Private equity in the UK – the first 25 years

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The private equity industry is key to Britain’s continued economic competitiveness, says Wol Kolade, past Chairman of the BVCA

This year, the BVCA – the British Private Equity and Venture Capital Association – celebrates its 25th anniversary. The organisation, like the industry it represents, has changed immeasurably over the past quarter of a century, as the sector has grown into one of the biggest success stories in the British economy.

Today, Britain is the private equity centre of Europe, and our industry is the second largest worldwide, after the US. In those 25 years we have gone from being little more than a cottage industry into part of the mainstream economy.

When people think of private equity they often associate it with buy-outs of big household names: AA, Boots, Debenhams. But of course the reality is that we are a much broader church than that. Private equity and venture capital are behind the medical diagnostic services we use in hospitals, the chips in our mobile phones, the manufactured components of our cars, the bioethanol fuels that may run them in the future, as well as the latest research into clean technologies that are trying to find solutions to some of the environmental challenges we face.

Private equity directly and indirectly benefits millions of workers and their families. Over the last 25 years it has been the returns that the best-performing parts of the industry have generated, often far in excess of those of the stock market, that have been the main reason for its growth. The reason the industry exists at all is because that is the way many investors, including public and private pension funds, want to invest their money. None of them is forced to invest in private equity – they choose to.

Britain benefits from the industry in other ways, too. For the financial year 2006/7, it is estimated that private equity-backed companies generated total sales of £310 billion, exports of £60 billion and contributed nearly £35 billion in taxes. That’s enough tax to pay for all the nurses and police officers in the UK.

During the same period, financial and professional services firms generated an estimated £5.4 billion in revenue through the provision of services to the private equity community.

So, as a driver of the UK economy and of Britain’s competitiveness, private equity has a compelling story to tell.
The founding of the BVCA in 1983, at the very beginning of our industry’s astonishing period of growth, seemed a bit optimistic at the time. But it has paid off.

The BVCA currently has more than 200 full members, who represent the vast majority of private equity and venture capital firms operating in the UK, and a further 200-plus associate member firms, including lawyers, accountants and other professional advisers to the industry.

We have come a long way in 25 years. From humble beginnings when we had just 34 full members and no associate membership to speak of, we have increased total membership twelve-fold. Total investment by member firms began at just £190 million, and has grown to over 100 times that, and total funds raised have increased by a multiple of 50 since 1983.

Some of the pieces in this book address those early days. With its roots very much in venture capital, its founders tell tales of the BVCA being set up when no-one, including the financial institutions such as banks and investment funds, really knew what venture capital was, and didn’t know much about early stage businesses or buy-outs. Recognising they had much to learn from each other, the joint benefits of educating investors, and the need for a lobbying organisation, the BVCA was born.

Despite having recently evolved into the British Private Equity and Venture Capital Association, better to reflect the full spectrum of organisations we now represent, even today the BVCA remains close to its venture capital roots. Of the 1,300 UK companies that received private equity investment in 2006/7, more than three quarters received less than £2 million, proving that despite the headlines, the industry today is not mainly about multi-billion pound buy-outs.

Growing businesses by adding value is at the heart of what all the BVCA’s member firms do. It is what unites the smallest venture firm and the largest buy-out house. Supporting start-ups and university spin-outs with early stage funding remains a critical part of our industry, and something that the UK economy as a whole continues to benefit from. Stories such as the one told in this book of Cambridge Sionex Radio (p.114), show the role of venture capital in taking a brilliant idea or invention, turning it into a university spin-out, and in this case into a world-leading company.

In the mid-market we take growing businesses and help propel them forward. At this stage in a company’s life we can add critical value through strategic advice, as well as the funds to invest in growth. More recently there has been a trend for multiple private equity owners to be part of the story of building and growing companies like Gala Coral, Tragus and Center Parcs (p.104).

At the big end we take mature businesses and re-focus and re-energise them. In some cases it is about an unloved division of a larger company, or turning businesses around, shaking up management and cutting out waste. Being brave enough to take tough decisions to build on strength rather than prop up failure. The case studies on transformational change and turnarounds in the later sections demonstrate exactly what I am talking about (p.100 and 111).
The BVCA celebrates its 25th anniversary in a very different political, economic and media environment from that in which it began life. The changing landscape over the intervening years, including the fall of the Thatcher government, the recession of the early 1990s, the domination of the internet, the dotcom bubble, the rise of New Labour, the development of mega funds, globalisation, the emerging economies of China and India and the credit crunch, have all helped shape the UK private equity story in a variety of ways.

It is also the case that as we have grown as an industry, so the size of our deals has increased, and so the numbers of those aware of private equity, and affected by it, have expanded greatly. People’s expectations of us today are different and we are having to change our own attitudes to transparency and communication.

Throughout this period of change the BVCA has been at the vanguard of helping the industry to adapt to its new responsibilities. We led the way by setting up the Walker Review into Transparency and Disclosure in early 2007. In our 25th year we are continuing to help establish best practice in this area and will ensure the fair implementation of Sir David Walker’s guidelines through the setting up of the Guidelines Monitoring Group, under its first Chairman, Sir Mike Rake.

As the economic environment becomes tougher, the BVCA will do all it can to protect the competitive advantage Britain currently enjoys in relation to other leading financial centres of the world. If the UK is to retain its competitive edge, as a place for private equity houses to base themselves, the tax and regulatory environment they operate within needs to be a stable and predictable one.

This book is a celebration of how far the industry has come, how much it has achieved and its aspirations for the future. It seeks to capture the effect of the changing economic and political landscape of the last 25 years on the industry, as well as provide a snapshot of the industry today. We have asked industry professionals, commentators and key stakeholders from the wider business community to impart their perspective on the industry and the challenges it has faced. I would like to extend my warm thanks to all those who have taken the time to contribute to the book.

The book has a second aim, too – to show what the industry does and how it does it. It is important to understand one central fact about private equity: private equity is about making businesses better. The stories here are of real businesses that employ thousands of people and the way private equity works with those businesses. That to me is where the real history, the real story, of this industry and the role it plays in the UK economy lies – and that is what we should be celebrating.
A changing dynamic
The skills of the private equity industry are unique and deserve wider appreciation, says Anthony Hilton

Diversity can be a strength, but it can also be a challenge. For the private equity industry, the difficulty is that the various techniques it employs and the differences in approach between houses are not properly understood by the public.

In spite of the serious efforts made by the BVCA and several of the leading firms to help people understand the industry, there is still a lack of appreciation generally of the range of skills and talents that are assembled under the generic ‘private equity’ label.

One of the purposes of this publication, which celebrates the 25 years since the founding of the BVCA, is to show how companies in the UK and beyond have benefited from the expertise and know-how of private equity practitioners. The book looks back at the industry’s roots, with contributions from pioneers such as Apax Partners’ Sir Ronald Cohen and Sir David Cooksey of Advent Venture Partners, and analyses the key issues going forward. It draws together the views of organisations such as the CBI and the NAPF, as well as the opinions of leading business figures, including Paul Myres and Sir David Walker. Finally, a series of articles containing in-depth case studies reveals how the industry really works in practice, whether it is providing development capital, pursuing a buy-and-build strategy, turning around distressed companies or planning a large buy-out.

A further challenge for private equity is politics. For much of the early years – when the focus was on start-ups, on development capital and on small buy-outs – the industry operated away from the public gaze. There was no discernible sign of political interest, other than a general enthusiasm among all parties that capital should be made available wherever possible for the funding of new businesses.

The industry inevitably has its cycles, but each has led to a higher peak. This was particularly evident after the millennium, when it became possible for private equity houses to raise funds of unprecedented size, and thereafter to become significant players in mergers and acquisitions.

Private equity firms had, of course, taken over major public companies in the past – most famously when Kohlberg Kravis Roberts took over RJR Nabisco in the US, and in Britain when supermarket group Gateway and home improvements business Magnet were both subject in the 1980s to bids from rival houses. Interestingly, though these deals were high profile and controversial at the time, they still failed to arouse the interest of politicians.

This time it is different: the significant increase in size and number of such bids, and the tendency to pursue well-known targets have changed the dynamic. The public woke up to the existence of private equity without knowing what it was. Private equity had to come to terms with public and political scrutiny.

It can be argued, with the benefit of hindsight, that it was too slow to adapt. As a result, the industry suffered from attacks born of political opportunism in some cases and elsewhere from genuine, though misplaced, concerns.

The worst of the storm has passed because the industry, led by the BVCA, has moved to become more transparent and better understood. For other reasons, the politicians have also moved on. However, there is a big difference between a volcano that is dormant and one that is extinct, and it is only right that this book acknowledges the political dimension, and tries to put it in a global context.

The private equity industry is a vital spur to efficiency and growth, but it still needs its licence to operate. Its activities need to be accepted as legitimate and useful by the public if it is to avoid being taxed or regulated out of existence.

Another challenge for private equity is geography. The industry started in the US, took root in Britain and is now making rapid inroads in mainland Europe. There are vast opportunities there as businesses restructure to cope with competition from Asia, but in spite of this, it is to Asia that some houses already look.

The pace of change in business is so rapid, the life cycle of companies so much shorter than in the past, even in Asia there are opportunities. For many houses, that is where the future lies. Perhaps they are right, perhaps not.

To an observer, it matters less than the fact that the industry continues to flourish. If private equity has a single core skill, it is the ability to deliver transformational change.
Imagine the scene. British trade unions cheer and the London media howl in protest as the newly elected Conservative Government fails to convince one of the last big private equity houses left in the City to reconsider moving its head office overseas.

As French President Nicolas Sarkozy welcomes the latest buy-out fund to Paris, he hails the success of his policy to make France’s capital a global financial centre with zero capital gains tax and low fiscal rates for non-doms.

Property prices in London’s Mayfair plummet as swathes of office space and luxury homes are put up for sale. Thousands of jobs are lost as lawyers, accountants and banks cut their UK private equity teams and switch to chic new offices on Paris’s left bank.

Alright, now breathe. Don’t panic. This is unlikely to ever happen. Private equity’s importance to the City and ultimately the overall British economy is surely too great for the Government ever to change radically the tax and regulatory structure that has fostered the growth of the industry.

Nonetheless, relations between policymakers and private equity executives reached their nadir in 2007. What started as a trade union-fuelled controversy over job cuts at private equity-owned companies, such as the AA motor services group and Iglo Birds Eye, the frozen foods group, snowballed into a full-blown political debate about tax, transparency and the overall economic contribution of buy-out firms.

The poster child for the unions’ campaign against private equity was Damon Buffini, Managing Partner of Permira. He played a role in both the £1.75 billion acquisition of the AA in 2004, when it joined a consortium with CVC Capital Partners, and the £1 billion takeover of Iglo Birds Eye in 2006.

Some buy-out executives claim the initial union campaign was triggered by an internal power-struggle between the GMB union and the AA staff, which led Paul Kenny, the Union Leader, to make Permira and Buffini the scapegoats for his own difficulties.

Whatever the truth of this, the union campaign caught the public’s imagination. Interestingly, this was not just a British phenomenon.

Private equity was an issue in the Swedish general election when one candidate proposed measures to curb its freedoms, but failed to win. The industry came under even greater attack in Germany.

The root cause in all these cases was the same. It had less to do with private equity as a method of finance than with the actions taken by private equity owners to return businesses to profitability. Companies frequently fall into private equity hands because they have underperformed. Sorting them out can require taking tough decisions on plant closures and job losses, which previous management shirked.

That said, in the British context, last year the buy-out industry arguably did not help itself. Just as the public mood was turning against it,
private equity firms embarked on some of the most daring buy-out bids ever seen in Europe, notably an £11.4 billion bid led by CVC for J Sainsbury, the supermarket.

CVC’s bid for J Sainsbury failed. But it was soon followed by an £11 billion bidding war for Alliance Boots, the pharmacy chain, with competing offers being made by Kohlberg Kravis Roberts and Terra Firma. With the acquisition of Boots, it seemed no house-hold-name company was beyond private equity’s reach, however big it was.

Another crucial – and perhaps unlikely – ingredient arrived to take the controversy to a higher level. The Labour party’s contest to choose a new leader and deputy after Tony Blair’s departure gave British trade unions, wielding their significant voice within the Labour party, the opportunity to press the buy-out debate to the fore.

The Treasury Select Committee announced it would hold an inquiry into private equity and the Government put pressure on the BVCA to review transparency and disclosure. This led to the BVCA’s appointment of Sir David Walker, the City grandee and Morgan Stanley Adviser, to draw up a code of con-duct for big buy-out firms.

The intriguing thing, and one overlooked in the UK at the time, was that a similar debate was happening in, of all places, the US. Private equity is a vastly important and long-established player in the US economy, but even in that country there was disquiet about the essentially secret nature of much of the activity. Again, the lack of transparency pro-vided fertile ground for public distrust and political criticism.

These issues have cropped up for decades, however. Those who undertake the challenge of restructuring businesses inevitably come under fire – witness the attacks on the con-glomerates run by Slater Walker or Harson Trust in the 1970s and 1980s. The fact that concerns over the pain of restructuring being felt by employees while the gains went else-where existed then, shows that it is not pri-ivate equity per se, but the pain of restructur-ing which arouses the interest of politicians. It is also the case that public concern can be short-lived – it now seems the early summer of 2007 was the low point. While the public image of big buy-out firms may take careful nurturing to recover, a combination of events since has served to deflect criticism away from the industry.

Firstly, the credit squeeze started in July 2007, cutting off buy-out firms’ access to the abund-ant amounts of cheap debt that had allowed them to mount their most ambitious bids in the US and Europe. The financial turmoil has shifted attention from the financial structures of private equity, to the operational improve-ments it can deliver.

The industry also took a significant step towards greater public understanding and accountability when Sir David Walker pro-duced his guidelines on transparency and dis-closure, which will apply on a ‘comply or explain’ basis to the biggest buy-out firms in the UK. While the code has attracted criti-cism from trade unions and policymakers for not going far enough, it should answer some of the attacks about lack of transparency as private equity firms start to publish more information about themselves.

While private equity investments still only account for about 1.5 per cent of GDP in the UK, the industry has expanded at an astonishing rate. Like any rapidly growing industry, private equity needs to mature. Buy-out executives must become more visible, explaining their strategies to workers, suppli-ers, customers and the wider public via the media. But these could be no more than the growing pains of an industry that has grown faster than anyone could have forecast.

This is certainly the view of practitioners, none of whom doubt the industry’s resilience. Sir Ronald Cohen, Founder of Apax Partners, forecasts it will double in size in five years and Stephen Schwarzman, Chairman of the Blackstone Group, said at the CBI’s 2007 con-ference: “Private equity is here to stay.” Not only would most politicians agree, but across Europe they are also more inclined than they were to accept Schwarzman’s other point – that it is also a force for good.
Private equity performance

Joanne Hart asks where the returns come from – financial engineering, multiple enhancement or by improving the running of the business?

“Financial engineering is well understood and it is available to everyone in the market. If it was that simple, most private equity firms would deliver similar returns. But in fact, returns vary enormously”

To many participants in the public market, the private equity industry has achieved significant returns purely and simply on leverage. Firms have bought cheap, sold dear and multiplied the equity return on their investments by gearing up the balance sheets. The process has been made even easier in recent years, thanks to the abundance of cheap money.

That, at least, is the perception from the outside. Within the industry, however, opinions are rather more varied. Some deny the financial wizardry proposition almost completely.

“Financial engineering is well understood and it is available to everyone in the market. If it was that simple, most private equity firms would deliver similar returns. But in fact, returns vary enormously,” says Permira Partner, Charles Sherwood.

Sherwood points to data which shows that in the ten years to March 2007, European buy-out funds produced pooled average returns of 11 per cent, but delivered a median average return of just 3 per cent. In other words, half the funds in the survey produced returns of more than 3 per cent, but half produced returns below 3 per cent. The upper quartile average return was 12 per cent over the period. And even if the data is analysed on an annual basis, the difference between pooled average, median and upper quartile returns is substantial.

“The average is basically meaningless. What actually characterises this industry is dispersion around the average and the fact that the more successful firms consistently outperform. So delivering returns has to be a bit more difficult. It has to depend on delivering some form of value-added that is not easily understood by everyone,” Sherwood suggests.

“Debt is important, but only in so far as it magnifies value that is created by other means,” he adds.

Other general partners agree. Most accept that financial engineering plays a part, but they stress that success cannot be achieved through gearing alone. Many participants claim too that different sectors of the market rely on leverage to a greater or lesser extent. Mega funds, or those firms with funds of more than £5 billion, are often accused of excess reliance on leverage, but they themselves believe they have talents the ‘smaller’ firms do not possess. Firms with funds of less
than £1 billion, meanwhile, frequently sug-

gest that they are the custodians of private
equity as it should be – they genuinely grow
businesses rather than using fancy financial
techniques to boost returns.

“For me, the highest quality investment gain
is to do with the performance of the underly-
ing business and that means selling more,
making higher profits and generating more
cash. If you run the business better, it grows
and when you come to sell, it will command a
higher multiple, not because of the econom-
ic cycle, but because it is a better business,”
says Paul Manson-Smith, Managing Partner
of Gresham Private Equity.

Manson-Smith cites Penn Pharmaceuticals, a
Welsh drugs manufacturer that Gresham
bought in 2000 for £12 million. At the time,
the business, which owned the rights to the
Thalidomide drug, employed 120 people.
Gresham split off the controversial
Thalidomide division, sold it to US grant
Celgene and built up the remaining busi-
ness, almost doubling the number of staff,
boosting turnover five-fold, increasing prof-
its ten-fold and generating a 12 times return
on investment.

Such stories are encouraging – and they may
become a more common feature of the pri-
vate equity landscape, particularly if condi-
tions in the lending markets are as tough as
they have been in the recent past. For, if debt
is less available, leverage will simply have to
play less of a role in the industry. Jon Moulton
of Alchemy Partners believes this will hit
large firms in particular.

“Big funds have made a lot of money out of
rising debt multiples. Looking forward, we are
going to see an increase in due diligence
accompanied by a reduction in prices, a
reduction in leverage and a reduction in
returns,” he says.

Most partners, in firms large and small, are con-

fident they will be able to withstand the chang-
ing environment and adapt to the new era.
Their confidence comes from a fundamental
belief in private equity’s business model.

“Private equity exploits what McKinsey
coined as ‘governance arbitrage’. What that
means is that successful firms pursue a differ-
ent governance model, which creates a real
closeness between managers and owners,”
says Sherwood.

Clearly, there is a difference between the way
listed companies and private equity-owned
companies are structured. In a listed compa-
y, the Board may own some shares and may
have options over more, but the vast majority
of the equity is owned by a wide variety of
institutional shareholders, who meet the
company once or twice a year.

In private equity-backed companies, the man-
agement owns a substantial and significant
percentage of the equity and so do the gener-
al partners. Not only that, but there are invari-
ably one or two general partners sitting on the
board of the companies in which they have
invested. This can create a genuine closeness,
as well as an alignment of interests.

It should also mean that both managers and
general partners are keen to improve the
companies with which they are involved.
Sherwood, meanwhile, points to Inmarsat,
which Permira and Apax backed in 2003.

“When we invested in the business, there
were 86 different shareholders, each with a
different agenda, including suppliers,
investors and customers. There was virtually
no alignment of interest between manage-
ment and owners and there was a poor line of
command. We changed the management
structure, the business was given a new lease
of life and by the time we floated it, it was a
big success,” he says.
These turnaround stories cannot be achieved by leverage alone. But they do require a degree of expertise within the private equity firms themselves.

“"In the past, private equity made returns from a third leverage, a third multiple arbitrage and a third from running the business better" says Sherwood.

Multiple arbitrage has played a part in private equity’s success as well, but that has diminished over time.

“"In the past, private equity made returns from a third leverage, a third multiple arbitrage and a third from running the business better. Recently, the competitive landscape has turned multiple enhancement into multiple compression and firms have been forced to do more with their portfolio companies to deliver the returns," says Jacques Callaghan of Hawkpoint.

Nigel McConnell of Cognetas points out that, at his mid-market firm, more than 60 per cent of returns are generated by operational improvements in the underlying businesses, rather than any kind of financial engineering. “We never buy a business unless we think we can improve underlying earnings,” he says.

This refrain is likely to become more pronounced across the industry. In the early days of private equity, leverage played an undeniably large role and in recent years, gearing moved to centre-stage again. Now, the debt multiples of 2005 and 2006 are simply not on offer – so private equity firms will have ample chance to prove they are not just financial wizards.

1 Source: European Private Equity and Venture Capital Association
The battle for hearts and minds

The private equity industry has made headway in terms of improving its public profile, says Anthony Hilton, but a number of challenges remain.

It is one of the maxims of public relations that it is what people believe that matters, not what is true, because – for better or worse – it is beliefs that drive action.

The private equity industry has learned this lesson too, albeit it left it rather late. For much of the period after 2000, when a combination of favourable circumstances came together to usher in a period of phenomenal growth, the industry was too busy managing its expansion to focus much on what people outside thought of it.

It is no coincidence that mid-way through the decade, in the three main areas of private equity activity – the US, Britain and mainland Europe – the strain began to show. The industry came under attack from both press and politicians.

While the focus was slightly different from country to country, the drivers underneath were remarkably similar – people were learning to adjust to a phenomenon that seemed to have the power to change their lives, by taking over the places where they worked, where they shopped and where they spent their leisure time. But they were not sure who these mysterious buyers were, where they came from, where they got their money, nor what their intentions were. Hence their concern.

Most public relations professionals will tell you there are times when their job is impossible. There are occasions – though thankfully they are rare – where the combination of a sensationalist and superficial media, an opportunistic and headline-hungry body politic and an electorate unwilling to engage with complex issues creates a perfect storm.

Something like this caught the private equity industry and for a few turbulent weeks it suffered, but the storm has now passed. This does not mean that the need for public relations has gone with it; but life should not be governed by the storm. The industry can now focus on some longer-term communication, rather than fire-fighting.

The main challenge to the private equity industry lies within its own ranks, because under that one label lies a diversity of belief and culture which makes it difficult to deliver a common programme.

The venture capital industry, for example, has always invested in public relations and has always had a good public image. In the UK, 3i had external and internal financial public relations from the early 1970s – long before it ever thought of becoming a listed company itself – and, generally speaking, it got a good press.

There are reasons for this. The public buy into the idea of risk-taking and backing young businesses and good ideas. They see how it can benefit individuals and the wider economy. They also intuitively know how difficult it is, so tend not to begrudge the rewards. Interestingly, in a straw poll, most critics of private equity did not associate venture capital with the genre – or with their criticisms. For these reasons the public relations imperative for this part of the industry is quite different from other parts. It needs to make sure that press and public understand how fragile the venture capital plant is, and how it needs to be protected from toxic shocks –
It remains a mistake to convey the impression of effortless profit because that will always invite a backlash along the lines of “if it is that easy, the practitioners do not deserve the rewards.”

These issues will get bigger not smaller in the coming decade because globalisation will increase the pressure on companies and highlight competitive weaknesses far more rapidly than before. Most businessmen today say they have never known a period where pricing pressure is so intense, where competition is so fierce and where the penalties for falling behind are so severe.

The companies that survive will be those that are adept at change. Inevitably, many will not be. It is then most likely that private equity will come on the scene to make the transformational change that a public company board may have failed to deliver. Private equity could be thought of as doing capitalism’s necessary, rather than dirty work – restructuring and reviving businesses, and taking the decisions others shrink from.

But it may never be universally liked – in the same way that people shoot the messenger when they do not like the message. Society has to get used to rapid change, but it is asking too much for those adversely affected by it in the short term to relish the experience or thank those who have delivered it. To some extent, private equity will always be seen as profiting from someone else’s discomfort. Just because it is difficult does not mean that the effort should not be made. Private equity needs to be understood and treated with respect, for it has a vital role to play.
Transforming the UK economy

Private equity-backed businesses are reckoned to be among the most efficient in the UK. How do they stack up in terms of job creation, export growth and investment? Joanne Hart reports.

In 1992, the Queen memorably referred to the year just gone as her annus horribilis. Only 15 years later, the private equity community might have used the same phrase to describe 2007. Not only did the industry suffer from increasingly tough markets and the virtual disappearance of cheap credit, but it was also lambasted by the media, the unions and the general public.

Yet independent research indicates that this criticism is invariably unfair – private equity firms are fundamentally beneficial for business. They boost efficiency, boost profitability, boost growth and boost employment — and they have been doing so for many years. The industry may have shot into the limelight in 2007, but it has been investing in UK companies and helping them to grow for decades. Over the past five years, this support has been particularly marked.

Between 2002 and 2007, for example, the number of people employed worldwide by UK private equity-backed companies rose by 8 per cent annually on average. Over the same period, the number of people employed by FTSE 100 companies rose just 0.4 per cent per annum, while the figure for the wider FTSE 250 index was 3 per cent a year.¹

In the UK alone, employee numbers have risen by 4 per cent a year, compared to the national average of 1 per cent annually. Private equity-backed companies currently employ 1.1 million people, equivalent to 8 per cent of the private sector workforce. Historically, private equity companies have been responsible for the employment of around three million people or 21 per cent of employees working in the private sector.²

“Private equity delivers a substantial contribution to stronger employment,” say consultants at AT Kearney.³

“A typical pattern that can be observed is an upturn in the first year after the buy-out and additional growth at a less steep, but steady, rate over the following two to five years,” they add.

Across the UK, there are almost 450 private equity, venture capital, funds of funds and secondaries investment firms, which together employ more than 9,300 people. As these firms use a range of financial, business and professional firms, nearly 15,400 professionals are involved in private equity-related work.

Firms operate on a nationwide basis. While many are concentrated in London, cities such as Bristol, Birmingham, Edinburgh, Leeds and Manchester also benefit from private equity. In fact, 60 per cent of legal, corporate finance and accounting firms operating in the industry and outside London consider private equity to be a significant source of revenue.⁴

The sector generates considerable investment, too. More than 1,250 businesses were backed by private equity in 2006 and their annual sales growth over the past five years has been around 8 per cent, compared to 6 per cent for the FTSE 100 and 5 per cent for the FTSE 250. Annual sales revenue at portfo-
Private equity-backed companies increased from £28 million to £36 million on average over this period, and, in more than 80 per cent of businesses, growth was organic rather than acquisition-led. Export growth has been robust, growing by 10 per cent per annum, compared to a national rate of 4 per cent.

Overall, in the financial year to April 2007, private equity-backed companies generated around £310 billion of sales revenue and £60 billion of export sales.

Investment has been substantial too, rising 11 per cent annually since 2002, compared to a national level of just 3 per cent. Spending on research and development (R&D) has been robust as well, rising 14 per cent over the past five years.¹

“Private equity-backed businesses have been pretty successful. When you benchmark them against listed companies, they perform well on all measures, employment, enterprise value and profitability,” says Harry Nicholson, Private Equity Partner at Ernst & Young.

Ernst & Young compiled a survey of exits in Europe and the US, which revealed that EBITDA (earnings before interest, taxes, depreciation, and amortisation) at private equity-backed companies rose by an average of 15 per cent in 2006. Two thirds of this growth was derived from fundamental business expansion, including investment and new product launches. The profitability of these businesses means that in the UK alone, they contributed £335 billion in taxes. Over the past five years, sales revenues from private equity-backed companies amounted to £1,331 billion and tax contributions totalled £140 billion.

“Private equity businesses do well because there are some very clever people in the industry and because they give management teams the chance to own their own businesses. This is particularly effective if change is necessary,” says Nicholson.

Ultimately, private equity brings a sharper focus to business and makes sure that things really happen and happen quickly,” he adds.

A World Economic Forum report published in 2008 bears this out: “It found that when a company goes private, a fundamental shift in board composition takes place. “The board size and the presence of outside directors are drastically reduced,” the report says, adding that private equity board members are most active in complex and challenging transactions.

Portfolio companies agree with the analysis that private equity ownership brings a sharper focus.

More than 90 per cent of those surveyed for the IE Consulting report in 2007 admit that they would not have existed at all – or grown more slowly – without private equity backing. This backing does not just come in the form of capital. Nearly every private equity-owned business maintains that their investors have provided advice on strategy and financing and introduced them to useful contacts.

Almost 40 per cent of management buy-out companies also said private equity firms had helped them become more efficient, while 32 per cent of businesses said private equity backing had boosted their R&D expenditure. A similar percentage said they had spent more on IT, thanks to support from private equity investors.

More than 90 per cent of those surveyed for the IE Consulting report in 2007 admit that they would not have existed at all – or grown more slowly – without private equity backing.
Portfolio companies that were not the subject of management buy-outs were even more positive about the impact of private equity backing on investment activity. Around 57 per cent said investments had been boosted by private equity support, while 54 per cent said R&D expenditure was higher than it would have been and 41 per cent said they had spent more on IT than they would otherwise have done.

Almost 60 per cent of businesses have received more than one round of investment and most companies believe this is the single most effective contribution that private equity has made.

Investment and efficiency helped companies to become more innovative. Last year, 65 per cent of businesses said they had introduced new products and services over the past two years, an increase of 10 per cent from 2006.

The World Economic Forum report also backs the role private equity firms play in boosting R&D and innovation. "Firms that undergo a buy-out pursue more economical- ly important innovations, as measured by patent citations, in the years after private equity investment," it says. The report adds that private equity-backed firms bring a greater focus to patent portfolios and concentrate more on a company’s core technolo- gies, but they maintain comparable levels of cutting-edge research.

Overall, the evidence suggests that private equity has played and continues to play an important role in the UK economy. Private equity firms have long maintained that they add most value to investee companies by providing support on many levels, not just financial – and managements seem to agree. Firms also maintain that they are encouraged to create strong, vital businesses because these are most attractive to potential purchasers: independent data backs up this thesis.

Even though private equity has been under the spotlight, therefore, accused of failing to nurture businesses, on-the-ground research tells another story. The industry contributes substantially to the UK economy and has become an integral part of it.

1 Data from IE Consulting 2007 Report: The economic impact of private equity and venture capital in the UK
2 Data from IE Consulting 2007 Report
3 Private Equity Creates Employment & Value, AT Kearney 2006
4 Data from Arbor Square Associates 2007 Report: The impact of private equity as a UK financial service
5 Data from IE Consulting 2007 Report
7 Data from IE Consulting 2007 Report
The rise of institutional investment in private equity

Pension funds in the US initially led the way when it came to investing in private equity, but those based in the UK are now increasing their allocations. Andrew Lebus, Managing Partner of Pantheon Ventures, looks at how institutional investment in the industry has evolved over the last 25 years.

While pension funds and local authorities have invested in private equity since the mid-1980s, it was not until the beginning of this decade that the asset class hit the agenda of almost every pension board trustee.

The American Research and Development Corporation is often credited as being the first professional private equity investor, having been formed in 1946 to commercialise new technologies developed during World War II.

In the ensuing years, wealthy families such as the Rockefellers continued to make private equity investments, but it was not until the establishment of the Employee Retirement Income Security Act (ERISA) in 1974, as adjusted in 1978, that pension funds first became involved. The ‘prudent man’ rule within the ERISA allowed pension funds to invest in private equity funds, provided that these investments did not endanger the entire portfolio. This, coupled with the stellar returns achieved by some early private equity funds, ensured that the seeds were sown for pension funds to become at first cautious, but increasingly enthusiastic, converts to private equity.

Pioneering public organisations in the US, such as CalPERS, were the first to participate and were instrumental in paving the way for future pension funds to invest in private equity.

While pension funds and local authorities have invested in private equity since the mid-1980s, it was not until the beginning of this decade that the asset class hit the agenda of almost every pension board trustee. In the UK, the Myners Report, published in 2001, was responsible for focusing pension funds on the benefits of private equity.

Further factors that influenced the growth of private equity participation relate to secular changes in asset allocation among pension funds, following the closure of defined benefit funds to new members. These changes led to a reduction in equity allocations and, consequently, to greater demand for fixed-income investments and alternative assets, including private equity. Today, private equity is probably considered by most pension funds. The 2007-2008 Russell Survey of Alternative Investments shows 57 per cent of US pension funds and 54 per cent of European pension funds currently invest in private equity.
The extraordinary long-term success of the listed private equity market notwithstanding, there remains an inherent tension between the benefits of having a permanent pool of capital and the burden of managing a publicly-listed vehicle in a market that, for its effectiveness and by definition, depends in part on keeping certain information private.

Development of the European secondary market

The explosive growth of private equity investment in the 1980s attracted a broad constituency of new investors. Some of the limited partnership fund was not sufficiently flexible to meet their strategic or liquidity requirements. In consequence, a market for secondary sales of private equity funds soon developed, beginning in the US with the formation of the Venture Capital Fund of America. GT Investment Company (now Pantheon Ventures) completed one of the first European purchases of a secondary interest in 1986. This was followed in 1987 by the formation of a number of dedicated secondary funds, including those of Coller Capital, HarbourVest, Landmark, Pantheon and Paul Capital.

It was not until the 1990s that the European secondary market really began to take off, with the creation of a number of dedicated secondary funds.

Development of funds of funds

In the early years, it was more common that private equity advisers would operate segregated accounts as gatekeepers on a largely non-discretionary basis. As relationships between advisers and clients developed and track records were established, the need for discretionary management services grew. Funds of funds, which enabled client interests to be pooled with proper alignment of interests, were a natural progression.

The early entrants are now among the largest global fund of funds managers in the world today. As the universe of private equity funds increases, investors need to devote greater resources to their programmes to conduct appropriate due diligence and secure access. Furthermore, the typical minimum commitment level of $10 million for many individual funds predicates a very substantial allocation if an investor is to achieve diversification across a number of funds, stages and regions.

The scope of work required to identify the best funds globally, to manage these relationships and to enable critical investment judgment to be made, requires skilled resources not usually available to any but the largest of institutions. Funds of funds offer institutions the benefit of significant economies of scale and are, therefore, here to stay.

Development of the listed private equity market

Listed private equity is one area where Europe, and predominantly the UK, has led development. The first quoted private equity vehicles were established in the late 1970s and 1980s as tax-efficient UK investment trusts; this marked the beginning of the listed market. At this time, capital for private equity was quite scarce and these trusts represented a meaningful source of funding for an industry operating at a relatively small scale. The first crop of private equity investment trusts included Pantheon, Candover, Graphite, Electra and HyCapital.

The growth of institutional allocations to private equity, however, ensured that the limited partnership became the dominant private equity structure and it was not until more recently that general partners began to think seriously about raising capital in public markets.

This development reflects the growing prominence of leading private equity fund-manager brands, which may have broadened the appeal of private equity to non-traditional investors. It may also, in part, reflect acknowledgement of the expected decline of defined benefit pension schemes as a source of capital for the industry in the longer term, and the commensurate growth of defined contribution schemes. These cannot easily invest in traditional Limited Partner structures because there is no ability to mark such interests to market.

Recent years have also witnessed the listing of management companies such as Fortress and Blackstone. It seems likely that other managers will come to the market, but in all probability this route will be suitable only for the largest groups, with the most visible brands and which have also diversified their revenue streams.

The extraordinary long-term success of the listed private equity market notwithstanding, there remains an inherent tension between the benefits of having a permanent pool of capital and the burden of managing a publicly-listed vehicle in a market that, for its effectiveness and by definition, depends in part on keeping certain information private.

Development of the European secondary market

The explosive growth of private equity investment in the 1980s attracted a broad constituency of new investors. Some of these groups subsequently found the fixed life of a traditional limited partnership fund was not sufficiently flexible to meet their strategic or liquidity requirements.

In consequence, a market for secondary sales of private equity funds soon developed, beginning in the US with the formation of the Venture Capital Fund of America. GT Investment Company (now Pantheon Ventures) completed one of the first European purchases of a secondary interest in 1986. This was followed in 1987 by the formation of the first European private equity secondary fund of funds, GT Venture Investment Company plc, a quoted vehicle now known as Pantheon International Participations plc. However, it was not until the 1990s that the European secondary market really began to take off, with the creation of a number of dedicated secondary funds, including those of Coller Capital, HarbourVest, Landmark, Pantheon and Paul Capital.

As the secondary market has matured, a diversity of transaction types and vendors has developed. Initially, the majority of secondary transactions consisted of either an interest in a single fund or a portfolio of fund interests. To parcel fund interests with other assets, such as direct company interests, was a natural progression, and deals of this type became more prevalent from the mid-1990s onwards.

More recent evolution has resulted in early secondaries, secondary directs, spin-outs and buy-ins, and stapled secondaries. The process of innovation in the secondary market continues, giving rise to more complicated structures such as transfers of economic interest and new mechanisms that enable vendors to retain a stake in the upside of the assets being transferred.

Institutional investors are becoming more comfortable with the concept of the transfer of private equity assets – any stigma that may once have attached to a secondary sale has long since evaporated. Secondary divestment is now acknowledged as a proactive tool for portfolio management rather than as the last resort of a troubled institution or a reflection of a fundamental flaw in the quality of the assets being divested.

In many cases, private equity can provide companies with a better form of ownership than public equity, yet the asset class still accounts for a relatively small proportion of global enterprise value. Despite the ups and downs of private equity cycles, there remains plenty of room for growth.
Individual investors

There are increasing opportunities for individual investors to get involved in private equity deals. Andrew Cave looks at Private Equity Investment Trusts and other specialist vehicles, such as Hotbed and Pi Capital, which make it possible for individuals to participate directly in some of the best private equity opportunities.

Venture capital comes in many shapes and sizes and a key development in recent years has been the establishment of organisations and vehicles that allow individual investors to participate directly in some of the best private equity opportunities.

Private Equity Investment Trusts (PEITs), which are traded on the London Stock Exchange, are a good example. First launched in the 1970s, PEITs enable individuals to invest, alongside institutions, in a portfolio of mainly unlisted companies selected by a single manager. Alternatively, they can invest in a fund of funds PEIT, which invests in a portfolio of direct investment funds, or indeed a hybrid of the two approaches. You do not have to be wealthy either – investors can get involved for as little as the price of a share.

The market capitalisation of London-listed PEITs, which include investment companies operated by the likes of Dunedin Capital, Electra Private Equity, F&C, Graphite and HgCapital, is estimated to be about £10 billion. Returns have been good too – even excluding 3i, the sector has enjoyed an increase over ten years of 223 per cent in share price total returns, compared to 82 per cent for the FTSE All Share Index.

“Investors are attracted to PEITs because their historical performance has been strong, because they give access to a large part of the economy that is otherwise closed to most investors and because investments in PEITs are liquid and easy to administer,” says William Eccles, a Senior Partner at Graphite Capital, which manages Graphite Enterprise Trust. “They are also seen as important tools in portfolio diversification.”

Each of the 20 listed PEITs – like each private equity firm – has its own investment strategy, which may be dictated by geography, size and type of investment and so on.

One notable deal involving a PEIT was the £17 million management buy-out of paper diary company Letts in 2000, a time when the sector was deeply unfashionable. Dunedin Capital provided the funding on that occasion and subsequently backed the acquisition of Filofax. The combined firm, known as Letts Filofax, has since become the market leader in branded diaries, supplying 40 per cent of all such products sold in the UK and exporting to more than 75 countries. The business was sold for £45 million in 2006.

The Electra Private Equity-led £98.3 million buy-out of safety equipment group CSG in 1998 was similarly successful. With Electra’s backing, CSG evolved from a company with a regional focus into an international business with two global brands. The investment trust was also able to introduce CSG to another of its portfolio companies, which used the company’s electronic identification system in its own products. In 2007, by which stage CSG had become a world leader in height safety equipment for industries such as oil and gas and construction, Electra Private Equity sold its shareholding for more than £280 million. Proceeds from the sale of assets are distributed to the trusts for reinvestment, rather than to investors. For this reason, holding
shares in PEITs is seen as a long-term investment and less suited to frequent trading.

Despite the uncertain beginning to 2008, Eccles believes the sector will continue to perform well. “Most PEIT managers have been operating for the past 25 years and we have learnt a great deal in all market conditions,” he says. “This experience should serve PEITs well for the next 25 years.”

Specialist investment vehicles such as Hotbed and Pi Capital are also meeting an increased demand from private investors for alternative investments, as they search for enhanced returns.

With the 2006 relaxation of pension rules, individual investors are now able to consider alternative assets as part of their pension portfolio. Research by Hotbed suggests that an increasing number of private client portfolios allocate about 20 per cent of their investments to private equity.

Such clients are normally experienced investors and may not wish to lock their capital into pooled funds over which they have no control. However, they also often do not have the time to seek out direct investment opportunities or to manage their investments personally.

Hotbed, set up in 2002 by Chief Executive Gary Robins, a former Investment Director at 3i, is the UK’s biggest private investor network. Its 600 high net worth members, mostly in their mid-50s with an average of £1 million each to invest, have invested £127 million in 36 private equity and commercial property deals. It sets out from the start to differentiate itself from business angel networks by appealing to what it identified as “passive” private investors, who have capital to invest, but neither the time nor inclination to become closely involved with the operation of their investments.

Robins says Hotbed’s investment opportunities originate through relationships its team has built up with other professionals throughout the UK and are mostly unavailable to private investors through other channels.

Members decide individually whether to invest, on a case-by-case basis, and Hotbed does the rest of the work – agreeing a clear exit plan, structuring and executing the deal, working with management to increase shareholder or asset value, and regularly reporting back to participating clients.

“The average return is consistently higher than on conventional assets and it’s a fun investment,” says Robins. “I think it’s even more interesting for private investors where they are able to select their own specific companies and build their own portfolios, rather than have a fund manager do the investing for them. But it’s not for the faint hearted or for people who don’t know what they’re doing.”

As well as participating directly in transactions, Hotbed’s members can invest in three Hotbed funds, including Parallel Private Equity, which invests alongside 3i and Barclays Private Equity in European buy-outs.

Pi Capital, meanwhile, was set up in 1998, but took its current form as a private investment club in 2002, when it was bought by Chief Executive David Giampaolo and other investors. It has more than 300 high net worth members, said to include Marks & Spencer Chief Executive Sir Martin Sorrell, Lastminute.com Co-founder Brent Hoberman and Alchemy Partners Managing Partner Jon Moulton.

“We focus on growth equity opportunities, but we do not do seed capital,” says Giampaolo. “We don’t raise money for companies. We invest in companies. We set up special investment vehicles to invest in companies and then invite our members to subscribe to take part on an opt-in basis. On average, between 40-60 investors participate in each deal we do.”

Giampaolo says there are important differences between a private investment club like Pi and a conventional venture capital or private equity fund. While funds are protected by the portfolio approach so that losses from some investments are offset by gains on others, Pi’s members subscribe for investments on a case-by-case basis. If the company they invest in fails, they lose their entire capital.

Giampaolo says this happens in an average of two of every ten companies Pi invests in. However, it has a high success rate in investments it makes alongside the likes of Alchemy Partners, Englefield Capital and BC Partners. Its best exit to date has been in biosciences firm Cosart, which produced a five-fold return, and Giampaolo says one investment in Pi’s current portfolio is very likely to surpass that.

On average, Pi takes a stake of between 25 and 40 per cent in direct investments and nominal levels in larger buy-outs in which it participates.
Giampaolo believes Pi can be more flexible on time limits than some traditional funds that are tied into fund cycles. He says there are some investments in its current portfolio, for example, that have made excellent progress that could be realised now, but it has decided to wait to exit because the businesses are still growing rapidly.

Pi has been averaging four deals a year, but recently sold a 19.9 per cent stake in itself to Bank of Scotland in a deal that involves access to a significant number of the investments made by the bank’s growth equity and integrated financing operations. Pi is also diversifying and recently secured its second property transaction. Memberships are still being taken by referrals, but Giampaolo says the club will be limited to 400-500 individuals.

Whether individual investors are motivated by this feeling of being part of a ‘club’, the chance to build their own portfolio or simply the returns on offer, the success of vehicles like Pi and Hotbed suggest this form of investment, like PEITs, is set to be a permanent and growing part of the private equity landscape.
The funding treadmill

The structure of the private equity industry is in many ways dictated by the ten-year life of funds and the need to deliver performance to raise new capital. Is this a necessary discipline or a source of inefficiency? Is permanent capital the answer? Joanne Hart reports

Private equity has been dominated by one particular style of funding for decades. It is relatively simple, relatively straightforward and relatively successful. Firms approach investors for ten-year money and spend roughly five years investing and five years divesting.

The model was conceived because the industry felt it needed this amount of time to make capital work effectively. But money starts running out after a few years, so most firms try and replenish their stocks every three or four years.

General partners are constantly aware of how much money they have in the pot, how much they might need in the future and where they might find that new capital. This pressure to deliver the returns that make their firms look attractive and make limited partners keen to invest in them.

But a number of general and limited partners feel the limited lifetime fund structure can lead to bad decision-making – if they are in fundraising mode, for instance, they may make exits unwisely.

This pressure has been particularly acute recently. Limited partners have been looking for returns and this has encouraged private equity firms to do deals. As a result, there is a feeling among some in the industry that certain deals should not have been done and may not have been done if the funding cycle were different.

This is a view held by Jacques Callaghan of Hawkpoint. “It is possible more value could be created for investors if companies did not have to be sold at particular times during the funding cycle to show potential investors that returns can be made,” he says.

Fundraising is also a lengthy and time-consuming process. As the private equity market has become more crowded and the search for returns has become more intense, investors have become more demanding – they are providing firms with ten-year money so they want to make sure that it is going to the right home.

Permira, for example, held 500 meetings over six months for its most recent fund, which raised €11 billion and has 180 investors. “They all had access to our senior managers and to detailed information on every single company we own,” says Chris Davison, the firm’s Director of Communications. “It is a slightly protracted process, but it provides transparency and comfort for investors.”

Some firms argue that the funding cycle imposes a discipline on the private equity industry that actively contributes to its success. “The ten-year model works. It keeps you on your toes and helps ensure that the good firms prosper and the not so good ones struggle,” says one general partner.

This seems logical and it encourages firms to focus on effective and pro-active communication with investors. “Our view of investor relations is that it should be a continuous affair. You are fundraising the whole time, which makes it far less transactional and far more long-term,” says Paul Marson-Smith, Chief Executive of Gresham.

As the industry matures, however, other options are appearing. Some firms have chosen to list and gain access to permanent capital in that way.

American Capital, for example, has based its entire model around a full listing. The NASDAQ-listed firm, a member of the S&P 500, has spawned an offshoot, European Capital, which operates using the same structure. Both businesses are regarded as successful and American Capital, with $20 billion in capital resources under management, is one of the largest providers of capital on the private equity landscape.

Others have meanwhile used a listing to provide an additional source of capital – Blackstone listed on the New York Stock Exchange in June 2007, raising $4.1 billion in the process, while Kohlberg Kravis Roberts has been preparing for an IPO since last summer.

While a listing is clearly an interesting option, it requires favourable market conditions and is principally open to large funds with such established track records that investors will be prepared to back them in this mode.

In a related development, meanwhile, the London Stock Exchange (LSE) seems to have endorsed the idea of investment vehicles for professional asset managers, with the creation in late 2007 of the Specialist Fund Market.
This is intended for highly specialised investment entities that wish to target institutional, professional and highly knowledgeable investors only. The LSE hopes that it will appeal to a variety of different types of investment managers, including those managing private equity funds seeking admission to a public market in London.

Some firms, such as Alchemy, have opted to create an entirely new structure, offering investors the chance to put £5 million or more into a fund with a £400 million annual capacity. Investments are made on an annual basis and there is a 12-month notice period from Alchemy or its limited partners.

“This is simple and easy to understand. Investors were after a fairer model and this structure offers fees that are lower than the traditional funds, but without any of their hurdles. You can get out any time you feel like it and the arrangement goes through to 2047,” says Jon Moulton, Managing Partner at Alchemy.

A couple of firms in the UK and the US have copied the Alchemy model. Others have opted for so-called evergreen funds, which, as their name suggests, do not have a limited lifespan.

These vehicles work well, practitioners say, provided there is a functioning secondary market. Six or seven years ago, if limited partners wanted to sell their exposure to a fund, they would have to accept a discount of 30 to 40 per cent. Now the situation is more developed. When conditions are stable, investors in good quality funds can sell their holdings quickly and at a premium.

Some private equity advisers believe the traditional ten-year funding model will come under increasing pressure as the broader economic environment changes.

“The competitive landscape has created multiple compression and that has forced firms to focus on performance enhancement of their portfolio companies. As that takes longer, the average holding period should get longer, so having the flexibility to circumvent fundraising cycles would be helpful,” says Hawkpoint’s Callaghan.

The private equity industry tends to say that portfolio companies are held for between three and five years. In the past few years, however, holding periods have come down to between two and three years in many cases, as firms sought to take advantage of the benign economic cycle. If firms now find themselves obliged to hold onto their investments for longer, to achieve the returns demanded by their limited partners, they may begin to regard the ten-year funding model as a hindrance.

“It is particularly challenging for the last asset in a fund. You have to make sure it is acquired in the first five years or you may pop up against the end of the fund. The key point is that most firms could return more value most of the time, if they were not under pressure to sell,” says one private equity adviser.

Although most industry participants believe the ten-year funding model will continue to play a dominant role, there is a feeling nevertheless that we are now entering a new era. While up to 90 per cent of investors are still putting their money into private equity for ten years, it can be very difficult to raise money within this framework. Some firms may ultimately be forced to do things differently.
The early days

The UK’s private equity industry may be thriving now, but 25 years ago it was a struggle to get investors interested in the sector. Sir Ronald Cohen, Founder of Apax Partners, details the persistence of the country’s first venture capitalists and the key role played by the early Chairmen of the BVCA.

The roots of the industry

The first modern venture capitalist was probably General Georges Doriot, who was a visiting lecturer at Harvard Business School when I was there. He had been responsible for an investment of US$70,000 to help launch DEC back in 1959. DEC floated in 1968 at a valuation of US$125 million. Doriot’s firm, American Research and Development, made an annualised return on its investment in excess of 100 per cent: it doubled its money each year.

It was among innovative companies such as DEC that the US turned out to have crucial advantages over Europe. One advantage was in education, especially in the area of new technology. A second was in the business culture, which admired success in business, welcomed innovation and encouraged competition and risk-taking. A third was in easy access to capital. Start-ups and early stage companies in the US were soon to find backers in the growing community of venture capital investors, and among institutional as well as individual investors in the shares traded on the NASDAQ stock market, which was created in 1970.

My first move into this area was with a company called MMG. It had its origins in a Harvard Business School project written in 1970 by one of my partners, Maurice Tchénio. Maurice was a brilliant student – top of the class, a Baker Scholar – who graduated with high distinction. His paper was, in effect, a draft business plan for MMG, the name of which he had coined. We launched MMG to provide advisory services to entrepreneurial companies. One of my colleagues was going to be based in his home town, Chicago, two were going back to Paris and I would be in London.

We tried to think out of the box. In the first year of our professional partnership, 1972, we considered what would have been one of the first private equity buy-outs in Europe, of the French crane manufacturer Potain. For the deal to make financial sense, the equity investment had to be leveraged with a significant amount of debt (just as one mixes equity and debt when one raises a mortgage to buy a house).

But in those days it proved impossible to raise the necessary debt for that kind of a transaction. We had the idea, but not the means. We were a decade too early. We made little progress and when, as a result, two of the founding partners indicated that they wanted to drop out of MMG, and Maurice Tchénio told me that he would prefer to operate more independently, I knew that in order to reverse the difficult turn of events I needed to find a new partner in New York. Whom did I know in New York who could replace our departing partner? Alan Patricof.
I had met Alan a couple of years previously and we had got on extremely well. He was one of the pioneers of American venture capital. He had set out a few years before me, in 1969, when he raised a $2.5 million fund from wealthy individuals in the US. Among his investors were two leading figures in American business, Bob Sarnoff and Edgar Bronfman.

He had also set up a corporate finance advisory business to supplement the revenues of his venture fund. I telephoned Alan and made him an offer. “Our Chicago-based partner is leaving. If you want to become our partner, we could help you in corporate finance in the US and you could help us to bring venture capital to Europe.”

Alan is the most careful of people; he does not often make commitments on the phone. But on this occasion he immediately said yes. We soon agreed on a fee-sharing arrangement for the corporate finance business we would do initially, and the deal was done.

MMG continued as an advisory business, with a New York office for which Alan was responsible. Our London office was to become the British arm of the expanded private equity firm, Alan Patricof Associates, when we raised our first venture capital fund in 1981.

The French office, under Maurice Tchénio, likewise used the Alan Patricof name when it raised its first venture capital fund in 1983. The names MMG and Alan Patricof Associates co-existed for some years, then we changed the name to MMG Patricof and finally, in 1991, as the firm expanded geographically and we felt the need to create a unified, international brand, the name in Europe was changed to Apax Partners.

With the benefit of Alan Patricof’s example in the US, we set our sights on being venture capital investors. But since there was no venture capital industry in Europe, and since none of the financial institutions, whether they were investment funds, lending banks or since none of the financial institutions really knew anything about early stage businesses or buy-outs, we found that we had to get the venture capital industry going ourselves.
investment banks, really knew anything about early stage businesses or buy-outs, we found that we had to get the venture capital industry going ourselves.

In this respect we were no different from many of the current generation of entrepreneurs who start new firms in a new industry: you find that considerable effort is needed to build up the sector at the same time as you build up your firm. A lot of my energy went into making the case for venture capital. Some of my colleagues thought it was a waste of my time. But I did not think we could be successful without this effort.

I was not the only one to realise it: some of our competitors recognised the same necessity. Among those who were very active in those early years were Michael Stoddart of Electra; Sir David Cooksey, Tony Lorenz, Colin Clive and Lionel Anthony, who were Chairman of the BVCA; Dick Onians, who was Chairman of the European Venture Capital Association; Roger Brooke of Candover; and Nick Ferguson of Schroder Ventures.

We organised meetings where we could pitch the case for venture capital to prospective investors. The first such meeting was held in London, at the Grosvenor House Hotel, in 1977. William Casey, the Head of the Securities and Exchange Commission, which regulates US stock exchanges, spoke. He had been invited by Alan Patricof, who was also a speaker.

Leading financial institutions came, but nobody was really interested in investing in small businesses. Private equity, venture capital, small-company investments: these were not on the agenda at that time.

We persisted nevertheless, and in the early 1980s we organised annual forums in hotel conference halls at each of which about 30 entrepreneurs would stand up one after another to expound, in four minutes each, the virtues of their businesses to potential investors. We began to create a feeling that perhaps there were worthwhile entrepreneurs and ventures in Britain after all.
The roots of the industry

25 years of the BVCA and the private equity industry

Sir David Cooksey, Founder of Advent Venture Partners, looks back at the early days of the industry and analyses its evolution over the last 25 years

The early 1980s saw the birth of a truly British venture capital industry. Until then, some UK-based funds invested almost exclusively in the US, typically Abingworth and Thompson Clive, while 3i (in its former guise of ICFC) mostly lent money in the UK to small companies on a long-term basis, but usually secured against the companies’ assets.

Other firms, such as Electra and Charterhouse, were well established, providing development capital to more mature companies, but there was nothing in the UK or continental Europe to match the equity financing for emerging technology-based companies that the US venture capital industry provided at that time.

It was a golden age for venture capital, with the developments in semiconductors, rotating magnetic memories and new software operating systems enabling the advent of micro computers and so on. Meanwhile, developments in microbiology provided the driving force behind new biotech companies. In every case, new entrants to the computing, telecoms and healthcare industries grasped the opportunities to dramatically reduce cost and improve functionality simultaneously.

Many established businesses struggled to embrace this rapid change and found that they could not compete. The result was the explosive growth of many recently-formed companies, many of which migrated to the NASDAQ stock market for their further funding requirements.

In the UK, several venture capital firms were formed to invest locally and by the end of 1981 there were about ten such firms in London. They were a mix of independents, such as Advent and Alan Patricof Associates (now Apax Partners), while Electra and ECI were experimenting with early stage equity investment, and there were captives, such as Citicorp Venture Capital (later spun off as CVC). Abingworth and Thompson Clive started to invest in Europe as well.

We all had much to learn from each other and the general partners of these firms met about six times a year for lunch, as the Venture Capital Lunch Club. Electra always provided the best hospitality and we would meet there as often as we could.

In the UK, several venture capital firms were formed to invest locally and by the end of 1981 there were about ten such firms in London.

All of this took place against a rapidly evolving economic backdrop, with Margaret Thatcher’s rise to power and the free market politics that she promoted making the UK a much more competitive place to do business. Venture capital was perceived to be a flag carrier for this new culture and many leading investment institutions decided to back the fledgling venture capital firms. Even the Bank of England helped the industry promote its cause because it saw the industry filling a void in the financing of dynamic small firms.

The culture was further stimulated by the London Stock Exchange’s introduction of the Unlisted Securities Market (USM), a stock market expressly designed to cater for smaller companies undergoing rapid growth. The intention was to emulate NASDAQ in the US, but the growth rates of the companies never compared to the US model. The USM later failed in the recession of the early 1990s, due to a lack of liquidity.

Nevertheless, the leading participants felt that their activities were having a substantial impact on the financing framework for small firms and that their Venture Capital Lunch Club should be reformulated as the British Venture Capital Association. The purpose was to provide a representative body to bring together the entire industry and to act as a lobby organisation when appropriate. I became the first Chairman and the first council members included Sir Ronald Cohen of Apax Partners, Tony Lorenz of EC and Colin Clive of Thompson Clive.

Most of the venture capitalists set out to finance businesses using the US model, which involved the exploitation of innovative technologies. They would seek to identify the sources of those technologies either already being exploited by a company or, more likely, residing at a university laboratory. In the latter case it would be necessary to form a company in which to spin out the technology.

British universities obtained the vast bulk of their funding from the Government, and most university professors at that time believed that involvement with business somehow demeaned the standing of their research. But others – seeing some of the extraordinary...
developments around Harvard, MIT and Stanford universities in the US – decided that the time had come to be much more open to involvement with business. This trend was further stimulated when the Government terminated the automatic ownership by the National Research & Development Corporation of intellectual property emerging from Government-financed research at the universities in 1985.

Over the past 20 years a series of measures has followed to encourage collaboration between universities and business. Many universities have developed competent technology transfer organisations and much more spin-out activity has followed. Many successful companies have been formed, particularly in the information technology, telecommunication, media and life sciences industries. As a result, Britain has managed to hold its own in the knowledge-based industries, whereas it had been failing badly 25 years ago. Even the professors, who 25 years ago were often disparaging about the quality of British management, now gladly participate in this process.

This is a high-risk process and there is fierce competition around the world in the high-tech industries. British venture capitalists have found it difficult to identify and grow successful technology-based businesses, often because our home market is too unresponsive or simply too small for the companies to succeed. There have been outstanding successes, but there have been too few of them and the industry has failed to consistently produce the high rates of return expected of it.

This caused many of those who started as pure venture capitalists to turn their attention to more mature companies. The result was venture capital broadening to private equity, with much buy-out activity starting in the mid-1980s. Since then, buy-out activity has burgeoned, embracing every part of the economy with very beneficial effect in terms of improving the performance of underperforming companies and the much more efficient use of capital to finance them. As buy-outs have grown and grown, private equity has moved from being an alternative asset to being a mainstream asset class. And it has attracted much more media and union attention, too.

London has developed as a European capital of private equity and the role of the BVCA has grown with the growth in the industry. The BVCA’s standing and influence is a tribute both to those who had the original vision, and to those who have ensured it remains an effective mouthpiece for a very important sector of the financial services industry.
The roots of the industry

The role of 3i

Baroness Sarah Hogg, Chairman, 3i, looks at the growth of the company and the industry over the past 25 years

At about the same time as the BVCA was launched, a pioneering private equity business – with the very catchy name of the Industrial and Commercial Finance Corporation (ICFC) – was going through one of its periodic transformations. ICFC, by then 40 years old, underwent a massive change programme in the early 1980s under the leadership of Jon Foulds, who later went on to chair and float the Halifax Building Society.

That was when the ‘3i’ name was born. This re-branding of the business was integral to its ambition: to capitalise on a wave of entrepreneurialism in the UK. But the ambition was broader than that: to deploy 3i’s skills across Europe, to accelerate the development of buy-outs and to make 3i an international name in financial services. In many ways, these aims mirrored those of the BVCA, as it sought to promote the UK private equity industry.

With shareholders’ funds of £461 million, the management at 3i also wanted to float the company – gaining independence from the clearing banks that had put up the original £10 million to found the business and still owned it.

Today, funds under management are more than £8 billion, approximately 60 per cent of 3i’s assets are outside the UK, and, as a member of the FTSE 100 since 1994, 3i has become recognised throughout the financial services world. In the past 25 years, 3i and the private equity industry have both changed enormously. At times, 3i has led, as in its redevelopment of growth capital, infrastructure and its Asian strategy, its people programmes, its use of quoted markets and its approach to public accountability. But sometimes, too – as in the early part of this decade – 3i has felt the sting of competition and has had to transform itself to regain its position, recharge its performance and transform remuneration to attract the best private equity investors around the world.

Naturally, having started life as an economist, I am all in favour of competition. In private equity, as elsewhere, it has helped to grow the market and improve the products or services on offer. The rapid growth of the industry and the number of competitors in the market have stimulated innovation in buy-outs and growth capital, and most recently in the application of private equity skills to infrastructure assets and quoted markets. And it is a further compliment to 3i that today a number of our competitors, such as Bridgepoint, Barclays Private Equity and Charterhouse, have been led by 3i alumni.

The acceleration of the move towards the management of external funds in the 1990s was another classic example of increased competition growing a market. The development of the European buy-out industry has clearly been dependent upon it, so, today, is the growth of the market in Asia. Globalisation has provided a further stimulus to growth, as well as creating the need for a different style of management within private equity firms. The challenges of running multi-country operations, dealing with different cultures and markets at varying stages of maturity, played to 3i’s strengths. The emphasis on ‘The best team for the job’ and a ‘One room,
One firm’s approach have enabled 3i to capitalise on the diversity of talent inside and outside the company.

Communications technology has played a major role in the growth of the industry and its internationalisation, as well as its ability to transact at an operational level. The speed with which our Asian business has grown would have been impossible with those early 1980s phones and faxes. However, some ‘old technology’ has served us well – notably, our permanent capital that has enabled us to enter markets before raising funds specific to them. It has also been very clear that our FTSE 100 status, the 3i brand and our reputation for transparency and good governance have helped considerably.

We have recently celebrated our tenth anniversary in Asia and, rather fittingly, ten per cent of our assets are now in this region. We are learning much from the process of our rapid development there, and gaining greater benefit for our European and US portfolio companies from our Asian presence than we had anticipated.

In 2008 we will also be celebrating our 25th year in continental Europe. This market today represents approximately 40 per cent of our portfolio and has been a key driver of returns and growth. Its development has also taught us much in terms of organisation and managing cultural diversity both within and outside of 3i. Building a truly sustainable international business depends so much on how people interact and support each other.

So much has changed over the past 25 years; but not our values or our belief in the importance of investing in relationships. It is these that I believe have enabled 3i to deal with the challenges of economic cycles and the changes in the competitive landscape.

As this book goes to print, the economic climate looks more uncertain than for some time, and the industry has been in the political spotlight. However, it is the challenging times that have led to the greatest innovation.
Enterprising spirit

Venture capital is still the toughest part of the business to get right, says Anne Glover OBE, CEO and Co-founder, Amadeus Capital Partners

The venture business in Europe has seen more volatility in its development over the last 25 years than any other segment of private equity.

Following the success of a still-young industry in the US, Sofinnova was founded as the first venture capital company in France in the 1970s. This was followed in the early 1980s, at the time of the personal computing boom, by a group of firms in the UK and continental Europe founded, for the most part, by people with some US business experience or education.

These pioneering firms, which included Advent, Alan Patricof Associates, Thompson Clive and ECI, backed early stage companies, only some of which were technology-related – venture capital has only become closely associated with technology investment in Europe since the mid-1990s.

Venture investing in the early days was local and very hands-on, not least because good managers were hard to find in Europe. The advent of secondary markets, the Unlisted Securities Market in the UK and Second Marché in France, stimulated the business by providing an exit route alongside NASDAQ.

Early successes included HATT’S RACAL Millicom, which owned the Vodafone franchise and was sold for £35.6 million in 1987, and ComputaCenter, which floated on the London Stock Exchange in May 1998. But in spite of such successes, Europe failed to gain the traction of the US. Investments tended to be locally focused and local European markets lacked the scale and homogeneity of the US market, which resulted in fewer large exits and lower overall returns.

The late 1980s saw an increase in continental European deals and the advent of the buy-out to Europe. In 1987, established firms were raising their third funds and by 1989, the number of buy-outs exceeded venture financings and deals were increasingly cross-border, with or without syndication.

Recession in the early 1990s brought the first buy-out boom to an end, but both the boom and the fallout affected venture capital, as funding had shifted to later stage companies and the contraction affected virtually all segments. A notable exception was biotechnology, a sector that produced a cluster of high-profile IPOs and trade sales, including Shire, Scotia and Biosimilars.

Similarly high-profile and global IT companies did not achieve scale until the mid-1990s and the beginning of the Internet explosion, which was triggered by the IPO of Netscape in 1995. Initially, few realised just how critical a phenomenon for business and consumer communication the Internet was. By 2000, this area attracted plenty of interest and prodigious quantities of money – representing 90 per cent of the total capital raised for IT in the previous 20 years – but in this initial phase, only a few profitable business models emerged. Sadly, many potentially viable young companies were washed away or forced to hibernate until the downturn was over.
The internet boom also stimulated the creation of many new venture firms in Europe. A number of those disappeared in the wake of 2001-2002, but a small group of home-grown and US entrants, who had backed successful companies in the late 1990s and invested in broad portfolios, survived and are the core of the resurgence in ventures we are seeing in Europe today.

Although some successful companies, like Lastminute and Kelkoo, weathered the storm of the dotcom and telecoms crash, the venture sector suffered severely. The track record of Europe’s ventures was too small and too limited to outweigh the excesses of 1999-2001, and it took exits such as CSR and Skype for confidence to return.

What we now see is that the firms that have come through this period, much as those that backed biotech in the 1990s, have a real commitment to supporting young and growing technology companies. Much of our business is no longer just about start-ups, though of course they remain an essential component, but about seeing companies through several years of growth with several rounds of finance and support on all fronts.

What has also changed is that technology is now completely global and it does not matter where a company is founded, where its investors are based or into which markets it sells products or services. This means that the US, with its large indigenous market – long an advantage – no longer has an automatic lead in building successful technology companies.

Furthermore, with a number of billion-dollar companies established in Europe, we have no problem today attracting the best managers from anywhere in the world into our young businesses.

The growth of successful venture investing globally will inevitably encounter further ups and downs because the enthusiasm with which founders, entrepreneurs and funders take to new technologies is not always adopted by the market, at least until a first wave beds down, and inevitably after some failures. Web 2.0 and cleantech may be today’s hot areas, though both are undoubtedly here to stay. What we have learned is that new opportunities always emerge from change and absolute levels of entrepreneurship and venture investment in the UK have systematically increased as global barriers have come down.

The environment for enterprise today is better than ever before. The social status of the entrepreneur this side of the Atlantic has risen; there is wide recognition that multiple talents are required to build successful businesses and we now see real collaboration, Silicon Valley-style, between technologists, entrepreneurs, managers and financiers. The fiscal environment since 2000 has improved for founders and owners of businesses – and let us hope that the UK remains competitive on the global stage in this respect.

The standing the UK and Europe have achieved in the creation of innovative businesses will, however, be challenged in the coming years by the emergence of China and India, as well as by the US. Levels of competition for technological excellence and development are greater than at any time in the past 25 years, so we need continuously to raise our game.
The wider business community has looked at the success of the private equity sector in recent years with a mixture of envy and admiration. Business people have envied a corporate governance model that allows executives to concentrate on the job in hand, without too many distractions from City analysts, regulators and the media, and which offers large rewards for success.

And they have admired the results that have often followed, in the shape of business turn-arounds, strategic expansion and growth. This success has had an impact on the way publicly listed companies are managed. For example, a number of PLCs have placed a greater focus on the efficient allocation of capital, and have attempted to get more alignment between the interests of managers and shareholders. In the case of some big, publicly-owned companies, the growth of shareholder activism has added an extra push in the same direction.

But this admiration has been tempered by the knowledge that business conditions have been just about ideal for private equity houses in recent years. Very low interest rates, a plentiful supply of credit, rising asset prices, macroeconomic stability – these have been exceptional times for raising substantial sums of capital, and for generating very large returns.

The big question has been about how much these returns have been to do with management skill, and how much to do with the favourable economic cycle. Academic studies show that the larger part of private equity returns over time has been a result of good management as opposed to financial engineering. But as acquisition prices and debt leverage have both risen in recent years, the question has inevitably gained more force.

We are now about to discover the answer. Credit conditions have changed dramatically for the worse since the summer of 2007. As a result, the spread between the yield on low- and high-risk debt – which had become unusually compressed – has widened sharply. The large European economies are faltering, and the US faces the possibility of a recession.

So these are going to be much more testing times. There are two particular challenges for private equity. One is that loans become harder to secure at a time when banks faced difficulties in distributing the debt they underwrite to other investors, such as pension or hedge funds.

The other is that the one big advantage that public equity has over private – greater liquidity in the secondary market – becomes more valuable in tougher times. Moreover, it would be a mistake to assume that the sector’s political enemies will become less aggressive in these changed economic circumstances. The same voices that so noisily condemned the profitability of private equity houses will be just as quick to pick on any bad publicity from the business problems that could emerge in an economic slowdown. In these circumstances, As The Economist argued last year: “Perhaps the greatest threat to the continued growth of private equity is regulation.” It concluded that: “The new kings of capitalism must try to prevent this from happening by showing that they really are a force for good.”

The sector is well-placed to respond to this challenge. For one thing, private equity firms have substantial amounts of capital at their disposal, and continue to raise large sums of new money. So if they need to, they have plenty of cash to support investments that might run into difficulties.

For another, the success of the sector has meant that the repayment terms on its loans have generally become much less onerous than in past business cycles. Repayment of principal is often delayed for a good number of years, which means that firms have more time to put things in order if one of their investments hits trouble.

At the same time, there will still be plenty of investment opportunities in these tougher economic conditions. The mega deals may be over for the time being. But business continues to be brisk at the small to medium-sized end of the market, and is likely to remain so as big, publicly-owned companies adjust their portfolios in response to changing economic circumstances.

Emerging market activities are proving to be very successful for some private equity houses, and distressed debt funds are attracting big inflows. As was shown in the Japanese banking crisis, private equity investment can be the best and sometimes even the only solution for publicly-owned companies that run into serious difficulties. More recently, Northern Rock was attracting interest from this kind of finance at a time when publicly-owned companies were keeping well away.

In addition, private equity firms have been making much greater efforts to explain how this form of corporate ownership has become an increasingly important component of an efficient capital market. As Blackstone’s Stephen Schwarzman told the CBI conference in November 2007: “Private equity’s major innovation is that it blends the best elements of private ownership with public market-sized capital.”

It was not, he acknowledged, the right solution for every company. But it filled a crucial gap in the corporate governance spectrum, and in so doing it challenged all companies to reach a new level of performance.

The BVCA has taken a lead over the past year in presenting private equity in its true light, as a dynamic part of the broad business community rather than a secretive club. At the same time, there will still be plenty of money. So if they need to, they have plenty of cash to support investments that might run into difficulties.

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The view from the NAPF

Pensions funds are increasing their investment in private equity. David Paterson, Head of Corporate Governance at the NAPF, explains why

I once attended a National Association of Pension Funds (NAPF) Investment Conference where the then head of the BVCA spoke about the attractions of venture capital for pension funds. This was a time – before the Myners review in 2001 – when few funds had invested much in the sector, even compared to today’s modest figures.

Returns in the previous few years had not been that impressive, and the conference audience was concerned about high fees and the lack of transparency around reporting and performance measurement. We were assured that the industry was taking steps to address those issues. It is interesting that issues around transparency – albeit to a wider stakeholder group – are still being debated today.

What has also changed in the private equity sector since then has been the sheer scale of the deals, the leverage and the concern about the lack of accountability compared to public equity markets. The calls to take account of the interests of the wider stakeholder group have been addressed by Sir David Walker’s proposals.

For pension funds, the concept of investment diversification has well and truly taken root during this period. Private equity therefore has not been ignored as a potential asset class.

Overall, 55 per cent of assets in defined benefit pension schemes in the NAPF’s Annual Survey 2007 are invested in equities, down from 61 per cent in 2005. A further 29 per cent are in fixed interest assets (up 4 per cent from 2005) and 16 per cent in alternatives and cash (up 2 per cent).

In terms of pension fund investment into private equity, there has been a clear shift – the percentage of schemes that invest in private equity has risen by 5 per cent over the last two years. Private equity now accounts for 1.7 per cent of all assets invested, up from 1 per cent in 2005.

There is also a split between the public and private sector, with more private equity investment from public sector pension funds (2.4 per cent of public sector assets compared with 1.5 per cent of private sector assets).

Pension funds are still most likely to access private equity investment through funds of funds arrangements, with 64 per cent of the pension funds surveyed by the NAPF having adopted this approach, compared to 44 per cent which have wholly or partly invested via a single private equity fund.
Six years on from his review of institutional investment for the Treasury, Paul Myners looks again at private equity as an asset class.

I argued in my review of institutional investment for the Chancellor in March 2001 that private equity had tended to be overlooked as an asset class by UK institutional investors and urged UK pension funds and others to take a greater interest. The points I made then remain valid, particularly the need for the private equity industry to increase disclosure about its activities and performance and for investors to increase their understanding of the relative merits of the public and private equity markets.

Private equity investment can have good and bad outcomes, just like other forms of ownership. The economy benefits from choice as a consequence of diversity of ownership and financing models. This is to be welcomed. Private equity owners can and do make employees redundant, cut back on research and development and default on debt. So do public equity and other forms of commercial ownership, including sole traders, partnerships and family firms. In fact, the similarities between different forms of ownership are far clearer than the differences.

There is little evidence to suggest that private equity poses any economic or systemic risk particular to this form of ownership. I make this assertion notwithstanding the heat generated by intense public scrutiny of private equity’s actions, rewards and governance.

Private equity investment returns vary over time and between different managers, or general partners, and between styles and specialisations. The message here is simple: investors need to show care and skill in the selection of managers, the best of whom produce stellar outcomes. But this is a sector where Alpha identification is critical – Beta is unlikely to be sufficient.

Of late, in the period before the credit crunch made its mark, we saw better relative returns from private equity funds, reflecting benign economic conditions, abundant credit and favourable exit valuations. Over time, investors should expect private equity to produce superior returns to public equity to compensate for the higher risk from private equity’s portfolio concentration, greater use of debt and lack of liquidity.

These superior returns are likely to reflect better oversight of management in investee companies. That private equity has not
Impressions of the industry – the impact of private equity

always, on average, produced returns superior to that of public equity is a source of worry — although I think the general quality of management in private equity has improved significantly over the past ten years, which gives grounds for optimism.

A new feature of private equity that became obvious from 2006 onwards was the emergence of very large private equity funds making offers or proposals to acquire leading publicly quoted companies, lock, stock and barrel.

Private equity appears to have two distinct advantages when bidding for public equity: firstly, its use of debt and secondly, a set of less restrictive governance protocols.

Why can it be that one form of ownership should favour an entirely different level of financing risk and approach to governance from another, given that both forms of ownership work under the same tax regime and are ultimately largely funded by the same beneficial owners, pensions and endowments?

The answer may lie in the second explanation for private equity’s competitive advantage: governance. The direct engagement between the private equity general partner and the investee company promotes much greater confidence and comfort with higher debt levels and implicit increase in equity volatility.

I also think the weight of corporate governance process and focus has promoted an increased risk aversion among the non-executives on many public company boards. This has not always been to the benefit of investors in these companies. And it has certainly led to strategies that private equity has identified as suboptimal and capable of improvement.

Private equity has many positive qualities but, as an investment sub-sector, remains poorly understood and suffers from a negative image. It is in the interests of the private equity industry to make greater efforts to explain the sector’s activities and the performance of the companies in which they invest. Put simply, private equity is more likely to prosper if the industry has a positive image, which will encourage others to invest and deal with it and will not cause alarm to employees, trade unions, suppliers, customers, regulators or legislators.

Sir David Walker’s proposals set a clear map for progress in this respect, a route that wise managers will follow with enthusiasm. To my mind, he could have gone further, but he has made a major and welcome contribution to promoting the cause of private equity. Those who disregard Walker will do so at some risk of seeing restrictions placed on the industry’s licence to operate.

Private equity-owned companies directly employ over 1.1 million people in the UK, with a significant additional number dependent in some way on businesses owned under this model.

Paul Myners is Chairman of Land Securities Group, Guardian Media Group, the Low Pay Commission and Tate, and Advisory Board Member of Englefield Capital. He is also a Member of the Court of the Bank of England.
Private equity and economic performance

Research into the performance of major UK businesses under private equity ownership could pose interesting questions for quoted companies and their boards, writes Sir David Walker.

The evidence appears to suggest that employment in businesses owned by private equity in Europe has grown at a faster rate than in comparable quoted companies.

The guidelines now in place in the UK for large private equity firms and portfolio companies will increase transparency where, until recently, substantial business activity was shrouded from the glare of the public spotlight. The guidelines are both substantial and unique in the world of private equity buy-out activity and the structure now being put in place by the BVCA provides for independent monitoring of the industry’s compliance.

My hope is that the guidelines and the framework of self-regulatory commitment that underpins them will come to be seen as a pragmatic and workable model that has relevance for others, as with the original Takeover Code and, later, the evolution of the ‘London approach’ in banking situations.

Much of the political, media and wider public concern about large-scale buy-out activity focused on how the financial benefits of the large returns generated by private equity are distributed, and the tax regime appropriate to them. These are important issues but, as I conducted my review and the associated consultation process, I have become increasingly concerned at the inadequacy of our understanding of the overall economic impact of large-scale buy-out activity.

Of course, many have views as to how and to what extent private equity generates employment and improves economic performance, but the database is partial and insufficient to support rigorous evidence-based analysis. This matters because, if private equity is indeed more effective in adding real economic value than comparable quoted companies, why should this be so and what lessons might be learned?

This is why I have attached such priority and importance to construction of an authoritative and comprehensive database for the industry and the development of a methodology for analysing how private equity generates often exceptional returns and how its performance compares with that of quoted companies. The need is to find a rigorous way of analysing the weight to be attached respectively to financial leverage, to change in the overall market environment in the relevant business sector, and to improved operational and strategic performance. Inevitably such attribution analysis and the integral comparisons with quoted company performance involve some key subjective judgement, for example the appropriate comparator index for deciding on the weight to be attached to market developments in quoted companies in similar business sectors and geographies.

It should be possible to reduce this subjectivity through the development of a reasonably standardised methodology. The priority for now is to complete development of a rigorous process and to produce results from it in which confidence can be dependably placed in the whole industry.

Substantial work is now in train, building on the review process and research by Ernst and Young, to create a template that should permit completion of an industry-wide, aggregate attribution analysis. It is envisaged that the first report on this work will cover exits by major private equity firms from portfolio companies in the UK over the three-year period 2005-2007, to be continued on a rolling basis for later periods.

On the basis of valuable but limited analyses undertaken so far, the evidence appears to suggest that employment in businesses owned by private equity in Europe has grown at a faster rate than in comparable quoted companies, that both enterprise value and earnings before interest, taxes, depreciation, and amortisation (EBITDA) have grown faster on the basis of similar comparisons with quoted companies and that a large part of the growth in EBITDA came from business expansion.

If the broader-based, industry-wide analyses now in train shows results that are broadly confirmatory of these findings, this should focus attention on major questions for both quoted company boardrooms and for the overall regulatory arrangements that bear on quoted companies.

Specifically, what would quoted companies need to do differently to achieve business performance levels closer to those achieved by private equity? And does the regulatory regime for quoted companies, in particular in relation to their governance arrangements, promote the right balance between the capacity of boards to contribute effectively to corporate strategy alongside discharge of their regulatory and related responsibilities?

These are difficult issues to be addressed, and better data and analysis of the performance of private equity in ownership of major UK businesses, hopefully to become available in the course of this year, should be a major input to the debate.

(The author is a Senior Adviser at Morgan Stanley but is writing in a personal capacity.)
Javier Echarri, Secretary General of the European Private Equity & Venture Capital Association, gives an overview of the way in which the European industry has developed over the past 25 years.

**The BVCA was founded** in the same year as the European Private Equity & Venture Capital Association (EVCA). Together, the two associations have played a major part in promoting and establishing what began in the early 1980s as a new feature on the financial and business landscape in the UK and Europe. EVCA has been closely involved at the European level in all the major discussions and decisions affecting private equity regulation, fundraising and investment over the years, but we could not have succeeded on our own. The 27 national associations in Europe, particularly the BVCA, have played a crucial part in supporting our efforts.

As we now enter the second 25 years of this industry’s development, it is more important than ever that we continue our work together to defend and promote private equity in Europe and beyond. From seed finance through to the largest buy-outs, private equity is now an established asset class in Europe, attracting capital from institutions worldwide, facilitating the creation of new businesses and supporting established businesses to become globally competitive. When EVCA was founded in 1983, we had fewer than 50 member firms. Today, we have more than 1,200 member firms covering Europe’s general partners (GPs) and the major US and international fund managers investing in Europe, as well as affiliated limited partners and intermediaries.

Conscious of the increasing globalisation of our industry, the EVCA and the BVCA are developing stronger ties and working closely with the National Venture Capital Association, the Private Equity Council in the USA, the International Limited Partners Association and national associations in Asia-Pacific and Latin America. In the next few years, I believe we should, in all continents, harmonise our guidelines, data methodologies and self-regulation.

The development of private equity in Europe has not always been smooth. If we have learned anything from the peaks through 1997-2000 and 2004-2007 and the subsequent adjustments, it is that this industry is highly cyclical and its fund managers constantly inventive.
Fundraising success in the early years was driven by ups and downs of local economies. Today, investors around the world follow those fund managers.

In the early and mid-1980s, EVCA and the BVCA spent time and money providing information on what our members did and why, and on educating entrepreneurs, managers and investors.

Today, our main activity is public affairs and communication. The case for investment has been made through long-term performance that has exceeded that of public market indices; entrepreneurship is no longer derided, but lauded – even when it includes a degree of failure; world-class managers join European private equity-backed businesses; and governments understand the industry’s role in their economies, though not always how that role is played.

What are some of the landmarks at a European level since 1983?

The associations have battled successfully in a number of countries, including the UK, Spain and France, for fiscal incentives for owner-managers and for appropriate national and EU regulatory frameworks.

In 1996, leading GPs supported by EVCA established a short-lived pan-European exit market, EASDAQ, following the early success of the Unlisted Securities Market ... the emergence of secondary (and tertiary) buy-outs to provide exits when public markets and trade sales are less accessible.

On self-regulation, EVCA’s first Valuation Guidelines were published in 1993, followed in 2005 by the publication of International Valuation Guidelines, produced together with the BVCA and the French national association – AFIC, which have been adopted by nearly 40 national associations worldwide. Guidelines on corporate governance and reporting have also been published. The current challenge is to find appropriate ways to communicate to wider audiences, while ensuring the efficient functioning of the private equity industry.

Although we have not succeeded in all our campaigns in Europe to avert regulation that might adversely affect the industry’s development (notably the consolidation of financial statements under IAS 27), we have notched up a substantial number of achievements of which I am proud. These include the 1988 European Seed Capital Funds Scheme and other programmes to promote private investment in innovative, technology-based companies; ... Fund Directive of 2003 that allowed pension funds to apply the ‘prudent man’ rule to investment in private equity funds.

In 2006, EVCA was asked to nominate representatives to the EU’s Expert Group exploring the activities of and barriers to success for private equity in Europe. The Group, which included leading EVCA members from the UK and the rest of Europe, reported in June 2007. It argued strongly for – among other things – a common private placement regime across the EU for alternative investment funds. This, when it happens, will be a huge leap forward for the industry and remains a priority. Other expert groups have since been established to review other aspects of the industry.

After 25 years of rapid growth, especially in the past five years where credit has enabled types and sizes of deal never before seen, perceptions of our industry have changed. This is the main challenge facing us all today. Our audiences are wider and more informed. At times, our opponents can be politically-motivated and quite vocal. We have to work hard to turn this round, particularly in a less benign economic environment. With the commitment of our members, the EVCA, BVCA and other national associations can achieve this.
The view from the US

Timothy Spangler, Partner and Chair of the investment funds group at US law firm Kaye Scholer LLP, explains why the British private equity industry matters to America.

Private equity enjoyed – or endured, depending on one’s perspective – enormous public spotlight last year on both sides of the Atlantic.

In many ways, 2007 can be seen as another record year in global private equity. However, challenges to the continued success of the industry remain unaddressed and, going forward, many US firms and observers will be looking to the UK for signs of how to overcome these obstacles.

The relevance of the UK experience to the US private equity industry is clear. The two leading countries for private equity remain the US and the UK, although the history and evolution of the two markets has been different in certain significant respects.

Similar to America, the British private equity industry possesses great breadth and depth. Private equity is now quite a broad church.

The term itself is commonly used to cover numerous investment styles and firms. However, meaningful generalisations are still possible and ‘private equity’ can be broken down into three broad categories: venture capital, buy-out, and turnaround.

Both the US and the UK have produced world-class contenders in each category, although the nature of the domestic market has left its mark on each side of the industry. Many of the same developments – such as the rise of so-called ‘mega funds’ and increased Government concern over the taxation of carried interest – have occurred simultaneously in both countries.

US private equity houses have been increasingly expanding their international operations over recent years, in search of new opportunities to leverage sector specialisations and ensure their ability to compete against global firms for larger deals. When contemplating such expansion, London is a compelling first point of call, both due to the language and legal similarities and the success of private equity investing in the UK over the past two decades. With a London base, many US firms...
can more easily expand to include a European presence, tapping in to the UK’s proximity to these countries. They can also benefit from the strong calibre of international talent on offer in London.

Fortunately – given the strong commercial drivers that lead US firms to establish UK operations – US and UK private equity fund documentation demonstrates a surprising amount of consistency, both intellectually and commercially. This is despite certain local changes to deal with the peculiarities of domestic taxation and historical differences in partnership law. This common base of understanding and practice means that American firms and professionals can look to their British counterparts for examples of how things can be done differently, or better.

Private equity funds, whether British or American, are typically established for similar periods of time – usually for eight to ten years to allow a series of investments into portfolio companies. They are also structured to have monies drawn down from investors over similar timeframes – often three to six years, reflecting the time needed to identify suitable targets and deploy the investor’s capital effectively. In each country, these funds charge a management fee on the committed capital to be able to cover the operating expenses of the firms that are managing the assets of the fund.

The general partner’s true upside in these arrangements has continued to be the carried interest earned on the profits of the fund, designed to create an alignment of interest with limited partners. There have, though, been increasing profits made from management fees.

The US-UK private equity model remains based on a limited partnership structure used to embody commercial and economic arrangements between an investment team (the general partner) and their investors (the limited partners). This model differs fundamentally from the corporate model that has dominated listed and unlisted commercial businesses for over a century.

One driver for the success of American and British private equity firms has been the relative legal and fiscal stability that has predominated over the last decade, thereby fostering the growth and success of these funds.

Private equity has historically been focused on raising investment monies from a limited number of sophisticated institutional investors rather than retail investors. Although the general public still lacks direct access to most private equity funds, their indirect exposure has potentially grown significantly in the past two years, through both the increasing allocation of public and private pensions to the asset class on the one hand, and the increase in publicly-offered opportunities to either participate in funds of funds or take positions in a particular private equity firm itself. The economically rational driver for such exposure increases has been the over-performance of private equity investment compared to investment in the public market.

Many British and American investors, legislators, regulators and tax professionals, however, are now thinking about private equity funds and the industry as a whole. As a result, efforts are underway in both countries to reconsider how private equity firms and funds are regulated and taxed. In the UK, Sir David Walker’s working group has proposed a code of conduct to address concerns about transparency in the private equity markets, consisting of guidelines and recommendations for funds to follow in dealing with their investors and their investments.

In both the US and the UK, the debate over how best to tax the carried interest earned by private equity professionals has been unfolding. The UK announced in October 2007 that all capital gains – including carried interest – would soon be taxed at 18 per cent instead of the former rate of 10 per cent, potentially reducing the country’s attractiveness to private equity funds. In the US, the question of whether it is right and proper to tax carried interest as capital gains is being discussed directly, although at this stage it is unclear whether such a change is politically palatable in a presidential election cycle.

In the post-Sarbanes-Oxley era, governments realise that the unilateral changes that they make with regards to their financial markets can have significant repercussions on their country’s ability to compete internationally in the global economy. In the case of private equity, Americans realise that their chief competitors are the British and any steps taken to resolve perceived problems locally need to be considered in light of the concurrent situation in the UK.

The private equity industry is in the process of charting its next phase of development. The questions on the table include the appropriate level of regulatory oversight and self-regulation, the proper level and method of taxation that funds, investors and sponsors should be subject to, the impact of the recent ‘credit crunch’ on returns and investor appetite for traditional private equity investing; the impact of hedge funds – both positive and negative – on the private equity industry; and many others. For all of these answers, the US will continue to look to the UK for insight, examples of success and alternative ways forward.
Developments and challenges in buy-outs

The buy-out industry’s ownership model – which aims to align the interests of a company’s management and shareholders – is central to its success, says Dr Robert Easton, Chairman of the BVCA’s Global Buy-out Committee and Managing Director at The Carlyle Group.

In 2002, Firth Rixson was a troubled UK manufacturing business listed on the London Stock Exchange. During that year, its share price declined rapidly from 70 pence and despite the best efforts of its management team, the business was unable to reverse its fortunes as a listed company.

But where public market investors saw a business in decline, struggling with an economic downturn, Carlyle saw the opportunity to create real and long-term value. By the time we acquired the business for £106 million in early 2003, Firth’s share price had plunged to less than nine pence. When we announced our tender offer, it represented a 120 per cent premium to the stock market’s valuation. The shareholders were delighted to accept.

Fast forward five years and Firth Rixson is a world leader in aircraft engine component-making, with 11 facilities across the world and contracts with every major aerospace engine manufacturer. Through customer contract wins and the acquisition of complementary businesses, annual sales doubled during our ownership to more than £500 million, while headcount remained stable at around 2,000 employees. As a result, both productivity and profitability soared at Firth Rixson. Oakhill Capital Partners bought the business for £945 million in November 2007.

Having spent seven years driving mergers and acquisitions and corporate strategy in listed companies, followed by seven years at Carlyle, I have seen first hand the different approaches to business management and value creation that the private equity and public market models employ. The transformation that took place at Firth Rixson is a great example of the advantages that private equity ownership can bring to a business.

In the first instance, public markets often undervalue assets, unable to support the investment of time and capital that can be required for a company to deliver on its full potential. Firth Rixson in 2002 was a prime example of assets that public markets have undervalued.
example. Conversely, the buy-out industry is often best placed to realise hidden value from such companies because of the unique way that we own and govern businesses and our longer-term investment horizons.

A typical public company will have in the region of 100,000 shareholders, very few of which will be able to exert any meaningful influence. Institutional investors in a private equity-backed company, by contrast, will number in the hundreds at most, and crucially will abdicate control of the investment, handing responsibility to the private equity firm to drive the business forward and realise value.

This closely-held structure results in short reporting lines between controlling shareholder and management, enabling the buy-out backed business to be fleet of foot. Decision-making is fast and not confused by mixed motivations. For example, where a public company may have obligations for capital allocation spread between divisions, a private equity-backed company is focused on investing with one central aim – increasing the value of equity.

This ownership structure also enables a buy-out house to inject debt into a company – a much misunderstood financial practice. The application of leverage is simply efficient cash and balance-sheet management practice, optimising the cost of capital of any business, although each case needs to be stress-tested in order to demonstrate that the business will be able to support debt repayments, even in the event of fluctuating economic conditions or a prolonged downturn. Successful private equity firms have deep expertise in financial structuring, and the related risk assessment, to make sure their portfolio companies have sufficient headroom with respect to their financing banks.

The nuances of the debt structure have become more complex as the industry has evolved – with the emergence of instruments such as second lien and PIK (payment-in-kind) notes – but the basic premise remains the same: that the intelligent use of leverage can increase balance sheet efficiency and help drive returns to the equity. Interestingly, public companies are now re-visiting the use of leverage to optimise their own cost of capital.

A key differentiator of the private equity model of company ownership is that it aligns the interests of management with those of the shareholder – the private equity firm – which are, in turn, aligned with those of the business. Where public markets remunerate executives with generous pay packages and stock options, the private equity-backed management team, having invested their own capital, has plenty to lose as well as gain – which is why the buy-out model is so attractive for hungry management teams that want to share in the success of the businesses they run.

A KPMG survey carried out in 2006 found that the vast majority of private equity-backed management teams believed that their share of the equity was the surest way to create meaningful personal wealth and most would have been happy to renegotiate their basic salaries and bonuses downwards for a bigger equity stake in their business. One of the buy-out industry’s advantages has been its ability to attract top-class management through offering attractive equity ownership schemes.

Management is instilled with a renewed sense of urgency following a buy-out because, while a private company need not concern itself with the vagaries of quarterly earnings volatility, private equity management is working within a defined timescale with clear targets and objectives. Resistance to change no longer holds any rewards, and all eyes in a private equity-backed company are fixed firmly on the same medium-term goal, maximising all the owners’ equity value in the years before a liquidity event is reached.

In many respects, this focus on value creation is simpler in a private equity-backed business than a quoted company equivalent. Private equity is single minded in its pursuit of cash-flow improvement – the ultimate measure of business success – and incentivises management teams accordingly, through both the equity ownership and annual cash bonus schemes. Where public companies often use a balanced business score card, seeking to take numerous complex metrics into account when measuring management’s performance, a buy-out backed business has a very short list of key performance indicators, all closely monitored, but with the focus on generating cash.

Private equity-owned businesses also benefit from the release of management time previously spent addressing the public markets – another big attraction for management teams. Before Carlyle came on board, the Firth Rixson team was battling to integrate acquisitions and drive productivity, simultaneously with maintaining quarterly earnings-per-share growth and communicating with a broad base of public shareholders. Removed from that kind of short-termism and distracting time commitment, the management team was able to effect real change at Firth Rixson. Importantly, while the close governance of
private equity-backed businesses results from the alignment implicit in the ownership model, there is also no need to appeal to the interests of many and minority stakeholders. This is vital for allowing the boards of buy-out backed businesses to concentrate on the job at hand. Therefore, it was heartening to see Sir David Walker recognise the success of private equity governance in his recent proposals for the asset class and it is important that heavy-handed regulation regarding this area of the industry continues to be kept to a minimum.

Deals such as Firth Rixson are examples of the fundamental benefits of the buy-out industry ownership model. However, Firth Rixson is not unusual among private equity transactions. Recent research by Ernst & Young took the 100 largest buy-out exits in the US and Europe and compared them to listed businesses based in the same country, operating in the same industry, over the same time period.

Enterprise value, which discounts the effect of leverage, increased by 33 per cent in the US and by 23 per cent in Europe for the private equity-backed companies, compared to 11 per cent and 15 per cent in their public market equivalents.

There is no doubt, of course, that private equity has benefited from a unique set of favourable circumstances over the past few years. A benign economic environment, coupled with the unprecedented availability of both debt and equity, has propelled the industry to new heights in terms of funds raised, and the size of the companies that have been targeted.

But as we enter a more challenging period, it is important to remember what it is that really makes buy-outs succeed. And for this, it is useful to look at another Carlyle investment, Dutch cable company Casema, acquired from France Telecom in the midst of the last economic slowdown. We signed the Casema deal over Christmas 2002 after many months of negotiation, during which time several other cable businesses went bankrupt. A club bank deal, by necessity, we had to provide 50 per cent of the transaction enterprise value in equity and to arrange and effectively underwrite all of the debt ourselves – a situation that may well feel familiar to private equity investors looking to buy companies today.

Recruiting a new Chief Executive, we invested heavily in Casema’s network and infrastructure, transforming the business from a utility-like analogue TV provider to the leading triple-play operator in the Netherlands. Revenues grew by 10 per cent a year during our holding period, EBITDA (earnings before interest, taxes, depreciation and amortisation) doubled and the headcount increased from 750 to 1,050.

Other buy-out houses may do things differently, and those choices are what set the best firms in the industry apart from the ordinary firms. But all BVCA member firms benefit from the ownership structure outlined above, and that is a fundamental advantage for any company backed by private equity.
Developments and challenges in venture capital

Jo Taylor, Chairman of the BVCA’s Venture Committee and Managing Partner of 3i’s venture capital business, looks at how the current challenges in the industry might shape the years to come.

Over the last 25 years, the UK venture capital industry has helped a vast number of aspiring entrepreneurs and ambitious management teams turn their dreams and aspirations into successful companies. In the UK, wealth creation and the deployment of capital has been second only to the US over that period.

In the early 1980s, venture capital, as opposed to private equity, was the bedrock of the BVCA’s membership and activity. Local investors sought to back talented management teams developing disruptive research and technology or innovative service models that could overturn the status quo in their targeted markets. Sums invested were modest and the risks were – and still are – high when backing pre-revenue fledgling companies. That said, the returns that were made rose as high as 20-30 times the capital invested on the successful investments.

So why has the UK provided such a successful environment for venture capital over the last 25 years?

First and foremost, the UK has provided these dynamic companies access to capital – in the initial stages from private investors, then from selective professional investment firms culminating in access to a thriving and generally supportive stock market. This vibrant stock market has allowed many venture-backed companies access to more significant sums of development capital to allow the continued growth when required, or when the total funding of the business is beyond the resources of their venture investors.

The stock market has also enabled early stage investors to sell on their minority shareholdings to new investors more easily, and generally on more attractive terms, than would have been the case had the business remained private.

The London Stock Exchange (LSE) has supported many venture-backed companies that have gone on to be a great success, companies such as ARM, Autonomy, CAT, CSR, Lastminute.com, Shire, and Wolfson Microelectronics to name a few. However, it is per-
So, what challenges face the UK venture capital industry, and how might this shape its performance in the coming years? While the industry was able to provide spectacular returns at the turn of the century, this cycle was short-lived. The damage caused on the downward part of that market cycle by high company valuations and ultimate business failures hit fund returns for the industry hard over the last five years. As this has also coincided with attractive returns made by private equity firms, some UK investors have begun to question the attractiveness of venture as an asset class. Looking forward, I would expect the venture asset class to regain favour with investors as the difference in returns narrows and competition within the private equity industry drives prices to less attractive levels.

The second challenge facing the UK venture capital industry is a structural one. Many venture funds are more naturally suited to a small investing team investing in a cultural, linguistic and legislative environment that is the most supportive in Europe. Also vital in creating a successful environment for venture capital is the availability of leading edge, disruptive technology that is capable of competing on a world stage. Over the years, the UK has been blessed with a strong culture of design, research and engineering, which has laid the foundation for significant wealth creation. The university network in the UK, together with significant entrepreneurial activity within research and development centres in UK corporates and consultancy firms, has created a regular flow of groundbreaking innovation.

The final ingredient in the successful development of the UK venture capital industry has been access to top quality management with the requisite skills and entrepreneurial flair needed to build fragile young companies into more significant businesses. While there has been some market cyclicality in the availability of management talent, the UK venture industry has been fortunate to source capable managers to lead companies from inception and then through first- and second-stage evolution.

The outlook for UK venture capital is the best it has been for many years, and this alternative asset class should appeal to investors searching for experienced investment teams still able to pick out high-growth companies, on attractive investment terms, and making the most of the more turbulent economic environment that I would expect to prevail through 2008.

The final ingredient in the successful development of the UK venture capital industry has been access to top quality management with the requisite skills and entrepreneurial flair needed.
Delivering transformational change

Private equity firms stand out for their ability to transform underperforming businesses. Andrew Cornelius, adviser to Homebase and Halfords, looks at how three well-known businesses were given a new lease of life.

RHM, Homebase and Halfords were all household-name businesses underachieving within the confines of bigger groups until taken under private equity ownership.

Although RHM is one of the largest food groups in the UK, with brands like Hovis in its portfolio, it was effectively managed as a federation of separate businesses by Tomkins, the ‘guns to buns’ conglomerate, until Doughty Hanson took control in a £1.18 billion deal in August 2000.

It took five years of private equity ownership to reorganise and reposition the business before Doughty Hanson exited via an IPO, which placed a £1.67 billion enterprise value on RHM in July 2005.

The turnrounds at DIY retailer Homebase (after its buy-out from J Sainsbury by Permira) and of Halfords (from The Boots Company, by CVC) were quicker, but both companies were re-energised by the increased focus and change in strategic direction after being set free from their parent groups.

Doughty Hanson recalls that “a number of businesses were underperforming and a stagnant management culture needed to be addressed” prior to its takeover of RHM.

The new owner’s first task after buying RHM was to establish a Value Enhancement Group, which carried out a detailed review of each business. The Group discovered that each business operated separately from the other, there was a manufacturing-led culture, performance and rewards were not aligned, the Manor Bakeries operation was seriously underperforming, and there was a £520 million pension deficit.

During the 30 month transformation period that followed, more than half the top 50 executives in the business were changed. This included the appointment of a new Chief Executive and Chief Financial Officer. The management team’s objectives were then aligned with those of shareholders, so that there was clear accountability and more lucrative rewards for outperformance.

RHM was also restructured, with centralised procurement, human resources and finance functions and reorganised so that 18 independent businesses were grouped into three core divisions to maximise economies of scale and operating synergies. Five non-core businesses were sold and one closed. The procurement savings alone topped £40 million, but there were also further significant savings in logistics, administration and group marketing. At Manor Bakeries, £20 million of savings were achieved.

The newly focused business then invested in product innovation and development, and the marketing support for its key brands, including Hovis. This resulted in market share gains, including a 4.5 per cent increase for Hovis over the 30 months, together with a 30 per cent increase in its prices. The terms of the pension plan were also renegotiated, which helped achieve a reduction in the deficit to £125 million by the time the business was sold.

This transformation under private equity ownership left RHM in a stronger competitive position and on a more secure financial footing. DIY business Homebase had its fortunes revived in similar fashion. At the time of its
Management also embarked on an ambitious plan to source more product, including cycles and in-car technology product, directly from overseas manufacturers, rather than buying through wholesalers.
The experience of multiple owners
An increasing number of companies have had more than one private equity owner. Sarah Butler and Philip Hoult examine how three major UK businesses have used multiple private equity owners at different stages of their life cycle.

In the early days of private equity, the traditional methods for exiting from an investment were a trade sale or a stock market flotation. As the industry matured, a third option emerged — selling the business to another private equity house. Secondary and even tertiary buy-outs are now a common feature of the market.

One household name to have had a series of private equity owners is Gala Coral. Back in 1997, Gala was a struggling business in a deeply unfashionable sector. Fast forward a decade and it has been transformed — with the backing along the way of some eight different private equity firms — into one of the country’s biggest privately-owned companies, employing more than 19,000 people and reporting turnover in the year to 29 September 2007 of £1.3 billion.

Gala was first bought out from brewing group Bass in a £236 million deal in 1997. Chairman John Kelly, who led the original buy-in backed by PPM Ventures (now PPM Capital) and Royal Bank Development Capital, says it was an obvious target. Profits had fallen by more than 40 per cent in the three years before Kelly took control, as Gala struggled to compete against the newly-launched National Lottery.

The business was not core to Bass and had gone through four managing directors in five years. Bass had nevertheless ploughed more than £100 million into improving Gala’s bingo halls. Kelly thought he could work those assets much harder and also saw a big opportunity to consolidate the fragmented bingo and gambling sector.

Together with PPM, Kelly developed a three-pronged strategy. They aimed to rebuild Gala by motivating management through new incentives, reducing the bingo firm’s heavy bureaucracy and its associated costs, and by focusing capital spending more aggressively on areas where it would generate income. “With private equity behind you there is only one stakeholder to answer to and that makes decision-making quick, which is what it needed to be,” Kelly says.

Although the cast of private equity owners may have changed over the last decade — Duke Street Capital, Credit Suisse Private Equity, Candover, Cinven and Permira are among those to have had a stake — Kelly and his team have always been backed on the acquisition trail. This culminated in 2005 with the £2.2 billion takeover of Coral Eurobet, the betting shop business — a transformational deal, which created Britain’s largest private equity-backed company.

Neil Goulden, Gala’s Chief Executive since 2004, says the Coral purchase demonstrated the flexibility that private equity backers can give a company. “There is no way Gala would have been able to buy Coral, a company bigger than our firm, if we had been a public company,” he says.

Goulden adds that Gala’s private equity backers have added value, not just through a willingness to put up funds for acquisitions, but in using their expertise to put together a suit-
How private equity works in practice

able financial structure. Their active interest in the running of the company and vast experience in all types of businesses were also major advantages.

“The business has been brilliantly successful and I am as proud as punch of it,” says Kelly. “It is not down to financial engineering – it is a mix of organic growth and sensible, value-adding transactions.”

Center Parcs, a leading short-break holiday operator, has had a similarly positive experience. At the beginning of the decade it was a successful but small part of a quoted plc – Scottish & Newcastle – before being sold to private equity house Deutsche Bank Capital Partners in 2001. A flotation on AIM followed in December 2003, with the company moving to the London Stock Exchange’s main market in September 2005. It returned to private equity ownership in April 2006, when Blackstone bought the business for £265 million.

Martin Dalby, Center Parcs’ Chief Executive throughout this period, agrees with Gala’s Kelly that one of the main advantages of having private equity owners is the pace at which change can be implemented. “Once private equity people make up their minds, then you can just get on with it,” he says. By contrast, under Scottish & Newcastle’s ownership, there were layers of approvals that management had to go through before they could implement their strategy. The stock market listing in turn meant a huge amount of management time was spent explaining the company’s position and strategy to the City. While quite enjoyable, Dalby says, this was a distraction from running the business. “We are a mid-sized business that does not have the resources of a FTSE 100 company,” he explains.

Dalby says Center Parcs’ two private equity owners have both created value through their financial structuring skills, but adds that their periods of ownership have also been marked by significant investment.

Under Deutsche Bank Capital Partners, the business was able to buy the Oasis holiday village in the Lake District, its only rival. It also built more accommodation on its existing sites and increased the range of services, such as restaurants, on offer. With Blackstone on board, the investment programme has been even more impressive. Soon after it bought Center Parcs, the private equity firm acquired the freeholds to the properties where the holiday villages are located. A £1 billion refinancing in early 2007 has reduced interest costs and allowed for additional capital expenditure on the villages. Center Parcs is undertaking a £100 million programme to upgrade its accommodation and improve facilities. It has struck deals with restaurant group Tragus (another Blackstone-owned business) and Starbucks, and invested in technology to bolster its online booking facility.

“We certainly could not have raised [on the stock market] the money that has now been made available,” says Dalby. But it is not just about funding, he adds – Blackstone has, for example, provided expertise in areas such as revenue and yield management that has significantly helped Center Parcs.

With turnover of £255.2 million for the year ending 17 April 2007, occupancy rates of over 90 per cent and repeat business of more than 60 per cent, the business continues to perform strongly.

Center Parcs also received a major boost in September 2007, when it won approval to develop a fifth village at Woburn in Bedfordshire. The business, which already employs more than 6,000 staff, expects the new village to create a significant number of jobs when it opens in 2010.

Although Dalby does not rule out a return to the stock market, he describes both periods of private equity ownership as “very satisfying”. “In both cases, they took time to understand the business model and have backed the management all along,” he says.

A third business to have grown substantially with the backing of multiple private equity owners is Tragus, the restaurant group.

In 2002, ECI Partners backed a management buy-in of the Café Rouge and Bella Pasta businesses for £25 million from Whitbread, which was keen to dispose of the operations because of their historic underperformance. “A lot of people in the trade press argued that we had overpaid,” says ECI’s Charlie Johnstone. “But we saw the potential to reposition the business.”

The new management team, with ECI’s backing, set about reviving the operation by returning Café Rouge to its French roots, rebranding Bella Pasta to Bella Italia and disposing of non-operating sites. A development

How private equity works in practice

“The shareholder base may have changed but the business has continued to grow”
Creating value through acquisitions

A private equity-backed buy-and-build strategy can rapidly transform a business into a market leader. Helen Dunne reports on the impressive results such an approach can bring.

When Bridgepoint Capital acquired Alliance Medical for £111 million in a secondary buy-out in January 2001, it recognised the potential to expand the presence of the healthcare company.

Six years and 16 acquisitions later, it has become the largest medical imaging company in Europe. The number of scanners Alliance Medical operates rose from 31 in 2001 to 190 in 2007, while employee numbers increased from 177 to 690.

Revenues have meanwhile grown six-fold over the same period to £132 million. Bridgepoint generated a return in excess of four times its investment when it sold Alliance Medical for £600 million. It has been a remarkable buy-and-build success story.

“When we acquired Alliance Medical, with the exception of a small joint venture in Europe, 99 per cent of its profits came from the UK,” explains Bridgepoint Director Jamie Wyatt.

“The first acquisition, in 2002, was to buy out that joint venture, and ultimately avoid conflicts as we used Alliance Medical as a platform for growth within Europe. Each subsequent acquisition helped Alliance Medical grow faster than it could on its own, just pursuing an organic growth strategy. We were able to accelerate growth through a buy-and-build strategy.”

In common with other buy-and-build investments, an incremental fund was set aside from day one to pursue acquisition opportunities. Alliance Medical, which provides diagnostic and imaging equipment to hospitals, operated in a fragmented marketplace with huge potential for consolidation. This is the ideal backdrop for a buy-and-build model, which, in the majority of cases, involves small-scale acquisitions. Nine of the acquisitions made by Alliance Medical, for example, involved one- or two-man operations.

Many private equity experts dismiss sectors with dominant market players as unsuitable for buy-and-build strategies. However, this is not a hard and fast rule. Alliance Medical, for example, was the dominant player in its sector within the UK – seven of its acquisitions involved market leaders within their country of operation.

“The most suitable sector for a buy-and-build strategy is highly fragmented with lots of operators, where there are many opportunities for deals to take place,” explains Steve O’Hare, Investment Director at Barclays Private Equity. “But the key thing is not just to identify synergies. It is vital that you have buy-in from the companies involved.

“You have got to have staff that believe in what you are trying to create, you need hearts and minds to make a buy-and-build strategy work. An acquisition will not work if executed poorly or if the cultural and strategic fit is not as first envisaged.”

There is always a risk in acquiring any company, whether large or small, that it diverts management attention away from the core business. As a result, many private equity firms pursuing a buy-and-build strategy set aside funds to finance an additional management
How private equity works in practice

resource within the platform company that is tasked with identifying potential acquisitions and, following a deal, integrating the target. Sovereign Capital, which typically invests between £5 million and £20 million of equity to support proven management teams, is committed to the buy-and-build model. In the past three years, for example, the private equity firm has made 14 new platform investments and 33 follow-on acquisitions involving £160 million of equity.

However, its model takes the pressure away from management teams to identify and integrate acquisitions by employing a four-person research and development team within Sovereign to do the work for them. For a private equity firm the size of Sovereign, this is a huge investment in personnel and demonstrates its belief in the importance of getting the target company right.

“The management of our companies may be fantastic at organising their businesses and delivering results, but they may not be the best corporate financier,” explains Managing Partner Ryan Robson. “Our research and development team identifies those businesses that they should want to buy.” Sovereign’s research and development team will help with integration, although the firm may also bring in extra management. “When you are pursuing a buy-and-build strategy, the platform company needs a much bigger management team than the initial size of the business would dictate,” explains Robson. “Without that extra investment, any acquisition will fail.”

Wyatt at Bridgepoint agrees. Alliance Medical pursued acquisitions across Europe, and each market brought different challenges and characteristics.

“You need to have both the infrastructure and management team right in the first place to grow the business, both through organic growth and bolt-on acquisitions,” he explains. “Internal controls are a vital part of the buy-and-build strategy, and it is necessary to have appropriate resources available to support management and the acquisitions they make.”

The first acquisition does, however, generally create a template for further transactions. For example, the same legal and accountancy firms are usually used for all transactions, which can reduce the timeline for subsequent acquisitions. David Novak, London-based Partner at Clayton, Dubilier & Rice, prefers to describe buy-and-build as “creating value through acquisitions”.

Clayton, Dubilier & Rice invests in platform companies that have the potential for significant organic growth, even if it subsequently proves impossible to identify suitable acquisitions.

Novak oversaw the purchase of Paris-based Rexel, a market leader in the wholesale distribution of electrical products, from Pinault-Printemps-Redoute in 2005. It has since acquired Dutch rival Hagemeyer and America’s GESCO, which doubled its sales, and made bolt-on acquisitions in Australia, France, Belgium, America, the UK and China.

“Rexel is a market leader in a highly fragmented market,” explains Novak. “It had meaningful operational efficiency opportunities, but was also in an industry space where there were meaningful acquisition opportunities.”

There are also benefits for the platform company in pursuing a buy-and-build strategy: Efficiencies of scale arise across all aspects of the business model. Costs are removed as duplication in areas, such as central office functions and IT systems, is eliminated.

The platform company also gains greater leverage in areas such as purchasing and recruitment. Rexel, for example, is able to negotiate better rates with global suppliers.

St Quinton was initially given £25 million. “He had a clean sheet of paper to start with. After three or four acquisitions, there was enough to start integrating to create a platform company,” explains Davison. “We then refined our strategy and carried on acquiring.” Subsequent purchases were funded from cash flow and new debt facilities. Over five years, 15 acquisitions were made.

“We built a business, Azzurri Communications, that did not exist before,” explains Davison. “We consolidated a highly fragmented industry, but it is hard work doing it the way that we did.” Azzurri’s annual turnover is now in excess of £100 million.

“It is hard work pursuing a buy-and-build strategy,” concedes Sovereign’s Robson. “You take a safe, stable platform company and, through acquisitions and investments, turn it into an exciting new business. But the returns should be higher on exit.”

A successfully executed buy-and-build strategy creates stronger, better businesses with more scope to grow.
Saving struggling businesses can take you a long way in life. Having rescued the likes of pizza chain Domino’s, the Salt Lake City Winter Olympics and the finances of Massachusetts, Mitt Romney sought the US Presidency. The Founder of Bain Capital trumpeted his record of turning around difficult management situations.

His UK private equity counterparts are also set to come to the fore following the credit crunch. Jon Moulton, Managing Partner of Alchemy Partners, says the lack of cheap credit will pressurise management actually to manage, and that is where turnaround specialists come in.

“We positively select for bad management,” Moulton explains – if the management is good, it can sometimes be hard to see what new owners could add. He also looks for “a business with a viable base somewhere in it”. When you do a turnaround, you are “buying a dream”.

One man’s dream has often been another man’s nightmare, but while poor management is usually a feature of underperforming companies, it is not always the case – it can be the ownership.
The UK’s largest pawnbroker, Harvey & Thompson Group (H&T), was a profitable company that generated cash, but Rutland considered that it was underperforming, with flat trading, when it bought H&T for £49 million in 2004. Cartwright actually worked in a store to get to know the business, and out of that came an analysis of the right employee levels, resulting in 15 per cent staff savings. He says this created a template for the stores – which also benefited from developing other lines, such as third-party cheque cashing – and by the time Rutland floated H&T on AIM in 2006, there were 12 new stores. There have since been further openings and H&T now employs more staff than it did in 2004.

Sometimes the business really is on its knees, however. Uskmouth power station in Wales was in the hands of the receiver when Rutland took the bold step of recommissioning the plant, investing £23 million of equity and negotiating £10 million of bank overdrafts and credit from suppliers and service providers. The firm’s appointment of an independent operating and maintenance contractor – Alstom – to run the station was key, and within four months the first power was sent into the grid.

The Rutland-owned company behind the business, Carron Energy, hired 15 managerial and administrative staff, while Alstom recruited 120 engineers and operatives – many of whom had worked at Uskmouth before it went into receivership.

When assessing potential targets, Mike Campbell, Managing Director of Ferranti Capital, looks for a strong brand name, well-established distribution channels and ideally “a unique or enabling technology or capability”. This is in part driven by Ferranti’s distinct exit strategy – either to sell to a Chinese company looking to expand into the West, or merge with a capable Chinese company in the same market and then float.

This approach was adopted three years ago – up until then, Ferranti was a conventional London-based venture capital company. Ferranti was keen to identify a way it could exploit the huge economic growth in China without the risk of investing in Chinese companies. Campbell says: “We found that when we visited Chinese companies in the manufacturing and engineering sectors, most said ‘we don’t need your money, but we need help to expand into the West’.”

A Ferranti success story is the purchase in December 2006 of premium brand precision engineering companies Jones & Shipman and Holroyd from Renold. The businesses were not core to Renold, and both were underperforming and suffering from under-investment. They also had a lacklustre senior management, but Ferranti liked the second-tier management. Bringing in a new top tier, motivating that second tier, as well as stripping out the costs of being a PLC, have made a huge difference to the business. A year later, both companies are in profit and have a clear direction and strategy.

Though Ferranti has grown the workforce in this case, turnarounds are inevitably associated with redundancies. It is often under-appreciated that such cuts may be essential to protect the long-term viability of the business and the jobs of those being kept on. And tears are not always shed if there is a clear-out of the bosses who caused the problems.

While the arrival of a private equity owner brings the feeling that at least something is happening, a major problem is simply the perception that an asset-stripper is in town. This reputation troubles Moulton and is particularly unjustified in his field, he reckons.

Whatever needs doing, speed is often vital – “you need the bravery and/or insensitivity to make decisions fast,” he adds.

Endless closed the overseas operation, strengthened the management and injected working capital, partly through a refinancing. The focus was changed from the difficult residential market to new-builds, and costs driven down, mainly through direct material sourcing from China. “It will achieve notable profits this year,” Forshaw says. “It took a lot longer and more capital than expected, but we allowed for that to a certain extent.”

Those involved in turnarounds maintain that there is greater satisfaction in transforming a struggling business and the fortunes of the people in it. Alchemy’s Moulton says: “There’s nothing better. You feel very pleased with yourself and you should be. You’ve done something very useful.”
The road to success – venture capital

Venture capital firms provide vital backing for spin-out businesses. Andrew Cave looks at how their support helped technology group CSR go from start-up to a £240 million stock market flotation in less than a decade.

CSR, the Bluetooth technology group that started life as Cambridge Silicon Radio in April 1999, has rapidly become that rarity – a British company that dominates its global market.

Its silicon chips are ranked number one in every segment of the Bluetooth market, with a unit market share in excess of 50 per cent. In terms of products, its market share is even higher, with 60 per cent of all Bluetooth products containing CSR’s integrated circuits.

However, CSR is not only a success for its three founding directors, six original engineers and the management and 1,000 staff who now operate the company – it is also a resounding triumph for the venture capital industry.

After an initial $9 million of funding from 3i Group, Amadeus Capital Partners and the information technology fund of Dutch venture capital group Gilde, CSR completed another three rounds of private fundraising, backed by the original venture capital firms and new investors.

When it floated in 2004 on the London Stock Exchange at £2 a share, valuing the company at £240 million, Amadeus and Gilde still had 13 per cent holdings, while 3i held 14 per cent.

Actually, 3i held on to some of its stake until 2007 and Partner Laurence Garrett is delighted with the investment. “Overall, we made about ten times our original investment in the company,” he says. “It’s a very good return.” Existing shareholders took out £38 million at flotation, but investors who remained shareholders also made good returns, as turnover more than trebled from £253 million to £850 million between 2003 and 2007. The shares reached as high as £15 before falling back, due to the effects of 2007’s credit crunch.

Headquartered in Cambridge, CSR now has 15 locations around the world and a 20 per cent operating margin.

However, its story dates back five years before its formation as a spin-out from Cambridge Consultants, where founding directors James Collier, Glenn Collinson and Phil O’Donovan and the other six staff worked on developing silicon for clients in the telecoms, automotive and healthcare industries.

The team came up with radio frequency silicon products using complementary metal oxide semiconductor (CMOS) silicon, with the aim of providing major size and cost efficiencies in mobile phones.

“Their strapline was that they wanted to democratise radio technology and make it much easier for people to use,” says Paul Goodridge, CSR’s finance director since 2000. “This was the vision that the venture capital firms bought into.”

Garrett of 3i agrees. “It was pretty obvious early on that they had something we could not ignore,” he says. “They were the first people in the world to achieve radio frequency at baseband on one single CMOS chip. It was a technological breakthrough.”
How private equity works in practice

Hermann Hauser, Co-founder of Amadeus, adds: "People ask me why we invested in something that had not been done before and was completely new. But the answer is that if you have the chance to do that, this is where the big wins are. Living in Cambridge, you learn to recognise a five-star wizard when you see one and James Collier is a five-star wizard.”

Amadeus, 3i and Glide provided $9 million in the 1999 fundraising and were joined by Intel Capital in a $7 million second round in 2000. A third round later that year raised $84 million and saw nine more investors, including the venture capital arms of electronics groups Philips, Siemens, Compaq and Sony, join the shareholder register as part of a concerted move to not just get financial investors, but also build relationships with commercial partners.

Then in 2002, a fourth fundraising brought in Scottish Equity Partners and LDC to take CSR through to flotation.

"Everybody was excited by the enthusiasm, energy and intelligence and skills of the original team,” says Goodridge. “James Collier, in particular, had this real vision for where the company could go with its technology and he has a very good commercial brain as well as great technical expertise.

“The three Founders saw that Bluetooth was going to be a huge market, but they were also highly competent managers and were able to elucidate what would make CSR into a significant business.”

The founders did not develop their technology for Bluetooth and originally toyed with using it on short-range wireless or wireless local area networks. However, after Bluetooth was adopted as the European standard called Bluetooth was the right approach.

“Were there difficult moments and times when we doubted whether we should be doing it? Absolutely. But every time, we and the other two venture capital firms made the decision to move forward and believed that the team would be able to pull it off.”

Bluetooth took some time to take off. By 2000, less than ten million Bluetooth units had been shipped worldwide. Now, however, this figure is more than one billion.

“Back in 2001, the technology marketplace was a very hard one to be in and Bluetooth was just not happening,” says Goodridge. “But we presented a very strong story about why we should continue to invest as a company and recruit quality engineers while they were available. The venture capital backers stayed invested and continued to support us.”

Hauser says the turning point came when CSR’s CMOS chips were used in a Sony phone.

“The phone was a total flop,” he says, “but a total flop in the mobile phone business means you sell six million products.

"It was fantastic to show that the product could do what we said it could do all along. It was an early success and then the product started being designed into phones. When that happens, it becomes very profitable because so very many mobile phones are now sold worldwide.”

CSR’s chips are now used in the mobile phones of Motorola, Nokia, Panasonic, Samsung and Sharp, the wireless headsets of Hutchison’s “3” and Logitech, almost all new models of laptop personal computers with Bluetooth capability introduced since 2003, and the communication systems of Saab, Audi and BMW cars.

Tony Carlisle, the Chairman of financial PR firm Citigate Dewe Rogerson who joined CSR as a Non-executive Director in 2005, gives credit to the CSR management for devising a business strategy that sought to add value to the products. Fierce price pressure was offset by production improvements that cut costs.

In addition, the venture capital backers were able to use their industry knowledge and experience to help CSR grow, recruiting John Hodgson, a highly experienced Briton in the US computer industry, as Chief Executive.

Later, Garrett introduced CSR to three of 3i’s other investee technology companies, which CSR ended up acquiring.

“The venture capitalists were not just there to look after their money at board meetings,” says Goodridge. “They were able to bring skills to the table as well.”

CSR’s experience has been “an example of private equity working really well,” Carlisle concludes.

“This was plainly a high-risk start-up that was well-backed by venture capital. The company has been properly managed at every level.”

"Back in 2001, the technology marketplace was a very hard one to be in and Bluetooth was just not happening”
Developing business potential – development capital

Private equity firms supply much-needed development capital to growing businesses. But, writes Derek Bedlow, their wide experience of helping to build companies is equally in demand.

The real crunch comes when it is time to take advantage of its market position and move the business up a level.

If you’re not growing, you’re slowing. Securing seed capital and getting a business off the ground is only the beginning of the story for most companies – having got airborne, the real crunch comes when it is time to take advantage of its market position and move the business up a level.

This is where development capital comes into play, funding the expansion of the business and diversifying some of the risk for the founders, while allowing them to retain an interest in the company when the time comes to seek fresh funding.

This was very much the story of Fat Face, an activewear brand and retailer which started life in 1989 as a T-shirt printing business designed to fund the ski-bum lifestyles of its founders, Tim Slade and Jules Leaver. By the time that ISIS Equity Partners came on the scene in 2000, the pair had developed the company into a £7 million business selling a range of branded clothing from a chain of 25 shops. It had, nonetheless, reached the point where significant development was vital to maintain its growth and Slade and Leaver were far from sure they were the people to do it. ISIS persuaded them otherwise and bought a minority stake for £3.5 million.

“We saw that the founders were still extremely able to contribute to the business over the next few years and one of our key roles with Fat Face was about giving the founders the confidence to keep growing,” says Mark Advani, Director of ISIS and former Non-executive Director of Fat Face. “The other option for them was to sell the company outright, but we persuaded them that they could remain involved so that they could continue to grow it.”

This faith proved to be justified. By the time that ISIS made its exit in 2005, selling its stake to Advent International, the Fat Face empire had grown to 97 outlets, complemented by a burgeoning mail order business, and grown its turnover eight-fold to £60 million.

“When we invested, it was a business that had grown quickly, but was still a bit of a secret,” Advani says. “We saw that the brand had developed a really good relationship with its customers and that there was an opportunity to roll it out further and to expand into mail order.”
Development capital is also invaluable when growing companies look to expand through acquisition. This was the experience of Software Solutions Partners (SSP), a software house focusing on the insurance industry, which teamed up with Lloyds Development Capital (LDC) in 2004 by exchanging a 30 per cent stake for an investment of £11.3 million. “We had a very good business,” says David Rasche, who co-founded the company with Laurence Walker in 2001. “We were enjoying it and we thought we could add more value. We wanted to take some of the risk off the table for the founders.”

The money enabled SSP to finance a series of strategic acquisitions worldwide, which allowed it to distribute its core product, the ‘insight’ software package, on a global basis. The business was also able to significantly diversify its generic client bases into other areas of the financial services industry. As a result, when the company was floated on AIM in 2006, its value had risen to more than £70 million.

“The track record of the management was strong, they had developed strong contracted revenues and we could see significant growth potential in their insight product,” says LDC Senior Director John Swarbrick. “They had identified opportunities to promote their product by building on their relationships with insurance companies and intermediaries.”

LDC brought more to the deal than just money. Swarbrick joined SSP’s board as a Non-executive Director and his, and his colleagues’, experience of corporate acquisitions proved to be invaluable as the company expanded. “The key question for companies at this stage is: does this acquisition enhance shareholder value? Our experience of buying and selling companies is very helpful in this regard. We were able to contribute to the debate over which companies to pursue and provide the benefit of our experience when it came to the execution and structuring of the acquisitions,” Swarbrick says.

More generally, LDC was able to provide advice on managing a growing business, based on its experience of investing in companies at similar stages of development. “John Swarbrick and others at LDC gave us very good non-executive advice,” says Rasche. “They were objective in their advice and weren’t just looking out for their own interests. We got a contribution from LDC that was very fair.”

In many respects, bringing this kind of experience to the deal is as essential as the capital private equity houses supply to growing companies – it provides private equity with a distinct advantage over other forms of finance available at this stage of development, whether bank debt, a trade sale or an AIM listing.

For sandwich chain EAT, the prior experience of its main investor Penta Capital in helping restaurant chain La Tasca to grow from 14 outlets to 67 is certainly proving to be as valuable as its money. When Penta bought its stake in August 2005, EAT had 42 outlets, but had plans to develop a further 100 shops and expand its production capacity to supply them. Already, it now has 85 shops and 2,000 staff, and profits have risen three-fold.

“Growing a business rapidly can be quite a dangerous venture if you don’t have the right people and infrastructure in place – you can overtrade quite easily,” says Penta Capital’s Torquil Macnaughton, who serves as a Non-executive Director on the company’s board. “The more experience you have in a sector, then the more you can help with forward planning – you know what happens when you reach certain levels. In this business, success is down to micro-management, making sure that you get the best deals from your suppliers and minimising costs. It’s concentrating on the small details that ultimately deliver the bottom line. EAT has grown rapidly, but without losing control.”

A common issue for companies at this stage of development is moving away from the owner-manager mentality to develop an organisational structure that can bear the weight of a growing business. At Fat Face, for example, the input of ISIS proved to be invaluable when it came to creating the senior management roles necessary to oversee the company’s expansions – and finding the right people to fill them.

“The real issue for Fat Face was that the business was expanding by 50 per cent per annum and, as a result, was constantly outgrowing its organisational structure,” says Advani. “The real difference we made was to help them judge when to recruit new organisational heads and helping them to do that. We also helped them to appoint a chairman and, ultimately, advised them on when it was the right time for the founders to take a step back.”

Perhaps the most valuable feature of development capital, however, is the time and flexibility that it provides for companies to find their feet compared with other sources of finance. Private equity investors are a long-term partner rather than a short-term investor.

For example, although Fat Face hit all the right notes financially, it did not do so in quite the same order as originally envisaged in its business plan. Advani argues that the company may not have enjoyed its ultimate success had it raised capital by another method.

“The business plan couldn’t take into account how much the business needed to change,” he says. “Having expanded from 150 to 1,600 people during the period of our investment, the organisation was almost unrecognisable by the end.

“Private equity is absolutely fantastic in the early years of a business like this, where you need all the shareholders to take a longer-term view and be prepared to invest in people and systems and infrastructure. No other form of finance could have achieved for Fat Face what private equity did.”
Looking ahead to the next 25 years

Private equity has come from nowhere to play a vital role in the UK and world economies. Its importance will only increase in years to come, predicts Simon Walker, Chief Executive of the BVCA

Predicting the future is a notoriously dangerous business. History is littered with people who looked into a crystal ball and got it wrong. The man at IBM who said there would only ever be demand for three computers worldwide. The Parliamentary Committee which said that there was no future for electricity. The man in the 1870s who said that telephones would never catch on.

So, it is a tall order to predict what the world of private equity will be like in 2033. What seems a safe bet is that given the way that everything is speeding up, the changes between now and then will be even greater than the changes we have seen in the last 25 years.

Back in the early 1980s, we didn’t exist as an industry. Today, we have come from nowhere to play a central part in the world’s industrialised economies. And yes, there’s no doubt that the speed of our growth has brought controversy.

I predict that 25 years from now, we will be playing an even bigger role, but with one important difference. We will no longer be seen as something mysterious or controversial. We will be an accepted part of the economic mainstream, just one form of ownership among others which makes a vital contribution to the overall well-being and productivity of the economy. And where, if you work in the private sector, it will be just as normal to work for a company owned by private equity as it is to work for one which is publicly listed.

That will partly be simply because of greater familiarity. But I think it will also be because, as the pace of globalisation and economic change hots up, so the disciplines and skills that private equity and venture capital offer will increasingly come into their own.

Why am I so sure? Because we know that economies in the developed world are going to have to find ways of becoming more productive. There will be more of a premium than ever on intellectual capital and the ability to develop new technologies. The companies that flourish will be those who are first to spot new opportunities in world markets, to keep fleet of foot and retain entrepreneurial flair. There are going to be fewer and fewer hiding places for businesses that dawdle and make tough decisions or trade on past glories.

So where are we going to find these skills and attributes? They are, of course, to be found in all sorts of businesses, but I do believe that there is a concentration of them in venture capital and private equity. People who are prepared to take risks with their own capital. People who know how to take a business from start-up and help it to expand into new markets. People who can take existing businesses and help re-energise them, taking tough decisions to focus on areas of growth, empowering management to drive the business forward and take a longer-term view on investment decisions away from the glare of the public markets.

In an era of globalisation and consolidation, it also seems a safe bet that economies will increasingly have to concentrate on their areas of strength. When you look at the UK, financial services is one of the relatively few areas where we have a genuinely world-beating industry. So we need to build on that, making London as attractive a place as possible for private equity and venture capital. That’s the only way in which we will continue to attract the brightest and best from around the world to come and work here.

But while I think the future for private equity should be very bright, it is by no means in the bag. If the wrong political decisions are taken in the US, the UK and in Europe, there is an alternative future. A future where private equity is so tied up in regulation that it becomes indistinguishable from other forms of ownership and so loses the focus and relative freedom which has been the very reason for its success.

That’s why it is so important for us to win the argument that is currently being waged between those who believe that the right response to globalisation is protectionism and regulation, and those, like me, who believe that in the long-run, open markets and competition will serve society best. Win it, and we should see faster growth, increased productivity, more innovation, and a higher tax take to help fund our public services. Lose it, and we will see falling productivity, worse pensions, lower investment and a sclerotic economy.

I am confident that we will win that argument because the facts will increasingly speak for themselves. The result, in 25 years’ time, will be an industry which will be even more important than it is today, but one that will have become boring in that it will be as much part of our national life as public companies are today.