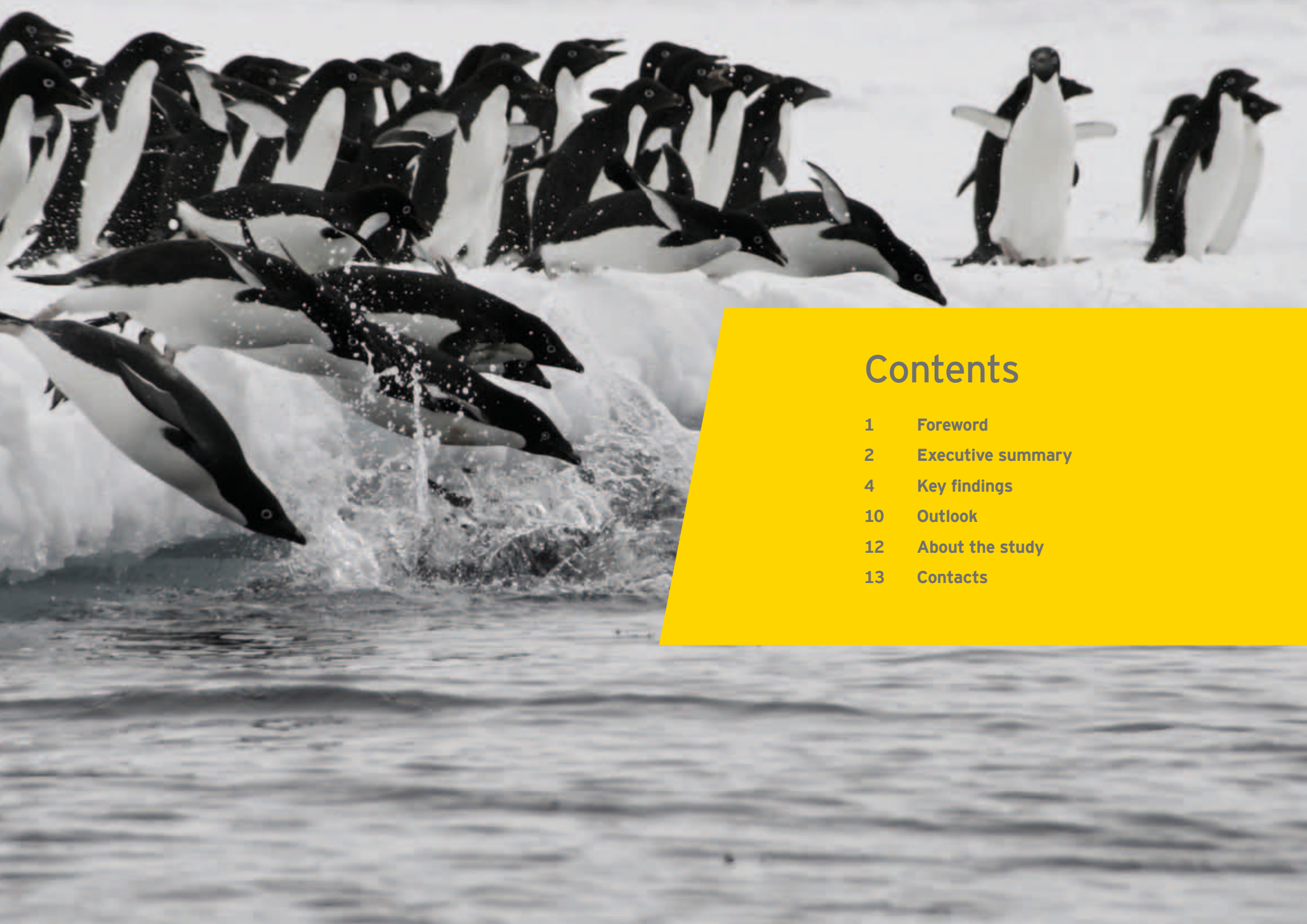




Return to warmer waters

How do private equity investors create value?
A study of 2010 European exits



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Foreword

Ernst & Young's sixth and latest study, 'How do private equity investors create value?' provides further empirical proof that private equity investment creates lasting value throughout economic cycles. On behalf of the European Private Equity and Venture Capital Association, we welcome this important and revealing research.

One of EVCA's core missions is to help tell the facts about the private equity industry. The high quality data in this study, can help us accomplish this, by shining light into the way that private equity generates its returns.

As the study shows, the process begins long before an investment is made, through exhaustive and diligent analysis of individual companies, their management teams and their markets. In this sense, private equity isn't about risk-taking, but rather risk mitigation. After this, private equity involvement has a strikingly positive impact across multiple business indicators, including new product lines, new markets or strategies to improve and transform their businesses.

To the pensioners and savers who are the ultimate beneficiaries of private equity, all returns are welcome. But it is particularly edifying to see the prominence of organic growth in driving returns. The multiplier effect of such growth across the economy benefits the whole of society.

In today's challenging economic environment, amid financial markets wary of systemic risk and stock markets plagued with volatility, private equity can provide a mechanism to accelerate growth through responsible investment that can support businesses of all sizes, through good times and bad. When the fire-fighting of today's market turmoil is over, Europe will need activities that provide growth, returns and prosperity. Ernst & Young's excellent study demonstrates that private equity's focus on creating lasting value is a core part of that vision.

Dörte Höppner
Secretary-General
European Private Equity and Venture Capital Association

Executive summary

Improving conditions

Our sixth study, Return to warmer waters, is set in a context of improving economic conditions following the deepest recession in living memory.

The year 2010 saw a thaw in the market. There was a significant upturn in the number of exits achieved by PE investors, rising from just 31 in 2009 to 57 in 2010, as PE was able to turn a more favorable environment to its advantage.

One of the key drivers of this was a large increase in the number of exits via IPO. At 11, this was the highest recorded since 2006, crystallizing a large amount of value for PE.

Another factor in 2010 was the return of secondary buyouts after a very quiet 2009, as PE houses showed a renewed confidence in making selective acquisitions and lending banks became more confident in providing acquisition finance. At the same time, creditor exits, which peaked in 2009, saw a marked reduction in line with an improved economic backdrop.

Overall, the exit numbers are highly encouraging in that they suggest a steady return to normality for PE that continued into the first half of 2011. Despite this, the absence of corporates from the M&A market is apparent in the 2010 figures for PE activity. Just nine (or 16% of exits) were to trade buyers, reflecting their cautious attitude towards acquisitions, and compared to historical activity of three times this level. The exit market will only stage a complete recovery when corporate investing fully recovers from the recession.

Despite the improvement in 2010, the difficult conditions over the past three years have resulted in a further ageing of the portfolio. The average hold period of companies exited in 2010 was 4.7 years, compared to 3.7 years pre-credit crunch (2005-07), translating into downward pressure on IRRs.

There was a significant upturn in the number of exits achieved by PE investors, rising from just 31 in 2009 to 57 in 2010, as PE was able to turn a more favorable environment to its advantage.



Our study demonstrates that PE exits continue to out-perform comparable public companies – even in difficult times – across most sectors and regions. Our analysis of returns attribution for exits since the start of the credit crunch (2008-10) shows that even where the contribution of extra leverage and stock market returns is negative, PE's return from strategic and operational improvement remains firmly in positive territory. The gross returns achieved by all PE exits 2005-10 are 3x those achieved on public markets with PE outperforming comparable public companies on all key value drivers – EBITDA growth, employment growth, productivity growth and valuation multiple.

In this year's study, we analyzed the components of performance to understand how PE-owned companies increase in value. We found confirmation of what we had been hearing anecdotally: organic revenue was the largest driver of profit growth, accounting for 46% of the total across the whole period of our research, and even more significant for 2010 exits.

Perhaps more striking, we found evidence that PE is achieving organic revenue growth not only through investment expertise, by choosing the right markets, but also through the execution of fundamental changes in portfolio companies. Key to achieving this is the amount of time spent by PE before a deal completes to ensure that the management team is strong and has the right skill sets in place to deliver on company strategy.

We found some evidence in the 2010 exits that PE firms are spending more time with their portfolio companies. In part, this was a reaction to the recession; it also represents a greater focus on designing and delivering on profit growth strategies.

And just as PE is taking time to buy well and improve portfolio company performance, we have also found that it is investing more time and effort in preparing its businesses for sale, to ensure the best possible outcome. Two elements of this stand out in this year's research. Firstly, there is often early engagement with management, potential new owners and advisers on the potential sale, to warm up key parties. Secondly, there is investment in preparing robust, sell-side information to describe the business and tackle any uncertainties head-on.

While 2010 was a positive year for PE exits, and the first half of 2011 has shown a further improvement in exit numbers, current volatility in the public markets will likely impact exits, particularly IPOs of PE-backed companies. The macro-economic outlook, still remains uncertain in Europe and beyond. However, as our research shows, PE has proved itself far better able to weather the storm than anyone had anticipated in 2008 and remains robust.

Key findings

2010 exits

Ernst & Young's 2010 study shows that exit activity increased substantially from the previous two years and on some measures was close to the peak of 2006-07. PE was able to take advantage of an improved economic outlook in 2010, stronger capital markets activity and a renewed confidence among PE investors to acquire high quality businesses. This reinforces one of our findings from last year's study – that the PE model offers protection against short-term risks and allows firms to choose the best time to exit their investments. Our analysis also points to a steady recovery in activity levels following the challenging years of 2008 and 2009.

€2.5b

The average entry EV for exits by IPO in 2010, at over €2.5b, is almost double the previous high of 2007.

There were 57 exits in 2010, a sharp rise from the lows of 2009 and 2008, when just over 30 exits were completed each year. The return of IPOs was one of the most notable drivers of this, as a total of 11 portfolio companies exited via IPO across Europe – the highest number since 2006. Exits via IPO also accounted for some of the largest companies in PE portfolios by entry EV: 19% of exits by number were by IPO, while 56% by entry EV were by IPO. Indeed, the average entry EV for exits by IPO in 2010, at over €2.5b, is almost double the previous high of 2007. This demonstrates that the public markets have been a key route to realizing large portfolio companies, with 2010 a particularly strong year for this. Over half of the IPO exits for the 2005-10 period with an entry EV of more than €1b took place in 2010. It is interesting to note however, that none of these IPOs were in the UK – demonstrating a continued distrust of PE-backed IPOs in the UK investment community.

Figure 1: PE exits 2005-2010, N and entry EV

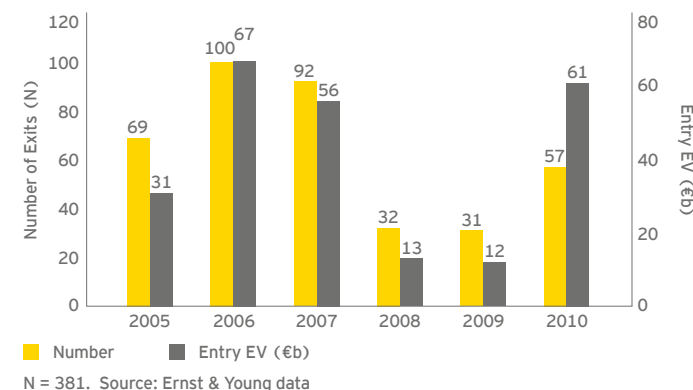
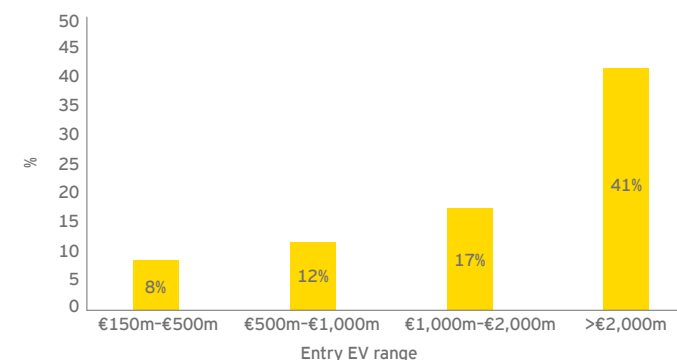


Figure 2: Percentage of PE exits by IPO, by entry EV range, 2005-10

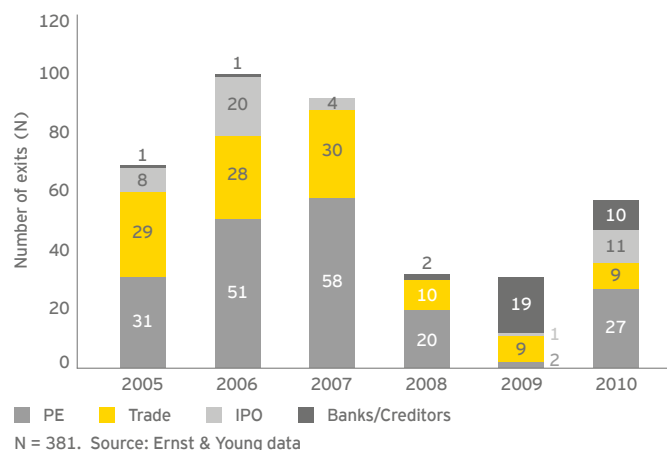


N = 381. Source: Ernst & Young data



In a highly encouraging sign, the number and proportion of creditor exits reduced sharply in 2010 compared with 2009. Looking back over the six-year period of our study, creditor exits accounted for 9% of the total – far less than was anticipated when the crisis began. It should also be noted that the vast majority of these creditor exits were a change of equity ownership triggered by reduced but still positive business profits and prospects, rather than companies being bankrupt or entering administration. Our analysis shows that creditor exits peaked in the third quarter of 2009 as the recession hit companies hard regardless of their ownership structure, and that numbers declined rapidly thereafter to a very low level in 2H 2010. This profile is inverse to the pattern of GDP growth over the recession, albeit with a lag of about six months.

Figure 3: PE exit routes 2005-2010



Exits to PE also recovered significantly in 2010, representing 47% of the number of realizations achieved over the year. This contrasts sharply with 2009, when just 7% of exits were to PE buyers. The improvement in secondary buyouts reflects improved debt market conditions – lending banks were more able to support PE in 2010 as their own positions stabilized – as well as a greater focus by PE on making new investments, following two years of heavy concentration on working with existing portfolio companies. In line with our findings in North America, our study has shown that secondaries have historically performed well. In many cases, they have produced higher than average returns, demonstrating there can still be significant value created during subsequent PE ownership.

However, the improved confidence among PE firms was not matched by corporates. Trade buyers remained highly cautious in 2010 and accounted for just 16% of exits by number in 2010, much lower than the 30% seen in prior years. Corporates have not returned to the M&A markets as quickly as PE, with our research showing corporate activity with PE, both buying from and selling to, well below historical levels.

Key findings

PE - owned businesses still out-performing

Even more encouraging, is the fact that private equity continues to out-perform equivalent public companies notwithstanding the challenging conditions we have seen over recent times. Our returns attribution analysis shows that, over the long term, 40% of the gross investment return on PE exits comes from out-performance, 31% from stock market returns and 29% from additional leverage (over public company benchmarks). Put another way, the gross return on the PE exits is over 3x the public market return. This has been achieved as PE exits have outperformed public companies on all key value drivers – +2.1% in EBITDA growth, +0.1% in employment growth and +0.7% in productivity growth. Analyzing these results further by country, sector and deal size shows positive investment returns and out-performance.

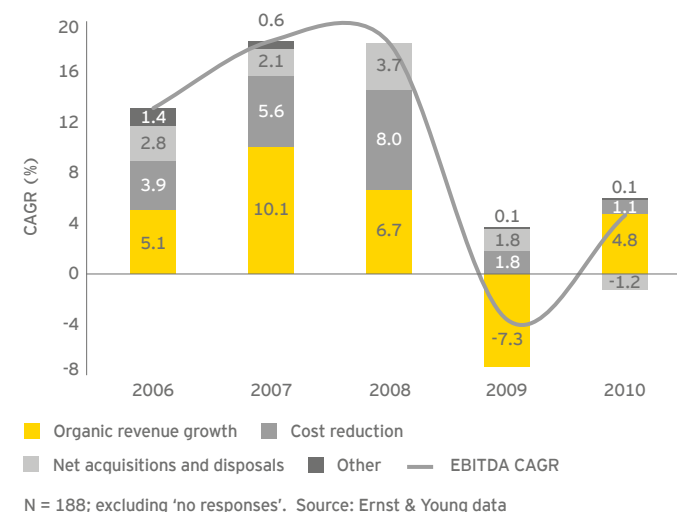
Carving out these exits between 2008 and 2010 – the worst of the recession – we found that, even though the other sources of return – stock market and additional leverage – were negative because of poor economic conditions, PE exits still generated positive returns overall because of its ability to add value to portfolio companies through strategic and operational improvement.

Organic revenue growth drives returns

As with North America, our analysis of European exits shows that EBITDA growth has risen in importance as a driver of PE's value creation compared to the pre-crisis years. This is in part a reflection of the fact that it is harder to generate returns through multiple expansion in difficult markets. However, it also provides strong evidence of PE's increased focus on growing portfolio companies. While this has always been an important component of PE's toolkit for value creation, recent times have seen firms place much greater emphasis on growth than was previously the case.

We analyzed the sources of EBITDA growth in companies exited in our database. The most striking finding is that organic revenue growth is proportionally the largest contributor, accounting for 46% of profit growth across the period, but that it is also more significant for companies exited in 2010. Cost-reduction and bolt-on acquisitions accounted for a much smaller share of EBITDA growth over the five-year period and in particular in 2010. In aggregate, bolt-on acquisitions outweigh disposals on this measure by 2.3 to 1.

Figure 4: Sources of EBITDA growth 2006-10, by year of exit



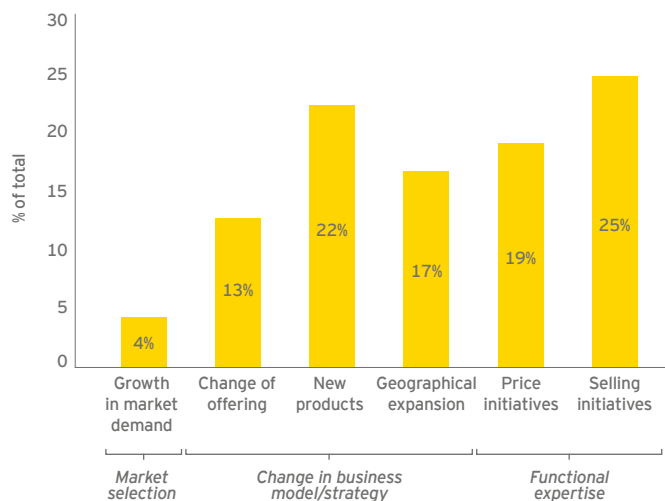


The strategies for organic revenue growth

PE is using a number of strategies for achieving organic revenue growth and we found evidence that PE ownership is leading to fundamental changes in its portfolio companies. Over half of the organic revenue growth comes from initiatives that changed the business model or strategy. Changing a company's offering by, for example, repositioning it in the market, developing and selling new products and expanding geographically were all highly important factors in driving organic revenue growth for companies in our research and particularly in 2010. Indeed, in aggregate, they accounted for more organic revenue growth than the more functional improvements to pricing and selling. Our study demonstrates that the more fundamental changes that PE investors are able to achieve in portfolio companies have the greatest impact on profit growth. It is a harder route to improving performance but it generates better results for companies and, ultimately, enhanced returns for PE.

The share of growth from market demand is lower than in prior years, reflecting the adverse effect on a number of businesses of the recession.

**Figure 5: Drivers of organic revenue EBITDA growth:
PE exits 2007-10**



N = 124, deals with no allocation data available excluded
Source: Ernst & Young data

Key findings

Achieving change under PE ownership

To achieve fundamental change, our study shows that PE is using a variety of approaches. As with our North American study, there is evidence that PE has been working more closely with its portfolio companies. This suggests that PE is willing and able to support portfolio companies' strategies to position them for future growth and that it will put in the time to re-evaluate and adapt business plans in response to a changing economic environment.

The 2010 exits showed that PE owners were proactively seeking potential buyers and engaging with them well in advance of a sale.

As we found in last year's report, getting the management right at the outset remains key to an investment's success and to achieving organic revenue growth. Our analysis for 2010 confirms that backing top teams or identifying them before the deal and putting them in place on completion are highly important. The penalties for getting this wrong are severe. Based on exits achieved between 2005-10, we found that replacing management during the investment adds up to 1.6 years to the holding period and reduces returns. However, it should be noted that PE's active ownership and ability to replace executives enables it to drive improvements in the companies it backs. Without this level of engagement, the companies may have suffered a worse fate, particularly in the difficult times we have witnessed over the last few years.

Clearly, a focus on getting the right team from the start is essential, particularly as we have highlighted that PE is increasingly seeking to implement far-reaching and profound changes to a business. PE uses a variety of strategies for this and our research found that it was investing significant time up front on ensuring they back the right people by: tracking the company before investment so that PE could observe the management at work; building strong relationships with the management team so that PE could understand their strengths and ambitions and – importantly – identifying any weaknesses that needed to be dealt with; and backing a management team that had successfully executed a similar strategy.



In last year's report, we pointed to an increased use of 100-day plans, operating partners and consultants by PE as other enablers of profit and value growth. This year, we sought to understand how they were being used to drive value. Our analysis shows that all these initiatives added value to profits growth for companies exited in 2009-10, with some interesting variations. Consultants were used in more than 60% of exits, with a skew towards larger businesses. Operating partners were used at about half the frequency of consultants overall, mostly when the incumbent management team was retained. 100-day plans were commonly used at the outset and more likely if there was a new management team.

Improving outcomes at the time of exit

Selling well is clearly an important factor in the success of an investment. No matter how much performance has been improved under PE ownership, if a sales process is not well-managed, a great deal of value can be lost, particularly in a challenging economic environment.

The 2010 exits showed that PE owners were proactively seeking potential buyers and engaging with them well in advance of a sale. PE has encouraged management to go on roadshows, maintain contact with advisors and meet with potential buyers months, and in some cases years, before a sale was anticipated.

Our study shows that the vast majority of 2010 exits that were sold to trade or PE buyers prepared robust information to provide to prospective buyers, and over 80% had vendor due diligence reports. Of these exits to PE and trade, the only instances in which vendor due diligence wasn't used, bar one, were those in which PE was unexpectedly approached by a buyer or there was just one buyer involved.

PE is leaving nothing to chance. These leading practices are allowing PE to run more streamlined auction processes that include only credible and genuinely interested bidders. This not only increases the opportunity to generate maximum value for a business, but also helps PE manage in-house resources effectively. Early engagement and full preparation are now the hallmarks of successful exits by PE.

80%

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A black and white photograph of a colony of penguins, likely Adelies, leaping from a snowy ice surface into the ocean. The penguins are captured in mid-air, with their bodies arched and wings spread. A large, dynamic splash of water is visible in the foreground, indicating the point of entry into the water. The background shows more penguins on the ice, creating a sense of a large group. The overall scene conveys a sense of movement and resilience in a cold environment.

Outlook

The study, based on the largest European businesses owned and exited by PE from 2005 to 2010, demonstrates the resilience of private equity even through the coldest of climates.



The PE business model is a robust and active form of ownership that drives growth in the companies it backs through fundamental and transformative change. This is good for the economy as a whole but also for PE, which our study shows consistently out-performs the public markets as a result.

Secondary buyouts have accounted for a large share of the exits in 2011, driven in part by a defrosting of the debt markets. There is, however, anecdotal evidence to suggest that PE buyers are setting the quality threshold higher on deals sourced from PE portfolios in response to LP concerns around how much value can be added to companies by successive PE owners.

Exit activity has improved, although the market is also not yet at full capacity. Corporates have not yet staged a major comeback on the M&A market, despite having built up significant cash reserves. There are some signs of their return in sectors such as IT and healthcare, but corporates will remain highly selective in the acquisitions they undertake. Given that trade buyers have always been an important exit route for PE, exit figures will not reach their potential until corporates are fully back in the market. Additionally, the uncertain economic climate is impacting confidence.

As a result, PE still faces the challenge of needing to realize a large number of companies in its portfolio. For the third year running, PE portfolios have continued to age rapidly. In December 2009, the average holding period of investments was 3.6 years; by December 2010, it was 4.2 years. PE remains under pressure to step up the pace of exit activity to ensure returns as measured by IRR are not dampened further. It is also facing pressure to return capital to LPs, particularly where firms are likely to need to raise new funds over the next 12 to 18 months.

However, LPs are not just seeking crystallized returns from the PE firms they will back in the future. They are also increasingly looking for evidence of operational improvement in PE portfolio companies. The fund investment process has professionalized significantly over the last few years and LPs are conducting much more thorough due diligence on new PE funds than they have in the past, drilling down into each PE manager's ability to add value. As our research highlights, PE is increasingly focusing on growing the businesses it backs. Those able to demonstrate a well-defined strategy of choosing the right markets to invest in and successful execution of value creation plans in their portfolio companies should continue to attract good levels of LP capital.

At the same time, PE continues to face the pressure of increased regulation both within Europe and on a global stage. While some of this has already come into force and PE is rising to the challenge of implementing the necessary changes, the full effects of a stricter regulatory regime governing the industry may not be known for many years to come.

As this year's study demonstrates, the PE model is alive and strong. It has remained resilient even through the harshest of environments. The full recovery of European economies may be further out than was expected in 2010 and PEs will need to utilize all of the lessons learned throughout the recession to steer portfolio companies through some more uncertain times ahead. However, our study shows that PE's active ownership enables it to withstand difficult conditions by driving growth in the companies it backs, to create stronger, more profitable businesses over the longer term and to generate investment returns that out-perform public market benchmarks.

About the study

The 2010 study provides a view into the performance and methods of PE, based on the analysis of just over 375 of the largest European businesses PE has exited over the last six years.

To avoid performance bias, and to ensure a focus on the largest businesses owned by PE, exits were screened to capture those that had an enterprise value at entry of more than €150m. This criterion was also applied to our estimate of the current size of PE portfolios. In total, we have identified 381 exits of businesses that met our criteria over the six years 2005-10.

This independent study is built on public data and confidential, detailed interviews with former PE owners of the exited businesses. The owners of these European-based businesses were not all European-based themselves; this is not a study on the performance of European-based PE investors, rather an analysis of the impact of PE on European businesses.

We assessed business performance for the duration of PE ownership i.e., from entry to exit, based on key performance measures, including change in enterprise value, profit (defined throughout this report as earnings before interest, tax, depreciation and amortization, or EBITDA) employment, productivity and valuation multiple. To better measure aggregate economic impact, we used weighted averages.

Overall, we have performance data for 271 businesses or 71% of the total population. Comparing mix by type of exit, deal size etc. there is no discernible bias in composition to the whole population.

Finally, in order to evaluate the performance of PE-owned businesses against comparable public companies, we have compiled data on public companies by country and sector over the same time period as the PE exits in our sample. The data was then aggregated to compare PE performance to that of public companies.

The ability to incorporate data obtained from top PE investors is an important feature of the study. Another is the scope and depth of our research, with a database of over 375 European PE exits. The Ernst & Young study is a leading piece of research, and is recognized by many commentators as an authoritative work in this field.

This independent study is built on public data and confidential, detailed interviews with former PE owners of the exited businesses.

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