Dear Reader,

It’s been a busy 2016. Private equity commitments to traditional funds, co-investments, separate accounts and direct deals hit an all-time high; further records seem likely in the new year as new investors enter the asset category and as veterans increase allocations.

Traditional asset managers, previously focused on public markets, are now big investors in venture capital-backed startups; and experienced limited partners, formerly interested mainly by buyouts, are moving into real estate, infrastructure, secondaries and other specialties. Investors continue to develop emerging geographies - including our China roundtable panelists. On the cusp of the new year, Lunar Capital’s Derek Sulger declares China not only the most promising PE market in the world, but also the most attractively priced.

To all, we wish joy over the holidays and a productive 2017!

Sincerely,

Antoine Dréan • Triago Founder and Chairman
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ANALYSIS: COMMITMENT RECORD
Shadow capital and traditional fundraising hit new highs

ROUNDTABLE: DRAGON POWER
China may be the world’s most attractive private equity market

PRIVATE EQUITY BLOG
The limited value of averages in PE, Why PE AUM will soar, Unicorn numbers set to grow as IPOs decline, VC performance improves, The Trump effect

SNAPSHOT
Unaffected by falling distributions...

Evolution of Private Equity Tickets & Fundraising

…and buyout returns attract investors.

Private Equity Net Asset Value Change – Global

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Fund Types Sold on the Secondary Market

Pricing Relative to Net Asset Value

96% 95%
92% 95%
85% 88%
88% 89%
91% 93%

Average Top Pricings H2 2016 Average Top Pricings H1 2016

95% 85% 88% 89% 91%
Private Equity’s All-Time Commitment Record

A fall in distributions doesn’t slow momentum, yet big tickets keep competition for fundraising hot.

Private equity fundraising for classic 10-year funds in 2016, augmented by commitments to co-investment, direct investment and separate accounts - known as shadow capital - should reach a record $681 billion this year. That would surpass the previous all-time highs of 2015 and 2008. In those years, $627 billion and $624 billion were respectively committed to both traditional PE funds and to shadow capital.

Annual fundraising for classic 10-year vehicles across all regions, sectors and categories, totals $473 billion year-to-date through December 16. A further $20 billion is forecast to close by year-end, setting a new post-financial crisis fundraising record of $493 billion for classic funds, 6 percent above last year’s high of $466 billion. This year is already the third best year ever for classic fundraising, trailing only 2008 and 2007, when $557 billion and $508 billion were respectively raised.

Ticket size has risen 47 percent in five years.

Every quarter in 2016 has seen higher classic fundraising, with the exception of the July through September period, when fundraising fell to $104 billion from $131 billion last year. In 2016’s first and second quarters, classic fundraising respectively hit $136 billion and $128 billion - year-on-year increases of 24 percent and 3 percent. Some $105 billion raised in the fourth quarter through December 16 has already surpassed the $102 billion raised in 2015’s final three months.

With $141 billion in shadow capital committed through the third quarter of 2016, at least $614 billion has been raised year-to-date for all forms of private equity investment, just $13 billion shy of 2015’s record. Though a new all-time high for annual commitments will certainly be hit, it comes as the cash returned to investors from realized PE investments - one of fundraising’s traditional growth engines - declines. At $331 billion, distributions to investors in the first nine months of 2016 are down 12 percent compared to the same period last year. Indeed, four years of meager fundraising and relatively slow investment following the 2008 financial crisis are likely to keep distributions in decline for several years. Yet low interest rates, slow global growth, and PE’s track record of uncorrelated double-digit returns are inciting an unprecedented number of investors to increase exposure to the asset category.

Despite fundraising records, competition for commitments remains intense: Shadow capital, on pace for a record $188 billion in 2016, has seen its market share of total annual commitments rise to 28 percent from 22 percent in just two years; there are a record 2,914 classic ten-year vehicles fundraising - a 13 percent increase in 24 months - seeking $980 billion, also an all-time high; and a Triago study of 100 large and small investors shows that the commitment to an individual private equity fund - known as a ticket - is up 47 percent on average over the past five years to $50 million, as many investors rationalize holdings and commit more to fewer managers. Indeed, increasing competition among PE fund managers, even as fundraising rises, is a major catalyst behind private equity’s expansion beyond buyouts into less crowded strategies in everything from real assets to credit.

Volume in the secondary market for stakes in closed private equity funds should hit $39 billion in 2016, down slightly from 2015’s $40 billion record. Volume has accelerated this year from a first quarter low, as net asset value growth for private firms and quoted equivalents has steadily picked up. Specialists and the secondary pockets of funds-of-funds hold a record $84 billion in uninvested capital.

With demand for secondaries experiencing long-term secular growth as investors buy to improve liquidity, reduce risk and increase exposure to managers and vintages, pricing remains attractive to buyers and sellers. In 2016’s second half, the average discount to net asset value on the secondary market is 7 percent, up from 9 percent in the first half.
Dragon Power

Is China the world’s most attractive private equity market?

Though China has elicited enormous investor enthusiasm over the years, concerns about its credit, real estate and technology sectors, and speculation about the possible imposition of U.S. trade tariffs, are cooling ardor for the country. Yet when risk and potential are calmly weighed up, it’s hard not to come to the conclusion that long-term growth in the world’s second largest economy will be anything but spectacular. Indeed, our roundtable participants, Yar-Ping Soo, the Singapore-based partner and head of Asian fund selection at Adams Street Partners, Jonathan Jia Zhu, managing director at global fund manager Bain Capital in Hong Kong, and Derek Sulger, the founder of Shanghai-based fund manager Lunar Capital, make the case that given depressed asset values, now may be the ideal time to invest in Chinese private equity.

JONATHAN JIA ZHU
Managing Director at Bain Capital

More than other nations - or regions - China is frequently labeled the most promising emerging market for private equity investment. Why is that?

DS: The most important reason is that China isn’t fragmented by rules and regulations as are all other emerging market areas of significant size. In China, you can build bigger businesses faster and more easily. The second most important reason - inextricably linked to the first - is the bright outlook for long-term Chinese growth and domestic consumption. In fact, today there is no major market - apart from India - advancing as rapidly as China, even if we’re experiencing economic expansion normalizing from 10 percent a few years ago to some 6.5 percent today. There is a caveat of sorts when it comes to investment enthusiasm for China. As economic growth has slowed, capital flows into Chinese private equity funds have fallen sharply. China is now not only the most promising market in the world - emerging or otherwise - it’s also the most attractively priced.

YPS: Derek’s got it right - scale can’t be underestimated when it comes to China’s appeal, in particular in relation to the country’s venture capital market. China is second to the U.S. when it comes to successful venture capital-backed tech startups, with Europe and the rest of the globe far behind. India is the only nation with the kind of overall scale that China has, but it’s got infrastructure problems, especially when it comes to internet availability. With a venture-backed business model, you can reach roughly a billion customers via China’s internet. There’s no other country in the world where you get those numbers. China’s managed currency is another reason why the country is often billed “most attractive emerging market.” Significant devaluations are the greatest potential value destroyer for emerging market private equity investments, but the danger of a big drop in China’s renminbi is minimal.

JJZ: By way of example, I would add that no other geographic grouping
of portfolio companies at Bain Capital Private Equity is growing as fast as our China holdings. Another element explaining China’s draw that hasn’t been mentioned yet is the exceptional strength of the country’s entrepreneurial culture, which generates an ever expanding circle of attractive investment opportunities.

As China transitions to a slower growth rate, does private equity have to change the way it invests?

YPS: The days when you could invest in most companies and simply ride to success on the back of China’s macro growth are over. Today, you’ve got to invest in fund managers with clear specialties and in teams that really know how to actively improve companies. Investing is also harder because the marketplace has gotten more crowded. We have sectors where the level of competition among private equity firms has driven prices to levels that we think may be unsustainable - one example is healthcare. Exceptional returns are there. You’ve just got to be more selective than in the past.

JJZ: Bain Capital Private Equity really identified the transition to a different growth environment back in 2011. The firm has been in China now for 11 years and for the first half of that period we invested mainly in manufacturing and industrial businesses. Significant industrial capacity was being built and basic exports were growing tremendously, but for the past five years we’ve invested more in areas like education, technology, finance and healthcare. Yar-Ping highlighted healthcare’s high prices, but if you choose wisely, there are opportunities for tremendous upside. Overall, our focus today is much more on consumer demand and services, more often than not in sectors where we believe there will be long-term secular growth.

China today is a small step away from being the biggest economy in the world.

Derek Sulger, Lunar Capital

DS: Concern with the slowdown in Chinese growth is overblown - though it’s certainly very real in some sectors. We tell our investors that as the second largest economy in the world, China today is just a small step away from being the biggest. Understanding the big picture helps bring home the depth of the opportunity set in China. It keeps our investors focused - not distracted by concerns about whether they should be in sector x, y or z, or at what point in the economic cycle they should be investing. The big picture encourages investors to seek opportunities across a broad range of sectors on a regular basis, much as they do in the U.S. - today’s largest economy.

How likely is it that trade wars or political instability will get in the way of successful private equity investment in China?

JJZ: Policy changes that have a big impact on economic issues are always a possibility, but the likely scenario in China is one of considerable stability. On the international front, the president-elect of the U.S. has spoken about punitive trade tariffs for China. Concerns about trade wars - or worries about the possibility of domestic political instability in China - are the result of a lack of transparency and ensuing speculation. If you apply common sense it’s hard to imagine a scenario where the risks of investing in China outweigh the promise.

DS: I think it’s important to put the possibility of political instability, as well as other risks to general private equity investment in China, into perspective. The state is no longer the driving force in the Chinese economy. For a long time now, the most powerful growth engines within the economy have been mid-sized private enterprises. Two thirds of taxes and two thirds of employment are accounted for by middle market companies with annual revenues of less than $75
China will continue to provide excellent investment opportunities.

Jonathan Jia Zhu, Bain Capital

short-term noise is, the priorities of China are further economic growth and job growth. These are very stable, long-term goals with which private equity is completely aligned.

YPS: Compared to other emerging markets, I’m the least worried about destabilizing events in China. There’s a greater prospect of long-term stability here than in Malaysia, Brazil, the Middle East and, arguably, even Britain, now that it’s voted to leave the European Union. My greatest concern in terms of China’s economic policy is the government’s tendency to flood certain sectors it wants to support with credit and investment. That distorts supply and demand, and can lead to nasty investment bubbles that burst.

Speaking of possible bubbles, corporate debt in China stands at 171 percent of GDP. Should that worry private equity investors?

YPS: It’s definitely a concern that corporate debt is generally rising and there will be cases where loans won’t be serviced. At current levels, debt could cause trouble in specific sectors, but with minimal impact on the broader economy. The highest levels of debt are in the real estate industry, so there could be some worries there. Debt needs monitoring, but current levels don’t threaten the health of overall private equity returns in China.

DS: Actually, corporate debt as a percentage of gross domestic product is pretty middling compared to other countries. It’s at the same level as in Australia, Canada, Malaysia and Korea. It’s a bit lower than in the U.S., and it’s a lot less than in Spain, Japan, Ireland or Sweden.

The greatest concern is whether borrowing is fueling an excessive increase in real estate prices, as Yar-Ping noted. But housing construction, compared to the size of China’s population, is at relatively low levels. Much of the increase in real estate values corresponds to a genuine shortage of housing for China’s growing middle class, implying that even this market is not seriously overheating.

JJZ: I couldn’t agree more. Most of the corporate debt in China is structured as revolving short-term one-year credits from banks. But over the past two years we’ve really seen the bond market take off – though it hasn’t been noticed by many outside of China. The maturity profile of Chinese debt is improving rapidly, and with the savings rate of the typical Chinese household at 30 percent to 40 percent of annual revenue, there’s plenty of liquidity to finance debt.

Debt doesn’t threaten China returns.

Yar-Ping Soo, Adams Street Partners

So then, what kind of return levels can Chinese private equity deliver over the next 10 years?

DS: For the next decade, there’s a better risk/reward outlook in China than in any other market, for all the reasons we’ve cited, but most importantly because of very low valuations. For example, the Hang Seng China Enterprises Index, a standard proxy for valuations in the Chinese public markets and, by extension, among private companies, is near a 7-year low. Current valuation - or as I like to say, China’s extremely depressed average denominator, relative to the numerator, take the latter as potential growth - is the most reliable predictor I know of for outsized private equity returns. There’s one real caveat related to that – the denominator is so high in the venture capital sector that it’s the diametric opposite of the overall average. So, while I’m very positive on technology’s ability to boost growth for most traditional sectors due to internet/mobile penetration and general scale, an awful lot of Chinese venture capital strategies will not only have trouble delivering returns, they’ll have difficulty returning investor capital.

JJZ: Despite change in China, we have consistently delivered attractive results for our investors. We believe China will continue to provide excellent investment opportunities for the foreseeable future.

YPS: Overall, it’s reasonable to expect something on the order of a 25 percent gross IRR and a 2.5x investment multiple for China, provided you choose well. It may come as a surprise, but I think the highest returns could come from majority control investments - more radical change is possible with control - in both the growth and buyout sectors. There have been relatively few such deals in a marketplace that is both attractively priced and increasingly open to control investments. Debt for buyouts, though still rare, is also more easily available in China than it was just two or three years ago. We are seeing new opportunities open up for leveraged value creation in one of the world’s highest growth markets.
The Significance of Averages in PE
Private equity registered a 7.6 percent average gain in 2016's first 9-months. That's slightly below the 7.8 percent appreciation of the S&P 500 over that period. Averages are a useful benchmark in private equity, but if taken too seriously they are a distraction. PE returns from general partners following identical strategies and investing from the same vintage produce annual returns that vary much more widely than those in more efficient stock and bond markets. Venture capital, PE's most inefficient sector, shows a 21 percent return gap, while the variation overall for PE is some 13 percent. Governed by similar variables, the difference between the best and worst stock and bond fund managers rarely exceeds 5 percent. So swing for the fences in PE. As we've noted before, time and money spent finding the best PE managers pays off.

PE's $4.3 Trillion in AUM is Set to Grow Much Bigger
Private equity assets under management could grow nearly three-and-a-half fold over the next decade to $15 trillion - from 1.5 percent to 3 percent of global financial assets - if historic growth rates repeat. But if traditional money managers aggressively expand into PE, the category could get a lot bigger. The likely catalyst: declining profit margins. Blackrock, the largest traditional manager, and a bellwether, announced in October that its assets under management increased 14 percent in a year to slightly more than $5 trillion, but its revenue declined, since about two-thirds of the money it manages is in low margin index trackers, not in the higher margin, actively managed funds that until recently were its bread and butter. As Blackrock and its peers look for higher margins, they're likely to turn to PE, where active management can still deliver outperformance for investors and high fees for managers.

Who Says You Need an IPO?
The multiplication of funding sources for 'unicorns' - privately-owned startups worth $1 billion or more - and a corresponding hollowing out of high-growth listed tech companies, means it's no longer evident that startup managements and their venture capital backers need to submit to the regulatory and reporting burdens of a stock market listing. Indeed, with traditional asset managers and hedge funds pouring money into the private market for unicorns, the runway for staying private is lengthening, not contracting. Pitchbook notes that a remarkable 66 percent of the $78.1 billion invested in venture capital-backed companies last year came from the likes of Fidelity, T. Rowe Price and Wellington, public asset managers, not VCs. These investors are looking to put more money into private companies and accelerate the development of today's expanding secondary market for private company shares. This should only further the growth of venture, and by extension overall private equity, beyond forecasts.

A Harbinger of Better VC Performance
Despite hand wringing over the potential for a significant drop in venture capital values, investors in the secondary market are showing considerable optimism. Average pricing for existing investor stakes in closed venture capital funds has steadily risen this year with pricing in the fourth quarter back to levels last seen in 2014. That was a year of general excitement over venture's prospects. Venture capital funds in the fourth quarter are trading at an average discount to net asset value of 11 percent - the same as the average for all of 2014 - after reaching a three-year low of 15 percent in the first quarter. On average, the net asset value of VC funds appreciated 3.5 percent in the third quarter of the year, after losing 1.5 percent in the first half.

Trump Effect
Donald Trump is arguably the most unpredictable president-elect the U.S. has ever had, but he does seem intent on launching a massive infrastructure spending program. This, and related speculation that such a burst of spending will lead to rising inflation, is increasing the popularity of private equity funds that specialize in infrastructure, where pricing is often indexed to rising prices. Private equity real estate funds, another inflation hedge, are also pulling in investors. PE real assets funds, dominated by these two categories, currently account for 18.7 percent of all PE vehicles currently seeking capital, with only venture capital funds accounting for a larger share – 23.9 percent. Watch for the market share of real assets to rise.

In venture capital, the runway for staying private is lengthening.
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