BDO PERSPECTIVE SEVENTH ANNUAL PRIVATE EQUITY STUDY

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Private Equity Activity Maintains Holding Pattern as Investors Await Economic Clarity

Following a robust 2014, private equity (PE) activity leveled off in 2015—and with 2016 off to a shaky economic start, PE industry leaders are moderating their expectations for the coming year.

According to BDO USA's 2016 ***PErspective Private Equity Study***, an annual survey of private equity fund managers in the United States and Western Europe, 95 percent of PE firms plan to close five deals or less in the coming year. The comparable statistic from last year's survey was 87 percent, which suggests that the deal market is getting more challenging.

The study also found that firms are largely planning to maintain 2015 investment levels and priorities as they wait out economic turbulence. Seventy-eight percent of fund managers say they invested $100 million or less in 2015, while another 78 percent anticipate deploying this same level of capital over the next 12 months. PE firms also remain focused on new platform deals, with two-thirds of respondents saying they directed the lion's share of their 2015 investments to new deals, comparable to the proportion reported in last year's study. Add-ons were the second most-popular use of capital, cited by 24 percent of fund managers. When asked which factors they expect to drive deal flow in the year ahead, 31 percent of respondents point to private equity exits, and another 31 percent cite private company capital raises and sales.

95%

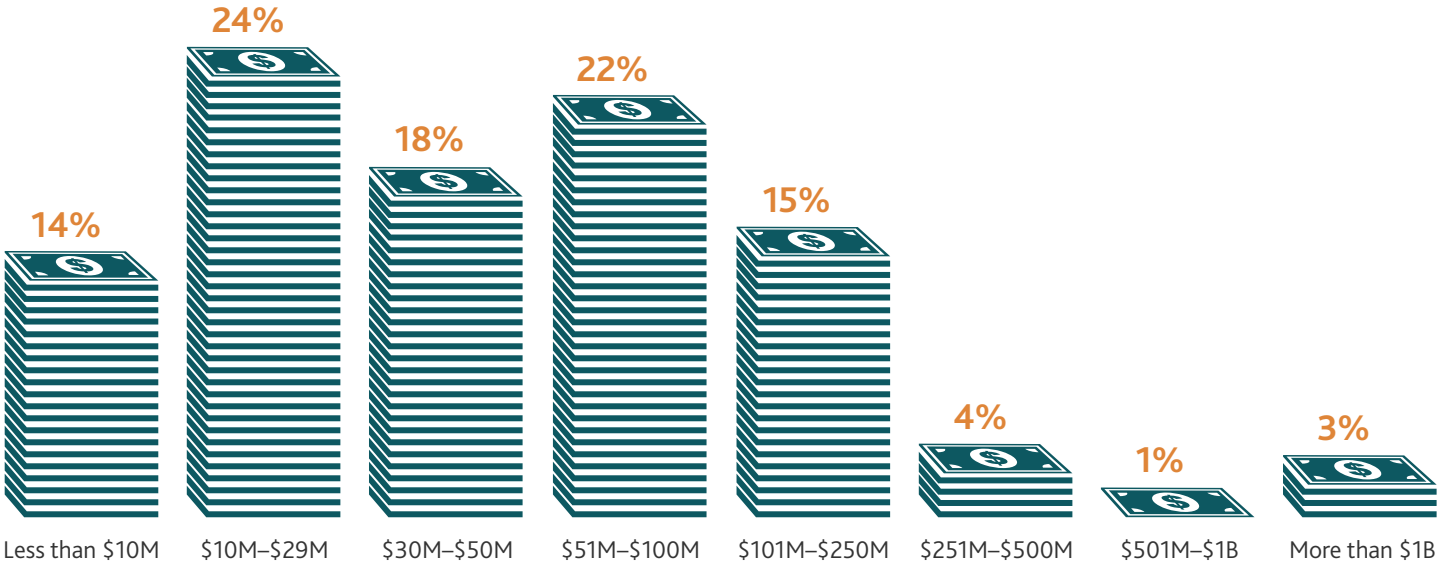
of PE firms plan to close five deals or less in the coming year.

The ***Seventh Annual BDO PErspective Private Equity Study*** is a national survey of 147 senior executives at private equity firms throughout the U.S. and Western Europe. The survey is administered by PitchBook, an independent and impartial research firm dedicated to providing premium data, news and analysis to the private equity industry.

"With private equity investments generally performing as well as, and in some cases better than, traditional public market investments, fund managers continue to see opportunity despite some economic bumps in the road. PE is a longer game, and though short-term fluctuations in performance are to be expected, the chances of long-term gain remain in investors'—and by extension, private equity firms'—favor."

Scott Hendon, partner and Private Equity practice co-leader at BDO

FUND MANAGERS' ANTICIPATED INVESTMENT LEVELS IN 2016



Private equity leaders also believe the challenges they faced in 2015 will hold steady in the coming year. As in our 2015 study, pricing remains the top challenge respondents expect PE firms to face in 2016, cited by more than a third of those surveyed. At the same time, 64 percent of fund managers cite gaps between buyer and seller pricing expectations as their top obstacle when it comes to closing deals, up from 48 percent in 2015. With the past few years largely favoring the sell-side, some sellers may need to come to grips with the possibility that economic realities are beginning to favor buyers.

Despite fund managers' conservative 2016 planning, though, 70 percent of respondents still feel optimistic about the investment environment for the year ahead, up from just over half of respondents (56 percent) in 2015.

Uneven Portfolio Company Performance May Be Driving Caution

Uneven portfolio company performance, catalyzed in part by economic uncertainty, may be an underlying factor creating the disconnect between fund managers' optimism about the investment environment and their conservative planning for 2016. Twenty-two percent of respondents report that 16 to 20 percent of their portfolio companies are performing below forecast, while another 20 percent of respondents say 20 percent or more of their portfolio companies are underperforming. However, the majority of respondents say that 15 percent or less of their portfolio companies are missing the mark, and 17 percent say that none of their portfolio companies are underperforming, the highest proportion since 2011.

The outlook for portfolio companies is not universally gloomy. Perceptions of bankruptcy risk have increased for a small proportion of respondents this year, with 8 percent of fund managers saying they are likely to declare bankruptcy for one or more portfolio companies in the coming year, up from 3 percent of respondents who had anticipated doing so last year. By way of comparison, 13 percent of fund managers in this year's survey report actually declaring bankruptcy for one or more portfolio companies in 2015, roughly consistent with the number who did so in 2014 (12 percent) and up from 8 percent in 2013.

When it comes to addressing underperforming portfolio companies, cost reduction programs and re-evaluating market strategies are leading tactics for fund managers, with 77 percent of respondents reporting that they have employed these approaches. Meanwhile, just 27 percent say they have engaged a turnaround professional.

Despite some difficulties in portfolio company performance, 67 percent of fund managers say that the value of their entire portfolio, including all funds, increased over the past year. Of those respondents reporting an increase in portfolio value, three-quarters say they saw growth of 6 to 25 percent, up from 68 percent of fund managers reporting the same level of growth last year. Only 13 percent of fund managers say their overall portfolio depreciated in 2015; 69 percent of these respondents report losses of 25 percent or less. These results remain consistent with last year's study.

As Valuations for Technology & Healthcare Companies Continue to Grow, Manufacturing Companies Remain Top Investment Target

In thinking about those industry segments that continue to thrive amid economic flux, fund managers cite the technology (68 percent) and healthcare/biotech (63 percent) sectors as the industries most likely to experience rising valuations throughout the coming year, consistent with their sentiments last year.

2015 saw tech companies achieve record valuations, with nearly 150 companies exceeding $1 billion or more. Even as the industry begins to cool in 2016, the sector's advancements in scalable IT services and cloud computing, as well as the continued proliferation of founder-owned startups, suggest that tech companies may continue to outpace other industries when it comes to unicorn valuations.

Private equity firms were also extremely active in the robust healthcare/biotech M&A environment last year. This trend is

"Given the uncertainty clouding market perceptions, fund managers need to be on the lookout for economic indicators that could forecast trouble down the line for their portfolio companies. Factors like wavering consumer confidence, faltering exports, loss of a major customer or inaccurate inventory estimates can be the canary in the coal mine for companies in struggling sectors, appearing before more traditional financial signals of distress. Fund managers who identify these warning signs early will be better positioned to help a distressed portfolio company execute a successful turnaround."

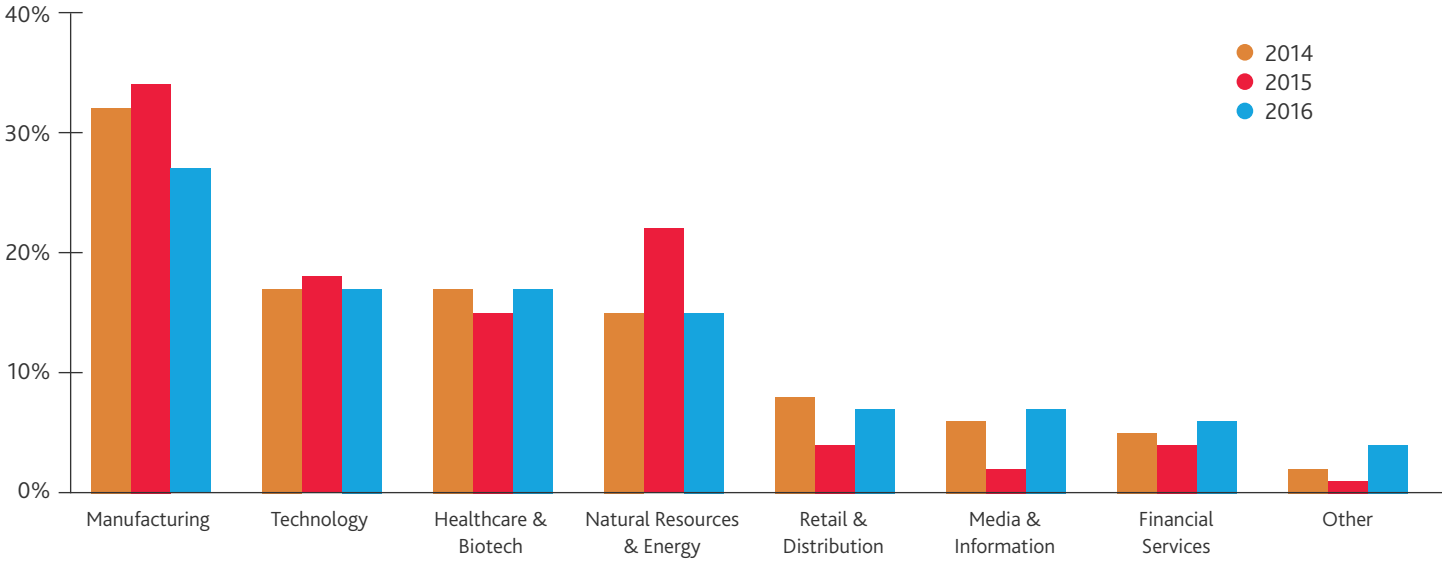
Karen Baum, BDO Transaction Advisory Services partner

"While PE interest in some healthcare segments, such as hospital and inpatient services, has been tempered up to this point, PE funds continue to be active in specialty areas such as behavioral health, dermatology and pain management, where they can leverage their operational expertise through a buy-and-build strategy and scale."

Patrick Pilch, managing director and Healthcare Advisory practice leader with The BDO Center for Healthcare Excellence & Innovation

INDUSTRIES PROVIDING THE GREATEST INVESTMENT OPPORTUNITY IN 2016

$ of Fund Managers



largely expected to continue in 2016, as service providers continue to consolidate and investors maintain interest in emerging healthcare technologies, such as mobile and telehealth.

Meanwhile, 59 percent of those surveyed deem the retail & distribution sector the most likely to see declining valuations this year as growth in the industry continues to stagnate and consumer confidence remains volatile. In addition, following a tumultuous year for the oil and gas sector, fund managers are somewhat polarized in their expectations for natural resources and energy companies, whose valuations have steadily fallen alongside oil prices since 2014. While 55 percent of fund managers surveyed believe the industry will continue to experience decreasing valuations over the next 12 months, more than a third believe valuations will increase, and 15 percent believe natural resources and energy will offer the greatest opportunity for investment. This disparity is likely driven by uncertainty about how natural resource and energy companies will weather a continued price depression, including whether a growing pool of distressed oil assets will provide promising investment prospects.

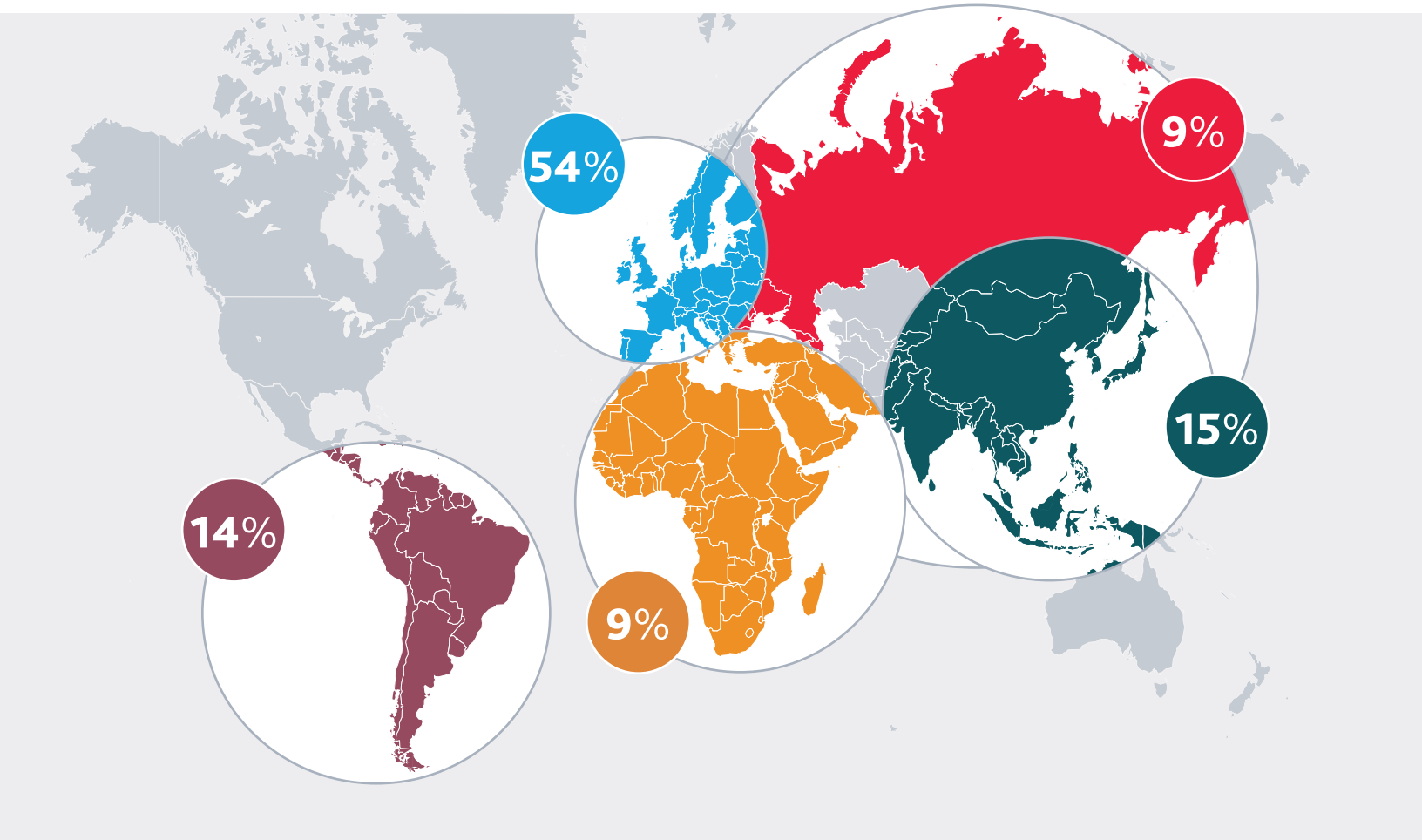
Though the natural resources sector is struggling, the manufacturing industry is poised for a solid year ahead—perhaps as a result of the oil slump, which has provided manufacturers some relief from lagging exports due to a strong U.S. dollar and weak demand for durable goods. About one-quarter of the fund managers surveyed indicate that the manufacturing sector will generate the greatest opportunity for investment in the next 12 months as manufacturers take advantage of low energy prices to ramp up production and minimize the associated costs.

"Manufacturers are taking advantage of current conditions to set themselves up for future success. The U.S. has a sustainable energy cost advantage, thereby making U.S. manufacturers more competitive globally. As such, the appeal of the manufacturing industry for private equity investment may continue for years to come."

Dan Shea, managing director with BDO Capital Advisors, LLC

Top International Investment Targets

Outside of North America, during the NEXT 12 months, which ONE of the following geographic areas do you think presents the greatest opportunity for new investments?



- Continental Europe
- Eastern Europe, including Russia
- South and Central America
- Asia, including Southeast Asia
- Middle East and Africa

Investment in Emerging Markets Tepid as Economic Woes Persist Globally

Despite the decrease in deal flow in the latter half of 2015, fund managers have a generally optimistic view of the international investment environment, with a majority (65 percent) believing it will be favorable for PE firms looking to invest. Despite this, two-thirds of respondents do not anticipate increasing their cross-border activity. The number of firms saying they do plan to pursue more cross-border deals, however, has increased slightly from 28 percent last year to 35 percent this year, suggesting that some funds may be increasingly willing to expand their geographic focus in order to find good deals.

While attitudes surrounding international investment have largely remained the same, there have been significant shifts in where fund managers believe opportunities lie. Last year, 41 percent of respondents pointed to Asia as the top region for international investment. However, though China's overall economic growth remains strong relative to other countries, its perceived market slowdown has generated concern that investor jitters and a depreciation of wealth may hinder investment opportunities in the region. As a result, just 15 percent of survey respondents point to Asia as their top regional target in 2016. Similarly, another 14 percent of fund managers cite Latin America—which is facing its own economic hardships—as a top investment opportunity, down from 30 percent last year.

With private equity firms seeking stability and more predictable market dynamics relative to those in emerging economies, more than half of the managers surveyed believe Europe will pose the best investment opportunities in 2016.

The challenges funds face in pursuing international activity have remained largely the same year-over-year. Fund managers point to local resources (31 percent), cultural nuances (30 percent) and regulations impacting cross-border acquisitions (23 percent) as the top challenges investors expect to face when evaluating or engaging in international transactions, consistent with 2015 results.

In an increasingly competitive deal environment, we have supported increased deal activity outside of the U.S., particularly in Canada and Europe. International deals can yield significant returns for PE firms seeking less frothy markets for new platform investments and strategic add-ons. These deals generally entail higher risk to complete and integrate; however, those firms that are looking beyond the U.S. market are poised to reap the benefits."

Ryan Guthrie, BDO Transaction Advisory Services partner

"Private equity firms with strong performance and leadership continue to attract Limited Partners, particularly pension funds. The soft 2015 and year-to-date portfolio performance are not expected to have a significant impact on raising new funds. In fact, despite certain risks, Limited Partners may see real opportunities in 2016, especially with firms focused on certain underperforming sectors."

Kevin Kaden, BDO Transaction Advisory Services partner

Fundraising Remains Robust, Fueled by Family Offices

Despite a cloudy economic forecast for 2016, it appears that investors remain eager to work with private equity firms and seek opportunities for potential long-term gain. Among the 64 percent of fund managers surveyed who say they are currently raising new funds from Limited Partners (LPs), 42 percent report receiving the majority of their financial commitments from family offices, followed by pension funds (24 percent) and international investors (21 percent). Fund managers with assets under management (AUM) of $251-$500 million, as well as those with AUM of more than $1 billion, show particularly strong interest in pension funds, with about half of the respondents from each bracket citing them as the primary source of financial commitments.

Overall, experience and results remain the most important criteria LPs assess when they evaluate potential General Partners. Fifty-eight percent of fund managers say LPs prioritize track record, and 27 percent rank the management team as the second most critical factor.

Exit Assumptions Remain Largely Steady, but Some Notable Trends Emerge

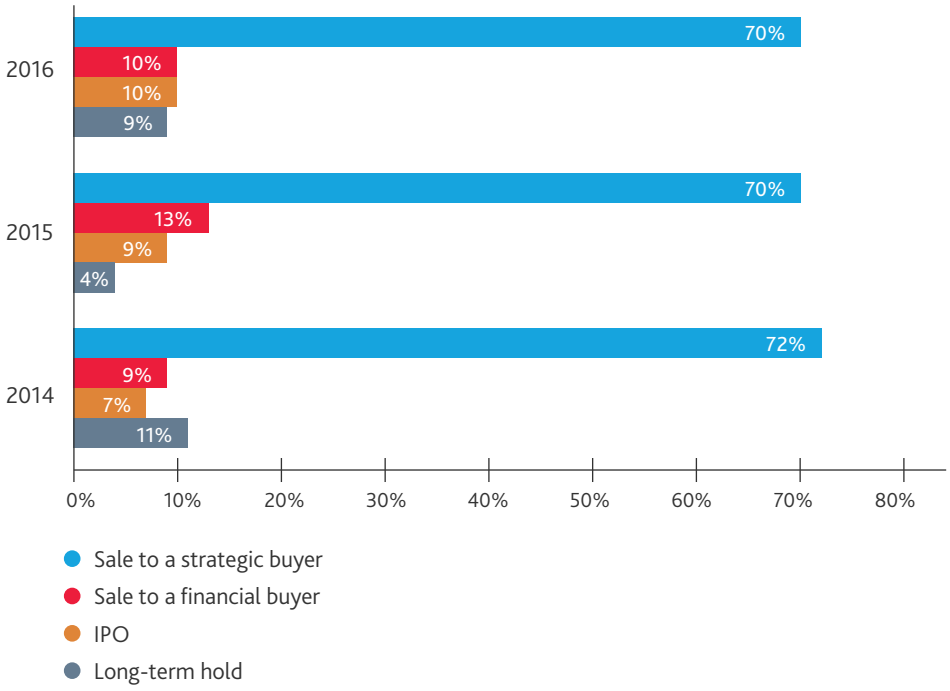
Consistent with prior years' studies, a plurality (46 percent) of fund managers indicate that their exit assumptions remain unchanged from a year ago. Seventy percent of respondents say sale to a strategic buyer is likely to generate the greatest returns in 2016, while 10 percent cite sale to a financial buyer, both fairly consistent with fund managers' sentiments in 2015 and 2014.

Though long-term holds remain uncommon relative to other exit options, they have appeared to grow slightly more prominent in this year's study. The proportion of fund managers saying they have increased focus on long-term holds more than doubled, from 7 percent to 15 percent, and 9 percent say they don't expect exits to generate positive returns in the current market, believing a long-term hold is the soundest option in 2016, up from 4 percent last year. It appears that smaller funds—those with less than $250 million in AUM—are most likely to pursue a long-term hold, with 23 percent reporting an average holding period of seven or more years. Nevertheless, holding periods across all AUM brackets align with the overall industry average of 5.5 years: More than half of respondents say their holding periods typically fall between four and six years.

Eighty-one percent of fund managers cite gaps in buyer and seller pricing expectations as the leading challenge to exiting their investments, a modest increase from last year (73 percent). Financial information uncovered by a third-party due diligence provider, considered the top challenge in 2015 by the second largest proportion of respondents (17 percent), grew less worrisome this year, ranked as the top concern by only 8 percent of respondents.

Respondents continue to be lukewarm on the prospect of public offerings, with only 10 percent expecting IPOs to generate the greatest returns in the coming year. In addition, just 4 percent of fund managers say they plan to increase their focus on IPOs as an exit option in 2016, down from 9 percent last year.

EXIT OPTIONS EXPECTED TO GENERATE THE GREATEST RETURN



Comparing Private Equity Trends in Europe and the United States

This year marked the first time the PErspective Private Equity Study was extended to include fund managers based in Western Europe. We found that, for the most part, European fund managers shared many of the same sentiments as their U.S. counterparts. Respondents were aligned in terms of anticipated deal flow in 2016, a primary focus on closing new platform deals, industries most likely to experience increasing valuations, exit assumptions and more.

But private equity fund managers in Europe and the United States operate in distinct environments, facing a number of different challenges, opportunities and regulatory barriers. Some of the more notable differences we observed this year include:

- European fund managers are more optimistic about their local investment environment than their peers in the United States. Eighty-eight percent of Western European respondents characterize the investment environment in their countries as favorable, a sentiment shared by 64 percent of U.S. respondents.

- U.S. firms are more likely to hire a dedicated business development professional to help them source deals. Thirty-three percent of U.S. fund managers say they use this strategy, while 18 percent of Western European fund managers report doing so.

- Western European fund managers depart from their U.S. peers when it comes to industries they expect will experience declining valuations. While 63 percent of U.S. respondents say the retail sector will see decreasing valuations, 55 percent of European fund managers feel similarly. Thirty-four percent of U.S. fund managers anticipate declining valuations in the tech sector, in contrast with 18 percent of European fund managers. Finally, 60 percent of European fund managers expect to see decreasing valuations in the financial services industry—the most-cited industry among this cohort. In comparison, 41 percent of U.S. respondents share this sentiment.

- Western European fund managers are more bullish on international investment, with 65 percent saying they plan to increase their cross-border transaction activity, while 78 percent of U.S. respondents say they will not.

- Western European fund managers are more concerned about cultural nuances and less concerned about regulations when executing international transactions. Forty-three percent and 18 percent, respectively, cite these as the top challenge they face. On the other hand, one-quarter of U.S. respondents point to cultural nuances as a challenge, while 28 percent cite regulation.

- Inbound investments comprise the majority of Western European respondents' financial commitments. Sixty-five percent of Western European fund managers say they're receiving most of their commitments from international investors, while only 8 percent of U.S. fund managers are receiving commitments from abroad.

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

Industry specialization and personal relationships are integral to deal sourcing

A majority of PE leaders (57 percent) say they specialize in an industry or region in order to identify and successfully execute deals, using their capital to focus on key industries and markets, especially in less traditional areas where capital may be lacking. Fifty percent work with buy-side intermediaries, such as bankers, as a sourcing strategy. This suggests that PE sponsors continue to rely on direct networking and relationships with intermediaries in order to target potential investment opportunities.

As deal volumes stagnate, funds are looking for add-ons to cushion low valuations

An overwhelming majority (88 percent) of fund managers sought add-on acquisitions last year in response to current market conditions, and the same percentage plan to use this strategy in 2016. Competition for sizeable deals is fierce in the current marketplace, and with deal volume languishing, tuck-in deals offer a relatively low-cost and low-stakes way to add value to an existing portfolio.

Regulatory concerns persist

Twenty-eight percent of respondents continue to cite Dodd-Frank as the most significant piece of regulation affecting their fund at the sponsor level, followed by the Affordable Care Act (23 percent). Another 18 percent are most concerned about the Alternative Investment Fund Managers Directive (AIFMD). With many European countries struggling to implement the regulation—and with the European Commission issuing warnings to those countries they perceive as dragging their feet—it appears that the AIFMD will remain top-of-mind overseas for the foreseeable future.

Enhanced transparency in focus

When asked which tactics they will leverage this year in response to increased SEC oversight, a majority (63 percent) of fund managers indicate that they plan to evaluate and improve their internal controls, and 42 percent say they will increase communications and disclosures to LPs. Thirty percent also cite monitoring agreements as an important component of their compliance plans in 2016.

Hiring practices to remain consistent with 2015 activity

Sixty-one percent of fund managers report increasing professional staff headcount among their portfolio companies in 2015, while 52 percent increased fund employee count, and 38 percent grew administrative staff among their portfolio companies. Looking to the year ahead, 62 percent plan to increase professional staff and 44 percent anticipate growing administrative staff among their portfolio companies. Fifty-three percent say they will add additional fund employees.

ABOUT BDO'S PRIVATE EQUITY PRACTICE

Strategically-focused and remarkably responsive, the experienced, multi-disciplinary partners and directors of BDO's Private Equity practice provide value-added assurance, tax and consulting services for all aspects of a fund's cycle, wherever private equity firms are investing.

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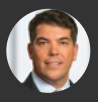
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