AVCAL

The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

JULY 2010

Deal Metrics Survey

A survey of Australian VC and PE deal activity in 2009

In association with

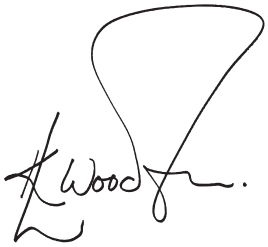
CRESCENDO PARTNERS

Message from the Chief Executive

Welcome to the second AVCAL Deal Metrics Survey, prepared in conjunction with Crescendo Partners. This is a follow on from the 1st survey and report from 2005 – 2008.

The survey covers the deals executed since the last survey up to the end of 2009. This period has continued to be challenging for PE and VC activity in Australia and the world. However, looking forward, there are encouraging signs that PE activity is picking up. This is supported by Australia's sustained recovery from the GFC and the gradual increase in credit availability.

The following article summarises the key metrics used to measure PE activity over the last five years, and provides an overview of the impact of the financial crisis and implications for the PE and VC industry going forward.



KATHERINE WOODTHORPE
Chief Executive, AVCAL
July 2010

Executive Summary
Signs of 'green shoots' sprouting

In November 2009, AVCAL commissioned Crescendo Partners to conduct the second annual Deal Metrics Survey of private equity (PE) and venture capital (VC) members. As a result, the deal metrics survey knowledge base has been extended to include transactions during FY09 and the first half of FY10 up until December 2009, and previous submissions between FY05 – FY08 have been further refined and updated. The knowledge base now comprises 418 transactions with total enterprise value (EV) in excess of $56b, primarily based on survey responses from forty PE firms and twenty VC firms.

While it may come as no surprise that both the value and volume of deal activity have further declined in FY09 and FY10 as a result of challenging economic conditions and tightened credit availability post-GFC, there are emerging signs of a recovery underway. Looking at PE deal activity over time in terms of quantity and value of transactions conducted suggests that the decline has slowed, and is poised to recommence a new, upward trajectory. This is likely to be supported by the continuing increased availability of credit financing used to fund deals and the improving economic conditions in Australia and globally. In addition, while the impact of the GFC has been most pronounced at the upper end of the EV range (>250m), activity has largely held up in mid-market deal range of $100 – 250m EV. Deal sizes appear to be rising, particularly in the area of bolt-on investments which saw a jump in average deal size in the first half of FY10. Looking overseas, Australia's performance appears to be in line with its US and European counterparts who were similarly impacted by a difficult economic environment and lack of liquidity in the credit markets.

Following the 2006/07 boom of financial sponsor-led buyouts, the slowdown in the local economy and the reduction of available levels of debt funding, private equity volumes and transaction value dropped significantly. PE investors have focused on deal sizes and sectors where attractive returns can still be delivered. Furthermore, significant activity has been centred around supporting portfolio companies through the downturn, as well as refinancing and restructuring portfolios as direct result of the GFC, partly contributing to the shift in focus from new deals to existing investments.

Valuation multiples are being transacted at a discount relative to FY06 and FY08 levels, suggesting there is still opportunity for PE firms to pursue acquisitions at attractive prices. Exit options have remained limited, largely due to the volatility and lack of confidence in equity markets and a disconnect between buyer and seller expectations, which have closed the door for IPO floats and made trade sales harder to come by. However, we see the potential for increased activity in the secondary 'sponsor-to-sponsor' market as PE firms look to exit from the large volume of deals made during FY06 and FY07 and valuation expectations between buyers and sellers begin to converge.

The VC sector has seen a consistent decline in deal volume and value over the last two years. The tough capital raising climate and withdrawal of government support has seen a significant reduction in new investment at a time when the global market downturn has made divestitures difficult. This has forced VC fund managers to inject more equity into their companies, with larger follow-on solo rounds seen in recent years as co-investment opportunities have decreased with the onset of the GFC. The healthcare and life sciences sector, in particular, has been the beneficiary of most of this funding given that many existing investee companies are now close to their final trial phases.

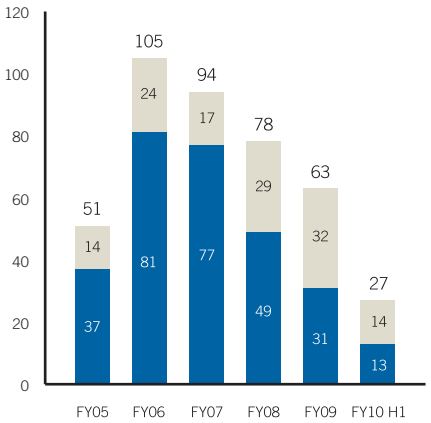
In summary, we anticipate a return to growth in private equity activity over the next couple of years given the more positive economic outlook and expected gradual increase in credit financing availability. This view is supported by the increasing levels of activity observed around potential transactions. The conditions in the venture capital landscape, on the other hand, are not expected to ease in the near term and the industry will continue to remain constrained by the lack of funding for new investments.

Private Equity Activity across the Survey Period

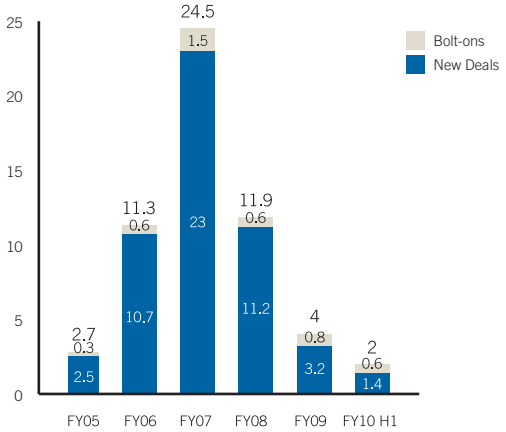
PE activity down but poised to 'turn the corner'

Private equity deal activity in FY09 and FY10 continued its decline following the impact of the GFC and subsequent freeze in the credit markets. Based on our updated deal metrics knowledge base, a total of 63 deals were completed in FY09 compared to 78 in FY08 and 94 in FY07. However, the drop in value was much more significant with only $4b worth of deals transacted versus $12b in FY08 and $25b in FY07 (largely due to several multi-billion dollar deals). Interestingly, while the number of new deals saw a decline of 37% CAGR between FY07 and FY09, the number of bolt-ons in contrast, grew at 37% CAGR over the same period, albeit at a smaller average deal sizes. This highlights the shift in focus from new deals to existing investments.

Number of transactions, FY05 – FY10 H1

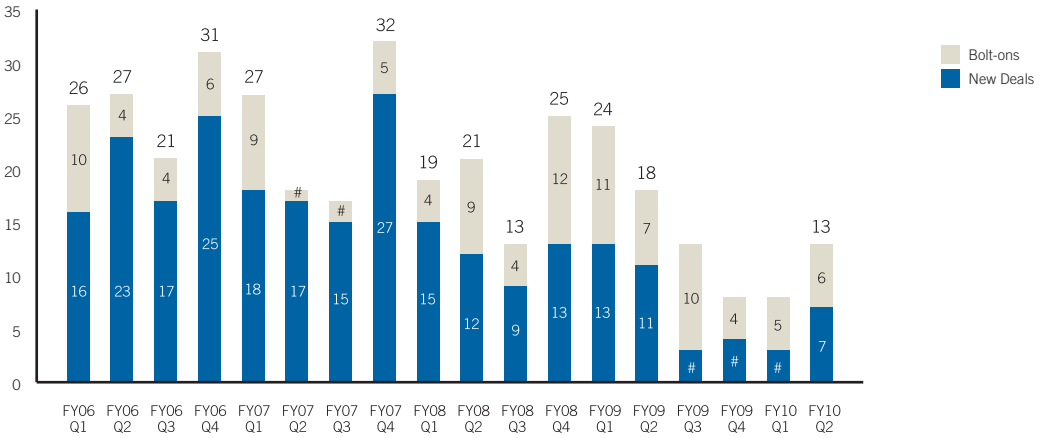


Enterprise value of transactions, FY05 – FY10 H1 (A$b)



On a quarterly basis, it appears that the decline in activity is slowing.

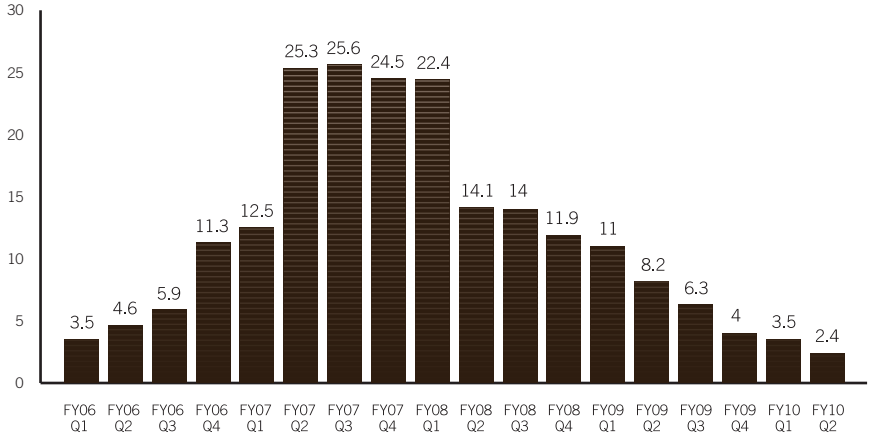
Number of transactions, FY06 Q1 – FY10 Q2



Note: # suppressed where total number of transactions is less than four

The drop off in deal value in FY08 from the peak in FY07 and the further decline in FY09 and FY10 following the impact of the GFC is illustrated by the monthly Moving Annual Total (MAT) of enterprise value from FY06 Q1 to FY10 Q2.

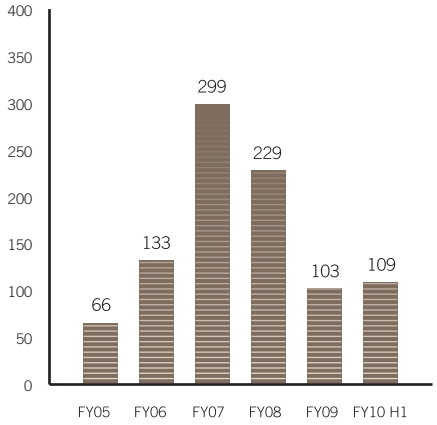
Moving annual total (MAT) of enterprise value of PE transactions, FY06 Q1 – FY10 Q2 (A$b)



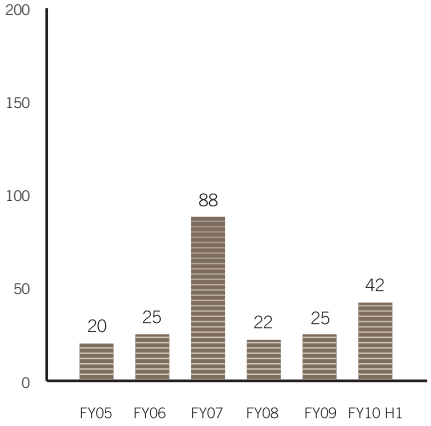
Note: MAT of new deals and bolt-ons refers to the trailing twelve month period from the end of that quarter

Despite a further slowdown in total deal flow volumes in FY10 on an annualised basis, the average value of deals appears to be picking up with a notable jump in average bolt-on deal size in FY10 H1, again highlighting the shift in focus of PE firms towards supporting existing investments.

Average enterprise value of new PE transactions FY05 – FY10 H1 (A$m)



Average enterprise value of bolt-on transactions FY05 – FY10 H1 (A$m)

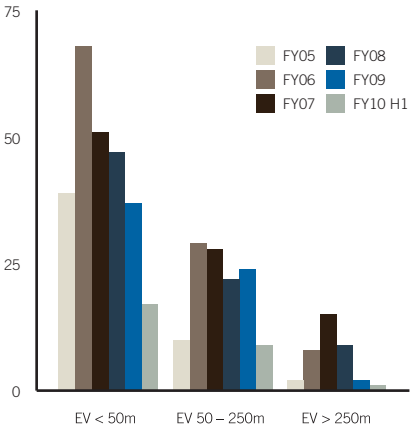


Activity holds up in the mid-market

Across EV bands, activity has most notably fallen off at the high-end for deals over $250m, which has declined sharply by 63% CAGR between FY07 and FY09. In contrast, deals in the mid-market range have been less impacted and have seen a smaller 7% decline in deal volumes over the same period.

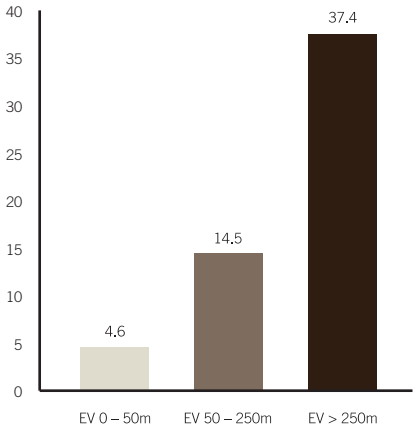
In value terms, the vast majority of deal value has come from large high-profile transactions of over $250m (FY05 – FY10 H1), which were transacted at the peak of the PE boom in FY07. Across the survey period, large deals in the EV band of over $250m account for approximately two thirds of total PE investment value despite representing less than ten percent of total number of deals.

Number of PE transactions by EV band



	EV < 50m	EV 50 – 250m	EV > 250m
%	62%	29%	9%
Total deals	259	122	37

Total value of PE transactions by EV band FY05 – FY10 H1 (A$b)

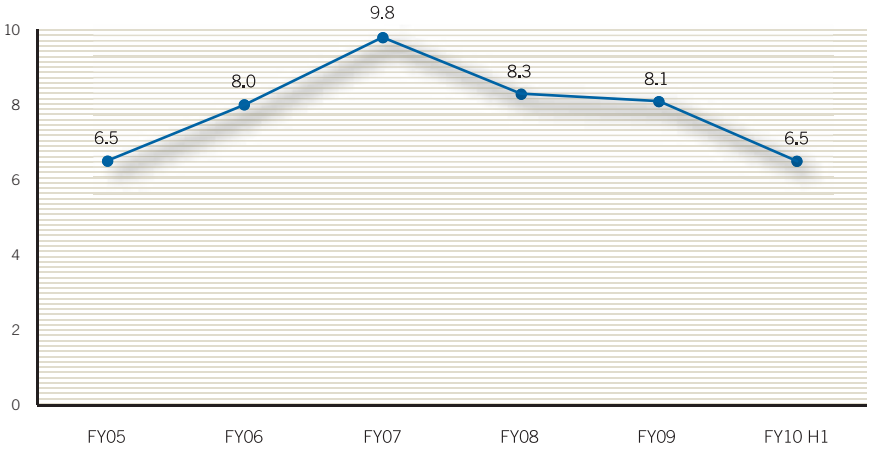


	EV 0 – 50m	EV 50 – 250m	EV > 250m
%	8%	26%	66%
Average EV	18m	119m	1,011m

Lower multiples and higher equity components

Valuation multiples have returned to FY05 levels after peaking in FY07 weighted by several large transactions. In FY10 H1, the average EBITDA multiple paid on entry (weighted by deal size) was in the mid 6x – 7x range for new deals and bolt-ons, providing opportunities for PE firms to make investments at fairly attractive prices.

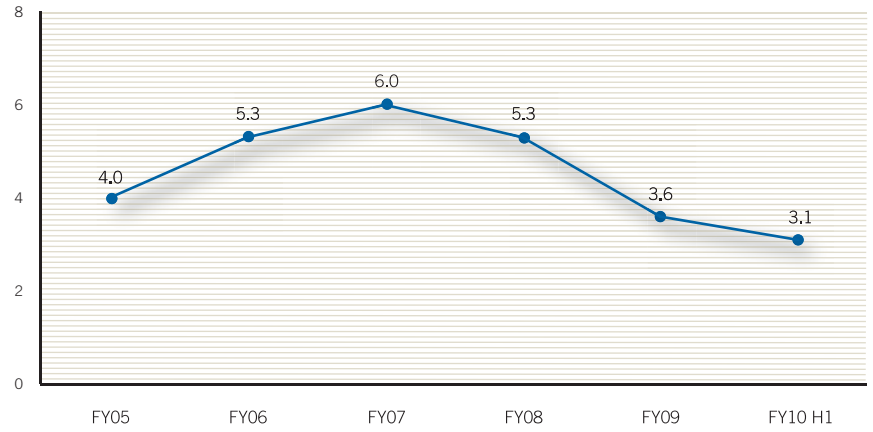
Average PE transaction EV/EBITDA multiples, FY05 – FY10 H1



Note: Includes new deals and bolt-ons; deal multiples have been weighted by deal size

The average transaction debt multiple (Debt to EBITDA ratio) was in the 5x – 6x range for most of FY06 – FY08. Since then, debt multiples have dropped significantly in line with the tightening of debt financing, and more recently appear to be steadying around the 3x mark. While debt multiples are likely to gradually rise as credit financing becomes increasingly available, banks still remain fairly cautious and are offering leverage more closely reflecting what was available around FY02 and FY04, well before the FY07 boom. The aftermath of the GFC has seen longer lead times for credit approval and tighter terms and conditions such as decreased leverage covenant limits and increased restrictions on equity distributions. Financing is, however, still available for well capitalised transactions with strong cash flow or asset coverage.

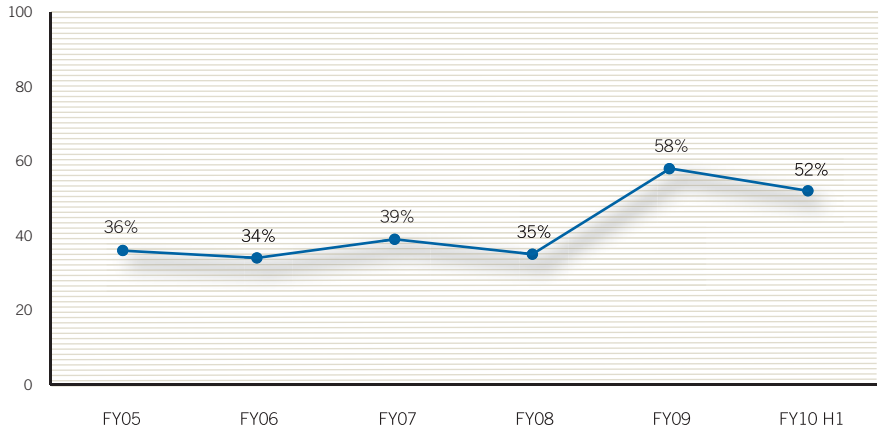
Average PE transaction Debt/EBITDA multiples, FY05 – FY10 H1



Note: Includes new deals and bolt-ons; deal multiples have been weighted by deal size

In line with the decline in debt multiples there has been an increase in the level of equity invested by PE managers, providing greater support on investments when completing deals. The proportion of equity invested of total deal value has significantly increased over time from an average of around 35% in FY05 to around 55% in FY09 and FY10 H1.

Percentage of equity invested of total enterprise value for PE transactions, FY05 – FY10 H1

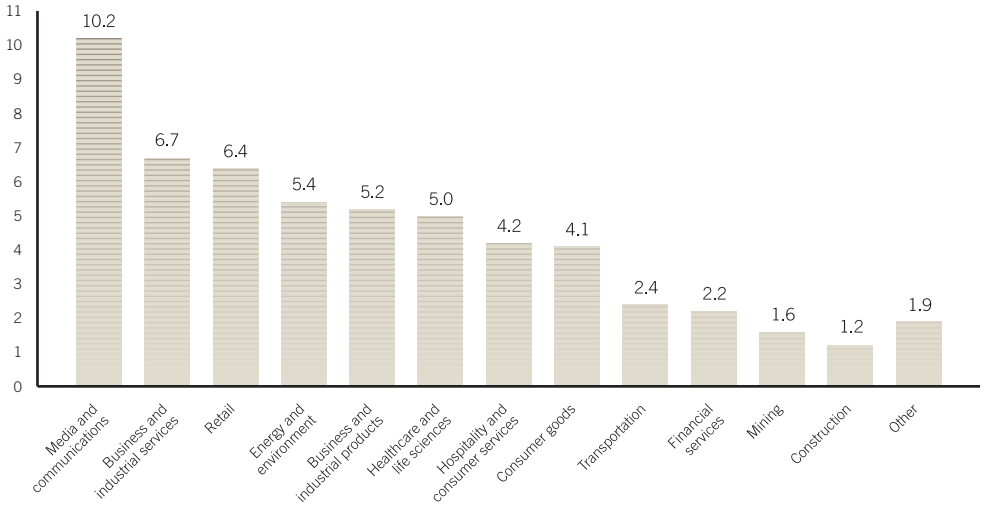


Note: Includes new deals and bolt-ons; deal multiples have been weighted by deal size

Activity lower across most sectors

At an aggregate level, a significant portion of deal value over the period FY05 to FY10 H1 has been transacted in media and communications, driven by a small number of multi-billion dollar deals in FY07. Business and industrial services and products, along with retail, energy and environment, and healthcare have also been sectors which PE firms have actively pursued driven by attractive industry structure and strong growth prospects.

PE transaction value by industry sector, FY05 – FY10 H1 (A$b)

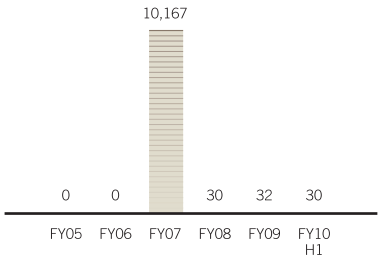


	Media and communications	Business and industrial services	Retail	Energy and environment	Business and industrial products	Healthcare and life sciences	Hospitality and consumer services	Consumer goods	Transportation	Financial services	Mining	Construction	Other
No. of transactions	7	70	47	41	51	24	45	51	11	21	14	4	32
Average EV (A$m)	1,460	95	136	131	102	206	93	80	219	107	112	312	59

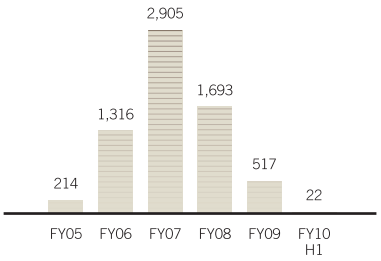
The contraction in deal activity has been felt across all industry sectors. Deal value dropped significantly in consumer goods, retail and the business & industrial services and products sectors in line with the overall business cycle downturn. However, activity in less cyclical industries such as healthcare, and energy and the environment, were also notably impacted. Energy and the environment did however, show some promising signs of a recovery in FY10 as reflected in larger size deals.

PE transaction value by industry sector and year, FY05 – FY10 H1 (A$m)

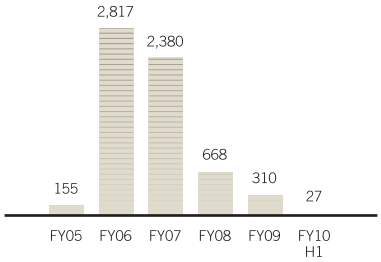
Media and Communications



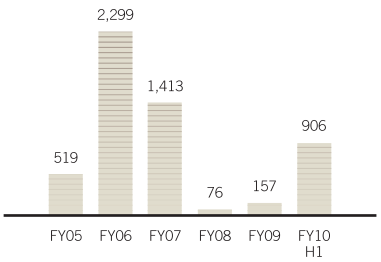
Business and Industrial Services



Retail

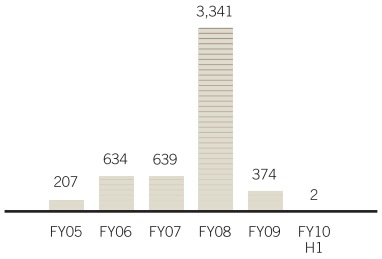


Energy and Environment

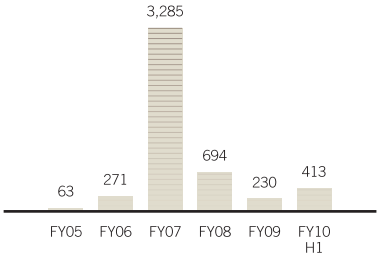


PE transaction value by industry sector and year, FY05 – FY10 H1 (A$m)

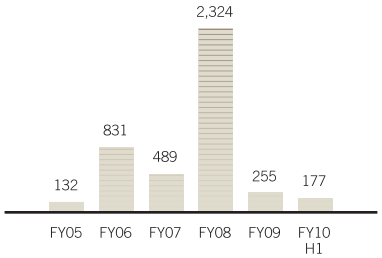
Business and Industrial Products



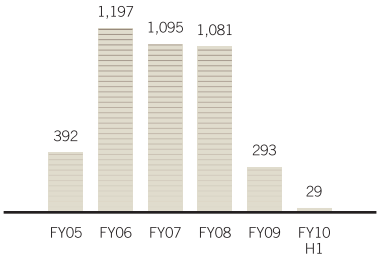
Healthcare and Life Sciences



Hospitality and Consumer Services

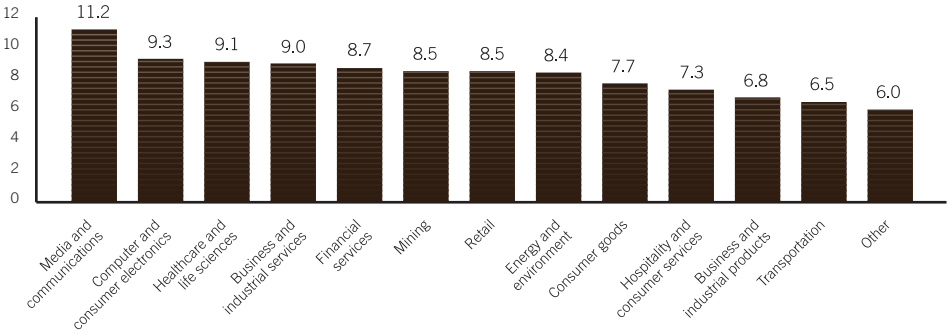


Consumer Goods



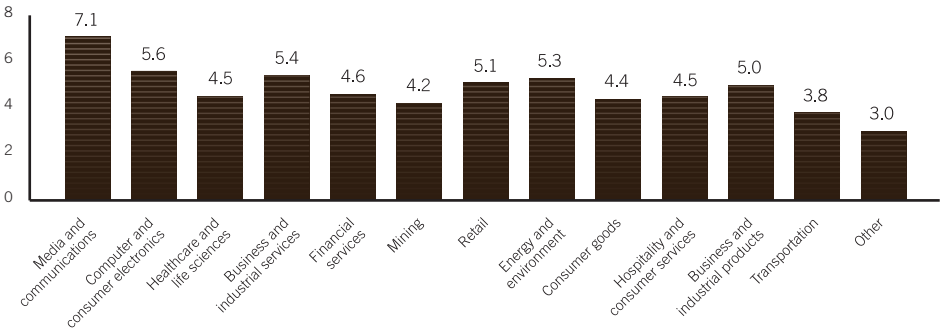
Across the entire sample, EV/EBITDA and Debt/EBITDA multiples have been relatively consistent with only media & communications deals commanding notably higher multiples and debt levels.

Average EV/EBITDA multiples by industry sector for new transactions, FY05 – FY10 H1 (xEBITDA)



Note: Deal multiples have been weighted by deal size

Average Debt/EBITDA multiples by industry sector for new transactions, FY05 – FY10 H1 (xEBITDA)



Note: Deal multiples have been weighted by deal size

Venture Capital Activity across the Survey Period

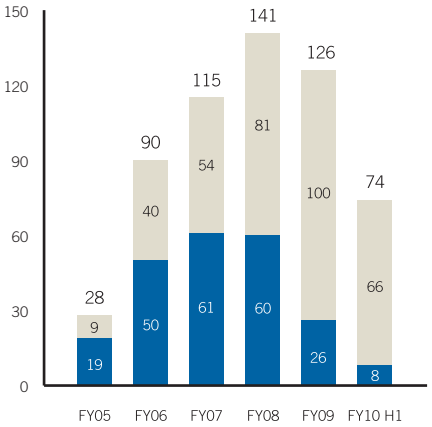
New company investment on the decline

As with PE, the value of VC investment has also been impacted by the GFC. Most notably, there has been a sharp decline in new VC investment which fell by 58% between FY08 and FY09, largely driven by the limited availability of funding flowing into the industry. Similar to the impact of the downturn in 2001 which brought VC funding close to a standstill, new VC investment appears to be on a downward trend and is likely to result in a shakeout of the VC industry.

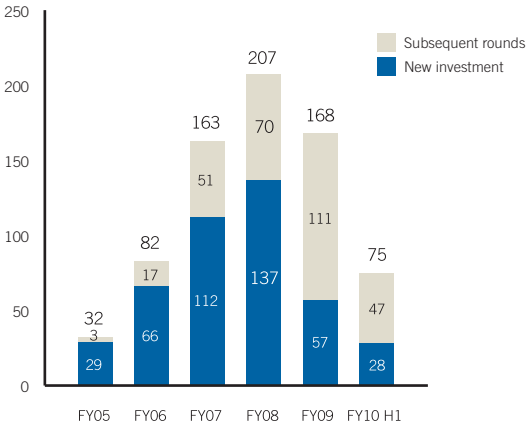
Funding concerns have been further exacerbated by the withdrawal of the government's 'Commercial Ready' innovation grant funding programme at the end of FY08, which provided an important source of funds to the industry. Coupled with uncertain global economic conditions and a tough fund-raising climate, this has resulted in a steady decline in new investment.

While overall levels of activity appear to be experiencing a slower decline, a large proportion of this activity can be attributed to increased follow-on round investments in existing companies rather than in new emerging companies.

Number of VC investments
FY05 – FY10 H1



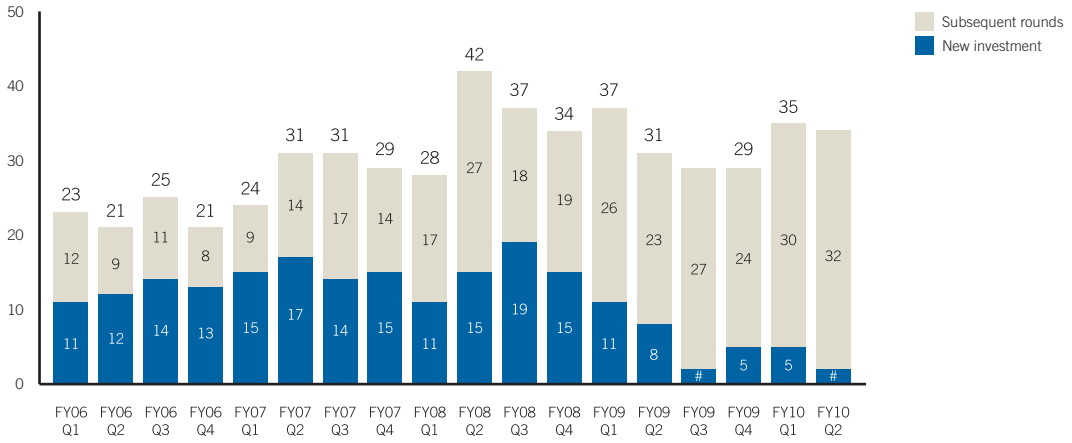
Value of VC investments
FY05 – FY10 H1 (A$m)



Note: Value of investment is the capital invested by survey respondents

This is further apparent when looking at VC activity on a quarterly MAT basis. The steady decline in new investment activity demonstrates the trend of VC managers reserving funds for follow-on funding.

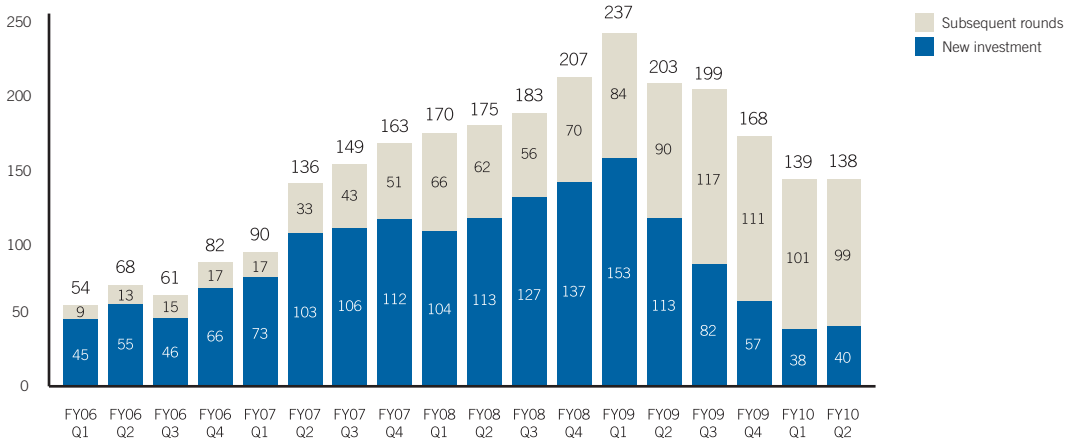
Number of VC investments by quarter, FY05 – FY10 Q2



Note: # suppressed where total number of transactions is less than four

A quarterly MAT in value terms showcases a similar dynamic, with the last two quarters retreating below pre-FY06 levels in terms of the value of new investments.

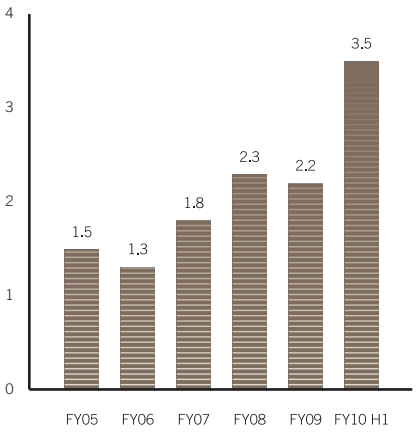
Moving annual total (MAT) of VC investment, FY05 – FY10 Q2 (A$m)



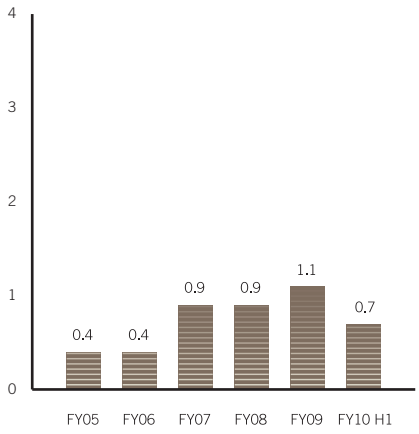
Note: Value of investment is the capital invested by survey respondents

In terms of investment sizes, there appears to be an increasing trend towards fewer and larger VC investments, particularly for new investments made by VC funds. This appears to be to some extent driven increased activity among larger VC funds, and has resulted in an overall increase in average value of investments.

Average VC new investment size FY05 – FY10 H1 (A$m)

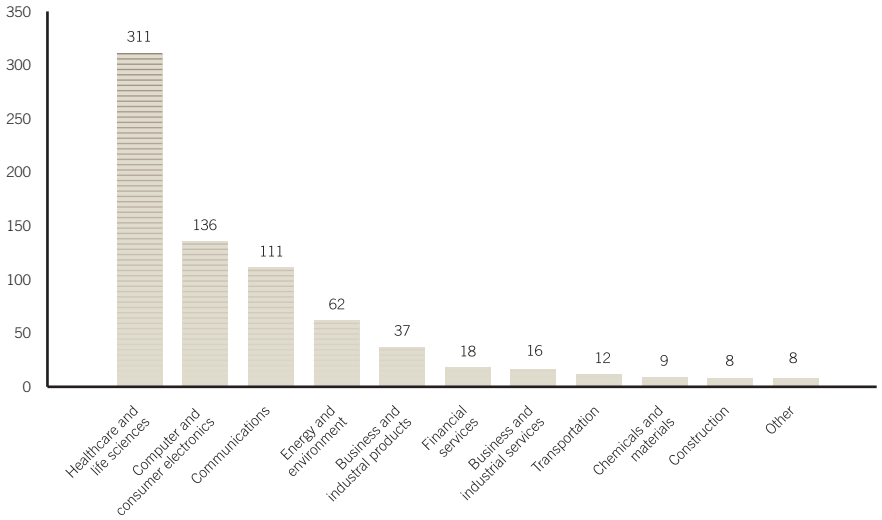


Average VC subsequent round investment size FY05 – FY10 H1 (A$m)



A large portion of VC investment over the last five years has been deployed in the healthcare and life sciences sector. Computer and consumer electronics, communications and energy and the environment have also been major areas of investment for VC funds.

VC investment by industry sector, FY05 – FY10 H1 (A$m)

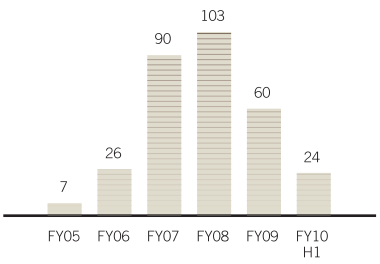


No. of transactions	268	98	87	50	29	<5	11	<5	7	6	12

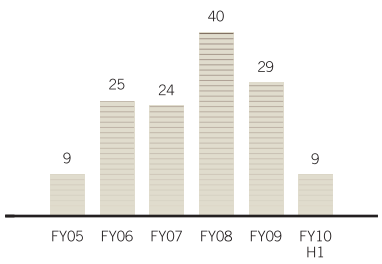
Looking forward, we anticipate that the healthcare and life sciences, and energy and environment sectors are likely to be key areas of focus among VC investors.

VC investment by industry sector and year, FY05 – FY10 H1 (A$m)

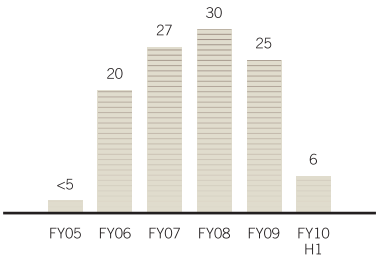
Healthcare and Life Sciences



Computer and Consumer Electronics



Communications



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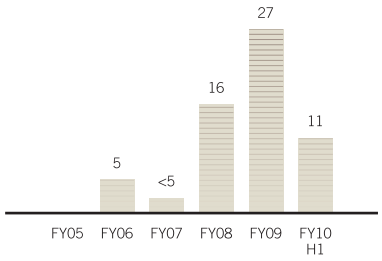

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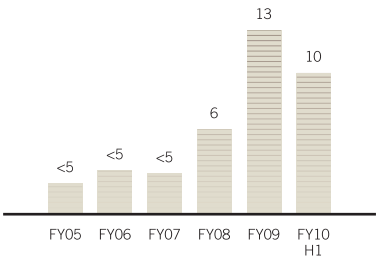

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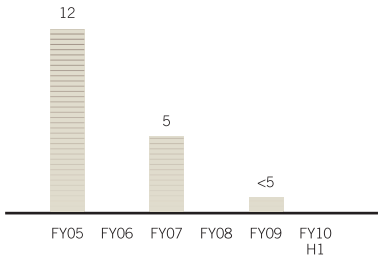

The downturn in the equity and consumer markets over the last two years has had a significant impact on the ability of VC funds to realise their investments. This has kept fund returns at historically low levels, making it even more difficult for the VC in industry to raise new capital at a time when most funds established in the late 1990s are now approaching their termination years.

Impact of the Global Financial Crisis

[1] Source: Capital IQ

[2] Note: Excludes companion funds

The financial crisis has undoubtedly changed the face of the PE industry. In the last couple of years, deal activity has predominately been confined to the small and mid-market range, transactions have seen less leverage and greater equity contribution, and PE firms have largely turned their attention away from new deals onto supporting and further building on existing investments. Australia appears to have fared in a similar way to its international counterparts, particularly North America and Europe, where the credit crisis also constrained the ability of PE players to finance transactions. In the US, total PE deal value of leveraged buyouts and management buyouts declined by 76% CAGR between FY07 – FY09, and like Australia, experienced a 'reset' to pre-FY06 levels.[1]

As predicted in last year's survey, there have been several PE investment write-offs. As a result, PE players have taken a more cautious approach to assessing earnings quality and earnings visibility, as well as closely monitoring economic conditions and industry risks. Furthermore, we have seen greater emphasis in commercial due diligence on the target, not just the "market story", and in understanding and quantifying the downside risks (as well as the upside).

Investors who provide funding to the industry have responded to the financial crisis by reallocating and restructuring their portfolios. In some cases, investors have looked to exit by divesting their exposures to PE funds, often at a discount.

From an industry perspective, no sector has emerged unscathed. Looking forward, we anticipate that industries which are less sensitive to the business cycle, such as healthcare and energy and the environment, or which typically lead an economic upswing such as retail and infrastructure, will likely fare better and present more opportunities in the short to mid-term.

For VC, fundraising remains the biggest challenge. There have been only two new VC funds raised in FY2010 so far, totaling $80m, half of which was funded by the Government's Innovation Investment Fund programme.[2] The downturn in the market, the lack of attractive exit opportunities and the need to ensure sufficient funds are available for further follow-on rounds have resulted in a major gap in the demand and supply of venture funding in Australia.

Outlook for Australian PE and VC Activity

Despite a significant drop in overall activity from peak levels in FY07 at the height of the '00's boom, there are signs of 'green shoots' emerging in the PE sector. Having ridden the downturn like many other industries, deal activity appears to be turning the corner, and is well positioned to recommence an ascent going forwards, supported by a resilient Australian economy and the gradual increasing of credit availability. Furthermore, despite the challenging context in which PE firms operate, opportunities still remain and the industry will continue to find innovative means of deploying capital and creating value to deliver the attractive returns that have become characteristic of the industry.

We are likely to see increasingly attractive opportunities emerging given that valuation multiples are hovering around FY05 levels and a convergence in value expectations between buyers and sellers is likely to materialise. Although traditional exit options such as IPOs and trade sales have been harder to come by, as time unfolds and further confidence and stability is restored in the equity markets, divestment opportunities will become increasingly viable. In the more immediate future, there is potential for increased activity in the secondary buyout market as PE firms look to exit from the large volume of investments made in FY06-07 boom period, especially given the substantially lower percentage of secondary buyouts in Australia relative to larger overseas markets such as the US.

The outlook for Australia's VC sector remains less certain with fundraising declining sharply in Australia and also globally. The gap between the availability of seed and other early-stage capital and demand for this capital has widened steadily over the last year. As a result, a shakeout of VC funds now looms over the industry. The funds that are able to successfully navigate through these challenging times will be those with a proven track record of successful investments and expertise in the industries which still have the capacity to utilise venture funding effectively.

For later stage investments, however, we expect a resurgence of PE activity to take place over the coming years. Supported by a resilient and strengthening Australian economy, a gradual increase in credit availability and the potential for investment at attractive valuation multiples, the Australian landscape presents attractive opportunities that will be of prime interest to not only local incumbents, but increasingly also to large international players pending the resolution of income taxability for foreign companies. What is certain is that both PE and VC will remain an important source of capital and support to Australian businesses and the broader economy.