Challenges in a new world

How do private equity investors create value? An Oceania study of 2008 exits

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Foreword

This is the second annual study on "How private equity investors create value" for the Australian private equity (PE) market, which this year has been expanded to include New Zealand. It was conducted in parallel with Ernst & Young's annual global private equity study.

As in previous years, we analysed completed exits, focusing on the facts of value creation and business performance under PE ownership. Given the economic landscape in 2008, our research focused on exits with enterprise value of over $25m (compared to $50m in 2007). In addition to gathering publicly available data on the exits, we have conducted face-to-face interviews with the PE owners to check key facts and enhance the level of insight arising from the study.

Despite smaller deal sizes, findings from the PE exits in Oceania align with exits globally and from Europe in particular. Thus, we are also able to draw meaningful comparisons with European performance, to understand the relative maturity, commonalities and differences.

Like Europe, the Oceania findings show a decline in the number of exits in 2008 as a result of the credit crunch although not as pronounced as in Europe. Interestingly there were no exits by bankruptcy. In addition the exits in 2008 achieved impressive performance improvement and growth. However, the outlook for 2009 reveals tougher conditions for PE exits, with further falls expected in the number of exits and some companies already proceeding with formal bankruptcies in early 2009. The next two years will need to see exit volumes increase in order to maintain expected returns to investors.

The report gives our private equity clients objective performance comparisons and market benchmarks, and provides insight into the likely characteristics of successful PE firms in the current challenging economic conditions.

Yet its findings have a broader audience than the PE market. They inform a public interest in how PE firms achieve superior investment returns. Moreover, the PE practices the study reveals – from portfolio management to incentive structures – are relevant to the corporate domain.

We hope you find this assessment of calendar 2008 Australian exits insightful, timely and useful.

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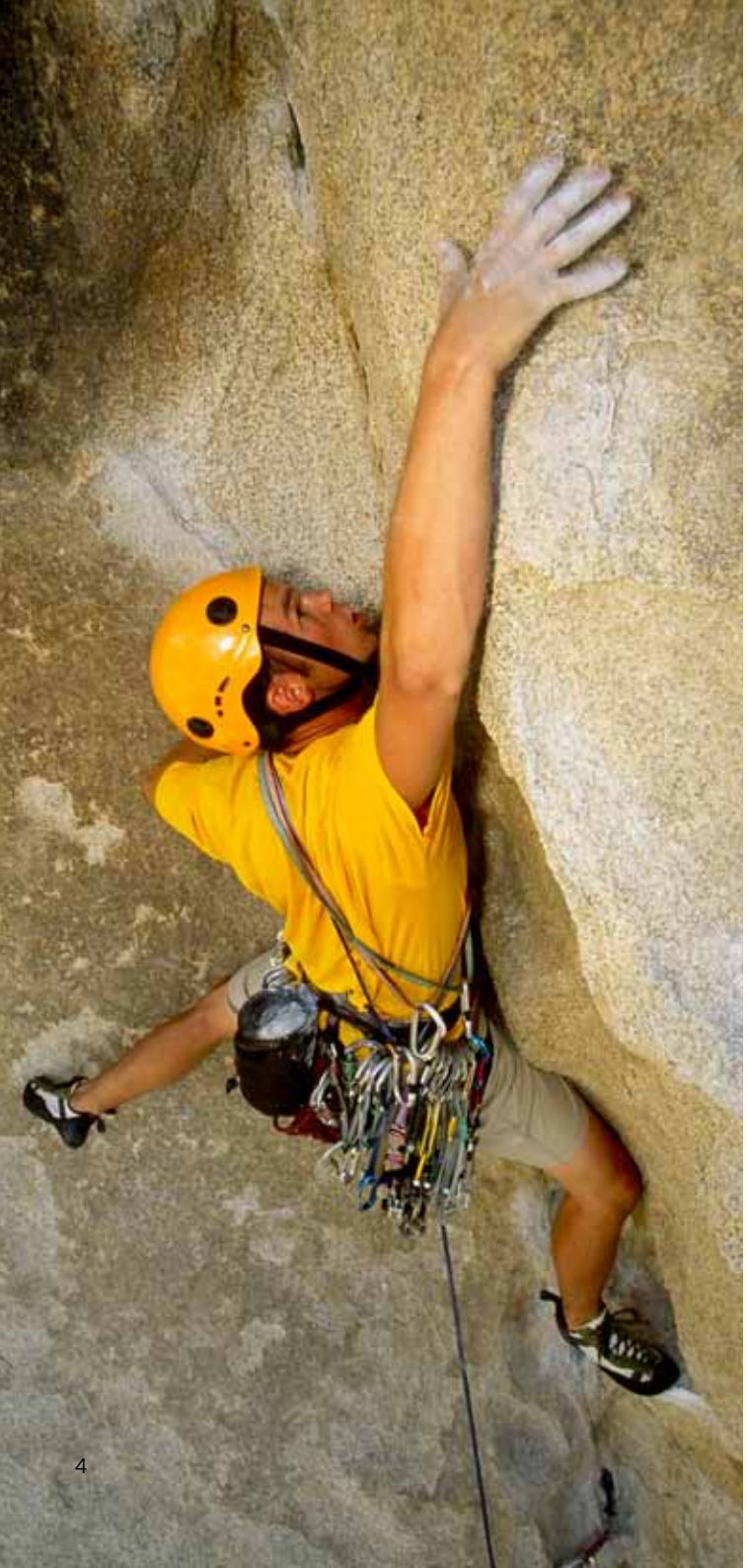


Executive summary

Growth of PE-owned businesses challenges public perceptions

For the second year running, the study's finding contradict the popular view that PE only succeeds on the back of leverage and market perception. Under PE ownership, businesses across Oceania achieved impressive growth and performance improvement. The average PE company grew its annual profit by 36% compound annual growth rate (CAGR) prior to exit, as compared with 11% for equivalent public companies.

The Oceania study also found this value creation came largely from organic revenue growth and acquisitions. However, there was a significant difference between the profit and cash flow growth of top quartile performers and the rest of the sample.

In the top quartile performers, 15% of earnings before interest tax depreciation and ammorisation (EBITDA) growth was attributed to core improvements. Organic revenue growth explained 45% of growth and acquisitions 27%. The organic revenue growth was largely achieved by improved pricing and selling initiatives.

Difficult times slow PE exits

However, while the success of growth initiatives that these results show is a positive endorsement for the PE model, the decline in the number and value of exits reflect the challenging macro-economic environment in which PE operated in calendar 2008.

Our findings show a decline in the number and value of completed exits during 2008. Comparisons between the low number of exits and the high value of assets that PE continues to hold in its portfolio point to a very real issue for the industry in the next few years. The rate of exits will need to increase markedly in 2010 and 2011 to maintain returns to investors and enable future fund raising.

However the reduced number of exits in 2008 seen alongside the high returns that those exits achieved reinforces the view that PE houses only sold strong businesses in 2008. If they were not certain of a high return, they held onto the asset. Indeed, the average hold period for troubled assets of seven years was approximately twice as long as that for all other investments.

Change in buyers

With the IPO market virtually closed and secondary sales (PE firm selling to another PE firm) also falling, corporate buyers moved in. In 2008, 77% of PE sales were to trade buyers, with just one PE-backed IPO early in the year. This contrasts with the European experience, where corporates became more cautious, accounting for only 26% of buyers, and new PE investors buying almost 74% of PE-owned businesses in 2008. Interestingly, in Europe, these 'secondary' deals performed just as well as primaries.

Outlook

The industry's record on value creation and growth in its businesses will be central to maintaining and building on its success. However, PE faces considerable challenges, both externally from the current scarcity of leveraged finance and internally resulting from portfolio imbalances, with an increasing number of poorer performing companies under PE management.

While there will always be buyers for good companies, poor assets will have to prove their performance over time. To make good on these assets, PE must continue to outperform the public benchmark and redouble its efforts to innovate and drive growth.

Key findings

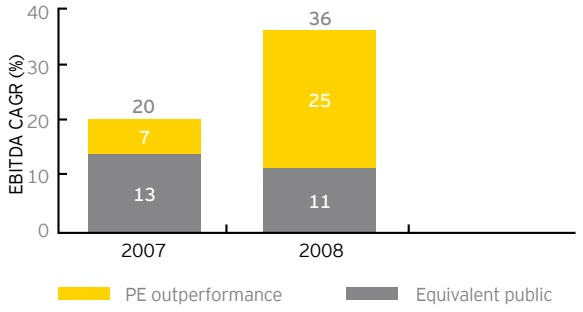
PE returns exceed public benchmark

Mirroring our 2007 research, the study found PE returns, even adjusted for extra leverage and multiple arbitrage, still exceed the public market benchmark. In fact, for large businesses, the PE model appears to create value regardless of sector, country, investing rationale and specific deal size.

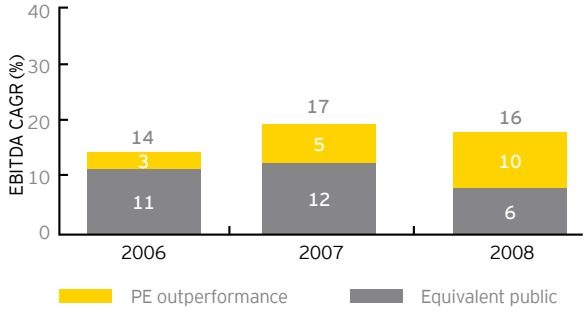
To assess whether PE growth is just a function of favorable market conditions, we benchmarked each of the PE deals against sector benchmarks drawn from listed company data over the same timeframe. These market benchmarks show strong growth too, but on each metric the PE investee businesses outperformed, particularly when it came to EBITDA growth.

In fact, the average PE investee company grew its annual profit by 36% of CAGR prior to exit, as compared with 11% for equivalent public companies. In addition, the valuation multiple – the ratio of business enterprise value to profits – grew by 2.8 turns from acquisition to exit

Oceania: EBITDA growth vs. public companies: PE exits 2007-2008



Europe: EBITDA growth vs. public companies: PE exits 2006-2008



Organic revenue growth initiatives drive profit growth

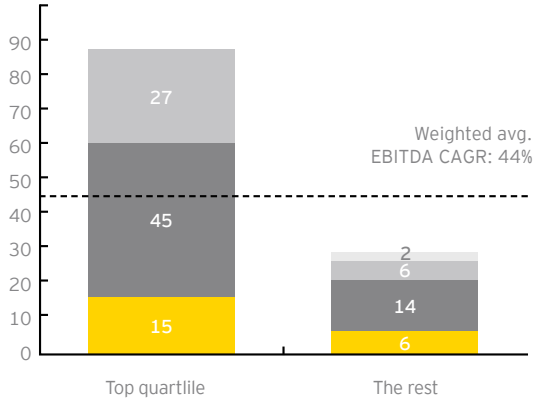
The Oceania study also found this value creation came largely from organic revenue growth and acquisitions. However, there was a significant difference between the profit and cash flow growth of top quartile performers and the rest of the sample.

In the top quartile performers, which grew by a weighted average EBITDA CAGR of 87%, core improvements accounted for only 15% of EBITDA growth. Organic revenue growth explained 45% of growth and acquisitions 27%. The organic revenue growth was largely achieved by improved pricing and selling initiatives.

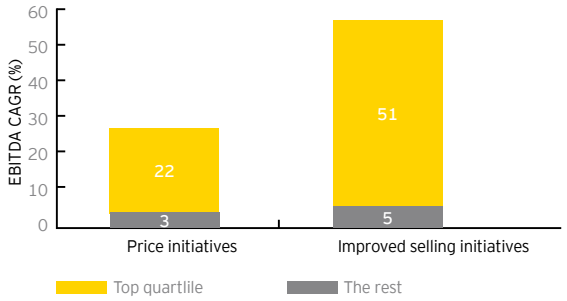
For example, top quartile companies variously:

- Focused on increased prices for loyal customer segments
- Reduced prices to target a new market during the downturn
- Developed new product variations to take advantage of emerging consumer trends
- Improved customer service and quality
- Focused on sales force effectiveness
- Improved customer quality – often letting go large, but unprofitable customers
- Expanded into new geographies

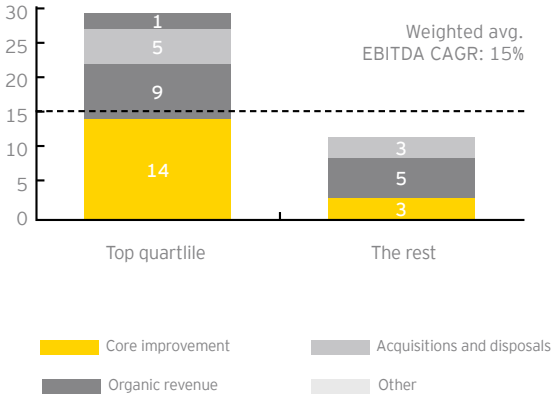
Oceania: Sources of EBITDA CAGR: PE Exits 2007-2008



Oceania: Impact of pricing and improved selling initiatives



Europe: Sources of EBITDA CAGR: PE Exits 2006-2008



Core improvements driven by operating model changes

Where companies in the top quartile made core improvements, the most common driver was a change in operating model, where structural changes to the business model enabled a step down in their cost base. Moreover, in the top quartile deals the effectiveness of operational efficiencies was much stronger, where the average impact was seven times greater than the rest of the pack.

Interestingly, only one deal in the Oceania sample focused on cost reductions alone – and this was one of the poorer performing exits.

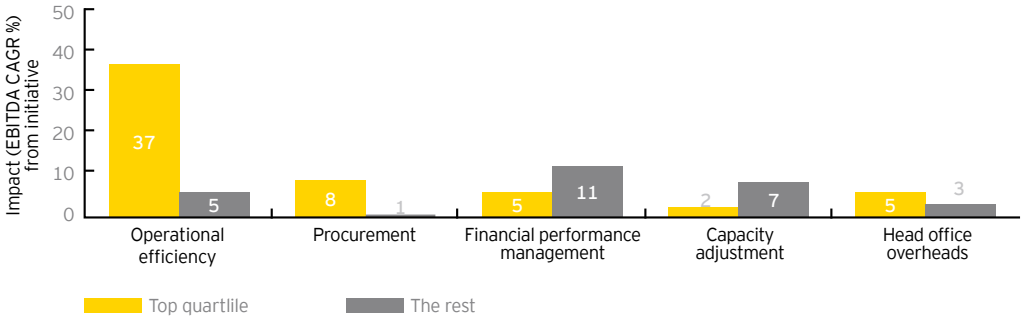
In Europe, half of the profit growth came from operational efficiency improvements, with core improvements accounting for the same percentage of EBITDA CAGR as organic and acquisitive growth combined.

This difference may derive from the fact that the Oceania deals were often "buy and builds" – where we would expect acquisitions to play a key role – or deals that targeted specific growth sectors. By contrast, in Europe, 38% of the businesses were acquired under an "improve core" rationale.

Operating model changes are the main driver of top quartile core improvement

Approach to cost reduction		Impact for top quartile cost reducers	Common drivers
1	**Variable cost control** Short term cost reductions identified and delivered quickly	Low	‣ Decreasing use of contract staff ‣ Seasonal/shift planning of personnel ‣ Discretionary cost reporting and control
2	**Operating model led cost reduction** Structural changes to the business model to enable a step down in cost base	High	‣ Operating model simplification, e.g., product-based specialisation within production facilities ‣ Product/brand/channel rationalisation programmes ‣ Outsourcing and off-shoring key functions ‣ Improved performance metrics, monitoring and incentivisation – tailored to the plan and strategy
3	**Continuous operational** Improvements and efficiency techniques used to further improve margin	Medium	‣ Automation of manufacturing processes ‣ Simplification of processes ‣ Delayered management structures

Oceania: Impact of core improvement: PE exits 2007-2008

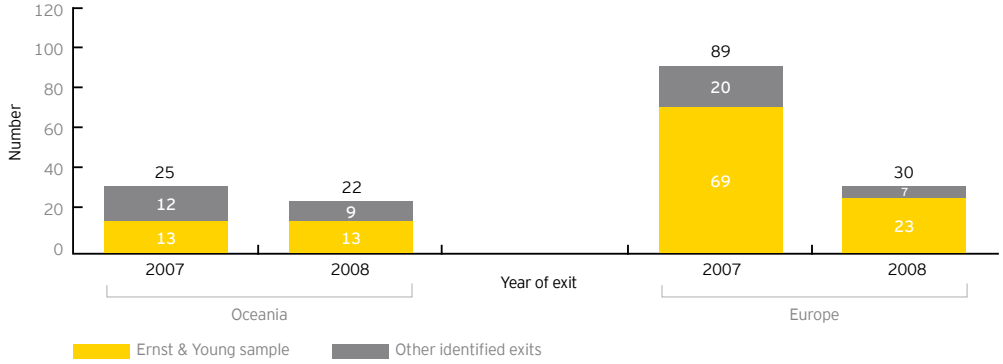


PE exits decline in number and enterprise value

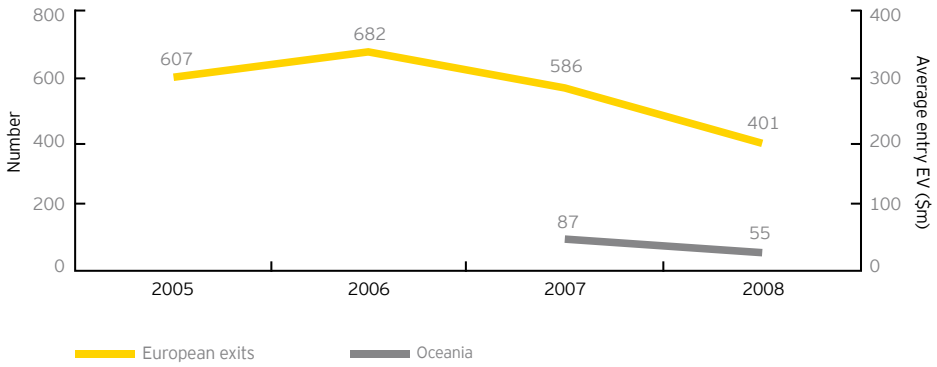
Not surprisingly, given the credit crunch in July 2007 and the financial crisis in September 2008, the year saw a slowdown in the number of businesses exited. As a result, the number of exits greater than A$25 million fell from 25 in 2007 to 22 in 2008. Of these, 16 were Australian deals, representing a 36% decline on 2007. In addition, due to the fall in the value of the larger exits in 2008, average entry enterprise value (EV) was around a third lower than in 2007.

In the same period, Europe saw an even sharper decline in the number and entry EV of exits. Volume fell by 66%, from 89 to 30 exits, and entry EV fell by 77%, as the mix of exits shifted towards smaller deals.

Number of identified exits: Oceania (Entry EV A$25m+), Europe (Entry EV €150m +)



Average entry enterprise value: PE Exits 2005-2008



Trade buyers dominate in Oceania

The mix of buyers of businesses from PE changed too. In 2007, secondaries and IPOs were the most successful exit routes in Oceania. Whereas, in 2008, 77% of PE sales were to trade buyers, with just one PE-backed IPO early in the year.

This contrasts with the European experience, where corporates became more cautious, accounting for only 26% of buyers, with new PE investors buying almost 74% of PE-owned businesses in 2008. Interestingly, these 'secondary' deals performed just as well as primaries, especially consolidation acquisitions, which had by far the highest EBITDA impact. While bolt-ons and expansions were common reasons for both primary and secondary PE acquisitions, these had the lowest EBITDA impact in Europe.

Growth in post-acquisition plans

In Oceania, the use of 100 day plans became more frequent than in 2007, particularly for top quartile performers, with 83% using post-acquisition plans. None of the top quartile performers changed CEOs at the start and only 33% changed during the period. By contrast, European top quartile exits were characterised by a higher number of CEO changes at the outset and during the first 100 days.

No evidence of short-term behavior towards troubled investments

Not every business performed well under PE ownership. Our European study found that approximately 13% of investments in our data fell short of minimum returns. However, in examining these deals, there was no evidence of a short-term mentality in PE behavior.

In fact, and perhaps contrary to public perception, PE remained committed to help poorly performing businesses to turnaround. Almost all received additional time with PE owners. The average length of PE ownership of these businesses was seven years, twice that of other investments. 43% experienced a change in top management, 36% saw further equity injections, as PE investors and management worked hard to change strategies and implement new actions to improve profits and cash flow.

The 2009 Oceania study sample did not include troubled investments[1]. However we note that two PE investee companies have been placed in formal receiverships in calendar 2009 and anticipate that other investee companies will continue to experience trading and covenant pressure given the tougher economic climate.

1 Our study classifies troubled investments as those deals that achieved an internal rate of return of less than 10%

Outlook

Our global, European and Oceania studies concur that the PE business model is a strong one. In Oceania in particular, the industry's continued performance has been driven by a focus on organic growth, acquisitions and improving operating models to transform the cost base.

Like all industries, PE has felt the impact of the global financial crisis. In 2009 we expect fewer exits than even 2008, a decline in the rate of profit growth, and a number of restructures or receiverships. Comparisons between the low number of exits and the high value of assets that PE continues to hold in its portfolio point to a very real issue for the industry in the next few years. The rate of exits will need to increase markedly in 2010 and 2011 to maintain returns to investors and enable future fund raising.

In fact the prospects of raising further funds will become increasingly more difficult given that limited partners have already spent more than they have realised over the last two years. We can expect to see limited Partners reduce the number of PE relationships with only the top quartile PE firms receiving the majority of new funds.

While the study results show that PE has held onto troubled investments in its portfolio and taken an active role in trying to turn them around, there is likely to be increasing pressure to reduce portfolio holdings to return cash to investors and to focus more time on making new investments. We foresee PE choosing to step back from some of these troubled investments, and to seek exit opportunities for them, particularly in funds with strong, if not already guaranteed, returns.

The results in this study around value creation suggest that, by selectively applying its distinct ownership model and targeted business improvement initiatives, PE has been able to achieve above market returns; indeed the top PE performers have achieved a considerable advantage over the rest of the industry. These skills are likely to be the key drivers of success as PE prepares its businesses to take advantage of a reawakening IPO market and focuses on "exit readiness".

We are already seeing signs of markets and financing improving in some areas. There is now a pipeline of PE-backed IPOs – something not seen for two to three years. Equity markets have seen some encouraging and sustained gains in recent months as well.

However, debt is unlikely to be available at the levels of recent years. The reality is, if the PE industry does not exit existing investments or create strong cash flows to reduce debt levels, it will have trouble refinancing a significant amount of the debt used to acquire these businesses, much of which matures in 2011-12. The current scarcity of leverage is likely to force all industries to innovate – for example, the use of mezzanine funds, equity warrants and vendor financing. We also anticipate more cooperation between PE houses and corporates, as strategic partnerships become a valuable enabler for new deals.

The PE industry unquestionably faces significant challenges to its business model, and will have to adapt to the changing economic and regulatory environment. However, as this study shows, the industry has continued to succeed in creating value. Continuing to implement performance improvement initiatives effectively, and continuing to innovate, will be key to the industry's success in the challenging times ahead.

About the study

Our 2008 Oceania study provides a view into the performance and methods of private equity based on the analysis of 26 of the largest Australian and New Zealand businesses PE has exited over the last two years. To avoid performance bias, and to ensure a focus on the largest businesses owned by PE, exits were screened to capture those that had an enterprise entry value of more than $A25m. This criterion was also applied to our estimate of the current size of PE portfolios.

We assessed business performance for the entire duration of PE ownership, based on specific key performance measures including change in enterprise value, profit (defined throughout this report as EBITDA) and valuation multiple. To better measure aggregate economic impact, we used weighted averages.

To benchmark the performance of PE-owned businesses against comparable public companies, we 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 to that of public companies

Finally the results of Oceania have been compared and contrasted with Europe where an identical study methodology has been adopted. The explicit difference between the two studies relates to the size of the market, where Europe deals included in the study were greater in size (entry enterprise value greater than €150m) and volume (over 300 exits over the last four years included in their sample) Despite these differences, both studies draw similar conclusions, indicating that size and volume of deals has no bearing on the overall result.

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