

A 2015 CohnReznick LLP Report



mo • men • tum

noun: impetus and driving force gained by the development of a process or course of events

MOMENTUM



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Preface

An abundant supply of capital and continued eagerness for investment activity within the private equity industry is the overarching basis of private equity activity and trends in 2015. While the industry is indeed expected to face continued challenges—from competition for deals to heightened regulation—the outlook for private equity this year is focused on expansion and optimism. How do middle market private equity players navigate the challenges and champion the opportunities





Dom Esposito

Jeremy Swan

in the landscape ahead for the next 12 months? In this report, CohnReznick's "2015 Middle Market Private Equity Outlook," we analyze the industry, activity drivers, and key issues that will make a difference for private equity executives for the coming year. Driven in part by new perspectives on longstanding issues as well as new insights on game-changers, in this report, CohnReznick identifies trends, opportunities, and challenges on this next 12-month horizon that will propel PE firms to undertake substantial shifts in strategy in order to better compete.

The "2015 Middle Market Private Equity Outlook" focuses on U.S. middle market private equity firms.* Accordingly, CohnReznick defines middle market private equity firms as those investing in middle market companies pursuant to the definition used by the National center for the Middle Market—that is, private equity companies with revenues between \$10 million and \$1 billion. We define public middle market companies as those with a market capitalization of \$10 million to \$2 billion.

Throughout 2015, we foresee competition for quality deals and steep valuations to be continuing forces of pressure for middle market private equity firms. We anticipate that during the year private equity firms will undergo significant shifts in strategy including:

- Enhanced interest in single-investor funds Demand from large limited partners, including pension funds, endowments, and insurance companies, is driving the creation of single-investor funds designed to capitalize on lower management fees.
- A shift to European-style diligence Pre-sale due diligence, driven by investment banks and savvy sellers, is speeding up the deal process for private equity funds and dramatically altering the manner and pace in which deals are closing.
- **Emphasis on Middle Market investments –** Private Equity is expected to focus resources on middle market acquisitions and value building due to the explosive growth potential of that segment.

The "2015 Middle Market Private Equity Outlook" underscores strategies that middle market PE firms can adopt in order to best compete for deals and optimize the value of their portfolio. While impractical to definitively predict the full range of opportunities and challenges that will unfold in 2015, this report highlights and provides solutions to those issues that will continue to gain momentum in 2015 as middle market private equity firms respond and adapt to this progressively dynamic business and economic environment.

Dom Esposito

Partner, National Practice and Growth Director Jeremy Swan
Principal,

Private Equity and

Venture Capital Industry Practice

January 2015



A Synergistic Duo into 2015: The Middle Market and Private Equity

Indeed, overall PE activity is strong heading into 2015 and the middle market can take much of the credit. In many ways, the middle market is the heart and soul of the private equity industry. That has never been truer than it will be in 2015 as PE firms of all sizes increase their focus on a clearly vibrant middle market.

CohnReznick observed a surge in middle market activity in 2014, with deal flow hitting record highs. Accordingly, \$362 billion was invested in the middle market and the number of middle market deals reached 1,650 in 2014¹. CohnReznick expects 2015 to result in even stronger private equity investment in middle market businesses.

Contributing to our outlook for a robust 2015 are the following factors:

CohnReznick anticipates that deal flow will remain buoyant in 2015, as non-bank lenders and BDCs build a stronger presence in the market, fueling an ever-growing supply of inexpensive leverage with flexible covenants for quality transactions. Lenders, encouraged by loan default rates that now sit at record lows, are sprinting to fund quality deals.

PE firms are under pressure to put money to work before fund investment periods end, which could further ignite the market in 2015. PE investors continue to have more capital on hand than they are able to put to work.

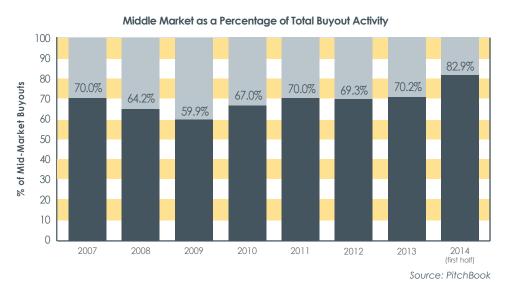
Excess fund capital is contributing to more sponsor-to-sponsor sales, resulting in an increase in the number of "selling up" sales, as smaller PE firms exit their companies through sales to larger PE firms who can inject more capital and help these businesses reach the next level in growth. In the United States exit activity across all types was particularly brisk, which saw a total of 1,021 PE-backed exits valued north of \$255 billion in 2014, according to PitchBook.

The Middle Market—An Engine of Strength for PE

The middle market is not immune to the higher valuations that are now pervasive across many industries and market sectors. In fact, median valuation-to-EBITDA multiples in the middle market rose to 10.7x in the first half of 2014, up from 10.2x the previous year, according to PitchBook. However, PE firms are finding even greater justifications for investing in these mid-sized businesses given the availability of leverage combined with the growth potential of middle market businesses—particularly, as compared to larger, more established, lower growth companies.

¹Pitchbook

Perhaps the most striking data point is that the middle market accounted for a staggering 83% of all private equity deals in the first half of 2014, up from the historical 70% threshold. "The middle market—and the lower middle market in particular—was once viewed as a cottage industry by private equity, garnering interest solely from firms targeting the market sector," said Jeremy Swan, a principal in CohnReznick's Private Equity and Venture Capital Practice. "Today, however, PE firms are much more comfortable doing deals in the middle market as well as the lower middle market. Even big name private equity brands like the Carlyle Group and Berkshire Partners are devoting more capital and energy to the middle market as they expand their horizons in their quest for quality deals and exciting growth opportunities."



Synergistic Partners: PE and the Middle Market

CohnReznick expects that middle market companies will benefit tremendously from PE investment in 2015—and the benefit reciprocates to PE as well. "Unlike other capital sources, private equity plays the role of a true strategic partner to the middle market," said Swan. "Private equity brings more than just capital. It brings strategic insight and critical relationships to middle market businesses, which can include introductions to both existing portfolio companies and new customers or partnerships. Private equity also helps to professionalize the management team and can assist in expanding the business into new product lines and regions."

Swan adds that the antiquated image of private equity obsessively focusing on cost cutting and financial engineering no longer applies in today's middle market. "Many PE professionals now play more of an operational role within portfolio companies, investing both their financial and intellectual capital to grow the business and increase value," he said.

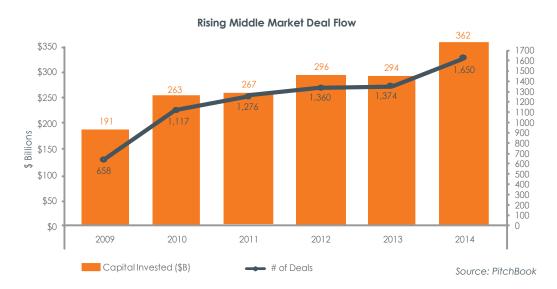
Private equity fund managers, overall, are more equipped today to transact with middle market companies. In fact, Carlyle Group LP, a private equity fund that previously generally targeted larger companies, is currently fundraising for a \$2 billion fund targeted at investing in middle market U.S. companies, according to published reports. Moreover, many new funds, including many spinout funds from both previous and existing PE firms, are targeting the middle market, as they see the opportunity for greater returns from the growth potential and the PE firms' ability to better enable the expansion of these businesses.

For private equity, the middle market represents a wealth of opportunity entering into 2015. In fact, according to a 2014 report by The National Center for the Middle Market, middle market businesses are growing several times faster than the S&P 500.

To put this into perspective, private equity firms managing funds of less than \$500 million, those that typically target middle market investments, have consistently generated higher returns for their investors compared to larger PE firms that manage funds over \$500 million, according to PitchBook. This is largely due to the explosive growth potential of companies in the middle market.

The Impact of Middle Market Deal Flow on the U.S. Economy

The impact of middle market private equity deal flow on the U.S. economy is profound, spurring innovation, productivity, competitiveness, and job growth. Private equity firms, more so than strategic acquirers, spend considerable resources post-close improving operations, hiring, and retaining the best talent and driving the growth of these businesses. Through the efforts of these firms, the culmination of each middle market transaction drives the economy forward and sets the stage for additional investment. Proceeds from the deal naturally provide liquidity to stakeholders, which will find its way to the economy in the form of additional investments or expenditures. As private equity funds continue to invest in middle market businesses and initiate growth strategies that typically involve the investment in equipment, facilities, and human capital, these activities will all serve to support the broader economy.



What does CohnReznick think?

Deal flow will likely remain robust throughout 2015 as PE firms continue to flock to middle market companies with the potential for high growth. CohnReznick expects that the middle market will remain a preferential investment area for private equity in 2015. We anticipate that, given the extremely competitive nature of private equity, the larger PE firms will continue to move downstream and target the middle market in their quest for the deals with the most upside growth potential. A steady supply of inexpensive credit as well as new PE players entering the middle market will further fuel deal activity over the next 12 months.



PE Rides the IPO Wave in 2014, But Will the Celebration Continue?

A giant wave of private equity-backed public offerings in the U.S. helped push IPO activity last year to the highest level since the dot-com bubble of 2000. Over 300 companies went public in 2014 raising in excess of \$90 billion. IPO activity in the middle market (companies with market caps of \$10 million to \$2 billion) was brisk. In 2014, 239 middle market companies went public versus 192 in 2013.

Seasoned and experienced private equity, venture capital, and corporate investors have taken advantage of vibrant stock markets, strong corporate balance sheets, and higher valuations. In 2014, CohnReznick research reveals that 64% of middle market IPOs have been backed by private capital sources and these offerings have raised more than \$18 billion in proceeds. As long as interest rates remain low and the appetite for IPOs continues, CohnReznick expects private equity investors to continue to exit via initial public offerings.

The implications for middle market business owners and private company management teams with aspirations of going public are clear. Partnering with a private equity firm could be a ticket to the IPO on-ramp. Private equity investors are accustomed to building value and increasing EBITDA. They work to help ground a company's financial and operational activities in order to attract public company investors. And if the private equity investors have a track record of exiting via IPO from previous investments, they will have experience navigating the IPO on-ramp and will employ a group of advisors who are well-versed and well-experienced in taking a company public.

Looking ahead to 2015, the pipeline remains robust as 122 companies* have already filed to raise capital on Wall Street through an IPO. CohnReznick believes the window will likely remain wide open as IPOs outperformed the broader markets by about 20% last year. Investor appetite for IPOs will likely remain high as long as the stock prices of these newly public companies continue to rise in value and broader public market conditions remain robust.

Contributing to the increase in 2014 IPO activity was the strength of the healthcare and life sciences sector, accounting for 43% of middle market IPOs. Technology also had a very impressive year, with 55 tech companies raising a total of \$32 billion, according to Renaissance Capital. That compares with 45 tech companies that went public in 2013, raising \$8 billion.

*As of the date of our research in January 2015.

Jumpstarting the Market

Another reason for the strong IPO showing: the two-year-old Jumpstart Our Business Startups (JOBS) Act. The Act is making it easier for Emerging Growth Companies, which now represent 84% of all IPOs, to access the public markets, both through the "testing the waters" and the "confidential filings" provisions of the JOBS Act. In fact, the JOBS Act has spurred 25% more U.S. initial public offerings annually since its inception, according to research by economists at Penn State University and the State University of New York at Buffalo.

"The resurgent IPO market cannot be attributed solely to the JOBS Act. Improving economic conditions, renewed consumer confidence, low interest rates, and a growing job market are all contributing factors," said Swan. "Still, the influence of the JOBS Act cannot be denied, and CohnReznick believes its effects will continue to have an in impact in 2015 as emerging growth companies take further advantage of the 'confidential filings' and 'testing the waters' provisions of the JOBS Act."

Naturally, there is some worry that the IPO market is becoming overheated. Indeed, CohnReznick clients in the \$5 million to \$50 million revenue range have related stories of fielding calls from bankers eager to take them public, where this may not have been the case in the past. This is a development that we will continue to watch, but it is too soon to proclaim a bubble.

Rather, for private equity firms that have been holding onto their companies for longer periods of time in the wake of the Great Recession, the favorable IPO market offers a much-welcome opportunity to realize a liquidity event for their better-performing holdings.

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Jeremy Swan
Principal, Private Equity
and Venture Capital
Practice



What does CohnReznick think?

We expect the IPO momentum to continue into 2015 as long as fundamentals remain solid and there are no unforeseen macroeconomic incidents. However, the pressure on IPOs to outperform the market will intensify, which means that companies entering the market must be well prepared to continue growing their businesses and impress investors.

Single-investor funds, as the name suggests, are sponsored by a single limited partner that commits the lion's share of the capital to a particular fund.



CohnReznick observed a significant new development that will likely impact much of the PE sector in 2015: the rise of single-investor funds. These types of funds are gaining popularity in Europe and could also secure traction in the U.S. as these funds take hold and increase in popularity among the LP base. In fact, several large international private equity firms that operate multiple funds have opted for a single LP in some of their smaller, sub-\$1 billion investment vehicles. Typically, the smaller single-investor funds tend to be more industry-focused or geographically-focused funds.

"With just one investor, PE firms are able to close new funds quickly and efficiently," said Swan. "LPs also enjoy the single-investor structure because they can more effectively customize the LP agreement to their liking and wield more control over fees and expenses. International LPs that have grown accustomed to this structure in some of their European investments may start to request the same opportunity from U.S.-based PE managers in 2015."

Another LP trend that continues to gain momentum is co-investment. LPs increasingly want the right to co-invest directly in private equity deals, and they are increasingly obtaining it. For the last few years, approximately one-fifth of all buyouts on an annual basis involve co-investment. The co-investment trend is up from less than 5% annually in the five years ending in 2008².

CohnReznick expects co-investment activity to increase even more in 2015 as LPs actively seek out co-investment opportunities. Why? First and foremost, co-investments are win-win propositions. LPs, for their part, can benefit from enhanced exposure to high quality deals, improved returns, and possibly even lower management fees and reduced carried interest.

Fund managers, meanwhile, cite a number of reasons related to why they are offering co-investment rights. A recent worldwide Preqin survey of 80 fund managers found that 76% offer co-investment rights to build stronger relationships with LPs, while 51% of GPs view co-investments as a valuable method for gaining access to additional capital for deals thereby allowing for investment into larger transactions that GPs may not be able to access with their fund capital alone. Moreover, in a highly competitive market, co-investment is another carrot that fund managers can use to entice LPs to invest in their funds.

²According to data compiled by Palico, a PE service provider



Still, there are several drawbacks to co-investments for GPs. One such downside is that co-investment can slow down a transaction. That is because GPs are subject to waiting for approval from the LP's investment committee before they can move forward with the deal. In addition, some LPs are using co-investment to gain valuable experience and ultimately make more direct investments on their own, without help from PE firms. More direct deal-making by LPs could increase competition in the market, making it more difficult for fund managers to source new deals and raise new funds.

What does CohnReznick think?

Limited partners are the life blood of the private equity industry. Without them, PE firms would not be in business. Limited partners are requesting more concessions and fund managers that do not heed their wishes may find it difficult to raise new capital, even from their tried-and-true investors. In 2015, LPs will continue to take a more active role in the private equity process, whether through co-investment, direct investment, or single-investor funds.

First Time Funds: Competing and Exceeding in 2015?

After hitting all-time lows in 2013, first-time funds roared back to life in 2014. CohnReznick believes that the number of first time funds coming to market is likely to swell even further in 2015, with 70% of private equity investors in North America saying they intend to invest in first-time private equity funds between now and 2016³.

This is a stunning turnaround from just a year ago, when only 207 fund managers were able to raise new capital, accounting for just 7% of all capital raised by private equity—one of the worst performances on record for first-time funds, according to Pregin, a provider of PE data.

So what accounts for this trend among investors in PE funds? "For the most part, LPs are attracted to the highly specialized nature of many of today's first time funds, which tend to have a laser-like focus on a particular industry subsector or situation," said Swan. "This specialized strategy will become an increasingly important differentiator into 2015 in the highly competitive private equity universe."

Furthermore, first-time fund managers are not neophytes—they are typically highly-skilled professionals with proven track records and deep industry experience, often gained at primarily larger more broadly focused funds. Indeed, some of the most effective managers now see an opportunity to spinout from their existing firms and capitalize on underserved segments in the market where they have unique expertise.

They will likely be encouraged in their efforts by a surfeit of capital in the market as well as by the growing LP appetite for specialized strategies. In fact, a recent poll of more than 5,000 private equity professionals⁴ found that 89% of respondents believe increasing specialization is the future of private equity.

How can first-time fund managers further distinguish themselves from other competitors in the market? CohnReznick believes the key to success in 2015 will be their ability to:

- Leverage industry specific expertise and relationships;
- · Generate proprietary deal flow from their deep industry contacts; and
- Provide intelligent, insightful advice that has a differential advantage over non-specialized competitors.

What does CohnReznick think?



An influx of first-time funds in 2015 will inevitably lead to more competition in an already fiercely competitive PE market. This could result in greater pressure on generalist funds. With more money chasing fewer quality deals, industry expertise and differentiated strategies will be at a premium in 2015.

³According to the Coller Capital Private Equity Barometer

⁴Conducted by Palico, a PE service provider

PE Firms Committing Greater Resources to Portfolio Companies

Heading into 2015, PE firms are continuing to invest more resources to "professionalize" their portfolio companies and prepare them for an exit. While it is difficult to quantify the time, effort, and capital that PE firms are investing in operational improvements, PE firms are undertaking activities that are indicative of this trend, including an increased use of and focus on operating partners, entrepreneurs in residence, and highly specialized third party service providers.

Fund managers are increasingly pursuing add-on strategies to grow their existing portfolio companies through the acquisition of, in many cases, smaller but also, as likely, larger players in their markets. In fact, add-on investments, much of which are targeted toward financing for add-on acquisitions, have been steadily rising as a share of overall buyout activity over the last decade, jumping from 36% of all buyouts in 2004 to more than 50% in recent years, according to Pitchbook.

Add-on strategies, however, have resulted in companies that are now running dozens of different financial, human resources, manufacturing, and technology platforms. PE firms see an opportunity to integrate these disparate platforms within portfolio companies in order to achieve a higher level of efficiency and cost savings.

"By investing in modernized, more efficient business systems, PE firms have greater assurance that their portfolio companies have reliable financials, streamlined inventory, and more automated operations," said John Macrae, a principal in CohnReznick's Advisory Group. "Further investment in corporate governance and compliance can make certain that nothing is amiss from a regulatory standpoint. Ultimately, investments in systems and processes can result in a more professional organization that is ready for the next level of growth or even for a liquidity transaction. Efforts to make an organization more efficient and professional can increase valuations when it comes time to sell."

66 As PE managers rely less on financial engineering and focus more on operational improvements, they are increasingly encouraging their portfolio companies to invest in big data solutions that can assist them in a greater understanding of customer behavior, controlling costs, and making more informed decisions.

David Rubin Principal, CohnReznick Advisory Group

2015 Tools: Big Data Leads to Smarter Decisions

Moving forward into 2015, in light of add-on strategies and PE firms' increased investments in their portfolio companies, CohnReznick believes PE firms will begin to adopt and implement solutions such as big data to drive greater returns in their portfolio. "As PE managers rely less on financial engineering and focus more on operational improvements, they are increasingly encouraging their portfolio companies to invest in big data solutions that can assist them in a greater understanding of customer behavior, controlling costs, and making more informed decisions," said David Rubin, a principal in CohnReznick's Advisory Group.

How does big data facilitate operational improvement? To illustrate, a PE firm that owns a large retail chain can use big data to uncover the key attributes of its best-performing stores and instill those traits in other locations. While it is the portfolio companies that are the users of solutions such as big data, CohnReznick believes the onus will increasingly be on private equity investors to make technology a priority and help portfolio companies turn their mountains of information into meaningful insight.

The increasing number of middle market transactions that collapse middeal or are executed at a lower valuation is motivation for companies to proactively conduct sell-side diligence.

Claudine Cohen Principal, CohnReznick Advisory Group



Will European-Style Vendor Diligence Invade America?

Increasingly, bankers are demanding that middle market firms conduct thorough sell-side diligence before entering into an engagement. CohnReznick believes that an increased focus on sell-side diligence will help bring greater transparency to the market, potentially shortening the sales process and increasing the certainty of close.

What is propelling the increased attention on sell-side due diligence? "The increasing number of middle market transactions that collapse mid-deal or are executed at a lower valuation is motivation for companies to proactively conduct sell-side diligence," said Claudine Cohen, a principal in CohnReznick's Advisory Group. Moreover, organizations are eager to reduce the possibility of unwelcome surprises during the sale process that could derail the transaction.

CohnReznick sees a number of emerging trends related to sell-side diligence that will continue to gain traction in 2015. The first is the rise of European-style vendor diligence in the U.S. market. As more international buyers search for opportunities in the U.S., they are starting to demand the same level of protection they receive back home.

"While buyers get protection in Europe, in the U.S., when a third-party firm helps the seller prepare its due diligence report, potential buyers that base their purchasing decision either solely or partly on that information cannot sue that outside firm if the acquisition turns sour. In other words, the third-party firm has no obligation to the buyer," said Sharon Bromberg, a partner in CohnReznick's Advisory Group.

Overseas, however, the diligence provider has an obligation to the buyer, and if things go wrong, the buyer can recover damages from that third-party

provider, although there is often a liability cap on what can be recovered. The question that U.S. sellers will need to increasingly consider in 2015, especially those pursuing an international deal, is whether they should produce a U.S.-based sell-side report, or whether they should invest in more thorough—and costly—international vendor diligence.

Another trend is warranty and indemnity (W&I) insurance. Typically, W&I insurance protects a buyer from financial loss resulting from inaccuracies in the representations and warranties provided by the seller as part of an acquisition or sale of a business. These warranties provide vital information to the buyer about the company it is acquiring and lay the groundwork for indemnification in the event of misrepresentations.

Typically, the seller sets up an escrow account to handle any breaches in warranty and indemnification. But determining exactly how much should be placed in that account can result in long, drawn out negotiations that delay deals and even impact final valuations.



"Both private equity buyers and sellers will increasingly embrace W&I insurance because it can alleviate much of the tension in the latter parts of a transaction and can expedite the move to close," said Margaret Shanley, a principal in CohnReznick's Advisory Group. Instead of the seller covering the costs related to breach, the responsibility shifts over to the insurance company.

Opening the Locked Box

Another emerging trend is the Locked Box concept—a mechanism designed to expedite the closing of deals. Transactions can often stall due to disputes over final price adjustments. The Locked Box closing mechanism is a way to reduce the often lengthy process of resolving these final price adjustments.

In essence, the Locked Box sets a fixed price for deals at the time of closing, thereby eliminating the need for time-consuming price adjustments post-close. Due to its ability to speed the sales process, we expect to see more and more deals completed under a Locked Box pricing mechanism in the coming year.

What does CohnReznick think?

In a hyper-competitive market, PE firms are eager to close deals faster than ever before—and CohnReznick expects 2015 to be the epitome of that ambition. PE firms will be on the hunt for sell-side diligence tools such as W&I insurance and the Locked Box—therefore, these mechanisms are likely to gain considerable momentum in 2015 as they help buyers and sellers reduce costs and complete the sale process more efficiently.

66 PE firms should get more creative in their hunt for deals if they want to see a decent return on investment. In 2015. they should narrow their investment focus and taraet niches where they can provide unique value and expertise. They should also continue to push further downstream into the lower middle market in their quest for proprietary, high-growth opportunities.

Jeremy Swan Principal, Private Equity and Venture Capital Practice



2015: Capital Overhang + Competition for Quality Deals = Need for New Strategies

The key to success for private equity firms has always been their ability to find and execute the deals with the most upside potential. Sourcing new and preferably proprietary deals will continue to be one of the industry's most significant challenges in 2015, attributable in large part to the amount of private equity capital chasing a smaller number of quality opportunities. As corporate buyers continue to outbid PE firms as they can better justify a strategic premium on valuation, it only serves to compound competition for quality deals further.

Even when PE firms identify companies with growth potential, the private equity industry must contend with soaring multiples that are climbing to as high as 15 times EBITDA. Further exacerbating the challenge of rising multiples chasing fewer deals is the amount of the industry's capital overhang going into 2015. The private equity overhang—otherwise referred to as dry powder—surged to \$1.141 billion as of the middle of 2014, the highest amount on record, according to research firm Preqin. CohnReznick anticipates that the capital overhang could keep valuations high across the board as funds feel pressure to put money to work before their investment period ends. Therefore, CohnReznick anticipates that the high level of capital overhang will continue to be an issue into 2015 and PE firms must find a way to respond.

CohnReznick Recommends Longer-Term Strategies

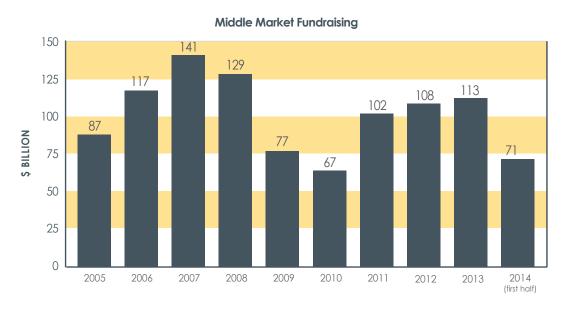
Swan says some larger firms including the Carlyle Group are responding by raising new funds with longer life spans, in some cases exceeding a 15-year life instead of the traditional five to seven year time horizon." This allows these firms to spend more time nurturing portfolio companies and maximizing their value, which could lead to more profitable exits down the road. CohnReznick expects to see this trend continue into 2015 and the foreseeable future.

In addition, fund managers are taking a long-term approach to business relationships. PE firms are spending more time networking with leaders in the industries in which they invest and they are building relationships with target companies that are not yet ready for an investment today, but could be looking for a private equity partner several years down the road.

Fundraising Solutions Point to Smaller PE Funds

In addition to longer-term strategies, the growth in the number of middle market firms has attracted substantial LP interest of late given the number and range of quality investment opportunities in the middle market. To put this into perspective, more than 160 middle market funds closed in 2014, totaling \$132 billion in commitments, which makes 2014 one of the strongest fundraising years in recent times, according to Pitchbook.

CohnReznick anticipates fundraising in the middle market to stay robust in 2015, especially as LPs shift their attention to smaller PE funds, which are perceived to be more likely to have a more differentiated, industry or situation-focused strategy than their larger peers.



Source: PitchBook

What does CohnReznick think?



PE firms must respond to the challenge of rising valuations by taking a creative approach to deal making. Middle market firms that can narrow their investment focus and move further downstream will be in more opportune positions to win deals and reap returns in 2015.



The focus of this Outlook is centered around our 2015 expectations for PE firms that are investing in and acquiring companies. Therefore, the industries where we expect to see substantial activity in 2015 are included in this Outlook. However, CohnReznick's expertise within the private equity space encompasses the real estate sector and fund investments in commercial real estate. Accordingly, we have expanded 2015 Outlook coverage of the real estate sector and included it in a separate 2015 Commercial Real Estate Outlook. Please refer to CohnReznick's Commercial Real Estate webpage.



WILL SKY-HIGH TECH VALUATIONS DERAIL PE INVESTMENT IN 2015?

Market valuations for privately held technology companies have been rising in recent years and CohnReznick expects they will continue to escalate into 2015. "In fact, billion-dollar valuations for companies like Uber and Airbnb are now the

standard for success in the tech industry, and that new high-water mark is rippling through the ecosystem, pulling up the valuations of tech companies across the board—including those in the middle market," said Alex Castelli, a CohnReznick partner and the Technology Industry Practice Leader.

CohnReznick believes that soaring valuations will likely continue to be a pain point for investors in 2015. While private equity firms are angling to close deals, they simply cannot rationalize the stratospheric price tags. Runaway valuations, with multiples often in the 13 to 15 times range, clearly had a negative impact on deal flow in 2014.

CohnReznick believes that high valuations will also impact exits into 2015. Though exit activity is still relatively robust, there have been three consecutive quarters of slowdown in 2014. Many prospective acquirers, including both strategic and financial investors, fear they simply will not realize a return on investment based on the multiples that are currently being demanded. Consequently, as long as purchase prices remain inflated, CohnReznick expects exit activity to continue to slide downward in 2015.

Why PE Loves Recurring Revenue

Still, the tech industry boasts a number of attractive features for PE investors. Perhaps the most significant is the rise of the recurring revenue model. Instead of charging upfront for the use of their product, long-term focused software vendors have shifted to a

subscription model that positions customers to pay for services over time. The subscription model can lead to stickier services and improved customer retention rates. It also makes future earnings and future cash flow more predictable, which is highly attractive to PE investors.

"Going forward, the challenge for technology companies in 2015 will be attracting new customers and sustaining revenue growth," said Castelli. "Granted, a subscription model is a solid approach to sustaining revenue, however, customers also expect regular updates and innovative enhancements to the products and services they purchase. In today's tech era, it is easier than ever for customers to switch to a competing technology if their current technology cannot remain as relevant to them as the competition."

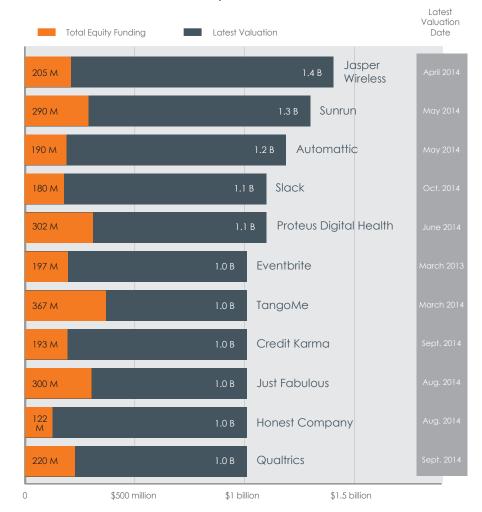
In fact, billiondollar valuations for companies like Uber and Airbnb are now the standard for success in the tech industry, and that new high-water mark is rippling through the ecosystem, pulling up the valuations of tech companies across the board—including those in the middle market.

Alex Castelli
Partner, Technology Industry
Practice Leader

Middle Market Startups Valued at One Billion +

66 The impact of rising valuations resulted in decreased investment in the technology sector. Through December 30, **2014**, PE firms invested \$65 billion in 408 technology companies, according to PitchBook. That is considerably less capital invested than the previous year's pace, when PE firms pumped \$100 billion into 410 tech companies. ??

Alex Castelli Partner, Technology Industry Practice Leader



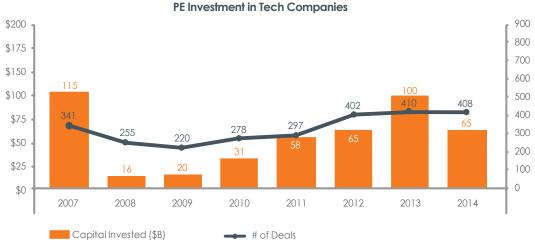


What Are the Tech Subsectors to Watch in 2015?

Though technology is a broad industry, several subsectors will prove to be especially appealing to PE investors in 2015. Cloud-based software companies, with their recurring revenue models, will continue to attract attention. In fact, approximately 70% of all capital invested in the first three quarters of 2014 went into software companies, the highest percentage on record, according to PitchBook.

Also high on the list are big data companies. CohnReznick believes that, in 2015, PE investors should keep a watchful eye on companies that can effectively analyze and derive value from the massive volume of business information being generated.

CohnReznick also expects to a see a further blurring of the lines between venture capital and private equity in the technology sector in 2015. Technology companies are not as capital intensive as they once were, which means they require less investment to propel operations. As such, private equity should be willing to invest smaller amounts of capital earlier on in the cycle to get involved with high-growth potential technology companies.



Source: Pitchbook and IssuWorks

What does CohnReznick think?

High valuations in the tech industry will continue to be a reality for PE investors in 2015. PE firms must decide whether they want to actively pursue tech deals in 2015 or whether they would rather sit on the sidelines and wait for valuations to cool down. Still, the market holds a number of attractive opportunities for PE investors in the coming year, including software companies with recurring revenue models as well as the new breed of data analytics companies that are quickly growing in size and significance.

66 You cannot even get into the P3 game unless you can differentiate yourself and really convince people that you can play at a certain level. That is something private equity can bring to the table. We are really starting to see daylight between those contractors who get it and want to grow, compared to those who are content with the status quo.

Jack Callahan
Partner, Construction
Industry Practice Leader



WHY THE CONSTRUCTION INDUSTRY MAY BE A HOT OPPORTUNITY FOR PE IN 2015

The intersection between the construction industry and private equity has generally been a path less traveled. PE investors have largely

avoided the construction sector due to a number of inherent risks, such as the cyclical nature of the business and a prevailing talent gap in the industry. But several factors will propel PE firms to take a more serious look at construction firms in 2015.

First, it is now widely understood that our national infrastructure, including the roads, bridges, and tunnels throughout America, is in a state of disrepair. According to Reed Construction Data, total construction spending is forecast to increase by 11.2% in 2015.

CohnReznick believes it is only a matter of time before an influx of government dollars is allocated to address the nation's crumbling infrastructure. When that happens, possibly starting in earnest in 2015, middle market construction companies stand to gain from these new billion-dollar infrastructure projects.

In addition, President Obama's recent immigration reform could help to kick-start the entry-level housing market. Millions of newly anointed citizens are poised to come out of the shadows and purchase property for the first time, possibly resulting in more demand for the construction of new, modestly-priced housing. With the financial crisis an increasingly distant memory, the construction industry is well positioned for a period of sustained growth.

In 2015, many construction firms will likely ask themselves whether they should remain content with the status quo, or seek outside investment to successfully compete for bigger contracts. "For instance, the ability of a middle market contractor to participate in a billion-dollar public-private partnership (P3s) is really about having the right relationships and a management team in place," said Jack Callahan, a CohnReznick partner and the Construction Industry Practice Leader. "You cannot even get into the P3 game unless you can differentiate yourself and really convince people that you can play at a certain level. That is something private equity can bring to the table. We are really starting to see daylight between those contractors who get it and want to grow, compared to those who are content with the status quo."



For private equity firms searching for new sources of deal flow and attractive valuations, the construction industry is looking better than ever as it is likely entering a period of long-term growth. But PE firms should proceed armed with industry intelligence.

"CohnReznick believes the PE firms should set their sights on construction firms that have made a substantial investment in building talent," said Swan. "Business owners that want to stand out from the crowd can do that by taking their hiring to the next level and establishing a set of systems, processes, and technology upgrades before going to market."

What does CohnReznick think?

The construction industry is poised for a rebound. 2015 is the year for PE firms to seize the opportunity and identify construction firms that have positioned themselves for substantial growth. Viable acquisition targets include construction companies that can realistically compete for larger contracts (including P3s) by bringing in seasoned management talent and successfully forge high-level relationships.

66 Although the healthcare sector remains in flux as a result of The Affordable Care Act and the changes it brings, PE investors are benefitting from macro trends in the industry such as the increasing number of consumers who are searching for a cheaper alternative to the expensive hospital system.

Richard Puzo,
Partner, Healthcare



PRIVATE EQUITY PUMPING NEW LIFE INTO THE HEALTHCARE INDUSTRY

Regulatory uncertainty, rising costs and rapid consolidation are on-going symptoms of the healthcare industry. But private equity interest

in the sector remains undiminished, with 2014 representing a postcrisis high for capital invested—and CohnReznick expects this trend to continue into 2015.

How strong is PE's commitment to investing in the healthcare industry? PE investors injected about \$48 billion into the industry through the first three quarters of 2014, which is nearly as much as the \$49 billion they invested in healthcare in all of the previous year, according to data from PitchBook.

"Although the healthcare sector remains in flux as a result of The Affordable Care Act and the changes it brings, PE investors are benefitting from macro trends in the industry such as the increasing number of consumers who are searching for a cheaper alternative to the expensive hospital system," said Richard Puzo, a CohnReznick partner and the Healthcare Industry Practice Leader. "This is leading to the creation of more retail medical practices to meet consumer demand, and to more investment opportunities for private equity. PE is also benefiting from numerous rollup opportunities resulting from the subsequent industry fragmentation."

The Healthcare Sector, Yes...But Which Subsectors Should PE Watch in 2015?

One of the most attractive areas for PE investors is the retail health category,

which includes urgent care facilities, surgery centers, pain management facilities, and dermatology clinics. What makes these retail health subsectors so attractive to PE? In brief, reimbursement issues are ratcheting up the pressure on smaller practices in these fields thereby forcing them to consider a strategic sale or merge with larger practices. In addition, health practices realize that by being part of a larger practice, they are able to realize the benefits of creating ancillary sources of income, reducing costs, having more effective management teams, and are able to more feasibly afford new technology. Last but not least, health practices realize that as they become larger, they have a greater opportunity to execute a liquidity event.

The Urgent Care Association estimates that the current ownership of clinics and care centers is split fairly evenly among physicians, corporations (including private investors and insurers), and hospitals. Many of these smaller operations, especially those owned by entrepreneurial physicians, are now looking to merge their practices with larger outfits. When executed properly, an acquisition can benefit all parties and result in tremendous growth and substantial economies of scale. For instance, a smaller practice can relieve itself of expensive, duplicative administrative burdens imposed on it, such as maintaining complex reporting systems and investing in state-of-the-art electronic medical records systems.



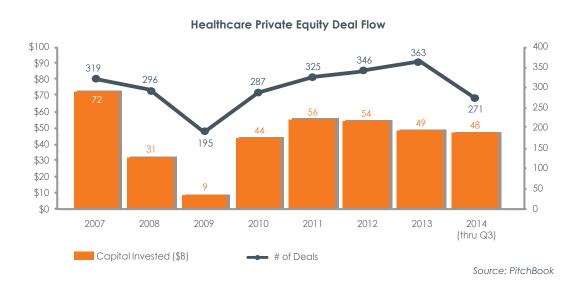
The top 10 providers account for less than 10% of the retail healthcare market, and most clinic operators own fewer than three centers. Therefore, the highly fragmented nature of retail healthcare presents PE investors with exciting opportunities for growth by building up their platforms through add-on acquisitions in 2015. In fact, there are more add-on acquisitions in healthcare than any other industry, according to PitchBook, with add-ons accounting for more than 70% of all healthcare deals.

Over the first three quarters of 2014, there were 69 exits for PE-backed companies in the industry.⁵ CohnReznick believes the brisk pace of investment activity in the retail healthcare subsector will continue into 2015 given the continuing market consolidation and the overall growth in healthcare services. Exit opportunities should also remain plentiful for PE investors—at least for the remainder of 2015.

⁵www.law360.com

"We expect PE firms will continue to bring their healthcare portfolio companies to market, especially those that they have grown significantly through add-on acquisition over the past four to six years," said Swan. "As long as economic conditions hold steady, the exit window should remain open for those healthcare companies who have a proven record of performance."

For middle market healthcare firms hoping to attract PE investors, the first order of business is scale. PE firms should look carefully for companies that are poised for growth. CohnReznick observes a number of smaller retail health practices in the \$10 million range that are actively growing through acquisition in preparation for a possible private equity transaction in the near future. Those that properly position themselves to attract investors are strengthening their infrastructure by implementing proper controls and accounting systems, as well as building professional management teams that are capable of scaling the business.



What does CohnReznick think?

The evolving healthcare industry offers increased opportunity for lucrative private equity investment in 2015, particularly in the subsector of retail health.

Both exit and acquisition opportunities are likely to remain robust throughout 2015 as the industry continues to consolidate. Private equity firms should target growth companies in the middle market that are strengthening their business infrastructure, including the implementation of the proper controls and accounting systems, as well as building professionalized management teams that can help scale the business.

PRIVATE EQUITY OUTLOOK BRIGHTENS FOR MANUFACTURING INDUSTRY

Manufacturing and wholesale distribution (M&WD) was one of the hardest hit industries in the United States during the 2008-2012 economic downturn. However, the industry as a whole rebounded in 2014, experiencing one of its highest

production outputs since the start of the financial crisis. In fact, capacity utilization rates—a key measurement of how intensely firms use resources—reached 79.2% in 2014, the highest rate since June 2008, according to the Federal Reserve Board.

The turnaround in manufacturing has not gone unnoticed by the private equity industry. In particular, subsectors such as aerospace and defense, food and beverage, and chemicals are attracting significant attention for potential acquirers.

In fact, 2014 saw the highest level of merger and acquisition activity in the industrial manufacturing sector in more than ten years. The first nine months of 2014 recorded 1,032 Manufacturing and Wholesale Distribution transactions totaling \$61.65 billion, compared to 1,029 deals worth \$57.46 billion during the same period the previous year according to Pitchbook.

The industry is expected to continue its upward trajectory in 2015. Why? CohnReznick identified the following key game changers that will be working in favor of the manufacturing industry in 2015:

- Energy costs, traditionally a significant line item for manufacturing and distribution companies, are in steady decline. Oil prices continue to fall as does the cost of natural gas thanks to the combination of abundant supply and declining global consumption.
- Low interest rates and plentiful credit are providing increased access to capital.
- A growing number of manufacturing companies are embracing new technologies such as 3-D printing, which are enabling organizations to work better, faster, and more cost effectively.

Challenges, however, do exist. Perhaps the most significant of which is the skill gap. "Nearly 80% of all manufacturing companies are currently experiencing a shortage of skilled workers, including engineers, chemists, and machinists," said Alan Wolfson, a CohnReznick partner and the Manufacturing and Wholesale Distribution Industry Practice Leader. "The problem is getting worse as older employees retire and younger talent flock to more vibrant industries such as the high-tech sector."

For PE firms. M&WD has lona been a favored sector for investment. Indeed, many PE firms have developed substantial subject matter expertise within the broader M&WD sector and specific subsectors. This industry knowledge coupled with extensive relationships within the industries enable PE firms to offer not only financial capital, but also intellectual capital and management support that can increase profitability and strengthen the company's overall value.

Alan Wolfson
Partner, Manufacturing
and Wholesale Distribution
Industry Practice Leader



However, CohnReznick believes the talent issue could improve in 2015, especially in the wake of recent immigration reform that could open the door to an increase in the number of skilled workers available to U.S. middle market companies.

What does CohnReznick think?

With all factors pointing to improving market and business conditions for M&WD in 2015, the industry will be highly attractive to the PE community. And while valuations in other sectors such as technology and retail are sky-rocketing, pricing in the M&WD market is expected to remain rational, which could further accelerate deal volumes in 2015. CohnReznick recommends that owners and management of M&WD companies give strong consideration to building and nurturing relationships with PE firms. In addition, PE and M&WD benefit through increased knowledge of how the needs of middle market companies can intersect with the resources that PE firms can provide to help grow their businesses.

RESTAURANT DEALS SOAR INTO 2015

The combination of low interest rates, improved credit terms and a stable U.S. economy will further fuel private equity's appetite for restaurant chains in 2015. As competition for deals with upward potential heated up, valuations soared in 2014. With restaurant deal flow and valuations reaching record highs in 2014,

CohnReznick expects valuations to remain steady in 2015. PE firms will be in positions of paying high prices for new deals yet also benefitting from greater profits as they divest of their current restaurant holdings.

Restaurant valuations are at historic highs as we head into 2015. Quick-service restaurants, for instance, are currently valued at approximately 14-times EBITDA, according to KeyBanc Capital Markets. To put this into perspective, the traditional multiple for the restaurant industry has historically been about 10 times EBITDA for this segment.

"That is great news for growth-oriented restaurant operators looking to sell their business," said Gary Levy, a CohnReznick partner and the Hospitality Industry Practice Leader. "However, for private equity, the soaring valuations are more of a mixed bag. On one hand, they will likely be paying top dollar for new deals. On the other hand, private equity will be motivated to sell existing portfolio companies to earn a spectacular return on investment."

The exit path of choice for PE firms is the public markets as the IPO market is strong and the window of opportunity is currently wide open. It is also where private equity firms can attract the highest prices. A prime example is Habit Restaurant, Inc., a private equity-backed company that saw its shares jump 120% on its first day of trading. Other restaurant companies that went public in 2014, such as Zoe's Kitchen, Dave & Buster's Entertainment, Inc., and El Pollo Loco Holdings, Inc., are still trading above their initial IPO prices.

Indeed, 2014 was a banner year for restaurant IPOs as they raised \$443 million⁶ in the public markets. CohnReznick anticipates the robust IPO market extending into 2015, especially if multiples remain high and the stock prices of recently-public restaurant companies continue to soar.

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Gary Levy
Partner, Hospitality Industry
Practice Leader

CohnReznick anticipates some segments within the restaurant space to attract private equity more intensely in 2015. One such segment is the fast-casual restaurant concept. This segment, extremely popular with the millennial generation, will likely remain in high demand in 2015 due to low commodity prices as well as the declining price of gas, which is putting more disposable income in the pockets of consumers.

⁶Source: Audit Analytics

PE Attracted to Smaller Restaurant Deals in 2015

CohnReznick observes another trend in the market: private equity's willingness to participate in smaller deals. Even the largest of PE firms are digging into smaller restaurant deals. KKR, for instance, recently acquired a minority stake in Lemonade Restaurant Group LLC, a cafeteria-style restaurant chain that has operations in only 16 locations.

"Previously, a restaurant operator would need at least \$10 million in EBITDA, along with a very convincing growth story, before private equity would even look at the deal," said Levy. As we head into 2015, however, \$5 million is the new \$10 million. "Today, we are seeing deals done with EBITDA of \$5 million or less, provided that investors like the concept and see the potential in growing operations and value," said Levy.

Private Capital Raised by Restaurant Companies via IPO



Source: Piper Jaffray and Audit Analytics

What does CohnReznick think?



High-growth restaurant concepts will continue to be very appealing to private equity firms in 2015. In particular, fast-casual concepts with strong potential for growth will be in high demand in 2015. Though valuations will likely remain at high levels, PE firms stand to gain from a growing appetite for restaurant deals in the public markets.

RETAIL AND CONSUMER PRODUCTS SECTOR APPEALS TO PE IN 2015

The retail and consumer products industry undoubtedly faced a number of challenges in 2014 due to slowing sales and growth rates that remained static in the low-single digits.

Moreover, many of the most promising retail outfits have already been selected by private equity firms, and those that remain come with sticker prices that do not justify an acquisition by

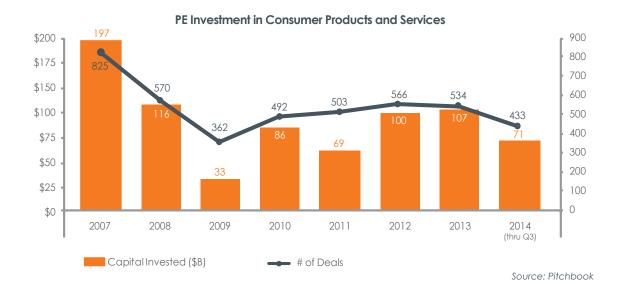
PE investors. However, CohnReznick believes the retail and consumer products industry is poised for stronger sales in 2015 that could present a window of investment opportunity for PE firms.

Despite the precarious state of certain segments of the retail market CohnReznick has identified several factors that could drive increased PE activity in the retail sector in 2015. These include:

- Greater disposable income due to plummeting gas prices
- Technological advances—such as omni-channel and big data—that are driving the steady proliferation of online and mobile shopping
- The emergence of international markets as the next frontier for many retailers

The drop in oil prices is a boon to the retail industry because it promises to place more disposable income in the pockets of consumers. Ultimately, that could mean more money flowing into the retail sector and faster growth for the industry as a whole.

Another cause for optimism is the technological change sweeping the retail sector. E-commerce reigns as the industry's strongest growth channel—in the U.S. alone, online retail sales are expected to reach \$370 billion in 2017, up from \$262 billion in 2013, according to research firm Forrester. "As additional consumers utilize mobile and internet technologies to do their shopping, PE firms should be targeting omni-channel retailers that are winning new customers by seamlessly integrating the online and offline shopping experience," said Richard Schurig, a CohnReznick partner and the Retail and Consumer Products Industry Practice Leader. Omni-channel was a key differentiator for retail companies in 2014 but will be even more integral to the success and longevity of retailers in 2015.



As additional consumers utilize mobile and internet technologies to do their shopping, PE firms should be targeting omnichannel retailers that are winning new customers by seamlessly integrating the online and offline shopping experience.

Richard Schurig
Partner, Retail and
Consumer Products
Industry Practice Leader

PE firms will also be more attracted to retailers that are leveraging big data to learn more about the customer and ultimately grow sales. Why? Because retail companies have an opportunity to use ecommerce data to gain insights into their customers' spending habits, and thus better optimize their inventory. Big data can also enable a retail brand with hundreds of locations to uncover why one store is successful and another is not. What are the notable propellers of the most successful retail locations of a particular brand? What attributes do the successful stores share, and how can those attributes be implemented across locations? Big data analytics can identify those winning patterns and behaviors for selling certain merchandise in certain stores as well.

Another frontier for retailers in 2015 will be increased international expansion. PE firms will increasingly be shopping for retail outfits that have established a strong presence in their local markets and will require assistance in their efforts to go global.

While 2015 will present retailers with positive drivers for stronger sales in 2015, perhaps one of the most significant differentiators in 2015 for retail companies will be brand recognition, or the ability for retailers to distinguish themselves in the market by having a clear identity and providing a one-of-a-kind experience to their consumers. PE firms in particular want to invest in strong, recognizable lifestyle brands that can stand on their own and thrive despite unrelenting competition from powerful online retailers such as Amazon. Brand recognition will be paramount in 2015—especially as Chinese retail giant Alibaba pursues its global expansion.

What does CohnReznick think?

The retail and consumer product environment is evolving at a rapid pace. This is creating significant challenges and opportunities for both companies and PE investors. The coming year should be a very promising one for retailers and PE investors who can identify and openly embrace the transformative, progressive changes and new channels of doing business that can provide competitive advantages.



Navigating Regulatory Burdens in 2015

PE firms with more than \$150 million in assets under management must now register with the Securities and Exchange Commission (SEC) as investment managers. Though the registration rule became effective in 2012, last year, the SEC began ramping up its examination pace. As a result, many PE firms will likely go through the examination process for the first time in 2015. This will require PE firms to put their internal documentation in order and further tighten many of their operating and compliance procedures.

For instance, PE professionals will need to develop robust internal controls and ensure their limited partnership agreements are fully transparent regarding fees and expenses. In addition, CohnReznick advises fund managers to form an internal advisory group to review and approve specific fund activities in accordance with LP agreements, and to ensure that the application of valuation processes and methodologies are consistent.

"It is also critical for PE firms to set the regulatory tone from the top," said Jay Levy, a CohnReznick partner and the Financial Services Industry Practice Leader. "This means putting in place a chief compliance officer who takes the role seriously and is not simply in the position by default. This person must be well versed in all the rules and regulations impacting PE and must have the power to ensure the firm is doing and documenting exactly what it says it is doing."

Also causing concern in PE circles are increasingly enforced federal guidelines aimed at ending risky lending practices that could make it more difficult for PE firms to execute on highly-leveraged bank loans. The potential impact on the PE industry could be fewer lending sources for primarily larger leveraged buyout deals, however, there will likely be a trickledown effect into the middle market if these trends continue.

It is also critical for private equity firms to set the regulatory tone from the top. This means putting in place a chief compliance officer who takes the role seriously and is not simply in the position by default. This person must be well versed in all the rules and regulations impacting PE and must have the power to ensure the firm is doing and documenting exactly what it says it is doing. ??

Jay Levy
Partner, Financial Services
Industry Practice Leader



The new federal guidelines, which generally apply to leveraged loans of \$20 million or more, went into effect last year. Under the guidelines, updated for the first time since 2001, leverage levels above six times debt-to-EBITDA after asset sales are now classified as "criticized loans." In 2014, the percentage of U.S. leveraged buyouts with a debt-to-EBITDA ratio above six times was at over 40%, the highest level since 2007, when it reached 52% according to \$&P Capital IQ LCD.

Banks that participate in deals that regulators consider too risky could face fines or other enforcement actions. The real concern for PE—and for company owners looking to sell their businesses to PE—is that these new guidelines could curtail the size and number of deals that are executed.

While regulated banks such as Credit Suisse and JPMorgan Chase may be less likely to benefit from lending to the private equity community, CohnReznick expects nonbank lenders to benefit from the new rules. Nonbank lenders accounted for 75.31% of total middle market volume in 2014, up from 70% three years ago, according to S&P Capital IQ LCD. And, thanks to the new federal guidelines, their share of the pie seems likely to grow significantly in 2015, as regulated banks find it harder to compete and private equity firms expand the number of lenders they approach.

What does CohnReznick think?



PE firms must take concrete steps in 2015 to prepare for possible examination by the SEC. They must also prepare themselves for new rules around leveraged lending. If a major source of debt capital is suddenly removed from the market, the ability of private equity firms to close deals could be negatively impacted.



Carried Interest Tax Reform and Other Tax Issues Ramp Up

PE firms will be holding their breath in 2015, at least where carried interest and tax issues are concerned. Following on the State of the Union Address, carried interest is back in the crosshairs of lawmakers. CohnReznick believes that while there are significant political headwinds battling the treatment of carried interest, it is a toss up as to whether this issue will be resolved in 2015. Prior to the State of the Union Address, many felt it was unlikely that the current administration would push to institute a higher tax rate on the receipt of proceeds related to a carried interest. However, the administration's recent tax proposals are focused on funding many 2015 initiatives through a range of tax hikes, potentially including the capital gains rate and carried interest, even though the capital gains rate has already increased from 15% to 20% in recent years, and the new Medicare surtax of 3.8% on net investment income (which includes capital gains) results in an overall capital gains rate for higher-income taxpayers of 23.8%.

Some Members of Congress think that carried interest should be taxed as ordinary income rather than as an allocation of capital gains. In doing so, it would raise the tax on carried interest to as high as 39.6% from the current 20% rate for the highest earners.

Several other tax issues remain looming on the horizon that could impact the private equity industry. The first is the effort on the part of cash-strapped states to move toward a benefit rule. California, for instance, has proposed new regulations stating that if a PE firm has limited partners that reside in California and derive benefit from those relationships, then that PE firm, no matter where it is based, is subject to California's tax rules and filings in California.

This approach to taxation could potentially gain traction in all states across the nation, especially as they search for new revenue sources. So, if a PE firm has ten limited partners in ten different states, the firm could ultimately be responsible for ten different tax filings. As a result, PE firms will need to be increasingly aware of the 2015 rules governing tax filings in all states.

Self-Employment Tax—An Upcoming Snare for PE?

Generally, a "limited partner's" distributive share is not subject to self-employment tax. However, in the last quarter of 2014, the IRS issued ILM 201436049 turning this general rule on its head. The ILM makes clear, at least with respect to members of a limited liability company who materially participate in LLC operations that constitute a trade or business, that the IRS intends to pursue imposing the self-employment tax on those limited equity owners/members. While final guidance from the IRS is forthcoming but not yet available, private equity firms should be aware of a potential self-employment tax snare where one did not exist previous to the 2014 ILM.

Although final guidance is not yet available, self-employment tax challenges for PE players do not end there. The industry and the IRS are in a debate over the IRS' recent treatment of some private equity entities as a trade or business rather than as investment entities. What is the difference? If treated as a trade or business for income tax purposes, income allocated to limited members within private equity funds may be subject to self-employment tax. Tax on previously untaxed income, clearly, has an impact on returns and the final decision could have sweeping implications for the private equity world. CohnReznick will keep the market abreast of new developments as they arise.

What does CohnReznick think?



Carried interest and a number of other tax issues that PE firms will need to be aware of, including the potential for new state filing requirements and self-employment tax challenges, will be in the crosshairs of the administration in 2015.

MOMENTUM



A healthy supply of capital and sustained competition for high quality investment transactions will be propelling fervent activity in the PE sector in 2015. A progressively dynamic business and economic environment paints an outlook for the PE industry that is marked by expansion and increased competition.

As the doors of opportunity widen for private equity investors, middle market private equity firms will be challenged by a convergence of persisting pressures, including increasing regulation, new tax threats, and the competitive necessity to differentiate investment funds. New perspectives on longstanding issues and new insights on game-changers will propel PE firms to undertake corresponding shifts in strategy in 2015 such as increased interest in single investor funds and "European-style" due diligence.

Competing for deals and optimizing the portfolio value of middle market private equity firms requires the identification of trends, opportunities, and challenges anticipated throughout the next 12 months—such as those underscored in this report. It is our hope that CohnReznick's effort to pair solutions offered with the issues identified in this report will better equip middle market PE firms to successfully compete in the dynamic and exciting 2015 business environment that stretches ahead.

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About CohnReznick's Private Equity and Venture Capital Industry Practice

As one of the leading accounting, tax, and advisory firms in the United States, CohnReznick provides private equity and venture capital firms, family offices, small business investment companies (SBICs), and other investment groups with technical skills grounded in deep industry expertise. With partner-level involvement at all stages, CohnReznick's PE and venture capital professionals offer fully coordinated delivery of services for every transaction—from acquisition to exit.

Our PE and venture capital clients rely on our professionals to help them maximize the value of their investments. Services to PE and venture capital clients include:

- Transaction Services including due diligence and purchase price dispute services grounded in industry insight;
- Value Enhancement Services to improve EBITDA and increase cash flow. Our Business Discovery Boot Camps lead management through a collaborative process that looks beyond functional boundaries to root out opportunities to eliminate waste and add value;
- Portfolio Company Compliance including audit, tax, and consulting services that culminate with a
 management report, as a by-product of our audit services, that summarizes our preliminary observations
 regarding EBITDA and working capital improvements that we discuss with both the portfolio company
 senior management and the outside investors; and
- Fund Compliance solutions.

CohnReznick Advantage for Private Equity and Venture Capital Industry

Industry Insights, Optimized Solutions

- Our understanding of private equity and venture capital industry drivers, combined with consistent client service teams, translates to thoughtful, well-prepared transaction advisory, compliance, and value enhancement services.
- We leverage industry expertise to expose risks and identify opportunities inherent to each transaction.

Transformative Advice

- Timely, relevant views on topics such as carried interest, capital formation, exit strategies, tax issues, and the impact of sovereign governments on limited partner investors.
- Thought leadership on the JOBS Act, potential immigration reform, SEC oversight, and trends in liquidity events and capital formation.

Responsive Culture

- In competitive situations where successful deals often hinge on our ability to deliver insightful results quickly, our clients benefit from an accessible team, empowered to meet their needs.
- Whether providing due diligence, transaction advisory, tax, or compliance service at the fund or portfolio company level, we recognize the time sensitivity of helping clients achieve investment goals and meet regulatory requirements.

Capital Markets Dexterity

- Our Firm culture collaboratively connects clients with proprietary opportunities for acquisitions, dispositions, and strategic partnerships.
- We have the institutional credibility necessary to connect private investors and their portfolio companies with acquisition opportunities, liquidity events, and other capital-raising needs.

Proactive, Resourceful Services

- Partner-led service teams introduce opportunities, initiate critical discussions, and ensure that client expectations are documented and met through customized Client Service Plans.
- As advisers to the private equity and venture capital community, we connect clients to our vast resources, including educational events, regulatory updates, and business opportunities.

National with Global Reach

- With offices in the leading financial centers, we are geographically situated to perform local fund-level and portfolio company services.
- As an independent member of Nexia International, we assist clients with acquisitions, dispositions, compliance, tax, and advisory services in 590 offices in more than 100 countries.

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