

# Myths and challenges

How do private equity investors create value?  
A study of 2012 European exits



Building a better  
working world

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# Foreword

We at the European Private Equity and Venture Capital Association (EVCA) welcome the eighth EY annual study of how European private equity investors create value. Over the years, these studies have consistently demonstrated how private equity investors successfully drive sustainable growth and improvements at the companies they back.

And this year is no exception. While the economic backdrop has been challenging for some years, the private equity industry has continued to deliver outperformance to investors through the development of mostly fit, healthy and expanding companies.

Yet this year's report is framed slightly differently to previous years – a move we fully support. One of our principal roles at the EVCA is to help those outside the industry understand how PE operates. The last few years have seen criticism of PE from a number of different sources. This year's report demonstrates clearly that the principal arguments put forward by the industry's detractors – that private equity cuts jobs, strips assets and relies on leverage for returns – are myths. The results of EY's independent analysis fights anecdote and fiction with fact: private equity grows employment, creates more valuable businesses and generates returns through strategic and operational transformation.

The report also highlights two areas of genuine concern to the industry – the dual challenges of a weak economic backdrop and insufficient levels of transaction activity. The EVCA is supporting the private equity industry to help manage these challenges, through a combination of promoting the industry to entrepreneurs and investors, networking between members to facilitate the exchange of ideas, representing the interests of private equity and venture capital among politicians and regulators and nurturing industry excellence by providing guidance and training on professional standards.

The European private equity industry today has an indispensable role to play in the region's economy. Europe needs the investment at company level and experienced hands-on support, which private equity is uniquely placed to provide to non-listed businesses. The next few years will not be easy for the European economy and for our industry, but if we continue to adapt to difficult market conditions the way we have since the onset of the financial crisis, we will emerge even stronger and better able to take advantage of the opportunities that will arise in good times and bad.



**Vincenzo Morelli**  
EVCA Chairman 2012-13

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## Executive summary

This is the latest of our annual studies looking at if and how private equity (PE) investors create value. Since we started this project in 2005, we have used a consistent set of criteria to select our study group: European-based businesses owned by PE, with enterprise value (EV) of more than €150m at the time of PE investment, or “entry.” Each year, we research the latest exits by PE houses from this group to analyze the performance of businesses throughout PE ownership. Through our analysis, our intent is to understand and explain whether and how PE adds value to the businesses it backs.

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*Myths and challenges* is the eighth of our annual studies on how PE creates value in the companies it backs in Europe. It is also the fifth year in succession that the study has been set against a challenging economic backdrop, with Europe in particular facing a high degree of uncertainty over its economic prospects.

Inevitably, as the Eurozone crisis persisted through 2012, exit numbers dropped last year to 61, a fall from 2011's tally of 85. One explanation for this was the lack of opportunity to list portfolio companies as stock markets remained volatile – there were just three PE-backed companies in our study population that exited via IPO. Another was the withdrawal of many European trade buyers. Of the exits to trade, European corporations accounted for just 40% by number, the lowest proportion recorded in any of our studies. US trade buyers remained constant, however, accounting for 10 of the exits, the same number as in 2011. Against a weaker economic backdrop, creditor exits increased.

Since we started these studies, we have consistently shown PE's ability to generate outperformance over public markets for its investors. We have provided clear evidence that PE improves the businesses it backs through an active ownership approach in partnership with management teams.

However, despite this and plenty of other evidence complementary to our own, PE faces a number of criticisms that may appear to suggest otherwise. Three frequent charges against the industry are that it cuts jobs, strips assets and relies solely on leverage for its returns. With eight years of data that we have gathered on businesses exited by PE in the course of these studies, the facts show that these three critiques are myths. In reality, PE as a whole expands employment while achieving productivity gains. The vast majority of PE-backed companies are worth more than their entry value – even double it, in some cases. And finally, PE returns evidence the strategic and operational improvements from its ownership.

But the data also tells us something else. PE faces two very significant challenges. The first is the economy. With Europe and many other regions showing little or no GDP growth over such a prolonged period, the PE portfolio has inevitably been affected. Profits growth in businesses exited in the boom times was running at over 15% a year; the figure for businesses exited in the last two years has fallen markedly to 5%. This is faster growth than benchmarked public companies have achieved annually over the same period, but it is clear that driving growth in the portfolio has become very difficult indeed. The effects of this will undoubtedly lead to some stress in the industry as investment returns decline, resulting in some PE firms struggling to raise a new fund.

The other challenge is PE's low activity since the crisis hit. New investments and particularly exits have slowed as a lack of confidence continues among buyers and sellers of all types. On an aggregated basis, the PE portfolio has remained static over the last few years. At 2012 exit activity levels, it will take 13 years to sell, implying an average hold period of 11 years.

Clearly, the low level of exit activity against a weak European macro environment is a challenge PE needs to confront. Yet overall, our study shows that PE as an industry continues to have a positive story to tell.



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# Key findings

The UK's largest PE portfolio companies have grown capital productivity by 11% a year since acquisition.

## Facing up to reality

The world's economy continues to stutter. Volatility is a fact of life. Europe remains in recession. Company growth is hard to achieve. These are the realities of today's markets. Success in adversity requires razor-sharp focus on what really matters. This is why, for this year's European PE value creation study, we have sought to separate truth from untruth and fact from fiction.

As PE has grown in stature and importance to the overall economy over the last decade, it has attracted increased levels of attention, not all of it positive. The 2012 US presidential campaign drew global attention to the PE industry. In addition to political bias, a number of accusations have been leveled at the industry by various politicians, corners of the media and union representatives, among others. Yet the particular criticisms that PE has faced – that it destroys jobs, strips assets and relies on leverage alone for returns – are off base.

The reality, however, is that PE does face two very significant challenges: the state of the economy and low exit activity. These are the issues that really matter to PE. Slow profit growth and a lack of confidence in M&A markets continue to put substantial pressure on a number of portfolio companies, PE funds and the industry as a whole.

## The myths

### Myth 1: PE-backed businesses cut jobs

The critics would have it that PE firms engage in job destruction, cutting workforces and indiscriminately closing down factories and business operations.

### The facts

PE grows employment. Our analysis shows that employee numbers increased annually across the portfolio by 2% from entry to exit. Our sample of exits runs from 2005 right through to 2012 and therefore includes the four-year period since the downturn began. This is clear evidence that, across both good and bad times, PE makes a net contribution to employment growth.

In addition, on a comparative basis, PE's employment record holds up well. Our analysis shows that employment growth in comparable public companies over the same period is broadly similar at 2.2%.

Yet, more importantly for the companies it backs, PE increases not only employment but also productivity. Labor productivity for companies in our sample increased by over 7% a year from the time PE acquired the business to the point of exit. In studies we have conducted for the British Private Equity and Venture Capital Association (BVCA), we have also found that capital productivity increases in PE-backed businesses. The UK's largest PE portfolio companies have grown capital productivity by 11% a year since acquisition.

This dispels another popular myth: that productivity gains come at the expense of employment numbers. In fact, this finding leads to a different conclusion. PE's ability to focus on productivity improvements creates fitter, more profitable companies that are in the best position to grow and therefore increase headcount.



# 2%

Rate of employment growth for PE-backed companies from entry to exit.

# 80%

Our research shows that over the long term, 80% of realized PE investments achieved a positive return for investors.

## Myth 2: PE houses are asset strippers

German politician Franz Müntefering once described investors such as PE houses as “swarms of locusts that fall on companies, stripping them bare before moving on.” Asset-stripping is also a common charge against the industry in the media.

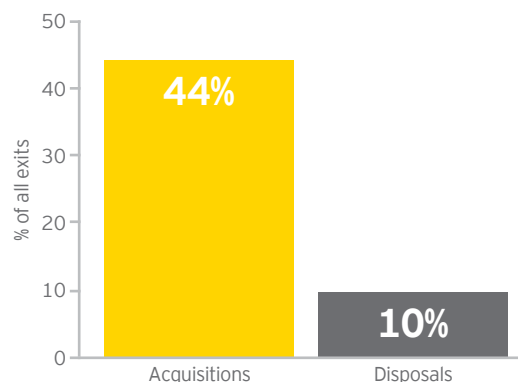
### The facts

Of the three myths that have grown around the industry, this one shows the greatest lack of understanding of how PE firms operate. In reality, it is not in PE’s interest to strip out assets. The industry’s model is predicated on creating long-term value in the businesses it backs. PE reaps rewards only when its portfolio companies are successful. When the time comes to exit there has to be a strong, sustainable business for PE to sell on to strategic buyers or other financial investors or list on the public markets in order for PE to generate returns for its investors. Our research shows that over 80% of realized PE investments achieved a positive return for investors.

PE focuses on absolute value growth through capital investment and hands-on involvement in its portfolio companies. For example, PE executes more add-on acquisitions than disposals. Nearly half of the businesses in the portfolio made add-on acquisitions to the businesses they had backed to build scale and to add new markets/segments to portfolio companies.

Meanwhile, just 10% of businesses owned by PE in our portfolio made disposals. Even when we examined land disposals, R&D figures and employee pensions, there was no evidence that PE stripped out valuable assets. Where disposals are made, PE’s thesis tends to center on refocusing on the core business or repositioning into more profitable business lines. The reality is that these disposals are likely to create more sustainable value in a business as unprofitable parts of the company are sold and management can concentrate on more promising areas.

Figure 1: Incidence of disposal and acquisitions in PE-backed businesses

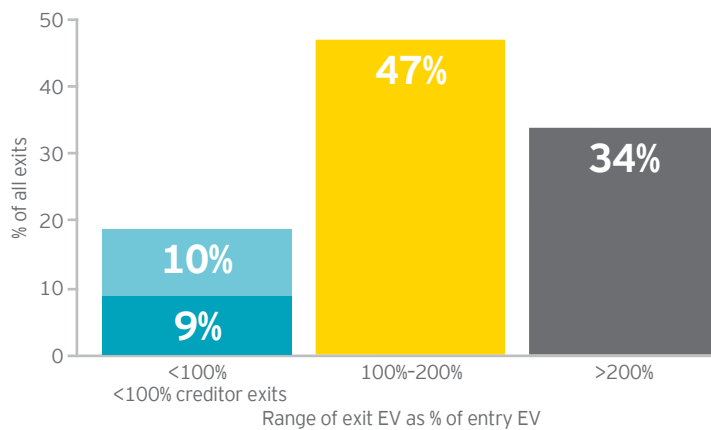




In recent research into the largest UK portfolio companies we conducted for the BVCA, we found that capital employed in these businesses had increased by 25% from the time of acquisition. This clearly demonstrates PE's focus on investment to generate value. In addition to capital, PE's active management style means that executives are represented on company boards, help refine and execute strategy and provide access to valuable contacts to support companies on their growth path.

This combination of investment and hands-on support leads to genuine value creation. Our analysis shows this. Over a third of PE-backed businesses in our sample doubled entry EV by the time they came to exit. Although 19% of the businesses in our study were less valuable at the time of exit, the majority of PE-backed businesses were more valuable at exit than they were when acquired. Significantly, these values do not include gains from any disposals made during the investment period – they represent the value created in the core business.

**Figure 2: Exit EV\* as % of entry EV**



\* Exit EV is of the last business exited i.e., excludes proceeds from disposals during the hold period

### Myth 3: PE is just a leveraged market play

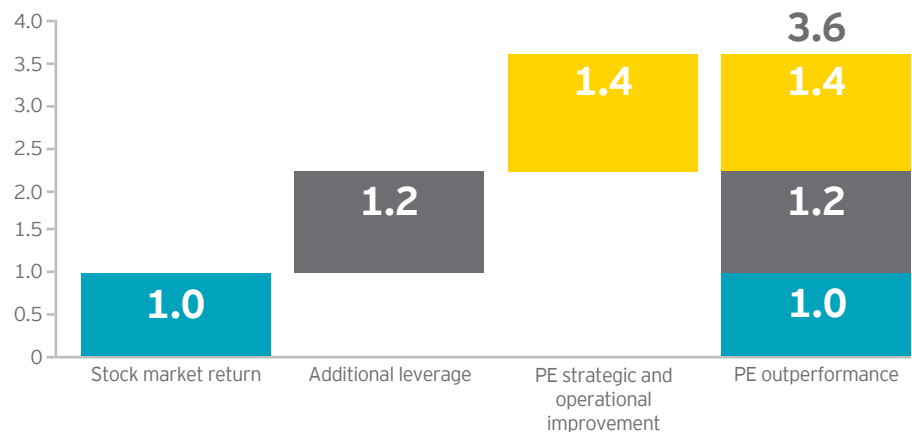
This charge against PE is that returns generated by PE are simply the result of adding leverage to the businesses it backs.

#### The facts

Over the years we have conducted this study, our returns attribution analysis has consistently pointed to PE's strategic and operational improvement measures as delivering outperformance. This shows that PE gross returns – i.e., before fees and charges – are more than leverage and market returns. For exits in our sample between 2005 and 2012, stock market returns (those from comparable public companies) account for 30%, leverage for under 35%, while fundamental improvements to the additional business account for over 35% of outperformance. While there is some variation in these percentages from year to year, strategic and operational outperformance has always made up the largest proportion of returns generated by PE in each of our eight annual studies. Even with the difficult economic conditions we have witnessed, where measures such as profit growth have been harder to achieve, and absolute returns have declined, this still holds true.

Overall, PE gross returns on exits have outperformed comparable public companies in the 2005-12 period by a factor of 3.6x. This has provided PE investors, such as pension funds and insurance companies, with a source of outperformance at a time of low interest rates and volatility in many other asset classes.

Figure 3: PE gross return versus public market, exits 2005-12



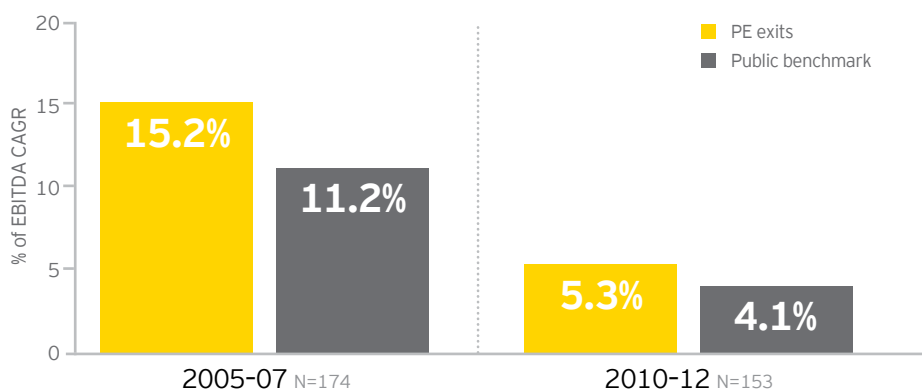
The reason for this outperformance is simple. The PE model is based on buying the right companies, at the right price, and partnering with and incentivizing high-quality management teams to deliver sustainable growth in value. Our analysis has shown that PE firms will often identify target companies up to a year – in some cases longer – before acquisition to ensure they understand where businesses can be grown and improved and know they can work in partnership with management. Our studies have also pointed to PE's widespread use of 100-day plans and specialist advisors post-deal to implement fundamental changes to portfolio companies and to focus management on value creation.

## The challenges

### Challenge 1: The economy

The prolonged nature of the downturn has clearly had an impact on the PE portfolio. Profit growth is the main driver of value creation and has decreased across the board from the boom years as the wider economic environment has adversely affected trading performance. Annual EBITDA growth in European PE-backed companies exited between 2005 and 2007 was 15.2%, significantly above the 11.2% rate achieved by comparable public companies. However, the sample for exits completed between 2010 and 2012 clearly demonstrates the impact the crisis has had: annual EBITDA growth slowed in these companies to 5.3%. This is higher than the figure for comparable public companies, of 4.1%, but it is still a significant drop from historical levels.

**Figure 4: Annual EBITDA growth of PE exits vs. public company benchmarks, by exit year range\***



\*Public company benchmarks matched by deal and comprise all public companies in same country, sector and time frame

PE has demonstrated greater resilience than many had expected in the immediate aftermath of the financial crisis. However, the industry is finding that growing portfolio companies is challenging in the extreme as gloomy economic conditions persist.

This is a real issue for PE. Lower-than-expected growth is inevitably affecting investor returns, pushing out exits and therefore impacting fund-raising as limited partners (LPs) await distributions from invested capital. The effect of this is far-reaching as it jeopardizes the future of some firms. There will be some PE houses that will not raise another fund. Others are having to scale back teams and retrench from some markets in the face of smaller fund sizes which put pressure on the fund economics.

The state of the global economy is clearly beyond PE's control. And while some investments in the European portfolio may well have been acquired – with the benefit of hindsight – at excessive valuations, many were not. PE is using the tools at its disposal to improve the businesses it backs, but the effects on the portfolio of challenging economic conditions are inescapable. PE remains resilient in adversity, but it is not immune to the sustained challenges a low-growth economy brings.

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# 13 years

Estimated time it will take to exit PE's current portfolio (at the current rate of exits).

## Challenge 2: Low activity levels

The economic environment and fall in confidence levels among corporates are impacting PE's ability to execute deals at both entry and exit. Since the onset of the crisis, the PE industry has seen low levels of activity relative to the size of the portfolio, particularly in realizations.

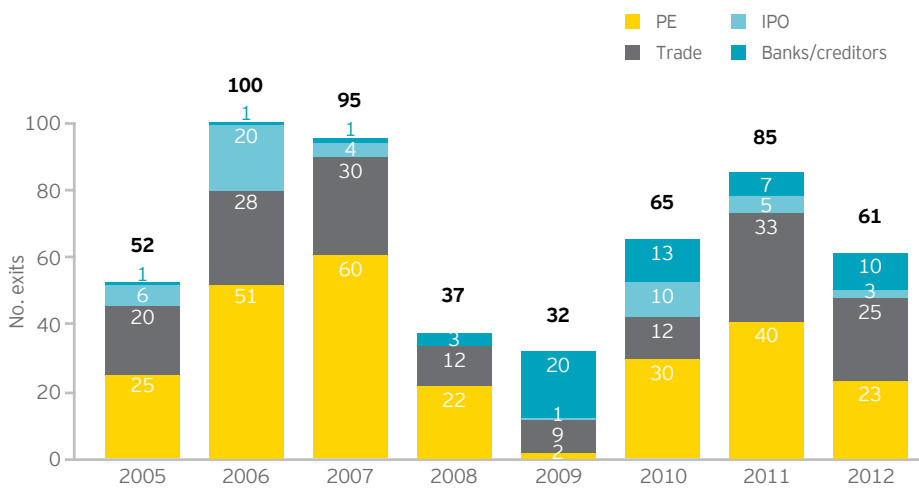
Given the economic uncertainty and low levels of market confidence that prevailed in 2012, it was no surprise that it was a disappointing year for new investments and exits. There was a fall in entry activity, with 92 new deals, from 100 in 2011. Yet the decline in exits was more significant. There were 61 exits from our sample in 2012, down from the 85 exits seen in 2011 and almost on par with 2010 levels.

Volatile stock market conditions meant that IPOs were challenged in 2012 as evidenced by absolute numbers and as a proportion of exits over 2011. And while the proportion of trade buyers increased, European corporations acquired only 10 of the 25 exits that went to trade. At 40% of exits to trade, this is the lowest percentage ever recorded in our study – a clear demonstration of the lack of confidence European corporates experienced in pursuing M&A strategies. However, at 10, the number of trade exits that went to US buyers remained the same as in 2011. This is just one sign that international buyers are becoming an increasingly important source of exits for PE, while European buyers continue to hold back.

In contrast with 2010 and 2011, when sales to other PE houses accounted for nearly half of exits, secondary buyouts as a proportion of exits fell to just over 35%. After falling in 2011, creditor exits increased in 2012 as the prolonged downturn took its toll on some businesses in the portfolio.

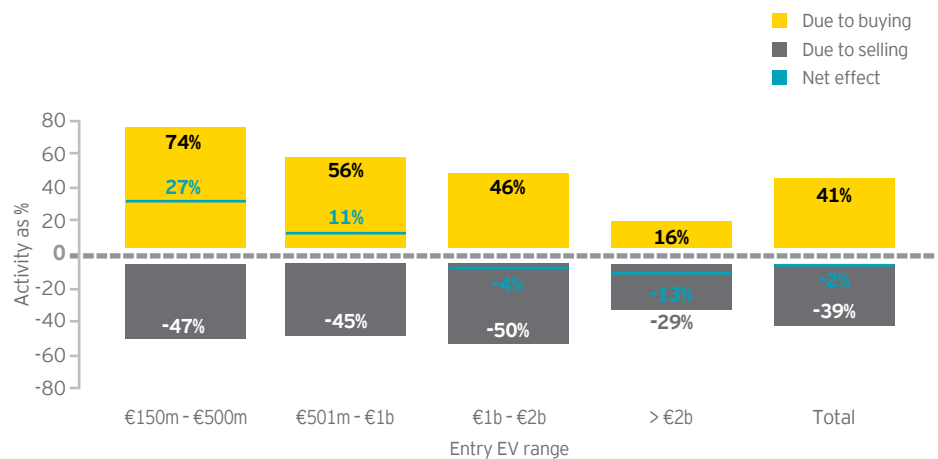
Last year's reduction in exit numbers has added to the pressing problem of the exit overhang. As a result, the average hold period in our sample increased further in 2012 to 4.7 years – the longest period in our series of studies. There are currently 777 businesses in the current portfolio with 61 exits in 2012. Based on these figures, it will take 13 years (or until 2025) to exit the current portfolio, resulting in an average ownership period of over 11 years. This will stretch the patience of LPs, management teams and PE firms alike.

**Figure 5: PE exits by year by exit route**



All segments of the market are facing much reduced deal activity levels. However, our analysis by deal size demonstrates that some areas are more active than others. The smaller deal size segment shows the greatest relative growth of its portfolio in our sample, with the €150m to €500m entry EV bracket growing by 27% between 2007 and 2012. Moving up the deal size spectrum, growth in the portfolio reduces. Investments with an entry EV of between €500m and €1b grew by 11% in the same period, but the two brackets above, €1b to €2b and then over €2b, saw declines of 4% and 13%, respectively, as these parts of the market have been hardest hit.

**Figure 6: Portfolio activity in entry EV 2008-12 vs. 2007 base, by entry EV range**



In all deal segments, the low level of exits over the long term presents a challenge for PE. Making new investments is obviously important, but PE will need to increase its focus on clearing the backlog of companies to be exited to return capital to investors and to prevent a further drag on returns as measured by internal rate of return (IRR). As we have suggested in previous reports, exit rates need to increase two to four fold over the coming few years if this overhang is to be managed successfully.

Nevertheless, low exit activity should not be interpreted as an indicator of the PE portfolio's overall health. Our analysis of companies in the portfolio shows there is value to be generated if PE can find ways of selling businesses. According to our data, 20% may generate a return of less than 1x equity, but over 40% are expected to achieve investment returns of at least 2x equity.

In today's M&A market, the bar has been raised in terms of selling well. PE still has more to do to ready their businesses for sale, widen the buyer pool and create competitive tension.



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# Outlook

The last few years have clearly been a challenging time for PE, with little improvement in 2012. However, many of the accusations leveled at the industry are not borne out by our research. They are myths. As such, they should be of little concern to PE as long as the facts can inform the debate about how the industry operates. The facts are that PE-backed businesses grow productivity and employment and that PE's portfolio companies are more valuable at exit than at entry.

Indeed, there is much that European PE is doing well. Firms are making good progress on preparing for the Alternative Investment Fund Managers Directive, which is currently being transposed into national laws. Once fully implemented, the regulations will enhance PE's reputation with investors and other stakeholders.

As our analysis has shown, some areas of the PE portfolio face significant challenges, but it is expected to deliver positive investment returns overall. This is because the PE model is working even in a difficult environment.

Yet the fact remains that PE needs to generate more realizations. There are some areas, such as the smaller €150m to €500m deal space, that remain more active. However, PE needs the help of a consistent, substantial market that will support an increase in exit activity levels. As we move through 2013, it seems unlikely that the market will be there to help with this challenge. The IPO window cannot be relied on, and European corporate buyers – usually among the most active buyers from the portfolio – remain circumspect.

PE needs to beat the wider M&A market by stimulating strategic interest from trade buyers, particularly those outside Europe. In particular, firms will need to look farther afield for buyers and improve their own selling skills to ensure they can successfully exit. Only by doing this will they be able to crystallize the value inherent in many PE-backed companies for their investors.

Generating successful exits will be the key to securing future funding from investors, who can be patient for only so long. As LPs scrutinize general partner track records ever more closely in the search for PE houses that can perform in good times and bad, those that have provided strong realizations against a difficult macroeconomic backdrop will be in a better position to attract capital.

These are the facts. They show there is plenty to test the mettle of Europe's PE industry. However, our data shows that the PE model remains resilient despite the challenges it faces.



# About the study

The 2012 study provides insights into the performance and methods of PE, based on the analysis of the largest European businesses that PE has owned and exited over the last eight years. The owners of these businesses were not owned or based in Europe themselves; this is not a study of the performance of European-based PE investors, but is rather an analysis of the impact of PE on European businesses.

To avoid performance bias, and to ensure a focus on the largest businesses owned by PE, exits were screened to capture only those that had an EV at entry of more than €150m. This criterion was also applied to our estimate of the current size of the PE portfolio. In total, we have identified 527 exits of businesses that met our criteria over the eight years from 2005 through 2012 – the “sample.”

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

This independent study is built with public data across the whole sample and detailed, confidential interviews with former PE owners of these businesses. Overall, we have performance data for up to 383 businesses or 73% of the total population. Looking across key performance dimensions (e.g., deal size, exit route, incidence of creditor exits), there is no discernible bias in the composition of the sample compared with the whole population. For some of the performance metrics, our sample size is smaller than 383, and there is no significant bias compared with the whole population as measured by EV growth.

## EV growth for the different sub-samples in this study

Performance measure	Sample size	EV growth
Relative returns and portfolio growth by sector, 2005-12	383	12.7%
PE returns compared with the market; Returns from PE relative to stock markets, by entry EV range	377	12.6%
Productivity and employment growth for PE-backed companies	210	12.0%

#### Number of exits in population and sample, by region

	UKI	France	GSA	Nordics	Med	Benelux	Central & Eastern Europe	Total
Number of exits in population, 2005-12	163	88	104	67	50	45	10	527
Coverage (sample as a % of population)	83%	74%	64%	67%	76%	67%	20%	73%

# 527

Number of businesses that met our criteria over the eight years from 2005 through 2012.

Finally, in order to evaluate the performance of PE-backed businesses against comparable public companies, we have compiled data on public companies by country and sector over the same time period as the PE exits in our sample. The data was then aggregated to compare PE performance with that of public companies.

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 database of more than 527 European PE exits. Our study is recognized by many commentators as the authoritative work in this field.

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# PE-backed businesses grow productively

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