The Triago Quarterly

March 2013

Dear Reader,

The first large-scale restructuring of the private equity space has begun.

While fundraising is on the rise, capital is going to fewer general partners. One reason for this: limited partners face growing difficulties keeping tabs on a private equity world fragmenting by geography, specialization and vehicle structure.

General partners and limited partners are in danger of getting lost in a growing and changing private equity space. LPs need insights into market conditions, non-traditional opportunities, co-investments and more, while GPs must often fine-tune strategy, hone messages and devote greater resources to building LP relationships. Through fund placement, secondary and strategic advisory, Triago helps LPs and GPs imaginatively. This quarterly is a natural extension of that effort.

As always we hope the information found here will help you make informed decisions.

Sincerely,

Antoine Dréan
Triago Founder and Chairman
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INSIDE

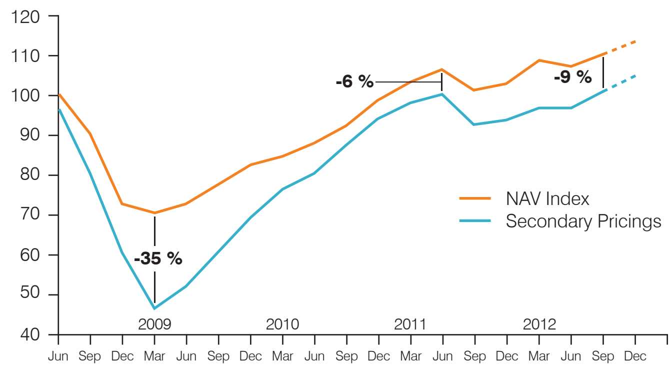
SNAPSHOT

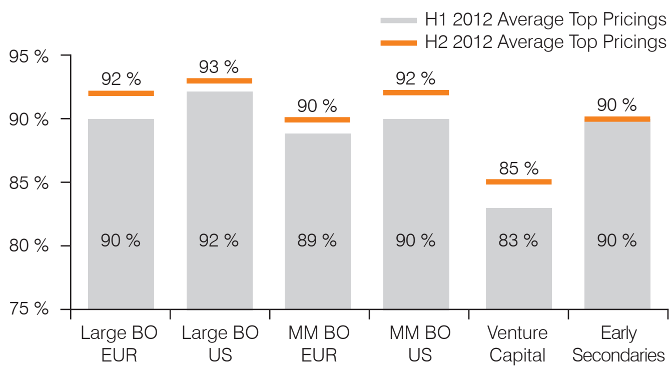
RISING FUND VALUES…

Private Equity Fund Net Asset Evolution

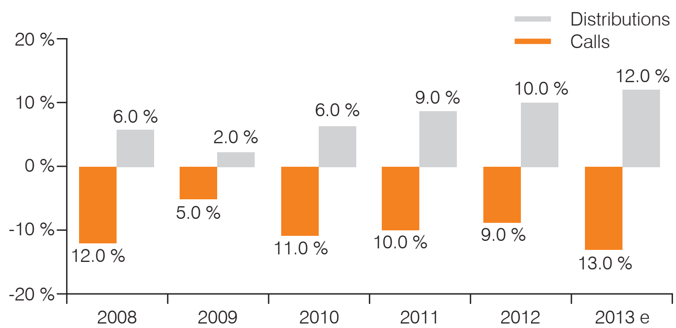
STRATEGY	FY 10	FY 11	Q1 12	Q2 12	Q3 12
Large BO	+27.0 %	+2.5%	+8.9%	-1,4%	+4,4%
MMBO	+21.5 %	+4.4%	+5.5%	-1,8%	+3,5%
VC	+10.2 %	+8.1%	+3.8%	+1,0%	+0,5%
Special Sit.	+20.6 %	+0.5%	+6.5%	+0,5%	+1,1%
Energy	+15.9 %	-4.3%	+3.0%	-2,4%	-0,5%
Average	+20.2 %	+4.1%	+6.3%	-1,2%	+2,3%

…SEEN NARROWING DISCOUNTS…





…AS CASH FLOWS STRENGTHEN.



Source: Triago's proprietary data

Market Snapshot Analysis: Relative Plenty

Rising volumes are seen for fundraising and secondaries, aided by expiring dry powder and increasing allocations to private equity.

Triago estimates net asset values across all categories of private equity funds rose 3 percent on average in the three months through December 2012, handily beating negative performance for listed comparables of portfolio companies in the U.S., where the majority of the industry's capital is invested. Triago expects PE funds to post an 8.5 percent average gain for 2012, versus modestly higher appreciation for publicly traded companies in the U.S. and Europe.

Fourth quarter performance, set against a 1 percent drop for the S&P 500 stock index, was the result of record exits from U.S. portfolios and rising exits elsewhere. Fourth quarter American exits amounted to $57 billion, 43 percent of the annual U.S. total. Globally, fourth quarter exits generated cash in excess of carrying value and off-set write-downs tied to the falling value of listed comparables. High exit levels in the US and Europe year-to-date should lead to further net asset value write-ups for the first quarter, given general partners' relatively conservative carrying values for portfolio companies.

Portfolios are clogged with a record 8,000 companies, worth an unprecedented $2 trillion, and held for an industry high of more than 5 years on average, so a significant boost in exits is hardly a surprise. The exit market is mirrored by the rising value of PE acquisitions, which ratcheted close to post-financial crisis highs in the fourth quarter.

Fueled by intense competition, the purchase price multiple for PE-backed transactions rose to a hefty 9.1 times EBITDA in 2012's second half, after hovering near the ten-year average of 8.4 times EBITDA in the first half, according to S&P Capital IQ data. Average purchase prices should remain high as GPs work to invest what Triago estimates is $145 billion in unused leveraged buyout commitments set to expire this year. A record 10 percent - twice the historic annual rate - of that unprecedented twelve-month bulge is likely to reach term without being invested, if purchases continue at their current pace. Triago believes expired dry powder will contribute significantly to improved fundraising in 2013, in light of tightly balanced limited partner cash flows.

Given record-low borrowing costs, exit pressure, and a projected annual record in dividend recapitalizations of $80 billion, 2013 distributions to LPs from private equity investments should rise to some 12 percent of committed capital from 10 percent last year. Yet calls on LPs to finance new private equity purchases should increase more, driven by easy credit and the certainty of lost fees for GPs if dry powder expires. At 13 percent of committed capital, Triago believes calls will edge out distributions, with free capital in short supply for many investors. Altering this balance are bigger 2013 average allocations to private equity from large U.S. pension funds, pegged by Bain & Company at 9.7 percent of assets under management this year versus 8.3 percent in 2012, and Triago's estimate of $14.5 billion in expiring un-invested commitments. Aided by this extra liquidity, fundraising could increase nearly a fifth to $318 billion in 2013 from 2012's $270 billion. With a record 2,000 PE funds currently looking to raise a total of $810 billion, many will miss targets or fail.

A record percentage of 2013's $145 billion dry powder bulge will revert to investors.

Rising active portfolio management, offsetting a sharp drop in big portfolio sales by banks, sent 2012 private equity fund secondary volume to a third-consecutive annual record of $26 billion - $1 billion more than in 2011. Exceptionally attractive pricing, driven by an unprecedented $62 billion in dry powder held by specialists and the secondary pockets of funds-of-funds, could yield 2013 volume of $30 billion.

A large number of liquidity events, such as portfolio company sales, are helping secondary pricing close in on net asset values, with many funds trading at par or small premiums to NAV. Overall, the average top bid in the secondary market narrowed in recent months to a less than 9 percent discount to September NAV, from 10 percent against June's lower NAV. Given appreciation of publicly quoted comparables year-to-date, and rising exits, the discount to lagging NAV should close further.

Roundtable
Brave New World

Secondary PE fund investing today isn't about big discounts, it's about making sellers happy.

The buying and selling of existing private equity funds has come a long way in ten years. Transactions on the secondary market were worth a record $26 billion in 2012, up nearly nine-fold from just $3 billion in 2002. Yet misconceptions about secondaries abound, as Triago's conversation with three experienced practitioners makes clear. Far from the occasional marketplace of a decade ago, when deals were often discounted fire sales, today's vibrant volume "is entirely a function of attractive pricing for sellers," Vincent Gombault, managing director at Axa Private Equity, tells Triago. Our roundtable participants also note that secondary investing should be lower risk than investing in primary fundraisings, a dynamic that raises interesting questions about relative returns, and just how much should be invested in secondary versus primary.

TRIAGO: Can investors get better returns by putting all their money in secondaries, rather than by investing in primary private equity opportunities?

Jonathan Costello, Executive Director at Morgan Stanley Alternative Investment Partners: Putting all your investment in secondaries could produce very attractive returns. We've compared average returns from secondary funds with average returns from primary private equity and venture capital portfolios for each vintage year from 1993 to 2008. For thirteen out of the sixteen vintages, including the '04 to '07 period of peak secondary pricing, the average secondary fund outperformed the average PE and VC fund by a range of 8-10 percentage points over fund life. We also found that secondary funds were less likely to lose money. If you look at all of private equity, about 28 percent of funds fail to return at least your investment, versus just 5 percent of secondary funds. Still, the majority of a typical PE portfolio should be in primaries. Many desired general partners' funds are not available for purchase in the secondary market.

Philipp Schnyder, Co-Head of Private Equity Secondaries at Partners Group: It's worth pointing out that private equity moves in cycles. This is a big reason why mixed portfolios make sense. We would be heavily weighted towards secondaries at the bottom of the cycle, when private equity net asset values are falling and there's dislocation and deep discounting in the secondary market. At the top of the cycle, it's logical to be heavily weighted towards primaries; net asset values are rising sharply, and mediocre or troubled managers dominate secondary supply. In the middle, which is where we are today, you should find many appealing opportunities in both markets.

Vincent Gombault, Managing Director of Funds-of-Funds and Private Debt at Axa Private Equity: In one way or another, we are all saying the same thing - manager quality should be the investor's first concern. Considering supply constraints in the secondary market, a realistic mix of exposure to primary and secondary opportunities for most investors is going to be 70-80 percent primary and 30-20 percent secondary.

TRIAGO: Given the likelihood that mature secondary interests will have a lower risk profile than primary opportunities - usually blind pools - should investors be aiming for lower returns on secondaries than on primaries?

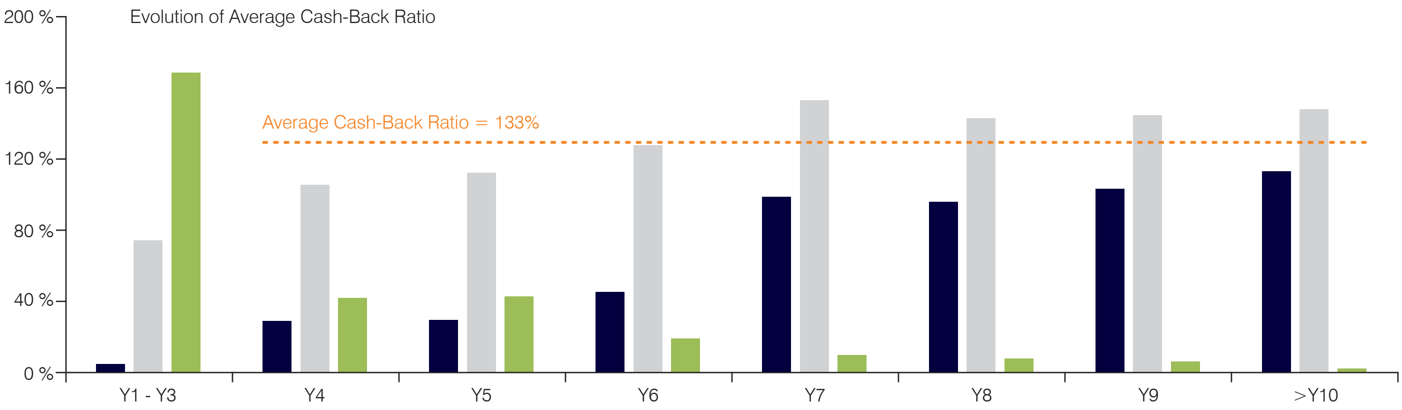
JC: We believe private equity should deliver a net return that's 600 basis points over what public markets generate annually to compensate for risk and illiquidity. Because secondaries contain assets that you can evaluate, and have a shorter average waiting period for return of capital to investors, they may be more likely to outperform that premium than primary fund opportunities. Net secondary multiples generally cluster in the 1.4 to 1.7 times invested capital range, with annual returns typically in the mid-to high-teens, rising to 20 percent-plus for opportunistic investors. One thing investors generally forego with secondaries is the exceptional 2 times-or-higher multiples on invested capital achieved with the best primary investments.

VG: Historically, the range of average annual returns on secondaries was 15-25 percent, but I don't think that can be expected going forward, considering low interest rates, modest return targets for riskier assets, and the growing number of buyers in this market. An average annual return of slightly more than 10 percent on secondaries is realistic in

“Many secondary transactions result in capital gains.”

Jonathan Costello, Morgan Stanley Alternative Investment Partners

AVERAGE RETURN ON SECONDARY SALES 2007-2012: 133 PERCENT OF PAID-IN CAPITAL



Notes: Cash-Back Ratio equals distributions, plus net proceeds from secondary transactions, divided by seller’s fund contributions prior to sale date. The average Cash-Back Ratio covers private equity funds transferred by Triago during 2007-2012 and does not include early secondaries. The horizontal axis represents the time from fund inception to secondary sale. Source: Triago

this new world. If this average return is slightly exceeded by the primary investment average - as might happen - investors should still be very happy, given the lower risk of secondaries. There is one caveat here - very experienced secondary specialists should achieve annual returns in the mid-teens. That should still beat primary averages.

PS: I think both of you are more or less right about expected returns. The average returns Jon mentions are within the reach of investors today. But I wouldn’t be surprised if, over the next decade, rising amounts of capital compress average returns to the levels Vincent cites.

TRIAGO: Using that 70/30 benchmark mentioned earlier, are there circumstances where investors should overweight or underweight secondaries?

PS: I’d say that weighting to secondaries can change quite a bit over time, depending on portfolio need and opportunity. Weighting should be influenced by the cycle of private equity that I noted. Beyond this, if suitable assets are for sale, limited partners may favor secondary investments over primary ones for access to a particular geography, sector or manager. The maturity profile of a private equity portfolio should also influence weighting. If you need cash distributions, you should increase the secondary allocation.

VG: To reduce the j-curve, the result of all the fees you’ve got to pay to a fund before it realizes investments and distributes capital, limited partners launching new investment programs should focus entirely on secondaries. If secondary opportunities are attractive and deep, an established private equity LP will want to overweight secondaries, as Philipp says. But given the short duration of secondary investments and the market’s generally shallow capacity, even the most aggressively opportunistic investors will, over the long-term, approach that 70/30 primary-secondary benchmark.

JC: I’ll just add that limited partners’ direct investment in secondaries is constrained by team resources, and the effort it can take to find attractive investments on the secondary market. For example, you can put together a promising, comprehensive Asian fund portfolio a lot more easily through primary investing, rather than by combing through a particularly thin and opaque Asian secondary market.

TRIAGO: Should investors be investing in secondaries mainly through funds?

PS: As Jon implies, this is largely a resource issue. There are not many groups equipped to buy secondaries deeply and regularly across segments and geographies. Most limited partners should rely primarily on specialist players for secondary exposure, making direct investments opportunistically, in sectors where they have expertise, or in funds managed by general partners they know through primary relationships.

VG: I agree. To invest optimally in secondaries, you need a dedicated team of 20-30 people. For a given portfolio, if you don’t know the component funds through your primary relationships, you will need technology that costs millions of dollars to analyze and price the assets. Sourcing and buying secondaries on a regular basis isn’t really that complicated, it’s just expensive.

JC: Another issue to consider here is that, once you’ve found an attractive investment, decision making is much shorter in the secondary market than in the primary market. Limited partners often mull over a primary opportunity for many months and through multiple closes before fundraising ends definitively. Resource challenges, and time-line differences between the primary and secondary market mean that even very large LPs may invest primarily through secondary specialist funds.

> *"We don't price funds as a function of a general partner's net asset value. To me, declared net asset value means nothing."*
>
> **Vincent Gombault, Axa Private Equity**

TRIAGO: Secondary pricing is dominated by discounts to net asset value. Can it ever be appealing to accept a discount?

JS: Accepting a discount is an opportunity cost decision. For example, if a fund, or a portfolio of funds, is relatively mature, or poses concentration or exposure issues, and you've got attractive redeployment opportunities, then accepting a discount makes sense. There is also a view among potential sellers that accepting a discount means losing money. Many secondary transactions result in capital gains, since many good funds are sold when the portfolio is held above cost. Discounts monetize assets and allow LPs to seize opportunities that they would not otherwise be able to invest in.

PS: If an investor has a negative view on a fund manager, or on fund holdings, accepting a discount can be an unmitigated positive. If concerns about poor returns pan out, taking a discount, even an extremely large one, can save you from loss.

VG: Regardless of whether a fund is sold at a discount, at par, or even at a premium to declared net asset value, there must be a split of current value and future return potential that is viewed as fair by both buyer and seller. A real division of benefit is key to closing secondary transactions, since private equity is one of the only asset classes where returns are not predicated on trading strategies and where portfolios are structured to be held to maturity.

TRIAGO: So, are premiums to net asset value justified sometimes?

VG: At Axa, we don't price funds as a function of a general partner's net asset value. To me, declared net asset value means nothing. What counts is asset quality. Asset quality is determined by our assessment of potential. Relative quality is enhanced by transparency regarding the nature of assets, and by clarity when it comes to the timing of liquidity events like portfolio company sales. The more information we have, the more aggressively we can price. What we pay may work out to be a premium to declared net asset value, almost as easily as it may wind up being at a discount to NAV.

PS: I agree entirely with Vincent. A study we did shows that when mature private equity portfolios are purchased on the secondary market, performance has almost nothing to do with the discount or premium paid relative to declared net asset value, though performance does correlate strongly with buyer ability to conduct analysis and forecast the value creation potential of all investments. A couple of years ago, in one of our most lucrative transactions ever, we actually paid a premium of 40 percent over declared net asset value.

JC: High quality assets and certainty of exits are attributes that would lead us to pay a minimal discount for a portfolio. We are still big believers in the practice of closing deals at discount. In the cases where we've seen premiums paid, it's almost always when there's a lot of activity in the portfolio after net asset value has been recorded.

TRIAGO: Since portfolios are structured to be held to maturity, is volume more dependent on attractive pricing for sellers in the private equity secondary market, than in, say, the stock market?

VG: Private equity secondary volume is entirely a function of attractive pricing for sellers. Consider the deep 60 percent-plus discounts to declared net asset value that constituted the average buyer's bid in 2009. With average pricing that low, there was virtually no volume in the secondary market. Notably, we were the first group to actually close a large secondary deal around this period, and the only way we could do that was by offering pricing that was attractive for the seller. That turned out to be a single-digit discount to declared net asset value. Other potential buyers thought we were crazy. But the price we paid relative to today's declared net asset value equals a discount of more than 30 percent, given the big gains we've had.

PS: Clearly, pricing that is close to declared net asset value fuels broad transaction volume and big deals in this market. But as I've implied, experienced specialists with resources are able to find willing sellers at deep discounts, even in periods of thin volume. When pricing makes transactions difficult, solutions allowing sellers to participate in the upside definitely help, though they are often complex and time consuming to structure.

JC: A relatively new element that looks set to become an important driver of volume in this market is fund restructuring. Recapitalizing general partners who have had trouble monetizing assets post-financial crisis, and who can't raise capital in a traditional manner, could become a large part of secondary market volume in the next few years. Another developing area where I think secondary volume may prove less price-dependent than it is in traditional transactions, is the restructuring going on among hedge funds and the cleaning out of their significant side-pocket holdings of private equity funds and assets. The supply side of the secondary market seems to be very strong going forward.

Private Equity Blog

A round-up of issues and challenges for limited partners and general partners.

SMALLER FUNDS SQUEEZED

In 2012, 466 PE vehicles held final closes on an average fund size of $579 million. In 2011, 15 percent less money was raised, yet more vehicles reached a final close: 513 funds closed on an average of $448 million. Post-financial crisis, LPs increasingly prize efficiency, investing more money with fewer managers and avoiding managers whose small size makes large investment difficult, or due diligence challenging. Ironically, the squeeze is severest in hot emerging markets. According to the Emerging Markets Private Equity Association, overstretched LPs don't like the cost of doing research in distant places. The group's December Emerging Markets Review says LPs "rush to brand." It notes that while emerging market fundraising soared 90 percent to $35 billion from 2009 to 2011, final closings fell 12.5 percent to 84, and average closing size rose 2-fold to $419 million. Fundraising may increase, but smaller funds must work harder to shine.

40 percent of PE funds holding final closes in 2012 missed their target – most falling 10 percent or more short of objective.

CLOSING BELOW TARGET

Top quality funds raised more capital more rapidly in 2012 than the previous year. But 40 percent of PE funds holding final closes in 2012 missed their target, with the majority falling 10 percent or more short of objective. For LPs that puts a new premium on researching and understanding the flexibility of costs and team structures at the GP firms that they are considering investing alongside. With investment periods from the record fundraising vintages of 2007 and 2008 ending this year and annual management fee step-downs kicking in, cost issues are finally becoming a major challenge for fund managers and their investors.

DEAD MONEY ISSUE

A little discussed frustration for many LPs are drawdown rates for buyout funds. Until 2007, LPs could expect on average that a majority of their committed capital would be invested within two years. But for 2007 and subsequent buyout vintages, drawdown rates have lengthened. It now takes an average of four years for more than half of an LP's committed capital to be invested. The longer this committed capital lies fallow, the bigger the drag is on annual returns, hence today's accent on strategies characterized by rapid drawdowns. Large amounts of unused capital also make investment committees reluctant to approve increased PE allocations, adding to fundraising difficulties.

BIG EXITS & PURCHASES

It may signal unhealthy pressure to get deals done, but the growing tendency of GPs to make big-scale exits and purchases is good news for cash distributions and drawdown rates. In the U.S., where the bulk of PE assets are invested, there were 43 exits of $1 billion or more in 2012, with nearly half of them taking place in Q4 – pushing PE-backed sales to a quarterly record of $57 billion, according to PitchBook. Meanwhile, U.S. PE acquisitions of $500 million or more increased from 4 percent of deal flow in Q1 2012 to 18 percent in Q4. With a record 12-month bulge of $145 billion in committed capital set to expire this year, the incentive for GPs to do big acquisitions will increase in 2013, while record-low borrowing costs, widely available debt, the best global IPO market in years, and pressure to return capital to LPs before fundraising, will encourage a rising number of $1 billion-plus exits.

REGULATORY-DRIVEN SECONDARIES

Declining from about 36 percent of secondary sales processes in the first quarter of 2012, bank portfolios accounted for some 10 percent of volume over the last six months. While good pricing should attract bank-owned portfolios to the secondary market, much of the approximately $80 billion in PE assets still on bank books affected by the Volcker Rule may not be sold. It's nearly three years since the rule restricting bank ownership of PE was signed into law and it's nine months since it was supposed to take effect, yet regulators are still struggling over its language. Implementation delays and expected loopholes mean that banks are likely to avoid full Volcker implementation for another decade, allowing their PE assets to be held to term.

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