THE TRIAGO QUARTERLY

Dear Reader,

It's shaping up as the best year for private equity exits and fundraising since the crisis. Private equity-backed purchases hit a three-year low in Q2, but that demonstrates resistance to paying high prices. These positives lend credence to the notion that PE managers produce superior returns, based on proprietary edge, while taking comparatively less risk than investors in public markets.

Over 2000 GPs are currently aiming to raise in excess of $800 billion - 2.3 times our 2013 fundraising forecast. LPs, struggling for mastery of complex portfolios, consider more strategies and invest with relatively few fund mangers. Many recognize the advantages of PE, yet it's more challenging than ever for GPs and LPs to navigate. This irony is dominant in our business and in this quarterly.

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

Sincerely,

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

INSIDE

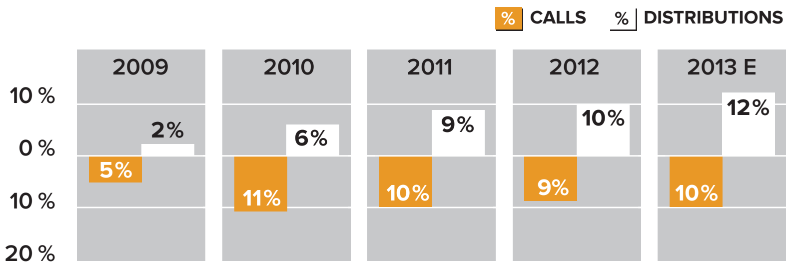
SNAPSHOT

Values are helped by exits…

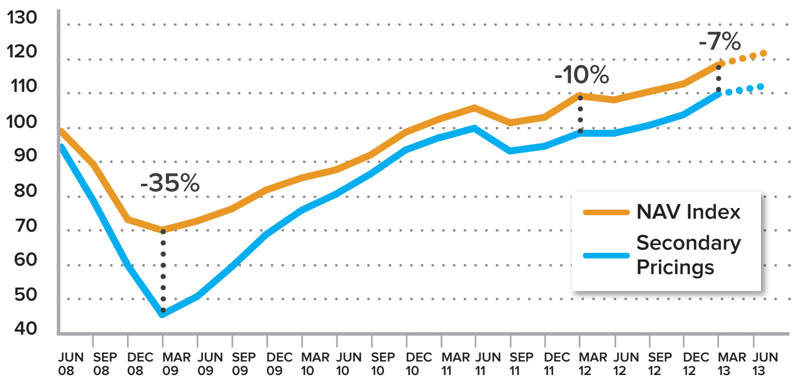
Private Equity Fund Net Asset Evolution

Strategy	FY 10	FY 11	FY 12	Q4 12	Q1 13
Large BO	+27.0 %	+2.5 %	+18.0 %	+5.3 %	+6.7 %
MM BO	+21.5 %	+4.4 %	+9.2 %	+1.8 %	+4.1 %
VC	+10.2 %	+8.1 %	+2.9 %	-2.3 %	+3.6 %
Special Sit.	+20.6 %	+0.5 %	+5.8 %	-2.2 %	+4.2 %
Energy	+15.9 %	-4.3 %	+1.0 %	+1.0 %	+2.0 %
Average	**+20.2 %**	**+4.1 %**	**+9.7 %**	**+2.1 %**	**+4.9 %**

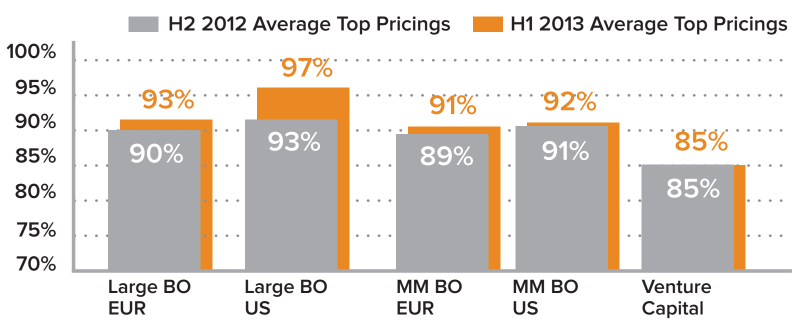
…sending net cash to investors…



…giving sellers leverage in secondaries.



Secondary Fund Types



Liquidity gets a boost

Portfolio exits rise, fundraising improves and secondary discounts narrow, but funds struggle to buy assets.

Average net asset values rose an estimated 6.6 percent in the first half of 2013 across all categories of private equity funds, aided by a positive exit environment and rising share prices for the listed comparables of portfolio companies.

High initial public offering prices for private equity-backed share sales in the world's developed markets have been of particular help to net asset values. Private equity exits of all kinds notched their second best three-month period ever in the second quarter, raising almost $100 billion.

Those exits, aided by dividend recapitalizations, are returning net cash to investors. In the first half of 2013, limited partners received distributions equal to 6 percent of the capital committed to private equity funds, while calls to finance new investments amounted to 4 percent of committed capital. An uptick in investments and calls in the second half is a reasonable assumption; general partners are likely to favor investing capital over giving up annual fee income as commitments expire. But even with calls forecast at 10 percent of committed capital for 2013, Triago expects the exit pace to continue, with distributions at 12 percent for the full year.

Unlike exits, the number of private equity-backed purchases has fallen steadily in 2013. With an estimated $145 billion in unspent PE commitments set for rolling 12-month expiry this year, many industry observers thought GPs would have invested more of that record bulge by now.

In Triago's conversations with GPs, they cite the uncertain global economic outlook as a key reason they are not willing to pony up the large sums sellers often want. Normally positive conditions for purchases - factors that are helping PE exits - are also contributing to broken negotiations, with owners opting for cheap financing over sales, or selling via attractively priced IPOs. Declining PE purchases in recent quarters also mean rising estimates concerning the amount of commitments likely to reach term without being invested. Triago believes some $20 billion may expire this year without being invested, adding significantly to investor cash.

Global fundraising in 2013, helped by positive investor cash flow and measured by final closes, hit $178 billion through June, on pace for a full year total of $356 billion, 32 percent more than 2012 and the largest annual sum raised since 2008. The less good news: the number of funds reaching final close rose only 5 percent versus the same period a year ago, to 277, while average fund size increased 9 percent to a record $643 million. A relatively small number of funds achieving final close, coupled with rising average fund size, is a multi-year trend. Post-financial crisis, LPs prize efficiency, committing more money to fewer managers, while frequently avoiding smaller funds where large investment is difficult, or due diligence is challenging.

> A volume log-jam in secondaries will break when specialists pay closer to par.

Greater LP liquidity, fueled by rising distributions, and a record $63 billion in committed but unspent capital held by secondary funds and the secondary pockets of funds-of-funds, means secondary market seller leverage is growing. July's average discount to net asset value is some 7 percent, narrowing from 9 percent at the end of 2012.

Sellers' power to accept or reject offers is rising, yet annual secondary market volume is likely to decline to $20 billion or less in 2013, falling about 23 percent from last year's record. With plenty of distributions coming in, LPs have less reason to sell their funds. This volume log-jam in the secondary fund market will probably break when more specialists, eager to deploy their large supplies of dry powder, pay closer to par. Some specialists, focusing on the lower risk of a mature secondary portfolio compared with primary blind-pool investments, are already adjusting assumptions, and hence their offers.

Long-Term Strategy

What are the best fund managers doing to put their firms on sustainable growth paths?

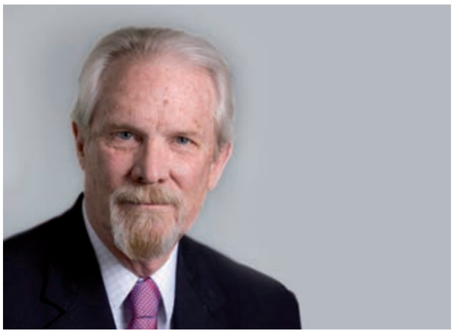
There is a palpable feeling among private equity professionals that it's never been harder to create a sustainable business model for general partner firms. Private equity fundraising has risen strongly in recent months, but it remains well below the levels achieved during the pre-financial crisis years of 2005 to 2008. As average fund size rises, the money that does get raised goes to surprisingly few firms. In this context, Triago invited two general partners who have built thriving businesses post-financial crisis, and a highly respected academic, to discuss what - beyond the necessity of posting good investment returns - can be done to put private equity asset management firms on sustainable growth paths.

CONNI JONSSON

Managing Partner at EQT Partners

DAVID JEFFREY

Head of Europe at StepStone Group



COLIN BLAYDON

Professor of Management and Director of the Center for Private Equity and Entrepreneurship at Dartmouth's Tuck School of Business

"Is long-term development harder to achieve today for private equity asset managers than it was before the financial crisis?"

CJ: It is harder than it was, but not because of lower annual fundraising, which many might identify as the culprit. It's tougher, overall, because there is more limited partner scrutiny of fund manager operations and more regulatory burden. A long-term shakeout is going on among general partners, with the weak falling by the wayside, but what that means for firms with good performance is that there is less fundraising competition than before the crisis. Pressure regarding governance is something that even general partners with top performance can't ignore if they want to build long-term relationships and sustainable business models.

DJ: For StepStone, there is no pre-crisis comparison. We were founded in 2007 and so only really got started in the teeth of the financial crisis. We have grown organically, but we have also made some strategic acquisitions to enhance our capabilities, during a period when investors are rationalizing their relationships with private equity managers. If your aim is to create a robust private equity group with solid long-term growth prospects, you've got to stay ahead of the curve by anticipating, as much as possible, the needs of investors. Hopefully, the financial crisis has reminded all managers looking to build businesses over the long-term to remain humble and avoid complacency.

CB: I agree with Conni and David's points. I'd underline that the StepStone model that David just spoke about is a particularly interesting example of adjusting to the times, and is so far a unique example of building a major private equity firm through consolidation. Private equity asset managers of all types are merging here and there, and we will see more of it. But none have used the process to build a major brand the way StepStone has done.

"What are the specific steps you've taken to build a sustainable business?"

CJ: Apart from producing good returns, the key moves we've made all serve to create a welcoming environment for us to operate in. It is of the utmost importance, and it will become more essential as our industry expands and matures, to reassure stakeholders that private equity firms are valuable, trustworthy economic partners. At EQT, we engage and communicate more intensely than in the past with unions, politicians and journalists, and through them, with broader society. Recent changes designed to improve transparency and accountability, which we publicize as much as possible, include bringing all our funds onshore and creating an independent board. General partners that don't take similar steps won't be able to invest freely, and they won't build organizations that endure.

DJ: At StepStone, everything from strategic development to the nitty-gritty of product implementation is client-led. That means whatever we do is a carefully crafted response to limited partners' needs. Sustainable long-term development depends on adhering to this client-first mentality, and constantly remaining on message.

"Colin, you don't operate a general partner business. But what are the issues today that managers should focus on if they want to transform investing prowess into a sustainable business model?"

CB: There are two particularly relevant issues. Given the large number of aging private equity firm founders, one is how leaders transition away from active involvement so that their firms thrive. What makes this difficult for many - particularly those running successful firms with a strong brand - is general partner and investor reluctance to see the architect of success step back. This is compounded by the difficulty general partner organizations have fostering career development and power-sharing in the presence of a strong, charismatic leader. Another big challenge today is communications. As Conni implied, this is increasingly important for attracting capital and closing deals. At the best-run firms, the once generally accepted ad-hoc approach to investor relations has morphed into a formal, broad public relations function, embracing all stakeholders.

"A number of firms are trying to zero-in on specialties to create more defensible business models. Is that wise?"

DJ: Expertise can give a manager a competitive advantage in complex industry sectors and geographies. It can be an even bigger plus for a manager to have more than one specialization, ideally in areas that are uncorrelated. The drawback is that specialization can constrain the sample size of attractive investment opportunities. It may even limit a manager to a poor macroeconomic investment environment. Notwithstanding the perceived move towards specialization, investors ultimately back firms that offer the best risk-adjusted returns.

CB: Evolution toward specialization is normal in a private equity industry that's mature and increasingly competitive. In fact, I would posit that firms that claim to be generalists today are general only in the sense that they are made up of multiple specialist teams. What's essential is that the evolution towards greater specialization be the gradual result of deal experience, and not the result of a plunge into virgin territory.

CJ: We are all saying the same thing. General partners should not be asking themselves "should I be a specialist." What they've really got to do is make up their minds about what they're good at and stick to it. Without that, there is no build up of knowledge and expertise and so no real value add for investors. EQT has invested in the same industrial sectors for twenty years, adding infrastructure along the way only because it shared characteristics with the kinds of deals we knew we were good at. The rest of our growth has been geographic. After Sweden, we expanded into the Nordics, and then into German-speaking Europe and the Benelux. We are carefully building up in the U.S. and Asia. In all these markets, we buy the same kinds of companies we've been investing in for decades.

"The U.S.-based superstrata of general partners - the famous mega-funds - say attracting retail money, particularly capital earmarked for retirement, is key to long-term general partner growth. Do you agree with that?"

CB: That seems to be the case. The large, institutionally-managed, defined-benefit pension pools that are indispensible sources of private equity capital in the U.S., are moving towards extinction. Defined-contribution plans – by definition small retail accounts managed by individuals – are set to take their place. Many general partners dependent on U.S. capital, are anxiously looking for ways to tap that retail money. Adding to worries, a long-term, illiquid, private equity fund investment style doesn't work with capital supplied by a multitude of individually managed accounts. Finding a standardized, pooled structure for retail retirement accounts that aligns interests and incentives fairly is not going to be easy, but it is key for the long-term viability of many general partners.

CJ: Granted, the eventual disappearance of defined-benefit plans is an issue that is challenging the established way of doing things in the U.S. But there are enough rapidly growing, professionally-managed capital sources internationally so that access to money should not be a major hurdle for general partners with good performance. A range of non-retail entities, both public and private, in China, Japan, the Middle East and Latin America are investing in private equity funds, with the flow growing quickly enough to make up for any future shortfall from U.S. pension funds. A structure giving retail investors in the U.S., or elsewhere, an attractive, low-cost way to invest in private equity would be a very positive development, but I don't see it as necessary for general partner survival.

DJ: I'm with Conni. I would add that while I understand the concern about finding a pooled structure that properly aligns interests, it strikes me as reasonable for retail investors to have the opportunity to access private equity, subject to the appropriate protections, since it has substantially outperformed almost every other asset class.

> Unorthodox PE structures often mean GPs sell services too cheaply to build sustainable businesses, or to deliver returns that satisfy investors.
>
> **CONNI JONSSON, EQT PARTNERS**

"Do private equity asset managers need to move beyond classic funds, offering co-investments, separate accounts, deal-by-deal structures, cash-out options and other non-traditional investing possibilities to keep their businesses relevant for investors?"

DJ: Traditionally, general partners have treated limited partners as an ATM every third or fourth year, while non-classical structures have been the province of managers struggling to fundraise. Yet increasingly we are seeing more creative general partners introducing less orthodox investment structures, not primarily as a means of growing their income, but as a reflection of evolving limited partner sophistication. Separate accounts are a way for limited partners to develop more customized and flexible portfolios, while reducing their costs. Similarly co-investments are a way for investors to benefit from their primary fund commitments and get incremental exposure to deals they like at lower fees. Savvy general partners looking to build long term relationships with investors are becoming attuned to these evolutions.

CJ: I understand the appeal of using non-classic structures as a means of building long-term relationships, but the offers boil down to general partners selling services cheaply – often too cheaply to build sustainable businesses, or to deliver returns that satisfy investors. You can offer an investor cut-price access to your expertise as a way of building a long-term relationship, but if you don't perform well the investor will still walk. Ultimately, unorthodox structures make superior performance harder, begging the question of just how relevant or desirable such terms are for investors. There is a quid pro quo implicit in a classic fund structure that's good for everyone. In exchange for a fair annual fee and fair carry over a threshold return, general partners can deliver the capital gains investors want, in a way that is sustainable over generations.

CB: We should keep in mind that today non-classic arrangements are the major fundraising strategy for the mega-firms we spoke of earlier, and the tier of general partners below that. The big guys are engaging in what is essentially a low-margin volume strategy. They are doing it aggressively and from a position of strength, increasing pressure on all private equity asset managers. Faced with this new competition, general partners who adhere to classic fundraising structures have less room for error than in the past. For the majority of firms, it's never been harder to build a sustainable business model in private equity.

PRIVATE EQUITY

BLOG

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

Prices: Not as Low as They Seem

Going by averages, it's been years since private equity firms paid so little for acquisitions. According to Standard & Poor's Leveraged Commentary & Data, between the fourth quarter of 2012 and 2013's second quarter, the average purchase price paid by PE firms fell from 9.2 times EBITDA to 7.8 times EBITDA. The latest multiple, down from one commonly associated with the low-profit deals of the 2005 to 2008 credit bubble, was last seen over three years ago. Yet a two-quarter fall in multiples - Q1 hit the ten-year average of 8.4 - is not representative of cheaper prices. It's evidence of failed negotiations in the large deal category, where prices are higher than in smaller transactions. A surprising number of funds are not spending money in the face of high prices, despite a record level of unused PE fund commitments set for expiration this year. The number of buyouts in the second quarter was the lowest in three years.

Leveraged Buyouts Lose Market Share

In the U.S., the world's largest private equity market, PE firms are engaging in fewer debt-fueled buyouts of mature companies, favoring instead smaller, growth capital deals. According to figures from Pitchbook, growth transactions, designed to help companies expand their revenues, accounted for 28 percent of all U.S. PE transactions in 2013's first half, while buyouts, focused on making larger, older companies more efficient, accounted for 34 percent of acquisitions. Those are respectively the high and low water marks of the past decade. The contrasting figures support the idea that PE firms are reluctant to invest in mature companies at a time of slow macroeconomic growth, but are actively looking for companies where products and strategy offer counter-cyclical growth potential.

Sensible: Swinging for the Fences in Private Equity

According to research recently presented by China Investment Corporation, China's enormous sovereign wealth fund, private equity returns from general partners following identical strategies and investing from the same vintage, produce annual returns that vary on average by 13 percent. Venture capital, PE's most inefficient sector, shows a 21.2 percent return gap. Yet the difference between the best and worst fixed income managers is only 3 percent annually. The clear implication: time and money spent finding the best PE managers pays off. In asset classes where proprietary information is hard to come by, and acting on such information is often illegal, the numbers indicate it's more profitable to follow an index strategy.

Secondary Direct Volume Should Rise

Secondary directs, where limited partners sell fund stakes en-masse to new investor groups - usually in conjunction with a restructuring of general partner teams and carry incentives - have seen their share of secondary market volume rise to 12 percent this year from half that level in 2012. Secondary directs could climb steadily, peaking in 2016 or 2017 at as much as 25 percent of market volume. Pressure to restructure poorly performing portfolios of record size, dating from the credit bubble's plentiful fundraising years of 2005 to 2008, should be at its maximum then. Yet to make secondary directs palatable to many potential sellers, arrangers will have to aggressively employ deferred payment, rollover and other options offering greater upside. Discounts to net asset value on secondary directs can be 20 percent or more.

> Secondary directs could peak at 25 percent of secondary market volume.

The Baby Boom-Driven Shift to Secondaries

Since the first baby boomers – born in 1946 according to the U.S. Census Bureau – began retiring in strength two years ago, Triago has seen more U.S. defined-benefit pension plans cutting allocations to primary private equity investing, while sharply raising investments in secondary fund stakes. Secondaries, like primary PE investing, offer potential double-digit annual returns, yet deliver typically in three to five years, versus ten years or more when investing in funds at launch. With the baby boom generation retiring over the next 16 years, defined-benefit plans should significantly increase secondary investment from dwindling capital bases. Meanwhile, general partners are likely to replace defined-benefit plan capital with pooled, retail structures for PE.

www.triago.com

OUR OFFICES

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

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

TRIAGO MIDDLE EAST & ASIA
DIFC, The Gate, Level 15
PO Box 50 6681, Dubai, UAE
Tel.: +971 4401 9525

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