

# BDO PErspective

December 2009

## BDO PErspective 2009 Private Equity Study Executive Summary

Squeezed. That may be the most appropriate characterization for the state of the private equity industry in 2009. The near collapse of the financial markets in 2008 set off a string of events that led to an unprecedented year of challenges for private equity funds, their portfolio companies and investors. A lack of available senior debt, pricing concerns and the liquidity crunch forced private equity funds to scramble for ways to deploy capital, while at the same time keeping their portfolio companies afloat and attempting to earn a return for investors. In other words, they were squeezed from all sides.

In September 2009, BDO Seidman's Private Equity Practice conducted in-depth interviews with nearly 100 senior executives at private equity firms to understand more fully the actions that private equity funds took to manage through these challenges, and to take the pulse of the industry to gather opinions on key issues that will impact private equity in the near future.

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Strategically-focused and remarkably responsive, the experienced, multi-disciplinary partners and directors of BDO Seidman'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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**“The lack of senior debt available, combined with pricing concerns, means funds will continue to face significant challenges as they work to source and close deals. Even so, executives are confident a change will come, and they’re ready to go when it does.” – LEE DURAN**

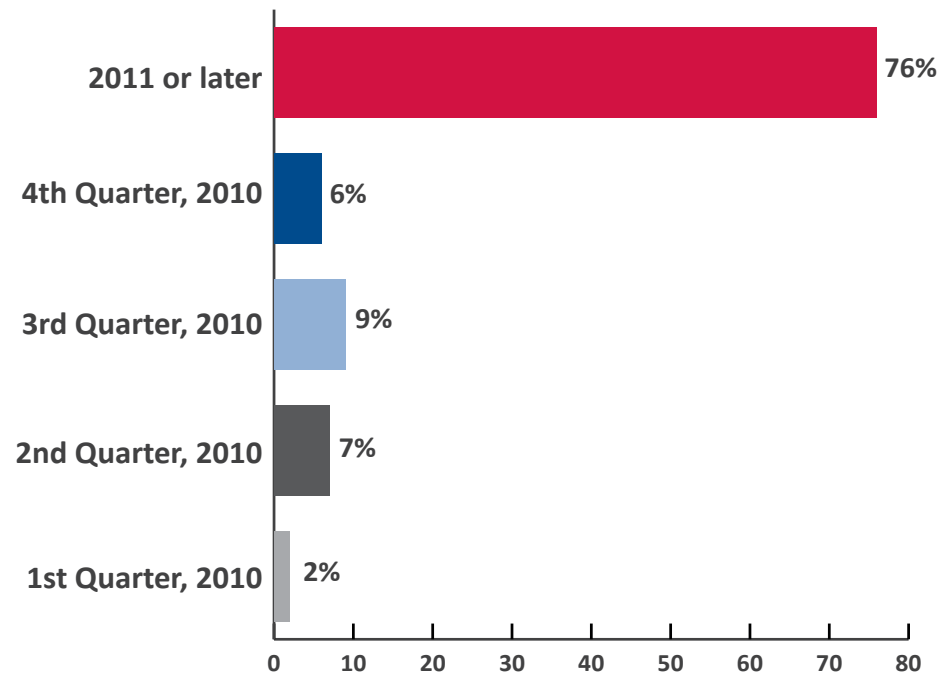
According to the *BDO Seidman PErerspective Private Equity Study*, despite recent signs of an uptick in the economy, private equity executives don’t expect a boom in deal flow volume anytime soon. The majority (76%) of private equity executives do not expect deal flow volume to return to 2007 highs until 2011 or later.

While early indications point to economic recovery, private equity executives, regardless of fund size, anticipate closing the same number of deals next year as they did during the past year. Three-fourths (76%) of respondents report closing between one and five new deals between Q3 2008 and Q3 2009 – and 82% expect to close between one and five new deals during the next year. The good news is that while 11% of respondents did not close any deals between Q3 2008 and Q3 2009, just 2% anticipate closing no deals in the next year.

## Funds Took Steps to Shore up Portfolios: Bankruptcy, Layoffs Prevalent

While private equity funds were hit hard in the past year, executives report that they’ve taken significant steps to mitigate losses, putting them on solid

In which quarter, of which year, do you expect global deal-flow volume to return to 2007 levels (approximately \$528 billion globally)?



**“Bankruptcy can be an important vehicle for restructuring a troubled company, and in recent months, we’ve seen many companies use bankruptcy to restructure debt. In many of these cases, the new debt can provide an otherwise operationally strong company the ability to emerge from bankruptcy with better leverage and a fresh balance sheet.”**

**– KEVIN KADEN**

ground for 2010. Half (51%) of executives surveyed say the overall value of their portfolio has decreased during the past year, and 56% say that more than 20% of their portfolio is performing below forecast or expectations. For those portfolio companies that are performing below forecast or expectations, 88% of PE executives report reducing costs by scaling back and 82% continue to monitor cash flow on a weekly basis.

As a result, nine in 10 (93%) report reducing headcount at their portfolio companies, 81% have renegotiated debt and 83% have reassessed their market strategy. Nearly three in 10 (28%) have declared bankruptcy for one or more portfolio companies, and 38% have engaged a turnaround professional.

Private equity executives will continue to view bankruptcy as a

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**“There’s no question that private equity has been hit hard by the downturn, but as executives look forward to a more hospitable deal climate, they’ve taken steps to remedy their battered portfolios, positioning them for growth once the economy turns around.” – MAT WOOD**

possibility for some portfolio companies in 2010 – 17% of those interviewed expect to declare bankruptcy for one or more portfolio companies in the next year.

**The Worst May Be Behind Them**

The good news is that the majority of executives believe that the worst is now behind them and remain committed to their primary investment strategies. Just 17% have asked their LPs to allow them to change investment strategies to broaden opportunities, and only 8% will do so moving forward. During the past 12 months, 86% of respondents said they reduced professional staff headcount at the operating company level, but only 40% believe they will need to do so in the coming year.

Looking forward, funds will need to continue to conduct extensive due diligence on potential acquisitions. With historical performance being impacted by economic conditions, and therefore less indicative of future success or failure, 36% of PE funds report that they’re placing a greater emphasis on the quality of earnings and cash flow when it comes to due diligence. One in five (20%) is using their internal team more now than they were in the past to scrutinize the target, and 17% have increased their use of specialist resources as a result of market turmoil.

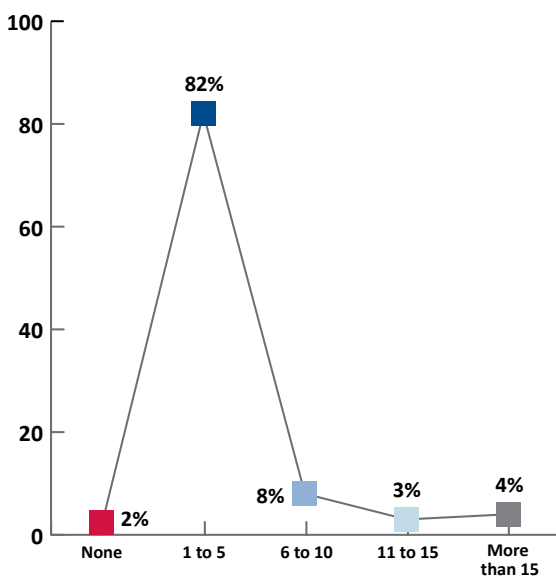
**Funds Seeking Bigger Deals in 2010 – Opportunities Exist in Asia, Healthcare Sector**

Despite anecdotal evidence pointing to more, but smaller, deals occurring now, private equity executives are hopeful that they will be able to deploy more capital in 2010 than they did in 2009. Nearly half (48%) of respondents report investing less than \$29 million through new deals and add-on acquisitions between Q3 2008 and Q3 2009, and 30% report investing between \$30 and \$100 million. The tables turn when they look ahead: 38% expect to invest less than \$29 million, and 39% expect to invest between \$30 and \$100 million in the coming year. Funds that invested \$101 million or more in the last year expect to invest about the same amount of capital between Q3 2009 and Q3 2010.

Overwhelmingly, PE executives believe that other than North America, Asia still holds the greatest opportunities for new investments during the next 12 months (66%). PE executives are split when it comes to other locations, and count South and Central America (9%), the Middle East and Africa (9%), Continental Europe (8%) and Eastern Europe (7%) as potential geographical targets.

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**Approximately, how many NEW deals do you predict you will close from June 30, 2009, to June 30, 2010?**



**“We expect to see continued innovation in investment strategies employed by private equity, and increased initial equity commitments until the credit markets stabilize.” – MAT WOOD**

In spite of recent buyout activity in the tech space, PE executives see the greatest opportunity in the healthcare (35%) and manufacturing (21%) industries, followed by natural resources (17%), financial services (12%) and technology (10%). Just 3% of executives believe there are opportunities in media, and even fewer (2%) see opportunity in retail.

## Funds Still Being Raised, Despite Extending Exit Timelines

In response to market conditions, eight in 10 (82%) PE executives report that they are extending average exit timelines. When asked how their exit assumptions have changed, 52% report an increased focus on recapitalizations and holding portfolio companies, 27% report an increased focus on acquisitions and 10% are focusing more on secondary buy-outs. Just 4% report an increased focus on IPOs.

An “exit wave” is unlikely in 2010, given the current environment, but in anticipation of more exits funds should ensure that sell-side diligence is leveraged to maximize value and ensure smooth liquidity event activities.

Despite a frosty fundraising environment, four in 10 (40%) PE executives report that they are receiving new commitments from LPs. Firms say they’re receiving the majority of first-

time financial commitments from pension funds (36%), family offices (29%) and international investors (25%).

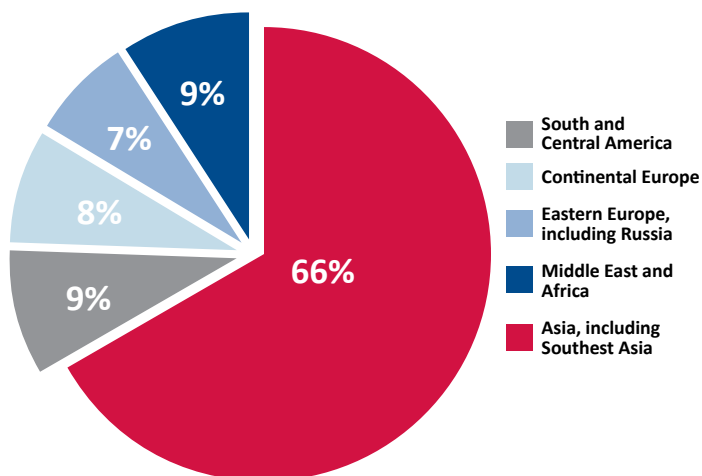
## Executives Concerned About Increased Regulation

Recent actions by the House Financial Services Committee suggest that fundamental changes to the private equity industry are afoot. Two-thirds (67%) of private equity executives surveyed expect the government’s new tax proposal on carried interest to pass. Private equity executives report that the passage of the proposal, which would raise the tax on carried interest from the current 15% capital gains rate to 39% and subject carried interest to self employment tax starting in 2011, will reduce the ability of funds to attract and retain top talent (43%), dilute the competitive position of US-based private equity firms (35%) and create additional administrative burdens (22%).

When it comes to the current administration’s proposals to regulate the private equity and alternative investment industries, 55% of PE executives believe that increased regulation will constrain the ability of certain funds and/or firms to do business, and that regulation will require cost and time that the industry cannot currently afford (26%). While 39% of private equity executives say their primary concern in the next year is the availability of leverage, 12% say they’re most concerned by these regulatory changes.

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Other than North America, during the NEXT 12 months, or so, which ONE of the following geographic areas do you think will have the greatest opportunity for new investments?

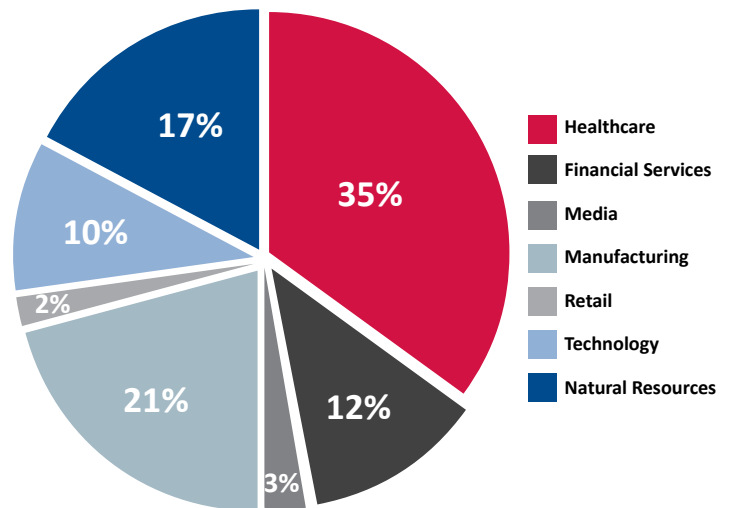


“Moving forward, it will be critical for funds to understand the impact that regulatory changes may have on their businesses in preparation for possible implementation in 2011.” – SCOTT HENDON

**Additional Findings from the BDO Seidman PERSpective Private Equity Study:**

- Focus on Earnings/Cash Flow:** With historical performance being impacted by economic conditions, and therefore less indicative of future success or failure, 36% of PE funds report that they’re placing a greater emphasis on the quality of earnings and cash flow when it comes to due diligence. One in five (20%) is using their internal team more now than they were in the past to scrutinize the target, and 17% are using specialist resources more now as a result of market turmoil.
- More Capital Directed through New Deals Last Year, Add-ons Not Far Behind:** More than half (56%) of capital invested between Q3 2008 and Q3 2009 went to new deals, while a sizeable portion (27%) went to add-on acquisitions and restructuring debt (10%). Among middle market funds – with active fund value of \$101 million to \$1 billion – the percentage of capital going to new deals was even greater (62%). One in five (21%) respondents from funds with less than \$100 million deployed capital through restructuring debt.
- Despite Economy, Execs Bring in a 3.5 GPA:** When asked to give a letter grade to their firm’s performance in closing quality deals, nearly half (47%) give it a “B,” and 30% say their firms deserve an “A.” One in five (21%) believe their performance warrants a “C.”
- Financial Risks:** Sixty-seven percent of executives interviewed say that quality of earnings and cash flows are the biggest financial risk to their next acquisition, followed by structure and leverage (33%).

During the NEXT 12 months, or so, in which ONE of the following sectors do you expect to see the greatest opportunity for new investments?



“Private equity firms with a proven track record and a solid history continue to be successful in launching new funds, even in the current marketplace. But many continue to face challenges in today’s fundraising environment, with 2009 fundraising being significantly below 2007 levels.”  
 – SCOTT HENDON

The BDO Seidman PERSpective Private Equity Study is a national telephone survey conducted by Market Measurement, Inc., an independent market research consulting firm, whose executive interviewers spoke directly to senior private equity executives, using a telephone survey conducted within a sample of private equity funds (ranging from \$10 million to more than \$1 billion).

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