
Recent trends in private equity

INTRODUCTION

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A note on terminology

Private equity is a broad term generally used to describe any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. Private equity is sometimes used to refer only to the buy-out and buy-in investment sector. In Europe, the term **venture capital** is used to refer to all stages of investment in private equity whereas in the United States the term refers only to early-stage and expanding companies. This note uses the term in its broadest sense (unless stated otherwise): to include both venture capital (in the U.S. sense of the word) and management buy-outs and buy-ins.

A note on source material

Official or government-produced information on private equity firms and markets is almost non-existent. Almost all data regarding private equity is compiled through member surveys and estimates compiled by industry associations such as the British Venture Capital Association (**BVCA**) and the European Venture Capital Association (**EVCA**), by industry publications, and by consultancy/research firms. As a result, there is a substantial time lag in the compilation of useful or comparative data (the BVCA's current full data set is for the year ending 2006; the EVCA has published some preliminary data for 2007). Similarly, data is not comparable across sources (and often not within sources from year-to-year¹).

Discussion of the international private equity market is based primarily on material produced by the EVCA, Practical Law Company (**PLC**), International Financial Services, London (**IFS**) and *Private Equity International* magazine. Discussion of the U.K. private equity market is based primarily on material produced by IFS and the BVCA.

Information on particular firms' activities is increasingly available (at least in the U.K.) as many firms now publish regular "Annual Review" documents in response to the Guidelines for Disclosure and Transparency in Private Equity published by the Walker Working Group in November 2007.

¹ As the composition of an industry body's membership changes over time.

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THE INTERNATIONAL PRIVATE EQUITY MARKET

Private equity investments made and funds raised

According to IFSL estimates, a record \$365 bn 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 (though investment figures are inflated by a number of larger-than-usual transactions in the U.S., discussed on page 5).

Over the past ten years there have been two noticeable peaks in private equity activity – the first being related to the internet/technology boom in the United States (and to a lesser extent elsewhere) during 1999-2001 and the second during 2005-2006 relating to the substantial expansion in debt financing prior to the 2007 “credit crunch”. In this context, the apparent “dip” in 2002-2004 should be viewed more as a return to a baseline level of activity from an exceptional peak, rather than as a significant downturn.

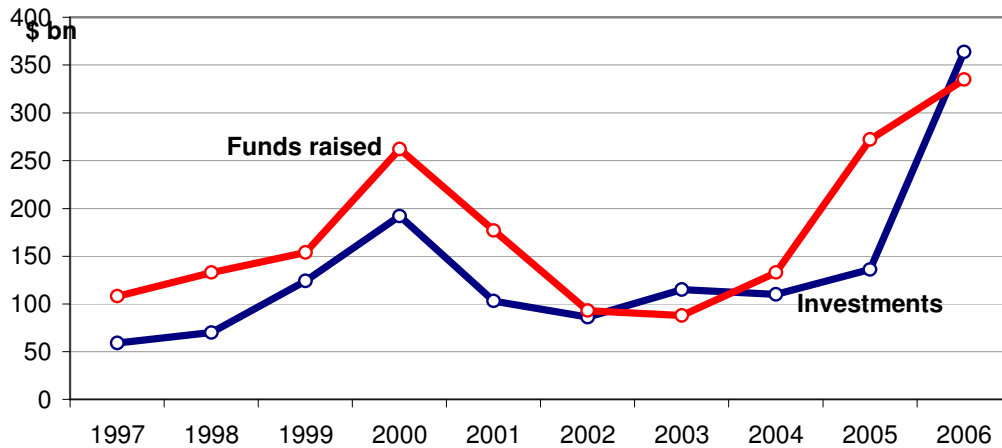


Figure 1 - Total funds raised and number of investments (worldwide) – 1997-2006

Private equity investments by financing stage

Buyouts have accounted for a growing portion of private equity investments by value in recent years, and increased their share of global private equity investment from a fifth to more than four-fifths between 2000 and 2006.

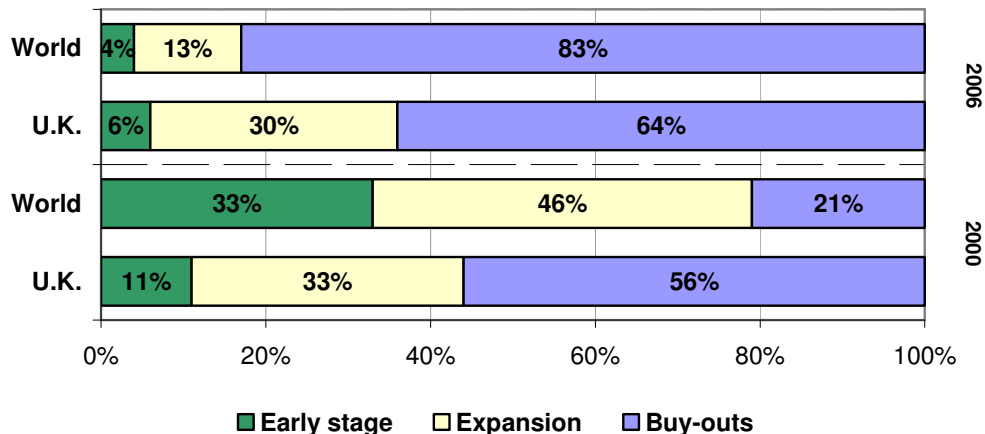


Figure 2 – P.E. investments by financing stage (worldwide & UK) – 2000 vs 2006

Private equity investment and funds raised by country

The regional breakdown of private equity investment activity in Figure 3 below shows that in 2006, North America accounted for approximately 60% of global private equity investments (down from 67% in 2000) founded on 47% of funds raised (down from 69%). 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 substantial spike in U.S. investment activity in 2006 shown in Figure 3 below is partly a result of a number of larger-than-usual transactions, including six of the largest private equity transactions ever recorded: Hospital Corporation of America, Inc. (US\$32.7 bn), Harrah's Entertainment, inc. (US\$27.4 bn), Clear Channel Communications, Inc. (US\$25.7 bn), Kinder Morgan, Inc. (US\$21.6 bn), Freescale Semi-Conductor, Inc. (US\$17.6 bn) and Albertson's LLC (US\$17.4 bn).

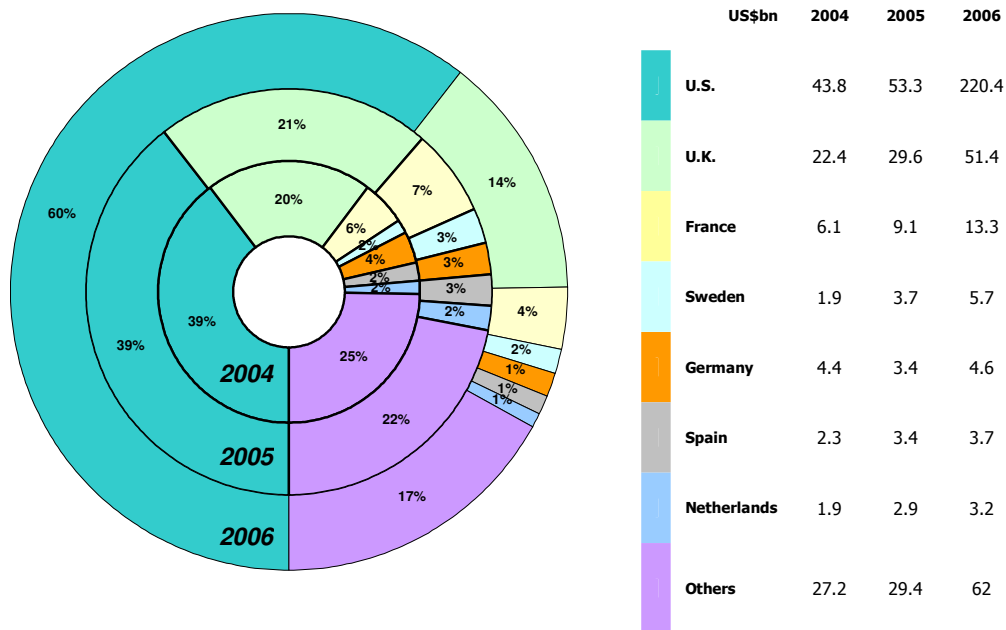


Figure 3 – Private equity investment by country – 2004-2006

Recent trends in the United States

In 2006, US private equity firms raised US\$215.4 bn, an increase of 33% on 2005. Concerns regarding the health of the US sub-prime mortgage market and mortgage-backed securities markets in mid-2007 filtered into the leveraged finance market, which led to an almost complete shut down of the leveraged finance market and, by association, large private equity deal making. The leveraged finance market found that large leveraged finance lenders had stopped writing new commitments, and those lenders who wrote commitments prior to July 2007 were unable to syndicate those underwritings. The lack of a syndication market further compounded the credit crunch. In the few instances where lenders were able to syndicate loans post-closing, they did so at a loss even though there was no indication that the portfolio company was experiencing any financial difficulty.

The tightening of the credit markets also led to a number of terminated or restructured signed but not closed deals. These market conditions led to some sponsors attempting to enforce renegotiation of the deal on the basis of **material adverse change clauses** in the original transaction documentation (e.g. Home Depot) or to termination of the deal in its entirety (e.g. Harman International). More recently, Cerberus Capital walked away from its US\$4 bn acquisition of United Rentals without claiming that United Rentals suffered a material adverse effect or that its lenders had pulled out of the deal. Rather, Cerberus stated it was entitled to terminate the acquisition agreement and pay a reverse break-up fee.

In addition to the credit crunch, the US private equity industry is also faced with a potential law change in how private equity carried interests are **taxed**. Under existing US tax law, carried interests (i.e. the share of profits paid to the sponsor by limited partners of a private equity fund) are generally taxed at the rate applicable to capital gains (generally 15%) as opposed to income tax rates (which can reach 35%). The US House of Representatives has passed a tax bill that would raise the rate of tax on carried interests to 35%, however the bill's passage through the Senate and the White House is not guaranteed.

A recent report in the *Economist* magazine² however, recently declared rumours of the death of private equity as "proving to be greatly exaggerated". The recent dispute between Bain Capital and its consortium of financiers over Bain's attempt to take Clear Channel Communications private³ was settled on the basis that the banks would value Clear Channel at US\$18 bn rather than the \$19.4 bn approved by shareholders in September 2007.

Larger firms continue to raise funds from institutional investors. Other firms have taken "creative" measures to bolster performance, for example one private-equity owner selling a 49% stake in a firm in its portfolio to another private-equity firm, thus allowing the seller to realise a profit while allowing the existing debt financing to remain in place, sparing the new owner from having to refinance the deal.

Private-equity firms have also been **buying up private-equity debt** held by the banks – often borrowing from the bank to do so (e.g. A bank sells debt with a nominal value of US\$10 bn to a private-equity firm or consortium for US\$8 bn, lending the buyers US\$7 bn towards the price. The bank takes a US\$2 bn write-down, but reduces its overhang of non-performing debt and gets an additional US\$1 bn of equity. Meanwhile, the private-equity firm buys debt at a fire-sale price.)

Evidence also suggests that private equity funds will become more reliant on **sovereign wealth funds** as a funding source as pension funds and non-profit endowments reduce their exposure to leveraged buy-out investments. China's State Administration of Foreign Exchange recently announced it would invest more than US\$2.5 bn in the latest fund to be raised by Texas Pacific Group (**TPG**), thought to be the largest single commitment ever to a private equity fund.

² 'Private equity: All Clear?', *The Economist*, 15 May 2008

³ The consortium of banks — Citigroup, Deutsche, Morgan Stanley, Credit Suisse, Royal Bank of Scotland and Wachovia — tried to enforce the MAC clause found in the Clear Channel financing contract.

Recent trends in Europe

2006 was (yet another) record-breaking year, both in terms fundraising and transactional activity in Europe. The overall value of buyout deals reached €160 bn, an increase of 42% on 2005. An unprecedented number of deals exceeding €1 billion that took place during the year was largely responsible for this increase in pan-European deal value.

The trend towards ever-bigger deals continued during the first half of 2007. Just in the first quarter of 2007 there were 12 transactions thought to be worth over €1 billion in Europe, which led analysts to believe that mega-deals would remain important throughout 2007. However, the global market turmoil that began in July 2007 combined with the ensuing liquidity crunch in the debt markets have made many experts re-evaluate these optimistic expectations.

The likely repercussions of the credit crunch on the private equity industry in Europe are still not entirely clear. Preliminary data for the year to end-2007 from the EVCA indicates that while the level of private equity investment in the E.U. has remained broadly constant while the funds raised and divestments have declined by roughly 40% over the course of the year (See Figure 3 below). Estimates by PLC for the third quarter of 2007 indicate that while the volume of deals in Europe has remained relatively stable, there has been a 29% decline in overall deal value in relation to the previous quarter.

There is relatively uniform consensus that the number of high profile transactions over the coming months is likely to decrease significantly as potential acquirers needing leveraged finance face harsher lending conditions. This could result in an increase in the number of mid-cap deals (<€500 m), which in turn could lead to increased buyouts of companies located in emerging market jurisdictions.

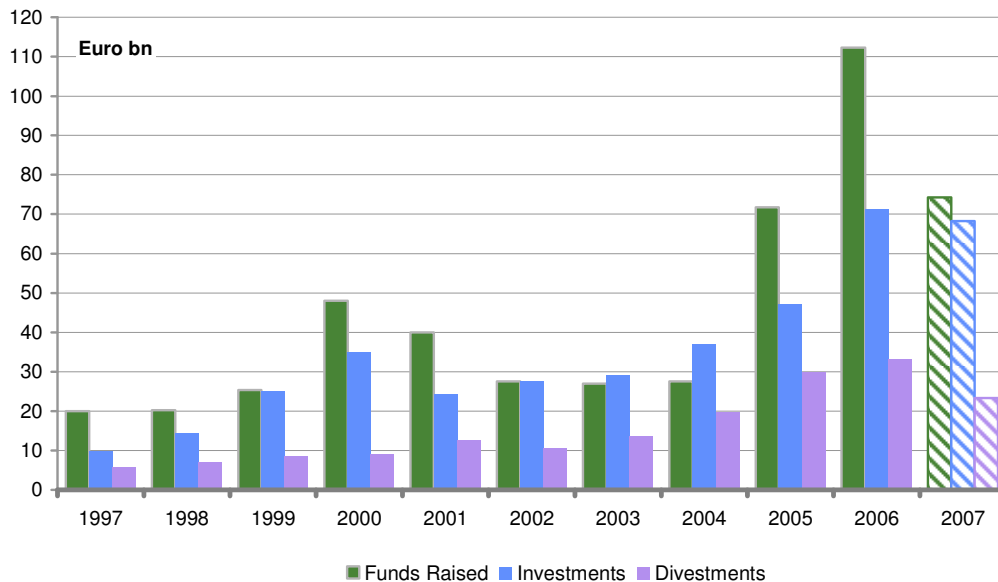


Figure 4 – Private equity in Europe – 1997-2007 (estimate)

European investment by sector

Figure 5 below charts EVCA estimates of European private equity investment by sector for 2006 and 2007. As in the U.K. (see Figure 11 below), private equity investment in Europe is dominated by investment in companies specialising in consumer goods and services. Note however, the much larger level of investment in communications by private equity firms based in Europe than those based in the U.K.⁴

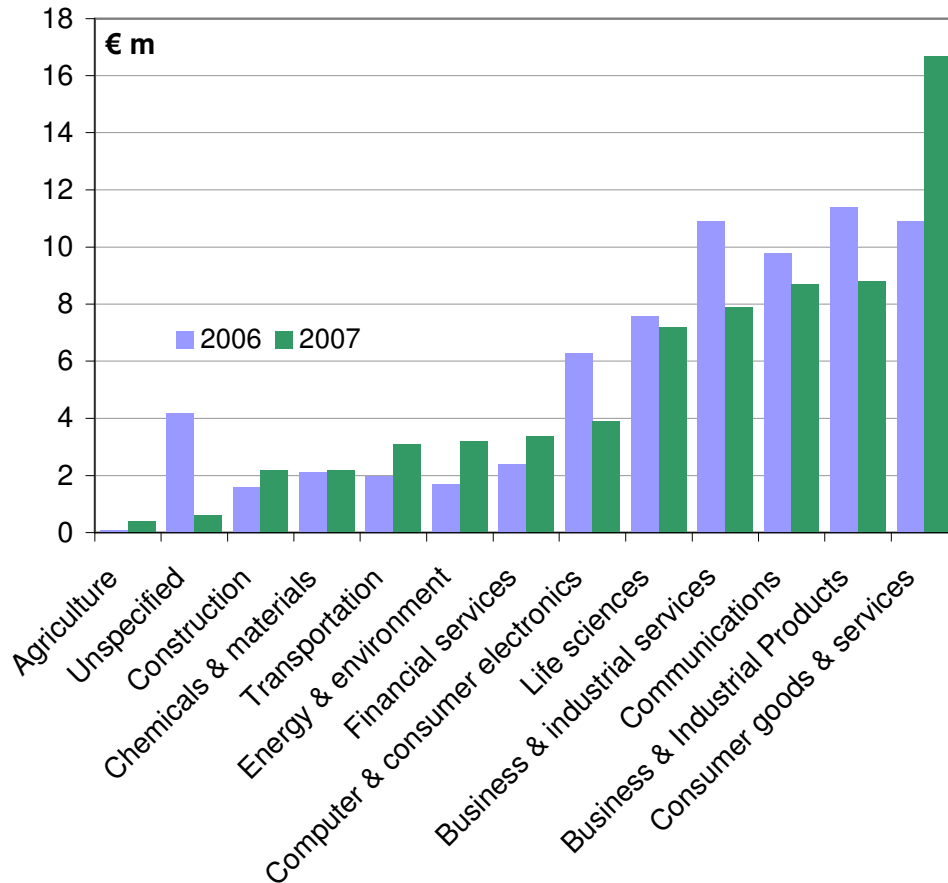


Figure 5 - Investment by industry sector (Europe) – 2006-2007

Divestments

Total divestments by private equity firms across Europe in 2006 totalled a record US\$33 bn in 2006, 23% of which were trade sales, 17% by repayments of preference shares and loans, 17% of sales to other private equity houses and 9% by IPOs. A similar analysis for U.K. firms can be found on page 13.

⁴ While the source data for the two charts is not strictly comparable – one compiled by the EVCA and the other by BVCA – the U.K. data can be treated as a subset of that for Europe.

Private equity fund structures

The following summarises the most common corporate structures for private equity funds in the jurisdictions of those firms listed in Figure 6 below.

United States

The legal structure private equity funds most commonly use is the **Delaware limited partnership**. The limited partnership affords investors limited liability for the fund's obligations while the fund sponsor, or an affiliate, acts as the general partner and has unlimited liability for the fund's obligations.

An alternative to the limited partnership is the **Delaware limited liability company (LLC)**. However, an LLC is not generally appropriate for funds that either have non-U.S. investors or that invest outside the U.S., due to some jurisdictions' adverse tax treatment of LLCs. This is because LLCs are not residents of the U.S. for tax treaty purposes, or, in some cases, LLCs are not recognised as a pass-through entity under the tax rules of some jurisdictions. Both limited partnerships and LLCs are generally treated as pass-through vehicles for U.S. tax purposes, allowing investors flow-through tax treatment.

Some private equity funds, due to their investor mix or investor focus, are organised **offshore**, typically in the Cayman Islands or the British Virgin Islands. These structures generally provide a similar level of limited liability to investors as that provided by a Delaware vehicle.

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. Private individuals who wish to invest in private equity generally invest through a publicly listed corporate vehicle such as an investment trust or venture capital trust, as limited partnerships may not be marketed to retail investors.

UK

The most common vehicle for institutional investors is a **limited partnership**. Firms tend to raise a new fund every three to five years. A fund-raising can be spread over several months. The vehicle is usually an English limited partnership, although Guernsey, Jersey, Scottish and Delaware limited partnerships are also used. 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.

Venture Capital Trusts are quoted vehicles that aim to encourage investment in smaller unlisted (unquoted and AIM quoted) UK companies by offering private investors tax incentives in return for a three-year investment commitment.

Private Equity Investment Trusts are investment vehicles which are quoted on the London Stock Exchange. They invest principally in a range of unquoted companies and are mainly managed by larger private equity firms. The type of investments they undertake are not restricted by legislation and so they do not offer tax benefits to private investors.

France

France has a number of corporate vehicles that receive tax concessions beneficial to private equity activities.

Fonds commun de placement à risques (FCPR). These are the most commonly used structure provide for, subject to certain conditions, tax exemption of income derived from the ownership of the interest in the FCPR (individual investors) or taxation at a low rate of the capital gains on the disposal of the interest in the FCPR (corporate investors). This favourable regime is only available if the FCPR satisfies, specific detailed investment quotas in particular industries/entities for unlisted companies. FCPRs are the most commonly used private equity vehicle in France. More than 75% of the funds raised in 2006 were invested in FCPRs.

Fonds commun de placement dans l'innovation (FCPI). This is a type of FCPR available to individuals. Individuals are entitled to a tax deduction equal to 25% of the amount invested in the FCPI up to €12,000 per person. In addition, individual and corporate investors in FCPIs may benefit from the same favourable regime as provided for a FCPR, if a FCPI meets the conditions to be qualified as a FCPR.

Fonds d'investissement de proximité (FIP). This is a type of FCPR available to individuals. Individuals are entitled to the same tax credit as when investing in a FCPI. The FIP is subject to the same requirements as the FCPI, except that it must invest: in small and medium-sized companies located in areas close to the place of incorporation of the fund and at least 10% of its assets in companies that have been in existence for less than five years.

Société de capital risque (SCR). This benefits from an optional tax regime open to joint stock companies. Its shareholders (whether individual or corporate investors) are subject to a tax regime that is similar to the FCPR. Provided certain requirements are met, an SCR is exempt from corporate tax on income and capital gains realised from investments. An SCR's shareholder may also benefit from tax incentives. The Financial Markets Authority (*Autorité des Marchés Financiers*) does not supervise SCRs.

Société unipersonnelle d'investissement à risque (SUIR). This is a type of SCR for individuals. SUIRs are exempt from corporate tax on 100% of their income for ten years. Dividends paid by the SUIR are exempt from personal income tax if the SUIR invests exclusively in unlisted companies: that are subject to corporate income tax; that are less than five years old; the capital of which is predominantly held (directly or indirectly) by individuals.

Organisme de placement collectif immobilier (OPCI). The POCI is a new legal structure introduced to increase private equity investment in real estate.

The Netherlands

The following legal vehicles are used for private equity funds in the Netherlands: private companies (**BV**); public companies (**NV**); limited partnerships; and funds for joint account. Only the BV and the NV have legal personality at present. A limited partnership can opt for legal personality under the new law on partnerships (*personenvennootschappen*) which is expected to come into force in the second half of 2008.

Sweden

Limited partnerships and foreign limited partnerships are the most common legal structures used by private equity funds in Sweden. Swedish limited partnership has often been used when all investors in the private equity fund are Swedish. However, as a result of, among other things, the Swedish participating provisions (enacted in 2003), the last few years have seen an increased number of funds for international as well as domestic investors structured as a Swedish limited liability company.

Canada

Private equity funds in Canada are most commonly structured either as limited partnerships or trusts (formed under the laws of the relevant Canadian province). Limited partnerships are more common, because it is unclear if trusts provide limited liability (i.e. a court could determine that an investor who is the beneficiary of a trust is liable for the obligations of the trust beyond the amount he has contributed). While a number of Canadian provinces have legislated to remove this concern, this is not an issue for limited partnerships, as limited partners enjoy limited liability to the extent of their invested capital. However, limited liability can be lost if the investor participates in the management or control of the business of the limited partnership. In a limited partnership, both losses and gains are passed on to investors annually while, in a trust, only gains are passed on to the investor. Losses remain in the trust to be offset for tax purposes against future gains. Limited partnerships have proven particularly attractive to corporations, wealthy individuals and institutional investors (including endowments, insurance companies and pension funds) as well as a diverse range of non-resident investors (mostly located in the US).

The world's largest private equity firms

The table below shows the top 50 private equity firms ranked by the amount of capital raised over the past five years.⁵ The table demonstrates a cluster of 4 firms with a substantially larger amount of capital raised (US\$28bn+).

The average amount of capital raised per firm over this period was US\$11bn and the median US\$8.4 bn. The total amount of funds raised by the top 50 firms accounted for 69% of the estimated US\$800bn total private capital raised since 2002. The total capital raised by the top 13 firms (US\$278bn) is broadly equivalent to that raised by the next 37 firms (US\$273bn).

Firms nominally headquartered in the United States are highlighted in yellow, those in the U.K. in blue and others (France, Canada, the Netherlands, Australia, Sweden) in pink. Short profiles of the leading UK firms are on the following page.

Rank	Name of Firm	Headquarters	Capital raised over 2002-2007 (US\$bn)
1.	The Carlyle Group	U.S.	\$32.5
2.	Kohlberg Kravis Roberts	U.S.	\$31.1
3.	Goldman Sachs Principal Investment Area	U.S.	\$31
4.	The Blackstone Group	U.S.	\$28.4
5.	TPG	U.S.	\$23.5
6.	Permira	U.K.	\$21.5
7.	Apax Partners	U.K.	\$18.9
8.	Bain Capital	U.S.	\$17.3
9.	Providence Equity Partners	U.S.	\$16.4
10.	CVC Capital Partners	U.K.	\$15.6
11.	Cinven	U.K.	\$15
12.	Apollo Management	U.S.	\$13.9
13.	3i Group	U.K.	\$13.4
14.	Warburg Pincus	U.S.	\$13.3
15.	Terra Firma Capital Partners	U.K.	\$12.9
16.	Hellman & Friedman	U.S.	\$12
17.	CCMP Capital	U.S.	\$11.7
18.	General Atlantic	U.S.	\$11.4
19.	Silver Lake Partners	U.S.	\$11
20.	Teachers' Private Capital	Canada	\$10.8
21.	EQT Partners	Sweden	\$10.3
22.	First Reserve Corporation	U.S.	\$10
23.	American Capital	U.S.	\$9.6
24.	Charterhouse Capital Partners	U.K.	\$9
25.	Lehman Brothers Private Equity	U.S.	\$8.5
26.	Candover	U.K.	\$8.3
27.	Fortress Investment Group	U.S.	\$8.3
28.	Sun Capital Partners	U.S.	\$8
29.	BC Partners	U.K.	\$7.9
30.	Thomas H Lee Partners	U.S.	\$7.5
31.	Leonard Green & Partners	U.S.	\$7.2
32.	Madison Dearborn Partners	U.S.	\$6.5
33.	Onex	Canada	\$6.3
34.	Cerberus Capital Management	U.S.	\$6.1
35.	PAI Partners	France	\$6.1
36.	Bridgepoint	U.K.	\$6.1
37.	Doughty Hanson & Company	U.K.	\$5.9
38.	Alphavest Partners	Netherlands	\$5.4
39.	TA Associates	U.S.	\$5.2
40.	Berkshire Partners	U.S.	\$4.8
41.	Pacific Equity Partners	Australia	\$4.7
42.	Welsh, Carson, Anderson & Stowe	U.S.	\$4.7
43.	Advent International	U.S.	\$4.6
44.	GTCR Golder Rauner	Chicago	\$4.6
45.	Nordic Capital	Sweden	\$4.5
46.	Oak Investment Partners	U.S.	\$4.1
47.	Clayton, Dublier & Rice	U.S.	\$4
48.	ABN Amro Capital	Netherlands	\$3.9
49.	Oaktree Capital Management	U.S.	\$3.9
50.	Summit Partners	U.S.	\$3.9

Figure 6 - The world's largest private equity firms - 2007

⁵ Compiled by Private Equity International magazine.

Permira

Established: 1985. **Offices:** Frankfurt, Guernsey, London, Luxembourg, Madrid, Milan, New York, Paris, Stockholm, Tokyo. **Key sectors:** Chemicals, consumer, industrial products and services, technology, media & communications. **Primary funding sources:** pension funds and institutional investors. **Website:** www.permira.com.

2007 acquisitions: Provimi (Netherlands, animal nutrition, €1.6 bn), ProSiebenSat (Germany, commercial TV broadcaster, €6.7 bn), Valentino Fashion Group/HUGO BOSS (Italy/Germany, luxury goods, €5.3 bn), Galaxy Entertainment Group (Hong Kong, casino, hotels and leisure, €593 m).

Apax Partners

Established: 1969 (U.S.), 1981 (U.K.) **Offices:** Hong Kong, Munich, Tel Aviv, Milan, Mumbai, Madrid, Stockholm, London, New York. **Key sectors:** Technology and telecommunications, retail and consumer, media, healthcare, and financial and business services. **Primary funding sources:** banks (7%), endowments (6.5%), funds of funds (10.8%), gatekeepers (4.3%), HNW individuals (12.7%), insurance (9.1%), private pension funds (11.7%), public pension funds (31.9%) and sovereign funds (6.0%).⁶ **Website:** www.apax.com.

2007 acquisitions: Apollo Hospitals (India, acute hospitals, €0.6 bn), Cengage Learning (USA/Canada, media, €3.6 bn), Electro Stocks (Spain, electrical components distribution, €0.4 bn), Hub International (USA, mid-market insurance brokerage, €1.0), Plantasjen (Norway, garden retail), Qualitest Pharmaceuticals (USA, generic pharmaceuticals, €0.7 bn), SMART Technologies (Canada), Trader Media Group (UK, automotive classified advertising, €2.6 bn).

CVC Capital Partners

Established: 1981. **Offices:** London, Frankfurt, Paris, Milan, Amsterdam, Stockholm, Jersey, Madrid, Brussels, Copenhagen, Hong Kong, Zurich, Sydney, Seoul, Tokyo, Luxembourg, New York, Singapore. **Key sectors:** Distribution, food/beverages, IT/media, manufacturing, retail and services. **Primary funding sources:** public and corporate pension funds (45%), "fund of funds" (16.3%), private individuals (9.6%), insurance (7%), banks (5%), university endowments (4.2%) and other (12.5%). **Website:** www.cvc.com.

2007 acquisitions: Acromas (the AA and Saga) (Motoring services, United Kingdom), Amtek Engineering (Metal Stamping and Precision Engineering, Singapore), DYWIDAG-Systems International (Construction and Mining Technology, Germany), Fraikin (Truck long-term operational leasing, France), GS Paper & Packaging (Recycled brown paper & corrugated boxes, China), Ista (Submetering services, Germany), Koninklijke Volker Wessels Stevin (Building, construction & property development, Netherlands), Matas (Personal care retail chain, Denmark), Nien Made (Window Blinds & Shutters, Taiwan), PBL Media (Publishing, Broadcasting & Online Media, Australia), Samsonite (Luggage and Travel Accessories, United States), Taminco (Animal Feed and Water Treatment Technology, Belgium), Univar (Chemical Distribution, United States), Zhuhai Zhongfu (PET beverage packaging, China)

Cinven

Established: 1977. **Offices:** London, Paris, Frankfurt and Milan **Key sectors:** business and financial services, healthcare, industrials, retail, leisure and consumer, and technology, media and telecommunications. **Primary funding sources:** Public pension (34%), fund of funds (21%), banks (12%), insurance (12%), corporate pension (10%), and other (11%). **Website:** www.cinven.com.

2007 acquisitions: Coor (€536 m, Integrated Facilities Management), Completel (€788m, Cable operator), USP Hospitales (€675, Hospital operator), Spire Healthcare (€2130, Hospital operator), Camaïeu (€1470, Clothing retailer), Gondola (€1335, Casual dining operator), Ziggo (€5450, Cable operator), Phadia (€1285, Allergy testing).

⁶ For most recent fund: Apax Europe VII (US\$39 bn)

THE PRIVATE EQUITY MARKET IN THE UNITED KINGDOM

The BVCA estimates the investment by U.K. private equity firms in 2006 reached a record £21.8 bn in 1,630 companies (see Figure 7). This figure however, cannot be directly compared with those from previous years⁷ however, and the like-for-like increase on 2005 is around 27%.

Private equity investment in the U.K. increased by 50% to £10.2 bn into 1,318 companies. These 1,318 U.K. companies represent 81% of all companies backed by U.K. private equity firms in 2006, but just 47% of the total equity invested (compared to 58% in 2005).

Overseas investment in 2006 by U.K. private equity firms shows a marked increase on 2005. Total overseas investment reached £11.6 bn in 2006, up nearly two and a half times from £4.9 bn in 2005 and representing 53% of total investment (compared to 42% in 2005). (However this figure is most affected by the changes discussed in footnote 7 below).

Investments were made in 312 overseas companies in 2006, an increase of 37% over the previous year. Most investment outside the UK (£10 bn) was in **continental Europe**. A total of 214 companies received investment, more than double the number funded than other overseas territories combined. The amount of investment in continental Europe was only slightly less than the sum invested in the UK, but the average investment size was much larger (£47m compared to £8m the UK).

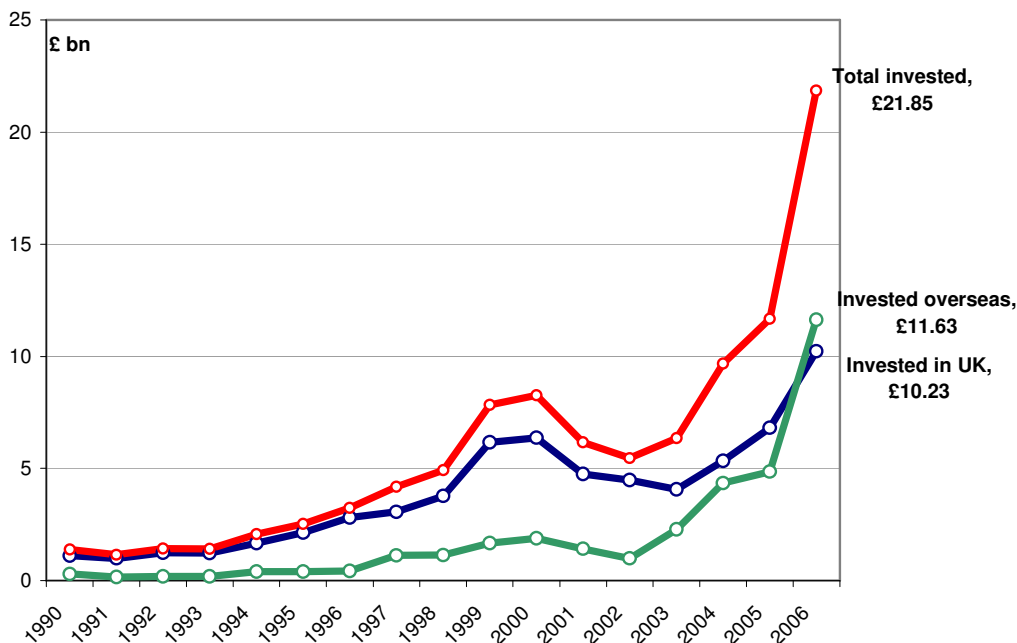


Figure 7 - Funds invested (U.K.) – 1990-2006

Divestments

Of the US\$33bn divested by private equity firms across Europe in 2006, US\$24bn was accounted for by U.K. firms. The highest amount (£2.8 billion) was divested through repayment of preference shares or loans, with trade sales (£2.5 billion), divestments on IPO/floatation (£1.413 billion) and sales to another private equity firm (£1.4 billion) the next largest categories.

⁷ A recent change to BVCA methodology means 2006 figures apply not only to investments undertaken by BVCA member firms, but also those on which member firms were lead adviser regardless of where the investment fund is domiciled. This change mostly affects the data relating to overseas investments, rather than that relating to the U.K.

U.K. investment in the post-credit crunch era

A recent report in the *Financial Times*⁸ discussed the investment options for those U.K private equity funds sitting on large funds and seeking to identify potential investment targets in an economic downturn.

Large buy-outs on the scale of the £11bn takeover of Alliance Boots in 2007 are considered to be unlikely as banks will be unwilling to add to the substantial buyout debt on their books until their balance sheets are repaired.

Private equity firms may however aim to take **strategic stakes** in particular targets (e.g. TPG's announcement to invest £179m for a 23% stake in Bradford & Bingley, the troubled specialist mortgage lender).

Another option is to target **small cap companies** where finance for deals is still available (generally reckoned to be for companies with a market capitalisation of less than £500m). The Carlyle group recently revealed it was considering a bid for Filtronic, a maker of microwave and radio frequency components.

A third option, yet to be seen in the UK, is to **acquire leverage** or buy companies that already have large amounts of debt compared to their equity's market value. The *FT* author offered two potential candidates: Yell, publisher of the Yellow Pages, and Premier Foods, which makes Branston pickle and Hovis bread – both heavily indebted and with private equity backgrounds.

Private equity firms might also **buy leveraged loans** at big discounts (see also the discussion of same on page 6). e.g. Oaktree Capital Management has raised US\$10.9bn for the world's biggest distressed debt fund.

One further option is for private equity firms is to **provide equity to distressed companies** (e.g. TPG's investment in Bradford & Bingley). As banks' lending standards tighten, companies will turn to the equity market for money. However, the volume of rights issues has been such that the institutions who underwrite these cash calls could soon suffer fatigue.

So far this year, a total of £22.8bn has been raised through rights issues in the UK, more than any previous annual total since 1980, according to UBS, which thinks the desire to fund these issues is likely to wane. UBS has compiled a list based on a methodology from Standard & Poor's, the credit rating agency. This includes a number of debt and coverage ratios, such as interest cover and free operating cash flow to debt. Companies which score poorly on a combination of these measures include Kingfisher, Debenhams, Pennon, Rexam, National Grid, United Utilities, Mitchells & Butlers, Punch Taverns, BBA, Tate & Lyle and Rentokil Initial.

For private equity, such investments obviously lack the glamour of a leveraged buyout, but they do have a number of advantages. Buying whole companies requires a premium to be paid. This is not the case in "rescue" situations; if the stake is large enough, there is the prospect of board representation (TPG will get two seats on the Bradford & Bingley board).

⁸ 'Discounted deals remain available for private equity', *Financial Times*, 6 June 2008

Investment by growth stage and investment size

As the BVCA puts it, "private equity firms are investing more in the companies they choose to back". Although the number of UK companies receiving investment increased by just 11 in 2006 (to 1,318), the amount invested increased by 50% to £10.2 bn.

Nearly two-thirds of total UK investment (61%) went into a combination of management buy-out (**MBO**) and buy-in (**MBI**) activity, but the nominal rise in the amount invested in MBOs/MBIs conceals a drop of 5% on 2005 and 16% on 2004 in the proportion of total funds so invested. This shift in allocation has been mostly to the benefit of early stage companies, particularly start-ups, and those businesses receiving expansion finance.

Investment in start-ups increased considerably in 2006 to £531m in 245 companies (from £160m in 208 businesses in 2005), again indicating larger investments.

Total expansion stage financing rose by 53% to £2.99 bn (in 573 businesses), although it remained stable as a proportion of the total invested, accounting for 29%.

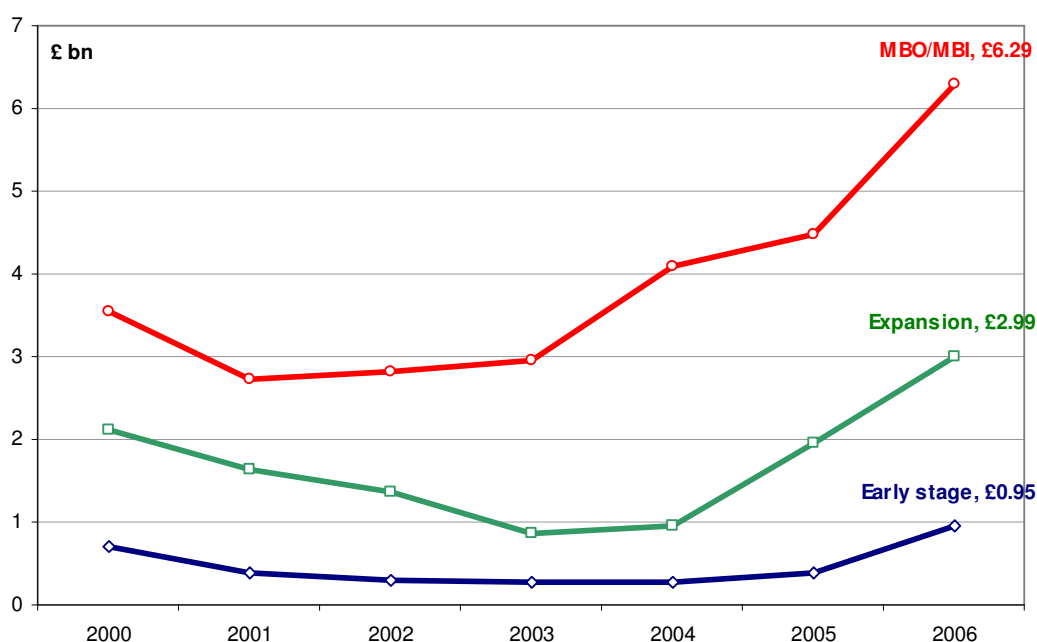


Figure 8 - Investment by growth stage (U.K.) – 2000-2006

Management buy-outs and buy-ins

Within the MBO/MBI group the allocation to MBOs increased markedly in 2006. Well over half (59%) of total UK investment in 2006 went to funding MBOs compared with 2% in MBIs. The amount invested in MBOs increased to £6.0 bn in 2006 compared with £3.7 bn in 2005, with 339 firms receiving funding in 2006 against 259 the previous year.

The proportions of the number of MBOs when divided into bands of small (<£10m), mid-sized (£10m-£100m) and large (>£100m) investment have remained roughly constant since 2004 (see Figure 9), however in 2006 those deals larger than £100m received a smaller proportion of investment funds than in 2005 – £3.2 bn was invested, representing 53% of total MBO investment in 2006 compared to 62% in 2005.

	% of companies			% of amount invested		
	2006	2005	2004	2006	2005	2004
Small (<£10m)	76%	78%	68%	7%	9%	18%
Mid-sized (£10-100m)	21%	18%	28%	40%	29%	53%
Large (>£100m)	4%	4%	4%	53%	62%	29%

Figure 9 – MBOs by investment size band (U.K.) – 2004-2006

The proportion invested in mid-sized deals (£10m-£100m), however, increased to £2.4 bn, representing 40% of the total MBO investment compared to 29% in 2005. There were 256 small MBOs with less than £10m of equity receiving £431 m, compared to 201 in 2005 receiving £343 m, showing a slight fall in the proportion by both number of deals and amount invested.

Management buy-in activity was lower than in the previous two years. Just 26 buy-ins received £217m of funding in 2006, compared to 49 receiving £744m in 2005. Most of these (19) were in the small category, attracting £50m of investment. There were no large buy-in deals, but in the mid-sized category, seven companies received the lion's share – £167m, representing 77% of total MBI investment.

Correlations between investment and firm size

In 2006, each company receiving private equity investment received, on average, £2.2m compared with £0.8m in 2005. The amount of private equity provided is generally related to the size of the company receiving the funding; i.e., a small company is likely to receive smaller amounts of investment. Early stage or expanding companies tend to require finance to start up their business or to develop part of it. Private equity for management buy-outs and buy-ins helps to finance the acquisition of an entire company, which means that the sums involved are generally larger.

As some of the largest deals skew the average amounts invested and the average figure cited above, Figure 12 shows the actual spread of private equity investment size. The trend is similar to the previous two years and is cited as evidence of the private equity industry's commitment to financing smaller businesses. In 2006, 39% of companies financed received amounts less than £200,000, and 68% received less than £1m. These companies include those that were funded through VCTs and those receiving follow-on investment. Only 10% of all companies financed in 2006 received amounts greater than £10m.

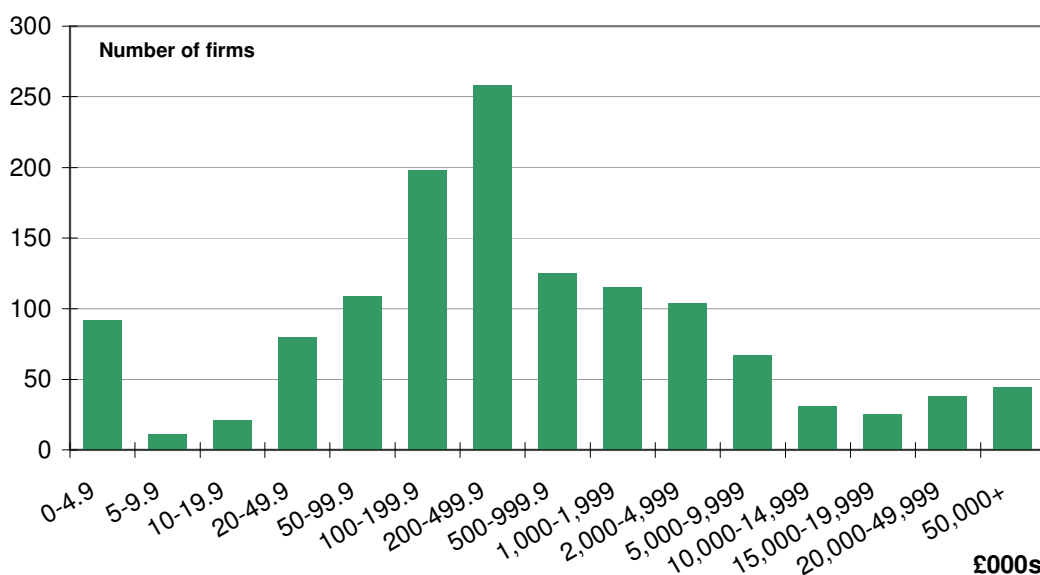


Figure 10 – Private equity received by companies (U.K.) – 2006

Investment by industry sector

Three sectors, **consumer services**, **industrials** and **health care**, received 72% of the total amount invested in 2006 (see Figure 11).

The largest proportion, a third, went to consumer services, which attracted £3.3 bn, a 2% rise on 2005. The number of companies receiving investment increased by 13% to 261, however, bringing the average deal size down slightly from £14m in 2005 to £12.7m in 2006. Within the sector, more **general retailers** attracted funding than any other subsector, but the amount invested was less. Across all sectors and subsectors, **travel & leisure** attracted the most investment. A total of 83 companies received £1,880m, 19% of the total amount invested. The average deal size was also greater, £22.7m in 2006 compared with £17.2m in 2005.

In the **industrials** sector, the **construction & materials** subsector attracted by far the most investment, with £1.1 bn of the £2.8 bn total invested in the sector going to 26 companies. The highest number of companies receiving funding was in **support services**, where 85 firms attracted £521m.

The third most popular sector, **health care**, attracted investment totalling £1.1 bn in 2006, well over double the amount invested in 2005. Most funding went into **health care equipment & services**, where 140 firms received £973m, representing a substantial increase on 2005. Far fewer companies in **pharmaceuticals & biotechnology** (90 in 2006 against 138 in 2005) attracted funding, although the overall amount invested was higher at £210m compared with £130m in 2005.

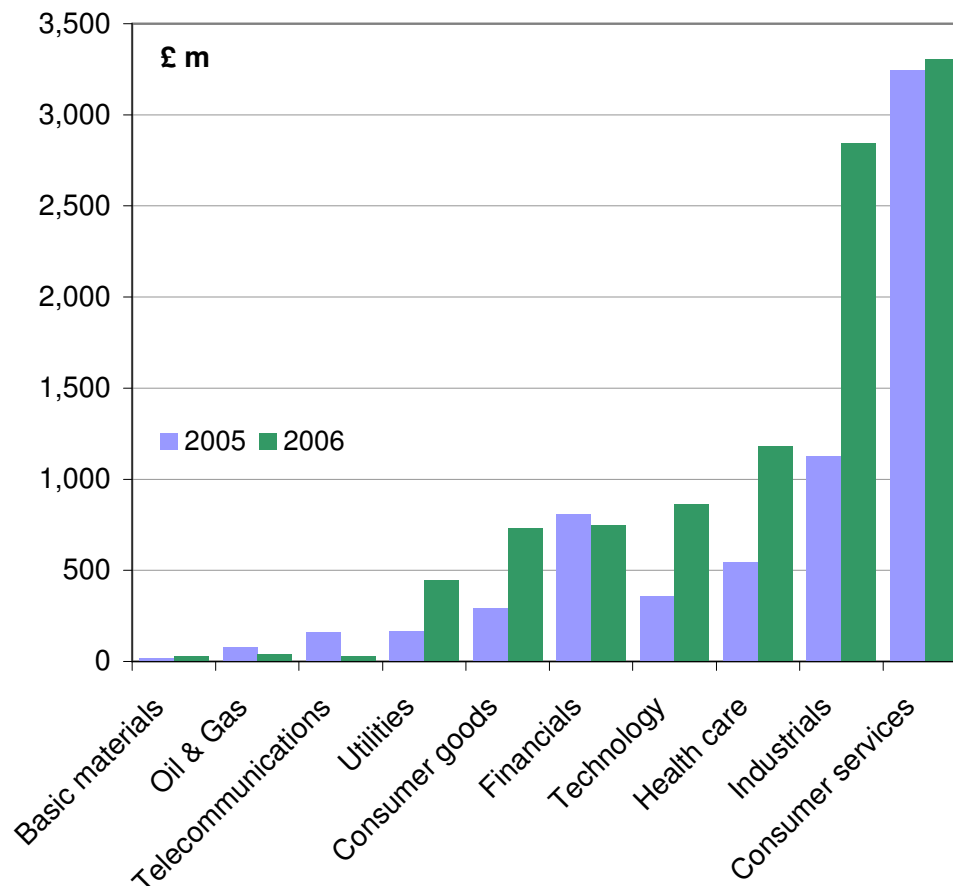


Figure 11 - Investment by industry sector (U.K.) – 2005-2006

Investment in **technology** companies increased significantly in 2006, with a 35% increase in investment to £918m, although there was a decline in the number of companies financed (517 down from 644 in 2005). This still means that 39% of total UK businesses receiving private equity funding were technology-related.

Investment in **computer-related** companies (involved in hardware, internet, semiconductors and software) accounted for 47% of all technology companies backed and 34% of the total investment amount, yet again remaining the most active subsector of this industry. Most of the computer-related companies financed were in **computer software** – 196 companies received £231m in 2006 (compared to 180 firms receiving £150m in 2005). Most of these firms (101) were in the early stages of their development and received a total of £91m.

As in 2005, **communications** companies received the most funding of any other individual technology sector – £243m in 36 companies (compared to £197m in 58 companies in 2005). The bulk of this investment (£152m) was in four MBO/MBI companies.

Investment increased in **biotechnology** firms in 2006 with £122m going to 43 companies. This is more than double the amount invested in 2005 (£58m), but a drop in the number of companies financed (from 67 in 2005). As a result, this will mean some much larger investments than last year and, in fact, a large proportion of the funding in this sector (78%) went into three MBO/MBIs.

Source of funds

UK funds raised £34.3 billion in 2006, 26% higher than the amount raised in 2005 (£27.3 billion). Pension funds continued to be the most active private equity investors. Overall, they provided £9.9 bn, 29% of the total raised, down slightly a 31% contribution in 2005. Overseas pension funds were by far the biggest contributors, providing £7.9 bn against the £2 bn committed by UK funds, but nevertheless the UK share increased by 37% in 2006.

The lower amount of funds raised during 2004 reflects a stage in the fundraising cycle rather than a downturn – 2004 saw mainly mid-market fundraisings. Some very large funds were out in the marketplace raising new funds, reflected in the figures for 2005.

Cyclical variations in the amount of private equity funds raised each year as it is strongly influenced by the prevailing economic climate and the timing of the maturity. In recent years there have also been an increase in the number of significantly larger buy-out funds raised, partly due to a maturing UK private equity market becoming increasingly pan-European in its focus and the fact that some of the large US private equity houses have set up offices in London to take advantage of investment opportunities more easily reached from a base in the UK.

Funds raised by source

29% of all funds raised in 2006 came from **pension funds**. Of the total £9.9 bn raised from pension funds, nearly 80% (£7.9 bn) came from overseas based pension funds.

16% of all funds raised in 2006 came from “**funds of funds**” (i.e. an investment fund that uses an investment strategy of holding a portfolio of other investment funds rather than securities). Of the total £5.3 bn raised from funds of funds the bulk (71% - £3.8 bn) was again raised from overseas sources.

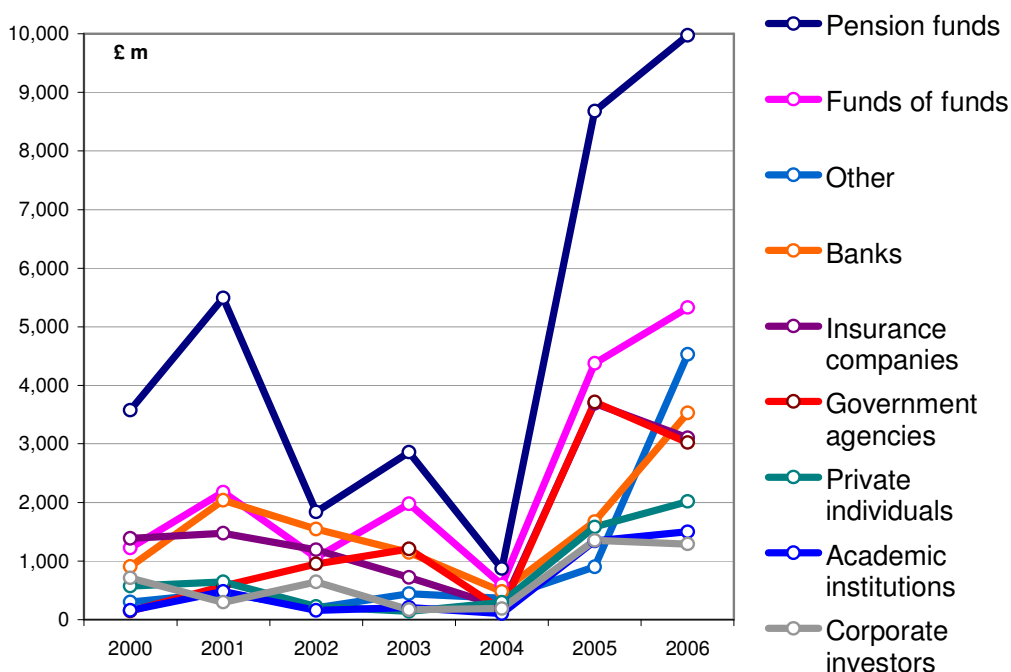


Figure 12 - Funds raised by source (U.K.) – 2000-2006

Funds raised by country

72% of all funds raised in 2006 came from overseas investors: the **United States** accounted for 37% (£12.6 bn) of the total amount raised, **continental Europe** 22% (£7.5 bn – of which the **Netherlands** accounted for £1.3 bn and **France** and **Germany** £0.9 bn each), and **Asia** 18% (£1.4 bn).

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