

# THE TRIAGO QUARTERLY

Dear Reader,

Private equity's assets under management have grown to \$4.3 trillion from \$30 billion over the past two decades. Structural catalysts behind long-term growth - private equity's micro focus and its lack of correlation with public markets - aided by today's low interest rates, have set the stage for rapidly rising investor allocations. Indeed, since our founding in 1992 we've never seen a greater number of investors increasing the share of capital they devote to PE.

Private equity embraces all investment categories. If you're pursuing an activist, long-term investment strategy, you're a private equity investor. With an activist approach to value creation, private equity offers the promise of 10 percent-plus returns, even in years when stock markets perform poorly. That's why it continues to grow.

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

Sincerely,



Antoine Dréan • Triago Founder and Chairman  
ad@triago.com

## ANALYSIS: ALLOCATIONS UP, DISTRIBUTIONS FALL

Fundraising is sustained by returns, as investors get less cash back

## ROUNDTABLE: BECOMING ONE

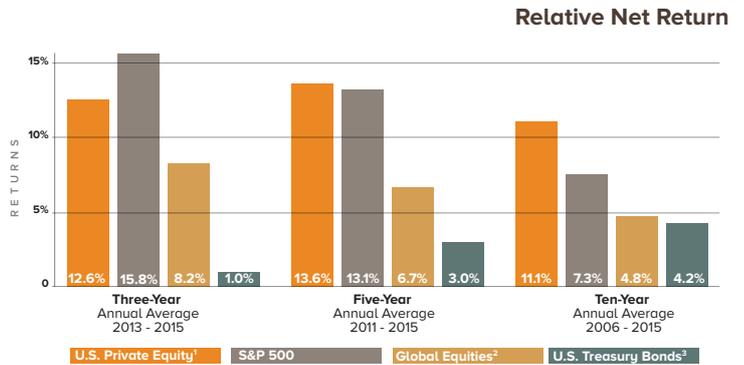
Why mergers & acquisitions among GPs make sense

## PRIVATE EQUITY BLOG

The numerator and denominator effect on PE, More GPs charge for co-investment, First-time managers are doing well, Tail-ends rise among secondaries, LPs partner with industrials

## SNAPSHOT

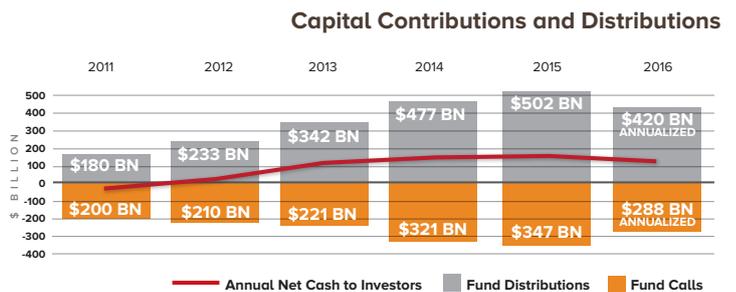
### Better long-term PE returns attract capital...



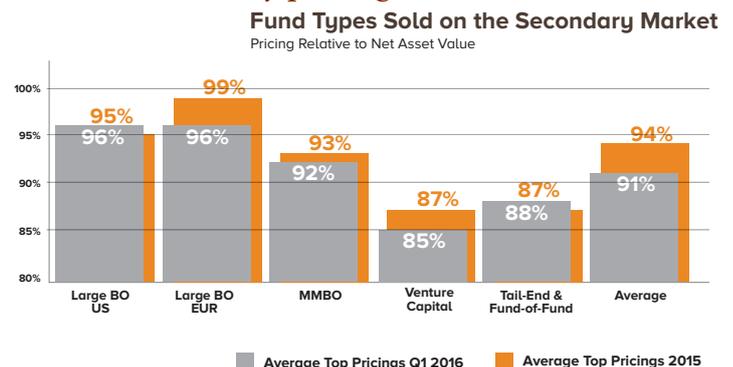
### Private Equity Fund Net Asset Value Evolution - Global

STRATEGY	FY 2011	FY 2012	FY 2013	FY 2014	Q4 2015	FY 2015
Large BO	+2.5%	+18.0%	+24.2%	+15.8%	+6.2%	+3.9%
MM BO	+4.4%	+9.2%	+11.9%	+16.1%	+2.6%	+5.6%
VC	+8.1%	+2.9%	+18.7%	+16.3%	+1.5%	+7.8%
Special Sit.	+0.5%	+5.8%	+11.1%	+5.1%	-2.0%	+1.3%
Energy	-4.3%	+1.0%	+6.4%	-0.8%	-7.6%	-31.9%
<b>Average</b>	<b>+4.1%</b>	<b>+9.7%</b>	<b>+16.4%</b>	<b>+14.1%</b>	<b>+3.3%</b>	<b>+2.6%</b>

### ...even as distributions fall...



### ...while secondary pricing drifts lower.



Sources: <sup>1</sup>Three-Year performance - Triago, Five-Year & Ten-Year Performance - Burgiss Private IQ All; <sup>2</sup>MSCI ACWI Index; <sup>3</sup>Barclays U.S. Treasury Index

# Investors Allocate More as Distributions Fall

## Fundraising highs are sustained by PE's double-digit return promise, even as investors get less cash back.

Global commitments to private equity funds set a post-financial crisis quarterly record of \$136 billion in the first three months of 2016. As of May 16 - roughly half way through the year's second quarter - a further \$58 billion had been committed. At the current pace, \$518 billion will be raised for PE funds through year-end, eclipsing 2015's post-financial crisis high of \$466 billion and ranking 2016 as the second best fundraising year ever behind 2008. That year, private equity funds collected \$557 billion across all regions and strategies.

Three quarters in a row of falling cash distributions from realized private equity investments have had no noticeable impact on fundraising. Put off by stock market volatility and historically low interest rates, and drawn by PE's double-digit returns over the past decade, investors are increasing the percentage of their portfolios earmarked for the asset class. After meeting with hundreds of investors year-to-date, Triago believes an unprecedented number are currently increasing their allocation to PE relative to other assets. A range of surveys support this conclusion.

## A record number of investors are increasing private equity allocations in 2016.

Distributions in the first quarter of 2016 fell 17 percent year-on-year to \$105 billion. Cash from realized investments peaked at a record \$133 billion in the second quarter of 2015 before falling to \$129 billion and \$110 billion respectively in last year's third and fourth quarters. Distributions will diminish further in the next half-decade, as lean fundraising and slow investment following the financial crisis translate into fewer realizations. Yet steadily increasing allocations to private equity and the circumstances fostering that expansion - slow growth and the likelihood of a sustained period of low global interest rates - make further annual fundraising highs likely.

Traditional fundraising in the first quarter was augmented by \$43 billion in shadow capital, monies

committed to private equity through co-investment, direct investment and separate accounts, all non-fund structures. While shadow capital's growth slowed due to a difficult acquisition market in recent quarters - uninvested commitments called up to finance private equity fund purchases actually fell 20 percent year-on-year in the first quarter of 2016 to \$72 billion - non-fund commitments continue to ratchet up. At an annualized rate, \$173 billion in shadow capital will be committed this year, 7.5 percent more than 2015's record of \$161 billion. At the current commitment pace for traditional and shadow capital, 2016 will top 2015 as the biggest year ever for PE fundraising, with \$691 billion collected, 10.2 percent more than the previous record.

Last year and the first quarter of 2016 proved no exception to the rule that when returns from public stock markets are exceptionally volatile, or negative, private equity outperforms listed equity. In 2015, PE across all categories and geographies, registered a 2.6 percent annual gain, beating major U.S. and world stock indexes. In 2016's first quarter, PE's 2.5 percent estimated appreciation bested the S&P 500 and the MSCI World index, which posted a 1.35 percent increase and a 0.2 percent loss respectively.

At \$13 billion, year-to-date through May 16, secondary volume for private equity fund stakes is down 9 percent versus the same period last year. Yet 2016's secondary transactions could still match or exceed last year's record of \$40 billion. Transactions this year have been priced with the depressed values of last year's third quarter in mind, when funds fell 3 percent on average. With 2015's fourth quarter improvement in net asset value - 3.3 percent appreciation across all geographies and strategies - now clearly in focus and appreciation in the first quarter, transaction volume and pricing are likely to increase.

The average discount to net asset value for secondaries is 9 percent, versus 2015's 6 percent, while a record \$82 billion in committed but uninvested capital has been earmarked for secondaries by specialist funds and the secondary pockets of funds-of-funds.

# Becoming One

## Why mergers and acquisitions among private equity fund managers make sense.

Intermediate Capital Group's Christophe Evain, one of our three roundtable participants, notes that the biggest barrier to consolidation among private equity fund managers is the tendency of general partners to be "proudly idiosyncratic". Being so self-consciously different can be wonderful - it often leads to outstanding investment performance. But our participants posit that when misapplied in today's competitive private equity world, it gets in the way of common sense. Willfully ignoring the potential opportunities offered by manager combinations as competition intensifies "may mean a significant number of managers wait too long to consolidate", notes Aberdeen's Alistair Watson. Watson, Evain and our third participant, L Capital's Philippe Franchet, speak from experience. All of their firms have embarked on recent acquisitions or mergers - listed beneath their photos below.



**ALISTAIR WATSON**

Senior Investment Manager at  
Aberdeen Asset Management

*Acquisition: Flag Capital Management*

**What economic or industry developments favor mergers and acquisitions between general partners?**

**AW:** In a crowded, competitive, increasingly demanding private equity market, one of the most evident drivers of consolidation is rising cost, whether it's tied to marketing, regulation or reporting. Lower mid-market firms in particular are being squeezed, with many founding partners taking compensation that's below the going rate in order to defray rising expenses. That means it's harder for small firms to survive on their own, increasing the appeal of becoming part of a larger group. The flip side is



**PHILIPPE FRANCHET**

Senior Partner at L Capital  
Management

*Merger: Catterton*

that acquisitions of smaller managers can be an attractive way for big managers to get access to sought-after sector expertise.

**PF:** Sourcing deals and creating value is one of the biggest challenges for everyone, given high asset prices. In retail, where both L Capital and Catterton specialize, consumer demand for many products and brands is now global. If you can help companies tap into growing worldwide demand, you can source better deals with greater potential. Combining L Capital's Asian and European operations with Catterton's network in North America and South America, gives us the kind of global offering that will maximize returns.



**CHRISTOPHE EVAIN**

CEO at Intermediate Capital Group

*Acquisition: Management of Graphite  
Enterprise Trust*

Growing globalization in retail and in other industries will drive more mergers between geographically diverse, but similarly focused fund managers.

**CE:** I'd point out that you don't really get much operational synergy just by growing team size. Apart from the geographical advantage Philippe mentioned, the benefits of scale usually come by branching into new areas or specialties and using the same platform for fundraising, compliance and reporting. That lowers your costs, increases your fundraising capacity and means more efficient, manageable administration. Investors also like multi-strategy platforms today. They simplify the



*"It's agreed then: the dog, cat, gerbil and parakeet general partnerships will merge, forming the Unipet platform."*

process of investing in a widening range of private equity strategies, and take pressure off in-house resources, letting investors write bigger checks to a smaller number of favored managers - the ones that investors think will outperform. The general appeal of platforms is why we're moving beyond our historic expertise in credit, whether through the purchase of the management contract of Graphite's fund-of-funds business, or via organic expansion into areas like real estate.

**Will we see a significant uptick in mergers and acquisitions between private equity managers?**

**CE:** M&A will continue to spread because of the appeal of one-stop shopping for investors, and the benefits I just mentioned. But the pace of growth will be gradual. Many fund manager groups that invest directly and focus on a single strategy are what I would call "proudly idiosyncratic" and not likely to be all that attracted to consolidation. Single strategy groups are usually structured as close-knit private partnerships and they put a premium on the particularities that set them apart and - one hopes - lead to outperformance. That said, over time, the pressures we've touched

on are likely to chip away at anti-consolidation sentiment.

**AW:** In our experience, the people heading general partner firms are not necessarily the first to appreciate the benefits of consolidation. Far too many see even arms-length support from a larger organization as implying weakness, as a threat to their investment processes, and as a cap on their earnings potential. Yet in truth, the industry trends and

## Fund manager M&A will become a major trend in our industry.

*Philippe Franchet, L Capital*

pressures favoring consolidation, the ups and downs of performance and the potential pitfalls of relying on a single-strategy, may mean that a significant number of managers wait too long to consolidate. When it comes to mergers, fund managers should be more forward thinking and proactive. Done the right way and at an inflection point - for example at a moment of generational change - consolidation makes organizations stronger.

**PF:** In an asset class like private equity where investors typically commit their

capital for 10 years or longer, change happens slowly. Though it may take five to 10 years, I'm convinced that fund manager M&A will become a major trend in our industry. As we've said, it's becoming harder to compete. The long-term result will inevitably be greater professionalization and organizations that give pride of place to efficient performance. Eventually, any stigma attached to consolidation will fade away.

**What are the biggest challenges when it comes to the success of mergers and acquisitions involving GPs?**

**PF:** Private equity is first and foremost a people business, so the key to consolidation success is how well the individuals involved are integrated. For consolidation to work, the cultures of firms must be aligned. You won't successfully merge an organization where the emphasis is on creating an entity that's sustainable over multiple generations with another one where partners have come together pretty much purely to make money in the here and

now. Both models are capable of producing great investment returns, but your chances of getting a cohesive, stable team out of two firms with such different mind sets are pretty much zero. The way the economics of deals are shared among team members at merging firms should also essentially be the same for unions not to create a self-destructive shock. Compatibility of people and culture is everything when it comes to successful private equity fund mergers.

**AW:** At Aberdeen, we've been going through the integration of the Flag team for the past seven months and I would echo Philippe's sentiments fully. Successful mergers are all about

## Acquiring just for fees is risky.

*Alistair Watson, Aberdeen Asset Management*

good cultural fit and sharing the same philosophy. I'd add that as a large organization that's bought smaller, independent teams, the onus is on us to make sure that we've got an overall platform and environment where teams can continue to do their day to day job the way they always have.

**CE:** All the challenge of acquisition in our industry stems from the fact that we are buying assets on legs that can walk out the door. In addition to the broad compatibility we've been speaking about, there's got to be total buy-in from all elements when it comes to the combined group's vision. These deals are transformative and everyone has to be on board with the ambitions driving them.

**AW:** Just to follow up, when you're acquiring other firms, you've got to make sure your acquisitions really are bringing on board useful investment expertise for clients. If your acquisitions are only about gathering more assets in order to collect more fees, there's more chance you'll lose clients.

### Considering their small share of industry assets, why do funds-of-funds account for such a large share of GP consolidation?

**AW:** To maximize their appeal for today's more sophisticated limited partners - who are investing greater sums directly with private equity managers - funds-of-funds need global scale. That should be combined with an ability to invest in specialty niches and to offer customized accounts. Many funds-of-funds without scale, or without these abilities, see themselves as more or less natural candidates for consolidation.

All this means M&A is generally regarded as a more acceptable solution to competitive challenge in the fund-of-funds sphere than among private equity managers - at least for now.

**PF:** The consolidation I've seen among funds-of-funds tends to be defensive. Funds-of-funds have fewer clients than before and overall the sector's profits are being squeezed as low margin products like customized accounts gain ground. So funds-of-funds are seeking greater leverage across the board to lower their costs and increase their attraction for investors. They're merging to increase their coverage of geographies and specialties, enhancing fundraising appeal; and they're gathering more assets, which they use to negotiate lower fees with funds in exchange for bigger investments.

**CE:** I agree absolutely on the advantages of size and specialization, but the mergers are more than defensive. There's a new commercial opportunity today that the smartest funds-of-funds are seizing. The best business model doesn't emphasize hand holding for novice investors as it did a decade ago. It relies on providing value-added service for a group composed of more experienced private equity investors. For savvy, small investors who have difficulty reaching the threshold ticket-size of large primary funds, the more firepower their fund-of-funds can deploy, the better deal they get on fees. For the biggest limited partners, using a fund-of-funds becomes more interesting in direct proportion with the fund-of-funds' ability to invest in a wide range of top performing niche funds. Through merger and acquisition the best funds-of-funds have stayed ahead of the curve, transforming themselves into highly sought after, profitable providers of value-added services.

### We've talked about the trends favoring fund manager mergers. Will there be a parallel consolidation among fund investors?

**PF:** I'm skeptical that will happen. When limited partners are confronted with what they view as serious resource limitations in private equity they're more likely to drop it as an investment, selling their portfolio or ceasing activity, rather than consolidating their firepower with other investors.

**AW:** U.K. local public pension schemes, through the suggestion of government, are working to consolidate into buying groups to give themselves more power as investors across asset classes, as larger investors can benefit from favorable fee terms. It's a trend that we see gaining momentum, though it's still very early days.

**CE:** Yes, there's the U.K. example, and in Southern California, Orange County is leading a pooling of public pension fund private equity assets. There's also consolidation in the Australian superannuation fund sector, but I really don't see investor consolidation happening on a broad scale - particularly in the public sector where pension funds answer to investment committees that are usually very resistant to change. National pride issues also interfere in the case of, say, small sovereign wealth funds. Instead of pursuing consolidation, we're seeing many investors increase their negotiating power by committing more money to fewer managers. Scale can provide better access to managers, but it's far from clear that big investors do better than smaller ones, particularly when it comes to the much greater direct investment and co-investment that larger groups engage in these days. The jury is still out on those investments. Small size may be a much better long-term fit for investors than it is for fund managers.

## PRIVATE EQUITY

## BLOG

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

### Neither a Denominator nor a Numerator Effect Slows PE

The stock market volatility of recent quarters has negatively impacted the listed holdings of numerous investors. The result: significant numbers have seen better performing private equity holdings - the numerator here - lifted to a proportion of overall investment - the denominator - that is above target allocation. During the financial crisis, this shrinking 'denominator effect' led investors to slow PE investment. Yet Triago sees no impact from the denominator effect today. Instead, an unprecedented number of investors are increasing PE allocations. That's because the consensus view, confirmed by the financial crisis, is that PE outperforms in bear markets, or when stock returns are modest or exceptionally volatile. A 'numerator effect' is equally being discounted. PE investment realization has slowed recently, keeping the overall proportion of PE in portfolios relatively high, yet investors keep doubling down on the asset class.

### More GPs Are Charging for Co-Investment

Monies committed to co-investment, managed accounts and direct investment grew from 11 percent of commitments to private equity in 2009 to 26 percent in 2015. These low-to-zero margin non-fund commitments - known collectively as shadow capital - are pressuring general partner bottom lines, and more are doing something about it. A year ago, slightly less than one in four of the hundreds of GPs Triago speaks with quarterly were either charging or intending to charge for co-investment. Year-to-date, the proportion of GPs charging or intending to charge for co-investment has risen materially to one in three. Annual fees average 1 percent of value,

and carry above preferred returns averages 9 percent on co-investment, according to Triago estimates. If charges become standard, the appeal of co-investment will diminish.

year. Tail-ends are the only category of PE fund where secondary sales are currently running higher than last year's and they are likely to see their market share rise to 40 percent

## First-time private equity managers are raising record amounts.

### First-Time Managers are Doing Better than You Might Think

Some data providers posit that capital commitments to first-time managers declined in 2015. But if deal-by-deal capital for first-time managers - a form of co-investment - is considered, first-timers raised a record sum in 2015, collecting \$79 billion, or 12.6 percent of the \$627 billion committed through classic fund structures and shadow capital. Some 47 percent of the capital going to first-time managers was done deal-by-deal, with investors opting in or opting out of proposed transactions. A \$78 billion high was raised for first-timers in 2008, but just 17 percent of that was committed outside of classic fund structures. A recent Collier Capital survey notes that for 91 percent of investors debut managers have equaled or outperformed the rest of their PE portfolio, a sound reason for their popularity.

### Tail-Ends Come to the Fore

In the secondary market where investor stakes in closed private equity funds are bought and sold, so-called tail-end transactions are gathering steam. Funds that are at least 9 years old - tail-ends - have seen their volume in the secondary market rise to 28 percent of total sales value year-to-date through May 16, up from just 18 percent in the same period last

or more in the next two years. That reflects milestone fundraising records between 2005 and 2008, longer hold periods for investments, and steadily rising pricing for tail-ends. Still sold at much wider discounts than younger portfolios, which in theory have more appreciation potential, higher pricing for tail-ends means sellers are coming to terms with buyers more frequently.

### LPs Partnering with Industrials

A recently created \$5 billion joint-venture for buying troubled Indian power assets, established by investors - the Caisse de depot et placement de Quebec, the Kuwait Investment Authority and the State General Reserve Fund of Oman - with India's largest private power company, Tata Power and PE general partner ICICI Venture, represents cooperation others will copy. Tapping hard-to-replicate corporate operational expertise places large sums of investor capital in promising private equity strategies. For industrials like Tata, the appeal of such partnerships is fund manager upside - annual fees and carry - with little or limited capital outlay for overhauling relatively risky assets. For GPs, such joint-ventures monetize dealmaking and financial engineering in strategies that would otherwise be difficult to enter.

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