Taking stock

How do private equity investors create value?

A study of 2013 European exits

Building a better working world

Contents

Executive summary

This is the ninth in our series of studies examining how European private equity (PE) investors create value in their portfolio companies. Covering PE exits completed between 2005 and 2013, the studies track PE's performance and company improvement record from the pre-crisis period through the economic downturn to the start of the recovery witnessed in 2013.

With the benefit of nearly a decade of data at our disposal, this year's study takes stock by analyzing the long-term view of European PE's value creation capability. Our analysis shows that while the external factors of economic cycles, perceptions of the industry and predictions of where it might end up are subject to violent swings, the underlying PE value creation record has remained constant. That's not to say that PE hasn't been affected by capital flowing in and out of the industry and by wider macro challenges. It evidently has. But what it does mean is that PE has not wavered in its long-term focus on its core business model: making selective, carefully evaluated investments; using control to enable strategic and operational improvements to the businesses it backs; and aligning incentives between management and investors, which collectively underpin a strong performance record.

Our analysis shows that PE has consistently outperformed public equity markets. We have shown this in each of our eight previous studies, and the results from 2013 add further weight to this. Exits between 2005, when our studies began, and 2013 show that the gross investment returns from PE-backed companies outperformed comparable publicly listed companies by a multiple of over three times.

Additional financial leverage has played a part in this result, but the PE effect — the strategic and operational improvements made to companies by PE — comes through strongly accounting for a greater, and growing, share of the outperformance. Our analysis also shows that this effect has been evident throughout the economic cycle. While the performance attributable to additional leverage and stock market returns changes according to economic conditions, PE's value-creating capability is consistent.

This is because PE is highly selective in choosing the right business to invest in, and because PE ownership enables fundamental change in the companies it backs to build better businesses that generate long-term, sustainable growth.

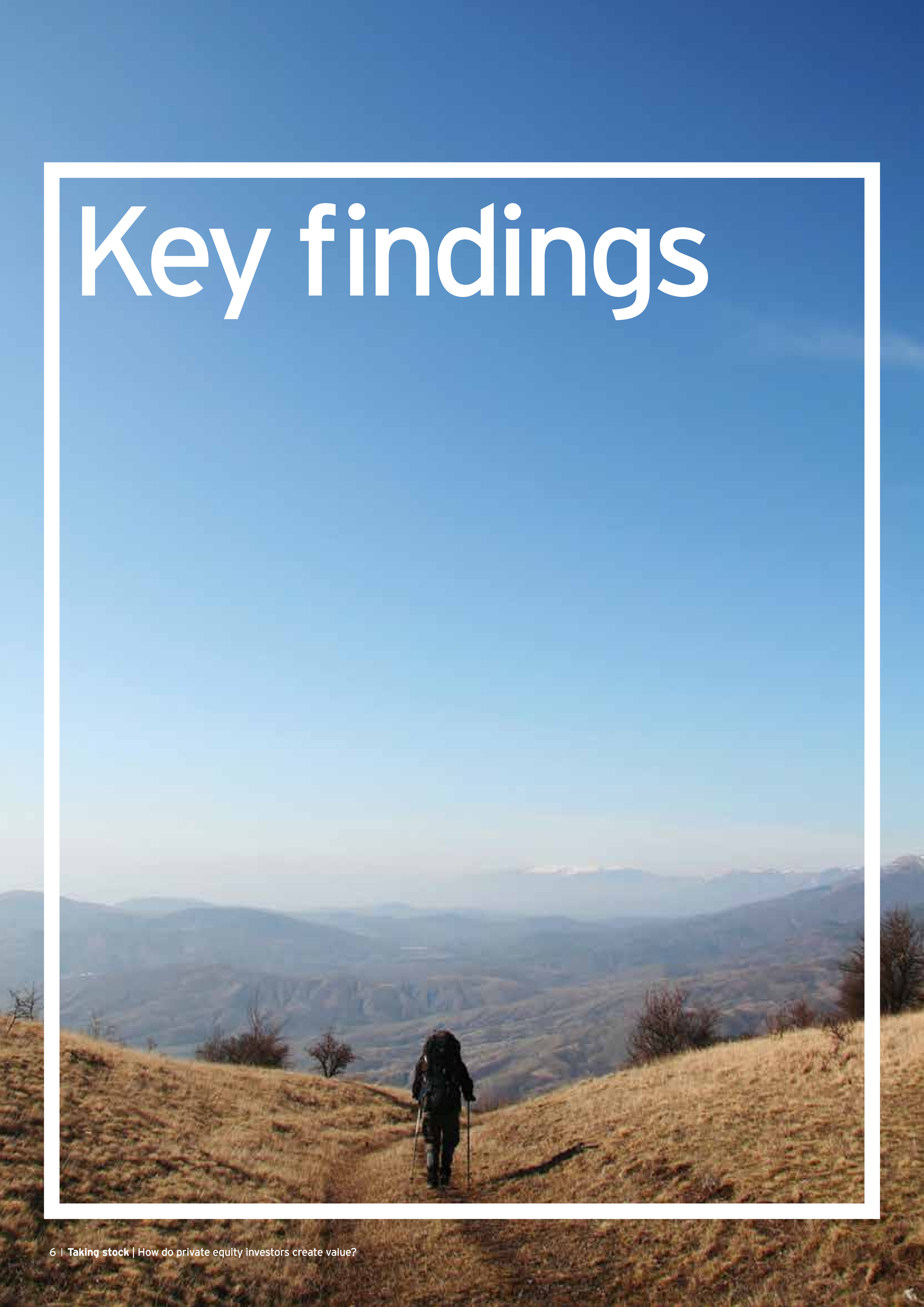
Our analysis shows that this is true in good times and bad. In aggregate, investments exited between 2005 and 2013 grew EBITDA annually by over 8% — impressive given the effect of the downturn evident in our data since 2008. Faster profit growth is the most significant source of PE outperformance versus public company benchmarks. Organic revenue growth has been shown to be a vital driver of this as PE seeks out opportunities to support businesses in repositioning their offerings, developing new products and expanding into new markets.

Over the last nine years, our studies have attempted to cut through the euphoria of the pre-crisis days and the doom-laden messages of the post-crisis times to uncover what has really been happening in the European PE portfolio. Of course, there were ever-larger deals completed in the 2005–07 period, and there were certainly casualties in the form of creditor exits when the financial crisis hit. Yet it is clear that PE's value creation credentials never left the industry in spite of what was happening around it.

With an improvement in exit numbers in our sample last year, driven by the reopening of the IPO window plus an increase in secondary buyout activity, the value created in the portfolio over the last few years is now starting to crystallize. We expect 2014 to start the return of corporates to the M&A markets, offering further opportunities for exit — and new investment opportunities.

When we started our studies, European PE was barely out of its infancy. After being surrounded by turbulence for nearly a decade, European PE has consistently shown its mettle and is emerging as a mature and integral part of the continent's economic landscape.

Key findings



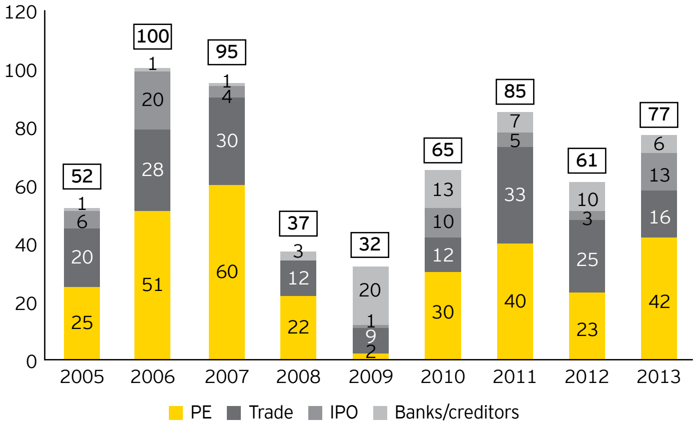
Exit activity in 2013

As the European economy started to improve following several years of instability, PE seized the opportunity to realize portfolio companies, making 2013 a good year for PE exits. There were 77 exits in our population, a significant improvement on the 61 seen in 2012, with an improving trend in two of the three main exit routes.

IPOs stage a comeback

The big story for the year was the return of exits via IPO. Indeed, PE-backed IPOs rebounded to a level not seen since 2006, with 13 companies in our sample listing, compared to just 3 in 2012 and 5 in 2011. PE took advantage of welcoming public markets to realize value from its portfolio, as some of its highest-profile companies opted to list.

Figure 1. Number of PE exits by exit route, 2005–13



Increasing sales to PE

Secondary buyouts also staged a recovery as PE firms made the most of improved and increasingly liquid debt markets in Europe. In 2012, sales to other PE firms accounted for 38% of exits by number; in 2013, the proportion was far higher at 55%. This marked the highest share of exits since 2007, marking increased confidence in the next stage of growth for these businesses.

Creditor exits on a downward path

The rate of creditor exits slowed in 2013, more in value than in number, another encouraging trend. Indeed, exits to creditors fell to their lowest level since before the crisis, with 6 in our sample for 2013, down from 10 in 2012. This suggests that the worst may be behind PE in Europe, although there are still creditor exits to come.

Corporates remain on the sidelines

Nevertheless, the third main exit route – trade – declined in 2013. Despite improving confidence among corporates, just 16 were sales to trade, compared with 25 in 2012. European corporates represented 44% of the total, with their activity one-third of the level of 2005-07.

Overall, the exit market in Europe is showing signs of recovery, with improved public market conditions and active debt markets allowing for realization by IPO and secondary buyout. However, it has not yet completely normalized. As we have noted in previous reports, trade buyers will need to return in force over the coming years for this to happen. With M&A numbers increasing through 2014, we may see some improvement this year as corporates start to return to the Europe PE portfolio for acquisitions, as they have already done in the US.

PE emerging strongly from the downturn

Our results demonstrate that PE is now emerging from the post-crisis period in good shape. After a difficult period, exits are coming through more steadily, and the value in the portfolio is now starting to be realized. The last 10 years have been an extraordinary period for European PE – it has experienced a boom followed by bust at a relatively early stage of its development. As it now settles into greater maturity, and with the benefit of nearly a decade of data, this report looks at how the industry arrived at this point. We examine how PE has managed through economic volatility and swings in public opinion and assess PE's long-term value creation record.

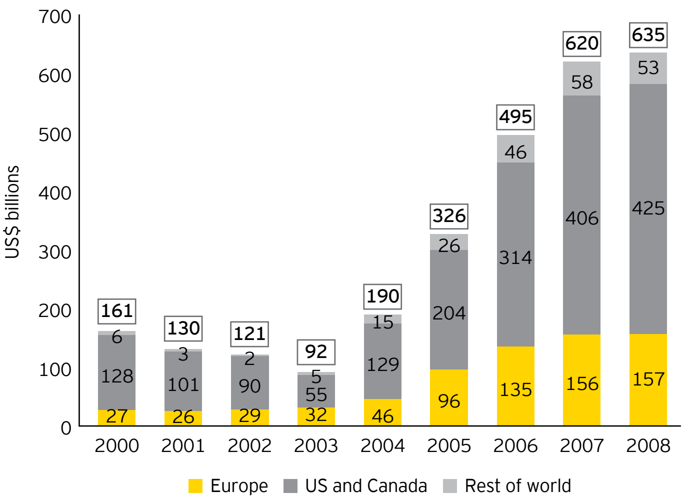
Our study this year views the industry's value creation record through a long-term lens. It shows that while PE has not been immune from the swings of the capital markets and the cyclical nature of the wider economy, it has continued to deliver returns to its limited partners (LPs) by first investing in the right businesses and then building long-term sustainable growth in the companies it backs.

Pre-crisis exuberance

Compared with many other asset classes, PE in Europe is a relative latecomer. In the late 1990s, it was still in its infancy, with many newly formed partnerships emerging and established firms just starting to expand their European coverage.

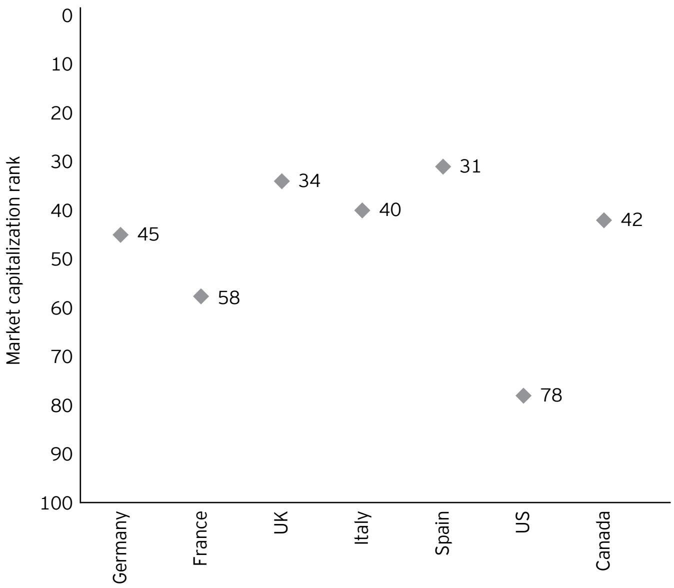
In the early 2000s, however, the economic environment started to heat up. The debt markets in particular became more liquid from 2005 onward, and capital flowed into the industry from LPs on an unprecedented scale: European PE fund-raising reached a peak in 2008 of US$157b, a total that still has not been surpassed. This was a growth in scale of sixfold in a handful of years.

Figure 2. Global PE fund-raising, 2000–08



With ready availability of debt and large amounts of equity capital to deploy, PE targeted ever-larger deals. The peak year for the value of deals in Europe was 2007, when US$246b of PE deals were completed, attesting to the scale of the acquisitions being made by PE. PE deals became so large that they began to equal the size of the very largest companies on the public markets. For example, in the UK, the largest PE deal — Alliance Boots — was the 34th-biggest company by market capitalization on the London stock market. It was clearly a time of exuberance, and the prevailing view was that no public company was out of PE's reach.

Figure 3. Public stock market ranking of largest PE deal, 2000–07



This sequence of events led to many believing that PE would become an asset class so large it would challenge public equities and that there would be a seismic shift in the modern capital landscape. At this point, the largest funds raised had been around the US$20b mark; yet in a classic sign of the hubris that characterized the time, there were some predicting that a US$100b deal was just around the corner.

Underpinning this sentiment of invincibility were, of course, strong returns. Our analysis of gross investment return for exits in the 2005–07 period averages 3.3x invested equity, with a gross internal rate of return (IRR) of 40%. Yet the attribution of these returns also highlights that additional leverage over and above comparable public company net debt, plus heady stock market returns, were exaggerating the uplift in PE investment returns. Additional leverage and comparable public company return accounted for almost two-thirds of the gain.

Figure 4. Equity multiple on PE exits — attributable sources, 2005-07

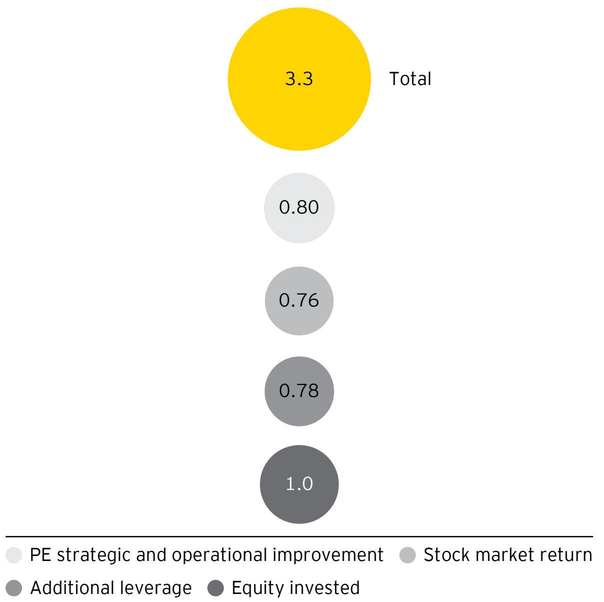
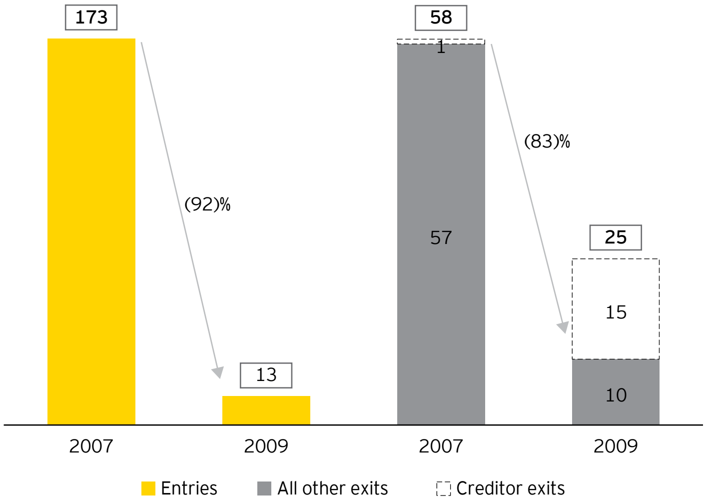


Figure 5. New PE investment and PE exits — entry enterprise value (£b)



The crash and predictions of PE's demise

Then came the shock. Following the collapse of Lehman Brothers in 2008, PE was hit hard by the effects of the financial crisis and the economic malaise that ensued at a global level. The instability of the euro over the years that followed added a further dimension to the difficulties faced by the industry. PE slowed down its investment and exit activity dramatically in Europe as its focus shifted to preservation. In our population of midsize and large investments, new investing activity fell 92% from 2007 to 2009, and exit activity, excluding forced or creditor exits, fell by 83% in value and 87% in number (from 94 to 12). Meanwhile, creditor exits in our population increased from 1 or 2 a year in the 2005–07 period to 20 in 2009.

As the crisis unfolded, the prevailing view changed from one of PE challenging the public markets to one that PE was now irreparably damaged and that it would never fully recover. Some even predicted that up to 50% of the entire PE portfolio would fall to creditors and that up to 40% of PE firms would never raise another fund.

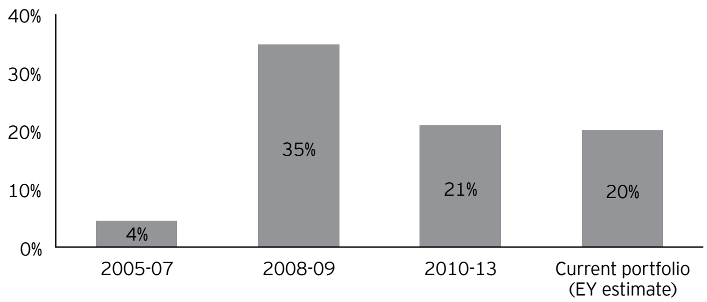
In the meantime, LPs were forced to withdraw some of their support for the industry. Many faced relative overexposure to PE as public markets investments fell in value. In addition, with fewer exits completing than they had anticipated, many faced issues with liquidity. As a result, fund-raising totals fell to reach a low in Europe of US$60b in 2010, a decline of 62% from 2007.

At the same time, public opinion around PE shifted to negative in the extreme. The pre-crisis era had already seen politicians and the media voicing concerns about the transparency and modus operandi of PE houses as they targeted household names and ever-larger companies. European PE's immaturity at this stage was all too evident: the industry failed to respond quickly or effectively enough to these criticisms, and the mud stuck. This meant that, post-crisis, PE was lumped together with other — unrelated — parts of the financial landscape, and the industry was blamed for playing a part in causing the economic woes that characterized the period.

Detractors proved wrong

However, despite the narrative surrounding the industry shifting to pessimistic mode, PE portfolios remained resilient to the downturn: the 50% creditor exit predictions proved to be wholly unfounded. In fact, the 2010–13 rate is 13% of exits going to creditors — a remarkable outcome, given the strength of the downturn. Even a more challenging financial test (i.e., measuring the investments where PE investors lose money) shows the resilience of the PE-backed businesses over time — both those exited and in portfolio. The results over 2010–13 show that 21% of exits returned equity to investors less than their investment. Or 79% of all investments returned more than the initial investment — a pattern that we expect to continue as the current portfolio is realized. PE has been a careful and selective investor with a strong, albeit not perfect, track record.

Figure 6. Percentage of PE exits with equity multiple less than 1

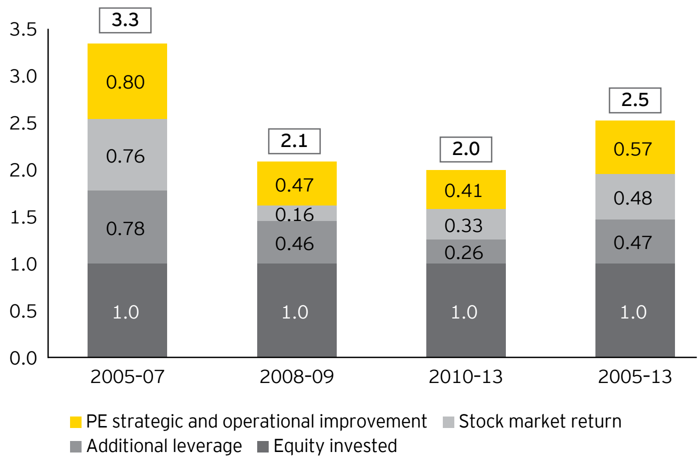


PE outperforms through ups and downs

In fact, PE-backed businesses remained more than resilient, with those exited showing outperformance against comparable public companies in every year we have conducted these studies, bar 2009. For portfolio companies exited between 2005 and 2013, PE investors achieved a gross return of 2.5x equity invested, with PE's contribution in the form of strategic and operational improvement initiatives in the companies it backs resulting in the largest single source of gain. Despite the difficult post-crisis period, our results show that the PE effect remains strong.

Drilling down further to analyze by stage of the economic cycle, our results point to PE's ability to add value to portfolio companies through good and bad times. Returns were clearly boosted during the boom years by additional leverage and high stock market returns; they were also affected by the downturn as leverage became less available and the stock markets fell. From a high of 3.3x in the pre-crisis era, returns fell to 2.1x in 2008–09, where they remained in 2010 to 2013 as the effects of the euro crisis took their toll on the PE exits achieved.

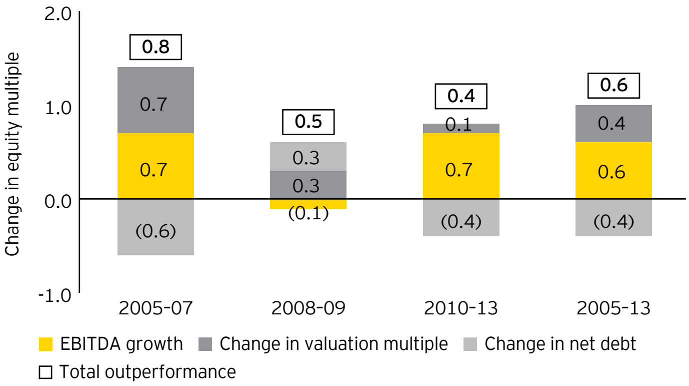
Figure 7. Equity multiple on PE exits — attributable sources, 2005–13



Nevertheless, PE's core focus — its value-enhancing measures above market — has had a positive effect throughout the period, accounting for an average of 0.6x of PE's 2.5x return between 2005 and 2013. The extra leverage effect and the contribution of stock market returns have waxed and waned over time, while the PE strategic and operational improvement effect has been the most consistent throughout.

Investors in PE (principally pension and life insurance funds) focus on the total return achieved on their investments, which at a gross level is over 3x comparable public company performance. An important, though declining, element of this outperformance comes from the additional financial leverage that typifies PE investments versus public company benchmarks. In aggregate, the increased financial leverage of 57% net debt in PE exits, versus 19% in comparable public companies, enhances equity returns to the benefit of investors in the PE asset class. As holding periods have lengthened since the downturn, the benefit of additional leverage has declined.

Figure 8. Sources of PE outperformance



Adjusting for differences in financial leverage gives a proper comparison of investor return and the underlying performance drivers. Over the whole period of our studies (2005–13), the most important source of PE outperformance is faster profit growth. The relative importance of this has increased since the pressure of the downturn and now represents the major source of PE outperformance. As we have shown in prior studies, faster profit growth in PE-backed businesses stems from faster growth in productivity, rather than employment. Most profit growth comes from initiatives to increase revenue, including international expansion, targeted investment in sales resources, and backing new products and brands. Profit growth is also boosted by operational efficiency initiatives, and the effect of bolt-on acquisitions, which exceed the effect of partial disposals.

The change in valuation multiple was a significant driver of outperformance in the 2005–07 exits, as savvy PE investors benefited from low market prices that were still found across Europe in the early 2000s. However, as acquisition prices rose – from an average 9x in 2005–07 exits, to 10x in 2008–09 exits to over 11x in 2010–13 exits – this source of outperformance has declined. It is interesting to note that most of the PE investments in our population were both acquired and sold in competitive auctions, or to/from public stock markets, where there was little systematic opportunity to buy low or sell high.

The third value driver, change in net debt, was adverse in two of the three time periods, as a result of organic and inorganic investments in the PE-backed businesses, ahead of public company benchmarks. This reversed in 2008–09, when PE acted fast to conserve cash.

Where is European PE today?

As we've demonstrated, PE's record of value creation comes through loud and clear despite the background noise that has surrounded it. As exit markets normalize over the coming years with the return of trade buyers to Europe, and as PE works through the exit overhang, our research points to continued outperformance as a result of the industry's focus on selective investment, sustainable growth and business improvement.

Our analysis of the current portfolio finds evidence of considerable value that has yet to be realized, with some of PE's best portfolio companies still to come to market. Distributions from these investments will help to underpin continued growth in the fund-raising market. In 2013, US$114b was committed to European funds, and the signs so far this year suggest the totals will be higher in 2014 – LPs are demonstrating a vote of confidence in European PE.

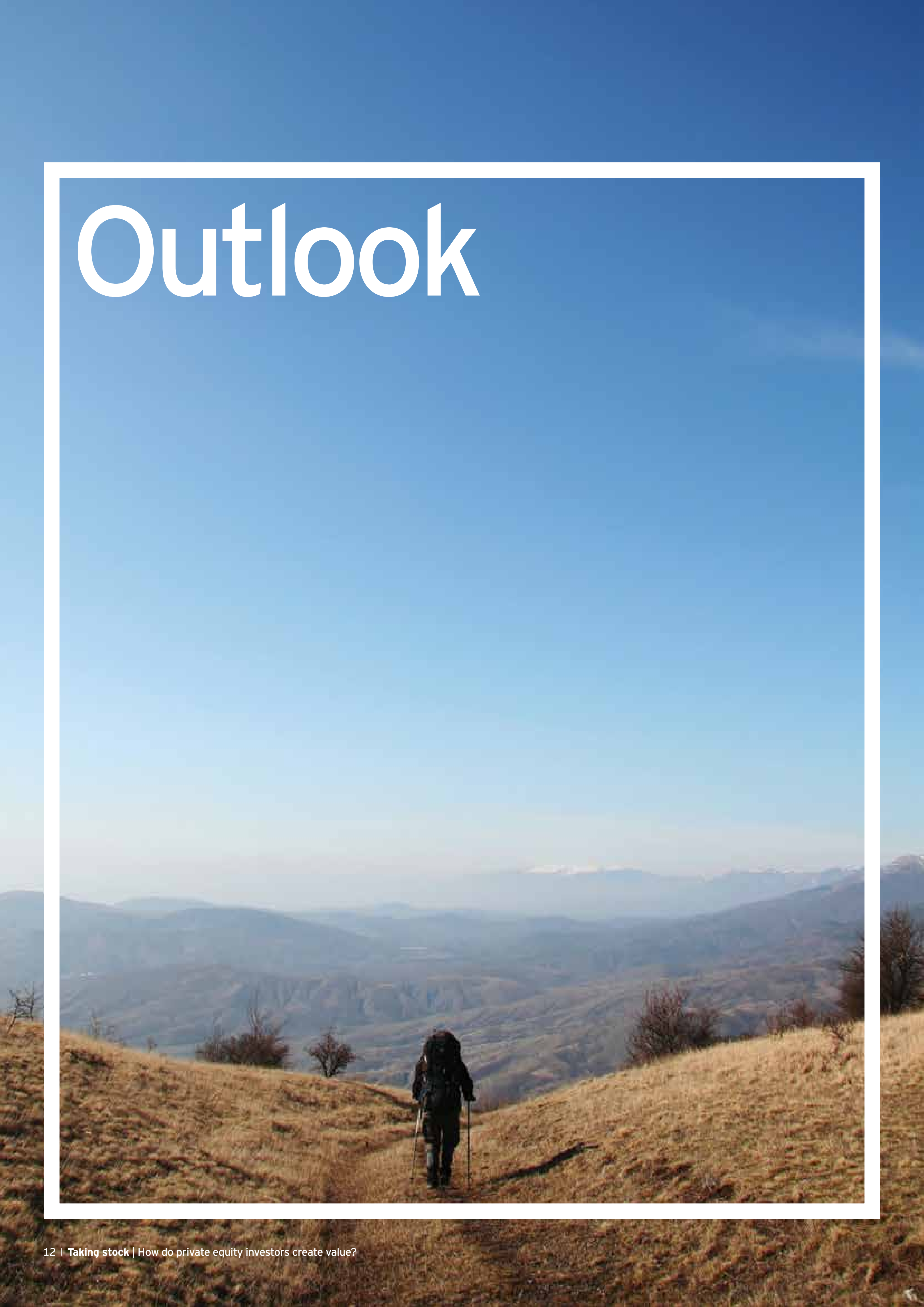
Strong fund-raisings, coupled with an increasingly mature debt market in Europe, are increasing deal totals as PE continues to source high-quality deals across the continent. Last year saw US$87b of PE deals in Europe completed, the highest value since 2008. This trend has followed through into 2014 as M&A activity has picked up and secondary buyouts have continued apace.

With exit, fund-raising and investment totals all on an upward path, PE has now turned the corner after a difficult few years.

Meanwhile, over recent years PE has taken great strides to improve its reporting to LPs and to engage more effectively with wider stakeholders. This is a significant, long-term development and will help to improve the industry's image and standing. In addition, the industry is now taking on increasing regulation in the form of AIFMD in Europe and Dodd-Frank in the US. These developments will ultimately lead to advancements in disclosure and communications and further establish PE as an integral part of the capital markets landscape.

The last decade has been one of enormous upheaval for European PE, particularly given its relative immaturity before the crisis. Nevertheless, the PE model in Europe has proved it can withstand external, macro shocks by delivering outperformance versus public market companies through an unstinting focus on creating value in the businesses it backs.

Outlook



Our studies over the last nine years have demonstrated the consistency of PE's approach to building value in the companies it backs. They have helped to prove that the PE model thrives amid periods of exuberance and external shocks as the industry continues to deliver market-beating returns.

European PE firms are staying true to the core model of being disciplined, highly selective and hands-on investors — just as they have through the economic cycle. They have also been building their own businesses through embracing the opportunities of greater sector focus, moving into new markets, expanding their investor and operational teams, and fostering rising talent.

Six years on from the onset of the financial crisis, it is clear that PE has not only weathered the economic storm but has emerged relatively unscathed, largely because of its unrelenting focus on creating sustainable growth in each of its investments. Despite this, the industry still has its detractors. Now that European PE is a regulated, mature industry that has become an established part of the economic landscape, it's high time that the debate moved on.

There is more that PE can do to shift the narrative to a more positive tone. As we've demonstrated in all our studies, the industry has a good story to tell. Moves to build in-house investor relations and communications teams have helped professionalize PE's engagement with all stakeholders. However, the industry needs to build on its work to improve transparency and disclosure through greater collaboration at a national and European level. Momentum is starting to build on these efforts, in many cases led by the national and European associations, but further development relies on the continued involvement of PE firms at an individual level.

European PE is adjusting to the new regulatory environment and is making good progress on implementing the requirements imposed by AIFMD. This is helping to institutionalize and standardize procedures and processes within PE firms and puts in place third-party oversight of funds. These developments may not be welcomed by all, but over the longer term, they should help PE to validate its record of value creation and its ability to achieve above-market returns for its investors.

The European IPO staged a comeback in 2013, and so far, 2014 looks as though it will be another strong year for exits on the public markets. While it is highly likely that the number of exits via IPO will surpass that of last year, PE will need to manage these exits with care: there are some signs that the headiness of the markets that characterized 2013 is now starting to abate.

At the same time, a deepening and further development of the European credit market means that secondary buyouts will continue to be a good exit route for PE, including for some of the larger companies in the portfolio. The outlook for M&A is also promising as corporates are picking up their activity levels, which should provide both exit and new investment opportunities for PE — and will help to normalize PE exit activity over the coming years.

New investment will be supported by the improvement in the fund-raising market, where totals are beginning to reach levels not seen since the crisis. There is evidence that this pickup is the start of a long-term trend: LPs continue to be attracted by PE's long-term performance record and are increasing their allocations to the asset class.

Overall, the outlook for PE is positive. The conditions around the industry are improving on all fronts — there is a greater availability of equity and debt capital for investment, a steady pickup in the economic environment, a shift in the perception of the role PE has to play in the European economy, and, in mid-2014, strong activity in two of the three main exit routes.

About the study

The 2013 study provides insights into the performance and methods of PE, based on analysis of the largest European businesses that PE has owned and exited over the past nine years.

To avoid performance bias, and to ensure a focus on the largest European businesses owned by PE, exits were screened to capture only those that had and enterprise value (EV) at entry of more than €150m. This criterion also applies to our estimates of the current size of the PE portfolio, and the new investments into, and exits out of, this population. In total we have identified 604 exits of businesses that met our criteria over the study period from 2005 to 2013.

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

In order to benchmark the performance of PE-backed businesses, we have compiled comparable financial data on over 6,000 public companies across European stock markets. This enables us to create country, industry sector and time-matched public company benchmarks for each PE investment. The data was then aggregated to compare the performance of PE-owned businesses with that of public companies over the period of PE ownership.

This independent study is built with public data across the whole population and detailed, confidential interviews with former PE owners of these businesses. Overall, we have performance data for 434 businesses, or 72% of the total population. Looking across key performance dimensions (e.g., deal size, sector, incidence of creditor exits), there is no discernable bias in the composition of the sample compared with the whole population.

The ability to incorporate data obtained directly from interviews with top PE investors is an important feature of the study. Another is the scope and depth of our research, with a data base of more than 400 European PE exits. Our study is recognized by many commentators as the authoritative work in this field.

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