

Reporting Private Equity

Private equity - state of the market

Private equity markets continued their steady recovery in a supportive economic environment in 2010, helped along by economic recoveries in the US and Northern Europe and continued growth in Asia. Even volatility in equity markets, driven by fears that the second leg of a double dip recession might materialize, did not have a significant impact on private equity investment or realization activity. The upward trend in the real economy and the re-opening of debt markets has had a positive impact on the private equity industry.

In this article we review the current stay of play of private equity from a global point of view and then we take a closer look at several markets that are likely to drive private equity returns in the coming year and beyond. Specifically, we focus on:

- European buyout investments;
- Secondary transactions; and
- Asian private equity.

1. The global view of private equity

After spending 2009 tending to their portfolio companies, private equity managers across the globe began making deals again in 2010. As Figure 1 below shows, global LBO volumes recovered to 2008 levels and the LBO share of a relatively quiet overall M&A market rose to 17%.

	Global LBO Volumes	Global M&A Volumes	LBO Share of M&A Markets
2006	\$897 bn	\$3,601 bn	25%
2007	\$995 bn	\$4,165 bn	24%
2008	\$382 bn	\$2,887 bn	13%
2009	\$219 bn	\$1,900 bn	12%
2010	\$400 bn	\$2,300 bn	17%

Table 7: Global M&A and LBO markets.
Source: Goldman Sachs research, BC Partners.

Company valuations on the rise

Managers' focus during 2009 on improving operational performance of portfolio companies paid off in 2010, as company valuations went up, helped along by the increase in public market comparables. For example, the S&P Index 500, NASDAQ COMP, RUSSELL 3000 INDEX and MSCI WORLD were up by 15%, 18%, 17%, 12% respectively.³

³ Based on total returns.

Purchase price multiples have also been driven higher by the increase in interest by both trade and equity buyers on the lookout for good quality companies. As one market observer noted, "It is clear that there is a greater appetite for quality deals at the right price. Increasing buyer confidence and a shortage of good businesses for sale has led to higher multiples, which in turn is fuelling optimism in the market."⁴

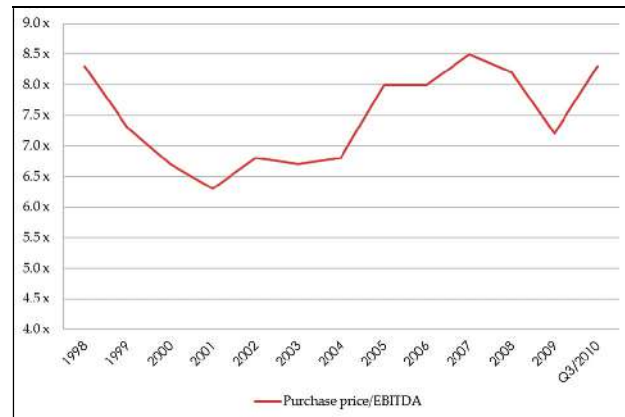


Figure 10: Purchase price multiples for large and middle market buyouts, example US.

Source: S&P LCD Leveraged Loan Review, S&P Q3 2010 Leverage Buyout Review.

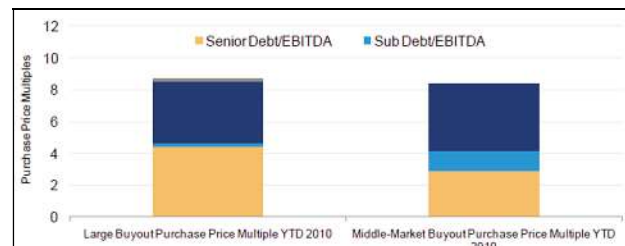


Figure 11: Large vs. Market Buyout Purchase Price Multiples as of 30.09.2010.

Source: S&P Q3 2010 Leverage Buyout Review.

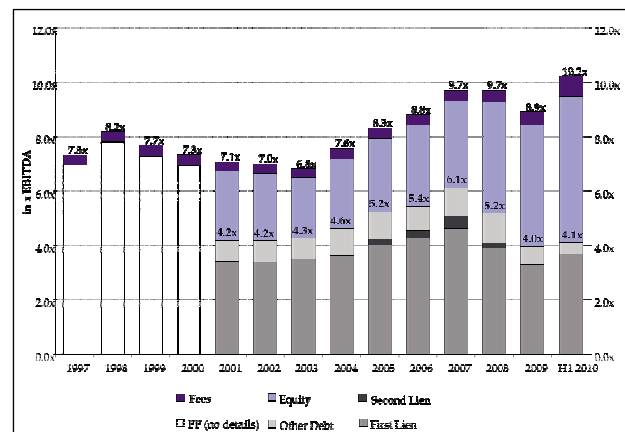


Figure 12: European LBO deal structures and prices.
Source: S&P LCD European Leveraged Buyout Review (Q2 2010).

Exits are back

Despite the increase in deal activity, 2010 was a better environment for exiting companies rather than invest-

⁴ Private Equity Multiples on the Up, in News Alert, 8 February 2011.

ing in them. In addition to a sale to other private equity funds, other exit routes gained importance again, such as corporate buyers who have accumulated above-average liquidity positions to enable strategic or opportunistic acquisitions. Furthermore, the IPO exit window opened up, allowing larger buyout funds to seek a gradual exit from some of their holdings.

Fundraising makes a slow recovery globally

Global fundraising began to recover overall in 2010, up from its 2009 low, but is still far below its 2008 peak level, and not all regions have seen improvements over the previous year.

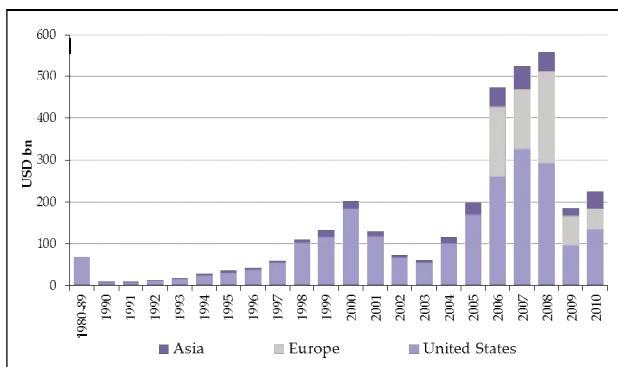


Figure 13: Global fundraising from 1980 to 2010. Source: Private Equity Analyst.

US fundraising increased in 2010 over 2009, in contrast to Europe, which experienced a slight decline. This is partly attributable to the fact that US pension funds are allocating more capital to private equity in order to boost returns, and thereby compensate for funding shortfalls. In addition, strong distributions in 2010, particularly in the fourth quarter, are potentially resulting in what limited partners are calling a "reverse denominator effect." This can occur when investors have stopped making new private equity commitments for a period of time, while stock markets have been rising and large distributions made on existing investments. Investors can find that they are under-allocated to private equity, which may in turn lead them to start committing aggressively to new funds in order to meet their allocation target.

European fundraising registered a small decline over 2009, with most of the demand from investors coming from those seeking commitments to small and middle market buyout funds. Not a single large/mega buyout fund was raised in the region with a size above EUR 2.5 billion in 2010.

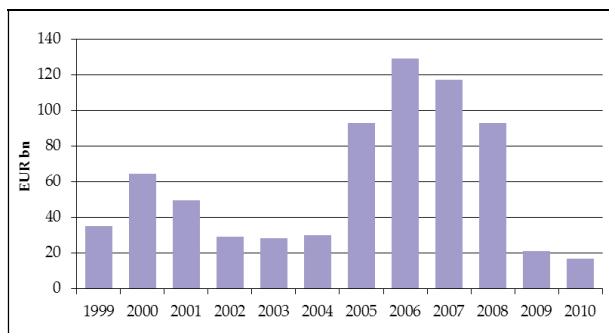


Figure 14: European fund raising. Source: Thomson Reuters – Thomson ONE.

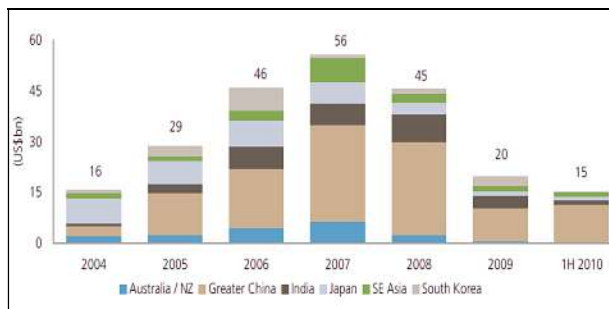


Figure 15: Private equity fund raising in Asia-Pacific, by country. Source: Asian Venture Capital Journal.

Private equity fund raising in Asia has recovered from its trough in 2009 but is far below its peak in 2007. At the height of the market in 2007-2008, a large number of Asian mega funds were raised, for example, KKR's USD 4 billion Asia buyout fund in 2007 and CVC's USD 4.25 billion Asia buyout fund in 2008. The past 24 months have shown that such funds are too big to deploy capital meaningfully across the region as the buyout opportunity in developed markets such as Japan and Australia was over estimated, as well as in developing markets such as China and India, where the markets are driven almost entirely by growth capital deals. The capital overhang, which is attributable mostly to the pan-regional funds as well as Japan and Australia, will likely continue in the course of 2011/2012.

2. European buyout investments

After having hit bottom in 2009 after the crisis, 2010 saw a strong recovery in the European buyout market with its volume having doubled in 2010 to hit EUR 49 billion. The 505 completed deals are significantly up as compared to 433 deals in 2009. The increase is triggered by higher availability of leverage, low interest rates, improved earnings visibility of portfolio companies and some fund managers being under pressure to deploy capital after many months of limited investment activity.

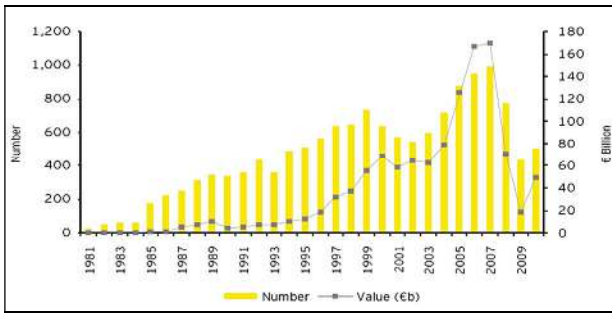


Figure 16: Trends of European buyouts/buy-ins.
Source: Ernst & Young: European buyouts watch, Q4 2010 / CMBOR, Ernst & Young, Barclays Private Equity.

Resurgence in debt markets

The real story of the year has been the resurgence in debt markets, after a retrenchment in 2008-2009 that saw equity contribution requirements for private equity firms exceed the 1:1 equity-to-debt ratio. As one market observer put it: “debt market conditions are still far removed from the environment that characterized the few years leading up to the credit crunch,” but there are, “clear signs of revival began to show towards the end of 2009 and continued into 2010.”⁵ This has included, towards the end of 2010 and beginning of 2011, an increase in refinancing of portfolio companies to take on more debt. The market has even seen the return of “covenant-light” loans.⁶

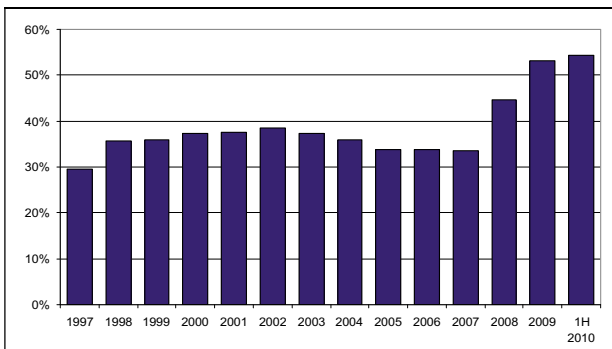


Figure 17: Equity contribution as a % of transaction value.
Source: S&P (LCD European Leveraged Buyout Review).

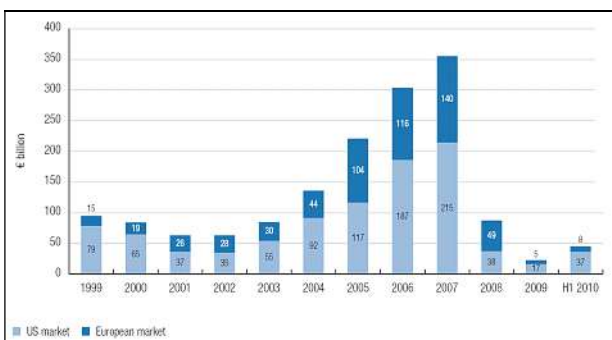


Figure 18: Senior loan volume – LBO transactions.
Source: 2010 EVCA buyout report - an EVCA Research Paper - October 2010, page 9.

Favorable exit environment

The exit environment has improved in 2010 over the previous year, notably with the re-opening of the IPO window and increased activity from cash-rich trade buyers. Nevertheless, a report from Ernst & Young observed that, “there is still a significant amount locked up in management buy-out investments and there is some way to go before the market reaches any form of equilibrium. As activity increases over the next one to two years, private equity houses will be pressured to manage challenging exit processes while also devoting significant time to originating, winning and completing new deals.”⁷

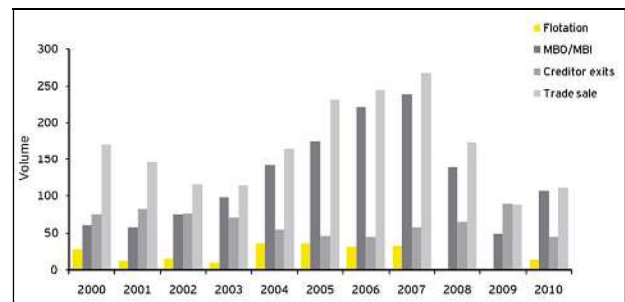


Figure 19: Exits of European buyouts/buy-ins.
Source: Ernst & Young, European buyouts watch, Q4 2010 / CMBOR, Ernst & Young, Barclays Private Equity.

Small and middle market buyout remain an attractive segment

Given the increase in buyout activity in Europe and the recovery in debt markets, we expect that small and middle markets will continue to be an attractive segment for investors. General partners in this segment can still acquire companies at attractive multiples and they will benefit from the opportunity to buy companies that have been recession-tested.

3. Secondary transactions

2010 was the busiest year on record in the private equity secondary market, with estimated fundraising volume expected to hit USD 22 billion for the first time.⁸ The increase reflects the broader recovery in the merger and acquisition market, spurred on by gains in public equities. The composition of the secondary market also changed over the last 12 months, with strategic sellers replacing those primarily concerned with liquidity. Regulatory pressures and attractive prices on mega buyout funds prompted strategic sel-

⁵ 2010 EVCA Buyout Report - an EVCA Research Paper - October 2010, p. 9.
⁶ EVCA news, 11 February 2011.

⁷ Ernst & Young: European buyouts watch, Q4 2010 / CMBOR, Ernst & Young, Barclays Private Equity, p. 2
⁸ Real Deals, 16 February 2011.

lers, such as public pension funds and financial institutions, to access the secondary market in greater numbers than in 2009.⁹

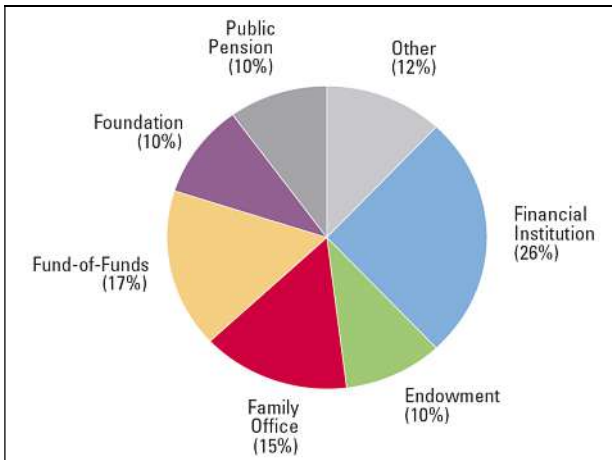


Figure 20: Secondary market seller universe in 2010 (Number of Sellers).
Source: Cogent Partners, Secondary Pricing Trends & Analysis, January 2011.

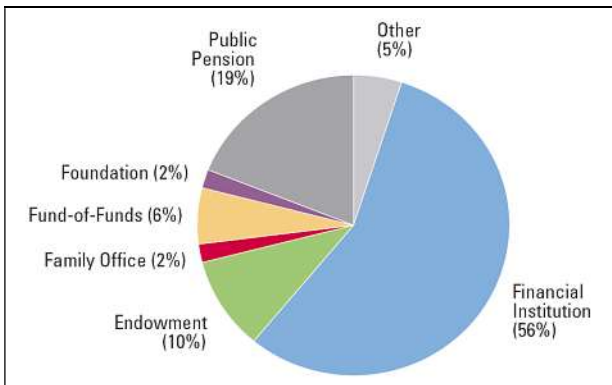


Figure 21: Secondary market seller universe in 2010 (Transaction Value).
Source: Cogent Partners, Secondary Pricing Trends & Analysis, January 2011.

Discounts to NAV are narrowing

The buyer’s market of 2009 began giving ground to sellers in the first half of 2010, with discounts to NAV continuing to narrow in H2 2010, in conjunction with the continuing improvement in the underlying NAVs. The market had reached discounts of 60%-70% in H1 2009, as buyers were anticipating write-downs taken by general partners between September 2008 and March 2009. By H2 2010 these discounts had shrunk to just 5% in competitive situations for the strongest assets. Buyers could expect to pay single-digits discounts, or even par, for high quality assets, especially for those that were priced on the basis of September or December 2010 valuations.

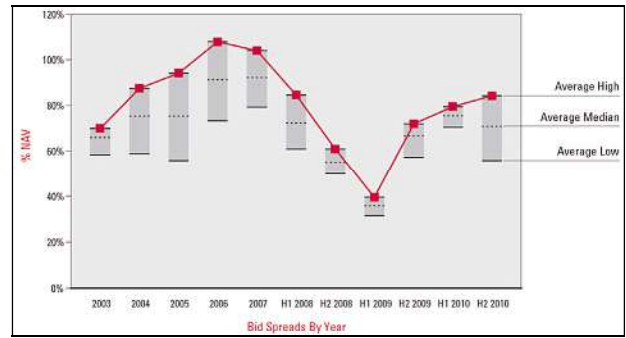


Figure 22: Secondary bid spreads over time.
Source: Cogent Partners, Secondary Pricing Trends & Analysis, January 2011.

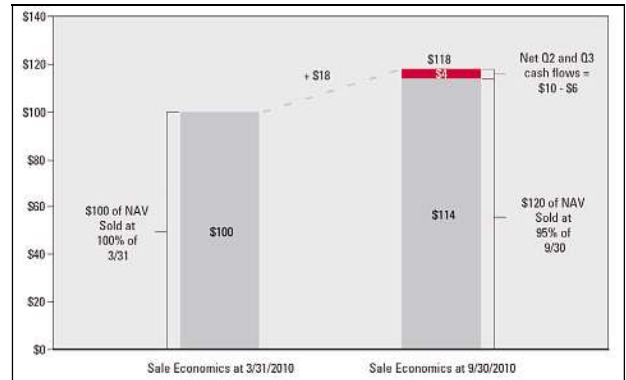


Figure 23: Dollar price improvement example.
Source: Cogent Partners, Secondary Pricing Trends & Analysis, January 2011.

Where the best opportunities will lie

The deal flow for new opportunities remains strong. Though the first wave of large transactions following the crisis is completed, banks continue to divest assets for liquidity and regulatory reasons. The low discount environment is also facilitating selected “tail end” management solutions for fund-of-fund managers.

The market pricing is getting more expensive, especially for large buy-out funds in auctions, but there are still many less competitive opportunities. Many well known large buy-out funds are getting too expensive, especially given limited early liquidity potential and still high remaining leverage on underlying assets. Promising opportunities remain especially when it comes to smaller funds or less well known managers, in proprietary or limited auction situations.

4. Asian private equity

The global economic crisis that began in late 2008 did not hit Asian emerging markets as hard as the West, owing in large part to the region’s relatively strong macro-economic footing. Most countries in Asia are running current account and budget surpluses and corporate and personal balance sheets are generally

⁹ Cogent Partners, Secondary Pricing Trends & Analysis, January 2011, p.1/6.

sound across the region. As a result, while private equity investments slowed significantly beginning in late 2008, they began to rebound from mid-2009 onwards and never were as negatively impacted as they were in western private equity markets. In addition, returns in Asian emerging markets have been more resilient in the aftermath of the financial crisis as compared to their developed world counterparts (on a TVPI basis as computed by Cambridge Associates)¹⁰. This is partly due to the fact that private equity in Asia is much less driven by debt than in the West, since expansion capital and small buyouts dominate the market.

As the Asian private equity market continues to mature, there has been a meaningful increase in exit activity. However, as can be seen in the chart, private equity-backed IPO volume has decreased due to ongoing market volatility, trade sales are expected to increase as international corporates continue to look to the East to fuel their future growth and manage costs. As the market matures, secondary buyouts are also expected to become a more meaningful exit route, as they are in more developed markets.

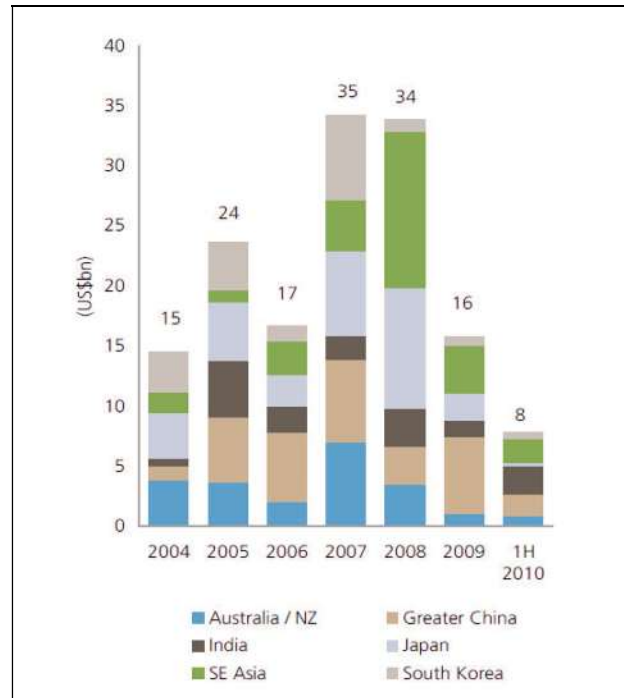
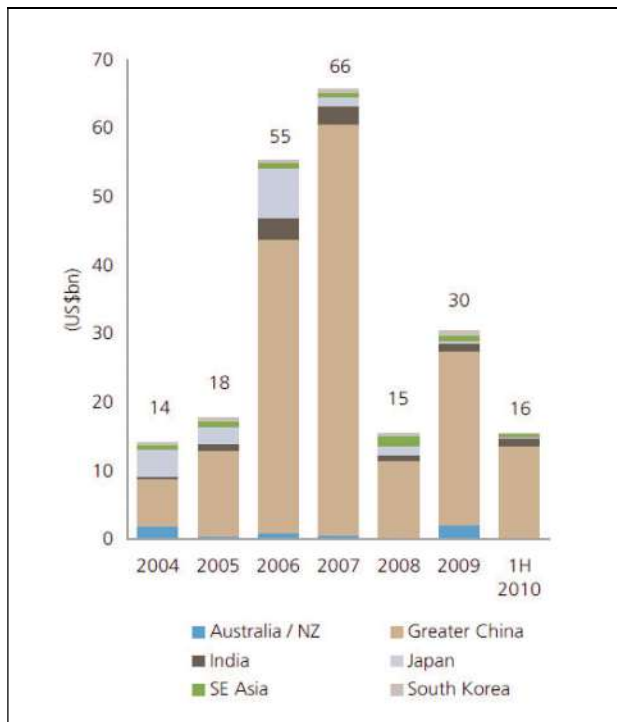


Figure 24: Private equity-backed IPOs. Source: Asian Venture Capital Journal.

Figure 25: Private equity-backed M&A trade sale exits. Source: Asian Venture Capital Journal.

Attractions of Asian private equity

Given the attractive structure of Asia’s private equity market, particularly in emerging markets such as China, India and Indonesia, and the region’s sound macro-economic footing, it is not surprising that the region has increasingly captured the interest of private equity investors. As the chart below shows, many institutional investors are considering increasing their Asia exposure.

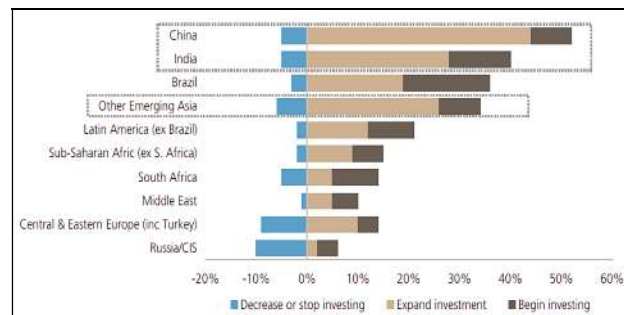


Figure 26: Limited partners’ planned changes to their emerging markets private equity strategy over the next two years. Source: Collier Capital and EMPEA, Emerging Markets Private Equity Survey, 2010.

They see the asset class as an excellent way of investing in high growth industries at lower volatility than is typical of Asian public equity markets. Private equity is also seen as an attractive asset class to gain access to companies that are tied to the fast growing consumer class in China, India and Indonesia, since public markets across Asia are in general dominated by state owned companies and firms in sectors such as natural

¹⁰ The Boston Consulting Group, New Markets, New Rules, November 2010, p. 4

resources and heavy industry. Equally important, the pricing environment has remained attractive in the private equity space, even while entry prices have risen due to an increasing amount of international capital looking for outsized returns in Asia. In our experience, the very best and most experienced general partners have continued to invest at reasonable multiples (for the most part single digit price earnings multiples for firms growing in excess of 25% to 50% per annum). On a growth adjusted basis, acquisition multiples in Asia remain attractive in private markets.

Investors are also attracted to the private equity ecosystems that have developed in the region - especially in China and India, the two engines of the Asia growth story - whereby top-tier local managers follow the same rigorous due diligence and monitoring practices as their counterparts in the West. This offers investors in Asia the opportunity to profit from these managers' ability to select promising companies, cultivate them with operational expertise and finally exit them, all in the context of the region's high growth economies.

Focus on first-generation entrepreneurs

Much of the investment so far has been in first-generation entrepreneurs who have built large, profitable businesses in relatively short period of time. These entrepreneurs are often willing to sell a minority stake in their business to a private equity firm that can help take their company to the next level in terms of corporate governance, new markets and strategy. Most Asian entrepreneurs are also reluctant to take debt financing, which means private equity firms are in a good position to become partners with the region's leading entrepreneurs.

China at the heart of Asian private equity

Investments in China continue to run ahead of fundraising with little capital overhang. It is still possible to buy growth companies at single digit price-earnings multiples in China. Small and middle market growth capital managers are most demanded for new commitments by institutional investors. The buyout market is growing with the majority of deals using no leverage. Most privately owned companies have no long-term debt; however, working capital lines can be at risk for some firms. China is a core market due to its size of the opportunities it offers and an entrepreneurial and open business culture. Given the large amount of capital flowing to China in recent years, many entrepreneurs have unrealistic expectations as to

valuation. Another problem is the quality of local management teams, especially in middle management: that is a real concern in markets such as China and this makes choosing the right general partner even more important as the best ones have demonstrated an ability to identify promising teams. In China, there is also a growing supply of local capital for private equity. In September 2010, it was announced that insurers would be allowed to invest a percentage of their assets in private equity and real estate, in order to improve their returns and help channel more funds into investment in the country's private equity sector.

Opportunities in India and Indonesia

In India, like in China, the focus of limited partners lies on small and middle private equity managers. With little competition from hedge funds and investment banks, private equity firms are well positioned for the near-term future. Private equity as an asset class is still developing. Only a handful of firms have delivered returns compensating investors for Indian risk. "A continuing issue in the Indian market is the fact that a high proportion of private equity deals involve listed companies through private investment in public equity ("PIPE") transactions. Some international investors are not keen on the high exposure of private equity to the public markets in India, but PIPES have become an important component of how private equity functions in India. There are very few funds that only invest in unlisted companies, because in India a very large number of companies list at a relatively early stage and more than 80% have a market capitalization of under USD 100 million."¹¹ India is an important market because of its strength as a services provider in areas such as healthcare and technology.

There are also interesting opportunities in frontier markets such as Indonesia, where both the macro (Indonesia likely to be upgraded to investment grade in 2011) and micro stories (strong consumer story, natural resource plays leveraged to China) look interesting. In Indonesia, there is an undersupply of institutional capital for companies, which provides good opportunities for local private equity players. In the past three years, a small number of institutional quality fund managers has emerged. The supply/demand balance is in the limited partners' favor.

The Asia private equity market is likely to continue to be one of the most attractive private equity markets

¹¹ Source: Broadgate Mainland, 1 October 2010, page 5.

given the positive macro outlook, evolving maturity of the private equity eco-system and in particular the opportunity sets in developing Asia such as China, India and Indonesia.

5. Summary

The upward trend in the real economy and the re-opening of the debt market has had a positive impact on the private equity industry. This led to cautious optimism, but fears of a double-dip in the global and European economies haven't fully disappeared.

Global fundraising has recovered during 2010 from its 2009 low, but is still far below its 2008 peak. The US and Asia were up, whereas Europe slightly lower than prior year. The fundraising environment remains challenging as best managers are significantly oversubscribed.

The investment activity on the primary side has recovered from its 2009 low and the revival of debt markets has been supporting buyout activities again.

2010 was one of the strongest periods in the recent past for both pricing and volume in the secondary market. Although the market pricing is rich, there are still many less competitive opportunities (i.e. small funds, less well known managers, proprietary or limited auction situations).

Good investment opportunities are in particular seen with regard to small and middle market buyout funds, secondary transactions and in Asia (i.e. China, India and Indonesia).

The Asia private equity market, in particular China, India and Indonesia, is likely to continue to be one of the most attractive private equity markets and many institutional investors are considering to increase their Asia exposure.

If private equity fund managers stay disciplined and no external shocks occur, current performance should continue well into 2011.

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