PANTHEON

in>focus

Outlook for 2015

Chris Meads, Head of Investment

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ACTIVE STRATEGIES FOR A LOW-GROWTH WORLD

Economic stimulus is nothing without structural reform. Nor for that matter is swingeing austerity. Just when most of the world appeared to be recovering from the economic ills of the past six years, symptoms have returned to many markets that indicate the medicine administered has proven unsuccessful as the widespread cure.

Europe, having turned a corner, is slipping into recession once more. Deflation across the Eurozone is a threat, and indeed already a reality in some markets[1]. The UK, which emerged strongly from the downturn, may not be able to escape the pull backwards. Meanwhile, Japan has slipped into recession once more, with its fifth technical recession since 2002 deeper than at first thought[2]. At the end of 2014, the Bank of Japan signalled its intention to lift its bond buying program to unprecedented levels, while the European Central Bank appeared to be preparing to embark on quantitative easing in the hope of rekindling growth. So, just as one large central bank – the U.S. Federal Reserve – seems to be turning off the printing presses, two other central banks appear ready to flood markets with masses of liquidity.

The problem of slow growth is most acute in those two markets, but not confined to them. A large part of the world is now faced with the symptoms of what economists call "secular stagnation" – a long-term reduction in the potential growth rates of developed economies. Meanwhile, large emerging markets, including China and India, have stronger growth but seem unlikely to recapture the heady double-digit or high single-digit rates registered just a couple of years ago. The prospect of anaemic growth leaves policymakers around the world grappling with ways to stimulate their economies, create jobs and increase prosperity for their citizens.

As investors, we have to find ways to generate returns against a backdrop of persistent uncertainty and volatility. In the face of slower growth and stagnation, the quest for yield has become fundamental. Treasury yields flirt with record lows and high-yield credit can prove to be anything but. Private equity is not immune to downward pressure on returns, but managers must be more active and dynamic in order to create value.

Amidst the uncertainty, bright spots remain on the horizon. In the U.S., growth is on an upward trajectory, jobs are being created and wages show signs of increasing[3]. The U.S. experience of quantitative easing shows that such measures can work, but only when allied with financial and structural reform. Certain emerging markets are also showing strong signs of continued growth and undervaluation from a private equity perspective. And globally, oil prices – which at time of writing were at a five-year low below $65 a barrel[4] – can provide a fillip for growth, particularly in those countries reliant on oil imports for their manufacturing output.

We will now delve into the big topics affecting countries around the world and examine the macroeconomic and private equity environment in our core markets.

[1] Source: Eurostat Newsrelease, October 2014. Six EU countries including Greece, Bulgaria, Hungary and Spain were registering negative annual inflation

[2] Source: Japan Recession 2014: Why Abenomics Isn't Working, Jessica Menton, International Business Times, December 8, 2014

[3] Source: Big Job Gains and Rising Pay in Labor Data, Nelson D Schwartz, New York Times, December 5, 2014

[4] Source: Bloomberg Energy & Oil Prices, December 11, 2014. Brent Crude priced at $64.85 a barrel

KEY TAKEAWAYS FOR 2015

1. Active private equity investing is important for potential returns amid high asset prices and slowing growth
2. Real assets can be attractive as they aim to provide an inflation hedge in a low-yield environment
3. U.S. and India investment backdrop brighter; Europe and Japan showing weaker signs
4. Energy, healthcare and U.S. manufacturing remain as top investment themes
5. Global shift from DB to DC pension schemes continues

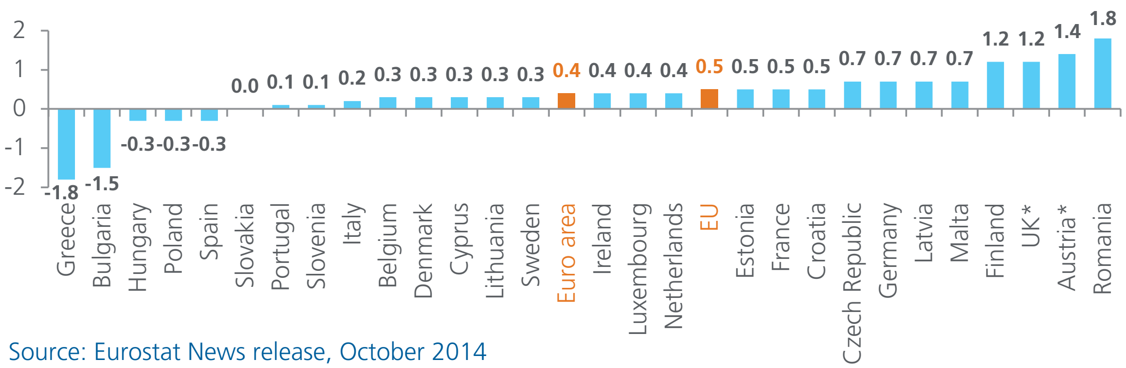
JAPAN AND EUROPE QUANTITATIVE EASING LOOMS

The U.S. Federal Reserve announced an end to quantitative easing in October 2014, having observed a marked improvement in the U.S. economy since the near $4 trillion monetary experiment began in 2008. Joblessness has fallen, consumer spending and business investment are growing, and inflation – pushed down in part by low oil prices – is picking up and wages are responding[5]. Normal economic progress, though not boundless growth, is returning.

Contrast the situation in the U.S. with that in Western Europe and Japan – two Old World economies where last year we observed encouraging signs of growth[6]. As we enter 2015, both are tipping backwards as deflation and recession take hold once more. The result is that as one massive monetary program comes to a close, two new packages are ready to take its place. It's worth asking whether or not they can be as successful as the U.S., and what the implications of the measures might be. The U.S. experience has shown that quantitative easing can stimulate growth, but by no means in isolation. In this case, a clear-out of the banking system on an unprecedented scale helped pave the way for new lending.

In Europe, a brief honeymoon of improving economic growth has been replaced with a deteriorating outlook. The European Union registered GDP growth of just 0.3% in the third quarter, with its largest actor Germany having effectively ground to a halt since the end of March[7]. ECB President Mario Draghi, who arguably drew a line under Europe's sovereign debt crisis with the now-famous words "whatever it takes", stands ready to administer emergency liquidity[8]. Yet, without long-term reform, the benefit is likely to be short-lived. Deflation is already a reality in some Eurozone countries, as shown in Figure 1 below.

Figure 1: European annual inflation (%) as of October 2014



Source: Eurostat News release, October 2014
*Data for Austria provisional and data for UK as of September 2014

[5] Source: Big Job Gains and Rising Pay in Labor Data, Nelson D Schwartz, New York Times, December 5, 2014
[6] Source: Japan Recession and EU Slump Hold Lessons for U.S., Investor's Business Daily, November 17, 2014
[7] Source: Eurostat, December 5, 2014. Germany contracted by 0.1% in Q2 followed by 0.1% growth in Q3
[8] Source: European Central Bank United on €1 trillion Liquidity Injection, Claire Jones, Financial Times, November 6, 2014

Meanwhile, Japan's return to recession in 2014 stemmed from an ill-conceived gamble to increase sales tax from 5% to 8%. After living with years of economic stagnation, the nation's consumers remain cautious and are clearly not easily won over by the "three arrows" expansionist policies of Prime Minister Shinzo Abe. Market reforms have been slow in coming, and with levels of public confidence evidently low, those promises are arguably more difficult to deliver.

"We haven't seen any sustained push on the more structural reforms required to embed growth in Japan, be that on immigration reform, labor market reform or breaking up some of their enormous monopolies," said Pantheon's Head of Investment, Chris Meads.

Europe also needs to reform its labor markets, clean out its banking problems, and deal with its inconsistent Stability and Growth Pact, which is driving the continent into deflation through continued government expenditure cuts.

SECULAR STAGNATION: THE NEW NORMAL?

Secular stagnation is not a new term. It was first coined by U.S. Keynesian economist Alvin Hansen in the 1930s. But it has taken on an altogether modern twist following a much-lauded speech by former U.S. Treasury Secretary Larry Summers in early 2014[9].

Secular stagnation not only highlights a long-term lowering of growth expectations across developed economies, it also points the finger at governments for failing to invest in growth-generating projects and hence keeping GDP below its potential. Loose monetary policy can provide a short-term stimulus by bringing some of tomorrow's demand into today, but the long-term fix requires more investment and structural reform.

In the last 12-months, secular stagnation has been discussed in relation to the U.S., Western Europe and Japan – and resonates with symptoms found in all those geographies. While Japan is already grappling with massive monetary stimulus, and the U.S. appears to be exiting the woods, Europe appears behind the curve due to its inaction on both monetary and fiscal policy.

Germany, which could so easily be a driver for growth and investment across the Eurozone, appears to have put a brake on progress with its hairshirt approach to austerity. In October[10], the country reported its largest one-month drop in factory orders, industrial output and exports since 2009. Germany's own Bundesbank has halved growth estimates for 2015 to just 1%[11]. And yet the underperformance seems in stark contrast to its financial position. In the first half of 2014[12], Germany posted its largest budget surplus since reunification.

Calls to spend cash are falling on deaf ears and continued austerity in the face of deflation is driving a wedge between Chancellor Angela Merkel's administration and other Eurozone partners, most notably France and Italy.

Spain is arguably enjoying the most success and offers the best template to other similar European economies. Its labor market reforms made it easier and cheaper to terminate employment contracts and discouraged collective wage negotiation. Those changes angered many but at last appear to be helping to create new jobs, with signs that exports are also improving[13].

With the Eurozone slipping, it is unclear whether the UK can escape its backwards pull. Monetary independence has allowed the Bank of England to enjoy some success inflating the economy with liquidity.

[9] Source: Booming Budget Surplus Puts Pressure on Germany to Spend, Michelle Martin and Noah Barkin, Reuters, September 1, 2014
[10] Source: Spain's Labor Market Turns the Corner, Tobias Buck, Financial Times, July 24, 2014
[11] Source: Office of Budget Responsibility, Economic and fiscal outlook, December 3, 2014
[12] Source: OECD, China Economic Forecast Summary, November 2014
[13] Source: Spain's Labor Market Turns the Corner, Tobias Buck, Financial Times, July 24, 2014

However, the recovery remains fragile. Although unemployment is falling, wages show few signs of increasing. In his Autumn Statement in December, Chancellor of the Exchequer George Osborne revised growth rates downwards for 2016 and beyond[14] – a potential signal that with monetary stimulus removed there has been neither sufficient structural reform nor enough growth-promoting new investment to set the economy on a sustainable long-term upwards trend.

"The political system in many countries does not seem to be aligned with doing the sensible things required for economic growth. All of these countries have had the opportunity to engage in infrastructure spending which would promote their long-term growth rates," Meads said.

EMERGING MARKETS ATTRACTIVE DESPITE HEADWINDS

Long-term slowing growth extends to large emerging markets, presenting challenges for their respective administrations. Additional political volatility creates a backdrop of uncertainty for investors, despite the potential long-term attractive characteristics as these economies grow.

China growth has come off its peak, and while much has been made of attempts to increase the pace of growth, the OECD is predicting that GDP expansion will dip below 7% in 2016, while OECD member growth increases to 3%[15]. Addressing wasteful investment will help, but China's transition to a domestically-driven consumption economy will inevitably mean slower-paced growth in the long run.

> "It just gets a lot harder from this point forward to grow at 7-8% each year. History and statistics are not on China's side and I'm not sure that is embedded in people's expectations for asset prices yet."
>
> **~ Chris Meads**

India meanwhile is enjoying a honeymoon period following the election of Narendra Modi as Prime Minister in May 2014. India should be set to benefit significantly from low oil prices and markets responded positively to pledges of tax and financial reforms, though the reality tends to be harder than the promises. The new government is on the brink of pushing through a proposal to allow foreign groups to own 49% of Indian insurers, compared with the current 26%[16]. While it stands to be the first major reform of his administration, the serious wrangling it has prompted could set the tone for more difficult reforms ahead.

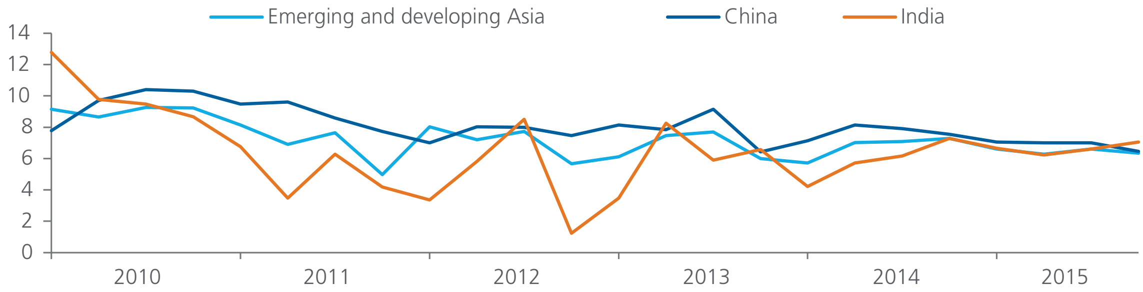
The remaining BRICs – Brazil and Russia – are in a much more parlous state. Brazil's president Dilma Rousseff narrowly secured another term but critics are questioning whether she has the resolve to make budget cuts and raise interest rates that will increase unemployment in the short term.

In Russia, few would bet against President Putin's resolve, however his room for manoeuvre is now severely limited. The rouble has sunk by approximately 50% against the dollar since the beginning of 2014 due to economic sanctions and low oil prices. The severity of the fall intensified mid-December with an almost 20% drop in one day, the largest fall in 16 years[17].

In addition, the biggest drain on Russia's resources stands to be its massive foreign debt position. The country has some $650 billion in external debt, more than $100 billion of which is due for repayment in the coming year even though global capital markets are effectively shut to Russia[18]. While the country has ample foreign currency reserves for now, the flight of capital offshore is a real risk and can quickly undermine the Kremlin's position[19].

[14] Source: Sanctions, Oil, Recession - Russian company bonds feel the pain, Sujato Rao, Reuters, December 8, 2014
[15] Source: OECD, China Economic Forecast Summary, November 2014
[16] Source: Modi Struggles in First Big Battle of Reform Campaign, Victor Mallet and Avantika Chilkoti, Financial Times, December 8, 2014
[17] Source: Plunging Rouble Unsettles Russians, James Marson, Wall Street Journal, December 16, 2014
[18] Source: Sanctions, Oil, Recession - Russian Company Bonds Feel the Pain, Sujato Rao, Reuters, December 8, 2014

Figure 2: GDP growth forecasts: Asia, China and India



Source: IMF World Economic Outlook, October 2014

Recent currency depreciation in Russia clearly poses a real threat to the global economy with the obvious knock-on effect for banks and investors across Europe and the U.S. and the potential for Russia's financial instability to infect other emerging markets. We continue to monitor the situation closely.

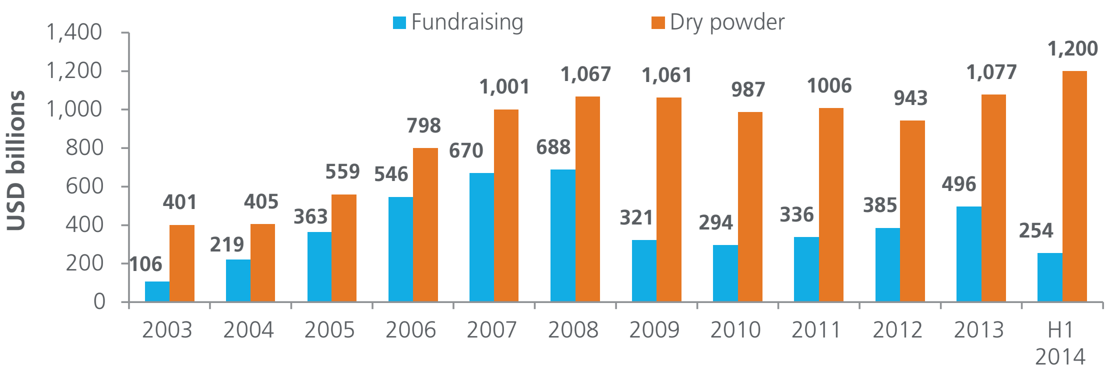
Despite the prevailing macroeconomic and political headwinds, experienced private equity managers should still be able to operate effectively in these markets, making manager selection critical. Volatility in equity prices in the short term can create buying opportunities for private equity managers with a longer-term time horizon. Our recent InFocus[20] highlighted China, India and Indonesia as offering the most attractive relative valuations among the major emerging markets.

WIDESPREAD ASSET PRICE INFLATION IMPACTS PRIVATE EQUITY

One of the hazardous consequences of quantitative easing is the widespread asset price inflation witnessed globally. Stock markets are well above where they stood before the crisis, while bond yields are at some of their lowest levels.

Private equity has not been immune. Public market comparables set a high benchmark for valuations, while cheap loans and high-yield bonds enable sponsors to stretch prices further. Furthermore, fundraising has been enjoying its best run since 2008[21] with record levels of dry powder (see Figure 3 below) increasing competition for assets. We expect that run to continue in 2015 as the European Central Bank and the Bank of Japan take on the mantle of providers of liquidity of last resort to the global economy.

Figure 3: Global fundraising and dry powder remain strong



Source: Preqin as of October 2014

[19] Source: How Russia's Debt and Currency Markets Could Spiral into Crisis, Michael J Casey, WSJ Moneybeat, October 3, 2014

[20] Today's Opportunity in Emerging Markets, Pantheon InFocus, October 2014. Paper took into account various metrics including public market valuations, CAPE ratios and expected GDP and earnings growth

[21] Source: Preqin, October 2014. Funds raised totalled $320 billion in the first three quarters of 2014, and dry powder stood at $1.2 trillion

> “The liquidity-driven rally in asset prices globally may not be over. Despite a poor economic outlook in Europe and yet another recession, certain assets are likely to rally in price.”
>
> **~ Chris Meads**

While we believe that there are still good investments to be made despite high prices – as we will outline in more detail below – we also believe it's a good time to consider selling mature assets at full prices. Not only should this apply to underlying companies over which our manager universe has discretion, but also to fund positions over which Pantheon has ultimate control.

ACTIVE INVESTMENT PROVIDES ROUTE TO SUCCESS

The macroeconomic environment and socio-political backdrop are important factors which influence Pantheon's strategic view on certain investment markets. For instance, we are more positively inclined to the U.S. than last year given improving fundamentals, and similarly our view on India has also improved. Meanwhile, our view on Europe is marginally more bearish because of the strengthening economic headwinds.

However, slavish adherence to such broad views would overlook beneficial undercurrents and opportunities in any individual market. In the face of low growth and high asset prices globally, we feel that a more fundamental view on investment and value creation is needed. The discipline of investors and the value-adding operational skill of private equity managers have always been important, but now they are critical. Expanding valuation multiples and cheap leverage cannot be relied upon to lift returns in these markets.

> “Good investing requires much more activism, more attention to detail and more focus on change. We know these things are hard, but smart private equity investors will create value even in high-priced markets.”
>
> **~ Chris Meads**

Quantitative research has become even more important at private equity firms to inform and improve investment decisions, with the ultimate aim of delivering better returns. Pantheon conducted studies including an investigation into the pace of distributions from general partners, which found that funds that distributed more than their vintage peers during the first few years of their commitment period were more likely to be top quartile performers over the long term[22]. Meanwhile, another recent InFocus highlighted the importance of geographic diversification on an inter-regional as well as intra-regional basis[23].

Quantitative research into general partner behavior is crucial in enhancing an understanding of which managers have the toolkit and track record to potentially succeed in this unique market environment. Forthcoming Pantheon studies will include “Are GPs good market timers?” and “How does private equity impact the risk-return profile of portfolios that invest across asset classes?”

PRIVATE EQUITY INVESTMENT THEMES FOR 2015

While we see high prices and fierce competition for assets in many markets, we do believe there are broad themes shaping consumption trends globally. These are investment themes which private equity can tap into and ultimately profit from.

Among these we see demand for new energy sources, resurgent U.S. manufacturing and the ageing global populations as driving forces for our investment markets.

[22] Early Indicators of Private Equity Performance Pantheon InFocus, July 2014
[23] The Benefits of Global Diversification Pantheon InFocus, May 2014

Energy

At first look, falling oil prices would appear to set an unfavorable backdrop for energy investment. Some commentary indicates that at current oil price levels, many new energy projects are simply uneconomic[24]. But at Pantheon, we believe in the theory of tilting towards investments in unconventional energy exploration, where managers seek to discover and establish profitable production. In that context, the commodity price should be less important than finding ways to increase production and reduce extraction costs. Selecting the right managers and co-investment partners, and diversifying appropriately over time by commodity type and geography is key. While there is certainly correlation between commodity prices and the success of energy investments, a higher degree of the investment return should be predicated on the value creation traits private equity firms typically look for.

More broadly, we believe there are a wide range of investment opportunities within the energy sector itself and across a number of related sectors including industrials, transportation and commercial services. The challenge for private equity is how best to navigate significant short-term commodity price volatility. Depending on an investor's view of long-term energy prices (and assuming a degree of patience), we believe today's depressed prices for energy assets to be a compelling entry point into this strategically important sector.

Manufacturing

Low-cost energy from unconventional energy sources, such as shale oil and gas, also play into a long-term secular trend to be potentially exploited in manufacturing. Cheaper energy, combined with the rising cost of labor in China, is driving the so-called "re-shoring" of manufacturing from Asia to the U.S. Estimates put the economic benefit to the U.S. at $100 billion, with many industries including furniture production, machinery, computers, electronics, appliances and electrical equipment at the tipping point for returning to the U.S.[25]

Some key industries, such as chemicals manufacture, stand to benefit doubly from low energy and commodity prices. Chemicals require relatively high levels of energy in the production process, while natural gas liquids – which are now significantly cheaper – are a raw material for many products[26].

Healthcare

The ageing population in both developed and emerging markets is another long-term trend that presents challenges for governments, and investment opportunities for private equity. In developed markets, it's about achieving better health outcomes with greater efficiency and hence lower cost. Meanwhile, in emerging markets, the opportunity lies in establishing services and providing the mechanisms for delivering healthcare services to new markets.

Long-term demographic trends are a powerful force and we believe there is strong potential in both primary fund commitments with skilled managers, as well as co-investments, in the healthcare space.

The high price of financial assets broadly, and private equity assets more specifically, makes finding value and creating superior returns more difficult. But it is by no means impossible.

Investors must set a high bar on due diligence. That means seeking out general partners who are maintaining investment discipline even though they face many temptations – such as the lure of raising and deploying large sums of dry powder, and the impulse to draw on cheap and plentiful debt to finance acquisitions and increase returns. It is also essential for private equity investors

[24] Source: More than $150 billion of Oil Projects Face the Axe in 2015, Ron Busso, Reuters, December 5, 2014
[25] Source: The Boston Consulting Group, U.S. Manufacturing Nears the Tipping Point, March 2012
[26] Source: American Chemistry Council, Shale Gas, Competitiveness, and New U.S. Chemical Industry Investment, May 2013

UNLOCKING PRIVATE EQUITY FOR DEFINED CONTRIBUTION PENSION PLANS

Private equity's investor base today includes some of the world's largest institutions, such as sovereign wealth funds, public and corporate Defined Benefit (DB) pension plans, insurance groups and banks. It also numbers family offices, and high net worth individuals. Defined Contribution (DC) savers, however, have been largely excluded from the asset class until now.

The reason may lie in marked cultural and structural differences between DB and DC schemes, with DC schemes the clear losers when it comes to respective performance. Between 1997 and 2013, DB plans delivered annualized returns of 7.9%, compared with 6.8% from DC plans[27].

DC plan participants have effectively been excluded by requirements designed to give individual savers greater control over their retirement savings. These include the need for daily valuations and the ability to allow individuals to move money from one savings product to another. Creating the structure to meet these requirements within an asset class where general partner valuations are given quarterly, and funds are characterized by illiquid ten-year investment and divestment cycles, has proven to be a challenge for private equity firms. However, potential solutions to these issues exist and private equity firms are seeking to unlock the market, ultimately improving access and choice for all individuals.

to review investment strategies constantly and to take an active approach to portfolio management. Secondaries and co-investment can help investors to take advantage of attractive investment opportunities, pockets of value, and underlying market dynamics. By maintaining a disciplined and measured pace of deployment, investors can preserve the option to increase their investment if prices fall, and potentially mitigate the risk of exposure to over-priced assets should the market turn.

THE LURE OF REAL ASSETS

Investors continue to seek yield and returns in markets that offer few relatively safe or secure options. With bond yields low, investors are seeking assets that can deliver higher returns in the long-run, as well as provide a running yield. The term "real assets" generally refers to physical investments such as real estate, energy, infrastructure, agriculture and timber, with underlying asset prices generally less correlated to traditional public equities and bonds. Such investments represent long-term financial claims on underlying hard assets, grounded by demand in the real economy or supported by government policy. "Real assets are becoming a defined opportunity. Essentially, these are attractive as investors are not taking as much equity market valuation risk and they provide some protection against inflation," Chris Meads commented.

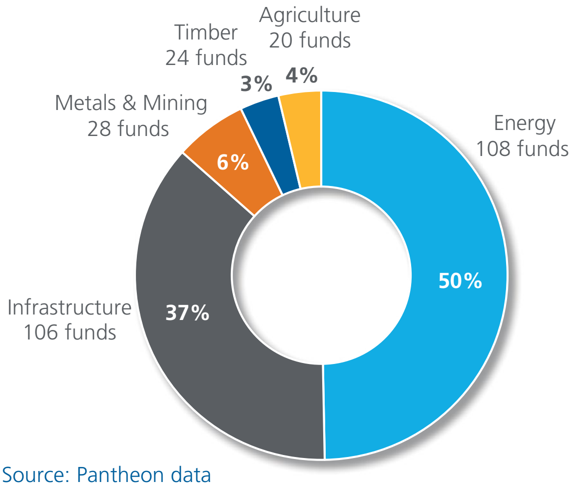
Infrastructure is principal among these investments and currently accounts for the majority of capital, along with energy and mining (as shown in Figure 4 on page 10).

The sector has attracted significant interest from large investment groups including sovereign wealth funds and public pension schemes for large existing assets, such as large utilities, roads and rail. As a result, the competition for these "trophy" style assets is fierce and valuations are high.

[27] Source: Defined Contribution Institutional Investment Association/BNY Mellon Retirement Group, July 2013

However, below the first tier are regional networks and assets. Prices for these are significantly lower and present good value and potentially attractive yields and returns. We also see long-term potential in commodities and timber.

Figure 4: Real assets dominated by infrastructure and energy/mining



Source: Pantheon data

CONCLUSION

It is disappointing, though perhaps not surprising, that more than a year after observing welcome signs of recovery in many economies, we are talking again about stagnation. Only a few developed economies, most notably the U.S., appear to be escaping the gravitational pull of persistently low growth and recession. Governments bear much of the responsibility for failing to enact necessary market reforms and invest in the right places to promote new growth. Without these actions, we believe Europe and Japan, in particular, will struggle to escape secular stagnation.

We think there are still attractive investments to be made for private equity investors. But they will require more active effort to identify markets that are undervalued and investment themes that can generate outsized growth opportunities. More activism will be needed by underlying fund managers to create and add value within their portfolio companies as asset prices remain high.

We think investments made in 2015 will be able to yield good returns relative to public markets, but 2015 may not be the best vintage across the entire economic cycle because the starting costs of investment will be, in general, high. Market dislocation and volatility often lead to opportunities for the best private equity managers – the challenge is in sourcing those opportunities and then adding value over the long term.

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