

“Change is the Law of Life”

Navigating the Private Equity Asset Class in the 10th Year of One of the Longest Bull Markets in History

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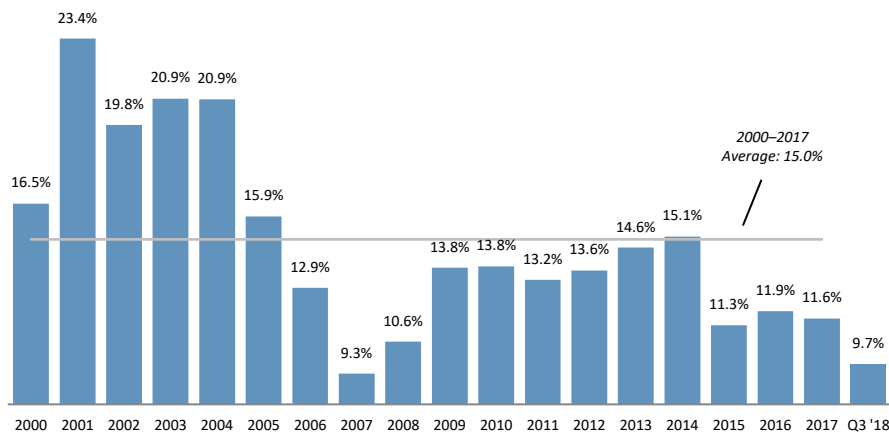
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Traditional private equity models are facing significant headwinds. With a record number of firms and dry powder available, the reactive buyout auction “book-taker” approach is competing for lower returns even against the backdrop of cyclical warning signs, an unprecedented macro environment and increasing secular technology-related disruption. The Ares LBO Yield, a quarterly calculation we compute to measure the reward and relative value for a “market” leveraged buyout transaction, is approaching levels not seen since the prior credit cycle peak in 2007. With compressed returns, more than ever before, private equity firms must reassess their playbooks in originating, evaluating, structuring and shepherding their investments.

Ares' LBO Yield Tracker
Pre-Tax Cash Yield of a Marketplace Leveraged Buyout*



* A measurement developed by Ares to track corporate buyouts with \$50 million or more of EBITDA. Marketplace transaction data sourced from S&P Capital IQ – Q3 2018 Leveraged Buyout Review. Further information on our methodology is detailed on page 4.

“Change is the law of life. And those who look only to the past or present are certain to miss the future.”

— John F Kennedy, Frankfurt 1963

Executive Summary

As we survey unprecedented market dynamics for the private equity landscape in what is one of the longest bull markets in history, we believe the standard private equity manual of risk pricing and value creation is missing the future using Kennedy’s parlance. In this report, we review the current market environment and explore how private equity investors might position themselves to respond to the increasing challenges.

I. Private Equity Returns Are Under Significant Pressure

At the end of 2017, a record was reached in both the number of buyout firms and the amount of capital those firms have to deploy with more than 1,900 private equity firms that have close to \$900 billion of dry powder.¹ The increased crowding of the marketplace has directly elevated valuations and correspondingly reduced the inherent return on equity benefit of a leveraged buyout when measured on a free cash flow yield basis devoid of enterprise value expansion. The Ares LBO Yield, a quarterly calculation we compute to measure the reward and relative value for a “market” leveraged buyout transaction, is approaching levels not seen since the prior credit cycle peak in 2007. *Discussed further on page 4.*

II. Potential for a Meaningful Market Correction

Despite underlying strong economic trends, we are exercising caution given the combination of cyclical warning signs paired with an unprecedented macro environment. With the age of this economic recovery, we are seeing rising valuations, increasing leverage levels and a proliferation of issuer-friendly credit terms, which are just three chapters of the typical late cycle story. At the same time, we have not witnessed a monetary, fiscal and political environment where there is such limited ammunition to fight a potential downturn when compared to any crisis in recent memory. Hank Paulson’s famed “bazooka” of 2008 feels more like it would be a water pistol in today’s environment. *Discussed further on page 5.*

III. Accelerated Pace of Technological Disruption Increases Company Selection Risk

Both the speed and breadth of technological disruption from the digital revolution is occurring at an accelerated pace. It is very telling that executives at the largest U.S. companies mentioned Amazon almost as often as taxes during investor calls in 2017.² This expansion of disruptive threats is arriving from multiple angles – disruption “above” from large technology conglomerates and “below” where new connectivity-enhancing technologies allow start-ups to scale more quickly. Increasingly, incumbent companies may no longer be able to simply leverage their scale within their industry, rather they may be forced to justify their place in the value chain through amplified differentiation in order to avoid obsolescence. *Discussed further on page 9.*

IV. Elements of Traditional Private Equity Models Appear Broken

For private equity, where there has been a historical focus on acquiring “stable” industry leaders with highly leverageable scaled assets, the consequences of these disruptive forces may be profound. Not only will a portfolio company’s stability be tested by a potential market correction, but also from the new reality of today’s increasingly competitive environment. We believe being a reactive buyout auction “book-taker” reliant on financial engineering is not a sustainable approach for investors seeking consistent double-digit returns from their managers. *Discussed further on page 13.*

V. Navigating the Challenges to Generate Compelling Risk-Adjusted Returns

To win in this market, we believe private equity managers will need to react flexibly to the increasing number of seismic changes. Creating advantaged deal-flow, pursuing more creative transactions, developing enhanced due diligence techniques, building industry specialization without suffering from industry bias and effectively shepherding portfolio companies through business model change will be critical. *Discussed further on page 14.*

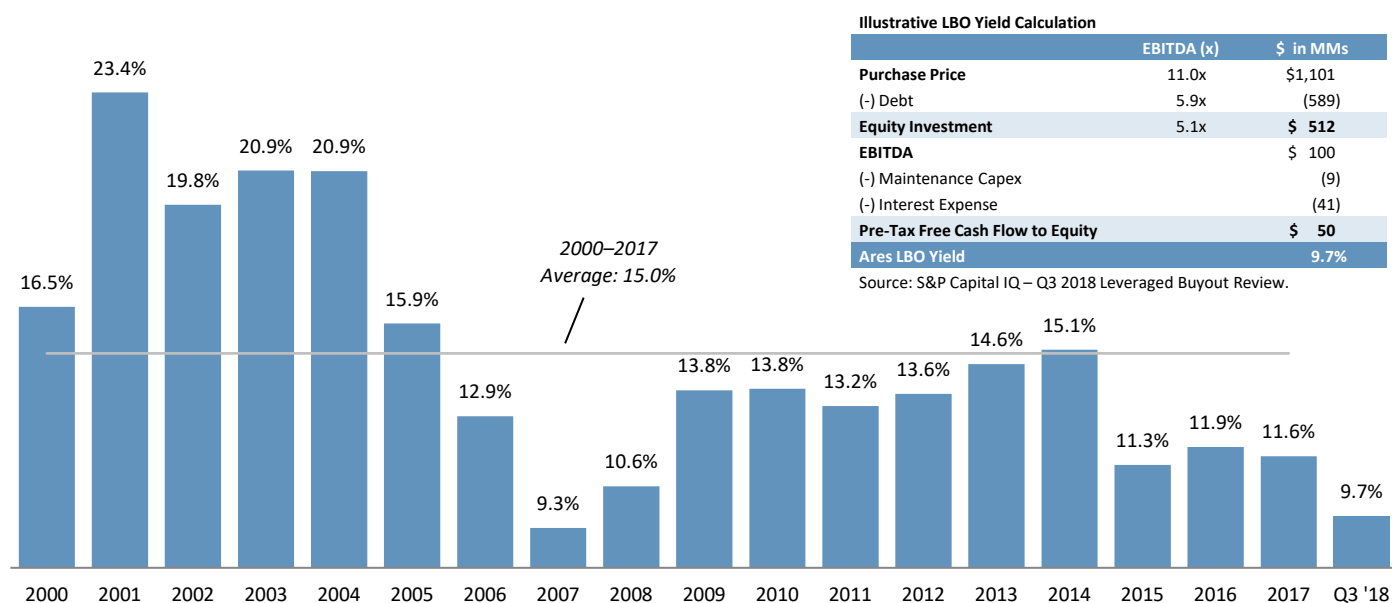
This is a fascinating period in the evolution of private equity. We believe the convergence of heightened cyclical risk and secular technology-related disruption will create a new set of challenges for the asset class, but also exciting opportunities for those investors who appreciate that “change is the law of life.”

I. Private Equity Returns Are Under Significant Pressure

Studying the competitive private equity landscape, we focus first on market participants' dependence on financial engineering. The increased crowding of our marketplace has directly elevated valuations and correspondingly reduced the inherent return on equity benefit of a leveraged buyout when measured on a free cash flow yield basis. At the end of 2017, a record was reached in both the number of buyout firms and the amount of capital those firms have to deploy with more than 1,900 private equity firms that have close to \$900 billion of dry powder.¹ This increased competitive intensity in the market has led to an elevated valuation environment with average purchase multiples reaching 11.0x EBITDA.³

We can see this effect by evaluating a measurement we coined back in 2013, the Ares LBO Yield, which is a quarterly calculation we compute for a "market" buyout that measures the reward side of the leveraged buyout risk-reward equation. We believe this metric represents a general overview of the health and relative value attractiveness of the market-average buyout. As shown in *Figure 1*, the Ares LBO Yield for the market has compressed from 14.6% to 9.7% in the last five years and is approaching levels not seen since the prior credit cycle peak in 2007.

Figure 1
Ares LBO Yields



Illustrative LBO Yield Calculation

	EBITDA (x)	\$ in MM
Purchase Price	11.0x	\$1,101
(-) Debt	5.9x	(589)
Equity Investment	5.1x	\$ 512
EBITDA		\$ 100
(-) Maintenance Capex		(9)
(-) Interest Expense		(41)
Pre-Tax Free Cash Flow to Equity		\$ 50
Ares LBO Yield		9.7%

Source: S&P Capital IQ – Q3 2018 Leveraged Buyout Review.

Note: S&P Capital IQ – Q3 2018 Leveraged Buyout Review. Represents EBITDA less maintenance capex and interest expense divided by total purchase price less debt of large corporate LBOs (>=\$50 million of EBITDA).

While this metric tells a very important side of the rate of return story, it does not fully capture the current market forces elevating the risk side of the private equity asset class. An Ares LBO Yield of 9.7% does not provide much cushion from the potential for exit multiple contraction, fundamental misses in earnings projections, the potential for unrealized adjustments to EBITDA that were used upon entry to value the business, or the impact of a rising interest rate environment. This low LBO risk premium becomes even clearer when considering that in Q3 2018, the 9.7% Ares LBO Yield is only at a slight premium to the 7.1% yield implied by the Credit Suisse Leverage Loan Index for what is a senior, liquid investment. Historically, the Ares LBO Yield has generally traded at a 5–7% premium to the Leveraged Loan Index compared to the 2.6% premium today.⁴ This makes asset selection and due diligence as important today as any other time during our nearly thirty years of pricing risk in the private equity market.

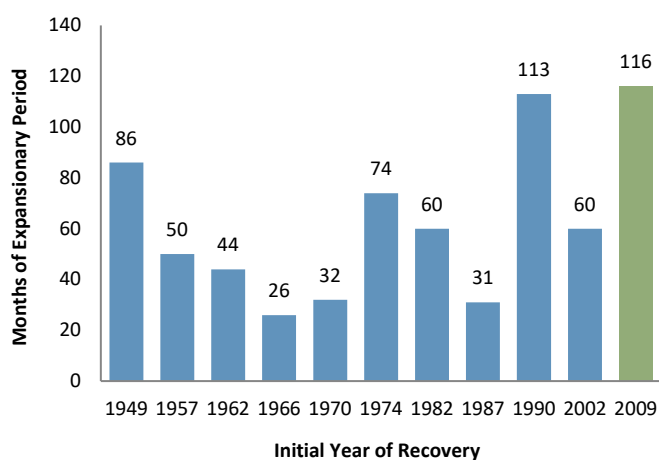
II. Potential for a Meaningful Market Correction

With respect to the macro and cyclical environment, two themes predominate: we are well into the current recovery, and the fiscal, monetary and political tools to combat a potential recession are weaker than we have ever observed. It is the combination of these factors that could drive the potential for a meaningful market correction.

Late Cycle Warning Signs

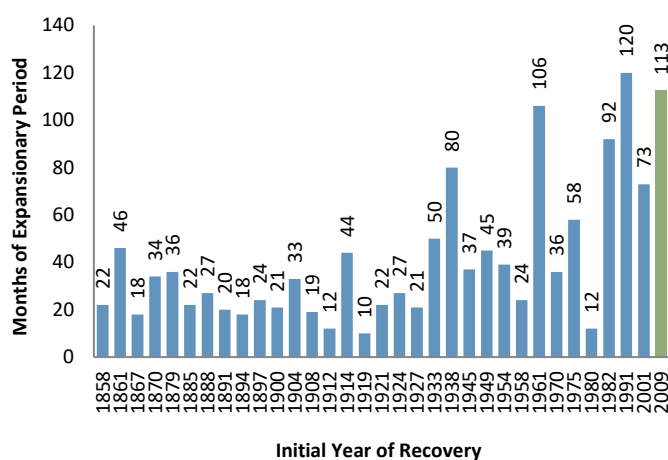
At the risk of covering well-trodden ground, the current recovery is different in duration and character than any other we have seen in the post-World War II era. When measured by the length of the U.S. equity market recovery, it is the longest recovery since World War II as illustrated in *Figure 2*. When measured by gross domestic product (“GDP”) growth, the current recovery has lasted 113 months making it the second longest recovery since the American Civil War (see *Figure 3*).

Figure 2
U.S. Equity Market Recovery Lengths



Source: FactSet referenced by Chang, Sue. “Welcome to the longest bull market in Wall Street history.” *MarketWatch*. August 22, 2018. Recovery data updated as of October 31, 2018.

Figure 3
U.S. GDP Recovery Lengths



Source: Business cycles defined by NBER’s Business Cycle Dating Committee. Expansion is defined as period between a trough and a peak. <http://www.nber.org/cycles.html> Recovery data updated as of October 31, 2018.

We generally agree with the former Chair of the Board of Governors of the Federal Reserve System (the “Fed”), Janet Yellen, that “it’s a myth that expansions die of old age” and thus entering the tenth or eleventh year of a recovery does not on its own presage a recession.⁵ Public and private valuations, however, are near historic peaks backed by global economic growth combined with an unemployment rate in the United States hovering around 3.7%, the lowest level since 2000.⁶

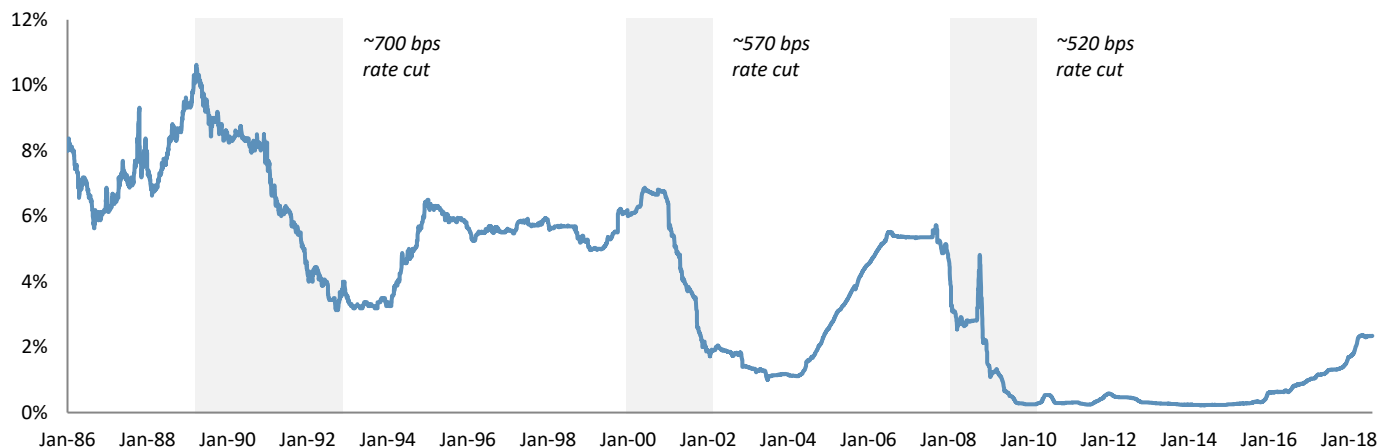
Another familiar late-cycle theme is the expansion in both the amount of corporate credit being provided and the loosening of terms under which it is being provided. The global leveraged credit market is approaching \$3.5 trillion, over 1.6x the size of the market in 2009 and leverage levels continue to climb.⁷ According to Covenant Review, in the past three years, leverage in large cap, broadly syndicated M&A-related deals increased from 6.4x EBITDA in Q1 2015 to 7.7x in Q1 2018.⁸ The quality of adjusted EBITDA is also lower as the percentage of EBITDA that is based on “add-backs” has increased from approximately 10% in Q1 2015 to over 30% in Q1 2018.⁸ Furthermore, these add-backs now increasingly include items such as projected cost savings from initiatives not yet implemented, to name one of the more creative categories we have seen.

Unprecedented Monetary, Fiscal and Political Backdrop and its Impact on Cyclical Risk

While these cyclical warning signs are nothing new, they are paired with a combined monetary, fiscal and political environment that is unprecedented. This state of the world clouds the ability to probability weight outcomes but nonetheless could have a meaningful impact on the magnitude of the next cycle. Typically, in a recovery, Fed-mandated rate increases and the fiscal salve of increasing tax revenues from a recovering economy leave policy-makers ammunition to combat a future recession with stimulus. Today, the traditional tools of most developed market governments, both monetary and fiscal, appear to be weaker than we would expect to see at this stage of a recovery of this duration.

With respect to monetary policy, current short-term interest rates are near 2% with a relatively flat yield curve. We have also seen increasing levels of U.S. Executive Branch commentary on monetary policy. While it is unclear to what extent policy moves by the independent Fed will be impacted, there appears to be an elevated risk of the ever-present political incentive to keep rates low, potentially creating a lower for longer scenario which risks accelerating inflation in an unhealthy manner. As demonstrated by *Figure 4*, if we assume the zero-bound floor is binding, the room for a potential cut in rates of approximately 3% by the Fed is meaningfully less than what we have seen in past market corrections. Simply put, while other monetary options exist, the current and forecasted rate environment limits a critical tool for policy-makers.

Figure 4
3-Month LIBOR Rates

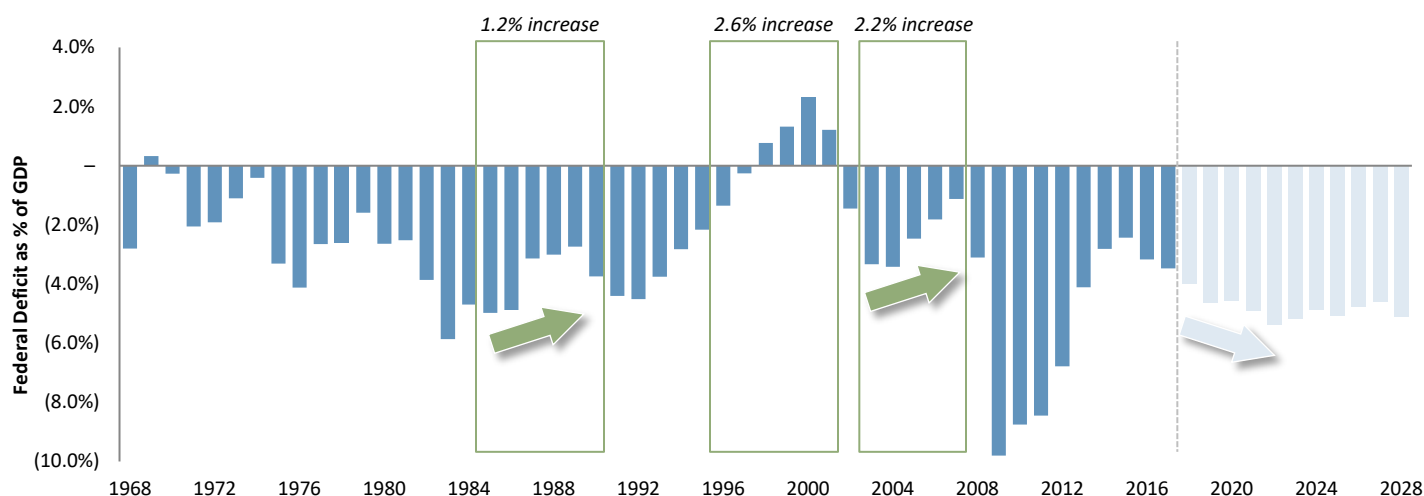


Note: Shaded columns represent recessions.

Source: Federal Reserve Economic Data. 3-Month London Interbank Offered Rate (LIBOR), based on U.S. Dollar, Percent, Daily, Not Seasonally Adjusted.
<https://fred.stlouisfed.org>

Fiscally, the United States presents a similar lack of cushion with historical and projected budget deficits moving in the opposite direction vis-à-vis what we have seen late in the last three cycles. As illustrated in *Figure 5*, in each of those prior periods, budget deficits were reduced or turned to surpluses of 1%–3% of GDP as the recovery entered the later periods of the cycle. By contrast, due primarily to increasing entitlements and lower tax revenues, U.S. Federal budget deficits are now projected to reach over \$1 trillion by 2020, assuming the current expansion continues largely unabated into its twelfth year. While the U.S. dollar represents the world’s reserve currency with strong demand for its sovereign debt, escalating deficits may impact both of these financial system “givens” with unpredictable outcomes. Essentially, dollars get “printed” to monetize the U.S. Federal government’s growing demand for debt thereby rapidly de-valuing the U.S. currency. We view this as a low probability scenario, but one we contemplate nonetheless.

Figure 5
U.S. Federal Deficit as % of GDP

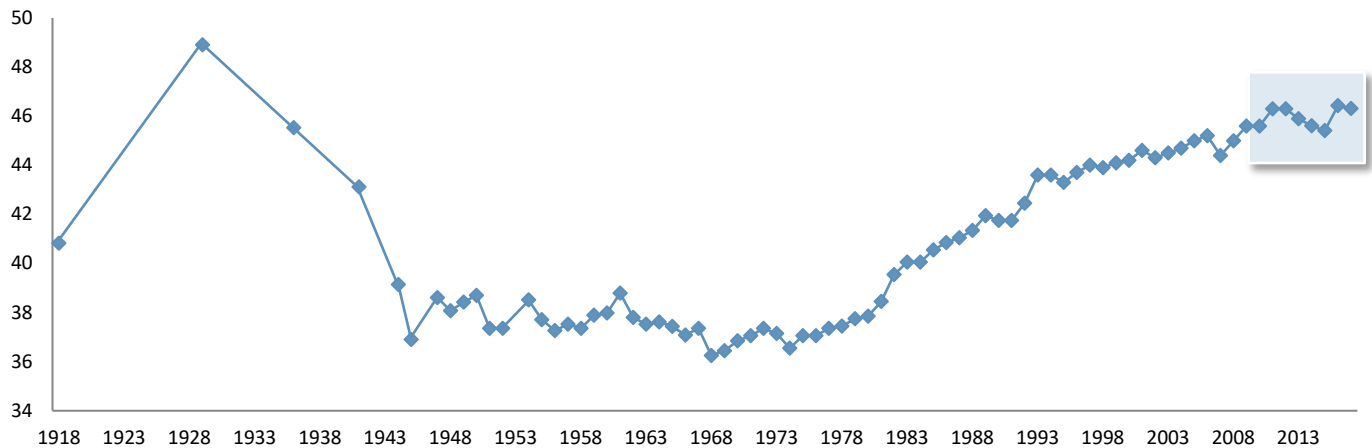


Source: The Budget and Economic Outlook: 2018 to 2028. Congressional Budget Office. April 2018.

Perhaps as important as the theoretical tools, the political climate may be more challenging for the government to practically marshal its traditional tools in combatting a recession given increased levels of polarization. While monetary policy has historically operated with a greater degree of independence from political considerations, it is important to remember that just a decade ago, some of the Fed’s quantitative easing programs – particularly to foreign banks – were carried out largely in secret.⁹ It is hard for us to envision that ever reoccurring with the same level of stealth. An important and powerful counterbalance today versus the state of the global financial system during the last crisis stems from the fact that the global banking complex is much better capitalized with healthier capital ratios; the U.S.’s largest bank holding companies added more than \$750 billion in equity capital since 2009.¹⁰ Given this strong financial system foundation, the level of intervention that was required in 2008 will likely not be required in our next business cycle recession.

In terms of what could drive the next correction, our crystal ball is no clearer than anyone else’s; however, we believe factors like the growth in nationalism, fears over trade wars and rising income inequality add risk to the geopolitical environment. One particularly concerning metric is the Gini coefficient in the U.S., which is a measure of statistical dispersion that approximates the level of income inequality in a country with increasing values representing increasing inequality. In the U.S., this metric has been rising consistently since the 1970s and is now reaching levels last seen in the Gilded Age of the 1920s (see *Figure 6*). While there are a variety of policy prescriptions on the left and right to address this issue, we believe these levels of inequality in a political environment as polarized as today adds to the instability of the current geopolitical climate.

Figure 6
U.S. Gini Coefficient for Gross Equivalized Household Income



Source: U.S. Bureau of the Census, Income, Poverty, and Health Insurance Coverage in the United States 2015. U.S. Census Bureau, Current Population Survey, 2017 and 2018 Annual Social and Economic Supplements.

While the timing of a potential recession is unclear, we believe there is the potential for a meaningful correction. We believe this correction will likely not be as severe as the Great Recession given the health of the banking system, but may be more severe than a typical business cycle recession. For private equity, the consequences of a meaningful correction are relatively straightforward given the general pro-cyclical bent of the asset class.

III. Accelerated Pace of Technological Disruption Increases Company Selection Risk

Paired with an uncertain cyclical and macro environment, the secular impact of technology-based disruption will put further pressure on the traditional private equity model. While there is nothing new about technological change impacting industries, the speed and breadth of disruption from the digital revolution is accelerating at a pace different than what we have ever experienced. Traditional large and mid-cap private equity is likely to be negatively impacted by these trends as the typically constructed private equity portfolio is under-indexed to disruptive businesses and the leverage in a buyout can limit the ability of a company to weather technology-enabled industry change.

Changes in the Pace of Innovation

With respect to the speed of today's disruptive forces, it is natural to think that the future pace of innovation is likely to match what has been achieved historically. However, the graveyard of disrupted companies appears to be filled with shorter and shorter-lived incumbents. For example, Blockbuster filed for bankruptcy just three years after Netflix introduced its streaming service. Nokia, the "Cell Phone King" (see Figure 7) in 2007, went from controlling approximately 40% of the world's mobile phones in 2007 (in contrast, Samsung and Apple, collectively, control less than 40% today¹¹) to being dethroned in less than seven years culminating in a sale to Microsoft, which in turn poetically sold it two years later to Apple's supply chain partner, Foxconn, for a mere \$350 million. Although these are simplistic examples, they are emblematic of the increase in game-changing business models embraced rapidly in today's marketplace. Further to this point, it is instructive to note that the number of years it has taken technological innovations to reach a 25% adoption rate in the U.S. has been shrinking rather consistently (see Figure 8).

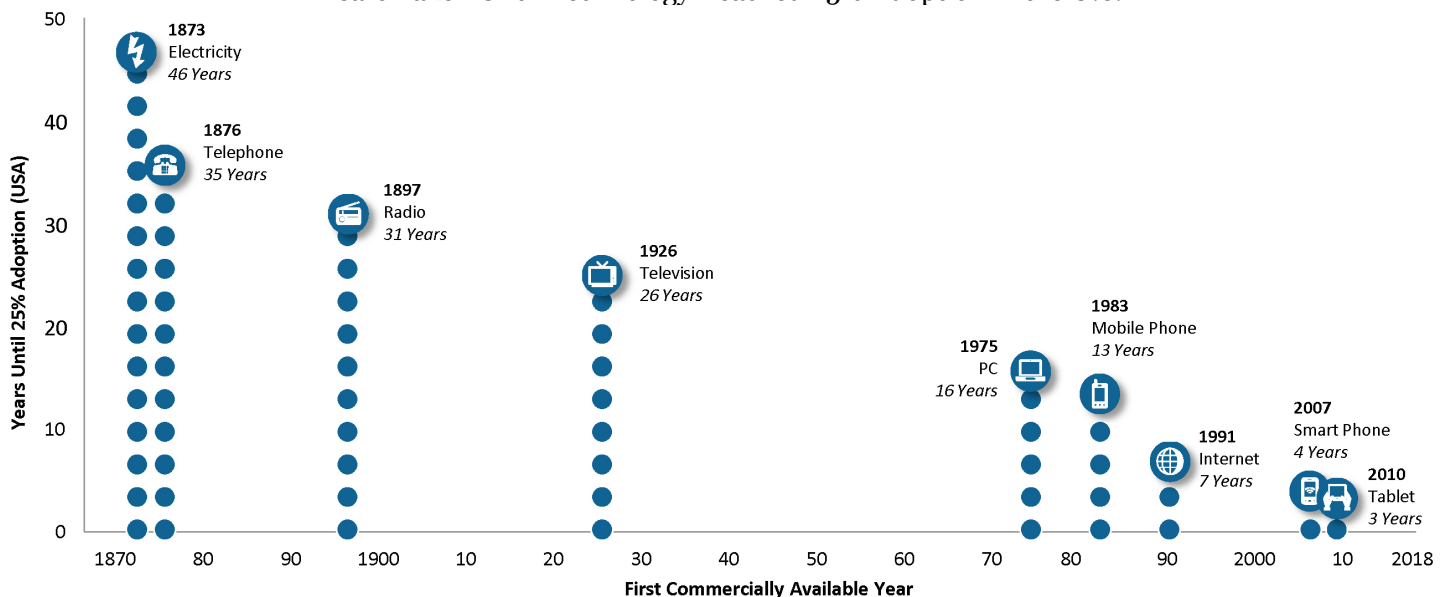
Figure 7 *Forbes* Front Cover (November 2007)



Photo Credit: Nicky Boone/Redux

Source: From *Forbes*, November 2007
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Figure 8
Years Taken Until Technology Reached 25% Adoption in the U.S.



Source: Desilver, Drew. "Chart of the Week: The Ever-Accelerating Rate of Technology Adoption." Pew Research Center. March 14, 2014.

<http://www.pewresearch.org/fact-tank/2014/03/14/chart-of-the-week-the-ever-accelerating-rate-of-technology-adoption>

Additional data from Asymco <http://www.asymco.com/2013/11/18/seeing-whats-next-2/>

Accelerating Breadth of Disruption — Smart Devices, Social Media and the Data Era

While the examples referenced above are in the technology or technology-adjacent sectors, the breadth of disruption across traditional industries has expanded at a rapid pace in the past five years necessitating a sense of urgency to “adapt or die.” This expansion of disruptive threats is arriving from multiple angles – disruption “above” from large technology conglomerates and “below” where new connectivity-enhancing technologies allow start-ups to scale more quickly.

The current innovation cycle (whether you call it the “Data Era,” “Cognitive Era” or the “Interconnected Era”) is partly defined by the rapid proliferation of interconnected “smart” devices (mobile phones, fitness devices, smart TVs and speakers, connected cars, etc.), which has created enormous amounts of data.

Companies that have been slow to center their businesses around the intelligent application of their data assets have seen their franchises erode quickly. Large technology conglomerates from “above,” notably FAANG (Facebook, Apple, Amazon, Netflix, Google), have managed to leverage the vast amount of data they capture into major ancillary and vertical revenue streams – as typified by Netflix, a DVD and now streaming distributor creating a television studio that takes home as many Emmy awards as HBO. From a competitive standpoint, these data assets are extremely hard to replicate and often feature positive feedback cycles as they get more powerful with greater customer interaction creating a sustaining competitive advantage. Moreover, these conglomerates are looking afield of their core markets to leverage that advantage further such as Amazon’s entry into pharmaceutical distribution and brick and mortar grocery.

Companies that have been slow to center their business around the intelligent application of their data assets have seen their franchises erode quickly.

From “below,” we have seen the receding of traditional competitive moats provided by scale such as brand strength, distribution, or fixed assets such as real estate. The development of better distribution and informational channels enabled by the internet, smart phones, and social media has eased the path to mass consumer adoption or scaled execution. Staid categories such as razors, where building a sizable distribution network and consumer brand could take a decade, have seen viral success in companies like Dollar Shave Club, which in approximately five years went from a start-up with a charismatic advertisement to becoming the second largest seller of men’s razors in the U.S.¹²

The largest and most disruptive impact has potentially come from cloud-based applications accessed through smart phones, which has allowed firms to create platforms that serve intermediary layers between a customer and large, fragmented labor forces or asset bases.

Similarly, the growth of direct-to-consumer brands (e.g., Casper and Away) highlight the ability to scale exponentially and quickly build a brand through internet and social media without relying on distributors or assembling physical real estate. The largest and most disruptive impact has potentially come from cloud-based applications accessed through smart phones, which has allowed firms to create platforms that serve intermediary layers between a customer and large, fragmented labor forces or asset bases (e.g., Uber, Postmates, AirBnB). These platforms can be scaled and managed with a mere fraction of the traditional capital, labor and other resources previously required.

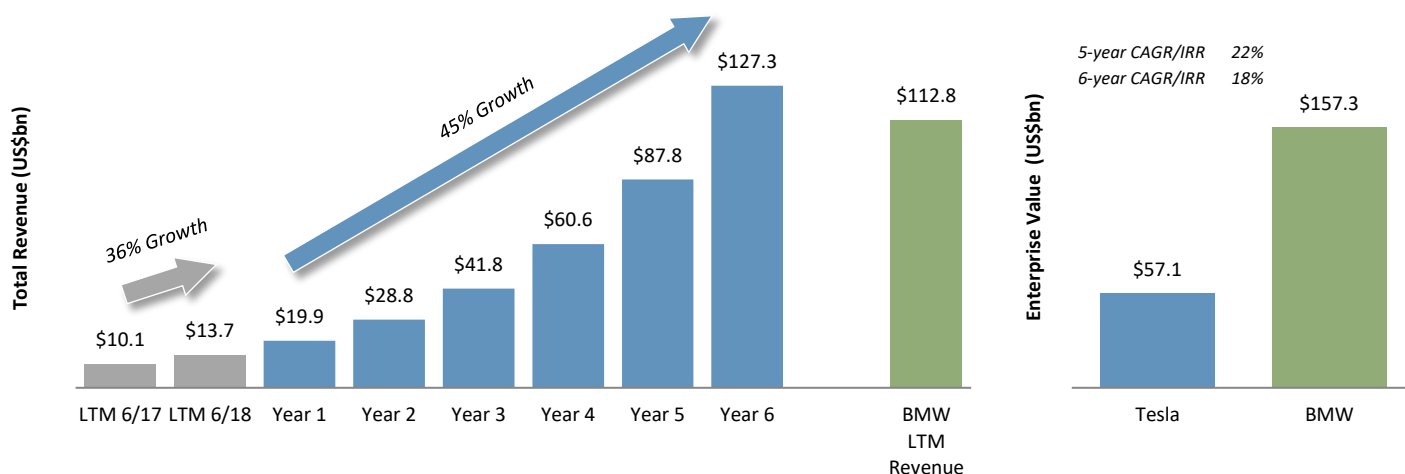
Aggressive Reaction from Investors and Capital Markets

While advances in technology have accelerated disruption from “above” and “below,” the reaction by investors and the capital markets to these changes has been an equally critical dynamic. Investors are willing to provide capital at increasingly tighter risk premiums to fund customer acquisition and infrastructure buildout for disruptive businesses even in industries where infrequent purchases and logistical barriers add challenges to scaling. Many of the direct-to-consumer companies mentioned above have raised almost as much in outside private capital (for a minority stake) as they generate in annual revenue. In the public markets, we have seen a similar dynamic with 83% of U.S. IPOs YTD through October involving firms that lost money in the 12 months leading up to their debut, topping the previous high-water mark of 81% in 2000.¹³

An Illustration — Tesla vs. BMW

At a micro-level, an example of how tightly disruptive theses are being priced today can be illustrated by comparing the valuations of Tesla, a disruptor, and BMW, an established incumbent. We have performed a simplified estimate for what the returns would be to a Tesla investor if Tesla maintained or slightly improved its current growth rate and upon reaching BMW’s size received a valuation in-line with BMW’s current enterprise value. With this approach, measuring the time it would take Tesla to reach that milestone and the relative difference in enterprise value can be a proxy for the IRR of an all-equity investment (excluding factors such as interim cash flow and leverage). If one extrapolates Tesla’s current growth rate and assumes Tesla can maintain a 45% revenue CAGR (slightly above its most recent annual growth in the trailing twelve month period), it would take between 5 and 6 years for Tesla to be as large of a business by-revenue as BMW. If we then assume that upon reaching BMW’s scale, Tesla will be similarly valued as a large leading incumbent (implicitly assuming an equivalent degree of profitability and a valuation reflecting a more mature business), the implied enterprise value growth or IRR is around 20%. While this is a healthy rate of return on an absolute basis, given that return is predicated on a case that requires scaling a business nearly 10x in an industry where operational complexity is a meaningful barrier to scale, we believe that this return is tighter than one would typically receive for assuming that kind of scaling risk. Many investors have already incorrectly underestimated Tesla, and Tesla may well exceed this case or maintain a premium valuation relative to today’s mature BMW. Nevertheless, we do believe Tesla is representative of how investors are “pricing to perfection” disruptive assets, providing a ready source of capital for potential disruptive efforts.

Figure 9
Tesla and BMW Revenue & Enterprise Value Comparison



Note: IRR assumes all equity structure (TSLA has debt outstanding, including convertible securities).
Source: Capital IQ of October 23, 2018.

When considering private equity's ability to invest in disruptive assets, businesses disrupting from "above" that benefit from data assets with economies of scope are too large and companies disrupting from "below" are often of a size and valuation that are outside of the mainstream private equity investment mandate. Instead, private equity has traditionally focused on opportunities where leverage can be utilized, given proven business models and leading market positions are key credit criteria. A levered capital structure and the associated interest burden together with concerns over sacrificing short-term profitability can restrict the ability of a company to pursue business model changes or make needed investments.

IV. Elements of Traditional Private Equity Models Appear Broken

In the face of these articulated cyclical and secular pressures, we believe certain “tried and true” traditional private equity strategies will be vigorously tested. Yet, while the tumult from technological changes, late-cycle fears and an uncertain macro environment are certainly threats, they also present opportunities for private equity managers adept at recognizing their presence, understanding them, and reacting accordingly. Of note, there are three historical approaches utilized in private equity investing that we question due to the commercial forces we have been highlighting:

Approach #1 at Risk – Shorter-Term Value Creation

We believe that sponsors that are focused primarily on shorter-term value creation — namely margin improvement and cost optimization — will find their model coming under increasing pressure. While certain efficiency opportunities such as sourcing initiatives can be accretive without making cuts that put a franchise at risk, we believe focusing myopically on those opportunities at the expense of long-term investments necessary to ensure a company’s strategic relevance is a mistake. The ever-accelerating rate of competitive moats becoming penetrable if not entirely irrelevant, implies elevated risk from a three- to five-year plan simply centered around a harvesting of bloated margins through price changes or disruptive cost-outs.

Approach #2 at Risk – Light Touch Sponsorship

We compete with and know many sponsors that promote a light touch with portfolio company management teams because of a focus on scaled assets that heretofore have consistently benefited from predictable EBITDA growth due to a market-leading position. While we, too, are often light touch with our portfolio companies, Ares private equity employs a “pull model” with management whereby a team can access the Ares network for any number of value-creating levers that have been identified. The issue with sponsors reliant on only acquiring market leaders is that these sponsors may themselves be under-resourced to assist a company in its growth should management seek such help. This leaves their portfolio companies vulnerable to strategic disintermediation risk when competitors develop a superior customer value proposition. Companies need to disrupt themselves before they are disrupted and sponsors should play a role in accomplishing that.

Approach #3 at Risk – Roll-Up Investing

Another common scale-focused private equity strategy involves constructing a portfolio of private equity investments within a fund primarily of roll-up platforms. We believe that many market participants that pursue this approach do not recognize that this model is under attack because they are benefiting from both the current benign credit market and rising valuation environment. The attack to this approach is coming because the short-term “arbitrage” of rolling-up smaller companies in a given industry for 6–7x EBITDA solely to monetize the larger enterprise for 12x EBITDA is predicated on a stable backdrop. When exit multiples contract, absent making a business better at a fundamental level, the projected return will not materialize. It does bear emphasis that inorganic acquisition-fueled growth that is strategically accretive and supports the development of a market share gaining business model will always be an important return generating tool for sponsors.

V. Navigating the Challenges to Generate Compelling Risk-Adjusted Returns

While threats abound for various traditional private equity approaches, we believe there is still ample opportunity for private equity firms cognizant of these threats. Specifically, we believe the following will be critical tools to achieve compelling risk-adjusted returns:

Create “Advantaged” Deal-Flow

The ability to access opportunities on a proprietary or advantaged basis can create value on the buy and deliver excess returns. While this becomes more challenging in a competitive private equity environment, the importance of relationships and institutional credibility are relevant characteristics particularly in specialized situations outside of formal banker-run auction processes.

While “creating proprietary opportunities” has been something of a truism in private equity, we continue to believe that opportunity exists for a sponsor that is aggressive in proactively developing industry ecosystems, building a reputation as a good long-term steward of a business, or participating in non-traditional situations. For private equity teams that operate within larger investment firms, the ability to actually derive discernible benefit from their platform can be a source of meaningful competitive advantage across the investment life cycle from origination to exit. Given the long-term and controlling nature of a typical private equity investment, where a seller is entrusting a sponsor with total control over their company for the next five to seven years, a seller may put a high premium on the reputation of a given sponsor, depending on the amount of rollover investment or the seller’s attachment to the company.

Building that reputation as a sponsor is a long-term process given the need to demonstrate and build a “brand” over multiple investments. Thus, firms can leverage their reputation as a true sustainable competitive advantage. Another alternative is to develop niche expertise in specialized investment styles and industries where a firm can locate specialized opportunities that fewer competitors can tap.

Ultimately, even in intermediated processes, it has been our experience that in certain cases a sponsor may “win in a tie” or win with a price that another sponsor offered or would be willing to top. Moreover, there are certain circumstances where management has meaningful input as to the direction of a potential transaction. If, as we suspect, the secular challenges facing prospective portfolio companies become more pronounced, management teams will need to be even more careful in picking their partner to ensure they have a long-term focus on creating value in a sustainable way. Whether it is “winning in a tie” or creating a truly proprietary look, the nature of private equity’s relatively concentrated positions is such that successfully investing in a few advantaged positions may be the difference between compelling or average returns.

Pursue More Creative Transactions with Flexible Capital

As in previous cycles, the potential to capitalize on changes in a cyclical environment will create significant opportunity for firms that are able to utilize flexible capital. Enhancing that opportunity stems from the aforementioned paucity of policy-maker tools to respond to a recession coupled with a series of structural changes to the leveraged credit markets that we believe will exacerbate volatility in a correction. Firms that can invest flexibly up and down the capital structure may be better suited to protect downside risk through a volatile cycle, while preserving attractive upside patiently over time. Typically, the universe of non-traditional private equity opportunities, whether distressed or rescue capital, will quickly expand in a correction with the size of the opportunity set dependent on both the size of the leveraged credit market and the depth of the cycle. With a leveraged credit market that is over 60% larger than in the last recession and the potential for a downturn more severe than a typical business cycle recession, we believe firms that can access these

non-traditional situations in a less-crowded space than the large and mid-cap LBO market will be advantaged if that opportunity set rapidly expands.

In addition to the universe of potential flexible capital opportunities, there are a number of structural changes in the makeup of the leveraged credit market, which may contribute to the volatility of security prices in a recession. Notably, the pullback of banks from riskier market-making services and the rise of debt ETFs, which have doubled in size over the past five years may create a vacuum of liquidity in a risk-off correction.¹⁴ The combination of market-maker intermediaries being unable to provide a bid to stabilize markets and an increasing percentage of the market consisting of players with a fundamental liquidity mismatch of daily-redemption investors backing more illiquid assets could increase the potential for fire-sales – creating greater opportunities for firms set up to capitalize on these mispriced assets.

Develop Enhanced Due Diligence Techniques

As discussed in the preceding sections, we believe today's environment presents both elevated cyclical risk and technological risk. While cyclical risk is a common concern that most sponsors are accustomed to underwriting, we believe assessing disruption risk requires an enhanced set of due diligence resources. Technological risk requires both a detailed understanding of a given industry's dynamics as well as a broad perspective on industry analogues and potential new competitive entrants. While a detailed understanding of an industry can be attained on a deal-by-deal basis from existing executive networks and is a natural product of a typical diligence engagement, providing a broader perspective creates an opportunity to both differentiate and create more generalizable firm resources. These resources include experts, such as operating advisors with familiarity of disruption from "above" and "below," and data, including aggregated information from public sources supplemented with sources and expertise collected across an alternative asset platform.

While appropriately underwriting cyclical and technological risk has become increasingly more important, sponsors in turn are being forced to diligence these risks in truncated process timelines, as increased sponsor competition for assets has led bankers to use this leverage to run abbreviated processes. In our experience, we have seen processes run as short as three weeks post the receipt of summary company confidential information. Conducting diligence in ever-shortening timelines, makes a robust infrastructure of in-house resources more critical as the reduced friction of "employed" resources becomes a greater advantage in an accelerated process.

Create Industry Specialization Without Suffering from Industry Bias

In our view, generalist firm structures are of the past. In today's environment, meaningful specialization is required at the partner level within industry verticals. Otherwise, private equity fund managers may be vulnerable by not having sufficient resources to fully evaluate and assess disruptive risk. Given the increasing breadth of threats which are coming in more unconventional forms, there is a greater requirement to have a complete set of industry-specific resources to fully evaluate potential risks.

That being said, we believe excessive industry silos within a firm presents a meaningful risk which may lead to "missing the forest for the trees." A more dynamic industry landscape is one in which the importance of assessing relative value is critical. Specifically, unfavorable legacy business models and capital market overreaction can create significant opportunity for investors that are able to assess value across different industry sectors and transaction types. In particular, capital-market overreaction can "generalize" an intra-industry trend to industry-wide malaise or exuberance resulting in entire sectors being oversold or "priced to perfection." We have found exploiting that mispricing and deploying disproportionate capital in certain sectors that present attractive relative value has been a path to delivering differentiated returns.

Effectively Shepherd Portfolio Companies through Periods of Technological Change

We expect firms which can react flexibly to non-traditional situations, unlock differentiated opportunities, and shepherd companies through industries impacted by technological change to be best positioned to deliver value and benefit from monetizing well-positioned companies in a market saturated with buyout capital.

Incremental to strategies that are focused on differentiation in the investment process, from a portfolio company management perspective, shepherding companies through technological change is a critical proficiency for private equity managers to master. This entails both appropriately underwriting technological risks in the diligence process and ensuring that portfolio companies are investing in the right resources and personnel to adapt to changing technology in its industry. This portfolio company support can come in multiple forms: targeted board members, temporary “surge” technology resources, assistance in executive searches, organizational design and guidance on appropriate company investments. The correct mix of resources will be both market and company dependent, but given the nature of disruptive threats, “outsider” resources, personnel and perspective are especially critical. As a result, a private equity firm with cross-industry expertise will have an edge in guiding a company through that process and creating a competitive advantage relative to industry incumbents.

In our view, private equity continues to offer three critical investment advantages compared to public market investing. First, the average hold period for a private equity investor of just over six years¹⁵ is well in excess of the average public market investor, which is measured in months.¹⁶ A longer investment horizon naturally offers a greater ability to react to a shifting industry landscape. Second, the private nature of many private equity holdings further alleviates the complications intrinsic to a strategic repositioning as it allows these changes to happen without the harsh glare of quarterly public reporting. Third and most directly, by creating a focused board of directors aligned around long-term value creation, private equity can resolve some of the principal agent conflicts and institutional inertia that can plague public companies. With foresight and a properly capitalized balance sheet, private equity can enact change more quickly and boldly than a typical public market investor, where even under a successful activist campaign can take over a year to direct meaningful change. Given the accelerating pace of technology-induced change and the aforementioned urgency to “adapt or die,” private equity’s ability to act with speed is critical.

Conclusion

Late cycle warning signs and less effective countercyclical monetary, fiscal, and political tools elevate the risk of a more meaningful correction in the near to medium term. Heightened cyclical risk has historically been a challenge for private equity models that are pro-cyclically biased and unable to deploy capital in corrections through flexible capital opportunities. Simultaneously, accelerated technology-related disruption that is increasingly impacting a broader set of industries creates new challenges for many sponsors wedded to shorter-term value creation or the financial engineering provided by leverage.

With this array of challenges comes a set of opportunities, as we believe the ability to differentiate as a private equity manager has never been greater. Whether creating value in the investment process through the use of flexible capital, advantaged sourcing, industry specialization, enhanced due diligence technologies or through more proactive portfolio management, private equity managers have a variety of avenues to separate themselves from the pack. Given the ever-growing amount of capital committed to private equity, there will continue to be attractive private-market exit opportunities with a potential premium attached to companies that have proven an ability to weather these cyclical and secular trends. Ultimately, the opportunity for differentiation enabled by the confluence of factors discussed here, ensures that appropriately selecting private equity managers is now a more critical role than ever. While some of these trends are still emerging and have not fully impacted realized results, we expect to see asset allocators that embrace the reality that “change is the law of life” and react accordingly should deliver superior risk-adjusted returns for their beneficiaries in the years to come.

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¹⁷ AUM amounts include funds managed by Ivy Hill Asset Management, L.P., a wholly owned portfolio company of Ares Capital Corporation and a registered investment adviser.