

STRATEGIC RESEARCH

Trends in Private Equity

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Executive Summary

Overview

Private equity activity in 2006 hit post-bubble highs, with substantial increases in both venture capital and leveraged buy-out fundraising and deal flow. The 2 largest VC and 4 largest LBO funds ever all debuted in 2006. Further, nine of the ten largest leveraged buy-out deals in the history of US capital markets were announced in 2006, and 17 of the 20 largest have taken place over the last 18 months. Thomson Financial Strategic Research set out to investigate trends in the private equity marketplace, and the potential implications for public companies. We suggest several key implications for management to consider.

- 1) Private equity owned firms, both LBO and venture capital, differ from public companies on a fundamental level in terms of the signal to employees. That is, these firms operate with a clear deadline in mind - a sale, IPO or other liquidity event. Private equity managers want to buy companies, fix them, grow them and sell them. As compared to the operating strategy of a perpetual "going concern," this may allow managers and employees alike to focus more clearly and immediately on value creation and cost reduction.
- 2) Private equity managers with their own "skin in the game" and active shareholders alike will push for more involved and helpful directors. More candidates outside the traditional top-brand executive profile may become common in the board room as competing interests seek to add differing sets of professional experiences and skill levels.
- 3) The competition for top-level executives will become more relentless as well. A whole new competitive market has emerged for senior management, and this could put pressure on executive compensation to retain talent.
- 4) Although private equity investment may slow from the 2006 levels, dramatically increased supply and substantially increased demand for private equity services will likely serve to buoy investment activity in this sector in coming periods.

- 5) As the Committee on Capital Markets Regulation and legislators alike begin to look at recent legislative attempts at policing public equity markets, it appears probable that some of the more onerous provisions could be eased or changed in the near future. Such actions could work to make public capital markets more competitive again, and serve to suppress private equity activity.

Key Findings

- Venture capital fund raising reached roughly \$25 billion in 2006, versus \$22 billion in 2005. This was the most investment witnessed since 2001. Buy-out funds saw investments of roughly \$200 billion in 2006 compared to \$100 in 2005, the highest total ever recorded for one year.

Chart 7 – Sector Breakdown of VC Investment, 2006

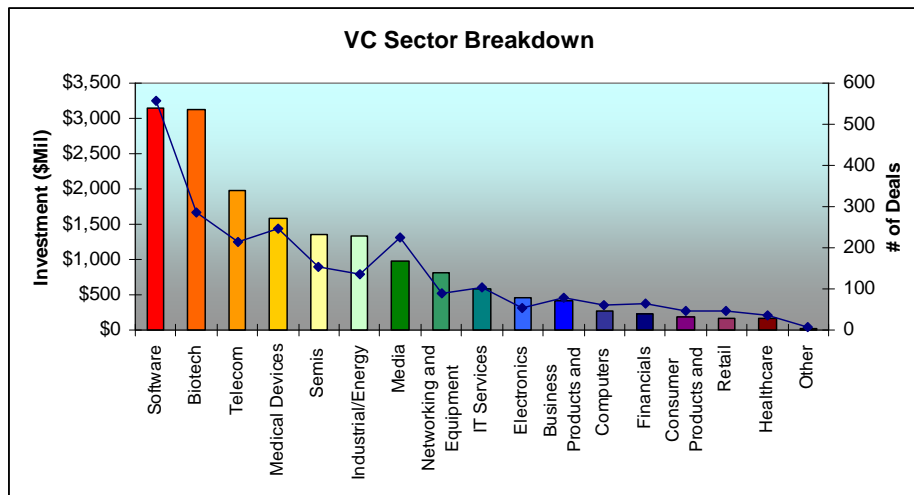


Chart 11 – LBO Sector Breakdown

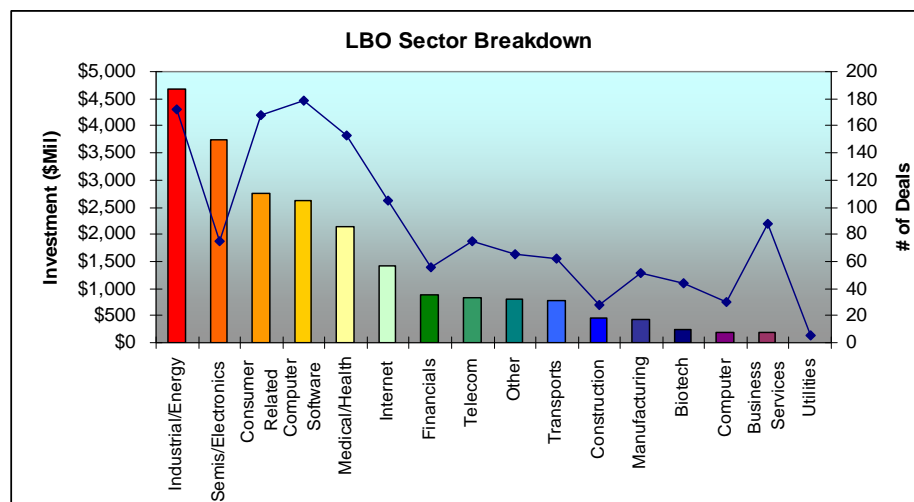


Chart 9 – LBO Investment by Fund Size

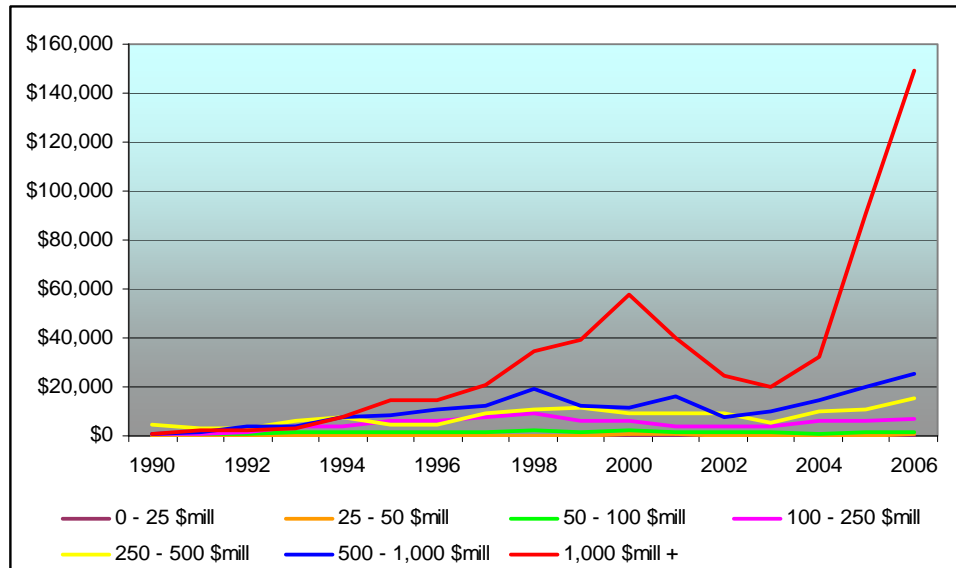
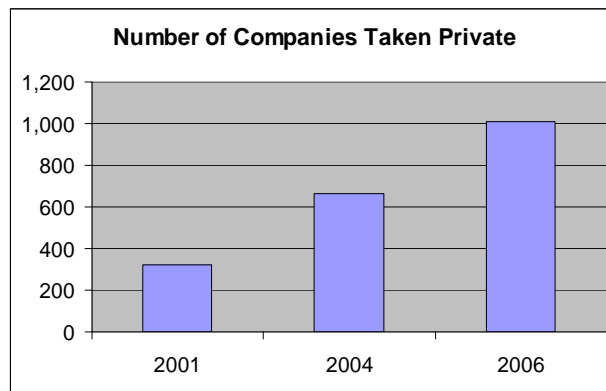


Chart 10 – Number of LBO deals



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Considerations for Investor Relations

Playing the Deal

- 1) **Know your odds** - Monitor key ratios to gauge potential interest from acquirers. Check net cash to market cap and net cash to sales, and compare with peers. Monitor debt ratio, return on capital and efficiency ratio (revenue/employee) relative to your competitors. Acquirers are often looking for underleveraged companies, with significant hard, underutilized assets, a large cash balance and stable cash flows along with potential operational inefficiencies.
- 2) **Keep a poker face** - Prior to a public announcement, investor relations professionals will likely be notified of a potential deal ahead of time by the senior management team. Discussions with Thomson clients indicate that on average, IR was notified of potential agreements several weeks before public acknowledgement of deal negotiations. This is a critical time for IR to formulate the message for the street, and to prepare management for the issues to come (flood of calls, risk arbitrage activity, increased volatility in the stock, etc.). If the buyer is a strategic acquirer, IR and Corporate Communications should lay the foundation for coordination with their counterparties at the acquiring firm.
- 3) **Ante up** - Once the deal is made public, IR and Corp. Communications will switch to crisis management mode, as analysts, investors and employees alike inundate management with requests for information. Trading volume and stock volatility will soar. One point that was consistently stressed by clients was the importance of carefully scripting all news releases and monitoring all media and analyst contact with management so as to follow Reg FD guidelines. Also, clients noted that a strategic merger was a more difficult transaction to handle at this stage than a buy-out, as all releases must be vetted by counsel and management on both sides. At this time, it may be necessary to utilize outside vendors (IR or PR consultants) to help manage the workload.
- 4) **Count the chips** - Deals that require shareholder approval were considered especially tricky, as management may favor a deal but IR disclosures must remain impartial, with no endorsement. Proxy solicitors and surveillance services can help IR and management to understand the shareholder base and gauge the level of support for a deal.
- 5) **Play out the hand** - Continuing our analogy, multiple other players will now have their hands in the proverbial pot, as investors, regulators, investment bankers, legal counsel, etc. will all be involved in the process as the deal unfolds. Unfortunately, many Investor Relations Officers may find that at this point they are facilitating the eventual obsolescence of their own position.

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For more information about this report, please contact Chris.Schelling@Thomson.com.

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