

Dealmaker

Providing business owners and managers with M&A market insight Fall 2011

Private Equity 101



Stephen McGee
Managing Director, Grant Thornton Corporate Finance

The private equity industry has been around for quite a while now, and data would suggest that private equity funds currently own in excess of 6,000 companies in the United States. Despite this fact, many private business owners do not have a robust understanding of private equity. In this special private equity edition of *Dealmaker*, we thought it would make sense to provide a Private Equity 101 primer, as well as some new data Grant Thornton has produced on trends in private equity fundraising, investing and exit activity. First, let's start off with a glossary of common terms.

Private equity fund: A committed pool of capital that is used to make investments in companies, typically a 10-year fund. In other words, at the end of the fund's life, the capital and any profits accumulated are returned to the investors. This means the first one to five years of a fund's life are focused on making investments. Years two through seven are spent creating value in the companies acquired, and years five to 10 are focused on selling those companies and generating a return. Private equity funds have different investment mandates ranging from minority equity

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investments to control buyouts, small deals to big deals, geographically focused funds to sector-focused funds, healthy deals to distressed deals, and private companies to public companies.

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Private Equity 101 (continued)

Limited partners: The investors in the private equity fund. Typically, limited partners are pension funds, endowments, insurance companies, high net-worth individuals and family offices. Their liability is limited to the capital they invest in the fund.

General partners: These are the guys and gals who raise and manage the fund during its 10-year life cycle. They are typically compensated by a management fee (2% of the fund) and a carry (20% of the profit returned to the limited partners).

Leveraged buyout (LBO): This is the most common form of private equity transaction. A fund buys a controlling equity position (more than 50%) in a company using a combination of equity from its fund and debt borrowed from a bank. Typical equity contribution ratios for LBOs run in the 30 – 40% range. For example, a company with \$10 million of EBITDA purchased for 6x EBITDA, or \$60 million, may be financed with \$35 million of debt (leverage) secured by the company's assets and cash flows, and \$25 million of equity from the private equity fund. If leverage is restricted (i.e., a bank will only lend \$25 million to finance the acquisition), the resulting gap is commonly bridged using mezzanine capital or sub-debt. The availability of debt is therefore critical to private equity funds' ability to buy companies at competitive prices.

Mezzanine capital or sub-debt: This is a hybrid of debt and equity. It commonly accounts for around 1x – 1.5x EBITDA in the capital structure of an LBO. It is unsecured debt in that it ranks behind the bank in terms of priority. Principal does not get repaid until the end of the investment term, which is normally five years. During the five-year term, a cash interest coupon (approximately 12%) is payable, and there may also be a non-cash interest pay in kind (PIK) of around 2 percent that accrues and is added to the principal, which must be repaid in the fifth year. In addition to the 14 percent total interest cost, there may also be warrants for a minority equity position in the company (typically around 10%). The combination of cash interest, PIK and warrants is intended to generate a total return to the mezzanine provider in the high-teens to low-20s percent range.

Internal rate of return (IRR): How funds measure the performance of an individual investment and the fund overall. This is essentially the implied compounded annual return calculated from the cash-on-cash return. For example, if an equity investment of \$10 million turns into \$30 million when the portfolio company is sold five years later, that would be an IRR of 25 percent. This IRR would be typical of the minimum kind of return a fund targets. It is important to note that this is not paid annually to the fund, rather it is the implied annual return calculated based on the proceeds from the future sale of the company compared with the funds invested on day one of the acquisition.

Rollover equity: In most LBOs the private equity fund gives the selling shareholders an opportunity to roll over some equity back into the deal. This is particularly common when the selling shareholders are integral to the future of the company and will remain in leadership positions during the private equity fund's ownership. Private equity funds like to refer to this as the second bite of the apple. Consider the previous example of the \$60 million LBO. If instead of taking their cash off the table, the owners decided to roll over \$5 million into the LBO, that would give them a 20% ownership position going forward, and their proceeds from the LBO would be \$55 million (\$60 million less \$5 million rolled over). If the company is sold five years later and the equity is worth \$75 million (25% IRR), the selling shareholders would get an additional \$15 million. Their total proceeds from the initial LBO and the second bite would be \$70 million (\$55 million plus the additional \$15 million).

Exit: When a private equity fund realizes an investment, this is typically referred to as an exit. Exits are achieved in one of three principal ways: the sale of the company to a strategic buyer, the sale of the company to another private equity fund (a secondary buyout) or an initial public offering (IPO). During the ownership of a company – cash flows permitting – the private equity fund may make dividend distributions to return capital to the fund. These distributions may be funded from the cash flows of the portfolio company or from new debt raised by the portfolio company. •

This list is not intended to be exhaustive, but it covers the basics of private equity. These terms should help you navigate the fall edition of *Dealmaker* as we take a deeper look at the private equity industry and the issues and trends it faces.

Private equity trends in North America



Eamonn Travers
Associate, Grant Thornton Corporate Finance

Family- and privately owned businesses are anticipated to account for about 51% of private equity M&A activity in North America, while the acquisition of other private equity firm portfolio companies (through secondary buyouts) is expected to account for 30% of dealflow. Corporate divestitures (17%) and IPOs (2%) will make up the remainder of M&A activity in the year ahead.

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Summary

A recent Grant Thornton survey of 20 private equity firms in North America identified the following issues and expectations with respect to the year ahead:

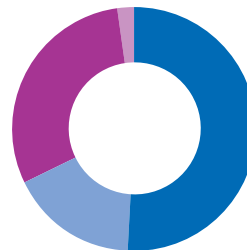
- Sixty-five percent of private equity firms expect increased M&A activity.
- Private equity exit activity is expected to increase by 50%.
- Fundraising conditions will continue to be challenging.
- Competition will be the biggest challenge facing private equity firms.
- Price remains key to winning deals.

M&A activity expected to increase

Nearly two-thirds of private equity firms we surveyed in North America predict increased M&A activity in the next 12 months. This bullish outlook compares favorably with other international regions and is significantly ahead of Western Europe, where confidence is tempered by economic instability in the region.

Expected sources of dealflow in North America

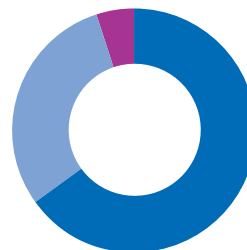
- Family/private business **51%**
- Corporate divestitures **17%**
- Secondary buyouts **30%**
- Other **2%**



Source: Grant Thornton International 2011 *Global Private Equity Report – A Force for Growth*

Expected M&A activity in North America

- Increase **65%**
- Stay the same **30%**
- Decrease **5%**



Source: Grant Thornton International 2011 *Global Private Equity Report – A Force for Growth*

Private equity trends in North America (continued)

Price is still king

When it comes to winning deals, price is still king. Private equity firms in North America surveyed by Grant Thornton identify price (37%) as a key factor to winning deals. Aside from price, quality corporate networks (37%), sector experience (29%) and advisory relationships (29%) remain central elements to winning deals and provide an important source of differentiation for general partners.

Competition to acquire quality assets is fierce, with strategic buyers looking to invest record amounts of accumulated cash and private equity funds racing to deploy uninvested capital before funds expire, it's hardly surprising that prices (valuations) are being driven up.

Fundraising conditions still demanding

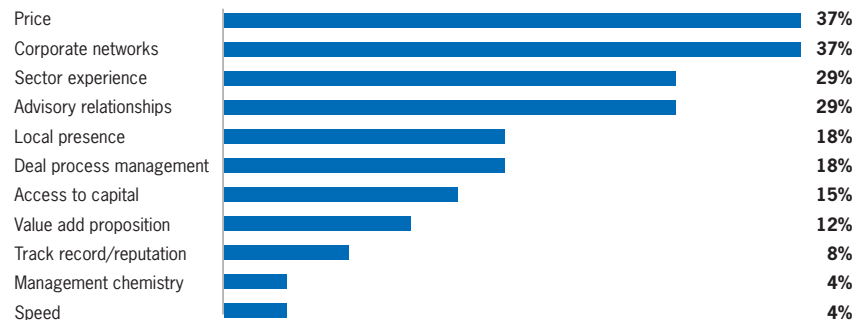
Fundraising continues to be challenging, with over half of private equity firms in North America seeing the environment as negative. Only 23% of private equity firms believe fundraising will improve in the next 12 months, as limited partners (banks, pension funds, insurance companies, etc.) are more deliberate and selective about where they put their money.

In such an environment, well-established private equity funds with proven track records for generating consistent returns are raising required amounts more quickly than others.

Another factor affecting fundraising is the increasing demand by limited partners for greater transparency from private equity funds. It is likely general partners will face additional demands from limited partners to provide more comprehensive reports as a precondition to funding.

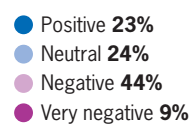
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Determinants for identifying and winning deals in North America



Source: Grant Thornton International 2011 Global Private Equity Report – A Force for Growth

Fundraising expectations in North America



Source: Grant Thornton International 2011 Global Private Equity Report – A Force for Growth

Only 23% of private equity firms believe fundraising will improve in the next 12 months, as limited partners (banks, pension funds, insurance companies, etc.) are more deliberate and selective about where they put their money.

Private equity trends in North America (continued)

Focus on value creation

Private equity firms are working closely with their portfolio companies to improve their bottom line. Given the backdrop of low revenue growth and the need for private equity firms to demonstrate their ability to generate returns, general partners are taking an active role in improving company performance.

More than 50% of private equity firms in North America expect to take a hands-on approach when it comes

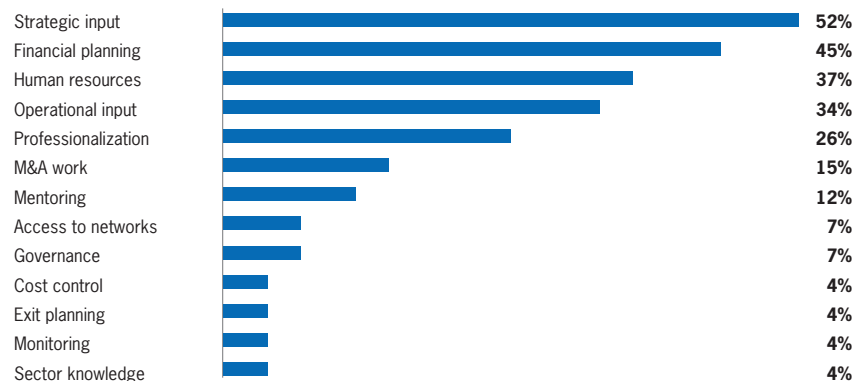
to providing strategic input for their businesses.

General partners also expect to assist portfolio businesses with financial planning (45%), human resources (37%) and operational systems (34%) as they attempt to maximize fund performance.

More than ever, portfolio companies continue to benefit from the professionalization (26%) of their businesses as they come under institutional ownership.

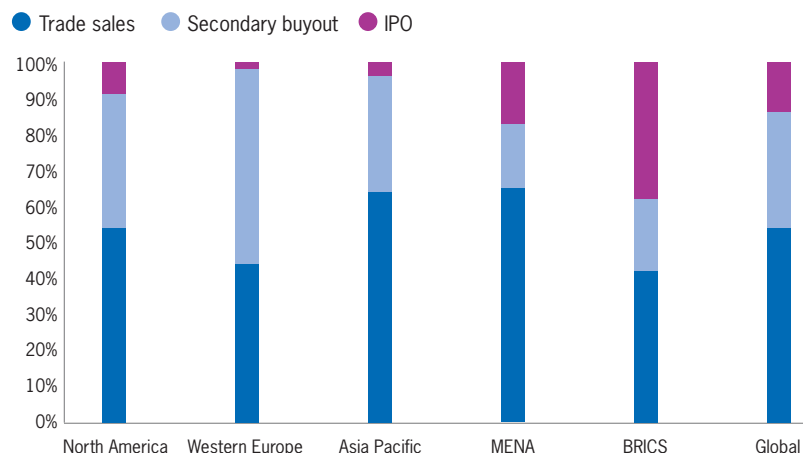


Expected portfolio involvement by private equity in North America



Source: Grant Thornton International 2011 Global Private Equity Report – A Force for Growth

Predicted global exit activity



Source: Grant Thornton International 2011 Global Private Equity Report – A Force for Growth

Greater exit activity expected

Over half of private equity firms in North America expect an increase in exit activity over the next 12 months. Trade sales to strategic buyers (55%) are expected to be the main route to exit investments in the year ahead for private equity firms in North America.

The IPO market is predicted to contribute only 10% to total exit activity in North America, with the remaining 35% accounted for through secondary buyouts (sales to other private equity firms).

It is worth noting that from a global perspective, private equity firms in emerging economies (Brazil, Russia, India, China and South Africa) still predict significant exit activity via IPOs (39%).

The lack of a viable IPO exit route can partly explain the rise of secondary buyouts, particularly in Western Europe (46%) and North America (35%), where the pressure on private equity firms to exit portfolios is matched by other private equity funds seeking opportunities to invest capital before investment periods expire.

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Private equity trends in North America (continued)

Competition represents biggest challenge

It is not surprising to learn that private equity firms in North America view competition (45%) as their biggest challenge over the next year, reflecting the keenly fought contest to win deals and raise funds in the industry. Regulation (37%) is also a major concern for general partners as the full implications of legislation introduced by the Dodd-Frank Act are still playing out.

The additional bureaucracy and compliance costs associated with increased regulation will be an ongoing challenge for the private equity industry.

Interestingly, macroeconomic issues (33%) registered a distant third behind competition and regulatory challenges. This contrasts sharply with the global picture where private equity firms continue to view the economic backdrop as their primary concern.

Other areas occupying private equity firms include a better understanding of limited partner sentiment (29%) and the need to maximize fund performance (15%). •

Anticipated challenges for private equity in North America



Source: Grant Thornton International 2011 Global Private Equity Report – A Force for Growth



Private equity exit activity for the first half of 2011



Nisha Raghava

Senior Associate, Grant Thornton Corporate Finance

One way to assess current M&A conditions is by analyzing the private equity (PE) market. Since PE firms are in the business of buying and selling companies, they can, in many respects, be considered the M&A pros. This article summarizes the findings of a recent survey undertaken by Grant Thornton LLP and PitchBook Data, Inc. that looked at the present state of PE exit activity and historical trends.

PE investment-to-exit imbalance

The current number of PE-backed companies is 6,107 – almost triple the number from 2004. This growth was driven by not only an increase in PE groups, but also by the recent lag in PE exit activity. During the recession, PE firms smartly opted to hold their investments rather than sell at depressed values.

One of the key results is that PE portfolios are quite aged, with many PE funds holding investments that would otherwise have long been divested. The chart to the right separates the current 6,107 PE-backed companies by the year of original investment. Based off the current median hold period of five years,

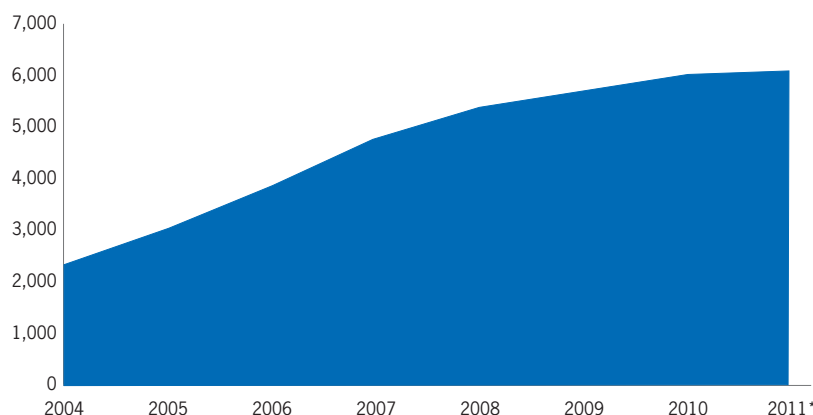
more than 1,600 companies are overdue for an exit, 922 investments are due for an exit before year-end, and more than 1,000 companies are due for an exit before the end of next year. These figures are significantly higher than historical norms.

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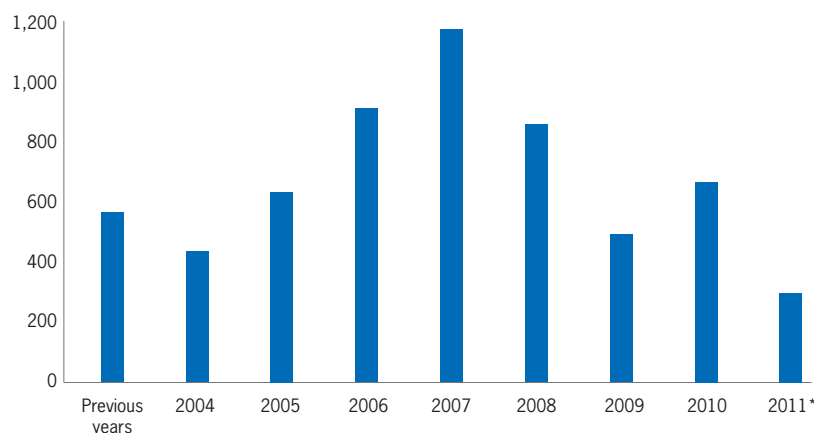
Number of PE-backed companies



* Through 2Q 2011

Source: PitchBook Data, Inc.

Number of PE-backed companies by original investment year



* Through 2Q 2011

Source: PitchBook Data, Inc.

Private equity exit activity for the first half of 2011 (continued)

As a result of this, there is pressure on PE groups to exit mature investments and return capital to investors. In some cases, limited partners are holding back on committing additional funds until they see more distributions.

Relevance to you

The anticipated increase in private equity exit activity may offer a great

opportunity for companies looking to grow through acquisition. Historically, strategic buyers have been the number one acquirer of PE portfolio companies, as the combination of two operating companies typically leads to synergies and other strategic opportunities for superior returns. Further, PE firms often have a very positive influence on the operations of their portfolio companies

– these effects can range from bringing more discipline to functions such as finance and accounting to advising on strategic decisions to exit unprofitable operations or invest in promising technology or acquisitions. A company looking to grow through acquisition might find PE exits to be a good pipeline for target opportunities.

Buyers of PE exits

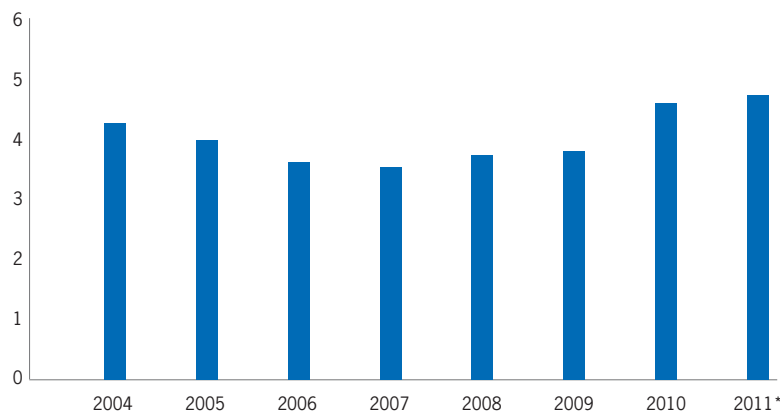
As noted, the principal form of exit for PE-backed companies is corporate acquisitions (sales to strategic acquirers), followed by secondary buyouts (sales to other private equity firms) and IPOs (taking the company public). Corporate acquirers closed 101 deals in the first half of 2011 with a median deal size of \$170 million, the second-highest amount ever. These strategic acquisitions are expected to remain strong as corporations have record amounts of cash on their balance sheets. Moreover, they are under tremendous pressure to either invest that cash in profitable growth or return it to shareholders.

Secondary buyout activity was relatively weak, with only 66 deals in the first half of this year. One possible reason for this is that several deals may have been pulled forward into Q4 2010 (instead of 2011 as planned) in response to concerns about expiring capital gains tax rates (which have now been extended through 2012). In a rush to exit, PE firms likely turned to other PE firms for their ability to run an efficient process and transact quickly. Going forward, secondary buyout activity is expected to increase as PE firms continue to chip away at the estimated \$450 billion overhang (uninvested PE capital).

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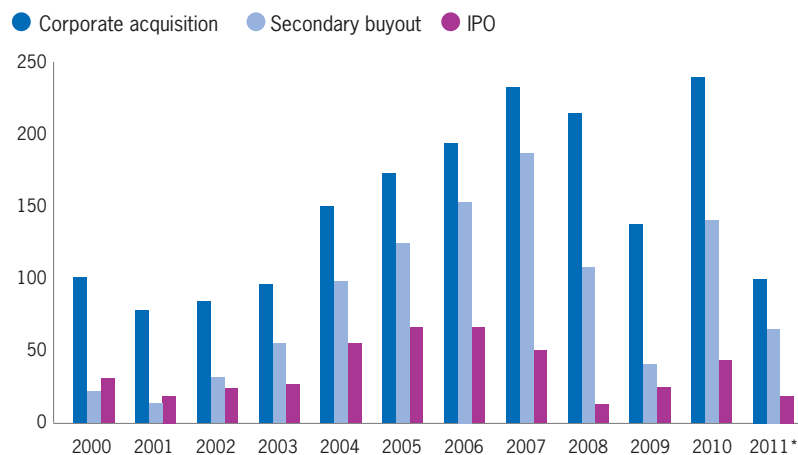
Median holding period

Number of years held



Source: PitchBook Data, Inc.
*Through 2Q 2011

Number of exits by transaction type



* Through 2Q 2011

Source: PitchBook Data, Inc.

Private equity exit activity for the first half of 2011 (continued)

PE IPO exit activity slowed dramatically following the downturn in equity markets, but fortunately, PE firms have taken advantage of improved stock markets and taken 63 companies public over the last year and a half. The remainder of the year is expected to be active with 82 PE-backed companies sitting in IPO registration.

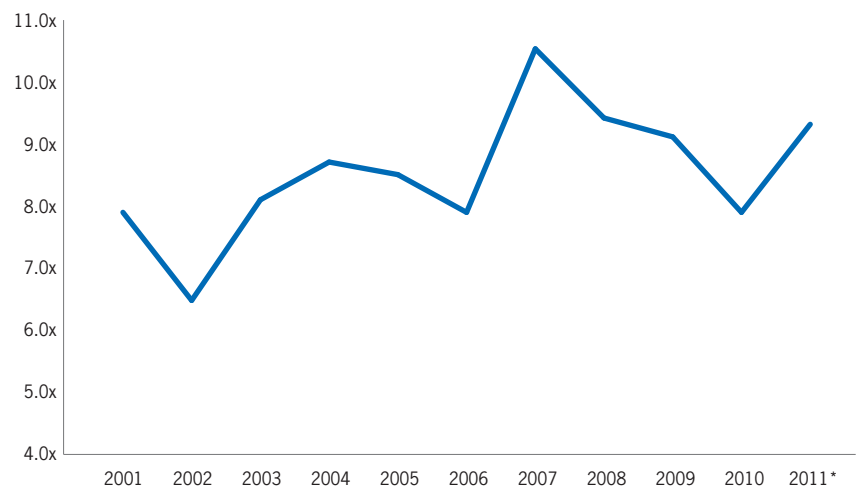
Valuation

Underlying both PE exits and the health of the M&A markets for sellers is a marked improvement in valuation levels for most companies. As demonstrated in the chart, valuation multiples of EBITDA have rebounded. While still off the highs of 2007, average multiples are showing significant improvement. At the same time, earnings are also improving for many companies. This, combined with increasing multiples, is driving significant increases in valuation.

Relevance to you

Increasing PE exit activity may also indicate that it is a good time to sell. In addition to other factors, PE firms take into consideration the general health of the M&A market when divesting portfolio companies. In this respect, PE firms and business owners are similar – both are looking to sell at the optimal time. This helps explain why most PE firms, and many privately held business owners, have held on to their companies over the past two years. The good news for business owners considering a sale is that PE exit activity is picking up, which is certainly one indication that M&A markets are strong right now and can support a reasonable valuation range. •

Median exit EBITDA multiple



Through 3Q 2011

Source: PitchBook Data, Inc.

The good news for business owners considering a sale is that PE exit activity is picking up, which is certainly one indication that M&A markets are strong right now and can support a reasonable valuation range.

Does partnering with private equity always make for a happy marriage?



Stephen McGee
Managing Director, Grant Thornton Corporate Finance

When considering the sale of a company, there are two primary types of buyers: strategic buyers (other companies) and financial buyers (private equity). Sellers often think that a strategic buyer will pay a higher price than a financial buyer because they will generate synergies from the acquisition. The problem with this assumption is that strategic buyers include competitors as well as other upstream/downstream industry participants. That's when things can get sticky. A lot of entrepreneurs hate the idea of selling to a competitor or another industry participant. Moreover, even if they would potentially sell to a competitor, they may be unwilling to share confidential information about their company with an industry participant during the sale process. There is also usually a valid concern that a strategic buyer may fundamentally change the way the company operates, putting current employees' jobs at risk and eliminating a future role for the selling shareholders, even if that is something that they desire.

Over the years, private equity transactions have become a common way for business owners, concerned with the issues that accompany the sale of a business to a strategic buyer, to extract liquidity from their businesses. Business owners looking to diversify their personal net worth, but still willing and eager to continue running the company and share in its future upside, often find themselves partnering with private firms to take some chips off the table now but still have a meaningful role and equity position in the company going forward. But does it make for a happy marriage?

There's no question about it: Once a private equity firm invests in a company, things start to change. After all, the private equity firm generates a good portion of its return from creating value in the acquired company, most typically

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through a combination of revenue growth and profitability improvements. But what makes a company successful at \$20 million may not be what is required to get the company to \$150 million in revenue. So, change is inevitable.

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Does partnering with private equity always make for a happy marriage? (continued)

The data also confirms this belief. Over the past three years, the World Economic Forum has sponsored a series of research projects regarding the global impact of private equity. The research looked at several important factors affecting companies that are backed or owned by private equity firms. Some of the findings included:

- Firms that undergo a buyout pursue more economically important innovations, as measured by patent citations, in the years after private equity investment. In analyzing 495 firms, the overall increase in activity was 25 percent.
- The study looked at 4,000 companies in Asia, Europe and the United States. The companies were surveyed regarding 18 management practice areas. The research found that private equity-owned portfolio companies are on average the best-managed ownership group. Across a wide range of management practices, private equity-owned companies are significantly better managed than government-, family- and privately owned firms. Often, private equity-owned portfolio companies are particularly strong at operational management practices, such as the adoption of lean manufacturing practices, using continuous improvements and comprehensive performance documentation processes.

- In analyzing 20 industries in 26 countries, the impact of private equity was assessed. The assessment found that over a 16-year period, industries where private equity firms have been active in the past five years grew more rapidly than other sectors. Looking at measures such as total production, value added, employment and consumption of fixed capital, growth was, on average, 11.5 percent greater in sectors with private equity activity.

Many business owners recognize that they may benefit from bringing a private equity partner on board, but that doesn't guarantee that the marriage will be a happy one. Problems usually start with the realization that for the first time in a long time (or maybe ever), the entrepreneur will have to answer to someone else. Some business owners can come to grips with this and some cannot. Therefore, it is better to be honest with yourself regarding this issue before even contemplating a private equity transaction.

A related concern is control, which can range from day-to-day control over operational decision-making to shareholder- and board-level control over significant decisions such as when, how, to whom and at what value a subsequent sale may occur. There is a significant difference between operational control and economic control. Most private equity funds want nothing to do with the day-to-day operations, but they have a fiduciary responsibility to be involved in the significant strategic decisions.

So, what happens if things start going wrong? Most entrepreneurs are concerned that if the business encounters challenges, the private equity partner will swoop in and, in short order, replace management – specifically them. They fear that they will be forced out of the operations of the business and thus lose control while still maintaining a significant ownership position. For some entrepreneurs, the potential for being on the outside looking in negates the benefit of working with a financial partner to get some chips off the table while still having a second bite of the apple.

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Does partnering with private equity always make for a happy marriage? (continued)

In addition to value creation, private equity returns are enhanced through the use of leverage (debt). As adventurous and aggressive as many entrepreneurs are, a large number of them are extremely wary of debt. Some of these fears are generational, others have to do with past near-death (bankruptcy) experiences. Some entrepreneurs are afraid of being pressured by the bank if the company has challenges. Whatever the reason, this dislike of debt flies in the face of a traditional private equity transaction.

Keep in mind that this is a two-way street. Not all of the relationship issues may be on the business owner's side of the table. While many private equity firms are attracted to the entrepreneur and their entrepreneurial spirit, they can also be scared off by an entrepreneur who has too much entrepreneurial spirit. Too much of a good thing can become problematic if the entrepreneur is perceived to be overly aggressive or unfocused (pursuing too many opportunities at once). It's also a problem if the owner is unwilling to delegate, not sensitive to risk management, not open to suggestions, impatient or unwilling to respect authority.

While many private equity firms are attracted to the entrepreneur and their entrepreneurial spirit, they can also be scared off by an entrepreneur who has too much entrepreneurial spirit.

And finally, nothing is worse for a private equity firm than finding a company it really likes and then discovering that it has inadequate financial reporting systems and controls in place. Aside from being a good business practice for any owner, a private equity firm needs its portfolio companies to maintain good reporting systems and controls. They must be able to monitor their investments and present accurate financial results to their limited partners and other financing sources. Accounting processes that may work for an entrepreneur with little or no debt may not be suitable for a private equity investor. Having audited financial statements is an obvious start to bringing accounts up to par, but having sophisticated reporting systems and controls allows a company to operate in a truly professional manner. Sometimes, it's as simple as having a high-quality controller or CFO take control of the process and ensure conformity to an acceptable standard.

So, does partnership with private equity make for a happy marriage? Maybe. Just like with any partnership, the more honest both parties are about their strengths and weaknesses, and goals and objectives, the more likely it is that they will find a business soul mate to take the next step with them. •

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Stephen McGee

National Practice Leader
Grant Thornton Corporate Finance LLC
T 617.848.4988
E stephen.mcgee@us.gt.com

www.GrantThornton.com/Dealmaker

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