

THE MCKINSEY & COMPANY REPORT

PRIVATE EQUITY CANADA

2005

**BUYOUTS:
THE END OF THE BEGINNING,
OR THE BEGINNING OF THE END?**

This publication is not intended to be used as the basis for trading in the shares of any company, or undertaking any other financial transaction, without consulting appropriate professional advisors in each instance.

The views and opinions expressed in this publication are those of the authors, and they do not necessarily represent those of McKinsey & Company.

Copyright © 2006 McKinsey & Company.

All rights reserved.

Printed in Canada.

Designed by Patrick White, McKinsey & Company.

Foreword

This is the fifth installment of the *Private Equity Canada* series produced by Goodman and Carr LLP and McKinsey & Company. Our objective is to provide a fact-based perspective on key trends shaping the Canadian private equity market to help the industry grow and its participants succeed.

We have based our conclusions on Thomson Macdonald's market research conducted in Canada and on McKinsey & Company's proprietary research focused on the United States and Europe. As before, our 2005 survey was consistent with 2004's to permit year-over-year comparisons. The 98 survey respondents represent Canada's largest private equity firms – and over 93 percent of the entire Canadian capital pool.

Private Equity Canada 2005 consists of two volumes:

- Volume 1, produced by Goodman and Carr LLP, provides an in-depth review of key market facts. It describes the main characteristics of Canada's private equity market, the preferences of its participants, and the market activity over the past year.
- Volume 2, prepared by McKinsey & Company, draws on the authors' extensive experience in serving institutional investors and other private equity market participants. It focuses on the buyout industry's growth in the past 5 years and offers a perspective on where the industry is heading and what these trends could hold for GPs and LPs globally and in Canada.

We hope you find *Private Equity Canada 2005* useful, valuable, and thought-provoking.



Robert Palter
Principal
McKinsey & Company

McKinsey & Company¹ is an international management consulting firm that specializes in helping clients achieve substantial and lasting improvements in their performance. Its Canadian Practice, based in Toronto and Montreal, draws on McKinsey's network of over 80 offices to provide objective counsel to management teams facing strategic, organizational, or operational opportunities and challenges. For more information, please visit us at www.mckinsey.com or contact us by phone at 416 313 3700 or 514 939 6800.

1 McKinsey & Company is not an investment advisor and will not provide investment advice.

Contents

2.0	Executive summary	1
2.1	Ever-larger deals, ever-bigger players	3
	What triggered this growth?	5
	A changing and maturing industry	8
2.2	Where does the industry go from here?	13
	Possible risks	14
	Implications for GPs: Building for long-term success	16
	Implications for LPs: New approaches	18
2.3	Implications for Canada	20

2.0 Executive summary

The global private equity market has set a scorching pace in the past few years. Buyout deals have grown ever larger, the players ever bigger, and the competition ever fiercer. What has triggered this growth? And where does the industry go from here? Is it the end of the beginning? Or the beginning of the end? What are the implications for the industry – and for Canada’s GPs and LPs?

To gain an informed perspective on the market’s evolution, McKinsey & Company analyzed the industry’s drivers over the past 5 years and its emerging trends to determine their likely impact on the marketplace and its players.

Based on our proprietary research and our interviews, we believe the buyout industry will probably continue its growth trajectory – and it will likely continue to mature. In this maturing industry, the biggest players should be well-positioned to consolidate the market further, if they remain focused on institutionalizing their capabilities, benefiting from their scale, and avoiding falling prey to price competition. The biggest unknown is whether there will be enough good companies to support the needs of this growing pool of capital.

In this volume, we:

- Review the buyout industry’s tremendous gains over the past 5 years in the United States and Europe, examine the likely triggers for this growth now and in the future, and offer evidence that the industry is maturing
- Outline the key drivers of the industry’s changing structure, explore the possible risks, discuss the implications for GPs and LPs, and suggest possible actions they could take to enhance their performance
- Argue that the Canadian industry will likely follow the global trend toward an even larger, more competitive marketplace with more auctions.

We would like to thank everyone who contributed to *Private Equity Canada 2005*, Volume 2, including our colleagues Andreas Beroutsos, Corinne Johnson, Conor Kehoe, Bruno Roy, Antoon Schneider, Gal Shay, and the McKinsey & Company communication team.

If you have comments or questions about this volume, please contact any one of the following at McKinsey & Company.

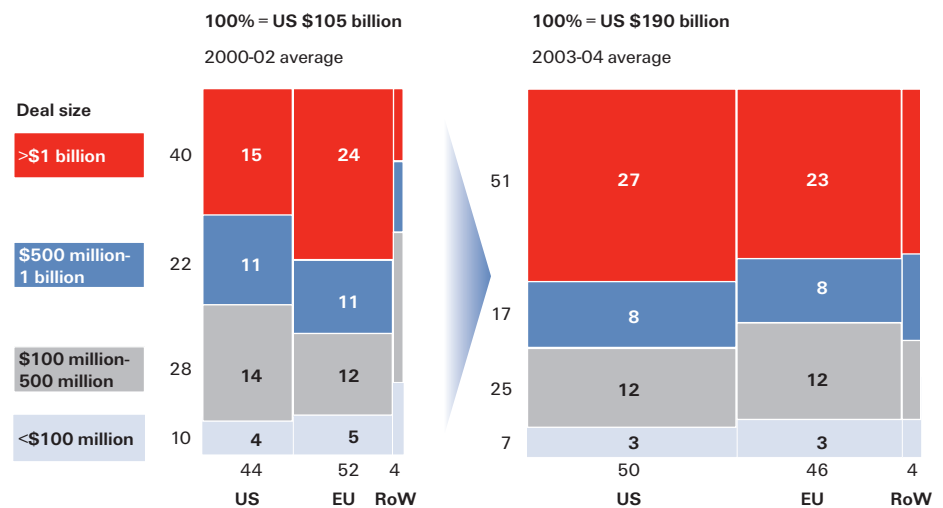
- **Robert Palter**, Principal
T: 416 313 3774
Robert_Paltermckinsey.com
- **David Alexander**, Associate Principal
T: 972 9 971 8518
David_Alexandermckinsey.com
- **Joseph Cyriac**, Associate Principal
T: 212 446 7449
Joseph_Cyriacmckinsey.com

2.1 Ever-larger deals, ever-bigger players

Over the past 5 years, the buyout industry has grown at a remarkable rate in the United States and Europe. Buyout fundraising and transactions are at unprecedented levels.

Buyout investments averaged an estimated US \$190 billion annually in 2003-04, almost double that of the previous 3 years. Interestingly, most of this activity was concentrated in two types of deals: mega-cap (over US \$1 billion in enterprise value) and mid-market (US \$100 million to \$500 million). In fact, the mega-cap share grew from an estimated 40 to 51 percent of all transactions from 2000-02 to 2003-04.

Exhibit 1
BUYOUT INVESTMENTS DOUBLED, CONCENTRATED IN LARGER DEALS
 Percentage of total deal value



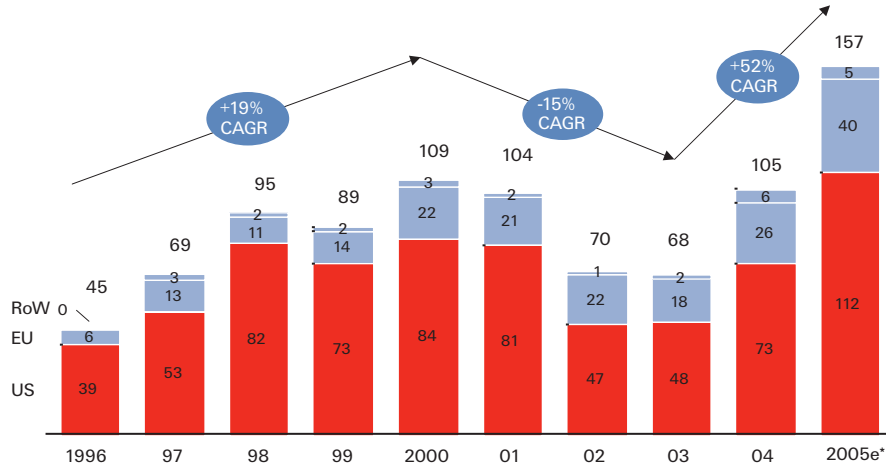
Source: McKinsey analysis

2005 was also a record year for fundraising, with buyouts attracting over US \$160 billion. This value was an all-time high, and it reflected an ongoing upswing from the lows seen in 2002 and 2003 and a continuation of the industry's cyclical nature.

Exhibit 2

FUNDRAISING HAS INCREASED, ALTHOUGH WITH A CYCLICAL TREND

Fundraising by buyout funds
US \$ Billions



* Annualized, based on 11 months of data
Source: Capital IQ; Venture Economics; McKinsey analysis

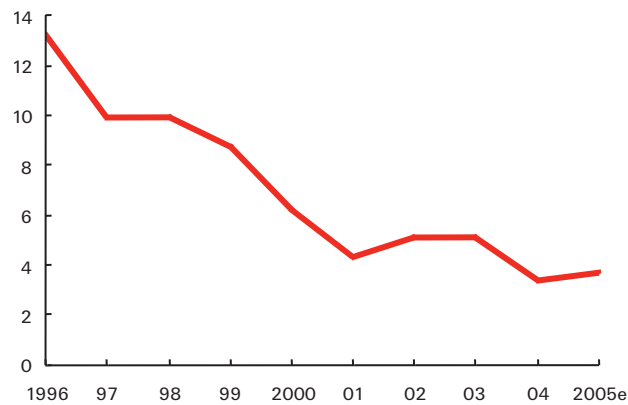
Just the year before, many would have argued that this level of fundraising would result in too much available capital, exacerbating an already competitive environment. In reality, this record growth in funds raised was offset by a growing number of very large deals, ending in an estimated overhang of 3.7 years' worth of capital.

Exhibit 3

CAPITAL OVERHANG HAS BEEN DECREASING IN THE UNITED STATES

Years' worth of overhang*

ESTIMATE



* Overhang divided by average equity investments during the previous 3 years
Source: Venture Expert; Venture Economics; McKinsey analysis

WHAT TRIGGERED THIS GROWTH?

We believe the drivers were – and will likely continue to be:

- The increasingly challenging return environment in public equities and fixed income
- Institutional investors becoming more comfortable with private equity
- The recovery in GP returns during 2003 and 2004.

Increasingly challenging return environment in public equities and fixed income

Market conditions in public equities and fixed income remain challenging for institutional investors, and many expect forward-looking returns to be lower than those they achieved in the past decade.

As a result, many institutional investors around the world have revised their expectations for long-term rates of return from public securities. According to a survey of pension accounting assumptions, Canadian and US private pension plans have reduced their aggregate return forecasts by over 30 basis points on average over the previous year.²

Three main drivers can help explain these lower return expectations:

- **The long-term trend toward lower interest rates.** Despite increases in interest rates over the past 18 months, the longer term trend has been lower interest rates. The yield on the 10-year Canada bond has declined from about 10.3 percent in December 1990 to 4 percent as of December 2005, while that on 10-year US Treasuries has declined from 8.1 to 4.4 percent.
- **Increased correlations between major financial markets.** Recent studies show globalization has increased the correlation between major investment markets over the past 2 decades, particularly during bear markets. This phenomenon directly impacts the benefits from international diversification, hence decreasing expected returns for a given level of risk.
- **The decreasing equity risk premium.** While equities may provide a premium over bonds, the equity risk premium over the past several years has been lower than most previous research has indicated. Furthermore,

² Watson Wyatt, *2004 Survey of Accounting Assumptions for Non-U.S. Defined Benefit Plans*, page 9.

many industry observers argue the market is not likely to return an equity risk premium in line with historical experience.

To meet their actuarial return needs, institutions have significantly increased their allocations to alternative asset classes, with private equity still receiving the bulk. Why? Top-quartile-performing private equity provides the potential for higher returns than public equities, in part because of the illiquidity premium and information asymmetry. And private equity's risk profile is becoming increasingly similar to that of public equities, because of the move to fair market accounting and greater exits in the public markets.

Interestingly, only the top quartile funds have historically outperformed public equities. Median funds have typically equalled or slightly underperformed public equities. Consequently, many institutional investors may not achieve the desired results from their increasing allocation to private equity if they cannot successfully select and access the top quartile funds.

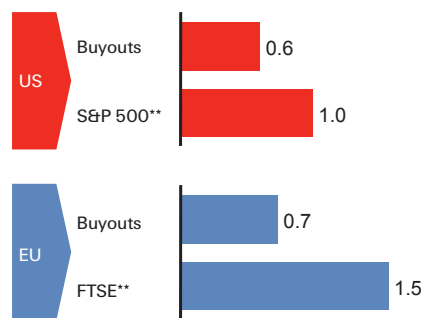
Exhibit 4

BUYOUTS' VOLATILITY IS CONVERGING ON EQUITIES' – BUT TOP QUARTILE MATTERS

Volatility is low...

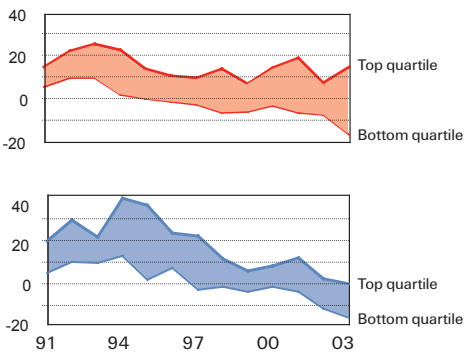
Relative risk of annual investments, 1991-2000

Standard deviation of fund vintage year returns as fraction of average return*



...but selection risk is high

Returns by vintage year
Percent



* For buyout and mezzanine funds with vintage years 1991-2000, returns as of December 31, 2004

** Standard deviation of 1991-2000 returns on public market index, assuming buyout-like investment profile (fund is invested over years 1 to 4 and divested over years 3 to 8 with an average holding period of 4 years)

Source: Venture Expert; Venture Economics; NVCA; EVCA; McKinsey analysis

Investors' increasing level of comfort

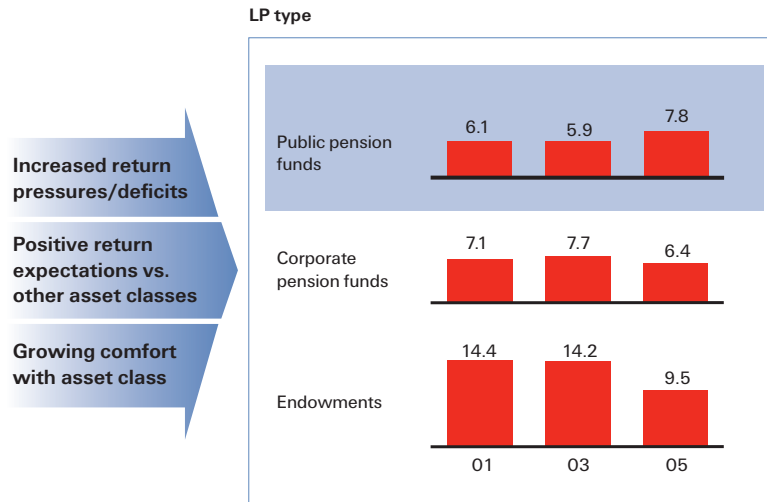
Many North American public pension funds have become more comfortable with private equity investing over the past 5 years and have increasingly answered the GPs' call for new funds. Since 2001, capital inflows were largely driven by public pension funds increasing their allocations from an average 6.1 to 7.8 percent in 2005. In addition, the growth in the fund-of-funds business has been significant, attracting new investors. In 2004, funds-of-funds accounted for an estimated 17 percent of fundraising, up from less than 5 percent in the mid-1990s.

At the same time, more experienced investors, such as corporate pension funds and endowments, slowed their allocations to private equity and other alternative investments. Corporate pension funds decreased their strategic allocations from 7.1 percent in 2001 to 6.4 percent in 2005; endowments' numbers fell from 14.4 percent to just 9.5 percent. Is this a leading indicator?

Exhibit 5

MORE GROWTH HAS COME FROM LESS EXPERIENCED LPs

North American LPs' mean strategic allocations to private equity
Percentage of assets



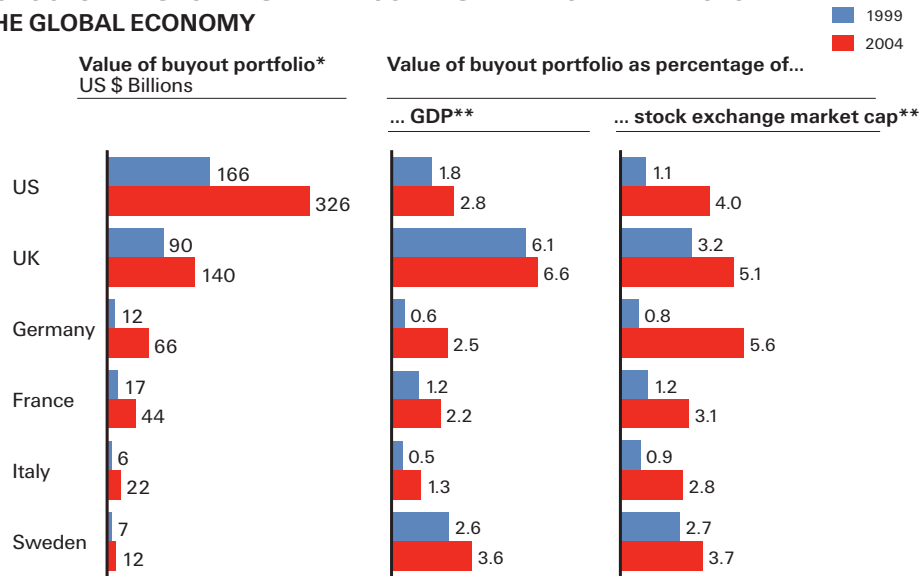
Source: *The 2005-2006 Russell Survey on Alternative Investing*; McKinsey analysis

This flow of capital into private equity is valued at approximately US \$800 billion – a significant amount in the global capital markets. Private equity can no longer be considered a cottage industry. Rather, its scale and global scope signify an industry that is changing – and maturing. Many of the leading

private equity investors have achieved a scale where they would rank in the Fortune 500 companies in terms of employees. This is equally true on a Canadian scale. For example, Onex had revenues of approximately Cdn \$16.6 billion in 2005, ranking it the 23rd largest company by revenue in Canada.³

Exhibit 6

BUYOUTS ARE GROWING AND BECOMING AN IMPORTANT FACTOR IN THE GLOBAL ECONOMY



* 5-yr total deal value

** 5-yr total deal value as a percentage of the fifth year's GDP and market cap of all listed companies

Source: Global Insight; Capital IQ; *Buyouts*; Venture Economics; Global Vantage; McKinsey analysis

Improving private equity returns

2003 and 2004 were very strong years for returns in buyouts, and this performance was ahead of that achieved by the public equity indices. As a result, many institutions allocated capital to this asset class to try to capture these attractive returns.

A CHANGING AND MATURING INDUSTRY

The growth and maturing of the industry have brought changes to the industry's structure. We are finding that players are moving into three distinct groups.

- 1. The mega-caps** have typically raised a fund of more than US \$7 billion and target investments over US \$1 billion in enterprise value. They tend to have global footprints, with highly recognizable brand names. These

³ Source: Compustat. According to the *Financial Post*, Onex was the 13th largest company in Canada by revenue in 2003 and the 16th largest by revenue in 2004.

players have shaped the industry for the past 3 to 5 years – and will likely continue to do so.

2. **The large-caps** raise funds between US \$2 billion and US \$7 billion. Typically, their average deal is sized between US \$500 million and US \$1 billion.
3. **The mid-caps** tend to raise between US \$500 million and US \$2 billion and target transactions under US \$500 million.

Exhibit 7

GP INDUSTRY STRUCTURE IS SEGMENTING INTO THREE GROUPS – EXAMPLES OF FUNDS

Mega-cap players	Large-cap players		Mid-cap players	
	US	EU	US	EU
Apollo Management	Cerberus	Allianz ³	Advent International	Barclays
Bain Capital ¹	Clayton, Dubilier & Rice	Apax Partners ²	Francisco Partners	Bridgepoint
The Blackstone Group	DLJ/CSFB	BC Partners	General Atlantic	Duke Street Capital
Carlyle Group	First Reserve Corporation	Candover	GTCR	Electra Partners
CVC Capital Partners	Forstmann Little & Co.	Charterhouse	Kelso & Company	EQT Partners
Goldman Sachs	Hellman & Friedman	Cinven	Lindsay Goldberg & Bessemer	Investcorp
J.P. Morgan ¹	Madison Dearborn Partners	Doughty Hanson & Co.	Lone Star Funds	Montagu Private Equity
KKR	Providence Equity Partners Inc.	Eurazeo ³	Matlin Patterson	Nordic Capital
Texas Pacific Group ¹	Ripplewood ²	PAI	Oaktree Capital Management	3i Group PLC
Thomas H. Lee	Silver Lake Partners	Permira	Onex	
Warburg Pincus	WCAS	Terra Firma	Summit Partners	

¹ Most recent fund is approximately US \$4 billion

² Included in the large segment as firm competes with large-cap GPs

³ Do not have funds; Allianz invests from BS; Eurazeo is a listed company

Source: Capital IQ; Initiative Europe; Venture Economics; *Buyouts*; McKinsey analysis

In addition to this segmentation, we are seeing other signs of a maturing industry, such as auctions, secondary deals (where buyout firms sell to other buyout firms), consortia, specialized niche strategies, and globalization. The trends toward auctions and secondary deals have important implications for industry dynamics.

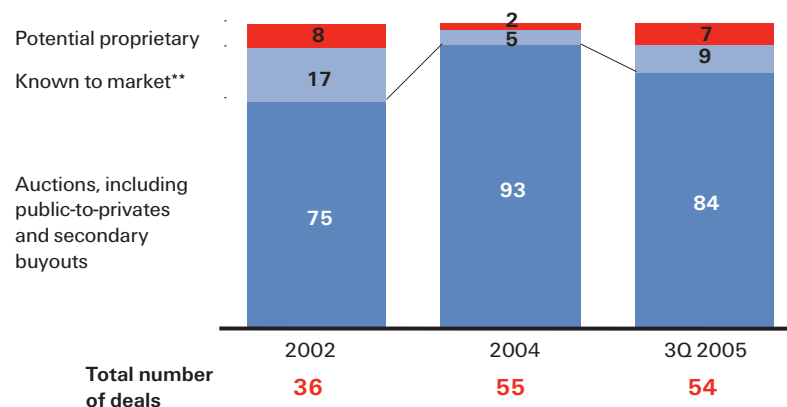
Auctions

Substantially more buyout investments are now being closed through auctions. In 2005, 84 percent of US companies that were sold for more than US \$500 million were auctioned – a significant increase over 2002's 75 percent. In Europe, the numbers grew from 64 to 87 percent over the same period.

Exhibit 8

AUCTIONS HAVE BEEN THE LARGEST SOURCE OF DEAL FLOW IN THE UNITED STATES FOR SEVERAL YEARS

Percentage of deals* above US \$500 million



* Defined as deals having at least one second-round PE firm bidder, with the deal winner gaining majority control of the asset, and excluding real estate, hotel, and nursing home deals

** No public evidence of competitive bidding found

Source: SDC; Auction Block; Factiva; McKinsey analysis

This growth stems largely from the higher multiples sellers are achieving in auctions. For example, 2004-05 US deals produced an average EBITDA multiple of 9.5X versus an estimated 5.1X on proprietary-sourced transactions.

In analyzing the auctions, we found their nature is changing in three fundamental ways:

- 1. Auctions are becoming increasingly competitive, with multiple bidders in the second round.** On average, identified auctions between 2003 and 2005 had 4.1 bidders in the second round. Interestingly, smaller deals (US \$500 million to US \$1 billion in value) tended to have 3.7 bidders on average in the second round, whereas the very large deals (more than US \$2.5 billion) averaged 5.2.
- 2. Consortia are actively involved in auctions and have a high success rate.** Over the past 3 years, the number of consortia formed to execute extremely large transactions – like SunGard, Hertz, and Neiman Marcus – has grown. In 2004, for example, consortia completed 64 percent of transactions over \$500 million, up substantially from 36 percent in 2000. Despite the added complexity of executing a transaction through a consortium, the success rate remains very high. It is estimated that consortia win approximately 85 percent of the auctions they enter.

However, they have not yet been fully tested on the management of the portfolio companies or the exit of the transactions.

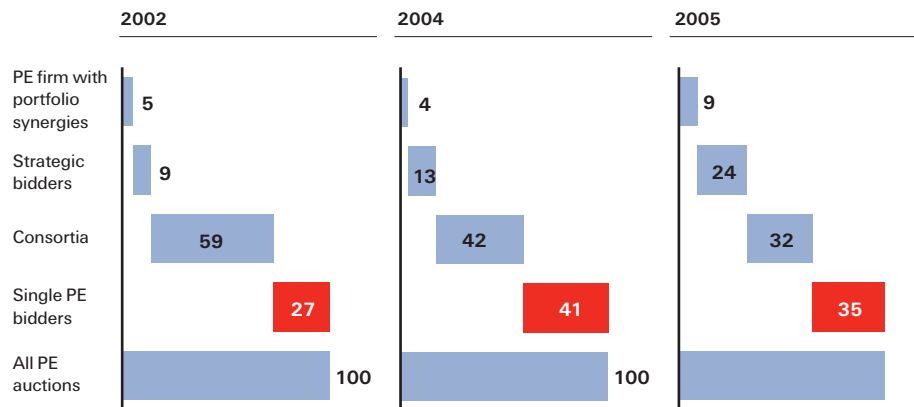
- 3. Strategic bidders are re-entering.** As strategic investors' equities strengthened after the 2001-02 capital markets' contraction, so did their participation in auctions where buyout investors are present.

The growing presence of strategic bidders can only heighten the competitiveness of auctions. In addition, corporate investors are increasingly taking a private equity approach to transactions: leverage, management changes, and a focus on rapid performance improvement. As such, these corporate bidders should be considered a legitimate threat to private equity investors. They have synergies that private equity investors don't, which they can use to bid higher, and they have similar capabilities.

Exhibit 9

STRATEGIC BIDDERS ARE INCREASINGLY PARTICIPATING IN AUCTIONS WITH BUYOUT INVESTORS

Percentage of auctions won by bidder types



Source: SDC; Auction Block; Factiva; McKinsey analysis

When analyzing auctions, people always ask: "Why did the winners pay so much? And did they overpay?" Since we only examined recent auctions, it is too soon to tell whether the winners overpaid. What we did surface in our interviews, however, were some common reasons that the auction-winning GPs gave for their high bids.

- **They were confident they could realize the upside and they factored that into their bids.** This was the most commonly cited reason. The winners believed they truly understood the investment's upside potential because of their in-depth due diligence. And they believed they had the skills, knowledge, tools, and relationships to capture this upside. As such, they were often willing to factor this into the purchase price to close deals.
- **They had a bullish view of the industry cycle,** whereas the losers tended to have a flat one.
- **They identified synergy opportunities in portfolio companies,** which would reduce costs or drive revenue, and they factored a portion of those synergies into their pricing.
- **They had a superior management team available** that could replace the target company's team and realize the business's full value.

Secondary deals

The industry is also experiencing many more secondary deals, possibly due to a supply bottleneck or fundraising concerns. In 2003, 15 percent of US deals were secondaries. A year later, the number rose to 23 percent. In Europe, the trend was even more pronounced, with these deals jumping from 18 percent in 2000 to 40 percent in 2004.

These trends have typically benefited many of the largest and most global players in the industry. In fact, it is estimated that firms specializing in mega-cap and large-cap deals boosted their share of assets under management from 16 to 35 percent over the 6 years from 2000 to 2005, whereas those that focused on mid-cap and small-cap gained little or no share. We believe this is a clear sign that the industry has started to consolidate. If that is so, today's handful of ever-larger players are likely to assume an even larger role in the future.

* * *

In the next chapter, we look at what could be in store for the future of the buyout industry.

2.2 Where does the industry go from here?

The explosive growth in funds raised, deals done, and mega-cap firms is leading many observers to question the buyout industry's future. Are we at the end of the beginning, or at the beginning of the end? Are we heading for new heights? About to plateau? Or facing a downturn?

To develop a long-term perspective on these questions, we analyzed the evolution of the key drivers of the industry's structure and its players. The analysis suggests that:

- **LPs' capital commitments to buyouts across the globe should continue to grow.** Public equities and fixed incomes are expected to yield lower returns over the medium and longer terms, thus making top-returning private equity investments a good alternative.
- **The strategies of the leading industry players have laid the foundation for continued growth and success.** The largest funds have played a key role in shaping the industry over the past 5 years. They have accounted for a disproportionate share of the deals done and the funds raised. And they are realizing the benefits of scale – typically a differentiator in maturing industries – in several key areas:
 - **I-banking relationships.** Bigger buyout funds generate bigger fees for investment banks and thus tend to enjoy preferred treatment.
 - **Access to supply.** Bigger buyout funds tend to have larger footprints and networks, enabling them to access more and bigger deals.
 - **Industry and functional expertise.** Larger funds can more easily support specialization by their people. This expertise helps these funds quickly spot attractive investment opportunities and effectively create value in the portfolio companies. It also makes them attractive partners for target companies.

- **Ability to attract and retain talent.** Bigger funds tend to earn bigger management fees, so they can offer more to attract and retain the best. And their bigger deals can be more exciting to top talent.
- **The market’s cyclical nature, however, could have a short-term negative impact on fundraising and returns.** Higher interest rates or an economic slowdown resulting in some bankruptcies would likely affect the market. If the buyout industry’s cyclical pattern continues, an uptick would eventually follow such a contraction. Also, history indicates that a period of significant fundraising is typically followed by a slow phase in the new deal market, which in turn negatively affects fundraising.

In sum, we believe the industry should continue to grow and its biggest players are well-positioned to further consolidate the market, as they increasingly institutionalize their capabilities and benefit from their scale. Yet the biggest unknown to the ongoing growth of the industry and the success of the participants is whether there will be enough good companies to support the needs of this growing pool of capital and these larger players. Only time and market conditions will tell.

In the remainder of this chapter, we explore the possible risks to the buyout industry’s growth trajectory and the implications of a more competitive and consolidated environment for GPs and LPs.

POSSIBLE RISKS

Despite this rosy forecast, a few clouds could appear on the horizon – for example, an oversupply of exits in 5 years’ time and rising interest rates and purchase multiples.

Potential oversupply of exits

Given the significant amount of fundraising and investing over the past 3 years – and assuming the investments appreciate in value and are held for 4 to 6 years on average – considerably more money will likely flow to the exit market in 2009-11 than the amount raised in 2005. With all this supply, exit multiples may come under pressure – and, if the capital markets are bearish in 4 to 6 years, overall private equity returns could also suffer.

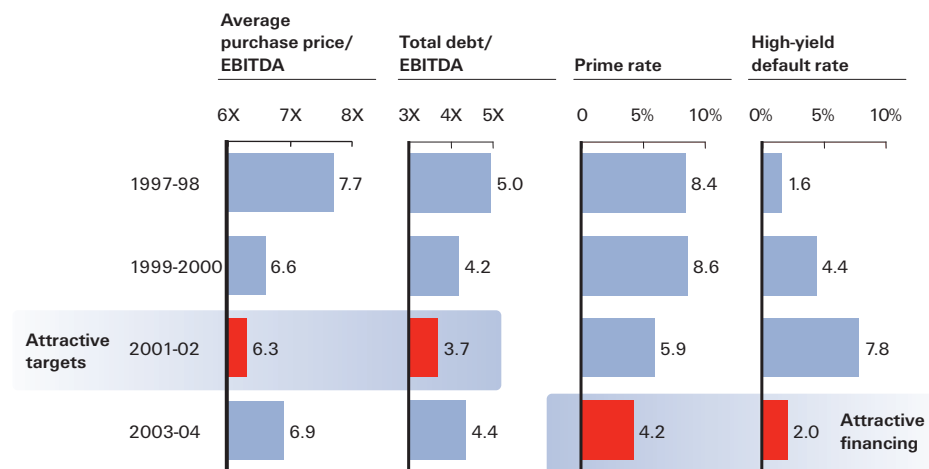
Rising interest rates and purchase multiples

Over the past 3 years, a significant driver of growth in the global buyout industry has been readily available and relatively cheap debt. Buyout deals are increasingly being completed with leverage at record levels (e.g., 5X to 6X EBITDA). As interest rates slowly climb, the liquidity in the debt markets will decrease – and buyout returns will likely come under pressure.

Exhibit 10

HIGHER INTEREST RATES AND PURCHASE MULTIPLES MAY AFFECT INDUSTRY GROWTH

US EXAMPLE



Source: McKinsey analysis

Interest rates have increased more than 150 basis points over the past 24 months. Rising entry multiples on transactions could slow growth as well, because they can result in lower returns. 2001 to 2002 saw relatively low purchase multiples that fuelled considerable buyout activity. Purchase multiples have steadily increased from this low and, in some cases, were above 8X EBITDA in 2005. If multiples continue to rise, it is possible that returns will be depressed, slowing future fundraising.

IMPLICATIONS FOR GPs: BUILDING FOR LONG-TERM SUCCESS

Buyout GPs will probably need to change their approaches to produce attractive returns in a more competitive and consolidated industry. The successful ones will likely adhere to four principles, albeit in varying degrees depending on their overall strategies.

1. Become more active owners

In the future, there will likely be few “easy” deals where returns can be driven through leverage or multiple arbitrage. Consequently, buyout GPs will probably need to improve their portfolio companies’ operations so they can deliver the right returns consistently. This would mean:

- Being more involved in the company’s activities to increase value through strategic, organizational, and operational changes
- Finding deal partners able to work with the management and dedicate sufficient time to drive value immediately after closing the transaction
- Relying more on experts in operations, pricing, and technology and developing better processes for interacting with the portfolio companies.

2. Take a greater industry focus

Buyout investing will continue to be opportunistic. However, as competition intensifies, buyout GPs could differentiate themselves through industry focus. This doesn’t necessarily mean a narrow industry focus at the firm or fund level (e.g., energy investing only or telecommunications investing only) but rather at the partner level, where each partner specializes in two or three industries.

This in-depth industry knowledge and wider networks would enable GPs to better assess investment opportunities in a difficult environment. It could also stimulate deal flow by enhancing the GPs’ value propositions to target companies.

This specialization would need to be weighed against the risk of focusing on an industry that could become fundamentally unattractive. A balanced approach of industry focus and selective opportunism would probably be the most effective.

3. Assess the attractiveness of expanding into Asia

Asia⁴ represents a large, fast-growing marketplace with an emerging private equity industry. It could be an interesting market for institutions concerned about the competitiveness of North American and European markets, now and in the future. Moreover, many of the LPs we interviewed expressed an interest in Asia; having a position there could help GPs raise funds. However, the Asian private equity market presents certain challenges. The capital markets are not as robust as the North American or European ones, and investors have not yet made money on a large scale there. As a result, uncertainty still exists about the potential in Asia.

The key success factors in pursuing this expansion strategy would likely be having a local senior deal-maker and the patience to manage a startup-like opportunity in a different cultural environment.

4. Change the game in auctions

Given that auctions will likely continue and become increasingly competitive, what else could GPs do to increase their odds of success, while keeping their bids at reasonable levels?

- **Increase flexibility in deal terms.** Our interviews with agents indicated that private equity bidders unwilling to take a full package of assets or materially alter term sheets typically don't win auctions. Accordingly, GPs probably would need to be more creative in restructuring transactions after closing.
- **Increase speed.** Auctions can be hugely disruptive to sellers. As such, a firm that can execute the due diligence, negotiation process, and closing in a relatively short time is likely to be viewed more favourably by the seller, assuming the price offered is reasonable.
- **Deepen trust-based relationships.** Sellers want to maximize their value, but they know they need to work with the GP for some time – and they want to be sure that their people will be treated fairly and with respect. GPs, therefore, need to strive to build solid relationships across the organization from the very beginning of the process. This would help them gain the seller's endorsement as the preferred buyer.

4 In this context, Asia does not include Japan, which has a well-developed capital market.

IMPLICATIONS FOR LPs: NEW APPROACHES

To continue to generate attractive returns from their buyout investments in the future, LPs should probably take four specific actions.

1. Adapt the portfolio strategy

Historically, most LPs have built a portfolio focused on trying to select the best performers in buyout and venture capital in North America and Europe – not unlike their public equity colleagues actively managing their portfolios. As the buyout industry consolidates, LPs should reflect on their approach. Institutions may want to consider altering their strategies, organizations, and investment processes to take advantage of the changing nature of GPs' strategies and approaches in the mega-cap, large-cap, and mid-cap segments.

For example, if the market continues to consolidate around the large funds – and these funds increasingly form consortia to work together on the same deals – it may make sense to view them as a form of private equity sub-index into which an LP could invest.

The search for outperformance could then be focused on actively managing mid-market funds and selectively pursuing co-investment opportunities. The mid-market opportunity is the most intriguing, as players in this segment will likely pursue distinctive strategies, presenting alpha opportunities through more informed LP fund selection of the top-quartile performers.

In revising their portfolio approaches, LPs should draw on proprietary research, align their capabilities with their strategies, and outsource selectively.

2. Draw on proprietary research

Having a unique perspective on where to invest (geography, mid-/large-cap, distressed, etc.) and when to invest (in other words, pursuing tactical vintage allocation) will become increasingly important. In addition, having proprietary knowledge on the likelihood of a GP's strategy succeeding will help LPs improve their chances of selecting the best GPs.

Larger pension plans and endowments could probably support an in-house research capability. Smaller institutions would probably need to undertake this research on a project basis with advisors.

3. Align capabilities with strategy

To access the funds that fit with their strategies, LPs will have to have the capabilities that GPs value in their partners. LPs will need highly skilled, responsive, and insightful investment professionals who understand and are able to effectively execute their strategies.

As well as being able to originate, these professionals would need to be able to stress-test the robustness and replicability of a GP's strategy during a due diligence. They would need to be able to analyze previous transactions and identify the sources of value creation, and then determine if the GP could generate that value in future market conditions.

These professionals would also need to be aligned with the institution's strategy and interests through a rigorous performance management system that evaluates qualitative inputs to private equity returns (e.g., the GP's perception of the LP), as well as the financial returns generated.

4. Outsource selectively

Each institution should consider the role that outsiders can play in executing a revised portfolio strategy. For example, advisors and gatekeepers could be helpful in undertaking specific parts of the due diligence (e.g., historical return calculations) that would enhance an institution's ability to choose an investment. In addition, extremely large funds could consider using fund-of-funds to help them access smaller investments where it would be uneconomical for a large institution to manage them.

* * *

The first signs of the private equity industry's move toward maturation and concentration began to appear about 5 years ago. We are now seeing many of the same trends surfacing in Canada. In our final chapter, we outline some of them and discuss their implications for Canada.

2.3 Implications for Canada

We believe the Canadian private equity industry will likely follow the global trend toward an even bigger, more competitive marketplace with more auctions. As evidence, Canada is now experiencing many of the same changes we saw taking place in the global market over the past few years. For example, we are seeing:

- **More institutional investors entering private equity.** In the past 2 years, for example, OP Trust and PSP launched private equity programs.
- **Investors increasing their allocations to private equity.** For example, OMERS has announced intentions to increase its target allocation from 20 to 37.5 percent.
- **The market starting to bifurcate** into a handful of large firms/funds (e.g., Onex, Birch Hill, and EdgeStone) and many mid-market funds.
- **The average amount of capital under management for the big, leading firms growing steadily.** In their most recent funds, Onex closed US \$1.7 billion and Birch Hill Cdn \$850 million – significant increases over their previous funds.

Looking ahead, the large Canadian institutional investors could play an even more important role in shaping the global buyout industry. We also think it is likely that US mid-market players will increasingly turn their attention to the Canadian marketplace, as they seek opportunities in less competitive areas close to home.

* * *

As we move further into this exciting, yet challenging, stage in the evolving private equity industry, Canadian LPs and GPs that continue to adapt their skills and capabilities will be the most likely to succeed in the new reality.

110 Charles Street West
Toronto, Ontario M5S 1K9
T: 416 313 3700
F: 416 313 2999

1250, boulevard René-Lévesque Ouest
Bureau 4430
Montréal, Québec H3B 4W8
T: 514 939 6800
F: 514 939 6810

www.mckinsey.com