Adrian Blundell-Wignall

Deputy Director DAF/OECD

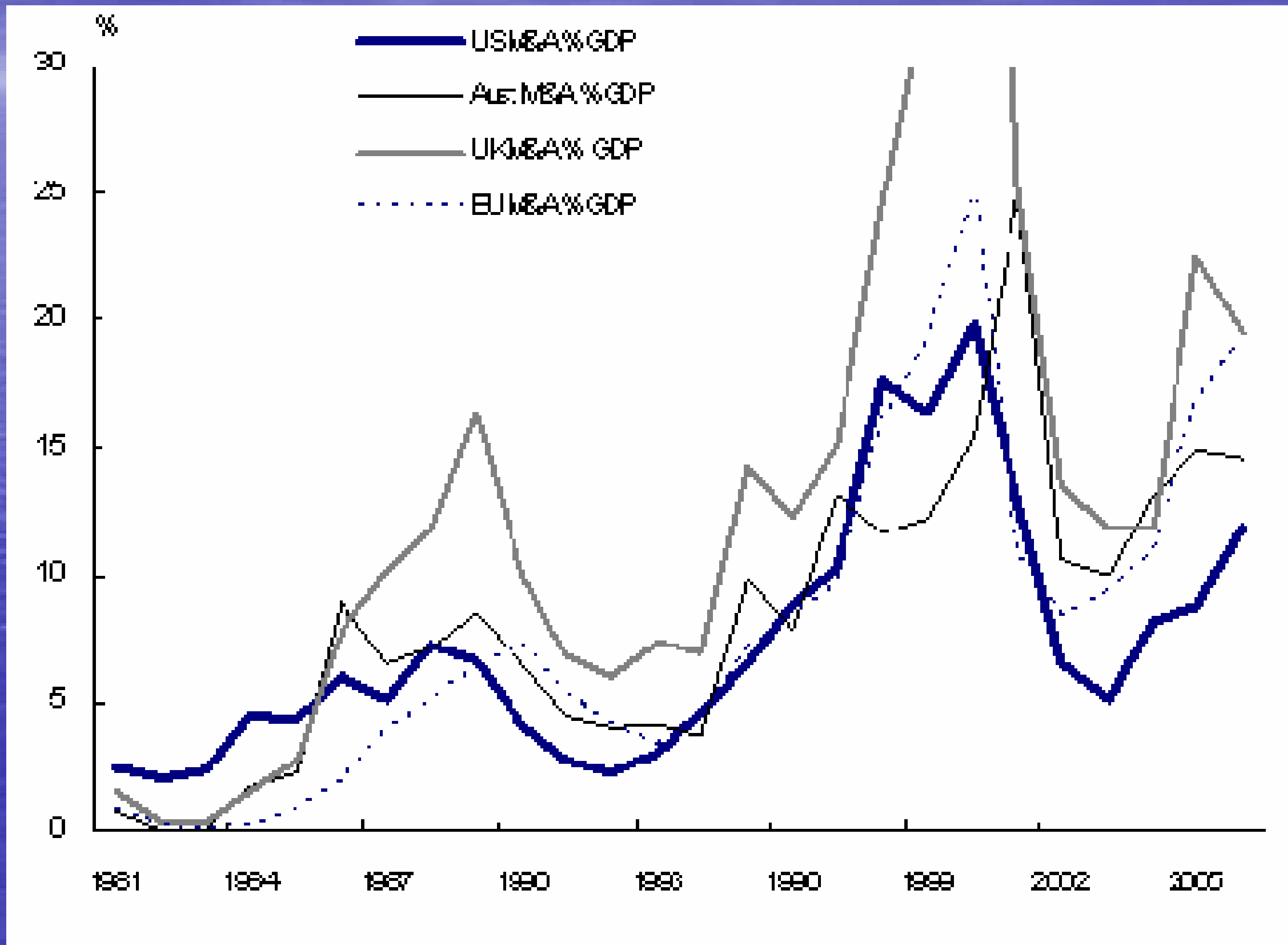
Private Equity Trends and Issues

(A Private View)

TUAC Conference

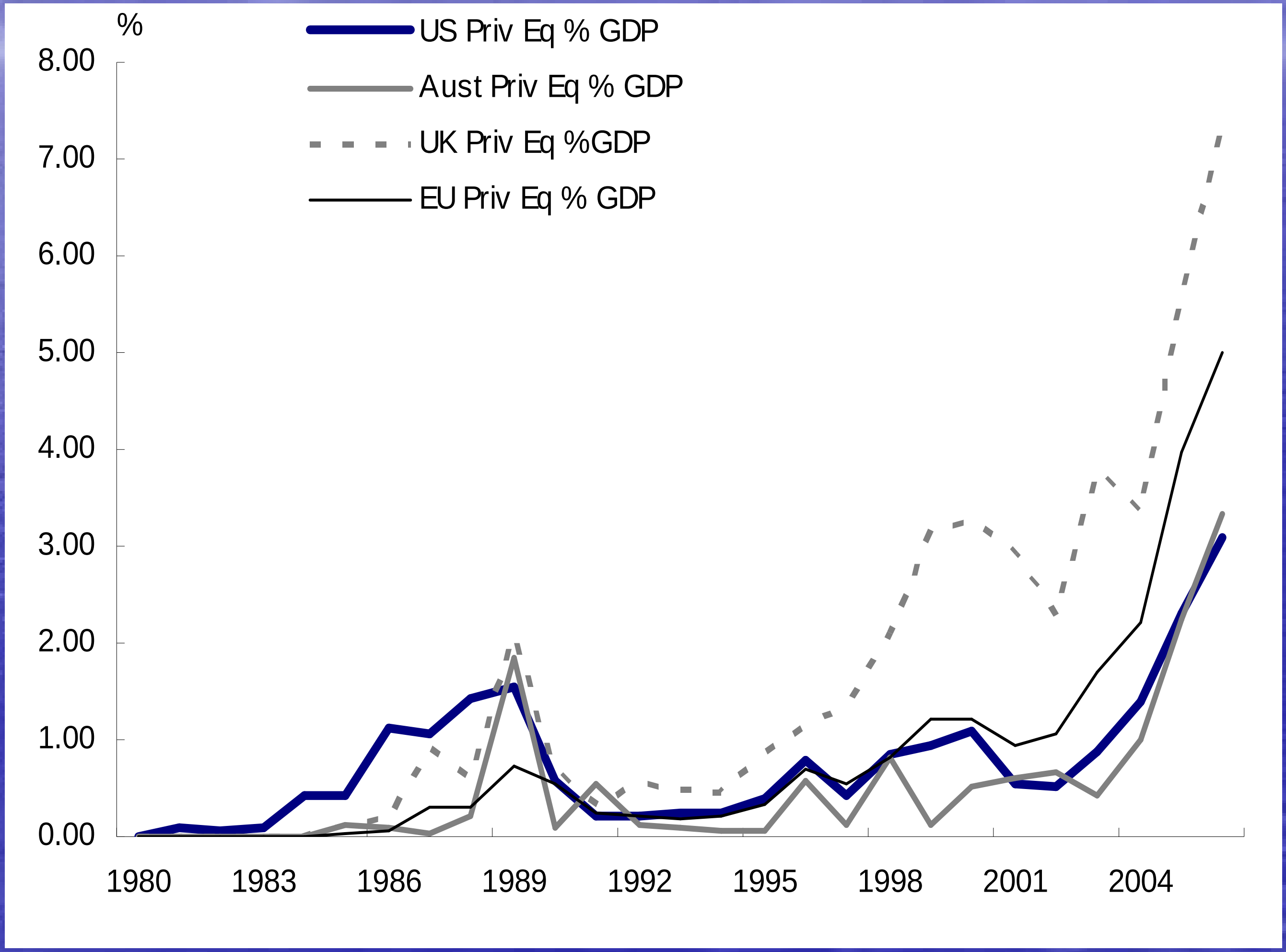
M&A All Completed Deals %GDP

- Total M&A huge, but less than the 90s
- Scrip Deals dominated the 1990s in the tech sector



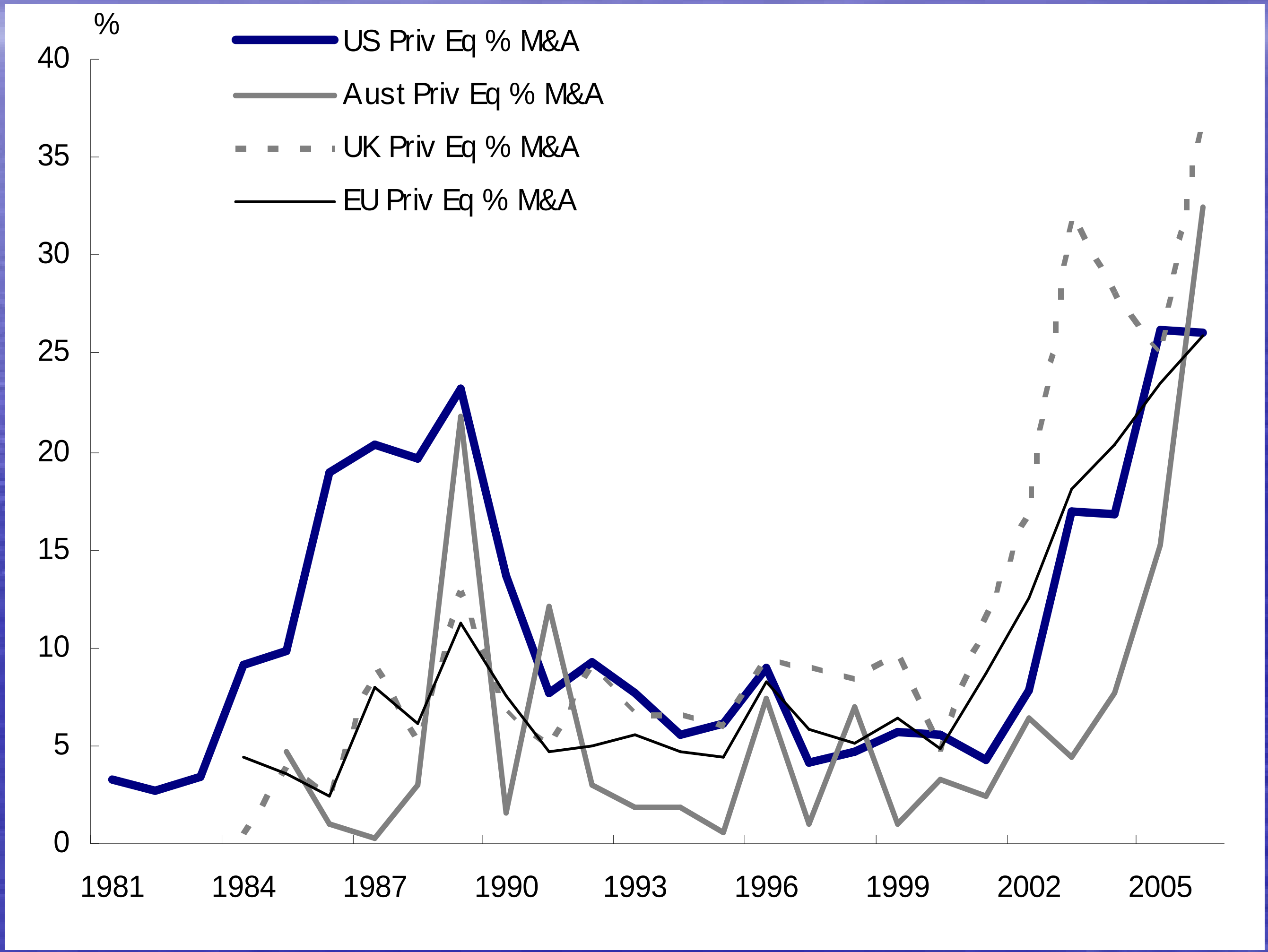
LBO All Completed Deals %GDP

- Deals are much stronger than the 1980's LBO boom.
- UK & Europe lead the US and Australia



LBO Deals % of M&A

- Private equity is about 30% of M&A. a bit more in the UK
- Deals are getting larger (2006 16% deals and 26% of volume of M&A)

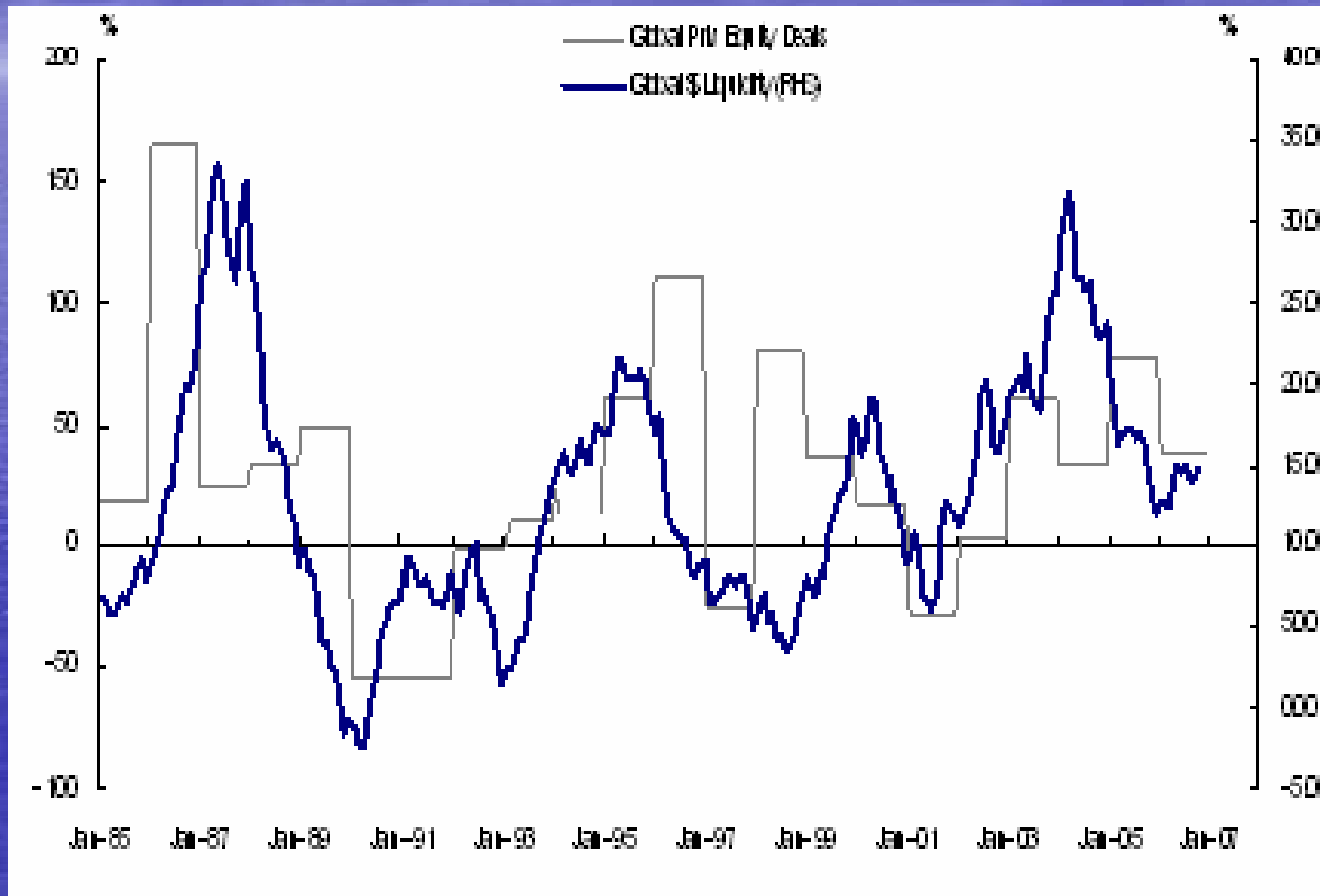


Why Now?

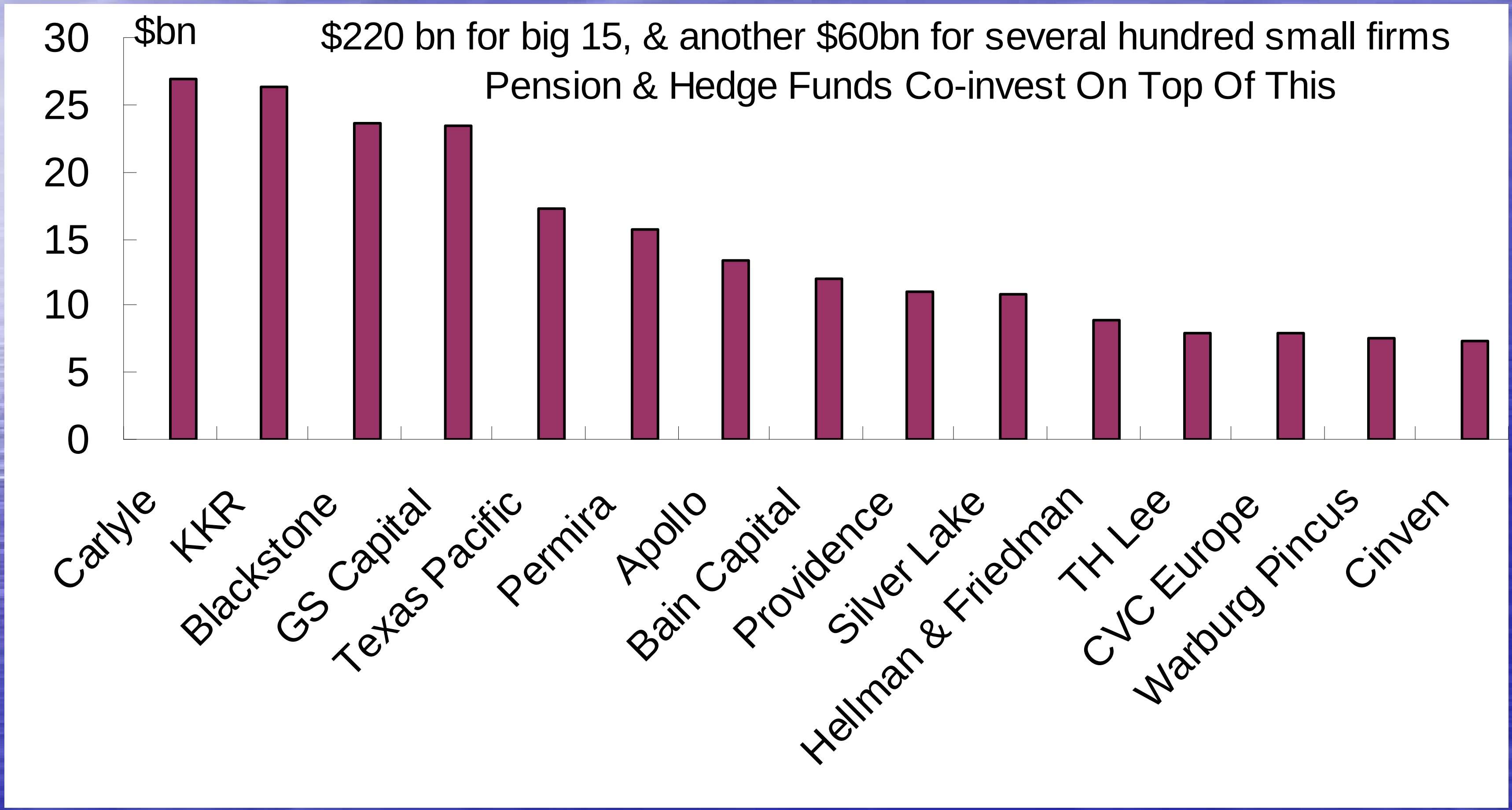
- Strong corporate balance sheets (unlike households)
- Irresistible low global interest rates and strong liquidity flows—few economic fears to date.
- Equity financing was expensive in 2003/2004.
- Strong corporate cash flows.
- Bond buying/search for yield (pension funds & hedge funds).
- Asset allocation into alternative investments.
- Increased corporate governance pressures.
- Short-termism (buybacks/low capex by companies + performance measurement of fund managers).

LBOs Must Be Accommodated

- Deals have always been tied to the global liquidity cycle.
- The US has tightened so who is accommodating now?



How Much Capital & Who?



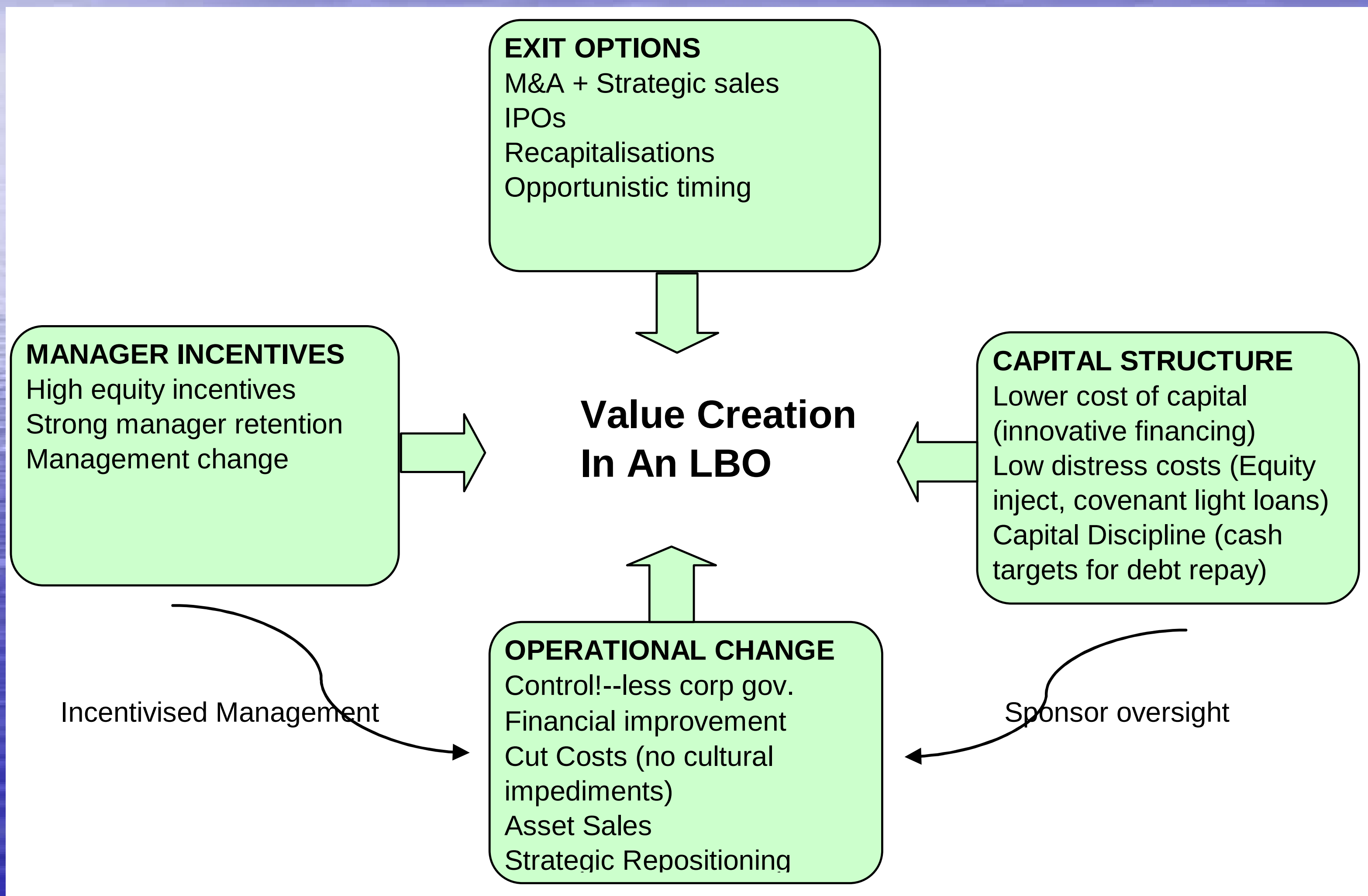
Which Industries Do They Attack?

- In the US/UK/Aust they like Consumer, healthcare, some tech, & some industrials, some property and infrastructure—stable cash flows are attractive. Financials are less favoured in the US.
- In Japan & Taiwan they like Financials.
- In Asia they like tech.
- But in a mania anyone is up for grabs (airlines for goodness sake!).

What Companies Are Sort For LBO?

- Under levered: LBO's involve borrowing a lot, so highly levered Companies not attractive.
- High Cost Structure: choose companies with margins below peers (too many employees, inefficient back office, bloated overheads, poor operating leverage).
- Valuation: low valuation vs publicly traded peers (poor growth & margins).
- High Free cash Flow: as interest payments post deal will be much higher.

LBO Value Creation Forces



Capital Structure

- High reliance on debt e.g. 5 to 8 x EBIT.
- Forces targets for debt repayment and generating cash flow quickly.
- Use innovative financing, capital discipline that can reduce the cost of capital.
- Liquidity management is enhanced by the use of low covenant loans, and an ability to negotiate with lenders in a non-mark-to-market atmosphere.
- New capital injections can be used more easily.
- Potential problems can relate to: Interest rates rise and/or spreads widen sharply; global liquidity tightens. Credit crunch conditions emerge making negotiations with lenders difficult.
- Triggers: (Major default by LBO company; inflation/monetary policy; exchange rate crises/carry trade reversal; regulatory changes on hedge funds and private equity)

Operational Change

- Full control, no public reporting.
- Sale of non core assets.
- Stringent cost reduction under conditions of full control—debt requires brutality here.
- Problems can arise when parameters of the deal change—energy and materials prices rise; competitive bidding pressure in labour markets; business cycle slowdown.

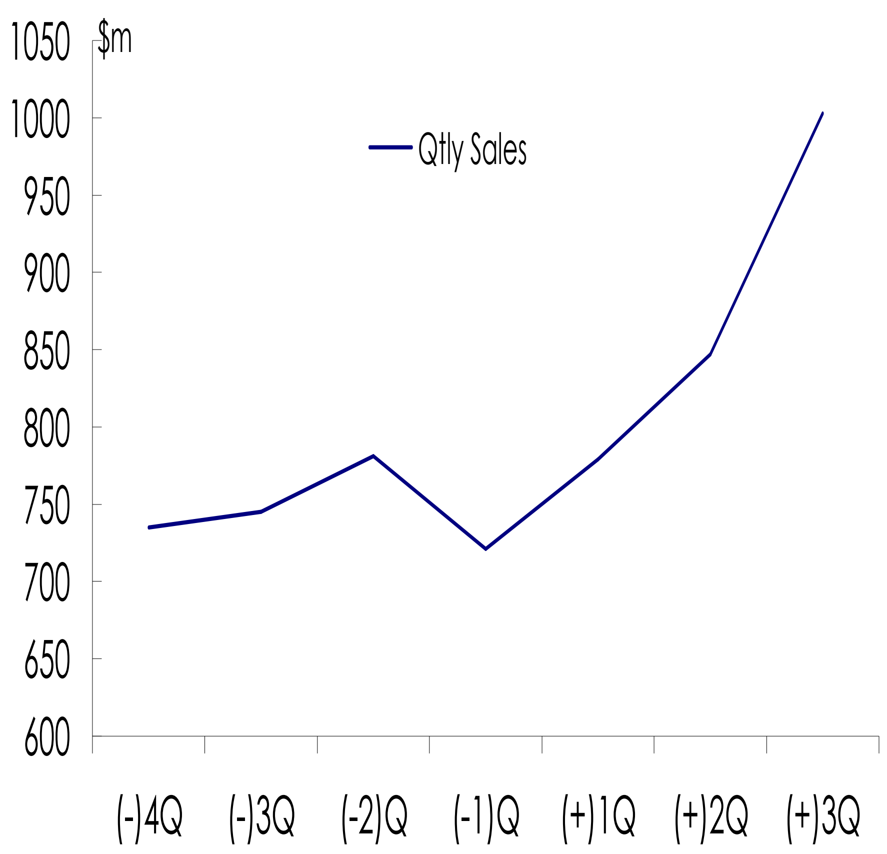
Incentives

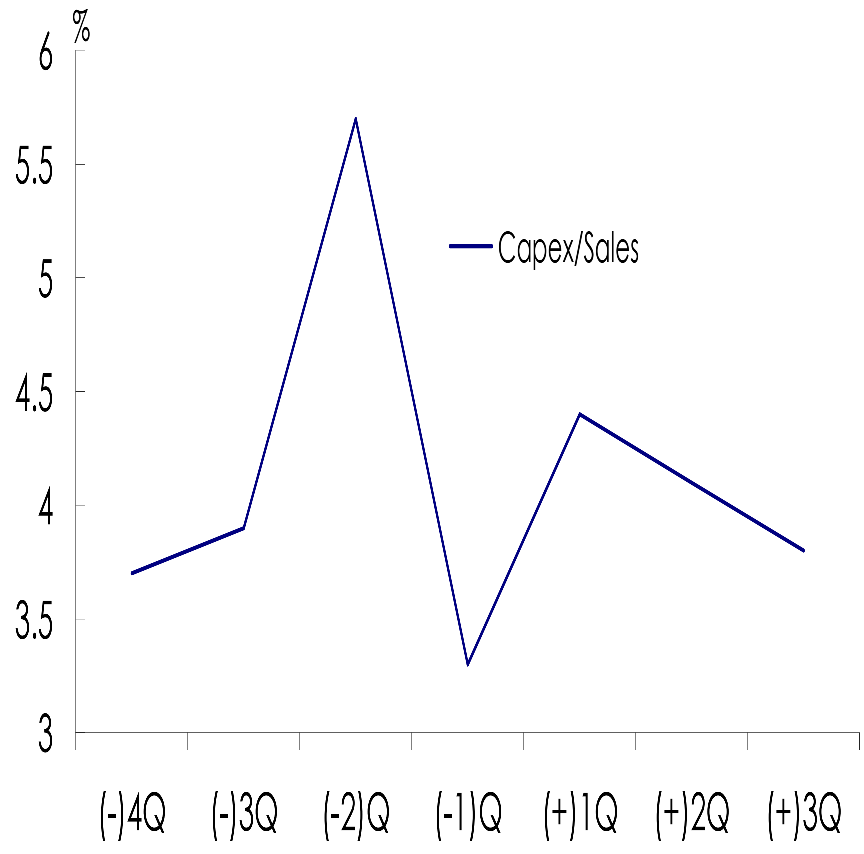
- Equity of up to 10% often ‘available’ for incentives. 0.4-0.5% of deal size is ‘normal’.
- Management can’t exit before investors.
- Forfeit new equity on termination.
- Existing options vest at the deal.
- Risks relate to ultimate success financially and culturally within the firm (e.g. only given to a few and others may leave).

Exit Options

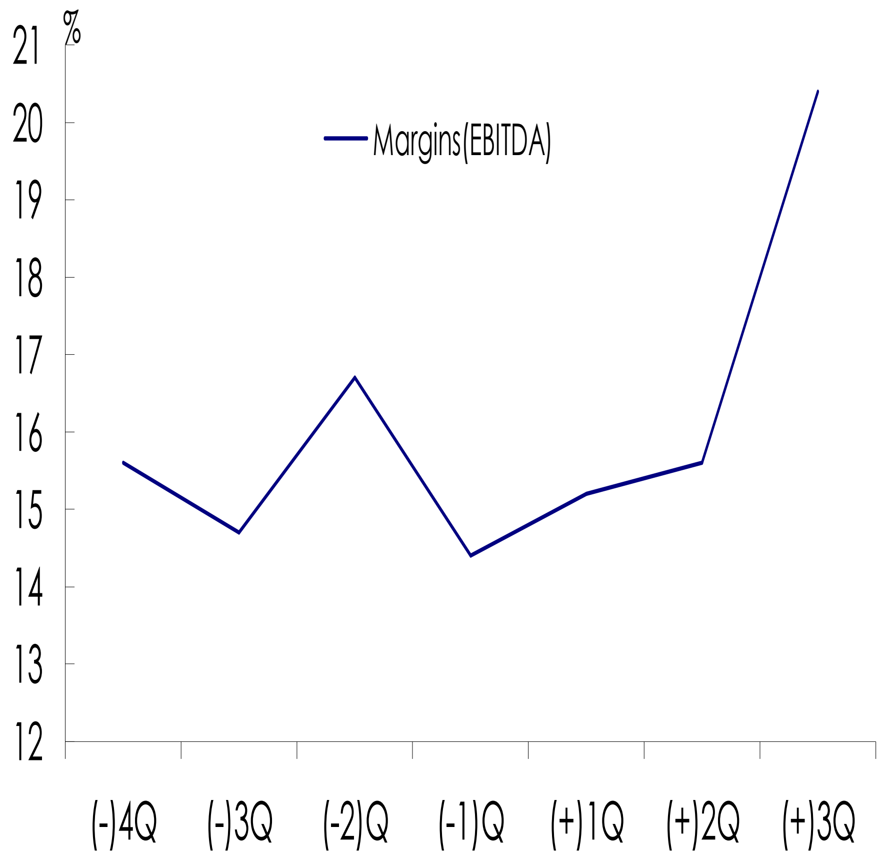
- Multi exit strategies are a great advantage. They can sell to a strategic buyer; do an IPO, financial recapitalisations.
- This can adjust to the regulatory and tax environment and the depth of capital markets regionally.
- Potential problems can relate to persistent poor market conditions; excess supply of LBO companies versus flow demand; expensive valuations driven by LBO’s that cause equities to be re-rated excessively.

Sales & Capex Before & After LBO (SEC Filings 12 US Co's, Citigroup)

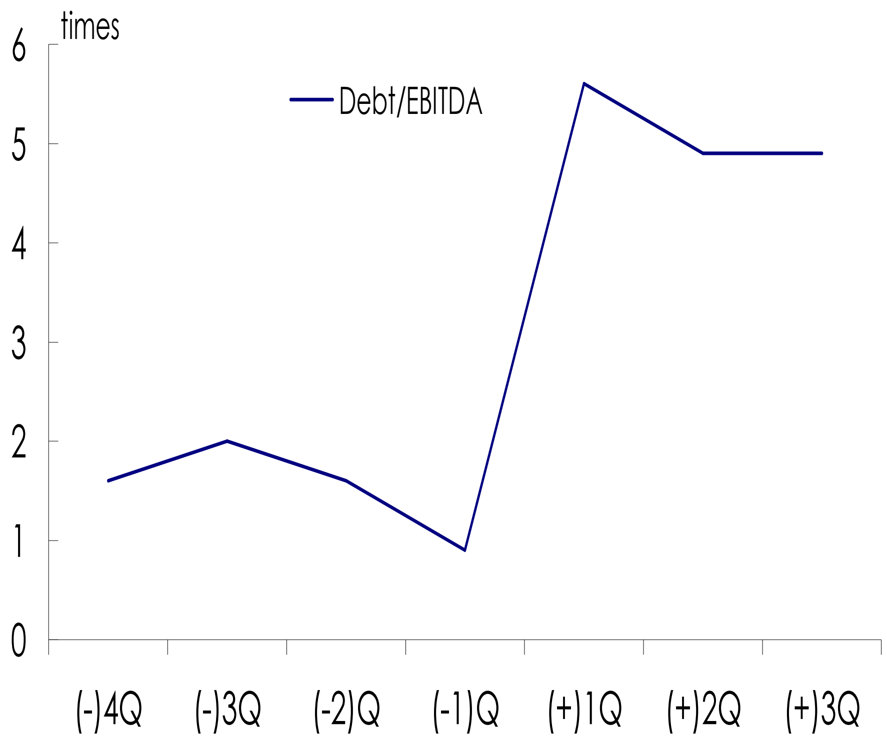


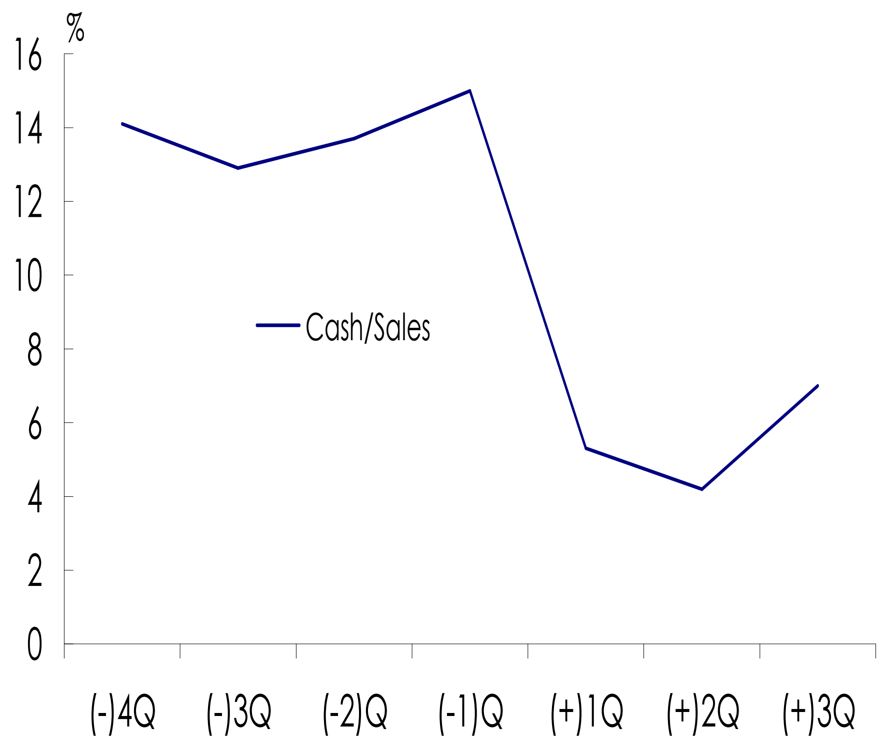


Margins & Costs Before & After LBO (SEC Filings 12 US Co's, Citigroup)



Financials Before & After LBO (SEC Filings 12 US Co's, Citigroup)





A Typical Private Equity Deal

Public Company		The Deal Phase Period 1		Exit Yr4 ,10% Growth	
Market Cap $m	100	Mkt Cap, (20% prem bid) $m	120	IPO Value	315.0
EBIT (margin 10%) $m	12	EBIT (margin 10%) $m	12	EBIT (margin 20%) $m	35.1
Sales $m (costs 108)	120	Sales $m (costs 108)	120	Sales $m (costs 140.6)	175.7
PE (vs say peer avg of 10)	8.3	PE (vs say peer avg of 10)	10.0	PE exit 10% disc. to deal mult.	9.0
Debt on balance Sheet (1xEBIT) $m	10	Debt @ (7x EBIT) $m	84	Debt $m--constant target	84.0
Debt service @ 7%	0.7	Debt service @ 6% $m	5.04	Debt service @ 6%	5.0
Net Profit before tax $m	11.3	Net profit before tax $m	6.96	Net profit before tax	30.1
Profit after tax @ 30%	7.91	Net profit after tax @30% $m	4.872	Net profit after tax @30%	21.1
		Equity contribution to deal $m	36	Compounded Equity at Cost of K	45.4
Yield %	7.91	Yield for Priv Eq investors %	13.5	Yield % On Equity	46.4
		Yld incl.up front fee @2%	20.2	Capital gain % on Priv Eq	774.9
				Capital Gain on public Company	214.981

So If You Want To Avoid It

- Good companies executing well make LBO trawling difficult.
- Low costs flexible labour arrangements.
- Strong management team executing well, with strategic vision in acquisitions.
- High PE relative to peers making the company expensive to buy.
- Optimal capital structure and gearing.

Public versus Private Comparison

	Capital Structure	Ownership Structure	Operational Issues	Earnings Performance	Compensation Incentives	Corporate Govenance
Public Co. Model	Low leverage tolerance	Retail & Insto mix, with low operating influence. Pressure on instos to perform in s/run	Continued investment to expand Reluctance to major divestitures	Market pressure to meet Qtly or 6-monthly performance.	Options gone post FAS 123 More limited upside for management Intense public scrutiny	Frequent investor meetings Guidance to analysts Realtionships with analysts
LBO Firm Model	High leverage 5 to 8 x EBITDA	Financial sponsors have maj ownership & role in the business	Stringent cost reduction Sale of non-core assets	Longer-term focus to max value for eventual exit from private model	Significant ownership & upside potential for management. No public reporting.	Reduced pub. discl. Analysts & investors cant get info.on deal Fee structure: moral hazard, + premium bids, =misallocatiom risk (new short-termism) Taxation incentives (offshore, int. deductib., transfer pricing, VAT) affect corp gov.