

# INDUSTRY WHITE PAPER

January 2003

## European Private Equity: Nature Abhors a Vacuum

### Executive Summary

Eighty percent of the total of all funds raised by the European private equity sector were raised between 1997-2001, successfully overcoming a number of structural impediments. The more recent slowdown is cyclical rather than structural and we expect a pickup in private equity activity in 2004-2005.

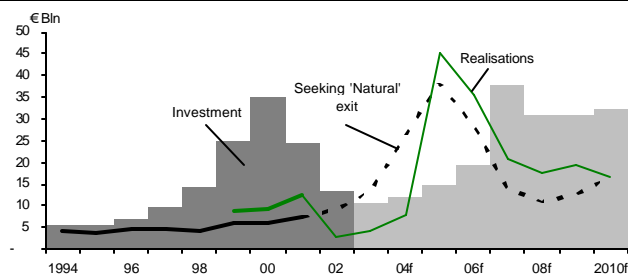
Investors have become more risk averse since 2001, often requiring unrealistic equity returns even as the realisations from existing funds diminished in number and value. New money raised for European private equity as a whole is down by 75% from its 2001 peak and much of the remainder is focused on larger, lower risk, targets and supported by Fund of Fund investors.

Augusta's analysis shows that among those factors influencing fund performance are geography, sector, economic variables, vintage year and deal stage. Research demonstrates that the credit screening of underperformance is more reliable than the identification of out-performance.

Investment realisations, essential to the rebuilding of the sector, remain difficult or unpalatable and the public equity capital markets for mid and small capitalisation issues are effectively closed. A number of exit strategies, including exit proxies such as secondary sales, buybacks and re-structurings, are now becoming important to investment capital recycling.

Augusta believes that there is an opportunity for positive liquidity events to fill the vacuum created by declining equity markets. This involves using a combination of invested capital and structured finance designed to return capital to investors whilst retaining the option for long term capital growth.

### European Private Equity Investments and Realisations



Source: EVCA, PWC, Augusta Finance

**James Sproule**  
Economics & Research  
Tel. +44 207 236 0100  
Mob.+44 7866 808 366  
jsroule@augustafinance.com

**Stewart Binnie**  
Private Equity  
Tel. + 44 207 236 0100  
Mob.+44 7768 664 319  
sbinnie@augustafinance.com

## Table of Contents

European Private Equity: .....	1
Executive Summary.....	1
Overview.....	3
Risk and Reward.....	4
Development of European Private Equity .....	5
Finding the Money .....	6
Drivers of Value.....	8
Fund Managers.....	10
Private Equity – Making Money.....	12
Assessing Value.....	12
Secondary Investments .....	12
Realisations: the Acid Test.....	13
Future of Private Equity Markets.....	16
The United States Model .....	16
Prospects for Europe .....	18
Exits.....	20
Augusta’s Conclusion .....	21
Appendix 1: University of Texas Investment Management Company (UTIMCO) Fund Performance.....	22
Appendix 2: Glossary.....	23
Disclaimer.....	28

## Overview

“Private equity” refers to equity investments, almost exclusively undertaken by professional investors, in unlisted companies. The usual vehicle for such investments is an investment fund structured as a limited partnership in which a General Partner (GP) or Investment Manager invests capital on behalf of the other Limited Partners (LPs), typically pension funds and life companies or high net worth individuals. GP’s are compensated through an annual management fee of around 2%, together with some 20% share of the realised gains if and when an agreed hurdle rate has been exceeded.

Investments in the fund by the LPs take the form of committed capital which is drawn down by the GP as required by investment activities. Gains are distributed pro rata as received and are dependent on a liquidity event, such as a trade sale or IPO in respect of the investee companies.

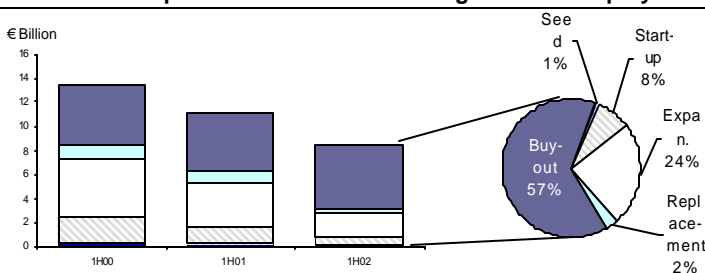
The life of a limited partnership is usually ten years with a five year investment period and an average investment life of three to five years. Fund performance is measured by comparing cash invested to cash received over the life of the fund, expressed as an internal rate of return (IRR) or a multiple of cash invested. Historically, the expectation has been that private equity will achieve an annual return 3-5% above the comparable public equity market indices.

Private equity typically takes one of two forms: (i) venture capital which is focused on the start-up, seed, early stage or development/replacement capital needs of companies, where there is an expectation of high growth and high returns and (ii) capital devoted to the management buy-outs/ins of mature companies in which a combination of financial engineering supported by robust cash flows and enhanced performance can give rise to significant returns.

For venture capital, growth is everything ...

... for buyouts, cash is king.

### Breakdown of Capital Growth versus Leveraged Private Equity



Source: EVCA, PWC

Private equity is increasingly seen as a financial asset class in its own right, with characteristics in respect of horizon, liquidity and transparency which make it separate and different from other asset classes. This report examines:

- The growth drivers in private equity markets;
- The differing dynamics between growth-focused venture capital, leveraged buyout finance and other forms of private equity;

- how value is assessed and realised in private equity portfolios;
- what sectors are most likely to see private equity financings;
- how the market for private equity is likely to develop over the next few years.
- alternative financing solutions

### Exits

Most value creation takes place in the first three years

Value creation (and risk) in any private equity transaction usually peaks within the first three years of the life of an investment. During this period, strategic and operational issues are resolved, the management team becomes established and the potential financial performance of the business becomes clear. Once the benefits of change have evidenced themselves in strong cash flows or earnings growth, the value of the enhanced business can be determined. The problem is that time is the enemy of robust returns; the longer the wait for a realisation after the initial period of management consolidation, the longer the period over which those benefits must be amortised and the lower the return on investment.

Exit options are...

For Private Equity managers there are four broad considerations: which strongly performing investments can be safely held awaiting a recovery in valuations; which investments should or must receive additional funding in order to survive or prosper; which investments should or can be sold off immediately, regardless of valuation, in order to return capital to the fund; and which investments should be neglected on the grounds that their value has no material consequences for the fund and the prospects for improvement are slight.

... IPO, impossible...

Augusta believes that the following options exist at present:

... trade sale or sale to financial buyers ...

- IPO's can effectively be ignored for now as less than 3% of investments were exited in this manner successfully in 2002.
- Trade sales at robust prices are still possible as the recent sales of Go, Homebase and other large buyouts have demonstrated. However, the significant fall in M&A activity in the technology sector especially is a strong indication that exits through trade sale are not as popular or as frequent as they were.
- Sales to financial buyers are increasing, made possible by lower valuations. The rise of a secondary market for private equity investments at both the portfolio and company level has brought greater liquidity to the market than existed previously.
- Invest more cash and await better times. Between 20-30% of new money presently being invested in European private equity is in the 'down-round' or 'up-round' follow-on of existing investments. Such follow on investing, while preserving the value of the initial investment, generally lowers the overall return. While this option is preferable to a write off or buy-back, such investments often do little to enhance overall private equity fund returns.

... devote more cash and await better times...

...or  
releverage,  
extract cash  
and preserve  
upside

- Financial restructuring. For those companies which have established cash flows, Augusta Finance believes that introduction of further leverage into the balance sheet offers a timely means of achieving both a partial realisation and the preservation of an equity upside which can be realised when markets recover fully. Releveraging can also make available the cash required for further investment, either in existing holdings, or to take advantage of the lower valuations available in today's marketplace
- It is our view that every GP should review its portfolio in order to identify those companies capable of generating cash and supporting leverage in this way and should seek to develop creative financing solutions which meet their needs.

### Augusta's Conclusion

Assessing the current environment and looking at the potential for European Private Equity, we have reached the following conclusions:

Private Equity  
will start to  
emerge from  
the present  
trough by the  
end of  
2003...

... PE  
professionals  
can create  
intrinsic  
value...

... invest,  
hold, realise,  
is no longer a  
viable  
strategy ...

... returns  
will be  
dependant  
upon use of  
the full capital  
spectrum

- Whilst the present market trough has resulted in a dramatic reduction in company valuations, fewer investments, infrequent liquidity events and a tortuous fund raising process, the investment cycle will begin to rebalance towards the end of 2003 as capital recycling begins to have an effect and returns expectations become more realistic.
- The progression from investment peak through trough has been a vital step in creating a wider base of professional knowledge and experience which, coupled with altered expectations, will lead to a larger, more sustainable pool of private equity capital which recognises the virtues and drawbacks of private equity as an asset class.
- Invest – hold – realise will cease to be an adequate PE strategy. Financial structuring and an understanding of the full range of financial instruments and options available to companies *throughout the life of an investment* will play a vital role in maximising value.
- The ability of Private Equity firms to invest their capital effectively, using leverage to drive value creation and as a means of creating innovative financing solutions, will be the key to achieving upper quartile performance.
- The types of capital available to mid-market companies will increase as companies seek financing solutions less exposed to the vagaries of the investment cycle and have recourse to a greater variety of financing instruments, drawing on the resources on both investors and their advisers in their search for new capital.

## Disclaimer

---

This brief has been prepared and/or issued by and is distributed by Augusta Finance plc and/or one of its affiliates (“Augusta Finance”) which is regulated by the Financial Services Authority in the United Kingdom (“FSA”) and is not for distribution to private customers (as defined by the FSA) and no financial instruments discussed herein will be made available to such private customers. This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy any securities or other instruments mentioned in it. No part of this document may be reproduced in any manner without the written permission of Augusta Finance. While we take precautions to ensure that the source and the information we base our analysis on is reliable, we do not represent that this information is accurate or complete and it should not be relied upon as such. It is provided with the understanding that Augusta Finance is not acting in a fiduciary capacity. Opinions expressed herein are subject to change without notice. While Augusta Finance does not intend to make a market or deal as principle in the securities or products mentioned in this document, it may act as a placing agent for securities issued by any one or more of the companies mentioned in this report in the future (subject to receiving the necessary regulatory consents). In addition, Augusta Finance, its shareholders, directors, officers, associates an/or employees may from time to time have long or short positions in such securities or in options, futures or other derivative instrument based thereon. Therefore, Augusta Finance may in the future place a private offering of securities, or may in the future perform investment banking or other services for, or solicit investment banking or other business from any company mentioned in this document. All rights reserved. Copyright Augusta Finance. Augusta Finance plc, is registered in England no. 4399945, with its registered office at 2 Wardrobe Place, London EC4V 5AH.