Private equity: implications for financial efficiency and stability

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Private equity has become an important source of finance in recent years for firms wanting to undertake a major restructuring or capital investment. Previously, its increased use was mainly associated with the 'back to basics' policy of many large companies and the consequent sale of non-core subsidiaries. Private equity investment houses have, however, diversified into financing other types of transaction. In doing so, they have achieved some attractive rates of return on amounts invested, which has led to an increase in the funds at their disposal.

This article[1] *describes the current state of the UK private equity market. It also considers the extent to which private equity promotes efficiency by facilitating the 'shake-up' of businesses, and whether the success of investment houses in attracting substantially increased funds for investment poses any threats to financial stability. Private equity comprises equity investment in all types of unquoted companies, whether provided by individuals, funds or institutions.*[2] *The article concentrates on larger transactions (particularly management buy-outs and buy-ins of over £10 million), and excludes start-up and early-stage venture capital finance, which in effect forms a distinct market with different characteristics.*[3]

Recent trends in private equity

Despite many individual differences, private equity investments, particularly the larger ones, have the following features in common:

- A private equity house purchases a major stake in the share capital of a business (often jointly with the managers of the business); sometimes it purchases the entire share capital.
- Injection of equity is usually accompanied by substantial borrowing, so that the business has a highly leveraged capital structure.
- Change of ownership and financial restructuring is frequently accompanied by the installation of a new senior management team, the adoption of a new strategy or a major capital investment.
- The private equity house aims to sell its shareholding typically after two to five years (though sometimes longer), usually by way of a trade sale or listing.

Although private equity investors typically acquire a controlling stake in businesses, they do not see themselves as long-term shareholders. Their role is rather one of providing support through periods of major change—typically lasting up to five years—after which they will sell their stake in the business, aiming to receive a high return for their investment risk during the period of change.

The availability of private equity has grown substantially in recent years. The annual amount invested by members of the British Venture Capital Association (BVCA), which includes virtually all the major private equity houses based in the United Kingdom, almost quadrupled in the six years to 1998, when funds invested were £4.9 billion (see Chart 1).

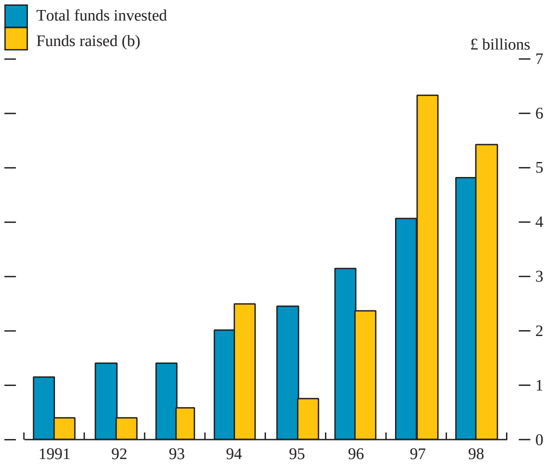
Funds raised by BVCA members have grown more erratically, with a particularly large amount in 1997, when some £6.5 billion was committed for private equity investment opportunities. Funds raised in 1998 were lower, at £5.5 billion, although the total rises to just over £10 billion when funds raised by US investment banks are included.[4] The heightened investor interest in private equity largely reflects the high returns that have been earned in recent years. Investors are not just re-investing the monies from maturing funds, but appear to be allocating a larger part of their portfolios to private equity.

Specialist investment houses are responsible for virtually all investments of private equity. Most are independent venture

(1) Based on discussions with various market participants, to whom the authors are most grateful, and on an earlier Bank of England internal paper by Mark Pratt and Ian Peacock.
(2) According to the British Venture Capital Association's definition.
(3) For a description of this market, see *Finance for small firms—a seventh report*, Bank of England, January 2000.
(4) These US funds are generally for investment internationally, with an indeterminate proportion likely to be invested in the United Kingdom.

capital firms, but some are owned by financial institutions such as banks. They raise finance from a range of investors, the most important being pension funds and insurance companies subscribing to special funds set up for this purpose, although the latter were less important in 1998 (see Chart 2).

Chart 1
Private equity: annual funds raised and invested(a)

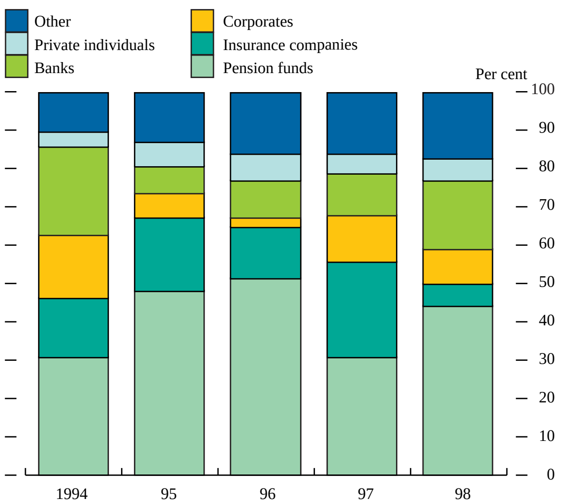


Notes: 1991–93 funds invested exceeded funds raised, as funds raised earlier completed their investment phases.
Both columns include start-up and early-stage venture capital (which generally represent less than 10% of the total).

Source: BVCA.

(a) By BVCA members.
(b) The definition of funds raised has changed over the period.

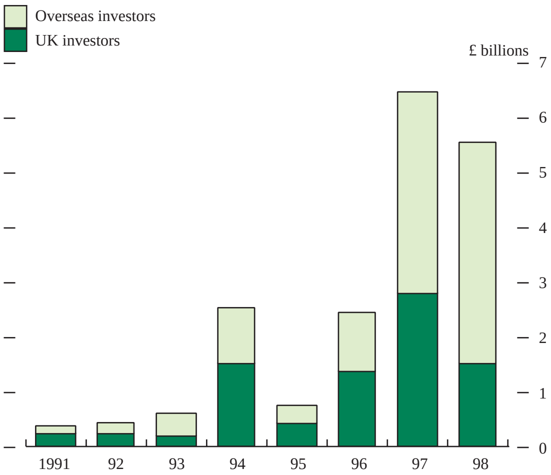
Chart 2
Sources of funding by type of investor



Source: BVCA *Annual Report*, page 27.

Much of the finance subscribed to UK-managed private equity funds now comes from overseas investors. In 1998, funds raised from UK insurance companies and pension funds both fell, so that funds raised from all UK sources represented only about 30% of the total (see Chart 3), and from UK insurance companies and pension funds, only 13%. Some market participants believe that UK institutions are unlikely to regain their position as major funders of UK private equity in the near future.

Chart 3
Private equity: funds raised by source



Source: BVCA *Report on Investment Activity* 1998.

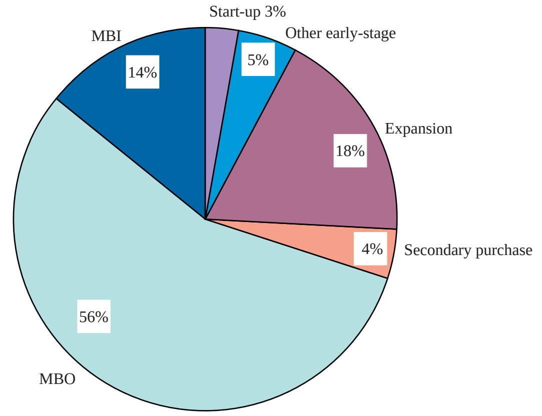
American investors are particularly significant. American private equity business has become much more competitive in recent years; most US transactions are auctioned, and there are many potential private equity investors and trade buyers bidding for each company to be sold. The United Kingdom is regarded by American investors as a gateway to the wider European market, which is thought to offer considerable potential. As well as the institutional investors themselves, this has also attracted a number of American law firms and investment banks, and, most important, several major American private equity houses have set up operations in London. Mainland European investors (for example Dutch pension funds) have also become significant sources of finance for funds managed by UK-based houses, which are increasingly turning their sights to opportunities in continental Europe.

The main types of transaction in which private equity (as defined here) is used are:

- management buy-outs and buy-ins (MBOs and MBIs);
- public to private transactions;
- the internal expansion of established businesses; and
- company turnarounds.

Chart 4 presents a breakdown of UK investment by BVCA members during 1998, showing the importance of MBOs and MBIs compared with other forms of private equity, such as early-stage and expansion finance. Separate data, compiled by the Centre for Management Buyout Research (CMBOR), BZW Private Equity and Deloitte & Touche Corporate Finance, show that public to private transactions represented 18.8% of MBOs and MBIs by value in 1998 and that this percentage has fluctuated widely over the last ten years.

Chart 4
UK private equity investment by financing stage



Source: BVCA *Report on Investment Activity* 1998, page 11.

The private equity market

Private equity in the United Kingdom grew from venture and development capital, providing start-up and expansion finance for established businesses finding it difficult to go public, or not wishing to do so. During the mid to late 1980s, there was a rapid expansion of MBOs and MBIs, some of which were public to private transactions, but the volume of these deals fell sharply following the failure of some very large transactions, including Magnet and Isosceles. During the early 1990s, smaller MBOs and development capital formed the bulk of the business. There has been further change recently, with the reappearance of both larger MBOs and public to private deals. Development capital, which traditionally provided finance for manufacturing industry, has also increasingly been directed towards services, including technology. A recent innovation is the so-called 'buy and build' transaction, whereby a private equity house will buy different firms in the same sector with a view to merging them and achieving the benefits of synergy as a result.

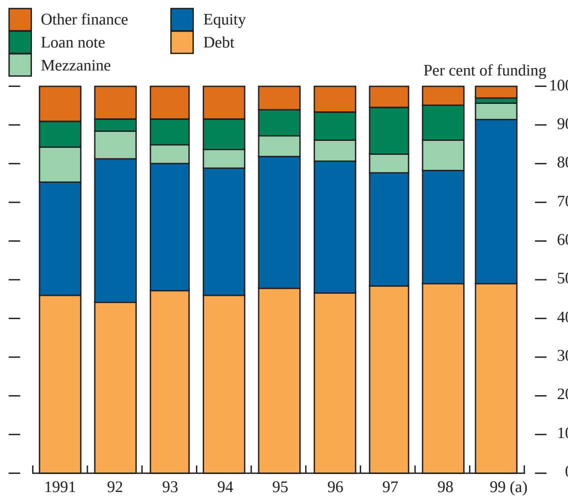
Private equity houses tend to specialise in types of transaction where they have particular expertise, or in sectors of the economy that they know well. Houses also differ in the size of transactions that they undertake and in the degree to which they become involved in the strategy and management of the businesses in which they invest. A common characteristic of private equity houses, however, is that they monitor closely the performance of the businesses in which they have a stake and will almost always be represented on the board.

Private equity houses work closely with banks and mezzanine houses,[1] as equity is usually just part of a wider package of finance. Indeed, most of the larger private equity transactions involve more debt than equity, since, as is explained below, leveraging is deliberately used to boost the returns on equity. In turn, the debt can be sub-divided into senior and mezzanine layers.[2] Mezzanine debt lies between senior debt and equity in terms of priority for repayment. Lenders accordingly look for a return of some 15%–20% a year or more, which includes the benefit of equity warrants. Since it is a less expensive alternative to equity, which seeks returns of at least 25%–30% (see below), the use of mezzanine finance allows financing structures to be more highly leveraged, with a corresponding increase in risk. In the United Kingdom, mezzanine finance for all but the largest transactions is usually provided by specialist funds and banks.

Larger transactions are increasingly being financed partly through European high-yield bond issues.[3] Amounts issued in this market during the first ten months of 1999 totalled around $14 billion, according to Morgan Stanley Dean Witter, with some major recent transactions, including Kappa and Hillsdown, incorporating substantial high-yield debt tranches. There are signs that high-yield debt has become a regular aspect of European private equity financings, though there remain aspects of this market (for example, security, subordination and documentation) which have yet to be standardised.

Chart 5 shows the average proportions of capital represented by debt, equity, and other forms of finance for MBOs/MBIs undertaken in the United Kingdom, and how this has changed over the course of the 1990s. Higher corporate valuations, associated with rising stock markets, and a greater willingness by banks to provide senior debt and by shareholders who are selling to accept subordinated loan notes in part payment, all led to an increase in the leverage of the average UK MBO/MBI during 1997 and the first half

Chart 5
UK MBOs/MBIs average deal structure



Sources: CMBOR, BZW Private Equity and Deloitte & Touche Corporate Finance.

(a) To autumn 1999.

(1) There are a number of specialist mezzanine debt providers and banks that provide mezzanine debt either independently or in association with senior debt. Mezzanine debt is usually in the form of subordinated loans, preferred stock or a combination of the two.
(2) See Pratt, M J and Crowe, A E (1995), 'Mezzanine finance', *Bank of England Quarterly Bulletin*, Vol 35(4), pages 370–74.
(3) High-yield debt, like mezzanine debt, lies between senior debt and equity in terms of repayment priority.

of 1998. The proportion of the average MBO/MBI financed by equity fell from 42% to 27% between the second half of 1996 and the first half of 1998. This trend was reversed during the second half of 1998 and early 1999, as banks became more cautious about lending for highly leveraged transactions and the high-yield debt market became inactive. Though the movement towards lower equity resumed during 1999, there does appear to be a resistance level at around 25%–30%.

The investment funds established by private equity houses are usually closed-ended,(1) with a planned life-span of ten to twelve years. The fund will be invested in the first four to five years (or sometimes longer), and the investments gradually liquidated thereafter, with the proceeds returned to investors. The nature of the investments means that most funds do not pay an annual dividend but instead make a distribution whenever an investee company is sold or refinanced. Most private equity houses aim for an internal rate of return of 25%–30% a year to investors. Many have, however, been able to achieve annual returns of more than 30% in the past five years.

Private equity houses are remunerated in various ways for managing investment funds. They receive an annual fee, which may be, say, 0.5% on funds committed but not yet invested and, say, 1.5%–2% on amounts invested. In addition, they receive a payment linked to realised profits. This is called ‘carried interest’ and is usually 20% of any profit (sometimes in excess of a floor). It is designed to align the interests of fund managers and investors, and is paid to the management companies for distribution to themselves and to the individual managers within these companies.

The returns on private equity and financial efficiency

The development of an active private equity market has facilitated the restructuring of businesses. It has been of particular benefit to private and smaller listed companies which, with the increasing dominance of institutional investors and their focus on larger listed companies, have found listing to be less attractive than before. The high returns that investments have earned in recent years have been partly due to economic buoyancy and rising share prices, but they have also probably reflected improvements in the efficiency of businesses in which investments have been made. This section considers the different ways in which private equity investment houses have been able to achieve these improvements.

Leverage itself, in a perfect market and in the absence of taxation, does not increase the value of enterprises. Yet investors who are regular users of leverage have constantly produced very high returns on their investments(2) (see the box opposite). How is this apparent contradiction resolved?

The comparatively high returns on private equity can be attributed to:

- the direct effects of leverage;
- identification of businesses that are undervalued;
- improvement to operational efficiency; and
- rising equity markets.

The direct effects of leverage

Because interest costs are a tax-deductible expense, whereas dividends only carry a partial tax credit to investors (withdrawn in the United Kingdom since 1997) and retained earnings do not reduce tax at all, leveraged companies can build up more value than non-leveraged ones. Some private equity transactions place considerable importance on tax shields, although it is rare to find a transaction that is proposed on the basis of tax savings alone.

Another factor that could be relevant is that the interest rate on the debt sometimes does not fully reflect the risk taken in leveraged transactions. For example, the losses sustained on US high-yield debt in the early 1990s suggest that the return on this type of debt did not compensate for the risk. To the extent that this is correct, the return on equity may have been greater than was justified by the risk.

Though the direct effects of leverage, arising from tax effects and market imperfections, should not be ignored, the effect that leverage has on corporate behaviour through the incentive effects on management (see below) has probably made a much more important contribution to the equity returns earned.

Identification of businesses that are undervalued

Private equity investors have become adept at identifying undervalued businesses, especially those with a reliable cash flow. One such class of business comprises subsidiaries of diversified companies which, perhaps because they were not central to their parent’s strategy, have been starved of capital and/or good management. Options available to the group management include a trade sale or a flotation on the listed market, but the sale to the subsidiary’s current management has for some years been a viable alternative. Between 1989 and 1999, 44% of UK MBO/MBIs of more than £10 million involved subsidiaries and divisions of UK parent companies.(3)

A second category of neglected businesses is smaller listed companies which their management and/or shareholders feel

(1) With fixed capital, rather than variable like unit trusts or open-ended investment companies.
(2) There is a voluminous literature on this subject, but see, for example, Brealey, R A and Myers, S C (1996), *Principles of Corporate Finance*, Chapter 17.
(3) Between 1 January 1989 and 30 June 1999 inclusive. Source: KPMG Corporate Finance, September 1999.

How leveraging ratchets up the returns on equity

A simple example illustrates the basic driver of a private equity transaction, which is the ability to transform a stable non-growing cash flow into a high equity return over a limited period through the judicious use of leverage (albeit with an increase in equity risk).

The base case is a company with stable earnings before interest and tax (EBIT) of 100 and, initially, no debt. This company is not highly rated in stock market terms, so is available for sale at a multiple of 7 times EBIT, ie 700. If the company is financed entirely by equity, the return on that equity is 14.3% (= 100/700).

Year	1	2	3	4	5	6	7	8
EBIT	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Senior debt interest	50.0	45.0	39.5	33.5	26.8	19.5	11.4	2.6
Starting senior debt	500.0	450.0	395.0	334.5	268.0	194.7	114.2	25.6
Ending senior debt	450.0	395.0	334.5	268.0	194.7	114.2	25.6	-71.8
Ending equity value	250.0	305.0	365.5	432.1	505.3	585.8	674.4	771.8
IRR	25.0	23.5	22.3	21.2	20.4	19.6	19.0	18.4

A private equity fund decides to buy the company for 700, financed as follows: 500 in senior debt and 200 in equity (similar to the average leveraging in the MBO/MBI market). The senior debt pays interest at 10% per annum. The table shows the development of the company with this capital structure. In year 1, half of earnings (50) go to the payment of senior debt interest (ie interest cover is 2 times). This leaves 50 to repay senior debt (ignoring tax). Gradually over the years, the senior debt balance falls until, at the end of year 8, all senior debt is repaid and there is a deposit balance of 71.8. The sale price is assumed to be exactly the same as the purchase price, ie 700; no improvements have been made in the operations of the company so no change in price is merited.

The bottom line shows the internal rate of return (IRR) to shareholders when they come to sell their holdings. The effect of leverage in isolation, ie without any improvement in profitability or in the price/earnings ratio, produces an equity IRR of between 18% per annum and 25% per annum, depending on the period over which the investment is held. This compares with the non-leveraged return of 14.3%. However, risk has also risen as a result of leverage in the company. For a four-year investment, which is a typical holding period for this type of investment, the equity IRR is 21.2%.

are undervalued by the market. There has been widespread comment that many smaller companies do not obtain much benefit from listing: there is not much trading in their shares owing to patchy research and institutional indifference, and they face difficulty and expense in raising new capital. The trend towards more passive fund management through tracker funds may have also accentuated the lack of investor interest in smaller quoted companies.(1) These trends have prompted a number of companies to de-list since 1997. During the first nine months of 1999, there were 39 de-listings, totalling £3.7 billion,(2) compared with 27 de-listings totalling £2.7 billion during the whole of 1998 and an average of less than 5 per year between 1990 and 1997.

Senior management have been the driving force behind many de-listings (although private equity houses have also initiated some). They see purchase by a private equity fund as a foundation for their company's development, which might also allow them to retain their jobs and acquire a stake in their company. Private equity ownership is not, however, an enduring alternative to listing. Private equity houses are concerned primarily with a business's performance over the following two to five years and how they can generate additional shareholder value by way of leveraging and operational efficiencies. Investors in the public market do not look at performance over such a specific period.

Improvements to operational efficiency

Improvements to operational efficiency can take a number of forms. Private equity houses work closely with the senior management of the businesses they are supporting and rely on them to deliver efficiency improvements. If they do not have confidence in existing management, they will install replacements and will ensure that there are appropriate incentives by way of an equity stake, share options or a profit-related bonus.

Management will focus on both cost reduction and revenue enhancement. The first is perhaps easier to achieve in the short run, for example by cutting back on working capital, eliminating non-operational assets, such as prestige offices, or reducing head office staff. Indeed, leveraging is itself a strong incentive to cost-cutting exercises, which make an immediate, albeit one-off, contribution to cash flow and may allow an early reduction in borrowing. There is a danger, however, that cost-cutting taken to excess may damage the long-term survival of a business.

There are many possible routes to higher revenues—for example, more aggressive pricing, more effective marketing and re-designed products—but they usually involve a commitment of cash, which is a scarce resource in a leveraged company. Sustained improvements in revenue growth are more difficult to achieve and ultimately must stem from fundamental improvements in the way a

(1) The magnitude of this effect is, however, debatable.
(2) Sources: CMBOR, BZW Private Equity and Deloitte & Touche Corporate Finance.

The risks from leveraging

The previous box showed how leverage can increase the returns to shareholders, even if earnings remain static. However, leverage also magnifies their losses should earnings fall. This is illustrated by a simple example.

Case A shows the effect on the previous example of a breakeven year in year 2 and EBIT of 50 in year 3, with earnings recovering to a stable 100 thereafter. As a result, it is assumed that the sales multiple declines from 7 times to 5 times continuing earnings. Both of these assumptions are arbitrary. The decline in earnings is very steep although, as EBIT is the difference between income and expenditure, a comparatively small change in either or both of these measures can have a disproportionately large effect on EBIT. The change in the sales multiple reflects the lower long-term earnings expectations that would probably follow a two-year recession.

Case A

Year	1	2	3	4	5	6	7	8
EBIT	100.0	0.0	50.0	100.0	100.0	100.0	100.0	100.0
Senior debt interest	50.0	45.0	49.5	49.5	44.4	38.8	32.7	26.0
Starting senior debt	500.0	450.0	495.0	494.5	444.0	388.3	327.2	259.9
Ending senior debt	450.0	495.0	494.5	444.0	388.3	327.2	259.9	185.9
Ending equity value	250.0	5.0	5.5	56.1	111.7	172.8	240.1	314.1
IRR	25.0	-84.2	-69.8	-27.2	-11.0	-2.4	2.6	5.8

The first year is exactly as before (the sale price has been kept at 700 for this one year to reflect the fact that everything appears to be going normally). However, the effect on a leveraged company of the elimination of EBIT in the second year is dramatic. In Case A, senior debt goes back to near its original facility amount of 500. The company almost certainly breaches its covenants and there would probably be a payment default, which would entitle lenders to seek repayment. Although the downturn in earnings is short (albeit steep), the equity value is almost completely wiped out by the reduction in the earnings multiple. The IRR is negative until year 7, despite the resumption of EBIT at 50 in year 3 and 100 thereafter. In practice, the company would be reliant on its bankers for several years and, even if supported, would take a very long time to reach a satisfactory IRR.

Case B shows a company that is leveraged at only 20%, which is about average for the UK corporate sector. The impact of leverage in this case is much less during years 2 and 3 than the more highly leveraged company in Case A and, although the equity loses some value, there is little threat to the company's continued existence. After year 4, by which time the IRR is positive again, deposits begin to build up quickly and equity returns are very dependent on the deposit rate.

Case B

Year	1	2	3	4
EBIT	100.0	0.0	50.0	100.0
Senior debt interest	14.0	5.4	5.9	1.5
Starting senior debt	140.0	54.0	59.4	15.3
Ending senior debt/deposits	54.0	59.4	15.3	83.1
Ending equity value	646.0	440.6	484.7	583.1
IRR	15.4	-11.3	-4.7	1.0

In summary, an unexpected decline in earnings, particularly during the early years of a leveraged transaction, has a very large effect on equity returns.

business is managed. Some private equity houses have become more proactive in identifying firms to buy, initiating merger and acquisition proposals, and involving themselves in day-to-day management of the companies. In order to carry out these functions properly, the investors themselves have had to acquire specialist management and industry expertise, even though this increases their own cost base.

Private equity promotes efficiency in three ways. By judicious use of leverage, it encourages a capital structure which maximises post-tax return for a given risk appetite. Second, by identifying inefficiencies in the pricing of businesses, it helps to produce a more efficient allocation of resources. Third, private equity, combined with leverage, encourages operational efficiency, particularly cash-flow efficiency.

It is, however, becoming more difficult to generate returns in the first two ways. Perceptions of maximum prudent degrees of leverage among private equity houses and investors in listed companies appear to be converging. In addition, vendors now guard against unduly low selling prices by the use of auctions and by retaining a residual stake in businesses that are sold off. Consequently, the likelihood is that private equity houses will increasingly have to look to operational efficiencies for their returns. They are becoming less financial engineers and more hands-on shareholders, and are developing the relevant skills to do this. To this end, many houses are starting to employ more people with specialist management experience and technical knowledge. They are also seeking to secure economies by combining businesses in the same sector. The distinction between private equity houses and non-financial firms which seek to create value by takeover of under-performing firms is becoming more blurred.

Risks associated with the private equity market

The risks of private equity to investors have, in the past, been given more prominence than the efficiency benefits, partly because of certain highly publicised MBO failures in the late 1980s.(1) Although there is now greater expertise in the market, so that some of the past mistakes are less likely to be repeated, there remain considerable risks in this type of financing.

The risks from leverage

Private equity, like all investment, is based on projections for costs and revenues, which, no matter how well researched, are subject to uncertainty. Leverage, however, makes a business susceptible to comparatively small divergences between actual and projected revenues and costs. The box opposite shows how, with a highly leveraged financial structure, a short-lived, albeit steep, decline in earnings can eliminate the returns to shareholders. Leveraged structures are most exposed during the early years of a transaction, before there has been a chance to repay borrowing.

The multi-layered financial structure of many private equity transactions means that when difficulties do occur they may be difficult to correct, because the holders of different types of debt and equity may have conflicting interests. Discussions on restructuring the finances of a business will typically include senior bank lenders, as well as any mezzanine lenders, and it is inevitably harder to obtain a consensus on one way forward, the more interests that are involved.

Transactions where loans have been widely syndicated, or where mezzanine finance has taken the form of a high-yield bond (which is becoming more frequent), are therefore likely to be especially difficult to restructure.

The overhang of uninvested funds

In 1998, approximately £5.5 billion of new equity was raised by members of the BVCA for private equity investment in the United Kingdom and continental Europe. A further £4.7 billion was raised by US houses which are members of the BVCA. If, say, £7 billion(2) is invested in the United Kingdom with an average debt to equity ratio of 3:1, this would imply that there is an additional £28 billion of leveraged transactions in prospect. Competition to invest this overhang of funds is leading many UK and US-based private equity houses to look for investment opportunities increasingly in mainland Europe, where prospective returns are thought to be higher. Equity houses are also becoming more active in identifying possible investment opportunities themselves, rather than waiting for deals to be offered to them. More fundamentally, the pressure to invest may be tempting investment houses to relax their investment criteria—ie to write deals which promise a lower return and/or entail more risk than they had previously been willing to accept.

Whether houses succumb to this pressure depends largely on the incentives that they face. There is short-run financial motivation for funds to be invested, insofar as houses receive a higher fee on invested funds than on committed funds. But investment houses are concerned about the threat to their reputation if the deals they write subsequently fail to live up to expectations (and of course the carried interest accruing to fund management companies, and to the individual managers within them, is an important motivator).

Early in 1998, it did appear that the UK private equity market was showing signs of overheating. Some transactions were completed at prices of around 13 times cash flow,(3) and some senior banks were prepared to lend up to 8 times cash flow. Such leverage ratios had not been seen since the late 1980s. Furthermore, some lenders who had little or no experience of the leveraged market began to be active in it. The subsequent worldwide financial turbulence resulted in banks being more cautious about lending for leveraged transactions. It also brought about the temporary closure of the fledgling European high-yield market. These developments caused difficulty for the financing of a few transactions, but they seemed to prevent any serious ‘bubble’ developing. The more stable economic conditions prevailing in 1999 were associated with a strong recovery in volumes of private equity transactions and a revival of European high-yield debt issues. There is little evidence of new, inexperienced lending and investing institutions contributing to overheating at present. However, the volume of money and the competition for new transactions is such that even some experienced houses appear tempted to take more risks. Recent transactions suggest that some banks are again taking very large debt and equity positions in highly priced acquisitions. There is also concern that shortages of skilled personnel are leading to a decline in professional standards in some organisations.

This trend is unlikely to result in a threat to overall financial stability, assuming that the overhang of funds remains at or around the level of £25 billion–£30 billion, as indicated above. While this could represent a very large increase in the size of the United Kingdom’s domestic merger and acquisition business (which totalled £29.5 billion in 1998),(4) it is equivalent to around 1% of outstanding UK bank lending at end-December 1998, so total financing of UK private equity deals remains a relatively small proportion of UK banks’ total business.

On occasion, however, there may be a risk of distortions in particular parts of the market, reflecting sudden swings in investors’ sectoral preferences (eg the retail sector in the United Kingdom ten years ago and, from time to time, the media sector in the United States).

(1) See Jackson-Cookland, C, Crowe, A E and Pratt, M J (1998), ‘Highly leveraged transactions: management buy-outs’, *Bank of England Financial Stability Review*, Issue 4, pages 57–64.
(2) The precise amount cannot be calculated from published data.
(3) Cash flow as measured by EBITDA, ie earnings before interest, tax, depreciation and amortisation, and therefore ignoring working capital changes.
(4) The figure refers to total acquisitions and mergers in the United Kingdom by UK companies. Source: Office for National Statistics, *Financial Statistics*, December 1999.

Conclusions

The growth in private equity investment in recent years has been strongly associated with the policy of many large companies to sell non-core subsidiary businesses. This has created a financing need that has partly been met by private equity. It has, in particular, helped businesses that have been neglected by their owners (or by the listed market) to raise capital for expansion. Private equity investors have, in effect, assumed the risks of supporting businesses through a period of major change. They are not long-term shareholders, however, and, for this reason, the private equity market is not an enduring alternative to a listing for the companies in question.(1)

The private equity market is international. UK-based investment houses obtain much of their funding from overseas, especially from the United States. A number of American investment houses have also set up offices in London, as Europe is seen to offer attractive investment opportunities. The UK investment funds themselves are increasingly investing in continental Europe and to some extent in the United States.

There would seem to be no shortage of investment opportunities for private equity funds. Most large companies continue to maintain a 'back to basics' policy, which entails the disposal of non-core businesses. More fundamentally, technological and economic change creates continuing pressure for the restructuring of both companies and industries. The closer integration of the European market is, in particular, likely to give rise to considerable opportunities for restructuring and hence for private equity investment. The concerns that many smaller companies have expressed about the benefits of a listing have also opened up a new area for private equity investment. In short, the opportunities for private equity investment are unlikely to dry up in the foreseeable future.

Returns of more than 30% a year have attracted substantially increased inflows to private equity funds. These funds have intensified competition among investment houses, which may depress prospective returns. At the same time, the near-universal use of auctions to sell businesses has narrowed the scope for private equity investors to buy into businesses at clearly advantageous prices. These developments are putting pressure on the returns to be expected from private equity investments. They also mean that returns will, to an increasing extent, depend on investors bringing about efficiency improvements in the businesses in which they invest.

The pressure to maintain rates of return is changing the way that private equity houses operate. Many are becoming more pro-active in identifying investment opportunities, and have begun, for example, to look to mainland Europe. Some houses are becoming more involved in the operations of the businesses in which they invest. They are also becoming more ambitious in the scope of their transactions, looking to engineer mergers of companies to achieve cost savings. This will require them to acquire new skills—for example, in technical knowledge and hands-on industrial management.

Private equity is a relatively risky form of investment insofar as it typically relies on leverage for high returns. The current large overhang of uninvested funds has encouraged private equity houses to assume further risk in an effort to maintain their earlier, enviable track record. There were signs early in 1998, for example, that the prices paid for businesses by equity houses were on an upward trend and that structures were becoming more highly leveraged. However, the increased caution of banks in lending following the global financial turmoil of 1998 caused a cooling off, and a temporary closure in the nascent European high-yield debt market. The less turbulent conditions in 1999 encouraged a revival of high-yield debt, which is beginning to show signs of becoming an established form of finance. Some ambitious and complex financings have been seen recently and the pace of the market has increased, though some comfort might be taken from the fact that most of the lenders and investors are experienced professionals, not newcomers to the market.

The development of the private equity market and the levels of gearing that have accompanied it could, in principle, weaken the financial position of lenders. At present, the market is not large enough for this to appear to be a significant threat.

(1) Unless the secondary market sale of private companies to other private equity houses becomes much more common.