Return to warmer waters
How do private equity investors create value?
A study of 2010 North American exits
Foreword

Ernst & Young is pleased to present its latest annual study on “How do private equity investors create value? A study of 2010 North American exits.” Now in its fifth year, the analysis builds upon our previous research to demonstrate that private equity (PE) continues to create outperformance through strategic and operational improvements, even in the harshest of climates.

The last five years proved to be a tumultuous time for PE-backed exit returns, but 2010 represented the return of a more active PE market. Those who managed well through the deep dive were rewarded in 2010, demonstrating the resiliency of PE. Our study, based on 230 of the largest exits (greater than US$150m entry enterprise value, or EV) over the last five years, represents a combined entry enterprise value of US$213.3b and uncovers the leading practices used by firms who enjoyed those rewards.

We have also run the study in Europe for six years, and it is interesting to note the similarities and differences between the two geographic regions.

As the longest running study of its kind, we believe our analyses provide additional facts and insight, which prove that PE can provide a mechanism to accelerate growth. PE accomplishes this through responsible investment that can support businesses of all sizes, through good times and bad.

However, the outlook for PE remains uncertain, consistent with the state of the overall global economy. PE is facing a record number of portfolio companies held for a longer periods of time. While we have seen higher sales volume in 2010 and so far in 2011, the “overhang” is significant. At a time when PE and the market are experiencing yet further unprecedented events, we are encouraged that our analysis continues to be a part of the dialogue.

Jeff Bunder
Global Private Equity Leader
Executive summary

Our fifth study, Return to warmer waters, is set in a context of the improving economic conditions in 2010 that followed the deep recession of 2008 and 2009.

The laser-sharp focus on preserving value in the portfolio over the difficult years of 2008-09 was rewarded as exit volumes recovered in 2010 and portfolio companies generally exhibited improved performance.

The thaw in the market in 2010 was driven by a renewed appetite among PE investors for good-quality businesses, bolstered by a greater availability of acquisition finance, as exits via secondary buyouts nearly doubled by volume in our sample over the previous year. The year also observed the return of the IPO markets, as PE investors took advantage of a more favorable landscape in the public equity markets. Most importantly, exits to trade buyers were higher in volume terms – representing over half the buyers of 2010 exits – showing a selective return to the M&A market by strategic buyers.

Overall, the exit trends point to a return to more normal levels, particularly as our North American findings are consistent with the research we have conducted in Europe. Despite this, both markets face the same challenge of subdued M&A activity by corporates. Given the importance of trade sales as an exit route, PE exit activity will not recover fully until corporates return in full force.

This year’s study builds on our previous research to demonstrate that PE consistently creates outperformance through strategic and operational improvement, even in the harshest of climates. Fifty-seven percent of returns generated by PE between 2006 and 2010 can be attributed to PE’s value-add, with operational improvement driving the majority of value creation, rather than multiple expansion and additional leverage. And, our study shows that PE exits continue to outperform comparable public companies in terms of EBITDA growth, employment growth and productivity growth.

57%

Proportion of returns generated by PE between 2006 to 2010 that was the result of PE's value-add, with EBITDA growth driving the majority of value creation, rather than multiple expansion and additional leverage.
While PE is showing signs of renewed strength, challenges remain. The mixed outlook for the economic environment is a source of continued uncertainty which will undoubtedly affect PE-owned businesses, as both the US and Europe struggle to deal with complex sovereign debt issues. The fund-raising environment remains difficult, although 2011 has started show signs of improved conditions. Exits will also need to increase sharply over the coming years as holding periods are now at record levels in our sample and PE’s portfolio continues to increase in number.

Yet despite these issues, PE has clearly taken on board some highly valuable lessons from experience over the last few years. It has emerged from the recession stronger and better equipped to make difficult, value-enhancing changes to the companies it backs.

We also analyzed the components of operating performance to better understand how PE-owned companies achieved EBITDA growth. PE’s agility in the face of the downturn has been key. PE reacted quickly by increasing its focus on operational enhancement and driving fundamental changes through its portfolio companies, concentrating on enhancing organic revenue opportunities and streamlining operations.

Our study found that over half of organic revenue growth came in the form of geographical expansion, change of offering and new products. Equally important to PE in North American exits was to drive operational efficiencies through cost reductions and restructuring, which represented just under 30% of overall EBITDA growth in our sample.

To enable these value-creation strategies, we also found evidence of PE increasingly investing in in-house portfolio management teams, backing the right management team at the outset and working more closely with that team to drive transformational change.
2010 exits

Ernst & Young’s 2010 study shows an improvement in PE exit activity over the previous two years, marking the start of a return to more normal levels. PE sought to take advantage of the recovery in the wider economy characterized by improved valuations, higher levels of confidence among some buyers and increased capital markets activity — all in all, a receptive environment that PE capitalized on by exiting companies in its portfolio. This follows an intense period of value preservation in 2008 and 2009, when firms worked to reduce or refinance debt loads. Extending debt maturities provided breathing room to implement strategic and operational improvements and cost reductions.

These initiatives clearly paid off for PE, as firms that managed their portfolios effectively during the crisis were well rewarded in 2010. In an encouraging sign, our study observes that performance is improving; IRRs are positive in 2010 but remain below the average of prior years. This demonstrates that PE’s unique form of ownership enabled it to steer portfolio companies through a difficult environment and position them well for an upturn in economic conditions. The results of the improvements made to the portfolio over the last two to three years could result in further increases in valuations in the future, as long as the economy stabilizes.

A market in recovery

The recovery in exits was evident in 2010. PE exits by number increased to 118 in 2010 — from 51 in 2008 and 76 in 2009 — a similar figure to those recorded in pre-crisis times. In our report last year, we pointed to PE firms concentrating on exiting companies in 2009 in non-cyclical and counter-cyclical sectors, particularly via IPO. In 2010, the market began to normalize as PE divested across industry sectors, reaffirming more positive market conditions.

Though creditor exits still appeared in our sample in 2010, their numbers decreased slightly, as industries that were hardest hit by the recession — real estate, retail and consumer products appeared to bottom out. Over the five-year period of our study, creditor exits accounted for 13% of the total — less than what was anticipated when the crisis began. As with the creditor exits in Europe, many of these were not bankruptcies, but rather a change in equity ownership triggered by reduced but still positive business profits and prospects, and a small part of PE’s overall portfolio.

The best performing sectors were energy and telecom, which exhibited recession-proof credentials. Industrials also performed well in 2010, consistent with the start of the economic recovery.
As we predicted in our last study, exits to PE staged a comeback in 2010, doubling in volume compared with 2009. While this is clearly a far cry from 2007 levels, when over one-third of exits were via secondary buyouts, it reflects an increased appetite among PE for buying high-quality businesses supported by improved debt markets.

Corporates also re-emerged as a significant source of liquidity, representing over 50% of buyers of PE exits in 2010. After years on the sidelines, strategic buyers began to slowly and selectively re-engage in the broader M&A space. A considerable amount of this activity was focused on acquiring from PE, as PE’s desire for liquidity was met by large corporate cash reserves amassed over the last three years. By the end of 2010, non-financial US corporates had over US$2,000b of cash on their balance sheets and a lack of conviction in terms of plans for spend.¹

The proportion of IPOs in the 2010 sample reduced in volume to one-fifth of the PE exits, with 23 PE-backed IPOs occurring in 2010 – only two more than in our 2009 sample. IPO continued to be a popular exit route for deals of all sizes, though it was the chosen exit route in 2010 for a significant portion of the largest deals – companies sold through IPO had the highest average entry enterprise value at US$1.1b.

PE firms are beginning to exit the largest portfolio holdings at a faster pace than the next size tier. Between 2008 and 2010, portfolio companies with an entry EV over US$2b dropped 30% versus those companies with an entry EV between US$1b and US$2b, which only fell 13%. This can likely be attributed to the open IPO window in 2010 and fewer options with other sale alternatives.

¹ Source: Capital IQ.
Key findings

Private deals show highest returns with “take-privates” returns declining the most
This year, we analyzed the performance profile of the four main sources of deals over the 2006–10 period. Returns from buying a privately-owned business performed the best of the four categories when creditor exits are included. This is in contrast to take-private deals – where companies are de-listed – which under-performed.

Our study also found that, despite limited partners’ (LPs) apparent disquiet about the prevalence of secondaries – where PEs buy from other PEs, these deals provided the second-best returns over the full five-year period, despite a decline from the highs of 2006–07. This outcome includes creditor exits contained in our sample. In many cases, secondaries have produced higher-than-average returns, demonstrating there can still be significant value created during subsequent PE ownership.

Secondary deals provided the second-best returns over the full five-year period, despite a decline from the highs of 2006–07.

Value creation at the heart of PE outperformance
Our studies, which now span a five-year period, have shown that PE is able to create enduring value in the companies it backs, and that it consistently outperforms public companies in key value drivers – EBITDA growth, employment growth and productivity. Consistent with our European study, our returns analysis shows that PE strategic and operational improvement drove most of the value created in PE portfolios over the long and short term. For the 2006–10 period, this accounted for 57% of PE returns over the five years, while stock market return was responsible for less than 1%, and additional leverage (over public company benchmarks) for just over 40%. This is consistent through good times and bad, and even where other sources of returns, such as stock market returns, are negative. PE’s returns continue to be driven by its ability to effect change in the companies it backs in a private setting.
Organic revenue growth and cost reductions are largest sources of EBITDA growth

Our analysis shows that operational improvement remains the most important driver of PE’s value creation, rather than multiple expansion and additional leverage, consistent with the findings in our European study. However, our study also shows that this component has increased in importance compared with pre-crisis years. This is, in part, a reflection of the fact that it is more difficult to generate returns through multiple expansion and leverage in low growth economic cycles. It also provides evidence of PE’s increased focus on improving operations of these businesses.

In this year’s study, we sought to determine how PE achieved EBITDA growth during the holding period. Over the longer term, revenue growth was the most important source, accounting for over 40%. Cost reductions were responsible for approximately 30% of EBITDA growth, and acquisitions also began to play a significant role, representing about 20% of growth. PE’s ability to use every available lever to enhance the operations and growth prospects of its portfolio companies was clearly vital to their success during times of economic stress.

Organic revenue growth accounted for over 40% of EBITDA growth. Cost reductions were responsible for approximately 30%, and acquisitions also began to play a significant role, representing about 20% of growth.
Key findings

The strategies that enable EBITDA growth

PE used all methods to achieve growth through one of the toughest recessions in history – focusing on organic revenue growth and cost reductions with equal emphasis. Our study shows that PE stayed close to its portfolio during the downturn, flexing strategy as necessary. PE was able to spot good growth opportunities and benefit from growth in market demand – much of this in non-cyclical and counter-cyclical industries. However, changing business models or strategies drove over half of organic revenue growth. And, as in Europe, these factors accounted for more organic revenue growth than the functional changes made to pricing and selling initiatives.

Geographical expansion has played a particularly important role. The superior growth opportunities in emerging markets, particularly as developed economies have stalled, provided a further lever for PE to add value: by assisting portfolio companies in expanding in these markets to exploit the growth opportunity, particularly in India and China. For example, our research uncovered evidence of PE using its networks to open the right doors for businesses looking to expand into emerging markets, but lacking the contact base and local know-how. PE is helping to de-risk the process of capitalizing on the opportunities available in new markets.

Fig 4: Drivers of organic revenue EBITDA growth, PE exits, 2007–2010

As the recession continued to persist in North America, cost reductions and restructuring played an increasing role in delivering growth. Operational efficiencies and improvements in procurement practices combined for nearly 70% of EBITDA growth from cost reductions and restructuring.

PE is digging far deeper into every aspect of a company’s operations. These fundamental changes – while difficult to achieve – clearly have the greatest impact on profit growth and have yielded better results for both PE and the businesses it backs. There is also growing sentiment that achieving efficiencies in these businesses can be leveraged across the portfolio, providing additional growth opportunities for all businesses in the PE stable.

70%

Operational efficiencies and improvements in procurement practices combined for nearly 70% of EBITDA growth from cost reductions and restructuring.
**PE driving fundamental change**

Our study this year also focused closely on the levers that PE is using to generate outperformance. PE has a clear and increasing focus on making fundamental changes to the underlying operations of portfolio companies – a trend we began to note in last year’s study. This was accelerated by the crisis and in the space of just three years, its toolkit for creating value has expanded and become more sophisticated. Having taken on board some of the lessons of the past few years, PE is now implementing and developing several leading practices that drive operational performance and form the strategic direction of the companies in its portfolio.

As we find year to year, backing the right management team from the outset of the investment is paramount. Our study found that changing management team during the investment increased the holding period by up to two years, in many cases resulting in reduced returns – a similar finding to our European results. Management teams with the relevant industry knowledge and experience, or those that have previously executed on a similar strategy, were invaluable. Our study also provides evidence that the most effective management teams were flexible and able to meet the challenges of growing the business.

The experience of the downturn has focused PE’s attention, still further, on ensuring management has the necessary skills and bandwidth to implement improvements and direct strategy. Enhancing and expanding the management team has become a more vital part of PE’s active ownership model than in the past. PE is routinely changing the composition of management teams, taking a more customized approach and bringing new skills and experience to portfolio boards to provide a more strategic focus.

We have seen 100-day plans become a standard practice on new deals as a means of executing change rapidly and focusing management’s attention on the execution of the company’s strategy. The use of 100-day plans was more prevalent when cost control initiatives were being implemented and their use also correlated to outperformance in EBITDA growth.

In order to support and provide resources for fundamental change, PE is also increasingly bringing talent in-house. Our research found an increased utilization of operating partners and consultants, who work closely with investee companies to drive business improvement – across all enterprise sizes. In line with our findings in Europe, these resources were found more often in portfolio companies where management teams were changed, with operating partners used at about half the frequency of external consultants.

Clearly, there is no “one size fits all” approach. However, our research suggests that, where PE invests in businesses with multiple value-creation levers and where leading practice is followed to exploit these opportunities, it is able to unleash and significantly increase value.

Our research points to an industry that is on track to emerge stronger from the downturn and leaving nothing to chance. It has learned some valuable lessons along the way. A prolonged focus on achieving organic revenue growth, balanced with effecting operational efficiencies, should continue to benefit PE through another period of uncertainty.
Outlook

The study, based on the largest US businesses exited from 2006 to 2010, demonstrates the resilience of PE, even through the toughest times. It is a robust and active form of ownership, which consistently creates value through the strategic and operational improvements it is able to drive down into the portfolio companies.
Looking ahead, the improved environment for exits that started in 2010, and continued into the first half of 2011, appears to have slowed. Exits via IPO, in particular, saw a substantial rise through the second quarter of 2011. While the pipeline for PE-backed IPOs is also strong, with a number of large PE-backed companies filing to go public in the US over the remainder of 2011, public markets remain volatile – leaving it an uncertain exit route for PE investors. Once again in the face of a tougher exit environment, PE will be challenged to increase its exit activity to achieve a more “normal” level of sales.

There is a large part of the PE story that has yet to unfold. The number of companies in PE’s portfolio continues to expand and in 2010, in the US, reached a record level of approximately 6,000, including a large component of deals completed during the boom years of 2005-07. The inevitable result, as our analysis finds, is a continued increase in holding periods. The average holding period for deals exited in 2010, at 4.4 years, was the longest since our study began in 2006. A shortage of activity by corporates both in the US and Europe – which remain largely out of the M&A markets – will continue to impact exit activity levels. Trade buyers have historically provided the most significant exit routes for PE and, until they return to the market with more consistency, exit figures will be muted.

The industry is also under pressure to return capital to LPs, especially those looking to raise new funds in the next 12 to 18 months. But LPs are not just seeking crystallized returns from the funds they will back in the future. They remain highly selective and are seeking to rationalize the number of GP relationships they maintain. As a result, they have become more focused on conducting extensive due diligence and are increasingly seeking to understand how PE firms add value. LPs are also increasingly wary of secondary buyouts as they become more prevalent, once again. However, as our research highlights, PE is increasingly focusing on operational improvements in the businesses it backs, regardless of how the deal was sourced, to generate strong returns from secondary buyout deals, as from other types of transactions. Those able to demonstrate a consistent track record in creating value in their portfolio that translates into best-in-class realized returns, should be well positioned to attract fresh capital.

PE, similar to other industries, is not immune to continued macro-economic uncertainties, including the impacts of the US and European sovereign debt issues that cloud the horizon. And growth in many developed economies will likely be subdued for a number of years to come.

However, as our research demonstrates, PE is resilient, nimble and has demonstrated an ability to withstand shocks. It has taken on board valuable lessons and has regrouped following the crisis. PE will once again have an opportunity to prove that its active ownership – as we have found in both the North American and European studies – enables it to create stronger and more profitable businesses. This is despite difficult times; by driving operational improvements and growth in the companies it backs, the industry delivers solid returns that outperform public market benchmarks. This confers benefits not only on the companies themselves, the PE houses and their investors, but also on the economy as a whole by creating sustainable, well-managed and growing businesses.

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2 Source: Pitchbook.
The 2010 study provides a view into the performance and methods of PE, based on the analysis of just over 440 of the largest North American businesses PE has exited over the last five 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 entry enterprise value of US$150m and above. This criterion was also applied to our estimate of the current size of PE portfolios.

We assessed business performance for the duration of PE ownership, based on key performance measures, including changes in EV, profit (defined throughout the report as earnings before interest, depreciation, tax and amortization, or EBITDA), employment, productivity and valuation multiples. To measure aggregate economic impact more effectively, we used weighted averages.

The study was built upon public data and private, detailed interviews with former PE owners of the exited businesses. In order to benchmark the performance of PE-owned businesses against comparable public companies, we have compiled data on public companies by sector over the same time period as the PE exits in our sample. The data was then aggregated to compare PE performance with that of public companies.

The ability to incorporate data obtained from top PE investors is an important feature of the study. Another is the scope and depth of the research, with a sample including 441 North American exits. The Ernst & Young study is a leading piece of research, and is recognized by many commentators as an authoritative work in the field.
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