

**11<sup>th</sup> FINSIA / MELBOURNE CENTRE FOR FINANCIAL STUDIES  
BANKING AND FINANCE CONFERENCE**

**PRIVATE EQUITY:**

**ITS RECENT DEVELOPMENTS AND NEW CHALLENGES**

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Managing Director  
Allco Equity Partners Ltd  
25 September, 2006**



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## 1. Overview of Private Equity

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- Basic Structure
- Differences with Hedge Funds and Cash Boxes
- Types

# 1. Overview of Private Equity

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## Basic Structure

- Funds providers (Limited Partners) enter into a contractual obligation with Manager (General Partners) to supply funds (equity) over fixed period (usually 5 years) at call, subject to certain key criteria being met e.g. due diligence, threshold IRR, capital to be returned by year 7 etc.
- Manager acquires business using funds for equity and borrows senior and mezzanine debt secured solely against acquisition balance sheet.
- Manager (General Partner) receives management fee of 2% p.a. of committed funds and 20% of equity returns above threshold, say 8% p.a.
- By end of fund timeline all monies returned. Manager goes out and raises new fund.
- Investors objective is to achieve above average returns through Managers ability to secure assets using proprietary deal flow and/or specialist management skills.

# 1. Overview of Private Equity

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## Key differences – private equity versus cash box versus hedge funds

- Private equity funds
  - Focus on owning, operating, then sale of whole business
  - Strict contractual requirement e.g. investment geography, due diligence. Together with lack of balance sheet limits investments to unlisted sector
  - Timeline for acquisition and then sale is 2 - 4 years due to fund limited life. Any capital drawn down must be returned
  - Manager performance fees emerge after several years
  
- Hedge Funds
  - Can invest in any asset class without due diligence
  - Focus on short term liquid assets
  - Managers performance measured and paid each year

# 1. Overview of Private Equity

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- Cash Boxes
  - Investment criteria similar to private equity
  - No obligation to undertake due diligence or limits on investment geography  
Capital is not repayable
  - Balance sheet allows assets to be financed either non-recourse or using own balance sheet
  - Can invest in unlisted or listed sector

# 1. Overview of Private Equity

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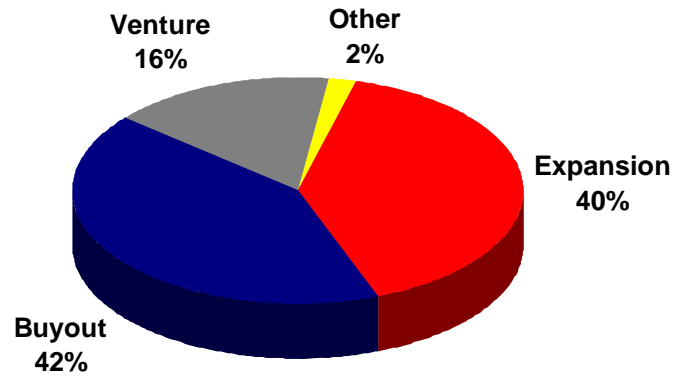
## Investment Class / Composition

- Buyout – Acquisition of large scale, mature business
- Expansion – Financing by equity, warrants or convertible notes of expansion capital for existing business
- Venture – Finance for start ups, particularly in technology sector
- Other – Finance for business ideas or very early business plans e.g. Angel funds or investment in distressed debt, equity linked debt, sub debt etc

# 1. Overview of Private Equity

## Investment Class / Composition

### Capital by Investment Class



### Key Features of the Market: 1995 - June 2005

	1995	June 2005
Capital (AUD m)	1,660	12,200
Number of Funds	26	164
Median fund size (AUD m)	30	150
Manager birth rate	8% per annum	

# 1. Overview of Private Equity

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## Investment Class / Composition 2004/2005

### New Investments

Stage	No. Deals	Amount (AUD m)	%
Buyout	25	1,089.1	63%
Expansion	105	274.0	16%
Venture	60	203.1	12%
Other	19	174.9	10%
Total	209	1,741.1	100%

### Investments Realised

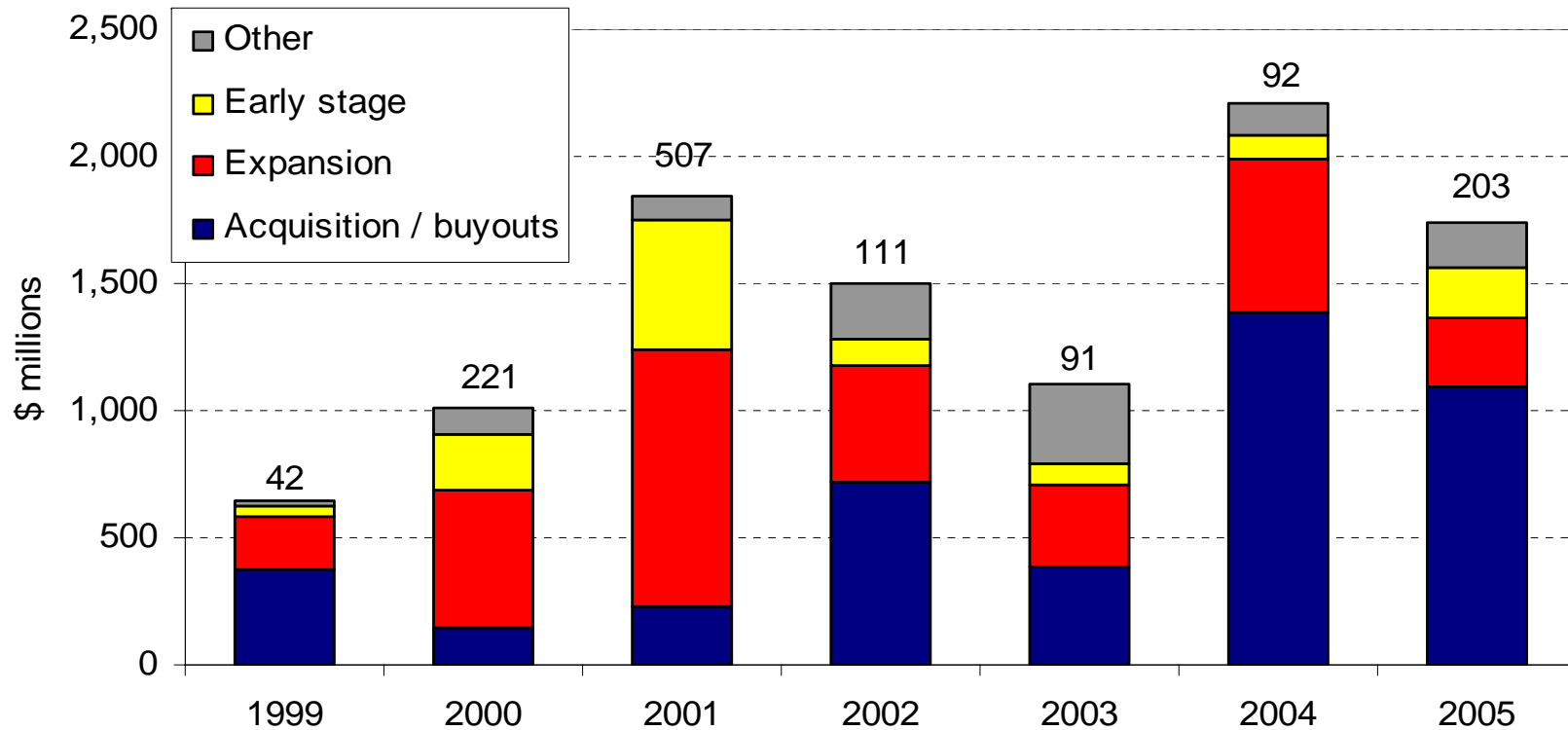
Exit Method	Number	%
Trade Sale	43	56
Write-off	11	14
IPO	5	7
Other	18	23
Total	77	100

# 1. Overview of Private Equity

## Investment Class / Composition

Aquisition / buyouts sector dominates by value

Early Stage, Expansion & Buyout Investment 1993 to 2005



# 1. Overview of Private Equity

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## Performance

Australian Private Equity Returns 1987-2005  
(at 30 June 2005)

Sector	Number of Funds	Pooled Average (% pa IRR)	Upper (% pa IRR)	Median (% pa IRR)	Lower (% pa IRR)
Buyout/Later Stage	27	24.6	42.3	9.4	-5.6
Expansion	55	5.2	10.8	0.5	-5.9
Venture	28	6.9	2.7	0.0	-10.7
All Private Equity	110	10.6	12.6	0.1	-8.7

# 1. Overview of Private Equity

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## Performance

### Global Private Equity Returns – Horizon Returns

*Periods to 30 June 2005 (Australia) and 31 March 2005 (US)*

Sector	1 yr (% pa IRR)	3 Yr (% pa IRR)	5 Yr (% pa IRR)	10 Yr (% pa IRR)
Australia – Buyout / Later Stage	19.2	37.8	24.6	---
Australia - All Private Equity	10.7	14.6	8.0	---
S&P/ASX300 (Accum)	26.0	14.7	9.8	---
US – All Private Equity	14.0	5.3	-0.5	12.5
S&P500	4.8	1.0	-4.7	8.9

## 2. Scale and Recent Growth

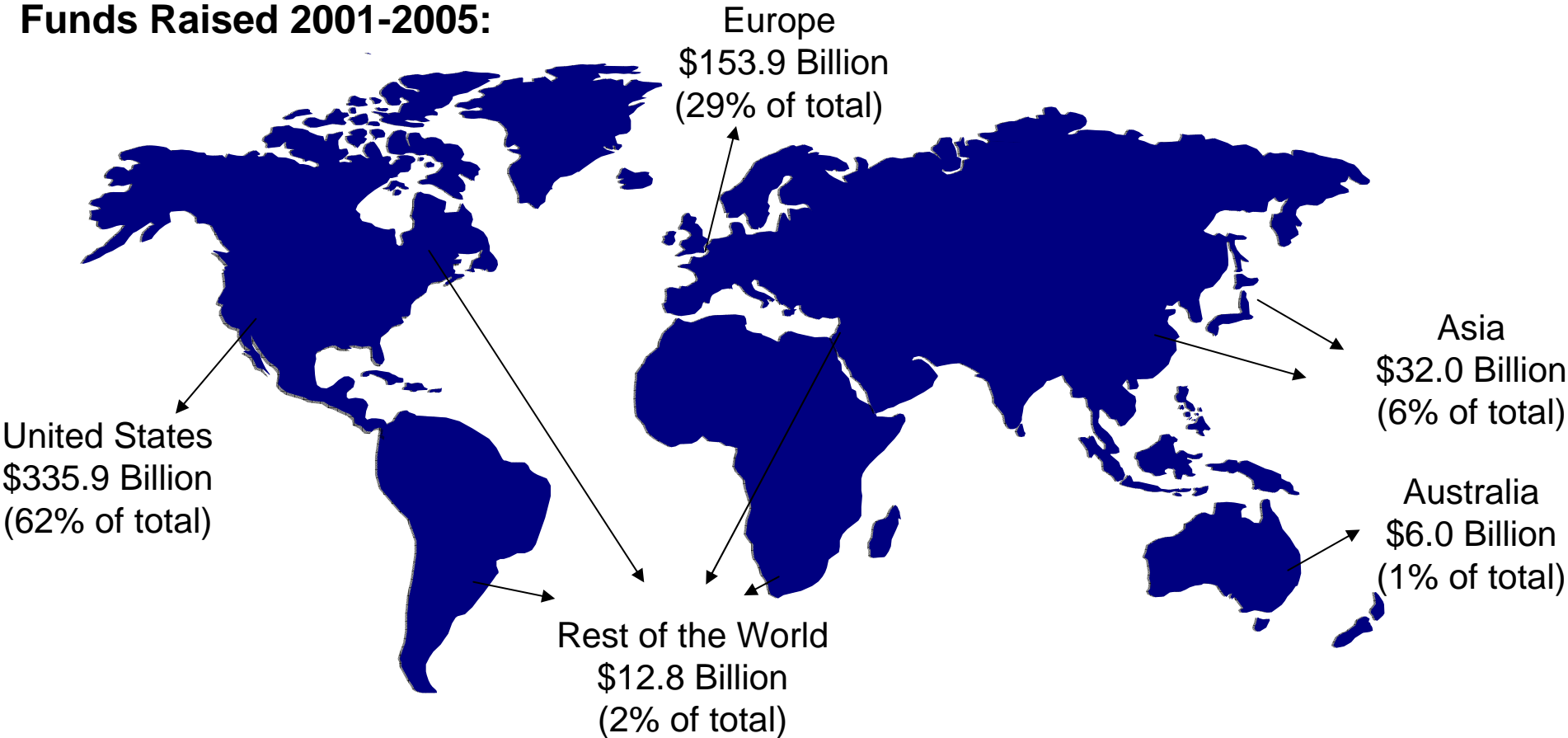
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- In Australia
- In Region

## 2. Scale and Recent Growth

Private Equity is a large and growing asset class

### Funds Raised 2001-2005:



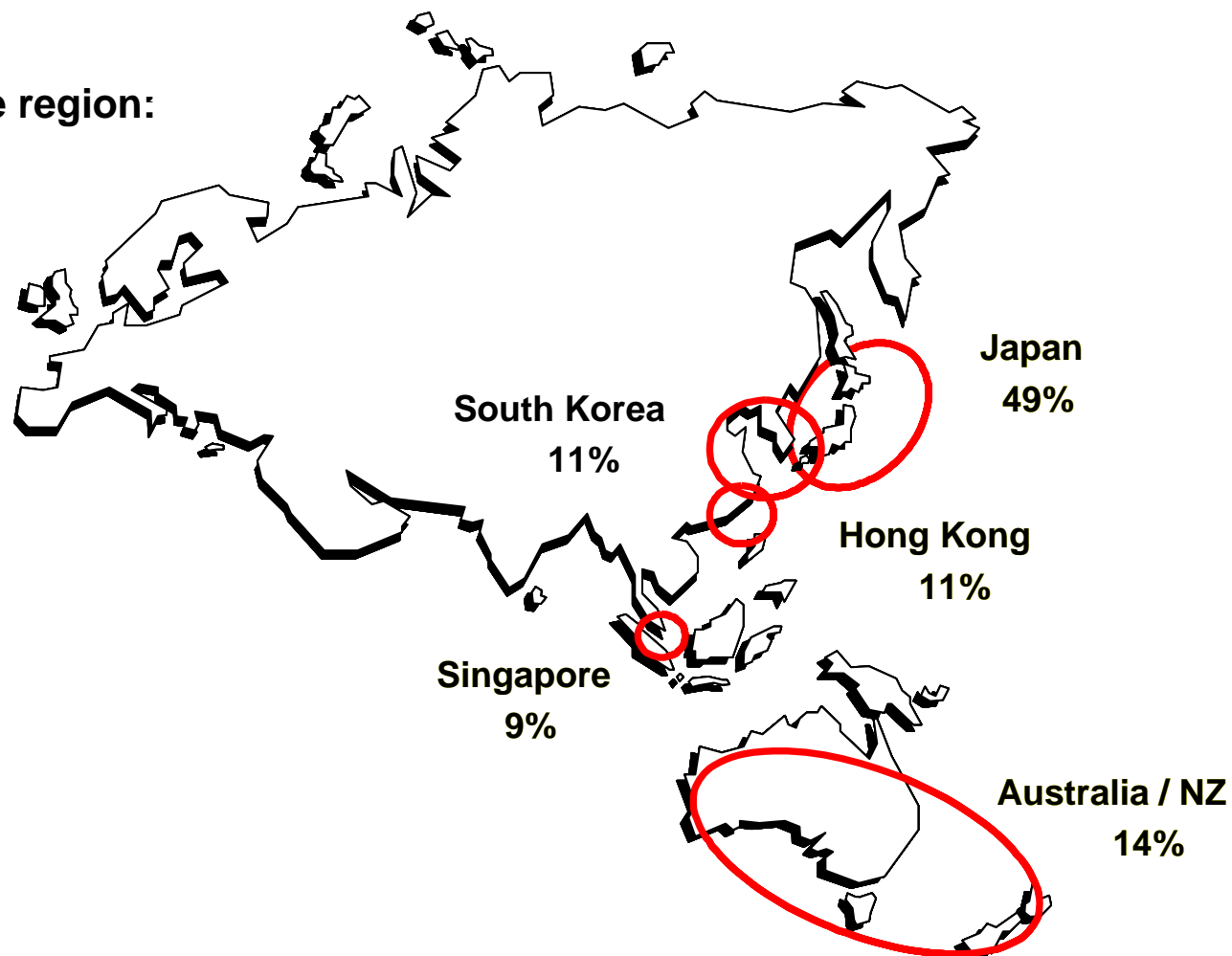
Source: Venture Economics, Buyout and Venture funds raised, 2005 HarbourVest estimates

## 2. Scale and Recent Growth

Australia is a significant part of the fastest growing region

Five major markets in the region:

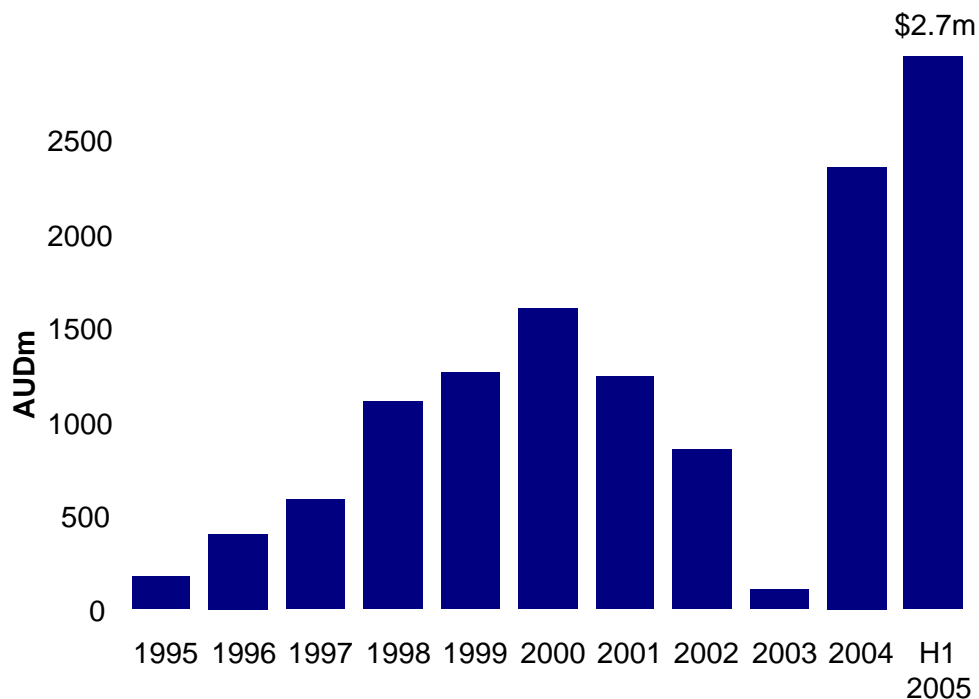
- Japan
- Australia
- Hong Kong
- South Korea
- Singapore



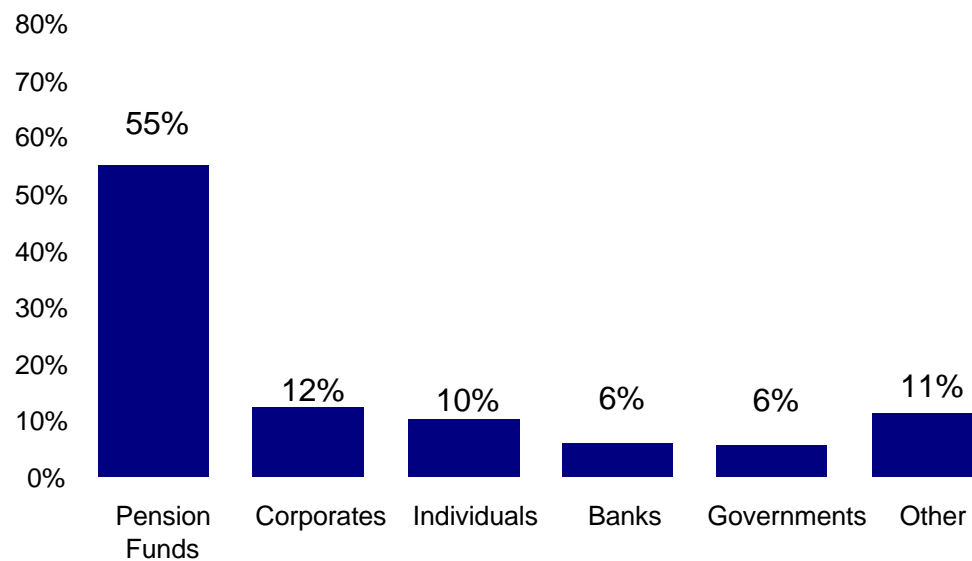
## 2. Scale and Recent Growth

Australian Market Has Grown rapidly

### Capital Raised



### Sources of Capital

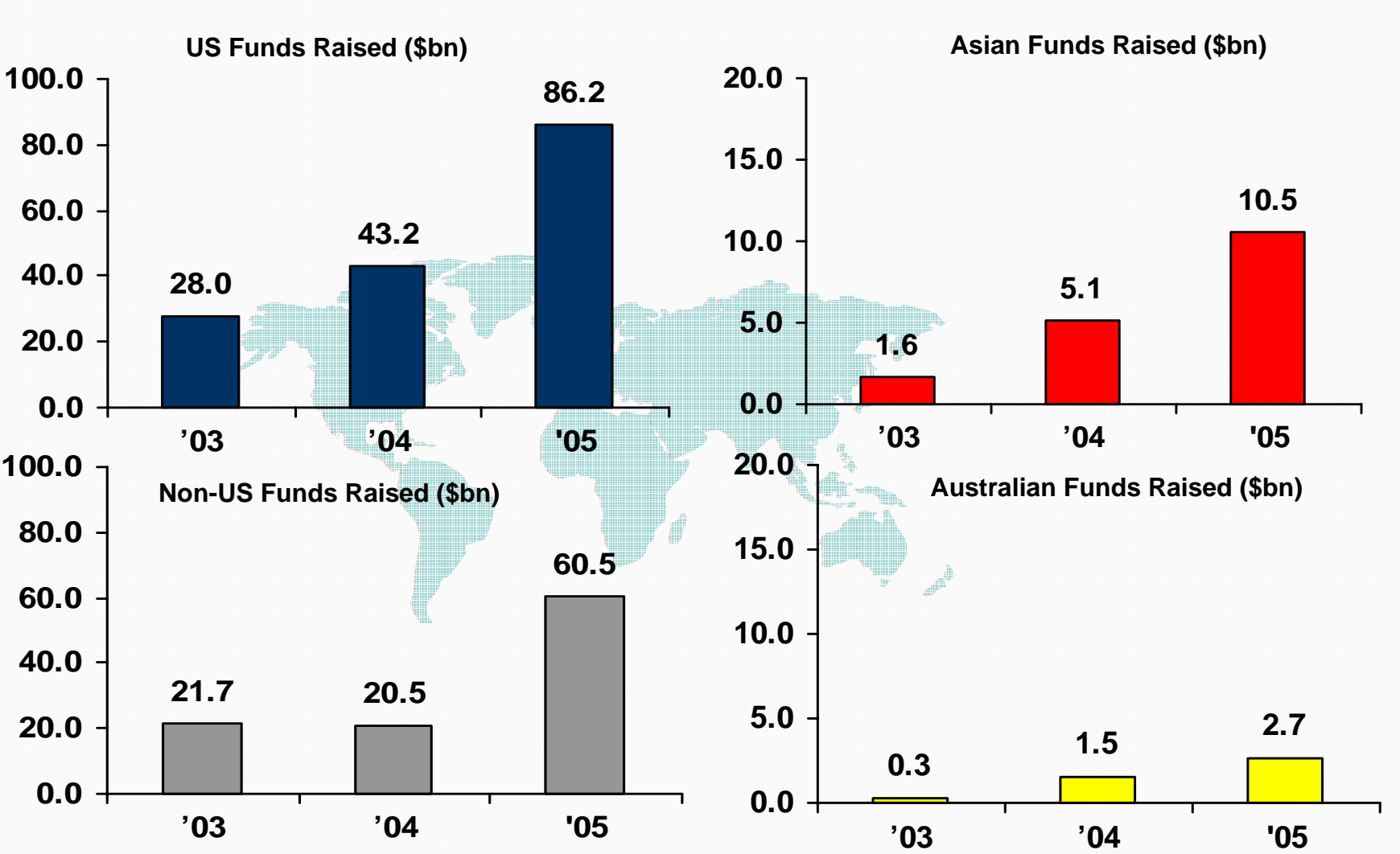


2004/05: AUD 2,160m (19 Funds)



## 2. Scale and Recent Growth

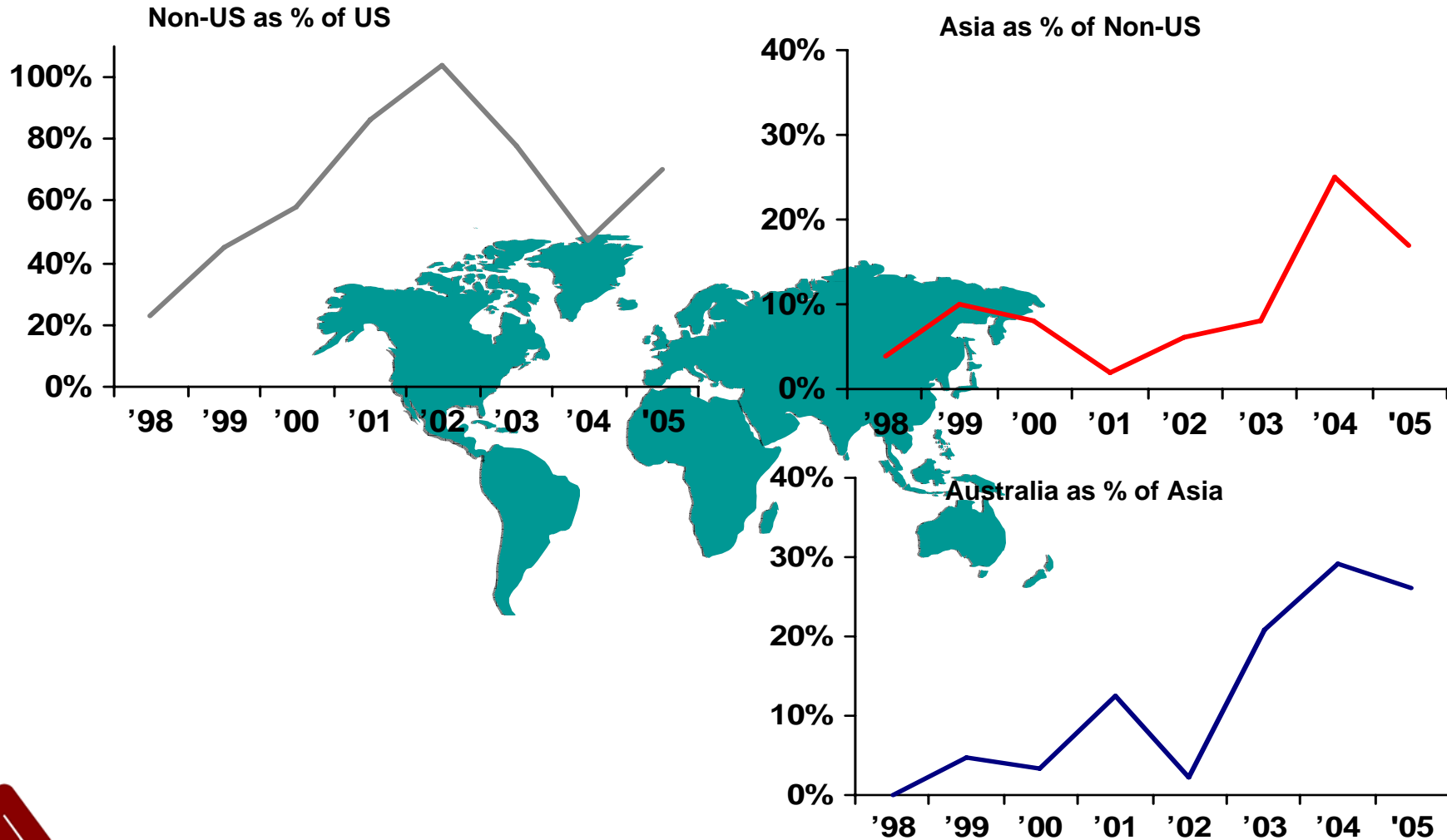
2005 saw record fundraising levels with non-US markets accelerating



Source: Venture Economics, Buyout funds only, 2005 HarbourVest estimates

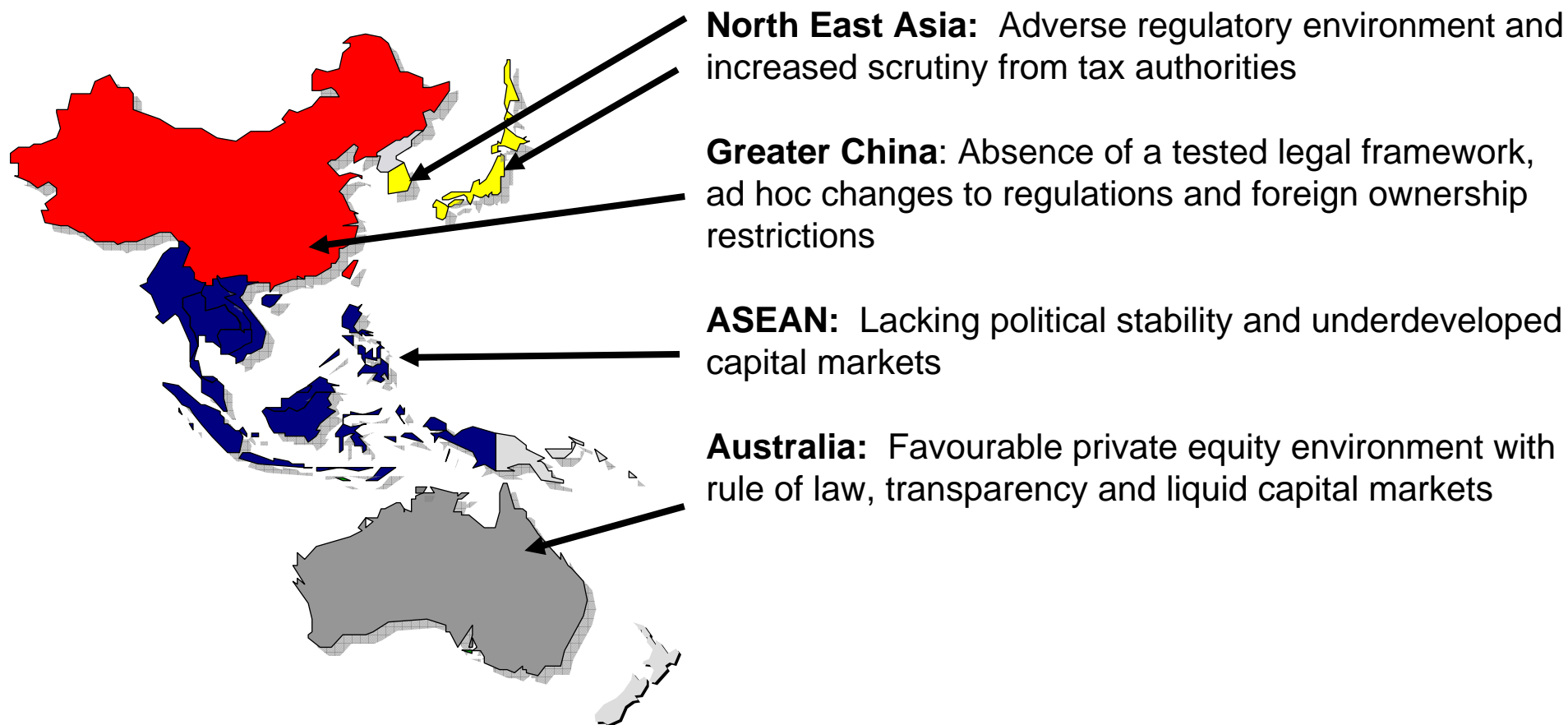
## 2. Scale and Recent Growth

Australia has seen its share of investable funds increase significantly



## 2. Scale and Recent Growth

Recent influx is due to Australia's favourable private equity environment within Asia Pacific



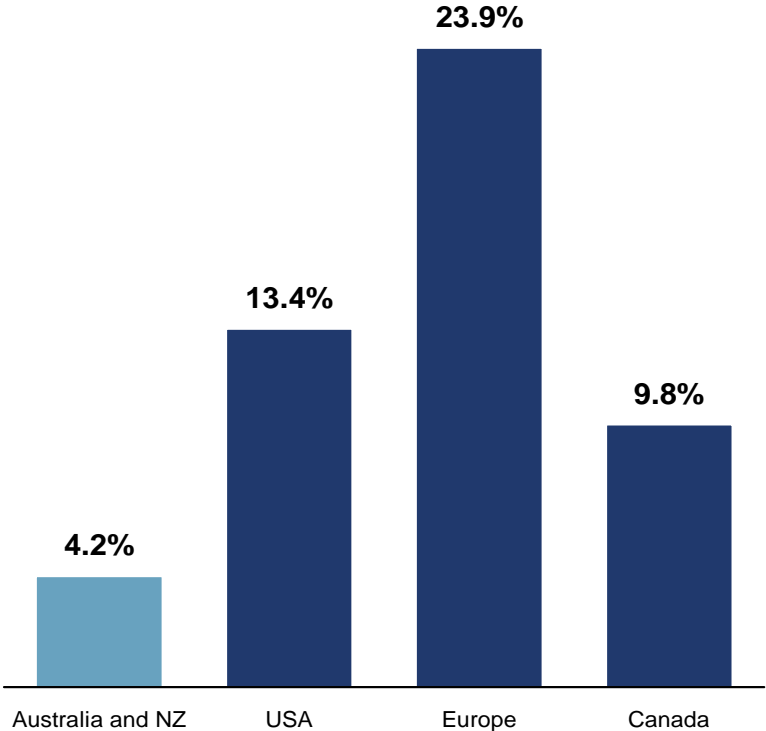
### **3. Penetration of Private Equity in Australian M&A Market**

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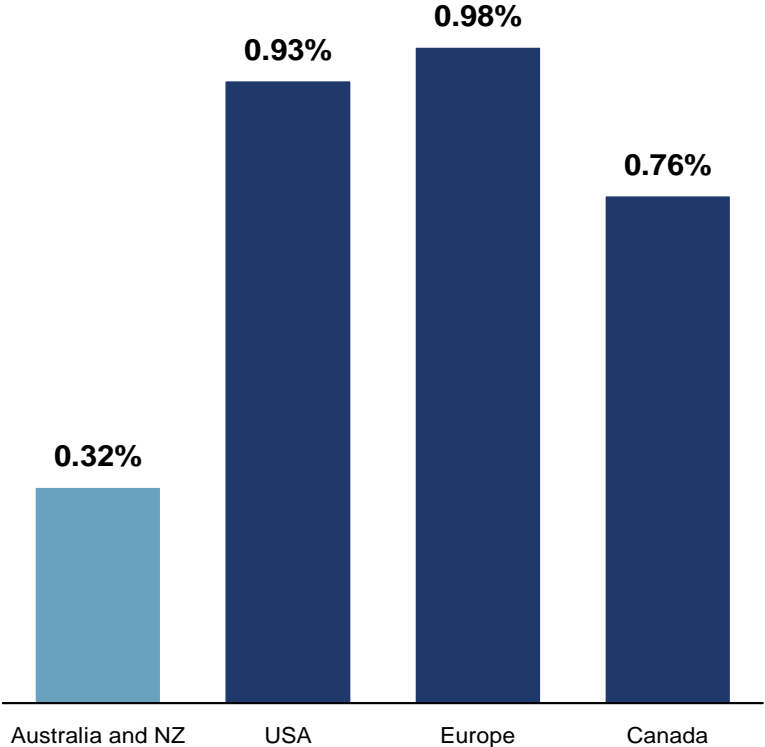
### 3. Penetration of Private Equity in Australia

Private Equity markets are still immature in Australia despite increasing competition and capital focused on the region

2005 Financial Sponsor Buyside Deals as a % of Total M&A



2004 Financial Sponsor Buyside Deals as a % of GDP



### 3. Penetration of Private Equity in Australia

This could change as large international and domestic funds arrive in Australia

Funds with local presence 2004 <sup>(1)</sup>:

International Funds	Fund size (US\$)	Large Domestic Funds	Fund size (US\$)
CVC	750	CHAMP	413
Newbridge	750	PEP	375
Carlyle	-	Macquarie	-
CCMP	-	B&B	-
Affinity	-		
Nikko	-		
	<u>1,500</u>		<u>788</u>
		Medium Domestic Funds	Fund size (US\$)
		AEP	-
# of groups	<input type="text" value="8"/>	Ironbridge	338
		Archer	338
		ABN Amro	225
		Catalyst	263
		Gresham	-
			<u>1,163</u>
<b>Total funds available 2004 (US\$M)</b>			<b>3,450</b>

(1) Excludes funds under US\$200M

Funds with local presence 2006 <sup>(1)</sup>:

International Funds <sup>(2)</sup>	Fund size (US\$)	Large Domestic Funds	Fund size (US\$)
CVC	1,975	CHAMP	713
Newbridge	1,500	PEP	900
Carlyle	1,500	Macquarie	750
CCMP	1,550	B&B	750
Affinity	750		
Nikko	500		
	<u>7,775</u>		<u>3,113</u>
		Medium Domestic Funds	Fund size (US\$)
		AEP	413
# of groups	<input type="text" value="16"/>	Ironbridge	338
		Archer	338
		ABN Amro	375
		Catalyst	263
		Gresham	375
			<u>2,102</u>
<b>Total funds currently available (US\$M)</b>			<b>12,613</b>
<b>Multiple of 2004 figure</b>			<b>3.7</b>

(1) Excludes funds under US\$200M

(2) Excludes offshore funds that operate in Australia such as Bain Capital and KKR

### 3. Penetration of Private Equity in Australia

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**The European and US experience would suggest significant room for growth through a wider opportunity set**

- Public to privates – Cash boxes and schemes
- Larger transactions – Brambles, WACO
- Corporate partnerships – Macquarie / Dynabold
- Turnarounds – Goodman Fielder

### 3. Penetration of Private Equity in Australia

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#### Recent analysis suggests there is not yet a capital overhang in the buyout market

- Wilshire Private Market Group estimates supply of buyout capital by year ending 2005 at \$3,435 million which implies \$687 million of equity per annum over five years. June 2002 – June 2004 average investment flow was \$560 million per annum
- Potential demand has been estimated based on average annual total mergers and acquisitions in Australia 2000 – 2004 of \$68 billion with low point of \$45 billion
- Assuming a participation rate by private equity of 6% (4.2% in 2005) in all merger and acquisition deals and a 30% equity contribution, \$810 million per annum of equity is required

### 3. Penetration of Private Equity in Australia

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**Although in Australia, private equity share of public market deals might be more constrained compared with Europe and the United States**

- Most Australian private equity firms have contractual obligations to undertake due diligence and do not have a balance sheet. Australian public company boards rarely agree to exclusive due diligence
- Australian Takeover rules limit ability of most private equity firms to participate other than in very friendly deals
  - 20% limit before offer must be made compared with 30% in UK, Europe and the US
  - Obligation to fully fund offer with bank commitment, not letter of offer
  - Hedge fund activity

## 4. Managing the Peak

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- Strategy
- Use of Gearing

## 4. Managing the Peak

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**Private equity investment skills are currently being challenged**

- Strong economy and economic outlook
- Strong stock market with excess capital held by Australian institutions
- Strong corporate balance sheets
- Readily available debt
- Large pools of recently raised private equity

**This is leading to higher prices and even more gearing to meet IRR hurdles**

## 4. Managing the Peak

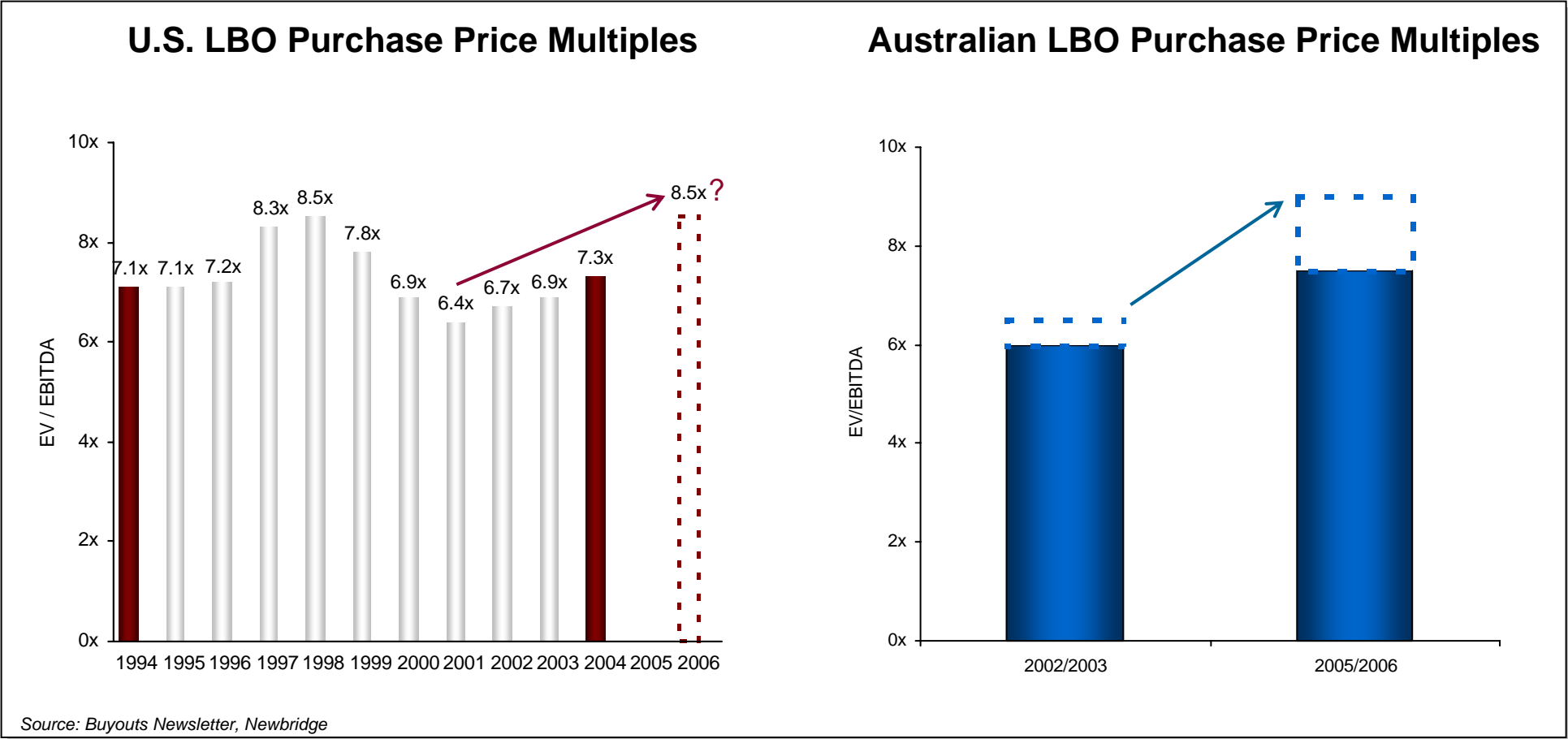
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**Value can still be found and patience will help – it's not always going to be like this!**

- Better quality companies allow more gearing
- Attracting management talent
- Operational improvement
- Consolidation plays
- White knight situations

# 4. Managing the Peak

LBO purchase price multiples are rising



# 4. Managing the Peak

## Strategic Tool Kit



## 4. Managing the Peak

Fine Weather

All Weather



### SOURCE OF RETURNS

Deal	Acquisition Date	Exit Date	Estimated Multiple of Equity	Above Expected Growth	Cheap Debt / Strong Cash Flow	Multiple Expansion	Operating Turnaround	A Deal – “it’s just cheap”	Exchange Rate
A	2000	2003	5x	?		✓			
B	2001	2003	5x		✓	✓			
C	2001	2004	5x	?	✓	✓			✓
D	2001	2004	6x	✓		✓			✓
E	2002	2004	3x		✓	✓			
F	2003	2005	3x		✓	✓			
NZDF	2002	2005	10x			✓	✓		} Graeme Hart
GMF	2003	2005	10x			✓	✓		

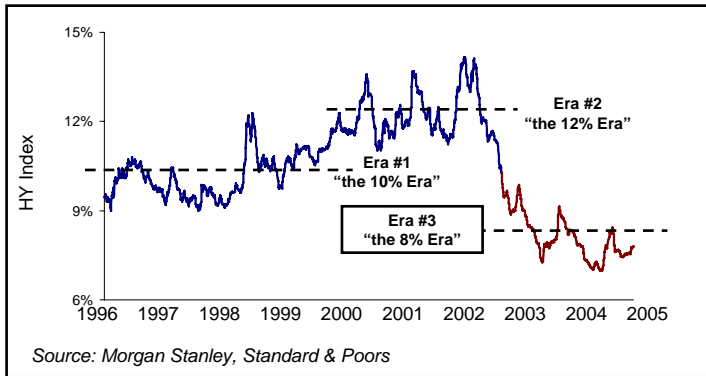
2001 – 2003 was a great period to buy assets in Australia

No major operational turnaround (except Hart) – mainly multiple expansion

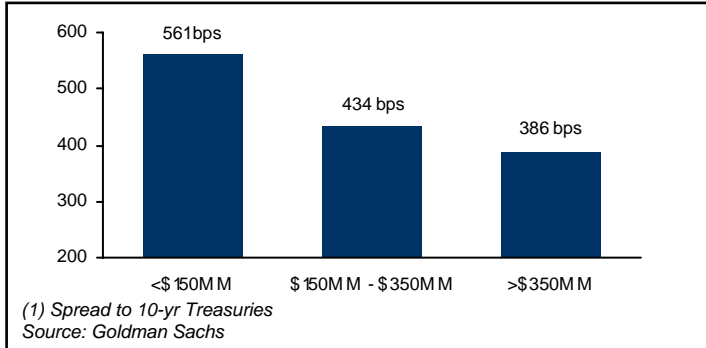


# 4. Managing the Peak

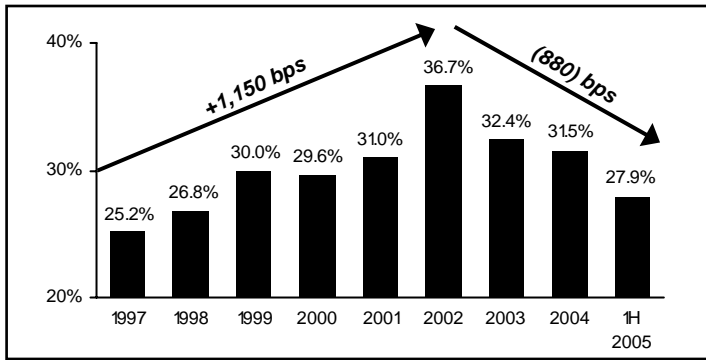
High-Yield Pricing



High-Yield Spread by Size of Issuance<sup>(1)</sup>

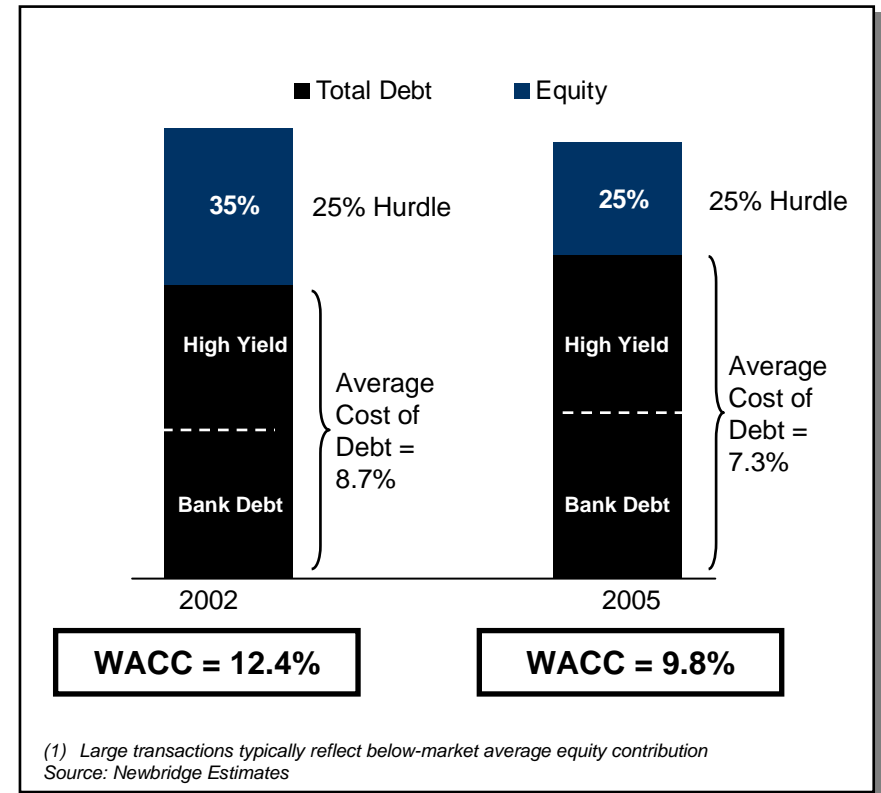


Average Equity Commitment



- Increased gearing is being used to solve for higher prices

## Representative Cost of Capital for a Large Transaction<sup>(1)</sup>



Reduced cost of capital takes some of the sting out of higher valuations – but this just re-levels the playing field



## 5. Conclusion

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- Private equity is a large and growing asset class
- It has become a permanent feature of Australian private merger and acquisition and investment market. It may become more common in public M&A market
- Generates new opportunities for investment banks and Australian management skills
- 2005 vintage investments are likely to prove to be challenging due to price pressure

