DUFF & PHELPS

Valuation Insights

Third Quarter 2014

In this edition of Valuation Insights we discuss the growing confidence and appetite for investment in the private equity industry as reported in a new study, *Global Private Equity Outlook*, which was jointly released by Duff & Phelps and Shearman & Sterling LLP and published in association with Mergermarket. The report also discusses the most active sectors, valuation trends, cross-border activity, regional deal flow as well as how current and anticipated regulations may affect the industry.

In our Technical Notes section we discuss how renewed regulatory scrutiny of private equity may ultimately benefit the industry. The article discusses how the industry is responding to Dodd-Frank, increased SEC oversight and inspections and the Alternative Investment Fund Managers Directive.

Our International Spotlight article discusses a new audit reform Directive from the European Parliament and its impact on the provision of valuation services for public interest entities.

Finally, our Spotlight article discusses Duff & Phelps' recent acquisition of the restructuring and insolvency division of RSM Farrell Grant Sparks, located in the Republic of Ireland.

In every issue you will find industry market multiples which are useful for benchmark valuation purposes. We hope that you will find this and future issues of this newsletter informative and reliable resources.

Read this issue to find out more.

Inside

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Global Private Equity Report

After weathering a long financial storm, private equity firms have entered 2014 with growing boldness and an increased appetite for investment. Industry leaders predict that the coming12 months will see this confidence level continue and are forecasting a significant uptick in global private equity activity.

On behalf of Duff & Phelps and Shearman & Sterling LLP, Mergermarket interviewed 75 private equity executives from Europe, North America, and Asia-Pacific regarding their investment strategies. Respondents in the inaugural report, Global Private Equity Outlook, are optimistic about private equity activity over the next 12 months. In fact, a majority of respondents (87%) believe that there will be a near-term increase in buyout activity and 72% expect fundraising prospects to improve in the next year. "Last year's significant level of fundraising, coupled with market strength and an abundance of investment opportunities, suggest that private equity activity is primed to expand over the next year," a Europe-based partner says.

The report, available for download at www.duffandphelps.com/2014PEOutlook, reviews the different strategies firms currently employ to stay ahead of the competition and to achieve the desired return from their investments. It also considers the impact of the current and anticipated regulatory environment on the industry. Although private equity has traditionally been lightly regulated, it may likely face increased oversight. The survey results address the various drivers of buyouts and exits in the current market while also exploring regional and industry-specific trends.

Highlights from the report include:

- 87% of respondents expect a near-term increase in buyout activity.
- The value of year-to-date exits at $227bn is fast approaching 2013's total of $282bn.
- Private equity respondents expect the consumer and technology, media and telecommunications (TMT) sectors to offer the best opportunities in 2014, followed by the energy, healthcare and industrials sectors.
- New entrants are intensifying already fierce competition and co-investments, alongside fund managers, are becoming more common.
- Depth and methodology of due diligence, including attention paid to new regulatory requirements, are increasing the average time to complete a transaction; more than a quarter of respondents (28%) think that regulatory and compliance risks are the top challenges faced by private equity firms.
- The value of cross-border buyouts are on the rise, with the majority of respondents planning to invest in new markets. On average, cross-border transactions will make up 30% of respondents' acquisitions over the next 12 months. Year-to-date, there have been 331 cross-over buyouts worth US$101bn and 310 exits worth US$115bn, according to Mergermarket.
- Across all regions, near-term exits are predominantly domestic while acquisitions and financing reflect greater international interest.
- 72% expect fundraising prospects to improve in the next year. Nearly 40% of the respondents will fundraise in H1 2015 and a majority plan to keep the new funds the same size as their current ones.

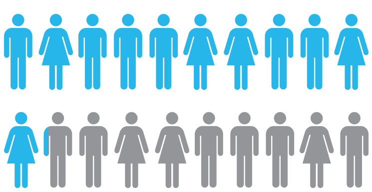
To read more of the findings from the report, visit www.duffandphelps.com/2014PEOutlook.

Private Equity Environment Bullish with Rising International Appetite and Growing Competition

Cross-Border Activity Expected to Rise Over the Next 12 Months

56%

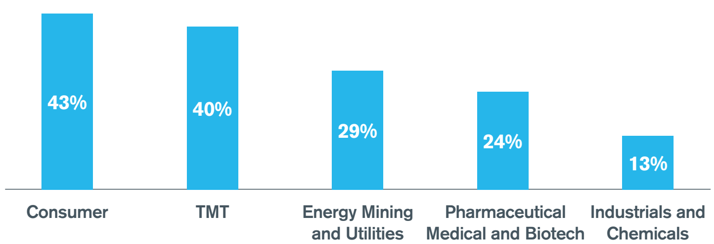
of respondents plan to invest in a new market



66%

of North American respondents will access foreign markets for financing, but 83% will exit domestically

Consumer and TMT Sectors Attract the Most Investment Interest



Technical Notes - Private Equity under the Microscope - How Renewed Regulatory Scrutiny will Ultimately Benefit the Industry

Recent speeches by Securities and Exchange Commission (SEC) staff members have questioned General Partner's (GP's) transparency, valuation and disclosure policies and, in the process, validated the independent effort among many Limited Partner's (LP's) to push for change. As was widely-reported in this regard, the SEC recently announced that it has created a new private fund unit dedicated to the examination of private equity and hedge funds.

While the private equity industry is the latest sector to undergo increased regulatory scrutiny, it is by no means the first, and will not be the last. Below, we explore the landscape, factors and perspectives currently impacting the industry.

Expanded Regulatory Environment

In the past, the private equity industry operated in an environment with limited regulatory oversight through an effective culture of self-policing that often goes unheralded. But those days are passing. As the asset class has grown, market practices have been driven by individual limited partner preferences as articulated through limited partner agreements (LPAs) and advocacy groups such as the Institutional Limited Partner Association (ILPA). Historically, securities laws exempted certain investment vehicles with a limited number of sophisticated investors from registration. Following the 2008/2009 financial crisis, both the U.S. Congress and the European Union enacted legislation that would directly impact all large alternative investment managers.

In the U.S. the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), was signed into law in 2010. Dodd-Frank requires certain investment managers to register with the SEC resulting in ongoing oversight and inspections. Further, auditors of such regulated entities also face additional scrutiny from the Public Company Accounting Oversight Board (PCAOB) and the SEC.

In Europe, the Alternative Investment Fund Managers Directive (AIFMD) entered into force in 2013. AIFMD imposes far reaching rules that will have a profound impact on Alternative Investment Fund Manager's (AIFMs) general operations, and in particular the way they communicate and interact with investors and other stakeholders.

SEC Inspections

The SEC is well underway in executing its statutory mandate of inspecting registered private equity fund advisors and managers. In a recent speech, Andrew J. Bowden, Director, SEC Office of Compliance Inspections and Examinations, said "When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time." [1] Of the approximately 1,100 registered private equity investment advisors, the 50% figure noted applies to approximately 150 newly registered managers for which initial presence exams have been completed. Inspectors have also subsequently identified weaknesses related to marketing and valuation practices.

Any deviation from legal agreements, agreed upon practices, or established regulations may be considered problematic. Clearly, private equity is a highly-functioning, high-growth sector, and could hardly have operated with the trajectory of success it has had if these criticisms were systemic across the industry. Greater clarity from regulators, and a middle-ground must be found.

Private Equity Factors to Remember

Transparency is beneficial to both investors and managers. In this vein, it is prudent to highlight some of the aspects of private equity which could be deemed vigilant, rather than villainous. These factors include:

- The majority of private equity returns benefit the "man on the street" (taxpayers backstop the pension liabilities of public pension funds; private equity returns which pay benefits remove the taxpayer backstop obligation);
- Most GPs work to do the "right thing";
- LPAs are generally thoroughly negotiated by both sides LP/GP;
- All LPAs have some gray area which may be subject to interpretation;
- LPs generally expend less resources to monitor compliance;
- Understood practices, such as the use of "affiliated" consultants or operating partners have not been well documented;
- Reading LPAs with fresh regulatory eyes, without the benefit of years of understood practice, can cause different interpretations;
- LPs generally receive reimbursement of all historical management fees before incentive fees (carried interest) are allocated;
- On a pro-forma basis, fees paid by portfolio companies do not impact the value of the company when sold;
- Valuation processes are becoming increasingly rigorous, with many managers validating their fair value estimates through an independent third party; and
- Some cynically believe that at least in some respects, the SEC needs to demonstrate that their inspections are fruitful to justify the expense involved.

For more information contact **David Larsen**, Managing Director, at +1 415 693 5330.

1. May 6, 2014 Speech; Private Equity International (PEI), Private fund Compliance Forum 2014; New York, NY.

International in Focus
Impact of European Audit Reform on Valuation Services

The European Parliament has finalized an audit reform Directive that prescribes new rules for the audit of Public Interest Entities. Public Interest Entities (PIE's) refer to European public companies as well as other European entities including unlisted companies deemed important to public interests, such as banks or insurers.

The Directive includes:

1. Limits on the number of years a PIE can employ the same audit firm. PIEs using a single auditor must put their audit out for bid at least every 10 years. While the incumbent audit firm could be retained as part of this process, the company won't be permitted to rehire the same audit firm after 20 years. For PIEs that use a joint audit (i.e. French companies) these periods are extended to 14 years and 24 years, respectively, for each of the auditors.

2. Restrictions on non-audit services. Non-audit services that audit firms are prohibited from providing to their audit clients have been expanded to preserve independence. **Valuation services are on the "black-list" of prohibited non-audit services** including valuations performed in connection with actuarial services or litigation support services. Member States are authorized to amend the black-list to the extent it has no material consequences on financial reporting.[1]

3. A cap on fees for non-audit services (relative to audit fees) that an auditor can generate from each audit client. Questions remain on whether and how this will be adopted consistently across European countries.

The reforms were formally adopted by the European Union (EU) Council of Ministers on May 27th, 2014. Each of the EU Member States will have two years to formally adopt the Directive which will be effective in June of 2016. Restrictions on non-audit services are expected to have a limited impact on how auditors provide valuation services. Most EU countries currently have rules in place that prohibit auditors from providing valuation services to their PIE audit clients, if these services have material impacts on financial statements.

On the other hand, mandatory rotations will have a far greater impact on how audit firms provide valuation services. PIEs and their Audit Committees will have to assess whether their selection of a valuation service provider (to the extent it is an audit firm) will limit their choice of auditors for the next renewal and bid process as part of the mandatory rotation. If a PIE uses an audit firm for permitted valuation services, that is not their auditor, it could create a situation where the PIE may not be permitted to retain the valuation service provider as auditor in the future. There may be situations where valuation services provided by an audit firm create a conflict whereby that firm cannot bid on the audit for a few years. And there will also be situations where audit firm rotation may lead to valuation service provider rotation as well, particularly when the valuation service provider is an audit firm, to avoid limiting the pool of potential future auditor candidates for the PIE.

PIEs should begin to consider the potential impact that their current valuation service provider may have on the selection of an auditor when they face mandatory rotation. Selection of an independent valuation provider that does not provide audit services would help mitigate the potential conflicts that could arise in the future.

Implications for Public companies

- Public companies have a limited number of audit firms to choose from (Big 4 principally for the larger listed companies). They need to be careful not to limit their choices of potential auditors as part of mandated rotation requirements.
- If a Big 4 is engaged as auditor and another for valuation services the company will be limited to two remaining Big 4 options for auditor in the future or be required to shift valuation services to another provider. In France, for example, the situation is compounded by the requirement for joint audits.
- Use of an independent valuation services provider offers public companies stability and continuity of their valuation services in the new environment of auditor rotation and restriction of non-audit services.

For more information, contact **Yann Magnan**, Valuation Advisory Services Leader for Europe, at +33 (0) 1 40 06 40 23.

1. Paragraph 9 from the Regs: (9) It should be possible for Member States to decide to allow the statutory auditors and the audit firms to provide certain tax and valuation services when such services are immaterial or have no direct effect, separately or in the aggregate, on the audited financial statements. Where such services involve aggressive tax planning, they should not be considered as immaterial. Accordingly, a statutory auditor or an audit firm should not provide such services to the audited entity. A statutory auditor or an audit firm should be able to provide non-audit services which are not prohibited under this Regulation, if the provision of those services has been approved in advance by the audit committee and if the statutory auditor or the audit firm has satisfied itself that provision of those services does not pose a threat to the independence of the statutory auditor or the audit firm that cannot be reduced to an acceptable level by the application of safeguards.

Spotlight - Duff & Phelps Acquires the Restructuring and Insolvency Division of RSM Farrell Grant Sparks

On July 10, Duff & Phelps announced that the firm acquired the Restructuring and Insolvency Division of RSM Farrell Grant Sparks, located in the Republic of Ireland. Duff & Phelps now has more than 50 restructuring and insolvency professionals in Dublin and Longford, who will continue to provide a broad array of high quality turnaround, corporate recovery and property asset management. Managing Directors Declan Taite, Pearse Farrell and Anne O'Dwyer will lead Duff & Phelps' restructuring practice in Ireland while supporting client access to Duff & Phelps' broader services platform.

Commented Declan, "On behalf of the Restructuring and Insolvency team in Ireland, we are very pleased to join the global restructuring practice at Duff & Phelps. We are confident that Duff & Phelps' broader resources and diversified capabilities will benefit many of our existing clients and, likewise, we believe that our technical expertise, strong local reputation and deep knowledge of the restructuring landscape will help Duff & Phelps grow throughout Ireland and internationally."

The transaction expands Duff & Phelps' Global Restructuring Advisory Practice to include more than 200 professionals across Europe, the U.S. and Canada. For more information, please visit www.duffandphelps.ie or contact a member of the team below.

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ANNOUNCING THE FIRST EVER CROSS-FUNCTIONAL INTELLECTUAL PROPERTY SUMMIT

Join us for this exclusive event where we will bring together corporate executives, attorneys, investors, tax professionals, CEOs, CFOs, and other experts to discuss the best practices, case examples, challenges and opportunities in valuing, managing, monetizing, structuring, and defending intellectual property assets.

Three unique tracks to explore:

- **Valuation and M&A** - Navigate IP in M&A transactions, IP valuation in early-stage businesses, and IP strategy and value maximization
- **Tax and Transfer Pricing** - Explore recent OECD developments and international tax planning, bridge the divide in valuations done for financial reporting vs. transfer pricing, and learn best practices to consider when valuing IP–including forecasting and calculating discount rates
- **Licensing, Litigation and Strategy** - Discuss trends in the legal landscape for patents and trade secrets, the legal environment for IP and its impact on licensing, and IP considerations when doing business in China

Keynote Speaker: Judge Paul Michel, Retired Chief Judge of the US Court of Appeals for the Federal Circuit

To learn more, and register for this event, visit **www.duffandphelps.com/ipvaluesummit**

North American Industry Market Multiples
As of June 30, 2014

Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
Energy	20.9	24.2	20.1	23.3	11.3	9.6
Energy Equipment & Services	24.4	21.9	18.4	19.9	10.2	10.6
Integrated Oil & Gas	12.6	—	10.9	—	7.2	—
Materials	19.3	15.0	16.0	16.8	11.2	9.2
Chemicals	19.7	21.8	15.5	21.4	11.6	11.1
Diversified Chemicals	17.3	—	16.4	—	11.5	—
Specialty Chemicals	21.4	—	16.5	—	12.8	—
Construction Materials	43.0	—	31.5	—	16.7	—
Metals & Mining	17.4	13.8	18.0	18.5	12.3	10.0
Paper & Forest Products	18.3	15.5	16.3	15.2	9.9	8.8
Industrials	21.8	17.7	15.9	17.0	11.6	11.4
Aerospace & Defense	20.2	19.4	15.0	22.1	11.4	15.6
Industrial Machinery	22.7	15.2	16.5	16.0	11.9	10.5
Commercial Services & Supplies	22.9	25.1	15.1	18.7	10.3	7.3
Road & Rail	24.6	18.6	17.2	15.3	10.2	10.9
Railroads	20.0	—	17.2	—	11.7	—
Consumer Discretionary	20.2	16.7	15.3	13.8	11.6	10.3
Auto Parts & Equipment	16.3	14.3	12.7	11.8	9.2	6.9
Automobile Manufacturers	—	—	—	—	11.3	—
Household Durables	20.1	—	16.2	—	14.1	—
Leisure Equipment & Products	12.6	—	14.7	—	11.3	—
Textiles, Apparel & Luxury Goods	19.7	—	14.9	—	12.8	—
Restaurants	29.1	17.2	21.0	12.1	13.5	8.0
Broadcasting	16.6	—	15.6	—	11.9	—
Cable & Satellite	19.7	—	15.4	12.5	9.5	6.7
Publishing	22.3	10.4	17.2	12.1	10.5	6.0
Multiline Retail	19.0	—	13.5	—	8.7	—

Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
Consumer Staples	19.5	18.2	15.8	16.8	12.2	11.6
Beverages	19.7	49.0	17.2	38.4	15.1	14.3
Food Products	21.5	16.3	17.3	17.5	12.9	11.8
Household Products	20.1	—	15.2	—	11.9	—
Health Care	24.1	13.2	18.4	19.4	14.5	13.7
Health Care Equipment	26.0	—	19.0	—	15.1	—
Health Care Services	20.2	—	15.7	—	12.5	—
Biotechnology	19.0	8.2	24.3	—	23.7	—
Pharmaceuticals	24.2	—	18.3	39.7	14.5	18.5
Information Technology	24.7	23.1	20.7	19.5	15.4	15.1
Internet Software & Services	28.2	29.4	28.1	25.0	20.7	18.1
IT Services	23.0	25.1	16.0	20.8	12.1	10.6
Software	30.7	39.2	28.5	34.5	20.7	24.0
Technology Hardware & Equipment	21.0	17.1	18.8	15.2	13.8	10.9
Communications Equipment	27.1	18.8	21.3	13.7	17.3	13.6
Computers & Peripherals	18.5	—	16.5	—	12.7	—
Semiconductors	26.1	—	24.6	—	18.0	—
Telecommunication Services	19.4	18.1	16.2	14.4	8.2	8.3
Integrated Telecommunication Services	12.4	—	14.6	13.4	6.3	8.3
Wireless Telecommunication Services	17.9	—	16.3	—	9.0	—
Utilities	19.9	16.7	15.5	18.1	10.0	11.5
Electric Utilities	19.1	—	15.5	—	9.9	—
Gas Utilities	19.3	—	14.2	—	9.3	—

Industry	Market Value of Equity to Net Income		Market Value of Equity to Book Value	
	U.S.	Canada	U.S.	Canada
Financials	15.2	12.9	1.1	1.2
Commercial Banks	14.3	12.7	1.1	2.0
Investment Banking and Brokerage	20.4	—	1.6	1.2
Insurance	13.4	13.8	1.1	1.5

An industry must have a minimum of 5 company participants to be calculated. For all reported multiples in the U.S. and Canada, the average number of companies in the calculation sample was 87 (U.S.), and 29 (Canada); the median number of companies in the calculation sample was 46 (U.S.), and 12 (Canada). Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

European Industry Market Multiples
As of June 30, 2014

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Cable & Satellite	47.3	29.5	11.7
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Pharmaceuticals	25.1	21.0	14.6
Information Technology	21.0	16.6	12.6
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Communications Equipment	17.2	15.8	12.2
Computers & Peripherals	14.7	15.0	12.2
Semiconductors	25.1	25.1	16.2
Telecommunication Services	18.9	16.9	8.7
Integrated Telecommunication Services	17.1	13.0	7.7
Wireless Telecommunication Services	6.0	17.7	8.9
Utilities	16.8	18.5	10.8
Electric Utilities	13.8	16.0	9.8
Gas Utilities	13.9	14.5	9.6

Industry	Market Value of Equity to Net Income	Market Value of Equity to Book Value
Financials	14.2	1.0
Commercial Banks	12.3	0.7
Investment Banking and Brokerage	25.0	1.5
Insurance	11.7	1.3

An industry must have a minimum of five company participants to be calculated. For all reported multiples in Europe, the average number of companies in the calculation sample was 91 and the median number of companies in the calculation sample was 42 Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

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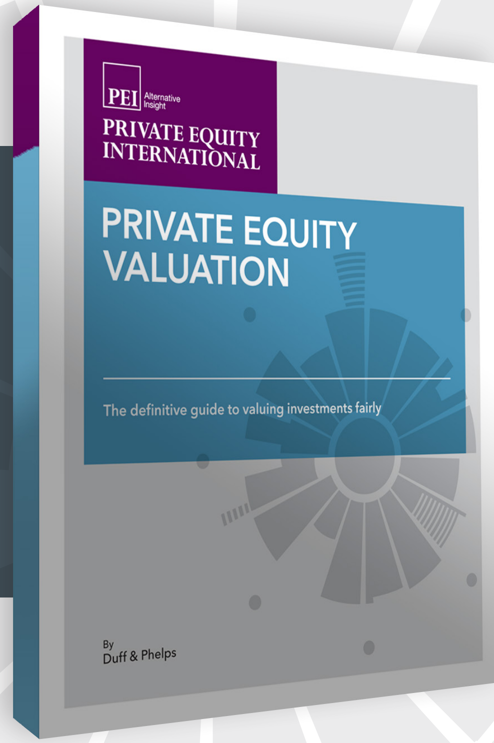
PRIVATE EQUITY VALUATION

The definitive guide to valuing investments fairly



Written by Duff & Phelps, PEI's brand new publication *Private Equity Valuation* is essential for all professionals buying, selling and valuing private equity assets.

The new guide provides fund managers and investors with essential tools and best practices for valuing their investments, including illustrative examples on valuation techniques and nuances for a variety of assets and scenarios.

Also included is a handy A-Z reference with over 80 common terms from absolute return to waterfall analysis, as well as guidance on applying fair value under Dodd-Frank and AIFMD.

The new guide is available for purchase at
www.privateequityinternational.com/pevaluation
Clients and friends of the firm can enter promo code DPVAL15 to receive a discount of 15%.

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