PRIVATE EQUITY

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The private equity market has become an important source of funds for startup and young firms, firms in financial distress and those seeking buyout financing. Private equity has experienced substantial growth over the past two decades, both in terms of capital under management and amounts invested, and the private equity industry is now considered a recognised asset class. The UK is the largest private equity centre in Europe and is second in size globally only to the US. London is one of the leading international centres for the management of private equity investments.

Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradeable on a public stock market. Private equities are generally less liquid than publicly traded stocks and are thought of as a long-term investment. Categories of private equity investment include all types of venture investing, buyout investing and special situations. It should be stressed that any analysis of the private equity market is handicapped by a lack of readily available information. Data from various sources may not be entirely comparable due to differing methodologies. We have relied on public sources of data for this report, primarily organisations that collect data and publish newsletters and reports for the private equity community.

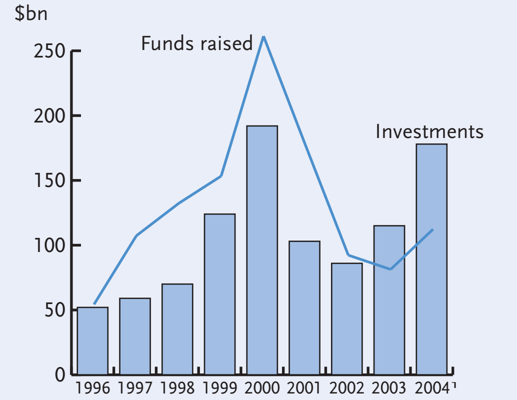
SIZE AND REGIONAL BREAKDOWN OF THE PRIVATE EQUITY MARKET

Global private equity According to IFSL estimates, nearly $180bn of private equity was invested globally in 2004, up over a half on the previous year as market confidence and trading conditions improved (Chart 1). Funds raised globally increased 40% in 2004 to $112bn. Prior to this, investments and funds raised increased markedly during the 1990s to reach record levels in 2000. The subsequent falls in 2001 and 2002 were due to the slowdown in the global economy and declines in equity markets, particularly in the technology sector. The decline in fund raising between 2000 and 2003 was also due to a large overhang created by the end of 2000 between funds raised and funds invested.

Geographic breakdown The regional breakdown of private equity activity shows that in 2004, 66% of global private equity investments (up from 58% in 1998) and 62% of funds raised (down from 72%) were managed in North America (Chart 2). Between 1998 and 2004, Europe increased its share of investments (from 24% to 26%) and funds raised (from 18% to 31%). Asia-Pacific region's share of investments and of funds raised during this period was virtually unchanged at around 6% while share of the rest of the world fell.

The country breakdown for private equity activity shows that private equity firms in the US managed 64% of global investments (Table 1) and 59% of funds raised in 2004. The UK was the second largest private equity centre with 13% of investments and 11% of funds raised. Since the mid-1990s,

Chart 1 Global private equity



[1] 2004 figures may not be entirely comparable with previous years as they are an IFSL estimate based on various sources

Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers, Thomson Financial, Centre for Asia Priv. Equity Res., NVCA

Table 1 Top 10 countries for private equity investments

2004, $bn	Total investment value	% share	As % of GDP
US	113.7	64	1.0
UK	23.7	13	1.1
Japan	6.6	4	0.1
France	6.5	4	0.3
Germany	4.7	3	0.2
Spain	2.4	1	0.2
Netherlands	2.1	1	0.4
Sweden	2.0	1	0.6
Italy	1.8	1	0.1
China	1.4	1	0.0
Others	12.0	7	0.0
Total	**176.9**	**100**	**0.3**

Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers Thomson Financial, Centre for Asia Private Equity Research, IFSL estimates

Private equity activity

Investments represent the financing of businesses through venture capital, buyouts and other forms of financing.

Fundraising refers to the money investors have committed to private equity funds in any one year.

Divestments represents the realisation or exiting of a private equity investment. This is generally done by: selling the company; writing off the investment or floating the company on a stock market.

UK's share rose partly due to an overall increase in private equity activity in Europe. Other important centres for private equity include Japan, France, Germany and Spain. As a per cent of GDP, the UK in 2004 had the highest ratio of investments and funds raised, both at 1.1% of GDP.

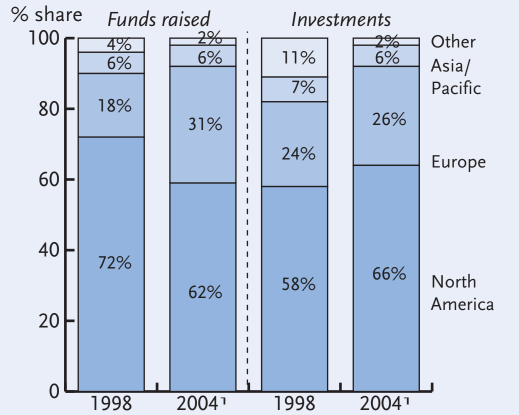
UK private equity The UK is the largest centre for the management of private equity investments and fund raising in Europe (Chart 3) and is second only to the US globally. Most large pan-European players are based in London. Firms located in the UK also attract the largest proportion of European private equity investments.

Investments Worldwide investments of UK private equity firms totalled a record £9.7bn in 2004 exceeding the previous record in 2000 according to the annual British Venture Capital Association (BVCA) survey of its members. The bulk of the 52% increase in investments in 2004 was due to growth in the value of management buy-outs in Continental Europe and the UK. Investments were made in 1,566 companies in 2004, up 5% on the previous year. European Venture Capital Association (EVCA) figures, which also include estimates for non-BVCA member data, indicate that total investments of private equity firms located in the UK reached a record £13.0bn in 2004.

The UK private equity industry has become more global over the past decade. In 2004, private equity firms in the UK invested 45% of their funds in companies located overseas, up from 13% in 1996. Nearly a half of this was in Continental Europe, and a tenth in the US. The UK's influence overseas is considerable, both through direct investment from the UK offices of private equity firms and through their offices overseas. A regional breakdown of investment activity within the UK shows that London accounted for 27% of private equity investments in 2004, down from 36% in 2003.

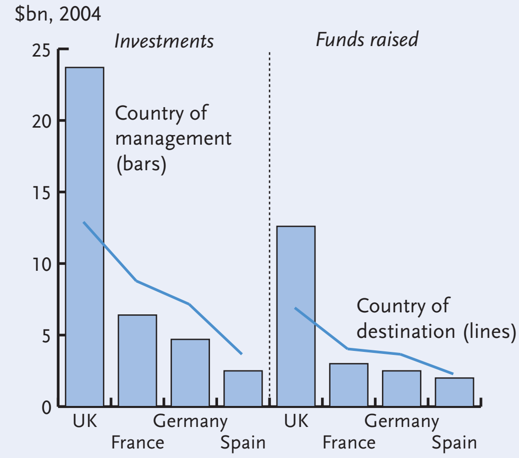
Funds raised in the UK decreased by 63% in 2004 to £3.3bn. The fall was largely due to cyclical factors and maturity of existing managed funds. Overseas investors generated two-thirds of funds raised in 2004, slightly down from their contribution in the previous year. Investors from North America were the largest source of funds with 41% of the total followed by those from Continental Europe with a fifth. The above figures are published by the BVCA and represent the amount raised by independent funds only.

Chart 2 Regional breakdown of private equity investments



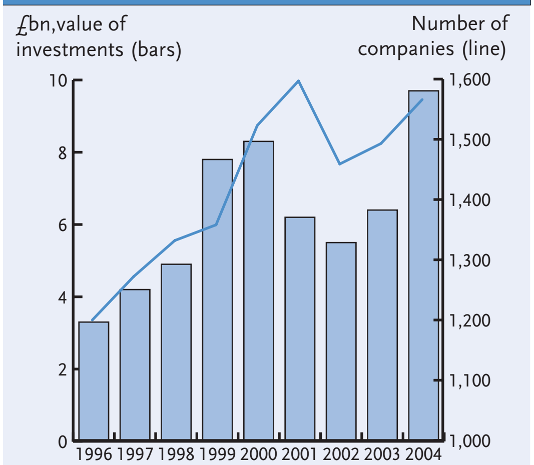
¹ 2004 figures may not be entirely comparable with 1998 as they are an IFSL estimate based on a number of different sources
Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers, Thomson Financial, Centre for Asia Priv. Equity Res., NVCA

Chart 3 Private equity investments in Europe



Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers

Chart 4 UK private equity investments



Source: BVCA

Private equity investments

Venture capital represents investing in companies that have undeveloped or developing products or revenue. Investments can be classified into:

- *Seed stage* Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase

- *Start-up stage* Financing for product development and initial marketing.

- *Expansion stage* Financing for growth and expansion of a company which is breaking even or trading profitably.

- *Replacement capital* Purchase of shares from another investor or to reduce gearing via the refinancing of debt.

Buyout funds typically target the acquisition of a significant portion or majority control of businesses which normally entails a change of ownership. These are typically investments in more mature companies.

Special situation includes a range of investments such as distressed debt, equity-linked debt, projects finance and leasing. This category includes investment in subordinated debt, referred to as mezzanine debt financing.

According to EVCA figures, which are wider in scope as they also include funds raised by captive funds and realised capital gains, the overall value for funds managed in the UK in 2004 totalled £6.9bn. As a source of funds, investors from the UK generated £3.3bn of global funds raised.

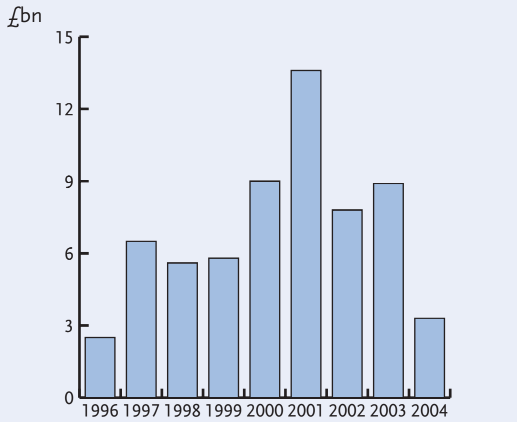
Divestments The UK's $8.6bn in divestments in 2004 accounted for around a third of the European total. The number of divestments in the UK increased by 18% in 2004 to 1,519. Write-offs accounted for the largest number of divestments while trade sales represented the largest category by value of divestment.

As shown in Chart 6, European divestments increased by 58% in 2004 to a record $24.4bn. Trade sales accounted for 23.7% of this, followed by repayment of shares/loans 21.3%, sale to other venture capitalists 13.1% and write-offs 9.6%. Most of the reminder was accounted for by sales to financial institutions and sales of quoted equities and IPOs.

Secondary market for private equity The secondary market dates back to the global economic crisis of the late 1980s, which produced a large lack of liquidity among many of financial institutions, especially those with less liquid assets such as private equity. In the US, this lack of liquidity created a new market for investors - the acquisition of secondary interests in private equity funds or in companies.

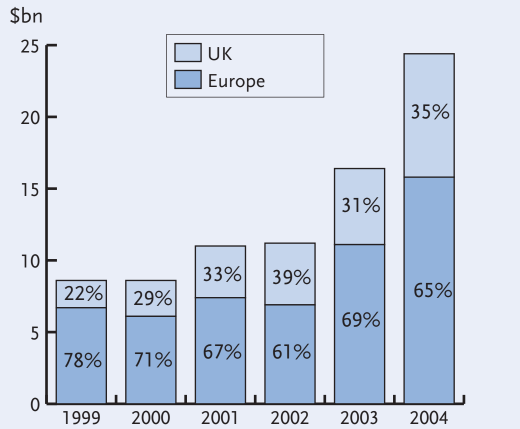
The global private equity secondary market has experienced substantial growth over the past decade. Between 3% and 5% of the total committed capital each year is invested in the secondary market (Chart 7). This is expected to rise to between 7% and 10% in the coming years. Secondary transactions on the private equity market totalled around $5.5bn in 2004 up

Chart 5 UK private equity fund raising[1]



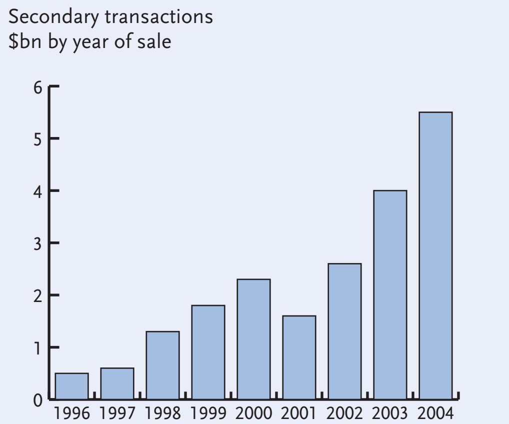
[1] these figures are not comparable with EVCA figures for fund raising as they only include "independent funds"
Source: BVCA

Chart 6 European divestments



Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers, BVCA

Chart 7 Global private equity secondary market



Source: Lexington Partners; University of Nottingham from $4.0bn in the previous year. Europe accounted for between 30% and 40% of this. Opportunistic specialist secondary investors are the major players in this market with about a half of transactions. Fund of funds with around 40% of the market account for most of the remainder.

FINANCING STAGE

Investments can be categorised according to the financing stage into: venture capital; buyouts and special situations. Buyouts account for the bulk of investments by value due to the significantly larger size of such deals compared with other investments while venture capital accounts for the majority of investments by number.

Globally, buyouts' share of private equity investments by value increased from 21% to 78% between 1999 and 2004 (Chart 8 and Chart 9). According to IFSL estimates more than three-quarters of the 22% share of venture capital investments in 2004 was in expansion stage companies and the remainder in early stage. In Europe, buyouts, expansion stage and early stage investments accounted for 72%, 21% and 7% of investments respectively in 2004. Buyouts also generated the bulk of private equity investments in the UK with 77% of the total in 2004. Expansion stage companies accounted for 18% and early stage investments for the remaining 5%.

Funds raised Of total funds raised in the UK in 2004, 91% of capital is expected to be invested in buyouts. Investments in expansion stage companies are expected to accounted for 7% and early stage investments for 2% (Chart 10). In Europe 65% of funds raised in 2004 are expected to be allocated to buyouts, a quarter to expansion stage companies and 10% to early stage funds.

Historical overview of the private equity market

1930s and 1940s The private equity market in Europe dates back to the formation of groups such as Charterhouse Development Capital in 1934 and 3i in 1945. In the US it originates from the The American Research and Development Corp established in 1946. These companies provided a private sector solution to the lack of financing for new enterprises and small businesses.

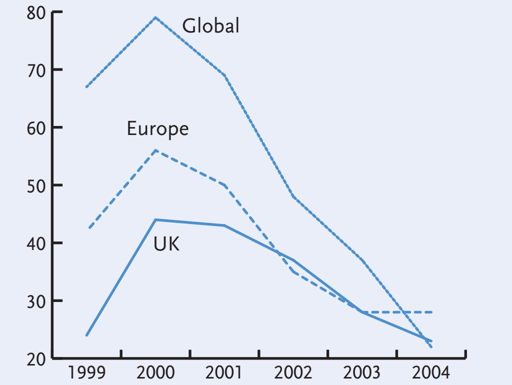
1950s, 1960s and early 1970s During this period there was little growth in private equity investments. Most private venture capital firms formed during this period managed venture capital investments of wealthy families.

1970s Limited partnerships gained in popularity and numerous regulatory and tax changes helped the private equity market both in Europe and in the US. Organised venture capital financing through limited partnerships was beginning to be recognised as an industry. Structural and legal changes allowed for the liberalisation of investment choices available to institutions.

1980s Venture capital financing increased tenfold in the early 1980s but dropped between 1987 and 1991 due to losses and the slowdown of the global economy. During the late 1980s a number of large partnerships were created specifically to provide equity capital for non-venture financing needs.

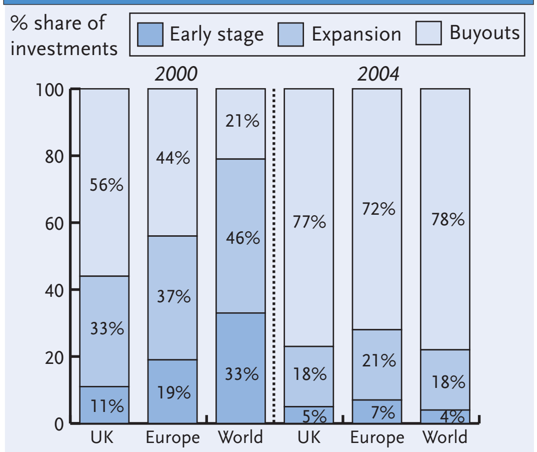
1990s Dramatic rise in private equity investments, particularly in the technology sector boosted by further tax changes in Europe.

Chart 8 Venture capital investments



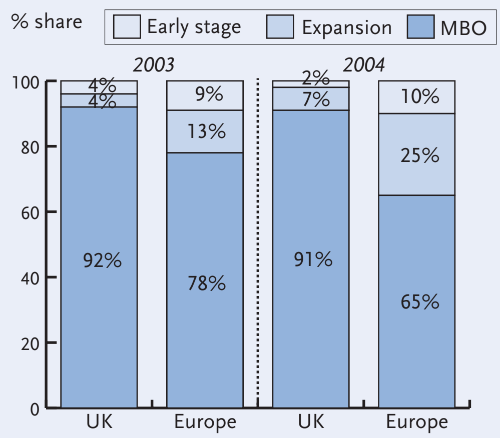
Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers

Chart 9 Investments by financing stage



Source: BVCA, EVCA/Thomson Venture Economics PricewaterhouseCoopers, IFSL estimates

Chart 10 Funds raised by expected stage of investment



Source: BVCA, EVCA/Thomson Venture Economics, PricewaterhouseCoopers

INVESTMENTS BY INDUSTRY SECTOR

High-tech, consumer, communications and other services sectors have typically attracted most private equity investments in recent years. In Europe consumer investments accounted for nearly a fifth of total investments in 2004. This was followed by the high-tech sector with 16%, 'other services' with 11% and communications with 11%. In the UK, sectors which received most private equity capital in 2004 included: general retailers 26%, support services 16%, and leisure and hotels 7% (Table 2).

Around £10bn was invested in UK technology companies between 1984 and 2004. Technology related investments (communications, computer, electronics, biotechnology and medical) decreased by 17% in 2004 to £678m. As Chart 11 shows, technology related investments are still below peaks seen in North America and Europe in 2000 and in Asia Pacific and the UK in 2001.

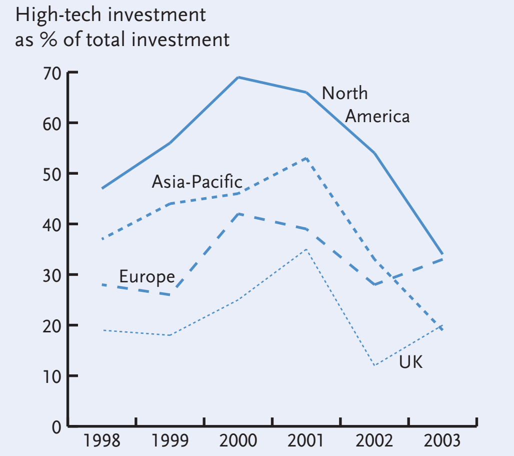
Table 2 UK investment activity by sector

	investment, £bn		*% share*	
	2003	**2004**	***2003***	***2004***
General retailers	698	1,413	*17*	*26*
Support services	434	840	*11*	*16*
Leisure & hotels	1,039	384	*26*	*7*
Speciality & other finan.	164	289	*4*	*5*
Insurance	17	284	*0*	*5*
Software	155	180	*4*	*3*
Pharmac. & healthcare	87	174	*2*	*3*
Biotechnology	84	72	*2*	*1*
E-commerce	399	72	*10*	*1*
Communication	260	58	*6*	*1*
Other	737	1,570	*18*	*29*
Total	**4,074**	**5,336**	***100***	***100***

[1] Table 2 only includes investments in companies located in the UK whereas Chart 4 also includes overseas investments

Source: BVCA

Chart 11 High-tech investment



Source: EVCA/Thomson Venture Economics/PricewaterhouseCoopers

STRUCTURE OF PRIVATE EQUITY MARKET

The private equity market has three major players and an assortment of minor players. The major players include investors, intermediaries and issuers.

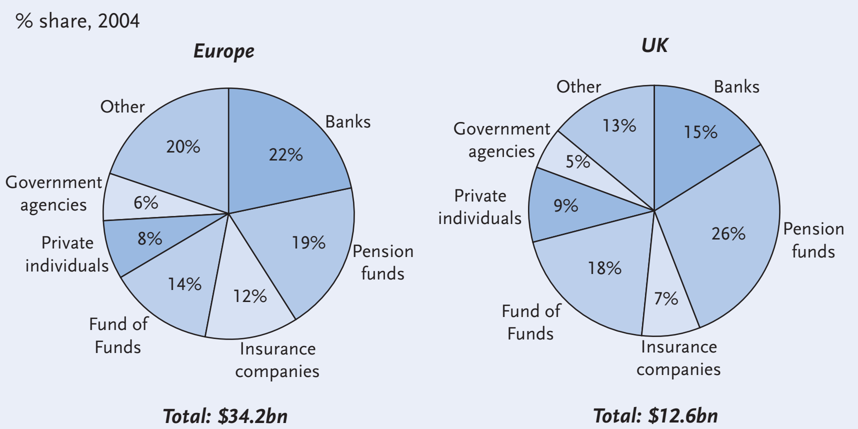
Investors in Private Equity

The number and variety of groups that invest in private equity has expanded substantially to include a wide range of different types of investors. Up to two decades ago, the private equity market predominantly consisted of wealthy individuals investing into early stage companies. Today, institutional investors with long-term commitments to the asset class provide the vast majority of the contributed capital in private equity funds.

Banks were the largest providers of capital in Europe, with 22% of total funds raised in 2004. Pension funds came second with 19%, followed by fund of funds and insurance companies with 13.5% and 12.0% of funds respectively. Much of the remainder was generated by private individuals, corporate investors and government agencies.

In the UK, overseas investors accounted for over two-thirds of funds raised by UK equity firms. Around 40% of this was from North America and most of the remainder from Continental Europe. Pension funds were the largest investors in UK funds with 26% of amounts raised in 2004. They were followed by funds of funds (18%), banks (15%), and private individuals (9%).

Chart 12 Sources of new funds raised



Source: EVCA, BVCA

Intermediaries

The growth in the private equity market over the past three decades is largely attributable to the emergence of private equity funds that raise and invest funds from investors. Private equity funds are organised mainly as limited partnerships. Under the partnership arrangement, investors who contribute to the fund's capital are the limited partners and professional managers running the fund serve as the general partners.

Intermediaries not organised as limited partnerships, such as Small Business Investment Companies and publicly traded investment companies only play a marginal role in the private equity market. About four-fifths of private equity investments flow through specialised intermediaries, almost all of which are in the form of limited partnerships. The remainder is invested directly in firms through co-investments (direct investing alongside private equity partnerships) and other forms of direct investments.

Organisations which only manage funds (known as Independents) accounted for 69% of investments in 2003. Organisations which only invest for a parent (Captives) accounted for 6% while the remaining 25% was accounted for by organisations which do both (Semi-captives).

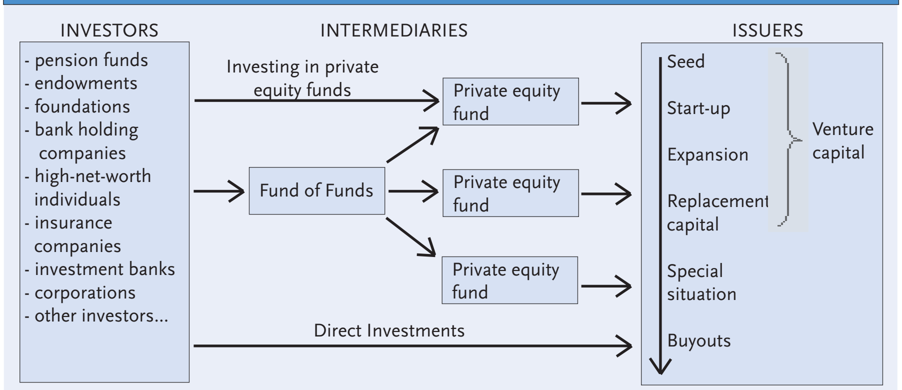
Issuers

Issuers in the private equity market vary widely in size and in their reasons for raising capital. As private equity is one of the most expensive forms of finance, issuers generally are firms that do not have an alternative source of financing such as a bank loan, private placement or the public equity market.

Firms seeking venture capital are typically young firms that are projected to show high growth rates in the future. Seed or start-up capital is the money used to purchase equity-based interest in a new or existing company which is still not operational. Venture capital also includes early-stage capital provided for companies that have commenced trading but have not moved into profitability or proved its commercial viability. Later stage investments where the product or service is widely available are also considered as venture capital investments.

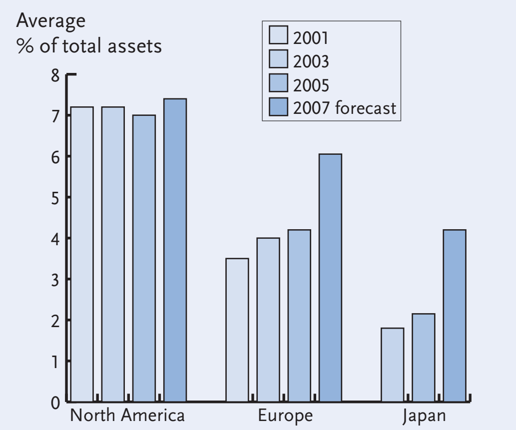
Non-venture private equity investments include middle-market companies that use the private equity market to raise finance for expansion or a change in their capital structure. Public companies can also be issuers in the non-venture private equity market. These companies issue a combination of debt and private equity to finance a management or leveraged buyout. They also issue private equity to help them through periods of financial distress.

Chart 13 Private equity market



Source: Federal Reserve Bank of Dallas, IFSL, EVCA/Thomson Venture Economics/PricewaterhouseCoopers

Chart 14 Institutional investors allocation to private equity



Source: Russell Investment Group

AGENTS AND ADVISERS

Agents and advisers are an integral part of the private equity market. They represent "information producers" whose role is to place private equity, raise funds for private equity partnerships and evaluate partnerships for potential investors.

There are three main types of agents and advisers:

- *Those helping firms raise private equity* through search and evaluation services. They advise on the structure timing and pricing of equity issues and assist in negotiations.

- *Those helping limited partnerships raise funds* are typically confined to large partnerships that are dedicated to non-venture investments such as buyouts and distressed debt. Agents are rarely used to raise money for traditional venture capital partnerships.

- *Those advising institutional investors* on the placement of funds they have allocated to the private equity market. Advisers usually specialise in evaluating and recommending limited partnership investments and sometimes advise on direct investments.

PRIVATE EQUITY AS AN ALTERNATIVE INVESTMENT

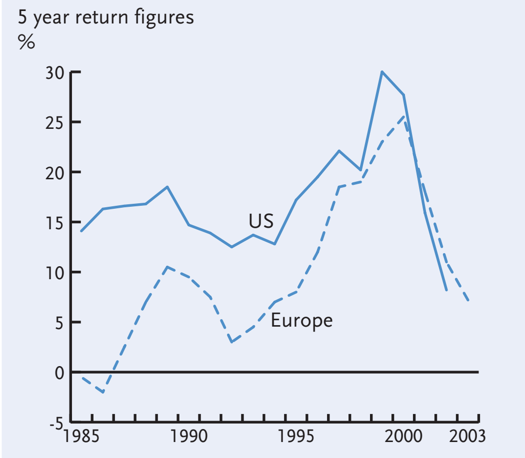
Over the past two decades private equity has become broadly accepted as an asset class. Investing in private equity improves portfolio diversification. Although there probably is some correlation between private equity and public equity and bond markets the correlation is not high. For many institutions, the potential higher returns of private equity investments over more conventional asset classes justify the higher risk of such investments

Private equity investments are relatively illiquid, particularly in the early years. The life-cycle of a typical private equity fund investment averages ten years or more. Investors in private securities generally receive their return through one of three ways: an initial public offering, a sale or merger, or a recapitalization. As the companies that are financed are not listed on a public exchange, investors wishing to exit a private equity holding do so by selling the holding to another investor through the secondary market.

US institutional investors currently allocate a higher proportion of their portfolios to private equity than European and Japanese. However their average allocation of 7% is predicted by Russell Investment Group to increase only marginally by 2007 whereas the share of portfolio allocation to private equity is expected to increase from 4% to 6% in Europe and to double from 2% to 4% in Japan between 2005 and 2007 (Chart 14).

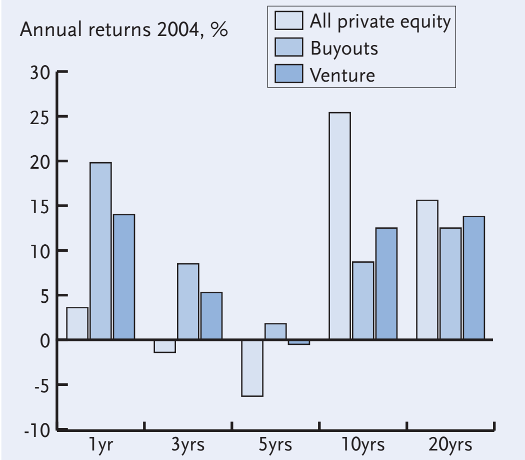
Private equity investments in the early years may show a drop in net asset value before showing any significant growth. The overall return since inception reflects the performance of private equity most accurately. An important reason for the high growth of the private equity market since the

Chart 15 Private equity returns



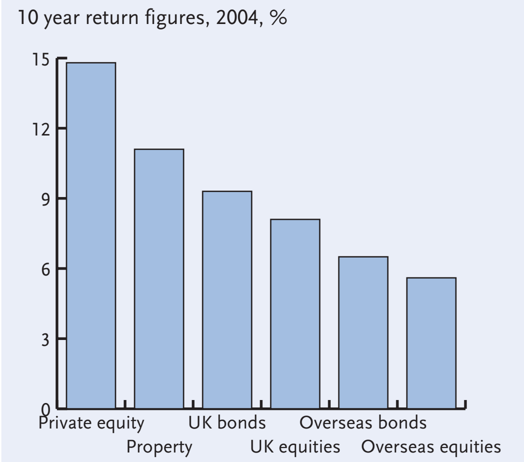
Source: Thomson Venture Economics

Chart 16 UK private equity returns



Source: BVCA

Chart 17 UK ten year returns



Source: BVCA

1980s has been the fact that private equity investments generated consistently higher returns than most public equity markets and bond markets. This has been the case in the US for over twenty years and in Europe for the past ten years (Chart 15). Looking at short-term trends, global private equity investments averaged a 14% return over one year in 2004 (Table 3). Venture capital investment averaged a 3.6% return over one year and buyouts a 19.8% return. European private equity registered a higher than average one year return in 2004 with 17.7%.

The net return of UK private equity funds raised between 1980 and 2004 measured to end-2004: 1 year 19.8%, 3 years 11.5%, five years 9.4% and ten years 14.8% (Chart 16, Chart 17). Over one, three, five and ten years, total UK private equity outperformed nearly all FTSE indices.

CONTRIBUTION TO THE UK ECONOMY

Over the past two decades, the UK private equity industry has invested around £62bn in over 21,000 firms in the UK and nearly 4,000 firms overseas. The private equity industry and private equity backed firms provide a significant contribution to the UK economy in a number of ways:

- Overall, private equity backed firms provided around 2.7 million jobs in 2004. Private equity backed firms have created more jobs than other private sector firms as shown in Chart 18. In addition to this, some 170 private equity funds employ several thousand people.

- Through investment overseas, the industry contributes to invisible exports through income and capital gains. Exports of private equity backed companies grew by 20% annually over the five years to 2003/04 compared with 3.3% overall growth rate of UK exports.

- Sales revenue of private equity backed companies rose by 23% a year between 1998/99 and 2003/04, more than twice the rise in sales of FTSE 100 and FTSE Mid-250 companies during this period. Private equity backed companies contributed £23bn in taxes in 2003/04.

LINKS TO OTHER SOURCES OF INFORMATION:

BVCA
www.bvca.co.uk

EVCA
www.evca.com

PricewaterhouseCoopers
www.pwcmoneytree.com

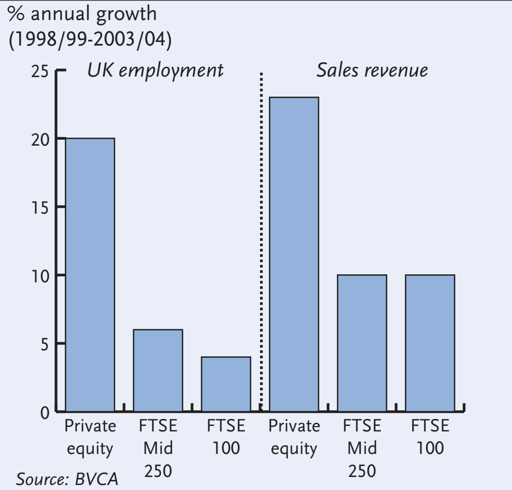
Table 3 Private equity returns

Annual returns 2004, %

	1yr	3yrs	5yrs	10yrs	20yrs
Europe (through 3/31/05)					
Venture	2.0	-6.6	-2.3	6.0	6.0
Buyouts	22.8	2.6	5.7	12.3	12.3
All private equity	17.7	-1.0	2.8	9.5	9.5
Global (through 3/12/04)					
Venture	3.6	-1.4	-6.3	25.4	15.6
Buyouts	19.8	8.5	1.8	8.7	13.0
All private equity	14.0	5.3	-0.5	12.5	13.8

Source: National Venture Capital Association, EVCA, Thomson Venture Economics/PricewaterhouseCoopers

Chart 18 Comparative growth



Source: BVCA

IFSL: International Financial Services, London (IFSL) is a private sector organisation, with over 30 years experience of successfully promoting the UK-based financial services industry throughout the world.

Research: informs by raising awareness of the UK's role in international financial markets and by highlighting the major contribution of financial services to the UK economy. IFSL has also produced a separate series of six reports on UK product expertise. Other major publications include International Financial Markets in the UK, Financial Sector Net Exports and World Invisible Trade.

This report, compiled by IFSL's Economist Marko Maslakovic, is the 14th report in IFSL's City Business Series.

All IFSL's publications can be downloaded at **www.ifsl.org.uk.** Further information on statistics and publications can be obtained from the website or:

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Data files
Datafiles in excel format for all charts and tables published in this report can be downloaded from the Research section of IFSL's website **www.ifsl.org.uk**