DECEMBER 2017

THE TRIAGO QUARTERLY

Dear Reader,

We've written here before about how far PE has come and where it's going. But behind all the growth, innovation and success we've experienced in this industry, and at this firm, is teamwork – people rolling up their sleeves, bringing to bear diverse backgrounds and doing a lot of heavy lifting together. What we love about the mechanics of private equity, is the sheer diversity of its moving parts – the truly endless range of investment strategies that can fit into the long-term, activist private equity model.

It all comes together into a coherent whole, governed by what could be called the transcending tenets mentioned above. That's actually what we like about this holiday season too, though it is a little different, with people from all over the world taking time off to be with others, whether to marvel at milestones or to reflect on how much better we can make things, from the narrow confines of an industry to the broader world.

To all, of we wish joy over the holidays and a constructive 2018!

Sincerely, The Triago Team

ANALYSIS: 2008 HIGH SURPASSED
Fundraising's post-financial crisis recovery completes, secondary volume hits record

ROUNDTABLE: LATIN RENAISSANCE
Private equity investment in Latin America generates new enthusiasm

PRIVATE EQUITY BLOG
The low risk of PE investing, PE-backed firms do better in downturns, Leverage makes the secondary market resilient, Tax reform's modest impact on PE, Top quartile persistence weakens as first-time fundraisings hit record

SNAPSHOT

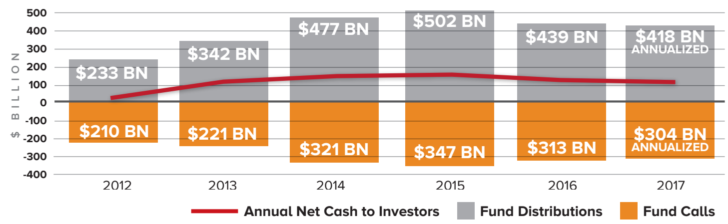
Returns register a four-year H1 high...

Private Equity Net Asset Value Change – Global

STRATEGY	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	H1 2017
Large BO	+18.0%	+24.2%	+15.8%	+3.9%	+16.2%	+9.5%
MM BO	+9.2%	+11.9%	+16.1%	+5.6%	+14.6%	+9.1%
VC	+2.9%	+18.7%	+16.3%	+7.8%	+5.1%	+5.5%
Special Sit.	+5.8%	+11.1%	+5.1%	+1.3%	- 2.0%	+8.2%
Energy	+1.0%	+6.4%	-0.8%	-31.9%	+9.1%	+1.4%
Average	**+9.7%**	**+16.4%**	**+14.1%**	**+2.6%**	**+11.9%**	**+8.4%**

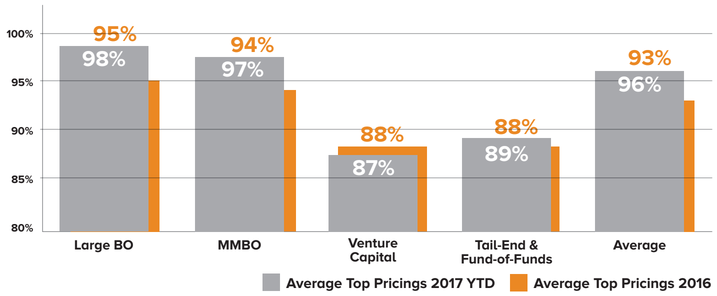
...as net cash holds up better than expected.

Capital Contributions and Distributions



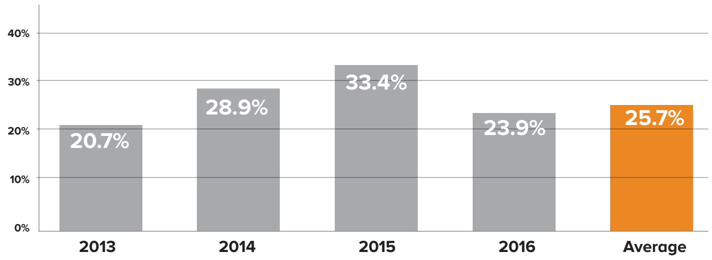
Secondary prices hit an all-time record...

Fund Types Sold on the Secondary Market
Pricing Relative to Net Asset Value



...while used PE funds deliver strong returns.

Secondary Fund Performance by Vintage Year[1]
Annual Net Internal Rate of Return



[1]Triago study covers the performance of 84 secondary funds through September 2017. "Vintage" corresponds to the year each fund began investing.

PE Fundraising Blows Past the 2008 High

Fundraising's post-financial crisis recovery is complete, while secondary pricing climbs to a record.

With some $594 billion raised year-to-date through December 15 for private equity fund structures, 2017 has surpassed the longstanding record of 2008, when $557 billion was raised for classic structures across all strategies and regions. A further $27 billion is forecast to close by year-end for an all-time record of $621 billion.

In addition to exceeding the previous record by 11 percent, 2017 fund commitments should be 15 percent higher than 2016's $539 billion - revised upwards from $494 billion due to the $45 billion in equity collected last year by SoftBank's Vision Fund. At $98 billion in equity and debt, Vision is four times the size of the next biggest PE fund and should hold a final close on $100 billion by year-end.

Classic fundraising in 2017 is being augmented by an estimated $179 billion in commitments to co-investment, direct investment and separate accounts. So-called shadow capital - monies committed outside of classic fund structures - grew rapidly from 2010's $24 billion to a record $183 billion last year. But shadow capital's expansion has slowed, stabilizing in the last three years at 20-to-25 percent of annual private equity commitments.

Distributions to investors from fund portfolio sales have fallen for two years - a mechanical effect of four years of slow fundraising and investment after the 2008 financial crisis - yet more cash is going back to investors than expected. That's due to a booming leveraged loan market for dividend recapitalizations, fueled by the cheapest credit pricing in living memory. Dividend recaps in the U.S. alone amounted to $15.3 billion in the first nine months of 2017, almost as much as the $15.7 billion tally for all of 2016, according to Leveraged Commentary & Data.

Annualizing nine-month figures of some $313 billion in distributions and $228 billion in investor-financed capital calls for investments, a net $114 billion will be returned to investors in 2017. That's a fifth more than our estimate in 2017's first half and bodes well for 2018 fundraising, though a continuing increase in allocations to private equity from all types of investors - at the expense of stocks and debt instruments - should be the principal driver of any new fundraising high in 2018.

While fundraising is at a record, the contest for investor capital remains rude. Today, a record 3,129 private equity funds, ranging from buyout to credit vehicles, are targeting a high of $1.152 trillion. Over the last year, the number of fundraisings has risen 7 percent while the amount of capital sought has soared 18 percent - a fifth more than the hike in commitments. This trend is long-term. Annual private equity commitments have risen 42 percent over four years, while capital targeted is up 65 percent. Funds closing today take less time and raise more than ever before, yet their numbers have dwindled for four years - as a range of data providers demonstrate - while the supplicant fund population has soared.

Secondary volume hits a $45 billion high.

Mirroring the fundraising record, pricing and volume in the secondary market are also at all-time peaks. Even though private equity fund net asset values gained 8.4 percent in the first half of the year, a four-year high, the typical fund purchased on the secondary market is selling at 96 percent of its fund NAV, surpassing the previous annual record of 94 percent in 2015 and 2014. The enthusiasm for buying is generated by strong returns. A Triago study of the performance of 84 secondary funds launched between 2013 and 2016 - all years when mean annual pricing varied between 92 and 94 percent of NAV - shows an average yearly return of 26 percent. Secondary volume - driven by the appeal of high prices - is estimated at $45 billion in 2017, surpassing 2016's $39 billion and the former high of $40 billion in 2015.

Another banner year is likely. Unspent capital for secondaries, accumulated by specialist funds, funds-of-funds and in-house institutional investors, is at a record $122 billion.

Latin American Renaissance

Private equity investment in the region generates new enthusiasm.

Following years of political and economic dislocation in Latin America, notably in the headline economies of Brazil and Argentina, private equity investors see an opportunity to invest in growth at bargain basement prices, say our roundtable participants - two fund managers and fund investor Cristina Alcaide. This year, Brazil came out of its worst recession ever, while Argentina's President Mauricio Macri pursues reforms that are ending high inflation and opening up the long isolated economy to outside investment. Despite the propitious outlook, our participants believe that the secret to successful private equity investment in Latin America - where the gulf between the best and worst performing managers is larger than in any other region - hinges on a healthy disregard for economic cycles, and a focus on the particular.

CRISTINA ALCAIDE
Senior Vice President at PineBridge Investments

THOMAS W. KEESEE
Partner at Bozano Investimentos

NICK WOLLAK
Founder and Managing Partner at Axxon Group

Why invest in Latin American private equity?

CA: Latin America is all about untapped opportunity. You've got the potential to invest in companies at much lower purchase price multiples than is possible in developed markets, or even in most other emerging market regions. But you've got to be selective. On a very general level, we think the best investments are concentrated in non-cyclical sectors like healthcare and infrastructure and in technology-based growth companies, particularly those helping local champions in various industries adapt to a digital world - Latin America has catching up to do in this regard. There's also a great entrepreneurial vibe emanating from tech companies and it's driving significant change in markets as diverse as Brazil and Peru.

TWK: Cristina is right - a key attraction in Latin America is pricing. Nowhere is that truer than in Brazil. After years of recession, the economy shows signs of stabilization, yet financing is scarce. Private equity is one of the few viable alternatives for companies seeking growth capital. Brazil is also the largest economy in the region but many companies there operate within just one state. That means there's a huge opportunity to grow firms into regional and nationwide businesses, organically or through mergers and acquisitions.

NW: I'd also zero-in on the appeal of small and midsized companies in Brazil. Many are family-owned businesses that offer great products or services, but often don't operate with the efficiency or professionalism that would make them clear acquisition targets for either national or international companies. That rich vein of family-owned businesses offers fantastic potential regardless of economic cycle, provided purchasers have the kind of operational and management experience needed to improve and expand them.

TWK: Just to touch on the issue of economic cycles and investor appeal, I'd divide investors into two segments: long-termers, who maintain exposure throughout cycles, and a larger group that I'd refer to as tourists who come and go and tend to invest only once the up cycle has been in evidence for some time.

Tourists were all over Brazil during the boom years, but disappeared when the recession hit in 2014. The long-termers largely remained invested and now they're seizing opportunities created by capital shortage and low prices. Over the next 18 to 24 months - given economic bottoming in Brazil and Argentina's market friendly reforms - more general enthusiasm for the region may return, but with a corresponding rise in prices.

We've spoken a lot about Brazil. Is it the most attractive country in Latin America today for private equity investment?

CA: Latin American countries are so extraordinarily diverse in terms of size, regulation, types of business, corporate culture and political structure that trying to compare or rank them based on macroeconomic outlook is difficult. The Andean states of Columbia, Peru and Chile have better private equity returns in recent years - partly because of more sustained investment from domestic pension funds and other local investors - than either Brazil or Mexico. But the latter two countries have a return potential tied to their size that isn't found anywhere else in the region. The Andean states also have developed more investor-friendly regulations and labor markets than either Brazil or Argentina. But the flip side is that economies like Argentina and Brazil have greater potential for reform-driven upside. We would argue that apart from extreme situations, in Latin America you should really be focusing on the micro and investing in the best opportunities, regardless of the country or where we are in the economic cycle.

TWK: I would agree completely with Cristina. Local investor participation in private equity is a key gauge of the attractiveness of sectors and opportunities, and although locals don't ignore the macro environment, they tend to be more focused on the micro. In Brazil, we are seeing more commitments to PE funds from the country's family offices. Going forward, local investors are likely to be much more present than in the past, smoothing out demand and pricing and encouraging more participation by foreign investors.

NW: I'd really underline the point that successful private equity investment in this region is driven by micro potential. In many Latin American countries you'll find truly exciting PE investments cropping up independently of macroeconomics. Still, if forced to choose, I'd say that the most intriguing market in Latin America, apart from Brazil, is Argentina. We haven't invested there directly since the government bond default of 2001, but with the election of President [Mauricio] Macri in 2015, Argentina's been making remarkable strides adopting the institutional and regulatory framework needed to right the economy and attract long-term investment. The positives we're seeing will have to take root before we'll seriously consider returning, but given the current pace of evolution, that could happen soon.

What general rules of thumb are there for sensibly investing in Latin America?

NW: As we've implied, economic cycles change very abruptly and unexpectedly in Latin America. The guidelines I'd cite for investors include don't try to time the market and invest consistently through up and down cycles, staying firmly focused on the micro. The inability to depend on macro trends also puts a premium on doing deep due diligence when choosing fund managers.

CA: I'd say that before investors commit to Latin America, they should map out the downside scenarios and be sure they can handle the potential shocks they may face. If we look back to the boom years before Brazil's recession, there were a lot of investors who thought the path to stellar returns would be a more or less straight line with minimal volatility, but that's not how Latin America works. You can't come in and out of the region following a purely opportunistic strategy and hope to do well. As an LP, you've got to get to know the GP teams that are in the region and you need to have a clear idea of how they can apply their skills on the micro level.

TWK: I think we're all emphasizing the same basic point. Those investors in Latin America who, regardless of cycle, concentrate on finding good corporate-level opportunities - whether through fund investments or directly - are the ones who do well. For example, we invested in a Brazilian specialty food retailer in 2010, during what turned out to be the tail end of a boom, and we exited in 2015, a period which from a macro standpoint, was absolutely the worst time. But because of the dynamics of the sector and the strength of the company, and most crucially, because of the improvements pushed through by management, we exited at a multiple to cash flow that was significantly above what we paid.

The most intriguing market, apart from Brazil, is Argentina.

Nick Wollak, Axxon Group

What did you sell the company for?

TWK: Our acquisition price was about 8 times cash flow, our exit was at a multiple of 10 and the cash flow had more than doubled, so our net return was 2.6 times invested capital.

CA: I'd just add that we all know that basic guideline for real estate investment - 'location, location, location.' Well, in Latin American private equity there's also an overarching guideline for both LPs and GPs - 'selection, selection, selection.'

Do risks differ in Latin America compared with other emerging market regions?

CA: Considering the region's volatility, heightened risk revolves around typically short windows for exiting investments. If you don't have nimble, imaginative managers, you can wind up holding on to companies for too long. There is also above average currency risk in each of the national markets. Typically, limited partners mitigate that risk by investing across a wide range of countries. This is where the exceptional macroeconomic diversity of Latin America - compared with, say, Southeast Asia - is actually a strong point.

TWK: With regard to exits, it's crucial to have more than one alternative. Ideally, you want to find two or three viable exit strategies even before you invest. In addition to an initial public offering or strategic sale, another option is a sale to a financial sponsor. In recent years we've seen the arrival in Latin America of big, $1 billion-plus funds obliged to write equity checks equal to what companies raise in IPOs. But we also have smaller, mostly local middle market investors who can pony up considerably less and still impact investment returns. I would posit that this segmentation gives the middle market investors an advantage in terms of exit opportunities.

NW: I'd add that the practice of 'dollar-cost averaging,' staggering regular payments for assets over the life of a private equity fund, a tactic employed by many Latin American managers, is actually a fairly effective means of neutralizing currency volatility. To further smooth out the impact of volatility, many managers also avoid concentrating capital disbursement for acquisitions in any particular year and instead spread it out evenly over an entire [typically five-year] investment period.

What level of return can investors reasonably expect from Latin American private equity?

CA: If you do your homework as an investor, you should be able to build a fund portfolio with the potential to match or exceed returns available in any other region in the world. But, I'll say it again, it all comes down to micro selection. In Latin America, being able to identify the best managers is arguably more critical than anywhere else. That's because the difference between top and bottom performing funds that come from the same vintage year and that focus on the same strategy averages some 40 percent. That's greater than in any other region, developed or undeveloped. The exceptional disparity means that if you can identify top-performing managers with a reliable competitive edge, you have the potential to do very well indeed.

NW: We aim for a gross return of at least three times our investments and we've always exceeded our fund performance targets. Our goal amounts to what we believe is an eminently achievable target for regional investments.

TWK: Though we don't have an investment multiple goal, our internal rate of return target is a 25-30 percent net yield. In practice, this equates to a 2.5 to 3.5 gross multiple. Given the relatively low acquisition prices we spoke about and the growth potential of regional companies, returns for sophisticated investors in Latin America can indeed be competitive with those of any other market in the world.

PRIVATE EQUITY BLOG

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

The Real Reason Private Equity Investment is Attractive

The outperformance of PE compared to public equities is widely publicized, with data from a range of providers showing that the former has outperformed relevant stock indexes by some 300 basis points annually over the last decade. Less appreciated is the lack of downside in PE. Research from Hamilton Lane and J.P. Morgan Asset Management shows two fifths of public equities experience catastrophic loss - a 70 percent or greater drop from peak value with minimal recovery. Yet less than 3 out of 100 PE funds suffer similar loss, making stocks a stunning 13 times more risky in this regard. While smaller PE funds are believed by many to outperform their larger brethren - they often hunt for investment in less capitalized corners of the market - billion-dollar-plus funds are especially low risk. According to Cambridge Associates, only seven PE funds managing over a billion dollars have ever lost money for investors.

PE-Backed Firms Do Better in Downturns

According to a fascinating 47-page report by Stanford's Shai Bernstein, Harvard's Josh Lerner and Northwestern's Filippo Mezzanotti titled "Private Equity and Financial Fragility During the Crisis," PE-owned companies do better than non-PE-backed firms of similar size, purpose and profitability during downturns. The academics found that on average over 500 PE-owned U.K. companies that entered the financial crisis with greater debt on their books than their peers recovered faster and ultimately captured more market share than non-PE backed companies. The long-term horizon of 10-year funds, the traditionally activist approach of PE owners and their access to cash meant the PE-backed companies were able to issue more debt and equity than peers, making them more resilient and finally faster growing. The exceptionally low interest rates that characterize most downturns were clearly a crucial success ingredient.

Annual secondary market leverage equals 23 percent of total volume.

A Resilient Secondary Market

Leverage used to buy secondaries in 2017 equals some 23 percent of the market's total volume of $45 billion. Use of deferred payments, debt and newer forms of leverage like preferred equity has ratcheted up returns, witness the average performance of secondary funds noted on page 1, while simultaneously keeping pricing attractive for sellers. And though it seems counterintuitive, the growth of leverage for secondaries - largely non-existent a decade ago - and the emergence of scores of banks and private funds eager to provide it, implies market resilience. The relatively low risk of PE, touched on throughout this blog, should ensure that leverage remains available, with little to no interruption in the event of a dip - sharp or gradual - in net asset values. Leverage will also help reconcile buyers - who would otherwise seek deep discounts in the event of recession - with sellers.

Tax Reform's Modest Impact on PE

Average annual interest payments at PE portfolio companies in the U.S. are between 32 percent and 42 percent of annual cash flow, according to industry estimates. At these levels - not much above the deductability cap of 30 percent of corporate cash flow on annual interest payments - tax reform in the U.S. should have minimal impact on PE returns. This is particularly true given the corporate tax cut from 35 percent to 21 percent. As a result of tax reform, portfolio companies may pay down debt a little more rapidly, while focusing more squarely on operational improvements for returns. Lengthening the time necessary to qualify for carried interest tax treatment to three years from one year should have little impact on fund managers – today only 11 percent of all portfolio companies are sold in less than three years.

Top-Quartile Persistence Weakens

A soon-to-be published study by Massachusetts Institute of Technology economist Antoinette Schoar indicates that only 12 percent of top-performing private equity managers now have back-to-back top-quartile funds, versus 28 percent and 31 percent prior to 2004 and 1999. This helps explain a variety of trends including the growth of limited partner staffs and the growing willingness of investors to invest in first-time funds, which frequently exploit less crowded niches holding the promise of above average returns. Indeed, a record 700-plus first-time funds are fundraising today, more than either the previous apex of 520 in 2008 or the 513 seeking capital in 2016.

OUR OFFICES

TRIAGO AMERICAS
499 Park Avenue, 20th Fl.
New York, NY 10022, USA
Tel: +1 (212) 593-4994

TRIAGO UK
43 Brook Street
London W1K 4HJ, UK
Tel.: +44 (0)203 871 4018

TRIAGO EUROPE
1 Boulevard de la Madeleine
75001 Paris, France
Tel: +33 (0)1 47 03 01 10

TRIAGO MIDDLE EAST and ASIA
DIFC – Emirates Financial Towers
PO Box 506681, Dubai, UAE
Tel.: +971 4 433 1009

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