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PRIVATE EQUITY

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*Quality In Everything We Do*

# How Do Private Equity Investors Create Value?

A Study of 2006 Exits in the US and Western Europe



**“We wanted to grow the business and increase capital expenditure to get the new products out into the marketplace.”**

**“Although management’s plan was to complete strategic acquisitions, we pushed them harder so they pursued larger deals than they otherwise would.”**

**“It’s hard to overpay for a good business and a good team.”**

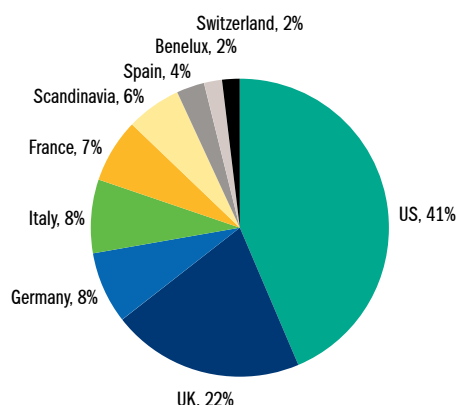
# The Importance of Private Equity

In 2006, Private Equity invested another record amount in US and European businesses: US\$450bn, an increase of 60% on the 2005 figure of US\$280bn<sup>1</sup>. Private Equity has also become increasingly important for investors acting on behalf of a broad spectrum of the general public. In both the US and Europe in 2006, the flow of investment into Private Equity from pension funds increased, representing more than a quarter of new investment<sup>2</sup>. Further investment came from endowments, foundations, and funds of funds.

This rapid growth in the scale and success of Private Equity has brought with it increased scrutiny: politicians in many countries are reviewing whether and how to regulate and tax the industry; corporates are considering how to compete with and learn from the different business model; concerns are being raised about the security of jobs and employment benefits. Despite those concerns, what is clear is that Private Equity firms are developing new strategies for successful investing. Although the credit squeeze in 2007 may reduce the benefits from leverage and enhance the importance of underlying profit growth, Private Equity will continue to be an important factor in the world's financial markets.

This second annual study by Ernst & Young provides new facts and perspectives on how Private Equity investors create value. It is based on original research which mapped business performance and Private Equity investors' strategies across the largest deals exited in 2006. The sample is drawn from the top 100 exits in each of the US and Western Europe, ranked by entry enterprise value. The US accounts for the largest proportion of businesses in the study (41%), followed by the UK (22%), Germany and Italy (8% each), France (7%), and the rest of Europe (14%).

**Figure 1: Deal sample by country 2006**



Source: Largest 100 exits of business in Western Europe, and largest 100 exits of business in the US in 2006. Ernst & Young obtained detailed financial information on 112 deals and interviewed Private Equity directors responsible for 83 of those deals. All graphs and charts in this document reflect this same source, unless otherwise stated.

<sup>1</sup> Source: EVCA and 'Buyouts Magazine', January 2007

<sup>2</sup> Source: EVCA and Dow Jones 'Private Equity Analyst'

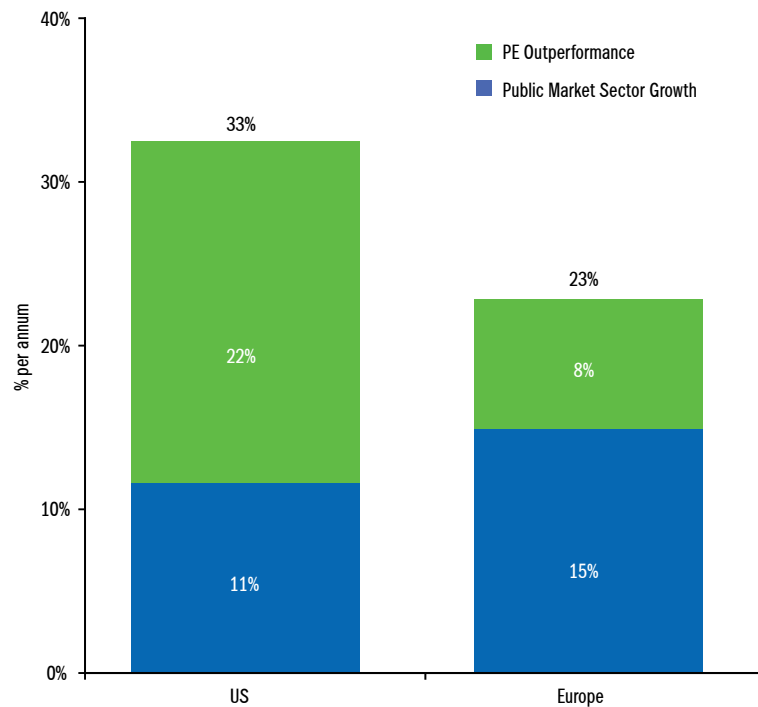
# Private Equity Generates Strong and Sustainable Growth

over  
**80%**  
growth  
in enterprise  
value

In 2006, the Private Equity industry once again showed its ability to grow and strengthen the businesses under its ownership. The average enterprise value (EV) of the businesses studied in the US grew from US\$1.2bn when acquired, to US\$2.2bn at exit (+83%). In Europe, the average value grew from US\$800m to US\$1.5bn at exit (+81%). The average US hold period, at three years, was somewhat shorter than the European average hold period of three and a half years.

The annual rate of growth in EV achieved by the largest Private Equity-owned businesses outperformed equivalent public companies (in the same country, industry sector, and timeframe). Average annual EV growth rates were 33% in the US and 23% in Europe, compared to public company equivalents of 11% and 15% respectively.<sup>3</sup>

**Figure 2: Growth in business value versus public market sector**



<sup>3</sup> Source: Thomson Financial

# US\$6.1bn growth in EBITDA

One reason for the difference in EV growth is that the valuation multiple of Private Equity businesses grew faster than the trading multiple<sup>4</sup> of public company benchmarks: 1.6 times in the US versus a decline of 0.1 times, and 2.4 times in Europe versus a decline of 0.3 times. The upswing in the M&A cycle witnessed in the last few years, and within this the higher leverage ratios from favorable debt markets, have acted to the advantage of Private Equity investors. Their skill and luck in judging the timing of acquisitions and exits is one of the key success factors of Private Equity. However, the study also shows that Private Equity investors sold improved businesses with better prospects than they acquired.

The second reason that the Private Equity-owned businesses outperformed is that they achieved faster profit growth than their public counterparts – in both the US and Europe. Over the whole study sample, EBITDA grew by US\$6.1bn, from US\$14.6bn to US\$20.7bn: a global average annual growth rate of 15%. This growth rate is 17% higher than for equivalent public companies.

There has been some public comment that Private Equity ownership is synonymous with a short-term, cost-cutting focus. The findings in this study do not support those statements. Two-thirds of the growth in EBITDA came from business expansion, with organic revenue growth being the most significant element. This included the benefits of investment in sales and marketing and new product launches – and investment in attractive industry sectors in the US, and expansion into new geographies in Europe. Acquisitions were also important – to accelerate growth into new product categories and markets – as well as to achieve savings through synergies. It is worth noting that acquisition strategies varied slightly, with US Private Equity firms tending to make more but smaller acquisitions than in Europe.

<sup>4</sup> Trading multiple: The EV/EBITDA multiple of public quoted companies rather than the EV/EBITDA multiple of actual acquisitions

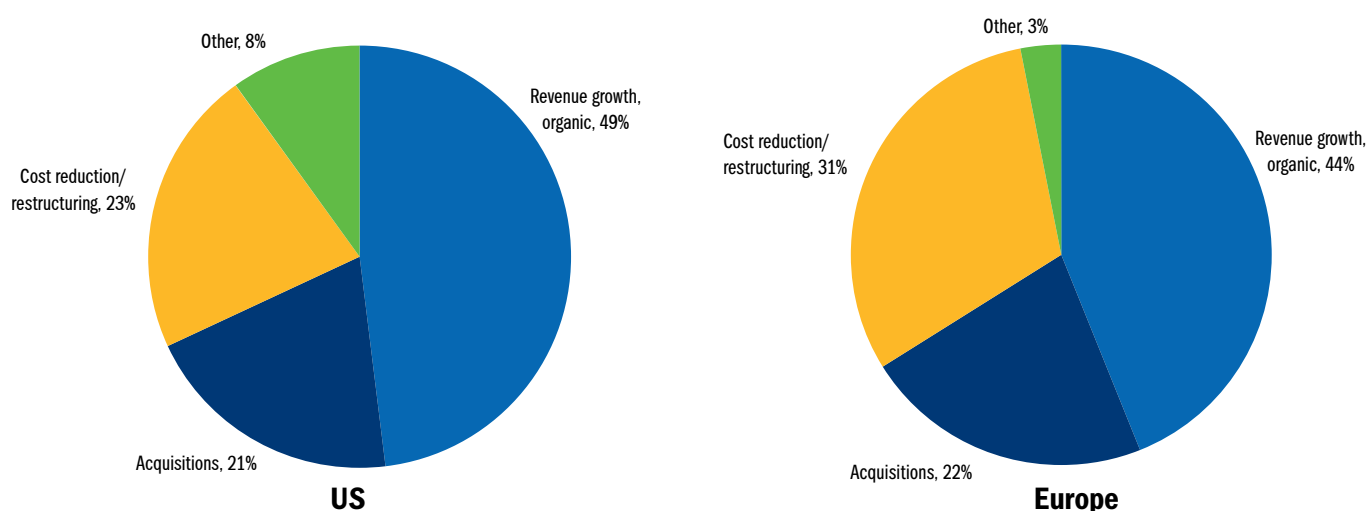
**5%**  
employee  
growth  
per annum  
in Europe

Cost reductions are the third important element of EBITDA growth in both the US and Europe, accounting for 23% and 31% respectively of the total growth in EBITDA, with half achieved by improvements in operational efficiency (see figure 3).

Employment levels were the same, or higher, at exit versus entry in 80% of US deals, and in 60% of European deals. A more detailed look at Europe showed that employment in businesses owned by Private Equity grew by an average of 5% per annum across the UK, France, and Germany, where two-thirds of the deals took place, compared to 3% for equivalent public company benchmarks.

There is also evidence that the benefits of Private Equity ownership are sustained. The study shows that in the US most Private Equity exits were by IPO, and academic research<sup>5</sup> has found that the IPOs of Private Equity-owned businesses subsequently outperform public company benchmarks. In Europe, where most Private Equity exits were from sale to new Private Equity owners (secondaries), 30% of the businesses in the study that had been acquired from PE owners grew long-term EBITDA twice as fast as those that had been acquired from either trade sellers or public markets.

**Figure 3: Sources of EBITDA growth**



5. Cao and Lerner; Boston College, Harvard University and National Bureau of Economic Research; 2006.

# Successful Private Equity Strategies

**70%**  
of US deals  
benefited from  
sector focus

“The deal was incomprehensible without prior knowledge of the business. We spent 18 months with the management team to understand the contracts, accounts, and processes.”

“We had identified the opportunity and tracked the company for about eight years before finally signing the deal.”

So what are Private Equity's secrets of success? Ernst & Young has identified four factors that explain the growth in value of Private Equity investments.

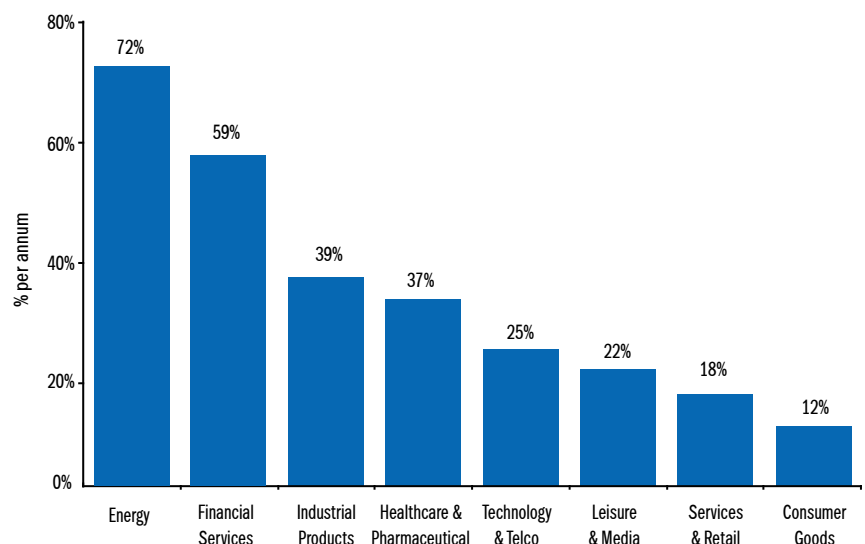
## Careful and selective buying

Private Equity investors are highly selective and well researched when making the decision to buy a business. This finding was true across deals in the US and all main European countries. Three-quarters of investments resulted from proactive deal origination strategies, including company or sector tracking, building relationships with management, or introductions from established contacts. This was further complemented by exhaustive evaluation and due diligence process. Only 11% of the 2006 deals resulted from Private Equity investors starting work during the formal sale process. Better preparation, strength of relationship with target management, and sector focus were the most important factors cited in winning the deal.

While performance does vary by industry sector, all sectors showed positive growth in business value. Sector focus is highly prevalent in the US and becoming more prevalent amongst European Private Equity investors. In Europe, sector focus was an advantage in 25% of the deals, establishing credibility with management, and helping to evaluate the growth potential of the target; in the US this was true in two-thirds of the deals. In both regions, these deals performed above average.

One important difference between the US and Europe was the higher percentage of US deals that were club deals, i.e., groups of three or more investors: 30% compared to 8% in Europe. One reason for this was the larger size of the US deals, relative to the size of Private Equity investors' funds and their need to diversify risk.

**Figure 4: EV growth by industry sector, 2006 PE exits, US and Europe**





**74%**  
made  
management  
changes  
in the US

## Driving delivery of the business plan

While buying well is important, success depends on growing the value of the business. Private Equity investors drive a process of rapid change, with new business plans, often new management, new incentives, and strong board-level leadership.

The focus on developing the best plan for the business, and the subsequent execution of the plan, are the most common catalysts for faster growth. The study identified two strategies that were most successful in both the US and Europe. Both these strategies had, in different ways, clarity of purpose and responsibility between management and investor.

### Strategy 1

The Private Equity investor backed the quality of the incumbent management team and their plan, and supported them with investment for growth. This strategy was used in 17% of the deals in the US and 22% of the deals in Europe.

### Strategy 2

The Private Equity investor installed a new management team with a new plan for the business, then worked with them to implement it. This was a more common approach in both the US and Europe, adopted by 39% and 48% of the deals respectively.

“We formed an alternative management team, and performed an ‘outside in’ analysis of alternative business strategy and identified significant operating improvements.”

“The incumbent management team was good and we were confident in their ability to execute the plan.”

Across almost all deals and ownership strategies, Private Equity investors were heavily involved in the business after acquisition. They made rapid decisions alongside management, challenged progress, and made available specialist expertise, e.g., industry, regulatory, financial, and M&A. The intensity of engagement between Private Equity investors and management was often stronger than under the previous owners.



**68%**  
made  
management  
changes  
in Europe

## Management and incentives

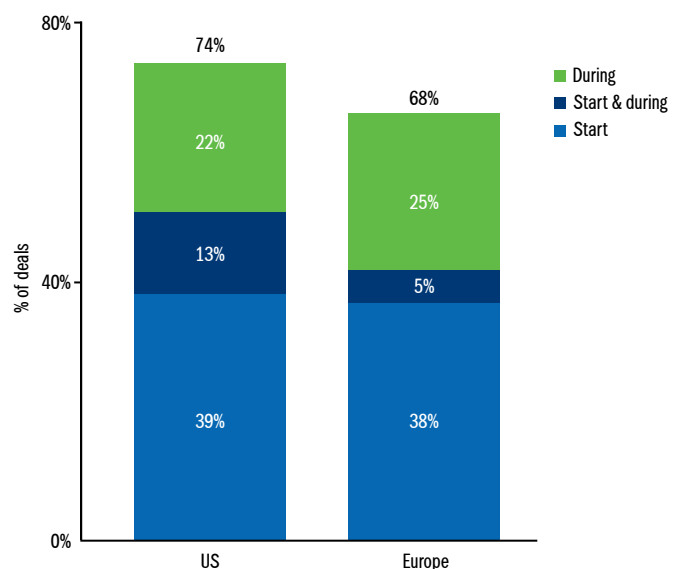
Judgements about the quality and ability of management to execute plans are some of the most important decisions that Private Equity investors make. In close to three-quarters of the deals in both the US and Europe, there were changes in top management. The CEO was changed in 61% of US deals and 45% of European deals. In Europe, Private Equity owners have become more confident about changing management, with the 2006 figure of 68% a strong increase from 44% in 2005. In both the US and Europe, changing management at the outset of the deal correlated with better performance.

Increasing the share of equity and widening incentives are critical success factors for attracting, retaining, and motivating the best talent. In most deals, management was granted equity in the business, typically in the range of 5% to 10%, which is greater than that on offer for managers in public companies. It is also noticeable in both the US and Europe that incentive plans were spread to broader groups of senior and middle management, widening the impact of this tool to drive business growth. The close alignment of incentives between a single investor group and management team on a common objective – maximizing exit proceeds in three to five years – is a distinctive and powerful feature of Private Equity ownership.

“We changed the Chief Executive twice – firstly on completion and then when we thought the Chief Executive was not meeting our performance expectations.”

“The top 125 employees were given attractive incentives based on EBITDA goals. All 10,000 employees were able to participate in an Employee Share Ownership Plan.”

**Figure 5: Frequency of change in top management**



**80%**  
met or  
exceeded  
expectation  
at exit

## Selling well

Value is realized for Private Equity investors when businesses are sold – and as serial sellers of businesses, Private Equity investors have well-developed sales skills. In 80% of deals, the sale process met or exceeded the expected results from the original investment case.

There was a fundamentally different approach to the exit between the US and Europe, with 61% of US exits by IPO route compared to 17% in Europe.

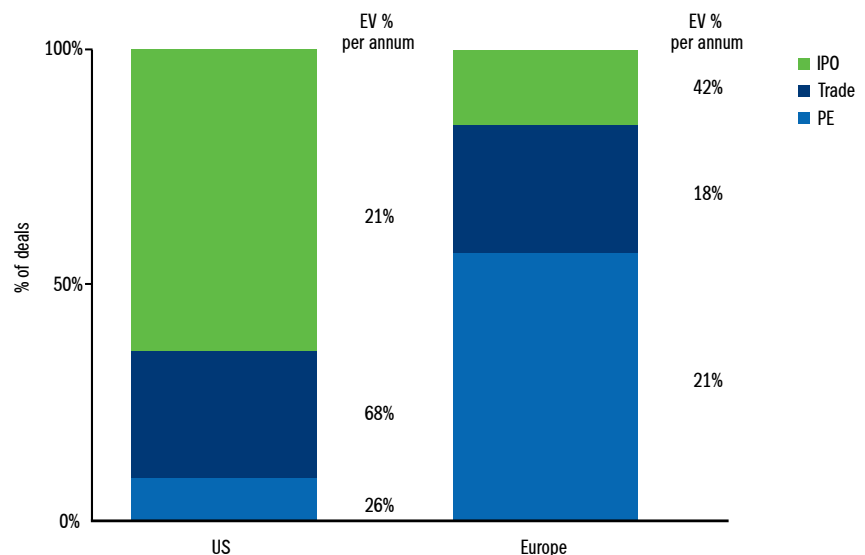
US Private Equity investors planned their exits strategically in respect of how to sell, and to whom, concentrating on the banks and brokerage houses who managed the IPO process. Their timing decision, once an IPO window had been agreed, was not too critical. However, the study shows the highest exit value was received when selling to a strategic buyer.

In Europe on the other hand, the focus on exit to corporate or new Private Equity buyers has increased the effort directed to selling. Exit planning started early, with considerable thought about structuring and positioning the business to make it attractive to likely buyers, as well as networking and relationship development with those buyers. Greater preparation went into the robustness of management plans, the detail of diligence, and other reports. Effort was made to warm up the market, making potential buyers aware of the upcoming sale several months before the formal process started. A quarter of the European deals reported extra value was added by more active management of the exit process.

“After a year into the investment, we started discussing the growth story in various forums which ‘warmed up the market’ significantly.”

“We issued a bond a few months before the commencement of the exit process. This provided great positive visibility in the market.”

**Figure 6: Enterprise value growth by exit type**



# Looking Ahead

“The company had a strong core business and management team both with a lot of room for growth – we made it happen.”

Private Equity investors have the freedom and expertise to pick and choose their targets and the timing of their investments. This allows them to identify good businesses, develop fresh plans for faster growth, and be confident that the value potential exceeds the acquisition price. The flexibility to decide when to buy and sell also allows them to take advantage of market or sector shifts.

In owning businesses, Private Equity investors act as a catalyst for rapid change through a combination of new plans, management teams, and incentives – with strong investor involvement throughout.

In 2005, Ernst & Young’s research pointed towards continued growth for Private Equity, and the data for 2006 confirmed this. Looking ahead to the outlook for 2007 and beyond, Private Equity is facing a tougher environment. The credit squeeze in August/September 2007 will undoubtedly put pressure on the financing of deals.

This environment may prompt a more conservative approach with an increasing need for deal diligence at acquisition. In Europe, a key challenge will be to develop alternative exit routes alongside secondary sales. However, leverage and multiple expansion are only a part of the Private Equity story. As this study shows, Private Equity ownership leads to real added value from sustainable improvements in performance and growth. This approach should continue to benefit investors in Private Equity, and the businesses owned by Private Equity.

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