

The private equity market is an important source of funds for startup and young firms, firms in financial distress and those seeking buyout financing. As this IFSL report shows, the UK is the largest and most developed private equity centre in Europe and is second in size globally only to the US. London is one of the leading international centres for the management of private equity investments.

SIZE AND REGIONAL BREAKDOWN

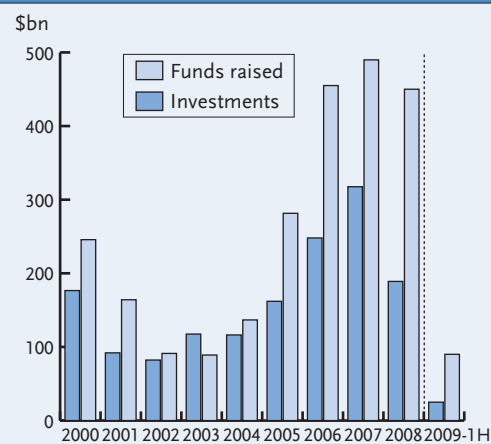
Investments According to IFSL estimates, \$189bn¹ of private equity was invested globally in 2008, down 40% on the previous year (Chart 1). Investment activity slowed in the second half of the year (Chart 2) as liquidity dried up and investors became more risk averse as equity markets fell. Many private equity firms saw a sharp decline in their stock prices and faced write-downs in the value of their existing private equity portfolio holdings. The economic slowdown is also likely to affect completed private equity deals as around \$500bn in loans extended on these deals will need to be refinanced in the next few years. Prior to this, in the three years to 2008, private equity firms enjoyed a growing market driven by a strong global economy, rising corporate profitability and high levels of inexpensive credit.

Buyouts' share of total investments fell to 41% in 2008 from 89% in the previous year as the contraction in the credit markets made it more difficult for private equity firms to obtain debt financing from banks to complete deals. The number of buyouts declined 70% in Europe and nearly 80% in the US. Deal volume for buyouts worth more than \$3 billion showed the largest decline (84%) as they require the most debt finance.

Early indicators for 2009 show that activity was down further in the first half of the year with firms doing smaller deals and using less leverage. As large buyout activity slowed, investments hit a 12 year low and dropped to \$24bn in the first half of 2009, down to one-sixth the level in the same period in 2008. Private-equity backed deals generated only 7% of global M&A volume in 2008, the lowest level since 2001 and down from the all-time high of 21% in 2006. This fell further to 3.5% in the first half of 2009.

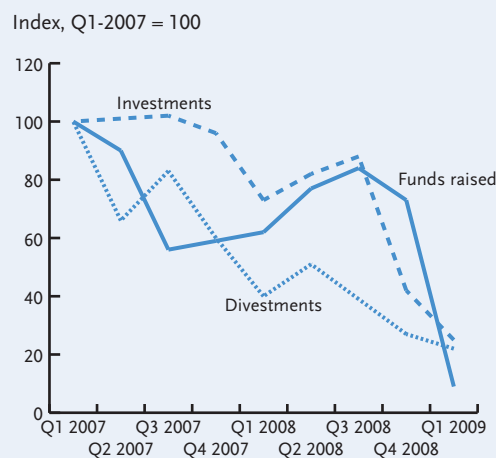
Funds raised Despite the financial crisis and fall in private equity investments, fund-raising levels were down only 8% in 2008 to \$450bn, a result of a relatively strong start to the year. The slowdown in fund-raising accelerated in the first half of 2009, with under \$100bn raised, a two-thirds drop on the same period in 2008. The number of abandoned fund-raisings totalled 30 in the first half of 2009, matching the amount abandoned in the whole of 2008 and double the 14 in 2007. This has allowed other participants to enter the market such as sovereign wealth funds and hedge funds which has raised some concerns about transparency and disclosure of such transactions. Prior to the economic slowdown, the market saw intense competition for private equity financing. The fall in investment activity and economic slowdown have given a boost to the secondary market for private equity where existing stakes in private equity holdings are bought and sold.

Chart 1 Global private equity market



Source: IFSL estimates based on PEREP_Analytics, Thomson Reuters, PricewaterhouseCoopers, EVCA data

Chart 2 European private equity market, quarterly trends



Source: PEREP_Analytics, EVCA

Table 1 Top countries for private equity investments and funds raised

\$bn	2007		2008	
	Investment value	Funds raised	Investment value	Funds raised
US	106	302	48	288
UK	50	61	32	65
France	18	10	12	15
China	11	11	13	13
India	18	6	11	8
Japan	15	5	10	3
Australia	15	6	2	3
Others	85	89	61	55
Total	318	490	189	450

Source: IFSL estimates based on PEREP_Analytics, Thomson Reuters, PricewaterhouseCoopers, EVCA, AVCJ data

¹ Data from various sources may not be entirely comparable due to differing methodologies. IFSL relies on public sources of data for this report, primarily organisations that collect data and publish newsletters and reports for the private equity community.

Funds under management Private equity funds under management totalled \$2.5 trillion at the end of 2008 (Chart 3). The 15% increase during the year was due to strong fund raising activity in the first half of 2008 and an increase in unrealised portfolio investments, as firms were reluctant to exit their stakes in market conditions of falling valuations. Funds available for investments totalled 40% of overall assets under management or some \$1 trillion, a result of high fund raising volumes between 2006 and 2008. These funds can be used to inject capital into troubled portfolio companies during the economic downturn or to fund new investments. IFSL forecasts that funds under management will increase to over \$3.5 trillion dollars by 2015. This growth will be slower than in recent years as markets gradually recover and private equity companies increasingly realise existing portfolio holdings.

Potential changes in financial regulation may place additional requirements and restrictions on private equity funds. There is a great deal of uncertainty around the detail of any future regulatory changes. Possibilities under consideration include changes in US capital gains tax laws. In Europe possible changes include new disclosure requirements, harmonised governance standards, and limits on leverage. These changes may result in reducing the number of alternative investment funds that European institutional investors such as pension funds have access to.

Geographic breakdown The regional breakdown of private equity activity shows that in 2008, North America accounted for 26% of private equity investments, down from 34% in the previous year as buyout activity in the US fell (Table 1, Chart 4). North America maintained its two-thirds share of funds raised in 2008. Europe increased its share of investments in 2008 from 34% to 40%. It also increased its share of funds raised from 24% to 25%. There has been a rise in the importance of Asia-Pacific and emerging markets in recent years, particularly China, Singapore, South Korea and India.

The UK private equity market is the most developed outside the US. Private equity funds based in the UK accounted for 17% of global investments and 15% of funds raised. Other important centres for private equity in Europe include France, Germany, Sweden, Netherlands and Spain. New York and London are the leading locations for private equity firms. There were 17 firms amongst the largest 50 headquartered in New York and 10 in London. Firms located in New York accounted for 36% of funds raised in the five years up to 2008. Firms in London accounted for 18% (Chart 5).

UK private equity London is the largest European centre for the management of private equity investments and funds (Table 2). Firms located in the UK have also attracted the largest proportion of European private equity investments in recent years. Many factors contribute to the attraction of the UK as a centre for private equity such as: the availability of funds to invest; opportunities to make investments, people with the necessary skills to source, negotiate, structure and manage investments; and the availability of exit opportunities such as the large equity market.

Definition of private equity

Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. This also includes public companies that are delisted as part of the transaction.

Chart 3 Private equity worldwide assets under management

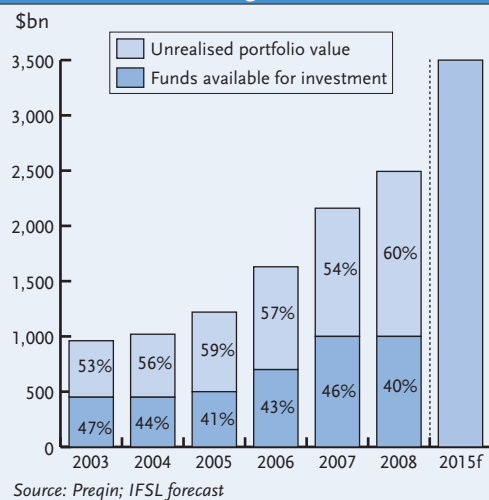


Chart 4 Regional breakdown of private equity investments and funds raised

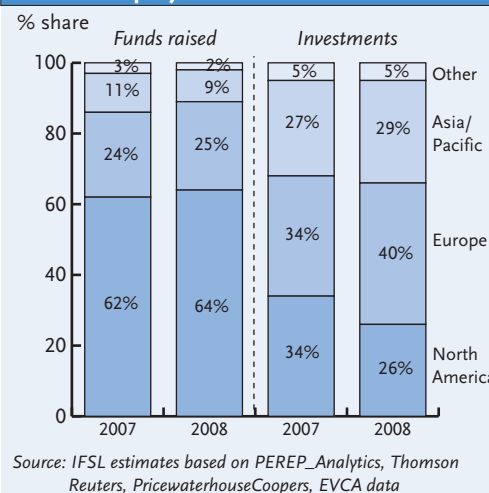
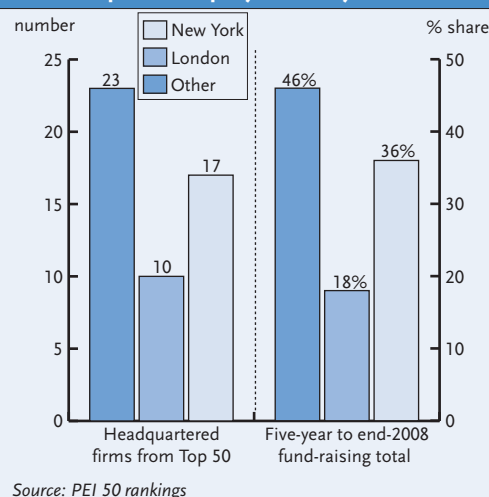


Chart 5 London vs. New York - share of private equity industry



Investments Worldwide investments of UK private equity firms mirrored falls on the global markets and declined 38% in 2008 to £19.5bn according to the BVCA survey of its members (Chart 6). This was considerably below the record £32bn raised in the previous year but nevertheless is the third-best investment year on record. Investments were made in 1,571 companies in 2008, down from 1,680 in the previous year.

The UK private equity industry has become more global over the past decade. In 2008, private equity firms in the UK invested 57% of their funds in companies located overseas, down from 62% a year earlier. Over 70% of overseas investments were in Continental European countries, and around a fifth in the US. The UK's influence overseas is considerable, both through direct investment from the UK offices of private equity firms and through their offices overseas. A regional breakdown of investment activity within the UK shows that firms located in London saw investment levels decline to around £4.5bn in 2008, down from £8.2bn in the previous year. All other regions with the exception of Scotland experienced falling investment levels in 2008.

Funds raised in the UK totalled £23.1bn in 2008 down from £29.2bn in the previous year (Chart 6). Overseas investors generated around three-quarters of funds raised. Investors from North America were the largest source of funds with 45% followed by investors from the UK 24% and Continental Europe most of the remainder. These figures from the BVCA represent the amount raised by independent funds only.

Secondary market for private equity pools capital from investors to purchase existing stakes in private equity funds. It has seen considerable investor interest so far in 2009. Around \$15.6bn in capital was raised in the first half of 2009 already, setting a new annual record with six months left in the year. Secondary funds had raised \$7.4bn in 2008, less than half the amount raised in 2007 (Chart 7).

Despite record fund raising in 2009 the value of secondary buyouts was only \$2bn in the first half of 2009 as potential sellers have yet to adjust to the low prices the buyers are currently offering. The slowdown in investment activity on the secondary market began following the sharp correction of global equity markets in September 2008. It is likely that this will be followed by a narrowing of bid-ask spreads in the second half of 2009 and an increase in secondary dealmaking. There is probably over \$100bn of private equity interests that will become available for sale over the next two to three years.

Fund of funds accounted for around a third of secondary market investments in recent years, followed by institutional investors a fifth, and family offices and secondary funds for much of the remainder. North American fund managers dominate the secondary market with over a half located in this region. Europe accounts for a third and Asia for most of the remainder.

FINANCING STAGE AND INDUSTRY BREAKDOWN

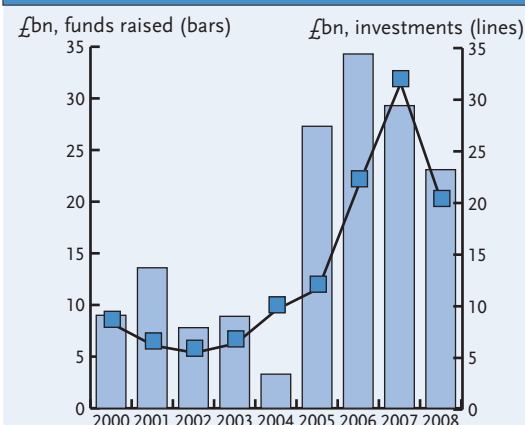
Private equity investments and funds raised can be categorised according to the financing stage into: venture capital; buyouts and special situations.

Table 2 Private equity investments and funds raised in Europe

\$bn, 2008	Investments		Funds raised	
	Country of manag.	Country of destination	Country of manag.	Country of origin
UK	31.7	19.0	65.2	15.6
France	12.4	12.8	15.2	8.9
Germany	10.0	13.0	3.4	4.9
Sweden	4.8	3.1	9.3	2.0
Others	20.9	31.8	17.5	79.2
Total	79.7	79.7	110.6	110.6

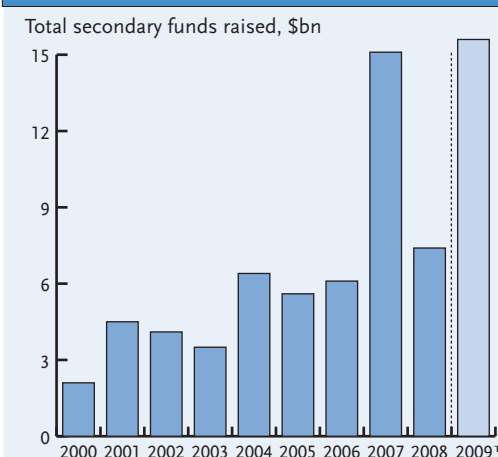
Source: PEREP_Analytics

Chart 6 UK private equity investments and funds raised¹



¹ figures are not comparable with EVCA figures as they only include independent funds raised and BVCA member investments
Source: BVCA

Chart 7 Global private equity secondary market



¹ 1H-2009

Source: Probitas Partners; Dow Jones Private Equity Analyst

Buyouts generally account for the bulk of investments by value due to the significantly larger size of such deals compared with other investments. Venture capital accounts for the majority of investments by number.

Investments Globally, buyouts' share of the value of private equity investments dropped sharply in 2008 to 41% from 89% in the previous year as liquidity in the markets dried up and it became more difficult to obtain bank loans to finance deals (Chart 8). A general deleveraging has occurred since the start of the credit crisis. Average debt levels in buyouts fell to 42% in 2008 from 47% in 2007. This was the lowest level since 1994. Venture capital investments have largely remained at recent years' levels (Chart 9).

Among the biggest buyouts in 2008 were the \$3.5bn acquisition of the Weather Channel by Bain Capital and Blackstone, and Carlyle's \$2.5bn takeover of consulting firm Booz Allen Hamilton. The largest private equity deals in the first half of 2009 were Kohlberg Kravis Robert's \$1.8bn buyout of Korean beer company Oriental Brewery, and the £553 million acquisition of energy research unit Wood Mackenzie by Charterhouse Capital from Candover. These deals however were small compared with some of the large buyouts in the years preceding the credit crisis (Table 3). Buyout managers are shifting funds to distressed debt, bankruptcy financing, private investments in public equity, emerging markets and financial institutions. In the UK, buyouts generated the bulk of private equity investments in 2008 with 59% of the total. Expansion stage companies accounted for 37% and early stage investments for the remaining 4%.

Funds raised Globally 41% of funds raised in 2008 are expected to be

Private equity activity

Investments represent the financing of businesses through venture capital, buyouts and other forms of financing.

Venture capital represents investment in companies that have undeveloped or developing products. Investments can be classified into:

- Seed stage: Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase
- Start-up stage: Financing for product development and initial marketing.
- Expansion stage: Financing for growth and expansion of a company which is breaking even or trading profitably.
- Replacement capital: Purchase of shares from another investor or to reduce gearing via the refinancing of debt.

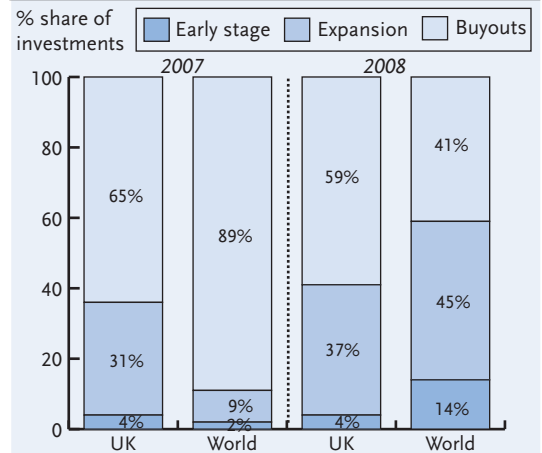
Buyout funds typically target the acquisition of a significant portion or majority control of businesses which normally entails a change of ownership. These are generally investments in more mature companies.

Special situation includes a range of investments such as distressed debt, equity-linked debt, project finance and leasing. This category includes investment in subordinated debt, referred to as mezzanine debt financing.

Fund raising refers to the money investors have committed to private equity funds in any one year.

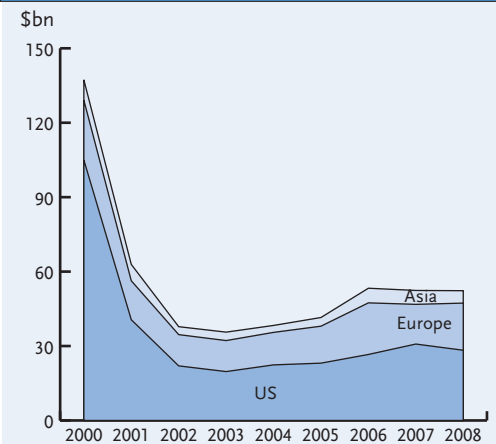
Divestments represent the realisation or exiting of a private equity investment. This is generally done by: selling the company; writing off the investment or floating the company on a stock market.

Chart 8 Private equity investments by financing stage



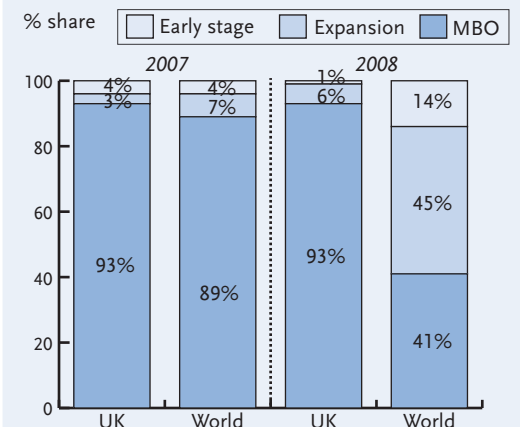
Source: IFSL estimates based on PEREP_Analytics, Thomson Reuters, PricewaterhouseCoopers, NVCA, EVCA data

Chart 9 Venture capital investments



Source: IFSL estimates based on PEREP_Analytics, Thomson Reuters, PricewaterhouseCoopers, EVCA data

Chart 10 Private equity funds raised by expected stage of investment



Source: IFSL estimates based on PEREP_Analytics, Thomson Reuters, PricewaterhouseCoopers, NVCA, EVCA data

allocated to buyouts, 45% to expansion stage and 14% to early stage firms. Of total funds raised in the UK in 2008, over 90% of capital is expected to be invested in buyouts. Investments in expansion stage companies are expected to account for 6% and early stage investments for 1% of the total (Chart 10).

Exits Private equity firms buy companies in order to sell them at a profit at a later stage. This has become more difficult since the start of the economic slowdown. Private equity exit transactions in which portfolio companies are sold to a buyer or another private equity firm totalled just under \$21bn in the first half of 2009, the lowest amount during that period since 2001. This was down 82% from the \$115 billion in exit deals in the comparable period in 2008.

European private equity firms exited from more than 2,000 companies in 2008, at cost value of €13.9bn. This was close to the 2003 exit level and down by a half from 2007 levels. UK's divestments fell to £10.7bn in 2008 from £13.6bn in 2007. The number of divested companies fell 46% during the year to 1,494. The biggest proportion of divestments in 2008 came from trade sales and repayments of preference shares (each accounting for 31% of the total), followed by write-offs (16%).

Industry breakdown High-tech, consumer, communications and other services sectors have attracted a large proportion of private equity investments worldwide over the past decade. In the UK, industrial products generated 29% of investments in 2008 (up from 17% in 2007), followed by consumer services 22% (down from 51%), and health care 15% (up from 7%). The financial sector and consumer services were sectors where investment fell markedly in 2008.

STRUCTURE OF THE PRIVATE EQUITY MARKET

A private equity firm is usually structured as a limited partnership, where the general partner receives capital from limited partners (pension funds, hedge funds, etc), and pays the managers, advisers and lenders out of fees.

Investors in private equity The number and variety of groups that invest in private equity have expanded substantially to include a wide range of investors. Institutional investors with long-term commitments to the asset class provide the vast majority of the capital in private equity funds and new categories of investors such as sovereign wealth funds have entered this market. Pension funds were the largest providers of capital in Europe in 2008, with 25% of total funds raised (up on 18% in the previous year) (Chart 12). Fund of funds followed with 14% (up on 11%). The next largest providers were banks 7% (down on 14%) and insurance companies 7% (down on 8%).

In the UK, overseas investors accounted for three-quarters of funds raised. Almost a half of funds raised were from North America and most of the remainder from Continental Europe. Pension funds were the largest investors in UK funds with 36% of the amount raised in 2008 (up from 23% in the previous year). They were followed by fund of funds 17% (21%) and private individuals 10% (8%) (Chart 12).

Table 3 Largest private equity transactions

Announcement year	\$bn
TXU (2007)	43.8
Equity Office Prop. Trust (2006)	38.9
Hospital Corp. of Amer. (2006)	32.7
RJR Nabisco (1989)	31.1
Harrah's Entertainment (2006)	27.4
Clear Channel Comm. (2006)	25.7
Kinder Morgan (2006)	21.6
Freescall Semicond. (2006)	17.6
Albertson's (2006)	17.4
Hertz (2005)	15.0

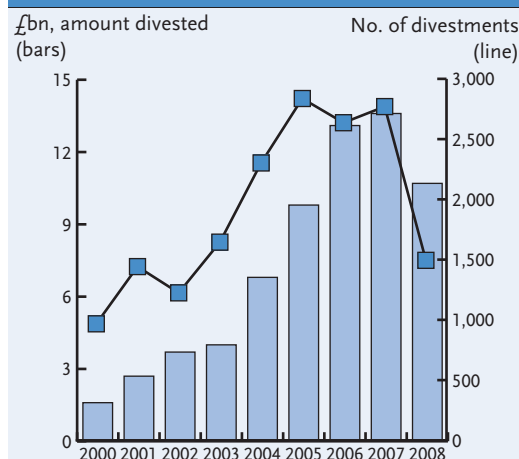
Source: Fortune

Table 4 Exits of individual buyout transactions

% share	2000 to 2002	2003 to 2005	2006 to 2007	Average
Bankruptcy	6	4	3	6
IPO	8	10	1	13
Sold to strategic buyer	39	41	38	39
Sold to financial buyer	30	30	22	24
Sold to LBO-backed firm	5	6	14	5
Sold to management	2	1	1	2
Other / unknown	9	7	22	11
Total	100	100	100	100

Source: World Economic Forum

Chart 11 UK private equity divestments



Source: BVCA

Intermediaries The growth in the private equity market over the past decade is largely attributable to the emergence of private equity funds that raise and invest funds from investors. Private equity funds are organised mainly as limited partnerships. Investors who contribute to the fund's capital are the limited partners while professional managers running the fund serve as the general partners. About four-fifths of private equity investments flow through specialised intermediaries, almost all of which are in the form of limited partnerships. The remainder is invested directly in firms through co-investments (direct investing alongside private equity firms) and other forms of direct investments.

Issuers in the private equity market vary widely in size and in their reasons for raising capital. As private equity is one of the most expensive forms of finance, issuers generally are firms that do not have an alternative source of financing such as a bank loan, private placement or the public equity market.

Firms seeking venture capital are typically young firms that are projected to show high growth rates. Seed or start-up capital is the money used to purchase equity-based interest in a new or existing company which is not yet operational. Venture capital also includes early-stage capital provided for companies that have commenced trading but have not moved into profitability or proved its commercial viability. Later stage investments where the product or service is widely available are also considered as venture capital investments.

Non-venture private equity investments include middle-market companies that use the private equity market to raise finance for expansion or a change in their capital structure. Public companies can also be issuers in the non-venture private equity market. These companies issue a combination of debt and private equity to finance a management or leveraged buyout. They also issue private equity to help them through periods of financial distress.

Chart 12 Sources of new funds raised

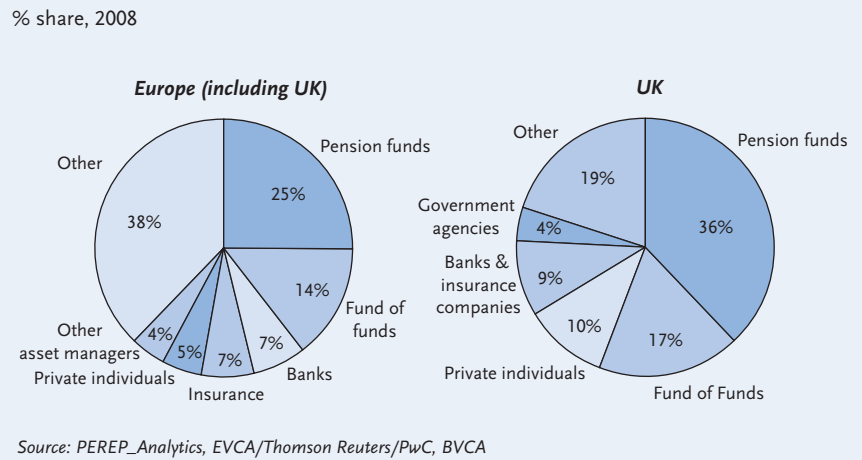
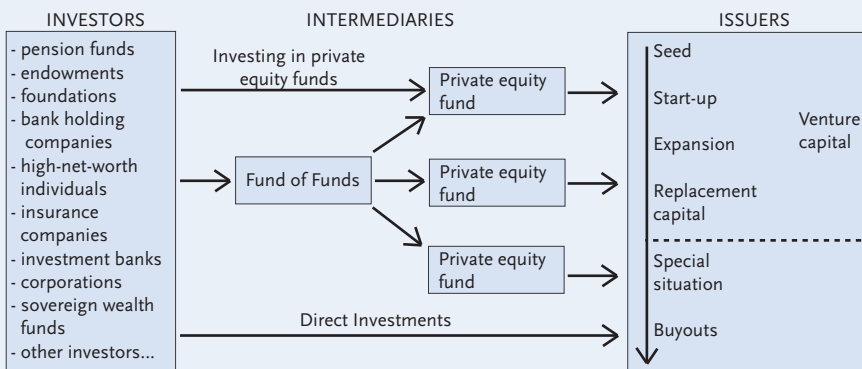


Table 5 Largest private equity firms

Firms ranked by amount of capital raised for direct private equity investment in 5 years up to end-2008	\$bn
TPG	52.4
Fort Worth (Texas)	49.0
Goldman Sachs Principal Inv. Area	47.8
New York	47.8
The Carlyle Group	47.8
Washington DC	47.8
Kohlberg Kravis Roberts	40.5
New York	40.5
Apollo Global Management	35.2
New York	35.2
Bain Capital	35.0
Boston	35.0
CVC Capital Partners	33.7
London	33.7
The Blackstone Group	30.8
New York	30.8
Warburg Pincus	23.0
New York	23.0
Apax Partners	21.3
London	21.3

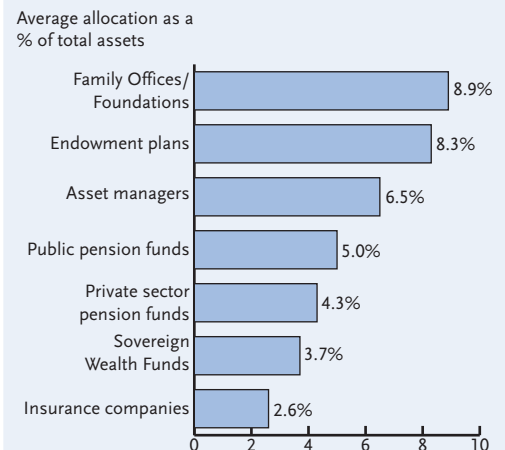
Source: Private Equity International

Chart 13 Private equity market



Source: Federal Reserve Bank of Dallas, EVCA/Thomson Reuters/PricewaterhouseCoopers

Chart 14 Institutional investment in private equity



Source: Preqin

Private equity as an asset class

Over the past two decades private equity has become broadly accepted as an asset class. Investing in private equity contributes to portfolio diversification. Although there is some correlation between returns on private equity and public equity and bond markets the correlation is not high. For many institutions, the potential higher returns of private equity investments over conventional asset classes justify the higher risk of such investments.

Private equity investments are relatively illiquid, particularly in the early years. The life-cycle of an average private equity fund investment averages three to seven years. Investors in private securities generally exit their investment and achieve returns through an initial public offering, a sale (to corporate buyers or another private equity firm), a merger, or a recapitalization. As the companies are not listed on a public exchange, investors wishing to exit their private equity holding do so by selling the holding to another investor through the secondary market.

Agents and advisers are an integral part of the private equity market. They represent “information producers” whose role is to place private equity, raise funds for private equity partnerships and evaluate partnerships for potential investors. The three main types of agents and advisers include: those helping firms raise private equity through search and evaluation services; those helping limited partnerships raise funds typically through buyouts and distressed debt; and those advising institutional investors on the placement of funds they have allocated to the private equity market.

PRIVATE EQUITY AS AN ALTERNATIVE INVESTMENT

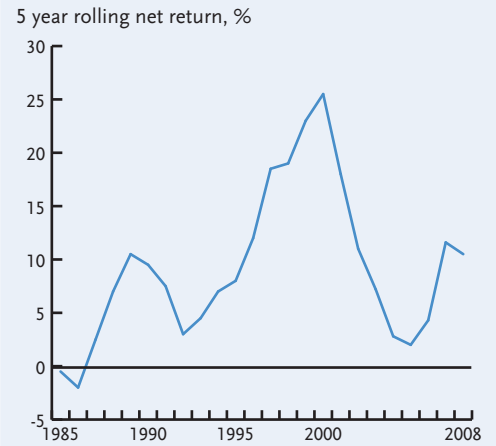
An important reason for the high growth of the private equity market since the 1980s has been the fact that private equity investments generated consistently higher returns than most public equity markets and bond markets. As private equity investments are generally medium and long term investments, one year returns are inappropriate as a realistic measure of private equity performance due to the volatility in returns.

A marked drop in returns was seen in 2008. One-year returns for European private equity averaged minus 24.9% in 2008 with the majority of the decline coming in the later part of the year. This included a negative 17.9% return for venture capital and minus 26.4% for buyouts. The private equity industry has produced strong returns in the years leading up to the credit-crisis. The long term performance of the European private equity industry remained strong in 2008. The 5 year rolling net return in Europe totalled 10.5% in 2008 (Chart 15) down from 11.6% in 2007. The net internal rate of return since inception to December 2008 averaged 10.3% for all private equity, with buyout funds returning 14.2% and venture funds 3.1%.

The net return of UK private equity funds measured at end-2008 was: 3 years 16.7%, five years 20.4% and ten years 15.4%. Ten year returns on UK private equity significantly outperformed other major asset classes such as UK equities (1.4%) and bonds (4.7%) (Table 6).

US institutional investors allocate an average of 7% of portfolios to private equity, a higher proportion than the 5% share in Europe and 3% in Japan. It is likely that private equity allocation from all types of investors declined since the start of the credit crisis as investors looked for more safe investments.

Chart 15 Private equity returns in Europe



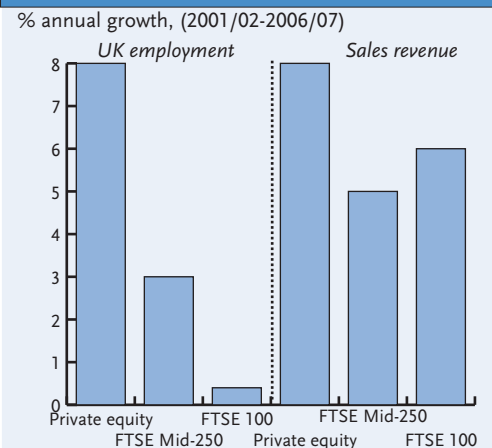
Source: Thomson Reuters; EVCA

Table 6 UK private equity returns

Average annual returns 2008, %		of which	
	All private equity	Technology	Non-technology
3yrs	16.7	0.7	17.9
5yrs	20.4	0.9	22.0
10yrs	15.4	-2.0	16.8
return figures, %		10yr to 2008	2008
Private equity		15.4	-9.8
Property		7.7	-22.7
Overseas equities		3.3	-22.5
UK bonds		4.7	1.9
Overseas bonds		5.7	17.0
UK equity		1.4	-29.6
Cash		5.4	3.1
Alternatives		8.7	1.4

Source: BVCA

Chart 16 Comparative growth



Source: BVCA

CONTRIBUTION TO THE UK ECONOMY

Over the past two decades, the UK private equity industry has invested over £150bn in around 30,000 firms worldwide. The BVCA has drawn attention to the significant contribution to the UK economy made by private equity:

- Companies that have received private equity backing in the UK account for employment of around 3 million people, or 16% of UK private sector employees. In addition private equity funds based in the UK employ several thousand people. Growth in employment in private equity firms is greater than in other private sector firms (Chart 16).
- Through investment overseas, the industry contributes to the current account of the UK balance of payments through income and capital gains. Exports of private equity backed companies grew by 10% annually over the five years to 2006/07 totalling a cumulative £188bn in export sales during this period.
- Sales revenue of private equity backed companies rose by 8% a year between 2001/02 and 2006/07 totalling £1,331bn during this period. Private equity backed companies contributed £35bn in taxes in 2006/07.
- Higher rate of return provides an attractive asset for institutional investors, lifting prospective income of their clients.

LINKS TO OTHER SOURCES OF INFORMATION:

BVCA

www.bvca.co.uk

EVCA

www.evca.eu

PEREP_Analytics

www.perepanalytics.eu

Thomson Reuters

www.thomsonreuters.com

PricewaterhouseCoopers

www.pwcmoneytree.com

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Data files

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