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Private Equity – a world of opportunities

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Introduction

As Australian savings and investment portfolios grow, individuals and institutions are looking to expand their asset allocations into the Alternative assets classes. According to Investment Trends[1], the leading investments for individuals who invest in Alternatives are Infrastructure, Private Equity and Real Estate.

The investor's main objectives for investing in Private Equity are to diversify their portfolio, diversify risk, achieve higher returns and hold longer-term investments. Top quartile Private Equity has consistantly achieved all those objectives.

Fortune has favoured Private Equity in recent years with low interest rates and robust economic expansion. The size of the Private Equity market is growing rapidly across industries and more countries. Larger partnerships have the ability to buy and restructure large public companies.

Returns for top-quartile managers have exceeded those of the public markets over ten and twenty years. Credit Suisse New York's research estimates that the weighted average cost of capital for a buyout today is 20 percent less than the 10 year average. In 2006, the exit multiple for Private Equity deals were at a ten year high, valued at more than $US 50m and at 8.2x EBITDA (Credit Suisse NY).

Credit Suisse suggests that the best Private Equity will continue to outperform corresponding public equity benchmarks and maintain strong performance. The best Private Equity managers (see Chart 1), applying the lessons learned in leaner days, have prepared for the inevitable time of economic downturn, less benign interest rates and contracting transaction multiples. As credit conditions tighten Credit Suisse's analysis suggests that the best private equity managers can maintain strong performance.

What is Private Equity?

Private Equity is any investment strategy that usually involves the purchase of a controlling share in a private company, generally in connection with leverage buyouts or growth capital, venture capital or mezzanine investments. Private Equity investments may be in any industry and geography including companies or infrastructure.

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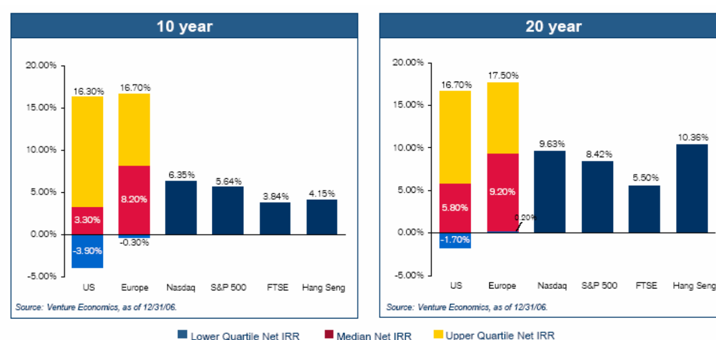
[1] Investment Trends Pty Ltd. Dec 06 Alternative Investments: Investor Report

Why invest in Private Equity?

1. **Portfolio diversification:** Private Equity returns have historically demonstrated a low correlation to the returns of other traditional assets and the asset class is growing significantly. It offers significant diversity across geographies, multiple industries and offers access to some of the world's most highly motivated and well-run private companies.

2. **High long-term absolute returns:** Private Equity has historically outperformed other asset classes, including the public markets (see chart below). Over the 10 year period ended June 30, 2006 the annual return from an investment in a top-quartile US Private Equity Fund tripled historically that of the Standard & Poors 500 Index (see Chart 1 below). Over the last 20 years, top-quartile Private Equity returns almost doubled the index on an annual average basis.

Chart 1



The 10-year and 20-year return histories for U.S. and Europe Private Equity versus U.S., European and Australian stock markets. The returns are based on the cumulative net IRRs of all private equity funds formed since the beginning of each illustrated period and thereafter, excluding returns from private funds formed in vintage years 2004 to 2006 as they are deemed irrelevant because these funds are early in their investment cycles. Ten-year returns are for funds formed in vintage years 1994 to 2003 and 20-year returns are for funds formed in vintage years 1984 to 2003. Due to the historically poor performance of European venture funds, information displayed excludes performance of these funds. Including the performance of the venture funds, 10 year returns were -5.90%, -0.80% and 9.30% for lower quartile, median and upper quartile, respectively, and 20 year returns were -4.50%, 0.90% and 11.10% for lower quartile, median and upper quartile, respectively. Public markets were calculated using the compounded annual growth rates of end-of-the-month levels of various indices over the periods under construction. The 10-year and 20-year return numbers for the NASDAQ Composite, S&P500, FTSE and Australian All ordinaries are based on data starting June 1997 and June 1987, respectively.

3. **Highly informed investment opportunities in private companies:**
   There are a substantially larger number of private companies than public companies in Australia and the world. Private Equity managers are highly selective when investing in businesses that are offered for sale. They are fully informed about the private companies they invest in, having done extensive due diligence and many managers have, during the due diligence phase, worked with the management team to develop a plan to improve/streamline operations and profitability. Private companies may disclose 100% of information to investors and hence investment decisions by Private Equity managers have public information risk.

4. **Access to experienced Private Equity Managers:**
   Top quartile Private Equity managers have established impressive records in company selection, buy-outs, company strategy, operational transformation and the realisation of greater enterprise value when selling their portfolio across a range of industries.

   Their industry teams are generally specialised and experienced through multiple buyouts where they take a long-term view of increasing and realising the entire enterprise value; invest for the future; and have no pressure to manage to public quarterly earnings reports. They have a long record of delivering better managed operations at their companies, more efficient utilization of capital and more highly motivated and rewarded management and employees.

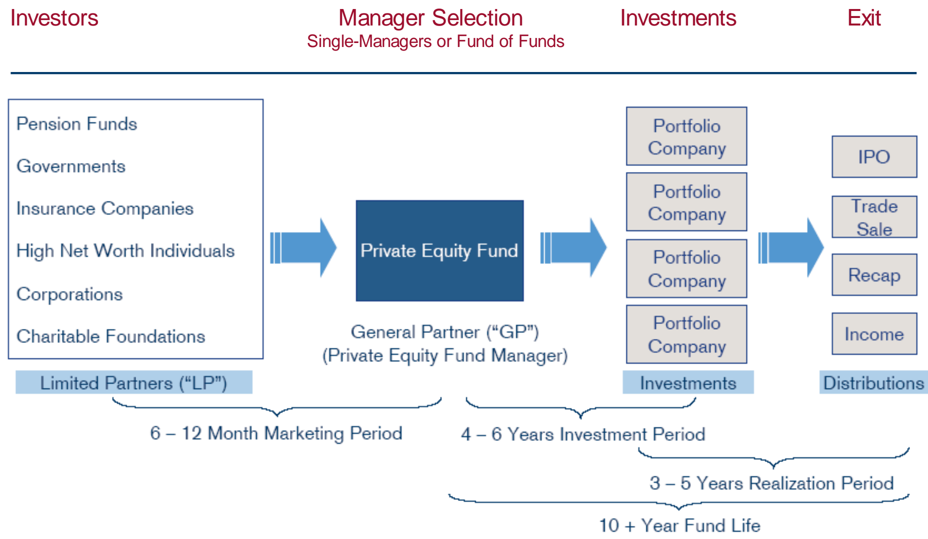
5. **Private Equity is a growing asset class:**
   Key factors that drive returns include a broadening of the available industries and geographic regions, favourable economic conditions, improved acquisition finance, and an evolving approach to investment management by the leading private equity firms.

How to access Private Equity?

Private Equity firms aggregate capital from investors to invest in a portfolio of companies that they actively select (and actively manage/monitor). The agregation of capital is typically through Limited Partnerships, trusts or related unlisted securities. Investments are then made through Private Equity Managers or a Fund of Managers, who in turn look to buy controlling interests in a diversified portfolio of underlying companies in industries in which they specialise. This is outlined in Chart 2 below.

Returns are generally realised by capital gain from the sale of the transformed companies to strategic competitors, other Private Equity managers who may be looking to “roll-up” a series of companies across an industry, through an IPO on a listed exchange or sometimes by recapitalisation of the company.

Chart 2



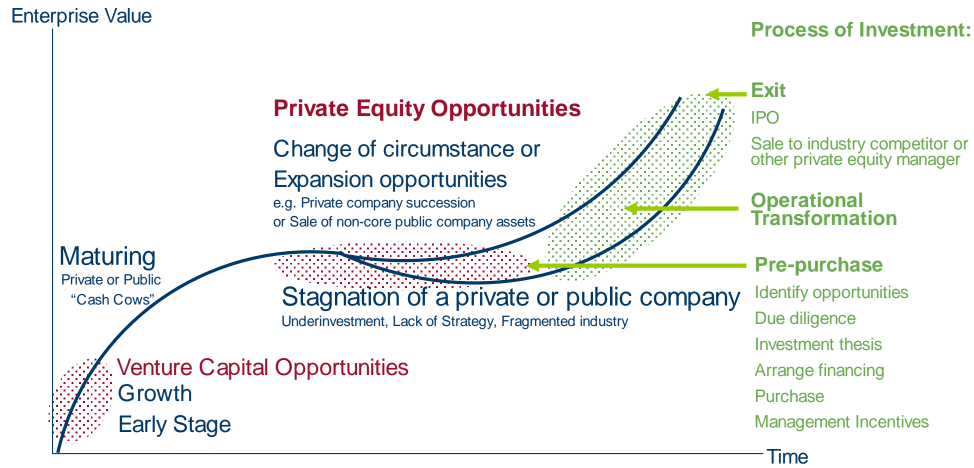
What do Private Equity Managers do?

Private Equity Managers utilize a broad range of strategies to create value:

- Invest in companies at critical stages (i.e. seed, growth, turnaround)
- Buyout private companies or non-core businesses and restructure, refocus or revitalize inefficient operating companies
- Acquire growth companies operating in fragmented industries to aggregate larger opportunities ("Roll-ups")

Life Cycle of a Company

Almost every company at some stage in its life-cycle becomes a private-equity opportunity. It will either be a private company where the controlling family looks to realize their life's enterprise; the non-core assets of public and private companies; or those companies targeted by Private Equity managers that are underperforming or distressed which they believe can be revitalized. These companies typically need recapitalization, refocus, new strategy, transformation of operations, new technologies or new



management.

Chart 3

Value proposition of experienced Private Equity Managers

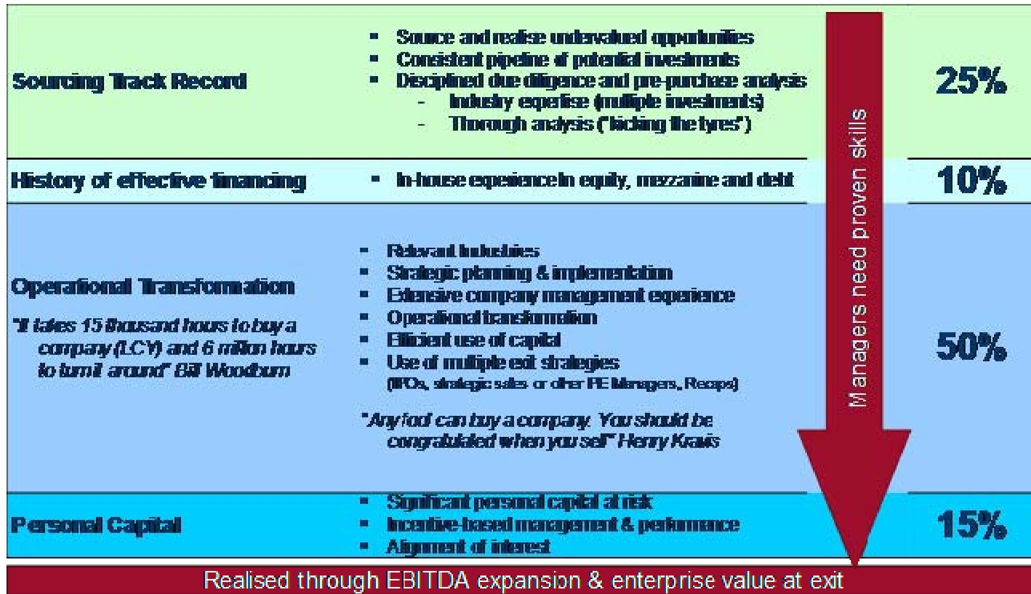
Successful investment demands a comprehensive strategy that places greater emphasis on operational improvements as a key driver of investment returns.

The best Private Equity firms have evolved from financial engineers to highly experienced business operators, willing and able to bring about lasting change in the Private Equity investments.

Experienced managers have a range of dedicated skills across the industries they specialise in. Chart 4 below identifies many of those skills and estimates the value-added benefit of each of them. As investments have become larger and more sophisticated, the critical skill that adds most value has become the operational experience of the managers Industry teams. Value is realised through the implementation of operational and other improvements and a significant expansion in a sustainable EBITDA. The successful sale and exit of the company is then generally to strategic competitors of the company.

Chart 4

Value proposition to evaluate in experienced Private Equity managers



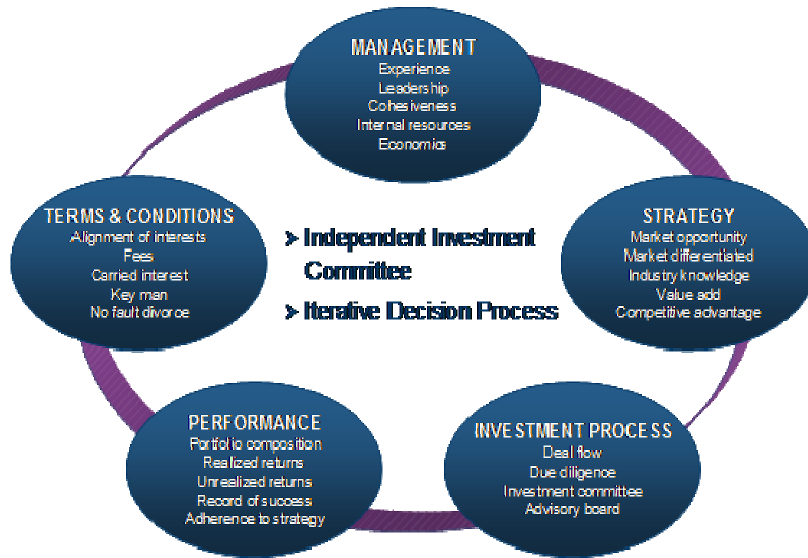
Source: Credit Suisse

The importance of Manager Selection

Top quartile Private Equity managers generally have a wide range of in-house skills and experience. Investors need to ensure that these have been evaluated carefully before investing. The role of a fund manager in a fund of fund situation is to rigorously investigate and analyse these skills and invest in only those managers that have established consistency, industry operational and management skills, experience, teams and sustained performance through several business cycles. These factors are outlined in Chart 5 below.

Chart 5

Critical factors for selecting Private Equity managers

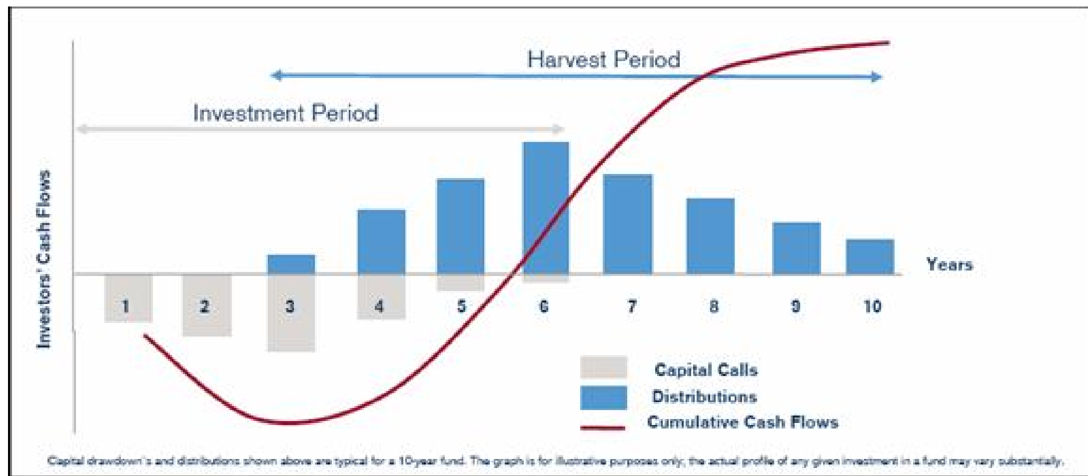


The timeframe of investments

Top quartile Private Equity managers have a history of outperforming traditional equity investments. Returns usually accumulate in later years. Private Equity typically has investment periods of 3-5 years and a realisation period of 3-8 years starting in approximately year 3. The flow of capital out (funded by investors) and back (distributed to investors) follows a "J curve". This is illustrated in Chart 6 below.

Chart 6

Flow of cash J Curve.



Fees and expenses

Private Equity is managed by highly skilled managers who also invest their own capital and work actively to implement their operational strategy through the board and management. For this, they receive a

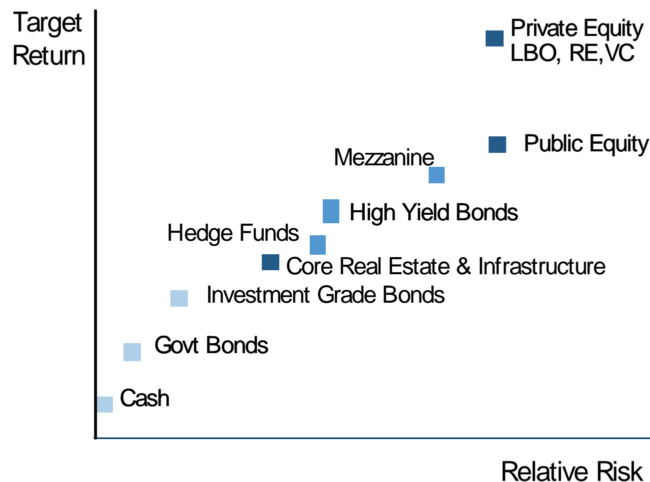
management fee and a further performance fee provided they deliver more than a minimum "Preferred Return" to all investors.

Risks of Private Equity

Private Equity is estimated to have similar risk characteristics to listed equity (see chart 7 below). This can be mitigated by choosing Managers who have a history of consistent, disciplined, "hands-on" company investments, and strategy. Investing in a Fund of Funds may also reduce this risk. Risk is mitigated by solid due-diligence and a thorough understanding of the target.

Chart 7

Estimated risk/return of different assets



Risk can be mitigated further by choosing managers who have a history of consistent, disciplined, "hands on" company investments and strategy. Risk is also mitigated by solid due diligence and a thorough understanding of the target. Investing in a Fund of Funds may also reduce the risk.

Key Drivers of robust Private Equity returns

Four key factors have helped drive private equity's recent robust returns in the last five years: broadening of the markets private equity players participate in; favourable economic and financing markets; improving acquisition pricing; and an evolving approach to investment management by the leading private equity firms.

1. Broadening of the markets

On the supply side, the Private Equity opportunity set has been expanding rapidly. The overall buyout market has grown dramatically from $6.5 billion in 1994 to $44.8 billion (Credit Suisse NY). This expansion has been facilitated by private equity's growth along various dimensions.

In the 1990s, private equity was concentrated in a few core industries in the US: financial services, consumer goods, retail distribution and industrials. Today private equity is a globalizing business and investments now go well beyond the original core industries.

Private Equity managers have gained expertise in a wider range of industries, while professional managers have gained an appreciation of the power of Private Equity to build their franchises. In addition, private equity firms are raising larger funds and/or forming consortiums, which have expanded the market by enabling private equity firms to buy ever larger companies. Yet despite this expansion, private equity fund transactions today account for less than 20% of global M&A activity.

2. Favourable economic and financing markets

The economic and financing environments have been excellent in the big Private Equity markets in Europe and the United States. Steady economic growth has provided good baseline company performance. Big benefits have also come from the true “borrower’s market” - interest rates have been very low, and buyout firms relying on extensive debt financing have benefited greatly.

3. Favorable acquisition pricing

M&A transaction valuations have grown significantly from 2001 to 2005, rising from an average of 6.1 to 8.2x EBITDA. This factor alone creates substantial returns, with an equity increase in value of approximately 10% per year simply due to rising deal prices. Exits were not only higher priced, but easier to accomplish.

4. From cost cutting to business building

The fourth factor stands out as particularly important for the future: Private Equity managers have become smarter operators. A decade ago, the Private Equity model called mainly for financial engineering. Private Equity partners improved the performance of their investments primarily through obvious, simple cost cuts and reduced capital spending. Times have changed. Managing investments through a recession has caused Private Equity funds to focus on operational issues. More and more, successful investment demands a comprehensive strategy, one that places greater emphasis on operational improvements as a key source of performance.

To meet this challenge, the leading Private Equity firms have recruited seasoned executives from across the business landscape. The former CEOs of GE, IBM and The Gap and senior managers from companies like Target Stores, Nextel and Viacom now work in Private Equity. For the recruits, this speaks to the appeal of running a business free from the quarterly earnings scrutiny to which publicly held companies are subject. For the private equity firms, this speaks to their evolution from financial engineers to savvy business operators, willing and able to bring about lasting change in their investments.

This evolution represents the most significant development in the Private Equity field in the last decade - from a philosophy of financial engineering or simple cost cutting to one of proactive franchise building, will figure importantly in sustaining private equity returns throughout the full business cycle.

The Profit In Tomorrow's Vintages

So how might private equity fare in a more restrained environment? Credit Suisse New York has developed a model to look at potential returns. We began by deconstructing the returns experienced in the current market. Those returns derive from three sources: the leverage from financial engineering, operating improvements in the business itself, and the multiple expansion that results from investing during a market low and selling at or near a pricing cycle high.

In the recent past, successful Private Equity investments may have realized total five-year gains in the mid-30% range. To arrive at an estimate of the levers driving those returns, we began with a "base" return of 9%, which represents the gain achieved simply by growing revenue and EBITDA at 5% annually. (By deploying working capital more efficiently as it grows, an owner's equity return can exceed its earnings growth.) Credit Suisse then levered the model, financing 70% of it with debt at an average cost of 7%. That leverage adds another 9.4% to returns. Through operational improvements that are assumed to boost annual revenue growth from 5% to 7% (causing EBITDA growth to rise to 10%) and employ working capital more efficiently, we estimate returns increase by an additional 10.2%. Finally, applying a bit less than the most recent multiple expansion history, we could add another 7% by buying into our model company at 6.5x EBITDA and selling it off for 8x.

In creating a model for a less expansive future, we made the assumption that operational improvements function as an independent variable: good management is good management. We dialled down the amount of leverage available to 60% and dialled up its cost to 9.5%, closer to historic averages. We also built in a more modest .5x multiple increase which we believe possible when operational change improves earnings prospects.

Two factors stood out in this scenario. Not surprisingly, the returns did shrink. Falling into the low-20% range, they looked a good deal more modest than current returns, but they still outpaced the historic returns generated by public equity. Second, operating improvements assumed critical importance in the success of the investment. Under the first example, they only account for about one-third of the total gain. In the projected scenario, they account for the majority. Our modelling thus anticipates the growing importance of operational expertise. While we expect overall returns to decline, well-run private equity funds are expected to continue to outperform public benchmarks. Within that environment, we believe that middle market companies may offer the greatest scope for operating enhancements, because it is often easier to find improvements in these companies. In our scenario operational improvements may also come in the form of synergistic acquisitions. Again, these may be easier to find among fragmented businesses populated with a range of smaller companies.

Conclusion - Private Equity for high networth investors and sustainable outperformance

In summary, Credit Suisse believes that private equity returns will decline somewhat, but the asset class will retain its appeal. While financing markets are likely to revert at some point to longer term averages, and acquisition multiples are more likely to contract than increase from here, operating sources of value creation remain easier to achieve. We feel that leading private equity managers can continue to exploit these other sources of value creation as the cycle shifts to a new phase.

Investors, however, may have to exercise greater due diligence when investing in the sector. As noted earlier, the dispersion in returns between Private Equity managers has been significant. Top quartile US private equity funds posted, on average, annual returns of 24.7% and 20.2% over the 10 and 20 year periods ended March 31, 2006, respectively.

In contrast, median US private equity managers posted average annual returns of 9.6% and 9.3% over the same time periods[2]. That compares to a top quartile to median spread among large-cap core equity managers of 1.1% and 0.8% for the 10- and 20-year periods.[3] Predicting manager performance is not easy, but history does provide a few clues. Manager returns do not revert to a mean. In fact, a study done by McKinsey Consultants has demonstrated that fully 71% of the managers of a first quartile private equity fund finish in the first or second quartile with a follow-up fund (2005 analysis based on 2004 data).

Despite these clues evaluating Private Equity managers remains a complex task, but one critical to achieving good performance. The huge inflow of funds into private equity makes the task even more difficult, as successful managers raise extremely large pools of capital. These dramatically larger funds in particular may succumb to the temptation to pursue smaller gains.

Looking ahead, we anticipate investors will need to interpret these performance measurements against a changing market environment – one in which managers will need to excel in new areas, particularly operational capabilities. The end result is that in the future of private equity, both careful manager selection and careful operational work by funds themselves will be critical success factors.

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[2] Source: Venture Economics. Private Equity returns are for the periods ended March 31, 2006 and are based on the cumulative net IRRs for private equity funds formed between 1980 and 1999.
[3] Lipper Inc. For periods ended June 30, 2006, tracking 237 funds for the 10 year period and 59 funds for the 20 year period.