

PRIVATE EQUITY

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The private equity market is 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 a recognised asset class in its own right. 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.

International Financial Services, London
29-30 Cornhill
London, EC3V 3NF

Tel: +44 (0)20 7213 9100
Fax: +44 (0)20 7213 9133
E-mail: enquiries@ifsl.org.uk

www.ifsl.org.uk

SIZE AND REGIONAL BREAKDOWN OF THE PRIVATE EQUITY MARKET

Global private equity According to IFSL estimates, \$135bn of private equity was invested globally in 2005. This was up more than a fifth on the previous year due to a rise in buyouts as market confidence and trading conditions improved (Chart 1). Buyouts have generated a growing portion of private equity investments by value, and increased their share of investments from a fifth to more than two-thirds between 2000 and 2005. By contrast, the share of early stage or venture capital investment has declined during this period. Private equity fund raising also surpassed prior years in 2005 and totalled \$232bn, up three-quarters on 2004.

Prior to this, after reaching a peak in 2000, private equity investments and funds raised fell in the next couple of years due to the slowdown in the global economy and declines in equity markets, particularly in the technology sector. The fall in funds raised between 2001 and 2003 was also due to a large excess created by the end of 2000 of funds raised over funds invested.

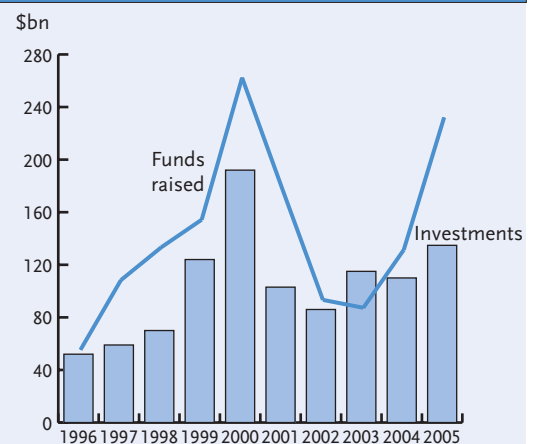
Geographic breakdown The regional breakdown of private equity activity shows that in 2005, North America accounted for 40% of global private equity investments (down from 68% in 2000) and 52% of funds raised (down from 69%) (Chart 2). Between 2000 and 2005, Europe increased its share of investments (from 17% to 43%) and funds raised (from 17% to 38%). This was largely a result of strong buyout market activity in Europe. Asia-Pacific region's share of investments increased from 6% to 11% during this period while its share of funds raised remained unchanged at around 8%.

The UK is the second most mature market outside the US for private equity

Definition of private equity

Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable 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.

Chart 1 Global private equity market



Source: IFSL estimates based on EVCA/Thomson Financial/PwC, Aper data

Table 1 Top 10 countries for private equity investments

	2004	2005		
	investment value (\$bn)	investment value (\$bn)	% share	As % of GDP
US	43.8	53.3	40	0.4
UK	22.4	29.6	22	1.3
France	6.1	9.1	7	0.4
Sweden	1.9	3.7	3	1.0
Spain	2.3	3.4	3	0.3
Germany	4.4	3.4	3	0.1
Netherlands	1.9	2.9	2	0.5
Japan	7.1	2.1	2	0.0
others	20.1	30.3	20	0.2
Total	110.0	134.8	100	0.3

Source: IFSL estimates based on EVCA/Thomson Financial/PwC, Aper data

Private equity activity

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

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

Divestments represent 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.

(by country of management). Private equity funds based in the UK accounted for 22% of global investments and a quarter of funds raised. Since the mid-1990s, UK's global share has risen partly due to an overall increase in private equity activity in Europe. Other important centres for private equity include Japan, France, Germany and Spain. Private equity investment in China and India has been on an upward trend over the past five years and this is likely to accelerate. As a per cent of GDP, the UK had the highest ratio of investments in 2005 with 1.3%.

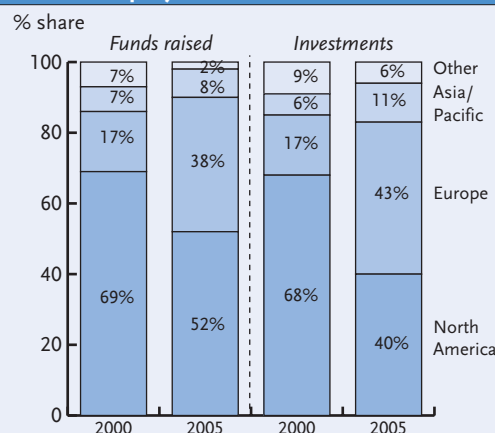
UK private equity The UK is the largest centre for the management of private equity investments and funds raised in Europe (Chart 3). Most large pan-European businesses are based in London. Firms located in the UK also attract the largest proportion of European private equity investments.

Investments Worldwide investments of UK private equity firms totalled a record £11.7bn in 2005 up a fifth on the previous year according to the annual British Venture Capital Association (BVCA) survey of its members (Chart 4). The bulk of the increase in investments in 2005 was due to growth in the value of management buy-outs in Continental Europe and the UK. Investments were made in 1,535 companies in 2005, down 2% on the previous year. European Venture Capital Association (EVCA) figures, which also include estimates for non-BVCA members, indicate that total investments managed by private equity firms located in the UK reached a record £16.3bn in 2005.

The UK private equity industry has become more global over the past decade. In 2005, private equity firms in the UK invested 42% of their funds in companies located overseas, up from 13% in 1996. Over 85% of overseas investments were in Continental European countries, and around 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 35% of private equity investments in 2005, up from 27% in the previous year.

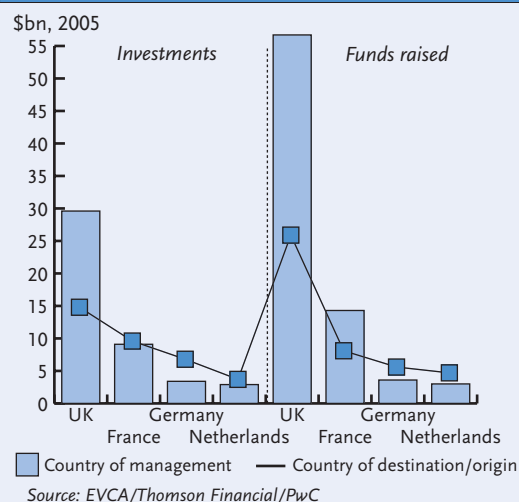
Funds raised in the UK increased by over eight times in 2005 to £27.3bn (Chart 5). The increase was largely a reflection of a number of very large funds raised by UK-based firms to finance buyout deals in 2005 and the low level of funds raised in recent years. Overseas investors generated over three-quarters of funds raised in 2005, up from two-thirds in the previous year. Investors from North America were the largest source of funds with 45% of

Chart 2 Regional breakdown of private equity investments



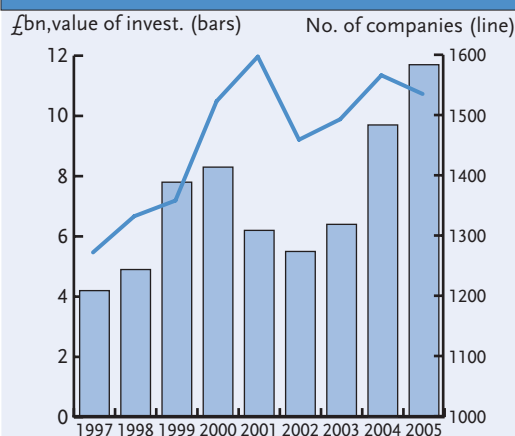
Source: IFSL estimates based on EVCA/Thomson Financial/PwC, Aper data

Chart 3 Private equity investments in Europe



Source: EVCA/Thomson Financial/PwC

Chart 4 UK private equity investments



¹ these figures are not comparable with EVCA figures as they only include BVCA member investments
Source: BVCA

Private equity investments

Venture capital represents investment in companies that have undeveloped or developing products. 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, project finance and leasing. This category includes investment in subordinated debt, referred to as mezzanine debt financing.

the overall total followed by investors from the UK with a fifth. The above figures are published by the BVCA and represent the amount raised by independent funds only.

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 of funds managed in the UK in 2005 totalled £31.2bn. As a source of funds, investors from the UK generated £14.2bn of global funds raised.

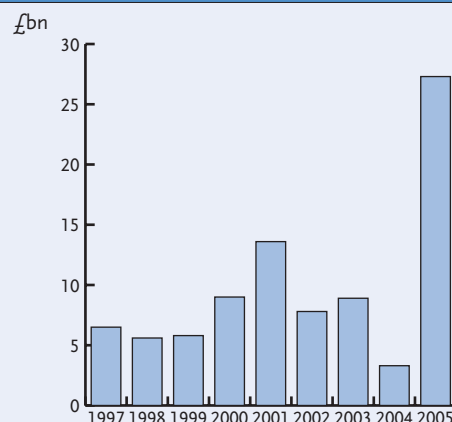
Divestments The UK's \$17.8bn in divestments in 2005 accounted for nearly a half of the European total (Chart 6). The number of divestments in the UK increased by 86% in 2005 to 2,837. Repayments of preference shares/loans accounted for the largest number of divestments while trade sales represented the largest category by value of divestment.

European divestments increased by nearly a half in 2005 to a record \$37bn. Repayment of shares/loans accounted for 22% of this, followed by trade sales with 23%, sales to other venture capitalists 18% and write-offs 5%. Most of the remainder 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 resulted in a large lack of liquidity among many of financial institutions, especially those with less liquid assets. 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. Today, most sales are driven by the desire to enhance liquidity in still uncertain investment holdings and to better manage overall investment portfolios.

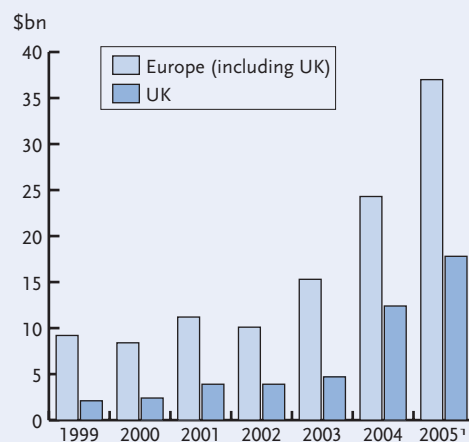
The global private equity secondary market has experienced substantial

Chart 5 UK private equity fund raising¹



¹ these figures are not comparable with EVCA figures as they only include independent funds
Source: BVCA

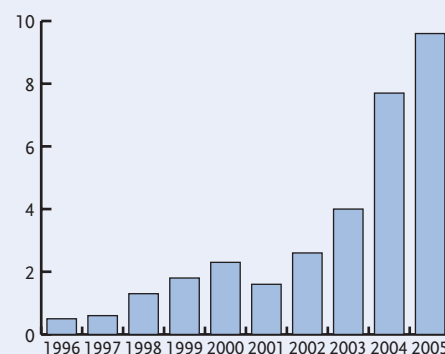
Chart 6 European divestments at cost



¹ UK figure does not include non-BVCA members in the UK
Source: BVCA, EVCA/Thomson Financial/PwC

Chart 7 Global private equity secondary market

Secondary transactions
\$bn by year of sale



Source: The Private Equity Analyst (1996-2003 data); Triago (2004 and 2005 data)

growth over the past decade although lack of transparency associated with secondary sales require a degree of estimation in annual trends. Estimates for the proportion of total committed capital that is invested in the secondary market range from 3% to 5%. This is expected to rise to between 7% and 10% in the coming years. Secondary transactions on the private equity market totalled around \$9.6bn in 2005 up from \$7.7bn in the previous year (Chart 7). Europe accounted for between 30% and 40% of these transactions. Opportunistic specialist secondary investors are the major participants 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. Venture capital accounts for the majority of investments by number.

Globally, buyouts' share of private equity investments by value increased from 21% to 66% between 2000 and 2005 (Chart 9). According to IFSL estimates, more than a half of the 33% share of venture capital investments in 2005 was in expansion stage companies and the remainder in early stage companies. In Europe, buyouts, expansion stage and early stage investments accounted for 73%, 22% and 5% of investments respectively in 2005. Buyouts also generated the bulk of private equity investments in the UK with 70% of the total in 2005. Expansion stage companies accounted for 26% and early stage investments for the remaining 4%.

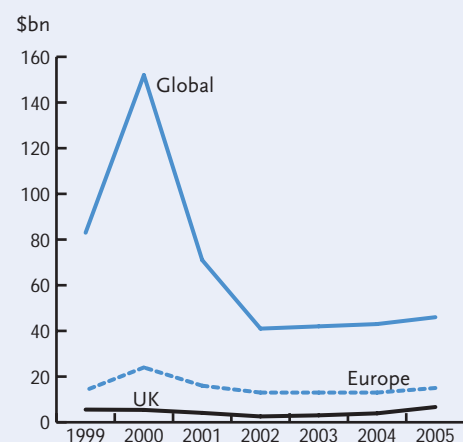
Funds raised Of total funds raised in the UK in 2005, 91% of capital is expected to be invested in buyouts. Investments in expansion stage companies are expected to account for 3% and early stage investments for 6% (Chart 10). In Europe 80% of funds raised in 2005 are expected to be allocated to buyouts, and around a tenth each for expansion stage and early stage funds.

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 28% of total investments in 2005. This was followed by the high-tech sector with 17%, and communications with 15%. In the UK, sectors which received most private equity capital in 2005 included: consumer services 48%, industrials 17% and financials 12% (Table 2). The largest private equity deals are listed in Table 3.

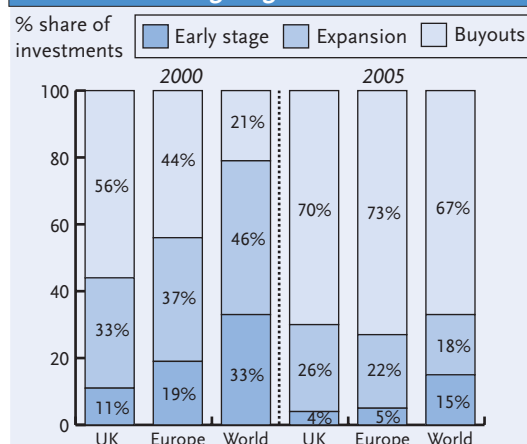
Over £10bn has been invested in UK technology companies over the past two decades. Technology related investments (communications, computer, electronics, biotechnology and medical) totalled £362bn in 2005. As Chart 11 shows, global technology related investments are still below peaks seen in 2000.

Chart 8 Venture capital investments



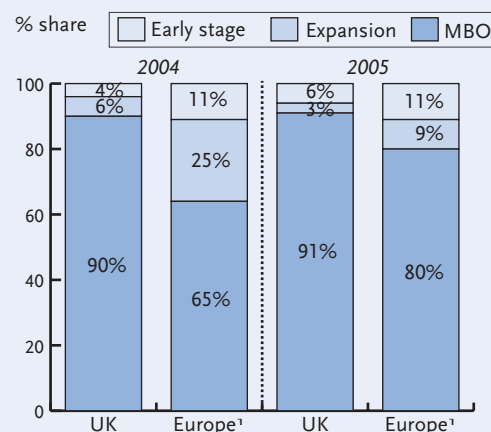
Source: IFSL estimates based on EVCA/Thomson Financial/PwC, Aper data

Chart 9 Private equity investments by financing stage



Source: BVCA, EVCA/Thomson Financial/PwC, Aper, IFSL estimates

Chart 10 Private equity funds raised by expected stage of investment



¹ Including UK

Source: BVCA, EVCA/Thomson Financial/PwC

STRUCTURE OF PRIVATE EQUITY MARKET

Three major types of participants - investors, intermediaries and issuers - are involved in the private equity market .

Investors in Private Equity

The number and variety of groups that invest in private equity have 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 capital in private equity funds.

Pension funds were the largest providers of capital in Europe, with a quarter of total funds raised in 2005 (Chart 12). Banks came second with 18%, followed by fund of funds and insurance companies with 13% and 11% of funds respectively. Much of the remainder was generated by private individuals, corporate investors and government agencies. As shown in Chart 13, private equity companies typically use debt to free up cash allowing them to make additional investments.

In the UK, overseas investors accounted for around four-fifths of funds raised by UK equity firms. Around 56% of this was from North America and most of the remainder from Continental Europe. Pension funds were the largest investors in UK funds with 31% of amount raised in 2005. They were followed by funds of funds (16%) and banks (14%).

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 while 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.

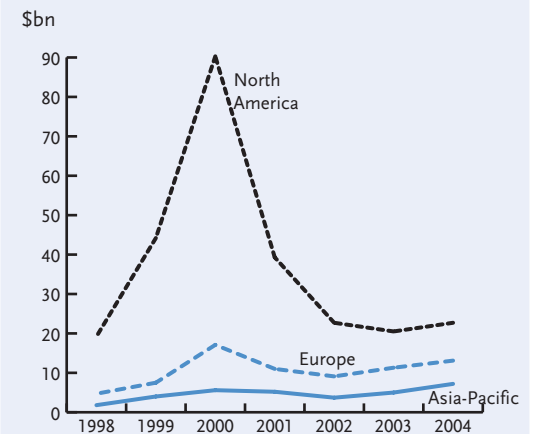
Organisations which only manage funds (known as

Table 2 UK private equity investment activity by sector

2005	Investment		Companies	
	£bn	% share	Number	% share
Consumer Services	3,243	48	231	18
Industrials	1,127	17	268	21
Financials	810	12	69	5
Health Care	549	8	251	19
Technology	362	5	360	28
Consumer Goods	293	4	63	5
Utilities	166	2	15	1
Telecommunications	162	2	6	0
Oil and gas	83	1	10	1
Basic Materials	18	0	34	3
Total	6,813	100	1,307	100

¹ Table 2 only includes investments in companies located in the UK whereas Chart 4 also includes overseas investments
Source: BVCA

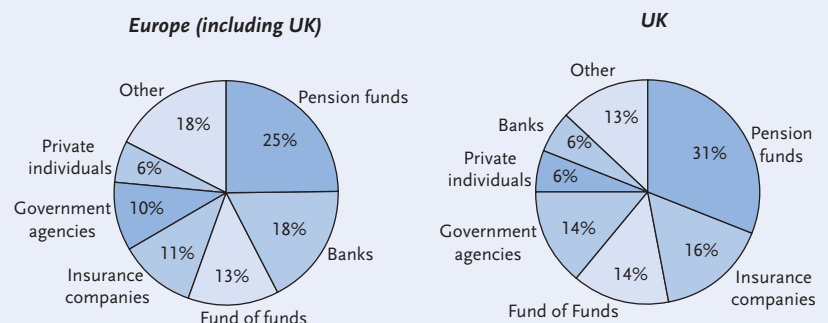
Chart 11 High-tech investment



Source: EVCA/Thomson Financial/PwC, BVCA

Chart 12 Sources of new funds raised

% share, 2005



Source: EVCA, BVCA

Independents) accounted for 80% of investments in 2005. Organisations which only invest for a parent (Captives) accounted for 4% while the remaining 16% 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. 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.

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:

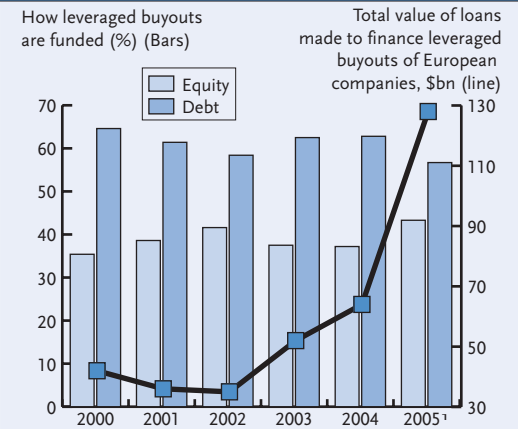
- *Those helping firms raise private equity* through search and evaluation services. They advise on the structure timing and pricing of equity issues and assist in negotiations.
- *Those helping limited partnerships raise funds* are typically confined to large partnerships that are dedicated to non-venture 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

Table 3 Largest private equity transactions

Announcement date	\$bn	Number of sponsors
HCA (06/06)	33.0	3
RJR Nabisco (10/88)	30.2	1
BAA (03/06)	30.2	1
Kinder Morgan (05/06)	26.5	4
Albertsons (01/06)	17.4	1
Hertz (09/05)	15.1	3
Univision (06/06)	13.4	5
VNU (03/06)	11.6	6
SunGard Data Systems (03/05)	10.8	7
TDC (11/05)	10.6	5

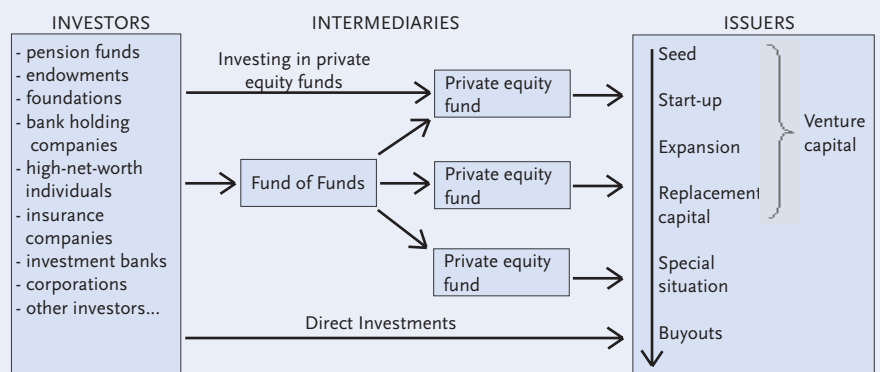
Source: Dealogic, Thomson Financial, Economist

Chart 13 Leveraged buyouts financing



¹ first nine months
Source: Dealogic, Financial Times

Chart 14 Private equity market



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

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 contributes to portfolio diversification. Although there is some correlation between returns on 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 average private equity fund investment averages three to seven years or more. Investors in private securities generally exit their investment and achieve returns through an initial public offering, a sale or merger, or a recapitalization. As the companies are not listed on a public exchange, investors wishing to exit their 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 between 2005 and 2007, whereas the share of portfolio allocation to private equity in Europe is expected to increase from 4% to 6% and to double from 2% to 4% in Japan. Around 40% of institutions in Europe invested a proportion of their portfolios in private equity in 2005 (Chart 15).

An important reason for the high growth of the private equity market since the 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 16). Looking at very short-term trends, returns on private equity investments averaged 34% in Europe and 18% in the US in 2005. As private equity investments are generally medium and long term investments, one year returns are inappropriate as a realistic measure of private equity performance due to the volatility in returns. In the long term, 10 and 20 year returns in Europe and the US ranged between 10% and 14%.

The net return of UK private equity funds measured at end-2005 was: 1 year 37.2%, 3 years 21.1%, five years 11.9% and ten years 16.4% (Chart 17). As shown in Chart 18, ten year returns on private equity outperformed the other major asset classes.

Chart 15 Institutional investment in private equity

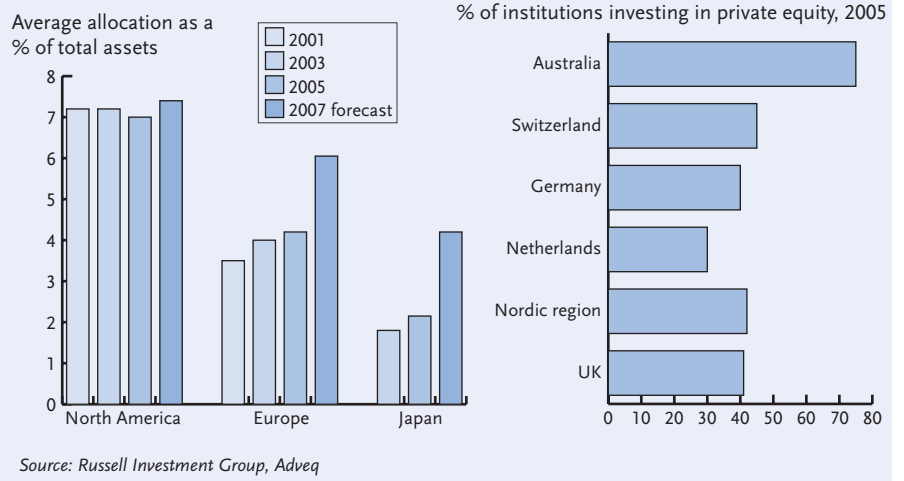
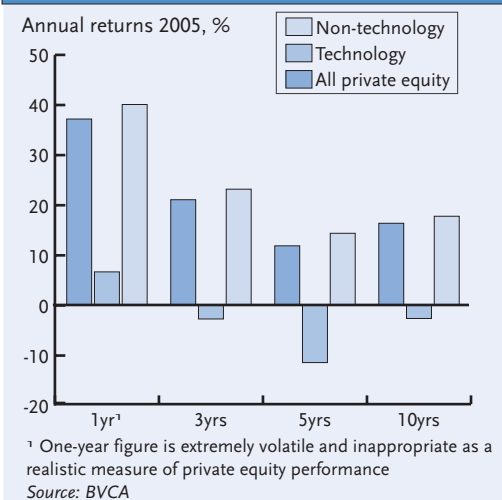


Chart 16 Private equity returns



Chart 17 UK private equity returns



CONTRIBUTION TO THE UK ECONOMY

Over the past two decades, the UK private equity industry has invested around £75bn in over 22,000 firms in the UK and around 4,000 firms overseas. The private equity industry and private equity backed firms make a significant contribution to the UK economy in a number of ways:

- Overall, 2.9 million people were employed in private equity backed firms in 2005, equivalent to 19% of UK private sector employees. In addition private equity funds based in the UK employ several thousand people. Growth in employment in private equity firms is greater than in other private sector firms as shown in Chart 19.
- Through investment overseas, the industry contributes to the current account of the UK balance of payments through income and capital gains. Exports of private equity backed companies grew by 27% annually over the five years to 2004/05 totalling in aggregate £25bn in export sales.
- Sales revenue of private equity backed companies rose by 20% a year between 1999/00 and 2004/05 totalling £233bn in aggregate during this period. Private equity backed companies contributed £29bn in taxes in 2004/05.

LINKS TO OTHER SOURCES OF INFORMATION:

BVCA
www.bvca.co.uk

EVCA
www.evca.com

Thomson Financial
www.thomson.com

PricewaterhouseCoopers
www.pwcmoneytree.com

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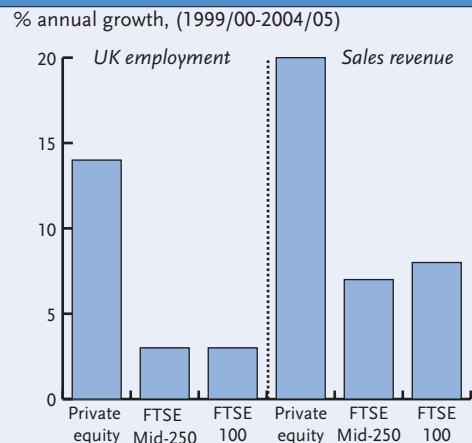
Data files Datafiles in excel format for all charts and tables published in this report can be downloaded from the Research section of IFSL's website www.ifsl.org.uk

Chart 18 UK ten year returns



Source: BVCA

Chart 19 Comparative growth



Source: BVCA

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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. This publication is one of 15 financial sector reports in IFSL's City Business Series. Six reports are published in a separate series highlighting UK product expertise. Other regular publications include International Financial Markets in the UK, Financial Sector Net Exports, World Invisible Trade and City Indicators Bulletin.

This report was compiled by IFSL's Senior Economist Marko Maslakovic.

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Duncan McKenzie, Director of Economics
+44 (0)20 7213 9124
d.mckenzie@ifsl.org.uk

Marko Maslakovic, Senior Economist
+44 (0)20 7213 9123
m.maslakovic@ifsl.org.uk