



Private equity growth in transition

Evolve to meet
tomorrow's challenges

Deloitte Center
for Financial Services



Contents

Perspectives on growth	1
Section 1: Growth of the private equity industry	3
Section 2: Evolve to meet tomorrow's challenges	9
Contacts	16



Perspectives on growth

Private equity has grown dramatically over the past decade. Investor allocations, the outperformance of private versus public companies, and market appreciation have caused global assets to grow a new high of \$3.65 trillion, excluding venture capital.¹ This puts private equity industry assets well above the \$2.80 trillion held by alternative investment peer, hedge funds.²

Furthermore, private equity has outpaced other asset classes over the past decade, with assets rising at a robust 13.7 percent compound annual growth rate (CAGR) since year-end 2005.³ Comparatively, assets for worldwide regulated open-ended funds grew at a 7.7 percent CAGR,⁴ while hedge funds grew at 7.5 percent.⁵

Even though the industry has experienced steady growth over the past several years, it is critical to keep an eye on how the global environment may be shifting. Private equity growth has been slowing over the past few years,⁶ a trend that may persist. If this happens, managing to a new normal in private equity may be next on the agenda.

To counter the uncertainty of what lies ahead, whether it be a potential downshift in the pace of industry expansion or a momentary lull before returning to business-as-usual, we invite private equity managers to take a closer look at past industry growth and how its possible evolution may impact the business. Historic patterns, current trends, and future expectations are all part and parcel of managing toward an environment in transition. Taking a deeper dive into these areas, as detailed in Section 1 of this report, will arm private equity firms with information, ideas, and scenarios around how the growth story may play out.

Deloitte's perspective on potential industry growth scenarios is illustrated in our five-year projection for private equity assets. As reviewed later in the report, our Moderate scenario anticipates that private equity assets under management (AUM) may reach \$4.66 trillion by 2020, representing a 5.0 percent CAGR. This viewpoint takes into account both the current environment and our positive outlook toward future growth, albeit at a more subdued pace than over the last decade.

At the organization level, growth in revenue and profitability may be influenced in two ways: directly, through fund performance and investor commitments (which have been historically driven through the deal making by the front office, as well as fund-raising efforts backed by historical performance); and indirectly, through enhancing the operations of the middle and back offices. The division of this equation, meaning which part of the business influences a given percent of profit, becomes even more important if the pace of growth slows. If a slowdown occurs, all areas need to be adjusted accordingly. In that light, the important questions become not only "How do we grow?" but also "How do we protect the value of the growth already achieved? And how do we position the firm for tomorrow?"

Given our expectation for relatively slower growth in the future, this report focuses substantively on the latter two questions, offering actionable insights for private equity managers to consider in Section 2 of this report. However, first it is important to get a better understanding of growth itself.



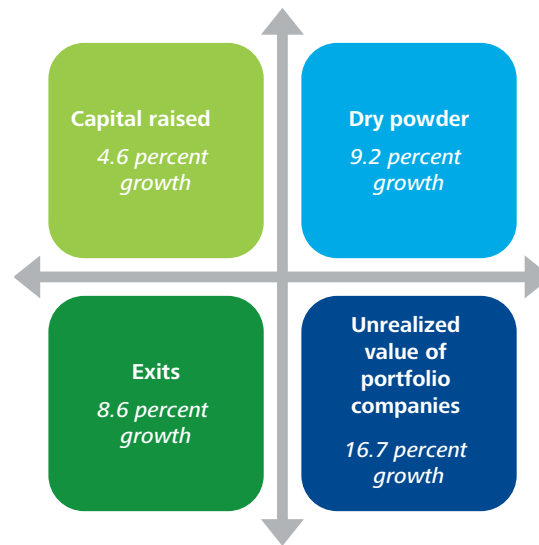
SECTION 1

Growth of the private equity industry

Private equity industry growth is perhaps best viewed through four metrics. As illustrated in Figure 1, these include capital raised, which has grown at a 4.6 percent CAGR over the past decade; dry powder or uncalled capital, at a 9.2 percent rate; exits, growing at 8.6 percent; and the unrealized value of portfolio companies at 16.7 percent. Total AUM, composed of dry powder and unrealized portfolio value, has grown at 13.7 percent annually.⁷ As previously noted, this puts private equity assets at a high of \$3.65 trillion.

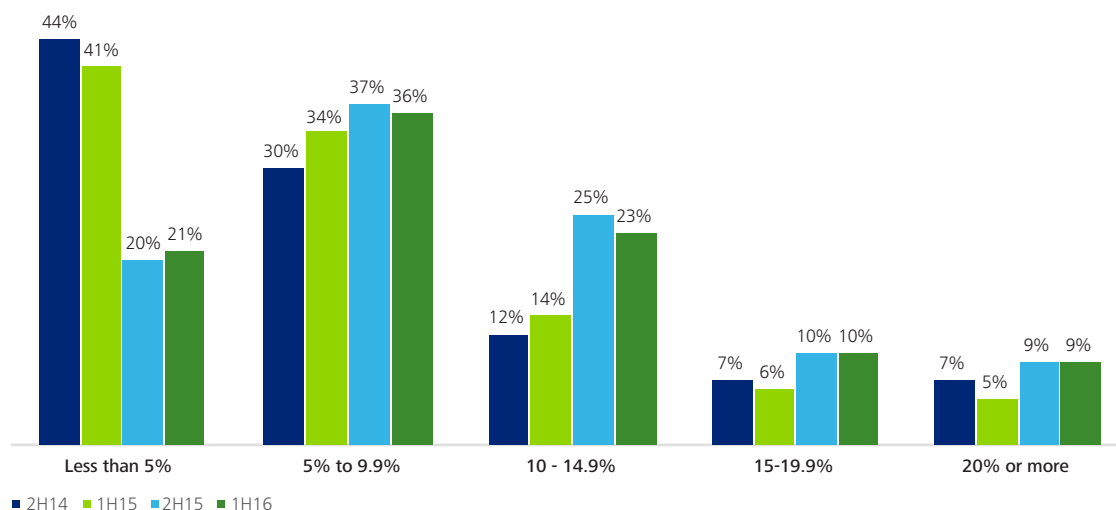
A number of factors have contributed to the recent high growth rate. While private equity firms were increasing fund profitability through favorable deal terms, improving valuations, easy access to capital, and financial engineering, investors have likewise been increasing their portfolio allocations to the asset class. Institutional investors surveyed by data provider Preqin, Ltd. report increasing their allocations across the board. Between mid-year 2014 and 2016, the number of investors allocating less than 5 percent to private equity dropped considerably (as shown in Figure 2), while all other allocation buckets increased.⁸ It appears this positive inclination may continue, as 88 percent of investors polled in 2016 plan to commit the same amount of capital or increase allocations over the next 12 months.⁹

Figure 1: A decade of private equity growth (by CAGR)



Source: Deloitte analysis of Preqin global data. © 2016 Preqin Ltd. / www.preqin.com. All data for the period of year-end 2005–2015, with the exception of exits, which is from 2006–2015. Unrealized value for year-end 2015 estimated by Deloitte.

Figure 2: Increase in investor allocations to private equity



Source: Deloitte analysis of survey data from Preqin Investor Outlook: Alternative Assets reports: 2H14–1H16. © 2016 Preqin Ltd. / www.preqin.com.

Public pension plans represent the largest investors, with 30 percent of total private equity assets as illustrated in Figure 3. Yet it is family offices (FOs) that actually contribute the highest percentage of their portfolio to the asset class. FO interest in private equity has increased over time, with FOs growing from 4 to 9 percent of total investors between 2011 and 2016, to reach the highest current allocation of 27 percent.¹⁰ While FOs hold only 5 percent of total private equity assets, these limited partners may represent an emerging opportunity,¹¹ particularly as 56 percent of FO survey respondents in 2016 indicate they have “more appetite for private equity.”¹²

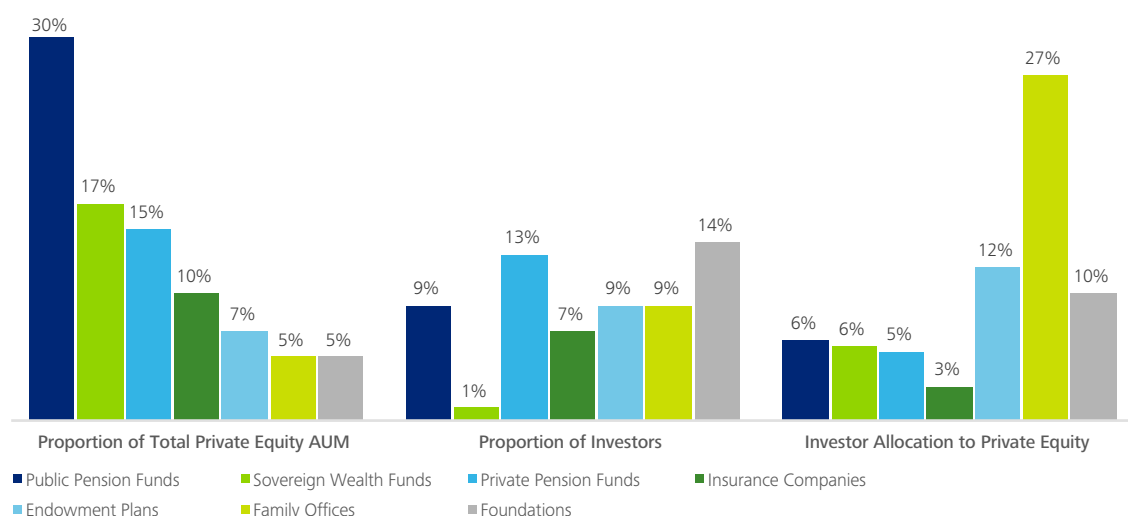
The rising interest in private equity by limited partners is driven by a number of factors, including diversification, the search for non-correlated assets, and fund outperformance versus standard benchmarks. Private

equity performance has generally not disappointed over time, as returns have commonly exceeded benchmarks, even during down markets. Cambridge Associates’ performance statistics show that their CA U.S. Private Equity Index has outperformed the Nasdaq Composite, Russell 2000, and S&P 500 for consecutive time periods, from 25 years back through third quarter 2015.¹³ Based on outperformance versus benchmarks over time, private equity may continue to be a preferred asset class. As evidence, 95 percent of surveyed investors expect portfolio returns to exceed public market returns in 2016, up from 92 percent in 2012.¹⁴

New heights, new challenges

High industry growth rates have brought new trials for private equity firms. With assets at an all-time high, general partners are being forced to compete aggressively

Figure 3: Composition of limited partner universe and allocations to private equity—Largest investors*



Source: Deloitte analysis of Preqin data, 2016 Preqin Global Private Equity & Venture Capital Report, © 2016 Preqin Ltd. / www.preqin.com.

Note: Data includes venture capital investors.

*Totals do not equal 100% of investors, as only the top 7 investor classes by percent of total private equity assets are shown.

for attractive deals.¹⁵ For example, 60 percent of buyout managers and 44 percent of growth managers reported seeing a rise in competition for transactions over the 12-month period ending in June 2015.¹⁶

For firms looking to acquire new portfolio companies, the number of potential deals is limited simply due to the finite number of companies available. Census data, shown in Figure 4, illustrates that while the number of US companies has barely changed over the past 20 years, the number of private equity firms has grown by a factor of 14 over the same time period. The net result is that the number of US companies per private equity firm has been dramatically reduced, from over 17,000 in 1992 to less than 1,400 in 2012.¹⁷ Fast forward to 2015, there were 4,910 private equity firms globally, excluding venture capital companies, which represents a 9.2 percent CAGR from the 1,571 firms that existed in 2002.¹⁸

Responding to this competitive environment, private equity managers are employing varied strategies to drive growth. In deal making, more complex, multi-party transactions are being structured to satisfy the needs of different investors, while deeper due diligence is becoming the norm prior to investing in assets with high valuations. Based on their size, level of experience, and willingness to manage risk, private equity firms are both specializing and diversifying. Some funds are focusing on specific niches, while others are looking more broadly for emerging (and potentially disruptive) players and markets.

Private equity firms are also offering a wider array of investment types, including co-investment opportunities and separate accounts in order to increase asset levels.¹⁹ Also adding to the complexity is the fact that assembling a team of skilled professionals to implement these changes may become a greater challenge going forward. Increasing competition from venture capital firms and investment banks is already making it more difficult for private equity firms to attract and retain talent.

Figure 4: Declining ratio of US companies to private equity firms

Year	Number of US companies	Number of private equity firms*	Number of US companies for each private equity firm
1992	5,095,356	293	17,390
2002	5,697,759	1,571	3,627
2012	5,726,160	4,110	1,393

Sources: Deloitte Center for Financial Services analysis. Statistics of US Businesses, United States Census Bureau, USB Annual Data:1992, 2002, 2012; © 2016 Preqin Ltd. / www.preqin.com.
*Excludes venture capital firms.

Where do we grow from here?

While the private equity industry is strong and healthy at present, even the most optimistic industry observers may be hard-pressed to anticipate that the recent pace of growth will persist, at least in the near term. This is both the result of the maturation of the private equity industry itself, as discussed above, and the current economic outlook.

Over the next 18 months, global economic growth is anticipated to slow slightly. The International Monetary Fund (IMF) revised its projections for global growth in 2016 and 2017, to 3.4 percent and 3.6 percent respectively, a 0.2 percentage point downward revision for both years.²⁰ This has largely been based on a slowdown of the Chinese economy, lower commodity prices, and challenging emerging market and developing economies.²¹ However, this outlook was offset by a silver lining, domestically. Confidence in the health of the US economy has improved enough to warrant a more normal monetary policy—enough so as to raise interest rates by 25 basis points, the first increase since 2006.²² This decision was supported by the fact that US GDP increased 2.1 percent in the third quarter.²³

Though the interest rate rise may indicate a positive outlook for the US overall, it also is a double-edged sword. On one hand it raises the cost of debt for private equity firms. On the other hand, it may present a buying opportunity for private equity firms, as valuations return to normal.

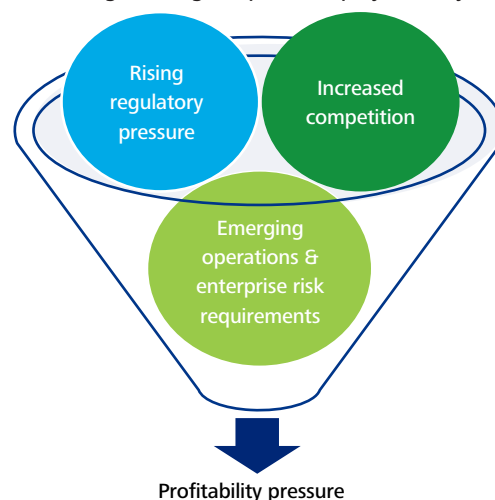
In addition to the market environment, there are other challenges facing the industry. As indicated in Figure 5, heightened levels of competition, escalating regulatory oversight, and emerging operational and enterprise risk requirements are already squeezing profitability—even before these firms experience slowing markets. This complicates strategic planning because private equity firms may no longer be able to count on the high market growth rates of the past few years.

Projecting a new phase of growth

Our analysis indicates the private equity industry may be entering a new phase of growth. To shed more light on how a shifting environment may affect the industry, we created a tri-scenario asset-based model that spans the next five years. Our "Moderate" scenario, which we believe is the one most likely to occur, projects a 5.0 percent CAGR in private equity AUM from year-end 2015 through 2020. This is a considerably lower rate than the 9.3 percent growth rate seen from year-end 2010 through 2015, and the more robust 13.6 percent CAGR spanning 2006 through 2010. (See Figure 6.)

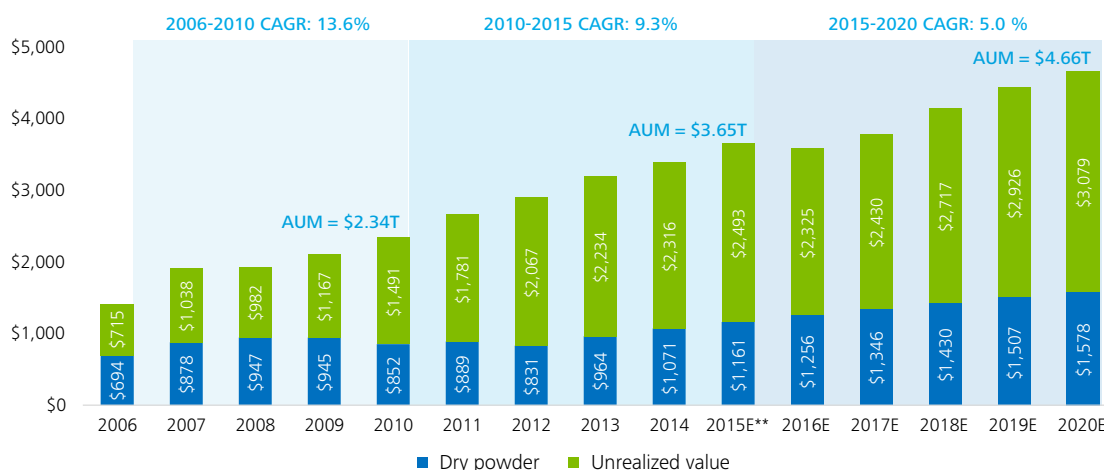
In our Moderate scenario, private equity assets would increase from \$3.65 trillion at year-end 2015 to reach an estimated \$4.66 trillion in 2020. This forecast reflects our anticipation that industry growth may decline over the next eighteen months to two years, and may pick up after 2017. Key drivers for this scenario include a tightening monetary cycle, which will likely increase the cost of debt; continued competition for portfolio companies (as shown in Figure 4); and heightened portfolio valuations.

Figure 5: Challenges facing the private equity industry



Source: Deloitte Center for Financial Services analysis

Figure 6: Deloitte's proprietary global growth model for private equity (\$B)* – Moderate scenario



Sources: © 2016 Preqin Ltd. / www.preqin.com (2006–1H15); Deloitte Center for Financial Services analysis (2H15E–2020E).

*Data excludes venture capital. **Unrealized value data was extrapolated to reach Deloitte's December 2015 estimate.

We also created two additional scenarios that may play out in the near future. These help capture the breadth of uncertainty around the market overall:

- Our Optimistic scenario projects total AUM growth within the industry to be at an 8.4 percent CAGR, with dry powder rising at 9.9 percent and unrealized value at 7.7 percent. Underlying drivers include a better than expected economic environment, and enhanced limited partner confidence, due in part to increased transparency from the successful adoption of compliance practices to manage new regulatory obligations.
- Our Pessimistic scenario pegs the total AUM growth at 3.1 percent, due to relatively modest growth of dry powder at 5.8 percent and unrealized value at 1.8 percent. This particular scenario is driven by a potential extended market downturn, lower portfolio valuations, and more stringent regulatory expectations.

Challenge: Shifting asset composition ahead

A key differentiator of our model is how we anticipate the mix in asset composition to occur. Historical data from 2006 onward suggest that the expansion of the private equity industry was driven primarily by unrealized value, in contrast to dry powder. For example, between year-end 2005 and 2015, unrealized value grew at a 16.7 percent CAGR, versus dry powder at 9.2 percent.²⁴ However, we expect this trend to shift over the next five years. According to our Moderate scenario, unrealized value would increase to \$3.08 trillion, compounding at a 4.3 percent CAGR between year-end 2015 and 2020. Dry powder, on the other hand would outpace it with a CAGR of 6.3 percent, increasing to \$1.58 trillion by 2020. This change in the ratio of dry powder to unrealized value would be driven primarily by higher expected capital commitments from investors seeking the relatively higher alpha historically delivered by private equity.

Over the past three years, private equity firms have made record distributions,²⁵ making it prudent for limited partners to adjust their asset allocations proactively. We expect this trend to continue in the near future, as exits will increase at 7.9 percent, reaching \$615 billion in total value by 2020. This should result in the aforementioned uptick in dry powder as limited partners reinvest their distributions back into the next round of private equity funds given the consistent track record of outperformance versus benchmarks.²⁶

Managing to a moderated growth environment

Both limited partners and private equity firms have found out that the era of rich valuations and large deal size (2005-2007) failed to deliver significant alpha.²⁷ We do not expect a *deja vu* in the private equity space as firms are increasingly cautious about acquisitions in the current market environment. In contrast, limited partners are expected to back their proclivity for private equity as a preferred asset class, shown by the higher growth rate expected for capital commitments in our model.

Private equity growth model methodology

The core of our private equity growth model was structured around analyzing the flow of capital at different stages within the industry. We looked at the various metrics for the private equity industry using data from Preqin, Ltd., and analyzed its growth as compared to broader economic growth in the world, as projected by the IMF. In our calculations:

- We distilled the entire cash flow cycle into three equations. The main variables included were capital raised, called capital, exits, unrealized value, and dry powder. We analyzed how these variables have historically performed in contrast to GDP, and how they would perform given the expected economic forecast by the IMF. While capital raised, dry powder, exits, and unrealized value as data inputs were provided by Preqin, the remaining variables were calculated by Deloitte.
- The base data analyzed were for the period from December 2006 to December 2015 (though extrapolation was done for data only available through mid-year 2015), encompassing one full market cycle.
- After running our statistical analysis, we generated a forecast for the next five years for each of these variables. (Most of these variables are interrelated; for example, total AUM is a sum of unrealized value and dry powder.) Using those relationships, we estimated what the total assets of the industry might look like in 2020. We created three different economic scenarios that may pan out in the future: Pessimistic, Moderate, and Optimistic. From these we adopted the Moderate scenario as the preferred version, as it aligns with the overall growth expectations that our analysis revealed.



SECTION 2

Evolve to meet tomorrow's challenges

If there were an imaginary sign that read: "Warning, slower growth ahead for private equity," what would firms do in response? Managers may adopt the strategies outlined in Figure 7, many of which we already see in practice.

As industry growth moderates, private equity firms may continue to shift more time and resources from front-office deal-making to growing profitability through restructuring and operational efficiencies. Key questions managers should answer in this process include: "What is the operational spend? Where can I improve our processes? And where can I take more cost out of the business?"

In today's complex environment, however, challenges facing the industry are not solely related to growth and profitability management. Rising regulatory oversight, the tightening lending environment,²⁸ and the impact of technology are creating new opportunities and challenges that have not previously affected firms to this extent. These challenges are discussed below as they affect both the private equity firms and the portfolio companies.

Figure 7: Anticipated responses of private equity firms to moderated growth



Fast growth

- Company expansion
- Blockbuster deals
- Broad reach
- Embracing risk
- Financial engineering & leverage
- Quicker portfolio turnover
- Growth-focused talent strategy
- Hiring up
- Short-term profit focus, high goals
- Growing market share
- IPO-focused exits



Moderated growth

- Leaner firms
- Smaller deals
- Specialization
- Avoiding risk
- Post-deal organic growth & value creation
- Longer holding periods
- Talent pool remix for mature market
- Co-sourcing or outsourcing
- Downsized goals, lengthened expectations
- Building transparency, building trust
- GP-to-GP sales

WHAT IS THE OPERATIONAL SPEND?

WHERE CAN I IMPROVE OUR PROCESSES?

WHERE CAN I TAKE MORE COST OUT OF THE BUSINESS?

The private equity firm: Evolve through robust internal operating controls & processes

Trying to improve operational efficiency while addressing the rising cost of regulatory compliance is a balancing act that mutual fund and hedge fund firms have addressed for many years. The private equity industry is now actively engaged in this exercise as well, in part due to the increase in regulatory oversight of private fund advisers.²⁹ This means that private equity managers now need to actively address the full scope of operations and regulatory concerns by answering these questions: “What are the operational processes that are used to run the business? What is the governance and oversight around the process and any resulting conflicts of interest? And what is the evidence that we are doing what we should be doing?”

This process may turn out to be more challenging for private equity managers than for their investment management counterparts, as private equity is unique in its regulatory stance. In private equity, a significant number of conflicts and risks specific to the business are also tied to operational processes, heightening the importance of the controls and governance around these processes.

Managers should take a closer look at two specific areas of current regulatory focus as they relate to operations and business process: fee and expense allocations, and conflicts of interest. Firms may also want to consider creating greater role definition around risk-prone functions.

Fee and expense allocation & documentation

After the Dodd-Frank Act required registration of private fund advisers to be finalized in 2012,³⁰ the Securities and Exchange Commission (SEC) did a sweep of the industry—notably expressed in its well-publicized speech, “Spreading Sunshine in Private Equity.”³¹ Subsequent examinations conducted by the SEC found pervasive issues with the regulation and compliance practices of managers, issues that were tied to the ways they operated their funds and

the infrastructure of the firms. In the 150 exams that the SEC conducted as of 2015, the primary concerns the agency raised centered on fee and expense allocation, with half of the firms examined showing material weaknesses or violations in this area.³² Understandably, fee and expense allocation oversight has continued as an SEC examination priority for 2016.³³

Addressing this issue is an operational challenge in that it may be related to underinvestment in technology, combined with the requirement to maintain books and records in accordance with Rule 204-2 of the Investment Advisers Act of 1940 (Advisers Act).³⁴ The effectiveness of internal controls management may affect the growth of a private equity firm, as more time will need to be spent on internal governance processes and operational controls. This impact comes directly through operational costs, and secondarily through allocation of front-end deal generator resources toward middle-office fee and expense allocation decisions. Those decisions will need to flow through the governance processes of the firm to the books and records, in order to comply with the complex provisions of each fund offering and related disclosures.

Well-documented internal controls, coupled with a strong training program, are key to both handling operational issues appropriately, and preventing deal-makers from being distracted by them. Having clear procedures in place will help answer the expected questions from the SEC such as: “Do policies and procedures follow industry practices? Are there documented controls and processes around valuation? And are the funds themselves acting on what they have told their investors they are doing?”

WHAT ARE THE OPERATIONAL PROCESSES THAT
ARE USED TO RUN THE BUSINESS?
WHAT IS THE GOVERNANCE AND OVERSIGHT
AROUND THE PROCESS AND ANY RESULTING
CONFLICTS OF INTEREST?
AND WHAT IS THE EVIDENCE THAT WE ARE
DOING WHAT WE SHOULD BE DOING?

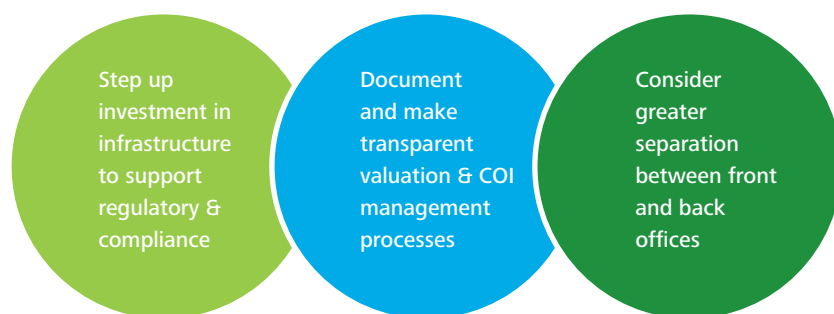
Conflicts of interest

Conflict of interest (COI) management is another high priority focus of the SEC,³⁵ with the private equity sector more exposed to this issue than are other types of investment managers. Private equity has unique and inherent COIs for a number of reasons. For example, potential conflicts may include how the manager handles issues arising from controlling investments in a portfolio company from which they receive fees; how fees and expenses are allocated to private equity funds versus the management company; and the process of how the private equity firm may direct its portfolio companies to use service providers, buy products, or influence financial reporting.

A primary challenge facing private equity firms lies in the operationalization of the regulatory obligations of the Advisers Act. This process must navigate conflicts that differ from hedge funds and mutual funds, since private equity firms have a higher level of control over their portfolio companies compared to the continued arms-length investments of the other types of managers.



Figure 8: Evolve through internal controls & processes



Valuation

Valuation is one of the highest-profile conflict areas for private equity firms. Because private equity firms value their investments in the non-public portfolio companies in their portfolio, conflicts can arise as these valuations have a direct impact on the perceived success of both the private equity firm overall, and its funds. Investors are also looking closer at valuation, as evidenced by the 70 percent of limited partners surveyed that believe pricing and valuation represent the biggest industry challenge in 2016.³⁶ Processes around valuation may have even greater impact on both firms and investors; as holding periods for portfolio companies increase, the potential for valuation conflicts may also rise.

Fundraising is an especially risk-prone area for valuation. Private equity firms grow by launching the next fund, and in doing so they market the performance of the current or previous fund. If the front office deal makers are responsible for valuations of the current fund, the whole process has a clear COI issue. This is because most marketing materials used to raise new capital are based on historical fund performance, which is calculated using internal rate of returns (IRR). As such, valuation is a critical component of the IRR calculation. The concern is that if private equity firms market higher returns than warranted, they risk misleading the public.

Recently the SEC has shown more interest in both the marketing of private equity funds and the valuations used in the performance calculations. The SEC also advises that marketing will continue to be a risk area.³⁷ To help manage this COI and pass regulator reviews, private equity firms need to establish clear controls to manage potential valuation conflict as it relates to marketing or reporting performance.

Source: Deloitte Center for Financial Services analysis

Greater role definition around risk-prone functions

More organizations are moving to create increased definition around risk-prone functions. In regard to valuation, only 51 percent of respondents to Deloitte's Private Equity Fair Value Survey now indicate the investment transaction team serves as the initial preparer of investment valuations in 2015, down from 65 percent in 2014, and 68 percent in 2013.³⁸ The decline in the tendency for the investment transaction team to prepare valuations is generally a result of higher use of dedicated in-house or external valuation specialists, or internal accounting department personnel, as well as external investor pressure and principles of good governance. These measures introduce a greater level of risk protection for the firm.

Separately, private equity managers in Europe are being required under the Alternative Investment Fund Managers Directive (AIFMD) to implement a risk management function and respect its independence from operating units, including matters relating to portfolio management as a measure of COI prevention.³⁹ While this practice is not yet standard in the US, private equity firms with global operations may be inclined toward adopting it as a safeguard domestically and to support their expansion abroad.

The portfolio company: Evolve through value creation & operational excellence

Growth strategies are continuing to evolve for portfolio company management. While private equity firms have historically focused on increasing the value of the fund through securing favorable deal terms during the acquisition of portfolio companies, these terms have become less attractive due to lower available levels of financial leverage.⁴⁰ As a result, managers have turned their attention toward post-transaction value creation. Though the goal is still finding portfolio companies with good products, services, and distribution during the deal-making process, enhancing the performance of the acquired business is the first rule in the playbook after the transaction is done.

Value creation & operational excellence

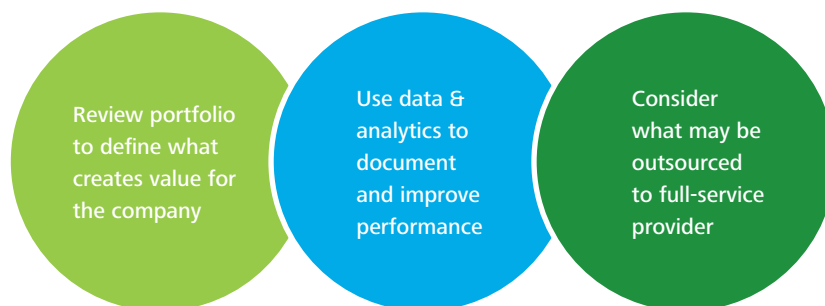
As dependence on financial leverage has lessened, value creation has become a stronger profitability driver for portfolio companies. This process starts with a complete assessment of the new company, and is specifically

designed to discover which customers or pieces of business generate value, as well as those that do not. The private equity manager's goal is to extract value from the portfolio company in the least capital-intensive manner possible. This means figuring out how to redeploy or eliminate non-productive capital, whether fixed assets or working capital.

The use of data and analytics to aid in this initial assessment, and in supporting future performance, is an evolving practice within the private equity industry. At present, private equity as a whole lags behind its mutual fund and hedge fund counterparts in the use of data. After all, hedge and mutual fund managers are supported by the numerous data and analytics providers that cover public companies and markets. This leaves space for fast movers in private equity to gain a competitive advantage. Managers should ask



Figure 9: Evolve through portfolio value creation & operational excellence



Source: Deloitte Center for Financial Services analysis

ARE WE GETTING CONSISTENT DATA FROM OURSELVES & OUR PORTFOLIO COMPANIES SO WE CAN USE IT FOR BOTH BUSINESS ANALYSIS AND ACHIEVING ECONOMIES OF SCALE?

“Are we getting consistent data from ourselves and our portfolio companies so we can use it for both business analysis and achieving economies of scale?” The accuracy of the data received from the portfolio companies, and how well it is leveraged for strategic decision making, are also important aspects of operational efficiency. As holding periods are lengthening⁴¹—so much so, that the industry seems to be moving toward a portfolio holding company model—costs incurred through day-to-day operations have become a more important issue.

This is where operational excellence takes center stage. Once the value creation chain has been established, and data and analytics are leveraged to provide a clear picture into the business, the private equity firm is able to focus on a comprehensive operational strategy for the portfolio company.

Broadly, private equity firms manage the operations of recently acquired portfolio companies in various ways to meet stated value creation goals. The private equity firm may choose to manage portfolio company operations itself, if it has a majority stake. On the other hand, if it has a minority stake, the private equity firm is less likely to have that option, and instead may work with existing management, or partner with an outsourced provider for operational support.

While private equity firms have already increased the level of their back-office outsourcing,⁴² certain processes that support the front office may follow as well. Along this line, firms may want to improve allocation of their expensive in-house talent and resources by outsourcing components of initial due diligence, operational due diligence, and growth strategy formation processes for the portfolio company. The broader the range of services offered by the outsourced provider, the better, as this may help to lower the cost of operations across the board.

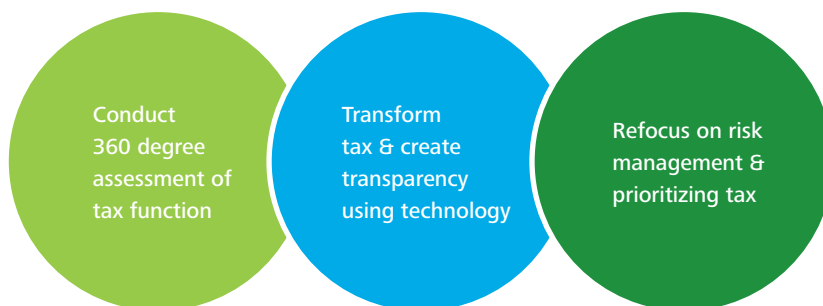
Enterprisewide: Evolve through tax transformation

When it comes to the growth of the enterprise at large, evolution of the tax approach is a pivotal issue for private equity firms. As the industry has matured, and rules and regulations have become more time-consuming, tax requirements have become challenging—particularly for private equity firms that have grown their portfolios and become more structurally complex. In particular, the Foreign Account Tax Compliance Act⁴³ (FATCA) in the United States and the international Common Reporting Standards (CRS)⁴⁴ have both become strong drivers behind the evolution in transparency and tax reporting. In addition, Base Erosion and Profit Shifting (BEPS) will begin to affect private equity firms and their portfolio companies later this year.⁴⁵ These regulations represent the escalated pace at which various governments are looking for more transparency into private equity firms and determining who their limited partners are.

This heavy focus on taxation was not as prevalent a decade ago. Yet given the escalation in reporting requirements, many private equity firms of all sizes, from start-ups to large global entities, are taking another look at how to comply with tax laws in the most cost-effective and efficient



Figure 10: Evolve through tax transformation



Source: Deloitte Center for Financial Services analysis

way possible. Even though an organization may believe all possible steps are being taken today in regard to oversight and automation of the tax function, it is a good idea to inquire: “Do I need to transform my tax department, given what’s coming down the road?” During this process, private equity firms should step back and take a fresh look at the tax department as a whole, and at those of its portfolio companies. Some of the factors to be explored include understanding the true tax complexity of the organization, analyzing the existing talent pool of the tax team, and re-scanning global and regional tax requirements to facilitate compliance. This assessment may be necessary because it may have never have been done for start-up funds or portfolio companies. Additionally, the organization may have evolved since the last assessment was conducted.

Tax transformation is an emerging topic in other areas of financial services such as the insurance industry⁴⁶; private equity is moving in this direction as well. Forward-looking private equity firms are actively assessing their tax functions with an aim to transform them into tax departments of the future, using technology as the enabling tool.

Additionally, organizations of all sizes, especially mid-tier and larger private equity firms that are expanding their portfolios, should confirm that they periodically refocus on risk management as it relates to the process of identifying areas of tax-related risk, communicating these to the chief financial officer, and setting up risk mitigation processes around them. Global private equity firms need to determine that they are not inadvertently subjecting significant gains in their portfolio to additional tax requirements in the various regions where the portfolio companies operate.

DO I NEED TO TRANSFORM MY TAX DEPARTMENT, GIVEN WHAT’S COMING DOWN THE ROAD?

New priorities for a changing world

Profitability, growth, and performance will likely remain top objectives for private equity managers and investors, regardless of how the market evolves. As the environment transitions toward a new normal where returns may be harder to achieve and growth is slowing, different strategies may be required for firms to remain competitive.

Highlighting the value-add of the private equity firm and its investment process will likely become more central to retaining competitive advantage. Firms may want to adopt more innovative approaches to meet changing customer needs for investment types, such as separate accounts. Managers may also need to differentiate themselves based on creating more targeted or niche investment strategies.

In a heightened regulatory environment with slower growth, internal controls and transparent processes increase in importance. With this change likely comes a greater focus on value creation in portfolio companies and overall operational efficiency. While firms may want to continue managing a large percentage of operations in-house, incentives to outsource may become more attractive. Private equity firms will need to balance the dual objectives of cost reduction with improvement in operations and internal controls.

In doing this, outlays for investment in technology, infrastructure, and operational support may be required to assist more traditional firms in meeting the rising standards of regulators and demands of investors. Even though this is happening at a time when growth is slowing, private equity firms still need to forge ahead toward a future focused on transparency, innovation, and nimbleness. Embracing this new paradigm can position both large and small private equity firms to meet the challenges of tomorrow.

Endnotes

- ¹ By Deloitte estimate, based on prorating the \$3.5T figure from Preqin data as of June 2015, forward to December 2015. © 2016 Preqin Ltd. / www.preqin.com. Note: Venture capital data are excluded from this number and all data in this report unless otherwise noted.
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For more information, please contact

Executive Sponsor

Patrick Henry

Vice Chairman
US Investment Management Leader
Deloitte & Touche LLP
+1 212 436 4853
phenry@deloitte.com

Deloitte Center for Financial Services

Jim Eckenrode

Executive Director
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 585 4877
jeckenrode@deloitte.com

Doug Dannemiller

Research Leader, Investment Management
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 437 2067
ddannemiller@deloitte.com

Author

J. Lynette DeWitt

Research Manager, Investment Management
Deloitte Center for Financial Services
Deloitte Services LP

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Tim Carpenter, Partner, Deloitte Tax LLP
Rajan Chari, Partner, Deloitte & Touche LLP
Edward Daley, Partner, Deloitte Tax LLP
Karl Ehram, Principal, Deloitte & Touche LLP
Frank Fumai, Partner, Deloitte & Touche LLP
Randall Hottle, Senior Manager, Deloitte Consulting LLP
Abs Kotulski, Senior Manager, Deloitte Consulting LLP
Kamal Mistry, Principal, Deloitte Consulting LLP
George Psarianos, Director, Deloitte Transactions and Business Analytics LLP
Sridhar Rajan, Principal, Deloitte Consulting LLP
Mark Sirower, Principal, Deloitte Consulting LLP
Gauthier Vincent, Principal, Deloitte Consulting LLP

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Danny Bachman, Senior Manager, Deloitte Services LP
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Michelle Chodosh, Marketing Manager, Deloitte Services LP
Sallie Doerfler, Senior Market Research Analyst, Deloitte Center for Financial Services, Deloitte Services LP
Rumki Majumdar, Research Analyst, Deloitte Services India Pvt. Ltd.
Robin Plocharczyk, Marketing Manager, Deloitte Services LP

Deloitte Center *for* Financial Services

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