Preqin Special Report: Exits in Private Equity

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Exits in Private Equity

Using data from Deals Analyst and Performance Analyst, Preqin has examined trends and performance of the various exit strategies used by private equity buyout firms to realize gains for their investors. Preqin currently holds in-depth data for over 21,000 buyout deals and over 7,500 PE-backed exits across the globe, containing information on deal and exit value, buyers, sellers, debt financing providers, financial and legal advisors and more.

For more information on Deals Analyst and Performance Analyst, please visit: www.preqin.com

The Buyout Exit Crisis

The brief of any private equity buyout general partner (GP) is to create value in its underlying investments in order to generate returns for its limited partners (LPs). Following the credit crisis and subsequent recession that occurred from mid-2008 onwards, the ability of many fund managers to fulfil this brief and provide a profitable exit has been called into question. While buyout funds enjoyed unprecedented returns in the boom era, the market crash has led to two years of poor exit conditions, meaning that private equity buyout firms have been under pressure to return capital to LPs in a climate of few liquidity events. In general, the dispersion of performance results for buyout funds is very wide and therefore fund selection has always been a critical issue for LPs. Following this period of poor exit conditions however, the competition for fundraising is now higher than ever.

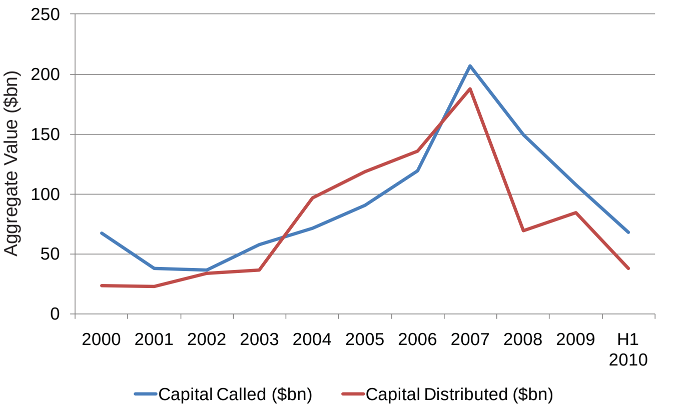
Returns are generally realized by buyout firms through one or more of the following broad exit types: an initial public offering (IPO), a trade sale or merger, a secondary sale to another GP, restructuring, recapitalization, or a sale directly to the management of the portfolio company. During 2008 and 2009 many fund managers were unable to make profitable exits from their investments, and retained mature investments past their expected lifecycle. As shown in Fig. 1, this has caused a dearth in levels of distributions made to investors, resulting in a corresponding fall in the amount of contributions made to buyout funds and further hindering fund managers' fundraising efforts.

Buyout Exit Market Overview - Peak to Valley

Clearly the economic crisis had a profound impact on private equity buyout firms, but how has it affected the ways that GPs return capital to their investors in contrast to the pre-crisis boom era? As we can see in Fig. 2, the boom that reached its peak in mid-2007 can be characterized by a large number of exits across all types – particularly in trade sales, secondary market deals and IPOs. During the period of Q3 2006 to Q4 2007 there were 1,523 buyout exits made, with an aggregate value of approximately $337 billion. Restructuring exits represented just 0.7% and recapitalizations 1.8% of all exits in this period; trade sales, secondary sales and IPOs/private placements accounted for 41.6%, 29.8% and 12% respectively.

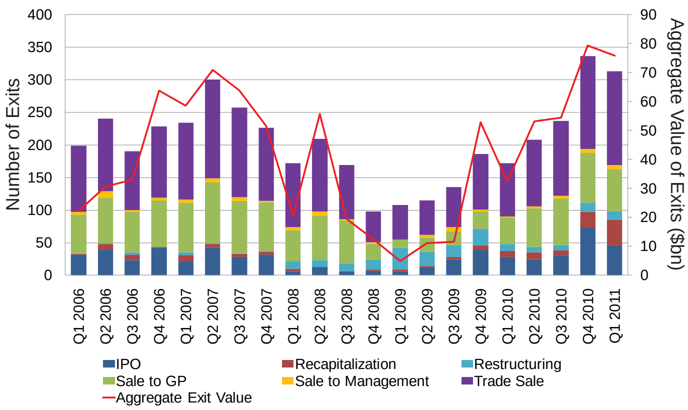
In contrast, from Q1 2008 to Q3 2009 the onset of the economic crisis caused the number of buyout investment exits to stall to 1,174, with an aggregate value of $139 billion. This deceleration highlights the importance of the role of healthy equity markets in facilitating profitable private equity-backed returns. Healthy equity markets steer realizations for private equity exits, either as the vehicle for IPOs or on a comparable basis for trade and secondary sale activity. Consequently the general market downturn severely limited such opportunities. Fig. 2 highlights that the types of exits that were successfully made during this period of crisis were of a markedly different composition. IPOs/private placements made up just 6.1% of exits made during this period, and while trade sales made up a similar proportion of exits to the boom era (39%), the aggregate value of this exit type was down to approximately $92.9 billion in Q1 2008 to Q3 2009 from $151.7 billion during Q3 2006

Fig. 1: Buyout Fund Contributions and Distributions, 2000 – H1 2010



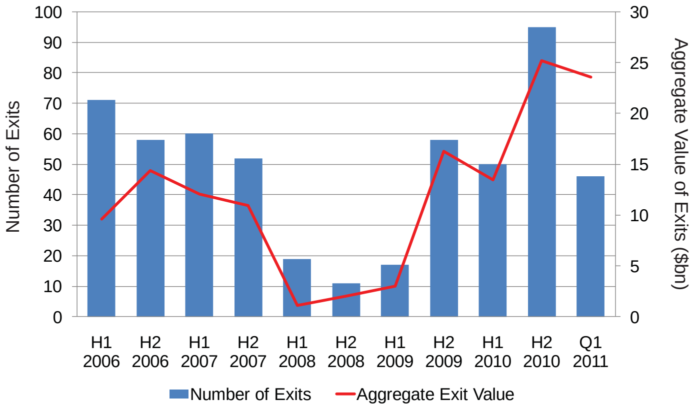
Source: Preqin

Fig. 2: Breakdown of PE Buyout-Backed Exits by Type, 2006 - Q1 2011



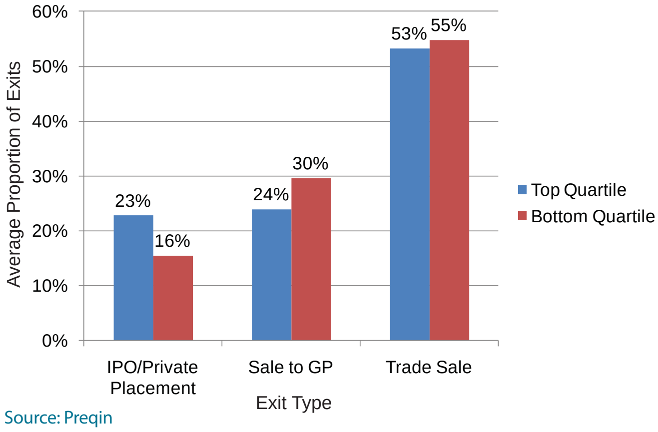
Source: Preqin

Fig. 3: Semi-Annual Number and Aggregate Value of PE Buyout-Backed IPOs/Private Placements, 2006 - Q1 2011



Source: Preqin

Fig. 4: Average Composition of Top Quartile and Bottom Quartile PE Buyout-Backed Exits



Source: Preqin

to Q4 2007. With industries and sectors worldwide performing poorly during the recession, many companies held by buyout firms were facing a lack of revenue and the increasing burden of debt. Consequently, restructuring exits became more prevalent and rose to represent 9.2% of all exits made across this period. In Q1 2009 alone restructuring deals accounted for over a quarter of all exits.

Analysis of Post-Crisis Exit Trends

As broader economic conditions started to improve in 2010, buyout firms have found it opportune to exit investments made during the previous cycle. Does this represent a return to pre-crisis market exit conditions for buyout funds? As shown in Fig. 2, 2010 saw activity in the private equity-backed buyout exit market recovering to reach levels not seen since the onset of the financial crisis. Q4 in particular represented a very strong quarter, with $64 billion of new deals announced – the highest since Q2 2008 – and $79 billion in exits – the highest quarter of all time.

One of the catalysts for this resurgence has been the strong market for IPO and private placement exits. As shown in Fig. 3, 145 IPOs and share sales occurred during 2010 with an aggregate value of $38.7 billion, twice the aggregate value seen in 2009, and a twelve-fold increase in comparison to 2008, the lowest point for IPO activity in recent years. This trend looks to continue into 2011, with the year already seeing several large IPOs for portfolio companies purchased during the buyout boom. One such example is Kinder Morgan, which raised $2.865 billion in February 2011 and priced its shares above the expected range due to strong demand. Discussions of bringing firms with heavy debt-loads - such as Freescale Semiconductor and Caesars Entertainment - onto the market to payoff their liabilities is another indication that firms which were considered too burdened with debt might be more appealing to investors now with the strong IPO demand.

Restructuring exits have declined since 2008-2009. Following the crisis, debt markets have normalized and the 'wall' of bonds and loans set to mature eroded, reducing the threat of mass defaults. Consequently following the crisis buyout firms have been more able to use high-yield bonds and other methods to refinance debt. Despite this, PE-backed restructuring exits remain more prevalent in contrast to during the boom era, and represented 4.6% of all buyout fund exits that occurred during 2010. The impact of the crisis hurt the gearing ratios of many portfolio companies by causing excess debt, and it is clear that restructuring is still attractive to buyout firms as a method of providing an injection of equity.

Comparison of Top and Bottom Quartile Funds by Types of Exit

How do the types of exit used by top and bottom performing funds differ? Due to the large disparity in performance, the most significant difference in the composition of exit types exists between the top and bottom quartile ranked buyout funds. These differences are most apparent when focusing on investment failures (i.e. write offs) and the three main types of full exit available to private equity buyout firms – IPOs/private placements, secondary sales to GP and trade sales.

In general, bottom quartile funds often struggle to exit their investments and therefore it is unsurprising that on average they have the largest proportion of deals written off (6%). By contrast, just 2% of top quartile funds' deals end in a write off on average. In terms of successful exits, 23% of all top quartile funds' exits are via IPOs and private placement offerings; whereas such offerings make up on average just 16% of exits completed by bottom quartile funds, as shown in Fig 4. By definition, poorer performing buyout funds are often those that have been unable to successfully increase the value of their underlying portfolio companies and consequently these companies are often less attractive prospects for share offerings. A further difference can be seen in activity in the secondary sales market. Sales to GPs make up on average 30% of all bottom quartile funds' exits, whereas for top quartile funds this proportion is significantly lower (24%). Bottom quartile funds that cannot realize returns are also much more likely to tap into the secondary market and sell to another GP, as poorly performing portfolio companies can be attractive targets in the secondary market. Buying GPs may believe they will be able to achieve a beneficial deal on such investments and implement an improvement plan of their own that will result in a positive future return.

The Return of Dividend Recapitalizations

A significant trend over the past 12 months has been the increasing number of dividend recapitalizations seen in the buyout fund universe. This exit occurs when a buyout fund manager issues a special dividend to its LPs that is financed through the portfolio company taking on additional debt. Dividend recapitalizations have often been portrayed as a 'negative' investment exit due to the perceived harmful effects of removing capital from the portfolio company whilst burdening it with further debt. While there can be a conflict of interests between a GP's responsibility for the portfolio company and the desire to provide returns to investors, a dividend recapitalization does not necessarily compromise the health of the underlying business. Indeed, there are circumstances in which taking on increased levels of debt is a positive strategy that can create a tax shield or increase fundamental value through equity/debt rebalancing. There is a significant minority of portfolio companies that are subjected to one, or even several, dividend recapitalizations prior to their ultimate sale through an IPO or secondary deal.

Across 2010 and into 2011, dividend recapitalizations experienced a resurgence. Preqin has data on 73 dividend recaps occurring between H2 2010 – Q1 2011 with an aggregate value of $13.6 billion. The actual volume over this period is likely to be higher still, as these events are not well reported in many cases. More than ever investors are now placing increased scrutiny of existing relationships with buyout firms by keenly assessing past performance and future prospects. Consequently the impetus is on GPs to quickly provide returns on their current investments in order to encourage fundraising. In comparison to exits such as IPOs or trade sales, dividend recapitalizations can usually provide a quick burst of liquidity – thus facilitating a more immediate distribution to investors.

Outlook for the Future

At present, private equity buyout fundraising activity has lagged behind the general market recovery and remained depressed in comparison to pre-crisis levels; however based upon current levels of exits it can be anticipated that the fundraising environment will soon improve. Regardless of what types of exit methods are being utilized by buyout fund managers, it is a positive sign for the private equity industry as a whole to note that capital is being returned to investors in increasing amounts. Over the past year investment exits have risen in both number and value and we expect to see a corresponding rise in the number of distributions to, and contributions from, LPs. This should lead to a reduction of the average length of time taken for buyout funds to reach first close.

However, buyout fund managers should remain cautiously optimistic. Given the fact that 2005-2006 were record fundraising years, it is perhaps unsurprising that exits are now at higher levels than during the pre-crisis period and this may represent a short lived return of activity. While it remains too early to ascertain whether the increasing levels in number and value of buyout exits represents a complete revitalization for private equity and a return of investor confidence, it is certainly a positive indicator of recovery.

Data Sources:

Deals Analyst

www.preqin.com/deals

Deals Analyst is the most extensive, detailed source of information on private equity backed buyout deals in the world. This comprehensive product contains in-depth data for over 21,000 buyout deals across the globe, including information on deal value, buyers, sellers, debt financing providers, financial and legal advisors, exit details and more.

Key features of this powerful database include:

*** Details for over 21,000 deals globally.**

*** Currently covers all deals announced or completed since 2006, plus past 10 years data for the 500 biggest firms.**

*** Includes info on debt providers plus financial and legal teams used.**

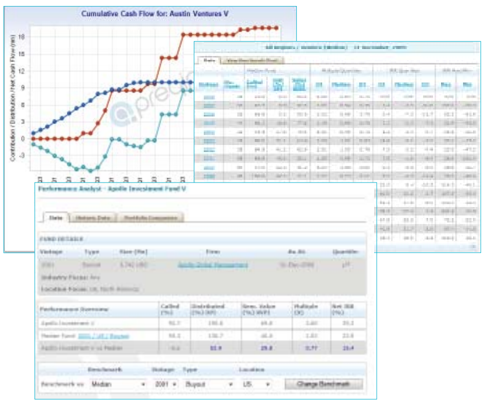
*** Typical Preqin functionality - a variety of advanced tools enabling you to search, analyze and download data with ease.**

Performance Analyst

www.preqin.com/pa

Performance Analyst is the most comprehensive, detailed source of private equity performance data available today. Preqin's team of analysts collect and monitor data from a number of different sources, including from GPs themselves, in order to provide the most comprehensive private equity performance data available today.

Key features of this powerful database include:



View performance data online: for private equity funds worldwide. Compare individual funds against each other and the appropriate benchmarks.
Compare funds of all types: venture, buyout, mezzanine, distressed, special situations, real estate, natural resources, fund of funds, secondary.
Assess key performance data for each fund: size, vintage, type, called-up, distributed, unrealized value, multiple, IRR.
View historic performance: for over 15,000 data points to assess how performance data has changed over time (Premium access required).
Keep current with developments: with monthly updates you always have access to the latest data.
View cash flow graphs for over 1,700 funds: assess how quickly funds have called and distributed capital and what their net cash flow position is.
Select, compare and analyze: funds according to your criteria: by type, size, vintage year etc.
Assess each firm's long-term track record: quartile performance over several fund generations.
Median, pooled, weighted and average benchmarks: view fully transparent market benchmarks by fund type and region focus. Benchmark data for called-up, distributed, unrealized value, and top, median and bottom quartile IRRs and multiples.
Top performing GPs: view a list of firms that have consistently had funds ranked in the 1st and 2nd quartiles.
Download: data to spreadsheet for further analysis (Premium access required).
Create a tailored peer group: of funds for comparative purposes.

Deals Analyst (Standard) $1,950 / €1,375 / £1,150
Deals Analyst (Premium) $3,950 / €2,825 / £2,350

Performance Analyst (Standard) $1,950 / €1,375 / £1,150
Performance Analyst (Premium) $3,950 / €2,825 / £2,350

For more information or to apply for a demo, please visit:
www.preqin.com

About Preqin

Preqin private equity provides information products and services to private equity and venture capital firms, fund of funds, investors, placement agents, law firms, investment banks and advisors across the following main areas:

- Fund Performance
- Buyout Deals
- Fundraising
- Investor Profiles
- Fund Terms
- Fund Manager Profiles
- Compensation

Our customers can access this market intelligence in four different ways:

- Hard copy publications
- Online database services
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Our services and products are used daily by thousands of professionals from around the world. If you are in need of information on the private equity industry then we can help.

Our information is drawn from as many sources as possible, with our large teams of dedicated analysts working to ensure that our research is far reaching, detailed and up to date.

Preqin regularly releases research and information on fundraising and all other aspects of the private equity industry as both research reports, and as part of our monthly Spotlight newsletter. To register to receive more research and analysis, please visit **www.preqin.com/spotlight**

If you have any comments on this report, please contact: **info@preqin.com**

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