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Master the next buyout wave: European private equity outlook 2008

Roland Berger Strategy Consultants
Private equity market appraisal

September 2007

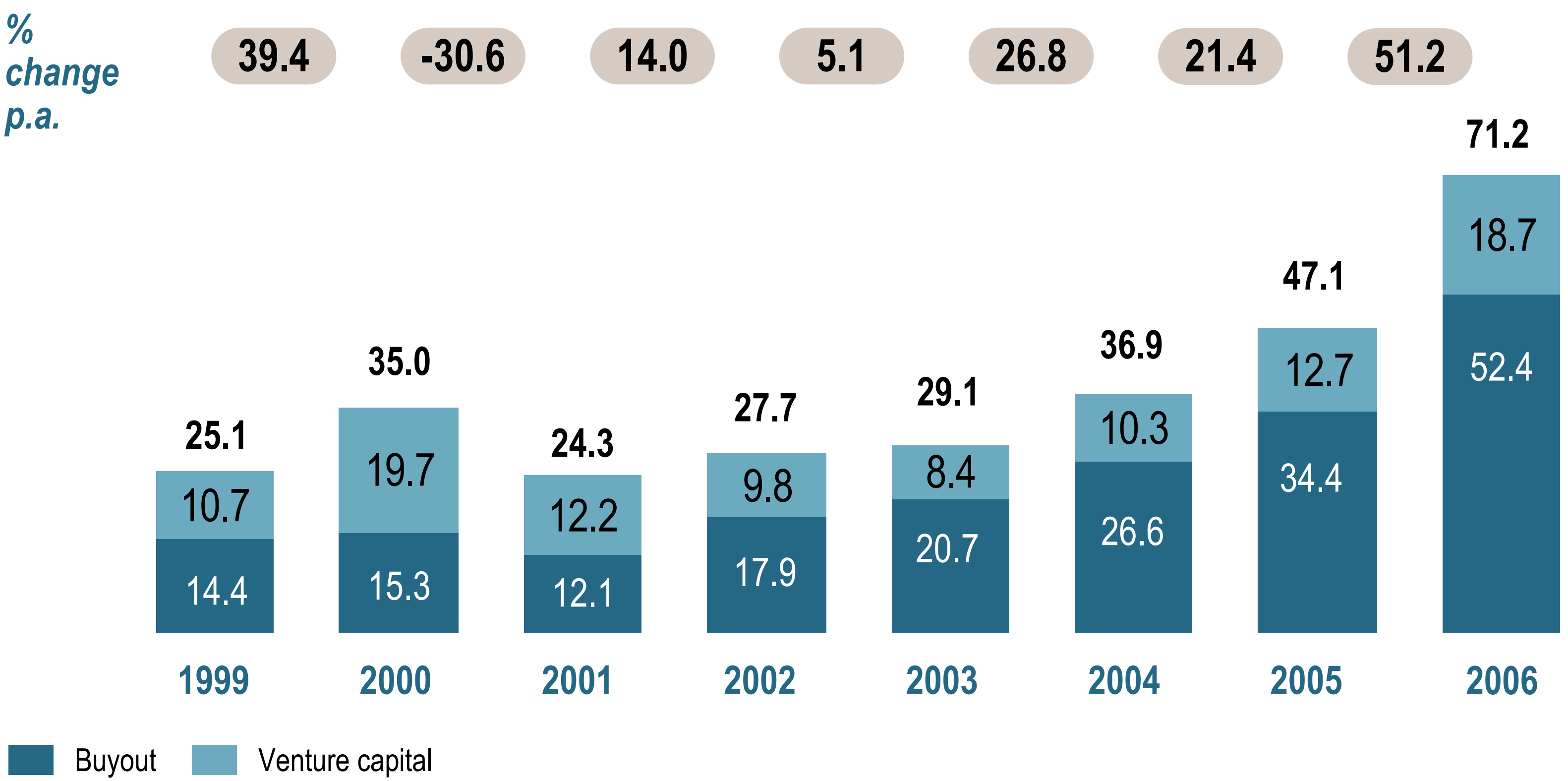
Contents

A.

European private equity market overview

In 2006, the European private equity market reached a new record volume of EUR 70 bn

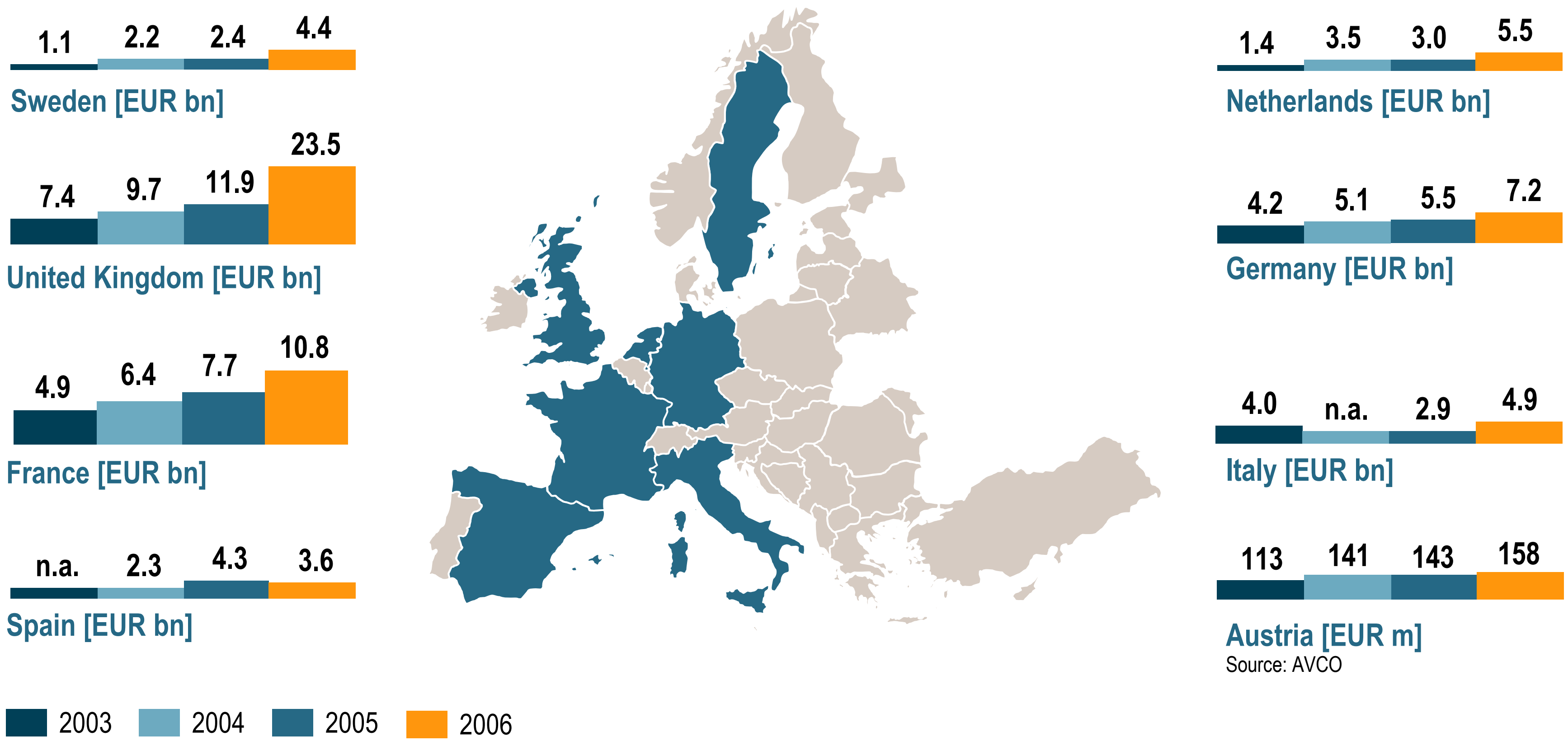
European private equity investments [EUR bn]



Source: EVCA, Roland Berger

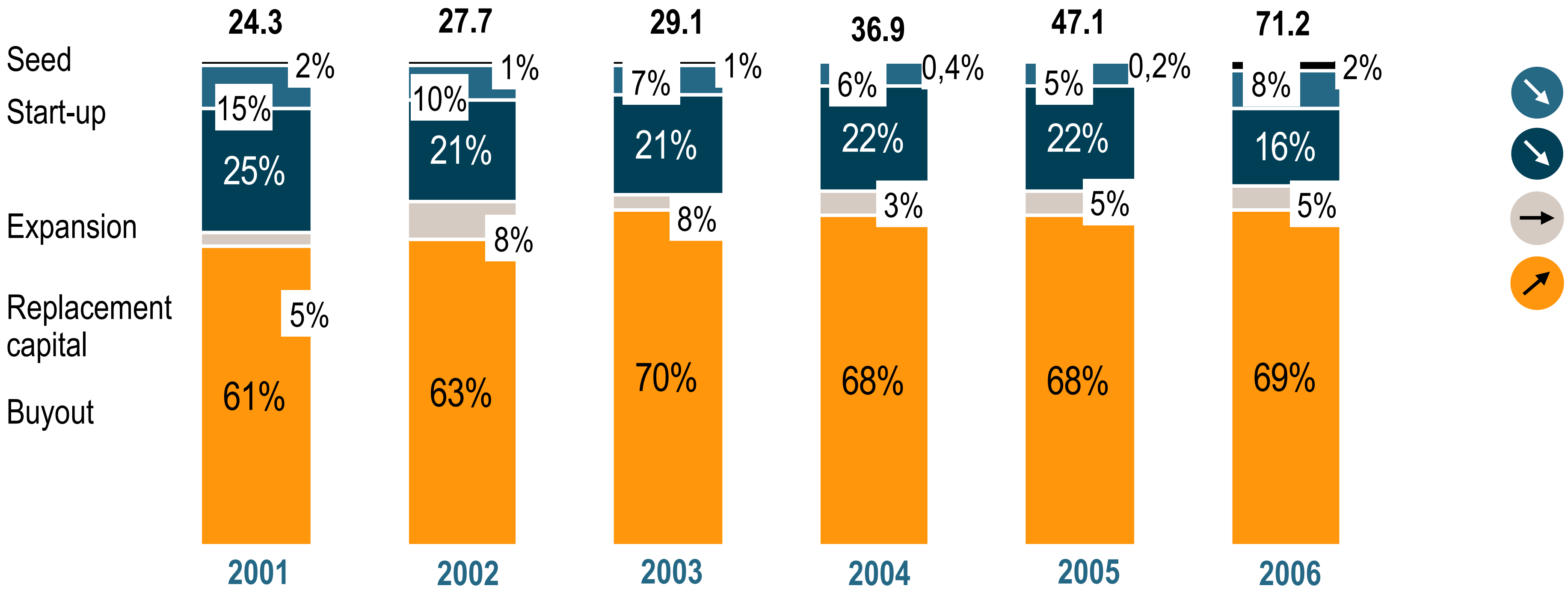
National PE markets are taking off across Europe

European PE investments by country, 2006 [EUR bn/m]



The focus remains on late-stage buyout financing, now and in the future

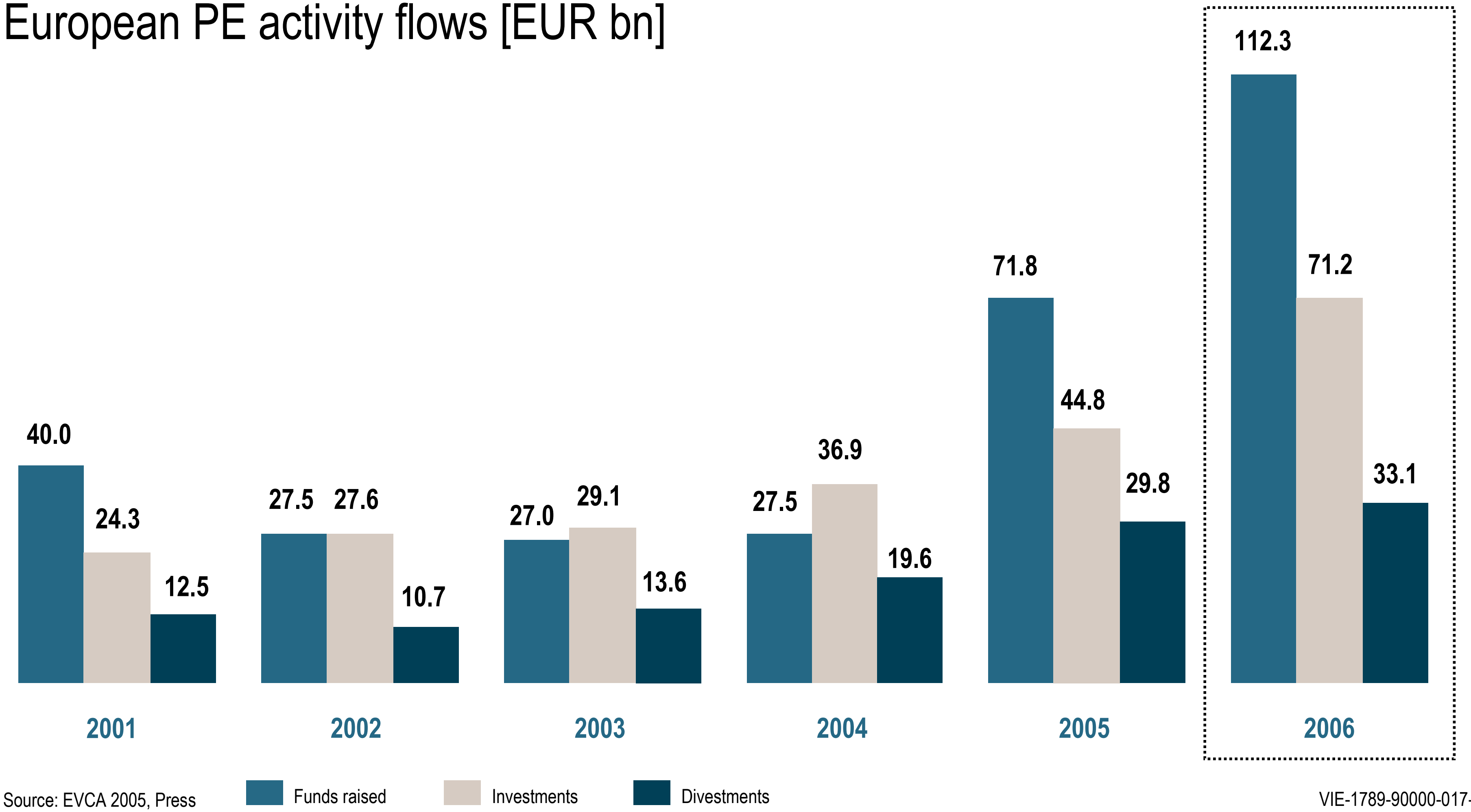
European PE investments in terms of investment stage [EUR bn and %]



Source: EVCA

Overall, funds raised reached a new record of EUR 100 bn in 2006 – Exceeding the actual investment by far

European PE activity flows [EUR bn]



Source: EVCA 2005, Press

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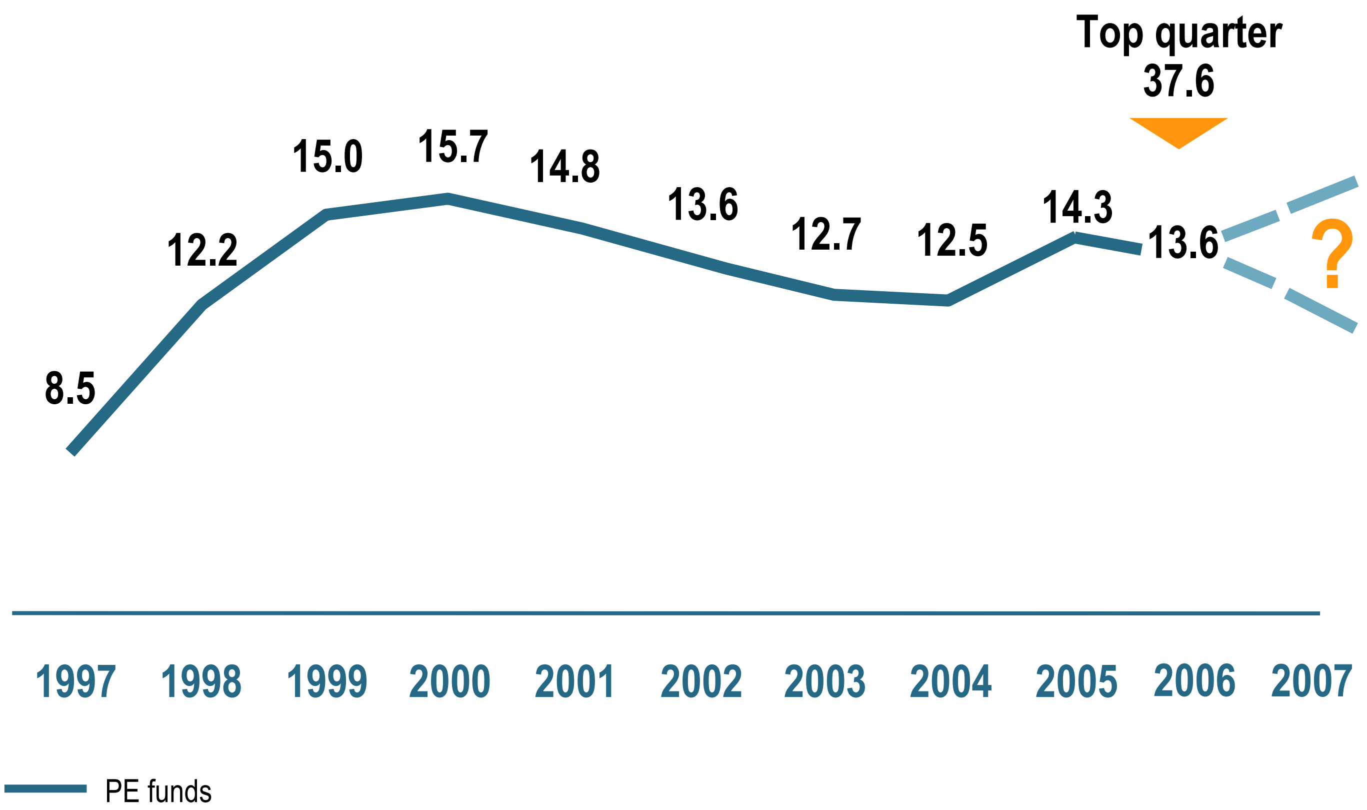
The question is: Will profit grow along the same lines – Or is a downturn to be expected?

10-year rolling IRR (European private equity funds) [%]



REMARKS

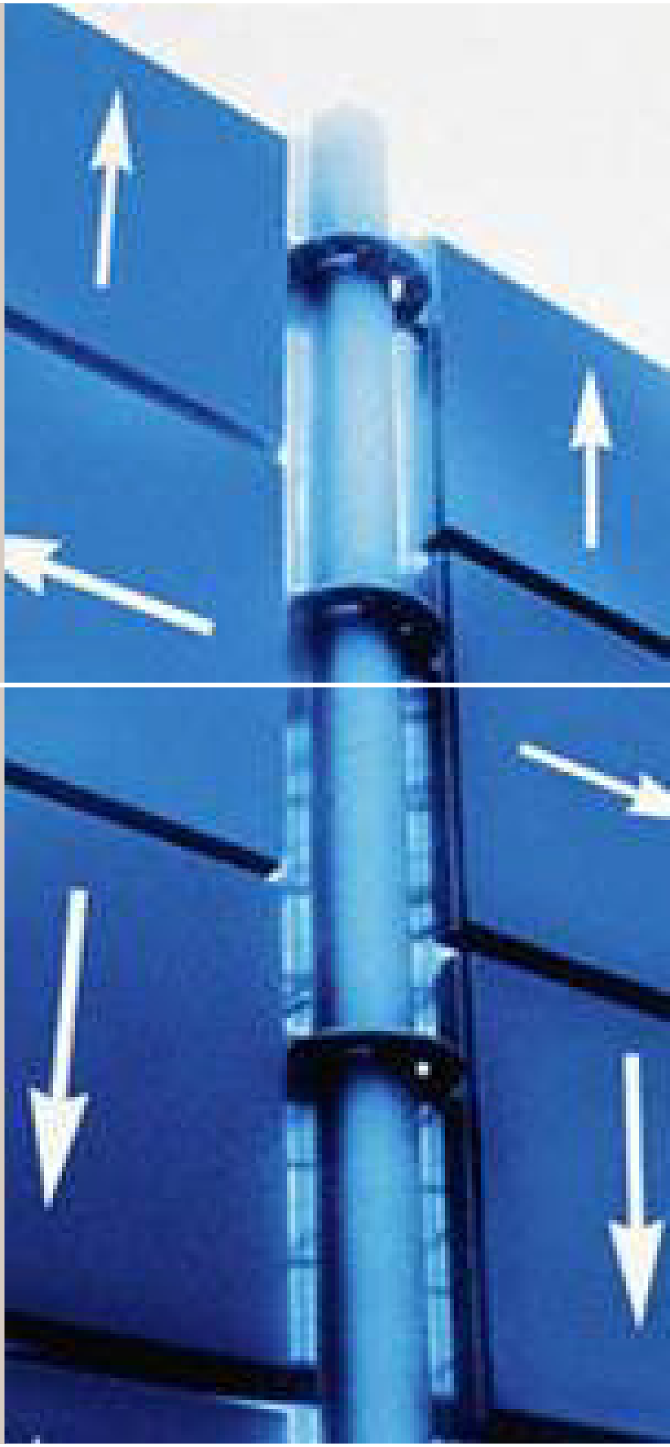
> Only top funds manage to meet the high demands by investors

> Private equity funds need to take a close look at levers available for value creation

Source: Thomson Financial/EVCA

B.

The PE environment is becoming more difficult



Judging by indicators of macroeconomic development, the PE environment will become more difficult

CURRENT SITUATION

> **Banks** in Europe **are stuck with 30-40 bn Euro of leverage loans** that can not be syndicated in the current market environment

> As a consequence the **deal size of leveraged buy-outs has decreased** significantly due to limited availability of debt financing

> **Leverage levels have decreased**, reducing the valuations that PE firms are able to pay; still, EBITDA multiples reached values over 6

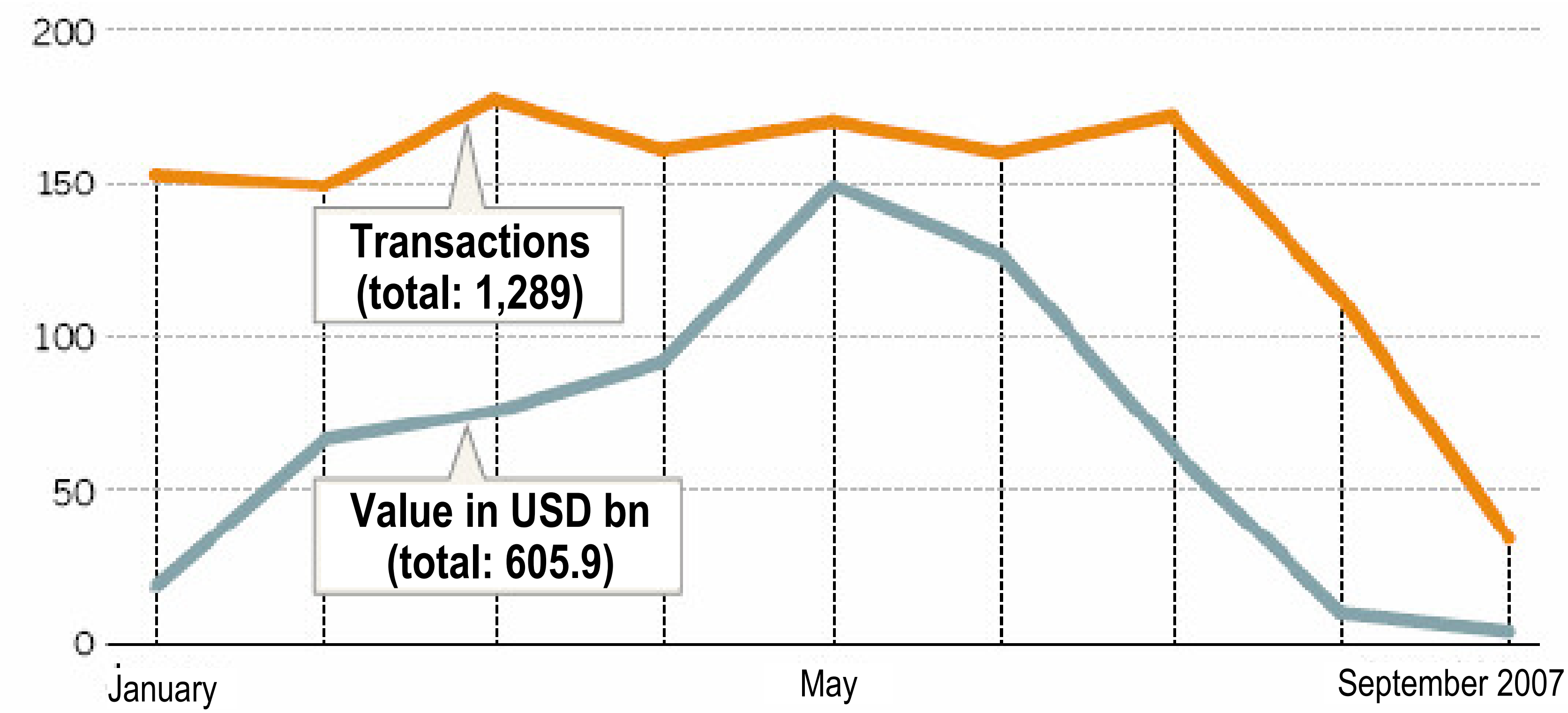
> **Many investments** by PE firms are **ready to go public, but stock exchanges are not**

> **Profit outlook** is **not** as **stable** anymore

Will these trends continue? – Outlook for 2008

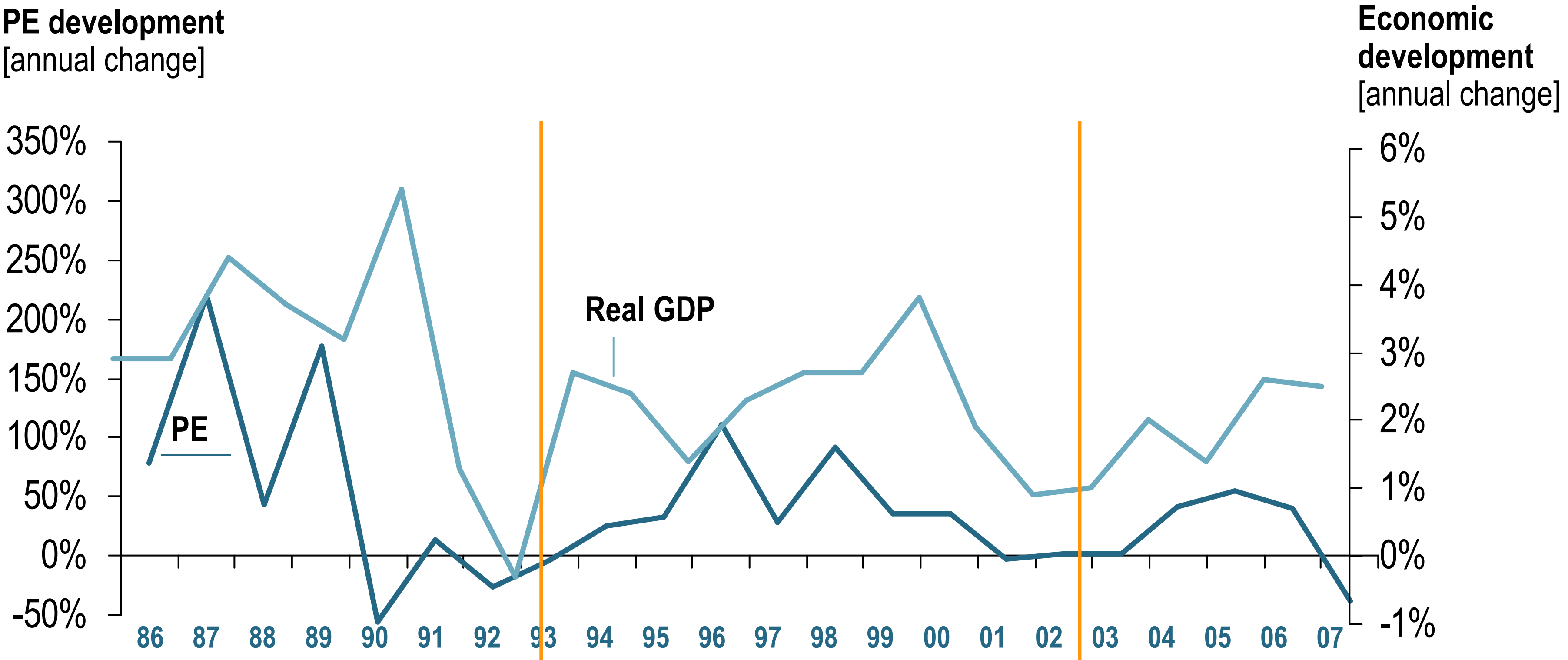
Market snapshot: The takeover market has ground to a halt – Recovery expected in next six months

Worldwide takeovers by financial investors [in 2007]



Source: Thomson Financial

Where is the PE market headed? From a macroeconomic perspective, economic growth is needed



1st wave: 1980s
Breaking up conglomerates

2nd wave: 1990s
Bull market and crash

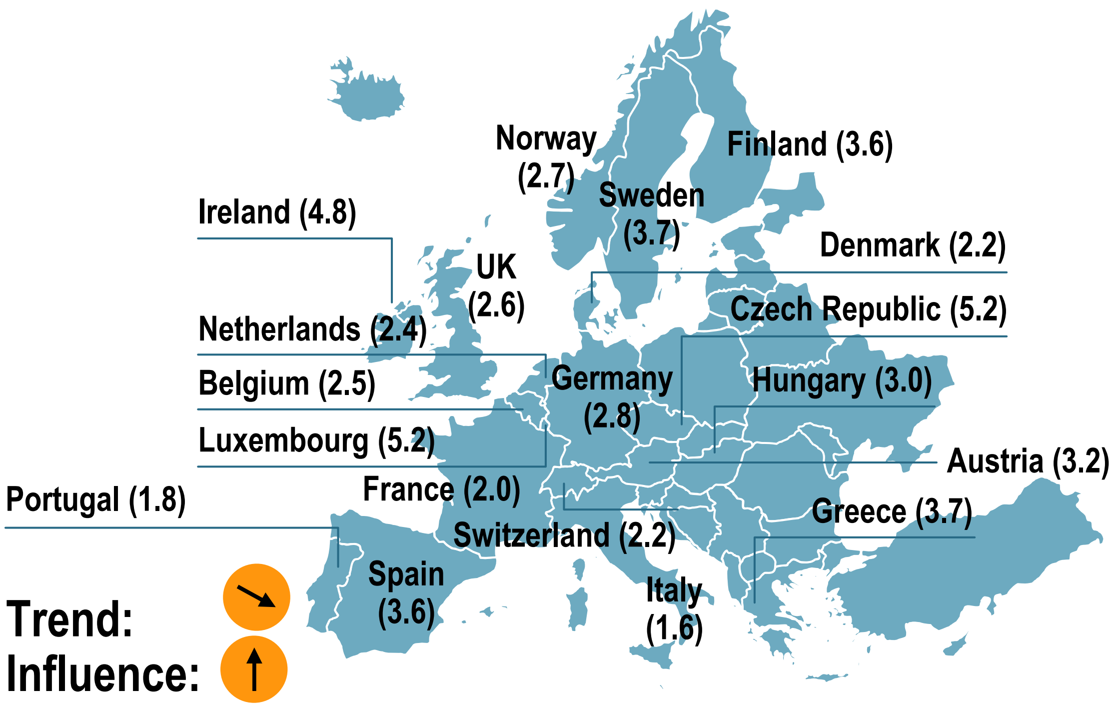
3rd wave: today
PE funds bubble?

Source: Roland Berger, Thomson Financial, EIU

The influence of a strong economy is high, but growth rates are slightly decreasing

Forecast data 2007 – GDP change p.a.

EU economies



REMARKS

> European economies are back on the growth track, 2008 slight decrease in growth rate expected

> With EBITDA multiples of over 6, a strong economy is necessary for investments to earn the required returns

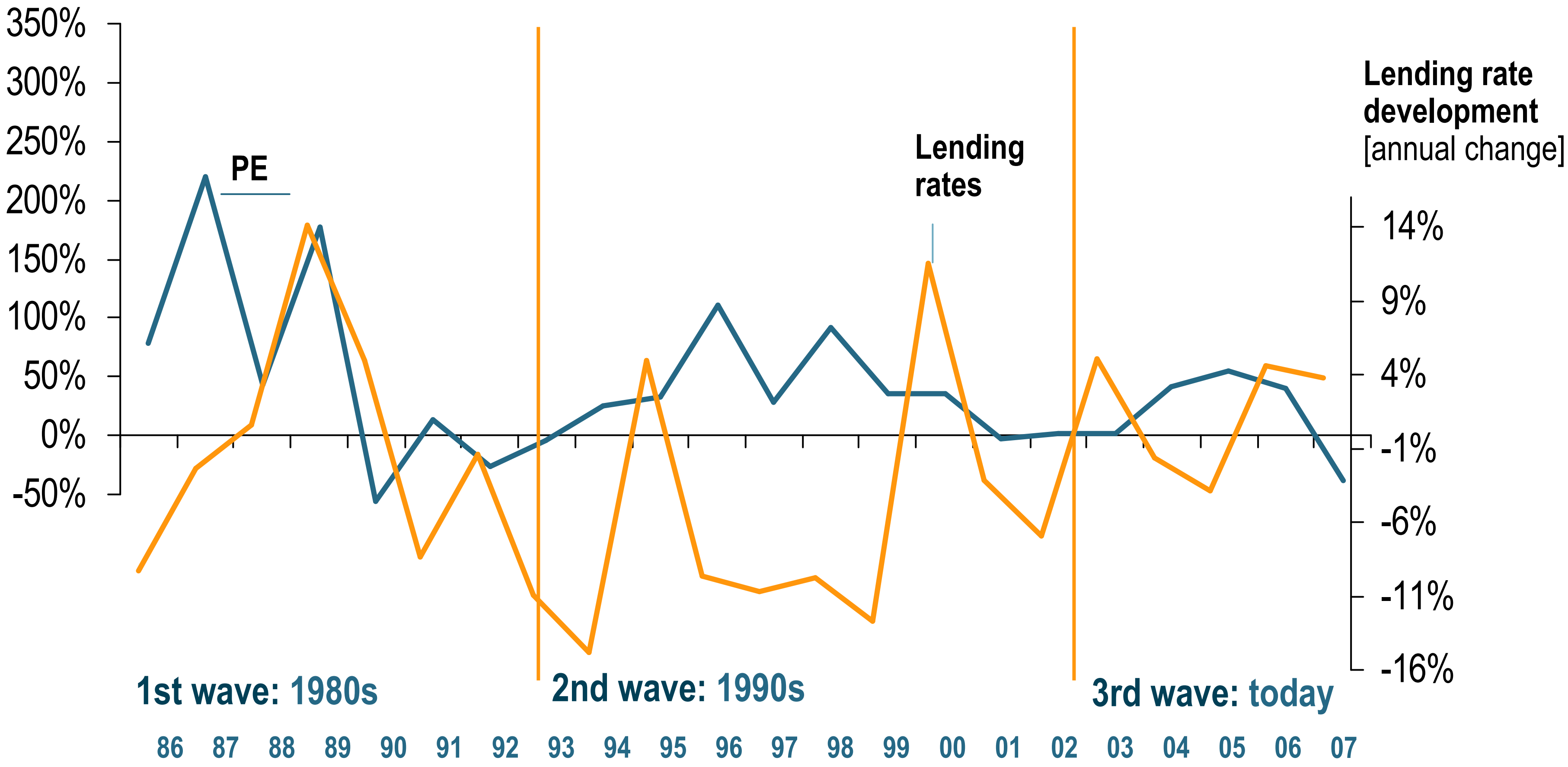
> Highly leveraged companies hitting cyclical conditions face a high risk of default – earnings of PE firms become volatile

> Cost cutting and restructuring are key to securing returns especially in low-growth industries

Source: EIU

And low interest rates are crucial for bearing the financing burden

PE development [annual change]



Source: Roland Berger, Thomson Financial, EIU

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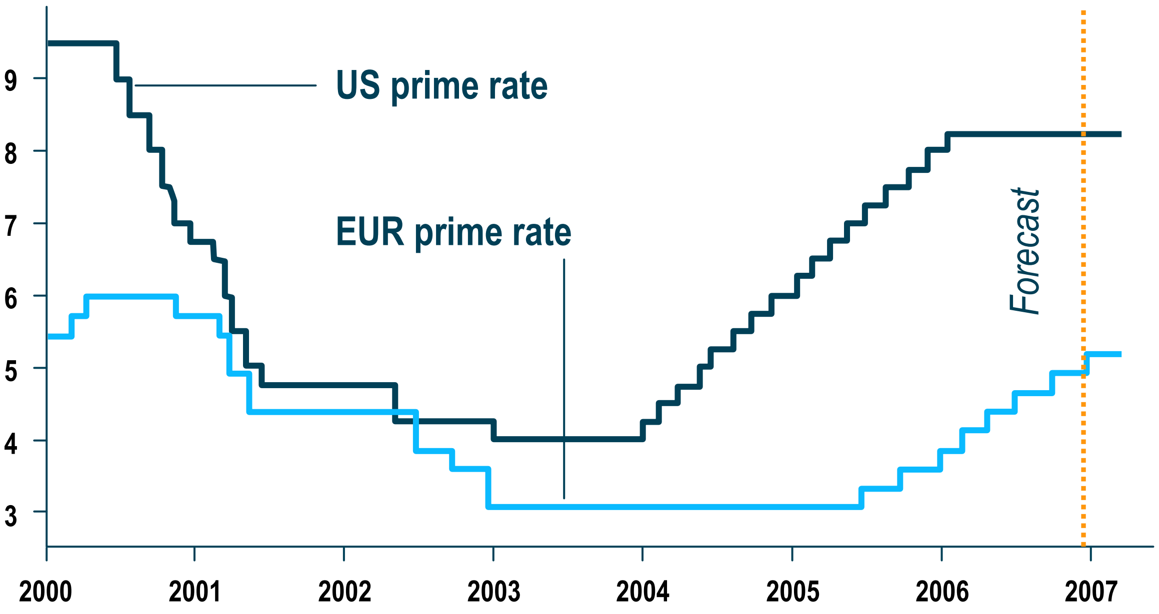
Rising interest rates influence bank attitudes – Some PE firms have hedged against this risk

Forecast data 2007 – Lending rates

Lending rates



Trend: ↗ **Influence:** →

REMARKS

> Interest rates will most likely rise further, which will have a strong impact on PE firms' policies, if these have not hedged their interest rates (most have)

> Increasing interest rates could lead to over-leveraged companies and defaulting credits

> Banks could freeze their easy credit policies and thus break the PE system, which depends on free access to high leverage

> Investments will have to earn higher returns to serve the credit lines; restructuring becomes more important

Source: FTD

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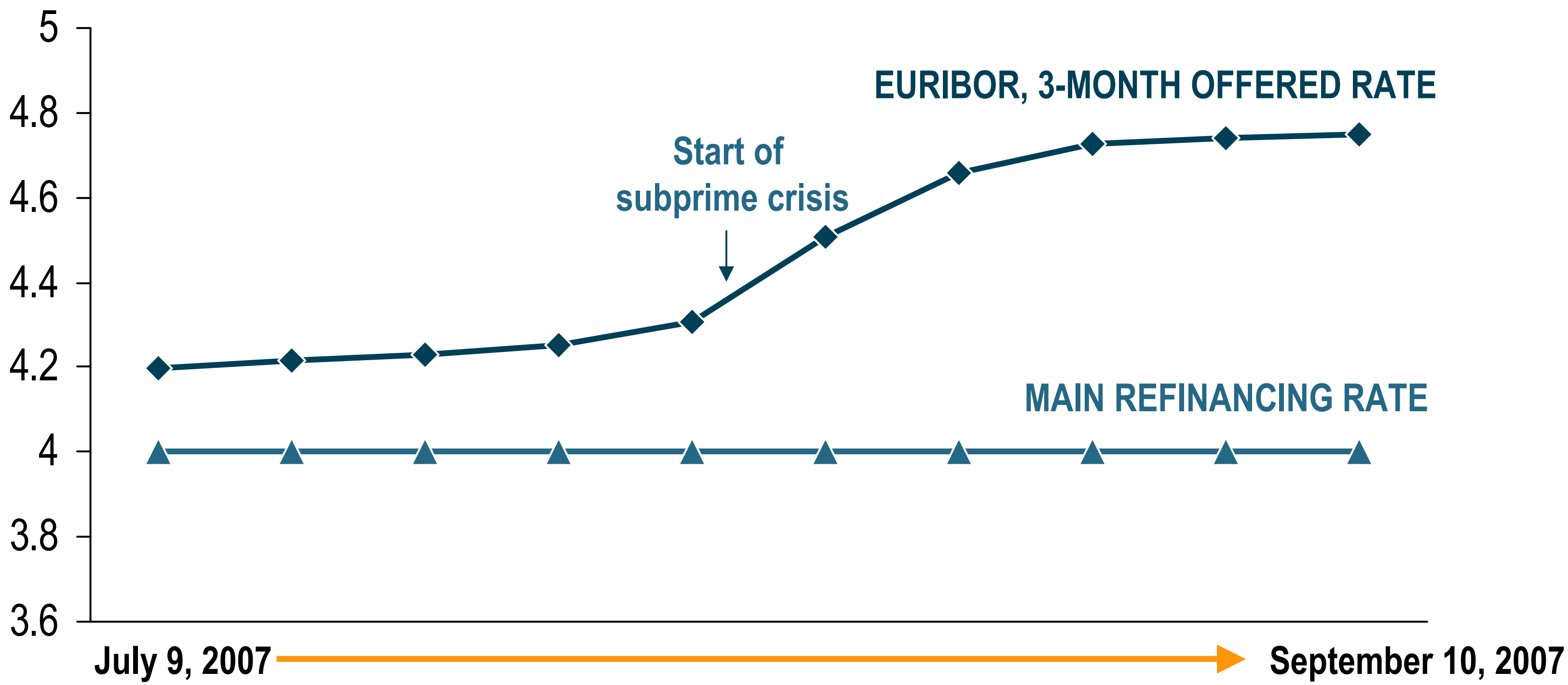
"Money is getting expensive", as the inter-bank interest spread shows

Development of interest spread [discount rate vs. 3-month Euribor]



Source: Thomson Financial Datastream

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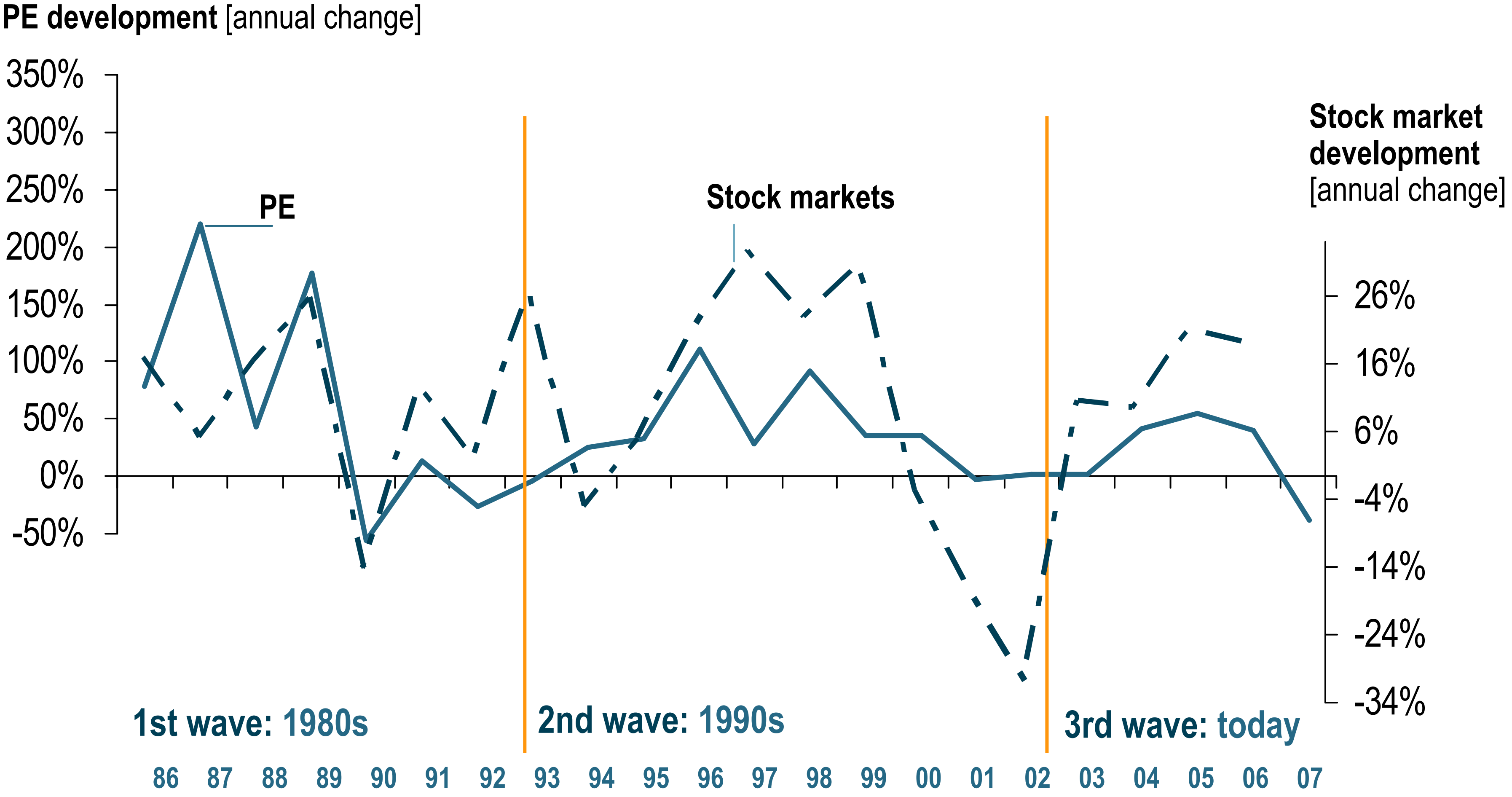
Healthy stock markets provide exit options for PE investments



Source: Roland Berger, Thomson Financial, EIU

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European stock market not likely to boom in 2007 – Only slight growth expected

Forecast data 2007 – Stock market

Stock market development (example: Euro Stoxx)

Trend: ↗ **Influence:** →

REMARKS

> The European stock market is not likely to relax next year, little growth is expected

> Many investments by PE firms are ready to go public – an efficient exit channel would be important, but is not possible in Europe

> Most investments today therefore go to secondary private equity investors to avoid going public

> Restructuring the investment to get a good price on the secondary market is increasingly important

Source: Bloomberg; HSH Nordbank

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Other microeconomic indicators show that the going is getting tougher

Microeconomic indicators for PE investments

> **Increased covenants requirements:** Covenants used to play a minor role, but are now starting to become more important once again for PE firms. Take US investor KKR and First Data: they must not exceed some defined maximum ratio of debt to operating profit

> **Increased risk premium:** The impact of the subprime crisis is starting to hit PE firms. Interest rates were up one-third in July. Original financing plans have led nowhere

> **Difficult refinancing:** USD 330 bn are currently tied up in loans and bonds that were earmarked to refinance takeovers over the past few months. Many deals may fall through

The balance of power has shifted in favor of the providers of capital at the expense of PE firms

Source: Roland Berger

OUTLOOK: The PE environment is becoming more difficult

OUTLOOK

> Highly leveraged companies hitting cyclical conditions have a high risk of defaulting – PE earnings have become volatile. **GDP growth** is expected to **remain stable** in the EU, but cannot offset cyclical trends

> The **US mortgage crisis** and exceptionally high loans are squeezing credit institutions

> **Interest rates** are **rising**. In response, banks are tightening their credit policies

> Shareholders worldwide are alienated by the US mortgage crisis – the **stock market** seems to be a difficult exit channel

Active portfolio management and restructuring will separate successful investments from the rest

Source: Roland Berger

C.

A call for active PE performance improvement!

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Where does the profit come from when the going gets tougher?

ACQUISITION	HOLDING PERIOD	EXIT
1. **Purchase price**	**2.** **Investment performance**	**3.** **Selling price**
Low purchase price (e.g. purchase value/ EBITDA) in relation to fair value; high leverage	Actions designed to ensure and drive profitable growth (cut costs, improve sales, reduce working capital, improve liquidity)	Selection of the right moment and exit channel to realize highest value

Investor has to manage three critical steps in order to meet the high performance requirements

Source: Roland Berger

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The acquisition phase leaves limited room for value creation – The days of "lucky buys" are over

Current SITUATION

- Number of private equity firms and fund volumes have increased as a result of insufficient investment opportunities
- Sellers tend to use experienced investment banks, increasing the level of professional pricing/valuation
- Auctions are used to realize highest offers

IMPLICATIONS for purchase price

- When companies are sold through auctions, prices tend to skyrocket
- Little chance of realizing value especially as the seller's price will take possible restructuring opportunities into account
- Value creation in the acquisition phase is not very probable

Source: Roland Berger

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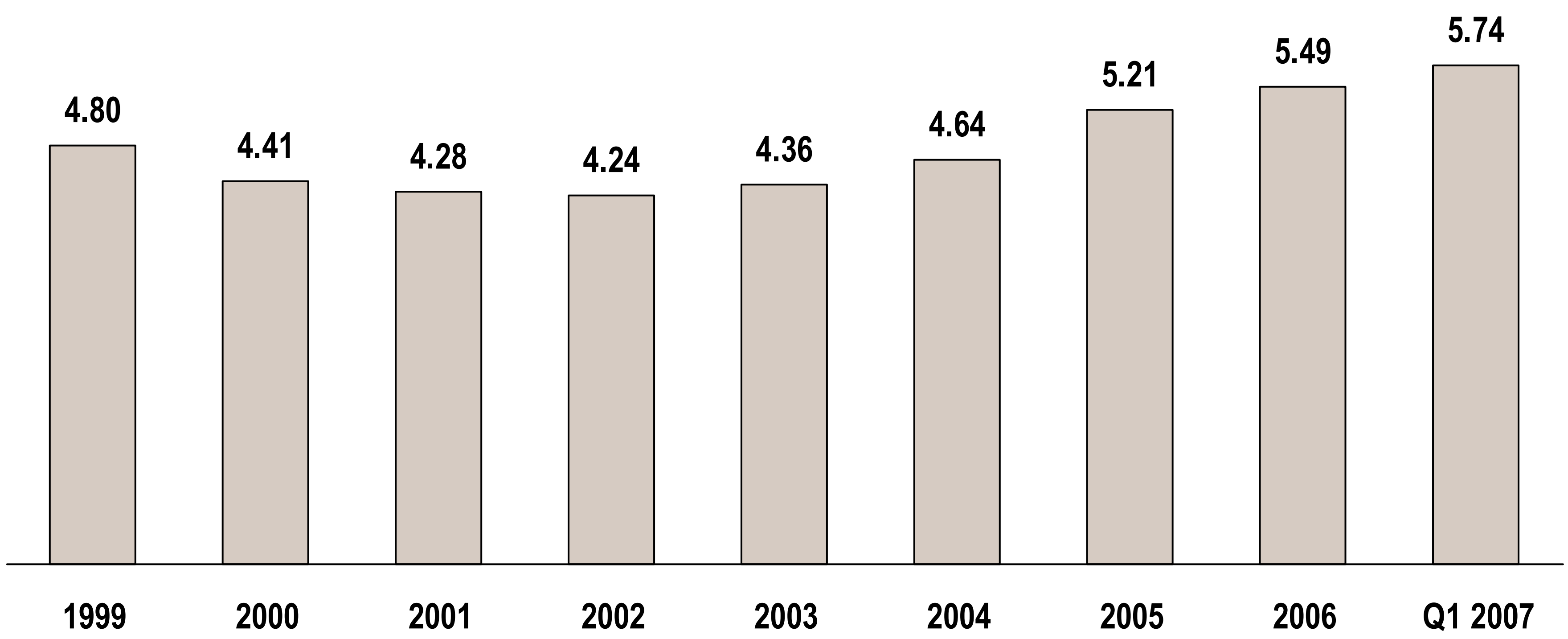
EBITDA multiples are approaching levels last seen in the 1990s

Leverage ratios (total debt/EBITDA, in European LBOs)



Source: EVCA Barometer

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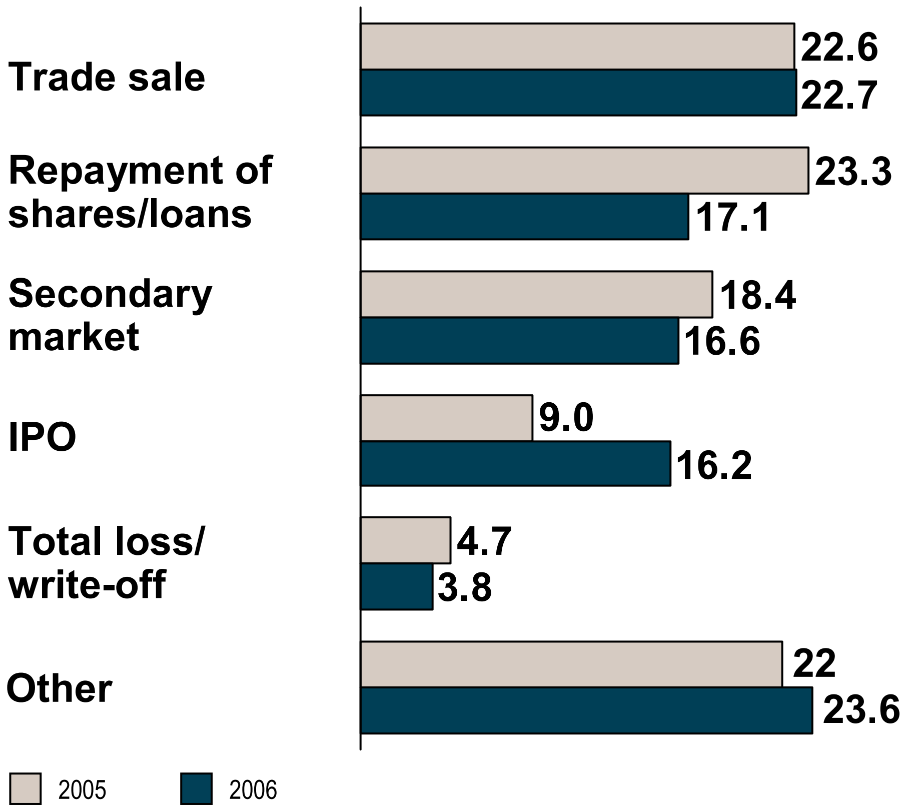
Also, generating value through exits is rather limited with current channel options

EXIT CHANNEL [%]



> **IPOs** are difficult in current market conditions (due to consequences of US mortgage crisis). But they are promising in terms of return

> **Sale to secondary** PE investor is the main exit channel. But this is getting harder as EBITDA multiples are reaching their limits and little room for optimization is left

> **Trade sales** to strategic investors are a very important exit channel but not always possible

Source: EVCA Yearbook 2007

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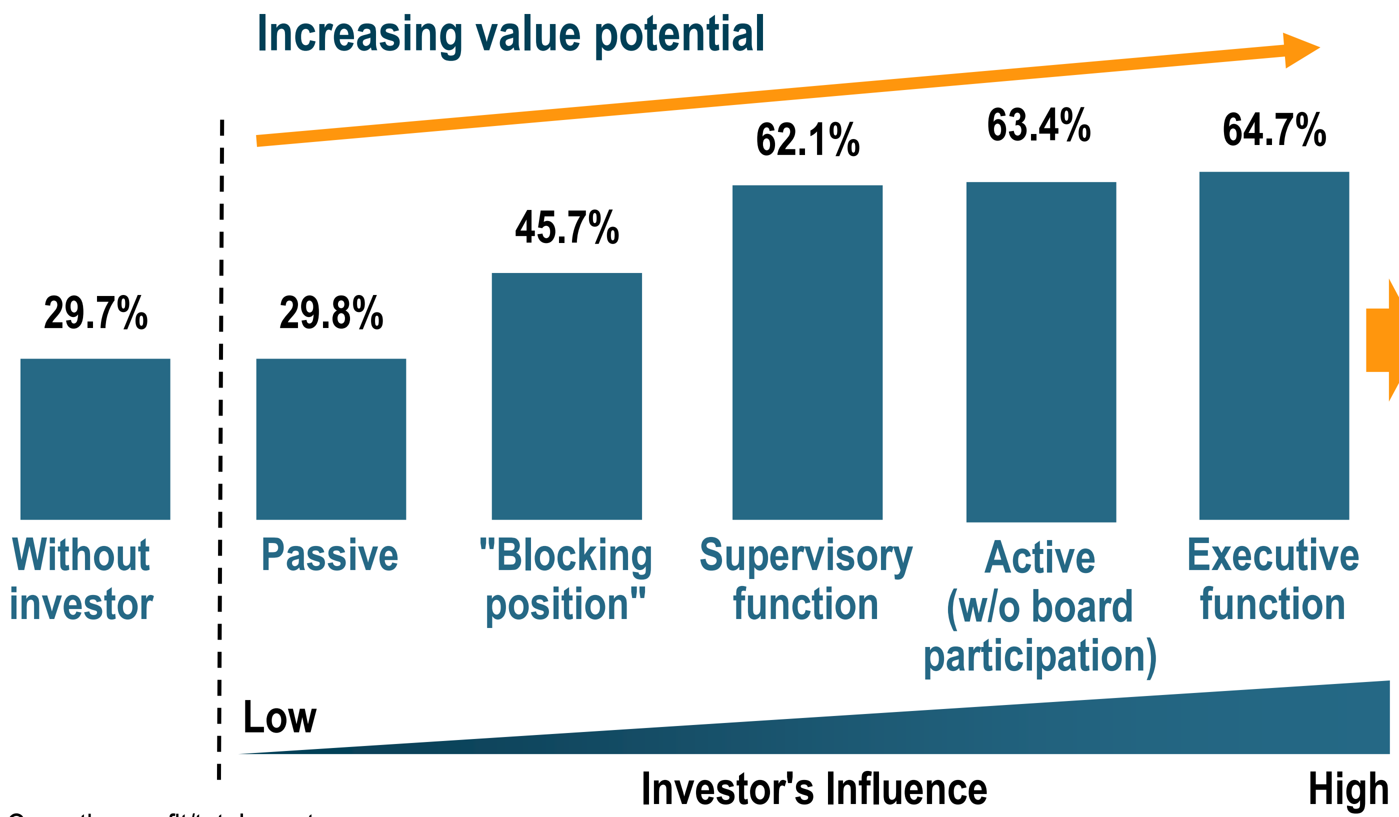
The holding period therefore offers the largest potential for value creation – This requires active PE investors

ROI improvement[1)] in 2 years, US restructuring cases [% points]



Active involvement in restructuring secures higher return for investor

1) Operating profit/total assets

Source: Roland Berger

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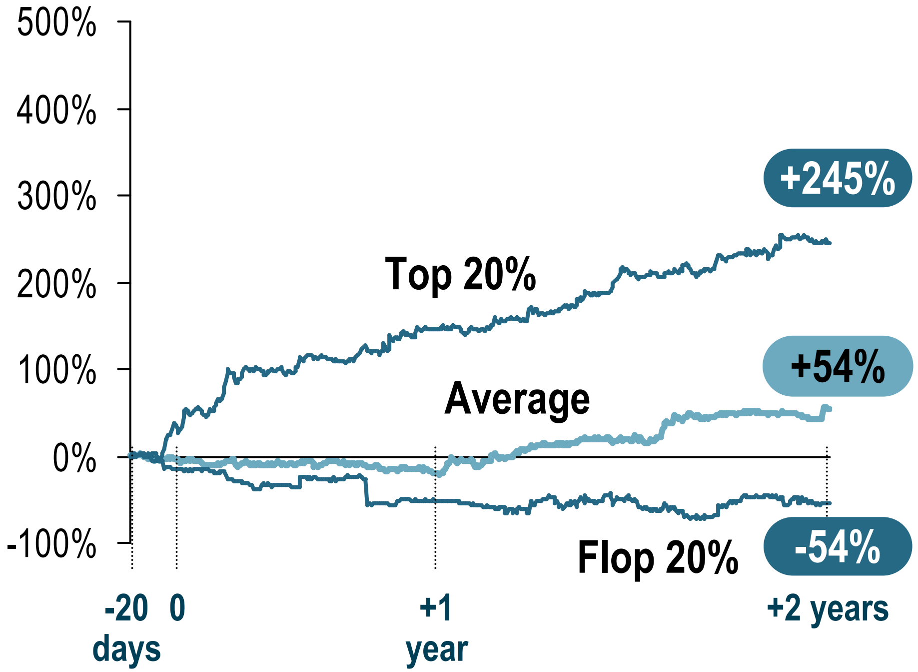
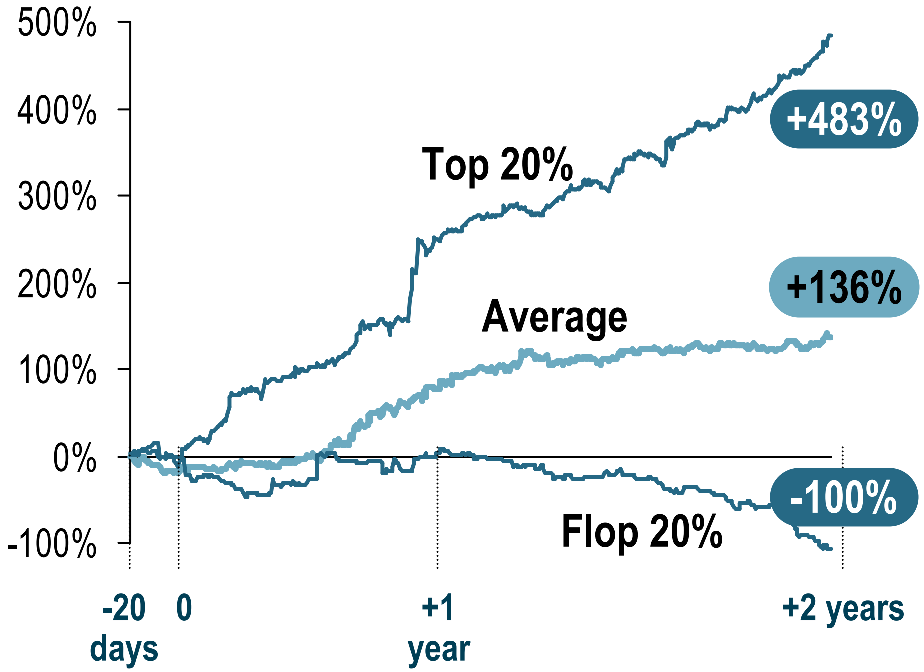
Comprehensive restructuring definitely has a positive impact on value creation

Development of cumulative abnormal return in comparison to CDAX

MINOR DOWNSIZING – FOCUS ON COSTS



SUBSTANTIAL DOWNSIZING – FOCUS ON COSTS AND GROWTH



Source: Thomson Financial, Datastream; Dow Jones & Reuters, Factiva ;Roland Berger

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proDEVELOPMENT

Would you like to know more? Do you know any clients who may want to discuss options for private equity?

Please contact Jörg Horstmann (HAM) if you would like to discuss private equity waves or contribute to our understanding of these issues and its value for business. We appreciate your input!

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