The Competitive Impact of Global Private Equity: Creative Destruction and Innovation[1]

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[1] This study is a compendium of all major studies which have been done by various organizations about the impact of private equity and its activities in various countries around the World. It draws on the insights and analysis from the Thunderbird Global Private Equity Board of Advisors located in major countries around the World.

Contents

Executive Summary …………………………………………………………3

Perspective ……………………………………………………………………5

2008 Developments ……………………………………………………………7

Competitiveness, Innovation and Value ………………………………8

Private Equity Critics and Hold the Status Quo …..………………..10

Employment Issue from a Different Perspective ………..……… 14

Private Equity Best Practices for Public Companies ……………… 15

Global Private Equity Developments ……………………………... 26

United States ……………………………………………………………….. 29

Europe – United Kingdom …………………………………………….... 31

Europe – Germany …………………………………………...…….. 33

Australia ……………………………………………………………………… 35

Asia General ……………………………………………………………….. 36

Asia – China ………………………………………………………….…. 37

Asia – India ……………………………………………………….……….. 39

Executive Summary

Private equity, in the foreseeable future, will continue to be an important, highly creative area of finance and will continue to expand globally beyond the U.S., Britain and continental Europe. Emerging markets are increasingly attractive. The profitability of private equity also will continue to be substantially higher than the average returns provided by public sector markets, particularly for the largest private equity companies. However, there are several developments that may likely slow its growth during 2008 and perhaps into 2009. Also, very large deals may be on hold this year.

Global financial instability that began during the second half of 2007 with the U.S. Federal Reserve curtailing the growth of liquidity and raising U.S. interest rates, culminated in the advent of the sub-prime loan crisis. Although the crisis was centered primarily in the United States, the effects spilled over in to Europe as investors in Special Investment Vehicles (SIVs) faced threatened cash flow disruptions as insurers providing credit enhancements were overwhelmed. Major commercial banks at the heart of this crisis lost shareholder capital adequacy cushions and tightened credit availability in the fourth quarter of 2007. This caused spreads on riskier investments to rise sharply and credit rating agencies to downgrade participants and financial instruments involved. In response to the emerging financial crisis, both the Federal Reserve and the U.S. Treasury moved quickly to stabilize financial markets. The Fed lowered interest rates and injected liquidity into major financial institutions. The U.S. Treasury moved to put subsidies into the hands of lower income families in order to help offset the rise in servicing costs for adjustable rate mortgages coming off teaser origination rates.

The tightening of credit standards by financial institutions caused a liquidity crunch especially for highly leveraged hedge funds and commercial banks resulting in failures. Many mortgage origination firms failed and the largest home mortgage provider, Countrywide, which faced serious liquidity problems was absorbed by Bank of America. Defaults and delinquencies on home mortgages rose sharply as hundreds of thousands of families were impacted. Other major problems emerged and among the most notable: Northern Rock was nationalized by the British government, Bear Stearns was taken over by JPMorganChase, and Carlyle Capital (a subsidiary of Carlyle Group) collapsing in March 2008. This follows a year 2007 when fund sizes broke records and Limited Partners (LPs) continued to receive in excess of 25% returns on their investments[2].

However, given the reliance of the private equity business model on leverage and bank debt, 2008 may be a transition year with slower and smaller sized activity especially in the United States, Britain and Continental Europe. Activity in the rapidly growing emerging and transitional markets of Eastern Europe, China

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[2] Mark O'Hare, "Performance Spotlight: Survivorship Bias – What Survivorship Bias?" Preqin, March 2008, pp. 6-7.

and India may remain the growth leaders in new private equity activity for 2008 and beyond, as investors look for higher return opportunities and for investment diversification.[3] A defining trend for private equity is that it is increasingly going global in search of higher returns on new investments. This is being promoted by superior performance, access to additional funding and improving regulatory environments and more supportive country policies toward private enterprise and entrepreneurship. Western and Eastern Europe are the most often talked about target markets, although interest continues to expand for opportunities in Asia, Latin America, and the Middle East/Africa areas.

The very largest and best performing funds seem to be having little difficulty, despite the financial market chaos by currently raising roughly $100 billion in funding for new investments. Smaller, less strongly performing private equity companies may find it more difficult and given the problems in debt markets the average size of acquisitions may also fall to under $2 billion.[4] Smaller investments by pension funds are being made up by growing allocations from Sovereign Wealth Funds. Also, wealthy individuals and family offices have been increasing their access to private equity either through listed buyout firms or funds of private equity funds.

There have been other recent interesting developments related to private equity. One of these is the continuation in the rapid growth of Sovereign Wealth Funds and increased activity in the corporate venturing area. It is estimated that Sovereign Wealth Funds may have grown to over $3 trillion in total asset size of which approximately $150 billion is committed to private equity.[5] In another area, there has been increasing convergence between hedge funds and private equity as hedge funds try to maintain high return levels for their investors.[6] Hedge Funds are moving toward private equity to boost returns, attract more capital, diversify risk, and increase the payback size while private equity firms are moving toward hedge fund activities to attract more capital, receive larger paychecks, boost returns, and diversify risk.[7] A recent common interest particularly evident between the two parties is in the area of distress asset investments.

Other developments in global private equity practices in reaction to criticism from selected interest groups includes: stub equity provisions, co-investment by debt investors, clubbing or co-investing for large deals, and smaller specialized investments. Stub provisions allow for the original shareholders to receive a portion of the profits when the company is sold. Co-investment gives debt

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[3] John Evans, David Nott, Don Spitzer, Oliver Tant, "Heads up: What Next for Private Equity?" KPMG, 2007.
[4] Henny Sender, "Private Equity Eyes Huge Funds," Financial Times, March 11, 2008.
[5] Preqin, "Sovereign Wealth Fund Review," March 13, 2008.
[6] Silicon Valley/San Jose Business Journal, May 25, 2007; and earlier "Hedge Fund and Private Equity Convergence Survey," Association for Corporate Growth and Grant Thornton, June 12, 2006.
[7] "Hedge Fund and Private Equity Convergence Survey," Association for Corporate Growth and Grant Thornton, June 12, 2006.

investors an opportunity to co-invest in the equity position of an LBO and reduce some of the concentration risk. Clubbing (Syndication) is evident as in recent years several private equity groups collaborate in "clubs" of several members on an investment. Some smaller private equity companies are showing an interest in pursuing smaller investments in specialized areas they want to work in the longer-term such as environmental, bio-medical or technology areas.[8]

Since 2000, the global financial environment of abundant liquidity, low interest rates, flat yield curves, and narrow credit spreads has provided the perfect atmosphere for private equity to explode. But, the rapid growth and headline deals of private equity have resulted in criticism and calls for regulation.
A positive economic impact can be defined to include more jobs created in competitive industries, increased productivity and efficiency or output per unit of labor, value of company's performance increased for shareholders, new innovations which result in increased competitiveness for a company as reflected in a gain in market share. These indicators are not always easily measured in part because the data are not always captured or it takes a long period before all the benefits of a buyout transaction are actually realized.

Perspective

Financial markets in the United States are very large, efficient and innovative. They are the largest segment of the services industry and they manage two-thirds of the World's surplus saving inflows of over $2 trillion into the U.S. economy each year. Even this inflow is small in comparison to the total value of transactions in the U.S. domestic financial markets as capital markets alone are estimated at almost $65 trillion. The financial system and markets and the near 10 million people working in them in the US are a major source of new jobs and financial innovation and source of continuous economic growth despite periodic shocks such as from the technology bubble in 2000 and the current sub-prime loan crisis.

The U.S is attractive to global capital inflows because of its large economic size and growth, the safety and soundness of the legal system, its efficiency and liquidity, and its robustness and creativity. The financial service industry is an important driver of the U.S. knowledge based economy and its continued global competitiveness. The emergence of the financial services industry as the largest industry sector in the U.S. is only one of many structural changes that are underway in the global competitiveness of the World economy.

Within the massive U.S. financial system, private equity, including venture capital, is a relatively small but important and rapidly growing sector. Private equity is important because of its support of new ventures and its ability to buyout

[8] "Weekly Corporate Growth Report," May 21, 2007, pp. 1-12; "High Yield Report," May 14, 2007, p. 1; "Financial Executive," March 2007, p. 34; and "Private Equity's New Entrepreneurs," March 2007.

competitively vulnerable companies to which it then gives new operational life. The business model of the private equity company is to buy businesses at a low price, improving operations performance and profitability, and then sell the revitalized and competitive company for a gain. Normally this is accomplished within a relatively short period of three to five years depending on market conditions although sometimes investments last up to seven years or longer.

In a recent article in the Economist it was reported that almost half of all private equity investors (LPs) have achieved net returns of 16% or more over the lifetimes of their private equity portfolios during 2007. These results have been driven by North American and European buyout funds from which over 60% of LPs have achieved net returns above 16%.[9] Furthermore, slightly over 60% of US private equity investment has been done by the top 20 firms and the top 25% of the private equity funds consistently beat the rest by an estimated 25% or greater return.[10] The search for continued returns at these high levels has caused private equity firms in North America and Europe to increasingly look at global expansion. New opportunities are being sought in Eastern Europe and rapidly-growing emerging markets such as China, India and throughout the Asia Pacific region. In addition, private equity companies have looked overseas for new opportunities in an attempt to diversify their portfolio returns from North American and Europe where they have concentrated their activities exhausting easier opportunities.

In 2007, global M&A activity totaled almost $4 trillion dollars, while global private equity transactions (of which global LBO volume reached $161 billion) including venture capital reached an estimated $2 trillion. Global private equity transactions help transmit technology, management skills and operational innovations to other countries.

The growth in participants, funds under management, and increased allocation of funds to private equity investments suggests that there is a perception by many major investment managers that private equity activities are adding clear value. “The 20 largest pension plan investors in private equity have a total investment in private equity of approximately $173 billion, equivalent to 8.8% of their combined assets under management” and …” with a margin (for the 108 pension plans surveyed relative to the rest of their investment portfolios) of between 4% and 9% per year over all time horizons from 1 to 10 years.” [11] The challenge is accurately measuring the actual value added which is why there is increased emphasis on private equity companies providing more information on their activities and performance.

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[9] Coller Capital’s, Semiannual Global Private Equity Barometer, Summer 2007.
[10] “Special Report on Asset Management: Plenty of Alternatives,” The Economist , March 1, 2008, p.12.
[11] “Private Equity: Delivering Superior Returns for Pension Funds,” Performance Spotlight, Preqin, January 2008, p. 5

Originally, private equity value creation was the result of the unique skills of individuals who could look at a company, identify its inefficiencies, and know what to do to make the company to be profitable and competitive. This financial and operational restructuring of company to enhance performance talent is not easily defined or described. When the reward offsets the risks and time consuming efforts, it acts. Private equity is now growing into a larger company business model in which more players are trying to replicate the skills of the masters. As the volume of activity in terms of number of deals and deal size has grown, private equity becoming more transparent and less secretive. But, for those who are considered best, it is truly an art and a special skill.

Despite the concerns about transparency and motives, very experienced executives at pension funds, insurance companies, banks, and family offices have been able to learn enough about the business model and the players to provide an increasing amount of investment funds to support private equity fund activity. There is a growing market demand for the activities of private equity firms from the perspective of investors. The two key considerations given by LPs in selecting a General Partner (GP) are: aggregate performance of the GP's funds (cited by 85% of LPs) and the continuity/succession within GP teams (cited by 84% of LPs).[12] Additional factors that have recent importance include: the performance of the GP's most recent fund, the quality and transparency of a GP's reporting, and the apportionment of carried interest within a GP's team. [13]

2008 Developments

This year has seen a continuation of the adverse impact of the sub-prime loan problems and the reaction to these problems -- mainly the tightening of credit -- has spread to other sectors of the financial markets. Concern about the extent of the slowdown in growth in the United States is having a negative impact on economic outlook in most major industrial countries and rapidly growing emerging markets. Consequently, private equity activities may not escape the impact of these developments. Uncertain economic conditions in an election year, higher risk spreads and tighter liquidity particularly in the United States, have all contributed to the cancellation of several major deals.

The International Monetary Fund,[14] in its recent analysis of the causes and consequences of global financial instability has pointed out that the increase in credit risks resulting from the loosening of credit standards is likely to spill over into private equity transactions. "These risks have been exacerbated by signs of similar credit indiscipline in the leverage buyout (LBO) sector. Through mid-2007, there had been a marked rise in the covenant-lite loans, less-creditworthy deals, leverage, and price multiples on acquisitions."[15] The IMF further comments,

[12] Coller Capital, Ibid.
[13] Coller Capital, Ibid.
[14] IMF, Global Financial Stability Report: Financial Market Turbulence, October 2007, pp. 1-38.
[15] Ibid, p. 2.

"…the correlation of returns across all asset classes has continued to rise, eroding the benefits of portfolio diversification, while speculative positioning in futures markets is becoming increasingly concentrated."[16] The impact of slower LBO activity is likely to be more concentrated in the United States rather than in Europe, which has experienced less of a boom and has a greater reliance on bank lending.

The IMF goes on to say, "Gains to private equity holders on LBO targets are increasingly reliant on earnings growth, as valuation multiples and leverage rise, and as leveraged loan rates have increased. It appears that private equity has picked most of the "low hanging fruit," potentially straining the viability of targets in the period ahead."[17] This strain on viability is likely to increase LBO refinancing risks and, "Even if the LBO market weathers this initial storm, medium-term prospects appear challenging. The most recent deals will likely face refinancing difficulties … and may ... have to carry a more demanding debt service burden than anticipated."[18]

Private equity firms may also see tougher times ahead in emerging markets for the following four reasons: "..the growing market of syndicated loans …shares similar evidence of credit indiscipline as in the leveraged loan segment; …domestic and foreign banks are relying increasingly on international borrowing to finance rapid domestic credit growth; … corporates are increasingly engaged in carry-trade-style external borrowing that could pose losses if carry traders rapidly unwind; and, … financial institutions are increasingly using structured and synthetic instruments to increase returns potentially exposing them to losses as volatility rises.[19]

Competitiveness, Innovation and Value

The private equity industry has come under significant criticism for not creating value other than making a few people very rich. As a result there are efforts underway to subject it to increased regulation by governments in the United Stated, the United Kingdom, Germany, and South Korea. Regulating industries to some "country norm" will undermine a country's competitiveness and prevent the activity of "creative destruction" which is believed necessary for economic growth and improved competitiveness.

Michael Porter in writing about the competitive advantage of nations[20] states "A nation's competitiveness depends on the capacity of its industry to innovate and upgrade. Companies gain advantage against the world's best competitors

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[16] Ibid, p. 4.
[17] Ibid, p. 17.
[18] Ibid, p. 17.
[19] Ibid, p. 22.
[20] Michael E. Porter, "The Competitive Advantage of Nations," Harvard Business Review, March-April 1990, pp. 73-93.

because of pressure and challenge."[21] He continues, "The basis of competition has shifted more and more to the creation and assimilation of knowledge…"[22] "Companies achieve competitive advantage through acts of innovation."[23] "…the capacity for innovation may come into an existing company through senior managers who are more able to perceive opportunities and more likely to pursue them. Or innovation may occur as a company diversifies, brings in new resources, skills, or perspectives to another industry."[24]

"With few exceptions, innovation is the result of unusual effort. The company that successfully implements a new or better way of competing pursues its approach with dogged determination, often in the face of harsh criticism and tough obstacles. In fact, to succeed, innovation usually requires pressure, necessity, and even adversity: fear of loss often proves more powerful than the hope of gain."[25] "Ultimately, the only way to sustain a competitive advantage is to upgrade it – to move to more sophisticated types."[26] Porter identified two prerequisites for this to happen or to be able to sustain competitive advantage which were: "First, a company must adopt a global approach." and "Second, creating more sustainable advantages often means that a company must make its existing advantage obsolete – even while it is still an advantage."[27]

Creative destruction, as described by Joseph Schumpeter, defines capitalism as a method of change. "The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers, goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that the capitalist enterprise creates."[28] He goes on to describe the process of going from a craft shop (garage) to a major multinational corporation as "… the same process of industrial mutation … that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in …"[29]

Private equity companies continually engage in the process Schumpeter and Porter describe. This process is necessary to the continued economic growth and competitiveness of countries which seek to benefit consumers. Creative destruction as used by the private equity industry represents the productive and competitive use of knowledge in strategic ways to gain the competitive edge.

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[21] Ibid. p. 73.
[22] Ibid.
[23] Ibid. p. 74.
[24] Ibid. p. 75.
[25] Ibid.
[26] Ibid.
[27] Ibid.
[28] Joseph A. Schumpeter, Capitalism, Socialism, and Democracy, Harper, 1975, pp.82-85.(originally published in 1942)
[29] Ibid.

Regulation pushes things to the norm which risks constraining innovation. Even so, creative destruction can hurt in the short run as workers with obsolete working skills are replaced with more knowledgeable workers or by more efficient technology. Growth and competitiveness require continuous knowledge creation for labor and continuous innovation for companies which creates new opportunities for workers with higher value added skills. The alternative is higher costs, (caused by subsidizing competitively unproductive labor and/or capital) which eventually lead to a loss of competitiveness and greater pain for society. The primary objective of public and private companies is to increase shareholder value not to increase employment which is a public policy of government concern.

Private Equity Critics and Hold the Status Quo

The other side of the story is told by others such as the Service Employees International Union (SEIU).[30] They question the lack of transparency of Private Equity stating "…buyout firms operate virtually free of oversight and public accountability, their profits and practices largely hidden from view."[31] They also criticize Private Equity buyouts because "…the profits come during a period of historic income inequality in America."[32] In this respect they focus on the executives in private equity companies that make substantial amounts of money but pay only the capital gain tax rate of 15%, while a number of workers lose their jobs following the buyout. SEIU provides a set of principals for the Private Equity buyout industry that include:

1. The buyout industry should play by the same set of rules as everyone else.
2. Workers should have a voice in the deals and benefit from their outcome.
3. Community stakeholders should have a voice in the deals and benefit from their outcome.

Negative stories about the works of private equity are not unique to the United States. An article appeared in the Financial Times regarding the 150 year old department store named Debenhams in the U.K.[33] Weak performance since the company was sold back to the market has fuelled the debate over whether private equity adds value to businesses or merely hollows them out for short-tem profit. John Lovering of CVC Capital Partners claimed that after the buyout Debenhams was better run, more efficient, and had more growth potential (public sale made more than 3x the £600 million that had been put into the acquisition in three years). Following three quarters of underperformance did private equity help the store turnaround? "UK trade unions and politicians charge that the

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[30] "Behind the Buyouts: Inside the World of Private equity," SEIU, April 2007.
[31] Ibid. p. 6.
[32] Ibid. p. 7.
[33] Elizabeth Rigby, "Flip or Flop: The inside story of a private equity deal", Financial Times, August 6, 2007, p. 9.

industry makes its money by loading acquisitions with debt, stripping assets, cutting jobs, using the extra cash flow to pay themselves huge dividends and then dodging tax on wealth they generate." Sir David Walker formerly of Morgan Stanley was appointed to review the industry's transparency and implement a code of conduct for the buyout groups. Debenhams CEO said the downturn during the last three quarters was due to bad weather, weak fashion trends, interest rate increases and a market that was tough for all retailers.

The take over plan was to improve cash management, cut costs, increase sales, expand margins, and to squeeze more efficiencies out of the business. As a result, cash flow tripled and was used to pay down debt. The company had been purchased with £600 million and £1.4 billion debt which had been put on the company's books. Debt was reduced to £856 million by August 2004. In addition, prices were slashed to get rid of slow moving inventory (generated £30 million the first month) yet critics argued that this hurt the brand. More frequent discounting -- 16 sales events a year -- began to affect the store's image. Supplier relationships changed so payment went from an average of 27 days to a 60 day average after delivery and additional discounts were demanded from suppliers. This improved cash flow by £100 million in the first year. Suppliers were reduced to a core group in order to get better terms. The result was that the margin improved 3.8 percentage points. Head office staff was cut 17% by closing the company's catalogue business -- despite the opening of 17 new stores. Store renovation expenditure was cut sharply on a per square foot basis to £7 vs. Marks and Spencer's £80-90 per square foot spend on renovations – further changing the image. Private equity also raised £500 million by selling some store assets.

During the summer of 2005 the private equity company completed a £1.9 billion debt issue and paid their shareholders £900 million; as a result private equity investors made more than £1 billion on its £600 million investment in just 18 months.

In September 2007, investment banks began to pitch going public and Citigroup and Merrill got the go ahead. On the road show, investors want guarantees that the new private equity management would stay on for 3 years hence. They received that commitment. But conditions began to deteriorate during the road show. Sales were over-estimated in the prospectus and the stock price fell below the re-issuance price. According to Mr. Templeman head of the private equity company we misread some of the fashion trends particularly in menswear which is a seasonal business and fashion trends can change quickly. It is reported that Mr. Templeman is looking for a buyer for Debenhams.

In another article in the Wall Street Journal in November 2007[34] it is written that private equity companies claim they make companies better but not always the

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[34] Tennille Tracy, "How Private equity Payoff Misses Some," The Wall Street Journal, November 29, 2007, p. C3.

case for rank and file according to a preliminary summary of study on job creation by American Enterprise Institute. “Over first five years of ownership, private equity firms reduce their work force by amounts greater than other companies: the losses come mostly in the second and third years, and cuts are greater in retail businesses than in industrial companies.”[35] Researchers include Steven Davis of University of Chicago and Josh Lerner of Harvard University who said the results are preliminary and do not include jobs created by as a result of newly opened facilities. Results will look different with this data. Private equity came under new scrutiny in Washington this year as Democrats took control of Congress and expressed concern that wealthy private equity managers are able to pay a 15% capital gains tax instead of higher ordinary income tax on much of their compensation. Private equity managers stress that they are reformers of broken companies. Blackstone’s CEO Schwarzman says, “We take the tough, unpopular decisions that other management teams dodge. We move people from jobs rooted in the past into the jobs of the future in the markets set to grow.”

Davis and Learner analyzed 5,000 buyout deals using Census data for 1980-2005 and found that company-owned buyout firms maintained employment levels on par with competitors in the first year after buyout. However their employment levels dropped in the second and third years. By the end of the five years, job growth within private equity backed companies was a ‘few percentage points’ below competitors. It means they eliminate more jobs or added fewer jobs than competitors. By industry: in manufacturing where there are lots of acquisitions, LBO backed firms maintained employment levels similar to competitors. Within the retail sector LBO backed companies maintained significantly lower levels.

An article in Business Week in November 2007 reported that with the days of easy money over for private equity firms, CEOs are under intense pressure from their LBO bosses to squeeze profits out of acquired companies or else -- time will kill you say CEOs. [36] Tales of quick and brutal corporate breakups, rollups, and reorganizations are expected to lead to radical internal restructuring.
For years private equity firms reaped vast sums by acquiring companies, sucking cash from balance sheet and then selling them or taking them public so called “strip and flip.” This ended with tightening of credit in July 2007 because it became difficult to refinance massive debt at low interest rates.

With tight credit conditions, the best shot at generating strong returns is to make companies more profitable by slashing costs, boosting sales in global markets, and paying down debt. This means firms will lean more heavily on buyout CEO managers. The CEO must create value when bond investors are expressing serious doubt and must keep employees focused even when there is downsizing. Half of the companies that defaulted on debt in 2007 were owned by private equity and US companies are relatively lean after 4 years of lackluster job growth. Nevertheless, CEOs move to big private equity firms because they get

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[35] Ibid.
[36] Emily Thornton, “Perform or Perish,” Business Week, November 2007, pp. 38-45.

big equity stakes in the companies they manage if all goes well and companies are sold for good price.

Steven Kaplan at University of Chicago studied 150 private equity CEOs and found that CEOs who bring hard qualities such as aggressiveness, persistence, insistence on high standards, and the ability to hold people accountable are significantly more likely to succeed. Soft skills do not work like they do in public companies. Soft skills like listening, developing talent, being open to criticism, and treating people with respect are unlikely to work out. Private equity firms cause creative destruction which results in change and may entail job cuts of up to 10% of the work force which may be necessary to manage the cost and productivity of labor. If poor performers are not removed they turn into your biggest problem.

The implication from these reports is that private equity is big and bad and that it needs to be regulated to mediocrity and involve all affected parties so that creative destruction becomes constrained to protect those impacted by change, most specifically workers. This self-interest position of the SEIU for example and others threaten to jeopardize innovation and the future competitiveness of the United States, which is necessary to build future jobs for US workers. Peter Drucker defined innovation as change that creates a new dimension of performance.[37] The four main elements that countries need for a vigorous private equity sector is: large pools of capital invested on behalf of others (e.g. pension funds), companies that can generate sizeable added value, managers with skill sets that can transform companies, and available exit possibilities.[38]

Douglas Lowenstein of Columbia University[39] has also addressed the issue of more transparency in and regulation of private equity. Lowenstein recognized that as private equity has grown it has attracted more attention, but made little effort to explain how it works, did not profile success stories, did not collect data to profile macroeconomic benefit, did not document well the return to limited partners, and made little effort to reach out to interested stakeholders. In this respect the industry became a victim of its own success. Superior returns attracted more money to private equity and it grew in success. An anti-private equity wave begin in Germany caused by claims of job reductions with the acquisition of Grohe by TPG and CSFB. This wave spread to the U.K. where labor unions attacked the business model. The private equity industry was slow to respond and so the Private Equity Council was born to address these shortcomings.

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[37] Peter Drucker, Innovation and Entrepreneurship, Harper & Row, 1985

[38] Colin Blaydon and Fred Wainwright, Center for PE and Entrepreneurship, Tuck School of Business, European Business Forum, and Spring 2007, pp. 15-23.

[39] Douglas Lowenstein "Private Equity and Public Policy – A Look Ahead" Columbia University, February 15, 2008.

Private equity firms buy, invest, and grow companies; not buy, strip, and flip. Growing competitive companies is important to the U.S. economy but private equity companies can not just speak about EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Jobs are one valid measure of success and several studies document this measure as good. Dr. Shapiro Clinton, an economist, found that there was a period of initial job losses but that overall in private equity investments actually increased the number of jobs. Professor Josh Lerner from Harvard states that firms acquired by private equity on average are losing jobs at a faster rate than peers before they are purchased. Over time as the business is stabilized and refocused by private equity investors employment rises to match industry average at old facilities and exceeds average industry-wide creation at new facilities. More jobs do not always mean stronger, more competitive companies, however.

For example, Carlyle investment in Axletech resulted in a strong growing company and SunGard's new research projects grew from 10 to 50+ in 2007. This growth meant that there was a significant impact on innovation (economically important innovations). Private equity acquired firms tend to maintain cutting edge research, but not all private equity deals work out as planned. Private equity is no longer just about financial engineering but is about improving operations and strategic repositioning. Increasingly, major private equity firms are now fully engaged in telling their story and revealing more information about what they do and more detail about their performance.

Private equity has distributed $500 billion in investment returns and strengthened public and private pension funds. They have made higher education scholarships to needy students, and they help make grants possible for medical research and other socially important causes. Congress is checking private equity ownership of nursing homes, telecommunication firms, and media companies, but organized labor may continue to attack private equity. This year may also see more attention on issues of income disparity and tax fairness. In any event, the private days of private equity are over.

Employment Issue from a Different Perspective

Job creation or jobs lost is an important emotional issue associated with private equity transactions. From a broader perspective, there are several fundamental trends including globalization and rapid technological change that are causing a major shift in the competitive advantage of the United States. The focus on the lack of job creation is a major issue in the United States especially in this election year. For example, most major US business magazines such as Business Week carry regular articles about what they identify are the various causes. However, the U.S. is experiencing job creation in areas that are consistent with these new major trends. For example, during the period 2000 to 2006, the U.S. civilian employment increased by 3.6 million jobs. While employment in the

manufacturing sector (both durable and non-durable goods) declined by 3 million jobs, the service sector created almost 5.9 million new jobs. The areas showing the strongest employment growth are consistent with and related to the shift in the relative competitive position of the U.S. toward higher value added activities, including financial services, professional and business services, education and health care.[40]

A recent article in Business Week complained that U.S. multinational corporations are cutting more than 2 million jobs in the U.S. even though these companies have plenty of cash and soaring profits from overseas operations.[41] Even the U.S. operations of foreign multinationals cut 500 thousand jobs in the United States. The author complains that U.S. multinationals are decoupling from the U.S. economy. It seems inconsistent that we expect multinational corporations to increase inefficient employment and retain their global competitiveness.

Those that chastise private equity and those chastising U.S. multinationals are missing the main point: in order to remain competitive companies must innovate and become globally efficient. Thus, unfavorable U.S. business conditions – including the corporate tax system - must be compared against a more favorable environment elsewhere. To survive U.S. companies must remain globally competitive. The U.S. does have an important competitive advantage in the area of research and development. Hence, these activities are remaining in the United States and continue to grow. Still they require a different labor force than required for manufacturing and these are the jobs that are being created by private equity. The author correctly recognizes that the "real boost to national economies comes from the formation of new multinationals, which in their early hyper growth years create an enormous number of jobs and put down deep roots."[42] This is what private equity is all about -- why it is so important from a U.S. competitiveness perspective. If we remember that private equity is doing what is required to improve competitiveness, we will place as few barriers as possible in front of its activities.

Private Equity Best Practices for Public Companies

Some key insights about private equity from the recent World Economic Forum – Davos 2008 are that the private equity structure provides several advantages over public ownership such as better alignment of management and shareholder interests, faster decision making and no short-term earnings constraint. Private equity has better ability to use greater financial leverage to support growth plans whereas public companies have greater flexibility to access debt and capital markets. Private equity firms also have an advantage of a superior governance

[40] Economic Report of the President 2007, Table B-46, pp. 284-285.
[41] Michael Mandel, "Multinationals: Are They Good for America?" BusinessWeek, March 10, 2008, pp.41-46.
[42] Ibid. p. 46.

model, more focused boards, and they can attract more talented directors by using incentives. There is concern whether the move toward large transactions hurt the higher growth prospects associated with smaller firms. Private equity firms seem to be holding acquired firms in private portfolios for longer periods and consequently managers are paying more attention to longer term value creation. In general, it was felt that concerns about lower transparency and decreased accountability at private equity firms are largely misplaced since the largest investors are institutional such as pension funds. Finally, public policy considerations should not be the focus of managers of public or private companies.[43]

Is private equity the best way for creative destruction to take place? Do private equity transactions actually result in creative destruction that creates growth and improved competitiveness? What are the costs that we can anticipate in this process? We know that globalization will be a defining theme for private equity in the future.[44] The following two recent studies address these questions.

A recent book by Orit Gadiesh, Chairman and Hugh MacArthur, Partner; and both with Bain & Company titled Lessons from Private Equity Any Company Can Use[45] provides a excellent contemporary look into private equity best practices. The authors point out that the most important role of the CEO is to make the company more valuable and to reward star performers and this is what private equity is about. Private equity accomplishes this by pursuing the following steps: define full potential of the company, develop a blueprint or plan of how to get there, accelerate performance, harness the talent, make equity sweat, and foster results.[46] Private equity companies in the top quartile have achieved an IRR of 36% annual average over the period 1969 to 2006 compared to an S&P 500 return of 28%. Private equity makes companies more competitive and it supports real economic growth.

Private equity is a major force in global finance the authors proclaim and neither public criticism nor tax legislation will reverse its position. The best or top private equity firms have set the performance benchmarks globally and no company is immune from private equity consideration for takeover. Private equity success offers lessons for public companies: don't divide resources into too many initiatives – 3-5 pillars of value creation are enough, develop a roadmap with measurable actions of where you want to go, get the right people to own key initiatives and reward them by monetizing a few metrics, attract the best talent with the right incentives, make equity sweat by getting comfortable with leverage

[43] This paragraph reflects the observations from Martin Haemmig from the World Economic Forum – Davos 2008.
[44] Apax Partners, "Unlocking Global Value – Future Trends in Private Equity Investment Worldwide," April 2006.
[45] Orit Gadiesh and Hugh MacArthur, Lessons from Private Equity Any Company Can Use, Harvard Business Press, 2008.
[46] Ibid. p. 5.

and using it for cash generation (higher debt to equity ratio strengthens focus on cash), and develop a results oriented mind-set repeatable across activities.[47]

Gadiesh and MacArthur in the next six chapters spell out in detail how to implement these six steps that private equity companies follow to achieve success. In defining the full potential of the company, private equity focuses on creating operating value and building a sustainable wealth creation platform. A best practice of private equity is to insure that management is positioned for success, understands they are accountable and clearly understand the few metrics they will be measured by for large rewards. Everyone must understand and support the blueprint to success – shared vision of actions and target metrics that must be achieved. The Board of Directors must be engaged and provide value added support to the management team, be an expert in the industry, ask critical questions, and think middle-term 3-5 years. Another private equity best practice is to embrace leverage (70% debt), build efficiency, and focus on cash generation (measured by EBITDA) to pay down debt. The best practice six steps followed by private equity: define full potential, develop the blueprint, accelerate performance, harness the talent, make equity sweat, and foster results oriented mind-set, should be the steps followed by any successful company – public or private.

The questions about the value of private equity are also addressed by Robert Pozen in a recent article in the Harvard Business Review.[48] He asks if private equity can get that kind of performance out of a company why can't the company get that kind of performance. Pozen presents several arguments in analyzing the answer to this question. First, private equity has a huge advantage from its insulation from Wall Street's obsession with quarterly earnings. Even so, private equity funds must ultimately satisfy the temporal demands of Wall Street in order to reap capital gains on their investments. Empirical analysis does not support that collusive deals, excessive leverage, or overpriced IPOs cause success of private equity activities. Research by Steven Kaplan of U of Chicago and Antoinette Schoar of MIT shows that net returns after fees to limited partners of private equity funds on average have slightly underperformed the S&P 500 over the past two decades. However, when they analyzed the largest private equity funds they found that net returns to limited partners have been significantly higher than the S&P500 and most importantly that these higher returns have been persistent over long periods of time.

The top private equity funds have become very large and are likely to continue to play an influential role in future market cycles. Corporate directors, therefore, should try to understand to what extent successful practices of top private equity funds can be applied to the specific circumstances of their public companies. A review after buyouts reveals five major thrusts of reform which translates into five

[47] Ibid, pp. 14-25.
[48] Robert Pozen, "If Private Equity Sized Up Your Business," Harvard Business Review, November 2007.

key questions directors should ask senior management and expect thoughtful analysis in the answer provided. The five key questions are:

1. Have we left too much cash on our balance sheet instead of raising our cash dividends or buying back our own shares?
2. Do we have the optimal capital structure with the lowest weighted after-tax cost of capital including debt and equity?
3. Do we have an operating plan that will significantly increase shareholder value with specific metrics to monitor performance?
4. Are the compensation rewards for our top executives tied closely enough to increases in shareholder value with real penalties for nonperformance?
5. Have our Board members dedicated enough time and do they have sufficient industry expertise and financial incentive to maximize shareholder value?

The first three questions relate to operating strategy and the remaining two focuses on incentive structure for management and the Board.

The issue faced by the directors is: How can we capture for our public shareholders the kind of value increase a private equity firm would seek from our company?

1. Is there excess much cash on the balance sheet?
   Private equity firms tend to keep idle cash to a minimum and require daily reports on cash levels to insure this is the case. Some of the reason for a company to keep high cash levels include: safety cushion for tough times, war chest for funding new internal initiatives, and make acquisitions. Cyclical industries need a cushion, but private equity firms have recently structured large acquisitions without substantial cash cushions in cyclical industries like semiconductors. Large cash hoards can cause bad decisions in acquisitions which decreased shareholder value. Stock buybacks is another reason for cash, but in reality there are only modest reductions in the amount of actual shares outstanding. Buybacks only increase shareholder's value, if the shares are undervalued. A more reliable way of increasing shareholder value is to raise cash dividends. Companies that raised dividends outperformed the market by 4% in the year they were raised based on a study of the period 1990-2006. Tax reductions have improved the value of cash dividends by lowering the tax rate to 15% on qualified dividends and capital gains. The main argument against paying higher dividends is the challenge of being able to lower the dividends should the company's position necessitate this in the future.

2. Is the capital structure optimal?
   Public companies tend to have low ratios of debt to equity. Private equity funds raise debt and reduce equity in companies they acquire and this debt level is higher than currently exists in public companies. The most

common arguments against high debt levels usually given by public companies are: Increased leverage will lower credit rating on debt and therefore substantially increase borrowing cost. The effect of both will decrease the appeal of the company's stock to public investors. Pozen argues that the logic holds little veracity. Leverage beyond a certain point will lead to a lower credit rating; however, until recently the increased cost for lower credit ratings has been modest. Furthermore, investors in public companies have become comfortable with higher leverage ratios. Impact on a company's market multiple has shrunk sharply over the past five years. A counter argument is that a public company is much less diversified than a private equity fund which owns many firms and therefore higher debt levels are riskier for a company. But this view is too parochial. A more appropriate viewpoint is that of shareholders. Since shareholders can hold stocks in a diversified portfolio of public companies, shareholders can adjust leverage to what they want. Directors should insist on careful empirical analyses of various combinations of debt and equity to arrive at the lowest after tax cost of total capital including debt and equity.

3 Does the operating plan significantly increase shareholder value?
While increased leverage has contributed to the success of private equity, improved operating performance of acquired companies has been more important. In a 2005 study by Ernst & Young of 100 companies in Europe owned by private equity companies, they calculated that the value of these businesses grew at twice the annual rate achieved by public companies in the same country and same sector. "Making long-term improvements in the profit growth and value of businesses do not come from cost cutting or financial engineering but it comes from focused investment, making the few key changes fast and recognizing the benefit of shared incentives of investors and management." Also in a 2005 McKinsey study of 60 deals by 11 private equity firms with above average track records, it was found that in 63% of the deals studied the primary source of value creation was "company performance" as compared with 32% from "market/sector appreciation plus financial leverage" and 5% from "arbitrage." Private equity firms devise value-creating plans and execute them effectively. Public companies need a great operating plan plus directors that monitor its implementation as closely as private equity does. Private equity companies undertake near continual review and revision, tracking progress against key performance indicators. If a company falls behind private equity acts decisively. For example, where necessary plans were redrawn, management changed and sometimes investment increased. There are no generic formulas how private equity firms improve operating performance but there is consistent toughness in controlling costs.

Performance should be measured against general administrative costs and total operating costs relative to gross profits. Improving operating performance requires astute business judgment about where to cut back

within existing units. Directors should also look at selling non-core business – a favorite private equity technique for cost cutting. Directors should urge management to find acquisitions at reasonable prices that would consolidate the company's market position or realize economies of scale. Bold strategies and effective implementation serve shareholders well but require a highly creative and motivated management group. Directors should also examine the compensation incentive packages.

4. Is executive compensation tied closely enough to shareholder value?
   With private equity, equity stakes in these companies are much larger than in public companies. Kaplin estimated that the stock interest of CEOs increased by four times when the company was acquired by a private equity firm. McKinsey found that private equity offers top management rewards equal to 15% to 20% of the company's total equity. These incentives are offered to a much more select group of executives in private equity backed firms than in public companies. Benefactors are chosen on the basis of their direct contribution to shareholder value as proven drivers of a company's performance. The managing executives only receive rewards if the private equity fund that owns the company realizes a substantial gain, which is usually when the company is sold or there is a public offering.

   Directors of public companies should learn that stock rewards should be tied to increase in shareholder value. Stock options do this but restricted shares are effectively guaranteeing a substantial gain to recipients regardless of how shareholder value changes. The need is to separate an option exercise from general market gain and relate it to company performance or more specifically, when company earnings targets are met or exceeded. Compensation is like performance indexed options adjusted annually. A private equity firm does not allow an executive to leave with a large compensation package if the company performs poorly. The implication is that public company directors must link bonuses to performance.

5. Do directors devote enough time and have enough incentive to increase shareholder value?
   Board composition differs for private equity controlled companies from public companies. Private equity favors operating with a smaller number of 4-8 directors, versus 10-14 in public companies. Public companies require that three main committees: audit, compensation, and governance/nominating be composed solely of independent directors. Private equity firms recruit directors with extensive operating experience in the same industry as the acquired company. In public companies, experienced executives may not qualify as independent because of business ties.

Private equity directors spend much more time on company business than do public company directors. Public boards usually meet six times a year with each meeting lasting a day and a half. The estimated total time is 132 to 183 hours including travel. In contrast, private equity directors spend three to five days per month and more at the beginning. A public company director received an average of $136,360 in 2005 according to a Spencer Stuart study. If a company gets into trouble directors face risks financially and legally. In private equity companies, directors spend more time but the compensation is not paid in wages but as a share of the private equity performance fees or typically a share of the 20% of the return to the private equity firm. Private equity favors low annual wages but high performance stock options.

6. Getting the Message?
   Companies below $20 billion are private equity target firms so they should adjust urgently. The golden rule in private equity is: use small, expert boards that are focused on a company and its performance in industries that they know.

Recently, the World Economic Forum released a study by Anuradha Gurung and Josh Learner on the Global Economic Impact of Private Equity Report 2008.[49] The Forum recognized that private equity has grown rapidly both in market share and geographically. The report studied the impact of private equity on employment, managerial time-horizons, overall health of companies, and the economy in general. The following is a summary of its findings.

Studies of buyouts in the 1980s had two limitations – they focused on a relatively small number of transactions in the U.S. and to lesser extent in the U.K., while today the market is more global and non-U.S. (especially continental Europe); which incidentally is now larger than the United States in private equity transactions.

The second limitation relates to the fact that the industry has grown and evolved significantly since its formative years. The purpose of the World Economic Forum study is to analyze equity investments by professionally managed partnerships that involve buyouts or other equity investments with a substantial amount of associated indebtedness. Thus this study does not focus on venture capital type investment in start-ups. The project drew on existing databases and focused on most developed markets in the U.S. and the U.K.

The 2008 Report covered the following topics:

- demography of private equity firms, number duration, outcome of transactions,

[49] Anuradha Gurung and Josh Learner, Globalization of Alternative Investments: The Global Economic Impact of Private Equity Report 2008, World Economics Forum, 2008.

- willingness of PE backed firms to make long-term investments in innovative activities,
- impact of private equity on the employment of existing companies as well as tendency to open new facilities, and
- consequences of private equity investment for the governance of private firms.

The World Economic Forum study complemented the examination of the above topics by incorporating four case studies with focus on Germany, U.K., China and India. The key findings of the nature of 21,397 private equity transactions during 1970-2007 and their outcome are summarized below. The Report provided descriptive evidence on the growth of private equity transactions and their changing nature including LBO transactions. The Report analyzes the extent to which LBO are successfully executed and explores whether exit success has varied by time periods, and third, the Report focuses on the longevity of the staying power of LBOs. The following paragraphs provide a summary of the World Economic Forum Report.

The Report found that private equity activity has accelerated with more than 40% of buyouts taking place since January 2004. The total value of firms acquired in LBOs was $3.6 trillion over the sample period of which $2.7 trillion occurred during 2001-2007. LBOs which took a public company to a private company only accounted for 6.7% of all transactions and in value terms represent 28% of all firms acquired. Therefore, the vast majority of buyouts are of private firms and corporate divisions.

Non-U.S. private equity activity has grown to be larger than U.S. based activity in the past few years and the growth in continental Europe buyouts has been very pronounced. LBOs outside the U.S. and Western Europe only accounted for 12% of global LBO transactions in number and 9% in value during 2001-2007.

The traditional depiction of buyouts in old and declining industries does not reflect the rise in buyout activity in high growth, high tech sectors in the last decade. Industries where buyouts were most prevalent include chemicals, machinery and retailing.

Initial Public Offerings (IPOs) accounted for only 13% of private equity investment exits and this exit route seems to have decreased in importance over time. The most common exit route is sales to another corporation which accounted for 39% of all exits. The second most common form of exit is secondary buyouts, which has increased in importance over the past decade and represented 24% of all exits.

Only 6% of buyouts transactions end in bankruptcy or financial restructuring which implies a lower success rate compared to bankruptcy rates among U.S. publicly traded firms. However, it also suggests that buyouts have a lower

average default rate than U.S. corporate bond issuers and substantially lower default ratethan average junk bond issuers.

Private equity investors have a long-term ownership bias as 58% are exited more than 5 years after the initial transaction. The so called quick flip exit within two years accounts for only 12% of deals and has decreased in the last few years. At the same time, the number of businesses operating under private equity has grown rapidly. For example, the number of firms entering LBO status has been substantially higher than the number of firms leaving LBO status every year since 1970. There were 14,000 firms held in form of LBO status at the beginning of 2007. This is significant growth when compared to the 5,000 firms in the year 2000 and 2,000 firms in the 1990s. Almost 40% of all LBOs remain in this form 10 years after the original leveraged buyout was announced. Also, the length of time firms remain private has increased in recent years.

The following is the long-term investment study's key findings summarized from the report. The impact of private equity on the time horizon of companies in the portfolio – private status allows managers to proceed with challenging restructuring of the company without catering to pressures of market demand for quarterly profits – looked at 495 firms worldwide.

Key findings - overall:

- Firms that undergo buyout pursue more economically important innovations as measured by patent citations in the years after private equity investments;
- Private equity backed companies maintain comparable levels of cutting edge research and post-buyout these businesses display no deterioration in the extent to which their research is basic or fundamental as measured by patent originality and generality;
- Quality of patenting does not appear to be systematically changed after private equity transactions;
- Innovation becomes more targeted post-buyout - patent portfolios of firms become more focused years after PE investments;
- Private equity backed firms concentrate on core technologies. The increase in patent importance is greatest in patent classes where the firm has had its historic focus and where it increases its activities after private equity investment.

Key findings - employment study:

- Critics have claimed huge job losses – earlier studies have had limitations but this study, of the period 1980 to 2005, tracked 5,000 target firms and 300,000 target establishments 5 years before and after private equity transactions. These firms are compared against other comparable public firms;

- Employment grows more slowly at target establishments in the prior year and two years after private equity firm takes over;
- Employment declines more rapidly in the target than in the control sample in wake of private equity transactions – two-year employment difference is 7% in favor of control sample firms. In years four and five, employment in private equity backed firms mirrors that in control group;
- Post-transaction buyout firms create about as many jobs as peers. The gross job creation in wake of private equity transactions is similar in target and control firms;
- Firms backed by private equity have 6% more greenfield job creation than peers in first 2 years after private equity takes over: 15% vs. 9%. It appears that job losses at the target companies in wake of private equity takeover are partially offset by substantially larger job gains in the form of greenfield job creation by target firms.
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Key findings – governance study:

- Board composition in the U.K. between 1998 and 2003 – study covered 88 sponsored by at least one private equity fund compared against pure management buyouts;
- When a company goes private there is a fundament shift in the Board as both the size and presence of outside directors is reduced. However, there was no significant difference between MBOs and LBOs in private equity deals as outside directors are replaced by individuals employed by the private equity sponsor. In the MBO the outside directors disappears and only management is left;
- Private equity board members are most active in complex and challenging transactions;
- Presence of LBO sponsors on the Board depends on the style of the private equity firm. If there is more than one LBO sponsor, then the Board is larger;
- Private equity investors remain actively engaged with their portfolio businesses years after the transaction whereas the percent of the LBO sponsors sitting on the Board only slightly decreases over time.

Key Observations of the Case Studies are:
- Analysis of six private equity transactions in Germany, the U.K., China, and India,
- Results:
  - LBO is the long-run governance structure for many firms;
  - Employment falls more rapidly at target post-transaction, but private equity firms engage in more greenfield job creation than control firms. Private equity accelerates the pace of acquisitions and divestitures. Private equity groups act as catalysts for change in the economy;
  - The net impact of private equity is that it neither destroys many nor creates many jobs;

- LBOs outside of U.S. and Europe only accounted for 12% of global LBO transactions and 9% in value between 2001-2007;
- Private equity in the emerging economies is expanding and maturing for minority and growth capital investments.

There is a greater move toward transparency and governance. Private equity is shifting from a deal making culture to an industry that conforms to the norms of a company on a public listed market. For example, there are growing demands for disclosure especially in Europe and the United States. In the U.S., there is a focus on the quality of reporting financial performance and balance sheet structures. There is a need for descriptions of how performance has been achieved, directors' remuneration, and even the primary risks faced.[50]

Driven by the desire to access public equity markets, private equity firms are increasing in size and in visibility. Regulatory issues are also causing a shift as is the need to manage growing taxation risks. Currently, South Korea and Germany have double taxation policies for private equity companies.

Adopting a "fair value" accounting standard is becoming a necessity. There is a convergence to a worldwide accounting standard in respect to "fair value" reporting. Private equity companies will no longer be able to value companies at cost. Also, GPs are listing their firms on public exchanges which requires more disclosure. Basel II, Pillar 2 requirements focuses on a general improvement in governance in the financial services industry which will also have an impact on private equity companies' reporting. Private equity firms may need to establish controls to manage risk -- including fraud.

There have been recent developments concerning the "fair value" issue. [51] The new FAS 141R, issued in December 2007 requires companies that acquire assets or assume liabilities in a deal to record the items at their acquisition date fair value rather than at historical costs. A contingent liability is an obligation to make payments based on the outcome of future events. FAS 141R replaces the long-standing "probable and reasonably estimable" criteria (stipulated under FAS 5) with fair-value measurement. As a result, buyers in M&A transactions should expect to book many more contingent liabilities and at significantly higher cost estimate than reported by sellers. The company must determine the estimated fair market value of the future payout and record it as part of the purchase price on the day of the sale. When the payout is finally made the company must record the difference between the estimated fair value and the actual payout as an expense or gain.

In another development, there is some evidence that private equity companies may be increasing their use of outside companies to help them with their own

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[50] "Fundraising Record," Private Equity and Venture Capital, PriceWaterhouseCoopers 2006. Total of $272 billion raised in 2005 up 105% from $133 billion in 2004 Invested PE & VC

51 Marte Leone, "TopLine: Facing Up to Fair Value," CFO Magazine, February 2008.

reporting requirements perhaps in response to requests for more transparency and fair value.[52] The U.K. private equity fund industry is 90% on shore and the majority of these firms do their administration in house. In the 1970s and 1980s, large offshore private equity funds used lawyers to set up fund structure and to run them. Pension funds were the major contributors to the €112.3 billion raised in 2007. In the U.K. 27% went into fund of funds and 18% into specific private equity companies. LPs are demanding a change in administration and standards of governance for PE. This change is happening more quickly in Europe than in the U.S., where private equity is even less likely to be outsourced than in Europe. It is estimated that 10-15% of U.S. private equity funds outsource some administration functions. One reason for not outsourcing in U.S. is that there are no credible players. In the case of hedge funds, they just do not want to get bogged down with administration. Also supporting outsourcing administration is the increasing complexity of fund structures. There is also growing need for IT specialists to provide the best accounting and administration platform. Outsourcing companies provide better career opportunities and stability to accounts and administers than do private equity funds. All funds have Dec 31 as their year end. Quarterly reports to LP's must be prepared and the reports must be high quality to keep LP's invested and committed to the fund's success.

Global Private Equity Developments

Private equity firms are becoming more transparent and are introducing more formal corporate governance structures.[53] General Partners use different approaches in the U.K. where British Venture Capital Association (BVCA) is using voluntary code. Private equity has tended to create value through the unique skills of its principals and while focusing on acquiring businesses at the right price, then improving operational performance and then selling them. Consequently, fundraising is at record levels as it is moving from the U.S. to Europe and Asia. U.K. is a serious player, as a result demands for disclosure are loudest in Europe. Some GPs list Permanent Capital Vehicles on stock exchanges and GP's management firms are also listing. South Korean and German authorities are challenging private equity holding company structures. Europe is pushing transparency, increased focus on quality of reporting financial performance and balance sheet structures, descriptions of how performance has been achieved, director's remuneration and the primary risks faced.

Convergence of worldwide accounting standards is pushing PE toward fair value (price received for selling asset in an orderly transaction). Private equity firms will also have to disclose valuation methodology used under Basel II Pillar 2

52 "Private Equity Discovers Outsourcing" Global Outsourcing Services Fall 2007 Examples: IBT, CACEIS, Northern Trust (full service), JPMorgan WSS (With HM Capital), IPES

[53] PicewaterhouseCoopers Private Equity Going Public: Global Private Equity Report 2006" 2007

requirements. All of these reporting requirements will increase costs for private equity companies and therefore reduce returns. SAS70 also requires reviews of corporate governance.

Taxation risks arise as GPs have responsibility to use tax-efficient structures so that returns to investors are maximized. The concern, however, is double taxation. More investors are becoming concerned with this possibility. Germany is challenging private equity holding companies established in Luxembourg and South Korea is challenging dividends paid to the Netherlands.

Value creation in private equity occurs by building a portfolio of companies and managing them profitably. Private equity is reacting to greater competition by improving its unique ability to improve portfolio companies' operating performance. The focus is on enhancing these companies' ability to create economic value through strategic advice as well as practical assistance in important transitions such as expanding into new countries. Growth in size and visibility and economic importance make regulatory changes inevitable. "Fair value" valuations of portfolio companies and accounting and regulatory changes will increase volatility of performance and require increased risk assessment

Private equity fund raising and investment trends suggest Asia is becoming the destination country for private equity investment. Global private equity activity has exploded with $136 billion invested globally in 2005 or 0.31% of global GDP. Fundraising was $272 billion in 2005. Global annual investment has grown at 10.1% since 1998 while fundraising has expanded at 10.8%. The key destinations have been China (up 328% to $8.8 billion), Singapore (up 241% to $4.4billion), South Korea (up 35% to $2.1 billion), and India (up 45% to $1.94 billion). Investments made exceed local funds raised. In essence capital is transferred from U.S. and Europe to rapidly growing emerging markets.

There has been increasing penetration of Europe's economy with $55 billion invested in Europe in 2005. High technology and expansion capital continues to recover and represent 35% of total 2005 investment. Expansion capital was $29 billion up 31%. Buyouts totaled $73 billion globally up 9% in 2005, and were up at a 13.2% average annual rate over 5-years with technology up 7.5% average annual rate over 5 years.

Deloitte undertook a survey of private equity venture capital companies at the end of 2006 and the results are based on 505 responses (279 from the Americas, 140 Europe, Middle East Africa, and 86 Asia Pacific).[54] The survey shows that private equity and venture capital continue to globalize from the U.S. and the U.K. in search of new opportunities for high returns. The survey focuses on expansion plans, target countries, changing business practices and barriers to continued expansion. Of the companies that responded, 56% see global expansion continuing versus the $15.8 billion invested in 2005. U.K. continues to

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[54] "Global Trends in Venture Capital 2006 Survey," Deloitte Touche Tohmatsu, end 2006.

see a venture capital boom with $2.8 billion invested. Canada is also growing after $1.5 billion was invested in 590 companies in 2005. The top target companies were: China for a total of $2.3 billion in 147 companies in 2005 up from $0.7 billion in 2004 and Israel as it attracted $1.3 billion in 2005. Finally, governments are beginning to put public funds behind private dollars to support venture capital activities in support of global competition.

Strategies for global investing include growing cooperation among venture capital companies to expand through networks and partnerships with local venture capital firms forming strategic alliances. Venture capital companies are targeting Low-cost locations, higher quality deal flow, emergence of entrepreneurial environment, diversification of industry, and access to quality entrepreneurs. European respondents interested in Western Europe and Asia primarily consider low cost location. Asia respondents wanted more global focus for diversity and a focus on low cost and diversification. U.S. respondents were interested in China and India and then the U.K. and Canada. Investors do not yet favor Latin America because of political instability in the region.

Avenues to growth changed little from industries such as software, communications, networking and clean technology, medical devices, and new materials -- all of which are on the rise. But energy and environmental investments are most likely to see the greatest increase along with nanotechnology and healthcare services. In the eyes of venture capital firms on non-U.S. vs. U.S., the United States is still the top destination for R&D manufacturing and engineering.

With respect to the globalization of the Limited Partner base, the key reasons identified for not globalizing was that ‘there is no place like home’ along with the impediments to investing in a foreign country. The U.S. in nearly every case is very attractive to investors. The top concerns for U.S. and non-U.S. responses alike include taxation, intellectual property laws, and environmental regulations. Nevertheless, there is an increasing amount of interest and desire to go global in the future.

Collier Capital completed a survey of worldwide trends in private equity and captured the views of 102 private equity investors.[55] They found that there was a limited impact of private equity controversy on LPs. European and American LPs were divided on GP transparency -- 56% of Europeans believe GP should account to stakeholders but only 1/3 LPs feel this way in the United States. Return expectations for Asia-Pacific increased but decreased for European buyouts. Investors see signs that the global buyout boom is ending, especially for North America’s LPs. LPs think GPs will deploy less cash in thecoming year, with North America likely to be hardest hit by private equity downturn.

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[55] “Global Private Equity Barometer” Winter 2007-08 Coller Capital

Respondents see no reduction in investor demand for private equity, but investor access problems are growing in less developed markets. LPs are planning wider – as well as greater – private equity exposure next year (2008) and 78% of LPs plan to increase the number of GP relationships. Almost all plan to increase the total value of their private equity commitments. In this respect, almost 2/3 of investors plan to re-balance their portfolios toward buyouts and just over 1/3 toward venture capital.

Forty percent of LPs are investing in emerging markets compared to 26% two years ago. Shortages of proven GPs deters emerging markets investment as 70% of investors say they lack the necessary expertise and resources to manage exposure to emerging private equity markets. India and China top LPs ranking of private equity emerging markets. Asia-Pacific offers the most attractive opportunities for GP investment over next year. Forty one percent of LPs are investing directly in private companies which is an increase from the 35% in the summer 2006. One-third of investors plan to increase their level of direct investment over the next 3 years -- especially LPs seeking the GPs of tomorrow. For instance, 66% say they will invest in first time funds over the next 2-3 years. LPs say they will exert moderate pressure on buyout fund terms and conditions but the majority of LPs expect status quo. One-half of European LPs think European venture capital firms can rival North American venture capital firms. Government attitudes are believed to be the biggest block to the success of European venture capital.

UNITED STATES

Willis Stein & Partners presented an overview of the private equity industry in the United States at the Federal Reserve Bank of Chicago Private Equity Conference in 2006.[56] Their U.S. perspective is summarized as follows.

High net worth individuals have increased their investment in private equity from 10% to 22% of their investments. Total returns and IRR for private equity has been double the return of the S&P 500 during the past 5 years and private equity has out performed hedge funds since 2004. The source of private equity funds is shifting with less coming from pension funds and insurance companies and more coming from fund of funds, wealthy individuals and foreigners.

There are more mega private equity funds that are larger than $10 billion. These funds have annually invested $150-200 billion with increases in the number of deals, deal value and average deal size. The acquisition multiples purchase price (enterprise value)/EBITDA have averaged about 7x. Leverage multiples Debt/EBITDA have been about 5x with the high over 6x today. Deal size is growing with higher leverage (5-8x) and more robust multiples (8-17x) with the

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[56] Willis Stein & Partners, "Overview of the Private Equity Industry in the United States," Federal Reserve Bank of Chicago Private Equity Conference, 2006.

averages moving toward public sector comparables. The market structure is more global from funding, acquisition, and exit strategies.

There are several factors to worry about: new investment vehicles (hedge funds, new publicly traded permanent capital – KKR, Apollo), SPACs, BDCs, and IDCs that offer higher asset price and lower return. Increasingly today, hedge fund activity increasingly overlaps with private equity. Nevertheless, there is a continuing case for private equity, as well funded funds can take a longer-term view and greater risks. Private equity adds value since entry multiples are lower than public companies, managers still avoid quarter-to-quarter earnings pressures, it injects capital into businesses, leverages investments more aggressively, builds attractive assets for future buyers, and can pick exit timing. Private equity investors strengthen management, drive revenue growth, create operating efficiencies, strengthen balance sheet, identify acquisitions, and develop exit opportunities. In addition, mid-market private equity is increasingly attractive: 90% of which are private targets, the valuation multiple is between 8-9x, the acquisition price is under $500 million, and the quality of CEO is greater in mid-market vs. small market firms.

Ten years ago annual meetings consisted of media. But now it is half bankers who focus on business in small clusters.[57] Careers and companies have taken different paths because of the impact of private equity. Private equity activity scares staff and tends to lose about a half year of productivity after transaction because of job/company uncertainty. Private equity means measurement and hitting targets. Companies that are flipped often rot but the private equity model is just different not right or wrong.

Global Insight reports that the total revenue of venture backed companies is 17.6% of the U.S. GDP or $2.3 trillion. Total employment of venture backed companies is 9.1% of U.S. private sector employment or 10.4 million jobs in 2006 – a 3.6% increase over year earlier levels.[58] A total of $26 billion was invested in 2006 and sales of these new companies grew by 11.8% compared to a 6.5% average increase for U.S. By sectors, computers and peripherals employed almost 2 million workers, industrial/energy 1.25 million, retailing/distribution 1.1 million, software 866,000, and consumer products 765,000. There was some state concentration as California venture backed companies had 2.4 million jobs, followed by Texas with 1.1 million and California had $566.6 billion in revenue in 2006. Out of 100 business plans presented only 10 are usually promising and out of these only 1 gets funded. On the sell side only 1 in 6 companies ever goes public and normally 1 in 3 firms is acquired.

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[57] Tony Silber, “Private Equity’s Impact in US,”Federal Reserve Bank of Chicago Private Equity Conference, 2006.

[58] Global Insight, Venture Impact: The Economic Importance of Venture Capital Backed Companies to the US economy, 4th edition, 2007.

In answering the question who invests in venture funds: pension funds represent 42%, finance and insurance companies 25%, endowments or foundations 21%, individuals or families 10%, and corporations 2%. Driven by the entrepreneurial spirit, financial recognition of success, access to good science, and open capital markets, and protection of intellectual property; venture capital backed companies create jobs and add workers faster than non-ventured backed companies. Venture capital financed companies in computers and peripherals sector produced the largest number of jobs -- employing almost 2 million workers with the industrial and energy sector creating 1.1 million, and the software sector 867,000 jobs. Employment growth of venture capital backed companies exceeded employment growth in those same industries. Furthermore, 23,500 venture capital backed companies generated $2.3 trillion in sales in 2006. Sales by venture backed companies grew faster than sales by non-venture backed companies over the period 2003-2006 -- 11.8% vs. 6.5%, networking and equipment grew 23.9% vs. 10.1%, biotech grew 19.1% vs. 9.4%, and financial services expanded 16.2% vs. 6.0%. The impact of venture capital was widespread with the employment and sales growth spread across 15 states with the largest impact in California and Texas.

Europe – United Kingdom

The British Venture Capital Association (BVCA) conducts an annual report on activities in the U.K. for both private equity and venture capital.[59] World wide employment increased by 9% per year over past 5 years to 2006 by U.K. private equity companies which were faster than the 1%-2% increase registered by other companies. Three-quarters of the respondents said growth was internal not by acquisition and 92% of respondents said that without private equity they would not exist or would have developed less rapidly. Over the period 2001 to 2006, private equity backed companies' sales rose by 9% and exports grew by 6% -- compared to 5% and to 2% nationally. During same period investment by private equity firms rose by 18% vs. an overall domestic increase of 1%. There were £424 billion of total sales over the last 5 years, £48 billion worth of exports generated in the last 5 years, and £26 billion taxes paid in 2006.

In 2006, employment at private equity backed companies was 1.2 million workers representing 8% of the U.K. private sector employees. According 62% of all venture backed companies, they increased their worldwide employment by 12% vs. 2% for non-venture backed companies. U.K. employment grew by 9% vs. the national decline by 0.4%. Seven percent said growth was internal or organic not by acquisition. Sales growth was 8% annually vs. 5% over past 5 years and investment was 8% annually vs. 1% annually for the U.K.

Of the companies in which venture capital invested, 55% introduced new products or services in past 2 years and 71% identified the principal contribution

[59] BVCA ,The Economic Impact of Private Equity and Venture Capital in the UK: Annual Survey, 2007

to be that of strategic direction. Managed buy out firms accounted for 72% of turnover and 77% of the U.K. employment increase. MBO firms increased sales revenue by 10% per year over past 5 years vs. 5-7% for non-buyout companies. Investment in R&D increased at an average annual rate of 21% during the past 5 years. The percent of employees participating in ownership increased from 12% to 26% also during the past 5 years.

In response to the question about what was the most important contribution from the private equity company: 92% said private equity was an important source of guidance, 71% said financial advice, 69% valued strategy advice, and 63% reported contacts, 52% management, and 39% said marketing.

One-half of the U.K. companies that floated on London Stock Exchange from 1998-04 were private equity backed and their after market performance was better than non-private equity backed companies. The U.K. private equity industry accounts for 51% of the European market and is second only to U.S., while France accounts for 16% and Germany 6%. Since 1984, £80 billion has been invested in about 29,000 companies. In 2005, BVCA members invested £11.7 billion in 1,535 companies worldwide and 66% of the investments in the U.K. received less than £1 million.

U.K. private equity firms employ around 5,000 workers of which 3,000 are professionals. The majority of private equity companies are medium-sized (£46 million) employ 600 people and fast growing with 72% receiving more than one round of investment, and 76% of the reported private equity still had a stake in the company.

Dr. Tony Golding commented on survey by BVCA's "The Economic Impact of Private Equity and Venture Capital in the UK" pointing out that several aspects merit critical examination.[60] The statement that private equity firms employ 19% of private sector workforce in U.K. is misleading since 19% refers to every company that has ever received private equity funding including those where private equity is no longer involved. A more accurate statement is that "This year we have estimated the number of people employed by companies that are currently backed by private equity as 1.2 million or 8% of U.K. private sector employment.

Second, the results are un-weighted by size (of investment, turnover, assets, etc) "Average employment growth for U.K. private equity backed firms over 2001 to 2006 was 9% annually. These results should have been reported by size, since small companies push up the average. For example, in 2005, BVCA members invested £6.8 billion in 1,305 U.K. companies and 66% of those businesses received amounts of less than £1 million.

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[60] Dr. Tony Golding comments on survey by BVCA "The Economic Impact of Private Equity and Venture Capital in the UK"

Third, the methodology is not correct since over 90% of the U.K. private equity firms are members of BVCA they all should have been asked for the information but instead the data is received in an unreliable way as a random sample of private equity backed business was used.

AltAssets comments on the BVCA Survey saying that BVCA has about 165 members representing the vast majority of private equity and venture capital companies in the U.K. This represents investments in over 11,000 companies employing 3 million people and implies that in the U.K. entrepreneurship is closely linked with private equity. AltAssets points out that the U.K. needs acertain level of immigration to replenish and enhance the workforce and to raise the level of productivity, they need an environment to support entrepreneurs with low interest rates and low inflation, and they don't need to be regulated disproportionate to any perceived benefits. AltAssets supports the following recommendations with respect to private equity:

- to broaden and simplify the scope of employee and management share agreements,
- to extend the substantial shareholder exemption to investment companies,
- to make further simplifications and changes to capital gains tax,
- provide fiscal incentives to invest in venture capital trusts,
- abolish stamp duty on transfer of shares, and
- to support research and development.

Europe - Germany

In a FAZ Finance Study on the "Economic Impact of Private Equity in Germany" it is stated that private equity has come to play a significant role in restructuring projects of large companies and that many non-core activities have been acquired and turned into profitable business which allows the company to focus on core business.[61] Private equity is an alternative to bank loans especially for non-listed companies. In a buyout, managers become entrepreneurs which mean more risk and motivation for the management team. A private equity financial sponsor can add value in areas of structured financing and internal organizational improvements.

In the FAZ survey, the period analyzed was 1997 to1999 and it was found that private equity sustains economic growth and creates jobs. Forty-five companies were examined and the results tracked between 1998 and 2003. The peer group was from the same industries and sales volumes were compared against 3,575 companies in the benchmark group. During 1998-2003, the sale of private equity buyout companies rose 7.4% vs. 3.9% for benchmark companies. Employment rose an average of 4.5% a year vs. 2.2% for the benchmark companies – that is private equity buyouts grew twice as fast as the benchmark. Buyout sales were

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[61] FAZ Finance Studies "Economic Impact of Private Equity in Germany" Nov 2004

noticeable in the auto industry and in mechanical and plant engineering which also grew faster in sales and employment than the benchmark group.

During the period 1997-2000, private equity grew by more than 50% on average but then slowed when the technology bubble hit in 2000 with venture activities hit hardest. Since this time private equity has recovered its strong growth rate. Private equity as a percent of GDP is currently about equal to 0.1%, but growth could slow with the change in tax and legal framework being discussed.

One aspect of this recovery in private equity activity has been the use of management buyouts. A management buyout occurs when the financial sponsor uses a new company to acquire the majority stake while the management team purchases a minority stake. Sometimes new management is brought into the deal. Private equity helps structure the purchase and tries to achieve optimum ratio between debt and equity capital. Bank loans are used to finance the purchase. The high loan to equity ratio is also important in operating the business. Three factors help boost the value of equity: first, cash flow is used to repay loans, second, private equity puts strong emphasis on profitability by raising revenues and cutting costs. Third, strategic improvements are made that improves the revenue multiple used to determine purchase price when the company is sold. Sale occurs normally between 2-7 years and then the financial sponsor divests its share. The reasons for management buyouts are the sale of the subsidiary, succession issues and to allow the former owners to realize the benefits of their lifelong achievements and guarantee the continued existence of their company.

The buyout market has grown dramatically from 1996 to 2004 to almost €2 billion, an increase of 50% with most transactions in the €50 to €250 million range. The main driver has been restructuring activities. Management teams have purchased non-core activities which investors restructure and modernize. This enables companies to reposition themselves and become more competitive with new opportunities. Buyouts usually target industries undergoing profound structural changes or innovative technologies like automotives, special chemicals, communication technology and mechanical engineering.

The conclusion is that private equity is better than the past reputation and it is not a raider as has been perceived. If it can be shown that private equity accelerates growth, then the government should improve the framework and regulatory conditions to support private equity. BVCA and NVCA have shown that private equity contributes to economic growth and economic competitiveness especially because of its focus on R&D investments. Sales at private equity companies grew at 11% vs. 10% in other U.K. companies. U.K. private equity companies created more jobs which increased by 7% vs. a 6% growth in other companies.

The German study also focused on German buyouts between 1997 and 1999 when there were 100 buyouts of at least €10 million during this period. Analysis

of their performance showed that four out of the 100 companies were insolvent and 26 could no longer be traced which left 70 companies for the study. Sales and employment data was collected for 45 of the 70 companies. The benchmark data included approximately 800,000 firms and companies which were grouped by size. Acquisitions were excluded from the study.

The results during past 5 years show that private equity companies performed much better than the benchmark companies. For example, sales rose 7.4% vs. 3.9% for the benchmark companies. Private equity employment creation grew at an average rate of 4.5% annually vs. 2.2% in the benchmark companies. Thus, the results for private equity managed in the U.K. and Germany are comparable. Productivity in the sample companies was below the benchmark until after 2002 when it exceeded the benchmark by 4% vs. 0%. This suggests that buyout companies are on average as productive as their competitors.

Focusing on the results by sector, in the auto sector (a large sector with 10 companies) sales growth averaged 13.3% per year vs. 5.9% per year in the benchmark. Furthermore, employment in the auto sector grew 6.7% per year vs. 1.3% per year in the benchmark companies. This means that sales growth per employee averaged 6.7% per year vs. 2.5% per year in the benchmark. Buyout companies developed to be much better than competitors. For example: in the mechanical and plant engineering sector, sales growth averaged 5.3% per year vs. 4.2% per year in the benchmark group. Furthermore, employment in this sector grew an average of 1.95% per year vs. -0.65 % per year, and sales growth per employee averaged 2.88% per year vs. 1.62 % per year in the benchmark group of companies in the same sector.

In summary, the performance by private equity investments during this period was far superior when compared to the benchmark group. Private equity investments grew faster than benchmark overall. By sector, auto and mechanical and plant engineering had superior productivity gains although this was not the case overall. Private equity contributes significantly to growth and employment and therefore they generate more tax revenues. Private equity does cherry pick companies that show the most promise or that will contribute to consolidation, restructuring and modernization of traditional businesses. This study does not show that private equity restructuring always leads to job losses. Therefore, an improvement in the tax and legal framework could increase the role of private equity in GDP and contribute to economic growth for the nation. Compared to other countries, Germany currently ranks low in tax benefits for private equity firms.

In a more recent study of the private equity activities in Germany, Ernst and Young surveyed a total of 53 buyouts in the first half 2005, 69 and 44 buyouts in second and first halves of 2004, respectively.[62] The value of the buyouts was:

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62 Ernst & Young “German Private Equity Activity June 2005: The Economic Impact of Private Equity”

€12.9 billion, €10.6 billion, and €12.9 billion, respectively. The largest deal was €6.1 billion but there were a large number of small transactions. The split of buyouts by sector varies year to year but the real estate sector is important throughout. The value of U.S. and U.K. private equity led deals exceeds German led deals. In Germany, exit routes are dominated by secondary buyouts since IPOs are difficult. Dr. Holger Frommann in BVK Economic Impact of Buyouts and VC, reports that private equity creates companies focused on growth, value creation and technological progress – and that private equity companies are able to react with greater flexibility to the needs of market. This helps to attract new funds and to support progress with investments to create new jobs and promote economic growth. In 2000, private equity had €71 billion investments in 5,500 companies with 350,000 employees. In 2005 we have 5,600 companies managed by private equity with 638,000 employees and €114 billion in investments.

Australia

PriceWaterhouseCoopers did an Economic Impact of Private Equity in Australia that includes venture capital activity.[63] The employment impact of companies that private equity companies had invested in was 650,000 which represented 8% of total private sector employment. In addition, 78% of the companies in the survey say they are hiring for 2007 vs. the 5% of companies in the entire economy. Three-quarters of the private equity owned companies launched new products in 2006 vs. the 27% overall last year and most of these products were in technology. Furthermore, 82% of the private equity companies provide ongoing technical training for staff while 79% reported that they share some profits with employees.

Private equity activities in Australia are expanding at an increasing rate. To date the cumulative amount invested is $14 billion and this investment has experienced an average annual growth of 27% over the period 1999-2006. The total number of companies invested in is 900 when the companies in New Zealand are included. The average fund size in 2006 is $400 million and the average fund growth during 2003-2006 was 63%. More than half of the amount invested went to consumer related companies and 25% went to health and technology sectors. Private equity and venture capital activities in Australia and New Zealand have experienced strong growth so far, but it is still in its early stages relative to the U.S. measured as a percentage of GDP.

Private equity investment is outperforming publicly listed companies in data analyzed at the end of 2006 which was based on a 296 sample surveyed with findings based on 50 responses. With respect to Investment performance, private equity additional funding allows for diversification of growth methods and has a strong impact on the ability of the company to innovate. Analysis of the

[63] "Economic Impact of Private Equity and Venture Capital in Australia 2006," PriceWaterhouseCoopers, 2007.

respondents shows that 55% expect the companies in which private equity invested to increase employment by more than 10% in the year ahead. A majority of respondents expect a stock market listing within three years. The study suggests that the reasons for seeking private equity investment include: financial flexibility, debt financing when it is not available, credibility boost, and overall business expertise. In the other benefits category: 27% included positive impact of private equity on higher sales, cost management, operational efficiency, and cash flow. Non-financial benefits of private equity investments reported include export sales, marketing, executive recruitment, other recruitment, and strategy -- 80% of respondents emphasized the value of strategy.

While 58% is the average share of ownership by private equity there is usually only a minority board representation. Private equity investments have a strong impact on human capital through apprenticeships, technical training, soft skills training and training that is offered for management. Accordingly, 14% of management accepted training as did 39% of all staff. This represents a total of 57% of staff trained which is somewhat higher than what is offered by other companies in Australia.

Asia General

Private equity companies have invaded Asia Pacific with almost $33 billion raised in 2006 in new capital up 39% from 2005.[64] This follows the rapid expansion where the amount invested was up 68% in 2005 to $30 billion. In China alone, private equity and venture capital investment rose to $8.8 billion in 2005. In a 2006 survey of private equity companies operating in Asia Pacific KPMG reported that “The findings of this report suggest that private equity if fulfilling an important development function in mentoring entrepreneurs and mid-and late-stage managements about operational best practices, transparency and corporate governance, and achieving regional and global competitiveness.”[65] In a Citibank presentation at the Federal Reserve Bank of Chicago conference on private equity, they confirmed that Asia has led the explosion of emerging market private equity fundraising. They also confirmed that there was a slight preference for China over India in investments but that there was a preference for regional funds over single country funds.

The base return from Asia on private equity investments is expected to be about 17% with a premium for emerging markets of 6-8% being required in addition to the base. A comparison of returns among regions shows that emerging markets is best by far, but that governance is the most serious constraint. Private equity has expanded globally with more European competition in emerging markets for North American private equity companies. There also has been an increase in regulatory changes and an improvement in legal frameworks in emerging

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[64] “Private Equity: Implications for Economic Growth in Asia Pacific,” KPMG, 2007.
[65] Ibid, p.5.

markets. Even so, private equity fund managers must be more actively engaged in emerging markets in order to hedge against risk.

In Asia, it is believed that the greatest potential for private equity exists in China, India, Taiwan, Australia, Vietnam, Singapore, Korea, Japan, and Malaysia.[66] Asia, in general, is less competitive than in the United States and Europe and valuations are also lower in Asia than elsewhere. One warning given is that private equity companies need to develop more realistic expectations regarding their exit timing and strategy. The IPO market is beginning to develop with increased activity but it is still not a readily available exit strategy for most private equity investments yet. Trade sales or secondary buyouts are possible alternatives.

Asia – China

Persistent strong economic growth in China has made it a very attractive growth market for private equity and venture capital investors.[67] Estimates of the pool of funds available to support private equity investment is currently at about $10 billion managed by more than 100 private equity companies. About 8% of the amount invested represents "direct" equity funds managed by local governments to achieve public sector objectives.[68] Unlike the in the United States, private equity funds in China focus more on late-stage venture capital investments selecting companies that have proven performance records.[69] Areas of interest are technology, health care, agriculture, pharmaceuticals and energy. Private equity investments in China have benefited from favorable tax treatment primarily in the areas of tax holidays for production firms and withholding tax exemption when the foreign equity interest exceeds 25%.[70] Given the family business nature of many Chinese companies, private equity investment has been more minority ownership resulting in a different relationship between management and shareholders compared to private equity in most other countries. Since it is difficult to sell companies in China valuations are lower, but at the same time smaller investment can go a long way because of low costs of the factors of production. The private equity model in China also uses little leverage or debt because only a limited number of banks are allowed to make loans to companies. As banking laws continue to modernize this is likely to change.

Venture capital share of private equity invested in China for the year 2007 is estimated to exceed $2.5 billion and the primary target of these investments was

[66] Ibid, p. 10.
[67] "Private Equity in China: Risk for Reward," China Business Review, 2004 and "How Private Equity Firms Can Play in China," The McKinsey Quarterly, March 31, 2005.
[68] AltAssets, "The Power of Funds," Almeida Capital, February 6, 2008.
[69] AltAssets, "Opportunities Arise as Private Equity in China Evolves," Almeida Capital, October 10, 2007.
[70] KPMG, Ibid, p.3 China.

service companies and represents a 5% increase from the year earlier level.[71] The primary target in the service companies' area was in the early stage business/consumer/retail industry which has accounted for about 70% of investments. The key driver in the sector is the rapid growth of the middle class which is consuming more services. Other areas being watched by investors include the health care industry and information services including software, communications, and networks.

In August 2007 the Chinese government passed a new competition law to become effective in one year. The law could impact private equity companies as it contains prohibitions and reporting requirements relating to mergers and acquisitions and other investment activity.[72] Also, investing in state owned enterprises have not yet been focused on by private equity because acquisition is difficult and expensive.

Asia – India

Investor appetite for India, and specifically infrastructure, with almost $20 billion invested in 2007 in 91 projects, has by some estimates overtaken China in terms of the volume of private equity investment.[73] Professor Amit Bubna working with Venture Intelligence conducted a survey of 75 private equity backed companies over the period 2000-2005 with 49 respondents.[74] He found that private equity backed companies grew significantly faster than non-private equity backed companies. Also, wages at private equity backed companies grew at a much higher rate compared to peer non-private equity backed companies. Ninty-six percent of the top executives at private equity companies believe that their companies would not have existed or would have developed slower without private equity investment. More than 60% of the top executives at private equity backed companies said that the number of their employees had increased after the private equity investment. Executives believed that private equity and venture capital investment when chosen and leveraged well can help Indian companies innovate, create new business, and accelerate growth in several ways that add overall value to the Indian economy.

Private equity investment has enabled Indian companies to achieve scale to compete globally over the past five years as private equity companies grew at an almost 23% annually10% for non-private backed companies. This pattern of superior performance with private equity investment was particularly evident in the technology and health/medical sectors. Private equity has alsoinvested in 10

[71] AltAssets, "China Quarterly Venture Capital Report," Almeida Capital, March 25, 2008 with information adapted from China Quarterly Venture Capital Report released by Ernst& Young and Dow Jones VentureOne, released on March 25, 2008.
[72] AltAssets, "China's New Anti-monopoly Law," Almeida Capital, December 19, 2007.
[73] "Emerging Markets Private Equity: Quarterly Review," EMPEA, Q1 2008, p. 1.
[74] Venture Intelligence," Private Equity Impact – Impact of Private Equity and Venture Capital on the Indian Economy," 2005.

of the top 15 business process outsourcing companies and those companies have experienced strong employment expansion.

In India, private equity investments support capital expenditure for 50% of the companies, marketing 21% and R&D 29% - a total of 79% of private backed companies financed capital and R&D. Consequently, patent growth during the 2000-2005 was 28% at private equity backed companies but at non-private equity backed companies was a higher 30%. Even so private equity backed companies saw a 32% average annual increase in wages vs. 6% at non-private equity companies. In private equity backed technology companies 58% of the investment was to support R&D. In terms of company size 44% was invested in mid-cap, 36% in small cap and 20% in large cap. Most of the private equity investment has been in technology 29%, healthcare 21%, financial services 20%, manufacturing 15% and textiles 9%.

The main contribution of private equity investment was in strategic direction according to 65% of the respondents, 52% said it was financial advice, 22% identified recruitment, and 9% said marketing. In terms of contact with private equity investors, 65% said it was several times a week to once a month. Of the companies in which private equity has invested, 60% were previously self-funded by family and friends. Private equity investments in India were $20 million in 1996 and have since jumped to $2.2 billion. In terms of deal size there have been 72 transactions under $5 million, 55 in the $5 to $55 million range, 102 in the $10-$25 million category, 41 in the $25 to $50 million group, 21 at the $50 to $100 level, and 3 in the $100 to $200 million range. Broken down by stage 20% were early, 15% growth, 36% late stage, 22% pipe, and 4% buyout. By region, investments in companies located in the west and south dominate at 38% and 36% of total investments. By city, investments were concentrated in Mumbai with 68 deals at $1.8 billion, Delhi had 51 deals valued at $1.7 billion, Bangalore had 40 transactions totaling $395 million, Chennai had 21 deals valued at $344 million, and Hyderabad had 17 investments valued at $492 million.

The table below lists the major reports and studies by geographic areas.

Geographic area	**Date of release**	**Author & title**	**Organization/ Company**
Global	April 2006	“Unlocking Global Value – Future Trends in Private Equity Investment Worldwide”	Apax Partners
Global	July 2006	“The State of the Private Equity Industry”	Federal Reserve Bank of Chicago
Global	2007	“Global Trends in Venture Capital: 2006 Survey”	Deloitte
Global	2007	“Private Equity Going Public: Global Private Equity Report 2006”	PriceWater-houseCoopers
Global	2007	“The 2008 Preqin Global private Equity Review”	Preqin

Global	May 2007	"Private Equity International's Ranking of the World's Largest Private Equity Firms"	Private Equity International
Global	Winter 2007-08	"Global Private Equity Barometer"	Coller Capital
Global	2007	"Heads Up: What Next for Private Equity?"	KPMG
Global	2008	"Semiannual Global Private Equity Report"	Coller Capital
Global	2008	"Globalization of Alternative Investments: The Global Economic Impact of Private Equity Report 2008"	Anuradha Gurung and Josh Learner World Economic Forum
United States	2006	"US Private Equity Perspective"	Federal Reserve Bank of Chicago
United States	2007	"Venture Impact: The Economic Importance of Venture Capital Backed Companies to the US Economy" 4th edition	Global Insight National Venture Capital Association
United States	February 15, 2008	"Private Equity and Public Policy – A Look Ahead"	Columbia University
United Kingdom	November 25, 2003	Richard Green, "The Economic Impact of Private Equity and Venture Capital on the UK"	BVCA
United Kingdom	November 2006	Elissa Brodey, "The Economic Impact of Private Equity in the UK 2006"	BVCA
Germany	November 2004	"Economic Impact of Private Equity in Germany"	FAZ Institute
Germany	June 2005	"German Private Equity Activity: The Economic Impact of Private Equity"	Ernst & Young
Australia	2007	"Economic Impact of Private Equity and Venture Capital in Australia 2006"	PriceWater-houseCoopers
Asia Pacific	2007	"Private Equity: Implications for Economic Growth in Asia Pacific"	KPMG
Asia	2006	"Asia Private Equity Landscape"	Citigroup
India	2007	"Private Equity Impact: Impact of private Equity and Venture Capital on the Indian Economy"	Venture Intelligence

The table below shows the number of private equity and venture capital companies by geographic area and the funds raised by each.

March 2008	Number	Of Active	Funds		Funds Raised March 08
	US	Europe	ROW	Total	$ Billion
Venture	222	87	109	418	$73
Buyout	172	64	44	280	$304
Fund of Funds	104	73	13	190	$36
Real Estate	161	82	43	286	$79
Other	188	63	68	170	$94
Total	847	369	277	1,344	$586

Source: Preqin, Private Equity Spotlight and the 2008 Preqin Private Equity Review, March 2008.