

PRIVATE EQUITY 2007

August 2007

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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 and most developed 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.

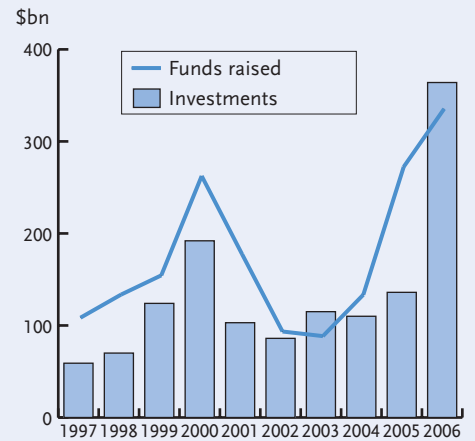
SIZE AND REGIONAL BREAKDOWN OF THE PRIVATE EQUITY MARKET

Global private equity According to IFSL estimates, a record \$365bn of private equity was invested globally in 2006 up nearly three times on the previous year. Private equity fund raising also surpassed prior years in 2006 and totalled \$335bn, up a quarter on 2005. Improved market confidence and trading conditions and strong performance along with stable long-term returns have contributed to this growth. Buyouts have accounted for a growing portion of private equity investments by value in recent years, and increased their share of investments from a fifth to more than four-fifths between 2000 and 2006. By contrast, the share of early stage or venture capital investment has declined during this period.

Along with the increase in the size of the global private equity industry, there has been a move towards greater transparency and disclosure and more formal corporate governance structures. This is particularly evident in Europe where the British Venture Capital Association (BVCA) is commissioning a review of the private equity industry with the intention of establishing a voluntary code or set of guidelines to encourage greater transparency and disclosure. Individual groups are beginning to take actions ranging from strengthening their corporate governance structures through to adopting 'fair value' accounting for portfolio companies.

Geographic breakdown The regional breakdown of private equity activity shows that in 2006, North America accounted for around 60% of global private equity investments (down from 67% in 2000) and 47% of funds

Chart 1 Global private equity market



Source: IFSL estimates based on EVCA/Thomson Financial/PwC, APER, Private Equity Intelligence, NVCA, Dealogic data

Table 1 Top countries for private equity investments

	2005	2006		
	investment value (\$bn)	investment value (\$bn)	% share	As % of GDP
US	53.3	220.4	60	1.7
UK	29.6	51.4	14	2.3
France	9.1	13.3	4	0.6
Sweden	3.7	5.7	2	1.5
Germany	3.4	4.6	1	0.2
Spain	3.4	3.7	1	0.3
Netherlands	2.9	3.2	1	0.5
others	29.4	62.0	17	0.1
Total	134.8	364.3	100	0.6

Source: IFSL estimates based on EVCA/Thomson Financial/PwC, APER, NVCA, Dealogic data

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.

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.

raised (down from 69%) (Table 1, Chart 2). Between 2000 and 2006, Europe increased its share of investments (from 21% to 24%) and funds raised (from 21% to 44%). This was largely a result of strong buyout market activity in Europe. In recent years, there has been a rise in the importance of Asia-Pacific and emerging markets as investment destinations, particularly China, Singapore, South Korea and India. Asia-Pacific's share of investments increased from 6% to 14% during this period while its share of funds raised remained unchanged at around 8%.

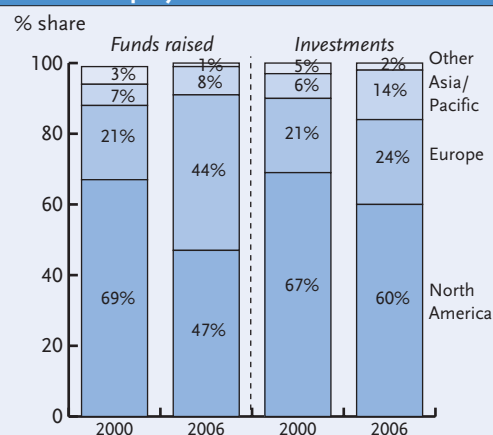
The UK is the second most developed market outside the US for private equity. Private equity funds based in the UK accounted for 14% of global investments and 28% of funds raised. Since the mid-1990s, the UK's global share has risen partly due to an overall increase in private equity activity in Europe. Other important centres for private equity in Europe include 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 along with the US had the highest ratio of investments in 2006 with 2.2%.

UK private equity The UK is the largest European centre for the management of private equity investments and funds (Table 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 £21.9bn in 2006 according to the BVCA survey of its members (Chart 3). The 2006 figure is nearly twice the previous year's figure, but this was largely due to an increase in BVCA membership and a change in the method of reporting. Excluding these changes, growth on a like-for-like basis was around a quarter. The bulk of this increase was due to growth in the value of management buy-outs in Continental Europe and the UK. Investments were made in 1,630 companies in 2006, up 6% 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 £27.9bn in 2006.

The UK private equity industry has become more global over the past decade. In 2006, private equity firms in the UK invested 53% of their funds in companies located overseas, up from 13% a decade earlier. 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

Chart 2 Regional breakdown of private equity investments



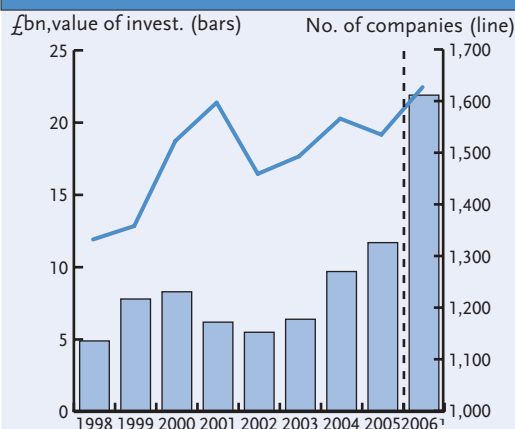
Source: IFSL estimates based on EVCA/Thomson Financial/PwC, APER, NVCA, Private Equity Intelligence and Dealogic data

Table 2 Private equity investments and funds raised in Europe

\$bn	Investments		Funds raised	
	Country of manag.	Country of destination	Country of manag.	Country of origin
UK	54.0	31.0	99.0	31.5
France	13.3	14.3	14.0	11.6
Germany	4.6	9.5	3.7	5.7
Netherlands	3.2	7.3	3.4	7.3

Source: EVCA/Thomson Financial/PwC

Chart 3 UK private equity investments



¹ 2006 is not comparable to prior years due to increased BVCA membership & change in method of reporting; ² figures are not compar. with EVCA data as they only include BVCA member invest.
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.

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 a quarter of private equity investments in 2006, up from 22% in the previous year.

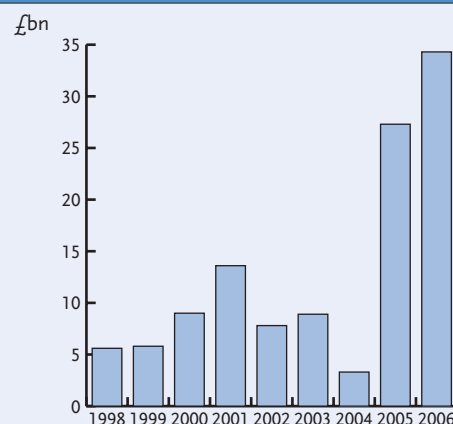
Funds raised in the UK increased to £34.3bn in 2006 from £27.3bn in 2005 (Chart 4). The increase was largely a reflection of an increase in funds raised by UK-based firms to finance buyout deals. Overseas investors generated nearly three-quarters of funds raised in 2006, slightly down on the previous year. Investors from North America were the largest source of funds with 37% of the overall total followed by investors from the UK with 28%. 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 2006 totalled £50.6bn. As a source of funds, investors from the UK generated £16.1bn of global funds raised.

Divestments The UK's \$24bn in divestments in 2006 accounted for nearly three-quarters of the European total (Chart 5). The number of divestments in the UK totalled 2,636 in 2006. Repayments of preference shares/loans accounted for the largest number of divestments followed by trade sales.

European divestments increased by 10% in 2006 to a record \$33bn. Trade sales accounted for 23% of this, followed by repayments of shares and loans with 17%, sales to other private equity houses 17% and IPOs 9%. Most of the remainder was accounted for by sales of quoted equity, write-offs and sales to financial institutions.

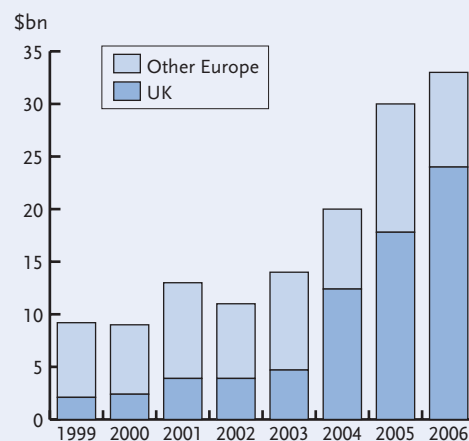
Secondary market for private equity The secondary market dates back to the global economic crisis of the late 1980s, which resulted in a large lack of

Chart 4 UK private equity fund raising¹



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

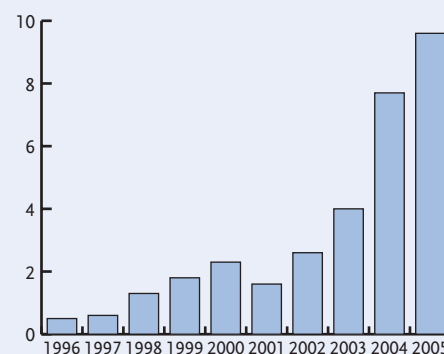
Chart 5 European divestments at cost



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

Chart 6 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)

liquidity among many 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 growth over the past decade although lack of information in relation to 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 6). 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 83% between 2000 and 2006 (Chart 8). Expansion stage investments accounted for 13% and startups for the remainder of the total in 2006. In Europe, buyouts, expansion stage and early stage investments accounted for 71%, 21% and 8% of investments respectively in 2006. Buyouts also generated the bulk of private equity investments in the UK with 64% of the total in 2006. Expansion stage companies accounted for 30% and early stage investments for the remaining 6%.

Funds raised Of total funds raised in the UK in 2006, 84% of capital is expected to be invested in buyouts. Investments in expansion stage companies are expected to account for 12% and early stage investments for 4% (Chart 9). In Europe 84% of funds raised in 2006 are expected to be allocated to buyouts, 10% in expansion stage and 6% early stage funds.

STRUCTURE OF PRIVATE EQUITY MARKET

High-tech, consumer, communications and other services sectors have typically attracted most private equity investments in recent years. In Europe consumer investments accounted for 15% of total investments in 2006. This was followed by communications with 14% and industrial products and services with 10%.

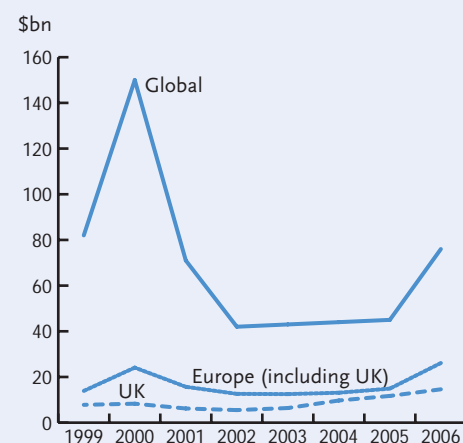
Over £11bn has been invested in UK technology companies over the past two decades. Technology related investments (communications, computer, electronics, biotechnology and medical) totalled £918m in 2006. As Chart 10

Table 3 Largest private equity transactions

Announcement year	\$bn
Equity Office Prop. Trust (2007)	38.9
Hospital Corp. of Amer. (2006)	32.7
RJR Nabisco (1989)	31.1
Harrah's Entertainment (2006)	27.4
Clear Channel Comm. (2006)	25.7
Kinder Morgan (2006)	21.6
Freescale Semicond. (2006)	17.6
Albertson's (2006)	17.4
Hertz (2005)	15.0
TDC (2005)	13.9

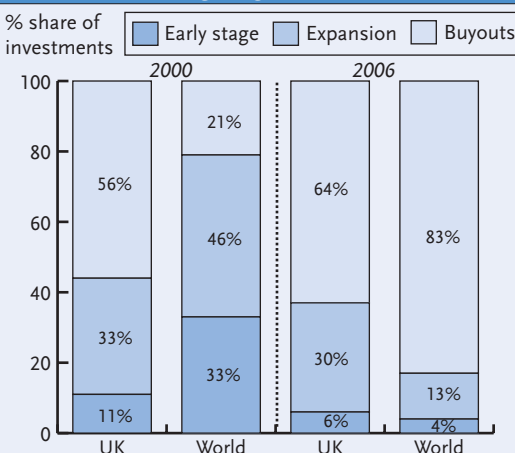
Source: Fortune

Chart 7 Venture capital investments



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

Chart 8 Private equity investments by financing stage



Source: IFSL estimate based on BVCA, EVCA/Thomson Financial/PwC, Aper, Dealogic and Private Equity Intelligence data

shows, global technology related investments are still below peaks seen in 2000.

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 27% of total funds raised in 2006 (Chart 11). Fund of funds came second with 18%, followed by banks and insurance companies with 14% and 10% respectively. Much of the remainder was generated by private individuals, corporate investors and government agencies.

In the UK, overseas investors accounted for over 70% of funds raised by UK equity firms. Around a half of this was from North America and most of the remainder from Continental Europe. Pension funds were the largest investors in UK funds with 29% of the amount raised in 2006. They were followed by funds of funds (16%) and banks (10%).

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.

Chart 9 Private equity funds raised by expected stage of investment

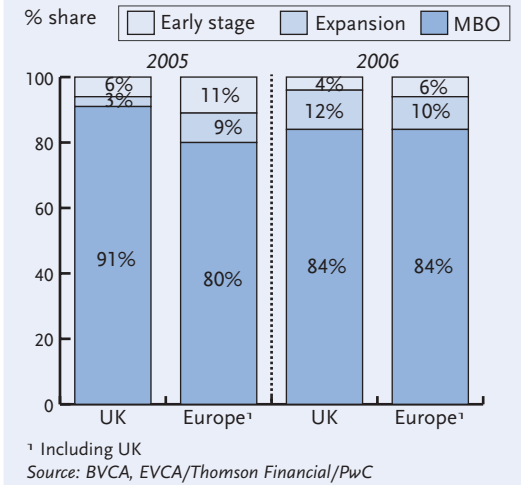


Chart 10 High-tech investment

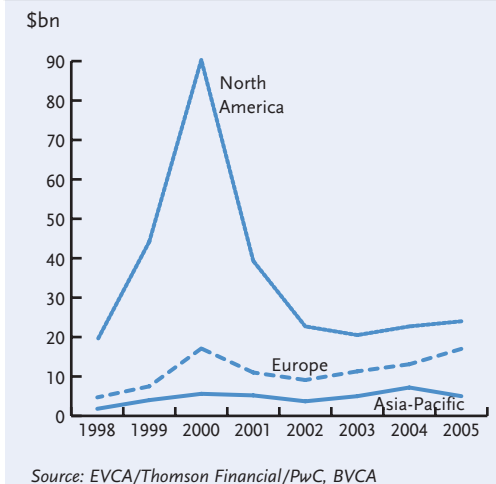
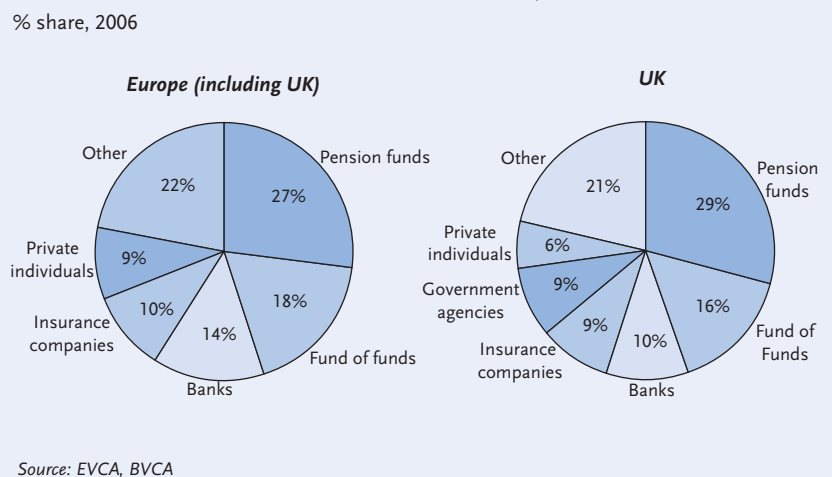


Chart 11 Sources of new funds raised



Organisations which only manage funds (known as 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

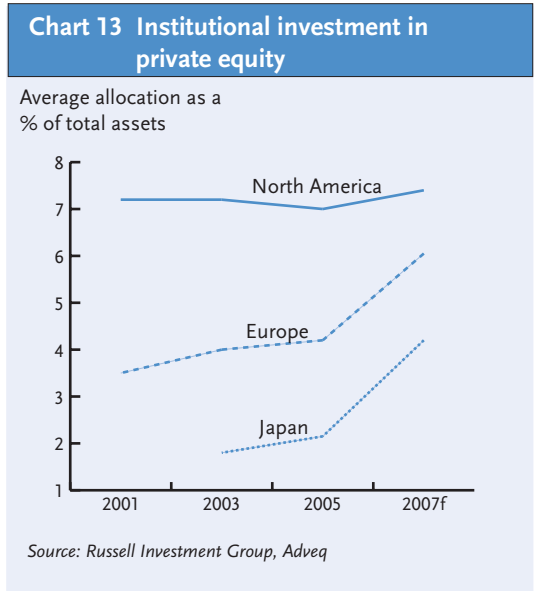
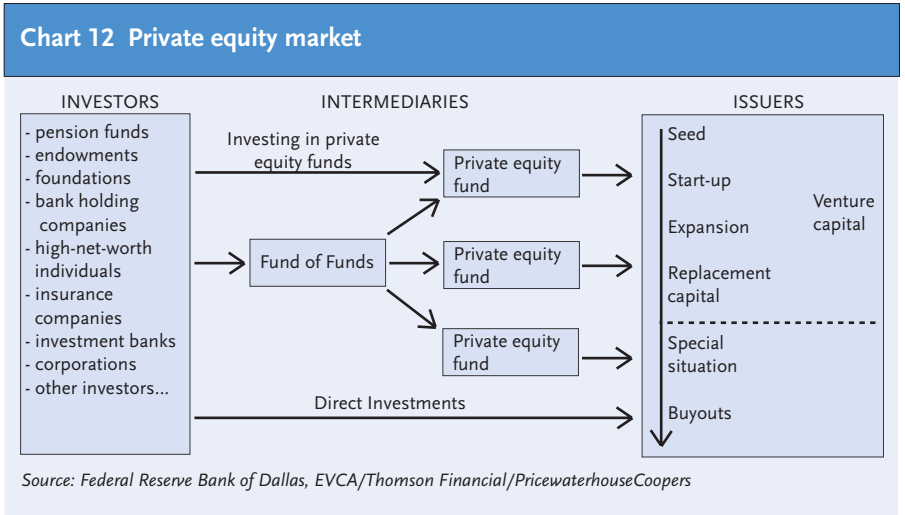
Agents and advisers are an integral part of the private equity market. They represent “information producers” whose role is to place private equity, raise funds for private equity partnerships and evaluate partnerships for potential investors.

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

Firms ranked by amount of capital raised for direct private equity investment between 2001 and 2006		
Firm	Location	\$bn
The Carlyle Group	Washington DC	32.5
Kohlebeg Kravis Roberts	New York	31.1
Goldman Sachs Princ. Investm. Area	New York	31.0
The Blackstone Group	New York	28.4
TPG	Fort Worth	23.5
Permira	London	21.5
Apax Partners	London	18.9
Bain Capital	Boston	17.3
Providence Equity Partners	Providence	16.4
CVC Capital partners	London	15.7

Source: Private Equity International



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 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 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 an 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 (to corporate buyers or another private equity firm), a 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 (Chart 13).

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. Private equity returns in the US had outperformed returns in Europe in the 1990s (Chart 14). Since then however returns in the US and Europe have been at similar levels. 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.

The net return of UK private equity funds measured at end-2006 was: 3 years 31.1%, five years 20.9% and ten years 18.7% (Chart 16). Ten year returns on private equity outperformed the other major asset classes.

CONTRIBUTION TO THE UK ECONOMY

Over the past two decades, the UK private equity industry has invested around £80bn in over 29,000 firms worldwide. The private equity industry and private equity backed firms make a significant contribution to the UK economy in a number of ways:

- Overall, 2.8 million people were employed in private equity backed

Chart 14 Private equity returns

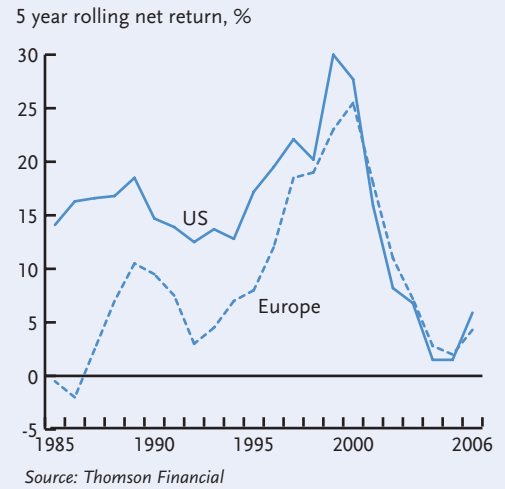


Table 5 UK private equity returns

Average annual returns 2006, %			
	All private equity	of which	
		Technology	Non-technology
3yrs	31.1	3.3	33.6
5yrs	20.9	-4.8	23.3
10yrs	18.7	-1.5	20.1

10 year return figures, 2006, %	
Private equity	18.7
Property	13.9
UK equity	8
UK bonds	7.8
Overseas equities	7.3
Overseas bonds	5.5

Source: BVCA

Chart 15 Comparative growth



firms in 2006, 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 15.

- 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 6% annually over the five years to 2005/06 totalling in aggregate £48bn in export sales.
- Sales revenue of private equity backed companies rose by 9% a year between 2000/01 and 2005/06 totalling £424bn in aggregate during this period. Private equity backed companies contributed £26bn in taxes in 2005/06.
- Higher rate of return provides an attractive asset for institutional investors, lifting prospective income of their clients.

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

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