

# We'll make it better

The name says a lot: leveraged buyouts. As the private equity industry takes flak over debt levels, research from Capital Dynamics shows that operational improvements are the real driver of value in private equity investment. **Grant Murgatroyd** reports

Private equity shares many characteristics with other investment classes but, in one very important respect, it is different. General partners (GPs) do not need to turn to the standard disclaimers of fund managers in listed equities because in private equity, past performance is a guide to future performance.

In one of the most highly regarded pieces of academic research into the industry, *Private Equity Performance: Returns, Persistence, & Capital Flows*, Steven Kaplan and Antoinette Schoar found that realised returns persisted strongly across different funds raised by a partnership. General partners whose funds outperform the industry in one fund are likely to outperform the industry in the next, and vice versa. Persistence was found not only between two consecutive funds, but also between the current fund and the second previous fund.

These findings are important for the private equity industry and for the strategies that will be followed in the years to come. But if the best funds are able to stay at the top of the pile, how do they do it? Switzerland-headquartered fund-of-funds manager Capital Dynamics teamed up with the Center for Entrepreneurial and Financial Studies at the Technical University Munich (CEFS) to ask three questions:

- To what extent is value creation driven by operational improvement and what is the dependency on leverage?
- How did value creation happen in the past?
- What is private equity value creation likely to look like in the future?

### The inside track

The research analysed 241 transactions completed between 1986 and 2006, comparing enterprise value, equity, sales, Ebitda and net debt at entry and exit, as well as interim cash flows at the GP level.

The anonymous sample was based on data collected by Capital Dynamics when conducting due diligence on investments and funds as a limited partner. Transaction sizes ranged from €1m to €4.3bn.

The mean internal rate of return (IRR) was 48.3% and the median 30.3%. The average gross increase in value was 2.7 times investment cost, or a median 2.0 times. Limited partner returns were not calculated, but research in 2008 by Professors Andrew Metrick and Ayako Yasuda of Wharton Business School estimated that general partner fees of all types amounted to \$10.35 for every \$100m under management. Gearing was an average 1.7 times on entry, falling to 0.8 times on exit, which was on average 3.5 years later.

The traditional approach to assessing value creation was modified to measure: total value created; the leverage effect; value creation, subdivided into Ebitda growth, the free cash flow effect, the multiple effect and a 'combination effect' of Ebitda growth and multiple. The operational improvement component made the distinction between sales growth and improved margins.

### Added value

Of the average 2.7 times increase in value over the cost of the equity invested by the GP, 0.89 times was accounted for by the use of leverage, 0.88% from Ebitda growth, 0.42 times by free cash flow improvement and 0.47% by multiple growth. Of the growth in Ebitda, 80% was attributed to sales growth and just 20% to margin improvement. The findings show that, even without the use of leverage, value creation was 1.84 times over the average hold period of 3.5 years.

There is some support for the argument that private equity firms took advantage of liquid and cheap debt markets to generate value. Between 2001 and 2006, the share of value creation through the use of leverage

was 8% higher than between 1989 and 2000. The leverage component was of increasing importance during the latter period, which saw Ebitda growth decrease by 16%. During both periods, Ebitda growth was generated by sales growth and not margin improvements, so it can be said that private equity portfolio companies used the friendly capital markets environment since 2001 to drive sales growth, among other things.

The analysis of transactions from the past two recessions (deals in 1990-93 and 2000-03) yields even more distinct results. Both leverage and sales growth played an important role in those transactions, with sales growth 34% higher than in non-recession years, though overall Ebitda growth was a much more significant driver of value in non-recessionary periods, where margin improvement accounted for 37% of Ebitda growth, compared with just 17% during recessions (see graphs).

A comparative analysis of value drivers was conducted for firms of different sizes, which confirmed that leverage is a more important driver of value in larger transactions. The increase in enterprise value shifted to a higher leverage effect (12% of gain) for firms with a transaction size of more than €100m, while 27% of Ebitda growth was driven by margin improvements, considerably higher than for smaller transaction sizes. The authors concluded that this refutes the perception that private equity creates value for smaller firms by making them more efficient.

### In the public eye

Lastly, the report compares the performance of private equity portfolio companies against publicly traded companies. Each of the 241 sampled companies was matched to a comparable publicly traded company (in terms of geography, industry, sales and Ebitda) with the unlevered, equity-only IRR calculated for both data sets – the difference being the operational alpha in private equity. Private equity was found to have outperformed by 6% on an unlevered basis, while the higher use of leverage increased the absolute return of private equity by 21% compared with the public market.

The research is important because it helps paint a clearer picture of value creation mechanisms in private equity. Historically, benchmarking could only be done on IRRs and multiples, where past performance is no guide to future performance. By lifting the lid on how and where value is created, potential investors can form an opinion of

how successful that manager will be in the future. And, perhaps more importantly, it supports the view that private equity investments generate value throughout the economic cycle by improving the businesses in which it invests.

Private equity has always been hampered, at least in public perception terms, by its private nature. Commentators have long questioned the performance, but almost all data sets are incomplete. In its exhaustive *World Private Equity Report 2009*, the World Economic Forum noted that lack of access to data prevented it from drawing accurate conclusions. In fact, there is only one group that really knows how it performs and what it does with portfolio companies – investors in funds or limited partners (LPs).

So it was telling in March when the Institutional Limited Partners Association, representing 220 of the biggest pension funds, endowments and sovereign wealth funds, warned the European Union over proposals to prevent European institutions investing in private equity funds outside

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the 27 EU member states and to limit the amount of leverage that can be put into deals. It said: 'Not only will EU investors have reduced access to non-EU private equity managers, there exists a real concern that the proposal will effectively close Europe off from the capital solutions... that comprise the global private equity industry.' ■

Grant Murgatroyd is editor of *Corporate Financier*.

## Private Equity Demystified

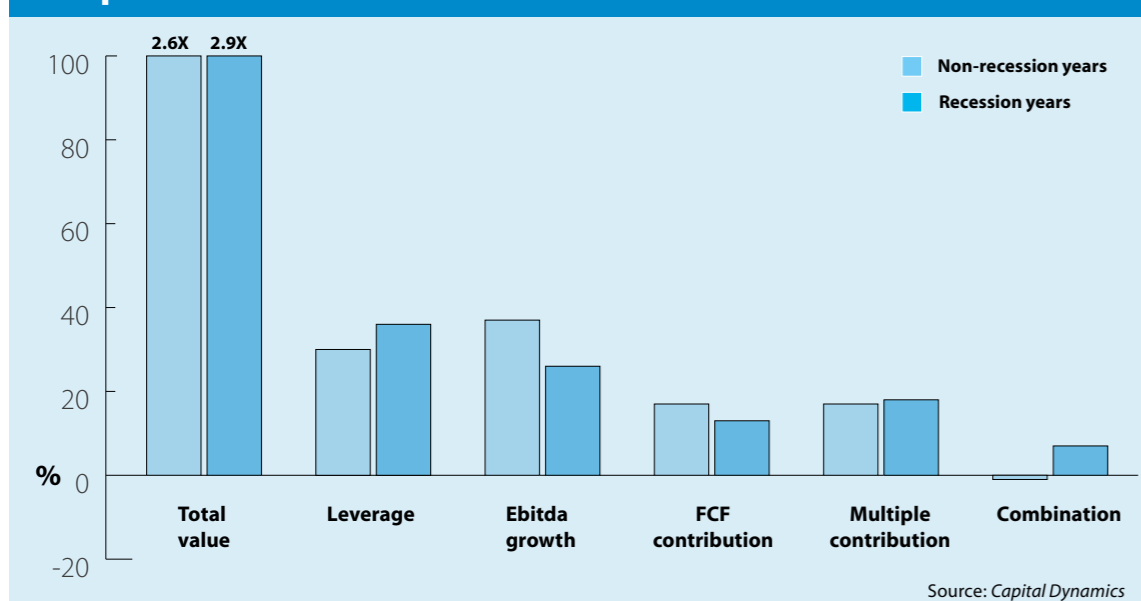
The Corporate Finance Faculty has published the second edition of *Private Equity Demystified*, written by Professor Mike Wright of the Centre for Management Buy-out Research at the University of Nottingham and John Gilligan, a partner at PKF.

First published in 2007 as the private equity industry found itself facing increasing public and regulatory scrutiny, *Private Equity Demystified* aimed to do exactly what its title suggests – objectively set out how the industry functions, from fund-raising to investment, portfolio company management, exit and incentivisation. The publication, part of the faculty's thought leadership programme 'Financing Change', was well received by the corporate finance community and the government, including at the Treasury.

Now, two years into the credit crunch and recession, *Private Equity Demystified* has been updated and republished. The second edition builds on the work of the first edition to reflect this recent turmoil and examines the way in which the banking market has changed its approach to private equity investments. It also includes more discussion of both mid-market buyouts and the dynamics of the restructuring industry.

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## Comparison of value drivers



## Ebitda improvement drivers: through boom and bust

