

Creating growth: *the challenge of buying well in today's market*

Global private equity report 2014/15

EXECUTIVE SUMMARY



Foreword

Private equity has always focused on creating value and helping promote growth in portfolio companies. Since the industry began, private equity firms have tried many ways to meet this ultimate objective – and with varying success. Now, post the global financial crisis, the question being asked more than ever is: how can private equity deliver its value-added promises?

Whilst the market has benefitted from wider exit options and an improvement in the fundraising climate, at the same time as debt finance markets have eased, finding good quality deals at good prices is proving a real challenge for many private equity buyers. There is so much more competition both in developed and emerging markets.

In addition to the private equity cycle adding to the pot of money looking for a home, LPs themselves are increasingly seeking to put funds to work directly, representing another source of competition for the best deals.

Then there are corporate buyers and such is their hunger in certain sectors right now that, even with favourable debt markets, it is tough for private equity to compete.

More competition means one thing: higher prices. And higher prices at entry make it harder to achieve attractive returns at exit. This means there is a growing and clear emphasis on how to generate the value needed to justify the commitment of further capital and costs to private equity.

Put simply, the responsibility is with private equity firms to identify and pull the most important levers in the value generation machine that most now either have, or at least recognise, they need to build.

This is the fourth annual Grant Thornton global private equity survey and we interviewed **175** private equity firms from across the globe. This year we focus on the themes of 'buying well' in today's market, and the role that secondary buyouts are playing in this challenging but fast-moving environment.

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Entry multiples

“It’s less about entry multiples and more about returns”

Traditionally, PE investment has placed a heavy emphasis on the deal entry price as this was frequently seen as a core driver of the eventual return on the investment. Our survey has evidenced a shift in emphasis suggesting that whilst entry price remains important, the ability to transform business performance during the portfolio stage is a necessity.

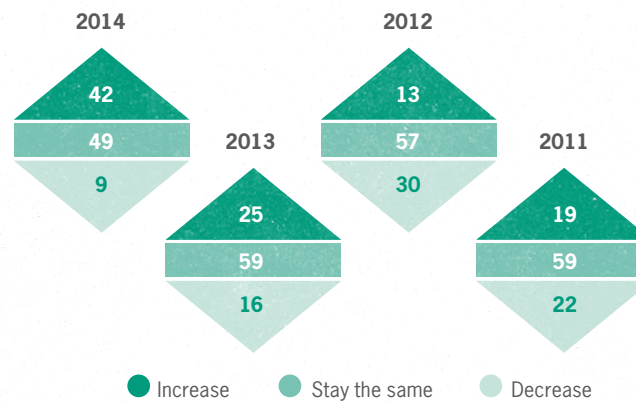
Headlines

- Entry multiples are increasing and are expected to stay high.
- The survey results clearly indicate that old fashioned multiple arbitrage is by far the least important portfolio value driver.

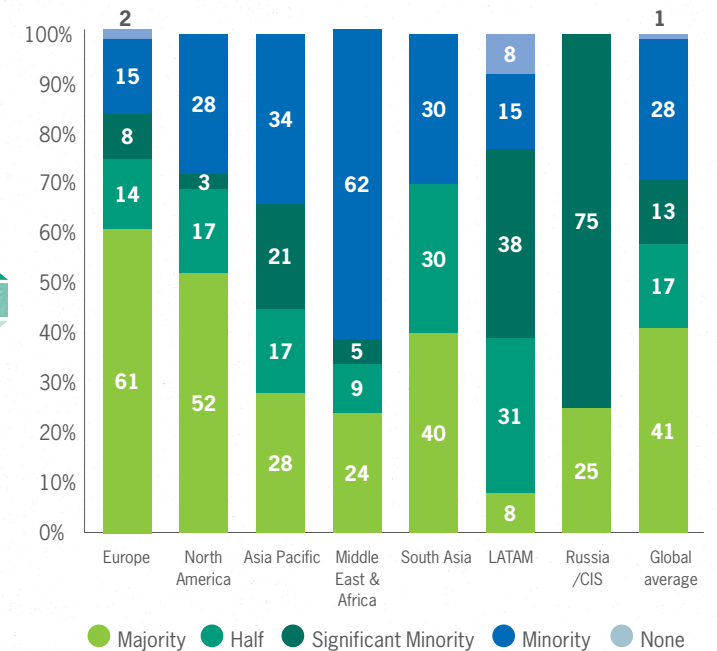
“We like to think it’s about 50% purchase price and 50% improvement. It’s probably less than that, probably more like one third price and two thirds improvement.”

CANADA

DO YOU FORESEE ENTRY MULTIPLES INCREASING, DECREASING OR STAYING THE SAME IN YOUR MARKET OVER THE NEXT 12 MONTHS? (%)



ON WHAT PROPORTION OF DEALS ARE YOU COMPETING AGAINST OTHER PE FIRMS? (%)



Entry multiples *continued*

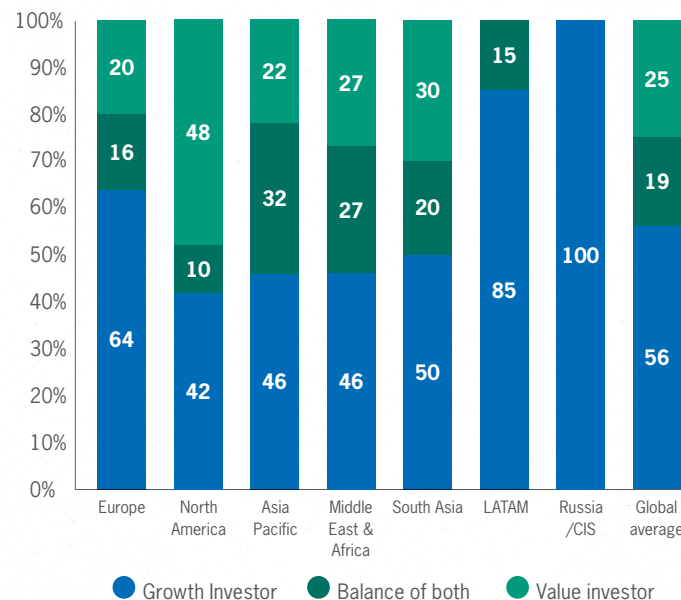
Headlines

- Around the world the vast majority of GPs see themselves as ‘Growth Investors’ as opposed to ‘Value Investors’ which suggests that in a climate where full entry values are an increasing reality, there is an acceptance that transformational work will have to be done to create the desired returns.

‘Growth Investing’ – a strategy whereby an investor seeks out investments with what they deem good growth potential.

‘Value Investing’ – the strategy of selecting investments that trade for less than their intrinsic values.

DO YOU CONSIDER YOURSELF A GROWTH INVESTOR, A VALUE INVESTOR, OR SOMETHING ELSE? (%)



The Grant Thornton view

- Does greater portfolio engagement imply longer hold periods? What implications could this have on fundraising strategy and liquidity realisation?
- Is there a need for greater investment in sector and business skills to drive value creation in the portfolio businesses?
- For each investment is there a credible investment thesis which is supported by robust commercial/strategic evidence?

“Any strategy predicated on buying well is flawed because everything you buy you have to overpay for. I think it’s all about what you do to the company after you have bought it. Those that will really make money will be those that can really have an impact on their portfolio companies.”

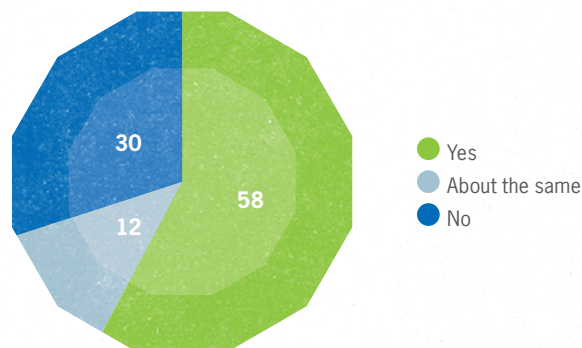
UK

Secondary buyouts

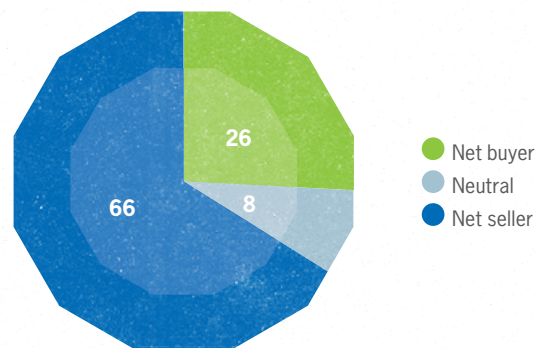
“Secondary buyouts are a serious buy side option not just an exit make weight”

The secondary market is perceived as an increasingly significant source of investment opportunities. There is a widely held belief that it will be difficult to generate a sufficient return from these assets due to the perceived ‘higher quality, lower risk’ profile and that the exiting PE investor may well have stripped out much of the value-add potential. However, in our view, there is an opportunity to exploit the secondary market.

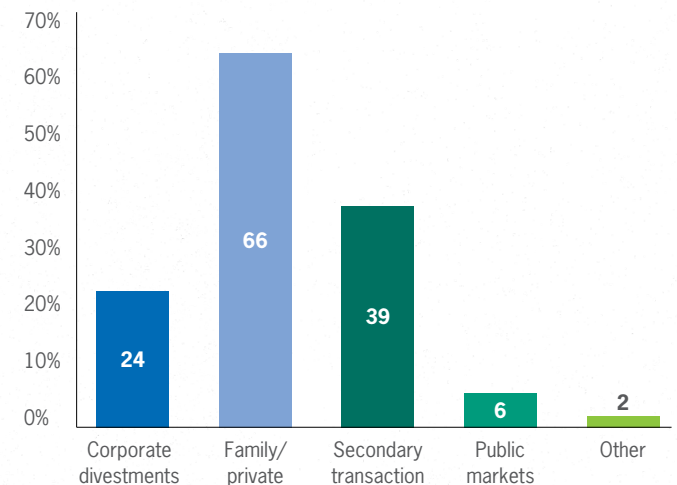
ON AVERAGE, DO YOU PERCEIVE THAT PE FIRMS PAY HIGHER MULTIPLES FOR BUSINESSES ACQUIRED VIA SECONDARY TRANSACTIONS THAN THROUGH OTHER ROUTES? (%)



ARE YOU A NET BUYER OR NET SELLER WITHIN SECONDARY TRANSACTIONS? (%)



WHAT DO YOU EXPECT TO BE THE MOST SIGNIFICANT SOURCE OF DEALS OVER THE NEXT 12 MONTHS? (%)



“This increase is driven by the fact that there are late vintage PE funds coming to the end of the fund period and having to exit.”

SOUTH AFRICA

“It is harder to generate value. But it’s perhaps more reliable. The returns are not necessarily as high compared with if you got a trade buyer. They are stable, you are unlikely to face major shocks.”

SCANDINAVIA

Secondary buyouts *continued*

Headlines

- Opportunities will arise from the build-up of primary investments that need to be realised due to end of life fund profiles.
- The lower risk profile, higher quality perception of secondary transactions implies safer, but less spectacular returns.

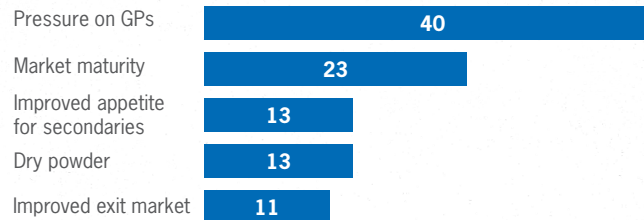
“Yes I would agree that PE firms pay higher multiples for businesses acquired via Secondaries, this would be a natural assumption given the work the PE firm will have done to refine the business.”

CHINA

“The business should be in good shape having been run by another PE firm. The principle disadvantage is the management team will usually be taking some money off the table and that can have an effect on their motivation.”

UK

WHY DO YOU EXPECT THE LEVEL OF SECONDARY DEALS TO INCREASE/STAY THE SAME? (%)



The Grant Thornton view

- Could an appropriate weighting in the portfolio towards more secondary investments lead to average portfolio returns being substantially the same as a traditional portfolio mix where the returns from a few ‘high performing’ investments are expected to outweigh a number of ‘poor performing’ investments?
- What are the options for motivating a management team which will be taking money off the table?

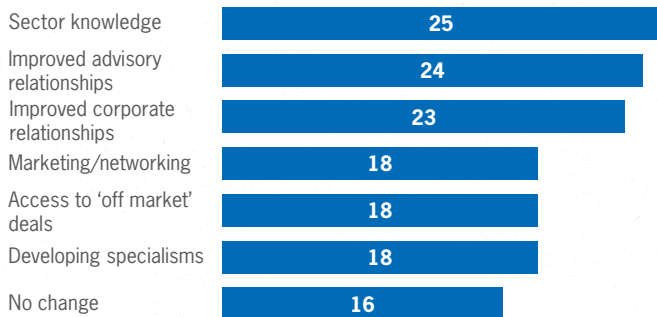
Getting to know the owners/managers

“It pays to understand management team capability early in the process”

The building of long-term relationships with owner/managers in pursuit of ‘off-market’ opportunities is a widely adopted response to the highly competitive PE investment landscape. Additionally, being able to assess management’s ability to implement a post-acquisition plan is a vital part of the investment decision process.

Despite this focus, it is interesting that there is an inconsistency between what PE firms consider to be the building of good relationships with management during the origination phase, and the survey findings that it is management issues that are the single largest reason for a deal to collapse. We consider that PE investors should explore deploying far more robust processes to evaluate management’s ability to deliver their investment proposition ahead of committing to formal financial, tax, legal and commercial diligence procedures.

IN WHAT WAYS ARE PE FIRMS HAVING TO DEVELOP AND ADAPT THEIR APPROACH TO DEAL ORIGINATION IN ORDER TO IDENTIFY DEALS IN TODAY’S MARKET? (%)



“You may settle for a price below your target rate of return if you feel there is a good management team in place that you trust; that therefore reduces any concerns over other knock-on risks along the way.”

BRAZIL

“It’s about finding a good company in an average market – or rather, it is usually about finding good management in an average market. Good management is of paramount importance.”

UAE



The Grant Thornton view

- In assessing management, what more could be done to mitigate deal execution risk?
- The business plan will inevitably require change – can the present management team deliver a plan that may be very different to its current one?
- Are management relationships sufficiently broad or are they restricted to a narrow senior team?

Grant Thornton and the private equity industry

This report highlights a number of opportunities for those within private equity. At Grant Thornton our network of professionals can provide support in realising and taking advantage of these opportunities. We have in-depth experience working with private equity firms around the globe, bringing together international teams from corporate finance, restructuring and performance improvement, taxation and assurance services that provide bespoke solutions – from investment, through the growth phase to exit.

As well as acting for private equity firms, we also advise many private equity-backed companies, and management teams seeking private equity investment.

If you have any questions about the findings in our report or would like to discuss how these results may affect you and your business, we would be more than happy to discuss further.



For further information please contact:

Martin Goddard

T +44 (0)20 7728 2770

E martin.goddard@gti.gt.com

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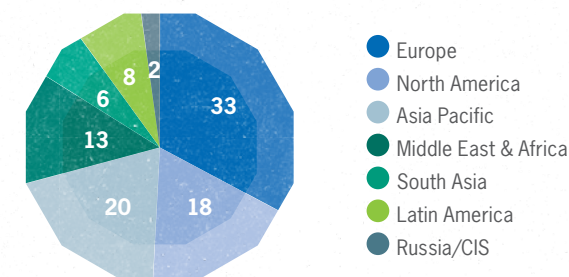
- \$4.5 billion turnover
- 2,800+ member firm partners with 38,500 people
- More than 700 offices in 130 countries

Methodology

This document presents the findings of the fourth annual Grant Thornton Global Private Equity Study. The findings are based on data gathered from 175 interviews with GPs. Respondents are spread across the seven regions covered by the study: Europe, North America, Asia Pacific, Middle East & Africa, South Asia, Latin America and Russia/CIS (see pie chart).

In addition to our regular ‘barometer’ questions which provide insight into expected key trends throughout the private equity cycle, this year’s study also explores the significance of buying well in generating value, as well as GPs’ latest views on secondary buyouts.

REGIONAL BREAKDOWN OF RESPONDENTS (%)



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