

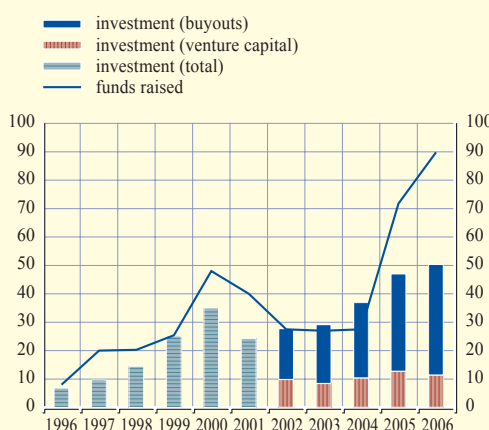
Box 5

WHAT IS BEHIND THE SURGE IN PRIVATE EQUITY ACTIVITY?

The private equity industry in Europe has changed substantially over the past few years. Preliminary figures suggest that the amount of funds raised reached a total of €90 billion in 2006, a 25% increase by comparison with 2005 and more than three times the 2004 value (see the chart).¹ At the same time, total investment (excluding bank debt) amounted to only around €50 billion in 2006. This might signal further large buyout deals in the period ahead, as nearly 80% of the total funds raised were expected to be allocated to the buyout segment, compared with approximately 40% in 2000. This should be seen against the background of a buoyant market for buyout deals, especially leveraged buyouts: the total market value of buyout transactions in Europe increased to €160.3 billion in 2006, up from around €130 billion in the previous year.² While the role of private equity in providing finance and management services has increased in the last few years, the absolute aggregate values involved annually are still relatively small, representing less than 1% of nominal GDP in the EU. Regarding investors, pension funds took the lead as the main source of capital raised, representing 22% of the total funds raised, followed by “funds of funds”³ and banks. This indicates that private equity has established itself as an investment vehicle for institutional investors. Against this background, this box elaborates on the factors driving recent developments in the private equity sector, in particular the surge in buyout activity.

Activity in the European private equity market

(EUR billions; gross flows)



Source: EVCA.
Note: Data for 2006 are preliminary.

Purpose of private equity activity

Private equity is equity financing of unquoted companies or the financing of the equity tranche of buyouts of public companies. Targets are often mature companies with a stable cash flow and assets to be used as collateral. The incentives to undertake buyouts are mainly related to corporate governance. The aim of a buyout deal is to increase the valuation of a company and enhance efficiency by, for example, reducing costs, restructuring management and organisation, streamlining operations or divesting non-core businesses. For publicly traded companies, there is a distinction between executive management and ownership, while the two are intertwined in a company run by a private equity firm. As a consequence, risk diversification decreases

1 According to the European Private Equity and Venture Capital Association (EVCA).
2 According to the Centre for Management Buyout Research (CMBOR).
3 For example, mutual funds which invest in other mutual funds.

drastically when a company is taken private through a buyout deal. Nevertheless, taking a public company private via a buyout transaction could reduce agency costs related to the public capital market, by aligning more closely the interests of the management and owners of the company. Furthermore, in some cases, public firms have been taken private to avoid costs (both perceived and actual) associated with regulatory compliance and shareholder scrutiny.⁴

Reasons for the increase in private equity activity

There are several reasons, on both the demand and supply sides, why private equity activity is surging at present. For example, financial innovation has been important in facilitating complex funding structures that have allowed buyout partnerships to pursue larger deals with higher leverage multiples. Thus, the buyout market has witnessed increasing flexibility in debt structures in order to meet various investors' preferences, strategies and desired levels of risk exposure. Innovation has increased the ability of the market to repackage, trade and sell down credit risk, which has enabled debt providers to spread risk more widely. The wider distribution of syndicated loans has contributed to enhanced risk-sharing by banks by allowing them to sell down their potentially very large deal-specific debt exposures.⁵ Moreover, the expansion of the credit derivatives market has further enhanced the risk management of debt exposure by allowing banks to distribute default risk to third parties that are more willing to bear it. Finally, the wider distribution of syndicated loans involving several partnerships ("club deals") has entailed the arrangement of record-breaking deals in terms of amounts. Large leveraged deals have also been facilitated by the current easy access to debt financing, fuelled by favourable general financing conditions and low interest rates. At the same time, more relaxed attitudes towards risk and leverage have encouraged new types of player to allocate a share of their funds to "alternative asset classes" – such as private equity – either as equity or debt investors. The previously relatively untapped potential of the M&A and corporate debt markets in the European Union has provided an additional boost to this activity. Overall, highly leveraged private equity deals can involve a shift in the balance sheet as extreme as moving from a publicly quoted company with 70-80% equity and 20-30% debt to a private structure with 20-30% equity and 70-80% debt.

Other important driving forces behind the recent surge in private equity activity are the steady rise in corporate profitability and a wider range of exit strategies. The steady rise in corporate profitability, underpinned by the current benign macroeconomic and financial conditions, has increased companies' free cash flows and therefore their attractiveness as targets. An excess of cash or strong cash flows can be used to repay the debt raised in the buyout transaction. At the same time, the development of exit markets for buyout deals has improved the liquidity structure of buyout investments. The increasing specialisation of buyout partnerships in particular phases of the corporate restructuring/turnaround processes has enhanced the role of secondary sales as an exit strategy and shortened the investment periods of individual partnerships. There are several exit options open to a private equity investment company: to sell to an investor; to sell the company through an initial public offering (which highlights the importance of a functioning market segment for IPOs and of smooth access to stock exchanges); or to sell to another private equity fund.

4 In the United States, managers of some publicly traded companies subject to more stringent regulation following the implementation of the Sarbanes-Oxley Act have reportedly opted to pursue management buyouts as a means of reducing the regulatory burden.

5 See also ECB (2007), "Large banks and private equity-sponsored leveraged buyouts in the EU".

What are the possible effects of private equity activity?

The increased importance of private equity has affected corporate governance in the euro area, as private equity could be used to carry out significant restructuring in more mature industries. Recent research found that management buyout plants in the United Kingdom were significantly less productive than comparable plants before the transfer of ownership, but experienced a substantial increase in total factor productivity after a buyout.⁶ Moreover, evidence from the United States, the United Kingdom and the Netherlands shows that buyouts are followed by significant increases in new product development and other aspects of corporate entrepreneurship.⁷ At the same time, concerns have been expressed about possible negative implications for the longer-term health of target companies, which are often left with additional debt after the private equity firms have cashed in on their investment. In addition, while, according to the EVCA, net employment growth in buyout-financed companies in the EU rose by an annual average of 2.4% between 1997 and 2004, compared with average annual growth in employment in the EU15 of 1.2%,⁸ the short-term dynamics of employment show that jobs are usually cut during the first year after a takeover deal, implying short-term employment costs.⁹ The delisting of individual companies, which often follows the buyout deal, may also increase the opaqueness of the corporate sector and thus worsen problems of asymmetrical information, for example for remaining minority shareholders.

Overall, the activity of private equity funds may often increase the efficiency and the long-run growth of the companies which are involved in the deals, even though employment costs may be observed in the short-term. In addition, since buyout deals have become highly leveraged, they can affect the overall indebtedness of the non-financial corporate sector and increase its vulnerability to negative shocks. The performance of the new risk transfer markets which have accompanied the surge in private equity activity also remains to be tested in less favourable circumstances.

6 R. Harris, D. Siegel and M. Wright (2005), "Assessing the impact of management buyouts on economic efficiency: plant-level evidence from the United Kingdom", *Review of Economics and Statistics*, Vol. 87 (1).

7 CMBOR (2007), "The impact of private equity: setting the record straight".

8 EVCA (2005), "Employment contribution of private equity and venture capital in Europe".

9 Work Foundation (2007), "Inside the dark box: shedding light on private equity".