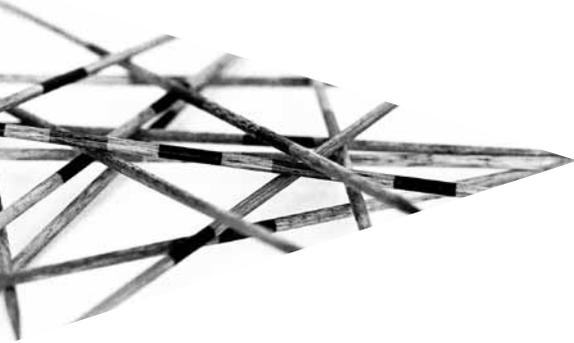


# PE Insights

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## Private equity steps up and searches for opportunities amid volatile markets and an evolving legislative landscape

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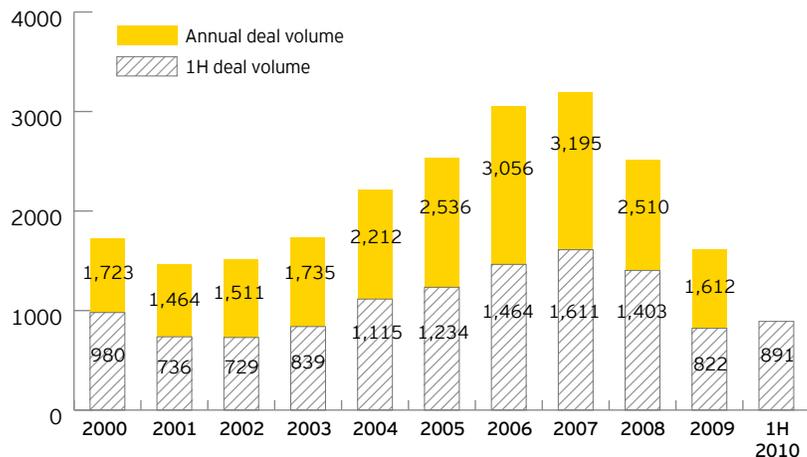
The first half of 2010 was characterized by volatile global equities markets, mixed messages about the state of the global economy and sweeping regulatory changes that are likely to have a profound impact on the world's financial system. Against this backdrop, private equity (PE) firms have stepped up their activity, deploying capital at an increasing rate, successfully exiting investments and strengthening the positions of their portfolio companies. Leverage continues to return as banks become more comfortable with the financing of "quality" deals, and the high-yield markets appear on track for yet another record year. Deal values are increasing, and PE firms are once again teaming to execute on larger transactions.

We look for this positive momentum to continue as we head into the second half of the year. While sovereign debt issues in Europe and broader concerns about the global economic recovery represent substantial headwinds, the significant amount of dry powder – in excess of US\$500 billion, according to Preqin – and the availability of financing provide the platform for a significant increase in buyout activity, alongside an already robust pipeline of exits.

### Deal values are increasing, with larger deals slowly returning

PE market fundamentals have improved in 2010 and the industry is more buoyant. Globally, PE firms announced 891 acquisitions valued at US\$84.1 billion in the six months to June 2010, up from 822 transactions valued at US\$32.6 billion for the same period last year, according to Dealogic. There were 22 announced PE deals over US\$1 billion in the first six months of 2010, compared to just seven for the same period last year, signaling the return of larger deals, although it is still less than the 2006-07 peak. PE firms continue to put more equity into deals than historic levels. According to Standard & Poor's, US PE firms contribute, on average, 46% of equity. The percentage is higher in Europe, where the average equity contribution is 50%.

## Announced global PE deal volume: 2000-1H 2010



Source: Dealogic

This chart captures transactions where the buyer is a PE firm acquiring global targets, excluding repurchases and add-on acquisitions.

As they did in 2009, minority-stake deals continue to play an important role. Of the 891 announced transactions, almost half, or 442, were minority stakes. Prior to 2008, minority deals made up 30% to 36% of PE transactions.

## Exits pick up steam, albeit IPOs make a cautious return

PE exits continue their upward trend as firms capitalize on historically high levels of cash among corporate acquirers, further interest in secondary buyouts among PE firms and increasing activity in the capital markets. In the first half of 2010, PE firms exited 286 investments valued at US\$77.1 billion through trade sales, a value three times higher than in the previous period. Secondary exits also returned as a significant driver of activity – making up 31% of the first half’s exits through trade sales, the largest percentage since the second half of 2008.

PE sponsors took 62 companies public in the first half of 2010, raising US\$15.5 billion in gross proceeds. This is a significant increase given that just five PE-backed companies raised less than US\$600 million in the first two quarters of 2009. Activity in Europe, which lagged behind the US and Asia-Pacific in 2009, led in proceeds raised – approximately US\$7 billion in the first half of 2010 from 11 filings. Exchanges in North and South America saw 32 offerings by PE-backed firms raise approximately US\$6 billion, and Asia-Pacific saw 19 initial public offerings (IPOs) raise US\$2.6 billion. Largely because of the extreme volatility in global equity markets, pricing was challenging as investors closely scrutinized each deal, causing several planned offerings to be withdrawn or postponed. However, the aftermarket performance for IPO companies was generally positive. According to Ipreo, 2010 IPOs of PE-backed companies outperformed the S&P 500 index by approximately 7% through the end of the second quarter. As we head into the second half of 2010, the pipeline of PE-backed companies seeking an IPO continues to build – 52 PE-backed companies filed in the first half of 2010 are now waiting to go public. Among them is HCA, which could potentially result in US\$4.6 billion in gross proceeds, making it the largest PE-backed IPO in history. It is important to note that the proceeds raised from the majority of these offerings were used to reduce debt levels.

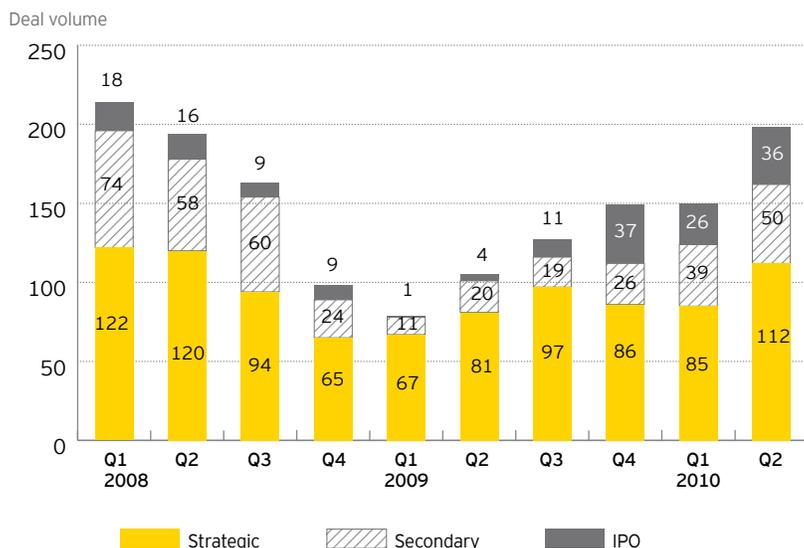
## Announced global PE deal value: 2000-1H 2010



Source: Dealogic

This chart captures transactions where the buyer is a PE firm acquiring global targets, excluding repurchases and add-on transactions.

## Quarterly global PE exits: 2008-Q2 2010



Source: Dealogic

This chart captures transactions where the seller is a PE firm.

## Legislative changes – a closer reality

Legislative changes on both sides of the Atlantic are becoming a reality.

- ▶ **Alternative Investment Fund Managers (AIFM) Directive:** In May, the Council of the European Union and the Economic and Monetary Affairs Committee of the European Parliament agreed on their position on the directive. The directive may not only limit a PE firm outside the European Union (EU) from marketing its fund to EU investors, it may also impact a PE firm's ability to acquire significant or controlling influence over non-listed companies in the EU. In addition, there are concerns about the potential additional costs of reporting requirements. The directive is scheduled to be voted upon by the European Parliament this September. Should agreement be reached across the European Commission, European Parliament and Council of the EU, the final measure could be announced later this year.
- ▶ **Carried interest:** The carried interest debate gained traction in the US when the House of Representatives passed the carried interest tax provision as part of the American Jobs and Closing Tax Loopholes Act of 2010 in late May. This measure would initially tax 50% of carried interest as ordinary

income in 2011 and 2012, increasing to 75% in 2013 and beyond. While the Senate had failed three times to pass the "tax extenders" legislation before adjourning for the 4th of July holiday, the legislation did include the carried interest tax hike. In the last Senate proposal that was defeated, 75% of carried interest would be taxed as ordinary income in 2011. For assets held for more than five years, only 50% of the carried interest from the sale would be taxed as ordinary income. The Senate is expected to pick the "tax extenders" legislation back up again this month. Similar carried interest proposals are also being seriously considered at the state level and, in particular, by New York state.

Carried interest is not only a US issue. It is also being debated in the UK, where capital gains tax has increased from 18% to 28% for higher-income earners. This applies to capital gains arising on or after 23 June 2010 and affects the tax paid by PE fund managers on carried interest on or after this date. Although carried interest taxation may not affect the core of what PE does best, it may adversely impact talent retention in the future.

- ▶ **Financial reform:** In the US, the House and Senate approved a sweeping rewrite of the nation's financial regulations, which was signed into law on 21 July. The bill contains several provisions that impact PE, including new registration requirements for PE funds. Most advisors to hedge funds and PE funds with more than US\$100 million in assets under management will be required to register with the Securities and Exchange Commission (SEC) and be subject to SEC regulatory oversight (venture capital funds will be exempt, with a definition of such funds to be provided by the SEC within a year of enactment). However, advisors with less than US\$150 million in assets under management in the US whose only clients are private funds will remain exempt from registration, subject to record-keeping and reporting requirements to be established by the SEC. Organizations that are required to register will need to establish a formal compliance policy and a framework that encompasses (1) the identification and treatment of conflicts, (2) the hiring of a chief compliance officer, and (3) testing, reporting and inspections by the SEC. Advisors to smaller funds may also be subject to record-keeping and reporting requirements.

Another provision affecting PE is the much-discussed Volcker Rule. Limitations are now imposed on proprietary trading and investments in hedge funds and PE funds by banking entities. Going forward investment levels will be limited to de minimis levels, permitting investments in hedge funds and PE funds of no more than 3% of their Tier 1 capital. An additional provision limits ownership to 3% of the equity of any single PE fund. Certain derivatives activities, including equity derivatives, are required to be “pushed out” of insured banks into nonbank affiliates. The bill also restricts employee investments in bank-managed PE funds to those employees who are actively involved in the managing of the fund and restricts banks that sponsor PE and hedge funds from entering into certain types of transactions with their own in-house funds.

## Fund-raising remains a challenge, yet plenty of dry powder

With LPs in the driver’s seat, fund terms appear to be moving in favor of LPs. In a recent *Preqin Fund Terms Advisor* survey of 50 institutional investors, 66% of LPs had observed changes in the structure and level of management fees. This frequently involved realignment of transaction fees and, in some cases, an overall reduction in management fees. Additionally, the survey revealed that management fees of new buyout funds (2010 vintages or those yet to hold an initial close) seeking US\$1 billion or more were down 32 basis points from 2008, to 1.59%.

In the first half of 2010, 145 PE funds raised US\$92.4 billion, down from

US\$159.1 billion from 231 funds for the same period last year. The numbers masked several growing concerns about future fund-raising efforts. According to Preqin, funds took nearly 20 months to close in 2010, nearly double the time it took in 2004. What’s more, funds over US\$1 billion took longer to market and some closed below target. According to Preqin, funds with targets between US\$500 million and US\$1 billion either met their targets or were oversubscribed.

The amount of dry powder is both a concern and an opportunity. Between 2004 and 2009, buyout funds raised over US\$1 trillion globally, according to Preqin. Of this amount, over half (US\$519 billion) has yet to be deployed, leading some general partners to negotiate with their LPs in an attempt to extend the lives of their funds.

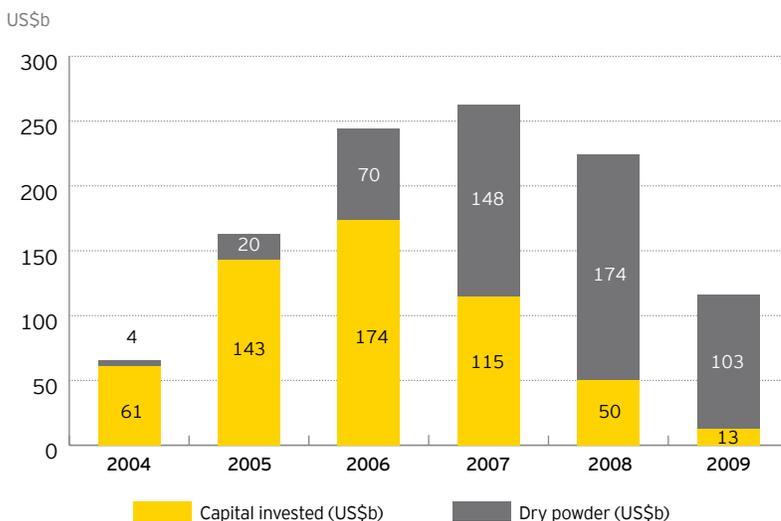
Nonetheless, funds will continue to be raised, albeit smaller in size with longer raise periods, as LPs continue to look to the asset class for outsized returns. A recent Collier Capital study that surveyed 110 global LPs indicated that 64% of LPs expected to speed up new commitments to PE funds in the remainder of 2010 and 2011.

## Outlook and opportunities

**Increased market activity in a volatile environment.** The euro zone financial crisis has put a dent in the market recovery and investor confidence. The strength of the market will continue to be questioned in the short to medium term. That said, PE firms are active in the US, Asia, the UK, the Nordics and parts of Southern Europe. With increased competition for assets and a fluid market, PE firms are selective in the opportunities they pursue, while recognizing speed and creative financing are necessary to complete deals. In terms of exits, timing is critical as market conditions can change quickly. In order to achieve the best price, PE firms need to be in a state of constant readiness across various exit routes in order to take advantage of the market alternatives when the conditions are right.

**Refinancing may lead to opportunities.** According to Standard & Poor’s, in 2011, US\$300 billion of debt is due from US companies. Of this amount, 41% is considered speculative-grade debt, or junk. This will increase to US\$550 billion in 2014, with 72% expected to be categorized as junk. These significant levels of debt maturities, coupled with prevailing liquidity issues, will present distressed-debt

### Buyout funds – capital invested and dry powder remaining by vintage year as of 31 December 2009



Source: Preqin

opportunities. Also, the amount of debt needed to be refinanced may exceed the amount of capital available in the market and, therefore, companies that are able to preserve, optimize, raise and invest capital will be the likely winners in this environment. Interestingly, we are starting to see more investment activity from distressed-debt funds that were relatively quiet in 2009. We expect this trend to continue.

**Emerging markets remain attractive.** Emerging markets such as Brazil, China and India continue to garner PE interest. Although PE activity in Brazil hasn't been robust in the past, it is becoming an attractive investment destination, with a number of PE firms opening or having plans to establish offices there. Additionally, 15 funds focusing on Brazil or Latin America are on the road fund-raising as of May 2010, according to Preqin. With Brazil hosting the 2014 World Cup and 2016 Olympics, investments are expected to pour in to develop the infrastructure and technology needed in advance of these two world events. China and India present infrastructure opportunities as these two growing economies need to develop their infrastructures to support growth. Interest in Asia will only grow, with firms realizing significant growth from their Asian investments. For example, Singapore's Temasek has recently reported a record growth of 42% in the value of its investments, with Asia, excluding Japan, accounting for 46% of its current portfolio. Obviously, Temasek benefited from its Asian investments, and it plans to increase its exposure to Asia over the next decade.

As we move into the second half of 2010, PE behavior has shifted from a defensive position to aggressively seeking new opportunities. PE firms that worked diligently on their portfolios through the trough of the economic cycle to position themselves for the eventual upswing are now beginning to see those efforts pay off. Values of PE portfolios are rising, exits are up markedly and distributions are beginning to flow back to LPs. Additionally, PE firms are deploying capital raised in a more forgiving environment to make acquisitions at multiples that are significantly lower than prior years. Deals are getting larger as firms are encouraged by the improvement in the economy, the quality of assets for sale and the increasingly accommodative lending markets.

While substantial challenges remain – the risk of a double dip recession, the impact of the financial reform and stubborn fund-raising markets, – opportunities are at last beginning to outweigh the risks. Recessionary dislocation remains throughout developed markets and emerging markets represent an underpenetrated opportunity. We expect PE firms to be busy over the next several years as they work to actively capitalize on this environment.

**PE Insights** provides strategic and business viewpoints on market issues facing private equity firms and their portfolio companies. For more information on the topic discussed in this edition, contact **John Harley** at +44 20 7951 5115, **Jeff Bunder** at +1 212 773 2889, **Bob Partridge** at +852 2846 9973 or **Bryan Zekulich** at +61 2 9248 5833 or send email to [ey.privateequity@ey.com](mailto:ey.privateequity@ey.com).

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