BVCA Research & Economics

An introduction to private equity and venture capital

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Background on BVCA

- BVCA is trade body for UK private equity firms
- We have over 500 members, around 230 of which are General Partners (GPs)
- Represent everyone from 3-man (VC) bands to the big buyout houses (Blackstone, KKR etc)
- Produce annual data on activity and performance in the industry
- Lobby and represent the industry to UK Govt., Brussels (with EVCA), etc

Different views of ‘private equity’

- “Private equity is risk capital provided in a wide variety of situations, ranging from finance provided to business start-ups to the purchase of large, mature quoted companies and everything in between.” (Gilligan & Wright, 2010)

- “(Private equity buyouts) leave the company saddled with debt and interest payments, its workers are laid off, and its assets are sold. A once profitable and healthy company is milked for short-term profits, benefiting neither workers nor the real economy.” (Rasmussen, 2008)

Defining 'private equity'

- I prefer a broad definition:

  "medium to long-term finance provided in return for an equity stake in companies, which is later sold to generate a return for investors"

- This covers everything from seed/start-up capital right the way through to buyouts of large global firms
- Leverage, stake and control vary but key features – active management model, incentive structures – are normally similar
- Exits – realising investments – are critical
- Further reading: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1935879

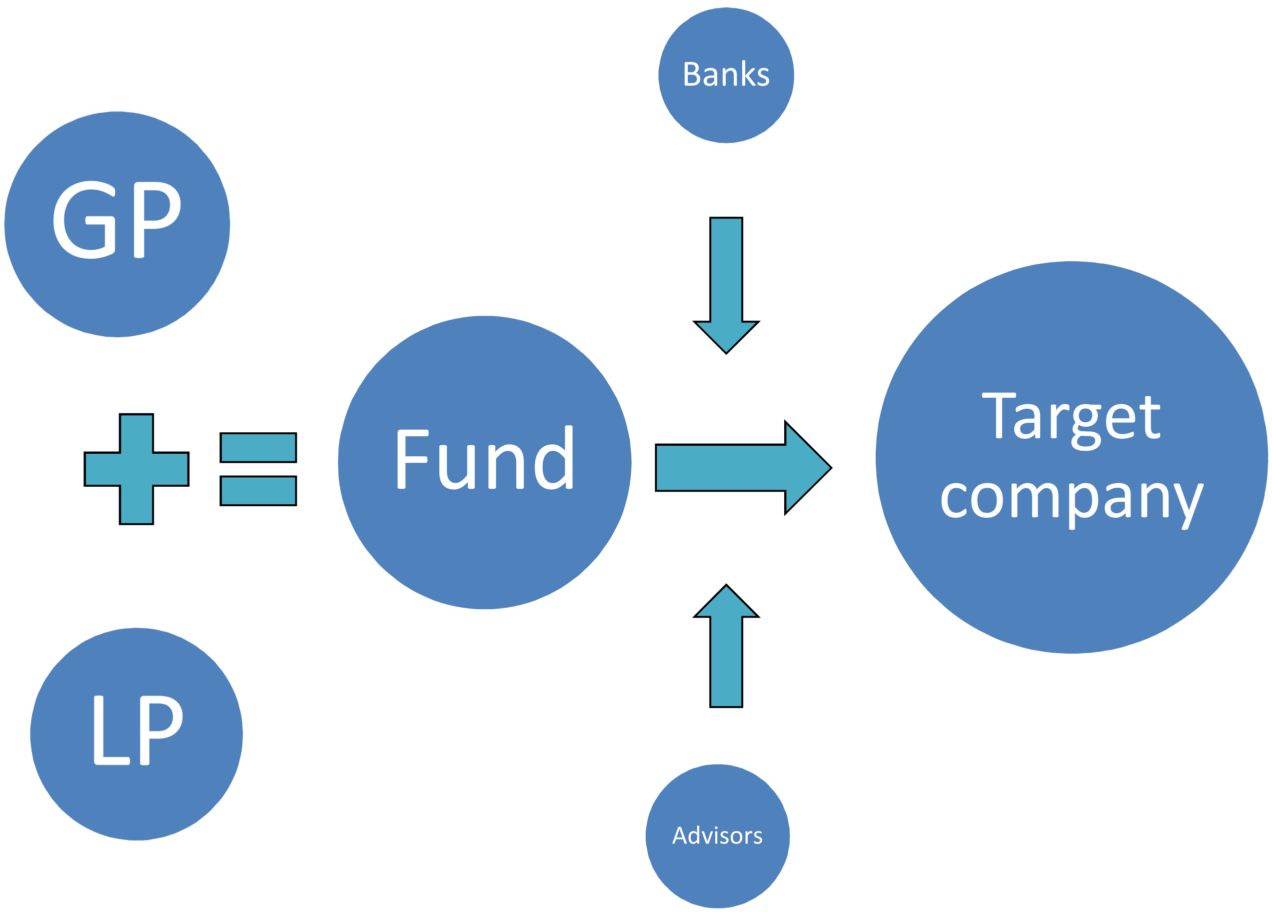
Private equity is everywhere!

Basic structure of PE

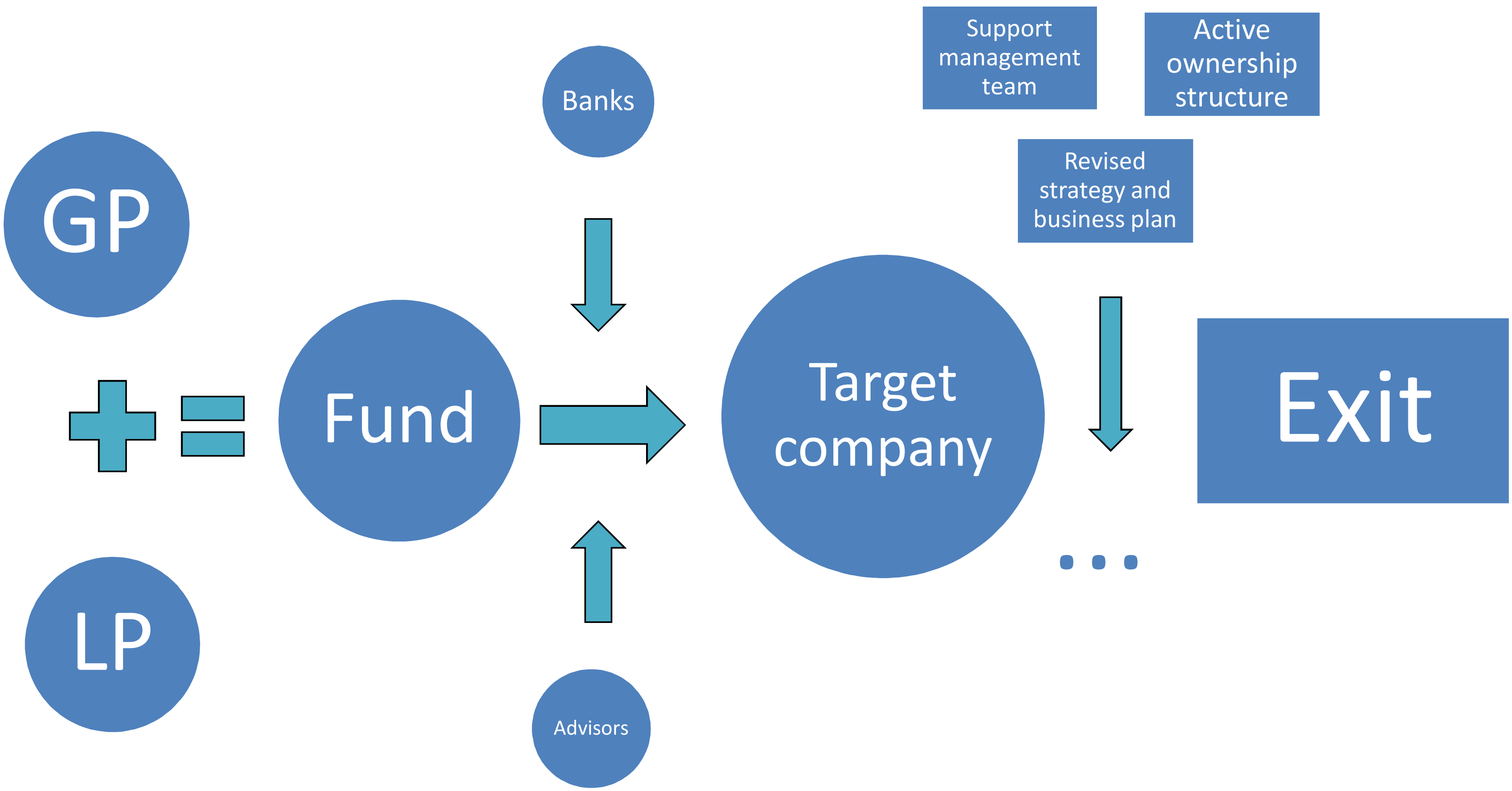
Key players in PE deals

- General Partners (GPs)
  - The fund managers, take active role in developing company
- Limited Partners (LPs)
  - Investors in the PE fund, normally no direct involvement in target company
  - No participation in investment decision
- Investee Company
  - Company receiving investment from PE house
- Other players: banks, lawyers, advisors

PE deal in practice #1



PE deal in practice #2

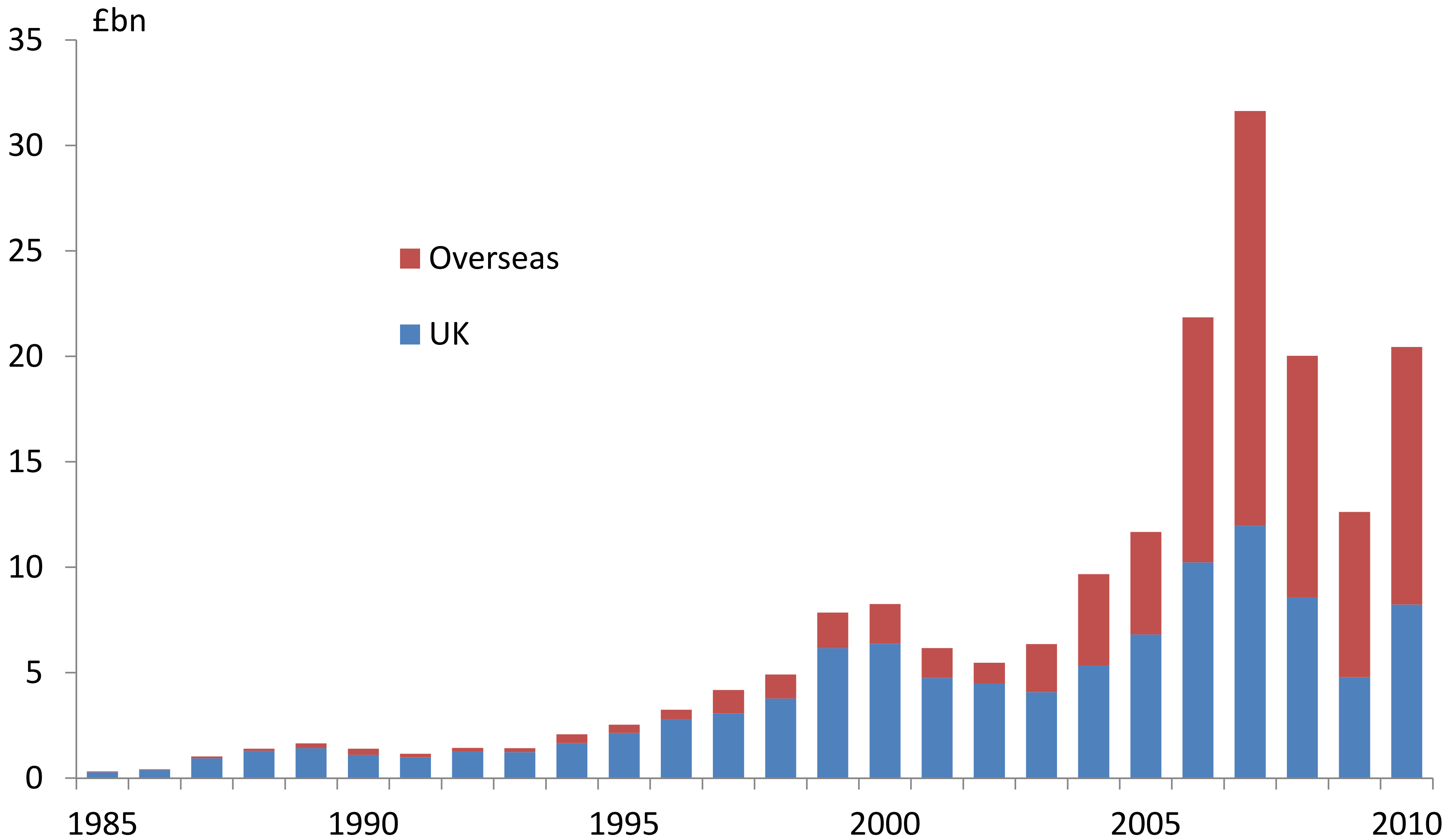


Remuneration structure

- GPs receive standard management fee of around 1.5% or 2% per annum
- Other fees may also apply in specific circumstances (eg investment fees) but are becoming less widespread
- LP agreement (LPA) also sets out carried interest arrangements
  - Carry is when GPs get a share of returns, and is paid after LPs receive a preferred return (hurdle rate)
- Carry and fees give rise to ‘2 and 20’ structure, although this is continuing to evolve

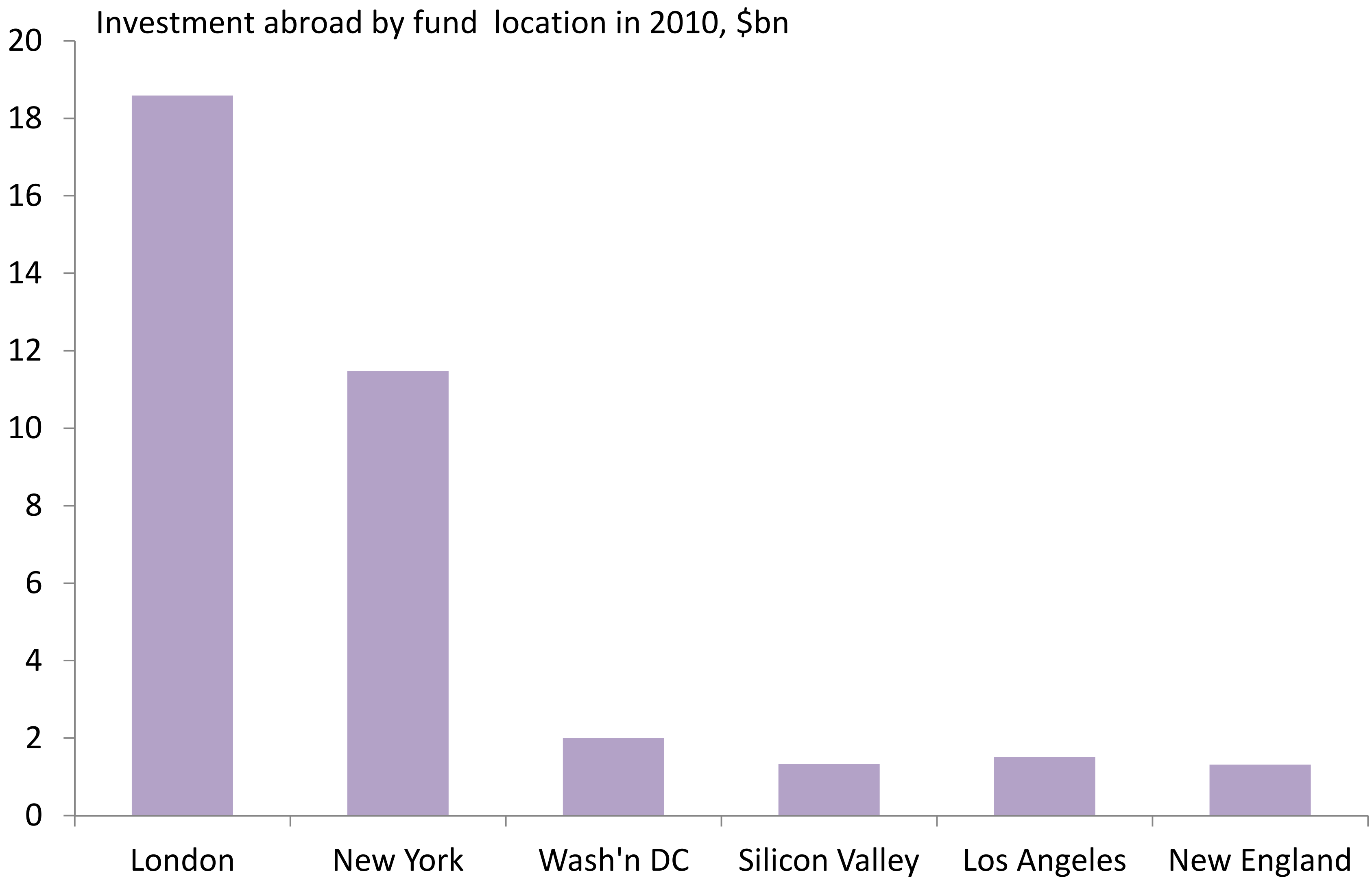
Activity & trends

UK acts as a global hub for PE



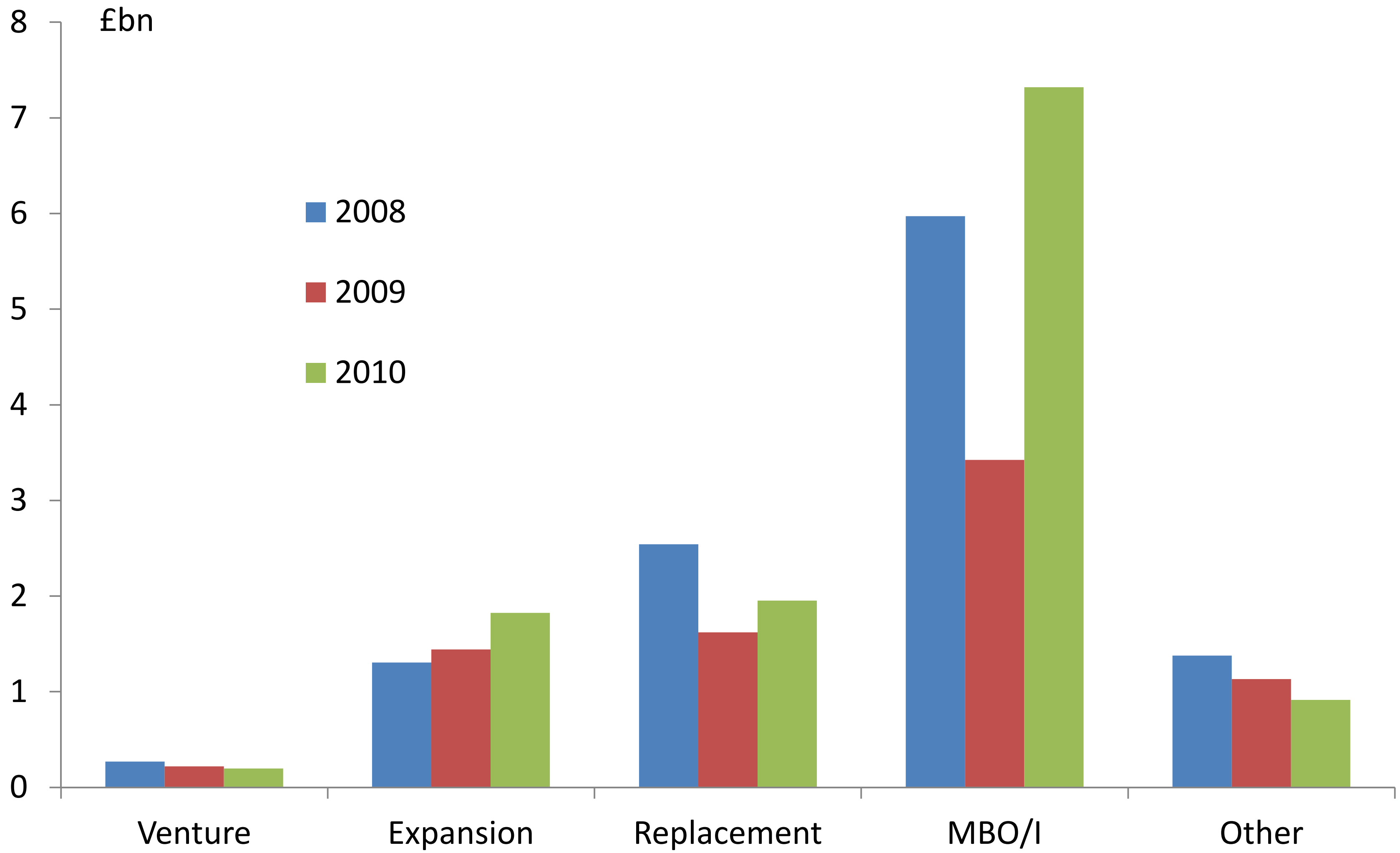
Source: BVCA

London is the global centre



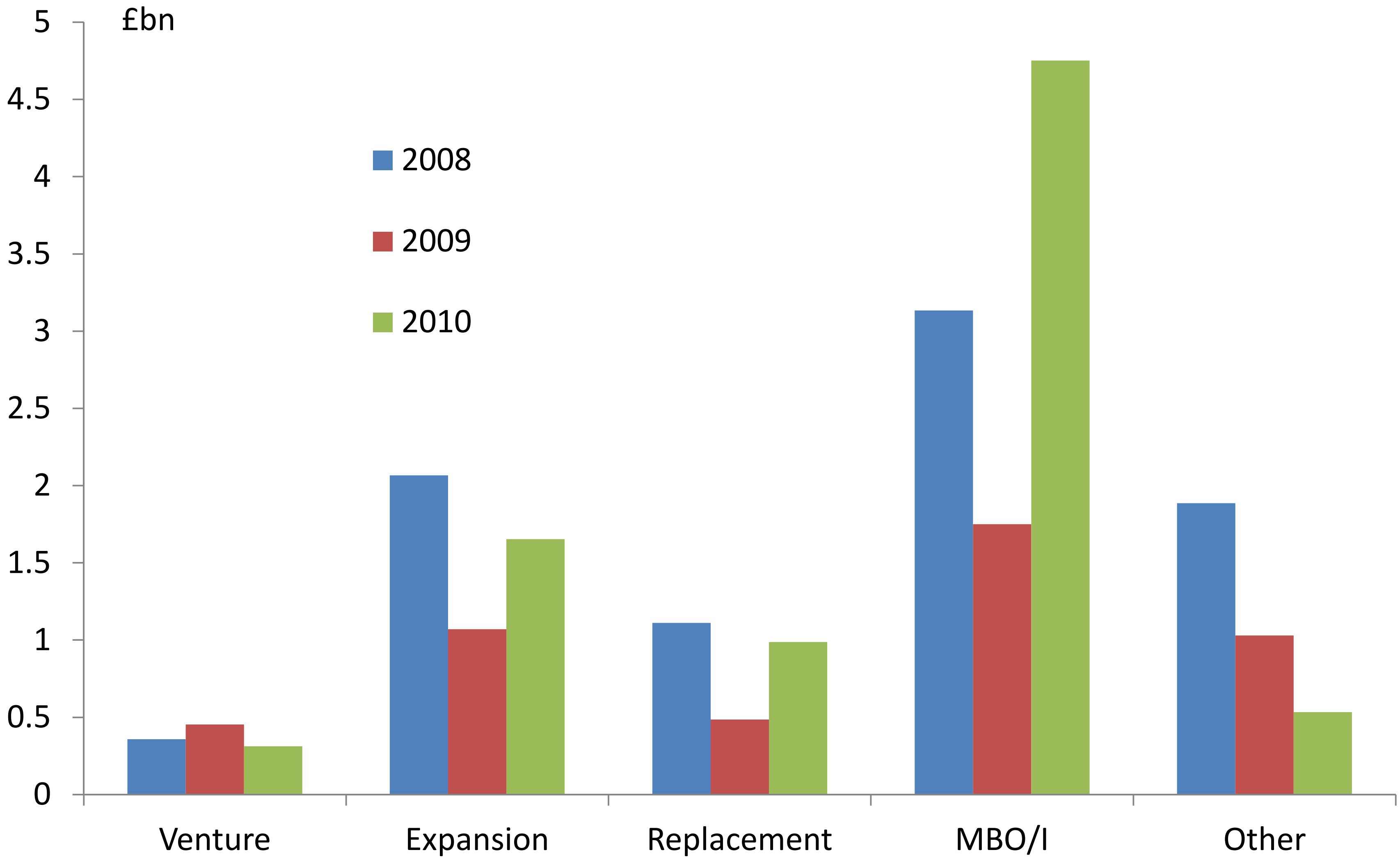
Source: BVCA and ThomsonOne

UK-led overseas investments by stage



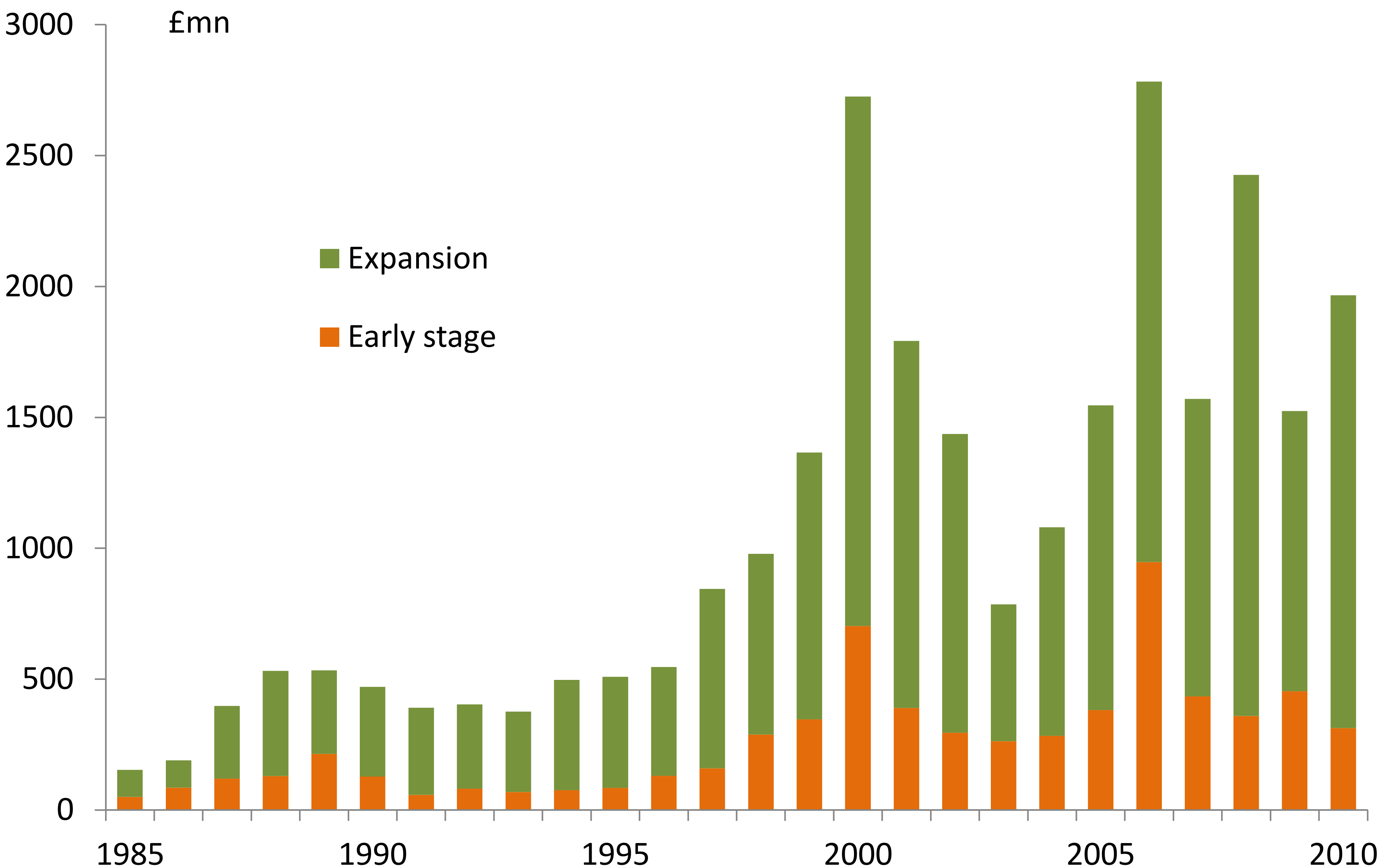
Source: BVCA

UK investments by stage



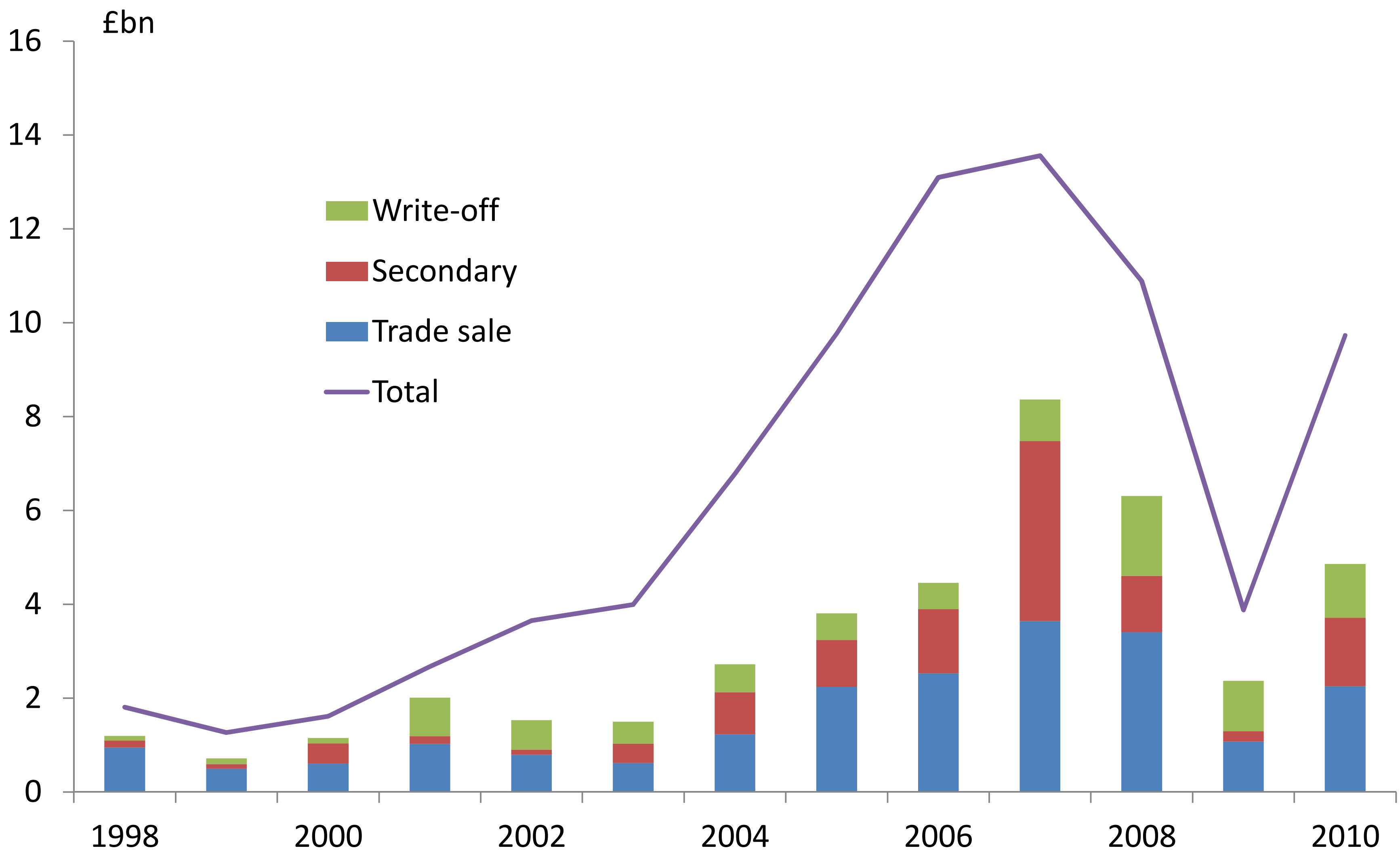
Source: BVCA

VC: early stage vs expansion



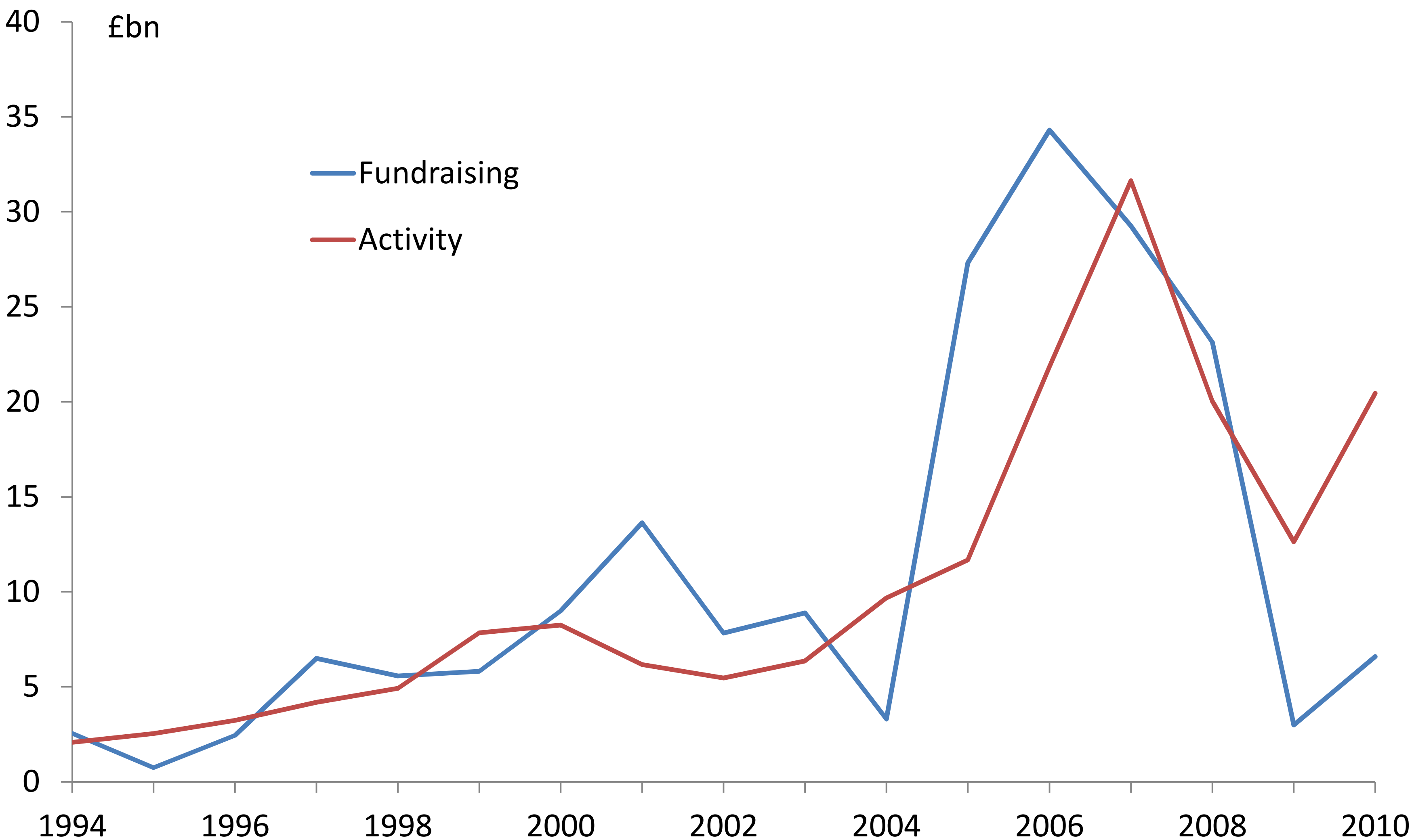
Source: BVCA

Exiting investments is a key concern



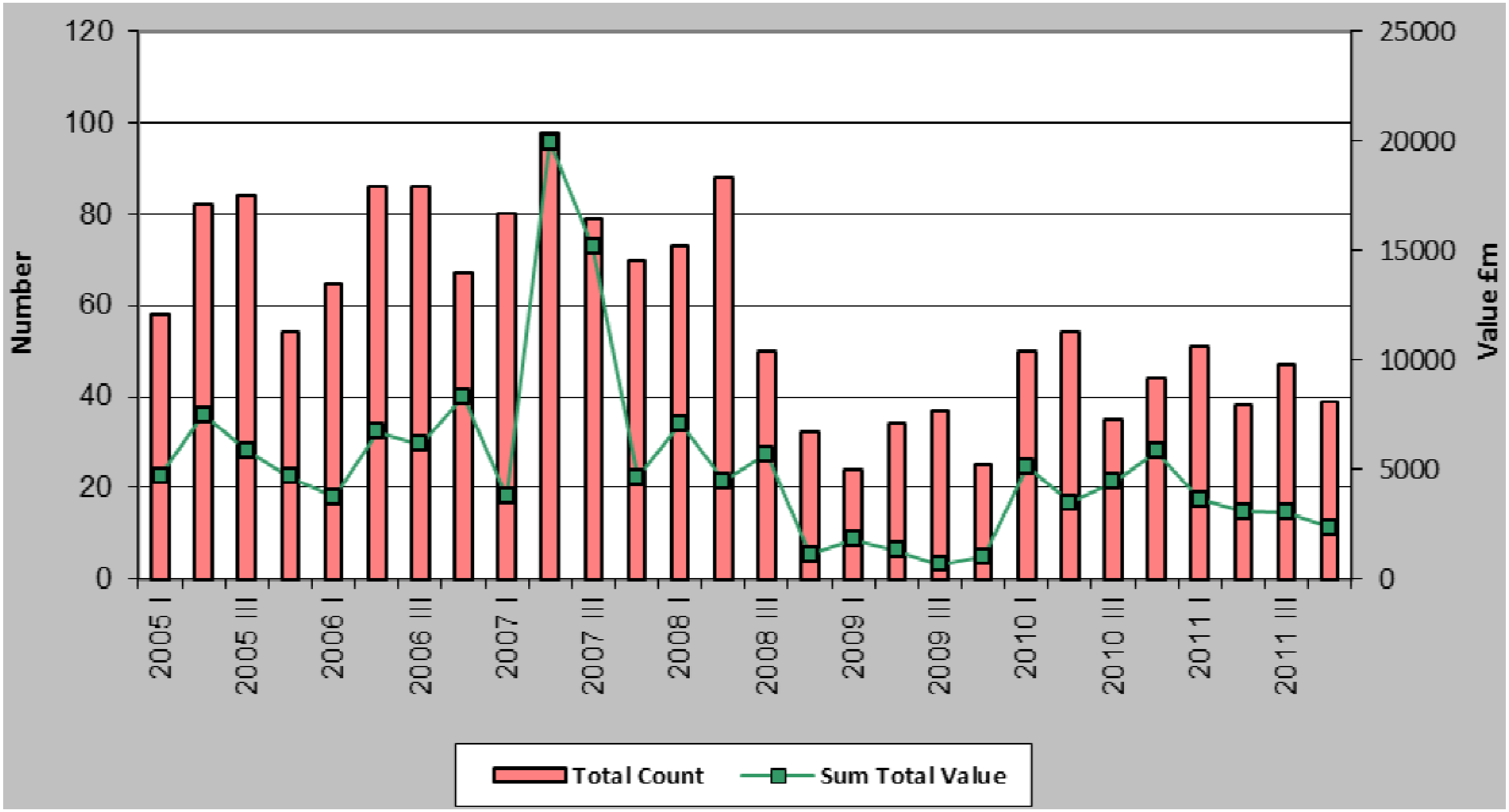
Source: BVCA

Fundraising will continue to lag activity



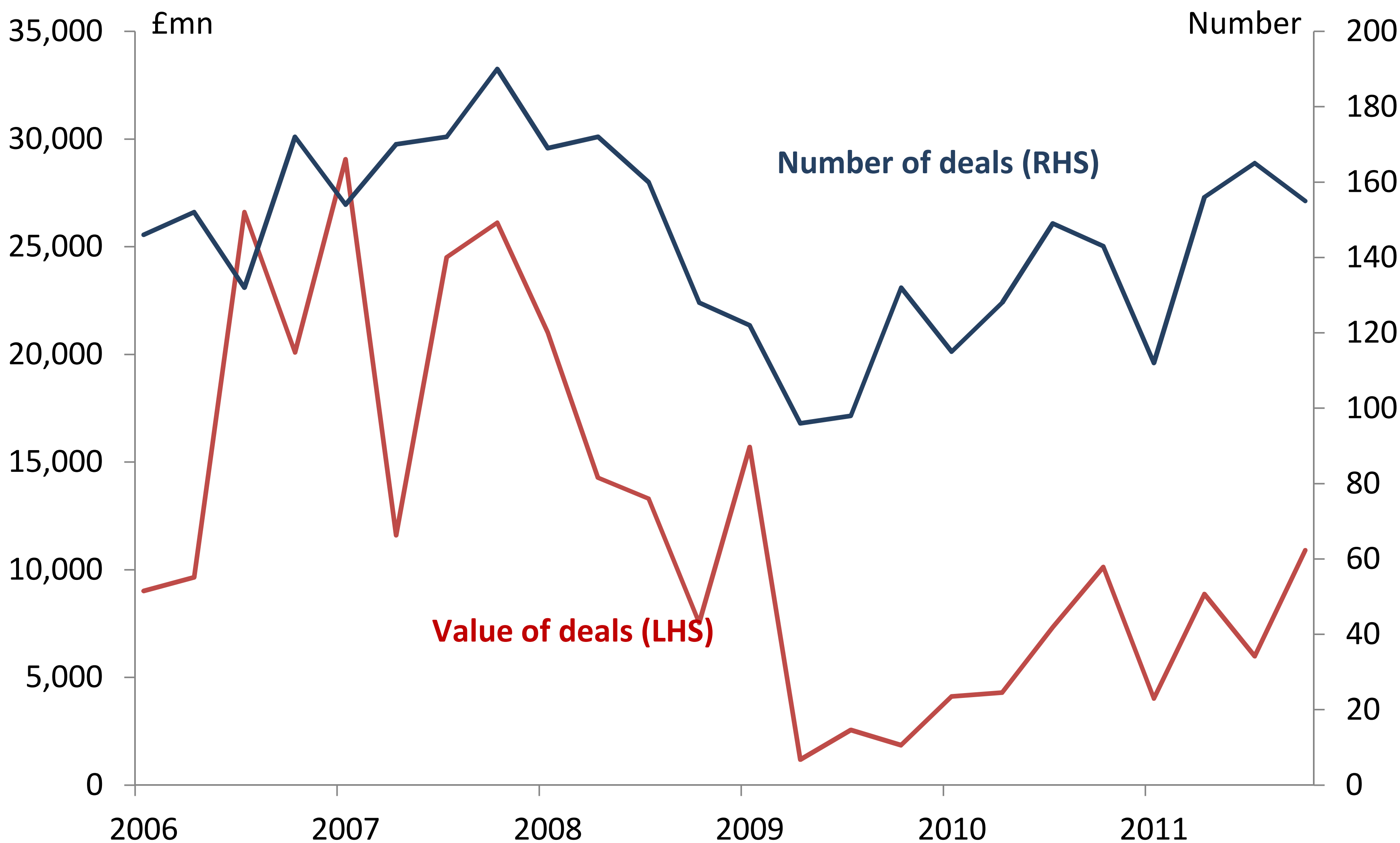
Source: BVCA

Activity disappointed in 2011...



Source: CMBOR

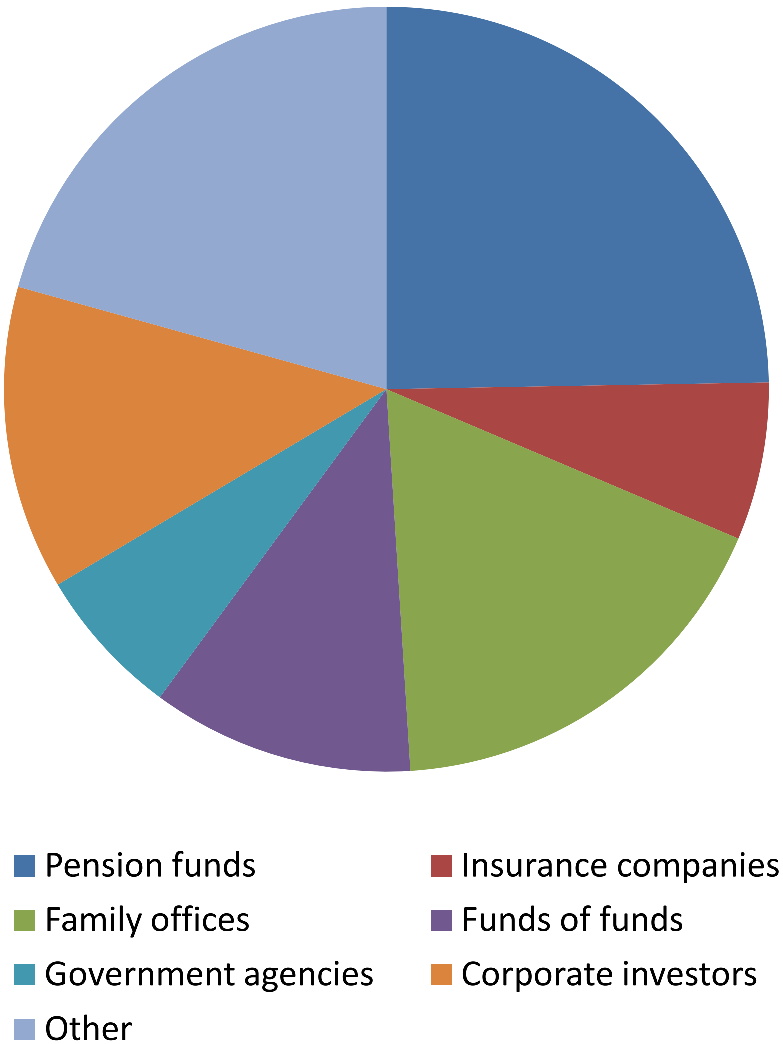
Or has it?



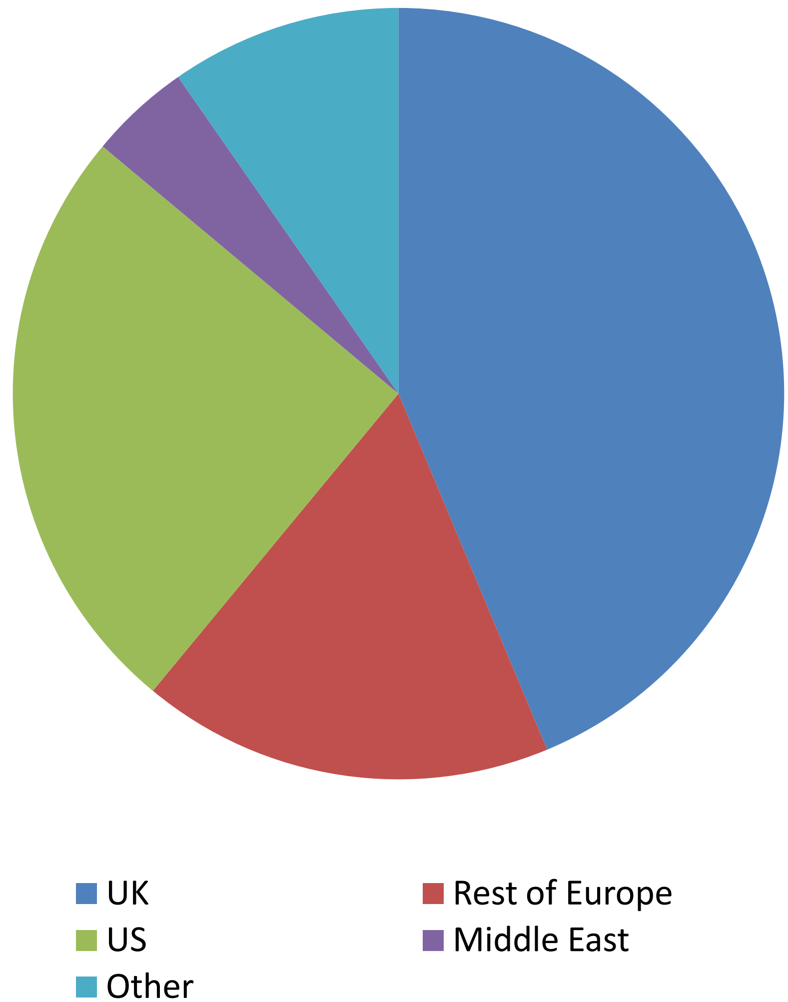
Source: ThomsonOne

Fundraising sources in 2010

By type



By location



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Fund performance

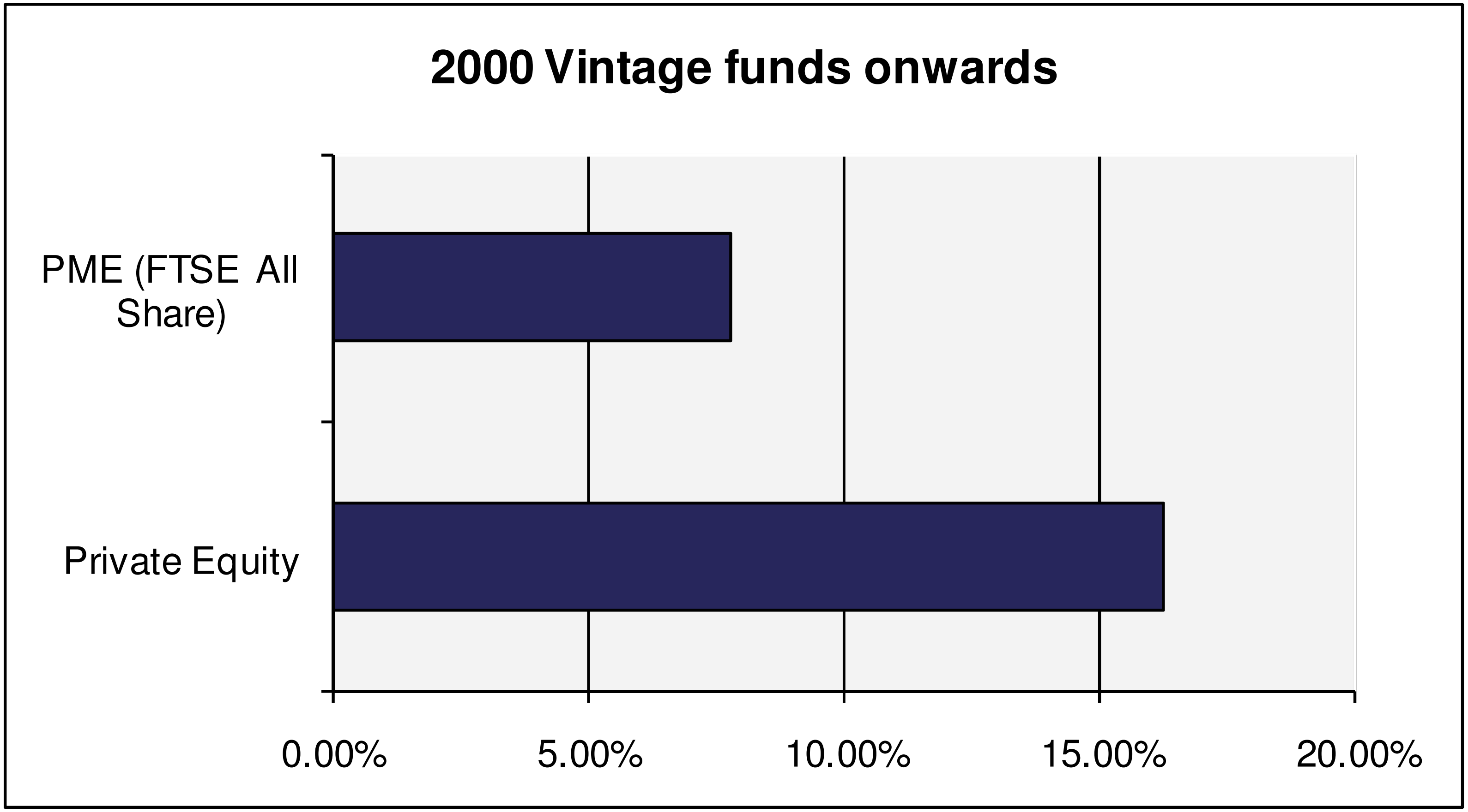
Measuring PE performance

- Multiples measure cash-on-cash returns (eg 2x) but give no indication of timing
- Industry standard is the internal rate of return (IRR)

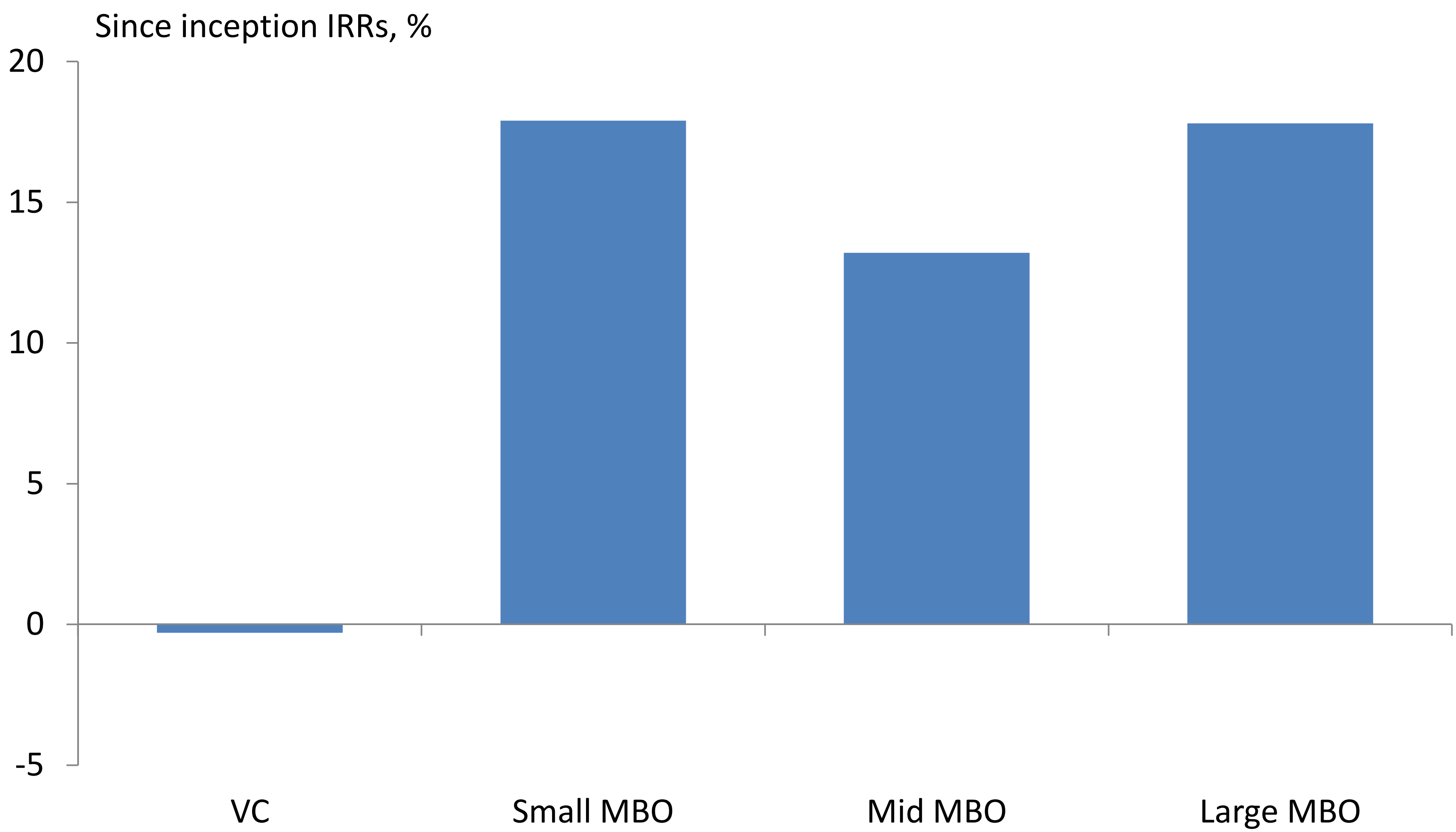
$$NPV = 0 = \sum \frac{C_i}{(1+r)^i}$$

- There are known issues with backward looking IRRs in particular – alternatives methods have been proposed (eg IMIRRs)

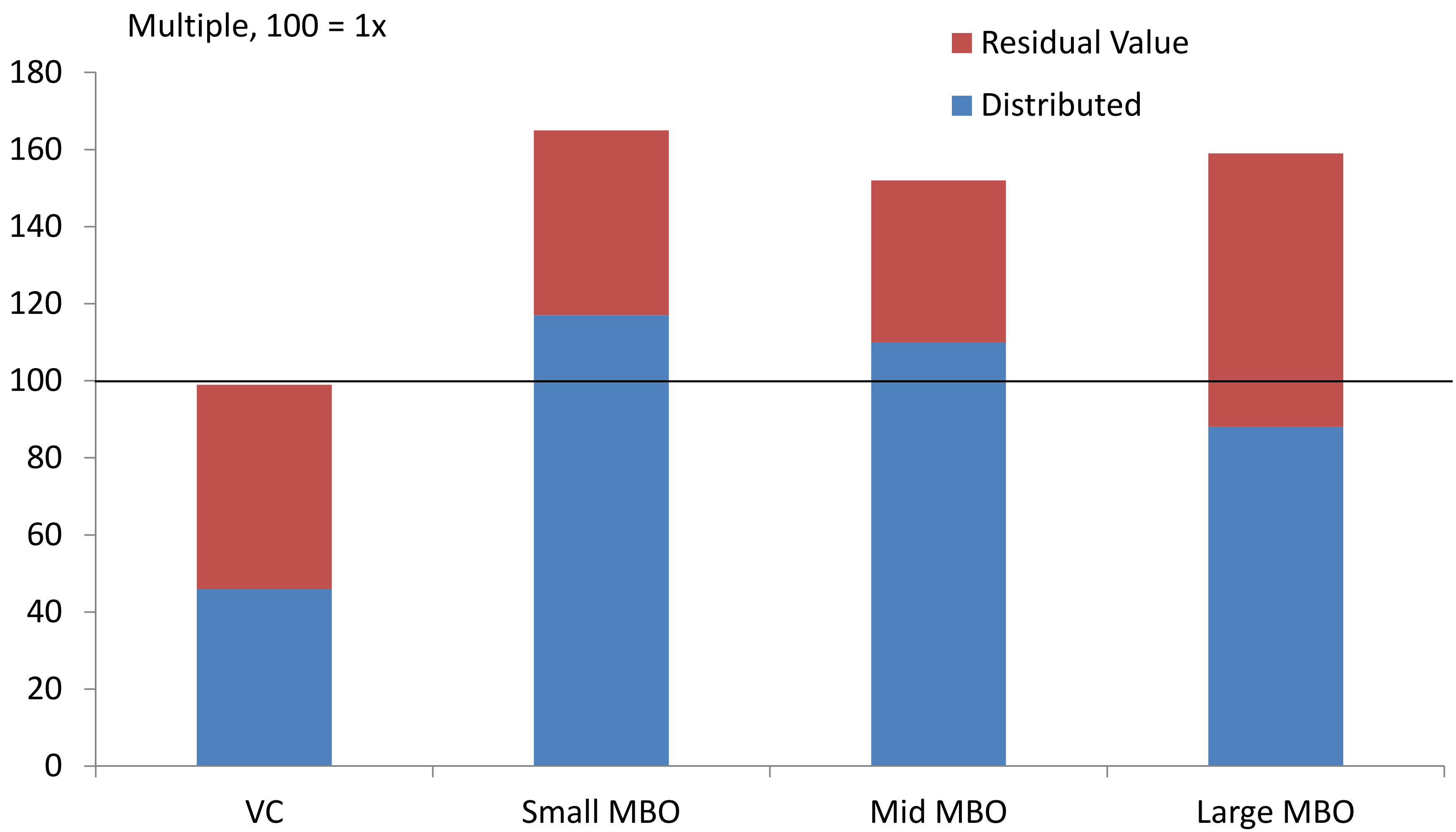
PE outperforms public markets



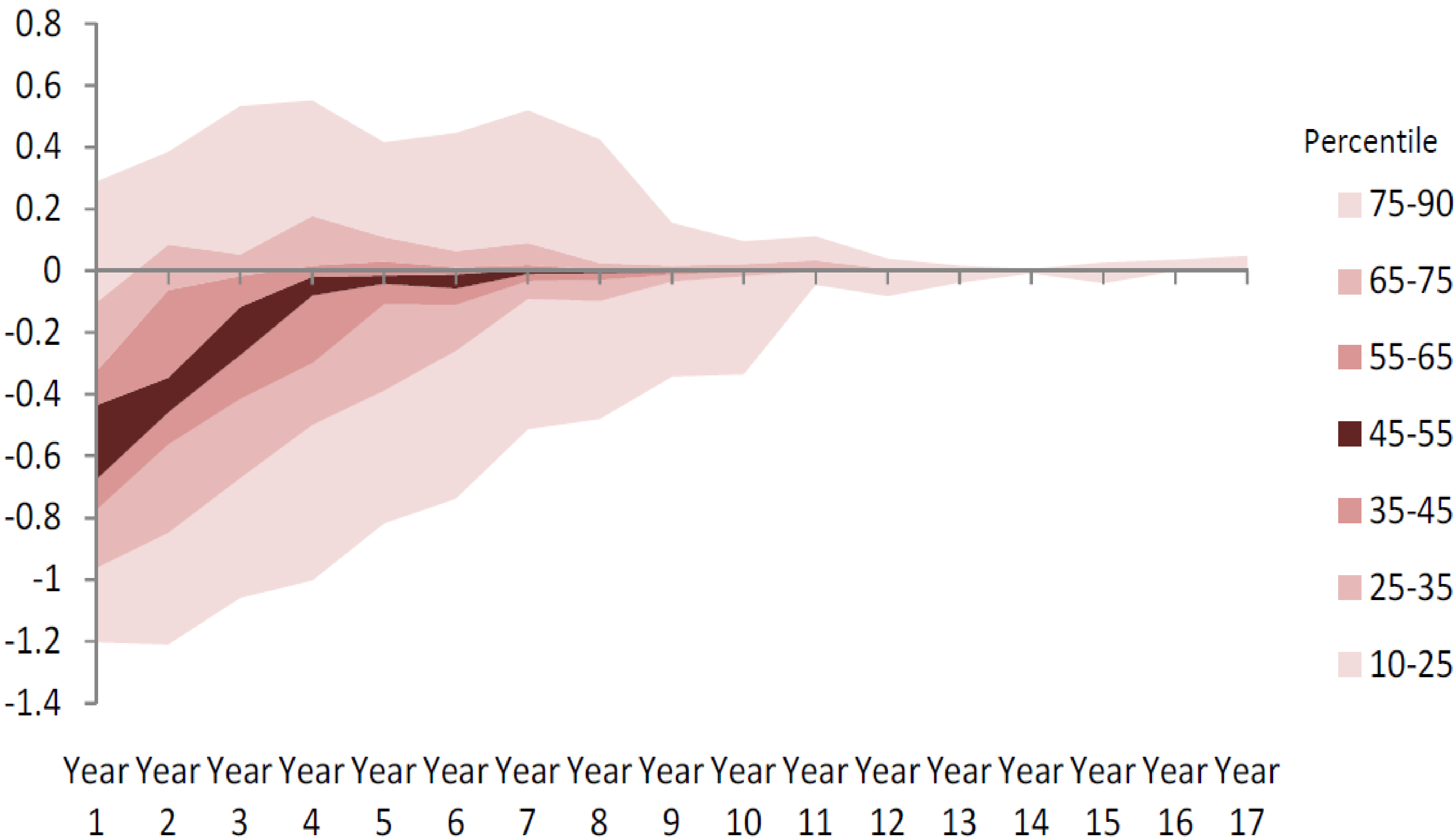
Mid-market delivering good returns



Although valuations still to be realised



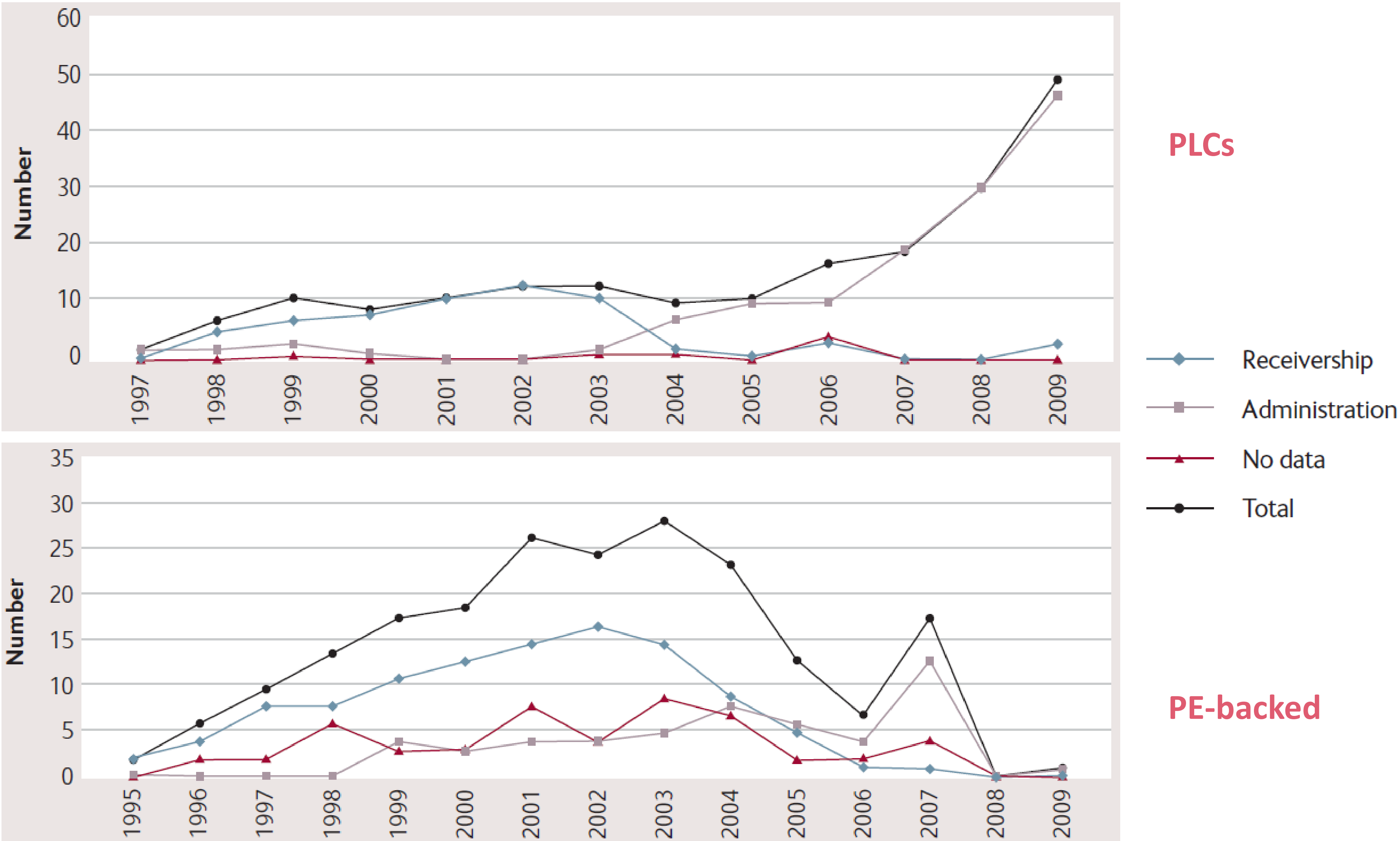
But no systematic bias in mature funds



Further reading: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1813802

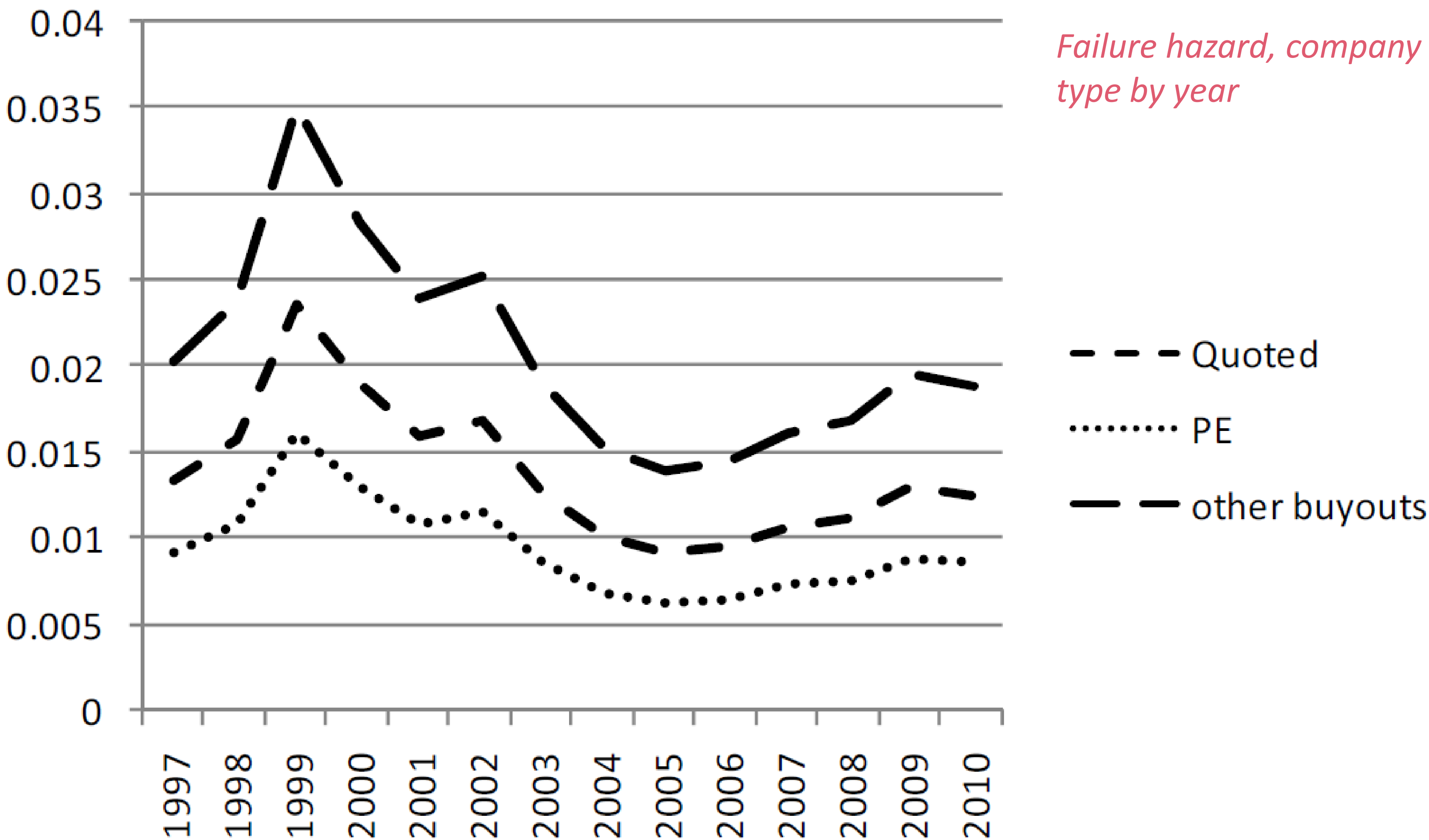
Impact of PE backing

Private equity and insolvency



Further reading: http://www.bvca.co.uk/assets/features/show/PrivateEquityandInsolvency_April2010

PE portfolios weathered the recession



http://admin.bvca.co.uk/library/documents/PE_company_performance_recession1.pdf

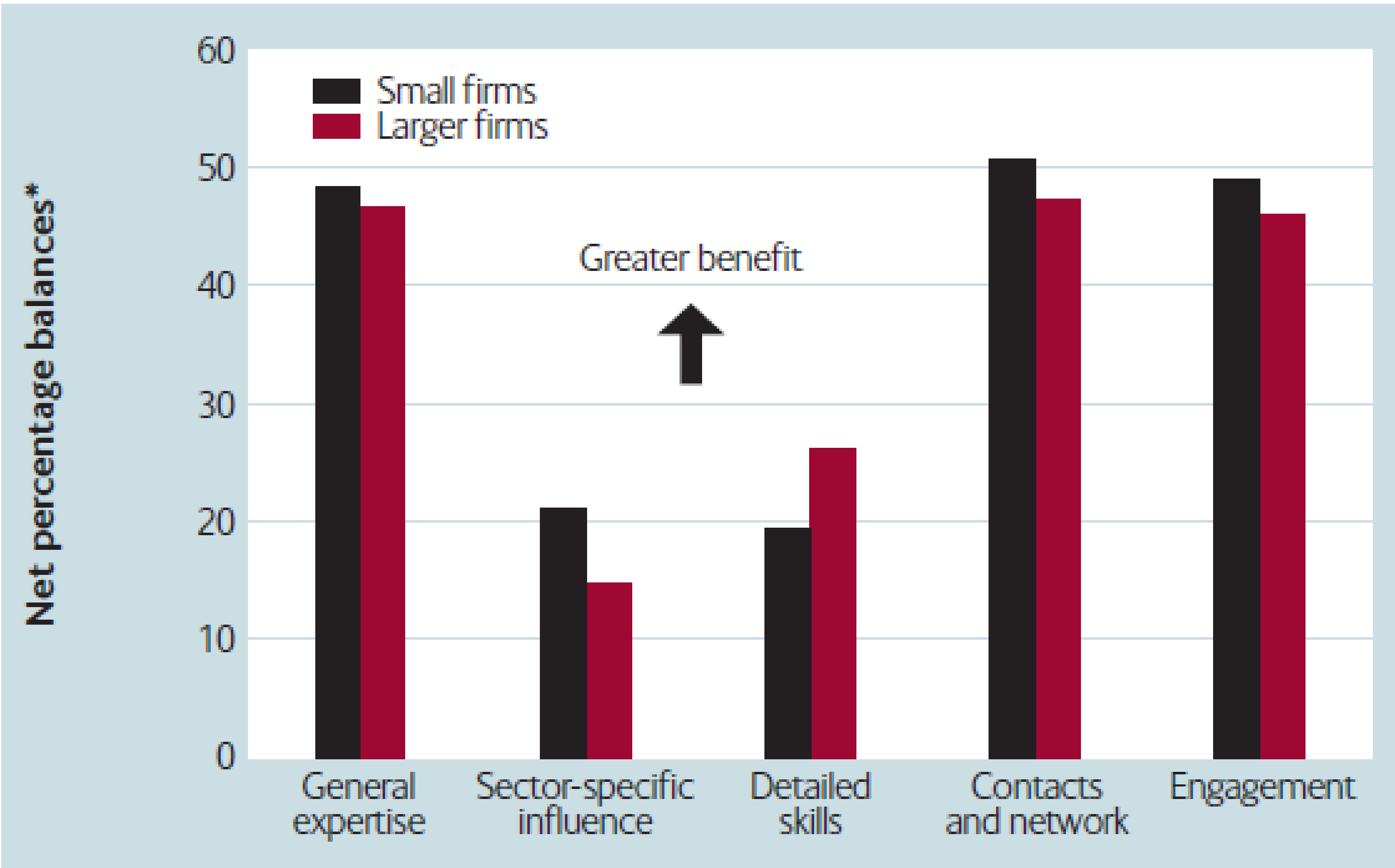
… and delivered good returns

Return on assets (%)	PE-backed	Listed	Matched private
2006	8.9	1.2	6.1
2007	10.1	1.7	6.5
2008	9.7	0.9	5.5
2009	8.6	1.7	4.4

http://admin.bvca.co.uk/library/documents/PE_company_performance_recession1.pdf

Business leaders value PE backing

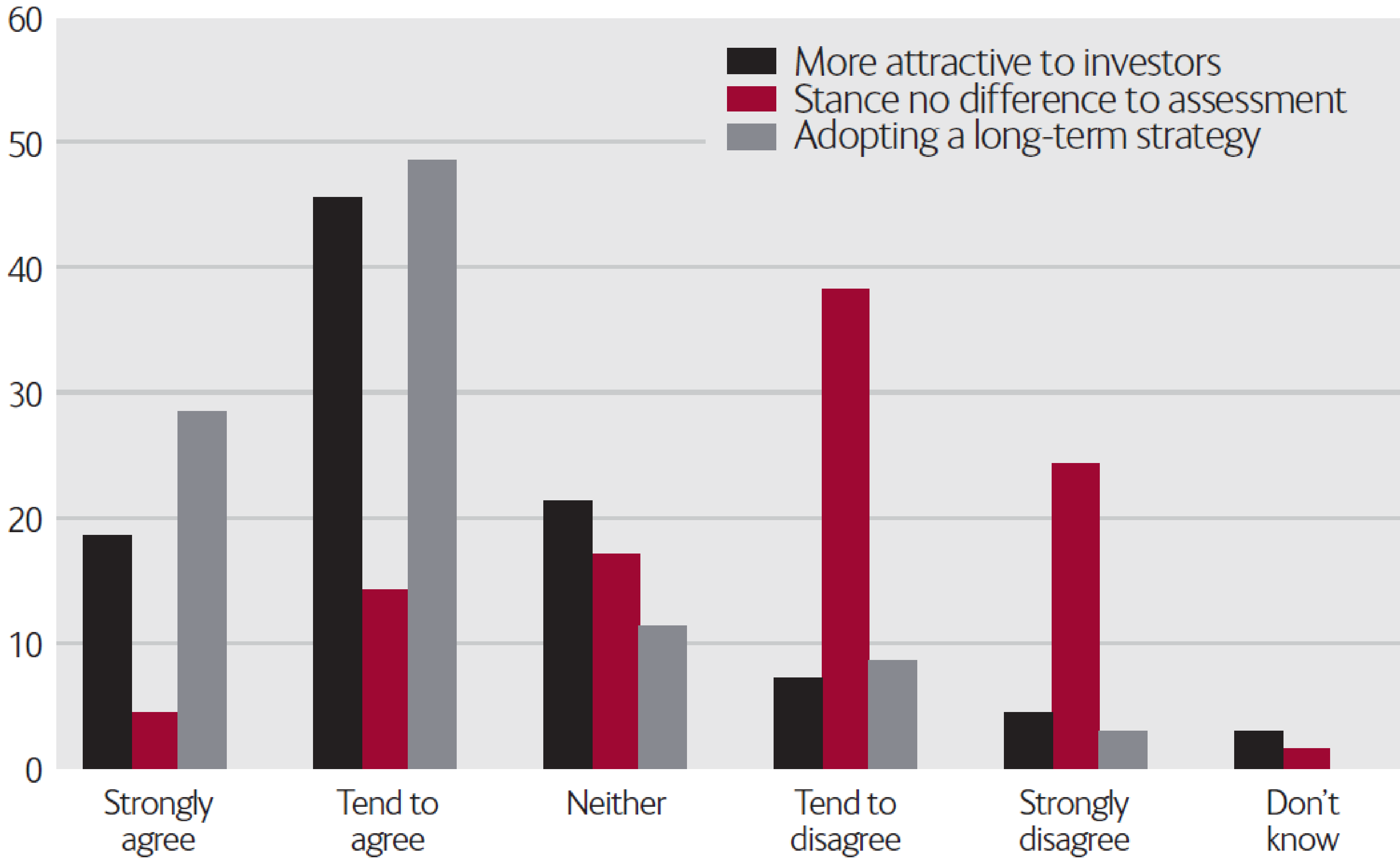
Benefits of PE backing by firm size



** Slight benefits/disadvantages given half the weight of significant benefits/disadvantages.*

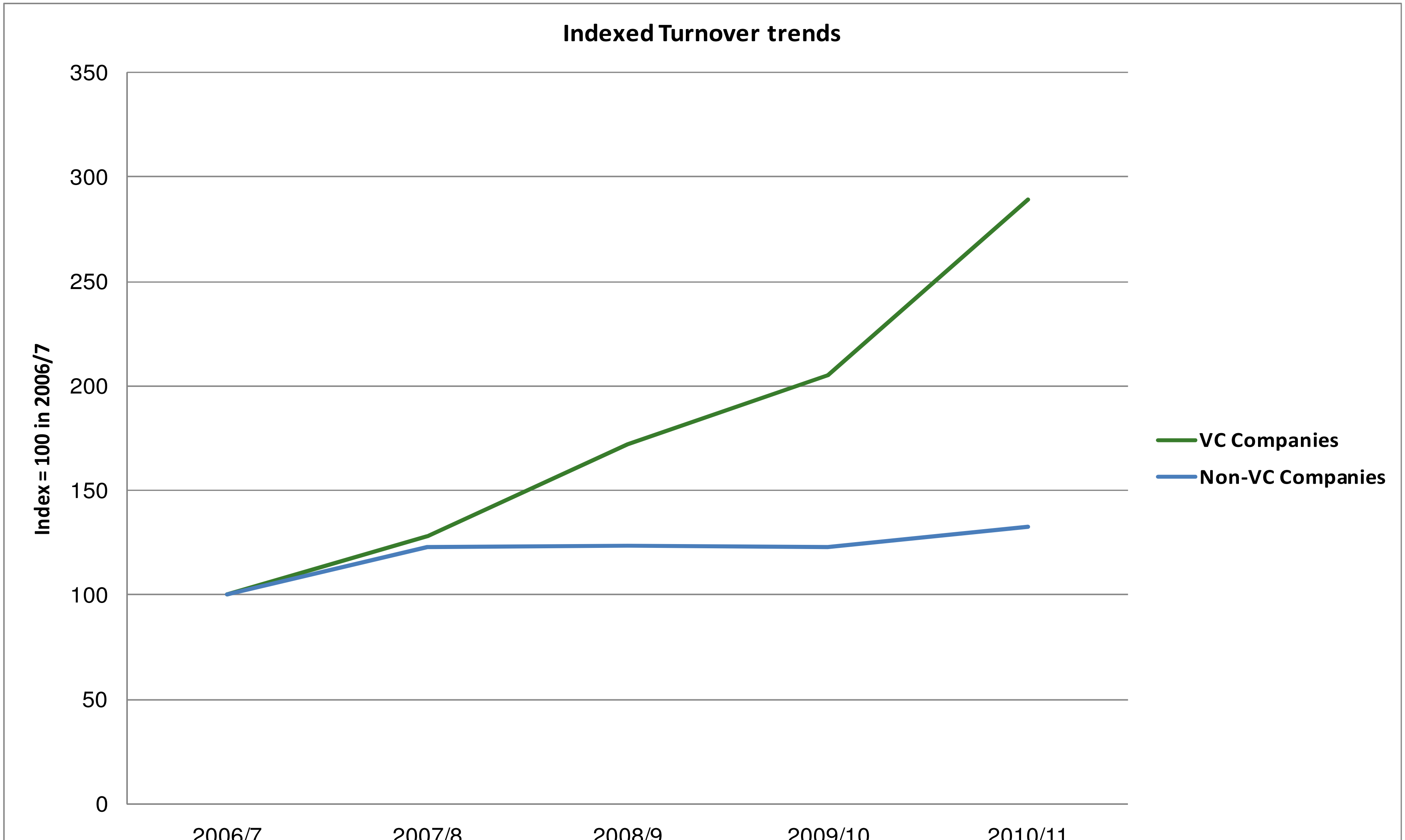
Further reading: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1698627

PE takes sustainability seriously



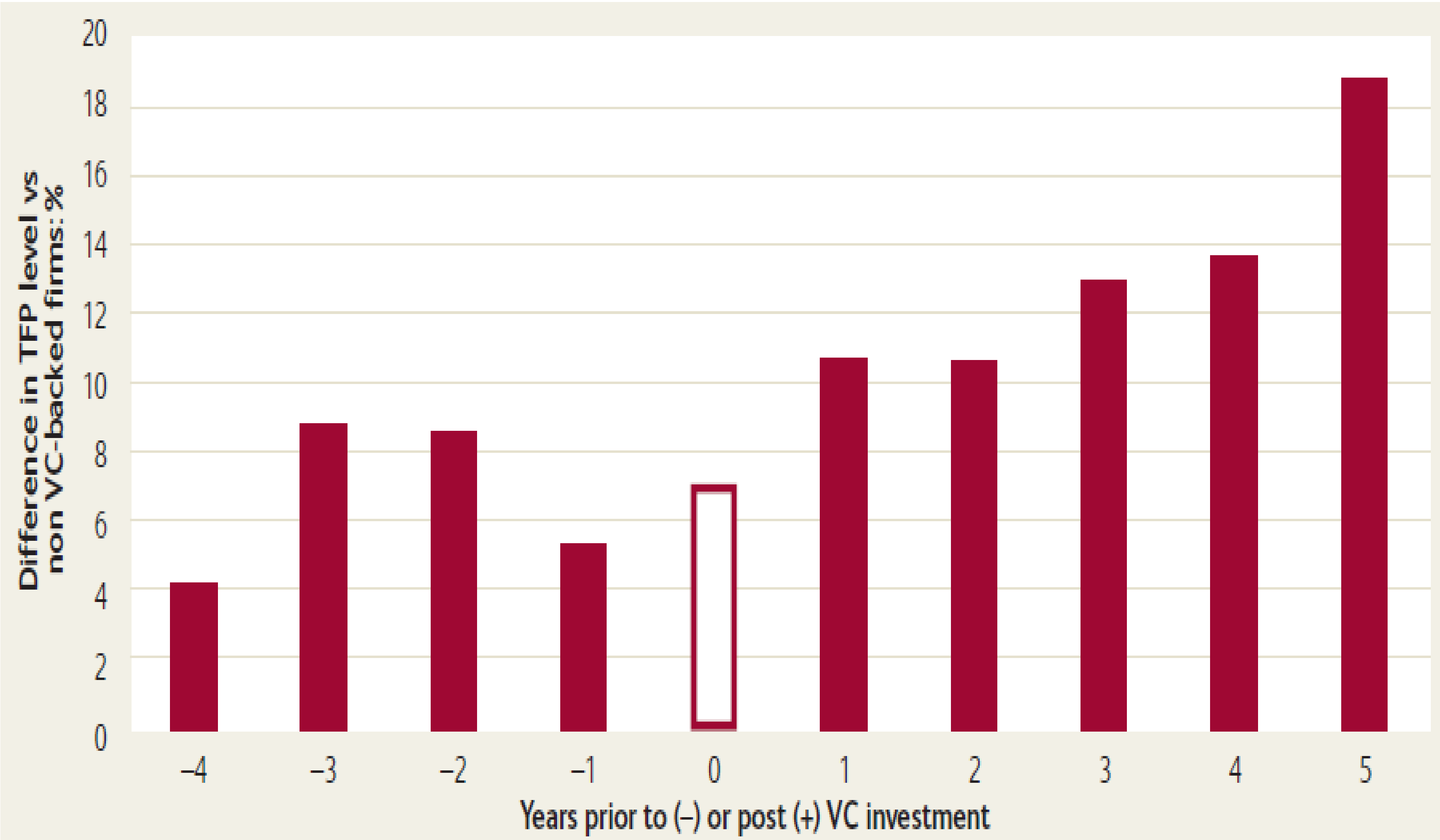
Further reading: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1953846

UK VC firms have grown more swiftly



Source: BVCA & Experian CorpFin

Economic impact – US TFP



Further reading: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1875764

Economic impact - summary

- Economic impact unlikely to be uniformly positive
- Studies generally ambiguous about employment impact; probably reflects deal type first and foremost (eg organic growth vs buy-and-build)
- Impact on capital likely to be positive; some signs here. Productivity (Y/N) does generally increase
- But increasing K/L in a small open economy implies fall in real product wage
- This implies PE reduces the labour share

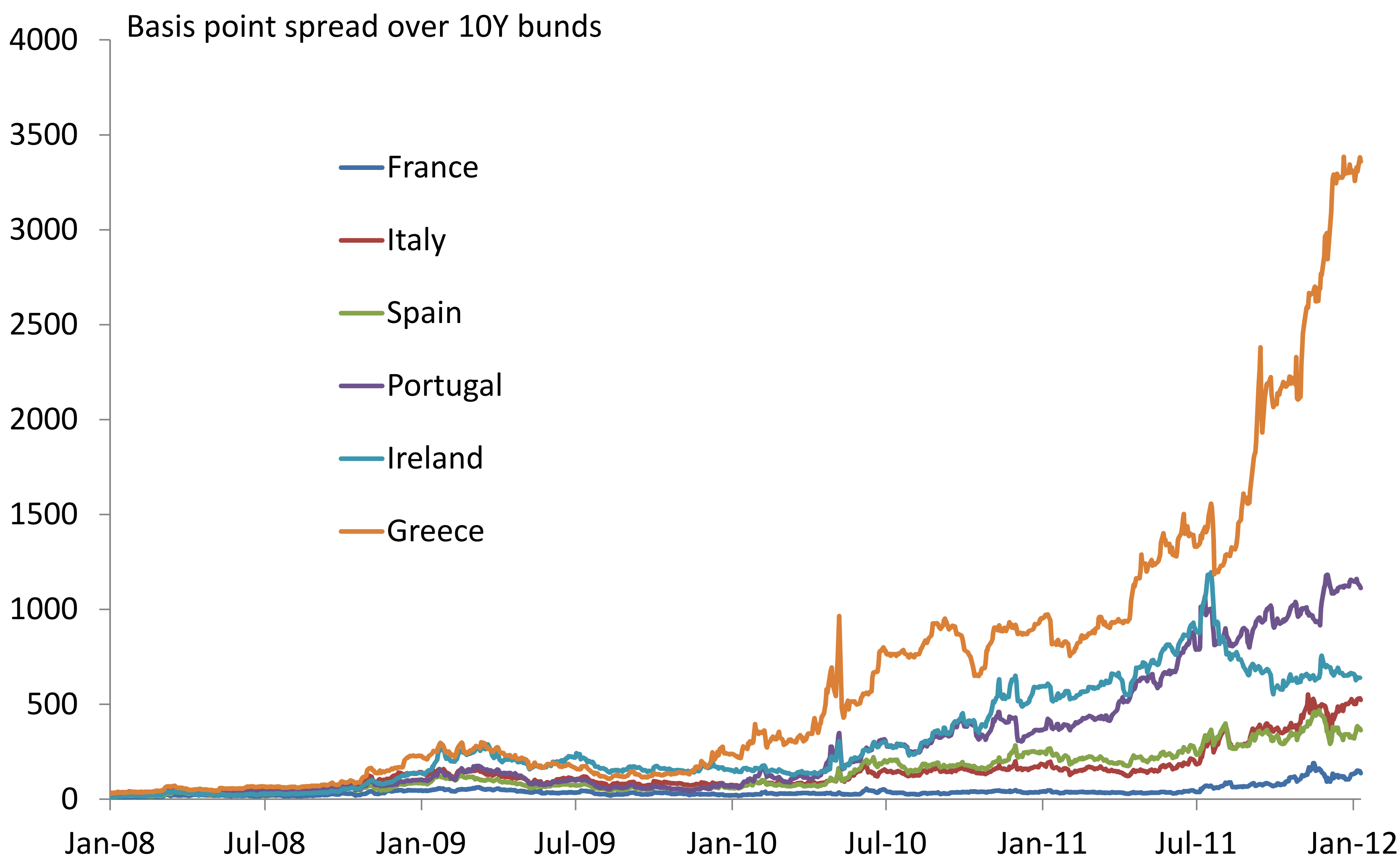
Outlook for European PE

No post-recession 'catch-up' expected

GDP growth (%)	Average, 1980-2007	2009	2010	2011	2012	Average, 2013-16
Australia	3.4	1.4	2.7	1.8	3.3	3.3
Canada	2.8	-2.8	3.2	2.1	1.9	2.4
France	2.1	-2.6	1.4	1.7	1.4	2.0
Germany	1.9	-5.1	3.6	2.7	1.3	1.4
Italy	1.7	-5.2	1.3	0.6	0.3	0.9
Japan	2.6	-6.3	4.0	-0.5	2.3	1.7
Sweden	2.5	-5.3	5.7	4.4	3.8	2.9
UK	2.5	-4.9	1.4	1.1	1.6	2.6
US	3.0	-3.5	3.0	1.5	1.8	3.1

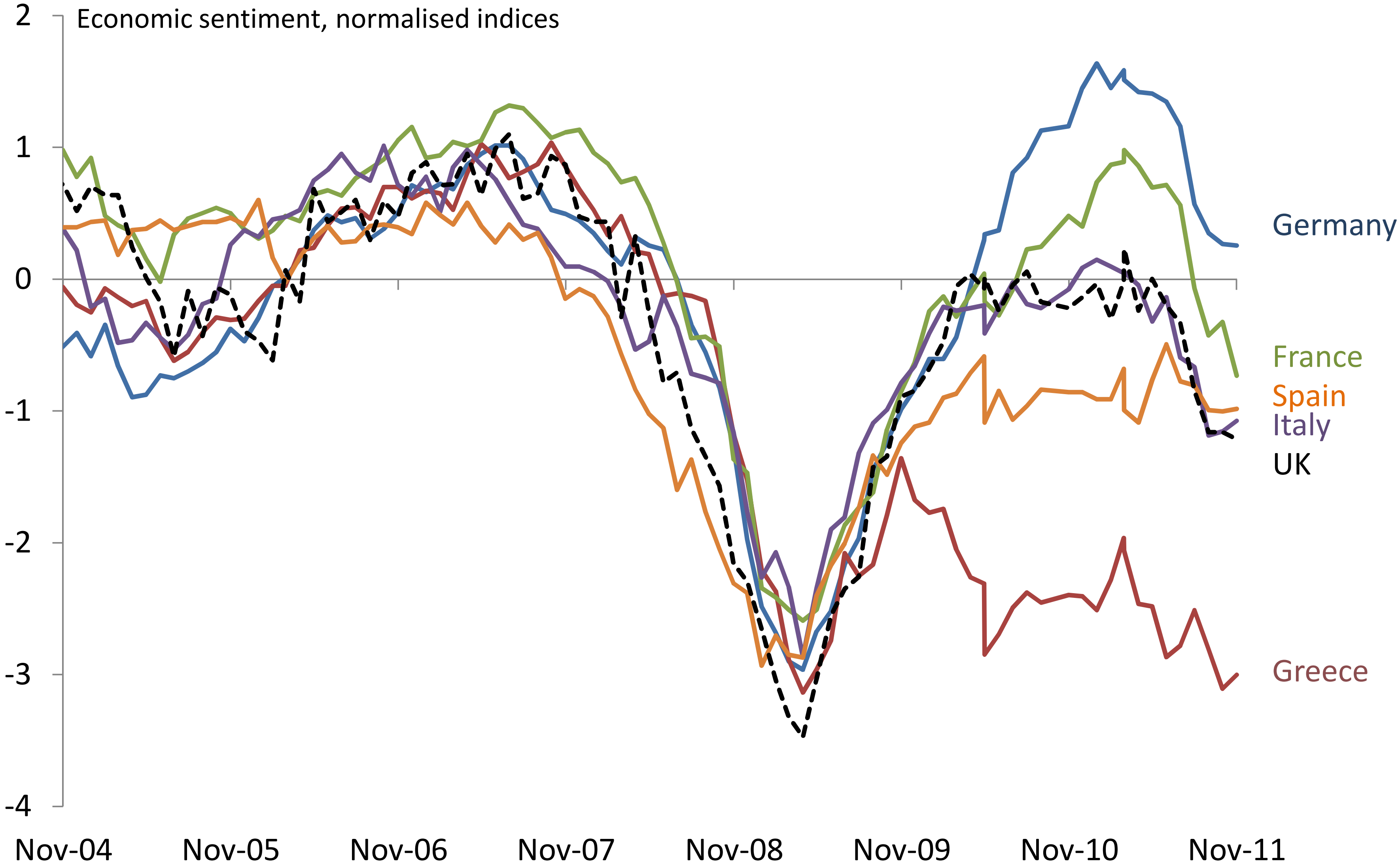
Source: IMF

Debt crisis will not disappear soon



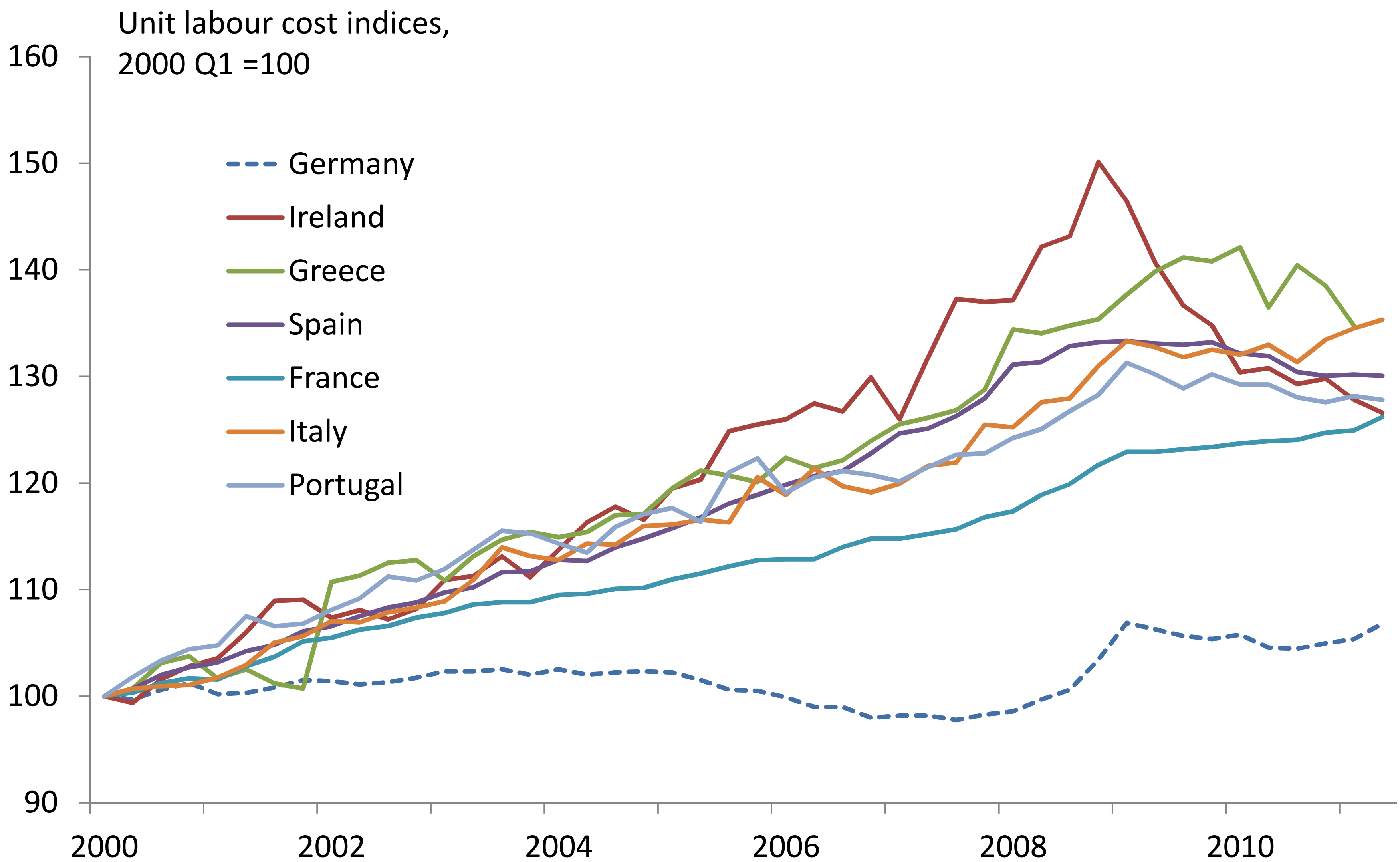
Source: Bloomberg
Note: As of 12pm GMT on 10Jan12

Uncertainty is hitting confidence



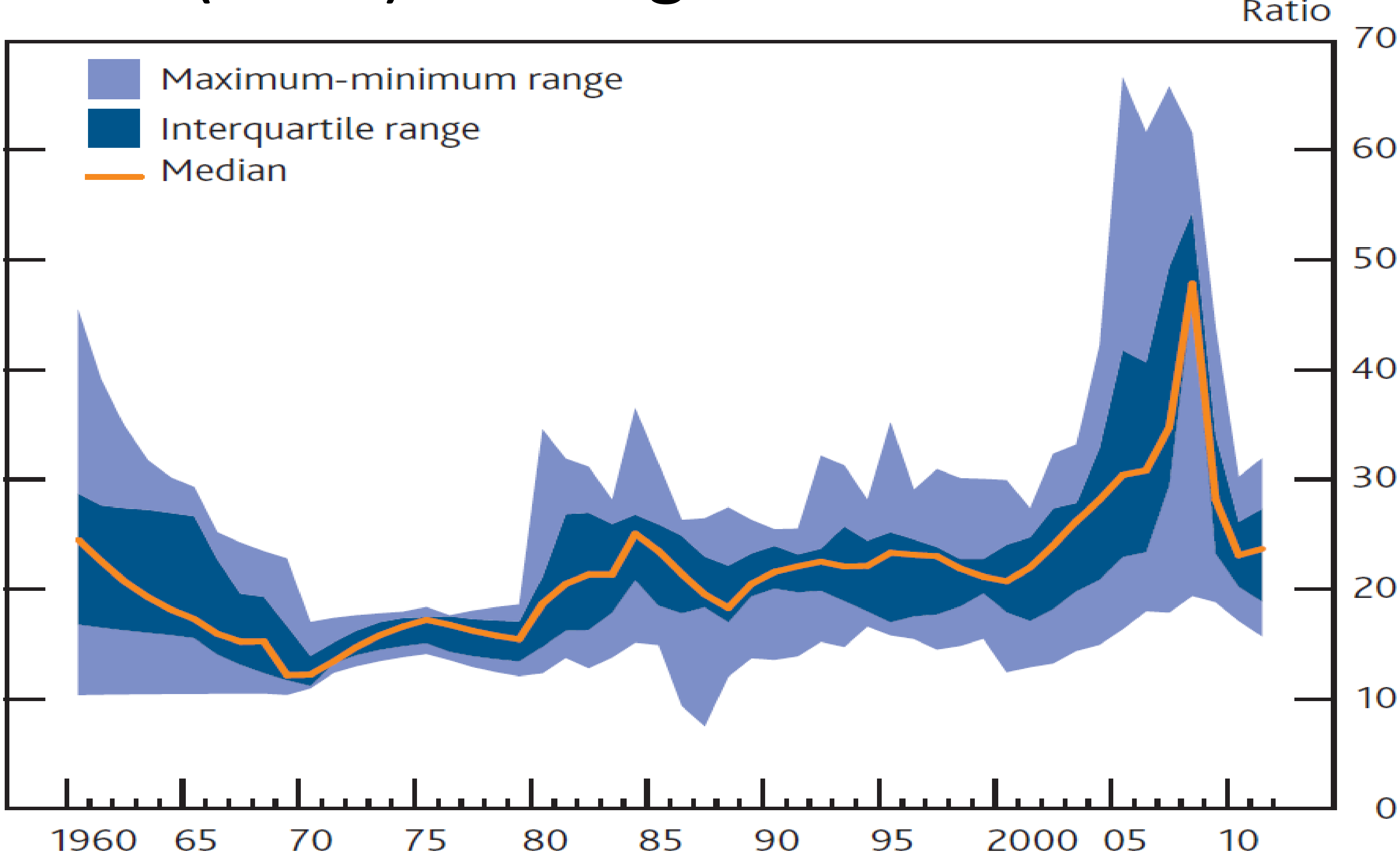
Source: EC and BVCA

Economic adjustment will be painful



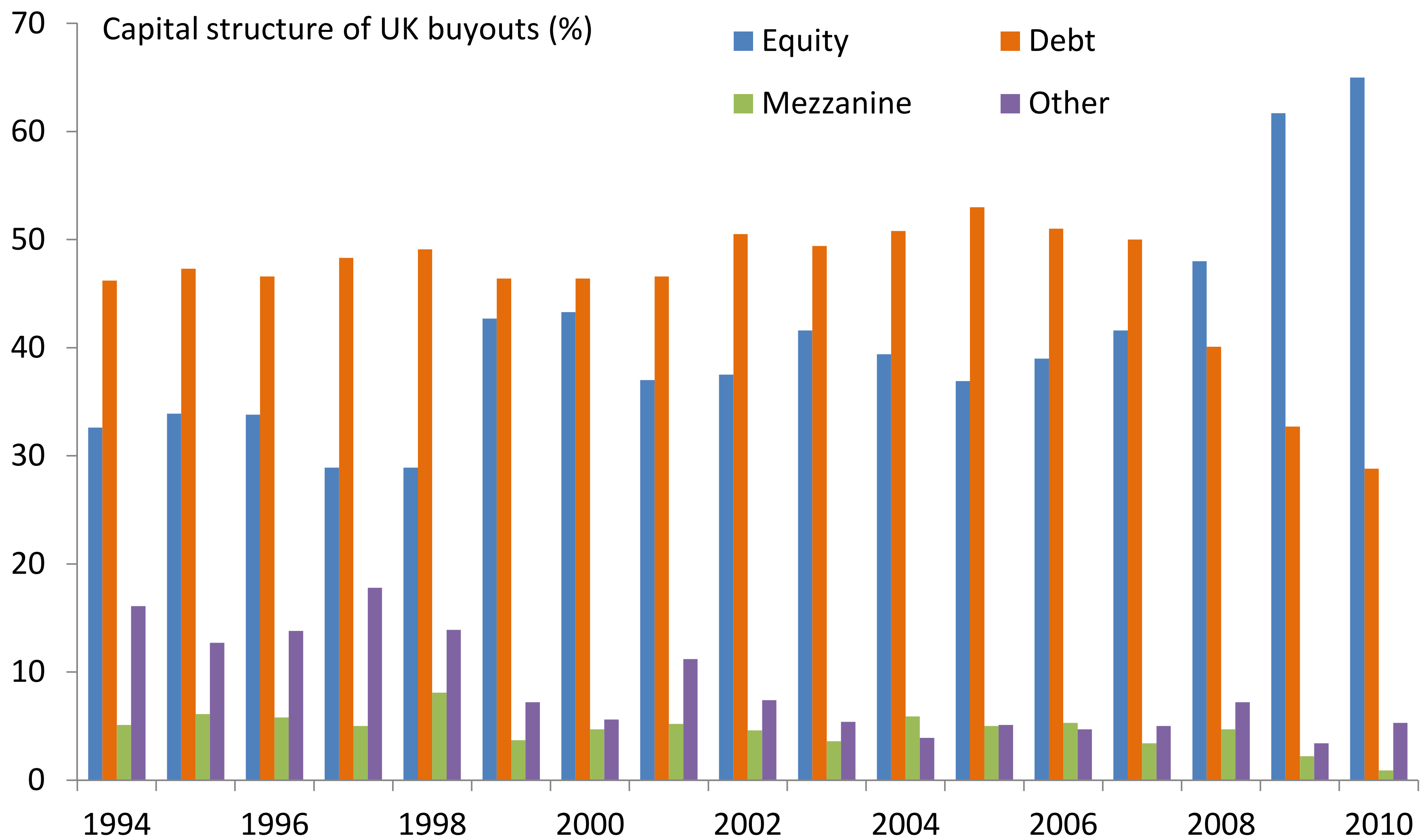
Source: Eurostat

(Bank) Leverage will be lower



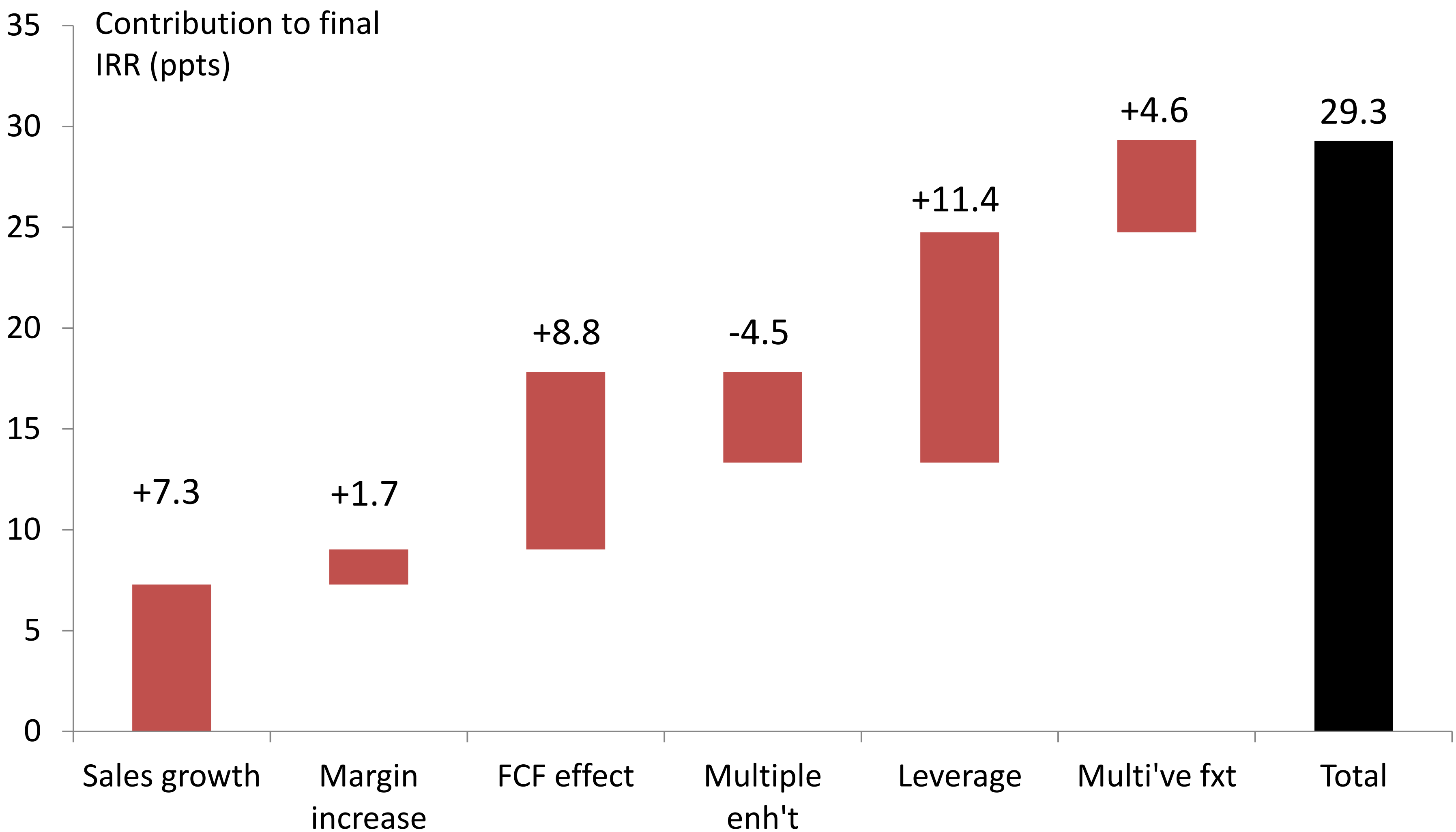
Source: BoE

But PE leverage wasn't out of control



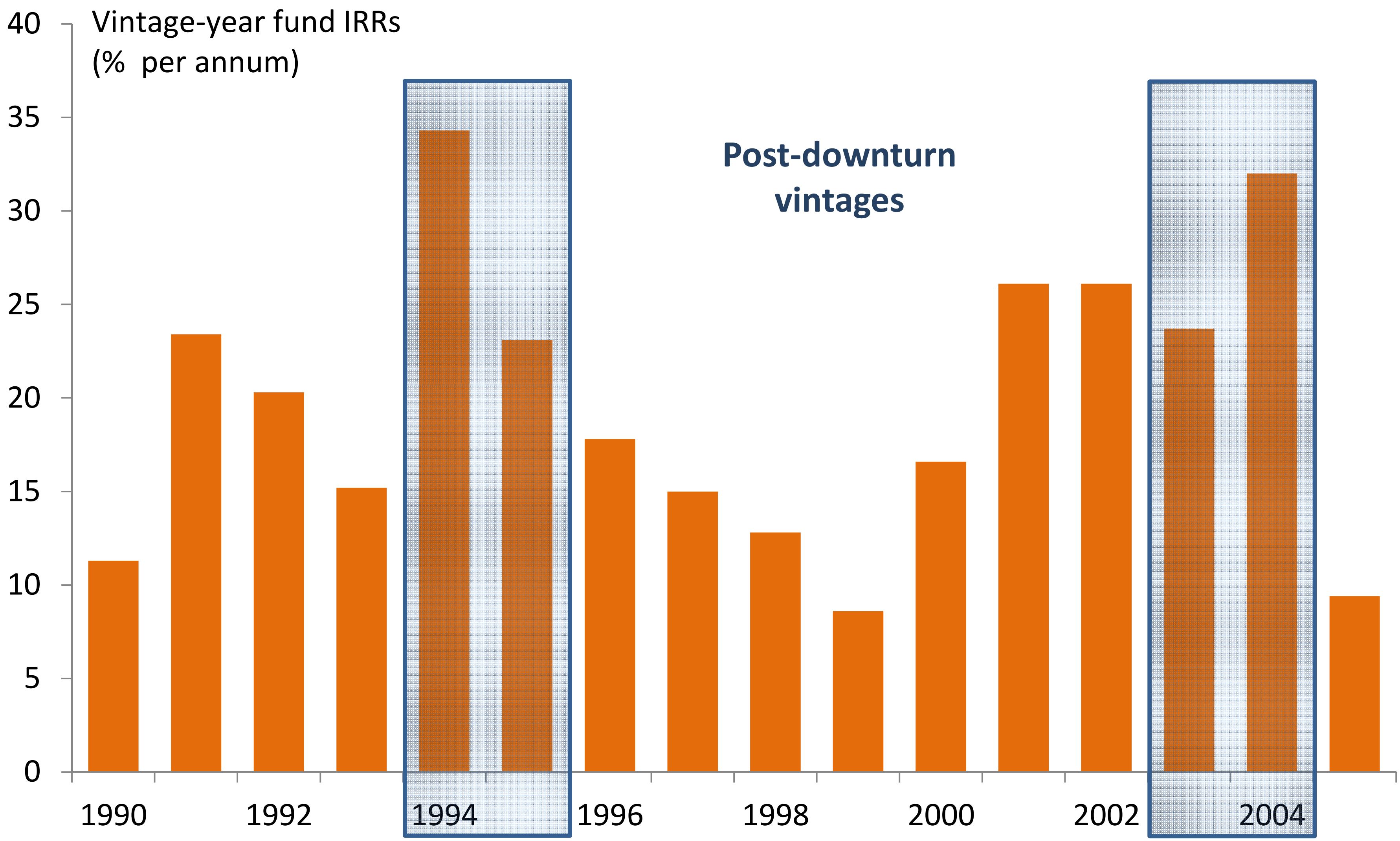
Source: CMBOR

And other factors also drive PE returns



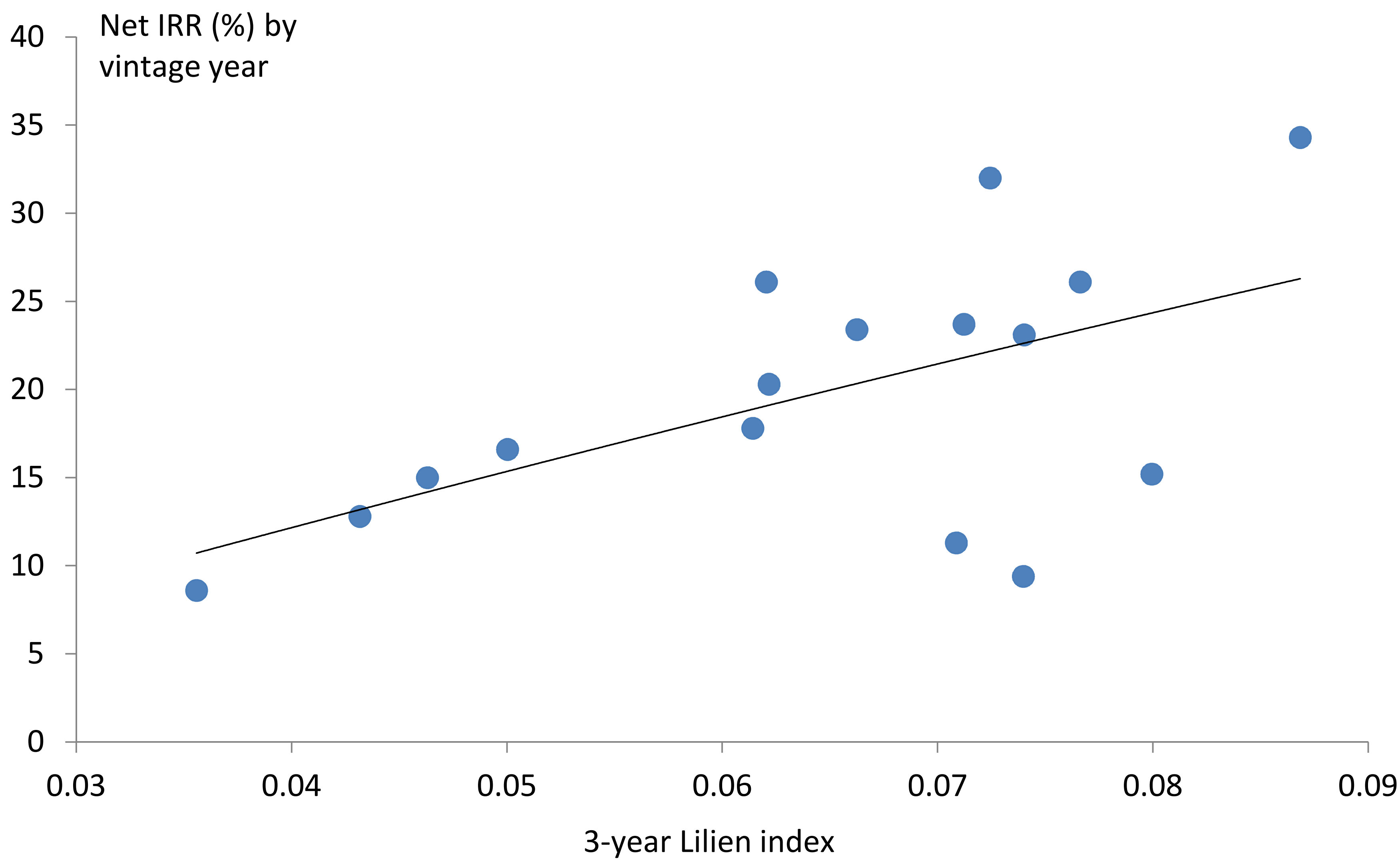
Source: Kaserer (2011); 332 European deals, median results.
‘Return attribution in mid-market buy-out transactions – new evidence from Europe’, CEFS Research Report.

PE performs well after downturns



Source: BVCA

PE returns and structural change



Source: BVCA

Summary

- Private equity is an active management model, which delivers returns by building business performance
- LPs trust GPs with their money; cashflows are large and irregular
- Activity is still below 2007 peak, but buyout returns have held up well
- Lower bank leverage and weak growth pose challenges but also opportunities: PE is very good at change