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2013 Private Equity Fund Outlook

In search of firm footing

Deloitte Center for Financial Services

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Introduction

As 2013 approaches, private equity firms find themselves navigating new ground as limited partners (LPs), regulators, legislators, the public, and equity shareholders dissect the industry's business practices and look for changes. The industry is fielding tough questions from regulators on operational areas like marketing documents, the safety of client assets, and various conflicts of interest. It is being thrown into the political debate as legislators and the public scrutinize fee structures and profitability as part of the tax debate. In addition, LPs are demanding better alignment of terms, more insight into distribution and expense allocations, and customized relationships.

Complicating matters further, deal making remains elusive as competition for quality investments remains high and those willing to sell are demanding bigger valuations.[1] Continued economic weakness and market volatility is clouding the investment environment, slowing the pace of initial public offerings, and making it more difficult for prior investments to recover their value.

And yet, the industry continues on its upward trek. Assets under management[2] (AuM) climbed to a record $3 trillion in 2012,[3] and LPs are still attracted to private equity given the industry's historic ability to generate returns across various economic environments.

We expect the industry to continue attracting fresh capital during 2013, but we expect that growth to be uneven. Investors are being increasingly selective about where they're putting cash. While a handful of general partners (GPs) will likely raise significant capital, we believe much of the industry may struggle to raise new funds. Their success will likely hinge on their ability to tap emerging opportunities in age-old industries like oil and gas, expand hybrid offerings that access traded instruments such as

bank debt and other distressed assets, open new cash veins with public equity investors and corporations, and offer LPs customized solutions such as separate account mandates and co-investment strategies.

In short, GPs will have to rethink their business and operating models in 2013 in the following ways:

- Managing regulatory, compliance, and tax uncertainties
- Pursuing new growth opportunities amidst elusive exits
- Identifying operational efficiencies to combat cost pressures

1 Dan Primack, "Private equity has $1 Trillion to Invest," Fortune, July 31, 2012, <http://finance.fortune.cnn.com/2012/07/31/private-equity-has-1-trillion-to-invest/>.
2 AUM is calculated as the sum of uncalled commitments ($1 trillion) and the market value of portfolio companies ($2 trillion).
3 David Benoit, "Private Equity Industry Hits $3 Trillion in Assets," The Wall Street Journal, July 30, 2012, <http://blogs.wsj.com/deals/2012/07/30/private-equity-industry-hits-3-trillion-in-assets/>.

Managing regulatory, compliance, and tax uncertainties

Private equity funds are facing intense scrutiny over regulatory, compliance, and tax issues as LPs and regulators take a closer look at the industry's practices. Self-governance has historically been the industry's preferred approach, but those days are now over.

Private equity advisers are confronting many of the same tax and regulatory developments faced by hedge funds. Focus areas in 2012 included the Securities and Exchange Commission's (SEC) registration and Form PF — both mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) — the Foreign Account Tax Compliance Act (FATCA), and the Alternative Investment Fund Managers Directive (AIFMD).

Greater regulatory and compliance demands have been especially challenging and costly for many private equity managers who have yet to fully achieve their target compliance program to meet the new standards. Firms are also preparing for potentially higher tax burdens on portfolio and management companies, but struggling to pick the right path because there are many unanswered questions about potential tax legislation reform.

What's new for 2013

The pace of regulatory- and compliance-driven investments will likely accelerate in 2013 as firms strive to meet demands from regulators, LPs, and tax legislators.

While the SEC's regulatory focus may shift as a new chairperson takes over, some details are firming up with the recent examinations' focus on waterfalls and the release of agency guidance on its upcoming "presence exams." Still, many private equity advisers have limited experience sharing operational information with regulators and might not be prepared to manage comprehensive SEC investigations without the right level of support.

In the months ahead, we expect some private equity advisers will continue to enhance their compliance strategies by investing in infrastructure and personnel, fortifying their controls, training employees, and developing robust compliance policies. Others lacking effective in-house compliance policies or controls, will likely turn to service providers to quickly ramp up compliance infrastructures.

Increasingly sophisticated LPs are also prompting private equity shops to improve their compliance capabilities by asking for improved transparency and customized reporting. Due diligence is no longer an afterthought for LPs, which are instead prolonging the process and more comprehensively digging into a firm's operational and organizational infrastructure to assess its resilience.

Tax compliance and optimization strategies are also attracting attention in the industry as private equity managers prepare for potential tax changes, including the expiration of Bush-era tax cuts, an increase in the self-employment tax rate, and a new Medicare Contribution Tax. The industry may face additional tax-driven challenges and opportunities as the government tries to reduce public debt levels through tax policy reforms. For example, some legislators continue to consider carried interest legislation a priority.

At the portfolio company level, tax burdens may increase in certain jurisdictions as governments face pressure to raise tax revenues in response to economic weakness. The New York Attorney General recently announced an investigation over the use of management fee waivers as a tax optimization strategy, creating even more uncertainty around policy changes.[4]

In light of all these changes, private equity advisers will need to increasingly pursue strategies to mitigate tax risks at both the management company and portfolio company level.

Bottom line

Following in the footsteps of the hedge fund industry in recent years, we believe private equity is set to face more scrutiny in 2013 and beyond. Firms are girding for additional oversight by putting in place more robust compliance infrastructures and hiring experienced people to manage them. Creating a culture of compliance, especially among senior executives, takes time, but it will be key to attracting assets in the future as investors pay more attention to this hot-button issue.

4 Victor Fleischer, "What's at Issue in the Private Equity Tax Inquiry," The New York Times, September 4, 2012, <http://dealbook.nytimes.com/2012/09/04/whats-at-issue-in-the-private-equity-tax-inquiry/>.

Pursuing new growth opportunities amidst elusive exits

Private equity funds are grappling with the increasing regulatory burden at a time when returns are getting harder to unearth. Deals dried up last year as the market for initial public offerings slowed. Additionally, many investments made during the investment heydays of 2006 to 2008 are not performing as well as projected, thanks to the ripple effects of the global financial crisis and lingering economic weakness. Still, the bond market remains healthy, even as credit terms have tightened and equity contributions have increased. The revival of dividend recapitalizations funded by Payment In Kind (PIK) toggle bonds offers evidence of this.[5]

With public pension underfunding approaching record levels and bond yields near all-time lows, we believe the private equity industry is well positioned to tactically seize growth opportunities in 2013. LPs are still attracted to private equity given the industry's historic ability to generate returns across various economic environments. Private equity firms with the strongest track records, or those that are willing to support customized relationships, will likely see a greater share of new asset growth in what is likely to be an uneven year for the industry's development.

What's new for 2013

Deal activity is likely to pick up in 2013 as private equity managers put more capital to work. Sectors such as oil and gas, real estate, healthcare, distressed debt, and infrastructure may be ripe areas to mine for opportunity in the year ahead. Despite rising volatility and inflation risks, investments should also pick up in emerging markets like China, India, and Brazil.

Exit activity always depends on market conditions, and if those conditions remain tight many firms may look to alternative strategies. Some may choose to exit certain investments earlier and at lower than anticipated valuations than they had originally envisioned given pressure to give cash back to LPs. Selling portfolio companies to other private equity firms may also be a popular avenue in this regard.

Another option firms may pursue is to solicit cash infusions from public equity investors or corporations, where cash stockpiles continue to mount. This may be a sound strategy for companies who have seen their home currencies appreciate, such as those based in Japan; Japanese corporations hold about $2.5 trillion in cash, surpassing the estimated $2 trillion held by U.S. firms.[6]

Customization may offer another viable route to fundraising. We expect LPs to ratchet up their demands in 2013 for separate account mandates, co-investment strategies, or secondary market fund investments. Such customized relationships can also help solidify ongoing collaboration between LPs and GPs. Certain municipal pension funds may use customization to channel investment dollars into their local economies.

Some established private equity firms will likely continue moving to a broader mix of asset management products. This strategy allows them to expand on their existing relationships and make better use of their established distribution channels. In fact, some are on their way to becoming diversified financial service providers, leveraging strong performance records, close LP relationships, and in some cases a permanent capital base from public equity markets to expand their offerings.

Taking advantage of new rules that restrict traditional banking activities, many private equity firms have hired talented traders and are planning to grow hedge fund, mutual fund, and even exchange traded fund AuM in 2013. Certain private equity advisers may expand through real estate investment trusts or by adding capital markets capabilities. Diversification could be a meaningful growth engine in 2013, especially for established private equity advisers with strong track records.

Bottom line

With growth expected to be uneven in the private equity industry in 2013, we believe executives will be selective about where they choose to invest their time and resources. For some more experienced firms, adding new assets will be a top priority. Others will be more focused on putting cash to work and successfully liquidating legacy investments.

5 Agnes T. Crane, "With Safeguards Built In, PIK-Toggle Bonds Rise Again," The Globe and Mail, November 7, 2012, <http://www.theglobeandmail.com/globe-investor/investment-ideas/with-safeguards-built-in-pik-toggle-bonds-rise-again/article5066946/>.

6 Kana Inagaki and Atsuko Fukase, "Cash-Rich Japanese Firms Go on Global Buying Spree," The Wall Street Journal, May 29, 2012, <http://online.wsj.com/article/SB10001424052702303505504577403743150818820.html>.

Identifying operational efficiencies to combat cost pressures

A volatile geopolitical backdrop in the United States, Europe, and emerging markets like China and India is squeezing the private equity industry's top-line revenue growth, which is highly geared to economic developments. The industry cannot rely on the coattails of GDP growth, multiple expansion, or leverage to drive alpha — at least not for the forseeable future.

Private equity firms will therefore need to find efficiencies in their own operations as well as their portfolio companies to help generate returns. Emerging capabilities in data management, accounting, customer relationship management (CRM), and waterfall automation technologies are providing alternatives for private equity managers as they consider changes to their operating model and underlying infrastructure.

What's new for 2013

Private equity firms looking to boost the performance of their operations in 2013 will likely look to two areas: third-party administration, and process and technology improvements.

The outsourcing of back-office functions has helped private equity shops become more comfortable with using third-party administrators, and we expect these relationships to expand to more ancillary services, such as investor reporting portals, in the coming years.

Meanwhile, the industry will continue to adopt improving technology capabilities in fund accounting, CRM, waterfall automation, data management, tax databases, and document management systems to control deal flow. While many of these technologies have existed for years, the push to improve, automate, and control the manual processes prevalent in the private equity industry is driving late adopters to reconsider their benefits.

The increasing costs associated with investor demands for information and transparency, as well as new compliance requirements driven from Dodd-Frank, FATCA, and AIFMD, are also prompting private equity managers to reevaluate the skills sets and processes they need in-house to fulfill these requirements. A fresh look at people, processes, and enabling technologies will continue to drive gains in efficiencies and improvements in the capabilities of private equity managers.

Portfolio company managers are also likely to focus on improving operations, given the lackluster growth that continues to challenge many geographies and industries. This focus will be especially apparent in the middle market, where some managers are developing sophisticated cross-functional operations expertise.

Bottom line

With firms challenged to deliver top-line growth, the focus is shifting back to the operations side of the business. Prior successes in outsourcing back-office services to third-party providers are paving the way for firms to expand such relationships as well as firms that currently operate in-house to consider leveraging an outsourcing partner. While some in the industry have yet to tap the full benefits of improved technology capabilities, many will likely make up lost ground in 2013 as cost efficiencies emerge as a tangible lever to deliver alpha.

Of course, gains in operational efficiency don't materialize overnight. We believe private equity executives will increasingly embrace a longer time horizon when evaluating streamlining opportunities during 2013, because challenging conditions may persist for an extended period of time.

Conclusion

The private equity industry faces an unprecedented level of uncertainty around deal making, fundraising, regulatory developments, tax legislation, and increasing operational demands. These challenges are prompting investors to be more selective about who they partner with as they try to navigate the slippery surface the markets have become. They are looking for GPs with proven track records for managing uncertainty and delivering returns in difficult times. But they're also on the hunt for private equity firms who will work with them to offer a customized level of service that aligns with their complex needs.

As we look across the terrain, we see the potential for bifurcation between firms who are reaching new heights by taking these demands seriously and changing their ways, and those who are standing still and not pursuing new paths. We believe there are plenty of opportunities for the industry to narrow this gap in the year to come, if they shift their focus and adapt to the new market realities.

The question now is whether private equity funds can reach new heights while balancing increasing demands from LPs, regulators, and shareholders.

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