private equity funding creates a virtuous cycle up to a certain level. Capable fund managers develop management teams, educate business owners about the private equity model, and attract additional foreign direct investment. The presence of a thriving private equity industry also opens up other exit options to private equity funds. Two prior regions of vogue were the MENA region and Central and Eastern Europe. Large pan-regional funds were raised in these regions during the 2006-2008 period and few of these funds have been successful. Coming out of the Great Recession, it is clear that Central and Eastern Europe is starkly divided between emerging countries like Poland and the Czech Republic, and more corrupt, less business friendly frontier countries like Romania or Bulgaria. The MENA region fared well through the Recession, but the Arab Spring has created far more political uncertainty across the region and particularly in large growing economies like Egypt, which were previously driving prosperity in the region. It is likely that these two regions will have difficulty raising international private equity capital in the next fund cycle.

The challenge for the secondary market will be to find attractive opportunities in an increasingly transparent and crowded market. There was considerable fundraising activity in the secondary market in 2012. In the first nine months of the year, an aggregate of USD15.7 billion was raised, which is on track to challenge the record fundraising amount achieved in 2009. During the year, AXA Private Equity raised the largest secondary fund in history, at USD7.1
billion, and currently, according to Prequin, there are 32 funds that are attempting to raise an aggregate of USD27 billion. From Altius’ perspective, large amounts of capital inflows into a segment can create supply/demand imbalances and potentially lower returns.

Thus far, the high level of fundraising has been supported by an equally high level of secondary transaction value. At present, there is a good supply of deals, as European financial institutions have started and are still looking at, shedding private assets from their balance sheets due to regulatory concerns. Public pension plans are utilising the secondary market to actively manage their private equity portfolios and exposure. While the supply has been good, these sellers are more strategic sellers (not necessarily “distressed” sellers), and as a result, pricing has remained firm.

As the secondary market continues to mature and become more efficient, secondary funds/buyers are going to have to find areas of inefficiency where there is less competition in an effort to generate strong returns consistent with past returns in the secondary market. Lastly, the secondary market has historically been quite cyclical, so while supply remains buoyant, a downturn may prove challenging to secondary funds with large amounts of capital to deploy.

6. Infrastructure

There are a number of challenges facing investors today within the infrastructure market. Rising asset prices is one issue, especially for core brownfield assets. This sector of the market is seen as a “safe haven,” and the promised yield is viewed as an attractive replacement for low-yielding fixed income securities. Therefore, capital is rushing into the space, bidding up asset prices and likely reducing future returns.

Regulatory risk is also alive and well. A recent example is Norway’s proposal to cut tariffs for future Gassled gas transportation contracts by 90%. Gassled seemed like

Dry Powder in the Secondaries Market

Source: Prequin
Furthermore, the market dislocation created by the increasing regulatory pressure on banks has resulted in greater opportunities for non-traditional debt providers, as well as opportunities around distressed credit sales. Indeed, the conditions attached to bank rescue packages by the European Competition Entity and the new regulations being implemented (essentially Basel III and Dodd Frank) are forcing banks to exit or decrease their level of activity in private equity and leveraged lending. Finally, given the very uncertain and challenging macro environment, the premium for investing in private credit strategies above public credit strategies is one of the highest in history, according to fund managers active in this space. On a segment level, Altius is seeing the best opportunities in the small and lower-mid market where the issue of refinancing will be the most acute as the charts show. (See page 7)

The market has been quick to spot the opportunity set, and a plethora of funds focusing on distressed or primary issuance of debt for the private equity industry has emerged. The challenge for investors is the selection of the right managers to implement the strategy which will provide the type of risk-return profile they are looking for. Many of these funds are first time funds set up by ex-investment bankers or hedge fund managers diversifying into private equity type investing, or even mezzanine focused funds that are seeing the opportunity to climb the capital structure where risk-return profiles are more attractive than in the traditional mezzanine space. Many of these funds will not be able to raise the capital they are looking for and therefore will not be viable firms. When looking into the specific segment of the market, investors should keep in mind the major risks related to first time funds and adequate experience.

7. Private Credit

Private credit strategies have attracted the attention of LPs and broader investor communities lately. The main reason is performance: investors are looking at ways to enhance their returns on traditional credit and fixed income portfolios, which have displayed very meager performance over the last couple of years, due to the very low interest rate environment in most of the Western World.
Although the US and Europe are the most newsworthy in terms of proposed changes to compliance and regulations, because of their size and global reach, many other governments are in the process of reviewing and revising their regulatory structures.

Most significant perhaps is the fact that in July 2013, the Alternative Investment Fund Managers Directive (“AIFMD”), the main new piece of regulation affecting the European private equity industry, will become effective even though the European Commission only recently published its draft implementation measures. All 27 member states of the EU are in the process of drawing up legislation to bring AIFMD into force at a national level, but in the absence of final regulations, the member states themselves are still trying to work out what much of it means in practice.

In the UK, the timing awkwardly overlaps the transformation of the UK Financial Services Authority into two new authorities on 1st April 2013. The Directive offers little flexibility for member states but some are proposing to introduce additional measures to those required by the EU. For example, Germany removed the rule that exempted smaller managers, a move which could harm its venture capital market. For non EU organisations, the Directive will still have
implications due to the restrictions on being able to market products in the EU.

As well as AIFMD, EU institutions and regulators are dealing with:

- Solvency II, a fundamental review of the capital adequacy regime for the European insurance industry – it aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements (2014 implementation);

- Basel III, a long term package of changes to the original Basel Accord which helped the strength, soundness and stability of the international banking system, due to commence on 1 January 2013;

- MiFID II, the expected update of the Markets in Financial Instruments Directive ("MiFID") for implementation in 2015; and

- The consultation on the EU Pensions Fund Directive ("IORPII") which could have far reaching consequences for both the funding of pension schemes and the way in which they are managed.

Outside of Europe, in July 2010, the US passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, being the most significant changes to financial regulation in a generation. It made changes in the American financial regulatory environment that affect all federal financial regulatory agencies and almost every part of the US financial services industry, including, of course those non US entities that wish to do business in the US or invest into the US. Many new oversight agencies were created and the SEC’s regulatory regime was expanded to include many firms that had hitherto not been required to be regulated. This latter change brought the US into line with regimes, such as the UK, in the regulation of private equity and hedge funds. Also in 2010, the US Government enacted the Foreign Account Tax Compliance Act ("FATCA") as part of the Hiring Incentives to Restore Employment ("HIRE") Act. It is designed to combat tax evasion by US persons holdings investments in offshore accounts but has wide ranging implications as, amongst other things, FATCA requires foreign financial institutions ("FFI’s") to report directly to the IRS certain information about financial accounts held by US taxpayers. To properly comply with these new reporting requirements, an FFI will generally have to enter into a special agreement with the IRS by June 30th 2013. At the current time a number of governments have announced, or are working on, bilateral agreements with the IRS on the implementation of FATCA. An FFI that satisfies the conditions imposed under the applicable bilateral agreement and any applicable local legislation generally will not be subject to the regular FATCA reporting obligations and will not need to enter into a special agreement with the IRS. It is reported by the IRS that they are in discussions with up to 50 countries and jurisdictions concerning these bilateral agreements, and the IRS has recently issued models of draft bi-lateral agreements for use in these negotiations.

Although the US and Europe are the most newsworthy in terms of proposed changes to compliance and regulations, because of their size and global reach, many other governments are in the process of reviewing and revising their regulatory structures, many with implementation dates also in 2013. It is going to be a busy and lucrative year for lawyers, accountants and compliance professionals, and a challenging year for GPs and LPs to implement all these regulatory changes.

9. Client Services/Reporting: Increasing need for transparency across GPs and Private Equity Advisors

Standardised capital call and distribution templates, which were released by Institutional Limited Partners Association (ILPA) in January 2011, are taking root in the industry, and several leading GPs have begun to adopt them. The level of uptake has been promising so far and has been led by several institutional LPs, most notably CalPERS, who earlier in the year endorsed the templates and will require their adoption by any private equity firms that they commit a sizeable portion of capital to. There has been a complementary movement on a standardisation in fund reporting, with
an increasing number of GPs either adopting industry body templates, or moving towards more investor-friendly forms of reporting with regards to their fund structures and holdings.

“THIS STANDARDISATION AND TRANSPARENCY IN THE INDUSTRY HAS BEEN INCREASING SINCE THE GLOBAL FINANCIAL CRISIS, AND ALTUIS EXPECTS THE TREND TO CONTINUE.”

This standardisation and transparency in the industry has been increasing in momentum since the global financial crisis, and Altius expects the trend to continue as LPs are now more conscious of the risk and compliance considerations in their portfolios. EisnerAmper, the accounting and advisory services firm, issued a report earlier in the year stating that 92% of GP survey respondents acknowledged that transparency ranks among LPs’ leading concerns. This increasing demand for transparency affects not only the direct GPs, but also advisory firms and intermediaries. Altius is seeing more interest from clients on issues ranging from increased compliance at the investment due diligence stage, to management fees and carried interest charges, to performance attributes, to risks inherent within underlying portfolio company holdings as well as ESG. The challenge in meeting these requirements, for both GPs and advisors, lies in staying abreast of these developments, effective resource management and investment into any available technologies that will aid these processes.

There is a clear grudging acceptance that the World is slowly but surely becoming a different place for the GP, with more focus on areas other than just returns, and to survive there is a need to adapt.

10. Investor Relations

As last year unfolded it became increasingly clear that a major shift in GP-LP relations in the private equity world was being confirmed. Stung by the abrupt valuation shifts and mark-to-market losses through the financial crisis, LPs began demanding more information, with greater transparency and on a more regular basis, as the price for continuing to support their General Partners. Most major GPs are now meeting with significant LPs on a quarterly basis, with full portfolio reviews, including all major changes, cashflow statements, and details of drawdowns, distributions and any valuation changes.

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As a result of this pressure, most PE firms have had to increase their establishment in IR teams significantly; many have doubled their staffing in the last five years, and this trend is set to continue given the rapid change in compliance and regulatory standards around the Globe. As mentioned above, organisations such as the ILPA, which monitors and comments on these matters on behalf of global LPs, have gained members, staff, traction and credence throughout this period. Most GPs of any standing have had to comply with the standards for reporting and Advisory Board activity as a result. The challenge for all GPs, not merely the largest or most profitable, will be to meet the continuing demand from their investors in this regard. As mentioned above, transparency in reporting has also increased due to similar pressures. This change is not likely to go away once the financial climate improves, and the cost of keeping LPs satisfied in this way must be factored in henceforth.