Private equity professionals expressed cautious optimism at the start of 2012. Both 2010 and 2011 saw year-over-year increases in the overall level of deal flow volume and capital invested, the U.S. economy seemed to be improving and private equity firms were sitting on more than $450 billion of “dry powder” just waiting to be invested. It seemed almost certain that 2012 was poised to be the best year for the private equity industry since the financial downturn in 2008.

However, early optimism was quickly muted as political and regulatory uncertainty in the U.S., combined with a dearth of desirable deal opportunities, contributed to an unexpected decline in total deal flow volume and capital invested through September 2012. Even so, the year was not without its bright spots. In fact, a turnaround began to take shape during the fourth quarter when, according to PitchBook, the amount of capital invested neared levels not seen since the fourth quarter of 2011 and, before then, the fourth quarter of 2010.

To take the pulse of the industry and identify the key challenges and opportunities that will impact private equity in 2013, the Private Equity practice at BDO USA, LLP, conducted its fourth annual Perspective Private Equity Study from November through December 2012. This year’s study, which examined the
opinions of more than 100 senior professionals at private equity firms throughout the U.S., found that despite a disappointing year in 2012, private equity professionals remain confident in the industry’s sustained recovery, as firms continue to adjust and adapt to today’s evolving investment environment.

In fact, the majority of private equity fund managers (75 percent) responding to BDO’s study reported that they believe the current environment is either “somewhat” or “very” favorable for private equity funds looking to invest. That’s compared to a mere 3 percent of respondents who identified the current environment as “very unfavorable” and another 22 percent who said it was “somewhat unfavorable” for private equity funds trying to close new deals.

At the same time, however, fund managers are not anticipating a sudden boom in the level of deal volume in 2013. Fifty-seven percent of fund managers – regardless of fund size – expected to close between two and four new deals during the next 12 months, which is only a small increase from the 47 percent of fund managers who indicated they closed between two and four new deals during 2012.

Fund managers did, however, report a more optimistic outlook than last year, when only 7 percent of respondents expected to close more than four new deals in the year ahead. Looking into 2013, 36 percent of fund managers expect to close more than four new deals during the next 12 months. That’s a 29 percent increase in the number of funds that expect to close five or more deals when compared to last year and, if expectations hold true, it could point to a marked uptick in deal flow volume in 2013.

Correspondingly, fund managers remain confident in their primary investment strategies. Only 11 percent of respondents said they have asked their Limited Partners (LPs) to allow them to change investment strategies to broaden opportunities and only 9 percent said they will do so during the next 12 months. Fund managers at large funds – those with more than $1 billion in assets under management – were the most likely to reevaluate their investment strategies, with 22 percent having done so in the past year and 16 percent indicating they will do so in the coming year.

"Political and regulatory uncertainty, combined with the dearth of projects meeting fund managers’ criteria, made 2012 a disappointing year for many private equity fund managers who saw both deal volume and capital invested decline. Even so, many fund managers have taken steps to enable them to succeed in the ‘new normal’ investment environment and remain confident that 2013 will bring new opportunities to put their capital to work." – Lee Duran, Partner & Private Equity Practice Leader at BDO

**SECONDARY BUYOUTS EXPECTED TO DRIVE DEAL FLOW**

When it comes to opportunities for deal flow, secondary buyouts are expected to be a major driver of activity in 2013. According to PitchBook, 47 percent of the more than 6,500 private equity-backed companies at the end of 2012 were acquired from 2005 to 2008, during the height of the investment boom. With the median age of a private equity-backed company at approximately 4.9 years, many private equity funds will be looking hard for opportunities to exit their mature investments in 2013. Conversely, with billions of dollars of “dry powder” still in many funds’ coffers, others will be eager to put that capital to work.

As such, BDO’s study found that 64 percent of fund managers believe that private equity funds exiting their current investments will be the key driver of private equity deal flow in the next 12 months. Another 14 percent reported that private equity funds investing in distressed businesses will be the key driver and 10 percent thought it would be corporates seeking financing for strategic acquisitions.

“Secondary buyouts emerged as a prominent exit and deal-sourcing opportunity in 2012. Fund managers expect this trend to continue in 2013, as private equity firms seek out opportunities to realize a return on their mature investments, many of which were made before the financial downturn, and establish or bolster return track records, which is critical when it comes to raising new funds.” – Ryan Guthrie, Partner in the Private Equity Practice at BDO

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The healthcare and biotech industry was also identified as an attractive sector for new investments in 2013, with 19 percent of respondents indicating that it will provide the greatest opportunities, followed by natural resources and energy (17 percent), financial services (5 percent) and media/information (4 percent). Only 3 percent of respondents indicated that retail and distribution will provide the greatest opportunities during the coming year. Still, many private equity funds continue to find compelling investment opportunities in the retail sector, providing capital to companies with strong value propositions to fuel their expansion into new merchandising channels and markets overseas.

“U.S. manufacturing will continue to be an attractive sector for private equity investments, particularly as reshoring accelerates and domestic companies look to expand their operations into foreign markets. Today, we’re finding compelling investment opportunities in U.S. manufacturing companies with quality, technology, product design and innovation that cannot easily be replicated by low-cost providers overseas.” – Robert Austin, Director with Industrial Growth Partners

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SOUTH AND CENTRAL AMERICA CONTINUE TO PRESENT THE GREATEST OPPORTUNITY FOR NEW INVESTMENTS

With regard to geographies that will provide compelling investment opportunities in 2013, the largest percentage of respondents (42 percent) – regardless of fund size - indicated that, other than North America, South and Central America will present the greatest opportunities for new investments during the next 12 months. That’s followed by Continental Europe and Asia, including Southeast Asia (equally, 22 percent), the Middle East and Africa (10 percent) and Eastern Europe, including Russia (4 percent).

On the other hand, large funds - those with more than $1 billion in assets under management – are looking to Continental Europe for the most attractive investment opportunities outside of North America in the coming year, with nearly half (47 percent) identifying that region as the geography that will present the greatest opportunity for new investments in 2013. That’s followed by South and Central America (32 percent), the Middle East and Africa (16 percent) and Eastern Europe, including Russia (5 percent). No respondents from funds with more than $1 billion in assets under management identified Asia, including Southeast Asia, as the region that will provide the most compelling investment opportunities during the next 12 months.

FUNDS INCREASE HOLDING PERIODS, LOOK TO SALES TO STRATEGIC BUYERS TO GENERATE RETURNS

While exit activity may continue to increase in 2013 as secondary buyout activity ramps up, fund managers’ expected average holding period for individual portfolio companies is also on the rise. PitchBook data conclude that the median holding period for portfolio companies has risen approximately 53 percent since 2007, from 3.49 years to 5.33 years after the first half of 2012.

According to BDO’s study, this trend is likely to continue. In fact, the majority of private equity fund managers (82 percent) responding to BDO’s study said that their current expected average holding period is longer now than 12 months ago. Of those with longer holding periods, the largest percentage of respondents (35 percent) indicated that their expected average holding period is now seven-12 months longer and another 29 percent reported that it is 13-18 months longer.

When asked how their exit assumptions have changed when compared to 12 months ago, 35 percent of fund managers reported an increased focus on sales to strategic buyers, 11 percent reported an increased focus on sales to financial buyers and 9 percent indicated an increased focus on a long-term hold. Only 4 percent reported an increased focus on IPOs, roughly the same (2 percent) as in last year’s study.

With the exception of IPOs, fund managers’ changes in exit assumptions correspond with their expectations for the greatest returns. The majority (64 percent) of fund managers expect sales to strategic buyers to generate the greatest returns during the next 12 months, followed by 15 percent who think IPOs will generate the greatest returns and 11 percent who reported that sales to financial buyers will do so. One in 10 fund managers (10 percent) reported that exits will not generate a positive return in the current market, which speaks to...
the lingering challenges of portfolio company performance and the hangover from frothy valuations placed on original investments.

**PORTFOLIO COMPANY PERFORMANCE & QUALITY OF TARGETS RANK AMONG TOP CHALLENGES FACING PRIVATE EQUITY**

When asked to rank the challenges facing private equity firms in the coming year, the largest percentage of fund managers (28 percent) indicated that the identification of quality targets would be their most significant challenge, followed by maintaining portfolio company performance (26 percent). Fund managers with larger funds – those with more than $1 billion in assets under management – were particularly concerned about maintaining portfolio company performance, with the most respondents (35 percent) ranking it as the primary challenge they will face during the next 12 months.

“Private equity fund managers are feeling pressure on all sides of the fund cycle. General malaise in the global economy, combined with pricing concerns, has created a challenging environment for fund managers working to source and close deals while, at the same time, they are under increasing pressure to optimize portfolio company performance and realize returns on their aging investments.” – Lee Duran, Partner & Private Equity Practice Leader at BDO

**PORTFOLIO PERFORMANCE IS ON THE RISE AS FUNDS MITIGATE LOSSES**

In good news for private equity firms, portfolio company performance seems to be on the mend. According to BDO’s study, 64 percent of fund managers saw the overall value of their current portfolio increase during the past 12 months. That’s compared to only 15 percent who saw the value of their portfolio decline and approximately one in five (21 percent) who indicated the value of their current portfolio stayed the same during 2012.

Of fund managers who saw the value of their portfolio decline, 46 percent indicated that their fund’s value decreased by less than 6 percent and the same percentage (46 percent) said that it had declined by 6-15 percent. Another 8 percent reported that their fund’s value declined by 16-25 percent, the largest reported decrease. That’s a 29 percent improvement from last year’s study, when 83 percent of respondents reported that their fund’s value decreased by 6 percent or more.

Conversely, of fund managers who saw the value of their portfolio increase, the largest percentage (38 percent) reported increases of 16-25 percent during the past year, followed by increases of 6-15 percent, which were reported by 34 percent of respondents. Nine percent of respondents reported an increase of 26-35 percent and another 7 percent reported increases of more than 50 percent in 2012.

The improvements fund managers have seen in the performance of their portfolio companies during the past year correspond with steps they have taken to mitigate losses and improve the returns on their investments. During the past year, 72 percent of fund managers have reassessed market strategy at portfolio companies performing below forecasts or expectations. Another 67 percent have monitored cash flow on a weekly basis, 58 percent have reduced headcount, 58 percent have reduced costs by scaling back, and 53 percent have renegotiated debt.

“Track record will always be a critical differentiator for private equity firms looking to raise new funds. However, with blockbuster deals – and returns – becoming more elusive, Limited Partners have increased their focus on funds’ management teams and their ability to make operational enhancements to garner a return on Limited Partners’ investments.” – Dan Shea, Managing Director with BDO Capital Advisors, LLC and a Member of the Private Equity Practice at BDO
FUNDRAISING CONTINUES, WITH FAMILY OFFICES, PENSION FUNDS COMMITTING CAPITAL

Despite a difficult fundraising environment, the majority (64 percent) of fund managers are receiving new commitments from LPs. That’s a marginal increase from last year when 63 percent of fund managers were receiving new commitments from LPs, but a significant uptick from 2010 and 2009 when 56 percent and 40 percent of fund managers were raising new funds, respectively. The largest percentage of fund managers (45 percent) indicated that they are receiving the majority of first-time financial commitments from family offices, followed by pension funds (24 percent), international investors (18 percent), endowment funds (10 percent) and universities (2 percent).

When it comes to Limited Partnership Agreements, 15 percent of fund managers indicated their management fees have changed, with 6 percent reporting an increase and 9 percent reporting a decrease. Of those who reported an increase or decrease, 75 percent and 70 percent, respectively, indicated that their management fee has changed 0.50 percent above or below the standard 2 percent management fee.

Other major findings from the BDO Perspective Private Equity Study include:

- **Funds Invest Most Capital Toward New Deals, Add-Ons:** Nearly three in four (72 percent) fund managers invested the most capital toward new deals during 2012, and another 14 percent directed the most capital toward add-on acquisitions. Approximately 7 percent of fund managers reported directing the most capital toward funding portfolio working capital needs, while paying back portfolio company debt and restructuring debt were both identified as top capital expenditures by 4 percent of respondents.

- **Funds Continue to Pursue Add-On Acquisitions:** Add-on acquisitions will likely receive a significant amount of capital in 2013 as well, with 87 percent of fund managers reporting they will seek add-on deals in the year ahead. That’s compared to 81 percent who reported seeking add-ons in 2012. Fund managers at smaller funds – those with less than $250 million in assets under management - reported the largest shift in their focus on add-on deals. Eighty-seven percent indicated they will seek add-on acquisitions in 2013 compared to only 76 percent who did so in 2012.

- **Tax Burdens, Changes to Treatment of Carried Interest Pose Significant Challenge:** One in seven (14 percent) private equity fund managers – regardless of fund size – identified the impact of tax burdens on private equity, including the possible increase of tax on carried interest along with increasing tax rates and surtax on net investment income, as the most significant challenge facing private equity firms in 2013. Pricing also ranked among top concerns, with 15 percent of fund managers identifying it as the primary challenge in the year ahead.

- **Funds Report Hiring, Increasing Headcount at Portfolio Company & Fund Level:** For the third year in a row, the majority of private equity fund managers (71 percent in 2012, 62 percent in 2011 and 63 percent in 2010) reported that they will increase professional staff headcount at the portfolio company level during the next 12 months. When asked about the past 12 months, 63 percent of respondents said they have increased professional staff headcount and another 30 percent reported increasing administrative staff headcount at the operating company level. At the fund level, 51 percent of respondents reported increasing employee count during the past year and 44 percent said they plan to do so during the next 12 months.

- **Bankruptcy Filings Among Private Equity-Backed Companies Set to Decline:** One in 10 (10 percent) fund managers reported that they declared bankruptcy on one or more portfolio companies in 2012. However, when looking into 2013, the outlook is brighter. Only 5 percent of fund managers expect to declare bankruptcy for one or more portfolio companies in the coming year.

“Today, more than ever, investors are looking for General Partners with the ability to add distinctive value to their portfolio companies. Limited Partners are demanding investment cases that are built on tangible blueprints to drive fundamental improvements in their acquired businesses, rather than just financial arbitrage or leveraged growth.” – Doron Grosman, Operating Partner with Court Square